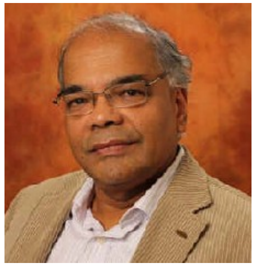
Prof. H.A. de S. Gunasekara was Professor of Economics and Head of the Dept of Economics & Political Science of the then University of Ceylon. He succeeded Prof. Das Gupta to become the second occupant of the Chair (and the first Sri Lankan) in the Department in 1961.

He also served as the Dean of the Faculty of Arts at Peradeniya (1963-1969) and later on as Secretary, Ministry of Planning (1970-1977) under Prime Minister Sirimavo Bandaranaike. He was a much respected academic and public servant. A large number of his students have made outstanding contributions to both academic and public life in Sri Lanka and overseas.



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He is the author/editor of over 10 books, 4 edited volumes, 60 chapters in multi-author volumes and 95 articles in academic journals. During his career, he has served as consultant to the World Bank, Asian Development Bank, ILO, UNDP, UNIDO, ESCAP and AUSAID – these assignments have resulted in work on Bangladesh, Cambodia, Ethiopia, Georgia, India, Indonesia, Jordan, Laos, Malaysia, Nepal, Pakistan, Sri Lanka, Thailand and Vietnam. He holds a B.Com. (First Class Honours) from the University of Peradeniya and a PhD in Economics from La Trobe University, Australia.

PROFESSOR H.A. DE S. GUNASEKARA MEMORIAL ORATION 2013

12th July, 2013
at
4.00 pm

Senate Room
University of Peradeniya

Department of Economics & Statistics
and the
Prof. H A de S Gunasekara Memorial Trust Fund

PROFESSOR H.A. DE S. GUNASEKERA
MEMORIAL ORATION 2013

Program

4.00 - 4.05	**Opening Ceremony**
4.05 - 4.10	**Welcome and Introductory Remarks** *Head, Department of Economics and Statistics*
4.10 - 4.15	**Vice Chancellor's address** *Vice-chancellor, University of Peradeniya*
4.15 - 4.20	**Introducing the speaker** *Dean, Faculty of Arts*
4.20 - 5.20	**Oration** *Professor Prema-chandra Athukorala,* *Professor of Economics, Australian National University, and* *Honorary Professorial Research Fellow,* *University of Manchester, UK*
5.20 - 5.30	**Vote of Thanks** *Secretary, Professor H A de S Gunasekera Memorial Trust Fund*
5.30 - 6.30	**Refreshments** Committee Room, Senate Building

Sri Lanka's Post-conflict Development Challenge:

Learning from the Past

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Abstract

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 sustained 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 of economic performance over the past decade suggests that return to the failed past policies of inward-oriented development strategies offers no viable solutions for the problems confronting Sri Lanka ─ a small, capital- and resource-poor country ─ in today's globalized world. Sri Lanka must change its economic policies drastically and urgently to cope with the huge development challenges.

Professor H.A. de S. Gunasekara Memorial Oration 2013, to be delivered on 12 July 2013 at the University of Peradeniya

Sri Lanka's Post-conflict Development Challenge:

Learning from the Past

1. INTRODUCTION

Sri Lanka had been trapped for a quarter of a century in a long, bloody and seemingly intractable separatist war until 2009 when the government crushed the separatist forces and achieved a decisive military victory. The end of the war was widely welcomed by the majority of the Sri Lankan population and by the international community and generated a surge of optimism about the economic prospects for Sri Lanka, with high expectations that Sri Lanka would embark on a period of sustained economic growth.

The immediate post-conflict period appeared to validate that optimism. With renewed confidence, Sri Lanka experienced a substantial economic recovery during the initial three years. But, as the large and rapidly growing literature on post-conflict 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 did not take long for the early optimism to fade. By 2011 concerns about the sustainability of the recovery were being raised following developments in the economic policy front. In early 2012, slowing economic growth, a sharp deterioration of the current account and rapidly declining foreign reserves compelled the authorities to implement a substantial devaluation of the currency and unpopular measures to curb public expenditures, while resorting to increased reliance on short term commercial borrowings in international capital markets. Early this year (17 February 2013) the government requested a further US$1.5 billion loan as budgetary support from the IMF after the completion of borrowing under the $2billion Stand-by Agreement (SBA) singed in 2009. There are widespread concerns that the country is moving into a debt trap.

[1] For reviews of literature, see the recent *World Development Report 2011* devoted to 'Conflict, Security and Development' and Coyne and Mathers (2011).

The purpose of this paper is to contribute to the contemporary debate in Sri Lanka on economic reforms for sustainable growth in Sri Lanka during the post-conflict era by examining the recent experiences from a historical perspective. It aims to broaden our understanding of the nature of current developments and to assess the likely future trajectory of Sri Lanka's economic evolution. The paper is structured as follows. Section 2 provides an overview of policy-making and economic performance during the post-independence until the late 1990s, focussing specifically on the economic liberalisation reforms initiated in the late 1970s and their outcome. Section 3 examines changes in the policy scene since the late 1990s that shaped policy making in the post-conflict period and the key elements of the new development strategy. Section 4 discusses recent macroeconomic developments with particular attention to role of public sector investments, fiscal deficit and external financing issues and their impact on investment and export performance. The paper ends in Section 5 with some concluding remakes.

2. HISTORICAL CONTEXT

In 1948, Sri Lanka (known until 1972 as Ceylon) 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 ahead of countries such as (South) Korea and Thailand (Table 1). 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, 1982) in a region of violent turmoil and conflict. The balance of payments position was healthy backed by large foreign exchange reserves and a sound budgetary position.[3] All of these initial conditions had provided the setting for the

[2] 'Colombo …. [was] the "Clapham Junction" of ships voyaging in the East' (Arunachalam 1907, p 26)

[3] Both the domestic and external financial positions were so sound that Mr. D.S. Senanayake, the first prime minister of the country, in an interview with the Newsweek in 1948 stated that Sri Lanka 'wanted neither grants nor loans from the United States or any other country' (Wijesinghe 1976).

expectation that, of all post-colonial nations, Sri Lanka would prove ‘the best in Asia’ (Wriggins 1960).

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 (Figure 1). In spite of poor growth performance, Sri Lanka’s living standards, measured by most indicators of quality of life, continued to be exceptionally good relative to its per capita income (Sen 1981). However, from about the late 1960, even in terms of these indicators Sri Lanka slipped in global rankings compared to the high-performing East Asian economies (Cuthbertson and Athukorala 1991). Providing direct welfare to the poor had become increasingly difficult to sustain in the face of slow expansion in the overall economy,.

The reasons for Sri Lanka’s growth slowdown during this period have been the subject of much debate.[4] Many analysts, particularly those associated with international donor agencies such as the World Bank, argued during the 1960s and particularly during the 1970s that government expenditures on health, nutrition, and education (often described as “consumer subsidies”) were primarily responsible for the slowdown by diverting government resources away from direct growth-oriented investments. However, there are strong reasons to argue that that the primary cause of the slide to slow growth and stagnation was the turn away from international trade that underpinned inward-looking policies, in the context of an environment that was hostile to long-term private investment. Social expenditures delivered high levels of social indicators and played an important role in maintaining political stability at low cost—Sri Lanka’s expenditure on police and military forces was among the lowest in the world. Government expenditure on universal free education and health care 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 in 1948, Sri Lanka continued to be an open-trading nation with only relatively minor trade or exchange rate restrictions and liberal domestic policies. From the late 1950s on, a combination of change in political leadership and balance-of-payments difficulties led to the adoption of a state-led import-substitution industrialization strategy. From the mid-1950s, prices of the key export commodities of Sri

