Sri Lanka's Balance of Payments 1978-89: an exploratory study

by

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CONTENTS

1. INTRODUCTION 1

2. THE OVERALL BALANCE 2

3 THE CURRENT ACCOUNT BALANCE 3
3.1 General Trends 3
3.2 Composition 5

4. THE TRADE BALANCE 6
4.1 Import Expenditures 7
4.1.1 Trends 7
4.1.2 Composition and Origin 8
4.1.3 Explanatory Factors 10
4.1.4 Import Prices and Volumes 10
Import Volumes 11
4.1.5 The Monetary Approach to the Balance of Payments 15
4.1.6 Trends in Import Expenditures of Other Developing Countries 17
4.1.7 Foreign Financing - a Catch 22 18

4.2 Exports 19
4.2.1 Trends 19
4.2.2 Composition and Markets 20
4.2.3 Explanatory Factors 22
4.2.3.1 Export Volumes 22
4.2.3.2 Export Prices 27
4.2.3.3 Export Receipts 28

4.3 Trade Deficit 29
4.3.1 The Terms of Trade 29
4.3.2 The Trade Deficit and External Financing 30
4.3.3 The Trade Deficit and the Budget Deficit 31

5. SERVICES AND TRANSFERS 32
5.1 Services 32
5.2 Transfers 34

6. THE CAPITAL ACCOUNT 36

7. FINANCING OF THE DEFICIT 39
7.1 Reserve Position 39

8. CONCLUSIONS AND POLICY IMPLICATIONS 42

REFERENCE 44

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1. INTRODUCTION

The aim of the study is to analyse the balance of payments performance of the Sri Lankan economy with a view to identifying the major factors which account for this performance. Arguments are developed and propositions explored at various levels of generality. Explanations of phenomena at lower levels of generality are intended to reinforce and enrich the picture painted at higher levels. The time period chosen for the study is the post 1978 period. A longer time-span would have perhaps permitted a better appreciation of the influence of structural factors, but data limitations and other considerations precluded such a broadening of the time horizon. Given the exploratory nature of the study, considerable use is made of graphs and simple statistical indicators. Since many, if not most, of the time series data which the study makes use of are strongly trended (upwards), rates of change transformations have been applied. The problem with the use of trended variables, is that they tend to be highly correlated with each other "with the obvious danger that such correlations will be at least partly spurious" (see Thomas 1985:6).

The fundamental conclusion of the study is that developments in Sri Lanka's external payments situation over the short-term can be seen as fundamentally an outcome of developments in the external environment. At a policy level, and in somewhat general terms, this means that effective economic management needs to take cognizance of the latter. Failure to do so could lead to serious miscalculations in planning and policy formulation.

2. THE OVERALL BALANCE

The balance of payments is a record of a nation's transactions with other nations. A summary of these transactions for 1989 (in SDR terms) is given in Table 2.1. The table shows that the two major components of the balance of payments are the current and capital accounts. The sum of the balances on the two accounts, after allowing for errors and omissions, is equal to the overall balance. Financing of a payments imbalance is, for the most part, through a depletion of reserves.[1] Since reserves are limited, and since their availability determines a country's ability to maintain a steady flow of essential imports, a systematic depletion of reserves is cause for concern. In fact, a country is said to have a balance of payments problem when payments imbalances lead to an unsustainable depletion of reserves. At some point in time corrective action has to be taken. The nature of this action will depend on the general economic strategy pursued by a country, as well as the flexibility afforded it by actual holdings of, and access to, reserves.

Table 2.1
Summary of Balance of Payments 1989 (SDR)

	1989
Current account	-290
Capital account	252
Errors and omissions	-29
Overall balance	-67
Financing of overall balance	67

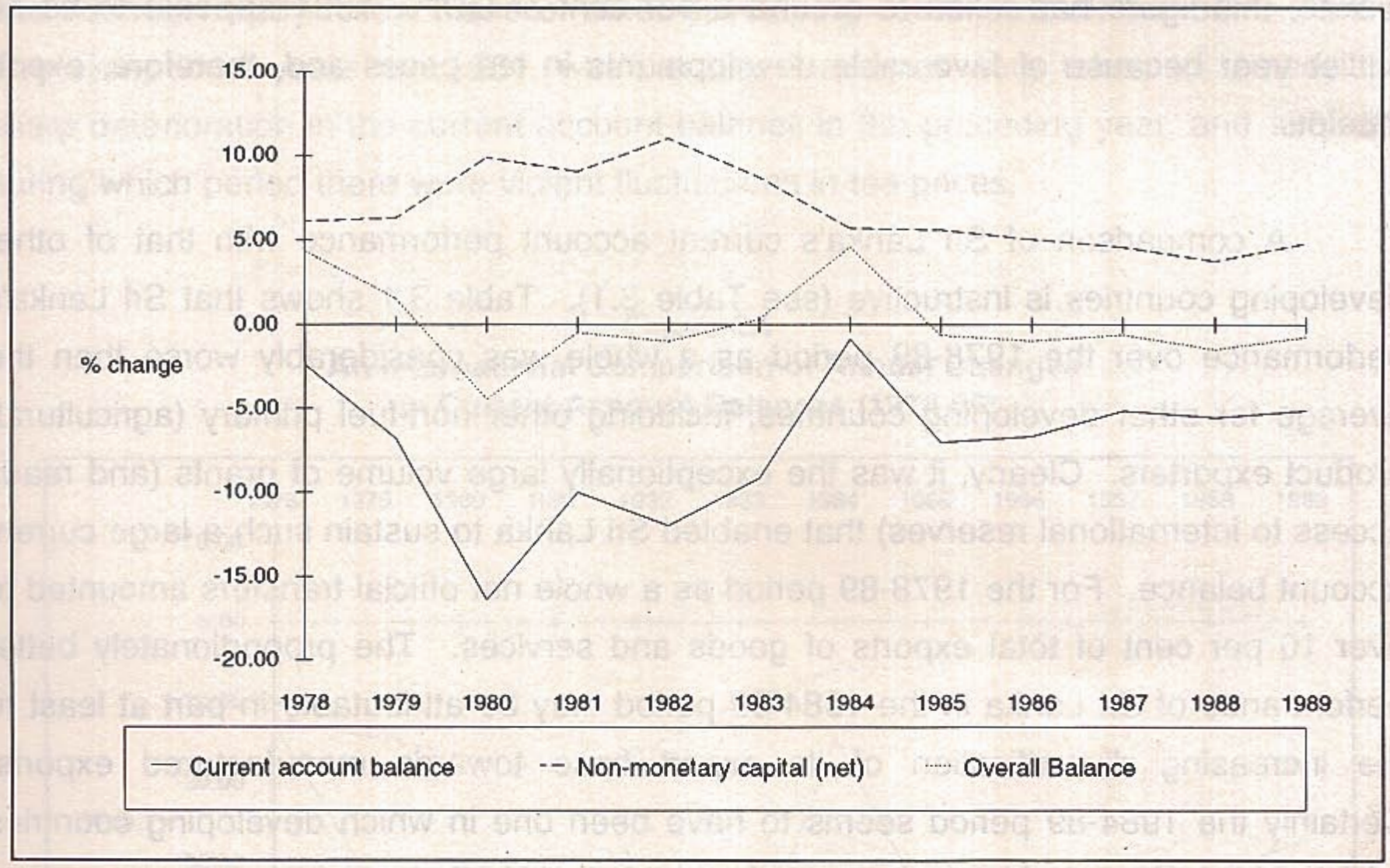
Source: "Annual Report 1989", Central Bank of Sri Lanka

Plotting the overall balance and its components as a percentage of GDP at current market prices over the 1978-89 period (see Figure 2.1) reveals that the former is primarily influenced by changes in the current account balance. Changes in the capital account balance appear to have done little more than temper this relation. Accordingly, it is to the current account balance and changes in it that we first turn our attention.

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1. The level of gross reserves can be supported temporarily through foreign borrowing and drawing from a country's account with the IMF, but this cannot continue indefinitely.

Figure 2.1
Changes in the Balance of Payments and its Components



3 THE CURRENT ACCOUNT BALANCE

3.1 General Trends

Between 1978 and 1989 the current account was continuously in deficit. The average annual deficit amounted to 7.3 per cent of GDP, or 10.4 per cent of GDP if grants are excluded. The figure for the sub-period 1984-89 was just over half that of the preceding 1978-83 sub-period, indicating a substantial improvement in the current account balance between the two sub-periods. Excluding grants, however, the improvement is less marked.

The plot of annual data in Figure 2.1 indicates that there was a precipitous deterioration in the current account balance between 1978 and 1980, followed by a systematic improvement thereafter. This deterioration was the result of a hike in world oil prices and rapid domestic expansion. By 1980 the deficit was of the order of some 16 per cent of GDP - more than double the period average. By 1989, as a result of an

improvement in the external environment and a moderation in the rate of economic growth, this figure had fallen to around 5 per cent of GDP. 1984 appears to be an outlier year because of favourable developments in tea prices and, therefore, export receipts.

A comparison of Sri Lanka's current account performance with that of other developing countries is instructive (see Table 3.1). Table 3.1 shows that Sri Lanka's performance over the 1978-89 period as a whole was considerably worse than the average for other developing countries, including other non-fuel primary (agricultural) product exporters. Clearly, it was the exceptionally large volume of grants (and ready access to international reserves) that enabled Sri Lanka to sustain such a large current account balance. For the 1978-89 period as a whole net official transfers amounted to over 10 per cent of total exports of goods and services. The proportionately better performance of Sri Lanka in the 1984-89 period may be attributable in part at least to the increasing diversification of its export base towards manufactured exports. Certainly the 1984-89 period seems to have been one in which developing countries oriented towards manufactured exports fared relatively better.

Table 3.1
An International Comparison of Sri Lanka's Current Account Deficit as a Proportion of Exports of Goods and Services[a/]

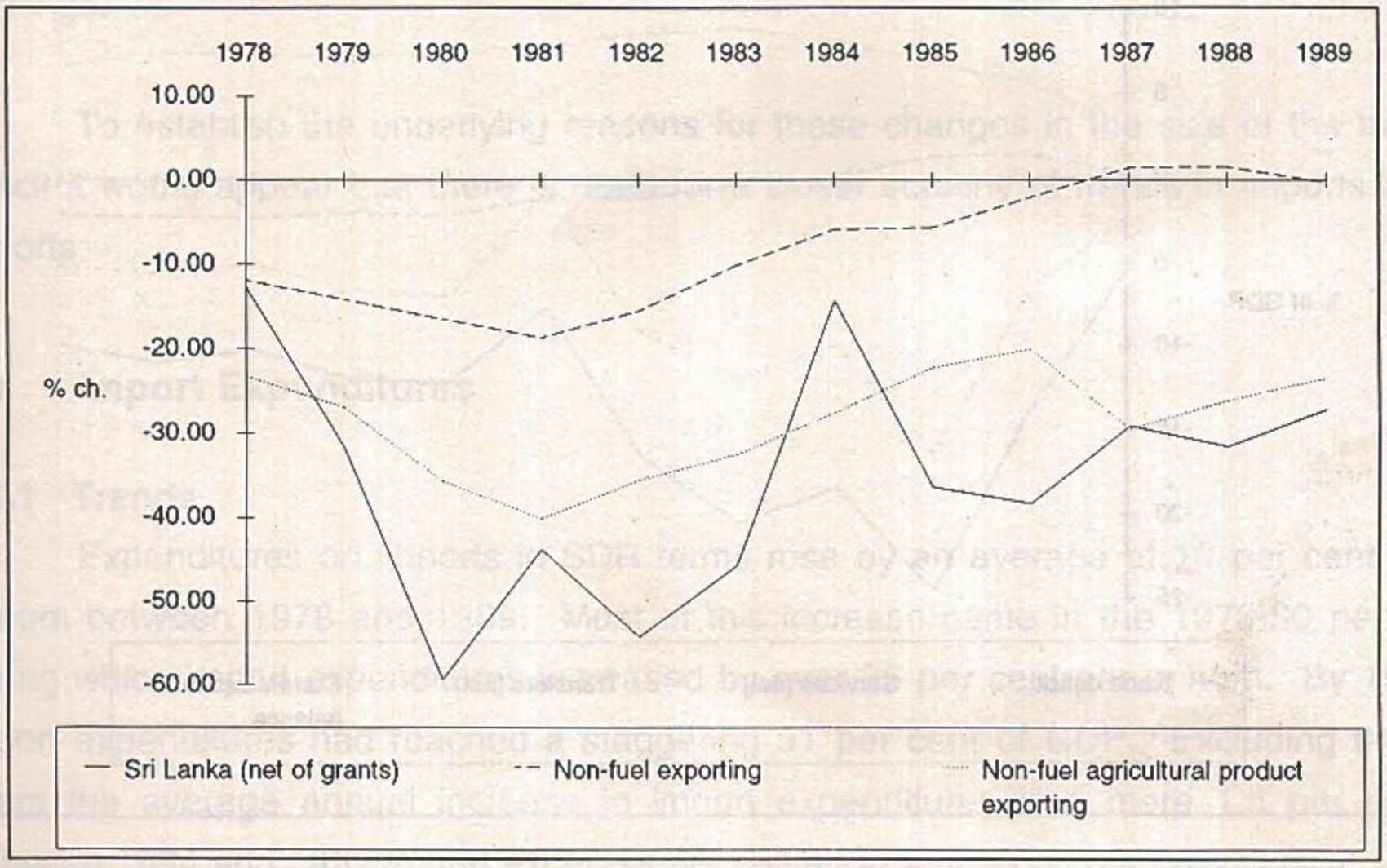
	1978-89	1978-83	1984-89
Sri Lanka (before grants)	-35.4	-41.3	-29.5
Sri Lanka (after grants)	-24.7	-30.5	-18.9
Asia	-3.3	-7.2	0.7
Developing countries	-3.7	-4.8	-2.5
Non-fuel exporting	-8.2	-14.5	-1.9
Non-fuel primary product exporting	-25.4	-28.3	-22.5
Non-fuel agricultural product exporting	-28.6	-32.4	-24.8
Non-fuel manufacture exporting	-2.9	-8.4	2.5

a/ The 1989 figures for countries other than Sri Lanka are estimates
Sources: "World Economic Outlook", International Monetary Fund
"Annual Report 1989", Central Bank

An international comparison of **annual changes** in current account balances provides further corroboration of the importance of external influences (see Figure 3.1).

Figure 3.1 shows that changes in Sri Lanka's current account balance between 1978 and 1989 generally follow those of other developing countries over the same period. The exceptional years are 1981, when drastic measures were taken to remedy the sharp deterioration in the current account balance in the preceding year, and 1983-85, during which period there were violent fluctuations in tea prices.

Figure 3.1
An International Comparison of Annual Changes in Current Account Balances (1978-89)

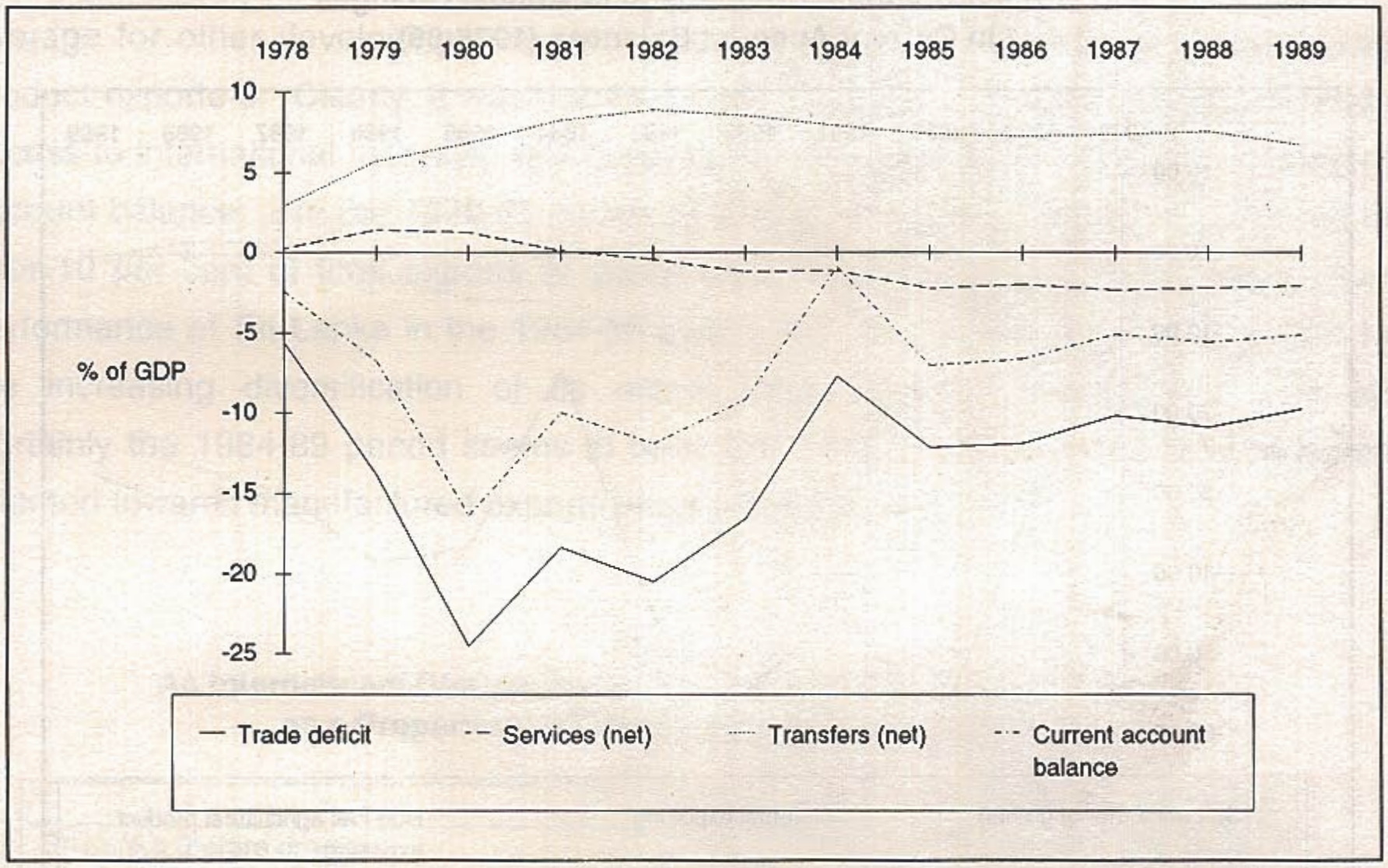


3.2 Composition

The external current account has three major components the trade, services and transfers accounts. For most developing countries it is typically the trade account which is the most important of these. Sri Lanka is no exception. Between 1978 and 1989 the average annual trade deficit was double that of the current account deficit (after grants). Moreover, from Figure 3.2 it would appear that **changes** in the current account balance over this period were almost entirely accounted for by changes in the

trade balance. In relation to the latter, changes in net transfers were modest, as were those of services. Thus, in the analysis of the current account balance and its movement, it seems appropriate to begin with the **trade balance** and its determinants.

Figure 3.2:
The Components of the Current Account Balance 1978-89
(as a percentage of GDP at current market prices)



4. THE TRADE BALANCE

The merchandise trade account was continuously in deficit over the 1978-89 period as a whole. The magnitude of this deficit amounted to an annual average of 13.5 per cent of GDP at current market prices. The average annual deficit for the 1978-83 sub-period was 16.6 per cent of GDP while for the sub-period 1984-89 it was 10.4 per cent. In other words, there was a significant improvement in the trade balance which corresponds to, and indeed underlies, the improvement in the current account balance.

Annual data show that the watershed year was 1980. Economic liberalisation, a massive expansion in domestic demand, and a substantial hike in world oil prices, saw the trade deficit rise steeply from 5.6 per cent of GDP in 1978 to a colossal 24.5 per cent of GDP in 1980. Imports as a percentage of GDP trebled over this short period. From 1980 onwards the trend in the deficit, as a proportion of GDP, was downwards. Between 1980 and 1986 this was primarily because of a contraction in imports - the exception being 1984 when there was also a significant expansion in export earnings due to a favourable movement in tea prices. The improvement in the trade balance between 1986 and 1989 was due more to the relatively greater expansion of export earnings.

