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**Economic and Political Challenges in Sri Lanka:  
An Overview**

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## **Economic and Political Challenges in Sri Lanka: An Overview**

The majority of South Asian countries have been subject to heightened political unrest in recent years. Notwithstanding such developments, the region as a whole has also recorded one of its more dynamic periods of economic growth; GDP growth has averaged in excess of 9 per cent per annum during the last few years. Indeed, the South Asian region has been one of the more dynamic regional performers in the global economy during this period. While regional growth has been driven primarily by a rapidly expanding Indian economy, the other South Asian countries too have seen fairly robust economic growth amidst worsening human security conditions.

Sri Lanka has not been an exception to this trend. The country has seen an upsurge in its economic growth in the midst of a heightened military effort from early 2006 in its long-standing separatist conflict. By its own acknowledgment, the government is attempting a difficult ‘balancing act’; to restore civil administration in all parts of the country through military gains on the battle-front, while ensuring that it implements a far reaching development programme to achieve sustained economic growth. Indeed, Sri Lanka makes an interesting case study of a country that is witnessing a nuanced shift in policy – in its approach to economic development as well as conflict resolution. The political and economic imperatives have also combined to bring a new dimension to Sri Lanka’s international relations – political relations with its ‘traditional’ sources of development assistance in the West has often got more fractious while it has been strengthening economic and political links with immediate neighbours in both South Asia as well as the wider emerging economic powers such as China.

The current confluence of political and economic policies has to be understood in the context of Sri Lanka’s development challenges. Three decades of a relatively open and liberal economy is widely recognized to have brought substantive benefits to the country in terms of raising its overall growth and reducing poverty. The benefits, however, have

not been equitably spread throughout the country. The country's more industrialized Western Province – contributing more than 50 per cent towards GDP – has benefited disproportionately. The agrarian based rural economy – where more than 80 per cent of the country's poor resides – has been lagging behind.<sup>1</sup>

Nearly three decades of a separatist conflict in the country – between the government of Sri Lanka (GOSL) and the Liberation Tigers of Tamil Eelam (LTTE) – has also taken a toll on the polity as well as the economy. The conflict which has for the most part been confined to the North and East of the country, has led to large numbers of internally displaced persons (IDPs). Whilst accurate estimates of poverty and other related indicators are not readily accessible, available evidence suggests that the two provinces lag behind significantly in terms of poverty, infrastructure, access to health/education, etc. Child recruitment to armed militias has been another pervading characteristic of these two provinces.

Sri Lanka's recent past offers an interesting example of divergent approaches adopted by two opposing political parties to meet these economic and political challenges. Indeed, the policy approach and the outcomes have to a degree been a reflection of developments in the wider South Asian region. In December 2001 – on the back of Sri Lanka's worst year of economic performance that saw an output contraction of 1.5 per cent – the country saw the election of a right-of-centre government under the United National Party (UNP) that was firmly committed to further deregulation of the economy and towards the implementation of a 'negotiated settlement' with the LTTE. To the latter end, in February 2002, it signed a Ceasefire Agreement (CFA)<sup>2</sup> and set about implementing its economic programme. An economically prudent fiscal re-structuring programme saw immediate results; the fiscal deficit was curtailed, inflation moderated and GDP growth picked up – assisted in part by a resurgence of economic activity in the North and East of the country following the cessation of hostilities.

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<sup>1</sup> The country had already undergone an uprising during 1987-89 led by the Marxist-oriented Janatha Vimukthi Peramuna (JVP) fuelled by perceptions of inequitable distribution of access to economic opportunities.

<sup>2</sup> The co-chairs to the process were the US, EU, Japan and Norway.

However, the improvements on the macroeconomic front and a two-year ceasefire failed to persuade the electorate to return the incumbent government to office when fresh elections were called in April 2004. Perhaps somewhat ironically, ‘peace’ receded as the most critical factor for voters after a period of relative calm, to be overtaken by the ‘economy’. The government’s concentration on securing macroeconomic stability allowed little leeway for ‘populist’ measures – such as wage increases, public sector jobs, subsidies to farmers, etc. The regeneration in GDP growth – visible as it was in the stock market, services sector, foreign trade and investment – was concentrated in pockets of the economy, and largely failed to permeate to the rural economy.