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

Lanka began to experience a long secular decline. Although periodically interrupted by 'tea price booms', the country entered a period of frequent balance of payments crises, import restrictions and slow growth. 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. Following a hesitant and mild liberalization attempt during 1968–70, the period from 1970 to 1977 saw further government intervention in the economy under the guise of creating a socialist society. 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 policy makers in Sri Lanka, like their counterparts in most other developing countries, expected the expansion of import-substituting industries to reduce the heavy dependence of the economy on imports. The reality was quite different, however. While consumer-goods imports were reduced substantially, this was achieved at the expense of increased reliance on imported capital goods and raw materials, resulting, contrary to expectation, in an even more rigid dependence on imports. Given these structural features, the growth dynamism of the newly established industrial sector tended to show a close functional relationship with the fortunes of the traditional export industries. Unanticipated import curtailments brought about by foreign exchange scarcity turned out to be the main constraint on industrial expansion. From about the late 1960s there was a policy emphasis on export promotion through selective incentives and encouraging export-oriented foreign direct investment. However this policy shift had little impact on relaxing the balance of payments constraint, because the overall policy context was highly unfavourable to private-sector activity in general and to export production in particular. Reflecting the cumulative impact of stringent trade controls and overvalued real exchange rate, the overall incentive structure of the economy was characterised by a significant 'anti-export' bias throughout this period (Cuthbertson and Athukorala 1991, Chapter 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] With these reforms Sri Lanka pioneered policy liberalization in South Asia, a decade or more ahead of its neighbours. The first round of reforms carried out during 1977-79 included a significant trade reform: supplanting quantitative restrictions on imports with tariffs and revising the tariff structure to achieve greater uniformity; lifting of price controls on domestic trade; opening up the economy to foreign direct investment (FDI), with new incentives for export-oriented foreign investment under an attractive Free Trade Zone (FTZ) scheme; the unification of the exchange rate followed by a sharp devaluation; financial reform: adjusting interest rates to levels above the rate of inflation, opening the banking sector to foreign banks and freeing credit markets to determine interest rates; and the abolition of state enterprise monopolies over the imports of a number of key commodities and the introduction of limits on public sector participation in the economy. The most important aspect of the new foreign investment policy was the setting up of the Greater Colombo Economic Commission (GCEC) in 1978 with wide-ranging powers to establish and operate Export Processing Zones (EPZs). As an important part of the FDI policy, steps were also taken to enter into Investment Protection Agreements and Double Taxation Relief Agreements with the major investing countries. A guarantee against nationalisation of foreign assets without compensation was provided under the Article 157 of the new Constitution of Sri Lanka adopted in 1978.[6]

The reforms opened up a golden window of opportunity for Sri Lanka for integrating into the global economy by restructuring the economy in line with its natural comparative advantage in labour intensive manufacturing. China was yet to start its liberalization and other countries such as India and Vietnam were more than a decade away from such reforms. The country seemed poised to embark on a trajectory of rapid growth that would enable it to emulate the dynamic East Asian economies. But this was not to be. The reform process lost

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[5] For details on the reform process, see Rajapatirana (1989), Cuthbertson and Athukorala (1991), More (1997), Dunham and Kelegama (1997), Snodgrass (1998) and Athukorala and Rajapatirana (2000). For a review of the Sri Lankan experience with trade policy reforms from a comparative South Asian perspective, see Panagariya (2002)

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

momentum in the early 1980s, first because of an unfortunate shift in policy priorities towards politically appealing glamour investment projects, and subsequently owing to the onset of the ethnic conflict in 1983 between Sinhalese-dominated Government of Sri Lanka and the Tamil militants.

The government not only failed to maintain the initial pace of liberalization but also diverted resources to a huge foreign aid–supported public investment program and to employment expansion in public enterprises. Government spending rose sharply; food subsidies were drastically cut but increases in transfers to loss-making state enterprises offset these budget savings.[7] Although some of the investment projects in irrigation, land development, and hydropower had some economic rationale, other components of this public sector investment program, such as the construction of a new capital and a large-scale house-building program, had questionable economic value. The public sector spending boom generated inflationary pressures and 'Dutch disease' effects, undermining the expected positive impact of liberalisation reforms on the growth of labour-intensive export industries (Athukorala and Jayasuriya 1994).

The major blow to Sri Lanka's ability to reap benefits from this remarkable policy transition came from the escalation of the separatist war.[8] 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)[9] 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

[7] Governments spending on food subsidies were slashed by nearly 70% during 1979-82, but, ironically, annual transfers to loss-making state-owned enterprises expanded; the transfer to the national airline, for example, at times exceeded the annual food subsidy during 1980-1988.

[8] I do not discuss in detail the complex economic, political and historical roots of the separatist struggle. A more detailed discussion of the post-independence economic and policy history up to the early 1990s, including the economic background to the social and ethnic conflicts that erupted in the 1970s and 1980s is in Athukorala and Jayasuriya (1994). For discussions that focus on the socio-ethnic conflicts in Sri Lanka, see Abeyratne (2004), Dunham and Jayasuriya (2000) and Richardson 2005.

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

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. This included an ambitious privatization program, further tariff cuts and simplification of the tariff structure, removing exchange controls on current account transactions and several important changes to the foreign investment policy framework in line with the increased outward orientation of the economy, and a more flexible exchange rate regime. Second-wave reforms not only strengthened incentives for the expansion of labour-intensive export industries and re-infused dynamism into the economy, but also provided a policy orientation that replaced the traditional left–right ideological divide and established a de facto consensus across the political spectrum on the basis of a pro-market, open, liberal economic policy regime (Dunham and Kelegama 1997). 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 (Sachs and Warner 1995).

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' (More 1997, p. 1009). Indeed, the new government extended the privatization and deregulatory policies and pursued trade and macroeconomic policies that were largely indistinguishable from the previous government. The liberalization process, particularly in the privatization area, accelerated under the new regime. Further tariff reform, in particular progressively harmonizing the tariff structure towards a single band over the medium term was a key element of PA government's policy reform package. An important dimension of this positive aspect was the shaping of expectations by foreshadowing changes and then delivering the changes. All in all, 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, P. 47).

Despite the unsettled conditions, the reforms dramatically transformed the economic landscape of Sri Lanka. Growth surged, from an average of 2.9 precent during 1970–77 to over 4.5 precent during 1978–2000. The tourism sector also started to boom, and Sri Lanka appeared set to establish itself as a prime tourist destination. The share of manufacturing in GDP rose from around 10% in the mid-1970s to over 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 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 (Figure 2). Export-oriented manufacturing sector emerged as the major generator of employment opportunities in the economy, accounting for over half of total employment growth during the 1980s and 1990s. 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.

Opening up of the country to foreign direct investment combined with significant trade liberalisation played a pivotal role in the emergence of a dynamic labour-intensive export industry linked to international supply networks. Export-oriented FDI attracted to Sri Lanka during this period was heavily concentrated in standard light consumer goods industries such as garments, footwear, sport goods, and cutting and polishing imported diamonds. There is, however, 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. There is evidence that there is somewht of a herd mentality in the site selection process of electronics multi-national firms, particularly if the first-comer is a major player in the industry. If the two projects of Motorola and Harris Corporations had been successful, other multinationals would probably have followed suit (Athukorala and Rajapatirana, 2000; Snodgrass, 1998).

In a summing up of the Sri Lankan experience under market-oriented policy reforms, 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). Viewed against this backdrop, it is understandable that the end of conflict would generate much optimism in the country and in the wider international development community about the future trajectory of the economy, both inside and outside the country.

3. 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. As early as the late the 1990s, trade liberalisation process suffered a setback because of the pressure of 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 changed frequently in an ad hoc manner. The protectionist tendencies soon received added impetus from the growing discontent amongst the electorate, 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 program.[10] The anti-liberalisation lobby also

[10] In assessing the actual outcome, they downplayed (or overlooked) the incomplete and staggered nature of the reforms process, and the debilitating impact of the continuing ethnic conflict on the investment climate of the country, while ignoring Sri Lanka's own past experience of failure with inward-orineted policies (Rajapatirana 2004)

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 30-decade old civil war in May 2009, President Rajapakse consolidated power by calling fresh presidential and parliamentary elections in 2010 and winning both decisively.

The development strategy of the new government emphasised the role of the state in 'guiding the markets' in redressing untoward effects of economic globalisation, and effectively ruled out privatisation of the key remaining state enterprises, while conspicuously avoiding any reference to trade policy reforms (Government of Sri Lanka , 2006 and 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 for achieving balanced growth. Privatization of key state enterprises (banking, power, energy, transport, and ports) was explicitly ruled out. In sum, it was an eclectic program that was designed to appeal to the to the government's core rural constituency, as well as small business, while attempting not to alienate big business, international investors, and international donors. 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, characterized by reliance on price-based measures and scant-use of non-tariff measures (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. 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. In addition to these, there is a 'special commodity levy on imports of a small number of 'essential' commodities.

