INSTITUTE OF POLICY STUDIES

Employment Consequences of Alternative Stabilization/Adjustment Measures:

The Case of Sri Lanka, 1970 - 1985

By
Purnima Rajapakse

Research Studies **Employment Series 7**

D.F.C.C. Building - 2nd Floor
73/5, Galle Road
Colombo 3.
Sri Lanka

INSTITUTE OF POLICY STUDIES

Employment Consequences of Alternative Stabilization/Adjustment Measures:

The Case of Sri Lanka, 1970–1985

By
Purnima Rajapakse

USAID / DIC
COLOMBO, SRI LANKA

NA 80/35

INSTITUTE OF POLICY STUDIES PROJECT

RESEARCH SEMINAR ON EMPLOYMENT AND UNEMPLOYMENT ISSUES

February 11 - 13, 1988

Employment Consequences of Alternative Stabilization/Adjustment Measures:

The Case of Sri Lanka, 1970—1985

Purnima Rajapakse

TABLE OF CONTENTS

		Page
1.	Introduction	5
2.	Theoretical Overview of Monetarist — and Post - Keynesian/Structuralist approaches to the Causes of Unemployment and Economic Instability	6
2.1	Differing types of unemployment	6
2.2	Monetarism in theory	7
2.3	A post - Keynesian/structuralist perspective	8
3.	The Economy and Employment	11
3.1	Structural features of the Sri Lankan economy ..	11
3.2	Macro trends, 1970 - 85	12
3.3	Employment : the magnitude of the problem and policy issues ..	13
4.	Empirical Consideration of the Employment Consequences of Public Expenditure, the Private Sector Response, Exchange Rate Adjustments and Prices and Incomes Policies	15
4.1	The State's role in employment generation	15
4.2	The private sector response	16
4.3	Exchange rate adjustments	17
4.4	Prices and income policy	18
	Concluding Remarks	18
	Footnotes	21
	Text Tables	24
	References	35

1. Introduction

The main aim of this paper is to investigate the extent to which stabilization measures have influenced employment creation in Sri Lanka during the period 1970-85. While there is no unique answer to the relationship between stabilization policies and employment, in order to provide a better understanding of the issues involved here, the approach adopted will locate the Sri Lankan experience within the context of the two main currents which have influenced stabilization and development policies within capitalist economies, namely, structuralism and monetarism. In other words, between those economists (i.e. monetarists) who feel that the fundamental causes of inflation and payments imbalances are autonomous monetary impulses, and that growth and development are best achieved by market forces unhindered by state intervention, and those economists (structuralists) who see the major causes of instability as structural, whether internally or externally generated, and state involvement in the economy as a necessary condition for growth and development.

In theory the monetarist approach distinguishes stabilization policies from development policies (while the structuralist approach does not), with the former seen in terms of a short-term, and the latter a longer-term, perspective. In practice however, this distinction has become increasingly blurred, with the consequence that monetarist stabilization programmes can today include a very wide variety of policies designed to affect both aggregate nominal demand, and aggregate real supply in the short run. Despite the inclusion of policies aimed at increasing the level of aggregate real supply in the short run, the view held here is that this does not, and cannot, represent a consistent monetarist position. To assume that factors of production, and thus output, are not fixed in the short run would undermine the very essence of the monetarist theoretical paradigm as it is precisely because output is assumed fixed in neo-classical theory (at least in the short run) that an increase in the money supply leads to an increase in prices. Moreover, if output can be increased in the short run, what then do monetarists mean by short run? More importantly, if output can be increased in the short run, and if such supply — increasing or output-increasing policies are included in stabilization programmes, it is relevant to ask why measures to stimulate demand should not be included in such programmes (instead of the demand restraint measures which are automatically included) to prevent a recession. For these reasons, in analysing the monetarist position on stabilization, output is assumed fixed in the short run and only demand restraint policies such as reductions in public expenditure and exchange rate devaluations will be considered here. Moreover, given the gradual and long — term nature of structuralist stabilization policies (i.e. the elimination of structural bottlenecks), for comparison with the monetarist approach, only short-term structuralist stabilization measures such as prices and incomes policies and dual exchange rates will be considered. More specifically, an attempt will be made to look at the way in which these policies have influenced the factor mix in production, and whether or not reductions in public expenditure have been accompanied by a corresponding "crowding in" by the private sector, with an increase in capital formation and employment generation by the latter.

Due to data limitations this study is only concerned with open unemployment anc the issue of underemployment will nct be taken up. Further, given the paucity of information relating even to open unemployment, frequent use is made of data on production and investment as proxies for employment. Within this context constant technologies are assumed throughout. In view of these

limitations, the findings of this study cannot be considered as definitive statements on the subject, but rather as providing a rough indication of the likely consequences of certain policies. The approach adopted here should be useful in suggesting directions in which one might move to test hypotheses more scientifically.

The outline of this paper is as follows. Section two provides a theoretical overview of monetarist and post-Keynesian/structuralist approaches to the causes of unemployment and economic instability. It aims to show that economic policies pursued vis-a-vis employment generation and instability are not technical in the sense of being free from theoretical choices and perspectives and that they logically and necessarily follow from the assumptions of the respective theories. The third section briefly discusses certain salient structural features of the economy and macro-economic trends over the period 1970-85. It also considers the magnitude of the employment problem and the policy context within which employment has been generated. The fourth section provides an empirical consideration of the employment consequences of various stabilization measures adopted during 1970-85. These are : variations in public sector expenditure, exchange rate adjustments, and prices and incomes policies. Within this section the private sector's response (in terms of employment generation) to the various stabilization measures adopted is also considered. The final section offers some conclusions derived from the preceding analysis.

2. Theoretical Overview of Monetarist and Post-Keynesian/Structuralist Approaches to the Causes of Unemployment and Economic Instability.

2.1 *Differing types of unemployment*

According to both structuralists and monetarists unemployment in Less Developed Countries (LDCs) could broadly be classified into cyclical and structural categories. Cyclical unemployment is said to result from production being constrained by a deficiency in aggregate effective demand and is thus considered to be shortrun in nature. Structural unemployment on the other hand is said to arise not because of a lack of effective demand, but due to structural constraints; these depend on the theoretical paradigm used to analyse the economy. For instance, in LDCs, production and employment generation is seen by structuralists to be constrained by insufficient capital accumulation while factor price distortions are seen by monetarists to lead to production techniques which are capital-intensive as opposed to labour-intensive. Unlike cyclical unemployment, structural unemployment can thus be considered to be supply determined and to be more long-term in nature, requiring the creation of additional productive capacity through investment and/or the elimination of market distortions.

Although at any time of unemployment both structural and demand deficit causes may be operative, it will obviously not be possible to say that one particular worker is unemployed because of deficit demand and another for structural reasons. This should not however obscure the fact that both causes can be operative and their cure would, depending on what school of thought one operates within, entail quite divergent policies with different implications for the rest of the economy.

2.2 *Monetarism in theory*

A fundamental proposition of monetarism is that the real side of the economy (capital formation, output, employment etc.) is ultimately affected only by real factors such as the quantity and quality of land, labour and capital, and is considered to be separate from monetary factors as

well as being inherently stable. The real economy is also regarded as having a natural tendency towards equilibrium under the free play of market forces. Equilibrium, according to the monetarists, is a position in which all factors of production are fully employed at a price equal to their marginal product. The monetary side is on the other hand seen as being potentially unstable since it is affected by government policy. Monetary phenomena such as inflation and balance of payment problems (i.e. stabilization problems) are seen as resulting from government "monetary mismanagement" (i.e. budget deficits) leading to an excessive expansion in the money supply.

In terms of employment the equilibrium level and its price (i.e. the real wage) are, according to monetarists, determined by the interaction of the aggregate demand and supply schedules for labour. At real wage rates higher than the equilibrium rate, the supply of labour will exceed demand and competitive presssures among workers will force the money wage down, commodity prices remaining constant, until the real wage falls to its original level. Similarly, at a lower real wage, the quantity of labour demand will exceed its supply, and competition among producers will drive the money wage up until the real wage reaches its equilibrium position. Only at the equilibrium wage will all those willing to work be able to obtain jobs so that there is no involuntary unemployment. In other words, in the idealized flexible wages world of neo-classical economics there can never be unemployment (or only the natural rate of unemployment).

