Sri Lanka
State of the Economy Report 2012

Chapter 1
Policy Perspectives

by
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1. Policy Perspectives

The aftershocks of the 2008/09 global financial crisis are yet to recede. The debt-ridden countries of the European Union (EU) are still struggling to get their economies back on track, whilst the US is seeing only marginal growth since the financial crisis. Emerging economies on the other hand have come out relatively unscathed and spent much of their efforts trying to place a break on growth. Indeed, faltering GDP growth in developed countries is precipitating a rapid convergence of living standards and a shift in economic power from the West to East.

> *For Sri Lanka, the transition to a post-conflict era raises legitimate economic, political and social aspirations that call for a steady and politically harmonious growth process*

Sri Lanka too has been a rising star in emerging market economies, posting a speedy rebound with GDP growth averaging at 8 per cent since the country saw an end to its long-drawn conflict in May 2009. With a GDP growth of 8.3 per cent, an unemployment rate of 4.2 per cent, and an inflation rate of 6.7 per cent by end 2011, Sri Lanka at first glance appears to have weathered the global downturn remarkably well, and positioned itself for sustained growth and stability in the medium term. Higher growth, with a per capita GDP of US$ 2,836 in 2011, has been accompanied by sharp improvements in tackling absolute poverty across the country and falling income inequality, keeping with the government's stated development objectives of rapid and equitable growth.

Sri Lanka's most obvious development achievements in its post-conflict phase of growth have been in the areas of infrastructure. Infrastructure development has been driven by an ambitious public investment programme that has seen the country's public investment-to-GDP ratio climb to an average of 6.0-6.5 per cent from the more typical range of 4.0-4.5 per cent, seen over the last decade. Whilst this shift has been accompanied more recently with a better mix of fiscal consolidation efforts -- focused more on cutting current spending than on axing investment and raising taxes -- there has also been a greater reliance on foreign private capital to meet Sri Lanka's development programmes.

Greater reliance on such sources of funding may be inevitable, as the country climbs up the rank of middle income countries, whereby traditional sources of overseas development assistance (ODA) funding for large scale infrastructure projects are on the wane. However, in the case of Sri Lanka, the uptake of costlier funds has been swift in order to meet post-conflict development aspirations. The share of non-concessional loans and commercial borrowing in Sri Lanka's outstanding foreign debt has increased sharply from 7.3 per cent in 2006 to 42.9 per cent in 2011. Indeed, in July 2012, Sri Lanka announced the issuance of a fresh US$ 1 billion Sovereign Bond, the fifth since the country started to tap the international capital market. Dependence on such foreign capital to finance public expenditures necessarily imposes constraints on domestic policy options on the macroeconomic front. Indeed, as noted in the 'Sri Lanka: State of the Economy 2011' report, "foreign currency denominated debt carries well-known additional risks, especially in relation to the exchange rate…the trade-off between fiscal conditions and exchange rate management can constrict a country's macroeconomic space considerably."

Such stresses and strains on the economy were clearly evident in the second half of 2011. Sri Lanka's financial market had swung sharply from an environment of excess rupee liquidity in the beginning of 2011, to constrained liquidity conditions by the third quarter of 2011. Excess rupee liquidity was created as the Central Bank of Sri Lanka (CBSL) stepped up intervention in the foreign exchange market to prevent an undue appreciation of the currency on the back of significant higher inflows of foreign capital. The relaxed monetary policy regime in turn fuelled a mini credit boom -- with credit to the private sector growing at 34 per cent - draining liquidity in the financial market and leading to upward pressure on interest rates.

Despite evidence of a sharply deteriorating external current account deficit, driven by a surge in imports fuelled by access to relatively cheap credit and an over-valued exchange rate, the CBSL continued to hold policy interest rates steady and resorted to reverse intervention in the foreign exchange market to ensure that the rupee stays within a pre-determined band. In doing so, Sri Lanka also saw its accumulated gross official reserves -- a large component of which is borrowed liabilities -- fall from a peak of US$ 8 billion in July 2011 to US$ 5.5 billion by February 2012 in defense of the currency. The policy strategy was reminiscent of what followed in 2008 which eventually saw Sri Lanka approach the International Monetary Fund (IMF) for a Stand-By Arrangement (SBA) for balance of payments (BOP) support in February 2009.