Pursell and Ahsan (2011)[11] have undertaken a systematic comparison of Sri Lanka's tariff structure during 2004-2011 by taking into account both normal import duties and the five para-tariffs.[12] Their estimates are summarized in Table 2. According to these estimates the total (Customs duty + para-tariff) protection rate, 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%. These protection rates are very high by world standards and suggest that Sri Lanka's previously long term declining trend in average tariffs which started in about 1982 and continued until the turn of the 20th century have clearly reversed. Nearly all of the dramatic increase in the average protectiveness of the import tax system is attributable to para-tariffs.

Disaggregated data reported in Pursell and Ahsan (2011) suggest that after allowing for para-tariffs the protective structure had become even more complex, with 75 different total protection rates ranging from zero to more than 90%. A large number (42%) of industrial tariff lines had low TPRs of below 10%, while a third (32.2%) of tariff lines had TPRs of 35% or higher, with many clustering in the range of 35% to 60%. Almost 40% of agricultural TPRs were within a range of 70% to 80%, while only a few (6.7%) were below 10%. The TRPs on almost half (46.1%) of agricultural tariff lines exceeded 50%.

As already noted, tariff increases (mostly in the form of para tariffs) since the late 1990s were driven predominantly by revenue considerations rather than for providing incentives for import-substituting industries. However, in recent years, tariffs on intermediate inputs have been substantially reduced or eliminated in order to support domestic industries. The tariff cuts combined with the already existing high tariffs on final goods would have significantly increased the effective rate of protection for domestic market oriented production (and hence infused an 'anti-export bias' into the incentive structure). An important point that seems to have

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[11] See also Pursell (2011a) and (2011b) for syntheses of key findings of this study.

[12] In estimating total protection rate Pursell and Ahsan (2011) and only para-tariffs to custom duties, excluding the other export taxes which have an equal domestic counterpart and hence are probably con-protective.

been ignored in the contemporary policy debate in the country is that ignored is that a cascading tariff structure of this nature runs counter to the government's objective of increasing domestic value addition in industrial production.[13]

An interesting example of how a cascading tariff structure encourages domestic production which is not consistent with the countries comparative advantage is provided by recent development in the Sri Lankan automobile industry. The current tariff structure is characterized by very high import tariff on completely-built automobiles (300%) coupled with low tariffs on car parts and components (on average 5%). This cascading tariff structure has made local assembly of certain models of automobiles highly profitable.[14] Since 2006 four assembly plants have been set up under the approval of the Ministry of Industry and Trade: Micro Car Company (2006), Union Enterprise (2008), Universal Auto Assembly (2008), and Frontier Automobile (2010). All these plants are fully locally owned, but operate under licensing arrangements with car makers in China (Union Enterprise and Frontier), Korea (Micro Car) and India (Frontier).

All four automobile plants are engaged in simple assembly of imported completely-knocked-down (CKD) units of outdated models which have already been scrapped from their production schedule by the parent companies. It is therefore doubtful whether the expected gains

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[13] Effective rate of protection measures the degree to which a given tariff structure makes domestic production relatively more profitable compared to a situation with zero tariffs (that is, when both intermediate inputs and the final products are available domestically at the world market price).

The simplest formula, ignoring transport cost and other taxes, for calculating effective rate of protection is:

$$ERP_j \quad = \frac{t_j - a_{ij}t_i}{1-a_{ij}}$$

where, j is the final product and *i* is the intermediate product, t is tariff , and α is the share of intermediate good in total value of the final good. It can be seen from this equation that, for give rates of final and intermediate tariffs, domestic production of lower value added products (that is products with higher α) enjoy greater protection compared to higher value added products.

[14] The minimum domestic content requirement used by the Ministry of Industries for approving new car assembly project is 30% (which is permeably a rather conservative norm, given that virtually all components are imported and it is unlikely that labour cost can be as high as 30%). Combining this figure with 300% final goods tariff and an intermediate good tariff of 7.5% gives an effective rate of protection of 425% (see the formula in Note 14).

(in the forms of technology transfer, backward linkages to local spare part manufactures, foreign exchange saving, and supply of vehicles to the local market at affordable prices)[15] would be sufficient to counterbalance the government revenue losses involved. Indeed the excise duty rebate appears to be an anomaly given that the cascading tariff structure already provides local automobile assemblers with massive effective protection.

In January 2010 the government introduced an excise duty rebate exception scheme as a further incentive for these companies. Currently excise duty is charged on all vehicles produced, assembled or imported into Sri Lanka at 25%, 48% and 65%, depending on the engine capacity. Under this rebate scheme, automobile assembled in Sri Lanka are eligible for complete exemption from these duties provided the domestic content is not less than 30% of the exactor price and the value of locally manufactured components accounts for at least half of the domestic content.

FDI policy

The promotion of foreign investment, particularly in export-oriented manufacturing was a pivotal element of Sri Lanka's market-oriented policy reforms which were initiated in 1997. As noted, these policy initiatives 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 the role of 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 'a more outward-oriented' trade regime, strengthening and increasing overseas market access for Sri Lankan products, attracting foreign direct investment, and further integrating Sri Lanka into the world economy' (Government of Sri Lanka, 2010, p.18).

In 2008 the parliament passed the 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 which is likely to bring economic and social benefits to the country and which is also likely to change

[15] As listed in the government gazette announcing the excise duty rebate scheme.

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, p. 3). This definition leaves a great deal of room for discretion in the investment approval process.

The '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), include 7 enterprises with foreign capital participation (including Colombo Hilton). Both the Fitch Group and Moody Corporation, two major credit rating agencies, have warned that the bill would erode investor confidence and potentially affect Sri Lanka's investment rating (Goodhand 2012).

Another new measure affecting foreign investment has been the increase in the minimum level of investment required for a firm to qualify for tax holiday under the BOI scheme. Up until 2010, the minimum level of investment required for a company to qualify for a five-year tax holiday under the BOI scheme was US$ 500,000. This minimum threshold seems highly excessive when compared to that in other countries in the region: Malaysia 65,000; Thailand 65,000; South Korea 50,000; India 2,100 (Word Bank 2010).

In terms of the multi-country *Doing Business* assessment conducted by the World Bank, Sri Lanka's investment climate has improved in recent year. Sri Lanka's ranking in this assessment increased from the 96th position in 2012 to 81st position in 2013. However, we need to interpret this raking with caution because it is based on information gathered from the *exiting* firms and related interest holders in a country; perceptions of firms who have left the country or those of prospective investors are not captured. There has been a notable deterioration in the overall investment climate in terms of various other indicators, which are widely used by foreign investors in country risk assessment. For instance, on the Enabling Trade Index produced by the World Trade Forum, Sri Lanka occupies the 103th position among 132 countries: among the Asian countries only Bangladesh ranks below Sri Lanka. Various subindices of the International Country Risk Guide Index (ICRG) compiled by the Political Risk Services Group, a database which is widely used by foreign investors in assessing country risk, indicate significant deterioration in the overall investment climate of the country in recent years (http:www.prsgroup.com).

State-Owned Enterprises

The privatization program was abandoned following the regime shift 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%. 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, 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 (Ministry Of Finance 2012, p. 513). 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 Ceylon Petroleum Corporation.

Emphasis on Import-substitution

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. The 2012 *Annual Report of the Ministry of Finance* proposes 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. The key policy message of the report is that the structure of the external accounts of the economy 'provides a road map to diversify the economy' (Ministry of Finance 2012, p. 35). This is in sharp contrast to the basis tenant of the outward-oriented development strategy pursed 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.

Promoting the production of subsidiary food crops and dairy products may have economic merit as part of rural development and the post-conflict reconstruction process in the Northern and Eastern Provinces. One can even argue in favor of the use of moderate tariff protection to stabilize the domestic prices of these products in order to cushion the farmers against the vagaries of world markets, even though such measures would entail some economy-wide welfare losses. But, the potential contribution of these products to improving the balance of payments position is unlikely to be very significant. The food products listed in the Ministry report (Table 15) accounts for a tiny percentage of (less than 5%) of the current import bill of the country.

