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ECONOMIC LIBERALIZATION AND STRUCTURAL REFORM: THE EXPERIENCE OF SRI LANKA, 1977-93

David Dunham and Saman Kelegama

1. Introduction

Three years before the World Bank introduced its first structural adjustment loan in 1980, Sri Lanka had embarked on a process of economic liberalization. The literature on this experience is already extensive (Jayawardena *et al.* 1987; Herring 1987; Lal & Rajapatirana 1989; Moore 1990; Cuthbertson & Athukorala 1991; Athukorala & Jayasuriya 1991; Gunatilleke 1992; Kelegama 1992; White & Kelegama 1993; Athukorala & Rajapatirana 1993). It illustrates the complexity of successfully managing the transition from a closed to an export-oriented economy, though why the process of liberalization faltered has not been adequately answered.

Sri Lanka is small (its population in 1977 was below 14 million). Exports in the late 1970s were dominated by treecrops (tea, rubber and coconuts) that had flourished since the colonial era. The domestic private sector was dominated by merchant capital. High literacy rates and a political system with a long history of universal franchise (granted in 1931) together created strong political awareness. The country had an entrenched welfare tradition, a commitment to large social expenditures (including a universal food subsidy), a strong element of political patronage and an astute awareness of ethnicity (Lal & Rajapatirana 1989; Moore 1990; Jayantha 1992). Prior to liberalization in 1977, it pursued a closed, import-substitution strategy. The state sector dominated the national economy (foreign-owned plantations being nationalized in 1975), and it was bloated by the welfare-constituency-state employment nexus of political patronage. The entire import bill was subject to quotas and licensing. The economy was stagnant, and in the mid-1970s, the country had faced unsustainable fiscal deficits, a balance of payments crisis and widespread hardship. In 1977, the newly elected government of the United National Party (UNP) moved to introduce a liberalization package.

One main argument in the Sri Lankan liberalization debate is that the country failed to achieve the gains that had been predicted from the new package of policies because the liberalization was itself not sufficiently far-reaching (Lal & Rajapathirana 1989). While the initial measures were bold, they left an "unfinished agenda" (*ibid.*: 29), and the reason -- in this view -- was solely attributable to macroeconomic mismanagement. We argue that this explanation is incomplete, and that initial conditions, economic circumstances and the nature of the political system played a role in shaping the path that Sri Lanka followed. The main argument is that, in the course of the liberalization exercise, there was tension between stabilization and structural adjustment, and that it was this uneasy relationship that led to the half-hearted implementation of liberalization policies. A crucial explanatory factor is seen to lie in the politics of adjustment, in the need for the government to respond promptly to domestic social pressure and in the way this was accommodated in bargaining with the IMF and World Bank regarding the programmes adopted.

The presentation is in four sections. Section 2 focuses on theory of liberalization and structural adjustment, and sets out issues that seem relevant to the Sri Lankan case. Section 3 provides an overview of the country's liberalization experience since 1977 and of the accompanying problems of stabilization of the economy. Section 4 examines problems encountered in the transition to a liberalized economy and to sustained economic growth. A final section summarizes main points that emerge from the Sri Lankan experience.

2. Economic Liberalization: some theoretical aspects

Stabilization and liberalization/adjustment policies advocated by the IMF and the World Bank dominate policy-making in developing countries. In brief, economic liberalization means the process of transition from an inward-looking, heavily protected and highly regulated economic regime towards an open economy that strives for efficiency through competition in the market. Stabilization aims to minimize short-term macroeconomic imbalance through managed reductions on the demand side. Structural adjustment is intended to give a boost to the supply-side by releasing market forces and by institutional changes that reorient the economy over the medium-term to achieve greater efficiency (Thomas *et al.* 1991; Mosley 1991). The IMF has been primarily associated with stabilization and the Bank with structural adjustment, though the two have gradually merged over the 1980s. The Bank has usually required an IMF stand-by arrangement to be in place before entering into negotiations on programme lending, and blessings of the Bank have in turn become a condition for aid-consortium finance.

The logic of liberalization is in theory quite simple. It was intended to create what advocates see as 'the right kind of growth'. Targets for reform were inward-looking regimes; trade policies characterized by licensing and quantitative restrictions (QRs), high and highly differentiated tariff rates, export taxes and endless bureaucratic procedures and paperwork; financial repression; trade, banking and industrial production suffering from inefficient, loss-making public enterprise; price controls, subsidies, and entry and exit restrictions on the private sector that created price distortions. Policies in these situations were seen to be anti-export and anti-private sector; they were an impediment to growth, and removing these impediments was the essence of the reformist agenda (Bhagwati, 1978; Krueger, 1978).

The private sector was the "engine of growth" in the new scenario. Devaluation and the replacement of QRs by tariffs would reduce anti-export bias. Depreciation of the real exchange rate would (automatically) draw resources into the production of exports and import substitutes. It would switch demand to non-tradables, and it would improve the current account of the balance of payments. Demand would however need to be kept in check by appropriate macroeconomic policy (by stabilization measures) to ensure that a realistic exchange rate could be consistently maintained (Corden 1985).

The sheer diversity of policy reforms that can fall under the umbrella encompassed by the Bank's structural adjustment package makes stereotypes dangerous. However, they have been conveniently arranged by Mosley (1991:229) into four main categories. These are given below with minor modifications:

(i) liberalization of trade involving exchange devaluation, the removal of import quotas and their replacement by tariffs, lowering of tariffs and the provision of export incentives;

(ii) resource mobilization through financial liberalization, budget and fiscal reform, interest rate policy, external debt management and improved financial performance of public enterprises;

(iii) more efficient use of resources by revising priorities of public investment programmes, raising agricultural prices, privatization, price decontrol, the reduction or removal of subsidies, revised industrial incentives and encouragement of foreign direct investment; and

(iv) institutional reforms to increase the capacity of government to formulate and implement effective policies and the public investment programmes to support market forces, and to remove bureaucratic constraints on private initiative.

The villain was state intervention, and a central condition of most programmes was withdrawal of the state from anything more than a facilitatory role in the economy.

This normative scenario, however, is conveyed as comparative statics. It takes no account of the dynamics of transition from a closed to an open economy, or of the possible tensions and contradictions that may emerge in a likely stabilization/liberalization exercise. Once allowance is made for these problems, the important question is "what is the optimal economic management package that should accompany a liberalization programme?" Questions of timing, sequencing and the political economy of liberalization have come to the surface (Mussa 1987), though the implications of a simultaneous stabilization and liberalization effort has not always been explicit.

2.1 Timing

There is a good deal of consensus that a stable macroeconomic environment makes a liberalization programme easier, and this has led to the view that liberalization is most likely to succeed under conditions of domestic and external equilibrium (Wolf 1986; Michaely 1986). This conclusion would broadly seem to imply that there are no external shocks, that macroeconomic problems are within manageable proportions and there is political stability.[1] The problem is that countries often have little choice but to embark on a liberalization programme in situations of acute balance of payments problems, low growth, high inflation and rising government deficits. Furthermore, IMF and World Bank conditionalities have often made stabilization a precondition for external financing, and parallel efforts at liberalization and crisis management have as a result been essential. It is assumed that these programmes will be mutually reinforcing. However, simultaneous implementation can also exert conflicting pressures on policy, for example on the exchange rate, the speed of tariff reduction, or on infrastructural investment. It can impede the transition from stabilization to sustained export growth. We argue below that these conflicting pressures have been very strong in the Sri Lankan experience.

2.2 Sequencing

If this is the case, and management of these programmes is such a crucial issue, then considerable onus is likely to rest on their sequencing. Three aspects are normally identified: (i) the speed at which liberalization is implemented; (ii) the stages involved and the links between them; and (iii) the order in which various markets are liberalized. A fourth issue, intimately linked to the others, is political feasibility.

(i) The speed of liberalization

The main issue here is whether liberalization is more likely to succeed when it is implemented gradually or as a 'one-shot' programme. In theory, if the post-liberalization trade regime is so superior to the earlier distorted one, then it is obviously preferable to make the transition as rapidly as possible. But in the real world rigidities exist, social costs of adjustment have political consequences and the choice is less simple. There are at least two costs to trade liberalization that are important here: the 'J-curve effect' (associated with balance of payments adjustments) and distributional effects (that are heavily influenced by what happens to welfare expenditure and employment). The speed of liberalization is also affected by the macroeconomic situation.

