

THE BUDGET

BANKS AND INFLATION

New Directions for Local Banks

In his Budget Speech, on November 5, the Minister of Finance stated emphatically that he would introduce a new approach to banking this year "as a matter of definite policy". The series of measures he would introduce in this regard include a more liberal system of financial assistance from the Banks to those "who have nothing to offer as security except their good ideas, physical strength and education"; and a decentralisation in the decision-making process of the nationalised banks.

Two other vital areas in which the nationalised banks will be called upon to play a more effective and dynamic role are—firstly, the plantation sector, particularly the Government's subsidy schemes and financing of the nationalised plantations industries and also those banking functions relevant to the operations of the export trade in tea, rubber and coconut which were earlier handled by the Agency Houses. Secondly, a streamlining of the process of financing State Corporations and closer supervision and financial control. Also, encouraging foreign banks to mobilise external capital for development projects in the country and drawing on the expertise, management skills and technical know-how that they could possibly attract.

Financing Enterprises of Educated Youth

Educated youth who have nothing to offer by way of property or guarantees will become credit-worthy to the extent that new enterprises to be organised by and run by them, mainly agricultural, can be established with bank finance. A sum of Rs. 100 million will be made available to the domestic nationalised banking sector for this purpose. Money, however, will not be given in the form of handouts. It is intended that in every case of assistance the banks will provide management services, establish project feasibility studies, provide extension services and take

all the steps necessary to give the guidance, advice and supervision necessary to ensure the success of all such projects.

Decentralisation

The Minister felt that the control of the nationalised banks has remained highly centralised with practically all the decisions being taken at Head Office level. His view was that private sector investment licensing in the present system has its problems. It has to run the gauntlet of a massive bureaucracy which neither makes for expeditious decision-making nor takes adequate account of commercial profitability. The existence of bureaucratic controls inevitably breeds corruption. Transferring as many of these decisions as possible to a decentralised and flexible banking system is one method of putting an end to these abuses. The policy would therefore be to decentralise the banks' administration so as to make it possible for effective decisions to be taken at local levels.

Plantations

In the administration of the different producer-subsidy schemes the Minister announced that, in consultation with his colleagues, he has decided to avoid a great deal of the existing bureaucratic process of form filling and the like to ensure that the banks will undertake the totality of this service to persons being financed by the bank. The bank will also undertake the responsibility of acting as the agent of the Tea and Rubber Controller, of the Land Reform Commission, of the Department of Import and Export Control and of the Exchange Controller whenever they undertake financing operations on behalf of these departments in relation to agricultural development or trade.

The actual supervision of the administration of subsidies and their proper utilisation will also be checked upon by the banks. Even the functions which used to be performed in respect of the Estate Companies by the estate departments of the agency companies could be worked extremely efficiently and well through the banking system thereby avoiding

many of the problems that arose under the earlier dispensation. The administrative arrangements to make this possible within the banking system will require training, the recruitment of personnel and a whole new approach to the system of banking as we know it. The Minister expressed confidence that this change of direction is something he would be able to achieve within a short space of time.

State Corporations

A policy with regard to State Corporations obtaining their financial requirements from the banking sector was explicitly spelled out. The system of providing finance to the State Corporations through the banking sector would continue. But, in any case where a State Corporation is shown to be running losses not due to adverse trading conditions or misfortunes of an unforeseeable kind, but due to plain downright mismanagement or absence of necessary financial controls the Bank should report every such instance to the Government. Where the Government thereupon thinks it desirable to set the affairs of the Corporation in order by imposing limitations upon its autonomy, through the ministry in charge of that particular corporation, it should do so by imposing budgetary controls in much the same manner that local government institutions or co-operatives which are not well managed are made to function better than before.

Foreign Banks

The foreign Commercial Banks have been engaged mainly in the financing of the import and export trade in the sectors not controlled by State Corporations or Government Departments and financing of the estate plantations and the export trade in tea, rubber and coconut through the Agency Houses. With the nationalisation of the estates as phase two of land reform, ownership and economic control of our greatest asset, the lands of this country, are also now in State hands. In these circumstances, the banking functions relevant to their operations will be transferred to the nationalised bank-

ing sector, viz. the Bank of Ceylon and the People's Bank. This is tantamount to a *de facto* nationalisation of the private activities of foreign commercial banks.

What was expected of the foreign banks was not merely a mobilisation of domestic resources and its channelling out to the traditional forms of investment. What was required is the infusion of new external capital from private sources to be used in the establishment of new enterprises in this country, to provide new employment for our people to teach them new skills, to develop new projects, to provide management consultancy services and to provide a catalyst service to bring to them the talents and skills, technical competence and know-how that has to be brought in here to modernise our nation and to bring it in line with the international community. For this purpose, quite apart from the existing foreign Commercial Banks, new foreign banks interested in coming into this country have been invited not for the purpose of sharing in the mobilization of our domestic resources but in order to bring into the country new capital, new expertise, technical know-how, management skills and competence.