With the SBA yet to be fully disbursed, policy corrections were put in place in February 2012, allowing the exchange rate to move in line with underlying economic fundamentals, adjusting policy interest rates and imposing a ceiling on credit growth of commercial banks. Whilst the policy corrections were in the right direction bringing some long-awaited adjustments, they did involve a cost. As opposed to a more gradual depreciation of the currency, the sudden policy shift saw the rupee depreciate by over 20 per cent with significant overshooting and volatility as would be expected. Attempts to force the pace of credit growth too, lead to financial resource misallocation that Sri Lanka can ill afford. More critically, uncertainty in movements of key macroeconomic indicators destabilizes investor confidence in policy, as well as the near term outlook for the economy.

Thus, Sri Lanka needs to be more sensitive to the risks of undermining its long term growth objectives and be more circumspect in implementing prudent and timely policy interventions. Competent management of the macroeconomic environment is all the more critical in an era of increased reliance on foreign capital and global economic uncertainties that makes the country more vulnerable to periodic BOP stresses.

The upshot of efforts to regain macroeconomic stability is that the country will see a slowdown in its targeted GDP growth for 2012. Not surprisingly, the tighter monetary policy stance and subdued global demand saw the CBSL revise Sri Lanka's GDP forecast down to 7.2 per cent for 2012. This should not be a cause for alarm; a lower growth target in an environment of macroeconomic stability is to be preferred to one of high growth accompanied by unsustainable macroeconomic fundamentals.

While economic growth alone should not be the sole yardstick by which governments attempt to gain legitimacy, growth does matter. Rapid growth over a period of years allows countries such as Sri Lanka to grow from low income levels to middle-income status. The trickier part is to ensure that the growth process is sustainable and inclusive. This is particularly so for a country emerging from a prolonged and divisive conflict. For Sri Lanka, the transition to a post-conflict era raises legitimate economic, political, and social aspirations that call for a steady and politically harmonious growth process.

The available evidence suggests that much has already been achieved in bridging sectoral and regional disparities. Higher growth has been accompanied by sharper declines in poverty across the more disadvantaged estate and rural agriculture sectors, relative to the better off urban areas of economic activity. Nonetheless, socio-economic disparities do persist across provinces and population groups in the country. While Sri Lanka has seen a reduction of inequality at the aggregate level over recent years, more than a half of income is still received by the richest 20 per cent of households.

Income inequality captures both vertical inequality among individuals or households, and horizontal inequality across economic, social and political groups with common identities such as ethnicity, caste, gender and location. The extremes of the equity spectrum -- perfect equality or perfect inequality -- are both inimical to growth. For most countries, inequality lies somewhere between these two, and impacts on their efforts to maximize growth, dependent partly on specific country contexts.

More recent literature finds that inequality may shorten growth duration. For instance, it can make it difficult for the poor to invest in education and health and improve their economic opportunities. At the same time, the evidence cautions against distortionary incentives to address inequality. Poorly designed efforts can be more harmful to growth than inequality per se. On balance, promoting policies that maximize the use of productive resources can tilt the scales towards the notion that attention to inequality can bring significant long run benefits for growth. What is also perhaps critical to the argument is emerging evidence that suggests that for developing countries, longer growth spells -- as opposed to rapid growth spells -- are associated with more equality in income distribution. Thus, sustaining a country's long term growth momentum is vital.

For Sri Lanka, the sources of faster growth in recent years have been kick-started, not surprisingly, by the government. There has been a remarkable strengthening of the country's infrastructure development programmes, making up for decades of underinvestment. Better infrastructure in roads, ports, airports, etc., that will improve running costs and cut-down on delays will filter through to all parts of the economy and bring gains in efficiency. Even as the rapid expansion of the country's physical assets bode well for longer term growth prospects, the multiplier effects of the infrastructure boom is also providing an immediate boost to current growth. In 2011, construction activities grew by 14.2 per cent, and by 17.9 per cent in the first half of 2012. The momentum will continue for some time yet, but it would be prudent to desist from extrapolating long term growth targets based on growth rates of the recent past.

