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**PRO-POOR MACROECONOMIC POLICIES  
IN SRI LANKA**

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## EXECUTIVE SUMMARY

- The aim of the present study is to look at how the macroeconomic environment has impacted on poverty, income distribution and human development in Sri Lanka, with a view to providing a coherent set of policy recommendations constituting what may be described as a pro-poor growth strategy (PPGS).
- The time frame for the study is 1977-2004; a period that witnessed an increasing liberalisation of the economy. An important distinction is drawn between four sub-periods on the basis of differences in macroeconomic policy emphases and corresponding macroeconomic dynamics. The four sub-periods identified are 1977-84, 1985-89, 1990-94, and 1995-2004. The year 2004 has been taken as the terminal date of the study for logistical reasons.
- The study begins by providing an overview of the present situation (or at least the situation depicted by the most recent available data) pertaining to poverty, income distribution, and human development in Sri Lanka. This is done in chapter 2. The data presented and analysed in this chapter show the following. Firstly, Sri Lanka's general level of poverty and extent of income disparities are in line with averages for other developing market-oriented economies at similar *per capita* income levels and/or stages of economic development. In contrast, Sri Lanka's level of human development is well above levels for other developing countries at similar *per capita* income levels and/or stages of economic development. Secondly, the distribution of heads of poor Sri Lankan households show that only a small proportion of them are unemployed, most of them have had limited education, and, in those land areas of the country for which data are available, relatively the largest proportion of them are Sinhalese in ethnicity. Third, there are considerable regional variations in levels of poverty, income, and human development in Sri Lanka, with the industrialised Western Province being the best off on all counts and the rural, including estate, areas the worst. Although comparable socio-economic data for the war-torn North and East of the country are not available after 1987, there is every reason to suppose that the two areas concerned are among the poorest and the most deprived in the country.
- Chapter 3 then proceeds to indicate the important macroeconomic policy changes and trends in the post-1977 period in Sri Lanka on the bases of the aforementioned periodisation. It is argued that the policy emphases in each sub-period alternate between growth and stabilisation, with policy emphases in the post-1990 period being also conditioned by Structural Adjustment Facility (SAF) agreements and related policy thinking. In the post-1977 period as a whole Sri Lankan policy makers experimented with two active and one passive growth-promotion strategies. One of the active growth-promotion strategies was a large-scale, foreign funded, state-led, investment programme and, the other was an export-oriented industrialisation (EOI) programme. The former was implemented in the 1977-84 sub-period and the latter in the 1990-94 sub-period. The passive strategy was a so-called "level-playing-field" strategy, implemented in the sub-period 1995-2004. The level-playing-field strategy is another name for the standard growth promotion strategy adopted in most Structural Adjustment Programmes (SAPs). It comprised macroeconomic stabilisation and economic liberalisation (*viz.*, trade and financial liberalisation as well as privatisation) components.

- Data presented in chapter 3 show that average rates of investment, growth and inflation for the Sri Lankan economy in the 1980s and 1990s were in line with the averages for other market-oriented developing economies with similar *per capita* income levels and/or stages of development, while Sri Lanka's comparative savings rates and foreign reserve cover for imports were significantly lower. Macroeconomic data for Sri Lanka show significant variations in average rates of both growth and inflation among the four sub-periods, with the high growth periods of 1977-84 and 1990-94 witnessing correspondingly higher average rates of inflation. Underlying these macroeconomic trends were marked shifts in the structure of production and employment, as well as in the composition of investment. The structure of production and employment shifted away from agriculture and towards services and, to only a limited extent, towards manufacturing. Attention is focused on the fact that the shift in employment did not fully reflect the accompanying shift in composition of aggregate value added. The composition of investment is shown to have moved away from the state and towards the private sector.
- Against the backdrop of the macroeconomic picture painted in chapter 3, chapter 4 attempts to explain the observed trends in economic growth, inflation and external payments in Sri Lanka. It is argued that Sri Lanka's failure to achieve the requisite acceleration of economic growth is due in large measure to a policy failure; a failure to consistently adopt the type of export-oriented industrialisation policies of, for example, the successful East Asian economies. In this context, it is also argued that neither a policy of expanding government capital expenditure nor wholesale economic liberalisation offer the same prospects for a sustainable and appreciable rise in the economic growth rate. Indeed, wholesale economic liberalisation has even proven to be damaging to the growth process, particularly given the contractionary fiscal and monetary policies which have tended to accompany it. It has also been argued that the failure to develop a viable domestic agricultural food production sector was an additional obstacle preventing acceleration of economic growth. In contrast, the failure to expunge inflation from the system is not seen as consequential for economic growth. It is denied that inflation and external imbalance are essentially monetary phenomena, in the sense that they are primarily the result of excessive money creation. Inflation in Sri Lanka, it has been argued, is for the most part, the result of food and import price pressures. Money creation is seen as effectively endogenous, with the monetary authorities having little real discretion with regard to the amount of liquidity in the system at any point in time. The prime mover of the external balance in Sri Lanka, the trade balance, is explained by such factors as the terms of trade, international competitiveness of domestic producers, and levels of foreign and domestic demand.
- The analyses of chapters 2 to 4 are used in chapter 5 to address the principal objective of the study – the way in which macroeconomic developments and accompanying policies have impacted on poverty, income distribution and human development. The basic contention of the chapter is that the continuing high poverty incidence in Sri Lanka is largely attributable to a failure to achieve an acceleration of economic growth. This failure and the relatively high levels of poverty seen in rural and plantation sectors are in turn attributable to the failure to shift the structure of the economy towards industry. It is further argued that there is no compelling international or Sri Lankan evidence to support the proposition that income inequality is a necessary adjunct of accelerated

economic growth, or that a more equitable distribution of income would not enhance poverty reduction in the context of accelerated growth. Instead, there is good reason to suppose that in the absence of re-distributive policies the economic growth process may well flounder on the rocks of social and political turmoil. Finally, data are presented to show that Sri Lanka's "outlier" status in terms of its achievements on the human development front are in large part attributable to a fairly long-standing commitment of policy makers to high levels of *per capita* social expenditures. As in the case of income re-distribution policies, it is argued that these achievements in respect of human development are not necessarily incompatible with accelerated economic growth, and, in all probability, are indispensable for the sustainability of the latter.

- The concluding chapter of the study, chapter 6, draws out the many policy implications of the preceding analyses with a view to highlighting the key elements of a poverty reduction growth strategy (PRGS) for Sri Lanka. It is argued that a PPGS needs in the first instance to be pro-growth; it needs to generate a growth dynamic which would lead to a rapid and sustainable increase in *per capita* income levels. Such a strategy should be founded on export-oriented (and import-substituting) industrialisation, and the promotion of domestic food production. Rural industrialisation should be promoted, but attention needs to be paid to the nature of the products produced and the technologies adopted. In this regard the industrialisation strategy needs to be made consistent with the nature and goals of the broader growth strategy. It should not simply be a collection of *ad hoc* measures to promote employment generation and provide income support. Fiscal, monetary and exchange rate policies should be fundamentally geared towards the promotion of growth, and not stabilisation, not even stabilisation in the guise of poverty alleviation. Policies promoting income distribution and human development should accompany any accelerated growth process to ensure, among other things, the social and political sustainability of this process. That is to say, growth should be "shared growth".

## CHAPTER 1: INTRODUCTION

Sri Lanka's development experience in the post World War II period has been frequently cited as supporting one of two contrasting viewpoints. On the one hand, it is seen as an example of a developing country that has successfully raised levels of human development above those typically associated with developing countries at similar levels of per capita income. On the other hand, it is seen as an example of a developing country that has allowed a policy commitment to human development to damage the very growth process on which a sustainable improvement in living standards is built. These contrasting views of Sri Lanka's development record find resonance in the debate in the general development literature between those who highlight 'economic' development in terms of GDP growth and those who highlight 'human' development in terms of social indicators or the UNDP-type human development index (HDI). Though this duality in the analysis of development has its uses, the link between the two processes of 'economic' and 'human' development should not be lost sight of. The Sri Lankan experience can indeed be used to illustrate the distinction as well as the connection between the two processes. Thus, while Sri Lanka's 'outlier' position in terms of 'human' development (or people's living conditions) is most certainly the result of a fairly consistent policy commitment to redistribution and human development, the fact that standards of living have not risen faster over time is also undoubtedly due to the policy failure to develop an appropriately dynamic economic growth process. However, and this is a fundamental argument of the present study, nothing in Sri Lanka's development experience suggests that a commitment to re-distribution and human development is necessarily inconsistent with the attainment of a more rapid economic growth. In fact, it will be argued that the sustainability of rapid economic growth is dependent in the Sri Lankan context on accompanying redistributive and human development policies.

The aim of the present study is to consider how the macroeconomic environment has impacted on poverty, income distribution and human development in Sri Lanka, with a view to providing a number of policy recommendations which together constitute what may be regarded as a pro-poor growth strategy (PPGS). The time period taken for the study is 1977-2004. The first draft of the study was completed in 2003 covering the period 1977-2001 as most available data at the commencement of the study was up to this date<sup>1</sup>. In a revision undertaken prior to publication in 2005, information pertaining to either the full three years, 2002-04, or a part of it, was brought into the study depending on the availability of data. Due to data availability problems, a few data tables and some statistical computations continue to remain in the conditions they were in at the first draft stage of the monograph. The period 1977-2004 constitutes a period of increasing economic liberalisation. It is also a period in which economic policy in Sri Lanka came increasingly under the conditionality provisions of the international financial institutions (IFIs) and, therefore, also their guidance and monitoring. Indeed, as a consequence of the latter, the post 1977 period may also be said to be a period when Sri Lankan economic policy shifted increasingly toward what may be called the 'structural adjustment policy' (SAP) model.

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<sup>1</sup> Most of the analytical work of the present study was done in the period March-April of 2002.

In the outline of macroeconomic policies and trends over the post 1977 period, an important distinction is drawn between four sub-periods; 1977-84, 1985-89, 1990-94 and 1995-2004. Each sub-period is argued to be characterised by differences in policy emphases and corresponding macroeconomic dynamics. The important policy differences between the sub-periods are, in the first place, their respective growth and stabilisation policy orientations, and, secondly, the specific nature of these orientations. It is argued that the growth emphasis came in the 1977-84 and 1990-94 sub-periods, with the latter also paying considerable attention to poverty alleviation. The other two sub-periods witnessed a shift in policy focus to stabilisation, with the post-1995 period being also caricatured as a “level playing field” approach to economic growth – an approach which sought to create a non-discriminatory incentive structure. It is of note that although the rhetoric of poverty alleviation and human development continued in the post-1995 phase. A factor of great significance in discussions of poverty in Sri Lanka at the time of the revision of study prior to publication, i.e. in 2005, was the devastation caused by tsunami of December 2004 in the island’s coastal belt. Given the nature of the research questions raised and as terminal year for the revision has been 2004, no significant focus has been placed on tsunami effects in the main body of the study, even at points where poverty issues are examined.

The study begins with an overview of the present situation and recent trends in poverty, income distribution and human development in Sri Lanka. This is the subject matter of chapter 2. Chapter 3 provides an overview of macroeconomic policies and trends, bringing out important similarities and differences in these policies and trends during the different sub-periods noted above. Chapter 4 then attempts to explain these macroeconomic developments, also in relation to policies adopted. Particular attention is paid to the macroeconomic phenomena of economic growth and “stability”<sup>2</sup>. In many instances the explanations of these phenomena can be seen, and are shown, to differ from what may be deemed to be the “conventional wisdom”, certainly from what underlies present macroeconomic policy positions. Theoretical arguments and empirical evidence are provided in support of explanations that the authors of the study believe to be plausible. Against this backdrop, chapter 5 then considers the impact of macroeconomic developments and accompanying policies on poverty, income distribution and human development. The final chapter, chapter 6, attempts to draw together the main threads of the arguments developed in the preceding chapters in the context of an attempt to indicate the key elements of a PPGS for Sri Lanka.

An important contention of the study is that the present macroeconomic policy framework is neither particularly pro-poor nor pro-growth. It is argued that economic liberalisation *per se* will not ensure a sustainable acceleration of economic growth. The specific problem at the present juncture is seen to be the shift in macroeconomic policy towards the level-playing-field strategy. It will be shown that this shift has actually damaged the growth process and growth potential of the Sri Lankan economy, making it increasingly unstable and vulnerable to shocks. It is argued that a pro-growth economic strategy requires, among other things, a return to a state-supported, export-oriented,

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<sup>2</sup> Stability according to present convention refers to the curtailment of inflation and elimination of external payments imbalances.



economic strategy along the lines of the successful East Asian economies. It is further argued that such a strategy can be made pro-poor by paying explicit attention to the structure of production, particularly (domestically oriented) agricultural food production and rural industrialisation, as well as income distribution and human development related expenditures.

## **Chapter 2: Poverty, Income Distribution and Human Development**

### ***I. Introduction***

There have been vicissitudes in the rate of economic growth achieved by Sri Lanka but on average the country has registered 3-4 per cent annual growth throughout the past half century. Over the same period, and notwithstanding these limited growth achievements, Sri Lanka made considerable progress in terms of human well-being. This progress is well known and attributable in large measure to a sustained policy concern with poverty alleviation and human development. Certain important policy experiments in the Sri Lankan welfare state, which have become rather controversial in today's context of liberalisation and globalisation, had their origins in the aftermath of universal adult franchise and limited self-government granted by the colonial administrators in 1931 – while the country was still a colony within the British Empire. In spite of this policy history and the country's undoubted achievements in respect of social well-being, it is all too evident that poverty, marginalisation, and deprivation continues to afflict a large segment of the Sri Lankan population. In fact, these problems began to attract the closer attention of analysts as well as policy makers since the mid-1980s. As a result of mass media, particularly television, people could begin to see the growing gulf which separated the rich and the poor in terms of ownership of wealth and life styles. Greater awareness on the part of the ordinary people about their relatively lower standards of living has made issues of poverty, excessive income inequality, and access to certain basic amenities serious political issues in the country's democratic polity, particularly in the context of certain political parties and groups highlighting these issues in their political campaigns. In response, numerous attempts have been made to devise and implement special programmes for poverty alleviation and welfare improvement.

This chapter attempts to examine how conditions of poverty, income distribution and human development have changed over the last two decades, and, in the process, to identify the most vulnerable social groups. Against this backdrop some of the aforementioned special programmes for poverty alleviation and welfare improvement will be examined. No attempt is made to go into details of poverty measurement exercises, which have been in abundance in the recent past<sup>3</sup>. Available measures are used in our analysis, with whatever comments that are necessary and relevant for interpretation of the evidence.

### ***II. Poverty: extent and trends***

#### **The Sri Lanka situation**

Even a cursory glance of the available literature will show that extensive research has been carried out on the issue of measuring poverty in Sri Lanka. The more recent literature provides three kinds of measures for estimating the incidence, depth and

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<sup>3</sup> Lakshman (1997) provides a survey of the relevant literature that was available up to the time of writing of that article. See also World Bank (1995) and World Bank (2000: 27-39).

severity of poverty. These measures are the headcount index, the poverty gap index, and the squared poverty gap index. A brief description of these indices is as follows;

- The Headcount index measures the *incidence* of poverty by measuring the percentage of individuals in a given population whose standard of living falls below the poverty line.
- The Poverty Gap index measures the *depth* of poverty by measuring the average shortfall between an individual's level of consumption and the poverty line where the shortfall for all the individuals whose consumption is above the poverty line is zero.
- The Squared Poverty Gap index measures the *severity* of poverty by measuring the squared shortfall between an individual's level of consumption and the poverty line. Hence, this index places greater weight on poorer individuals.

Internationally comparable consumption poverty estimates currently available for Sri Lanka are derived from the reference poverty lines developed by Datt and Gunewardena (1997), further extended in Gunewardena (2000)<sup>4</sup>. These estimates relate to the ten-year period 1985/86 to 1995/96. Household survey data that are now available for the period after the mid-1990s have not so far been analysed on similar methodological lines. Having declared an 'official' poverty line of Rs. 1423 at 2002 prices, the Department of Census and Statistics (DCS) has used its *Household Income and Expenditure Survey* (HIES) of 1990/91, 1995/96 and 2002 to estimate poverty incidence in Sri Lanka and its different sectors during those three Survey years. The two above sets of poverty incidence data are presented in Table 2.1<sup>5</sup>. Data in Table 2.1 do not cover the north and the east of the country as the relevant household income expenditure surveys were not conducted in these regions due to the prevailing conflict there. While the conflict zone is only likely to be worse off in terms of poverty incidence, there is cause for serious social concern in estimates for the rest of the country as well.

Estimates of Gunawardena (2000) show that poverty incidence declined between 1985/86 and 1990/91 in terms of both poverty lines, but rose again, though not to 1985/86 levels, by 1995/96<sup>6</sup>. The retrogression in the poverty situation of the whole country during the second sub-period was largely a result of the increasing incidence of poverty in both rural and estate sectors. Most disturbing is the fact that the poverty incidence in the estate sector in 1995/96 was above the 1985/86 level. It is the only sector out of the three in which such deterioration of conditions took place. Overall, rural and estate (as opposed

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<sup>4</sup> See Gunatilaka (2003)

<sup>5</sup> Only headcount ratios are presented since the aim of the present chapter is not a rigorous study of poverty measurements *per se*.

<sup>6</sup> As shown in Gunatilaka (2000), the same contrasting trends between 1985/6 and 1990/91 and between 1990/91 and 1995/96 prevailed in respect of the 'depth' and 'severity' measures of poverty as well. The year 1990/91 represented a recovery period after several years of low growth. The overall growth rate was 6 per cent, with agriculture also doing well as a result of favourable climatic conditions, better international and local prices and an abeyance of civil disturbances. The corresponding reduction in poverty levels in 1990/91 was therefore predictable. In 1995, the agricultural growth rate was 5.5 per cent, but in 1996, the sector contracted by 4.6 per cent due to drought. Thus, it is not surprising that the 1995/96 survey showed poverty levels rising again.

to urban) poverty trends tend to dominate national trends, since more than 90 per cent of all poor Sri Lankans live in rural or estate areas. In regard to the direction of change in poverty incidence between 1990/91 and 1995/96, Gunawardena (2000) estimates agree with those of DCS (2004)<sup>7</sup>. As between 1995/96 and 2002, poverty incidence has declined in all three sectors.

**Table 2.1**  
**Poverty by Sector, 1985/86, 1990/91, 1995/96 and 2002**

Sector	Poverty Line		Incidence (Head Count Ratios)			
	At 1995/96 Prices	At 2002 Prices	1985/86	1990/91	1995/96	2002
All Island	Rs. 791.67		30.92	19.86	25.17	
	Rs. 910.42		40.97	29.49	35.95	
		Rs. 1423		26.10	28.80	22.70
Urban Sector	Rs. 791.67		18.38	14.97	14.67	
	Rs. 910.42		25.65	22	22.35	
		Rs. 1423		16.30	14.00	7.90
Rural Sector	Rs. 791.67		35.55	21.98	26.95	
	Rs. 910.42		46.45	32.25	38.02	
		Rs. 1423		29.40	30.90	24.70
Estate Sector	Rs. 791.67		20.53	12.42	24.92	
	Rs. 910.42		30.02	23.29	41.07	
		Rs. 1423		20.50	38.40	30.00

Source: Gunewardena (2000) based on Department of Census and Statistics (DCS), *Household Income and Expenditure Survey* (HIES) 1985/86, 1990/91, 1995/96 and DCS (2004) based on HIES 1990/91, 1995/96, 2002

There has always been an element of peculiarity in head count ratio computations of poverty incidence for the estate sector. The general impression has tended to be that the great majority of the estate sector population are “poorer” than the majority of the rural sector population in Sri Lanka. This popular perception is confirmed by DCS (2004) estimates for 1995/96 and 2002. The data presented in Table 2.1 for the period before 1995/96, including also the lower poverty line headcount ratio in Gunewardena (2002) for 1995/96, contradict this popular perception in keeping with the findings of many other studies. One explanation for estate sector poverty incidence being lower than among the rural population is that headcount computations accord a considerable weight to “regularity” of employment. Manual work is more regularly available in the estate sector than in rural areas. What is not picked up is the fact that living conditions (e.g. housing) are typically worse in the estates than in villages, the estate sector population has in most cases poorer access to social service facilities (e.g. education) than the rural population,

<sup>7</sup> Except for the slight increase in the higher poverty line ratio for the urban sector in Gunawardena (2000) and the decline in the DCS (2004) ratio for that sector.

and the hourly rate of pay for manual work also may be lower in estates than in many rural areas (see also Lakshman, 1997).

The pattern of distribution of poverty incidence by district is shown in Table 2.2, which has two segments. The segment A data are from Gunawardena (2000) and those of B from DCS (2004) and are not comparable. This information shows that poverty is widespread and not a phenomenon limited to only some areas. Its incidence is significantly lower in two Western Province districts, Colombo and Gampaha, than in others. According to segment A data, poverty incidence in Nuwara Eliya district with a large share of estate sector population was significantly low in two of the three survey years covered. No such distinction can be seen in the incidence of poverty in this district, however, according to segment B data.

**Table 2.2**  
**Trends in poverty measures by district 1985-2002**

District	A. Poverty Incidence <sup>a</sup>			B. Poverty Incidence <sup>b</sup>		
	1985/86	1990/91	1995/96	1990/91	1995/96	2002
Colombo	12	13	10	16	12	6
Gampaha	26	12	11	15	14	11
Kalutara	24	25	26	32	29	20
Kandy	35	29	30	36	37	25
Matale	34	23	35	29	42	30
Nuwara Eliya	16	11	21	20	32	23
Galle	40	23	25	30	32	26
Matara	31	24	28	29	35	27
Hambantota	49	25	27	32	31	32
Kurunegala	35	18	34	27	26	25
Puttalam	30	19	33	22	31	31
Anuradhapura	37	20	33	24	27	20
Polonnaruwa	23	14	27	24	20	24
Badulla	38	23	30	31	41	37
Moneragala	45	26	49	34	56	37
Ratnapura	45	19	37	31	46	34
Kegalle	36	28	25	31	36	32
Sri Lanka	31	20	25	22	24	19

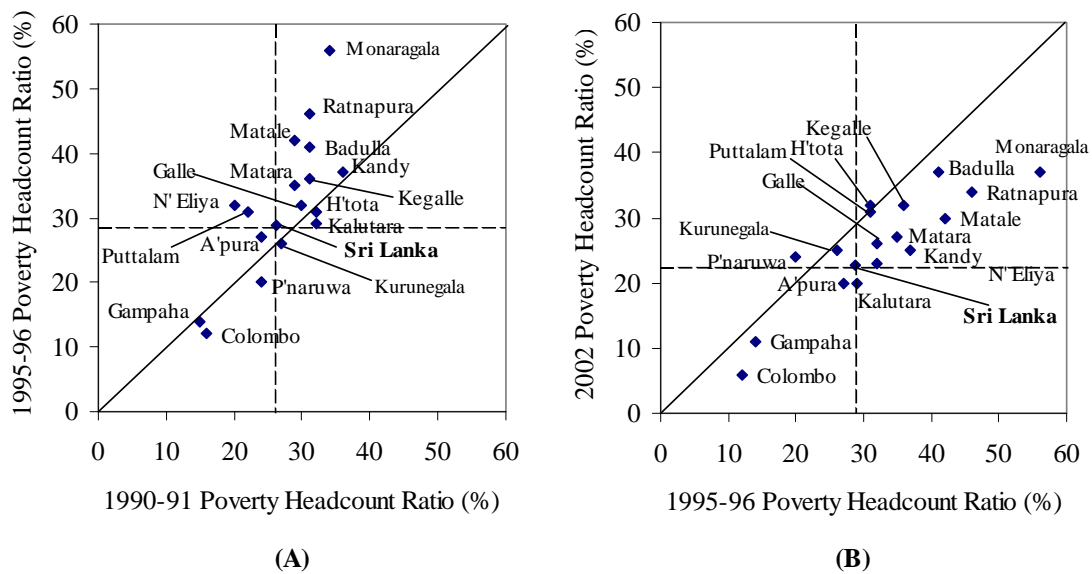
Notes: <sup>a</sup> Using the lower poverty line of Rs. 791.67 as per Gunewardena (2000)

<sup>b</sup> Using 2002 official poverty line of Rs.1423 as per DCS (2004).

Source: Gunewardena (2000) and DCS (2004).

Part of the data in Table 2.2 is plotted in Fig. 2.1 in order to examine how poverty incidence changed in different districts over the period under consideration. Fig. 2.1 would help the reader to locate different districts in relation to the national headcount

ratio<sup>8</sup>. It uses only the DCS (2004) data, however, with part A showing changes from 1990-91 to 1995-96 and part B, changes from 1995-96 to 2002. The districts falling below the diagonal line are the ones which experienced declines in poverty incidence between the two years compared. As noted, the districts in the war-affected north and east are not covered. Regional trends in poverty appear to be similar to the national and main sectoral patterns. Estimates of Gunawardena (2000) (Table 2.2) show that in the majority of districts, the incidence of poverty declined between 1985/86 and 1990/91 and rose thereafter. Fig. 2.1 also shows the increase in poverty incidence in the majority of districts between 1990-91 and 1995-96 followed by its decline again in the majority of districts between 1995-96 and 2000.



**Figure 2.1: The behaviour of district level Poverty Headcount Ratios in two sub-periods: (A) 1990-91 to 1995-96 and (B) 1995-96 to 2002.**

All available evidence shows that the economically dynamic and industrialised Western Province (excluding the Kalutara District), centred as it is on the metropolitan hub and located around the port of Colombo, had forged ahead in terms of reduction in poverty incidence. There was no such consistency in the performance of other districts in terms of poverty reduction. At high level poverty end of the scale, the districts falling into, for example, the group of four with the highest poverty incidence are different in different years under consideration. One consistent pattern though is that, in both sets of data and in all four years, Moneragala District falls among the group of four poorest districts in the country.

<sup>8</sup> For example Fig. 2.1 shows that, in terms of poverty incidence, only Colombo, Gampaha and Anuradhapura did better than the national average in 2002 as well as in 1995/96 (see part B of the Figure).

Following the widespread practice, the multifarious factors behind changes in the poverty incidence have been classified by Gunewardena (2000) into (i) factors associated with growth of incomes/ consumption and (ii) those associated with changes in the pattern of distribution of incomes/ consumption expenditures<sup>9</sup>. Table 2.3 presents the results of this exercise as reported in Gunatilake (2003). The negative (positive) sign before a number in this Table denotes that the relevant component had the effect of reducing (increasing) poverty. In most cases, the impact of growth appears to have been stronger than the impact of redistribution but the data in Table 2.3 are not adequate to mount a conclusive argument to say that poverty reduction policies should focus mainly or primarily on growth. In fact the best solution to poverty reduction would be “shared growth”. This implies that poverty reduction strategies would include policies for redistribution along with policies for growth.

**Table 2.3**  
**Contribution of Growth and Redistribution to Change in Poverty Incidence:**  
**1985-96**

<i>Period &amp; Sector</i>	<b>Growth Component</b>	<b>Redistribution Component</b>	<b>Residual</b>	<b>Total Change in Poverty</b>
<b>All Island</b>				
1985-90	-7.91	-3.44	0.28	-11.07
1990-95	3.31	1.73	0.28	5.32
1985-95-	-4.30	-1.21	-0.24	-5.75
<b>Urban</b>				
1985-90	-4.88	2.20	-0.73	-3.41
1990-95	2.39	-2.59	-0.10	-0.30
1985-95-	-2.72	-0.40	-0.59	-3.71
<b>Rural</b>				
1985-90	-8.73	-5.48	0.63	-13.58
1990-95	3.57	1.22	0.19	4.98
1985-95-	-4.71	-3.96	0.07	-8.60
<b>Estate</b>				
1985-90	-8.45	0.67	-0.33	-8.11
1990-95	3.35	7.78	1.37	12.50
1985-95-	-4.84	11.34	-2.11	4.39

Notes: These data pertain to the Lower Poverty line = Rs. 791.67 per person per month.

Source: Gunewardena (2000)

The above analysis, as well as the earlier studies of poverty incidence that have been surveyed in Lakshman (1997), highlights several important points. First, data sets from

<sup>9</sup> The growth component is the change in poverty assuming distribution to be constant and only consumption growth taking place. The distribution component is the change in poverty assuming consumption growth to be constant and only distribution changing. We have not attempted to carry out an exercise similar to that of Gunewardena (2000) using the poverty incidence data of DCS (2004).

different surveys belonging to the same survey series but carried out in five-year-like intervals can produce significant variations in poverty levels. But those variations, rather than indicating any real trends that prevailed over the period concerned, largely reflect the impact of exogenous shocks that have taken place in survey years<sup>10</sup>. Second, consumption poverty levels show extreme sensitivity to even slight changes in the poverty line that is used. Gunewardena (2000) dataset in Table 2.1, for example, shows that a 15 per cent increase in the poverty line would raise the incidence of poverty (using 1995/6 data) by about 44 per cent island-wide, by 46 per cent in urban areas, by 23 per cent in rural areas and by 64 per cent in the estate sector. This reveals the existence of large numbers of nearly poor households that are highly vulnerable to cyclical and other exogenous changes in incomes and employment. Third, although the estimates of incidence, depth etc., of poverty are widely referred to in formulations of poverty reduction policies, these numbers are indeed of little use in understanding the dynamics of the socio-economic processes which determine the rise or the fall of poverty among the people of a country.

### International comparisons

Notwithstanding the well-known pitfalls associated with international comparisons of poverty estimates, it is perhaps useful to conclude this initial picture of poverty in Sri Lanka with such a comparison. The relevant data are drawn from the World Bank's *World Development Indicators* and presented in Table 2.4 below. They show that for the most recent estimates available consumption poverty levels in Sri Lanka compare favourably with other South Asian countries. Thus, whether one takes a US\$ 1 or US\$ 2 poverty line, the percentage of the population below these poverty lines is considerably lower in Sri Lanka than in other South Asian countries (viz. Bangladesh, India, Nepal and Pakistan). At US\$1 per day Sri Lanka's consumption poverty level is 8 per cent as compared with unweighted average of 31 per cent for the other South Asian countries while at US\$ 2 per day, the relevant levels are 51 per cent and 78 per cent, respectively.

**Table 2.4**  
Sri Lanka's Comparative Poverty performance, latest estimates

	Survey Year	US\$ 1/day	US\$ 2/day	Per capita income US\$/year <sup>a</sup>
Bangladesh	2000	36.0	82.8	400
India	1999-2000	35.3	80.6	540
Nepal	1995-1996	39.1	80.9	240
Pakistan	1998-1999	13.4	65.6	520
Unweighted AVERAGE of above		31.0	77.5	425
<b>SRI LANKA</b>	1999-2000	7.6	50.7	930

Note: <sup>a</sup> Per capita figures are for 2003

Source: World Development Indicators, 2005

Although Sri Lanka's consumption poverty levels compare favourably with other South Asian countries, they do not appear to be exceptionally low, at least not in relation to *per*

<sup>10</sup> See footnote 6 above



*capita* income levels. Specifically, Sri Lanka's ranking in terms of consumption poverty levels accords with its ranking among developing countries in terms of *per capita* income<sup>11</sup>.

### ***III. Characteristics of the Poor***

Poverty research focuses on social groups in poverty in an attempt to understand the "characteristics" of the poor in the country. Relative proportions of the poor belonging to various regional, occupational, sectoral and such other population categories are highlighted in this research. Certainly, these types of exercises cannot adequately capture the dynamic character of poverty<sup>12</sup>. Yet understanding the nature of poverty in terms of such characteristics, even by way of "causally inexplicit relationships" or mere "characteristics-poverty links", is considered helpful in formulation of policies aimed at the alleviation of poverty (Lipton, 1983, p.3). Much effort has gone into making such a classification of poverty groups and thereby developing a taxonomy of poverty in Sri Lanka<sup>13</sup>.

#### **A rural phenomenon**

The statistical evidence shows quite clearly that poverty is fundamentally a rural phenomenon in that the rural sector<sup>14</sup> is by far the main repository of poverty in the country. Given the dominance of the rural sector as a repository of poverty, it would be a matter of practical policy significance to know what has happened to the incidence of poverty in the rural sector over time. World Bank (1995) has thus considered it significant that the proportion of rural households in poverty had declined from 32 to 24 per cent over 1985-90<sup>15</sup>. This particular conclusion has, however, been subjected to an extensive critical examination in Dunham and Edwards (1997). These two authors contended that the choice of 1985 and 1990 to arrive at the above conclusion produced misleading results. Since the year 1985/6 witnessed, in many respects, a downturn in the rural economy, and 1990, a mini boom, the comparison of conditions in these two years is bound to provide optimistic results in regard to poverty trends among the rural

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<sup>11</sup> In a scale of 1 to 100 Sri Lanka's per capita income ranking is 48 while its consumption poverty level ranking is 52, i.e., its relative consumption poverty level is higher than would be suggested by its relative per capita income level in comparison with other developing countries (including so-called "transition" countries).

<sup>12</sup> Reproduction of poverty is a dynamic process. Information about how many families were able to get out of poverty, how many continued to remain in poverty over the years, why those who emerged out of poverty and those who continued to be in poverty did so, is of enormous significance to understanding the dynamics of reproduction of poverty in a society.

<sup>13</sup> A summary of this kind of literature pertaining to Sri Lanka can be found in Hopkins and Jogarathnam (1990) and Edirisinghe (1990).

<sup>14</sup> The rural sector, in the three-fold classification system adopted in the normal tradition of Sri Lankan statistical practice, is smaller and narrower in its spread than what one would usually understand by the rural sector within the more conventional two-fold rural-urban classification. In Sri Lanka, the "estate sector" is excluded from the rural sector for purposes of socio-economic analysis. However, in terms of location and other characteristics usually associated with the descriptor "rural" the estate sector is clearly rural.

<sup>15</sup> According to Table 2.1 the decline in poverty headcount ratio (lower poverty line) in the rural sector between 1985/86 and 1990/91 was from 36 to 22 per cent.

community. The increase again in rural poverty incidence (Table 2.1) from 22 per cent in 1990/91 to 27 per cent in 1995/96 perhaps vindicates this argument. Estimates based on DCS (2004), however, indicate a decline in rural poverty, in this case, from 26 per cent in 1995/96 to 21 per cent in 2002 (Table 2.1). While it is possible for this conclusion also to be contested on statistical and other factors, there is perhaps reason for policy makers to be pleased with the available statistical evidence that as compared to mid-1980s there has been some easing of the thorny issue of the relatively high incidence of rural poverty in the country.

**Table 2.5**  
**Rural Sector Concentration of the Poor: Results of Some Studies Based on Five Sample Surveys**

Data Sources	Population Share of Rural Sector	Proportion of Poor in Rural Sector
CFS, 1978/79	68.4	77.1 <sup>b</sup> 71.9 <sup>d</sup>
LFSS, 1980/81		73.9 <sup>a</sup>
CFS, 1981/82	74.2	82.2 <sup>b</sup> 78.7 <sup>d</sup>
LFSS, 1985/86	72.7	84.2 <sup>c</sup>
CFS, 1986/87	74.0	88.1 <sup>e</sup> 88.5 <sup>f</sup>
DCS (2004) <sup>g</sup>	80.0 (2001)	87.3 (2002)

Notes: The relevant numbers are reproduced from the following studies (Notes: a to f)

a. Bhalla and Glewwe, 1985

b. Gunaratne, 1985a

c. Korale (ed), 1987

d. Anand and Harris, 1985

e. POOR (ONE) in Edirisinghe (1990)

f. POOR (TWO) in Edirisinghe (1990)

g. A rough set of estimates based on population data from the Census of 2001 and poverty headcount estimates of DCS based on its HIES of 2004. It must be noted that the civil conflict in the north and east had prevented the Census of 2001 also from being fully conducted in those regions.

Sources: LFSS stands for Department of Census & Statistics (DCS) *Labour Force and Socio-economic Survey*. CFS stands for Central Bank (CB) *Report on Consumer finances & Socio-economic Survey*. HIES stands for *Household Income and Expenditure Survey*.

One aspect of the argument that poverty in Sri Lanka has been a rural phenomenon is that the rural sector dominates in the distribution of the country's population. The other aspect of this argument is that the ratio of the numbers in poverty within the rural sector is well in excess of the rural share of the total population. Table 2.5 compares these two proportions during six survey years during 1978-2002. Poverty measures underlying the proportion of the poor in the rural sector in different years (third column of Table 2.5) are based on different criteria. The numbers in this column for different years are therefore, not mutually comparable. While the population share in the rural sector was around 68-80

per cent, in all survey years, a larger share of the country's poor was found to be in that sector. This is indeed no surprise as the poverty headcount ratio has always been higher in the rural than in the urban sector.

### Employment/unemployment

The poverty problem in Sri Lanka appears also to be one of poorly remunerated employment, with the poor being most appropriately referred to as the “working poor”. In the three survey years between 1985 and 1996, covered in Table 2.6, over 91 per cent of the poor were found to be employed, with the relevant share going up to 95 per cent in 1995/96. The poverty incidence among the employed dropped from 32 per cent in 1985/86 to 20 per cent in 1990/91, later rising again to 26 per cent in 1995/96. Yet a point of significance for the present study is that a large number of the employed are actually underemployed in the sense that their jobs are either not full-time and/or their levels of remuneration are below subsistence levels.

**Table 2.6**  
**Poverty by Employment of Principal Income Earner, 1985-96**

	Poverty Incidence			Distribution of Numbers in poverty		
	1985/86	1990/91	1995/96	1985/86	1990/91	1995/96
Employed	31.50	19.90	25.67	91.35	92.25	94.94
Unemployed	33.98	15.93	21.34	1.77	0.46	0.36
Labour force Non-participant	24.67	19.91	18.04	6.88	7.29	4.67

Source: Gunewardena (2000).

Notes: Lower Poverty line = Rs. 791.67 per person per month

Data under definitions and classifications used in Table 2.6 are not available for any year after 1995/96. According to DCS (2004), 93.5 per cent of the poor in the country in 2002, and 93, 90 and 93 per cent of those in rural, urban and estate sectors respectively were in the category of the “employed”<sup>16</sup>. The phenomenon of the “working poor” appears to continue.

As already noted, the bulk of Sri Lanka's poor are located in the rural sector. Lacking land and other property, the vast majority of the rural population have no income sources other than work. The problem is that available opportunities for paid employment in this sector are subject to seasonality, variability and irregularity. Studies of the sector, viz., Alailima, 1986, Marga, 1981, Bhalla and Glewwe, 1985, Edirisinghe, 1990, have all found the poor to be concentrated in the following socio-economic categories:

- (i) landless agricultural workers,
- (ii) small land-owning peasants cultivating food crops using family labour,
- (iii) those engaged in fishing and animal husbandry,
- (iv) workers in small scale, often cottage type, rural industry,

<sup>16</sup> This Survey presents four employment categories – self-employed, regular wage/salary workers, casual workers and ‘others’. The first three categories cover the ‘employed’ and the last category, the unemployed and labour force non-participants.

- (v) small traders and self-employed persons in personal and other service activities and
- (vi) self-employed craftsmen like masons and carpenters<sup>17</sup>.

A person falling into any of these categories need not necessarily be poor, in the sense of not being able to maintain even the absolute minimum level of nutrition, if he/she were in a position to obtain full time work - paid or own account. This was particularly so in the 1980s, and also later when informal sector wage rates, including those in the rural economy, were at life sustaining levels. Indeed, even casual daily paid workers in rural areas benefited from this general rise in informal sector wages. In fact, several of the above mentioned studies note that informal sector wages would have easily provided the minimum nutrition level income if workers had had regular employment for at least two weeks a month. The problem was that no such regularity of work was forthcoming. The presence of above employment categories among the groups identified as poor (with poor defined as those living below subsistence conditions) may be largely attributable to extensive under-employment among those worker categories<sup>18</sup>.

It is a popular conception that poverty is closely associated with unemployment. As Table 2.6 shows, however, under strict statistical definitions only a negligible proportion of Sri Lanka's poor would be counted as unemployed. DCS (2004) also shows that only about 7 per cent of the poor were unemployed. This is because most unemployed are not household heads but junior members of the family who tend to be first time job seekers<sup>19</sup>. That is to say, most unemployed are counted among families with employed family heads. Of course, a family with an unemployed household head is quite likely to be in poverty since the head of the household will tend to be the main bread-winner. Nevertheless, because of low levels of remuneration, and the importance of all incomes for the sustenance of low income families, even the presence of a few unemployed junior family members is likely to push the typical low income family into poverty.

### **Economic activity and occupation**

Agriculture forms the industry category with the largest concentration of the poor in Sri Lanka. Principal income earners in 50 per cent of poor households were in agricultural work in 1985. This figure has declined to 43 per cent in 1995. Of those who work in agriculture, roughly a third was found to have been poor. Similarly high proportions of workers in manufacturing, construction, and mining and quarrying are among the poor according to Table 2.7 but, in contrast, these workers account for, using 1995 data, a significantly smaller proportion of the total poor – 10 per cent, 7 per cent, and 2 per cent, respectively. The percentage of agricultural workers among the poor in 2002 is not

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<sup>17</sup> The daily wages of these craftsmen went up to levels where they would indeed be earning more than many public servants if they gained opportunities for regular employment - the point discussed in the following paragraph.

<sup>18</sup> Under-reporting of the incomes of these categories of workers could also be a factor here although it has not been taken explicitly into account. However, mitigating this is the fact that most of the statistical measures of poverty shown in the text are based on expenditure data.

<sup>19</sup> Household and Labour Force surveys and Census reports repeatedly show that the unemployed in Sri Lanka are heavily concentrated among young age groups. Such unemployed youth are unlikely to have been household heads whether poor or non-poor.

available in poverty statistics for 2002 but these statistics also show the high incidence of poverty among agricultural workers, with the relevant headcount ratio at 23 per cent..

**Table 2.7**  
**Trends in Poverty by Industry of Principal Income Earner 1985-95**

	Poverty Incidence			Distribution of Numbers in Poverty		
	1985	1990	1995	1985	1990	1995
Agriculture	38.92	20.99	34.09	49.57	39.92	43.14
Mining and Quarrying	39.07	26.20	40.14	1.46	1.58	2.12
Manufacturing	26.93	18.34	21.35	9.49	9.61	10.44
Construction	35.92	26.09	27.21	6.16	5.59	6.67
Wholesale and Retail Trade	19.66	15.36	17.76	6.59	8.78	8.42
Transportation	16.59	9.93	15.29	3.10	3.03	3.35
Finance	5.13	5.58	5.09	0.24	0.31	0.35
Communications	14.90	15.48	13.75	5.33	11.09	9.03
Unclassified	67.86	41.73	50.03	9.41	12.42	11.44
Unemployed/Non-labour force participants	26.13	19.82	18.31	8.65	7.64	5.06

Source: Gunewardena (2000).

Notes: Lower Poverty line = Rs. 791.67 per person per month

**Table 2.8**  
**Trends in Poverty by Occupation of Principal Income Earner 1985-95**

	Poverty Incidence			Distribution of Numbers in Poverty		
	1985	1990	1995	1985	1990	1995
Professional	5.13	4.85	5.04	0.83	1.15	1.18
Managerial	1.68	0.34	3.98	0.05	0.02	0.23
Clerical	7.42	6.87	6.67	1.42	1.79	1.57
Sales Workers	20.07	15.04	17.44	5.76	7.91	7.72
Service Workers	23.79	16.54	17.25	3.23	3.39	3.18
Farmers	39.32	21.10	34.71	47.91	38.26	42.38
Production Workers	36.84	26.07	29.86	31.94	39.04	37.99
Unemployed/Labour Force Non-participants	33.83	23.36	18.05	0.04	0.17	0.34
Unidentified	26.13	19.77	18.31	8.65	7.62	5.06

Source: Gunewardena (2000).

Notes: Lower Poverty line = Rs. 791.67 per person per month

In terms of the occupation of the principal income earner, farmers again count for over 40 per cent of all poor, with production workers accounting for a similar share (see Table 2.8). The incidence of poverty among farmers in 1985 was nearly 40 per cent, although by 1995 it had gone down to 35 per cent. High poverty levels among production workers appear to reflect the wage and other working conditions in small, cottage and micro industry, which employ a large proportion of “industrial workers”. In contrast, there is less poverty among workers in the service sectors, and least among professional and managerial classes.

## Real wage trends

Since the preceding discussion points to the fact that most of the poor are wage earners, it is pertinent to consider trends in real wages of workers with a view to deriving a clearer picture of income trends among the poor. This, however, is an area of investigation hampered by inadequacies and limitations in the available statistical data. Minimum wages indices for wage workers in some organised sectors are available but it is well known that the coverage of these data is limited and their mode of compilation calls for considerable caution in their interpretation<sup>20</sup>. With this lacuna in mind the minimum wage data (see Table 2.9) may be interpreted as depicting the following:

- During the period covered there was an overall decline in real wage levels in the sectors of industry, commerce and services covered by the Wages Boards.
- Real wages of workers in plantations covered by Wages Boards rose steadily up to the mid 1990s, but declined thereafter.
- Real wages of non-executive and minor grades in government service were, at best, relatively stagnant during this period, particularly if the rise in their wages in 2004 is ignored.
- The growth of real wages of government teachers has been the lowest among state sector employees. In 1995, a large nominal salary increase was awarded to this sector but this gain was very short lived as the decline in the real wage rate index continued since then.

It has to be recognised that in the Sri Lankan context wages received in the course of formal employment are not always equivalent to total earnings. In order to compensate for the decline or stagnation in real wages, many workers in the organised sector - perhaps excluding the unskilled - have tended to resort to secondary earning activities. The progressive liberalisation of the economy in the post-1977 period certainly offered greater opportunities for this type of “moonlighting” behaviour. What this means is that, even a fall in the minimum real wage of workers in the organised sector cannot necessarily be interpreted as implying a fall in their actual real earnings. Having said this, it is perhaps fair to say that the majority of the poor in receipt of employment income are unlikely to have any significant supplementary income support possibilities of the type referred to above.

