Stabilization and Liberalization: a closer look at the Sri Lankan experience 1977-93

David Dunham

and

Saman Kelegama

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1. Introduction

Three years before the World Bank introduced its first structural adjustment loan in 1980, Sri Lanka had embarked on a process of economic liberalization. The subsequent experience has been documented to the end of the 1980s. (Jayawardena *et al.* 1987; Herring 1987; Lal & Rajapatirana 1989; Moore 1990; Cuthbertson & Athukorala 1991; Athukorala & Jayasuriya 1991; Kelegama 1992; White & Kelegama 1993; Athukorala & Rajapatirana 1993). The events described illustrate how difficult it is to manage the transition from a closed to an open economy. However, tensions between the differing needs of stabilization and adjustment have received little explicit attention in the literature. Why Sri Lankan liberalization faltered during this period has still not been adequately answered. This paper attempts to provide an answer to this crucial question.

Sri Lanka is small (its population in 1977 was below 14 million). Exports in the late 1970s were predominantly the tree crops (tea, rubber and coconuts) that had flourished since the colonial era. The domestic private sector was dominated by merchant capital. High literacy rates and a long history of universal franchise (granted in 1931) created strong political awareness. The country had an entrenched welfare tradition, a commitment to large social expenditures (including a universal food subsidy), a strong element of political patronage and an astute awareness of ethnicity (Lal & Rajapatirana 1989; Moore 1990; Jayantha 1992). Prior to liberalization, it pursued a closed, import-substitution strategy. The state sector dominated the economy (foreign-owned plantations were nationalized in 1975), and it was bloated by the welfare-constituency-state employment nexus of political patronage. The entire import bill was subject to quotas and licensing. The economy was stagnant, and in the mid-1970s the country had faced unsustainable fiscal deficits, a balance of payments crisis and widespread

hardship. In 1977, the newly elected government of the United National Party (UNP) introduced a liberalization package that was by then inevitable (Herring 1987).

One prominent contention in the Sri Lankan liberalization debate is that the country failed to achieve the gains that had been predicted from the new package of policies because the liberalization that took place was not sufficiently far-reaching (Lal & Rajapatirana 1989). The initial measures were bold, but left an "unfinished agenda" (*ibid.*: 29), and the reason -- in this view -- was solely attributable to macroeconomic mismanagement. We argue that this explanation is incomplete. Initial conditions, economic circumstances and the nature of the political system all played a part in shaping the path that Sri Lanka followed. But our main argument is that, in the course of the liberalization exercise, there was tension between the stabilization and structural adjustment programmes themselves, and that this uneasy relationship contributed heavily to the half-hearted implementation of liberalization policies. A crucial explanatory factor is seen to lie in the politics of adjustment, in the need for the government to respond promptly to domestic social pressure and in the way in which this was accommodated in bargaining with the IMF and World Bank regarding the programmes adopted.

The presentation is in four sections. Section 2 focuses on theory and sets out issues that structure discussion of the Sri Lankan case. Section 3 provides an overview of the country's liberalization experience, extending it to 1993, and of problems in stabilizing and then generating growth in the economy. Section 4 examines problems in the transition to a liberalized economy and to sustained economic growth. A final section summarizes main points that emerge from the Sri Lankan experience.

2. Economic Liberalization: some theoretical aspects

Stabilization and liberalization/adjustment policies dominate discussion of economic policy in developing countries. In brief, economic liberalization means the process of transition from an inward-looking, protected and highly regulated economic regime towards an open economy that strives for efficiency through the market. Stabilization aims to minimize short-term macroeconomic imbalance through management of the demand side. Structural adjustment is intended to give a boost to the supply-side by releasing market forces and by institutional changes that reorient the economy over the medium-term to achieve greater efficiency (Thomas *et al.* 1991; Mosley 1991). The IMF

has been associated primarily with stabilization and the World Bank with structural adjustment, though the two approaches increasingly merged over the 1980s. The Bank usually required IMF stand-by arrangements to be in place before entering into negotiations on programme lending, and blessings of the Bank have become a condition for aid-consortium finance.

The logic of liberalization is in theory simple. It is a way of bringing market forces to bear on resource allocation and creating an open, export-oriented economy on East Asian lines. Inward-looking regimes; restrictive and bureaucratized trade policies; financial repression; inefficient, loss-making public enterprise; price controls, subsidies, and entry and exit restrictions on the private sector are all judged undesirable. They are considered anti-export, anti-private sector and an impediment to growth. Their removal is taken up as the core of the reformist agenda. The private sector is made the "engine of growth". Devaluation and the replacement of quantitative restrictions (QRs) by tariffs reduce anti-export bias. Depreciation of the real exchange rate (automatically) draws resources into the production of exports and import substitutes. It switches demand to tradeables, and it improves the current account of the balance of payments. Demand has to be kept in check by macroeconomic policy (by stabilization measures) to maintain a realistic exchange rate (Corden 1985), but with such measures in place, private investment will forge ahead as market distortions are removed.

The sheer diversity of the reforms contained in structural adjustment packages has been emphasized by Mosley (1991:229). They have been very wide-ranging. But it is assumed that different components can be implemented consistently and that stabilization and structural reforms pull in the same direction. Allowance is made for "gearing problems" with respect to the timing, sequencing and political economy of a liberalization package (Nelson 1984; Mussa 1987), but the practical difficulties of pursuing stabilization and liberalization together -- problems of political palatability, overall policy consistency and administrative capacity -- receive less attention.

2.1 The Timing of a Liberalization Programme

One lesson from Latin American experience of the 1970s was that a stable macroeconomic environment made economic reform easier. Liberalization was most likely to succeed under conditions of domestic and external equilibrium -- if there were no external shocks, macroeconomic problems were of manageable proportions and

there was political stability. Intuitively, this seems correct. But many countries have had no choice but to embark on liberalization under difficult circumstances -- with an incipient balance of payments crisis, low growth, high inflation and rising fiscal deficits. IMF and World Bank conditionalities have made stabilization a precondition for external finance, and liberalization and crisis management have had to move in parallel. Implementing them simultaneously has also created conflicting pressures on policy -- on the exchange rate, the interest rate, the speed of tariff reduction or infrastructural investment. It has made serious demands on management, administrative capacities and political support for the government. Selowsky (1986) has suggested that liberalizing during a time of crisis may even result in deeper recession and less political stability than would have been the case otherwise -- and East European experience would seem to support this conclusion.

But there are counter arguments. Taking on stabilization and adjustment together can signal the determination of government to make reforms, and help to sell its case. Nelson has made the point that a stabilization package is at root a set of negative prescriptions and that, while leaders may be convinced that it is necessary, it is hard to generate widespread enthusiasm for a programme of austerity (1984:991). With the promise of longer-term gains from adjustment, it may be that much easier to sell. Ultimately, of course, prevailing economic and political conditions are all important. Ambitious reforms have often had most success when a strong government was elected (or seized power) in a situation of crisis and repudiated failed policies of its predecessors (Nelson 1984; Haggard & Webb 1993) -- though, as the crisis is resolved, retaining power can lessen the urgency of more reforms. We argue below that conflicting pressures exerted by stabilization and adjustment policies reinforced just such a trend in the Sri Lankan case.