According to this view, if involuntary unemployment is to exist in the long run, then it is a consequence of frictions that impede the working of the market mechanism in that the price system does not reflect relative scarcities (i.e. it is distorted). An explicit diagnosis of unemployment along these lines would suggest that if wages were sufficiently flexible, along with prices and exchange rates, and if taxes and labour regulations were set so as not to interfere with the function of prices in reflecting relative scarcities, then the economy would move more readily towards full employment and government intervention to reduce involuntary unemployment would be unnecessary.

Most monetarists also attribute problems such as cyclical unemployment to monetary instability, arguing that while the real side is inherently separate from the monetary side, it is nevertheless affected in the short run by monetary disequilibrium via "incorrect inflationary expectations", given the fact that markets are diffused and the economic system is slow to adapt. Moreover, in the context of LDCs, even short-run monetary/real transmissions are denied by some monetarists due to the relatively fixed nature of output. According to this view people are supposed to possess rational expectations.

In terms of economic stabilization, for monetarists, the transmission of inflationary impulses and balance of payments disequilibria comes about as a result of the following combination of factors :

(i) If financing budget deficits involves bank borrowing (i.e. printing money), there will consequently be a larger amount of money in circulation chasing a given amount of goods and services. This will lead to higher price.[1] The inflationary impact will be greater if public expenditure is concentrated on non-productive or long-gestation activity. In addition, where money wages are indexed to inflation through cost of living allowances, this will generate further inflationary pressures by increasing unit costs without necessarily expanding production.

(ii) An increase in the money supply will cause aggregate demand to rise so that demand for imports also rises, causing an adverse impact on the balance of payments (Polak, 1977). The domestic inflation resulting from budget deficits also causes production costs to rise and exports to become less competitive, especially if exchange rates are inflexible. By the same process imports become relatively cheaper and the loss of competitiveness of exports and import substitutes results in a further deterioration in the balance of payments.

It becomes apparent that monetarists base their hopes of controlling inflation and reducing external payments imbalances on the control of budget deficits (and thus domestic credit). If countries experience severe payments imbalances, monetarists recommend, in addition to a phased financial retrenchment, a devaluation of the exchange rate in line with the rate of inflation to maintain competitiveness. Moreover, devaluation is recommended not only to improve a country's trade competitiveness, but also to supplement budgetary measures to reduce domestic demand and consumption. A devaluation, by making all imported goods (and their substitutes) more expensive in relation to wages, causes a decline in real wages which would by itself tend to reduce consumption.

In terms of the employment consequences of these stabilization measures, apart from government policies to promote competition, private enterprise and free trade, monetarists view state intervention in the economy through a budget deficit as not just unnecessary, but also undesirable. They consider it to be incapable of affecting real factors such as employment, that it leads to a distortion of the correct relative prices/incentives, and therefore discourages more efficient private enterprises. Monetarists argue that no matter how state expenditure is financed, economies are bound to suffer. If it is financed by borrowing, private investment will be "crowded out"; if it is financed through increased taxation, incentives to innovate and increase productivity will be choked off; and if the expenditure is financed by printing money, then (as noted above) the public will off-load the increase in their money balances, and prices will rise. Thus, if markets are allowed to work, they argue, the economy will grow and stabilize. Accordingly, developing countries are urged to reduce state ownership, end industrial promotion through direct state investment, encourage private investment (both domestic and foreign), reduce corporate, business and income taxes (switching to sales taxes, if necessary), and eliminate state subsidies on basic foods and on such public services as transport, health and education. Monetarists believe that these policies will lead to a significant "crowding in" phenomenon in which the decrease in government — induced capital formation is more than offset by a rise in private sector investment and employment.

In the context of exchange rates, apart from the need for a realistic rate to improve the relative prices of traded vis-a-vis non-traded goods and bring about a shift in resources towards the traded goods sector, monetarists believe that when the domestic currency is overvalued in terms of foreign currency there is a bias towards more advanced (labour-saving) production methods since the true cost of importing capital goods is undervalued.

2.3 *A post-Keynesian/Structuralist perspective*

Keynesians differ from monetarists in their position on the demand for labour in that the latter is seen not so much in terms of physical productivity but rather of productivity in terms of returns. Labour demand is therefore related not so much to the real or money wage, but rather to expectations. Thus during periods of rapid economic expansion, firms might demand labour even though money and real wages may have risen, while in a crisis, the demand for labour will decrease even though money and real wages may have fallen. In addition, post-Keynesians see the possibility of a decline in money wages relative to prices reducing consumption demand and hence employment, while a decline in both money wages and prices undermines business confidence and reduces investment demand and employment. According to post-Keynesians then, flexible wages cannot perform any market clearing function, and variations in the wage rate cannot eliminate unemployment.

Unlike in monetarism, in Keynesian/structuralist thinking there is generally a tendency not to separate development policy (the real side) from stabilization (the monetary side) due to a view of interaction between the two. Market phenomena are determined, according to structuralists, by both real and monetary factors, and monetary factors such as changes in the money supply can affect output and employment. Moreover, according to this view, there is nothing inherent in the market mechanism that could be relied upon to push the economy to full employment equilibrium. This is derived from the Keynesian view that much of what happens in an actual economy can be understood only by assuming the existence of uncertainty. To put it differently, "The essence of a real economy that operates in historical time is that its past cannot be changed and its future cannot be known. In such an economy, there may be no tendency to move towards long run equilibrium" (Burbridge, 1979 : p. 140).

The Keynesian explanation of cyclical unemployment starts from the simple proposition that employment varies directly with production, and production depends on aggregate effective demand or gross national expenditure. If gross national expenditure falls short of the level required to employ the entire labour force, part of the labour force will be "involuntarily" unemployed and will remain so as long as aggregate demand remains unchanged. (i.e. there will be cyclical unemployment). The Keynesian prescription for reducing or eradicating unemployment is therefore quite simple : increase aggregate demand through direct increases in government expenditure (see section below) or by government policies which indirectly encourage more private investment (e.g. low interest rates, tax allowances and investment subsidies).

In respect of structural unemployment, the post-Keynesian/structuralist position is that it is part and parcel of the development process. Structural unemployment is seen to be influenced by the economic structure and institutional characteristics of LDCs. There is also a view that the existing structure not only brings about a poor employment performance and income distribution but also limits growth. The policy proposals recommended thus tend to emphasise the need to shift the structural balance in directions which would increase employment, improve income distribution and ease growth bottlenecks such as the unavailability of foreign exchange.

Similar to this school's analysis of employment, the structuralist/post-Keynesian approach to economic stabilization also asserts that the roots of inflation and external payments imbalances are imbedded in the economic structure. This, in developing countries, is typically characterized by resource immobility, market segmentation, and disequilibrium between sectoral demands and supplies. Structuralists contend that as growth proceeds, the economy is prone to develop extended bottlenecks since the changes in demand associated with higher income levels are not followed by an adequate supply response. A characterization of the main bottlenecks would include : the supply of food products; the availability of foreign exchange; the rigidity in the expenditure and revenue structure of the government; the inability to raise domestic savings and the scarcity of various intermediate inputs such as fuel, fertilizer, transport facilities, electricity, and credit (Canavese, 1982; Foxley, 1981; Seers, 1962; Seers, 1981).