We turn now to wage trends in the informal sector. Sanderatne (1985) suggests that immediately following the policy reforms of 1977 there was a significant rise in informal or unorganised sector nominal wages. The extent to which this relative rise in informal sector nominal wages continued into the post-1985 period is difficult to judge but

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<sup>20</sup> The minimum wages indices are based either on minimum wages set by Wages Boards in the corporate sector or on initial starting wages in government service. The wages and own account earnings of the bulk of the working population engaged in non-plantation agriculture and other informal activities are not covered in these indices. Even for corporate and government sectors, the indices based on minimum and initial wages exclude income supplements like annual increments, overtime payments, bonus earnings and other incentive payments, although the statutory and living allowances are included (see Rodrigo, 1980).

impressionistic evidence suggests that after the initial spurt the trend in real wage levels for activities in this sector was downward.

**Table 2.9**  
**Real Wage Rate Indices**

*December 1978=100*

Year	Workers under Wages Boards			Central Government		
	Plantation Agriculture	Industry & Commerce	Services	Non-Exec. Officers	Minor Employees	School Teachers
1978	99	103	-	105	105	105
1979	116	105	108	111	113	107
1980	116	105	99	97	99	91
1981	98	96	93	93	96	85
1982	104	93	98	104	112	96
1983	100	83	90	103	114	95
1984	108	79	83	100	113	105
1985	117	87	81	113	129	105
1986	114	89	75	109	125	98
1987	110	94	72	102	116	91
1988	122	87	74	117	133	107
1989	126	97	71	114	128	106
1990	123	90	64	104	122	96
1991	122	97	71	103	123	94
1992	126	97	70	96	116	88
1993	137	90	62	106	124	96
1994	129	87	68	109	121	93
1995	121	95	67	109	121	111
1996	114	86	61	95	111	96
1997	111	81	60	97	111	89
1998	115	85	53	101	108	84
1999	112	83	56	96	103	81
2000	108	81	53	97	106	81
2001	97	76	54	101	115	85
2002	96	74	51	106	123	89
2003	98	72	48	100	116	84
2004	92	69	49	112	134	94

Source: Central Bank

The preceding suggests that trends in real wages for “lower grade” workers in both formal and informal sectors was declining for most of the period under review, certainly over the period for which poverty indices are available, i.e., 1985-02. This would seem to suggest some link between poverty levels and real wage trends. This is consistent with the notion of the “working poor” referred to above.

## Education

Poverty is also strongly associated with fewer years of schooling of principal income earners (see table 2.10). Around 40 per cent of those with no schooling at all are poor, but the contribution of this group towards poverty is relatively low, at around 10 per cent. This corresponds with the small proportion of people with no schooling at all in the country's population at large. From table 2.10 it may be seen that principal income earners with only primary schooling account for roughly 40 per cent of all poor, and poverty incidence among this group hovers around the 40 per cent level. The next largest contribution to poverty – roughly a quarter - comes from households whose principal income earner has only lower secondary schooling. About a third of such households are poor. Households whose principal income earner has at least upper secondary schooling contribute around 15 per cent to total poor, while at least a fifth of such households are usually poor. The contribution to poverty and poverty incidence of households whose principal income earner has studied at least up to the GCE (Ordinary Level) are considerably lower.

**Table 2.10**  
**Trends in Poverty by Education of Principal Income Earner 1985-1995**

	Poverty Incidence			Contribution to poverty		
	1985	1990	1995	1985	1990	1995
No Schooling	45.24	31.17	39.76	12.68	11.08	8.56
Primary Schooling	44.26	27.59	38.05	42.22	42.00	37.51
Lower Secondary Schooling	32.54	20.80	30.96	26.47	24.91	26.52
Upper Secondary Schooling	23.88	16.67	22.22	13.30	15.12	18.14
GCE O/L	10.01	7.98	10.82	4.72	6.13	7.73
GCE A/L	6.42	3.08	4.86	0.57	0.61	1.40
Graduate and above	0.71	1.84	1.49	0.05	0.15	0.15

Source: Gunewardena (2000).

Notes: Lower Poverty line = Rs. 791.67 per person per month

The pattern of distribution of the poor in 2002 by different educational attainment levels of household head remains broadly similar to what Table 2.10 shows [DCS (2004)]. At the high end of educational attainment, DCS (2004) provides information for only one category combining three from Table 2.10 - upper secondary, GCE (O Level) and GCE (A. level). No data are provided for 'graduate and above' category. Thus for 2002, the contribution to poverty percentages for the four categories – no schooling, primary schooling, lower secondary and upper secondary – turn out to be 13, 49, 21, and 17.

## Gender

Households whose principal income earner is male constitute the vast majority of poor households – roughly 84 per cent (Table 2.11). This is not surprising as the principal income earner in most households is male. However, poverty incidence among households with male and female principal income earners is remarkably similar. Computations from DCS (2004) for year 2002 also confirm this, with poverty incidence among male and female headed households being respectively 23 and 22 per cent. Thus, if the principal income earner is female, then the household is as likely to be poor as if the principal income earner was a male. It needs adding, however, that micro level case studies suggest female-headed households, particularly those with no adult children, are among the poorest of the poor (see Ratnayake, 1998).



**Table 2.11**  
**Trends in Poverty by Gender of Principal Income Earner**

	Poverty Incidence			Distribution of Numbers in Poverty		
	1985	1990	1995	1985	1990	1995
Male	31.12	19.89	25.77	84.40	84.86	84.30
Female	30.14	19.76	22.33	16.60	15.14	15.70

Source: Gunewardena (2000).

Notes: Lower Poverty line = Rs. 791.67 per person per month

### **Ethnicity**

Given the ethnic dimensions of the recent civil turmoil in Sri Lanka and frequent complaints of minority discrimination, it is only natural that considerable attention is often focused on estimates of poverty trends by ethnicity. However, one major problem with the available data in this regard is that they exclude the conflict areas of the North, where Sri Lankan Tamils constitute the majority, and the East, where both Sri Lankan Tamils and Moors account for roughly a third each of the total population. On the basis of the available data Gunewardena (2000) shows that, corresponding to their proportion in the population as a whole, the overwhelming majority of the poor are Sinhalese. Table 2.12 presents a summary of these data. The data presented in the table shows that of those in poverty in 1995, 84 per cent were from the Sinhalese community. This is significantly higher than the 70 per cent population share of the Sinhalese. The table also shows that the poverty incidence is lowest among Indian and Sri Lankan Tamils. When comparing poverty incidence trends, however, the picture is somewhat reversed. Thus the poverty incidence among the Sinhalese appears to have fallen between 1985 and 1995, while that among Indian and Sri Lankan Tamils appears to have risen between these two dates<sup>21</sup>.

**Table 2.12**  
**Trends in Poverty by Ethnicity of Principal Income Earner**

	Poverty Incidence			Contribution to poverty		
	1985	1990	1995	1985	1990	1995
Sinhalese	31.70	19.84	25.04	87.20	83.78	84.07
Sri Lankan Tamil	26.23	19.81	27.10	3.54	4.93	5.21
Indian Tamil	20.81	11.71	22.98	2.85	2.43	3.89
Sri Lankan Moors	32.65	24.78	28.89	6.16	7.82	6.66

Source: Gunewardena (2000).

Notes: Lower Poverty line = Rs. 791.67 per person per month

<sup>21</sup> DCS (2004) presents a different tabulation, indicating the distribution of each of the four main ethnic groups between the poor and non-poor categories. The Sinhalese with 19 per cent of poor among them appear to have been marginally better off in 2002 than the other communities – 22 per cent for Sri Lankan Tamil, 21 per cent for Indian Tamil and 21 per cent for Sri Lankan Moors.

## IV. Income Inequality

### The Sri Lankan experience

Table 2.13 brings together data on the distribution of household income and expenditure between 1973 and 2003/04 from two sets of publications from the Central Bank and DCS. These data appear to show that in the years following liberalisation there was a remarkable degree of stability in relative income distribution as measured by the so-called “Gini” coefficient<sup>22</sup>. The liberalisation process itself has resulted in a rise in inequality according to some analysts [e.g. Lakshman (1997): 174-5]. Other commentators [e.g. Dunham and Jayasuriya (2000)] have, however, challenged this interpretation, questioning the reliability of the 1973 Survey data, which are so crucially important to mount an argument of increased inequality after liberalisation. dependent on the isolated 1973 evidence. Dunham and Jayasuriya (2000) argue that “... apart from the 1973 figure (where the trend is probably correct but the extent of the improvement that occurred would seem greatly exaggerated), there has been a remarkable degree of stability in the distribution of income” (p.102)<sup>23</sup>.

**Table 2.13**  
**Changes in Size Distribution of Income 1978/79 – 2003.04**

<i>Consumer Finance and Socio-Economic Survey (CFSS)</i>	1973	1978/79	1981/82	1986/87	1996/97 <sup>a</sup>	2003/04 <sup>a</sup>
Quintile	<b>Share of Income Receiver Income (%)</b>					
1	4.97	3.76	3.62	3.54	4.04	3.80
2	10.08	8.37	7.94	7.79	8.79	8.30
3	15.85	13.30	12.39	12.48	13.54	13.00
4	23.21	20.46	19.22	19.45	20.67	20.20
5	45.89	54.09	56.80	56.74	52.96	54.80
Gini Coefficient (Spending Units)	0.35	0.43	0.45	0.46	0.43	0.46
Gini Coefficient (Income Receivers)	0.41	0.50	0.52	0.52	0.48	0.50
<i>Household Income and Expenditure Survey (HIES)</i>		<b>1980/81</b>	<b>1985/86</b>	<b>1990/91</b>	<b>1995/96</b>	<b>2002</b>
Gini coefficient for household income		0.43	0.46	0.47	0.46	0.47
Urban		0.44	0.48	0.62	0.47	0.48
Rural		0.38	0.43	0.42	0.46	0.45
Estate		0.27	0.31	0.25	0.34	0.34

Notes: <sup>a</sup> Excluding Northern and Eastern Provinces

Source: Central Bank of Sri Lanka (1999 and 2005); DCS (2000 and 2004)

Although aggregate data appear to paint a picture of fairly static income distribution in the period of concern, it is otherwise with regional income data. These data, in contrast,

<sup>22</sup> Higher values of the Gini coefficient indicate a more unequal distribution.

<sup>23</sup> It is of note that their argument is based on two numbers not presented in table 2.13, namely the Gini ratios for 1953 (0.46) and 1963 (0.45).

point to the existence of widening gaps between regions; between, on the one hand, the dynamic and industrialised Western Province<sup>24</sup> with its metropolitan hub of Colombo, and, on the other hand, the rest of the country. An indication of this gap is provided in table 2.14, which presents mean incomes in different agro-ecological zones as percentages of the mean income in the Colombo Municipality for different survey years. The data in this table show that income disparities between Colombo and all other districts have risen continuously in the post-liberalisation period. In the pre-liberalisation period mean monthly incomes in the Wet Zone districts appear to have moved in line with those in the Colombo Municipality. Although in 1986/87 the predominantly Tamil-speaking northern and eastern provinces fell out of the data set altogether as the region was rapidly overtaken by conflict, there can be little doubt that the mean monthly income gap between Colombo and these areas continued to rise after this date. The fact that the mean income disparities are most pronounced with respect to Zone 4 is in all probability mostly due to the low wage structure of plantation agriculture, and the high incidence of rural landlessness, in the region. The increasing regional disparities suggested by the mean monthly income data appear to be supported by data on the contributions of administrative provinces to overall GDP. These data are not, however, presented here within the text, with a solitary number relegated to a footnote, because they only go back to 1996 and the methodologies of their computation are still in early stages of development. An important question, not as yet adequately probed into, is raised by these regional data. Why do the regional disparities, which available data appear to indicate, fail to show up in the overall inequality measures? Why does inequality among regions appear to count for an insignificant proportion of aggregate income inequality?

**Table 2.14**  
**Mean Monthly Income in Different Zones<sup>a</sup> as Share of Income in Colombo Municipality**

Zone	1973	1978/79	1981/82	1986/87	1996/97
1	95	95	57	52	56
2	95	67	60	52	42
3	99	76	57	n/a	n/a
4	65	46	50	36	39

Notes: <sup>a</sup> Zone 1: Wet Zone districts of the south western seaboard including Colombo District but excluding Colombo Municipality; Zone 2: Dry Zone districts of the south-east, north-west and north-central regions; Zone 3: Dry Zone Districts of the north-east; Zone 4: Wet-Zone Districts of the south-western littoral and central mountainous region.

Source: Data for 1973 through to 1986/87 from Lakshman (1997) citing Central Bank's Consumer Finance and Socio-Economic Survey data for the relevant years. Data for 1996/97 are from Central Bank (1999).

### International comparisons

International comparisons of income dispersions, as with international comparisons of poverty levels, are known to be littered with innumerable statistical potholes, not the least of which are the varied methodologies used for the computation of dispersions in

<sup>24</sup> It is estimated that the Western Province incorporates 79 per cent of all industries in the country and produces 50 per cent of the country's GDP.

different countries, differences in timings of surveys, etc. As with the comparison of poverty levels, it is felt that it would nevertheless be useful to get some idea of how Sri Lanka's income dispersion compares internationally. Table 2.15 presents a comparison of Sri Lanka's income dispersion with those of other developing countries, making use of distribution indicators published for different countries in the World Bank's Development Indicators database<sup>25</sup>. It may be seen that according to the most recent survey information that is available, Sri Lanka's level of income inequality is around the average for South Asian countries. This level of inequality is, however, less than the average for all countries and all developing (including transitional) countries for which estimates are available.

**Table 2.15**  
**An international comparison of Sri Lanka's income disparities, latest estimates**

	Survey Year	Gini Index
Bangladesh	2002	31.8
India	1999-00	32.5
Nepal	1995-96	36.7
Pakistan	1998-99	33.0
Unweighted AVERAGE of above		33.5
SRI LANKA	1999-00	33.2
All countries (a)	Early 2000's	40.0
All developing countries (b)	Early 2000's	42.2

Notes: (a) Estimates are available for a total of 118 countries

(b) Estimates are available for a total of 93 developing and transitional economies

Source: *World Development Indicators*, 2002 and 2005

## ***V. Human Development***

### **International comparisons: Sri Lanka as an "outlier"**

In the literature on development, Sri Lanka is widely cited as a country that has achieved respectable levels of human development in spite of continuing low levels of per capita income. For example, according to data provided in the UNDP's *Human Development Report 2004* Sri Lanka's relative international ranking in 2002 in terms of human development [as depicted by the Human Development Index (HDI)] and PPP income per capita was 96 and 112, respectively. In a scale from 1 to 100 with 1 representing the highest ranking for both indicators, these two numbers would be equivalent to 54 and 63 respectively. This rough and ready summary indicator of Sri Lanka's international "outlier" status with regard to human development is confirmed by a more detailed international comparison involving many of the widely used important social indicators. Such a comparison is provided in table 2.16. This table compares selected social indicators of Sri Lanka with averages for 4 broad country categories (viz., All Developing Countries, Least Developed Countries, Sub-Saharan Africa, and Industrial Countries) as given in some recent UNDP Human Development reports. The data in table 2.16 show in terms of most of the important social indicators, Sri Lanka achieves a

<sup>25</sup> It is worth bearing in mind that the Gini ratio for Sri Lanka in Table 2.15 is significantly lower than those in Table 2.13 for the corresponding period.

higher human development rating than the average for all developing countries. In fact, it would appear (see columns 1 and 5) that Sri Lankan social indicators even compare favourably with those of the ‘industrialised countries’.

**Table 2.16**  
**Selected Social Indicators: Sri Lanka compared with Some Broad Country Categories<sup>a</sup>**

	<b>Sri Lanka</b>	<b>A</b>	<b>B</b>	<b>C</b>	<b>D</b>
Life Expectancy at Birth	72.2	62.1	50.6	49.9	73.8
Population % with Access to:					
Health Services	93	80	49	53	..
Safe Water	57	71	57	51	..
Sanitation	63	39	36	45	..
Daily calorie supply per capita	2275	2553	2054	2096	..
Adult Literacy Rate	90.1	69.7	48.4	56.2	98.3
Births attended by trained health personnel (%)	94	54	30	38	99
Low Birth Weight Babies %	25	18	23	16	6
Infant Mortality Rate per 1000 live births	16	64	103	97	14
One year olds Immunised %	79	68	37	52	75
Under 5 Mortality Rate per 1000 live births	19	95	169	174	18
Maternal Mortality Rate per 100,000 live births	140	471	1030	971	31
Thousands of people/Doctor	7.1	5.8	19.0	18.5	0.5
Thousands of people/Nurse	1.8	4.7	13.8	6.5	0.1
Gross School Enrolment Rates (Combined 1 <sup>st</sup> & 2nd levels):	87	74	46	53	98

(a) The exact time period these data refer to vary but in all cases, the figures refer to some time in the early and mid-1990s. Column titles A-D refer to A) All developing countries, B) Least developed countries, C) Sub-Saharan Africa, and D) Industrial countries. The mark .. indicates that the relevant data are not available in the sources cited.

Source: UNDP (1990), (1995) & (1997)

### **Trends in human development in Sri Lanka**

Trends in human development in Sri Lanka are depicted in tables 2.17 and 2.18. Table 2.17 provides a summary of human development trends in the form of the absolute value of the HDI for Sri Lanka for several years between 1975 and 2000. What these data show is that levels of human development have steadily improved over the reference period, although the rate of improvement appears to have slowed. The last line of the table also shows that Sri Lanka’s relative international ranking has remained fairly steady in the process. The country could not maintain the improved position it was able to achieve in 1995 in terms of international ranking during the subsequent years. Table 2.18 reinforces and elaborates on this picture of a general improvement in human development. Of particular note are the decline in infant and child mortality and the increase in access of the population to safe water and sanitation.

**Table 2.17**  
**HDI Ranking**

	1975	1980	1985	1990	1995	2000	2003
HDI <sup>a</sup>	0.607	0.649	0.681	0.705	0.727	..	0.751
% increase in HDI		6.9%	4.9%	3.5%	3.1%	..	3.3%
HDI Rank	52	60	62	71	67	89	93
Total No countries in ranking	100	112	123	135	139	173	177
Place in ranking on a scale of 1 to 100	52	53.6	50.4	52.6	48.2	51.4	52.5

Note: <sup>a</sup> These *HDI* figures are from UNDP (2005)

Source: UNDP, *Human Development Report* (various years)

**Table 2.18**  
**Social Indicators 1975-2005**

	1975	1985	1990	1995	2000	2003
Infant Mortality Per 1000 live births	n.a.	32 (1988)	27 (1989)	17 (1996)	13.6	11.2 (2002)
Under 5 Mortality	73	34.6 (1987)	36 (1989)	29.5 (1993)	20.8	15 (2003)
Malnutrition (% of children less than 5 who are underweight)	n.a.	38 (1980-88)		37.7 (1993)	29.4	29 (1995-03)
Life Expectancy in years	66	71 (1987)	70.9	72.5	72.1	74 (2003)
Adult Literacy						
Males %	n.a.	91	n.a.	93.2 (1994)	96.5 (1998)	88.6 (2003)
Females %	n.a.	83	n.a.	86.9 (1994)	94 (1998)	92.2 (2003)
Youth (15-24)	n.a.	n.a.	n.a.	n.a.	96.8 (1998)	95.6 (2003)
Population with access to safe water %	21.8 (1978/79)	41	n.a.	72 (1994)	75.4	78 (2002)
Population with access to sanitation %	n.a.	50	n.a.	76 (1994)	72.6	91 (2002)
Net primary enrolment	n.a.	100	n.a.	n.a.	100	n.a.
Net secondary enrolment	n.a.	71	n.a.	n.a.	n.a.	n.a.

Sources: UNDP, *Human Development Report* (various years); UNDP, *National Human Development Report* (1998); Department of Census and Statistics, *Statistical Abstract*

Although the evidence presented above paints an unequivocal picture of considerable improvements in human development over the recent past in both absolute and relative terms, the extent of the achievements suggested by these data need some qualification. For one thing the data in Tables 2.17 and 2.18 are aggregates, hiding significant variation by geographical region and social strata. Table 2.19 provides a breakdown of human deprivation along regional lines. Obtained from the last *National Human Development Report* compiled by the UNDP for Sri Lanka, this Table refers 1994/95 data. It clearly shows that there are significant disparities between regions, with human development

attainment in the urbanised western province exceeding that of other regions, all of which are below the national average. The pattern of regional disparity would remain very similar had recent data been used in the analysis. Although the empirical data is not presented here, it is obvious that similar disparities exist with regard to human development attainments of different social groupings. The human development indicators provided in tables 2.17 and 2.18 also pay little or no attention to the quality of services available for people from service providers in sectors such as education and health. Thus, hidden in the 96 per cent adult literacy rate in table 2.18 is a very high proportion of functional illiteracy. Going beyond the high literacy and high school participation rates, questions may be raised about the quality of primary and secondary education that is imparted by many schools in the country - the bulk of them in the state sector. For example, less than 25 per cent of all candidates at the General Certificate of Education (GCE) Ordinary Level Examination obtain “full passes”, with the failure rate in mathematics known to be particularly high.

**Table 2.19**  
**Regional Human Deprivation in Sri Lanka 1994/95**

	<b>Human Poverty Index</b> (rank within parentheses)	<b>Adult Illiteracy</b>	<b>Population Without Access to Safe Water</b>	<b>Population Without Access to Safe Sanitation</b>	<b>Births not in institutions</b>
			<i>percentages</i>		
SRI LANKA	18	9	28	24	15.9
Western Province	14 (1)	6	18	11	3.0
Central Province	23 (4)	15	26	24	21.5
Southern Province	20 (2)	11	35	20	8.6
North Western Province	21 (3)	8	35	30	12.8
North Central Province	24 (6)	10	48	32	20.0
Uva Province	27 (7)	17	45	34	36.1
Sabaragamuwa Province	23 (5)	11	32	23	16.9

Source: UNDP (1998) National Human Development Report

Note: The Human Poverty Index denotes the percentage of the population experiencing deprivation in the following dimensions of human poverty: life expectancy, illiteracy rates and combined primary and junior secondary education non-enrolment rate, deprivation in access to safe drinking water, deprivation in access to safe sanitation, deprivation in access to adequate basic health care.

## ***VI. Poverty Alleviation Policies and Measures***

Policy alleviation policies and measures may be defined as those policies and measures which seek to raise the consumption levels and general living standards of the poorer sections of the population. Although the current thrust of development policy thinking favours the adoption of poverty alleviation policies and measures, it is of note that Sri Lankan policy makers have had a long standing commitment to poverty alleviation, going back to pre-independence times and even during historical periods when such a commitment was not so fashionable. Broadly speaking, the poverty alleviation policies and measures adopted in Sri Lanka can be clustered under four main headings:

- ❑ Free or subsidised social and economic services
- ❑ *Ad hoc* consumer and producer subsidies
- ❑ Integrated Rural Development Programmes (IRDPs)
- ❑ General income support and employment promotion schemes

### **Free/subsidised social and economic services**

The Sri Lankan state has traditionally provided a number of free or subsidised social and economic services. The rationale for this has been, at least in part, poverty alleviation in the sense of an attempt to raise the living standards of the poor. Perhaps the two most important of such free/ subsidised services have been education and healthcare.

Free education from primary school to university first degree level was introduced in 1944 and still continues in the state sector of education. The bulk of the available health service facilities in government institutions, including hospitalisation and medicines, have remained free of charge. In the post-1977 period of liberalisation the private and fee-levying segments of these and other social sector services<sup>26</sup> have gradually expanded. But the government's commitment to maintain public sector facilities, the bulk of it free of charge, has continued, although the state funding channelled into these two sectors, as a proportion of GDP, has declined from the levels of the second half of the 1970s and has stagnated since the early 1980s (see table 2.20).

### **Consumer and producer subsidies**

In Sri Lanka consumer subsidies have mainly assumed the form of food subsidies. Food subsidies were to be found even in pre-independence days, i.e. during the early 1940s, when these were introduced to meet the exigencies of war. Initially, the food items under subsidy, mainly rice, were distributed from co-operative and other designated shops on a rationing basis, at less than market prices. There was no targeting and everyone was issued a ration book to be used when obtaining the rationed food items. This policy was continued long after the war and was subject to increasing criticism, particularly in respect of the absence of targeting. As a consequence some targeting of the food subsidy was introduced in the early 1970s. In 1978 food subsidies were replaced to a large extent by food stamps issued to families below a designated income level. In 1994, with a change in government, significant use was once again made of food subsidies by way of the introduction of a comprehensive subsidy scheme on bread. However, the fiscal burden this imposed, particularly in the context of a rise in global wheat prices, led to its abandonment a few years later.

Aside from food subsidies, there was a variety of other consumer subsidies implemented at various points of time, including railway and bus transport subsidies for school children and old-age pensioners, housing subsidies, school mid-day meals, energy subsidies and so on. However, these have typically been smaller, and less consequential for poverty alleviation, than the food subsidy measures.

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<sup>26</sup> This includes, in addition to formal private sector institutions providing educational and medical facilities, the expansion of private tuition by teachers of state educational establishments after normal school hours and private practice among government sector doctors.



**Table 2.20**  
**Government Expenditures on Social Services/ Welfare, 1979-2003**

*Three Year Averages: As per cent of GDP*

	1975- 77	1978- 80	1981- 83	1984- 86	1987- 89	1990- 92	1993- 95	1996- 98	1999- 01	2002- 04
<b>Current</b>										
<b>Expenditure on Social Services</b>	<b>10.5</b>	<b>10.5</b>	<b>6.7</b>	<b>6.1</b>	<b>7.2</b>	<b>7.9</b>	<b>8.1</b>	<b>6.9</b>	<b>6.1</b>	<b>6.5</b>
Education	2.6	2.2	2	2	2.4	2.4	2.4	2	1.8	1.8
Health	1.3	1.2	1	1	1.2	1.1	1.3	1.1	1.1	1.3
Welfare	6.5	7.1	3.5	3	3.5	4.3	4.4	3.6	2.9	3.1
Housing	0	0	0	0	0	0	0	0	0	
Community Services	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.3	0.3
<b>Capital</b>										
<b>Expenditure on Social Services</b>	<b>0.8</b>	<b>1.9</b>	<b>1.8</b>	<b>1.2</b>	<b>1.5</b>	<b>1.1</b>	<b>1.3</b>	<b>1.4</b>	<b>1.3</b>	<b>1.2</b>
Education	0.3	0.5	0.5	0.5	0.5	0.4	0.5	0.6	0.5	0.4
Health	0.3	0.7	0.3	0.2	0.6	0.4	0.3	0.3	0.4	0.3
Welfare	0	0	0	0	0	0.1	0.3	0.1	0	0.0
Housing	0.1	0.6	0.9	0.3	0.3	0.2	0.2	0.1	0.2	0.2
Community Services	0.1	0.1	0.1	0.1	0.1	0	0.1	0.3	0.2	0.1
<b>Total</b>										
<b>Expenditure on Social Services</b>	<b>11.3</b>	<b>12.5</b>	<b>8.5</b>	<b>7.3</b>	<b>8.6</b>	<b>9</b>	<b>9.5</b>	<b>8.3</b>	<b>7.4</b>	<b>7.7</b>
Education	2.9	2.7	2.5	2.5	2.9	2.8	2.9	2.6	2.4	2.2
Health	1.6	1.9	1.4	1.2	1.8	1.5	1.5	1.4	1.5	1.6
Welfare	6.5	7.1	3.5	3	3.5	4.4	4.6	3.7	3	3.1
Housing	0.2	0.6	0.9	0.3	0.3	0.2	0.2	0.1	0.2	0.2
Community Services	0.1	0.2	0.2	0.2	0.2	0.1	0.2	0.4	0.4	0.5

Note: The information used in the preparation of this Table comes from the “functional” classification of government expenditure, provided in the Central Bank Annual Reports. The classification system used by the Central Bank was changed in the latter part of the 1980s. The five-fold classification of expenditure on social services appears after this change. Before this change, part of social service expenditure was given as “transfers to households”. The items of food subsidy expenditure, pensions and “other” transfers to households were taken as part of “welfare expenditure” during the time before the classification change was made in the 1980s.

Source: Central Bank of Sri Lanka, *Annual Report* (various issues).

As was noted above, poverty in Sri Lanka is, and has traditionally been, a largely rural phenomenon, with the poor including large numbers of agricultural producers. Hence, producer subsidies, in the form of direct grants, concessional credit facilities, fertilizer subsidies, free irrigation water supplies, and the like, have been conceived of in large measure as poverty alleviation measures. As with consumption subsidies, producer subsidies have tended to be *ad hoc* and untargeted. The use of such subsidies was most widespread in the 1970s and before. Today they are relatively insignificant in both size and effect.

In addition to the above mentioned consumer and producer subsidies there have also been various public assistance schemes, including special schemes at times of natural disasters. A major social welfare item in recent government budgets has been the assistance

extended to refugees. In 1996, all the above type of welfare payments, including food stamps, amounted to 10 per cent of total government expenditure and 3 per cent of GDP (Gunatilaka, 1997, table 2, p. 11; see also Ratnayake, 1992, Ch. 2).

### **Integrated Rural Development Programmes (IRDPs)**

IRDPs have been a widely used policy initiative to promote rural development in general and to alleviate rural poverty in particular. The first IRDP in Sri Lanka was launched in 1979. Since this time there have been a number of IRDPs covering many of the poorer regions in Sri Lanka, all of which have been formulated and implemented with foreign assistance. It is unfortunate that the civil conflict since the mid-1980s did not permit IRDPs to be introduced in the conflict-ridden districts of the north and east of the country, although there were some initial plans to set up IRDPs in some of these districts.

In terms of their conceptualisation, the IRDPs have undergone considerable change over time. The basic purpose of IRDPs has always been to provide necessary infrastructure and institutional facilities and certain types of production assistance to people in the rural areas concerned with the aim of expanding incomes and lowering poverty levels. The philosophy guiding the implementation of IRDPs in the early stages was what has subsequently been labelled as the “top-down” approach. In the wake of extensive criticism of this approach later IRDPs came to adopt a more participatory or “bottom-up” approach. Some IRDPs have adopted the “participatory approach” in the name of social mobilisation. The participatory development or social mobilisation paradigm emerged as a response to the failure of the dominant 'model' of development that was in practice, trying to make development more “people-centred”. Mobilisation of people has been seen as supplementary to accumulation of physical capital. Participatory systems of development have been implemented through community groups. While creating awareness among these groups about the reality around them, co-operation and savings habits have been promoted within groups. The people organised into groups have also been encouraged and assisted to undertake self-employment activities in order to move away from poverty on a sustainable basis. Many a participatory programme of development has focused on organising women. Women are considered a disadvantaged group in these exercises and attempt has been made to integrate them into the development process as important partners. In fact, women constitute the bulk of the people organised as groups in many social mobilisation programmes<sup>27</sup>.

### **General income support and self-employment schemes**

Towards the late 1980s and early 1990s there was a policy shift away from *ad hoc* and partial poverty alleviation measures and towards more general, all encompassing, income support and self-employment schemes. Specifically, a committee was appointed in 1988 under the chairmanship of the then Governor of the Central Bank to advise the government on policies required for alleviation of poverty. The political party, which was in power continuously from 1977, namely the UNP, fought parliamentary and presidential elections in that year, i.e., 1988, on an explicit poverty alleviation agenda. The beginnings of the wide-ranging poverty alleviation programme by the name of

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<sup>27</sup> For a review of the history and performance of IRDPs see (Lakshman et al. 1994; Ratnayake, 1992, ch.2).

*janasaviya* commenced in the aftermath of these elections, in the context of an export-oriented growth strategy and a structural adjustment programme (see chapter 3 for details). The highly populist *janasaviya* programme required enormous resources, which the government could not raise. As a consequence, and contrary to promises made during the elections, the government was compelled to undertake the implementation of the programme by stages, each stage to cover only a few districts in the country. When the then President, Mr R. Premadasa, was assassinated in May 1993, *janasaviya* was not yet implemented in the entire country. The People's Alliance (PA), which came to power in the Presidential and Parliamentary elections of 1994 and 1995, continued with a scaled-down version of what was in essence the same programme, except now relabelled as the *samurdhi* programme, in the context of an even more fundamental commitment to market friendly policies.

As conceptualised the *janasaviya* and *samurdhi* programmes were/are seen as targeted programmes to achieve basically two type of objectives: (a) to enhance consumption entitlements of the beneficiaries (the safety net element) and (b) to facilitate them taking up self-employment activities (economic self-reliance element). To achieve (a) above, a sum of money would be transferred monthly to the recipient households, the size of the transfer depending on their pre-transfer income level (see Gunatilaka, 1992 and Ratnayake, 1998 for details). In the *janasaviya* programme, part of the income transfer was to be compulsorily credited to savings accounts opened in the name of recipients<sup>28</sup>. The intention was that the income transfer was to end within a two year period, during which time, it was hoped, the recipients would use the funds transferred to savings accounts plus whatever credit they could raise from banks as capital to commence income-earning activities or to further develop those activities already commenced. The *samurdhi* programme too emphasises the importance of savings and introduced voluntary/compulsory saving schemes among beneficiaries.

The economic self-reliance objective noted above in respect of the beneficiaries was to be achieved in both programmes through self-employment projects. The mechanism of group formation and group action, common to almost every participatory development initiative discussed above, has been used in these two poverty alleviation programmes as well. The groups so formed were to provide some collective strength to members, helping them gain technical and marketing skills for self-employment activities and to borrow from financial institutions. In addition to individual savings, a fund was created in the course of the implementation of the *janasaviya* programme, the so-called *janasaviya* Trust Fund, to enable *janasaviya* beneficiaries commence self-employment activities. This Fund also adopted the group mechanism in the disbursement of funds but the amount so disbursed per person was rather negligible<sup>29</sup>.

*Janasaviya* and *samurdhi* can be treated, as indeed they should be, as a special poverty alleviation programme of one single genre. It has become highly politicised over the period of its existence from its initial conceptualisation in 1988. During five electoral

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<sup>28</sup> There were widely expressed doubts as to whether this was done in the case of all recipients.

<sup>29</sup> This fund remains in existence to-date, in the form of the National Development Trust Fund.

cycles since 1988<sup>30</sup>, this programme has taken a centre stage in the string of election promises made by both right of centre and left of centre political constellations to win electoral support. Between elections it has become – or at least criticised by political opponents to have become – a programme used by elected governments to satisfy their party supporters in addition to providing assistance to the poor. Various in-house as well as external evaluations have been made of their effectiveness. Whatever the research results and opinions on this count, this programme has acquired the position, politically, of something like the rice subsidy programme of yore – having debatable socio-economic results but a surrounding political economy making its continuation rather compelling.

## ***VII. Summary***

The chapter sought to examine how conditions of poverty, income distribution and human development in Sri Lanka changed over the last two decades. The major points made in this regard were as follows:

- Poverty affects a significant percentage of the population, viz., around 45% if one takes US\$ 2 per day as the poverty line and adjusts for international comparability. This figure is considerably lower than the average for South Asia. It is, however, consistent with Sri Lanka's relative international position in terms of per capita income.
- Survey data over the period 1985-02, analysed using national poverty line estimates, suggest that poverty levels have declined, significantly if the comparison base is 1985/86 but marginally, if the base for comparison is 1990/91<sup>31</sup>. However, the many problems associated with these data, including the limited number of years for which comparable data are available, makes any conclusions with regard to poverty trends little more than tentative.
- Poverty in Sri Lanka (as in most other developing countries) is shown to be largely a rural, including estate, phenomenon. Poverty is geographically widespread, with the least affected areas being the more industrialised Western province.
- Most heads of poor households are employed in commodity production activities (agriculture and industry) as farmers or production workers, and possess limited education. The gender of the poor household head does not appear to have a significant bearing on household poverty but ethnicity apparently does, with relatively most poor coming from the Sinhalese community.
- Income dispersion is no more unequal in Sri Lanka than the average for South Asian countries, and is considerably more equal than the average for all developing and developed countries.
- There are considerable variations in income levels between regions which are not picked up by aggregate dispersion indicators.

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<sup>30</sup> Presidential and Parliamentary elections of 1988, 1994-5 and 1999-2000, Parliamentary elections of 2002 and 2004.

<sup>31</sup> It may be noted that this conclusion does not accurately reflect the behaviour of poverty conditions in the estate sector over this period.

- Survey data shows that income distribution has been relatively static over time. The same data limitations noted in the case of the analysis of consumption poverty trends apply here as well.
- Aggregate, as well as disaggregate, social indicators confirm the widely held belief that Sri Lanka's level of human development is considerably higher than that suggested by its relative (international) per capita income level.
- Aggregate data suggest that Sri Lanka has experienced a continuous improvement in human development for a considerable period of time. However, regionally disaggregated data show that the improvement in human development is not widespread, and a closer scrutiny of individual social indicators suggests that the aggregate numbers may be painting a somewhat rosier picture of the extent of human development than is actually the case.
- Sri Lankan policy making has had a long commitment to poverty alleviation going back even to the pre-independence era. The policies and measures adopted have been numerous and varied. They included free or subsidised social and economic services, consumption and production subsidies, integrated rural development programmes, and general income support and self-employment creation schemes (viz., *janasaviya* and *samurdhi*).
- Over time, poverty alleviation policies and measures have become less *ad hoc* and more targeted. Of late fiscal outlays in respect of poverty alleviation have tended to contract.

## Chapter 3: Macroeconomic Policies and Trends

### *I. Introduction*

The present chapter will outline important macroeconomic policies and trends in what is referred to as the economic liberalisation period, i.e., the period after 1977. This outline will be based on a periodisation of the post-1977 period into four distinct sub-periods, each characterised by a difference in policy emphasis and corresponding macroeconomic dynamic. The four sub-periods identified are;

- 1977-84
- 1985-89
- 1990-94
- 1995 and beyond

The following sub-section will highlight the policy emphases and corresponding macroeconomic trends during these four sub-periods and their difference from one sub-period to another. As a prelude to this some consideration will be given to the socio-economic context in which the whole liberalisation strategy was embarked upon in 1977 and continued thereafter.

### *II. The General Economic Policy Framework and its Evolution over Time*

#### **Background to 'open economy' policy reforms of 1977**

The open economy policy reforms came in the wake of a concerted import substituting industrialisation (ISI) growth strategy over the period 1970-77. The ISI strategy adopted in this period had all the usual trappings of such a regime including high tariffs, import and exchange controls, price controls, industrial licensing, over-arching presence of state enterprises, and central planning. The strategy ended up having seriously deleterious consequences for the economy and general living standards, not least because of the hostile international environment in which it was implemented. Economic growth (and employment) slowed while inflation picked up. The data presented in table 3.1 below shows economic growth slowing from an average of 4.7 per cent in the 1960s to an average of 3 per cent for the period 1971-77. At the same time, inflation rose from 3 per cent in the former period to 5.7 per cent in the latter. The one bright spot over the latter period was the significant improvement in the country's external balance. This improvement owed something to good fortune, by way of a positive development in the external terms of trade, particularly during 1975-77, and also something to the economic strategy itself, with its emphasis on self-reliance. In fact, the *overall* external balance went from minus 1.3 per cent of GDP in the 1960s to plus 1.7 per cent of GDP in the period, 1971-77. The trade balance in 1977 turned surplus for the first time since the mid-1950s. These developments gave rise in the process to a healthy build up of foreign exchange reserves. One unpopular side effect of the policy of self-reliance was the frequent shortages of certain basic consumer items.

The overall results of the 1970-77 policy experiences may be summed up as relatively successful stabilisation through rigorous controls but without the creation of a

macroeconomic dynamism which could temper, if not overcome, the worsening social problems like unemployment, underemployment, and poverty. There was, towards the end of this period, an increasing emphasis on promoting export-oriented industry<sup>1</sup>, with the assistance of foreign direct investment. Early signs of an emerging industrial export sector were visible by about 1976. It appears as if policy makers were thinking of changing course even before the 1977 change of political regime.

**Table 3.1**  
**Selected Macroeconomic Indicators for the Period 1960-77**

	1961-70	1971-77
	<i>Percentage change</i>	
GDP at constant prices	4.7	3.0
Agriculture	6.3	1.8
Manufacturing	6.3	1.8
Consumer price index	3.0	5.7
	<i>As percentage of GDP</i>	
Trade balance	-3.1	-2.6
Current account balance	-2.9	-1.1
Overall Balance	-1.3	1.7

Source: Central Bank Reports

### 1977-84: Government investment-led growth

The introduction of policies of economic liberalisation - or so-called “open economy” policies – by the incoming United National Party (UNP) in 1977 was thus largely the result of a general policy shift away from ISI type policies rather than any particular force of circumstance as was the case in many other developing countries which have adopted these policies. A World Bank report commenting on the changes saw them in the following light:

Although the change in strategy was a Sri Lankan initiative, based on the new Sri Lankan government's own perception of a desirable strategy and designed by Sri Lankan officials, it went far in the direction of adopting policies which the Bank, and most other donors, had long advocated. .... (I)n 1977 the Bank's role was quite limited....The Government therefore initially turned to the IMF for help and advice. The Bank's role became more significant later, in helping to ease the costs inherent in the liberalisation strategy (World Bank, 1986, p.13).

In view of the poor growth performance in the preceding ISI period, the focus of the policies initiated in this phase was, not unexpectedly, the promotion of economic growth and creation of employment. The aim was to “kick-start” the economy and yield quick results in terms of economic growth and employment. It needs recalling that Sri Lanka was seen by a number of proponents of the then fast rising economic liberalisation creed as an important “test case”. Accordingly, liberalisation measures were accompanied by

<sup>1</sup> A proposal to set up a Free Trade Zone in Sri Lanka was first mooted in 1975, although it only materialised in 1978.

large-scale, foreign funded, government capital expenditures. Government capital expenditure averaged a massive 16.5 per cent of GDP between 1978 and 1984, with around two-thirds of this expenditure being funded by foreign aid and borrowings (see table 3.18).

The thrust of policies of economic liberalisation adopted in this initial phase was: the liberalisation of economic transactions through the reduction of direct state controls; the expansion of the economic area available to the private sector for its operations; and, a change in the focus of economic activity from an inward- to an outward-orientation. The following were the principal policy measures introduced to achieve these liberalisation objectives:

- Removal of most import quotas and reduction of import tariffs;
- Reduction of foreign exchange controls on current account transactions;
- Abolition of many price controls, while retaining a system of "administered prices" in respect of certain important consumer goods;
- Greater autonomy for public corporations in respect of product pricing;
- Opening up of some hitherto closed economic activities to private sector;
- Replacement of food subsidies with food stamps;
- Incentives to promote export-oriented or foreign exchange earning economic activities;
- Exchange rate unification and devaluation of the rupee;
- Raising of interest rates;
- Institutional, fiscal, and other measures to promote foreign direct investment (FDI), including the setting up of a Free Trade Zone (FTZ);
- Allowing establishment of new foreign banks and off-shore banking facilities;
- Policy action to weaken trade unions.

Although economic growth accelerated and remained high for most of the phase, by 1984 it was evident that the growth momentum was beginning to wane (although growth levels remained high) as government capital expenditures were rapidly tapering off. Specifically, by the end of the phase most of the major construction works of the Accelerated Mahaweli Programme<sup>2</sup> were nearing completion, no new projects were being planned, and foreign aid flows were beginning to dry up. The world recession of the early 1980s had the effect of greatly restricting the supply of resources that developed countries could release in the form of official foreign assistance to developing countries. Moreover, the acceleration of world inflation meant that even the already committed aid was losing its value in real terms.

In addition to the declining growth momentum, the country was experiencing serious external balance problems and intolerable levels of inflation (see below for more details) by the end of the phase. The trade deficit soared, averaging an unprecedented 16.3 per

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<sup>2</sup> This was the jewel in the expanded public investment programme of the government of the period. It involved the multi-purpose (basically irrigation, land development and hidro-electricity generation) river valley development programme surrounding the island's longest river, Mahaweli. Originally planned to take 30 years to complete, the government of 1977 had decided to telescope it to its 6 year term of office. Hence the word "accelerated" in the title of the Programme.



cent of GDP between 1977 and 1983, peaking at over 24 per cent of GDP in 1980. It was still around 17 per cent of GDP in 1983. Although aid flows and concessional borrowings had met most of the large foreign exchange gap, the fear was that, with these flows drying up, the external balance would be unsustainable. Certainly foreign reserves had fallen to precariously low levels by 1983 (to a level amounting to 2 months of imports from well over 5 months of imports in 1978). In the meantime, average inflation rates had risen three fold. The average rate of consumer price inflation for the 1978-83 sub-period was 15.5 per cent.

In spite of these developing problems, the year 1982 saw Mr J.R. Jayawardena, the leader of the UNP and the initiator of the 1977 reforms, elected as President. Mr Jayawardena's victory was widely interpreted by him and his supporters as a mandate to continue with the same set of policies. However, the underlying economic weaknesses were becoming increasingly numerous and ever more pronounced, being also compounded by a growing number of political and social problems.

### **1985-89: External balance stabilisation**

With the most pressing macroeconomic problems being a deteriorating foreign reserve position and high levels of consumer price inflation, the attention of policy makers turned increasingly to macroeconomic stabilisation during 1985-89. Growth was put on a back-burner.

At the same time the political climate in the country had begun to deteriorate. The forces of violence and insurgency were mounting. By the end of this phase the country was host to two theatres of virtual civil war – one in the north and east of the country, related to separatist demands of Tamil nationalists led by the Liberation Tigers of Tamil Elam (LTTE), and the other in the rest of the country led by revolutionary Janatha Vimukthi Peramuna (JVP) organisation. In this political confusion and chaos the numbers who lost their lives were estimated to be in tens of thousands. The international human rights standing of the country suffered heavily.