To establish the underlying reasons for these changes in the size of the trade deficit it would appear that there is need for a closer scrutiny of trends in imports and exports.

4.1 Import Expenditures

4.1.1 Trends

Expenditures on imports in SDR terms rose by an average of 10 per cent per annum between 1978 and 1989. Most of this increase came in the 1978-80 period, during which import expenditures increased by over 35 per cent per annum. By 1980 import expenditures had reached a staggering 51 per cent of GDP. Excluding these years the average annual increase in import expenditures is a mere 1.5 per cent. Between 1984 and 1989 import expenditures settled at around 30 per cent of GDP.

At the sectoral level the most rapid growth in import expenditures between 1978 and 1989 was in intermediate goods imports. The average annual rate of expenditure on these imports (13.2 per cent) was double that of either consumption or investment goods import expenditures (6.5 per cent). Most of the increases in intermediate and investment goods import expenditures took place in the 1978-83 sub-period. Expenditures on intermediates during this sub-period grew at an average annual rate of 28 per cent, and those on investment imports by an average annual rate of 26 per cent. Expenditures on intermediate imports in the 1984-89 sub-period fell to an annual

average of 0.5 per cent while those on investment imports fell to an annual growth (contraction) rate of - 10 per cent. By contrast, increases in expenditures on consumer goods imports were more evenly dispersed between the two sub-periods, the average rate of increase in each sub-period being 8.4 per cent and 4.9 per cent, respectively. Interestingly, from 1980 onwards the growth of consumption and investment goods imports appear to have moved inversely to each other. Between 1980 and 1984. expenditure on investment goods imports grew rapidly while those on consumption goods imports declined. After 1985 the reverse pattern was manifest.

4.1.2 Composition and Origin

Underlying these trends in the aggregate level of import expenditures are marked changes in the composition and origin of imports. In terms of compositional changes, there was a relative increase in intermediate goods imports - already the single largest component of import expenditure in 1978 - and a relative decline in consumer and investment goods imports (see Table 4.1). Compositional changes in expenditures on intermediate products have, in turn, been made up of increases in expenditures on textiles and clothing and (to a much lesser extent) wheat and fertiliser, and a corresponding relative decline in expenditures on petroleum products - after 1982. The major contributor to changes in investment goods imports has been transport equipment. Import expenditures under this head rose precipitously between 1978 and 1982, and fell systematically thereafter. In SDR terms, expenditures on transport equipment in 1989 were around one-eighth of their value in 1982. Changes in consumer goods imports have mostly reflected changes in food and drink imports, particularly flour, sugar, rice and dairy products. The major contributor to the relative decline in expenditure under this head has been flour, largely as a result of the opening of the Prima flour mill in Trincomalee and the resulting shift in expenditure from consumer to intermediate goods imports (of wheat). In 1978 flour imports alone accounted for 15 per cent of total expenditure on imports. By 1981 this figure was down to 0.1 per cent - a level at which it has continued to remain. It warrants repeating, however, that increases in wheat imports (classified under intermediate products) did offset this decline in flour imports to a considerable extent. The initial decline in the proportion of total imports accounted for by consumer goods imports can be attributed in part at least to a corresponding increase in both intermediate and investment goods

imports resulting from an acceleration in investment and rapid expansion of the economy, much as the subsequent rise in the relative share of consumer imports was in large measure a result of the relative decline in investment goods imports consequent upon the slow-down in investment and growth.

Table 4.1
The Composition of Import Expenditures 1978-98
(percentages of total imports)

	1978	1982	1989
Consumer	34.6	15.4	26.1
Intermediate	40.3	56.8	56.4
Investment	22.9	27.6	15.0

Source: "Annual Report 1989", Central Bank of Sri Lanka

The notable change between 1978 and 1988[2] in terms of the **origin of imports** has been the declining share of imports from industrialised countries and the corresponding increase from developing countries, particularly Asian developing countries (see Table 4.2). In 1978, imports from industrialised countries accounted for 54 per cent of total imports. By 1988 the figure was down to 44 per cent, the reductions being evenly spread across industrialised countries with the exception of Japan. Japan's share actually increased from 11 per cent of total expenditures in 1978 to 14 per cent in 1988, although it too experienced a loss of share to other Asian countries towards the end of the 1978-88 period. The fall in the share of expenditure on imports from the Middle East region was, needless to say, due to the relative fall in world-market oil prices from 1982 onwards.

Table 4.2
The Origin of Sri Lanka's Imports

	1978	1982	1988
Industrialised countries	54	45	44
Japan	11	15	14
Developing countries	41	55	55
Asian	22	27	37
Middle East	15	24	10
Other	5	0	1

Source: "Direction of Trade Statistics", International Monetary Fund

2 The figure for 1989 was not available at the time of writing.

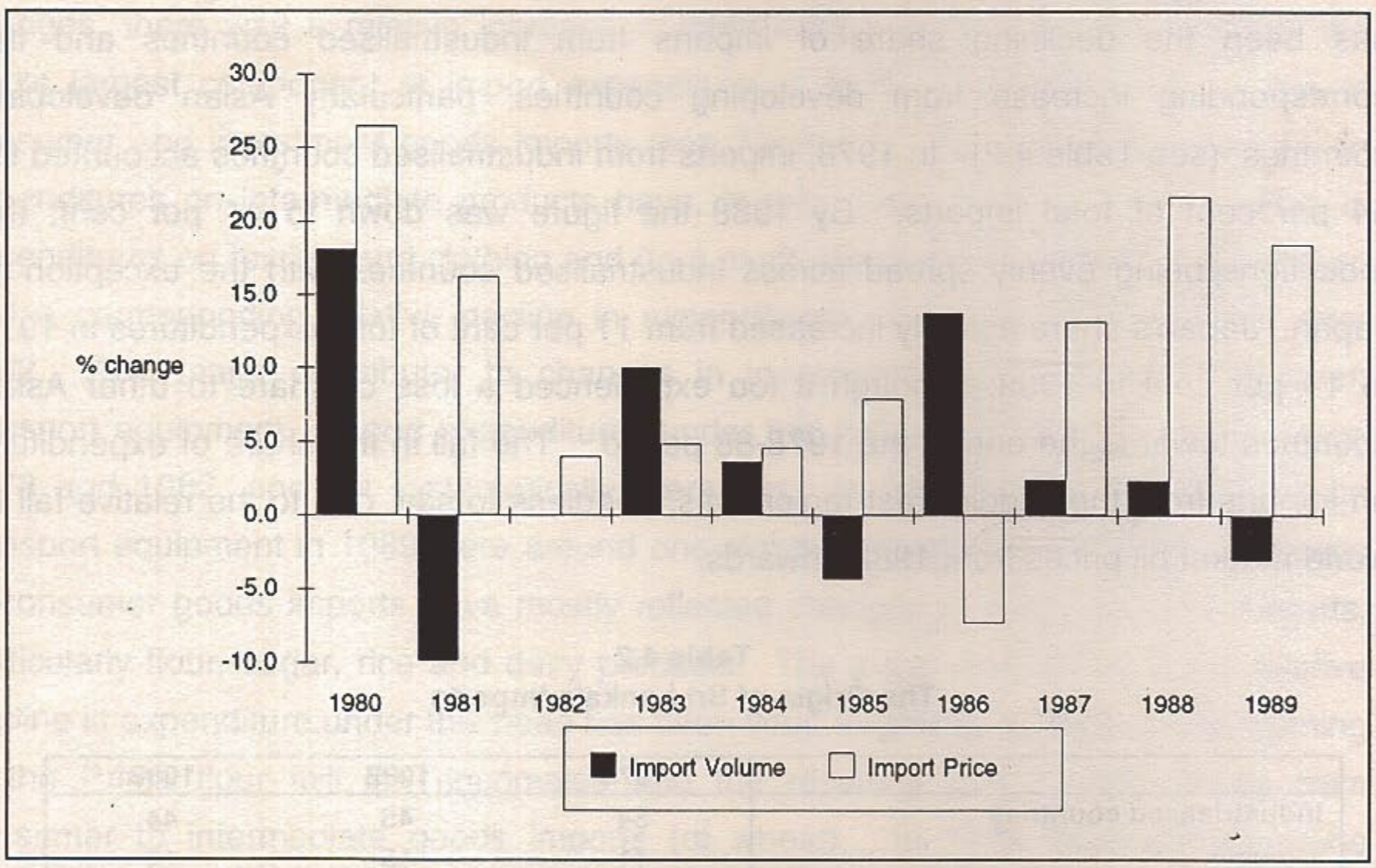
4.1.3 Explanatory Factors

4.1.4 Import Prices and Volumes

Import Prices

One approach to the explanation of changes in expenditure on imports is to analyse separately its two components, price and volume changes. As one might expect, price changes account for most of the observed variation in import value (see Figure 4.1). Between 1980 and 1989 the average increase in import prices amounted to 77 per cent of the average annual increase in import expenditure, with price changes exceeding volume changes in every year except 1983 and 1986.[3]

Figure 4.1
Expenditure on Imports and Import Prices (percentage changes)



As one might also expect, a large part of this increase in import prices is attributable to a depreciation of the rupee. But how much? Between 1980 and 1989 the average annual rate of depreciation of the Sri Lankan rupee in terms of the US

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3. The period 1980-89 is used here because the new, more reliable, trade indices of the Central Bank only begin in 1979.

dollar was around 9 per cent. Assuming that the contribution of the depreciation in the US dollar value of the rupee to the rise in import prices did not exceed the magnitude of the former in any one year, the depreciation of the currency could have contributed at most some 66 per cent of the increase in import prices over this period and, therefore, at most some 50 per cent of the increase in the import bill. It also means that autonomous increases in import prices accounted for at least 25 per cent of the increase in the import bill. If we make the more realistic assumption that currency depreciation was not transmitted in full to all import prices, the extent of the contribution of autonomous price increases could be considerably more, possibly in the range of 30 per cent to 35 per cent of the total increase in import expenditure.

Although currency depreciation appears to have accounted for a large part of the increase in the rupee prices of imports (at both the aggregate and sectoral levels) the movement in the latter over the 1980-89 period was mostly induced by corresponding movements in the foreign currency (US$) price of imports (see Figure 4.2). In other words, movements in the exchange rate for the most part tended to reinforce the impact of external price changes - the exceptions being 1982 and 1983.

At a sectoral level it would appear that changes (increases) in the rupee prices of imports of investment goods were, as one would expect, given the domestic structure of production, most responsive to currency depreciation, and the rupee prices of consumer goods the least responsive. It would also appear that price changes were most important in accounting for changes in expenditure on investment goods (95 per cent) and least important in the case of intermediates (64 per cent). Within the intermediate category, however, there is a significant variation between products. Thus, while price changes accounted for around 80 per cent of changes in expenditure on petroleum imports, they accounted for only 30 per cent of expenditures on textiles and clothing imports.

Import Volumes

Given the composition and diverse end-uses of imports, it is unlikely that aggregate import volumes can be linked to any single explanatory variable such as real income changes. In fact, changes in the former appear to bear little or no relation to changes in the latter. A study of the sectoral components of aggregate imports,

Figure 4.2
US$ and Sri Lankan Rupee Prices of Imports 1980-89 - percentage changes

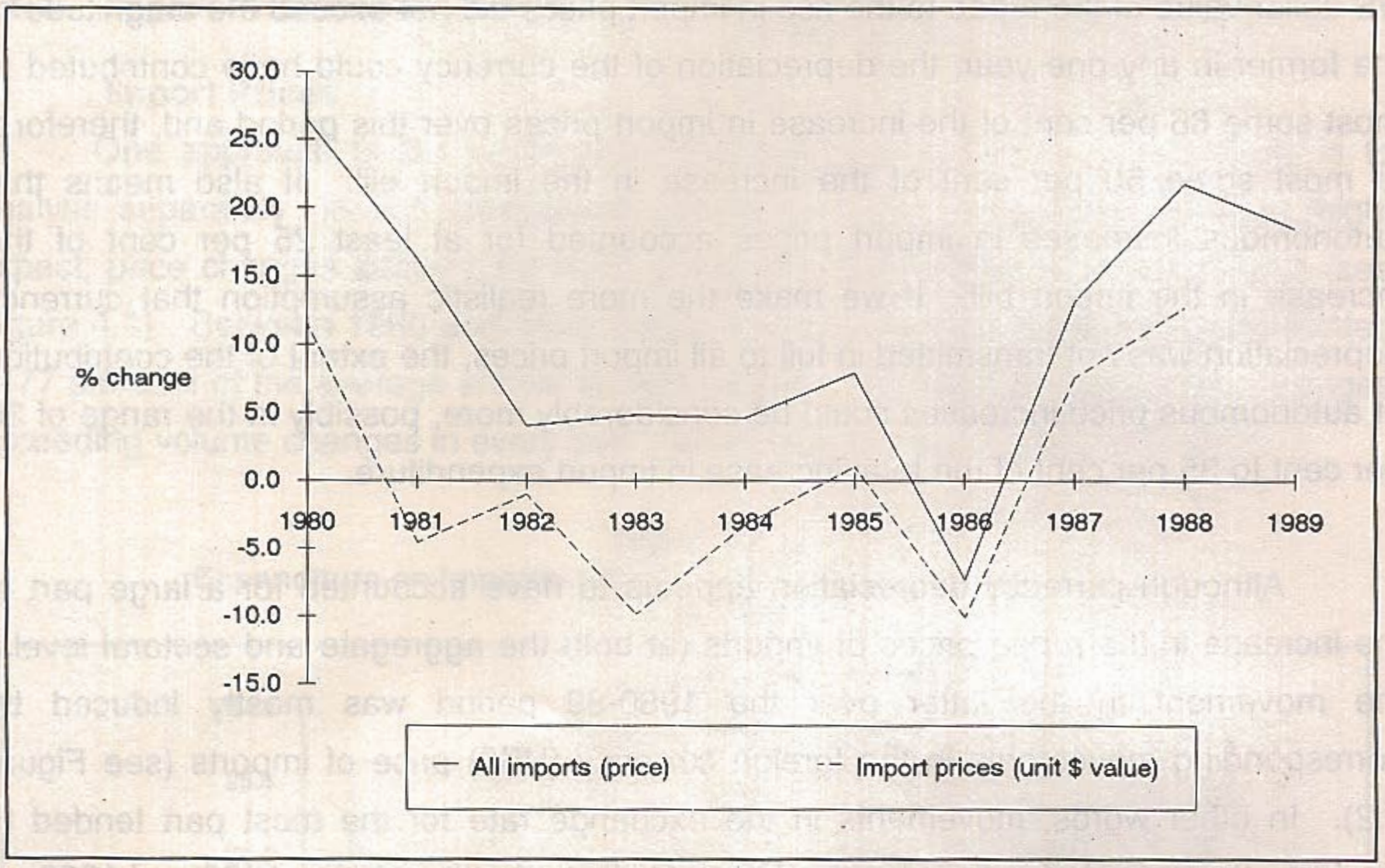
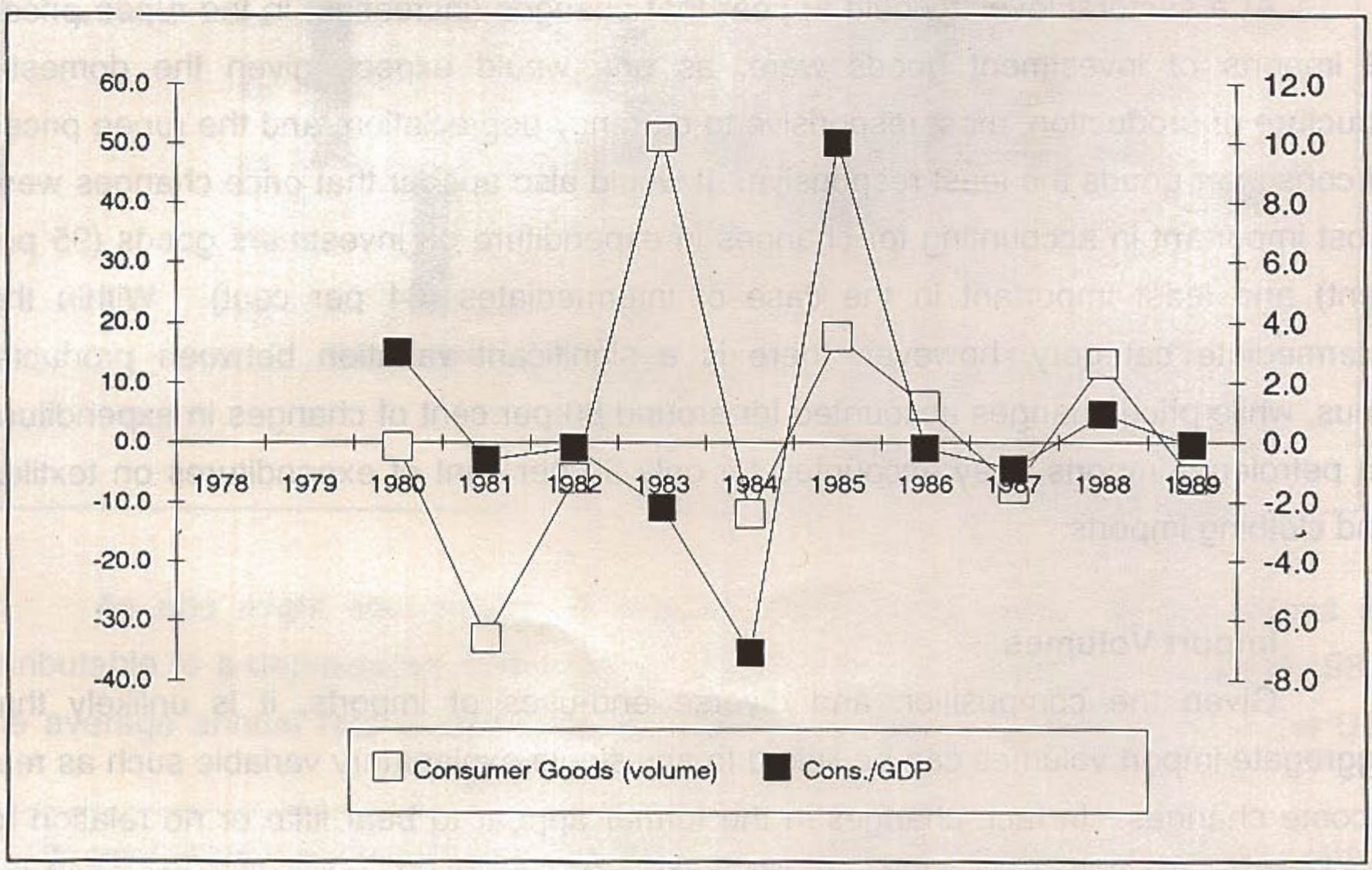
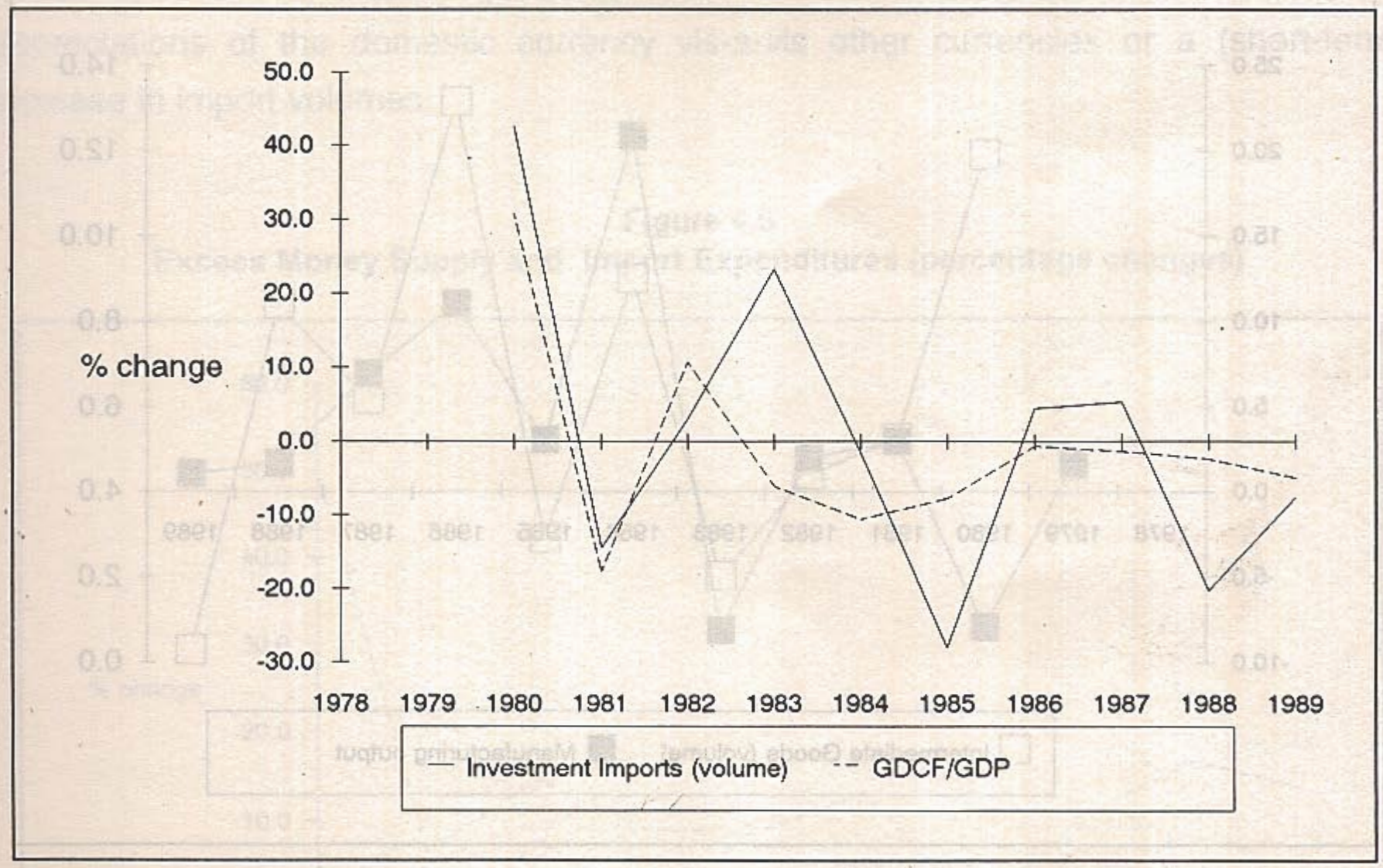