The 'J-curve' occurs because full effects of liberalization/devaluation on investment in export-oriented industries appear in the long-run, whereas imports respond almost immediately to repressed demand. Export diversification also takes time; in the meantime, the country is more vulnerable to external shocks and, if foreign capital inflows fail to provide the necessary balance of payments support, there may be need to slow down the liberalization process because of the impact of the J-curve effect on the government budget. Moreover, if a country devalues from a position of deficit on its balance-of-payments, then the current account will deteriorate further in domestic currency.

The other effect is on income distribution, and there are two facets to the problem. The first concerns the impact of the liberalization process on income distribution in general. Rodrik (1992) has argued that, in the early '80s, the depth and the persistence of the macroeconomic crisis facing developing countries in the wake of the second oil shock of 1979 were so great that they relegated distributional issues to second place on the agenda. This may have been so, but at the national level, social dislocation has electoral consequences. It is not always clear that investment and employment opportunities in tradeables will necessarily offset the political costs of lost employment through the liberalization of imports -- or that it will do so immediately (Mussa 1986). Stabilization also, in general, sees cuts in secondary income because the pressure to reduce government expenditure falls on welfare services, affecting vulnerable groups.

The second facet is more specific. In any protected industry, labour, management and investors stand to lose when protection is lifted (whether totally or partially). Lowering protection, removing fertilizer subsidies or privatizing and "streamlining" a state enterprise are also far more immediate and tangible than most stabilization measures. There are identifiable losers, and the more drawn out the process, the better their chances of organizing and stymieing reforms through the political system (Mosley 1991). Others may be unclear how they will fare, but still react negatively to the prospect of increased uncertainty.

Together these pressures have made governments sensitive to the likely repercussions of proceeding too quickly, and many have pressed for a more gradual approach to economic reforms to preclude a possible backlash. Stringent policies under a stabilization programme only make matters worse.

(ii) Stages

The difficulty in progressing logically towards a fully-opened economy over predefined stages can be illustrated with reference to an initial trade liberalization package. Two stages are often identified. There is a necessary shift in the form of protection from QRs to tariffs, which will not necessarily mean significant change in the level and structure of protection. And there is a second stage which entails more choice between the uniform and non-uniform treatment of different activities (Michaely 1986). The conventional view is that these are generally sequential and that there should be movement towards uniform treatment of different activities or unification of effective protection coefficients across different sectors.[2] However, powerful groups in import substitution industries lose from the removal of QRs. It takes time for a 'new rich' to emerge in export-oriented industry in support of the new policy, and if the old rich are not accommodated in the emerging structure of incentives they can be extremely disruptive. There are therefore very real pressures to co-opt and accommodate. Secondly, investors respond differently to the removal of QRs from industry to industry. If the contraction of one industry results in much greater loss of employment during stage 1 than is the case with others, then justification may be found for removing the protection more gradually in that particular case.[3] This is all the more so when restrictive macroeconomic policies create business uncertainty.

(iii) The order in which various markets are liberalized

Krueger (1986) suggests that an optimal order for the overall dismantling of controls might be to start with the liberalization of trade, followed by the decontrol of prices and the liberalization of financial markets and labour markets, leaving the capital account of the balance of payments to the end. Others who have different views.[4] This is a debatable issue, and no theory has been sufficiently tested to justify any presumed order. There is consensus on two issues (1) that the capital account should be liberalized after trade liberalization -- when domestic resources have responded to altered policy signals and after the new structure of production has been consolidated; and (2) that financial market liberalization should only be carried out when the government deficit is under control (Edwards 1986; Krueger 1986; Bruno 1988). It is clear, however, that there are considerable areas of judgement in what is often implied in theory to be almost a logical transition.

2.3 Politics and Bargaining

Related factors that affect the sequencing of a liberalization programme are the degree of dependence on external funding and external pressures for compliance on the one hand (Mosley *et al.* 1991), and domestic political responses on the other -- expectations and the strength of opposition or lobbying. Domestically, commitment to reform and the coherence and the consistency of government policy are likely to affect resource allocation by the private sector, and to play a role in shaping the business climate that we alluded to earlier. There are unlikely to be significant shifts in resource allocation if investors sense reversibility in the policy environment. Krueger (1981:101) makes the point that "expectations can be self-fulfilling".

This may seem to favour a "one-shot" programme, a government being more likely to succeed in the early days of a parliament when it has strong support and momentum as has been argued by Cuthbertson and Athukorala (1991). But a one-shot programme in practice has rarely been feasible. Mosley *et al.* (1991) record country experiences with detours and stoppages as opposition is encountered, and much less is known about the theory of piecemeal reform. Moreover, the nature and timing of the actual programme will be the outcome of a bargaining strategy between the government and the Bretton Woods institutions -- so that "easy reforms" (*i.e.* those that will meet little domestic political opposition) will be the first to be implemented.

Liberalizing a controlled regime therefore poses complex problems of management, some of them formidable. Adjustment costs can be mitigated, to some extent, by appropriate policy choices and with the political determination to see things through. But they cannot be altogether avoided. How they affect the speed and sequencing of liberalization is then an empirical question. The path that is actually followed in a particular country will inevitably be shaped by external events, by local circumstances, political responses to reform and the nature of the political system. These will be brought out more clearly in the Sri Lankan case.

3. The Sri Lankan Setting and the Problems of Stabilization of a Liberalized Economy

Sri Lanka had two phases of liberalization -- a partial phase from 1978-88 and a further liberalization phase from 1989-93. This section traces major contours of the Sri Lankan experience, and it is in four parts. The first looks at the early phase of liberalization from 1978-88. This is followed by a discussion of related problems of stabilization. A third outlines reforms of the second phase from 1989-93, and it is in turn followed by discussion of the problems of stabilization during the later period. The theme running through these discussions is how conflicting objectives and adverse external conditions undermined the extent of the reforms.

3.1 The First Phase of Liberalization: 1978-88

Prior to 1977, Sri Lanka had a tightly regulated and closed economy, strongly committed to a policy of social welfare. There was strict control of imports through quotas and licensing, the operation of state monopolies and the rationing of hard currency. The state exerted a direct control over trade and commerce, and public corporations existed in almost all sectors of the economy.[5] Social security and welfare expenditures (25% of government expenditure in the mid-1970s) were mostly financed by the surpluses squeezed from a large (but shrinking) traditional export sector by way of export taxes. However, this model was ruptured in the first half of the 1970s. A sharp deterioration in the terms of trade (due largely to the oil price-hike and the high price of imported rice), together with the nationalization of plantations and a shortfall in output of plantation crops, created severe balance of payments deficits and mounting budget deficits. The old model of growth was no longer sustainable. Low growth, high unemployment (over 20%), deteriorating social services, shortages and the rationing/black marketeering of essential goods created widespread disaffection, and led to a landslide victory for the UNP in the 1977 elections.[6]

By the time of the elections, the macroeconomic environment had actually begun to improve. There had been a sharp upward trend in the terms of trade but it came far too late to save the previous government. The UNP campaigned on a programme of trade liberalization, and the electorate, weary of crises and shortages, embraced it as a likely way out of its long-suffering predicament. External economic conditions, a strong mandate for reform and the absence of effective opposition in the initial years (the UNP won 83% of seats in the National Assembly) gave the new government and its policies a favourable start and enormous political momentum.