2.2 Speed and Sequencing

Whether a liberalization package is more likely to succeed as a 'one shot' programme or phased and implemented gradually is difficult to answer. The choice is likely to be shaped by many factors -- the macroeconomic situation, the political system, the strength of the bureaucracy, and the credibility and support enjoyed by the government. If the post-liberalization trade regime is so superior to an earlier distorted one then, in theory, it would seem preferable to make the transition as rapidly as possible. But in

the real world rigidities persist, social costs of adjustment have political consequences and the speed and sequencing of reform is itself a policy issue.

Problems are encountered of a technical and a political nature. On the technical side, external shocks, macroeconomic imbalance and the need for external funds are common complicating factors. Since the full effects of trade liberalization and devaluation on export industries only appear in the medium-term, whereas imports respond immediately to repressed demand, the short-term effect on the balance of trade is frequently negative. The country is more vulnerable to the cost-push effects of imported inflation and to external shocks. If the balance of payments is not supported by capital inflows, liberalization may have to be slowed because of effects on the government budget. And if the country devalues from a position of deficit on the balance of payments, the current account will deteriorate in domestic currency. Stabilization may then assume greater importance than liberalization and growth.

Political and administrative systems have similarly been found to affect the speed and pattern of reform. There has been much debate about the capacity of authoritarian and democratic regimes to maintain macroeconomic stability and take tough decisions (see Haggard & Webb 1993). And, if politicians look to patronage as a mechanism of support, reducing the number of state jobs, licenses, subsidies and concessions may be difficult to realise (Nelson 1984). Much will also depend on the politicisation, competence, morale and honesty of the government bureaucracy and on public response to the programme. If job losses from import liberalization are followed quickly by cuts in secondary incomes -- because pressures to reduce government expenditure fall on welfare services -- fears of a political backlash may also slow reform.

How secure the government feels, how committed it is to reform, politicians' calculations of who will lose and who will benefit and their assessment of probable repercussion are therefore likely to be crucial. The speed of reform itself becomes a political issue. A "one shot" approach can make government efforts more credible, and make less demands on public tolerance of hardship and austerity -- but is likely to need strong government and can incite more opposition. A gradualist approach allows time for flexibility and a more managed response to opposition, and it is more easily reversible. There is time for benefits to be seen and to build support -- but, the more drawn out the process, the more opportunity there is for opposition to organize and to stymie reforms through the political system (Mosley 1991).

2.3 Bargaining and the Theory of Piecemeal Reform

The pace of reform has also been presented as a function of external pressures and the need for external funding on the one hand, and domestic political responses on the other. Mosley, Harrigan & Toye (1991) saw it as the outcome of a bargaining strategy with the Bretton Woods institutions. Willingness to comply with Bank/Fund positions is seen to depend on bargaining ploys and on political and financial needs not only at the time of agreement, but during implementation, Governments tend to give priority to "easy reforms" -- to those that will meet little domestic political opposition -- and a distinction emerges between programmes as designed and as they are actually implemented.

One reason is that who gains and who loses at national level is always to some extent a matter of politics. Austerity measures and welfare cuts may raise questions of equity, but the sustainability of a stabilization-cum-liberalization programme has often more to do with the generation of political support and the bargaining power of different economic groups. This works in various ways. In a protected industry, for example, not only labour, but management and investors may stand to lose if protection is lifted. When opposition is seen to be strong, there can be tacit agreement to go slow with reforms in exchange for political support or at least acquiescence.

There may also be a tendency for the government to extend incentives to non-priority areas. Powerful groups in import substitution may lose with the removal of QRs. But it takes time for new groups to emerge in export-oriented industry, and if the former are not accommodated in the emerging structure of incentives, they can be extremely disruptive. There are therefore very real pressures to co-opt and accommodate. Restrictions may be removed more gradually or on a discriminatory basis, and (partial) waivers, concessions and subsidies granted to maintain political momentum. If it goes so far that winners and losers are no longer determined on economic performance, there will be a loss of policy consistency and the resulting uncertainty may be an obstacle to further private sector investment.

The need to build support in the course of economic reform is therefore important, reinforcing the view that reform is "not an application of economic principles, but rather an improvisation (Mosley 1991:227)". Unfortunately, while optimal policy solutions have been explored at length, much less is known about the theory of piecemeal reform.

3. The Sri Lankan Setting: problems of stabilization in a liberalized economy

Sri Lanka has experienced two waves of liberalization -- the first from 1977-88 and the second since 1989. This section examines the experience of the two phases in the light of the theoretical framework that has been presented. The theme running through the discussion is how conflicting objectives and adverse external conditions undermined the extent of economic reforms.

3.1 The First Phase: 1977-88

Prior to 1977, Sri Lanka had a closed economy, tightly regulated and wedded to a policy of social welfare. The state had direct control over trade and commerce, and public corporations existed in almost all sectors of the economy. From independence in 1948, massive social security and welfare expenditures were financed by surpluses squeezed from the export sector, but in the early 1970s the model was ruptured. Deterioration in the terms of trade, nationalization of plantations, drought and a significant fall in the output of plantation crops created balance of payments problems and mounting budget deficits. The old model of growth was no longer sustainable. Low growth, high unemployment, deteriorating social services and the rationing/black marketeering of essential goods nurtured disaffection, and it saw a landslide victory for the UNP in the 1977 elections.

By the election, the economic situation was improving, but there was widespread feeling that earlier policies had failed and that there was need for change. External economic conditions, a strong mandate for reform and the absence of effective opposition in the initial years gave the new government and its policies enormous political momentum. Moreover, as Lal & Rajapatirana (1989) point out, the UNP did not have to rely on acquiescence of existing industrialists. There were clear indications that, with liberalization, substantial foreign assistance would be forthcoming. The details of the reforms themselves have been widely documented (Cuthbertson & Athukorala 1991: Athukorala & Jayasuriya 1991) and, though they now seem fairly conventional, they brought momentous changes to the Sri Lankan economy. Trade liberalization, partial liberalization of financial markets, the replacement of food subsidies by food stamps and tangible benefits to individual consumers with the availability of consumer goods were of almost unparalleled effect. However, the pace

of reform soon slowed and subsequent adjustments in trade policy were only marginal (Cuthbertson & Athukorala 1991).

The thrust of the new government's development policy was infrastructural investment to strengthen the supply-side. It was dominated by three "lead" projects: the Free Trade Zone, the Accelerated Mahaweli Development Programme (AMDP) and the Housing Programme. Of these, the largest and most magnificent was the AMDP: it promised large-scale employment in the construction phase and in the later land settlement, increased food self-sufficiency, and hydro-electricity. In the late 1970s, the government's reputation seemed staked on its success. The scale of the endeavour (to settle 140,000 families and construct 5 major dams in a six year period) was intended to capture the public imagination, and to portray the image of a government concerned with the country's poor. It also appealed to the donor community which rewarded policy reforms with concessional aid and funded a growing proportion of Mahaweli investment -- though counterpart contributions still remained immense (Levy 1985).[1] Total expenditure on the AMDP alone was 6% of GDP in 1982 and 1983.

