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STABILIZATION AND ADJUSTMENT: A SECOND LOOK AT THE SRI LANKAN EXPERIENCE, 1977–93

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I. INTRODUCTION

THREE years before the World Bank embarked on its first structural adjustment loan in 1980, Sri Lanka had begun a process of economic liberalization. It is therefore one of very few countries that have had nearly two decades of reform experience. What was achieved has been extensively documented to the end of the 1980s (Jayawardena et al. 1987; Herring 1987; Lal and Rajapatirana 1989; Cuthbertson and Athukorala 1991; Kelegama 1992; White and Kelegama 1993; Athukorala and Rajapatirana 1993; Athukorala and Jayasuriya 1994). The discussion has been detailed and it has been very wide-ranging, but why the Sri Lankan reform effort faltered in the second half of the decade has still not been adequately explained.

Part of the reason lies with the theoretical starting point. The contention of mainstream economists has been that liberalization in Sri Lanka (as in so many developing countries) was not sufficiently far-reaching (Lal and Rajapatirana 1989). The initial reforms are acknowledged to have been immensely important, but macroeconomic mismanagement is said to have left an "unfinished agenda" (Lal and Rajapatirana 1989, p. 29). We argue that this explanation is insufficient; that initial conditions, economic circumstances, and the nature of the political system reduced the government's room to maneuver; and that tensions between the differing needs of stabilization and adjustment hindered the reform process. A crucial explanatory factor in all these elements is seen to lie in the political sustainability of the reform process and the need for the government to respond promptly to domestic social pressures.

The presentation is in five sections. Section II sets out the theoretical standpoint that structures the ensuing discussion, and it is followed by a brief outline of conditions in Sri Lanka at the start of the liberalization process in 1977. Section III contains an overview of the country's economic policy up to 1993. Section IV looks at problems encountered by efforts to stabilize the economy, and Section V looks at problems of adjustment. The last section brings the discussion together.

II. STABILIZATION AND ADJUSTMENT: A THEORETICAL STARTING POINT

Stabilization and liberalization/adjustment dominate discussion of economic policy in developing countries. The orthodox distinction is that stabilization is designed to minimize a short-term macroeconomic imbalance through the management of the demand side, while structural adjustment boosts the supply side by releasing market forces and through institutional changes to increase the efficiency of the economy over the medium term (Thomas et al. 1991; Mosley 1991). Economic liberalization and an increasing market orientation are seen as the keys in achieving the aims of structural adjustment. Stabilization and adjustment have traditionally been sponsored by the World Bank and the IMF, respectively, but over the course of the 1980s their views have in practice merged and become interlinked.

Of the two, stabilization is seen in theory to be the first priority. However, as the macroeconomic environment improves, emphasis is expected to shift to economic liberalization and adjustment. Liberalization, it is argued, is more likely to succeed when macroeconomic problems are of more manageable proportions, the economy is less vulnerable to external shocks, and there is political stability. The problem is that this logical progression is rarely attainable. Most countries have had to embark on economic liberalization under far more onerous conditions—with an incipient balance-of-payments crisis, low growth, rising fiscal deficits, high inflation, and some threat of political instability (Rodrik 1990). In many cases, IMF and World Bank conditionalities have made external finance contingent on the adoption of a stabilization program, and liberalization and crisis management have had to move hand in hand.

In this situation, when wide-ranging reforms under a structural adjustment package have had to be attempted simultaneously with stabilization efforts, they have often created conflicting demands on economic policy. They have affected technical consistency, and they have put pressure on management, administrative capacities, and political support for the government. Reducing the budget deficit has in particular proved to be inordinately complex. Nevertheless, theory assumes that the different components of a stabilization-cum-liberalization package can be implemented consistently and that they will logically tend to pull in the same direction. Allowance is made for "gearing problems" with respect to the timing and sequencing of a liberalization package (Michaely 1986), but practical difficulties that are encountered when they are pursued together—problems of political palatability, overall policy consistency, and institutional capacity—receive less attention. Hesitancy, digressions, or backtracking tend to be interpreted as economic mismanagement.

However, several commentators have challenged this perception of the process of economic reform. Thomas and Grindle (1990) have questioned the unilinear model that underlies it, and Rodrik (1990) has argued—we think quite correctly—that what really matters is not the pristine application of what is theoretically desirable, but sustainability. Illiberal and politically motivated policies that generate political support for the government and for the government's reform process may (within certain bounds) be a price that has to be paid to sustain the overall momentum. One implication to be drawn from this position is that a different kind of theorization may in fact be needed that explores the underlying rationale and structure of piecemeal reform. This has still to be attempted. However, adopting this broader view, the extent that policy failures are the result of economic mismanagement, may have to be reassessed. Political, economic, and institutional constraints that impinge on the formulation and implementation of economic policy are likely to provide the rationale for a considerable proportion of it.