The essence of a structuralist stabilization programme is therefore a development programme to achieve the needed structural changes. Almost by definition, this would be long-term in nature since structural disequilibrium can be eliminated only by a reallocation of investment. More specifically, structuralist inflation theory is based on three main elements :

(i) relative prices that change when economic structures change (such as a foreign exchange constraint brought on by deteriorating terms of trade);

(ii) downward inflexibility of some money prices; and

(iii) a money supply being passively adjusted by the financial system to the level of spending (Canavese, 1982). If money prices are inflexible downwards, then the changes in relative prices would in turn be reflected in an increase in the general price level which in a passive money environment would result in an inflationary process. Although structuralists do not deny the possiblity of an excess demand induced inflation, they do not consider it as a necessary condition for inflation. They do, however, maintain that a sustained increase in the general price level needs either the existence of some sort of "propagation elements" [2] linking changes in money prices to changes in money wages and changes in money wages to changes in costs (and hence changes in other money prices) or repeated changes in economic structure over time (or both things at the same time). Hence the money supply, according to this view, is another mechanism for propagating inflation rather than, as the monetarists maintain, its prime cause.[3] Furthermore, in response to the monetarist claim that inflation could always be halted by clamping a firm ceiling on the money supply, structuralists argue that apart from the dubious monetarist proposition of an inflexible velocity of circulation,[4] argument rests on the assumption that there are no technical obstacles to controlling the money supply. This, the structuralists argue, is not correct because of international capital flows, large fluctuations in import prices and local harvests which cannot be controlled, as well as the existence of short-term assets which can substitute for money. Moreover, since prices are inflexible downwards, attempts to control the money supply and government expenditure will therefore have their primary impact on output and employment with only a slight, if any, abatement in the level of prices.

According to structuralists, the balance of payments problems of developing countries are primarily due to external factors such as (i) deteriorating terms of trade which reduce export earnings and increase expenditure on imports, (ii) rising world interest rates which cause foreign debt repayments to rise, and (iii) recession in industrial countries which leads to a fall in demand for developing country exports (Foxley, 1981; Nicholas, 1984; Seers, 1962). This latter point is of crucial importance to structuralists since they contend that demand from developed countries for developing country products is generally price inelastic (at least in a downward direction) and income inelastic (in an upward direction), while due to their nature the supply of these products (particularly tree crops) is typically price inelastic. These economists also contend that developing country demand for developed country products is also price inelastic in an upward direction and highly income elastic. This contrasts with the tacit assumption of the monetarists which is one of a high degree of price elasticity of demand and supply for exports and imports. Since the use of exchange rate policy crucially depends on the above mentioned elasticity assumptions, structuralists criticise the monetarist prescription for developing countries to devalue in line with their rates of inflation.

The consequence of a strict monetary policy for monetarists would be to keep output linked to exports. It follows that as long as LDC exports, typically primary commodities, are booming, the economy and employment are able to grow rapidly without inflation, and without industrialization. Structuralists are however generally sceptical of such views since they see world demand for primary commodities as being relatively weak, with the consequence that in the long run LDCs would be unable to expand output of these products at the rate needed to maintain an adequate pace of economic growth and level of employment. They therefore see the need for diversifying investment in the economy to avoid stagnation, including investment led by the state in such fields as import substitution industries which are secured by protection.[5] This, it is believed would allow output and employment to grow more rapidly than the trend in exports would permit. The problem here, according to them, is one of low domestic savings due to low per capita income and hence the need to rely on external savings. Post-Keynesians and structuralists thus advocate budget deficits that allow for public investment in proportion to the availability of external finance. They see budget

deficits as one of the most important policy instruments available, and believe that any adverse effects such deficits may have on inflation and the balance of payments should be set against their benefits in terms of growth and employment.[6] These economists accordingly tend to a certain extent to view stabilization problems as an inevitable by-product of development.[7]

Post-Keynesians also point out that the contention that funded borrowings "crowd out" private sector borrowings ignores the role that deficit financing plays as a regulator of economic activity whether as a built-in stabilizer or as an active instrument of demand management. According to this view, deficit financing takes place only when there is inadequate private investment; it therefore does not pre-empt such investment.

In terms of controlling inflation, structuralists recommend : (i) the adoption of basic food strategies to expand domestic food supplies and keep wage demands down, (ii) some type of price and incomes policy, (iii) attempts to secure international agreement on prices; and (iv) relatively fixed exchange rates supported by adequate external adjustment funding. In terms of achieving external balance, the structuralist policy prescriptions include : (i) control of non-essential imports, (ii) commodity agreements to eliminate over-production and restore remunerative prices for exports, and (iii) diversification towards industrial products using import tariffs, export subsidies and perhaps dual exchange rates.

Given their scepticism of the general effectiveness of devaluation, structuralists consider a system of dual exchange rates an appropriate instrument for industrial development and the generation of employment. Its advantage over a conventional system is that it permits existing domestic cost structures to be adjusted to make selected domestic goods competitive with foreign goods. Structuralists feel that the main obstacle to the industrialization of LDCs is not that their costs are in general too high, but that the costs of producing manufactured goods are high in relation to the costs of producing primary commodities.

3. The Economy and Employment

3.1 *Structural features of the Sri Lankan economy*

Perhaps the most striking feature of the Sri Lankan economy when compared with other countries of similarly low per capita income is the social progress made in such areas as literacy, health, life expectancy, mortality, population growth and nutrition. Sri Lanka nevertheless shares with its fellow LDCs a number of structurally retarding features.

Sri Lanka has a large agricultural sector which accounts for around one third of GDP and two thirds of employment; a relatively weak manufacturing sector accounting for some 15% of GDP; a small construction sector; a large service sector much of it comprising labour-intensive activities with relatively low productivity; and a large informal sector involving around 20% of the total labour force and complementing the activities of the formal sector.

The dynamic of Sri Lanka's economic system — its growth and development potential — has been greatly influenced by the export sector, comprising mainly three primary commodities (tea, rubber and coconuts). Not only do exports provide the foreign exchange needed to buy certain basic consumption goods and the intermediate and capital goods necessary for any industrialization strategy, they have also provided the bulk of the government's revenue through export taxation. The problem

with this structural over dependence on the export sector is that export earnings and the government's revenue base have been severely constrained by a tendency for the terms of trade to deteriorate. The country is continually confronted with a choice between growth with mounting balance of payments and budgetary problems (problems aggravated compounded by the fact that the government is the biggest investor and importer of intermediate and capital goods), and no growth at all.

3.2 *Macro trends* 1970 - 1985

In considering the period 1970-85, a distinction is usually made between the sub-periods 1970-77 and 1978-85 since they were characterized by different governments with quite divergent policy regimes which had important implications for the structure and dynamic of the economy.

The effort to make domestic incomes less vulnerable to fluctuations in the country's terms of trade and the need to provide employment to a growing population led pre-1977 governments to promote industrialization based on import substitution. Quantitative restrictions on imports, a high tariff structure and a dual exchange rate were employed to encourage the creation of domestic industries. This process of state-sponsored industrialization which began in the mid 1950s continued well into the 1960s and 1970s. During this period the foreign-owned plantations, oil, omnibus services, insurance and banking were nationalized, and the state became the country's largest producer. Between 1970 and 1977, the government increased its presence throughout the economy, especially in the management of economic resources, with many prices being administered and production and consumption being subsidized. By 1977 over 6,000 items were under price controls, and the transfers on subsidies came to account for around 23% of total government current expenditure.

During 1970-77 the average annual GDP growth rate fell from 4.4% in the previous decade to 2.9%. This sluggishness has to be explained by the acute scarcity of foreign exchange brought on by the poor performance of traditional exports due to deteriorating terms of trade for much of this period and the fact that import substitution industrialization did not lead to a sufficient expansion of industrial exports to meet the new demands for imports of that sector. Moreover, the welfare and other claims on the stagnant earnings of the traditional export sector meant that these earnings were not sufficient to finance the import requirements of the industrial sector. During this period capacity utilization in industrial plant averaged only 60%. A further consequence of foreign exchange scarcity was low domestic savings and this, in the absence of any significant foreign capital inflows, meant inadequate capital formation. These factors together led to a rise in unemployment, concentrated among the educated and younger age groups. External factors such as deteriorating terms of trade were also seen to play a key role in the instability problems (i.e. inflation and current account imbalances) of this period (see Table 1).

The period 1978-85 by contrast was marked by a liberalisation of the economy. The development strategy initiated in late 1977 gave priority to export-led growth, a reduction in the role of the state in the economy (with a corresponding increase in that of the private sector) and to the expansion of market forces in the allocation of resources. To this end there was a reduction in price controls and subsidies, an elimination of quotas and their replacement by tariffs, unification and devaluation of the exchange rate, a considerable relaxation of controls on foreign exchange transactions, incentives for foreign investment, the opening up of domestic trade to the private sector, and recourse to interest rates for allocating credit.