Whether the investment was cost-effective was not at the time relevant. It served a political need. It created a desired image; it generated employment to compensate for losses to the poor from the removal of the food subsidy, and it provided the government with an invaluable mechanism for dispensation of patronage. It was not a retreat of the state from economic activities, so much as a shift in priority to the three lead projects. The role of the state declined in terms of intervention, but remained high in terms of investment to develop the supply side in the long-run.

The short-term response of the economy was extremely positive. The average annual growth rate of GDP over the period 1977-82 was over 6% (in spite of the second oil shock of 1979 and further decline in the prices of export crops). But there was a worrying divergence between declared liberalization objectives and what was actually implemented. The ostensible cause was commitment to the AMDP. Cost estimates soared beyond expectations (from Rs. 11 billion or US$ 610 million in 1977 to Rs. 18 billion or US$ 860 million in 1980), and its implementation bid up the price of domestic resources (Cuthbertson & Athukorala 1991). Together with the cost-push effect from imported inputs, it led to high inflation, massive budget deficits and balance of

1 The aid-funded share as a percentage of total investment in the AMDP rose from 30% in 1979 to 83% in 1985, falling back thereafter (Athukorala & Jayasuriya 1991:Table 5.2).

payments problems (see Table 1). The government saw this as a J-curve effect and pushed ahead with its programme, as a result of which the real exchange rate continued to appreciate. But it was soon clear that the success of liberalization in stimulating growth could not be sustained (Stern 1984). As Lal & Rajapatirana put it (1989:43), while the economy was partly liberalized, it was not being stabilized. The government's room for manoeuvre was substantially reduced; lobbies had time to form, and a more gradualist approach to liberalization had become almost inevitable.

A major crisis was only averted by unprecedented capital inflows in the form of concessional aid (a third as outright grants) and by worker remittances (rising from 0.3% of GDP in 1977 to 5.2% in 1982). Stern (1984) has pointed out that there was no shift of domestic resources from consumption to investment. Almost a third of new investment over the 1978-85 period was from external sources (see Table 3), funding levels that ran counter to stabilization and liberalization objectives agreed with the Bretton Woods institutions. The reason for this apparent slackness lay in political imperatives: the need for employment creation on the side of the government and the interest of European donors in construction contracts. As we shall see, the experience highlights advantages and disadvantages of a heavy reliance on international financial institutions and bilateral donors for development finance.

The government failed to appreciate the severity of the problem it was facing, but it was increasingly clear that it was on a pattern of growth that could only have a limited life span. Reserves were drawn in to meet the current account deficit, the government had to resort to commercial borrowing at market rates to finance the budget deficit, and external debt quadrupled during the early 1980s. On the fiscal front, "belt -tightening" (a clamp down on wages and salaries and a sharp reduction in food subsidies) were not enough to avoid the need to resort to expansionary financing. Nor could the efficiency of public sector enterprises be improved; heavy subsidies were needed to keep them afloat in a liberalized policy environment, and there was back-tracking as high tariffs were maintained to afford protection. On the monetary front, there was an unabated increase in bank credit and money supply, although there were also occasional squeezes to restore stability.

Table 1 shows little improvement on main macroeconomic indicators between 1986 and 1989, and little was achieved by way of adjustment or liberalization beyond the initial opening up after 1977 -- though that in itself was a major policy achievement. The

Table 1: Key Macroeconomic Indicators, 1978-93

	1970-77	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Growth (% p.a.)	2.8	8.2	6.5	5.5	6.1	4.8	4.9	5.1	4.9	4.3	1.5	2.7	2.3	6.2	4.6	4.3	6.9
Budget Deficit (before grants) as a % of GDP	-9.3	-13.8	-13.8	-23.1	-15.5	-17.4	-13.4	-9.0	-11.7	-12.2	-11.1	-15.6	-11.2	-9.9	-11.6	-7.4	-8.1
Inflation (%)	5.8	12.1	10.8	26.1	18.0	10.8	14.0	16.6	1.5	8.0	7.7	14.0	11.6	21.5	12.2	11.4	11.2
Current Account (Balance of Payments) as a % of GDP*	-1.2	-2.4	-6.8	-16.4	-9.9	-11.9	-9.2	-0.9	-7.0	-6.6	-5.1	-5.6	-4.4	-3.2	-5.4	-3.6	-5.4
Real Exchange Rate (Trading Partner weighted)	-	100	100	98	99	99	93	77	101	117	118	114	121	118	113	112	-
Investment as a % of GDP	14.4	19.9	25.2	31.2	31.2	31.9	31.0	28.3	25.9	25.8	23.3	22.5	21.5	21.9	22.6	23.5	24.0
Public Investment (% of GDP)**	6.0	12.1	12.2	18.3	14.6	16.7	-	-	-	-	-	-	-	-	-	-	-
Domestic Savings as a % of GDP	13.4	15.3	13.8	11.2	11.7	11.9	13.8	19.9	11.9	12.0	12.8	12.0	12.2	14.3	12.7	15.3	15.5
Terms of Trade	163	189	136	110	87	82	100	122	100	89	99	93	91	87	86	89	-
Exports as a % of GDP	14.5	25.2	29.2	26.5	24.1	21.3	20.5	24.2	20.4	18.9	20.9	21.1	22.3	24.7	22.6	25.9	26.6
Imports as a % of GDP	17.0	30.6	43.1	51.0	42.6	41.9	37.1	31.9	31.6	30.7	31.0	32.1	31.8	33.4	33.7	36.0	39.3
Nominal Interest Rate	10.1	15.8	16.0	21.1	21.1	22.3	21.8	21.9	21.2	20.6	19.8	18.9	20.0	20.0	20.75	20.0	21.5
Real Interest Rate	4.1	3.0	4.7	-4.0	2.6	10.4	6.8	4.5	19.4	11.7	11.2	4.3	7.5	-1.2	7.7	7.7	9.3

Notes: Inflation (p) was estimated using the Colombo Consumer Price Index and the Real Interest Rate was estimated as [{(1+r)/(1+p)} - 1]100.

* Current account includes trade in services;

** Public investment is not available for the post-1982 years.

Sources: Central Bank of Sri Lanka, Annual Reports (various issues) and Institute of Policy Studies, Data Base.

ethnic crisis that escalated after 1983, the rebellion in the South during 1987-89 and macroeconomic imbalance engendered policy paralysis and the economy gradually stagnated. The extent of macroeconomic instability can be gauged by the budget deficits and the high level of inflation towards the end of this period. Political events took precedence over stabilization and further liberalization.

3.2 Problems of Stabilization During the First Phase

Stabilization was difficult in the early '80s for a variety of reasons. Ethnic violence after 1983 was a major factor, but there were also others: external shocks, the social costs of adjustment, political commitments of the government, the difficulty in curtailing subsidies to public enterprises and in raising government revenue.

(i) External shocks

The downturn in the terms of trade after the second oil price hike in 1979 was important. Tea prices collapsed again in 1978 and prices of oil, fertilizers, sugar and investment goods rose in the following year. Between 1978 and 1982 the terms of trade deteriorated by over 40%, placing enormous pressure on the adjustment process and on the economy in general. Herring (1987) estimated that Sri Lanka lost 7% of its national income in 1982 and 8% in 1983 from terms of trade effects -- almost equivalent to the annual costs of the three lead programmes. The UNP government wanted to avoid the risk of recession in the wake of major policy response and it was unclear if one could have been implemented without considerable political dissent. With elections due in 1982, it was not considered expedient.