These political developments unfolded through several important events which had serious socio-political repercussions. These events included:

- The decision of the government after the electoral victory in the 1982 Presidential elections to hold a referendum and to extend the life of Parliament without holding the Parliamentary elections due in that year.
- The killing of several soldiers in the north by the LTTE and the resulting anti-Tamil violence in the rest of the country, particularly Colombo and its surroundings, in July 1983 (often called the black July).
- The banning of the JVP as a political organisation, pushing it into clandestine operations.
- Indian intervention to stop the government's armed campaign against the LTTE, and the subsequent introduction of the Indian Peace Keeping Force (IPKF) into the north and east of the country.
- Passing of the 13<sup>th</sup> Amendment to the Constitution (1987), setting up the Provincial Councils structure.

By the end of the 1980s economic growth had fallen to 2 per cent, open unemployment had risen to over 16 per cent, and foreign reserves had slumped to a level sufficient to cover only two months of imports. The economy's performance on other important counts – poverty, equity and social justice – was also disturbing.

### **1990-94: Export-oriented growth<sup>3</sup> with poverty alleviation**

Low growth, high and rising levels of unemployment, coupled with social and political turmoil, shifted the policy emphasis back to economic growth, but with a strong emphasis on poverty alleviation. The ruling UNP contested (and won) elections in the late 1980s on a platform of social welfare, with the afore-mentioned *janasaviya* programme representing the centrepiece of this platform. This shift in policy focus was however, conditioned by the terms of a Structural Adjustment Facility (SAF) agreement signed with the IMF in 1989 to cover the period 1989-92, later extended for the period 1992-95 in the form of an Extended Structural Adjustment Facility (ESAF). The SAF had been necessitated by the precarious state of Sri Lanka's foreign exchange reserves in 1989. The SAF and ESAF agreements not only required further commitments in respect of economic liberalisation, they also required considerable macroeconomic policy attention to be focused on stabilisation – particularly in respect of the restoration of external balance. The Policy Framework Paper (PFP), which guided the operation of the SAF of 1989-92, required the GOSL to, among other things, do the following:

- Contain public expenditures and increase their efficiency;
- Raise government revenues and reduce the budget deficit;
- Improve the efficiency of the civil administrative system and reduce its costs;
- Reduce the number of public enterprises and increase the efficiency of those remaining;
- Increase the international competitiveness of manufacturing and its export-orientation, and
- Reduce excess liquidity in the system.

The policy measures suggested to achieve these objectives were the familiar ones; reduction/ elimination of subsidies, currency depreciation (or the "flexible management of the exchange rate"), reduction of the size of government (both numbers employed and areas under government administration), privatisation, tax reform and reduction of tariffs, liberalisation and development of money and capital markets, and so on.

While the basis for growth policies remained economic liberalisation, the emphasis shifted in earnest towards Export-Oriented Industrialisation (EOI). The policy measures adopted for this purpose included the following<sup>4</sup>:

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<sup>3</sup> In comparisons of economic policy regimes of Sri Lanka before and after 1977, the pre-1977 era is often described as an import-substitution era as opposed to the post-1977 era described as a whole as an export-oriented era. As clarified later on in this section, we call the 1990-94 phase in the post-1977 period "export-oriented" because during this phase policy emphasis shifted in earnest toward export-oriented industrialisation. This should not be interpreted as implying that the other phases of the post-1977 period ceased to be export-oriented, moving into a different regime like one of import-substitution orientation.

<sup>4</sup> See also chapter 4 below for further details.

- Reform of the institutional structure influencing FDI. The two institutions in operation at the time which approved, regulated and monitored FDI flows – the Greater Colombo Economic Commission and Foreign Investment Advisory Council – were combined into one single investment approval and facilitating agency by the name of Board of Investments (BOI) in 1990.
- The establishment of another FTZ in Koggala in the Southern Province in 1991<sup>5</sup>.
- The initiation of a government supported garments factory development programme under the auspices of which it was proposed to set up 200 district-level garments factories producing for the export market.
- The rupee was allowed to depreciate significantly in 1989, with some (not altogether convincing) attempts made to maintain its competitiveness.
- Financial assistance was provided to the industrial sector on concessionary terms through various credit schemes. Development banks for long-term credit were used for this purpose.

### **1995 and beyond: Inflation stabilisation with “level playing field” structural adjustment**

This phase commences with a change of government; from the UNP to a coalition of anti-UNP forces, the People’s Alliance (PA). The PA won the Parliamentary elections in 1994 and the Presidential elections in 1995. Some of the fears political instability, expressed at the time of promulgation of the Presidential Constitution of 1978, came to be experienced during the latter phase of this period. The period since 2000 witnessed three Parliamentary elections in less than five years. In the two year period, 2002-04, the President with executive powers, on the one hand, and the Parliamentary majority and part of executive, the Cabinet of Ministers, on the other, were respectively from the SLFP-led PA<sup>6</sup> and the UNP-led political coalitions, the latter called United National Front (UNF). The governments formed were dependent on rather unstable and very thin Parliamentary majorities won by coalitions of political parties, with significant differences of social and political ideologies. Governments were constantly concerned about their political survival. This was clearly not a satisfactory environment for autonomously working out economic policy stances for long term national development.

The period since 1995 has also seen vicissitudes in the military and political environment surrounding the civil war in the north and east of the country. The government’s military operations rose to their highest levels during this period with ballooning military expenditures. The years 2000-01 also witnessed heavy damage to life and property inflicted by Tamil militants in the areas around Colombo. There was a sudden about turn in events in 2002 when the short-lived UNP-led government had signed a ceasefire agreement with the LTTE with the mediation of the government of Norway. This rather uneasy truce has continued up to the time of writing (2005) – no outright conflict

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<sup>5</sup> There were already two other FTZs in existence in Sri Lanka at the time – one in Katunayake and the other in Biyagama. Since the setting up of the BOI, foreign direct investments were so facilitated as to enable policy makers say that the whole country had become an FTZ.

<sup>6</sup> The left-of-centre coalition since 2004 which included also the Janatha Vimukthi Peramuna (JVP) has named itself United People’s Freedom Alliance (UPFA).

between the defence forces and the LTTE but continuing allegations of both sides against one another about ceasefire violations. This ceasefire, after many years of violent conflict, has had significant implications for macro-economic policy and development processes.

Of the political groupings which held power during this period, the PA represented the left-of-centre coalition of political parties of Sri Lankan politics, and the UNF, the right-of-centre coalition. The governments formed by the PA, despite the socialist lineage of most of its partners, has openly declared its policy position as “market-oriented” and “private-sector-led” although, perhaps, rhetorically these expressions were qualified by the globally well-known expression of “with a human face”. The right-of-centre UNF government of 2002-04, perhaps even more than the pre-1995 UNP, was ideologically committed to private sector and market orientation. The poverty reduction strategy paper (PRSP) of the government of Sri Lanka, which the World Bank website considers as reflecting Sri Lanka’s economic strategy at the time of writing<sup>7</sup>, is the best evidence to show this rather close agreement between the two main political camps about economic policy since 1995. The preparation of this PRSP was commenced during the left-of-centre regime of 2000-02 and was completed and adopted by the right-of-centre regime of 2002-04.

In terms of the macroeconomic policy focus, 1995 and beyond witnessed a clear shift in policy emphasis away from an active promotion of economic growth, towards economic stabilisation and the creation of a so-called “level-playing field” – in line with “structural adjustment thinking” at the global level. With regard to economic stabilisation, stress was placed on the curtailment of inflation. Indeed, the curtailment and even elimination of inflation came to be seen as a pre-condition for a sustainable increase in the economic growth rate. As such, the low inflation objective assumed centre stage in policy thinking for much of the period. The following quotation from one of the early budget speeches of the new Minister of Finance captures this thinking fairly well:

In order to sustain high economic growth, together with projected favourable outcome in the balance of payments front, it is necessary that inflation in 1995 is contained below 8 per cent. (Budget Speech 1995: 53).

The Central Bank Report of 1996 reiterated this policy position stating that government economic policy had the objective of creating and developing the “basis for private-sector led non-inflationary economic growth with external viability” (p. 114).

The stabilisation measures adopted with the purpose of curtailing inflation included the following:

- “Fiscal consolidation” through reduction in the size of the budget deficit<sup>8</sup>;

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<sup>7</sup> See: <http://www.worldbank.lk/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/SRILANKAEXTN/0,,contentMDK:20153414~menuPK:232812~pagePK:1497618~piPK:217854~theSitePK:233047.00.html>. The tsunami of December 2004 has introduced a major complication into Sri Lanka’s socio-economic policy at the time of writing but the following empirical analysis covering the period till 2004 does not take tsunami effects explicitly into consideration.

<sup>8</sup> Measures to achieve this objective included, as Central Bank Reports of this period mentioned *ad infinitum*, the following: broadening of tax base, improvement of tax administration and compliance, rationalising fiscal incentives, closing tax loopholes, reforming public enterprises,

- Control of money supply; and
- Exchange rate stability.

Policy makers were not simply of the view that curtailment of inflation would facilitate rapid growth, they also adopted the view that the active promotion of economic growth was not necessary and, worse still, counter productive, since it led to distortions and inefficiencies in the economy. Hence, the export promotion strategy was eschewed for a “level playing field” strategy. The latter required that domestic producers did not receive more favourable treatment than foreign producers. The new thinking is reflected in the following quotation from the Central Bank report of 2000 in a section entitled “Guidelines for an effective industrial policy”:

*World experience has shown that active support to selected industry by the government has been of limited success<sup>9</sup>. Instead, it is the overall facilitation by the government that has promoted industry on a sustainable basis. These measures include economic liberalisation, research and development, skills and human capital development that contribute to raising competitiveness of a country’s industrial products (p. 83).*

Advocates of the level-playing field strategy held the view that growth would be promoted by eliminating inflation and getting prices right. The latter meant, in the Sri Lankan case, the necessity for further economic liberalisation and development of markets. Specifically, it meant the need for;

- An intensification of trade liberalisation through further simplification of the tariff structure<sup>10</sup> and progressive reduction of non-tariff barriers;
- The liberalisation and deregulation of financial, labour and land markets; and,
- The continuing (and accelerated) privatisation of state owned enterprises.

### **III. Fiscal, Monetary and Exchange Rate Policies**

The aim of the present section is to look in greater detail at fiscal, monetary and exchange rate policies in the context of the preceding historical overview of shifts in macroeconomic policy emphases. This analysis, together with the historical overview, provides the necessary policy framework for understanding the various macroeconomic developments over the period under review.

#### **Fiscal policy**

In general terms, fiscal policy has been more contractionary between 1990 and 2004 than in the preceding period of 1978-89 (see table 3.3). The average budget deficit (as a percentage of GDP), both before and after grants, fell between the above major sub-

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simplifying the structure and reducing the rates of income taxation, simplifying import tariff structure, reducing tariff protection and so on. A Goods and Services Tax was introduced in 1998 and this was transformed into a Value Added Tax in 2003.

<sup>9</sup> That there is an interpretation of ‘world experience’ in respect of industrial growth that contradicts the position enunciated here has not, naturally, been mentioned in this Central Bank Report.

<sup>10</sup> A three-band tariff system was introduced in 1996 with rates applicable for each of these bands being 10, 20 and 35 per cent respectively. Although a few product categories remained outside this structure, most traded goods have been placed somewhere in it.

periods, 1978-89 and 1990-2004, the average deficit before grants falling by 34 per cent and the deficit after grants by 36 per cent. This fall in the magnitude of the deficit reflects both the shift in emphases in the growth and stabilisation policy noted above as well as general global and regional trends (see table 3.3).

**Table 3.2**  
**Sri Lanka's Comparative Fiscal Performance, annual averages, 1980-2000**

<b>OVERALL BUDGET DEFICIT</b>	<i>Per cent of GDP</i>	
	<b>1980-90</b>	<b>1990-2003<sup>a</sup></b>
India	-7.0	-5.6
Nepal	-6.2	-5.0 <sup>b</sup>
Pakistan	-6.8	-6.9
<b>SRI LANKA</b>	<b>-11.2</b>	<b>-7.7</b>
S. ASIA	-6.6	-5.8
LOW & MIDDLE INCOME countries	-5.2	-2.7 <sup>b</sup>
WORLD	-4.2	-2.6 <sup>c</sup>

Note: <sup>a</sup> Data not available for 2002

<sup>b</sup> Data not available for 2003

<sup>c</sup> Data not available from 1999

Source: World Development Indicators, Various Years

The trend fall in Sri Lanka's deficit over the period as a whole came about in spite of a significant reduction in government revenue. Obviously, this meant a fall in government expenditure, larger than the fall in revenue. Between 1978-89 and 1990-2004, average aggregate government expenditure as a ratio of GDP fell by 7.3 percentage points as against a 2.4 percentage point fall in revenue (table 3.3). In fact, the ration of government expenditure to GDP fell consistently over the entire period 1978-2004. The major source of this fall in government expenditure was capital expenditure. Average capital expenditure to GDP percentage fell by 8.6 percentage points between the two major sub-periods and by 11 percentage points between the 1978-84 and 1995-2004. Of course, the exceptional level of this expenditure in the late 1970s and early 1980s was an important part in this fall in capital expenditure. It was noted above that during this period the Sri Lankan government undertook major donor-funded infrastructure and housing projects, which boosted both government and aggregate capital expenditure. Once the so-called "lead projects"<sup>11</sup> of public investment came to an end, the level of government capital expenditure was allowed to fall. This decline in government capital expenditure continued long after the completion of the aforementioned projects. As was suggested above, this decline is due to a combination of factors like the shift in development strategy thinking from a state-led development processes to a private sector-led one, and the pressures exerted on fiscal expenditures by the Structural Adjustment Facility (SAF) and Extended Structural Adjustment Facility (ESAF) agreements which Sri Lanka entered into in 1989 and 1992 respectively. The PRSP noted above has provided the more recent policy framework for this reduction of fiscal expenditure. It is

<sup>11</sup> Three public sector investment projects were at this time described as "lead projects": the Accelerated Mahaweli Project already noted, the Free Trade Zone construction project and the extensive project of urban housing.

worth noting in this context that the downward trend in government capital expenditure in Sri Lanka mirrored similar trends in other developing countries pursuing “structural adjustment policies” under auspices of Washington institutions. In the successful East Asian economies, in contrast, government capital expenditure levels were maintained.

**Table 3.3**  
**Budget deficit and its components, as percentages of GDP, 1978-2004**

	1978-89	1990-04	1978-84	1985-89	1990-94	1995-04
Budget deficit (before grants)	14.1	9.3	15.0	12.4	9.7	9.0
Budget deficit (after grants)	11.5	7.4	13.0	10.0	7.9	7.2
<b>Expenditure</b>	<b>34.8</b>	<b>27.5</b>	<b>36.0</b>	<b>33.3</b>	<b>29.8</b>	<b>26.4</b>
Current	19.5	20.9	19	20.5	21.7	20.5
Civil administration.	6.4	5.1	5.6	7.0	5.8	4.6
Defense	1.6	4.4	0.7	2.4	3.5	4.8
Interest	4.6	6.2	4	5.2	6.2	6.2
Transfers (total)	7.0	5.2	8	5.8	6.1	4.8
To Households	4.3	4.1	5	4.2	4.9	3.7
Capital	13.9	5.3	16	11.3	6.1	5.0
<b>Revenue</b>	<b>20.7</b>	<b>18.3</b>	<b>20</b>	<b>20.9</b>	<b>20.1</b>	<b>17.4</b>
Income and profits tax	2.8	2.4	3	2.7	2.5	2.3
Expenditure taxes	14.0	12.8	13.5	14.4	14.1	12.1
Domestic goods and services.	7.4	9.4	7	8.1	9.2	9.5
International trade	6.6	3.3	7	6.3	4.9	2.5
Defence levy					1.1	2.2 <sup>a</sup>

Note: <sup>a</sup> Defence levy was removed in 2003.

Source: Central Bank of Sri Lanka Annual Reports (various years)

Current expenditure as a percentage of GDP marginally rose between the two major sub-periods largely as a result of increases in defence expenditures and debt servicing costs, and in spite of falls in civil administration costs and transfers to enterprises and households. It is of particular note that by 1995-2004, debt service costs came to account for more than defence or civil administration or transfers to enterprises and households.

The fall in average revenue as a percentage of GDP between the two major sub-periods was largely a result of falls in revenues from expenditure taxes. The major source of the fall in the latter in turn was a fall in trade tax receipts, and this in turn the result of trade liberalisation policies. Receipts from trade based taxes fell from an average of 6.6 per cent of GDP during 1978-89 (7 per cent in 1981) to 2.5 per cent during 1990-2004 ( 2 per cent in 2004). Concomitantly, revenues from taxes on domestic goods and services rose during the same period, from 7.4 per cent (6 per cent in 1981) of GDP to 9.5 per cent (9.1 per cent in 2004). Meanwhile, revenues from income taxes as a per cent of GDP also have marginally declined. Although the shift in revenue composition away from taxes based on international trade is mirrored in other developing countries, the compensating shift towards revenues from taxes on domestic goods and services appears to be relatively extreme in Sri Lanka. In most other developing economies, certainly most other South Asian and East Asian economies, there have also been significant compensating shifts towards revenues from taxes on income, profits and capital gains. This latter shift has been most evident in the case of the successful East Asian economies.

**Table 3.4**  
**Deficit financing, debt, and their components, 1978-2004**

	1978-89	1990-04	1978-84	1985-89	1990-94	1995-04
	<i>As percentage of GDP</i>					
Deficit financing	14.1	9.3	15	12.4	9.7	9.0
Domestic	6.7	5.9	7	6.1	4.7	6.5
Foreign	7.5	2.9	8	6.2	4.7	1.9
Grants	2.6	1.0	3	2.4	1.8	0.7
Privatisation		0.1			0.4	0.6
	<i>As percentage of total debt</i>					
Domestic	50.1	49.4	54.4	43.9	43.2	52.5
Central bank	17.2	5.7	18.0	16.1	8.0	4.6
Commercial banks	1.4	9.2	1.3	1.6	8.0	9.8
Savings institutions	9.2	7.5	9.7	8.4	7.8	7.2
Provident and pension funds	11.9	17.0	11.3	12.7	16.1	17.5
Private business and individuals	0.1	6.4	0.2	0.1	1.1	9.0
Foreign	49.9	50.6	45.6	56.0	56.8	47.5
Concessionary	45.7	48.8	41.0	50.4	54.2	46.0
Non-concessionary	4.2	1.8	4.6	5.6	2.6	1.6
Real rates on 12 month TBs	1.4	6.1 <sup>a</sup>				

Note: <sup>a</sup> 1990-01

Source: Central Bank of Sri Lanka Annual Reports (various years)

According to Table 3.4, deficit financing in 1978-89 amounted to 14.1 per cent of GDP and in 1990-04, 9.3 per cent. Of these totals, domestic component of deficit financing amounted to 6.7 per cent and 5.9 per cent respectively of GDP. This means that of total deficit financing, the domestic component rose from 47 to 63 per cent when the two major sub-periods are compared, while foreign financing component fell correspondingly. The major shift to domestic financing of the deficit came in the sub-period 1995-2004. During this sub-period domestic debt as a percentage of total debt increased. Along with the rise in domestic financing, there has been a shift to more commercial sources of financing and more market determined borrowing rates. One aspect of this has been the shift in bank financing away from the Central Bank and towards commercial bank sources. Another has been the higher, more market determined, rates paid to captive sources (and the increasing release of these captive sources to the market). The shift in domestic financing towards more commercial sources of financing and more market determined borrowing rates appears to have caused real rates on government debt instruments to rise sharply. Thus, real rates on 12 month Treasury Bills (TBs) jumped to an average 6.1 per cent in the period 1990-2001 from a mere 1.4 per cent in the preceding 1978-1989 period.

Compositional changes in the overall public debt stock have, however, not mirrored this shift towards domestic financing of the deficit. The domestic proportion of the public debt increased marginally from 54.2 per cent in 1978-79 to 55.0 per cent in 2002-04. The relative constancy of the foreign share of public debt, in spite of the change in debt financing away from foreign sources, is largely due to the relatively longer-term nature of this debt and the effect of currency depreciation on its value.



## Monetary policy

With the shift in policy emphasis towards stabilisation, and the growing view among policy makers that inflation was caused by excess liquidity in the system, not surprisingly there was an increasing tendency on the part of monetary authorities to target the cash base of the system after 1990, and more especially from 1995 to 2004, than in the preceding period of 1978 to 1989. Tables 3.5 and 3.6 provide evidence of this policy shift.

**Table 3.5**  
**Money Market Rates and Liquidity, Annual Averages for selected Periods, 1978-04**

	1978-89	1990-01	1978-84	1985-89	1990-94	1995-04
	<i>Percentage</i>					
Real inter-bank rate	4.6	10.2	2.1	8.1	8.2	7.9
Real Central Bank advance rate	0.3	5.6	-2.5	4.3	4.6	9.1
High powered money/GDP	9.8	10.8	9.3	10.4	10.8	9.2

Source: Central Bank of Sri Lanka Annual Reports (various years)

It needs noting that the real evidence for the shift in policy stance is to be found in the rise in real money market interest rates and not the ratio of high-powered money to GDP. Indeed, somewhat perversely, the ratio of high powered money to GDP actually rises in the period 1990-2001 as a whole as compared with 1978-89. It is only in the period 1995-2001 that there was both a rise in real money market rates and a corresponding fall in the high-powered money to GDP ratio. The money market rates given in the table are the (real) inter-bank and Central Bank advance rates for the two periods. Inter-bank rates can be thought of as the price of cash in the Sri Lankan financial system. Higher real inter-bank rates mean that cash has become more expensive in real terms. From Table 3.6 it can be seen that the real inter-bank rate more than doubled as between 1978-89 and 1990-01<sup>12</sup>.

**Table 3.6**  
**Volatility of the real Inter-bank rates, Annual Averages, 1978-2004**

	1978-89	1990-04
<b>Real inter-bank rate</b>		
<i>Mean</i>	4.6	9.7
<i>Standard Deviation</i>	6.2	12.5
<i>Range</i>	20	48.0

Source: Central Bank of Sri Lanka Annual Reports (various years)

Table 3.6 shows the relative volatility of real interest rates in the sub-periods 1978-89 and 1990-2001. These data confirm the impression of a relative tightening of monetary policy in the latter period. It is of note that in the only year when the monetary authorities sought to directly and actively control the money base according to money stock “rules”, i.e., 1995, inter-bank rates soared (reaching a maximum rate of 102 per cent in that year), eventually resulting in an abandonment of this hard-line position.

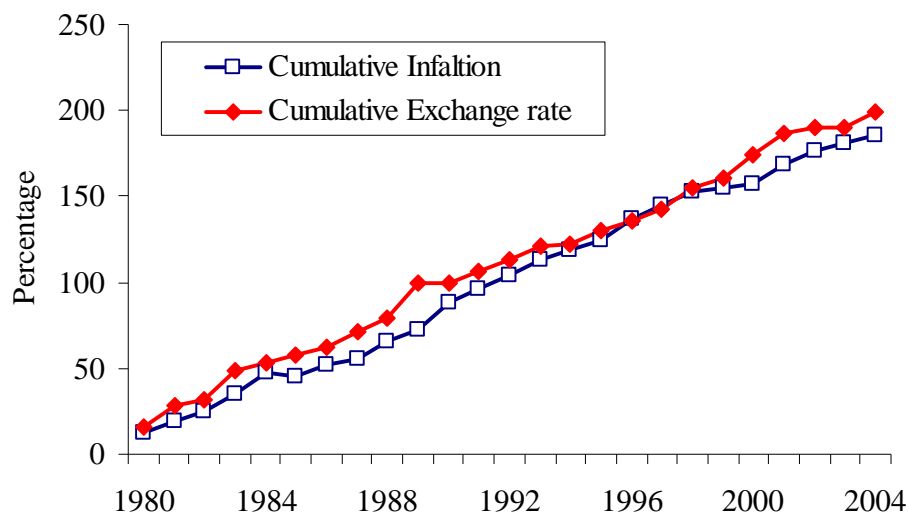
<sup>12</sup> Although the rise in the Central Bank’s advance rate was proportionately even greater, it needs noting that this rate has only of late become an effective policy instrument reflecting money market conditions.

Tighter monetary policy (in the form of higher reserve requirements, higher reverse repurchase rates, etc.) was one of the major factors driving real money market rates higher in the period 1990-2004. Also important, however, were the shift in the financing of the budget deficit towards money market sources (noted earlier) and the shift of financing of private working capital requirements towards commercial banking sources.

### Exchange rate policy

Figure 3.1 shows that the movement of the nominal exchange rate between the Sri Lankan rupee and the US dollar has broadly followed inflation differentials between Sri Lanka and the US over the period under consideration as a whole. That is to say, the monetary authorities appear to have been pursuing what may be described as “a real US dollar anchor” strategy for most of this period, notwithstanding the changes in policy emphases noted above. Figure 3.1 also shows that in cumulative terms nominal rupee-dollar exchange rate movements have frequently more than compensated for inflation differentials between Sri Lanka and the US, giving rise to periodic real under-valuations (a real depreciation) of the Sri Lankan rupee vis-à-vis the US dollar in recent years. Of particular note in this regard is the (apparently paradoxical) fact that periods of real depreciation seemed to coincide with periods of growing payments imbalances. We will return to this in chapter 4 in the context of the discussion of the problem of currency overvaluation, particularly between 1995 and 2001.

**Figure 3.1**  
Cumulative Sri Lankan/US Inflation Differentials vs Rupee/US\$ Exchange Rate Changes, 1979-2001



## IV. Macroeconomic Trends

### Growth and structural change in aggregate output

The Sri Lankan economy grew by an annual average of 4.0 per cent during 1980-90 and by 4.8 per cent during 1990-2003 according to available international data. The latter average was adversely affected by, in many respects the rather atypical, negative growth experience of 2001. During the two decades from 1980, leaving out 2001, the average annual growth rate was 4.6 per cent. This average rate compares favourably with the average for low and low-middle income countries, but is less than the average for the South and, more so, the East Asian regions. Comparing the 1980s with the 1990s reveals that the Sri Lankan economy performed better in the latter than in the former period (table 3.7).

**Table 3.7**  
**Sri Lanka's Comparative Growth Performance, 1980-90 and 1990-2002**

	<i>Annual Averages</i>	
	<b>1980-90</b>	<b>1990-2002</b>
	<i>Percentages</i>	
China	10.3	9.7
Indonesia	6.1	3.6
Korea (Rep)	8.9	5.6
Malaysia	5.3	6.2
Thailand	7.6	3.7
Unweighted average of above (a)	7.6	5.8
E Asia and Pacific weighted average	7.5	7.3
Bangladesh	3.7	4.9
India	5.7	5.8
Nepal	4.6	4.7
Pakistan	6.3	3.6
<b>SRI LANKA</b>	<b>4.0</b>	<b>4.8</b>
Unweighted average of above (a)	5.1	4.8
S. Asian weighted average	5.5	5.4
Low income countries	4.7	4.3
Lower middle income countries	4.0	3.2
Middle income countries	2.9	3.2

Source: World Bank, World Development Indicators, 2004

Getting back to data available in national sources, Table 3.8 shows the overall and sectoral performance of the economy during 1978-2004 and the different sub-periods of this quarter century. During the whole period under consideration as well as during various sub-periods, the average annual growth rates of industry (defined broadly to include electricity, water and sanitation etc. as well in addition to manufacturing) and services have been considerably more than that of agriculture. For 1978-04 as a whole the annual average growth rates of industry and services (5.8 percent and 5.4 per cent respectively) have been more than double that of agriculture (2.2 percent). The major contribution to make the average annual growth rate of industry higher than that of

services for 1978-04 as a whole, it appears, came largely from the industry growth of 1990-94 – the sub-period when the 7.4 per cent average in the rate of industrial growth was the highest for all sub-periods. Indeed, these data show that the average annual growth rates of industry and services were virtually the same in the sub-periods of 1978-89 and 1995-2004.

Over the post-liberalisation period of 1978-2004 as a whole, there were two sub-periods of above average annual aggregate GDP growth - 1978-84 and 1990-1994. The average annual growth rates in these two periods were 5.9 and 5.5 per cent respectively. In both these high growth sub-periods the average annual growth of agricultural production was above the respective 1978-04 average. The average annual growth rates of both industry and services in the two high growth periods were also above their annual averages for 1979-04. It is of note that the annual average growth of manufacturing output during 1978-84 was below the average for 1978-04, while during the high growth period of 1990-94, it was considerably above this average.

**Table 3.8**  
**Aggregate and Sectoral GDP Growth, 1978-2004**

	<b>1978- 2004</b>	<b>1978- 89</b>	<b>1990- 2004</b>	<b>1978- 84</b>	<b>1985- 89</b>	<b>1990- 94</b>	<b>1995- 2004</b>
	<i>Annual Average Growth Rate</i>						
<b>GDP</b>	<b>4.8</b>	<b>4.7</b>	<b>4.9</b>	<b>5.9</b>	<b>3.1</b>	<b>5.5</b>	<b>4.5</b>
<b>Agriculture</b>	<b>2.2</b>	<b>2.5</b>	<b>1.9</b>	<b>3.5</b>	<b>1.1</b>	<b>3.5</b>	<b>1.1</b>
Plantation	1.5	1.2	1.8	0.3	2.3	2.1	1.6
Non-plantation	2.6	3.2	2.0	5	0.7	4.1	1.0
<b>Industry</b>	<b>5.8</b>	<b>5.6</b>	<b>5.9</b>	<b>6.3</b>	<b>4.7</b>	<b>7.4</b>	<b>5.2</b>
Manufacturing	6.1	5.5	6.7	5.2	5.9	8.9	5.5
Factory	7.7	7.7	7.6	7.1	8.6	10.6	6.2
<b>Commodity production</b>	<b>4.2</b>	<b>4.1</b>	<b>4.3</b>	<b>4.9</b>	<b>3</b>	<b>5.7</b>	<b>3.5</b>
<b>Services</b>	<b>5.4</b>	<b>5.5</b>	<b>5.4</b>	<b>7.2</b>	<b>3.2</b>	<b>5.4</b>	<b>5.4</b>
Transport, Storage & Communication	6.1	5.1	6.8	7.1	2.2	5.1	7.7
Wholesale and Retail Trade	5.2	5.3	5.1	6.9	3	6.3	4.5
Banking, Insurance & Real Estate	8.6	9.4	8.0	11.5	6.4	7.4	8.4

Source: Central Bank of Sri Lanka Annual Reports (various years)

The differential growth trends by sector alluded to above resulted in a shift in the composition of GDP towards services and away from agriculture. As table 3.10 shows, this tendency was observed throughout the period. Within services, the share of banking and finance increased four-fold, from 1.8 per cent of GDP in 1977-78 to 8.7 per cent in 2000-04, while the share of trade increased by some 3 percentage points, from 18.3 per cent of GDP to 21.5 per cent between the same two periods. Significantly, within trade, the share of import trade rose – from 2.6 to 9.7 per cent of GDP over this period – while the share of export trade declined from 5.8 per cent to 2.5 per cent. The structural change within the agriculture sector during the post-liberalisation period is of particular interest. There was a shift of agriculture away from plantations towards non-plantation agriculture. Within non-plantation agriculture, paddy gradually lost its share compared with non-paddy agriculture. The share of paddy agriculture in total value added by the agriculture sector (i.e. inclusive of forestry and fishing) declined from 18 to 15 per cent as between

1977-78 and 2003-04. In contrast, the share of non-paddy, non-plantation activities rose from 42 to 46 per cent of total agriculture sector value-added.

Finally, while the share of industry (28 to 27 per cent of GDP) remained more or less stable, there was a marginal decline in the share of manufacturing, from 22 to 17 per cent of GDP between 1977-78 and 2000-04. However, these data on manufacturing need some qualification. First, there is an element of statistical distortion in this decline in manufacturing. The manufacturing value-added, as defined in Sri Lanka includes the manufacturing component of export crop processing. The export crop processing part of 'manufacturing' declined consistently from 11 per cent of GDP in 1977-78 to 2 per cent in 2003-04. Second, the process of liberalisation led to some loss of industrial activity. This relative drop appears to have continued into the first few years of the 1980s. Over time however, the positive tendencies in industrial value added more than compensated for these negative tendencies. The small industry component of manufacturing rose marginally from 1.1 per cent of GDP in 1977-78 to 1.2 in 2003-04 and the factory industry component from 9 to 14 per cent from 1977-78 to 2003-04. Overall, the share of commodity production (i.e., agriculture and industry) in GDP fell from 59 per cent in 1977-78 to 46 per cent in 2000-04, while that of services rose by a commensurate extent.

**Table 3.9**  
**Sector Composition of GDP, Selected Periods of 1977-2004**

	<i>Percentages</i>					
	1977-78	1983-84	1985-86	1989-90	1994-95	2000-04
Agriculture, Forestry and Fishing	30.6	28.5	27.4	26	23.4	19.4
Plantation agric	9.1	7.8	5.8	5.5	3.6	3.1
Non-plantation agric.	18.3	16.6	17.8	16.4	14.8	11.9
Industry	28	26.3	26.4	26.4	26.4	26.9
Mining and Quarrying	1.8	2.4	2.4	2.5	2	1.7
Manufacturing	21.6	14.5	15	15.1	15.6	16.7
Factory Industry.	8.7	8.5	9.4	10.8	12.4	13.6
Construction.	4.1	8.3	7.7	7.5	7.4	7.0
Electricity, gas, Water and Sanitary Services.	0.6	1.2	1.4	1.2	1.5	1.5
<b>Commodity production</b>	<b>58.5</b>	<b>54.8</b>	<b>53.8</b>	<b>52.3</b>	<b>49.7</b>	<b>46.3</b>
Services						
Of which:	41.5	45.2	46.2	47.7	50.3	53.7
Transport, Storage and Communication.	7.6	11	11.1	10	10	13.0
Wholesale and Retail Trade.	18.3	19.3	19.6	20.9	22	21.5
Imports.	2.6	7.7	6.8	7.3	9.1	9.7
Exports.	5.8	1.8	1.6	1.6	2.1	2.5
Domestic.	10	9.8	11.2	12	10.7	9.3
Banking, Insurance and Real Estate.	1.8	3.5	4	4.6	7	8.7
Personal Services	7.7	4.6	4.2	4	4.1	4.1
G.D.P.	100	100	100	100	100	100

Source: Central Bank Report (Various issues)

### **Employment and unemployment**

No consistent annual data series on employment/unemployment in Sri Lanka over the time period under consideration is available. Two statistical surveys – the *Consumer Finances and Socio Economic Survey* conducted by the Central Bank since 1953 and the

*Labour Force and Socio-economic Survey* conducted by the Department of Census and Statistics since 1969 – are extensively used in Sri Lankan socio-economic studies to obtain information about issues related to employment and unemployment. However, it has to be recognised that these surveys were conducted initially in ten-year, and later in five-year, intervals. From 1990 onwards, the Department of Census and Statistics began a Quarterly Labour Force survey based on a smaller population sample than the one used in the Department’s Labour Force and Socio-economic Surveys. There are acknowledged limitations with the Quarterly Survey, but its advantage is that it provides a more regular stream of information. Bearing these data limitations in mind, an attempt is made in this section to provide some basic information on the nature of, and trends in, employment and unemployment using selected data from the above mentioned Quarterly Survey coupled with data from the *Labour Force and Socio-economic Survey* for the years 1978/79 and 1986/87.

**Table 3.10**  
**Sectoral Breakdown of Employment, 1978-2004**

	1978/9	1986/7	1990	1995	2000	2004 <sup>a</sup>
	<i>Percentage of total employment</i>					
Agriculture	51.5	49.3	46.8	36.7	35.7	34.0
Industry	20	18.7	19.4	22.2	23.4	22.0
Mining and Quarrying <sup>b</sup>	1.2	1.3	1.6	1.7	0.9	
Manufacturing	13.6	12.6	13.3	14.7	16.5	16.9
Construction	4.7	4.4	3.9	5.3	5.5	5.1
Electricity, Gas and Water <sup>c</sup>	0.5	0.4	0.6	0.5	0.5	
Services	27.8	27.9	30.7	35.7	37.5	44.1
Trade, hotels, etc	9.7	10	9.6	12.2	12.4	14.2
Transport, storage and communications	4.6	4.3	4.1	4.7	4.7	5.8
Banks, insurance and real estate	0.5	1.3	1.3	1.5	2.1	2.5
Personal services	13	12.3	15.7	17.3	18.3	21.6
Unclassified	0.7	4	3.2	5.4	3.3	
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
Total estimated no. employed (millions)			5.05	5.36	6.31	7.32
Unemployment (per cent of labour force)			16.3	12.3	7.6	8.3

Notes: <sup>a</sup> Average for first three quarters of 2004.

<sup>b</sup> Categorised under Personal Services in QLFS from 1st quarter 2002

<sup>c</sup> Categorised under Personal Services in QLFS from 1st quarter 2001

Source: Authors’ calculations based on *Labour Force and Socio-economic Survey* and the *Quarterly Labour Force Survey of the Department of Census and Statistics*, various years

3.10 provides information on aggregate and sectoral employment trends, as well as unemployment trends. This information suggests that the number employed in Sri Lanka rose steadily in the 1990s and the early 2000s (from 1990 to 2004), resulting in a fall the unemployment rate from 16.3 per cent in 1990 to 7.6 per cent in 2000, slightly rising to 8.3 per cent in 2004. The information also suggests that, along with the rise in employment and concomitant fall in unemployment, there has been a shift in the sectoral composition of employment.

When table 3.10 is compared with Table 3.9, it would appear that the shift in employment composition only partly reflected the accompanying sectoral shift in value added. While the proportion of GDP accounted for by commodity production fell by 12 percentage points between 1977-78 and 2000-04, employment in commodity production fell by a comparable 12 percentage points between 1978/9 and 2000 and a somewhat higher 15.5 percentage points between 1978/9 and 2004. However, while almost the entire 12 percentage point fall in the share of value added by commodity production was due to a corresponding fall in the share of agricultural production (i.e. a decline by 11 percentage points), there was a more than proportionate fall in the share of agricultural employment – a fall by 15.8 percentage points between 1978/9 and 2000 and by 17.5 percentage points between 1978/9 and 2004.. Meanwhile, the share of employment accounted for by industrial sector activities rose between 2-3 percentage points, depending on the last year brought into comparison, even though the share of this sector in value added declined marginally 1 percentage point between 1977-78 and 2000-04. More significantly still is the fact that while almost the entirety in the increase in the industrial sector share of employment came from manufacturing, the share of value added in the latter actually declined by as much as 5 percentage points. Similarly, about half of the increase in the share of employment in the services sector took place in personal services sub-sector which experienced a decline in the value added share. In other words, a large part of the shift in employment out of agriculture appears to have been accounted for by a movement towards low value added manufacturing and services activities.

### Investment and savings

This sub-section attempts to highlight the important trends in capital formation and savings during the post-liberalisation era. Some relevant comparisons are made in Table 3.11 between Sri Lanka and certain groupings of developing countries. First, Sri Lanka's investment rate (i.e. aggregate investment as a percentage of GDP) compares favourably with the average rate for South Asian countries and even the average for all low and middle income developing countries, but not the average for the fast growing East Asian economies. Also, it would appear that Sri Lanka performed relatively better in the 1980-90 period than in the following 1990-2000 period.

**Table 3.11**  
**Sri Lanka's comparative investment and savings performance, period annual averages, 1980-2000**

	1980-1990	1990-2000
<b>GROSS FIXED CAPITAL FORMATION ( per cent of GDP)</b>		
Sri Lanka	25.9	24.9
South Asia	19.6	21.4
East Asia & Pacific	28.2	32.4
LOW & MIDDLE INCOME countries	23.4	23.9
<b>DOMESTIC SAVINGS ( per cent of GDP)</b>		
Sri Lanka	12.8	16.2
South Asia	17.3	19.1
East Asia & Pacific	31.9	36.0
LOW & MIDDLE INCOME countries	25.1	25.3

Source: World Development Indicators, 2002



Second, Table 3.12 shows that average investment rates were the highest in the 1978-84 sub-period (when growth was piggy-backed on a massive surge in foreign funded government capital expenditure) and lowest in the ensuing 1985-89 period (when both government capital expenditure and foreign financing began to dry up). Average investment rates picked up again in the 1990s, reaching 30 per cent in 2000. This rate fell to 22 per cent in the crisis year of 2001, rising back to 25 per cent in 2004.

Third, over the 1978 to 2001 period as a whole there was a rise in private sector investment and a corresponding fall in public sector investment. Central bank national accounts data traditionally includes investments by public corporations under private sector investments, only excluding these in more recent reporting. Table 3.12 provides estimates of private sector investment excluding investments by public corporations using data provided in the fiscal accounts. It is evident that whether one includes or excludes public corporations from estimates of private sector investment, there is an unmistakable rise in the relative magnitude of private sector investment and a corresponding fall in public sector investment in terms of sub-period averages for 1978-2004. During 1978-84, public sector investment, including investment by public corporations, amounted to 10 per cent (in 1979 this ratio was around 14.5 per cent) of GDP. By 1995-04 this figure had fallen to under 6 per cent of GDP. The data show that much of the fall in public sector investment occurred with the shift in policy stance away from state-led towards private sector-led accumulation processes between 1985-89 and 1990-94 sub-periods.

**Table 3.12**  
**Aggregate investment and savings, 1978-2004**

	1978-89	1990-04	1978-84	1985-89	1990-94	1995-04
	<i>As per cent of GDP</i>					
<b>Aggregate Investment</b>	25.7	24.6	27.6	23.1	24.4	24.7
<i>Private (1)</i>	20	21.4	21.7	17.6	20.7	21.7
<i>Private (2)</i>	15.3	18.3	17.6	12.6	17.2	18.9
<i>Public (3)</i>	5.7	3.2	5.9	5.5	3.7	2.9
<i>Public (4)</i>	10.4	6.3	9.9	10.5	7.2	5.8
<b>Foreign direct investment</b>	0.7	1.2	0.9	0.5	1.1	1.2
<b>Domestic savings</b>	13.2	15.8	13.9	12.2	14.7	16.4
<i>Private</i>	12.1	18.4	12.3	11.8	16.2	19.6
<i>Public</i>	1.1	-2.7	1.6	0.4	-1.6	-3.2
<b>Foreign Savings</b>	12.5	8.6	13.6	10.9	9.7	8.1

Notes: (1) Includes public corporations

(2) Authors' own calculations excluding public corporations

(3) Excludes public corporations

(4) Authors' own calculations including public corporations

Source: Central Bank of Sri Lanka Annual Reports (various years)

Fourth, although foreign direct investment as a proportion of GDP nearly doubled over the 1978-2004 period, it still amounted to less than 5 per cent of total investment. However, this is still substantially above the South Asian average, and even above the average for most successful East Asian economies during their high growth periods, i.e., prior to the liberalisations of their capital accounts.



Fifth, Sri Lanka's domestic savings rate has been below the rates achieved by other South Asian economies, and well below the averages for low and middle income developing countries, respectively. Needless to say, Sri Lanka's savings rates are not even comparable with those of the successful East Asian economies (see table 3.11).

Sixth, over the 1978-2004 period as a whole there has been a slow but steady rise in the domestic savings rate. The rise in domestic savings reflected a pronounced rise in private savings which more than offset a fall in public savings. Between the 1978-1989 and 1990-2004 sub-periods the period average annual rate of private savings rose by nearly 50 per cent while the period average annual rate of public savings rate went from positive to negative - implying public dissaving.

Lastly, corresponding to the rise in domestic savings noted above, there has been a drop in the rate of foreign savings from 12.5 per cent in 1978-89 to 8.6 per cent in 1990-2004.

## **Inflation**

### *Indicators*

There has not been a dearth of index numbers to measure inflation in Sri Lanka in the recent past. Five such indicators of inflation have, until very recently, been regularly published in the annual Central Bank Report: the Colombo Consumers Price Index (CCPI), the Greater Colombo Consumers' Price Index (GCCPI), the Colombo District Consumers' Price Index (CDCPI), the Sri Lanka Consumers' Price Index (SLCPI) and the Wholesale Price Index (WPI)<sup>13</sup>. The Central Bank Annual Report for 2004 has not published the GCCPI, apparently replacing it with CDCPI<sup>14</sup>. In addition, to these published price indices, there is the implicit GDP deflator (GDPD) that can be derived from national accounting statistics. Of the above mentioned indices, the computation of SLCPI, CDCPI and the other District indices noted in footnote was commenced in the mid-1990s. These are therefore, of limited use in this analysis of trends since the late-1970s. Most of these indicators of inflation tend to move together, with the CCPI and GDPD moving particularly closely together<sup>15</sup>. The GCCPI also goes back to 1989, making its use also in the present study somewhat limited. The most volatile of the three indicators is the WPI, computed by the Central Bank from 1974 onwards. To the extent that the WPI can be considered to be a producer price index, its movement could be considered to reflect the most fundamental inflation forces at work in the economy.

In discussions of inflation, the CCPI is the most widely used and quoted index. Its coverage is restricted to household consumption items such as food and drink, housing, fuel and light, clothing, and a few other consumer items and is officially used and widely viewed as a cost of living index. The major drawback of this index is that its coverage and weights are based on the expenditure patterns of the Colombo city working classes in

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<sup>13</sup> Note that, until the arrival of SLCPI and the District indices noted in the following note, all *consumer* price indices were based on condition in the Colombo metropolis or its environs.

<sup>14</sup> In addition, the Central Bank has commenced the practice of publishing price indices for selected Administrative Districts. The Annual Report for 2004 has indices for four Districts: Anuradhapura, Matale and Matara, in addition to the Colombo District noted in the text.

<sup>15</sup> This is due to the fact that the CCPI is used to a considerable extent to derive constant price data series which form components of GDP at constant prices.

