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Sri Lanka's Post-conflict Development Challenge: Learning from the Past

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Sri Lanka's Post-conflict Development Challenge: Learning from the Past

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Abstract: The end of the ethnic conflict in Sri Lanka in 2009 generated widespread expectations of a period of sustained economic growth, building on the achievements of the liberalisation reforms sustained over three previous decades. However, recent developments have dampened that optimism, rekindling fears that Sri Lanka's tale of missed opportunities may continue. The analysis in this paper suggests that return to the failed past policies of inward-oriented development strategies offers no viable solutions for the economic problems confronting Sri Lanka.

Key words: Sri Lanka**,** ethnic conflict, economic growth, trade liberalization, foreign debt

JEL Codes: O11, O53, F34, F52,

Sri Lanka's Post-conflict Development Challenge: Learning from the Past[1]

INTRUDUCTION

Sri Lanka had been trapped for a quarter of a century in a long, bloody and seemingly intractable separatist war until 2009 when the government crushed the separatist forces and achieved a decisive military victory. The end of the war was widely welcomed by the majority of the Sri Lankan population and by the international community and generated a surge of optimism about the economic prospects for Sri Lanka, with high expectations that Sri Lanka would embark on a period of sustained economic growth.

The immediate post-conflict period appeared to validate that optimism. With renewed confidence, Sri Lanka experienced a substantial economic recovery during the initial three years. But, as the large and rapidly growing literature on post-conflict recovery has shown, a resurgence of growth in the immediate aftermath of an end to a violent conflict is no guarantee of a sustained recovery over the medium to long term.[2] In Sri Lanka's case, it has not taken long for the early optimism to fade. By 2011 concerns about the sustainability of the recovery were being raised

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[1] This paper is based on the H.A. de. S. Gunasekara Memorial Oration delivered at the University of Peradeniya, Sri Lanka on 12 July 2013. I am indebted to Sisira Jayasuriya and Sarath Rajapatirana for years of collaborative research on which the paper draws heavily, and to Nimal Sanderatne for suggestions and comments.

[2] For reviews of the related literature see World Bank, *World Developmen Report 2011* (Washington DC: World Bank, 2011; Coyne, Christopher J. and Rachel L. Mathers, *The Handbook on the Political Economy of War* (Cheltenham, U.K : Edward Elgar, 2011).

following developments in the economic policy front. In early 2012, slowing economic growth, a sharp deterioration of the current account and rapidly declining foreign reserves compelled the authorities to implement a substantial devaluation of the currency and unpopular measures to curb public expenditures, while resorting to increased reliance on short term commercial borrowings in international capital markets. There are widespread concerns that the country is moving into a debt trap. In this context, this paper aims to contribute to the debate on economic reforms for sustainable growth in Sri Lanka during the post-conflict era by examining the recent experiences from a historical perspective.

The paper begins with an overview of policy-making and economic performance during the post-independence until the late 1990s, focussing specifically on the economic liberalisation reforms initiated in the late 1970s and their outcome. The next section discusses changes in the policy scene since the late 1990s that shaped policy making in the post-conflict period and the key elements of the new development strategy. The following examines recent macroeconomic developments with particular attention to role of public sector investments, fiscal deficit and external financing issues and their implications for the sustainability of the post-cnflit growth momentum. The final section offers some concluding remakes.

HISTORICAL CONTEXT

In 1948, Sri Lanka (known until 1972 as Ceylon) entered Independence well placed for continuing economic achievement. At that time, and well into the 1950s, Sri Lanka ranked as one of the most prosperous Asian countries, with per capita income (and other development indicators) placing it not only well above its South Asian neighbours but also much ahead of countries such as South Korea and Thailand[3]. It was also favoured with many early advantages which were not shared by most other Asian countries: strategic location in the Indian Ocean[4], an open economy with a vibrant export sector, a high level of education, an absence of extreme poverty and inequality, a relatively well-developed physical infrastructure, and a broad-based and efficient administrative apparatus. It was 'an oasis of stability, peace and order'[5] in a region of violent turmoil and conflict. The balance of payments position was healthy backed by large foreign exchange reserves and a sound budgetary

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[3] Kravis, Irvin B., Allen Heston and Robert Summers (1983), *World Production and Income: International Comparison of Real Gross Product* (Baltimore: Johns Hopkins University Press, 1982).

[4] 'Colombo …. [was] the "Clapham Junction" of ships voyaging in the East' (Arurachalam, Ponnambalam, "Population: The Island's Races, Religions, Languages, Castes, and Customs", ed. Arnold Wright, *Twentieth Century Impressions of Ceylon*, London: Lloyd's Greater Britain Publishing Company, 1907), p. 324.

[5] de Silva, Kinsley M. , *A History of Ceylon*, (New Delhi: Oxford University Press, 1981), p. 489 .

position.[6] All of these initial conditions had provided the setting for the expectation that, of all post-colonial nations, Sri Lanka would prove 'the best in Asia'.[7]

But the early promise of strong economic growth was not sustained. During the two decades from about the early 1960s growth of Sri Lanka's per capita income fell way behind the fast growing East Asian economies (Figure 1), rapidly converging to the levels of its South Asian neighbours. In spite of poor growth performance, Sri Lanka's living standards, measured by most indicators of quality of life, continued to be exceptionally good relative to its per capita income[8] (Sen 1981). However, from about the late 1960, even in terms of these indicators Sri Lanka slipped in global rankings compared to the high-performing East Asian economies.[9] The provision of direct welfare

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[6] Both the domestic and external financial positions were so sound that Mr. D.S. Senanayake, the first prime minister of the country, in an interview with the Newsweek in 1948 stated that Sri Lanka 'wanted neither grants nor loans from the United States or any other country' (Wijesinghe, Melory E.: *The Economy of Sri Lanka, 1948-1975*, Colombo: Ranco Printers, 1976).

[7] Jiggins, Janice, "Dismantling Welfarerism in Sri Lanka', *Overseas Development Institute Review*, 2(1), 25-43.

[8] Sen, Amartya, "Public Action and Quality of Life in Developing Countries", *Oxford Bulletin of Economics and Statistics* 43 (4) (1981): 287-319.

[9] Jiggins (Note 6); Cuthbertson, Aandrew G. and Prema-chandra Athukorala (1991), "Sri Lanka", in Demetris Papageorgou, Michael Michaely and Armeane Choksi (eds.), *Liberalizing Foreign Trade Volume 5: Indonesia, Pakistan and Sri Lanka* (Oxford: Basil Blackwell, 1991), pp. 285-416; Dunham, David and Sirira Jayasuriya , "Equity, Growth and Insurrection: Liberalization and the Welfare Debate in Contemporary Sri Lanka", *Oxford Development Studies* 28(1) (2000): 97–110.

to the poor had become increasingly difficult to sustain in the face of slow expansion in the overall economy.

