# INSTITUTE OF POLICY STUDIES

# THE SRI LANKAN BALANCE OF PAYMENTS 1990

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# THE SRI LANKAN BALANCE OF PAYMENTS 1990

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## 1. INTRODUCTION

There was a marked improvement in the Sri Lankan balance of payments in 1990. The overall balance moved from a deficit of SDR 67m in 1989 to a surplus of SDR 130m in 1990. As a result, both the gross official reserve position and the debt service ratio improved. Gross official reserves rose from an equivalent of 1.4 months of imports (of goods and services) in 1989 to an equivalent of 1.6 months in 1990, and the debt service ratio declined from 20.6% in 1989 to 14.3% in 1990. Underlying the improvement in the overall balance were improvements in both current and capital accounts. The current account balance (net of official grants) improved from a deficit of SDR 400m (7.1% of GDP) in 1989 to one of SDR 300m (5.1% of GDP) in 1990, and the capital account from a surplus of SDR 251 (4.2% of GDP) in 1989 to one of SDR 297 (5.1% of GDP) in 1990.

**Table 1: The Balance of Payments Outturn 1989 and 1990 (SDRm)**

| | 1989 | 1990 |
|---|---|---|
| Overall Balance | -67 | 130 |
| Current Account Balance | -400 (7.1%) | -300 (5.1%) |
| Capital Account Balance | 251 (4.2%) | 297 (5.1%) |
| Official Reserves (months imports of goods and services) | 1.4 | 1.6 |
| Debt service ratio* | 20.6% | 14.3% |

( ) As percentages of GDP

* The debt service ratio is the ratio of debt service payments to receipts from exports of goods and services and transfers

Source: Central Bank of Sri Lanka, "Annual Report 1990"

It can be seen from Table 2 below that Sri Lanka's balance of payments performance in 1990 compared very favourably at the international level. Unlike Sri Lanka, most countries, including the NICs, experienced a deterioration in their current account position over the course of the year. Sri Lanka's current account deficit as a proportion of GNP was less than the average for other South Asian economies in 1990, whereas it had been greater in the previous year.

**Table 2: Current Account Deficits: an international comparison - 1989/1990**

| Current account deficits as percentages of GNP | 1989 | 1990 |
|---|---|---|
| Sri Lanka | -4.5 | -4.0 |
| Industrialised countries | -1.8 | -1.9 |
| Less developed countries | -2.1 | -4.3 |
| Asian Countries | -2.2 | -2.5 |
| South Asian countries | -4.4 | -4.8 |
| NICs | 6.4 | 4.6 |

Source: Asia Week

## 2. THE CURRENT ACCOUNT BALANCE

The improvement in Sri Lanka's current account in 1990 is primarily attributable to good performances in both the trade and services accounts. The trade account balance moved from a deficit equivalent to 9.5% of GDP in 1989 to 8.8% of GDP in 1990. The services account performed relatively better, moving from a deficit of 2.2% of GDP in 1989 to 0.9% of GDP in 1990. The surplus on the transfers account, however, declined.

### 2.1 THE TRADE BALANCE

Improvement in the trade balance was attributable to a faster growth in export receipts than import expenditures. Export receipts rose from SDR 1216m in 1989 to SDR 1461m in 1990 (a rise of 20%), while import expenditures rose from SDR 1737m to SDR 1980m (a rise of 14%). Since import prices grew more rapidly than export prices (the terms of trade deteriorating by 10%), the relatively faster growth in exports must have been the result of a relatively better **export volume** performance. In fact, export volumes, led by industrial exports, expanded by a significant 11%, while import volumes contracted by 2%, primarily as a result of a contraction in consumer (and possibly investment[1]) imports.

**Table 3: Trade Prices, Volumes and Values 1990 (percentage changes 1989/90)**

| **Imports** | 1990 |
|---|---|
| Import Value | 38 |
| Import Volume | -2 |
| Import Price | 41 |
| **Exports** | |
| Export Value | 42 |
| Export Volume | 11 |
| Export Price | 28 |
| Terms of trade | -10 |
| Relative volume* | 14 |

* Export volume index/ import volume index

Source: Central Bank of Sri Lanka "Annual Report 1990"

1. Figures for investment volumes in 1990 given in the Central Bank's Annual Report and Monthly Bulletins appear to be contradictory. Volume changes for each investment category are significantly negative while the figure for the aggregate level of investment imports is positive.