III. THE SRI LANKAN SETTING

Prior to 1977, Sri Lanka's economy was inward-looking. The state pursued an import-substitution strategy. There were quantitative restrictions on imports and stringent exchange controls. Public corporations were dominant in almost all sectors of the economy; the state was committed to heavy social expenditures and a bloated state sector was sustained by surpluses squeezed from plantation exports. There was an entrenched tradition of political patronage and an astute awareness of ethnicity (Lal and Rajapatirana 1989; Moore 1990; Jayantha 1992).

However, by the mid-1970s, the basic model had been ruptured. A sharp deterioration in terms of trade, the nationalization of estates, and several years of drought culminated in a fall in the output of plantation crops. The country faced unsustainable budget deficits, a balance-of-payments crisis, and widespread hardship. Low growth, high unemployment, and the rationing and black marketing of essential goods nurtured disaffection. Whichever party had come to power in the 1977 elections, changes in economic policy were almost inevitable (Herring 1987). In the event, the opposition (the United National Party—UNP) was swept to power with a landslide victory.[1]

Thereafter, more favorable external conditions, a strong mandate for reform, and the absence of any effective opposition gave the new government and its policies enormous political momentum. There was widespread popular support for the open economy, and the government's task was simplified because it did not have to rely on the acquiescence of import-substituting industrialists. There were clear indica-

[1] By the time of the election, the economy was improving, but there was widespread belief that earlier policies had failed and there was need for change.

tions by the end of 1977 that substantial foreign assistance would be forthcoming with the opening up of the economy. Devaluation, trade liberalization, the partial liberalization of financial markets, the replacement of food subsidies by more targeted food stamps, and tangible benefits to consumers from deregulation were to have a major effect on investor attitudes and on growth performance.[2]

By 1982, however, the pace of reform had slackened. The government was becoming increasingly authoritarian. The constitution had been restructured on Gaullist lines with a strong executive presidency and increasing centralization. Manipulation of the law and power struggles in the UNP to be "the heir apparent" were creating political uncertainties (Manor 1984). The government was embroiled in a massive Keynsian-type fiscal injection by way of infrastructural investment. It continued to be bound to loss-making public sector enterprises, and there were beginning to be signs of backtracking in trade liberalization. The investment program was comprised of three "lead projects": the free trade zone, the Accelerated Mahaweli Development Program (AMDP), and a public housing scheme, of which the largest and most magnificent was the AMDP. Initiated in 1970, its implementation was accelerated (in a slightly reduced form) from thirty to six years. It was a major endeavor: it overshadowed all other aspects of development policy, promising massive employment (during construction and in the later land settlement), rice self-sufficiency, and hydroelectricity.[3]

Cost estimates for the AMDP soared (from U.S.$610 million in 1977 to U.S.$860 million in 1980) and its implementation bid up the price of domestic resources (Cuthbertson and Athukorala 1991). Since it was largely donor-funded, aid inflows, together with the cost-push effect from domestic and imported inputs, fueled domestic inflation, massive budget deficits, and balance-of-payments problems (see Table I). The government interpreted the deteriorating trade balance as a J-curve effect and pushed ahead with its program. But the situation was serious, and a major crisis was only averted by the unprecedented capital inflows (not only from concessional aid but also worker remittances—the latter increasing from 0.3 per cent of GDP in 1977 to 5.2 per cent in 1982). The real exchange rate appreciated by 20 per cent between 1979 and 1982, reducing the gains to exporters of the earlier devaluation (Levy 1985). All in all, therefore, the project ran counter to the

[2] Over the period 1977–82, real GDP grew on average by 6 per cent a year, despite the oil shock of 1979 and declining prices for the country's main export crops.

[3] The scale of the endeavor (to settle 140,000 families and construct five major dams in a six-year period) was intended to capture the public imagination. It also appealed to the donor community which rewarded policy reforms with concessional aid and funded a growing proportion of Mahaweli investment—though counterpart contributions still remained immense (Levy 1985). The aid-funded share as a percentage of total investment in the AMDP rose from 30 per cent in 1979 to 83 per cent in 1985, falling back thereafter (Athukorala and Jayasuriya 1994, Table 5.2). Total expenditure on the AMDP alone was 6 per cent of GDP in 1982 and 1983.

