Sri Lanka's Post-civil War Development Challenge: Learning from the Past

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The end of the ethnic conflict in Sri Lanka in 2009 generated widespread expectations of a period of sustained economic growth, building on the achievements of the liberalisation reforms over three previous decades. However, recent developments have dampened that optimism, rekindling fears that Sri Lanka's tale of missed opportunities may continue. The analysis in this paper suggests that return to the failed past policies of inward-oriented development strategies offers no viable solutions for the economic problems confronting Sri Lanka.

Key words: Sri Lanka**,** ethnic conflict, economic growth, trade liberalization, foreign debt

Introduction

Sri Lanka had been trapped for a quarter of a century in a bloody separatist war until 2009 when the government crushed the separatist forces and achieved a decisive military victory. The end of the war generated a surge of optimism about the economic prospects for Sri Lanka, with high expectations that the country would embark on a period of sustained economic growth.

The immediate post-civil war period appeared to validate that optimism. With renewed confidence, Sri Lanka experienced a substantial economic recovery. But, as the large and rapidly growing literature on post-civil war recovery has shown, a resurgence of growth in the immediate aftermath of an end to a violent conflict is no guarantee of a sustained recovery over the medium to long term.[1] In Sri Lanka's case, it has not taken long for the early optimism to fade. By 2014 there were clear signs that debt-fuelled growth dynamism was not sustainable. Also, despite the glowing headline economic numbers, early signs of popular dissatisfaction with the economic performance and complaints about the increasing cost of living had begun to emerge. A clear warning signal of waning electoral support came from the provincial council elections held in September 2014 in one of the nine provinces in the country, where the government share of the votes slumped from 72% to 51%. In November 2014 President Mahinda Rajapaksa called a snap election, two full years ahead of his second six year term, anticipating further erosion of his electoral support as economic conditions worsening. At the election held on 8 January 2015, in a stunning change in the political regime in the country, the common opposition candidate, Maithripala Sirisena emerged victorious, with the share of total votes received by the incumbent president falling to 47.6% from 57.9% in the previous election.

In this context, this paper aims to contribute to the debate on economic reforms for sustainable growth in Sri Lanka during the post-civil war era by examining the recent experiences from a historical perspective. he paper begins with an overview of policy-making and economic performance during the post-independence period until the late 1990s, focussing specifically on the economic liberalisation reforms initiated in the late 1970s and their outcome. The next section discusses changes in the policy scene since the late 1990s that shaped policy making in the post-civil war period and the key elements of the new development strategy. The following examines recent macroeconomic developments with particular attention to the role of public sector investments, fiscal deficit and external financing issues and their implications for the sustainability of the post-civil war growth momentum.The final section offers some concluding remarks.

Historical context

In 1948, Sri Lanka ('Ceylon' until 1972) entered Independence well placed for continuing economic achievement. At that time, and well into the 1950s, Sri Lanka ranked as one of the most prosperous Asian countries, with per capita income (and other development indicators) placing it not only well above its South Asian neighbours but also much ahead of countries such as South Korea and Thailand (Kravis et al 1983). It was also favoured with many early advantages which were not shared by most other Asian countries: strategic location in the Indian Ocean[2], an open economy with a vibrant export sector, a high level of education, an absence of extreme poverty and inequality, a relatively well-developed physical infrastructure, and a broad-based and efficient administrative apparatus. It was 'an oasis of stability, peace and order' (de Silva 1981, 489) in a region of violent conflict and turmoil. The balance of payments position was healthy, backed by large foreign exchange reserves and a sound budgetary position. All of these initial conditions had provided the setting for the expectation that, of all post-colonial nations, Sri Lanka would prove 'the best in Asia' (Jiggins 1973, 26).

But the early promise of strong economic growth was not sustained. During the two decades from about the early 1960s growth of Sri Lanka's per capita income fell way behind the fast growing East Asian economies, rapidly converging to the levels of its South Asian neighbours (Athukorala and Rajapatirana 2000, Snodgrass 1998). Until about the mid-1960s, Sri Lanka's standards of living, measured by the usual indicators such as adult literary, life expectancy, infant mortality remained well above those of other developing countries. From then, however, the picture turned out to be less impressive when one shifts from a single-period cross-country comparison to a time series analysis that takes into account Sri Lanka's capacity to improve upon the highly favourable initial position (Bhalla and Glewwe 1986, Dunham and Jayasuriya 2000). The standards of living in Korea, Taiwan and some other high-performing economies in Asia had begun to improve more rapidly than Sri Lanka. There were also indications of deterioration in the quality of education and health care (World Bank 2004).

The reasons for Sri Lanka's growth slowdown during this period have been the subject of much debate.[3] Many analysts, particularly those associated with international donor agencies such as the World Bank, argued during the 1960s and the 1970s that government expenditures on health, nutrition, and education were primarily responsible for the slowdown by diverting government resources away from direct growth-oriented investments. Of course there would have been some room for redressing the investment-redistribution trade-off through better targeting of social welfare services, which were provided free of charge irrespective of the income status of the recipients. However, there are strong reasons to argue that the primary cause of the slide to slow growth and stagnation was the turn away from international trade in favour of inward-looking policies as it has been illustrated by the East Asia experience (Perkin 2013), government expenditure on human capital development could have played a vital complementary role in economic growth and structural transformation of the country under a market-friendly, outward-oriented development strategy.

