

# Rationale for Liberalization of Sri Lankan Economy - Some Milestones

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## Dual Economic Strategy

The British colonial rulers who administered Sri Lanka (then Ceylon) for almost 150 years up to 1948, introduced a plantation economy in the country with the opening up of coffee plantations in the 1840s, and later after 1880, new crops like tea and rubber. With the emergence of this new economy in the 1840s at the expense of the traditional peasant agriculture, the process of integration of the Sri Lankan economy with the world economy and its attendant vulnerabilities was set in motion.

For the first time the British embarked on an export oriented economic strategy and giving pride of place to private entrepreneurship. This paved the way to a policy of free enterprise that encouraged entrepreneurship, creating an economic climate conducive to attracting foreign investment and private sector participation in economic activities.

As a result of these changes, a dual economy came into being consisting of domestic subsistence agriculture and a growing export oriented plantation sector and related private sector based commercial, banking, trade, transport and other services, while the state sector was mainly confined to administrative and defense activities.

However during the Second World War period a few industrial ventures such as plywood, acetic acid, drugs, ceramics, glass, steel, paper, leather, and textiles, emerged under state ownership. These manufacturing facilities were established after the outbreak of the War, as an immediate response to the disruption of the flow of imports of a large number of essential commodities. Therefore, some

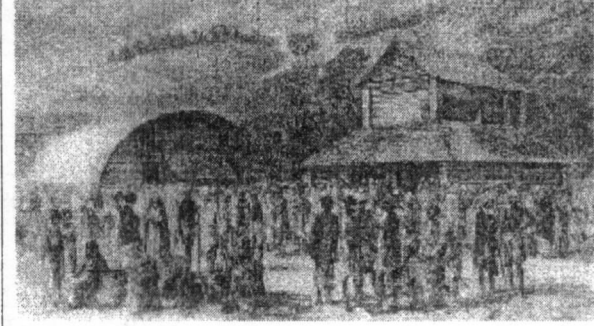
economists have chosen to describe Sri Lanka as a classic case of a "dual" economy. The economic policy that was followed by the colonial administration remained unchanged immediately after political independence in 1948. Although various development activities were expedited, there were hardly any changes in the structure of the economy and policies were designed to promote an open and market-oriented "dualistic" export economy" (Dilemmas of Development p57) that followed British rule. This could be illustrated by analyzing the contribution made by different sectors to the GDP. At independence in 1948, the contribution of export production to GDP was 31.6 per cent, while local production for domestic use was 25.1 per cent. The remaining 43.3 per cent was contrib-

After a change in the political leadership in 1956 the conditions underlying the growth record of the period up to 1977 were different from that of the period before. The economy was gradually "closed" and "controlled" by enforcing various restructuring fiscal, monetary and legal measures. With the change of the regime in 1956, the new government announced its commitment to a socialist policy oriented administration where the state sector became more prominent than the private sector. This changing political ethos after 1956 was a very clear watershed in the Sri Lanka polity. A change in the political leadership emerged from those who advocated capitalist economic policies to those of socialist persuasion. The new government not

only sought to diversify the economy and to end its "foreign trade orientation", but also, to ensure a measure of "economic freedom" through the indigenization of the export import trade and the expansion of what was then a small industrial base. Thus it was after 1956 that a conscious effort was made to change the development strategies to industrialize the country with public sector participation.

The State Industrial Corporations Act of 1957 and the "Ten Year Plan" of 1959 both contributed to the establishment of State-Owned Enterprises (SOEs) in the country. The deep commitment of the pre 1956 government to follow the then existing laissez-faire and open economic policies were abandoned. Consequently, several economic fiscal policy measures were introduced to maintain price stability and to change development strategies from open economic policies to more restricted trade-oriented policies along with expansion of the public sector.

Coffee Estate and Pulping House in Mid 1800s.  
CILN June 22, 1872.



uted by the services sector. Around 92 per cent of exports were from the tree crop sector - tea rubber and coconut.

The Sri Lankan leaders who took over power after independence in 1948 mostly represented the western educated intelligentsia and were not inclined to transform the classical export economy that had evolved over a century under British rule. Economic activities were largely confined to the private sector and the state was mainly involved in providing social services and general administration.