When compared with the preceding period, 1978-85 recorded a GDP growth rate of 5.6% as against 2.9% and an increase in the level of investment from 15% to 27% of GDP. These increases were made possible however not by any appreciable expansion in exports, but by massive capital expenditures undertaken by the state and funded, in the absence of adequate national savings, by an unprecedented (for Sri Lanka) volume of foreign, mainly official, finance.

While increased growth resulted in a fall in open unemployment, the increased extraversion of the economy at a time when world market forces were particularly disruptive has meant that growth was accompanied by mounting instability problems (see Table 1). In a bid to correct these imbalances, the government, with the active support of the IMF, launched a programme aimed at cutting its expenditure (especially investment expenditure) and strengthening the incentive framework through such measures as the depreciation of the exchange rate. This in turn has recently led to a slowdown in economic growth and an increase in open unemployment.

Though satisfactory data is lacking there are grounds for suggesting that post-1977 growth has not been able to resolve the problems of poverty. In fact, with the recent slow-down in the rate of growth, there are increasing signs that poverty has become more widespread, income distribution has deteriorated, and welfare and nutrition levels have fallen (Khatkhate, 1982; Nicholas, 1984; Nicholas, 1986; UNICEF, 1985; World Bank, 1977; World Bank, 1978; World Bank, 1986; World Bank, 1987).

3.3 *Employment : the magnitude of the problem and policy issues*

In the 1970s unemployment was a key political issue in Sri Lanka. It could hardly have been otherwise given the highly visible link between open unemployment, particularly among the educated youth, and the 1971 insurrection. After having disappeared from the political agenda for a while, unemployment has, with the present social unrest in the country, once again reappeared as a politically explosive issue.

The roots of the problem go back many years. Slow economic growth brought on by low levels of investment due to the scarcity of foreign exchange in the 1970s was accompanied by an increase in open unemployment. Based on the 1971 census figures, unemployment was projected to have increased from 18% of the labour force in 1971 to over 20%, or one million unemployed, by 1977. Apart from slow growth, the ILO's influential 1971 study on unemployment in Sri Lanka also identified a "serious mismatch" between the job aspirations of those with post-primary education and the jobs available to them. The study argued for labour market and educational reforms to bring the two into line. Other important causes for the high levels of open unemployment included : the post-war demographic bulge following the eradication of malaria; and rising female participation rates reflecting the rapid expansion in female education, the financial need to work, the higher age at marriage and reduced fertility (ILO. 1971: Irvin, 1986; World Bank, 1978).

As noted above, the rapid economic expansion after 1977 led to part of the backlog of unemployment being cleared. This was made possible by a growth pattern biased towards relatively labour-intensive sectors (services, construction, paddy and garments). The liberalization of the economy has however also had negative employment consequences. In particular, the increased availability of imported commodities has affected small-scale, labour-intensive, import substituting industries, many of which were located in the informal sector. A well-known case is that of handloom textile production. Estimates prepared by the Ministry of Textile Industries indicate that out of

111,000 handlooms in the country at the time of liberalization, about 30,000 had ceased to function by 1980. The net effect on employment is nevertheless likely to have been positive in the years immediately after 1977, especially since the large outflow of Sri Lankan labour to the Middle East during that time and the out-migration of a significant number of plantation workers of Indian origin resulted in a decline in the labour force participation rate.

There are however increasing signs that this positive impact has not been maintained more recently as a number of factors which pushed employment growth earlier have lost their dynamism. The initial high growth rates in construction activity reflected the rapid expansion in investment (in particular public investments in the Accelerated Mahaweli Programme and housing, and private investments in tourist hotel construction). With no new large-scale public schemes being undertaken, and with chronic under-utilization of capacity in the hotel industry due to the current unrest in the country, construction activity has recently declined sharply. In terms of services, the expansion of the financial and trade sectors was largely a catching-up exercise after the opening up of the economy and increased domestic demand caused by the increase in public investment. Further growth here will depend on a continued high level of economic activity. In paddy, self-sufficiency is within reach at existing per capita consumption levels and, since export prospects for Sri Lankan rice are poor, the scope for acreage increases and the intensification of production appears limited. Moreover, employment opportunities in paddy during the post-1977 period mainly benefited existing workers who were resettled on newly irrigated lands. Growth in the garment industry is being constrained by import quotas imposed by the developed countries. In terms of labour migration, there are obvious limits to the repatriation of plantation workers of Indian origin, while the slower growth of the Middle Eastern economies has meant a decline in demand for migrant workers and, in fact, significant numbers of Sri Lankan migrants have returned home in recent years.

Owing to these negative developments it is estimated that unemployment, which fell to about 14.7% of the labour force in 1981 had increased to 16.2% by 1986.[8]

Although the issue of a structural mismatch between jobs demanded and offered and the ensuing labour market segmentation may still be pertinent, there is reason to believe that the main problem of unemployment is simply the need to create more jobs. For instance, although industrial capacity utilization increased from 60% to 70% between 1977 and 1978, reflecting the release of the import constraint, capacity utilization has since grown very slowly, averaging 73% by 1980. Since the supply of labour is determined to a large extent by longer term demographic trends, the main task must therefore be to stimulate the demand for labour through macro-economic policies. A crucial factor (as will be demonstrated in the following pages) is therefore the level of investment.

The impact of wages on employment generation does however appear to be more ambiguous than suggested by orthodox theory. During 1970-77 for instance minimum real wages in the organized private sector increased by 47% while nominal wages went up by 113%[9]. Employment in the organized private sector (based on Employment Provident Fund (EPF) active accounts data) during this period rose by 15%. During 1978-85 on the other hand nominal wages increased by 161% and real wages only by 7%, reflecting the decontrol of prices during this period (see Table 6). The number of active accounts with the EPF in the same period increased by 37%. The higher level of private sector employment generation during the latter period cannot however be attributed to a lower rate of real wage increases brought on by lower nominal wage increases (the rate of the latter in fact rising as between the two periods), but rather to better expectations of profitability. For instance during the boom period of 1978-80, despite both nominal and real wages increasing sharply, the number

of active accounts with the EPF recorded its highest rate of increase for the entire 1978-85 period. On the other hand during 1970-73 when nominal and real wages were held near constant, the prevailing pessimistic expectations meant that private sector employment generation recorded its lowest increase for the 1970-77 period.

4. Empirical Consideration of the Employment Consequences of Public Expenditure, the Private Sector Response, Exchange Rate Adjustments and Prices and Income Policies.

4.1 *The State's role in employment generation*

Monetarists would attribute the improvements in the rate of economic growth and employment creation in the years following liberalization in 1977 directly to such liberalization, while attributing the slowdown in the rate of growth and increased unemployment in recent years to a loss of momentum in carrying out further policy reforms. The reforms they would urge include improving the incentive framework, particularly through further tariff changes and a more realistic exchange rate so as to lead to a more diversified export base; and the containment of public spending to release resources to the private sector and bring about "more sustainable growth".

Despite the admittedly significant degree of liberalization since 1977, the driving force behind the subsequent high rates of economic growth and employment generation was not exports or market forces (the former providing only 60% of the foreign exchange required by imports during 1978-85), but massive capital investments undertaken by the state. Although the level of domestic saving during this period rose (as a result of a change in the wage-profit share in national income), this was not enough to match the expansion in investment. The difference has been met by foreign savings. Thus, as a percentage of its own total expenditure, a total which has also risen massively, capital expenditure by the state has gone up from an average of 28% in 1970-77 to around 44% in 1978-85, while as a percentage of GDP (at current market prices) it has risen from an average of 6.3% to 14.7% between these periods. The state's role in the growth process is also evident from the fact that a slowdown in the rate of expansion of government investment expenditure since 1980 has been accompanied by a corresponding decline in the rate of growth of the economy in real terms from an average of 6.8% during 1978-80 to 5.2% during 1981-85 (see Table 2). In terms of employment, the rate of growth of civilian employment in government and semi-government institutions between 1978 and 1980 were 12.6% and 24.6% respectively, while the corresponding rates during 1981-85 were 4.5% and -4.0%, the latter category decreasing by -5.9% between 1983 and 1985 (see Table 3).