During the first decade after independence, Sri Lanka continued to remain an open-trading nation with only relatively minor trade and foreign exchange restrictions and liberal domestic policies. However, from the late 1950s onwards, a combination of change in political leadership and balance-of-payments difficulties led to the adoption of a state-led import-substitution industrialization strategy. Import restrictions, initially imposed to address payments difficulties, became increasingly more restrictive as the development strategy shifted to import-substitution policies and led to pervasive state interventions in the economy. By the mid-1970s, the Sri Lankan economy was one of the most inward-oriented and regulated economies outside the communist bloc, characterized by stringent trade and exchange controls and by pervasive state interventions in all areas of economic activity. Widespread nationalization measures and threats, coupled with various economic controls, had effectively marginalized the private sector in the economy. The annual average growth rate of per capita GNP declined from 2.8% in the 1960s to a mere 0.7% during 1970-77 (Athukorala and Jayasuriya 1994, 28).[4]

As a reaction to the dismal economic outcome of the inward-looking policy, in 1977 Sri Lanka embarked on an extensive economic liberalization process that marked a decisive break with decades of protectionist policies.[5] The first round of reforms carried out during 1977-79 included a significant trade policy reforms; opening up the economy to foreign direct investment (FDI), with new incentives for export-oriented foreign direct investment (FDI) under an attractive Free Trade Zone (FTZ) scheme and constitutional guarantee against nationalisation of foreign assets without compensation;[6] abolition of the multiple exchange rates followed by a sharp devaluation of the unified exchange rate; and the introduction of limits on direct public sector participation in the economy.

Sri Lanka's ability to reap benefits from this remarkable policy transition was seriously hampered by the escalation of the ethnic conflict in the early 1980s.[7] During 1983-2009 the economy continued to be burdened by the massive military expenditure (which increased from 1% to 5.0 % of GDP between 1984 and 2008)[8] and its consequences for macroeconomic instability. The Northern Province and large parts of the Eastern Province (which together account for one-third of Sri Lanka's total land area and almost 12% of the population) remained mostly cut off from the national economy. Even in the rest of the country, prospects for attracting foreign investment, particularly in long-term ventures, was seriously hampered by the lingering fear of sporadic attacks by the rebels. The government's preoccupation with the civil war also hampered capturing the full benefits of economic opening through delays and inconsistencies in the implementation of the reform processes.

There was, however, no retreat to the old control regime. In a decisive move to infuse momentum to the unfinished reform process, a significant ‘second wave’ liberalization package was implemented in 1990. By the mid-1990s Sri Lanka ranked amongst the few developing countries that had made a clear policy transition from inward orientation to global economic integration. After 17 years in government, the United National Party (UNP) lost power at the 1994 general elections to the Peoples’ Alliance (PA), a centre-left coalition led by the Sri Lanka Freedom Party (SLFP) which had governed the country during most of the era of economic dirigisme. However, there was no significant change in the broad direction of economic policies; the gains from export-oriented industrialization had been impressive enough to set the stage for ‘leading the left to the right’ (Moore 1997). The new government extended the privatization and deregulatory policies and pursued trade and macroeconomic policies that were largely indistinguishable from the previous government. By the mid-1990s Sri Lanka appeared to be “at the point of moving into an important policy phase marked by shifting the agenda away from protection and towards achieving a stable and predictable economic policy environment” (Cuthbertson 1997, 637).

Despite the unsettled conditions, the reforms dramatically transformed the economic landscape of Sri Lanka. The share of manufacturing in GDP rose from around 10% in the mid-1970s to nearly 20% (about two percentage points higher than the share of agriculture) by the dawn of the new millennium. The export structure of the economy underwent a remarkable transformation from land-intensive, plantation exports to labour-intensive manufacturing. The share of manufacturing in total merchandise trade increased from 5% in the mid-1970s to over 70% in the same period, ending the historic dependence of the economy on three primary commodities (tea, rubber and coconut products). This successful diversification of the export structure effectively ended the prolonged (1955–1975) deterioration of the terms of trade (Athukorala 2004). Export-oriented manufacturing sector emerged as the major generator of employment opportunities in the economy, accounting for over half of total employment growth during 1985-2000 (Athukorala 2007, Table 5). With the gradual erosion of the dominant role of state-owned enterprises (SOE) the private sector was largely responsible for economic dynamism of the country. The annual growth rate of the economy surged from an average of 2.9 percent during 1970–77 to over 4.5 percent during 1978–2000. The percentage of people living below the poverty line (the poverty headcount) declined from 28.8% in 1995 to 22.7% in 2002 and then to 15.2% in 2006. In an assessment of Sri Lanka's economic performance during the reform era, World Bank's *Sri Lanka Development Policy Review* of 2004 noted that "It would be hard to find a more convincing case of trade and industrial transformation of a small island economy through market-friendly policy reforms"(World Bank 2004, 6).