1951. It has long been argued that household consumption patterns have altered significantly since then and that, among other things, food, drink, and clothing, now account for a smaller slice of the household budget than in 1951, while rent, fuel and light, and miscellaneous items, including consumer durables, account for much larger slices. Moreover, a retail price index computed on the basis of weights derived from consumption expenditure patterns of the working classes living in the capital city is unlikely to be representative of the entire country given that the bulk of the population is rural and a large number is still outside the wage labour nexus. Some of the indices introduced in more recent times, particularly the SLCPI, appear to have been intended to address some of these criticisms of the CCPI.

**Table 3.13**  
**Relative Weights and Base Year Assigned to different components of household expenditure in Sri Lanka's Consumer Price Indices**

Expenditure Group	CCPI 1952=100	GCCPI 1989=100	CDCPI 1996-97=100	SLCPI 1995-97=100
Food & Drink	61.9	69.3	63.1 <sup>a</sup>	71.2
Housing	5.7	8.9	13.2	15.2 <sup>b</sup>
Clothing	9.4	2.8	6.2	4.1
Fuel and light	4.3	5.4	4.9	-
Miscellaneous <sup>c</sup>	18.7	13.6	12.6	9.5

Note: a The sum of weights for food (58.7) and liquor, tobacco, betel and arecanut (4.4)

<sup>b</sup> Includes (i) housing, water, electricity, gas and other fuels and (ii) furnishing, household equipment, and routine house maintenance.

<sup>c</sup> Includes personal care & health, recreation and education, consumer durables, transport & communications and miscellaneous.

Source: Central Bank of Sri Lanka, Various Annual Reports

The Central Bank's policy to introduce more 'representative' and 'accurate' consumer price indices commenced with the GCCPI. Constructed using consumer expenditure data from the 1985/6 *Labour Force and Socio-economic Survey* revalued at January to June 1989 prices, the GCCPI was an index with 1989=100. Comparing the weights assigned to the different consumption expenditure components of the two indices reveals that, contrary to expectation, expenditure on food and drink accounts for even more of the household family budget in the GCCPI than in the CCPI (table 3.14). The same comment applies to the other two indices in Table 3.13 as well.

A comparison of the rates of inflation depicted by the GCCPI and CCPI for the period 1990 to 2001 reveals a significant congruence of the two series in terms of trend, although in a few years (e.g. 1994, 1995 and 2000), there is notable divergence. The comparison also reveals, however, a significant divergence in the levels of inflation depicted by the two series<sup>16</sup>; the CCPI generally showing a higher level of inflation than

<sup>16</sup> The annual inflation rates reflected in GCCPI (available from 1990) and CCPI for the period after 1990 are given below:

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
CCPI	12.2	11.4	11.7	8.5	7.7	15.9	9.6	9.4	4.7	6.2	14.2
GCCPI	11.5	9.4	8.4	4.7	3.9	14.6	7.1	6.9	3.8	3.2	11.0

the GCCPI. One reason for the GCCPI to indicate a lower rate of inflation is the higher weight given in that index to the relatively static housing component<sup>17</sup>.

The commodity coverage of the WPI is wider than that of the CCPI. It includes, in addition to consumer goods, intermediate and investment goods. The weights used for the compilation of the index are based on product shares in the total value of domestic production plus imports during 1974. Internationally traded goods receive a higher weight than in the CCPI. Imports (27.17 per cent) and exports (22.52 per cent) have a combined weight of 50 per cent in the WPI as against 40 per cent in the CCPI. The weight assigned to food in the WPI, at 68 per cent, is also quite high. The failure to revise the weights used in the compilation of the WPI weakens its reliability as an indicator of underlying inflationary pressures since there have undoubtedly been considerable changes in the patterns of production and trade since 1974. Moreover, the WPI is not a particularly good indicator of underlying cost pressures, partly because of the large food component it represents.

The coverage of the GDPD is the widest of the indices being discussed here. It includes all goods and services of domestic origin weighted by their respective contributions to total value added. Conceptually, therefore, it is arguably the best indicator of general inflationary forces operating in the economy, from whatever source they may emerge. However, unlike the CCPI and the WPI it does not directly reflect changes in import prices. This is a distinction worth bearing in mind in any empirical study of inflation in Sri Lanka since it suggests that the response of the GDPD to external price changes is likely to be less immediate and pronounced than those of the CCPI and the WPI. One of the major drawbacks of the GDPD is that it is difficult to ascertain its quality as an indicator of general inflationary forces. The quality of any economy-wide deflator like the GDPD, as is well known, depends heavily on the quality of the price indices used to derive the constant price estimates of value added in various sectors of the economy. Neither the Central Bank nor the Department of Census and Statistics provides adequately detailed information about the primary price indices used in the computation of these statistics. However, a comparison of inflation trends depicted by the GDPD and the CCPI would seem to suggest that the latter is relied upon heavily in the construction of constant price GDP series.

### *Trends*

Sri Lanka has experienced an annual average inflation rate of just over 11 per cent per annum over the period 1980-2000, which is lower than the weighted average for low, lower-middle and middle income countries over the same period, but higher than the weighted and unweighted averages for both its South Asian neighbours and the East Asian and Pacific region group of countries (see table 3.14). The apparent downward trend in Sri Lanka's inflation over the 1978-2004 period as a whole is consistent with both regional and global trends. Within this period, the sub-periods in which average annual inflation was the highest (see table 3.15), namely 1978-84 and 1990-94, were also the sub-periods with the highest average annual economic growth rates. During these same sub-periods, the average annual increases in food prices and broad money stock

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<sup>17</sup> In the CCPI the rent index is completely static and in the GCCPI, the housing index is almost static, rising by 0.1 – 0.2 every year. This housing index in 1992 was 109.1 and in 2001, 110.4.

have also been relatively high. We will return to causal links between these latter variables and aggregate price movements in chapter 4 in the context of the analysis of the causes of aggregate price level movements in the Sri Lankan economy.

**Table 3.14**  
**Sri Lanka's comparative inflation performance, period annual averages, 1980-2000(a)**

	1980-90	1990-2000
	<i>Percentages</i>	
E. ASIA		
China	5.6	6.4
Indonesia	11.2	15.6
Korea (Rep)	9	5.4
Malaysia	2.5	3.8
Thailand	5.2	4.1
Unweighted average of above (b)	6.7	7.1
E ASIA AND PACIFIC weighted average	8.0	7.4
S. ASIA		
Bangladesh	9.6	4.1
India	8.5	8.2
Nepal	10.5	8.7
Pakistan	7.4	9.4
<b>SRI LANKA</b>	<b>12.5</b>	<b>9.9</b>
Unweighted average of above (b)	9.7	8.1
S. ASIA weighted average		
LOW INCOME countries	10.5	15.8
LOWER-MIDDLE INCOME countries	13.8	33.0
MIDDLE INCOME countries	16.9	60.8

Notes: <sup>a</sup> Inflation rates are given by percentage changes in the GDP deflator

<sup>b</sup> Author's calculations

Source: World Development Indicators, 2002

**Table 3.15**  
**Inflation, 1978-2004**

	1978-89	1990-04	1978-84	1985-89	1990-94	1995-04
	<i>Percentage</i>					
Colombo Consumer price	12.6	10.4	15.5	8.5	13.1	9.1
Wholesale price index	12.8	9.0	18.9	4.4	10.5	8.2
Gross Domestic Product	11.5	9.6	14.8	6.9	12.0	8.4

Source: Central Bank of Sri Lanka Annual Reports (various years)

### External balance and structure of international trade

The Sri Lankan economy achieved a positive average annual (overall) external balance of around a little over 1 per cent of GDP over 1978-2004 and nearly 2 per cent of GDP over 1990-2004 (table 3.17). In terms of the reserve cover, this translated into an annual average of about 3 months of imports. Table 3.16, drawing from the World Bank, *World Development Indicators* of 2002, indicates that Sri Lanka's reserve cover during both 1980-90 and 1990-2000 did not compare favourably with either the average reserve cover for low and lower-middle income economies, or even the average for other South Asian economies. Of note, however, is the fact that Sri Lanka's low annual average reserve

cover for the post-1977 period is largely attributable to the exceptionally low levels of cover experienced in the pre-1990 period. Indeed, reserve cover in the post-1990 period corresponded roughly with the South Asian average, although it still lagged behind the average for lower-middle income economies. In 2004 however, Sri Lanka's reserve cover had dropped to the lowest level among countries in South Asia.

**Table 3.16**  
**International Comparison of Sri Lanka's Gross Reserve Cover, Annual Averages, 1980-2000 and 2004**

	1980-90	1990-2000	2004
	<i>Months of imports</i>		
<b>GROSS INTERNATIONAL RESERVES</b>			
<b>IN MONTHS OF IMPORTS</b>			
Bangladesh	2.0	3.8	3
India	5.2	4.8	14.1
Nepal	5.2	6.0	-
Pakistan	2.6	1.7	6.6
<b>SRI LANKA</b>	1.8	3.8	2.8
Unweighted average of above <sup>a</sup>	3.4	4.0	6.6
LOW INCOME countries	4.0	4.1	-
LOWER-MIDDLE INCOME countries	5.3	6.5	-

<sup>a</sup> Authors' calculations

Source: World Development Indicators, 2002 & 2004

Of the four sub-periods 1978-84, 1985-89, 1990-94 and 1995-04 in table 3.17, the official reserve cover, at 3.7 months of imports in both cases, was the highest in the last two sub-periods. While this improvement in official reserve cover reflects a continuing positive external balance situation, these reserve cover averages tend to mask certain important trends. Thus, at the commencement of the 1990-94 sub-period, in 1990, the official reserve cover was down to critical levels – under 2 months of imports. From this very weak position, the economy witnessed a gradual increase in official reserve cover, reaching 5 months of imports in 1994. From this high point, the official reserve cover again fell progressively to 1.8 months of imports in 2000. It rose again to 4.2 months in 2003 and 3.4 months in 2004<sup>18</sup>.

Table 3.17 shows the factors underlying these trends in the overall balance and the reserve cover by focusing on the major items in the fall of both the current account deficit and capital account surplus. The fall in the current account deficit is largely attributable to the trend decline in the trade deficit and the trend increase in transfers as the rising private inward remittances more than offset the decline in foreign aid inflows. The trend decline in the capital account surplus is almost exclusively the result of the decline in government foreign borrowings, reflecting, as noted above, the shift in economic dynamic from the government to the private sector.

<sup>18</sup> The data for the reserve cover (both official and total) for the period 1989-2004 are given below in months of imports:

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
<b>Official</b>	1.7	1.9	2.9	3.4	5.1	5.1	4.9	4.4	4.3	4.2	3.4	1.8	2.8	3.4	4.2	3.4
<b>Total</b>	3.5	3.8	4.7	5.2	7.3	7.3	6.9	6.1	6.7	6.2	5.3	3.7	4.7	5.0	5.8	5.3

**Table 3.17**  
**The balance of payments, 1978-2004**

	Per cent of GDP					
	1978-89	1990-04	1978-84	1985-89	1990-94	1995-04
<b>Current account</b>	<b>-8.8</b>	<b>-4.4</b>	<b>-10.0</b>	<b>-7.2</b>	<b>-6.0</b>	<b>-3.5</b>
Trade balance	-13.1	-11.5	-14.9	-10.5	-11.1	-9.5
Exports	23.6	33.7	25.4	21.1	25.6	29.6
Imports	36.7	45.2	40.3	31.7	36.6	39.1
Services	1.0	1.2	1.6	0.1	1.3	1.2
Income	-1.8	-1.7	-1.5	-2.3	-1.7	-1.3
Transfers	5.1	7.2	4.8	5.6	5.5	6.1
Private	4.0	6.7	3.7	4.6	4.9	5.8
Official	1.1	0.4	1.2	1.0	0.7	0.3
<b>Capital and financial account</b>	<b>9.0</b>	<b>5.5</b>	<b>10.1</b>	<b>7.4</b>	<b>8.3</b>	<b>3.6</b>
Long-term	6.0	4.3	7.4	4.2	5.5	3.1
Government	4.6	2.6	5.3	3.8	3.7	1.6
Private	1.4	1.3	2.1	0.4	1.9	1.2
<b>Overall Balance</b>	<b>0.6</b>	<b>1.7</b>	<b>0.8</b>	<b>0.4</b>	<b>3.0</b>	<b>0.8</b>
Official reserves/months of imports	2.6	3.6	3.0	2.0	3.7	3.7
Rs vs US\$ per cent depreciation	9.0 <sup>b</sup>	5.4	8.9 <sup>a</sup>	9.2	4.6	7.7

Notes: <sup>a</sup> 1979 starting date

Source: Central Bank of Sri Lanka Annual Reports (various years)

Finally, underlying the trend decline in the trade deficit was a rise in both exports and imports as a percentage of GDP, with the rise in exports marginally out-stripping the rise in imports (see table 3.17). Data presented in table 3.18 shows that along with these changes, there was also a compositional change in both exports and imports, particularly exports. From being a largely “primary exporting” country in 1978, with tea alone accounting for nearly half of total export earnings, Sri Lanka became primarily a manufactured goods exporter by the turn of the century. Specifically, between 1978 and 2004 the share of agricultural products in total exports fell from 79 per cent to 18 per cent while the share of industrial products rose correspondingly from 14 to 80 per cent. At the same time, the share of tea exports fell from 49 per cent to 13 per cent, while the share of textiles and garments rose from 4 to 49 per cent. The share of other manufactured exports (i.e. non-textile and non-garment exports) also rose over this period from 4 to 29 per cent.

On the side of imports, the major compositional shift was in respect of consumer and intermediate goods. Between 1978 and 2004 the share of consumer goods in total imports fell by 17 percentage points while the share of intermediate goods rose by a similar magnitude (with the difference coming from a decline in share of investment imports). Within the consumer goods category there was a marked decline in the share of food and drink imports, amounting to an astonishing 21 percentage points. Much of the fall is however attributable to extraordinary increases in imports of flour – counted as an intermediate good – at the beginning of the period. Discounting for this the decline in the share of food and drink imports is in the order of 8 percentage points, and largely attributable to an increased self-sufficiency in rice and sugar production.

**Table 3.18**  
**Changes in the composition of trade, selected years, 1978-2001**

	1978	1990	2001	2004
<i>Percentage of total exports</i>				
Agricultural goods	<b>79</b>	<b>36</b>	<b>19</b>	<b>18</b>
Tea	49	25	14	13
Rubber	15	4	<1	<1
Minor agricultural products	6	4	3	3
Industrial goods	<b>14</b>	<b>52</b>	<b>77</b>	<b>80</b>
Textiles and garments	4	32	53	49
Other manufactured products	4	16	23	29
<i>Percentage of total imports</i>				
Consumer goods	<b>35</b>	<b>26</b>	<b>21</b>	<b>18</b>
Food and drink	28	15	9	7
Non-food consumer items	7	12	10	11
Intermediate goods	<b>42</b>	<b>52</b>	<b>56</b>	<b>60</b>
Textiles	4	13	22	19
Investment goods	<b>23</b>	<b>22</b>	<b>18</b>	<b>21</b>
Unclassified			6	1

Source: Central Bank of Sri Lanka Annual Reports (various years)

## ***V. Summary***

The chapter outlined the important macroeconomic policies and trends in Sri Lanka in the period after 1977, i.e., in the period of economic liberalisation. The major points made in this regard were as follows:

- The outline of key macroeconomic policy changes and trends in the period after 1977 needs to be founded on a periodisation of this period. The periodisation should be based on certain fundamental differences in policy emphases and corresponding macroeconomic dynamics.
- In this context four distinct sub-periods can be identified;
  - **1977-84** – A focus on growth (and employment generation) founded on massive, foreign-financed, government-run, capital expenditure programmes.
  - **1985-89** – A shift in focus towards stabilisation, particularly the restoration of external balance.
  - **1990-94** – A focus on growth with poverty alleviation, with the former founded on EOI and a general policy environment conditioned by the terms and conditions of a SAF and ESAF concluded with the IMF.
  - **1995-04** – A strong focus on stabilisation, with inflation targeting assuming centre stage, and the growth strategy shifting to a non-interventionist, level playing field, one.
- These shifts in policy emphases has meant that fiscal and monetary policy tended to be more contractionary in the 1990s than in the 1980s, and particularly contractionary

in the second half of the 1990s, when exchange rate policy was also fundamentally geared towards stabilisation (fiscal tightening and the curtailment of inflation).

- The burden of fiscal adjustment appears to have fallen primarily on expenditure, particularly capital expenditure. Current expenditure, as a percentage of GDP, even rose over the period under consideration as a whole, largely as a result of increases in debt servicing costs and defence expenditures, and in spite of contractions in both civil administration costs and transfers to households and public enterprises. Tax revenues fell over this period as a result of a policy-induced fall in trade tax revenues, with the fall in the latter being partially compensated by a rise in expenditure taxes. Income taxes as a percentage of GDP remained fairly static. As a result the tax incidence shifted towards expenditure taxation.
- Deficit financing shifted towards domestic sources, with the latter in turn shifting towards more commercial sources thereby exerting an upward pressure on money market rates. Notwithstanding these changes in the composition of deficit financing, the composition of the debt in terms of its domestic and foreign components remained fairly stable as a consequence of the impact of the exchange rate on the latter.
- Contractionary monetary policy focused, to different degrees in different sub-periods, on controlling the cash base of the system. This had certain observable consequences for interbank and other money market rates; reinforcing the upward pressures exerted on these rates by the switch in deficit financing towards commercial money market sources.
- Nominal exchange rate adjustments appear to have followed purchasing power parity norms in relation to the US dollar.
- Sri Lanka achieved an average growth rate of 4.8 per cent over the period 1978-04 as a whole, which compares favourably with the average for low and middle income countries but not the fast growing East Asian economies. This rate was roughly equal to the unweighted average for South Asian economies over the same period.
- Economic growth was significantly higher in the 1978-84 and 1990-94 sub-periods than in the other two sub-periods. Underpinning the rapid economic growth in these two sub-periods was a rapid growth in commodity production.
- Economic growth was accompanied by a shift in the structure of production away from agriculture and towards services. The share of industry in total value added also declined.
- With the limited data available, it would appear that employment levels rose and unemployment fell in the period 1990-2004. The shift in employment away from agriculture was at least partly towards low value added manufacturing and services activities.
- Sri Lankan investment rates compare favourably, while domestic savings rates do not, with those of other LDCs, including other South Asian countries.
- There was a shift in sources of investment away from government and towards the private sector, in keeping with the shift in policy emphases noted above. At the same



time there was a sharp rise in private savings (most notably from the late 1980s onwards) which more than offset a decline in public savings levels.

- It was noted that there are several different indicators of inflation in Sri Lanka and that caution needs to be exercised in the use and interpretation of each of these. The three most important indicators of inflation for the analytical purposes of this study are; the Colombo consumer price index, the wholesale price index, and the implicit GDP deflator.
- Sri Lanka's rate of inflation in terms of consumer prices was shown to be below the average rate for low income, lower-middle and even middle income developing countries but above that for other South Asian and East Asian countries over the 1980-2000 period as a whole. It would appear that relative to the above groups of countries, Sri Lanka performed better on the inflation front in the 1990s than in the 1980s. However, it should be apparent that the general downward trend in inflation experienced by Sri Lanka over the 1980-2000 period mirrors downward trends in other developing (and developed) countries over the same period.
- The two sub-periods in which inflation rates were highest in Sri Lanka were 1978-84 and 1990-94, which were also the sub-periods in which average economic growth rates were the highest.
- Although Sri Lanka's external balance has been positive in net terms over the 1978-2000 period, this has not translated into a particularly high reserve cover in respect of imports as compared to other developing countries, including other South Asian countries.
- In terms of reserve cover, the 1990s was considerably better for Sri Lanka than the 1980s, and even comparable to levels of reserve cover achieved by other developing countries. It was noted, however, that the period averages masked certain important underlying trends.
- Underlying trends in the overall balance and reserve cover were falls in both the current account deficit and capital (financial) account surplus. The former is mostly attributable to an improvement in the trade balance and private remittances, while the latter is entirely attributable to a decline in foreign borrowings by government to fund capital formation.
- Changes in the trade balance were accompanied by compositional changes in both exports and imports. In the case of exports there was a wholesale shift out of plantation agriculture products and towards manufactures, while in the case of imports the shift has been away from consumer goods (food and drink) and towards intermediates.

## Chapter 4: Understanding Macroeconomic Trends

### *I. Introduction*

The purpose of this chapter is to identify the principal sources of economic growth, inflation and external balance in Sri Lanka. In the course of this analysis consideration will be given to a number of the standard explanations of these macroeconomic phenomena, particularly those which underlie the present macroeconomic policy perspective. Consideration will also be given to the impact which various macroeconomic policies have had on macroeconomic developments. The reader should be warned that there is no intention here of econometrically “explaining” some of the variables taken up for discussion through multiple regression type of analyses. Scatter plots and two variable relationships are often used in the spirit of exploratory data type analyses to see what kind of relationship exists between the variables taken up for consideration.

### *II. Economic Growth: The Critique of Some Familiar Arguments*

Standard macroeconomic explanations of economic growth tend to focus attention very strongly on factors such as aggregate investment, domestic savings, and inflation. We will, therefore, begin this chapter by giving some consideration to these factors and their relationship to growth in the Sri Lankan context.

#### **Investment**

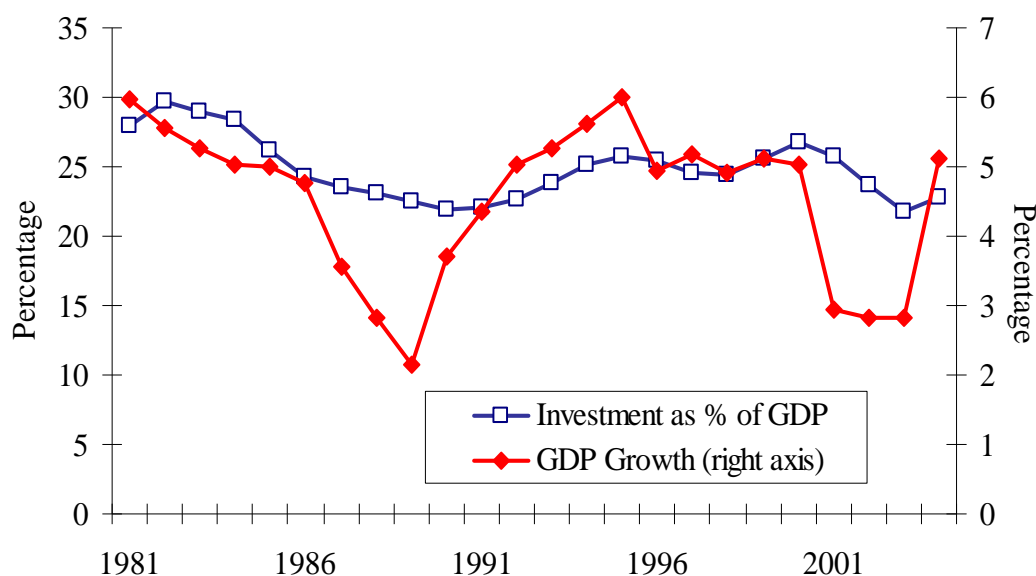
As one might expect, trend output growth and investment (as a percentage of GDP) have tended to move together over the longer term (see figure 4.1). However, it is not clear from these data that investment has in any sense “led” output growth<sup>1</sup>. In fact, visual inspection of the data would suggest that growth has actually led investment at a couple of turning points. This result may be partly explained by the fact that in national accounts computations many sub-components of aggregate investment are approximated by import data and that imports are a function of economic growth. However, it may also be explained by the fact that changes in investment can be expected to respond to changes in capacity utilisation; rising as the growth rate and corresponding levels of capacity utilisation rise, and falling as they fall<sup>2</sup>.

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<sup>1</sup> Weeks (2001) arrives at a similar conclusion in the context of a review of growth in sub-Saharan Africa.

<sup>2</sup> A number of quantitative techniques exist for testing the direction of causality between two variables including so-called Granger and Sims causality tests – see Granger (1969) and Sims (1972). Data limitations in respect of the time period chosen for the present study preclude the use of such techniques. However, it is noteworthy that a recent study of the relation between growth and investment in India over the period 1950-96 which made use of these techniques of causality test concluded that, if anything, growth is the cause of capital accumulation rather than the other way around (see Chandra and Sandilands, 2003).

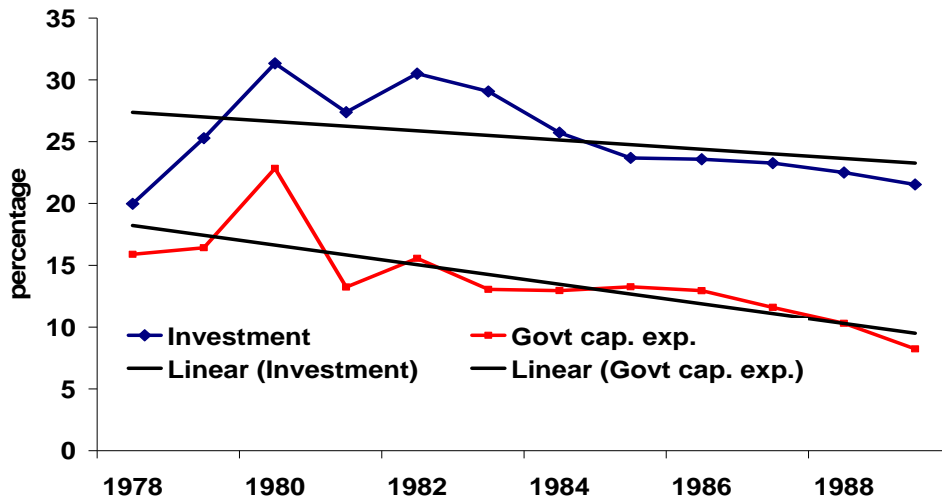
**Figure 4.1**  
Trends in economic growth and investment as a percentage of GDP, 1981-2004(a)



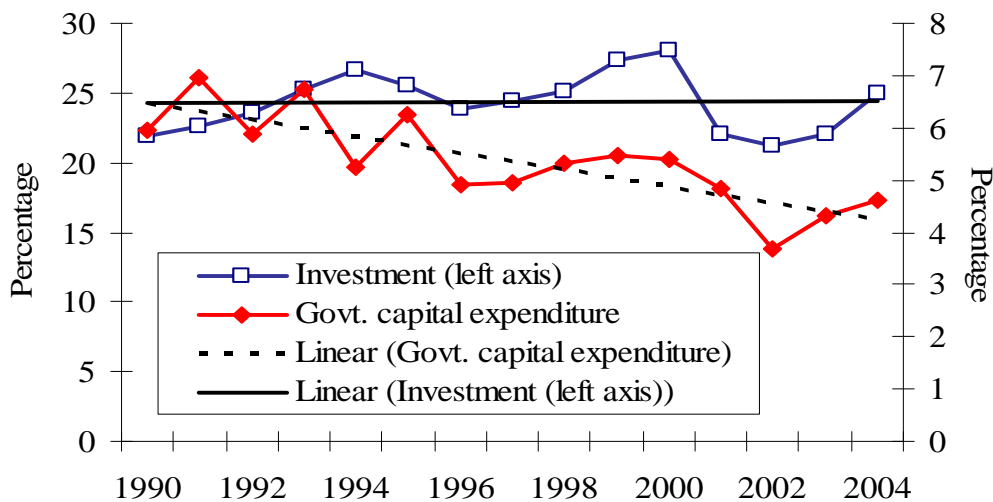
Note: (a) Three year moving average smoothing has been applied to both variables.

Much has been written on the issues of “crowding-in” and “crowding-out” in policy related debates on growth. Depending on underlying conditions, government expenditure is considered to lead to both processes of crowding-in and crowding-out. Government expenditure, particularly government capital expenditure, is argued to induce and encourage private capital expenditure, thus giving rise to crowding-in. At the same time, it is argued that if government expenditure becomes excessive it tends to crowd-out private capital expenditure by pre-empting private sector borrowing or raising the costs of that borrowing. The data depicted in the two figures 4.2 and 4.3 suggest that, while there may have been some “crowding-in” between 1978 and 1989, this phenomenon was absent in the ensuing 1990-2004 period. Thus, while the decline in government capital expenditure during 1978-89 can be seen to have corresponded to a decline in aggregate investment expenditure (Figure 4.2), the continuing decline in government capital expenditure during 1990-2004 was accompanied by an increase, though rather slow, in the trend rate of investment (Figure 4.3). This difference can perhaps be explained by the different growth dynamics operating in the two periods. In the former the growth dynamic stemmed, for the most part, from an externally funded public investment programme, while in the latter it stemmed from the promotion of the private sector.

**Figure 4.2**  
Investment and government capital expenditure as percentages of GDP, 1978-1989



**Figure 4.3**  
Investment and government capital expenditure as percentages of GDP, 1990-2004



In regard to whether there has been crowding-out what matters is the link between the budget deficit (or rather domestic money market financing of the deficit), money market interest rates and private investment. Table 4.1 provides period averages for these three variables. Domestic money market financing of the deficit is taken to be domestic market financing of the deficit less central bank financing. The relevant money market rates are taken to be the real rates on 3-month treasury bills<sup>3</sup>. Private investment is

<sup>3</sup> Real rates are taken to discount for the possible nominal interest rate effect of the inflationary consequences of the deficit and its financing.

estimated by deducting government capital transfers to non-financial public enterprises from gross domestic fixed capital formation accounted for by “private sector and public corporations” in the national accounts. The table does not lend support to the existence of a relation between domestic money market financing of deficit and either real interest rates or private investment.

This is not to say that, as government is less and less able to draw on captive money market sources, such a relation will not materialize. Indeed, as has been suggested earlier and will be elaborated on further below, such a relation appears to be increasingly manifest in the 1995-2004 period. Rather, what the data over the 1979-2004 period as a whole would seem to suggest is that the phenomenon of crowding-out is not an inevitable concomitant of a non-inflationary financing of the deficit. Much depends on the extent to which government borrowing from captive sources (and printing money) is precluded.

**Table 4.1**  
**Deficit financing, money market rates and private investment, period averages, 1979-2004**

	1978-84	1985-89	1990-94	1995-04
	<i>Percentage</i>			
Non-central bank domestic market financing of the deficit (as % of GDP)	4.4	3.6	6.6	6.5
Real 3 month treasury bill rate	-3.0	7.1	3.9	4.2
Private investment (as % of GDP)	14.0	11.6	19.5	20.4

Source: Authors' computations from Central Bank of Sri Lanka Annual Report data (various years)

## Savings

It has frequently been argued that one of the reasons for Sri Lanka's failure to achieve a more sustained increase in economic growth is the failure to raise the rate of aggregate savings in general (aggregate savings in relation to GDP), and, more especially, the rate of domestic savings. While the assumed causal relation between output growth and domestic savings is subject to considerable theoretical and empirical doubt, what is of concern here is the standard explanations proffered for sluggish domestic savings in Sri Lanka. These explanations tend to attribute sluggish domestic savings to, on the one hand, the failure to raise public savings through “appropriate” fiscal policies, and, on the other, the failure to encourage and facilitate private savings by means of financial liberalisation – market-oriented financial sector reform. The following sections will consider these arguments.

### *Public savings*

It was noted in the preceding chapter that the public savings rate fell steadily between 1978 and 2004. In 1978 the level of public savings was positive - in the order of 2.8 per cent of GDP. A downward trend in this level eventually gave rise to public dissaving, amounting to (-) 3.8 per cent of GDP by 2004. In today's global deflationary environment, the conventional wisdom which held that all public dissaving is bad is under intellectual and policy critique. This critique appears, however, to be confined to advanced countries. Public dissaving in LDCs is still unquestioningly assumed to be bad. The relative merits of public saving as against dissaving will not be taken up here. Instead, what will be considered is the standard explanation for this dissaving.

Typically, the assumption is that public dissaving is the product of government excesses, and a failure to adopt “rational” [e.g. the typical structural adjustment (SAP)-style] fiscal policies. In fact, the Sri Lankan data suggests that a considerable part of the dissaving is actually attributable to the adoption of SAP-style policies. Two of the most important of such policies in this regard are the switch to money market sources of deficit financing and trade liberalisation. To begin with, fiscal data show that most of the decline in public savings is accounted for by a decline in revenues, whether one takes end points or period averages. Taking end points, the movement from positive public savings in 1978 to dissaving in 2004 is mostly accounted for by the fall in government revenue - from 25.9 per cent of GDP in 1978 to 15.3 per cent in 2004. Current expenditure too declined between the same two end points from 23 to 19 per cent of GDP. Underlying the fall in revenues is a sizeable fall in trade based tax revenues; from a sum equivalent to 13.4 per cent of GDP in 1978 to a mere 2.4 per cent of GDP in 2004<sup>4</sup>. As will be shown later, the fall in trade based tax revenues was the product of trade liberalisation policies, as total value of trade as a percentage of GDP actually rose between these two years (see table 4.15).

**Table 4.2**  
**Determinants of Public Savings, Period Averages and Selected Years, 1978-2004**

	<i>Percentages of GDP (Except last row)</i>					
	<b>1978</b>	<b>1978-84</b>	<b>1985-89</b>	<b>1990-94</b>	<b>1995-04</b>	<b>2004</b>
<b>Public savings</b>	<b>2.8</b>	<b>1.6</b>	<b>0.4</b>	<b>-1.6</b>	<b>-3.2</b>	<b>-3.8</b>
<b>Current expenditure</b>	23.1	19.0	20.5	21.7	20.5	19.2
Defence	>1%	0.7	2.4	3.5	4.8	3.6
Interest	3.2	4.2	5.2	6.2	6.2	5.9
<i>Domestic</i>	2.5	3.3	3.9	5.1	5.5	5.2
Social expenditure (a)	13.5 (b)	9.9	9.0	9.5	9.0	11.0
<b>Revenue</b>	25.9	20.5	20.9	20.1	17.5	15.3
Trade based taxes	13.4	6.9	6.3	4.9	2.6	2.4
<b>Domestic debt</b>	38	40	42	42	51.7	56.3
<b>Real 3 mth TB rate (%)</b>	1.2	-3.0	7.1	3.9	4.2	-2.0

(a) Includes what the source documents classify as ‘social expenditure’ (including e.g. expenditure on education, health, community services etc.) and transfers to households.

(b) 1979 figure

Source: Central Bank of Sri Lanka Annual Reports (various years)

On the current expenditure side the data show that the principal expenditure pressures came from defense-related expenditures and debt servicing. Current expenditures on defense rose from under 1 per cent of GDP in 1978 to 4.8 per cent during 1995-04. The contemporary truce in the civil war has produced signs of some easing of pressure on this account, as the percentage came down to 3.6 per cent of GDP in 2004. Still, compared to the early post-liberalisation period, defence expenditure was a major drain on public finances even in 2004. Debt servicing expenses rose from 3.2 per cent of GDP in 1978 to

<sup>4</sup> There was, in addition, a decline in taxes on incomes and profits (both corporate and non-corporate) from 3 per cent during 1978-84 to 2.3 per cent during 1995-2004. As a result of extensive use of tax holidays and other fiscal incentives to promote investment, the rapidly growing sectors of the economy were either untaxed or marginally taxed. In addition, there was the gradual reduction of corporate and personal income tax rates.

5.2 per cent in 2004. The rise in debt servicing had less to do with the rise in the magnitude of the overall debt than with the shift in composition of deficit financing towards commercial sources (see below). In fact, the shift towards money market sources of deficit financing also caused the real interest rate and the burden of domestic debt to rise. At the same time, it is of note that current social expenditure fell from 13.5 per cent of GDP to 11 per cent of GDP between 1978 and 2004 and expenditure on civil administration from 5.6 per cent of GDP to around 2 per cent of GDP. Social expenditures and those on public administration, it warrants remarking, are frequently cited as the sources of fiscal excesses in developing countries like Sri Lanka.

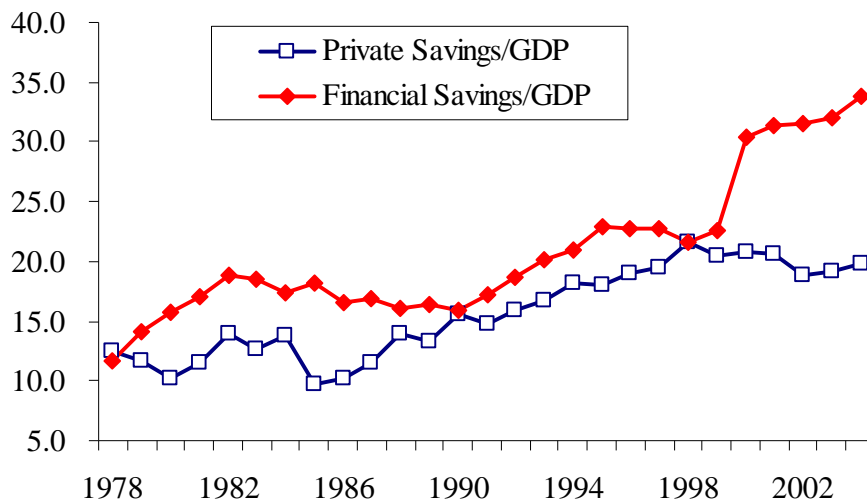
#### *Private savings*

The behaviour of private savings over 1978-2004 has been examined briefly in the preceding chapter. The rate of aggregate private savings was rather static between 1978 and 1985, then rose steadily between 1985 and 1998, and again stagnated after 1998. It is sometimes argued that the rise in aggregate private savings after 1985, and certainly between 1990 and 1998, was due to the liberalisation and development of the financial system. Certainly, there appears to have been a considerable degree of liberalisation of Sri Lanka's financial sector since the early 1990s. This is evidenced by the privatisation of two development finance institutions and a major merchant bank, the (further) easing of restrictions on certain commercial banking activities by foreign firms, the reduction in stamp duties on financial transactions, the promotion and development of specialist financing institutions such as venture capital companies, the encouragement of merchant banking and leasing activities, the development of the equity market, the shift to more market oriented financing of the budget deficit, etc. A fairly common measure of financial liberalisation is taken to be the rate of financial savings – the savings and fixed deposit liabilities of the banking system as a proportion of GDP. If the rate of aggregate private savings were explained by financial liberalisation, one would expect to see a close correspondence between the rate of aggregate private savings and the rate of financial savings. Figure 4.4 depicts the movement of these two variables over the 1978-2004 period. At first glance the relation between aggregate private and financial savings appears to be quite good, at least up to the late 1990s, with the data for the whole period yielding a correlation coefficient ( $R^2$ ) of 0.77 between the two variables. However, closer inspection of the chart, even for 1978-1998, suggests that the correspondence is rather illusory. In fact, there appears to be a close correspondence of the two variables for only the period, 1990-95. Moreover, although the protracted rise in the aggregate private savings rate began in 1985 and continued unabated right up to 1998, the financial savings rate actually fell between 1985 and 1990, and then rose only up to 1995, falling slowly from this point onwards till about 1998. Between 1998 and 2004, while the rate of financial savings increased quite sharply, the rate of private savings declined, or at best stagnated.

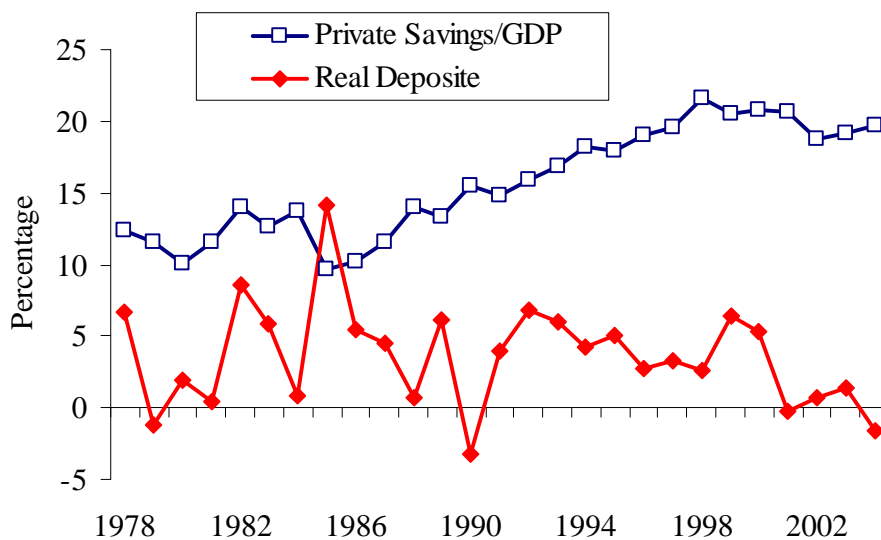
One of the tenets of the financial liberalisation thesis has been the alleged link between the savings rate and the real rate of interest. It is argued that one reason for low savings rates in financially repressed economies is that the real interest rate is below the market clearing rate. Accordingly, one should expect to see a rise in the real interest rate accompanying a rise in the aggregate private savings rate. Figure 4.5 plots the rate of aggregate private savings and the real 12 month fixed deposit rate between 1978 and

2004. It is apparent that the relation between the two variables is poor. While there was a steep upward trend in private savings (as a percentage of GDP) between 1985 and 1998, there was simultaneously a downward trend in the real deposit rate<sup>5</sup>. Of course, when it is recognised that profits comprise a significant proportion of aggregate private savings, and, contrary to economic orthodoxy, that interest payments are a deduction from profits, the above inverse relation is readily understandable.

**Figure 4.4**  
**Aggregate private savings vs financial savings, as percentages of GDP, 1978-2004**



**Figure 4.5**  
**Private savings as a percentage of GDP and the real deposit rate, 1978-2004**



<sup>5</sup> If the real deposit rate in 1985 is excluded on the basis of its outlier status, then the trend in the real deposit rate is flat - a result that still does not vindicate the financial liberalisation thesis.



## Inflation

Yet another frequently voiced argument about growth-inflation link in Sri Lanka (and many other developing countries) is that the failure to achieve a sustained increase in the rate of economic growth is the result of a failure to curtail inflation, or at least to bring it down to “acceptably” low levels. The tacit assumption of this line of argument is that there is an inverse relation between economic growth and the rate of inflation. While the empirical basis for such a relation has been shown to be, at best, tenuous, the inverse relation between inflation and economic growth has nevertheless been taken as axiomatic by successive groups of Sri Lankan policy makers in the post-1978 period, especially during 1995-2004. The following statements are indicative of the general policy perspective in this regard<sup>6</sup>:

A fundamental requisite to achieve our savings-investment objective, together with the full exploitation of growth potentials in agriculture, industry and service sectors, is the maintenance of price stability or curbing inflation. The rate of inflation in all successful growing economies has been single digit. In Thailand and in Malaysia, the rise in prices was around 4 percent while in Sri Lanka we witnessed a very high inflation rate of around 13 percent. (Budget Speech 1995, p17)

Inflation hurts us in many ways... It raises doubts in savers' minds about the real value of their money and savings. Investors tend to move away from durable investment projects and hedge to cover short-term drops in income.... High inflation encourages imports and harms exports. The high rate of inflation causes potential investors to shy away because of risks associated with the exchange rate and the wage rate. (Budget Speech 1995, p18)

The empirical basis for these arguments, as noted, is rather doubtful to say the least. While cases of rapid growth combined with higher rates of inflation appear to be more common, the opposite situations showing higher growth associated with lower inflation cannot also be ruled out. To begin with, it may be noted that in the 1955-73 period, Japan had both the highest average inflation rate (5.8 per cent) and strongest growth (8.6 per cent) amongst the developed countries. Further, table 4.3 presenting the relevant data for selected East and Southeast Asian countries does not support the assertions in the quotations above that there was a clear inverse relation between growth and inflation. The data presented in this table show that, while it could be argued that an inverse relation of this type existed in the case of Thailand, no such relation is evident for Malaysia or the successful East Asian economies as a group. In the case of Malaysia, the fall in average inflation between the 1970s and the 1980s was accompanied by a corresponding fall in

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<sup>6</sup> A slightly different perspective about growth-inflation link is presented in the following quote also from a Budget Speech, made at a time characterised by a falling rate of inflation:

The declining trend in inflation will have far reaching beneficial effects across the economy. It has resulted in lower interest rates which will encourage investment and thereby enhance future growth. Increases in the cost of living will also be eased. This Government is proud to state that its commitment to fiscal prudence has in a large measure helped to bring down inflationary pressure. (Budget Speech, 2004)

the average economic growth rate, while the rise in inflation between the 1980s and the 1990s was accompanied by a corresponding rise in the average economic growth rate.

These conclusions are reinforced by a comparison of changes in period growth rates and inflation rates for all developing countries and regional groupings of developing countries. Figure 4.6 is a scatter diagram which compares changes in average growth and inflation rates for selected Asian countries between the periods 1980-90 and 1990-2000. It shows, as one would expect, that there is no apparent inverse relation between changes in economic growth and inflation.

