Sri Lanka
State of the Economy Report 2014

Chapter 1
Policy Perspectives

by
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1. Policy Perspectives

Over five years since the end of the armed conflict in May 2009, the Sri Lankan economy is now firmly on a path of economic transformation. In the post-war period, the country exited from a precarious external payments position, to successfully conclude a Stand-by Agreement (SBA) with the International Monetary Fund (IMF) in 2012. GDP growth has picked up from an average of 5.5 per cent during 2000-2009 to 7.5 per cent in the post-war period, and is estimated to exceed 7 per cent in 2014 as well. February 2014 marked five consecutive years of single-digit inflation, and the country is now able to borrow in international capital markets at rates that would be the envy of many crisis-ridden European countries. An impressive and far-ranging public infrastructure drive continues apace, and is strengthening the country's prospects for attracting a new wave of foreign investment and for becoming a strong regional economic hub. Yet, there is a growing sense of frustration that the economy has not fully harnessed its post-war dividend and is performing less than what it is capable of.

One of the most noticeable symptoms of this is the uninspiring private investment performance, characterized by the slow growth in foreign direct investment (FDI) and domestic private investment, reflected in remarkably low levels of credit uptake by the private sector over the last 18 months. Since the signalling of monetary policy easing in December 2012, low interest rates that prevailed throughout much of 2013 and into 2014 has been slow to translate into higher private sector lending. Credit growth in 2013 was a sluggish 7.5 per cent, and by June 2014 had decelerated further to just 2 per cent on a year-on-year basis. GDP growth in 2013 was estimated at 7.3 per cent. But questions are emerging as to whether macroeconomic indicators are fully capturing the dynamics of an evolving Sri Lankan economy. For instance, although the construction sector grew by 14.4 per cent in 2013, cement sales grew by only 2.9 per cent; by contrast, when the construction sector grew by 21.6 per cent in 2012, cement sales grew by 28.7 per cent.[1]

The changing structure of the post-war Sri Lankan economy could hold the explanation in part. Sources of growth in recent years have been largely dominated by the domestic non-tradable sector Non-tradable services like wholesale and retail trade, and non-tradable industry activities like construction and utilities, have been at the heart of this. These are also the sectors in which the government has a significant share of activity in. It is not unusual, then, that private sector credit demand has been so sluggish - the sectors that are booming are the sectors in which opportunities for private investment is relatively limited.

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[1] Central Bank of Sri Lanka, "Selected Economic Indicators", various issues.

Some part of the mismatch of the numbers could also be because the nature of economic activities under way now, is not being fully captured in existing techniques of national accounting. To rectify this, the government's statistics office has embarked on a timely effort of revising how the country's national accounts are compiled, and updating what is included in it. 'Rebasing' the compilation of national accounts - i.e., taking a snapshot of the economy in a more recent year in order to see the size and composition of different sectors in the economy - will no doubt strengthen confidence in ongoing efforts to improve data collection and analysis.

In the second half of 2014, it is expected that the sustained low interest rates (nearing almost one year) would finally trigger an increase in private sector borrowing. There are already some indications that private firms are responding to the very low borrowing costs to expand investments. However, with rates likely to remain low for the rest of 2014, the authorities would need to be cautious about asset price bubbles, and igniting inflationary pressure from the loose monetary policy stance if rates remain too low for too long.

What must be avoided is a consumption driven credit boom as was the case in 2010/11 in the previous round of aggressive monetary policy easing. It coincided with a 'pawning boom' that came unstuck as international gold prices plummeted. Several measures were adopted in 2012 to avert a looming balance of payments (BOP) crisis - re-adjustment to import duties, a change in exchange rate management, imposition of credit ceiling on banks, etc. This time around, early and prudent policy responses to any emerging signs of macroeconomic instability will provide an environment of policy consistency, and encourage the private sector to undertake investments.

It is likely that towards the latter part of 2014, interest rates could edge up, as credit demand picks up once again. For the government, it is a delicate trade-off. Sri Lanka is increasingly dependent on foreign investor demand for its Treasury bills and bonds to finance its fiscal deficit. If interest rates reduce further, and consequently the yields on Treasury bonds, it would make these bonds less attractive to foreign investors. If it falls to a level where the spread between the return on Treasury bonds and the return on Sri Lanka's Sovereign bonds is quite slim, foreign investors would consider the elevated currency risk and sell off their investments, or at the least, avoid future investments in rupee denominated Treasury bills and bonds. This could adversely impact the government's ongoing and much needed capital raising efforts.

Sources of growth in recent years have been largely dominated by the domestic non-tradable sector.

Another factor which may influence an edging up of interest rates would be the drawing down of the extraordinary monetary measures in the US ('tapering' of quantitative easing by the US Federal Reserve). This, coupled with a sustained recovery in output in the US economy, could push up global interest rates and consequently raise the international borrowing costs for Sri Lanka as well.