INFLATION

Right at the outset of his Budget Speech the Minister of Finance took on the subjects of inflation and devaluation. He summed up his views on inflation thus: "What is relevant is not the budget deficit as such, which is financed by bank borrowing, but the need to ensure that the overall limits set to money supply taking the Government and private sector together are 'safe' in the sense of not provoking an excessive rise in prices. I am far from being a believer in outright inflation, which is simply a disguised form of taxation and fraught with dangerous consequences." Later on the Minister explains in his speech the repercussions of inflationary and recessionary trends throughout the world and how they are being dealt with. (See Box)

The UNCTAD Secretariat also reported recently on this trend. It

Many of the economic difficulties of the present day not merely in Sri Lanka but throughout the world, especially in developing countries, arise from a wide degree of inflation prevailing in the industrialised countries simultaneously with a recession which reduces the demand for goods. A change in prices paid on any one essential imported commodity, be it an item of manufacture, fuel or food, would result in creating not merely an inflationary impact on our economy but changing the economic picture as a whole, even requiring reconsideration of the entire domestic budget. It is now internationally recognised that these external shocks are most appropriately dealt with by specific arrangements to finance the resulting imbalances rather than by enforced measures of deflationary domestic adjustments, detrimental to development.

Felix R. Dias Bandaranaike
Minister of Finance
Budget Speech, November 5, 1975

concluded in the following simple terms that both inflation and recession in the developed countries pose grave problems for the developing countries.

Major Problem for Developing Countries

"The seventh special session of the General Assembly has identified inflation in the developed countries as creating a major problem for the developing world.

Inflation in the developed market economy countries is no new phenomenon—it has marked the entire post-war reconstruction and growth period. Since the late 1960's, however, its pace has accelerated, culminating in the highest peace time rates in the modern economic history of these countries.

Why has inflation been such a pervasive feature of the post-war growth pattern of the developed market economy countries? Obviously, there cannot be a simple answer. It is clear that no inflation can take place without national governments fuelling the economy with new money. But why is more money created than the increased output of goods and ser-

vices justify? A widely accepted answer is that built-in institutional pressures leave no other options to politicians (at least if they want to stay in office). These pressures are, in particular, industrial concentration, unionization and the protection demanded by the weak and uncompetitive sectors.

In wage negotiations, trade unions in sectors where productivity has gone up usually lead the battle for wage increases. They set the pattern for increases in less productive sectors, whose employees expect to be treated equally. Thus, the wage rate for the economy as a whole will be determined in the sectors enjoying the fastest productivity growth. In sectors where productivity is rising at a slower pace whilst wages follow the general trend, prices will rise as employers defend their profit margins. These price rises are generally not compensated by price falls in the sectors where productivity has gone up and profit margins have increased. Inflationary pressures on prices are increased through government protection of high cost industries accorded out of social considerations or appeasement.

If the supply of money is not augmented, people will be unable to buy the generally higher priced goods. Firms will sell less, and unemployment will follow. In the trade-off between unemployment and inflation, governments have generally preferred higher rates of inflation to higher rates of unemployment because, traditionally, the public is more sensitive to higher rates of unemployment than to inflation. There is a certain point, however, when public concern over inflation becomes so great that governments need to take action.

At the same time, the struggle among the social groups for a bigger piece of the economic pie continues, pushing up wages, prices and profits, and governments find themselves torn between policies of inflation dampening and employment creation. In the course of these stop-go policies, inflationary pressures lose their stimulating effect on the economy.

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The result is "stagflation" inflation coupled with low or even negative growth—which has become a pervasive factor in Western countries.

This new phenomenon of stagflation seems to defy conventional economic remedies and has given rise to doubts regarding the ability of the developed market economy countries to assure long-term stability and balanced growth. These doubts are shared by the developing countries. Inflation always hits hardest the economically weakest members of a system, those who have no power to push up the price of their contribution.

Inflation has a deteriorating effect on the prices of the commodities they have to offer. One of the reasons for this is that the output of commodities, especially agricultural commodities, cannot be easily adjusted to changes in prices and demand.

In contrast to manufactures, whose supply can be more readily adjusted to changes in demand, commodity prices show sharp up - and down-turns. In the upswing, the increased prices of commodities are incorporated in prices of manufactured goods. During the downswing of the business cycle, however, commodity prices fall sharply, while prices of manufactures continue to rise, due to the above-mentioned institutional pressures. The consequence is that when the business cycle has run its full course, primary commodity prices are often at levels prevailing before the upswing, while the prices of manufactures show a net gain. In this way, inflation has had a longterm deteriorating effect on the terms of trade.

But the impact of inflation on developing countries is not only limited to the price relationship of their primary commodities with manufactures. It also affects their respective volume of sales. In times of a business upswing and strong demand, exporters find it difficult to export more as they cannot easily expand production. In a recession, commodity processors drastically decrease their purchases of raw materials. The result is that, while the developing countries cannot fully enjoy the effects of an upswing, they are fully hit by the effects of a recession.

Both inflation and recession in the developed countries therefore pose grave problems for the developing countries."