In hindsight, the policy reforms it undertook now seem fairly conventional. The main planks were the following:

(i) substantial devaluation (by 46%), unification of the exchange rate and amendment of the Finance Act to enable foreign banks to operate in Sri Lanka;

(ii) abolition of exchange controls and replacement of QRs by import tariffs, lowering nominal rates of protection;

(iii) the removal of many price controls, allowing prices to move into line with market prices -- the producer price for rice rose markedly (by over 20%); food subsidies were removed and replaced by a food stamp scheme;

(iv) partial liberalization of the financial market, with interest rates set closer to market-clearing levels;

(v) a powerful incentive package for foreign direct investment -- including the creation of a Free Trade Zone, relaxation of import licensing requirements and tax holidays; and

(vi) easier repatriation of capital.[7]

The private sector, both foreign and domestic, was destined to play a more active role in the Sri Lankan economy. Higher investment was to be financed by the mobilization of domestic savings; the efficiency of public sector enterprises was to be improved, and public sector claims on resources were to be reduced. Export growth would also be facilitated through a more flexible exchange rate policy and by the provision of special incentives for non-traditional exports. Planning was dismissed as a policy tool and the role of the state in the economy was to be markedly reduced.

Less conventionally, the government embarked on infrastructural investment to kick start the economy. One of the objectives was to develop the supply side in order to lay the foundation for rapid industrialization and growth. Its investment programme was dominated by three "lead" projects, the Free Trade Zone, the Accelerated Mahaweli Development Programme (AMDP) and the Housing Programme. Of these, the largest and most significant was the AMDP: it promised to generate large-scale employment during the construction phase and in the subsequent land settlement, to increase food self-sufficiency, and to raise hydro-electricity generation. In the late '70s, the government's reputation seemed likely to stand or fall with the success or failure of the AMDP. The scale of the endeavour (to settle 218,000 families and construct 5 major dams in a six year period) was designed to capture the public imagination, and to portray the image of a government concerned with the future of the country's poor farmers and landless workers.[8] It also captured the imagination of the donor community which rewarded the government's policy reforms with enormous concessional aid and funded a growing proportion of total Mahaweli investment -- though counterpart contributions still remained immense (Levy 1985).[9] Expenditure on the AMDP alone was 6% of GDP in 1982 and 1983.

Whether the investment in these projects was cost-effective -- whether alternative scenarios would have yielded better returns or entailed lower costs -- was a frequent question, but it was not really relevant. Above all else, the investment reflected the political need to generate a large amount of new employment quickly to compensate for losses to the poor from the removal of the food subsidy. It also presented the government with an invaluable mechanism for the dispensation of patronage. There was not so much a retreat of the state from economic activities, as a shift in the nature of its predominance and fields of operation towards these three lead projects.

The short-term response of the Sri Lankan economy to these measures was extremely positive. The average annual growth rate of GDP over the period 1977-82 was over 6% (more than double that of the previous period -- see Table 1). Moreover, it was achieved in spite of the second oil shock of 1979 and a further decline in the prices of major export crops. Sri Lanka was heralded (prematurely) a show case of IMF liberalization. Yet, at least until 1985, there was this worrying divergence between the government's declared liberalization objectives and what was actually implemented. The underlying cause was the commitment to the three lead projects and resulting macroeconomic instability. Cost estimates of the AMDP in particular soared beyond all expectations (from Rs 11 million or US$ 610 million in 1977 to Rs 18 million or US$ 860 million in 1980), and its implementation exerted a massive pressure on domestic resources. Together with the cost-push effect from imported inputs, this led to high inflation, and to massive budget deficits and balance of payments problems during the early-1980s (see Table 1). The government interpreted this as a J-curve effect and pushed ahead with its programme, but "while the country was being partly liberalized, it was not being stabilized" (Lal & Rajapatirana 1989:43). The government's room for manoeuvre was substantially reduced; lobbies had time to form, and a more gradualist approach to further liberalization became almost inevitable.

The government's public investment programme was massive by any scale. Gross domestic investment doubled from 14.4% of GDP over the period from 1970-77 to 31% during the early 1980s (see Table 1). The three lead projects accounted for three quarters of public investment -- the AMDP alone for rather less than half. These were long-gestation projects, whose rates of return were by no means exceptional. Donors provided the necessary foriegn exchange but increased the demand for non-tradeables, and this resulted in turn in an overvalued exchange rate. Appreciation of the real exchange rate offset the export sector's earlier gains from devaluation, and it had to be corrected via commercial policies (namely, subsidies and taxes). In 1980, the budget deficit was the equivalent of 23% of GDP, and inflation in the range of 26% (see Table 1).

A major crisis was only averted by unprecedented capital inflows in the form of concessional aid (a third of which was as outright grants) and worker remittances (which rose from 0.3% of GDP in 1977 to 5.2% in 1982). The Sri Lankan post-1977 investment experience reflects remarkable success in external resource mobilization, but domestic resource mobilization was extremely modest. Almost one-third of the new investment over the 1978-85 period came from external sources (see Table 3), though public investment on this scale ran counter to stabilization and liberalization objectives of the IMF and the World Bank. The reason for this apparent slackness lay in the nature of political imperatives: the need for employment creation on the side of the government and the interest of European donors in foreign construction contracts. However, as we shall see, this experience highlights many of the advantages and disadvantages of a heavy reliance on international financial institutions and bilateral donors for a country's development finance.

The government failed to perceive the severity of the problem immediately; "in the popular consciousness the 1978-82 period was not...a period of stress" (Athukorala & Jayasuriya 1991), but it was increasingly clear that this pattern of growth could not be sustained for much longer into the future. Reserves were drawn in to meet the current account deficit, the government had to resort to extensive commercial lending at market rates to finance the budget deficit, and external debt quadrupled during the early 1980s. On the fiscal front, "belt-tightening" (a clamp down on wages and salaries and a sharp reduction in food subsidies) could not save the government from having to resort to expansionary financing. The efficiency of public sector enterprises could not be improved; heavy subsidies were needed to keep them afloat in the liberalized policy environment, and there was back-tracking in the sense that licensing was increasingly necessary to afford protection. On the monetary front, there was an unabated increase in bank credit and money supply, although there were occasional squeezes to restore stability.

Table 1 shows little improvement on main macroeconomic indicators between 1986 and 1989, and little was achieved by way of adjustment or liberalization. The war in the South and macroeconomic imbalance prevented further progress and the economy stagnated. The state failed to achieve interest rates realistic enough to favour financial market liberalization, and realistic exchange rates could not be achieved by devaluations alone in the face of high rates of inflation. Defense expenditure also loomed as a major problem.

3.2 Problems of Stabilization During the First Phase

There were several reasons why stabilization of the economy proved difficult prior to 1989.[10] The outburst of violence and civil disturbances after 1983 was a major factor, but there were also others. External shocks, the social costs of adjustment, political commitments of the government, the difficulty in curtailing subsidies to public enterprises and raising government revenue all proved important.

(i) External shocks

A major contributory factor was the downward turn in the terms of trade. The rise between 1976 and 1978 had been temporary. Tea prices collapsed in 1978 and prices of oil, fertilizers, sugar and investment goods rose in the following year. The terms of trade deteriorated between 1978 and 1982 by over 40%, placing enormous pressure on the adjustment process and on the economy in general (Kelegama 1989; Athukorala & Jayasuriya 1991; White & Kelegama 1993). Herring (1987) estimated that Sri Lanka lost 7% of its national income in 1982 and 8% in 1983 from terms of trade effects -- almost equivalent to the total cost of the three lead programmes in those years. The government also wanted to avoid the likelihood of recession that would have been induced by a major policy response to these external shocks. It was unclear if such a programme could have been implemented without considerable political dissent and, with elections due in 1982, this was held not to be expedient.

After trade liberalization, Sri Lanka was also that much more vulnerable to external shocks. Export diversification did not really get under way until the late-1980s. High inflation, fueled by the massive influx of foreign capital, led to an appreciation of the real exchange rate (see Table 1) and shifted the relative prices of tradables and non-tradeables towards the latter -- there was a "Dutch Disease" type of effect in the Sri Lankan economy (White & Wignaraja 1992). Incentive structures showed a bias against traditional exports -- further reducing export volumes and with them government revenues. Devaluation, tariff adjustments and export subsidies favoured the manufacturing export sector in price terms (Cuthbertson & Athukorala 1991; Kelegama 1992), but bureaucratic impediments and non-price factors -- inadequate skills, research and training for export production, and institutional problems -- steadily eroded that advantage. There was little state intervention in the supply-side of the economy because policy-makers adopted the view that market forces would resolve such problems. The massive inflow of imports (30% of GDP during 1978-83) lengthened the J-curve effect.