Linear extrapolations do not factor in policies, the role of government, the state of market, and regulatory institutions that will determine long term growth dynamics. Indeed, factors that spur growth at one phase of development might impede it at another. Infrastructure financing -- maintaining existing infrastructure as well as new investments -- is costly. Sri Lanka has opted to rely on foreign savings to finance a large bulk of its new infrastructure needs. However, as already discussed, accumulating non-concessional external public debt poses other risks and should only be seen as a last resort.

Domestic resource mobilization efforts stand high on the policy agenda for sustaining stable long term growth. Sri Lanka has fared poorly in these efforts, the country's revenue-to-GDP ratio has declined progressively over the last two decades to stand at 14.2 per cent in 2011 relative to a low-middle income average of 20 per cent; Sri Lanka's domestic saving ratio stood at 15.4 per cent in 2011. Aside from the possibility that socio-cultural norms play a role -- i.e., that Sri Lankans lack a culture of savings -- the country's macroeconomic environment over the decades has also not helped. A high inflationary environment has been a habitual feature of the economy, discouraging saving and rewarding borrowing. In addition, the country's current demographic transition -- a rapidly ageing population with fewer earners and a larger proportion of dependents -- will, over time, work against Sri Lanka's long term growth aspirations. In the absence of savings, and adequate social security, the elderly will depend on the younger generations for support. In such instances, ageing can reduce the ability of younger workers to save as they have to support older adults longer.

The flip side of low domestic savings is high consumption spending. In 2011, total consumption was 84.6 per cent of GDP in Sri Lanka. Consumption spending has been a source of faster growth in recent years; indeed, the sector-wise exposure of the banking sector shows consumer lending to have grown by 60 per cent by December 2011. Again, the overall macroeconomic environment -- movements in inflation, interest rates and exchange rates -- has a bearing on the behaviour of savers and borrowers. It is important, therefore, to have prudent policies in place that will strike an appropriate balance between consumption and investment, foreign and domestic demand.

In a low savings and investment environment with a dwindling working age population, aside from attracting underutilized population groups such as youth, females and elderly into the labour force, only productivity gains will support long term growth. The ability of low-productivity sectors such as agriculture to support Sri Lanka's growth is of particular concern, especially in view of its role as an important source of employment in the country, as well as being at the core of some socio-economic parameters that go beyond growth, such as food security and poverty reduction. Indeed, the global food crisis of 2008 highlighted the merits of having a strong domestic food production sector in a low-middle income country like Sri Lanka – currently providing 85 per cent of the country's food requirement -- under conditions of growing volatility in world commodity markets.

Still, however, the challenges to raising productivity in the agriculture sector are many. Expanding the extent of agricultural land operated, or intensifying operations in a given extent of land often comes at the expense of exploitative land and forest usage, leading to natural resource degradation that can in turn, impede sustainable long term growth. Ensuring productivity gains in agriculture call for new technology, generated through sustained investment in agricultural research and extension. Sri Lanka has done poorly in this regard over recent decades.

Ensuring that the economy overall enjoys total factor productivity growth -- the efficiency with which workers and capital are used -- means facilitating a structural transition of shifting the often underemployed rural labour to more productive and better paid jobs. With the country's rate of unemployment at 4.2 per cent and future demographic developments that suggest a shrinking working age population, sustaining higher long term growth will critically depend, among other factors, on the availability of a skilled, productive, and flexible workforce.