**Import Substitution-led Growth in a Closed Economy**

From 1960 onwards strict exchange control measures were applied on imports, foreign travel, expenses for study abroad and for capital transfers. This was followed by regulations that applied to commodity trade and on trade protection. In 1962, all imports were subjected to license or permits, except food items, petroleum, fuel, fertilizer and pharmaceuticals. Some of these imports were brought under government monopoly. Trade restrictions brought new investments in import substitution industries. As a result of exchange and import controls an explicit industrial policy came into being which boosted industrial activity in the country in the early 1960s. This was the beginning of Sri Lankan industrialization, which helped the country to achieve eco-



Colombo Harbour was nationalized by the Banadaranaika's Govt.

nomie independence to a certain level. These policies were extended to the most productive activities, thus expanding the public sector with the establishment of 22 public sector corporations. A drive toward nationalization of some private companies was initiated, with the government taking over the bus transport service, port cargo operations and some foreign owned services such as the distribution of Petroleum products and insurance in the early sixties. Further the People's Bank was established under the State and the co-operative sector ownership. **This era could be identified**

**as an import controlled led period of industrial expansion.**

The manufacturing facilities undertaken by the government under the Industrial Corporations Act of 1957 have no doubt contributed immensely towards the economic development of the country. In the absence of such ventures the economy would never have achieved a satisfactory growth level, because the private sector was not in a position to invest in such huge capital intensive ventures such as cement, steel, ceramic, textiles, electricity, water, shipping and telecommunication. The latter were some of those major investments in the state sector.

During the period 1965-1970 under the UNP regime, the Sri Lanka rupee which was pegged to the Sterling Pound was devalued by 20%, with the announcement of the devaluation of Sterling in 1967. In 1968, the Foreign Exchange Entitlement Certificate Scheme (FEECS) was introduced in order to provide a favorable exchange rate for non-traditional exports and to impose an additional rupee cost on imports. Some non-essential imports were liberalized and brought under open general license with the FEEC rate being applicable. Hence the policy followed by this regime from 1965-70 was accompanied

by some liberalization policies which were abandoned after 1970. During this period the private sector was given some opportunity to be more active in the economy.

But again the state became more active in the import export trade after the SLFP led left coalition assumed office in 1970. The plantation sector that was in the hands of the foreign companies was nationalized in 1975, and was followed by the Land Reform Act of 1972. The latter was the most remarkable and final nationalization act under this regime. The Business Acquisition Act of 1971 provided the necessary legal mechanisms to the government to nationalize private business establishments.

These changes brought immense gains to the economy since such initiatives on very important aspects of economic policy could not be expected from the private sector. As a result of the establishment of SOEs, the share of GDP of such enterprises increased from 5.7 per cent in 1961 to 12.2 per cent in 1974 and to above 15 per cent in 1977. However it is very difficult to argue that these SOEs functioned efficiently and made profits. The major reason for this inefficiency has been political motivation and inexperienced management.

After trade restrictions were introduced a number of measures were adopted to strengthen policy. Quantitative restrictions were replaced by tariffs as the major protective device. Goods termed as "luxury items" were

**Table 1**  
**Sectoral Composition and Growth Rates of Agriculture and Industry 1960-1977**

Category	1960-1964		1965-1969		1970-1977	
	GDP Share	Growth Rate	GDP Share	Growth Rate	GDP Share	Growth Rate
1.0 Agriculture, Forestry, Fishing, and Hunting	46.1	2.5	41.4	2.4	36.8	2.1
1.1 Export Agriculture (including export processing)	26.7	1.5	22.7	0.5	17.0	-1.7
1.2 Domestic Agriculture	8.3	7.0	15.6	5.6	17.5	3.5
2.0 Industry	10.3	7.6	12.9	12.0	16.5	1.0
2.1 Manufacturing (excluding export processing)	5.6	10.1	7.5	11.6	9.1	2.3
3.0 GDP	100.0	4.1	100.0	4.8	100.0	2.9

Note: Estimates for 1960-70 are based on data at 1969 factor cost prices, while those for the rest of the period are based on data at 1970 factor cost.  
Source: Dilemma of Development (SLAE)

most adversely affected. By mid 1970s, a complete ban on luxury items was imposed, and the entire import trade was subjected to quotas and licensing. The tariffs on imports ranged from 10 percent to 300 percent, and were differentiated according to the degree of competition with domestic substitutions.

Trade restrictions were also accompanied by restrictions on foreign direct investments. Restrictions on remittances of dividends and profits were introduced through exchange controls. There was a marked increase in the government's direct control over trade and commerce, through nationalisation and state entry into commercial undertakings. Monopoly to import essential goods like textile, canned food items, spare parts and building materials etc. were granted to a number of public enterprises. With all these activities the public sector expanded rapidly.