The experience during the closed-economy era clearly suggest that import-substitution attempt in import-competing manufacturing is unlikely to bring about the anticipated benefits of reducing the import bill. Most of the industrial products listed in the Ministry report are intermediate- and capital-goods, which are highly capital intensive, and also import intensive, particularly given Sri Lanka's narrow domestic resource base. If these industries were to be supported by high-tariffs, they would have a significant 'inefficiency spillover effect' on the other industries: passing of their inefficiency on to upstream user industries through the supply of substandard products, usually at very high prices. During the closed economy era most capital- and intermediate-goods producing industries in Sri Lanka were involved in ''negative value-added'' production at world prices, and they were a major drag on the expansion of the forwardly-linked final goods producing industries (Athukorala and Rajapatirana 2000a and 200b)

Domestic value added' (or 'domestic content)[16] has already become a key criterion used in approving new manufacturing projects (both foreign and local) by the Board of Investment and the Ministry of Industries' (or 'domestic content'). The problem with the use of this criteria, which harks back to the defunct development advocacy during the import-substitution era, is that attempts to increase domestic content through direct policy intervention could stifle the evolution of the export structure in line with changing patterns of internationalization of production and frustrate employment generation (Little 1981; Athukorala 1998). For achieving economic growth through export expansion, what is more relevant is the market potential of the given export products (which determines the total net addition to national income), not net foreign exchange earnings per unit of exports. Goods

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[16]Both these terms are used interchangeably in the relevant official documents and policy debate in Sri Lanka, to imply the latter (domestic content = the sum of domestically procured inputs, wages and returns to domestic capital as a percentage of the ex-factory value of the given products)

that are made to local specifications using local raw material account for only a small and shrinking share of manufactured exports from developing countries. Success in increasing the volume of net foreign exchange earnings (*total* domestic value added, as against *per unit* value added) therefore depends crucially on the country's ability to enter the fast-growing markets for made-to-order manufactured goods, and component production and assembly within vertically integrated production systems, which are typically more import intensive. In the former area, producing what is sought in competitive international markets, in contrast to producing import substituting products for a shortage-ridden supplier's market, calls for a vector of imported inputs meeting exacting quality requirements and specifications. Substitution of inferior locally produced inputs for higher quality imported inputs may lead to significant market losses, and the cost involved in correcting the defects at a further stage may be prohibitive. Hence it is unrealistic to expect export producers to source many inputs from local suppliers at the formative stage of export-oriented industrialisation. In the area of component production and final assembly in electronics and electrical goods, the input structure is determined as part of the overall process of international production - the ability of policy makers to influence procurement practices of firms involved is intrinsically limited. In these products, the per-unit domestic value added is normally low, but the total addition to the national income of the country can be much higher - because of the larger sales volume (compared to resource-based products).

The above remarks by no means imply that domestic value addition (and domestic input linkages) is bad or that footloose production is an immutable feature of the production structure of a developing country under outward-oriented industrialisation strategy. Of course, the greater the linkages between the export sectors and the rest of the economy the greater would be the benefits to the economy from export expansion, provided such linkages are the natural outcome of industrial deepening. What I argue here is simply that there is little room for increasing value addition through policy intervention, and that such intervention may in fact act as a brake on development.

The government budget of 2011 introduced new export taxes on tea and rubber exported in raw and semi processed form (Government of Sri Lanka 2010) to promote further processing of these products.[17] There is however no presumption that the expected reduction in domestic market price of these products per se would promote resource-based industrialisation. The dominant costs in most resource-based industries are capital charges rather than raw material inputs, and the involvement of foreign firms is vital for forging marketing links (Roemer 1979). It is important to note that during the closed-economy era when the rate of export tax was much higher than the newly proposed rates, almost the entire domestic production of tea and rubber (and other primary exports) was exported in raw form. By contrast, in the 1980s and 1990s, a number of highly successful export-oriented 'downstream' manufacturing firms emerged, resulting in a notable reduction in the share of tea and rubber exported in raw form, notwithstanding the elimination of export duties.

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 (Lakshman 2013). But, in practice, there has been a fundamental contradiction between exchange rate policy and fiscal and monetary policy.

During the period from 2005 to 2008 the Central Bank managed to maintain a stable nominal exchange rate by drawing on foreign reserves and foreign borrowing, including a one-billion sovereign bond issue,[18] 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. The US$ 2.5 billion SBA helped Sri Lanka to avoid a balance-of-payments crisis, build foreign exchange reserves and improve investor confidence.[19] This enabled the Central Bank to maintain the fixed exchange rate though further borrowing. But, the government largely failed to adhere to the promised

[17] As part of liberalisation reforms initiated in 1997, export duties on the principal agricultural commodities were reduced in successive stages and virtually removed in 1993.

[18] There was also some foreign fund flows 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) (CBSL 2010).

[19] Following the signing of the SBA, Standard and Poor's and Moody upgraded Sri Lanka's foreign currency rating, while Fitch upgraded sovereign rating.

fiscal consolidation under the SBA. Consequently there was a massive appreciation of the real exchange rate during 2005-2011 compared with the previous five years (Figure 3), eroding relative profitability of tradable production (both exports and import-competing products) fueling imports demand (Table 3).

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 deflation of foreign exchange reserves. By the end of 2102, the nominal effective exchange rate had depreciated by 11.6%, but this had translated to only about 7.4 % depreciation in the real exchange rate because of the higher domestic inflation compared to that of trading partner countries. Thus the real exchange rate appreciation that took place over the past six years was never erased. Monthly data for the past eight months (October 2013 – June 2013) show a remarkably stability of the bilateral exchange rate between the Sri Lankan rupee and the US$ and the other major currencies. These patterns, combined with the increase in the rate of increase in domestic inflation, suggest that this mild degree of real depreciation would have perhaps dissipated in recent months. Whether the relative stability of the nominal exchange rate is an outcome of Central bank intervention (‘leaning against the wind’) or due increase in capital inflows following the significant opening of the capital account in recent years remains unclear. The pressure for nominal appreciation of the rupee has been compounded by the recent move to partially open up the capital account, permitting foreign investors to investment domestic treasury bills and bonds, and permitting foreign currency borrowing by Sri Lankan banks and other financial instructions, and private firms.

The widening budget deficit was mainly due to government spending on ‘faster than programmed, lumpy disbursements for a couple of large foreign financed infrastructure projects and for their counterpart funds’ (IMF 2011, p. 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, many government infrastructure projects, such as a modern port and other facilities (being built with Chinese assistance), are located in the Southern regions of Sri Lanka - the heartland of the electoral support base of the President. The prioritisation and economic efficiency of these 'flagship projects' are questionable. Even when largely foreign funded, these projects pull in substantial domestic resources for counterpart funding and contribute to the fiscal deficit. Public investment projects of this type may not become a major impediment to a sustainable growth recovery if they are a minor part of the overall investment program and the government is in a strong fiscal position.

The massive public investment program that was implemented following the liberalisation reforms in 1977 was mainly funded by concessionary foreign long term loans and grants. It did not involve a massive build-up of foreign debt. Moreover it was implemented in the context of a structural adjustment program involving a major currency depreciation, which at least partly offset some of the negative real exchange rate appreciation pressure. The massive public investment program of new government is largely funded by foreign loans and implemented with a strong Central bank commitment to maintain the 'dollar value of the Rupee' by resisting pressures for nominal depreciation.

4 ECONOMIC PERFORMANCE

Performance of the Sri Lankan economy has been adversely affected by the surge in world oil and food prices (during 2007-2008) and the global financial crisis that followed. Despite these external shocks, and the intensification of the civil war at its final stage, the Sri Lankan economy expanded by an annual average rate of 6.5% during 2005-2012. Per capita income almost tripled from US$1,062 to US$2,053 (Table 3). The rate of inflation came down from 22.5% in 2008 to 5% in 2010 (Table 3). The unemployment rate fell from 8.3% in 2004 to 4.4% in 2010. Between 2005 and 2012 the percentage of people living below the poverty line (the poverty head count ratio) declined sharply from 15.2% to 6.5% accompanied by a reduction in the poverty gap 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 an improvement in income distribution. The reduction in both relative and absolute poverty has taken place across all provinces in the country and among the urban, rural and estate sectors, albeit at varying degree. However, when we go beyond these indicators and analyse the overall growth experiences from a long-term sustainability perspective, there are a several qualifications to this rosy picture.

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 construction and infrastructure development projects (Table 4). These sectors accounted for over 70% of the total increment in real GDP between 2004 and 2012.

Manufacturing grew only at a modest rate, resulting in a decline in its share in GDP from 18.5% during 2000-04 to 17.5% during 2005-2011. 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 textile and garment, and non-metallic mineral products where export production is concentrated, have recorded much slower growth. 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.

The doubling of per capita income in current US$ terms during this period 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 (2000) prices in order to allow for these factors, the increase is per capital income in 2010 (US$ 1240) was only 30% higher than that in 2004 (US$ 959) (Figure 4).

