

# Invigorating the Anaemic Economy

## PART I

### The Anaemic Economy - 1995-2001

Economic management in the last seven years, far from laying the foundation for a viable economy, had on the contrary weakened the fundamentals and steered the economy to mediocre performance first and to a virtual standstill in 2001. The lacklustre performance demonstrated by moderate economic growth, falling external assets, slowing of export growth, yawning budget deficits, rising public debt, shrinking public investment, falling share prices, continuous currency depreciation and rising prices in the six years 1995-2000 culminated in an economic crisis of alarming proportions from which there is no easy recovery. The deterioration of the economy over this period is clearly illustrated by the following facts and figures published in official documents.

### Declining Economic Growth

The average annual economic growth in Sri Lanka in the six years 1995-2000 was 5.1 per cent which was lower than 7.5 per cent in Maldives, 6.4 per cent in India and 6.0 per cent in Bangladesh. It is noteworthy that Sri Lanka had the lowest growth rate of all South Asian countries in the agricultural sector in this period — only 1.9 per cent — whereas Pakistan had 5.2 per cent, Bangladesh 3.9 per cent and India 2.5 per cent. Sri Lanka's industrial growth in these six years of 6.4 per cent was lower than that of Maldives, Bhutan, Bangladesh and India. Economic growth in 2001 was minus 0.6 per cent and 2001 may well be the only year with negative growth in the country's history. This sharp drop cannot be ascribed to the global downturn, particularly the US recession, as some other countries, which

export much to the US, show much higher growth. India for example, which sells nearly a quarter of its exports to the US is estimated by the *Economist* to have had 5.2 per cent growth in 2001 and China which too exports about the same proportion to the US was estimated to grow at 7.5 per cent. The average annual economic growth in the seven years 1995-2001 is 4.3 per cent. Both agricultural and industrial production declined. In the first ten months of last year, tea and coconut output had fallen by 3.4 per cent and 5.9 per cent respectively and private industrial pro-

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duction had plummeted by 9.4 per cent in the 12 months to October 2001.

It has been pointed out by some that the GNP doubled between 1994 and 2000. It is true that the GNP increased by 114 per cent in this period but that is GNP at current factor cost prices. GNP at constant factor cost prices or in real terms rose by only 34 per cent. In the seven years 1988 to 1994 GNP at current factor cost prices increased more — by 160 per cent — and GNP at constant factor cost prices increased by 35 per cent.

### Falling Domestic Food Production

Domestic food production shows little progress. Paddy production in 2000 of 2,859,000 metric tons was only 1.7 per cent higher than the 2,810,000 metric tons in 1995 and it was expected to fall further in 2001 because of the prolonged drought. Production of subsidiary foods has declined on account of free trade policies and liberalized imports in the last six years; the fall in production between 1995 and 2000 was as follows: - potatoes by 41 per cent, chilies

by 34 per cent, black gram by 32 per cent, green gram by 27 per cent, cowpea by 25 per cent, red onions by 12 per cent, maize by 11 per cent and Soya beans by 75 per cent. Only big onions, groundnuts and kurakkan appear to have increased in production in this period. The drought would have caused a further drop in subsidiary food crop output in 2001. Employment and income of thousands of farmers who cultivate these crops have been adversely affected.

### Weakening Export Growth

The average annual export growth rate of Sri Lanka in 1995-2000 was 9.8 per cent and it was lower than 15.1 per cent of Bangladesh, 12.5 per cent of Nepal and 10.7 per cent of Bhutan. Although exports rose by 19.8 per cent in 2000, they have declined in 2001. In the first ten months of 2001, exports in dollar terms have declined by 9.1 per cent over the corresponding period in 2000. The principal export — textiles and garments — has dropped by 11.4 per cent and agricultural exports by 5.8 per cent. Tea prices in dollar terms were 17.5 per cent lower in October than a year ago. Minor agricultural exports show an alarming trend; all except pepper, nutmeg and cinnamon declined in export volume in the last six years. Between 1995 and 2000, export volume fell by 98 per cent in other oil seeds, 97 per cent in coffee, 91 per cent in cocoa products, 80 per cent in arecanuts, 74 per cent in cashew nuts, 66 per cent in sesame seed, 58 per cent in cardamoms, 47 per cent in vegetables, 38 per cent in unmanufactured tobacco, 31 per cent in essential oils, 14 per cent in cloves, 12 per cent in betel leaves, 3 per cent in fruits and 67 per cent in others. The drought is likely to have caused a further drop in production in 2001. Several minor agricultural exports like coffee, cardamom, sesame seed, other oil seeds, cocoa products and cashew nuts may cease to be exported in the near future if the current trends continue.