(ii) Social costs of adjustment

The country's welfare tradition and the considerable political awareness of its electorate were such that governments were sensitive to the adverse effects of policy on poor and vulnerable people. By the middle of the 1980s, there was a growing body of (largely impressionistic) evidence to suggest that the country's growth rate was accompanied by a persistent level of high unemployment and by deteriorating standards of living (UNICEF 1985). This concern was not reduced by the creation of an Executive Presidency and the greater centralization of power that came with it in 1978. The government remained vulnerable to claims that it was insensitive to suffering.

Employment generation increased after liberalization, despite significant losses due to the adverse effects of import liberalization on domestic industry (Osmani 1987; Kelegama

Table 1: Key Macroeconomic Indicators, 1978-93

	1970-77	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Growth (% p.a.)	2.8	8.2	6.5	5.5	6.1	4.8	4.9	5.1	4.9	4.3	1.5	2.7	2.3	6.2	4.6	4.3	6.0
Budget Deficit (before grants) as a % of GDP	-9.3	-13.8	-13.8	-23.1	-15.5	-17.4	-13.4	-9.0	-11.7	-12.2	-11.1	-15.6	-11.2	-9.9	-11.6	-7.4	-8.1
Inflation (%)	5.8	12.1	10.8	26.1	18.0	10.8	14.0	16.6	1.5	8.0	7.7	14.0	11.6	21.5	12.2	11.4	11.2
Current Account (Balance of Payments) as a % of GDP*	-1.2	-2.4	-6.8	-16.4	-9.9	-11.9	-9.2	-0.9	-7.0	-6.6	-5.1	-5.6	-4.4	-3.2	5.4	-3.6	-5.4
Real Exchange Rate (Trading Partner weighted)	-	100	100	98	99	99	93	77	101	117	118	114	121	118	113	112	-
Investment as a % of GDP	14.4	19.9	25.2	31.2	31.2	31.9	31.0	28.3	25.9	25.8	23.3	22.5	21.5	21.9	22.6	23.5	24.0
Public Investment (% of GDP)**	6.0	12.1	12.2	18.3	14.6	16.7	-	-	-	-	-	-	-	-	-	-	-
Domestic Savings as a % of GDP	13.4	15.3	13.8	11.2	11.7	11.9	13.8	19.9	11.9	12.0	12.8	12.0	12.2	14.3	12.7	15.3	15.5
Terms of Trade	163	189	136	110	87	82	100	122	100	89	99	93	91	87	86	89	-
Exports as a % of GDP	14.5	25.2	29.2	26.5	24.1	21.3	20.5	24.2	20.4	18.9	20.9	21.1	22.3	24.7	22.6	25.9	26.6
Imports as a % of GDP	17.0	30.6	43.1	51.0	42.6	41.9	37.1	31.9	31.6	30.7	31.0	32.1	31.8	33.4	33.7	36.0	39.3
Nominal Interest Rate	10.1	15.8	16.0	21.1	21.1	22.3	21.8	21.9	21.2	20.6	19.8	18.9	20.0	20.0	20.75	20.0	21.5
Real Interest Rate	4.1	3.0	4.7	-4.0	2.6	10.4	6.8	4.5	19.4	11.7	11.2	4.3	7.5	-1.2	7.7	7.7	9.3

Notes: Inflation (p) was estimated using the Colombo Consumer Price Index and the Real Interest Rate was estimated as $[\{(1+r)/(1+p)\} - 1]*100$.
* Current account includes trade in services; ** - Public investment is not available for the post-1982 years.
Sources: Central Bank of Sri Lanka, Annual Reports (various issues) and Institute of Policy Studies, Data Base.

1989). Unemployment fell, as far as can be judged with any real accuracy, from over 20% in 1977 to 11% in 1981/82 (Korale 1986). However, many of the new jobs created were in the construction industry, associated with the three lead projects, and were by nature transitory. Thus, when public investment declined in the mid-1980s, unemployment crept up.[11] By mid-1980s unemployment had increased to about 20 per cent (Karunatilake 1987:285). Unemployment in the 15-25 age-group was in the range of 30-40% in 1984/85 (DCS 1987:281) and much of it was rural, educated and male -- a factor not unrelated to Sri Lanka's history of rural insurrection.

Government policy in 1970s and early '80s assumed that economic growth would 'trickle down' to the bottom income deciles and alleviate poverty. Policy was preoccupied with infrastructural development and with macroeconomic technicalities. The free rice ration was abolished and replaced by food stamps -- the value of which was sharply reduced by the subsequent inflation. Losses to the poor were not offset by higher incomes. On the contrary, the limited evidence available suggests that the benefits of reform were distributed unequally, heavily concentrated amongst the top 10% of all income receivers -- half a million out of a total employed population of about 5 million (UNICEF 1985; Jayawardena *et al.* 1987 Lakshman 1989). There was also evidence of a deterioration of real incomes of the poorest deciles, and of reduced calorie intakes significantly depressing nutritional levels (Jayawardena *et al.* 1987; Sahn 1987).[12] More ruthless cuts in welfare expenditure would have had a high political cost.

(iii) Political commitments

Political imperatives also made stabilization more difficult on other scores, not least through the government's commitment to the three lead projects. Costs of the AMDP rocketed; the sheer scale of capital spending and the number of sub-projects entailed in a major river valley development posed serious problems of control and coordination and, because of the large foreign capital component, it became over-ambitious. It fostered waste and corruption.[13] Estimates of "leakages" vary, but have invariably been high. The government nevertheless continued to push these projects. This was partly for technical reasons -- a need to reduce the vulnerability brought about by a high import dependence of staple foodstuffs, the need for more power generation as a precondition for any substantial increase in manufacturing and the availability of aid.

But the reasons were predominantly political. It was important in the wake of reductions in food subsidies to be generating employment. The party's image was intimately associated with the success of the projects (the President's credibility was linked with the AMDP, and the Prime Minister was personally associated with the Housing Programme), and for the practical political reason that these schemes offered the party invaluable sources of patronage. This was aggravated by the fact that donors who chided the government for its failure to cut expenditure were often the first to complain when counterpart funds were not forthcoming for the projects they were funding (Stern 1984).

Overall, this meant that reduced expenditure on lead projects was politically difficult -- they became in practice irreversible. Given their scale and enormous share of public expenditure, the government's ability to respond to macroeconomic imbalance was consequently limited. They effectively precluded the implementation other projects that might have offered quicker returns, and they meant that export-promotion was overshadowed in the government's set of priorities. Rather than reducing rent seeking (*a la* Krueger 1974), commercial profit continued to hinge on good political connections (Moore 1990). In the second half of the 1980s, military expenditure also rose markedly. There was a sharp escalation in costs to meet the Tamil secessionist movement in the North and East of the country after 1983 and insurgency in the South from 1987-89. Defense costs made increasing demands on the government budget and they made stabilization difficult.

(iv) The difficulty in curtailing subsidies to public enterprises

Private sector investment during the period from 1977 to 1988 was concentrated heavily in the non-tradable sector. Investment in the tradeable sector was not very promising, and this had implications for subsidies to inefficient public enterprises. Some observers have maintained that the massive scale of the public investment programme discouraged private investment. Lal & Rajapathirana (1989), for instance, have argued that private investment was crowded out by the public sector borrowing that was necessary. This, however, was not the case. As a percentage of total credit, credit to the private sector increased from 19.6% in 1977 to 34.9% in 1981 and to 43.9% in 1985. This would hardly seem to be evidence of crowding out.

However, the private sector generally preferred to deal in non-tradeables.[14] Public enterprises were the ones which were producing tradeables (other than in the still limited niche of the Free Trade Zone), and they accounted for a majority of the country's industrial output.[15] But they were poorly managed and heavily subsidized, and they could not be easily dismantled or privatized for a number of reasons. It would have resulted in an erosion of the production base of the country. It would have led to difficult and politically costly legal battles over employment dismissals, and it would have eliminated an avenue for dispensation of political patronage. Loss-making enterprises were a burden on the public purse that could not be removed in the short-term.