Insert Figure 1 about here

The reasons for Sri Lanka's growth slowdown during this period have been the subject of much debate.[10] Many analysts, particularly those associated with international donor agencies such as the World Bank, argued during the 1960s and particularly during the 1970s that government expenditures on health, nutrition, and education (often described as "consumer subsidies") were primarily responsible for the slowdown by diverting government resources away from direct growth-oriented investments. However, there are strong reasons to argue that that the primary cause of the slide to slow growth and stagnation was the turn away from international trade in favour inward-looking policies. Social expenditures delivered high levels of social indicators and played an important role in maintaining political stability at low cost—Sri Lanka's expenditure on police and military forces was among the lowest in the world. Government expenditure on universal free education and health care could have played a vital complementary role in economic growth and structural transformation of the country under a market-friendly, outward-oriented development strategy.

During the first decade after independence in 1948, Sri Lanka continued to be an open-trading nation with only relatively minor trade or exchange rate restrictions and liberal domestic policies. From the late 1950s on, a combination of change in political leadership and balance-of-

[10] For a comprehensive review of this debate, see Osmani, Siddiqur R., "Is there a conflict between growth and welfarerism? The significance of the Sri Lanka debate", *Development and Change,* 25(2) (1994): 387-421.

payments difficulties led to the adoption of a state-led import-substitution industrialization strategy. Import restrictions, initially imposed to address payments difficulties, became increasingly more restrictive as the development strategy shifted to import-substitution policies and led to pervasive state interventions in the economy. By the mid-1970s, the Sri Lankan economy was one of the most inward-oriented and regulated economies outside the communist bloc, characterized by stringent trade and exchange controls and by pervasive state interventions in all areas of economic activity. Widespread nationalization measures and threats, coupled with various economic controls, had effectively marginalized the private sector in the economy.

The policy makers in Sri Lanka, like their counterparts in most other developing countries, expected the expansion of import-substituting industries to reduce the heavy dependence of the economy on imports. The reality was quite different, however. While consumer-goods imports were reduced substantially, this was achieved at the expense of increased reliance on imported capital goods and raw materials, resulting, contrary to expectation, in an even more rigid dependence on imports. Given these structural features, the growth dynamism of the newly established industrial sector tended to show a close functional relationship with the fortunes of the traditional export industries. Unanticipated import curtailments brought about by foreign exchange scarcity turned out to be the main constraint on industrial expansion. From about the late 1960s there was a policy emphasis on export promotion through selective incentives and encouraging export-oriented foreign direct investment. However this policy shift had little impact on relaxing the balance of payments constraint, because the overall policy context was highly unfavourable to private-sector activity in general and to export production in particular. Reflecting the cumulative impact of stringent trade controls and overvalued real exchange rate, the overall incentive structure of the economy was characterised by a significant ‘anti-export’ bias throughout this period.[11]

[11] Cuthbertson and Athukorala (Note 8).

As a reaction to the dismal economic outcome of the inward-looking policy, in 1977 Sri Lanka embarked on an extensive economic liberalization process that marked a decisive break with decades of protectionist policies.[12] The first round of reforms carried out during 1977-79 included a significant trade policy reforms; opening up the economy to foreign direct investment (FDI), with new incentives for export-oriented foreign direct investment (FDI) under an attractive Free Trade Zone (FTZ) scheme and constitutional guarantee against nationalisation of foreign assets without compensation;[13] abolition of the multifle exchange rates followed by a sharp devaluation of the unified exchange rate; and the introduction of limits on direct public sector participation in the

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[12] For details on the reform process, see Cuthbertson and Athukorala (Note 8), Dunham, David and Saman Kelegama, "Does Leadership Matters in the Economic Reform Process? Liberalization and Governance in Sri Lanka", *World Development*, 25(2) (1997): 179-190; Mik Moore, "Leading the Left to the Right: Populist Coalitions and Economic Reforms", *World Development*, 25(7) (1997): 1009-1028; Snodgrass, Donald R., "The Economic Development of Sri Lanka: A Tale of Missed Opportunities" in Robert I. Rotberg (ed.), *Creating Peace in Sri Lanka: Civil War and Reconcililation* (Washington D.C.: Brookings Institution Press, 1998), pp. 89–107; Athukorala, Prema-chandra and Sarath Rajapatirana, *Liberalisation and Industrial Transformation: Sri Lanka in International Perspective*, Oxford and Delhi: Oxford University Press, 2000).

[13] Article 157 of the new Constitution of Sri Lanka adopted in 1978. Following the nationalisation of the foreign-owned gas and petroleum outlets during 1962-1964, Sri Lanka became the first country against which the US government invoked the Hickenlooper Amendment requiring the suspension of US aid to countries expropriating US property without compensation (Olson, Richard S., 'Expropriation and International Economic Coercion: Ceylon and the West, 1961-65', *Journal of Developing Areas*, 11(2) (1977): 205-226). The constitutional guarantee was therefore vital to restore investor confidence.

economy. At the time of reforms, the country seemed poised to embark on a trajectory of rapid growth that would enable it to emulate the dynamic East Asian economies. China was yet to start its liberalization and other countries such as India and Vietnam were more than a decade away from such reforms.

Sri Lanka's ability to reap benefits from this remarkable policy transition was seriously hampered by the escalation of the ethnic conflict in the early 1980s.[14] During 1983-2009 the economy continued to be burdened by the massive military expenditure (which increased from 1% to 5.0 % of GDP between 1984 and 2008)[15] and its consequences for macroeconomic instability. The Northern Province and large parts of the Eastern Province (which together account for one-third of Sri Lanka's total land area and almost 12% of the population) remained mostly cut off from the national economy. Even in the rest of the country, prospects for attracting foreign investment, particularly in long-term ventures, was seriously hampered by the lingering fear of sporadic attacks by the rebels. The government's preoccupation with the civil war also hampered capturing the full benefits of economic opening through delays and inconsistencies in the implementation of the reform processes.

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[14] On the political and economic roots of the ethnic conflict see Athukorala, Prema-chandraand Sirira Jayasuriya, *Macroeconomic Policies, Crises and Growth in Sri Lanka, 1969–1990* (Washington, DC: World Bank, 1994); Abeyratne, Sirimal, "Economic Roots of political Conflict: The Case of Sri Lanka", *World Economy*, 27(8) (2004): 1295-1314; Richardson, John, *Paradise Poisoned: Learning about Conflict, Terrorism and development of Sri Lanka's Civil Wars* (Kandy, Sri Lanka: International Centre for Ethnic studies, 2005).

[15] Unless otherwise stated, the data reported in the paper are from, Central Bank of Sri Lanka, *Annual Report* (Colombo: Central Bank of Sri Lanka) (various issues).