### 2.1.1 IMPORT EXPENDITURES

Price increases would appear to account completely for the increase in import expenditures. Import prices rose by 41% while the rupee value of imports rose by 38%. Currency depreciation could have accounted for as much as 60% of this increase if the lagged impact of the 17% depreciation in the Sri Lankan Rupee against the SDR in late 1989 is added to its 7.5% depreciation against the SDR in 1990. If the relevant currency for trade purposes is considered to be the US dollar, the contribution of currency depreciation is more in the order of 40%. In either case a significant part of the increase in import expenditures is directly attributable to purely exogenous import price increases.

Among other things, this would suggest a limited role for demand-side factors, such as changes in the budget deficit and credit expansion, in explaining import expenditures in 1990. However, this impression may not do justice to the influence of these variables. It could plausibly be argued that the contraction in the size of the overall budget deficit from 11% of GDP in 1989 to 9.9% in 1990 contributed, through its effect on aggregate demand, to lower import volumes and, in turn, to improve trade account performance. The fact that the expansion in credit, although sizeable, was very much less than the increase in import expenditures would suggest that, even if it did not restrict imports, it did not significantly encourage their expansion. Indeed, from what was said earlier, credit expansion would appear to have played no more than an accommodating role, enabling domestic producers to absorb external price shocks. Finally, it could also be argued that the depreciation of the currency in 1989, which fed through into import price rises in 1990, was largely the result of fiscal and credit-induced excess demand pressures in 1989.

Looking at the post-1978 period as a whole, it would seem that import price changes accounted for most of the changes in import expenditures. Price increases accounted for 77% of the annual increase in import expenditures, with price changes exceeding volume changes in every year except 1982 and 1983. Further, although some 50% of the increases in import prices were the result of currency depreciation, movements in the exchange rate tended for the most part to reinforce external price changes - the exceptions, oddly enough, being 1982 and 1983.

A second factor which appears to have had an important bearing on import expenditures over the post-1978 period as a whole is foreign financing. Much of the foreign financing available (both to the government and private sectors) by way of grants, loans and credits was used to pay for imports, particularly for intermediate and investment goods. Hence there was a close relationship between foreign financing and import expenditures. Indeed, the contraction in foreign financing could be a factor explaining the fall in import volumes in 1990.

Demand-side factors too, such as the budget deficit and credit expansion, have exerted an influence on import expenditures during the post 1978 period. Thus budgetary and domestic credit expansion in the period between 1979 and 1981 clearly exerted pressure on import expenditures over and above those emanating from exogenous increases in import prices, just as increasing restraint on both these fronts

in the period after 1986 - after the commencement of the programme of structural reform - undoubtedly helped to a moderate the rate of growth of import expenditures.

### 2.1.2 EXPORT RECEIPTS

Inspite of the creditable volume performance, price changes still accounted for around 70% of the increase in export receipts in 1990. The small magnitude of currency depreciation in 1990 (0.6% against the US dollar), and the inability of a small country like Sri Lanka to influence world market prices (even in the case of tea), would suggest that most of the export price increase, and therefore the larger part of the growth in export receipts, was exogenous. However, as noted above, the 17% depreciation of the Rupee in 1989, because it took place towards the end of the year, must have fed through into 1990 prices and could therefore explain a significant part of the increase in export receipts in the latter year.

The increase in export volumes in 1990 can be largely attributed to supply-side factors. Favourable climatic conditions and a dramatic improvement in the political and security situation boosted output and export volumes. Increases in export prices may have played some role here, particularly in the case of industrial products. Thus, the 18% increase in export prices of industrial products during the year may have contributed in some measure to the 24% increase in volume. On the demand side, real incomes of industrialised countries as a whole fell, as the international recession gathered momentum, and do not appear to have offered Sri Lankan exporters much encouragement. Part of the reason for the low volume of tea exports, in spite of a substantial (43%) increase in prices, was the Gulf crisis and the resulting disruption to Sri Lanka's largest tea export market.