Opening up of the country to foreign direct investment combined with significant trade liberalisation played a pivotal role in the emergence of the new export-oriented manufacturing industry. Export-oriented FDI attracted to Sri Lanka during this period was, however, heavily concentrated in standard light consumer goods industries such as garments, footwear, sport goods, and cutting and polishing imported diamonds. There is evidence to suggest that foreign firms could have played a much more important role in export expansion, with involvement in a wider range of export products, if it were not for the increase in political risk following the eruption of the ethnic conflict in 1983. Foreign firms involved in vertically integrated assembly activities in high-tech industries (such as electronics and electrical goods), unlike those involved in light consumer goods industries, view investment risks from a long-term perspective because output disruption in a given location can disturb production plans for the entire production chain. In fact, in the early 1980s two electronics multinationals, Motorola and Harris Corporation, signed agreements with the Board of Investment and incorporated subsidiary companies to set up assembly plants in Sri Lanka. However, they soon left the country as the political climate begun to deteriorate. If the two projects of Motorola and Harris Corporations had been successful, other multinationals would probably have followed suit (Snodgrass 1998).

Recent policy shifts

Notwithstanding the notable economic achievements during the reform era, there has been a back-sliding from liberalization reforms over the past one-and-a-half decades (Rajapatirana 2004, Pursell 2011, Kaminski and Ng 2013). As early as the late 1990s, trade liberalisation process suffered a setback because of the pressure for raising additional revenue from import tariffs to finance the ballooning war budget. The planned reduction of tariffs into a single band was abandoned and from then on tariffs were adjusted frequently in an ad hoc manner. The protectionist tendencies soon received added impetus from the growing discontent amongst the electorate, which was propelled by the crisis economic conditions as the civil war accelerated. The populist policies received strong backing from an anti-liberalization lobby with strong vested interests and ideological support from a group of senior academic economists who used the failure of reform policies to fully meet initial expectations to argue that the failure of so-called 'neo-liberal' policies demonstrated the need for returning to a more nationalist economic programme. The anti-liberalisation lobby also received added impetus from the backlash against economic globalisation and 'Washington Consensus' in international policy circles.

These developments set the stage for Mr Mahinda Rajapakse, who had long been one of the most active, campaigning member of the ruling coalition, to win the presidential election of November 2005 by promising a 'new vision' for achieving 'balanced growth'. After the country returned to a state of normalcy at the end of the three-decade old civil war in May 2009, President Rajapakse consolidated power by calling fresh presidential and parliamentary elections in 2010 and winning both decisively (Uyangoda 2010).

The development strategy of the Rajapaksa regime emphasised the role of the state in 'guiding the markets' with a view to redressing untoward effects of economic globalisation, Privatization of key state enterprises (banking, power, energy, transport, and ports) was explicitly ruled out, while conspicuously avoiding any reference to trade policy reforms (Government of Sri Lanka 2010). Rapid infrastructure development of rural and conflict-affected parts of the country and the promotion of small and medium enterprises were the key policy priorities under the new policy. In line with this eclectic programme, the past five years have seen a number of developments in the Sri Lankan policy scene, which marked a notable departure from the market-oriented policy stance maintained for over three decades from the late 1970s.

Trade policy regime

If we take into account only the customs duties (CD) and quantitative trade restriction which comes under the direct surveillance of the World Trade Organisation (WTO), Sri Lanka has continued to maintain a fairly open and transparent trade regime (WTO 2011). However, there were numerous other import taxes introduced during the period of the war to raise revenue in order to defray the costs of specific government services, or to promote local producers (Pursell 2011, Athukorala 2012). By 2009 the Sri Lankan tariff schedule included nine import taxes in addition to the standard customs duty. Of these nine taxes, five were 'para-tariffs': taxes which are only applied to imports and there is no domestic equivalent, and hence add to whatever protection is provided to domestic production by customs duties. The total nominal protection rate (Customs duty + para-tariff) went up slightly between late 2002 and early 2004, but then more than doubled between 2004 and 2009. The average protection rate for agriculture increased from 28.1% to 49.6%, for industrial products from 10.7% to 24.1%, and for all imports lines from 13.4% to 27.9% (Athukorala 2012).

In a context of slow export growth and widening trade deficits (see below), there has been a renewed emphasis in recent years on import substitution. In 2012 the Ministry of Finance came up with a two-pronged approach: direct import substitution in subsidiary food crops and import-competing manufacturing industries, and increasing the domestic input content in export products (Ministry of Finance 2013). The government budget of 2011 introduced new export taxes on tea and rubber exported in raw and semi processed form to promote further processing of these products. These policy measures are in sharp contrast to the basic tenet of the outward-oriented development strategy pursued by the country during the 1980s and 1990s which aimed to restructure the trade patterns and the economy in line with the country’s comparative advantage within the global economy.

FDI policy

As noted, promotion of FDI combined with significant trade liberalisation played a pivotal role in rapid expansion of export-oriented manufacturing in Sri Lanka. With the ending of the civil conflict, Sri Lanka is in a much better position to harness the gains from FDI, building on its achievements over the past three decades. However, paradoxically recent developments in the Sri Lankan policy scene have begun to send mixed signals to foreign investors, despite the new government has ‘officially’ committed to moving towards further integrating Sri Lanka into the world economy’ (Government of Sri Lanka 2010, 53).

In 2008 the parliament passed a *Strategic Development Projects (SDP) Act*, empowering the minister in charge of the Board of Investment (BOI) to grant exemption to ‘strategic development project’ from all taxes for a period of up to 25 years. In the Act, a strategic development project means ‘a project which is in the national interest and likely to bring economic and social benefits to the country and which is also likely to change the landscape of the country, primarily through provision of goods and services which will be of benefit to the public, substantial inflow of foreign exchange, substantial employment, and technology transfer' (Government of Sri Lanka 2008). This definition leaves a great deal of room for discretion in the investment approval process.