There was, however, no retreat to the old control regime. In a decisive move to infuse momentum to the unfinished reform process, a significant 'second wave' liberalization package was implemented in 1990. By the mid-1990s Sri Lanka ranked amongst the few developing countries that had made a clear policy transition from inward orientation to global economic integration.[16] After 17 years in government, the United National Party (UNP) lost power at the 1994 general elections to the Peoples' Alliance (PA), a centre-left coalition led by the Sri Lanka Freedom Party (SLFP) which had governed the country during most of the era of economic dirigisme. However, there was no significant change in the broad direction of economic policies; the gains from export-oriented industrialization had been impressive enough to set the stage for 'leading the left to the right'[17]. The new government extended the privatization and deregulatory policies and pursued trade and macroeconomic policies that were largely indistinguishable from the previous government. By the mid-1990s Sri Lanka appeared to be "at the point of moving into an important policy phase marked by shifting the agenda away from protection and towards achieving a stable and predictable economic policy environment".[18]

Despite the unsettled conditions, the reforms dramatically transformed the economic landscape of Sri Lanka. The share of manufacturing in GDP rose from around 10% in the mid-1970s to over 20% (about two percentage points higher than the share of agriculture) by the dawn of the new millennium. The export structure of the economy underwent a remarkable transformation from land-intensive, plantation exports to labour-intensive manufacturing. The share of manufacturing in

[16] Sachs, Jeffry and Andrew Warner, 'Economic Reforms and the Process of Global Integration', *Brookings papers on Economic Activity*, 25 Anniversary Issue (1995): 1-95.

[17] Moore (Note 11), p. 1009.

[18] Cuthbertson, Aandrew G. "The Trade Policy Review of Sri Lanka", *World Economy*, 20(5) (1997), 633-648.

total merchandise trade increased from 5% in the mid-1970s to over 70% in the same period, ending the historic dependence on three primary commodities (tea, rubber and coconut products). This successful diversification of the export structure effectively ended the prolonged (1955–1975) deterioration of the terms of trade[19]. Opening up of the country to foreign direct investment combined with significant trade liberalisation played a pivotal role in the emergence of a dynamic labour-intensive export industry. Export-oriented manufacturing sector emerged as the major generator of employment opportunities in the economy, accounting for over half of total employment growth during the 1980s and 1990s. With the gradual erosion of the dominant role of state-owned enterprises (SOE) the private sector was largely responsible for economic dynamism of the country. Growth surged, from an average of 2.9 precent during 1970–77 to over 4.5 precent during 1978–2000. The percentage of people living below the poverty line (the poverty headcount) declined from 28.8% in 1995 to 22.7% in 2002 and then to 15.2% in 2005. World Bank's *Sri Lanka Development Policy Review* of 2004 noted that "It would be hard to find a more convincing case of trade and industrial transformation of a small island economy through market-friendly policy reforms".[20]

Export-oriented FDI attracted to Sri Lanka during this period was heavily concentrated in standard light consumer goods industries such as garments, footwear, sport goods, and cutting and polishing imported diamonds. There is, however, evidence to suggest that foreign firms could have played a much more important role in export expansion, with involvement in a wider range of export products, if it were not for the increase in political risk following the eruption of the ethnic conflict in 1983. Foreign firms involved in vertically integrated assembly activities in high-tech industries (such

[19] Athukorala, Prema-chndra; "Manufactured Exports and Terms of Trade of developing Countries: Evidence from Sri Lanka," *Journal of Development Studies*, 36(5) (2004): 89-104.

[20] World Bank, *Sri Lanka Development Policy Review* (Report no 29396-LK) (Washington, D.C.: World Bank, 2004), p. 8.

as electronics and electrical goods), unlike those involved in light consumer goods industries, view investment risks from a long-term perspective because output disruption in a given location can disturb production plans for the entire production chain. In fact, in the early 1980s two electronics multinationals, Motorola and Harris Corporation, signed agreements with the Board of Investment and incorporated subsidiary companies to set up assembly plants in Sri Lanka. However, they soon left the country as the political climate begun to deteriorate. If the two projects of Motorola and Harris Corporations had been successful, other multinationals would probably have followed suit.[21]

RECENT POLICY SHIFTS

Notwithstanding the notable economic achievements during the reform era, there has been a back-sliding from liberalization reforms over the past one-and-a-half decades.[22] As early as the late 1990s, trade liberalisation process suffered a setback because of the pressure of raising additional revenue from import tariffs to finance the ballooning war budget. The planned reduction of tariffs into a single band was abandoned and from then on tariffs were changed frequently in an ad hoc manner. The protectionist tendencies soon received added impetus from the growing discontent amongst the electorate, propelled by the crisis economic conditions as the civil war accelerated. The populist policies received strong backing from an anti-liberalization lobby with strong vested

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[21] Snodgrass (Note 11).

[22] Rajapatirana, Sarath: 'Industry Policy' in S. Kelegama (ed.), *Economic Policy in Sri Lanka: Issues and Debates* (New Delhi: Sage, 2004): 213-236; Pursell, Garry (2011), "Trade Policy in South Asia", in Raghavendra Jha (ed.), *Handbook of South Asian Economies* (London:Routledge): 219-237; Kaminsky, Bartlomeiji and Francis F. Ng, 'Increased in Protectionism and Its Impact on Sri Lanka's Performance in Global Markets' (Washington DC: World Bank, 2013) (mimeo).

interests and ideological support from a group of senior academic economists who used the failure of reform policies to fully meet initial expectations to argue that the failure of so-called ‘neo-liberal’ policies demonstrated the need for returning to a more nationalist economic program. The anti-liberalisation lobby also received added impetus from the backlash against economic globalisation and ‘Washington Consensus’ in international policy circles.

These developments set the stage for Mr Mahinda Rajapakse, who had long been one of the most active, campaigning member of the ruling coalition, to win the presidential election of November 2005, by promising a ‘new vision’ for achieving ‘balanced growth’. After the country returned to a state of normalcy at the end of the 30-decade old civil war in May 2009, President Rajapakse consolidated power by calling fresh presidential and parliamentary elections in 2010 and winning both decisively.[23]

The development strategy of the new government emphasised the role of the state in ‘guiding the markets’ in redressing untoward effects of economic globalisation, and effectively ruled out privatisation of the key remaining state enterprises, while conspicuously avoiding any reference to trade policy reforms.[24] Rapid infrastructure development of rural and conflict-affected parts of the country and the promotion of small and medium enterprises were the key policy priorities under the new policy for achieving balanced growth. Privatization of key state enterprises (banking, power, energy, transport, and ports) was explicitly ruled out. In line with this eclectic program, the past five

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[23] Uyangoda, Jayadeva, “Sri Lanka in 2009: From Civil War to Political Uncertainty”, *Asian Survey*, 50(1) (2010): 104-111.

[24] Government of Sri Lanka, *Mahinda Chinatana: Vision for A New Sri Lanka*, Colombo: Department of National Planning, 2006); Government of Sri Lanka, *Sri Lanka: The Emerging Wonder of Asia: Mahinda Chintana Vision for the Future* (Colombo: Department of National Planning, 2010).

years have seen a number of developments in the Sri Lankan policy scene, which marked a notable departure from the market-oriented policy stance maintained for over three decades from the late 1970s.

Trade policy regime

If we take into account only the customs duties (CD) and quantitative trade restriction which comes under the direct surveillance of the World Trade Organization (WTO), Sri Lanka has continued to maintain a fairly open and transparent trade regime.[25] However, there were numerous other import taxes introduced during the period of the war to raise revenue in order to defray the costs of specific government services, or to promote local producers (Pursell 2011a and b; Athukorala 2012). By 2009 the Sri Lankan tariff schedule included nine import taxes in addition to the standard customs duty. Of these nine taxes, five were 'para-tariffs': taxes which are only applied to imports and there is no domestic equivalent, and hence add to whatever protection is provided to domestic production by customs duties.