Figure 4.3 Consumer Goods Import Volumes and Consumption Expenditure/GDP 1980-89 - percentage changes



however, proves to be more fruitful. As one would expect, volume changes are mostly related to demand factors. Thus, there appears to be a reasonably good fit between, on the one hand, consumption and investment expenditures (as a proportion of GDP) and, on the other hand, changes in consumer and investment goods import volumes (see Figures 4.3 and 4.4). There is a significant improvement in the relation between consumer goods imports and consumption expenditure if 1983 is excluded - it being an exceptional year in which civil strife and drought combined to raise the volume of

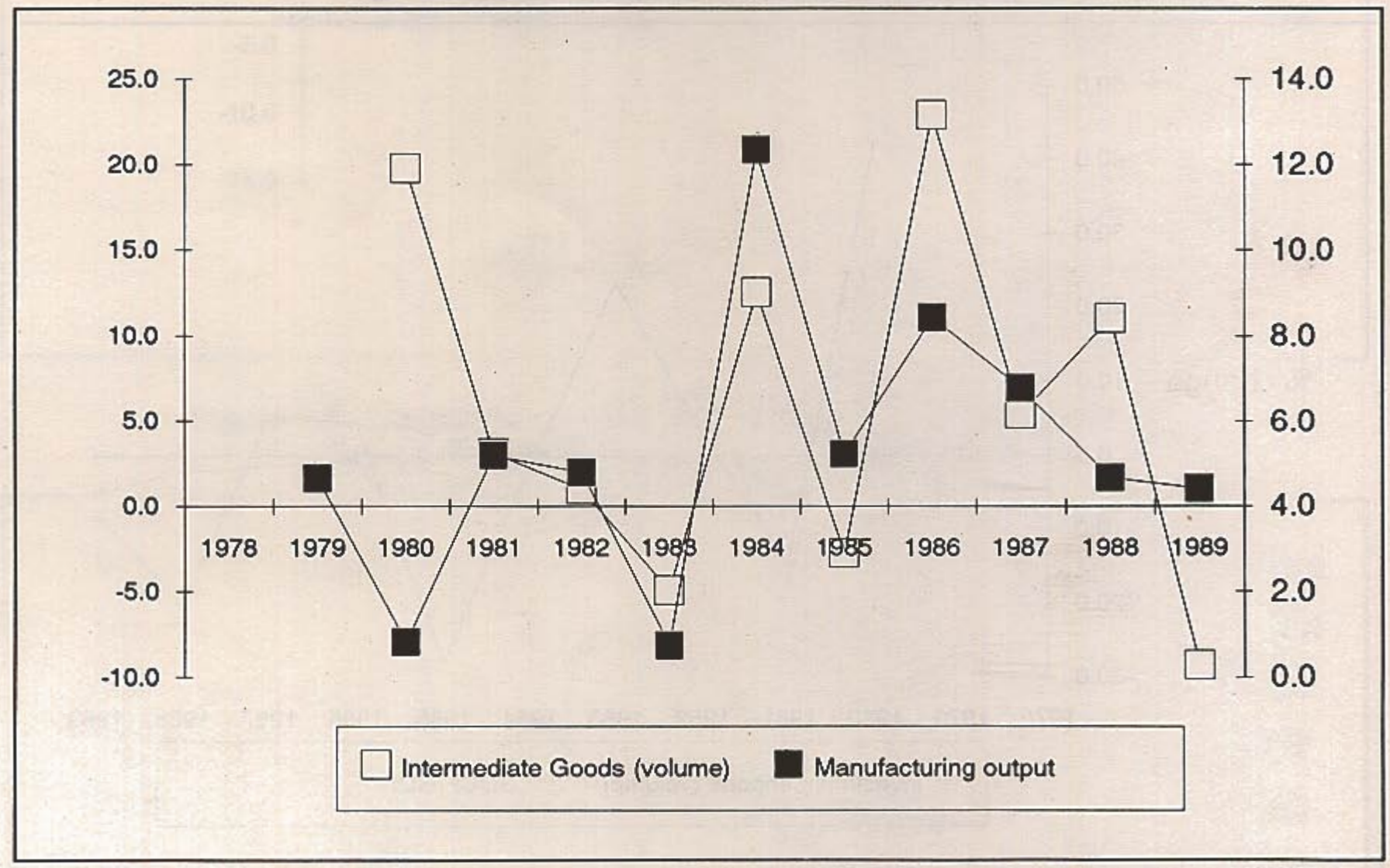
Figure 4.4
Investment Goods Import Volumes and Investment Expenditure/GDP1980-89 - percentage changes



consumption imports massively. Interestingly, there also appears to be a discernible inverse relation between changes in the volume of consumption and investment imports after 1983, that is, from a point when the pace of investment had slackened, demand pressures had abated, and a serious attempt was made to keep the current account balance under control. Since intermediate goods imports are primarily inputs into manufacturing processes one would expect, and find, a correspondence between changes in the volume of intermediate imports and changes in the volume of

manufacturing output, especially if fertiliser imports are excluded from the intermediate goods category (see Figure 4.5). 1981 and 1988 are odd years. 1988 could be justified in terms of the interruptions to manufacturing production as a result of civil strife, but the reason for 1981 is less clear. One possible explanation could be that the massive contraction in government investment expenditure in that year spilt over into its demand for intermediates.

Figure 4.5
Intermediate Goods Import Volumes and Manufacturing Output 1980-89 - percentage changes

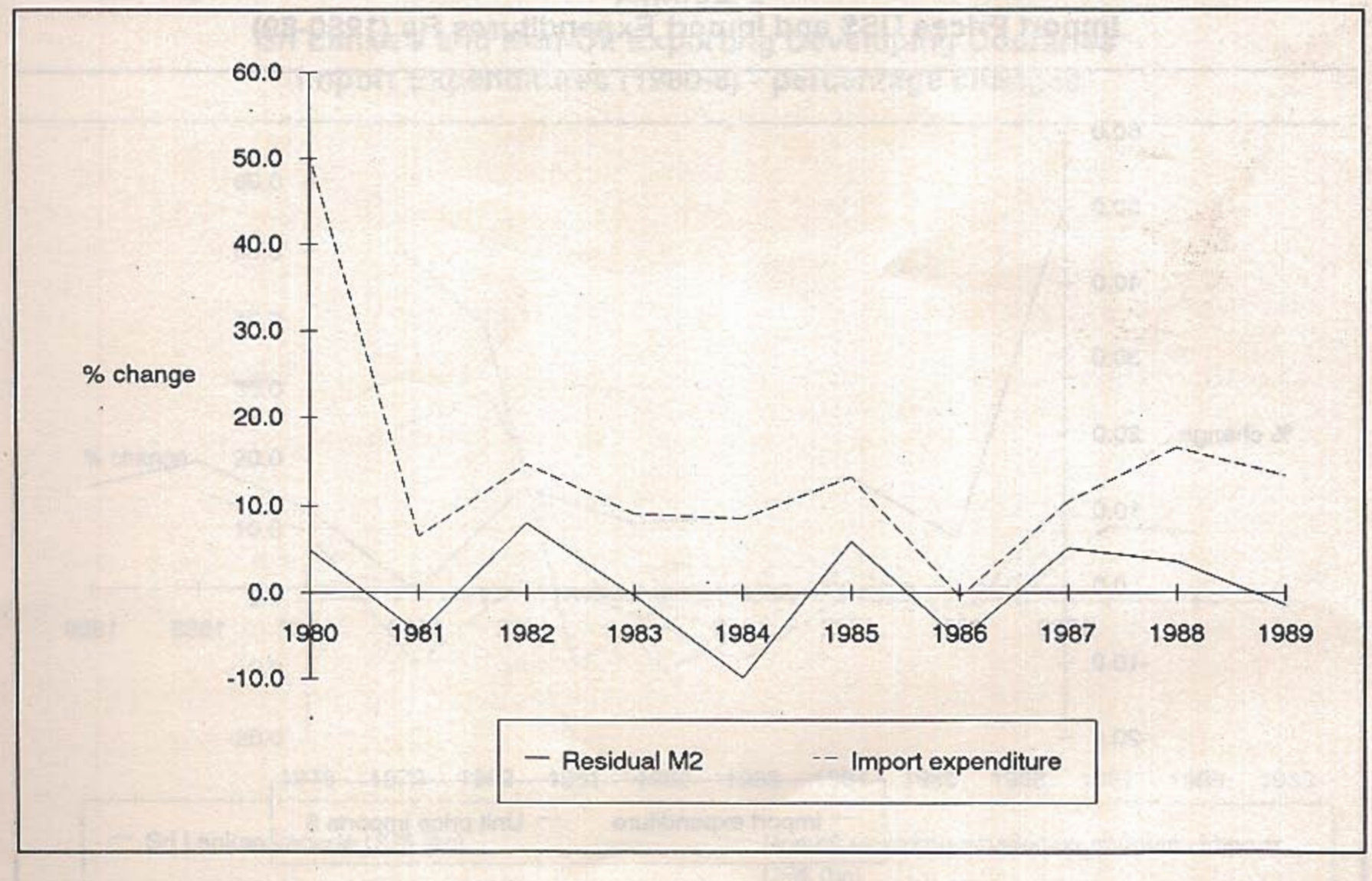


Finally, there is some evidence of volume changes being responsive to price changes but only in the period after 1983. The same reasons advanced above to explain the appearance of the inverse relation between consumer and investment good import volumes after 1983 could be used to explain the appearance of the inverse relation between import volumes and prices.

4.1.5 The Monetary Approach to the Balance of Payments

A second approach to the explanation of changes in import expenditures is provided by the so-called monetary approach to the balance of payments. The monetary approach to the balance of payments is an extension of the logic of Monetarist-type analyses to the open economy context. This approach contends that increases in import expenditures are the result of increases in the money stock. An increase in the money stock leads to excess holdings of (real) money balances by individuals. They respond by spending the excess money balances. This increase in expenditure leads, on the one hand, to an increase in the domestic price level, and, on the other, to an increase in import expenditures, whether these expenditures comprise depreciations of the domestic currency vis-a-vis other currencies or a (short-term) increase in import volumes.

Figure 4.6
Excess Money Supply and Import Expenditures (percentage changes)

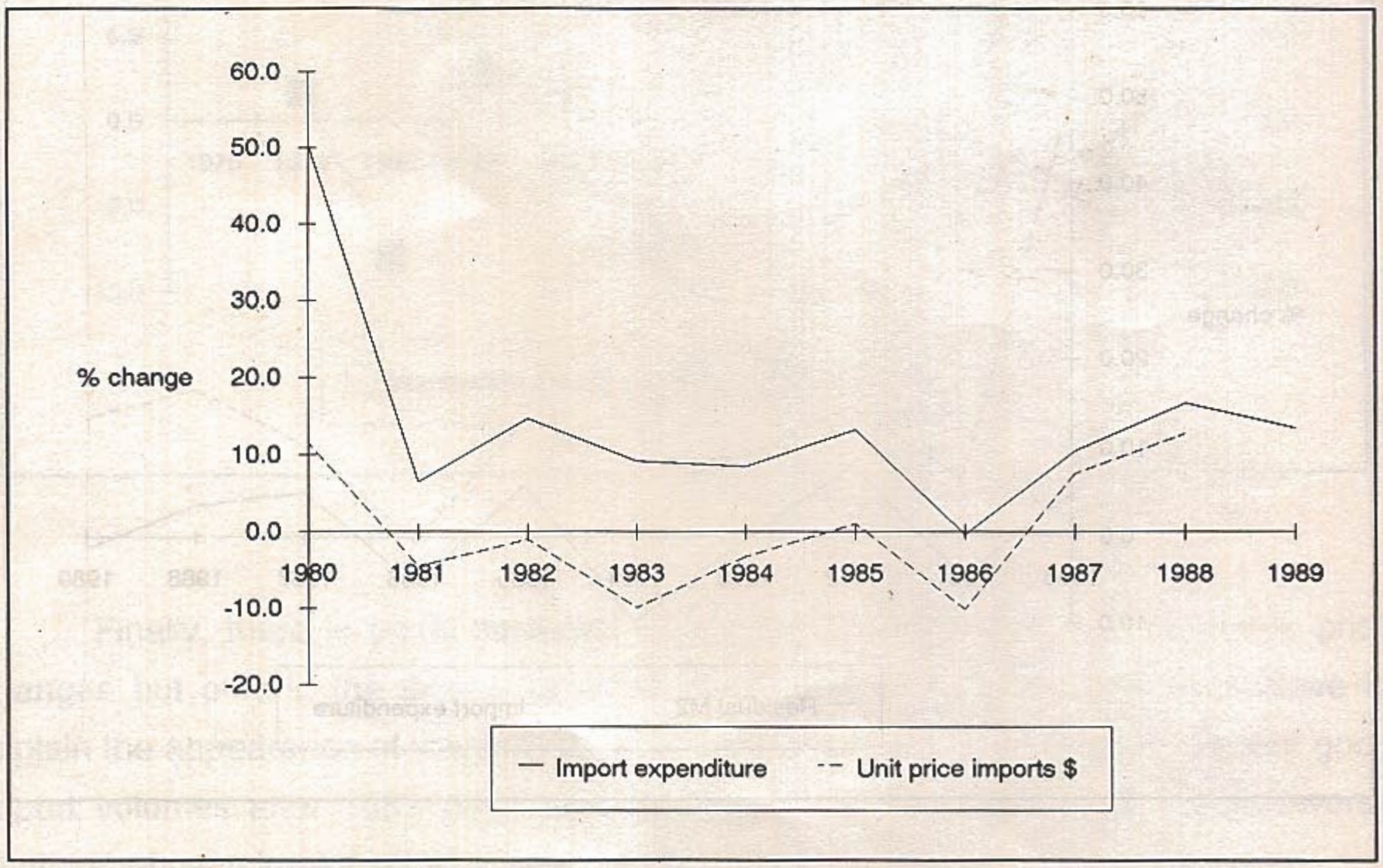


One way of directly testing the validity of the monetary approach is to define excess money supply as money supply changes which exceed changes in gross

domestic expenditure, and relate these (changes in excess money supply) to changes in import expenditures. Figure 4.6 is a plot of changes in excess of money supply and import expenditures. The reasonably close joint movement of the two variables would seem at first glance to provide strong support for the monetary approach.

It needs pointing out, however, that Figure 4.6 is also consistent with an alternative explanation running from autonomous changes in import volumes and prices to accommodating changes in money stock. Thus, an increase in import expenditure resulting from exogenous increases in import prices and/or growth-induced increases in import volumes exert, in the context of an accommodating monetary policy, an upward pressure on the domestic price level as well as exacerbating payments imbalances. This in turn puts pressure on the exchange rate, changes in which further exacerbate these pressures. Support for this alternative explanation of the observed phenomena comes in the form of Figure 4.7, which is a plot of changes in the US dollar price of

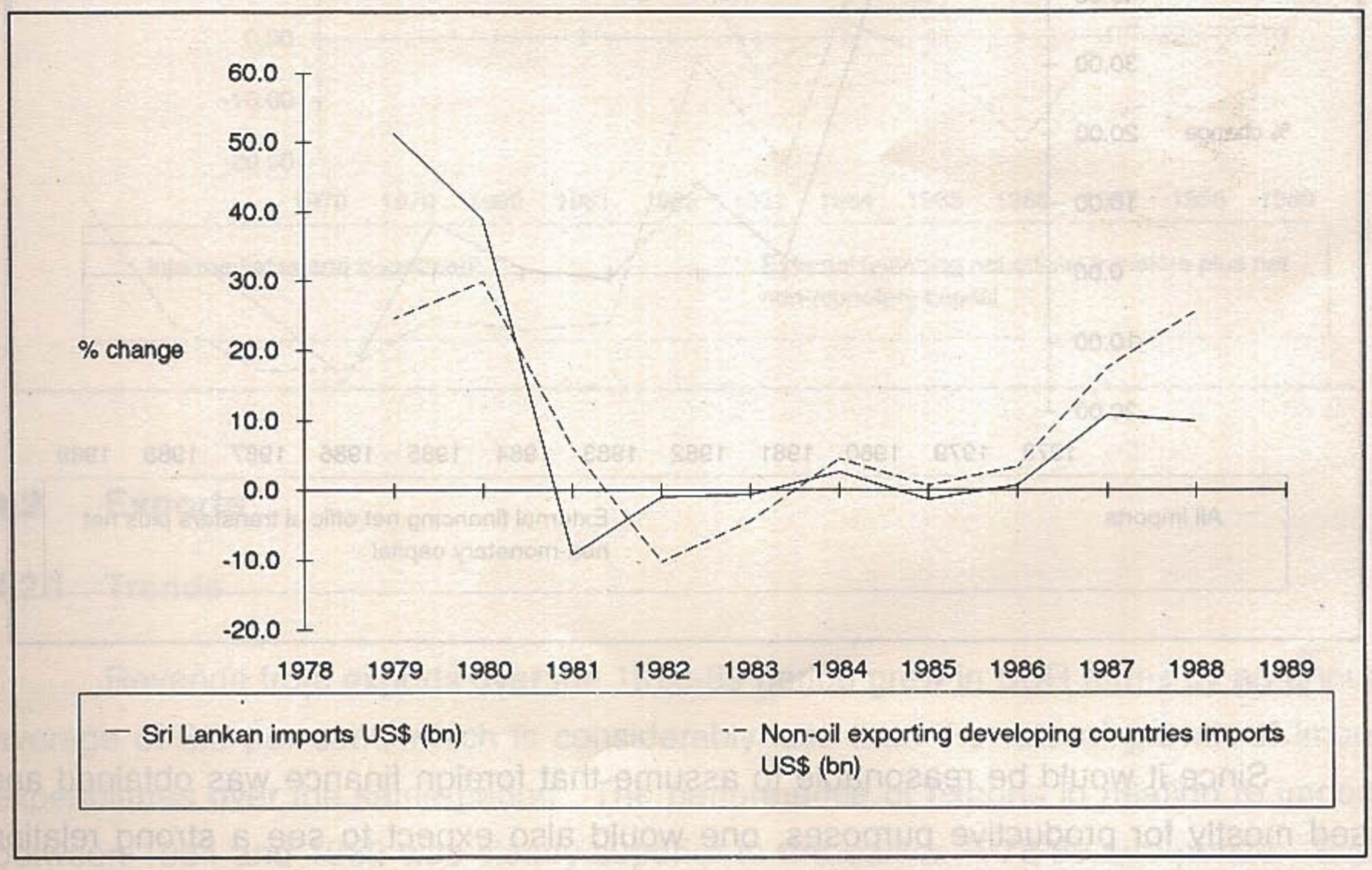
Figure 4.7
Import Prices US$ and Import Expenditures Rs (1980-89)



4.1.6 Trends in Import Expenditures of Other Developing Countries

A further indication of the extent to which Sri Lanka's import expenditures are influenced by external factors, is derived from a comparison of the pattern of these expenditures over time with those of other (non-oil exporting) developing countries. Figure 4.8 is a graph of the percentage changes in the US dollar value of import expenditures by Sri Lanka and other non-oil exporting developing countries. It tends to confirm the expected relation. The exceptional year is 1982 when import expenditures in Sri Lanka continued to rise while those of non-oil producing countries contracted. The explanation for this discrepancy is that the change in 1982 represents, in part, a correction in Sri Lanka's import expenditures with respect to the preceding year's excessive policy-induced contraction. The fact that Sri Lanka's import expenditures have risen by less than those of other non-oil exporting developing countries, after 1983, is attributable to the impact on investment and output of the political turmoil during this period.

