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Macroeconomic policy for full and productive employment and decent work for all:

Sri Lanka country study

Dushni Weerakoon
Nisha Arunatilake

Country
Employment
Policy Unit

Employment
Policy
Department

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Preface

The primary goal of the ILO is to contribute, with member States, to achieve full and productive employment and decent work for all, including women and young people, a goal embedded in the ILO Declaration 2008 on *Social Justice for a Fair Globalization, and*[1] which has now been widely adopted by the international community.

In order to support member States and the social partners to reach the goal, the ILO pursues a Decent Work Agenda which comprises four interrelated areas: Respect for fundamental worker's rights and international labour standards, employment promotion, social protection and social dialogue. Explanations of this integrated approach and related challenges are contained in a number of key documents: in those explaining and elaborating the concept of decent work[2], in the Employment Policy Convention, 1964 (No. 122), and in the Global Employment Agenda.

The Global Employment Agenda was developed by the ILO through tripartite consensus of its Governing Body's Employment and Social Policy Committee. Since its adoption in 2003 it has been further articulated and made more operational and today it constitutes the basic framework through which the ILO pursues the objective of placing employment at the centre of economic and social policies.[3]

The Employment Sector is fully engaged in the implementation of the Global Employment Agenda, and is doing so through a large range of technical support and capacity building activities, advisory services and policy research. As part of its research and publications programme, the Employment Sector promotes knowledge-generation around key policy issues and topics conforming to the core elements of the Global Employment Agenda and the Decent Work Agenda. The Sector's publications consist of books, monographs, working papers, employment reports and policy briefs.[4]

The *Employment Working Papers* series is designed to disseminate the main findings of research initiatives undertaken by the various departments and programmes of the Sector. The working papers are intended to encourage exchange of ideas and to stimulate debate. The views expressed are the responsibility of the author(s) and do not necessarily represent those of the ILO.

José Manuel Salazar-Xirinachs
Executive Director
Employment Sector

[1] See http://www.ilo.org/public/english/bureau/dgo/download/dg_announce_en.pdf

[2] See the successive Reports of the Director-General to the International Labour Conference: *Decent work* (1999); *Reducing the decent work deficit: A global challenge* (2001); *Working out of poverty* (2003).

[3] See http://www.ilo.org/gea. And in particular: *Implementing the Global Employment Agenda: Employment strategies in support of decent work, "Vision" document*, ILO, 2006.

[4] See http://www.ilo.org/employment.

Foreword

At the 99th session of the International Labour Conference, constituents endorsed the need to promote a 'pro-employment' macroeconomic framework. It was felt that the current framework, while making an important contribution to the goal of macroeconomic stability, paid insufficient attention to the way in which macroeconomic policy instruments either helped or hindered employment creation and poverty reduction. In the standard framework that has evolved since the days of the structural adjustment programmes of the 1980s and 1990s, and has remained intact during the 2000s, the emphasis has been on attaining key nominal targets pertaining to debts, deficits and inflation. The rationale is that attaining such targets in the medium to long run will engender a predictable macroeconomic environment that is crucial for supporting growth and hence employment creation. Evidence of the recent decades has shown that macroeconomic stability is necessary, but by no means sufficient to engender inclusive, job-rich growth.

The ILO/Korea partnership programme has been supporting the Employment Policy Department's endeavour to identify existing constraints in the macroeconomic policy instruments that may hinder generation of full and productive employment, and to suggest a way forward for job-rich growth. A series of country case studies has been conducted, and the current case study of Sri Lanka represents one result. The country case study analyzes recent macroeconomic performance, shows their relationship with employment outcomes or lack thereof, reviews the existing programmes on employment and social safety nets, and reflects the views of the ILO constituency and other key national stakeholders that were collected through interviews and consultations.

With an annual average GDP growth in the range of 5 per cent, Sri Lanka has witnessed a considerable reduction of its unemployment rate over the past decade despite the long-term internal conflict. However, employment growth is explained more by growth in public sector employment and informal types of employment than in formal private sector employment. Furthermore, unemployment remains high for women and youths, including for the educated. Such outcome can be attributed to insufficient long term investment by the private sector in the context characterized by volatility and unpredictability in the macroeconomic fundamentals, compounded by socio-political flux of a long drawn armed separatist conflict in the country.

The results of the analysis were presented and discussed at a high-level tripartite National Workshop on National Human Resources and Employment Policy in Colombo, in October, 2011. As Sri Lanka sees the dividend of restored peace, it is hoped that the outcome analysis and recommendations put forward by this paper be fully taken into consideration for creating more enabling macroeconomic environment for both employment creation and poverty reduction in the country – towards more inclusive growth.

Iyanatul Islam Chief Country Employment Policy Unit	Azita Berar Awad Director of Employment Policy Department

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Acknowledgments

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Abstract

Sri Lanka has witnessed a considerable reduction of its unemployment rate over the past decade. Annual average GDP growth in the range of 5 per cent has helped to generate employment. However, employment growth is explained more by growth in public sector employment and informal types of employment than in formal private sector employment. Furthermore, unemployment remains high for females, for youth and for the educated. Such outcome can be attributed to insufficient long term investment by the private sector in the context characterized by volatility and unpredictability in the macroeconomic fundamentals, compounded by socio-political flux of a long drawn armed separatist conflict in the country. In an environment characterized by uncertainty and volatility, contractual or informal employment arrangements may be seen to provide the necessary flexibility to adjust to a changing economic environment. Yet, given the missing unemployment insurance system and the lower likelihood of such workers to be covered by the social safety nets, contractual or informal employment arrangements are not conducive towards achieving Sri Lanka's development objectives. To retain macroeconomic policy manoeuvrability in order to appropriately respond to its development priorities and to avoid the need for IMF conditionality-driven policy setting in future, Sri Lanka needs to ensure prudent macroeconomic management. In 2011, with a fiscal deficit target of 7 per cent, a moderate inflation averaging 6-7 per cent, and a fairly healthy external reserve position, Sri Lanka does have the opportunity to gear its macroeconomic policies towards productive employment, by adjusting and releasing resources for capital investment in infrastructure and spending on key sectors such as health and education.

Key words: employment, full employment, decent work, poverty alleviation, fiscal policy monetary policy, exchange rate, Sri Lanka

JEL Codes: E24, E 31, E 52, E58, E62, J21

1. Introduction and background

Sri Lanka's decision to embark on an economic reform process in the late 1970s – complemented by a second wave of reforms in the early 1990s – saw a sweeping dismantling of barriers to a market economy and marked a systemic shift in the country's approach to economic development.[5] It yielded swift results – primarily by lifting the country's GDP growth rate well above its historical trends. However, in the ensuing decades, the economy has also been subject to 'unbalanced' growth across sectors and provinces, despite efforts to mobilize broad-based support by offering compensatory measures to those less likely to benefit directly from the reform process.[6] More critically, a long simmering armed separatist conflict that spanned three decades stymied the country's efforts to achieve policy and political stability needed for a sustained development effort.[7] Nonetheless, Sri Lanka was able to post a credible GDP growth rate of around 5 per cent per annum throughout this period, allowing the country to make some progress in improving employment outcomes and poverty reduction efforts.

Sri Lanka's economic policy focus over the last decade has reflected some of these tensions. Reform efforts for the most part stalled from the late 1990s, as governments increasingly began to grapple with the emergence of 'coalition politics' that saw a shortening of electoral cycles.[8] It also introduced an element of policy discontinuity. For example, Sri Lanka moved from a general apathy towards reform – that called for price restraints on a variety of essential goods and reining in of privatization – to a pro-reform zeal during a brief hiatus in 2002-04. It was initiated on the back of a weak macroeconomic environment that called for immediate stabilization measures. In the medium-term, significant de-regulatory measures were to be implemented to improve the country's economic efficiency, particularly aimed at enhancing the environment for businesses.[9]

The measures aimed at fiscal consolidation like the removal of subsidies, wage freezes, etc. – proved unpopular, while the 'benefits' of greater macroeconomic stability were perceived to favour only pockets of the urban economy. The disenchantment of rural voters was clearly evident when in 2004 Sri Lanka voted in a government that signalled a nuanced shift in economic policy in both tone and focus. The new policy framework laid emphasis on building a strong 'national' economy and indicated a qualitative change in the degree of state involvement in economic activity.[10] The focus of policy attention shifted to the rural economy, agriculture, and small and medium enterprises (SMEs) as vehicles for generating a vision of 'growth with equity'. Most notably, privatization was ruled out as an option in any public sector reform exercise.

[5] These policy reforms have been well documented. See Cuthbertson and Athukorala, 1991; Athukorala and Jayasuriya, 1994.

[6] Indeed, the inequitable distribution of the benefits of the post-reform economic growth also led the country towards a violent social uprising in the late 1980s.

[7] See Arunatilaka, et. al., 2001.

[8] Despite the life of an elected Parliament being six years, Sri Lanka witnessed Parliamentary elections in quick succession in 2000, 2001 and 2004 as coalitions fell apart.

[9] See Government of Sri Lanka, 2002.

[10] See Ministry of Finance and Planning, 2006.

The policy direction appears to be an attempt to allay a sense of disenchantment amongst those left behind by economic progress. Over time, the reforms saw the transformation of the Sri Lankan economy – from an agrarian to an increasingly industrialized and services oriented economy. A credible growth performance has allowed the country to achieve a gradual reduction in poverty, with the national poverty headcount ratio estimated to have fallen from 26.1 per cent in 1990/91 to 15.2 per cent by 2006/07. Sri Lanka has also witnessed a persistent reduction in its rate of unemployment, estimated to be around 5.8 per cent by end 2009. In spite of these achievements, it is recognized that Sri Lanka's economic performance has fallen short of expectations. The country's GDP growth has been well below its potential, and its economic performance has been dogged by a volatile macroeconomic environment, arising primarily from weak public finance management. Of equal concern has been emerging evidence of sectoral and spatial inequities. The concentration of economic activities in the Western Province – contributing more than 50 per cent towards the country's GDP – and widening gaps in poverty reduction efforts across urban, rural and the estate sectors is one such example. Measured by the commonly used Gini-coefficient, Sri Lanka has witnessed a gradual rise in income inequality in recent years. Moreover, while Sri Lanka's unemployment rate of just under 6 per cent looks promising at first glance, detailed analysis of employment shows that unemployment remains high for females, for youth and for the educated.[11] A large proportion of the employment that has been created has been in the more vulnerable category of informal sector activities – currently accounting for nearly 62 per cent of employment.

Slow job growth and skills mismatch are main reasons explaining the large proportion of employment in the informal sector.[12] The World Bank (2005) investment climate survey identifies factors affecting businesses in urban and rural areas. The results show that the high cost of energy and transport and their poor quality, high cost of credit,[13] and the difficulties in accessing credit, are main reasons hampering business activities in both rural and urban areas. In addition to the above, in the urban areas rigid laws that restrict the adjustment of business activities during economic downturns and uncertainty and lack of stability in the macroeconomic policy environment are also identified factors that hinder business activity.[14] In the rural areas, access to input and end markets are a major constraint in business development. Technological advancements have increased employment opportunities for high skilled workers, for example in Information Technology Enabled Services (ITES). However, evidence shows that there is a shortage of persons with skills demanded by the ITES sector, indicating that the education sector should adapt to meet these emerging demands.[15]

The government's economic policy focus post-2005 was implemented against the backdrop of a heightened military conflict in the country. On the external front, Sri Lanka was grappling with the sustained rise in international oil prices. During 2005-08, a high

[11] Arunatilake, N and P. Jayawardena, 2010a.

[12] Ibid.

[13] Officials of the Ministry of Labour and Labour Relations also pointed the need for lowering interest rates to stimulate investment.

[14] When consulted for this study, the , Employer's Federation of Ceylon, also expressed the need for more flexibility in labour legislation to allow firms to make use of emerging opportunities.

[15] Institute of Policy Studies, 2010.

GDP growth (averaging near 6.8 per cent per annum) was maintained at the cost of a weakening macroeconomic environment. The economy was prone to overheat as a result of an expansionary fiscal policy thrust that in turn was accompanied by an accommodative monetary policy stance. Unremarkably, sustaining the growth momentum began to prove difficult, even before the global economic crisis began to hit Sri Lanka towards the latter half of 2008. As the macroeconomic situation worsened, Sri Lanka was compelled to approach the International Monetary Fund (IMF) for balance of payments (BOP) support under a Stand-By Arrangement (SBA) in February 2009.

The country's medium-term economic prospects received a boost with the decisive ending to the three decade long armed separatist violence in the country in May 2009. It saw the government receive a strong political mandate in 2010 that has offered the country a fresh opportunity to focus singularly on its socio-economic development efforts. The economic programme is intended to deliver rapid infrastructure development to the war ravaged regions of the North and East of Sri Lanka, while focusing on bridging the rural-urban divide in the rest of the country.

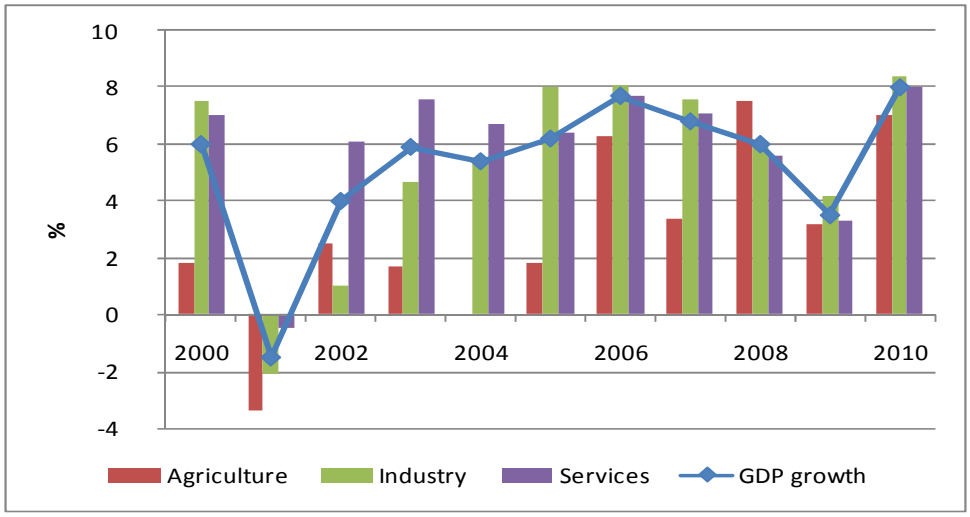
In 2010, the Sri Lankan economy began to reap the benefits of peace and stability, and an improving external economic environment following the global economic crisis of 2008/09. GDP growth bounced back to a healthy 8 per cent with broad based growth across all sectors; the external payments position remains strong on the back of higher earnings from exports, tourist arrivals and migrant remittances; the macroeconomic fundamentals have improved with moderate inflation, falling interest rates and a stable rate of exchange.

However, whilst the short to medium-term outlook for the economy looks promising, there are longer-term risks that have to be borne in mind. Sri Lanka's fiscal situation remains fragile despite progress made in bridging the deficit from 9.9 per cent of GDP in 2009 to 7.9 per cent in 2010. As the government embarks on a heavy public investment infrastructure drive, fiscal pressures, as well as attendant inflationary pressures will need to be managed prudently. A post-conflict reconstruction related economic revival could be sustained in the longer term only if accompanied by reforms aimed at improving productivity and efficiency in the economy. This will yield the most optimum outcome for sustained employment generation in the country, particularly in the more formalized sectors of the economy.