TABLE I

KEY MACROECONOMIC INDICATORS, 1970–77 AVERAGE AND 1978–93

	1970–77	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Growth (%, per annum)	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	6.9
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[a]	–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)[b]	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	4.5	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

Sources: CBC (various years); Institute of Policy Studies, Data base.

Note: Inflation (p) was estimated using the Colombo consumer price index and the real interest rate was estimated as $[(1 + r)/(1 + p) - 1]100$.

[a] Current account includes trade in services.

[b] Public investment is not available for the post-1982 years.

stabilization and liberalization objectives that were agreed with the Bretton Woods institutions.

There were also other reversals in the reform process. Transfers to public sector enterprises increased; a number of ad hoc duty changes widened the variance of effective protection on different sectors; the government looked to non-price measures to promote exports; and ceilings on interest rates were used to ease the problems of financing the public sector deficit (Lal and Rajapatirana 1989). The reform effort could not be sustained and, by 1985, crisis management and stabilization were again the major issue. Macroeconomic imbalance, the ethnic crisis that escalated after 1983, and insurgency in the south from 1987 to 1989 effectively paralyzed the process of economic reform and the economy gradually stagnated.

It was this experience that was gauged to have reflected macroeconomic mismanagement. However, with reelection of the ruling party under a more populist president and the defeat of the insurgents in 1989, the government embarked on a second wave of economic reform. This time, donors who had been prepared to overlook the lack of any effective stabilization policy in the early 1980s (Jayawardena et al. 1987) took a totally different stand and the government was compelled to embark on a serious stabilization program. Efforts were made to reduce the budget deficit and to bring down the rate of inflation; an ambitious program of privatization was initiated; and incentive reforms were introduced to invigorate the private sector (Dunham and Kelegama 1997). The economy grew by 5.5 per cent per annum between 1989 and 1993, but there were still questions being raised about economic mismanagement. How far was the succession of criticism justified?

IV. STABILIZATION

Sri Lanka's experience with economic reform in the 1980s did not correspond with textbook views as to what should have been happening. However, it is important to see it against a backcloth of international events and the priorities of the government. Export-oriented industrialization (emulation of Singapore) was the long-term objective after 1977, but sustained pursuit of this objective also needed political support.[4] We will argue that, from this perspective, there was a necessary trade-off between what might have been technically desirable by way of economic policy and the political gains that could be made from the foreign resources available, and that the social costs of reform made some compromise inevitable.

[4] An important element in this respect was the creation of an increasingly centralized and authoritarian state.

A. *External Shocks*

Orthodox views of the stabilization/liberalization process give much more weight to domestic economic management than they do to external developments. The potential destabilizing effect of the latter is nevertheless acknowledged to be considerable, and this was undoubtedly true in Sri Lanka. After the initial liberalization effort in 1977/78, the Sri Lankan economy was hit by a sharp downturn in terms of trade in the wake of the second oil-price hike of 1979.[5] The external terms of trade deteriorated by a massive 62.3 per cent between 1978 and 1983. Herring (1987) estimated that Sri Lanka lost the equivalent of 7 per cent of its GDP in 1982 and 8 per cent in 1983 in terms of trade effects—almost the annual cost of the three lead programs. This complicated the task of macroeconomic management, though it elicited no immediate policy response from the government. This was partly because of the volume of the foreign-capital inflows and because it thought that the J-curve effect after devaluation would eventually work to its advantage. But it was also because of a fear that adjustment would instigate recession. Unemployment was high, the period was not perceived by the population at large as in any sense one of crisis (Athukorala and Jayasuirya 1994, p. 92) and, with elections due in 1982 a program that dampened the public mood and implied renewed austerity was not politically expedient. After 1982, a slight upturn was recorded in terms of trade, only for the political situation to deteriorate with the eruption of ethnic violence and with new pressures being placed on macroeconomic management.

B. *The Accelerated Mahaweli Development Progam*

A second area of controversy concerns the AMDP. Was the decision to accelerate the Mahaweli Project—and then, in a deteriorating macroeconomic situation, to persist with it—not in itself an example of economic mismanagement when the country was supposedly in the throes of an economic reform program? Since the AMDP had generated much of the macroeconomic imbalance, the answer was ostensibly positive. The scale of capital spending and the number of sub-projects it entailed posed serious problems of control and, because of the large foreign-capital component available, it became overambitious. But again the situation in practice was more complex.