Thus, support for the incumbent government shrank on two counts: the failure to translate the truce swiftly into economic benefits for rural Sri Lanka, and the perception that the government was conceding too much in forging ahead with its peace initiative.<sup>3</sup> A new United People’s Freedom Alliance (UPFA) coalition government of left-of-centre and Marxist-oriented parties signaled that its approach would differ from that of the previous policy framework in tone and focus with a stronger emphasis on the rural economy, agriculture, and small and medium enterprises (SMEs) as vehicles for generating a vision of ‘growth with equity’.<sup>4</sup> The election of a new president in November 2005 from the UPFA was to see the economic policy shift consolidate further. For example, the government assumed a rather radical stance with respect to privatization, categorically specifying that it will not be amongst the menu of public enterprise reform options.

On the political front, faced with an escalation in hostilities since the election of the new president – considered to be a ‘hardliner’ relative to his political opponent in the elections – the government launched its counter-offensive from early 2006.<sup>5</sup> The government’s policy stance since has been based on the premise that sustained economic development

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<sup>3</sup> While large scale hostilities ceased for the most part, there was a disproportionately large number of CFA violations ruled against the LTTE by the Norwegian-led truce monitors.

<sup>4</sup> It was not only Sri Lanka, but India too underwent a similar re-orientation of government economic policy concurrently with the defeat of the ruling right-of-centre BJP government’s slogan of ‘India Shining’ to that of the Common Minimum Programme (CMP) under the Congress Party led coalition.

<sup>5</sup> In effect, the LTTE ensured the defeat of the UNP candidate by disallowing the population under its control to vote. The overwhelming number of such votes was expected to be cast for the UNP.

of the country can only be achieved with the restoration of administrative control and democratic governance throughout all parts of the country. While the government has set in motion an All Party Representatives Committee (APRC) to formulate a basis for appropriate constitutional arrangements for a political solution to the conflict, it sees the elimination of terrorism as a necessary first step.<sup>6</sup> To this end, the government's key policy focus has been in the area of defence, pervading into key economic policy management decisions as well.

On the face of it, Sri Lanka has made impressive economic gains during 2005-07 (see Table 1). GDP growth has averaged near 7 per cent per annum during this period, up from a trend growth of around 5 per cent; the country's rate of unemployment is estimated at its lowest recorded of 6 per cent; poverty as measured by the poverty headcount ratio is estimated to have reduced from 22.7 per cent in 2002 to 15.6 per cent in 2006/07. But these developments have come amidst signs of significant weakening of macroeconomic fundamentals in the country, the most visible manifestation being spiraling inflation that peaked at an annual rate of 21 per cent by mid-2008. Inflation in part has been a result of cost-push pressures that have come as a result of rising oil prices. But given that Sri Lanka's inflation rates remain well above comparative global and competitor country rates suggests that domestic policy bears the greater responsibility for high inflation. Monetary policy was geared to accommodate expanding fiscal expenditure needs during 2005/06.

The Central Bank began to tighten monetary policy sharply in early 2007. However, efforts to rein in inflation were further complicated by rising food prices from mid-2007. A newly created Colombo Consumers' Price Index, for instance, shows an annual increase of 20.3 per cent for food and non-alcoholic beverages in 2007 as opposed to a price increase of 8.9 per cent for that category in the previous year (see Table 3). Sri Lanka's experience of food price increases is only partially related to the global crisis. While global price increases in Sri Lanka's major agricultural imports – wheat, corn

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<sup>6</sup> Peace talks had collapsed with the withdrawal by the LTTE from peace talks in April 2003. They were resumed in 2006 amidst escalation in clashes. In January 2008, the GOSL formally withdrew from the CFA.