During the 1970-77 period however, despite low economic growth, public sector employment creation expanded rapidly (in relation to the available capital stock, see Table 3) suggesting a more labour intensive development strategy than what was adopted in the subsequent period. These employment figures however need to be interpreted with some caution: apart from the fact that the increase in public sector employment generation after 1970 was from a low base, the nationalization of agricultural lands during this period tended to greatly inflate these figures.

Although, to a certain extent, the creation of public sector jobs (especially in clerical and allied grades) during the entire period could have been due to the immediate need to alleviate the unemployment problem, there can be no doubt that the growth in employment in the public sector since 1977 was mainly the result of the growth in public investment. This is illustrated by the fact

that between 1970 and 1975 (prior to the nationalization of the plantations), 88,969 new jobs were created in semi-government institutions compared with 168,684 during the post-nationalization period of 1978-83. The decline in employment in the public sector as a whole in more recent years could be attributed to the completion of such large public investment projects as the Mahaweli and the fact that they have not been followed by new large-scale long-gestation schemes. Moreover the present policy of streamlining the public sector as evidenced by the current round of budgetary cuts and factory closures suggests that employment in this sector has already peaked. This appears to be confirmed by Table 3. Given existing policies this means that the burden of domestic job creation will fall increasingly on the private sector.

4.2 *The private sector response*

Inadequate and incomplete data precludes any definitive statement concerning private sector employment creation. There are indications that the performance of this sector as a supplier of jobs has not been commensurate with the leading role ascribed to it in the country's economic development. This cannot however be attributed to its being crowded out by the public sector. During 1970-77 for instance, credit to the private sector went up by 182% and to the public sector by 87%. Between 1978 and 1985 on the other hand, credit to the private sector rose by 1049% while public sector credit expansion was only 343% (see Table 1). Moreover, during 1970-77 the steady decline in public sector capital formation was accompanied by a corresponding decline in private investment.

A similar situation occurred during the 1980-85 period. As indicated in Table 2, private sector capital formation as a percentage of GDP has been steadily falling since 1980, at a time when the state's involvement in the economy is being reduced as a conscious policy objective. The decrease in private investment activity since 1980 has been in spite of the increased availability of Central Bank refinance (which enables commerical banks to grant loans to priority sectors at low interest rate).[10] The recent slowdown in private sector demand for credit for productive purposes is the result of greater uncertainty about the prospects for the economy due to the lower rate of economic activity and increased political unrest. In the absence of a significant demand for investment finance, the high private sector borrowing during the 1978-85 period could be explained by the deteriorating terms of trade caused by the 271% rise in import prices which fed into domestic inflation. It is also revealing that despite all the encouragement given to the private sector in the post-liberalization period, private investment as a percentage of GDP has not shown any significant improvement over the preceding 1970-77 period. This is perhaps an indication of the fact that despite the scarcity of foreign exchange in the earlier period, certain private sector concerns (especially industrial concerns) benefited from the incentive structure (for example, the dual exchange rate system) which prevailed at that time. As noted earlier, while employment in the organized private sector appears to have increased by 31% between 1978 and 1985, the number of active accounts of the EPF has increased by only 3% during the period 1981-85. Data from the Greater Colombo Economic Commission (GCEC) shows that while employment in enterprises coming under it (mainly in the Free Trade Zone) has increased from 261 persons in 1978 to 45,047 persons in 1986, over 80% of them are employed in textile, apparel, and leather products enterprises. Future employment prospects in this area however remain in doubt, given the quota restrictions faced by Sri Lanka in these lines of production.

The informal sector in Sri Lanka is characterized by a paucity of information. It is unclear whether this sector, which is responsible for a substantial portion of employment generation, benefited from economic liberalization. While it is evident that employment generation in such activities as private transport and wholesale and retail trade has increased quite considerably as noted above,

it is equally clear that increased competition following liberalization also led to the closure of a large number of small-scale enterprises producing for the domestic market. These enterprises, although inefficient in several respects, were nevertheless labour-intensive.

4.3 *Exchange rate adjustments*

Since 1977, the Sri Lankan rupee has depreciated by almost 45% in nominal terms against the currencies of the country's major trading partners on a trade weighted basis.[11] However, due to relative international price movements, the real exchange rate appreciated more or less continuously for much of this period, with only the sharp nominal depreciation of the rupee in 1986 against the SDR (brought on by maintaining the rupee rate vis-a-vis the declining US dollar) leading to a depreciation of the real rate (by 3%) for the first time since liberalization (see Table 4). Moreover, if one looks at the real exchange rate movement relative to the US dollar of the currencies of Sri Lanka's main competitors, the devaluation of the rupee required to restore the competitive position of Sri Lanka's exporters relative to its competitors would be around 11% (see Table 5).

The appreciation of the rupee for much of the post-1977 period would, according to the monetarists, have been a major contributory factor in the lack of buoyancy of exports during the period, and in the rate of employment generation being lower than it would have been with a more realistic exchange rate. The World Bank economic report for 1986 even queries the sufficiency of bringing the real exchange rate to its 1978 level, citing the deterioration in the terms of trade and loss of profitability of Sri Lanka's traditional exports, the increased scarcity value of foreign exchange due to the much higher debt service, and the fact that Sri Lanka's competitors have depreciated their currency much more than Sri Lanka.

In the case of tree crops, given their low supply elasticities, devaluations are unlikely to bring about an immediate increase in export volumes. If tree crop supply elasticities are higher than had been supposed, devaluations, while not affecting the world price level, will stimulate domestic production; this will lead to a further deterioration in the terms of trade, given that the initial deterioration was due to world overproduction. This in turn could have negative employment consequences not only in the tree crops sector but also in the rest of the economy, in view of the adverse effect terms of trade deterioration has on foreign exchange availability. The role played by exchange rates in the stimulation of other exports and related employment is also unclear. The export products that have shown the fastest growth since liberalization have been petroleum re-exports and garments. This had very little to do with the exchange rate structure. The expansion of garment exports was influenced by the quota allocations given to Sri Lanka. Within this context it should be noted that the growth of other Free Trade Zone exports and employment also had far more to do with factors such as investment incentives than exchange rates. Moreover, both the petroleum and garment industries have developed very poor linkages with the rest of the economy, with the former in particular having a minimal impact on employment generation. It is also misleading to attribute the growth in the service and construction sectors (i.e. the non-traded goods sector) to an overvalued exchange rate. Their growth stemmed from higher domestic demand caused by the massive increase in public expenditure.

Despite the appreciation of the real value of the rupee vis-a-vis other currencies for a greater part of the post-liberalization period, it is unlikely that the true cost of importing capital goods was, as a consequence, so undervalued that it brought about, as suggested in Table 7, a three-fold increase in the capital intensity of production and thus prevented a more labour-intensive production structure.

Furthermore, during 1978-85, the volume of imported capital goods increased by 113% despite their obviously greater cost brought on by the 45% nominal depreciation of the rupee. Perhaps a better explanation of this phenomenon could be the fact that imports of investment goods are more responsive to the availability of foreign exchange than their price. As noted above, during the 1978-85 period foreign exchange of an unprecedented volume has been made available to the country. The availability of foreign exchange also appeared to play a major part in the capital-intensive production structure which emerged in the agricultural sector since it enabled the government to subsidize the increased cost of imported inputs resulting from the depreciation of the rupee.

The impact of the dual exchange rate system, applicable during the 1970-77 period, on employment generation is less straightforward. While dual rates in conjunction with high import controls appear to have given the private sector adequate incentives to develop import substituting industries, their ability to satisfy the needs of the domestic market were constrained by their own dependence on imported inputs of limited availability. This in turn led to instability problems. Moreover, in some instances the domestic market was limited by the scarcity of complementary imported goods; for example, the demand for tyres was limited by the ban on car imports. Although inadequate data precludes a definitive statement, there appears to be no evidence to suggest that dual exchange rates brought on a more capital intensive production structure than the subsequent export-led industrialization. In fact, the data in Table 7 suggests the reverse. The volume of capital goods imports — these imports may be used as a proxy for capital-intensive investments — increased by only 15% during 1970-77, while as noted above it increased by 113% during 1978-85. Although this could be attributed to the chronic shortage of foreign exchange in the 1970-77 period, given the shortage the dual exchange rate appeared to ration foreign exchange effectively to prevent excessive imports of capital-intensive consumer goods and capital and intermediate goods that are labour-saving, like two-wheel tractors and weed killers. During 1970-77, for instance, the volume of "other consumer goods" imports (excluding food, drink and textiles) rose by 9% whereas in the subsequent 1978-85 period it increased by 202%.