A *Revival of Underperforming Enterprises and Underutilized Assets Act* was passed in November 2011 empowering the government to acquire and manage 37 'underperforming' or 'underutilized' private enterprises. These enterprises (some of which are said to be profit making, according to media commentaries), included 7 enterprises with foreign capital participation (including Colombo Hilton of which Mitsui of Japan was a significant shareholder). Both the Fitch Group and Moody Corporation, two major credit rating agencies, have warned that the bill would erode investor confidence and affect Sri Lanka's investment rating (Goodhand 2012).

State-Owned Enterprises

The privatization programme was abandoned following the regime change in 2005. Initially declared policy of the new government was not to privatize, but to restructure and improve performance of the existing ventures, if required with private sector involvement, but retaining government ownership of at least 51%. However, the past five years have seen further expansion of the role of SOEs in the economy by re-nationalizing some previously privatized ventures, revitalizing closed-down SOEs, fresh nationalization, and setting up of new ventures (eg. Lankaputra Development Bank, National Insurance Trust Fund, a second national airline (Mihin Lanka)). As already noted, 37 private enterprises were brought under government ownership in November 2011.

Total losses of public corporations increased from RS 8 billion (0.3 of GDP) in 2005 to 191 billion (2.5% of GDP) in 2012. Total budgetary transfers (both current and capital) to public enterprises increased from an average annual level of RS 78 billion (16.3%) of total government revenue during 2003-2007 to 212 billion (20.1%) in 2012. The latter figure does not include restructuring bonds amounting Rs. 53.9 billion issued in that year to settle outstanding dues from state-owned enterprises to the Petroleum Corporation and the Electricity Board (Ministry of Finance 2013).

Macroeconomic policy

The stated objective of government's macroeconomic policy was to achieve a stable exchange rate regime through appropriate coordination of exchange rate policy, and fiscal and monetary policies (Government of Sri Lanka 2010). But, in practice, there has been a fundamental contradiction between exchange rate policy, and fiscal policy and monetary policies.

During the period from 2006 to 2008 the Central Bank maintained a stable nominal exchange rate of the rupee vis a vis the US$ by drawing on foreign reserves and foreign borrowing, including a one-billion sovereign bond issue,[9] in a context where fiscal and monetary policy excesses continued to fuel domestic inflation. By late 2008, the country was on the brink of a balance of payments crisis: foreign reserves were approaching alarming levels, external debt was rising and the Central Bank was struggling to meet debt servicing commitments. The government had no alternative but to go to the IMF and negotiate a Stand-by Agreement (SBA). The US$ 2.5 billion SBA helped Sri Lanka to avoid a balance-of-payments crisis, improve investor confidence, and stabilize the exchange rate US$ through further commercial borrowing. But, the government failed to adhere to the promised fiscal consolidation under the SBA.

In February 2012 the Central Bank was forced to abandon foreign exchange market intervention to back up the exchange rate, in the face of widening current account deficit and rapid depletion of foreign exchange reserves. However, from about the fourth quarter of 2013 the Central Bank resumed stabilizing the exchange rate drawing on foreign exchange reserves built up through sovereign bond issues. The persistent stability of the nominal exchange rate coupled with higher domestic inflation compared to that of the trading partner countries have resulted in an appreciation of the real exchange rate by about 20% during 2005-2013 compared to the previous five years, eroding the competitiveness of export-oriented and import-competing production in the economy (Table 1).

The budget deficit widened mainly because of government spending on 'faster-than-programed, lumpy disbursements for a couple of large foreign financed infrastructure projects and for their counterpart funds' (IMF 2010, 4). A large scale reconstruction effort with substantial public sector involvement was clearly needed after a quarter century of destruction, neglect and decay of essential physical infrastructure. However, prioritization and economic efficiency of many government infrastructure projects, such as a modern port and other facilities (being built with Chinese assistance) located in the heartland of the electoral support base of the President are questionable (Law & Society Trust 2012, Sarvananthan 2015). The massive construction projects also became the focal point of widespread public concern and complaints of financial excesses (Kumarage 2014).

Insert Table 1 about here

Economic performance

During 2010-13, the Sri Lankan economy grew at an average annual rate of 7.0% (Table 1). This was by far the highest average growth rate for any consecutive four-year period in the country's post-independent history.[10] Per capita income increased from US$ 1,062 in 2004 to US$ 3,191 in 2013. The rate of inflation came down from a historical height of 22.6% in 2008 to an average annual rate of 6% during the ensuing five years. The unemployment rate fell continuously from 8.3% in 2004 to 4.4% in 2013. Between 2006 and 2012 the poverty head count ratio declined from 15.2% to 6.7% accompanied by a reduction in the poverty gap from 3.1% to 1.7%. The Gini coefficient also declined from 0.40 to 0.36 between these two years indicating that rapid growth was accompanied by a more equitable distribution of income (CBSL 2014)[11]. However, these impressive headline economic figures need to be treated with caution for a number of reasons.