In the post-1978 period, price increases accounted for around 65% of the average increase in export receipts. Some 70% of these price increases could in turn have been accounted for by currency depreciation. However, in many years the increase in rupee prices was significantly less than the magnitude of the depreciation. Thus, in 1989 the rate of depreciation of the Rupee was nearly double that of the increase in export prices. Further, in 1982, 1985 and 1986 the Rupee price of exports actually 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.

The other factors which appear to have generally affected export receipts over the post- 1978 period are those which had an impact on volume-domestic supply conditions, particularly in agriculture, and the state of world demand. On the supply side, climatic conditions and, since 1983, the general political and security situation in the country, were important in certain years. On the demand side, it would appear, as one would expect, that industrial export volumes were particularly sensitive to demand conditions in industrialised countries (see Nicholas et. al. 1990).

## 2.2 THE EVOLVING PATTERN OF INTERNATIONAL TRADE

With progressive liberalisation of the economy there has been a significant change in the pattern of external trade. Table 4 shows that there has been a major shift away from traditional, agricultural exports such as tea, rubber and coconut products, towards industrial exports, in particular textiles and garments. From 1986 onwards textiles and garments accounted for a greater proportion of the total value of exports than tea, although they remain second to tea in terms of net foreign exchange earnings because of their high import content.

Along with export product diversification, there has also been a shift in the geographic orientation of Sri Lanka's exports. The share absorbed by industrialised countries rose from 40.1% of the total in 1978 to 59.1% in 1990 (a near 50% increase) while that of developing countries has fallen from 56.8% to 38.6% over the same period. The most notable increase among industrialised countries is in the share of the United States, which rose from 7 per cent of total Sri Lankan exports in 1978 to 25 per cent in 1990. The US market is crucial to Sri Lanka because it absorbs a major proportion of the ouput of the country's most dynamic export sector; accounting for 73 per cent of all garments exports. Although the share of Sri Lankan exports to all developing countries fell, that going to the Middle East rose. This was a result of increased tea exports to the Gulf region, which accounted for 55 per cent of total tea exports before the outbreak of the Gulf war.