### Drop in Tourist Arrivals & Migrants Transfers

Tourist arrivals which declined from 436,440 in 1999 to 400,414 in 2000

or by about 8 per cent are expected to drop further particularly as a result of the global downturn and the fear created by terrorist attacks at Katunayake airport. In the first ten months of 2001 tourist arrivals were 10.5 per cent less than in the corresponding period in 2000, while migrants transfers (net) were 3.3 per cent lower. The country's foreign exchange earnings from both sources — tourism and migrants remittances are likely to show a marked drop in 2001.

#### Large Current Account Deficits and Fall in External Assets

Sri Lanka's average annual current account deficit in the balance of payments in 1995-2000 was 4.1 per cent of GDP which was higher than India's average deficit of 1.2 per cent of GDP and Bangladesh's 2.0 per cent of GDP. In 2000 for example, the current account deficit was \$ 989 million or 6.0 per cent of GDP caused mainly by a large trade deficit of \$ 1798 million. The current account deficits have been filled mainly by using the country's official foreign exchange reserves which fell from \$ 2063 million in 1995 to \$ 1202 million in September 2001 or by 42 per cent. Actually, official foreign exchange reserves fell to as low as \$ 942 million at the end of March 2001 — the equivalent of 1.6 months' imports. The IMF standby of \$ 131 million in April however boosted the reserves to \$ 1202 million by September — the equivalent of 2.3 months of imports which is still rather low. Total external assets, *i.e.* including those of commercial banks have fallen from \$2902 million at the end of 1995 to \$ 2131 million at the end of 2000 and risen slightly to \$ 2240 million by October, 2001.

The large current account deficits are also a major cause of the depreciation of the rupee from \$ 1 = Rs. 54.0475 in 1995 to US \$ 1 = 74.3235 in 2000 and US\$ 1 = Rs. 92.7400 in November 2001. The constantly depreciating rupee tended to increase prices of all imported goods and raise the general price level in the country.

#### Trickling Foreign Investment

The liberal tax reliefs and other generous concessions offered by the government had not been successful in attracting foreign direct investment (FDI) on a large scale. The total amount of FDI received by Sri Lanka in the six years 1994-1999 amounted to \$ 1142 million in contrast to the \$ 22,451 million received by Malaysia (which has a population of 22 million, a little bigger than Sri Lanka's 19 million). Sri Lanka has received only about one-twentieth of the FDI Malaysia had got. The highest annual amount of FDI Sri Lanka received, in the six years was \$177 million in 1999 (which was lower than the \$ 187 million in 1993) but it declined to \$ 173 million in 2000. FDI inflow is likely to be less in 2001 on account of the global downturn and uncertainty created by both terrorist attacks on the airport and the general elections. It is also important to note that FDI contributed to only 5.6 per cent to the gross fixed capital formation in Sri Lanka in the six years as compared to 18.3 per cent in Malaysia. Investment in all countries is financed mainly by domestic savings; the expectation of substantial FDI inflows has led to the neglect of measures to raise domestic savings.

#### Outflow of Portfolio Investments and Collapse of the Share Market

The all share price index of the Colombo Stock Exchange declined from as high as 987 at the end of 1994 to 572 at the end of 1999 and then to 503 in mid-November 2001. The main reason for the fall is the withdrawal or net sales by foreign investors — by Rs.1.5 billion in 1998, Rs.0.9 billion in 1999 and Rs.3.4 billion in 2000 — due to lack of confidence.

#### Rising Prices

Consumer prices in Sri Lanka increased at a higher rate than all the other South Asian countries in the six years 1995-2000. They increased by 8.9 per cent a year on the average in contrast to 8.8 per cent in Pakistan, 7.8 per cent in Bhutan 7.1 per cent in Nepal, 6.2 per cent in Bangladesh and 5.5 per cent in India and 3.3 per cent in Maldives. They

rose by 6.2 per cent in 2000 and were rising at around 14 per cent per annum in 2001 or double the rate in 2000. The annual average price increase in November 2001 was 14.2 per cent as compared to 6.2 per cent in November 2000. A major reason for price increase is the large-scale deficit financing. Cost of credit rose from 1995 to 2000. Central Bank figures show that the Bank Rate has risen from 17.00 per cent to 25.00 per cent, Inter-Bank Call Loan rate from 14.00-28.00 to 20.25-32.00 and the Weighted Prime Lending Rate from 17.80 per cent to 21.46 per cent in this period. In 2001 interest rates appear to have been artificially lowered despite heavy government borrowing presumably to help the government.