These policies and measures had favourable prospects, while it also caused damage to the economy. The corruption, mismanagement and irregularities occurred at the implementation level and were responsible for the adverse result of these policies. The bureaucracy and the inherent corruption embodied to it, had a profound impact on resource allocation, income distribution and growth.

In absence of competition as imports were banned, the local producers were tempted to produce goods of very inferior quality, and consumers had no choice but to buy such goods. Co-operative outlets, which were dens of corruption, were chosen to sell most of state, monopolized imports. But the average people hardly got a chance to buy their needs as shortages occurred very frequently. Long queues were very common at any outlet. Black marketers were busy cashing in on the situation.

#### **Export Oriented or Outward Looking led Growth.**

As a result of the weakness in the management of the economy under the

policy of import substitution the progress of the economy was very slow. The annual average growth between 1970-1977 was only 2.9 per cent (table 1). Excessive political interference, incompetent management, poor technology and labour disputes made many of the large state sector industrial establishments unprofitable, putting a burden on the Treasury. However, only a few were able to reach high quality standards and they were able to export their products making profits. Thus, in 1976, the largest industrial exports were recorded in refined petroleum products (70%) garments (10%) ceramic and footwear etc.

During this period most of the South East Asian Economies, which are known as Asian Tigers, recorded rapid economic growth by shifting their economic policies from import substitution to exports.

With the change of government in 1977 the economy was opened up and liberalization strategies were introduced to re-integrate the Sri Lanka economy to the world trade market from its isolated closed nature. At the same time policy measures were introduced to promote export led development, which was followed by many East Asian countries at that time.

With the announcement of the liberalization policy the economy was freed from the inward looking strategy with various controls and restrictions and it adopted a policy of outward looking export led growth. As part of its liberalisation package the government announced a fixed exchange rate policy with a managed float (attached to a basket of currencies), and established a "free trade zone" for export promotion, free of tariff barriers. At the same time monetary reforms were introduced with structural reforms. Within the period 1977-88 some of the state owned enterprises were transferred to the private sector, or were closed down/liquidated under various names such as Peopleisation, Liberalization, Privatization, or Structural Adjustment Programs (SAP).

These developments emerged in the Sri

Lankan economy at a time when extensive discussions were taking place on the respective "roles of the state and private sector in a market economy". As a result of these economic policy discussions over the period, the topic acquired enormous significance. While this debate was going on with regard to the role of the state in economic development in the 1980s, more developing countries came under the influence of so called SAP of the IMF and the World Bank.

A basic position of SAPs, which advocated promoting development, through structural adjustment prerequisite was the reduction of the size and role of the government and the liberalisation of markets to achieve so-called effective growth and development. Based on the Adam Smiths classical economic doctrine of "laissez faire" this SAP formula was to prescribe policies for the third world contingent upon economic aid packages from the IMF and the World Bank.

Sri Lanka as a developing country very badly needed the financial support from these international agencies for its internal development and balance of payment (BOP) requirements, and it had no alternative but to implement those reforms. On the other hand Sri Lanka could not follow the economic development policies of the neighboring East Asian "Newly Industrialized Countries" (NIC) but rather had to follow the IMF dictates of the SAP.

#### **Maintenance Economy/ the Clear-cut Liberalization**

Privatization was considered as the single most significant concept taught by the classical school of economics. Adam Smith in his "Wealth of Nations" argues that because private ownership concentrates on the cost and benefits of decisions of owners of capital they have strong incentives to use resources efficiently.

The extensive discussions of the respective roles of the state and markets in an open economy were taking place among the economists during

this period. Equally strong arguments were presented for and against the market economic philosophy, which was based on Adam Smith's "Laissez Faire" policy. In the meantime, most of the developing countries in all five continents gradually came under the so-called Structural Adjustment Program of the IMF and the World Bank (WB).

This was also called "Maintenance Economic Theory". According to them the state has only a minimal role to play: Mainly (a) Provision of social/public goods and merit goods, including protection of society from external aggression and maintenance of law and order and (b) infra structural services and institution building necessary for the working of the market economy (W D Lakshman 1995-Dilemmas of Development) The fact that a separation between the market and the state in an economy is possible, was a basic principle of classical economics and that is why the science of economics is called "political economy". (Sirimal 1995)

As mentioned above, by opening up of the economy by liberalising trade, prices and industrial controls, government attempted to replicate the development attained by Asian countries, namely Taiwan, Singapore and South Korea. The leaders of the government were even compelled to announce that they intend to make Sri Lanka another Singapore. To achieve that objective the following initiatives and policies were implemented through the 1977 budget:

I. The devaluation of the rupee by 46.2 per cent against the US Dol-

## The Philosophy of the IMF & the World Bank

*The basic assumption of the IMF and World Bank was that a free market economy and market forces provide a system which ensures a better allocation of resources and faster economic growth compared to centrally planned economies. Accordingly, inflation must be rigidly controlled even at the expense of slower growth in the short run. The economy should be opened up to face competition from abroad and protection of local industries and subsidies must be eliminated to allow market forces of supply and demand to determine prices. State controls should be dismantled and market forces should freely operative.*

*The IMF maintained that adjustments should be made in the balance of payments, a reduction of the fiscal deficit, the devaluation of currency, an increase in interest rates and that the liberalisation of exchange controls should be implemented before the transfer of loan funds.*

*Implementation of these policies were apparent since 1977 in the Sri Lankan economy. Within the economic liberalization framework the private sector was given an opportunity to participate in economic activities more freely. The establishment of private banks and branches of various foreign banks and private insurance companies in early eighties was a good example of the implementation of liberalization strategies in Sri Lanka. These two major financial business fields were fully under state monopoly since 1960. The privatization of state sector institutions also took place simultaneously.*

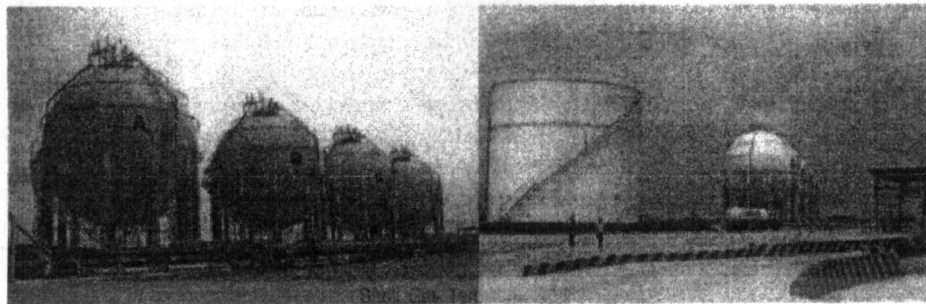
lar and the unification of the dual exchange rates that prevailed earlier and a floating rate was adopted.

- II. Abolition of the system of pervasive exchange controls and quantitative restrictions and their replacement with tariffs.
- III. Removal of price controls except for a few essential consumer goods. The system of indiscriminate food subsidies was replaced by food stamp programme aimed at low-income segments of the population.
- IV. Adoption of measures to attract foreign private investment, including changes in regulations governing the repatriation of profits and foreign investment licensing.
- V. The raising of domestic interest rates. The process of implementation of these measures was not always smooth, but these reforms,

however led to a number of basic changes in the trade regime and in the macro-economic situation (V Kanesa-lingam, 1995).

These policies were followed by changes in fiscal policy. Through these measures the government expected to accelerate economic growth and development. The government budget was assigned a multiplicity of functions such as development of infrastructure, higher allocations for education, health and other services and the creation of a favourable climate for the private sector. The fiscal deficits rose to 18 per cent of GDP in 1980-82 and gradually declined to 11-13 per cent during 1983-88. The reforms were not altogether successful. With the increase in public sector expenditure beyond the country's available resources the government had to seek various foreign credits.

The resulting expansion in aggregate demand and the increasing depreciation of the exchange rate fuelled inflation. Inflation impeded the development of the export sector and its diversifica-



Shell Gas Terminal

tion, and also led to the deterioration of the external terms of trade resulting in a large deficit in the current account, which averaged 16 per cent of GDP in 1980-82 and later to 10 per cent.

In 1986 another step was taken to fulfill a requirement of the reform process. The country's rigid administrative system that was manipulated by the officials of the bureaucracy was a big obstacle to progress. As a result the appointment of the Administrative Reforms Committee

took place in 1986. The establishment of Export Promotion Zones (EPZs) was another step, which was required to establish appropriate institutional mechanisms to enable the private sector to participate in economic development. The Export Development Board (EDB) was also another such institution.