4.4 *Prices and income policy*

In analysing the employment consequences of the prices and de facto wages policy (whereby public sector wage increases were kept small with priority given to increases for the lower paid) of the government of 1970-77, it would be necessary to investigate whether such policies brought on a more stable rate of growth of inflation and incomes and whether this in turn encouraged capital formation. Although it is generally acknowledged that the government's prices and incomes policy succeeded in narrowing income differentials, as seen from Tables 1 and 2, prices were not stable during the 1970-77 period and capital formation steadily decreased in both the private and public sectors. Other factors such as the deteriorating terms of trade and the shortage of foreign exchange seemed to play a far more important role in determining the behaviour of prices and (in the absence of adequate domestic savings) capital formation. Moreover the introduction of a compulsory savings scheme together with a ceiling on incomes in the early 1970s, essentially to increase domestic savings, at a time when the government had imposed strict controls on its own expenditure, led to a further deterioration in economic activity with no concomitant increase in domestic savings.

Concluding Remarks

While the liberalization measures introduced since 1977 such as the release of the import constraint did have a positive growth and net employment effect, it appears that these led to a once-and-for-all increase in economic activity. This is evident from the fact that a contraction of the

public sector has been accompanied by a slowdown in the rate of growth of the whole economy. Within this context it could thus be argued that any adverse effects the budget deficits might have had on inflation and the current account balance need to be set against their benefits in terms of growth and employment, for there is no doubt that the latter have been the direct outcome of the government's massive capital expenditure programmes.

It was also seen that the poor performance of the private sector during the 1970-85 period could not be attributed to its being crowded out by the public sector. Moreover other stabilization instruments such as a continued depreciation of the exchange rate were not effective in changing the structure of production from a capital-intensive to a more labour-intensive one, while there is some evidence to suggest that a system of dual exchange rates is more effective in this respect. The employment consequences of a prices and income policy however appear to be more ambiguous.

From the analysis of this paper it is evident that despite the significant degree of liberalization the economic strategy implemented during the post-1977 period could, in fact, be described as a type of right-wing Keynesianism, characterized by a leading role for the state in the accumulation process, and an erosion, in real terms, of social welfare expenditure. In this respect it warrants remarking, that the development strategy adopted in 1978-85 was not, in essence, dissimilar to previous strategies especially if one allows for differences in the amount of external assistance.

As the gap between labour force growth and domestic job creation is likely to widen in the near future (especially in the context of negative net-migration, with migrant workers returning from the Middle East exceeding those leaving for the Middle East), recent studies have estimated that just to stabilize unemployment at its current level, it will be necessary to maintain the investment share in GDP at its present level. As seen above, despite the larger role given to the private sector in generating growth and employment, its performance has so far been insufficient. In the present unsettled international environment and the state of unrest in the country, it is unlikely that private sector activity (especially investment activity) will expand significantly in the near future. Without defending the inefficiencies of the public sector, it could be argued that, in the absence of an adequate private sector response, the present policy as reflected in the 1987-89 stabilization programme of curtailing public investment to bring about "more sustainable growth" is unlikely to be effective in that it is leading to a steady erosion of the productive base of the country in an environment where there is nothing to replace it.

While a monetarist/neo-classical explanation of the causes of unemployment does not appear to hold much empirical validity in the Sri Lankan context, their policies as regards to stabilization certainly cannot be regarded as costless in the short run. This much appears to be recognized even by the World Bank which says in its 1986 economic report on Sri Lanka that : "It is unclear whether this adjustment can be made without disrupting the growth process and plunging the economy into recession". Moreover, the "short-term" stabilization measures that are recommended appear to be affecting the production structure of the economy in such a way that they will lead to long-term costs.

FOOTNOTES

1. This result is obtained by the quantity equality which relates the stock (or supply) of money (Ms) and the speed at which it circulates in the economy (i.e. the velocity of circulation, V) to the quantity of goods brought and sold (Q) and their price (P). Thus the total amount of money spent on the output of the economy (MV) must equal the total value of that output (PQ); i.e. MV=PQ. For monetarists the money stock is given exogenously (independent of the demand for it) and determined by domestic credit expansion and changes in net foreign asset holdings. Domestic credit in turn is determined by credit to the private sector and credit to the government. For these economists (especially in the context of LDCs) it is typically credit to the government, and in particular, borrowing from the banking sector to finance budget deficits that is the major source of growth of the money stock, and the major cause of inflation. Budget deficits in turn are usually seen as the result of state involvement in the economy through active industrial promotion and economic management policies. Monetarists also argue that there is generally a stable demand function for money in relation to the money value of national income, so that V is more or less constant. According to them, V is determined by factors such as the desirability and cost of holding money. This assumption of a constant V is thus considered to be particularly justified in most LDCs where the financial system is underdeveloped and money is held primarily as a means of circulation. In addition it is assumed that Q cannot be easily increased because in LDCs capital is limited and the production structure is not versatile. Thus any increase in Ms with the demand for money being stable must be reflected in increased expenditure and a rise in the general price level, P.

2. Propagation elements are mechanisms which cannot generate inflation by themselves, but can keep inflation going.

3. Post-Keynesians such as Kaldor argue that in credit money economies (the characteristic form of capitalist economies since the Second World War) money supply can never exceed the amount individuals wish to hold. This is because credit money comes into existence as a result of borrowings by businesses, individuals or public agencies from banks, and if such borrowings result in more money coming into existence than the public wishes to hold at a given level of income (for expenditure), the excess gets directly or indirectly repaid to banks and is thus neutralized. In the case of credit money, therefore, Kaldor goes on to argue that : "It is never true that the level of expenditure on goods and services rises in consequence of the amount of bank money held by the public. On the contrary, it is a rise in the level of expenditure which calls forth an increase in the amount of bank money" (Kaldor, 1980 : 294).

4. Unlike monetarists — who claim that money is only held for transaction purposes — post-Keynesians maintain that money is also held as a store of value and for speculative reasons; for a given income they thus do not consider the velocity of circulation (V) to be constant. Hence they argue that if the monetary authorities did ever try to regulate spending by limiting the money stock, there would be a compensating increase in V.

5. It is hoped that once the protected industries are able to attain an adequate level of efficiency, they would develop an export capacity to enable self-sustaining industrial development. A move to manufactured products through export diversification is moreover considered to be a move to products for which world demand is stronger and one which would generate greater value added and employment. This would also have the effect of arresting the secular decline in the terms of trade which developing countries are supposed to face.

6. Even rising budget deficits are seen by these economists as being due to structural problems, since apart from the need for state intervention to stimulate growth and employment, the deteriorating terms of trade cause tax revenues from exports to fall and/or government expenditure to rise, while increasing world interest rates add to the debt service burden.

7. This is particularly so in the case of import substitution industrialisation since, structural change brought on by this method of industrialisation is not costless as it inevitably brings on an acceleration in domestic inflation and, to the extent that manufactured exports do not expand adequately to meet the new demands for imports induced by such industrialization, an acute foreign exchange crisis. An acceleration in inflation comes about through a combination of such factors as : recurrent devaluations, as a consequence of continuous pressure being maintained on the exchange rate; import substitutes being more expensive than the goods they replace due to higher factor costs per unit of output, underutilization of plant and bureaucratic delays; upward pressure exerted on factor costs in other industries partly because of the example set by the newcomers, and partly because such factors have become more scarce and ; strains appearing on the infrastructure of the economy due to the increased demand by the import substituting industries.

8. There figures are from Irvin (1986) and Korale (1985). The 1981 figure of 14.7% has been estimated by Korale from the Labour Force & Socio-Economic Survey 1980-81, Census of Population 1981 and the Consumer Finance and Socio-Economic Survey 1981-82, taking into account shortcomings in the sampling techniques and survey design used in those studies. The 1986 figures have been projected by Irvin from a 1981 base.

