Long-Run Trends in the Sri Lankan Economy

P. Samararatne, R. Gunatilaka,
H. White and C. Alderson

Research Studies
Working Paper No. 4

INSTITUTE OF POLICY STUDIES
99, St. Michael's Road, Colombo 3, Sri Lanka
November, 1995

200 - ROCAR
250 - FOREIGN

INSTITUTE OF POLICY STUDIES

Long-Run Trends in the Sri Lankan Economy

P. Samararatne, R. Gunatilaka, H. White and C. Alderson,

Contents

Introduction 1

1. Real Growth in the Sri Lankan Economy 2
2. The Sectoral Composition of GDP 3
3. The Agricultural Sector 5
4. Industry 11
5. Expenditure Decomposition of GDP 14
6. Savings and Investment 18
7. Government Finance 20
8. Public Debt 23
9. The Balance of Payments 28
10. External Debt 35
11. Macroeconomic Balance 37
12. External Trade 39
13. Sri Lanka's Competitiveness in the World Economy 42
14. Social Development 46

Concluding Note 50

Long-Run Trends in the Sri Lankan Economy

P. Samararatne, R. Gunatilaka, H. White and C. Alderson

Introduction

Understanding economic changes in the economy requires a knowledge of a wide range of interrelated factors and a perspective on their developments over time.

The Institute of Policy Studies has constructed an economic and social data base, drawn from a variety of published sources, to enable the analysis of these trends. In this regard, we wish to acknowledge the Central Bank of Sri Lanka and the Department of Census and Statistics as the primary sources for data on which the major part of our calculations are based. Some of these data are presented in the current work.

The aim of this paper is to provide readers with an overview of the main features of and changes in, the Sri Lankan economy during the last thirty years. Thus, the first two chapters set the scene by considering real growth trends of the Sri Lankan economy as a whole, and then examining underlying sectoral growth trends. We also seek to illustrate some important economic relationships in later chapters, such as the output and expenditure decompositions of GDP and the link between the current and capital accounts of the balance of payments. Also considered are developments in government finance, and the government's debt position. Moreover, the paper contains some analysis on long-term changes in the country's external debt situation, developments in external trade, and focuses on movements in the real exchange rate as one of the main determinants of export competitiveness. The final chapter analyses Sri Lanka's performance in the area of social development where traditionally the country has outperformed most other low-income as well as middle-income developing countries.

At a more practical level, the paper seeks to demonstrate the manner in which the database can be used to provide insights relating to the long-term performance of the Sri Lankan economy. Thus, it will be of interest to policy-makers and students alike. Further details of the IPS Socio-Economic Database (which may be purchased on computer diskette) are available from the IPS.

1. Real Growth in the Sri Lankan Economy

Economic growth is commonly measured by the change in either Gross Domestic Product (GDP) or Gross National Product (GNP), both of which calculate the total value added in production within the economy, summing across all sectors. The GNP figure accounts not only for production by domestic input factors (as in GDP), but also includes net factor incomes from abroad. In their own right, one-off figures mean very little since value figures include price changes and take no account of population growth. It is therefore better to look at real per capita figures over a long time period. In Sri Lanka, the GDP and GNP figures have followed very similar trends, so the difference between them is relatively unimportant.

Figure 1.1 shows how Sri Lanka's real per capita GNP, calculated at 1992 constant prices, has grown since 1959. The annual increase appears to have been more or less constant from 1959 to 1977, and constant but greater from 1978 to the present. Since the base is growing, the constant annual increments indicate a falling annual growth rate across time within each period.

Figure 1.1

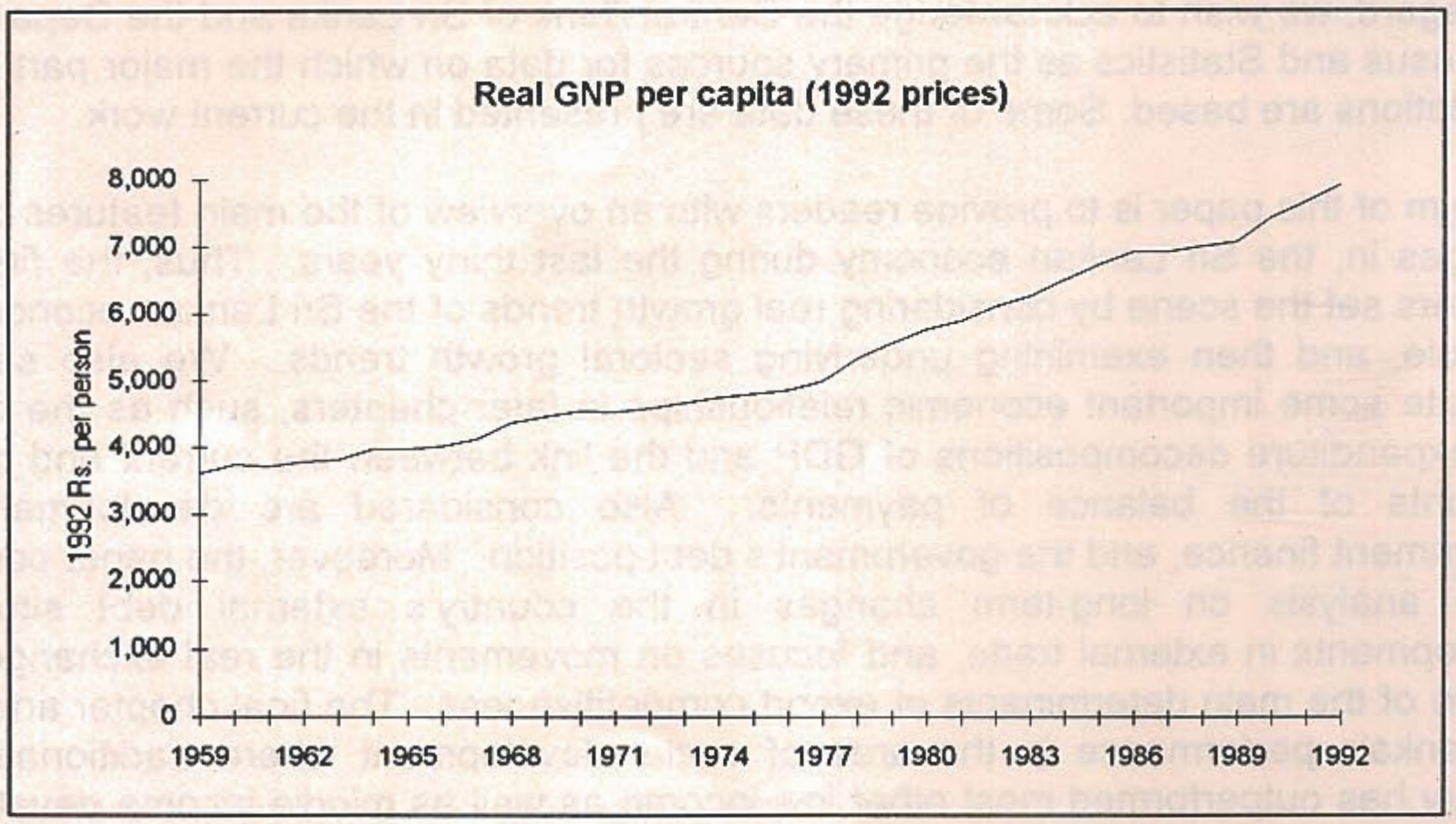
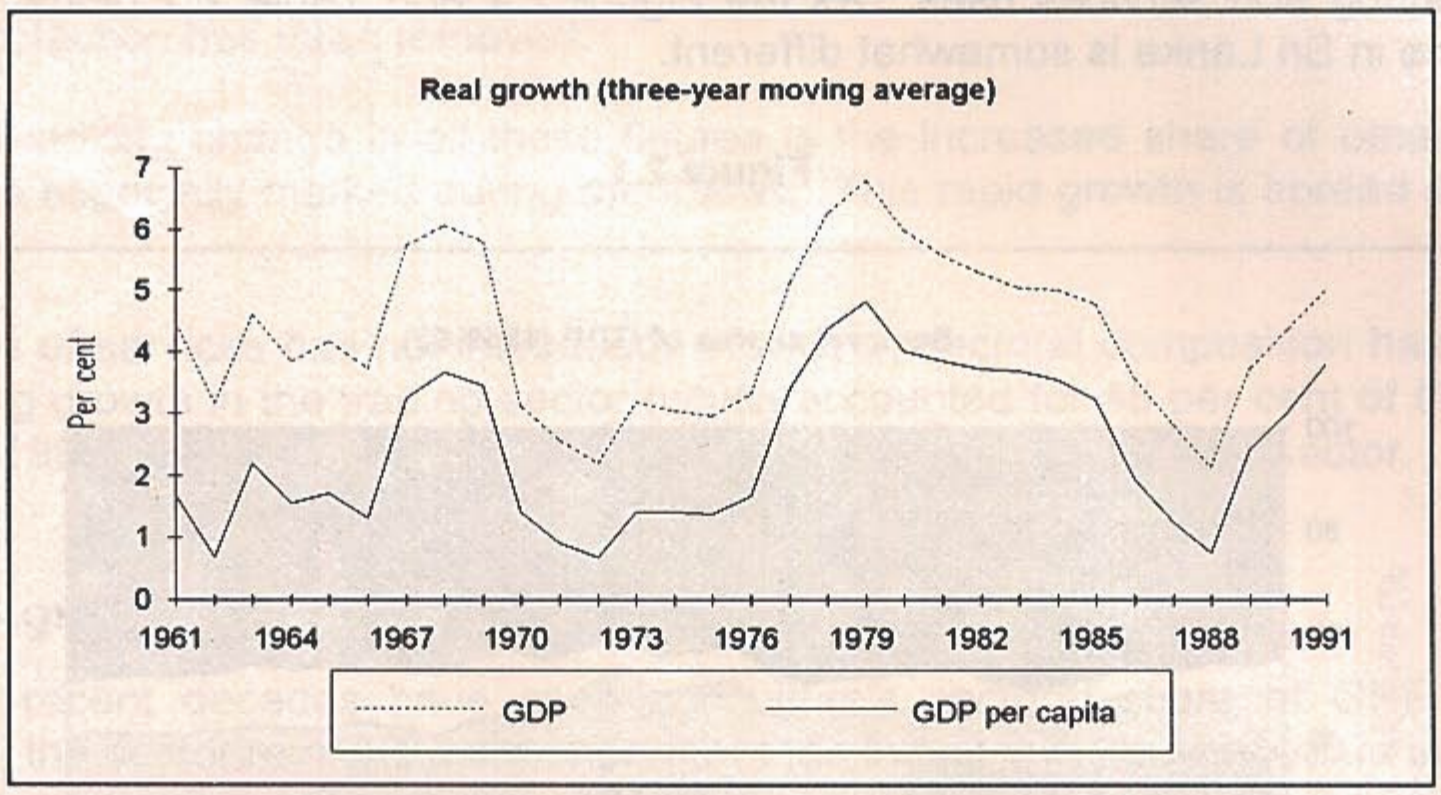


Figure 1.2 shows the real per centage growth rates of both GDP and GDP per capita, calculated as three-year moving averages, in order to give a better idea of the trend. This figure does not show so clearly the downward trend in growth rates in the two periods pre-and post-1977, suggested by Figure 1.1. It does, however, show a period of rapidly declining annual GDP growth rates from 1978 to 1988 following accelerating growth from 1975 to 1979. Both Figures 1.1 and 1.2 suggest that real growth has shown a marked increase since 1988.

Figure 1.2



The gap between real GDP figures and per capita figures, indicating the magnitude of population growth, has narrowed over the period, as Table 1.1 shows (also see the chapter on Social Development). GDP growth is therefore followed more closely now by the per capita figure.

Table 1.1
Real growth rates

	1960-77	1978-85	1986-92
GDP	3.9	5.8	3.7
Population	2.2	1.6	1.4
Per capita GDP	3.2	4.1	2.3

2. The Sectoral Composition of GDP

The Gross Domestic Product (GDP) of a country is the sum of the value added of the different sectors of production. The national accounts presented by the Central Bank identify eleven sectors, which may be classified as follows:

Agriculture	agriculture, forestry and fishing
Manufacturing	agroprocessing, factory industry, small industry
Other industry	mining and quarrying, construction, electricity, gas, and water and sanitary services
Services	transport, storage and communication, wholesale and retail trade, banking, insurance and real estate, ownership of dwellings, public administration and defence, and other services

In most developing countries the share of agriculture falls over time and that of manufacturing and services rises. As the Figure 2.1 and Table 2.1 below show, the experience in Sri Lanka is somewhat different.

Figure 2.1

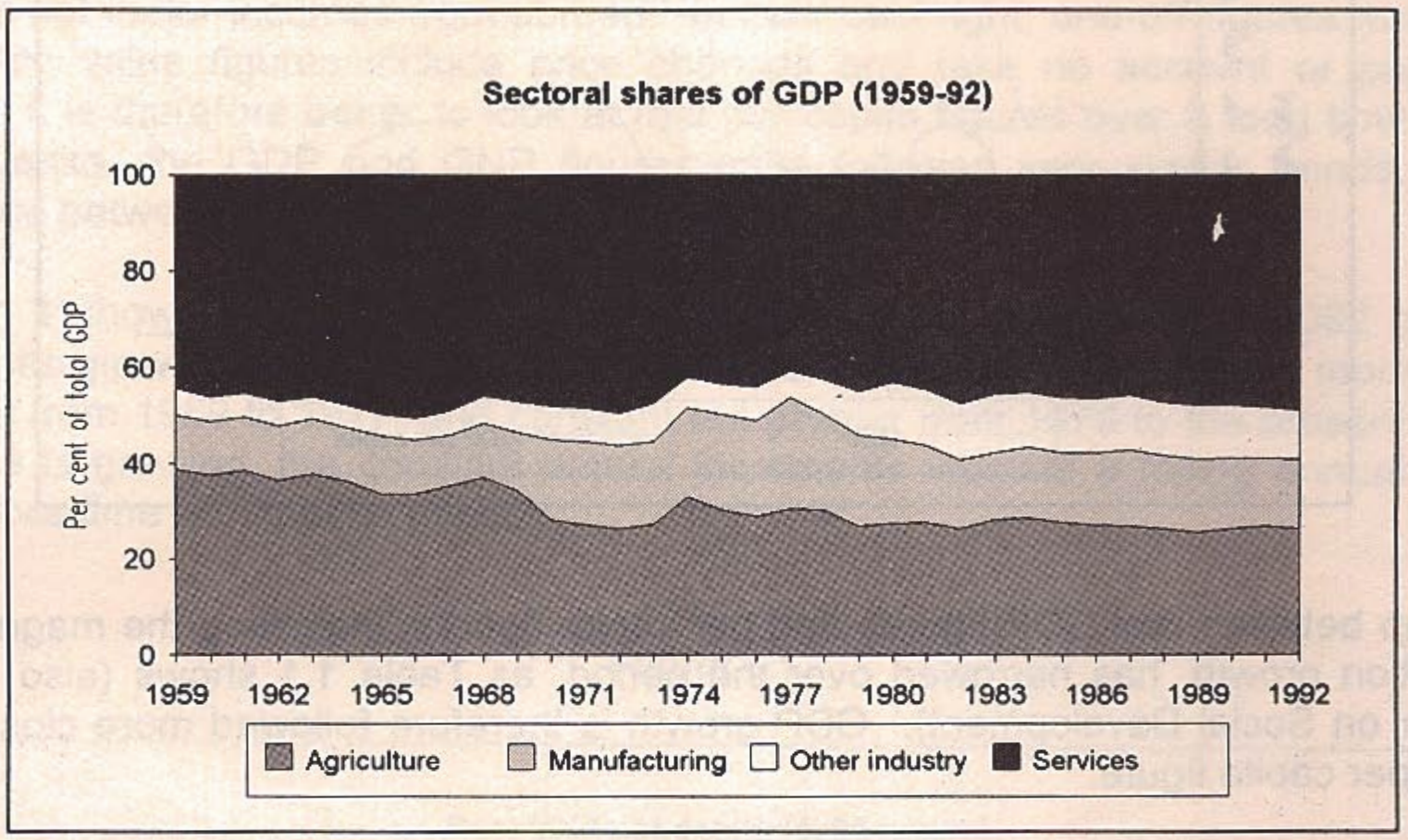


Table 2.1: Sectoral shares of GDP (period averages)

	1959-69	1970-77	1978-92
Agriculture	36.4	29.1	27.3
Manufacturing	11.4	19.2	15.8
Other industry	5.2	6.7	11.0
Services[a]	47.0	44.9	45.9
Total	100.0	100.0	100.0

Note: [a] Excluding construction, electricity, gas, water and sanitary services which are categorised under other industry.

The share of agriculture fell steadily during the 1960s, from 38.3 per cent in 1959 to 26.3 per cent by 1972. Since that time the share has fluctuated - in 1992 it was again 26.3 per cent. One reason behind the fluctuations has been changes in commodity prices: the export prices of important commodities boomed in 1974, 1977 and 1984.

The share of manufacturing was at its highest during the 1970s - these figures do not, however, necessarily mean that there has been "deindustralisation" during the 1980s. First, a sector's share can fall even if it is growing provided other sectors are growing

faster. Second, the manufacturing sector was heavily protected in the 1970s, as a result of which its value added figures were inflated. The latter would have since fallen as that protection has been removed.

The most striking change in all these figures is the increased share of other industry, which was especially marked during the 1980s. This rapid growth is spread across the sector.

The share of services has not increased. However, sectoral composition has changed with strong growth in the trading sector (which accounted for 45 per cent of the service sector in 1992) and in the smaller, banking, insurance and real estate sector.

3. The Agricultural Sector

Although recent decades have seen agriculture's sectoral share of GDP declining modestly, the sector remains more important than industry in terms of value added, and also accounts for a very large share of employment in the Sri Lankan economy. While the population remains mostly rural, it is essential to bear in mind the significance of agriculture in providing incomes, and particularly in attempting to improve the incomes of the very poor.

The major plantation sectors of tea, rubber, and coconut account for a major part of agricultural output and exports. Production of all these crops fluctuates dramatically from year to year, especially that of coconuts; rubber production however appears to be on a downward trend (see Table 3.1 and Figure 3.1). Sri Lanka's share of total world trade has declined massively since 1963, and the share of Sri Lanka's exports accounted for by the three major crops has fallen from just under 80 per cent in 1974 to around 20 per cent in 1992 (see Figure 3.2). However, this does not necessarily mean that production of these crops has declined, since world trade has grown rapidly, and the trade shares are calculated in value terms such that world price trends must also be analysed.

Paddy is extremely important in the domestic economy for subsistence. Production has quadrupled in the last 40 years, but trade remains essentially inward. Of the minor agricultural crops, some - mostly spices, coffee, and more recently oils, commercial vegetable production, and cashew nuts - are for the most part exported (in fact the export figures are taken as a proxy for total production, assuming domestic consumption to be negligible). The total export value of these crops has increased by over 420 per cent since 1968 (although figures for some crops were unavailable in the early years) whereas that of tea has increased by less than 120 per cent. The other minor crops, including sugar, manioc, onions, gram, maize and chillies, are produced for domestic consumption. For all these minor crops, accurate figures for production and extent cultivated are difficult to estimate due to inter-cropping and the subsistence nature of many of them. Sugar production figures are also quoted by the Central Bank, but since domestic production accounts for only 14 per cent of consumption, the trends have not been analysed here.

Table 3.1
Production index for plantation crops (1970=100)

	1970-74	1975-79	1980-84	1985-89	1990-92
Tea	99.8	96.5	92.0	101.1	102.5
Rubber	91.4	94.9	83.4	79.2	67.4
Coconut	96.0	88.8	88.1	101.3	94.2

In the remainder of this section, the performance of each of the main agricultural sectors are reviewed in turn.

Figure 3.1

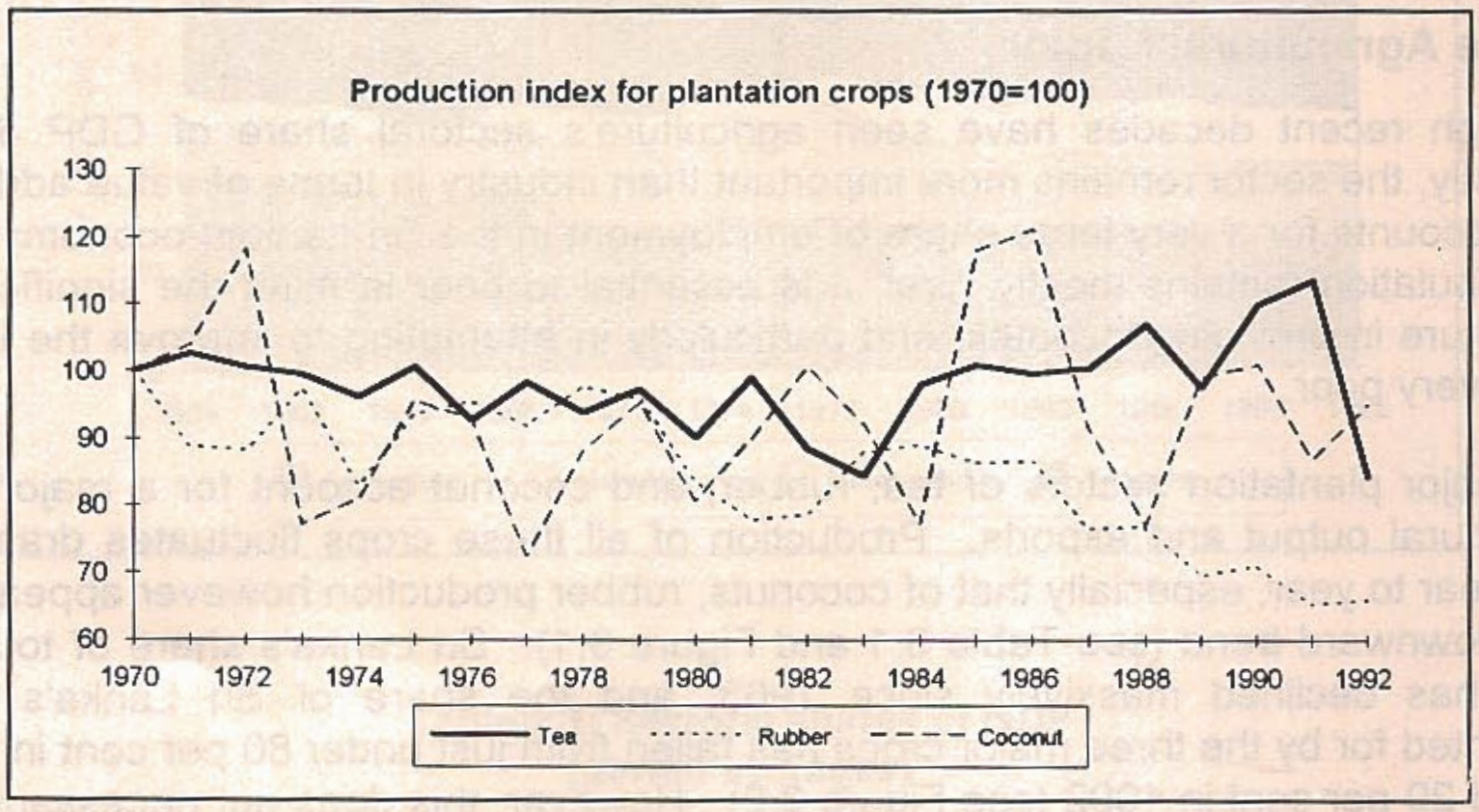
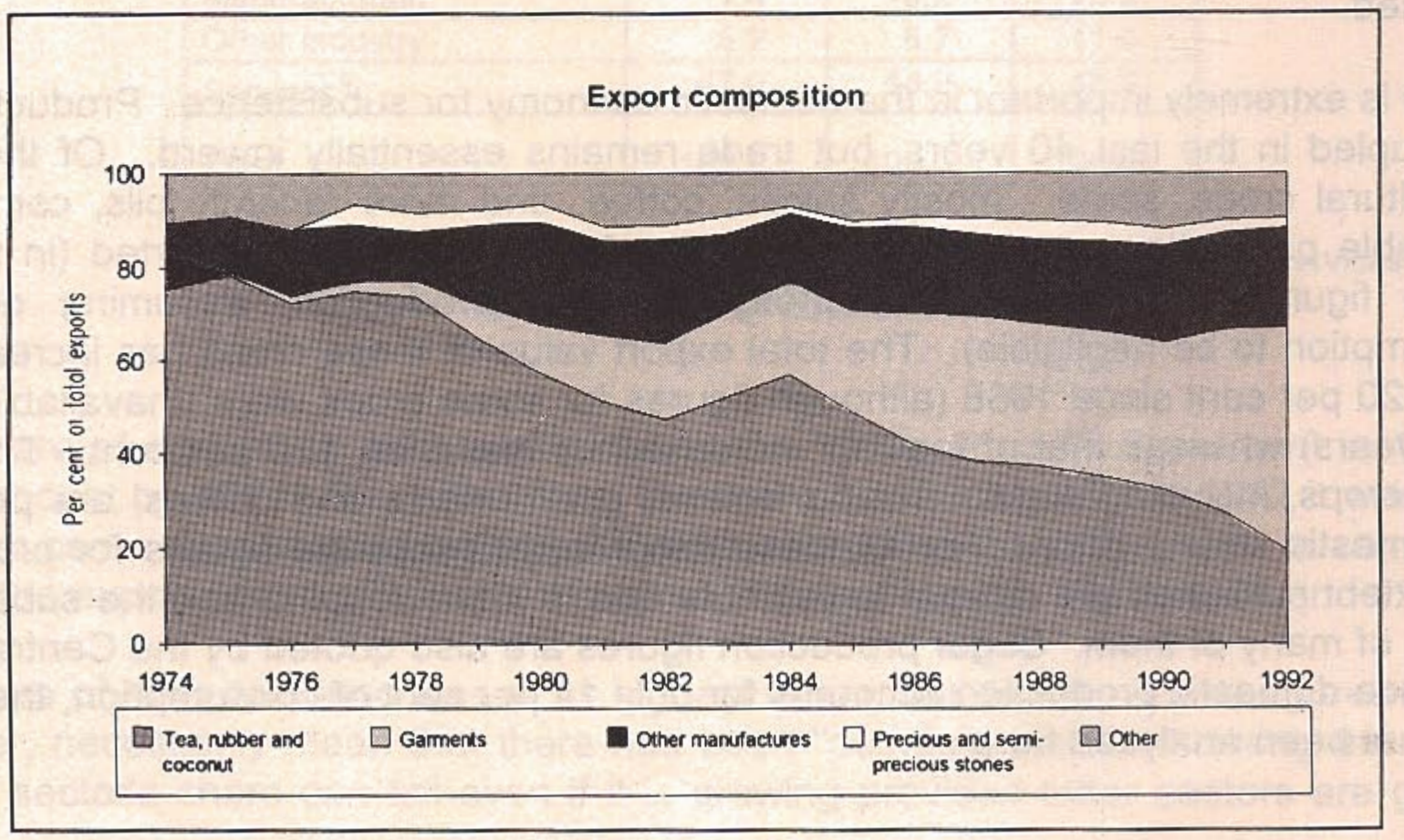