(v) Problems of revenue

Over the medium-term it also became clear that there was an inherent conflict between the government's need to raise revenue and reduce the budget deficit as part of a stabilization programme, and objectives of the country's overall liberalization exercise. In the initial post-liberalization period, revenues increased. Rents associated with quotas had rarely fallen in the past to the government, and so the shift from quotas to tariffs at the same level of protection augmented revenue. Lowering tariffs also boosted revenues as long as imports rose faster. But eventually lower tariffs on external trade and cuts in income tax ate into government revenue. Taxes from previously profitable firms in the import-competing sector declined with trade liberalization, and they were not immediately replaced by taxes from newly profitable exporting firms. The problem was exacerbated by external shocks and led to the introduction of *ad hoc* measures for revenue collection because the government found it difficult to find steady new sources of revenue.

3.3 The Second Phase of Liberalization: 1989-93

By the late 1980s, the country was engulfed in a serious political crisis with two wars taking place -- one in the North and East of the country, and the other in the South. Growth was in the range of 2 per cent p.a. during 1988/89 and, with the ongoing political crisis, stabilization of the economy was problematic. The UNP government, re-elected to power in 1989, managed to crush the rebellion in the South and it was desperate to revive the economy. However, international donors who had been inclined to overlook the lack of an effective stabilization policy in the 1980s (Jayawardena *et al.* 1987) were no longer prepared to acquiesce to such a glaring anomaly. Aid was made contingent on two factors: stabilization of the economy and further liberalization to promote the private sector as an effective "engine of growth". Major policies implemented were the following:

Liberalization measures:

(i) reduction of the maximum nominal tariff on imports (from 100% to 50%), and the introduction of a four band tariff;

(ii) tax system reforms to reduce income and corporate taxes, and the abolition of wealth and capital gains taxes to stimulate the capital market;

(iii) the progressive elimination of export duties on traditional crops, further devaluation of the rupee and a major drive towards export-led growth;

(iv) further liberalization of the commodity market: prices of certain key commodities (wheat and fertilizer) being aligned with world market prices;

(v) liberalization of exchange controls on the current account of the balance of payments and the abolition of compulsory currency surrender requirements for exporters;

Stabilization measures:

(vi) reduction of the budget deficit to 6-7% of GDP;

(vii) a high interest rate policy to bring the level of inflation to a single digit figure; and

(viii) a programme of privatization with the objective, *inter alia*, of reducing the fiscal burden on the government. In 1992, management of the state-owned tree crop sector was put in private hands, and efforts were made to restructure the two state-owned banks.

With more normal conditions, the economy sprang back in 1990 with remarkable resilience. The economy grew by over 6%; there was a marked increase in share market activity, tourist arrivals rose, and official reserves grew. There was also a fortuitous improvement in tea prices. Yet the subsequent rate of growth remained extremely modest.[16] It was considerably below that recorded by the NICs and second-tier NICs of East and South-East Asia, and no serious inroads were being made into the backlog of unemployment (IPS 1992).

3.4 Problems of Stabilization during the Second Phase

Though serious about stabilization, the new government was confronted with additional problems after 1989, and to certain extent the problem of stabilization remained. Several factors contributed to this continuing dilemma,

(i) High interest rates

With pressures to liberalize the economy further, a crucial area of concern in terms of macroeconomic management was control of the rate of inflation. The stabilization package that was adopted meant a high interest rate policy, increasing the cost of capital to the private sector. When the export sector was given high priority and the private sector was designated as the "engine of growth" of the Sri Lankan economy, lobbies had put tremendous pressure on government for tax concessions to reduce high cost of production. The government offered tax incentives in the form of tax holidays to placate them. This not only distorted the overall incentive framework, but it encouraged rent seeking activities and it had adverse effects on state revenue (IPS 1993). However, given the size of the budget deficit, revenue losses had to be made up on other fronts. Stop-gap measures were introduced to secure additional revenue -- principally through increased excise duties, an income tax surcharge and a defence levy. These costs were passed on where possible to the consumer by the private sector in the form of higher prices, creating pressure for a higher interest rate to curtail the rate of inflation. It became almost a vicious circle.

The state also reduced its capital expenditure to bring down the budget deficit. In other words, it sacrificed capital expenditure in favour of recurrent expenditure (salaries, wages, interest payments, welfare and pension payments etc.) which was far more difficult to cut politically. This policy curtailed vital public investment projects in infrastructure development in areas such as telecommunications, transport, irrigation and power that were essential for any substantial growth of the private sector investment. Private sector production costs were kept high, and it was then compelled to lobby for tax concessions with their ensuing revenue implications.

(ii) Welfare and defence expenditure

The difficulty in successfully implementing a stabilization programme was further compounded by the continuing political need to protect weak groups in society. Rural poverty -- a factor of considerable concern in the wake of the southern insurgency -- became the grounds for a major poverty alleviation programme (the Janasaviya

Programme) instituted in 1989.[17] Moreover, because of growing regional disparities in industrial development during the 1977-88 period, a programme to establish 200 garment factories in rural areas was started in late 1991.[18] That the poverty programme was overambitious and poorly targetted initially reflected the political importance of securing a firmer political base in the rural areas. Welfare subsidies rose as a result. Having fallen from 21 per cent of government current expenditure in 1979 to 4.5 per cent in 1988, they rose again to 12 per cent in 1990.

With the continued war in the North and the East, defense expenditure also rose to 12 per cent of total expenditure (or over 4 per cent of GDP) in 1992 . Together with the cost of rehabilitating refugees, it made an enormous demand on the government budget. High defence expenditure has, in effect, to be viewed as a major internal shock to the economy, and stabilization under such circumstances is problematic because the government finds it difficult to identify large new areas for expenditure reduction.

Thus, in contrast to the 1978-88 period, the early 1990s did see the implementation of stabilization measures, and these made possible a further liberalization of the Sri Lankan economy. However, the demands of stabilization in terms of monetary policy, together with political pressures during implementation, produced contradictions. The result was a lack of coherence in government policy, and a lack of consistency and predictability in implementation that affected business confidence. *Ad hoc* decision-making had a dampening effect on long-term investment, and the economic and political climate was an impediment to any major expansion in foreign direct investment. The latter remained in the order of 1.5% of GDP. There were inherent contradictions between stabilization and the ultimate objective of export-led growth.

4. Problems of the Transition to a Liberalized Economy

The previous section highlighted impediments to stabilization of the Sri Lankan economy. A question that then arises is whether some of these impediments (such as the high vulnerability to external shocks and the high cost of adjustment) could have been reduced or avoided with a different timing or sequencing of the liberalization package. Questions also arise concerning the effectiveness of exchange rate liberalization and the role of foreign capital inflows.

4.1 Problems of Timing

Cuthbertson and Athukorala (1991) argue that liberalization has the best chance of sustained success during the early days of a government because it will have more political momentum. In Sri Lanka, the UNP government that came to power with a landslide victory in 1977 had liberalization as its mandate. Politically, therefore, it could not have been better placed, though the country was still recovering from the effects of economic crisis. As the country's export structure was still dominated by weak primary products, liberalization hinged on external funding and the signing of a Stand-by Agreement and an Extended Fund Facility agreement with the IMF. Whether, in theory, the timing was 'right' is therefore an open question. But in practice, it is doubtful if conditions are ever 'ideal' for the opening up of an economy. Moreover, it was extremely unfortunate that, two years into its programme, Sri Lanka was confronted with the second oil-price hike and, in the years thereafter, with other external shocks. With the benefit of hindsight, the country's timing may not appear to have been particularly well chosen, but events determined the timing of this policy change and not economic astrology. In 1977, the country was desperate for foreign capital, and it was highly probable that, had it failed to liberalize its economy, the same level of external support would not have been forthcoming (Herring 1987).

These problems were compounded by the decision to embark on such a massive infrastructural programme. The scale and political stature of the three lead projects (the AMDP in particular) were such that they were accorded the highest political priority. The difficulty that arose was therefore one of reconciling liberalization with political imperatives, such as employment creation and patronage. We will return to this later. There was also, finally, the fact that the country's liberalization programme began before supportive institutions had been created. The Export Development Board (EDB) and the Presidential Tariff Commission (PTC) were instituted around 1980, when the development pattern was already set. Subsequent efforts by these bodies to move incentive structures towards tradeables ran into established interests which reacted to conflicting economic and political signals to the country's business community.