**Table 4: Composition of Exports and Imports**

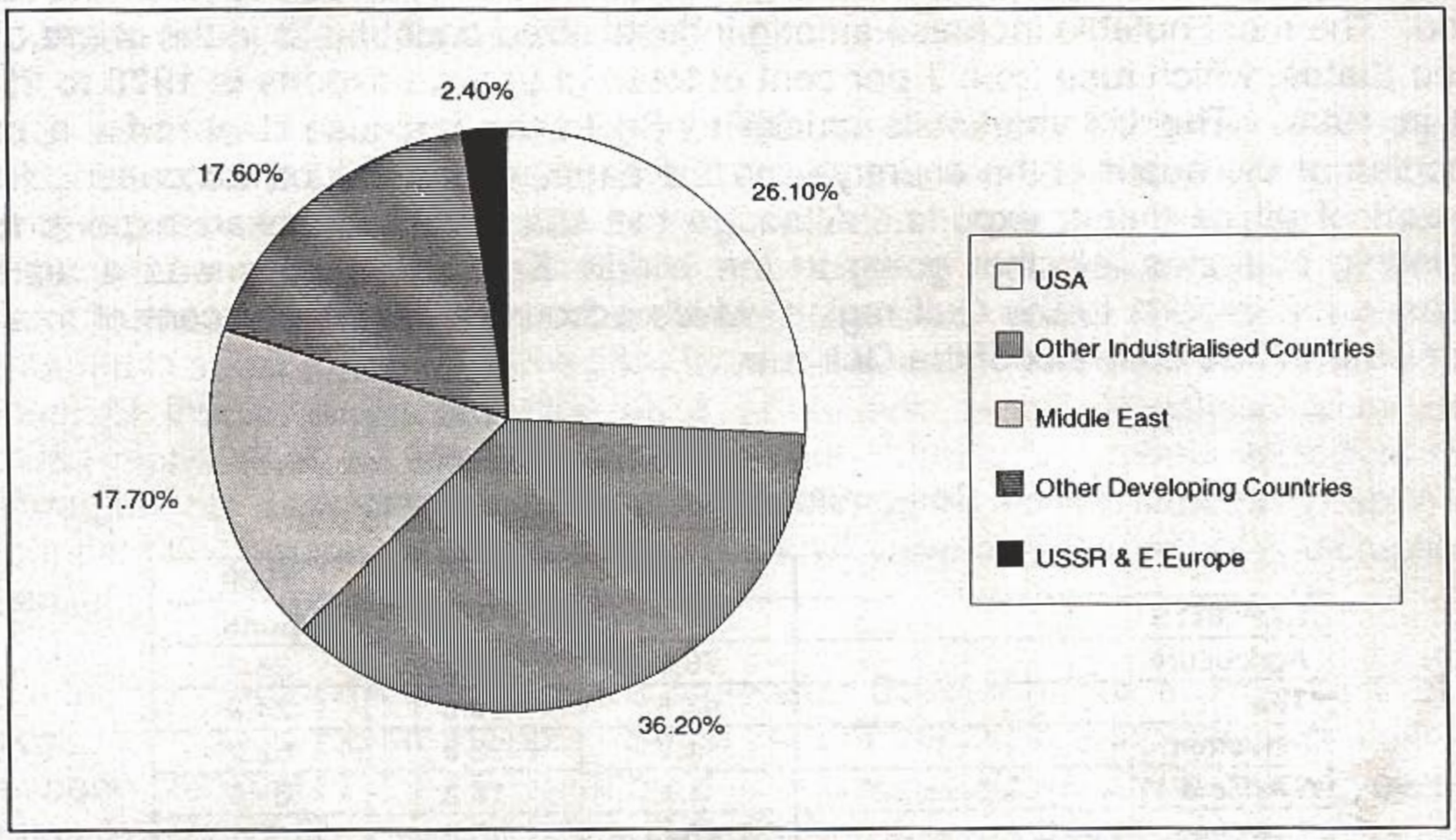
| | 1978 | 1982 | 1990 |
|---|---|---|---|
| **EXPORTS** | As a Percentage of Total Exports | | |
| Agriculture | 78.9 | 54.3 | 36.3 |
| *Tea* | 48.5 | 29.6 | 24.9 |
| Industrial | 14.7 | 38.6 | 52.2 |
| *Textile & Wearing Apparel* | 3.6 | 16.3 | 31.6 |
| *Petroleum Products* | 7.2 | 15.3 | 5.0 |
| Mineral | 6.4 | 4.0 | 4.4 |
| **IMPORTS** | As a Percentage of Total Imports | | |
| Food Grains* | 19.9 | 6.6 | 6.4 |
| Other Consumer Goods | 14.5 | 13 | 23.1 |
| Intermediate Goods | 39.5 | 52.5 | 51.0 |
| Investment Goods | 22.2 | 27.6 | 17.8 |

* Includes rice, wheat and flour.
Note: Percentages do not add up to 100% due to the unclassified product category
Source: Central Bank of Sri Lanka "Annual Report 1990"

Significant compositional changes are also apparent for imports. Table 4 indicates an increase in the share of non-grain consumer and intermediate goods and a decline in the share of grain and investment goods. The intermediate goods component grew in the early liberalisation period due to the imports of petroleum and fertilizers. More recently, this category has increased further due to large imports of