**Table 4.3**  
**Annual average growth and inflation rates for selected East Asian economies, 1961-2004**

	1961-70	1971-80	1981-90	1991-2000	2001-04
<i>Average Annual Inflation: Percentages</i>					
Indonesia	210.6	17.5	8.6	12.9	11.1
Korea	9	16.5	6.4	5.2	2.9
Malaysia	0.9	6	3.2	3.8	2.6
Philippines	5.7	14.9	14.6	8.9	4.1
Singapore <sup>a</sup>	1.9	6.7	2.3	2	-0.5
Thailand	2.3	10	4.4	4.6	2.3
<b>Composite of above</b>	<b>63.1</b>	<b>14.2</b>	<b>7</b>	<b>6.1</b>	<b>3.8</b>
<i>Average Annual Growth: Percentages</i>					
Indonesia	3.7	8	5.5	4.4	3.6
Korea	8.5	8.3	9.2	6.3	4.6
Malaysia		8	6	7.1	4.2
Philippines	5.2	6.1	1.7	2.9	4.1
Singapore	9.4	9.1	7.4	7.9	2.3
Thailand	8.3	6.8	7.9	4.5	5.1
<b>Composite of above</b>	<b>6.3</b>	<b>7.6</b>	<b>6.9</b>	<b>5.7</b>	<b>4.0</b>

Note: <sup>a</sup> Without 2004 inflation figures

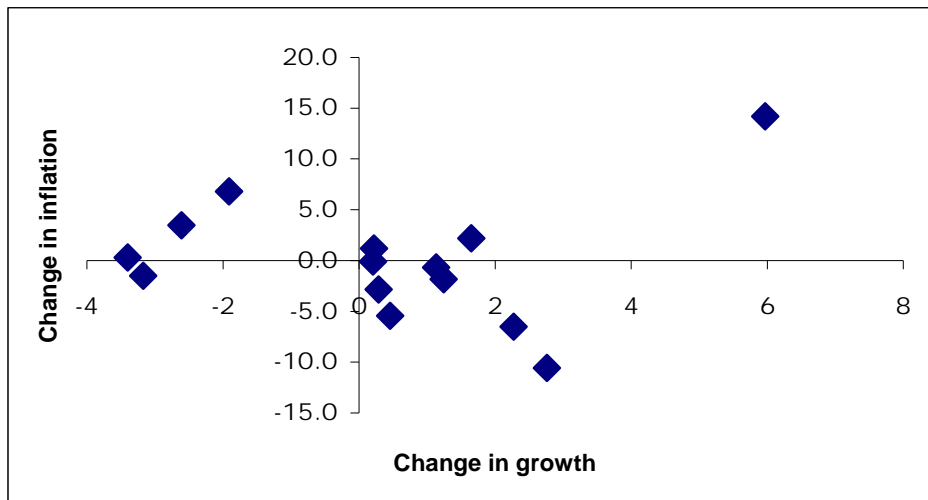
Source: IMF, *International Financial Statistics*, Washington DC, various years

Let us now look at the Sri Lankan experience over the 1980s and the 1990s. It was shown earlier that Sri Lanka has not experienced a significantly higher inflation rate than its South Asian neighbours, and for the most part has experienced a lower rate than other lower-middle income developing countries (Table 3.14 in chapter 3). A comparison of period average growth rates with period average inflation rates shows that inflation moves together with growth and not inversely (see figure 4.7).

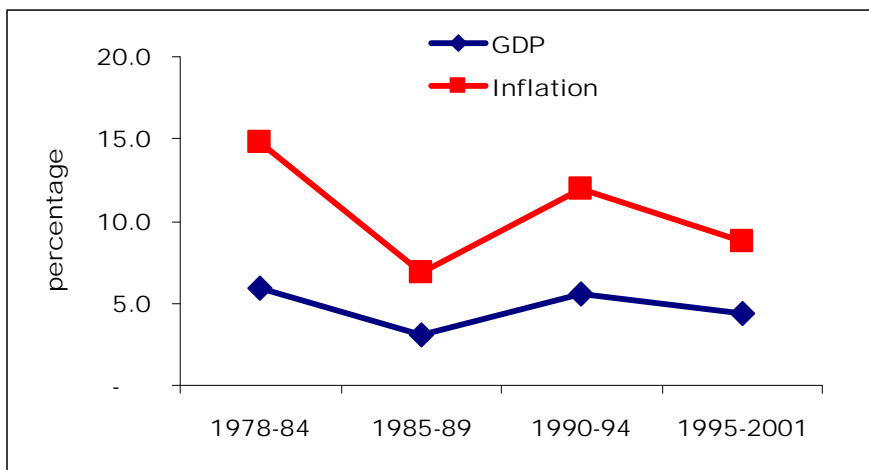
This argument should not be interpreted as saying that inflation has had a positive impact on growth, or even that curbing excessive inflationary pressures would have no significant positive impact on economic growth. Rather, the argument is that inflation tends to accompany accelerations in economic growth, and, indeed, the latter may even necessitate some inflation in the system as prices adjust to rapid structural changes. Hence, misguided policies, which seek to expunge all inflation from the system, are likely to do more harm than good with respect to economic growth, and, as such, are likely to result in only temporary reductions in inflation. In the end, and this is the real

lesson to be drawn from the East Asian experience regarding the link between growth and inflation, a sustained reduction in inflation rates to levels comparable with advanced country averages (and commensurate with phases in the international business cycle) will only be brought about by successful growth-augmenting strategies.

**Figure 4.6**  
Scatter plot of changes in growth vs changes in inflation for selected Asian economies, 1980-2000



**Figure 4.7**  
A comparison of average rates of growth and inflation over the period 1978-2001



### ***III. Economic Growth: The Fundamentals***

To understand the fundamentals of the economic growth process in the Sri Lankan economy with a view to deriving lessons for raising the rate of growth, one needs to look at the structure and dynamics of production.

## Commodity production

It is not unreasonable to expect that economic growth, particularly in developing countries, is fundamentally explained by changes in commodity production. This follows from the fact that;

- Commodity production, at least in most low and lower middle income countries, accounts for the largest share of GDP,
- Value added in commodity production tends to be more volatile than value added in services, and
- Value added in services is, arguably to a large extent, *derivative* of value added in commodity production.

Cross country data pertaining to low and middle-income developing countries over the last twenty years appear to confirm the above. These data show that changes in average annual growth rates of real value added in developing countries between the periods 1980-1990 and 1990-2000 are primarily associated with changes in commodity production growth rates (as opposed to services growth rates), and, in particular, industrial sector growth rates (see table 4.4).

**Table 4.4**  
**Coefficients of Correlation between Differences in Period Averages of (a) Aggregate and (b) Sectoral growth rates for developing countries, 1980-90 compared with 1990-2000<sup>a</sup>**

<i>Aggregate growth rate vs</i>	<i>Correlation Coefficient</i>
Commodity production <sup>b</sup>	0.87
Industrial output growth	0.83
Services output growth	0.78

Notes: <sup>a</sup> Data for 71 developing countries were used. The results are based on unweighted period averages.

<sup>b</sup> Composite of agriculture and industry growth rates weighted by GDP shares

Source: Authors' calculations using data drawn from the *World Development Report 2002*

Analogous Sri Lankan data for the period 1978-2001 are presented in table 4.5. These data show that changes in economic growth are more closely associated with changes in commodity production than with those in services in terms of value added at constant prices.

**Table 4.5**  
**Coefficients of Correlation between Annual Aggregate and Annual Sectoral Output Growth Rates for Sri Lanka 1978-2001**

<i>Aggregate growth rate vs</i>	<i>Correlation Coefficient</i>
Commodity production (a)	0.90
Services output growth	0.82

Notes: (a) Composite of agriculture and industry growth rates weighted by GDP shares.

Source: Authors' calculations using data drawn from the *World Development Report 2002*

### Industry

Commodity production comprises agricultural and industrial production activities. For a number of reasons growth in industrial production is argued to be potentially and actually higher than agricultural production growth over the medium and long-term. Hence, a shift in commodity production away from agriculture and towards industry is seen as

being likely to raise the overall economic growth rate<sup>7</sup>. Several studies of the experience of present-day advanced countries and the successful East Asian economies appear to confirm this hypothesis (see for example, Hansen and Zhang, 1996)<sup>8</sup>. In Sri Lanka, however, the rate of industrial growth and the concomitant shift to industry appears to have been entirely inadequate to generate an economy-wide growth rate in the order of magnitude of what would be required for “take off”. Specifically, while industrial growth has been higher than that of agriculture in the 1978-2004 period as a whole, and while there has been a shift away from agricultural production over this period (see table 4.6), the level and consistency of industrial growth has been inadequate to push aggregate economic growth up significantly and to shift the economy clearly towards industrial production. At first glance the data even appear to show a fall in the share of industrial value added over this period, from 27.2 per cent of GDP in 1978 to 26.5 per cent of GDP in 2004. As noted in chapter 3, this reflects, however, a distortion which emanates from the very nature of the data. It is perhaps useful to repeat the argument of chapter 3 regarding this point. Industrial value added is defined in Sri Lanka to include export processing of traditional agricultural exports. The shift away from agricultural production therefore, would involve a decline in this component of “industrial” production. Export processing fell from 9.1 per cent of GDP in 1978 to 2.2 per cent of GDP in 2001 as the value added in plantation agriculture diminished. When this component is excluded from industrial value added, one would observe a rise in the industrial value added from 18.2 to 24.7 per cent of GDP between 1978 and 2004.

**Table 4.6**  
**Composition of GDP, selected years, 1978-2001**

	<i>Percentage of GDP</i>			
	1978	1990	2000	2004
Agriculture	30.5	26.3	20.5	17.9
Agriculture (including export processing)	39.5	29.3	22.5	19.6
Industry (a)	27.2	26	27.6	26.5
Industry (excluding export processing)	18.2	23	25.5	24.7
<b>Commodity production</b>	<b>57.7</b>	<b>52.3</b>	<b>48.0</b>	<b>44.3</b>
Services (b)	42.3	47.7	52.0	55.7
GDP	100	100	100.0	100

Notes: (a) Includes electricity, gas, water and sanitary services

(b) Excludes electricity, gas, water and sanitary services

Source: Central Bank of Sri Lanka Annual Reports (various years)

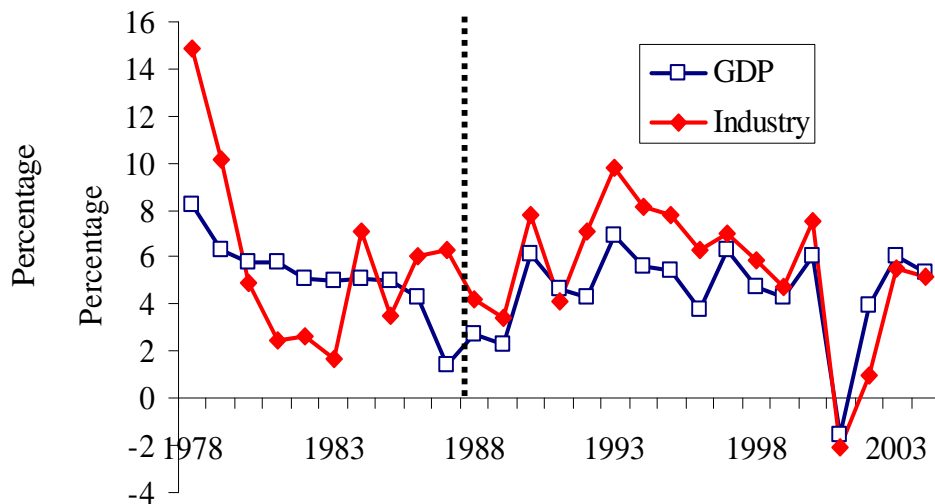
Even allowing for this qualification, the conclusion remains unchanged that the greater part of the shift in the structure of value added in Sri Lanka has been towards services. Even if export processing is excluded from value added by industrial activity, the increase in the share of industry can be seen to only account for one-third of the decline in share of agriculture. The problem remains one of an inadequate expansion of industrial production. It is a problem which becomes compounded with the shift in the commodity production structure away from agriculture. With this latter shift it is clear that industrial

<sup>7</sup> The rationale for higher growth emanating from the shift in production structure towards industry was most famously provided by N. Kaldor and is known today in the growth and development literature as Kaldor’s Growth Laws (see Kaldor 1966 and 1967).

<sup>8</sup> See also Bairam (1991) and also Drakopoulos and Theodossiou (1991).

production assumes, or should assume, a pivotal role in terms of aggregate economic growth (see figure 4.8).

**Figure 4.8**  
**GDP and Industrial sector growth rates, 1978-2001**



Export-oriented manufacturing

The question then is why industry has failed to take off. Whether export processing is included or excluded from industrial value added, it may be observed from data provided in table 4.7 that the latter is dominated by the movement of factory industry, at least from the mid-1980s onwards.<sup>9</sup> Factory industry growth is, in turn, fundamentally linked to (manufactured) export activity. Figure 4.9 shows the downward trend in the growth of earnings from manufactured exports over the 1990s. There was an increase in the rate of growth of earnings from manufactured exports during 2001-04, reflecting partly the revival from the negative growth condition of 2001, over the entire period, 1990-2004, these earnings show a negative trend. The question as to why industrial growth failed to take off thus becomes one of why export-oriented manufacturing failed to take off. Why has there not been, in Sri Lanka, as a sustained increase in manufactured exports as was seen, for example, in the successful East Asian economies during their take-off years? The short answer to this question lies in the (policy) failure to promote and diversify the manufactured production base for exports coupled with the failure to maintain/improve competitiveness in domestic manufacturing.

Table 4.8 shows that there has been little change in the general composition of Sri Lanka's manufactured export earnings since the mid-1980s. In 2004, 62 per cent of these

<sup>9</sup> It is of note that in the period 1978-84 construction activity contributed as much to growth in industrial value added as factory industry. This point will be returned to later in the context of a discussion of the public works based growth strategy pursued in those years.

earnings came from one product category, garments and textiles. If not for the slight move in the composition of export earnings away from garments and textiles during 2001-04, this ratio would have been higher. The textiles and garments ratio at the turn of the century was closer to 70 per cent. The problem of this heavy dependence on a single manufactured product category is compounded by the fact that the industry in question is a highly competitive industry (with competitors mostly drawn from other low and lower middle income developing countries). The industry is likely to become even more competitive with the imminent termination of the Multi-Fibre Agreement (MFA). Although there appears to have been some shift in export earnings towards the sub-categories “Leather, Rubber, Paper, Wood and Ceramics” and “Machinery, Mechanical and Electrical Appliances”, the extent of this shift has been modest. Prior to 2001, this shift has been almost entirely the result of shifts away from other non-Textile and Garments categories. In fact, the share of non-Textiles and Garments manufactured export earnings, at 30 per cent, fell to its lowest point in 2000, recovering however, to 38 per cent by 2004.

**Table 4.7**  
**Growth and composition of industrial value added, period averages, 1978-2004**

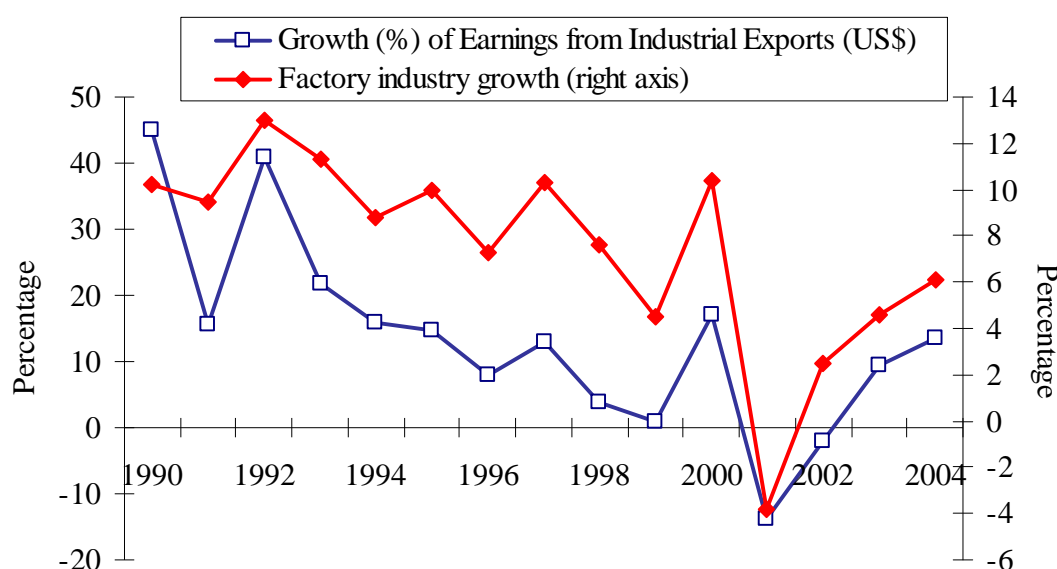
	1978-84	1985-89	1990-94	1995-04
<i>Growth rates (percentage change)</i>				
<b>Industry</b>	6.3	4.7	7.4	5.2
Export processing	0.6	1.8	2.3	2.0
Factory industry	7.1	8.6	10.6	6.2
Construction	8	1.2	5.3	4.6
Electricity, water, etc	12.3	4.3	8.9	6.0
<b>Real GDP</b>	<b>5.9</b>	<b>3.1</b>	<b>5.5</b>	<b>4.5</b>
<i>Contribution to industrial value added growth (percentage)</i>				
Export processing	1.9	4.9	2.7	1.6
Factory industry	37.3	68.9	64.7	44.3
Small industry	9.5	-4.1	3.5	3.0
Construction	36	7	20.5	18.2
<b>Electricity, water, etc</b>	7.1	4.4	6.3	4.0

Source: Central Bank of Sri Lanka Annual Reports (various years)

Figure 4.10 shows that earnings from manufactured exports other than Textiles and Garments, as a percentage of GDP, rose steadily from the late 1980s to the mid-1990s, and stagnated thereafter. Both this stagnation and the general failure to diversify the export (and import substituting) manufacturing base, can be attributed to a large extent to a policy shift away from export promotion. Lip-service continued to be paid to export promotion from the mid-1990s onwards, but the fact was that there was a general withdrawal of incentives/support for export-oriented (and import-substituting)

manufacturing industries<sup>10</sup>. The overvaluation of the exchange rate and high lending rates formed an important part of this move away from explicit export promotion strategy. The broader growth consequences of the shift in strategy away from export promotion and towards the so-called “level playing field” approach will be discussed later in a general discussion of growth strategies. The remainder of this section will focus on the aforementioned factors and their consequences for the loss of competitiveness of Sri Lankan manufacturers.

**Figure 4.9**  
**Growth of Factory Industry and US dollar industrial exports earnings, 1990-2004**



**Table 4.8**  
**Composition of manufactured export earnings, selected years and period averages, 1978-2001**

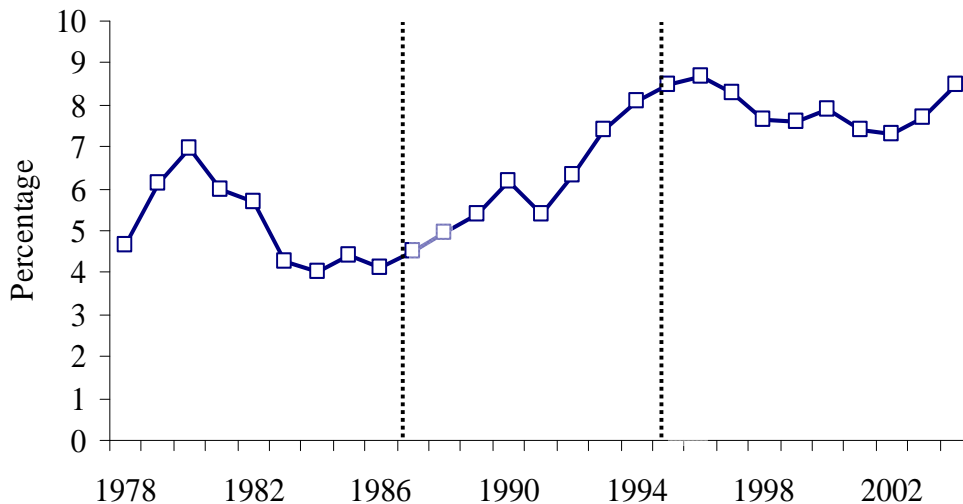
	1978	1978-84	1985-89	1990-94	1995-04
<i>Per cent of total manufactured export earnings</i>					
Food, Beverages and Tobacco	14.1	7.8	4.0	3.0	3.3
Textiles and Wearing Apparel	26.0	40.6	61.1	65.3	66.0
Chemical and Petroleum products	53.0	44.5	17.4	7.0	3.1
Leather, Rubber, Paper, Wood and Ceramics	5.9	5.3	8.1	11.8	12.1
Plastics	0.0	0.0	0.0	0.4	1.0
Machinery, Mechanical and Electrical Appliances	0.9	1.5	2.3	4.4	6.0
Jewellery and Diamonds	0.0	0.3	7.0	7.3	5.4

Source: Central Bank of Sri Lanka Annual Reports (various years)

<sup>10</sup> It must again be reiterated that the habit of describing the country’s industrial policy as “export oriented” prevailed throughout the post 1977 period although policy became truly export-oriented in only part of this period.



**Figure 4.10**  
**Non-Textile and Garments Manufactured Export Earnings, as a percentage of GDP, 1978-2004**



Currency overvaluation

It was noted in chapter 3 that the US dollar has represented something of a real anchor for movements in the Sri Lankan rupee for most of the 1979-2004 period<sup>11</sup>. The problem is that this purchasing power parity track of the US dollar by the Sri Lankan rupee has caused the rupee to lose competitiveness in respect of other currencies, especially those of competitor countries. This was so especially in the post-1990 period. Table 4.9 provides data to show that for the period 1979-2004 as a whole the Sri Lankan rupee appreciated in real terms against trading partner and competitor countries together, with the rate of appreciation markedly higher after 1990. While the rupee depreciated in real terms against trading partners, there has been substantial appreciation of the rupee against competitor country currencies.

Against all trading partners the rupee depreciated in real terms 1979 and 2004 by 32 per cent. This includes a 13 per cent and 37 per cent real depreciation of the rupee respectively against the US dollar and the German mark/euro with a real appreciation of 1 per cent against the Japanese Yen. In terms of the behaviour of the real external value of the rupee against trading partners, the period 1990-2004 has two distinct sub-periods – 1990-2001 characterised by a process of real appreciation, followed by a depreciation process in 2002-2004. In the former sub-period, the rupee had appreciated against trading partner currencies by 29 per cent. In contrast, the rupee depreciated in real terms against trading partner currencies in the ensuing sub-period of 2002-04 by a massive 46 per cent. As for the initial period of 1979-89, there was similar appreciation of the rupee against trading partner currencies in 1979-84, followed by a large depreciation in 1985-89. The rupee becoming considerably overvalued, somewhat fortuitously against trading partner

<sup>11</sup> 1979 is taken as the starting point in respect of exchange rate discussions because the picture of currency movements in 1978 was distorted by the unification of the dual exchange rate system that operated in the preceding period, and the major shift in policy regime that underlay these changes.

currencies as a whole over 1979-84, had made the net import bill for the massive capital expenditure programme undertaken during this period far lower than it otherwise would have been had purchasing power parities prevailed. That the rupee overvaluation during this period was far from a conscious policy on the part of the monetary authorities is evidenced by the fact that the currency maintained purchasing power parity with the US dollar throughout. Indeed, it was the appreciation of the latter against other major currencies that led to the real appreciation of the rupee against all trading partners during this period.

Against competitor countries the average real appreciation of the Sri Lankan rupee between 1979 and 2004 is 71 per cent, with most of this taking place in the period 1990-2004, a period when the growth dynamic shifted to export-based manufacturing activity. Between 1990 and 2004 the real value of the rupee appreciated by 52 per cent against competitor countries. Although the data presented in table 4.9 suggests that most of this appreciation in turn took place between 1990 and 1994, i.e., during the high industrial growth period, it warrants noting that there had been a large, 26 per cent, nominal depreciation of the rupee in late 1989. Hence, a significant part of the real appreciation of the rupee in the ensuing 1990-94 period can be taken as representing an erosion of the additional competitive advantage accorded to exporters by the preceding currency depreciation. Moreover, in the context of the other incentives (such as concessional credit, tax exemptions, tariff rebates, etc) which were put into place between 1990 and 1994, such erosion of competitiveness was unlikely to have a significant bearing on export performance. It was entirely another matter, however, when, in the ensuing post-1995 period, the real appreciation of the rupee against competitor country currencies continued amidst the dismantling of various export incentives.

**Table 4.9**  
**Cumulative overvaluation/undervaluation of the Sri Lankan rupee, period aggregates, 1979-2004 (a)**

	1979	1990	1979	1979	1985	1990	1995	1995
	-89	-04	-04	-84	-89	-94	-01	-04
	Percentages							
Trading partners(b)	-15.4	-16.6	-32.0	43.5	-58.8	16.5	13.0	-33.1
<i>US</i>	-27.1	13.8	-13.3	-5.8	-21.3	24.2	-14.6	-10.4
<i>Japan</i>	-16.2	16.9	0.7	48.9	-65.1	-3.5	32.8	20.4
<i>Germany</i>	-0.8	-36.0	-36.8	70.9	-71.7	16.5	27.8	-52.4
Competitors (c)	18.7	52.2	70.8	28.5	-9.9	34.7	22.8	17.5
<i>India</i>	16.9	45.9	62.8	26.0	-9.0	62.1	-4.5	-16.2
All (d)	<b>5.0</b>	<b>24.7</b>	<b>29.7</b>	<b>34.5</b>	<b>-29.5</b>	<b>27.4</b>	<b>18.9</b>	<b>-2.8</b>

(a) Positive sign implies overvaluation and negative sign implies undervaluation

(b) Trading partners comprise the US, Japan, Germany, France and the UK

(c) Competitors comprise India, Pakistan, Bangladesh, Malaysia, Indonesia, Korea, Philippines and Thailand

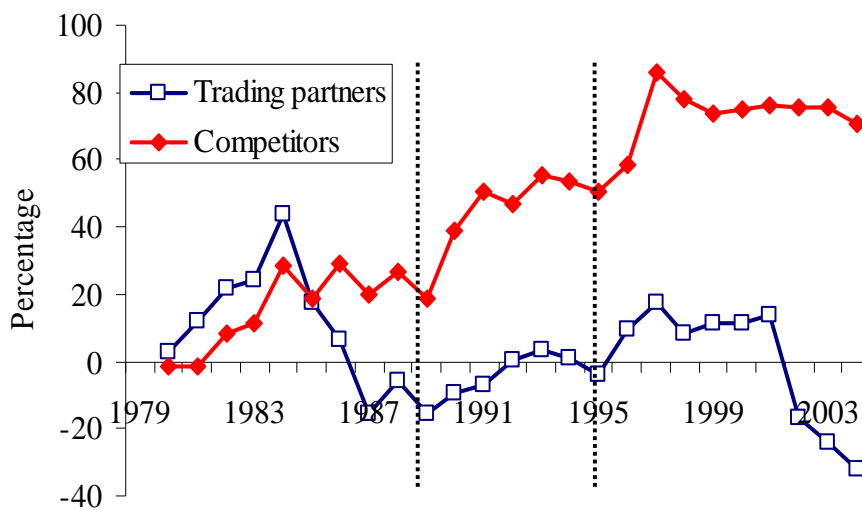
(d) Competitor countries have a 60 per cent weighting and trading partners a 40 per cent weighting

Source: Authors' calculations using data derived from the International Financial Statistics, October 2002

Figure 4.11 provides trend information on the real value of the Sri Lankan rupee in respect of trading partner and competitor countries since 1979. This information serves to complement the period averages data on rupee overvaluation presented in table 4.9.

When inflation differentials exceed exchange rate changes, the real value of the rupee is said to be rising. It is evident from the chart that 1989 and 1995 are watershed years for the real value of the Sri Lankan rupee. From 1989 the rupee loses considerable ground in respect of competitor countries, while from 1995 onwards up to 2001, it also loses ground in respect of trading partners. In terms of trade partner country currencies, the rupee depreciated in real terms but continued to remain overvalued against currencies of competitor countries.

**Figure 4.11**  
**Cumulative overvaluation/undervaluation of the Sri Lankan rupee vis-à-vis trading partners and competitors, 1979-2004 (a)**



#### High real lending rates

Table 4.10 presents the available data on a number of important lending rates. The unsecured lending rate is perhaps the least reliable indicator of interest rate pressures since the reporting of this rate tends to be somewhat arbitrary. Most policy attention tends to be focused on the prime lending rate. Unfortunately, the time period covered by this rate does not span the entire period under consideration. These limitations notwithstanding, the story told by all of the lending rates is fairly similar. Comparing period averages for real lending rates with those for aggregate GDP and industrial growth show that periods of relatively low real interest rates correspond to periods of relatively high aggregate and industrial production growth, and *vice versa*. The implication of this finding in view of the preceding analysis is that high real lending rates, particularly in the context of the above mentioned withdrawal of credit facilities to exporters, have most likely contributed to inertia of the industrial sector in the recent past.

**Table 4.10**  
**Real lending and production growth rates, period averages, 1978-2004**

	1978-84	1985-89	1990-94	1995-04
	Percentages			
Bills discounted <sup>a</sup>	4.5	10	8.5	12.1
Secured lending <sup>a,b</sup>	5.4	13.6	9.2	11.2
Unsecured lending <sup>a</sup>	7.2	14.9	12.3	13.0
Prime lending	-	8.8	7.4	8.9
Real GDP growth	5.9	3.1	5.5	4.5
Real Industrial production growth	6.3	4.7	7.4	5.2

(a) Mid-point rates

(b) Secured by stock in trade

Source: Authors' calculations based on Central Bank of Sri Lanka Annual Reports (various years)

*Agricultural food production*

Although agricultural production growth does not provide the basis for accelerated aggregate economic growth in the same way that industrial growth does, it is known that the growth of domestic food production, particularly on the basis of productivity increases, can play an important role in facilitating and sustaining an industry-led growth process, especially in its early stages. One crucial element in this regard is the cheap food provided by the sector for the growing urban and rural off-farm industrial and service sector work force. A cheap and efficient domestic food supply can help moderate wage hike pressures, particularly in the context of a competitive exchange rate strategy.

**Table 4.11**  
**Agricultural production growth and levels, period averages, 1979-2004**

	1979-89	1990-04	1979-84	1985-89	1990-94	1995-04
	Percentage					
<b><i>Growth rates</i></b>						
Paddy	2.4	2.3	5.6	-2.2	5.5	0.7
Other non-plantation agriculture	3.9	2.1	4.8	2.7	3.6	1.4
<b>Real GDP</b>	<b>4.7</b>	<b>4.9</b>	<b>5.9</b>	<b>3.1</b>	<b>5.5</b>	<b>4.5</b>
<b><i>Production levels of minor agricultural crops</i></b>			('000 Mt tons)			
Big onion	3.6	37.2	1.8	6	37.5	37.0
Black gram	8.6	8.1	7.8	9.8	10.4	7.0
Chillies	30.0	22.0	25.7	35.9	33.6	16.2
Cowpea	22.7	15.2	26.9	16.9	19.8	12.9
Gingelly (Sesame)	11.3	5.8	14.2	7.2	7.9	4.7
Green gram	16.5	18.2	14.3	19.6	27.8	13.3
Ground nuts	11.3	9.1	11.3	11.2	11.9	7.7
Kurakkan (Finger Millet)	8.9	4.6	10.8	6.3	4.7	4.5
Maize	40.8	42.5	37.5	45.3	59.2	34.1
Potatoes	80.5	65.3	68.1	98.0	63.7	66.1
Red onions	86.2	56.8	81.6	92.6	82.2	44.1
Soya beans	5.9	2.2	5.3	6.6	3.8	1.5

In Sri Lankan national accounts data, domestic food production comes under the sub-category “non-plantation agriculture”, covering paddy and other non-plantation agricultural products. Table 4.11 shows that growth of non-plantation agriculture was lower in the post-1990 period, particularly the post-1995 period, than the pre-1990 period. It shows that, as with industrial growth, alternating periods of high and low non-plantation agricultural growth correspond to alternating periods of high and low aggregate economic growth. The table also provides data on period average output levels of individual minor agricultural crops. It is particularly noteworthy that in the period 1995-2004 only big onions among minor agricultural products registered at least a comparable level in absolute production with the preceding sub-period, 1990-94, with all other crops registering falling production levels. Indeed, in the case of most crops, production levels in the 1995-2004 sub-period were the lowest among the four sub-periods into which we have divided the period under consideration.

Given the complex nature of policy and non-policy factors influencing agricultural production<sup>12</sup>, it is not possible to provide simple explanations for the poor performance of non-plantation agricultural sector over the last quarter century, nor even during the second half of the 1990s. During this more recent period, the poor performance of this segment of agriculture can no doubt be attributed partly to weather. However, it is clear that changes in the incentive structure pertaining to the sector, brought about by policy changes, also played a significant role. A contradiction which often prevented policy consistency in regard to non-plantation agriculture has been the conflict of interest between, on the one hand, consumers, whose agitation was for low food prices, and, on the other hand, agricultural producers whose interest lies in higher food prices<sup>13</sup>. Again, it is more than likely that these conflicting interests and corresponding pressures (reinforced by the liberalisation pressures emanating from the IFIs) were at least partly responsible for the lack of policy consistency with regard to non-plantation agricultural production.

**Table 4.12**  
**Quantity of imports of selected minor agricultural crops: Period Averages, 1978-99**

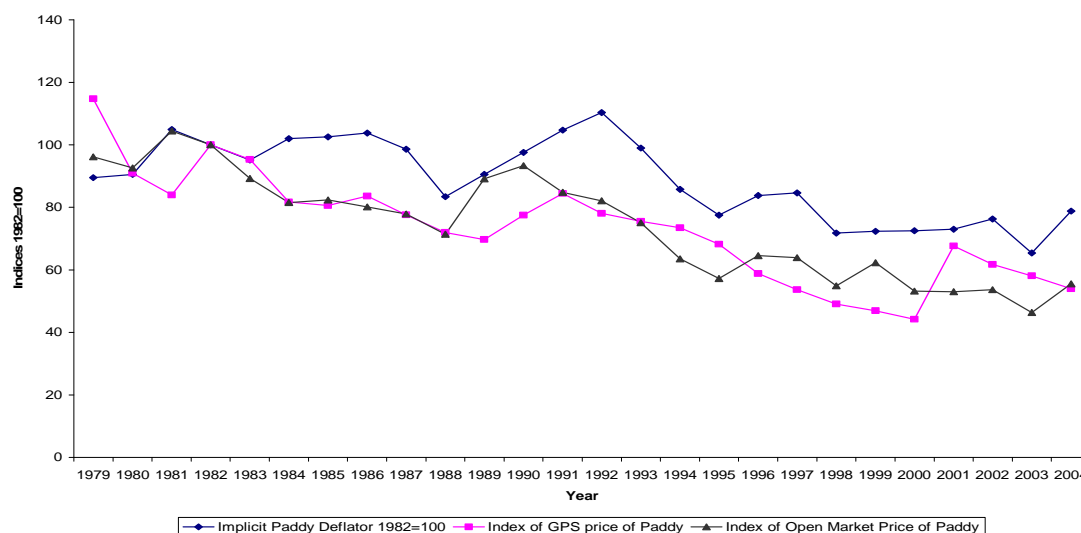
	1978-90	1990-94	1995-99	1990-99
	('000 Mt tons)			
Maize	9.9	40.0	86.3	69.1
Chillies	-	10.0	19.5	15.0
Soya beans	-	3.5	2.4	2.0
Potatoes	0.3	2.8	72.7	44.0
Big Onions	21.0	31.2	79.1	60.6

Source: Authors calculations based on FAOSTAT data

<sup>12</sup> As World Bank (2003: 17) argues, all these factors created a “complex and multi-dimensional maze of obstacles ... which ultimately dampened agricultural productivity growth”.

<sup>13</sup> With the shift to more market determined prices, it would appear that changes in food prices have come to reflect changes in conditions of supply. This comes out clearly if changes in the implicit GDP deflator of food prices are plotted in a graph together with changes in non-plantation agricultural production – the two variables used to reflect domestic food price movements and changes in domestic food production respectively. It may be seen that there is an almost perfect inverse relation between the two variables over the period 1992-2001. The correlation coefficient for the joint movement of the two variables is -0.92.

**Figure 4.12**  
Trends in the relative producer price for paddy, 1978-2004



Overall, the policy positions moved in the direction of greater liberalisation, especially because the IFIs consistently highlighted the importance of such policies. Within the context of this long-term liberalisation trend in respect of agricultural production, there were repeated instances of increasing agricultural protection and policy vacillations in respect of input and product subsidies for food agriculture. Yet the liberalisation drive has dominated the pattern of overall developments and there has been no consistent attempt to build up a (viable) domestic food production sector. In the case of paddy a major underlying problem appears to have been a shift in consumption patterns away from rice and towards other staples such as wheat flour. To a considerable extent, the effect of this shift on rice producers would have been perhaps mitigated if the paddy price support scheme that existed in the name of Guaranteed Price Scheme (GPS) was effective. Indeed in most years during the period under consideration, the GPS price was not only lower than the open market price, it also declined over the years in relative terms (Table 4.12). In the liberalising framework, paddy prices have, whatever the measure one uses to approximate to these, declined in relative terms. Their relative decline is shown in Table 4.12 in relation to the Colombo Consumers' Price Index (CCPI). Had a manufacturing sector price index been used instead, the decline in the terms of trade of paddy agriculture would have appeared more pronounced.

Coupled with the decline in credit facilities and fertiliser subsidies, it is small wonder that the rate of paddy output growth also fell in the 1995-2004 period (Table 4.11), notwithstanding a 2 per cent annual average rise in yields<sup>14</sup>. In the case of minor agricultural crops the decline in output levels is mostly attributable to liberalisation of imports of these crops following the adoption of structural adjustment policies. Problems caused by import liberalisation were aggravated by the overvaluation of the exchange rate

<sup>14</sup> Paddy yields per hectare rose from 3453 kg in 1990 and 3595 kg in 1995 to 3856 kg in 2000 and 4080 kg in 2004.

vis-à-vis currencies of the countries from which Sri Lanka obtained most of its agricultural food product requirements. The extent of the impact of trade liberalisation in general, and the adoption of the WTO Agreement on Agriculture in the second half of the 1990s, in particular, can be seen from a comparison of quantities of imports of selected minor agricultural products (table 4.12) with their domestic production levels (Table 4.11). The rise in imports of minor agricultural products in the post-1990 period, more especially in the post-1995 period, corresponds with the decreases in their domestic levels of production<sup>15</sup>.

#### ***IV. Growth and Growth Policies***

In chapter 3 three distinct sets of growth policies were identified in relation to Sri Lanka's growth experience over the 1978-2004 period; the public investment led strategy, the EOI strategy, and the so-called "level playing field" strategy. This section seeks to build on the description of each of these strategies provided in chapter 3 with a view to evaluating their relative conduciveness to a high and sustainable rate of economic growth. Some repetition of the presentation in chapter 3 in the following sections is considered to be unavoidable, but an attempt will be made to keep this repetition to a minimum.

##### **Public investment strategy, 1978-84**

While the public investment-led growth strategy adopted in the 1978-84 period undoubtedly boosted economic growth, it did so in a fundamentally unsustainable manner. First, the strategy was based on the existence of generous grant aid and concessional external borrowing facilities. Grant aid and concessional borrowing facilities in the order of 10 per cent of GDP funded a rise in aggregate investment as a percentage of GDP by an equal magnitude over the period 1979-84. Second, in spite of the generous levels of foreign financing which supported the massive increase in government capital expenditure between 1978 and 1984, these high levels of capital expenditure still placed a considerable burden on domestic resource mobilisation. Domestic resource requirements for this period amounted to an annual average of 7 per cent of GDP (and over 9 per cent of GDP in the period 1979-82). Third, the annual average current account deficit jumped to an order of magnitude of some 10 per cent of GDP over the same period, with the trade deficit, aggravated by the surge in world oil prices, rising to an annual average of over 18 per cent of GDP. Finally, and perhaps most importantly of all, the strategy failed to induce a corresponding sustainable increase in private sector activity. The expected structural increase in non-plantation agricultural production was not forthcoming in spite of the considerable investment in irrigation systems. Nor was there any significant expansion of the manufacturing sector as a result of the implied expansion in domestic demand. In actual fact, annual average manufacturing growth during this period, at 5.2 per cent, was the lowest, and services growth, at 7.2 per cent, the highest for any of the aforementioned sub-periods between 1978 and 2004 (see table 4.13).

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<sup>15</sup> The two sets of data are not exactly comparable since the FAOSTAT import data series only extend up to 1999.

**Table 4.13**  
**Selected macroeconomic variables pertaining to public investment-led growth process, 1978-2001**

	1978-84	1985-89	1990-94	1995-04
			<i>percentage of GDP</i>	
Budget deficit (before grants)	-15	-12.4	-9.7	-9.0
Government capital expenditure	16	11.3	6.1	5.0
Current account (BoP)	-10	-7.2	-6	-3.5
			<i>percentage change</i>	
GDP	5.9	3.1	5.5	4.5
<i>Non-plantation</i>	5.0	0.7	4.1	1.0
<i>Manufacturing</i>	5.2	5.9	8.9	5.5
<i>Services</i>	7.2	3.2	5.4	5.4

Source: Central Bank of Sri Lanka Annual Reports (various years)

### **Export-oriented manufacturing strategy, 1990-94**

The export-oriented strategy which prevailed over the period 1990-94<sup>16</sup>, probably having begun as early as 1987, was the most sustainable of the three strategies of growth in Sri Lanka. Certainly, the economic growth which resulted would probably have been more rapid and sustained had the strategy not included elements of the ensuing “level playing field” strategy, particularly trade and financial liberalisation, and had the stabilisation measures adopted during this period been less contractionary.

The export-oriented strategy, as outlined in chapter 3, was based on an aggressive promotion of manufactured exports, which began in earnest with a 26 per cent depreciation of the exchange rate in late 1989. The strategy entailed, among other things, concessional credit facilities, tariff rebates, fast-track import and export facilities, macroeconomic policy coordination in respect of all policies having a direct bearing on manufactured export activity, etc. Private sector investment rose in response, greatly facilitated by the concessional credit available to export-oriented manufacturers. The result was that factory industry value added surged on the basis of a sharp rise in manufactured exports (see table 4.14). These developments in turn encouraged foreign direct and portfolio investment flows and contributed to a rise in official external reserve cover from 1.7 to 5.1 months of imports.

Clearly there were many parallels between the strategy adopted by the Sri Lankan policy makers during these years and those pursued in the successful East Asian economies. In the Sri Lankan case, however, the export-oriented strategy was accompanied by a number of policies and measures which emanated from the structural adjustment programme the authorities had simultaneously embarked upon. These measures had certain detrimental consequences for the growth process. These policies and measures will be discussed in greater detail below in the context of the discussion of the so-called level playing field

<sup>16</sup> The reader is referred to footnote 3 of chapter 3 in order to avoid likely misunderstanding of the authors’ intentions in their description of this sub-period as one of “export-orientation”.



strategy, but a few of those which had produced negative consequences for economic growth during the 1990-94 period, particularly towards the end of it, may be noted here.

**Table 4.14**  
**Selected macroeconomic variables pertaining to the export-oriented growth process, 1978-2004**

	1978-84	1985-89	1990-94	1995-04
	<i>Annual percentage change</i>			
GDP	5.9	3.1	5.5	4.5
Factory industry growth	7.1	8.6	10.6	6.2
Manufactured export earnings (US\$) growth	16.7	7.8	27.8	7.4
GDP Food price deflator	16.0	8.0	13.7	9.5
Real discount rate	4.5	10.0	8.5	9.9
Nominal interest rate spread (a)	1.1	3.8	5.0	7.4
	<i>Cumulative percentages (positive = real appreciation, negative = real depreciation)</i>			
Rupee vs trading partner and competitor country(b) currencies	34.5	-29.5	27.4	-2.8
Rupee vs competitor country currencies (c)	28.5	-9.9	34.7	17.5
	<i>Months' imports</i>			
External reserves (end period)	3.5	1.7	5.1	4.5

Note: (a) Discount rate less 12 month deposit rate  
(b) & (c) See notes to Table 4.9 for the list of partner and competitor countries in trade used in these computations.

Source: Central Bank of Sri Lanka Annual Reports (various years)

One of the most important of these was the contractionary fiscal and monetary policy. This policy resulted in, on the one hand, a sharp decline in government capital expenditure and, on the other hand, an increase in real lending rates. The following quote from the 1994 Annual Report of the Central Bank is instructive in this regard:

In the wake of a sustained high growth in monetary aggregates, the Central Bank was compelled to pursue a tight monetary policy stance during 1994, although the Bank's ability to conduct aggressive open market operations was hampered by a depleted stock of Treasury bills in its portfolio. .... In the context of the limited scope for conducting open market operations through Treasury bills, the Central Bank issued its own securities with 3 - 6 month maturity to mop up excess liquidity. ... As a further means of restraining the growth of reserve money, the Central Bank terminated its short-term refinancing facility.... Export credit refinance facilities provided in respect of pre-shipment credit provided by commercial banks were terminated with effect from 31 May 1994. (Central Bank Annual Report, 1994: 160-61)

A second policy of importance in this regard was the progressive overvaluation of the exchange rate. This policy, like the contractionary fiscal and monetary policy, was the result of a misguided shift in policy focus towards the curtailment of inflation. From table 4.14 it may be seen that the overvaluation policy caused Sri Lanka's real exchange rate to appreciate by some 35 per cent against competitor country currencies during this period.

To the extent that the general policy environment remained friendly to export-oriented manufacturing, the adverse impact of these negative forces was somewhat mitigated. However, with the shift to the level playing fields strategy, and the withdrawal of compensating incentives and support measures for domestic producers, the negative growth consequences of these anti-inflation, “stabilisation” (and adjustment) measures became increasingly manifest.

### **Level playing field strategy, 1995-2004**

The level playing field growth strategy as outlined in chapter 3 may be regarded as the structural adjustment growth strategy in its purest form. As noted, this strategy is characterised by four important elements: trade liberalisation, financial liberalisation, privatisation/deregulation and stabilisation. The first three of these elements will be discussed immediately below while the stabilisation strategy will be taken up later in the context of the discussion of inflation and the balance of payments. The essential conclusion which emerges from this discussion is that the level playing field strategy, which saw the full light of day in the 1995-2004 sub-period, did not enhance economic growth in Sri Lanka and, what is more, actually stifled, if not reversed, the growth momentum generated by the preceding 1990-94 export-oriented manufacturing strategy.

#### Trade liberalisation

It has been repeatedly argued, in defence of trade liberalisation measures promoted under the auspices of structural adjustment packages, that trade liberalisation *per se*, as opposed to export promotion, is critical to the acceleration of economic growth in developing countries. The theoretical rationale offered includes, *inter alia*, economies of scale resulting from production for a larger market, lower input costs as a result of cheaper (and better) imports, increased efficiency of domestic producers as a result of increased competition from foreign producers, the more efficient use of resources as a result of specialisation in terms of natural comparative advantage, etc.