Sri Lanka was also more vulnerable to external shocks. Export diversification was slow, and high inflation, fueled by the massive influx of foreign capital, created a "Dutch Disease" type of effect in the Sri Lankan economy (Lal & Rajapatirana 1989). Incentive structures showed a bias against traditional exports -- further reducing export volumes and with them government revenues. There was little state intervention in the supply-side of the non-traditional export sector, policy-makers adopted the view that market forces alone would resolve emerging problems.[2] The massive inflow of imports (30%

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2 Devaluation, tariff adjustments and export subsidies favoured the manufacturing export sector in price terms (Cuthbertson & Athukorala 1991), but bureaucratic impediments and non-price factors -- inadequate skills, research and training for export production, and institutional problems -- steadily eroded that advantage (Kelegama 1992).

of GDP during 1978-83) lengthened the J-curve effect and the problems of stabilization persisted.

(ii) Social costs of adjustment

The country's welfare tradition and the political awareness of its electorate made successive governments sensitive to adverse effects of policy on poor and vulnerable sections of the community. By the mid-1980s, there was a mounting body of evidence that growth was accompanied by high unemployment and deteriorating standards of living (UNICEF 1985). Government sensitivity to the problems inherent in this continued and its fears were not reduced by creation of an Executive Presidency or the greater centralization of power that came with it in 1978. It remained vulnerable to claims that it was insensitive to suffering.

Employment generation increased after liberalization, despite significant losses from the adverse effects of import liberalization on domestic industry (Kelegama 1989). Unemployment fell, as far as can be judged with any real accuracy, but many of the jobs were in the construction phase of the three lead projects and by nature transitory. When public investment declined in the mid-1980s, unemployment rose.[3] By the mid-1980s unemployment had increased to about 20 per cent (Karunatilake 1987:285). That in the 15-25 age-group was 30-40 per cent in 1984/85 (DCS 1987:281) and much of the unemployment was rural, educated and male -- a factor not unrelated to Sri Lanka's recent history of rural insurrection.

Government policy in the late 1970s and early '80s was preoccupied with infrastructural development and with crisis management. It assumed that growth would 'trickle down' and alleviate poverty. The free rice ration was abolished and replaced by food stamps -- the real value of which was sharply reduced by inflation. But losses to the poor were not offset by higher incomes. On the contrary, the limited evidence available suggests that benefits of reform were distributed unequally, heavily concentrated amongst the top 10% of all income receivers -- half a million out of a total employed population of about 5 million (UNICEF 1985; Jayawardena *et al.* 1987; Lakshman 1989; Kelegama 1993a). There was also evidence of a deterioration in real incomes amongst the poorest deciles, and of reduced calorie intakes significantly depressing nutritional levels

3 Much of the other employment, in the Free Trade Zone in particular, was female employment associated with garment factories, taking advantage of Sri Lanka's quotas under the Multi Fibre Agreement.

(Jayawardena *et al.* 1987; Sahn 1987).[4] More ruthless cuts in welfare expenditure would have had a high political cost, and this placed limits on the scope for further reduction in government expenditure.

(iii) Political commitments

Political imperatives made stabilization more difficult in several ways, not least through government commitment to the three lead projects. As we have already noted, costs of the AMDP rocketed; the sheer scale of capital spending and the number of sub-projects entailed in a major river valley development posed serious problems of control and coordination and, having a large foreign capital component, it became over-ambitious. It fostered waste and corruption. Estimates of "leakages" vary, but have invariably been high. The government nevertheless continued to push these projects -- partly for technical reasons (the need to reduce import dependence on staple foodstuffs, for increased power generation as a precondition for substantial expansion of manufacturing) and partly because of the availability of aid. Donors who chided the government for its failure to cut its expenditure were often the first to complain when counterpart funds were not forthcoming for the projects they were financing (Stern 1984).

But the reasons were predominantly political. It was essential, in the wake of reductions in food subsidies, to be generating employment. The ruling party's image was intimately associated with the success of the projects (the President's credibility was linked with the AMDP, and the Prime Minister was personally associated with the Housing Programme), and the schemes offered the ruling party invaluable sources of patronage.

Reduced expenditure on lead projects was therefore politically difficult. They were in practice irreversible and, given their scale and their share of public expenditure, the government's ability to respond to macroeconomic imbalance was limited. They precluded implementation of projects that could have offered quicker returns, and meant that export-promotion was relegated in the government priorities. Instead of reducing rent seeking (*a la* Krueger 1974), commercial profit continued to hinge on good political connections (Moore 1990). In the second half of the 1980s, military

4 Bhalla & Glewwe (1986) have claimed that living standards improved after liberalization, though this claim has been disputed by Pyatt (1987) and by Anand & Kanbur (1991).

expenditure also rose markedly. There was a sharp escalation in costs to meet the Tamil secessionist movement in the North and East of the country after 1983 and later insurgency in the South. Defense costs made increasing demands on the government budget and made stabilization even more difficult.

(iv) The difficulty in curtailing subsidies to public enterprises

During the first phase of liberalization, private sector investment was concentrated in the non-tradable sector. Investment in the tradeable sector was not very significant, and this had implications for subsidies to state enterprise. Some observers have maintained that the scale of the public investment programme was such that it discouraged private investment. Lal & Rajapatirana (1989) have argued that private investment was crowded out by the public sector borrowing that was necessary. But this was not the case. As a percentage of total credit, credit to the private sector increased from 19.6% in 1977 to 34.9% in 1981 and to 43.9% in 1985. This would hardly seem evidence of crowding out.

More significant was the fact that the private sector preferred to deal in non-tradeables,[5] leaving tradeables to the state (other than in the still limited niche of the Free Trade Zone). State enterprises accounted for most of the country's industrial output.[6] They were poorly managed, heavily subsidized, and could not be easily dismantled or privatized. To have done so would have eroded the production base of the country in the early '80s, led to difficult and politically costly legal battles over employment dismissals, and eliminated an established avenue for the dispensation of patronage. Loss-making enterprises were a burden on the public purse, but they had a logic that could not be easily countered, not at least in the short-term.

(v) Problems of revenue

There was also an inherent conflict between the government's need to raise revenue and reduce the budget deficit as part of a stabilization programme, and the objectives

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5 Lindgran et al (1986:34) pointed out in the mid-1980s that "in general, investment appears to be limited more by the lack of bankable projects than by lack of credit to finance them". The reasons for this was inadequate development of the Sri Lankan private sector (in terms of capital accumulation, orientation and managerial skills) and an increasingly uncertain and potentially risk-prone investment climate. The Sri Lankan capitalist class of the early '80s was still mercantile in character; it was reluctant to jump from the relative safety of trading to investment in new areas of production. Limited experience in the preparation of saleable project proposals to risk-conscious banks, and limited financial strength to back-up credit were also a disadvantage. They were also aware that the high import content of industrial raw materials in many of the newer sub-sectors made investment particularly vulnerable to the terms of trade. This was all the more so, since the violence of 1983 and its aftermath had clear repercussions on business confidence in the Sri Lankan economy.