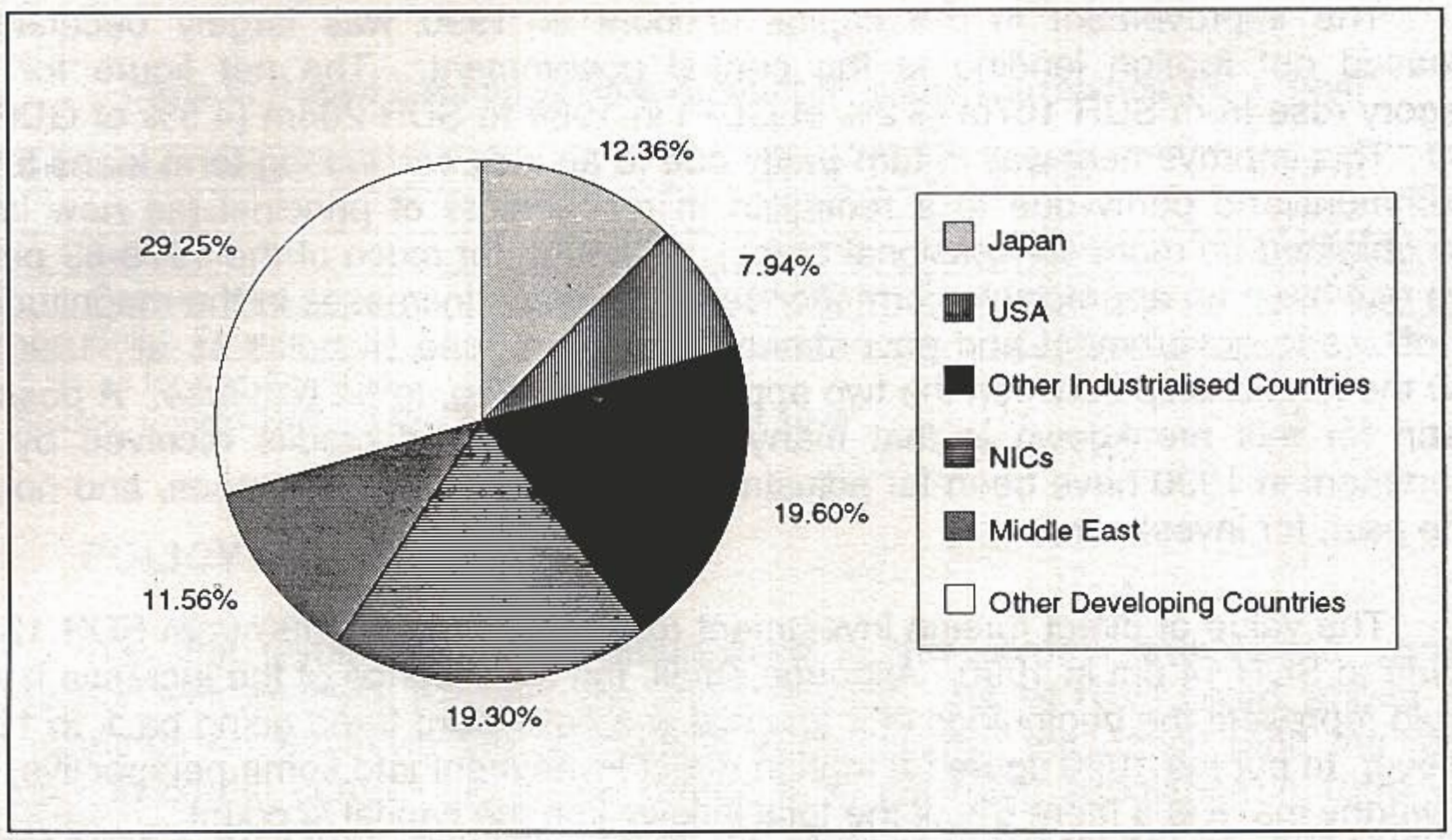
textiles that feed the booming garment export sector. Foodgrain imports fell dramatically from almost 20 per cent of total imports in 1978 to less than 7 per cent in 1982. This was mainly because of a drop in flour imports (partly compensated by increased wheat imports) and rice imports. A reversal of this trend is seen in the 1989 figure because of increased rice imports, but 1990 saw a drop in prices as well as in the volume of foodgrains. The investment-goods share of total imports has fallen since its initial burst between 1978 and 1982 as a result of a slowdown in investment and growth in the economy and, in recent years, the government's inability to implement several public investment programmes due to civil unrest in the country. In 1990, however, investment imports rose (for the first time since 1982).