9. Since no complete or consistent set of time series data is available for market clearing wages, minimum wages have been used here instead. Since the latter is set by Wages Boards which are in turn influenced by the government, minimum wages cannot be considered to be equivalent to market clearing wages. The use of minimum wages is however justified since what is being aimed here is only the illustration of certain salient characteristics of labour demand over time. Minimum wages in the public sector have not been used here to analyse the public sector demand for labour since the latter is also clearly influenced by non-economic criteria.

10. It is noteworthy that while loans granted under the Small and Medium Industries (SMI) II scheme to the private sector have been moving slowly, loans under the earlier SMI I scheme were snapped up even though these were at higher rates of interest.

11. Since 1983 the rupee has been set relative to the trade-weighted bundle of currencies of Sri Lanka's main trading partners. The countries included are the US, UK, West Germany, France, Japan and India, and the weights given to each are 0.2462, 0.1761, 0.1276, 0.0507, 0.3083 and 0.0911, respectively.

Table 1

SELECTED STABILIZATION

	1970	1971	1972	1973	1974	1975
Money Supply M2 (Rs.Mn.)	3114.8	3434.9	3974.0	4153.9	4568.1	4757.0
Domestic credit (Rs.Mn.)	4175.3	4480.5	4935.8	4811.9	5828.4	6232.8
Credit to public sector (Rs.Mn.)	3151.4	3367.7	3709.7	3450.8	4148.0	4373.0
Private sector credit expansion (Rs.Mn.)	1024.4	1108.6	1241.0	1327.5	1613.7	1839.6
Budget Deficits (Rs.Mn.)	936	1072	1082	1084	1298	2218
Govt. Cap. Exp.	812	742	888	1175	1410	1978
GDP deflator (% change)		2.0	2.9	16.2	26.2	12.3
Colombo Cost of Living Index (% change)		2.7	6.3	9.7	12.3	6.7
Import Price Index (% change)		6.3	5.9	33.3	75.0	16.7
Trade Balance (Rs.Mn.)	–316	–287	–255	–298	–1263	–1421
Imports (c.i.f.) (Rs.Mn.)	–2332	–2218	–2153	–2644	–4663	–5334
Terms of Trade Index	100	92	89	77	68	55

Source : Compiled from data in *Central Bank Annual Reports* & *World Bank Sri Lanka Country Economic Memoranda*

INDICATORS, 1970–1985

1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
6320.9	8716.8	10892.1	15057.6	19860.2	24446.8	30509.9	37256.8	43427.3	48408.9
7269.1	8796.1	10575.2	15113.8	25635.9	33824.2	42412.0	49806.7	49952.1	59226.1
4985.7	5890.6	5900.7	8175.2	14463.0	18570.7	23015.3	23740.9	20270.2	26089.8
2266.3	2884.2	8712.2	12193.4	16663.9	21035.1	25261.8	32273.6	35397.7	38534.7
3044	2117	6001	7609	14774	13259	17479	16581	13633	18778
2671	2093	5266	7347	12680	11757	15886	16667	20963	23342
5.8	18.0	7.7	15.7	18.2	20.5	9.9	14.6	17.0	1.7
1.2	1.3	12.1	10.8	26.1	18.0	10.8	14.0	16.6	1.5
–10.2	22.7	85.2	52.0	42.8	30.0	9.6	21.4	10.7	10.6
–710	+350	–2393	–7288	–16312	–15616	–20403	–20168	–11850	–19328
–5417	–6290	–15600	–22570	–33915	–36123	–41501	–45206	–49048	–54710
74	96	94	68	55	43	36	42	47	37

Table 2

SAVINGS AND INVESTMENT 1970 – 86

	1970	1971	Annual Average 1971–1977	1978	1979	1980	1981	1982	1983	1984 (a)	1985 (a)	1986 (a)	Annual Average 1978–86 (a)
Gross domestic Investment (Rs. Mn.)	2589	5259	3523	8554	13527	22465	22898	31121	36063	38708	38706	42031	28353
National Savings (Rs. Mn.)	1930	6539	2799	6622	7732	9272	11949	15493	20856	33154	22620	25158	16988
	Percentage of GDP at Current Market Prices.												
Gross Domestic Investment	18.9	14.4	16.0	20.0	25.8	33.7	26.9	31.1	28.4	25.8	23.8	23.2	24.0
Private Investment	10.7	7.2	8.3	8.1	9.1	12.6	10.8	12.0	12.6	11.1	9.0	9.3	9.5
Public Investment	8.2	7.2	7.7	11.9	16.7	21.1	16.1	19.1	15.8	14.7	14.8	13.9	14.5
of which budgetary	—	—	—	10.9	13.6	18.9	13.6	15.6	13.0	12.3	13.5	12.7	12.3

(a) Provisional

Source : Ministry of Finance & Planning, *Public Investment* 1987 – 1991

Table 3

CIVILIAN EMPLOYMENT IN THE PUBLIC SECTOR, 1975–85 [a]

	1970	1971	1972	1973	1974	1975	1976	1977
Government Institutions								
Administrative, technical and professional officers of staff rank	9,229	10,491	11,729	14,030	15,649	16,133	19,846	16,901
Subordinate employees [b]	95,474	103,050	114,000	130,338	144,186	150,891	118,309	185,893
Minor employees [c]	88,562	86,520	92,727	102,327	109,617	113,714	124,130	82,514
School teachers	96,966	97,864	100,836	106,674	107,979	109,855	111,097	119,004
Others	27,586	30,738	30,950	32,652	34,853	35,272	32,999	18,335
Total	317,817	328,663	350,242	386,021	412,284	425,865	406,381	422,647
Semi Government Institutions [d]								
Administrative, technical and professional officers of staff rank	6,315	12,362	14,788	15,360	15,755	14,793	14,648	11,402
Subordinate employees [b]	31,311	24,919	29,335	31,176	34,891	37,596	50,656	50,184
Minor employees [c]	122,680	85,152	111,828	120,342	155,669	169,930	455,899	516,806
Others [e]	9,909	52,927	45,345	42,728	40,686	36,865	19,841	38,641
Total	170,215	175,360	201,296	209,606	247,001	259,184	541,004	617,033

Table 3 (Contd.)

	1978	1979	1980	1981	1982	1983	1984	1985
Government Institutions								
Administrative, technical and professional officers, of staff rank	17,512	18,366	18,439	18,525	18,634	18,762	18,987	19,112
Subordinate employees *b/*	195,922	206,319	207,533	209,242	210,305	212,807	215,361	218,780
Minor employees *c/*	87,172	94,141	95,908	99,071	99,938	100,172	101,374	103,103
School teachers	126,437	133,269	135,270	134,991	136,978	137,302	138,950	140,824
Others	19,042	18,093	18,936	19,646	19,957	20,429	20,674	21,124
Total	446,085	470,188	476,086	481,475	485,812	489,472	495,346	502,943
Semi Government Institutions *d/*								
Administrative, technical and professional officers of staff rank	12,239	13,005	13,833	14,304	14,605	14,892	14,505	14,192
Subordinate employees *b/*	60,711	72,936	80,503	83,309	84,951	85,703	83,474	81,414
Minor employees *c/*	606,302	621,760	627,656	631,563	632,849	634,039	617,554	602,765
Others *e/*	37,782	41,333	47,130	49,023	49,829	51,083	49,755	48,550
Total	717,034	749,034	769,122	778,199	782,234	785,717	765,288	746,921

a/ The employees are classified according to categories and status, and include temporary and casual workers.

b/ Clerical workers.

c/ Semi-skilled and unskilled workers.

d/ Growth of employment in this category (public corporations, universities, research institutions, etc.) was exaggerated in the period by the nationalization of agricultural lands.

e/ Principals, teachers and other education workers.

Source : World Bank (1987) *Sri Lanka : Issues in Macro Economic and Industrial Development Policy* p. 83.

