

# The Problems of Domestic Resource Mobilisation in Sri Lanka

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## PART II

Continued from April

### Financial Institutions, Resource Mobilisation and Economic Growth

Financial institutions act as an intermediary to channel resources from surplus units to deficit units by creating a series of liabilities and assets in the process. The savings of the public which could otherwise remain in unproductive form are channelled into the financial system and disbursed among competing ends by the operations of the financial intermediaries. To perform this function efficiently, country's financial system should be characterised by certain pre-requisites: development of the institutional setup, availability of attractive forms of savings, maintenance of a high degree of solvency to build confidence among investors, lowering of transaction costs through improved customer services and so on.

Sri Lanka's capital market exhibits a lop-sided development: a securities market still in a rudimentary state of development and a non-securities market with a wide institutional infra-structure. Consequently, a bulk of the country's medium and long-term

capital needs are supplied by a few state-sponsored long-term lending institutions. However, these institutions are heavily dependent on the authorities for the initiative, guidance and the needed resources; they have not yet been able to liberate themselves from the subsidy/concession syndrome which is much injurious to the development of a healthy financial system.

With a phenomenally high dis-saving or a very low level of savings occurring in the government sector, the almost entirety of Sri Lanka's savings has taken place in the private sector in the recent past. (Table 3). Private savings as a ratio of GDP increased steadily from 17.6 per cent in 1977 to 21.1 per cent in 1984. However, private savings remained at a low level of about

13 percent thereafter with the exception of 1988 when it reached 18 per cent of GDP. With very low government savings, the overall domestic savings remained at around 17 per cent of GDP during 1977 - 88.

Against this background, investment demand increased from around 14% of GDP in 1977 to a peak level of 34% in 1980 and remained between a range of 23% and 30% thereafter (Table 4). Since domestic savings fell far short of country's investment demand, the savings investment gap continued to widen indicating the need for accelerating domestic resource mobilisation. However, the behaviour of total savings in the economy during 1977-88 shows a more or less constant share of GDP at around 17%. With

Table 3  
Savings in Sri Lanka

Year	Percentage Distribution		Percent of GDP			
	Private Savings	Govt. Savings	Total Savings	Private Savings	Govt. Savings	Total Savings
1977	98.3	1.7	100.0	17.6	0.3	17.9
1978	107.3	- 7.3	100.0	18.9	-1.3	17.6
1979	97.9	2.1	100.0	18.6	0.4	19.0
1980	120.9	-20.9	100.0	21.0	-3.4	17.4
1981	109.8	-9.8	100.0	19.5	-1.7	17.8
1982	107.6	-7.6	100.0	20.3	-1.5	18.8
1983	99.4	0.6	100.0	19.6	0.1	19.7
1984	84.6	15.4	100.0	21.1	3.8	24.9
1985	81.3	18.7	100.0	13.8	3.2	17.0
1986	76.8	23.2	100.0	13.0	3.9	16.9
1987	77.0	23.0	100.0	13.8	4.1	17.9
1988	104.0	-4.0	100.0	17.6	-0.7	16.9

Source: Central Bank of Sri Lanka

Table 4  
Investments in Sri Lanka

Year	Percentage Distribution			Percent of GDP		
	Private Sector	Govt Sector	Total	Private Sector	Govt. Sector	Total
1977	64.7	35.3	100.0	9.3	5.1	14.4
1978	68.2	31.8	100.0	13.7	6.4	20.1
1979	72.3	27.7	100.0	18.7	7.1	25.8
1980	74.7	25.3	100.0	25.2	8.6	33.8
1981	83.0	17.0	100.0	23.1	4.7	27.8
1982	83.8	16.2	100.0	25.8	5.0	30.8
1983	83.2	16.8	100.0	24.0	4.9	28.9
1984	82.3	17.7	100.0	21.3	4.5	25.8
1985	79.8	20.2	100.0	19.0	4.8	23.8
1986	77.2	22.8	100.0	18.2	5.4	23.6
1987	75.5	24.5	100.0	17.6	5.7	23.3
1988	72.7	27.3	100.0	16.8	6.3	23.1

Source: Central Bank of Sri Lanka

a very low level of savings or, in some years, dissavings in the government sector, the private sector has been able to improve its share of savings in the GDP from 18% in 1977 to 21% in 1984, but recorded a gradual decline thereafter with an average share of about 13%.