The importance of a skilled workforce for staying competitive and attracting investment and business is now well recognized. The demand for routine manual and cognitive tasks that are easily computerized are reducing, while the demand for complex communication and expert thinking types of jobs are increasing. If Sri Lanka is to develop and manage the available human resources in the country to ensure that people enter work equipped with the skills demanded by firms, improving access to high quality tertiary level education, and training workers who are able to learn new skills, are critical areas for policy attention. The present tertiary education sector is found to be inadequate, narrow in scope, and of low quality for a middle-income country. Clearly, changing the education system and structures will run up against opposition, as already evident from efforts to introduce a Higher Education Bill -- officially titled the Higher Education Quality Assurance, Accreditation and Quality Framework Bill -- to pave the way for a quality assurance and accreditation framework. As Sri Lanka's population ages and workers become more expensive, reforming the country's education system cannot be ignored for too long. As already mentioned, current demographic and labour force trends are working against the country's long term growth objectives.

Education reform, though essential, will take time to implement and produce results. In the interim, complementary strategies to promote innovation and entrepreneurship can produce faster results. An innovation policy constitutes those elements of science, technology and economic policy that explicitly aim to promote the development, spread, and efficient use of new products, processes, services, and business or organizational models. Fostering innovation and entrepreneurship improves the chances of sustaining productivity growth in an economy.

Sri Lanka's share of GDP to research and development (R&D) is poor. The available figures suggest it is as low as 0.1 per cent of GDP when compared with the globally recommended value for developing countries of 1 per cent. Despite stated policy intentions to raise this to 1.5 per cent of GDP by 2016, more needs to be done to put in place a holistic innovation policy that will bring together entrepreneurs and different organizations within the so-called 'innovation system,' such as universities, public laboratories, banks, business chambers, and other enterprises. Unless Sri Lanka improves its training in advanced science and technology related subjects, and develops skills in problem solving and creativity, it will exhaust the gains from adopting existing 'catch-up' technology without leaving much room for further productivity gains.

The environment in which many of these sorts of transitions take place is strongly influenced by broader factors such as the quality of institutions and governance in a country. Be it the promotion of private-public partnerships (PPPs) in driving innovation through pioneering institutions such as the Sri Lanka Institute of Nanotechnology (SLINTEC), greater private sector participation in government infrastructure programmes, or a circumspect management of the macroeconomic environment, institutional and governance aspects are important enabling conditions. It is an acknowledged fact that the socio-political and economic characteristics of a particular country matters in the interactions between institutions, policy process, and policy outcomes.

These issues have come to the fore with the rise of China and the renewed arguments about the relative merits of the state and the market. 'State capitalism' has entered the lexicon, describing a state that has the competency and capacity to use capitalist tools to achieve sustained economic growth. The Sri Lankan state too, is more vigourously involved in the economic sphere of late, through an ambitious public investment programme and the re-entry of previously privatized state owned enterprises (SOEs) into the government fold. However, there, the comparisons largely end. Sri Lanka, for instance, does not follow the Chinese footsteps of retaining the public structure in SOEs while functioning as a competitive firm. PPPs may be an alternative to improve productivity and efficiency, private investor entry is more likely to weed out politically expedient but financially unsound projects from being implemented. If PPPs are to be the way forward in Sri Lanka, building effective regulatory agencies is the prime catalyst to attracting private investment, and here too, Sri Lanka lags behind in establishing the required formal institutions.

What is clear from the preceding discussion is that there has to be coherence in the design of policies on several fronts, so that they add up to a plausible overall growth strategy. The opportunities and challenges for Sri Lanka are many: to leverage the global economy to accelerate growth and insulate it from external shocks; use its human resource endowment to avoid the stasis that can trap countries at middle-income level; manage and enhance the social mobility that comes with higher per capita income growth; and build institutional and governance structures that not only deliver sustainable growth, but also engineer social cohesion in the country. The road to sustained and equitable growth will not be easy -- it will take time, and there will be setbacks -- but Sri Lanka should press ahead. Ultimately, the political commitment and the nature of the political leadership will define the country's transition to meet the legitimate aspirations of its people for better living standards.

These and other issues pertinent to the debate on opportunities and challenges to accelerate growth in Sri Lanka will be discussed in the rest of the report.