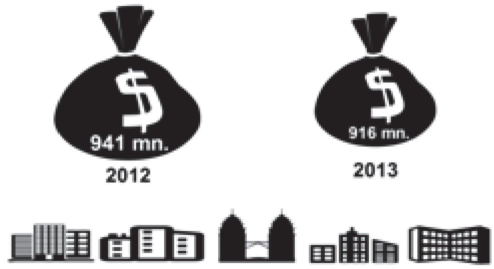
For now, the rupee remains stable, with no major pressures emanating from the external current account. Slow growth in import expenditure coupled with a recovery in export earnings, a steady growth in remittances (albeit lower than in previous years), and a steady rise in tourism earnings are all helping to bring down the deficit on the current account. It fell from 6.6 per cent of GDP in 2012 to 3.9 per cent of GDP in 2013, and looks set to decline further in

2014. The signs are hopeful; by the first half of 2014, export earnings had picked up substantially (growing by 16.8 per cent against the same period in 2013), and across all categories - indicative also of a gradually recovering external environment.

The recovery in export performance is good news for Sri Lanka. The country's economy is most vulnerable on the currency front. Despite reporting healthy official reserves of over US$ 9 billion, almost all of it is from accumulated borrowings. With a growing dependence on external sources of savings to meet the country's development financing needs, stability on the external sector is needed to retain foreign investor confidence on the medium to long-term outlook for the economy. This is all the more important in view of Sri Lanka's rising exposure to external sector developments on multiple fronts, as direct government foreign borrowing is increasingly accompanied by indirect government foreign borrowing and private sector borrowing.

It is to be hoped that the turnaround in export performance may also herald a change of fortunes in terms of FDI. Five years on from the end of the war, FDI has been a most conspicuous under-performer in an otherwise bullish economy. Net inflows of FDI in the immediate post-war period have not been materially higher than before, recording US$ 916 million in 2013 compared to US$ 941 million in 2012. Much of the recent FDI has been not in manufacturing export sectors, but in prominent mixed property development projects - the 'Altair Tower' set to be Sri Lanka's tallest building, a US$ 600+ million mixed-used development by the country's leading conglomerate, a 5-star Shangri-La Hotel and ITC Hotel, etc. While these will boost growth in the short-term through construction and allied sector growth, and in the medium term through allied services and employment creation, they have little impact on technology transfer that boosts longer term growth through positive spillovers on labour force skills and productivity of domestic firms.

Net inflows of FDI in the post-war period



Attracting more and better FDI becomes especially important for a country like Sri Lanka with a low level of domestic savings and weak public finances. Tax collection in Sri Lanka continues to be substantially low, with 2013 seeing the lowest tax-to-GDP ratio in recent years of just 11.6 per cent. The norm is for this rate to be around 18 per cent for lower middle-income countries and nearly 25 per cent for upper middle-income countries.

Problems with revenue also seem to have translated into reported delays in payments to government suppliers (for instance, fertilizer importers and construction contractors). This strategy of pushing large settlements from one year to the next, serve the purpose of meeting one year's budget deficit target, but cause much cash flow distress to the firms involved, and in turn places severe pressure on the banks from which the firms have taken advances. This undesirable cycle can only be curbed with strengthening of government finances by the dual approach of curbing wasteful public spending - including reining in loss making state-owned enterprises (SOEs) - and raising more government revenue. Of course, a pick-up in overall economic activity, as well as higher imports, would see a recovery in revenues, given that much of Sri Lanka's revenue comes from taxes on consumption. But for a more sustainable increase in tax revenues, more fundamental reforms to tax policy and tax administration would be required.

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The fiscal deficit since the end of the war

In the five years since the end of the war, the fiscal deficit has been slashed from 9.9 per cent of GDP in 2009 to 5.9 per cent in 2013. A positive feature has been a continued commitment towards capital expenditure. For a country requiring continuing investments in critical modern infrastructure - whether it is connective infrastructure, technology infrastructure or social infrastructure (schools, universities, etc.), Sri Lanka cannot afford to compromise on public investments in items that lay the foundations for competitiveness and sustained, inclusive growth.

The downside has been that the infrastructure development has been financed primarily through foreign loans or projects implemented by foreign state-backed firms (notably, Chinese). Many of the mega infrastructure projects have received strong sovereign guarantees, for instance to the Road Development Authority (RDA) and other non-revenue generating state entities, leading to an increase in the government's contingent liabilities as well. More worryingly, and as previously mentioned, reliance on external borrowing has made Sri Lanka not only more vulnerable to external shocks but also weakened its ability to ride them out.

In this context, the improvements in the global economic environment - reflected in a better export performance for Sri Lanka - is heartening. In Europe, the unprecedented confidence-building measures of the European Central Bank (ECB) during 2012-13 stabilized distressed financial markets in the region. With investors once again buying into European sovereign bonds, consumer confidence gradually recovering, and cautious expansions by firms, Europe appears to be finally exiting a recession, and joining the US in making an escape from the prolonged slowdown. Yet, policy makers appear nervous about the recovery not being robust enough.

