## *EXECUTIVE SUMMARY*

1. **Overview**. Sri Lanka is a well known outlier among developing nations. It was one of the first developing countries to understand the importance of investing in human resources and promoting gender equality. As a result, Sri Lanka has achieved human development outcomes more consistent with those of high income countries. It also liberalized its economy in the late 1970s, ahead of other developing nations. Despite acceleration of the civil conflict in the 1990s, economic growth has been healthy due to good macroeconomic management and progress in trade liberalization, privatization, and financial sector reform. Sri Lanka is today South Asia's most open economy, and has a relatively well developed capital market infrastructure. Its per capita income (US$ 820) remains the highest in the region, after Maldives. Unemployment and inflation have fallen to historical lows, the external current account has strengthened, exports have diversified and expanded, and foreign direct investment has risen.

2. There is growing realization, however, that Sri Lanka's development has been well below its potential. In the 1960s, Sri Lanka had the same per capita income as Korea, Malaysia, and Singapore. Thirty years later these three countries have per capita incomes that are several times higher than Sri Lanka's. Several reasons explain this divergence in economic performance. The first and most obvious one is the 17-year long war. This has taken a heavy social and economic toll on the country's performance. Second, relative to the early 1970s, public institutions and governance have weakened gradually over the years. Third, Sri Lanka has for many years given the public sector a significant role in creating jobs and transferring resources across groups. The size of the public sector has declined slightly over the years, but it continues to dominate the financial sector and utilities, while owning a large number of commercial enterprises. Per capita employment in the public sector is the largest in Asia. With productivity in the public sector typically well below that of the private sector, this has meant foregone opportunities in terms of growth and employment. Regulations regarding land transfers and exit policies in the labor market have exacerbated the situation by constraining efficiency in the private sector. It is testimony to the private sector's strength that employment in the private sector has increased significantly during the last decade despite these constraints.

3. Realizing Sri Lanka's enormous potential will first require an end to the war. In addition, as indicated in the 2000 Budget speech, the country needs to engage in a second wave of reforms that will increase opportunities, put the economy on a high growth path, and improve governance. Of particular importance are initiatives highlighted in the Budget aimed at accelerating privatization and strengthening public institutions.

4. **Recent political developments**. Since late 1998 elections have slowed the momentum for introducing key structural reforms. Provincial Council elections were held in the first half of 1999, and Presidential elections in December 1999. Since her re-election, President Kumaratunga has made new efforts at resolving the conflict. The opposition United National Party (UNP) has pledged its support to the Government's peace initiatives, and Norway is assisting the process. These developments have however been overshadowed by a volatile security situation with intensified military offensives, high profile assassinations, attempted assassinations, suicide bombings and a series of smaller bus bombings. Parliamentary elections scheduled for mid-2000 add an additional layer of uncertainty to the speed of policy reforms.

5. **Resilience in the face of adversities**. Despite the difficult domestic political conditions, the intensified civil conflict, and turbulence in world financial markets, the economy has continued to show resilience over the last 18 months. The first half of 1999 was particularly testing, with exports falling for the first time by as much as 10 percent due to weak global

demand for tea and garments. This was reversed in the second half of the year. Real GDP growth for 1999 was 4.3 percent, slightly lower than the long-term trend but comparing favorably with growth performance in other developing countries. Unemployment has fallen to a historical low (8.8 percent). Foreign direct investments increased somewhat. Combined with falling domestic and international commodity prices, macroeconomic policies have reduced inflation by half relative to 1998 (4.7 percent). The favorable trends have continued during the first quarter of 2000 with exports and industrial production growing by 24 and 12 percent, respectively, and inflation continuing on a downward trend.

6. **Short-term vulnerabilities**. Despite these successes, vulnerabilities remain on the external front. Sri Lanka's current account has improved considerably over the last decade, although there was a widening of the deficit to 3.3 percent of GDP in 1999. The capital account which has weakened steadily since 1990 was further affected in 1999. Net capital flows fell to a historical low of US$ 330 million, compared with an average of about US$ 600 million during 1990-98. The long-term deterioration in the capital account is due to rising amortization of official debt and a reversal in short-term capital flows (which have been large and negative in the last four years). This underlying trend was aggravated in 1999 when gross disbursements of concessional aid fell to a very low level (US$ 350 million compared with US$ 520 million in 1990-98) due to the completion of several large donor financed projects and continued delays in procurement. Large privatization receipts (US$ 430 million) over 1995-99 and sustained levels of long-term capital from the private sector helped mitigate the impact of this continued weakening in the capital account. As a result, external reserves have been partially protected, although falling steadily for six years. The balance of payments registered a deficit of US$ 260 million in 1999, and gross official reserves fell to 2.9 months of imports. The challenge in the future is to maintain sustainable long-term increases in private capital as well as maximize the use of foreign concessional assistance.