6 In the mid-1980s over 60% of industrial production was in the hands of the public sector although in most areas private sector ventures were no longer consciously excluded.

of liberalization. In the initial post-liberalization period, revenues increased. In the past, rents associated with quotas rarely went to the government, and a shift from quotas to tariffs at the same level of protection augmented revenue. Lowering tariffs also boosted revenue initially due to the large influx of imports. But eventually lower tariffs on external trade and cuts in income tax ate into government revenue. There was no visible 'Laffye Curve' effect in operation. Taxes from previously profitable firms in the import-competing sector declined with trade liberalization, and they were not immediately replaced by taxes from newly profitable exporting firms. The problem was exacerbated by external shocks and resulted in *ad hoc* measures for revenue collection. The government found it difficult to find new sources of revenue.

On all these scores, the needs of crisis management in an unstable macroeconomic and political environment meant that the stabilization effort was almost bound to falter.

3.3 The Second Phase: 1989-93

By the late 1980s, Sri Lanka was engulfed in a serious political crisis, waging one war in the North and East of the country, and another in the South. Growth was roughly 2% per annum during 1988/89 and, with the political crisis, stabilization was problematic. The UNP government was re-elected to power in 1989; it crushed the rebellion in the South, and it was desperate to revive the economy. However, donors who had overlooked the lack of an effective stabilization policy in the 1980s (Jayawardena *et al.* 1987) were no longer prepared to acquiesce to such a glaring anomaly. Aid was made contingent on two factors: stabilization of the economy and further liberalization to give a new lease of life to the private sector as an effective "engine of growth".

The result was a more rigorous effort at stabilization from 1989, and a second wave of liberalization. The former focussed on reduction of the budget deficit (to 6-7% of GDP), a high interest rate policy to bring down the rate of inflation, and a programme of privatization to reduce the fiscal burden on government.[7] The government's stabilization programme assumed high priority -- as did the further liberalization that was agreed with the IMF. Among the latter, the liberalization of exchange controls on the current account of the balance of payments (the major policy being the abolition of

7 Although privatization of state-owned enterprises was first mooted in the mid-1980s, the actual implementation could not be considered till the rebellion in the South was crushed.

compulsory currency surrender requirements of exporters) and tax incentives to stimulate the capital market were noteworthy.

With these policy measures in place and with more normal conditions, the economy sprang back in 1990 with remarkable resilience. Yet the subsequent rate of growth remained modest (see Table 1). It was considerably below that recorded by the NICs and second-tier NICs of East and South-East Asia.

3.4 Problems of Stabilization During the Second Phase

Though serious about stabilization, the new government was confronted with additional problems after 1989, and the problem of stabilization remained. Several factors contributed to the continuing dilemma,

(i) High interest rates

With pressure to liberalize the economy further, a crucial area of concern in macroeconomic management was control of inflation. The stabilization package that was adopted meant a high interest rate policy, and this raised the cost of capital to the private sector. When the export sector was given priority and the private sector designated as the "engine of growth" of the economy, lobbies put pressure on government for concessions to offset rising costs of production. The government offered tax incentives in the form of tax holidays to placate them. This not only distorted the overall incentive framework, but it encouraged rent-seeking activities and had adverse effects on state revenue (IPS 1993). Given the size of the budget deficit, revenue losses had to be made up on other fronts. Stop-gap measures were introduced -- principally through increased excise duties, an income tax surcharge and a defence levy. But private sector costs were passed on where possible to the consumer in the form of higher prices, creating pressure for an even higher interest rate to curtail the rising rate of inflation. It became a vicious circle.

The state also reduced its capital expenditure to bring down the budget deficit.. It sacrificed capital expenditure (for infrastructure, human resource development, etc.) in favour of recurrent expenditure (salaries, wages, interest payments, welfare and pension payments) because the latter was far more difficult to cut politically. However, curtailed public investment in infrastructure development in areas such as telecommunications, transport, irrigation and power, raised private sector costs. The

private sector response to calls for their involvement in infrastructure development under the privatisation programme was also slow. Private sector production costs were kept high, and they felt compelled to lobby for tax concessions with their ensuing revenue implications.

(ii) Welfare expenditure

The difficulty in implementing a stabilization programme was compounded by the continuing political need to protect weak groups in society. Rural poverty -- a factor of considerable concern in the wake of the southern insurgency -- became the grounds for a major poverty alleviation programme (the Janasaviya Programme) instituted in 1989.[8] Since 1989, more measures to alleviate poverty (such as a mid-day meal programme, free school uniform programme, rural electrification programme), have been implemented. Moreover, because of growing regional disparities in industrial development, a programme to establish 200 garment factories in rural areas began in late 1991.[9] That the poverty programme was overambitious and poorly targeted reflected political imperatives -- the importance of securing a firmer political base in the rural areas.

The new President championed the poor, and he was determined not to cut back on welfare expenditure despite pressure from the IMF and the World Bank. He was committed to further liberalization of the economy and aware of the accompanying costs, but he needed support or acquiescence of the poor to take market reforms further. Welfare subsidies rose. Having fallen from 21 per cent of government current expenditure in 1979 to 4.5 per cent in 1988, they surged up again to 12 per cent in 1990.

(iii) Political imperatives

With continued war in the north and east, defense expenditure also rose to 12 per cent of total expenditure (over 4 per cent of GDP) in 1992 and, together with the cost of rehabilitating refugees, made enormous demands on the government budget. High defence expenditure was a major internal shock to the economy. Stabilization under

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8 Since 1989, more measures to alleviate poverty (such as a mid-day meal programme, free school uniform programme, rural electrification programme) were implemented.

9 The 200 Garment Factories Programme, which entitled parent companies to special export concessions in the form of tax holidays, was employment oriented but reflected little concern with the economic viability of outlying locations.

such circumstances was problematic; the government found itself constrained financially and it found it difficult to identify large new areas for expenditure reduction.

Meanwhile, new costs were emerging. Decentralization of the administration and a degree of regional autonomy were evinced as a solution to the ethnic crisis, and a Provincial Council system was introduced in 1988. This was followed by Divisional Councils (Pradesiya Sabhas) and AGA (Assistant Government Agents) Divisions etc., to decentralize the government's development objectives and improve implementation. The decentralization strategy, in practice, however, proved extremely costly, with overlapping and duplication of functions with the central administration (ARC 1988).

The Provincial Councils became irremovable as the concept came as part of a bilateral political accord.[10] The President was also determined to create Divisional Secretariats from the AGA Divisions to make implementation of the micro-level poverty alleviation programme (Janasaviya) more effective. Prudent financial management in decentralization was therefore difficult because of the underlying political imperatives. The Administrative Reform Commission (ARC) and the press highlighted the need to reduce the size of the cadre, but with little success. Political needs in a period of national crisis made such a policy difficult.

(iv) Privatization and stabilization

In the short-run, proceeds from the privatization programme contributed little in terms of revenue to ease the budget deficit. This was for two reasons. First, most state-owned enterprises (SOEs) were in poor shape prior to privatization, and the State had to allocate substantial funds to refurbish them to make them attractive to private buyers. Legal costs, valuation costs, advertising costs, had also to borne by the State, as had compensation for retrenched labour. The cost of privatization was therefore sometimes high.