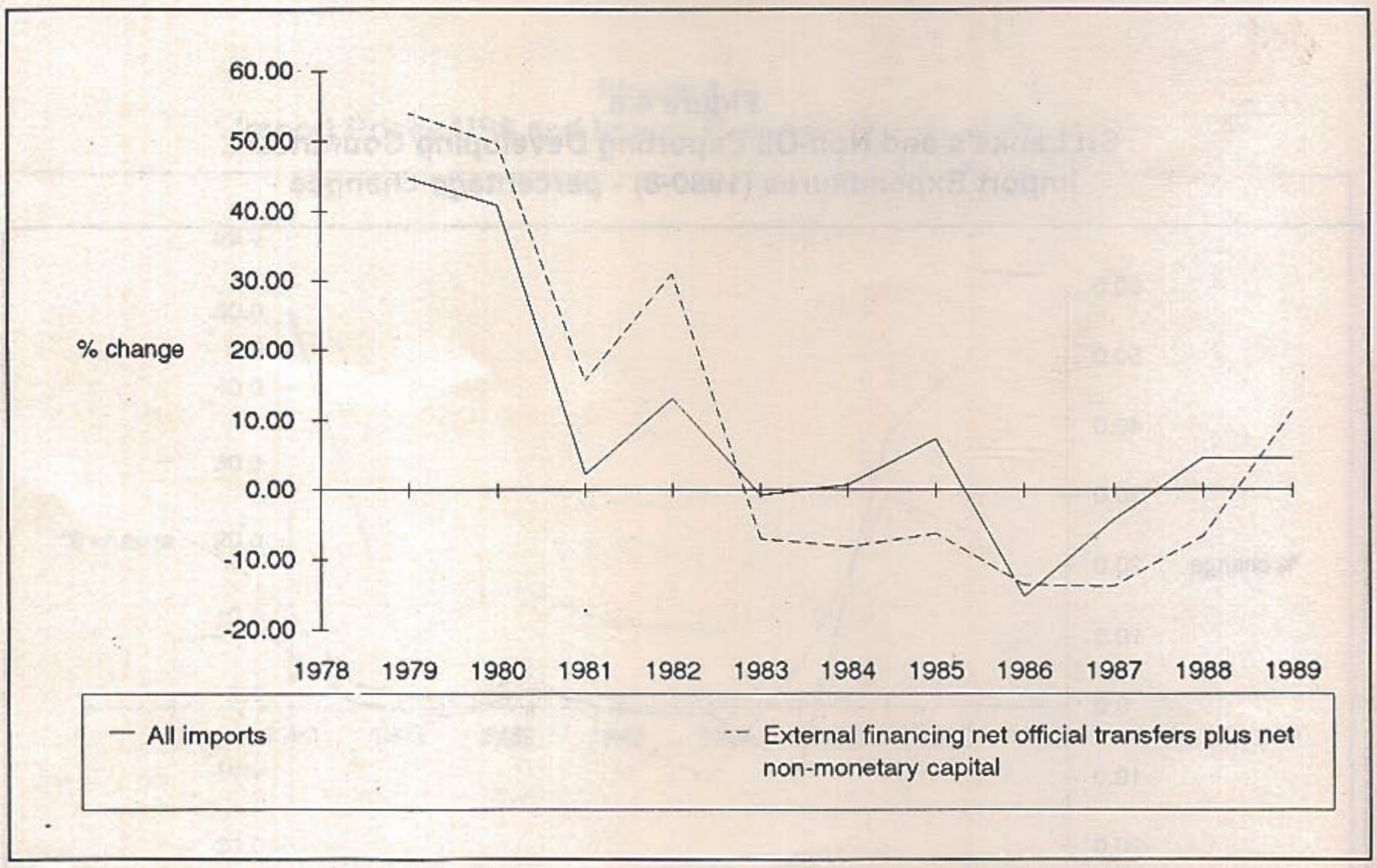
Figure 4.8
Sri Lanka's and Non-Oil Exporting Developing Countries' Import Expenditures (1980-8) - percentage changes



4.1.7 Foreign Financing - a Catch 22

Consideration needs also to be given to the role of foreign finance in the determination of import expenditures. Much of the expanded foreign financing available to Sri Lanka in the post- 1977 period, by way of grants and loans, was used to pay for imports, particularly those of intermediate and investment goods. Figure 4.9 is a plot of changes in the SDR value of net official grants and net non-monetary capital flows against changes in the SDR value of expenditures on all imports. It may be seen that the relationship between the two variables is a close one, with the possible exception of 1989. The discrepancy in this year is again attributable to the economic dislocation which resulted from the prevailing political turmoil.

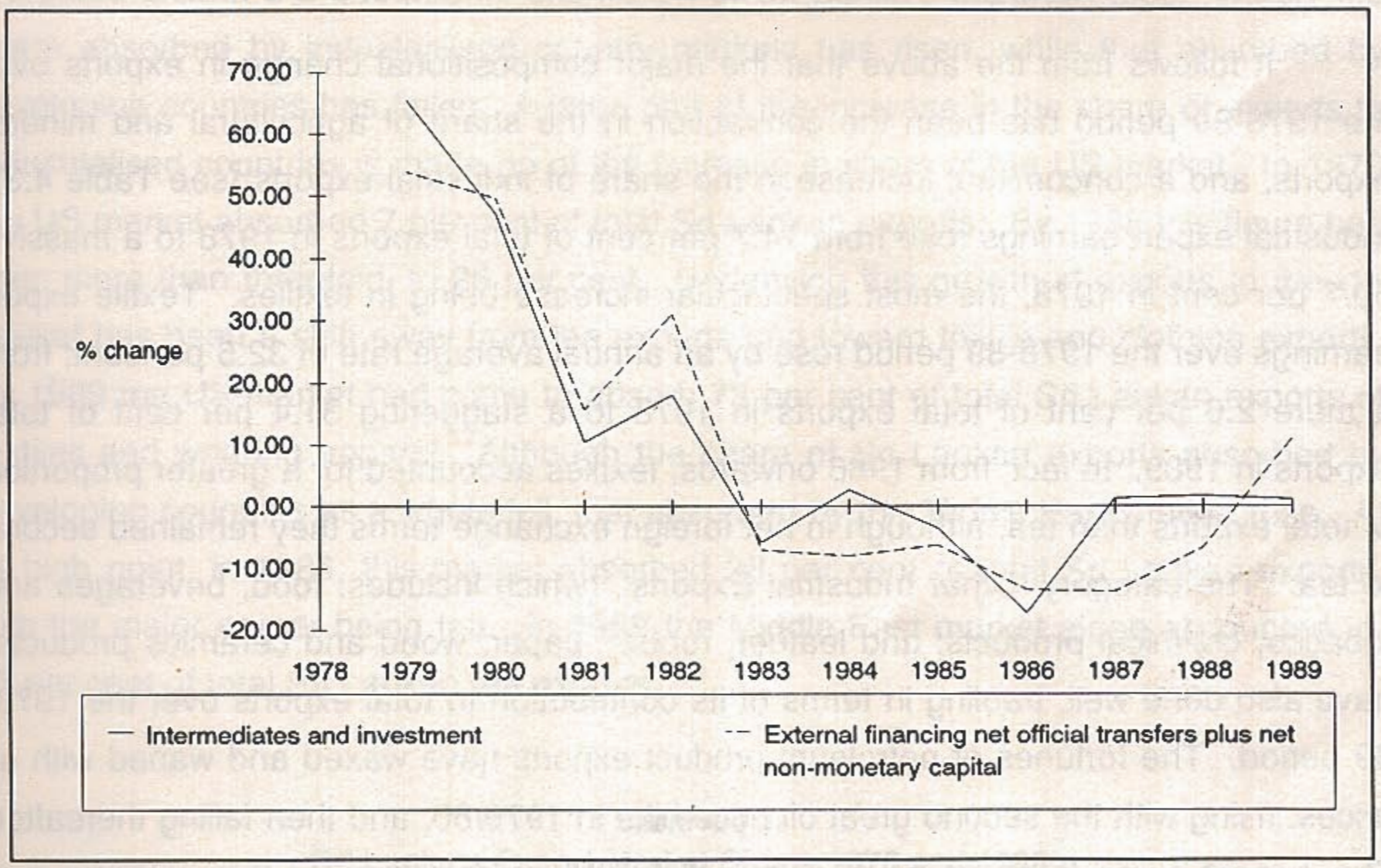
Figure 4.9
External Financing and Import Expenditures (1979-89) - percentage changes



Since it would be reasonable to assume that foreign finance was obtained and used mostly for productive purposes, one would also expect to see a strong relation between foreign financial flows and expenditures on intermediate and investment

commodities. Figure 4.10 provides general support for this contention, although the movement of the two variables in 1984 warrants comment. In 1984, expenditures on intermediate and investment imports rose appreciably, while the magnitude of external financing actually declined. The explanation for this apparent anomaly may be found in the windfall tea earnings of that year which diminished the need for external import expenditure support.

Figure 4.10
External Financing and Intermediate and Investment Goods Expenditures (1979-89) - percentage changes



4.2 Exports

4.2.1 Trends

Revenue from exports over the 1978-89 period grew in SDR terms by an annual average of 6.2 per cent, which is considerably less than the rate of growth of import expenditures over the same period. The performance of exports in relation to imports between 1984 and 1989 was clearly superior to the earlier 1978-83 sub-period. Even

allowing for the distorting influence of 1984 in these comparisons, there appears to be a distinct improvement in the export performance of the Sri Lankan economy in recent years. Thus, exports as a proportion of GDP rose by 17 per cent between 1986 and 1989. At a sectoral level, industrial exports have outperformed all others. Between 1978 and 1989 the average annual growth rate of industrial export earnings in SDR terms was 21 per cent, more than treble the average annual growth rate of agricultural export earnings (at 6 per cent) over the same period.

4.2.2 Composition and Markets

It follows from the above that the major compositional change in exports over the 1978-89 period has been the contraction in the share of agricultural and mineral exports, and a concomitant increase in the share of industrial exports (see Table 4.3). Industrial export earnings rose from 14.7 per cent of total exports in 1978 to a massive 50.7 per cent in 1978, the most spectacular increase being in textiles. Textile export earnings over the 1978-89 period rose by an annual average rate of 32.5 per cent; from a mere 2.6 per cent of total exports in 1978 to a staggering 31.4 per cent of total exports in 1989. In fact, from 1986 onwards, textiles accounted for a greater proportion of total exports than tea, although in net foreign exchange terms they remained second to tea. The category 'Other Industrial Exports', (which includes: food, beverages and tobacco, chemical products; and leather, rubber, paper, wood and ceramics products) have also done well, trebling in terms of its contribution to total exports over the 1978-89 period. The fortunes of petroleum product exports have waxed and waned with oil prices; rising with the second great oil price hike in 1979/80, and then falling thereafter. The current surge in oil prices augurs well for the performance of this category and could at least partly mitigate its deleterious import-side impact. Finally, agricultural export earnings grew by a meagre 7 per cent per annum over the 1978-89 period as a whole. From contributing 79 per cent of total export receipts in 1978, agricultural *exports contributed only 39 per cent in 1989. The biggest contraction in this sector was* in tea exports. In 1978 tea exports amounted to just under half of total export earnings. By 1989 its share was down to less than a quarter. In relative terms the performance of rubber exports has been even worse. The contribution of rubber to total export earnings in 1989 was only a third of its contribution in 1978.

Table 4.3
The Composition of Export Receipts 1978-89

	1978	1982	1989
Agricultural	78.9	54.3	39.3
Tea	48.5	29.6	24.3
Industrial	14.7	38.6	50.7
Textiles and Wearing Apparel	3.6	16.3	31.4
Mineral	6.4	4.0	4.8

Source: "Annual Report 1989", Central Bank of Sri Lanka

Along with export product diversification in the post-1977 period, there has been a marked shift in the geographic orientation of Sri Lanka's exports. Most notably the share absorbed by industrialised country markets has risen, while that absorbed by developing countries has fallen. A large part of the increase in the share of exports to industrialised countries is made up of the increase in share of the US market. In 1978 the US market absorbed 7 per cent of total Sri Lankan exports. By 1988 this figure had risen more than threefold, to 25 per cent. Underlying this growth in exports to the US market has been a shift away from tea exports and toward textile and clothing exports. By 1989 the US market had come to absorb 73 per cent of total Sri Lankan exports of textiles and wearing apparel. Although the share of Sri Lankan exports absorbed by developing countries as a whole fell, that absorbed by the Middle East market rose. At its high point, in 1984, this market absorbed 28 per cent of total Sri Lankan exports, with the major earner being tea. In 1989 the Middle East market alone accounted for 55 per cent of total Sri Lankan tea exports.

Table 4.4
Sri Lanka's Export Market Share, 1978 and 1988

	1978	1988
Industrialised Countries	39	59
United States	7	25
Developing Countries	50	36
Asia	18	14
Middle East	10	18

Source: "Annual Report 1989", Central Bank of Sri Lanka

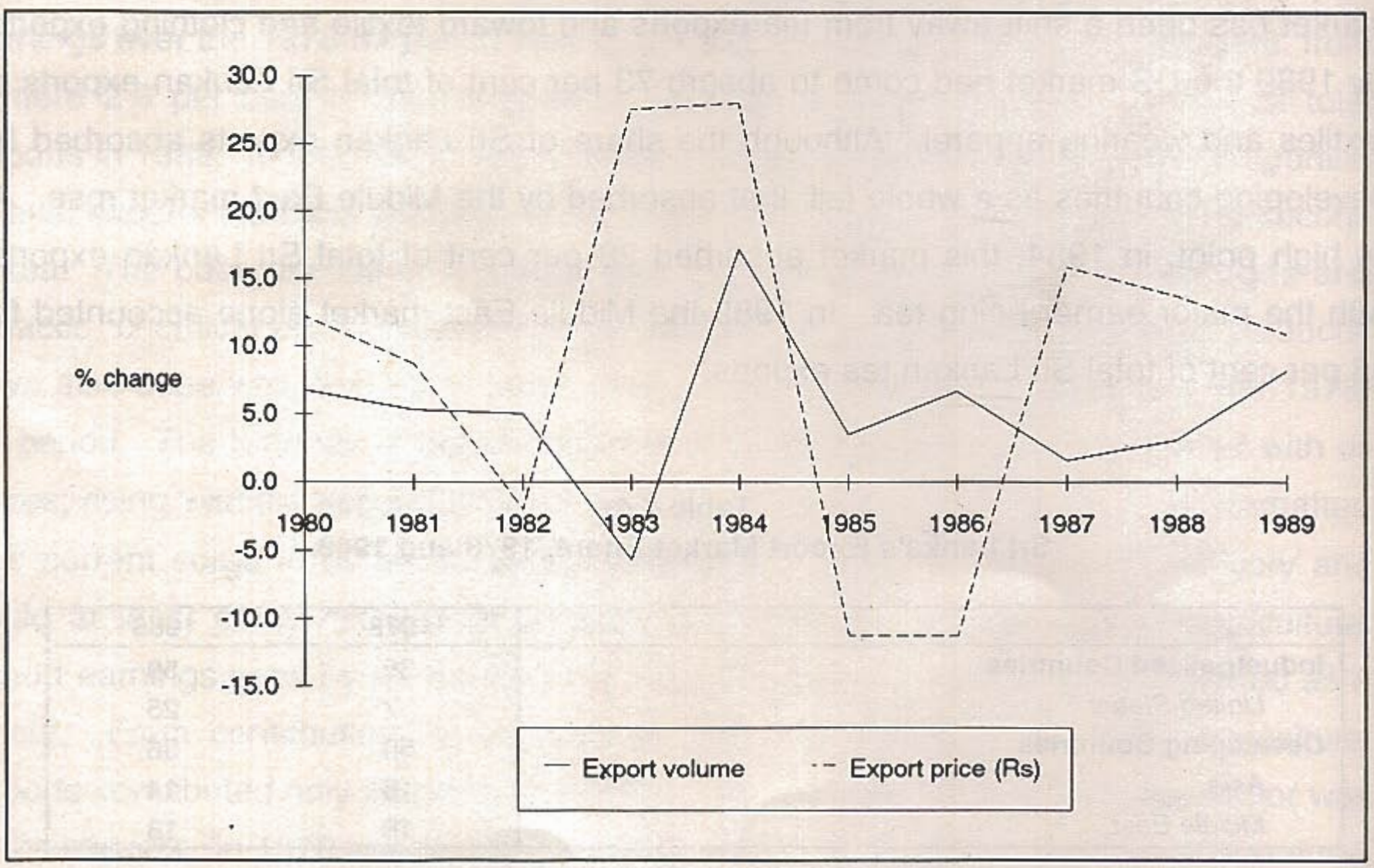
4.2.3 Explanatory Factors

4.2.3.1 Export Volumes

Export volume increases account for 35 per cent of the average annual increase in export receipts between 1980 and 1989. Hence the contribution of volume to value changes was considerably greater in the case of exports than in the case of imports.

