Some Factors in the Current Economic Crisis

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The crisis that Sri Lanka is passing through is one of the most complex in its recent history both politically and economically . The country's economic problems have grown to serious proportions. The rate of increase in the country's overall production (Gross Domestic Production) had sharply deteriorated to an average of a mere two percent during 1987-88, the lowest level recorded in the past 15 years. The economic performance in 1989 is unlikely to do any better; probably it could deteriorate further in the wake of the political turbulence and uncertainities. Three successive years of virtual economic stagnation has no parallel in the post-independence history of the country. The economic crisis has manifested in many forms such as growing macro-economic imbalances, increasing unemployment and under-employment and worsening poverty. It is the poor and the vulnerable who tend to suffer most, since they have the least economic 'fat' to absorb the blows such as frequent interruptions in economic activity, reduced employment and rising prices of consumer goods.

Natural Factors

Undoubtedly, natural factors beyond the country's control, have aggravated the worsening economic problems of the country. Adverse weather has made a substantial dent on the agricultural production levels for three successive years. Rubber production recorded a sizeable decline during 1987-88. Coconut production in 1988 fell to its lowest level in the decade. The prolonged drought in major paddy growing areas has caused a decline in the Maha crop of 1988/89 leading to a higher import level of rice this year as well as enhanced governmental expenditure to provide relief to the drought-affected populaiton.

According to newspaper reports, about *eight lakhs* of people have been affected by the drought particularly in the North Central, North-Western and Southern provinces. The severe floods and landslides in June this year have affected an estimated *four lakhs* of people in the Western and Sabaragamuwa provinces; caused damage to crops and household assets (including destruction of over 15,000 houses) and resettlement of several thousands dislocated by the landslides. The victims of such natural disasters must undoubtedly be the poor (who live in drought-prone and flood-affected areas) who have the least economic reserves to absorb the shocks. Such natural factors are however short-term in character. Return of good weather leads to a recovery of agricultural output. Rehabilitaiton and reconstruction could take care of the damage caused to physical assets.

Political Factors

A more important cause of the country's economic crisis has been the ethnic conflicts (since about 1983) and the widespread political turbulence and violence of the past two years (following the Indo-Sri Lanka Accord). The cost in terms of human lives lost is incalculable. Among the economic costs is the diversion of a substantial amount of fiscal resources for security purposes pre-empting investible resources for welfare and development. Expenditure on maintaining public order, safety and defence which had absorbed no more than about *one per cent* of the Gross Domestic Product historically, shot up to around *five per cent* by 1987;

ESTIMATES OF GOVERNMENT EXPENDITURE 1989

Ministry	*Expenditure (Rs.Mn)*	%
1. Finance	47,239.1	44.0
2. Defence	8,917.8	8.8
3. Public Administration	6,797.5	6.3
4. Education	6,359.5	5.9
5. Lands & Irrigation	5,370.2	5.0
6. Healrh	5,319.3	5.0
7. Transport & Highways	5,285.4	4.9
8. Power & linergy	5,015.2	4.8
9. Labour & Social Welfare	2,928.2	2.7
10. Agriculture & Food	2,716.5	2.5
11. Posts & Telecom	2,338.5	2.2
12. Housing & Construction	1,653.7	1.5
13. Higher Education	1,539.7	1.4
14. 12 Other Ministries	5,769.9	5.3
Total Expenditure	**107,250.5**	**100.0**

and defence-related imports reached about US$ 100 million, equivalent to *five per cent* of the country's import bill.

The allocation for defence expenditure in the 1989 budgetary estimates is nearly Rs. 9000 million, a level very much higher than the allocation for either education or health. A drop in agricultural and fisheries production in the North and East, decline in tourism, disruptions to trade and commerce, destruction of capital assets and the erosion of the investment climate were among the more important economic consequences of the ethnic and political conflicts. The overall result was a slow down in economic growth. The loss to the economy caused by the ethnic conflict has been estimated at *Rs. 50-55 billion* (by the World Bank) upto August 1987. To this figure must be added the economic losses that the country suffered on account of widespread violence and political instability of the past two years for which no estimates are available. The transport strike in June this year led to a general disruption of economic activity for more than one month. Some of the output losses (such as closure of schools and universities and loss of work-days in government departments and ministeries) would not get recorded in the Gross Domestic Production as the output of governmental services is valued on the basis of costs incurred (e.g. salaries paid) irrespective of whether the services were actually performed or delivered. On the other hand, increased expenditures on defence get added to the GDP although they do not contribute anything to the production process (civilian goods).