The decline in the unemployment rate was partly due to an increase in public sector recruitments and increase 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). Over the past ten years (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 (Ministry of Finance 2013, p. 670). A tentative estimate suggests that the total stock of Sri Lankan overseas contract migrant workers had reach 2 million by 2011, amounting to over 14% of the total working-age population of the country (Arunatilake et al 2011).

The external payments position of the country has deteriorated over the past three years. The trade deficit, which had come down 7.4% of GDP in 2009 from over 10% during the previous five years, increased to a historical high of 15.8% in 2013. Exports as a share of GDP declined from 30% in 2004 to 17% in 2010, while imports continued around 35% of GDP. In 2012, total imports were double the size of export earnings. Limited trade restrictions were not sufficiently effective to address the widening current account deficit even in the short term. In spite of rapid increase in remittance inflows and earnings from tourism, the current account deficit widened to 2.9% of GDP in 2010 and to 6.6% of GDP in 2012. Imports as a percentage of GDP has increased over the past two years, but still remains below the average level during 2005-2008. The major contributor to the widening current account deficit has been the massive contraction in exports as a share of GDP. While weak global demand in the aftermaths of the global financial crisis (2008-9) and the recent withdrawal of 'GSP Plus' tariff concessions would have played a role, a comparative analysis of Sri Lanka export performance suggests that the problem is mostly 'home grown' (Rajapatirana and Yatawara 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.

The data on FDI inflows point to an increase (in nominal US$ dollar terms) of about 5% in FDI inflows to Sri Lanka during 2005-11 compared to the previous five years. However, when the data are disaggregated by sector/industry, it is revealed that this increase has come largely from projects in the construction and services sectors. During 2010-12, manufacturing accounted for only 32% of total realized FDI. The bulk of these flows are to domestic market oriented industries (mostly food and beverages), with garments being the only export-oriented industry to attract some FDI. An even more alarming development is that, a large number of export oriented foreign firms had closed down their operations in Sri Lanka. According to a recent analysis of the profile of BOI-approved manufacturing firms based on a comparison of the firms in operation as at end of 2002 and 2009, 465 firms which were in operation in 2002 had disappeared from the BOI list in 2009 (Ekanayake 2011, Table 11). This number is too large to be interpreted solely as a recording error. Of these enterprises, the majority are firms with foreign capital participations (joint venture or fully foreign owned). The number of firms set up between 2002 and 2009 have virtually matched the numbers disappeared from records, leaving the total number of firms unchanged between the two years. However, 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 a number of developed countries have left the country (Ekanayake 2011, Table 12). No major MNE has setup operation in Sri Lankan manufacturing over the last decade. The data on export performance of BOI firms are patchy.

By 2012 total gross official foreign reserves (US$8.6 billion) was adequate to cover 5.4 months of imports. However, according to the IMF estimates net reserves (after netting out short-term borrowings from gross reserves) amounted to only 4.1 billion or 2.6 import moths (Table 3). Be that as it may, import-month equivalent is not an appropriate indicator of reserve adequacy given that the country has now integrated into global capital market through foreign borrowing: 'a run against a currency is rarely associated with an import spree' (Calvo 1995). What is required is to assess the reserve levels in relation to the volume of short-term foreign-currency liabilities. In other words, reserves as a percentage of the volume of accumulated short-term debt is by far the most appropriate indicator of reserve adequacy. This measure, which I dub the reserve adequacy index (RAI), has declined from 143.5 in 2010 to 85% in 2012 between 2010 and 2012, when gross reserves are used as the reserves are measured in gross terms. When the IMF figures of net reserves are used in the calculation, the comparable figure for 2012 is just 41%; the end-of-year reserves in 2012 was adequate to cover only 41% of the existing volume of accumulated short-term foreign debt ('volatile capital').[20]

The other side of the coin to the worsening current account deficit and massive foreign debt accumulation is widening budget deficit. A current account deficit means that that country (either the government or the private sector or both) is spending more than it is earning at a given time which must be financed by foreign capital.[21] In the Sri Lanka case, the private sector deficit (the difference between private saving and private is rather small (Table 3: compare private investment and saving figures). The current account deficit, therefore, predominantly mirrors in the budget deficit. The budget as a percentage of GDP has declined from 8 in 2010 to 6.4% in 2012, but this is much higher than the internationally

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[20] It is important to mention that my estimate of RAI covers only short-term government securities and banking sector external liabilities. In order to make a more accurate estimate, it is necessary to take into account foreign investment in domestic government securities and in domestic company shares, which are essentially a part of volatile capital (Athukorala and Warr 2002)

[21] CAB = (SP – IP) + (GRV - GTR - GX)

= private sector balance + public sector balance (or budget deficit/surplus)

where, SP: private saving, IP: private investment; GRV : government revenue, GTR government transfer payments and GX: government expenditure (other than transfers).

considered ‘safety rage’ of 3 to 5%. Moreover, the reported deficit figure needs to be treated cautiously because in recent years the government has been shifting transfers to the loss-making public enterprises ‘off budget’, by encouraging these enterprises to borrow on their own under government guaranty (Jayaratne 2013, Weerakoon 2013).

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. In this context, the Sri Lankan experience can be explained as the outcome of trade liberalisation that increased the potential returns to investments which capitalize on the country’s comparative advantage. Despite political risk and policy uncertainty, rapid export growth was consistent with this policy configuration as it ensured a handsome profit in labour intensive export production, which is usually characterised by a short payback period in a labour abundant economy. Interestingly, the Sri Lankan experience over the past three decades has clearly demonstrated that an outward-oriented policy regime can yield a superior development outcome compared to a closed-economy regime, even under severe strains of political and macroeconomic instability.

Viewed against this back drop, recent developments in the Sri Lankan policy scene 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. Sri Lanka’s tale of missed opportunities continues.

It would be a tragedy if Sri Lanka were to forget the bitter lessons of the past. It is no longer the pioneering liberalising country of the late 1970s. It is now forced to compete for foreign investment and export markets with the giant labour rich economies of China and India as well as with countries such as Vietnam and Bangladesh. Further, it faces a global economy that is in deeper trouble than at any time since the 1930s. In these difficult circumstances, there is no longer room anymore for using the state as the 'employer of last resort'.

Sri Lanka can benefit from continuing growth in the Asian region, but only if it can articulate and implement a development strategy that enables it to leverage its comparative advantages, attract investments and participate in international production networks to generate productive mass employment. Policies based on the past paradigm of inward oriented, state centred and directed economic development offer no viable long term solution to the huge challenges facing Sri Lanka or other small, capital and resource poor countries

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Table 1: Sri Lanka and Selected Asian Countries: Purchasing Power Parity GNP Relative to USA, 1950, 1960 and 1970

	1950	1960	1970	1975
Sri Lanka	11.4	12.5	9.3	8.3
India	7.1	7.4	6.0	5.8
Pakistan	9.0	6.8	8.1	7.8
Indonesia	---	5.8	4.8	6.2
Malaysia	14.6	15.1	15.6	17.5
Philippines	10.3	11.5	10.8	10.4
Singapore	---	16.6	24.2	28.3
South Korea	7.6	8.7	12.8	17.4
Thailand	9.6	9.6	11.9	13.1

Note: --- Data not available.

Source: Kravis, Heston and Summers (1983) and World Bank, World Development Indicators database

Table 2: Sri Lanka: Unweighted Average Protection Rates[1], 2002, 2004, 2009 and 2011

	Customs duties	Para-tariffs	Total protection rate
November 2002			
Agriculture (HS 01-24)	21.1	5.2	26.3
Industry (HS 25-87)[2]	7.6	2.5	10.1
All tariff lines	9.6	2.9	12.5
January 2004			
Agriculture (HS 01-24)	24.6	3.5	28.1
Industry (HS 25-87)[2]	8.8	1.9	10.7
All tariff lines	11.3	2.1	13.4
December 2009			
Agriculture (HS 01-24)	24.6	25.0	49.6
Industry (HS 25-87)[2]	10.3	13.7	24.0
All tariff lines	12.4	15.5	27.9
January 2011			
Agriculture (HS 01-24)	25.4	21.4	46.8
Industry (HS 25-87)[2]	9.1	10.6	19.7
All tariff lines	11.5	12.2	23.7

Notes:

1. All protection rates are percentages of cif import value.
2. This predominantly reflects manufacturing protection. Mining (less than 3%) accounts for a tiny share of industrial output.