Sri Lanka's system of national accounts has not been revised/updated since the early 1970s and "The national accounts suffer from insufficient data sources and underdeveloped statistical techniques" (IMF 2014, Statistical Appendix). Given the unavailability of detailed data needed to measure both output and intermediate inputs, some of the gross value-added figures are estimated indirectly using fixed ratios obtained from outdated studies or based on ad hoc assumptions. Of course, while the resulting biases can go either way, such a virtual 'non-system' naturally leaves room for 'creative' accounting. This is particularly important because of the concerns raised in the media during the Rajapaksa regime about political influence on the generation of headline national statistics. These concerns arose mostly after the government's move in 2007 to make the compilation of national accounts the sole responsibility of the Department of Census and Statistics (DCS), which was under the purview of the President during this period.[12] In January 2014, the DCS sacked the Acting Director of its National Accounts Department after he revealed that the CDS, in his absence, revised up the 2013 first quarter growth rate from 5.4 percent to 6 percent (Aneez and Sirilal 2014) The new CPI compiled by the DCS since 2007 has excluded alcohol (a commodity that accounts for a substantial share of household expenditure, particularly in working class household) and tobacco from the commodity basket, and some important items (such as the cost of transport and housing) are estimated using regulated (controlled) rather than market-determined prices (Sarvananthan 2014a). Quite apart from understating the cost of living, these limitations of the CPI are bound to overstate the rate of growth in the economy because CPI and its sub-indices are used for estimating real value-added in a number of sectors (in particular many subcategories in the services sector) (Shourie 1974).

The data on poverty and income distribution, which are usually published at the national level, are naturally subject to aggregation biases. For instance, in a disaggregated analysis of unpublished household survey data, Sarvananthan (2015) shows that poverty levels in some districts and sub-regions in the Eastern and Northern provinces still remain stubbornly high, notwithstanding massive government infrastructure investment in these areas. Relating to income inequality, there is a large difference between the latest available figure of the Gini ratio (for 2012) as reported in the Central Bank report (0.36) and the one reported by the Department of Census and Statistics for the same year (0.48) (SLDCS 2015).

Even if we take the official data at face value, there are several qualifications that must be made to the rosy picture when we analyse the overall growth experiences from a long-term sustainability perspective. First, the main drivers of growth have been the non-tradable sectors (construction, transport, utilities, trade and other services), reflecting largely the role of the major public sector infrastructure development projects. These sectors accounted for over 70% of the total increment in real GDP between 2004 and 2013. The manufacturing sector grew only at a modest rate, resulting in a decline in its share in GDP from 18.5% during 2000-04 to 16.5% during 2005-2013. Within manufacturing, the largest contributor to growth has been the food, beverages and tobacco product sector where the production is predominantly domestic market oriented. Sectors such as non-metallic mineral products, rubber and plastics, and miscellaneous manufacturing where export production is concentrated, have recorded much slower growth.[13] In sum, the sectoral profile of economic performance in recent years is consistent with the erosion of the competitiveness of traded goods production (real exchange rate appreciation) noted in the previous section.

Second, the threefold increase in per capita income in current US$ terms between 2004 and 2013 partly reflects domestic inflation and artificial stability of the exchange rate of the Sri Lankan rupee against the dollar. When the data are expressed in real (2005) prices in order to allow for these factors, per capita income in 2013 (US$ 1920) was only 62% higher than that in 2004 (US$ 1182) (Table 1).

Third, decline in the unemployment rate was partly due to an increase in public sector recruitments and a surge in overseas employment of Sri Lankans. In a dramatic reversal of the contraction in the size of the public sector workforce maintained over the previous decade, total employment in the public sector increased from around 900,000 (11.1% of the total labour force) in 2005 to over 1.2 million (14.%) in 2012 (Ministry of Finance 2013). During 2002-2012, on average, a quarter of a million Sri Lankans have been leaving annually for overseas employment, with the number increasing every year. The total number that left during 2008-2012 was 1307 thousands, up from 1078 thousands during the previous five years. A tentative estimate suggests that the total stock of Sri Lankan overseas contract migrant workers would have reached 2 million by 2011, amounting to over 14% of the total working-age population of the country (Arunatilake et al. 2011).

Fourth, although the official aggregate figures show a notable increase in total FDI inflows during the past three years, data at the sector/industry level reveal that the increase has come largely from projects in the construction and services sectors. During 2010-13, manufacturing accounted for only 31% of total realized FDI. The bulk of these flows were to domestic market oriented industries (mostly food and beverages), with garments being the only export-oriented industry to attract some FDI. There is evidence that a large number of export-oriented foreign firms have closed down their operations in Sri Lanka. A comparison of the firm-level records of the Board of Investment (BOI) shows that 465 firms which were in operation in 2002 had disappeared from the BOI list in 2009. This number is too large to be interpreted solely as a recording error. Of these firms, the majority are firms with foreign capital participations (joint venture or fully foreign owned). By contrast, the majority of newly established firms (over 80%) are fully locally owned. Investors from India now dominate the list of firms operating in Sri Lankan EPZs; many firms from Korea, Hong Kong and from a number of developed countries have left the country (Athukorala 2012).