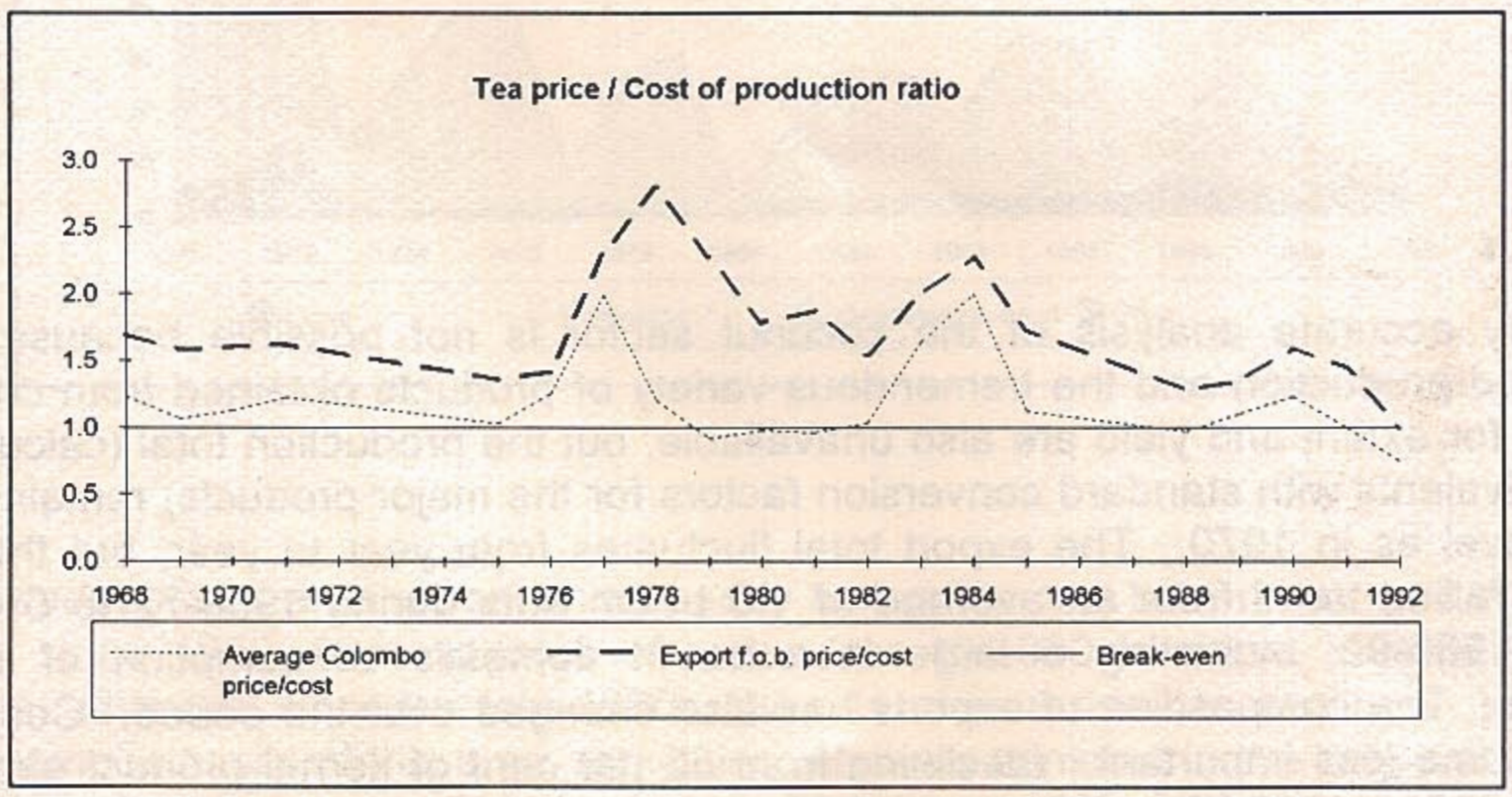
Figure 3.2



Tea

The area under tea cultivation has declined by around 7 per cent since the mid-1970s. Yields, from the late-1970s, have followed no real discernible trend, varying a good deal year by year, although the lowest yield category, medium-grown tea, appears to have improved somewhat. It is hoped that following the privatisation of most of the State sector plantations in 1992, average yields will improve, although the most run-down plantations remain under State management. Overall, there has been a slight increase in the production of high-grown teas and a decrease in medium-grown, such that total production has remained fairly constant since the late-1960s. Domestic tea prices since 1968 have increased almost in line with export prices but, while returns have remained positive in world markets since 1979, costs of production have exceeded the average domestic price in several years (see Figure 3.3). Total tea export volumes have remained constant since 1968, but the share going to the London auction has declined considerably (with a rapid absolute decline in quantities to London in the early 1980s). Sri Lanka's share of the London market declined from 12 per cent in 1981 to 2 per cent in 1992, while the price fetched by Sri Lankan tea remains around the average in London. The greatest volume of Sri Lankan tea now goes to Middle Eastern markets.

Figure 3.3

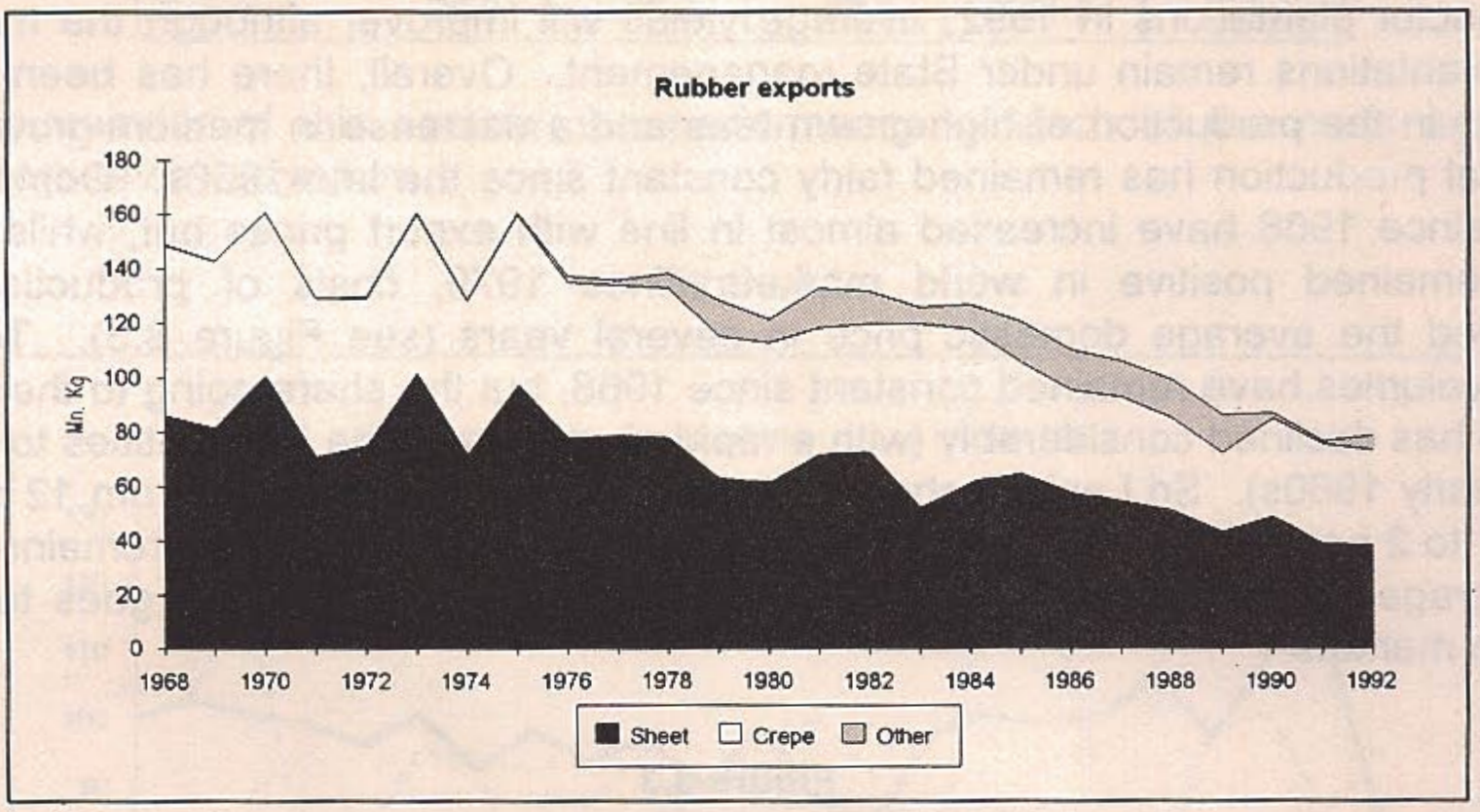


Rubber

Rubber yields have changed little overall since the mid-1970s, though they increased for a few years in the mid-1980s. The area under tapping declined by around 20 per cent over the same period, so total production has declined. Rubber production figures from 1970 to the present show a 30 per cent reduction in output, particularly that of sheet rubber, and this pattern is replicated by export volume figures (see Figure 3.4). The export f.o.b. price for all rubber has remained at around 200 per cent of production

costs, while in the domestic market, prices have only remained about 20 per cent above production costs.

Figure 3.4



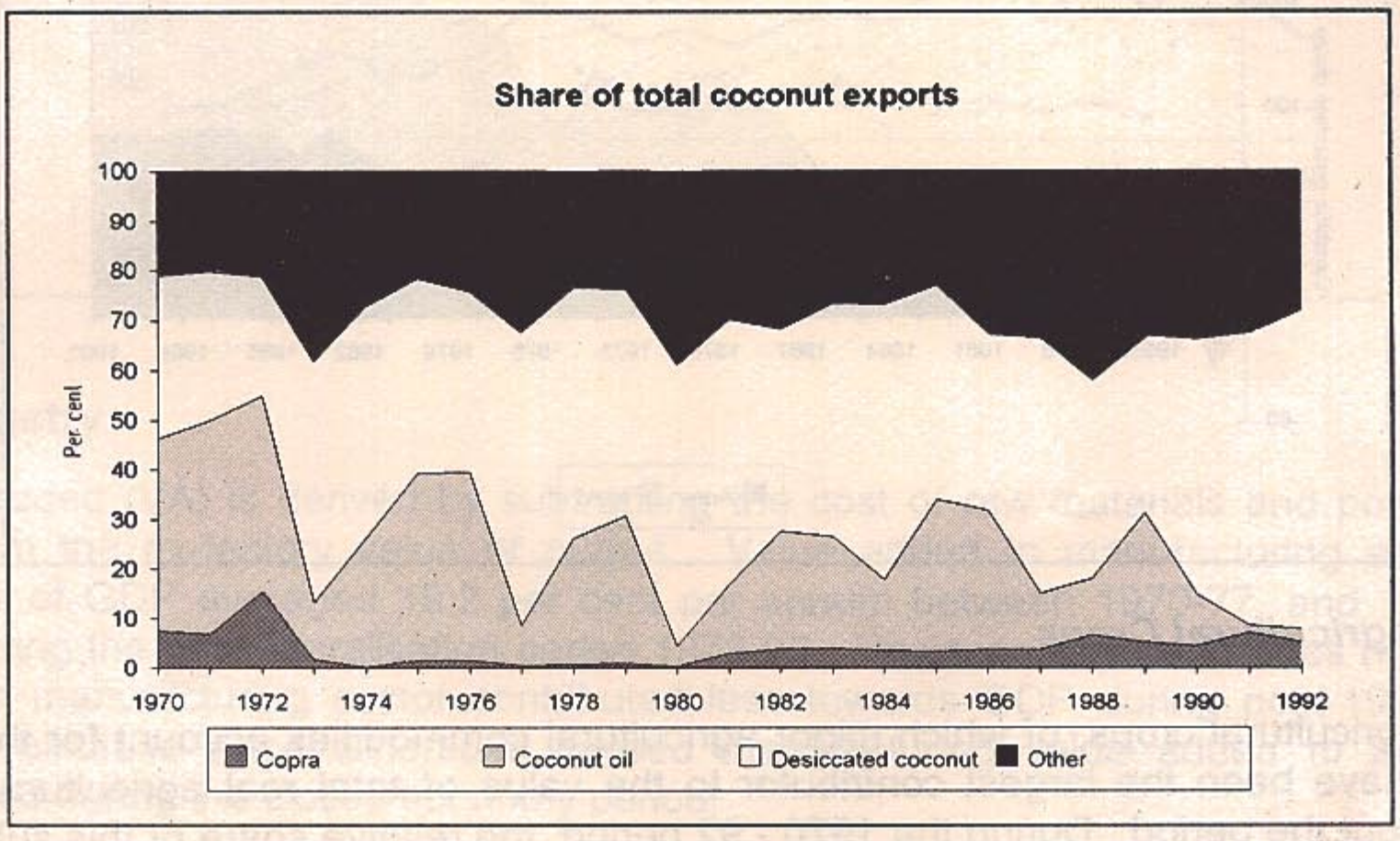
Coconut

A strictly accurate analysis of the coconut sector is not possible because of the dispersed production and the tremendous variety of products obtained from coconuts. Figures for extent and yield are also unavailable, but the production total (calculated in nut equivalents with standard conversion factors for the major products) remains at the same level as in 1970. The export total fluctuates from year to year, but there has been a falling trend from an average of 1.0 billion nuts during 1968-72 to 0.4 billion during 1988-92, indicating a large increase in domestic consumption of coconut products. The composition of exports has also changed over the period. Coconut oil has become less important, (declining from 52 per cent of kernel product exports by volume during 1968-72 to 20 per cent during 1988-92). Desiccated coconut on the other hand has gained more importance, (increasing from 36 per cent to 71 per cent over the same period). Copra exports on the other hand remained at about 10 per cent of the total (see Table 3.2). The composition of coconut exports by value is shown in Figure 3.5. Both domestic and export prices remain above the average costs of production.

Table 3.2
Coconut export volumes (Mn. nuts)

	1968-72		1988-92	
	Mn. nuts	%	Mn. nuts	%
Copra	116	11.4	34	8.2
Coconut oil	537	52.4	84	20.2
Desiccated coconut	372	36.3	298	71.6
3 major products	1024	100.0	416	100.0

Figure 3.5

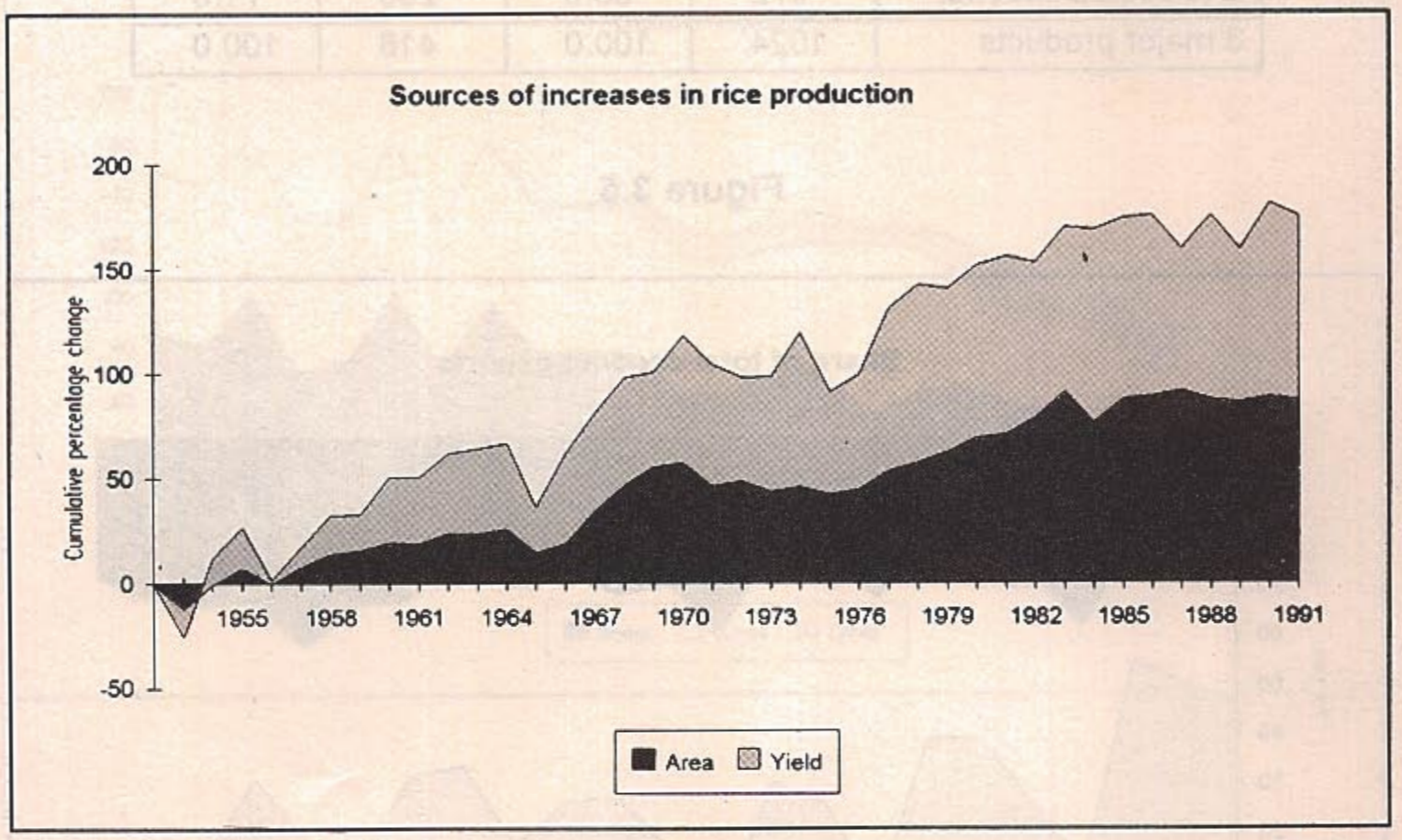


Paddy

The asweddumised area, upon which paddy cultivation can take place, has increased steadily since 1952, from an area of just under 400,000 hectares to over 700,000 hectares, although, since the late-1980s, the rate of increase has declined. However, the cropping intensity of this area, remaining relatively constant in the long-run from the 1950s, has declined since 1984 to around 110 per cent rather than over 130 per cent. Production of rice obviously varies every season, depending on climatic factors, but there has been a trend increase in both *maha* and *yala* output. This is attributable not only to the increased extent of cultivation, but also rapidly-growing yields -- from around 1,500 kg per hectare in the early-1950s to around 3,500 kg per hectare in the late-1980s -- production being equal to the product of average yield and the net harvested area. The total per centage increase in output is the sum of the total increase in the two components as shown in Figure 3.6. Until the present, this has been a very positive picture, but it does appear that production gains from both components have slowed recently. Paddy has been the single largest contributor to

the total value of real output throughout the 1970-92 period. Its share, on average, has been about 25 per cent of the total. The relative contribution of paddy however has been on a long-run declining trend since mid-1980s due to relatively high rate of growth of production of "other" agricultural commodities.

Figure 3.6

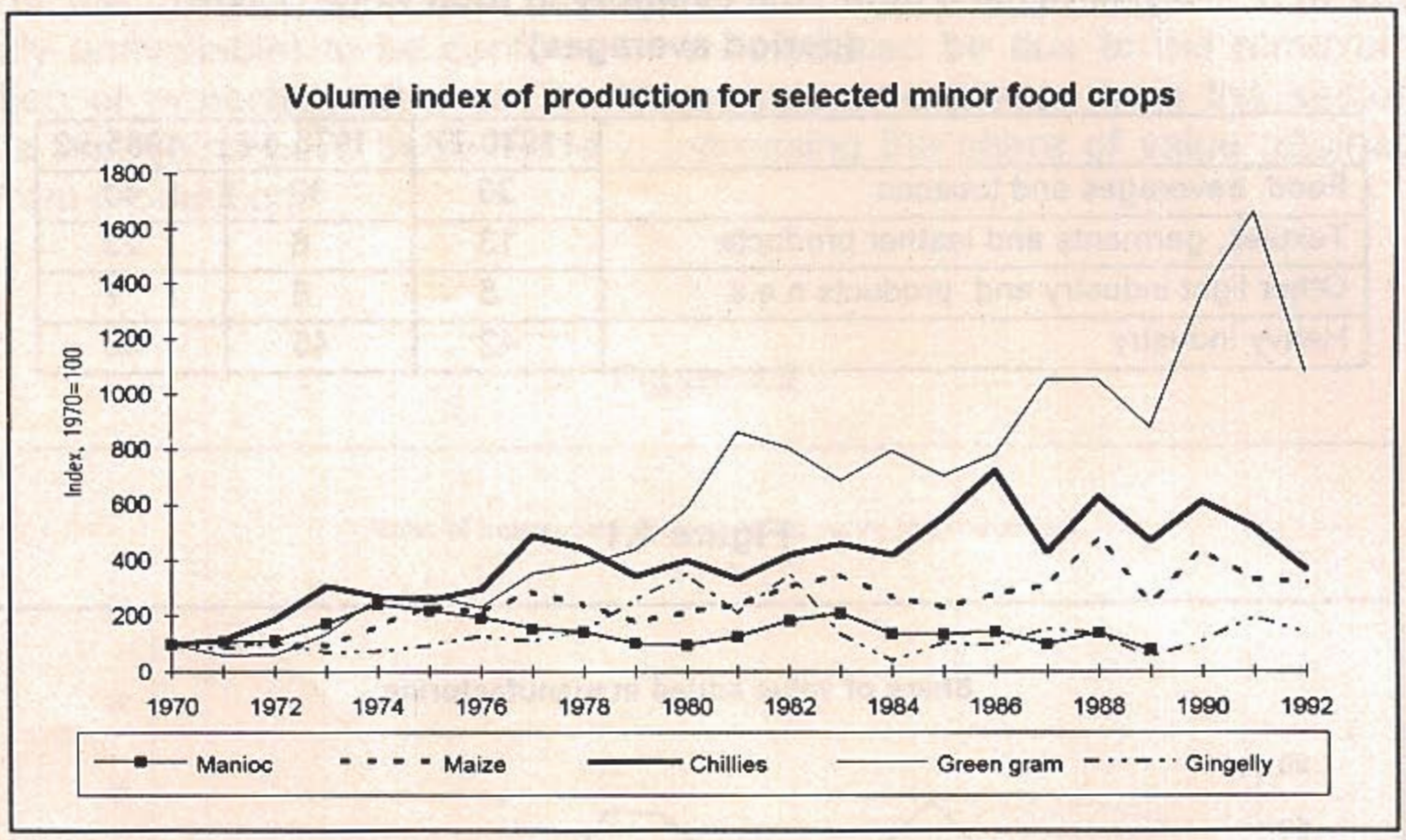


Other Agricultural Crops

Other agricultural crops, of which minor agricultural commodities account for the major share, have been the largest contributor to the value of total real agricultural output throughout the period. During the 1970 - 92 period, the relative share of this sub-sector has undergone three different phases. In 1970, its share was only about 37 per cent. This went up to about 50 per cent by 1976. Since then it had been on a declining trend till 1984 when it reached about 45 per cent of the value of total agricultural production. Since then it has again been increasing rapidly and, by 1992, it reached the highest recorded share of about 53 per cent of total agricultural output. (This is not shown in Figure 3.7 because the data for all other agricultural crops are not available in comparable volume terms).

Detailed trends in minor agricultural crops are difficult to discern because of the great diversity of crops. Some have increased in importance and others have declined. Of the export crops, spices and coffee remain important items, but there have been huge increases from the late-1970s in export volumes of cashew nuts, essential oils, vegetables, and, to a lesser extent, tobacco. The area under minor food crops appears to have increased by around 20 per cent since the early-1970s, and yields for three of the most important crops, viz. maize, chillies, and green gram, have improved by 50 per cent. Output of almost all the minor food crops has increased, some very dramatically (see Figure 3.7).

Figure 3.7



4. Industry

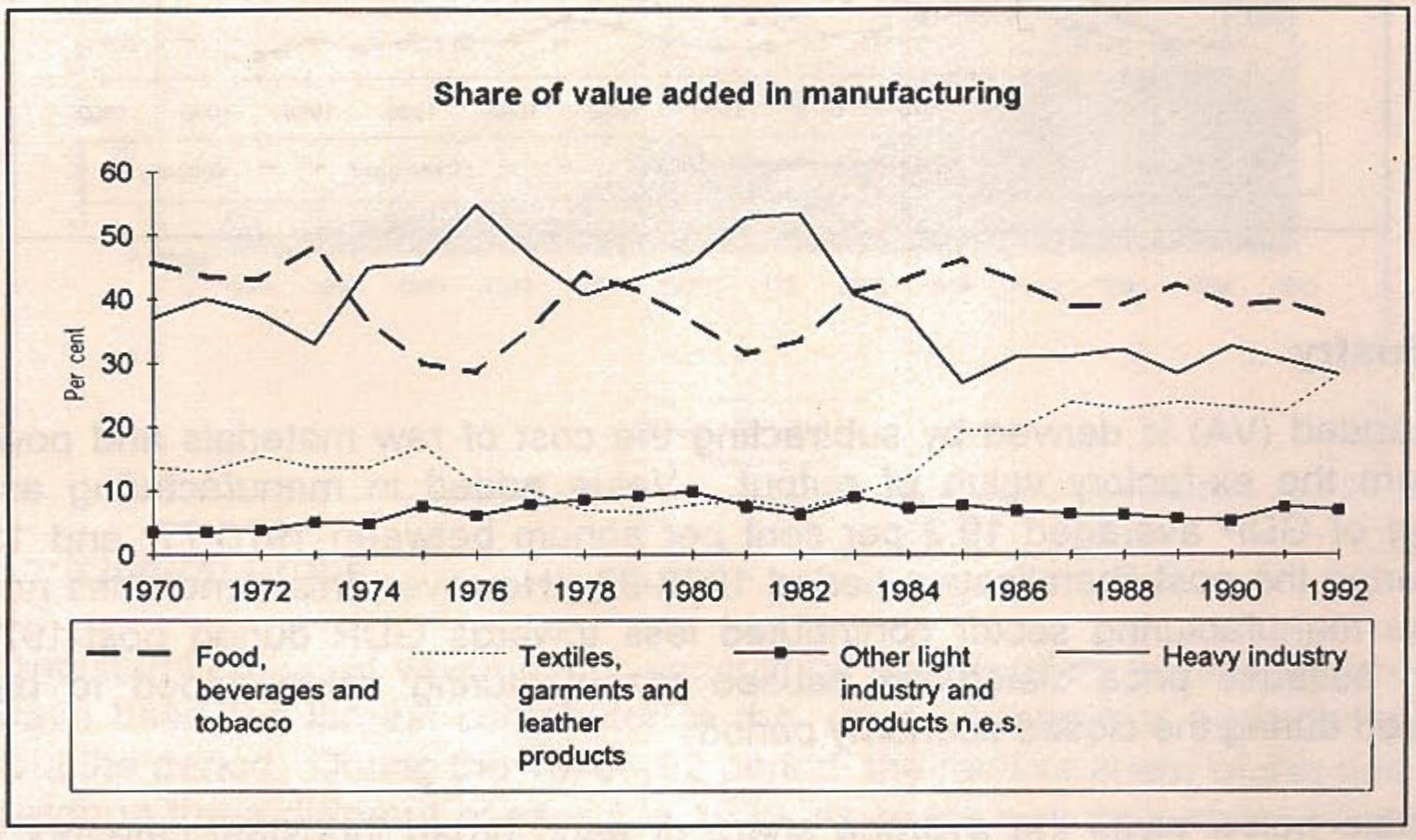
Value added (VA) is derived by subtracting the cost of raw materials and power and fuel from the ex-factory value of output. Value added in manufacturing as a per centage of GDP averaged 19.2 per cent per annum between 1970-77, and 15.8 per cent during the post-liberalisation period 1978-92. However, this trend does not mean that the manufacturing sector contributed less towards GDP during post-1977 than before, because price distortions caused manufacturing value added to be over-estimated during the closed economy period.