Source: Pursell and Ahsan (2011)

Table 3: Sri Lanka: Selected Macroeconomic Indicators, 2004-2012

	2004	2005	2006	2007	2008	2009	2010	2011	2012
GNP per capita at current price, US$	1062	1241	1421	1617	2014	2057	2400	2836	2923
GNP per capita at constant (2005) price, US$	1182	1241	1323	1400	1471	1505	1611	1727	1818
Real GDP (2002 price) growth (%)	5.4	6.2	7.7	6.8	6.0	3.5	8.0	8.3	6.4
Unemployment rate %	8.3	7.7	6.5	6.0	5.4	5.8	4.9	4.2	4.0
Gross national saving(% of GDP)	22.0	23.8	22.3	23.3	17.8	23.9	24.7	25.3	24.0
Of which public saving	-3.7	-2.6	-2.2	-1.6	-2.0	-3.7	-2.1	-0.9	-1.0
Gross domestic investment(% of GDP)	25.3	26.8	28.0	28.0	27.6	24.4	27.6	29.9	30.6
Of which public investment	5.6	5.6	6.1	6.3	6.4	6.5	6.1	6.2	6.9
Inflation (CPI) rate %	7.6	11.6	10.0	15.8	22.6	3.5	6.2	6.7	7.6
Government finance									
Budget deficit (% of GDP)	-7.5	-7.0	-7.0	-6.9	-7.0	-9.9	-8.0	-6.9	-6.4
Budget deficit (% of total revenue)	100.6	93.8	96.5	94.2	99.2	134.3	107.2	102.1	112.6
Public debt outstanding (% of GDP)	102.3	90.6	87.9	85.0	81.4	86.2	81.9	78.5	79.1
Foreign debt[2]	47.6	39.0	37.6	37.1	32.9	36.4	36.1	35.6	37.1
Selected outlays (% of total revenue)									
Interest payment	30.7	27.1	27.5	29.3	28.5	35.2	37.6	34.8	36.1
Salaries and wages	42.2	43.9	46.1	47.0	48.4	43.1	41.4	44.1	43.1
Transfers to public corporations	17.2	14.5	16.4	16.9	16.3	19.3	17.9	17.5	20.6
External sector									
Exchange rate, US$/Rp	101.2	100.5	104.0	110.6	108.3	114.9	113.1	110.5	127.6
Nominal effective exchange rate (2004 = 100)[1]	100	100.2	104.3	117.0	115.8	116.0	115.7	115.9	126.9
Real effective exchange rate (2004 = 100)[1]	100	92.8	90.6	90.5	77.0	75.1	73.4	71.9	77.4
Terms of trade (2004 = 100)	100.0	95.8	92.6	90.0	79.5	98.8	93.4	85.0	83.8
Trade balance (% of GDP)	-10.9	-10.3	-11.9	-11.3	-14.7	-7.4	-9.7	-16.4	-15.8
Exports (FOB)	27.9	26.0	24.3	23.6	19.9	16.8	17.4	17.8	16.4
Imports (CIF)	38.7	36.3	36.3	34.9	34.6	24.3	27.1	34.2	32.3
Current account balance (% of GDP)	-3.1	-2.7	-5.3	-4.3	-9.5	-0.5	-2.9	-7.8	-6.6
Total external debt (% of GDP)	54.9	46.5	49.4	51.0	43.7	49.7	50.1	49.7	56.7
Of which government debt				37.1	32.8	36.5	36.1	35.6	36.5
Debt service ratio[3] (%)	11.6	7.9	12.7	13.1	18.0	22.4	16.7	12.7	21.2
Foreign exchange reserves, gross (US$ million)	3439	4201	4005	4956	3640	7030	8621	7990	8585
In months of imports	5.2	5.7	4.7	5.3	3.1	8.3	7.7	4.7	5.4
Foreign exchange reserves, net (US$ million)	---	---	---	---	---	4150	5072	4011	4162
Foreign direct investment (US$ million)	227	234	451	548	691	384	435	896	813

Note:

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. Foreign investors' share in treasury bills:

	2008	2009	2010	2011	2012
Rs. Billion	6.3	8.4	10.1	10.6	11.3
% of GDP	0.1	0.8	1.2	1.7	1.6

3. External debt repayment and interest payments as a percentage of exports of goods and services.

--- Data not available

Source: Figures on net foreign exchange reserves are from IMF 2013, Table4; all other data series are compiled from Central Bank of Sri Lanka, *Annual Report* (various years).

Table 4: Gross domestic product by industrial origin, 2004-2012[1]

Sector	Share in GDP (%)			Average annual growth (%)			Share in output increment between 2004 and 2012 (%)
	2004	2008	2012	2004-08	2008-12	2004-12	
Agriculture[2]	13.0	12.1	11.1	2.4	4.3	3.3	8.3
Industry	27.7	28.4	30.4	4.4	8.3	6.1	34.4
Mining and quarrying	1.3	2.0	2.8	9.9	15.3	12.3	4.9
Manufacturing	18.1	17.5	17.1	3.5	5.9	4.6	15.6
Electricity, gas and water	2.2	2.4	2.4	5.3	6.3	5.7	2.6
Construction	6.0	6.5	8.1	5.1	12.7	8.5	11.2
Services	59.3	59.5	58.5	4.2	6.1	5.1	57.3
Wholesale and retail trade	24.7	24.2	23.0	4.0	5.3	4.6	20.5
Hotels and restaurants	0.6	0.4	0.7	0.3	24.9	11.3	0.8
Transport and communication	11.5	13.1	14.3	6.3	8.9	7.5	18.5
Banking insurance and real estate	8.4	8.7	8.9	4.6	7.0	5.6	9.6
Ownership of dwellings	3.8	3.1	2.5	0.7	1.3	0.9	0.6
Government services	8.0	7.7	6.8	3.3	3.5	3.4	5.0
Private services	2.3	2.4	2.3	4.1	6.1	5.0	2.3
Total GDP	100	100	100	4.0	6.6	5.1	100
Memo items							
Tradable production[3]	32.4	31.6	31.0	3.4	6.0	4.6	28.8
Non-tradable production	67.6	68.4	69.0	4.3	6.8	5.4	71.2

Notes:

1. Based on constant (2002) price data.
2. Including livestock, forestry and fishing.
3. Sum of agriculture, mining and quarrying and manufacturing.

Source: Compiled from Central Bank of Sri Lanka, *Annual Report* (various issues)

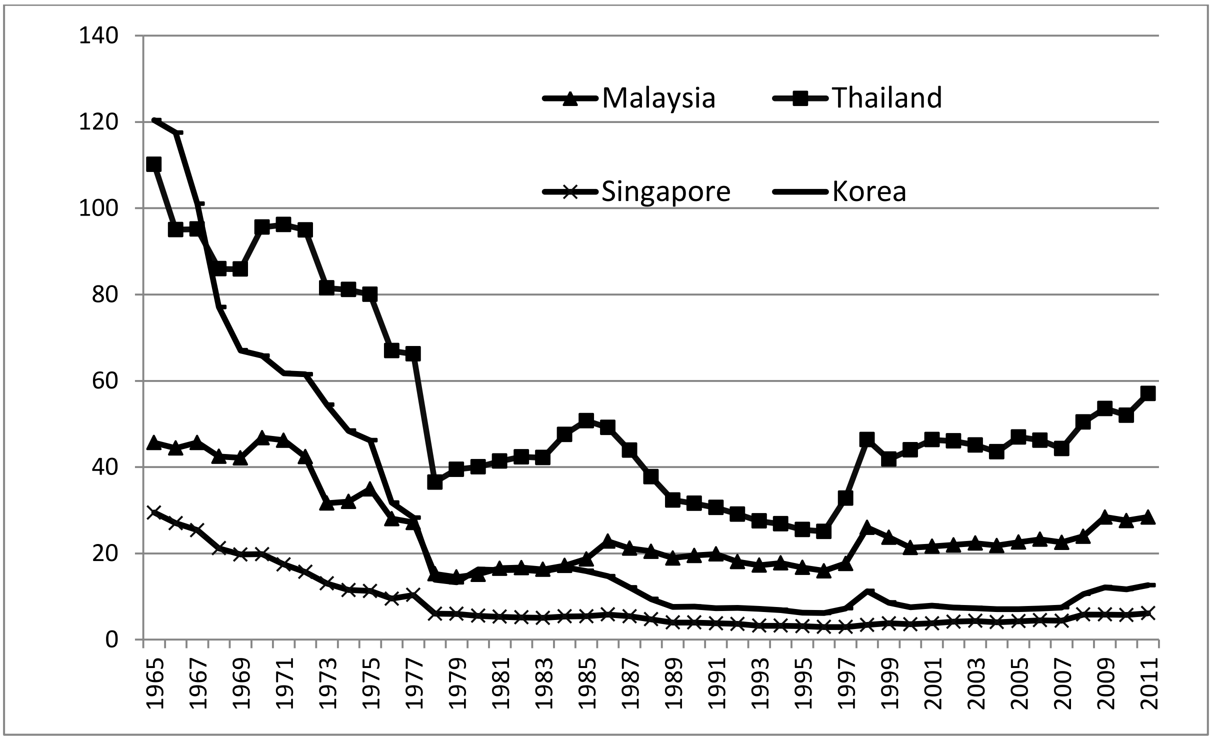
Table 5: Composition of outstanding external debt, 2004-2012 (%)