Unemployment rates remain stubbornly high in Europe, especially among younger workers. The average youth unemployment rate is around 23.5 per cent, much higher than pre-crisis (2008) levels of 14.5 per cent. This average masks worse situations in specific countries. In Greece, Spain, Portugal and Italy, the rates are as high as 56 per cent, 53 per cent, 40 per cent and 33 per cent, respectively. Meanwhile, political shifts in the region are also adding to the concerns. Anxiety over Russia's annexation of Crimea and its ripple effects on Europe, as well as the dimming hopes of tighter political cooperation and fiscal coordination in the

European Union (EU) to complement monetary integration, mean that the recovery remains fragile.

In the US, meanwhile, the economy appears to be making a decided escape from the slowdown, and has been posting steady growth and reductions in unemployment. However, as the extraordinary monetary policy measures draw down in the US, it remains to be seen how the global economy adjusts. In the latter part of 2013, the beginning of the Fed taper sent markets into a tail-spin, with emerging market economies (EMEs) hit particularly hard as capital flight occurred and their currencies depreciated sharply. In 2014, though, the taper effects would have been priced-in by global investors, and many appear sanguine about the remainder of the process. Yet, concerns stem from questions around the timing and speed of the Fed's actions. If the ongoing recovery of the US economy speeds up, and the Fed feels that it would lead to upward inflationary pressure, the taper may be quickened. If this happens too fast, it may reverse the gains from the expansion in the first place. If it happens too slowly, the prolonged period of easy money may create unstable asset-price bubbles (similar to what happened in EMEs during the height of the US quantitative easing).

As tighter monetary conditions take root in the US and Europe, global investors appear to have become more risk-averse. A first sign of this has been the sharp year-on-year decline of 9.6 per cent in net capital inflows to EMEs in 2013.[2] This scenario is a marked difference to what was seen in the immediate aftermath of the global financial crisis, where capital flows to EMEs soared, with global investors looking for alternative destinations to park their capital. On first glance, it may seem that this reversal in 2013, then, is mainly due to a changing global climate and the drawdown of US quantitative easing. This certainly is a key part of the story. But it is also explained by other factors. Several of the emerging economies that received large 'hot money' flows in the post-crisis, liquidity-flushed era, depended too much on global capital flows to finance their domestic demand. Their currencies appreciated, eroding export competitiveness, and eventually resulted in untenable current account deficits.

Much like how the Asian financial crisis unravelled inherent weaknesses in macro management and financial markets in Asian economies, the aftermath of the global crisis together with the effects of the Fed taper have shone the spotlight on the underlying risks and performance of a new cohort of current EMEs. Although it was the EMEs that demonstrated resilience in the aftermath of the global downturn and helped buoy global growth (despite the impact on them from contracted export demand), questions are now emerging on the issues in these economies, as investors take a 'look under the covers'. Several factors are influencing this concern, particularly in five of the EMEs: India, Indonesia, Turkey, Brazil, and South Africa - where economic growth has reached a low plateau, fiscal and current account deficits are rising, and minimal attempts at structural reforms are under way.

Nevertheless, it is without doubt that the entire global economy is in transition, with a shift in economic vitality from the established industrialized economies of Europe and North America, to emerging economies in Latin America, Africa, and most prominently, Asia.

Investor appetite for emerging markets in these regions may have seen peaks and troughs, but has remained alive. Nearly 15 years since the first acronym for emerging markets was coined - BRICs (Brazil, Russia, India, China), there has been a proliferation of acronyms and groupings - mostly

[2] Tyson, L. (2014), "Sense and Sensibility in Emerging Markets", available at http://www.project-syndicate.org/ commentary/laura-tyson-says-that-differentiation-of-country-and-sector-risk-will-determine-future-investment-flows [accessed on 9th May 2014].

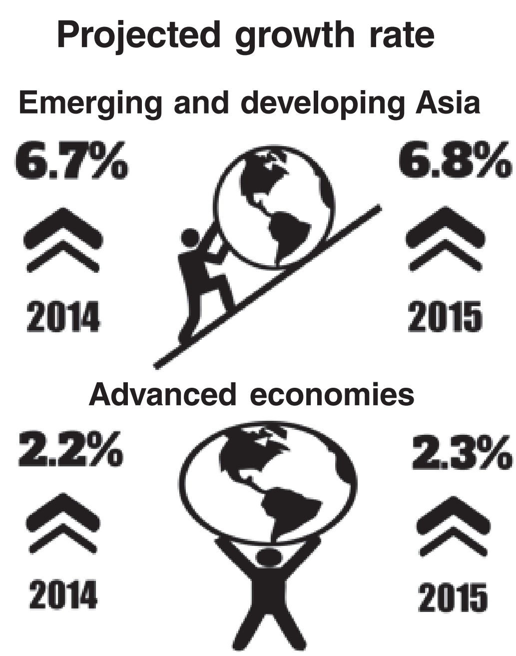
If there is one overarching feature of the shifts in economics, geopolitics and society in the 21st Century, it is the rise of Asia.