7. Another vulnerability relates to the fiscal situation. The budget deficit was reduced to 7.5 percent of GDP in 1999. The 2000 Budget introduced in February aimed at maintaining the deficit at the same level as in 1999. However, the escalation of the conflict in the Jaffna peninsula since May has called for an increase in defense expenditures of about 1 percent of GDP. Additional revenue and expenditure measures were taken to offset part of these military expenditures, and the aim is to contain the deficit to below 8 percent of GDP. Realizing this objective will however remain a challenge for Sri Lanka as it is based on ambitious revenue targets and early realization of privatization receipts. A more difficult task is to reduce the deficit over the medium-term as this calls for both revenue and expenditure improvements. The deficit declined by about 2-3 percentage points of GDP over 1990-99, but was accompanied by a fall of 3-4 percentage points of GDP in revenues (due in part to tax concessions). As a result, expenditures declined by 6-7 percentage points of GDP. Half of the reduction was in capital spending in a country greatly in need of better infrastructure. On the other hand, the gains made in reducing current expenditures over the decade were undermined by the increasing share of defense outlays and debt servicing. In addition, the wage bill was reduced by about 2 percentage points of GDP between 1990-99, in the face of a large expansion in the cadre of public servants. This fiscal situation could be adversely affected if the highly positive real interest rates of 1999 continue to persist.

8. Prudent monetary policy was successful in lowering inflation in 1999. It was however unable to reduce interest rates because of the large borrowing needs of the Government to make up for the shortfall in external financing. The financial sector has benefited from several structural enhancements in recent years. However, continuing governance weaknesses at the two state banks undermine the efficiency of the sector. Their portfolios remain weak (15-20 percent non-performing assets) and their management was unable to meet the targets specified under the

performance contracts signed with the Government in July 1998. The poor performance of these two state banks remains a serious concern for the Government, and some reform initiatives have recently been launched. As in the past, exchange rate policy in 1999 aimed at protecting Sri Lanka's external competitiveness.

9. **Sri Lanka's future economic and social development** will depend not merely on maintaining sound macroeconomic management and accelerating privatization, but more importantly on the country's ability to resolve the on-going conflict and move quickly into implementing key structural reforms to enhance economic growth and reduce poverty. The most difficult long-term challenge is resolving the conflict. The civil conflict has already taken a huge toll on the economy and its society, costing at least two years of GDP. Even more important, the conflict has caused a humanitarian problem of great proportions, taken the lives of several of its political leaders, and forced a generation of children to grow up in an environment of insecurity and conflict. Sri Lanka's social fabric is under stress due to the poverty and deteriorating health and education outcomes in war-torn areas, psychological trauma associated with the conflict, displacement, as well as rising levels of crime and violence. There are serious risks to future economic and social development if the conflict persists. Experiences of other countries around the world show that prolonged civil conflicts, especially those with ethnic undercurrents, ultimately lead to economic and social decline.

10. In restoring the health of its public finances, Sri Lanka will also need to rethink its poverty reduction strategy. Poverty remains a concern in Sri Lanka. Emerging analysis shows that despite healthy economic growth, there has been slow progress in poverty reduction between 1990 and 1996. More worrisome is the persistence and exacerbation of regional disparities during that period. The conflict affected areas in the North-East are undoubtedly the most deprived, while even the North Central and North Western provinces have experienced a near doubling of poverty rates. Excluding the North-East, one-fourth of the population lives below the poverty line. While the severe drought of 1996 could partially explain this poverty trend, it is evident that income fluctuations especially in rural areas create considerable vulnerabilities. Women and children bear a disproportionate burden of the conflict and some consequences of poverty such as alcoholism, domestic violence, and child abuse.

11. The large poverty programs of the 1990s have suffered from design and implementation weaknesses which have affected their effectiveness. The political bias in the implementation of successive state sponsored poverty programs has rendered the poor very vulnerable to changes in the political climate. The programs have not created opportunities and empowered the poor to lift themselves out of poverty in a sustained manner. Most poverty programs in Sri Lanka have had poor targeting as the transfers usually cover around 50 percent of the population. Emerging evidence indicates that 44 percent of the benefits from the Government's poverty program (Samurdhi) go to the top three income quintiles. The large expenses on poorly targeted income transfers, the high long-term administrative costs of hiring poverty workers into the public sector, and the weak exit mechanisms are some examples of the problems that need to be addressed.

12. There is today also a high degree of consensus that prevailing public sector institutions are in need of fundamental reforms. Sri Lanka's public administration has some positive aspects of good governance such as a well developed human resource base and a dedicated cohort of professional staff. However, a gradual deterioration in public sector institutions and governance started in the early 1970s, which combined with the civil conflict and youth rebellions of the past, have resulted in Sri Lanka's low ranking in Asia in governance (Human Development Center, 1999). The greatest returns to economic governance would arise from reintroducing strong institutional controls and incentives in the management of the public administration which is currently oversized, costly and suffers from low efficiency. Politicization of recruitment by

successive governments has become well established and expected. Financial accountability has weakened considerably over the years due primarily to insufficient parliamentary oversight and poor institutional structures or watchdog bodies. The administrative apparatus remains very centralized despite efforts since 1987 to devolve functions to the Provincial Councils. In all these areas, there are on-going initiatives by the Government to address the fundamental problems. However much remains to be done.

13. One area where there has been considerable improvements is in reducing the role of government in certain sectors of the economy. An <u>impressive privatization program</u> has been implemented since 1995, with the main successes being in the plantation and telecommunication sectors. Private sector participation has been encouraged in electricity production and the ports. Large privatization proceeds have been obtained which helped contain rising government debt. Realizing the benefit of increased private sector role in the economy, the Government announced its intentions to reinvigorate the privatization and liberalization program with a strong regulatory framework in place in the 2000 Budget. It has also expressed its interest in addressing some of the structural rigidities in the labor market to facilitate the planned restructuring of the economy. By undertaking such crucial and well sequenced reforms, in the context of a transparent and consultative process, Sri Lanka will be able to recapture the missed opportunities of the past and better meet the aspirations of its people.