SRI LANKA'S EXPERIENCE OF ECONOMIC LIBERALIZATION: A MACRO ECONOMIC ANALYSIS

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MASTER OF PHILOSOPHY

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CERTIFICATE

This is to certify that the dissertation entitled **"SRI LANKA'S EXPERIENCE OF ECONOMIC LIBERALIZATION: A MACRO ECONOMIC ANALYSIS"** submitted by me in partial fulfillment of the requirement for the award of **MASTER OF PHILOSOPHY** has not been previously submitted for any other degree of this or any other university.

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We recommend that this dissertation be placed before the Examiners for evaluation.

Jayati Ghosh
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Dedicated To

My Parents

&

My Late Brother

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LIST OF ACRONYMS

AMDP	Accelerated Mahawali Development Programme
BEPZ	Biyagama Export Processing Zone
BOI	Board of Investment
BTT	Barter Terms of Trade
BVS	Bonus Voucher Scheme
CAB	Current Account Balance
CBSL	Central Bank of Sri Lanka
CCPI	Colombo Consumer Price Index
CEB	Ceylon Electricity Board
CFAA	Capital & Financial Account
CP	Communist Party
CRA	Convertible Rupee Accounts
CWE	Cooperative Wholesale Establishment
DCS	Department of Census and Statistics
EDB	Export Development Board
EPZ	Export Processing Zone
ESAF	Enhanced Structural Adjustment Facility
FCBU	Foreign Currency Banking Units
FDI	Foreign Direct Investment
FEECS	Foreign Exchange Entitlement Certificate System
FIAC	Foreign Investment Advisory Committee
FTZ	Free Trade Zone
GCEC	Greater Colombo Economic Commission
GCPI	Greater Colombo Consumers' Price Index
GDP	Gross Domestic Product
GDPD	Gross Domestic Product Deflator
HDFC	Housing Development Finance Corporation of Sri Lanka
IMF	International Monetary Fund

ISS	Import Substitution Strategy
ITT	Income Terms of Trade
JVP	Janatha Vimukthy Peramuna
KEPZ	Katunayake Export Processing Zone
KGEPZ	Koggala Export Processing Zone
LSSP	Lanka Sama Samaja Party
LTTE	Liberation Tigers of Tamil Eelam
MFA	Multi Fiber Agreement
NDB	National Development Bank
NFKI	Net Foreign Capital Inflow
NICs	Newly Industrialized Countries
NPKI	Net Private Capital Inflows
NSB	Bank National Saving Bank
OGL	Open General Licenses
PA	People Alliance
PTCR	Presidential Tariff Commission Report
RRDB	Regional Rural Development Bank
SAF	Structural Adjustment facility
SLECIC	Sri Lanka Export Credit Insurance Cooperation
SLFP	Sri Lanka Freedom Party
SLSC	Sri Lanka Shipping Corporation
SLTB	Sri Lanka Transport Board
SMIB	State Mortgage and Investment
TDR	Trade Dependence Ratio
TOT	Terms of Trade
TULF	Tamil United Liberalization Front
UF	The United Front
UNP	United National Party
WPI	Wholesale Price Index

CHAPTER ONE

1.1 Introduction

Sri Lanka (Ceylon until 1972) regained her independence on 4th of February 1948 from the British colonial rule. Before the independence, the Portuguese, the Dutch and the British dominated the island nation for nearly five centuries. Sri Lanka located between 5° 55′ & 9° 50′ of North Latitude and between 79° 42′ & 81° 53′ of East Latitude with the total area of 65,610 sq. km and had a population of 19.3 million in 2003[1]. The climate in low country varies between min 24.4° C max 31.7° C and in hill country between min 17.1°C max 26.3C. Sri Lanka achieved universal adult franchise in 1931 and therefore at the time of independence the country had a vibrant democratic system. It inherited from the British a prosperous export sector, excellent human development with high education level and a stable macro economy.

However, during the five decades since independence, Sri Lanka's performance, in terms of economic development, has been controversial. Because Sri Lanka began her independence with flourishing economic conditions owing to a prosperous plantation sector inherited from the British colonial regime. Nonetheless, Sri Lanka failed to use this plantation surplus to lay a strong foundation towards sustainable economic development. Sri Lanka integrated her economy with the world via liberalization in 1977 with a view to boost its growth performance, but sluggish growth performance, except a short break of 1978-1982, is persisting even after the liberalization.

Three major factors contributed for the retardation of the development of Sri Lanka during the post independent period.

Firstly, Sri Lanka spent a significant portion of its resources, 3.3 per cent of GNP[2], on an average, on food subsidies from 1951 to 1977. However, it was

1 See Central Bank Report (2003)
2 See Kelegama(2000) page 1481

nearly 5 per cent of GDP[3] in the mid 1960s. Though provision of food subsidy is favored for reduction poverty, it may involve inappropriate incentives from the perspective of the economic development of the nation. Jayawardena (2004) argued that if Sri Lanka had abandoned the food subsidy it could have invested in plant and machinery at around 20 per cent of GDP as East Asia as a whole was then investing, instead of the 15 per cent it had succeeded in doing at that time. This comparison is important since East Asia's high growth rates were linked to high investment rates.

Secondly, Sri Lanka was compelled to direct a huge amount of money to the North East war since 1983 at the cost of investment. Though the war started in 1983, the root of this war began from independence. While the power transfer from the British was peaceful, ethnic antagonisms were also present, particularly between the Sinhalese nationalists who dreamt of a Sinhalese Sri Lanka and the minority Tamils, who feared that British rule would be replaced by Sinhalese rule. These ethnic tensions had been pushed to the background by political polarization and the anti-colonial struggle.[4] Furthermore, this ethnic hostility was further heated by the Official Language Act, which made the Sinhala Language the only official language in 1956, the standardization[5] of marks for the university admission in the early 1970[6]. Subsequently led all these to the eruption of a bloody civil war from the early part of the 1980s and had harmful repercussions on the Sri Lankan economy (further discussed in Chapter three).

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3 See Jayawardena(2004) page 98

4 Athukorala and Jayasuriya (1994)

5 The Government implements a scheme of education under which a Tamil student is required to achieve a higher standard than a Sinhalese student making it difficult for the Tamil students to enter Universities (Vije, 1985)

6 Firstly, the Official Language Act divided the people of Sri Lanka on the basis of languages. One of Sri Lanka's most eminent academic politician of the day Colvin R de Silva is reported to have said that ' one language, two nations; two languages, one nation'. Secondly, standardization of marks for the university admission, compelled the students who denied a university education became the leaders of the Tamil insurrectionary movement and Tamil United Liberalization Front (TULF) which came out with a call for a separate 'Eelam' state (see Jayawardena, 2004 for further elaboration of these points).

Thirdly, the most important factor is the frequent shift in the economic policies between two extreme ideologies i.e., liberal and left oriented ideologies. Sri Lanka has been ruled by the two major political parties i.e., United National Party (UNP) and Sri Lanka Freedom Party (SLFP) since independence. The economic policies depended upon the political parties that came to power. After Independence, the UNP formed the first government and adopted outward looking and open economic policy but the SLFP embarked upon inward looking closed economic policy when it came to power. These sequential policy shifts led to inconsistent process of growth and development and uncertainty ultimately reduced the confidence of investors both internally and externally.

1.2 Objectives

In this dissertation we propose to study the different policy regimes of Sri Lanka since independence and their impact on different macro economic variables and specifically growth. In addition, the relationship between social development and growth is also discussed. The objectives of the dissertation are as follows:

- To study the political economy of Sri Lanka since independence
- To review the policy initiatives (measures) undertaken by Sri Lanka during the liberalization
- To systematically analyze the quantitative and qualitative nature of economic variables influencing the Sri Lankan economy, and to assess the macro economic performance of Sri Lanka during the pre and post liberalization period.

1.3 Methodology

The impact of liberalization on the macro economy can be measured by examining the performance of the significant macroeconomic variables during pre and post liberalization regimes. The present study would use only secondary data. This study includes both internal as well as external factors that influenced the economy during the above-mentioned regimes. The methodology adopted by this study is to systematically look at variables such as gross domestic product, sectoral composition of GDP, unemployment rate, budget deficits and financing, inflation, income distribution, investment-savings imbalance, social indicators and the external sector including balance of payments, trade dependency, terms of trade and composition of exports and imports. The major data sources on macroeconomic variables are from the Central bank reports, which are published by the Central Bank of Sri Lanka annually and other publications of the Central Bank of Sri Lanka.

1.4 Review of the Literature on Liberalization

Scholte (2001) defines liberalization as a process of the replacement of command elements of an economic system by decentralized market type elements through privatization, reduction of government intervention etc. Briefly put, as Krueger (1998) noted, the liberalization involves action of making a trade regime less restrictive. Nonetheless, most programmes of economic reform have as their strategic aim the integration of the national economy with the world economy. Integration means not only increased market-based trade and financial flows, but also institutional harmonization with regard to trade policy, legal codes, tax system, ownership patterns and other regulatory arrangements.

In a broad swing of the pendulum, many developing countries have shifted from stringent controlled regimes to radical liberalization strategy particularly since the 1970s. The motivating factor behind such shift in policy paradigm has been some cross-country studies, which showed that there existed inefficiencies of the inward-looking strategies popular in the 1950s and 1960s (Cline, 1982). It was further argued that open trade leads to convergent rate of growth, that is, to higher growth rates in poorer countries than in richer countries (Sachs and Warner, 1995). Since then many academics and policy makers have proposed liberalization as an alternative to the import substitutions strategy, which has often been prescribed as the panacea for all economic ills. This group of scholars point to the achievement of the liberalization policies in various countries as the empirical verification of their arguments. However, more recently a set of economists, who are more critical of this approach have extensively challenged such arguments both on theoretical and empirical grounds (Rodrik, 1992; Rodriguez and Rodrik, 1999; Stiglitz, 2002).

At the theoretical level, there has been considerable debate on the effects of liberalization on the growth and welfare of an economy. The debate has become an extremely polarized one between two camps of scholars. While the former group focuses on the favourable effects of the reforms, the latter group focuses on the adverse effects of the reforms on the society and questions the sustainability of growth and development. In this section we discuss the major theoretical arguments put forward both in support and against liberalization. In this context we also examine some country-specific experiences with liberalization.

Arguments highlighting the beneficial effects of liberalization are primarily based on the arguments for free trade which were developed in 1970s by Little, Scitovsky and Scott, Bhagwati and Balassa.

According to Little, Scott and Scitovsky (1970), industrialization by means of import substitution strategy has typically been associated with efficiency loss due to tariff protection and controls, which distorted the allocation of resources. Industry has been over promoted at the cost of agriculture, which discouraged agricultural exports and created unequal distribution of income and employment in both industry and agriculture. Moreover, Little et al argue that such an import substitution strategy actually increases a country's dependence on imports and has a more devastating impact than direct import of final product for the following reasons. First, as long as an economy imports finished goods, its occasional inability to obtain or pay for these imports lowers the standard of living by making the imports unavailable. However when the economy produces the same goods domestically but with the aid of some imported inputs, an occasional inability to import these will also cause work stoppages, unemployment and a fall in the income generated by domestic manufacturing. A second consequence of import substitution, and the resulting demand for imported inputs, is that it creates further scope for more import substitution. Typically the establishment of domestic capacity to produce the inputs needed by the domestic final consumers' goods industries proceeds very slowly, creating too much capacity at the final stage and too little at the intermediate stages of production. This disparity calls for the importation of more inputs than anticipated and when the foreign exchange to pay for these imports is not available, it leads to the under utilization of capacity at the final stages of production. The third adverse consequence of import substitution is the shift in the distribution of income in favour of the urban sector and the higher income groups, whose expenditure pattern typically has the highest component of imports. Finally, protection does not encourage exports but actually discourages them. When a potential exporter makes use of an input which has paid an import tax it is obvious that costs are raised and that he is at a disadvantage compared with a manufacturer in the country supplying that input or in any other country where the import tax is lower. Equally, if the input comes from a protected domestic supplier the exporter is at a disadvantage, because the domestic supplier will certainly be selling his goods at a higher price than the import price. This can lead to severe BOP crises for many developing countries with chronic foreign-exchange shortages.

Balassa et al (1971) also argue that import substitution results in discrimination in favour of manufacturing and against primary activities. This discrimination is the result of deliberate policies aimed at providing incentives for the expansion of manufacturing, with agriculture paying much of the cost of this expansion in the form of lower product prices and higher input prices. Distortions in the relative prices of inputs and outputs due to the imposition of protective measures lead to inefficiencies in resource allocation that entail a cost for the national economy. Distortions in relative prices interfere with inter-industry specialization according to comparative advantage between primary activities and manufacturing industries as well as within the manufacturing sector itself. Intra-industry specialization and participation in the international division of the production process are also obstructed by barriers to imports and disincentives to exports. Moreover, in individual industries, the bias against exports and in favour of production for domestic use creates a divergence between social and private profitability. The reduced extent of inter-industry specialization due to the application of protective measures involves consumption as well as production cost. For one thing, protection interferes with consumer choice by distorting the prices paid by consumers; for another, it leads to the movement of resources for low-cost to high–cost industries. According to Balassa et al, the continued sheltering of domestic industry from foreign competition involves a dynamic cost as well to the national economy in the form of opportunities foregone for improvements in productivity. For one thing, the small size of domestic markets limits the scope of application of large-scale production methods. For another, technical change is hindered by the lack of sufficient domestic competition. These considerations explain why rather than catching up with industrial nations, developing countries could fall further behind in terms of productivity levels. High profits assured by protection tends to have further adverse effects because firms tend to follow a policy of low turnover and high profits rates and have little incentive for product improvement and technical change. In fact, in highly protected industries, product quality has often deteriorated and firms have been reluctant to assume the risk associated with the introduction of new products, production methods, and innovating activity in general.

Bhagwati (1978, 2004) emphasizes upon the growth enhancing effects of liberalization. According to Bhagwati, economic globalization contributes to growth by integrating national economies into the international economy through trade, direct foreign investment, short-term capital flows, international flows of workers and humanity and flows of technology. This process has important implications for poverty reduction. Bhagwati argues that the effect of trade on poverty is centred on a two-step argument: that trade enhances growth, and that growth reduces poverty. Growth is not a passive, trickle-down strategy for helping the poor. It is an active, pull-up strategy instead. It required a government that would energetically take steps to accelerate growth, through a variety of policies, including building infrastructure such as roads and ports and attracting foreign funds. By supplementing meagre domestic savings, the foreign funds thus could increase capital formation and hence jobs. An outward trade orientation can thus enable economies to export labour-intensive goods, which would add to employment and reduce poverty rapidly. Bhagwati criticizes the strategy of import substitution in heavy industry (such as electrical and machinery) rather than on the exports of light manufactures (such as toys and garments) on the grounds that such a development strategy undermines the cause of the poor by reducing growth and by delinking it from increased demand for the low-grade labour that constitutes the bulk of the poor. Instead, by pursuing outward-oriented growth-enhancing strategy, with labour-intensive goods and light manufactures being exported in far greater quantities, a developing country could increase the demand for labour and help the poor more.

A very cogent argument supporting liberalization can be found in Krueger (1978, 1997). Krueger draws attention to the empirical evidence shows that the bias toward export promotion resulted in faster growth than did the bias toward import substitution. According to Krueger, there are, broadly, two classes of influence that appear to make an export-oriented growth strategy more conducive to rapid growth than one based on import substitution. First, there are some strictly economic factors, such as returns to scale, indivisibilities, and the impact of competition, that probably produce a more satisfactory economic performance under an export-oriented strategy than under import substitution. Second, an export-promotion strategy appears to place certain kinds of constraints upon economic policy and its implementation; those constraints limit the magnitude and duration of policy mistakes and also tend to force policies to work through pricing rather than quantitative, intervention. A growth strategy oriented toward exports entails the development of policies that make markets and incentives function better, while an import-substitution strategy usually involves policies designed to frustrate individuals' maximizing behavior under market incentives. Krueger further points out four major economic considerations, which support the presumption that growth performance under export promotion may be superior to that under import substitution. They are: (1) relaxation of the link between agriculture and industry;(2) the degree to which economies of scale can be exploited; (3) the effects of competition on the performance of individual firm; and (4) the likelihood of foreign exchange shortage with its deleterious effects on growth. These links are elaborated below.

The agriculture industry Link: Generally, a large agricultural sector is a drag on the growth rate. Increases in agricultural productivity are hard to achieve, yet urban growth is likely to be closely linked to the fortunate of agriculture in many ways in economies where focus is upon import substitution. If agricultural output lags or declines, the resulting increase in food prices generally raises urban wages, thereby tending to limit industrial expansion. It may be argued that the amount of foreign exchange available for compensating for shortfall in agricultural output should not be identical under export promotion and import substitution. Because, first in addition to their holdings of foreign exchange reserve, the export oriented countries have had ready access to the private international financial markets as well as to official lenders; they could quickly and easily borrow, whereas countries oriented toward import substitution by and large had already used the lines of credit available to them on terms at which they were willing to borrow. Second, the import substitution countries appear generally to have been unduly optimistic about future foreign exchange earnings in relation to import demands; thus, their foreign exchange reserves were almost always very close to minimum levels, while export-oriented countries seem to have accumulated reserves at more rapid rates than expected.

Economies of Scale: To the extent that economies of scale exist and are functions of output levels in individual industries, it is clear that an export-push strategy relying upon selective expansion of industries, will dominate an import-substitution strategy where each industry's growth is limited. Under an export promotion strategy, new firms are basing their plans on both the domestic and export markets. In contrast, under import substitution, plans are based entirely or almost entirely on the profitability of the sheltered domestic market and the monopoly power will be a barrier for new entrants. Monopoly power, exercised by increasing the domestic price of the commodity above its international level, reduces still further the already small size of the domestic market. Therefore, an export push strategy is likely to enable to exploit economies of scale whereas an import substitution strategy is unable to do so.

Competition: It is necessary for exporters to compete satisfactorily in the international market. Meeting international competition requires cost consciousness, quality control, meeting customers' style preferences, changing product line with new technological developments, meeting delivery dates on time, and other requisites of a modern industrial society. Competitive pressures will certainly be less under import substitution than under export promotion. If managers allocate their time optimally among their various functions, more managerial time and effort will be devoted to plant efficiency and to cost and quality control under an export-push strategy than under import substitution.

No foreign exchange shortage: By definition and export-oriented growth strategy, relies on foreign exchange earning activities to be the leading growth sectors. When the growth of export industries slows, other sectors also experience a slowdown, and the decline in the growth of foreign exchange earnings is likely to be paralleled by a decline in the rate of growth of demand for foreign exchange. Even if the demand does not adjust immediately, past export growth is likely to have resulted in a moderately comfortable reserve position, so that small deviation from expected balance of payment position can be financed from reserves. In addition, the country is likely to be credit-worthy and able to borrow funds on acceptable terms in order to smooth whatever adjustments may be required. The balance of payments position of an export-oriented country is also protected because of the fact that the country must maintain a realistic exchange rate. All these factors tend to lead to a relatively comfortable balance of payment s positions wherein shortfalls in foreign exchange earnings can be met because the country is able to buy time to adjust. In contrast, import-substituting economies with overvalued exchange rates are plagued by foreign exchange shortages. When shortfalls in earnings occur, policies to adapt to the change result in a reduction in the rate of economic growth. In sum, an export-push strategy is not certain to result in fewer balance of payments problems, but there is a presumption in that direction. Conversely, import substitution is not necessarily bound to result in foreign exchange shortage, but it is likely to.

Apart from the theoretical arguments in favour of liberalization, many economists also point out the success stories whereby former developing countries made a transition to the developed world by adopting out-ward looking policies. For example, Dornbusch (1992) noted that countries which adopted outward-oriented policies, at least to the extent of neutralizing bias, performed better than countries who failed to recognize the adverse effects of restrictions on their export potential and further pointed out that liberal trade regime can do wonders for a country's economy. Krueger (1998) also draws attention to similar examples.[7] Country studies in Balassa (1982) revealed the advantages[8] of outward-oriented policies for export performance and for economic growth in the face of external shocks. Nayyar (1996) noted that economic liberalization is about bringing market prices closer to efficiency prices and allowing individuals, households or firms more freedom to make economic decision. Accordingly, the liberalization process would help to the price mechanism to function effectively with regard to the resource allocation. Meanwhile, liberalization policy is often contemplated as a measure of primary importance, expected to improve the allocation of resources lead to grater efficiency, expand output and accelerate growth (Kelegama, 1989). Therefore, efficient resource allocation will induce the country to expedite the development process with greater economic growth, which is essential if countries are to achieve their social and economic development goals.

On the other hand, many academics and economists warned that liberalization would ensure neither sustainable growth nor stabilization in the economy. Instead liberalization could increase inequalities within and among countries.

Rodrik (1992) argues that the benefits of liberalization could be subdued due to macro instability characterized by high and variable inflation and fiscal and balance of payments crisis. Trade reform is expected to work by reducing the distortions in the structure of relative prices and by directing resources to sectors that can make the best use of them; macroeconomic instability interferes with both. High and variable inflation serves to confound price signals by making it difficult to disentangle relative price changes from

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7 By the early 1960, a few then developing countries- most notably Korea, Taiwan, Hong Kong and Singapore- had abandoned import substitution and adopted outer-oriented trade strategies. The result was spectacularly rapid growth (see Krueger, 1998).

8 Outward –oriented developing economies experienced an average gain of 14 %, and economies characterized by inward orientation an average loss of 8%, in their export market shares in the 1974-1978 period and while outward-oriented economies GNP growth rates declined temporarily from 7.3 % in 1963-1973 to 5.5 % in 1973-1976, inward-oriented economies GNP growth rates fell from 5.9 % in 1963-1973 to 4.9 % in 1973-1976 (see Balassa 1982, page 25)

movements in the price level. The slowdown in domestic activity renders structural change more painful by exacerbating transitional unemployment. According to Rodrik, trade reform now raises new issues, which are not answered by the traditional arguments in favour of free trade. The first question concerns the credibility and the design of trade reform. There might be confusion among the public with regard to reform due to the asymmetric information. Owing to the lack of credibility on reforms the productivity efficiency gains from trade liberalization may be delayed and as a result it will be more difficult for the reform to be sustained. Secondly, one should carefully look at the link between trade policy and macroeconomic instability. Macro stability depends on sound fiscal policy and sound exchange rate management. During liberalization countries often take initiatives to devalue their currency to offset any adverse effect of the reform on the balance of payments. But such initiative is problematic when inflation is still not safely under control. If the exchange rate is to be targeted on inflation, it cannot be used for the external balance. Thirdly, traditional arguments for free trade presupposes perfect competition when the ground reality of the developing countries could be altogether different. This requires an analysis of trade reform under imperfect competition. Prices exceed marginal costs of production in the context of imperfect competition. Consider an economy where trade protection is prevalent and which is subject to various types of imperfect competition. It is important to know the welfare consequences of a relaxation of trade restrictions. In such an economy, trade reform could affect welfare thorough four channels:(a) the volume of trade effect;(b) the excess profit effect;(c) the scale efficiency effect; and (d) technical efficiency effect. Protected sectors in developing countries will be precisely those with excess profits and unexploited scale economies. If, however, import expansion results in such sectors getting squeezed, liberalization can yield welfare losses. In sum, as the recent literature on trade and growth underscores, it certainly does not guarantee adequate levels of economic growth in the long run. An abysmal trade regime can perhaps drive a country into economic ruin; but good trade policy cannot make a poor country rich. Therefore, trade reform may not be a panacea to cure all economic problems. According to Rodrik, Trade policy plays a rather asymmetric role in development: A trade policy provides an enabling environment for development. It does not guarantee that entrepreneurs will take advantage of this environment, nor that private investment will be stimulated.

Stiglitz (2002; 2004) also warns that the process of liberalization has typically been accompanied by increasing inequalities, especially between developed and developing countries and such inequalities are often exacerbated by lending conditionalities. To highlight the differences in the effects of liberalization in the developing world, Stiglitz (2005) cites two examples- the success case of South East Asia and the failure case of Latin America[9]. This implies that the World Bank and the IMF sponsored liberalization policies need not necessarily help the developing countries to expedite their development process. Instead it could aggravate the existing problems of these countries.

Banuri (1991) argues that neither economic openness nor outward orientation leads to improved economic performance, changes in policy orientation do not lead necessarily to changes in openness, the appropriate degree of openness is different in different societies and attempts to impose a universal solution by force have been costly as well as ineffective and therefore economists should be looking at the institutional and historical features of different societies in order to understand their functioning, the range of their

9 The former shaped liberalization on its own terms and pursued a basic strategy of "export goods, import knowledge". They liberalized some things quickly and others slowly, like restricting short-term capital flows (not a typical policy of the IMF). The results are an eight-fold increase in income, lower poverty, and higher literacy and public health. . But the latter shaped liberalization in the terms of the IMF and World Bank. The growth in Latin America in the 1990's was half that of the 1950-1970's (before the reforms were adopted), and the wealth gap between poor and rich has widened with the upper 30% capturing almost all of the gains. Even Latin America's "A+ student", Argentina, has failed. And its one success, Chile, succeeded because it "didn't pursue Washington policies. Chile liberalized capital markets, but didn't completely privatize its copper industry. Further, Chile emphasized education and health as a means of halting inequality- areas where the IMF has little concern.

prospects and the feasible and desirable directions of policy and institutional changes.

Sen and Dreze (1995) noted that liberalization and market reforms alone are not enough to improve the quality of life; it is essential to tackle directly certain issues of equity such as in education, health and gender through a more active role by the government and people's participation. Therefore, if liberalization induces a country to achieve greater equity, that would be a best policy as far as developing countries are concerned.

It is generally argued that fiscal discipline and restructuring of public expenditure were the main elements under the stabilization and structural adjustment progrmame. However, East and South-East Asian countries behaved differently, even among them selves, and increased social overhead capital during the liberalization process.[10] Similar Government initiatives[11] and increased fiscal deficit were observed in Sri Lanka during the liberalization.

Bajpai (1993 and 1995) argued that structural adjustment is used to promote the marketization of economies through reliance on market signals to guide economic decision and allocate resources. However, the experience of different countries with similar reform programmes and stabilization have shown a spectrum of results when applied in the historically diverse circumstances of the third world. The outcomes of this orthodox approach have ranged from moderately successful to disastrous. While most of the literature on stabilization and structural reforms in developing countries is of the view that economic growth is more or less an assured product of

10 For example, while South Korea and Taiwan allowed substantial fiscal deficit, Singapore and Hong Kong emphasized budget balance and Malaysia and Thailand also have exhibited great fiscal prudence. These states have steadily increased their heavy support for education over time and the Governments in the NICs have played active roles in directly providing and subsidizing access to public health care and relatively cheap public housing (Ghosh, 1997).

11 Free education, free health, etc were made available to the people even after the introduction of liberalization in Sri Lanka and the Government initiated one million housing programme during the said period.

appropriate stabilization and reforms policies, there is no guarantee, that sustainable growth can be achieved.

1.5 The Sri Lankan Context

Sri Lanka was the first South Asian country to embark upon economic liberalization policies in 1977. The trade liberalization undertaken in 1977 represented an attempt to return to the type of open economy that existed during the decade following independence (Rajapatirana, 1988). Nevertheless, this liberalization was adopted after nearly two decades' existence of import substitution strategy. Lakshman(1996) noted that the major thrust of these policy reforms was to bring the Sri Lankan economy into closer integration with the ongoing process of globalization and he further argued that though there are some issues need to be addressed, the impact of reforms in Sri Lanka is very constructive. However, Ratnayake(1988) pointed out the main objectives of this policy package was to remove various growth-retarding deficiencies in the previous controlled trade regime and thereby to pave the way for resource allocation in line with international comparative advantage. Nonetheless, one important question that does arise is that, did the liberalization policies remove the growth-retarding deficiencies and lead to an efficient resource allocation? This study intends to answer this question to the maximum extent possible and also tries to answer the question of sustainability in the long run; this ultimately boils down to the issue of analyzing the general framework of the Sri Lankan economy and its liberalization process instead of partial analysis of the earlier studies. Kelegama (1986) noted that the new economic policies were launched on the basis that private enterprise oriented economies in East and South East Asia had achieved higher and more rapid economic progress than the others, therefore Sri Lanka's future lay in emulating these countries. Since during the post-independece period, Sri Lanka's[12] growth has not been commendable as

[12] At the time of political independence, Sri Lanka enjoyed the third highest per capita income in Asia after Japan and Malaysia (see Rajapatirana, 1988)

compared to the East and South East Asian economies. Though Sri Lanka was attracted by the success of East Asian countries, Cline[13] (1982), argued that the success of East Asian countries couldn't be generalized.

Moreover, Jayawardena (2004) noted that the country sought to move from a dirigiste framework which had paralyzed growth since independence to the direction of a liberal market oriented economy and, to the maximum extent possible, achieve a shift from consumption and subsidies towards investment, because subsidies led an unhealthy situation in which (as a percentage of GDP) consumption overtook investment. All these factors caused the economy to experience a sluggish growth rate during the pre liberalization period. Apart from these reasons, the slow performance of the agriculture sector also was one of the main reasons for the sluggish growth of Sri Lanka because of the over dependence exports of primary agricultural products, which is subject to frequent internal shocks such as floods, drought etc.

Many economists, for an example Abeyratne (1989), spoke of Sri Lanka's delays in industrialization until the early 1970s. The share of manufactures in exports was very marginal but in contrast primary agricultural products dominated the export composition of Sri Lanka. However, Athukorala and Jayasuriya (2004) noted that the reforms helped to transform a primary product exporting economy into one in which manufactures dominate exports. Improved performance of domestic manufacturing through greater export orientation caused improvement in output and total factor productivity growth, and employment generation. And they further argued that the Sri Lankan experience highlights the complementary role of investment liberalization for exploiting the potential gains from trade liberalization. This industrialization outcome is particularly impressive given

[13] He argued that while the model may work well if pursued by a limited number of countries, it may break down if a large majority of developing countries seeks to pursue it at the same time, because the resulting outpouring of manufactured exports might be more than Western markets could absorb.

that it occurred during a period of persistent civil strife and macroeconomic instability.

By and large, as Grobar and Gnanaselvam (1993) pointed out, while Sri Lanka has historically experienced slow rates of economic growth, the success of the economic reforms that were introduced beginning in 1977 caused new optimism regarding the future of Sri Lankan economy. After the implementation of liberalization Sri Lanka was relatively able to overcome from the two growth-retarding factors, food subsidy and sequential policy changes. But the ethnic war, which erupted in the early 1980s, continued to be a destructive factor on the Sri Lankan economy. Briefly put, as Athukorala and Rajapatirana (2000) pointed out, Sri Lanka is now classified among a handful of developing countries that have achieved clear policy shift from import-substitution to export-oriented industrialization. Though Sri Lanka shifted from inward looking strategy to outward orientation, the impacts of this policy shift should be analyzed in a constructive manner.

CHAPTER TWO

The Pre Liberalization Regime and the Performance of the Macro Economy

2.1 Pre Liberalization Regime in Sri Lanka (1948 - 1977)

Since independence, Sri Lanka's democratic political system has been dominated by the two political parties viz., United National Party (UNP) and the Sri Lanka Freedom Party (SLFP). The UNP, the right oriented party, adopted a basically liberal ideology. The SLFP, left oriented and alternative to the UNP, absorbed certain elements of socialist ideology. During the UNP's regime (1948 - 56,1965 -70 and 1977 - 94) it adopted partial liberalization (before 1970) and pure liberalization (after 1977) policies. During the SLFP's governance it pursued highly interventionist policies (1956 - 65) and import substitution strategies (1970 - 77). Due to these distinct ideologies, the Sri Lankan economy underwent consecutive policy changes when the governments changed during the last five decades. However, the SLFP led People Alliance (PA) formed the government in 1994 and embarked upon open economic policy without fundamentally changing the policy of the UNP.

Economists and policy makers identify the period before 1977 - 78 as less or no liberalization period and after 1977 - 78 as the liberalization period. This chapter analyzes the initial conditions, welfarism, the different phases of economic policies and the consistency of the macro economic performance in Sri Lanka during the pre-liberalization regime. The evolution of economic policies in this period is classified into 4 phases – 1) the open market economy 1948 - 56, 2) Closed Economy and the Import Substitution Strategy 1956 - 65, 3) Partial Liberalization 1965 - 70 and 4) Dirigiste Regime 1970 - 77. A brief focus is given on the performance of the social indicators during the same period.

2.2 Initial Condition

At the time of independence, Sri Lanka was mainly an agricultural economy. Traditionally tea, rubber and coconut have been the main plantation crops. Sri Lanka was highly dependent on these three crops for export earnings. The domestic agricultural sector mainly produced subsistence food crops. More than half the population of 7 million was dependent on agriculture for a livelihood. The agriculture sector directly contributed 40 per cent of national income in 1948 and the plantation sector performance dominated the activities of other sectors of the economy such as trade, banking, transport etc. Exports and imports together accounted for about 70 per cent of Gross Domestic Product (GDP)[1]

Sri Lanka began her development as an independent nation with a sound balance of payments, a government budget which had a comfortable current surplus and a standard of living which was among the highest in the South and South- East Asian countries. She had enjoyed a steady trade surplus over a prolonged period and her external assets stood at nearly one billion rupees in 1948, which was equal to the value of one year's imports (Marga, 1974). Sri Lanka had the finest chance for a rapid economic take off. At the time when the country regained Independence, it had the highest per capita income outside Japan in Asia. South Korea, Thailand, Indonesia and Malaysia were far behind Sri Lanka in terms of per capita income. But during the five decades of the post independent period, the economic performance of Sri Lanka was very poor. As Kelegama (2000) argued, the inability to get out of inter locking initial conditions of the 1950s due to political economic factors, policy errors and missed opportunities are the main reasons for the failure in achieving higher economic growth.

