

A stylized graphic on the left side of the slide features a mountain range with a prominent peak. The letters 'IPS' are written in a large, bold, sans-serif font across the base of the mountains. The background of the slide is a solid blue color with a diagonal line separating a darker blue upper section from a lighter blue lower section.

Economic and Political Challenges in Sri Lanka: An Overview

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Sri Lanka: Economic and Political Challenges

- Political challenges
 - Protracted separatist conflict between Government of Sri Lanka (GOSL) and Liberation Tigers of Tamil Eelam (LTTE)
 - Four rounds of peace talks (1985, 1990, 1994, 2002)
 - Significant military escalation since early 2006
- Economic challenges
 - GDP growth has picked up to 7 per cent p.a., but
 - significant imbalances in the economy; annual inflation running at over 21%
 - Weak state of public finances, lack of progress in reforms, etc.

Development Challenges

- 'War' has exacted a toll on governance structures
 - international relations being 'reshaped' to some degree as a result
- Current convergence of political/economic relations related to the country's development challenges
 - 3 decades of an open economy have brought benefits, but
 - Significant inequities across sectors and provinces have emerged
 - Inequities worse in conflict affected areas

Poverty Headcount Index by Sector (%)

	1990/91	1995/96	2002	2006/07
Urban	16.3	14.0	7.9	6.7
Rural	29.5	30.9	24.7	15.7
Estate	20.5	38.4	30.0	32.0
SRI LANKA	26.1	28.8	22.7	15.2

Source: DCS, Household Income and Expenditure Surveys

Policy Approaches: 2001 and 2004

United National Party (2001-2004) policy focus:

- Economic
 - Emphasis on further economic deregulation
- Political
 - Negotiate a political settlement with LTTE; a Ceasefire Agreement signed in February 2002
- Despite positive results on economic front/return of some 'normalcy' in security conditions, fails to be re-elected in April 2004
 - Perception that economic benefits limited to a few
 - Too accommodative in peace process

Policy Approaches: 2001 and 2004

United People's Freedom Alliance (2004/05-) policy focus:

- Economy
 - Strengthening 'national economy'
- Political
 - a more combative approach to LTTE
 - Counter-offensive launched from early 2006
 - GOSL Withdraws from Ceasefire Agreement in January 2008
- Policy stance is that sustained long-term development requires restoration of democratic governance by defeating all forms of terrorism
 - A necessary step before a political solution acceptable to all communities is implemented

Economic Challenges: Structural Imbalances

- Economic performance appears 'creditable'
 - GDP growth averaged 7% during 2005-07
 - Unemployment at its lowest recorded of 6%
 - Poverty reduced from 22.7% in 2002 to 15.2% in 2006/07
- Fiscal imbalances gathering momentum
 - Fiscal deficits averaging 8% of GDP
 - Defence budget up by 40% in 2007; a further 20% in 2008
 - Spending overruns in other areas (subsidies, wages, etc.)
- Growing demand for capital investment
 - Post-tsunami reconstruction
 - Infrastructure spending on energy, roads, ports, etc.
 - Reconstruction/rehabilitation of conflict affected areas

Economic Challenges: Resource Constraints

- 'Traditional' avenues of finance dwindling
 - 'Conditionalities' of IFIs against current economic thinking
 - 'conditionalities' tied to bilateral assistance source of contention
- Increasingly, alternative sources of assistance being tapped
 - Bilateral lines of credit, loans/grants from India, China, Iran, etc.
 - In 2007, China overtook Japan as SLs largest source of bilateral aid
- Short-term foreign borrowing at commercial rates on the rise
 - Raised a total of US\$ 1.3 bn during 2006-08
 - Credit rating downgraded from BB- to B+ in April 2008
 - Foreign debt service/exports expected to rise from 7.1% in 2006 to 11.5% in 2008
 - Total debt/GDP ratio already hovering at a high 90%

Economic Challenges: Macro Instability

- Build up of inflationary spiral since 2005, currently running at over 21%
 - Primary source remains domestic policy responses
 - Increases in prices of fuel only partly responsible
- Tighter monetary policy stance adopted since early 2007
 - Interest rates averaging 20%
 - Benefits offset by rising food prices since mid-2007
 - Outlook for a persistent reduction in inflation remains weak
- Despite the high economic burden from cost of living pressures, the government remains fairly popular

Political Challenges: the 'War'

- Demonstrated gains on the military effort
 - Cleared Eastern Province (EP) of the LTTE in late 2007
 - Holds first local elections in 20 years in May 2008
- EP to showcase political-economy policy thrust
 - 4 year plan of reconstruction to revive economy
 - Donor assistance trickling in slowly (WB, USAID, etc.)
 - Further decentralization of administrative powers, including 'sensitive' areas of police, land and land resettlement
- The GOSL can encounter some resistance to the latter, but remains electorally popular
 - Despite economic difficulties, won 2 further local elections in August 2008

The Outlook

- Medium-term political and economic outlook tied in to developments on the military front
- GOSL to continue with military effort to regain control over Northern Province
 - Already stated in relation to 2009 Budget that defence spending will be a priority for at least another year
 - In the interim, limited scope to address macroeconomic imbalances

Protracted Conflict or Decisive End to Military Efforts

- At best, can carry on 'balancing act' for another year
 - Exerting a heavy burden on government finances
 - GDP growth set to slow down in 2008
 - Public unlikely to put up with rising cost of living pressures indefinitely
 - Impact of conflict on civilians likely to be more pronounced in the North
- GOSL anticipates a decisive end sooner rather than later
 - Replicate local government elections in the Northern Province as well
 - Expectation is that a massive post-conflict reconstruction in the Northern and Eastern Provinces will provide country-wide economic boost
 - Likely to be aiming to have military effort 'wrapped up' before next general elections (2010) and presidential elections (2011)

Thank You

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