Fifth, the external payments position of the country has deteriorated over the past three years. In 2013, total imports were double the size of export earnings. There has been a massive contraction in exports of goods and services as a share of GDP, from average level of 25.6% during 2004-09 to 16.8% during 2010-13. In 2013, export earnings covered only 57% of total outlay on imports. While weak global demand in the aftermaths of the global financial crisis (2008-9) and the recent withdrawal of 'GSP Plus' tariff concessions by the European Union would have played a role, a comparative analysis of Sri Lanka export performance suggests that the problem is mostly 'home grown' (Rajapatirana 2013, Kaminski and Ng 2013). Sri Lanka's share in both world exports and exports from developing countries has declined sharply, indicating that Sri Lanka has failed to keep pace with the expansion in world demand. Viewed against the experience during the 1980s and 1990s, the continuous appreciation of the real exchange rate and Sri Lanka's failure to attract export-oriented foreign investors (and also to retain those who had set up production based in the country) appears to be the main factors behind the export slowdown. Reflecting largely the sluggish export performance, the current account deficit widened from 0.5% of GDP in 2009 to 7.8% in 2010. It has come down since then thanks to rapid increase in inward remittances by Sri Lankan overseas migrant workers and also slower import growth. But, at 3.9% of GDP, it is still well above the average level of the emerging market economies (1.8% of GDP).[14]

Total outstanding external debt almost doubled from US$ 20.9 billion (49.7% of GDP) in 2009 to 39.7 billion (59.2% of GDP) in 2013 (Table 2). This increase was underpinned by a palpable shift in the composition of external debt from concessional loans from bilateral donors and international developmental agencies to borrowings on commercial terms (IMF 2004). Within commercial borrowing private sector debt in the form of foreign bank borrowings and international debt securities issued by the state-owned banks under government guarantee has increased rapidly. There has also been a rapid growth of short-term debt (foreign capital flows to government securities and banking sector external liabilities), from US$ 5.3 billion in 2008 to 9.0 billion in 2013. As a result of the overall increase in debt and the shift of its composition from concessional debt to loans on commercial terms, the debt service ratio increased from an average level of 12.5% during 2004-08 to 25.3% in 2013. The debt service ratio is bound to increase more rapidly in three to five years' time when the accumulated long-term debt begins to mature.

By the end of 2013 total gross foreign-exchange reserves (US$7 billion) was adequate to cover 4.6 months of imports. However, according to the IMF estimates net foreign exchange reserves[15] amounted to only US$ 4.6 billion, which was sufficient to cover the import bill of the country for only about 2.5 months, which is below the tradition rule of thumb level for reserve holding for the Central Bank (reserves equivalent to at least three months' worth of imports). Be that as it may, the import-based reserve adequacy measure, which originated in the days of the old Bretton Woods system, is not an appropriate yardstick for measuring reserve adequacy given that the country is now significantly integrated into global capital markets through foreign borrowing and its short-term debt exposure has increased significantly in recent years. Under the Bretton Woods era, given the combination of fixed exchange rate and binding controls on capital flows, the worst situation that could be imagined relating to balance of payments management was that a country could lose access to trade credit (which normally matures in three months) (Athukorala and Warr 2002).

Table 2 about here

An important lesson learned from the string of financial crises that engulfed emerging market economies in the 1990s (eg. Mexico in 1995, East Asia in 1997, Brazil in 1999, Turkey in 1994) was that the prudential level of reserves needs to be determined in relation to the volume of short-term foreign-currency liabilities. Based on this experience, in 2001 the Executive Board of the IMF came up with the following guideline for assessing reserve adequacy of a country in its lending and surveillance activities:

> '…. holding reserves equal to short-run debt [is] an appropriate starting point for a country with significant but uncertain access to capital markets. But it is only a starting point. Countries may need to hold reserves well in excess of this level, depending on a variety of factors: macro-economic fundamentals; the exchange rate regime; the quality of private risk management and financial sector supervision; and the size and currency composition of the external debt (Fischer 2001, 3).

In terms of this criterion, Sri Lanka's ability to defend the rupee in the event of an external shock that could trigger short-term capital exodus has rapidly eroded in recent years. In 2008, when Sri Lanka entered into the SBA with the IMF, gross foreign exchange reserves amounted to a mere 48% of the total stock of outstanding short-term debt. The SBA helped restore the external reserve position during the two following years, lifting the reserve cover of short-term debt to 112% in 2010. This improvement was rather short-lived, however. During the next three years this figure had come down to about 70% when estimated using gross and net foreign-exchange reserves. The decline in the short-term debt cover is even sharper when measured in terms of net foreign-exchange reserves, from 77.5% in 2009 to 50.9% in 2013 (Table 2). It is important to note that the foreign-exchange reserves to short-term debt ratio is the single most empirically supported indicator of a country's vulnerability to currency crises.[16]

Finally, the other side of the coin to the worsening current account deficit and massive foreign debt accumulation is the widening budget deficit. A deficit in the current account means that the aggregate (public + private) domestic expenditure of the country exceeds aggregate income. In the Sri Lanka case, the private sector has continued to remain a net saver and the current account deficit solely mirrored the public-sector deficit (budget deficit) (Table 1). Form about the late 1990s until 2008, the budget deficit hovered around 7% of GDP, with military expenditure accounting for the lion's share of deficit financing, and reached a historical high of 9.9% of GDP at the final stage of the conflict in 2009. Notwithstanding a mild decline during the past three years, the budget deficit still remains well above the internationally considered 'safety range' of 3% to 5%. Even this mild decline in the officially reported deficit figures needs to be treated with caution because from about 2012 the government has been shifting budgetary transfers to the loss-making public enterprises 'off budget', by forcing these enterprises to borrow on their own from domestic banks under government guarantee (Weerakoon 2013, Sarvananthan 2014b).

