Sri Lanka
State of the Economy Report 2011

Chapter 1
Policy Perspectives

by
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1. Policy Perspectives

As the global economy begins the arduous road to recovery, 'growth' has become the cornerstone for the world's policy makers, be it the US policy on 'foundations for long term growth', UK's 'strategy for economic growth' or Japan's 'new growth strategy'. In this, Sri Lanka is no exception, setting itself an ambitious medium term growth target in excess of 8 per cent per annum in the country's new post-conflict environment. Indeed, Sri Lanka achieved it in 2010 with a strong economic rebound, amidst a steadily improving macroeconomic environment. This was in stark contrast to the experience a mere two years ago, when economic performance was at best erratic, with unacceptably high inflation and dwindling foreign exchange reserves. In 2010, Sri Lanka posted a record high of US$ 6.6 billion in official reserves, a moderate inflation rate of 5.9 per cent and a stable exchange rate for much of the year. The remarkable turnaround owes much to a renewed confidence in the country's long term economic prospects, reinforced by policy and political stability from a strong incumbent government.

> ***'For Sri Lanka, emerging from a costly era of a long drawn conflict, rising socio-economic aspirations must be met to help restore and cement social harmony in its post-conflict development efforts'***

Amidst the strong recovery and seemingly bright medium term prospects for the Sri Lankan economy, there are, nevertheless, some concerns about specific aspects of the country's recent economic performance. The relatively weak recovery of private investment to take advantage of the country's new stability has been one such area. Growth in private sector credit disbursement was slow to pick up, as has been inflows of foreign direct investment (FDI) to the country. Private sector credit growth was sluggish for much of 2010, picking up only towards the latter months of the year, while net FDI inflows saw only a mild recovery at US$ 435 million as against US$ 385 in the crisis-ridden year of 2009. As in the previous year, it was buoyant public investment that kept Sri Lanka's growth momentum moving to allow the country to reach a GDP growth of 8 per cent.

The sources of economic growth are obviously important, but there has never been clear agreement on what drives growth. Indeed development thought is littered with changing beliefs about what the best policies are to ensure rapid growth. During the 1980s, there was a seismic shift to focus on markets, prices, and incentives. These called for raising investment as high as possible, especially into industry; reducing fiscal imbalances through 'structural adjustment'; and 'getting prices right' in the process. In the 1990s, the policy prescriptions became more arduous, asking countries to go beyond a mere 'strengthening of the market'. They required countries to strengthen public institutions by reducing corruption and improving the rule of law; to introduce incentives and actions for private sector development to 'cut costs of doing business'; to improve education and skills of its labour force; to upgrade technology, etc.

Whatever the merits of changing agendas, economic theory does suggest that a sustained increase in investment raises the economy's growth rate - albeit temporarily - while more sophisticated models suggest that bringing improvements in productivity, notably due to innovation and to investments in human capital, allows growth to be enhanced in a more sustainable fashion. In this respect, Sri Lanka's public investment drive that is heavily tilted towards improving physical infrastructure capital in the country will no doubt provide a useful initial boost to growth. But, the longer term sustainability of that growth momentum can only be ensured with appropriate investment in technology, knowledge transfer, etc. Here, private sector investment, and FDI especially, has a particularly important role to play.

Private sector credit growth was relatively slow to take-off despite the new resilience and faster growth in the Sri Lankan economy from mid-2009. Credit growth picked up only towards the second half of 2010 to record an overall healthy growth of 25 per cent by year end - albeit on the back of a growth of 7 per cent in 2008 and contraction of 5.8 per cent in 2009. The reasons for the slow recovery in credit growth to the private sector in the Sri Lankan context are not entirely clear, although a similar global phenomenon is easier to understand. In a recessionary economic environment that follows from a financial crisis - such as the global economic downturn of 2008/09 - weak credit growth is to be expected as households and firms reduce their debt burdens. Whilst Sri Lanka was not unduly affected by the global financial crisis, the economy went through its own financial turmoil amidst an environment of excessive credit growth during 2005-07. It saw not only the unravelling of some important financial organizations and illegal 'ponzi schemes', but over-leveraging of households and firms. The average gross non-performing lending (NPL) ratio of the banking sector, for instance, jumped as a result from 5 per cent in 2007 to 8.5 per cent in 2009. It could also have been that the corporate sector had retained profits for re-investment purposes.