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1 Central Bank of Sri Lanka (CBSL) 1998

In 1960, Sri Lanka's per capita GDP- US$ 142- was considerably higher than that of Thailand (US$ 96) and Indonesia (US$ 51), very near to South Korea (US$ 156) and only 50 per cent lower than Malaysia (US$ 273). But by 2003 the picture was entirely different:

Sri Lanka's per capita income had risen to only US$ 947 compared with US$ 12637 for South Korea, US$ 4161 for Malaysia, US$ 2309 for Thailand and US$ 971 for Indonesia. In 2003, even though Sri Lanka's position in terms of per capita was better than its neighbours India (US $545), Pakistan (US $463), Bangladesh (US $376), Bhutan (US $738) and Nepal (US $234)[2], she had lost her prosperous position, which prevailed in the 1960s, as compared to the East Asian Countries during the last 50 years.

2.3 Welfare State

Sri Lanka faced severe economic problems during the 1930s. The left parties used the people's hardships to strengthen their influence and grew rapidly. But the British colonial administration was compelled by conservative nationalists, who later became the UNP leaders, to implement several welfare systems including free health, free education and food subsidies during the 1930s. They thought that extensive welfare programmes could contain the increasing support for the left parties. The political history of Sri Lanka after independence is somewhat exceptional for a developing country. Sri Lanka maintained a multi- party electoral system and after every single election the party in power was replaced by another. This naturally intensified the political leaders' sensitivity to popular demands and this sensitivity was expressed in a number of ways, which may have had important consequences for the country's economic development.[3]

At the first general election held in 1947 for the first Parliament, even though the UNP emerged as the largest party it was unable to get a clear mandate from the people and won only 40 per cent of the vote because the left parties -

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2 See Kelegama, (1998) and World Bank, 2003

3 See Karel Jansen, 1982 page 84 & 85

Lanka Sama Samaja Party (LSSP) and Communist Party (CP) were the challenging and alternative forces to the UNP. Anyway the UNP formed the first government led by Don Steven Senanayaka and it did not make drastic changes in economic policy and adopted almost same economic policy that persisted during the British regime.

Sri Lanka inherited from the British colonial rule a rich plantation sector (tea, rubber and coconut), which brought in 90 per cent of the foreign exchange earnings of the country. The bulk of these earnings were used for food import, part of it - rice - was for a food subsidy scheme promoted by the state (Kelegama, 1998). Therefore Sri Lanka lost an ideal opportunity to use this bulk of foreign exchange earnings for the country's economic development. Sri Lanka benefited from Korean War boom during 1951 - 52 and the tea boom during 1954 - 55. Due to the booms of exports prices, particularly rubber and tea prices, the terms of trade rose and external reserves also improved significantly (Central Bank of Sri Lanka - CBSL-1998). The Korean War-cum rubber boom was very temporary but it helped the government to maintain its welfare systems, particularly subsidy for rice, continuously. By early 1952, these welfare measures exerted tremendous pressure on government budgets. In 1951 - 52, welfare expenditures accounted for 29 per cent of the government current expenditure, even exceeding the expenditure on development (Central Bank of Sri Lanka -1951). But export prices started to decline in 1951 and on the other hand import prices were rising. As a result, the Government faced severe financial crisis to meet subsidies expenditure and decided to reduce the subsidies. Due to the reduction of the subsidy, the country faced an unprecedented massive public protest (Hartal), which resulted in the resignation of then Prime Minister Senanayaka. Henceforth whenever the issue of food subsidies came up, the specter of the Hartal haunted every Sri Lankan government (Athukorala and Jayasuriya 1994). Since then the welfare systems and the food subsidy started to play a major role in capturing power during every parliamentary election. As Kelegama explained (1998), politicians got the impression that the country is for a kind of government that panders to people's shortsighted wishes. Though East Asian countries provided free food to the people, unlike East Asian countries Sri Lanka implemented food subsidies with very low level of the rate of investment. It has been argued that if the food subsidy was abandoned in the early 1960s, Sri Lanka could have invested about 18 per cent on physical investment-same as East Asia during that time -instead of the average 14 per cent was invested. If this extra investment was made in an export oriented liberal trade and investment regime and compounded over 30 years, it would have accelerated economic growth to increase savings and investments as in East Asia. As Herring (1987) observed Sri Lanka developed an elaborate and expensive set of social welfare policies disproportionate to its per capita income. These policies were widely condemned in the official international developmemt community as 'premature welfarism', diverting resources from investment towards social consumption and thus retarding growth.

Table: 2.1 Social Expenditure as a Percentage of GNP, 1950/51 - 1977

Year	Education	Health	Food Subsidies	Other Social Welfare	Total Social Expenditure
1950-51	2.5	1.5	n.a	0.3	n.a
1951-52	3.0	1.9	5.3	0.4	10.6
1952-53	3.1	2.0	2.8	0.5	8.4
1953-54	2.9	1.9	0.3	0.4	5.5
1954-55	2.7	1.8	0.8	0.4	5.7
1955-56	3.2	2.0	1.5	0.5	7.2
1956-57	3.5	2.1	2.1	0.5	8.2
1957-58	3.8	2.2	2.2	0.6	8.8
1958-59	4.1	2.4	2.6	0.6	9.7
1959-60	3.8	2.2	3.1	0.6	9.7
1960-61	4.7	2.5	3.9	0.7	11.8
1961-62	4.7	2.2	3.5	0.7	11.1
1962-63	4.7	2.2	5.1	0.6	11.0
1963-64	4.8	2.0	5.1	0.6	12.5
1964-65	4.9	2.1	3.6	0.6	11.2
1965-66	4.7	2.1	3.6	0.6	11.0
1966-67	4.6	2.2	2.4	0.6	9.8
1967-88	4.1	2.0	3.0	0.5	9.6
1968-69	4.3	2.1	3.1	0.4	9.9

1969-70	4.6	2.1	2.8	0.4	9.9
1970-71	4.3	2.1	4.5	0.4	11.3
1971-72	4.4	2.6	4.1	0.5	11.6
1973	3.5	1.5	3.8	0.3	9.1
1974	2.8	1.3	4.0	0.2	9.3
1975	2.8	1.4	4.8	0.4	9.4
1976	3.1	1.6	3.4	0.8	8.9
1977	2.7	1.4	4.1	0.5	8.7

Source: Kelegama (1998)

Table 2.1 clearly shows that the social expenditure has absorbed a significant portion of GNP between 1950 - 51 and 1971 - 72. Expenditures on education and health will have a positive and long-term effect on the economic and social development of any country. Providing food subsidies for short periods is acceptable from the perspective of poverty. However long term provision of food subsidies would not be an instrument to induce people to work. Therefore it can be argued that the food subsidies were mainly used by the political parties to capture or retain the power. As data in table 2.1 indicate, even though the expenditures on education (3.8 per cent) and health (1.9 per cent) absorbed a major portion of the total social expenditure, food subsidies (3.3 per cent) has accounted a significant share of GNP during 1950 - 77.

2.4 Different Policy Regimes (1948 - 1977)

In the nearly 55 years since independence, Sri Lanka has gone through different economic policy phases. In the first, following independence, the economy was relatively open. In the second, which commenced in 1956, the government initiated closed economic policy and the import substitution strategy. This continued until 1965. In the third, a partial liberalization policy was embarked upon until 1977 when a strong liberalization effort was made. This section intends to analyze such each economic policy phase in detail.

2.4.1 An Open Market Economy 1948 - 56

Sri Lanka had a free trade policy during the immediate post independence period from 1948 to 1956 during which the UNP was in office. This period is seen as a liberal and market oriented regime in which the private sector played a key role in economic activity. It was an approach allowing market forces to determine the resource allocation pattern as well as trends and patterns of accumulation (Lakshman, 1997[a]). The new government continued some import and foreign exchange restrictions, which were imposed by the colonial government, but these restrictions were removed owing to the favourable balance of payment position (because of the rubber price boom) in the early part of 1950s. At the time of independence, Sri Lanka had a fixed exchange rate system and its rupee was fully convertible with the British Pound through its link with the Indian rupee. The Central Bank of Sri Lanka was established in 1950 for which advice was obtained from John Exter, an official of the U.S Federal System. After the establishment of the Central Bank, the Currency Board System was eliminated, since this system did not permit Sri Lanka to have any independent monetary policy.

In 1948, the plantation sector accounted for 90 per cent of foreign exchange earnings of the country. The bulk of these earnings were used for food imports. The total import bill was dominated by imports of essential foodstuffs. (Cuthbertson and Athukorala, 1991). Therefore the government gave higher priority to agricultural development to reduce food imports. As a result, large-scale public sector investment was made in agriculture related development projects. On the other hand, government sponsored investment in manufacturing industries was not a policy priority. During this period the government encouraged private enterprises and on the other hand inefficient industries closed down. By 1955, the government transformed state owned industries in to cooperation with the view to transferring them to the private sector in the form of joint stock companies.

However, an open market strategy based on export of plantation products soon proved to be unsustainable. As Kelegama (1998) explained, the welfare programme depended on plantation taxes, these taxes depended on better prices in the world market. Declines in world market prices led to foreign exchange problems, this problem called in for controls, and controls obviously led to Import Substitution Strategy (ISS). Therefore domestic and international factors compelled eventually the country to pursue an alternative economic policy.

2.4.2 Closed Economy and the Import Substitution Strategy[4] 1956 - 65

The UNP was defeated in the parliamentary election in 1956 and the SLFP led coalition came in to power. During the election campaign the SLFP promised to enact an Official Language Act[5] with the view to making the Sinhala language the only official language. The SLFP gained the power in that election and implemented the Official Language Act. Moreover the SLFP government adopted, to some extent, left oriented economic policies. However the Official Language Act widened the rift between the two major communities i.e., Sinhala and Tamil. Although the SLFP was not committed in ideological terms to Socialism[6]; it was not averse to adopting leftist rhetoric and promising to nationalize all foreign-owned plantations and to take over key industries.[7] During this regime a ten year macro economic plan was adopted with the purpose of achieving 5.9 per cent GNP growth rate a year by adopting closed economic policy and increased government intervention in the manufacturing sector.

During this period the government faced several problems such as growing budget deficit, sluggish export and unfavorable terms of trade. A prolonged trade union strike was resolved by large salary increases, which aggravated the situation. Amidst this turbulence, a Buddhist monk assassinated Prime Minister Bandaranaike in September 1959. In March 1960 the UNP regained power and increased the rice subsidy to attract voters but in the next election

[4] Though the SLFP was in power during the whole period, the first phase of the import substitution strategy was adopted in 1961-65

[5] This Act reduced the Tamil language to an inferior status (Vije, 1985 page- 1)

[6] Pro Western stance of the UNP compelled the SLFP to adopt an alternative policy (during the SLFP regime Sri Lanka maintained strong relationship with China and India) and coalition with left parties, forced the SLFP to absorb some left oriented policies.

[7] Athukorala and Jayasuriya 1994, page-10

held in July 1960 the SLFP regained power led by Mrs. Sirimavo Bandaranaike. On the economic front, the trade deficit increased further and as a result the Central Bank imposed selective credit controls to reduce the imports of non-essential goods such as automobiles, alcohol and cosmetics, and duties were increased on other imports such as petroleum, tobacco, watches and textiles with a view to reduce the trade deficit and to protect domestic producers from foreign competition.

In 1961, further stringent controls were imposed on foreign exchange and 49 luxury goods underwent a complete ban. Foreign oil companies were nationalized to meet increasing expenditure. The nationalization of oil companies badly affected the relationship of Sri Lanka with those countries where the oil companies had their headquarters, particularly the United States. In retaliation, the U.S. government cut off all financial aid to Sri Lanka (Athukorala and Jayasuriya 1994). During this regime the government took control of many private sectors such as the Bus service, Cargo handling in Colombo Port, the Insurance system and the Bank of Ceylon. Due to extreme government intervention in economic activities, this period is seen as highly regulated and protectionist regime.

2.4.3 Partial Liberalization 1965 - 70

The SLFP led coalition lost power after losing a vote of confidence in November, 1964 and subsequently the UNP formed the next government in 1965 with the support of Federal Party, the major Tamil party, and small groups. The UNP government was able to obtain foreign aid from International Monetary Fund (IMF) and World Bank due to its pro western stance.

During 1965 - 70, a partial trade liberalization package was introduced with devaluation of currency by 20 per cent in 1967. In 1968 a dual exchange rate system was introduced through the Foreign Exchange Entitlement Certificate System (FEECS). Under the FEECS all external transactions were divided into two categories i.e. essential and non-essential. Essential imports included rice, flour, sugar, drugs, fertilizer and petroleum while essential exports included the traditional crops viz. tea rubber and coconut. Nonessential transactions included non-traditional exports and non-essential imports. Non - essential imports were subject to an additional margin over the official exchange rate. Non-traditional exports were entitled to receive the higher FEECS rate while traditional exports were paid for at the official exchange rate.

Non-essential imports were liberalized and brought under a system of Open General Licenses (OGL). Essential items were kept at zero rates, while liquor, tobacco and luxury vehicles etc. were under a maximum rate of 300 per cent. These changes were accompanied by a partial relaxation of import restrictions. As Athukorala and Jayasuriya (1994) observed, the 1965 - 70 period can be characterized as one when a weak and hesitant attempt was made to liberalize the economy. The political determination to achieve full-scale liberalization was lacking, since the government was quite aware that the political opposition could arouse strong anti-government agitation. In any case, the brief episode of liberalization came to an end in 1970 when the Unite Left Front led by the SLFP was elected to power.

2.4.4 Dirigiste Regime 1970 - 77

The United Front (UF) consisting of the SLFP, Lanka Sama Samaja Party (LSSP) and the Communist Party (CP) formed the next government after the general election held in 1970. Mrs. Sirimavo Bandaranaike became the Prime Minister. The macroeconomic situation was worsening when the United Front took control of the government. During the election campaign, the rice subsidy was a burning issue because the UNP government had made a reduction in welfare measures including rice subsidy during its tenure and therefore the UF had promised to resurrect it. Since the left parties i.e., LSSP and CP were with the SLFP as a major partners, people believed that the government would eradicate poverty and unemployment and solve the landlessness problem. The UF promised socialist reforms and was willing to impose state control and regulation and the LSSP and the CP gave top priority to equity and committed to have a strong public sector.

In April 1971, the government faced a major challenge within one year of assuming office with the eruption of an armed insurrection. Mostly educated but unemployed rural Sinhalese youths led by the Janatha Vimukthy Peramuna (JVP, literally, People Liberation Front), a radical left wing group, attacked police stations and other government institutions. But the government was able to bring the situation under control with the help of military and political support from Western and Communist blocks. On the request of Sri Lanka, India sent a limited number of armed forces to crush the insurgency within a relatively short period. Due to the insurgency the Government was compelled to take some policy measures including land reform in 1972 and a take over of foreign owned tea rubber plantations in 1975. By 1976, agency houses, banking, insurance, most of the press, and much of wholesaling and retailing were to be under the control of state corporations and cooperatives (Weerakoon, 2004). At the same time Sri Lanka faced internal and external shocks due to the increases in the prices of oil and main food in the imports side and drastic reduction in output of the major agricultural crops. Meanwhile, the Government followed socialist oriented policies with import substitution strategy.

The government implemented individual licensing scheme for all imports and tightened the stringent control on foreign exchange to meet the balance of payments crisis. The fixed exchange rate system inherited from the previous government continued throughout this period. The premium for the FEECS also was raised to 65 per cent in November 1972. As an additional incentive to promote non-traditional exports of goods and services, Convertible Rupee Accounts (CRA) were introduced for gem exports. Under this scheme, on the request of the exporters 25 per cent of the value of gem exports was credited to the CRAs of the respective exporters. They could use this amount for imports or payments for services such as travel. As a whole, the period 1970 - 77 is seen as the time when the most stringent trade restrictions were introduced in Sri Lanka.

2.5 Macroeconomic Crisis 1973 - 75

Poor economic performance, balance of payments problems and fiscal deficit were the underlying factors which precipitated a crisis in the early part of 1970s. By 1973, the import substitution policy pursued by a highly restrictionist trade regime[8] had made the Sri Lankan economy extremely vulnerable to external shocks (Athukorala and Jayasuriya, 1994). One important objective of import substitution strategy was to reduce the dependence of the economy on foreign trade through growth of domestic production. However, even though imports of final consumption goods declined, the import dependence of the economy exacerbated as the import substitution strategy increased the demand for imports of intermediate and investment goods to run the domestic import substitution industries. This was a dilemma of the import substitution strategy which itself depended on imports. At the same time, Sri Lanka faced the first oil shock in 1973 and as a result import prices rose significantly. Due to these factors, Sri Lanka faced continuing deterioration in the terms of trade, stagnation in overall export growth and rising external debt. On the other hand Sri Lanka could not attract significant private capital inflow due to the protectionist trade regime and IMF drawings also were not available after 1968 because the obtainable concessionary funds had been fully used by Sri Lanka. Meanwhile, Sri Lanka was unable to obtain loans from the World Bank due to its preconditions to cut consumer subsidies.

8 Balassa (as quoted in Sebestian, 1997) also found that countries with faster export growth had experienced a faster rate of growth of GDP and he concluded that this was strong evidence favouring the hypothesis that protectionism seriously hampered performance.

By the time of the first oil shock in 1973, the Sri Lankan economy was already fragile. The combined impacts of oil shocks plunged the Sri Lankan economy to be considered as one of the world's worst affected economies during this period. At the same time, although the volume of gross imports fell drastically, the net import bill increased more than three fold. On the other hand, fertilizer prices were increasing and major import prices such as rice, wheat and sugar started to rise due to the world commodity price boom. But the effects of the price boom on Sri Lanka's major exports were much less than that on imports. As a result, the terms of trade deteriorated severely in 1973 - 75. Due to these adverse economic conditions, the government took several measures to subdue the harmful repercussion on economy. Initially, food subsidies and other welfare expenditures underwent a major cut and subsequently bus rail fares, postal, telephone and telegraph charges were increased.

By 1975, people's economic hardship was at its peak. Reduction of food subsidies, exorbitant prices of all essential commodities and severe unemployment affected adversely the normal life of the people. LSSP and CP, coalition partners, left the government in 1975 and 1977 respectively. In 1976 - 77, the economy came to a grinding halt with pervasive shortages of food, raw materials and medicines. As a result, the people gave a massive defeat to all the parties that had been allied with the UF government while the UNP gained an overwhelming electoral mandate at the general election held in 1977.

2.6 Performance of Macro Economy (1948 - 1977)

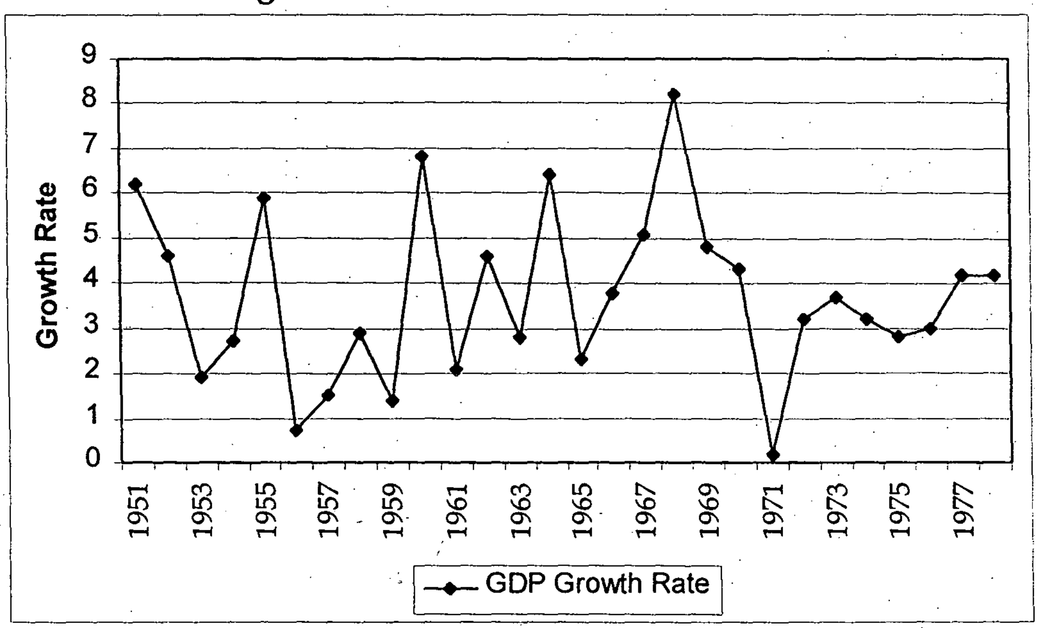
As we have just described in Sri Lanka, the two major political parties alternated in power at successive elections, and each had its differences of emphasis in regard to policy priorities and therefore since independence, Sri Lanka embarked upon different economic policies until the liberalization of

1977. This section attempts to examine the performance of the macro economy during the pre the liberalization regime i.e., 1948 -77.

2.6.1 GDP Growth Rate

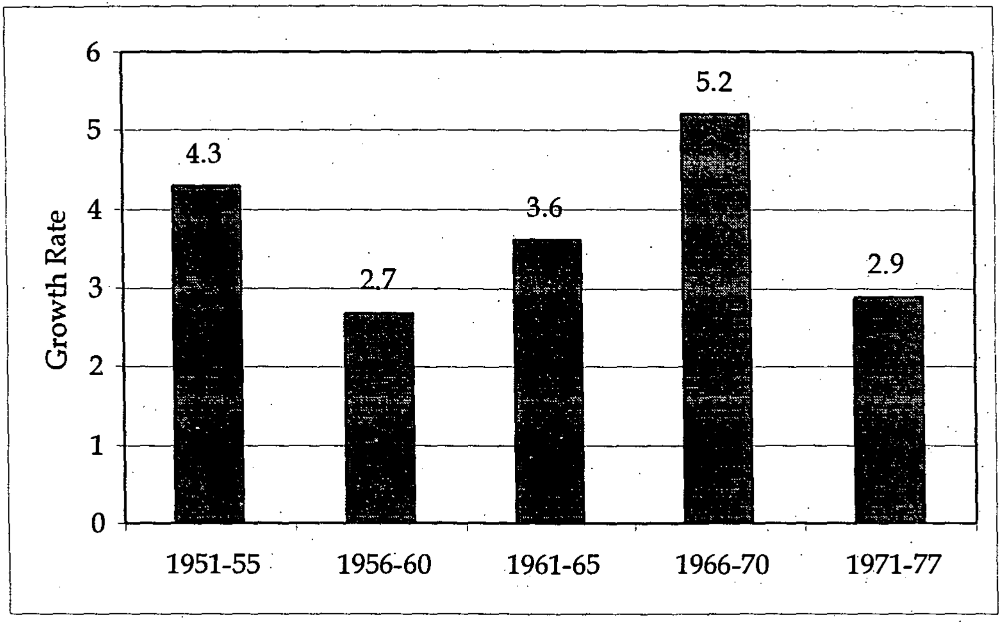
It is argued that economic growth is a vital indicator to describe the overall economic performance of a country. Acharya (2002) considers that economic growth is the principal yardstick of macroeconomic performance. Therefore countries tend to give higher priority for achieving a higher rate of economic growth. Even though there is no concrete guarantee for the trickle down process, Bhagwati (2002) has argued that growth helps to reduce poverty because of three central reasons: (1) it creates jobs that pull up the poor into gainful employment by providing more economic opportunity (2) it provides the revenues with which we can build more schools and provide more health facilities for the poor and (3) it creates the incentives that enable the poor to access these facilities and also for the advancement of progressive social agendas generally.

Figure 2.1 GDP Annual Growth Rate



Source: Central Bank of Sri Lanka (Various Annual Reports)

Figure: 2.2 GDP Growth Rate (Five Years Average)



Source: Central Bank of Sri Lanka (Various Annual Reports)

The period between 1948 and 1977 had several types of distinct policy regimes i.e. open economy and partial liberalization regime (1948 - 55 and 1966 - 70) and dirigiste regime (1956 - 65 and 1971 - 77). The GDP grew at the annual rate of 4.3 percent in 1951 - 55, 2.7 per cent in 1956 - 60 and 3.6 per cent in 1961 - 65. But in sharp contrast, the GDP recorded 5.2 per cent annual growth rate during 1966 - 70 but the average annual growth fell down to 2.9 per cent in 1971 - 77. Undoubtedly, the low growth rate has been recorded during the dirigiste regimes (1956 - 60,1961 - 65 and 1971 - 77) while the open (1951 - 55) and the partial liberalized regime (1966 - 70) recorded relatively higher growth rates.

The year 1971 recorded a very low annul growth rate of 0.2 per cent due to serious political turmoil in that year in the southern part of the country. The first oil shock of 1973 and the consequent drop in import capacity had adverse repercussion on investment. As a result, the year 1973 recorded another low-level growth rate of 3.7 per cent. More over, during 1973 - 74, an extensive drought conditions had adversely affected agricultural production and subsequently drop in the growth rate. Apart from internal and external shocks particularly in 1973 - 74, policy factors including the presence of extensive control over economic activity, the import substitution bias of policy, the focus on self reliance and consequent inadequacy of foreign capital inflow, the bias of policy against private initiative and so on have had their impact for the sluggish growth performance of the economy during the closed economic regimes.i.e, 1956 - 65 and1971 - 77.

2.6.2 Sectoral Growth Rate of GDP (1951 - 77)

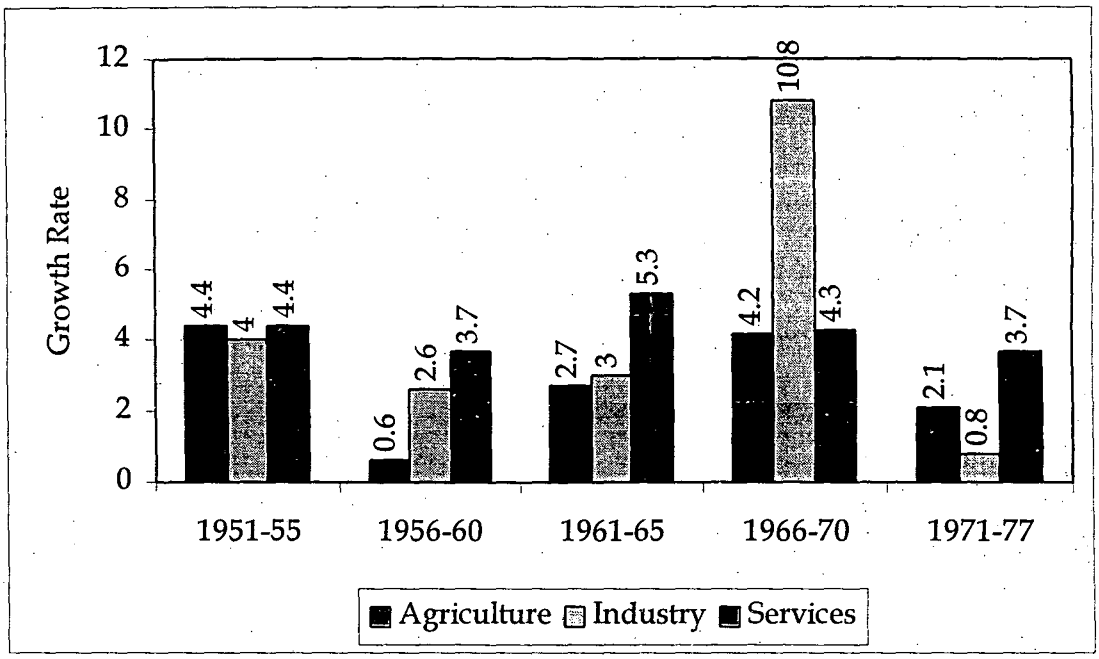
GDP Growth rate will show the overall growth rates of the three sectors viz., Agriculture, Industry and Services. It is important to look at the sectoral growth rates, which will give clear detail of the contribution of each sector to the overall GDP growth rate. Though there was fluctuation in the growth of all three sectors, as a whole the rates of growth of agriculture and service sectors have registered a clear decline. Their compound growth rates had negatively increased by 0.4 per cent and 0.8 per cent respectively during 1951 - 77. In contrast, the industry sector recorded 1.7 per cent compound growth during the same period.

Table: 2.2 Sectoral Growth Rate of GDP (At Current Market Prices)

Year	Agriculture	Industry	Services	Year	Agriculture	Industry	Services
1951	9.1	6.4	5.3	1965	-5.9	0.7	9.9
1952	3.7	8.0	4.7	1966	1.7	8.4	3.9
1953	-0.9	0.6	3.8	1967	8.5	9.3	1.6
1954	5.3	-3.3	2.6	1968	5.8	17.1	7.7
1955	5.0	8.4	5.8	1969	1.3	9.9	5.5
1956	-4.6	12.6	1.3	1970	3.8	9.3	2.8
1957	0.6	-1.1	2.2	1971	-2.4	-0.2	1.2
1958	2.3	0.0	3.6	1972	3.1	-1.7	4.8
1959	-1.0	-2.5	3.1	1973	-0.8	5.8	3.0
1960	5.8	4.0	8.4	1974	5.8	-2.8	6.7
1961	7.4	0.1	-2.0	1975	-2.4	0.9	4.8
1962	3.1	6.5	5.1	1976	1.2	7.6	0.9
1963	5.6	2.8	-0.1	1977	10.4	-4.3	4.7
1964	3.5	5.1	9.8	****	***	***	***

Source: Central Bank of Sri Lanka (Various Annual Reports

Figure: 2.3 Sectoral Growth Rate of GDP (1951-77)



Source: Table: 2.2

As can be seen from Table 2.2 the average annual growth rates of agriculture, industry and services sectors constituted 4.4 per cent, 4.0 per cent and 4.4 per cent respectively during 1951 - 55. Rapid progress of land colonisation and increased productivity owing to increased utilization of fertilizer were the major reasons for agricultural growth. Expansion of manufacturing and construction sectors contributed significantly to the industrial sector growth. Likewise, faster growth of public administration and wholesale and retail trade resulted substantially in the growth of the services sector.

Meanwhile, the average annual growth rate of agriculture, industry and services sectors fell to 0.6 per cent, 2.6 per cent and 3.7 per cent respectively in 1956 - 60. The growth rate of agriculture has lagged behind than that of overall GDP in the four periods from 1956 - 60 to 1971 - 77. Unfavorable weather conditions, increasing input prices, particularly fertilizer, poor disbursement levels of agricultural credits and insufficient incentive for replanting of tea to keep up growth in production were reasons for the poor performance of agricultural growth rate. Poor performance of the construction and manufacturing sectors and the sluggish performance of wholesale and retail services resulted in the decline of growth rates of industry and services sectors respectively in this closed economic regime.

But during the 1961 - 65 period, the growth rates of agriculture and service sectors rose to 2.7 per cent and 5.3 per cent respectively while the growth rate of the industrial sector increased very marginally to 3 per cent. Increased domestic agricultural production, primarily food crops production, helped the growth of the agricultural sector. The introduction of the FEEC System helped the expansion of the mining and quarrying sector, which contributed to the growth of industrial sector. For the growth of services sector, electricity, transport and housing sectors contributed significantly.

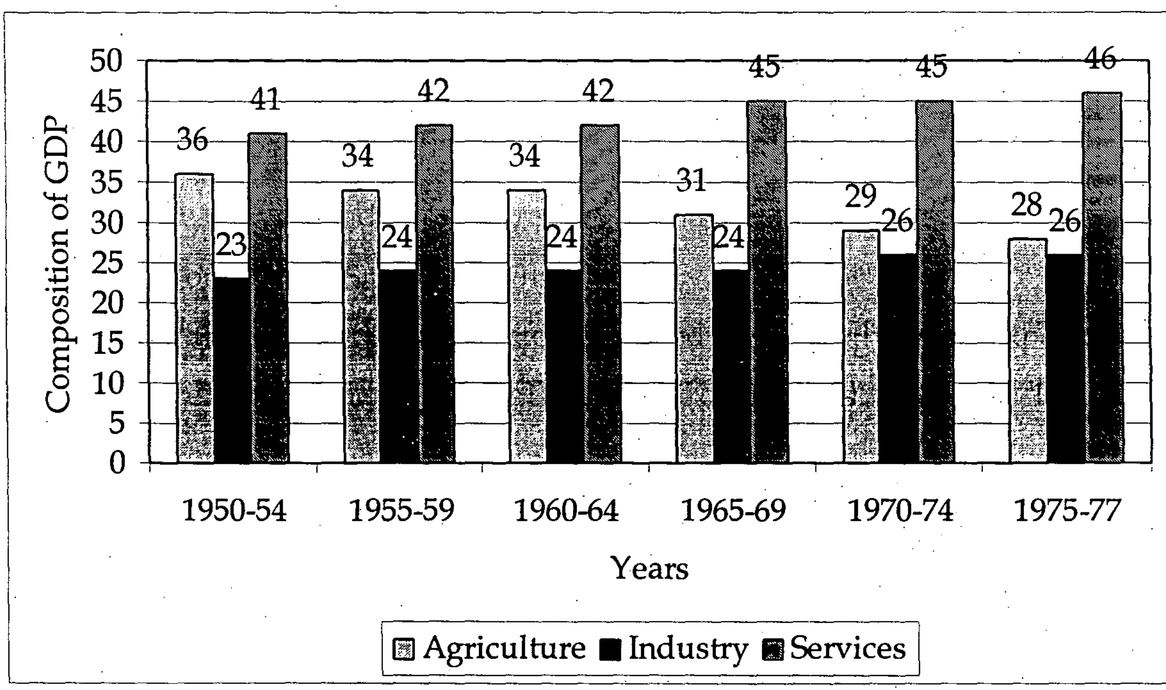
In sharp contrast, during the 1966 - 70 period, the agricultural sector maintained an average annual growth rate of 4.2 per cent but the industrial sector recorded a historic 10.8 per cent growth rate while the growth rate of the service sector declined to 4.3 per cent. Increased use of high yielding varieties of seed, fertilizer, agro chemical, tractors and provision of bank credits contributed to the growth of agricultural sector. Expansion of Gem production and construction sector resulted in the bullish growth of industry sector. However, the continuous dismal performance of electricity, financial services and trade sectors contributed to the decline of services sector growth.