Concluding remarks

The market-oriented policy reforms initiated in 1977 have led to far-reaching changes in the structure and performance of the Sri Lankan economy. It is important to note that what has been achieved in Sri Lanka under liberalisation reforms occurred while civil war has persisted for much of the period. In addition to its direct debilitating effect of political risk on investor perception, the civil war constrained capturing the full benefits of economic opening through delays and inconsistencies in the implementation of reform process and macroeconomic instability emanating from massive war financing.

Viewed against this backdrop, the developments in the Sri Lankan policy scene during the post-civil war years do not augur well for the future of the Sri Lankan economy. After showing remarkable resilience during decades of war and conflict, the Sri Lankan economy has failed to capitalise on the window of opportunity presented by the end of the military conflict. Post-civil war 'recovery' has so far been largely underpinned by a widening current account deficit, which mirror a widening budget deficit, financed with an equally large inflow of funds from the rest of the world, with a notable shift in its composition from foreign aid and concessionary credit to commercial borrowings.

The policy dilemma of the new regime is how to redirect policy changes to restore international competitiveness of the economy and to contain debt dependency while maintaining the living standards of the population and an adequate growth momentum to sustain employment levels. Even under an optimistic scenario of availability of external financing, the debt-driven growth dynamism can be sustained only as long as foreigners keep lending to Sri Lanka and increasing their total Sri Lankan exposure. Eventually sustaining robust growth requires macroeconomic adjustments to restore the international competitiveness of the economy through depreciation of the real exchange rate. Realistically, this will require a substantial nominal depreciation of the rupee. However, under the current economic conditions, relying on nominal exchange rate depreciation alone for achieving this economic adjustment could be a recipe for economic disaster. Given the massive build-up of foreign-currency denominated government debt, exchange rate depreciation naturally worsens budgetary woes. And given the increased exposure of the economy to global capital markets a large abrupt change in the exchange rate could also shatter investor confidence, triggering capital outflows. Therefore, what is required is a comprehensive policy package encompassing greater exchange rate flexibility and fiscal consolidation (which requires both rationalisation of expenditure and widening the revenue base) to achieve a durable reduction in public debt, and complementary measures, including trade and investment policy reforms, to improve the overall investment climate in the country.

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Notes

[1] For reviews of the related literature see Coyne et al. (2011).

[2] 'Colombo …. [was] the "Clapham Junction" of ships voyaging in the East' (Arurachalam 1907, 324).

[3] For a comprehensive review of this debate, see Osmani (1994).

[4] Slow economic growth and high unemployment provided the breeding ground for a new radical youth movement, the Janatha Vimukthi Peramuna (JVP, the Peoples' liberation Front), which launched an armed uprising in 1971 to capture state power (Obeysekera 1974).

[5] For details on the reform process see Moore (1997), Snodgrass (1998) and Athukorala and Rajapatirana (2000).

[6] Article 157 of the new Constitution of Sri Lanka adopted in 1978. Following the nationalisation of the foreign-owned gas and petroleum outlets during 1962-1964, Sri Lanka became the first country against which the US government invoked the Hickenlooper Amendment requiring the suspension of US aid to countries expropriating US property without compensation (Olson 1977). The constitutional guarantee was, therefore, vital to restore investor confidence.

[7] For details on the courses and economic consequences of the ethnic conflict see Abeyratne (2004), Richardson (2005) and Bandarage (2009) . .

[8] Unless otherwise stated, the data reported in the paper are from the *Annual Report* (various issues) of the Central Bank of Sri Lanka.

[9]There was also some foreign funds flowing to the treasury bill market following the opening of that market to foreign investors (with an aggregate ceiling of 10% of the outstanding treasury bill issues) (Central Bank of Sri Lanka 2012).

[10] This comparison is based on real GDP growth rates for the period 1950-2013 (CBSL (2014), Special Statistical Appendix, Table 2).

[11] The data are based on the Household Income and Expenditure Survey (HIES) conducted by the Department of Census and Statistics, Sri Lanka.

[12] DCS has been the ‘official’ organisation responsible for compiling national accounts throughout. However the Central Bank started to compile national accounts independently with effect from 1959 because CDS data were normally available only after a considerable delay. During the ensuing years the Central Bank national accounts series, which was subject to periodic scrutiny by the International Monitory Fund, turned out to be the *de facto* official series used in monitoring the performance of the economy. The compilation of national accounts by the Central Bank was terminated in 2007.

[13] The only notable exception has been the export-oriented ready-made garment industry, which had already been well integrated within the global apparel value chain as a producer of upmarket apparel products (lingerie and fashion casual wear) thanks to trade-cum-investment liberalization reforms in the 1980s and 1990s.

[14] The figure is from the IMF World Economic Outlook Database

[15] Gross official reserves after netting out short-term (less than one year) contractual payment obligations and foreign exchange swap arrangements with domestic banks.

[16] See Jeanne and Ranciere (2011) and the works cited therein.