Overall, Sri Lanka's experience suggests that both supply and demand factors played a role in muting private sector investment appetite. Despite the signs of an early economic recovery, over-leveraged households and firms were less willing to borrow while banks too were less willing to lend. Indeed, the economic downturn spurred increased savings by the private sector. Under the circumstances, the Central Bank of Sri Lanka (CBSL) acted aggressively to cut policy interest rates and used other means to convince banks to lower their lending rates, including setting mandatory measures. On the whole, these had only limited impacts. Therefore, it is not surprising that as households and firms pay back debts, cheaper credit was likely to provide less of a stimulus than at other times.

For private investors, other avenues to make short term financial gains were clearly available, not least through a booming domestic stock market. Sri Lanka's bourse gained by over 95 per cent in 2010, to become the second best performer on a global scale for a second consecutive year. While renewed investor confidence in the long term prospects of the economy no doubt played a part, the gains were also driven to a large extent by speculative trading that compelled the regulators to step in. The relatively low returns from fixed income assets also played a role in channelling funds to the share market. For banks, the government debt securities continued to provide a healthy return at zero risk, negating any urgent need to seek out riskier corporate and household borrowers.

To an extent, the subdued private sector appetite to expand factories and invest in new machinery through credit from the banking system was perhaps a mixed blessing. If private sector credit growth had kicked off at a rapid pace, the government's own fiscal excesses - albeit a much improved outcome relative to that of the previous year - could not have been accommodated without igniting destabilizing consequences. Sri Lanka's fiscal deficit of 7.9 per cent of GDP in 2010 was financed through domestic borrowing of 3.6 per cent of GDP. Given that the private sector was in effect not competing for funds, the government was able to successfully retain a low inflation and interest rate regime despite fiscal pressures and a rapid recovery in economic activities.

However, the government's stance on deficit financing - i.e., limiting reliance on domestic sources of finance - in its attempt to retain a relaxed monetary policy stance to spur growth can prove to be double-edged. It necessarily raises Sri Lanka's reliance on foreign financing to meet the country's growing public investment needs. The repeated calls for fiscal consolidation efforts stem from a recognition of the potential medium to long term risks that arise from rising exposure to external debt.

The dominant source of deficit financing in recent years has been foreign currency denominated borrowing. In 2009, foreign financing stood at 4.8 per cent of GDP and declined only marginally to 4.4 per cent in 2010. The greater country risk exposure that is associated with foreign currency debt - sensitivities to sovereign ratings in the event of debt roll-over, exchange rate risks, etc. - are well known. Sri Lanka's external debt-to-GDP ratio, however, has remained unchanged for the most part; in fact, it declined from 36.5 per cent in 2009 to 36.1 per cent in 2010. Movements in the exchange rate have a clear bearing on external debt indicators. An appreciating currency, as was the experience of the rupee in 2010, helps to improve fiscal indicators by lowering the external debt-to-GDP ratio.

Notwithstanding the overall figures, the composition of the debt matters. Here, Sri Lanka has seen a rapid change in its external debt structure with non-concessional and commercial sources raising their share from 7.3 per cent in 2006 to 37.5 per cent in 2010. These are costlier sources of foreign finance, and not surprisingly, the country's overall external debt service ratio has crept up over the period from an annual average of 12 per cent during 2002-04 to 16.4 per cent over 2008-10. To make certain that future external debt service payments can be met comfortably and limit the country's exposure to unanticipated external shocks, Sri Lanka must ensure that its foreign exchange earnings remain strong. As a first step, a prudent course is to limit foreign currency borrowing to projects that will, either directly or indirectly, enhance the foreign exchange needed to service future payments.