Notwithstanding the various studies undertaken by, or at the behest of, the IFIs themselves, a great deal of empirical evidence shows, as common sense suggests, that trade liberalisation *per se* has not enhanced the growth processes of developing countries in either the recent or the distant past. Indeed, there is now a significant literature showing, contrary to “conventional wisdom”, that advanced countries themselves did not grow as a result of trade liberalisation *per se*. Rather, extensive and protracted protection/ promotion of domestic industry had formed the basis for their growth processes<sup>17</sup>.

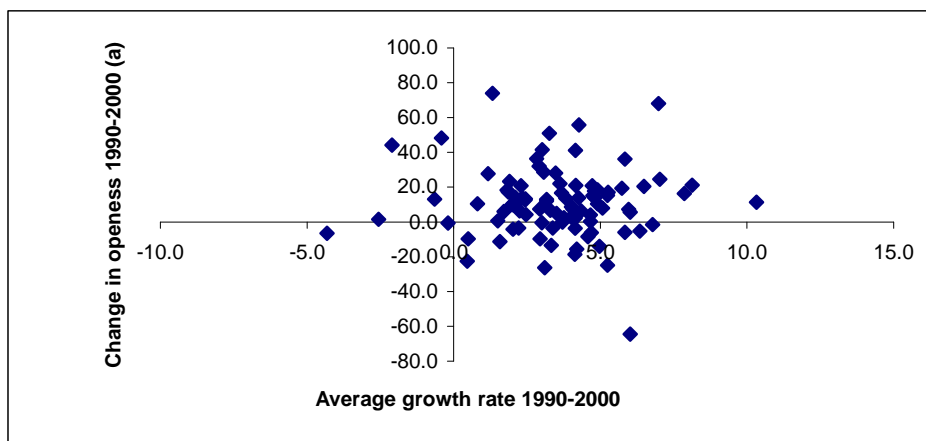
Many studies use changes in the value of trade as a proportion of GDP as an indicator of trade liberalisation. These studies, seeking to show that trade liberalisation has impacted positively on economic growth, typically derive a composite weighted average indicator of openness, using relative GDP levels as weights. Since the weighted average approach assigns a disproportionately large weight to countries like China and India, that have in fact grown due to extensive support for domestic industries, the result is an apparently high degree of correlation between openness and economic growth. Even if one does not eliminate those countries which have expanded trade on the basis of considerable state

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<sup>17</sup> See for example Chang (2002) and Shafaeddin (1998)

intervention, but instead compares openness with economic growth (on an unweighted basis), then it is entirely unclear that economic growth is related to trade liberalisation. Figure 4.13 does precisely this. It compares economic growth and openness for an unweighted sample of developing countries. It confirms the expectation that there is no apparent relation between openness and economic growth. If one were to go further and look at the experiences of high growth developing economies, such as those in East Asia, it is evident that, although rising and high economic growth rates were accompanied by trade expansion, the latter had little or nothing to do with liberalisation *per se*. Where these countries were forced to reduce trade barriers and eliminate other direct trade supports, they resorted aggressively to indirect protective/ promotional mechanisms, including concessionary credit, hidden subsidies, tax exemptions, research and development support, etc.

**Figure 4.13**  
**Openness and economic growth across developing countries, 1990-2000<sup>18</sup>**



(a) Change in openness is given by the change in the ratio of trade to GDP

The Sri Lankan data also do not vindicate the thesis that trade liberalisation accelerates economic growth. To begin with there appears to be no consistent relation between period average ratios of trade to GDP and GDP growth. Thus, although there appears to have been an increasing openness of trade in the 1995-2004 sub-period as compared with the preceding 1990-94 sub-period, the average growth rate declined from the latter to the former sub-period. Of course it could be argued that the ratio of trade to GDP is a flawed measure of trade liberalisation. An alternative, more robust, measure may arguably be trade tax revenues as a percentage of GDP. Indeed, comparing trends in trade as a percentage of GDP with trade taxes as a percentage of GDP (see figure 4.14) does show a clear divergence between the two variables, with attendant consequences for their respective ability to depict openness. In figure 4.14, the two variables move together up to 1990 while after 1990 they diverge. However, a comparison of trade taxes with GDP growth suggests an even weaker relation between trade liberalisation and economic growth. Of note in this regard is again the sharp fall in trade based taxes as a percentage

<sup>18</sup> The developing countries selected are those for which data are provided in the World Bank's World Development tables of 2002.

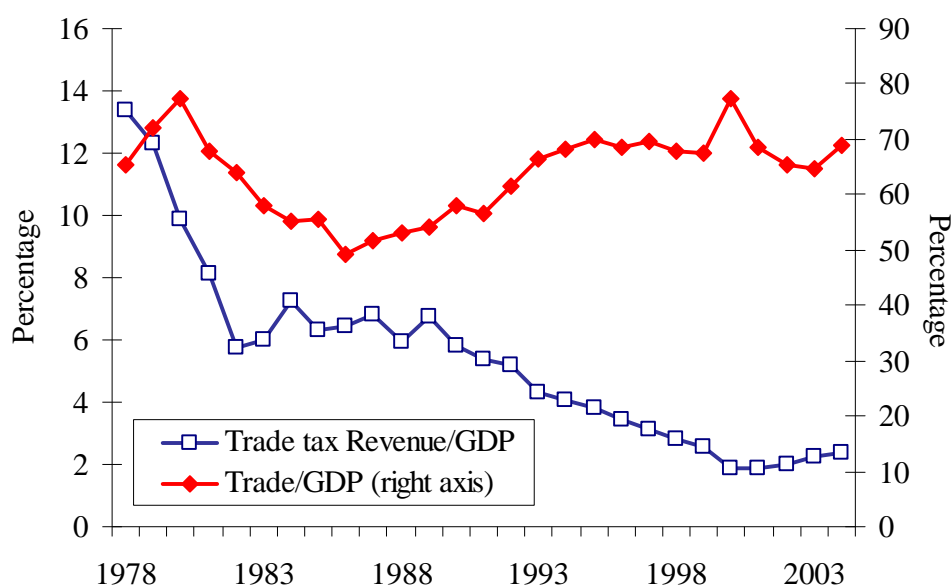
of GDP and the corresponding fall in GDP growth between sub-periods 1990-94 and 1995-2004.

**Table 4.15**  
**Trade liberalisation, 1978-2004, period averages**

	1978-89	1990-01	1978-84	1985-89	1990-94	1995-04
GDP growth	4.7	4.7	<i>Percentage change</i>		5.5	4.5
			<i>Percentage of GDP</i>			
<b>Trade</b>	<b>60.3</b>	<b>66.7</b>	<b>65.7</b>	<b>52.8</b>	<b>62.2</b>	<b>68.7</b>
Exports	23.6	28.4	25.4	21.1	25.6	29.6
Agricultural	13.4	6.7	16.3	9.4	6.9	6.1
Manufactured	8.5	20.6	7.5	9.9	17.1	22.6
Imports	36.7	38.3	40.3	31.7	36.6	39.1
<b>Trade tax revenues</b>	<b>7.9</b>	<b>3.7</b>	<b>9</b>	<b>6.4</b>	<b>4.9</b>	<b>2.6</b>
Import tax revenues	4.7	3.6	4	5.6	4.8	2.5
Export tax revenues	3.2	0.1	5	0.8	0.1	0.0

Source: Central Bank of Sri Lanka Annual Reports (various years)

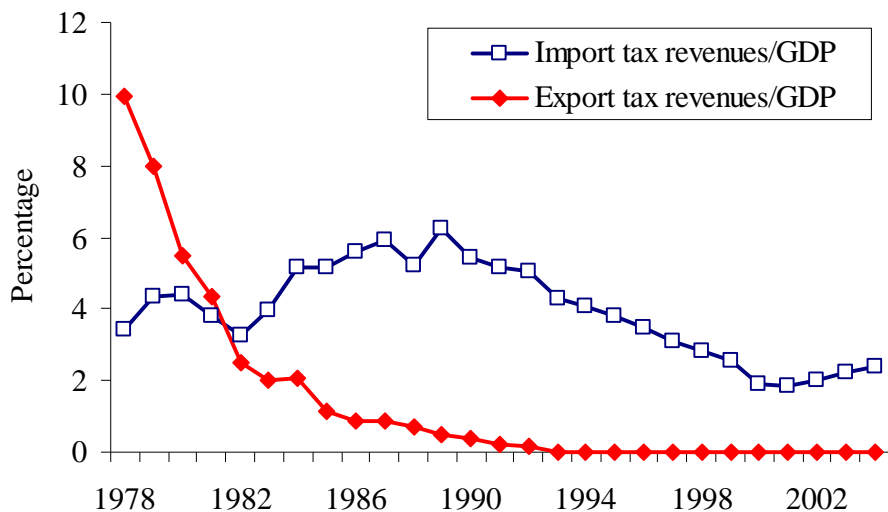
**Figure 4.14**  
**Trade values and revenues as percentages of GDP, 1978-2004**



It could be further argued that aggregate trade taxes as a percentage of GDP mask the nature of the dynamic impulses which such reductions impart to the economic system and that a more comprehensive understanding of these impulses requires a disaggregation of the trade taxes. Certainly, export tax revenues in Sri Lanka pertain mostly to duties in respect of the export of traditional export crops (tea, rubber and coconut products) while import tax revenues pertain to duties which have a broader impact on economic activity.

Moreover, it is also apparent that reductions in the two sources of trade-based taxes were far from synchronised (see figure 4.15). However, a comparison of the movement of agricultural exports with reductions in export revenues, and changes in overall GDP with the changes in revenues from import duties, does not help the liberalisation case (see table 4.15). The data presented in table 4.15 shows that agricultural exports as a percentage of GDP have declined systematically despite the decline in duties on these exports. Also, the correspondence between reduced revenues from tariffs and GDP growth does not appear to be any better. Of particular note once again is the combination, in the 1995-2004 sub-period, of the sharp fall in tariff revenue with the decline in the average GDP growth rate.

**Figure 4.15**  
**Import and export tax revenues as percentages of GDP, 1978-2004**



Financial liberalisation

It was noted earlier in the context of the discussion of private savings that the financial sector has grown considerably over 1978-2004 as a whole in spite of the fact that the most concerted policy assistance for this growth was provided in the 1990-2004 sub-period. Data provided in table 4.16 show a rising direct contribution of the sector to GDP growth throughout the entire 1978-2004 period, with the contribution becoming the largest in the post-1990 period, and in particular, during 1995-04. That is to say, these data appear to show that the financial sector grew most rapidly when financial sector liberalisation and development was pursued the most vigorously. One further point of note is that the increased contribution of the financial sector to aggregate value added growth has meant that the share of this sector in overall GDP has also risen appreciably – as shown in the last row of Table 4.16. Figure 4.16 contrasts the trends in the GDP share of the financial sector – banking, insurance and real estate in the national accounts – with that of the fast growing factory industry sector. The GDP shares of the two sectors have been normalised to facilitate comparison. It can be seen from the chart that the financial sector has expanded considerably more rapidly than the factory industry sector. In value

added terms, the financial sector rose from just under one quarter the size of factory industry in 1978, to just under three-fourths its size by 2004. Given this fact alone, it could be argued with some justification that the excessive growth of the financial sector actually stifled industrial growth<sup>19</sup>.

**Table 4.16**  
**Financial sector developments 1978-2004, period averages**

	1978-89	1990-04	1978-84	1985-89	1990-94	1995-04
	<i>Percentage</i>					
Contribution of banking, etc. to GDP growth	7	12.4	6	8.7	7.4	15.0
Real deposit rate (1)	2.2	0.8	0.4	4.7	1.3	0.6
Loan-deposit spread (2)	2.3	6.6	1.1	3.8	5	7.4
	<i>Percentage of GDP</i>					
Financial savings (3)	17.9	27.6	16.8	19.4	22.9	29.9
Aggregate private savings	12.1	18.4	12.3	11.8	16.2	19.6
Loans and advances by commercial banks	24.4	26.1	24	24.9	25.4	26.4
Aggregate Investment	25.7	25.0	27.6	23.1	24.4	25.3
Banking, insurance, etc.	3.6	7.3	3.1	4.2	5.6	8.1

Notes: (1) Weighted average

(2) The loan rate is taken as the mid-point of the bills discounted rate and the deposit rate is taken as the mid-point of the 12 month fixed deposit rate.

(3) Comprising savings and fixed deposits of commercial banks

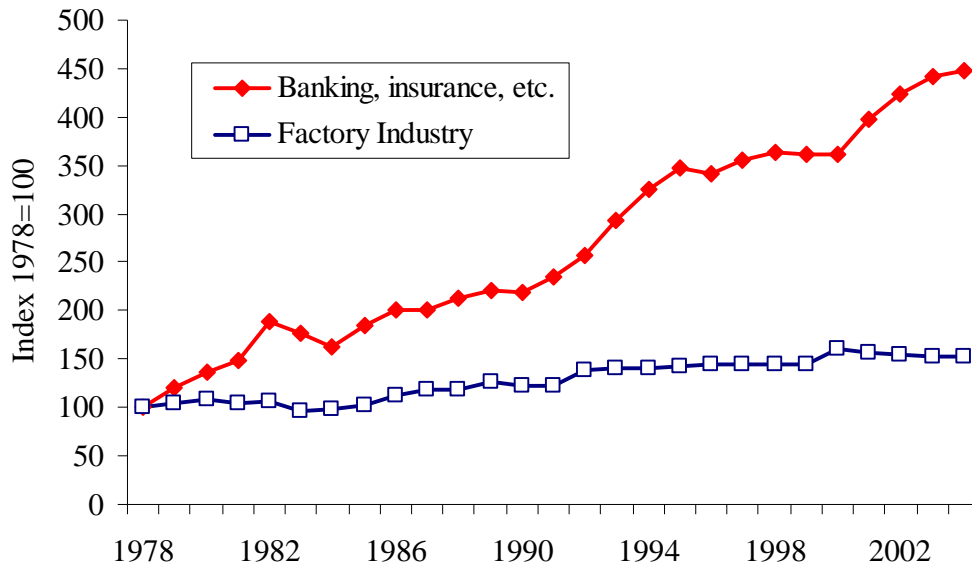
Source: Central Bank Annual Report (various issues)

As is well known proponents of financial liberalisation contend that growth in many developing economies has been retarded by repression of the financial sector in the form of excessive state domination of the sector, caps on interest rates, credit ceilings and directives, discriminatory taxes of and on financial institutions and instruments, inflationary and “captive sources” financing of the deficit, etc.<sup>20</sup> Financial liberalisation is supposed to enhance economic growth by, among other things, raising financial savings. It is tacitly assumed that the higher financial savings will translate into higher investment lending. Some aspects of the financial liberalisation argument have already been alluded to above in the context of the assessment of orthodox aggregate savings explanations. Evidence was provided to show that the link assumed between financial savings and aggregate savings is unclear while that between financial savings and the real interest rate is even perverse in the case of Sri Lanka. Consideration in the present section will be given additionally to, on the one hand, the assumed link between financial savings and investment and, on the other hand, the alleged efficiency of a liberalised financial sector.

<sup>19</sup> A number of authors have of late been arguing the case for a more restrained and sustainable development of the financial sector based on the experience of the successful East Asian economies, viz., Crotty and Lee (2002), Stiglitz (1998), Chang *et al.* (1998)

<sup>20</sup> See Fry (1992) for a comprehensive outline of the standard financial repression thesis and some of its modern incarnations.

**Figure 4.16**  
**Value-added in financial and industrial sectors as proportions of GDP, 1978-2004**



With regard to the assumed link between financial savings and investment, data provided in table 4.16 show that changes in the rate of financial savings do not systematically accompany changes in either the rate of loans and advances by commercial banks (which are mostly to businesses) or aggregate investment. Thus, over the 1979-2004 period as a whole, comparing the beginning and end years, financial savings with commercial banks to GDP rose by 22 percentage points while ratio of loans and advances of commercial banks to GDP rose by only 3 percentage points. Over the period 1990-2004, again comparing the end points, when financial savings rose by 15 percentage points of GDP, loans and advances of commercial banks rose a mere 0.7 percentage points. In fact, the structure of commercial bank assets has clearly shifted away from loans and advances and towards other assets, including government debt. The share of loans and advances in total commercial bank assets has declined from 63.4 per cent in 1978-84 to 52.8 per cent in 52.8 per cent. This shift was particularly evident in the post-1990 period.

It is frequently argued, also in Sri Lankan policy circles, that state financial institutions are inherently inefficient, with the most obvious manifestation of this inefficiency being the prevalence of high lending/deposit spreads. The greater the preponderance of state financial institutions, and/or the less competitive the financial sector environment, the greater, it is argued, would be the loan/deposit interest rate spread. Since it can be assumed that the post-1990 financial environment, and certainly the post-1995 financial environment, was comparatively more competitive, one would expect, according to this line of thinking, to see some decrease in interest rate spreads. However, as table 4.16 shows, not only have spreads increased over the post-1990 period as a whole, average spreads actually reached their highest level in the 1995-2004 period. In this table the loan rate is taken as the mid-point of the bills discount rate, and the deposit rate as the mid point of the 12-month fixed deposit rate. The picture of rising spreads is not altered if other indicators are used to indicate loan and deposit rates.

### Privatisation<sup>21</sup>

It is generally agreed, also in policy circles, that there was much rhetoric but little action on privatisation in the 1980s. One or two problematic public enterprises were closed down but in general there was no selling of any State Owned Enterprise (SOE) to the private sector until 1989 – when Sri Lanka entered into a SAP with the IMF. The record of privatisation in Sri Lanka from 1989 to 2002 is summarised in table 4.17. Between 1989 and 1994, 43 enterprises were privatised. Of these, 28 were in manufacturing, 12 in services (mostly trade and hotel/ restaurant business) and 3 in finance. Although these enterprises constituted slightly less than half of the enterprises privatised during 1989-04, they brought in less than a quarter of the total proceeds of all privatisations of the 16 years concerned. To some extent, this imbalance could be said to reflect an inflation of asset values. However, to a large extent, it appears to reflect the fact that the bulk of enterprises privatised during the earlier sub-period were of a relatively small size.

It should also be evident from the data provided in table 4.17 that most attention in the early privatisation process was focused on manufacturing SOEs. In fact, the majority of these were divested by mid-1990s. So far no comprehensive study has been made of the performance of the post-privatisation performance of these enterprises. Impressionistic evidence would suggest however that the privatised manufacturing companies have had mixed fortunes. A few companies, such as those in the areas of ceramics, distilleries, and cement, which were doing financially very well prior to privatisation, are known to be doing financially as well or even better in private hands. Other companies, such as those in textiles, performed well initially after privatisation, but then faltered (being eventually closed down) in the face of fierce competition with imports. Yet others were closed down shortly after privatisation. Indeed, the privatisation of these companies appears to have been intended to facilitate these closures and subsequent sale of assets to competitors.

Twenty five privatisations since 1995 involved public enterprises in plantations and in agri-business. Most evidence pertaining to the functioning of plantations under private management suggest that performance improvements have been considerable. The consensus view on these privatisations is even that by transferring the ownership of once nationalised estates to the private sector the government has corrected the earlier policy mistake of taking over plantations management.

There have also been privatisations in the financial sector. Two of the most important of these have involved the divestiture of state development banks, the Development Finance Corporation of Ceylon (DFCC) and the National Development Bank (NDB). These divestitures were among the most lucrative for government. In terms of financial indicators of corporate well-being, such as asset growth, return on equity, and the like, it would appear that both banks have performed well following divestiture. However, it is important to recognise that state development banks were not set up with purely commercial objectives in mind. Rather their purpose was to provide low cost, long-term, finance for strategic investment purposes. What is evident is that after divestiture both

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<sup>21</sup> There are many viewpoints from which a process of privatisation can be examined. Our focus on the subject here is very limited. We examine privatisation only from the point of view of the implications of this process for industrial development in general, and export-oriented industrialisation in particular.



banks have moved away from development banking activities and towards commercial and investment banking ones. In the case of both banks the structure of their assets has moved away from loans, the time duration of loans has fallen, lending has moved away from facilitating fixed capital formation, interest charges have risen, lending has become more risk averse, etc.

**Table 4.17**  
**Progress of Privatisation, 1989-2004**

<i>Year and Sector</i>	<b>Number of Enterprises</b>	<b>Proceeds in year from 1989-04 Total (%)</b>	<b>% Foreign</b>
1989 - Services	1	0.1	94.7
1990 - Manufacturing	4		81.7
Services	1	0.6	0
1991 - Manufacturing	3		0
Services	1	1.3	0
1992 - Manufacturing	9		16.7
Services	4	7.6	59.9
1993 - Manufacturing	7		42.1
Finance	3		87.2
Services	3	12.3	46.8
1994 - Manufacturing	5		0
Services	2	2.2	50.2
1995 - Agriculture	6		0
Manufacturing	3		97.8
Finance	1	5.2	0
1996 - Agriculture	7		0
Manufacturing	2		93.4
Services	1	15.1	100
1997 - Agriculture	5		0
Manufacturing	3		0
Services	1	26.2	83.6
1998 - Agriculture	3		0
Services	1	7.8	100
1999 - No privatisation	0		0
2000 - Agriculture <sup>a</sup>	2	..	0
2001 - Manufacturing	1		100
Finance	1	8.9	0
2002 - Agriculture	2		0
Services	1	2.8	0
2003 - Industry	1	0.0	0
Finance	2	8.9	0
Other Services	4	1.1	90.7
2004 - Industry	1	0.0	0
Total (Rs. Million)	91	68061.5	

Note: <sup>a</sup> Land Lease only

Source: Central Bank Report 2004

Finally, although the privatisation process has involved only a few of Sri Lanka's major utilities, the evidence gleaned from these privatisations, in conjunction with experiences with similar privatisations in other developing countries, may be summarised as follows. Where a sustainable competitive environment can be ensured, the privatisation appears to be an unequivocal success, as in the case of telecommunications. Where no such competitive environment can be ensured, particularly when the public utility concerned is a natural monopoly, then considerable caution needs to be exercised in respect of

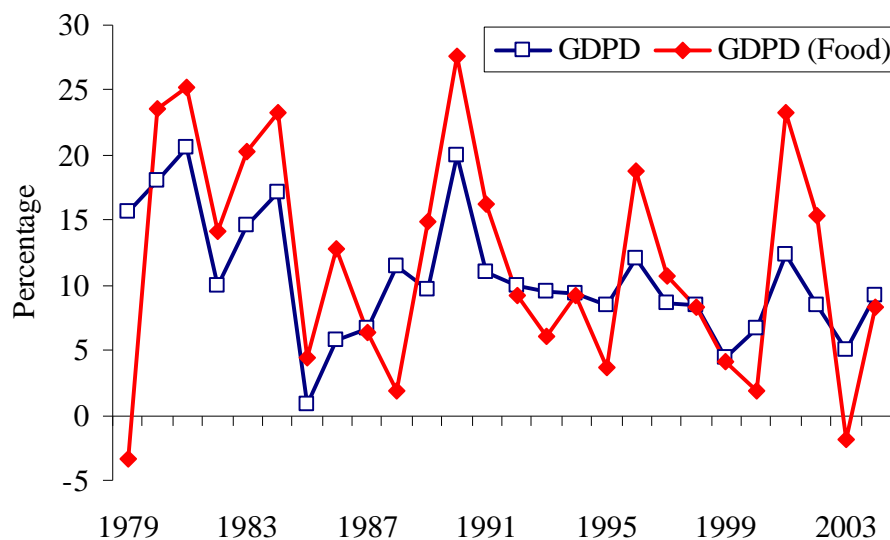
privatisation. Examples of these tend to be found in sectors such as energy and rail transport. Privatisation of utility companies in these sectors, without adequate regulatory safeguards, may give rise to price changes in an order of magnitude which would do serious harm to the competitive position of much of domestic industry. As the well-known case of the US energy giant Enron has shown, in such ‘natural monopoly’ industries, adequate regulatory safeguards may be difficult to devise.

## V. Inflationary pressures

### Explaining inflation

The major explanation for the movement of the aggregate price level in Sri Lanka over the 1978-2004 period appears to lie in movements of food and import prices. Of the two latter set of prices, those of food have been influenced to a considerable extent, with a lag, by the movements of import prices.

**Figure 4.17**  
Aggregate and food GDP deflators, percentage change, 1979-2004



Since food has a 60 per cent weight in the CCPI, it is hardly surprising that movements in the CCPI would correspond closely to movements in food prices. However, no such correspondence between food and the implicit GDP deflator can be expected *a priori*. The food component of the GDP deflator has a weighting of between 10 per cent and 15 per cent. Nevertheless, as figure 4.17 shows, movements in this index tend to be fairly closely associated with movements in the food deflator.

Given the relative openness of the Sri Lankan economy, and its historic dependence on imports to meet the demand for both final products and inputs, one can expect that import prices will also have an important bearing on domestic price level movements. In fact, multiple regression results suggest that food and import prices explain most of the movement of the aggregate price level (see table 4.18 which provides the relevant

regression results)<sup>22</sup>. These results show that variations in food and import prices correspond to 90% of the variations in the implicit GDP deflator. Both independent variables are significant. Parameter estimates suggest that changes in food prices are more important than changes in import prices in explaining inflation, but there is every reason to believe that the latter has some bearing on the former, particularly in certain years<sup>23</sup>.

Contrary to these and similar findings<sup>24</sup>, it has been taken as axiomatic in policy circles that inflation in Sri Lanka is fundamentally attributable to excessive money creation. The following quote is illustrative of this thinking.

The long-run stable relationship observed between the stock of money and the general price level has formed the economic rationale behind the control of the stock of money so as to achieve stability in both domestic and external values of the Sri Lankan Rupee. With the growth in the real output and an expansion in the proportion of the monetised transactions, the bank is required to supply an adequate quantity of money to the economy in order to ensure smooth functioning of the system. However, if money supply grows over and above these requirements, such excess money will create additional liquidity in the economic system, eventually exerting upward pressure on the general price level.” [CB (1990): 50-1]

In fact, there is little or no evidence to support the contention that inflation in Sri Lanka over the period in question was largely due to excessive money creation. For the proponents of the monetary approach to the explanation of inflation, who see money as largely a medium of circulation, the appropriate definition of money stock should be narrow money or M1 (cash plus demand deposits). The argument is that a change in M1 in excess of what is required to meet real increases in output will spill over into inflation. However, the empirical relation between changes in M1 and GDP at market prices in Sri Lanka has been extremely poor, as evidenced by the volatility of the income velocity of circulation of M1 (see figure 4.18)<sup>25</sup>. Indeed, tacit recognition of the absence of such a relation has caused proponents of the monetary explanation of inflation in Sri Lanka, as elsewhere, to adopt broader definitions of money stock in empirical analyses. A favourite in this regard is M2 (M1 plus savings and fixed deposits of commercial banks), and, more recently, M3 (M2 plus deposits with other deposit taking institutions)<sup>26</sup>.

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<sup>22</sup> US dollar import prices have been taken to discount the impact of currency depreciation on domestic inflation thereby showing the impact of purely exogenous forces on domestic inflation.

<sup>23</sup> It needs noting in this context that the correlation coefficient for the two independent variables is -0.075 suggesting that multicollinearity is not a significant problem.

<sup>24</sup> See Nicholas 1990.

<sup>25</sup> Interestingly, the relation between M1 and consumer inflation has been shown to have been particularly strong in the 1970-77 period. However, since consumer prices were largely controlled during this period the direction of causality must have been, if anything, from prices to M1 and not the other way around.

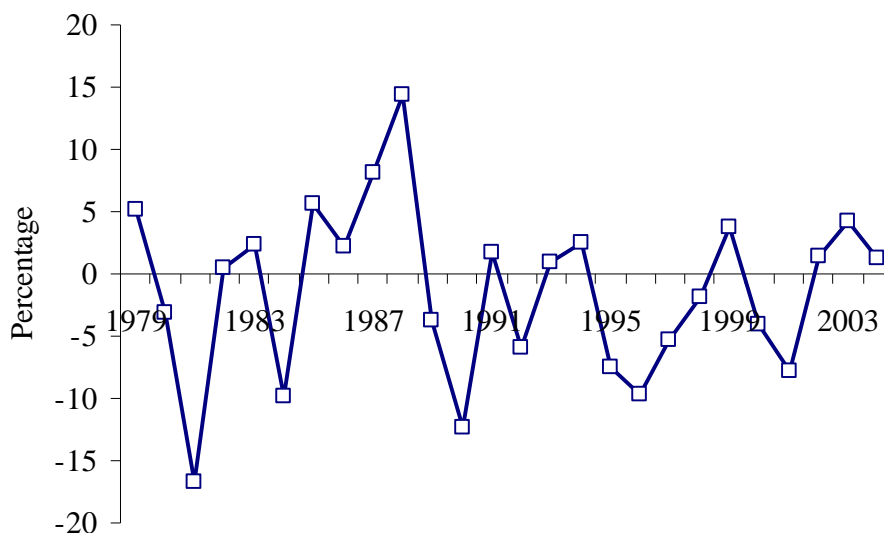
<sup>26</sup> Proponents of the monetary explanation of inflation have tended to gloss over the theoretical problems involved with choosing broader measures of money stock in empirical analyses. Specifically, the problem of how increases in savings and fixed deposits can be construed as

**Table 4.18**  
**Regression results for explanation of changes in the GDP deflator in terms of the GDP food deflator and import prices (US dollar values), 1979-2004**

**SUMMARY OUTPUT**

<i>Regression Statistics</i>				
Multiple R	0.9			
R Square	0.8			
Adjusted R Square	0.8			
Standard Error	2.4			
Observations	26			
<i>ANOVA</i>				
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>
Regression	2	447.92	223.96	39.99
Residual	23	128.79	5.60	
Total	25	576.71		
	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>
Intercept	2.9	1.0	2.9	0.0
GDP Deflator - Food	0.4	0.1	7.4	0.0
Import Price	0.2	0.0	5.6	0.0

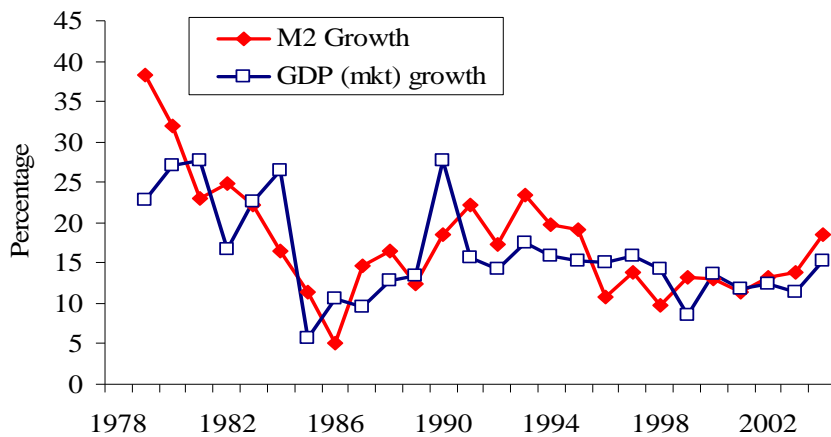
**Figure 4.18**  
**Income velocity of circulation of narrow money stock (M1), annualized percentage change, 1979-2004**



giving rise to predictable increases in expenditures in developing countries in the same way that increases in cash and demand deposits are argued to do is typically not broached.

A comparison of changes in M2 and GDP at current market prices shows that, although annual changes in the two variables do not always correspond to one another, their trend movements are quite close (see figure 4.19). As is well known, the contemporaneous movement of broad money stock and inflation does not imply causality from the former to the latter. This movement is equally consistent with the view that broad money stock is “endogenous”, i.e., the changes in M2 are induced by corresponding changes in the nominal value of GDP. Certainly, the fact that changes in nominal GDP are mostly explained by changes in real GDP, food prices, and import prices (see regression table 4.19), suggests strongly that the corresponding changes in M2 are endogenous with respect to those of nominal GDP. Further support for the endogeneity of M2 growth is provided below in the context of the discussion of the balance of payments.

**Figure 4.19**  
**Changes in broad money stock vs changes in the GDP deflator, 1979-2004**



It warrants adding in the above context that those familiar with the operation of a market-based financial system, even one pertaining to a developing country like Sri Lanka, are rarely surprised by the notion that either the broad money stock or the high-powered money base of the system are essentially endogenous<sup>27</sup>. This is because it is well known that for the most part commercial banking loan activities are not constrained by their deposit bases, and the cash base of the financial system tends to be highly elastic – becoming increasingly so with the development and increasing sophistication of the financial system. We will return to this issue again below in the context of the discussion of monetary policy.

Finally, it is also sometimes argued that changes in the size of the budget deficit have a significant impact on inflation via their direct impact on aggregate demand. However, the relation between changes in the size of the budget deficit and changes in aggregate demand (aggregate expenditure on domestic goods and imports less the budget deficit) for the period as a whole is poor (see figure 4.20). A close scrutiny of the data reveals that in many years there has even been a significant inverse relation between the two.

<sup>27</sup> The classic work on why money stock is necessarily endogenous is by the American economist Basil Moore (see Moore 1972 and 1988). Other important contributions are to be found in Goodhart (1986) and (1989), and Wray (1990).

**Table 4.19**  
**Regression results for explanation of changes in nominal GDP in terms of real GDP, food prices and import prices (local currency), 1979-2001**

**SUMMARY OUTPUT**

<i>Regression Statistics</i>	
Multiple R	0.9
R Square	0.8
Adjusted R Square	0.8
Standard Error	2.7
Observations	26

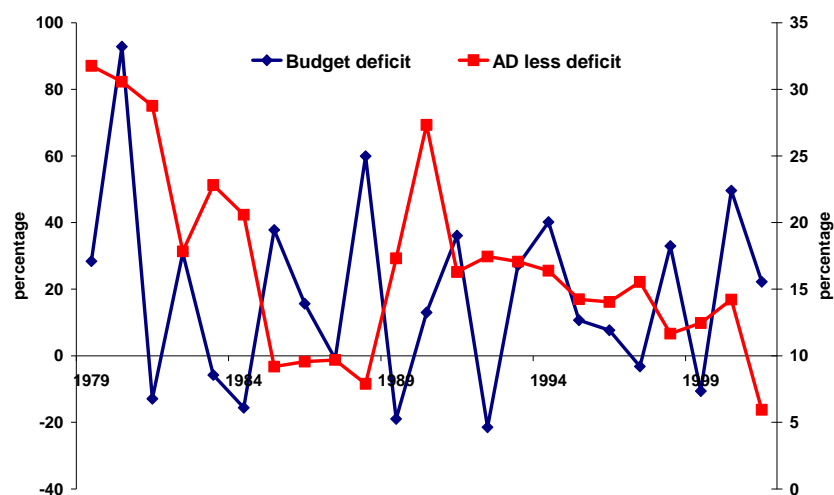
  

<b>ANOVA</b>				
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>
Regression	3	746.71	248.90	33.30
Residual	22	164.44	7.47	
Total	25	911.15		

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>
Intercept	0.9	1.8	0.5	0.6
GDP Real	1.4	0.3	4.7	0.0
Import Price	0.2	0.0	5.0	0.0
GDP Deflator - Food	0.5	0.1	7.6	0.0

**Figure 4.20**  
**Changes in the budget deficit vs changes in aggregate demand, 1979-2001**



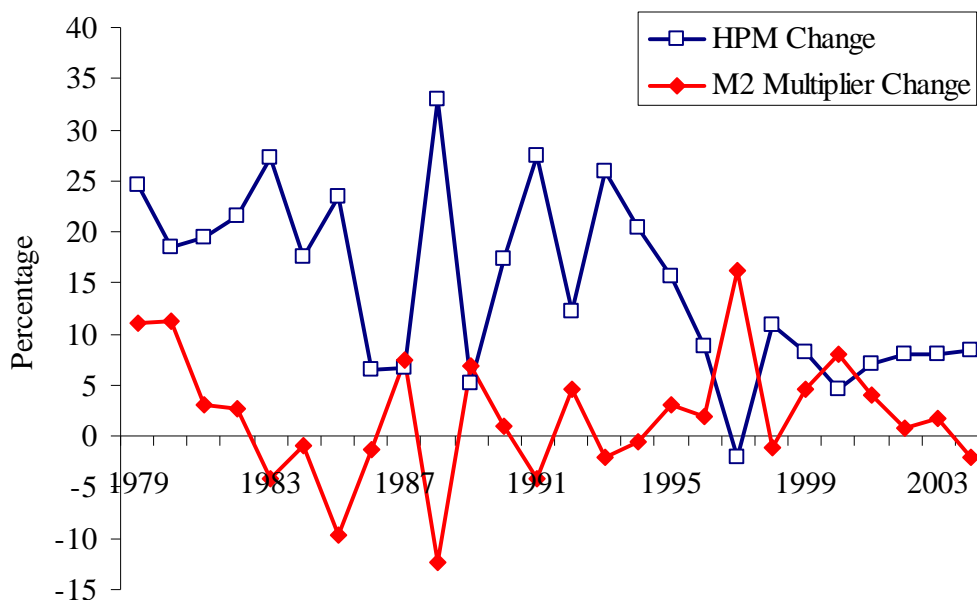
**The nature and consequences of anti-inflation policies**

It was argued earlier that inflation has been seen in policy circles, albeit to varying degrees, as essentially a monetary phenomenon resulting from an excessive expansion of the money base of the system due to the printing of money to finance excessive fiscal deficits. Hence, most anti-inflation policies, particularly those in the post-1990 period, have sought to control the money base by, in the final instance, controlling the size of the

budget deficit and so-called “inflationary financing” - printing of money to finance the deficit.

Before proceeding to a discussion of the precise nature and broader economic consequences of this anti-inflation policy stance, it would be useful to begin by looking more closely at the alleged causal relation between the money base and the money stock. A fundamental assumption underlying the belief that control of the money base will have a predictable effect on the money stock is that there is a stable relation between the two. Most importantly, movements in the ratio of cash to GDP should not be offset by opposite movements in the so-called money multiplier – in this case the ratio of broad money stock to cash. If this were to happen, it would mean that any policy induced change in the cash base is being offset by an opposite change in the velocity of cash circulation. In point of fact, this is precisely what the empirical evidence shows (see figure 4.21). The correlation coefficient for the cotemporaneous movement of high powered money (cash held by the public and by the banking system with the central bank) and the broad money multiplier is -0.58. What this suggests is that the money base is also, to a considerable extent, endogenous – determined by demand. This should, as noted above, hardly be surprising in a market-based financial system such as that found in Sri Lanka. Typically, in such a system an increase in the demand for cash is largely accommodated, unless the authorities are willing to tolerate high and volatile interest rates. The more accommodating the monetary policy, the relatively lower and less volatile are interest rates.

**Figure 4.21**  
**Broad money multiplier vs high powered money, percentage changes, 1979-2004**



Notwithstanding official policy pronouncements, the standard practice in most countries is actually one of targeting (money market) interest rates; that is, the price of cash. By raising the price of cash to borrowers the demand for this cash is choked off. In Sri

Lanka too this has been the general practice, although, as noted above, the authorities have tended to be less accommodating in the post-1990 period than the preceding 1978-89 period. On the one recent notable occasion (viz., 1995) when rhetoric got the better of common sense, and a concerted policy attempt was made to impose quantitative limits on the money base, the results in terms of surging money market rates were spectacular. Real interbank rates in that year, 1995, rose to a mid-point average of 59 per cent from 21 per cent the preceding year. Needless to say, this experiment with quantitative targeting was short-lived.

The preceding means that the anti-inflation policies pursued by the Sri Lankan authorities have in effect been the standard demand management policies of raising real interest rates and controlling the size of the budget deficit, with the latter having consequences for inflation in terms of its consequences for aggregate demand and not any alleged increase in the money base. To the extent that concern with the size of the growth of the money base gave rise to a shift in deficit financing away from printing money and towards borrowing from money markets, anti-inflation fiscal policy could be said to have impacted on the latter by reinforcing the upward pressure on interest rates. The question that remains then is what impact higher interest rates and contractionary fiscal policy had on the curtailment of inflation and the economy as a whole in Sri Lanka.

**Table 4.20**  
**Monetary policy indicators and macroeconomic trends, 1978-2001**

	1978-89	1990-04	1978-84	1985-89	1990-94	1995-04
	<i>Percentage</i>					
Real interbank rate	4.6	8.0	2.1	8.1	8.2	7.9
Real Central Bank advance rate	0.3	7.6	-2.5	4.3	4.6	9.1
High Powered money/GDP	9.8	9.7	9.3	10.4	10.8	9.2
Broad money multiplier	3	2.5	3.1	2.9	2.8	2.4
Budget deficit after grants/GDP	-11.5	-7.4	-13	-10	-7.9	-7.2
	<i>Percentage change</i>					
GDP at current mkt prices	17.8	15.0	23.9	10.4	18.2	13.3
Gross Domestic Product Deflator	11.5	9.6	14.8	6.9	12	8.4
Real GDP	4.7	4.9	5.9	3.1	5.5	4.5

Source: Central Bank of Sri Lanka Annual Reports (various years)

Considering the impact of interest rates first, it needs noting that unlike money stock changes, interest rate changes cannot be argued to impact only on monetary variables – the nominal expenditures of individuals. Since most money market borrowers in developing countries like Sri Lanka are businesses, and a great deal of borrowing is for production or production-related purposes, it is difficult to argue that higher interest rates have no significant wider economic consequences, particularly in respect of output growth. Certainly, any dampening effect higher interest rates may have had on inflation in the post-1995 period cannot be separated from the likely negative effect it had on economic growth (see table 4.20). This is not to say that high interest rates may not be required to curb excessive surges in domestic demand over the short run. Rather, the argument here is it that changes in interest rates have to be recognised as also likely to produce a direct impact on the level of real economic activity. Hence, even if inflation is argued to be the result of excessive demand pressures, monetary policy would still need



to strike a balance between the control of excess demand and the possible damage to real economic activity. That is to say, contrary to present practice, monetary policy should not focus solely on the curtailment of inflation.

With regard to fiscal policy, it was argued above, and demonstrated empirically, that for the most part changes in the budget deficit do not correspond to proportionate changes in aggregate demand. This means that, among other things, changes in the budget deficit could have had no predictable impact on inflation via the aggregate demand channel. On the other hand, fiscal policy has had, as was shown, important consequences for economic growth, aside from any possible consequences it has had via the aforementioned impact on interest rate changes.

The point being made here with regard to both monetary and fiscal policy is that, in the context of the earlier discussion of the sources of inflationary pressures in the Sri Lankan economy, the stances adopted in these two policy areas would have had only limited short-term consequences for inflation. It follows from that analysis in fact that the structural curtailment of inflation would require more fundamentally the curtailment of food and import price inflation. With respect to the former this would point to a comprehensive food production strategy. Placing an increasing reliance on imported food would make food prices, and therefore inflation, vulnerable to external shocks and consequences of a competitive exchange rate policy. Indeed, the greater the reliance that is placed on the importation of food, the less effective would a competitive exchange rate policy be in the promotion of manufactured exports and import-substituting domestic production. In the case of imported inflation the basic principle should be to attempt to provide as many key inputs domestically as possible. Over the short-term, and in the context of specific external shocks, there may be the need for, on the one hand, the government budget to absorb part of the shock and only transmit price increases gradually, and/or, on the other hand, a policy of lagging the exchange rate.

## ***VI. External payments imbalances***

### **Explaining trends in the external payments balance**

It was argued in chapter 3 that movements in the overall balance are primarily determined by movements in the current account balance and the latter in turn by the trade balance. The question which needs addressing here is what explains movements in the trade balance. Since the trade balance comprises import expenditures and export receipts, it would seem appropriate to begin by asking what determines these two variables.

The Sri Lankan evidence appears to show that import expenditure is explained by real GDP growth and import prices. Regression results for the relation between changes in import expenditures and growth and changes in import prices give an  $R^2$  of 0.9 and statistically significant parameter estimates for growth and changes in import prices (see multiple regression results presented in table 4.21). Although the data in respect of export earnings is not as conclusive as with import expenditures, they suggest, as a number of other developing country studies have also shown, that most of the movement in export earnings is explained by movements in real GDP growth of developed countries and export prices. Multiple regression results in table 4.22 show an  $R^2$  of 0.7 for the regression of export earnings growth against the developed country GDP growth and

relative price variables, with statically significant parameter estimates for both explanatory variables. Given the importance of trade prices in the explanations of both import expenditures and export earnings, it is hardly surprising to find that there is a significant inverse relation between the terms of trade and the trade balance (see figure 4.22<sup>28</sup>).

**Table 4.21**  
**Regression results for explanation of changes in import expenditure by real GDP growth and changes in import prices, 1979-2004**

SUMMARY OUTPUT				
<i>Regression Statistics</i>				
Multiple R		0.9		
R Square		0.7		
Adjusted R Square		0.7		
Standard Error		7.1		
Observations		26		

ANOVA				
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>
Regression	2	3322.52	1661.26	33.13
Residual	23	1153.45	50.15	
Total	25	4475.97		

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>
Intercept	-8.2	4.1	-2.0	0.1
X Variable 1	3.6	0.8	4.6	0.0
X Variable 2	0.8	0.1	6.5	0.0

According to conventional wisdom, the trade balance is to a large extent influenced by money stock changes. As in the case of inflation, the theoretical premises underlying this line of thinking would seem to suggest that the appropriate definition of money stock is narrow money, or M1. Changes in narrow money stock in excess of output growth would result in an increase in expenditure on both domestically produced goods and imports. Sri Lankan data shows that the link between narrow money stock and the trade balance (or even import expenditures) is poor. As in the case of inflation, however, the link with broad money stock growth is considerably better, particularly with respect to import expenditure (see figure 4.23). However, as in the case of inflation, such a link does not prove causality. It is equally plausible that money stock changes are endogenous, with import price changes providing the dynamic impulse for both inflationary developments and accommodating money stock changes. In this context it is noteworthy that the correlation coefficient for changes in import expenditures and changes in US dollar import prices is 0.7. This, in itself, would appear to suggest that the direction of causality is unlikely to be from broad money stock to import expenditures, but rather the reverse – from import prices to import expenditures and then to money stock. This

<sup>28</sup> In this Figure, trade balance has been taken to mean trade deficit, so that any increase (decrease) in this variable would imply a deterioration (improvement) in trade balance.

reinforces the conclusions reached earlier (in the discussion of inflation) regarding the endogeneity of broad money stock changes.