#### Yawning Budget Deficits

Deficit financing is a regular feature in South Asia. The country which has been having the largest budget deficits in the period 1995-2000 is Sri Lanka; its average annual budget deficit was 9.0 per cent of GDP which exceeded those of all other countries. Pakistan 6.5 per cent, India and Bangladesh 4.8 per cent, Nepal 4.3 per cent, Maldives 3.4 per cent and Bhutan 0.8 per cent. This large-scale deficit financing in the last six years bears testimony to the poor fiscal management by the Sri Lankan authorities. The budget deficit in 2000 was 9.8 per cent of GDP and the target deficit for 2001 according to the Budget Speech, is 8.5 per cent of GDP, but the actual figure is expected to be 10.5 per cent of GDP. The budget deficit in 2001 is estimated at Rs. 149 billion much higher than the estimated budget deficit of Rs. 123 billion. The deficit had increased rapidly with the pre-election concessions and reliefs granted to win over the people: increase in salaries by granting an interim allowance of Rs.1,200 to all public servants including teachers and Rs.750 for all pensioners from 1<sup>st</sup> October, increase in Samurdhi benefits by Rs.100-200 a month and the allocation of Rs.150 million to provide loans to beneficiaries, new consumer subsidies for wheat flour and gas and

reducing the price of kerosene by Rs. 2.00 a litre; abolition of import duties on raw materials, reduction of tariff on cement from 25 to 15 per cent and reduction of port tariffs on milk powder and milk food by 18 per cent, on fertilizer by 19 per cent and reduction of export tariff on textiles by 34.8 per cent and coconut products by 31 per cent; abolition of the diesel tax and Save the Nation contribution and the reduction of the National Security Levy from 7.5 per cent to 6.5 per cent and the turnover tax on bank loans by one percent and compensation of Rs. 21.3 million to the victims of civil riots at Mawanella.

The yawning budget deficit was being financed in the usual manner by borrowing. Government borrowing from the banking system amounted to Rs. 45 billion although the Budget estimates indicated that there would be no bank borrowing. The large-scale bank borrowing is one of the major causes of inflation, which as mentioned earlier is increasing at the rate of around 14 per cent a year. It has also resulted in the increase in government's domestic debt by Rs. 154 billion from Rs. 625 billion at the end of September 2000 to Rs. 779 billion at the end of September 2001; government's debts to the banks rose by Rs. 61 billion from Rs. 165 billion to Rs. 226 billion in this period.

### **Rising Public Debt**

Government debt has reached high and worrisome levels. It rose from Rs. 552 billion at the end of 1994 to Rs. 1219 billion at the end of 2000 or 97 per cent of GDP and to Rs. 1,372 billion in August 2001. With the rapidly increasing deficit and borrowing to fill it, public debt had exceeded the GDP for 2001. Higher the public debt higher the interest; in 2000 interest payments were Rs. 71.2 billion and they accounted for one-third of government revenue. They were estimated to rise over Rs. 90 billion by the end of 2001 or nearly 35 per cent of revenue or over 6.3 per cent of GDP. Higher interests normally lead to higher taxation to increase revenue.

### **Emasculation of Public Investment**

In accordance with the neo-liberal philosophy of withdrawal of the state from economic activity, public investment has been reduced from 7.9 per cent of GDP in 1995 to 6.4 per cent in 2000. Budget Estimates expected to raise it to 7.4 per cent of GDP in 2001 but this was too optimistic. The target for 2000 in the previous Estimates was 8.1 per cent but the actual turnout was 6.4 per cent. Further capital expenditure is likely to have been reduced drastically to meet the cost of the pre-election concessions and reliefs. Containing or reducing capital expenditure relatively means less investment in the economic and social infrastructure, which will tend to slow economic growth. Public investment does not crowd out private investment; on the contrary, it stimulates private investment both by improving the infrastructure and providing contracts and sub-contracts in state development projects. Downsizing of the public sector resulted in the loss of employment to 168,884 employees; total public sector employment fell from 1,325,164 in 1994 to 1,156,280 in 2000 disproving the claim that there was no retrenchment in the public sector in the last six years.