Meanwhile the average annual growth rate of all three sectors declined drastically during the closed economic regime of 1971 - 77 because the agricultural sector registered only 2.1 per cent growth rate while industry and services sectors recorded only 0.8 per cent and 3.7 per cent growth rates respectively. The monsoon failure for three years from 1971 to 1973, the subsequent surge in international prices of grain and petroleum and the decline of private sector investment, as a result of land reforms led to a drastic drop in agricultural production in this period. Heavy resource constraint resulting from increased government expenditure and the deterioration of the foreign exchange situation and the first oil shock of 1973 were some of the main reasons for the slow growth of industrial and service sectors during this period.

2.6.3 Sectoral Composition of GDP

Sectoral composition of GDP will provide the information regarding the contribution of each sector to the GDP. During the early period of independence, service and agriculture sectors played a prominent role in the composition of GDP in Sri Lanka while industry was in the third place. By 1977, though the share of service sector increased significantly at the expense of agriculture sector, industry was in the third place as it was in 1950. Shockingly, the share of industry almost did not change during the 27 years period.

Figure: 2.4 Sectoral Composition of GDP



Source: Central Bank of Sri Lanka - 1998

2.6.4 Employment

Growth of employment in Sri Lanka should be examined in relation to changes in economic policies and strategies that were adopted by successive governments. The two ideologically differed ruling parties (UNP and SLFP) adopted different policies to create employment opportunities.

Table: 2.3 Employment

		As a % of Labour force by Sex						
Year	Total (000)	Male	Female	Agriculture, Hunting & Forestry	Manuf-acturing	Mining & Quarrying	Const-ruction	Services
1963	3200	84.7	80.0	52.6	9.1	0.3	2.7	35.3
1968-69	3610	88.8	79.9	n.a.	n.a.	n.a.	n.a.	n.a.
1971	3649	85.7	68.9	50.1	9.2	0.4	2.9	37.4
1973	3767	86.3	73.2	n.a.	n.a.	n.a.	n.a.	n.a.
1975	3973	85.7	66.9	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Central Bank of Sri Lanka (1998)

Since independence, employment generation for the growing labour force has been a major problem confronted by successive governments in Sri Lanka. Though great emphasis was placed on employment creation through large-scale industrialization and expansion of small-scale industries and agricultural development during the first Economic Plan (1959 - 1968) for the country, it did not materialise due to increased government expenditure, the deterioration of foreign reserves and the stagnation of the private sector. Again the Five - Year Plan (1972 - 1976), placed greater emphasis on the employment generation in agriculture, industry, construction and services sectors. However, as in the case of the previous plan, domestic and external factors contributed to the failure of the Plan and unemployment was at historic high (24 per cent) in 1973. During the pre liberalization regime, more than half of the population depended in the agriculture, hunting and forestry for their employment. Sri Lanka placed great emphasis on developing peasant agriculture since independence and traditionally a significant portion of population engaged in plantation sector.

At the sometime, a significant portion of population engaged in the services sector while other sectors such as manufacturing, mining and quarrying and construction played a marginal role in providing employment opportunities. Sri Lanka's higher literacy rate continued to be an important factor to induce people to find a job in the services sector related activities. At the same time, since the Government followed colonial economic policy without major fundamental changes during the early years of independence, the industry sector (manufacturing, mining and quarrying and construction) was not in the forefront of the agenda. Even in the import substitution regime, Sri Lanka was depending on imports to pursue import substitution strategy. As composite effects, the industry sector did not grow drastically during the pre liberalization regime. Therefore, the industry sector played a less role in creating employment opportunities.

It is important to note that as a percentage of Labour force, male participation in the employment was greater than that of female during 1963 - 75 and employment among males had increased marginally but declined drastically among females during the same period. Higher literacy rate and domination of the agriculture sector discouraged females to find a job in agriculture related activities. As a result, female participation was less than that of male in the employment. Stagnation of the industry sector was one of the main reasons for the decline trend of female participation in the employment opportunities.

2.6.5 Unemployment

High rates of youth unemployment are seen as a tremendous waste of an important national resource which impinges adversely on the economic performance and social welfare of any nation. However, eradication of unemployment has been considered as the biggest challenge before the development process of a developing country like Sri Lanka. Since human resources are crucial to building the economy, economic growth rate of Sri Lanka would be accelerated if Sri Lanka utilized its lobour reserves effectively. And employment generation would be a powerful instrument to eradicate poverty and curtail social unrest.

Table: 2.4 Unemployment

Year	Total No ('000)	As % of Labour Force Male	As % of Labour Force Female	Unemployment Rate
1963	265	15.3	20.0	16.6
1968/69	559	11.2	20.1	14.3
1971	839	14.3	31.1	18.7
1973	793	13.7	26.8	18.3
1975	984	14.3	33.1	19.7

Source: Central Bank of Sri Lanka (1998)

Even though time series data are not available for unemployment in Sri Lanka between 1948 and 1977, data have been collected for different periods. According to table 2.4, unemployment was a severe problem during the sixties and seventies. Unemployment was higher during the dirigiste regime (1963,1971,1973 and 1975) than during the partial liberalized regime (1968 - 69). Notably, the unemployment was very much higher among educated youths in the mid 1970s and was the main reason for an insurgency in 1971 in the southern part of Sri Lanka.

2.6.6 Inflation

There are four main indicators to measure inflation in Sri Lanka viz., the Colombo Consumers' Price Index[9] (CCPI), which is the official cost of living index, the Greater Colombo Consumers' Price Index[10](GCPI), the Wholesale rice Index[11] (WPI) and the implicit Gross Domestic Product Deflator[12](GDPD).

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9 CCPI is computed monthly by the Department of Census and Statistics (DCS) and retail price data are collected from seven markets within the Colombo Municipal area.

10 GCPI commenced in 1989 and price data are collected in 14 markets, including 7 markets in the Colombo Municipality and other 7 markets in the Greater Colombo area. Since GCPI commenced in 1989, it has not been included in table 2.6

11 WPI is computed by the Central Bank of Sri Lanka since 1974 and the weights of this index are based on a product share of the total value of domestic production and imports in the calander year 1974. Since WPI commenced in 1974, it has not been included in table 2.6

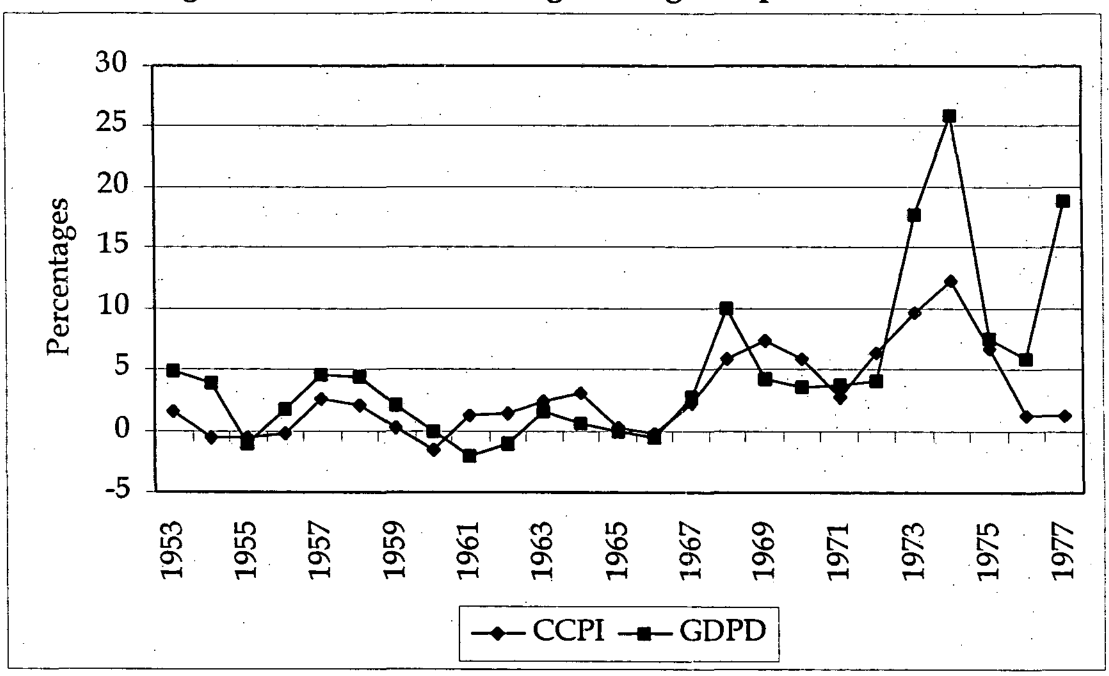
12 GDPD is implicit in National Account statistics and has the widest coverage of all indicators. This series has been computed by splicing several series of implicit GDP deflators obtained with different base years. See Central bank of Sri Lanka annual report (2003) (special statistics appendix-Table 10)

Table : 2.5 Inflation

Year	Inflation (CCPI)	Inflation (GDPD)	Year	Inflation (CCPI)	Inflation (GDPD)
1952	-	-	1965	0.3	0.0
1953	1.6	4.9	1966	-0.2	-0.6
1954	-0.5	3.9	1967	2.2	2.7
1955	-0.6	-1.1	1968	5.8	10.0
1956	-0.3	1.8	1969	7.4	4.2
1957	2.6	4.5	1970	5.9	3.5
1958	2.1	4.3	1971	2.7	3.7
1959	0.2	2.1	1972	6.3	4.1
1960	-1.6	0.0	1973	9.6	17.6
1961	1.3	-2.0	1974	12.3	25.9
1962	1.4	-1.0	1975	6.7	7.5
1963	2.4	1.5	1976	1.2	5.9
1964	3.1	0.6	1977	1.2	18.8

Sources: Department of Census and Statistics and Central Bank of Sri Lanka

Figure 2.5 Annual Percentage Changes in price Indices



Legend:

CCPI= Colombo Consumers' Price Index , GDPD= Gross Domestic Product Deflator Sources: Table: 2.5

The period 1953-66 is viewed as a low inflation regime. During this period, the average annual inflation reflected in the CCPI was only 0.8 per cent and GDP deflator also reflected a similar trend with 1.4 per cent average of annual inflation during the corresponding period. However, the 1967 - 77 period witnessed a moderate inflation with double-digit rate of inflation in certain years, for example 1973 and 1974, in this period. The devaluation of rupee in 1967 and the subsequent increase in import prices, increased money supply and the first oil price hike of 1973 - 74 were the reasons for this spurt in inflation.

Notably, the inflation level reflected by GDP deflator showed a higher increase than the CCPI. The reason was that the CCPI has larger weights for items, which were subsidized, and subject to price controls. As clear evidence, there was a sharp difference between these two indices in 1973 - 75 in which period the country experienced the first oil price shock when price controls were enforced to keep the prices in control. Thus significant repressed inflation existed in the economy, which was captured more accurately by the GDP deflator.

2.6.7 Investment, Saving and Imbalance

This section intends to analyze the performance of investment and saving during the pre liberalization era. In addition, the magnitude of imbalance between investment and saving and the financing of investment also are analyzed.

2.6.7.1 Investment

Investment is the critical component in determining the total out put of an open economy i.e., (Y=C+I+G+XM). Investment is generated by two sectors viz., the Government sector and the private sector. If private sector failed to provide enough investment for capital formation, the Government could intervene to maintain investment at sizable proportions of GDP by increasing public investment. In Sri Lanka, though the private sector played a key role in capital formation, the Government also had almost constant proportion in the rate of investment over the period.

Table: 2.6 Investment (at market prices)

Rs.Million

Year	Private Investment	Percentage of GDP	Government Investment	Percentage of GDP	Total Investment	Rate of Investment [13]
1959	799	12	314	5	1113	17
1960	675	10	303	5	978	15
1961	707	10	395	6	1102	16
1962	677	9	403	6	1080	15
1963	772	11	388	5	1160	16
1964	777	10	336	4	1113	14
1965	610	8	403	5	1013	13
1966	842	10	353	4	1195	14
1967	931	10	446	5	1377	15
1968	1168	11	531	5	1699	16
1969	1748	15	505	4	2253	19
1970	1981	15	608	4	2589	19
1971	1662	12	736	5	2398	17
1972	1808	12	830	5	2638	17
1973	1874	10	654	4	2528	14
1974	2661	10	1474	6	3735	16
1975	2637	10	1503	6	4140	16
1976	2926	9	1970	7	4896	16
1977	3404	9	1855	5	5259	14

Source: Central Bank of Sri Lanka, Various Annual Reports

The slow growth of the economy coincided with the low rate of investment during the pre liberalization period. Except a brief interlude of partial liberalization during 1965 -70, the policy environment after 1960 was not favorable to private investment. During the early years after independence, Sri Lanka's investment policy centred on peasant agriculture. Investment in education, health, power and transportation also received higher priority. At the same time, although industrial development was left to the private sector, the public sector dominance discouraged private investment. The nationalization programme of the early 1960s and stringent tightening of imports and exchange controls to contain a growing balance payment deficit mainly discouraged private investment. On the other hand, foreign exchange

[13] Rate of Investment mean total investment as a percentage of GDP, See Central Bank annual report 2003, page 77

earning declined and getting external borrowing was also difficult due to the anti western stance of the government till the partial liberalization, which was introduced in 1965. These factors affected the government's investment till 1966.

However, the Development programme introduced in 1966 encouraged private investment. The relaxation of trade and exchange controls also contributed an increase in private investment. As a result, as a percentage of GDP, the private investment increased continuously (from 8 per cent in 1965 to 15 per cent in 1970 but declined to 12 in 1971) till the introduction of closed economic policy in 1971. Meanwhile, many public corporations were established to produce manufactured goods, steel, mining and chemicals during this period. As a result, the rate of investment had increased during the same period.

A virtually closed economic policy regime had a severe impact on domestic investment during 1970 - 77. The scarcity of external resources compelled a restrictive policy with regard to the importation of industrial raw materials and placed heavy emphasis on import substitution. The threat of nationalization of private institutions and the land reforms of 1972 discouraged private sector investment. Although the government's investment was increasing moderately during this period, that was not enough to counterbalance the declines of private investment. The outcome was a continuous decline in the rate of investment.

2.6.7.2 Saving

Almost throughout the pre liberalization regime, Sri Lanka experienced sluggish growth of investment due to the inadequate mobilization of domestic savings. Domestic saving ratio registered a marked decline since the early 1960s. Except 1970 and 1971, this declining trend lasted till 1976. Exceedingly buoyant consumption pattern of both public and private sectors contributed for the decline of domestic savings. A basic reason for this buoyancy of consumption expenditure was the effect of the two export booms (The Korean war boom and tea boom) on the consumption habits of the people (Atapattu, 1997). National savings failed to compensate for the shortfall of domestic savings, as Sri Lanka was a net exporter of long-term capital during this period.

Table: 2.7 Saving

Rs.Million

Year	Domestic Savings	National Savings	Net Private Transfer	Domestic Savings[14] Ratio (% of GDP)	National Savings[15] Ratio (% of GDP)	Rate of Investment
1959	950	860	-56	14.8	13.4	17
1960	785	711	-31	11.7	10.6	15
1961	1045	976	-30	15.2	14.2	16
1962	990	913	-30	14.2	13.1	15
1963	1048	960	-30	14.2	13.0	16
1964	959	881	-36	12.3	11.3	14
1965	1043	1011	-24	12.9	12.5	13
1966	900	842	-26	10.8	10.1	14
1967	1084	1003	-24	12.0	11.1	15
1968	1383	1318	-13	12.9	12.3	16
1969	1520	1415	-7	13.0	12.1	19
1970	2282	2050	-5	16.7	15.0	19
1971	2248	2065	-20	16.0	14.7	17
1972	2455	2257	-26	16.1	14.8	17
1973	2301	2116	2	12.5	11.5	14
1974	1949	1783	-2	8.2	7.5	16
1975	2153	1967	19	8.1	7.4	16
1976	4198	1357	56	13.9	4.5	16
1977	6590	6444	122	18.1	17.7	14

Source: Central Bank Reports-Various Issues

The national saving ratio averaged 11.9 per cent over the period 1959 - 77 as compared to the domestic saving ratio of 13.3 per cent. One important thing should be noted here that the domestic saving ratio had been greater that than that of national saving, because net foreign transfer had been negative

[14] Domestic savings include both private and government savings (Central Bank report-2003, page 77)

[15] National savings include domestic savings, net foreign private transfer and net Factor Income from Abroad (Central Bank report-2003, page 77)

throughout the period except the late 1970s. At the same time the investment ratio averaged 15.7 per cent during the same period. National savings, which continued to deteriorate until the end of the 1960s, showed a sharp increase in 1970 and 1971, but declined thereafter to the lowest level of 8.1 per cent in 1975. The trend of national savings clearly explains the volatility and the low level of investment. Although the government placed emphasis on increasing domestic savings ratio through growth of output, that did not materialise due to the poor performance of the economy.

Since 1956, stringent state control led to the sluggish growth in the private sector savings. Therefore the greater part of the responsibility for mobilizing resources for investment devolved on the public sector. Far from playing this role, the public sector, in fact, diverted a part of private savings into government consumption. The surplus resulting from the excess of government revenue over recurrent expenditure and the surpluses of public enterprises are the sources of public savings. The low economic growth and the narrow tax base restricted public revenue growth. Public expenditure tending to favour social welfare items pushed up public consumption expenditures. There were major constraints on public finances, which ruled out surpluses in the government current account. The outcome was that the contribution to domestic savings from the public sector was almost zero throughout the period.

2.6.7.3 Imbalance

With regard to the imbalance between the investment ratio and the domestic saving ratio, two important things should be noted. One is that it is preferable if a country maintained the imbalance at very low level. That will imply a sustainable condition of the economy in which investment is financed through domestic savings. The second point is that both the investment ratio and the domestic saving ratio should be maintained at higher level. In Sri Lanka, although the imbalance was very marginal, the investment ratio and the domestic saving ratio were not enough to achieve a bullish growth during the pre liberalization period.

Table: 2.8 Imbalance (Annual Averages: Rs. Million Except colums4&6)

Year	GDP	Total Investment	Investment Ratio	Domestic Savings	Domestic Saving Ratio	Imbalance
1959-63	6871	1087	15	964	14	1
1964-68	8794	1279	14	1074	12	2
1969-73	14612	2481	16	2161	14	2
1974-77	29240	4508	15	3723	12	3
1959-77	59517	9355	15	7922	13	2

Source: Central Bank of Sri Lanka, Annual Report (Various issues)

As can be seen in Table 2.8, there was no significant change in the investment ratio and it remained at nearly 15 per cent throughout the pre liberalization regime. On the other hand, domestic savings also accounted for around 13 per cent during the corresponding period. Therefore, the macro imbalance, with regard to investment financing, was very marginal and it was only 2 per cent of GDP. This gap was financed mainly through external aid and foreign borrowing. Though this narrow imbalance between investment and domestic savings provided sustainable and stable conditions for macro economy, low levels of investment and domestic saving did not provide enough capital formation in this period. And thus Sri Lanka experienced very low levels of GDP growth during the pre liberalization period.

2.6.8 Income distribution

Income inequality is of fundamental interest not only to economists, but also to other social scientists (Thorbecke, and Charumilind, 2002). Income inequality can have harmful repercussions on the economy, because as Barro (1999) argued inequality of wealth and income motivates the poor to engage in crime, riots, and other disruptive activities. The participation of the poor in crime and other anti-social actions represents a direct waste of resources because the time and energy of the criminals are not devoted to productive efforts. Defensive efforts by potential victims represent a further loss of resources. Moreover, the threats to property rights deter investment. Through these various dimensions of socio-political unrest, more inequality tends to reduce the productivity of an economy and retards growth in poor countries. In 1971, JVP led educated unemployed youths engaged in an insurrection against the government. Henceforth, the Government compelled to initiate several programmes, including land reform, with the view to reducing income inequality. Apart from these initiatives, free education, free health and other welfare programmes were implemented. These Social welfare policies adopted by successive governments have helped to enhance human development and facilitated a certain degree of income redistribution from the rich to the poor thus reducing income inequality (Colombage, 1998).

Table : 2.9 Income Distribution

Income Group	**1953**	**1963**	**1973**
Poorest 40%	14.50	14.66	19.29
Middle 40%	31.70	33.03	37.76
Richest 20%	53.80	52.31	42.95
Gini Coefficient	0.46	0.45	0.35

Source: Central Bank of Sri Lanka (1998)

As the data in Table 2.9 show, the richest 20 per cent of income receivers received 53.8 per cent of the total income in 1953 but this declined to 42.95 per cent in 1973. On the other hand, the poorest 40 per cent of income receivers increased their share in the total income from 14.5 per cent in 1953 to 19.29 percent in 1973. As a whole, the Gini Coefficient declined from 0.46 in 1953 to 0.35 in 1973. This shows a marked decline in income inequalities during the nearly two and half decades period. Though the welfare programmes, particularly food subsidies, continued to implement for a long time, a major reform effort in the form of nationalization of estates, land reform and stringent price controls contributed significantly to the decline of income inequality in 1973. The closed economic regime had witnessed sharp increases in real incomes of a wide cross section of the society. But this type of stringent redistributive policies did not implement during the pre 1970 period and as a result the Gini coefficient was higher than that of 1973.

2.6.9 Budget Deficit and Financing

The budget is a summary of government revenue, expenditure and resource mobilization for financing the deficit. When the government's expenditure exceeds the revenue, there will be a budget deficit, which could be financed through borrowings from both domestic and external sources.

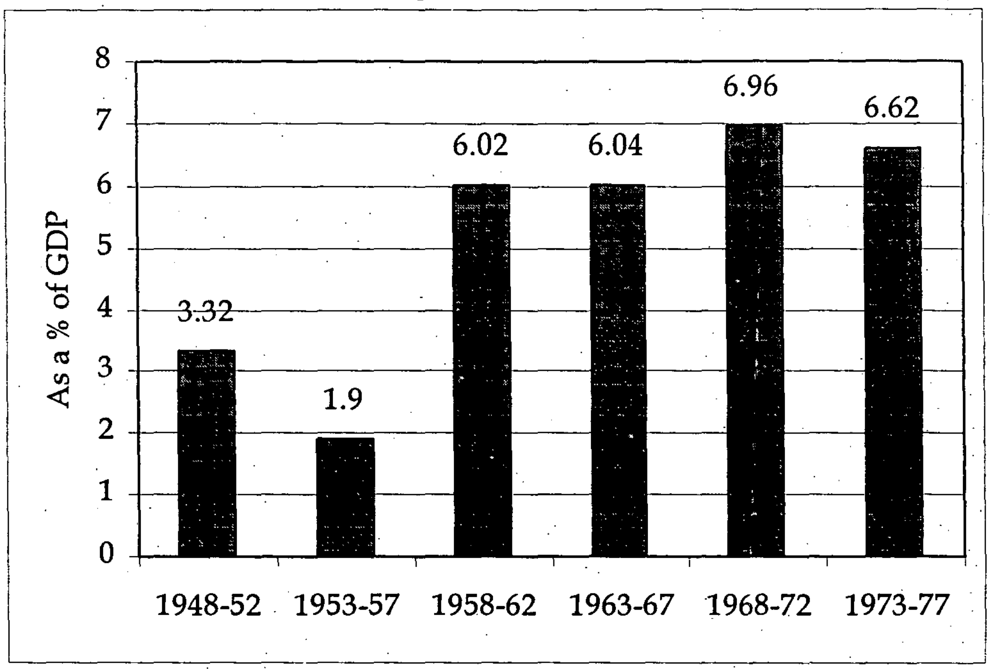
Table 2.10 Budget Deficit and Financing Values in Rupees Million

			Financing				
Year	Overall Budget Deficit (Before Grants)	As % of GDP	Foreign loans	Foreign Grants	Domestic Financing	Foreign Financing (as a % of overall deficit-after grants)	Domestic Financing (as a % of overall deficit-after grants)
1948	48	1.7	0	0	48	0.0	100.0
1949	109	3.6	0	0	109	0.0	100.0
1950	163	4.2	0	0	163	0.0	100.0
1951	50	1.1	0	0	50	0.0	100.0
1952	269	6.0	0	7	263	0.0	100.0
1953	238	5.3	0	3	234	0.0	100.0
1954	-5	-0.1	63	19	87	***	*****
1955	-91	-1.7	12	26	129	***	*****
1956	66	1.3	5	23	37	11.9	88.1
1957	245	4.7	19	11	216	8.1	91.9
1958	222	4.0	20	13	189	9.6	90.4
1959	413	6.4	30	18	365	7.6	92.4
1960	418	6.3	24	9	385	5.9	94.4
1961	462	6.8	10	13	439	2.2	97.8
1962	456	6.6	35	18	403	8.0	92.0
1963	392	5.4	61	31	300	16.9	83.1
1964	462	6.0	64	32	366	14.9	85.1
1965	430	5.3	76	24	331	18.7	81.5
1966	566	6.8	77	42	448	14.7	85.3
1967	607	6.7	189	19	398	32.1	67.7
1968	715	6.7	161	29	525	23.5	76.5
1969	788	6.7	334	20	434	43.4	56.4
1970	936	6.9	163	63	710	18.7	81.3
1971	1084	7.7	175	60	849	17.1	82.9
1972	1035	6.8	209	75	752	21.7	78.3
1973	992	5.4	132	47	813	14.0	86.0
1974	1035	4.4	126	252	657	16.1	83.9
1975	2102	7.9	310	404	1388	18.3	81.7
1976	2913	9.6	591	367	1956	23.2	76.8
1977	2127	5.8	754	501	872	46.4	53.6

Sources: Central Bank of Sri Lanka (Various Annual Reports)

Except for 1954 and 1955, Sri Lanka continued to experience budget deficit since independence. The capital expenditure had declined in 1954 and 1955 and current expenditure also declined in 1955. On the other hand, current revenue (tax and non tax) increased during the said period. These were the main reason for the budget surplus.

Figure: 2.6 Overall Budget Deficit as a Percentage of GDP



Source: Table 2.10

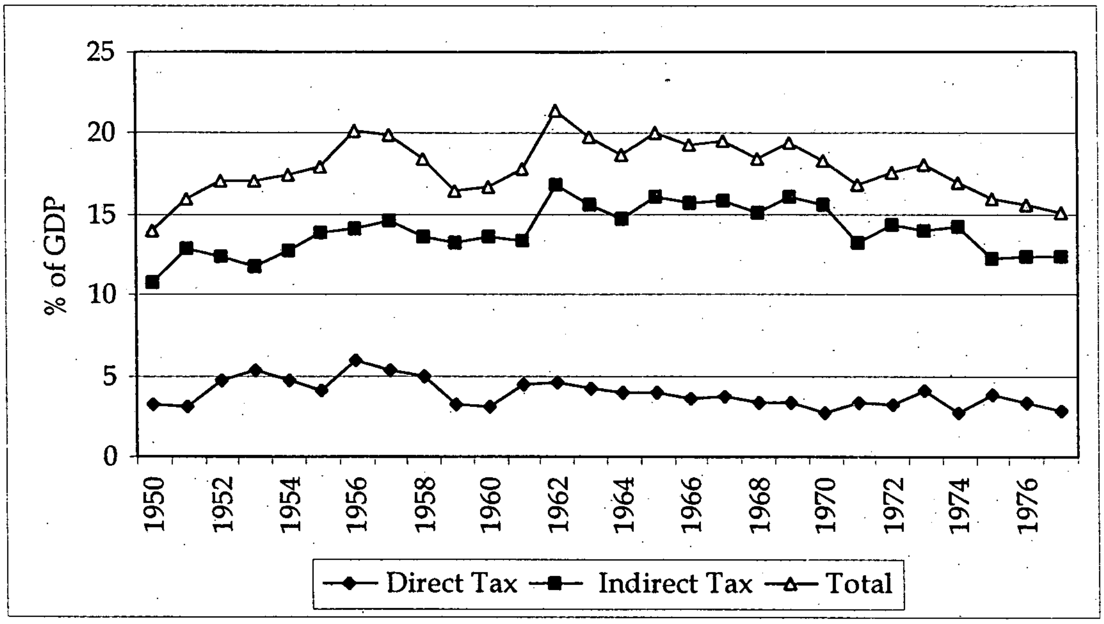
In Sri Lanka, increased government involvement in the economic activities led to a sharp increase in government expenditure and higher budget deficit during the pre liberalization regime. Except for 1954 and 1955, Sri Lanka had a deficit budget for the entire period of 1948 - 77. Importantly, deficit financing had been more through domestic sources than external sources.

The role of foreign financing started to increase from the mid 1970s. The reason was that the SLFP government managed to get financial assistance from the left block, particularly from China, in the form of foreign aid and concessional loans in that period.

2.6.10 Tax - GDP Ratio

In a developing country like Sri Lanka, an efficient taxation system has several important functions to perform in an economy. Its main function is to raise revenue for the government for its public expenditure. The second function is to reduce inequalities through a policy of redistribution of income and wealth. Third, the tax system is also used for social puposes such as discouraging certain activities (for example excess duties on liquor and tobacco), which are considered undesirable.

Figure: 2.7 Tax - GDP Ratio



Sources: Central Bank of Sri Lanka (Various Annual Reports)

In developed countries, direct taxes constitute a significant role while indirect taxes play a relatively less significant role. In contrast, in the developing countries the case is quiet opposite. In Sri Lanka, the Direct tax (such as income tax) played an insignificant role in the revenue front of the economy. It averaged only 3.9 per cent in the GDP during the pre liberalization regime. On the other hand, though the indirect tax (such as taxes on international trade and on domestic goods and services) played a greater role than the direct tax, it accounted 13.9 per cent (on average) of GDP during the same period. As result, the total tax revenue was almost less than 20 per cent of GDP and averaged 17.9 per cent of GDP during the 1950 - 77 period.

2.6.11 Balance of Payments[16]

During the early years after independence, Sri Lanka enjoyed a balance of payment surplus (owing to current account surplus) due to the rubber and tea price booms. This comfortable position enabled the country to maintain an open trade and payments system with larger consumer subsidies. However, the balance of payments started to deteriorate in the late 1950s due to increased imports prices and declines in the terms of trade. In addition, there were no compensatory movements in export volume to counterbalance escalating import prices. As a result, a balance of payments deficit was inevitable. Whenever the external deficit became a serious problem, the Government tried to restrict the fiscal deficit. On most occasions, either welfare expenditures or capital expenditures became targets of adjustment.

However, the transfer of power from the UNP to the SLFP in 1956 aggravated the balance of payments situation due to the commitment of the SLFP for strong welfare expenditures. On the monetary policy front, the interest rates were maintained at a low level with the view to providing low cost credit to the government. But this low interest rate discouraged saving (particularly in 1960), reduced the efficiency of investment and encouraged consumption. All these developments led to balance of payments imbalances and to a hasty decline of external assets during the 1960s.

During the 1965 - 70 period, the UNP regime initiated various steps to find a sustainable solution to the balance of payments problems. The Open General Licence system, exchange rate reforms and Bonus Voucher Scheme are some important measures taken by the government with the view to promoting exports. In addition, a dual exchange rate system - FEECS - was introduced

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16 Consist two broad areas i.e., current account and capital& financial account

with the view to promoting non-traditional exports and to curtailing non-essential imports. All these measures were considered to be important to reduce the balance of payments deficit. Besides, foreign aid and other foreign capital flows were very important to finance the balance of payments deficits.

Again government power went to the hands of SLFP in 1970. During 1970 - 77, the country faced several internal and external shocks such as the insurrection of the JVP in 1971,the first oil shock of 1973,sharp deterioration of TOT and a drastic decline in agricultural production owing to severe drought. Apart from these developments, SLFP government had disagreements with international monetary institutions on domestic economic policy maters and as a result the government was unable to get significant financial aid from these institutions. Under these circumstances, the government tightened the restrictions on trade and payments to meet the balance of payment crisis. As a result, the balance of payments achieved a surplus in the later part of 1970s. This strength in the balance of payments was achieved at the high cost of severe hardship for the people in the form of scarcities and unemployment (Samararatne, 1997).