by portfolio investors and fund managers looking to come up with a new investment basket on EMEs.[3] While many agree that strictly going by these for investment decisions is not a prudent strategy, it does have the ability of highlighting to a wide audience the profound shifts taking place in the global economy. More importantly, what is most conspicuous is how much Asia, as a region, features prominently in this 'alphabet soup' of emerging markets groupings.

If there is one overarching feature of the shifts in economics, geopolitics and society in the 21st Century, it is the rise of Asia. Asian economies - particularly those in East and Southeast Asia as well as India - are at the heart of the tectonic shifts that are under way.

Asia is now home to about 60 per cent of the world's people, generates around one-fourth of global output (set to rise to half by 2050), and produces 47 per cent of the world's manufacturing. With this has come a rise in prosperity, with around one-third of global middle-class spending accounted for by Asians. The spectre of the Asian financial crisis that badly hit some key economies has faded into distant memory. In the six or so years following the onset of the global recession, projected and actual growth rates in emerging and developing Asia were often as much as 6 percentage points higher on average than that of advanced economies. In 2014 and 2015, while advanced economies are set to grow at 2.2 and 2.3 per cent, emerging and developing Asia is set to grow at 6.7 and 6.8 per cent, respectively. This is higher also than the 4.9 per cent and 5.3 per cent forecast for the wider group of emerging market and developing economies.

China, one of two regional anchors along with India, has long surpassed Germany as the world's leading exporter. Asian firms (Japanese automobiles, South Korean electronics, Chinese e-commerce sites, etc.) are among the world's most valuable brands. Japanese and South Korean cars are ubiquitous on European roads, American technology giants like Apple source billions of dollars worth of advanced components from South Korean and Taiwanese suppliers, and Chinese firms are buying into German, British and American companies across a slew of sectors. Western multinationals and consumer brands have flocked to Asian cities to gain



[3] The first to include Sri Lanka is the PPICS (Peru, the Philippines, Indonesia, Colombia, Sri Lanka).

a foothold in the growing market, as Asians aspire to a Western standard of living, and increasingly, can well afford it. Industry estimates suggest that Asian consumers account for a half of the US$ 80 billion global luxury goods market.[4] Technology diffusion is not only enabling Asian firms to compete better on a global scale but also giving rise to disruptions in consumption patterns through e-commerce. China's Alibaba online marketplace, for instance, now boasts 180 million users, handled around US$ 250 billion worth of transactions in 2013 (more than eBay and Amazon combined), and has filed for what is arguably the world's largest technology Initial Public Offering (IPO) valued at close to US$ 20 billion (higher than that of Facebook's). Meanwhile, intra-Asian trade is proving to be a most vital element of Asia's economic vibrancy, post-crisis. Exports to China by the top-10 exporting countries of the Association of South East Asian Nations (ASEAN) now exceed their exports to either the North American Free Trade Agreement (NAFTA) region or the EU.

Newer emerging Asian economies are also showing promise. Indonesia, home to about 40 per cent of ASEANs citizens (around 240 million people), generates just under 40 per cent of its GDP. It has risen to become the world's 15th largest economy, surpassing the symbolic trillion dollar GDP mark in 2012. The Philippines is making great strides in recovering from being 'the sick man of Asia', following sweeping reforms. GDP grew by 7.2 per cent in 2013, the fastest in ASEAN, and this too despite the devastation wreaked by Typhoon Haiyan. The Philippines sovereign debt was upgraded to investment grade by ratings agencies like Fitch, Standard & Poor's and Moody's, and the country rose up 26 places in the Global Competitiveness Index (since 2010) and 30 places in the Doing Business Index.

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But the rise of Asia is by no means a foregone conclusion; many factors will influence the future trajectory of this rise. Aside from numerous country-specific challenges, some wider challenges merit discussion, particularly in understanding the Asian context in which Sri Lanka operates as well as in drawing lessons for Sri Lanka's own growth efforts.

The nature of governance and the role of the state has been a standout feature of the economic growth trajectory of Asian countries. The strategic government involvement in economic development - across an array of activities - was conspicuous for both its reach and efficacy. That the state should have a role in deciding resource allocation and economic production would have been a heretical notion about a generation ago, as failed experiments in strict central planning amply demonstrated. But more recently, largely because of the narrative built around the success of Asian economies, the idea that the state does have a role has much wider currency. Even developed countries that would have earlier shunned such policies, have been some of the strongest advocates of state involvement, especially after the crisis - whether it is the decision to bail out their banks (including taking equity stakes in some of them), the decision to provide government assistance to specific sectors (for instance, the US automobile industry when it

[4] Chadha, R. and P. Husband (2006), *The Cult of the Luxury Brand: Inside Asia's Love Affair With Luxury*, Nocholas Brealy International, London.