2. Linkages between macroeconomic outcomes, employment and poverty

Sri Lanka's GDP growth over the last decade has averaged 5 per cent per annum, albeit with some volatility. GDP growth contracted sharply in 2001 (the sharpest downturn in its post-independence history), on the back of both domestic and external shocks to the economy (Figure 1). The combined effects of poor weather conditions on agricultural output, a terrorist attack on the country's international airport that adversely impacted the export sector and the global downturn following 9/11 terror attacks were some proximate causes.[16]

Figure 1: GDP and sectoral growth



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

A gradual recovery thereafter saw GDP growth hit a peak of 7.7 per cent in 2006, before plummeting once again to 3.5 per cent in 2009. A growth spurt averaging 6.8 per cent per annum during 2006-08 was largely on the back of an expansionary fiscal policy and accommodative monetary policy stance that saw Sri Lanka record an annual inflation rate of over 16 per cent over the same period. The sustainability of the growth spurt was already in considerable doubt even before the cumulative impact of the global economic crisis brought it to a sharp halt. As Sri Lanka adopted 'corrective measures' to rein in inflation – primarily by way of tightening monetary policy – the onset of the global economic crisis coincided to contract aggregate demand in the economy from the latter part of 2008. The economy posted a strong recovery in 2010 with a GDP growth of 8 per cent, largely on the back of a much improved economic climate in the country following the decisive end to the 30 year conflict in May 2009, helped by an improving global economic environment.

The services sector performance has been the mainstay of GDP growth in recent years. It has come to account for nearly 60 per cent of GDP and 42 per cent of total employment in the country (Table 1). By contrast, while agriculture's share of GDP has shrunk sharply in the last decade, it continues to be a significant source of livelihoods and employment. After an initial burst in the 1980s following the opening up of the Sri Lankan economy,

[16] Sri Lanka was compelled to approach the IMF for a SBA of US$ 253 million in 2001 as BOP support.

industrial sector performance has been largely lacklustre thereafter, although it continues to be an important source of employment.

The government at present appears convinced of the need to concentrate on improving rural infrastructure as a means of reviving economic growth in the rural agrarian sector. Others, while acknowledging the need for improved infrastructure services, also contend that such lagging sectors do poorly only because reform efforts have not gone far enough (World Bank, 2007). The services and industry sectors are argued to have achieved faster growth because they have opened up most to competition. Notwithstanding the above, an overriding concern for Sri Lanka remains the slow generation of employment opportunities for the surplus rural agrarian labour in the services and industrial sectors.

Table 1: Sectoral output and employment

	2000			2010		
	Growth[a]	Share of GDP	Share of Employment[c]	Growth[b]	Share of GDP	Share of Employment[c]
GDP	4.0			6.4		
Agriculture	0.5	19.7	36.0	4.9	11.9	32.5
Industry	3.3	25.7	23.7	7.0	28.7	24.6
Services	5.4	54.6	40.3	6.4	59.3	42.9

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

Notes: a: Annual average for 2000-04; b. Annual average for 2005-10; c: Employment data excludes Northern and Eastern Provinces.

In this context, the rather modest performance of the industrial sector over the last decade is particularly worrying. The critical manufacturing sub-sector holds the potential to generate not only employment, but employment that is likely to provide pro-poor benefits. For instance, skilled and unskilled workers in manufacturing were estimated to account for 51 and 17 per cent, respectively, of income generated from manufacturing activities in 2006.[17] A sizeable proportion of such workers are considered to represent low-income segments of the population.

The manufacturing sub-sector continues to be dominated by the export-oriented apparel industry, reliant on low-skilled female labour. Sri Lanka's inability to attract foreign direct investment (FDI) to higher value manufacturing industries has often been cited as a key reason why the country has failed to move up the technology-intensive ladder to create a more dynamic manufacturing sector. Poor progress in this area has been attributed in some measure to the increase in political risk following the emergence of an armed conflict in the country (Athukorala, 2006). The share of FDI as a percentage of GDP has hovered stubbornly around 1.0-1.5 per cent of GDP (Table 2).

Aside from such considerations, Sri Lanka's overall macroeconomic performance also failed to provide a stable and predictable environment to foster long-term investment. The rate of investment has remained in the range of 25-27 per cent of GDP. With a low rate of domestic savings to draw on and very modest volumes of FDI, the fact that Sri Lanka was able to reach an investment rate of 25-27 per cent was largely thanks to the rising numbers of migrant workers' repatriating earnings back to Sri Lanka. Indeed, not only has remittance inflows supported domestic capital formation in the country, but they have proven to be an important means of bridging Sri Lanka's current account deficit and providing balance of payments (BOP) support. Sri Lanka's macroeconomic outcomes over

[17] See Chandrasiri, S., 2009.

the last decade have been relatively weak. High fiscal deficits – continuing in the range of 7-9 per cent of GDP on average – have seen a build of Sri Lanka's public debt.[18] Such constraints narrow the options for policy manoeuvrability, limiting the ability to respond appropriately to domestic and external shocks in particular. High and volatile rates of inflation have been the most significant manifestation of resultant macroeconomic instability. In turn, Sri Lanka's interest rate and exchange rate regime have failed to provide the necessary stability to underpin long-term investment planning across all sectors of economic activity.

Table 2: Select economic indicators

		2000	2002	2004	2006	2008	2010
GDP growth	%	6.0	4.0	5.4	7.7	6.0	8.0
Investment	% of GDP	28.0	21.2	25.3	28.0	27.6	27.8
Domestic savings	% of GDP	17.4	14.4	16.4	17.0	13.9	18.7
FDI	% of GDP	1.0	1.1	1.0	1.6	1.7	0.9
Remittances	% of GDP	7.0	7.8	7.6	7.6	7.2	8.3
C/A balance	% of GDP	-6.4	-1.4	-3.1	-5.3	-9.5	-2.9
Fiscal balance	% of GDP	-9.5	-8.9	-7.9	-7.0	-7.0	-7.9
Govt. debt	% of GDP	96.9	105.4	102.3	87.8	81.4	81.9
Rate of inflation	%	6.2	9.6	9.0	10.0	22.6	5.9
Interest rate[a]	%	21.5	12.2	10.2	15.2	18.5	9.3
Exchange rate	Rs/$	80.06	96.73	104.61	107.71	113.14	110.95

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

Notes: a: Commercial banks' Average Weighted Prime Lending Rate (AWPR).

This not only undermines the country's growth potential, but has other clear adverse implications for supporting employment growth, decent standards of living and poverty alleviation efforts. Employers are more likely to look for contractual workers in an uncertain business environment. Moreover, high and volatile rates of inflation often mean that real wages of workers fail to keep up with cost of living pressures. And most critically, it is the poor that are disproportionately affected by high inflation.

Table 3: Poverty headcount index by sector[a]

	2002	2006/07			2009/10[b]
			Male	Female	
Sri Lanka	22.7	15.2	15.3	15.1	7.6
Urban	7.9	6.7	6.0	9.3	6.5
Rural	24.7	15.7	15.8	15.2	7.6
Estate	30.3	32.0	31.8	33.2	9.2

Source: Department of Census and Statistics, *Household and Income Expenditure Survey*, various years.

Notes: a: Excludes the Northern and Eastern Provinces; b: Preliminary estimates for 3 months data only.

[18] To a degree, a proximate cause of macroeconomic instability/volatility was a result of the conflict; terrorist attacks on economic targets such as the international airport causes severe disruptions to economic activity while any intensification of the conflict imposes additional fiscal burdens on the Treasury by way of higher than anticipated defence expenditures.

Despite the less than satisfactory macroeconomic environment, an annual average GDP growth in the range of 5 per cent has seen Sri Lanka experiencing a consistent reduction in overall poverty in recent years.[19] The national poverty headcount (excluding the Northern and Eastern Provinces) dropped from 22.7 per cent in 2002 to 15.2 per cent in 2006/07 – i.e., an estimated 2.8 million poor people (Table 3). The prevalence of poverty in the urban sector declined more sharply, suggesting rising equity gaps vis-à-vis the rural and estate sectors. The latest Household and Income Expenditure Survey (HIES) data collected by the Department of Census and Statistics (DCS) suggests that poverty has declined even further by 2009/10. Whilst initial estimates for only 3 months of data are available, the most significant drop in poverty has been that in the disadvantaged estate sector. Better information gathering techniques employed by the DCS is partly understood to account for the change. Available data (2006/07) on poverty characteristics of the head of the household show that poverty in female-headed households is not significantly different from male-headed households.

Table 4: Demographic and labour force trends[a]

	2000	2002	2004	2006	2008	2010
Population ('000 persons)	19,102	19,007	19,462	19,886	20,217	20,653
Labour force ('000 persons)	6,827	7,145	8,061	7,599	7,569	7,610
LFPR (%)	50.3	50.3	48.6	51.2	50.2	48.6
Male	67.2	67.9	66.7	68.1	67.9	67.3
Female	33.9	33.6	31.5	35.7	34.3	32.1
Unemployment rate (%)	7.6	8.8	8.3	6.5	5.2	4.9
By gender						
Male	5.8	6.6	6.0	4.7	3.6	3.5
Female	11.1	12.9	12.8	9.7	8.0	7.5
By age group						
15-19	23.4	30.1	28.3	23.1	20.6	21.1
20-29	17.4	20.1	19.2	15.9	13.2	13.7
By education level						
GCE (O/L)	11.3	13.3	12.3	9.9	7.4	6.9
GCE (A/L)	14.9	16.8	16.8	11.6	9.9	11.3
Underemployment rate (%)	n.a.	n.a.	n.a.	5.3	4.0	3.8
Male	n.a.	n.a.	n.a.	4.8	3.4	3.3
Female	n.a.	n.a.	n.a.	6.3	5.2	4.9

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

Notes: a: Date excludes Northern and Eastern Provinces with exception of 2004 (2004 excludes Mulathivu and Kilinochchi districts only); b:LFPR=Labour Force Participation Rate; n.a=data is not available.

Obviously, Sri Lanka's economic performance has been accompanied by some changes to the country's labour force and employment outcomes (Table 4). In terms of trends in unemployment rate, the Sri Lankan labour market seems to have done well over the years. According to the labour force survey (LFS) data by the Department of Census and Statistics, the overall unemployment rate for Sri Lanka has come down from 8.8 per cent in 2002 to 4.9 per cent in 2010.[20] This decrease is reflected across males and females.

[19] The official poverty line of 2002 is defined at the per-capita expenditure for a person to be able to meet the nutritional anchor of 2030 kilocalories in 2002.

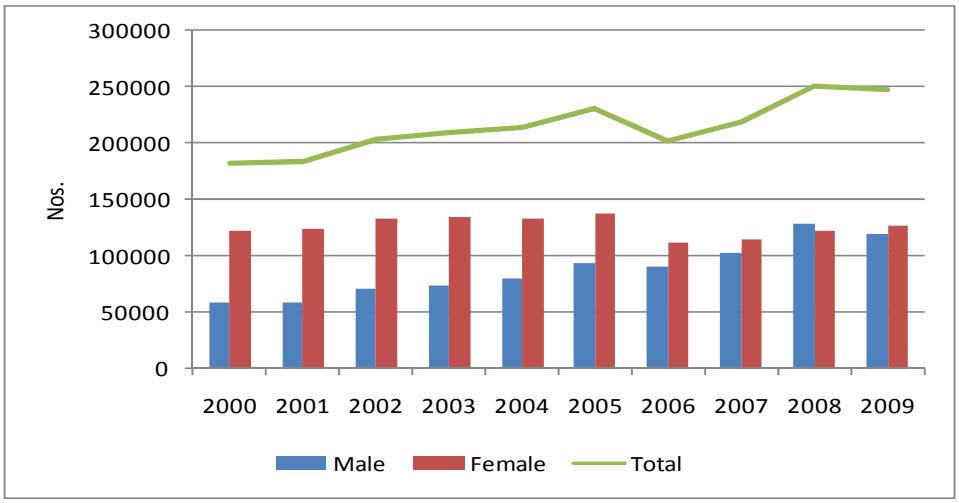
[20] As the definition of unemployment has changed somewhat since 2006, unemployment rates are strictly not comparable over time. Since 2006, the definition has become more stringent, implying

It is also encouraging that the decline is sharper for youth in the 20-24 age group, and for females with more than an Advance-level education – two groups that have had historically high unemployment rates. The unemployment rate edged up in 2009 in response to loss of employment in some sectors following the economic downturn, but recovered in 2010.

The unemployment rate alone does not provide a full picture of the labour market conditions of an economy. This is because the unemployment rate might hide the fact that workers are underemployed or doing unproductive work. Hence, usually along with unemployment rates, other indicators are examined to assess labour market performance. The employment-to-population ratio for Sri Lanka has remained around 45 from 2003 onwards, indicating that the ability of the economy to create jobs has stagnated over the years. The proportion of workers participating in the labour market – the labour force participation rate – also had remained just below 50 per cent over the same period. According to the LFS data, around 60 per cent of the employed were working in the informal sector. These included 83 per cent of those in the agricultural sector, and around half (49 per cent) of those in the non-agriculture sector.

Sri Lanka's regulatory environment governing the labour market is also argued to contribute to the generation of informal job growth (World Bank, 2006). For example, the Termination of Employment of Workmen (Special Provision) Act of 1971 (TEWA) specifies strict procedures for employers in firms with more than 15 workers to follow before terminating workers. This encourages employers to keep full-time employees to below 15 to circumvent such legislation.[21] This has also resulted in increasing the share of temporary workers in manufacturing firms. The World Bank's *Investment Climate Survey* (2005) finds that the median number of temporary workers in urban manufacturing firms is 15, when the corresponding median number of permanent workers is 90.

Figure 2: Departures for foreign employment by sex



Source: Sri Lanka Bureau of Foreign Employment, *Annual Statistical Report of Foreign Employment 2009*.

that the unemployment rate post-2006 would be slightly higher than the reported value on the basis of the earlier definition.

[21] Under the revised compensation formula of TEWA introduced in 2005, a worker with 20 years of experience receives the equivalent of 39 months of salary, while the corresponding compensation received by workers in other Asian countries is estimated at 16.3 months of salary (World Bank, 2006). During 2000 to 2003 period, employers forwarded 71 to 105 applications on termination on average. This number is considered to be modest. Some employers prefer to settle terminations through voluntary retirement schemes with the agreement of the employees.

Part of the improvement in the unemployment rate in Sri Lanka can be attributed to foreign employment, others being demographic changes and higher participation in education.[22] The departures for foreign employment have been increasing over the last decade (Figure 2). More than 200,000 persons are estimated to depart for temporary employment abroad each year. According to the Sri Lanka Bureau of Foreign Employment (SLBFE), the stock of overseas contract workers at present is around 1.7 million, which is equivalent to 20 per cent of the workforce in domestic employment.[23] However, the effect of migration on labour force participation is less pronounced. Labour force participation rates have remained stagnant, despite large numbers of workers emigrating for work. This is partly due to the fact that many of the low skilled female workers who migrate for work are housewives and is not captured in the labour statistics as economically active.

While there have been some marginal changes to the profile of out-migrants in more recent years – with more opportunities for skilled migrants emerging in labour constrained economies of the EU and the US, unskilled migrants still account for nearly 70 per cent of the total, and female migrants continue to make up about 65 per cent of the total stock of migrants from Sri Lanka (Table 5). The latter provide their services as 'housemaids' in the Middle East. Lack of adequate livelihood and employment opportunities at home has been the prime driver for most such out-migration. While remittances of migrant workers have proven to be a dependable and rising source of foreign exchange for the country, it has associated social costs as well as potential problems of 'brain drain' with the rising migration of skilled categories of workers.

Table 5: Migrant profile (2009)

	Men	Women
Total	119,276	127,843
By Age		
29 & below	50,341	40,427
30-39	40,586	44,402
40 & above	28,349	43,014
By skill		
Professional level	2,687	133
Middle level	5,407	985
Clerical & related	5,869	837
Skilled	55,846	5,384
Semi skilled	5,676	360
Unskilled	43,791	6,367
Housemaid	-	113,777

Source: Sri Lanka Bureau of Foreign Employment, Annual Statistical Report of Foreign Employment 2009.

Available labour force data from the Labour Force Survey carried out by the DCS, suggests that the employed population grew at an average annual rate of 1.5 per cent from 2000 to 2009 (Table 6). During this period, the workers in informal types of employment

[22] Arunatilake, N., and P. Jayawardena, 2010b.