Second, the proceeds from privatization were not very impressive. Most SOEs were sold using tender procedures that were not transparent. Cronies influenced the sale and there were accusations that some enterprises were grossly undervalued. Net proceeds from the privatization exercise failed as a result to make a significant contribution to state revenue. Sri Lankan experience indeed suggests that privatization

10 The Indo-Lanka accord of 1987 gave the birth to the Provincial Council System.

is unlikely to assist as a stabilization policy in the short-run, even though it may ease expenditure burdens of the state in the long-run.

In contrast to the 1978-88 period, the early 1990s saw the implementation of stabilization measures and these made possible further liberalization of the Sri Lankan economy. However, the demands of stabilization in terms of monetary policy, together with political pressures during implementation, produced contradictions. There was a lack of coherence in government policy, and a lack of consistency and predictability in implementation that affected business confidence. *Ad hoc* decision-making had a dampening effect on long-term investment, and the economic and political climate was an impediment to any major expansion in foreign direct investment. The latter remained in the order of 1% of GDP. There were inherent contradictions between stabilization and the ultimate objective of export-led growth.

4. Problems of the Transition to a Liberalized Economy

The previous section revealed tension between the needs of stabilization and those of increased liberalization in the Sri Lankan case. But could some of these tensions have been reduced or avoided with better timing and sequencing of the liberalization programme? In answering this question, particular attention will be paid to effects of external shocks, the effectiveness of exchange rate liberalization, the role of foreign capital inflows and the high costs of adjustment as some of the most critical pressure points. We argue that expectations were too high, and that many of the problems encountered were unavoidable.

4.1 The Question of Timing

Cuthbertson and Athukorala (1991) argue that liberalization has the best chance of sustained success during the early days of a government when it has the most political momentum. If this is the case, timing in the Sri Lankan case should have been ideal. The UNP government had a landslide victory and liberalization as its mandate. The country was desperate for foreign capital, and external support was high. And if the previous government had been returned to power, it too would, in all probability, have done the same (Herring 1987). There was no question of choosing the best time to open up the economy: it was a matter of urgent necessity. The policy shift when it came was nevertheless momentous, and it was negotiated successfully -- partly because of the lack of any effective parliamentary opposition. But the underlying

structural weaknesses remained. The country was still recovering from the effects of economic crisis and, as its export structure was dominated by weak primary products, liberalization hinged on external funding -- on a Stand-by Agreement and Extended Fund Facility Agreement with the IMF. There were therefore strong pressures for compliance in the initial years.

By the early '80s, the liberalization process was complicated by the decision to embark on an infrastructural development programme, the scale and political stature of which accorded it the highest priority. There were difficulties in reconciling liberalization with political imperatives, and growing macroeconomic imbalances emerged in the wake of the second oil price hike and external shocks. The liberalization programme was also begun before supportive institutions had been created. The Export Development Board (EDB) and the Presidential Tariff Commission (PTC) were instituted around 1980, when the development pattern was set. Efforts to direct incentive structures towards tradeables ran into established interests which manoeuvered effectively between conflicting economic and political signals to the country's business community. It was unlikely, that better timing would have made a difference.

4.2 Problems of Sequencing: the speed and stages of reform with reference to the tariff structure

The IMF and the World Bank singled out protection as a major impediment to growth in the industrial sector after the 1977 reforms. The tariff structure, they claimed, was neither rational nor uniform, and the persistence of arbitrary tariffs contributed to the lack of dynamism in particular industries (World Bank 1984). The objective in 1980 was a uniform tariff, and it had not materialized. Was this then a case of mismanagement of the liberalization exercise?

The first steps in the sequencing of trade liberalization in Sri Lanka were a devaluation, followed by removal of QRs and their replacement with a hastily formed tariff system. No attempt was made to rein-in imports, and the tariff reform was not phased in pre-announced stages. There were therefore definite grey areas. However, a main reason for disparities in protection levels was the fact that comprehensive data were not available, and that the necessary speed of the 1977 transition meant that additional in-depth studies could not be carried out. Internal inconsistencies in tariffs and the wide variance in effective levels of protection between product categories were therefore in

part a function of the speed of the initial liberalization (PTC 1985:81). And they had adverse consequences. They dealt a severe blow to many domestic industries and they reinforced the creation of lobbies to reverse "ill-judged" decisions.

Further reductions in tariff levels under the liberalization programme were then slow in coming. Subsequent steps (including creation of the PTC) were largely defensive. They reflected two main motives. There were *ad hoc* changes in response to demands from local manufacturers adversely affected by lower import duties or heavily dependent on imports. And there were changes motivated by government's need to bolster its dwindling revenue. Neither were to prove consistent with its liberalization programme. The effective protection coefficient (EPC) of the manufacturing sector for total sales rose from 1.5 in 1979 to 1.6 in 1981 (see Table 2) and the Presidential Tariff Commission (1985) found that the variance of the EPC had increased between these years.[11]

Table 2: EPCs for the Overall Manufacturing Sector for Total Sales (Domestic and External), 1979-89

1979	1981	1983	1985	1987	1989
1.50	1.61	1.56	1.35	1.40	1.77

Source: Edwards (1993).

In the process of fine-tuning, the PTC appears to have been trapped by political lobbies. It was forced to yield to pressures to provide protection or to reduce particular import rates on a selective basis. This was hardly surprising, given the patronage that characterized the country's political system, appreciation of the real exchange rate and market failures on the supply-side. As a result, the tariff structure revealed no apparent rationale in terms of either comparative advantage or the encouragement of infant industries (Cuthbertson & Khan 1981).[12] This was also in part because of the lack of a coherent industrial strategy on which tariff changes could be based. The government lacked such a strategy until 1989.

11 Protection is a relative concept, some activities being protected in relation to others. Variance therefore provides information on the extent to which highly protected industries benefit from the protected structure relative to the least protected. If protection succeeds in getting resources to move from one activity to another, the variance of SPCs provides an indication of the potential resource misallocation in the tariff structure. Other things being equal, this potential will be greater, the wider the variance of the EPCs (see Greenaway 1988).

12 This reflects the difficulty in judging appropriate protection levels for various industries in the first stage of transition, whether for further protection or for liberalization.

The liberalization process was truncated because it was overtaken by macroeconomic crisis in the early '80s. Key factors in this break were problems of stabilization (which we have already analyzed), and costs of adjustment as manifested in continuing high levels of unemployment. The latter were important politically, because they were not effectively offset by the higher rate of growth.

The initial trade liberalization in 1977 saw considerable job losses.[13] There was some redeployment (there was improvement in the overall employment situation by 1981/82), but losses were not offset by opportunities in expanding activities -- partly because the emerging industries were in other locations and partly because different skills and abilities were required by them. Some who had lost jobs were absorbed by the expanding construction and service sectors; some secured jobs in new industries or obtained land under the AMDP, and others migrated abroad, particularly to the Middle East.[14] But in the early 1980s, a large part of this displaced labour was still unemployed.