The implementation of the policies of liberalisation also had links with export led growth promotion. Efforts were made by the government to secure as much foreign capital as possible for export oriented production. But it tended to neglect import substitution. There was an unlimited flow of imports due to the free import policy. As a result the production of manufactured goods for the domestic market collapsed. Meanwhile at the beginning most of the investors were expected to import capital

## Call to further rationalize FOREX regulation

*Directors of the International Monetary Fund (IMF) have welcomed the adoption of a fully flexible exchange rate mechanism by Sri Lanka.*

*According to a Public Information Notice issued by the IMF on the Article IV, consultations with Sri Lanka, directors have "emphasized that the Central Bank should limit its intervention in the foreign exchange market to dampening volatility, as well as to permit the Central Bank to build up reserves".*

*The recent relaxation of foreign exchange regulations have been welcomed while they have recommended that the remaining regulations be rationalized to reinforce the market determination of the exchange rate.*

*They have requested Sri Lanka to maintain a tight monetary policy at least until the fiscal adjustment takes place, inflation declines and reserves start to increase. Several directors have cautioned Sri Lanka against any easing of interest rates prematurely. The country will also have to ensure that the open market operations are consistent with the monetary targets.*

*The directors, while welcoming Sri Lanka's policy adaptations, especially the substantial fiscal consolidation, the concerted improvement in the financial position of the public enterprises and the flexible exchange rate policy, have raised serious concern at the slow pace of reform implementation.*

*The fiscal targets for 2001 and 2002 and the revenue and expenditure measures are appropriate, but the main challenge for Sri Lanka in the short term is to arrest the severe deterioration in the fiscal accounts that took place in 2000 by*

*putting security related spending under control and improving revenue collection. For Sri Lanka to be viable in the medium term, the authorities will have to move forward with an ambitious structural reform agenda, states the report.*

*The directors have expressed hope that Sri Lanka would implement a programme to foster sustainable growth and poverty reduction under a programme that could be supported by the Poverty Reduction and Growth Arrangement. It has been requested to improve the performance of the public sector activities to establish an economic environment conducive to a higher growth.*

*The structural reform agenda should be supported by medium term fiscal consolidation which would help to release resources for more productive private sector activities.*

*Therefore, the directors have endorsed the Government's medium term objective of reducing the overall deficit to below five per cent of GDP.*

*Some directors of the team have stressed the importance of controlling security-related expenditure while ensuring those social programs and outlays for poverty alleviation are not crowded out.*

*It has also been suggested that "plans be developed to make the civil service pension scheme more affordable while treatment for government and non-government employees be unified to increase labour mobility".*

*It has been requested to move ahead with the proposed revision of the procedures for dispute settlement and arbitration to improve the functioning of the labour market.*

*An overhaul of key labour legislation would also allow enterprises greater freedom to determine appropriate staffing levels and thereby facilitate job creation. (Sun. Observer 27.05.2001)*

goods as their investment contribution. Later this situation changed because transfers of foreign direct investment never took place in the expected form. The most significant achievement of the Government-led initiatives visible in foreign direct investment during the post-1977 period includes:

- Implementation of policies to promote export oriented industrialization within the framework of a liberalized trade regime.
- Setting up of the Greater Colombo Economic Commission (GCEC) in 1978 with wide ranging powers to grant eligible enterprises with fiscal incentives and to establish and operate export processing zones.
- Relaxing of investment entry, foreign ownership and exchange control restrictions to eligible enterprises.
- The signing of investment protection and double tax relief agree-

ments with major capital exporting countries in 1978.

- Ratification of article 157 of the new constitution of Sri Lanka which protects investments against expropriation and nationalization.

The above measures were implemented before major steps were taken towards economic liberalization in South Asia in countries like Malaysia and Thailand. But a fair share of foreign capital did not flow into Sri Lanka in the 1980s and 1990s. This fact could be supported by following facts.

- Between 1979 and 1997, FDI inflows have ranged from maximum 2.02 per cent of GDP (1993) to a minimum 0.06 per cent of GDP (1978) with the average for the period remaining at 1.0 of GDP.

- Sri Lanka's share of global FDI flows to developing countries declined from 0.28 percent during the period 1982-87 to around 0.14 per cent in 1992-1997.

Some important high lights of recent developments and implementation of liberalization policy and the expected future liberalization plans taken from the agreement between Government of Sri Lanka and IMF (Letter of Intent from President to IMF) could be stated as follows:

"In addition to the liberalization of financial markets, there was a significant increase in the outward looking orientation of the economy, diversification of the export base and further progress made in privatization. Moreover, modest progress was made in other key areas including restructuring of the civil service and state monopolies, financial (Box 11) and labor market reforms. Structural reforms are focused in the current plan to have a major impact on the financial sector, public enterprises, public administration, and pensions. The authorities are implementing plans for restructuring and management changes in the two state banks and for an enhanced bank supervision framework for the commercial bank sector. While the privatization and state enterprise-restructuring program continues, the challenge remains to reform the civil service and pension system. Prospects for regional trade integration were boosted by the Indo-Lanka Free Trade Agreement, which came into effect in February 2000".