The Table below gives the average share of each broad industrial category in total value added for the periods 1970-77,1978-84 and 1985-92. The category 'other light industry and products n.e.s' includes wood and wood products and paper and paper products. 'Heavy industry' denotes chemicals, petroleum, coal, rubber and plastic products, non-metallic mineral products, basic metal products, fabricated metal products, machinery and transport equipment. It can be seen from the Table that food, beverages and tobacco, and heavy industry have had the largest shares in total value added throughout this period. However, whereas the share of the category 'other light industry and products n.e.s' has remained steady throughout the period, the heavy industrial sector has not grown fast enough relative to other sectors in order to maintain its share in total value added which declined from 45 per cent of total value added during 1978-84, to 30 per cent during 1985-92. The share of textiles, garments and leather products has leapt from an average of 8 per cent during 1978-84, to 23 per cent during 1985-92. The category 'other light industry and products n.e.s' has contributed the least towards total value added since its share has not exceeded 10 per cent of total value added throughout this period. (See also Figure 4.1).

Table 4.1
Share of each industrial category in total value added
(period averages)

	1970-77	1978-84	1985-92
Food, beverages and tobacco	39	39	41
Textiles, garments and leather products	13	8	23
Other light industry and products n.e.s.	5	8	7
Heavy industry	42	45	30

Figure 4.1

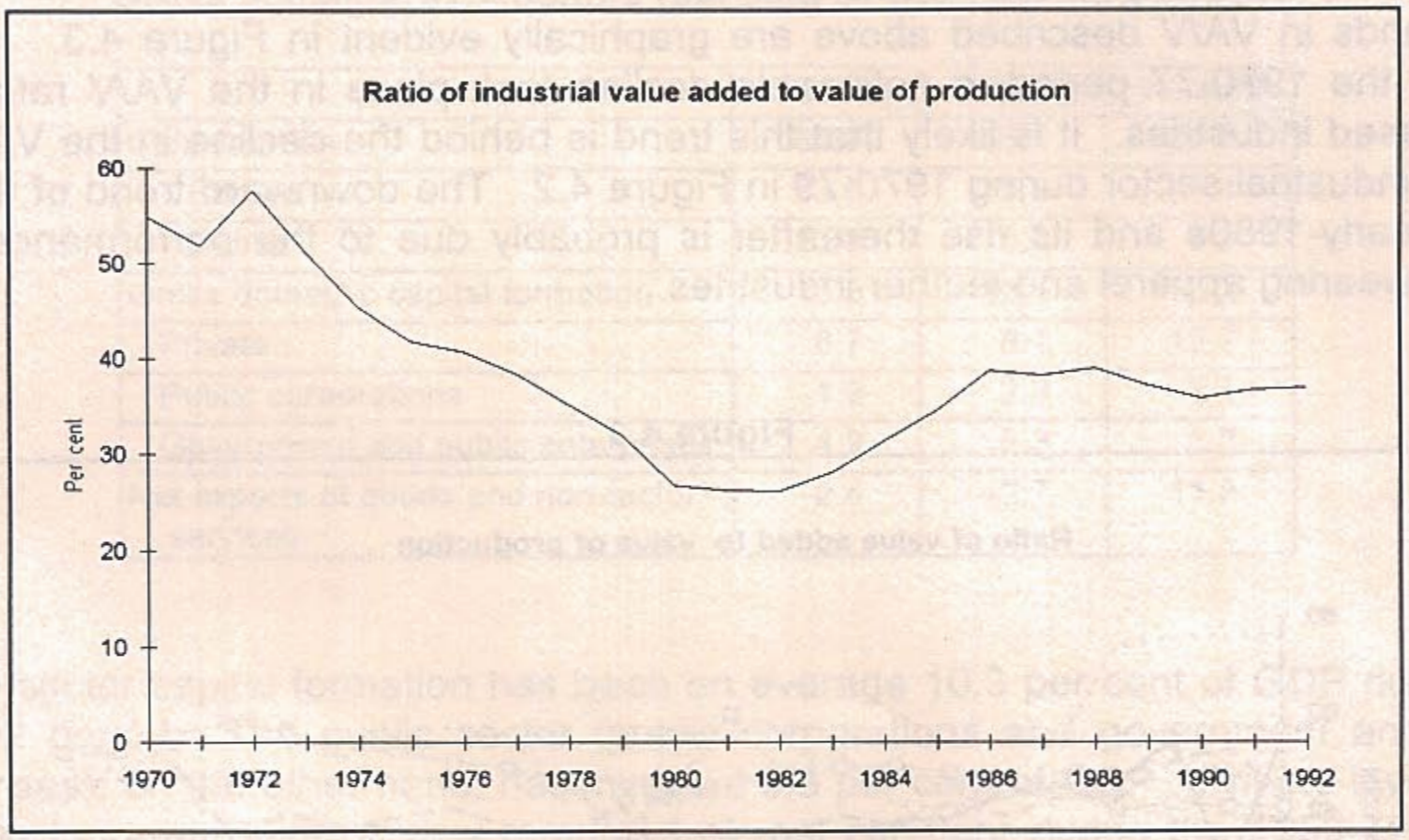


Nevertheless, when examining the performance of the manufacturing sector in the economy over the long term, it is more useful to calculate the ratio between value added (VA) and value of production (V). This ratio indicates the share of total value of production accounted for by salaries, wages and profits, or in other words, net income accruing to the economy from industrial activity, and can be calculated in terms of total value added as well as in terms of the ratio for each industrial category.

During the period 1970-92, total value added fell steadily from a peak of around 58 per cent of total value in 1972 over the next seven years, and was at an all time low of approximately 27 per cent from 1980-82 (see Figure 4.2). This could have been partly due to the transition from the old (1970) to the new (1982) GDP series which took place during this period and which could have affected the estimation of value added. The pre-1982 data may not therefore be strictly comparable to the post-1982 data. Nevertheless, from 1982 onwards, the ratio VA/V rose to 37 per cent and this level was maintained until 1992, other than for a slight decline during the politically turbulent

1988-1989 period. The plateau effect could possibly reflect an exhaustion of the 'level' effects of the initial liberalisation. However, this hypothesis requires real GDP data (presently unavailable) to be confirmed. It could also be due to the removal and re-application of protection after 1977. Nevertheless, evidence from the sectoral level suggests that gains have been made in increasing the share of value retained by Sri Lanka from production.

Figure 4.2



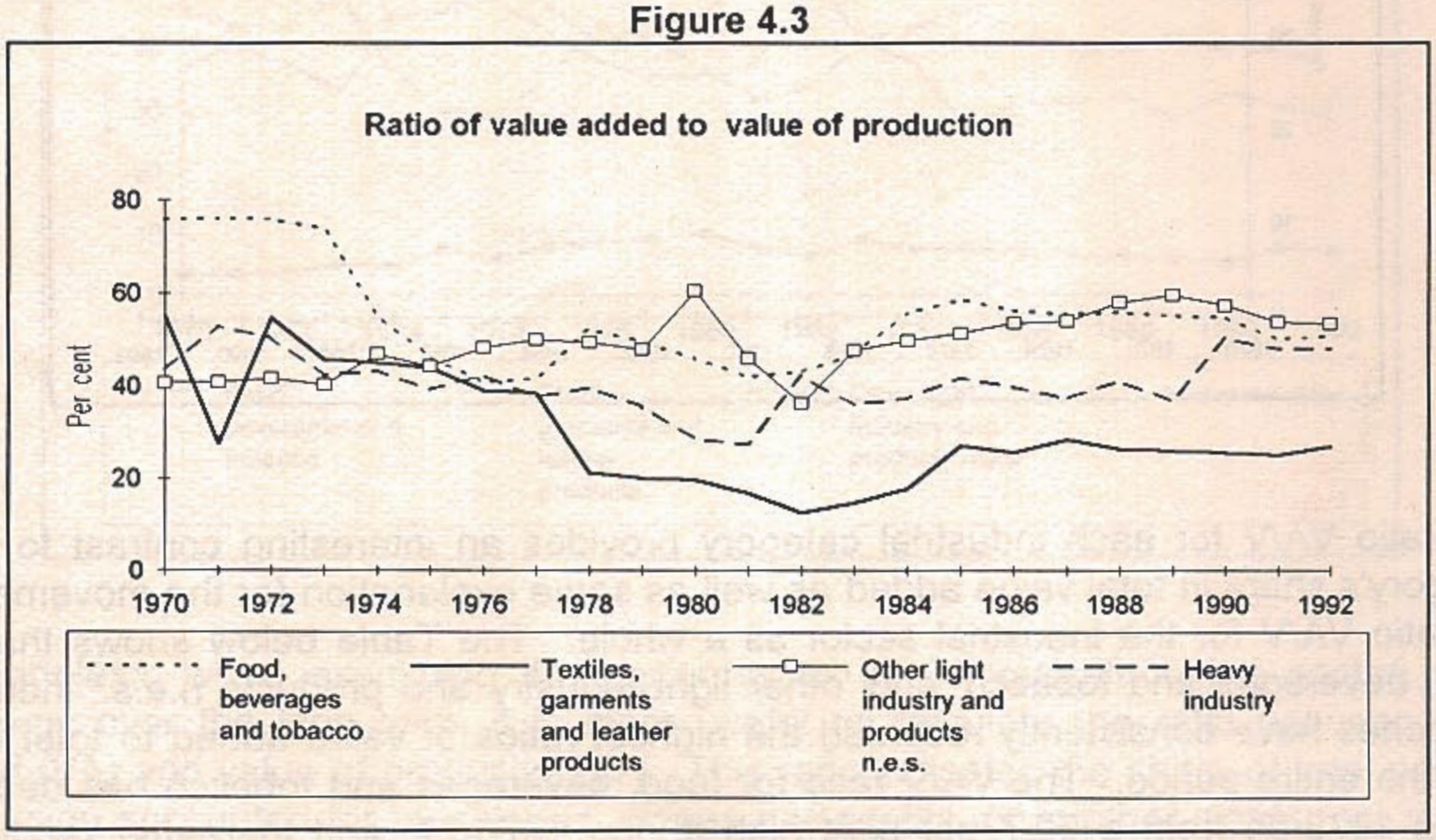
The ratio VA/V for each industrial category provides an interesting contrast to each category's share in total value added as well as some explanation for the movement of the ratio VA/V for the industrial sector as a whole. The Table below shows that the 'food, beverages and tobacco' and 'other light industry and products n.e.s.' industrial categories have consistently recorded the highest ratios of value added to total value over the entire period. The VA/V ratio for food, beverages and tobacco has declined during 1978-84 from a 60.7 per cent high during 1970-77, and thereafter recovered somewhat in subsequent period. In contrast, the ratio for other light industry and products n.e.s. has consistently increased throughout the 1970-92 period: it climbed steadily from 1970 onwards to peak at approximately 60 per cent in 1980, fell sharply in 1982 and thereafter recovered. By the late-1980s, this category, at approximately 56 per cent, had the highest ratio of value added to total value of production of all the industrial categories. The corresponding figures for the textile, garments and leather industries indicate that, despite the surge in this sector's relative share in value added, net income from this industry as indicated by its VA/V ratio is relatively low due to the high import content in the inputs used in the garment industry.

Table 4.2
Ratio of value added to total value of each industrial category
(period averages)

	1970-77	1978-84	1985-92
Food, beverages and tobacco	60.7	48.0	54.7
Textiles, garments and leather products	43.8	17.6	26.5
Other light industry and products n.e.s.	44.1	48.3	55.2
Heavy industry	43.9	35.3	42.9

The trends in VA/V described above are graphically evident in Figure 4.3. It shows that, in the 1970-77 period, a noticeable decline took place in the VA/V ratio of the agro-based industries. It is likely that this trend is behind the decline in the VA/V ratio for the industrial sector during 1970-79 in Figure 4.2. The downward trend of the latter in the early-1980s and its rise thereafter is probably due to the performance of the textile, wearing apparel and leather industries.

Figure 4.3



5. Expenditure Decomposition of GDP

A key national income accounting identity underlying macroeconomic analysis is that output equals expenditure equals income. In Section 2, the output decomposition of GDP was analysed. Here GDP is examined from the point of view of the expenditure decomposition (i.e. GDP = Consumption + Investment + Exports - Imports).

On average, gross domestic capital formation (GDCF) during the 1959-92 period has been 19.9 per cent of GDP. The period 1959-77 witnessed a relatively low rate of

GDCF of 15.8 per cent and was rather stable. On the other hand, during 1978-92, the investment ratio remained at a relatively high level of 25.2 per cent. Starting from 1978, the investment ratio increased very rapidly till 1980, in which year the peak investment ratio of 33.8 per cent was achieved. The surge in investment infused heavy demand pressures during this period. From then on it gradually declined until 1989, when it fell to 21.7 per cent. Since 1990, the ratio of GDCF has again been on an increasing trend.

Table 5.1
Gross domestic expenditure (per cent of GDP, period averages)

	1959-69	1970-77	1978-92
Consumption	86.9	86.6	86.6
Private	73.3	75.7	77.4
Public	13.6	10.9	9.2
Gross domestic capital formation	15.5	16.1	25.2
Private	8.7	8.1	12.7
Public corporations	1.9	2.8	7.1
Government and public enterprises	4.9	5.3	5.3
Net exports of goods and non-factor services	-2.4	-2.7	-11.8

Private sector capital formation has been on average 10.3 per cent of GDP during the 1959-92 period. The public sector (public corporations and government and public enterprises), on the other hand, has invested 9.6 per cent of GDP. Private investment from the long-run point of view remained almost constant during the 1959-77 period. During the post-1977 period it has been on a long-run increasing trend. Within these long-run trends, there exist a number of medium-term trends. Within the 1959-77 period, the sub-periods (1960-65, 1970-77) which were characterised by inward orientation in foreign trade and payments and more government interventions in domestic resource allocation, experienced gradually decreasing levels of capital formation. On the other hand, the 1966-70 period, in which some progress was made towards market orientation in resource allocation and opening the external sector, the rate of private investment was on an increasing trend. After an initial surge following the economic liberalisation in 1977, the private sector rate of GDCF again fell during 1981-89 largely due to faltering liberalisation momentum, macroeconomic imbalance and political instability prevailing during this period. The turnaround in investment ratio since 1990 has been primarily induced by the cessation of political violence in the South and more effective stabilisation, structural adjustment as well as the liberalisation policies implemented during this period.

The public sector investment ratio was on a mild growth path during the 1959-77 period. A short-term rapid phase of growth of investment was experienced during 1978 -80 followed by a long-run decline in the subsequent period. Throughout the early period, the government policy of import substitution and active intervention in

production led to high levels of public investment. Following the policy reforms of 1977, the government's policy has been to reduce its direct participation in production activities gradually. However, during 1978-80, public investment soared resulting from the availability of foreign aid at unprecedented levels, which led to very high government investment in three lead infrastructure projects. By 1980, most of the expenditures of the lead projects had already been committed. On the other hand, severe internal and external imbalances compelled the government to check the expenditure levels. The public investment ratio thus experienced a gradual decline during the ensuing period. Since 1989, this fall was magnified following the implementation of the structural adjustment and stabilisation programme.

As far as the contribution to total investment is concerned, the share of private sector investment had been on a long-run declining trend during the 1959-1980 period. In 1959, this sector's share was 62.2 per cent. It declined to 40 per cent by 1978 and, in 1980, it further decreased to 38.2 per cent. Since 1980, the investment share of the private sector has been on a long-run increasing trend. This increase was especially pronounced during the 1981-82 and 1989-92 sub-periods. Another notable feature of long-run trends in investment has been the divergent movements of private and public investment rates since 1988. Compared to the earlier period, in which both variables moved in the same direction, private investment has been increasing whereas public investment has been decreasing since 1988. The economic reforms which have been implemented since 1988 thus seem to have laid the foundations for investment and growth based primarily on private sector initiatives.

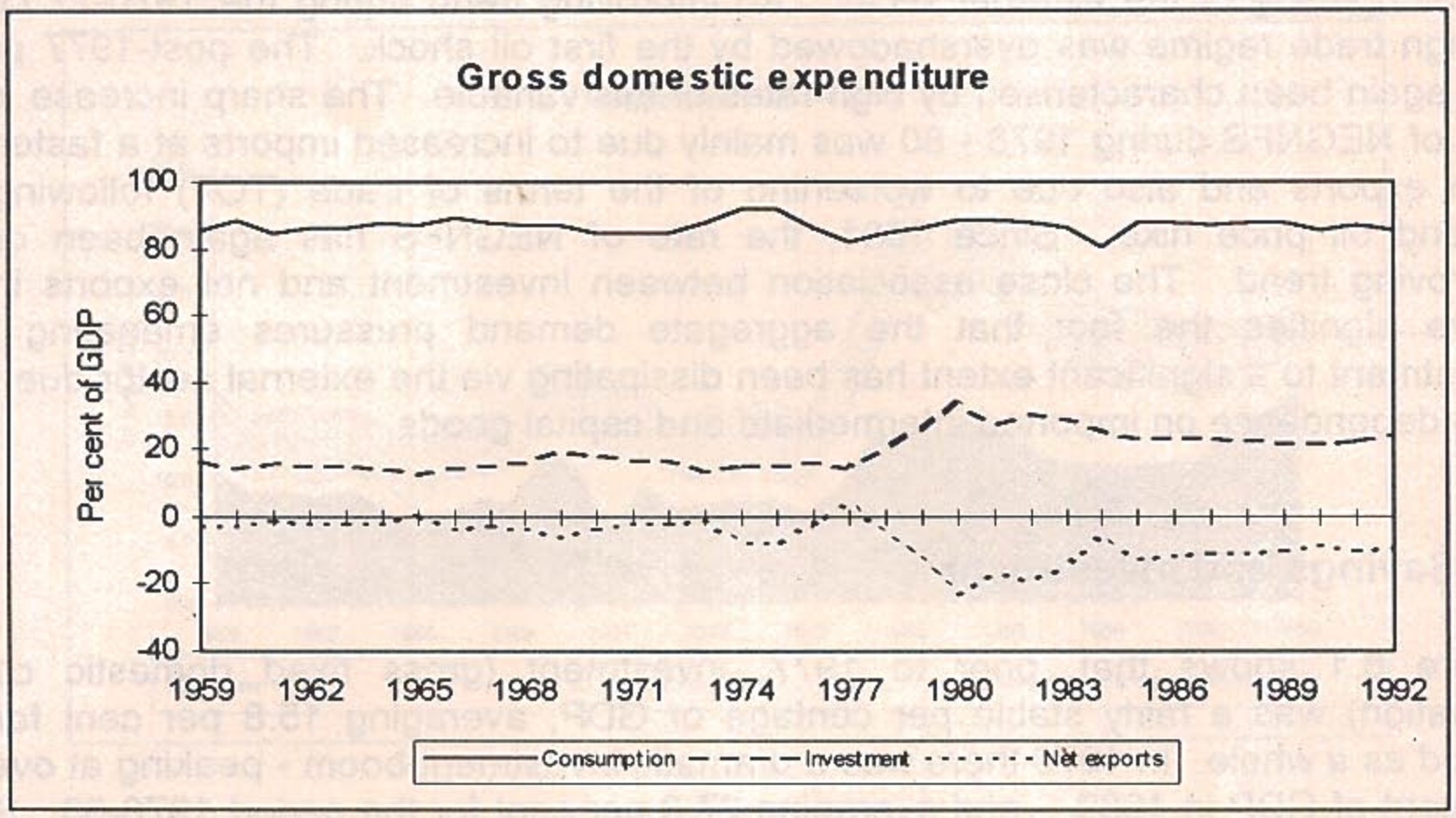
Consumption expenditure is the largest component of the aggregate demand. The overall average propensity to consume (APC) has been 86.7 per cent on average. It has been quite stable from the long-run point of view. Period averages of private and public sector APC have been 75.6 and 11.1 per cent, respectively. The public sector APC has in the long-run been decreasing at a moderate pace. When the sample period is sub-divided, we can distinguish certain variations in the public consumption pattern. From 1959 to 1965, it increased albeit at a very low rate. In 1965, the public consumption rate was at its highest level of 14.3 per cent of GDP. Since then, despite minor variations in certain years, it has been on a declining trend. In 1981, the lowest rate of 7.4 per cent of GDP was reached. This was followed by a brief spell of three years in which it remained at about 8 per cent. In 1985, the public sector APC again increased and has been around 10 per cent during the remaining period.

The private sector APC was quite stable during the periods 1959-72 and 1985-92. The interim period of 1973-1984, however, was characterised by relatively high variations. For instance, private sector APC increased from 71.8 per cent in 1972 to 82.6 per cent by 1975, and again decreased to 73.3 per cent in 1977.[1]

---

1 These high variations also would have been caused by errors in data. It seems that the expenditure and GDP figures for the periods 1970-77 and 1984-87 have not been adjusted to revised data on net exports of goods and non-factor services.

Figure 5.1



Private and public sector shares of total consumption have on average been 87.2 and 12.8 per cent, respectively during this period. The period from 1959 to 1972 was characterised by rather stable values of these variables. Since then, the public sector share gradually declined up to 1981, in which year the lowest level of 8.4 per cent of GDP was recorded. Starting from 1982, the share of the public sector increased marginally till 1985, and since then it has stabilised around 11 per cent of total consumption.

Net exports of goods and non-factor services (NEGNFS), the least important component of aggregate demand, has been negative except in 1965 and 1977, when it experienced marginal surpluses.[2] The post-1977 period experienced significantly higher rates of NEGNFS compared to the earlier period. The respective rates are 2.5 and 11.8 per cent. More open trade regimes have been associated with higher rates in

---

2 The long-run trends in exports and imports of goods and non-factor services are fully treated under the balance of payments in Section 9. The only difference in the present analysis is that in national income accounts, exports and imports are recorded net of factor income from abroad (NFY). A separate detailed trend analysis of exports and imports of goods and non-factor services is therefore warranted only if the exclusion of NFY would systematically alter the long-run trends in exports and imports of goods and services. NFY has consistently been negative and remained on average at a very low level of 1.2 per cent of GDP. The most notable feature in NFY is its sudden jump in 1981 separating the sample into two sub-periods, viz, 1959-80 and 1981-92. Despite the fact that the latter period experienced relatively high levels of NFY, within each sub-period it remained rather stable. This stability, together its relative low magnitude, has prevented NFY from exerting any systematic influence on the trend behaviour of exports and imports of goods and services. Thus we confine the following section to a brief sketch of the long-run trends in net exports of goods and non-factor services. For a detailed separate trend analysis of these variables, the reader should refer to Section 9.

NEGNFS. An initial improving trend in this variable was reversed in 1965 with the partial opening of the external sector. An improving trend during the 1970-77 closed foreign trade regime was overshadowed by the first oil shock. The post-1977 period has again been characterised by high rates of this variable. The sharp increase in the rate of NEGNFS during 1978 - 80 was mainly due to increased imports at a faster rate than exports and also due to worsening of the terms of trade (TOT) following the second oil price hike. Since 1981, the rate of NEGNFS has again been on an improving trend. The close association between investment and net exports in the figure signifies the fact that the aggregate demand pressures emanating from investment to a significant extent has been dissipating via the external sector due to its high dependence on imported intermediate and capital goods.

6. Savings and Investment

Figure 6.1 shows that, prior to 1977, investment (gross fixed domestic capital formation) was a fairly stable per centage of GDP, averaging 15.8 per cent for the period as a whole. In 1978 there was a dramatic investment boom - peaking at over 33 per cent of GDP in 1980 -- and averaging 27.8 per cent for the period 1978-83. Since that time, the investment rate has been somewhat lower -- an average of 23.3 per cent for the period 1984-92 -- but still substantially above that in the pre-liberalisation period.

Figure 6.1 shows that, while the constant investment rate remained constant up to 1977, the share of private sector investment fell steadily. In 1959 private investment accounted for 63.2 per cent of total gross domestic capital formation; by 1977 this figure had fallen to 50.0 per cent. Both public and private investment rose in the investment boom, but public investment rose more rapidly, so that the share of the private sector in total investment fell further. The largest part of the increase was investment by public corporations. The last three years have seen a dramatic reversal, with a surge of private investment. In the mid-1980s private investment was just over 10 per cent of GDP but by the early-1990s this figure was more than 15 per cent.

Investment must be financed from savings, which may come from a variety of sources (see Figure 6.2). First are domestic savings, which are defined as the excess of GDP over consumption. National savings are domestic savings plus net factor income from abroad and private current transfers. "Foreign savings" is the name given to foreign capital inflows which also contribute to increased investment. Which of these have been paying for investment in Sri Lanka?

