of this marked improvement, the calendar year 1953 closed with a deficit provisionally estimated at Rs. 176 million, which was little more than half of the record deficit of Rs. 322 million in the calendar year 1952.

18. A monetary authority faced with a continuing loss of external assets caused by Government deficit financing could have attempted to check the loss by contracting credit to the private sector of the economy. This the Central Bank did not do, because the banking system was financing essential production and there was no evidence that bank credit was being used to support speculative activity. In fact, the Central Bank might usefully have encouraged extension of credit to the private sector ; but it could not have done this until the Government had brought the budget deficit under control, because such action would have caused an excessive money supply to expand still further.

19. Normally, changes in credit supply can be expected to influence the domestic price level. The prices of Ceylon's export and import goods are determined externally and are little affected by changes in the internal monetary situation. Although the price index of commodities domestically produced and consumed fell on the average very slightly in 1953, the trend was distinctly downward in the second half of the year. During the first half when the money supply was almost constant, domestic prices did not show any pronounced tendency to fall. In fact, at one stage (May and June), the index rose seasonally. From July onward it fell steadily, reaching 96 ·7 at the end of the year as compared with 100 ·6 at the beginning of the year, thus reflecting the impact on the domestic price level of a contracting money supply as the budget deficit narrowed. In spite of the fall in the domestic group, the consumer's price index as a whole rose to 101 ·6 in 1953 as against 100 in 1952. The reason was that the price levels of both the export group and the import group were higher. The former rose by 17 ·1 per cent and the latter by 2 ·5 per cent. Towards the end of the year, however, the import group showed a falling trend, reaching a low point of 104 ·1 in December as against a peak of 112 ·3 in August.

20. Of the factors responsible for the loss of external assets, the budget deficit and the resulting expansion of credit were measures within Ceylon's control. The action taken by Government to reduce the budget deficit and the policies and measures adopted by the Central Bank to check the inflationary impact of deficit financing are discussed in the next section.

III. Policies and Measures

21. The continuing drain on Ceylon's external assets was fundamentally a fiscal problem. It was a monetary problem only in the sense that the financing of the Government deficit through credit expansion caused the money supply to become excessive in relation to the terms of trade and the level of export income. Some fall of external assets was to be expected with the worsening of the terms of trade after the collapse of the Korean War boom. But it would be a mistake to exaggerate the importance of the worsening and regard it as the principal reason for Ceylon's difficulties. The years 1950 and 1951 were exceptional and Ceylon was then enjoying the benefits of a boom. By contrast the 1953 terms of trade were considerably better than those in 1952 or in the pre-Korean War years of 1948 and 1949

when the loss of external assets was small despite terms of trade that were much more unfavourable than in 1953. By any reasonable standard, prices in 1953 for Ceylon's principal export commodities were good. In addition, import prices were distinctly lower during the year. If the economy had been adjusting itself only to the worsening terms of trade that followed the collapse of the boom, the adjustment would have been completed earlier. The 1952 Annual Report stated: "The liquid assets built up by consumers during the boom would have been sufficient to finance an excess of imports for a brief period only." The economy remained in disequilibrium in 1953 with the drain on external assets persisting, because the internal cause of the drain persisted.

22. The internal cause was that the Government, by drawing down its cash balances, and the banking system, by creating credit, had been pumping large amounts of new money into the economy. The new money had been required to meet an excessive budget deficit. The drain on external assets was bound to persist until this deficit was reduced to a level at which it could be financed without creating new money.

23. External assets serve two functions. First, they protect the exchange value of the currency. To do this, they should not be allowed to fall below a minimum level; and this minimum must be set at a high figure because of Ceylon's heavy dependence on foreign trade. At the rate of drain in the first half of 1953, they would have disappeared in just over two years. Second, external assets act as a cushion to soften the impact of fluctuations of income on consumption. They can be built up when incomes are rising and allowed to drop when incomes are falling. But the level of consumption which Ceylon aims at maintaining in the face of falling income should not be so high as to cause external assets to drop below the minimum level. In 1952 and 1953, Ceylon maintained consumption at a much higher level than could be justified when incomes were substantially lower. The result was that the country sacrificed external assets which it could have put to better use.

24. Government had recognised in 1952 that the budget deficit was excessive and had taken measures to reduce expenditures and increase revenues by adopting the Eight-Point Austerity Programme. But these proved inadequate. The deficits of the first two quarters of 1953 differed little from the average of quarterly deficits of 1952; and further action had to be taken to reduce the budget deficit drastically. Government had the choice of cutting down consumption by eliminating the food subsidy bill from the budget or of postponing development by restricting expenditures on capital works. It decided to choose the former.

