

The Economy

Deteriorating terms of trade and balance of payment problems

The worsening balance of trade situation continued into 1981, with the merchandise trade deficit widening; and by the end of the first half of this year the adverse balance amounted to Rs. 9,034 million (SDR 407 million), according to latest Customs data. This compares with a deficit of Rs. 7,629 million (SDR 369 million) recorded for the same period in 1980.

The terms of trade began to deteriorate sharply from 1979 and this adverse movement has continued since. It was a result of the sharp increase of import prices and volume, and the slow rate of growth in the export sector, specially the major exports. Thus, Sri Lanka's terms of trade or the purchasing power of its exports have declined by 28 percentage points in 1979, and 14 percentage points in 1980 and this trend has continued into 1981. The Central Bank shows that the terms of trade which deteriorated from 100 in 1978 to 72 in 1979; reached 58 for the year 1980.

The Central Bank commenting on the 1980 situation concluded that the terms of trade effect on the merchandise trade deficit would amount to more than 70 per cent of the total deficit

"A loss of real resources of this magnitude is unbearable to any economy, more so to a developing economy, with an on-going development programme to which the country is committed, and rather sluggish export sector which cannot keep pace with the sharp expansion of the import sector. Even though the deterioration of the terms of trade has been common to other developing countries in the region, the impact appears to have been less severe than in the case of Sri Lanka".

Further compounding the situation is the falling exchange rate of the rupee.

Sri Lanka's gross external assets had as a result reached its lowest position since 1977. According to provisional data, gross external assets in 1981 declined to Rs. 5,837 million (SDR 270 million) by the end of July 1981. In 1979 it stood at a peak of its 9,679 million. The decline occurred despite a drawing of Rs. 803 million under the IMF Extended Fund Facility. The assets of the Central Bank and of the commercial banks decreased by Rs. 439 million and Rs. 149 million, respectively. The level of gross external assets as at the end of the month was adequate

to finance approximately two months' imports projected for 1981.

Balance of payment support had become necessary and on August 5 this year the Government agreed to a recommendation from the Minister of Finance to approve a US\$ 75 million commercial loan. It was a Euro-dollar loan negotiated by the Ministry of Finance and Planning for 75 million US dollars from the Chemical Bank of America which is to be syndicated jointly with the Bank of Tokyo and the Indo-Suvez Bank of Asia.

According to the official bulletin: "This loan will be used to support the balance of payments and the Government budget in 1981. The loan will have a maturity period of eight years, a grace period of five years an interest rate of 5/8 per cent over the London Inter-bank offered rate for the first six years and 3/4 per cent over for the balance two years. The loan has a commitment fee of 1/4 per

paced the growth in available concessional aid and investment flows forcing Sri Lanka to undertake commercial borrowing on a significant scale and, as pointed out, causing net reserves to decline for the first time since 1975.

The strong need for "stabilization" measures has been stressed by the World Bank in its report to the Aid Group meeting earlier this year. An important element in this stabilization task, it said, was the size of the current account deficit in the balance of payments, which had increased from 5% of GDP in 1978 to 19% of GDP in 1980. In one of its fore-casts the Bank indicated that in this situation the Government could easily find itself faced with a budget deficit amounting to 18% of GDP, requiring excessive borrowing from the Central Bank, and an external current account deficit of 21% of GDP, requiring a large drawdown in gross reserves and substantial external borrowing on commercial terms.

The balance of payments pressures resulting from this situation could force the Government to take undesirable restrictive measures. Thus, if the stabilization effort were

CENTRAL BANK TRADE INDICES (1978=100) - EXPORTS

Period	Price Index		Terms of Trade
	All Exports	All Imports	
1970	107	16	106
1971	104	17	98
1972	102	18	94
1973	103	24	82
1974	89	42	72
1975	107	49	58
1976	102	44	78
1977	94	54	102
1978	100	100	100
1979		152	72
1980		217	58

cent per annum on undrawn balances and a management fee of 1/4 per cent of the total loan and an agency fee of 600 US dollars per annum. There are conditions for the reimbursement of expenses incurred by the banks in the negotiation and execution of the loan up to a maximum of 35,000 US dollars. Offers were received from four banks but terms offered by the Chemical Bank were the best and more advantageous than terms previously obtained in Sri Lanka in private capital markets."

The sharp worsening in the terms of trade from the end of 1979 has had a profound effect on the government budget, on inflation and on the balance of payments. Furthermore, the increase in the current account deficit greatly out-

relaxed in 1982, the Bank cautions, Government's import liberalization policy would be threatened and economic management greatly complicated. In particular, it would be extremely difficult in 1983 and 1984 to reverse the greater momentum which would have developed in the government investment programme; the large imbalance on the trade account, which could lead to speculation against the exchange rate; and the acceleration of inflation, which would result from the required adjustments in the exchange rate and its second effects on wages and government spending. In addition, both foreign indebtedness and the debt service burden would rise, to the detriment of future development programmes.