**Figure 1: The Destination of Sri Lankan Exports in 1990**




With respect to the origin of Sri Lankan imports, there has been a swing away from industrialised countries, and towards developing countries, especially those of South East Asia. The share of industrialised-country imports in 1978 was 55.1% of to total imports, whereas by 1990 it had fallen to 39.8%. In contrast, the share of imports accounted for by the four NICs (Hong Kong, Taiwan, South Korea and Singapore) rose from a mere 2.8% of total imports in 1978 to 19.2% in 1990.

**Figure 2: The Origin of Sri Lankan Imports in 1990**




## 2.3 THE SERVICES BALANCE

The improvement in the services balance in 1990 is almost entirely accounted for by the increase in travel income and the fall in investment income outflows. The travel account balance rose from a net figure of SDR 3m in 1989 to SDR 44m in 1990 as a result of a 60% increase in tourist arrivals. At the same time the investment income account went from a SDR 128m deficit in 1989 to a SDR 109m deficit in 1990, inspite of a growth in the size of outstanding debt. This was largely the result of a decline in net interest payments consequent upon the fall in world market interest rates and some restructuring of debt.

## 2.4 THE TRANSFERS BALANCE

The transfers account balance contracted by SDR 7m in 1990 (or around 2% of the 1989 figure). This contraction is made up of a decline in official transfers and a sizeable expansion in private transfers from SDR 258m in 1989 to SDR 274m in 1990. Private remittances have on the whole performed spectacularly well in the post-1978 period, mainly because of the migration of Sri Lankan labour to the Middle East. As a proportion of GDP these remittances peaked in 1982, levelling off thereafter. The renewed buoyancy of the level of remittances in 1990 was due to the uncertainty in the entire Middle East region as a result of escalating political and military tensions towards the latter part of the year.

## 3. THE CAPITAL ACCOUNT

The improvement in the capital account in 1990 was largely because of increased net foreign lending to the central government. The net figure for this category rose from SDR 167m (3.2% of GDP) in 1989 to SDR 264m (4.5% of GDP) in 1990. This improvement was in turn partly due to an increase in long-term loans to the government and partly due to a reduction in repayments of principal (as new loans were obtained on more concessional terms). Although for much of the 1978-89 period there has been an appreciable correspondence between increases in the magnitude of net inflows to government and government investment (see Nicholas et. al., 1990), in 1990 the relationship between the two appears, if anything, to be perverse. A possible reason for this breakdown is that many of the loans and credits received by the government in 1990 have been for adjustment and restructuring purposes, and not, as in the past, for investment.

The value of direct foreign investment rose marginally in 1990 from SDR 13.7m in 1989 to SDR 14.6m in 1990. Although small, the significance of the increase is that it could represent the beginnings of a reversal in a downward trend going back to 1983. However, to put the 1990 figure for foreign direct investment into some perspective, it is noteworthy that it is a mere 6% of the total inflows into the capital account.

## 4. FINANCING THE OVERALL DEFICIT

The positive balance of payments outturn together with drawings from the IMF (12 million SDRs) enabled the monetary authorities to increase its gross reserves (78.5 million SDRs) and repay some of its outstanding foreign currency debt to the commercial banks and the rest of the banking system.

## 5. THE EXCHANGE RATE

The exchange rates for the Sri Lankan Rupee against currencies of selected countries for end-December 1989, 1990, and end-April 1991 are given in Table 5 below. This Table shows that, while there has been some depreciation of the Rupee against the Japanese Yen (4.3%), the German Mark (9.4%) and the British Pound Sterling (14.0%) in 1990, there was virtually no depreciation against the US Dollar (0.6%). It also shows that by the end of April 1991 the Rupee had further depreciated marginally against the US Dollar (1.6%) and the Japanese Yen (1.3%) while actually appreciating against the German Mark (10.6%) and the British Pound (8.2%). In the context of a relatively rapid rise in the domestic rate of inflation, this has resulted in a significant appreciation of the real effective exchange rate - the nominal exchange rate adjusted for inflation differentials between Sri Lanka and her major trading partners. By the end of April of 1991 the real exchange rate index had fallen by 16.4% in relation to its December 1989 level (see Figure 3)[2] In fact, the current level of the index is the third lowest over the entire post-1978 period. If it is granted that the end-of-year 1989