[23] These figures are not adjusted for arrival of temporary workers after completing their work contracts.

grew at 1 per cent per annum, on average.[24] This overall growth is largely due to growth in informal types of employment in the first six years (2000-06) of the period. These statistics confirm the arguments made earlier that macroeconomic volatility is likely to encourage informal/contractual employment arrangements. In the last three years, there was a decline in this type of employment. This is possibly due to the large recruitments to the public sector during the latter period. The government absorbed more than 40,000 unemployed graduates into the public sector on the basis of a pre-election pledge, while recruitment to Sri Lanka's armed forces rose sharply in the wake of heightened military activity during 2006-09.

Table 6: Historical table of currently employed persons by employment status

	Employed Population (No.)	Employee			Employer	Own Account Worker	Unpaid Family Worker
		Total (Public+ Private)	Public	Private			
2000[a]	6,310,145	56.3	13.4	42.9	2.3	28.4	13.0
2001[a]	6,235,588	58.6	13.9	44.7	2.3	28.5	10.6
2002[a]	6,519,415	57.9	13.4	44.5	2.8	28.6	10.7
2004[b]	7,394,029	59.4	13.0	46.4	2.9	28.3	9.4
2006[a]	7,105,322	55.6	13.4	42.1	3.1	30.8	10.5
2007[a]	7,041,874	56.5	13.8	42.7	2.8	30.4	10.3
2008[a]	7,174,706	56.0	14.9	41.1	3.0	30.2	10.8
2009[a]	7,139,537	57.3	15.2	42.1	2.7	29.0	11.0
2009Q3[a]	7,641,730	58.2	15.7	42.5	2.9	28.1	10.7
2010Q3[a]	7,174,706	55.2	14.1	41.2	3.2	31.8	9.8

Source: Department of Census and Statistics, Quarterly Report of the Sri Lanka Labour Force Survey, various years.
Notes: a: Excluding Northern and Eastern Provinces, b: Excluding Mulathivu and Kilinochchi districts.

Employment is an important aspect of decent work. However, employment alone is often not sufficient to improve wellbeing. To be decent, those jobs should provide a "fair income, security in the workplace and social protection for families, better prospects for personal development and social integration, freedom for people to express their concerns, organize and participate in the decisions that affect their lives and equality of opportunity and treatment for all women and men"[25]. Given the scope of the present study, all aspects of decent work cannot be examined. But the following paragraphs examine the influence of growth on two aspects of decent work, namely, social protection and fair income.

Majority of social security schemes in Sri Lanka are employment based. Informal sector workers are less likely to be covered by social safety nets. For instance, in the case of retirement benefit schemes, Sri Lanka currently has two main schemes – the public Service

[24] The formal, informal break down of workers shows that more than 90 per cent of own account workers and all unpaid family workers are in the informal sector. Exact time trends in formal/ informal employment cannot be estimated, as these two types of employment cannot be distinguished for surveys prior to 2006. The reported trends are for own account workers and unpaid family workers.

[25] http://www.ilo.org/global/about-the-ilo/decent-work-agenda/lang--en/index.htm, [accessed November 1, 2011].

Pension Scheme (PSPS) provided to former permanent public servants at retirement and the Employees' Provident Fund (EPF) available for formal private sector workers.[26] The latter covers 63 per cent of the formal private sector workers. In addition, there are retirement schemes for farmers (28 per cent coverage), fishermen (78 per cent coverage), self-employed persons (7.7 per cent coverage), and a variety of other workers in the informal sector. Together, all the programmes cover only a little more than a quarter of the working age population in the country.[27]

Sri Lanka does not have an unemployment insurance scheme. However, Sri Lankan formal sector workers have extensive job protection. It is extremely that public sector workers are laid off. Under the Termination of Employment of Workman Act (TEWA) of 1971, even formal private sector workers have a high level of job protection. TEWA stipulates employers with more than 14 workers to seek authorization of the Commission of Labour for intended layoffs. In the case of a layoff, workers are provided with compensation. The above mentioned laws that protect formal sector workers from unemployment and related income losses are not relevant for informal sector workers. As highlighted earlier, most informal sector workers either work for themselves or do not have permanent employers. There are instances in the past where the government has provided work-for-pay programmes during times of covariate shocks, such that these types of workers are able to earn an income during periods of reduced economic activity. However, these are largely ad hoc programmes, introduced following a disaster.

Turning next to earnings, available information on wages indicated that nominal wages grew during 2000-09 (Table 7). Real wages declined for workers in the formal private sector workers,[28] as well as for those in informal types of private employment from 2000 to 2007. However, this trend has reversed in the last couple of years, during which time most categories of private sector workers saw an increase in real wages. In comparison, public sector wages increased in real terms over the entire period. Again, these statistics confirm that the real wages of those in private sector employment eroded for the most part during the 2000-09 decade.

Working poverty levels are also indicative of the adequacy of remuneration received by workers. According to the calculations by the DCS using Household Income and Expenditure Survey HIES (2006/07), around 14 per cent of the workers in Sri Lanka are poor. Working poverty rates are highest in the agriculture sector where 21 per cent of the workers are poor and lowest in the services sector where only 9 per cent of the workers are poor. In the industry sector 14 per cent of the workers are poor. The working poverty rates calculated using HIES 2009/10 indicates that along with general levels of poverty in the country, the proportion of workers who are working but poor have declined to 8 per cent.

[26] In addition, some formal private sector workers are covered by approved private provident funds and other private pension funds.

[27] See World Bank, 2006.

[28] The information for formal private sector workers are available only for those workers whose wages are governed by the Wages Boards.

Table 7: Trends in wages

	Government Employees[a]		Workers in Wages Boards Trades[a]				Informal Sector Workers (Selected)[b]	
	Central govt.	Teachers	All	Agriculture	Industry & commerce	Services	Male helper -masonary	Male paddy worker
				Nominal *(% change)*				
2000	8.3	7.4	2.3	2.4	3.4	0.0	n.a.	n.a.
2001	20.8	18.7	4.9	2.9	7.3	17.5	n.a.	n.a.
2002	16.4	15.0	7.4	7.9	7.3	3.1	n.a.	n.a.
2003	0.0	0.0	7.0	8.9	2.3	0.0	7.5	n.a.
2004	22.8	21	2.3	1.1	3.4	10.8	9.5	13.6
2005	29.1	27.3	7.8	9.3	3.3	3.8	1.8	2.4
2006	30.3	26.7	2.1	2.6	1.1	0.0	11.8	9.8
2007	21.5	18.9	21.4	16.2	39.6	35.6	14.7	16.7
2008	7.5	7.2	25.6	25.5	23.3	29.7	18.4	23.2
2009[c]	9.4	9.4	4.9	2.7	9.4	12.8	11.7	9.4
				Real (*% change*)				
2000	1.9	1.0	-3.6	-3.6	-2.7	-5.7	n.a.	n.a.
2001	5.9	4.1	-8.2	-9.8	-6.1	2.8	n.a.	n.a.
2002	6.4	5.1	-2.0	-1.5	-2.0	-5.9	n.a.	n.a.
2003	-6.0	-6.0	0.7	2.5	-3.8	-6.0	1.2	2.5
2004	14.0	12.4	-4.8	-5.9	-3.7	2.9	1.9	6.0
2005	15.8	14.1	-3.5	-2.3	-7.6	-7.0	-9.8	-9.2
2006	18.5	15.2	-7.1	-6.7	-8.0	-9.0	-1.9	-3.9
2007	21.5	18.9	4.1	-0.3	19.6	16	-1.1	0.9
2008	7.5	7.2	2.6	2.6	0.9	5.9	0.5	-4.0
2009[c]	9.4	9.4	1.6	-0.6	5.8	9.4	5.8	3.5
				Real Wage Index				
2000	102.1	81.5	94.3	107.7	80.8	52.8	n.a.	n.a.
2001	108.1	84.7	86.6	97.1	75.9	54.3	n.a.	n.a.
2002	115.0	89.0	84.9	95.6	74.4	51.1	n.a.	n.a.
2003	108.1	83.7	85.4	98.0	71.6	48.1	n.a.	n.a.
2004	123.3	94.1	81.3	92.2	68.9	49.5	n.a.	n.a.
2005	142.7	107.4	78.5	90.2	63.7	46.0	n.a.	n.a.
2006	163.5	119.6	70.5	81.3	56.6	40.5	n.a.	n.a.
2007	171.6	122.8	73.6	81.3	67.9	47.1	n.a.	n.a.
2008	150.4	107.4	75.5	83.5	68.5	49.9	n.a.	n.a.
2009[c]	159.0	113.5	76.7	83.0	72.5	54.6	n.a.	n.a.

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

Notes: a: Based on wage rate indices; b: Informal private sector daily wages; c: Provisional; n.a.= not available. The index numbers are calculated on fixed weights based on the numbers employed as at 31 December 1978. The wage rates used in the calculation of index numbers are minimum wages for different trades fixed by the Wages Boards.

The following sections will attempt to examine the alignment between macroeconomic management in key areas – fiscal policy, monetary policy, exchange rate policy and capital account management – to meet the broader economic goals of growth, structural change, employment and poverty reduction.

3. Fiscal policy: Impact on employment and poverty

As previously noted, Sri Lanka's fiscal performance over the last decade has been a continuing source of concern. Structural rigidities underpinning fiscal management has allowed little leeway to gear fiscal policy towards growth enhancing objectives. The weaknesses are evident on both the expenditure and revenue fronts (Table 8).

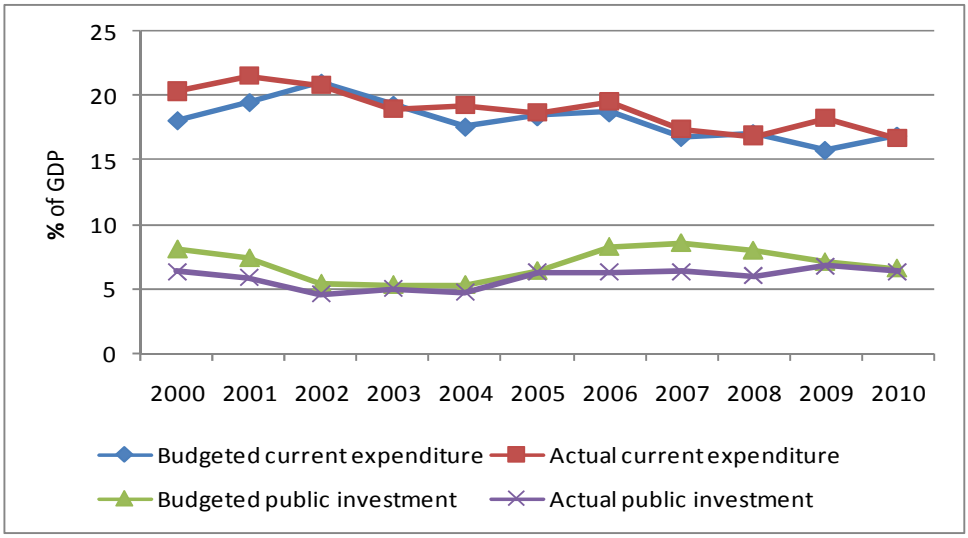
Table 8: Government revenue and expenditure

% of GDP	2000	2002	2004	2006	2008	2010
Total revenue	16.8	16.5	15.4	16.3	15.6	14.9
Tax revenue	14.5	14.0	13.9	14.6	13.3	13.0
Total Expenditure	26.7	25.4	23.5	24.3	22.6	22.9
Recurrent	20.2	20.9	19.2	18.6	16.9	16.7
Public investment	6.5	4.6	4.8	6.0	6.0	6.4

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

A key area of weakness has been the consistent decline in revenue generation. The decision in 1998 to move to a value added system in the form of a Goods and Services Tax (GST) at a less than neutral rate *vis-à-vis* the previous turnover tax – coupled with exemptions – saw tax revenue begin to decline. Despite efforts to compensate for the revenue loss through the introduction of additional taxes, Sri Lanka has seen its tax revenue decline to 13 per cent of GDP in 2010 from a ratio of over 20 per cent in the 1990s.

Figure 3: Budgeted and realized expenditure

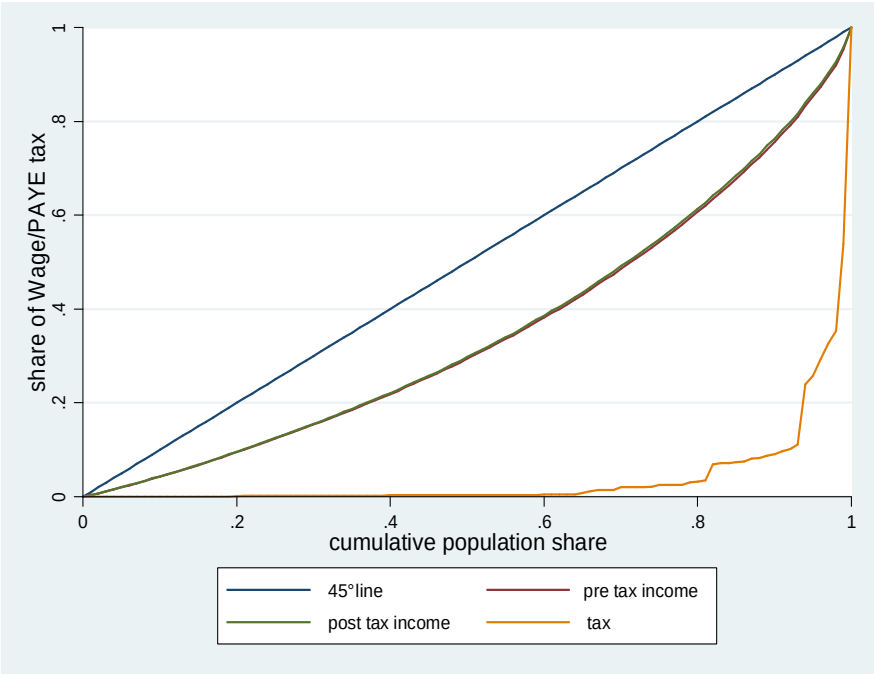


Source: Central Bank of Sri Lanka, *Annual Report*, various issues.

The government proposed a new tax structure in the budget for 2011. The key changes proposed include taxing previously tax-exempted public servants and increasing the tax threshold. A study conducted to examine the progressivity of the proposed changes shows that both the existing and the proposed tax structures are progressive, and that there is very little change in progressivity as only a small segment of those in the very high income

range are taxed under both structures (Figure 4).[29] The proposed tax structure reduces the number of individuals being taxed and reduces tax revenue from taxing incomes, but improves equity across population groups by taxing public servants.

Figure 4: Distribution of taxes under the current tax structure



Source: Arunatilake, N., P. Jayawardena, A. Wijesinghe, N. Perera, 2011, "Tax Reforms in Sri Lanka, Will a Tax on Public Servants Improve Progressivity", Institute of Policy Studies, mimeo.

On the expenditure front, overruns on recurrent expenditure has been a continuous problem with the government curtailing budgeted capital expenditures as a result, to bridge overshooting of fiscal deficit targets (see Figure 3). This has obvious adverse consequences on long-term growth prospects with much needed improvements to infrastructure development being delayed.

There are significant structural rigidities in current spending. Salaries and wages of public sector employees, interest payments on public debt, and transfers and subsidies to households and government entities account for nearly the entirety of government revenue collection (Table 9). Consecutive governments have found it politically difficult to implement reforms with the objective of rationalizing expenditures in these areas and redirecting such funds towards supporting capital investment.

Table 9: Recurrent expenditure

% of GDP	2000	2002	2004	2006	2008	2010
1. Salaries & wages	5.5	5.6	5.2	6.0	5.4	5.4
2. Interest payments	5.7	7.4	5.9	5.1	4.8	6.3
3. Transfers & subsidies	4.2	4.7	5.2	4.9	3.9	3.5
(1)+(2)+(3) as % of total revenue	90.9	106.8	106.4	98.4	95.0	103.6

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

[29] Arunatilake, et. al, 2011.

