Sri Lanka
State of the Economy Report 2013

Chapter 1
Policy Perspectives

by
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1. Policy Perspectives

Nearly five years since the onset of the global economic downturn in 2008, the global economy is still faltering. While, it is not unusual for the recovery from a debt-fuelled crisis of this nature to be protracted, as households, firms and governments deleverage, what has been especially disconcerting is the continual unraveling of new crises which dampen confidence worldwide. Expectations of a smooth and linear recovery have been discarded. Questions are emerging about a 'new normal' setting in – a prolonged period of subdued growth in the developed world – where the underlying growth rate appears to be far below the trend rate seen before the financial crisis.

Physical infrastructure is only part of the arsenal the Sri Lankan economy needs to make a strong middle income transition. Social infra-structure will determine the quality of the country's workforce that truly drives growth

The sluggish recovery in 2012 was disrupted by intermitted crises on various fronts.

In the Euro area, austerity pressures, and sovereign debt problems coupled with political inertia resulted in a GDP contraction of 0.4 per cent. Many Euro zone governments, which have been compelled to push stronger austerity measures due to conditionalities of bailout packages, are facing stiff opposition from their citizens. The picture in Europe remains bleak. Unemployment across the region remains high, the region's economies continue to contract, and bank lending remains feeble. A major policy initiative that had contributed to improving confidence in the Euro – the European Central Bank's (ECB) Outright Monetary Transactions (OMT) scheme – is being challenged by German courts on constitutionality grounds.

Meanwhile, the United States (US) economy grew by 2.3 per cent in 2012 off a low base, but political gridlock remains a challenge to stimulating further growth. Yet, the US economy continues to show signs of recovery with job creation in the six months, to April 2013 being 50 per cent higher than in the previous six months, on average. Job creation has been steady in recent months and has helped bring down the unemployment level to 7.6 per cent, despite a decline in public sector employment. There is speculation that by the latter part of 2013, the US Federal Reserve is likely to begin cutting back bond sales, i.e., rolling back the third wave of quantitative easing (QE3) indicative of the Fed's confidence of US economic recovery.

In both these regions, the debate over austerity versus stimulus has created a challenging, and often acrid, political economy climate. This has further hurt medium term confidence among consumers, companies, and financial markets, that central banks and governments can 'put the economic show back on the road' after big global shocks.

Even emerging economies experienced a moderation of growth in 2012, although they demonstrated partial 'decoupling' in the recovery period prior to this. The dependence of emerging economies on weak markets in the West depressed economic growth in those countries too. Domestic policy issues also played a role, causing 'self-inflicted wounds' as in the case of India's back and forth on a new Foreign Direct Investment (FDI) regime. Compared to the highs in 2010 and 2011, China grew at 7.8 per cent in 2012, whilst India grew at a very weak 4.5 per cent. Meanwhile, the Middle East recovered from the growth disruptions faced in 2011 stemming from the political upheaval in that year, to grow at 5.2 per cent in 2012.

Some governments appear to be doing something more decisive about this than others. For instance, China's 12th Five Year Plan clearly indicates pro-market reforms and policies to generate greater domestic demand as a way to stimulate growth. It contains a focus on urbanization and services sector development, as well as a shift from the low-cost model to greater technological intensity and innovation. Around September 2013, there is likely to be important pronouncements by China regarding the future directions of economic policy – a customary event following a change of leadership. By contrast, India is in policy paralysis with the incumbent government unable to forge ahead on important structural reforms that would put the country on a sustained growth footing. The Indian economy has faltered recently, with growth slowing down, and fiscal and current account deficits running high amid persistent inflation. Meanwhile, the looming elections in 2014, with no clear outcome, adds to the current uncertainty.

This challenging external economic climate did place a drag on Sri Lanka's economy too, but the country remained an impressive performer amidst the highly subdued growth seen both in the developed and developing world.

After posting impressive growth rates of over 8 per cent in the two years following the end of the conflict, growth in 2012 moderated to 6.4 per cent. Following economic overheating in the second half of 2011 – evidenced mainly by a rapidly expanding trade deficit – the government undertook a series of adjustment measures in early 2012. These came in the form of higher interest rates (with a credit ceiling on bank lending), allowing flexibility on the exchange rate, tax hikes on a major import item (cars), and higher energy prices (through allowing greater pass-through and a cut in subsidies). Coupled with adverse weather that affected agriculture, growth moderated considerably.