### **Downturn in Business and Unemployment**

Free imports in the open economy has resulted in the weakening or closure of many small and medium industries producing import substitutes. The Small and Medium Entrepreneurs' Lanka Organization (SMELO) had informed the government that more than 745 small and medium scale enterprises had closed down during the last six months of 2001. It stated further that every month at least hundred of small enterprises were shutting down due to the absence of proper economic policies to safeguard these industries. In the shoe industry for example, it was reported that half of the ten big producers had closed down while Bata was suffering losses and further, many of the 1000 small producers were surviving with difficulty. Free imports of tyres and tubes, sanitaryware, hardware and many others were also affecting local manufacturers adversely. To make matter worse, the fall in demand as a result of

the US recession had serious effects on the garments industry. The Sri Lanka Chamber of Garments Exporters has reported that 250 out of the 850 factories involved in garments exports are currently operating below 50 per cent capacity and some of the factories were paying half-month wages. The import duty concessions extended by the US to Mexico and the Sub-Saharan African countries and the likely concessions to Pakistan were expected to hurt Sri Lankan garments exports further. The Chamber had warned of the possible closure of at least 50 factories in the following weeks on account of falling orders. The Chamber therefore had requested assistance from the government in the forms of using the cess on garments exports to pay salaries of their workers, suspension of loan repayments and reduced interest rates, rebate on electricity charges in terms of capacity utilization, refund of war risk premia on Marine and Airfreight and reduction of the terminal handling charges. Tourist hotels too had sought state assistance to overcome the difficulties they were facing on account of the fall in tourist arrivals.

The Labour Department reported on "unprecedented" number of applications seeking permission to closure or lay off staff from firms struggling against the economic downturn. There had been 35 such applications in the last three months of 2001, mainly from firms in the apparel and tourism sectors. There may have been many other cases — not reported to the Labour Department — of staff being asked to stay at home on paid leave. Some economists estimated Sri Lanka's unemployment exceeded 10 per cent of the labour force and it was likely to rise with the global downturn and the falling demand for Sri Lanka's exports.

### **Chicken and Three-Wheelers!**

The increasing population and the increase in employment and income tend to result in increase in consumption and increase in imports. The population increased from 16.6 million in 1988 to 17.6 million in 1993 and then to 19.4 million in 2000

while per capita GDP rose by 6.2 per cent between 1988 and 1993 and by 6.9 per cent between 1995 and 2000. Thus, the increase in consumption including chicken and increase in imports including three-wheelers is not a new phenomenon — it is a process which has gone on for years. It is not only the number of three-wheelers, which have increased, but also the number of motor cars, buses, lorries, vans and motorcycles. The number of new registration of motor vehicles in the six years 1995-2000 was 543,757. This does not mean that there were no motor vehicle imports in the previous years. In fact, the new registrations in the six years 1988-1993 was 503,297. It is not only motor vehicles but all imports increased over the years. The total value of imports increased from \$ 5311 million in 1995 to \$ 7320 million or by 38 per cent but the total value of imports rose from \$ 2233 million in 1988 to \$ 4011 million in 1993 or by 80 per cent. Does the greater increase in imports in the earlier six years indicate that they were more prosperous than the later six years?

The interesting point, however, is that the increase in imports in 1988-1993 was accompanied by an increase in the official foreign exchange reserves by \$ 1397 million whereas the increase in imports in 1995-2000 appears to have been financed partly by using the foreign exchange reserves which fell by \$ 861 million in the period. Official reserves rose from \$ 278 million in 1988 to \$ 1675 million in 1993 but they dropped from \$ 2063 million in 1995 to \$ 1221 million in October 2001. Apart from using up foreign exchange reserves to the extent of \$ 861 million, the authorities increased foreign borrowing by \$ 236 million between 1995 and 2000. The pursuit of amateurish policies based partly on political expediency, and partly on preference for foreign enterprise over indigenous enterprise and downsizing the state's role in guiding, building up and protecting the economy to complement private enterprise (as in East Asia) economic mismanagement at all levels, the absence of a full-time Minister of Finance and widespread corruption,

cronyism, lawlessness and injustice had all contributed to the economic crisis.