The most contentious area has been that of public sector wages and salaries. With slow growth of employment opportunities in the formal private sector, state employment is often viewed as the most promising, ensuring not only guaranteed employment, but also attractive pension prospects thereafter. Governments are also sensitive to the voter constituency of nearly 1.2 million public sector employees, where pre-election pledges of job creation in the state sector and enhanced wages have become a key battleground to win votes.

Another area requiring policy reform in the context of fiscal consolidation is addressing issues related to state-owned enterprises (SOEs). Sri Lanka's nascent privatization programme stagnated from the late 1990s. Since 2005, there has been a clear policy reversal with further privatization efforts ruled out in favour of 'restructuring' SOEs. However, as SOEs continue to makes losses – particularly those such as the Ceylon Petroleum Corporation (CPC) and the Ceylon Electricity Board (CEB) – they impose a heavy burden on an already stretched Treasury.[30]

In 2003, Sri Lanka passed a Fiscal Management Responsibility Act (FMRA), which provides the legal framework necessary to meet internationally accepted transparency practices. However, the implementation and enforcement of FMRA provisions have been incomplete. The FMRA, however, has been responsible for some improvements in budgetary information, including the publication of an Annual Report by the Ministry of Finance and Planning, a medium-term fiscal framework to be presented with the annual Budget, a Mid-Year Review of Fiscal Performance to be tabled in Parliament, etc.

The government spends a considerable sum of money on employment facilitation, training and assisting job search. For example, the Samurdhi Authority, the administrative body in charge of the government's main poverty alleviation programme, spent close to Rs. 687 million in assisting the self-employed and small businesses in various sectors. In addition, the public technical and vocational training institutions are estimated to have enrolled more than 60,000 (in 2004). Of these, close to 40,000 have completed their training. Given lack of a clear monitoring and evaluation system, there is little knowledge on the effectiveness of these training programmes. Available evidence suggests that the effectiveness of these programmes in improving employability is low, due to a variety of factors including, outdated syllabuses, lack of facilities, poor quality trainers, lack of linkages with industry and lack of practical training.[31]

According to the Central Bank of Sri Lanka (2009), the Government spent Rs. 9,298 million on 1.6 million families under its Samurdhi subsidy programme in 2009. In parallel, 173,000 families were given dry rations (at a cost of Rs. 2,859 million) and 72,000 families benefitted from the Samurdhi Nutrition Programme (at a cost of Rs. 518 million). The Sri Lanka Samurdhi Authority also spends money on community development and in providing employment assistance. Samurdhi is a means tested programme, where beneficiaries are identified by local officials. The programme has long been criticized for poor targeting. Although only 15.2 per cent of the country was poor in 2006/07, 32 per cent were Samurdhi recipients. Measures introduced to improve targeting have reduced the number of beneficiaries over time, but the proportion of beneficiaries is far above the

[30] Information on the GDP share of SOEs is not available. Available information suggests they account for 80 per cent of petroleum products importation and distribution, 30 per cent of bus transportation services, and over 50 per cent of banking services (Central Bank of Sri Lanka, *Annual Report 2006*).

[31] Chandrasiri, 2006.

proportion of poor in the country. The programme also needs to increase benefit levels, adjust these levels with inflation, and link benefits to human development such as school participation of children and the utilization of health care.[32]

3.1 Recent fiscal policy developments

Sri Lanka's change of government in 2005 heralded a nuanced shift in economic policy objectives that intruded into the scope of fiscal policy management. As the government entered into an intensified military effort in the Eastern and Northern Provinces of the country from 2006 – that imposed additional burdens on expenditures – it was also committed to ensure that broad based economic development was not neglected. The most notable was a renewed emphasis on infrastructure development, aimed at revitalizing the rural economy and bridging inequities across sectors and provinces of the country.

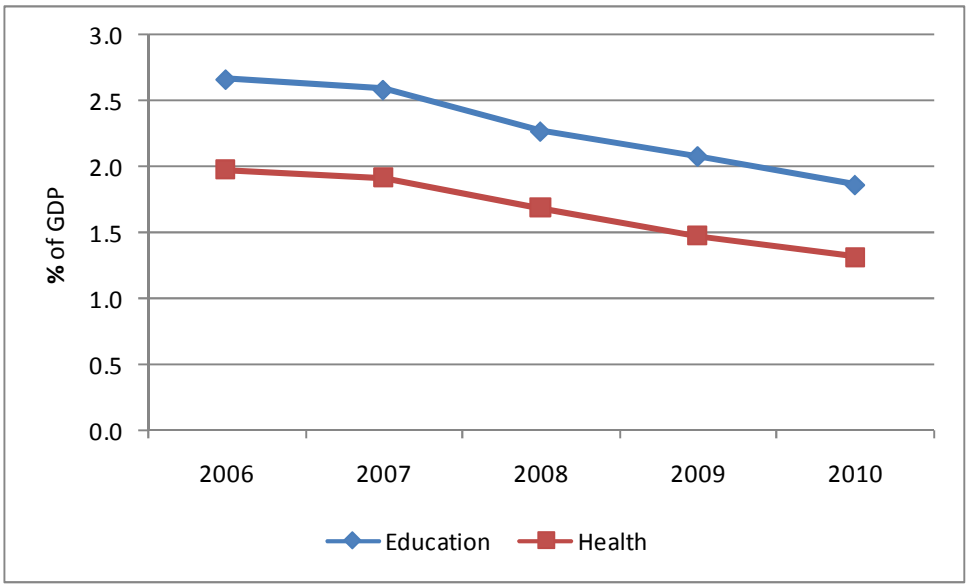
In essence, Sri Lanka embarked on a state-led infrastructure development programme. This was not entirely unexpected. There was a high degree of risk related to the outcome of the government's military efforts, which in turn created an uncertain economic climate for the private sector. In addition, the government was perceived as less business-friendly relative to previous governments with its emphasis on building a strong 'national' economy and policy pronouncements against privatization, etc. The government also signalled its intentions to absorb more than 40,000 unemployed graduates to an already bloated public sector.

Thus, the government took the initiative to raise public investment, which had already gone up considerably in 2005, as a result of the reconstruction related expenditures following the December 2004 tsunami disaster that hit Sri Lanka. Thus, public investment that stood at 4.8 per cent of GDP rose consistently to 6.0-6.5 per cent of GDP in the subsequent years (see Table 8). The intention was to ensure that economic growth remained buoyant and voter sentiments remained with the government even as the military effort gathered momentum.

On the face of it, the government appeared to have brought its current spending under some degree of control to allow such a reallocation of resources to capital spending (see Table 8). However, as evident from Figure 5, total expenditures as a percentage of GDP in key social sectors of education and health underwent cuts in annual budget allocations to accommodate fiscal adjustments.

[32] World Bank, 2006.

Figure 5: Total expenditure on health and education



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

Notes: Includes both current and capital expenditures.

Available evidence suggests that although education and health services are provided free of user fees, households on average spend 6.2 per cent of their monthly expenditure on health and education. Further, these incidences of out-of-pocket expenditure on health and education is regressive, indicating that this could contribute to widening the existing inequalities in quality and access to these services.[33] As shown in Table 10, the share of out-of-pocket expenditure by the poor on health and education is more than their share in income. For example, the poorest 10 per cent in the population earn 1.7 per cent of the national income, but spend 3.5 per cent of total out-of-pocket expenditure on education. To reverse these trends, more investments are needed to improve facilities to poorer more vulnerable segments of the population.

[33] Arunatilake et al., 2010b.

Table 10: Distributional Incidence of out-of-pocket payments on health and education (2006)

Income Decile	Equivalent Household Expenditure	Total Out-of-Pocket Expenditure on Education	Total Out-of-Pocket Expenditure on Health
poorest 10%	1.7	3.5	3.8
2	4.7	8.7	8.9
3	8.7	14.2	15.3
4	13.6	20.9	23.2
5	19.5	29.4	30.6
6	26.7	40.0	41.0
7	35.4	49.1	50.8
8	46.3	61.0	63.4
9	60.0	75.7	78.0
richest 10%	100.0	100.0	100.0
Test of dominance			
Against 45 line	-	-	-
Against Lorenz curve		+	+
Gini/CI	0.501	0.34	0.290
Robust SE	*0.016*	*0.014*	*0.021*
Kakwani (G-C)	1.7	0.161	0.211

Source: Arunatilake et al., 2010b.

Note: Dominance tests: A '-' indicates that the 45-degree line (Lorenz curve) dominates the concentration curve (pro-rich) while a '+' indicates that the concentration curve dominates the 45-degree line (Lorenz curve) (pro-poor). A '0' indicates no dominance. Results are weighted to correct for sample selection.

Enforcing indiscriminate spending cuts purely as a means of achieving a conditional deficit target can be counter-productive. Such measures obviously have far reaching consequences in meeting broader objectives of long-term socio-economic development and poverty alleviation. When countries run into economic problems as result, as Sri Lanka did when it approached the IMF for SBA package in 2009, fiscal space is further constrained by IMF-led conditionality targets.

Weak public finances constrain the ability of governments to respond with appropriate policy flexibility to shocks. Sri Lanka's fiscal policy outcomes raised the country's vulnerability to macroeconomic instability on various fronts when the country was exposed to both domestic and external shocks. The external shock came via the sustained rise in international oil prices from mid-2004, which was to continue until mid-2008. The domestic shock emerged from an escalating military conflict with an uncertain final outcome that dampened investor confidence. Defence expenditures during this period increased sharply from 2.6 per cent of GDP in 2005 to 4.6 per cent of GDP in 2008.[34]

[34] See Central Bank of Sri Lanka, *Annual Report*, various issues.

Table 11: Foreign debt dynamics

		2006	2007	2008	2009	2010
Foreign debt	% of GDP	37.5	37.1	32.8	36.5	36.1
Concessional	% share	92.7	82.9	84.7	72.2	62.6
Non-concessional	% share	2.8	3.4	3.9	4.5	7.3
Commercial	% share	4.4	13.7	11.3	23.3	30.2
Debt service ratio[a]	%	12.7	13.1	15.1	19.0	15.2
Debt service ratio[b]	%	9.8	10.0	11.7	13.7	10.7

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

Notes: a: As a percentage of earnings from exports of goods and services; b: As a percentage of earnings from exports of goods, services, income and private transfers.

Even as the fiscal deficit was contained and held steady at 7 per cent of GDP per annum during 2006-08, risks to macroeconomic instability arose from the means employed to finance the deficit. Where Sri Lanka has historically relied on long-term concessionary loans in its foreign financing component, the government began increasingly to turn to short-term foreign commercial borrowing to bridge its financing needs.[35] This was partly on account of its need for quick disbursement of funds, and partly a means of avoiding conditionality-driven lending by international financial institutions (IFIs).

The result was that the share of costlier non-concessional and commercial foreign borrowing increased markedly over time from 7.2 per cent of total foreign debt in 2006 to 37.5 per cent by 2010 (Table 11). Sri Lanka's foreign debt service ratio also rose accordingly from 12.7 per cent in 2006 to a high of 19 per cent in 2009 in the wake of the downturn in export earnings that year. The additional exchange rate risks associated with foreign debt, particularly those of a short-term tenure, are well known. Sri Lanka's risk exposure was further heightened with the decision taken from 2006 to allow foreign investors to take up to 10 per cent of issued government debt securities. Indeed, in 2009, nearly two-thirds of the foreign financing component of the budget (totalling 4.8 per cent of GDP) was from Treasury bills and bonds.[36] Clearly, volatility of such short-term capital flows can only add to risks for macroeconomic stability, particularly in the face of unanticipated shocks to the economy.

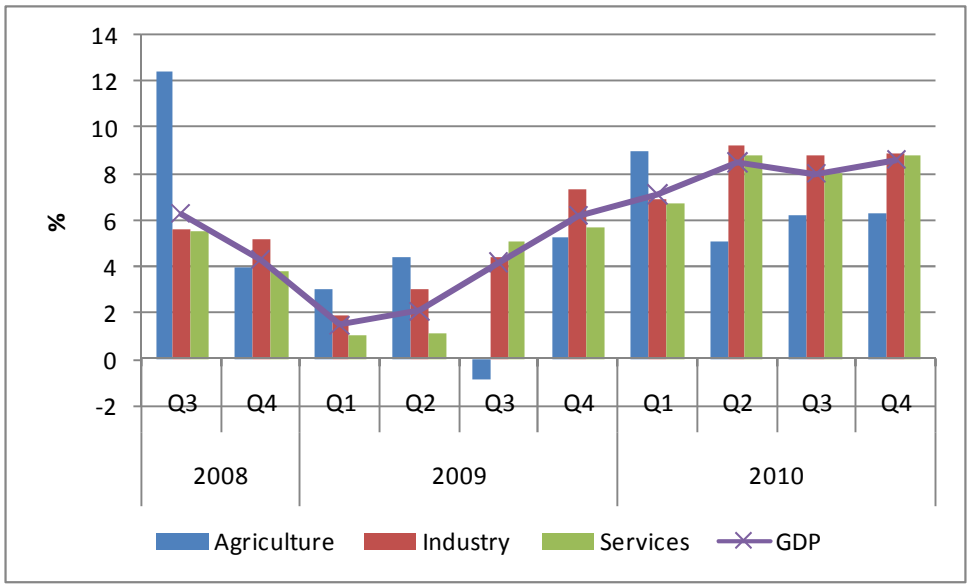
3.2 The global economic crisis and Sri Lanka's fiscal policy response

Sri Lanka was to feel the initial impact of the global financial crisis from the third quarter of 2008. The initial manifestation was in the form of an outflow of short-term foreign capital. However, as the crisis spread, the real sectors of the economy began to feel the impact from the fourth quarter of 2008 (Figure 6).

[35] Sri Lanka went it for its first ever sovereign rating in December 2005 and obtained a BB- and a BB+ from Fitch Ratings and Standard and Poor's, respectively.

[36] See Institute of Policy Studies, 2010.

Figure 6: Quarterly GDP growth



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

The channels of exposure were primarily through the export sector as Sri Lanka's primary export markets, the US and the EU, began to experience a rapid contraction in demand for goods and services. Critical export industries such as tea and garments, which absorbs a bulk of the most vulnerable sections of the population, were the most severely affected. While precise estimates of resultant job losses are not available, for instance, owing to the greater share of employment in the informal sector, available data indicate that there were quarter-on-quarter (qoq) job losses starting from the second quarter of 2009. The sectors that were most affected were manufacturing, wholesale and retail trade, repair of motor vehicles and other goods, financial intermediation and real estate, renting and business activities (ILO, 2009).

In January 2009, the government announced a Rs. 16 billion economic stimulus package to help exporters adversely affected by the global economic downturn.[37] This amounted to only 0.5 per cent of GDP, highlighting the limited fiscal space that the government had to provide for an adequate stimulus package or relief to affected households. Transfers and subsidies to households were held steady as a percentage of GDP through the crisis[38] – despite evidence of job losses and reduced wages in some critical sectors that support employment of the more vulnerable segments, particularly low and unskilled female labour.

Many of these interventions through the stimulus package were to safeguard production rather than to directly safeguard employment and incomes. The limited incentives given to companies to maintain work forces were not sufficient. Many firms in the manufacturing sector were not hopeful of benefiting from the government's stimulus package, as the package was available only to those who could maintain revenue and

[37] Under this system, incentives for producers in terms of a rebate scheme as well as energy price reductions were offered.