Table: 2.11 Balance of Payments

Year	Current Account Balance [17]	As a % of GDP	Capital & Financial Account Balance [18]	As a % of GDP	Overall Account Balance	As a % of GDP
1950	28.8	3.5	-4.6	-0.6	35.0	4.3
1951	18.7	1.9	-8.6	-0.9	19.6	2.0
1952	-93.6	-9.9	5.3	0.6	-79.3	-8.4
1953	-33.2	-3.5	-8.2	-0.9	-44.6	-4.7
1954	64.3	6.4	4.4	0.4	66.8	6.7
1955	67.8	6.2	-10.3	-0.9	58.5	5.3
1956	17.2	1.6	-2.3	-0.2	10.9	1.0
1957	-40.9	-3.7	-3.1	-0.3	-46.2	-4.2
1958	-32.1	-2.8	3.6	0.3	-32.7	-2.8

17 Component of the current account balance are trade balance, services & income (net) and transfer (net)

18 component of the Capital & Financial Account Balance are long term capital (net)-direct investment- other private capital and government capital-and short term capital (net)

1959	-43.7	-3.2	12.8	0.9	-29.8	-2.2
1960	-46.2	-3.3	0.4	0.02	-40.3	-2.9
1961	-19.7	-1.4	6.5	0.5	-16.5	-1.1
1962	-29.1	-2	8.6	0.6	-14.2	-1.0
1963	-35.3	-2.3	16.8	1.1	-16.8	-1.1
1964	-33.6	-2.1	7.1	0.4	-26.6	-1.6
1965	12.2	0.7	8.8	0.5	19.7	1.2
1966	-60.9	-3.5	15.7	0.9	49.0	-2.8
1967	-59.2	-3.2	36.0	1.9	87.9	4.7
1968	-59.6	-3.4	33.9	1.9	-29.4	-1.7
1969	-133.9	-7.0	75.1	3.8	-53.2	-2.8
1970	-58.8	-2.6	56.6	2.5	-7.0	-0.3
1971	-36.4	-1.5	70.4	3	32.9	1.4
1972	-32.8	-1.3	42.4	1.7	69.5	2.7
1973	-25.1	-0.9	67.3	2.3	45.9	1.6
1974	-136.4	-3.8	83.6	2.3	-57.0	-1.6
1975	-111.4	-2.9	58.2	1.5	10.4	0.3
1976	-5.8	-0.2	70.3	2	118.3	3.3
1977	144.1	3.5	36.7	0.9	360.9	8.8

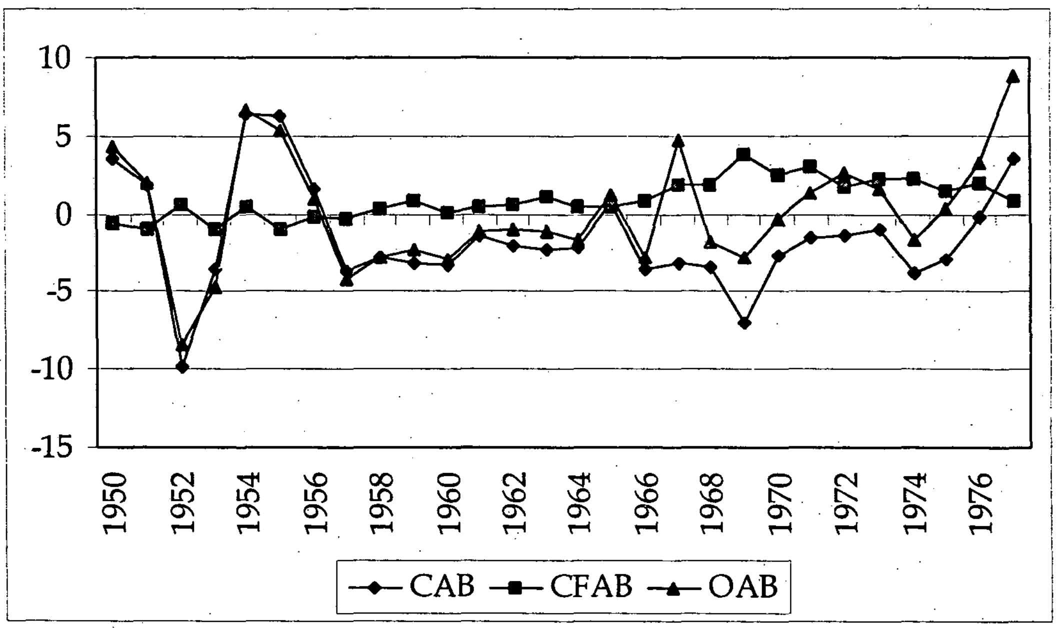
Sources: Central Bank of Sri Lanka (Various Annual Reports)

During the early years after independence, commodity exports accounted for more than 90 per cent of total foreign exchange receipts and the level of reserves was comfortable but was declining. Two price booms in the first seven years after independence helped to strengthen the level of reserves. However, the balance of payments started to deteriorate in the late 1950s due to increase imports and declines in the term of trade. During the 1960s and early 1970s the trade account was continuously in deficit due to its vulnerability to only three primary agricultural exports and heavy dependence on essential consumer imports. This, coupled with the net outflows on services and transfers, led to continuous deficits in the current account. In the mid 1970s, although the trade account remained in deficit, the improvement in the services account with the impact of nationalization of many economic activities and the improvement in the transfers account to a net inflow, led to a decline in the current account deficit.

During the early years of independence the capital account was in deficit, with private direct investment outflows and other private capital outflows far exceeding long-term inflows to the government. With nationalization of many economic activities and the inward oriented policies in the 1960s, private capital flows declined virtually to a trickle. The only significant capital flows during that period comprised foreign loans to the government mainly on account of bilateral aid. By the mid 1960s, the country was able to obtain foreign assistance from donor countries. This helped to alleviate the shortage of goods in the economy and assistance was obtained from the IMF in the form of stand - by arrangement and compensatory financing.

Nevertheless, these policy measures failed to achieve an overall improvement in the balance of payments except for a small current account surplus and overall surplus in 1965. as a whole Sri Lanka experienced unfavorable balance of payments, except few years, throughout the pre liberalization periods.

Figure:2.8 Balance of Payments



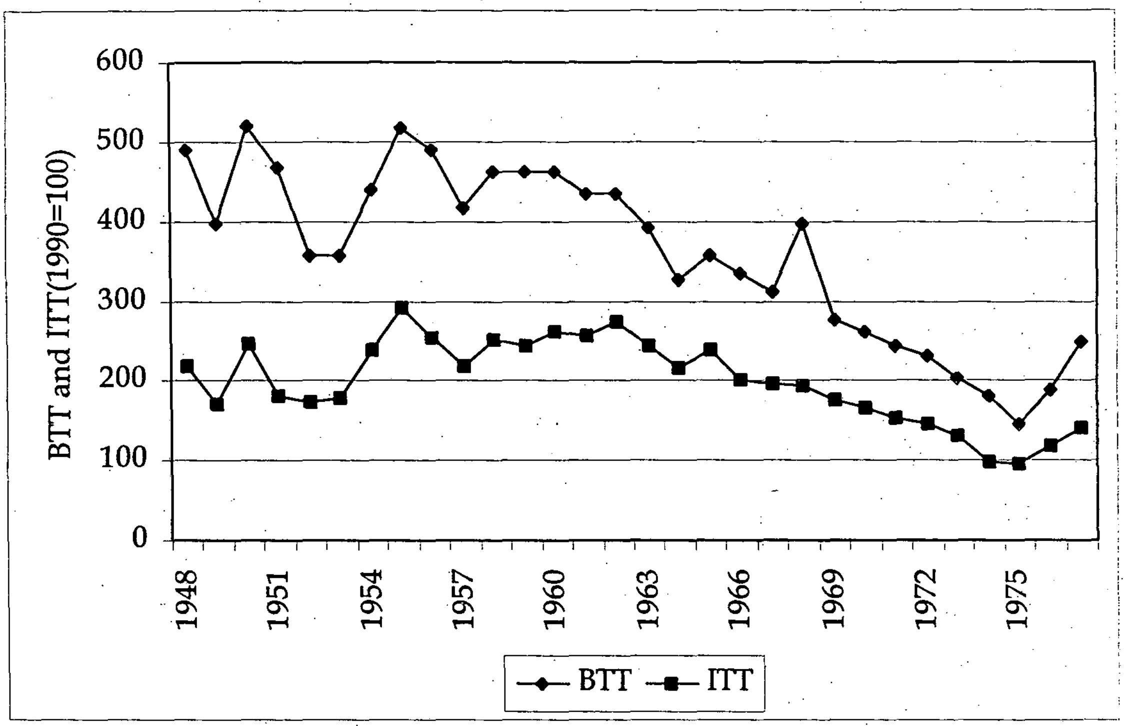
Source: Table 2.11

2.6.12 Terms of Trade (TOT), 1990=100

Sri Lanka is a classic case, which can be used to support the well-known structuralist hypothesis of secular deterioration of the TOT of developing countries (Samararatne, 1997). Like other most developing countries, Sri Lanka has suffered from prolonged unfavorable terms of trade during the three decades periods, from 1948 to 1977. Here the trend of the both Barter

Terms of Trade (BTT) and Income Terms of Trade (ITT)[19] are analyzed with the view to examine the ratio of export to import price (BTT) and import purchasing power of export earning (ITT).

Figure: 2.9 Barter Terms of Trade (BTT) and Income Terms of Trade (ITT) (1990=100)



Source: Source: Central Bank of Sri Lanka (Annual Reports, Various Issues)

BTT was most favourable in the fifties due to the rubber price hike during the period of the Korean War (1950 - 51) and the ensuing world tea boom (1954 - 55). According to compound rate of growth[20], BTT fell by 0.13 per cent between 1948 and 1957 despite these favourable price booms. During the sixties and till the mid seventies, except 1968,1976 and 1977, the BTT was deteriorating continuously. And it fell by 4.8 per cent and 6.4 per cent during 1958 - 67 and 1968 - 77 respectively.

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19 BTT=[Px/Pm]×100 (the ratio of export to import price) and ITT==[QxPx]/ Pm (import purchasing power of export earning), where Px and Pm are price indices of exports and imports, and Qx is an index of export volume (Athukorala, 2004)

20 Compound (over a period of time) rate of growth can be calculated from $\beta_2 = \ln(1+r)$ by taking the antilog of the estimated β_2 and subtracting 1 from it and multiplying the difference by 100 (Gujarati, 2003, page.180).

Sri Lanka experienced several TOT shocks during 1968-77 i.e., the first oil price hike of 1973-75 and price boom for Sri Lanka's major primary exports in 1976 - 77. Sri Lanka's two major exports viz., tea and rubber were among the commodities, which experienced sharpest falls in price in the world market, except during the Korean War boom of 1950 - 51 and the tea boom of 1954 - 55. Though a worldwide commodity price boom of 1976 - 77 adversely affected the import bill, the unfavorable implication of this situation was partly offset by higher tea, rubber and coconut prices. However, during 1948 - 77, as a whole, the BTT deteriorated by 3.3 per cent, according to annual compound rate.

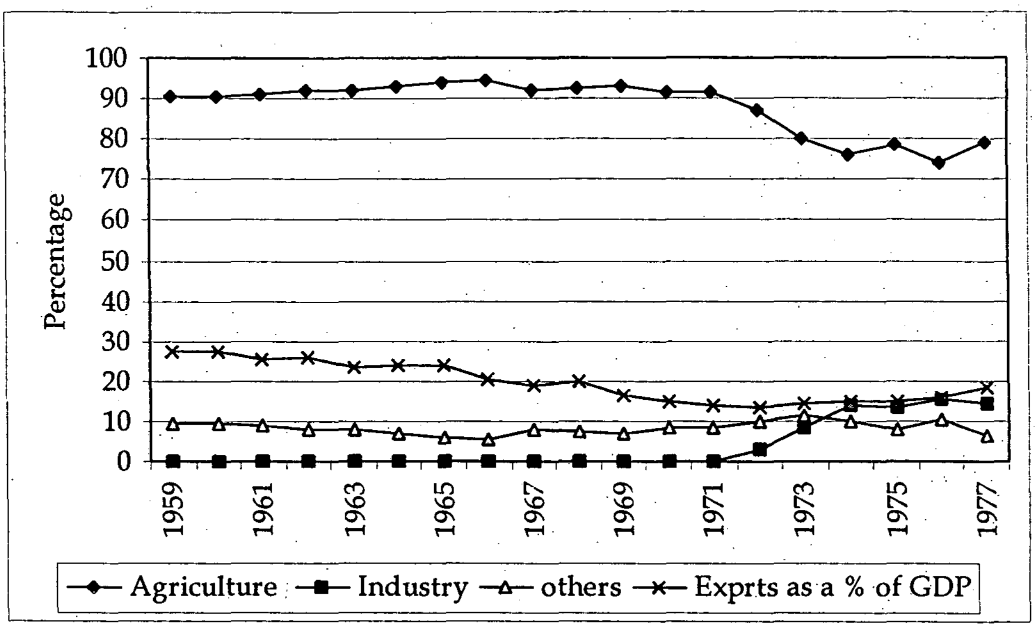
Meanwhile, during the ten years period from 1948 to 1957, the ITT recorded annual compound rate of 2.7 in contrast to the 0.13 per cent deterioration of BTT during the same period. But during the next ten-year period from 1958 to 1967, the ITT deteriorated by 2.8 per cent in contrast to 4.8per cent decline of BTT during the same period. This scenario continued to the next ten-year period because during 1968-77 the ITT deteriorated by 5.8per cent while BTT declined by 6.4 per cent during the same period. As a whole, ITT deteriorated by 2 per cent against 3.3 per cent deterioration of the BTT during 1948 - 77.

Due to the anti- export bias inherent in the import-substitution policy regime of 1956 - 65 and 1971 - 77, the fear of nationalization that pervaded the plantation sector from the late 1950s and the dismal performance of state-owned plantation companies following nationalization in the early 1970s, there was no significant volume growth to counterbalance adverse price trends (Athukorala and Jayasuriya, 1994). If the volume of exports had increased, the deterioration of BTT could have been counterbalanced thorough positive ITT which, however, did not materialize.

2.6.13 Composition of Exports and Exports as a Percentage of GDP

At independence, Sri Lanka, like many other developing countries, highly depended on primary agricultural commodities for exports. These consisted of three-plantation crops viz., tea, rubber and coconut. The dominant position held by the plantation crops lasted until early 1970s. The share of industrial export (textile and garments, food, beverages and tobacco, petroleum products, rubber products ceramic products diamond and jewellery, machinery and equipment etc) started to increase gradually from 1972. Meanwhile, total exports, as a percentage of GDP, declined steadily, albeit with fluctuations, during the pre liberalization era.

Figure: 2.10 Composition of Exports and Exports as a percentage of GDP



Note: (a) Till 1963 agricultural exports include tea, rubber and coconut kernel products, while minor agricultural crops have been categories under other exports.
(b)Till 1971 all industrial exports have been included under other exports.
(c) Includes gem and other mineral products

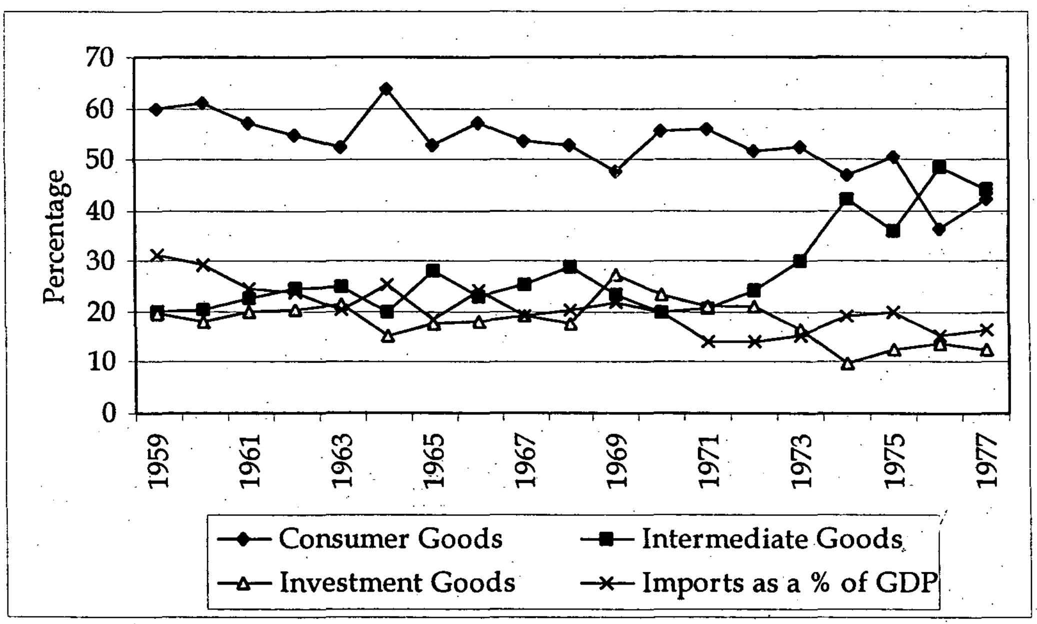
Sources: Central Bank of Sri Lanka (Various Annual Reports)

Agricultural exports dominated in the composition of exports in Sri Lanka till 1971(90.5 per cent in 1959 and 91.5 per cent in 1971). It registered 1.05 per cent annual decline during 1959 - 77(according to compound growth). Industrial exports were very marginal in this period while other minor exports items constituted nearly 8 per cent during the corresponding period. Though the share of agriculture exports started to decline, it dominantly remained as a major export item till the early 1970s. At the same time, the share of industrial exports started to increase gradually at the expense of agricultural exports from 1972 and, on the other hand, other export items accounted for nearly 9 per cent till the late 1970s. Importantly, Total exports, as a % of GDP, declined by 3.8 per cent annually (according to compound growth rate). The decline was drastic during 1970 - 76.

2.6.14 Composition of Imports and Imports as a Percentage of GDP

Sri Lanka's import structure consisted of three major categories viz., Consumer goods (rice, floor, sugar etc), intermediate goods (petroleum, fertilizer, chemical, textile and clothing etc) and investment goods (machinery and equipment, transport equipment, building materials etc). Of these, consumer goods alone constituted more almost 60 per cent of the total imports during the late 1950s. However, the share of consumer goods started to decline gradually with a parallel increase of intermediate goods. Meanwhile, the share of investment goods in imports also fell.

Figure: 2.11 Composition of Import and Imports as a Percentage of GDP



Sources: Central Bank of Sri Lanka (Various annual Reports)

The share of consumer goods further declined to 47.9 per cent in 1969 and reached 42.2 per cent in 1977 while the share of investment goods increased to

27.5 per cent in 1969 and declined to 12.4 per cent in 1977. In contrast, the share of intermediate goods steadily increased to 23.3 per cent in 1969 and reached 44.1 per cent in 1977. According to the compound growth rate, the imports of consumer goods registered 1.7 per cent decline during the 1959 - 77 period. But intermediate goods accounted for 3.8 per cent compond growth during the same period. Meanwhile, the imports of investment goods also registered 2.2 per cent decline in this period. Total imports, as a percentage of GDP, had declined by 3.2 per cent annually during the pre reform period (according to compound growth rate). This decline was drastic during the closed economic regime of 1970 - 77. During this import stringent import substitution regime, the government reduced the imports of consumer and investment goods but in sharp contrast the government was unable to reduce the imports of intermediate goods (mainly petroleum) since the import substitution strategy itself was depending on imports. This was one of the main reasons for the failure of the import substitution strategy in this period.

2.6.15 Trade Dependency [21] 1950 - 77

The trade dependence, according to the Trade Dependence Ratio (TDR), of Sri Lanka has undergone a drastic change between 1950 and 1977.

Table : 2.12 Trade Dependency

Year	Trade Dependency Ratio
1950	70.6
1950-59	68.1
1960-69	41.6
1970-77	32.8

Source: Central Bank Annual reports

As the data in Table 2.12 describes, the TDR declined continuously until 1977. Combined impact of sluggish export performance and stringent import controls contributed to the drastic decline of TDR during the 1960s and 1970s.

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21 The country's dependence on foreign trade, measured by the trade dependence ratio (TDR), is defined as the ratio of the sum of exports and imports to GDP (Pieris, 1997, Page 40)

2.6.16 Social Indicators (Health Indices and Literacy)

Among developing countries, Sri Lanka is often cited as an exceptional case for her excellent achievement in social indicators irrespective of the low level of per capita GDP.[22] The first finance minister of Sri Lanka is reported to have said that about 40 per cent of the government budget was devoted to health, education, food, labour and social services and argued that Sri Lanka may very justly and proudly call itself a social service state (as quoted in Alailima, 1997). Therefore Sri Lanka laid a strong foundation for the improvement of the standard of living of its masses by allocating a significant part of its resources in social welfare programmes, particularly the food ration, education and health services even during the pre independence period. Sen (1985) correctly pointed out that several innovative changes were introduced into social welfare programmes in Sri Lanka in the 1940s, and the momentum of fast expansion was clearly present through the 1950s. The introduction of food subsidies and also of free school meals, rapid expansion of hospitals, etc., took place over that period. These exemplary measures helped Sri Lanka to enjoy a better position in terms of Social indicators among many developing countries even during the 1950s.

Table : 2.13 Health indices and Literacy

Year	Birth Rate (Per '000)	Death Rate (Per '000	Infant Mortality (Per '000 Live Births)	Maternal mortality (Per '000 Live Births	Life Expectancy at Birth (Years) (a)	Health Expenditure/ GDP Ratio	Literacy Rate(a)	Education Expenditure/ GDP Ratio
1946	38.4	20.3	141	n.a.	42.2	n.a.	n.a	n.a
1948	40.6	13.2	92	8.30	-	1.84	58.0	n.a
1953	39.4	10.9	71	4.90	-	1.81	65.4	2.90
1955	37.3	11.0	71	4.10	58.2	1.87	-	2.67
1963	34.1	8.5	56	2.40	61.7	2.15	71.6	4.43
1971	30.4	7.7	45	1.40	65.5	2.09	78.5	4.15
1977	27.9	7.4	42	1.00	-	1.37	-	2.68

(a) Data available only in census years
Sources: Department of Census and Statistics and Central Bank of Sri Lanka

22 For an elaboration of this point see Bhalla (1985)

At the time of independence in 1948, Sri Lanka enjoyed reasonably high living standards-life expectancy of 54 years (which was almost identical to that of Japanese-57.5 years), a literacy rate of 58 per cent and an infant mortality rate of 111 deaths. Even in 1950, Sri Lanka had an impressively low level of infant mortality-77 deaths per 1000 live births. By contrast Philippines had 102 deaths, Thailand 64 and Malaysia 91 deaths. The adjusted school enrollment ratio (primary and secondary school enrolments as percent of population 5-19 years), in Sri Lanka, at 54 per cent was among the highest in the developing world in 1950.[23] This excellent performance of Sri Lanka continued in the following dacades, with continuous improvement in all of these indicators.

As a whole during the import substitution regime Sri Lanka experienced lower growth and inefficiency. Many reasons could be attributed here. Most importantly, Sri Lanka's import substitution strategy itself was depending on imports (mainly petroleum and investment goods). Moreover, Sri Lanka had to experience the most extreme first oil shock in 1973 - 74 and as a result the world prices of commodities experienced a sudden upward movement at around this time. But the increase of world prices had less impact on the primary exports than on the imports of Sri Lanka. Sri Lanka was unable face effectively this external shock due to the sluggish exports performce because Sri Lanka could not maintain comfortable foreign reserves due to its import substitution strategy. At the same time, Sri Lanka was unable to get massive financial inflows. After the land reform and the nationalization of the plantation sector in 1972 the growth of agriculture sector declined drastically. The growth rate fell to - 0.8 per cent in 1973 and averaged 1.2 per cent during the 1970 - 76 period. Inefficiency and mismanagement of the plantation sector contributed to this decline. The growth of the industry sector averaged only 2.7 per cent during this period. As a whole, during the import substitution regime Sri Lanka experienced many macroeconomic problems including low growth, high unemployment and unfavorable terms of trade.

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23 Economic and social indicators' data has been taken from Bhalla (1985)

CHAPTER THREE

The Post Liberalization Regime and the Performance of the Macro Economy

3.1 Post Liberalization Regime in Sri Lanka (Post 1977)

The year 1977 was a watershed in the economic history of independent Sri Lanka. With its sweeping electoral victory (140 of 168 seats), the new UNP government reversed the economic policies from a tightly controlled, inward looking, welfare oriented economic strategy to a more liberalized, outward looking and growth - oriented strategy. This change in policy regime was the result of pressures generated by contemporary changes in both the domestic political economy and the international economic system (Lakshman, 1996[a]). The new Government believed that economic policies pursued since 1970 were responsible for the poor economic performance in the period 1970 - 77 and introduced a package of new economic policies to cure the ailing economy. As Herring (1987) stated, the 1977 elections were largely a referendum on the perceived failures of the 'closed economy' and the champions of a liberalized 'open economy' triumphed decisively.

After the crushing election defeat in 1977, the traditional opposition was in disarray and the decline of the left wing parties was accompanied by a weakening of the trade unions. All these development created a strong sense of political stability which paved the way to the UNP to take the decision of open economic policy (Athukorala, 1995). In addition, there are several reasons for the UNP's attraction towards outward oriented economic strategy. Firstly, during the election campaign, the UNP had promised they would introduce market oriented open economic policy if they came in to power.

Secondly, as Dani Rodrik (1999) noted during the 1950s and 1960s import substitution was in vogue but during the 1970s out ward - orientation was the norm. Moreover, the poor performance of the 1970 - 77 closed economic regime emphasized an alternative economic policy for the Sri Lankan economy. Thirdly, the success of the ASEAN and East Asian economies strengthened the thinking of the policy makers that open economic policy could be a panacea to cure all economic ills, since the export oriented ASEAN and East Asian economies had achieved higher rates of economic growth and higher per capita income than the controlled economies of Asia in that time. The performance of the average annual growth rate of ASEAN and East Asian Countries in 1970 - 75 was far better than that of South Asian controlled economies.

Fourthly, Sri Lanka had to depend on multilateral institutions and western donor countries to get large - scale loans and aid to expedite the development process by boosting large - scale investment. At the same time, USA openly encouraged developing countries to follow free market policies and responded more favorably to private enterprise oriented countries in granting aid (Kelegama 1986). During the 1978 budget debate, the newly elected then President Mr.J.R. Jayawardene is reported to have said as follows:

> The World Bank and IMF came to our aid. They said, 'you go ahead; we will give you cover. Under the money we are giving you, you can free both import controls and exchange controls'.[1]

This President's statement helps us to realize that how far World Bank, IMF and Western donor community influenced on Sri Lanka in formulating liberalization policy. In this context, the Sri Lankan policy makers felt that large - scale financial inflow was essential to achieve bullish economic growth and therefore they felt that liberalization could expedite economic development.

3.2 Salient features of liberalization

The process of liberalization has several salient features as summarized here.

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[1] See Cuthbertson 1997, page 639

3.2.1 The Role of the Government

The Government reduced its involvement in economic activities and encouraged the private sector to play a key role in economic activities. The preferential treatment enjoyed by the public sector came to an end through curtailing monopolies in the public sector such as insurance and telecommunication during 1978 - 83. However, imports of wheat, crude oil and defense related items were kept under state controls. Moreover, greater competition was introduced between the public and private sectors in bus transport. Numerous tax incentives were granted to the private sector and trade restrictions were released with the view to attracting private sectors to play a major role in economic activities from 1978.

However, as Dunham and Kelegama (1994) noted, the role of the state declined in terms of intervention but remained significant in terms of investment (average 6 per cent of GDP during 1977 - 82) to develop the supply side in the long run. Since private sector participation in infrastructure projects was low, the Government undertook several infrastructural projects to support the private sector led development strategy. Special attention was given to the development of the Colombo Sea Port and connection of the major cities via super fast high ways. The National Insurance Corporation and Mahaweli Authority were the public sector institutions established during this period. Activities were expanded in some existing public sector ventures and corporations, such as the Sri Lanka Shipping Corporation (SLSC), Cooperative Wholesale Establishment (CWE) and Ceylon Electricity Board (CEB). Due to the high expenditure on these projects, the public sector share in the economy rose significantly. Even though the Government opened up the bus transport service to the private sector, continuous expansion was made by public enterprises in ports and shipping services.

On the financial sector front, several new public financial institutions such as the National Development Bank (NDB) Regional Rural Development Bank

(RRDB) and the Sri Lanka Export Credit Insurance Cooperation (SLECIC) were established. However due to the growth of private sector banking activities and the abolition of the public sector insurance monopoly in 1985, the relative size of the public sector in the financial sector declined from 78 per cent in 1978 to 60 per cent in 1988[2].

3.2.2 Trade Policy Reforms

Krueger (1984) noted that the enormous success of Europe and Japan in expanding output and raising living standards during the post war era has clearly been related to sustained liberalization of trade and capital flows. Among the developing countries progress has varied markedly, but notably the most successful developing countries maintained liberalized trade and payments regimes, which in turn have been made feasible only by relatively liberal domestic economic policies. In line with her argument, trade reforms were the main elements of the liberalization in Sri Lanka. Elimination of most import controls and replacing them with a tariff system, abolition of price controls, devaluation of currency, incentives for the exports and Foreign Direct Investment and partially liberalized exchange controls were the main elements of the trade liberalization in Sri Lanka.

3.2.2.1 Abolition of Price Control

Domestic price controls on most key commodities (such as rice, wheat flour, sugar, kerosene etc) were abandoned with the view to allowing free market forces to operate. Supervisory and other controls on public enterprises were relaxed allowing them greater freedom to charge economic prices.

3.2.2.2 Relaxation of Controls on Imports

Controls on imports and exchange payments and remittances were relaxed and allowed free imports without controls except in a few items on the basis of a revised and lower tariff structure. The public sector monopoly on imports

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2 See Central Bank of Sri Lanka 1998, page 213

was reduced gradually and by 1997 such controls were limited to crude oil and defense related items that were kept under state control. Trade liberalization was designed to revive domestic industry by free flow of machinery, spare parts and raw materials as well as to stimulate new areas of private business activity. Total imports as percentage of GDP doubled between 1977 and 1978.

3.2.2.3 Rationalization and Simplification of Tariff System

Panagariya (2003) noted that evidence on the direct relationship between trade barriers and income growth has been more controversial but if one must choose a policy variable to allow trade to grow faster, the reduction in trade barriers is likely to be the prime candidate. Sri Lanka also implemented several reforms with regard to the trade barriers in the November 1977 budget.

Firstly, quantitative restrictions of the pre 1977 were removed and a tariff system was implemented. The tariff structure which had rates ranging from 10 per cent to 500 per cent and more than 19 major tariff bands prior to 1977 was reduced to six bands as follows

1977 Six-Band Tariff Schedule

1.	0%	- essential consumer goods
2.	5%	- raw materials, spare parts and machinery
3.	12.5% to 25 %	- intermediate goods
4.	50%	- revenue rate (manufactured consumer goods for revenue purpose)
5.	100%	- protective band (imports under OGL for prevent over importation)
6.	500%	-Prohibitive band (luxury items)

1987 Six-Band Tariff Schedule

1.	0%	- essential consumer goods
2.	5%	- raw materials

3. 10% to 50 %(9 rates) - intermediate band
4. 60% - revenue band
5. 75% to 150%(4 rates)- protective band
6. 250% -Prohibitive band (luxury items)

During the second wave of liberalization from 1989, the tariff structure underwent further drastic changes.

1989 Four-Band Tariff Schedule

1. 5% - raw materials
2 15% - intermediate inputs and semi - finished goods
3. 35% - chemical, their mixtures as industrial inputs
4. 50% - Finished products

Source: Presidential Tariff Commission

Further more, after the implementation of the recommendations of the Presidential Tariff Commission Report a major tariff reform came into effect in 1990. Accordingly, the tariff structure was reduced to 4 bands in 1991 and a three-band tariff structure, 10 per cent, 20 per cent and 35 per cent, was introduced in 1995.

3.2.2.4 Support for Export Industries

An export promotion strategy was introduced with the view to increase output and competitiveness. Export industries were supported by providing generous incentives including tax concessions, duty free imports of raw materials and investment goods, credit facilities at low rates of interest and institutional developments such as the establishment of the Export Development Board, National Development Bank and Regional Rural Development Bank.

3.2.2.5 Encouragement of Foreign Direct Investment through Attractive Incentives

Unprecedented attractive incentives and tax holidays were given to the foreign investors and offshore banking facilities were made available to attract foreign investment. Foreign banks also were invited to open their branches in Sri Lanka. In addition, several other measures were taken to attract foreign investors including i) infrastructure development (construction of Colombo - Katunayake and Colombo - Habarana express ways and electrification programme under Mahawali development programme were initiated); ii) relaxation of the rules and regulations governing repatriation of profits and withdrawal of capital; iii) the relaxation of industry licensing procedures and the opening up of room for approval of 100 per cent foreign ownership of business establishments; iv) constitutional guarantee to foreign investors vis - à - vis repatriation of capital; and v) investment guarantee agreements with a number of investing countries.

3.2.2.6 Unification of Exchange Rate

After the initial devaluation of the Sri Lankan Rupee by 46 per cent from Rs 8.60 to Rs 16 per US dollar in November 1977, the exchange rate was unified[3] and a managed float system was adopted with a view to giving weight to market demand and supply conditions. More over, exchange restrictions on current international transactions were removed gradually with the view to allowing international trade to play a pivotal role in the domestic economy. There was gradual liberalization of foreign exchange for a variety of purposes like medical care, business and holiday travel, membership fees of professional institutions and tuition and registration fees for education.