As 2012 progressed, the country saw a sharp decline in both exports and imports. The former was due to the weak health of destination markets of Sri Lanka's exports and the lower prices of key commodities like cotton and rubber which depressed export prices. The latter was due to the rupee depreciation, tighter credit conditions and duty hikes which curbed import demand, and also lower world commodity prices. The tighter credit conditions were a central feature of the 2012 growth slowdown in the country. Credit to the private sector saw a sharp decline throughout 2012 in response to the credit ceiling imposed by the Central Bank of Sri Lanka (CBSL) and higher policy interest rates.

Before policy corrections took full effect, the policy rate was reduced by CBSL in December 2012, and the credit ceiling was lifted in January 2013. Credit demand by the private sector still remained highly subdued. The relatively high interest rates and temperate economic growth appears to have eased credit demand by the first quarter of 2013. Lending to the private sector in January 2013 of Rs. 9.7 billion was less than one-fourth that of a year earlier (Rs. 44.5 billion).

Policy rate cuts have remained so far 'sticky', i.e., not translated into lower bank lending rates. Commercial lending rates showed initial signs of declining as the Average Weighted Prime Lending Rate (AWPLR) stayed below 14 per cent since mid-March. It may not be surprising that commercial lending rates have been so sticky considering the significant volumes of government activity in the market, coupled with lacklustre private sector credit demand. In the first quarter of 2013, the government accepted Rs. 406 billion in bond and bill auctions, compared to Rs. 146 billion in the same quarter last year. This reduces supply of funds to lend to the private sector and keeps interest rates up. Since mid-March 2013, however, Treasury bill and bond auctions have been smaller in magnitude.

An emerging trend to watch, that would influence these rates, is commercial banks tapping cheaper off-shore sources of capital. In both early 2012 and again in early 2013, the CBSL steadily relaxed restrictions on foreign exchange transactions for Licensed Commercial Banks (LCBs) and local companies. By 2013, the CBSL had introduced an 'External Commercial Borrowing Scheme' to encourage foreign borrowings by companies for investment and business purposes. Several local banks took advantage of this and raised a total of US$ 973 million in long term dollar loans in 2012. While this no doubt helps address domestic credit shortfalls and supports private sector expansion as there is less competition for funds, it does throw up new risks associated with a greater exposure to external shocks by non-sovereign entities like commercial banks and private businesses. Additionally, the experience of the sudden rupee devaluation would have left a sour after taste among some of the private sector and it is unclear how many of them will seek to borrow from foreign sources. Many Sri Lankan corporate entities faced the impact of currency devaluation in early 2012 on the carrying value of their foreign currency denominated assets and liabilities.

While encouraging private sources of foreign borrowing in to the country, the CBSL has indicated that it will not tap foreign capital markets for borrowings this year. The recent strategy seems to be towards retiring short term debt and going for longer term debt, with over Rs. 13 billion worth of 20 and 30 year bonds issued in May 2013.

Higher domestic borrowing may cause further crowding out domestically, not to mention inflationary pressures. There is a heightened risk to inflation from both a demand and supply perspective. If market rates correct and the CBSL aggressively coerces private sector credit growth, demand side inflationary pressure would edge up.

On the other hand, the utilities price correction would heat up inflation from the supply side, albeit to a lesser extent.

For now, however, the CBSL appears to consider that there exists room for further relaxation of monetary policy on account of moderate inflationary pressure (aside from a one-off adjustment to prices from electricity tariffs), owing to subdued economic activity and a fairly stable rupee. In May 2013, it undertook a further policy rate cut of 50 basis points and by June market interest rates were seen to be edging downward. Yet borrowing costs remained sticky. Responding to this, the CBSL undertook further easing by cutting the Statutory Reserve Requirement (SRR) of commercial banks by 2 per cent in late June 2013, in a bid to boost liquidity.

However, attempting to use monetary policy to revive economic growth will come up against fiscal constraints.

At first glance, Sri Lanka's debt-to-GDP ratio has reduced from the highs of over 100 per cent in the early 2000s to around 80 per cent in the past three years. Yet, this is largely attributable to the rapid growth of nominal GDP in the immediate post-conflict period and an unrealistically pegged nominal exchange rate. While it remains below any alarming level, it is still relatively higher than many emerging market economies – China at around 20 per cent, India at around 70 per cent, Turkey at around 40 per cent, and Brazil at around 64 per cent. The slight edging up seen in 2012 to 81 per cent, from 78.5 per cent in 2011 is largely on account of the depreciation of the rupee in that year.

Within overall government debt, Sri Lanka's changing external debt profile warrants closer inspection. While Sri Lanka's external debt-to-GDP ratio has remained unchanged for the most part over the last few years (at around 36 per cent), the composition of this external debt matters. As noted in 'Sri Lanka: State of the Economy 2012' report, "the share of non-concessional loans and commercial borrowing in Sri Lanka's outstanding foreign debt has increased sharply". In fact, it rose from 7.3 per cent in 2006 to 50.5 per cent in 2012.