Figure 6.1

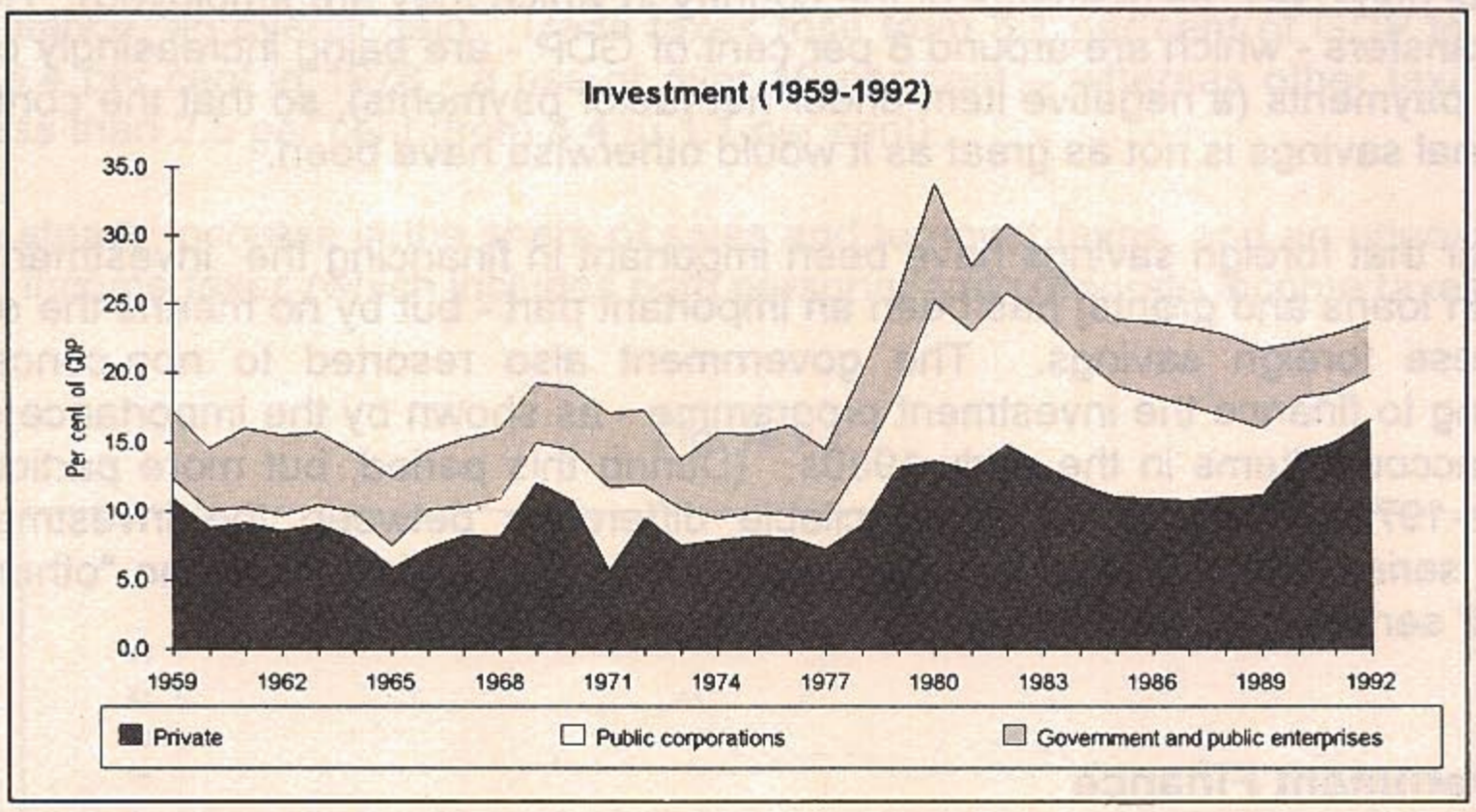
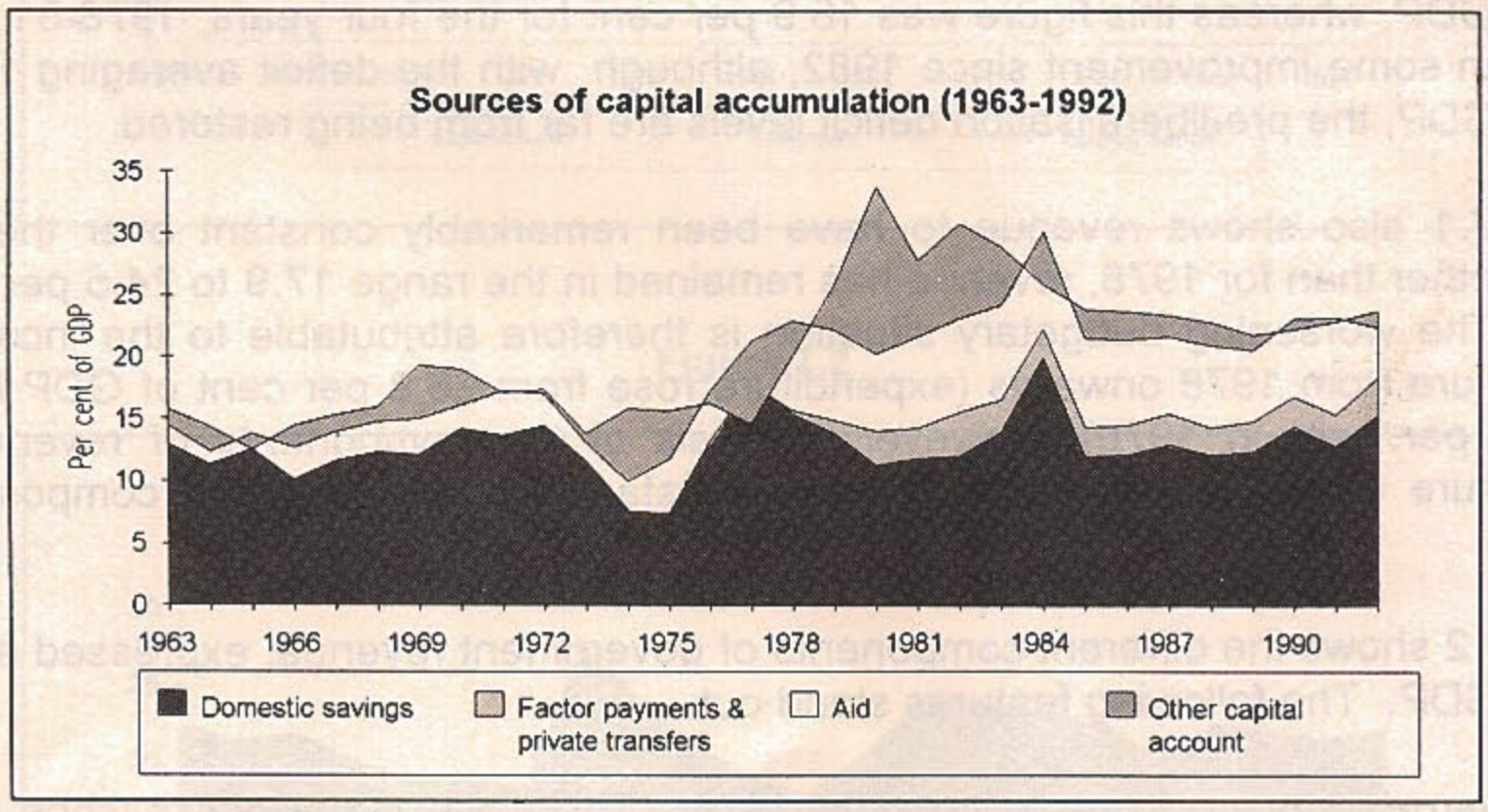


Figure 6.2



Apart from peaks in the period 1977-78 and in 1984 (corresponding to positive movements in commodity prices), the domestic savings rate has been quite stable - averaging 13.2 per cent over the period as a whole with no discernible trend. For the period 1984-92 the rate has averaged 13.7 per cent -- that is, not much more than half the value of the investment rate. Clearly, the higher investment of the 1980s has not been financed out of increased domestic savings. National savings have shown an increase on account of the remittances (private transfers) received from Sri Lankan workers in the Middle East. (These remittances appear as transfers rather than factor

payments since workers on contracts of more than one year are treated, for national accounts purposes, as residents of the country in which they are employed). However, these transfers - which are around 8 per cent of GDP - are being increasingly offset by interest payments (a negative item under net factor payments), so that the contribution of national savings is not as great as it would otherwise have been.

It is clear that foreign savings have been important in financing the investment boom. Aid (both loans and grants) has been an important part - but by no means the only part - of these foreign savings. The government also resorted to non-concessional borrowing to finance the investment programme - as shown by the importance of other capital account items in the early-1980s. (During this period, but more particularly in the late-1970s, there is an irreconcilable difference between the investment and savings series, which is also included under errors and omissions in the "other capital account" series).

7. Government Finance

Figure 7.1 shows government expenditure, revenue and the resulting budget deficit (as a per cent of GDP) for the period 1971-92. A clear deterioration in the deficit is visible at the time of liberalisation. During the period 1971-77, the deficit averaged 9.1 per cent of GDP, whereas this figure was 18.9 per cent for the four years, 1978-81. There has been some improvement since 1982, although with the deficit averaging 15.6 per cent of GDP, the pre-liberalisation deficit levels are far from being restored.

Figure 7.1 also shows revenue to have been remarkably constant over the whole period; other than for 1978, revenue has remained in the range 17.9 to 24.5 per cent of GDP. The worsening budgetary situation is therefore attributable to the increase in expenditure from 1978 onwards (expenditure rose from 26.8 per cent of GDP in 1977 to 44.2 per cent in 1978). However, analysis of the components of revenue and expenditure shows that there have been substantial changes in the composition of both.

Figure 7.2 shows the different components of government revenue, expressed as a per cent of GDP. The following features stand out:

1. A large increase in trade taxes in 1978. There are two likely reasons for this increase. First, and most important, the sharp rise in the rupee value of traded goods consequent upon the rapid devaluation of the currency from November 1977. Second, the replacement of quota restrictions on imports with tariffs.

2. The reduction in other revenue sources, also in 1978. The main component of this category until 1977 was income from the dual exchange rate scheme, FEEC. Under this scheme, the Foreign Exchange Entitlement Certificates (or FEECs), were issued to those who surrendered foreign exchange to commercial banks against the export of certain goods and services and against certain inward remittances. The scheme was abolished in November 1977. Hence exchange-

rate liberalisation had two contradictory effects on government revenue - an increase from trade taxes and the loss of FEEC income. The figures suggest, on balance, an overall gain. Trade taxes rose from 3.1 per cent of GDP in 1977 to 13.4 per cent in 1978 - a rise of over 10 per cent -- whereas other taxes fell by less than 2.5 per cent (from 3.4 to 1.1 per cent).

3. A steady increase in the share of sales and turnover taxes, and an opposite trend in income taxes (which includes both personal and corporate income taxes).

Figure 7.1

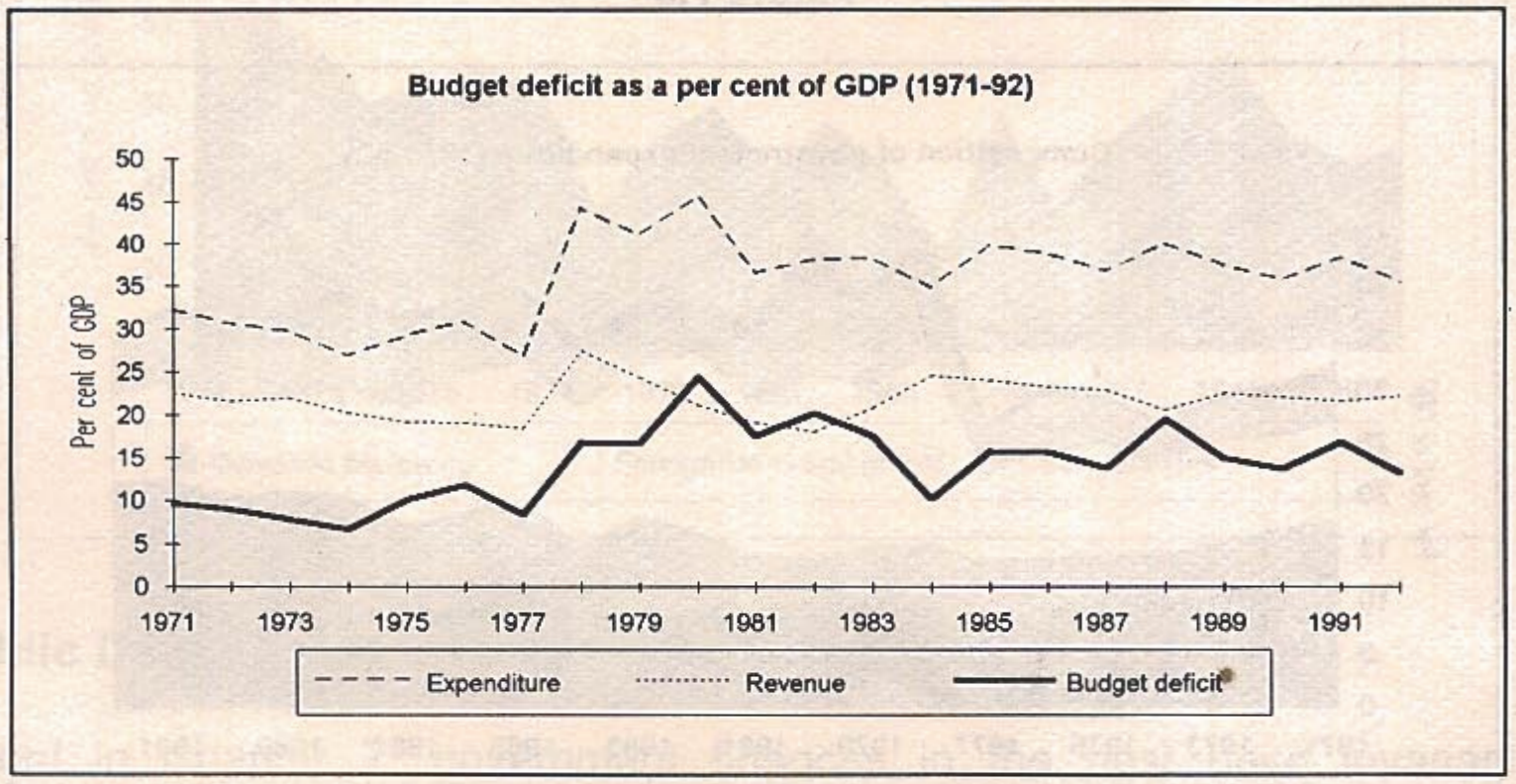


Figure 7.2

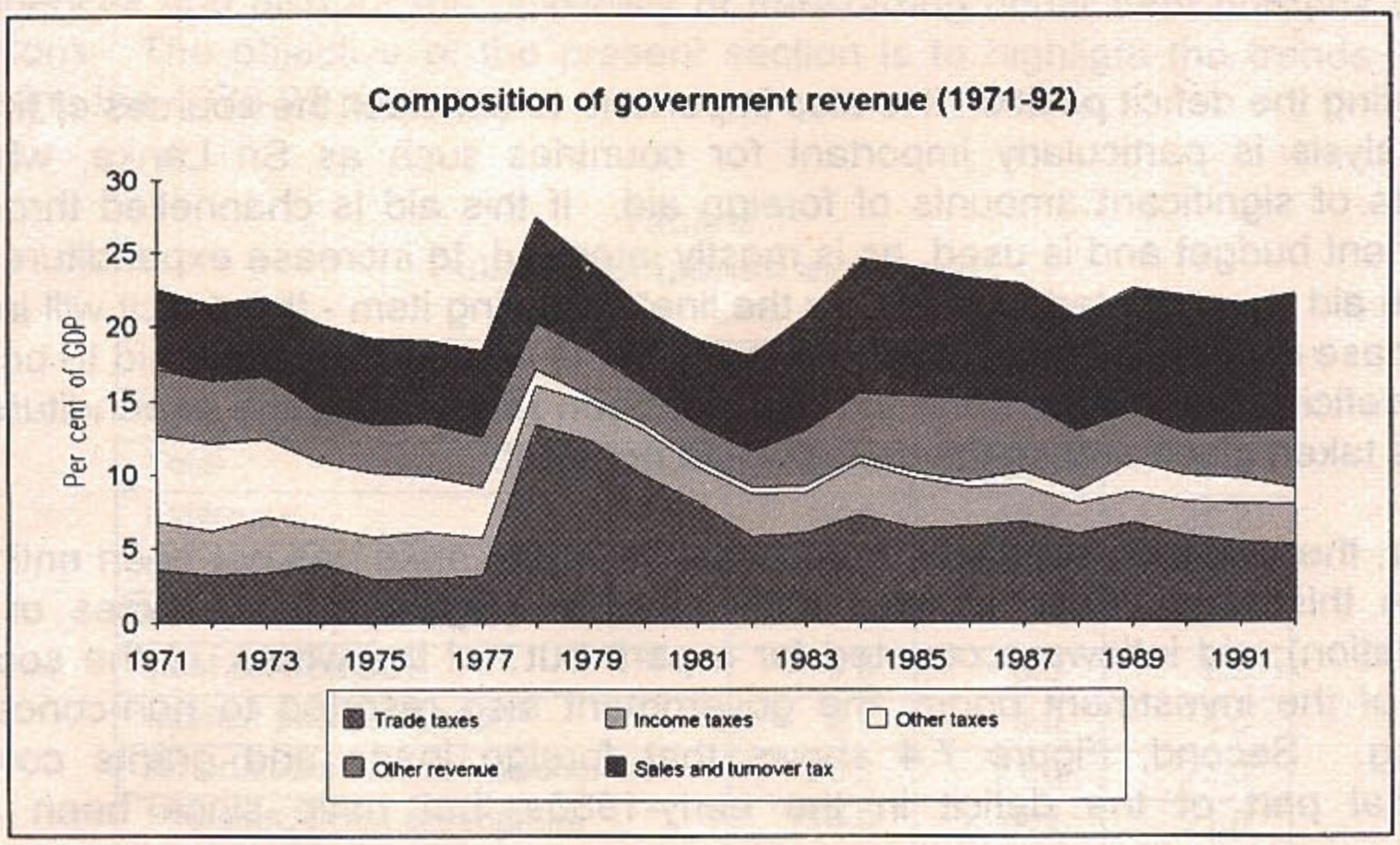
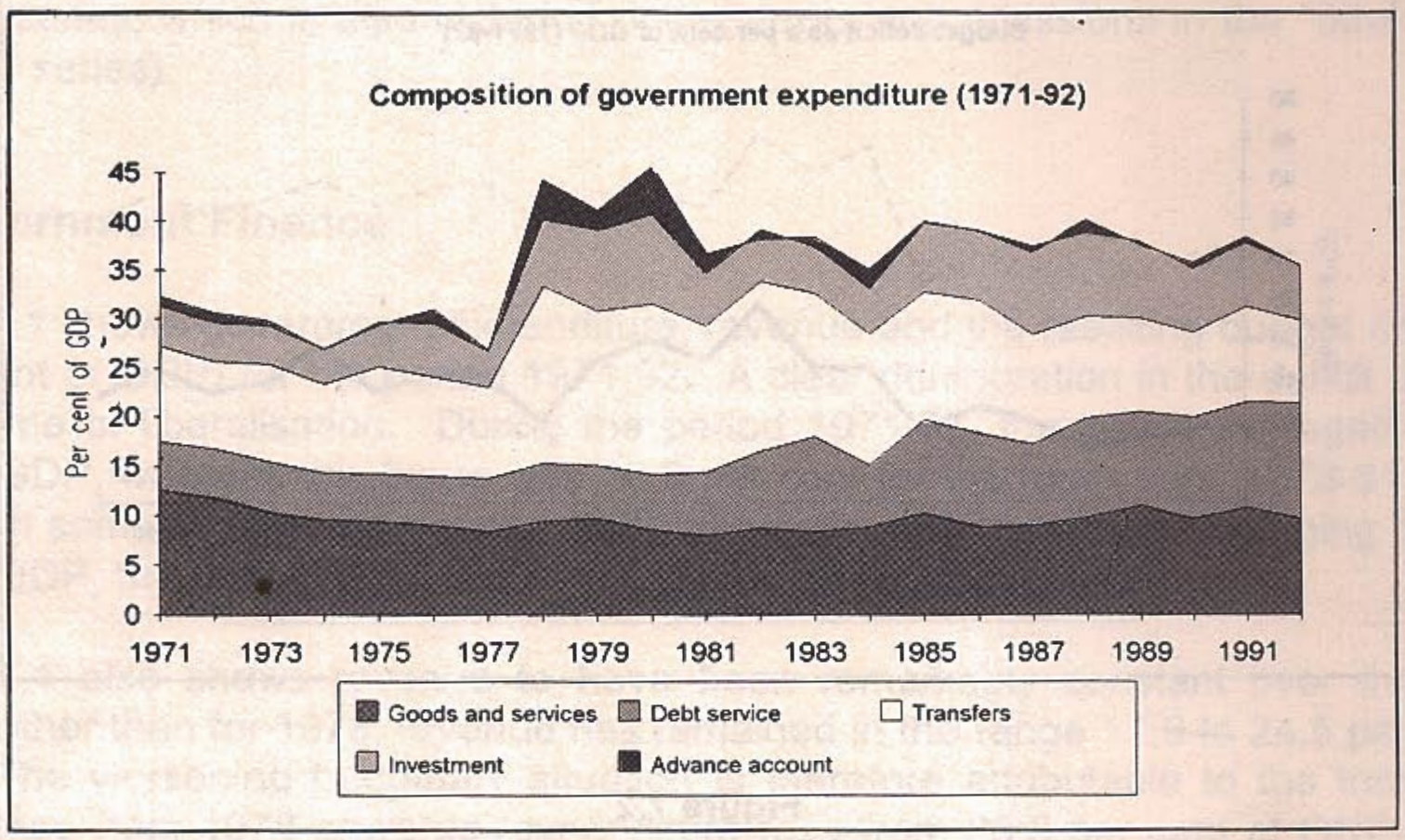


Figure 7.3 shows that the initial increase in government expenditure was fuelled by two items - transfers and investment. It was shown in an earlier section (see Figure 6.1 above) that the government investment boom in the wake of liberalisation was largely channelled through the public corporations -- requiring a corresponding increase in capital transfers from government to these institutions. These transfers have diminished in importance as the investment boom has subsided. But government expenditure has not decreased accordingly because of the growing importance of debt service payments -- which by 1992 accounted for one-third of all government expenditure.

Figure 7.3

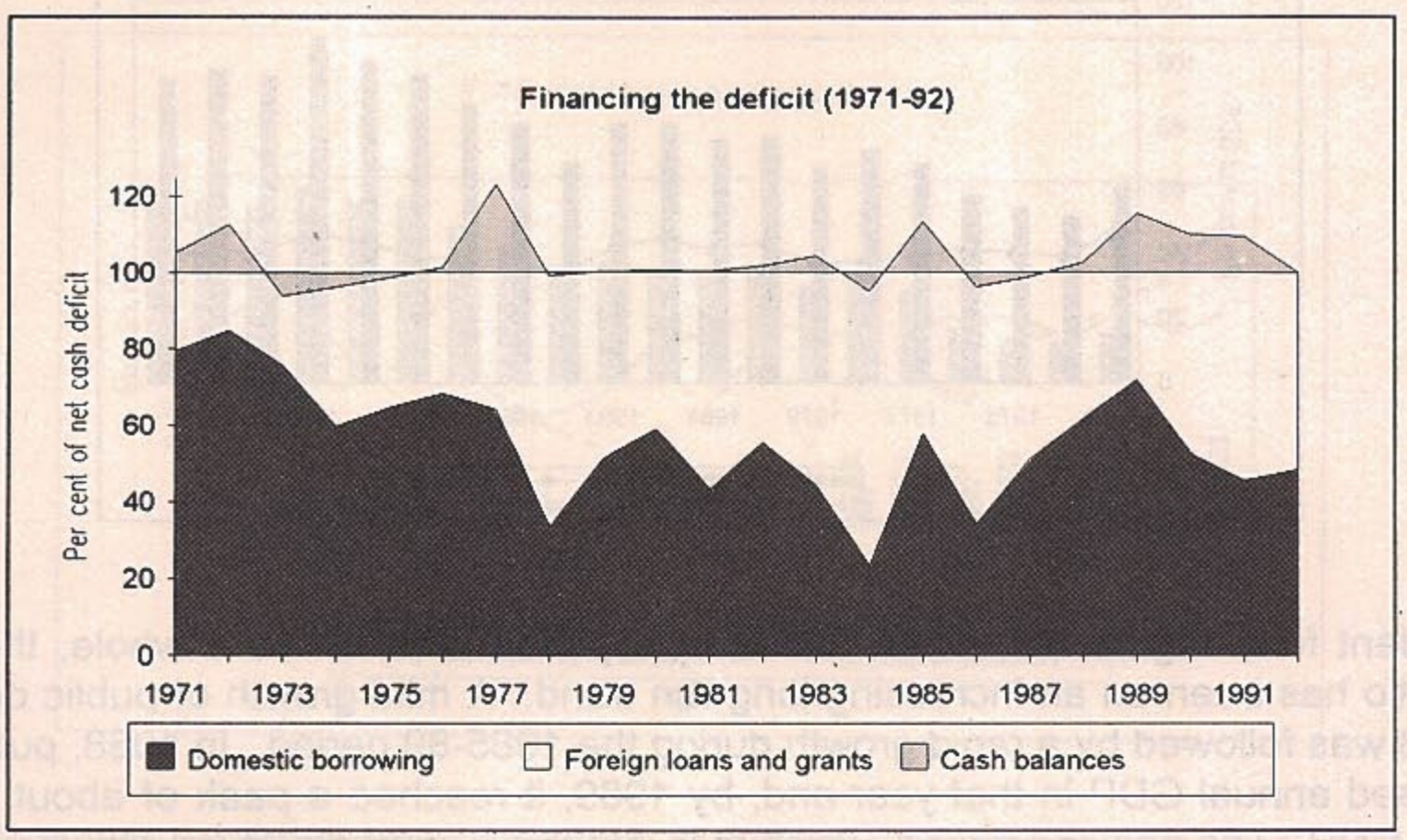


In analysing the deficit position it is also important to consider the sources of financing. This analysis is particularly important for countries such as Sri Lanka, which are recipients of significant amounts of foreign aid. If this aid is channelled through the government budget and is used, as is mostly intended, to increase expenditures then - since the aid is accounted as a "below the line" financing item - the deficit will increase. Such a case is often interpreted as one in which the country needs the aid to bridge the budget deficit. But in fact, if the aid had not been forthcoming the expenditure would not have taken place and so the deficit would not exist.

However, the evidence suggests that the deficit in Sri Lanka has not been entirely aid-driven in this way. First, as was shown earlier (Figure 6.2 - sources of capital accumulation), aid inflows accounted for a part, but not the whole, of the sources of finance of the investment boom; the government also resorted to non-concessional borrowing. Second, Figure 7.4 shows that foreign loans and grants covered a substantial part of the deficit in the early-1980s, but have since been of less

importance. Third, the growing burden of debt service is further evidence of the extent of non-concessional borrowing in earlier periods.

Figure 7.4



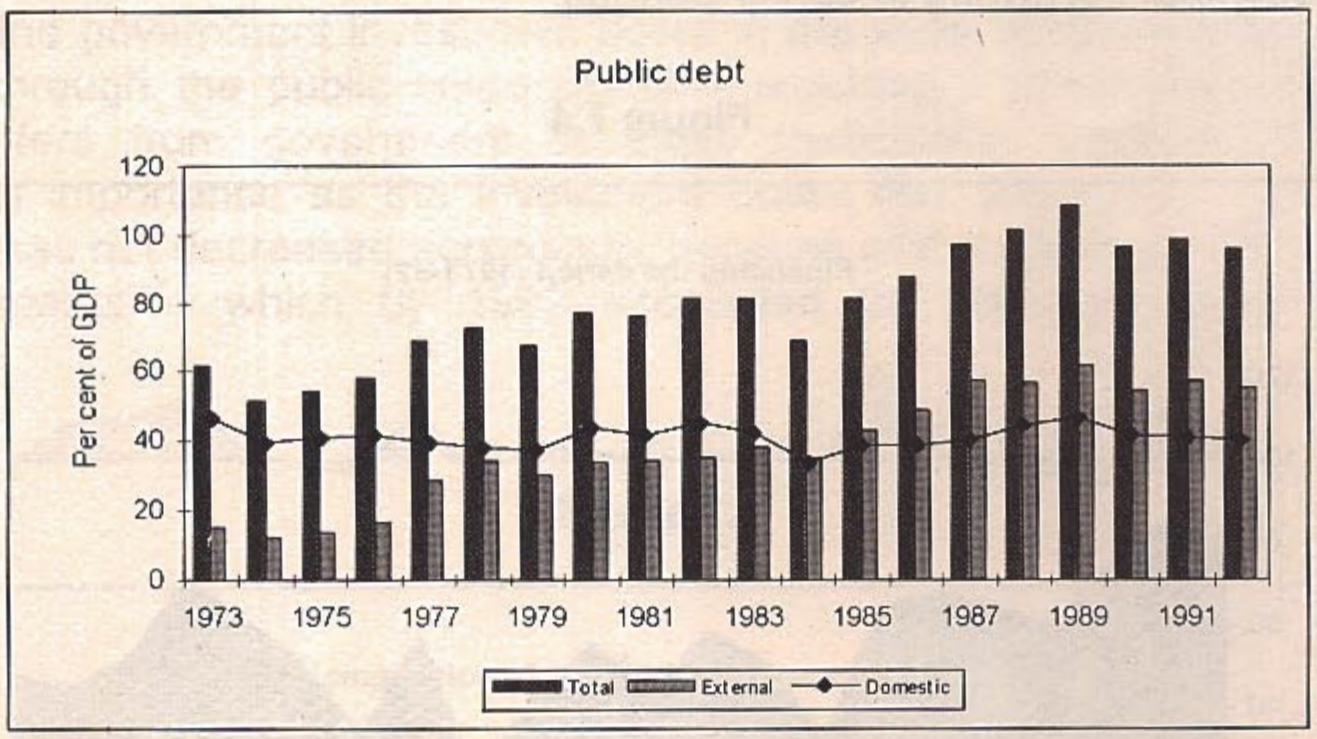
8. Public Debt

As noted in Chapter 7, government finances in the past have invariably been characterised by budget deficits of varying degree. Deficit financing through domestic and foreign borrowing eventually led to accumulation of a considerable amount of public debt over the years. High public sector debts are criticised for their inflationary consequences and also for the possibility of transferring unfair debt burdens to future generations. The objective of the present section is to highlight the trends in public debt during the 1973-92 period.

