

The Exchange Rate as an Instrument of Development Policy  
(a case study of Sri Lanka)

by  
Mudiyanselage S. Sathkumara  
(Sri Lanka)

86170

A thesis submitted in partial fulfilment of the requirements for obtaining the Degree of Master of Development Studies (Economic Policy and Planning), of the Institute of Social Studies, The Hague, Netherlands.

## TABLE OF CONTENTS

	Page
Acknowledgements	ii
List of Tables	vii
INTRODUCTION	1
Objective of the Study	1
Statement of the Problem	1
Chapter Outline	4
CHAPTER ONE	
A THEORETICAL DISCUSSION ON TRADE POLICIES AND THE CHOICE OF EXCHANGE RATE	7
1.1 Trade Policy as a Strategy of Economic Development	7
1.2 Import Substitution Industrialization	8
1.3 Export Promotion in Manufactured Products	13
1.4 Exchange Controls and Commercial Policy	14
1.5 Choice of Optimum Exchange Rate Regime	17
1.5.1 Pegging to a Single Currency	30
1.5.2 Pegging to a Currency Composite	32
1.5.3 Floating Exchange Rate	35
1.5.4 Empirical Evidence on Success of Flexible Rate	37
1.5.5 Dual Exchange Rates	39
1.6 Exchange Rate Regime seems to be most Suitable for Sri Lanka	41
CHAPTER TWO	
FIXED EXCHANGE RATE REGIME WITH INWARD- LOOKING TRADE POLICIES (1960-67)	50
2.1 The Commercial and Exchange Rate Policies	50
2.2 The Effect on the Balance of Payments	57
2.3 The Effect on the Level of Economic Activity	61

	Page
2.4 The Effect on Investment and Resource Allocation	66
2.5 The Effect on Prices, Wages and Income Distribution	69
2.6 Resume	74
 CHAPTER THREE	
DUAL EXCHANGE RATE REGIME WITH LIBERALIZATION ATTEMPTS (1968-70)	80
3.1 The Outward-Looking Trade Policies	80
3.2 Exchange Rate Devaluation in 1967	82
3.3 Dual Exchange Rates System	84
3.4 The Effect on the Balance of Payments	88
3.5 The Effect on the Level of Economic Activity	93
3.6 The Effect on Investment and Sectoral Allocation	100
3.7 The Effect on Prices, Wages and Income Distribution	105
3.8 Resume	111
 CHAPTER FOUR	
DUAL EXCHANGE RATE REGIME WITH RESTRICTIVE POLICIES (1971-77)	115
4.1 The Trade and Exchange Rate Policies	115
4.2 The Effect on the Balance of Payments	121
4.3 The Effect on the Level of Economic Activity	127
4.4 The Effect on Investment and Sectoral Allocation	131
4.5 The Effect on Prices, Wages and Income Distribution	134
4.6 Resume	138

	Page
CHAPTER FIVE	
FLEXIBLE EXCHANGE RATE REGIME WITH IMPORT LIBERATION (1978 onwards)	143
5.1 The Trade and Exchange Rate Policies	143
5.2 The Effect on the Balance of Payments	151
5.3 The Effect on the Level of Economic Activity	159
5.4 The Effect on Investment and Sectoral Allocation	163
5.5 The Effect on Prices, Wages and Income Distribution	168
5.6 Resume	174
CHAPTER SIX	
SUMMARY AND CONCLUSIONS	177
6.1 Trade and Exchange Rate Policies	177
6.2 The Effect on the Balance of Payments	184
6.3 The Effect on the Level of Economic Activity	187
6.4 The Effect on Investment and Resource Allocation	189
6.5 The Effect on Prices, Wages and Income Distribution	191
6.6 Most Appropriate Exchange Rate Policy for Sri Lanka	194
APPENDIX	
A Effective Rate of Protection	198
B Exchange Rate Regimes in practice by end of 1980	200
C1 Central Bank Trade Indices - Exports (1958 = 100)	203

	Page
C2 Central Bank Trade Indices - Imports (1958 = 100)	204
D1 Central Bank Trade Indices - Exports (1967 = 100)	205
D2 Central Bank Trade Indices - Imports (1967 = 100)	206
E1 Central Bank Trade Indices - Exports (1978 = 100)	207
E2 Central Bank Trade Indices - Imports (1978 = 100)	208
F Wholesale Price Index (1974 = 100)	209
G Cost of Living Index Numbers - Colombo Town (1952 = 100)	210
 BIBLIOGRAPHY OF WORKS CITED	 211