Structural Weaknesses of the Economy

The above mentioned factors namely the adverse weather, and the ethnic and political conflicts explain only some parts of the process that created the current economic crisis. The roots of the crisis go much deeper, that is the structural weaknesses of the economy. A crisis was more or less inevitable in the way the economy evolved in the past, (about, ten years) and given the failure to adopt early measures to correct its course.

The main source of economic growth in the past decade was *services* rather than commodity production (that is industrial or agricultural production). The growth of the services sector has accounted for more than 60 per cent of the overall growth in domestic production (Gross Domestic Product). Utilities, transport, trade and commerce, public administration and defence were among the fastest growing activities under the liberalised economic regime. While the services have accounted for more than 50 per cent of the GDP, the share of industry has stagnated at around 14-15 per cent of the GDP throughout the decade. This situation is in sharp contrast with many other developing countries in a comparable stage of development where the share of industry in GDP exceeds 20 per cent. Inspite of a decade of liberal policies, Sri Lanka's industries have played a disappointingly modest role in generating growth and employment. Sri Lanka has failed to make the transition from a primary-producing and mercantile-biased economy to an economy with a substantial degree of industrialisation. Given this failure to restructure the economy, a viable base has not emerged for a sustained growth process and employment expansion.

Nature of Industrial Growth

Virtually the only industrial product category which showed a sustained growth was garments; but this industry is characterised by (a) relatively low domestic value-added (less than 30 per cent of the export value), being heavily dependent on imported inputs and (b) low linkages with the rest of the economy; the local textile manufacturing industry having failed to develop the capacity to supply the materials needed by the garments industry. Moreover; the continuing growth of the garments industry was itself hampered by the import quotas imposed by the developed countires.

The disappointing performance of the Public Manufacturing Eneterprises (PMEs) has been another important cause of low industrial growth in the country. The PMEs which number about 40 and account for close to half of the manufacturing output has recorded an average growth rate of only about one per cent per year over the past decade. Employment has also increased only marginally.

Sri Lanka failed to evolve a clear-cut industrial policy and strategy. It was only in 1987 (that is, ten years after the liberalisation) that an Industrial Policy Statement was issued; but then it was too late, for, political instability had led to a deterioration of the investment climate.

Rise in Unemployment

An important manifestation of the poor performance of industry has been the failure to arrest the growth of unemployment, particularly over the past five years or so. Industrial growth has failed to provide a dynamic source of employment generation. In 1986, only about 19 per cent of the employed population of the country was engaged is some form of industrial activity. Official estimates indicate a level of unemployment of over 1.2 million, that is 18-20 per cent of the labour force. Most of the unemployed are youth with at least middle-school education, and hence receptive to training and adaptable to modern enterprise environment. The aspiraitons of most unemployed youth are also for industrial, technical and professional employment of some type. It is the growth of industry that can serve as an important means of meeting such aspirations.

On the other hand, the governments have over the years attempted to deal with the problem of unemployment by expanding the agricultural frontier with emphasis on irrigated paddy agriculture. Heavy emphasis was placed on capital intensive irrigation and settlement projects. The Accelerated Mahaweli Development Project was the lead project of the government over the past decade. Whatever its other benefits, the new employment generation that came out of this Project compares very unfavourably with the massive investment that was incurred. No doubt the construction phase of this project (in the late 70's and early 80's) created a large volume of employment; but these were temporary jobs that phased out with the end of the construction boom. The permament employment that resulted from the Accelerated Mahaweli Project has been estimated (by the World Bank) to be no more than about 55,000 by 1987 compared with an investment expenditure of about Rs. 44,000 million. Thus, new employment had come at very great cost; each new job entailing a total capital investment of about *eight lakhs* of rupees. Moreover, new employment created represents less than *five* per cent of the estimated unemployed population of the country, Hence, Mahaweli was a costly exercise in terms of alleviating the unemployment problem.