Ongoing developments in the industrialized economies offer a salutary lesson and a necessary reminder of the choices available to governments. Economic growth can be given a short term boost by fiscal and/or monetary policy stimulus, but at the risk of worsening long term debt problems. Alternatively, a more cautious approach on fiscal austerity can damage growth in the short term, and indeed incur electoral unpopularity along the way. For Sri Lanka, the current Stand-by Arrangement (SBA) with the International Monetary Fund (IMF) has provided an external anchor, underscoring the government's fiscal and monetary framework. As the IMF programme ends in 2012, Sri Lanka will have not only a healthier economy and stronger public finances, but also the necessary 'political space' to consolidate public finances in the absence of major electoral imperatives.

In view of the above concerns, it is encouraging that the overall fiscal outcomes in 2010 are positive. The deficit was reduced from 9.9 per cent of GDP in 2009 to 7.9 per cent in 2010 and looks set to be reduced further to under 7 per cent in 2011. This is, of course, not to imply that low fiscal targets per se are always desirable or appropriate. Arguably, Sri Lanka's expansionary fiscal policy stance of 2009 in the midst of a sharp economic downturn and domestic socio-political imperatives stemming from immediate rehabilitation needs of a war weary population could be justified. Without such a fiscal stimulus to the economy, the private sector's reluctance to undertake investment would have depressed economic activity even further than the 3.5 per cent growth recorded in 2009. Rather than adopt a dogmatic approach to fiscal targets, what is needed is a clear understanding that sound public finances allows a country the necessary leeway to respond appropriately to emerging domestic and/or external shocks. In the circumstances, what Sri Lanka needs to do first of all is to lower its deficit to a manageable level that will, over time, reduce the country's debt overhang; that in turn will release 'fiscal space' to respond appropriately to context-specific needs of the country through fiscal and/or monetary policy measures.

In this context, Sri Lanka's near term fiscal consolidation plans appear to be reasonable. In 2010, expenditure as a percentage of GDP was lowered to 22.9 per cent of GDP, primarily through rationalization of current expenditures. Encouragingly, capital expenditures remained more or less in line with budget forecasts. There is ample evidence to suggest that fiscal consolidation efforts via spending cuts rather than tax increases are more likely to support medium term growth prospects. This, the government has attempted to do through cuts in current expenditure, while supporting a higher rate of capital expenditure. Moreover, expenditure rationalization is being accompanied by fresh efforts to generate additional revenues by way of tax reforms on the basis of the recommendations of a Presidential Commission on Taxation. Tax reforms appear to be aimed at raising taxes on consumption and property rather than on income or savings. Taxing the former is less harmful to growth than taxing the latter.

Fiscal policy has clear implications not only for sustained high growth, but also in relation to the distributional impacts of such growth. For instance, Sri Lanka's current focus on public infrastructure is found to be concentrated heavily on the construction of roads, ports, airports, etc. By contrast, capital investment in education and health which stood at 1.1 per cent of GDP in 2006 had declined to 0.6 per cent by 2010. The tight fiscal constraints within which the government is attempting to achieve a host of complex objectives are clear. Perhaps, most importantly it also serves to underline the necessity for placing Sri Lanka's public finances on a sounder footing as an immediate priority.

The consolidation of public finances will also help in setting monetary and exchange rate policy that will support long term growth objectives. Indeed, any adverse impact of fiscal tightening on output growth can be offset to an extent by monetary easing. This is what Sri Lanka did in 2010, although with limited results in stimulating private sector credit growth. However, despite a largely benevolent inflationary environment in 2010, there can be emerging threats to price stability. Thus, monetary policy should not sow the seeds of raising inflation expectations even as fiscal consolidation efforts bear results. Sri Lanka's potential growth rate without a risk of overheating can only be guessed at, but stability has its own rewards by providing a stable, predictable macroeconomic environment in which businesses could flourish. The costs of higher, and possibly more volatile, inflation would outweigh any output gains from excessive monetary easing. It is also the poor who ultimately suffer the most from price inflation, negating efforts to ensure equitable benefits of growth; the poor, unlike workers in formal employment, have limited options to defend themselves against inflation.