Table 8.1
Public debt (period averages)

	1973-77	1978-92	1973-92
Public debt (as % of GDP)			
Total	59.2	86.1	79.4
External	17.4	45.1	38.2
Domestic	41.8	40.9	41.1
Debt service payments			
Debt service/GDP	5.0	8.5	7.6
Interest payments/GDP	2.7	5.0	4.5
Amortisation/Capital expenditure	26.2	21.0	22.3
Interest/Current expenditure	14.0	24.1	21.6

Figure 8.1



As evident from Figure 8.1, when the sample period is taken as a whole, the public debt ratio has been on an increasing long-run trend. A mild growth of public debt ratio till 1983 was followed by a rapid growth during the 1985-89 period. In 1988, public debt surpassed annual GDP in that year and, by 1989, it reached a peak of about 109 per cent of GDP. The ensuing period, which falls into the current structural adjustment cum stabilisation programme, was characterised by a slightly reduced level of public debt of about 97 per cent of GDP on average.

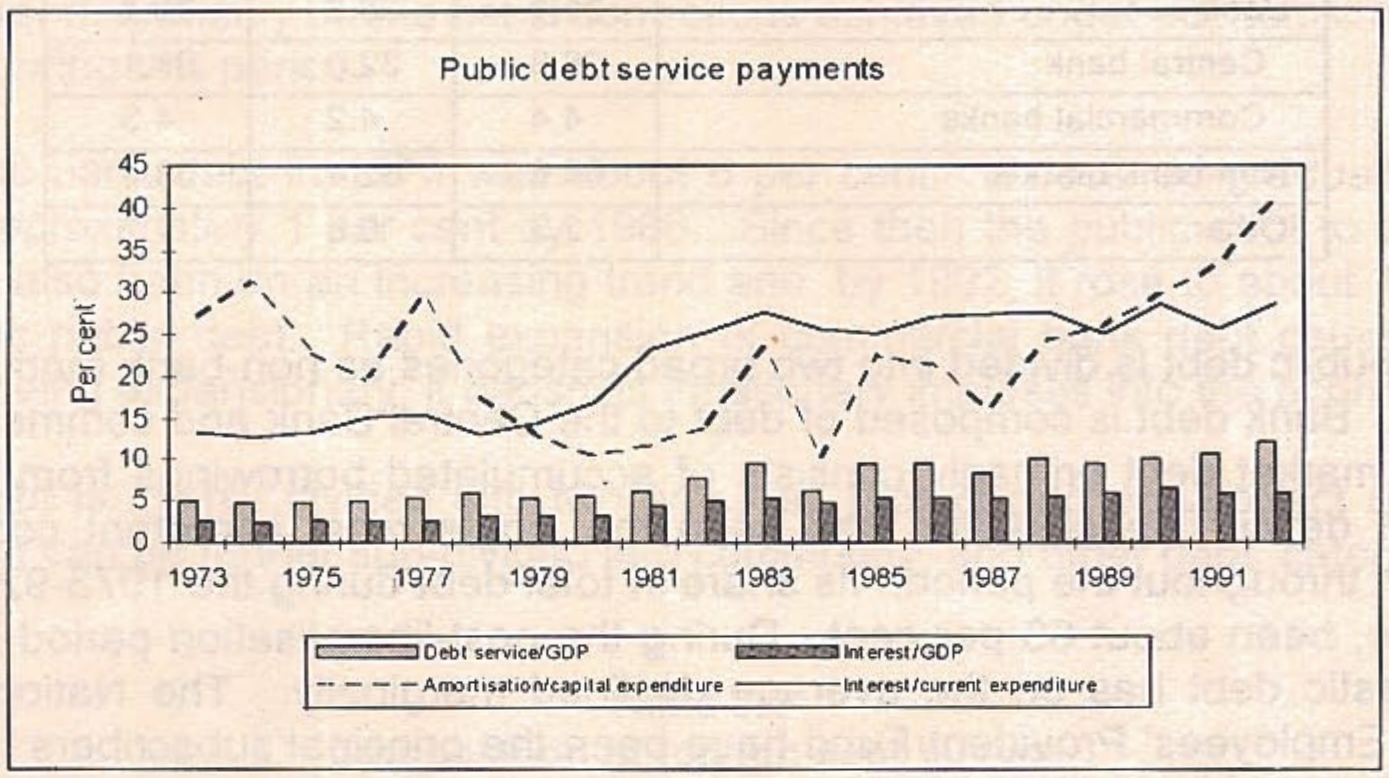
The domestic component of public debt did not experience significant variations during the period under review (1984 being an outlier). During the 1973-77 and the 1978-92 periods it was 42 and 41 per cent of GDP, respectively. Foreign debt ratio has been on an increasing trend. It increased on an average basis from about 17 per cent in the 1973-77 period to 45 per cent in the 1978-92 period. Reflecting these trends, foreign debt became the principal component of public debt in 1984 and continued to the present. The positive association between foreign and domestic components of public debt, evident in Figure 8.1, could be ascribed to the need for domestic counterpart funds to implement foreign aid funded development programmes.

All indicators in Figure 8.2 point out that public debt service payments have been increasing since the late-1970s. Debt service to GDP remained stable at the level of about 5 per cent of GDP until 1977, and since then it has been on an increasing trend. The period average during the latter period increased to about 9 per cent of GDP. In 1992, the debt service ratio rose to about 12 per cent of GDP, the highest level experienced during the period under review.

Debt service is composed of amortisation and interest payments. Amortisation payments as a per cent of GDP increased from 2.4 per cent during the 1973-77 period to 3.4 per cent in the subsequent period. Interest payments increased from 2.7 to 5 per cent during the same period. Amortisation and interest payments as a per cent of capital and current expenditures, respectively, are also depicted in Figure 8.2. The

movements in these variables over the long-run attest to the general tendency of increasing public debt servicing during the post-1977 period.

Figure 8.2



Although economic theory is of little help in determining the optimal public debt ratio, interest payments clearly impose a limit on its growth. Interest payments are usually met out of current receipts and the interest service ratio indicates the tax rate required to service interest charges of the public debt. Thus, as interest service increases, it imposes an increasing dead-weight loss on the economy via increased domestic taxes. Even though it is argued that interest servicing can be met by issuing new bonds, this can only be done if the real income growth is equal to or higher than the real interest rate. Otherwise, public debt to GDP ratio will increase, *ad infinitum*.

Repayment of existing public debt, on the other hand causes no problems since it only requires refunding the maturing debt by issuing new obligations. Privately held public debt is relatively more susceptible to management problems in the refunding process. However, since the bulk of domestic public debt is held by public and other captive sources (Figure 8.3), and foreign debt is mainly multilateral and bilateral (Figure 8.5), refunding of Sri Lanka's public debt is unlikely to pose management problems. If transfer of the debt burden to future generations, through refunding, is deemed unacceptable, then the government will have to repay the existing debt. Compared with domestic debt, repayment of foreign debt entails a transfer of real resources. Thus it is very important that public foreign borrowings be channeled to productive investments so as to guarantee the ability to meet the future debt service obligations..

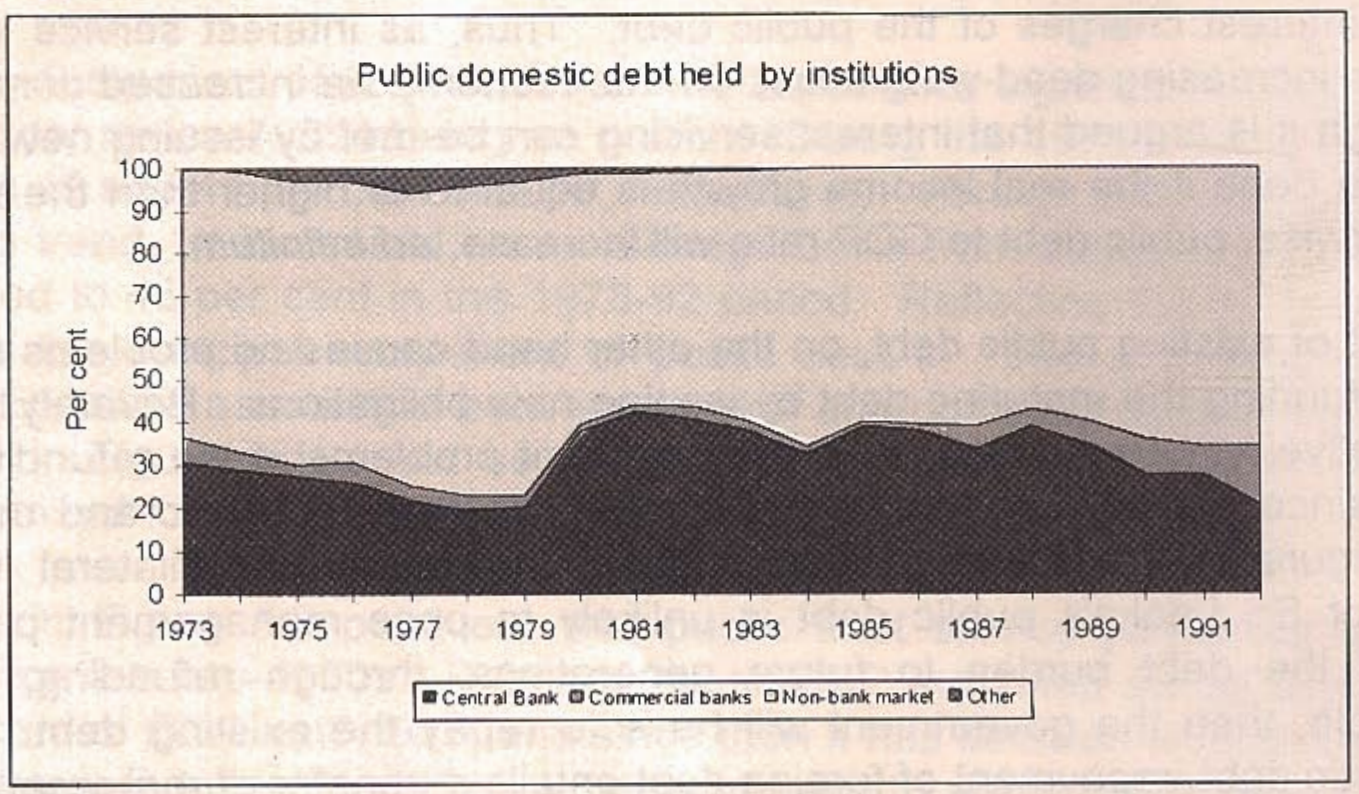
The distribution of domestic debt by type of holder is depicted in Figure 8.3. This also brings into focus the implications of deficit financing and public debt for domestic liquidity and therefore for inflation.

Table 8.2
Composition of domestic public debt by institutions (period averages)

	1973-77	1978-92	1973-92
Bank	31.1	36.8	35.4
Central bank	26.8	32.6	31.1
Commercial banks	4.4	4.2	4.3
Non-bank market	66.6	62.4	63.4
Other	2.3	0.8	1.2

Domestic public debt is divided into two broad categories as non-bank market debt and bank debt. Bank debt is composed of debt to the Central Bank and commercial banks. Non-bank market debt primarily consists of accumulated borrowings from the captive sources of deficit financing and has been the single most important component of public debt throughout the period. Its share in total debt during the 1973-92 period has on average, been about 63 per cent. During the post-liberalisation period its share of total domestic debt has on the average declined marginally. The National Savings Bank and Employees' Provident Fund have been the principal subscribers to non-bank public market debt.

Figure 8.3



Bank debt on average has been about 35 per cent of the domestic public debt. Of this more than 31 per cent has been Central Bank borrowings. Central Bank borrowing through government securities and provisional advances leads to monetary expansion and rising prices since it increases net domestic assets of the Central Bank and therefore the high-powered or reserve money base. Central Bank debt has undergone two distinct phases during this period. Starting from 1973, its share in total debt

experienced a continuous decline and dropped to about 19 per cent in 1978. In 1980, it again increased sharply to about 38 per cent and the ensuing period was generally characterised by a relatively high share of Central Bank debt reflecting the financing needs of large budget deficits (public investment programmes, foreign aid counterpart funds, etc). However, since 1989, the share of Central Bank debt has again been on a declining trend, primarily due to fiscal corrections achieved under economic stabilisation initiatives during this period.

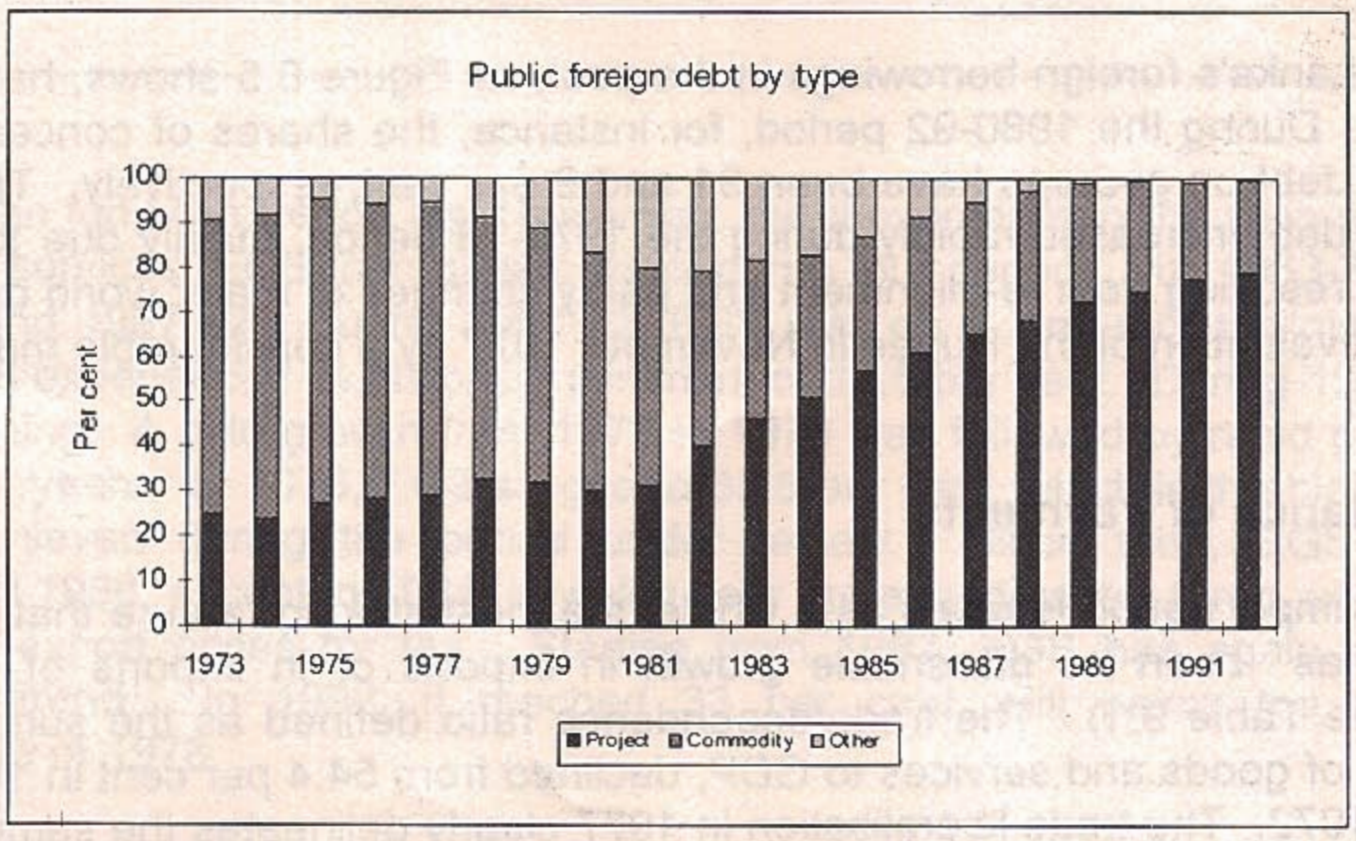
Commercial bank debt in 1973 was about 6 per cent. It declined gradually and had reached approximately 1 per cent by 1986. Since then the public debt to commercial banks has also been on an increasing trend and, by 1992, it rose to about 14 per cent of domestic public debt. Rapid expansion of commercial bank debt causes concern because, being expansionary, it transmits inflationary impulses into the economy.

Foreign debt is mainly divided into two types as project and non-project debt. Non-project debt can be further sub-divided into commodity, and other debt, categories.

Table 8.3
Composition of foreign debt by type

	1973-77	1978-92	1973-92
Project	26.7	54.6	47.6
Commodity	66.6	35.6	43.4
Other	6.7	9.9	9.1

Figure 8.4

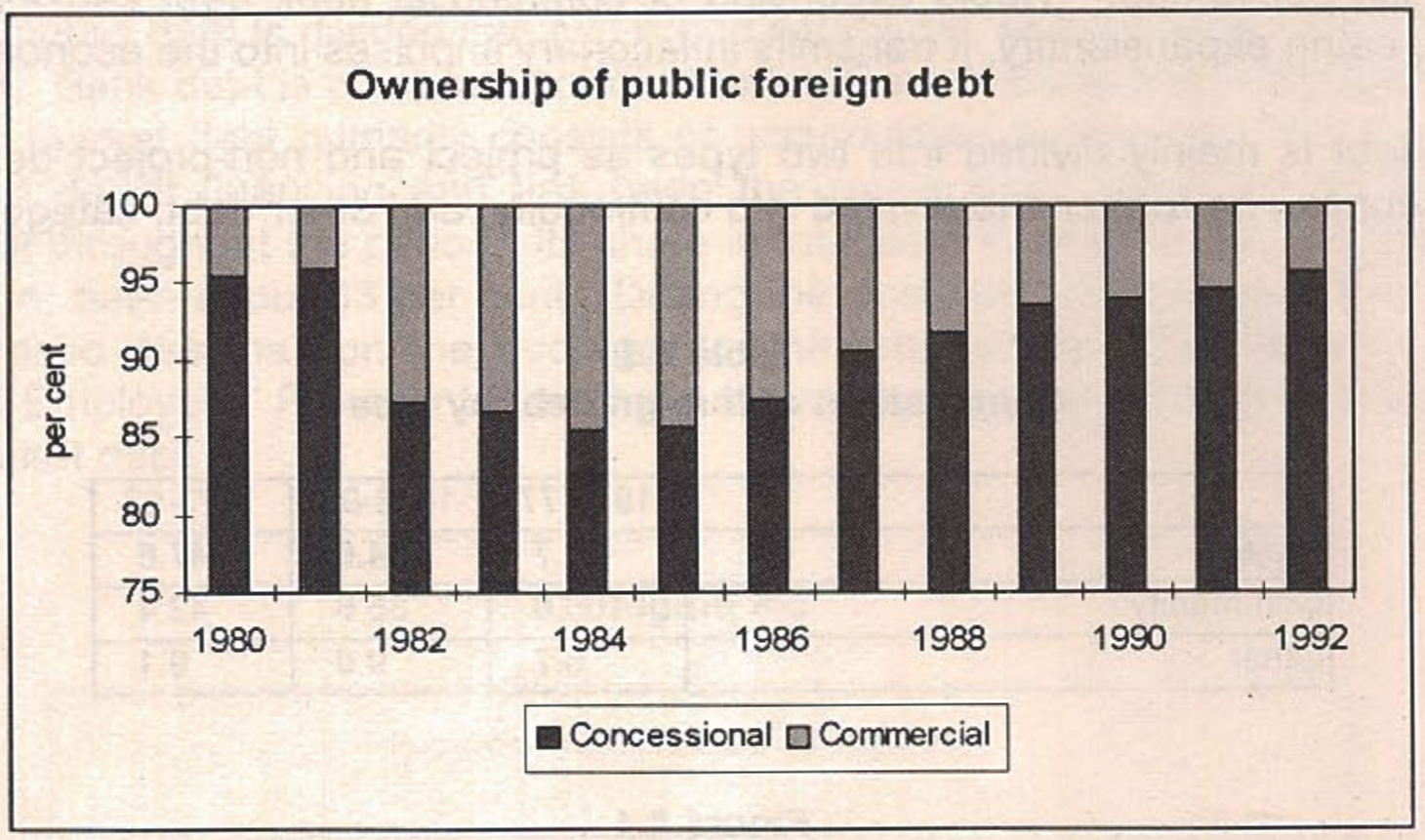


As far as the long-run trends are concerned, as evident from Figure 8.4, the most significant feature has been the gradual decline of the relative importance of

commodity type debt and its replacement by project debt. For instance, in 1973, the shares of commodity and project debt were 66 and 25 per cent respectively. However, by 1992, the share of commodity type debt had decreased to about 21 per cent whereas project type debt had increased to 79 per cent.

The public foreign debt is also classified as concessional and commercial. The former includes both bilateral and multilateral debt whereas the latter gives accumulated borrowings from financial markets.

Figure 8.5



Most of Sri Lanka's foreign borrowings in the past, as Figure 8.5 shows, have been on easy terms. During the 1980-92 period, for instance, the shares of concessional and commercial debt on average have been 91 and 9 per cent, respectively. The share of commercial debt increased rapidly during the 1975-78 period, mainly due to increased debt liability resulting from re-alignment and parity changes of major world currencies in 1975 and devaluation of the Rupee in November 1977 by a considerable margin.

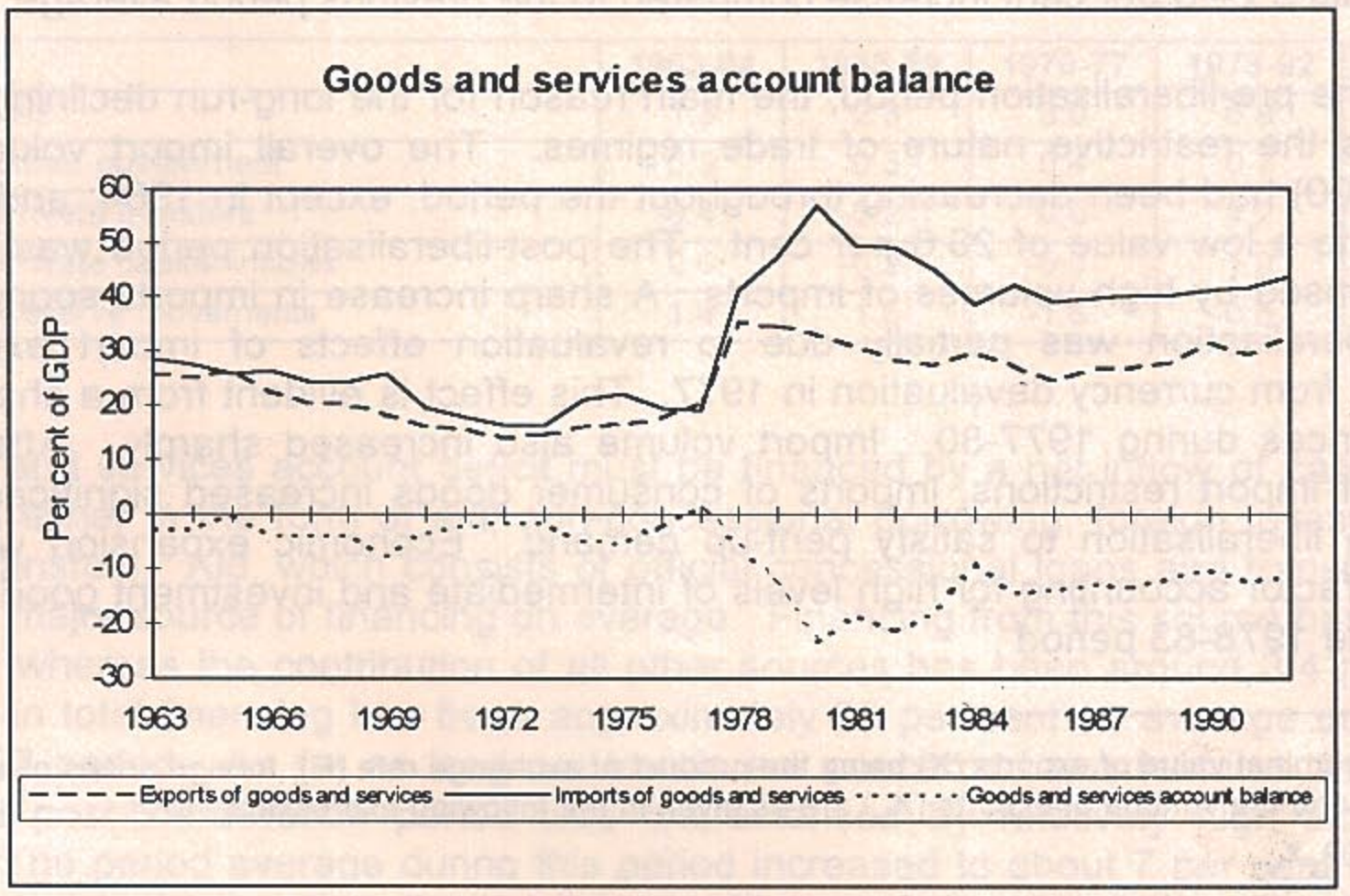
9. The Balance of Payments

When the sample period is taken as a whole, the most striking feature that emerges is that there has been no discernible growth in exports or in imports of goods and services (see Table 9.1). The trade/dependence ratio defined as the sum of exports and imports of goods and services to GDP, declined from 54.4 per cent in 1963 to 30.7 per cent in 1972. The trade liberalisation in 1977 clearly delineates the sample into two distinct sub-periods. Compared to the earlier period, the post-1977 period was characterised by higher levels of both imports and exports of goods and services.

Table 9.1
Goods and services balance (per cent of GDP, period averages)

	1963-64	1965-69	1970-77	1978-92
Exports of goods and services	25.5	21.7	16.7	29.8
Imports of goods and services	28.0	25.2	19.0	43.6
Deficit in goods and services A/C	2.5	3.5	2.3	13.7

Figure 9.1



As far as the long-run trends are concerned, the movements in the ratio of exports of goods and services (EGS) can be sub-divided into four periods, viz. 1963-72, 1973-78, 1979-86, and 1987-92. During 1963-72, EGS was on a long-run declining trend. In 1972, EGS experienced its historical minimum of 14.5 per cent. During 1973-78, EGS was increasing. A mild growth from 1973 to 1976 was followed by rapid growth in the subsequent years. In 1978, EGS surged to 35.5 per cent, which is the highest level of exports achieved during the period under review. Since then, EGS decreased gradually till 1986, except in 1984, in which year the export sector fared well due to the favourable export prices for tea. Starting from 1987, EGS has again been on an increasing trend. In 1992, it reached 33 per cent, still below the best export performance of 1978.

Over the period 1963-77, the poor export performance could be mainly attributed to inward oriented trade policies. The sudden improved export performance in 1978 was to a great extent due to the revaluation effect of export earnings following the exchange

rate devaluation in the previous year.[3] The export volume index in 1978 increased only by 6.4 per cent. The export price index, on the other hand, increased by 81.8 per cent.

The ratio of imports of goods and services (IGS) roughly followed the same pattern as exports in the long run. IGS experienced three distinct phases during the period under review. From 1963 to 1977, it was on a declining trend. The period average was 22.3 per cent. This was followed by a sharply growing short-term trend during the early trade liberalisation period and, by 1980, it reached a peak of 56.6 per cent of GDP. From 1981 to 1986, IGS again experienced a rapid decline. During the rest of the period, it has been increasing albeit at a very slow pace. In the post-liberalisation period, the rate of growth of IGS on average has been about 43.6 per cent, which represents a 24.6 per cent increase compared to the previous period average.