Following the conclusion of the Stand-By Arrangement (SBA) programme with the International Monetary Fund (IMF) in 2012, it appears that there will be no further financial support to Sri Lanka from the agency. The CBSL announced that it will not pursue an Extended Fund Facility (EFF) with the IMF. Whilst there is no need for further balance of payments support at this point in time, an extended formal relationship with the IMF could provide comfort and confidence to markets (particularly bond market investors).

Meanwhile, requests by the Treasury to the IMF for a 'budgetary support' programme, instead of an EFF, were declined. Subsequent to Sri Lanka's move into middle-income status, the World Bank's support too is increasingly coming in the form of 'budgetary support'. Yet, the IMF's traditional role is in providing balance of payments support and 'budgetary support' is typically an extraordinary form of assistance provided to countries during times of distress, when it is unable to tap international capital markets. The IMF's rejection of the request is not unusual, as Sri Lanka is not in such a position.

In fact, the situation is quite the opposite. Sri Lanka has been successful in tapping international dollar-denominated bonds. The strategy of CBSL up to 2012 has been to retire high cost domestic borrowings with cheaper foreign borrowings. Dollar-denominated bonds issued between 2009 and 2012 have been at around half the rate of domestic loans, and have regularly seen a reduction in yields – 7.4 per cent in 2009 (due in 2015), 6.25 per cent in 2010 (due in 2020), 6.25 per cent in 2011 (due in 2021), and 5.88 per cent in 2012 (due in 2022). The most recent bond in July 2012 at the low 5.87 per cent was substantially tighter than the initial price guidance of 6.12 per cent and lower than the 6.25 per cent rate on similar-dated debt a year earlier. Sri Lanka maintained its sovereign credit ratings by agencies like Fitch (BB- stable), Moody's (B1 positive) and Standard and Poors (B+ stable) in 2012, when a host of other countries saw their ratings decline (for instance, South Africa, Cyprus, Spain, Portugal, and France). In early July 2013, though, Moody's downgraded its rating from B1 positive to B1 stable citing the lead reason as "a decline in the strength of the external payments position in the past two years".

With rising external liabilities, and resultant higher foreign debt service outflows, foreign exchange inflows need to rise to support it. But this requires a focus beyond remittance inflows to the critical role that export earnings play. This focus has been lacking recently and Sri Lanka's export performance is disconcerting.

An important part of sustaining growth through a transition to middle-income status and beyond is being more open to the global trading system. Sri Lanka was a leader among its regional peers when it liberalized its foreign trade regime in 1977. With crop processing like tea, rubber and coconut, as well as high quality ready-made garments leading the way, the trade-to-GDP ratio had increased to over 80 per cent by 2000. However, Sri Lanka seems to have regressed of late. By 2010, this ratio had almost halved, to 44 per cent. Sri Lanka's exports-to-GDP ratio fell from around 33 per cent of GDP in 2000 to 16.4 per cent in 2012. The Sri Lankan economy is now trading less and less with the world, and this has been accompanied by a fall of Sri Lanka's share of exports in total world trade.

Evidence suggests that Sri Lanka's total effective rate of protection is higher now than in any previous post-liberalization period. This substantial decline in trade openness has occurred at a time when the rest of the world is integrating more and more, global trade is accelerating, and most countries are making an aggressive push towards bilateral and regional preferential trading arrangements.

Recent trends do not bode well either. In 2012, Sri Lanka's exports contracted by 7.4 per cent across all segments (except mining). The latest results from the first half of 2013 showed a 4.5 per cent contraction, with industrial exports declining by 4.7 per cent. During the same period, Sri Lanka's competitors like Bangladesh and Vietnam increased their exports, by 16.2 per cent and 19.7 per cent, respectively. So, clearly, only a part of Sri Lanka's export performance can be attributed to the weak global economic climate, and depressed demand in Sri Lanka's key markets. The other half of the story is more ominous. Sri Lanka has not been successful in expanding its export markets through both bilateral and regional trading arrangements, as well as through enhanced competitiveness.

This focus away from export-led growth has manifested itself in a changing structure of the economy. Much of the sources of growth in the post-conflict years have been both directly from domestic non-tradable sectors like construction (infrastructure development) and retail, as well as the tourism sector, and indirectly through foreign worker remittances. It is understandable that following decades of constraint during the conflict, non-tradeables like construction and retail would see a natural boost. But literature suggests that countries which successfully navigated the middle-income transition, saw their tradeables sector grow much faster than non-tradeables.