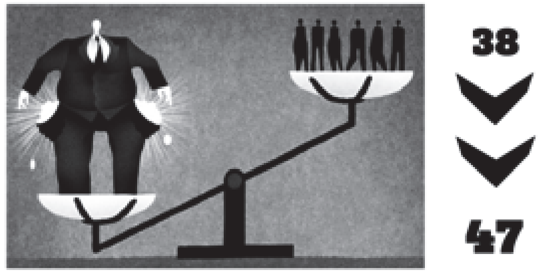
was in trouble, or now the renewable energy industry), or the decision to provide overall fiscal stimulus and allow extraordinary monetary expansions to spur growth.

The rise in wealth and affluence in Asia is startling, but not surprising given the rapid growth seen there. Industry estimates suggest that Chinese consumers lap up 10 per cent of worldwide luxury sales,[5] Southeast Asian shoppers account for between one-fourth and half of all purchases at designer outlets in Europe,[6] and despite mediocre economic growth, Indian sales of high-end cars in 2013 rose by between 15 to 30 per cent.[7]

Just 60 years ago, the picture in Asia was very different. It was the world's poorest region. Strong growth has lifted millions out of poverty. But much remains to be done. The ADB estimates that around 1.7 billion people in Asia live on less than US$ 2 a day, and roughly 800 million on less than US$ 1 a day.[8] Disparities exist among sub-regions of Asia as well - poverty remains highest in South Asia and is lowest in East Asia (driven mainly by China's slashing of poverty from 85 per cent in 1990 to 30 per cent by 2008).

In addition to poverty, income inequality continues to be a challenge for the region. According to further ADB estimates, in the 12 countries that account for more than four-fifths of Asia's population, income disparities worsened over the last two decades. During this period, the Gini-coefficient (measuring inequality) in Asia has deteriorated sharply from 38 to 47.[9] While the glitzy Chinese city of Shanghai has achieved living standards similar to Portugal, the number of poor in just eight Indian states is more

Gini-coefficient in Asia
(last two decades)



than in 26 of the poorest African countries combined.

China is one of the first countries to see a push back from people on this rising inequality, particularly those rural workers who work in low-paid jobs in the coastal industrial cities. Following severe labour unrest in 2010, China was forced to let wages rise by as much as 30 per cent. This trend is only going to continue, in line with the new effort at pivoting towards domestic consumption. In fact, China's current five-year plan mandates that the average official minimum wage across the country must rise by at least 13 per cent every year. Pay differentials between China's industrial regions and the US cities, where the parent companies reside, have narrowed. Chinese workers in American-owned factories are reported to be now getting 25 per cent of the US pay rates, compared to just 5 per cent in 2000.

Another characteristic of the rise of Asia is the seismic shift taking place in its demographic structure. Asia is ageing at an unprecedented pace. Emerging evidence suggests that this increase in the 'ageing population' will occur more rapidly than in the West, giving rise to numerous public policy

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5 Mckkinsey and Company (2011), "Understanding China's Growing Love for Luxury", McKinsey Consumer and Shopper Insights, March 2011.

6 Bain and Company (various years), "Luxury Goods Worldwide Market Study".

7 "India's Luxury Car Sales Accelerating", *South China Morning Post*, 10 February 2014, http://www.scmp.com/business/companies /article/1424901/indias-luxury-car-sales-accelerating [accessed on 20 May 2014].

8 Global Development Network (2013), "Q&A with Takehiko Nakao, President, Asian Development Bank", available at http://www.gdn.int/html/feature_archive_detail.php?id=54#sthash.rRklMpjm.dpuf [accessed on 27 April 2014].

9 Zhuang, J., *et al*., (2014), "Rising Inequality in Asia and Policy Implications", ADBI Working Paper 463, Asian Development Bank Institute, Tokyo.

challenges including financing of health care and social welfare (pensions, etc.). Some countries like Japan and South Korea will experience this more rapidly than others like India and Indonesia. China will be particularly challenged, as its one-child policy will cause a sharp rise in old-age dependency. Slowly, the demographic dividend - where the working age population is higher than the population of dependents - which helped many of these Asian countries to attain rapid growth will wane.

Another prominent feature of the Asian industrialization-led growth story has been the rapid urbanization of Asian cities, characterized by extensive rural-urban migration, heightened pressure on urban infrastructure like transport, water, housing and sanitation, and the concomitant rise in pollution. While the more newly industrialized countries in Asia such as China and India still do not have a majority urban population, the number of urban inhabitants is growing fast. It is estimated that by 2025, over half of the population in Asia will be urban.