The principal objective of the AMDP was to increase power production (which was a precondition for any substantial expansion of manufacturing) and to reduce the country's import dependence on staple foods. However, at the same time, it projected a message that was politically crucial, namely, that the rural poor—the potential losers from economic reform—would also gain. In the late 1970s and

[5] Tea prices collapsed in 1979 and the price of oil, fertilizers, sugar, and investment goods rose the following year.

early 1980s, the AMDP (which was in every sense highly visible) projected a vision of a "renewed" and more just society which was important in sustaining popularity for the government and for its new economic policies. It promised employment for the poor, and it provided the government with innumerable channels for the dispensation of patronage. The UNP's reputation and its credibility was tied to the success of the venture.[6]

Moreover, outside the AMDP, the effects of liberalization on income were soon seen to be seriously regressive. The government had assumed that growth would trickle down and alleviate poverty. The free rice ration was abolished and replaced by food stamps (the real value of which was, within a few years, seriously eroded by inflation), jobs had been lost through the effects of trade liberalization on domestic industry and real wage rates were stagnant or declining. However, setbacks for the poor were not offset by higher incomes. The urban "middle class" dynamics of economic reform were soon visible and it was increasingly resented. The benefits of reform were heavily concentrated on the top 10 per cent of income receivers (UNICEF 1985; Jayawardena et al. 1987; Lakshman 1989; Kelegama 1993).

It was therefore crucial for the government that employment was created to maintain social stability. Much of the employment that was being generated, in the free trade zone and in tourism, was for female workers. It increased female participation rates, but the most vociferous unemployed were rural, educated, young, male, and Sinhalese—a phenomenon linked with Sri Lanka's history of rural insurrection. The UNP had been particularly successful in securing the rural vote (Bruton et al. 1992) and it championed increased employment in the AMDP (in the construction phase, even if the work was transitory, and in the subsequent land settlement) and in the public service.[7] Western governments were open to large-scale foreign projects for their construction industries during the international recession (de Silva and Wriggins 1994). Concessional aid was forthcoming for major projects, but the president was convinced that this might only be the case for a relatively short period of time. It seemed logical, therefore, to try to lock up funding for large long-term projects during his term in office (Athukorala and Jayasuriya 1994, p. 80). It was then, extremely difficult to move into a lower gear. The government could not afford to step back from its commitment to the AMDP

6 One member of the cabinet (Gamani Dissanayake) also made the telling point that, apart from the Mahaweli, there was little that the newly elected UNP government of 1977 had to put up immediately for funding (de Silva and Wriggins 1994, p. 363). The president was to be closely associated with the AMDP, and the prime minister was personally associated with the housing program.

7 Government employment increased by approximately 22 per cent between 1977 and 1982, most of it before 1980 (Bruton et al. 1992, p. 158). However, in practice, employment by the AMDP was far less than expected, Karunatilake (1988) has suggested that at its peak employment in the construction was no more than 20,000.

in the name of sound economic policy. By the end of the 1980s major investment in the AMDP had ended.

C. *The Budget Deficit and the Social Cost of Adjustment*

Government failure to rein in the budget deficit has been a continual source of instability throughout Sri Lanka's liberalization experience. It averaged 16.7 per cent of GDP between 1978 and 1982 and, though it was subsequently lower, there were persistent deficits after 1989 (see Table I). As always, there were strong political imperatives that made reductions difficult. During the early period, there was also an inherent conflict between the need to raise revenue to reduce the public sector deficit for macroeconomic stability and the needs of liberalization.

In the immediate post-liberalization period, revenue was not an issue. Government revenue increased. Rents associated with quotas had gone to the government, and the shift from quotas to tariffs at the same level of protection produced additional income. The lowering of tariffs boosted revenue because there was a large influx of imports, but eventually lower tariffs on external trade and cuts in income tax had the reverse effect. There was no visible "Laffye curve" effect in operation. 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 export firms. The problem was also exacerbated by external shocks. Export diversification was slow, and with appreciation of the real exchange rate and incentive structures biased against traditional exports, export volumes fell, and with them government revenues. Lal and Rajapatirana (1989, p. 45) have argued that if taxes on traded goods had been reduced in the early 1980s, appreciation of the real exchange rate could have been accommodated without a rise in the general price level. However, at a time when they were already falling sharply (from 47 per cent of government revenue in 1980 to 32 per cent in 1982) this was by no means easy. The government found it difficult to find new sources of revenue and it resorted to ad hoc revenue measures. Moreover, 18–20 per cent of GDP (excluding grants) was a comparatively high revenue outturn in the early 1980s.