Between 2004 and 2009 the average protection rate (Customs duties + para tariffs) for agriculture increased from 28.1% to 49.6%, for industrial products from 10.7% to 24.1%, and for all imports from 13.4% to 27.9%. Nearly all of the increase in the average protectiveness of the import tax system is attributable to para-tariffs. Disaggregated data suggest that after allowing for para-tariffs the protective structure had become even more complex, with 75 different total protection rates ranging from zero to more than 90%.

In a context of slow export growth and widening trade deficits (see below), there has been a renewed emphasis in recent years on import substitution. In 2012 the Ministry of Finance came up with a two-pronged approach: direct import substitution in subsidiary food crops and import

[25] World Trade Organization), *Trade Policy Review: Sri Lanka 2010* (Geneva: World Trade Organization, 2011)

competing manufacturing industries, and increasing the domestic input content in export products.[26] This is in sharp contrast to the basis tenant of the outward-oriented development strategy pursed by the country during the 1980s and 1990s which aimed to restructure the trade patterns and the economy in line with the country's comparative advantage within the global economy.

Promoting the production of subsidiary food crops and dairy products may have economic merit as part of rural development and the post-conflict reconstruction process in the Northern and Eastern Provinces. One can even argue in favor of the use of moderate tariff protection to stabilize the domestic prices of these products in order to cushion the farmers against the vagaries of world markets, even though such measures would entail some economy-wide welfare losses. But, the potential contribution of these products to improving the balance of payments position is unlikely to be very significant. The food products listed in the Ministry report accounts for a tiny percentage of (less than 5%) of the current import bill of the country.

The government budget of 2011 introduced new export taxes on tea and rubber exported in raw and semi processed form to promote further processing of these products. There is however no presumption that the expected reduction in domestic market price of these products per se would promote resource-based industrialisation. The dominant costs in most resource-based industries are capital charges rather than raw material inputs, and the involvement of foreign firms is vital for forging marketing links.[27] It is important to note that during the closed-economy era when the rate of export tax was much higher than the newly proposed rates, almost the entire domestic production of tea and rubber (and other primary exports) was exported in raw form. By contrast, in the 1980s

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[26] Ministry of Finance, *Annual Report 2012* (Colombo: Ministry of Finance, 213), p. 35.

[27] Roemer, Michael, "Resource-based Industrialization in the Developing Countries", Journal of Development Economics, 6(2) (1979): 163-202).

and 1990s, a number of highly successful export-oriented 'downstream' manufacturing firms emerged, resulting in a notable reduction in the share of tea and rubber exported in raw form, notwithstanding the elimination of export duties.

FDI policy

As noted, promotion of FDI combined with significant trade liberalisation played a pivotal role in rapid expansion of export-oriented manufacturing in Sri Lanka. With the ending of the civil conflict, Sri Lanka is in a much better position to harness the gains from the role of FDI, building on its achievements over the past three decades. However, paradoxically recent developments in the Sri Lankan policy scene have begun to send mixed signals to foreign investors, despite the new government has 'officially' committed to moving towards further integrating Sri Lanka into the world economy'. [28]

In 2008 the parliament passed a *Strategic Development Projects (SDP) Act*, empowering the minister in charge of the Board of Investment (BOI) to grant exemption to 'strategic development project' from all taxes for a period of up to 25 years. In the Act a strategic development project means 'a project which is in the national interest and which is likely to bring economic and social benefits to the country and which is also likely to change the landscape of the country, primarily through provision of goods and services which will be of benefit to the public, substantial inflow of foreign exchange, substantial employment, and technology transfer'. [29] This definition leaves a great deal of room for discretion in the investment approval process.

A *Revival of Underperforming Enterprises and Underutilized Assets Act* was passed in November 2011 empowering the government to acquire and manage 37 'underperforming' or

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[28] Government of Sri Lanka (2010) (Note 23), p. 53.

[29] Government of Sri Lanka, *Strategic Development Projects Act, No. 14 of 2008* (Colombo: Lanka: Government Publication Bureau, 2008).

'underutilized' private enterprises.[30] These enterprises (some of which are said to be profit making, according to media commentaries), included 7 enterprises with foreign capital participation (including Colombo Hilton of which Mitsui of Japan was a significant shareholder). Both the Fitch Group and Moody Corporation, two major credit rating agencies, have warned that the bill would erode investor confidence and affect Sri Lanka's investment rating.

State-Owned Enterprises

The privatization program was abandoned following the regime shift in 2005. Initially declared policy of the new government was not to privatize, but to restructure and improve performance of the existing ventures, if required with private sector involvement, but retaining government ownership of at least 51%. The past five years have seen further expansion of the role of SOEs in the economy by re-nationalizing some previously privatized ventures, revitalizing closed-down SOEs, fresh nationalization, and setting up of new ventures (eg. Lankaputra Development Bank, National Insurance Trust Fund, Mihin Lanka). As already noted, 37 private enterprises were brought under government ownership in November 2011.

Total losses of public corporations increased from RS 8 billion (0.3 of GDP) in 2005 to 191 billion (2.5% of GDP) in 2012.[31] Total budgetary transfers (both current and capital) to public enterprises increased from an average annual level of RS 78 billion (16.3%) of total government revenue during 2003-2007 to 212 billion (20.1%) in 2012. The latter figure does not include

[30] Goodhand, Jonathan, "Sri Lanka in 2011: Consolidation and Militarization of the Post-War Regime", *Asian Survey*, 52(1) (2012): 130-137.

[31] Ministry of Finance, *Annual Report 2012* (Colombo: Ministry of Finance, 2013), p. 53.

restructuring bonds amounting Rs. 53.9 billion issued in that year to settle outstanding dues from state-owned enterprises to the Ceylon Petroleum Corporation.

Macroeconomic policy

The stated objective of government's macroeconomic policy was to achieve a stable exchange rate regime through appropriate coordination of exchange rate policy, and fiscal and monetary policies [32]. But, in practice, there has been a fundamental contradiction between exchange rate policy and fiscal and monetary policies.

During the period from 2005 to 2008 the Central Bank managed to maintain a stable nominal exchange rate by drawing on foreign reserves and foreign borrowing, including a one-billion sovereign bond issue,[33] in a context where fiscal and monetary policy excesses continued to fuel domestic inflation. By late 2008, the country was on the brink of a balance of payments crisis: foreign reserves were approaching alarming levels, external debt was rising and the Central Bank was struggling to meet debt servicing commitments. The government had no alternative but to go to the IMF and negotiate a Stand-by Agreement (SBA). The US$ 2.5 billion SBA helped Sri Lanka to avoid a balance-of-

[32] Lakshman, Waligamage D., 'Exchange Rate as a Policy Instrument: A Critical Evaluation of Sri Lankan Experience' (revised version of H.A. De S. Gunasekara Memorial Oration – 2012), *Economic Review* (Peoples Bank, Colombo), April/May, (2012): 1-8.