## **PART II Invigorating the Economy**

The new government is facing a daunting economic situation of declining production and investment, negative growth, falling exports, tourist arrivals, migrants transfers and external reserves, yawning budget deficit, rising prices and trade unions agitating for higher wages. The challenge before the new government therefore is to arrest the economic decline, remedy the shortcomings, stabilize the economy and push it onto the path of development by sound economic management. The objectives are clear: to increase investment, production, exports, tourism and external reserves, to reduce the budget gap, arrest the inflationary rise in prices and deal with the trade unions, but the crucial question is whether the legacy of incompetent economic management, and the prevailing adverse external environment will permit quick solutions.

### **The Budget**

The first thing the new government has to do is to prepare the Budget for 2002, for without it the government will not be able to spend money this year. In preparing this budget the government needs to provide adequate funds for current as well as capital expenditure of government without creating a large budget deficit. One of the major reasons for the economic mess today is the excessive budget deficits exceeding 10 per cent of GDP in 2000 and 2001. Excessive deficit financing needs to be reduced and this can be done by cutting unnecessary or low priority and wasteful expenditure on the one hand and increasing revenue on the other. Some of the unnecessary and wasteful expenditure which can be cut without any adverse effect on the economy or the people are the new luxury buildings in Kotte, fleets of a dozen or more motor vehicles used by ministers and unnecessary travelling, subsidized meals for Members of Parliament and high rents paid to luxury buildings used as ministry offices, but these are not enough. Consequently, measures need to be taken to raise revenue. Tax revenue has

declined from 17.8 per cent of GDP in 1995 to 14.5 per cent in 2000 as result of tax reductions when the escalating war expenditure warranted higher taxation. Average import duty for example was reduced from 9.6 per cent in 1994 to 7.0 per cent in 1999 and then to 4.5 per cent in 2000. This is a very low ratio when compared to developed countries. The ratio of tax revenue to GDP exceeds 50 per cent in Sweden, 40-50 per cent in Denmark, Finland, Belgium, France, Italy, Netherlands and Norway, 30-40 per cent in Germany, Britain, Canada and Switzerland and 20-30 per cent in US, Japan and South Korea. Tax revenue must be increased and the most feasible ways seem to be an increase in a progressive way, income taxes and increase on a selective basis, import duties, excise taxes and goods and services taxes. Taxation should be progressive and the burdens should not be imposed on the lower income groups as far as possible. Normally, a new government would not like to increase taxes, but the fiscal situation is such that it does not have an alternative. It should at least begin by eliminating the current account deficit or the excess of recurrent expenditure over revenue, which was 3.4 per cent of GDP in 2000.

There are several other ways of reducing expenditure, but they are long-term measures and are not feasible in the first budget. Military expenditures accounting for about 17 per cent of the total expenditure (Rs. 71 billion in 2000 alone) can be reduced only by halting the war against terrorism and this is likely only through protracted negotiations. Besides, rehabilitation and employment-creation for the demobilized soldiers are likely to absorb a good part of the savings from ending the war. Subsidies and transfers account for about 10 per cent of the total expenditure but being sensitive items, they too cannot be reduced from the word go. The Samurdhi benefits for example are enjoyed by half the country's population when only a quarter are in actual poverty; this scheme needs to target only those living below the poverty line but this will be bitterly

opposed by those already enjoying the benefits. Appropriate measures to tackle this problem can be formulated — but not immediately. Subsidies to loss-making state-owned corporations can be stopped but it will result in unemployment — a prospect not to the liking of a new government. It is therefore necessary to take measures to increase the efficiency of state-owned enterprises to enable them to generate a surplus for government revenue. What is most important is to appoint independent and commercially oriented boards of directors to these enterprises and to stop politicizing them as in the past. Both India and China are restructuring their weak state-owned enterprises — not privatizing them as we have been doing; state-owned corporations in countries such as Taiwan and Singapore generate substantial revenue to the government; they are assets not liabilities and a source of income to which we have not paid enough attention.

Foreign loans and grants are generally for public investment and further are project related and they are normally not extended for recurrent expenditure and budget support. The government should negotiate them for some of their new projects and programmes, but they are unlikely to help the government in reducing the current budget deficits although they may help to reduce inflationary bank borrowing.