	2004	2005	2006	2007	2008	2009	2010	2011	2012
Medium and long-term debt	83.7	82.1	81.2	78.1	76.8	74.4	75.8	71.7	70.1
Government	74.5	71.8	73.3	71.2	70.8	65.8	64.7	60.6	56.6
Public corporations and private sector	7.2	7.4	6.1	5.4	5.0	5.1	5.8	5.3	6.1
With government guarantee	4.0	4.4	3.3	2.1	1.4	0.5	2.1	3.1	4.3
Without government guarantee	3.2	3.0	2.8	3.3	3.6	4.6	3.7	2.2	1.8
IMF drawings	2.0	2.9	1.7	1.5	1.0	3.4	5.3	5.8	7.5
Short-term debt	16.3	17.9	18.8	21.9	23.2	25.6	24.2	28.3	29.9
Short-term government securities	5.1	5.1	4.5	6.7	8.2	14.8	10.5	13.4	14.4
Banking sector external liabilities	11.2	12.8	14.3	15.1	15.0	10.8	13.7	14.9	15.5
Total	100	100	100	100	100	100	100	100	100
US$ million	12775	13020	13975	16483	17775	20913	24830	29387	33674
Memo items									
Gross foreign reserves/ short term debt (%)	165.7	180.3	152.4	137.5	88.2	131.4	143.5	96.0	85.3
Net foreign reserves/short-term debt (%)	---	---	---	---	---	77.6	84.4	48.2	41.3

Note: --- data not available

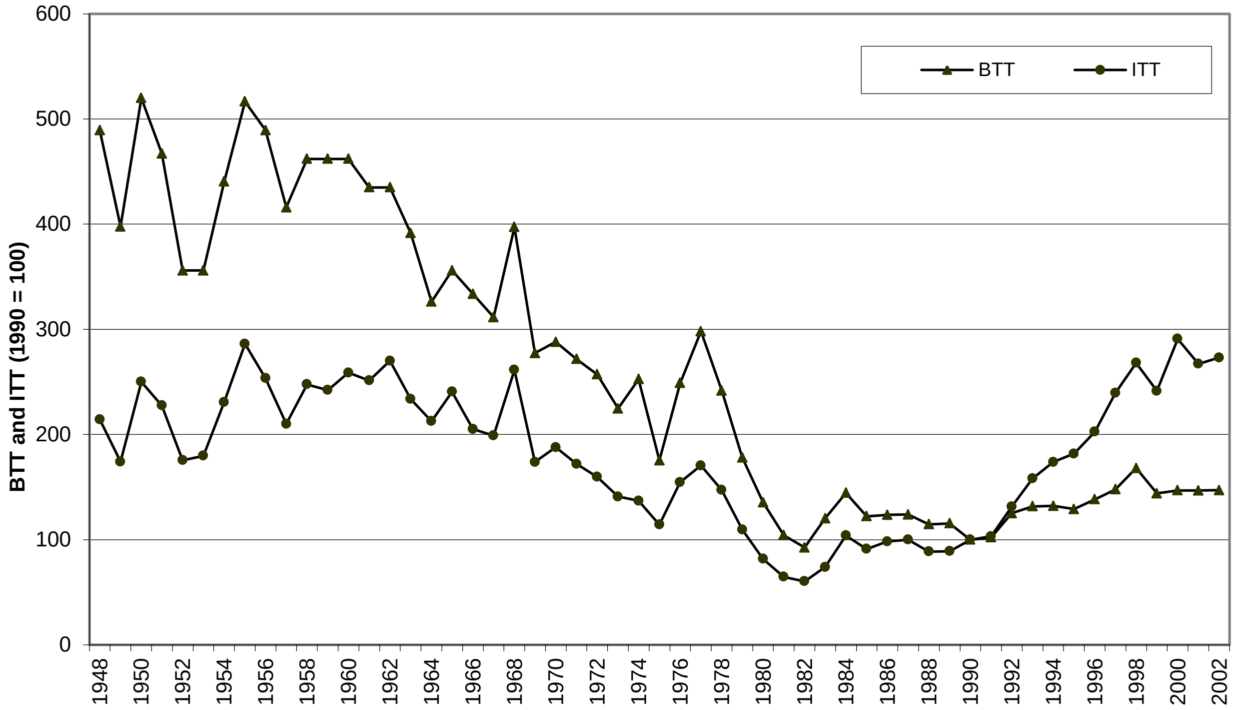
Source: Compiled from IMF (2013) (net foreign reserves) and Central Bank of Sri Lanka, Annual Report (various issues)

Figure 1: Sri Lanka's per capital GNP relative to South Korea, Malaysia, Singapore and Thailand, 1965-2011



Source: Source: Based on data compiled from World Bank, *World Development Indicator*s database.

Figure 2: Sri Lanka: Barter Terms of Trade (BTT) and Income Terms of Trade (ITT), 1948-2000 (1990 = 100)



Note

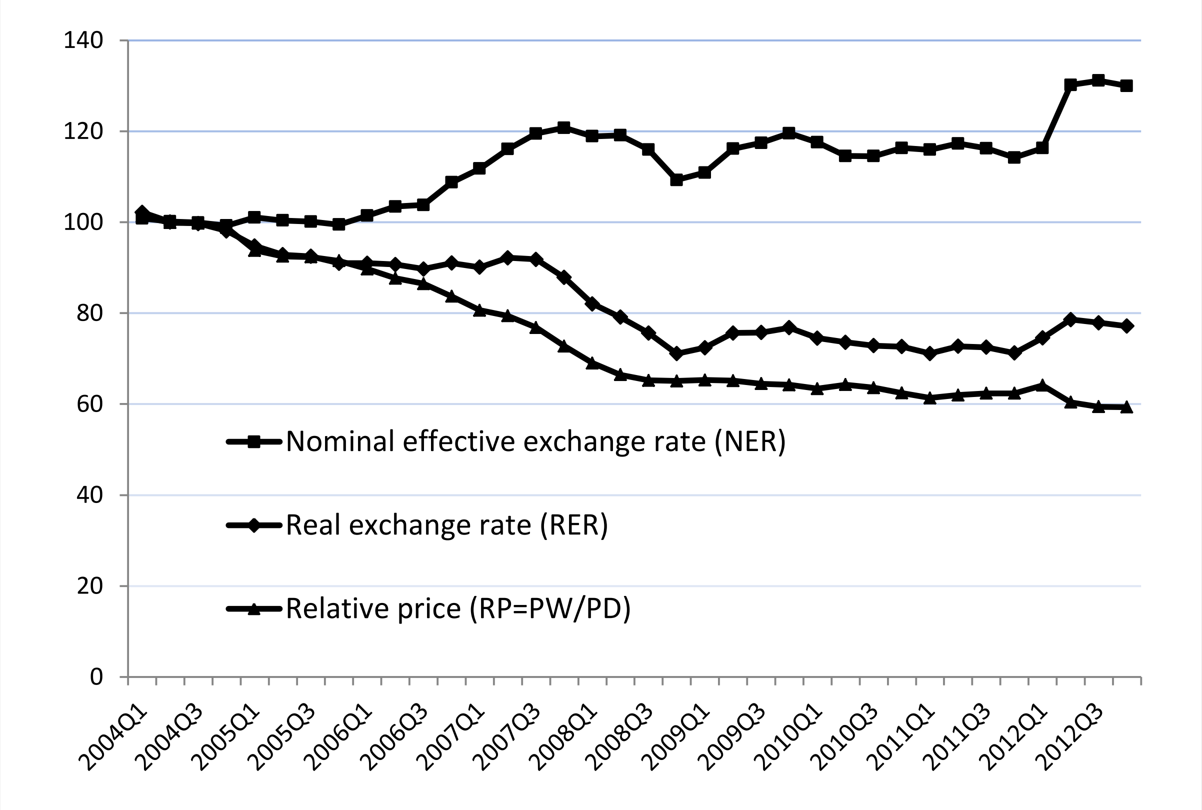
BTT = PX/PM , where PX is the export price index and PM import price index (This is what we normally call ‘the terms of trade.