4.2 Problems of Sequencing: the speed and stages of reform with reference to the tariff structure

The IMF and the World Bank singled out the protective structure that evolved after the 1977 reforms as a major impediment to growth in the industrial sector. The tariff structure, they claimed, was neither rational nor uniform, and the persistence of arbitrary tariffs contributed to the lack of dynamism in particular industries (World Bank 1984). The objective in 1980 was a uniform tariff, and yet it has still not materialized. Why did it prove so difficult?

The first two steps in the sequencing of trade liberalization in Sri Lanka were a devaluation, followed by the removal of QRs and their replacement with a hastily formed tariff system. No attempt was made to rein-in imports as tightly as had been the case with the earlier QRs. Nor was the tariff reform phased in pre-announced stages. One reason for disparities was that comprehensive data was just not available, and that the speed of the reform meant that in-depth studies could not be undertaken to fill the gap. Internal inconsistencies in tariffs and wide variance in effective levels of protection between product categories were therefore in part a function of the speed of the initial liberalization (PTC 1985:81). It was by no means entirely the case that "quicker was better". The outcome dealt a severe blow to domestic industries and it reinforced the creation of lobbies to reverse "ill-judged" decisions.

Further reductions in tariff levels were therefore slow in coming. Subsequent steps (including creation of the PTC) were largely defensive and they reflected two main motives. There were *ad hoc* changes in response to the demands from local manufacturers who were either adversely affected by lower import duties or heavily dependent on imports. And there were changes motivated by the government's need to bolster its dwindling revenue. Overall, the effective protection coefficient (EPC) of the manufacturing sector for total sales rose from 1.5 in 1979 to 1.6 in 1981 (see Table 2). The Presidential Tariff Commission (1985) found that the variance of the EPC had increased between these years.[19]

Table 2: EPCs for the Overall Manufacturing Sector for Total Sales (Domestic and External), 1979-89

1979	1981	1983	1985	1987	1989
1.50	1.61	1.56	1.35	1.40	1.77

Source: Edwards (1993).

In the process of fine-tuning, the PTC appeared to have been trapped by political lobbies. It had been forced to yield to pressures to provide protection or to reduce particular import rates on a selective basis. This was hardly surprising, given the patronage that characterized the country's political system, appreciation of the real exchange rate and market failures on the supply-side. As a result, the tariff structure revealed no apparent rationale in terms of either comparative advantage or the encouragement of infant industries (Cuthbertson & Khan 1981).[20] It was also in part because of the lack of a coherent industrial strategy on which tariff changes could be based. It is worth noting that the government lacked an industrial strategy until 1989.

The liberalization process was in effect truncated because it was overtaken by the macroeconomic crisis in the early '80s. Key factors in this break were (i) problems of stabilization (which we have already analyzed), and (ii) the costs of adjustment that were manifest in continuing high unemployment. The latter were important politically, and they were not effectively offset by the higher rate of growth. This was so for a number of reasons.

The initial trade liberalization in 1977 saw considerable job losses.[21] There was some redeployment (there was improvement in the overall employment situation by 1981/82), but losses were not immediately compensated by new opportunities in expanding activities -- partly because the emerging industries were in other locations and partly because different skills and abilities were required by them. Some people who had lost jobs were absorbed by the expanding construction and service sectors; some secured jobs in new industries or obtained land under the AMDP, and others migrated abroad, particularly to the Middle East.[22] But in the early 1980s, a large part of this displaced labour was still unemployed. Their presence exerted tremendous pressure on government, and it led to their recruitment in large numbers into state corporations (creating overstaffing). Public enterprises were sources of readily available employment, and rationalization to increase their efficiency was very much a secondary objective. Privatization was also more difficult with this overstaffing, because existing labour laws made retrenchment difficult.[23]

Questions were also raised about the quality of the employment that was generated. With the exception of the garment industry, labour absorption was concentrated in sectors that could not be expected to sustain a long-term growth in employment -- most notably in construction where winding-down was inevitable.[24] The expansion of service sector employment was also in large part due to the expansion of import trading after liberalization. It was important, therefore, that the regime of liberalized imports was buttressed by external props (in effect by foreign aid), rather than by any intrinsic strength of the domestic economy. The new employment was largely in areas financed by monetary expansion, increased capital inflows or worker remittances, all of which were prone to considerable buoyancy.

Nor was this all. Pressure for concessions pushed the focus of government policy towards manufacturing at the expense of other sectors -- such as peasant agriculture which contained the majority of the poor, and which lacked organized and forceful representation at the national level (IPS 1993). Efforts to promote peasant-based exports were therefore continually frustrated (Dunham 1993). Changes taking place in the country's industrial structure saw a reallocation of labour from the unorganized sector, and from the rural sector in particular, towards the urban, organized sector (largely industry and services). Those who lost jobs in rural areas, for example in the handloom sector, were not normally the ones to be employed in the Free Trade Zone located near to Colombo. Regional differences grew and accentuated existing disparities in the distribution of income.[25] This was all the more serious because of regional ethnic differences. Taken together, these effects were socially divisive. Measures were introduced to counteract this pattern (for example to protect handloom industries) regardless of the target of tariff rationalization or norms of market efficiency. The government was quite unenthusiastic about IMF and World Bank insistence on moving towards a more neutral incentive regime and about demands for investment cuts to reduce government expenditure (MOFP 1985: 88).

As the 1980s progressed, revenue constraints became a barrier to further reductions in the levels of protection because the government had raised much of its revenue from external trade (the Effective Protection Coefficient had increased to 1.77 by 1989 -- see Table 2). High import duties across-the-board, while good for revenue purposes, raised the protection level, and ran counter to rationalization of the tariff structure (PTC 1985). Nor was there a narrowing of duty bands to reduce disparities (World Bank 1984). This contributed to a further slowing down of the liberalization process.[26]

4.3 Other Problems of Transition

There were also other problems relating to the exchange rate adjustments and to foreign capital inflows.

(i) Problems of devaluations

The other key element in trade liberalization, besides the protection structure, is devaluation. Significant devaluations in the real exchange rate are normally crucial in shifting incentives to tradeables. However, as we have already seen, policy-makers in Sri

Lanka found it difficult to undertake large real depreciations. This was for several reasons. First, many state enterprises were loss-making; they were a burden on the government budget, and they required increasingly large transfers to keep them in any way viable. They were also, in general, highly dependent on imported inputs. Devaluation, by increasing their costs, inflated the size of these transfers. Fiscal imperatives therefore worked against marked devaluations.

Second, Sri Lanka being in general highly import-dependent, the costs of industrial and agricultural production and of domestic consumption were similarly affected. Devaluation posed a serious threat of cost-push inflation. In the welfare-oriented and highly politicised environment that had existed in Sri Lanka, partial wage indexation had also been unavoidable. Import- and wage-related cost increases, combined with declining terms of trade, ate into the margins that devaluation offered to exporters. Further devaluations were then needed to sustain export competitiveness, but this was politically difficult, as well as being undesirable from the standpoint of economic policy. Policy-makers tried to rely on commercial policies to avoid short term inflationary consequences and to maintain realistic exchange rates, but they were ineffective because of market failures on the supply side.

(ii) Problems of foreign capital inflows

During this period, there was no serious effort to liberalize the balance of payments. However, there was a real exchange rate appreciation in the wake of official capital inflows linked to the public investment programme. The difficulties countries have experienced in absorbing large foreign capital inflows have been discussed in the literature (Corden 1984). The essential point is that if they are absorbed by the domestic economy, then an appreciation of the real exchange rate is likely to follow because of imported inflation and the increased demand for non-tradeables (Levy 1985; White & Wignaraja 1992). Lal and Rajapathirana (1989) argue that, because of the restrictions on capital outflows, the appreciation of the real exchange rate was larger than it need have been. However, it is clear that -- along with other factors -- appreciation worked against on-going efforts to boost the production of tradeable goods.

