

## IMPACT OF THE GLOBAL ECONOMIC RECESSION ON SRI LANKA'S ECONOMY

The non-oil developing countries experienced an average growth rate of 5 per cent in the 1970's; but by late 1979 the global recession was setting in and its impact began to be felt in the 80's. The result was that in 1982 these countries recorded an average growth rate of only 1.8 per cent. As a low-income oil importing developing country Sri Lanka was among those affected by the deteriorating international economic situation. The timing of the recession was unfortunate for Sri Lanka as the country had been pursuing an open economic policy approach after 1977, with the hope of achieving a more rapid economic growth rate and higher levels of employment. Sri Lanka's economic growth performance no doubt recorded substantial improvement after 1977; but the process was accompanied by growing deficits in the budget and in the current account in the balance of payments, which reached unsustainable levels by 1980. Various measures had to be introduced from 1981, particularly a deliberate reduction in consumption and investment spending, to restore stability in the economy.

The country's export oriented development policy suffered a set back from the recession which dampened demand in developed country markets and induced more intensive protectionist policies in these countries. The most devastating effect on Sri Lanka's economy has been observed in its sharply deteriorating terms of trade. (See table)

The country faced an uphill task in that; on the one hand, it had to overcome the constraints imposed on its economy by rising oil prices and the increasing cost of all imports, declining export revenues, tighter access to industrial markets for manufactured products, higher cost of credits and declining concessional aid flows; and, on the other, to maintain

the growth momentum at levels adequate, at least, for preventing the economy from sliding back into a low equilibrium trap as in the period prior to 1977. The deteriorating global economic situation too made the process of adjustment to an "open economy" a difficult one; with each effort at adjustment being followed by a further need for adjustment.

The growth in Sri Lanka's real output of goods and services as indicated by the Gross Domestic Product averaged 6.2 per cent per annum during the period 1978-82. In per capita terms this represents a growth rate of 4.4 percent per annum; though it compared favourably with a GDP and per capita growth of only 2.9 per cent and 1.9 per cent, respectively, in the previous 7 year period. The significance of the growth performance between 1978-82 is brought more sharply into focus when observed in the light of the economic recession which affected the developing countries during this period.

by a drawdown of reserves and non-concessional borrowing. As a result, by the end of 1982, net international reserves were negative while the import coverage of gross reserves was equivalent to about two months, an uncomfortably low level for a country so dependent on imports of basic commodities such as food, fertilizer and petroleum. At the same time, Sri Lanka's debt service burden has been fast increasing which could be a source of concern in view of the stagnation in exports.

Sri Lanka's case seems to be an exception among the developing countries. Its growth performance, expressed in terms of Gross Domestic Product (GDP) averaged about 5.9 per cent during the 1977-82 period; compared with about a 2.0 per cent average growth rate of industrial nations, and a little over 3 per cent average growth rate of low income oil importing developing nations as a group, during the same period. On the employment front too, the achievement seems impressive with nearly 1.5 million additional jobs generated during the 1978-82 period, according to official figures. This performance at a time of recession in the West was largely supported by the favourable aid inflows from the West itself.

Selected Economic Indicators

	1978	1979	1980	1981	1982
GDP Growth rate (%)	8.2	6.3	5.8	5.8	5.1
Colombo Index-Consumer Price (% change)	12.1	10.8	26.1	18.0	10.8
External debt (year-end) as a % GDP	42.7	38.6	41.5	43.9	46.4
Terms of Trade (1978=100)	100.0	72.0	58.0	46.0	38.0
Debt Service Ratio	14.4	14.5	24.7	16.7	19.3

Much of the achievements in the country's economic growth has been possible only because of the external resources it has come to depend on. Roughly half of the large current account deficits during 1980-82 has been financed by gross aid disbursements. The other half as well as amortization has had to be met primarily

The economic performance in the period 1978-82 is at the same time noted for the unprecedented levels of investment. The annual average of Gross Domestic Investment was Rs.19.7 billion during 1978-82 as against an annual average of Rs. 3.5 billion in the previous seven year period. These achievements in investment and

growth were not without costs. The restoration of market incentives, reduction of consumer subsidies and movement towards international prices and adjustments in the exchange rate created severe pressures on the price level. This was reinforced by sustained expansion of Government spending and increased monetary expansion. But, the factors that caused the sharp increases in the domestic price level between 1978-81 were not wholly avoidable. The sharply increasing world prices of essential imports, a major revision of the exchange rate for the Rupee in 1977, followed by a further steady depreciation, and the periodic revision of the administered prices of basic consumer goods were all heavily influenced by the adverse developments in the international economic environment.

The problems in Sri Lanka's economy were reflected most strongly in the severe budgetary and balance of payments difficulties. This situation was further aggravated by a structurally weak external sector, where relatively stagnant exports could not finance the growth in imports. By mid 1981 Sri Lanka's gross international reserves reached their lowest point since 1977. The way out was to reduce expenditures or increase output or both.

International lending agencies suggested a currency depreciation as the means of both bringing about improvement in the trade balance and stimulating output by increasing external demand for the country's exports and shifting internal demand from imports to import substitutes. Success of this policy, however, was dependent on the capacity of the economy to produce the required extra output and, in Sri Lankan conditions, this capacity is very limited, at least in the short run. In these conditions it was decided that the first step should be a deliberate reduction in consumption and investment spending in order to restore economic stability in Sri Lanka. The international agencies however continued to maintain that, a realistic exchange rate was a necessary complementary condition to help the stabilization process succeed as well as to permit

the strengthening of the external sector in the medium term. They argued that there were indications that the more rapid increase in domestic than in international prices in recent years had not been compensated for fully by movements in the exchange rate which only contributed to the perpetuation of the structural weakness of Sri Lanka's external sector.

Sri Lanka's dependence on the international economic situation for its economic well-being is evident from the fact that its immediate balance of payments prospects (1983) have been helped considerably by the unexpected decline in petroleum prices and recent reductions in world interest rates. Together these two factors are expected to contribute to roughly a \$ 70 million saving on Sri Lanka's current account. Also, possible improvement in commodity export prices is expected to help generate a recovery in merchandise export earnings, while the build up of stocks during 1982, especially of petroleum, and the rise in import duties are likely to keep import growth down. As a result, the current account deficit is expected to decline from the equivalent of 15 percent of GDP in 1982 to 12 per cent in 1983. Existing aid agreed on and coming in as well as the aid from new commitments (especially of food and commodity aid) is expected to prevent a further loss of international reserves during 1983. The situation is that, the country's basic medium term balance of payments outlook is by no means favourable as the long-term stagnation in exports and the structural imbalance in the merchandise trade account are now being accompanied by rising debt service payments.

New measures and a shift in policies are being suggested as a means of undoing the adverse impact of the global recession of the last three years, particularly evident in the low level of reserves, the growing debt service burden, and the slow down in virtually all sources of foreign exchange earnings.