ITT = [PX/PM]*QX, where QX is the export volume index. ITT measures import purchasing power of total; export earnings.

Source: Athukorala (2004b).

Figure 3: Sri Lanka: Real exchange rate and its components, 2004Q1 – 2012Q4

(2004 = 100)



Notes:

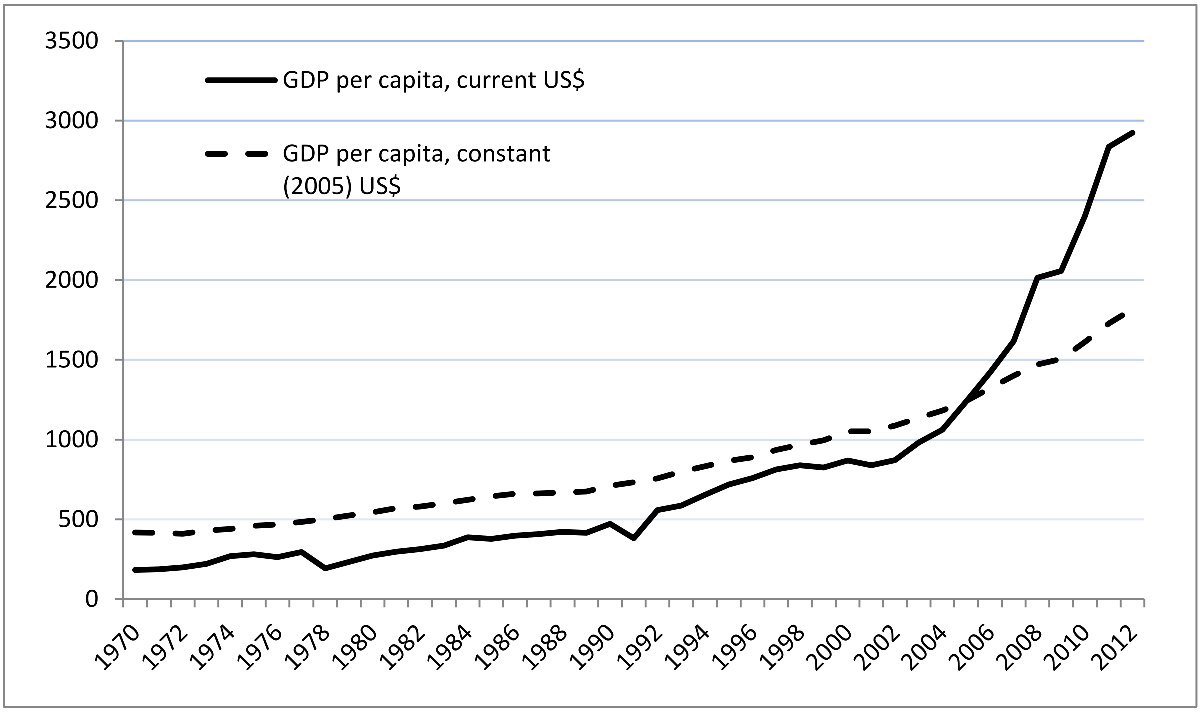
NEER: trade weighted nominal exchange rates relating to 24 top trading-partner countries (measured as rupee per foreign currency units); an increase indicates nominal depreciation.

RP: trade weights relative price (measured by the consumer price index) between Sri Lanka and its 24 top trading partners

REER = NEER*RP; an increase indicates real depreciation (improvement in the competitiveness of tradable goods production).

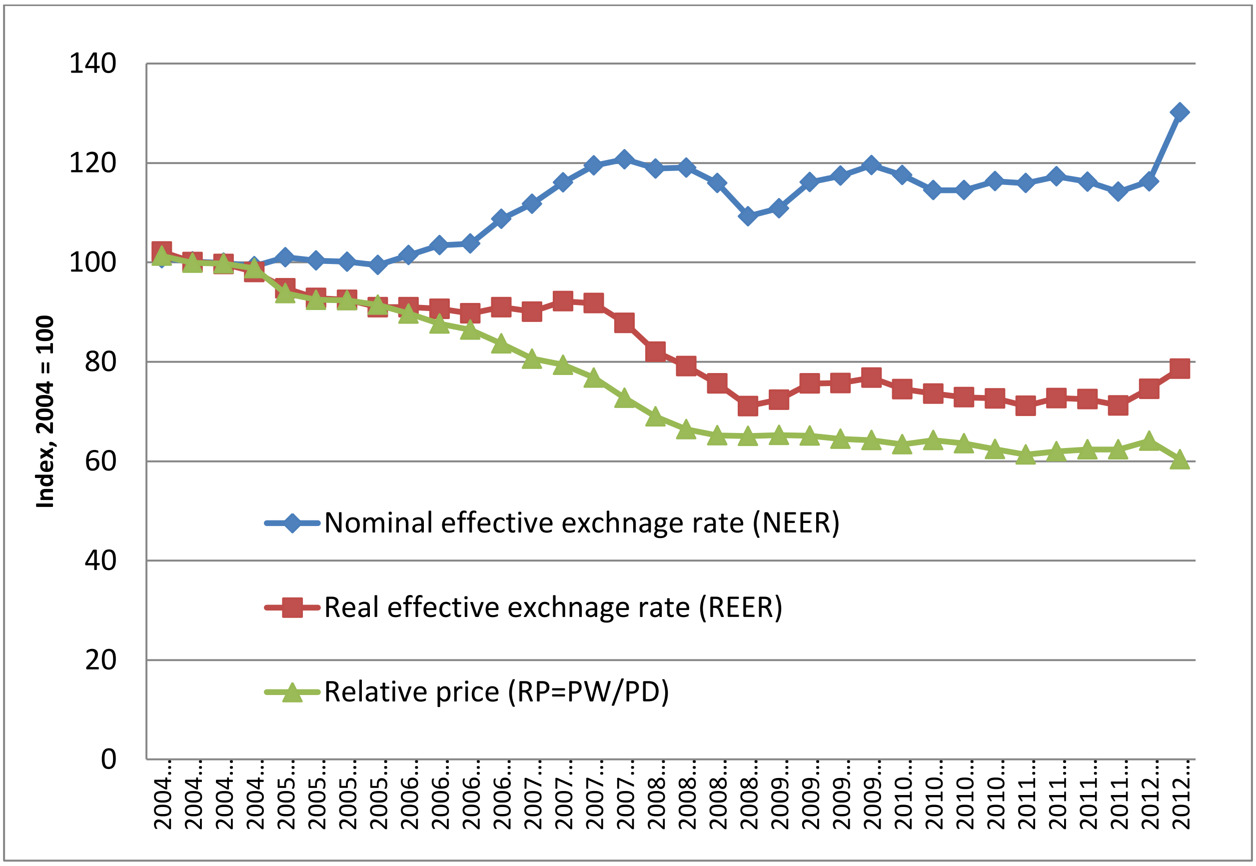
Source: Compiled from Central bank of Sri Lanka, *Annual Report* (various issues).

Figure 4: Sri Lanka, per capital GDP in current and constant (2005) price (US$), 1970-2012



Source: Based on data compiled from World Bank, World Development Indicators database, and Central Bank of Sri Lanka, *Annual Report 2012* (data for 2010-12).

Figure 4: Sri Lanka: Real exchange rate and its components, 2004Q1 – 2012Q2



Notes:

NEER: trade weighted nominal exchange rates relating to 24 top trading-partner countries (measured as rupee per foreign currency units)

RP: trade weights relative price (measured by the consumer price index) between Sri Lanka and its 24 top trading partners

REER = NEER*RP; an increase indicates depreciation (improvement in the competitiveness of tradable goods production).

Source: Compiled from Central bank of Sri Lanka, *Annual Report* (various issues).