[33] There was also some foreign fund flows to the treasury bill market following the opening of that market to foreign investors (with an aggregate ceiling of 10% of the outstanding treasury bill issues) (Central Bank of Sri Lanka, *Public Debt Management in Sri Lanka: Performance in 2010 and Strategies for 2011 and Beyond* (Colombo: Central Bank of Sri Lanka).

payments crisis, build foreign exchange reserves and improve investor confidence.[34] This enabled the Central Bank to maintain the fixed exchange rate through further borrowing. But, the government largely failed to adhere to the promised fiscal consolidation under the SBA. Consequently there was a massive appreciation of the real exchange rate during 2005-2011 compared with the previous five years, eroding relative profitability of tradable production (both exports and import-competing products) fueling imports demand (Figure 2).

Figure 2 about here

In February 2012 the Central Bank was forced to abandon foreign exchange market intervention to back up the exchange rate, in the face of widening current account deficit and rapid depletion of foreign exchange reserves. By the end of 2102, the nominal effective exchange rate had depreciated by 11.6%, but this had translated to only about 7.4 % depreciation in the real exchange rate because of the higher domestic inflation compared to that of trading partner countries. Thus the real exchange rate appreciation that took place over the past six years was never erased. Monthly data for the past eight months (October 2013 – June 2013) show a remarkably stability of the bilateral exchange rate between the Sri Lankan rupee and the US$ and the other major currencies. These patterns, combined with the increase in the rate of increase in domestic inflation, suggest that this mild degree of real depreciation would have perhaps dissipated in recent months.

The widening budget deficit was mainly due to government spending on 'faster than programmed, lumpy disbursements for a couple of large foreign financed infrastructure projects and

[34]Following the signing of the SBA, Standard and Poor's and Moody upgraded Sri Lanka's foreign currency rating, while Fitch upgraded sovereign rating (Goodhand 2012 (n.)).

for their counterpart funds'.[35] A large scale reconstruction effort with substantial public sector involvement was clearly needed after a quarter century of destruction, neglect and decay of essential physical infrastructure. However, many government infrastructure projects, such as a modern port and other facilities (being built with Chinese assistance), are located in the Southern regions of Sri Lanka - the heartland of the electoral support base of the President. The prioritization and economic efficiency of these 'flagship projects' are questionable.[36]

ECOMONIC PERFORMANCE

The Sri Lankan economy was adversely affected by the surge in world oil and food prices (during 2007-2008) and the global financial crisis that followed (Table 1). Despite these external shocks, and the intensification of the civil war at its final stage, the Sri Lankan economy expanded by an annual average rate of 6.5% during 2005-2012. Per capita income almost tripled from US$1,062 to US$2,053. The rate of inflation came down from a historical height of 22.5% in average annual rate of 6% during the ensuing four yrars. The unemployment rate fell continuously from 8.3% in 2004 to 4.0% in 2012. Between 2006/7 and 2012 the poverty head count ratio declined sharply from 15.2% to 6.5% accompanied by a reduction in the poverty gap 3.1% to 1.7%. The Gini coefficient also declined from 0.40 to 0.36 between these two years indicating that rapid growth was accompanied by an improvement in income distribution. The reduction in both relative and absolute poverty has taken place across all provinces in the country and among the urban, rural and estate sectors, albeit at varying degree.

[35] International Monetary Fund (2012), Sri Lanka: Eighth Review under the Stand-By Agreement, Washington, D.C.: International Monetary Fund), P. 4.

[36] Law & Society Trust, "Mega Development in Hambantotata", *LST Review*, 23 (Issue 299) (Colombo, Law and Society Trust, 2012).

However, when we go beyond these indicators and analyse the overall growth experiences from a long-term sustainability perspective, there are a several qualifications to this rosy picture.

Insert Table 1 about here

The main drivers of growth have been the non-tradable sectors (construction, transport, utilities, trade and other services), reflecting largely the role of the major public sector construction and infrastructure development projects (Table 2). These sectors accounted for over 70% of the total increment in real GDP between 2004 and 2012. The manufacturing sector grew only at a modest rate, resulting in a decline in its share in GDP from 18.5% during 2000-04 to 17.5% during 2005-2012. Within manufacturing, the largest contributor to growth has been the food, beverages and tobacco product sector where the production is predominantly domestic market oriented; Sectors such as textile and garment, and non-metallic mineral products where export production is concentrated, have recorded much slower growth. In sum, the sectoral profile of economic performance in recent years is consistent with the erosion of the competitiveness of traded goods production (real exchange rate appreciation) noted in the previous section.

Table 2 about here

The doubling of per capita income in current US$ terms partly reflects domestic inflation and artificial stability of the exchange rate of the Sri Lankan rupee against the dollar. When the data are expressed in real (2005) prices in order to allow for these factors, per capital income in 2012 (US$ 1818) was only 53% higher than that in 2004 (US$ 1182) (Table 1).

The decline in the unemployment rate was partly due to an increase in public sector recruitments and a surge in overseas employment of Sri Lankans. In a dramatic reversal of the contraction in the size of the public sector workforce maintained over the previous decade, total employment in the public sector increased from around 900,000 (11.1% of the total labor force) in 2005 to over 1.2 million (14.%) in 2012[37]. Over the past ten years (2002-2012), on average a quarter of a million Sri Lankans have been leaving annually for overseas employment, with the number increasing every year. The total number that left during 2008-2012 was 1307 thousands, up from 1078 thousands during the previous five years. A tentative estimate suggests that the total stock of Sri Lankan overseas contract migrant workers had reach 2 million by 2011, amounting to over 14% of the total working-age population of the country.[38]

The external payments position of the country has deteriorated over the past three years. The trade deficit, which had come down 7.4% of GDP in 2009 from over 10% during the previous five years, increased to a historical high of 15.8% in 2013. Exports as a share of GDP declined from 30% in 2004 to 17% in 2010, while imports continued around 35% of GDP. In 2012, total imports were double the size of export earnings. In spite of rapid increase in remittances by migrant workers and earnings from tourism, the current account deficit widened to 2.9% of GDP in 2010 and to 6.6% of GDP in 2012. Imports as a percentage of GDP has increased over the past two years, but still remains below the average level during 2005-2008. The major contributor to the widening current account deficit has been the massive contraction in exports as a share of GDP. While weak global demand in the aftermaths of the global financial crisis (2008-9) and the recent withdrawal of 'GSP Plus' tariff

[37] Ministry of Finance (note 29).

[38] Arunatilake, Nisha, Priyanka Jayawardena and Dushni Weerakook (2011), "Sri Lanka', in Saman Kelegama (ed.), Migration, Remittances and Development in South Asia", (New Delhi: Sage, 2011), pp. 112-140.

concessions by the European Union would have played a role, a comparative analysis of Sri Lanka export performance suggests that the problem is mostly 'home grown'.[39] Sri Lanka's share in both world exports and exports from developing countries has declined sharply, indicating that Sri Lanka has failed to keep pace with the expansion in world demand. Viewed against the experience during the 1980s and 1990s, the continuous appreciation of the real exchange rate and Sri Lanka's failure to attract export-oriented foreign investors (and also to retain those who had set up production based in the country) appears to be the main factors behind the export slowdown.