Dependence on remittances, for instance, seems to be an on-going strategy of the government to bridge shortfalls from export income. Noteworthy, then, is the tapering down of the year-on-year growth in remittances since October 2012. In fact, in May 2013 remittances recorded a monthly decline of 3.4 per cent. This would certainly be an area to watch, when considering the country's balance of payments stability, as remittances alone were responsible for covering 64 per cent of Sri Lanka's overall trade deficit in 2012.

A report on sustained economic growth by the Independent Commission on Growth and Development (2008), highlighted some specific areas that helped a set of some thirteen countries achieve 8 per cent plus growth and sustain it over a long period. While it is not prudent to draw direct policy implications from the experience of these countries, some overall common characteristics are worth noting. A key ingredient of their sustained growth was a tempering of macroeconomic volatility and uncertainty during their most successful periods, which helped raise private sector investment rates (domestic and foreign). Macroeconomic uncertainty has long been a key source of concern for the private sector in Sri Lanka, and regularly ranks high on business climate assessments. This is especially true of public finances and the budget deficit.

Of course, Sri Lanka has made steady improvements in the past several years. Inflation has remained in single digits for over four years, and a commitment to maintaining a narrow budget deficit appears strong. Under the watch of an IMF SBA since 2009, the overall fiscal outcomes in the last few years have been positive. The fiscal deficit was reduced from 9.9 per cent of GDP in 2010 to 6.9 per cent of GDP in 2011. It was further reduced to 6.4 per cent in 2012 (albeit slightly above the targeted 6.2 per cent). Concerns over the country's fiscal footing still remain, however, stemming both from the expenditure and revenue sides.

It was assumed that a stronger economy and continued political stability will provide the strong incumbent government the necessary elbow room to undertake critical reforms, which would put public finances on a further healthier footing. Yet, it appears that the commitment to such reforms has been rather lacklustre, both on the expenditure and revenue sides.

On the expenditure side, the biggest drain on the exchequer continues to be the loss-making state-owned enterprises (SOEs). The SOEs in the energy sector are particularly under the spotlight at present, following controversial moves to substantially revise electricity tariffs in mid-2013. The financial position of the Ceylon Electricity Board (CEB) has deteriorated dramatically in the past five years – with losses increasing from around Rs. 15 billion in 2006 to over Rs. 60 billion in 2012. The amount the government spent propping up the electricity sector in 2012 is almost double the Rs. 36.5 billion spent on the largest explicit subsidy -- fertilizer. Unpaid dues by the CEB to the Ceylon Petroleum Corporation (CPC) worsen this, and result in the two energy SOEs being entangled in a vicious cycle of loss-making.

Although tariff increases requested by the CEB were approved by the multi-sector regulator, the Public Utilities Commission of Sri Lanka (PUCSL), would have considerably stemmed (but not eliminated) the hemorrhaging of public funds, much of it was reversed after early May 2013. This move was seen as a significant blow to the policy reform process, as the independent regulator tasked with bringing the energy sector back to cost-reflectivity and profitability was severely undermined. The initiative seen in early 2012, in introducing tough but necessary adjustment measures, was missing this time around as reform imperatives were overtaken by political ones.

Sri Lanka cannot keep postponing bold and essential reforms to the energy sector. Evidence both domestically and internationally suggests a strong relationship between electricity supply and economic growth. Sri Lanka's ambitions of rapid growth towards middle-income status would certainly be hampered by insufficient and costly energy supply. Estimates suggest that a further 100MW of electricity is required to be added to the grid each year to meet the annual demand of the country, which is set to nearly double from around 9,286 GWh in 2010 to 17,489 GWh in 2020. Household expenditure patterns suggest that electricity consumption is highest among those in the middle class income group. A growth in this group would no doubt put additional pressures on energy resources.

Aside from inherent inefficiencies in the CEB, high tariffs in the country are attributed also to the fact that successive governments have failed to implement long term generation expansion plans as scheduled. Much delayed coal plants are now finally coming on stream, and much of the future grid expansion is hinged on coal-powered generation. But this brings new risks. While less reliance on thermal-fired plants would mean the avoidance of adverse impacts of global oil price movements, coal prices have shown greater volatility in the past. Yet, coal is widely acknowledged as the way forward for Sri Lanka to power its growth ambitions. Therefore, ensuring that investments in coal plants are rational and productive is vital. Recent experience with the Chinese-built Norochcholai Coal Power Plant, with its frequent breakdowns and array of technical problems, should strike a note of caution when planning future investments.

