

## **Abstract**

The State of the Economy report is an annual publication of the Institute of Policy Studies of Sri Lanka (IPS) providing a rigorous assessment of Sri Lanka's economic performance in the context of policy developments in both the domestic and external environment. The report also highlights emerging socio-economic issues in key areas of medium-term policy relevance for the country.

The "Sri Lanka: State of the Economy 2007 " report notes that the most promising feature of Sri Lanka's economic performance in 2005/06 was a steady acceleration in GDP growth to a rate of 7.4 per cent in 2006. Nonetheless, there are increasing signs of a gradual slowdown in economic growth – with the growth rate slowing in the first quarter of 2007 to 6.1 per cent and to 6.4 per cent in the second quarter of 2007. The report notes that Sri Lanka's economy displays a number of signs that demand is rapidly outpacing supply; consumer price inflation has seen a sharp increase while the external current account deficit has widened significantly. In part, the problems stem from the fact that Sri Lanka's recent economic expansion has been driven partly by relatively relaxed fiscal and monetary policies. The predominant policy concern remains the risk that inflation may fail to moderate sufficiently. The risks in the interim is that the macroeconomic environment is likely to be tightly constrained and volatile – leaving limited policy options in the face of any domestic or external shock – with very little tolerance margin for any policy errors.

In this context, the report emphasizes the need to re-orient government expenditures to priority and growth enhancing areas and to implement necessary reforms to boost the economy's supply capacity. The financing constraints on the government are stringent. Accelerated investment in infrastructure is a necessity if the economy is not to run up against supply side constraints. Encouraging private investment, particularly in infrastructure, will also depend on the approach to implementing broader reforms in the economy. Public-private partnerships require regulatory reforms to protect the interests of both investors and consumers.

The central theme of the State of the Economy 2007 report is that better infrastructure and improved public services are needed not only to increase growth, but also to ensure that the benefits of that growth are spread more widely. The report highlights related issues of enhancing access to land and microfinance, improving access to better quality education and health, the need to ensure sustainable and equitable utilization of the natural environment, etc. The supply-side constraints in infrastructure, skilled labour, and public services in Sri Lanka can seem formidable. However, what needs to be done comes back to the core issue: improve the capacity of the public sector to deliver basic services. All these require a commitment to major policy reforms.