Massive foreign capital inflows also of course had a positive side. They came at a time when the economy faced massive external shocks, enabled the government to maintain the momentum of its public investment programme and enabled it to avoid a deflationary policy stance that would otherwise have been necessary (Athukorala & Jayasuriya 1991). They eased the pain of adjustment. They also enabled the basics of the liberalization programme to be maintained without recourse to the extensive use of direct controls. In the short-run, the economy could be said to have suffered less in terms of reduced growth, higher unemployment or added social tensions. How these two sides should be weighed remains a difficult question.[27]

Table 3: Foreign Capital Inflows to Sri Lanka: 1978-92

	1978 - 85	**1985 - 90**	**1991 - 92**
Domestic Savings	13.7	12.6	14.1
(a) **National Savings**	19.6	19.4	20.8
(1) **Foreign Aid**			
Official Transfers	3.3	2.7	2.1
Concessional Loans	4.1	3.8	3.9
(2) **Other Loans**	2.9	0.5	1.2
(3) **FDI**	0.8	0.5	1.0
(b) **Foreign Savings** (1+2+3)	11.1	7.6	8.2
Total Savings (a+b)	30.8	27.0	29.0

Note: All values are as a percentage of GDP.

Source: Averages were estimated using Institute of Policy Studies, Data Base.

4.4 Problems of Further Liberalization in the Post-1989 Period

Because its budget deficit remained large, the government failed to reap the benefits of financial market liberalization. It was unable to mobilize more domestic savings or to reduce the country's dependence on foreign aid. Increased inflows of foreign capital, as aid and into the newly activated stock market, ballooned external asset reserves in the Central Bank.[28] This increased money supply, which in turn called for a higher interest rate in order to control it. As we noted earlier, the high interest rate policy itself had other repercussions on demand management.

The expectation had been that, with relaxation of the surrender requirement for exporters and the further liberalization of exchange controls, there would be an outflow of capital, reducing the impact of foreign capital inflows on exchange rate appreciation. This did not happen. The outflow of capital, other than from the stock exchange and the FTZ, was not significant. Most exporters preferred to keep only a small fraction of their earnings abroad because of the high interest rate in Sri Lanka. The one year Treasury Bill rate was in the range of 20-22 per cent, and the real interest rate in Sri Lanka was significantly higher than they could obtain elsewhere. This delayed the further liberalization of exchange controls -- a move towards Article 8 status with the IMF.[29] There were also other fears regarding the impact of further liberalization of exchange controls on the macroeconomy (Lakshman & Nicholas 1991).

The privatization programme was pursued aggressively in 1990-91 period, *inter alia*, as a measure of improving the efficiency of supply side activities, but it also ran into difficulties in 1992. The opposition of strong trade unions to labour retrenchment and allegations of "crony capitalism" arising from a lack of transparency in the privatization process made the government move cautiously (Kelegama, 1993). The government found it extremely difficult to dismantle labour legislation (such as the Termination of Employment Act) which it saw as an impediment to growth. Traditions of labour protection were too strongly rooted in Sri Lankan society. Many of these laws were seen as a hindrance to the privatization programme and to the structural adjustment process.[30]

The government also found it difficult to monitor and regulate the economy during further liberalization. In the case of privatization, for example, the legal framework was inadequate to safeguard public interests. There were cases of public monopolies simply being converted into private monopolies, with a resulting escalation in the prices of certain commodities. Managing and regulating the supply-side reforms remained problematic.

In fact, the crisis management associated with policies of stabilization was such that liberalizing markets in a pre-arranged sequence never arose as an issue. The capital account of the balance of payments still remains to be fully liberalized, though it will follow the conventional sequence; the liberalization of commodity, financial, and labour markets has shown no perceptible order. The path that has been followed has reflected what has been feasible, and it has shown that problems in the transition to an open economy are unlikely to be resolved by liberalizing faster. The discussion also shows that there was a very uneasy relationship between stabilization and adjustment.

5. Conclusions from Sri Lankan Experience

Theory maintains that the success of a liberalization programme is likely to depend on the effectiveness of the accompanying macroeconomic policy package and on the degree of government commitment to liberalization measures. In the Sri Lankan case, neither condition was effectively satisfied. The first phase lacked an adequate stabilization effort, and in the second *ad hoc* policy-making began smothering growth. The austerity programme, adjustment costs and political realities forced the government to compromise, and conflicting objectives placed further constraints on the country's economic expansion.

Several conclusions can be drawn from the Sri Lankan experience:

(1) **It suggests that it is extremely difficult to liberalize successfully when underlying fiscal problem have not been resolved**. In developing countries, a large public sector deficit entails either inflationary finance or foreign borrowing associated with a large current-account deficit. Or both, as in the case of Sri Lanka. Large-scale domestic borrowing is generally infeasible, and trade liberalization tends under such conditions to be unsustainable. Large capital inflows -- mainly as aid -- can also induce a 'Dutch Disease' type shock and neutralize efforts at liberalization.

A Keynsian-type fiscal stimulus can be reduced by stabilizing the economy, but this may only be feasible if there are also immediate and visible rewards from liberalization. In Sri Lanka, the factor reallocation costs that accompanied the post-1977 liberalization package resulted in increasing social and regional disparities. Had Sri Lanka followed a stringent stabilization package at that time, then the accompanying recession would have resulted in an even greater deterioration in welfare. It would have been politically infeasible. Similarly, after 1990, the size of the fiscal deficit led to the introduction of *ad hoc* revenue measures that ran counter to basic objectives of liberalization. Dove-tailing liberalization and stabilization measures proved extremely difficult.

(2) **Political limits on the costs of adjustment tend to be underemphasized**. Such a claim, by its nature is highly contextual, but in the case of Sri Lanka it was clear that transition problems were all the more difficult because the costs fell mainly on the poor, and because poverty and unemployment were grist to the mill of the southern insurgency. Political realities have to be recognized as the prime force in policy. As Krueger (1981) has argued, "it is senseless to incur the costs of adjustment only to reverse policies before they have had a chance to affect resource allocation and

growth. Yet, the evidence is that a significant number of stabilization programmes have foundered precisely because the authorities have been unwilling or unable politically to survive political pressure during the adjustment period" (*Ibid.*: 100-101). To argue that adjustment costs are the price that a society must bear to win longer-term gains, and that they will eventually be offset by the higher growth that comes from liberalization may be simply unrealistic.

(3) **The assumption that large-scale employment will result from trade liberalization greatly over-estimates the substitutability of production**. The two-factor Heckscher-Ohlin-Samuelson trade model implies that, at least in the early stages of growth, poor countries will find their comparative advantage by switching to the production and export of labour-intensive commodities (Krueger *et al.* 1981). Sri Lankan experience shows that there is an important distinction between import liberalization and export promotion. The effects of the former are immediate -- domestic industries that cannot compete are quickly eliminated, creating redundancy -- whereas the creation of export industry takes much more time. Import liberalization displaced more labour from import-substitution industries, and displaced it far more quickly than new jobs could be created.

(4) **Failure to initiate the expected level of export industrialization**. Several factors contributed to this failure. However, one element stands out as particularly relevant. Sri Lanka generated an incentive (price) bias towards manufactured exports. And yet, despite this, the growth rate was modest, export growth was narrowly based, and there was little diversification until the second half of the '80s. Market failures on the supply-side were an important cause (Dunham 1993). When inflation negated exchange rate depreciation, Sri Lankan policy-makers became (unsuccessfully) preoccupied with the adjustment of export taxes and subsidies (commercial policy). The aim was to restore an export bias in terms of price factors ("getting prices right"), to the neglect of non-price impediments.[31] Successful export-led industrialization is likely to require an interplay between incentives and supply-side factors (Lall 1991).

(5) **Initial conditions**. Sri Lanka lacked the infrastructural and entrepreneurial base to embark on an extensive and rapid export-led industrialization programme. The importance of the colonial inheritance for subsequent growth before and during liberalization in South Korea and Taiwan has been carefully documented (Jones & Sakong 1980; Saith 1986; Amsden 1989; Wade 1990). Similarly, the Sri Lankan case

shows that it is politically difficult to dismantle a strong commitment to welfarism with strong and firmly embedded roots in public sector employment. Success was never merely a function of adequate policies.