25. *Government Measures.*—Government adopted, beginning early in July, a series of measures to improve its cash position. First, the price of rationed rice, which, despite large increases in cost, had been supplied to the consumer at 25 cents per measure since December, 1950, was raised to 70 cents per measure. In order to alleviate hardship (off-ration rice being costlier than rationed rice) the amount of the ration was raised by ¾ measure to the 1942 level of 2 measures a week for manual workers, and the cut of ¼ measure imposed in September, 1952, was restored to other recipients. The net effect was to produce a substantial saving on the food subsidy bill. Second, the rates Government charged for postal and telegraph, railway and electricity services were raised. Since some of these services were run at a loss this measure attempted to eliminate the concealed subsidies on them.

26. Third, several tax increases were announced in the budget introduced in late July in order to produce additional revenues. These were : (*a*) higher duties on a variety of imports including some luxury imports; (*b*) a somewhat steep increase in personal tax rates especially on higher incomes ; (*c*) a higher corporate tax ; and (*d*) an excise duty, imposed for the first time, on domestically grown tobacco processed into manufactured tobacco. The 10 per cent surcharge on certain import duties imposed in September, 1952, as a temporary measure for one year was absorbed into the new rates. The only tax decreases were in respect of a few items of capital goods, duties on which were reduced to encourage domestic production.

27. Fourth, in order to secure an assured supply of rice at stable prices, Government entered into a four-year agreement with Burma for the purchase annually of a minimum quantity of rice with the option to increase purchases up to a maximum amount. The latter amount was fixed at a level which was considered sufficient to meet Ceylon's requirements of imported rice, even if supplies from other sources failed. Advantage was also taken of a weakening world market to contract for these purchases at favourable prices as compared with those Ceylon had previously paid. Following the Burma agreement, negotiations were concluded with China for the revision of the price of rice and of rubber traded under the five-year agreement.

28. With the supply of rice assured at rates lower than those contemplated when the price of rationed rice was raised to 70 cents per measure, Government felt able to reduce the price to the consumer to 55 cents per measure in October, 1953. At this reduced price it was expected that the loss incurred on subsidising rice and flour (whose selling price had remained unchanged) would be met by the profit Government made on sugar without having recourse to funds out of the general budget.

29. *Food Subsidies.*—One result of removing the burden of food subsidies from the general budget was that food subsidy expenditure in the financial year 1952-53 declined to Rs. 127 million as against a budgetary provision of Rs. 161 million and an outlay of Rs. 247 million in the financial year 1951-52. As in 1952, so also in 1953, " subsidies were not paid for by taxes but by newly created money. In other words, if subsidies had been eliminated, the budget deficit, and the expansion of credit, could have been reduced correspondingly and external assets would not have been used to support a level of consumption that the country could not afford."*

30. *Sale of Off-ration Rice.*—Early in the year, Government had itself ceased to sell rice at cost outside the ration with the result that domestically grown rice, which consumers could freely buy, rose substantially in price. In July, Government began once more to sell rice outside the ration and towards the end of the year reverted to the former policy of selling unlimited quantities of such rice. The effect was to reduce the price of domestically grown rice from Rs. 1·22 per measure in July to 87 cents per measure in December and to lower the cost of living. The

* The quotation is from the 1952 Annual Report.

guaranteed price of Rs. 12 per bushel of paddy was maintained during the year. Government is committed until 1957 to pay the domestic producer this guaranteed price which is about 25 per cent higher than the current price paid for imported rice. While it is desirable to encourage domestic production of rice, it is also important that production should be economic and competitive.

31. *Budget.*—As a result of the decision of Government that food subsidies should cease to be a charge on the general budget, the Government deficit became more manageable. It also meant that Government would not need to cut development expenditures to finance consumption. In fact, the emphasis of the budget was on productive development. Postponable expenditures on maintenance were reduced but the total provision for capital works was higher.

32. The budget for 1953-54 planned for a deficit of Rs. 93 million, which should, however, be revised to nearly Rs. 110 million, if the exceptional receipts from sale of Government owned scrap and ilmenite were excluded because of uncertainty of sale. Even the revised deficit compared favourably with the deficit of Rs. 232 million in the financial year 1952-53.