One factor which could explain the observed changes in export volumes is Rupee export prices. An increase or decrease in the Rupee price of the exportable commodity should encourage a corresponding change in its supply. Comparing changes in the unit Rupee price of exports with volume changes, however, appears to contradict this hypothesis (see Figure 4.11). Arguably the reason for the apparently

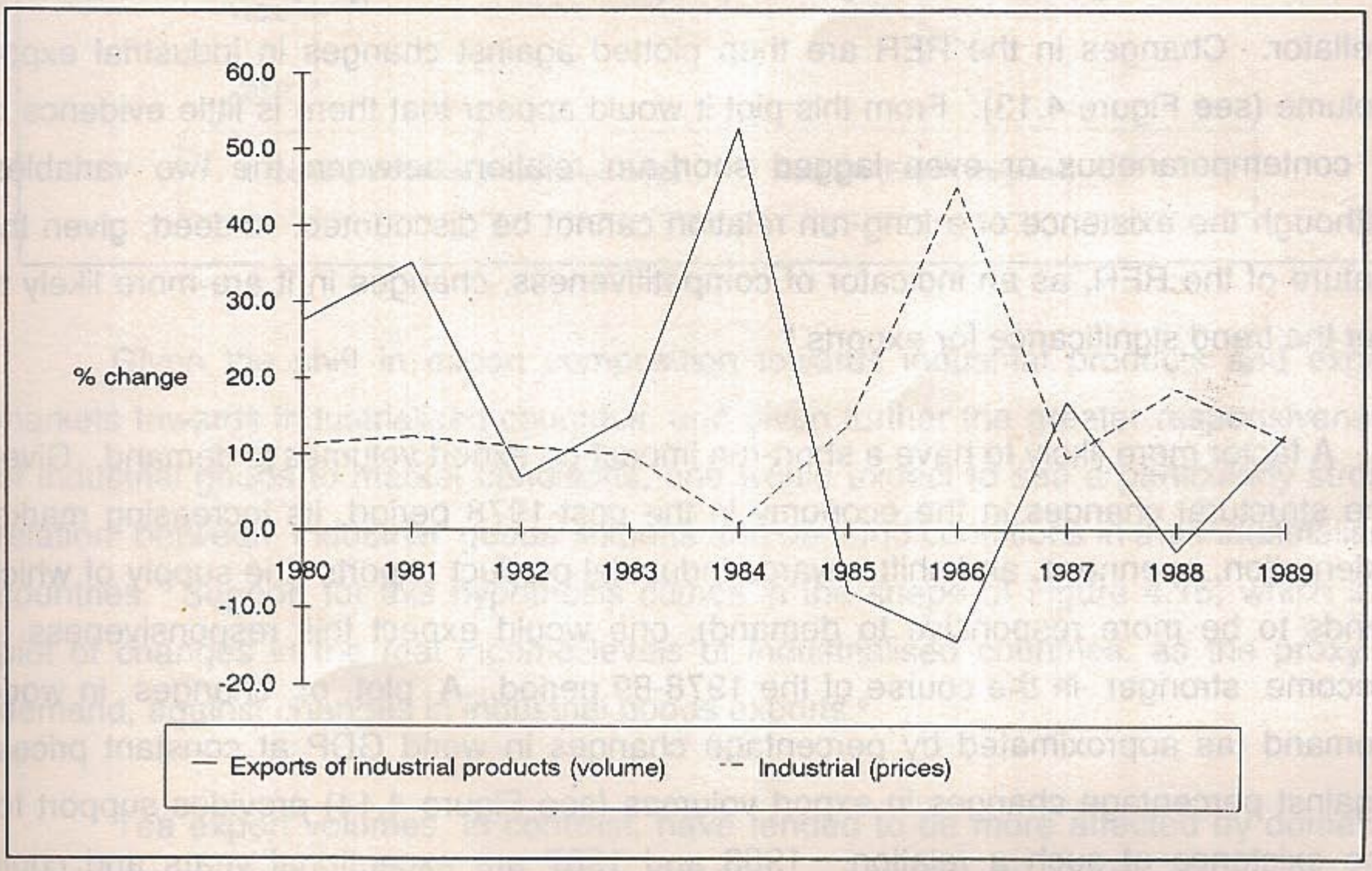
Figure 4.11
Export Volume and Price Changes 1980-89 (percentage changes)



poor relation between the two variables is aggregation across different commodity types, the supply behaviour of each being very different. For example, while industrial

production is fairly flexible over the short-run, agricultural production is not. Accordingly, we would expect at least industrial exports to be responsive to price changes. The changes in industrial export volumes compared with changes in industrial export prices (see Figure 4.12) do not, however, support this contention. Figure 4.12 seems to indicate that the relation between industrial export volumes and prices is, if anything, perverse. Lagging export volume changes by one year improves the fit of the two series, but only from 1986 onwards. The generally poor relation between industrial export volumes and prices is perhaps partly to be explained by the fact that the major component of industrial exports is textiles and garments, and that the export of these is, in large measure, subject to quota restrictions in their principal markets.[4]

Figure 4.12
Industrial Export Volumes and Prices 1980-89 (percentage changes)



It could be argued that the apparent non-correspondence between export volumes and Rupee prices is also caused by movements in the real exchange rate

4. That there is an improvement in the relation between price and volume changes of industrial exports in the subsequent years is perhaps to be explained by the diversification of the products and their markets in this category.

(RER) and its impact on export performance. The real exchange rate is a measure of a country's competitiveness. Operationally it is defined as:

$$RER = EP_T/P_N$$

Where,

E = the nominal exchange rate
P_T = the world price of tradeables
P_N = the domestic price of non-tradeables

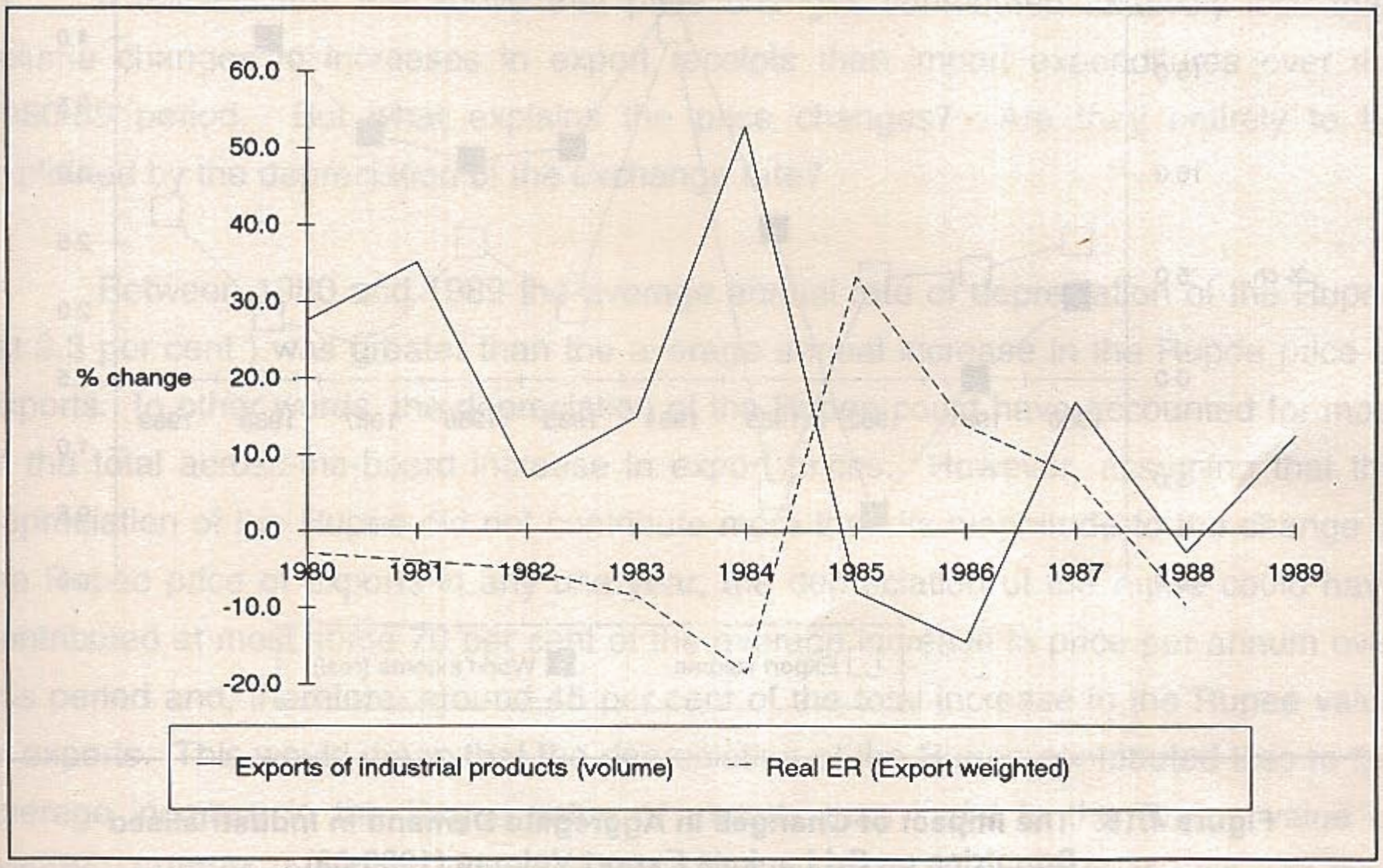
A fall (appreciation) in the RER indicates a deterioration of a country's competitiveness and, conversely, a rise (depreciation) in the RER indicates an improvement in its competitiveness. In assessing the impact of changes in the RER on Sri Lanka's exports, P_T is approximated by a composite index of the GDP deflators of Sri Lanka's trading partners - weighted by export share - and P_N by the domestic GDP deflator. Changes in the RER are then plotted against changes in industrial export volume (see Figure 4.13). From this plot it would appear that there is little evidence of a contemporaneous or even lagged short-run relation between the two variables, although the existence of a long-run relation cannot be discounted. Indeed, given the nature of the RER, as an indicator of competitiveness, changes in it are more likely to set the trend significance for exports.[5]

A factor more likely to have a short-run impact on export volumes is demand. Given the structural changes in the economy in the post-1978 period, its increasing market orientation, openness, and shift towards industrial product exports (the supply of which tends to be more responsive to demand), one would expect this responsiveness to become stronger in the course of the 1978-89 period. A plot of changes in world demand (as approximated by percentage changes in world GDP at constant prices) against percentage changes in export volumes (see Figure 4.14) provides support for the existence of such a relation. 1983 and 1987 are exceptional years and could perhaps be explained to some extent by the severe economic dislocation resulting from civil strife in those years.

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5. It needs also to be said that in the post-1978 Sri Lankan context it is perhaps more appropriate to consider changes in the real effective exchange rate (REER), since the latter takes into account taxes and subsidies on tradeables and these have been significant during this period.

Figure 4.13
Industrial Export Volumes and the Real Exchange Rate
1980-89 (percentage changes)



Given the shift in export composition towards industrial products and export markets towards industrialised countries, and given further the greater responsiveness of industrial goods to market conditions, one would expect to see a particularly strong relation between industrial goods exports and demand conditions in the industrialised countries. Support for this hypothesis comes in the shape of Figure 4.15, which is a plot of changes in the real income levels of industrialised countries, as the proxy of demand, against changes in industrial goods exports.[6]

Tea export volumes, in contrast, have tended to be more affected by domestic supply-side factors such as the climate and, more recently, the political and security situation.

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6. It warrants noting here that the World Bank Development Report 1990 also finds "Growth in the output and exports of developing countries is closely correlated with demand in the industrialised countries." (p12)

Figure 4.14: Real World Income and Sri Lankan Export Volumes (percentage changes) - 1980-89

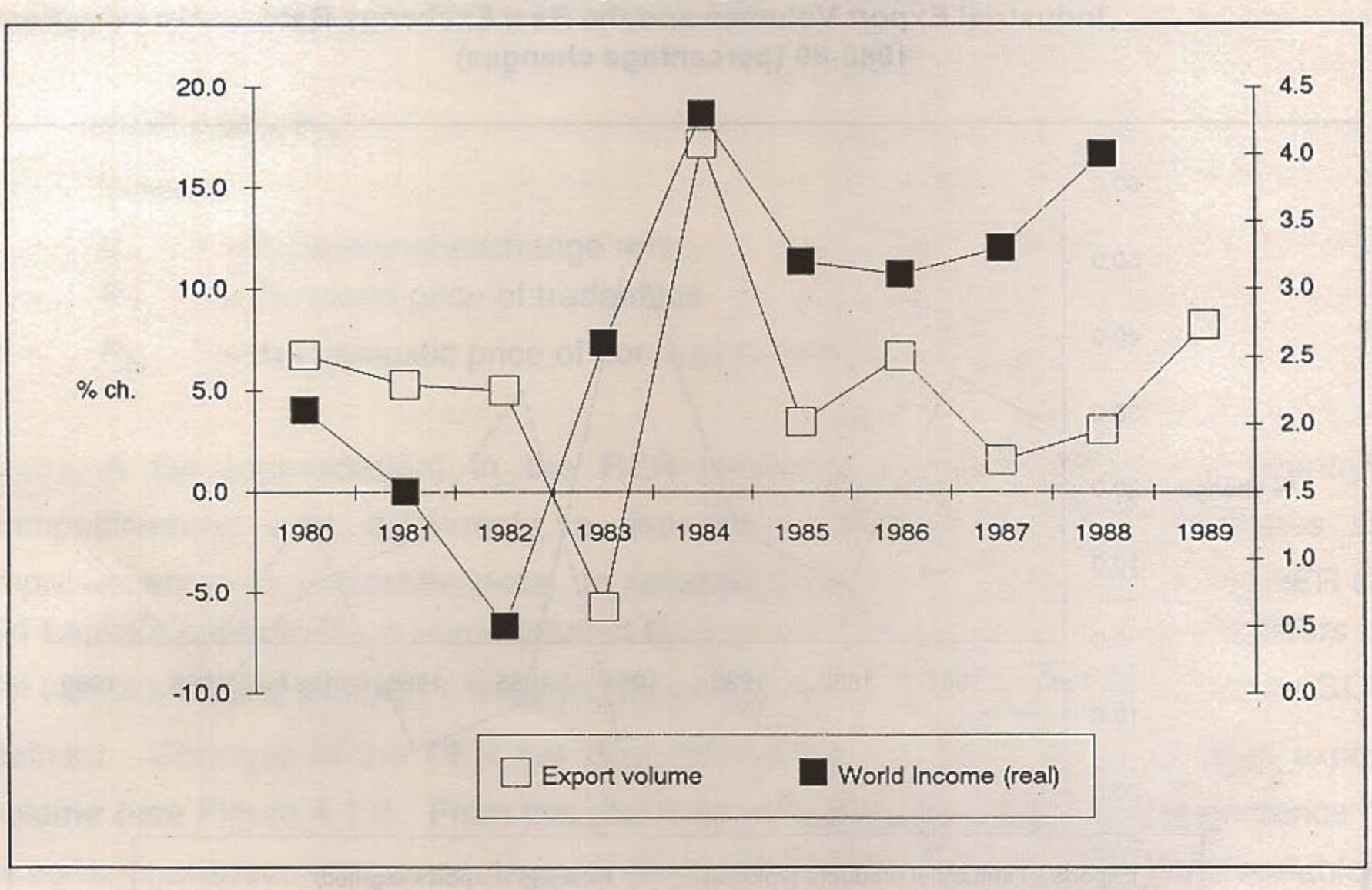
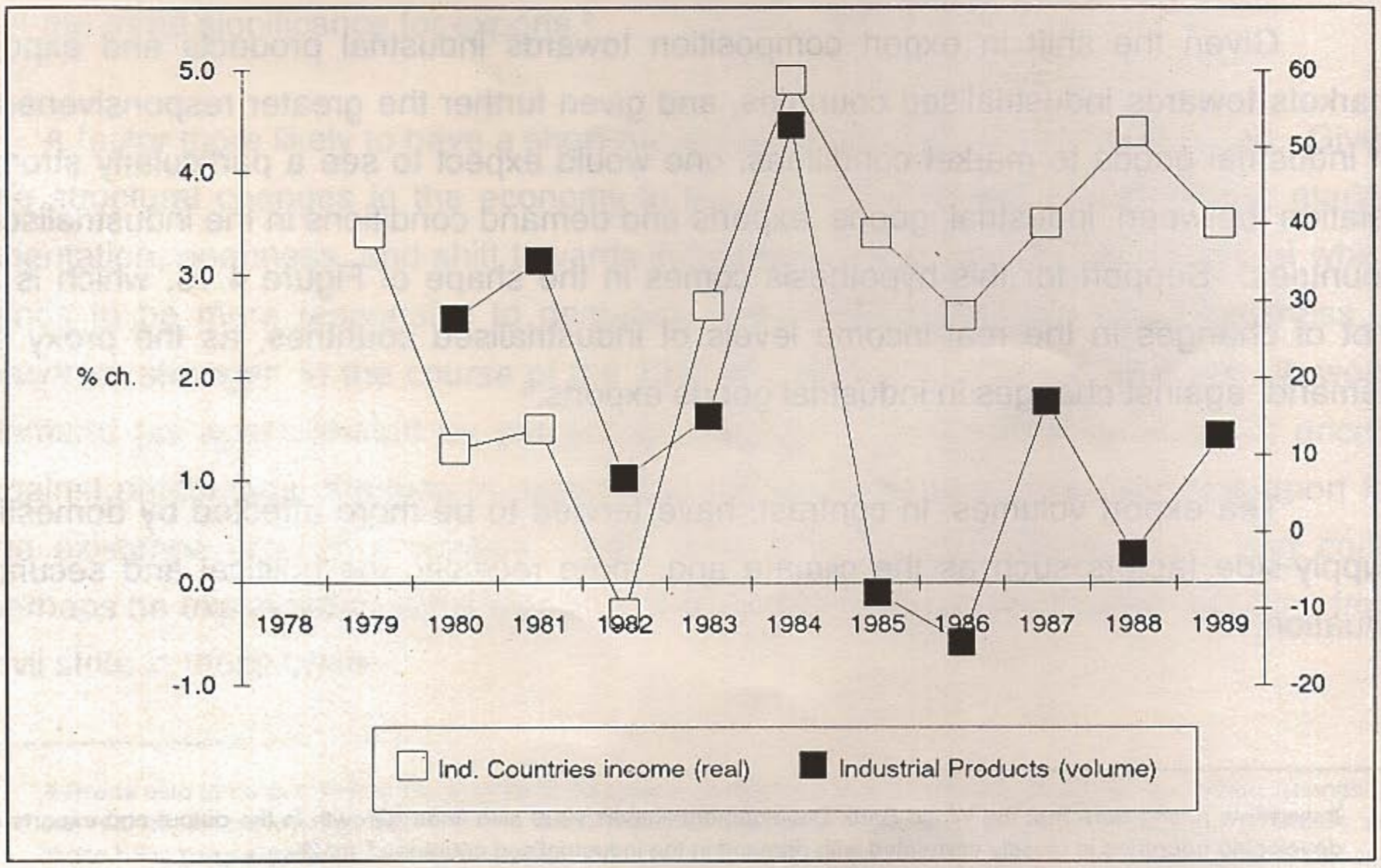


Figure 4.15: The Impact of Changes in Aggregate Demand in Industrialised Countries on Sri Lanka's Export Volume (1980-89)



4.2.3.2 Export Prices

It follows from the above that price changes contributed relatively less than volume changes to increases in export receipts than import expenditures over the 1980-89 period. But what explains the price changes? Are they entirely to be explained by the depreciation of the exchange rate?

Between 1980 and 1989 the average annual rate of depreciation of the Rupee (at 9.3 per cent) was greater than the average annual increase in the Rupee price of exports. In other words, the depreciation of the Rupee could have accounted for most of the total across-the-board increase in export prices. However, assuming that the depreciation of the Rupee did not contribute more than its magnitude to the change in the Rupee price of exports in any one year, the depreciation of the rupee could have contributed at most some 70 per cent of the average increase in price per annum over this period and, therefore, around 45 per cent of the total increase in the Rupee value of exports. This would mean that the depreciation of the Rupee contributed less to the average increase in the Rupee value of exports than it did to the Rupee value of imports. Further, in six out of the ten years, the increase in export price was less than the depreciation of the Rupee. In 1982, 1985 and 1986 the Rupee price of exports fell by 3 per cent, 11 per cent and 11 per cent, respectively, while the exchange rate depreciated by 3.6 per cent, 4 per cent and 3.9 per cent, respectively. In 1989 the rate of depreciation of the Rupee was nearly double that of the increase in export prices.