In Addition, the following excerpts of the 2001 budget speech would further disclose the government development policies implemented hitherto and which the government expects to implement in the future under the restructuring development program.

"Our vision for the next 10 years has a strong development focus of promoting a private sector led economy, improving governance, promoting economic growth and reducing poverty and unemployment. It aims at transforming Sri Lanka into a strong

and modern economy that can sustain 7-8 per cent growth within a competitive market environment through higher savings and investments as well as efficiency and productivity improvement.

The development of modern infrastructure is essential to create income-generating activities for the people and to reduce poverty and unemployment. Towards this end, both private sector as well as public sector investments will be directed to a rapid development of telecommunications, ports, power, highways, railways, storage and marketing facilities, water supply, information technology, industrial townships and modern infrastructure facilities.

Private sector led development will become an integral part of our growth strategy. The international trade and payments regime will be restructured to attain a fully liberalized open economy, guided by competitive market forces subject to necessary safeguards and regulatory supervision. The gradual deregulation of economic and business activities will provide increased opportunities to the private sector. Second generation policy reforms have been already launched in respect of ports, postal services, power and energy, transportation, petroleum, bunkering and aviation fuel, insurance and finance, to create an environment conducive for private sector led economic development.

Public sector commercial operations will be limited only to areas and activities that require the strategic presence of the public sector. Public enterprises will be fully commercialized and strategic alliances will be formed with the private sector to improve their performance. The on going listing of plantation companies will be completed and the remaining government held shares of already privatized enterprises as well as the government equity participation in hotels will be reduced.

The consolidation of public sector finance and a gradual phasing out of government participation in the economy will continue. The revenue flows of the Government will be strengthened with an increased emphasis on a modern tax administration and direct taxation. The share of income tax in total revenue will be raised from 10 per cent to 25 per cent by 2010".

Historical evidence reveals that Sri Lankan economic policy has been formulated taking into consideration the economic strategies followed by the major economies in the world. However, it has had a bias towards different world economic power bases from time to time depending on the political doctrines of those who have gained ruling power. Therefore the inconsistencies in the economic policies that were followed by various regimes in Sri Lanka were very obvious until 1977. The change that occurred in 1977 paved the way for a full fledged economic liberalization policy which continued for 17 years under a single political party with three leaders. In 1994 the ruling party and the leadership changed and it still continues with a commitment to further strengthen the liberalization policy.

#### **Liberalization of Sri Lankan Economy: Some Milestones**

##### **Period After 1994.**

The new regime of People's Alliance (PA) started since 1994 also designed its economic policies to enable them to continue with the open economic policies that was followed since 1977. To help this process the government established the "Public Enterprise Reform Commission" as a Committee in 1994 and ratified by an Act of Parliament in 1996. The present government at its initial stage in 1994 has accepted the re-structuring of public enterprise as an economic policy of the government.

The dismantling of the state monopolistic structures facilitated private sector participation in the economy in two ways. One was the opening up of the areas in which local private sector had a stake and the other was the opening up of sectors enabling the foreign private sector to participate. The passenger transport service is one such sector that confined only to local private sector. The foreign sector participation could be seen in almost all other important sectors in the economy. Among the service-oriented sectors the telecommunication

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emerged as the most newly developed sector with several private sector players. Intense competition prevailed in this sector. With the restructuring of the State-Owned telecommunications service, the deregulation, of value added telecommunication services and the entry of two new players in to the fixed access in 1996; Sri Lanka telecommunication industry witnessed a profound transformation. It also has become one of the most open and competitive among developing countries in the Asia - Pacific regions. Apart from this some development in the restructuring of State-Owned entity recently have demonstrated some resistance to the progress of pro-competitiveness. A case in point is the privatization of Gas service. On the other hand countries like ours with less competitive advantages find difficult to attract direct foreign investors without giving them such favorable conditions. These are common in many developing countries in their endeavors to integrate with the globaliza-

tion process. Although not similar, in nature, some comparable occurrences could be observed in the near history of liberalization process in many of developing countries. i.é. India and China. The countries not belonging to rich community some time may compelled to take such steps in this process because they do not have bargaining power internationally.

Details analysis of the developments under the liberalization policy after 1994 will be brought in our next issue of ECONOMIC REVIEW-July August, 2001.

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