[38] See Table 9.

employment levels. In the face of declining demand, many were unable to afford the costs of present levels of production.[39]

There is firm level evidence that confirms that the hotel and manufacturing sectors were affected by the global crisis. In 2008/09, it was estimated that 40,000 garment sector workers were estimated to have been laid off with the closure of several garment factories.[40] Sri Lanka also saw a drop in tourist arrivals by 11.2 per cent due to the security situation in the country as well as due to low demand resulting from the global financial crisis. According to the country's Board of Investment (BOI), 11 firms in the Export Processing Zones (EPZs) have closed down during September 2008-March 2009, while 3,198 workers lost their jobs. In comparison, only one firm closed between September 2007 and March 2008.[41] According to information from District Labour Offices of the Department of Labour, a majority of the closures were due to lack or reduction of orders and low demand.[42]

Already grappling with a fiscal deficit of 7.7 per cent of GDP in 2008, it could be argued that Sri Lanka was not required to provide any additional fiscal stimulus to mitigate any deflationary trends in the economy. Indeed, with the ending of conflict in May 2009, attention shifted swiftly to meeting rehabilitation and resettlement needs of over 300,000 internally displaced persons (IDPs) in the Northern and Eastern Provinces of the country. Substantial additional expenditures incurred – alongside a sharp drop in revenue generation as economic activity contracted –saw the realized deficit balloon to 9.8 per cent of GDP by end 2009. Thus, Sri Lanka's domestic compulsions overrode the need to subscribe to standard policy prescriptions followed in most other countries in regard to the provision of a fiscal stimulus package to deal with the downturn in the global economy.

3.3 Current and projected stance of fiscal policy

As Sri Lanka looks to a sustained period of high growth in the post-conflict era, fiscal policy will need to balance the dual objectives of sustaining peace and laying the foundation for long term economic development. The previously conflict-affected regions require rapid restoration of physical and social capital. All told, expectations of economic benefits have risen in a conflict-weary population across the country.

Progress on regaining macroeconomic stability can clash with the aim of achieving durable peace that rests partially on access to equal economic opportunities and decent standards of living. However, as both the global and domestic economic recovery takes effect, fiscal consolidation efforts are necessary if growth is to take place within a stable macroeconomic environment. In this context, a key issue for fiscal authorities will be to determine what is an acceptable moderate budget deficit, in effect, to balance the trade-off between fiscal stringency and potential social tensions that can be generated by inadequate public expenditures. Sri Lanka signed on to conventional macroeconomic conditionalities under the SBA with the IMF in July 2009.

[39] http://www.lankabusinessonline.com/fullstory.php?nid=1277882506. Downloaded on 29th April, 2009.

[40] *The Sunday Times*, 'Global Crisis Rips Garment Industry', 1st March, 2009.

[41] Gunatilake, R. 2009.

[42] Information from District Labour Offices relate to BOI as well as non-BOI firms. *Ibid.*

Sri Lanka's application for IMF funding was dogged by controversy. The application was first made in February 2009 as the country's external reserves plummeted to less than 1.5 months of imports. However, there was considerable foot dragging on the part of the IMF in finalizing the SBA in the face of opposition from influential developed economies opposed to the application. Their basis for the opposition was on grounds of 'human rights concerns' as the GOSL entered the final phase of its military campaign to defeat armed separatism in the country. In the event, the SBA was approved only in July 2009, two months after the end of the war when the economy had already begun to show signs of recovery.

With the end of the conflict, it became clear that the government would incur additional and immediate expenditures on humanitarian relief and rehabilitation of an estimated 300,000 internally displaced persons (IDPs) in the conflict-affected Northern and Eastern Provinces of Sri Lanka. Thereafter, post-conflict reconstruction of these regions was also expected to commence. The GOSL have to contend with these domestic imperatives in the midst of a sharp economic downturn that ate into government revenues. Thus, it was not surprising that the initial SBA request of US$ 1.9 billion was expanded to US$ 2.6 billion, while the IMF also adopted a more lenient conditionality framework in the dispensation of the tranches.

Table 12: Medium-term fiscal framework

% of GDP	**2011**	**2012**	**2013**
Total revenue	15.5	16.0	16.5
Tax revenue	13.9	14.6	15.0
Expenditure	22.7	21.5	21.3
Current	16.4	15.0	14.8
Public investment	6.5	6.5	6.5
Budget deficit	-6.8	-5.2	-4.8
Government debt	79.8	76.0	72.5

Source: Ministry of Finance and Planning, *Fiscal Management Report – 2011*, Colombo.

Thus, despite fairly stringent initial fiscal deficit targets, requiring Sri Lanka to trim its deficit progressively to 5 per cent of GDP by 2011, the targets were revised as Sri Lanka hit a deficit of 9.8 per cent of GDP in 2009. Under the revised targets, the country is expected to trim its deficit to 5 per cent only in 2012 (Table 12). Other deregulatory provisions that often accompany an SBA were also minimal. As opposed to requiring privatization of identified loss making state-owned enterprises, the SBA conditions required select entities (in the energy sector) to breakeven by the SBA completion period.

As a first step, a Presidential Commission on Taxation was appointed in 2009 with a mandate to recommend ways and means of improving the efficiency of the tax system through rationalization of taxes, broadening the tax base and improving the efficacy of the tax administration system in the country. Through reforms, which are to be implemented from 2010, the target is to raise the ratio of government revenue to GDP by 2 percentage points by the end of 2011. However, there are concerns whether recommendations of the Commission will be implemented in a holistic fashion or whether they will be implemented in an ad hoc fashion that could hinder the overall thrust of the revenue reforms. Indeed, it is surmised that only about 40 per cent of the recommendations of the previous Commission (1992) was ever implemented. Indeed, some of the recommendations of the current Commission were implemented in early 2011 – for instance, a sharp reduction in import duty rates on motor vehicles – disregarding accompanying broader recommendations on

phasing-in reforms in stages. Clearly, revenue imperatives and political economy factors are likely to heavily influence the implementation of the recommended changes. One of the most contentious will be the recommendation to bring in public employees into the tax net.[43]

Table 13: Planned expenditure

% of GDP	**2011**	**2012**	**2013**
Current	16.4	15.0	14.8
Salaries & wages	5.4	5.3	5.2
Interest payments	5.6	5.1	5.0
Subsidies & transfers	3.2	3.0	3.0
Other goods & services	2.1	1.6	1.5
Capital	6.5	6.5	6.5
Highways	1.6	1.7	1.1
Ports & aviation	0.4	0.2	0.1
Electricity	0.5	0.5	0.1
Water & irrigation	0.8	1.1	1.1
Education & health	0.6	0.8	0.9
Rural sector	0.6	0.6	0.4

Source: Ministry of Finance and Planning, *Fiscal Management Report – 2011*, Colombo.

On the expenditure front, the priority is to release financing for infrastructure investment and reconstruction spending. The largest expenditure item is on the construction of highways and water and irrigation services (Table 13). Meanwhile, capital expenditure on education and health is projected to see only a marginal increase. Indeed, capital investment on health and education, which stood at 1.1 per cent of GDP in 2006, had dropped progressively to 0.6 per cent of GDP by 2009.[44]

The planned curtailment of current expenditure appears to be an optimistic assumption. Certainly, restructuring of Sri Lanka's current debt portfolio will yield some savings in interest payments whilst spending on defence is also expected to reduce in the medium-term. Nonetheless, it is difficult to foresee cuts in wages and salaries given the lack of identified reforms to restructure the public sector and services in any convincing manner. Curtailment of expenditures on subsidies and transfers and on other goods and services might accrue through better targeting and/or rationalization of existing arrangements. Nonetheless, the Ministry of Finance remains optimistic that its medium-term adjustments will ensure a fiscally sustainable path that will support Sri Lanka's growth and broader development objectives.

3.4 The role of fiscal policy in supporting employment creation and poverty reduction

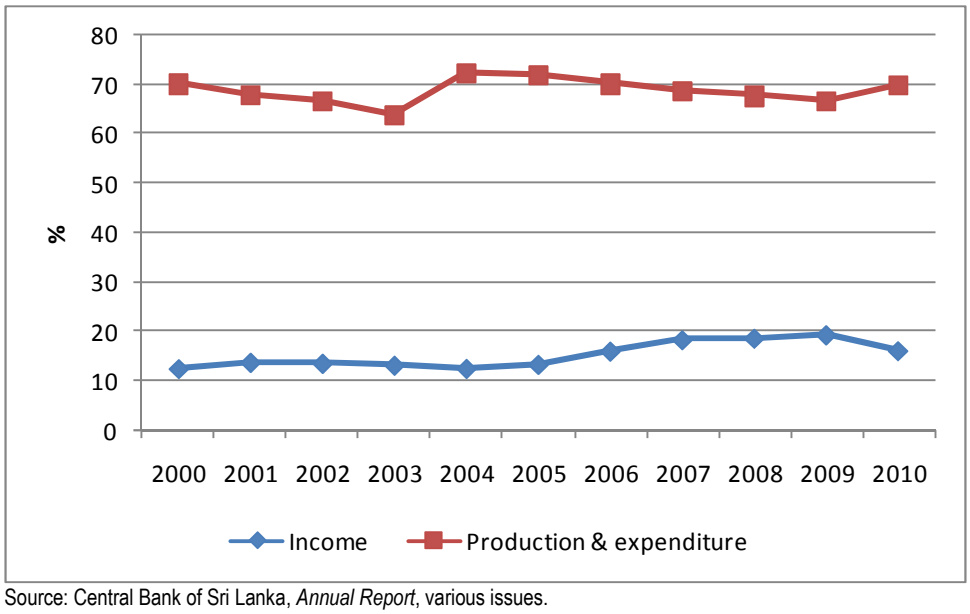
As tends to be the case in most developing countries, Sri Lanka's taxation is heavily reliant on indirect taxes. However, there has been some improvement to the 'progressivity' of the tax structure, where taxes on income have come to account for a greater share of total

[43] Sri Lanka's 1.2 million public sector employees have been exempt from payment of income tax on salaries since 1979.

[44] See Central Bank of Sri Lanka, *Annual Report*, various issues.

revenue, particularly in recent years (Figure 7). This is also likely to be an underestimate given that the regressivity of taxes such as VAT and import duties have been minimized through exemptions on basic consumption commodities as well as imposing high duties on items considered to be of 'luxury' in nature, etc.

Figure 7: Share of taxes on income and expenditure



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

The government has placed emphasis on economic infrastructure development. In 2009, the government spent 7 per cent of GDP on economic infrastructure. Of this, 5.8 per cent (an increase from 3.8 per cent in the previous year) were investments in economic infrastructure. The government envisages transforming Sri Lanka into a Naval, Aviation, Commercial, Energy and Knowledge hub. The infrastructure development in the North and East as well as agrarian drives have helped create employment in the conflict-affected areas.[45] There are no independent assessments on the employment created through these infrastructure projects. According to government sources the employment effects of some of these projects are large. For example, the government estimates that 6,000 direct employment and 50,000 to 100,000 indirect employment opportunities will be created at the completion of the Hambantota Harbour.[46]

Fiscal policy instruments have also been employed on the expenditure side to provide relief to households and identified sectors of the economy such as agriculture (Table 14). Sri Lanka has long provided a fertilizer subsidy to rice farmers on the argument that poorer farmers are not able to afford fertilizer otherwise. The subsidy is not targeted given the problems associated with attempting to administer a targeted subsidy. The justification for the subsidy is almost always on socio-political grounds rather than on grounds of economic efficiency.

[45] Interview with officials of Ministry of Labour and Labour Relations.

[46] Government of Sri Lanka, "Hambantota the new hub of development", http://www.priu.gov.lk/news_update/Current_Affairs/ca200703/20070312hambantota_new_hub_development.htm [Accessed 24th March 2011].

Table 14: Current transfers and subsidies

% of GDP	2000	2002	2004	2006	2008	2010
To households & other sectors	3.3	3.4	4.1	3.6	3.0	2.8
Samurdhi	0.8	0.6	0.4	0.4	0.2	0.2
Pensions	1.7	2.0	1.8	2.0	1.7	1.6
Fertilizer	0.1	0.2	0.2	0.4	0.6	0.5
Other	0.7	0.6	1.7	0.8	0.5	0.5

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

Sri Lanka also introduced a national poverty alleviation programme (Janasaviya) in 1992 that offered targeted income support and was later renamed (Samurdhi) in 1995. As previously discussed, targeting has been a perennial problem. Available evidence suggests a considerable leakage to the non-poor and under-coverage of the deserving poor. In 2002, while only 52.6 per cent of households of the poorest decile, 45.2 per cent of the 2nd decile and 40.7 per cent of the 3rd decile received Samurdhi welfare benefits, 2.4 per cent of the top decile, 7.9 per cent of the 9th decile and 13.4 per cent of the 8th decile also received benefits.[47]

The primary means through which fiscal policy has been employed to support strategic sectors of growth for employment generation has been through the application of tax policy. For instance, foreign investors have long been granted multiple tax holidays and concessions through the Board of Investment of Sri Lanka (BOI), as long as they met certain foreign capital and/or employment targets. Other segments to receive preferential tax treatment have been small and medium enterprises (SMEs), given their significant contribution to livelihood development and employment generation, particularly in the rural economy. There are no official estimates to assess SME sector growth and employment generation in any consistent fashion due to lack of data. Current estimates based on the Industrial Survey of 2008 suggest 90 per cent of industrial establishments are categorized as 'small and medium' and the contribution to employment in industries by them is 26 per cent.[48]

However, these measures have not always brought the intended results. Despite Sri Lanka's generous tax holidays under the BOI, foreign direct investment (FDI) inflows have been disappointing, largely on account of the inability to provide a stable policy and political environment in the country. There has also been a significant cost to the country in terms of the loss of revenue that such exemptions have engendered. Indeed a key recommendation of the Presidential Commission on Taxation has been to phase out such preferential tax treatment over the next few years.

Looking forward, the Budget for 2011 signals the government's intentions to use fiscal policy to address outstanding issues regarding the provision of social safety nets and old age pension schemes. The proposed schemes are contributory schemes subsidized by the government. Available information suggests that the proposed schemes might not fully

[47] Nanayakkara, A.G.W., 2006, "Poverty in Sri Lanka: Issues and Options", Department of Census and Statistics, Colombo.

[48] The questionnaire based "Annual Industrial Survey" carried out by the Department of Census and Statistics is not reliable or useful for comparative purposes. The response rate is estimated to be below 50 per cent, where mostly the larger industrial establishments receive responses.

address the current issues relating to coverage, sustainability and adequacy of benefit levels.

4. Monetary policy: impact on employment and poverty

The Central Bank of Sri Lanka (CBSL) is the key agency responsible for setting up and implementing monetary policy in the country. Historically, the CBSL was also instrumental in setting broader economic goals and objectives such as growth, employment, etc. However, with an amendment in 2002 to the Monetary Law Act, a decision was taken to free the CBSL of its multiple objectives and narrowly confine it to two core objectives, these being (i) maintaining economic and price stability, and (ii) maintaining financial system stability. In part, re-focusing the core objectives of the CBSL was in response to the country's long history of price instability. Additionally, with the growth of Sri Lanka's financial sector, strengthening the regulatory oversight by the CBSL was considered to be appropriate.

Monetary policy is set by a five member Monetary Board. The inclusion of the Secretary to the Ministry of Finance and Planning in the Monetary Board is subject to controversy, particularly in view of the fact that the CBSL is the responsible authority for public debt management in the country. Whilst it is recognized that some degree of coordination between fiscal and monetary policy is essential, the ability of the CBSL to act independently can be compromised given the composition of the Monetary Board and its responsibility for public debt management.

At present, the operating target of monetary policy set by the CBSL is reserve money. Each month, the Monetary Board reviews emerging economic factors such as fiscal developments, external sector developments, economic growth prospects, etc. and determines the future path of monetary policy. The key instruments employed are policy interest rates and open market operations (OMOs). According to CBSL officials, critical indicators such as official reserves, external debt, earnings from exports of goods services, etc., are monitored regularly to assess the threats of external shocks to the economy.