1. ප්‍රතිපත්ති දෘෂ්ටිකෝණයන්

2008/2009 වර්ෂයන්හි ඇති වූ ආර්ථික අර්බුදයේ පසු කම්පන තවදුරටත් නොනැසී පවතී. යුරෝපානු සංවිධානයේ රටවල් එනම් ණය බරින් පීඩිත රටවල් ඔවුන්ගේ යහපත් ආර්ථික තත්ත්වයට නැවත පිවිසීමට වෙර දරන අතරතුරදී ආර්ථික අර්බුදය හේතුවෙන් ඇමරිකා එක්සත් ජනපදය ආන්තික වශයෙන් පමණක් ආර්ථිකමය වශයෙන් වර්ධනයක් පෙන්නුම් කරයි. අනෙක් අතට දියුණු වෙමින් පවතින ආර්ථිකයක් ඊට සාපේක්ෂව නොනැසී පැවති අතර ආර්ථික වර්ධනයෙහි සැලකිය යුතු කාර්ය සාධන ලබා ගැනීමට වෙර දරමින් සිටී. නිසැක වශයෙන්ම සංවර්ධිත රටවල විචලනය වන දළ දේශීය නිෂ්පාදිත වර්ධනය පුද්ගලයන්ගේ ජීවන තත්ත්වය පහත හෙළීමට හේතු වී ඇති අතර එය ආර්ථික බලය බටහිර සිට පෙරදිගට ගෙන යෑමට ද හේතු වී ඇත.

ශ්‍රී ලංකාවද දැනට පවතින වෙළඳපොළ ආර්ථිකය තුළ නැඟී එන තරුවක් බවට පත් වී ඇති අතර, 2009 වර්ෂයේ මැයි මාසයේදී දීර්ඝ කාලීනව පැවති සිවිල් යුද්ධ තත්ත්වය නිමා වීමත් සමඟ දළ දේශීය නිෂ්පාදිතය සාමාන්‍ය වශයෙන් 8% ක් ලෙස වාර්තා කොට ඇත. 2011 වර්ෂයේ අවසානයේදී දළ දේශීය නිෂ්පාදිත වර්ධනය 8.3% ක් ද, විරැකියා අනුපාතය 4.2% ද උද්ධමනය 6.7% ක් ද පෙන්නුම් කරමින් ශ්‍රී ලංකාව සුවිශේෂී වශයෙන් ලෝක ආර්ථිකමය අවපාතයකට ළඟා වීම අභිබවා මධ්‍යස්ථ මට්ටමෙන් ආර්ථික වර්ධනයේ තිරසරබව හා චිරස්ථායී බව තහවුරු වී ඇත. 2011 වර්ෂයේදී ඒක පුද්ගල ආදායම ඇමරිකානු ඩොලර් 2836 පෙන්නුම් කරමින් ද, ඒ සමඟම රටේ නිරපේක්ෂ දරිද්‍රතාවය පහත හෙළමින්, ආදායම් විසමතාව අවම කරමින් ද ශීඝ්‍ර හා චිරස්ථායී ආර්ථික වර්ධනයක් ළඟා කර ගැනීම සම්බන්ධ රජයේ අභිප්‍රායන් මූලික කොට ගනිමින් ඉහළ ආර්ථික වර්ධනයක් ළඟා කර ගෙන ඇත.