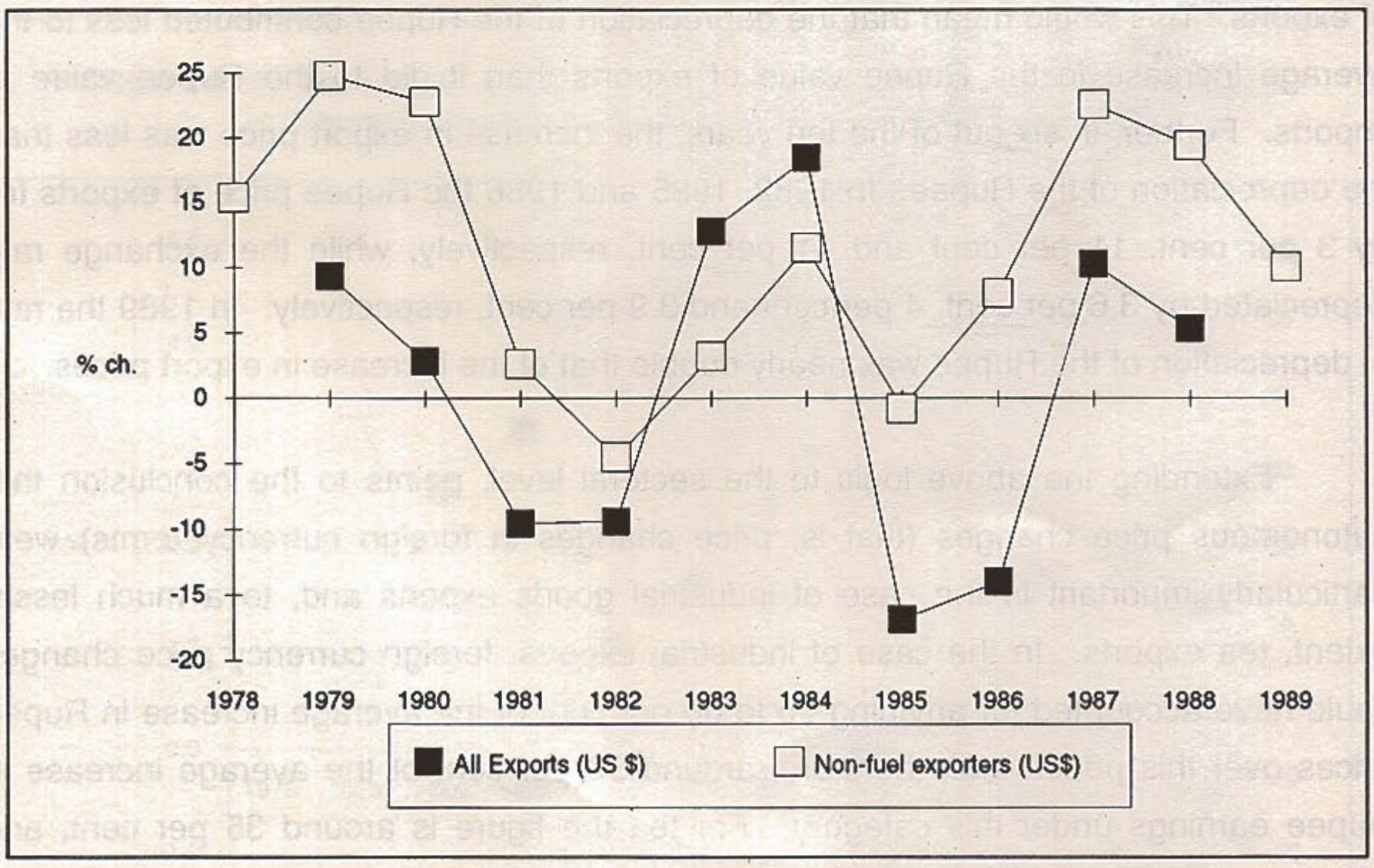
Extending the above logic to the sectoral level, points to the conclusion that autonomous price changes (that is, price changes in foreign currency terms) were particularly important in the case of industrial goods exports and, to a much lesser extent, tea exports. In the case of industrial exports, foreign currency price changes could have accounted for anything up to 60 per cent of the average increase in Rupee prices over this period and, therefore, around 30 per cent of the average increase in Rupee earnings under this category. For tea the figure is around 35 per cent, and therefore around 25 per cent of the average annual increase in tea earnings. It warrants noting, however, that industrial goods export prices increased by less than the rate of depreciation of the Rupee in only three out of ten years, while for tea it was

seven out of ten. It also warrants noting that the residual changes in the Rupee prices of tea exports, unlike industrial exports, are mostly to be explained by domestic factors - the domestic rate of inflation.

4.2.3.3 Export Receipts

From the preceding, one would not be remiss in concluding that export earnings are mostly influenced by external factors, especially if movements in the exchange rate are also seen as related to changes in the terms of trade. Some indication of the extent to which this is the case is given by Figure 4.16, which relates Sri Lanka's export earnings to those of other non-fuel exporting developing countries. The close correspondence of the two series is striking.

Figure 4.16
Sri Lanka's Export Earnings -vs- Non-Fuel Exporting Developing Countries (1978-89)

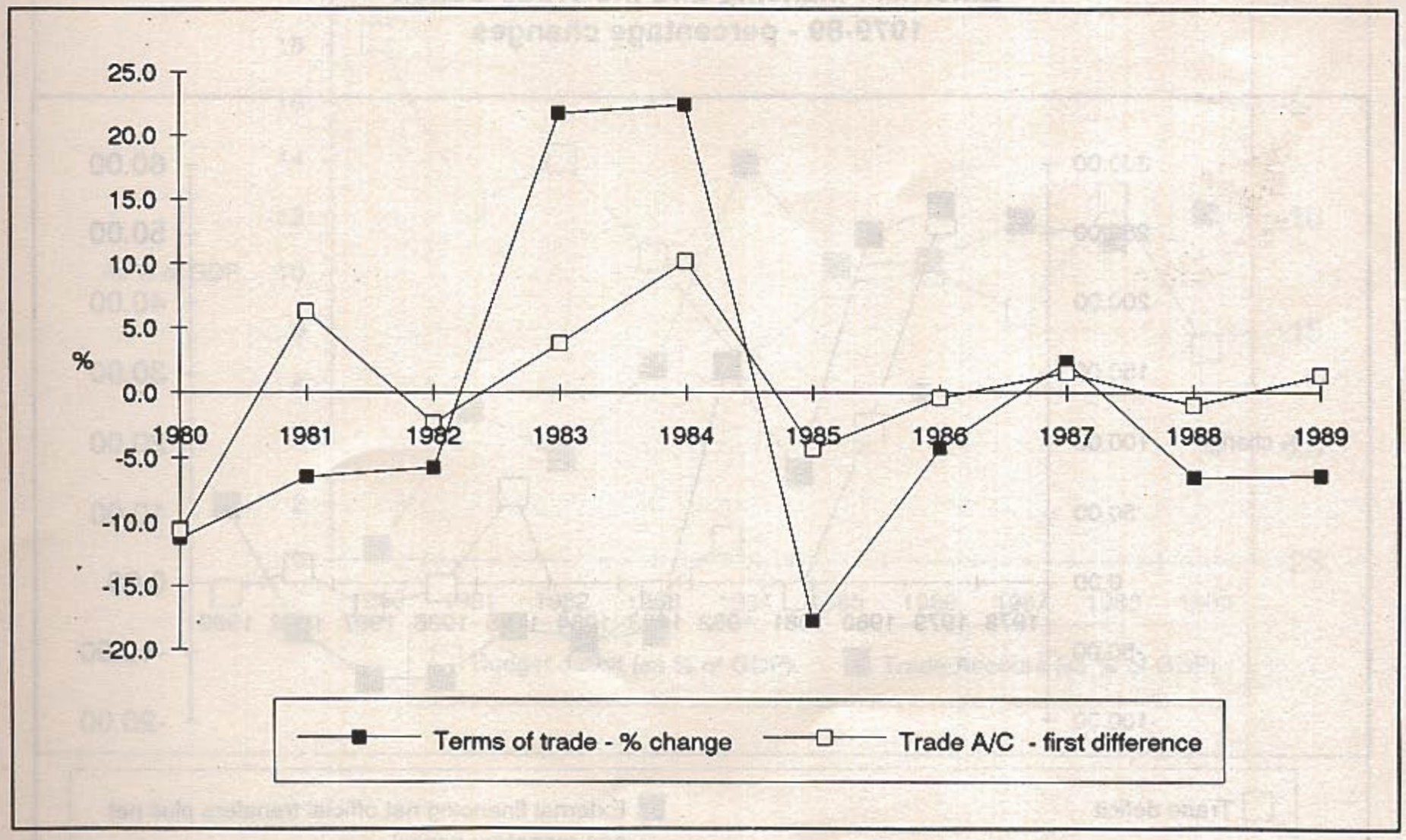


4.3 Trade Deficit

4.3.1 The Terms of Trade

From the preceding it would be reasonable to suppose that an important influence on the trade deficit is the **terms of trade**. Figure 4.17 is a plot of changes in the trade deficit (as a percentage of GDP) against percentage changes in the terms of trade index. It confirms the existence of a strong positive relation between the two variables. In those years where the relation appears weak, relative volume changes were particularly strong. Thus, the excessive deterioration and subsequent improvement in the trade balance in 1982 and 1984, respectively, were due to strong reinforcing movements in relative volumes. The considerable improvement in the trade balance in 1989 was, by contrast, attributable to strong compensating changes in relative volumes in that year.

Figure 4.17
Changes in Sri Lanka's Merchandise Trade Balance and Terms of Trade

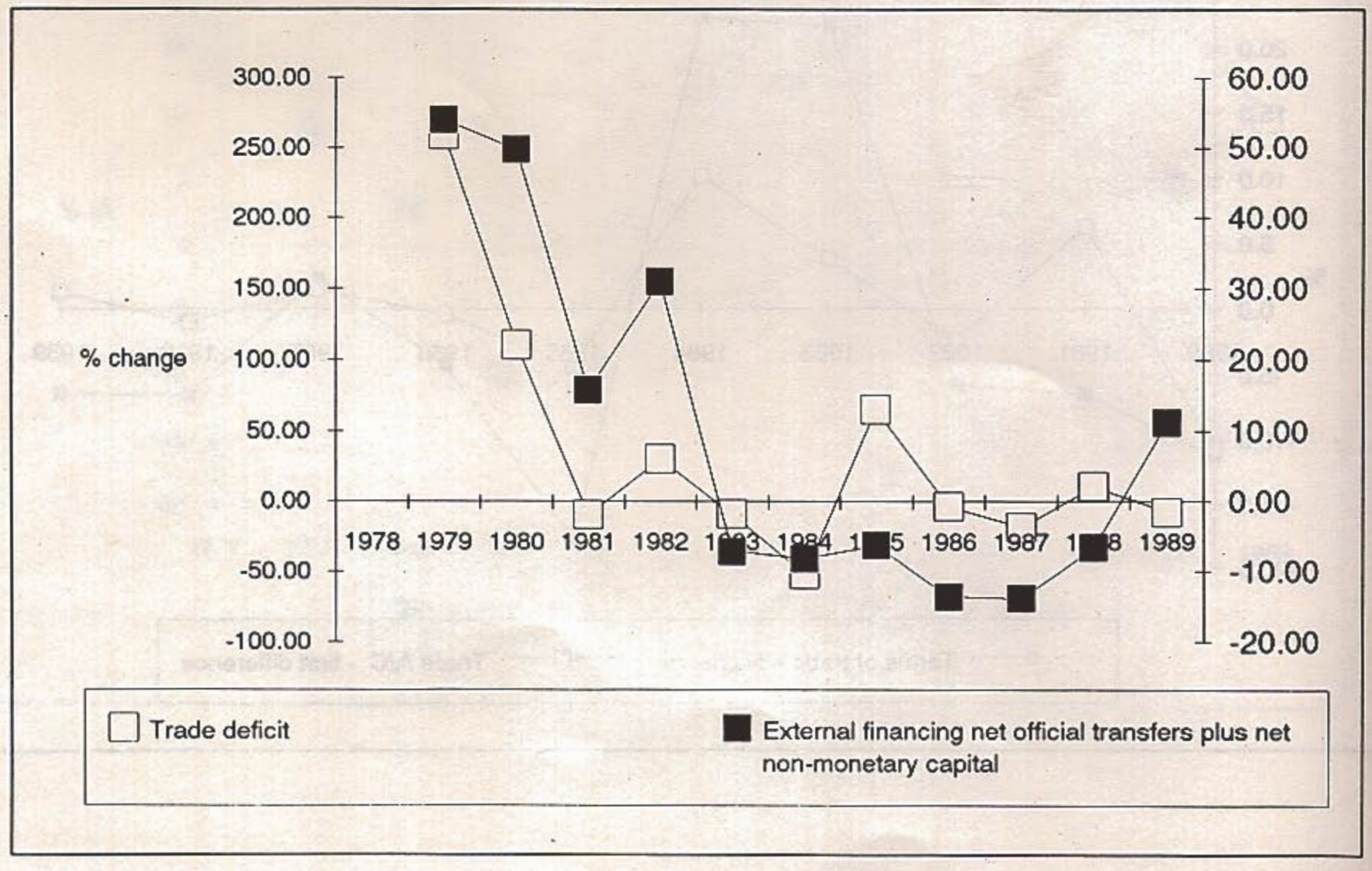


But what moves the terms of trade facing Sri Lanka? If one discounts the influence of random factors, it would appear that movements in the terms of trade facing Sri Lanka follow those facing most developing countries and these, in turn, are very much tied up with the international business cycle. When the developed countries are growing the terms of trade facing developing countries such as Sri Lanka broadly speaking improve. When the developed countries enter a period of recession, the terms of trade facing developing countries, especially those exporting consumer products and primary inputs, deteriorate.

4.3.2 The Trade Deficit and External Financing

A second factor which, it would appear from the earlier presentation, is likely to have a bearing on short-term movements in the trade balance, is external financing. Unlike the terms of trade, the impact of external financing on the trade balance is only via the import side. Nevertheless, Figure 4.18 would seem to suggest that this impact

Figure 4.18
External Financing and the Trade Deficit
1979-89 - percentage changes

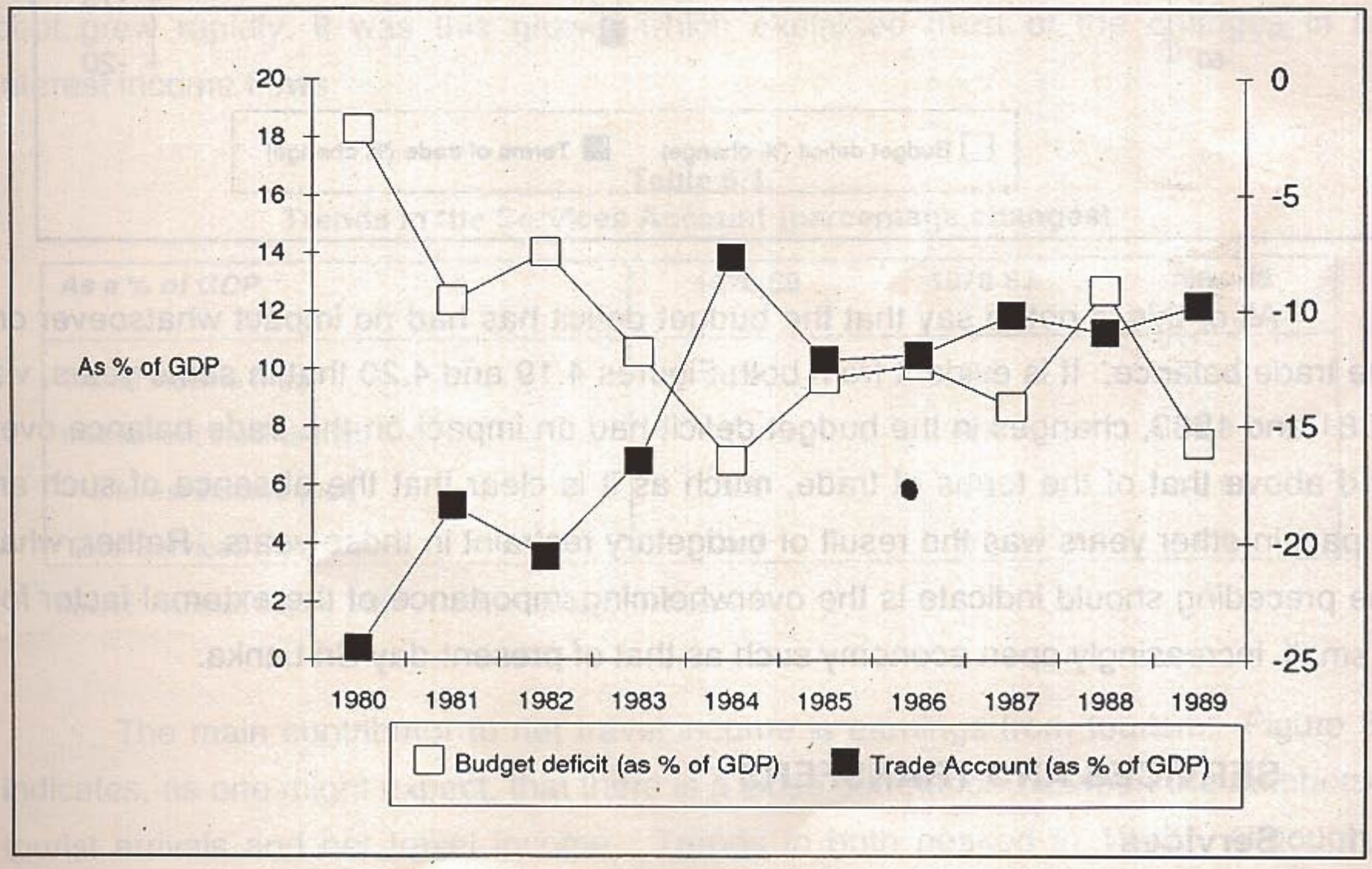


is significant and tends to reinforce the terms of trade effect. In some respects this result should not be surprising since it can be shown that changes in the volume of external financing (especially the loans and short-term credits components) are broadly related to world market developments.