There has been a notable increase in total FDI inflows during the past two years (Table 1). However, when the data are disaggregated by sector/industry, it is revealed that this increase has come largely from projects in the construction and services sectors. During 2010-12, manufacturing accounted for only 32% of total realized FDI. The bulk of these flows are to domestic market oriented industries (mostly food and beverages), with garments being the only export-oriented industry to attract some FDI. There is evidence that a large number of export oriented foreign firms have closed down their operations in Sri Lanka. A comparison of the firm-level records of the Board of Investment (BOI) shows that 465 firms which were in operation in 2002 had disappeared from the BOI list in 2009. This number is too large to be interpreted solely as a recording error. Of these firms, the majority are firms with foreign capital participations (joint venture or fully foreign owned). By contrast, the majority of newly established firms (over 80%) are fully locally owned. Investors from India now

[39] Rajapatirana, Sarath and Ravi A. Yatawara, "Export Growth and Appropriate Macroeconomic Policy: A Necessary Nexus", *Sri Lanka Economic Journal* (2013) (forthcoming).

dominate the list of firms operating in Sri Lankan EPZs; many firms from Korea, Hong Kong and from a number of developed countries have left the country.[40]

By the end of 2012 total gross official foreign reserves (US$7.1 billion) was adequate to cover 3.5 months of imports. However, according to the IMF estimates net reserves (after netting out short-tern (less than one year) foreign currency liabilities of the Central Bank and the central government) short-term borrowings from gross reserves) amounted to only US$ 4.2 billion or 2.1 import moths (Table 1). The tradition rule of thumb for central banks is that they should hold a quantity of foreign exchange reserves equivalent to at least three months' worth of imports. In any case, three-month import equivalence is not an appropriate yardstick for measuring reserve adequacy given that the country is now integrated into global capital markets through foreign borrowing and the short-term debt exposure has increased significantly in recent years (Table 3).[41]

Table 3 about here

An important lesson learned from the string of financial crises that engulfed emerging market economies in the 1990s (eg. Mexico in 1995, East Asia in 1997, Brazil in 1999, Turkey in 1994) was that the prudential level of reserves needs to be determined in relation to the volume of short-term foreign-currency liabilities. Based on this experience, in 2001 the Executive Board of the IMF came

[40] Ekanayake, A. Raveen (2011), 'Global Economic Integration via Foreign Direct Investment: Opportunities and Policy Options for Sri Lanka', Masters Research Essay, Crawford School of Economics and Government, Australian National University, Canberra.

[41] The tradition rule originated in the days of the old Bretton Woods system when, given the combination of fixed exchange rate controls on capital flows, the worst situation that could be imagined relating to balance of payment management was that a country could lose access to trade credit, worth roughly three months of imports.

up with the following guideline for assessing reserve adequacy of a country in its lending and surveillance activities:

> '…. holding reserves equal to short-run debt [is] an appropriate starting point for a country with significant but uncertain access to capital markets. But it is only a starting point. Countries may need to hold reserves well In excess of this level, depending on a variety of factors: macro-economic fundamentals; the exchange rate regime; the quality of private risk management and financial sector supervision; and the size and currency composition of the external debt (Fischer 2001).[42]

In terms of this criterion, Sri Lanka's ability to defend the rupee in the event of an external shock that could trigger short-term capital exodus has significantly weakened in rent years. In 2008, when Sri Lanka entered into the SBA with the IMF, gross foreign exchange reserves amounted to a mere 48% of the total stock of outstanding short-term debt. The SBA helped resort the external reserve position during the two following years, lifting the reserve cover of short-term debt to 112% in 2010. This improvement was rather short-lived, however. By the end of 2012 gross official foreign exchange reserves were adequate to cover only 68% of the existing volume of accumulated short-term foreign debt ('volatile capital') (Table 3, last row).[43]

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[42] Fischer, Stanley, 'Opening Remarks at the IMF/World Bank International Reserve Policy Issue Forum', (Washington DC: International Monetary Funds, April 28, 2001), http://www.imf.org/external /np/speeches/2001/042801.htm [accessed 16 May 2013].

[43] It is important to mention that my calculation here covers only short-term government securities and banking sector external liabilities. In order to make a more accurate estimate, it is necessary to take into account foreign investment in domestic company shares, which are essentially a part of volatile capital (Athukorala, Prema-chandra and Peter G. Warr (2002): "Vulnerability to a currency crisis: lessons from the Asian experience.", *World Economy*, 25(1) (2002): 33-570).

The other side of the coin to the worsening current account deficit and massive foreign debt accumulation is the widening budget deficit. A current account deficit means that that country (either the government or the private sector or both) is spending more than it is earning. In the Sri Lanka case, the private sector deficit (the difference between private saving and investment) is rather small (Table 1). The current account deficit, therefore, predominantly mirrors in the budget deficit. Over the past five years the budget deficit as a percentage of GDP has remained well beyond the internationally considered 'safety rage' of 3% to 5%. Moreover, the reported deficit figure needs to be treated with caution because in recent years the government has been shifting transfers to the loss-making public enterprises 'off budget', by encouraging these enterprises to borrow on their own under government guaranty.[44]

CONCLUDING REMARKS

The market-oriented policy reforms initiated in 1977 have led to far-reaching changes in the structure and performance of the Sri Lankan economy. It is important to note that what has been achieved in Sri Lanka under liberalisation reforms occurred while civil war has persisted for much of the period. In addition to its direct debilitating effect of political risk on investor perception, the civil war constrained capturing the full benefits of economic opening -through delays and inconsistencies in the implementation of reform process and macroeconomic instability emanating from massive war financing.

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[44] Weerakoon, Dushni, 'Sri Lanka's External Stability: Foreign Debt and Export Earnings', *Talking Economics*, Colombo: Institute of Policy Studies, 2013),

http: www.ips/lk/talkingeconomics/2013/05/ [accessed June 23, 2013].

Viewed against this back drop, recent developments in the Sri Lankan policy scene do not augur well for the future of the Sri Lankan economy. After showing remarkable resilience during decades of war and conflict the Sri Lankan economy has failed to capitalise on the window of opportunity presented by the end of the military conflict. Post-conflict ‘recovery’ has so far been largely underpinned by a widening current account deficit (which mirror a widening budget deficit) financed with an equally large inflow of funds from the rest of the world, which a notable shift in its composition from foreign aid and concessionary credit to commercial borrowings. The huge current account deficit could be sustained only as long as the lenders keep sending money to Sri Lanka and increasing their total Sri Lankan exposure. Eevntually current account adjustment would require a fall in the external value of the rupee to make Sri Lankan exports cheaper and imports more expensive. Currency depreciation would hurt those Sri Lankan banks and businesses that have borrowed in foreign currency, with painful ramifications on the domestic financial system.