Even in the later post-1989 period, when the government embarked on a serious privatization program, there was no significant increase in revenue in terms of GDP percentages. There were two reasons for this. First, there were costs to the privatization exercise. Most state-owned enterprises were in poor shape, and substantial refurbishment was needed to make them attractive to private buyers. Legal, valuation, and advertising costs had to be borne by the state, along with compensation costs for retrenched labor. And, second, there were questions of governance in the World Bank sense of accountability and managerial propriety (World Bank 1992).[8] Enterprises were sold using tender procedures that were not always trans-

[8] See Dunham and Kelegama (1997).

parent. Cronies influenced sales, and there were accusation that enterprises had been undervalued. There was clearly mismanagement, though the Sri Lankan experience suggests that privatization is unlikely to assist stabilization in the short run, even if it eases the expenditure burden of the state over the longer term.

On the expenditure side, there was also considerable rigidity in the early 1980s, largely as a result of the commitment to the three lead projects. Capital costs of the AMDP rocketed, and by 1985 the accumulated total had reached U.S.$1,456 million (Jogaratnam 1995).[9] The projects, once begun, had become practically irreversible for reasons we have already outlined and, given their scale and their share of public expenditure (44 per cent of total capital expenditure in 1983), the government's ability to respond to the macroeconomic imbalance was correspondingly limited. As Stern (1984) pointed out, donors who chided the government because it could not cut expenditure were often first to complain when counterpart funds were threatened for the projects that they were financing.

There was also difficulty in curtailing the subsidies to public enterprises which rose from less than 10 per cent of total government expenditure between 1970 and 1977 to over 25 per cent between 1978 and 1985. However, here again the situation was complicated. In the immediate post-liberalization period, private sector investment was heavily concentrated in the non-tradable sector. With large budget deficits, two-digit inflation, and an appreciating exchange rate, the government tried to use commercial policy (export tax reduction and subsidies) to generate an export bias for the manufacturing sector (Cuthbertson and Athukorala 1991; Kelegama 1992). It was nevertheless ineffective; the private sector preferred non-tradables, leaving tradables to the state (other than in the then limited niche of the free trade zone).[10]

Inadequate development of the Sri Lankan private sector (not only in terms of capital accumulation but of its orientation and management), together with what was perceived as an increasingly uncertain and risk-prone investment climate made reorientation to the private sector extremely difficult. The Sri Lankan capitalist class of the early 1980s was mercantile in character, and it was reluctant to jump from the comparative safety of trading into productive investment in new areas (Moore 1992). Despite the high cost of borrowing (with interest rates at 21–22 per cent), investment was limited more by the lack of bankable projects than by the credit to finance them (Lindgran et al. 1986, p. 34). Limited experience of the private sector in the preparation of salable projects to risk-conscious banks, and limited financial strength to backup credit were a disadvantage. Investors were aware

9 This figure is reached by aggregating annual expenditures in dollar terms at the respective annual exchange rates. See also CBC (1985 ed., p. 60).

10 The establishment of an export processing (or free trade) zone was a key element in the 1977 government's industrial strategy.

that the high import content of industrial raw materials in many of the newer subsectors made investment particularly vulnerable to the terms of trade. And the violence of 1983 and its aftermath had clear repercussions on business confidence in the Sri Lankan economy.

The net result was that state enterprises continued to account for over 60 per cent of the country's industrial output. Most were poorly managed and heavily subsidized, but they could not be so easily dismantled or privatized. To have done so would have eroded the production base of the country and generated a political outcry. It would have led to difficult and politically costly legal battles over employment dismissals, and it would have eliminated a major avenue of patronage that cemented political support. Loss-making enterprises nevertheless met with increasing difficulty in the newly liberalized environment: some tariff reductions were reversed to offer them greater protection, they were to prove an increasing burden on the public purse, but they could not realistically be abandoned, at least not in the short term.

Stabilization in the post-1989 period was frustrated inter alia by an increase in welfare expenditure. Rural poverty—a factor of considerable concern in the wake of the southern insurgency—became the grounds for a major poverty alleviation program (the Janasaviya Program) that was over-ambitious, poorly targeted and reflected political imperatives.[11] Thus, having fallen from 21 per cent of government current expenditure in 1979 to 4.5 per cent in 1988, welfare expenditure surged back to 12 per cent in 1990. Here again, in conventional terms, was apparent mismanagement. However, we have argued elsewhere (Dunham and Kelegama 1997) that a strong distributive dimension was essential for the political sustainability of the reform process. The new president championed the poor. He was committed to the development of a market economy and aware of the economic costs of his welfare program, but he needed support or acquiescence of the poor to take market reforms further.