Apart from the heavy capital costs, the scarcity of land resources places a sharp limit on the possible employment expansion through irrigation, land development and settlement projects. In this context, unemployment can be expected to rise further in future years unless industry could emerge as the lead sector providing the necessary dynamism to the economy.

Foreign Resource Gap

Another important manifestation of the structural weakness of the economy is the sizeable foreign resource gap that has persisted over the years. Export-oriented industrialisation was narrowly-based, being more or less confined to the garments industry, which given its low domestic value-added could not make a significant contribution to the alleviation of the foreign resource problem. Foreign payments (on imports, services and capital repayments) have exceeded the foreign recepits (from exports, services and private remittances) by an average of over Rs. 33,000 million (over US$ 1000 million) per year during 1985-88. On average, payments have been running at more than 1.5 times the flow of receipts. The greater part of this gap was financed by resorting to borrowings which had raised the outstanding external debt ofthe country to Rs. 162,548 million by end 1988 (a figure very close to US$ 5000 million).It is equivalent to 3.5 times the export earnings and over 70 per cent of the Gross Domestic Product of that year. In per capita terms, the external debt has amounted to nearly Rs. 10,000 compared with a per capita income level of less than Rs. 12,000 in 1988. The liberalised economic regime has been sustained more by resort to foreign borrowings than by a capacity build-up for expanded exports. The fact that this situaiton is unsustainable over the long-term became evident when by 1988 debt-servicing reached a record high of nearly 29 per cent of the export earnings. A sizeable outflow of foreign resources (through debt-servicing) had been created running parallel to the inflow of foreign loans and aid. Debt servicing has begun to reach a level almost equivalent to the foreign aid committments. In this way, the *net addition* to the external resources of the country through foreign aid flows has drastically declined over the years.

It was inevitable that the country's external assets came under heavy pressure resulting in a decline of external assets for four consecutive years (1985-88). The gross external assets which were adequate to finance four months of imports in 1986 fell to an equivalent of only 2 1/2 months of imports by the beginning of 1989. The pressure on external assets appears to have continued in the first half of 1989. In March this year, the IMF suspended outstanding credit supplies in view of the failure of the government to adopt corrective measures to deal with the macro-economic imbalances. Given this chain of events, speculation ran high about the the possible devaluation of the Rupee to an anticipated level of Rs. 40-45 per US Dollar. According to newspaper reports, such speculaiton had led to a flight of capital and delayed receipt of export proceeds, thereby aggravating further the external financial crisis. These events are basically manifestations of the underlying structural weaknesses of the economy compounded by political instability.

Debt Service Payments 1984 – 1988

Item	SDR Million				
	1984	1985	1986	1987 (*a*)	1988 (*b*)
1. Debt Service Payments	308·0	340·6	356·8	383·3	399·2
1.1 Amortization	132·3	165·5	213·5	253·5	250·7
To IMF	22·7	35·8	58·6	69·3	64·1
To Others	109·6	129·7	154·9	184·2	186·6
1.2 Interest Payments	175·7	175·1	143·3	129·8	148·5
To IMF	31·4	27·1	21·3	18·3	23·4
To Others	144·3	148·0	122·0	111·5	125·1
2. Exports of Goods & Services	1,756·1	1,619·0	1,352·6	1,384·4	1,386·9
3. Receipts from Goods, Services and Private Transfers	2,049·6	1,906·6	1,622·4	1,654·7	1,648·5
4. Debt Service Ratio : (1 as a % of 2)					
Overall	17·5	21·0	26·4	27·7	28·8
Excluding IMF	14·5	17·2	20·5	21·4	22·5
5. Debt Service Ratio : (1 as a % of 3)					
Overall	15·0	17·9	22·0	23·2	24·2
Excluding IMF	12·4	14·6	17·1	17·9	18·9

(*a*) Revised.
(*b*) Provisional.

Central Bank of Sri Lanka.