Table 1. Sri Lanka: Selected Macroeconomic Indicators, 2004-2012

	2004	2005	2006	2007	2008	2009	2010	2011	2012
GNP per capita at current price, US$	1062	1241	1421	1617	2014	2057	2400	2836	2923
GNP per capita at constant (2005) price, US$	1182	1241	1323	1400	1471	1505	1611	1727	1818
Real GDP (2002 price) growth (%)	5.4	6.2	7.7	6.8	6	3.5	8	8.3	6.4
Unemployment rate %	8.3	7.7	6.5	6	5.4	5.8	4.9	4.2	4
Gross national saving(% of GDP)	22	23.8	22.3	23.3	17.8	23.9	24.7	25.3	24
Of which public saving	-3.7	-2.6	-2.2	-1.6	-2	-3.7	-2.1	-0.9	-1
Gross domestic investment(% of GDP)	25.3	26.8	28	28	27.6	24.4	27.6	29.9	30.6
Of which public investment	5.6	5.6	6.1	6.3	6.4	6.5	6.1	6.2	6.9
Inflation (CPI) rate %	7.6	11.6	10	15.8	22.6	3.5	6.2	6.7	7.6
Government finance									
Budget deficit (% of GDP)	-7.5	-7	-7	-6.9	-7	-9.9	-8	-6.9	-6.4
Budget deficit (% of total revenue)	100.6	93.8	96.5	94.2	99.2	134.3	107.2	102.1	112.6
Public debt outstanding (% of GDP)	102.3	90.6	87.9	85	81.4	86.2	81.9	78.5	79.1
Of which foreign debt[2]	47.6	39	37.6	37.1	32.9	36.4	36.1	35.6	37.1
External sector									
Exchange rate, US$/Rp	101.2	100.5	104	110.6	108.3	114.9	113.1	110.5	127.6
Nominal effective exchange rate (2004 = 100)[1]	100	100.2	104.3	117	115.8	116	115.7	115.9	126.9
Real effective exchange rate (2004 = 100)[1]	100	92.8	90.6	90.5	77	75.1	73.4	71.9	77.4
Current account balance (% of GDP)	-3.1	-2.7	-5.3	-4.3	-9.5	-0.5	-2.9	-7.8	-6.6
Total external debt (% of GDP)	54.9	46.5	49.4	51	43.7	49.7	50.1	49.7	56.7
Debt service ratio[3] (%)	11.6	7.9	12.7	13.1	18	22.4	16.7	12.7	21.2
Official foreign exchange reserves, gross (US$ million)[4]	1834	2508	2526	3062	1594	4897	6410	5758	66775
In months of imports	2.8	3.4	3	3.7	1.4	3.9	3.5	3.2	3.5
Official foreign exchange reserves, net (US$ million)	---	---	---	---	---	4150	5072	4011	41625
Foreign direct investment (US$ million)	227	234	451	548	691	384	435	896	813

Note:

1. Original Central bank index inverted: an increase (decree) implies depreciation (appreciation)
2. The figures reported here do not include purchase of treasury bills by foreign investors, which increased from US$ 63 million (0.1% of GDP) to US$ 92 million (1.6% of GDP) in 2012.
3. External debt repayment and interest payments as a percentage of exports of goods and services.
4. Excluding Asian Clearance Union debit balances.
5. Provisional.

--- Data not available

Source: Data on foreign exchange reserves for the years 2009-2012 are from IMF (2013), Table 4; all other data series are compiled from Central Bank of Sri Lanka, *Annual Report* (various years).

Table 2. Gross domestic product by industrial origin, 2004-2012[1]

Sector	Share in GDP (%)			Average annual growth (%)			Share in output increment between 2004 and 2012 (%)
	2004	2008	2012	2004-08	2008-12	2004-12	
Agriculture[2]	13.0	12.1	11.1	2.4	4.3	3.3	8.3
Industry	27.7	28.4	30.4	4.4	8.3	6.1	34.4
Mining and quarrying	1.3	2.0	2.8	9.9	15.3	12.3	4.9
Manufacturing	18.1	17.5	17.1	3.5	5.9	4.6	15.6
Electricity, gas and water	2.2	2.4	2.4	5.3	6.3	5.7	2.6
Construction	6.0	6.5	8.1	5.1	12.7	8.5	11.2
Services	59.3	59.5	58.5	4.2	6.1	5.1	57.3
Wholesale and retail trade	24.7	24.2	23.0	4.0	5.3	4.6	20.5
Hotels and restaurants	0.6	0.4	0.7	0.3	24.9	11.3	0.8
Transport and communication	11.5	13.1	14.3	6.3	8.9	7.5	18.5
Banking insurance and real estate	8.4	8.7	8.9	4.6	7.0	5.6	9.6
Ownership of dwellings	3.8	3.1	2.5	0.7	1.3	0.9	0.6
Government services	8.0	7.7	6.8	3.3	3.5	3.4	5.0
Private services	2.3	2.4	2.3	4.1	6.1	5.0	2.3
Total GDP	100	100	100	4.0	6.6	5.1	100
Memo items							
Tradable production[3]	32.4	31.6	31.0	3.4	6.0	4.6	28.8
Non-tradable production	67.6	68.4	69.0	4.3	6.8	5.4	71.2

Notes:

1. Based on constant (2002) price data.
2. Including livestock, forestry and fishing.
1. Sum of agriculture, mining and quarrying and manufacturing.

Source: Compiled from Central Bank of Sri Lanka, *Annual Report* (various issues)

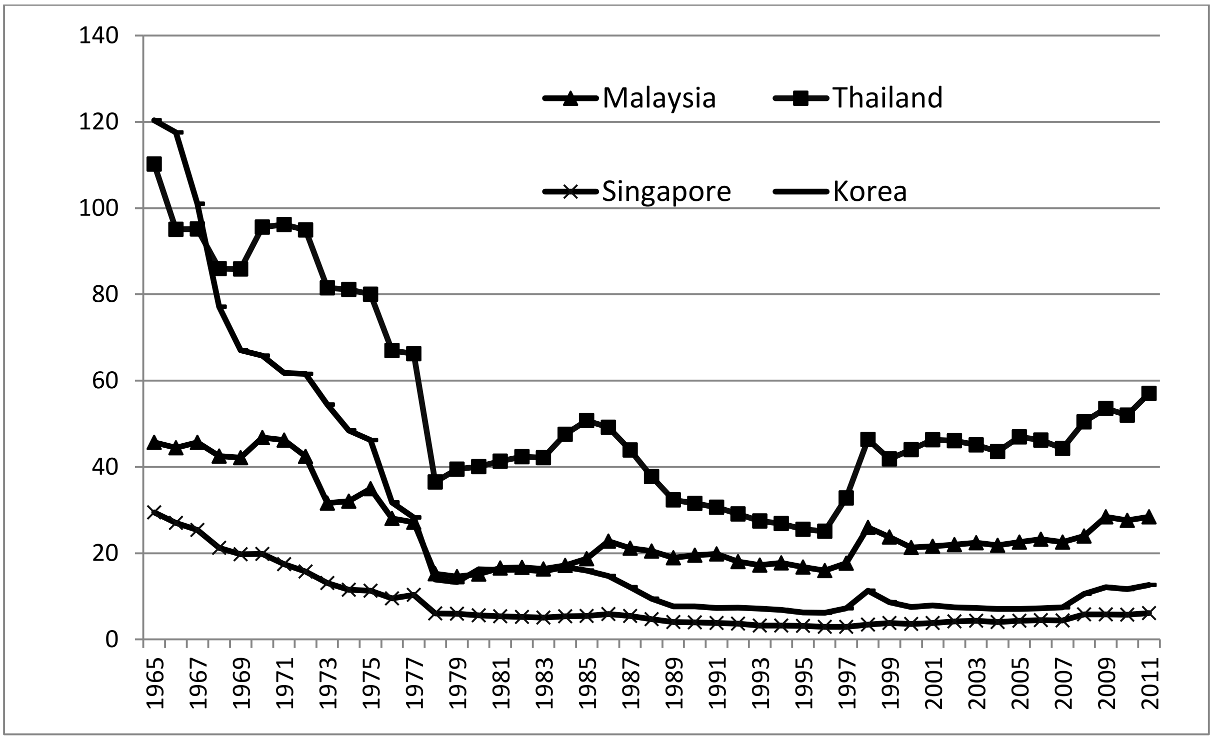
Table 3. Composition of outstanding external debt, 2004-2012 (%)