Political imperatives therefore made serious demands on the public budget, and with ongoing war in the north and east, costs involved in refugee rehabilitation, decentralization (evinced as a partial solution to the ethnic crisis), increasing debt repayments, and reducing the budget deficit was increasingly difficult.[12] High defense expenditure was a major internal shock to the economy. The government found itself constrained financially and unable to identify any viable large new area

[11] There were also a number of parallel measures, including a midday meal program for school children and a school uniform program.

[12] Provincial Councils were built into the Indo-Lanka Accord of 1987. The president was also determined to make implementation of the micro-level poverty alleviation program more effective. Prudent financial management in decentralization was therefore difficult because of the underlying political imperatives.

for expenditure reduction, so it reduced capital expenditure. It sacrificed investment because cuts in current expenditure (salaries, pensions, and welfare) were more difficult politically. However, curtailed public investment in infrastructure development in areas such as telecommunications, transport, irrigation, and power had the effect of raising private sector costs. This effect which was complemented by high interest rates and the high costs of borrowing pushed private sector firms to lobby (successfully) for tax concessions with ensuing revenue implications. The demands of stabilization in terms of a tight monetary policy were seen as a hindrance to investment. There was a lack of coherence in government policy, and a lack of consistency and predictability in implementation which affected business confidence. There were inherent contradictions between the needs of stabilization and those of structural adjustment.

V. LIBERALIZATION AND ADJUSTMENT

The previous section has shown that, throughout the country's liberalization experience, Sri Lankan policymakers were forced to struggle with problems of macroeconomic stability. In this section we ask whether the problems of economic management could have been reduced or avoided with better timing and sequencing of the liberalization program. We argue that expectations were too high and that many of the problems encountered were unavoidable.

A. *The Question of Timing*

The timing of trade liberalization in Sri Lanka was determined by elections and by a change of government rather than as a matter of technical choice. Cuthbertson and Athukorala (1991) have nevertheless argued that liberalization had the best chance of sustained success during the early days of the government when it had strong political momentum. The UNP government was returned in 1977, as we have noted, with a massive majority and liberalization as its mandate. However, the underlying weaknesses in the Sri Lankan economy still remained and by 1980 an unanticipated recession in the world economy had redefined the international environment. The economy was recovering from the effects of economic crisis; its export structure was dominated by weak primary products; and the indigenous capitalist class, as we have already noted, was highly underdeveloped. Reorienting the economy was therefore not just a matter of economic liberalization.

Trade reforms, for example, were started before supportive institutions had been created. The Export Development Board (EDB) and the Presidential Tariff Commission (PTC) were instituted around 1980 as their need became clearer, when the basic pattern of development was already set. As a result, efforts to direct incentive structures towards tradables ran into established interests which were able to maneuver effectively between conflicting economic and political signals to the country's business community. It was unlikely that better timing would have made a difference.

B. *Problems of Sequencing*

It seems unlikely that there was any serious discussion of sequencing in the Sri Lankan government's policy agenda. However, after the initial trade liberalization, various agencies had views about what should have priority. Both the IMF and the World Bank singled out import protection as a major impediment for growth in the industrial sector after the 1977 reforms. The tariff structure, they claimed, was neither rational nor uniform, and the persistence of arbitrary tariffs was contributing to the lack of dynamism in particular industries (World Bank 1984). The government was intent on a strategy of export-led industrialization, and one policy objective in 1980 had been a rational tariff structure (in terms of comparative advantage and infant industry arguments). Was this then a case of mismanagement in the liberalization exercise?

The sequencing of trade liberalization as it evolved was fairly conventional. Devaluation was followed by the replacement of most quantitative restrictions on imports by a hastily formed tariff system. But since there was no coherent industrial strategy on which tariff changes could be based, it was difficult to judge appropriate protection levels during the initial years. No attempt was made to rein in imports (which more than doubled in value in 1978), and tariff reform was not phased in pre-announced stages. Therefore, there were definite gray areas. The main reasons for disparities in protection levels appears to have been the fact that comprehensive data was not available and that additional in-depth studies could not be carried out rapidly. Internal inconsistencies in tariffs and the wide variance in effective levels of protection between product categories was therefore in part a function of the speed of the initial liberalization (PTC 1985, p. 81). It had adverse consequences. It dealt a severe blow to many domestic industries, and it reinforced the creation of lobbies to reverse "ill-judged" decisions.