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[3] A dual exchange rate system was introduced under the name of Foreign Exchange Entitlement Certificate Scheme (FEECS) in May 1968 with the view to encouraging non-traditional exports and discouraging non-essential imports. The premium rate above the official rate was set at 45 per cent initially, and was increased to 55 per cent in July 1969 and 65 per cent in November 1972. It remained at that level until the reforms introduced in 1977. In addition to the FEECS, there was also a system of Convertible Rupee Account (CRA) since1973. Both systems were abandoned under the exchange rate reforms of 1977 (see Lakshman 1996[b], page 703).

3.2.3 Industrial Policy Reforms

The economic policy reforms brought a complete turn around in industrial policy, focusing mainly on the export market and relying more on the private sector. Various attractive incentives were offered and measures were taken to minimize administrative problems and delays with the view to attracting foreign investment. Export oriented industrialization was the main objective of the industrial policy, to galvanize rapid economic growth.

The unification of the exchange rate, simplification of tariff system and abolition of foreign exchange budgeting had a significant impact on industrial sector activities. In the later part of the 1980s, the Government took steps to privatize several public sector industrial ventures in order to reduce the budgetary burden arising from these industrial ventures, to improve their efficiency and management, to promote competitiveness, and to attract foreign investment. Since 1990, special attention has been given to decentralization of industrial location. Special incentives have been given for investors in remote areas. The 200 Garment Factories Programme and industrial estates/parks were major policies in this direction. The industrial policy of the new Government elected in 1994 emphasized the continuation of export - oriented industrialization, primarily relying on the private sector. Special efforts were taken to improve technology and productivity with a view to improving industries' international competitiveness. The Government played a greater role in promoting foreign investment.

Moreover, several state institutions were established to attract foreign investment. The Greater Colombo Economic Commission (GCEC) was established in 1978 to simplify the approving procedure of investment in the export processing zones. But the Foreign Investment Advisory Committee (FIAC) approved foreign investments in the rest of the country. The Sri Lanka Export Credit Insurance Corporation (SLECIC) was set up in 1979 to provide insurance cover against non - payment of exports proceeds due to commercial and non - commercial risk for all types of exports. In 1979, the Export Development Board (EDB) was established with the view to assist exporters in product development and export marketing. In 1992, the status of the GCEC was elevated to a Board of Investment (BOI) to extend the promotional and facilitative activities in respect of both foreign and domestic investment from limited areas to the entire country. The BOI has facilitated the establishing of 148 commercial ventures in export processing zones, 465 enterprises located outside the zones and 154 enterprises set up under the Two Hundred Garment Factory Programme. During 1978 - 96, these enterprises contributed significantly to the economic development of the country through increased inflow of Foreign Direct Investment (FDI), increased exports, provision of employment opportunities, improving labour skills and opening up linkages with the global economy (Central Bank of Sri Lanka 1998)

3.2.4 Privatization

Privatization was announced as a state policy with a view to reducing the burden on the budget due to the operations of public enterprises and improving their efficiency and profitability. The privatization programme commenced with the break up of the single public corporation, which was handling public bus transport (the Sri Lanka Transport Board - SLTB) in to a number of smaller regional units in 1978 and the opening up of the field to private operators in 1979. However, the privatization process gained momentum particularly after 1989 i.e., during the second wave of liberalization. Firstly, the public owned United Motors was privatized as United Motors Lanka Limited in 1989. After 1989, 73 public enterprises including 20 plantation companies were privatized until 1997. Total funds mobilized through these means amounted to Rs.41, 997 million (Central Bank of Sri Lanka 1998).

3.2.5 Transfer of Resources

After the 1977 reforms, special attention was given to the transfer of resources from welfare or consumption to investment by limiting consumer subsidies. Particularly, food subsidies were replaced with the food stamp scheme for the benefit of lower income groups and the prices of most previously subsidized goods and services were allowed to rise according to market forces. The public and private investment ratios increased significantly due to heavy investment on three important projects, viz., the Accelerated Mahaweli Development Programme, Export Processing Zones and the Housing and Urban Development Programme, introduced in 1978. Moreover the Government created a conducive environment for foreign investment and all these measures enabled the country to maintain an overall investment ratio of about 23 - 25 per cent during the mid 1980s (Central Bank of Sri Lanka 1998).

Due to the Government's policy shift from welfare to investment, the percentage of total welfare expenditure in GNP decreased from 12.1 per cent in 1970 - 71 to 4.1 per cent in 1981.[4] Moreover, even though the former UNP Government maintained its objectives in this regard, subsidy expenditure again increased due to new subsidies on new programmes such as Janasaviya (literally people's strength - a major poverty alleviation programme), school mid - day meals and free school uniforms[5] introduced in the later part of the 1980s by the Premadasa government.

3.2.6 Mobilization of External Assistance and Large - Scale Investment on Mega Development Projects

The new Government's development policy centered around increasing infrastructral investment to strengthen the supply side. Higher priority was given to the three lead projects viz., Accelerated Mahawali Development

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4 See Jayasuriya 2000,Page 67

5 All these three programmes absorbed 0.7 per cent of GDP by 1996(Ratnayake, 1998, page 593)

Programme (AMDP), Export Processing Zones (EPZ) and the Housing Programme. Of these, AMDP was largest and most magnificent. The Government designed the AMDP as a multi purpose development programme with large scale employment during the construction phase and in the later land settlement, hydro electricity generationand increased food self sufficiency.

After the introduction of the open economic policy in 1977, the Government established Export Processing Zones (EPZ) and offered special tax incentives and infrastructural facilities to investors in these zones. Like AMDP, the EPZ also was considered most important to create massive employment opportunities. The first EPZ, Katunayake Export Processing Zone (KEPZ), was opened in June 1978. It is located very near to Katunayake International Airport and close to the Colombo Port. The remarkable success of KEPZ paved the way for setting up EPZs in Biyagama and Koggala. In 1986, the second EPZ was established at Biyagama(BEPZ) which was situated only 24 Km from the Colombo Port. In 1991, the third EPZ was established at Koggala(KGEPZ) in the southern province of Sri Lanka. Koggala EPZ was located only 16 Km from the Galle Port which is the only port in the entire southern part of Sri Lanka.

The Housing Programme was formulated with the view to create large - scale employment during the construction phase and to provide houses for the low - income families in the later phase. Sri Lanka's housing programme was so successful that Sri Lanka was held as a model for other developing countries (Indraratna, 1998). For the first time, island wide housing programmes were initiated in 1977. From 1977, three major public sector housing programmes, viz., the Hoarded Thousand Houses programme, the Million Houses programme and the 1.5 Million Houses programme were implemented to expand housing facilities for middle and low - income groups. The strategy was mainly based on the support - based approach and activities were facilitated by the provision of grants, construction of low cost houses for sale, supply of building materials etc. As a whole, 998606 new houses were built during the 1981 - 94 period. A rapid expansion of housing construction by private developers expanded from 1977 and housing loans to the private sector were given mainly by the two state banks, the State Mortgage and Investment Bank (SMIB), the National Saving Bank (NSB), the Housing Development Finance Corporation of Sri Lanka (HDFC), the Insurance Corporation and the Co - operative rural Banks. During 1985 - 96, the state owned Peoples' Bank granted 129,953 housing loans. The SMIB granted 59,481 loans while the HDFC has provided 18,819 loans.

3.2.7 Other Partial Economic Liberalization Measures

In addition, financial markets, commodity markets and labour markets were liberalized partially. In this section we intend to analyze such partial liberalization measures in brief.

3.2.7.1 Partial Liberalization of Financial Markets

The policy of maintaining low administratively determined interest rates was gradually abandoned. Interest rates were allowed to go up sharply to reflect supply and demand conditions in the market for loanable funds. The main objective of this measure was to provide positive real return to savers, to let the interest rate reflect the true cost of funds. This interest rate reform involved a substantial upward revision in deposit and loan rates. Before 1977, the Central Bank of Sri Lanka quite extensively used direct monetary controls such as credit rationing and ceilings and directives to commercial banks. After the introduction of the reforms in 1977, the interest rate was used as an active instrument in the control of the cost of money and to deal with the problems caused by domestic inflation. Due to the high rates of inflation, high nominal interest rates were considered necessary to maintain real interest rates at positive levels. There was also the underlying objective of enhancing financial savings, both domestic and foreign, and of discouraging the demand for credit for non - priority or non - productive purposes.

Table: 3.1 Interest Rate

		Deposit Rate				Deposit Rate	
End Period	Bank Rate	Savings	12-Month Fixed Deposits	End Period	Bank Rate	Savings	12-Month Fixed Deposits
1977	10.00	7.20	14.00-15.00	1991	17.00	6.50-14.00	10.00-20.00
1978	10.00	7.20	14.00-15.00	1992	17.00	6.50-14.00	13.50-20.00
1979	10.00	5.00-9.00	14.00-15.00	1993	17.00	5.50-14.00	13.50-17.50
1980	12.00	10.00.14.00	20.00	1994	17.00	5.50-13.00	10.00-17.00
1981	14.00	10.00-14.00	20.00-22.00	1995	17.00	5.00-13.00	10.00-17.00
1982	14.00	10.00-14.50	15.00-22.00	1996	17.00	4.50-13.00	12.00-17.75
1983	13.00	10.00-15.00	16.00-25.00	1997	17.00	3.00-11.00	8.50-15.25
1984	13.00	10.00-15.00	14.00-22.00	1998	17.00	2.00-10.00	9.00-13.00
1985	11.00	10.00-13.50	12.00-18.00	1999	16.00	2.00-10.00	9.00-12.50
1986	11.00	6.00-12.00	8.50-14.00	2000	25.00	2.00-11.00	9.00-15.00
1987	10.00	6.00-11.00	8.50-14.00	2001	18.00	4.00-12.00	9.50-14.50
1988	10.00	5.00-11.00	9.00-15.50	2002	18.00	3.50-11.00	7.50-11.00
1989	14.00	5.00-14.00	11.00-20.50	2003	15.00	2.10-7.25	5.00-7.75
1990	15.00	5.00-14.00	11.00-21.00	****	*****	*****	*****

Source: Central Bank of Sri Lanka, Annual Reports

Foreign Banks were allowed to operate in Sri Lanka and Foreign Currency Banking Units (FCBU) were established with the view to permitting banks to provide foreign currency loans to the exporters. Moreover, domestic companies producing for export markets were allowed to use the offshore banking facilities. Foreign exchange was made freely available for business promotion abroad. New domestic sector banks also were established using the liberal market environment.

3.2.7.2 Partial Liberalization of the Commodity Markets

The elimination of consumption subsidies and other price controls and the reduction of the state monopoly on commodity purchases by import liberalization allowed the market forces to determine the price of goods and services. During the pre liberalization regime, extensive consumption subsidies were implemented in two ways. One was that certain amount of essential commodities were provided to the people. The second was that apart from free subsidies a certain quantity of essential commodities (Rice, sugar and wheat flour) were provided at subsidized prices. This process came to an end in 1978 with the introduction of the Food Stamp to only targeted groups. Accordingly, the value of Food Stamp was fixed in nominal terms (i.e.rupee) which enabled the government to maintain a stable budget. However, this was a disadvantageous to the beneficiaries as the real value of these food stamps eroded with rising food prices.

3.2.7.3 Partial Liberalization of the Labour Market

The Government cracked down heavily on trade union powers and reduced industrial strife by keeping trade unions at the margins. This restrained demands for wage increases, thus creating a conducive environment for foreign investors looking for cheap labour production sites. Compensation packages for workers voluntarily retiring from the over - staffed public enterprises and public institutions were initiated to make possible the policy of reducing the size of the public sector.

3.2.8 Performance of Macro Economy (1977 - 2003)

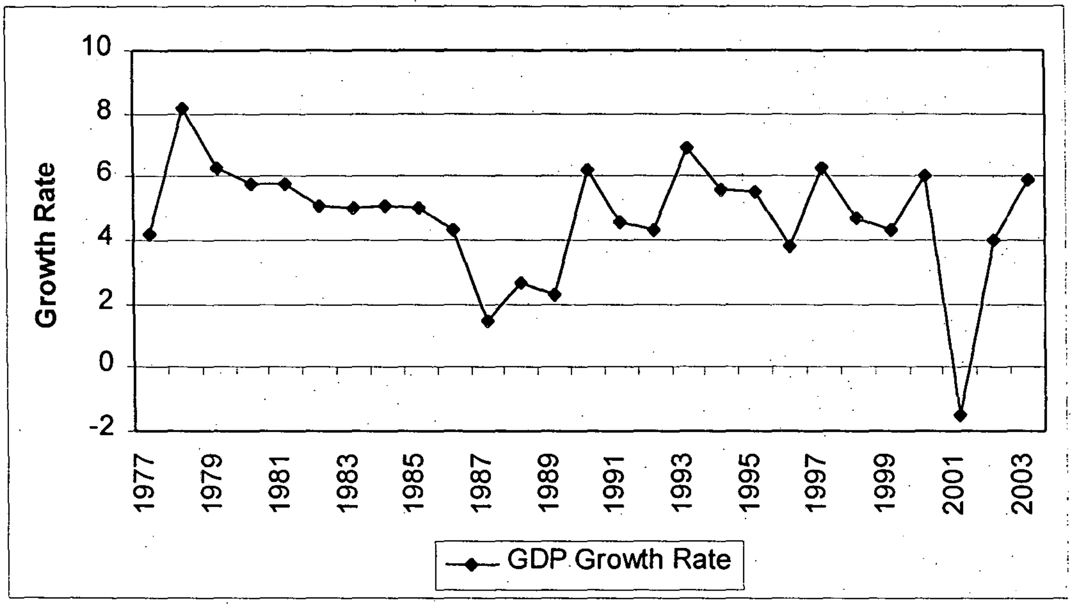
Since 1977, Sri Lankan economy entered an outward oriented strategy from inward looking economic policy and since then the performance of macro economy changed significantly. This section intends to examine the performance of the macroeconomic variables during the post liberalization regime i.e., 1977 - 2003.

3.2.8.1 GDP Growth Rate

After the introduction of open market reforms, the economy recovered and was on an upswing. The growth rate exceeded more than 8 per cent in 1978 and averaged nearly 6 per cent during the first six years of liberalization. Better weather conditions in 1977, improved commodity markets for the country's export crops due to liberalization and increased private investment (19 per cent of GDP) and public investment (6 per cent of GDP) contributed for the favourable growth condition in this period. Only after the liberalization, Sri Lanka was able to get massive aid and loan from international institutions and western donor community. For instance, the

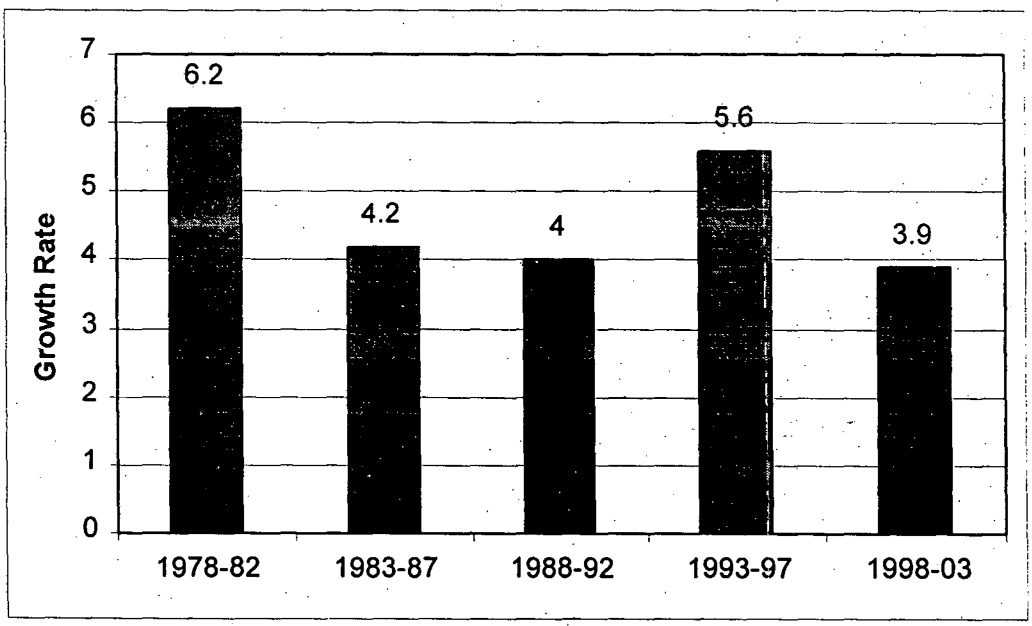
U.K came forward to sponsor to one of the Mahawali development projects i.e., Victoria Dam projects. But during the SLFP regime, this type of massive fund did not come into Sri Lanka.

Figure: 3.1 Annual GDP Growth Rate



Source: Central Bank of Sri Lanka (Various Annual Reports)

Figure 3.2 GDP Growth Rate (Average of Five Years Period)



Source: Central Bank of Sri Lanka (Various Annual Reports)

However, though the growth rate was higher compared to the previous closed economic regime, from 1978 the growth rate slowed down until 1989 because the Government did not implement a core of macro economic policies to keep the fundamentals of the economy in place and at sustainable levels. Due to the lack of appropriate policies for management of domestic consumer demand and fiscal profligacy, inflation was escalating, the interest rate began to rise and led to the crowding out of private investment. Further, the real effective exchange rate was appreciating and terms of trade also were deteriorating. Moreover, due to political instability[6] the economy failed to maintain the annual growth rate at higher rate as it was attained in 1978 over the subsequent period (Indraratna, 1998 and Cooray, 1986), particularly till 1983. The ethnic civil war in the early 1980 and the sporadic civil disturbances in the late 1980s aggravated the uncertainty in the investment climate and at times economic activity came almost to a standstill.

Every year after 1978, until 1989, there was a decline in the annual rate of growth. This slowing down of growth was caused mainly by the slowing down of the rate of growth of gross capital formation caused largely by the political turmoil in the country (Attapattu, 1997). The year 1983 witnessed the beginning of the militarisation of the country's long - standing ethnic problem around the demand for a separate state by the Tamil minority. This military conflict for a separate state in the north and the east of the country intensified as time passed, adversely affecting economic activity in these regions to a significant extent. (Pieris, 1997). In 1987, an agreement, Indo Sri Lanka Agreement, was reached between Sri Lanka and India to solve the North - East ethnic conflict and as part of agreement, Indian Peace Keeping Forces (IPKF) entered into Sri Lanka. Subsequently, this development led to a violent political movement headed by the JVP, a radical Sinhala nationalist front, which created total disarray during the period 1987 - 89. Due to these

[6] Due to widespread violence in 1983, a separatist civil war erupted in the North and the East of the country and subsequent uncertainty discouraged foreign and local investors and affected the economy.

unfavorable events, growth recorded a lower rate of 3.7 per cent during the next seven - year period i.e., 1983 - 89. However, the government was able to control the 'southern insurrection' within a short period of time.

On the whole, it is difficult to assess the direct impact of the war on economic growth, given the many factors that impact on the growth performance of a small trading country such as Sri Lanka. Nevertheless it is generally agreed that civil wars and other violent social conflicts are responsible for a deceleration of economic growth[7]. A study conducted by the Marga institution (1998) considers that a growth rate of 7% per year could have been achieved during 1983 - 96 if there were no war in Sri Lanka. Even though Sri Lanka had abandoned the food subsidy, which amounted 5 per cent of GDP in the mid -1960s, the financing of the internal civil conflict before the post - 2001 peace process had risen to the equivalent of 6 per cent of GDP, which in effect replaced the food subsidy (Jayawardene, 2004). Therefore, Sri Lanka was spending a significant part of its resources on another non - investment area even after the liberalization period.

In 1989, the Government implemented the second phase of reforms, which was commenced with a three year Structural Adjustment Facility (SAF) amounting to SDR 156 million under the programme from the IMF. Subsequently, in 1991 Sri Lanka entered into an Enhanced Structural Adjustment Facility (ESAF) amounting to SDR 336 million with the IMF. This period received added impetus due to the peace initiative of the Government with the LTTE. The rate of growth increased to an average of 5.5 per cent during 1990 - 94 due to better performance in manufacturing industry, trade, tourism enabled by peaceful environment of the country.

In 1994, SLFP led People Alliance (PA) came in to power after seventeen years of rule by the UNP but it continued the open economic policy and

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7 Even using a conservative 5% interest rate, the accumulated total cost of war up to 1996 is at least Rs.1,135 billion at 1996 prices (168.5% of the 1996 GDP, equivalent to US$ 20.6 billion). (Arunatilake *et al.*, 2001, page 1495).

implemented the third phase of reforms under the Stabilization and Structural Adjustment Programme of the World Bank and IMF.

The period 1995 - 2003[8] witnessed complicated ups and downs in the growth performance. In this period the country again faced a severe war in the North and East region. In 2001, the country's international airport was attacked by the LTTE and subsequently the growth rate fell down to - 1.5 per cent[9], which is the first negative growth rate in the history of independent Sri Lanka. The dismal performance of trade and tourism mainly contributed to this setback.

It is important to analysis the impact of the civil war since it has a strong negative impact on the economy. After the eruption of war in 1983, private investment was drastically declining (by 24 per cent in 1983 and 16 per cent in 1989) continuously until 1990 when a ceasefire agreement between the government and the LTTE came in to effect. On the other hand, total exports as a percentage of GDP were continuously declining from 24.3 in 1984 to 22.3 percent in 1989 and the total imports as a percentage of GDP also were declining from 40.0 per cent in 1983 to 32.0 percent in 1989. However both total exports and imports started to increase after the ceasefire agreement. Importantly, private investment declined from 25 per cent of GDP in 2000 to 19 percent in 2001 due to the LTTE attack on the Country's international airport and total exports and imports also declined due to this attack. Moreover, tourism is very important sector in the Sri Lankan economy. But here also, the escalation of the war and the subsequent uncertainty had harmful repercussions. The arrival[10] of tourists exceeded 400,000 in 1982 but fell below 200,000 by 1986. However, the arrival started to increase again following the ceasefire agreement in 1990 but fell again due to the Central Bank bombing in 1996. The arrival of tourists was 400,414 in 2000 but again

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8 Following a ceasefire agreement between the Government and the LTTE, the war came to an end since 2002 and as a result the growth rate started to pick up.

9 Due to the attack on the international airport, the country's main income source. i.e.,. tourism (contribute nearly 8 per cent to the GDP in 2000) and trade were affected severely. These are the main reason for the negative growth rate experienced by the country in 2001

10 All data were collected from various annual reports of the Central Bank of Sri Lanka.

fell to 336,794 following the LTTE attack on the Country's international airport. Therefore we can conclude that the war and the uncertainty have had a strong negative impact on the economy.

A study conducted by Arunatileke et al (2001) gives us an estimate of the economic cost of the war on the Sri Lankan economy.

Table: 3.2 Compounded Present Values (1996) of Estimated Cost of the War - 1984 -1996 (Mn of 1996 Rs)

	Interest rate		
	$r = 0.00$	$r = 0.05$	$r = 0.10$
Direct costs			
Direct government military expenditure	224,148	287,543	375,466
LTTE military expenditure	22,415	28,754	37,547
Government expenditure on relief services	20,742	20,742	20,742
Cost of lost infrastructure	93,584	93,584	93,584
Indirect costs			
Lost income due to foregone public investment	46,639	59,884	78,263
Lost income from reduced tourist arrival	91,832	118,365	155,323
Lost earnings due to lost foreign investment	423,446	495,252	288,897
Lost income due to displacement (up to 1995)	29,784	38,219	49,417
Lost income due to lost human capital of dead or injured persons	14,641	17,229	20,875
Output foregone in the Northern Province in 1996	9,031	9,031	9,031
Total	976,261	1,168,603	1,429,144

Source: Arunatileke et al (2001) (due to lack of yearly data values given in the last two columns are not compounded. This includes rehabilitation and reconstruction in the North and the East up to 1995)

3.2.8.2 Sectoral Growth Rate of GDP (1978 - 2003)

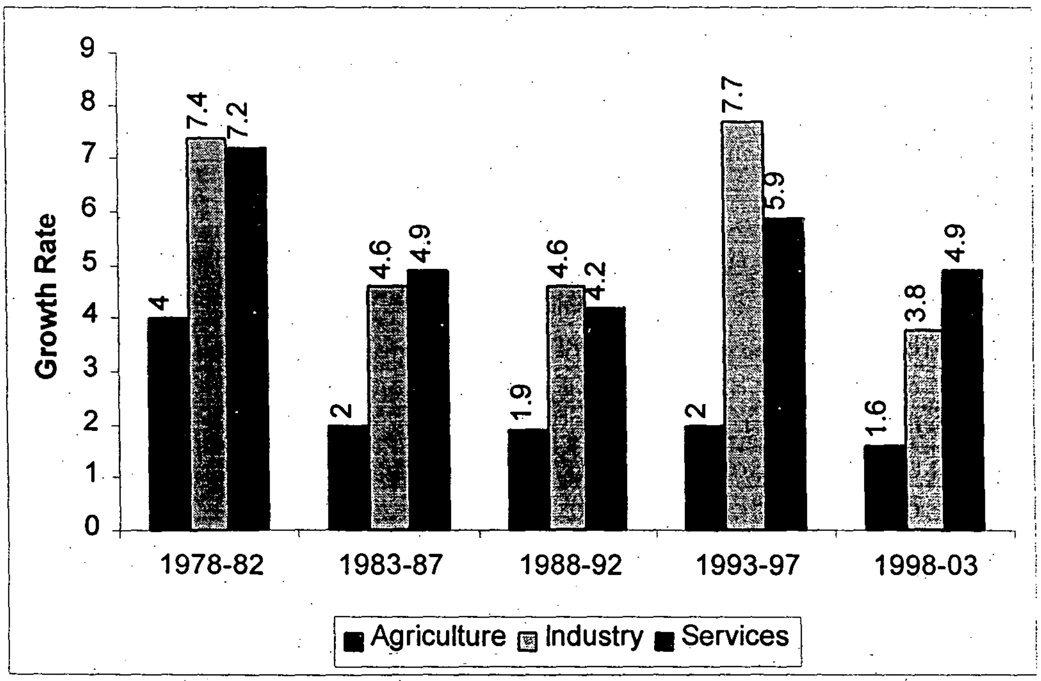
Though there were fluctuations in the growth rates of all three sectors, as a whole the growth of the agriculture sector has registered a clear decline. Its compound growth rate has declined by 3.2 per cent during 1977 - 2003. Likewise, the compound growth of industry sector has registered 1 per cent decline during the same period. In contrast, the service sector recorded 0.6 per cent compound growth during the said period.

Table: 3.3 Sectoral Growth Rate of GDP

Year	Agriculture	Industry	Services	Year	Agriculture	Industry	Services
1977	10.4	-4.3	4.7	1991	1.9	4.1	6.2
1978	5.4	15.9	7.4	1992	-1.6	7.1	5.3
1979	1.9	11.1	7.6	1993	4.9	9.6	6.2
1980	3.2	5.5	8.0	1994	3.3	8.0	5.1
1981	6.9	2.0	6.3	1995	3.3	7.6	4.9
1982	2.6	2.3	6.9	1996	-4.6	5.4	6.0
1983	5.0	1.7	6.7	1997	3.0	7.7	7.1
1984	-0.4	6.4	7.0	1998	2.5	5.9	5.1
1985	8.6	3.3	3.9	1999	4.5	4.8	4.0
1986	2.6	5.7	4.2	2000	1.8	7.5	7.0
1987	-5.8	6.0	2.7	2001	-3.4	-2.1	-0.5
1988	2.1	4.0	2.2	2002	2.5	1.0	6.1
1989	-1.1	3.2	3.2	2003	1.5	5.5	7.7
1990	8.5	7.5	4.2	****	***	***	***

Source: Central Bank of Sri Lanka (Various Annual Reports)

Figure: 3.3 Sectoral Growth Rate of GDP



Source: Table: 3.3

As the data in Table 3.3 show, during the 1978 - 82 period, the average annual growth rates of three sectors -agriculture, industry and services- increased to 4.0 per cent, 7.4 per cent and 7.2 per cent respectively from their previous level attained 1971 - 77. After the introduction of liberalization policies, imports of inputs, particularly fertilizer, increased significantly and as a result utilization of fertilizer increased drastically. Further more credit facilities were made easily available to the farmers under the integrated rural development programme. All these developments helped the Agriculture sector to increase its growth rate during the first five years of liberalization. Meanwhile the production of industry and services sectors expanded tremendously during the same period. Bullish growth of the construction sector owing to the large infrastructure projects and buoyancy in manufacturing sectors, particularly garments and textiles, contributed greatly to help the Industrial sector to achieve higher growth rate in this period. Likewise the rapid expansion of trade, banking, insurance, tourism, telecommunication and financial services were the underlying factors for the swift growth of the Services sector during the said period.

However, the average annual growth rates of the three sectors-agriculture, industry and services- declined to 2 per cent, 4.6 per cent and 4.9 per cent respectively during 1983 - 87 period. This period witnessed the eruption of the ethnic unrest, which plunged the country's economy in to unprecedented setback. Due to this ethnic imbroglio the production activities, particularly in the North and East of the country, of all three sectors were affected severely.

During the 1988 - 92 period, the average annual growth rates of agriculture and services sectors further declined to 1.9 per cent and 4.2 per cent respectively while the growth rate of the industry sector remained at 4.6 per cent during the same period. Along with the Northern and Eastern violence, the insurrection led by the JVP affected all economic activities throughout the country during this period. Agriculture production (mainly tea, rubber and paddy) declined and tourism also was affected and as a result the growth rate of the Agriculture and Services sectors declined. However, manufacturing production helped the Industry sector to achieve 4.6 per cent average annual growth rate.

Nonetheless the average annual growth rate of agriculture sector rose very marginally to 2 per cent while industry and services sectors recorded higher growth rates of 7.7 per cent and 5.9 per cent respectively in 1993 - 97. The SLFP led PA coalition Government came to power in 1993 and subsequently entered into a ceasefire agreement with the LTTE. In addition, tea, rubber and paddy production increased to some extent. Manufacturing sector also grew significantly. Tourism gained momentum during this period. All these developments helped to the Agriculture, Industry and Services sectors to record high growth rates.

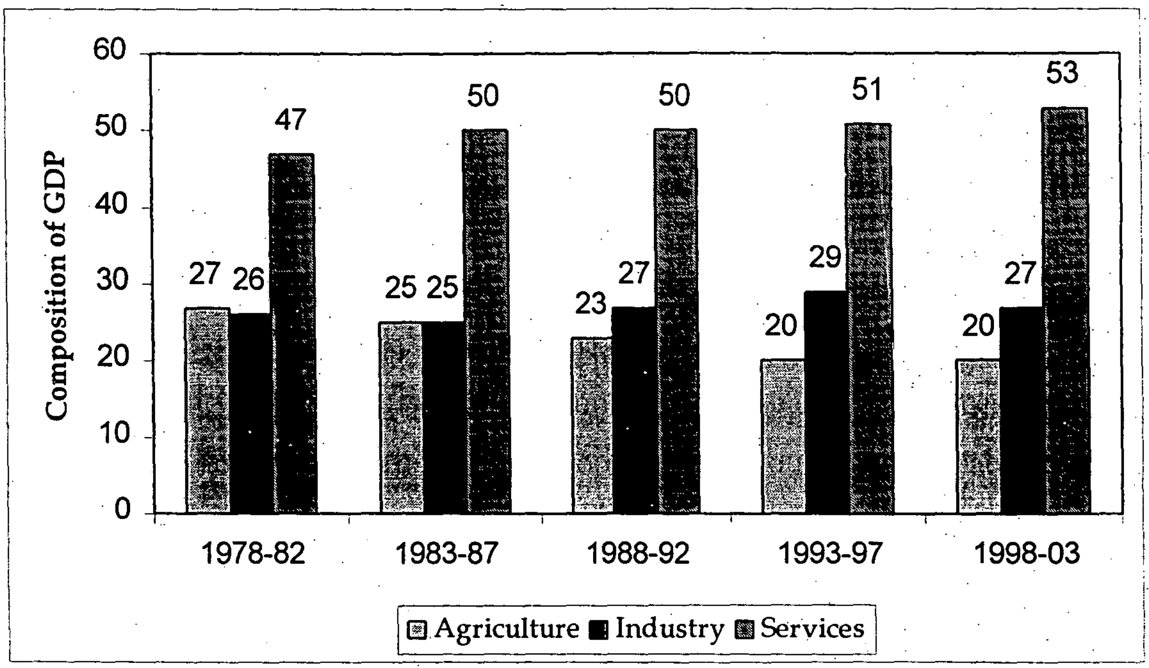
Meanwhile during 1998 - 03 period, the average annual growth rates of agriculture, industry and services sectors declined to 1.6 per cent, 3.8 per cent and 4.9 per cent respectively from their previous level. Though all three sectors recorded moderate growth rates during this period except 2001 during which all sectors constituted negative growth rates following the LTTE's attack on the international airport. This attack affected mainly international trade and tourism. This negative growth rates attained in 2001 pushed down the average annual growth rates of whole period from 1998 to 2003.