33. A change of Government occurred in October, 1953, and this was followed by administrative measures which aimed at further restricting avoidable expenditures. At the close of 1953 there was reason to believe that these measures would result in a budget deficit somewhat below the original Rs. 93 million. It is desirable to work for a lower deficit because the present level of external assets does not permit Government to undertake deficit financing on a scale which calls for further credit expansion to the Government sector.

34. In fact, there are strong reasons for urging greater economy in Government finances. In the past, Government has had to raise taxes primarily with the object of securing more revenues. The view is now widely held that the present tax rates on personal and corporate incomes are so high as to deter enterprise. If these high rates are maintained, it will be desirable to grant suitable tax reliefs on approved investment expenditures as an incentive to enterprise. There is also no justification on economic grounds for maintaining import duties on a wide range of capital goods and materials used in production. They also deter development by unnecessarily raising production costs.

35. The question arises how Government can finance an expanding programme of capital investment without imposing heavier taxation or without incurring excessive budget deficits. With the disappearance of the cushion of accumulated balances, with external assets at their present level, and in the absence of adequate domestic savings, additional funds can come only from sources outside Ceylon. But external borrowing brings its own problems and these were receiving the attention of the Government and the Central Bank towards the close of the year.

36. *Government Borrowing Operations.*—With the Government budget continuing heavily in deficit the problem of financing it grew to be especially difficult in the first half of 1953 when it became necessary to expand credit sharply beyond the high level reached in 1952. The 1952 Annual Report described how the treasury bill issue had attained its permitted maximum of Rs. 100 million (November), and how two loans for a total of Rs. 100 million had been floated (July). The Central Bank alone had increased its portfolio of rupee securities and treasury bills by Rs. 73 million and its direct advances to Government by Rs. 71 million.

37. By January, 1953, the Central Bank's advances were close to the maximum permitted under section 88 of the Monetary Law Act. Additional borrowing authority had to be sought by Government and in February the treasury bill limit was raised to Rs. 200 million. Thereafter the actual issue expanded sharply, the new limit being attained in June. In August two loans were floated simultaneously for a total of Rs. 80 million of which, however, Rs. 33 million were designed to convert or repay the maturing 3 per cent National Loan 1953. While these loans were fully subscribed, thus enabling funding operations to be effected by certain semi-Government agencies, they produced only a limited amount of new money.

38. Altogether in 1953, Government increased its gross rupee indebtedness by Rs. 180 million.

39. *Interest Rates and Open Market Operations.*—The critical financial situation which developed towards the end of 1952 and early in 1953 led to one important change of policy. Apart from a rise in the treasury bill rate from 0·40 per cent to 0·92 per cent between April and August, 1952, interest rates for short, medium and long-term Government borrowing had not reflected to any appreciable extent, until February, 1953, the wide and growing disparity between Government's need for cash and the supply of investment funds from non-banking sources. The main reason was that the Central Bank had ensured an adequate flow of money to Government by the creation of credit. In addition, the Central Bank had given active support to the prices of Government securities by open market operations.

40. The policy of maintaining exceptionally low rates of interest had been tenable under the conditions of abnormal prosperity prevailing in earlier years. It came more and more under strain as external assets declined and Government's deficits grew. Moreover, if continued, it was bound to aggravate inflationary dangers. Maintenance of low interest rates, under conditions which no longer justified them, not only discouraged savings but also would have tended to encourage liquidation of investment in Government securities. In any event, it increased the share of the burden of financing the Government, which the banking system, and especially the Central Bank, had to bear; and it indirectly contributed to the decline in external assets.

41. In March, 1953, therefore, the Central Bank recognised that it was no longer practicable to maintain the existing level of yields of Government securities. It was concerned to ensure as far as possible an orderly pattern on yields and prices, but on the basis that market forces should play a major part in determining them.

In the face of further heavy borrowing by Government, the treasury bill rate rose sharply from 0·92 per cent in February to an average of 2·47 per cent in July, and subsequently became stable at 2·48 per cent. The Central Bank's holding of treasury bills and rupee securities over this period increased by Rs. 63 million.

42. The treasury bill rate was the main determining factor in the upward movement of interest rates in 1953, since Government's borrowing was predominantly through the medium of treasury bills. As the bill rate rose, there was a natural adjustment of yields on short, medium and long-term Government securities. Prices in the Colombo market fell generally until August, the redemption yield on the longer-dated securities reaching a fraction over 4 per cent for maturities of more than 20 years compared with just under 3 per cent in 1952. The increased cost of money was recognised in the terms of the two new loans floated in August, namely, a 3 per cent loan issued at par with a currency of $2\frac{1}{2}$ years, and a $3\frac{1}{2}$ per cent loan issued at 99 maturing in 6-8 years and yielding 3·65 per cent to the final redemption date.