Their presence exerted tremendous pressure on the government, and it led to large-scale recruitment into state corporations (creating overstaffing). Public enterprises were sources of readily available employment, and rationalization to increase efficiency was a very secondary objective. Privatization was more difficult with this overstaffing, because existing labour laws made retrenchment difficult.[15]

Questions were also raised about the quality of the employment that was generated. With the exception of the garment industry, labour absorption was concentrated in sectors that could not sustain a long-term growth in employment -- most notably in construction where winding-down was inevitable.[16] The increase in service sector employment was largely due to the expansion of import trading after liberalization, and the regime of liberalized imports was buttressed by external props (in effect by foreign aid), more than any intrinsic strength of the domestic economy. New employment was

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13 It was estimated that nearly 128,000 workers were displaced in the handloom industries between 1977 and 1986 (Kelegama, 1989).

14 Stern (1984) has shown that employment under the Mahaweli Project peaked in 1981, and that employment fell with completion of the construction phase. Kelegama and Wignaraja (1992) have shown that labour absorption capacity of the manufacturing sector as a whole remained low during the post-1977 years.

15 Liberalization of the labour market was also partial. The power of the unions was significantly reduced in 1980 and, though this lowered rigidities in the labour market, the process was far from complete. Existing labour laws remained in operation, and still continue today.

16 The construction boom was driven largely by deficit financing and by foreign aid, but the government had eventually to prune down its construction programme to ease its budget deficits.

principally in areas financed by monetary expansion, increased capital inflows or worker remittances, all of which were prone to considerable buoyancy.

Nor was that all. Pressure for concessions pushed the focus of policy towards manufacturing at the expense of other sectors of the economy -- such as peasant agriculture which contained the majority of the poor, but lacked organized representation at national level (IPS 1993). Efforts to promote peasant-based exports were therefore continually frustrated (Dunham 1993). Changes in the country's industrial structure saw a reallocation of labour from the unorganized sector, and from the rural sector in particular, towards the urban, organized sector (largely industry and services). Those who lost jobs in rural areas, for example in the handloom sector, were not those employed in the Free Trade Zone located near Colombo. Regional differences grew, accentuating disparities in the distribution of income and increasing regional ethnic differences.[17] Taken together, these effects were socially divisive, and measures had to be introduced to counteract this pattern (for example to protect handloom industries) regardless of the target of tariff rationalization or norms of market efficiency. The government was quite unenthusiastic about IMF and World Bank insistence on moving towards a more neutral incentive regime (MOFP 1985: 88) and about demands for investment cuts to reduce government expenditure.

As the 1980s progressed, revenue constraints became a barrier to further reductions in the levels of protection because the government raised much of its revenue from external trade. High import duties across-the-board, while good for revenue purposes, raised the protection level (see Table 2) and ran counter to rationalization of the tariff structure (PTC 1985). Nor was there a narrowing of duty bands to reduce disparities (World Bank 1984). This contributed to a further slowing down of the liberalization process.[18]

4.3 Other Problems of Transition

There were also other problems relating to exchange rate adjustments and to foreign capital inflows.

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17 The diversion of employment from basic industries to construction and services also undermined many of the economic linkages that had existed earlier.

18 Most EPCs for 1983 were higher than the corresponding figures for 1981 -- 12 out of 20 industries had higher EPCs in 1983 (PTC 1985).

(i) Problems of devaluation

The other key element in trade liberalization, besides the protection structure, is devaluation. Significant devaluations in the real exchange rate are normally considered a crucial component of a liberalization strategy and a means of shifting incentives towards tradeables. However, policy-makers in Sri Lanka found real depreciations difficult. This was for several reasons. Many state enterprises were loss-making; they were a burden on the government budget, and they required increasingly large transfers to keep them viable. They were also, in general, highly dependent on imported inputs. Devaluation, by increasing their costs, inflated the size of these transfers. Fiscal imperatives therefore worked against marked devaluations.

Second, Sri Lanka being in general highly import-dependent, the costs of industrial and agricultural production and of domestic consumption would have been similarly affected. Devaluation posed a serious threat of cost-push inflation. In the welfare-oriented and highly politicised environment that had existed in Sri Lanka, partial wage indexation for a devaluation had been unavoidable, and import- and wage-related cost increases, combined with declining terms of trade, ate into the margins devaluation could hope to offer to exporters. Further devaluations were then needed to sustain export competitiveness. Policy-makers looked to commercial policies (tax cuts and increasing subsidies) to avoid short term inflationary consequences and to maintain realistic exchange rates, but these too were ineffective because of market failures on the supply side (Kelegama 1992).

(ii) Problems of foreign capital inflows

There was no serious effort to liberalize the capital account of the balance of payments in the 1980s, though there was a real exchange rate appreciation in the wake of official capital inflows linked to the public investment programme. The difficulties in absorbing large foreign capital inflows such as those which Sri Lanka secured in the wake of trade liberalization (see Table 3) have been discussed in the literature (Corden 1984). The essential point is that if they are absorbed by the domestic economy, an appreciation of the real exchange rate is likely to follow because of imported inflation and increased demand for non-tradeables (Levy 1985; White & Wignaraja 1992). Lal and Rajapatirana (1989) argue that, because of the restrictions on capital outflows, the appreciation of the real exchange rate was larger than it need have been. Full liberalization of the capital account was not desirable during the uncertain political situation in the 1980s as it could have led to a significant outflow of capital. However, it

is clear that -- along with other factors -- foreign capital induced exchange rate appreciation worked against the efforts to boost the production of tradeable goods.[19]

Table 3: Foreign Capital Inflows to Sri Lanka: 1978-92

	1978 - 85	1985 - 90	1991 - 92
Domestic Savings	13.7	12.6	14.1
(a) National Savings	19.6	19.4	20.8
(1) Foreign Aid			
Official Transfers	3.3	2.7	2.1
Concessional Loans	4.1	3.8	3.9
(2) Other Loans	2.9	0.5	1.2
(3) FDI	0.8	0.5	1.0
(b) Foreign Savings (1+2+3)	11.1	7.6	8.2
Total Savings (a+b)	30.8	27.0	29.0

Note: All values are as a percentage of GDP.
Source: Averages estimated from the Institute of Policy Studies, Data Base.

4.4 Problems of Further Liberalization in the Post-1989 Period

The large budget deficit meant the government failed to reap the benefits of financial market liberalization. It was unable to raise domestic savings (averaging around 14 per cent of GDP) or to reduce the country's dependence on foreign aid. Increased inflows of foreign capital, as aid and into the newly activated stock market, ballooned external asset reserves in the Central Bank. This increased money supply; it called for a higher interest rate in order to control it, and the high interest rate policy had repercussions on the costs of borrowing.