As a whole the growth rate of the Agriculture sector lagged behind than that of other two sectors. The average annual growth of this sector was only 2.6 per cent during 1978 - 2003 compared with 2.8 per cent of the pre liberalization period from 1951 to 1977. At the same time the industry sector constituted 5.3 per cent average annual growth rate during 1978 - 03 in contrast to 4.0 per cent of 1951 - 77 and the services sector accounted 5.4 per cent average annual growth rate during 1978 - 03 as compared with 4.1 per cent of 1951 - 77 period.

3.2.8.3 Sectoral Composition of GDP

The sectoral share of GDP continued in the same pattern as in the pre liberalization period during the post liberalization regime also. The share of service sector increased further at the expense of agriculture sector and the industry sector continued to be a third sector in the composition of GDP. Interestingly, the share of industry in 2003 was very much the same as it was in 1978. So the reforms did not lead to the acceleration of industrialization. The sectoral composition of the Industrial sector in GDP is below 40 per cent and the sectoral composition of the Services sector in the GDP is more than 50 per cent. This implies that the sectoral composition did not become favourable even after the liberalization. Moreover, though the share of the agriculture sector continued to decline, the industrial sector did not better off at the expense of the agriculture sector. In contrast, the share of services sector continued to dominant in the composition of GDP. Tourism and trade (both are very sensitive to the impact of the war) are the two major components of the services sector. Since Sri Lanka continued to face the civil war, depending on tourism and trade could be vulnerable.

Figure: 3.4 Sectoral Composition of GDP



Source: Central Bank of Sri Lanka - 1998 and 2003

In the post liberalization period, the average relative share of the Agriculture sector in GDP further declined to 25 per cent in 1983 - 87 from 27 per cent in 1978 - 82 due to the better performance of the other sectors. On the other hand, though the share of Industry declined slightly to 25 per cent in 1983 - 87 from 26 per cent in 1978 - 82 it equalised its share in GDP with that of Agriculture in 1984. During 1978 - 81 the construction sector grew at a much faster rate of 14.3 per cent at the peak of the public sector investment boom after liberalization. This development helped Industry to increase its share in GDP. At the same time the Services sector's average relative share increased considerably from 47 per cent in 1978 - 82 to 50 per cent in 1983 - 87. After the liberalization the Government removed the restrictions on the movement of foreign exchange, labour and services. As a result, the service sector such as banking, insurance, wholesale and retail trade and tourism expanded dramatically. Due to these developments the average relative share of the Service sector had increased during 1978 - 87.

As happened during the previous regimes, the average relative share of the agriculture sector in GDP continued to decline significantly from 23 per cent in 1988 - 92 to 20 per cent in 1993 - 97 and it remained at 20 per cent during 1998 - 03 because the Agriculture sector lagged behind other sectors. In contrast, industry's share had increased from 27 per cent in 1988 - 92 to 29 percent in 1993 - 97 and declined to 27 per cent in 1998 - 03. Though the initiation of the 200 Garment factories Programme helped the Industry sector to increase its share in GDP between 1988 - 92 and 1993 - 97 periods, the closure of some factories contributed mainly to the decline of the share of the Industry sector in the later period. The Service sector share in GDP had increased from 50 per cent in 1988 - 92 to 51 percent in 1993 - 97 and to 53 per cent in 1998 - 03. Expansion of financial services, particularly banking and insurance services, postal services and telecommunications contributed positively to the service sector to increase its share in GDP.

3.2.8.4 Employment

After the introduction of the liberalization policies, there was acceleration in the pace of employment growth. This experience was significantly different from the pre liberalization experience of low rates of employment growth. During the early years of liberalization, the high level of employment growth was directly associated with the changes in the socio-political environment and the subsequent high rates of economic growth. But the slow down of the employment growth coincided with low GDP growth since the second half of the 1980s is mainly attributed to considerable disruption of economic activity caused by the ethnic imbroglio in the Northern and Eastern provinces and a second insurrection in the rest of the country.

Table: 3.4 Employment

		As a % of Labour force by sex						
Year	Total (000)	Male	Fe-male	Agriculture, Hunting & Forestry	Manuf-acturing	Mining & Quarrying	Const-ruction	Serv-ices
1978-79	4647	90.8	75.1	52.0	12.5	1.2	5.0	29.3
1981	4119	86.7	69.0	45.3	10.1	0.9	3.0	40.7
1981-82	4673	92.2	78.7	50.5	12.3	1.7	5.1	30.4
1985-86	5132	89.2	79.2	49.3	12.6	1.3	4.4	32.3
1986-87	5271	88.7	76.4	47.7	13.4	1.9	5.7	31.3
1990	5047	88.2	76.6	46.8	13.3	1.6	3.9	34.5
1991	5016	89.8	77.0	42.5	15.0	1.1	4.7	36.7
1992	4962	89.3	77.8	42.1	13.1	1.6	4.8	38.4
1993	5201	90.3	78.3	41.5	13.2	1.5	4.4	39.4
1994	5281	90.3	79.9	39.5	14.3	0.8	4.1	41.3
1995	5357	91.0	81.3	36.7	14.7	1.7	5.3	41.6
1996	5537	91.8	82.3	37.4	14.6	1.6	5.4	41.1
1997	5608	92.3	83.9	36.2	16.4	1.6	5.6	40.2
1998	6049	93.5	86.0	40.3	14.2	1.2	4.9	38.7
1999	6083	93.3	87.0	36.2	14.8	1.2	5.3	42.4
2000	6310	94.2	88.9	36.0	16.6	1.1	5.5	40.3
2001	6236	93.8	88.6	32.6	16.9	1.8	5.2	43.5
2002	6519	93.4	87.1	36.2	16.6	-	4.6	44.9
2003	6945	93.9	86.5	34.7	16.1	-	5.4	43.8

Source: Central Bank of Sri Lanka (Central Bank reports- Various Reports)

It is important to note that the employment structure underwent drastic changes during the post liberalization period. As a percentage of labour force, like pre liberalization regime, male participation rate in employment was increasing gradually during the post liberalization period. Increased opportunities in the new development projects (such as Mahawali development programme, Exports Proceessing Zone) and foreign employments and military related activities contributed significantly for this increase. However, unlike pre liberalization regime female participation in the employment activities started to increase during the post liberalization period. Increased opportunities in labour - intensive light manufacturing sector, particularly in the garment industries, and the Middle East employment opportunities contributed highly to the upswing of the female participation rate.

Importantly, employment in the agriculture sector has been gradually declined throughout the post liberalization period. Following the liberalization, migration to the urban area, the aspirations to get a job in the industry sector and the expansion of military related employment mainly contributed to the decline of employment in the agriculture sector. However, employment in the service sector almost gradually been increased. The relative expansion of public service, trade and tourism sectors contributed for this tendency.

3.2.8.5 Unemployment

Unemployment was severe enough to lead an insurrection in 1971 in Sri Lanka and therefore the new government of 1977 generated several mega projects with the view to create massive employment opportunities. The new Government took two initiatives to eradicate the massive unemployment problem. One was the export oriented globally integrated development strategy which led a faster rate of growth employment opportunities compared to the preceding period of the closed economy. Due to the removal of restrictions on the movement of foreign exchange, labour, services and expansion of trade and tourism, a large number of Sri Lankan obtained employment in foreign countries, particularly in the Middle East.

Table: 3.5 Unemployment

Year	Total No ('000	As % of Labour Force Male	As % of Labour Force Female	Unemployment Rate
1978-79	874	9.2	24.9	14.8
1981	895	13.3	31.0	17.9
1981-82	609	7.8	21.3	11.7
1985-86	840	10.8	20.8	14.1
1986-87	967	11.3	23.6	15.5
1990	954	7.6	20.2	15.9
1991	862	9.9	23.4	14.7
1992	846	9.4	23.1	14.6
1993	831	9.7	21.7	13.8
1994	797	9.7	20.1	13.1
1995	749	9.0	18.7	12.3
1996	705	8.2	17.7	11.3
1997	658	7.7	16.1	10.5
1998	611	6.5	14.0	9.2
1999	591	6.7	13.0	8.9
2000	517	5.8	11.1	7.6
2001	537	6.2	11.4	7.9
2002	626	6.6	12.9	8.8
2003	648	6.1	13.5	8.6

Source: Central Bank of Sri Lanka (1998 &2003)

Note: survey data for the period since the mid-1980s do not envelop the entire country as situation of ethnic conflict in the North and East provinces have prevented the carrying out of the surveys in those regions. But commencing from 1st quarter of 2003, Eastern province is included and only the Northern Province is excluded from the survey.

The second initiative took the form of a massive public sector led infrastructure development progrmme under which three lead projects, Mahawali development programme, Export Promotion Zones and housing programme, were implemented with the view to generating enormous employment opportunities. EPZs were the key infrastructural mechanism to attract FDI, which was expected to play a crucial role in the promotion of export-oriented manufacturing. The increased opportunities for women in labour intensive light manufacturing activities and the job generation in garment and other factories for rural and urban female contributed to the significant reduction in unemployment. Apart from these scenarios, military expansion particularly after 1983, and migration to western countries and the

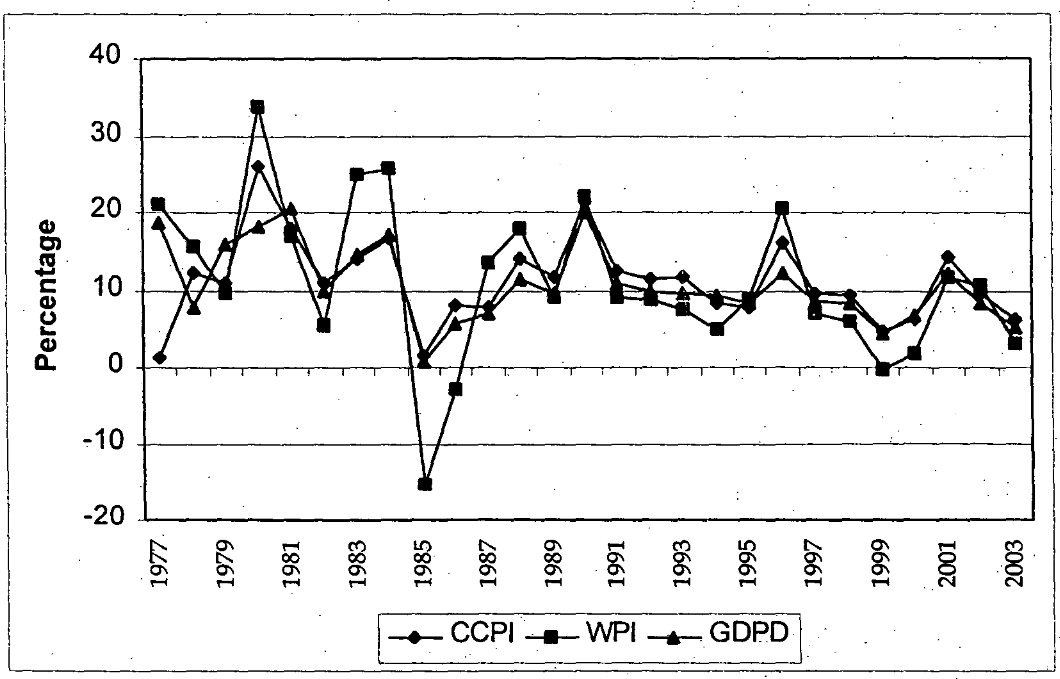
Middle east contributed to the dramatic decline in unemployment during the post liberalization regimes. During the second phase of liberalization (1988 - 93), the Government established 200 garment factories with the view to generate more employment opportunities especially for rural women.

Due to these all developments, the unemployment rate decline from 19.7 per cent in 1975 to 14.8per cent in 1978/79. Significantly, the unemployment rate was declining continuously (9.2 per cent in 1998 and 8.6 per cent in 2003) during the second and third phases of liberalization.

3.2.8.6 Inflation

As compared to the pre liberalization regime, the post liberalization period witnessed high inflation due to the currency devaluation, the direct impact of relaxation of price controls, removal of subsidies and high budget deficits.

Figure 3.5 Annual Percentage Changes in Price Indices



Source: Sources: Central Bank of Sri Lanka (Various annual reports)
Legend: CCPI= Colombo Consumer Price Index
WPI=Whole sale Price Index
GDPD= Gross Domestic Product Deflator

The period 1978 - 93 is viewed as a high inflation regime with prolonged double-digit inflation. The annual average increase in the CCPI was nearly13 percent during the 16 years from 1978 - 93. The WPI and GDP deflator also reflected a similar double - digit trend with 12.6 and 11.8 per cent annual average increase respectively during the corresponding period. The year 1980 experienced the highest inflation rate of 26.1 per cent, reflected by CCPI, in the history of independent Sri Lanka. Devaluation and depreciation of the rupee and the increase in world prices of imports, replacement of the extensive food subsidy with food stamp (fixed value in rupee) to the targeted groups, upward revision of the prices of wheat floor, kerosene and public transport fares, second oil shock and inflationary pressure caused by expansionist economic policies, particularly deficit financing met by bank borrowing resulted in the highest rate of CCPI. In addition, immediately after the liberalization, the Government initiated mega public investment programmes, and the resulting huge government capital expenditure and high budget deficits financed through expansionary measures, increased the inflation. More importantly, bad weather conditions and the civil disturbances contributed to more increase in the prices in the late 1980s. Due to the war, production of agriculture and fisheries drastically declined in the Northern and Eastern provinces. Fishing was completely banned in the high security zones in the North and East due to the security concern. All these developments contributed to the upsurge in double - digit inflation for the entire period of 1978 - 93.

However, the rate of inflation had been contained to single digit level during the 1994 -2003 periods, except for 1996 and 2001. Severe drought in 1986 and the increase in international prices of certain key consumer items in 2001 led to a sharp increase in prices in these years. However, the annual average inflation, as reflected in the CCPI, declined to 9.2 per cent in 1994 - 2003 from 13 percent in 1978 - 93. At the same time, the WPI and GDP deflator declined to 7.4 per cent and 8.3 per cent respectively in 1994 -2003 from 12.6 per cent and 11.8 per cent respectively in 1978 - 93. A fiscal consolidation programme which started since 1995 with the objective of moving the economy to a non -

inflationary high growth path did help the country to contain the inflation to a single digit level. Meanwhile, the continuous focus of monetary management on price stability and expansion in domestic production also contributed to the moderation of prices (Central Bank, 2002 & 2003).

As a whole, the annual average inflation, as reflected in the CCPI, has significantly increased from 2.9 per cent in the pre liberalization regime of 1953 - 77 to 11.5 per cent in the post liberalization period of 1978 - 2003. The GDP deflator also has a same trend. The annual average inflation, as reflected in the GDP deflator, has increased to 10.5 per cent in the post liberalization period in contrast to 4.9 per cent of the pre liberalization regime. Therefore, obviously, the rate of inflation has escalated during the liberalization period in Sri Lanka. As Bajpai (1995) correctly noted since inflation generates serious distortions, liberalization will take place under inappropriate signals.

3.2.8.7 Investment, Savings and Imbalance

This section analysis the performance of investment and saving during the post liberalization regime. In addition, the magnitude of imbalance between investment and saving and its financing are also analyzed.

3.2.8.7.1 Investment

Following the liberalization, though the government initiated several lead projects, the government's investment averaged only 7 per cent of GDP during 1978 - 1980. Since then it was only 5 per cent until 1986. But during the closed economic regime (1970 - 770) the government's investment averaged 5.3 per cent. During the whole period from 1980 to 2003, except 1985 - 91 and 2000 - 2002, the private investment exceeded 20 per cent of GDP. The former period was affected by the civil war and the second JVP insurrection and the latter was affected by the LTTE attack on the international airport. At the same time, however, the rate of investment averaged 25 per cent during the 1978 - 2003 as against 16 per cent of the 1970 -1977 period. It is important to note that the private investment was highly correlating with the peace and war of the country.

Table: 3.6 Investment

Rs.Million

Year	Private Investment	Percentage of GDP	Government Investment	Percentage of GDP	Total Investment	Rate of Investment
1977	3404	9	1855	5	5259	14
1978	5831	14	2723	6	8554	20
1979	9783	19	3744	7	13527	26
1980	16776	25	5689	9	22465	34
1981	19604	23	4006	5	23610	28
1982	25583	26	4944	5	30527	31
1983	29234	24	5898	5	35132	29
1984	32693	21	7015	5	39708	26
1985	30890	19	7792	5	38682	24
1986	32879	18	9584	5	42463	24
1987	34726	18	11174	6	45900	23
1988	37437	17	13125	6	50562	23
1989	40331	16	14391	6	54722	22
1990	58790	18	12665	4	71455	22
1991	69273	19	15883	4	85156	23
1992	89557	21	13682	3	103239	24
1993	106920	21	20755	4	127675	26
1994	138849	24	17661	3	156510	27
1995	148180	22	23645	4	171825	26
1996	162761	21	23503	3	186264	24
1997	187150	21	29953	3	217103	24
1998	221879	22	34010	3	255889	25
1999	266593	24	35230	3	301823	27
2000	311480	25	41152	3	352632	28
2001	267318	19	42366	3	309684	22
2002	305860	19	31922	2	337782	21
2003	352174	20	40766	2	392940	22

Source: Central Bank of Sri Lanka, Various Annual Reports

The level of investment remained at around 28 per cent until 1983. The underlying reason for this high investment ratio was the heavy private investment. The government continued to promote foreign private investment by establishing the second EPZ at Biyagama. Public expenditure on three lead projects, viz., the Accelerated Mahaweli development Programme, Export Processing Zones and the Houshing and Urban

Development programme also contributed this increase in the rate of investment. However, with the completion of these lead projects, the investment ratio declined. However, private domestic and foreign investment continued to increase.

But following the eruption of the civil war, private investment started to decline from 1983. As a result, the rate of investment averaged only 24 per cent during 1984 - 88 period. The investment ratio dropped further to about 22 per cent due to the unsettled political climate that prevailed during 1989 - 90. The effective control of the JVP threat and the initiation of the structural reform agenda helped to rebuild private sector confidence, and private investment started its upward trend after the early 1990s. The third EPZ was established at Koggala in 1991 while the 200 Garment factory programme commenced in 1992. The investment ratio rose again to about 24 per cent by 1996. Although the country was able to maintain the investment ratio at 28 per cent in 2000, the LTTE attack on the international airport brought down the investment ratio (mainly through declining in private investment).

3.2.8.7.2 Savings

Though there were fluctuations, both the national saving ratio and the domestic saving ratio have increased moderately over the period of 1977 - 2003. National saving registered 1.6 per cent compound growth while domestic saving showed 0.9 per cent compound growth during this period.'

Table: 3.7 Saving Rs. Million

Year	Domestic Savings	National Savings	Net Private Transfer	National Savings Ratio (% of GDP)	Domestic Savings Ratio (% of GDP)
1977	6590	6444	122	17.7	18.1
1978	6485	6613	342	15.5	15.2
1979	7229	7753	754	14.8	13.8
1980	7451	9314	2260	14.0	11.2
1981	9946	12156	3918	14.3	11.7
1982	11809	15283	5494	15.4	11.9
1983	16780	19943	6441	16.4	13.8
1984	30595	34132	7031	22.2	19.9
1985	19323	23057	7212	14.2	11.9
1986	21537	26024	8251	14.5	12.0
1987	25181	30099	9161	15.3	12.8
1988	26638	31521	10187	14.2	12.0
1989	30731	36776	11840	14.6	12.2
1990	46015	54060	14518	16.8	14.3
1991	47660	56596	16623	15.2	12.8
1992	63792	76126	20253	17.9	15.0
1993	79930	100912	27090	20.2	16.0
1994	88021	110605	30989	19.1	15.2
1995	102169	130216	34820	19.5	15.3
1996	117524	145944	39242	19.0	15.3
1997	154017	191408	46472	21.5	17.3
1998	194435	238209	54785	23.4	19.1
1999	215663	259901	62438	23.5	19.5
2000	218829	270392	73810	21.5	17.4
2001	222369	285702	87902	20.3	15.8
2002	234233	308618	104938	19.5	14.5
2003	276364	374940	116307	21.3	15.7

Source: Central Bank of Sri Lanka, Annual Report (Various Issues)

After the introduction of the reforms, the domestic saving ratio increased very marginally to 12.7 per cent in 1978 - 82 from 12 1974 - 77. However, the national saving ratio increased significantly from 9.2 per cent to 14.8 per cent during the corresponding period because net private transfers increased dramatically after the liberalization. Domestic saving ratio, despite fluctuations, reached 17 per cent in 1998 - 03 and averaged 14.6 per cent during 1978 - 03 while the national saving ratio, despite fluctuations, accounted for 21.5 per cent in 199 - 03 and averaged 17.8 per cent during 1978

- 03. Though the national savings increased after the liberalization, domestic savings did not increase as much as national savings. As Atapattu (1997) noted, the growth of output did not have a positive effect on domestic savings under the open economic policy regime. An increasing proportion of output growth was diverted to consumption through increase in imports.

3.2.8.7.3 Imbalance

The balance of investment and saving is crucial for the sustainable growth of any country. If investment - saving imbalance increased that means a particular country is increasingly depending on domestic and external resources for the financing of investment. This type of situation can cause a harmful repercussion by plunging the country into negative external shocks. The 1977 liberalization has increased the imbalance between investment and saving in Sri Lanka.

Table: 3.8 Investment - Saving Imbalance (Annual Averages: Rs. Million Except colums4&6)

Year	GDP	Total Investment	Investment Ratio	Domestic Saving	Domestic Saving Ratio	Imba-lance
1978-82	69164	19737	29	8584	12	17
1983-87	162784	40377	25	22683	14	11
1988-92	318657	73027	23	42967	13	10
1993-97	680964	171875	25	108332	16	9
1998-03	1355319	325125	24	226982	17	7
1978-03	2586888	630141	24	409548	16	8

Source: Central Bank of Sri Lanka, Annual Report (Various Issues)

After the introduction of reforms in 1977, the investment ratio increased dramatically and accounted for 29 per cent of GDP in 1978 - 82. This huge investment did not come from appreciable expansion in domestic savings or export earnings; instead it came from massive private investment and the capital expenditures undertaken by the state and funded by an unprecedented level of foreign savings. Though there was decline in investment ratio after 1983, it averaged 24 per cent during the entire period of 1978 - 03 in contrast to 13 per cent of pre liberalization regime. On the other hand domestic saving did not increase as much as investment and it declined marginally to 12 per cent in 1978 - 82 period. As a whole, domestic saving ratio averaged 16 per cent during post liberalization period, 1978 - 03, in contrast to 13 per cent of pre liberalization period. Though, on the whole, both investment and domestic saving ratios increased during the post liberalization period, the gap between these ratios also increased to 10 per cent (on average) during the post liberalization period in contrast to 2 per cent (on average) of pre liberalization regime.

This large imbalance between investment and domestic savings was financed by drawing down external assets, borrowing from the Central Bank, private remittance from abroad, external development assistance and direct foreign investments. As Lakshman (1996[a]) mentioned, the large imbalance between investment and domestic savings rendered the growth path unsustainable. It was highly vulnerable to shocks and therefore unstable too.

3.2.8.8 Income Distribution

It is argued that the liberalization will increase the income inequalities within the countries because market mechanism will be favourable to the rich. Patnaik(1997) pointed out that the liberalization - cum structural adjustment package, brings about four different kinds of distributional shift: from workers to capitalists, from petty producers and small capitalists to large capitalists, from domestic capitalists to foreign capitalists and from entrepreneurs to rentiers or from producing interests to financial interests. According to this argument, these shifts in income distribution would widen existing inequalities within and among countries. After the introduction of the reform process, income inequality has widened in Sri Lanka too. Glewwe (1988) argued that liberalization policies do not appear to have increased inequalities in Sri Lanka but inequality was lower after the 1977 economic liberalization policies were adopted. However, in sharp contrast, Ravallion and Jayasuriya (1988) contended that Glewwe has not considered the welfare distributional effects of the relative price changes induced by the policy reforms and noted that the policy reforms of the late 1970s (in Sri Lanka) increased inequality. Likewise, Laksman (1997) and Colombage(1998) also have come to the same conclusion that liberalization policies have increased income inequalities in Sri Lanka. In sum, as Sebastian (1997) noted critics of the World Bank and the IMF have argued that these institutions' policy recommendations (including trade liberalization) have resulted in heightened inequality in the developing countries. It is important to note that Sri Lanka also implemented the liberalization policies sponsored by World Bank and the IMF.

Table: 3.9 Income Distribution

Income Group	1978/79	1981/82	1986/87	1996/97	2002
Poorest 40%	16.06	15.25	14.14	15.30	n.a.
Middle 40%	34.07	32.79	33.56	34.80	n.a.
Richest 20%	49.87	51.96	52.30	49.90	n.a.
Gini Coefficient	0.43	0.45	0.46	0.46	0.48

Source: Central Bank of Sri Lanka (Various annual reports)

As the data in Table 3.9 indicate, the richest 20 per cent of income receivers increased their share very marginally in the total income, despite fluctuations, from 49.87 per cent in 1978/79 to 49.9 percent in 1996/97. On the contrary, the share of the poorest 40 per cent in the total income declined to 15.3 per cent in 1996/97 from 16.06 per cent in 1978/79. At the same time, the share of the middle 40 income receivers almost did not change during this period. All in all, Gini Coefficient has increased from 0.43 in 1978/79 to 0.48 in 2002. Though the structure of the income distribution did not undergo into a drastic change, the movement of the income distribution shows an increase in income inequalities during the whole period of liberalization. The widening inequalities seems to be the result of high profits to those sections benefiting from the liberalization such as import, whole sale and retail traders, transport agents and other businessmen, reduction of food subsidies relative increase of indirect taxation and several massive incentives to the exporters. More importantly the substantial increase in the inflation was greatly affected the poorer section. Furthermore, the positive influence of liberalized market forces on the income position of the society's wealthy classes was much stronger than on poorer ones. Therefore, as Justin Forsyth (as quoted in Ravallion, 2001) notes these current patterns of growth and globalization are widening income disparities.

3.2.8.9 Budget deficit and Financing [(a)]

Ghosh (1997) pointed out that the orthodox structural adjustment programme treats the government's overall deficit (or fiscal deficit) as the chief villain of the piece and the main imbalance that must be corrected if stabilization and adjustment are to occur. But in Sri Lanka, the post liberalization regime witnessed enormous budget deficit, which reached to 23 per cent of GDP in 1980 and averaged 11.5 per cent of GDP compared to 5 per cent of pre liberalization regime.

Table: 3.10 Budget deficit and Financing

Rs. Million

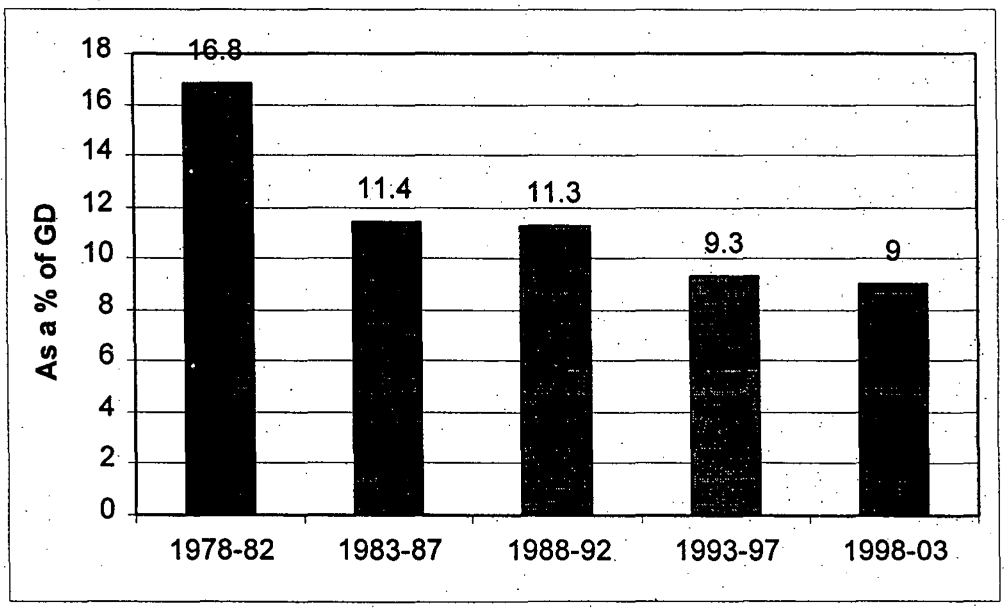
						Financing				
Year	Overall Budget Deficit (Before Grants)	As a % of GDP	Total Defense Expenditure	As a % of Current Expenditure	As a % of GDP	Foreign loans	Foreign Grants	Domestic	Foreign Financing (as a % of overall deficit-after grants)	Domestic Financing (as a % of overall deficit-after grants)
1977	2127	5.8	n.a	n.a	n.a	754	501	872	46.4	53.6
1978	6000	14.1	n.a	n.a	n.a	3292	661	2047	61.7	38.3
1979	7226	13.8	n.a	n.a	n.a	2348	1390	3488	40.2	59.8
1980	15366	23.1	n.a	n.a	n.a	3516	2620	9230	27.6	72.4
1981	13239	15.6	n.a	n.a	n.a	4880	2721	5638	46.4	53.6
1982	17302	17.4	1100	6.0	1.1	4744	3376	9182	34.1	65.9
1983	16320	13.4	1754	7.9	1.4	6372	3473	6475	49.6	50.4
1984	13776	9.0	2459	9.9	1.6	6492	3293	3991	61.9	38.1
1985	18985	11.7	5612	17.1	3.5	7109	3307	8569	45.3	54.7
1986	21955	12.2	9691	28.5	5.4	9061	3753	9141	49.8	50.2
1987	21749	11.1	10229	25.8	5.8	5716	4677	11356	33.5	66.5
1988	34783	15.7	10722	23.2	4.8	7128	6588	21067	25.3	74.7
1989	28185	11.2	8816	15.4	3.5	5926	6407	15852	27.2	72.8
1990	31850	9.9	13339	18.6	4.1	11644	6698	13508	46.3	53.7

1991	44189	11.9	14941	17.8	4.0	19329	7870	16149	54.5	47.9
1992	34042	8.0	18048	20.1	4.2	7361	8280	15551	32.1	80.3
1993	43321	8.7	20781	20.3	4.2	9855	8025	24241	28.9	74.6
1994	60727	10.5	26444	20.8	4.6	11778	8257	37696	23.8	82.2
1995	67225	10.1	43140	28.0	6.5	21224	9028	33972	38.5	67.0
1996	72380	9.4	44187	25.2	5.7	10160	7739	49754	17.0	90.9
1997	70061	7.9	47936	25.9	5.4	9958	7329	30275	12.9	68.2
1998	93147	9.2	54328	27.2	5.3	10197	7200	71362	11.9	88.1
1999	83255	7.5	48378	23.3	4.4	1484	6761	74876	1.9	98.1
2000	124541	9.9	76228	29.9	6.1	495	5145	118500	0.4	99.6
2001	152222	10.8	64138	21.1	4.6	14538	5500	123595	9.9	90.1
2002	141102	8.9	49163	14.8	3.1	1978	7079	126352	1.5	98.5
2003	141155	8.0	49721	14.8	2.8	43066	7956	79660	32.3	67.5

Sources: Central Bank of Sri Lanka (Various Annual Reports)

(a) Domestic financing includes privatization proceeds since 1991

Figure: 3.6 Overall Budget Deficit as Percentage of GDP



Source: Table: 3.10

The Government implemented the first phase of stablization programme with the auspices of IMF during 1981 - 85 period. The main purpose of this initiative was to increase the revenue and to reduce expenditure. However these stabilization measures were hampered by several factors including lack of political will to undertake bold deflationary programme in an election year (1982), terms of trade deterioration, drastic drop in tourist arrival following the communal violence in 1983 and increasing defense expenditure owing to the eruption of ethnic imbroglio in the North and East of the Country. The defense expenditure contributed substantially to the huge budget deficit particularly after 1983. On average, the defense expenditure alone accounted nearly 4.3 per cent of GDP between 1982 and 2003 and in the total current expenditure it averaged 20 per cent during the corresponding period.