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2 The real exchange rate index shown in Figure 1 is that for the Sri Lankan Rupee against the US Dollar using Sri Lankan and US prices.

real exchange rate represents something of an equilibrium level, then the present level is evidently seriously out of alignment.

**Table 5: Rupee Exchange Rate Against Selected Currencies 1989, 1990**

| Sri Lankan Rupee -vs- | 1989 | 1990 | 1991* |
|---|---|---|---|
| US Dollar | 40.00 | 40.24 | 40.90 |
| Japanese Yen | 0.2816 | 0.2943 | 0.2982 |
| German Mark | 23.70 | 26.16 | 23.38 |
| British Pound | 65.05 | 75.59 | 69.40 |

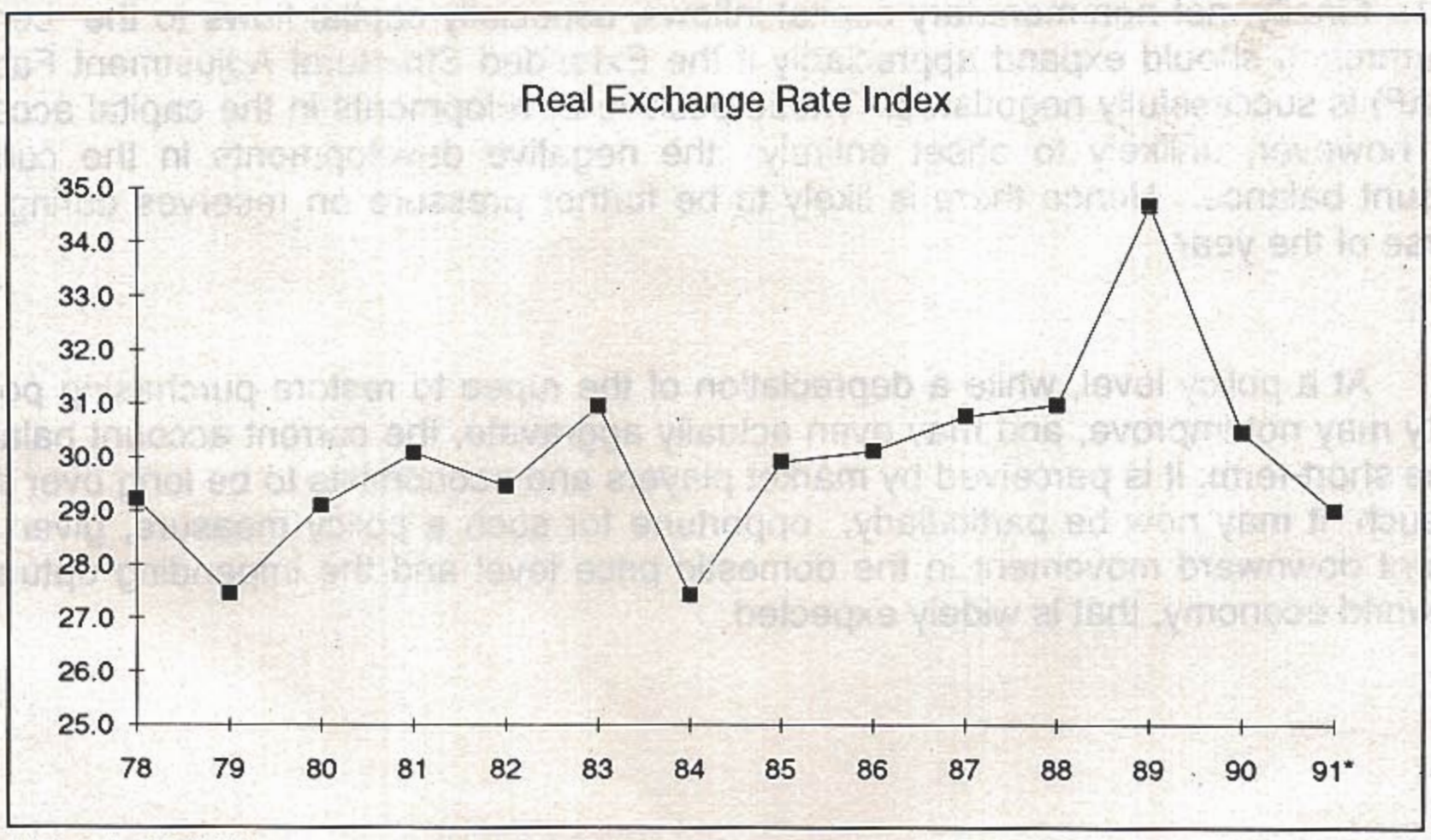
* Rates for end-April 1991

Source: Central Bank of Sri Lanka "Annual Report 1990"

## 6. POLICY ISSUES

The first issue that needs addressing in this context was raised earlier in connection with inflation; namely, the budget deficit. As we have noted, above, there are grounds for believing the contraction in the size of the deficit (and the relative restraint in credit) contributed to the reduction in the trade imbalance in 1990 via its (their) impact on import volumes. However, such a policy cannot in itself guarantee external equilibrium given the importance of autonomous price changes in the determination of trade balances. This is not to deny the usefulness of demand management policies in addressing payments imbalances, but to make a case for flexible targeting. Specifically, targets should be set mindful of the importance of exogenous factors in the short-term external payments outturn and of the difficulties, and possible inadvisability of, adjusting to them in the short-term.

**Figure 3: Real Exchange Rate for the Sri Lankan Rupee Against the US Dollar 1978-91**




* End-April 1991

The second issue concerns the appropriate exchange rate policy to be adopted. Given that the thrust of Sri Lanka's development policy is to make the economy more responsive to external stimuli, adjustments of the exchange rate to maintain competitiveness and relative parities can be considered of utmost importance. Domestic stability considerations may suggest the need for some lagging of requisite exchange rate adjustments at certain junctures, by between six to nine months, but not their indefinite postponement. The earlier discussion of real exchange rates would suggest that the nominal rate of exchange of the Sri Lankan Rupee against the US dollar at the end of April should have been around Rs 48 to 1 US$. The actual exchange rate was Rs 40.9 to 1 US$.