**Economic Growth**

Perhaps the most important determinant of economic growth in Sri Lanka is rain: good rainfall generally results in high growth and drought spells low growth. If the current thunderstorm rains and the North East monsoon rains result in a good Maha crop, the new government can start on a firm footing. If power supplies and production are not interrupted by the failure of the South west monsoon this year, that will contribute to higher production. No one can predict what the rainfall will be this year, but unless there is adequate rainfall the current trend of declining production of paddy, subsidiary crops, tea, rubber,

coconut and spices as well as industrial output will continue. The second major determinant of economic growth is the external demand for our exports, which determines the export prices and our export earnings. Exports are equal to about one-third of the GDP. Generally, high expansion of exports, like good rainfall, tends to promote high growth. A study of the figures of structure of the Gross Domestic Product and its annual changes indicates that economic growth is affected mainly by three factors: paddy output (depending on local rainfall), tea exports (depending on rainfall but more on world market) and textile and clothing exports (depending on the world market demand).

There were four years in the nineties which experienced high growth of 6.0 per cent and above — 1990, 1993, 1997 and 2000 — five years which had below 5 per cent growth — 1991, 1992, 1996, 1998 and 1999 — and two years with growth between 5.0 and 6.0 per cent — 1994 and 1995. In the high growth years, all the three sectors — paddy, tea and clothing — combined to bring about high growth in three years: 1990, 1993 and 1997; in 2000, paddy and tea showed moderate growth but clothing compensated for that by achieving high growth. In the moderate growth years too, it was clothing exports, which showed high growth while paddy and tea experienced moderate growth. Actually, tea did badly in 1995, but it was offset by the jump in clothing exports. Coming to the low growth years, high growth of clothing failed to offset the marked fall in paddy production in 1991, 1992 and 1996 and the decline in tea production in 1992 and low growth in 1991; in 1998 and 1999, paddy production recovered but production of tea slowed down and prices actually fell in 1999; clothing exports too showed a moderate growth in both years, particularly 1999. Thus, the eco-

nomie picture for 2002 will be shaped by rainfall as discussed above and the world economic situation, which determines the fate of our exports.

**Key Determinants of Economic Growth 1990-2000**  
(% Annual Changes)

Year	Change in Real DGP Growth	Change in Paddy Sector	Change in Tea Sector	Change in Factory Industry Sector
1990	6.2	21.3	12.6	10.2
1991	4.6	-5.9	3.2	9.5
1992	4.3	-2.0	-25.7	13.0
1993	6.9	9.6	29.6	11.3
1994	5.6	4.7	4.4	8.8
1995	5.5	4.7	1.6	10.0
1996	3.8	-26.7	5.1	7.3
1997	6.3	11.2	7.1	10.3
1998	4.7	18.3	1.1	7.6
1999	4.3	6.6	1.3	4.5
2000	6.0	4.2	4.0	9.3

Source: Central Bank Annual Reports

**Adverse External Environment**

The global downturn and the terrorist attacks in the US and the war against terrorism, according to the World Bank, are expected to result in a low economic growth of 1.4 per cent in the developed countries in 2001 and about the same in 2002. Economic growth in the US is estimated to fall from 1.0 per cent in 2001 to 0.6 per cent in 2002 and in the Euro area from 1.5 per cent to 1.0 per cent. The developing countries which achieved an economic growth rate of 5.5 per cent in 2000 are expected to have only 2.9 per cent growth in 2001 and about the same in 2002. This means slower growth in the world for Sri Lanka's exports than even now. In the first ten months of 2001, Sri Lankan exports in dollar terms, were 9.1 per cent less than in the first ten months of 2000: agricultural exports were 5.8 per cent lower and industrial exports 9.6 per cent lower, with textile and apparel exports 11.4 per cent lower. Further, prices of exports are now lower than last year: dollar prices of tea, for example, in October 2001 was 17.5 per cent less than a year ago and the unit value of total exports in July 2001 was 11 per cent lower than a year ago.

With the downturn deepening, indications are that our exports will continue to decline in 2002 too.