Urbanization is but one aspect of the growing concerns on the environmental outcomes of rapid growth. Asia's emergence as a significant player in the global economy takes place at a time when global ecosystems and the environment are undergoing vast transitions. It is now widely accepted that Asia cannot grow under the same 'pollute now clean later' pattern as the West. The realities of climate change do not allow environmental underpinnings of growth to be ignored. In fact, certain parts of Asia, especially countries located in the tropical region and in islands, are among the most vulnerable to impacts of global climate change. Asia is facing serious environmental degradation issues linked to poor land use management, unsustainable energy consumption, and over-use of natural resources. The industrialization process in many Asian countries have been at the heart of environmental degradation, as Western manufacturers found lax environmental laws an attractive feature of locating in many of these countries, while their own countries began to impose stringent standards.

China and India's appetite for coal and petroleum to meet the growing energy demand has placed further stress on greenhouse gas (GHG) emissions. The intensity of the 'capture fisheries' and aquaculture industry (where nearly 70-90 per cent of production is in Asia) are putting immense pressure on the natural fishery resource base. Rising consumption and increased modernization has heightened this pressure. Meanwhile, a city scape of an Asian mega-city is almost incomplete without the looming smog or haze. Such concentrations of smog and brown clouds over Asian cities create many costs including rising health costs. All of these appear to be influencing changing weather patterns, including freak events. The frequency and the intensity of natural disasters in Asia are showing an increasing trend. During the period 1980 to 2009, over 38 per cent of global economic losses due to natural disasters were reported from Asia.[10]

These are just some aspects of the overwhelming evidence that suggests that Asia's impressive economic growth has come at a significant cost to local, national and global ecosystems. While economic growth has brought some affluence in terms of physical wealth, associated damages to ecosystems and a decline of ecosystem services has created conditions that diminish the opportunity for converting this wealth into true human welfare.

Pan-regional cooperation will be required if Asia is to make any meaningful headway in tackling these challenges - many of which have cross-border implications. But such cooperation may not be easy to foster.

[10] ADB (2012), *ADB's Response to Natural Disasters and Disaster Risks*, Asian Development Bank, Manila.

Global economic losses due to natural disasters reported from Asia, 1980 to 2009

Across Asia, the geopolitical landscape is littered with hostilities. Some of the most critical ones are the maritime tussles in the South and East China Seas, particularly between Japan and China; demarcations of the Exclusive Economic Zone in the sea between China and the Philippines; and disputes linked to the Spratly Islands among China, Vietnam, Brunei and Malaysia. Meanwhile, South and North Korea continue to be at loggerheads, oscillating between good relations to dangerous escalations. Farther West in Asia, the hostilities are dominated by India and China as well as India and Pakistan. In the former case, the two countries have long-standing tensions around the control of South Tibet. In the latter case, the conflict around Jammu and Kashmir has been the overwhelming narrative shaping the two countries' relations, and by extension, the region's. This is further complicated by the spillover of terrorist groups across borders, proving to be a major destabilizing force.

While India continues to be an influential anchor in South Asia, China is strengthening its influence more broadly across the Asian region through strategic investments and assistance. Some argue that China's rising pre-eminence in Asia could be countered by a growing US engagement in the region - rekindled by its 'pivot to Asia' strategy. The Trans-Pacific Partnership (TPP) appears to be the key tool in this. It is not a typical trade deal; it straddles trade, investment, and strategic economic cooperation. Asian countries that are wary of the security implications of China's rise may warmly welcome a heightened US presence in the region. The TPP could prove to be a key factor in the US-China rivalry over economic leverage in the region, and a tool for Asia's other economies to hedge against the rise of China.

All of these developments reveal how far Asia has to go in terms of a common vision around its ascendance. The closest effort towards bridging this is of course, the moves by ASEAN to establish a fully fledged 'diplomatic and economic community' by 2015. But one cannot forget that this is limited to just a sub-set of Asian nations. Asia would need an ambitious regional effort of the type seen in Europe. But this too is easier said than done.

The European integration project was a far-reaching exercise that required courage and vision on the part of the region's political leaders, despite centuries of bitter rivalries. Such progress seems much farther away in Asia. Apart from ASEAN and a few other regional and bilateral initiatives, Asia is yet to see any far-reaching pan-Asian regional integration efforts. Too many territorial conflicts are continuing for too long without decisive resolution. Unlike the 'European project', few political leaders have emerged, willing to stake their careers to further an 'Asian project'. Groups of countries swing between fear/suspicion of, and mutual gain from, the two regional giants - China and India. Little regional cooperation on security and military affairs prevail. And possibly most crucially, there is a notable absence of pan-Asian institutional arrangements and agreements (similar to the European Commission) to further all these agendas in a manner that is strong, consistent, and widely accepted. While this does not for a moment suggest that the rise of Asia will be less peaceful or benign, it does throw up questions on the ability of the region to rise as a whole.