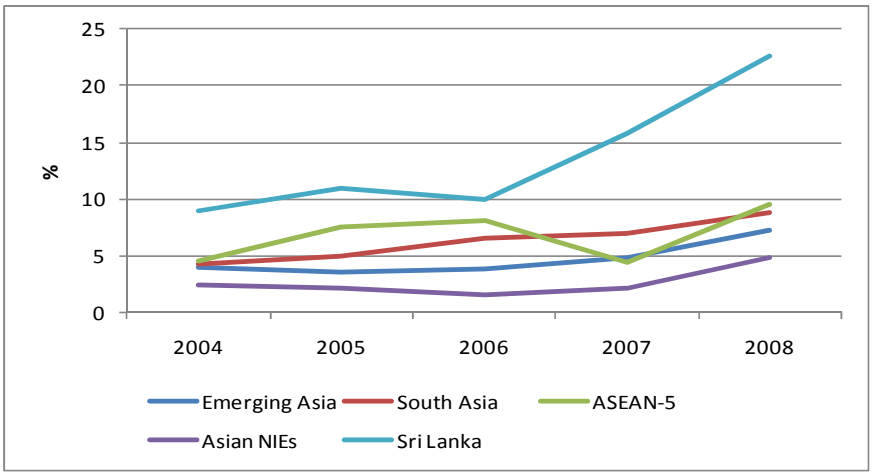
Despite a strong institutional base in the form of the CBSL, Sri Lanka has experienced high and volatile rates of inflation over the past decade as previously noted (see Table 2). Unsurprisingly, much of the pressures on monetary policy have emanated from Sri Lanka's fiscal weaknesses, giving some credence to the argument that there has been 'fiscal dominance' in setting monetary policy in the country. This was clearly apparent in the most recent episode of hyperinflation in the country during the period 2006-08. While external shocks (in the form of rising oil prices from 2004 onwards and food price inflation during 2007/08) contributed to aggravating inflationary pressures, domestic policy responses played the most critical contributory role.

4.1 Recent experience of monetary policy developments

As Sri Lanka's annual inflation rate peaked at 22.6 per cent in 2008, there was a tendency to assign responsibility to the rise in global oil prices. However, the fact that Sri Lanka's inflation rate was consistently and significantly above comparative country experiences – including net oil importing developing economies – pointed to the fact that the proximate causes could be found closer to home (Figure 8). Oil prices increases from

mid-2004 did contribute in part to fuelling cost-push pressures. However, the more pertinent cause was coming via demand pull factors, arising in large part to the influx of capital inflows following the December 2004 tsunami and the subsequent volumes of higher spending in the reconstruction process.[49]

Figure 8: Comparative rates of inflation



Source: IMF, *World Economic Outlook*, various issues.

The initial monetary policy response to evidence of rising inflationary pressures was moderate. Indeed, even as the domestic borrowing requirement to bridge the fiscal deficit peaked in 2006, the accommodative monetary policy stance added to the inflationary pressures that had been building up in the economy from mid-2004.[50] While various measures such as OMOs were used, adjustments to policy rates were the main instrument, at least until 2006, but this too was used only very sparingly (Figure 9). At times, real interest rates were negative as a result during this period.

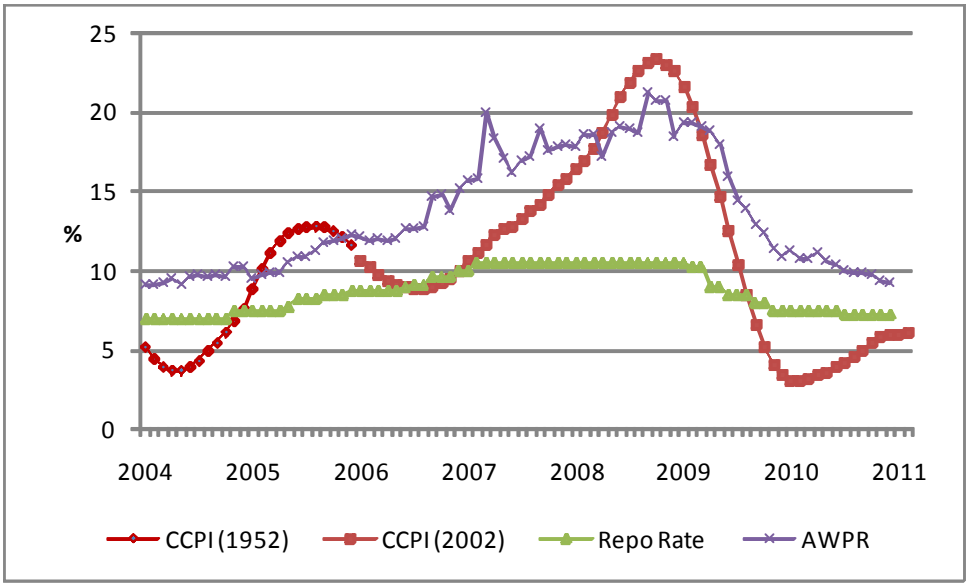
In early 2007, the CBSL abandoned policy interest rate adjustments and instead began to target monetary aggregates through OMOs and restrictive measures to limit the credit creating capacity of banks. Ultimately, the monetary policy correction had to be tighter than it need have been. From mid-2007, efforts to rein in inflation were further complicated by rising food prices in the country.[51] Rising food prices coupled with steady increases in fuel prices contributed more strongly to the inflationary spiral from mid-2007. Thus, despite a tighter monetary policy stance, the lagged effect of past excesses in monetary aggregates ensured that there was no let up in the unrelenting increase in the annual average rate of inflation, which peaked at 23.4 per cent on an annualized basis in October 2008.

[49] See Weerakoon, D., et. al, 2007.

[50] In 2006, the Department of Census and Statistics introduced a new CCPI with a new base year of 2002 replacing the older CCPI with a base year of 1952.

[51] For instance, the CCPI indicated an annual increase of 20.3 per cent for food and non-alcoholic beverages as opposed to a price increase of 8.9 per cent for that category in the previous year.

Figure 9: Trends in interest rates and inflation



Source: Central Bank of Sri Lanka, *Monthly Economic Indicators*, various issues.

Notes: CCPI=Colombo Consumers' Price Index, Repo Rate=Policy interest rates, AWPR= Commercial banks' Average Weighted Prime Lending Rate.

Thus, monetary policy had to deal with significant challenges arising from domestic policy developments, as well as external supply side shocks. On the domestic front, the demands of government expenditures and an accommodative monetary policy stance continued to fuel demand side inflationary pressures. In effect, Sri Lanka's relatively high economic growth during 2006-08 was due to the expansionary fiscal policy, supported by a relaxed monetary policy stance. The macroeconomic instability it generated would have eventually ensured a sharp slowdown even without the onset of the global economic crisis to provide an additional momentum.

4.2 The global economic crisis and Sri Lanka's monetary policy response

The initial manifestation of the global economic crisis came in the form of a financial meltdown. Given that the Sri Lankan financial industry had very limited or no exposure to the toxic assets that precipitated the crisis, there was little direct impact. Nonetheless, the Sri Lankan financial system was also undergoing similar problems – credit driven housing and consumption booms that posed systemic risks to the stability of the financial system.

Table 15: Monetary Indicators

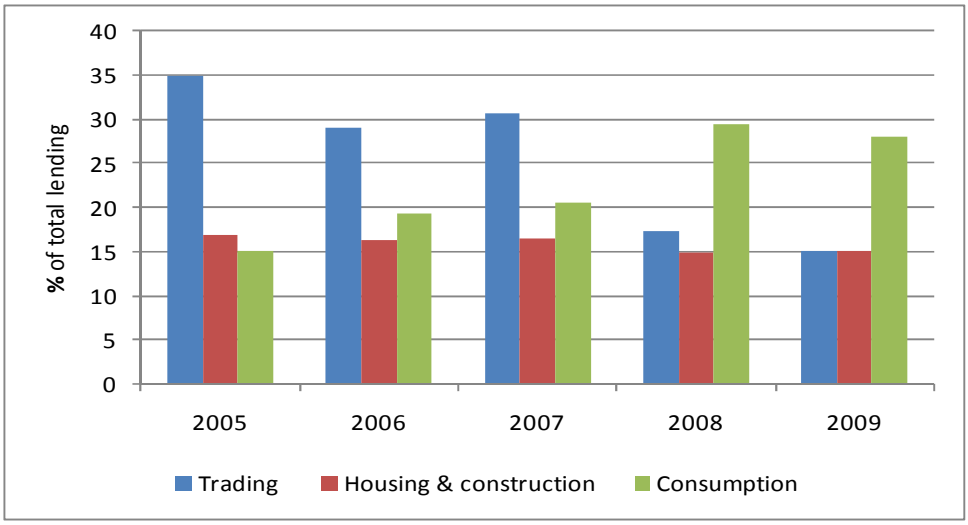
% change	2000	2002	2004	2006	2008	2010
Reserve money	4.7	12.3	20.9	21.2	1.5	18.8
Broad money supply (M_{2b})	12.9	13.4	19.6	17.8	8.5	15.8
Net credit to government	193.2	5.4	25.1	43.1	55.8	-2.1
Credit to private sector	11.8	12.0	22.1	24.0	7.0	25.1

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

Sri Lanka's financial problems were home grown. The culture of 'cheap credit' led to a rapid expansion in credit growth (Table 15). Credit growth to the private sector, for instance, peaked at about 26 per cent in mid-2007, compared to an annual average of

around 17 per cent during 2002-04. Such trends – where prices lose touch with the fundamentals in the midst of a credit boom – in turn can cause other downside risks to emerge in the economy. Access to cheap credit typically lends itself towards risk taking in financial markets on the part of borrowers and lenders. Not surprisingly, much of the credit boom saw lending rise to riskier areas of activity such as consumption (Figure 10). The share of lending for consumption purposes by Licensed Commercial Banks (LCBs) rose steeply from 15 per cent in 2005 to 30 per cent by 2008.

Figure 10: Lending by licensed commercial banks (LCBs)



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

Such developments pose risks to the health of the country's financial system stability. As credit dries up and interest rates begin to climb, borrowers become unable to repay loans. Indeed, the situation exacerbates as the liquidity squeeze begins to hit economic activity in general. Sri Lanka's experience was that sharply rising interest rates following the credit boom saw gross non-performing loans (NPL) ratio for the LCBs, for instance, rise from 5 per cent at end 2007 to 8 per cent by 2009.

A knock on effect was the exposure of many financial scams in the country during 2008/09. Some of these illegally operated schemes were run on the lines of "Ponsi" (pyramid) schemes that invariably run into difficulties during times of a liquidity squeeze. The inability to keep on attracting fresh deposits can quickly lead to an unravelling of such schemes. Many depositors lost their only source of income as a result, leading to economic hardships affecting a cross-section of the socio-economic spectrum.

As the tight monetary stance began to take effect, with even prime lending rates hitting a peak of 20 per cent, Sri Lanka began to see a persistent decline in the rate of inflation from mid-2008 (see Figure 9). The impact of the global economic crisis, by further contracting aggregate demand in the economy, reinforced what was already occurring due to domestic policy corrections. As demand pressures in the economy eased considerably, the sharp drop in international oil prices also played a role in easing cost-push pressures on inflation. As the rate of inflation dropped, it allowed a gradual easing of interest rates during 2009-10.

4.3 Current and projected stance of monetary policy

The gradual downturn in economic activity in 2009 and the accompanying deflationary environment allowed the CBSL to ease its monetary policy from mid-2009. Despite the improved economic outlook and business confidence following the end of the military conflict, the demand for credit from the private sector has been slow to pick up. In

fact, excess liquidity in Sri Lanka's financial market has been the order of the day. The banks have been slow to reduce their margins and lower their lending rates, partly owing to past credit excesses that have led to a mismatch of the asset and liabilities portfolios of banks. In order to speed up economic recovery, the CBSL has increasingly resorted to moral suasion and regulatory requirements, including calls to cut rates. The two state-owned banks were required to enforce a cut on their lending rates, whilst other LCBs were mandated to bring down their interest rates on credit cards in line with a CBSL directive.

The CBSL monetary policy framework for the medium-term forecasts a low and stable rate of inflation in the 'mid-single digits'.[52] It has also indicated a likely move from the current monetary targeting policy framework towards an inflation targeting policy framework.[53] Inflation targeting requires a Central Bank, which must at least be operationally independent, to announce a medium term target (or range) for inflation, be responsible for achieving those targets and provide regular public information about its strategy and decisions. It essentially requires an institutional commitment to price stability as the primary goal of monetary policy.

The openness, accountability and anti-inflation focus that targets can instil are viewed as obvious attractions as a medium-term strategy for monetary policy. The greater accountability that is placed on the Central Bank to meet its stated targets can also constrain political pressure on the entity, reducing the likelihood of the time-inconsistency trap to undertake overly expansionary monetary policy.

Nevertheless, inflation targeting is not without its problems. Critics of inflation targeting have long held the view that it is too rigid, that it allows too much discretion, that it has the potential to increase output instability, and that it will lower economic growth. Proponents of the strategy, however, contend that such concerns in reality are not serious objections to a properly designed inflation targeting strategy. But for developing economies, the risks are greater. They have specific problems that make inflation targeting difficult. The determinants of the inflationary process in developing countries are complex. For example, import prices play a significant role in the consumer price index, making the exchange rate itself an important element in inflation. The incidence of administered prices in the inflation index is a further complication. Countries such as Sri Lanka, which still have relatively high rates of inflation, might find it difficult to predict future inflation rates with any degree of accuracy, and setting targets might actually damage Central Bank credibility.

A key pre-requisite for inflation targeting is the absence of outright fiscal dominance to prevent monetization of deficits. This implies that an institutional framework to keep fiscal policy in check is critical to the success of an inflation targeting strategy. In its absence, governments may still continue to run large fiscal deficits that in the long run lead to the collapse of an inflation-targeting regime.

If Sri Lanka is to adopt an inflation-targeting strategy as the primary focus of its medium-term monetary policy, the issue of granting greater independence to the Central Bank cannot be ignored. An independent Central Bank, given the specific task of achieving and maintaining price stability, and appropriately empowered to do so through political

[52] Central Bank of Sri Lanka, 2011, *Road Map: Monetary and Financial Sector Policies for 2011 and Beyond*, Central Bank of Sri Lanka, Colombo.

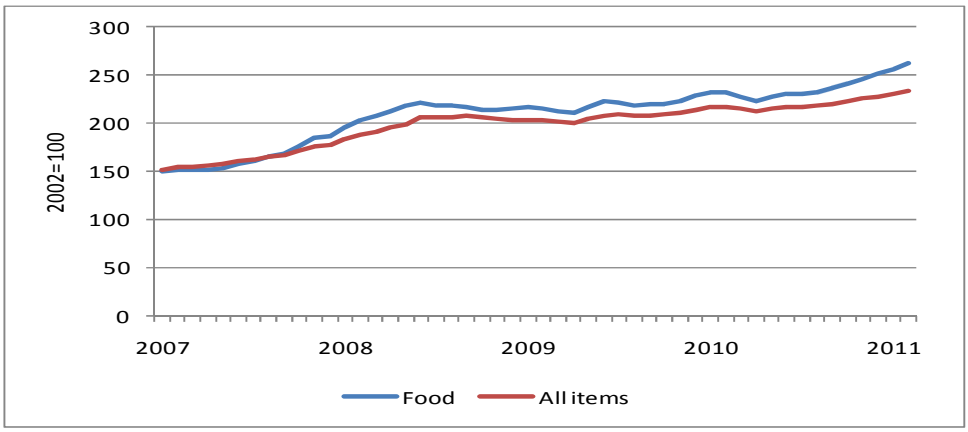
[53] Central Bank of Sri Lanka, 2010, *Recent Economic Developments: Highlights of 2010 and Prospects for 2011*, Central Bank of Sri Lanka, Colombo.

consensus, is expected to be able to counter the problem of time inconsistency. Such a strategy may also have the advantage of focusing the political debate on what a Central Bank can do most effectively in the long run, that is, control inflation, as opposed to assigning it a multitude of complex tasks (for example, to raise output growth, lower unemployment, and increase external competitiveness). However, whether or not the GOSL will allow the CBSL greater independence is not yet clear. Until such concerns are addressed, inflation targeting will remain merely a viable theoretical option for medium-term monetary policy strategy in Sri Lanka.