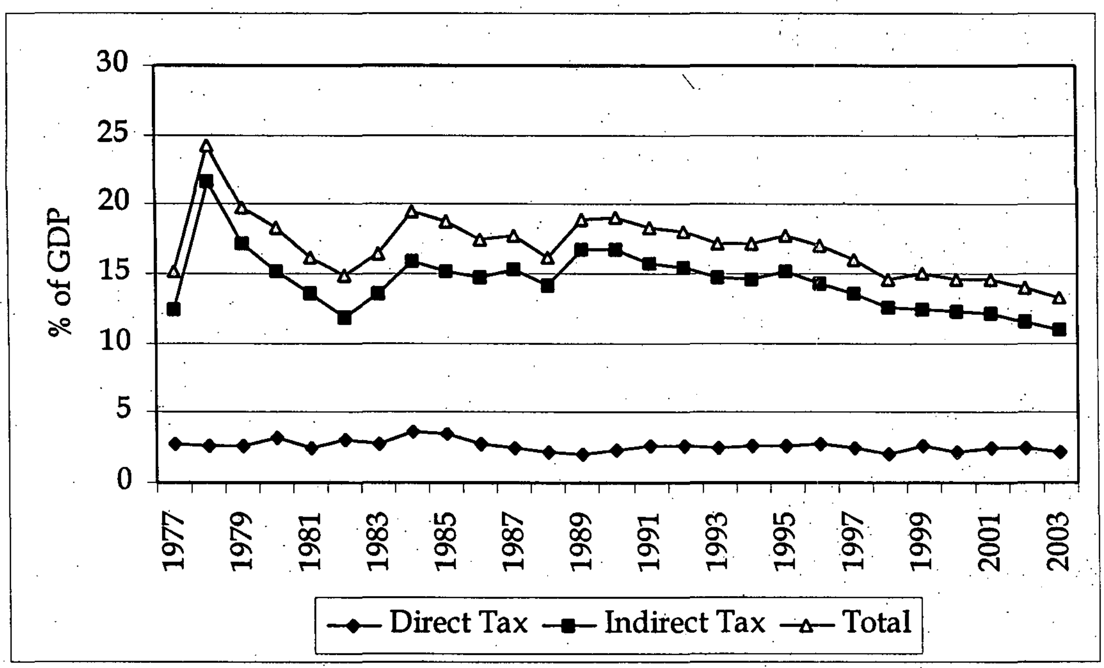
This worsening situation of huge budget deficit calls for comprehensive policy measures to rationalize the government expenditure and expand the revenue base. One important reason why taxation is essential in getting macroeconomic policies right is that alternative ways of financing government expenditure - money creation, mandating larger required reserves, domestic borrowing and foreign loans - can have very harmful effects on the economy (Waidyasekera, 2004). Increased budget deficit are financed through domestic and external sources. After the liberalization, Sri Lanka increasingly depended on external sources. During 1978 - 2003 periods, on average 69 per cent of the budget deficit was financed through domestic sources in contrast to 85 per cent during pre liberalization regime. On the other hand, on average, 31 per cent of deficit has been financed through external sources in contrast to 15 per cent of the pre liberalization period. The domestic borrowings would raise the interest rates and borrowings from external sources will increase debt and the debt service burden.

3.2.8.10 Tax – GDP Ratio

Following the liberalization, except for 1978 the tax GDP ratio continued to decline, despite fluctuations. One important reason why taxation is essential in getting macroeconomic policies right is that alternative ways of financing government expenditure - money creation, mandating larger reserves, domestic borrowing and foreign loans – can have very harmful effects on the economy. But in Sri Lanka, one of the alarming signals that has arisen is the continuing decline in the trend of government revenue. This implies that the Sri Lankan economy is increasingly dependent on the domestic and external debt to meet the budget deficit. As a percentage of GDP, total debt was 105.9

per cent in 2003. This is the clear sign that Sri Lanka is the thick of an economic crisis because government tax revenue has not kept pace with increasing GDP and per capita income.

Figure: 3.7 Tax - GDP Ratio



Sources: Central Bank of Sri Lanka (Various Annual Reports)

As compared with the pre liberalization period, the revenue from the direct tax further declined and averaged only 2.6 per cent of GDP during the 1977 - 2003 period. The average of the indirect tax increased marginally to 14.4 per cent of GDP, as compared with the pre liberalization regime. The total tax revenue also averaged 17 per cent of GDP during the post liberalization period with marginal decline from the pre liberalization average. As a whole, there was no drastic change in the structure of the government tax / GDP ratio between pre and post liberalization periods.

Though there was a downward fluctuation in the government tax revenue, a steady continuous decline is observed particularly from 1995. Several reasons could be attributed for this declining trend of tax revenue. Firstly, the government continued to provide unplanned and ad hoc tax exemptions, incentives and concessions. Secondly, the government increased the exemption threshold and reduced income tax and duty rates. Thirdly, the government granted regular tax amnesties and finally, there were weaknesses in revenue administration.

3.2.8.11 Balance of Payments

Following the liberalization, international trade expanded exponentially. It is important to note that imports grew remarkably faster than exports and precipitated large current account deficits, which reached 16 % of GDP in 1980. Except in the early 1980s, the current account deficit was maintained at single digit level till 2003. Private transfers, mainly workers remittances, contributed for this decline. On the other hand, the capital and financial account balance had never been deficit throughout the post liberalization epoch. Its continuous surplus helped Sri Lanka to have overall balance account surplus in many years and helped to minimize the magnitude of overall balance deficit in the deficit years.

Table: 3.11 Balance of Payments Values in US $ Million

Year	Current Account Balance	As a % of GDP	Capital & Financial Account Balance	As a % of GDP	Overall Balance	As a % of GDP
1977	144.1	3.5	36.7	0.9	360.9	8.8
1978	-93.1	-3.4	166.5	6.1	120.1	4.4
1979	-228.4	-6.8	212.3	6.3	51.9	1.5
1980	-660.0	-16.4	398.3	9.9	-191.9	-4.8
1981	-442.3	-10.0	400.6	9.1	19.9	0.5
1982	-568.1	-11.9	526.4	11.0	-48.0	-1.0
1983	-472.8	-9.1	451.0	8.7	18.0	0.3
1984	-54.7	-0.9	344.1	5.7	269.3	4.5
1985	-419.5	-7.0	333.0	5.6	-49.3	-0.8
1986	-426.1	-6.7	324.8	5.1	-70.3	-1.1
1987	-343.4	-5.1	282.2	4.2	-67.3	-1.0
1988	-389.3	-5.6	261.0	3.7	-90.7	-1.3
1989	-318.3	-4.6	276.9	4.0	-88.0	-1.3
1990	-377.0	-4.7	514.1	6.4	118.7	1.5
1991	-619.4	-6.9	857.7	9.5	290.2	3.2

1992	-554.6	-5.7	664.4	6.8	189.6	2.0
1993	-495.5	-4.8	1108.2	10.7	660.9	6.4
1994	-860.3	-7.3	942.9	8.0	239.7	2.0
1995	-786.5	-6.0	698.6	5.4	51.5	0.4
1996	-676.9	-4.9	459.0	3.3	-67.8	-0.5
1997	-392.9	-2.6	602.2	4.0	162.9	1.1
1998	-225.9	-1.4	413.4	2.6	36.8	0.2
1999	-563.0	-3.6	372.9	2.4	-263.2	-1.7
2000	-1066.0	-6.4	443.0	2.7	-521.9	-3.1
2001	-215.1	-1.4	562.0	3.6	220.1	1.3
2002	-236.5	-1.4	443.6	2.7	338.0	2.0
2003	-101.1	-0.6	702.2	3.9	502.4	2.8

Sources: Central Bank of Sri Lanka (Various Annual Reports

The liberalization period from 1978 to 2003 witnessed relatively high current account deficits, around 6 per cent of GDP on average compared to 1.5 per cent during the pre liberalization regime. Total exports accounted for a relatively high level of 24 per cent on average. They reached the historic level of 31 per cent in 1978 due to the currency devaluation of November 1977. Since then exports experienced a declining trend until 1986 except 1984. From 1987 onwards, total exports (as a % of GDP) had an increasing trend and reached 28 per cent of GDP in 2003 amidst very marginal declines in some certain years. Meanwhile, total imports accounted for a very high level of 38 per cent of GDP on average during the post liberalization periods (1978 - 2003) because Sri Lanka is increasingly dependent on imported inputs for its manufacturing exports particularly after the liberalization. The trade deficit has increased from 6.6 per cent of GDP in 1978 to 8.5 percent of GDP in 2003. Therefore, the liberalized regime has been associated with a larger trade deficit compared to the pre - liberalized regime.

The current account has largely followed the movements in the trade balance component. During the post - liberalization period, merchandise exports remained at a relatively high level on average. In 1978, they surged further reflecting the impact largely of the substantial currency devaluation of November 1977. Since then exports experienced agradual decline up to 1986, with the exception of 1984 when the export sector fared well due to favourable primary commodity prices in that year. The trend behaviour of merchandise imports has roughly been the same as that of merchandise exports. It must be noted here that, during the period when Sri Lanka has become an exporter of manufactured goods, its imports tended to move in tandem with exports because its manufactured exports have been heavily dependent on imports for their inputs. After the brief period of the ceasefire agreement, the war again erupted in 1994. Moreover, the LTTE captured a strategic Elephant Pass Army camp, which is the gateway of Jaffna district, in 2000. Following these developments, the government was compelled to purchase a huge amount of arms and ammunition in that period. This was reflected immediately in the current account deficits.

The service account of the balance of payments has not generally been decisive in the determination of the external imbalance in Sri Lanka (Samararatne, 1997). Services trade increased rapidly after the liberalization. Services & Income (net) increased from 0.3 per cent of GDP in 1978 to 1.1 percent of GDP in 2003. After the liberalization, relaxation on foreign traveling and devaluation of rupee induced people to migrate to foreign countries, particularly to the Middle East. Since then, remittances from Sri Lankan workers increased dramatically and therefore the private transfers (net) increased to 6.6 per cent of GDP in 2003 from 0.8 per cent of GDP in 1978 (Central Bank of Sri Lanka, 2003). Since remittances are transfer payments, their impact on the balance of payments always will be positive. Though the developments in the Services & Income and transfers accounts significantly contributed to reduce the magnitude of the current account deficit, the liberalized regime has been associated with larger current account deficit due to the larger trade deficit as compared to the pre liberalization regime.

Table: 3.12 Private Transfers

Year	Private Transfers (as a % of GDP)	Year	Private Transfers (as a % of GDP)
1977	0.6	1991	4.6
1978	0.8	1992	5.0
1979	1.4	1993	5.5
1980	3.7	1994	5.4
1981	4.9	1995	5.5
1982	5.7	1996	5.2
1983	5.6	1997	5.4
1984	4.7	1998	5.6
1985	4.5	1999	5.8
1986	4.5	2000	6.2
1987	4.9	2001	6.5
1988	4.8	2002	6.7
1989	5.3	2003	6.6
1990	4.5	****	***

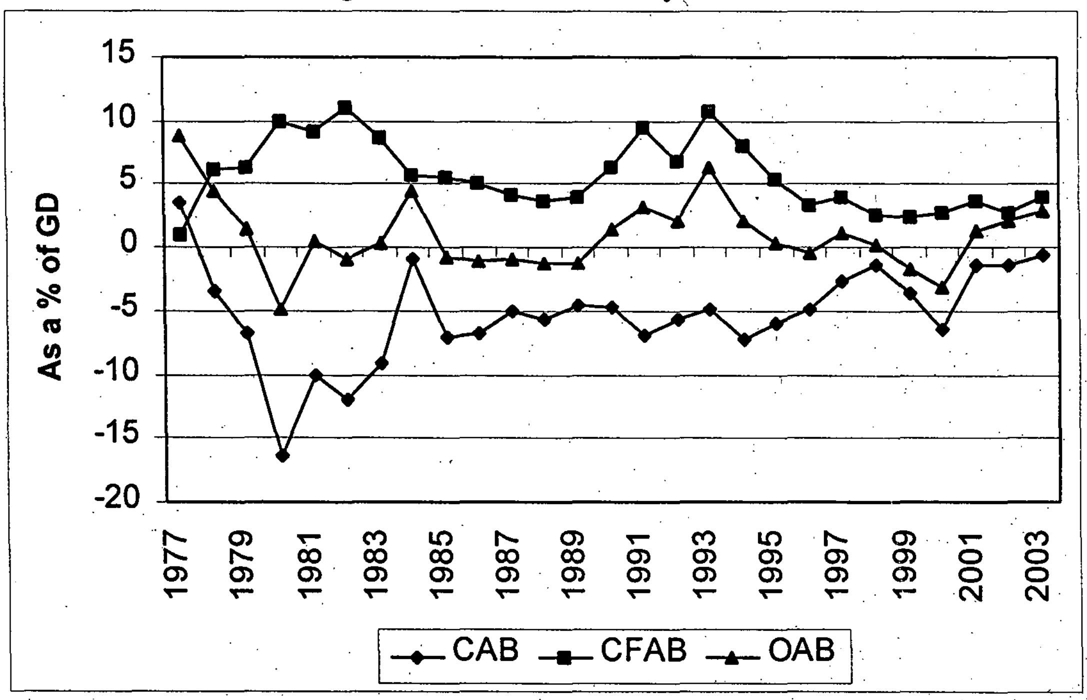
Source: Central Bank of Sri Lanka (Various Annual Reports)

The post 1977 period was characterized by relatively higher level of the Net Foreign Capital Inflow (NFKI). The magnitude of NFKI was positively associated with the momentum of trade and payments liberalization. This initial surge in capital inflowing the 1977 reforms could not be maintained during the 1983 - 89 period partly due to faltering momentum in trade and payments liberalization. Since 1990, NFKI again increased along with the commencement, in 1989, of the second wave of liberalization and structural adjustment.

However, during 1983 - 84, they dropped, followed by a period of erratic fluctuations till 1990. Since then NPKI increased gradually due to the incentives and concession and the peaceful environment in the southern part of Sri Lanka. FDI, the principle source of private capital inflows over the post reform periods, increased significantly. The movements in FDI were driven by changes in the domestic investment environment as fashioned by the momentum in the liberalization of trade and payments, investment incentives and political and economic stability. The period immediately after the economic reforms provided an environment conducive to FDI. But post 1983 period had negative impact on the inflow of FDI from time to time. The post

1983 experience of Sri Lanka revealed that economic and political stability of a country is more important than incentives offered. However, on average, Capital & Financial Account Balance surplus was 5.8 per cent of GDP during 1978 - 03 compared to less than 1 per cent of GDP during the pre liberalization of 1950 - 1977 period.

Figure: 3.8 Balance of Payments

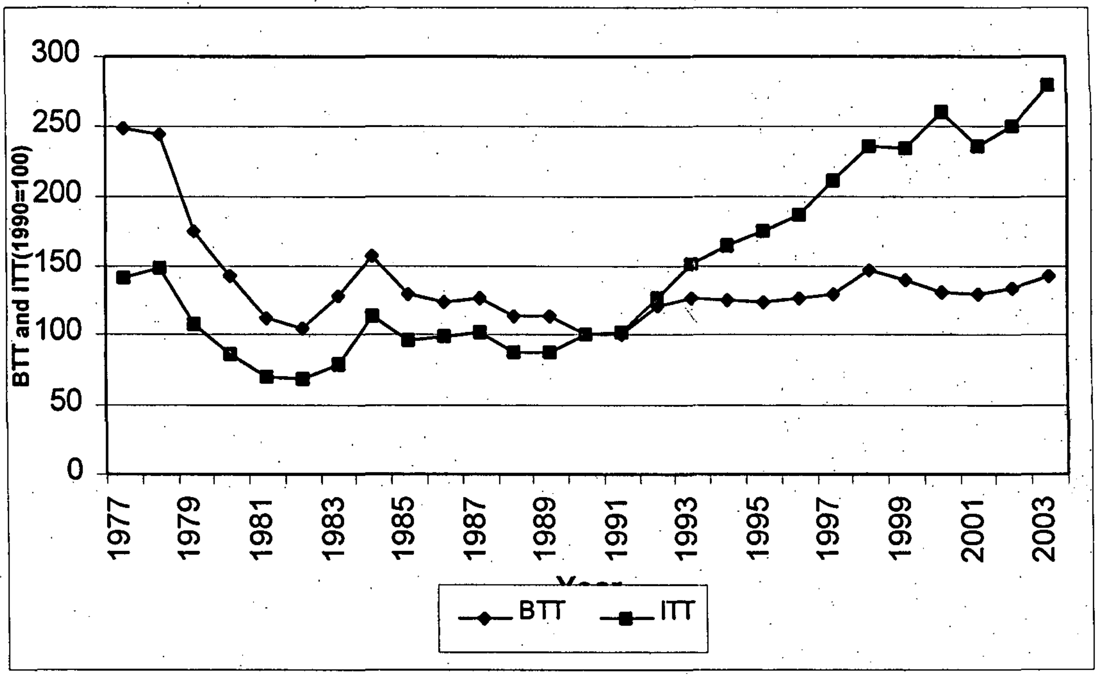


Source: Source: Central Bank of Sri Lanka (Annual Reports, Various Issues)

3.2.8.12 Terms of Trade [(a)] (TOT), 1990=100

Since Sri Lanka depended on three primary export commodities, viz., tea rubber and coconut, for export earnings in the early years after independence, she had experienced several external shocks related to changes in either export prices or import prices or other external factors such as oil price hikes. However, unlike during the pre liberalization periods, the country has managed to diversify its trade structure, from primary agricultural goods to industrial products, with the view to avoid external shocks during the post liberalization periods.

Figure: 3.9 Barter Terms of Trade (BTT) and Income Terms of Trade (ITT) (1990=100)



Source: Central Bank of Sri Lanka (Annual Reports, Various Issues)
Note: Indices based on 1978, 1981, 1985 and 1997 have been adjusted to the base year

Sri Lanka's export earnings had been heavily dependent on a few primary commodities till about the early 1980s. Imports, on the other hand constituted essential consumer, investment and intermediate goods. A foreign trade structure of this nature would have a strong potential to produce a long - term tendency for the TOT to deteriorate. However, favourable tea prices and the recovery of the world economy from the first oil shock - helped Sri Lanka to improve her BTT and ITT somewhat in 1977. However, both BTT and ITT continued to decline till 1983. This fall was primarily driven by exogenous shocks[11]. The TOT and BTT experienced a temporary improvement during the 1983 - 84 period following the boom conditions in export commodity prices. But after 1991, both BTT and ITT remained rather stable. This could largely be attributed to the structural transformation of exports. Because while the agricultural exports registered a continuous decline, the industrial exports and total exports steadily increased from1991.

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11 Export prices continued to increase moderately but import prices increased sharply.

According to annual compound rate, between 1978 and 1987 the BTT has deteriorated by 4.5 per cent while ITT declined only by 1.1 per cent, which implies that the ratio of export to import price (BTT) has deteriorated more sharply than that of import purchasing power of export earning (ITT take account the export volume) during these periods.

Interestingly, for the first time in Sri Lanka, BTT recorded an annual compound rate 2.3 per cent during 1988 - 97 while ITT recorded an annual compound bullish rate of 11.2 during the corresponding periods. However, the BTT deteriorated an annual compound rate of 0.9 per cent in 1998 - 03 while the ITT accounted an annual compound rate of 2.8 per cent during the same period. This implies that even though Sri Lanka suffered because of a marginal deterioration in terms of BTT she has offset this deterioration by an increased import purchasing power of export earning (ITT).

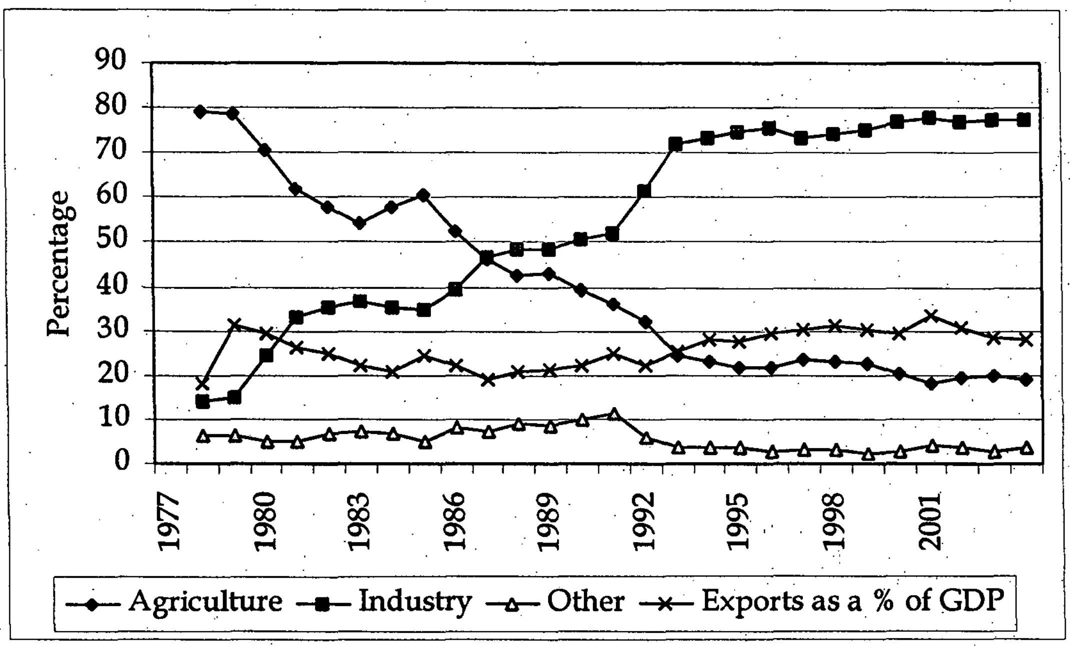
As a whole, the BTT deteriorated by only a compound rate of 0.5 per cent during the post liberalization period from 1978 to 2003 compared to 3.3 per cent deterioration during the pre reform period from 1948 to 1977. Meanwhile, the ITT has improved at a much faster rate (5.1 per cent compound rate) during the post reform period compared to 2.2 per cent deterioration during the pre reform period. This comparison suggests that market - oriented policy reforms can generate a superior ITT out come by improving supply elasticity of exports. During the post reform era, both the BTT and ITT have significantly improved, thanks to the rapid growth in manufactured exports. The positive trends of the ITT are even stronger, which means that the positive relative price trends have been reinforced by positive volume trends during the post reform period (Athukorala, 2003).

3.2.8.13 Composition of Exports and Exports as a Percentage of GDP

Though Sri Lanka focused on the diversification of the exports structure from plantation cum agricultural goods to industrial exports since the early 1960s, plantation crops constituted a significant portion in the total exports even in

1977(79 per cent). But the diversification process expedited after the liberalization era during which total exports, as a percentage of GDP also increased considerably. However, it is important to note that as a percentage of GDP industrial exports grew steadily during the post liberalization period. But the total exports, as a percentage of GDP, did not grow as much as industrial exports grew. Because, industrial exports registered 5.8 per cent compound growth during the 1977 - 2003 period. On the other hand, the compound growth rate of agricultural exports and other exports declined by 5.9 per cent and 3.7 per cent during the same period. As a result, as a percentage of GDP, the total exports constituted only 1.2 per cent compound growth rate during this period.

Figure: 3.10 Compositions of Exports and Exports as a Percentage of GDP



Source: Central Bank of Sri Lanka (Annual Reports, Various Issues)

Export promotion was the major objective of the liberalization policy of 1977. There was an expansion as well as a diversification of exports. The main feature of the change in the composition of exports during this period was the rise in the share of exports of industrial goods, dominantly garment and textiles, and the corresponding fall in the share of agricultural exports. For the first time in 1986, industrial exports surpassed the dominant place held by the agricultural exports since independence.

Meanwhile, significant changes took place in the commodity composition of exports during the post liberalization periods. Agricultural exports registered 5.97 per cent decline (according to compound growth rate) during the period of 1978 - 2003. The exports of agriculture sector lost its dominance to industrial exports. As a whole, the liberalization greatly contributed to changes of exports structure. Particularly, exports of industrial goods expanded tremendously after the liberalization. This sector accounted 5.8 percent compound growth during the period of 1978 - 2003. As a whole, the total exports, as a percentage of GDP, recorded an annual compound growth rate of 1. 2 per cent during the 1978 - 2003 period, compared to 3.8 per cent decline during the pre reform period.

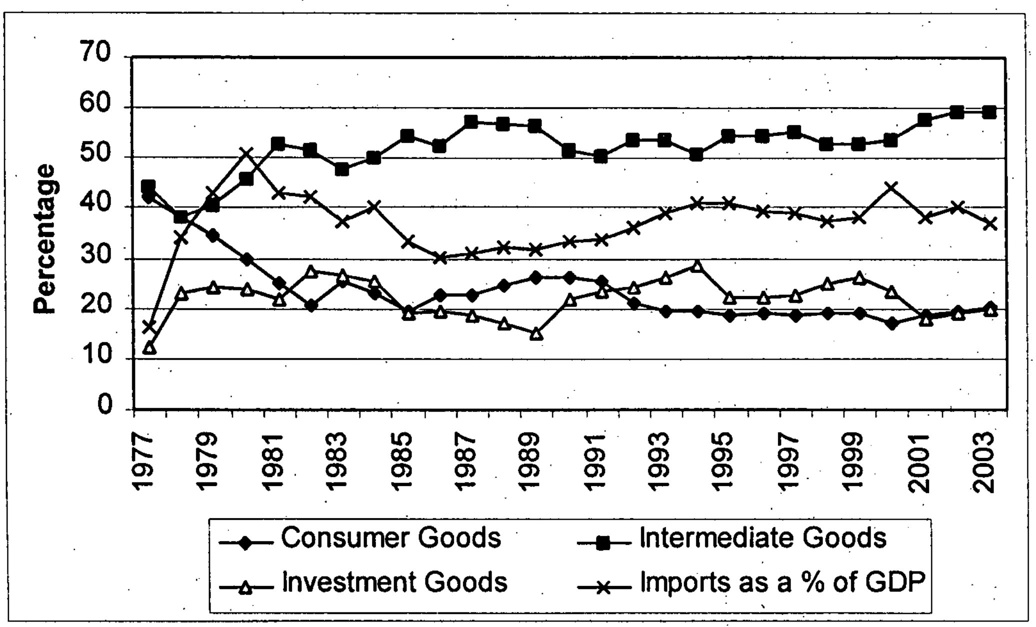
However, as Lakshman (1996[a]) pointed out, there were several external and domestic factors that delayed the positive impact of liberalization on exports growth till about the mid 1980s.(i) appreciation of the real exchange rate due to high inflation,(ii) inefficiency in State owned enterprises, particularly those in the plantation sectors,(iii) policy discrimination against plantation products,(iv) differential tax treatment of, or incentives to, different export products, (v) eruption of civil disturbances after 1983, and (vi) restrictive trade practices of industrial countries.

Nevertheless, exports, particularly industrial exports, expanded rapidly during the second phase of (post 1989) of liberalization. The share of tea, rubber and coconut in total export was continuously decreasing while textile and garments were emerging as a major export item of the country. As a whole, the pattern of the exports composition has changed from plantation cum agricultural goods to garments and textiles. However, as Pieris (1997) notes, the contribution of these garments and textiles towards solving the balance of payments and foreign exchange problems of the country, as per dollar earned through these exports, can be significantly less than a dollar earned through a commodity like tea because, the production of these garments and textiles heavily depends on imported inputs. Importantly, Sri Lanka's textile and garments industry greatly depended on quota system under Multi Fiber Agreement (MFA). Sri Lanka's major market for textile and garments is the U.S.A. In 2005, the quota system came to an end. Since then, Sri Lanka would have to compete in the world market with all garment - exporting countries. Therefore Sri Lanka's garments and textiles industry is moving to wards an unsustainable future.

3.2.8.14 Composition of Imports and Imports as a Percentage of GDP

The 1977 policy reforms led to a marked increase in the imports of intermediate goods with parallel declines in the imports of consumer goods. At the beginning of the reform process, the government initiated several mega development programmes and therefore the imports of intermediate goods and investment goods increased at an unprecedented level. The total imports also, as a percentage of GDP, marked a significant increase during the post liberalization regime from 1978.

Figure: 3.11 Compositions of Import and Imports as a Percentage of GDP



Source: Central Bank of Sri Lanka (Annual Reports, Various Issues)

Even though there were ups and downs in the share of consumer goods imports, a clear downward trend is observed in the long run with regard to consumer goods. It registered 2.3 per cent decline (according to compound growth rate) during the period of 1978 - 2003. At the same time, the imports of investment goods accounted 0.24 per cent compoud growth during this period. However, in sharp contrast the imports of intermediate goods registered 0.97 per cent compound growth over this same period. Heavy import intensive manufacturing products contributed significantly to the sharp rise of intermediate goods imports. The export oriented manufacturing production requires massive imported intermediate inputs. As a percentage of GDP, total imports recorded an annual compound rate of 0.67 per cent during 1978 - 2003, compared to 3.2 per cent decline during the pre reform period.

3.2.8.15 Trade Dependency 1977 - 2003

Panagariya (2003) argues that as far as developing countries are concerned, there is compelling evidence that openness (trade dependence) is a necessary condition for rapid growth. In line with Panagariya's argument, both trade dependency and growth increased significantly after the introduction of liberalization policies in Sri Lanka. The trade dependence, according to the Trade Dependence Ratio (TDR), of Sri Lanka shows a fluctuating tendency between 1978 and 2003. As a whole, the TDR was almost same during the periods of 1978 - 84 and 1995 - 03. Though the high growth coupled with higher TDR, some important things should be addressed here. Sri Lanka has succeeded in diversification, from primary exports to manufacturing goods, of her export structure

Table: 3.13 Trade Dependency

Year	Trade Dependency Ratio
1978-84	70.3
1985-88	59.0
1989-94	66.9
1995-03	68.5

Source: Central Bank Annual reports

The TDR tremendously increased from 32.8 per cent during 1970 - 77 to 70.3 per cent during 1978 - 84. Even though the TDR declined continuously till the 1989 - 94 period, it reached 68.5 per cent in 1995 - 03 which is equal to the 1978 - 84 period level. The basic point is that the TDR is very much higher during the post liberalization regime than that of pre liberalization era. Though both exports and imports increased drastically during this period, the percentage increase of imports is very much greater than that of exports. This situation increases the vulnerability to external shocks.

3.2.8.16 Social Indicators (Health indices and Literacy)

Sri Lanka has been referred to as a country where, at a relatively low per capita income level, respectable levels of human development have been achieved and the fruits of material advancement have been made available to a wider section of the society than was the case in most developing countries (Lakshman(1997 [b]). After the introduction of the liberalization policy, though the food subsidy was replaced with food stamps, free education and free health programmes continued with greater impetus because the government started to provide free school textbooks from 1980. In addition, two major poverty alleviation programmes, Janasaviya (literally, Peoples' Strength) and Samurthy (literally, Prosperity), were implemented from 1989 to 1994 and from 1994 till date respectively. It is obvious that some welfare programmes were and are in place even during the post liberalization period. By 1996,the sum of 1265 million rupees (0.7 per cent of GDP) and 8516 million rupees (4.9 per cent of GDP) were spent on Janasaviya and Samurthy programmes respectively[12].

Sri Lanka was *(is)* seen as an 'outlier' or an 'aberration' in the sense that the country has attained a higher stage of social development in respect of many welfare indicators than one would predict it to have on the basis of its low per

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[12] Source: Ratnayake, 1998

capita income (Lakshman, 1997b). Her achievement in terms of social indicators is remarkable and is, some times, compared to the performance of the developed countries.

Table: 3.14 Health Indices and Literacy

Year	Birth Rate (Per '000)	Death Rate (Per '000)	Infant Mortality (Per '000 Live Births)	Maternal Mortality (Per '000 Live Births)	Life Expectancy at Birth (Years) (a)	Health expenditure/ GDP Ratio	Literacy Rate(a)	Education Expenditure/GDP Ratio
1977	27.9	7.4	42	1.00	-	1.37	-	2.68
1978	28.5	6.6	37	0.80	-	1.63		2.67
1981	28.2	5.9	30	0.60	69.9	1.18	87.2	2.38
1985	24.6	6.2	24	0.50	-	1.29		2.74
1991	21.6	5.5	17	0.40	72.5	1.40	86.9	2.45
1994	19.9	5.6	17	n.a.	-	1.59	90.1	3.06
1997	17.9	6.1	16	n.a.	-	1.36	91.8	2.50
2000	18.4	6.1	13	n.a.	-	1.65	91.6	2.46
2003	n.a.	n.a	n.a	n.a.	-	1.56	n.a.	2.22

(a) Data available only in census years
Sources: Department of Census and Statistics and Central Bank of Sri Lanka

Health indicators continued to improve after the liberalization also. The death rate and infant and maternal mortality rates gradually declined through out post liberalization period. Life expectancy at birth also recorded further whopping increase during this period.

Though, health expenditure, as a percentage of GDP, increased between 1977 and 1978, subsequently it was always below the 1978 level. Furthermore, it has averaged only 1.5per cent during the post liberalization regime against 1.9 per cent average of pre liberalization era.

Apart from this laudable performance of health indicators, Sri Lanka further performed well in terms of its literacy rate, which increased from 87.2 in 1981, to 91.6 in 2000. On the other hand, as a percentage of GDP, expenditure on education declined during the post liberalization period. As a percentage of GDP, education expenditure also averaged only 2.6 per cent during the post liberalization period in sharp contrast to 3.6 per cent of pre liberalization regime. The role of universal primary education and a skilled workforce in improving productivity and laying the base for sustained development is now widely acknowledged, to the extent that even the World Bank cites this as an important element in the East Asian success (Ghose, 1997).

As Jayawardene(2004) pointed out even though this welfare programme helped Sri Lanka achieve better position in terms of social indicators, some economists argued that the food subsidies retarded the growth momentum of Sri Lanka. For example, the late Professor Joan Robinson, the celebrated Cambridge economist, always lamented the fact that Sri Lanka 'ate of the fruit before growing the tree'.

As a whole, following the liberalization the GDP growth increased to 8.2 per cent in 1978 and averaged for 6 per cent during the 1978 - 82 period. The agriculture sector growth was 5.4 per cent in 1977 and averaged 5 per cent during the 1977 - 82 period. The industry sector growth rate, which was in - 4.3 in 1977 soared to 15.9 per cent in 1978 and averaged 5 percent in 1977 - 82. The service sector growth averaged 6.8 per cent in the same period. It is important to note that compared with other sectors, the industry sector, particularly manufacturing and construction, received special attention. Due to the three lead projects i.e., Mahawaeli, EPZs and Housing programmes, the government investment increased temporarily. But after the completion of these projects public investment started to decline. On the other hand, after the eruption of the ethnic war, private investment was affected time to time due to instability and uncertainty. Service sectors, mainly tourism and trade, also were affected. After the escalation of the war mainly agricultural production and fishing were affected severely. Due to these factors post 1983 growth momentum was greatly fluctuating and strictly correlated, negatively, with the war. At the same time, the future of the manufacturing sector is questionable. Because Sri Lankan garment industry is greatly depending on imported inputs and the market of textiles and garments depended on quota system, which came to an end in 2005. As a result, the future of the garment industry is greatly uncertain.