Further reductions in tariff levels were then slow in coming. Subsequent steps (including the creation of the PTC) were largely defensive. They reflected two main motives. There were ad hoc changes in response to demands from local manufacturers who had been adversely affected by lower duties (or who were heavily dependent on imports). There were also changes motivated by the government's need to bolster its dwindling revenue.[13] Neither was consistent with its liberalization program, but it was simply not possible in practice to sustain the

[13] As the 1980s progressed, constraints became a barrier to further reductions in levels of protection because the government raised much of its revenue from external trade. High duties across-the-board, while good for revenue purposes, raised the protection level and ran counter to rationalization of the tariff structure (PTC 1985). Most effective protection coefficients were higher in 1983 than in 1981 (Athukorala 1986).

pace of reform.[14] Lobbies had begun to form, the government's room to maneuver was reduced, and a more gradualist approach to liberalization was then almost inevitable.

The political imperatives surrounding unemployment also slowed the reform process. Though there was some redeployment of those who had lost jobs after liberalization (there was improvement in the overall employment situation by 1981/82), losses were in no way offset by the opportunities that were being created in expanding activities—partly because the emerging industries were in other locations and partly because different skills and abilities were required. There was a reallocation of labor from the unorganized sector, and from the rural sector in particular, towards the urban organized sector (factory industry and services). Those who lost jobs in rural areas, for example in the hand-loom sector, were not those employed in the free trade zone located near Colombo. Regional differences grew, accentuating disparities in income distribution and increasing regional ethnic differences. Taken together, these effects were socially divisive. Some people who lost jobs in rural areas were absorbed by the expanding construction and service sectors; some secured jobs in new industries or obtained land under AMDP, and some 200,000 were economic migrants to the Middle East.[15] But in the early 1980s, a large proportion of this displaced labor was still unemployed. Their presence exerted tremendous pressure on the government. It led to protective measures, for example for the hand-loom industry (regardless of the target of tariff rationalization or norms of market efficiency) and to large-scale recruitment into state corporations which were seen as sources of available employment. Rationalization of state corporations was treated as very much a secondary objective, and privatization was complicated by overstaffing. Existing labor laws made retrenchment difficult.[16]

[14] In the process of fine tuning, the PTC appears to have been trapped by political lobbies. It was 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 (Kelegama 1992).

[15] Questions were also being raised about the quality of the employment that was created. With the exception of the garment industry, labor absorption was concentrated in sectors that could not sustain a long-term growth in employment—most notably in construction where winding-down was inevitable. The increase in service sector employment had come largely from the expansion in import trading after liberalization, and the regime of liberalized imports was buttressed more by external props (in effect by foreign aid) than by any intrinsic strength of the domestic economy. There was also a large-scale out-migration of plantation workers of Indian origin for resettlement in India (Bruton et al. 1992, p. 152).

[16] Liberalization of the labor market was also partial. The power of the trade unions was significantly reduced in 1980 with a major show of strength by the government. However, while this lowered rigidities in the labor market, the process was far from complete. Existing labor laws remained in operation and still continue today.

The other key element in trade liberalization was devaluation. Significant devaluations in the real exchange rate are normally considered a crucial component of a liberalization strategy, as a means of shifting the structure of incentives towards tradable goods. However, policymakers in Sri Lanka found real depreciations difficult for several reasons. Loss-making state enterprises were not only a burden on the government's budget, they were also highly dependent on imported inputs. Devaluation, by increasing costs, inflated the size of the necessary transfers and, given the importance of the state sector in the economy, it was problematic. As Sri Lanka is, in general, highly import-dependent, the costs of industrial and agricultural production and hence the general price level were all similarly affected. Devaluation posed a serious threat of cost-push inflation. In the welfare-oriented and highly politicized environment that existed in Sri Lanka, partial wage indexation had been almost unavoidable, and import and wage-related cost increases (combined with terms of trade) ate into the margins that devaluation had offered to exporters. Policymakers looked to commercial policies to restore export incentives (Kelegama 1992).