On the revenue side, taxation continues to be a concern. Recognizing the taxation imperative in fiscal consolidation, the government appointed a Presidential Taxation Commission in 2009. Following the release of its final report in 2010, some significant tax reforms were undertaken through the 2011 Budget. This included slashing of corporate and personal income tax rates with a view to encouraging economic activity, removing the Pay-As-You-Earn (PAYE) tax exemption enjoyed by public servants since the late 1970s, rationalizing some border taxes, and streamlining the tax incentives regime. But these reforms are yet to deliver higher revenue. In fact, in 2012, the tax-to-GDP ratio declined to its lowest level in 20 years at 11.5 per cent. This is well below the average tax ratio of comparable lower middle-income countries at 18 per cent. Essential administrative reforms did not accompany the reduction in rates, which in turn impeded the widening of the tax base to offset the revenue loss. Meanwhile, Value Added Tax (VAT) exemptions and zero ratings have increased to accommodate political lobbies.

The concern over fiscal weaknesses is also reflected in recent commentaries by many international organizations, including sovereign ratings agencies. Reports by Standard and Poors, Moodys, etc., during 2012 and early 2013 all point to risks emanating from this, albeit of a medium term nature.

Contributing to meeting a lower fiscal deficit target in 2012 vis-à-vis 2011, was the strategy of shifting of payments to suppliers and delaying or scaling back on capital expenditure projects, as well as the fact that the debts of SOEs are not reflected in the deficit numbers as they are passed on to the balance sheets of state banks that keep financing the losses. These are not sustainable strategies. While fiscal consolidation is certainly an important objective, it should not come at the expense of enhanced public investment in areas that contribute to sustained growth, like social and physical infrastructure. The role that infrastructure investment can play in recovery from economic crises and to promote growth, has been recognized across the world. A large part of US President Barack Obama's recovery and growth strategy is hinged on plans to overhaul the country's connective infrastructure. Facing a situation similar to the recent global downturn during the East Asian financial crisis, China focused its fiscal stimulus investments on highways, railroads, port facilities, and electricity -- areas that were bottlenecks to China's growth. Evidence suggests that infrastructure investment represents two-thirds of the growth increase in East Asia, and about half of the growth increase in Africa in the past two years.[1] Sri Lanka has clearly recognized this, and the infrastructure thrust in the past 5-7 years has been impressive. Two new container ports and a new international airport have been the epitome of this thrust. Most of the ongoing projects are foreign-funded, either on commercial loans or bilateral loans.

The next agenda needs to be private participation in infrastructure projects, to ease the financing burden on the government for the next raft of infrastructure projects. The opportunities are vast. The government estimates that, in port-related infrastructure alone, around US$ 10 billion of projects will open up for private investment over the next five-years. Mobilizing private capital for public projects is not easy. Recent experience in India amply demonstrates this. Despite a large infrastructure financing need, private capital in the form of private-public partnerships (PPPs) or infrastructure bonds have been slow to come in as investors are wary of tenuous processes and doing business with the state amidst concerns over corruption. This holds important lessons for Sri Lanka as well. While the rhetoric welcoming private investment into infrastructure has been clear and consistent by the Government of Sri Lanka (GoSL), murky procedures and political interference seem to have kept private investors away from any notable participation in public infrastructure projects. With a relatively small domestic private sector capable of undertaking such costly projects with long gestation periods, accompanied by their often risk-averse nature, foreign investment and joint ventures become ever more important. To what extent foreign investors are willing to navigate murky procedures and undertake long term commitments under Build-Own-Operate (BOO) or Build-Operate-Transfer (BOT) type of PPPs is still unclear. Meanwhile, for the domestic private sector, the recent relaxing of restrictions on overseas borrowing may ease the fundraising constraint faced by them, and could help position them to play a greater role in public infrastructure projects.

Physical infrastructure is only part of the arsenal the Sri Lankan economy needs to make towards a strong middle-income transition, and sustain growth over a longer period. Social infrastructure will determine the quality of the country's workforce that truly drives growth. While connective infrastructure has been getting much attention in Sri Lanka, sectors like education and health are beginning to show significant gaps resulting from under-investment in recent years.