Financial savings of the private sector, defined as the change in money, deposits with various institutions and actuarial reserves and provident fund balances, has also recorded a similar trend over this period. (Table 5) Though these savings grew in absolute terms from Rs. 2.9 billion in 1977 to Rs. 17.6 billion in 1988, it fluctuated widely between a range of 7.3% and 12% as a per cent. of GDP. However, these savings as a percentage of total savings grew from 46% in 1977 to 52% in 1987. This indicates that Sri Lanka's financial system has been successful in mobilising a larger volume of savings during this period, though that level of savings was not adequate to meet the country's investment needs.

The year to year fluctuations in the financial savings show a very broad correspondence to the movement of real interest rates in the economy. Since 1977, as a part of the new economic policy package, Sri Lanka has been pursuing an interest rate policy aiming at maintaining a positive real interest rate structure. The negative real interest rates in 1980 has caused, subject to a time lag of one year, the financial savings to fall in the following year. Similarly, the prevailing positive real rates brought about a similar outcome in 1985.

The growth in financial savings in absolute terms from Rs. 2.9 billion in 1977 to Rs. 17.6 billion in 1988 was the result of many salutary developments in the financial system. While the size and the geographical coverage of deposit accepting institutions expanded significantly, sophisticated savings instruments were introduced to attract new savings. The total number of financial institutions increased steadily from 331 in 1977 to 394 in 1988. The branch

net-work of commercial banks and rural banks rose from 1,259 in 1977 to 1,814 in 1988. With a net work of sub-post offices exceeding 2,500 all throughout the island and collectors of deposits for the National Savings Bank (NSB), the geographical coverage of deposit taking institutions has been fairly extensive. In this background, the financial system was sophisticated with the introduction of new instruments such as Negotiable Order to Withdrawal (NOW) Accounts, Certificates of Deposit (CDs) and income related various long-term savings schemes. Strict competition between commercial banks and non-bank financial institutions for deposits has led to the maintenance of competitive deposit rates on the one hand and the adoption of non-price marketing strategies, as is widely prevalent in other countries, to attract customers, on the other. Accordingly, commercial banks have come up with a full package of financial services to make savings with them more attractive. Such services included easy access to credit for depositors, daily computation of interest on savings accounts, overdraft facilities with variable interest rates and gambling type CDs with an enhanced total return should the investor correctly forecast the movement of the price of a primary commodity etc.

With the profit centres of commercial banks locating around short-term lending connected commercial and trading purposes, the establishment of a development oriented credit structure should address itself to two basic issues: the diversion of credit to priority sectors and the term transforma-

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Table 5

## Financial Savings of the Private Sector (with financial Intermediaries)

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
	(Rs. Million)											
Total Savings	2,982	3,744	6,298	7,093	6,677	10,918	12,523	12,704	11,636	8,316	14,773	17,560
1. Percent of GDP	8.2	8.8	12.0	10.7	7.9	11.0	10.3	8.3	7.2	4.6	7.5	7.9
2. Percent of total Private savings	45.7	46.1	64.7	52.0	40.2	54.3	52.4	38.3	52.9	33.4	51.5	44.9

1 Includes accrued interest on deposits,  
2 Insurance, Funds, EPF, and ETF balances.

Source: Central Bank of Sri Lanka.