During the pre-liberalisation period, the main reason for the long-run declining trend of IGS was the restrictive nature of trade regimes. The overall import volume index (1985=100) had been decreasing throughout the period, except in 1964, and dropped in 1974 to a low value of 26.6 per cent. The post-liberalisation period was generally characterised by high volumes of imports. A sharp increase in imports soon after the trade liberalisation was partially due to revaluation effects of import expenditure resulting from currency devaluation in 1977. This effect is evident from a sharp rise in import prices during 1977-80. Import volume also increased sharply. After a long period of import restrictions, imports of consumer goods increased significantly soon after the liberalisation to satisfy pent-up demand. Economic expansion was also another factor accounting for high levels of intermediate and investment goods imports during the 1978-83 period .

---

3 The nominal value of exports (X) being the product of exchange rate (E), foreign prices of exports (P_X), and the volume of exports (X_V) are as given in the following expression:

$X = EP_XX_V$,

the percentage change in nominal exports is the sum of the percentage change in the components as given below.

$$\hat{X} = \hat{E} + \hat{P}_X + \hat{X}_V$$

On the same reasoning, the percentage change in export share is the difference between rate of change in exports and imports.

$$\left(\frac{X}{Y}\right)^{\wedge} = \hat{X} - \hat{Y}$$

Therefore, the percentage change of export share could be alternatively written as,

$$\left(\frac{X}{Y}\right)^{\wedge} = \hat{E} + \hat{P}_X + \hat{X} - \hat{Y}$$

According to the last expression, if nothing changes but the exchange rate moves, $\left(\frac{X}{Y}\right)^{\wedge}$ tends to change.

The goods and services account balance (GSB) has been in deficit throughout the period except in 1965 and 1977, in which years it experienced marginal surpluses. From 1963 to 1977, the deficit in GSB was only 2.8 per cent on average and was without any discernible trend. The deficit in GSB has been quite high during the post-1977 liberalisation period and stood at 13.7 per cent on average. The period was also characterised by certain trend patterns of this variable. Starting from 1978 it deteriorated sharply and reached the highest deficit of 23.2 per cent of GDP by 1980. Since 1981, the GSB has been on an improving trend.

Table 9.2
Financing goods and services balance (per cent of GDP, period averages)

	1963-64	1965-69	1970-77	1978-92
Aid	1.3	2.3	3.0	6.9
Other government	0.3	0.3	0.4	0.7
Private transfers	-0.4	-0.2	0.0	4.2
Private capital inflows	0.0	-0.2	-0.3	1.9
Reserve movements	1.4	1.5	-1.6	-0.5

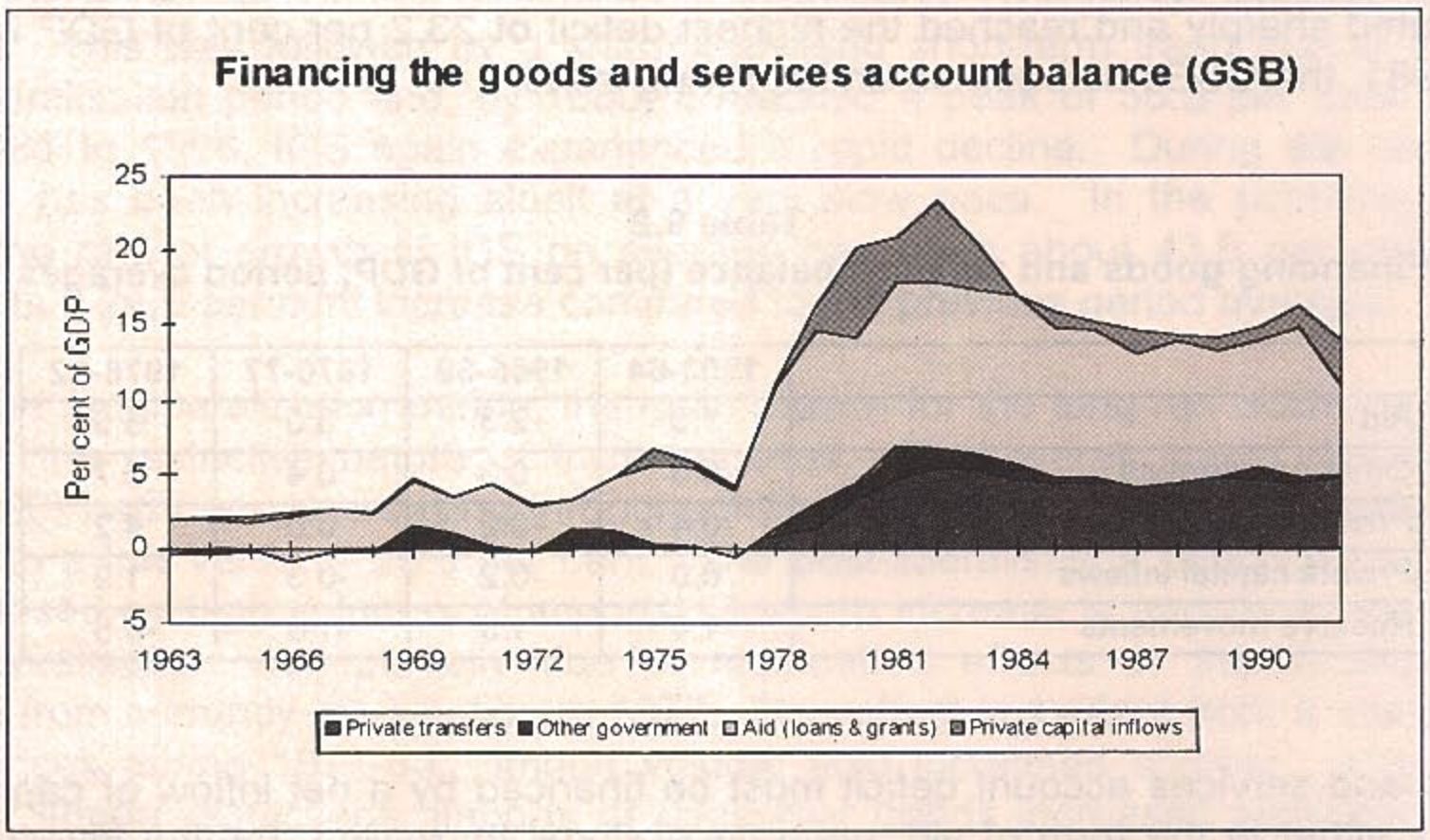
A goods and services account deficit must be financed by a net inflow of capital from overseas either in the form of aid, non-concessional borrowing, foreign investment or private transfers. Aid, which consists of official concessional loans and transfers, has been the major source of financing on average. Financing from this source has been 5 per cent, whereas the contribution of all other sources has been around 3.4 per cent. Its share in total financing has been approximately 80 per cent on average during the 1963-1992 period. As far as long-run trends are concerned two features stand out. First, the post-liberalisation period was characterised by relatively high aid capital inflows. The period average during this period increased to about 7 per cent from 2.5 per cent during the pre-liberalisation period. Second, foreign aid flows constitute two periodic trend patterns. From 1963 to 1984 it was on a long-run increasing trend. In 1985 this trend was reversed and it has since been on a long-run declining trend.

Financing from other sources during the post-liberalisation period increased to 48 per cent of total financing compared with 20 per cent during the pre-liberalisation period.

This outcome could be partly attributed to the emergence of private transfers as an important source of external financing. As far as long-run trends are concerned, the 1963-82 period was characterised by a continuous improvement of net capital inflows through this source. Before 1974, private transfers had been a source of net outflow. However, the magnitude has gradually been narrowing. In the mid-1970s this became a source of net inflow and its share as a source of external financing was sharply increasing till 1982, when it recorded its historical highest share of 5.5 per cent of GDP. This was followed by a decline of private transfers till 1986. Since then, private transfers have stabilised around 4.6 per cent of GDP. In 1992, for the first time, private transfers superseded foreign aid as the main source of external financing. Increasing

employment opportunities in the West-Asian countries have been the major contributing factor to the significant increase in private transfers.

Figure 9.2



Private capital inflows which consist of foreign direct investments, portfolio investments, and private foreign borrowings had, though insignificant, been negative and devoid of any discernible trend during the pre-liberalisation period. As a response to various incentives granted in the 1977 liberalisation programme, private capital inflows were on a rapidly increasing long-run trend during 1978-82, followed by some erratic fluctuations from 1983 to 1989. The precipitous fall in private capital inflows during the 1983-84 period was largely influenced by foreign direct investments, which suffered a severe setback following the 1983 communal disturbances. These inflows fell from 5.6 in 1982 to almost zero as a per cent of GDP by 1984. During the rest of the 1983-89 period, foreign private capital inflows remained low due mainly to political instability caused by the unrest in the South and the North-East, faltering foreign trade and payments liberalisation momentum, and increasing macroeconomic disequilibrium. Since 1990, private capital inflows have again been on a rapidly increasing trend. This could be ascribed to structural adjustment, stabilisation, and liberalisation policies in operation since 1989. Capital account liberalisation measures taken since 1989 could in particular have been a major contributory factor for the surge in portfolio capital inflows.

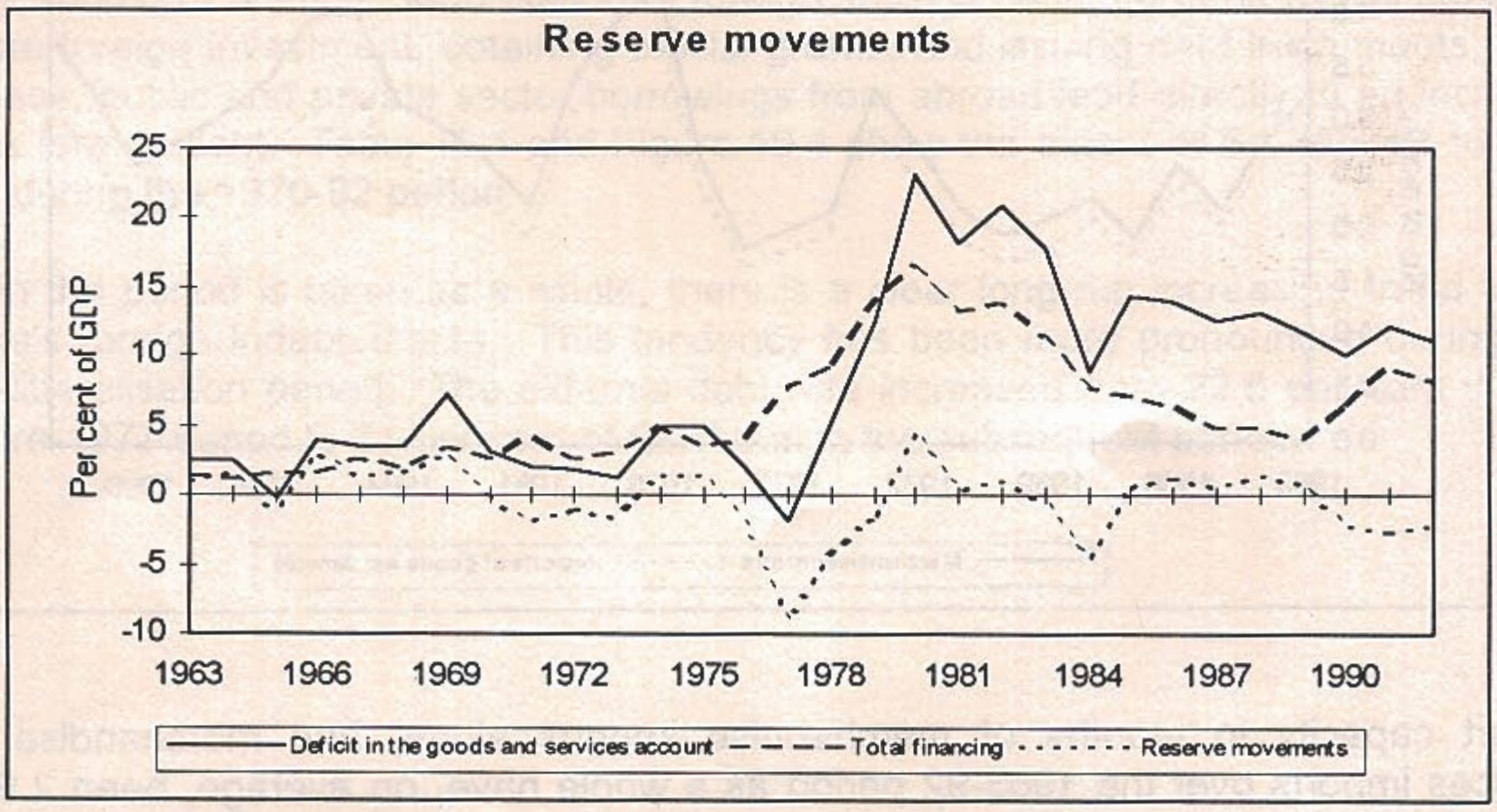
Other government capital inflows -- the least important source -- signify government non-concessionary borrowings. This has not shown a clear long-run trend when the period is taken as a whole. From 1963 to 1977 it fluctuated widely with no discernible trend. It was followed by an increasing trend during 1978-81, which corresponds to the

public investment boom. During 1982-87, it was again on a rapidly declining trend which could again be attributed to decreasing public investment during this period.

Net capital inflow in a given period is, by definition, equal to the sum of current account balance and reserve movements. Since private and official transfers are included under financing in the present analysis, net capital inflows plus total transfers should be equal to GSB plus change in reserves. Implied in this equivalence is the fact that when available resources through capital and transfers accounts are not sufficient to meet the deficit in the GSB, the gap should be bridged by drawing down reserves and vice versa.

In the case of Sri Lanka, except in 1965 and 1977, the goods and services account has been in a deficit, and total availability of financing has always been positive. As shown in Figure 9.3, the deficit in the goods and services account exceeded availability of total financing in most years leading to reserve depletion. From 1963 to 1970 there had been continuous pressure on external reserves to finance the balance of payments deficit. During the period 1970-77, external reserves accumulated at an average rate of 1.6 per cent. The early years of the period 1978-92 experienced an accumulation of reserves due to high capital inflows. This was followed by a long period of reserve depletion till 1989. The exceptional years were 1983/84 when reserves increased due to favourable tea prices. Since 1989, reserves have again been accumulating resulting from increased availability of financing, mainly due to increased private capital inflows.

Figure 9.3



We conclude this section with a brief view of the external reserve position. The external reserves of Sri Lanka comprise the external assets of government, government agencies, the Central Bank and the commercial banks. During the 1963-

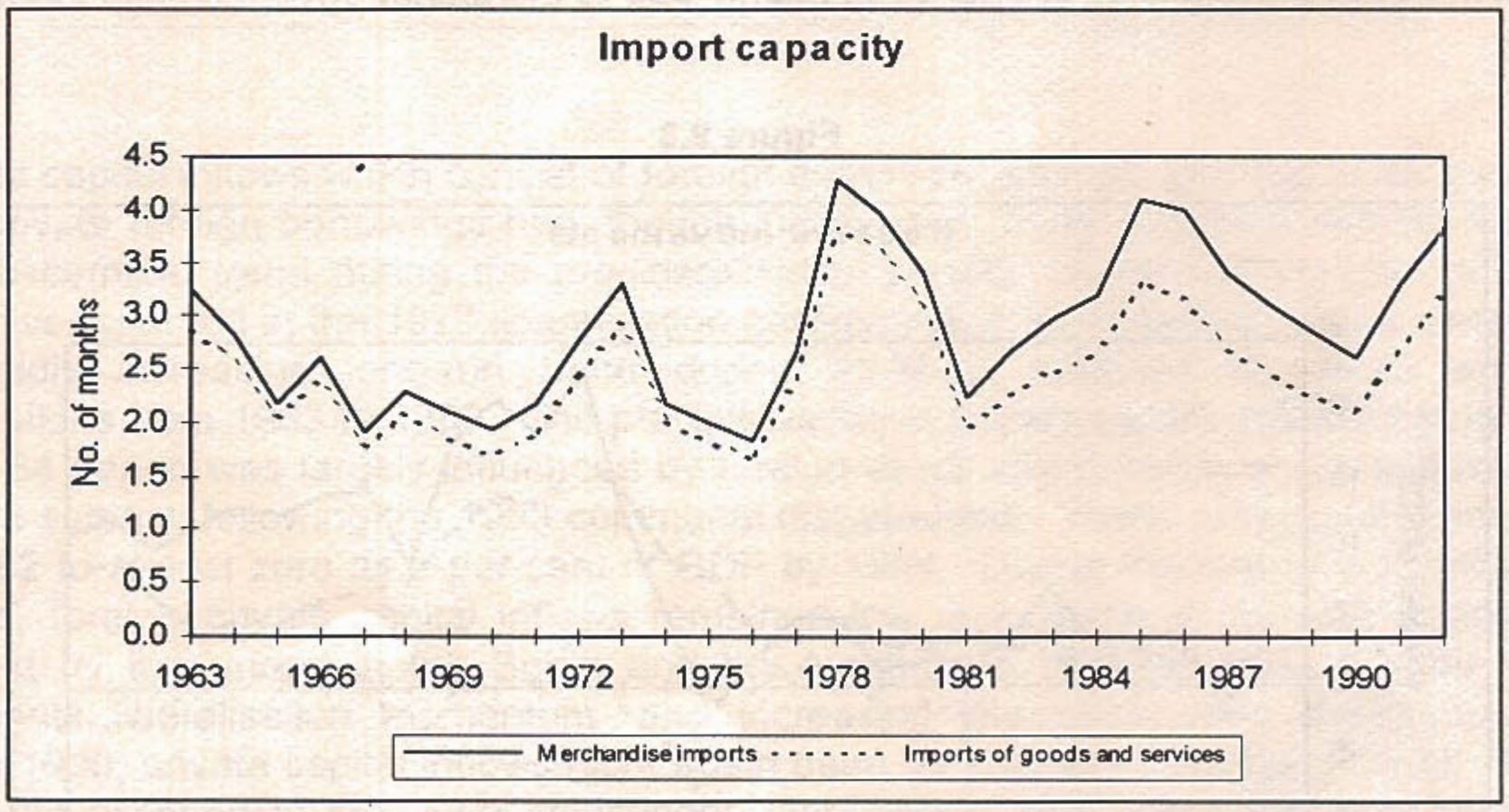
92 period, the Central Bank and the commercial banks alone held approximately 91 per cent of total external reserves. Official reserves have been about 65 per cent.

Table 9.3
External assets position (period averages)

	1963-64	1965-69	1970-77	1978-92
External reserves (% of total)				
Central bank & commercial banks	58.4	83.1	92	97
Official reserves	73.3	69.3	61.5	64.1
Import capacity (in months)				
Merchandise imports	3.0	2.2	2.4	3.3
Imports of goods and services	2.7	2.0	2.1	2.8

The external assets position of a country is normally evaluated on the basis of its import capacity. Variations in this variable are depicted in the following diagram.

Figure 9.4



Import capacity in months of merchandise imports alone, and merchandise plus services imports over the 1963-92 period as a whole have, on average, been 2.9 and 2.5 per cent, respectively. Compared to the 1970-77 period, import capacity during the post-liberalisation period has increased marginally. Import capacity reached its highest level in 1978 and 1985, mainly as a result of large capital inflows in 1978, and the buoyant export price for tea in 1985. Import capacity has again been increasing recently following large private capital inflows.

10. External Debt

When total absorption is higher than national income, the external account is in deficit and has to be financed through foreign sources. Total absorption constitutes consumption and investment of the private and public sectors. As explained in Section 5, the average propensity to consume has been more or less constant during this period. Therefore, as is usually the case, the main reason behind the disequilibrium in income and expenditure in both the private and public sectors has been the vicissitudes in investment expenditures. The investment ratio was fairly stable prior to 1977. During the post-liberalisation period, it has been relatively high and volatile.

Investment expenditure must be financed out of savings, which can be categorised as domestic, national, and foreign saving. Domestic saving is the part o fincome that is not used for consumption. As discussed earlier, the average propensity to consume over this period was fairly constant, and the domestic savings rate showed little discernible change. Thus the contribution of domestic savings to the financing of increased investment has been insignificant. National saving is defined as domestic saving plus net factor income from abroad and net private transfers. Even though the inflow of net private transfers has been an important source of foreign exchange earnings recently, their contribution has to a great extent been offset by negative net factor income from abroad mainly due to high interest payments on accumulated foreign debt.

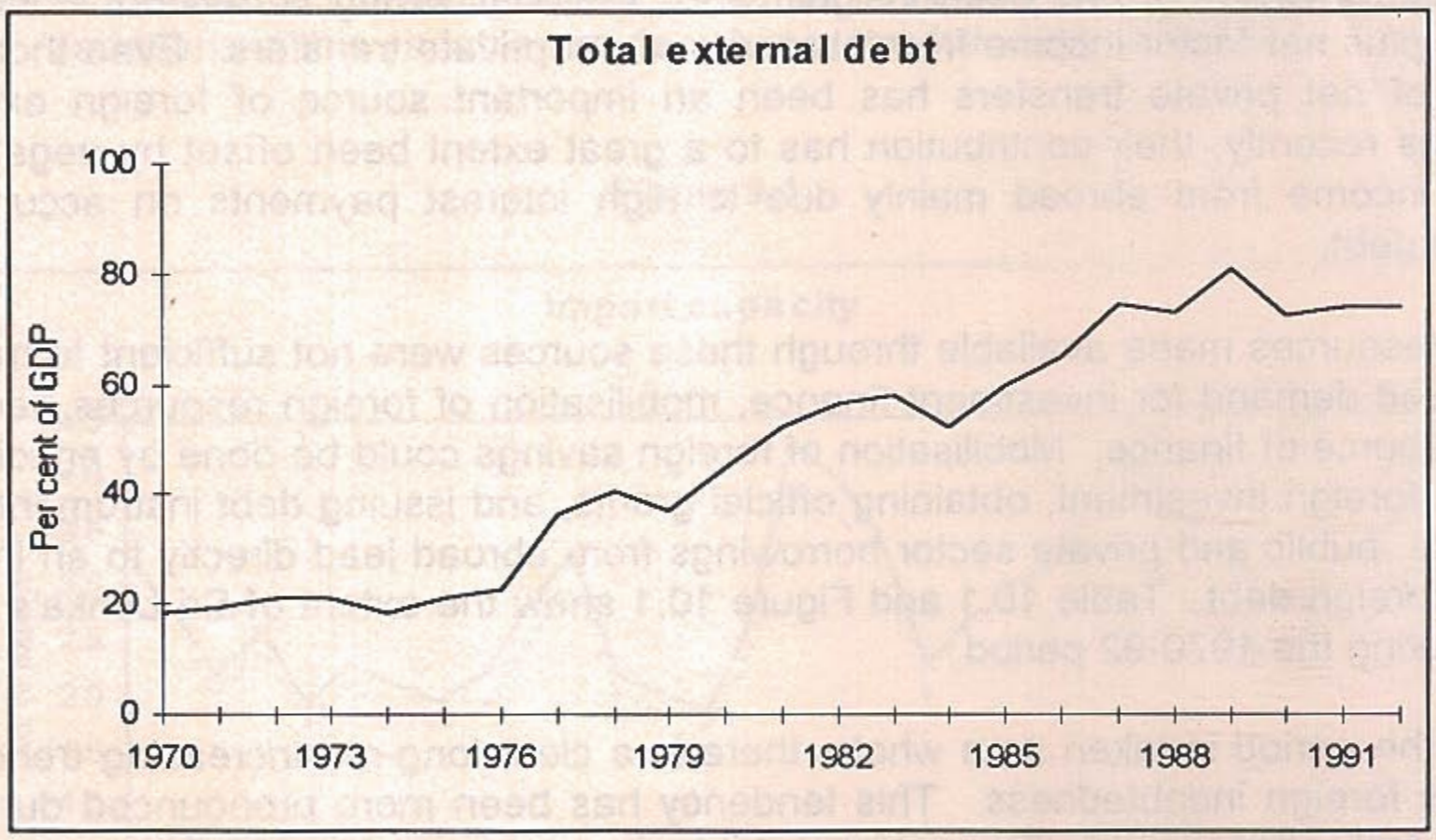
Since resources made available through these sources were not sufficient to meet the increased demand for investment finance, mobilisation of foreign resources became a major source of finance. Mobilisation of foreign savings could be done by encouraging private foreign investment, obtaining official grants, and issuing debt instruments. Out of these, public and private sector borrowings from abroad lead directly to an increase in the foreign debt. Table 10.1 and Figure 10.1 show the extent of Sri Lanka's foreign debt during the 1970-92 period.

When the period is taken as a whole, there is a clear long-run increasing trend in Sri Lanka's foreign indebtedness. This tendency has been more pronounced during the post-liberalisation period. The external debt rate increased from 22.5 per cent during the pre-1977 period to 61 per cent of GDP during the subsequent period.

Table 10.1
External debt (period averages)

	1970-77	1978-92	1970-92
External debt (as % of GDP)			
Total external debt	22.5	61.1	47.7
Debt service payments	3.4	5.8	4.9
Amortization	2.7	3.3	3.1
Interest payments	0.7	2.4	1.8
Debt service ratios			
Exports of goods and services	20.4	19.8	20.0
Receipts from exports of goods,	20.2	16.9	11.0
services, and private transfers			

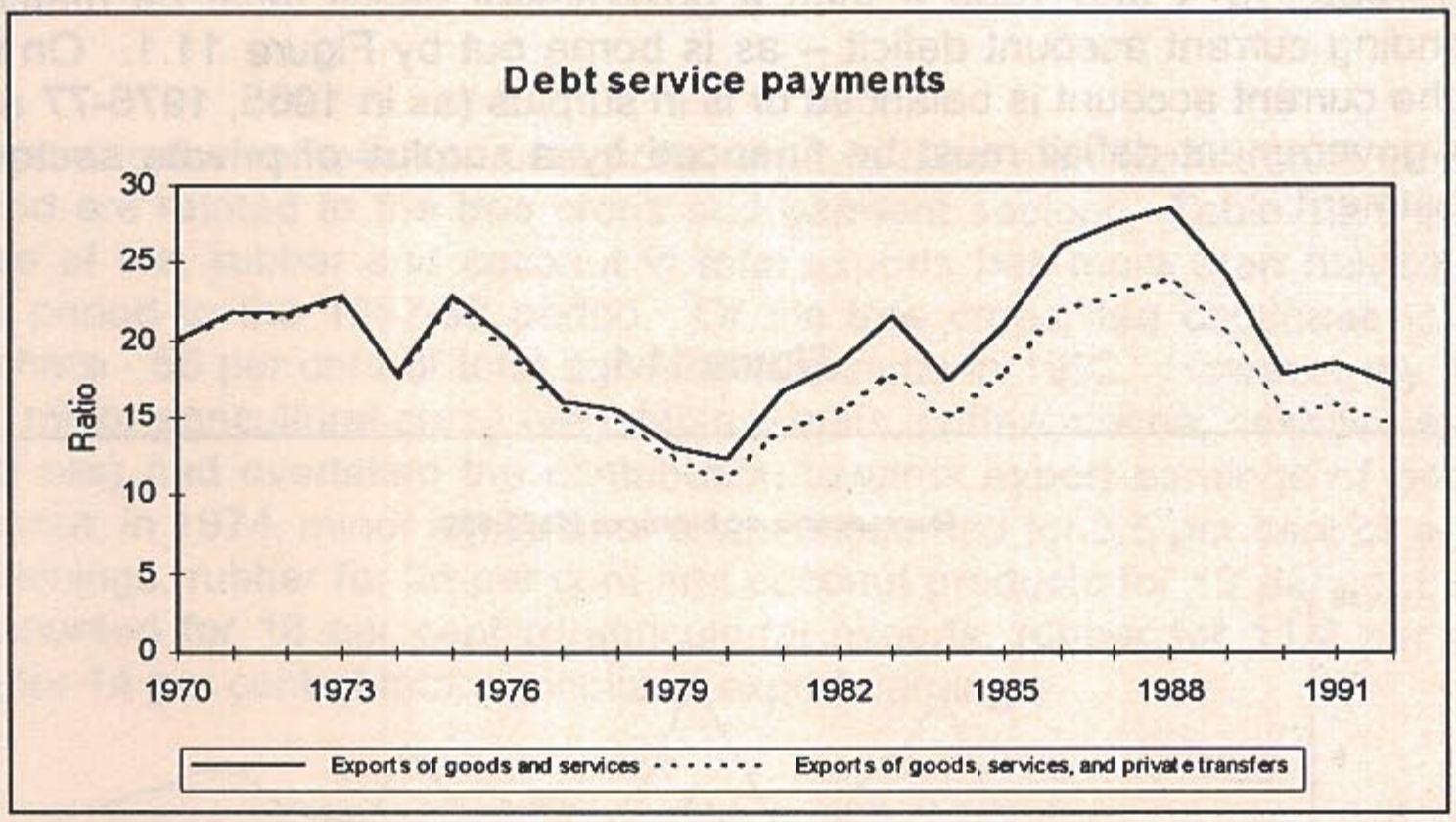
Figure 10.1



Debt service payments, which includes amortisation and interest payments, increased from 3 per cent of GDP in 1970 to about 8 per cent in 1988 which was the highest rate during the period under consideration. Amortisation payments on average do not show a significant difference between the two periods. However, interest payments increased more than three times during the second period.