Sri Lanka's rate of inflation has been rising incrementally from the last quarter of 2010, primarily on account of rising food prices following inclement weather conditions. Political turmoil in some key oil exporting countries has also mounted rising pressures on international oil prices. Such supply-side price shocks will have inevitable one-off impacts on inflation. Standard monetary policy responses to contain supply-side induced inflation are not effective and alternative interventions through administered price controls and tax measures were adopted. There is, however, the threat that food and fuel price increases will be absorbed into the general inflationary pressures via wage increases, even as a recovery in credit growth to the private sector is anticipated to quicken and add to inflationary pressure on the demand-side.

Thus, the CBSL has to be extra vigilant to identify emerging channels of inflationary pressure and respond appropriately. Excess rupee liquidity in the market - estimated at Rs. 120-130 billion even by early 2011 - has been a potential source of inflationary pressure for most of 2010. A sharp increase in short term foreign investment inflows to the government debt securities market, and perhaps more critically, high volumes of government foreign currency denominated borrowing injected significant foreign currency surpluses into the country. These inflows have been supplemented by better-than-average inflows of worker remittances and tourism receipts in the post-2009 setting. With the CBSL stepping in to mop up capital inflows and prevent the currency from appreciating unduly, a contributory outcome has been the expansion of the domestic monetary base. Rather than work through a pricing mechanism - raising policy rates - the CBSL opted to work through a quantity mechanism - employing regulatory measures such as an increase in the Statutory Reserve Requirement (SRR) of commercial banks from 7 per cent to 8 per cent in April 2011. This is a crude, but often effective mechanism to absorb excess liquidity if pursued with sufficient vigour. Its effectiveness in curtailing inflationary pressure will depend on levels of excess liquidity and demand for credit.

While excess rupee liquidity had dropped to under Rs. 70 billion by the end of the first quarter of 2011, with annual inflation at 7 per cent by June 2011, the inflationary consequences of an expanding monetary base cannot be ignored. There are few signs to suggest that capital inflows will ease in the near term. Sri Lanka issued a second Sovereign bond for US$ 1 billion in July 2011, following the issue of the first US$ 1 billion Sovereign bond in October 2010. Large volumes of foreign capital inflows may be viewed as a sign of the country's renewed economic prospects and as evidence of good investment opportunities, but there are also other, less palatable implications for the economy. The manner in which current account deficits are funded matter; the bulk of capital inflows have come not from current demand for Sri Lanka's goods and services, but rather as a result of capital account transactions that are tilted heavily towards government foreign currency denominated borrowing. Such developments have both short and long term implications regarding the health of a country's external payments position.

Large net capital inflows also have immediate short term impacts. They inevitably exert upward pressure on a country's exchange rate. The Sri Lankan rupee appreciated by 3 per cent against the US$ in nominal terms in spite of heavy intervention by the CBSL in the foreign exchange market. An appreciation of the real exchange rate, as has been occurring vis-à-vis a basket of trading partner currencies, makes Sri Lankan exports less competitive in international markets. There will, of course, be heavily import dependent export products that will gain a price advantage through cheaper imported inputs. A stronger rupee will also help to curb inflation, especially in the face of rising international commodity prices.

However, in the midst of a significant drop in the ratio of exports to GDP in recent years - from 28 per cent in 2004 to 16.7 per cent in 2010 - Sri Lanka cannot be complacent about the need to push for higher foreign exchange earnings in the midst of a heavier exposure to external debt repayments in the long term. The drop in the exports-to-GDP ratio despite an increase in absolute dollar terms suggests that the higher growth momentum Sri Lanka has been seeing more recently is driven less by an export-push and more by other factors, such as the higher public investment drive in infrastructure, etc. However, given the very limited domestic market, sustained high growth can only be achieved if Sri Lanka raises foreign demand for the country's goods and services.