European integration was also made relatively easy by their shared history, culture, languages, and (for the most part) political systems. In Asia, on the other hand, the region is so vast geographically and so diverse culturally and politically that it is hard to proclaim that similar integration is possible. While some countries in East Asia are globalizing rapidly and boosting prosperity, parts of Central Asia and South Asia are mired in poverty and backwardness. While some countries operate thriving, and at times cacophonous, democracies where the voices of the many are heard over the tyranny of a few, other countries are conspicuously and unashamedly undemocratic or authoritarian at best, and despotic at worst. Economic systems, too, do not cohere to a common model. The state-capitalism practised in China is vastly different to the liberal capitalism seen in Japan or Thailand. Meanwhile, countries like Vietnam, Singapore, Myanmar, and indeed Sri Lanka, contain features of both.

Sri Lanka must accept that strict replication of industrial policies of the type used in East Asia economies would be problematic today.

For Sri Lanka, the lessons from Asia's ascendancy are many, as are the opportunities and pitfalls. Sri Lanka's own economic policy orientation post-2005 reflects many of the East and Southeast Asian characteristics, with a strong state-led approach to development. State participation in public infrastructure projects, putting a freeze on privatization of SOEs, selective support to certain domestic industries, etc., have been key features of this stance. As seen in much of East Asia, this approach is not unprecedented. Many East Asian governments went beyond the standard neo-classical interpretation of 'getting the fundamentals right'. They proactively pursued industrial policy in bringing about structural adjustment and upgrading their respective economies. They cleverly prioritized infrastructure projects and ensured they were cost-effective and in line with industrial policy. They geared education and skill development policies to complement targeted future growth sectors. Thus, the overwhelming lesson from the experiences of East Asia was that the role of the state needs to be strategic and coherent, across industrial policy, infrastructure development, and education.

Yet, Sri Lanka must accept that strict replication of industrial policies of the type used in East Asia economies would be problematic today. For one, global trade rules have changed, making it almost impossible to adopt the kind of conspicuous protectionism employed by these economies. Secondly, most countries do not have the same political systems, which enable a heavy-handed approach to public policy making. Thus, for instance, the South Korean model of fostering large conglomerates - the chaebols - with very close linkages to elected officials, would not be easy today. Thirdly, many countries aiming to provide state support to spur growth may not have the fiscal space required to do so. South Korea, for instance, was able to use vast amounts of concessionary aid as well as war reparation fees paid by the US to invest in its heavy and chemical industry drive. Countries may also not necessarily have the technocratic capabilities to cleverly and effectively identify which industries are to be supported and promoted. Unlike Latin America's tryst with industrial policies, which handed out government support to strong and weak performers alike, in Asia, firms with perceived high potential were ex-ante identified and only those received help and many of these firms went on to be best-in-class performers. Yet, a misstep in devising this could mean a severe misallocation of resources, leading to rent-seeking and crony capitalism at best, and gross inefficiencies at worst.

As in many Asian countries, Sri Lanka is set to join the ranks where an ageing population is on the rise. In less than 20 years from now, the elderly population of Sri Lanka is expected to reach over 20 per cent of the total population and subsequent to that, one in every four people will be a pensioner. This places a massive economic burden both in terms of the costs of welfare financing as well as the costs of potentially slower growth due to the fewer numbers of working-age people. As can be seen in countries like Japan where this shift is well under way, the biggest risk lies in welfare financing. Age-related social security spending has soared over the last 20 years. Sri Lanka needs to invest in robust social security programmes now to ensure that welfare financing is sustainable and not a drag on the economy. The current social protection programmes are either under-financed, or lack the coverage and coherence, to be able to effectively cater to the looming demographic shift.

The health sector too will need to evolve to cope with the growing health care needs of an ageing population. The present public health care system has not kept pace with these changes, and if this is not addressed, the ageing population could be left with a large private health expenditure burden. While catering to these social welfare needs of an ageing population, Sri Lanka would need to keep growing in order to finance them. This becomes problematic with a shrinking working-age population. So, encouraging more women to join the workforce, revisiting restrictive labour laws that discourage hiring, providing opportunities for retirees to engage in productive activities, and making the existing working population more productive to counteract the rising dependency ratio, are critical areas for policy makers to focus on.

On the latter-most aspect of boosting the productivity and skills of the population, too, Sri Lanka has much to learn from the experience of Asian economies. The success of Asian education systems has its roots in a well-thought-out and constantly-improving strategy. Some of the critical success factors emerging from the comparative analysis are the strategies employed to improve

teacher quality and attract the best talent into the teaching profession; improvements made to school systems, curriculum and teaching methods; and enhancements to budgetary allocations to education (schools in particular) while ensuring accountability and performance in line with the finances spent by the state. Sri Lanka lags well behind on all of these aspects, stemming particularly from weak management and allocation of resources - be it teachers or finances - and the lack of accountability and weak governance at different levels of education delivery.