The World Bank estimates a fall in private capital flows to developing countries too, on account of the downturn and terrorist attacks in the US and war against terrorism, from \$ 240 billion in 2000 to \$ 160 billion or by 33 per cent in 2001. The picture is unlikely to show an improvement in 2002. Foreign direct investment to Asia alone is estimated to decline by 12 per cent this year. Both developed and developing countries experiencing low growth will be less able to invest abroad. The major foreign investors in Sri Lanka are the NICs in Asia such as South Korea and Singapore but they are all experiencing difficulties with the sharp fall in their electronic exports to the US and consequently will have less capacity to invest abroad. Singapore in fact as shown earlier had a negative growth of 2.2 per cent in 2001 — the worst performance in the country's 36-year history and is estimated to experience between negative 2.0 per cent and positive 2.0 per cent in 2002, in contrast to 9.9 per cent growth in 2000. The number of people made bankrupt reached a record 2904 in 2001. South Korea is expected to have less than 2 per cent growth and Hong Kong negative growth of minus 0.2 per cent. Japan, which continues to be in deep recession and will have a negative growth of 0.8 per cent in 2002, too will be investing less overseas. In addition to foreign private capital, official development assistance too is expected to fall this year and the next with main donors mired in the slowdown. Currently aid claims only 0.22 per cent of the GNP of developed countries far short of the 0.7 per cent goal agreed to by the international community, but even this low figure is likely to fall further. Japan, the largest giver of ODA has cut its ODA budget for 2002 by 10 per cent. The global slowdown and the terrorist attacks are also expected to cause a sharp decline in tourism. Tourist arrivals in Sri Lanka in the first ten months of 2001 were 10.5 per cent lower than in the corresponding period in 2000. Uncertainty and fear of war in the Middle East may reduce

the demand for foreign workers; in fact migrants' transfers are already declining: net inflows in the first ten months of 2001 show a fall 3.3 per cent. It appears as if Sri Lankans may not find employment opportunities in the Middle East as before and this will tend to aggravate the problem of unemployment.

#### Domestic Investment

If the external situation is unfavourable, can we stimulate the economy by increasing domestic consumption and investment which account for about two-thirds of the GDP; Consumption is already high and it accounts for 83 per cent of the GDP: besides, further increase in consumption will result in more imports and strain the balance of payments and reduce our external reserves. As it is the high level of consumption which reduces the resources available for investment, the appropriate approach is to not to increase but reduce consumption in order to expand investment. Sri Lanka's investment has been about 25 per cent of GDP in the last six years whereas that of East and South East Asian countries has been 35 to 40 per cent before the currency crisis. This relatively low level of investment has resulted from the low level of gross domestic savings in Sri Lanka, averaging about 17 per cent of GDP in recent years as compared to 30 to 50 per cent in East and South East Asian countries. Some of these countries have been receiving substantial foreign direct investment too, particularly Singapore, Hong Kong, Malaysia, but FDI has accounted for only about 7 per cent of the gross fixed capital formation in Thailand and below 3 per cent in Taiwan and South Korea in the nineties, bearing testimony to the importance of domestic savings. One of the surest ways of increasing savings is to achieve budget surpluses by measures to reduce current expenditure and to raise revenue which were discussed earlier. Current budget deficits, as shown earlier, are about 10 per cent of GDP. Budget surpluses would enable the government to make further improvements in the economic and social infrastructure and at the same time to expand the production base of the economy by establishing industrial undertakings which are shunned by the private sector, not to compete with private enterprise but to complement it.

Private investment may be deterred by the unfavourable external environment, particularly its effect in reducing exports and foreign capital inflows, but there is much scope for import substitution industries. It is unfortunate that for several years, the authorities concentrated on export industries and neglected import substitution industries, instead of encouraging both as Japan, and East and South East Asia have been doing. Further, import substitution industries of today can become the export industries of tomorrow as some of our early import substitution industries like garments, biscuits, rubber products, ceramics and leather products have demonstrated. Import substitution industries, like domestic food production, however, may not be able to get off the ground if imports are allowed freely: they need to be protected by selective restrictive measures and supported by concessional credit and subsidies at least in the initial stages. The developed countries like the US protect their weak industries even today, for example, steel, textiles, clothing, automobiles, sugar, groundnuts and tobacco. As the world market for exports has weakened, we have no alternative but to develop and expand import substitution industries to provide employment and income to the rising unemployed while conserving foreign exchange and increasing government revenue through higher import duties. It is difficult to see why we are importing cement, building glass, sanitaryware, hardware and rubber goods on a large scale when we can produce them here. What is blocking import substitution industrial development is our "free trade" mindset and our mistaken belief that import substitutes are necessarily of poor quality. Can anyone really say that our import substitutes like biscuits, chocolates, garments, ceramics and rubber and plastic goods are inferior? The new government should therefore review our industrial policy, taking into account the external situation, not only with the objective of conserving foreign exchange but also of expanding the country's production base to create employment and income and accelerate growth.