	2004	2005	2006	2007	2008	2009	2010	2011	2012
Medium and long-term debt	83.7	82.1	81.2	78.1	76.8	74.4	75.8	71.7	70.1
Government	74.5	71.8	73.3	71.2	70.8	65.8	64.7	60.6	56.6
Public corporations and private sector	7.2	7.4	6.1	5.4	5.0	5.1	5.8	5.3	6.1
With government guarantee	4.0	4.4	3.3	2.1	1.4	0.5	2.1	3.1	4.3
Without government guarantee	3.2	3.0	2.8	3.3	3.6	4.6	3.7	2.2	1.8
IMF drawings	2.0	2.9	1.7	1.5	1.0	3.4	5.3	5.8	7.5
Short-term debt	16.3	17.9	18.8	21.9	23.2	25.6	24.2	28.3	29.9
Short-term government securities	5.1	5.1	4.5	6.7	8.2	14.8	10.5	13.4	14.4
Banking sector external liabilities	11.2	12.8	14.3	15.1	15.0	10.8	13.7	14.9	15.5
Total	100	100	100	100	100	100	100	100	100
US$ million	12775	13020	13975	16483	17775	20913	24830	29387	33674
Memo items									
Gross official foreign reserves/ total short term debt (%)[1]	106.9	119.3	109.0	97.0	48.0	96.2	118.2	76.4	67.8

Note: 1 Net of Asian Clearance Union debt balance.

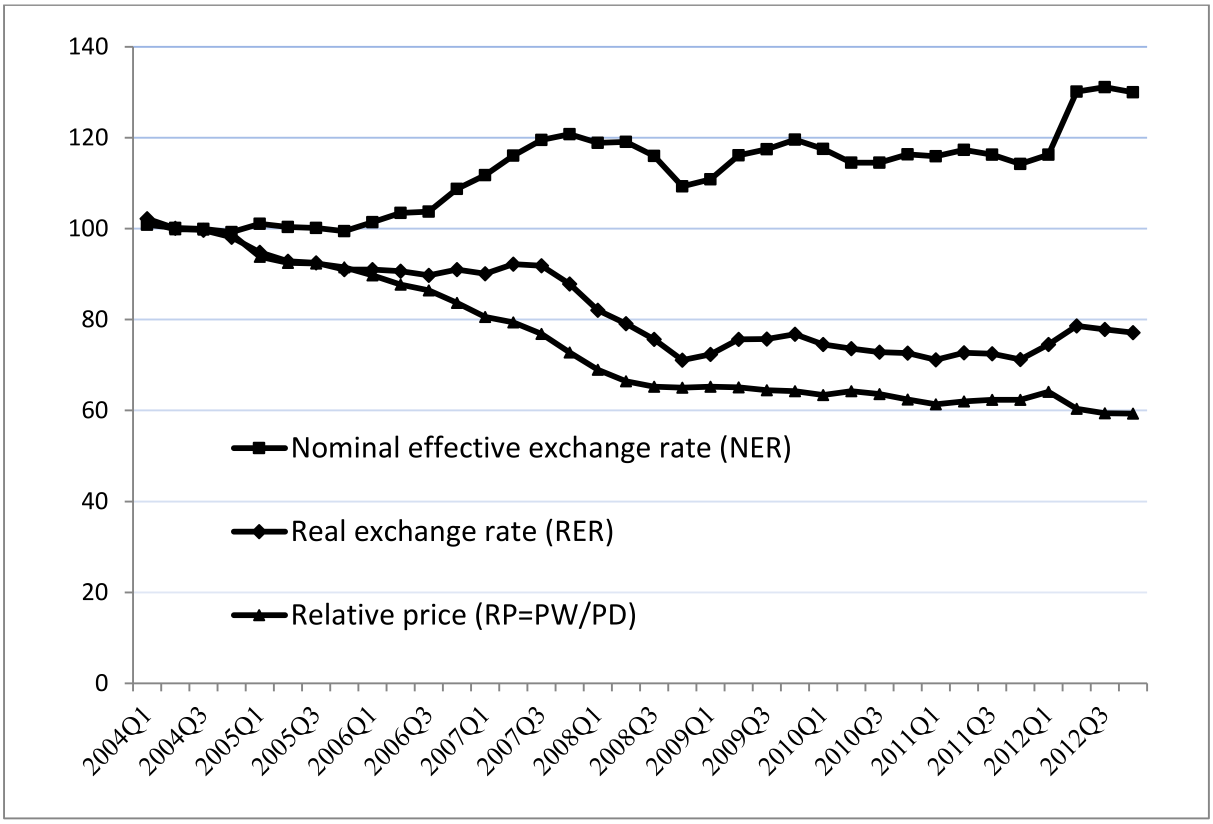
Source: Compiled from IMF (2013) (net foreign reserves) and Central Bank of Sri Lanka, Annual Report (various issues)

Figure 1: Sri Lanka's per capita GNP relative to South Korea, Malaysia, Singapore and Thailand, 1965-2011



Source: Source: Based on data compiled from World Bank, *World Development Indicator*s database.

Figure 2: Sri Lanka: Real exchange rate and its components, 2004Q1 – 2012Q4 (2004 = 100)



Notes:

NEER: trade weighted nominal exchange rates relating to 24 top trading-partner countries (measured as rupee per foreign currency units); an increase indicates nominal depreciation.

RP: trade weights relative price (measured by the consumer price index) between Sri Lanka and its 24 top trading partners

REER = NEER*RP; an increase indicates real depreciation (improvement in the competitiveness of tradable goods production).

Source: Compiled from Central bank of Sri Lanka, *Annual Report* (various issues).

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