Meanwhile, in Sri Lanka too, a faster rate of urbanization will bring its own challenges, although with an urbanization level of just 18 per cent, the country is much less urbanized than its counterparts in Asia. A history of spatially spread investments in social infrastructure coupled with successive initiatives to take industrial activities outside of the Western Province has meant that Sri Lanka did not see intensive urban centres emerge, except for a few districts. A large influx of rural migrants was also not seen on the scale of that in other Asian countries. The reason could be twofold. On one hand, rural poverty in Sri Lanka has not been as acute as in many of these Asian countries, and welfare services like health are well located across the country. On the other hand, it may also be because, while the Western Province cities did grow commercially, the growth, and resultant incomes, was not outstanding enough to attract migrants in any significant way. In contrast, the population in China's southern coastal cities grew very rapidly due to the thousands of export-oriented production facilities being located there, which proved to be a strong attraction for rural migrants seeking better incomes than in their villages.

However, as post-war growth and the middle-income transition bring with it changes in incomes, living patterns, and aspirations, issues of urbanization is becoming a policy concern. The experiences of Asian countries have much to offer Sri Lanka in understanding how best to manage these changes. The experience of Japan shows the importance of investing early in urban public transport that facilitates urbanization by connecting peripheral workers to productive jobs in cities. Already Sri Lanka appears to be late on this, evidenced by the crippling traffic jams faced by urban commuters daily in Colombo and major suburbs. As evidence from many Asian cities shows, urbanization does have strong agglomeration effects. Industries clustering closer together can spur productivity and innovation, while raising worker incomes. Like in Malaysia, Sri Lanka needs to identify key urban areas into which industries and FDI can be channelled, and build the energy, housing, and environmental management infrastructure around it. As Sri Lanka is relatively new to this, the country is at an advantage in being able to better plan and foster inclusive and sustainable urbanization.

Sri Lanka needs to identify key urban areas into which industries and FDI can be channelled, and build the energy, housing, and environmental management infrastructure around it.

While a rapid urban regeneration programme has already begun in many parts of the metro Colombo region, due considerations must also be given to the welfare of populations being resettled in unfamiliar locations, the societal upheaval due to severing of existing community ties, and the implication of relocation on livelihoods of workers (especially informal workers). While the ongoing urban regeneration efforts appear to be very much centrally-planned and implemented, which makes sense given the finances required for it, it is also important to consider the governance implications of this strategy. Not all urban regeneration across the country would, or ought to, be tackled centrally, and local authorities like Municipal Councils outside the metro-Colombo area need to be empowered to deliver better urban facilities to their constituents.

To avoid facing the same pitfalls of environment pollution across many Asian countries, Sri Lanka needs to tighten its policies and institutional frameworks that govern environmental protection and prevent ecosystem degradation. Re-arming ineffectual laws, implementing comprehensive plans that have already been drawn up, better coordination between responsible agencies to ensure maximum impact, and finding new ways to minimize the environmental impact of industrial activities, are crucial strategies.

With the end of the post-crisis era of easy credit and the slowing down of funds to emerging market economies like those in Asia, countries are going to have to focus more closely on growth-boosting structural reforms to attract finance and investment to spur the next wave of development. For Sri Lanka, too, the challenge is similar. With the post-war growth bump decisively over and a costly but essential infrastructure drive financed with borrowed funds under way, undertaking the critical reforms to ensure a sustained growth trajectory cannot be ignored. If Asia's experiences have taught any lessons, it is that fundamentally strong economies with the right policies in place and having done reforms when needed, have been able to successfully navigate multiple global storms and remain on a path of economic ascendance. Of course, there were inherent advantages that did help; for instance, a favourable demographic structure, developmental state models of governance, and the willingness to disregard environmental consequences in favour of rapid industrialization, etc. Sri Lanka's conditions are different, and following the Asian trajectory identically may not be feasible or desirable. Yet, there are salutary lessons to draw from Asia's rise, both for Sri Lanka's own development journey but also in understanding how best to latch on to it.

Sri Lanka cannot forget that it lies in an enviable geographical location that connects this rising Asia with the rest of the world.

There may be debates on its style and scale, its nature and intent, but the fact remains that Asia's rise is here, and will be a defining feature of the next few decades. Sri Lanka needs to better understand how it fits in. Amidst this, Sri Lanka cannot forget that it lies in an enviable geographical location that connects this rising Asia with the rest of the world. While looking at latching on to rising Asia, Sri Lanka cannot ignore countries to its West - whether it is in Africa, the Middle East, or traditional partners in the industrialized West. Although many are quick to assume it, the countries in Europe and North America are not in systemic decline. They will continue to be poles of innovation, creativity, consumption, and global leadership, and failing to recognize that and navigate accordingly, will only be to Sri Lanka's peril.