43. After August, 1953, there was no further general rise in interest rates. Both the shorter and longer term markets settled down at the levels which had been reached; and towards the end of the year prices of Government securities became slightly firmer. (In March, 1954, the treasury bill rate too has shown a small downward movement).

44. *Bank Rate.*—In July, 1953, the Central Bank rate for advances to commercial banks which had remained unchanged at $2\frac{1}{2}$ per cent since the commencement of business by the Bank in August, 1950, was raised to 3 per cent. This limited increase took particular account of the rise in the Bank's discount rate which, being based on the treasury bill rate, had already risen sharply; and generally it represented an adjustment to the basic change which had occurred. Its immediate practical effect was mainly to give further guidance to the commercial banks as regards their own policy. These banks had already in April, 1953, begun to raise the rates paid on fixed deposits and in July, 1953, they made a moderate increase in their scale of charges on loans and overdrafts.

45. *Savings Deposits.*—The upward trend of interest rates did not influence the policy of either the long-term lending institutions or the various savings institutions during the year. The need for a new approach designed to stimulate small savings is a matter which will call for earnest attention in 1954. In 1953 savings deposits showed an unsatisfactory trend. Allowing for accrued interest, there was a net withdrawal of savings deposits in contrast to the substantial increases in earlier years.

46. *Interest Rate Policy.*—The changed pattern of rates is of such importance as to merit some further comments. First, there is no doubt that the large size of Government's borrowing requirements in the first half of 1953 was a major factor in the steepness of the rise in rates over a comparatively short period. Second, although short-term rates rose rapidly under the pressing need to enlarge the treasury bill issue, the maximum level reached was broadly in line with those in many other countries similar to, or closely connected with, Ceylon. As regards Government's

long-term credit, the comparison was also not unfavourable with rates abroad. The yields on loans of 20 years and over at no time rose more than a fraction above 4 per cent.

47. Third, although Government securities fell in price as interest rates rose, it must be stressed that these securities are fundamentally different from a deposit repayable on demand. In subscribing to them an investor enters into a contract in which Government, for its part, undertakes not only to pay interest at regular intervals but also to repay the loan in full on a certain date. Between the date of issue and the date of redemption, Government securities, like any other marketable asset, may fluctuate in price according to the conditions prevailing. A recognition of this fact and a greater attention to market conditions on the part of many investing institutions and of private investors can only be beneficial to borrower and lender. Fourth, the higher rates paid in 1953 both on treasury bills and on the loans of August, 1953, undoubtedly stimulated subscriptions from non-banking sources on a scale far larger than would otherwise have been forthcoming.

48. Finally, in judging the merits of, as distinct from the necessity for, departing from previous policy, it is clear that higher interest rates have both disadvantages and advantages. On the one hand, they mean some increase in the cost of the development programme to Government and of borrowing by the private sector. On the other, they should stimulate the supply of savings and bring about a better and more efficient allocation of the country's resources through some weeding out of marginal projects. Much, of course, depends on the extent of the increase in interest rates.

49. *Reserve Ratios.*—The contraction in the money supply in the first half of 1953 inevitably involved a reduction in the resources of the commercial banks. By July, 1953, it had become clear that the banks were nearing a point where they might be obliged to restrict their lending to the private sector. It was also evident that further pressure was likely to develop as Government's cash position improved under the new budget policy and Government became able to repay part of its indebtedness to the Central Bank out of revenue or out of borrowing from the public. With these factors in mind, the Central Bank reduced in September, 1953, the ratio of reserves, which the commercial banks had to maintain with the Central Bank, to 10 per cent of the commercial banks' demand deposits from 14 per cent, to which level it had been raised in January, 1951. (The ratio for time deposits remained unchanged at 5 per cent). This figure of 10 per cent is the minimum required under section 93 of the Monetary Law Act. The effect was to increase substantially the commercial banks' employable resources and to permit them in some degree to extend credit further to the private sector. The pressure of a falling money supply, however, forced the banks generally to pay close attention to their cash position; and in the last quarter of 1953 there was a noticeably greater demand by them for short-term accommodation from the Central Bank.