Sri Lanka is continuing to reap the benefits of the impressive investments in education

[1] Lin, Justin (2011), *"Global Solutions to the Global Crisis: Beyond Keynesianism and the "New New Normal"*, text of speech delivered at Asian Society Hong Kong Center 2011, available at http://siteresources.worldbank.org/DEC/Resources/AsianSocietySpeech-Hongkong-JustinLin.pdf [accessed on 3rd February 2013].

and health in the post-independence period. However, the transition to middle-income brings with it new challenges to human development. Public expenditure in education has fallen from an average 2.3 per cent of GDP during the 2000 to 2010 period, to a 10-year low of 1.8 per cent of GDP in 2012. The average upper middle-income country spends 5 per cent of GDP, and the average lower middle-income country spends 4 per cent of GDP on education. Meanwhile, over 100,000 A/L graduates each year are not able to pursue higher education as state universities are unable to accommodate them, and the alternative of private higher education is affordable mainly to more affluent households. In 2012, 40,000 more were left out, than in 2011. The effects of Sri Lanka's waning demographic dividend are already manifesting itself in labour force participation rates. As much as 7 per cent fewer young people were in the labour force in 2010 compared to 2006. This means that with the demographic dividend on its way out, Sri Lanka is expecting to reach upper middle-income status and beyond, with fewer people working to get there. This necessarily means greater investment in education and skills development, so that the smaller cohort of young people still in the labour force generates more output per person.

Challenges in the health sector are also emerging, with changes appearing in the demographic and socio-economic character of the country, associated with the transition to middle-income. This is particularly true of Non-Communicable Diseases (NCDs) and malnutrition.

Along with lifestyle changes that accompany higher living standards, the epidemiological profile of the population will change, and it has already begun. Deaths due to NCDs, such as ischaemic heart disease, stroke, and cancer, are high and rising in Sri Lanka. Evidence suggests that nearly 90 per cent of the country's disease burden can be attributed to NCDs.[2] An ageing population will bring additional health care burdens too, as health demands of the old are generally higher than for other groups.

The ability of the state to provide improved health facilities to tackle these emerging challenges is compromised by low investment in the heath sector. Total expenditure on health has remained below 5 per cent of GDP between 1995 and 2008, and is low compared to the middle-income country average of around 8 per cent. This lower public investment has been accompanied by a rise in private expenditure on health, as aspirations towards advanced and conveniently accessible healthcare services emerge among the country's middle class. Expenditure on private hospitals and nursing homes has risen lately, mainly driven by this income group. The proportion of out-of-pocket expenditure (i.e., the individual cost borne by the patient) out of private health expenditure has grown over time. Sri Lankans spent Rs. 70 billion more out-of-pocket on healthcare in 2009, than 20 years ago. While much of this is driven by those who have higher spending power, this still has important equity implications. Higher private expenditure for health by individuals is inherently regressive, and breeds inequity and social exclusion in availing of quality health care services.

Meanwhile, gaps in nutrition are surfacing, and seem to be affecting the country's youth the most. The highest proportion of malnourished women is seen in the youngest age groups of 15-19 years (40 per cent) and 20-29 years (22 per cent). This 'adolescence nutritional deficiency' breeds a lifecycle of malnutrition, and would affect the country's productive potential.

Meeting these emerging human development needs will require greater state capacity, which comes largely in terms of tax revenue.

Higher domestic revenue will come to a great extent with higher economic growth. An important driver of this growth, then, is high rates of savings and investment. Countries that achieved 8 per cent plus growth and sustained it over an extended period, demonstrate the importance of high savings and investment. International literature as well as analysis for Sri Lanka, shows that a rising global middle class in a country is likely to spur more savings and investment.

Sri Lanka's domestic savings ratio stood at 17 per cent in 2012, rising from 15.4 per cent the previous year. As the 'Sri Lanka: State of the Economy 2011' noted, "a high inflationary environment has been a habitual feature of the economy, discouraging saving and rewarding borrowing". In addition to this, socio-cultural norms of Sri Lankans, like a lower propensity to save, along with rising domestic consumption expenditure add to the challenge. There was a ballooning of demand for imports of consumer goods following the end of the conflict. This had reached unsustainable levels, vis-à-vis foreign exchange earnings, and greatly contributed to the CBSL's stabilization measures introduced in early 2012. Yet the longer term trend is that national savings will not suffice investment demand and could stifle the country's ambitions of faster growth. This is where FDI plays a strong contributing role. FDI inflows to Sri Lanka have seen a significant increase in recent years, even during the time of the conflict, rising from US$ 223 million in 2004 to US$ 1,017 million in 2008. FDI inflows dropped to US$ 404 million in 2009 and US$ 478 million in 2010, largely due to the global economic downturn which slowed down investment flows worldwide. By 2011, inflows had picked up to US$ 956 million, driven almost entirely by investments in the hotel and leisure sector. By 2012, inflows amounted to US$ 898 million.