Figure 10.2 depicts the debt service payments of Sri Lanka based on two definitions. The difference between these two is the treatment of private transfers.

Figure 10.2



As far as trend behaviour is concerned, there is no significant difference between these two definitions. From the long-run point of view, debt service payments tended to decrease during the 1970-80 period. Starting from 1981, the ratio increased up to 1987, except that in 1984 the ratio decreased due to high export prices for tea. In 1987, the debt service payment reached its highest level of about 29 per cent of GDP. Since then it has declined as a result of improved export performance since 1987. As discussed before, private transfers from abroad, especially migrant worker remittances, have been an important source of foreign exchange earnings, especially during the post-liberalisation period and, as is evident from Figure 10.2, these flows have alleviated the external debt service problem significantly during this period.

11. Macroeconomic Balance

It must always be the case in any economy that the ***ex post*** savings gap (investment minus savings) is equal to the external current account (exports minus imports). Thus, if investment exceeds savings, then the external account must be in deficit. As described above, the current account deficit must correspond, in turn, to a net capital inflow.

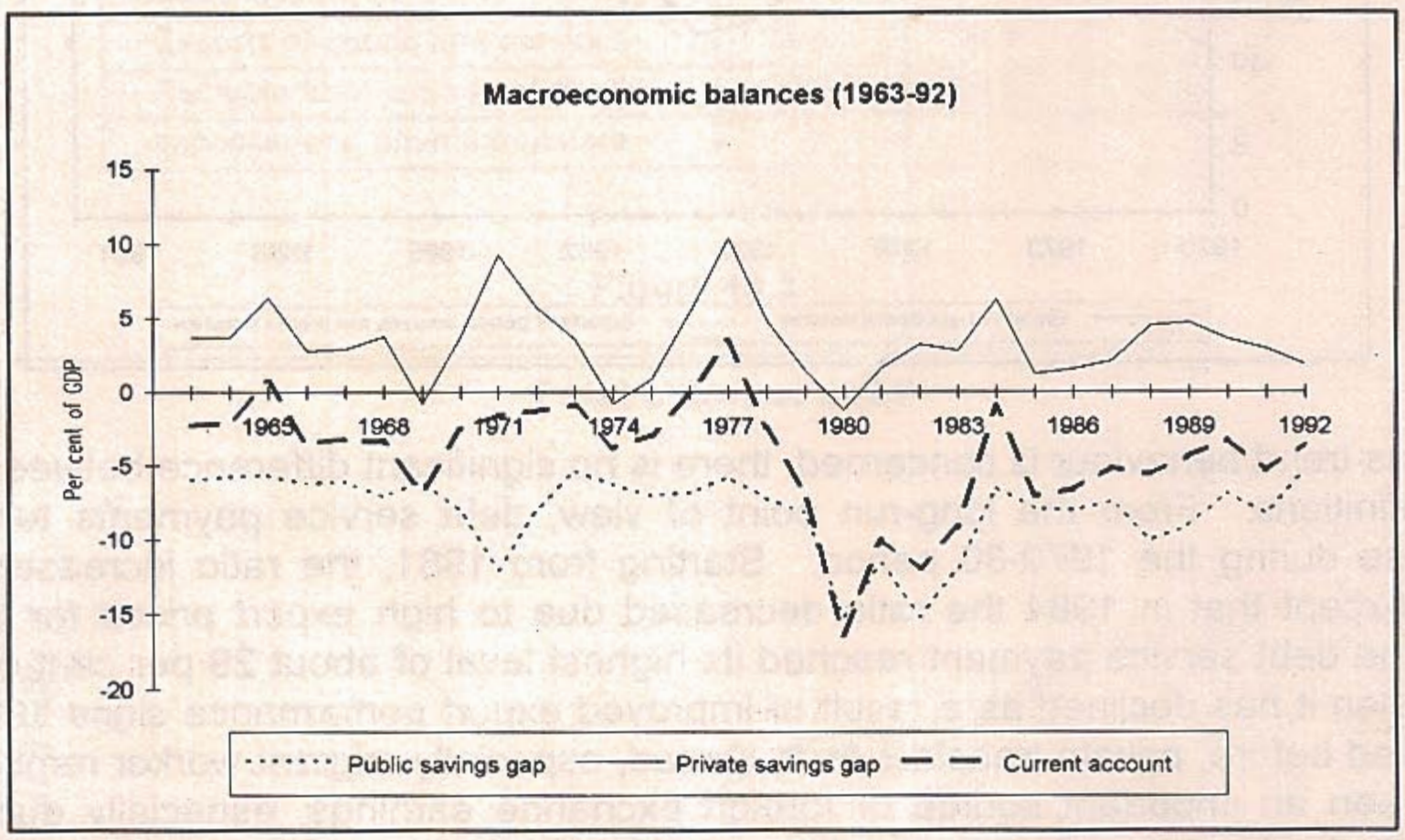
The savings gap may be disaggregated into the public and private savings gaps (the difference between public savings and investment and private savings and investment). The public savings gap is equal to the government (current) budget deficit. That is, it will always be the case that:

Government budget + Private savings gap = Current account

(Where a positive sign indicates a surplus in each case.)

Therefore, when the private savings gap is approximately zero -- as it has been in Sri Lanka in 1969, 1974 and 1980 -- then a government deficit must be matched by a corresponding current account deficit -- as is borne out by Figure 11.1. On the other hand, if the current account is balanced or is in surplus (as in 1965, 1976-77 and 1984) then the government deficit must be financed by a surplus of private sector savings over investment.

Figure 11.1



In Sri Lanka, the private sector has generated surpluses throughout almost the entire period 1963-92, whereas the government has been in persistent deficit.

Total savings are necessarily positively related to the terms of trade, since an improvement in the terms of trade can lead to an improvement in the trade balance and, hence, income. Figure 11.1 shows that the private sector balance improved in both the 1976-77 and 1984 commodity booms, whereas the government's position did not improve in the first of these -- suggesting that any additional revenue accruing to the government from the earlier boom was immediately spent.

The macroeconomic balance is an identity, and so one must be cautious in attempting to draw lessons about causal relationships from an analysis of such data. Nonetheless, in the Sri Lankan case it is difficult to avoid the conclusion that the large and persistent government budget deficit has had a deleterious effect on both the current account and on the ability of the private sector to profitably invest its own savings.

12. External Trade

Exports

With respect to the composition of exports, the two most significant trends to emerge in this period are related to the tree crops and garment sectors. Table 12.1 shows that the share of tea, rubber and coconut in total exports has more than halved from the 1974-80 period to the 1987-92 period. Of the tree crops, tea continues to hold the largest share - 56 per cent of total agricultural exports in 1992. However, by 1992, the share of minor agricultural crops (vegetables, fruits, coffee, cocoa, cashew, spices and essential oils) had overtaken the contribution towards export earnings of both rubber and coconut: in 1974, minor agricultural crops accounted for 5.5 per cent of agricultural export earnings, rubber for 26 per cent and coconut products for 19 per cent; by 1992, they accounted for 18 per cent of agricultural exports, rubber for 11.2 per cent and coconut for 14 per cent of total agricultural export earnings.

Table 12.1
Composition of exports
(as a per centage of total export earnings)

	1974-80	1981-86	1987-92
Rubber, tea and coconut	71	50	32
Garments	4	20	35
Other manufacturing	14	18	19
Precious and semi-precious stones	2	3	3
Other products	9	10	10

In direct contrast to the tree crop sector, the garment sector's share in export earnings has leapt from 4 per cent in the 1974-80 period to 35 per cent in the 1987-92 period. Other manufactured exports, of which the most important categories are petroleum products and leather, rubber, paper, wood and ceramics, have recorded a modest increase in share over the period. Leather, rubber, paper, wood and ceramic products have contributed more towards export earnings in recent years than have petroleum products: in 1992, the former group of products accounted for approximately 12 per cent of total manufactured exports while petroleum products accounted for approximately 3 per cent of total manufactured exports. There has been a slight increase in the share of precious and semi-precious stones in total export earnings. The share of each of these sectors in total exports is illustrated by area in Figure 12.1, which appeared as Figure 3.2 in Chapter 3, but which is included here for easy reference.

Figure 12.1

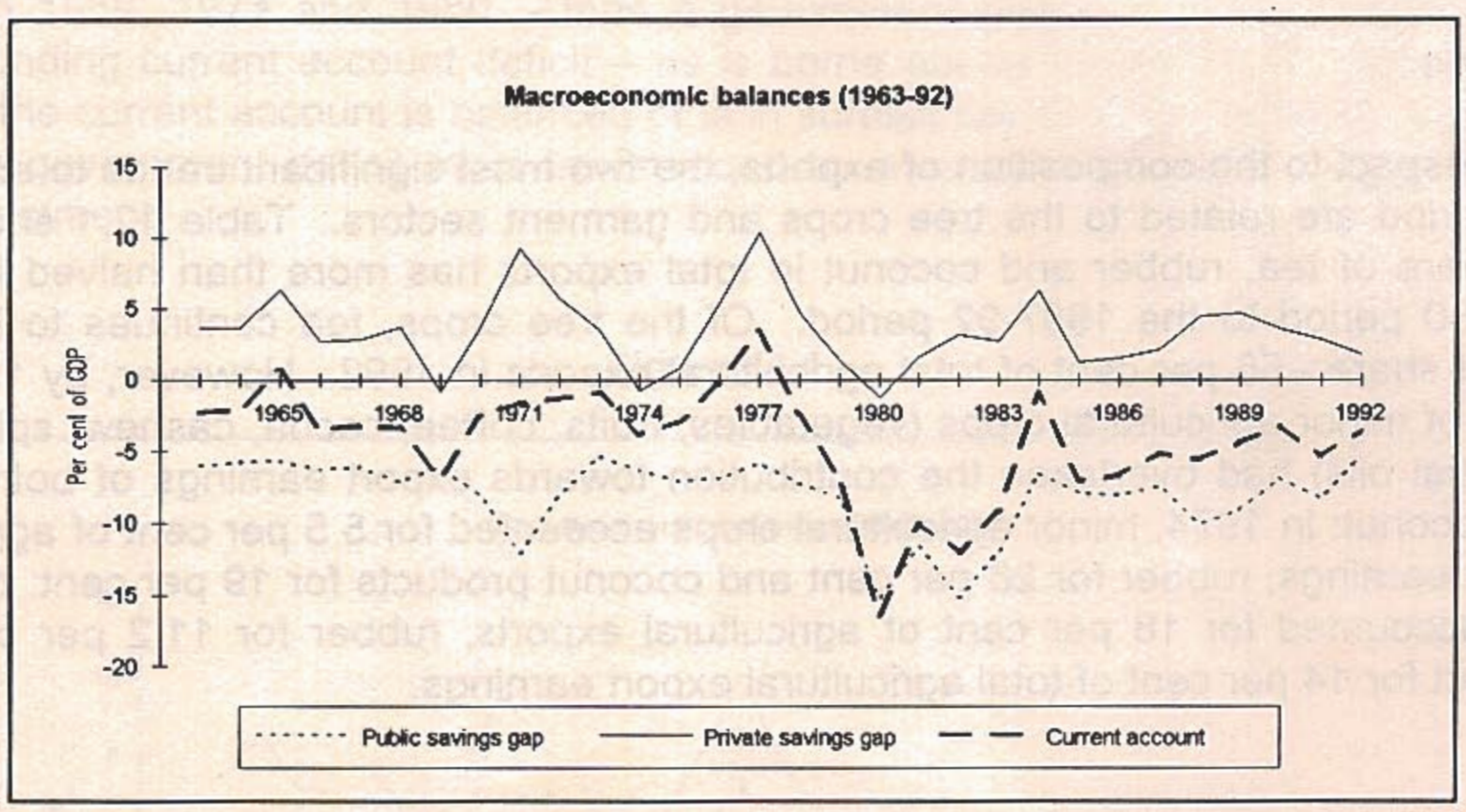


Table 12.2 shows period averages of the per centage share in total exports of Sri Lanka's five major trading partners during the period 1976-92. The most significant trend to emerge from this table is the growth of the US market's share in Sri Lanka's export trade: in the 1976-81 period, 8.4 per cent of total Sri Lankan exports found its way to the US market; in the period 1988-92, this share had leapt to 27.2 per cent. The increase in the share of exports to the Benelux countries has also been spectacular. Germany's share in Sri Lanka's export trade has also increased, and Japan's share has increased marginally. In contrast, the UK's importance as a destination for Sri Lankan exports has declined marginally.

Table 12.2
Direction of Sri Lankan exports

	1976-81	1982-87	1988-92
United States	8.4	20.7	27.2
United Kingdom	7.9	5.8	6.0
Japan	5.0	4.9	5.3
Germany	4.8	6.0	7.1
Benelux	0.5	1.6	4.6
Other	73.4	61.0	49.8

Imports

With regard to the composition of imports, the most noticeable trend to emerge is the halving of the share of consumer goods in total imports from 1960-70 to 1981-82 (see

Table 12.3). This category includes food and drink such as rice, flour, sugar, milk and milk products and other consumer goods such as vehicles, electrical goods and pharmaceutical products. In contrast, the share of textiles and other intermediate goods has increased significantly. Note that the import of textiles in the 1960-70 period would have been directly for consumption, whereas in the 1981-92 period, the bulk of textile imports has been as inputs for the garment industry. The import of crude oil for the refining industry would account for most of the expenditure on other intermediate goods. This category includes fertiliser, chemical elements and compounds, wheat and paper. The share of investment goods in total imports has remained more or less constant throughout the period. This category includes building materials, transport equipment, machinery and equipment. Figure 12.2 below illustrates the composition of imports over the period.

Table 12.3
Composition of imports

	1960-70	1971-80	1981-92
Consumer goods	49	41	21
Textiles	7	3	10
Other intermediates	24	37	40
Investment goods	20	18	20

Figure 12.2

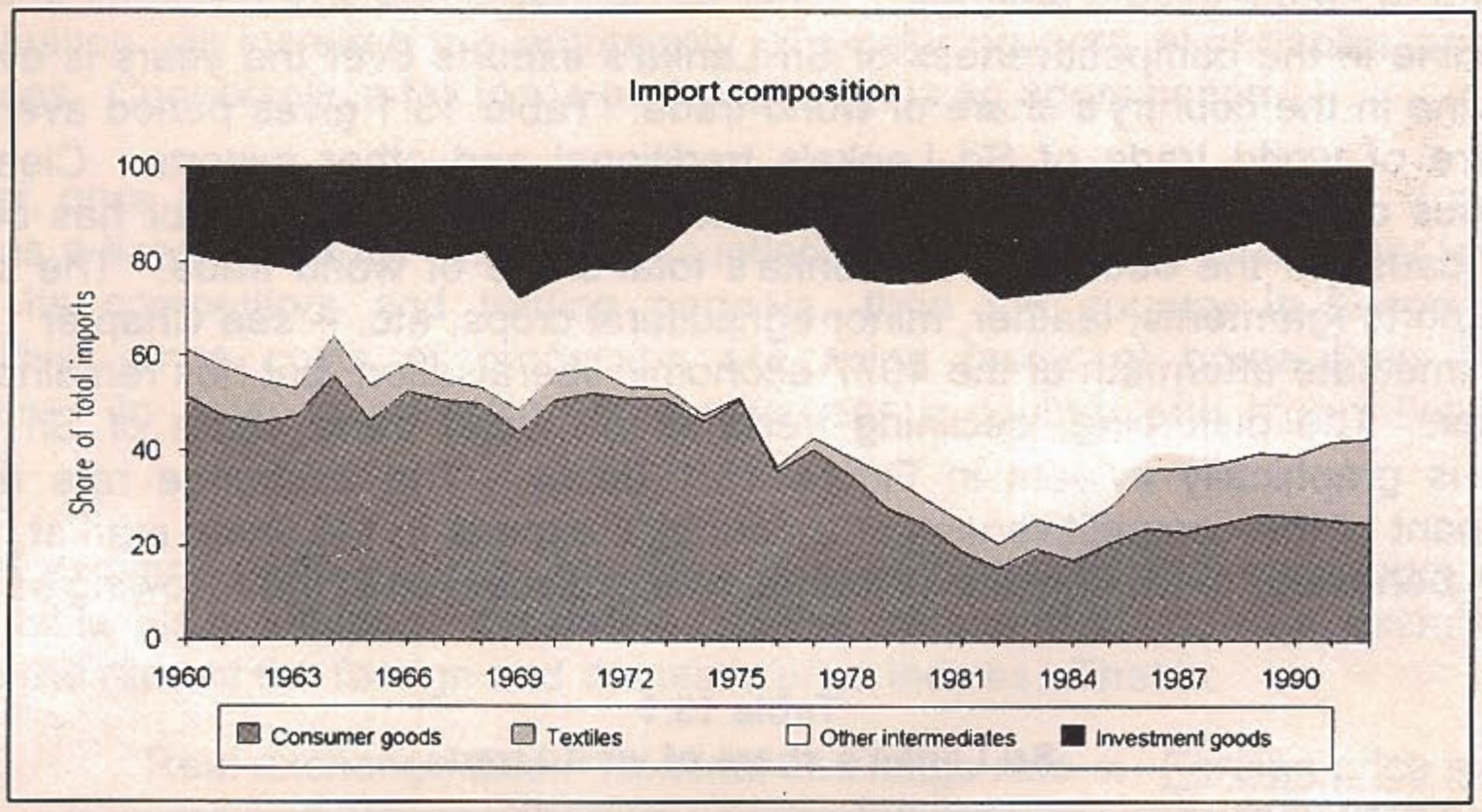


Table 12.4 gives period averages of the shares in total imports of Sri Lanka's six major trading partners. The most remarkable trend to emerge from the Table is the growing importance of regional trade. The share of the East Asian NICs (South Korea, Taiwan, HongKong and Singapore) in Sri Lanka's import trade during this period has increased

dramatically: from 8.6 per cent of the total in the period 1976-81, it rose to 18.8 per cent in the 1988-92 period. Imports from India have shown a slightly rising trend in recent years. The share of the US in Sri Lanka's imports has remained constant over the 1976-92 period. The UK's share has, in contrast, declined by approximately 2 per centage points and Iran's share has also declined marginally.

Table 12.4
Direction of Sri Lankan imports
(per centage share)

	1976-81	1982-87	1988-92
Japan	10.5	15.1	12.2
USA	6.6	6.3	6.2
United Kingdom	7.3	5.6	5.4
India	6.1	4.5	5.5
Iran	6.5	6.3	5.1
East Asian NICs	8.6	12.4	18.8
Other	54.4	49.8	46.8

13. Sri Lanka's Competitiveness in the World Economy

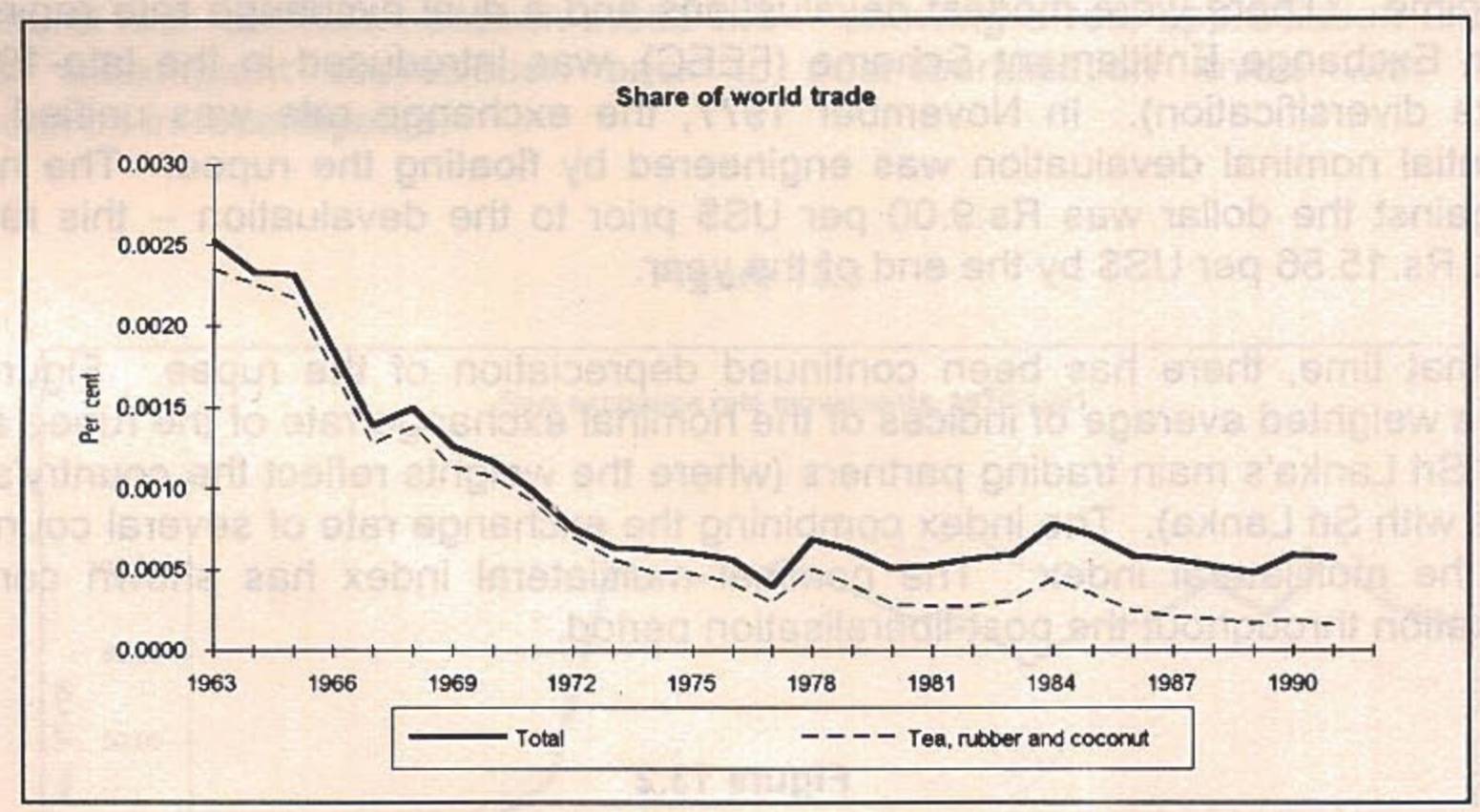
Sri Lanka's Share of World Trade

The decline in the competitiveness of Sri Lanka's exports over the years is evident in the decline in the country's share of world trade. Table 13.1 gives period averages of the share of world trade of Sri Lanka's traditional and other exports. Clearly, the continuous decline in the share of world trade of the tree crops sector has been the primary cause of the decline in Sri Lanka's total share of world trade. The share of other exports (garments, leather, minor agricultural crops, etc. -- see Chapter 12) grew in the immediate aftermath of the 1977 economic liberaisation, but has remained static thereafter. The disturbing, declining trend in the world trade share of Sri Lanka's exports is graphically evident in Figure 13.1 below. The exchange rate is a key determinant of the competitiveness of a country's exports in the world market, and the long-run behaviour of Sri Lanka's exchange rate is discussed in the following section.

Table 13.1
Sri Lanka's share of world trade

	1963-70	1971-77	1978-84	1985-91
Tea, rubber and coconut	0.0017	0.0006	0.0004	0.0002
Other exports	0.0001	0.0001	0.0003	0.0003
Total	0.0018	0.0007	0.0006	0.0005

Figure 13.1



The Real Exchange Rate

The exchange rate is a key factor in determining how competitive a country's goods are in world markets and o of the incentives to produce traded goods in Sri Lanka. The exchange rate is expressed as the quantity of rupees required to purchase one unit of foreign currency. Hence an increase in the rate -- that is, when more rupees are required to purchase one unit of foreign currency -- denotes a devaluation of the rupee. A devaluation will increase the profitability of producing both exportables and import substitutes. Conversely, a fall in the exchange rate is an appreciation.

However, price movements relative to other countries are also important. If a country maintains a fixed exchange rate whilst its inflation rate is running at a higher level than that of its competitors and trading partners, then the country is becoming *less* competitive, since costs of production are rising faster at home than they are elsewhere. In order to maintain competitiveness a country with high inflation must devalue.