In the near term, the primary responsibility for monetary authorities will be to strike a balance between the need for a rapid and sustained economic recovery without compromising macroeconomic stability. It will require the CBSL to impose monetary discipline as and when evidence of inflationary pressures emerges. As the government rolls out its infrastructure spending and private investment picks up, there will be the inevitable pull on aggregate demand. At the same time, the recovery in commodity prices will see Sri Lanka's oil import bill surge once again, adding to cost push pressures on domestic prices.

The immediate concern on the inflationary front has been the rising price of food items. Global food price movements are found to correlate with food price trends in Sri Lanka at the aggregate level – as Sri Lanka is an importer of commodities such as grain – as was the experience during the 2007/08 food price hike. Sri Lanka has also not been immune to the sharp rise in food prices experienced more recently (Figure 11). However, the proximate causes included weather-related disasters that saw a significant destruction of the country's rice production in early 2011.

Figure 11: Trends in food price inflation



Source: Department of Census and Statistics.

Sri Lanka's inflation rate has picked up as a result of rising food prices, where the food basket of the CCPI index accounts for approximately 48 per cent of expenditures. Clearly, standard monetary policy responses to inflation arising primarily from food price increases are not appropriate. Indeed, the government took measures to implement certain fiscal measures, such as duty waivers on customs import duty and reduction of taxes on some essential commodities. Whilst such measures are expected to reduce food prices and contain the food-related price inflation to the short term, if increases in food prices persist, there is the danger that it will be transmitted to general price inflationary pressures. In addition, tax relief and exemptions on the fiscal front will have a bearing on government revenue targets for the year.

4.4 The role of monetary policy in supporting employment creation and poverty reduction

The primary role of monetary policy as assigned to the CBSL is to ensure price and financial system stability in the economy. According to officials of the CBSL, impacts of macroeconomic policies on the economy as a whole, and specifically on poverty and employment, is given considerable attention. For the most part, given the time lag between output growth and employment statistics, the CBSL relies on surveys of industries or specific sectors to gather information on the labour force developments to monitor and evaluate outcomes. Adjustments to policies may be done as a result of such assessments.

Notwithstanding the above, Sri Lanka's recent experience in the areas of both price and financial system stability has not been favourable to support sustainable growth, employment generation and poverty reduction. Price instability weakens investor confidence in the economy and investors are constrained from taking a long-term view when planning future business expansion. Macroeconomic instability is also a deterrent to foreign investors. All these factors hinder sustained employment creation, particularly in the formal sector of the economy, which offers a more stable form of employment. Price instability also impacts adversely on real wages of the workforce. Often nominal wage increases fail to keep up with high and rising inflation as was evident from Table 7.

Other vulnerable sections of the population such as the elderly that depend on fixed income earnings also suffer disproportionately from price instability. Formal pension scheme payouts drop in real terms, and those dependent on interest on fixed income assets find that their real disposable income has dropped sharply as a result. For instance, real deposit rates were often negative during the inflationary spiral that Sri Lanka experienced in the recent past. Significant volatility in interest rates also introduces a high degree of uncertainty regarding future income streams for many households.

As already noted previously, asset price bubbles and excessive consumption during credit booms caused by fundamental weaknesses in the macroeconomic environment exposes households to debt that they cannot pay off when corrective measures are re-introduced. The risks of financial insecurity and loss of confidence in the financial system can in turn inhibit a savings culture amongst households, particularly those from poorer socio-economic segments.

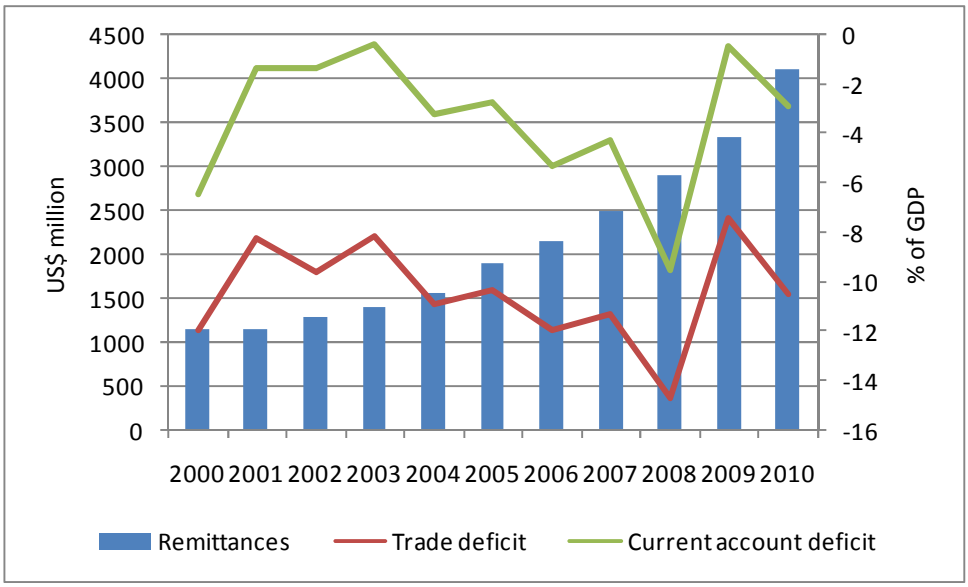
Nonetheless, monetary policy has also included efforts to support strategic sectors of the economy. In particular, the CBSL has been engaged in opening lines of subsidized credit to the SME sector. In the post-2005 period, and particularly since the end of the conflict in May 2009, renewed efforts have been made to encourage LCBs and other specialized commercial banks (SCBs) to actively lend to this sector. Such directives have increasingly being geared to encourage SME lending to the previously conflict-affected Northern and Eastern Provinces of the country. Indeed, it is expected that the CBSL will introduce a mandatory requirement on banks to lend a percentage of funds to the SME sector.

In 2009, a similar directive with regards to lending to the agriculture sector was imposed where banks are expected to ensure that up to 10 per cent of their lending is for agriculture purposes. The reasoning behind this directive is the often-heard argument that banks are unwilling to lend to the less profitable agriculture sector as opposed to the industrial and services sectors. Whilst there is some justification for attempting to ensure that more credit facilities are extended to agriculture, directed credit policies are not necessarily the most efficient means for resource allocation. Such policies also do not always yield the expected results given that banks can often lend to export plantations companies, etc., that in principle still qualify as composing the agriculture sector.

5. Exchange rate policy: impact on employment and poverty

Sri Lanka's exchange rate management is the responsibility of the CBSL, taking account of external sector developments and monetary policy imperatives. The country's current exchange rate regime is best described as a 'managed float'. This is despite the fact that as part of an IMF SBA package in 2001, Sri Lanka undertook to implement a floating rate regime, allowing the exchange rate to adjust to market fundamentals. While the CBSL compiles exchange rate indices in both nominal and real terms against a basket of 24 competitor country currencies, nominal exchange rate movements are primarily 'managed' against the US dollar.

Figure 12: External sector trends



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

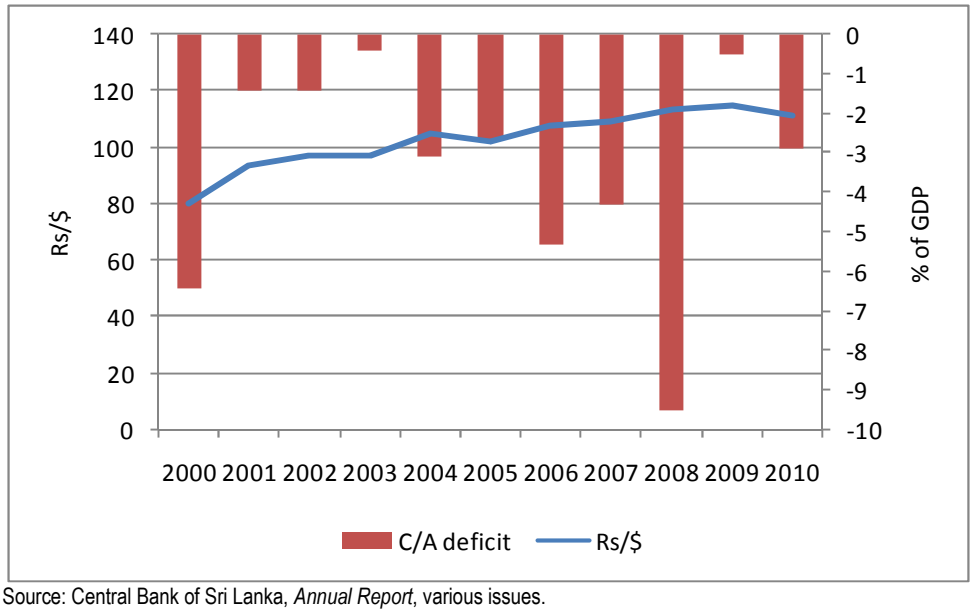
In line with developments in other macroeconomic indicators, Sri Lanka's nominal exchange rate movements have also indicated a high degree of volatility over the last decade. As a small open economy, with a trade to GDP ratio of approximately 60 per cent, external shocks can clearly have a major impact. Historically, growth in import expenditure has outstripped export earnings. For instance, while annual average import expenditure grew by 10.7 per cent per annum during 2000-08, the corresponding export earnings growth was only 6.8 per cent. It is only strong inflows of worker remittances, accounting for an average of 7 per cent of GDP per annum over the same period that allowed Sri Lanka to cushion its current account deficit over the years (Figure 12).

Remittance inflows have proved to be a stable and significant source of BOP support to the Sri Lankan economy. Indeed, remittances on occasion have played an important counter-cyclical role to smooth economic shocks, where migrants send more money to families during crises. For instance, as the Sri Lankan economy was subject to the external supply-side shock of a rapid rise in international oil prices during 2004-08, a sharp deterioration in the trade account was offset by higher inflows of remittances.[54] Similarly,

[54] The sharp increase in remittance inflows in 2005 is largely associated with the December 2004 tsunami that claimed the lives of nearly 36,000 people in Sri Lanka.

during the global economic downturn of 2008/09, remittance inflows remained healthy. And as previously noted, the end of the conflict in Sri Lanka also saw a significant increase in remittance inflows in 2009/10. While a sizeable surge in inflows that leads to a real exchange rate appreciation may hold adverse implications for the competitiveness of the export sector, there is little evidence to suggest that this has been a factor in Sri Lanka. Remittance inflows have been stable and persistent over a long period of time, negating any possible 'Dutch disease' effects.

Figure 13: Current account and exchange rate trends



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

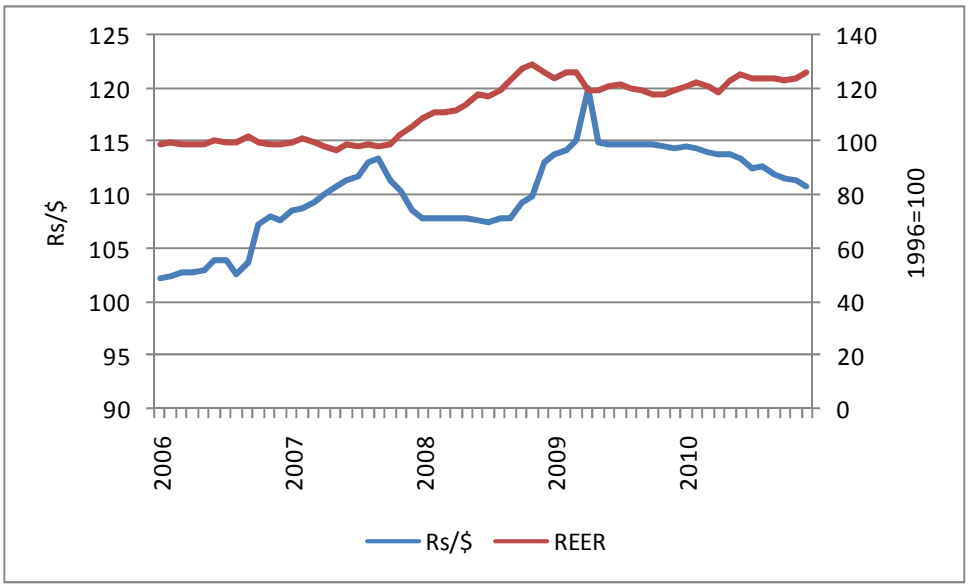
Despite the significant contribution from migrant remittances to closing Sri Lanka's current account deficit, the Sri Lankan rupee has historically tended to record a depreciating trend. For instance, the currency depreciated at an annual average of nearly 8 per cent during 2000-04. Indeed, the country was on the verge of an emerging foreign exchange crisis on the eve of the December 2004 tsunami, when expectations of foreign capital inflows for reconstruction purposes saw a sharp reversal in exchange rate movements. Post-2006, Sri Lanka's exchange rate policy was once more subject to some controversy.

5.1 Recent experience in exchange rate management

In the period 2006-08, exchange rate management clearly posed additional challenges to Sri Lanka. Not only was the country subject to an external shock in the form of rising oil prices, but domestic policy compulsions also saw a greater exposure to foreign debt management as previously noted.

A sustained deterioration in the external current account suggests, in principle, the need for a depreciation of the exchange rate. A gradual depreciation of the currency in such circumstances would allow the relative prices of Sri Lankan goods and services to be pulled down, making them more attractive in international markets and thus giving a boost to exports. However, growing pressure on the current account was also offset to an extent by developments in the capital account – i.e., foreign capital inflows in the form of short-term borrowing, inflows into the Treasury bill and bonds market, etc. Such inflows also have an impact on exchange rate movements. They can lead to upward pressure (appreciation) of the exchange rate. Critically, such exchange rate movements do not reflect a change in the aggregate demand for Sri Lanka's goods and services. They do, however, have the usual effect on relative prices, dampening net exports.

Figure 14: Nominal and real exchange rate movements



Source: Central Bank of Sri Lanka, www.cbsl.lk

The exchange rate also impacts on consumer prices, including the prices of key imported commodities, such as fuel and food, which has substantial impacts, in particular on the poor. The government has from time to time attempted to address these by administrative price controls, removal of import duties and other taxes, etc. For instance, diesel fuel continues to enjoy a subsidy given its broader impacts on the cost of living for poorer households, particularly via the mass transport sector costs. However, such measures in turn can have other distortionary knock-on effects that impinge on macroeconomic management.

Sri Lanka's exchange rate remained remarkably steady in the midst of rising inflation and a deteriorating current account performance during 2006-08 (Figure 14). The rupee saw a nominal depreciation of under 4 per cent between October 2006-October 2007, and even that gradual depreciation reversed with the inflow of foreign capital – US$ 500 million sovereign bond issue and other short term flows. Efforts were made thereafter to keep the exchange rate at an 'unofficial' peg of Rs. 108 to the US dollar even as the adverse impacts of the global financial crisis began to hit Sri Lanka in the third quarter of 2008.

A misalignment in the exchange rate – at odds with the fundamentals of the economy – has a cost. Clearly, when there is a sharp inflation rate differential between Sri Lanka and her competitor countries and nominal exchange rate movements do not reflect the fundamental imbalances that exist in the external current account, there will be an appreciation of the real exchange rate that leads to loss of competitiveness of exports in the international markets. The real exchange rate of the *rupee* as measured against a basket of 24 currencies appreciated sharply by nearly 28 per cent during the 12 months of October 2007-October 2008. Thus, Sri Lanka's export sector found itself attempting to compete in a rapidly shrinking global market, already disadvantaged through a loss of competitiveness as a result of exchange rate policy management.

A steady exchange rate was attractive for three key reasons. In the first instance, the spiralling inflationary pressures in the economy would have worsened in the context of a depreciating currency. A 'suppressed' exchange rate dampens net exports, and thus aggregate demand in the economy. In effect, it has deflationary consequences and supports monetary tightening measures. A second important reason to promote a stable exchange rate was with regards to fiscal consolidation. Sri Lanka's rising exposure to short-term foreign borrowing meant that a depreciating currency raises the costs of debt servicing and repayment of principle. A third factor was the drive to attract foreign investment into the

government debt securities market. A depreciating currency, or expectations of a future depreciation, raises the risks for investors and could deter such capital inflows from coming into the country. Thus, the policy flexibility to allow the exchange rate to mirror developments in the underlying fundamentals was severely constrained even before the advent of the global economic crisis. Under these circumstances, Sri Lanka found itself unable to cushion the external shock in any convincing manner.