(maize) and dairy products – did contribute to the general increase in food prices in the country, the most critical price increase was that of rice, the staple food. While changes in wheat prices do impact on domestic rice prices, given that only 4 per cent of the country's rice requirement is imported, the impact of world market prices has been minimal. Rather, market failures in the sector – particularly, the presence of an oligopoly of a few rice collector-stockist-miller combined operators – has been have been blamed for the increase in retail prices.<sup>7</sup>

While inflation pressures in the country have shown a modest easing from July 2008, there is little likelihood of a substantive deceleration in the immediate short-term. Fiscal profligacy has been the key underlying factor for the country's weak macroeconomic environment. Governments have routinely run deficits in the range of 8-9 per cent, allowing little leeway to absorb additional expenditures without fuelling inflation. Defence spending has increased quite sharply post-2005: the allocated expenditure for defence increased by 40 per cent in 2007, and by a further 20 per cent for 2008.<sup>8</sup> At the same time, the government has shown little inclination to cut costs in other areas. Rather, costs on public sector wages, for instance, have been on the increase due to populist measures that offered jobs in the public sector as well as due to the policy choice not to undertake any radical reforms of state owned enterprises that continue to be a drain on public resources.

The government is also facing additional pressures to come up with financial resources for public investment. The post December 2004 tsunami-related reconstruction effort meant that the government expenditure was already rising given that the committed aid did not fully materialize. Infrastructure bottlenecks in roads, energy, etc. have been accumulating due to under-expenditure over many years. Given the significant regional imbalances, the policy thrust on infrastructure development has been focused on rural re-generation, including measures offering fiscal incentives for private sector investors to

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<sup>7</sup> See "Does 'Foodflation' Call for Agricultural Reforms in Sri Lanka?" in *Sri Lanka: State of the Economy 2008*, Institute of Policy Studies, Colombo (forthcoming).

<sup>8</sup> At an estimated 3.5 per cent of GDP.

locate in provinces other than the country's main Western Province. In addition, economic development of previously conflict affected areas remains a high priority in the government's political-economy strategy for post-conflict reconciliation. Under these circumstances, public investment has increased from 4.8 per cent of GDP in 2004 to 6.4 per cent in 2007. But investment in infrastructure alone will not provide the anticipated productivity improvements. Broader institutional and deregulatory reforms are at a standstill.

Pressures on external sector performance have also mounted steadily. Sri Lanka has witnessed a sharp deterioration in the current account of the balance of payments (BOP) which is currently averaging a deficit of 4.5 per cent of GDP. Whilst an ever widening trade balance has been offset to a degree by increased remittance inflows, Sri Lanka has been facing a curtailment in other traditional sources of capital inflows. The government, locked-in with a coalition of smaller parties advancing the interests of narrower constituencies, finds itself unable to implement many of the standard 'conditionalities' that would come with development assistance from multilateral organizations such as the World Bank. Indeed, Sri Lanka's on-going PRGF was abandoned due to lack of movement in key areas of reform such as those related to loss making state owned enterprises (SOEs). The government has also increasingly found itself at the centre of fractious relations with other bilateral donors such as the EU and US with regards to allegations of human rights violations and weakening of governance across the country.<sup>9</sup>

In the face of such developments, the Sri Lankan government has increasingly looked to strengthen its outreach for development assistance to neighbouring countries. China, Iran and India have extended bilateral lines of credit and soft loans for major infrastructure developments such as a new international port, a coal power plant, etc. Indeed, China emerged as Sri Lanka's single largest source of bilateral donor assistance in 2007 overtaking a position that has traditionally been held by Japan. Sri Lanka also stepped in to host the 15<sup>th</sup> Heads of State Summit of the South Asian Association for Regional

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<sup>9</sup> The EU, for example, may yet withhold the renewal of its GSP-plus trade concessions to Sri Lanka which is to be reviewed and determined by end 2008. The concessions are of particular importance to the country's key export sector – i.e., garments..

Cooperation (SAARC) in July 2008 and assume the mantle of Chair,<sup>10</sup> viewed as a further means of consolidating support for its on-going military efforts amongst the South Asian region, particularly that of India and Pakistan.

The government has also increasingly resorted to foreign currency denominated commercial borrowing. Since obtaining a sovereign credit rating in December 2005, Sri Lanka has already raised US\$ 630 million in 2006, US\$ 500 million in 2007 and a further US\$ 200 million so far in 2008. These are relatively short term borrowing that brings additional foreign exchange exposure risks. Any adverse movements in the country's credit ratings – such as the downgrading by Fitch Ratings from BB- to B+ in April 2008 – adds to the costs of rolling over debt. Sri Lanka's external debt service remains manageable to date on account of the concessionary nature of the bulk of loans received in the past. But, it is rising incrementally and could pose high risks in the medium-term in view of the fact that the country's total debt to GDP ratio is already hovering around the 90 per cent mark.