There has also been some dispute about the lack of any attempt to liberalize the capital account of the balance of payments, given real exchange rate appreciation in the wake of official capital inflows linked to the public investment program in the early 1980s. The difficulty in absorbing large capital inflows has been discussed in the literature (Corden 1984). Basically, the argument is that if they are absorbed by the domestic economy, an appreciation of the real exchange rate is likely to follow because of imported inflation and the increased demand for non-tradables (Levy 1985). Lal and Rajapatirana (1989) argue that, in the case of Sri Lanka, restrictions on capital outflows meant that the real exchange rate appreciation was larger than it need have been. However, any suggestion that full liberalization of the capital account was desirable would seem questionable in the highly volatile political context of the 1980s. It could have led to a significant outflow of capital. However, what is clear is that—along with other factors—foreign capital induced exchange rate appreciation worked against efforts to boost production of tradable goods.[17]

The crisis management associated with adjustment was such that ad hoc policymaking became the order of the day. The path that was followed reflected what was feasible, and Sri Lankan experience showed that the problems encoun-

[17] It is also important to remember that massive foreign-capital inflows had a positive side as well. They came at a time when the economy faced massive external shocks, enabled the government to sustain the momentum of its public investment program and enabled it to avoid a deflationary policy stance that would otherwise have been necessary (Athukorala and Jayasuriya 1994). They also enabled the basics of the liberalization program to be maintained without recourse to the extensive use of direct controls. In the short term, the economy could be said to have suffered less in terms of reduced growth, higher unemployment, and added social tension.

tered in further liberalization were not always amenable to rational technocratic management. There was an uneasy relationship between macroeconomic stabilization and the country's structural adjustment program.

VI. CONCLUDING REMARKS

Our argument in this paper is not that the Sri Lankan reform process was adequately managed. There is sufficient evidence to the contrary. The AMDP was a digression from the liberalization exercise that the country had embarked upon, and it raised very serious questions about its management capacity at the speed and scale at which resources were made available. There was a tendency to believe that resource constraints no longer mattered (Athukorala and Jayasuriya 1994, p. 83) and that the allocation of funds or contracts on the grounds of political expediency was ultimately justified. Throughout the period of 1977–93 there were serious problems of accountability and administrative propriety. The issue here, however, is rather different. It is the way the process of economic reform is understood and the assessment of policy performance.

The Sri Lankan experience (or any other) can be assessed from at least two different standpoints. From a textbook perspective, it is clear that the reform process it embarked on was incomplete. The initial liberalization in 1977 was not followed up by a sufficiently rapid reduction in tariffs to ensure trade neutrality, and trade and financial reforms should have been completed before embarking on such a massive foreign-funded public sector investment as the AMDP. From this point of view, the Sri Lankan liberalization process in the early 1980s was undone by "revisionist thinking" that reversed some of the initial gains, and by the creation of new and increasingly more serious imbalances in the macro economy (Lal and Rajapatirana 1989). Similarly, it could be argued (though we have not documented it in detail) that high variance in effective protection rates, inadequate liberalization of domestic financial markets, the external capital account, and domestic labor markets were a further indication of mismanaged reform. Policy performance on this criterion is assessed against some stylized notion of a sound reform exercise.

The alternative is to view the Sri Lankan reform experience in relation to economic and political circumstances and the economic and political objectives of the incumbent government. The focus is then not so much on the government's resolve to liberalize the economy, as on the reasons why particular policy decisions were made or took the form that they did. In this perspective, economic and political concerns have to be seen together. External events and political imperatives (ethnic conflict, insurgency, the social costs of adjustment, and existing political commitments) assume a more critical role in the explanation, and the political viability and sustainability of reform becomes the crucial issue. As Krueger (1981) has argued, it seems senseless "to incur the costs of adjustment only to reverse policies before they have had any chance to affect resource allocation and growth. Yet the evidence is that a significant number of stabilization programs have foundered precisely because the authorities have been unwilling or unable politically to survive political pressure during the adjustment period" (pp. 100–101). The purpose of this analysis, it seems to us, should be to elicit a better understanding of the problems entailed and of the ways of escaping them.

This paper has tried to illustrate the relevance of such an approach in understanding the Sri Lanka policy agenda. The economic reform program that emerges is "not an application of economic principles, but rather an improvization" (Mosley 1991, p. 227). It suggests that, in the inevitably politicized process of trade-offs incorporating political responses, there is bound to be tension between stabilization and adjustment policies, and that in the Sri Lankan experience it was stabilization that was given lower priority. Domestic political needs may have seriously weakened the economic reform process, but continuing political support was crucial for its sustainability. In that sense ad hoc piecemeal reform had a rationale of its own.

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