While the country has no doubt struggled to sustain the boost seen in the years immediately following the end of the conflict, this does not take away from the impressive gains in prosperity made in recent years. Unemployment has fallen from 5.8 per cent in 2009 to 4.0 per cent in 2012 and poverty nearly halved between 2006/07 and 2009/10. The traditional 'lagging regions' are catching up, with the Western Province GDP dominance falling from 50.8 per cent in 2005 to 44.4 per cent in 2011, and provinces like Southern, Northern, North Central, and Uva showing steady increases in their contribution to national output. All of these contribute to a changing scenario of social mobility in the country. Private consumption expenditure (PCE) has risen steadily in recent years, growing by 70 per cent between 2008 and 2012. With higher growth and falling poverty comes the potential for a rising middle class.

Sales of motor cars, motorcycles, and consumer durables -- seen as luxury items in a low-income economy -- have risen in line with this rising upward mobility. The pent up demand for these were clearly visible when 2010/11 witnessed a dramatic rise in demand following substantial cuts in import tariffs in mid-2010. Even prior to the duty cuts, demand for personal-use motor vehicles had been rising. Annual registration of new motor cars was over 40 per cent higher in 2008 than in 2002, and 65 per cent higher in the case of motorcycles.

While such rises in domestic consumption will boost non export-oriented enterprises, it alone cannot drive sustained growth. It is export-oriented enterprises and their efficiencies that will determine rapid growth.

As pressures on Sri Lankan enterprises rise, both from domestic concerns like rising factor prices as well as threats to external competitiveness, they will look to become more efficient and 'go lean' as well as adopt greater product and process innovation. This will see a change in the internal operating structure of these enterprises -- towards greater adoption of technology combined with higher skilled labour. While the impact this has on job creation will be debated, it is clear that such a shift towards innovation is likely to benefit the skilled and educated. During the, albeit limited, industrialization period in Sri Lanka, a workforce which was generally very trainable owing to high literacy and health outcomes, was a definite advantage to typically lower-skilled manufacturing jobs. However, with the evolving pattern of growth, the future demand is likely to be for 'knowledge workers', possessing higher-order skills that go beyond basic education and literacy.

Moreover, with middle-income status come changes in aspirations on the type of employment sought by young people. Anecdotal evidence suggests that manufacturing enterprises are facing difficulties finding workers for the 'factory floor'. With a shifting of preferences away from blue-collar work, the pressure on the education system to deliver the required training and skills is immense. These changes seem to be influencing youth participation in the labour force. For instance, youth labour force participation rates in the estate sector saw the biggest decline between 2006 and 2010, falling by almost 12 per cent (compared to 7 per cent nationally). This could be a reflection of the changing aspirations of young people, away from the opportunities available in the estate sector, towards jobs elsewhere. With aspirations towards urban jobs (especially in the services sector, like retail) on the rise, and the consequent tighter competition for these jobs, urban unemployment among youth has shown an increase from 12 to 14 per cent between 2006 and 2010 -- the only sector to see a rise in youth unemployment during this period.

While Sri Lanka's rate of urbanization has been quite tame compared to other developing countries, this could change as the country makes the transition to middle-income. Associated with this is the creation of new vulnerable groups, especially those who are urban unemployed and slip into urban poverty. Looking at just the Poverty Head Count Index (PHCI) may be misleading. Although it shows that urban poverty HCI is very much lower than, say, in the estate sector, the actual number of poor in urban areas is higher. Moreover, the depth of urban poverty is more acute than in other sectors. The amount of monthly transfers needed to bring an urban poor individual out of poverty is Rs. 680 compared to Rs. 587 for an average poor individual in the country.[3]

It is not just in the urban sector. The skill-biased technological change that is likely to be a feature of Sri Lanka's middle-income transition, can have an impact on overall wage dispersion. Rising income inequality could reduce both social mobility and future prosperity. At the aggregate level, more than a half of all income in the country is received by the richest 20 per cent of households, while the poorest 20 per cent receive just 4.5 per cent of the income.

While equipping workers with the skills to latch on to the economic changes and minimize the gap between them and emerging income opportunities, the flip side is to create a safety net for the poorest and those most likely to be 'left out'. An important part of moving towards a middle-income country is ensuring adequate protection for the most disadvantaged population groups and those that are most vulnerable to shocks. While Sri Lanka has made impressive gains in reducing poverty, the fact remains that a significant share of households are clustered just above the poverty line and various shocks – be it at household level or macroeconomic – could easily push them back into poverty. Essential then, is a robust social protection system to address the emerging vulnerabilities. This is particularly important considering both Sri Lanka's rapidly ageing population, and also the high level of informal workers in the labour force, with little access to good safety nets. A high proportion of those employed in the construction, mining, and quarrying industry (83 per cent), hotel and restaurant industry (50 per cent), and manufacturing industry (45 per cent) are informal workers.[4]