Thus, the stresses on the Sri Lankan economy are clear. Government finances are stretched tight in meeting its socio-economic development objectives – addressing inequities across regions and sectors – and its political objective of significantly weakening the LTTE in order to implement a negotiated settlement to the long-drawn conflict. It views the latter as a necessary step to ensuring sustainable development across the country in the long-term.

In this, the government has been able to demonstrate military gains that have enabled it to restore democratic governance – albeit with certain weaknesses – in previously conflict-ridden areas. In early 2008, the government was able to gain full control over the Eastern Province where local elections were then held in May 2008 for the first time in 20 years. The government – campaigning jointly with a breakaway group of the LTTE that has since joined the mainstream political process – secured a victory and installed a former LTTE cadre as the Chief Minister of the Province. The Eastern Province – with an equal

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<sup>10</sup> The 15<sup>th</sup> SAARC Summit was scheduled to be hosted by the Maldives.

mix of all three major ethnic communities in the country – is viewed as holding out the potential to showcase its strategy with regard to post-conflict reconciliation.

On the political front, this includes the full implementation of decentralized administration as envisaged under an Indian brokered deal in 1987.<sup>11</sup> India's role in the Sri Lankan conflict in the past has often been adversarial. However, bilateral political and economic relations have improved markedly since the mid-1990s.<sup>12</sup> India has kept a 'hands-off' approach in more recent years but India's stance towards the Sri Lankan conflict remains vital in any negotiated settlement. In this respect, the proposal for full implementation of the 13<sup>th</sup> Amendment has received a nod from Indian quarters; the difficulties may lie in convincing the more 'nationalistic' elements of the Sri Lankan polity amongst the majority community which forms a vital chunk of the government's support base.

However, it could well be argued that the current regime with its demonstrated commitment to see the 'war' to an end is best placed to offer an effective political solution to the demands of the ethnic minorities for devolved powers.<sup>13</sup> Despite the significant 'costs' of the war for the masses, in particular of an unprecedented increase in the cost of living not witnessed for many years, as well as perceptions of corruption and weakening of governance, support for the on-going military effort against the LTTE has gained support, at least, amongst the majority community.<sup>14</sup> The government remains popular: this has been borne out by subsequent local government elections held in August 2008 where it managed to score a convincing victory.

It is attempting to further its political-economy development objectives by prioritizing development of the Eastern Province. It has drawn up a four year development

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<sup>11</sup> Under the 13<sup>th</sup> Amendment to the Constitution, the country was divided into nine administrative provinces. The full implementation of the 13<sup>th</sup> Amendment would involve devolution on matters such as police powers, land and land settlement which are opposed by some political parties.

<sup>12</sup> India and Sri Lanka signed a bilateral free trade agreement in December 1998 that is widely acknowledged to have been favourable to Sri Lanka.

<sup>13</sup> For example, the installment of a former LTTE cadre as the Chief Minister of the Eastern Province did not provoke any objections.

<sup>14</sup> See <http://www.cpalanka.org/polling.html>

programme with emphasis on improving economic infrastructure and human settlement development. While initial donor response has been slow due to lingering security concerns, there is growing re-orientation of donor projects towards the development of the Eastern Province. It presents strategically important opportunities for the donor community to advance governance and human rights by promoting economic, political and social development. The need for assistance in these areas is taking precedence as the military effort moves into the Northern Province. While death and displacement of the civilian population in the Eastern Province were kept to a minimum, the impact on the civilian population in the LTTE stronghold of the Northern Province is likely to be much more severe.