The real exchange rate captures movements in both the nominal exchange rate and differential levels of inflation. It is defined as the product of the nominal exchange rate index to the ratio of the foreign and domestic price indices. That is:

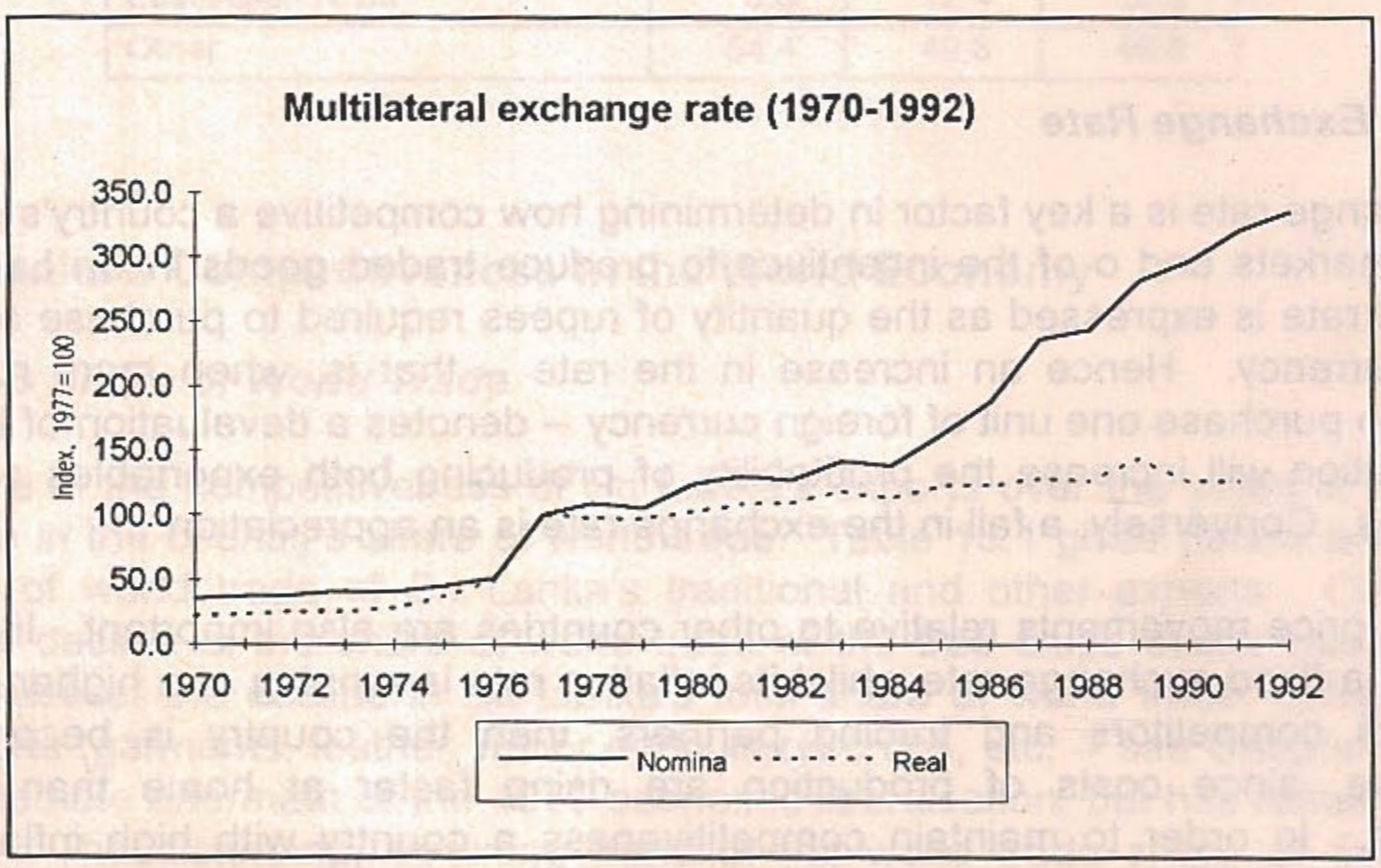
$$\text{Real exchange rate} = \text{Nominal exchange rate} \times \frac{\text{Foreign price index}}{\text{Domestic price index}}$$

Hence, if the nominal exchange rate is fixed, higher inflation at home causes the foreign/domestic price ration, and therefore the real exchange rate, to fall -- that is, there is an *appreciation* of the real exchange rate, or loss of competitiveness.

Prior to 1977, the Sri Lankan government maintained a more or less fixed exchange rate regime. (There were modest devaluations and a dual exchange rate regime; the Foreign Exchange Entitlement Scheme (FEEC), was introduced in the late-1960s to promote diversification). In November 1977, the exchange rate was unified and a substantial nominal devaluation was engineered by floating the rupee. The nominal rate against the dollar was Rs.9.00 per US$ prior to the devaluation -- this rate had risen to Rs.15.56 per US$ by the end of the year.

Since that time, there has been continued depreciation of the rupee. Figure 13.2 shows a weighted average of indices of the nominal exchange rate of the rupee against nine of Sri Lanka's main trading partners (where the weights reflect the country's share in trade with Sri Lanka). The index combining the exchange rate of several countries is called the multilateral index. The nominal multilateral index has shown continued depreciation throughout the post-liberalisation period.

Figure 13.2

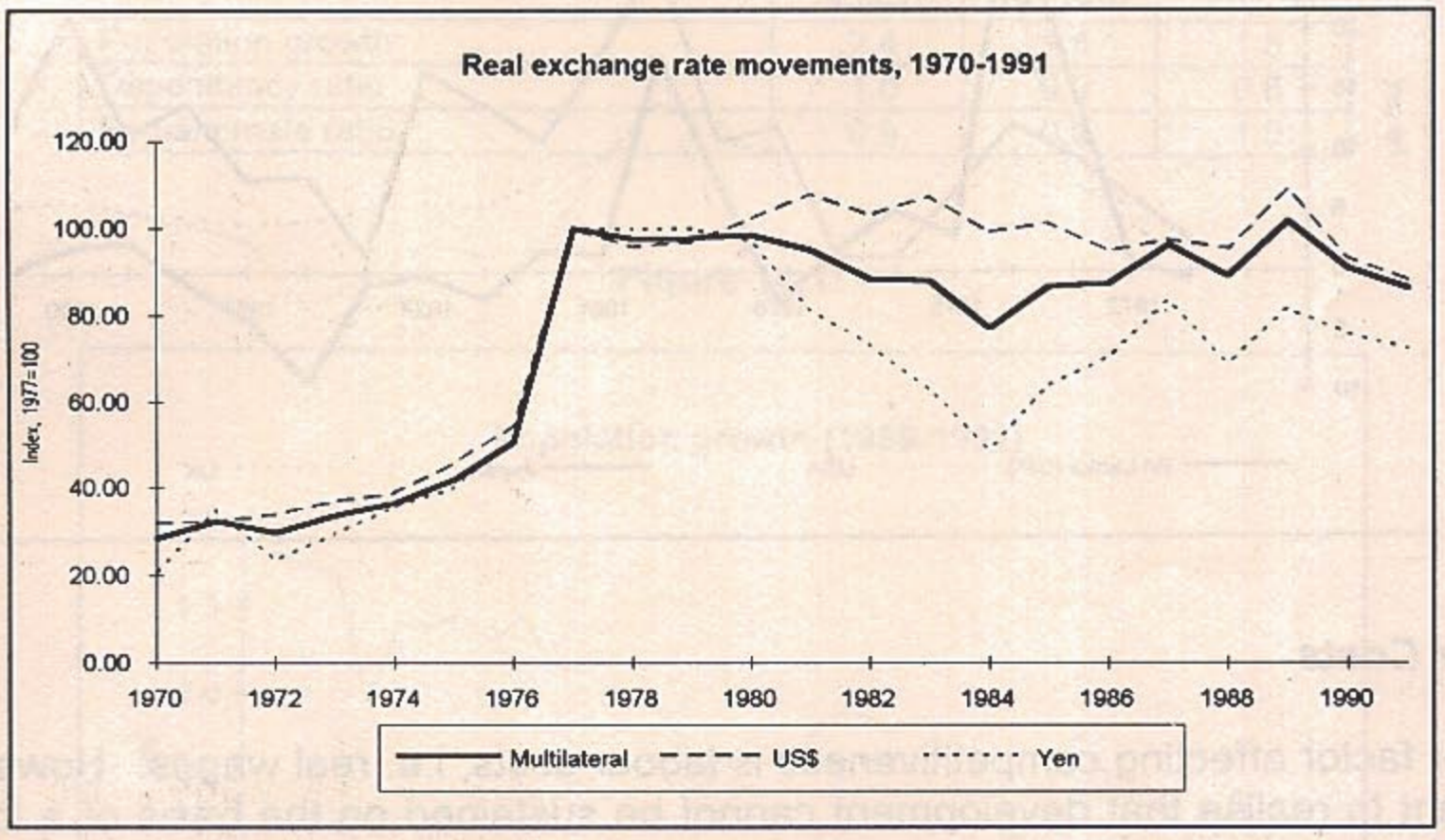


During the 1970s, when Sri Lanka maintained a fixed nominal rate, inflation was not too high by international standards -- averaging 5.7 per cent a year over the period 1970-77 compared to 8.4 and 14.4 per cent in the USA and UK, respectively (Sri Lanka's top two trading partners). Therefore, as shown in Figure 13.2, the real rate did not appreciate during this period (indeed, it depreciated slightly).

The nominal depreciation in 1977 was accompanied by an equivalent real depreciation. But since then -- and notably since 1980 -- there has been a growing wedge between the real and nominal rates. Figure 13.3 illustrates this in more detail. There was some real depreciation against the US dollar in the early 1980s, when that currency was strong. By contrast, there was a marked appreciation against the yen (Japan being a

low-inflation economy) -- bringing the real rate down to pre-liberalisation levels. The multilateral real rate falls between these two -- showing a real appreciation until 1984, and a subsequent depreciation back to post-liberalisation levels with renewed appreciation in recent years.

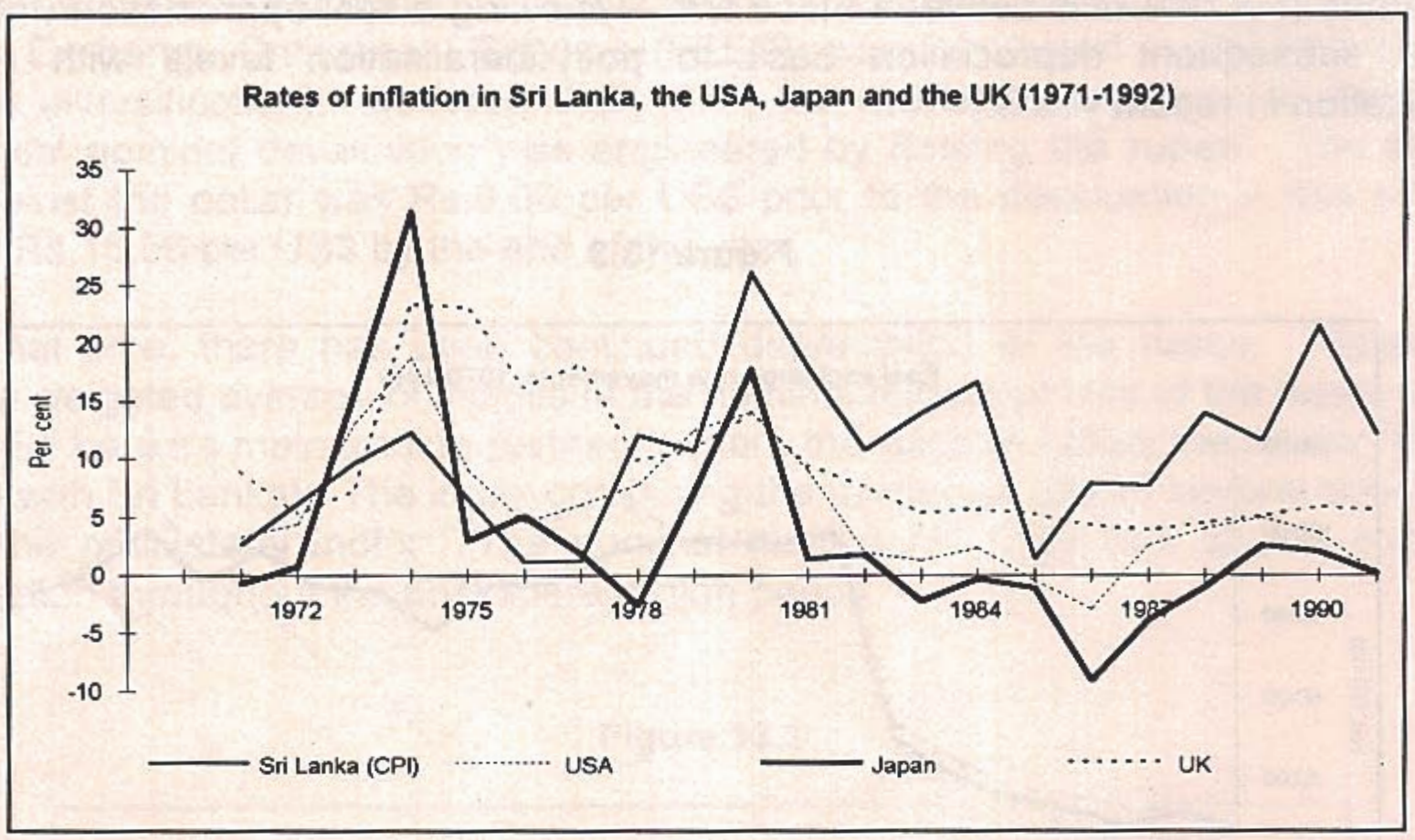
Figure 13.3



Since the nominal rate is being continually devalued, the wedge between the real and nominal rates should be the result of high domestic inflation (compared to trading partners). Figure 13.4 below plots Sri Lanka's inflation rate (as measured by the Colombo Consumer's Price Index -- CPI) against the inflation rates of the USA, Japan and the UK. It is clear that, apart from the blip of 1985, from 1977 onwards, Sri Lanka's inflation rate as measured by the CPI has progressively exceeded those of the USA, Japan and the UK.

Several factors may account for this high inflation -- including the aid and investment booms in the early 1980s (the period of appreciation). But nominal devaluation will also contribute to cost-push inflation in an economy highly dependent on imported inputs. Hence devaluation may not be the route to achieving a sustained real depreciation. Anti-inflationary measures, especially those which stimulate the supply-side to eliminate production bottlenecks, are also important.

Figure 13.4



Labour Costs

Another factor affecting competitiveness is labour costs, i.e. real wages. However, it is important to realise that development cannot be sustained on the basis of a low-wage economy. Indeed, development entails rising living standards which may be afforded through productivity increases. As is being much emphasised of late, a pre-requisite for general improvements in productivity is investment in human capital. In the next section we consider these investments and other aspects of social development.

14. Social Development

Population

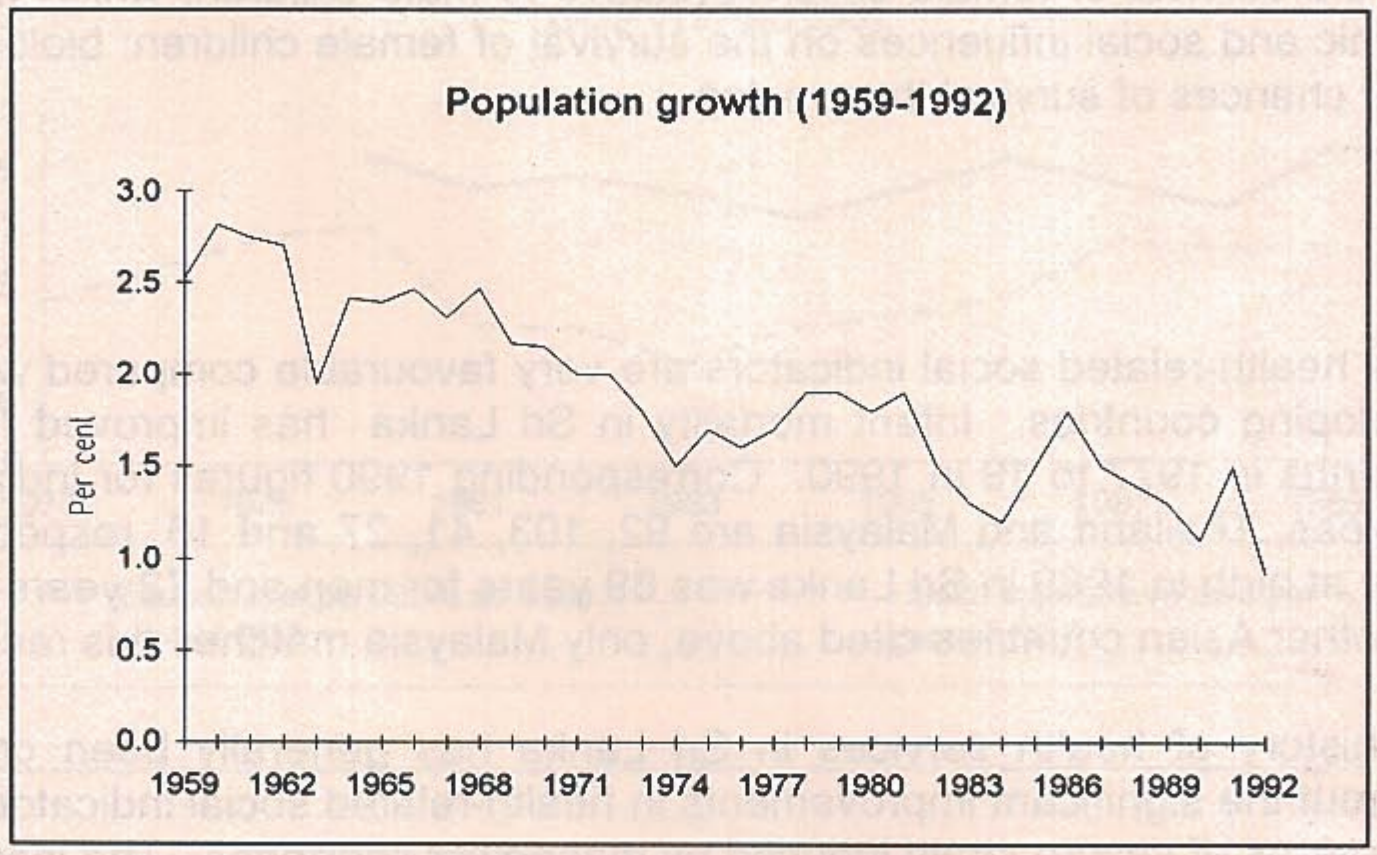
Sri Lanka's total population in 1992 was 17.4 million, recording an increase of 0.9 per cent over the previous year. This has been the first time in recent history that Sri Lanka has recorded a population growth rate of less than 1 per cent, which can be seen as the outcome of a decelerating trend in the country's population growth rates (see Figure 14.1). This trend is also evident from Table 14.1 which indicates that the growth rate, from an average of 2.4 in the 1959-70 period, dropped to 1.5 in the 1981-91 period. Declining population growth rates have coincided with a steady 75,000 new acceptors of family planning methods per annum over this period. Of the low income and low to middle, and middle income groups of countries, only Jamaica, El Salvador and the East European countries and the republics of the former Soviet Union have population growth rates lower than those of Sri Lanka for the 1981-91 period (World Bank, World Development Report 1993). However, since no population census has been taken in

Sri Lanka since 1981, population estimates should be regarded with some degree of caution, especially since the political turbulence of the last decade has made estimation more difficult.

Table 14.1
Population growth, dependency ratio, female/male ratio

	1959-70	1971-80	1981-91
Population growth	2.4	1.8	1.5
Dependency ratio	1.0	0.9	0.8
Female:male ratio	0.9	0.9	1.0

Figure 14.1



The dependency ratio is defined as the ratio of non-working-age population to working-age population. Working age is defined as between 15 and 54 years in this paper. In 1989, this ratio was 0.87, rising to 1.01 over the 1963-1970 period. This unfavourable trend was reversed in the 1970s when the ratio averaged 0.93 and decreased to 0.81 throughout the 1980s, and is reflected in the breakdown by age group of the population, period averages of which are given in Table 14.2. It can be seen that the proportion of those less than 15 years has decreased over the years, the proportion of those 55 and over has increased marginally, while the proportion of the working-age population has increased by the greatest number of per centage points.

Table 14.2
Age composition of Sri Lanka's population

	1959-70	1971-80	1981-91
Per centage of total population			
Under 15	41	39	36
Working age (15-54)	51	52	55
55 and above	8	9	9

The female/male ratio too has increased over the years from 0.90 in 1959 to 0.96 in 1991. This probably reflects the improved longevity of women relative to men as life expectancy at birth for women is 71.7 years while that for men is 67.8 years. It also reflects the large number of males who had a short life span due to political violence in contemporary Sri Lanka. However, data is insufficient to reach any conclusions with respect to the survival of female children relative to male children, which would reflect the economic and social influences on the survival of female children: biologically, they have better chances of survival than males.

Health

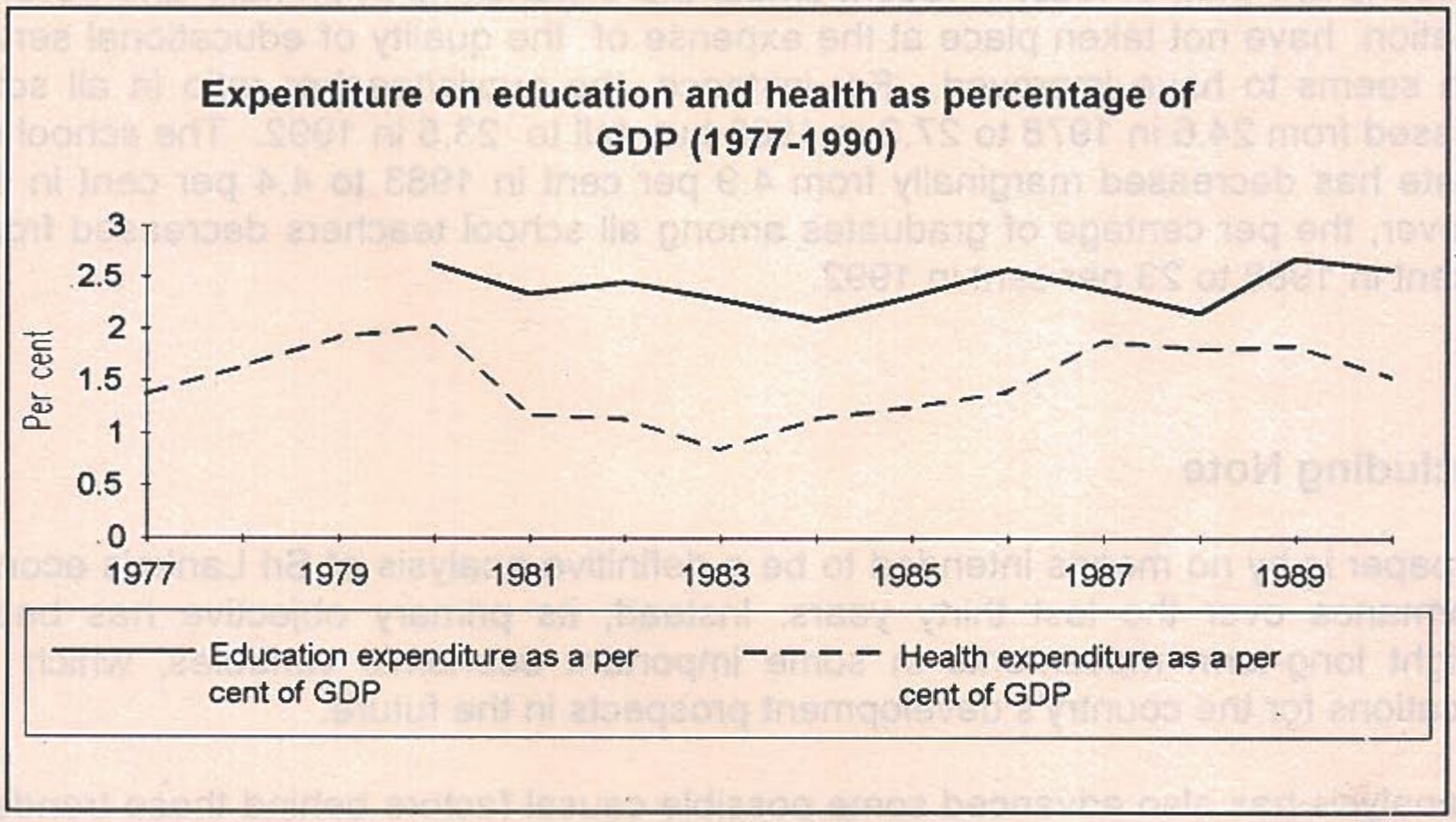
Sri Lanka's health-related social indicators are very favourable compared with those of other developing countries. Infant mortality in Sri Lanka has improved from 42 per 1000 live births in 1977 to 19 in 1990. Corresponding 1990 figures for India, Pakistan, the Philippines, Thailand and Malaysia are 92, 103, 41, 27 and 16, respectively. Life expectancy at birth in 1989 in Sri Lanka was 69 years for men and 72 years for women; of the five other Asian countries cited above, only Malaysia matches this record.

The long history of health services in Sri Lanka has generally been credited with bringing about the significant improvements in health-related social indicators, though it now shows signs of severe strain induced by manpower shortages. The increase in the number of social infrastructural facilities (hospitals, hospital beds, etc.) that has taken place over the period has not been accompanied by a congruent increase in the number of trained medical personnel. For example, the number of hospital beds increased fourfold from 10,911 in 1977 to 42,437 in 1991 so that, by 1989, Sri Lanka had 360 persons per hospital bed, compared with India where there were 1,300 persons per hospital bed. However, during the same period (1977-1991), the number of doctors, nurses and attendants in Sri Lanka increased only by approximately 20-25 per cent so that, by 1989, the number of persons per physician was 5,510 (the corresponding figure for India is 2,522). Nevertheless, these figures must be treated with some caution as the four-fold increase seems to have taken place within the space of just one year: in 1980, there were 10,207 hospital beds; the following year the number of hospital beds increased to 44,082.

The persistence of acute manpower shortages in relation to the levels of available infrastructural facilities is indicative of the general trend in health expenditure during the period: when total health expenditure as a per centage of GDP declined during the

early-1980s and recovered only in the late-1980s, current expenditure as a proportion of total expenditure declined from 91 per cent in 1977 to 55 per cent in 1980. By 1990, the ratio had recovered to 74 per cent of total expenditure on health. The increased proportion of capital expenditure on health reflects the use of foreign funds obtained for capital investment in the sector rather than for recurrent expenditure. Figure 14.2 plots expenditure on health as a per centage of GDP. This share fell from 2.0 per cent to 0.8 per cent in 1983, after which it recovered to 1.9 per cent in 1987 and declined marginally thereafter.

Figure 14.2



Education

Expenditure on education as a per centage of GDP has fluctuated between 2.1 and 2.7 over the period 1980-1990. The long-term trend has been fairly steady (see Figure 14.2). Approximately 80 per cent of total expenditure on education has been on general education, and 20 per cent on higher education over the period. These figures, coupled with those on expenditure on general and higher education, indicate the greater costs of higher education relative to general education: it costs far less to expand general education than higher education. For instance, in 1990, the government spent 18 times as much on a student in higher education as it spent on a student in general education.

According to the 1981 population census, 91.1 per cent of males and 83.2 per cent of females were literate. Total adult literacy was 87.2 per cent. While an average of 97 per cent of all students in general education attend government schools, in terms of enrollment rates, the per centage of the age group enrolled in primary education

increased from 99 in 1970 to 104 in 1990. Corresponding secondary enrollment rates were 47 per cent and 74 per cent, respectively. Among low-income developing countries, Sri Lanka's secondary enrollment performance has been bettered only by Egypt which has a rate of 82 per cent of the relevant age group (World Bank, World Development Report 1993). However, in terms of enrollment in tertiary education, Sri Lanka's rate of 4 per cent of the age group seems woefully inadequate for the country's development needs, especially given the fact that, of the total number of students who graduated in 1990, only 9.8 per cent were Engineering graduates and 17 per cent were graduates of Commerce and Management Studies, while 39 per cent graduated in Arts and Oriental Studies.

Indications are that, at least in recent times, the expansions in primary and secondary education have not taken place at the expense of the quality of educational services, which seems to have improved. For instance, the pupils/teacher ratio in all schools increased from 24.6 in 1978 to 27.3 in 1989 but fell to 23.5 in 1992. The school drop-out rate has decreased marginally from 4.9 per cent in 1983 to 4.4 per cent in 1991. However, the per centage of graduates among all school teachers decreased from 25 per cent in 1988 to 23 per cent in 1992.

Concluding Note

This paper is by no means intended to be a definitive analysis of Sri Lanka's economic performance over the last thirty years. Instead, its primary objective has been to highlight long-term movements in some important economic variables, which have implications for the country's development prospects in the future.

The analysis has also advanced some possible causal factors behind these trends, but has refrained from drawing policy implications. This is because the objective of the exercise has been to bring out changes and developments in the country's economic performance in a narrative sense, rather than to use the data series for sophisticated econometric analysis with a view to evaluating policy. Such analysis, however desirable, has been beyond the scope of this paper.

We do believe, however, that the next step in the process is econometric analysis of the relationships between macroeconomic variables emerging from the current work. Thus, this paper can be seen as a *reconnaissance* preceding the more demanding work of econometric modelling of the Sri Lankan economy.