4.3.3 The Trade Deficit and the Budget Deficit

It is frequently asserted that an important determinant of the trade deficit is the budget deficit. For some economists the impact of the budget deficit on the trade balance is direct, via corresponding changes in aggregate demand. For others the impact is indirect, via changes in the money stock.[7] A comparison of changes in the budget deficit with the changes in the trade balance suggests that the relationship is indeed close (see Figure 4.19). However, upon further investigation it turns out that the

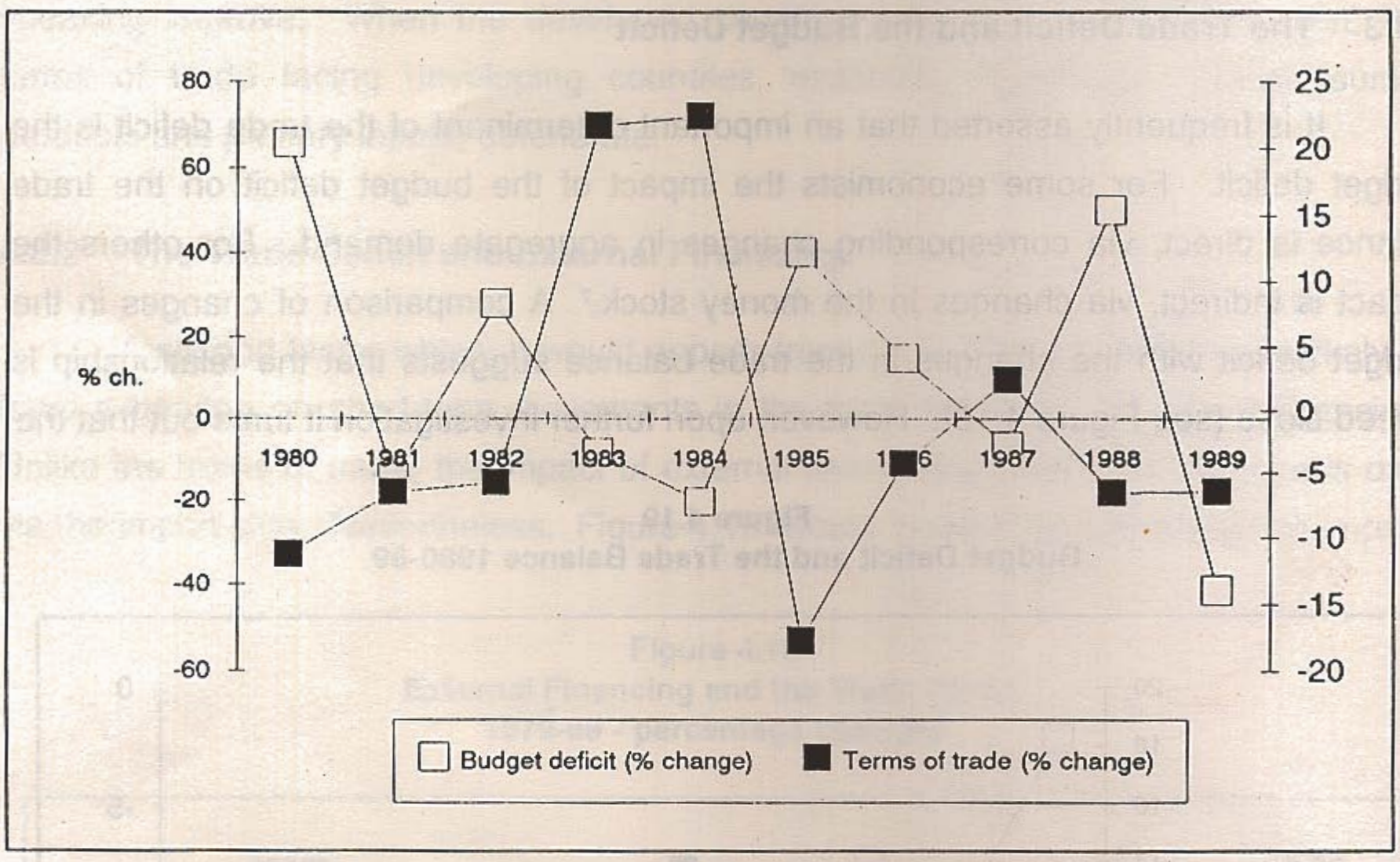
Figure 4.19
Budget Deficit and the Trade Balance 1980-89



7. The relation between changes in the money stock and import expenditures was discussed earlier in the context of a consideration of the Monetary Approach to the Balance of Payments.

budget deficit is itself inversely related to the terms of trade (see Figure 4.20). Hence, it would seem that much of the apparent joint movement of the budget deficit and the trade balance is explainable by the impact of the terms of trade on both.

Figure 4.20
Budget Deficit and Terms of Trade 1980-89 (percentage changes)



All of this is not to say that the budget deficit has had no impact whatsoever on the trade balance. It is evident from both Figures 4.19 and 4.20 that in some years, viz 1981 and 1989, changes in the budget deficit had an impact on the trade balance over and above that of the terms of trade, much as it is clear that the absence of such an impact in other years was the result of budgetary restraint in those years. Rather, what the preceding should indicate is the overwhelming importance of the external factor for a small, increasingly open economy such as that of present-day Sri Lanka.

5. SERVICES AND TRANSFERS

5.1 Services

In absolute terms, the contribution of the services balance to the current account balance is small. For the 1978-89 period as a whole, net services accounted

for just over 10 per cent of the annual current account balance. Between 1978 and 1980 the services account was in surplus and, as such, had a slight countervailing impact on the current account balance which had moved substantially into deficit. In 1981 the services account too moved into deficit, deteriorating steadily thereafter up to 1985. From 1985 to 1989 the level of the deficit stabilised (see Figure II.2).

The trend in the services account is largely explainable by two factors; changes in net investment income and net travel income (see Table V.1). From Figure V.1 it may be seen that changes in the deficit in the last couple of years are almost entirely explainable by changes in net investment income alone. The most important component of the latter is net interest payments. Net interest payments account for about 95 per cent of the total in this category. Changes in net interest income flows are explainable by changes in the size of the external debt and world market rates of interest. In periods when the rate of expansion of the external debt has slowed, as in the 1983-89 period, changes in world market interest rates explain most of the changes in net interest income flows. Analogously, in the earlier 1978-83 period, when external debt grew rapidly, it was this growth which explained most of the changes in net interest income flows.

Table 5.1
Trends in the Services Account (percentage changes)

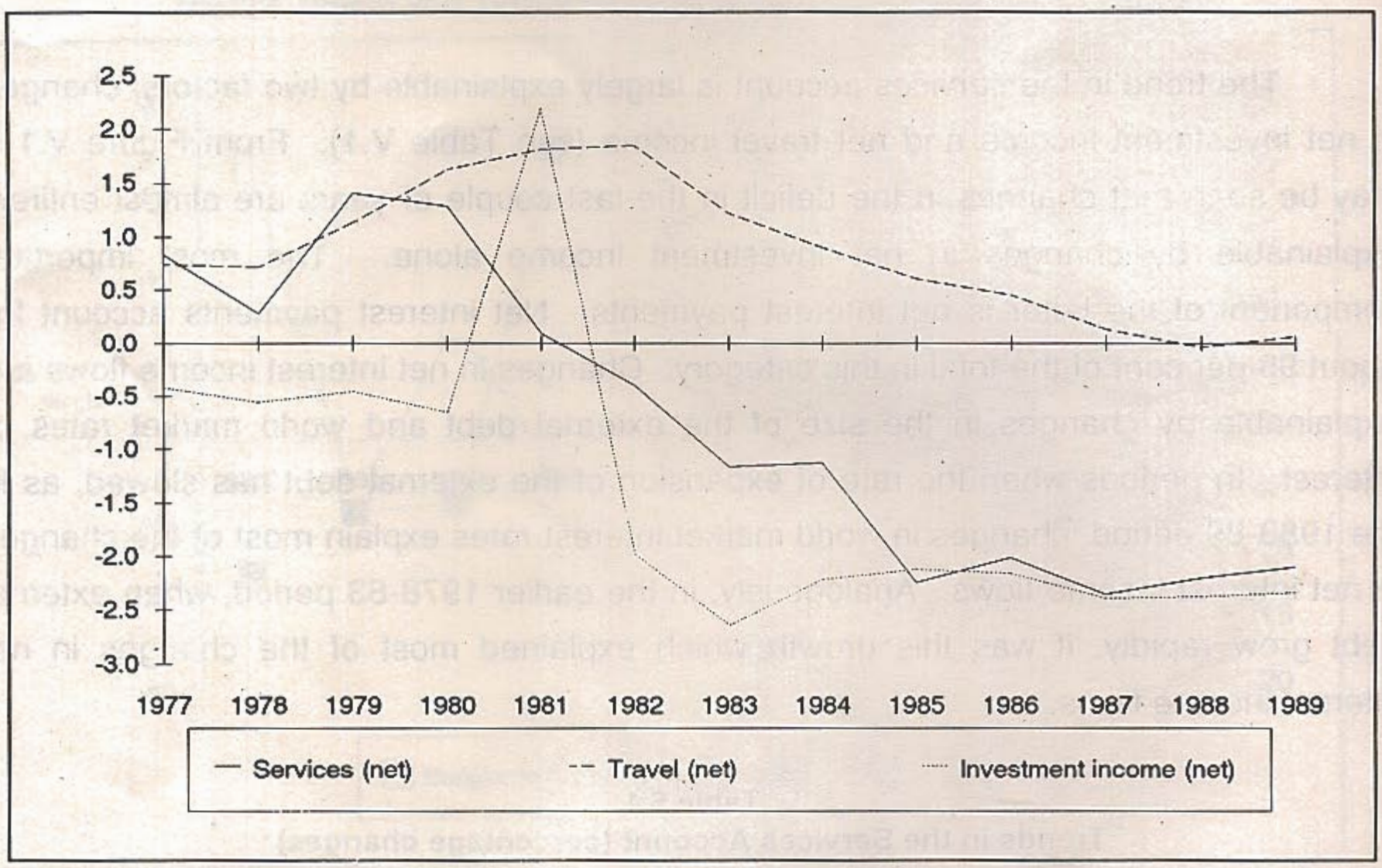
As a % of GDP	1978-89	1978-83	1984-89
Travel income (net)	0.9	1.4	0.4
Investment income (net)	-1.5	-0.7	-2.3
Interest income (net)	-1.6	-1.2	-2.0
Total Services (net)	-0.9	0.3	-2.0

Source: "Annual Report 1989", Central Bank of Sri Lanka

The main contributor to net travel income is earnings from tourism. Figure 5.2 indicates, as one might expect, that there is a close correlation between the numbers of tourist arrivals and net travel income. Trends in both peaked in 1982. Although in principle one would expect tourist arrivals to be considerably influenced by economic

conditions in the countries from which they come, in Sri Lanka's case, domestic factors have clearly outweighed these in the recent past.

Figure 5.1
Trends in the Services Account and its components



5.2 Transfers

The growth of net transfers has been far and away the outstanding positive current account development in the post-1978 period. In 1977 net transfers amounted to less than 2 per cent of GDP at current market prices. By 1982 the figure was up to 9 per cent of GDP. For the 1978-89 period as a whole the average annual rate is around 7 per cent of GDP, with the biggest contribution coming from private transfers. The major source of private transfers has been income repatriated by migrant workers in the Middle East. The relative contribution of these transfers was particularly pronounced over the 1984-89 sub-period, when Middle East migration grew most rapidly. From 1987, along with a fall in world oil prices, there has been a decline in these transfers, which can only be made worse by the present crisis in the region. Net official transfers comprising mainly official grants received by the central government, although proportionately smaller than net private transfers, were also significant. These transfers

amounted to an average annual 3 per cent of GDP for the 1978-89 period as a whole. After an initial spurt, net official transfers (as a proportion of GDP) declined. Possibly the most important reason for this decline is problems of disbursement of these funds resulting from domestic political and security problems.

Figure 5.2
Numbers of Tourist Arrivals and Net Travel Income (1978-89)

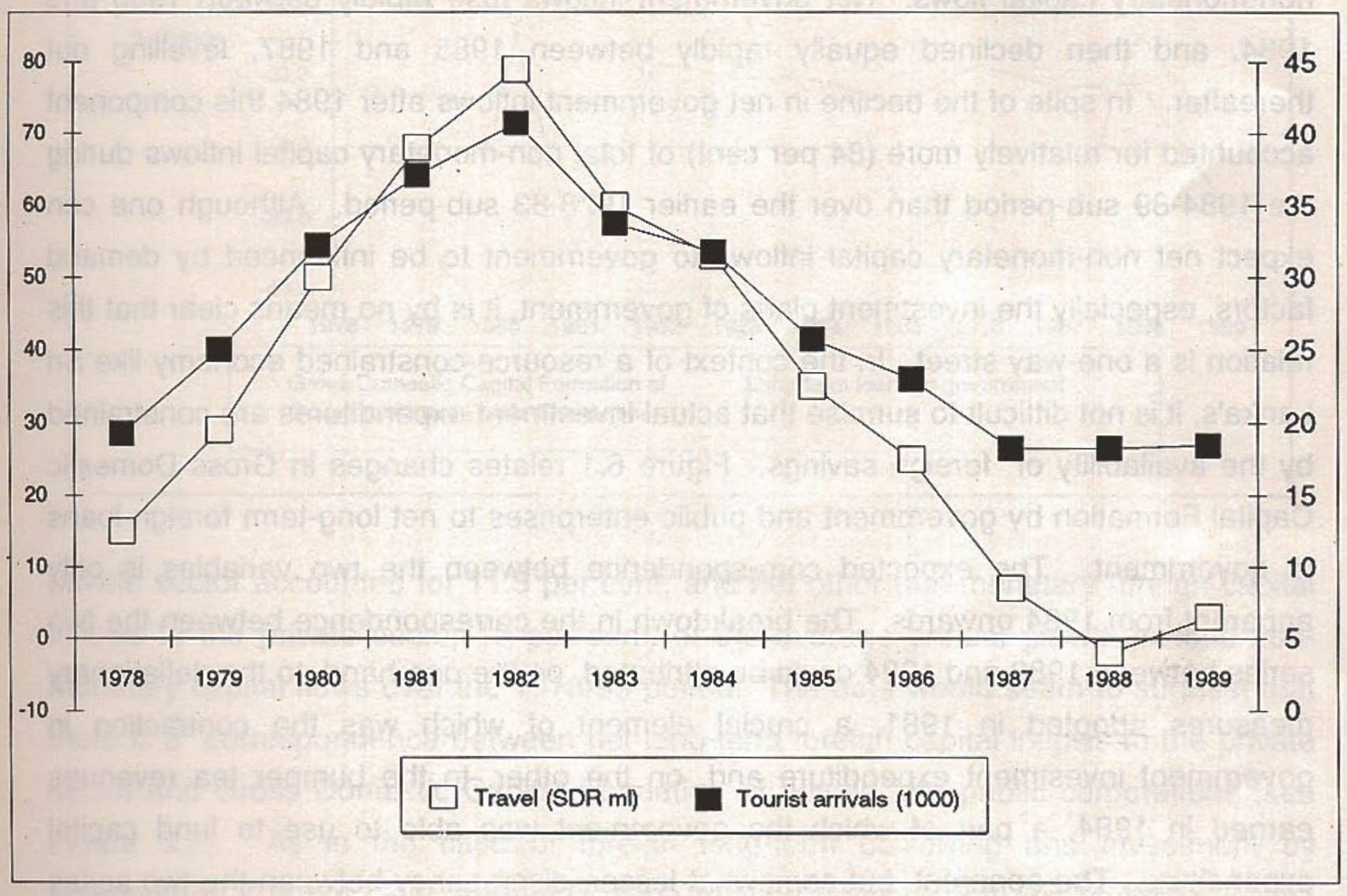


Table 5.2
Net Transfers as a Percentage of GDP at Current Market Prices

	1978-89	1978-83	1984-89
Private transfers (net)	4.0	3.5	4.5
Official transfers (net)	3.1	3.4	2.9
Total transfers (net)	7.1	6.9	7.4

6. THE CAPITAL ACCOUNT

Net non-monetary capital inflows rose considerably between 1978 and 1982, then fell continuously between 1983 and 1988, picking up again in 1989. The largest component of non-monetary capital flows is government long- and short-term borrowing (commodity, project and other loans received directly by the government). Over the 1978-89 period as a whole, this component amounted to around 70 per cent of total net non-monetary capital flows. Net government inflows rose rapidly between 1980 and 1984, and then declined equally rapidly between 1985 and 1987, levelling out thereafter. In spite of the decline in net government inflows after 1984 this component accounted for relatively more (84 per cent) of total non-monetary capital inflows during the 1984-89 sub-period than over the earlier 1978-83 sub-period. Although one can expect net non-monetary capital inflows to government to be influenced by demand factors, especially the investment plans of government, it is by no means clear that this relation is a one-way street. In the context of a resource-constrained economy like Sri Lanka's, it is not difficult to surmise that actual investment expenditures are constrained by the availability of foreign savings. Figure 6.1 relates changes in Gross Domestic Capital Formation by government and public enterprises to net long-term foreign loans to government. The expected correspondence between the two variables is only apparent from 1984 onwards. The breakdown in the correspondence between the two series between 1980 and 1984 could be attributed, on the one hand, to the deflationary measures adopted in 1981, a crucial element of which was the contraction in government investment expenditure and, on the other, to the bumper tea revenues earned in 1984, a part of which the government was able to use to fund capital expenditure. The apparent, but somewhat lesser, discrepancy between the two series in 1988 could be attributed to the acute civil strife in that year which hampered the implementation of many planned investment undertakings.[8]

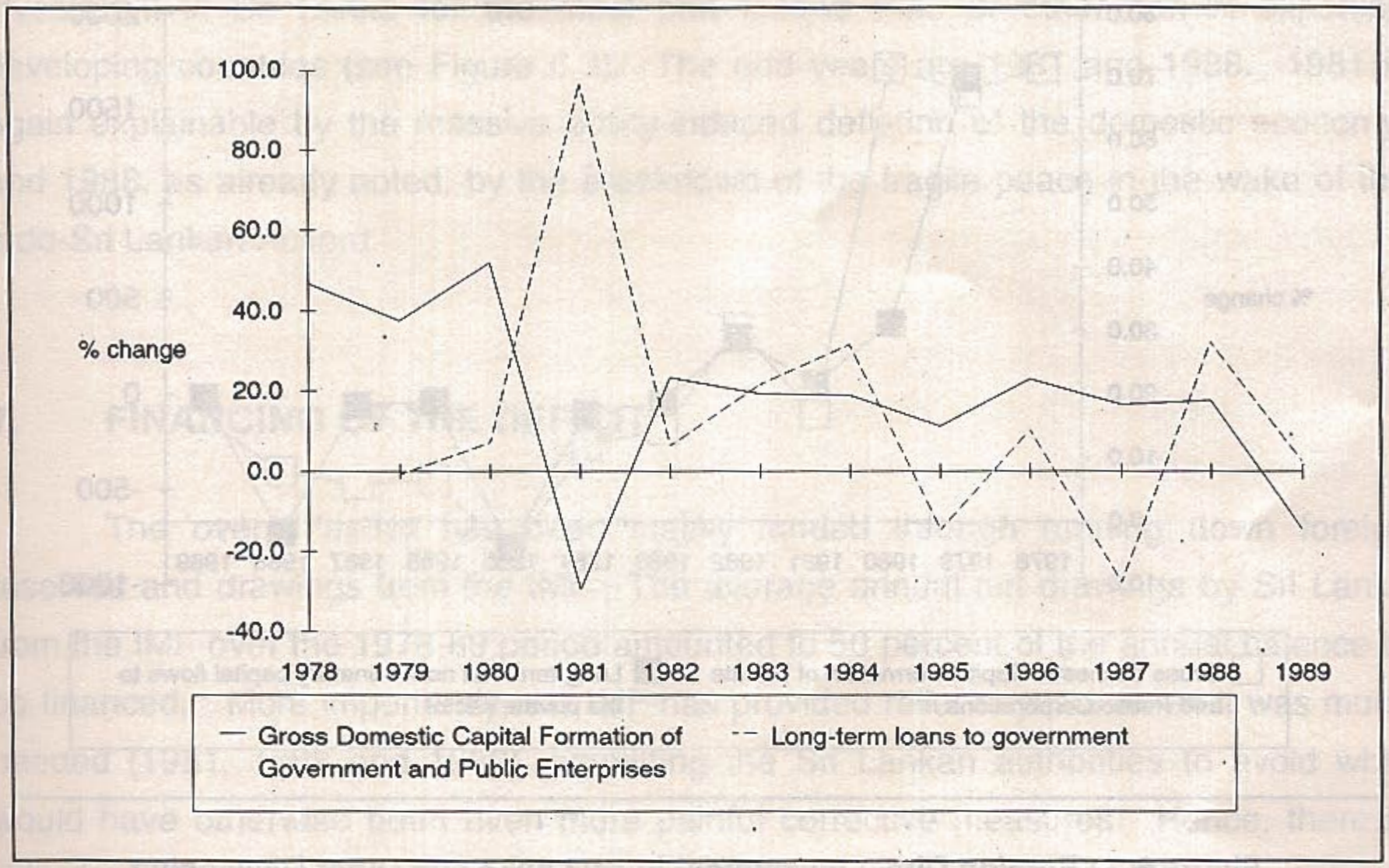
Net private sector non-monetary capital flows comprise direct investment and long- and short-term non-monetary capital flows.[9] Net foreign investment flows to the

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8. A further factor which may be affecting the correspondence between these two series is the fact that long-term foreign loans to the central government includes commodity loans. Although the latter are only a small proportion of the total for the period as a whole, in certain years the volume of commodity loans has been significant.