In summary, the government's approach to the development policy priorities in the medium-term is clear. The focus will remain on the military effort against the LTTE. Indeed, the Ministry of Finance has already indicated in its preparation of the Budget for 2009 that the priority of the government's expenditure programme would be on defence expenditures for at least another year. In the interim, any shortfalls are likely to be met by further borrowing that will offer little relief to deal with the prevailing widespread macroeconomic instability in the country. Undoubtedly, the anticipation is that an end to the conflict-related violence would permit the restoration of democratic governance and reconstruction of the worst affected areas. This is likely to entail a fairly large reconstruction effort that could garner international support and assistance, allowing Sri Lanka to weather any medium-term economic instability.

It is a risky policy strategy and not without potential pitfalls. The economy remains fragile despite impressive growth figures in recent years. Further stresses on the economy – by way of additional borrowing to meet rising expenditures – cannot be absorbed indefinitely. At best, the government can carry-on its 'balancing act' for another year. If the military effort were to continue beyond that, the Sri Lankan economy may well face an impending crisis. The growth momentum has already slackened with monetary tightening measures and the masses are unlikely to tolerate the burden of spiraling cost of living indefinitely. The military onslaught has also had other costs. Sri Lankan polity is

clearly polarized to a significant degree with charges made against the government of human rights violations, etc. The government, on the other hand, appears to be working towards its own time table: to wrap-up the 'war' in time for general elections scheduled to be held in 2010 and begin the long haul towards post-conflict development.

**Table 1: Selected Macroeconomic Indicators (2003–2007)**

	Unit	2003	2004	2005	2006	2007
<b>General</b>						
GDP	US\$ bn	18.8	20.0	24.0	27.3	32.9
GDP growth	%	5.9	5.4	6.2	7.7	6.8
Investment	% of GDP	22.0	25.3	26.8	28.0	27.9
Savings	% of GDP	16.0	16.4	17.9	17.0	17.6
Unemployment	%	8.4	8.3	7.2	6.5	6.0
<b>External sector</b>						
Trade balance	% of GDP	-8.4	-11.2	-10.7	-12.5	-11.0
Current a/c	% of GDP	-0.4	-3.1	-2.7	-5.3	-4.2
FDI	% of GDP	0.9	1.1	1.0	1.6	1.7
Official reserves	US\$ bn	2.3	2.2	2.7	2.8	3.5
Debt service <sup>a</sup>		11.6	11.6	7.9	12.7	13.0
<b>Fiscal variables</b>						
Govt. expenditure	% of GDP	22.9	22.8	23.8	24.3	23.5
Govt. revenue	% of GDP	15.2	14.9	15.5	16.3	15.8
Fiscal balance	% of GDP	-7.7	-7.9	-8.4	-8.0	-7.7
Govt. debt	% of GDP	102.3	102.3	90.6	88.7	85.8
<b>Prices and money</b>						
Inflation	% change	6.3	7.6	11.6	13.7	17.5
Interest rate <sup>b</sup>	%	7.2	7.6	10.4	13.0	20.0
Broad money M <sub>2</sub>	% change	15.3	19.6	19.1	17.8	16.6
Exchange rate	Rs/US\$	96.7	104.6	102.1	107.7	108.7

Notes: a: As a ratio of merchandise goods and services; b: 12-month Treasury bill rate.

Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

**Table 2: Sri Lanka: 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: Dept. of Census and Statistics, *Household Income and Expenditure Survey*, various years.

**Table 3: New Colombo Consumer Price Index<sup>a</sup>**

	Weights	2004	2005	2006	2007
Food & non-alcoholic beverages	46.7	9.0	11.4	8.9	20.3
Clothing & footwear	3.1	5.0	5.2	8.3	10.2
Housing, water, electricity	18.3	10.0	18.9	18.9	18.6
Furnishing, etc.	3.2	4.6	7.4	6.0	7.8
Health	4.2	0.0	0.9	4.7	2.1
Transport	9.5	17.6	12.6	11.0	13.6
Communication	4.4	12.8	-0.2	-0.7	-0.6
Recreation	2.2	5.2	5.7	0.5	5.2
Education	5.8	5.7	5.0	5.5	5.9
Misc.	2.6	6.9	4.4	5.4	7.0
ALL ITEMS	100.0	9.0	11.0	10.0	15.8

Notes: A new CCPI (2002=100) was introduced in 2007 to replace the old CCPI (1952=100).

Source: Central Bank of Sri Lanka, *Annual Report 2007*.