## Inflation

One of the major reasons for the inflationary rise in prices — 13-14 per cent a year — is the increase in import prices, by as much as 16 per cent in 2000, on account of higher prices in the supplying countries and depreciation of the rupee. Although we are powerless against price increases in the world market, we could stabilize the rupee by increased production and sound fiscal policy. Another is the excessive budget deficit, which we must try to reduce in order to stabilize prices. Yet another is inadequate production and excessive middlemen's margins in items like vegetables and fruits. As the production of potatoes, chillies, pulses, red onions, maize and others have fallen in the last six years, vigorous efforts need to be taken to step up their production. It is to bring down their prices that the cooperatives, Markfed and the Marketing Department were used to provide competition by the authorities in the past. It is not too late for the new government to at least revive Markfed and the cooperatives which played an important role in ensuring reasonable prices to the consumer as well as the producer. The role of cooperatives was neglected under the free market policies in recent years but the extensive use of the CWE to purchase and sell grains, vegetables and fruits is clear proof that the free market had not been a success; the role of the cooperatives needs to be restored. In fact one of the principal reasons for the demand of trade unions for higher wages is the high cost of living and this can be tackled to some extent by arresting inflation, increasing production and sale of vegetables and fruits through Markfed and the cooperatives in competition with private trade. The successful efforts made by the new Minister of Commerce and Consumer Affairs to reduce the prices of milk powder, tyres, batteries; cooking gas and diesel oil by persuasion rather than by fiat are laudable; price reduction of more items is envisaged by the Minister in the same way in the near future.

It will be difficult however, for the new government to resist higher salaries and wages, particularly if the Salaries Commission in fact recommends their increase. Further, a part of the salary increase has already been given by way of the interim allowance of Rs.1,200. As an increase in salaries and wages in the public sector will enlarge the budget deficit, the authorities may have no alternative but to find the required funds from higher taxation. The authorities should not insist that the private sector too pays these higher wages as a large number of firms are in difficulties because of the world economic downturn and are clearly unable to pay them. In the tea sector for example, it is not possible to pay higher wages when world tea market prices are falling; in fact, they have, as shown earlier, declined by 17.5 per cent in the last 12 months. Export prices are also falling in other agricultural exports and garments and some factories have been closed down.

## The IMF

The new government will find it very difficult to implement the reforms prescribed by the IMF in March 2001 without creating public unrest. For example, it may not be in a position to raise prices of petroleum products when the trade unions are already complaining of the high cost of living; it may not be able to undertake reforms in the labour market to facilitate greater mobility if the trade unions which have presumably supported the governing party at the election, are opposed to it. It will, for reasons discussed earlier, not succeed in freezing public servant's salaries and wages and it may find it difficult to privatize Shell and Telecom shares if the same trade unions do not support it. Besides, the stock market may not be favourable in the context of the global downturn. It behoves the new government therefore to convince the IMF of its difficulties and attempt to modify the reforms agreed to by the previous authorities. The IMF, it is reported, has become less rigid in its orthodox recommendations, and there is no reason why it should not appreciate the difficulties of the new government and approve new policy measures it may formulate while releasing the balance \$ 122 million of the tranche and recommending other do-

nors to release loans amounting to \$700 million withheld on account of the unsound policies.

Make no mistake, the balance of payments is going to be critical this year with the continuation of the global economic downturn, recession in Japan and uncertainty and fear created by terrorism. Our exports will continue to face bleak export markets and our export earnings are likely to decline. This will be compounded by the reduced inflow of migrants' transfers on account of the uncertain situation in the Middle East and the decline in tourism and foreign capital inflows. Unless imports are restricted, these adverse factors are bound to enlarge the deficit in the balance of payments and reduce our external reserves. In such a situation we may not have an alternative other than borrowing from the IMF. It is of crucial importance therefore to prepare the groundwork now regarding negotiations with the IMF. The government will have to face the dilemma of placating the IMF with at least some unpopular reforms in order to obtain assistance on the one hand and avoiding public unrest by taking such measures on the other. A middle path needs to be worked out with the help of the leading economists and negotiators to keep both sides happy.

It is hoped that the IMF, on its part, will follow the advice of Stanley Fischer, the former first deputy managing director at the IMF and its chief crisis manager until last August, given in his article on "What I learned at the IMF" in the *Newsweek* special edition December 2001-January 2002 as follows:-

"The role of the international institutions should be to support and advise, not to hector and impose. To that end financial support should not have too many strings attached. For the IMF, this means confining conditions to what is necessary to get the macro economy back on an even keel and to get financial and other key markets working properly".