Table 6

## Real Interest Rates: One Year Deposit Rates

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
	(In percent)											
Average Inflation Rate <sup>1</sup>	1.2	12.1	10.8	26.1	17.9	10.8	14.0	16.6	1.4	8.0	7.7	14.0
One Year Deposit Rate (Minimum)												
Commercial Banks	14	14	14	20	20	15	16	14	12	9	8.5	8.4
NSB	12	12	12	15	15	12	14	14	13	13	13	13.0
Real Interest Rate												
Commercial Banks	12.8	1.9	3.2	-6.1	2.1	4.2	2.0	-2.6	10.6	1	0.5	-5.6
NSB	10.8	0.1	1.2	-11	-2.9	4.2	0	-2.6	11.6	5	5.3	-1.0

1 As per Colombo Consumers' Price Index  
Source: Central Bank of Sri Lanka

tion of credit in favour of medium and long-term lending activities. To achieve these objectives, authorities in developing countries have chosen to interfere with the credit allocations that result from the operations of the market mechanism. Accordingly, Sri Lanka has employed two strategies to divert credit to priority sectors. In order to induce commercial banks and other long term lending institutions to supply an uninterrupted flow of short-term as well as medium and long-term credit at a relatively low rate of interest, a development oriented re-finance window has been opened

in the Central Bank. Under this scheme, short-term re-finance loans are provided for agricultural marketing and export purposes, while medium and long-term loans are provided for specific projects which are considered to be viable by the Central Bank.

Table 7 presents the outstanding re-finance granted by the Central Bank under different re-finance schemes in operation in Sri Lanka. Banks have on-lent these funds at their own risk, but at a final lending rate fixed by the Central Bank. Re-finance window which aims at higher Production by stimulating

domestic resource mobilisation is expansionary since it lends to an expansion in the reserve money base in the economy. Therefore, re-finance schemes should be used cautiously, since they might negate the achievements on the Production front by causing to build-up inflationary pressures in the system.

The other strategy employed by the Central Bank to effect a desirable credit allocation is the introduction of a National Credit Plan (NCP) for commercial banks. The NCP which is a selective credit control method

Table 7

## Outstanding Central Bank Credit Re-finance

(Rs. Million)

Year	Marketing Loans	Agricultural Production loans	Export Credit	Medium & Long Term Credit	Total
1978	604	153	138	64	959
1979	272	90	165	91	618
1980	115	113	524	210	962
1981	214	146	637	411	1408
1982	166	152	476	603	1397
1983	674	99	1548	623	2944
1984	298	95	1269	650	2312
1985	157	113	1176	693	2139
1986	541	221	1643	749	3154
1987	212	188	2091	1006	3497
1988	261	128	2317	1148	3854

Source: Central Bank of Sri Lanka

implemented through moral suasion attempts to divert the permissible level of credit by commercial banks to priority sectors. As an initial step, the Central Bank estimate the permissible level of credit to priority sector as revealed by the estimated monetary survey for the planning period. Then the credit needs of the priority sectors are estimated independently and planned credit levels, broken into quarterly targets, allocated among different purposes. These credit targets are discussed with individual commercial banks in a series of bilateral discussions with a view to reaching a consensus as far as possible.

There are many weaknesses in this credit planning exercise as an allocator of credit among different purposes, especially among priority sectors. Even though the priority sectors have been selected very carefully in view of their contribution to the value added and the generation of employment, market intervention to direct credit into pre-

ferred sectors does not necessarily result in an efficient allocation of resources. The preferred treatment of one sector as against another lowers costs in the former thereby imparting a wrong signal for allocation of resources. The resultant market distortions will lead to the maintenance of inefficient sectors at the patronage of authorities and, in the long run, trap the economy in a subsidy/concession syndrome from which it is difficult to escape without serious repercussions on the political stability of the country.

here has not been any appreciable change in the structure of commercial bank credit to private sector after the introduction of the NCP in 1981. Except tourism where the percentage share of credit has improved marginally, all the other priority sectors identified in the NCP have recorded a declining percentage share over the time. On the other hand, contrary to the objective of the Central Bank, the share of commercial pur-

poses in the total credit has increased significantly from 43.6% in 1976 to 51.2% in 1987, mostly on account of the vast expansion which this sector experienced in the national economy during this period. It, therefore, appears that the distribution of credit by commercial banks has taken place quite independent of the guidelines and the intervention of the authorities. Preparation of the NCP purely as a monetary exercise without reference to specifically identified projects and investment in various sectors may have contributed to this failure of the credit promotional activities

(To be continued in the next issue)