While there are a multitude of social protection programmes currently operational, most of them deliver grossly insufficient benefits, are poorly targeted, and do not cover the risks and vulnerabilities adequately. This is most evident in the country's largest programme, Samurdhi. The maximum amount of income transfer delivered by Samurdhi to a household is Rs. 1,500, while the national poverty line dictates that a person requires at least Rs. 3,300 per month to meet his/her consumption needs. Better targeting in social protection schemes like Samurdhi can free up more funds to give to those who most need it. Estimates reveal that only around 15 per cent of Samurdhi recipient households are actually poor, as much as 49 per cent of households identified as poor do not receive any Samurdhi benefits. At a time when fiscal pressures are rising, the government will have to move away from a blanket-approach to social welfare towards a more targeted and effective social protection architecture.

Another source of vulnerability emanates from changing weather patterns, and natural disaster-related shocks. Severe adverse rainfall events in Sri Lanka's dry zone in early 2011 and late 2012 heavily impacted farmer livelihoods, while severe cyclonic conditions in an unusually strong monsoon season in June 2013 hit fishing communities across the Southern and South-Eastern parts of the country causing nearly 50 fatalities. While social protection schemes must expand coverage to these emerging types of risk, a big part of guarding against these vulnerabilities is to have better information and provide it to those who need it. Called Climate Information Products (CIPs), these can help communities, and the country at large, make adaptation decisions and be better prepared for the fallout from adverse climatic changes. In Sri Lanka, credible CIPs are scarce -- especially in the areas of agriculture, water resource management, energy generation planning, and disaster risk management. Consequently, most people do not rely on formal CIPs and it impacts their readiness to adverse changes. IPS research in the Anuradhapura district, for instance, shows that while nearly three-fourths of farmers regularly look for weather reports in the media, less than 3 per cent treat those as their main source of information. The overwhelming majority said they relied on personal judgment, observations, and peers. Yet, many of them acknowledged that their long-held beliefs in local weather patterns have become less reliable, even obsolete, and the need for better CIPs is greater than before. Agencies tasked with providing CIPs, like the Department of Meteorology, would need a stronger focus on quality, timely and credible information accompanied by investment in state-of-the-art technical facilities and high levels of expertise.

Overall, Sri Lanka is facing new challenges as it makes the transition to a middle-income economy as is clear from the preceding discussion. A key characteristic of other economies that have made, or are making, this change is a growing global middle class in their societies and the acknowledgement that this can have positive impacts on growth and development. Although according to global benchmarks, Sri Lanka's middle class measures up to less than 5 per cent of the total population, as highlighted throughout this report, there are signs of upward mobility and an emerging middle class in the country. This is evidenced by, *inter alia*, a sharp decline in the incidence of poverty, growing demand for advanced services, luxury and consumer durable products, greater spending on private health care and education services, as well as the proliferation of technology and services that connect more Sri Lankans to global information and commerce. With their more discerning consumer demands, a growing domestic middle class can spur service and process innovations in the country. They can also have an impact on public policy, as some literature has shown that as this group gets larger, social policies on education and health become more progressive.

The best means of growing this middle class is to strengthen what is at the heart of their emergence -- access to secure, well-paying employment opportunities. This necessarily means that Sri Lanka must focus on expanding tertiary education and vocational training.

A distinguishing feature between the poor and the middle class is that as they are largely engaged in stable well-paying jobs, it gives them the space and resources to not only improve their living standards, but also be more engaged politically and demand better state services. So, for a government, a rising middle class can also bring with it, its own set of challenges. A growing middle class has greater demands on, and want a greater voice in, how they are governed and the institutions that govern them. This tendency has been seen in countries like India, with a rapidly growing middle class -- whether it be demanding a change from police inaction against sexual abuse, protests against corruption (for instance, the Anna Hazare movement), or the increasing number of public interest litigation using the Right to Information Act. Similarly, in countries like Turkey, where years of steadily growing incomes fostered a large middle class, which became increasingly less tolerant of an overbearing state and ultimately erupted in the kind of dissent seen recently. The efficacy of institutions to meet the evolving needs of people and the quality of rule of law in protecting their rights would become increasingly more important to the upwardly mobile social class, and the government needs to be cognizant of this.

The rising socio-economic prosperity in Sri Lanka, if fostered cleverly and inclusively with progressive public policies, can spur economic dynamism, innovation, and social progress, and place the country on firmer ground, as it makes a decisive transition into a middle-income economy and beyond.