(6) **External shocks**. External factors, and more especially the country's terms of trade, had a major effect on the outcome of its liberalization efforts after 1977. Nor was Sri Lanka unique in this. Helleiner noted that, even before 1979-82, African policy-makers complained that "international shocks were more costly ... than any failure to take full advantage of export opportunities (Helleiner 1986:143)". This is probably true of Sri Lanka.

(7) **Planning is important for the success of a liberalization programme**. Since the late 1970s, planning in Sri Lanka has been confined to the government's public investment programme, on the grounds it was unnecessary in the context of free market economy. Fifteen years later it is all too clear that the market by itself will not reduce unemployment or social and regional disparities. It is clear that, without planning, objectives that are socially and politically important will continue to remain untouched by the market mechanism.

The importance of the state in guiding the development of East Asian countries has received growing attention (Amsden 1989; Wade 1990), and the objective of development strategy has been seen as exploiting the comparative advantage of well-established industries while building up a comparative advantage in infant industries. The latter were developed in response to non-neutral promotional policies and under the influence of direct non-price determined interventions. The important point here is that intervention was selective and was focussed on industries that were judged to offer dynamic comparative advantage.[32]

Sri Lankan experience reflects the considerable complexity of the liberalization process and dangers of adhering too strictly to conventional lines of analysis. It offers encouraging and cautionary lessons for those who set out on the simultaneous programmes of stabilization and liberalization of their economies. They embark on a difficult task.

ENDNOTES

1 From this perspective, a prior stabilization package is often seen to be necessary. Selowsky (1986) has argued that if a liberalization programme is undertaken in a time of crisis, short-term stabilization costs will only add to the costs of factor reallocation. Being concentrated into a short period of time, the result may be deeper recession and political instability.

2 The rationale behind uniform tariffs is that resources can flow into areas of comparative advantage as determined by world prices. Simplicity, connotations of fairness, the fact that it leads to lower variation in protection, and that efficiency gains are derived on both the production and the consumption side, are also seen as justifications by its advocates (Balassa 1986; Wolf 1986).

3 It is also important to pre-announce tariff changes to reduce uncertainties. This will only lead to minor economic losses (Michaely 1986; Bruno 1988). In the contracting sector capital will be reduced slowly, in the expanding sector it will be built up gradually, with moderate changes in rents. Labour will also start moving gradually with such announcements.

4 See Lal (1987:288).

5 Under the State Trading Corporation Act of 1971, state trading corporations took over import trade and the domestic wholesale trade in all essential commodities. By 1976, the state sector directly accounted for 88% of the total import trade and about 30% of the export trade (Cuthbertson & Athukorala 1991).

6 A number of authoritarian moves, such as the extension of the life of the parliament from five to seven years under emergency legislation, nationalization of the largest privately-owned newspapers and perceptions that personal freedoms were being curtailed also played an important role by alientating public opinion (Herring 1987; Moore 1990).

7 The remittance of profits from foreign-owned companies and non-resident partnerships and of dividends of non-resident shareholders of rupee companies was permitted without prior approval.

8 J.R.Jayawardena, the Prime Minister, was reported to have said of the government's priorities, "employment first, employment second and employment third".

9 The aid-funded share as a percentage of total investment in the AMDP rose from 30% in 1979 to 83% in 1985, falling back thereafter (Athukorala & Jayasuriya 1991: table 5.2).

10 The inadequate stabilization could be gauged by the massive budget deficits and the high level of inflation during the 1977-88 period.

11 Much of the other employment, in the Free Trade Zone in particular, was female employment associated with garment factories taking advantage of Sri Lanka's quotas under the Multi Fibre Agreement.

12 Bhalla & Glewwe (1986) have claimed that living standards improved after liberalization, though this claim has been disputed by Pyatt (1987) and by Anand & Kanbur (1991).

13 The Public Investment Programme, a four-year rolling plan of public sector investments was largely introduced to bring more order and control into the planning and management of sub-projects of the AMDP.

14 Lindgran et al. (1986:34) pointed out in the mid-'80s that "in general, investment appears to be limited more by the lack of bankable projects than by lack of credit to finance them". The reason for this was inadequate development of the Sri Lankan private sector (in terms of capital accumulation, orientation and managerial skills) and an increasingly uncertain and potentially risk-prone investment climate. The Sri Lankan capitalist class of the early '80s was still mercantile in character; it was reluctant to jump from the relative safety of trading to

investment in new areas of production. Limited experience in the preparation of saleable project proposals to risk-conscious banks, and limited financial strength to back-up credit were also a disadvantage. They were also aware that the high import content of industrial raw materials in many of the newer sub-sectors made investment particularly vulnerable to the terms of trade. This was all the more so, since the violence of 1983 and its aftermath had clear repercussions on business confidence in the Sri Lankan economy.

15 In the mid-1980s over 60% of industrial production was in the hands of the public sector although in most areas private sector ventures were no longer consciously excluded.

16 The average was swelled by a high rate of growth in 1990 when the economy sprang back to normal from the low base of the insurgency of 1987-89.

17 Since 1989, more measures to alleviate poverty (such as a mid-day meal programme, free school uniform programme, rural electrification programme), were implemented.

18 The 200 Garment Factories Programme, which entitled parent companies to special export concessions in the form of tax holidays, reflected little concern with the economic viability of outlying locations.

19 Protection is seen as a relative concept, some activities being protected in relation to others. Variance therefore provides information on the extent to which the most highly protected industries benefit from the protected structure relative to the least protected. If protection succeeds in getting resources to move from one activity to another, the variance of EPCs provides an indication of the potential resource misallocation in the tariff structure. Other things being equal, this potential will be greater, the wider the variance of the EPCs (see Greenaway 1988).

20 This reflects the difficulty in judging appropriate protection levels for various industries in the first stage of transition, whether for further protection or for liberalization.

21 In the handloom industries, it was estimated that nearly 128,000 workers were displaced between 1977 and 1986 (Kelegama, 1989).

22 Stern (1984) has shown that employment under the Mahaweli Project peaked in 1981, and that employment fell with completion of the construction phase. Kelegama and Wignaraja (1992) have shown that the labour absorption capacity of the entire manufacturing sector remained low during the post-1977 years.

23 Liberalization of the labour market was also partial. The power of the unions was significantly reduced in 1980, and though this lowered rigidities in the labour market, the process was far from complete. Exisiting labour laws remained in operation, and still continue today.

24 The construction boom was driven largely by deficit financing and by foreign aid, but the government had eventually to prune down its construction programme to ease its budget deficits.

25 The diversion of employment from basic industries to construction and services also undermined many of the linkages that had existed earlier.

26 Most EPCs for 1983 were higher than the corresponding figures for 1981 -- 12 out of 20 industries having higher EPCs in 1983 (PTC 1985).

27 Since the country in 1977 had neither the supply potential nor the dynamic industrialist class to embark on major export-led growth, and since the terms of trade had deteriorated, it becomes difficult to argue that the current account liberalization should have taken place <u>before</u> the inflows of official capital linked to the public investment programme.

28 In late 1993 external official reserves were the equivalent of 6 months of imports.

29 Article 8 implies a stage where there are no restrictions on the free inflow and outflow of capital.

30 Godfrey (1990) has argued that labour market rigidities and outdated labour laws remain a major obstacle to structural adjustment in Sri Lanka.

31 It was assumed by international and domestic policy-makers that if incentives were "correct", export-led industrialization would take-off automatically. An industrial strategy was seen to be irrelevant, and minmal attention was given to supply-side factors. But there is no reason why "correct" incentives should have the desired effect if there are market failures on the supply-side (in factor, product and technology markets). Incentives are unlikely to produce supply-side factors such as capabilities, or the institutions to provide them if risks of market failure exist. Similar attitudes prevailed with regard to agricultural exports (Dunham, 1993).

32 The strategy of "picking winners" for selective intervention was based on comprehensive studies of the industrial sector both by the entrepreneurs and the bureaucrats (Lall 1991).

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