50. *Bank Credit to the Private Sector.*—Commercial bank credit to the private sector expanded over the year by Rs. 18 million. The expansion was partly the result of the general increase in the volume and the price of exports and was in line with the policy of the Central Bank that the contraction of the money supply should not restrain the banking system from supplying the legitimate credit needs of the private sector. To improve medium and long-term credit facilities available to the private sector, the Central Bank made recommendations for amending existing legislation relative to the State Mortgage Bank and the Ceylon Savings Bank so that these institutions might be enabled to adopt more liberal lending policies.

51. It is evident, however, that certain obstacles to lending exist, the removal of which is just as important as the factor of cost of credit, if banks are to be in a position to take a more active part in financing private development. These obstacles include existing restrictions on the speedy realisation of collateral pledged to secure bank advances, high stamp duties which such pledges by way of mortgages now attract, and difficulties experienced in establishing title to land offered as security. To remove them special legislation will be necessary—

(i) giving all commercial banks and accredited banking institutions operating in Ceylon the right to realise speedily on all types of collateral pledged as security for advances ;

(ii) reducing stamp duties on all mortgages pledged to secure such advances ; and

(iii) enabling approved lending institutions to insure, for the period of such advances, against possible defects of title to land pledged as security.

These matters were receiving the attention of the Central Bank in 1953.

52. *Exchange Control.*—The Central Bank administered exchange control in 1953 as agent of the Government, but with one important difference. On August 15 the new Exchange Control Act (reproduced in Appendix I) came into force and the earlier Defence (Finance) Regulations were simultaneously repealed. Under the Act, the administration of control became the responsibility of the Central Bank and for this purpose a separate Department of the Bank was constituted. The technical provisions of the new Act followed broadly the same lines as those of the previous legislation.

53. Ceylon's worsening balance of payments induced Government to request the Central Bank to reduce further the scope for remittances abroad ; and this was done in two stages, first in March and again in May, mainly by cutting down the previous free limits. The restrictions had the effect of substantially reducing the amount of permitted transfers of funds, especially to India. On the other hand, they undoubtedly increased the temptation for money to be sent out by illegal methods ; and greater attention was paid during the year to ways and means of combating such evasion. The need to accept the discipline of exchange control, when decided upon by Government in the national interest, is a clear duty of the community at large. At the same time severe control has certain disadvantages which must be balanced against the desired savings of exchange. First, it involves

extra costs of administration and may delay or interfere unduly with trade and other productive activities. Second, it inevitably gives rise to attempted evasion which may, if unchecked, lead to concealed losses of exchange, black market exchange rates and other undesirable features. Third, because some will always seek to exploit legal as well as illegal loopholes, there is a tendency for control to breed further controls. The simplification and relaxation of restrictions deserve attention as soon as circumstances permit.

54. Throughout the year the Central Bank continued to enjoy the active support and co-operation of the commercial banks in its task of enforcing exchange control.

IV. Basic Economic Data

Foreign Trade in Merchandise

55. *Exports.*—The movements of the export trade, its value, volume and price level, in 1953 as compared with previous years are described in table 24.* The table below, on the composition of exports, illustrates in particular the increasing importance of tea and the declining share of rubber in the export trade.

Composition of Exports

Commodity	Value in Rs. million			Percentage of total exports		
	1951	1952	1953	1951	1952	1953
Tea ..	800	723	825	42 ·0	48 ·2	52 ·6
Rubber	582	373	338	30 ·6	24 ·8	21 ·5
Major coconut products	320	232	244	16 ·8	15 ·4	15 ·6
Other domestic exports	124	84	83	6 ·5	5 ·6	5 ·3
Domestic exports	1,826	1,412	1,490	95 ·9	94 ·0	95 ·0
Re-exports	78	90	78	4 ·1	6 ·0	5 ·0
Total ..	1,904	1,502	1,568	100 ·0	100 ·0	100 ·0

56. The quantity of tea exported reached a record total of 335 ·6 million pounds and was sold at substantially higher prices, both the quantity and the price being nearly 7 per cent higher than in 1952.

Tea—Export Quantities and Prices

Year	Exports		Average market price per lb.			
	Quantity (Mil. lbs.)	f.o.b. price per lb. Rs. cts.	High-grown Rs. cts.	Medium-grown Rs. cts.	Low-grown Rs. cts.	All tea Rs. cts.
1951	305	2 62	2 12	1 80	1 95	1 90
1952	315	2 30	2 06	1 66	1 53	1 73
1953	336	2 46	2 06	1 79	1 80	1 91

* All tables referred to numerically in this part are those appearing in Appendix II.