Table 4

INDEX OF REAL TRADE WEIGHTED EXCHANGE RATE MOVEMENTS

(foreign currency per unit rupee)

	end 1977	*end* 1980	*end* 1983	*end* 1985	*end* 1986
Nominal trade weighted exchange rate	100	76.9	69.9	62.6	55.2
Domestic Consumer Private Index (CCPI)	100	170	241	276.3	298.4
Foreign Consumer Price Index	100	125	155	166.3	170.6
Real trade weighted exchange rate[2]	100	104.6	109	104	96.6

1. This is obtained by taking the consumer price index of the selected countries and trade weighting them to obtain a composite index.

2. The real exchange rate is defined as the nominal trade weighted exchange rate in terms of foreign currencies, multiplied by the domestic consumer price index and divided by the composite foreign consumer price index.

Source : IMF, *International Financial Statistics*

Table 5

RELATIVE MOVEMENTS OF THE REAL EXCHANGE RATES OF SRI LANKA AND SOME OF ITS MAIN COMPETITORS AGAINST THE US $ (INDEX OF US $ PER UNIT CURRENCY) [1]

	end 1977	*end* 1980	*end* 1983	*end* 1985	*end* 1986	
US $	100	100	100	100	100	
Sri Lankan Rupee	100	100	93	88.5	90.1	
Main Competitors :						Competitors in
Indian Rupee	100	96	75	72	76.4	Tea
Malaysian Ringgit	100	91	85	80	71.3	Rubber
Singapore Dollar	100	96	91	87	73.7	Textiles
Philippines Peso	100	—	—	83	81.3	Coconuts
Simple average	100	93	79	80.5	75.7	

1. In calculating the real exchange rates of these countries against the US $ a nominal index of US $ values per unit of domestic currency was multiplied by a ratio of domestic consumer to US consumer prices.

Source : IMF, *International Financial Statistics*

Table 6

MINIMUM WAGE RATE, 1970–1986

(December 1978=100)

Year	*Private*		*Public*	
	Money	*Real a/*	*Money*	*Real a/*
1970	31	53	62	108
1971	31	53	62	105
1972	34	52	62	99
1973	36	53	65	95
1974	46	59	74	95
1975	52	63	82	98
1976	54	64	86	103
1977	66	78	87	103
1978	95	99	100	105
1979	120	113	117	111
1980	147	111	129	97
1981	152	97	146	93
1982	176	101	188	108
1983	188	96	216	109
1984	229	98	247	107
1985	248	106	284	117
1986				

a/ Money wage deflated by Colombo Consumer Price Index.

Source : World Bank (1987) *Sri Lanka : Issues in Macro Economic and Industrial Development Policy.* p. 127

World Bank (1984) *Sri Lanka : Recent Economic Developments, Projects and Policies.* p. 130.

Table 7

THE ESTIMATED INCREMENTAL CAPITAL-LABOUR RATIO [a]

Nominal GDP (FC	13.19					25.69					62.65					149.42
Nominal Investment [b]		2.63	2.86	3.16	3.43	3.70	4.60	5.04	8.52	13.24	20.85	33.28	30.21	35.31	39.52	39.85
GDP Deflator	100	115	129	144	159	173	183	216	233	269	318	383	421	483	565	575
GDP (1970 prices)		2.29	2.24	2.19	2.16	2.14	2.51	2.33	3.66	4.92	6.96	6.08	7.16	7.31	6.99	6.93
5 year totals				11.02					19.98					34.47		

5 year total jobs created (19^6)	.430	.820	.440
K/L (1970 prices) (10^3)	25.63	24.36	78.34
— 1985 prices	147.37	140.07	450.46
— In US $		10.95	20.29

a. Evaluation of GDP, investment and GDP deflators from World Bank (1976).

b. Because calculations of the I/L ratio are based on 5-year averages, Investment has been used rather than Gross Fixed Capital Formulation assuming variations in inventories to cancel out.

Source : Irvin, G.W. (1986) *Sri Lanka : Current Prospects for Employment.* IPS Project Report, Colombo.

REFERENCES

Appelbaum, E. (1979) "The Labour Market" in A. S. Eichner (ed.) *A Guide To Post Keynesian Economics*, Macmillan, London.

Addison, J. T. & W. S. Siebert (1979) *The Market for Labour : An Analytical Treatment*. Goodyear, California.

Burbridge, J. B. (1979) "The International Dimension" in A. S. Eichner (ed.) *A Guide to Post-Keynesian Economics*, Macmillan, London.

Canavese, A. J. (1982) "The Structuralist Explanation in the Theory of Inflation". *World Development*. Vol. 10, No. 7

Central Bank of Sri Lanka (1987) *Annual Report* 1986. Colombo.

— (1986) *Review of the Economy* 1985. Colombo.

— (1985) *Review of the Economy* 1984. Colombo.

— (1979) *Review of the Economy* 1978. Colombo.

Cole, K., J. Cameron & C. Edwards (1985) *Why Economists Disagree*. Longman, London.

Foxley, A. (1981) "Stabilization Policies and Their Effects on Employment and Income Distribution : A Latin American Perspective" in W. R. Cline & S. Wentraub (eds.) *Economic Stabilization in Developing Countries*. The Brookings Institute, Washington D.C.

Freedman, M. & R. Freedman, (1980) *Free to Choose* Penguin Books, Harmondsworth.

International Labour Organization (1971) *Matching Employment Opportunities and Expectations : A Programme of Action* for Ceylon. Report, Geneva.

International Monetary Fund (1987) *International Financial Statistics*. (August) IMF, Washington D.C.

— (1983) *International Financial Statistics* (December) IMF, Washington, D.C.

Irvin, G. W. (1986) *Sri Lanka : Current Prospects for Employment* IPS Project Report, Colombo.

Kaldor, N. (1983) "Devaluation and Adjustment in Developing Countries." *Finance and Development*, Vol. 20, No. 2.

— (1980) "Monetarism and U.K. Monetary Policy". *Cambridge Journal of Economics* Vol. 4.

Khan, M. S. & M. D. Knight (1982) "Some Theoretical and Empirical Issues Relating to Economic Stabilization in Developing Countries", *World Development*, Vol. 10, No. 9.

— (1981) "Stabilization Programme in Developing Countries : A Formal Framework". *IMF Staff (March) Papers* (March). Washington.

Korale, R. B. M. (1985) "Employment and Wages : A Case Study of Sri Lanka". Colombo (Mimeo)

Nicholas, H. V. B. (1987) "The Post-1977 Economic Strategy: A Comparative and Theoretical Overview" in D. Dunham & C. Abeysekera (eds.) *Essays on The Sri Lankan Economy* 1977-83. Social Scientists Association of Sri Lanka, Colombo.

Nicholas, H. V. B. (1986) "Inflation in Sri Lanka, 1970-85 : A Preliminary Study". (Mimeo).

Polak, J. J. (1977) "Monetary Analysis of Income Formation and Payments Problems", in J. J. Polak et al. *Monetary Approach to the Balance of Payments*. IMF, Washington, D.C.

NA80/53
L

Sanderatne, N. (1985) "The Effects of Policies on Real Income and Employment" in N. Sanderatne et al. *Sri Lanka : The Social Impact of Economic Policies During the Last Decade*. UNICEF, Colombo.

Seers, D. (1981) "Inflation : The Latin American Experience". Institute of Development Studies; Discussion Paper No. 169. Sussex (November).

— (1962) "A Theory of Inflation and Growth in Under-Developed Economies Based on the Experience of Latin America". *Oxford Economic Papers* (June).

Todaro, M. P. (1982) *Economic Development in the Third World*. Longman, New York.

UNICEF (1985) *Sri Lanka : The Social Impact of Economic Policies During the Last Decade* UNICEF, Colombo.

Van Arkadie, B. K. Jansen & P. Wright (1980) *Structure, Policy and Distribution : A comparative study of Colombia, Sri Lanka and Kenya* ISS, The Hague.

World Bank (1987) *Sri Lanka : Issues in Macro Economic and Industrial Development Policy*. Washington D.C.

World Bank (1986) *Sri Lanka : Current Economic Situation and Outlook*, Washington D.C.

— (1978) *Development in Sri Lanka : Issues and Prospects*, Washington D.C.

— (1977) *Sri Lanka : Country Economic Memorandum*, Washington D.C.

USAID / DIC
COLOMBO. SRI LANKA