## 7. THE 1991 OUTTURN

On the basis of past performance and current trends, the expectation for 1991 is a slight worsening of the overall balance of payments situation. The current account deficit is likely to worsen significantly (possibly moving to between 6% and 6.5% of GDP) because of a further deterioration in the terms of trade and less than compensating developments in relative trade volumes. 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 that 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 usually improve and conversely, when the developed countries enter a period of recession the terms of trade deteriorate - especially the terms of trade of countries exporting consumer products and primary inputs. With falling world market interest rates[3] and an expected expansion in tourist arrivals the services account should register further gains, but these are unlikely to be sufficient to counterbalance the expected negative trade account developments. Nor is the transfers account likely to aid in this process, since neither private remittances nor official transfers are likely to increase significantly in 1991. Finally, net non-monetary capital inflows, especially capital flows to the central government, should expand appreciably if the Extended Structural Adjustment Facility (ESAF) is successfully negotiated. These positive developments in the capital account are, however, unlikely to offset entirely the negative developments in the current account balance. Hence there is likely to be further pressure on reserves during the course of the year.

At a policy level, while a depreciation of the rupee to restore purchasing power parity may not improve, and may even actually aggravate, the current account balance in the short-term, it is perceived by market players and economists to be long over due. As such, it may now be particularly, opportune for such a policy measure, given the current downward movement in the domestic price level and the impending upturn in the world economy, that is widely expected.

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3 The LIBOR rate has already fallen quite substantially this year.

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