**Table 4.22**  
**Regression results for explanation of changes in export earnings in terms of real GDP growth in the Developed Countries and changes in export prices, 1979-2001**

SUMMARY OUTPUT						
<i>Regression Statistics</i>						
Multiple R	0.7					
R Square	0.5					
Adjusted R Square	0.5					
Standard Error	9.4					
Observations	23					

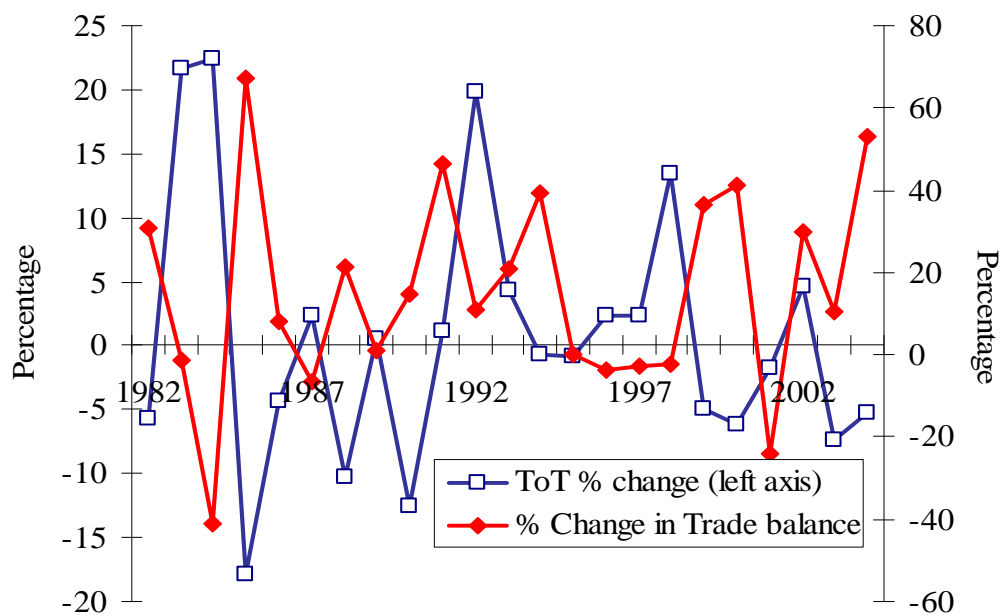
  

ANOVA						
	<i>df</i>	<i>SS</i>	<i>MS</i>	<i>F</i>	<i>F</i>	
Regression	2	1,961	980.7	11	11	
Residual	20	1,785	89.2			
Total	23	3,746				

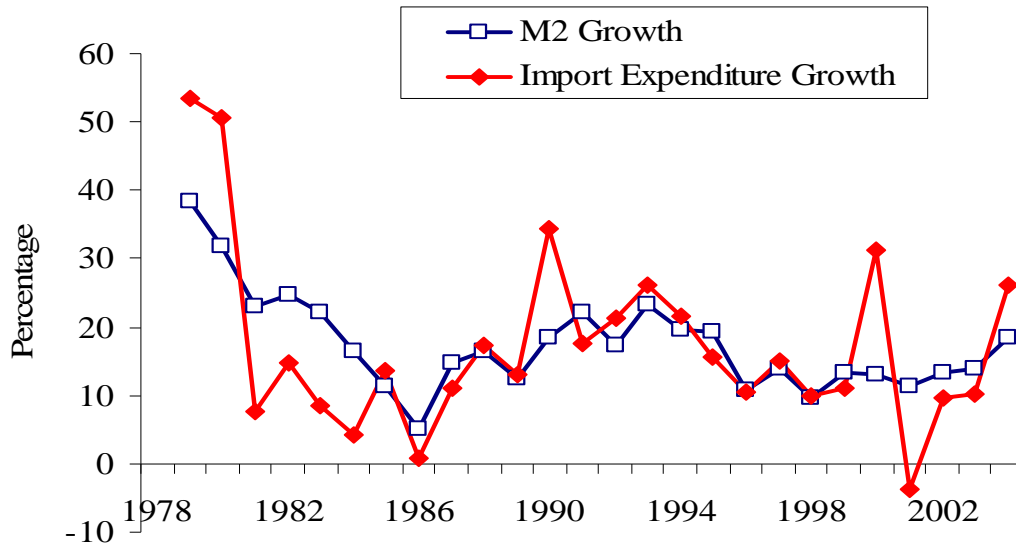
  

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>	<i>Lower 95%</i>	<i>Upper 95%</i>
Intercept	-5.6	4.7	-1.2	0.2	-4.2	15.4
GDP Real	0.7	0.2	4.1	0.0	0.4	1.1
Import Price	1.6	1.6	1.0	0.3	-1.8	5.0

**Figure 4.22**  
**Trade balance and terms of trade, 1981-2004**



**Figure 4.23**  
**Import expenditure and broad money stock growth, 1979-2004**



### External payments policies and the sustainability of the external balance

It was argued earlier that, as in the case of policy thinking on inflation, so in the case of policy thinking on external payments imbalances, the tendency, to varying degrees, has been to see the source of these imbalances as essentially the result of an excessive expansion in money stock. The only additional element that comes into the picture in the case of the external balance is the exchange rate. Specifically, the argument is that the added problem of external imbalance is the “stickiness” of the exchange rate; the inadequate adjustment of the exchange rate in compensation for money stock excesses. Although there is general agreement that the exchange rate should adjust to compensate for excessive increases in money stock, there is no consensus regarding the timing of such adjustments. Up to 1995 it would appear that the policy consensus was that there should be an immediate adjustment of the currency in relation to the US dollar as the nominal anchor. In the post-1995 period however the additional belief was that some lagging of the requisite adjustment was warranted by the need to curtail inflation and impose greater fiscal discipline.

On the basis of the earlier discussion of anti-inflation policy, it may be argued here that policies aimed at correcting external payments imbalances have typically also rested on a high interest monetary policy and a contractionary fiscal policy. For analogous reasons to those outlined earlier, these policies cannot be argued to have given rise to sustainable improvements in the external balance, even if they could be argued to have contributed to short-term improvements in it. In the final instance, a sustainable improvement in the overall payments balance will only result from an overall improvement in the current account balance, and in particular the trade account balance. Such an improvement would require most fundamentally a significant improvement in the competitive position of Sri Lanka’s manufacturing production in the context of an export-oriented and import-

substituting strategy. An indispensable element of this strategy, which needs particular emphasis here, is a competitive exchange rate policy; that is, an exchange rate policy in which the adjustment of the exchange rate takes into account movements in competitor countries' real exchange rates.

A sustainable improvement in Sri Lanka's trade balance will also require the promotion of greater food self-sufficiency and movement into higher value added (and less footloose) service sectors. The greater self-sufficiency in food production will not only reduce the import bill but, to repeat an earlier point, will also make currency depreciation more effective in terms of improving domestic competitiveness. If domestic food prices do not rise in tandem with currency depreciation there will be less pressure on nominal wages to adjust to this depreciation. Although services are unlikely to contribute anything like manufactured goods to an improved trade performance at Sri Lanka's present stage of development, it should be recognised that such services as tourism do nevertheless make a significant contribution to foreign currency earnings. Importantly, these services, as with manufactured exports, should possess a certain degree of price buoyancy. This means that the services to be promoted, like the manufactured goods to be promoted, should be those with the highest elasticity of demand. To take tourism as an example, this would involve paying particular heed to non-traditional, more up-market tourists, who, say, may be more interested in Sri Lanka's historical and cultural heritage.

With regard to the other components of the all-important current account balance, two additional elements need consideration: private remittances and income flows. Private remittances, approximated by the net balance on the private transfers account of the balance of payments, have averaged 4.9 per cent of GDP over the period 1978-2004. To put it differently, private remittances have paid for a little less than half of the average trade deficit of 11.2 per cent of GDP over the period, 1978-2004. During 1990-2004, at 5.5 per cent of GDP, these remittances have financed well over half of the trade deficit of that period, which amounted to 9.7 per cent of GDP. It is often argued that these remittances are important for the long-term sustainability of the external payments balance. However, leaving aside the conditions under which these flows are generated, it is a fact that the remittance flows themselves have had a sort of "Dutch disease" effect on the Sri Lankan economy, serving to retard the growth process. For one thing, in the absence of the private remittances flows, the value of the Sri Lankan rupee would most probably have been very much lower. For another, the authorities would most likely have been forced to more aggressively promote productive activity, also in respect of the implied poverty effects which a withdrawal of these flows is likely to have had (see later). As such private remittances cannot be said to positively contribute to the long-term sustainability of the external payments situation. Indeed the contrary appears to be the case.

With the hindsight of recent financial crises in East Asia, Russia and Latin America, it is recognised that a growing deficit on the income account is inimical to the long-term sustainability of the external payments balance of a country. In Sri Lanka's case the net outflow of income (by way of profits, interest, dividends, etc) has been modest; amounting to a mere annual average 1.6 per cent of GDP over the 1978-2004 period as a whole. The policy significance of these flows for the long-term sustainability of the external payments position needs some attention here because of the repeated calls by a

number of policy makers for full liberalisation of the capital account by way of an acceleration of the present strategy of easing various controls. Those supporting full liberalisation argue that the resulting increase in capital inflows will augment savings and (by the implied technology and management diffusion such inflows bring) increase productivity. To begin with, it needs recognising that FDI and portfolio flows are now essentially liberalised. The target of the liberalisers is in fact money market flows. However, it has to be recognised that money market flows contribute nothing directly to fixed capital formation while at the same time increasing the financial fragility of the system, making it more susceptible to contagion effects of financial crises in other developing countries and undermining the long term sustainability of external payments.

## ***V.II Summary***

The chapter attempted to identify the principal sources of economic growth, inflation and external balance in Sri Lanka. The major points made in this regard were as follows:

- Sri Lankan data covering the period 1978-2004 confirms that trends in the aggregate investment rate accompany those of economic growth. However, these data do not appear to lend support to the view that investment leads growth as such. These data also do not lend support to the view that aggregate investment is necessarily dependent on government capital expenditure or that there has been any significant “crowding-out” of private investment over the period under consideration.
- The following points were made with regard to aggregate savings. First, somewhat perversely, public dissaving appears to have mostly resulted from SAP-style policies. Second, there is no evidence of financial liberalisation, especially higher real interest rates, having had a positive impact on aggregate private savings.
- Inflation, at the level it remained, does not appear to have had any negative bearing on economic growth in the Sri Lankan case over the period under consideration. Indeed, inflation and growth even appear to have moved together.
- Sri Lanka’s failure to achieve a sustained rise in economic growth was interpreted as the result primarily of its failure to shift adequately towards an industrial base, particularly an export-oriented industrial base. The lack of a consistent policy commitment to such a shift is seen as the major source of this failure. Two important elements of this policy failure were shown to be the overvaluation of the exchange rate and excessively high interest rates.
- The failure to develop a viable domestic agricultural food production sector was seen as an additional factor impeding economic growth. This failure was argued to also have had deleterious long-term consequences for industrialisation, particularly because of its implied consequences for wages, to say nothing of the living standards of the poor.
- It was argued that Sri Lankan policy makers have adopted three different types of growth strategy in the post-1977 era; a state capital expenditure led strategy (1977-84), an EOI strategy (1990-94), and a stabilisation cum level-playing-field strategy (1995 and beyond). The first of these was argued to be unsustainable, while many

key elements of the third were argued to actually stifle growth. Only the second, the EOI strategy, offered the prospect of a sustainable, high-growth process. The problem was that it was short-lived and was implemented within the context of a Structural Adjustment Facility from the IMF.

- With regard to the key elements of the stabilisation cum level-playing-field strategy the following points were made;
  - Sri Lanka's experience with trade liberalisation does not support the contention that it has enhanced economic growth. In fact, there is evidence to suggest that it may have even harmed growth.
  - Financial liberalisation in Sri Lanka most likely resulted in an excessive growth of the financial sector (particularly in relation to the industrial sector). Moreover, Sri Lankan data do not appear to support many of the cherished contentions of the financial liberalisation thesis, e.g., that financial liberalisation will give rise to an increase in investment financing, or that it will give rise to an improvement in the operating efficiency of the financial sector (as manifest in declining loan/deposit rate spreads).
  - Privatisation began in earnest around the early 1990s but has not been particularly extensive to the present date. However, looking at those privatisations which have taken place, coupled with the approach of the policy makers to this process, provide some basis for an assessment of its significance from a growth point of view. The tentative conclusion which emerges is that a policy of privatisation for its own sake will not enhance economic growth and may even damage it. An example of the potential damage done by such an approach is the privatisation of the development banks and their subsequent orientation towards commercial banking and away from development banking.
- Economy-wide (as well as consumer) inflation in Sri Lanka is largely to be explained by movements in food prices and import prices. There appears to be no evidence to support the view that inflation in Sri Lanka is systematically due to excessive money creation. On the contrary, it was argued that money stock is largely endogenous and that when policy makers have attempted to target liquidity (as in the 1995-2001 period) it has resulted in high and volatile money market interest rates with attendant damaging consequences for economic growth.
- Movements in the trade balance are mostly explainable through reference to fluctuations in the terms of trade, the competitiveness of domestic producers, and domestic and foreign demand. Trade balance, like inflation, and for much the same reasons, is not fundamentally explained by money stock changes. Accordingly, policies founded on a curtailment of money stock expansion have not given rise to a sustainable improvement in the external balance, and may even have undermined an attainment of the latter as a result of their potentially damaging consequences for long-term growth. Rather, a sustainable improvement in the external balance, like economic growth, requires most fundamentally a significant improvement in the competitive position of Sri Lanka's manufacturing production in the context of an export-oriented and import-substituting strategy.

## **Chapter 5: The macroeconomic determinants of poverty, income distribution and human development in Sri Lanka**

### ***I. Introduction***

This chapter will bring together the various analytical strands and arguments presented in the preceding chapters to consider the way in which macroeconomic developments and accompanying policies have impacted on poverty, income distribution and human development. It needs stressing that the resulting analysis does not pretend in any way to constitute an all-encompassing analysis of these phenomena. Such an analysis would necessarily conceptualise poverty and human development more broadly than has been done in the present study, and it would, as a result, be required to take into account a number of social, political, cultural, ethnographic, and other factors in the explanation of these two phenomena, factors which the present study largely ignores. Actually, what follows cannot claim to even represent a comprehensive economic analysis of the aforementioned phenomena, since, among other things, little or no consideration is given to their microeconomic determinants. The focus is exclusively on their macroeconomic determinants. Apart from the terms of reference of the present study, justification for such a narrow focus is to be found in terms of analytical necessity (the necessity of compartmentalizing analyses of complex phenomena such as poverty) and the insights such partial analyses can provide.

### ***II. Poverty***

#### **Macroeconomic influences**

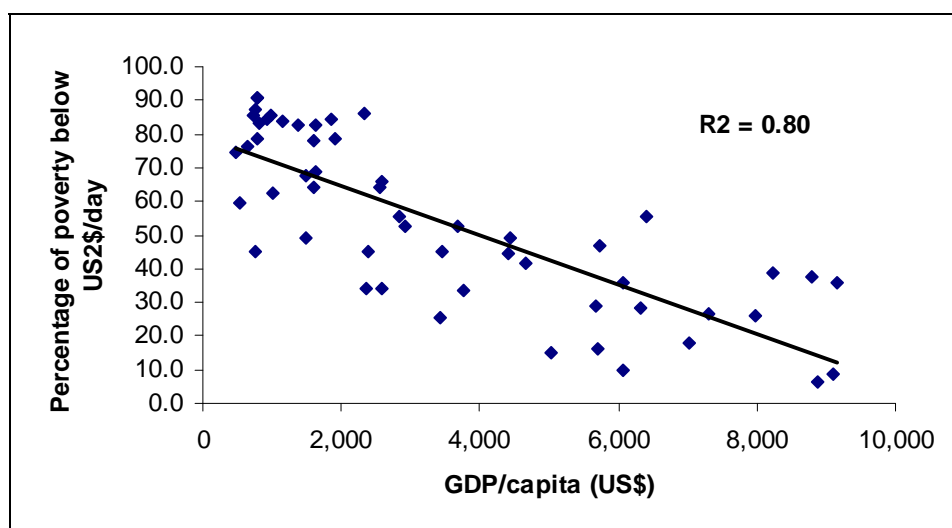
##### ***Economic growth and structural shifts in production***

Cross country and other data show that poverty levels tend to fall as *per capita* GDP levels rise because of the implied increase in employment and real income levels of the poor. Figure 5.1 is a scatter plot of GDP *per capita* in 2000 and the latest poverty estimates for a sample of 52 developing countries. Poverty is estimated by an international poverty line of US\$ 2/day. GDP *per capita* is in US dollar terms for comparability. All data are from the World Bank's "Development Indicators 2002" database. These data appear to support the contention that poverty tends to fall as GDP *per capita* rises.

This argument should not be taken to imply that economic growth *per se*, in the sense of a rise in GDP *per capita*, is a sufficient condition for poverty reduction. A number of studies show (see below) that factors such as income distribution and access to basic social and economic services can also have an important bearing on poverty reduction. While on a recent visit to Sri Lanka, Mr. Praful Patel, the Vice President for South Asia Region of the World Bank, remarked that: "The relationship between growth and poverty is clear but growth does not automatically fight poverty. There are many examples of countries with high growth where the poor benefit little" (*The Island*, August 20, 2003).



**Figure 5.1**  
Scatter plot of per capita GDP (2000) and poverty (latest estimate) for developing countries (a)



(a) These comprise 52 developing countries from Asia, Africa, Latin America and the Caribbean for which data are available. It excludes Transitional and Middle Eastern economies. If the latter are included the correlation coefficient falls to 0.75. Poverty level is defined as the percentage of the population subsisting on less than US\$ 2/day.

Table 5.1 presents some of the Sri Lankan data, analysed in detailed separately in earlier chapters, on the hypothesized link between poverty and growth. It suggests, in the first place that, to the extent there was a decline in poverty, it was at least partly attributable to the rise in *per capita* GDP levels. Specifically, to the extent that credence can be given to the figures on poverty levels, the apparent decline in consumption poverty levels between 1985/6 and 2002 may well be in large part the result of the corresponding rise in real *per capita* income levels between the two dates. However, a corollary of this argument is that the stickiness in consumption poverty levels is at least partly due to an inadequacy of economic growth. Explanations for this inadequacy were provided in chapter 4.

**Table 5.1**  
Poverty and economic growth in Sri Lanka, 1985-96

	1985/86	1990/91	1995/96	2002
GDP per capita (US\$)	US\$541	US\$598	US\$728	
<b>Poverty levels(a)</b>		<i>Percentage</i>		
Poverty incidence (lower)	31	20	25	23
Poverty incidence (upper)	41	29	36	-
Transfers to households (% of GDP)	4.0	5.3	4.4	3.4
GDP growth	4.6	5.4	4.6	4.0

Note: (a) Poverty level estimates for 1985-96 period are not comparable to the estimate given for 2002. See Ch. 2 for details.

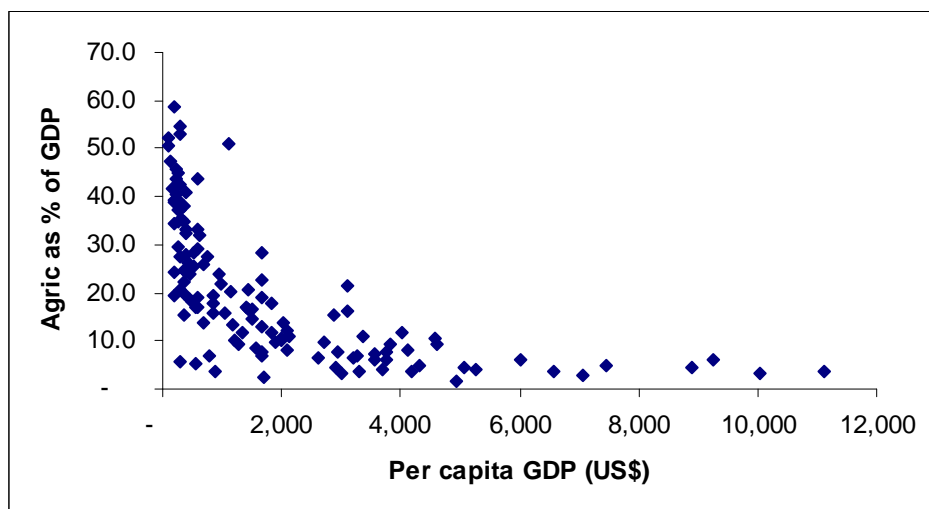
Sources: Table 2.1, Ch. 2; World Bank, World Development Indicators database; Central Bank Reports (various issues)

The data in table 5.1 also suggests that shorter term variations in poverty levels may be explained by the macroeconomic and social policy environment prevailing at the time of the household surveys used to construct poverty indices<sup>1</sup>. Of note in this context are factors such as the rate of economic growth and levels of transfers to households. Thus, the apparent drop of poverty level from 1985/6 to 1990/1 and its rise from 1990/1 to 1995/6 appear to correspond to variations in both redistributive transfers to households as a percentage of GDP and the economic growth rate in those years. This argument cannot, however, be extended to 2002 on the basis of data in Table 5.1, as the poverty estimate for this year is not comparable to those for the earlier years.

One can also expect, and data show, that poverty levels fall as countries shift their production structures away from agriculture and towards industry (and, somewhat later, towards services). The fall in poverty is explained by the fact that;

- The shift to industry causes the aggregate output growth rate (and therefore per capita income levels) to rise more rapidly, and,
- Industrial wages tend to rise more rapidly than agricultural wages (particularly in the early and middle phases of rapid industrialisation processes).

**Figure 5.2**  
Scatter plot of per capita GDP and agriculture share in GDP for developing countries and transitional economies, 2000(a)



(a) The correlation coefficient for the two variables is 0.62

Source: World Bank Development Indicators 2002

Figure 5.2 is a scatter plot of *per capita* GDP levels and agricultural share for all developing and transitional economies for which data are available in the World Bank's "Development Indicators 2002" database. It points to the existence of a clear relation between *per capita* income levels and agricultural share. As the share of total value added by economic activity in the agricultural sector declines, US dollar per capita income levels rise. The correlation coefficient for the two variables is 0.62.

<sup>1</sup> It has been also noted in Chapter 2 (p. 17) that changing fortunes of agriculture in relevant survey years, following changes in weather conditions, have often been important in poverty level shifts.

**Table 5.2**  
**Composition of aggregate value added and employment, 1986-2002**

	1985/86	1990/91	1995/96	2002
	<i>Percentages</i>			
<b>GDP composition</b>				
Agriculture	27.0	26.6	22.7	19.8
Industry	27.0	25.6	26.5	26.6
<i>Mining and Quarrying</i>	2.7	2.3	2.0	1.7
<i>Manufacturing</i>	15.6	14.5	16.0	16.6
Export processing	3.5	2.7	2.2	1.9
Factory	10.1	10.7	12.5	13.5
Small industry	2.0	1.1	1.3	1.2
<i>Construction</i>	7.4	7.4	7.2	6.9
<i>Electricity, Gas and Water</i>	1.3	1.3	1.4	1.4
Services	46.0	47.8	50.8	53.6
<i>Transport, storage and comm..</i>	10.7	9.8	10.2	12.8
<i>Wholesale and retail trade</i>	19.4	21.3	22.1	21.3
<i>Banking, insurance and real estate</i>	4.2	4.7	7.2	8.9
<i>Other</i>	11.6	12.0	11.2	10.6
<b>Total</b>	100.0	100.0	100.0	100.0
<b>Employment composition(a)</b>				
Agriculture	49.3	46.8	36.7	34.5
Industry	18.7	19.4	22.2	22.8
<i>Mining and Quarrying</i>	1.3	1.6	1.7	1.9
<i>Manufacturing</i>	12.6	13.3	14.7	16.5
<i>Construction</i>	4.4	3.9	5.3	4.4
<i>Electricity, Gas and Water</i>	0.4	0.6	0.5	-
Services	27.9	30.7	35.7	
<i>Transport, storage and comm..</i>	4.3	4.1	4.7	4.7
<i>Trade, hotels, etc</i>	10	9.6	12.2	14.7
<i>Banks, insurance and real estate</i>	1.3	1.3	1.5	2.6
<i>Personal services</i>	12.3	15.7	17.3	13.3
Unclassified	4	3.2	5.4	6.5
<b>Total</b>	100	100	100	

Note: (a) Industry classification system in respect of employment structure is different from the industry classification system adopted in analysing the GDP structure. Even in respect of employment structure, the classification system for different years is different.

Source: Authors' calculations based on Dept of Census and Statistics, Labour Force Survey, various years and Central Bank Reports various years

Table 5.2 shows that in Sri Lanka too there has been a significant shift away from agriculture between 1985 and 2002, both in respect of output and employment. In the context of the preceding international evidence this would suggest that the apparent decline in Sri Lankan poverty over this period may also be attributable to a structural shift of the economy. Certainly, to the extent that this structural shift enhanced overall output expansion it most likely had a positive impact on poverty levels. However, it may also be seen from the data given in the table that the shift away from agriculture in terms of value added did not result in a corresponding increase in the value added share of industry. In fact, the proportion of total value added by industry even fell, albeit marginally, between 1985/6 and 2002. In itself, this would suggest that the growth enhancing and poverty alleviating effects of the shift in production structure which took

place between these two years were somewhat muted. Or, to put it another way, the sluggishness in the decline in poverty levels in Sri Lanka could additionally be attributed to an inadequate shift in the structure of production towards industry.

Sectoral employment data presented in Table 5.2 would seem to suggest, however, that the problem is not simply one of an inadequate shift in the sectoral composition of value added, but, additionally, one involving the nature of that shift, particularly in respect of remunerative employment. Employment data show that the decline in the proportion of total employment within agriculture was greatly in excess of the decline in the proportion of value added by the sector. The decline in value added by agriculture between 1985/6 and 1995<sup>2</sup> was by 4 percentage points, and between 1985/86 and 2002 by 7 percentage points. The corresponding decline in the proportion of agricultural employment during these two periods was respectively by 13 and 15 percentage points. Looking at these figures one is likely to jump to the conclusion that this relative shift in employment away from agriculture was, to some considerable extent, from relatively low value added and poorly remunerated economic activities to high value added and better remunerated economic activities. Only about one third of the decline in the employment share of agriculture was accounted for by a corresponding rise in the employment share of industry whose value-added share did not increase. It was the services sector that absorbed as much as two-thirds of the decline in the employment share of agriculture. It would appear that much of the increase in employment during this period in industry and service sectors was in fact in low value added and poorly remunerated activities. Seth and Dev (2003: 4) find support for this argument in the conclusions of several independent studies, which find that the employment generated during the 1990s in manufacturing, construction and service sectors was "...in the form of work arrangements such as sub-contracting, casual and limited tenure appointments as opposed to full-time, quality employment". This means that although the macroeconomic policies adopted in the 1990s and the early 2000s may have generated employment, and in the process lowered open unemployment, they did so to a great extent by increasing the numbers employed in poorly remunerated jobs. It will be recalled in this context that data presented in table 2.9 of chapter 2 showed a gradual decline in real wages in the organised sectors of the economy. It may also be recalled that in the discussion in sub-section on Employment/Unemployment in chapter 2 we have referred to the phenomenon of "working poor"- indicating that the overwhelming mass (over 90 per cent) of the poor in Sri Lanka belongs to the category of "employed".

It could of course be argued that the poor remuneration in manufacturing and service activities into which labour shifted is to be accounted for by low labour productivity levels. However, evidence presented in table 5.3 (which is a modified version of a data table from Seth and Dev, 2003) appears to belie this, at least in the case of manufacturing. In this table real earnings growth is compared with labour productivity changes for key manufacturing activities over the period 1993 to 1999. Manufacturing activities are clustered according to the relative competitiveness of the industries. It would appear that the more competitive an industry is, the less would productivity increases translate into

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<sup>2</sup> Employment survey dates do not correspond exactly to dates of household income and consumption surveys on which poverty indicators are based.

earnings growth. In fact, for the most part productivity increases in more competitive industries are likely to translate into relative price declines.

Although precise data are not available, it is evident that in services too the relative growth of employment share is largely accounted for by a shift towards activities which are known to be low value added and/or poorly remunerated. Of particular note in this regard is the growth in relative employment in personal services and tourism. The highly competitive and depressed nature of tourism over the period in question (1985/6 to 2002) undoubtedly exerted downward pressure on wages in this sector, while value added and remuneration are both known to be low in the case of personal services.

**Table 5.3**  
**Average annual growth rates (%) of labour productivity and earnings (in constant prices) by industry, 1993-1999**

Manufacturing sector	Labour productivity	Real Earnings
<b>Highly competitive</b>		
Textiles	12.1	-2.5
Wearing Apparel	11.6	-4.0
Manu. Of Leather	18.5	-1.8
Manu. Of Wood & Cork products	6.4	-7.5
Plastic products	19.0	-1.2
Rubber products	14.8	0.5
Other non-metallic products	10.3	0.5
<b>Moderately competitive</b>		
Food manufacturing	19.0	8.3
Pottery etc.	11.1	5.0
Petroleum Refineries	22.2	9.7
<b>Least competitive</b>		
Manu. Of machinery	34.1	11.7
Jewellery	-0.6	13.6
<b>Total manufacturing</b>	<b>13.4</b>	<b>0.1</b>

**Source:** DCS, Annual Survey of Industry (various years), CCPI and GDP deflator for manufacturing from Central Bank Annual Report 2000.

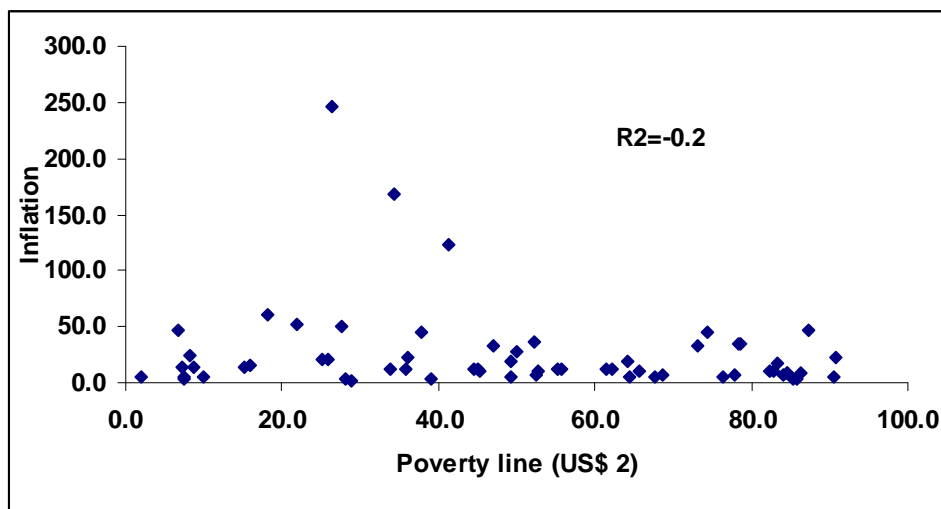
### Stability

It is frequently argued that macroeconomic instability in the form of high levels of inflation worsens poverty both directly and indirectly. The direct impact on poverty is argued to result from the fact that inflation acts as a “regressive and arbitrary tax”. The reasons are twofold. “First the poor tend to hold most of their financial assets in the form of cash rather than in interest bearing assets. Second, they are generally less able to protect the real value of their income and assets than are the better off. In consequence, increases in the price level generally erode the real wages and assets of the poor more than those of the non-poor” (World Bank, *PRSP Source Book*, 2000, p 4, chapter 6). Inflation is also argued to (indirectly) damage the poor via its alleged negative impact on economic growth.

Cross country data relating inflation and poverty do not appear to confirm the hypothesis that high inflation countries experience relatively higher levels of poverty than low inflation countries. Fig. 5.3 is a scatter plot of inflation and poverty for 61 developing market economies and transitional economies for which data are available. Inflation is

given by the average growth of the GDP deflator over the period 1980-2000 and poverty is the latest available estimate of poor falling below a consumption level equivalent to US\$ 2 per day. There does not appear to be any discernible pattern in the data, which is confirmed by the low correlation coefficient for the two variables. In fact, the correlation coefficient is negative, whereas the hypothesized relation is positive. Changes in the time period and indicator of poverty (e.g., using US\$ 1 per day as the poverty line) do not affect these conclusions. Allowing for the influence of relative per capita income levels on poverty also does not improve the relationship between inflation and poverty.

**Figure 5.3**  
**Scatter plot of inflation and poverty for developing and transitional economies (a)**



Note: (a) 61 developing and transitional economies were selected on the basis of availability of data in the source. Inflation is taken to be the average inflation rate for the period 1980-2000 and poverty is given by a poverty line of US\$ 2 per day.

Source: *World Development Indicators*, 2002, World Bank, Washington DC

Sri Lankan data appear to confirm the absence of the hypothesised relation between poverty levels and inflation. Table 5.4 compares poverty and average inflation levels for 1985/6, 1990/1 and 1995/6. It shows that, if anything, there is an inverse relation between inflation and poverty; that is, higher inflation corresponds to a lower incidence of poverty and visa versa. One explanation for this apparently perverse behaviour may be found in the source of the inflationary pressures. Since, in the Sri Lankan context, an increase in food prices was argued to be a major source of inflation, and since an increase in food prices represents in principle an increase in incomes of those in the rural sector where many of the poor are to be found, it is not altogether surprising that an increase in inflation, especially when it stems from a rise in food prices, corresponds to a reduction in poverty. Of particular note in this context is the decline in poverty incidence between 1985/86 and 1990/91. This decline corresponds to a rise in inflation which appears to be primarily attributable to a rise in food prices – the rise in the food price deflator is well in excess of the rise in import prices (the other major source of inflation in the Sri Lankan economy).

Finally, international evidence suggests that those countries experiencing recurrent external payments problems are typically those with high levels of poverty. This is not

difficult to understand since trends in the long-term balance of payments of a country in the final instance reflects its economic competitiveness vis-à-vis the outside world. The more competitive an economy, the higher is its growth rate likely to be and, therefore, the lower the incidence of poverty. The competitiveness, or rather the lack of competitiveness, of the Sri Lankan economy has been alluded to above, and is arguably at the heart of Sri Lanka's failure to achieve both a sustained improvement in its external balance position and a significant reduction in poverty. One aspect of Sri Lanka's external balance worthy of additional consideration in the context of poverty alleviation is private transfers. As remarked in chapter 4 the level of such transfers has been sizeable since the early 1980s. Apart from compensating for the trade imbalance, private transfers (inward remittances) can be argued to have sustained large numbers of the poor in Sri Lanka, especially since many of the migrant workers have tended to be from poor rural households. However, to the extent that such transfers have also arguably had a sort of Dutch Disease impact on the economy, they may have also contributed negatively to poverty eradication over the longer term.

**Table 5.4**  
**Poverty and inflation in Sri Lanka, 1986-02**

	1985/86	1990/91	1995/96	2002
Poverty incidence(a)	30.9	19.9	25.2	23
		<i>percentage</i>		
		<i>Percentage change</i>		
GDP Deflator	3.4	15.5	10.3	8.4
Food production deflator	8.6	22.0	11.3	12.4
<i>Paddy production deflator</i>	5.6	28.4	7.0	14.5
Import price index	4.0	15.5	13.8	-1.2

Note: (a) Note (a) to Table 5.1 applies here too.

Sources: Table 2.1, Ch. 2; Gunawardena (2000), Central Bank Reports (various issues)

### Macroeconomic policies

Not only have macroeconomic policies, particularly those pursued in the post-1989 period, and more especially those pursued in the post 1994 period, not aided poverty reduction, they may even have contributed to its continuing high levels. To begin with, macroeconomic policies (viz., growth and stabilisation policies) have not aided poverty reduction in so far as they have served to actually stifle economic growth. As was contended in chapter 4, this was what actually happened under structural adjustment policies. Additionally, certain growth and stabilisation policies have most likely had directly deleterious consequences for poverty in the Sri Lankan context.

With regard to growth policies, two points must be made particularly with respect to agricultural production. First, trade liberalisation appears to have damaged domestic food production, and therefore the income levels of many poor families, although it may have had some short-term dampening effect on domestic food price inflation. "... (In) all the sub-sectors (of agriculture) ... growth of real wages during the nineties has been either stagnant or negative" (Seth and Dev 2003: 14). Trade liberalisation (and level playing field policies) has also damaged import substituting activities of small manufacturers in both the urban and rural sectors, adversely affecting real income levels in these sectors as well.

Second, through an extensive literature survey, (Seth and Dev 2003: 21-25) examine many constraints on agricultural productivity growth. Policy action needed to eliminate these constraints, as these authors suggest, would require a significant degree of state intervention which structural adjustment policies would not permit. Especially noteworthy is how financial liberalisation has reduced the access of agricultural producers to credit at affordable rates and with affordable collateral. This has pushed up real non-collateralised lending rates in the agricultural sector, and increased the relative cost of borrowing of less well asset-endowed producers in that sector.

It was argued earlier that anti-inflation policies in Sri Lanka over the recent past have, to varying degrees, focused on contractionary fiscal and accompanying tight monetary policies. To the extent that contractionary fiscal policies have resulted in a curtailment of transfers to households, a reduction in real wages of government employees, and an increase in expenditure taxes, these policies can be said to have actively worsened poverty without attacking the source of inflation (which in most cases was shown to be higher food and import prices). To the extent that these policies also entailed a curtailment of capital expenditures, and to the extent that this in turn had a damaging effect on the growth process, it could be argued that these policies had also an indirectly deleterious impact on poverty without attacking the source of inflation. This is not to say that contractionary fiscal policies produced no dampening impact on inflation whatsoever. They probably did. However, in so far as they did not tackle the source of the inflationary problem, their effect in terms of the curtailment of inflation was limited while the collateral damage they inflicted on growth and poverty was in all probability considerable.

Similar conclusions may be derived in respect of anti-inflation monetary policies. It has been argued in chapters 3 and 4 that, to one degree or another, anti-inflation policies have typically entailed a rise in interest rates. These in turn have resulted in higher working capital costs which have squeezed profit margins and/or real wages, and quite possibly had a dampening effect on the level of economic activity and employment. It was argued in these chapters that higher interest rates also increased the debt servicing component of the deficit and thereby exerted further contractionary pressure in respect of the budget. Again, these monetary policies no doubt had some dampening effect on inflation, at the very least because they had a corresponding dampening effect on the level of economic activity. However, since these policies did not attack the source of the inflationary pressures, the same conclusions apply as with the contractionary fiscal policies.

In contrast, anti-inflation policies founded on improving domestic food production, apart from being more successful in respect of structurally lowering inflation, are likely to have considerable poverty alleviating side-effects in countries like Sri Lanka where so many of the poor are to be found engaged in agricultural food production activities.

Finally, some consideration needs also to be given to the poverty consequences of exchange rate policies. It was noted that policies aimed at a (short-term) correction of the external imbalance in Sri Lanka have tended to be the same as those aimed at curtailing inflation. That is to say, they have involved to one degree or another contractionary fiscal and monetary policies. The poverty implications of these (anti-inflation) policies have been discussed above but not the poverty consequences of the exchange rate policy. It has been argued that currency depreciation in general worsens poverty because it



increases the prices of basics in the economy without giving rise to a commensurate increase in incomes, particularly incomes of those involved in the production of non-traded goods – which is largely the poor. The Sri Lankan evidence at first glance lends support to the above; the fall in poverty coincides with years when the currency was relatively speaking the most overvalued. However, given the significance of the exchange rate for the competitiveness of the dynamic industrial export sector, and the significance of the latter for growth and sustained poverty reduction, one should be cautious about jumping to conclusions regarding the long-term poverty mitigating consequences of an overvalued exchange rate, even if the short term negative consequences can be acknowledged. Indeed, the important point to be made here is that policy makers should be aware of the possible poverty exacerbating effects of maintaining a competitive exchange rate – particularly in the context of a shift in production to the export-oriented industrial (largely urban) sector.

### ***III. Income distribution***

#### **Macroeconomic influences**

##### *Economic growth and production*

Conventional wisdom, as encapsulated in the well-known ‘Kuznets curve’ phenomenon, holds that economic development by way of rising per capita income levels is accompanied by (an initial) deterioration in the (size and functional) distribution of income. Kuznets’ findings were taken to imply, on the one hand, some sort of functional dependence of growth on income distribution, and, on the other, a denial that increasing income equality could contribute to a reduction in poverty for developing countries. Kuznets’ results have however, been challenged by a number of studies<sup>3</sup>, with the criticism going so far as to suggest that there may even be a positive relation between more equitable income distribution and (sustainable) economic growth. In any event, many of the critics of the Kuznets curve phenomenon point to the East Asian experience where, in a number of countries, accelerated growth and rising per capita income levels were accompanied by low and/or declining inequality. One of the authors of this report, joining a contemporary debate in respect of Sri Lanka, argued as early as the mid-1970s that economic growth and redistributive justice could be combined with mutual reinforcing effects on one another (see Lakshman, 1975). Looking at the World Development Report of 2006, with its theme of equity and development, talking about “complementarities between equity and prosperity” (p. 2), one wonders whether the World Bank itself is beginning to treat distribution as a significantly relevant factor for growth and development.

A number of recent studies have purported to show that a more equitable distribution of income can contribute significantly to poverty reduction in the context of economic growth. Specifically, they show that high rates of economic growth have a relatively greater impact in terms of poverty reduction when accompanied by an improvement in income distribution, with the relation being particularly strong in the case of lower-

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<sup>3</sup> See Rao (2002) for a survey of this literature.

middle income countries (such as Sri Lanka)<sup>4</sup>. Cross-country multiple regression analysis would appear to confirm the latter. The results from this analysis are presented below in table 5.5. They show that adding income distribution to per capita income levels improves the explanation of poverty. Both explanatory variables (per capita GDP and income distribution) have the expected sign and are statistically significant at the 5% level.

Firm conclusions regarding the relation between income distribution and growth and also the relation among growth, income distribution and poverty in the Sri Lankan case are precluded by the limitations pertaining to income distribution (and poverty) data noted in chapter 2. It was argued in chapter 2 that what the available data appears to show is a fair degree of stability in the size distribution of income during the period for which we have poverty data for the country. Notwithstanding the fact that data presented in table 5.6 show marginal changes in income distribution moving inversely to rates of growth in the three survey years of 1985/6, 1990/1 and 1995/6<sup>5</sup>, it is not clear that there is necessarily a functional relation between growth (or more specifically a rise in the per capita income level) and increasing income inequality. Firstly, it needs emphasising that the change in income distribution shown is only very marginal. Secondly, data from the Central Bank's "*Report on Consumer Finance and Socio-Economic Survey, 1996/97*", shows income distribution becoming more equitable between the two 1986 and 1996/7 (see Gunatilaka 2002 for a summary of these data). Thirdly, there is ample impressionistic evidence in the case of Sri Lanka to conclude the opposite; that greater income inequality is likely to lead, through social and political turmoil, to lower economic growth.

**Table 5.5**  
**Results for regression of poverty on per capita GDP and income distribution (GINI coefficient) for developing market and transitional economies (a)**

<i>Regression Statistics</i>	
Multiple R	0.78
R Square	0.61
Adjusted R Square	0.60
Standard Error	16.93
Observations	71

ANOVA			
	<i>df</i>	<i>F</i>	<i>Significance F</i>
Regression	2	53.4	1.16
Residual	68		
Total	70		

	<i>Coefficients</i>	<i>Standard Error</i>	<i>t Stat</i>	<i>P-value</i>
Intercept	52.9	9.96	5.3	1.315E-06
GDP per capita	-0.0073	0.00073	-10.0	4.4963E-15
Gini	0.505	0.218	2.3	0.02334565

(a) GDP data is for 2000 while data for poverty levels and income distribution is the latest available in the World Bank Development Indicators database.

<sup>4</sup> See, for example, the study by Dagdeviren, van der Hoeven and Weeks (2002).

<sup>5</sup> There is no such association between income distribution and growth between the mid-1990s and 2002. The poverty incidence data of 2002, however, are not comparable to those of the earlier years shown in Table 5.6.

Although there is no clear evidence of a relation between aggregate economic growth and island wide income distribution, there appears to be some evidence of a link between changes in the sectoral distribution of income and sectoral growth rates. Thus, the increase in inequality in the estate and rural sectors between 1985/6 and 1995/6 may plausibly be related to the stagnation in production activity in these sectors, while the marginal improvement in income equality in the urban sector between the same two years could be interpreted as reflecting the relatively better performance of the industrial and service sectors (which can be assumed to be fundamentally urban). The data on district-wise mean monthly income differences showing a rising income disparity between the industrialised Colombo district and other more agriculturally based districts appears to lend support to this interpretation (see chapter 2 table 2.14). Accordingly, and provided that some credence can be given to the income distribution data, it could be concluded that the factors which have prevented Sri Lanka from achieving an accelerated growth process (that is, the requisite shift in the structure of production) have simultaneously obstructed an improvement in distributional equality.