After the reforms, Sri Lanka expedited the diversification of export structure from primary agricultural exports, tea, rubber and cocounut, to manufacturing exports, mainly textiles and garments. In 1987, industrial exports surpassed the dominant place held by the agricultural sector in terms of exports since independence. Since the manufacturing exports greatly depended on the imported inputs and textile quota system, it is crucial for Sri Lanka to think other alternatives. But East Asian countries gradually shifted their production from textile and garments to soft electronics. However, this process is not seen in Sri Lanka.

It is important to note that during the early years of liberalization government investment significantly increased. Though these practices were against the liberalization process, it was necessary for the Sri Lankan government to provide essential infrastuctural facilities to domestic and foreign investors with a view to boost private investment. That is why the government initiated three lead projects. This development significantly increased the fiscal deficits during the early part of liberalization.

One of the major conditions of the Britton woods institutions is the reduction of current public expenditure, mainly welfare expenditure. However, the Sri Lankan experience is quite different in this regard. The 1977 government eliminated the extensive food subsidy programme and introduced food stamp programme only to the targeted groups. At the same time, this government introduced the provision of free school textbooks to all students. Moreover, the one million housing programme, primarily for the poor, also was initiated in this period. During the Premadasa regime, the government implemented several welfare programmes including Janasaviya (literally people's strength) poverty alleviation programme, free mid day meal and free uniform for all school children. On the one hand to fulfill the precondition of the World Bank and IMF, the government introduced the early retirement programme for government servants with a view to reduce the size of public sector. On the other hand, the government intiated the Janasaviya teaching programme. According to this programme, those who have food stamp gained 100 marks and easily got the job. In 1994, the Janasaviya programme was replaced with another poverty alleviation proramme called Samurthy (literally Prosperity) programme. Therefore, even during the liberalization process, welfare programmes are in place in Sri Lanka.

It is very difficult to assess the impact of the liberalization process on the economy since the country confronts a destructive war. It is obvious that the eruption of the war had harmful effects on the economy in various ways. Firstly, it undermined the country's political stability and subsequently discouraged the environment for investment. There is a strong negative correlation between the escalation of the war and the investment and trade particularly. Secondly, the war greatly affected the agriculture and fisheries production, particularly in the North and East, and the tourism in the rest of the country. The only positive impact of the war was the expansion of the armed forces, which provided the employment opportunities for thousands of youths.

CHAPTER FOUR

Social Developments and Economic Growth in Sri Lanka

The relationship between social development and economic growth can be complex. Newman and Thomson (1989) pointed out that economic growth depends on social development but not vice-versa. However, Colombatto (1991) argued that the impact of social development on economic growth, although statistically significant, was quite marginal. Critics of the welfarist approach to development have argued that by emphasizing activities which are essentially consumption oriented, the welfariast approach implies a reduction in the rate of growth. On the other hand, proponents of this approach point to the human capital aspects of welfarism, which could be instrumental in increasing productivity and growth in output. Particularly, education and health play a major role in increasing the standard of human capital through labour quality, which clearly contributes significantly to economic growth. Empirical study in Bloom *et al* (2004) suggests that health, in the form of life expectancy, has a significant positive effect on the rate of economic growth. Their main result is that health has a positive and statistically significant effect on economic growth. It suggests that a one-year improvement in a population's life expectancy contributes to a 4% increase in output. So health is a crucial aspect of human capital, and therefore a critical ingredient of economic growth. Thus improvements in health may increase output through labour productivity

As far as Sri Lanka is concerned, we argue that neither 'trickle - down effect'[1] (whereby social development would lead to economic growth) nor 'trickle - up effect' (whereby economic growth would make welfare improvements) did take place in Sri Lanka during the pre liberalization regime. In the early years of the implementation of welfare programmes, there was no strong positive relationship between economic growth and the expenditures on welfare programmes. Sri Lanka continued to implement all welfare

[1] See Colombatto(1991) for elaboration.

programmes with low level of per capita GDP and GDP growth. Thus economic growth did not make welfare improvements (trickle-up effect - whereby economic growth would make welfare improvements). Meanwhile, though Sri Lanka achieved an admirable position with regard to Social indicators, the growth rate did not pick up (trickle - down effect- whereby social development would lead to economic growth) until the introduction of liberalization policies in 1977. So social development did not lead to economic growth.

In academic circles, Sri Lanka is cited as an exceptional case among developing countries for her achievement in terms of social development. One important question that does arise here is why this remarkable achievement in social indicators did not help Sri Lanka to achieve a rapid growth during the pre liberalization regimes? Firstly, higher spending on welfare programmes should be accompanied with higher level of rate of investment and higher per capita GDP. Sri Lanka continued to implement all welfare programmes with low level of rate investment and low level of per capita GDP. Secondly, the industrialization was delayed till the introduction of the reforms. This led the country to depend mainly on the agriculture sector for production and employment. The growth in the agricultural production depends on favourable weather conditions. Always, the agriculutural sector has to face risk from floods or drought. Therefore, maintaining constant growth in the agriculture sector is difficult. The participation of females in agricultural activities was and is very marginal in Sri Lanka. As far as males are concerned, the employment is very much seasonal in the agricultural sector. These contributed to the low GDP growth and a relatively high unemployment problem during the pre liberalization period. Finally, since the late 1950s, Sri Lanka has had serious development problems including balance of payment deficit, extremely adverse terms of trade, preemption of a high percentage of the budget and of imports for food subsidies. As a composite effect, Sri Lanka was unable to overcome from the macroeconomic crisis mainly low GDP growth rate and high unemployment. In this context, achievement in social indicators did not help Sri Lanka to achieve a rapid growth to the maximum extent possible during the pre liberalization regimes.

Trade off between the implementation of extensive welfare programmes and investment

Since Sri Lanka continued to implement extensive welfare programmes with very low level of per capita income, a significant portion of the GDP was used for such programmes. Aturupane *et al* (1994) pointed out that the World Bank is widely considered as an example of the welfarist approach of mainstream economics, in which well-being depends primarily on income and noted that high incomes were necessary and sufficient for poor countries to raise social indicators. However, this argument did not have much ground in the case of Sri Lanka because there was a mismatch between huge expenditures on extensive welfare programmes and the low level of GDP growth in Sri Lanka. By the 1960s there were clear signs that Sri Lanka had been living far beyond its means (ILO, as quoted in Abeyratne, 2004). Welfare programmes covered the entire population of the country without the support of economic rationale and the essential economic foundation. The political competition in a multi-party democratic system has been instrumental in the initiation and the continuation of the system (Abeyratne, 2000). Development objectives emphasize increasing the human capital, productivity and incomes of the poor as means of meeting basic needs and increasing growth. Basic needs proponents would point to the human capital aspects of basic needs as possibly having long-term effects sufficient to cancel out any temporary reduction in growth (Hicks, 1979). However Sri Lanka was not following ....a basic needs approach, but rather was responding to political pressures for a set of social programmes (Isenman, 1980). Therefore we argue that the real motivation for the implementation of extensive welfare programmes was to gain political mileage rather than real economic development of the country.

Some argued that if Sri Lanka had liberalized its economy in the 1960s, higher growth rates could have been achieved. But Sri Lanka pursued a restrictive trade regime in that time. Perhaps one reason why Sri Lanka did not take a more outward - oriented development approach was its early commitment to welfarism (Rajapatirana1988). Due to the welfarism, the Government played a major role in the consumption and productive sectors. Financing of welfarism cum subsidies necessitated the imposition of high taxes, especially on foreign trade. This clearly distorted production incentives. The government's role as the chief importer of food also led to a problem in that a large amount of foreign exchange was apportioned to pay for this fixed level of food imports. These all developments were bottlenecks in increasing the rate of investment. Welfarism is not harmful for any country in terms of socio - economic development. Sri Lanka's commitment for the extensive welfarism was controversial, because Sri Lanka implemented all these welfare programmes (mainly food subsidy) for long time irrespective of her low income. Though East Asian countries were eagerly welfarists, they implemented welfarism with higher rate of investment unlike Sri Lanka.

Low investment and low GDP growth

At independence, Sri Lanka enjoyed economic prosperity (balance of payments surplus and comfortable external reserves) due to favorable world market price condition for the country's primary exports. However Sri Lanka diverted huge portion of this resource to the implementation of extensive welfare programmes rather than lay strong foundation for the economic development through increased investment. If the food ration programme had been restricted to the poorer half of the population in the mid 1960s, there would have been an annual average savings of about 2 per cent of GDP. Indeed, investment ratio was only 15 per cent during 1959-77. Sri Lanka resorted to welfarism as a means of human development long before such welfare concepts acquired a dominant position in developing thinking (Abeyratne, 2000). In Sri Lanka, there was a mismatch between the magnitude of welfare expenditure and the low level of per capita GDP. Amid low level of rate of investment, overemphasis on extensive welfarism (covered all section of the society) was a barrier to increase the investment.

Inability to exploit the benefits of social development due to the low growth

By the early 1970s, again there was a problem for Sri Lanka not only from the implementation side but also from the outcome of the welfare programme. Because Sri Lanka was unable to exploit the benefit from the social development due to dismal growth of GDP. To gain fully from the social development, there should be a parallel growth in GDP. The country faced a severe unemployment problem (18.7 per cent in 1971, 19.7 per cent in 1975, 14.8 per cent in 1978 and 8.6 per cent in 2003) particularly among educated youths, almost through out the pre liberalization period. Human development is a means to higher productivity. A well-nourished, healthy, educated, skilled, alert labour force is the most important productive asset (Streeten, 1994). Healthier workers are physically and mentally more energetic and robust. They are more productive and less likely to be absent from work because of illness (or illness in their family). Illness and disability reduce hourly wages substantially, with the effect especially strong in developing countries, where a higher proportion of the work force is engaged in manual labor than in industrial countries. Indeed, there was an irony in Sri Lanka because on the one hand Sri Lanka had excellent human development record but on the other hand it faced chronic unemployment problems.

Table 4.1 Unemployment Rate by Age Groups (Percentage of Labour Force)

Age Group (Years)	1963	1973	1986-87	Age Group (Years)	1994	2003
14-18	47.5	65.8	48.0	15-19	40.7	30.5
19-25	30.3	47.5	35.3	20-29	24.5	19.9
26-35	7.8	15.2	10.6	30-39	7.6	3.9
36-45	2.4	3.9	3.2	40-49	2.5	1.1 *
46-55	2.7	1.2	0.7	50 & above	1.2	
Over 55	1.9	0.8	0.6	\		
Total	13.8	24.0	15.5	Total	13.1	8.6

Note * 40-49 and 50 & above
Source: Central Bank of Sri Lanka (Various Annual Reports)

As shown in Table 4.1 during the pre liberalization regime, though the unemployment rate was very much higher, there was an alarming signal. Because most of the unemployed were between 14 and 25 age groups which was vulnerable groups. With improved human abilities owing to the extensive welfare system these younger economically productive groups confronted with the Government, which was unable to provide them a role to participate in the development process. Undoubtedly, this was a failure of the country that did not use the productive labour force in productive activities.

At the same time, like overall unemployment rate, employment among 14 -25 and 26 - 35 age groups was declining significantly during the post liberalization regime.

Table 4.2 Unemployment Rate by Level of Education (Percentage of Labour Force)

Level of Education	1963	1973	1986-87	1994	2003
No schooling	6.1	8.0	2.9	2.6	1.8 **
Completed primary education	10.5	14.1	5.0	5.0	
Completed secondary education	23.0	37.1	19.8	13.0	7.8
Obtained GCE (Ordinary Level)	39.3	47.4	28.5	19.6	12.9
Obtained GCE (Advanced Level)	13.9	44.4	36.8	23.7 *	16.4 *
Obtained university degree	0.0	16.2	7.6		

Note: GCE: General Certificate of Education
Note * GCE (A/L) and Above
** No Schooling and Completed Primary Education
Source: Central Bank of Sri Lanka (Various Annual Reports)

As can be seen in Table 4.2 the unemployment was very much higher among educated youths. The educated unemployed youths represent not just underutilized resourses but a threat to Sri Lanka's political stability. With the escalated social aspirations and expectations as a result of welfare system this younger generation, mostly Sinhala youths, engaged in an insurrection in 1971 in the southern part of Sri Lanka. Simultaneously, the North - East Tamil youths started to deviate from the mainstream politics towards violent paths due mainly to the standardization of 1970, which, they believed, diminished their university entrances. Table 4.3 shows the severity of the standardization. According to which the cutoff marks for the university entrance was determined on the basis of ethnic ratio.

Table: 4.3 Standardization for the University Entrance in 1970

Course	Cutoff marks for Tamil Student	Cutoff marks for Sinhala Student
Engineering (I)	250	227
Engineering (II)	232	212
Medicine & Dental Medicine	250	229
Agriculture, Veterinary and Biology	184	175
Physical Science	204	183
Architecture	194	180

Source: Hansard, division 83, No.5, 514 - 518, 06.01.1971 (as quoted in Tharmalingam, 1974)

Here country failed to utilize the ability of youths who had benefited from the state welfarism. Instead their ability became a threat to the future development and the stability of the country.

Improved education and health can make a major contribution to increase productivity. It has been argued that there is a stable relationship between the rate of increase in the productivity of labour and the fraction of the economically active population engaged in schooling (Razin, 1977). Furthermore, education has a positive effect on agricultural output when technology is changing, because educated farmers would keen to use improved technology in production. However, Sri Lanka was under import substitution strategy for a relatively long period during the pre liberalization regime. The import substitution strategy depended on imports for intermediate and investment goods. However, imports of investment goods declined drastically from 23.6 per cent of GDP in 1970 to 12.4 percent in 1977. As a result farmers were unable to use actively the improved technology since Sri Lanka depended on imports for capital goods. At the same time, during the pre reform period, the industrial sector reeled under sluggish growth and therefore the agriculture sector was unable to absorb all unemployed. Thus this period experienced massive unemployment problem. So, free education and free health were unable to contribute actively to the GDP growth of Sri Lanka.

Moreover, the country had to face enormous social demand, which was generated by extensive welfare programmes. The people brought up within the welfare system always pressurized the country to fulfill their aspiration. For an example, those who benefited from free education tended to seek white-collar skilled jobs in the government and formal private sectors. This required a parallel expansion of economic opportunities through sustained economic growth. However, this did not materialize due to the dismal growth performance of economy during the pre liberalization epoch.

Furthermore, welfare programmes required massive resources. During the first two decades of independence (1948 - 68,) social expenditure relating to education, health, food subsidies and public welfare assistance hovered around 40 per cent of total public expenditure or 10 - 12 per cent of GDP (Jayasuriya, 2004). During the 1950s and 1960s, the rate of investment constituted 12 per cent and 15 per cent of GDP respectively. This implies that a significant portion of resources had been used to welfare progrmmes. If welfare progrmmes were targeted to the poor, a significant of portion of resources could have been used to the capital formation. This did not happen. Due to low rate of investment, Sri Lanka experienced lower GDP growth. Therefore welfare programmes themselves were the stumbling blocks for the economy to experience a higher level of growth rate. These developments plunged the country to experience unprecedented unemployment problems. Ironically, welfare programmes resulted in increased healthy labour force. However, on the other hand, the country was unable to create employment opportunities due to low level of growth rate. On the ground, rapid growth of population and the rapid expansion of formal education contributed to the growing of educated youths. As a result there was huge unemployment problem particularly among educated youths.

Most importantly, Sri Lanka should have improved the social development without hindering the economic growth needs of the country. Indeed, however, that did not materialize until 1978. In sum, as quoted in Newman and Thomson (1989) Srinivasan claims that too much emphasis on basic needs provision will. ......hurt economic growth which in turn will damage future basic needs programmes.

Srinivasan's argument seems to be true as far as Sri Lanka is concerned. Two pieces of evidence can be cited here. First, Sri Lanka dismantled its extensive food subsidies programme in 1978. Second, the expenditures on total welfare programmes continued to decline. For an example, total welfare expenditure as a percentage GNP declined from 12.1 per cent in1970 - 71 to only 4.1 per cent in 1981[2]. This implies that Sri Lanka did not continue the extensive welfare programmes during the post liberalization regime as it was implemented during the pre liberalization regime.

Welfare systems are rationalized in development thinking at least in two respects, on equity and efficiency grounds. With respect to the rationalization based on equity criteria, the poor should have the right of access to basic needs by reducing the gap between the rich and the poor. Thus, welfare systems, by improving an egalitarian distribution pattern, fulfil certain

[2] Source: Central Bank of Sri Lanka (Annual Reports) given in Jayasuriya, 2000

development achievements. However, welfare systems only eliminate some symptoms of poverty rather than the cause of poverty.

Country studies in Fica and Ghateb (2005) suggest that expanding welfare state regimes are associated with low economic growth regimes, while contracting welfare state regimes are associated with high growth regimes. However, we also find that the structural decline in growth rates during the pre liberalization regime led to a downward structural break in the welfarism in Sri Lanka during the post liberalization regime. This suggests that declining growth regime forced politicians to cut the size of the welfare expenditures in the latter period.

During the 1950s, Sri Lanka increased welfare expenditures at a slightly faster rate than the growth rate of output. This was because when politicians maximized votes, voter support to politicians depended not only on the transfers they received, but also on the rate of output growth. As a consequence, transfer spending constrained the growth of the country. Over time, however, a threshold emerged wherein to maintain positive output growth, the government reduced transfer spending by cutting social welfare expenditures. More specifically, when growth fell, the welfare expenditures also declined, although at a faster rate than the reduction in growth. This ultimately created an upturn in growth after 1977.

Due to the increased GDP growth, Sri Lanka was in a position to benefit from the social development because, primarily, many Sri Lankan obtained employment opportunities and as a result the unemployment rate declined drastically. Free health helped Sri Lanka to have healthy labour force while free education guaranteed Sri Lankan to acquire at least primary education. However, like other developing countries, Sri Lanka also had huge unskilled unemployed. Nevertheless, many unemployed unskilled youths got employment opportunities particularly in the newly emerged garment industries and toys manufacturing industries during the post liberalization period. Further more, many Sri Lankan obtained employment opportunities abroad, particularly in the Middle East. These employment opportunities included unskilled workers and skilled workers (housemaids, carpenter, plumber, mason, technician etc) In addition, a number of Sri Lankans migrated to western countries to find a job. Only after the liberalization, controls on foreign traveling were relaxed (passports were and are issued within one day) and many foreign employment companies, which facilitated Sri Lankans to get a job easiliy, were opened in Sri Lanka and the devaluation of rupee induced people to migrate to the abroad. Due to these developments, foreign remittances became an important source for the foreign exchange earnings in Sri Lanka.

Therefore, we argue that firstly increased growth rate provided a chance for Sri Lanka to exploit the benefit of social development through increased employment opportunities at home as well as abroad. Secondly, this development helped Sri Lanka to maintain at least a moderate growth rate during the post of liberalization period.

However, if there was no war, the economy would have raised growth rate further and Sri Lanka would be in a position to use the benefit of social development in a mammoth scale. Therefore it is important to note that the government's commitment for free education is noteworthy but some controversial policy measures on education, which widened the ethnic strife, affected the economy. Thus, it is important to mention again about the standardization because its impacts are still persisting. The standardization of 1970 was extremely harmful for entire Tamil community in Sri Lanka. The Jayawardane government introduced a new form of liberalization from the early 1980s. According to which, the university admission was determined on the basis of the population of each district. Through this initiative the government tried to give more opportunities to rural youths through standardization by providing more chances in the university entrance. However, this initiative affected the university entrance of many youths, who were living in most populated districts like Colombo and Jaffna. However, the previous standardization was one of the main reasons for the secessionist war, which hindered GDP growth severely since 1983. Aturupana *et al* (1994) questioned that what Sri Lanka needs ......, for ....., human development and growth, is peace. Because the ethnic strife since 1983 has caused thousands of deaths and produced over 600,000 refugees as well as reducing growth.

Apart from this ethnic conflict, Sri Lanka witnessed another political conflict in 1987-89 period in the southern part of Sri Lanka. Again, JVP led Sinhala youths engaged in an uprising. As a result thousands of Sinhala youths were killed and economic growth averaged only 2.1 per cent in 1987-89. However, Dunham and Jayasuriya (2000) argued that welfare expenditure had played a role in maintaining social cohesion and political stability. This may be true till the insurrection of 1971 and the ethnic strife of post 1983 period.

Importantly, high social welfare achievements have created a new problem. Sri Lanka's over 65 years population is going to double from 9 per cent of the population in 1996 to 18 percent by 2021. In the USA it took 70 years and in France it took 130 years for the above 65 years population to double compared to 25 years that Sri Lanka will take in the future (de Silva as quoted in Kelegama, 1998). As a result the pension budget is going to emerge as a challenging problem for the country because the Government was the employer for 57 per 1,000 of the population in 1997, the highest rate in South Asia. India and Pakistan in contrast had each only 19 per 1,000 of their population in government employment (Jayawardena, 2004). Moreover, the old age dependency is also increasing. To meet all these challenges, Sri Lanka need to maintain high growth rate in the coming decades.

In sum, during the pre colonial period, the colonial governments implemented food subsidy programme with the view to encourage plantation agriculture and discourage peasant agriculture with the view to confirm that future Sri Lanka should depend on the imports of industrial and consumption goods while exporting plantation products. Unfortunately the independent Sri Lanka followed the extensive food subsidy policy without targeting the poor with the view to obtain political mileage. To exploit the benefit from the welfarism, there should be parallel growth in the GDP. During the pre liberalization regime, Sri Lanka was able to maintain dismal growth. However, during the post liberalization regime, to some extent, Sri Lanka maintained a moderate growth rate on average. Apart from this growth performance, increased employment opportunities in the newly emerged garment industry and in the Middle East, provided a chance to Sri Lanka to benefit from the welfare achievements. However, the ethnic war is a barrier to the smooth performance of the economy.

CHAPTER FIVE

Conclusion

During the 1950s Sri Lanka was in the third place in Asia after Japan and Malaysia in terms of per capita GDP. South Korea, Thailand and Indonesia were behind Sri Lanka. However, all these countries have surpassed Sri Lanka very long ago. Therefore, it is very important to know that what are the reasons contributed for the Sri Lanka's economic failure.

Many reasons could be attributed for this economic failure. Firstly, inability to get out interlocking initial conditions due to the political economy based on five - year electoral cycle. Though Sri Lanka regained her independence with favorable macroeconomic conditions (balance of payment surplus and comfortable foreign reserves), she failed to use this opportunity to lay strong foundation by increased investment on the industrial sector. Instead, Sri Lanka overemphasized on welfare programmes, particularly on food subsidies, and the agriculture sector. Critics blamed the first UNP Government of independent Sri Lanka for the deliberate discouragement of the industrial sector. Because left oriented parties captured a number of seats in the first parliamentary election. So pro western right oriented first UNP government thought that encouragement of the industrial sector would benefit the left parties via trade unions. Thus government encouraged agricultural development. Subsequently, the support base of left parties declined gradually. Since the agricultural production depends on favourable weather conditions, maintaining constant growth in the agriculture sector is difficult. The agriculture sector has to face frequent risk from floods or drought. Apart from these developments, following the land reform and the nationalization, agricultural production declined during the closed economic regime.

Secondly, during the pre liberalization regime, economic policy of Sri Lanka changed as the Government was altered in every election. As a result, Sri Lanka was unable to pursue a unique economic policy constantly and as a result economic growth was highly fluctuating during every policy epoch. However, after the UNP government initiated liberalisation policies in 1977, there was been no basic change in economic strategy regardless of which government has been in power.

Thirdly, the Country faced sporadic insurrections (first in 1971 and the second in 1987- 89) in the Southern part of Sri Lanka and is facing a destructive civil war (erupted in 1983) in the Northern and Eastern part of Sri Lanka. These developments had a negative impact on the economy. Though the first insurrection erupted during the pre liberalization regime and the second occurred during the post liberalization regime. Since the JVP entered into the parliament democracy, the country continued to struggle with the LTTE. The second JVP insurrection and the civil war with LTTE had severe negative impact on the economy during the post liberalization regime.

As a composite effects of all these developments, during the pre liberalization regime, Sri Lanka experienced low GDP growth, high unemployment problem, adverse terms of trade, over dependency on primary agricultural exports, low rate of investment and domestic savings, balance of payments problem, etc. Nevertheless, like many other developing countries, poor macroeconomic performance, macroeconomic crisis and changing development thinking of 1970s, induced Sri Lanka to embark upon the liberalization policies in 1977. It is very important to know whether the liberalization has brought solutions for all these macroeconomic problems.

Firstly, has GDP growth increased following the liberalization? Sri Lanka achieved higher rate of economic growth, although not in a consistent and sustained manner during the early years of reforms. However, the initial growth came from mainly construction, manufacturing and services sectors.

After the completion of three lead projects, government investment declined. From 1983, the country was compelled to face a destructive civil war, which resulted frequent decline in private investment and harmful effects upon on the tourism sector. Agricultural production and fishing were also affected severely in the Northern and Eastern part of Sri Lanka. Apart from direct economic cost of US$ 20.6 billion[1], the war resulted in several indirect costs such as emigration of skilled labour force, distruption to the education system, reduced efficiency of investment, infrastructure bottlenecks, deteriorating health conditions (low weight births, mental illness) and reduced labour productivity etc. As a composite effect, the post 1983 growth rate was greatly fluctuating. After liberalization, the major component of the Sri Lanka's GDP was textiles and garments. However, this industry is greatly dependent upon imported inputs and the MFA quota system (which ended in 2005) for marketing. Thus, Sri Lanka has to compete with all other garment exporting countries. Growing garment industries of other countries, such as China, might be a threat to the Sri Lankan garment industry in the future. At the same time, Sri Lanka did not start the diversification of its exports even towards light electronic production. Therefore the future of the Sri Lanka'exports is uncertain.

Secondly, has composition of gross domestic production changed favourably? The GDP composition has changed to some extent but not favourably. The share of the agriculture sector gradually declined. The service sector remained the dominant contributor to domestic product. Tourism, trade and insurance are key components of the services sector. But here also the war had a severe impact on the performance of these sectors. For an example, after the attack on the country's international airport foreign insurance companies increased the insurance premium to all cargo ships if they entered Sri Lanka. This development immediately affected country's exports and imports simultaneously. Tourism also was affected severely by the war from time to

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1 Arunatilake et al (2001) this direct economic cost was estimated for the 1984 - 96 period.

time. More importantly, the share of the industrial sector in GDP did not change because the share of the industrial sector was almost same during 1978 - 82 and 1998 - 03 periods. Therefore liberalization did not help Sri Lankan industrialization.

Thirdly, has the unemployment declined following the liberalization? Although Sri Lanka faced high rates of unemployment during the pre liberalization regime, the situation has improved after the introduction of liberalization. Increased opportunities in the newly emerged manufacturing industry (particularly garment industry), opportunities of employment abroad and in armed forces and increased opportunities of exporting services abroad (eg: through tourism, information technology related services, banking and finance, etc) played a major role in creating more employment opportunities. During the 1978 - 2003 period, 2,298,000 new jobs were created domestically. However, during the 1995 - 2001 period, 1,189,504 numbers of foreign employment (of which house maids alone accounted 698,254) have been registered. [2] But growing instability in the Middle East has created uncertainty for future employment opportunities in this region.

Fourthly, what happened to inflation? Inflation escalated to historic highs during the early years of liberalization. The rate of inflation as measured by the Colombo Consumer Price Index averaged less than 8 per cent per annum during the 1970s, had climbed to over 11 per cent per annum during the 1978 - 03 period despite ups and downs. This reflected high government spending and high private investment in a context of falling production because of civil war and diversion of resources into armed conflict.

Fifthly, have the rate of investment and domestic saving ratio increased substantially? Following the liberalization the rate of investment increased significantly but after the completion of three lead government projects public investment declined. After the eruption of the civil war private investment

[2] Source: Sri Lanka Bureau of Foreign Employment (as given in Korale, 2004)

also fluctuated from time to time. On the other hand, the domestic saving ratio did not increase to the level of investment ratio and as result the imbalance increased drastically. This implies the increased dependency of the economy on the inflow of foreign investment and other foreign resource flows.

Sixthly, what has happened to the trend of Income inequalities? Though there was no drastic change in the structure of income distribution, income inequalities have gradually widened during the post liberalization period.

Seventhly, what did happen to the budget deficit? Following the liberalization, Sri Lanka experienced huge budget deficits. Increased defense expenditure significantly contributed to the enormous budget deficit. On the other hand, government tax revenue as a percentage of GDP continued to decline. This situation led the country to greatly depend on the domestic and external debt. As a result, the external debt rose to 58.4 per cent of GDP in 2003 and the total government debt has exceeded 105 per cent of GDP in 2003. This is the clear alarm signal for the Sri Lankan economy because the country is moving towards an unfavourable and potential crisis situation.

Eighthly, has the balance of payments improved? Even after the liberalization Sri Lanka could not overcome the balance of payments problems because the current account deficit has been larger than that of capital and financial account surplus. Large trade deficit led to this situation despite increased migrant remittances. On the other hand, amid the deterioration of the BTT, ITT improved during the post liberalization regime. This implies that though the prices of imports have been increased than that of exports, however, exports volumes increased significantly and as a result Sri Lanka's purchasing power has been increased during the post liberalization period. The manufacturing industry played a major role in increasing the volume of exports and here also the future trend of ITT might be uncertain if the garment industry affected in the future.

Ninthly, has the structure of exports and imports changed? Following the liberalization the export structure changed significantly from plantation cum agricultural goods to industrial exports, dominantly garment and textiles. However, since the Sri Lankan garments industry greatly depends on imported inputs and quota system under Multi Fiber Agreement (which ended 2005) Sri Lanka would have to compete in the world market with all garments - exporting countries. Due to these factors, Sri Lanka's garments and textiles industry is facing an uncertain situation. However, the main element of the change in the composition of imports was the rise in the share of intermediate and investment goods and a corresponding decline in the share of consumption goods. Here the impacts of reforms on imports was positive because Sri Lanka managed to reduce the imports of consumption goods significantly and increased imports of intermediates goods, mainly petroleum, is inevitable because Sri Lanka is not a petroleum producing country. Since both exports and imports significantly increased, the country's dependency on trade also increased following the liberalization.

Finally, what happened to welfarism? Unlike East Asian countries, Sri Lankan welfarism was not accompanied by higher rates of investment. Restructuring of public expenditure is one of the main elements of the 'Washington Consensus'. Though the Bretton Woods institutions suggested reducing to reduce the current expenditure, mainly welfare expenditures, Sri Lanka continued to implement several welfare programmes including the food stamps programme, free school textbooks to all students, one million housing programme, primarily to the poor, Janasaviya (literally people's strength) poverty alleviation programme, free mid day meals and free uniform for all school children and Samurthy (literally Prosperity) poverty alleviation programme. However, Janasaviya and Samurthy targeted only the poor. During the reform process, Sri Lanka did not eliminate welfarism and also introduced some new welfare programmes because the people, who were brought up with the welfare programmes, are sensitive to the complete elimination of the welfarism. Thus, the democratic governments are always pressurized to implement popular welfare programmes to gain the electoral victory. Though Sri Lanka was not in a position to use the social welfare achievement to the maximum extent possible due to dismal growth performance during the pre liberalization regime, relatively high growth rates provided a chance to Sri Lanka to overcome such situation during the post liberalization regime. However, Sri Lanka has to face another emerging problem in connection with social development because due to the high social welfare achievement, Sri Lanka is facing the ageing population problem, which is increasing the pension budget and old age dependency.

In summary, the impact of liberalization on the economy has been mixed. The economy performed relatively well during the early years of reforms without any internal and external shocks. However, it was a temporary phenomenon. The year 1983 was an unfavorable turning point in the history of the country because Sri Lanka was compelled to divert a huge amount of money on the ethnic war from that year. Due to the war situation, Sri Lanka missed another opportunity of attracting some portion of the Japanese surplus in the mid 1980s. But many East Asian economies used that chance. Furthermore, at the time of liberalization, Sri Lanka was in a position to emerge as the regional hub in shipping, financial services, tourism etc. Since Sri Lanka was struggling with the war situation, other new liberalizers (for example Bangladesh liberalized its economy in 1987, Pakistan in 1988 and India in 1991) were able to catch up Sri Lanka's dream of becoming a regional hub.

It is very difficult to assess the real impact of the liberalization when a small economy faced a destructive civil war because the war affected each macroeconomic variable of the Sri Lankan economy. To solve these current macroeconomic problems faced by the country a bullish growth rate should be maintained in the coming years. If Sri Lanka decides to maintain such growth rates, the investment level has to be increased. The only short - term way to increase the level of investment is by attracting more foreign direct investment. For this, bringing the ethnic war to an end is important. That will ensure a stable and consistent economic environment for foreign investors. Moreover, meeting unbearable huge defense expenditures will not be conducive to firm and consistent economic management forever for a small developing country like Sri Lanka. If not, the country's future macroeconomic performance might be uncertain.

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