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Table 1. Sri Lanka: Selected Macroeconomic Indicators, 2004-2012

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
GNP per capita at current price, US$	1062	1241	1421	1617	2014	2057	2400	2836	2862	3191
GNP per capita at constant (2005) price, US$	1182	1241	1323	1400	1471	1505	1611	1727	1818	1920
Real GDP (2002 price) growth (%)	5.4	6.2	7.7	6.8	6	3.5	8	8.3	6.4	7.3
Unemployment rate %	8.3	7.7	6.5	6	5.4	5.8	4.9	4.2	4.0	4.4
Gross national saving(% of GDP)	22	23.8	22.3	23.3	17.8	23.9	24.7	25.3	24.0	20.0
Of which public saving	-3.7	-2.6	-2.2	-1.6	-2	-3.7	-2.1	-0.9	-1.0	-0.8
Gross domestic investment(% of GDP)	25.3	26.8	28	28	27.6	24.4	27.6	29.9	30.6	29.6
Of which public investment	5.6	5.6	6.1	6.3	6.4	6.5	6.1	6.2	6.9	6.9
Inflation (CPI) rate %	7.6	11.6	10	15.8	22.6	3.5	6.2	6.7	7.6	6.9
Government finance										
Budget deficit (% of GDP)	-7.5	-7	-7	-6.9	-7	-9.9	-8	-6.9	-6.5	-5.9
Budget deficit (% of total revenue)	100.6	93.8	96.5	94.2	99.2	134.3	107.2	102.1	112.6	111.5
Public debt outstanding (% of GDP)	102.3	90.6	87.9	85	81.4	86.2	81.9	78.5	79.2	78.2
Of which foreign debt[2]	47.6	39	37.6	37.1	32.9	36.4	36.1	35.6	36.5	34.1
External sector										
Exchange rate, US$/Rp	101.2	100.5	104	110.6	108.3	114.9	113.1	110.5	127.6	129.1
Nominal effective exchange rate (2004 = 100)[1]	100	100.2	104.3	117	115.8	116	115.7	115.9	126.9	125.6
Real effective exchange rate (2004 = 100)[1]	100	92.8	90.6	90.5	77	75.1	73.4	71.9	77.4	73.8
Trade balance (% of GDP)	-10.9	-10.3	-11.9	-11.3	-14.7	-7.4	-9.7	-16.4	-15.8	-9.4
Exports (FOB)	27.9	26.0	24.3	23.6	19.9	16.8	17.4	17.8	16.4	15.5
Imports (CIF)	38.7	36.3	36.3	34.9	34.6	24.3	27.1	34.2	32.3	26.9
Current account balance (% of GDP)	-3.1	-2.7	-5.3	-4.3	-9.5	-0.5	-2.9	-7.8	-6.6	-3.9
Gross foreign-exchange reserves (US$ million)[3]	1834	2508	2526	3062	1594	4897	6410	5758	6677	7041[5]
In months of imports	2.8	3.4	3.3	3.7	1.4	3.9	3.5	3.2	3.6	3.3
Net foreign-exchange reserves US$ million)	---	---	---	---	---	4150	5072	4011	4162	4597
In months of imports	---	---	---	---	---	3.3	2.8	2.3	2.2	2.2
Foreign direct investment[4] (US$ million)	217	234	480	603	752	404	478	956	941	919

Source: Data on net foreign-exchange reserves are from IMF (2013 and 2014); all other data are compiled from Central Bank of Sri Lanka, *Annual Report* (various years).

Notes:
1. Original Central bank index inverted: an increase (decree) implies depreciation (appreciation)
2. The figures reported here do not include purchase of treasury bills by foreign investors, which increased from US$ 63 million (0.1% of GDP) to US$ 92 million (1.6% of GDP) in 2012.
3. Net of Asian Clearance Union debit balances.
4. Net of foreign-currency loans received by the enterprises approved by the Board of Investment.
5. Provisional.

--- Data not available

Table 2. Sri Lanka: Composition of outstanding external debt, 2004-2012 US$ million)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Medium and long-term debt	10693	10689	11348	12873	13651	15559	18821	21070	23605	30717
Government[1]	9517	9348	10244	11736	12585	13761	16065	17809	19059	19291
Public corporations and private sector	920	963	852	890	889	1067	1440	1558	2054	5888
With government guarantee	511	573	461	346	249	105	521	911	1448	2376
Without government guarantee	409	391	391	544	640	962	919	647	606	3512
Central Bank: IMF drawings	256	378	238	247	178	711	1316	1704	2526	2665
Short-term debt	2082	2331	2627	3610	4124	5354	6009	8317	10069	9024
Short-term government securities[2]	652	664	629	1104	1458	3095	2607	3938	4849	2993
Banking sector external liabilities	1431	1667	1998	2489	2666	2259	3402	4379	5219	6031
Total external debt	12775	13020	13975	16483	17775	20913	24830	29387	33674	39741
Memorandum items										
Total external debt to GDP ratio (%)	54.9	46.5	49.4	51.0	43.7	49.7	50.1	55.4	62.5	59.2
Debt service ratio[3] (%)	11.6	7.9	12.7	13.1	18	22.4	16.7	12.7	19.7	25.3
Gross foreign-exchange reserves[4]/short term debt (%)	88.1	107.6	96.1	84.8	38.7	91.5	106.7	69.2	66.3	78.0
Net foreign-exchange reserves[5]/short term debt (%)	---	---	---	---	---	77.5	84.4	48.2	41.3	50.9

Source: Data on net foreign-exchange reserves are from IMF (2013 and 2014); all other data are compiled from Central Bank of Sri Lanka, *Annual Report* (various years).

Notes:

1. International sovereign bonds and loans
2. Treasury bills and treasury bonds.
3. External debt repayment and interest payments as a percentage of exports of goods and services.
4. Excluding Asian Clearance Union debit balances.
5. Excluding foreign exchange swap with domestic financial institutions and short-term contractual repayment obligations of the Central bank.

--- Data not available.