**Table 5.6**  
**Income distribution, growth and structural shifts in production in**  
**Sri Lanka, 1985-2002**

	1985/86	1990/91	1995/96	2002
<b>Gini coefficient for household income</b>	<i>Gini coefficient</i>			
All Island	0.46	0.47	0.46	0.47
<i>Urban</i>	0.48	0.62	0.47	0.48
<i>Rural</i>	0.43	0.42	0.46	0.45
<i>Estate</i>	0.31	0.25	0.34	0.34
	<i>Percentage</i>			
<b>GDP growth</b>	4.6	5.4	4.6	4.0
<b>Sectoral proportion of total GDP</b>				
Agriculture	23.6	22.4	17.7	20.5
<i>Non-plantation agriculture</i>	5.8	4.9	3.7	4.4
<i>Plantation agriculture</i>	17.8	17.5	14.1	18.1
Industry and services	72.6	73.4	77.3	2.7
<b>Inflation (GDP deflator)</b>	3.4	15.5	10.3	8.4
<b>Relative price indices (1978=100)</b>				
Food vs manufacturing	136.1	170.7	171.4	232.9
Food vs plantation	158	157.5	174.9	264.6
Manufacturing vs plantation	115.5	92.3	102.3	113.6

Sources: Dept of Census and Statistics Household Income and Expenditure Surveys and Central Bank Reports (various issues)

To the extent that improvements in distributional equality contribute to appreciable reductions in poverty for developing countries like Sri Lanka, it could be argued that the

continuing high poverty incidence levels in Sri Lanka are also attributable to structurally induced and perpetuated high income inequality levels. However, it needs stressing that the latter appear to be related to the same factors that impede the attainment of an accelerated growth process.

### *Stability*

Finally, it is frequently argued that inflation not only worsens poverty, but also skews income distribution. The underlying rationale for this contention is that incomes in lower income brackets tend to be relatively more fixed in relation to inflation than those in higher income brackets. That income distribution at the aggregate level in Sri Lanka has remained fairly constant in the face of some considerable volatility in the general rate of inflation would appear to contradict this hypothesis (see table 5.6). That is to say, aggregate increases in prices do not appear to have had any negative consequences for the economy-wide distribution of income<sup>6</sup>. It needs stressing that this should not be interpreted to mean that higher rates of inflation would have had no adverse consequences on distribution.

If aggregate price level movements do not appear to have had any noticeable impact on income distribution at the country level, it appears to be a different story with relative sectoral price movements. The data presented in Table 5.6 would seem to suggest that relative sectoral price movements (in the Consumer Finance survey years) may have had some impact on sectoral income distribution, reinforcing the distributional effects of changes in the production structure. Thus, the strong movement of the terms of trade against manufacturing and in favour of the plantation and non-plantation agriculture may help explain why income distribution worsened in the urban sectors while improving in the rural and estate sectors between 1985/6 and 1990/1, and why it worsened so much more for the estate sector from 1990/1 to 1995/96 and 2002.

### **Macroeconomic policies**

A number of cross country studies have purported to show that distribution within developing countries has worsened during periods of increasing economic liberalisation. Again, the reliability and coverage of income distribution data are such that analogous conclusions cannot be drawn in the Sri Lankan case from these data alone. That is to say, while these data appear to show that economic liberalisation after 1977 gives rise to an increase in income inequality, it was suggested in the discussion of these data in chapter 2 that there are grounds for questioning the comparability of the data over this period. From the preceding analyses it could nevertheless be plausibly argued that there are fairly good circumstantial reasons for believing that a number of the liberalisation policies adopted in Sri Lanka over the recent past have had, to one degree or another, detrimental consequences for income distribution. Hence, it is generally accepted that trade liberalisation (particularly in the context of the post 1994 level playing field strategy) has damaged agricultural production with attendant negative consequences for both poverty and income distribution (see chapter 4). Trade liberalisation is also argued to have damaged small scale import substituting producers, many of whom were to be found in

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<sup>6</sup> The inflation rates shown in the first three columns of Table 5.6 are averages of the two years covered by each of the surveys. However even taking period average inflation rates does not improve the relation between inflation and income distribution.

rural areas. Likewise, financial liberalisation may have worsened income distribution both between and within sectors through the implied shift in income towards financial asset holders, who are typically in the urban, upper income brackets. It may also have worsened income distribution by diminishing the access of rural poor and small producers to (concessional) credit facilities. The latter is evidenced by the rise in real rates on rural and non-collateralized lending. Although privatisation has not been extensive enough to have had a significant impact on overall income distribution, it would appear that certain privatisations may have had specific and identifiable impacts. The privatisation of plantation companies, for example, may have had a negative impact on income distribution (and poverty) in the estate sector. Sectoral data in table 5.6 shows a deteriorating income distribution in the sector in the post commercialization/privatisation period – post-1990. This is also consistent with the observation that real wage increases lagged productivity increases in this sector.

There is also reason to believe that stabilisation policies may have had certain detrimental consequences for income distribution, apart from having no structural impact on inflation. The shift in taxes from income and towards expenditure and the reduction in transfers to poor households in an attempt to cut the budget deficit more than likely had negative consequences for income distribution. Tight monetary policies may well have had similarly negative consequences for income distribution, reinforcing the negative distributional effects of financial liberalisation noted above. Lastly, while a policy of lagging the exchange rate may have had short to medium term positive consequences for poverty, it may also have served to depress wages, particularly those in traded goods sectors, worsening income distribution in those sectors.

#### ***IV. Human development***

##### **Macroeconomic influences**

Over the longer term the level of human development in most market based economic systems is related to the growth of per capita income. In low and middle income countries as important, if not more important, in explaining the level and trend in human development is the level of government expenditure on those services which affect human development, viz., health, education, sanitation, the provision of safe water, etc. A decline of government expenditure in respect of these services could result in a relative decline in human development in relation to the growth of per capita GDP while an increase could counter the negative human development effects of a slowdown in per capita growth. Naturally, in a market based setting there are limits to the extent to which the level of human development-oriented government expenditure can be maintained in the face of a slowdown in per capita GDP growth.

It was shown in chapter 2 that there was an appreciable improvement in human development in Sri Lanka over the period 1980-2000 as evidenced by, among other things, the rise in the UNDP's Human Development Index (HDI). The data presented in Table 5.7 would appear to confirm that this rise in human development is primarily attributable to a corresponding rise in both real per capita income and social expenditure levels. The data presented in the table show percentage increases in the HDI, per capita income level, and real per capita social expenditure for five sub-periods between 1980

and 2004. These data show that the rise and fall in HDI growth between selected years over the period 1980-2004 corresponds to a rise and fall in per capita income growth allowing for changes in social expenditure. In several sub-periods the movement of social expenditure appears to offset the impact of changes in per capita income. For example, the fact that the rise in the HDI in the 1995-2000 sub-period is significantly lower than in the 1990-95 sub-period in spite of the fact that the rise in per capita income in the two sub-periods is nearly identical, is explained by the fact that real per capita social expenditure in the former sub-period (1995-2000) is so much lower. Similarly, it would appear that the relatively high growth of per capita income in the 1980-85 sub-period (as compared with, say, the 1985-90 period) is not fully reflected in HDI growth because of the offsetting influence of the decline in real per capita social expenditure in that sub-period. Compensating HDI effects of movements in per capita income and social expenditure can be seen also in a comparison between 1995-00 and 2000-04 sub-periods. Finally, the period 1990-95 witnessed the strongest growth in the HDI because, as one might have expected, both per capita income and per capita real social expenditure rose strongly in this period<sup>7</sup>.

**Table 5.7**  
**Human development, per capita income and social expenditure, 1980-2000**

	1980-85	1985-90	1990-95	1995-00	2000-04
	<i>percentage</i>				
HDI	5.5	4	6.4	3.1	1.4
Per capita income	18.4	10.3	21.9	19.8	11.4
Real per capita social expenditure	-1.4	21.6	21.6	0.5	13.8

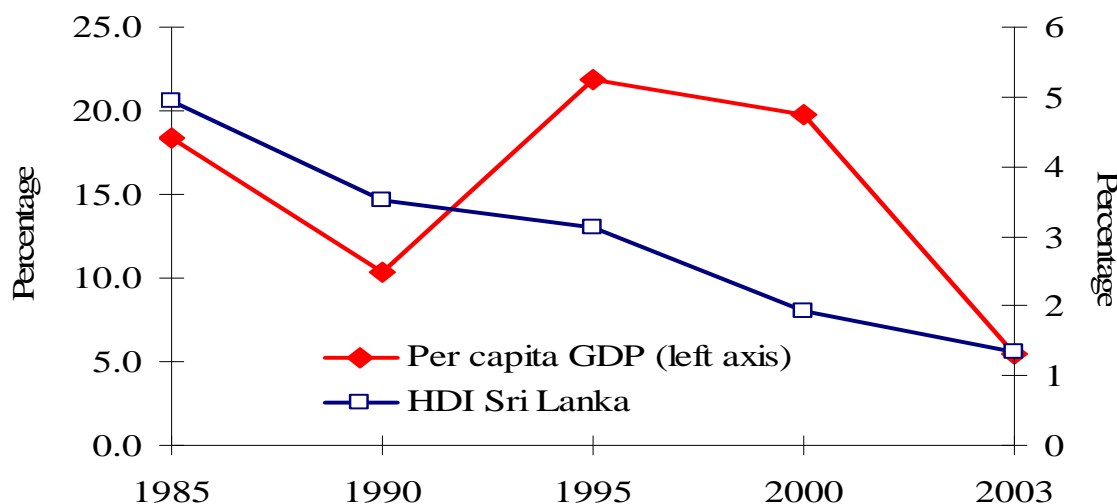
Source: *Human Development Report (2002, 2005)*, UN, Central Bank of Sri Lanka, Annual Reports (various issues).

It is often argued that inflation can worsen human development by, among other things, reducing real expenditures of government (and the private sector) on healthcare, education, sanitation, water, etc. The Sri Lankan experience, however, does not corroborate this hypothesis. Thus, per capita real human development related expenditures have risen continuously in respect of the four sub-periods under consideration while inflation has risen and fallen alternately. In fact, when human development related expenditures are expressed as a percentage of GDP there appears to be a direct correspondence between this variable and inflation (see Table 5.8). That is to say, periods of high inflation correspond to periods of relatively high human development related expenditure. While this should not be taken to imply that inflation is necessarily good for human development, these data may be taken as confirming the growing consensus view that moderate levels of inflation are not necessarily damaging to human development.

A similar argument could be advanced in respect of the external payments situation. Thus, although Sri Lanka has experienced recurrent external payments difficulties, these do not appear to have been of a nature which had a significant impact on human development.

<sup>7</sup> One should of course remember that the HDI incorporates a measure of per capita income in PPP dollar terms.

**Figure 5.4**  
**Human Development Index and Per Capita Income, percentage changes, 1980-2000**



**Table 5.8**  
**Inflation and social expenditure as a percentage of GDP, period averages, 1978-2001**

	1978-84	1985-89	1990-94	1995-01	2002-04
	<i>percentage</i>				
GDP deflator	14.8	6.9	12	8.8	7.5
Social expenditure (as % of GDP)	9.9	9	9.5	8.5	7.7

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

### Macroeconomic policies

To the extent that macroeconomic policies failed to promote rapid and sustained economic growth these policies can be said to have not contributed to the observed improvement in human development. At the level of the individual growth-oriented policies, it could be argued that certain of these may even have slowed this improvement. Thus, on the one hand, trade liberalisation may have facilitated access to better medicines and medical supplies, advanced educational materials and pedagogic techniques, etc. Financial liberalisation/development and the encouragement of private sector participation has facilitated an expansion of, and improvement in, medical and educational services, telecommunications, electricity supply, etc. On the other hand, there has been a simultaneously growing divergence in the degree of access to and the quality of the relevant services for different sections of the population (a point already made in chapter 2). This growing divergence results from the shift in responsibility for the payment of these services to the individual and away from the state which has accompanied the liberalisation process.

The stabilisation policies pursued may be said to have had a more unequivocally negative impact on human development in Sri Lanka. To begin with deflationary policies can be said to have hurt human development to the extent they damaged the growth process.

Further, to the extent that the anti-inflation policies misguidedly targeted the budget deficit and this in turn took the form of relative reductions in human development related expenditures, such policies can be said to have had a further direct impact on human development. Moreover, to the extent that the anti-inflation deficit financing policies increased the debt servicing requirements of the government, and these in turn put sustained pressure on the non-debt servicing components of government current expenditure, anti-inflation policies can also be said to have produced a directly deleterious impact on human development. It needs also emphasising in this context that the reduction in human development related government expenditures in the 1995-2004 period was not simply a consequence of pressures to reduce the budget deficit. Rather, it was also a consequence of the broader growth strategy pursued – the pressures on expenditure in general as a result of reductions in revenue generation due to the sharp decline in trade tax revenues, and the pressures on various expenditure components as a result of increases in debt servicing due to the shift in the mode of financing of the government's budget deficit (see chapter 4). We should perhaps end this section by highlighting the fact that, focusing as we did on the impact of macroeconomic policies on human development, we did not consider some of the very relevant factors in the broader political economy of determinants of human development levels in the society.

## ***V. Basic conclusion***

The basic argument of the authors of this report may be stated in the following terms:

- Economic growth, particularly rapid economic growth, is an indispensable precondition for a significant and proximate decline in poverty and rise in living standards of the majority of the population. Attempts at eliminating poverty and raising living standards in the absence of economic growth through, for example, the re-distribution of income and higher *per capita* real social welfare expenditures, will not be successful or sustainable and most likely end up giving rise to “shared poverty” – a phenomenon which is often seen as having characterised Sri Lanka in the period 1970-77. On the other side of the coin, ignoring income distribution and social expenditures in the context of rapid growth runs the very real risk of begetting social and political turmoil, thereby bringing to a halt, and quite possibly even reversing, the growth process. Rapid economic growth which is accompanied by a policy of more equitable income distribution and human development, i.e., a policy which may be termed “shared growth”, seems to offer the best possibility of, on the one hand, a sustainable growth process and, on the other hand, an appreciable reduction in poverty and rise in living standards.
- In the case of Sri Lanka, poverty incidence has remained stubbornly high because of a failure to achieve an acceleration of economic growth, i.e., a failure to achieve consistently high levels of economic growth. Attempts at redistributing income and/or allocating more resources for human development in the absence of an acceleration of economic growth could return Sri Lanka to its earlier condition of shared poverty, or even shared poverty coupled with social and political turmoil. However, if accelerated growth is not accompanied by redistributive and human development policies the sort of social and political turmoil witnessed in the second half of the 1980s appears to be a very real danger.



## VI. Summary

The present chapter built on the analyses of the preceding chapters with a view of analysing the way in which macroeconomic developments and accompanying policies have impacted on poverty, income distribution and human development. The major points made in this regard were as follows:

- The stickiness of poverty incidence in Sri Lanka appears to be fundamentally attributable to a failure to achieve an acceleration of economic growth. This failure and the relatively high levels of poverty seen in the rural and plantation sectors, are in turn attributable to the failure to shift the structure of the economy towards export-oriented industrialisation. Such a shift, it is argued, would provide remunerative employment opportunities for the poor in the rural and plantation sectors.
- The levels of inflation experienced by Sri Lanka do not appear to have had any significant impact on poverty. There is some suggestion that relative sectoral price level changes may have even had a positive effect on poverty in the rural sector in 1990/91.
- Structural adjustment policies, particularly trade and financial liberalisation, as well as stabilisation policies, were argued to have had certain negative consequences for poverty without significantly aiding either growth or structural (long-term) stability.
- There appears to be no compelling international or Sri Lankan evidence to support the proposition that income inequality is a necessary adjunct of accelerated economic growth, or that a more equitable distribution of income would not enhance poverty reduction in the context of accelerated growth. International evidence is presented (and other studies cited) to show that poverty reduction will tend to be enhanced when growth is accompanied by greater income equality. Sri Lankan data is presented to show that the relative greater incidences of poverty in the rural and estate sectors may be related to more unequal distributions of income in these sectors, although it is noted that the factors underling the latter are probably in large measure the same factors depressing the relative growth of these sectors.
- As in the case of poverty, there appears to be no evidence of aggregate price level changes having had any marked impact on overall income distribution, although there is some suggestion that relative sectoral price changes may well have impacted on sectoral distribution patterns.
- As with poverty incidences, adjustment and stabilisation policies are argued to have had a negative impact on income distribution.
- It is argued that the improvement in human development in Sri Lanka is to a large extent explainable by rising and high *per capita* income and state real *per capita* social expenditure levels. Inflation levels over the period under consideration do not appear to have been of a level which had any significantly negative influence on human development.
- Adjustment and stabilisation policies are argued to have harmed human development to the extent that they retarded economic growth and exerted (unnecessary) downward pressures on real *per capita* social expenditure levels.

## **Chapter 6: Elements of a pro-poor macroeconomic strategy**

### ***I. Introduction***

From the preceding analysis it can be concluded that Sri Lanka's growth strategy over the recent past has not been particularly pro-poor, or indeed particularly pro-growth. In fact, what this analysis suggests quite strongly is that a pro-poor growth strategy (PPGS) needs in the first instance to be more pro-growth. At the same time it suggests that a PPGS also needs to be more equitable, and continue to pay heed to human development. It is the purpose of this concluding chapter to expand on what are conceived to be the key elements of such a strategy, building on the major findings of the preceding chapters in the process.

### ***II. A pro-growth strategy***

The arguments and analyses presented in the preceding chapters, particularly those in chapters 4 and 5, suggest that Sri Lanka's continuing high levels of poverty are in large measure the result of an inadequate growth dynamism. The inadequate growth dynamism in turn has been argued to be the consequence of inappropriate macroeconomic policies. It is not simply that appropriate pro-growth policies have not been adopted, but also that those policies which were adopted have, to varying degrees, actually stifled growth. Accordingly, the following outline of the types of pro-growth policies which should be adopted will be set against a background of the detrimental aspects of those policies which have been adopted.

#### **The structure of production**

What then is the essence of a pro-growth strategy in the present Sri Lankan context? Quite simply a pro-growth strategy is one which actively favours commodity production, especially manufacturing and agricultural food production. This is not an argument for ignoring other sectors like tourism which has a capacity to contribute to value-added and employment growth. In chapters 4 and 5 reference has been made to what service sectors like tourism contribute to growth and development. In this brief summary of the main elements of a pro-poor growth strategy we will highlight the main arguments consistently raised and defended throughout the study. The following paragraphs in this section will attempt to develop the rationale and the policy implications of a policy of promoting manufacturing and agricultural food production.

##### *Export-oriented manufacturing*

The theoretical literature on the growth-augmenting potential of manufacturing activity is well established, going as far back as Adam Smith. In a nutshell manufacturing is argued to have this potential because it offers the greatest possibility for product diversification and expansion, as well as productivity increases. From a purely technical point of view, the shift towards manufacturing production for many market-oriented developing countries is not particularly difficult. All the requisite material inputs are readily available and manufacturing technologies are in principle, if not fact, transferable (by means of FDI flows and the direct purchase of inputs). Moreover, most mass production technologies do not require a particularly high level of skills on the part of labour – primary school education on the part of the work force is enough. Actually, most

developing countries have seen a shift in the production structures towards manufacturing; in some cases even before the formal ending of the colonial era. Many of these shifts took place on the basis of protected domestic markets in the context of imports-substituting-industrialisation strategies. Others, arguably the more successful ones, took place on the basis of production for the external market. Whatever the relative merits of the different approaches, it would appear that for a small, relatively open, low wage country like Sri Lanka the policy choices are in any event limited. In fact, as should be clear from the earlier chapters, the authors of the present report take the view that the emphasis in the present Sri Lankan context should fundamentally be on (manufactured) exports.

Although manufacturing activity should be fundamentally export oriented, it has to be acknowledged that many developing countries which have shifted their production structures towards manufacturing activities over the recent past have not, in contrast to the East Asian success stories, fared particularly well. This suggests that some policy attention needs to be paid to the nature of the manufacturing activities being encouraged. In this regard the following factors are important. Firstly, product groupings supported should be such that demand for them is relatively income elastic and price inelastic (ensuring a certain degree of price/revenue buoyancy). Second, and related to this, the product should be developable and differentiable. Product development and differentiation possibilities contribute to income elasticity and price/revenue buoyancy. Third, and more generally, encouragement should be given for a continuous diversification of the manufacturing production base. Many developing economies that have shifted towards manufacturing activities yet failed to take off in the manner of the successful East Asian economies have failed to diversify their manufacturing bases. Like Sri Lanka, many of them are producing a few standard, low value added, products such as garments; products which are also produced by numerous other developing countries.

While the major focus of attention in the promotion of manufacturing activity should be on export-oriented manufacturing, some support can also be given to import substituting manufacturing activities. Of course market size as well as both multilateral and bilateral trade agreements limit the scope for import substitution in the Sri Lankan context. However, a number of obvious areas for the promotion of import substituting activities remain. For example, given the continuing importance of food in the average household's budget, import substitution in respect of food processing is certainly worthy of consideration.

The promotion of domestic manufacturing requires policy makers to focus on costs of production, finance, market access, and the exchange rate. Since developing countries such as Sri Lanka are unable to influence world market prices for their manufactured exports, the competitive battle with other producers of similar products tends to be fought on the basis of costs. The important costs which have a bearing on this battle are wages, various input costs such as energy, transport, telecommunications, etc., interest charges, and marketing. Interest charges and marketing costs will be taken up in the present section in the context of the discussion of finance and market access, while the exchange rate will be taken up later in the context of a consideration of fiscal and monetary policies.

Traditionally the most important cost in competitive battles between countries is assumed to be wages. The fact that most workers in poor countries like Sri Lanka continue to

spend such high proportions of their incomes on basic food items would suggest that food prices have an important bearing on wage demands, and, hence, on wage costs. Aside from basic needs and food security arguments, this has been another important justification for a domestic food production policy, particularly in the context of an accompanying competitive exchange rate policy. We will return to this point below in the discussion of agricultural production.

Cost competitiveness in successful export driven growth processes have also crucially depended on the control of input costs such as energy, water, transport, etc. It has been argued that these costs are best controlled by either transferring the activities concerned to the private sector, or, at the very least, commercialising them (adopting full cost pricing rules). However, leaving aside the merits and demerits of subsidizing the provision of these inputs, it is well known that many of them are typically produced in the context of what may be described as “a natural monopoly environment” in developing countries. Hence, the assumed efficiency gains and corresponding price reductions from privatisations and commercialisations of public utilities providing these inputs are rarely forthcoming. The experience of most developing countries, as well as quite a few developed countries, is that privatisation/commercialisation of public utilities has resulted in significant increases in the prices of their outputs. Price and efficiency gains have taken place where the industry concerned is not a natural monopoly and where the regulatory authorities are able to guarantee a competitive environment. Even here, it is not self evident that from a development point of view the economic activity should necessarily be in the private sector and subject to market pricing rules. The point here is that policy makers need to consider carefully the dynamic cost consequences of privatisations/commercialisations.

We turn now to the issue of finance and interest charges. The financing requirements of manufacturing enterprises can be broken down into a long-term fixed capital formation financing requirement and a shorter-term working capital financing requirement. Contrary to the assumptions underlying the well-known financial liberalisation thesis, private financial institutions provide relatively little long-term investment finance, particularly in a developing country setting. It is well known that this type of finance comes for the most part from either the retained earnings of the manufacturing companies themselves or from state long- and medium-term credit institutions. In the early phases of development of manufacturing activities, when retained earnings are relatively small in terms of fixed capital formation requirements, state financing institutions necessarily have an important role to play in providing the requisite financing. The experience of all the successful Asian economies is that such financing played a crucial role in the success of these economies. In fact, following the East Asian example, and in the context of the promotion of manufacturing production, Sri Lanka developed two well run development finance institutions, the Development Finance Corporation of Ceylon (DFCC) and the National Development Bank (NDB). As noted in chapter 4, both were privatised in the wake of a shift in policy stance towards more “level playing field” type policies, with the result that both have moved away from development banking activities. As a consequence it would appear that there is presently no real source of long to medium term finance in Sri Lanka. Private commercial banks, by their nature, will not lend funds

long-term<sup>1</sup>. Nor will any other private financial institution, particularly not in the uncertain environment of a developing country like Sri Lanka. Hence, there is need at the present juncture to once again set up state long- to medium-term fixed capital formation financing entities.

While working capital finance can in principle be provided by commercial and merchant banks, concessional working capital facilities for exporters (and quite possibly certain import substituting producers) will require either direct or mediated state credit facilities. It is well known that when Sri Lankan exporters have most needed low cost credit facilities, e.g., when there is a downturn in world markets, working capital charges of private financial institutions, even in respect of fully collateralised loans, have been exceptionally high.

Finally, policy makers pursuing an export-oriented manufacturing growth strategy need to be cognisant of the issues of marketing and market access. Marketing costs in the highly competitive markets in which Sri Lanka will be seeking to break into tend to be fairly high. At present these costs are entirely borne by the individual producer. One of the important vehicles used by the successful East Asian countries for reducing marketing costs and simultaneously increasing market penetration was the “trading house”. Trading houses sought to improve the competitive advantage of exporters by pooling their marketing resources and gaining from economies of scale in contract size. In the case of China and a number of other East Asian economies trading houses also provided invaluable product information and other market intelligence aiding product development and market penetration.

Attention to market access (and relevant technology transfer) needs also to be taken into account in the framing of Foreign Direct Investment (FDI) codes. Many developing countries, Sri Lanka included, see the main purpose of attracting FDI as providing much needed foreign exchange and employment opportunities. A secondary consideration is the assumption that FDI inflows will provide a catalyst for the development process. However, FDI flows are typically quite small in relation to aggregate investment (under 10%), and have rarely, if at all, played a catalytic role in development processes. Again the experience of the successful East Asian economies is salutary in this regard. For the first generation of successful East Asian economies FDI inflows were important for technology and know-how transfers, to feed an on-going growth process. Hence, FDI codes were developed to ensure that such transfers took place. Good examples of these practices are to be found in the cases of Singapore and Malaysia. For the late comers, facing increasing impenetrable markets in the advanced countries for competing products, market access was as important if not more important. Hence, FDI codes were also used to facilitate market access.<sup>2</sup> Again, FDI was encouraged with a purpose of facilitating and sustaining an on-going growth process. Indeed, foreign investors were attracted to these countries, and contributed to the development processes in these countries, precisely because of the existing growth processes. The tendency of late in Sri Lanka has

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<sup>1</sup> Among other things, commercial banking principles require the matching of assets and liabilities time profiles.

<sup>2</sup> Partly in recognition of the success of these codes and practices, current proposals by the developed countries for the next round of GATT discussions includes an extension of the TRIMs agreement to prevent precisely this.

been to formulate investment codes in a way that simply attracts foreign investors without any strategic thinking behind this formulation. Such approaches to FDI code formulation certainly suit potential foreign investors but it is unclear what growth benefits it yields for Sri Lanka.

#### Agricultural food production

Although agricultural production *per se* does not have the same growth accelerating potential as manufacturing production, the promotion of domestically oriented agricultural food production is considered by the authors of the present study to be indispensable to the success of any industrialisation process. Its importance in this regard comes above all from the stability it brings to wage demands and costs, particularly in the context of a depreciating exchange rate. An excessive dependence on food imports, particularly basic food imports, will effectively neutralise the competitive impetus emanating from currency depreciations where wages adjust to compensate for (food) import price increases. To the extent that wages do not adjust to compensate for currency depreciations, it will mean that competitiveness is attained through real wage reductions.

Aside from food security arguments, the more direct importance of agricultural food production for poverty alleviation is fairly evident in Sri Lanka given the dependence of large numbers of the poor on incomes derived from this activity. An expansion of agricultural food production founded on an increase in labour productivity and land yields should raise farming incomes and have an overall positive impact on poverty levels provided that any displaced labour finds remunerative employment in the industrial and services sectors.

Policy measures to promote agricultural food production should include land reform, protection for domestic food producers, extension of credit, development of agricultural marketing services, development of extension services and directed rural industrialisation activities and agricultural price stabilisation schemes. An elaboration of certain of these policy prescriptions is called for here. On land reform, the proposal being mooted is for clearly defined land entitlements and not land titles *per se*. Those advocating land titles (in the context of a complete privatisation and commercialisation of all lands) argue that these will provide poor farmers with much needed access to credit because they will be able to use the land as collateral. The experience with such schemes in certain other developing countries, most notably in Latin America, is that the poor farmers end up being forced into “fire sales” of their land with the advent of the first crop failure, leaving them with no alternative form of livelihood and forcing them to migrate to the urban areas in search of alternative employment. It is well known that state common rural agricultural lands have provided a safety valve for many urban poor in developing countries. Land entitlements (say in the form of 100 year leases), in contrast should provide farmers with the necessary security of tenure, without the danger of them losing their means of livelihood and sustenance. In this context, it is proposed that credit should continue to be provided by state institutions and that these facilities should be expanded, but mostly for the purposes of domestic food production. It is well known that perceived risk and scale factors, as well as simple logistics, preclude significant private sector lending in rural areas in developing countries (except in the case of fully collateralised lending noted above). The private sector can however play a major role in developing agricultural marketing services. It has frequently been contended that, lacking the

necessary incentives and resources, state agricultural marketing enterprises in Sri Lanka have performed their functions poorly, even to the extent of acting as a disincentive to agricultural production. The introduction and active encouragement of private agricultural marketing services could not only improve the entire agricultural food distribution system, it may cause the state marketing bodies to improve their efficiency by, among other things, enabling them to focus on more limited aspects of the food distribution chain. Finally, agricultural price stabilisation schemes are warranted by, on the one hand, the viscidities of agricultural production and, on the other hand, the importance of stable food prices for wage demands. Specifically, shortfalls in domestic agricultural food production should trigger producer subsidies to maintain producer income levels without triggering inflationary food price increases.

#### Rural industrialisation

While most of the focus of industrialisation activities will be in the urban areas for obvious reasons (e.g., infrastructure, export market access, technical expertise, etc.), a pro-poor growth strategy needs to pay some heed to the potential for rural industrialisation, particularly since the vast majority of the poor are to be found in the rural areas and a significant proportion of these in off-farm activities. At a general level what needs to be said about the rural industrialisation process is that attention needs to be focused on what is being produced. Many rural industrialisation programmes see rural industrialisation activities as a way of providing employment and/or alleviating rural poverty without little or no regard being paid to the sustainability or development of these activities. Hence, rural industrialisation programmes end up getting rural producers to produce products (e.g., clay pots, wooden spoons, etc.) which have no dynamic market potential. In the context of the preceding discussion, and the experience of successful market-driven rural industrialisation schemes, the policy recommendation here is to orient rural industrialisation activities towards the provision of agricultural inputs, consumer goods for the rural community, and outsourcing activities for the urban based export-oriented producers.

### **Fiscal, monetary and exchange rate policies**

This section will look at the fiscal, monetary and exchange rate policy implications of a pro-growth strategy, which also seeks to stabilise growth.

#### Fiscal policies

One of the major justifications for targeting the budget deficit has been that reductions in the deficit allegedly enhance economic growth. The international and Sri Lankan evidence would appear to contradict this view point, suggesting that deficit targeting is not integral to a pro-growth policy. At the same time, this should not be construed as an argument in favour of an expansionary fiscal policy led growth process. Indeed, in the liberalised trade environment which prevails in Sri Lanka today such an expansionary policy is likely to result in an unsustainable increase in both the external payments deficit and domestic and foreign debt. Rather, fiscal policy needs to be guided by a careful evaluation of the growth (and welfare) consequences of expenditures, revenue generation measures and deficit financing.

### Expenditure

Capital expenditure has been the focus of most growth-related discussions pertaining to government expenditure. The economic logic underlying the neo-liberal-type approach holds that government capital expenditure tends to “crowd-out” private sector capital expenditure in developing countries because of the narrowness of financial markets in these countries. The counter argument holds that government capital expenditure can “crowd-in” private capital expenditure, i.e., it will induce private sector investment. The Sri Lankan experience presented in chapter 4 does not appear to provide support for either of these contentions. As such, the present report supports a policy of targeted capital expenditures, where priority is accorded to expenditures which contribute most to the export-oriented industrialisation process. Presently the rationale being offered for large, potentially wasteful, capital expenditure programmes is one of poverty alleviation, with little or no regard for (let alone assessment of) the growth-inducing consequences of these expenditures. As is well-known, in the absence of growth such expenditures will in any case be unsustainable (see below for a further discussion of these matters).

Although the importance of current expenditures in the promotion of economic growth has been downplayed by Sri Lankan policy makers over the recent past, the report suggests that transfers to public corporations and institutions in support of the industrialisation (and agricultural food production) process are vitally important in the promotion of economic growth. Of particular importance are transfers to facilitate the provision of concessional credit facilities and stabilise a number of strategic costs.

### Deficit financing

The essence of the deficit financing strategy should be to maintain and, where necessary, even restore “captive source” financing options<sup>3</sup>. It was shown in chapter 4 that the shift away from captive sources, together with the commercialisation of these sources and strictures on printing money, put an upward pressure on real interest rates. The latter has in turn raised the cost of debt servicing and refinancing, with the debt servicing component of current expenditure exerting an ever-increasing pressure on government budgetary constraint. One reason why the shift away from captive and other non-commercial sources of finance has put an upward pressure on money market rates is that it has made the treasury-bill auctions into increasingly zero-sum games for the buyers of treasury bill (typically the commercial banks).

Deficit financing should also be cognisant of the actual and expected liquidity requirements of the system when taking decisions about printing money to finance the deficit, and not adhere to rigid limits such as those set under the auspices of PRSP type programmes. There are numerous examples, particularly in the 1995-2001 period, when printing of money to fund the deficit was severely constrained while, paradoxically, the Central Bank was called upon to inject additional cash in the system (e.g., through reverse repurchase agreements).

The authorities should also be cognisant of the fact that the more the deficit is financed by recourse to foreign sources the less freedom they have to maintain a competitive

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<sup>3</sup> Captive sources are essentially non-market financing sources where the interest payable on the borrowed funds is at the discretion of the government.



exchange rate. Currency depreciation increases the local cost of foreign debt and the servicing of this debt. For example, the sharp rise in overall debt in 2001 was mostly attributable to the large fall in the value of the rupee in that year and the corresponding rise in the value of the foreign component of that debt. In this context, the authorities should be particularly wary of increasing long-term foreign debt, however concessional the initial terms of the corresponding borrowings may be. Wherever possible foreign debt should be substituted by local debt, and, where an increase in foreign borrowing is unavoidable, it should be relatively short-term.

#### Monetary policies

According to conventional wisdom monetary policy in a developing market economy should fundamentally aim at controlling inflation, and to this end should target the growth of high powered money. The analysis in chapter 4 cast doubt on the validity of both the assumed stability of the money multiplier as well as the causal link between (broad) money stock and inflation. The strong implication of that analysis was that inflation in Sri Lanka was more explainable by cost push factors and that money stock changes were largely endogenous. Moreover, as in most market based systems, the cash base of the Sri Lankan financial system was argued to be (also) largely endogenous, with attempts to control it resulting in high and volatile money market rates. This means, *inter alia*, that attempts to control high-powered money have little direct impact on inflation in Sri Lanka, only having an indirect impact via higher interest rates and changes in the level of economic activity. Therefore, the recommendation of the present report is that, in keeping with practice in most advanced countries and a large number of successful developing countries, monetary policy goals should not be limited to inflation targeting, but should consider the general state of the economy, particularly trends in growth and employment. It is also recommended that the key operative monetary policy variable should not be the cash base of the system but cash market interest rates – quite possibly reverse repurchase rates<sup>4</sup>. Since repurchase agreements and short treasury bills are substitutable some attention would also need to be paid to the structure of these rates.

None of the above should be construed as support for an “easy money”, low interest, policy. Such a policy would undoubtedly translate into inflationary pressures and external payments problems. In fact, it is recommended that interest rates be actively used to dampen demand induced inflationary pressures and balance of payments problems whenever they arise. Such a policy should not be damaging to growth provided that targeted concessional working capital and fixed capital credit facilities are in place.

#### Exchange rate policy

A pro-growth exchange rate policy is one which maintains the competitiveness of the currency. It was shown above that this competitiveness is not ensured by using the currency of a trading partner (or even group of trading partners) as an anchor. In fact, the lessons of the East Asian and Latin American currency crises are that if anything a high weight should be attached to currency and price movements of large regional competitors. Nor is competitiveness ensured by allowing, as is the current practice in Sri Lanka, forces of demand and supply to determine the rate. On the one hand, it is known that many of

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<sup>4</sup> Reverse repurchase rates are rates at which the Central Bank is willing to discount acceptable short-term debt (usually treasury bills) of commercial banks needing cash.

the forces underpinning the supply of foreign currency into the local foreign exchange market have little or nothing to do with the productive base of the domestic economy. A case in point here is private remittances. On the other hand, it is known that in a controlled capital account environment balancing demands for foreign currency in respect of domestic capital outflows are largely absent from the foreign exchange market, creating a built-in overvaluation bias for the currency.

In the final instance the cost advantage which Sri Lanka would obtain from a competitive exchange rate policy would depend on the extent to which currency depreciation impacts on local costs. The more liberalised developing economies become the less possibility for this dislocation between local costs and currency movements. The example referred to above was the consequences of currency depreciation for wage costs in the context of an increased dependence on imports of basic food items. However, the principle applies to all manner of costs, including interest rate charges. The more these costs are tied to external prices, the less effective a depreciation of the currency is likely to be in terms of improving the cost competitiveness of domestic producers.

It also needs remarking that a competitive depreciation policy is necessarily an adjunct of an export-oriented growth strategy. In the absence of the latter, competitive depreciations are likely to inflict more pain than benefits. Hence, somewhat paradoxically, competitive currency movements are to be eschewed until complimentary policies which would ensure a supply response of exporters of manufactured items are forthcoming. In the absence of such dynamism, the net impact of a competitive currency policy is likely to be inflation and a worsening of the trade balance.

### ***III. Equitable or shared growth***

It was noted in chapter 5 that a more equitable distribution of income accompanying an accelerated growth process could have a significantly greater impact on poverty than a distribution-neutral growth process. A number of studies, citing the experience of several successful East Asian economies, contend that a more equitable distribution is not harmful to the growth process, and may even positively enhance it. The paucity and reliability of Sri Lankan income distribution data are argued to be such that they preclude similarly definitive conclusions in this regard. However, to the extent that there appears to be no evidence suggesting that an improvement in income distribution has been harmful to the growth process, and since a large proportion of the poor are in employment, policies to promote a more equitable distribution of income should arguably be integral to a pro-poor growth strategy.

Even if it could be argued from the available data that the shift in production structure towards industry and services and away from agriculture improves income distribution, it is more than likely that such a shift in production structure only creates the necessary conditions for a more equitable distribution. Indeed, there are good theoretical and empirical reasons for believing that such a shift is quite consistent with a worsening of income disparities. Accordingly, there appears to be ample justification for the active promotion of more equitable or shared growth. Given Sri Lanka's history of civil disturbances and ethnic strife such a policy may even be seen as indispensable for the socio-political sustainability required for any rapid growth process.

For distributional policies to have the maximum possible effect on poverty, they need to be consistent with the pro-growth strategy outlined above. For example, policies which favour incomes of domestically oriented food producers (viz. credit, price support, etc.) will be far more cost effective in alleviating poverty over the longer term than policies favouring incomes of all agricultural producers. A similar reasoning can be applied to employment subsidies and wages support schemes favouring export-oriented industries.

At a more general level, one specific redistribution measure which is likely to have significant poverty alleviating consequences without any correspondingly detrimental effects on economic growth is tax reform. As shown in chapter 4 almost the entirety of the tax burden resulting from the decline in trade based taxation was assigned to expenditure taxation. This is in stark contrast to what happened in the successful East Asian economies, where most of the burden was in fact borne by profits and income taxation.

#### ***IV. Growth with human development***

While greater income equality is one vehicle for achieving more equitable or shared growth, another is maintaining and improving levels of real social expenditures, including transfers to poor households. It could be argued that there is something of a trade-off between the two. Thus, the greater the market orientation and/or the more developed the economy, the more income equality is required for shared growth. The greater the market orientation of the economy the more individuals will have to pay for services such as healthcare, education, water and sanitation. The more developed the economy the greater the capacity for individuals to pay for the latter. Similarly, the less market orientated and/or developed an economy, the more state social expenditures will be required to ensure shared growth. In this latter context it is not simply a question of an increased provision of services but also access to and quality of these services which matters.

Given Sri Lanka's level of development and degree of market orientation, the maintenance and increase in *per capita* real social expenditure levels appears to be important for shared growth. Moreover, given that access to, and quality of, many of the services provided on the basis of these expenditures are known to be problematic some attention needs to be paid to their provision. One important aspect of this policy discussion which may be broached here is the matter of commercialisation/privatisation. It is frequently contended that the quality and accessibility of services such as education and healthcare would greatly improve if they were subject to market strictures. In Sri Lanka's case this has meant encouraging private education and healthcare alongside continuing state provision of these services. Partly as a consequence of this ambivalent policy position, the quality, if not accessibility, of the public sector services has declined over time. Simply infusing more money into these services is unlikely to have the desired structural impact on them in terms of quality. What seems preferable is to introduce a degree of commercialisation. The aim should be to improve the quality of the services without impairing the access of the poor to these services. In this context across-the-board imposition of user charges is to be eschewed.

Extensive has been the study and debate in Sri Lanka on social sector policy and the reform of the prevalent social sector policy stances requires learning from past

experiences, which have been subjected to critical study from many perspectives. Our study, with its narrower focus, has not made a careful attempt to gain a deep understanding of the available knowledge about problems and policies in such complex areas like education and healthcare. We do not, therefore, wish to make conclusive suggestions here about what ought to be the principal elements of social sector policy within a pro-poor growth strategy. Two points are highlighted. First, policy makers ought to be concerned about both quantity and quality of the services the systems in place would provide. Second, the principle that the opportunities of using the available services must be equally distributed must be safeguarded in the reform effort.

An additional point of relevance which is closely related to our narrower study objectives is that, whatever shape the social sector reforms may take working on the above broad principles, these ought to be devised with an eye to their being financed without causing adverse long-term socio-economic impacts. It is of note that presently most social expenditure by government is domestically financed. However, given the importance attached to maintenance and even increases in these expenditures by both the international financial institutions (IFIs) and donor countries, and given the limited funds available to government in the present (low growth) circumstances, there appears to be some case for at least part of government social expenditures being funded by donor contributions, of course with requisite safeguards to avoid a loss of these earmarked funds to corruption.

## ***V. Summary***

The aim of this concluding chapter is to bring together the findings of the present study with a view to highlighting what are seen as the key elements of a PPGS for Sri Lanka. The major points made in this regard were as follows;

- A PPGS for Sri Lanka needs in the first instance to be pro-growth. That is to say, it needs to generate a growth dynamic which would lead to a rapid and sustainable increase in per capita income levels. Such a strategy should be founded on export-oriented (and import-substituting) industrialisation and the promotion of domestic food production. To ensure sustainability such a strategy also needs to be accompanied by active distributional and human development related measures. That is to say growth should be “shared growth”.
- Export-oriented (and import-substituting) industrialisation provides the best possibility for achieving rapid and sustainable economic growth. An effective industrial export-promotion strategy needs to be cognisant of the importance of both the nature and competitiveness of exports (and domestic import substituting commodities). With regard to the former this requires incentives and support to be given for the production of exports with the greatest price buoyancy and income elasticity. It also requires a general policy commitment to a continuous and extensive diversification of the export manufacturing base. With regard to the latter, (i.e., competitiveness) policy attention needs to be paid to factors such as low cost finance, labour and other input costs, technology acquisition and development, and the competitiveness of the exchange rate.

- Agricultural production is indispensable for stabilising industrial wages (and raising real wages of industrial workers) as well as raising incomes of agricultural producers – who constitute a high proportion of the poor. Policy measures to promote a dynamic agricultural food production sector need to include in the Sri Lankan context; land reform by way of a clear delineation of land entitlements (as opposed to land titles), concessional rural credit facilities, commercial marketing services, extension services, and the like. In view of the importance of food prices in the movement of the aggregate price level and wages, consideration should also be given to an agricultural price stabilisation scheme. Apart from mitigating excessive price movements, this would also help stabilise (farmer) incomes.
- Bearing in mind that many of the rural poor are employed in off-farm activities, there is need for serious attention to be paid to rural industrialisation. However, the promotion of rural industrialisation activities, and specific policy choices thereof, should not be geared to employment generation or income support *per se*. Guidance about production activities to be promoted must come from whether markets for the promoted activities are available or can be created. Rural industrialisation efforts should, therefore, be located in the context of the broader industrialisation and food production strategy. It is this broader strategy that should dictate the choice of the products to be produced, and method of production to be adopted, in the process of rural industrialisation, and not the goals of mere employment creation and income support.
- Fiscal policy should be oriented towards the needs of (shared) growth and not, as is presently the case, stabilisation. In this context careful consideration needs to be given to the composition of both expenditure and revenue, as well as the mode of deficit financing. Caution should be exercised in respect of massive state capital expenditures of the type undertaken in the early 1980s. Every attempt should be made to lower the debt servicing component of current expenditure. Revenue generation should shift from expenditure to income based taxation. Deficit financing should, as much as possible, move away from domestic money market and foreign sources, and towards captive sources (and strategic money market financing). This would also aid the process of reducing debt servicing costs.
- Monetary policy should, as in an increasing number of market-based economies, move away from being focused narrowly on the curtailment of inflation by targeting the money base, and towards a focus on broader macroeconomic goals (i.e., including economic growth) the management of interest rate, particularly money market rates.
- Exchange rate policy should seek fundamentally to maintain the international price competitiveness of domestic producers, and not, as is the current practice, the balancing of short term forces of supply and demand in the foreign exchange market.
- Policies promoting income distribution and human development should accompany any accelerated growth process to ensure, among other things, the social and political sustainability of this process. One potentially important redistribution measure already alluded to is a shift in the tax incidence. Human development requires a continuing commitment of government to the maintenance or even increase in current

levels of real per capita social expenditures, quite possibly with donor assistance in the interim prior to the attainment of higher levels of per capita GDP.

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