It was expected that, with relaxation of the surrender requirement for exporters and further liberalization of exchange controls (in March 1993), there would be an outflow of capital, reducing the impact of foreign capital inflows on exchange rate appreciation. This did not happen on the scale that was anticipated. The outflow of capital, other than from the stock exchange and the FTZ, was not significant, and exporters preferred

19 Massive foreign capital inflows also had a positive side. They came at a time when the economy faced massive external shocks, enabled the government to maintain the momentum of its public investment programme and enabled it to avoid a deflationary policy stance that would otherwise have been necessary (Athukorala & Jayasuriya 1991). They eased the pain of adjustment. They also enabled the basics of the liberalization programme to be maintained without recourse to the extensive use of direct controls. In the short-run, the economy could be said to have suffered less in terms of reduced growth, higher unemployment or added social tension. How these two sides should be weighed remains a difficult question.

to retain their earnings because of the high interest rate in Sri Lanka. The one year Treasury Bill rate was in the range of 20-22% during 1993, and the real interest rate was significantly higher than they could obtain elsewhere. This delayed further liberalization of exchange controls -- a move towards Article 8 status with the IMF (where there is full convertibility of currency in the current account of the balance of payments). There were also fears regarding the impact of further liberalization of exchange controls on the macroeconomy (see for instance Lakshman & Nicholas 1991).

Privatization was aggressively pursued after 1990 (*inter alia*, as a measure of improving the efficiency of supply side activities), but it too ran into difficulties in 1992. Opposition of strong trade unions to labour retrenchment and allegations of "crony capitalism" arising from a lack of transparency in the privatization process forced the government to move cautiously (Kelegama 1993b). It proved extremely difficult to dismantle labour legislation (such as the Termination of Employment of Workers Act) which was seen as an impediment to growth. Traditions of labour protection were too strongly rooted in Sri Lankan society.[20] The government also found it difficult to monitor and regulate the economy during further liberalization. In the case of privatization the legal framework was inadequate to safeguard public interests; some public monopolies were converted into private monopolies, with a resulting escalation in the prices of certain commodities. Managing and regulating supply-side reforms remained problematic.

The crisis management associated with policies of liberalization was such that liberalizing markets in a pre-arranged order never arose as an issue.[21] The path that was followed reflected what was feasible, and it has shown that problems in the transition to an open economy are not always amenable to rational technocratic management. There was in particular an uneasy relationship between macroeconomic stabilization and the country's structural adjustment programme.

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20 Godfrey (1990) has argued that labour market rigidities and outdated labour laws remain a major obstacle to structural adjustment in Sri Lanka.

21 For example, Krueger (1986) has suggested an optimal order for the overall dismantling of controls: starting with liberalization of trade, followed by liberalization of commodity markets and the liberalization of financial and labour markets, leaving the capital account of the balance of payment until last. This is not undisputed (see, for instance, Lal 1987) and no theory has been sufficiently tested to justify this preferred order.

5. What can we learn from the Sri Lankan Experience?

Theory maintains that the success of a liberalization programme is likely to depend on the effectiveness of the accompanying macroeconomic policy package and the degree of government commitment. In the Sri Lankan case neither condition was effectively satisfied. The first phase lacked an adequate stabilization effort, while in the second stabilization and *ad hoc* policy-making began to smother growth. Inadequate stabilization during the first phase made further liberalization difficult and stabilization in turn was hindered by political priorities and by unforeseen shocks. *Ad hoc* policy making during the second phase resulted from the stabilization package, along with rent-seeking activities and a lack of planning (guidance to the market economy). The austerity programme, adjustment costs and political realities forced the government to compromise, and conflicting objectives placed further constraints on the country's economic expansion. Economic reform was piecemeal and it was improvisation.

Several conclusions can however be drawn from the Sri Lankan experience. It suggests, for example, that it is difficult to liberalize successfully when underlying fiscal problems remain unresolved. In developing countries, a large public sector deficit entails either inflationary finance or foreign borrowing associated with a large current-account deficit. Or both, as in the case of Sri Lanka. Large-scale domestic borrowing is generally infeasible, and trade liberalization tends under such conditions to be unsustainable. Large capital inflows -- mainly as aid -- can induce a 'Dutch disease' type shock and neutralize efforts at liberalization. Large capital flows to an Export Processing Zone and a newly activated stock market can also make interest rate management difficult, compelling the government to resort to *ad hoc* policy measures.

A Keynsian-type fiscal stimulus can be reduced by stabilizing the economy, but this may only be feasible if there are immediate and visible rewards from liberalization. In Sri Lanka, factor reallocation costs that accompanied the post-1977 liberalization package resulted in increasing social and regional disparities. Had Sri Lanka embarked on a stringent stabilization package, the accompanying recession would have resulted in greater deterioration in welfare. It would have been politically infeasible. Similarly, after 1989, the size of the fiscal deficit led to the introduction of *ad hoc* revenue measures that ran counter to basic objectives of liberalization. Dove-tailing liberalization and stabilization measures proved extremely difficult.

Second, it suggests that there are political limits on the costs of adjustments. Such a claim, by its nature is highly contextual, but in the case of Sri Lanka it is clear that many transition problems were difficult to resolve because they fell mainly on the poor, and because poverty and unemployment were grist to the mill of the southern insurgency. Similarly, concessions had to be granted to established groups to weld together necessary political support. Such political realities have to be recognized as a prime force in policy. As Krueger has argued, "it is senseless to incur the costs of adjustment only to reverse policies before they have had a chance to affect resource allocation and growth. Yet, the evidence is that a significant number of stabilization programmes have foundered precisely because the authorities have been unwilling or unable politically to survive political pressure during the adjustment period" (1981: 100-101). To argue that adjustment costs are the price that a society must bear to win longer-term gains, and that they will eventually be offset by the higher growth that comes from liberalization may be quite unrealistic.

Third, Sri Lankan experience confirms the underlying importance of initial conditions. Unlike South Korea or Taiwan, Sri Lanka lacked the infrastructural, bureaucratic and entrepreneurial base to embark successfully on a rapid export-led industrialization programme at the time of liberalizing the economy. The Sri Lankan case also shows that it is politically difficult to dismantle a strong and entrenched commitment to welfarism when it has firmly embedded roots in public sector employment. Success was never merely a function of adequate policies.

Fourth, it underlines the importance of shocks (external and internal). External factors, and more especially the deterioration in the country's terms of trade, had a major effect on the outcome of its liberalization efforts. Nor was Sri Lanka unique in this. Helleiner noted that, even before 1979-82, African policy-makers complained that "international shocks were more costly ... than any failure to take full advantage of export opportunities (1986:143)". This is probably true of Sri Lanka. And of course internal shocks, such as war and insurgency, are always likely to run counter to stabilization efforts.

Finally, it suggests that monitoring and some elements of intervention is necessary for the success of a liberalization programme. From the late 1970s, planning in Sri Lanka was confined to preparation of a government's public investment programme, on the grounds that more was unnecessary in a free market economy. Fifteen years later it

was all too clear that the market by itself did not reduce unemployment, ease social and regional disparities, control corruption, or rein-in maverick firms or unregulated activities. Without planning, objectives that are socially and politically important may remain untouched by the market mechanism especially when initial conditions are weak. The importance of the state in guiding the development of East Asian countries has received growing attention (*a la* Wade 1990), and during the time of 1977 policy reform there was a misreading of the East Asian success story by the policy advisers to the Sri Lankan government. Even the International Financial Institutions discouraged any form of planning until the mid-1980s when the concept of "adjustment with a human face" became accepted internationally.

Sri Lankan experience reflects the considerable complexity of the liberalization process and the dangers of adhering too strictly to conventional lines of analysis. It offers encouraging and cautionary lessons for those who set out on the simultaneous programmes of stabilization and liberalization of their economies. They embark on a difficult task.

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