Thus, the details of macroeconomic policy management as outlined above matter for long term growth. They also matter if growth is to be accompanied by social progress in the country. For instance, sustained growth can help poverty alleviation by not only pulling the poor up into gainful employment, but also by providing larger volumes of revenue to finance targeted social programmes. On the face of it, Sri Lanka appears to have made significant strides in tackling overall poverty in the country and reducing emerging gaps between sectors of the economy. The Household and Income Expenditure Survey (HIES) carried out by the Department of Census and Statistics (DCS) appears to suggest that the poverty headcount index has dropped from 15.2 per cent in 2006/07 to around 8.9 per cent by 2009/10. The most promising is the suggestion that the gap between urban, rural and estate sectors have narrowed in the interim. The results on overall poverty reduction efforts are surprising in view of high price instability that was experienced in the interim years and the economic downturn experienced in 2009. However, the narrowing of inequity between sectors may not be so surprising given the emphasis placed on bridging urban-rural gaps in the government's development thrust since 2005, primarily in infrastructure spending and support to the agrarian sector. Despite the overall narrowing of imbalances, inequities in access to gainful economic opportunities - across different dimensions such as gender, geographic location, sector, ethnicity, etc. - continue to persist. Policies to address these become all the more important in the context of post-conflict reconciliation efforts.

As recently experienced across the world, an inequitable distribution of wealth creates a higher degree of economic insecurity that can often spill over into social unrest during times of acute crisis. Indeed, the global economic turmoil and rising food prices have seen many countries grappling with renewed socio-political tensions. Thus, even as the global economy recovers from a debilitating economic contraction and swelling numbers of unemployed in developed countries, renewed attention is being paid to the issue of inequality. While the gap in wealth between developed and developing countries is narrowing - a result of the latter group growing faster on average than the former - concerns about the chasm between the rich and poor within countries remain.

As Sri Lanka prepares for a spell of rapid growth in the coming years, this may inevitably bring social problems to contend with as well, unless issues of equity are addressed at the outset. The push for higher growth is often accompanied by technological progress. This can raise the relative demand for skilled workers. When the supply of skilled workers fails to keep pace with demand, which is often the case, it can lead to a widening wage gap between skilled and unskilled workers. If, as anticipated, Sri Lanka's economic growth becomes increasingly driven by a higher skilled services sector in the coming years, widening wage gaps can emerge. Additionally, as more and more employment is created in the contractual/informal sectors - where limited incentives are present for employers or the self-employed to invest in training - the lack of skills development can exacerbate structural rigidities in the labour market. Often the most vulnerable segments will be unskilled, female labour.

While there is broad consensus that economic growth is vital for development, it is also recognized that growth alone is not the be-all and end-all of development. In this context, the notion of economic growth that is both sustainable and inclusive becomes an important policy imperative for governments. While these are often fashionable lexicons in policy documents, country-specific contexts demand that they are not ignored. For Sri Lanka, emerging from a costly era of a long drawn conflict, rising socio-economic aspirations must be met to help restore and cement social harmony in its post-conflict development efforts. That calls for economic policies that will not only deliver broad-based rapid growth, but policies that are also sensitive to issues of equity in the distribution of, and access to, resources.

This year's *State of the Economy* report takes as its central theme the notion of 'Post-conflict Growth: Making it Inclusive' to understand the myriad channels through which growth is accompanied by reduction in inequalities. Besides the desirability of inclusive growth from a purely ethical standpoint, from a more practical perspective, inclusiveness is needed for sustaining economic growth, as exclusion leads to underemployment of productive resources that restricts growth.

Access to productive employment is a critical element to drive inclusive growth. It requires improving employability of workers on the one hand and improving access to productive employment opportunities, on the other. On the supply side, improving employability involves access to good quality health, education and other productive assets. On the demand side, improving access to employment requires opening up opportunities in various sectors of the economy in different geographic regions and for diverse types of workers. Initial conditions in an economy - such as levels of poverty and inequality, as well as other exogenous factors such as geography, demography, climate, governance, politics, social considerations and the policy environment - will also play an important role in determining the subsequent growth outcomes. In this context, the rest of this report examines the imperatives for inclusive growth in Sri Lanka across a spectrum of policy areas through a series of chapters and policy discussions.