සිවිල් යුධ තත්ත්වය නිමා කිරීමත් සමඟ ශ්‍රී ලංකාවේ කැපී පෙනෙන සංවර්ධනයක් පෙන්නුම් කරනුයේ යටිතල පහසුකම් සම්බන්ධයෙන් ය. යටිතල පහසුකම් සංවර්ධන ක්‍රියාදාමය නිශ්චිත ඉලක්කයන් සමඟ වූ පොදු ආයෝජන වැඩසටහනක් මඟින් ක්‍රියාත්මක කරනු ලබයි. දළ දේශීය නිෂ්පාදිතයේ 6.0 - 6.5 අතර වර්ධනයක් පෙන්නුම් කරමින් යටිතල පහසුකම් සංවර්ධනය සම්බන්ධයෙන් රාජ්‍ය ආයෝජනය ඉහළ අගයක් පෙන්නුම් කොට ඇති අතර එය පසුගිය දශක කිහිපය තුළ ඒ හා සම්බන්ධයෙන් පෙන්නුම් කළ 4.0 - 4.5 වඩා වැඩි අගයක් දක්වයි. මෙම වර්ධනය මෑත කාලීන වශයෙන් ශ්‍රී ලංකාව එළැඹි ආදායම් තහවුරු කර ගැනීම සඳහා වූ ප්‍රයත්න සමඟ ඉතා හොඳින් මුසු වී ඇති අතර, එවැනි ප්‍රයත්නයන් ආයෝජන හා බදු වැඩි කිරීම යන කරුණු පිළිබඳව සෘණාත්මක තීරණ නොගෙන පුනරාවර්තන වියදම් කපා හැරීම සම්බන්ධයෙන් වැඩි වශයෙන් යොමු වෙමින් එම තත්ත්වය ඉටු කර ගෙන ඇති අතර ශ්‍රී ලංකාවේ සංවර්ධන ව්‍යාපෘති සාක්ෂාත් කර ගැනීම සඳහා විදේශ පෞද්ගලික ආයෝජන වෙත දැඩි විශ්වාසයක් තබා කටයුතු කොට ඇත.

අප රට මධ්‍යම ප්‍රමාණයේ ආදායම් ලබන රටක් වශයෙන් දියුණු වී තිබීම හේතුවෙන් මහා පරිමාණ යටිතල පහසුකම් සම්බන්ධ ව්‍යාපෘති සඳහා විදේශ සංවර්ධන සහයෝගිතාවය (ODA) වැනි පාරම්පරික ක්‍රියා විධීන් හීන වී ගෙන යයි. එවන් අවදියක මෙසේ මූල්‍ය පිළිබඳ විශාල විශ්වාසයක් තබා කටයුතු කිරීම නොවැලැක්විය හැකි කරුණක් වේ. කෙසේ වෙතත් ශ්‍රී ලංකාව සහනදායී නොවන විදේශ ආධාර ලබා ගැනීම කඩිනම් වී ඇත්තේ පශ්චාත් යුධසමයේ පසු සංවර්ධන අරමුණු මුදුන් පමුණුවා ගැනීමේ අරමුණෙනි. 2011 වර්ෂයේදී ශ්‍රී ලංකාවේ කැපී පෙනෙන විදේශ ණය ලෙස පෙන්නුම් කළ හැකි සහනදායි නොවන ණය හා වානිජ ණය සම්බන්ධයෙන් සලකන විට 2006 වර්ෂයේ පැවති ප්‍රතිශතය වූ 7.3% සිට 2011 වර්ෂය වන විට 42.9% දක්වා සුවිශේෂී වර්ධනයක් පෙන්නුම් කරයි. 2012 වර්ෂයේ ජූලි මාසයේදී ශ්‍රී ලංකාව විසින් ඇමරිකානු ඩොලර් බිලියන 1 ක රන් ණයකර නිකුත් කරනු ලැබූ අතර එය ජාත්‍යන්තර ප්‍රාග්ධන වෙළඳපොලට ලංකාව පිවිසීමෙන් පසු ණයකර නිකුත් කළ පස්වෙනි අවස්ථාවය. රාජ්‍ය වියදම් සඳහා එසේ විදේශ මූල්‍ය කෙරෙහි පවතින පරාදීනත්වය සාර්ව ආර්ථිකයේ දේශීය ප්‍රතිපත්ති සම්බන්ධයෙන් නිසැක වශයෙන් බලපෑම් ඇති කරයි. මෙම කරුණු "ශ්‍රී ලංකාවේ 2011 රාජ්‍ය ආර්ථික තත්ත්වය" නැමැති වාර්තාවේ මෙසේ සඳහන් වේ. "විදේශ ණය අප