9. Other long-term private capital flows include investments and disinvestments of capital in firms other than those that are foreign or non-resident controlled, but where they hold shares.

Figure 6.1
Foreign Long-term Loans to Government and Investment by Government and Public Enterprises 1979-89 - percentage changes



private sector accounted for 11.5 per cent, and net other non-monetary foreign capital inflows to the private sector 19 per cent, of the average annual growth in total non-monetary capital flows over the 1978-89 period. The data would seem to suggest that there is a correspondence between net long-term foreign capital inflows to the private sector and Gross Domestic Capital Formation of private and public corporations (see Figure 6.2). As in the case of foreign long-term borrowing and investment by government, it is not clear *a priori* that the relation between the two variables is one way; from investment (demand) to capital supply.

Foreign direct investment flows appear to have been mostly affected by domestic political and security developments, being more sensitive to these factors than investment in general. Between 1978 and 1982 foreign investment flows increased significantly. With the outbreak of civil strife in 1983 this process went into reverse. In 1987 there was a short-lived revival of these flows brought about by the

Figure 6.2: Long-term Net Non-monetary Capital Flows to the Private Sector and Investment by Private and Public Corporations 1979-89 - percentage changes

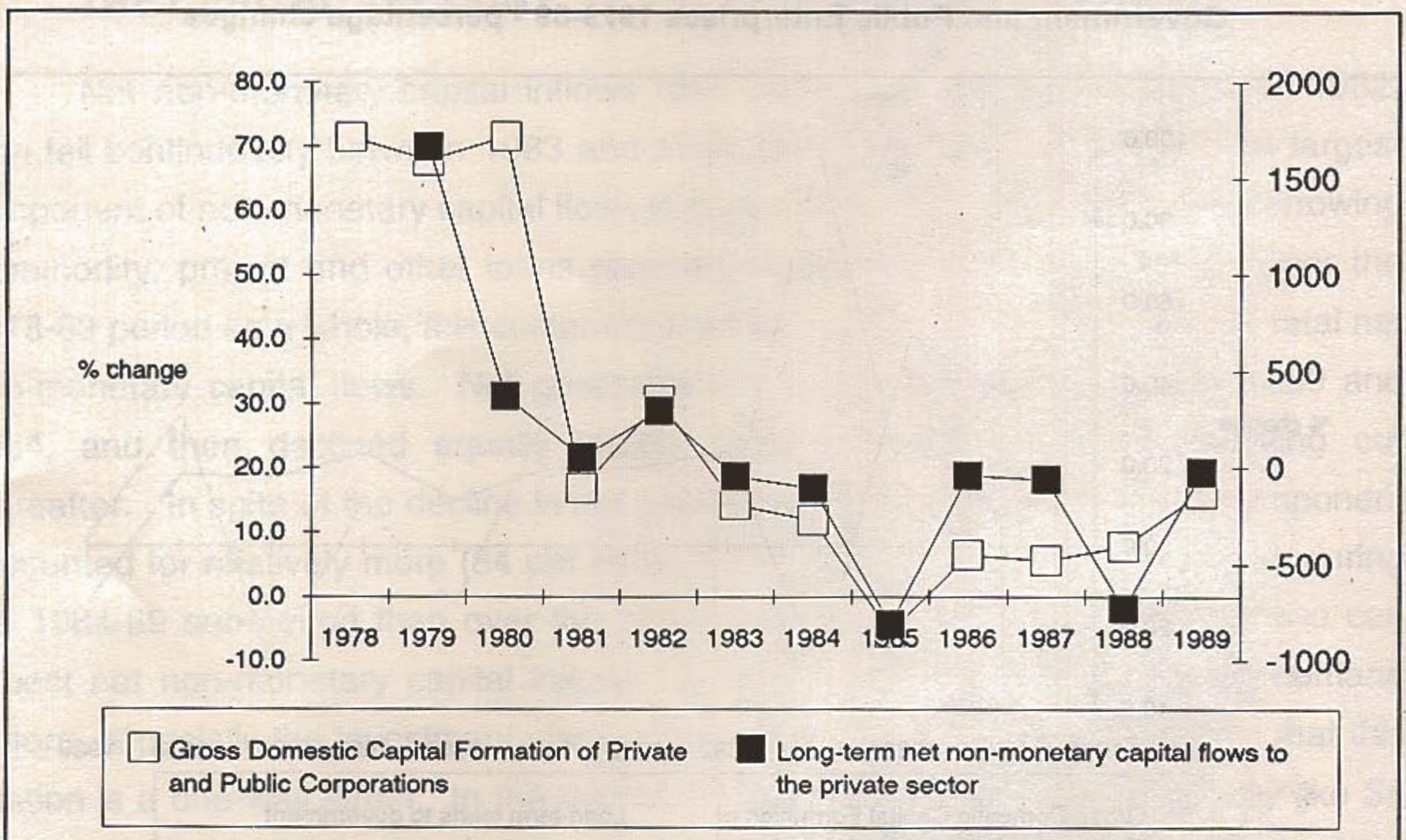
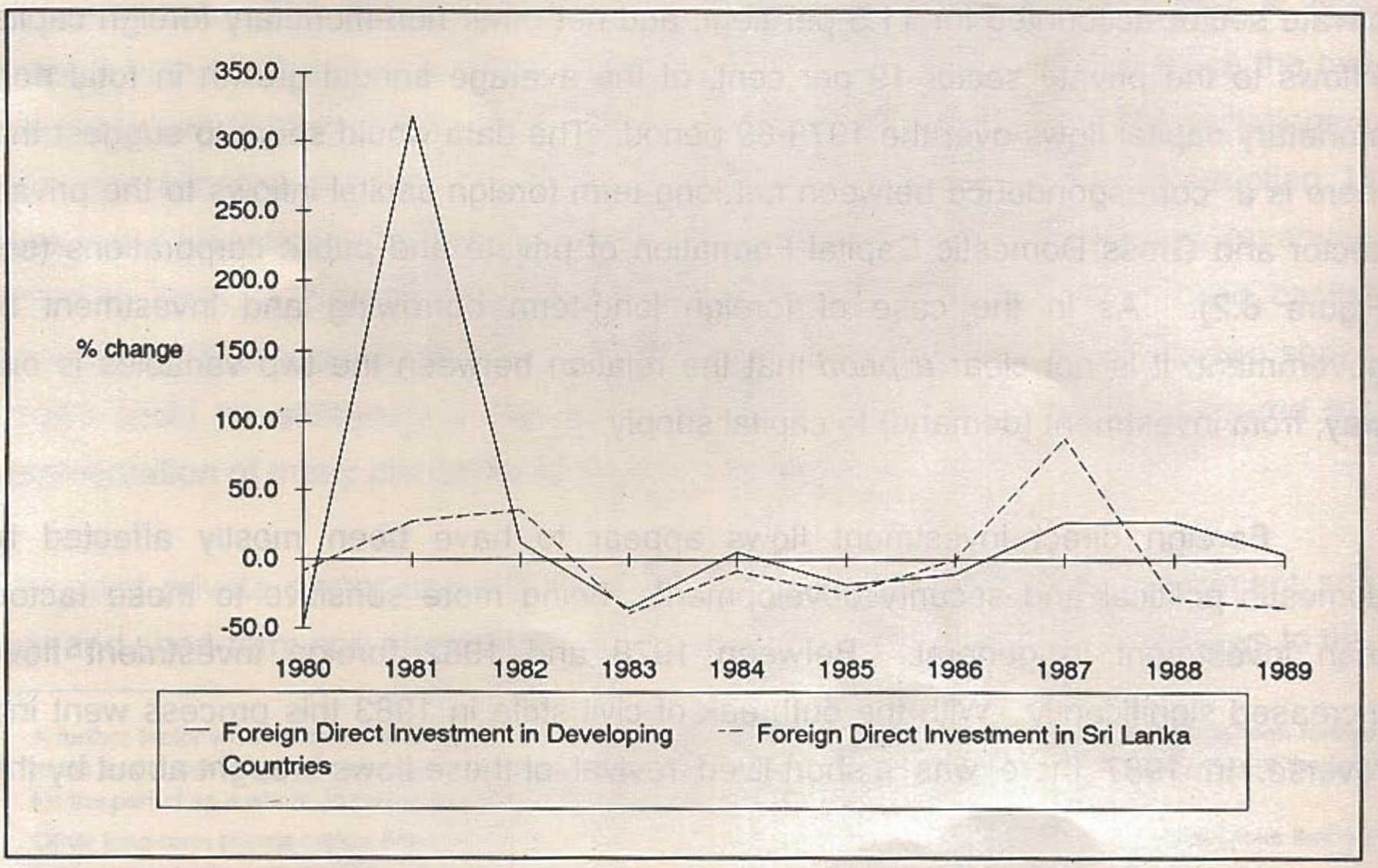


Figure 6.3 : Foreign Direct Investment in Sri Lanka and Other Developing Countries 1980-89 - percentage changes (SDR value)



equally short-lived expectations following the signing of the Indo-Sri Lankan Peace Accord. Having said this, it is interesting to note that the trend of foreign direct investment in Sri Lanka for the most part follows that for other non-oil exporting developing countries (see Figure 6.3). The odd years are 1981 and 1988. 1981 is again explainable by the massive policy-induced deflation of the domestic economy, and 1988, as already noted, by the breakdown of the fragile peace in the wake of the Indo-Sri Lankan Accord.

7. FINANCING OF THE DEFICIT

The overall deficit has been mainly funded through running down foreign reserves and drawings from the IMF. The average annual net drawings by Sri Lanka from the IMF over the 1978-89 period amounted to 50 percent of the annual balance to be financed. More importantly, the IMF has provided relief in years when it was much needed (1981, 1988 and 1989), permitting the Sri Lankan authorities to avoid what would have otherwise been even more painful corrective measures. Hence, there is little doubt that without IMF support Sri Lanka's reserve position would not have been tenable. In fact there would have been little hope of sustaining such a large current account imbalance, especially since IMF endorsement also opens the doors to a considerable volume of foreign grants and loans.[10]

7.1 Reserve Position

External reserves are made up of the assets of the government, government agencies, the Central Bank, and commercial banks, with the latter two accounting for around 95 per cent of the total. Over the 1978-89 period as a whole, gross external reserves or assets amounted to some 3.6 months of import expenditures. At the start of the period, reserves were equivalent to 5.4 months of imports. They had expanded considerably over the preceding two years because of buoyant export prices, especially tea prices. The liberalisation of the economy, a massive expansion in investment, and a (second) major hike in world oil prices (1979/80) left gross reserves at a mere 2.4

10. It bears repeating that foreign capital inflows not only facilitate but also encourage increases in import expenditures.

months of imports by 1980. The year was a turning point. A massive expansion in official foreign capital inflows, coupled with a dramatic rise in tea prices, saw gross reserves climb to an equivalent of 4.6 months of imports by 1984. The ensuing collapse in world market tea prices, the fall in direct foreign investment and the slump in tourism brought about some erosion of this position (particularly the official reserve position) in spite of an accompanying decline in the import price of oil. By 1988 gross external assets had fallen back to 3.1 months of imports. There was a slight improvement in the final 1989 figure after reserves had fallen to a precariously low level during the first half. A reversal of short-term capital flight through a depreciation of the rupee, a revival in tourism, and the first tranche of a SAF facility from the IMF, all contributed to the turn-around.

A comparison of Sri Lanka's reserve position with that of other developing countries over the 1978-89 period is generally favourable to Sri Lanka. It suggests that Sri Lanka's position was better than the average for developing countries, both including and excluding fuel exporters. It also suggests it was better than the average for Asian countries (see Table 7.1). Interestingly, the level of reserves held by developing countries specialising in the export of manufactures is less than for those specialising in the exports of agricultural commodities. This is perhaps to be explained by the fact that fluctuations in the prices of manufactures, and therefore the export earnings of these countries, are of a lesser magnitude than those specialising in the export of agricultural commodities. Hence countries specialising in the former typically need less reserves to safeguard against adverse developments. If this is indeed the case, then Sri Lanka's reserve holdings in the latter-half of the period under review, when there was a marked shift towards the export of manufactures, although lower than the preceding 1978-83 period, could be taken to represent an improvement over the former period, when exports were primarily agricultural.

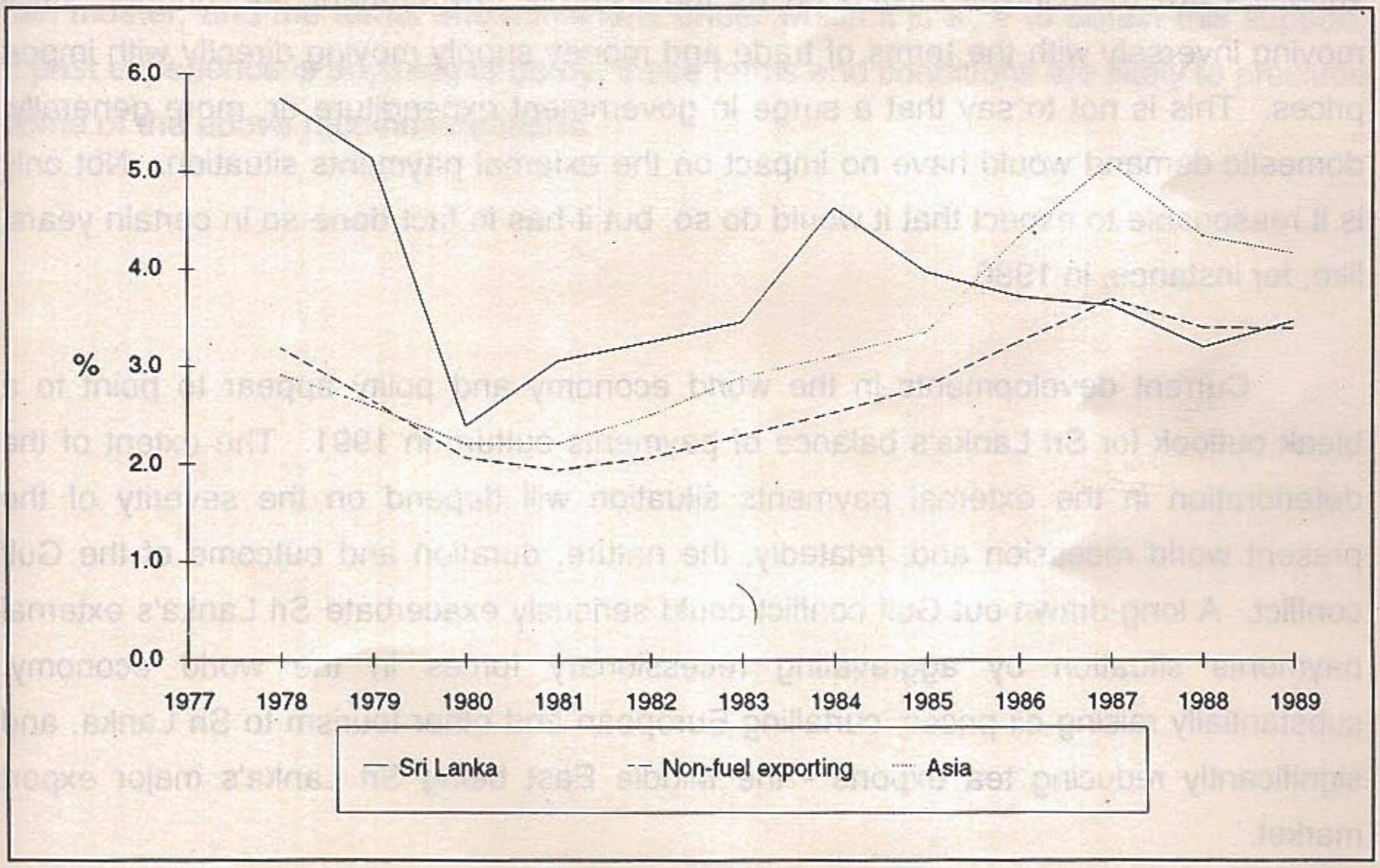
An international comparison of annual changes in reserve levels further suggests that changes in Sri Lanka's reserve position between 1978 and 1989 have largely reflected those of other developing countries, especially if one discounts the impact of the rise and subsequent fall in tea prices between 1983 and 1985 (see Figure 7.1). From figure 7.1 it is evident that the 1979/80 oil shock caused all non-oil

Table 7.1
Reserves as a Percentage of Imports (months)

	1978-89	1978-83	1984-89
Sri Lanka	3.6	3.7	3.5
Asia	3.3	2.6	4.1
Developing countries	3.2	3.0	3.3
Non-fuel exporting	2.8	2.4	3.2
Non-fuel primary product exporting	2.7	2.8	2.7
Non-fuel agricultural product exporting	3.3	3.0	3.7
Non-fuel manufacture exporting	2.3	2.2	2.3

Source: "Annual Report 1989", Central Bank of Sri Lanka
"World Economic Outlook", International Monetary Fund

Figure 7.1
External assets as a proportion of imports (in months)



exporting countries to suffer a deterioration in their reserve positions. With the subsequent decline in oil prices (in real as well as nominal terms) and the sustained growth of the developed country economies, most non-oil exporting countries experienced a significant improvement in their reserve positions, which continued up to

1987. In 1988 the situation again worsened for all developing countries, including Sri Lanka, stabilising somewhat in the following year. The downturn in 1988 was at least partly attributable to the temporary reversals wrought by the sharp declines in world stock markets towards the end of 1987.

8. CONCLUSIONS AND POLICY IMPLICATIONS

It would appear from the above study that the primary determinant of short-term developments in Sri Lanka's balance of payments is the external economic environment, particularly changes in world income/demand and the terms of trade. Contrary to prevailing orthodoxy, budget deficits and money supply expansion seem to be of lesser importance, if any. There is even evidence to suggest that both these variables are themselves influenced by the external environment; the budget deficit moving inversely with the terms of trade and money supply moving directly with import prices. This is not to say that a surge in government expenditure or, more generally, domestic demand would have no impact on the external payments situation. Not only is it reasonable to expect that it would do so, but it has in fact done so in certain years, like, for instance, in 1980.

Current developments in the world economy and polity appear to point to a bleak outlook for Sri Lanka's balance of payments outturn in 1991. The extent of the deterioration in the external payments situation will depend on the severity of the present world recession and, relatedly, the nature, duration and outcome of the Gulf conflict. A long-drawn-out Gulf conflict could seriously exacerbate Sri Lanka's external payments situation by aggravating recessionary forces in the world economy, substantially raising oil prices, curtailing European and other tourism to Sri Lanka, and significantly reducing tea exports - the Middle East being Sri Lanka's major export market.

The general policy recommendation accompanying this prognosis is that the government should batten down the hatches and wait for the storm to pass. Specifically, the government should be as restrained as possible on the expenditure front. While attempting to maintain relative cost parity, the monetary authorities should

lag any required depreciation of the currency behind the rate of inflation, making the necessary compensating adjustments in the ensuing upswing when export markets are more buoyant. Similarly, tariff adjustments should be postponed until the international environment shows clear signs of improving. The export sector, particularly the non-traditional sector, should be provided with temporary relief in the form of tax rebates and credit refinancing to help them weather the world market storms and compensate for a (temporarily) over-valued exchange rate. Raising interest rates at the present time is unlikely to have a positive impact on the balance of payments since the increase in import expenditures (like domestic inflation) is mostly the result of increases in import prices and not demand induced import volumes.[11]

It warrants pointing out, however, that in the final analysis Sri Lanka's ability to manoeuvre on the policy front depends crucially on the balance of payments support it can muster, and the terms and conditions under which it is able to obtain this support. If past experience is anything to go by, these terms and conditions are likely to preclude some of the above recommendations.

11. Low or even negative real rates of interest do not deter saving in a recessionary climate.

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