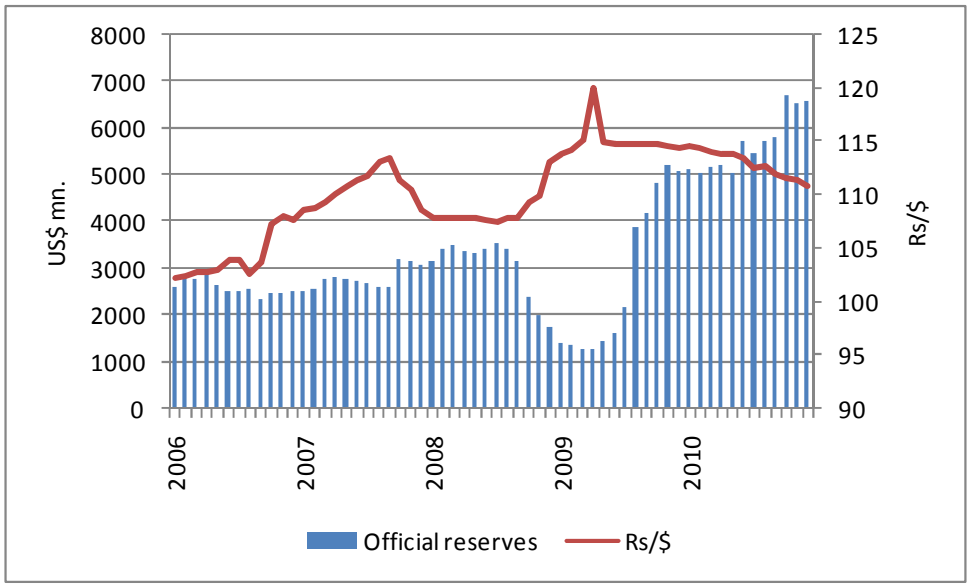
5.2 The global economic crisis and exchange rate management

The most notable direct impact of the unfolding global financial crisis on the Sri Lankan economy was the swift outflow of short-term capital from the country. The global credit crunch saw foreign investors cashing in their investments in the country from September 2008. Sri Lanka experienced a rapid outflow of an estimated US$ 400 million of foreign investments in Treasury bills and bond holdings from a total inflow at the time of US$ 650 million. Planned foreign borrowings also had to be abandoned as access to all forms of foreign capital became scarcer. A government invitation issued in October 2008 for proposals to raise a syndicated loan of US$ 300 million was quietly abandoned.

The policy response to these developments on the external front, *vis-à-vis* the exchange rate, was ill advised. In effect, the policy thrust was to 'lean against the wind' and defend the currency through a rundown of official reserves. It proved to be a costly policy response, as the country's official reserves shrank from US$ 3.4 billion in August 2008 (sufficient for 3 months of imports) to US$ 1.7 billion by December 2008 (sufficient for 1.5 months of imports).

With the depletion of reserves and continued pressure on the exchange rate, the CBSL made attempts to re-build external reserves through initiatives such as the issuance of 'diaspora' bonds and arranging currency swaps through other Central Banks. These proved inadequate to stem the pressure, and Sri Lanka was finally compelled to approach the IMF for a US$ 1.9 billion SBA for BOP support in February 2009. In March 2009, the country's exchange rate depreciated to an all time low of Rs. 120 against the US dollar, while official reserves too fell to a low of US$ 1,272 million, sufficient for only 1.2 months of imports.

Figure 15: Gross official reserves



Source: Central Bank of Sri Lanka, *Monthly Economic Indicators*, various issues.

The decisive ending of Sri Lanka's three-year long armed conflict in May 2009 was fortuitous. There was almost an overnight return of confidence in the medium-term outlook for the economy. The disbursement of the first tranche of the long awaited IMF facility[55] – enhanced to US$ 2.6 billion – in July 2009 was a further boost to regaining macroeconomic stability. With the improved outlook, net short-term foreign investment in Treasury bills and bonds, which stood at US$ 270 million in August 2009, had increased to US$ 1,354 by the end of the year.

With the onset of the global economic crisis, easing of oil prices and general slowdown in imports, Sri Lanka's trade imbalance began to improve sharply as the contraction in import expenditure outstripped the loss of export earnings. Sri Lanka also saw better than anticipated remittance inflows in 2009, which recorded a strong growth of 14 per cent. Indeed, any negative impact on remittances from the global economic crisis was more than offset by domestic developments. While there is no firm evidence to support the claim, it is surmised that the conflict-affected families of the North and East of Sri Lanka saw a sharp increase in remittance inflows following the end of the war from its large ethnic diaspora community overseas. These factors combined to narrow the current account deficit to -0.5 per cent of GDP in 2009 as against a deficit of -9.5 per cent of GDP in 2008. As a result, pressure on the exchange rate eased considerably.

5.3 Capital account management and macroeconomic policy implications

For all intents and purposes, Sri Lanka has maintained a closed capital account since the liberalization of its economy in the late 1970s. However, exchange control restrictions were significantly relaxed in order to encourage FDI inflows and associated outflows such as dividends, repatriation of profits, etc.

Over time, the country has progressively opened up further, for instance by allowing foreign borrowing for Sri Lankan corporate entities up to a limited threshold of equity, permitting foreign investment in government debt market within agreed limits, etc. Sri Lanka allows foreign equity capital investment up to 100 per cent in almost all sectors, apart from a limited list of restricted areas of activity.[56]

Despite the relaxation of exchange controls on capital account transfers to encourage FDI inflows, other factors have dampened foreign investor enthusiasm as previously noted. FDI inflows have averaged around 1.5 per cent of GDP, without any significant change in the composition of FDI in different economic sectors (Table 16). Services account for more than two-thirds, with the bulk of it going into the telecommunications and energy sectors in recent years. Within manufacturing, wearing apparel continues to be the major attraction. The employment impact has also remained limited, with enterprises under the BOI accounting for only a marginal increase in total employment in the country over time. Thus, progressive capital account liberalization and tax incentives over the last decade have failed to spur FDI-related economic diversification and structural change that in turn would have generated more dynamic employment opportunities. Enterprises established under the BOI tend to be heavily import-dependent, although this has lessened over time. In the T&G

[55] IMF approval for Sri Lanka's request for a SBA was delayed due to pressure from the US and EU on issues related to human rights in the country during the height of the military operations.

[56] See Board of Investment of Sri Lanka, www.boi.lk

industry, for instance, backward linkages have evolved only very slowly with value addition in the garment industry hovering around 25-30 per cent (Kelegama, 2009).

Table 16: Sectoral share of FDI

	2000	2009
Food, beverages & tobacco	3.3	5.9
Textile, wearing apparel & leather products	15.5	9.8
Wood & wood products	0.3	1.2
Paper & paper products	0.4	0.8
Chemical, petroleum, rubber & plastic products	6.3	7.2
Non metallic mineral products	2.7	1.6
Fabricated metal products, machinery & transport equipment	2.9	2.7
Manufactured products not elsewhere specified	4.7	3.6
Services	63.7	67.1
1. Total employment	367,849	474,128
(1) as % of total employment	5.8	6.6

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

Through the years of conflict, foreign investor interest in Sri Lanka's stock market has also been muted. As a result, the country has not had to deal with the potential downside risks associated with short-term capital flows, as the magnitude of such portfolios flows have been negligible (Table 17). Sri Lanka's exposure to external shocks via private foreign debt accumulation has also not been an issue given the 'closed' capital account policy in operation.

However, the increased recourse to foreign currency denominated borrowing in recent years has raised several issues with regards to capital account management *vis-à-vis* its implications on other macroeconomic fundamentals. For instance, Sri Lanka issued three Sovereign Bonds for US$ 500 million with a maturity of 5 years in 2007 and 2009, respectively, and a further US$ 1 billion in 2010 with a maturity of 10 years. In addition to these, the CBSL has also been issuing Sri Lanka Development Bonds (SLDBs) with a maturity of 2-3 years. Developments in capital account transactions have increasingly posed fresh challenges to the monetary authorities.

Table 17: Net capital account flows

US$ million	2000	2002	2004	2006	2008	2010
Long term						
FDI	173	185	217	451	691	435
Private	82	-21	14	-35	74	149
Government	47	162	439	491	252	1796
Short term						
Portfolio	-45	25	11	51	60	-230
Private	100	68	28	-30	594	-1032
Government	-	-	-	-	-213	531

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

As previously noted, Sri Lanka has seen a significant reversal in capital outflows since mid-2009, which invariably exerted upward pressure on the exchange rate; a phenomenon widely cited as the 'Dutch disease' effect. The monetary authorities were compelled to intervene in the foreign exchange market to hold the *rupee* steady as a result. By end 2009,

the CBSL had absorbed more than US$ 2.5 billion to ease upward pressure on the exchange rate and at the same time to rebuild the country's foreign reserves.[57] As such, official reserves stood at US$ 5,097 million by end 2009, sufficient for 6.2 months of imports *(see* Figure 15).

The upward pressure on the exchange continued into 2010. As a result, the gradual depreciation of the real effective exchange rate (REER) reversed once more from the beginning of 2010, despite the continued intervention of the CBSL in the foreign exchange market (see Figure 14). A key concern is that the upward pressure on the currency is not reflective of a shift in Sri Lanka's economic fundamentals, i.e., rising demand for the country's goods and services in international markets. Rather, it has been dictated by the rising volumes of foreign capital inflows, heavily tilted towards government borrowing, as opposed to the 'corrective' depreciation of a currency in line with a deteriorating current account deficit. Such distortions impact the competitiveness of Sri Lanka's export sector adversely. The cost increases associated with a large inflow of foreign capital lead to reduced profitability in industries that do not gain an offsetting increase in their prices. If a sustained exchange rate misalignment was to persevere, it could adversely impact employment generation in manufacturing exports.

5.4 Current and projected stance of exchange rate policy and implications on capital account management

Sri Lanka is facing the complex challenge of trying to pursue a progressively more open capital account regime, while attempting to retain some independence in monetary policy and 'manage' its exchange rate. For an open economy, theory suggests that in principle, it not possible to have free capital mobility, a fixed exchange rate and an independent monetary policy at the same time.

If an independent monetary policy – i.e., setting interest rates – takes precedence over an exchange rate target, then the exchange has to be allowed to move in line with market developments. But, in an environment of high and volatile capital inflows, this may not be very appropriate, particularly in view of retaining a measure of international export competitiveness to support an economic recovery and sustained growth in the medium-term. On the other hand, if the exchange rate is to be targeted, capital inflows have to be mopped up. The build-up of foreign exchange reserves allows the domestic monetary base to expand without a corresponding increase in production. It can potentially raise inflationary pressure, requiring an upward adjustment to interest rates.[58]

The inflow of foreign capital into Sri Lanka allowed the CBSL to build up gross official reserves of US$ 6.6 billion by end of 2010, sufficient for 6 months of imports. A general rule of thumb suggests that official reserves sufficient for around 3 months of imports are adequate. Indeed, this was the target set for Sri Lanka under the IMF SBA facility. Thus, Sri Lanka is comfortably placed at present, even discounting the fact that

[57] In this instance, depressed economic activity in the country and contracting demand for credit meant that the excess rupee liquidity did not ignite inflationary pressures, allowing the CBSL to ease interest rates.

[58] Higher domestic interest rates in turn can encourage more foreign capital inflows. However, given that Sri Lanka has to date only permitted a partial opening up of foreign investment into the country's debt market can mitigate the spiralling impact.

some US$ 1.5 billion of accumulated reserves are debt liabilities from investments in Treasury bills and bonds.[59]

The intention of the CBSL, as far as exchange rate policy is concerned, is clearly to ensure that the currency is held at a fairly steady rate. There are two possible outcomes in the near term. The first is that Sri Lanka will continue to enjoy strong inflows of foreign exchange in the current account via increased earnings from tourism, a recovery in the export sector and migrant remittances. Certainly, earnings have picked up in all three areas in 2010.

On the capital account, it is quite likely that government long-term foreign currency denominated borrowing will continue as costlier short-term debt is retired. The Budget for 2011 also signalled the intention of the CBSL to proceed with further liberalization of capital account transactions. Some of the measures to be introduced before January 2011 are:

1. Permitting foreigners to invest in rupee denominated debentures issued by local companies;
2. Enhancing access for companies to borrow from foreign sources;
3. Permitting individuals and corporate entities to invest in equity of overseas companies, etc.

These moves that include intentions to relax exchange control measures on capital outflows indicate that the CBSL is confident that Sri Lanka is comfortably positioned to receive the necessary capital inflows in the coming years. It also means that the monetary authorities expect some volume of outflows to ease pressure on the current trend of the exchange rate to appreciate. This will mitigate the need for CBSL intervention in the foreign exchange market that can potentially expand the monetary base and fuel inflation. The preference is clearly for a stable exchange rate, while employing interest rates to address inflationary pressures in the economy.

However, the strategy is not without risks for macroeconomic stability. Sri Lanka's targeted growth rate of 8-10 per cent in the medium-term is likely to be highly import-dependent. With greater exposure to foreign debt liabilities, the room for policy slippage is very narrow.

5.5 The role of exchange rate policy in supporting employment creation and poverty reduction

Sri Lanka's recent experience of exchange rate management highlights the inter-linkages with capital account developments. Exchange rate policy has a clear direct impact on the country's export performance and thus on employment growth and poverty reduction. Misaligned exchange rates create a degree of uncertainty of future exchange rate movements. Often, this prompts exporters to delay remitting their export earnings that exacerbates a foreign exchange crisis. Such uncertainty impacts on their *rupee* earnings and disrupts long-term investment planning. More critically, an overvalued real exchange rate leads to loss of competitiveness of their exports in foreign markets.

[59] It is also argued that the bulk of foreign capital inflows into government debt securities are not strictly 'short-term' given that Sri Lanka's secondary market for bonds is still not fully advanced.

Another segment of the labour force that is directly affected is Sri Lanka's large population of migrant workers, currently estimated to be over 1.7 million workers. Fluctuations in exchange rates impact the *rupee* earnings and savings of migrant households. In recent years, not only have they had to bear an excessive exchange rate risk, but they have also seen an erosion of real earnings remitted to their families in Sri Lanka, as a result of the rising cost-of-living pressures that the country has witnessed.

Nearly 65 per cent of Sri Lankan migrant workers are females, working in relatively low paid employment as housemaids. In terms of the geographic spread of migrants, more than a quarter of total migrants in 2009, for instance, came from the more affluent Western Province of the country.[60] Nonetheless, the geographic spread does suggest the potential for remittance inflows of such migrants to play an effective role in reducing poverty. Some of the country's poorest provinces account for a large number of migrants, particularly the estate sector dominated Central Province and the conflict-affected Eastern Province of the country.

The effects of worker migration on the labour market and household welfare are not very easy to establish. A recent study on Sri Lanka found that a large proportion of households (11 per cent) in the country receive remittances.[61] The level of remittances received by migrant households appears to be significant, being equivalent to 48 per cent of mean household income in the country. Households receiving remittances are found to have higher levels of total expenditure, reflecting higher spending on food, non-food, health and education. These households also receive a higher level of income from other sources such as from properties, financial and physical assets. There is some evidence that remittances can help households move to higher income deciles. Remittances also increase the number of sources of incomes of households, thereby improving their ability to cope with adverse shocks.

However, over reliance on migration as a source of employment can reduce incentives for domestic policy reforms to improve job creation. Further, as Sri Lanka gears itself to send more skilled workers for temporary employment overseas, it can have other costs on the labour force and economy. Information available on expatriates in countries of the Organization for Economic Cooperation and Development (OECD) shows that compared to other countries in Asia, Sri Lanka has the highest rate of emigration to OECD countries (19.4 per cent) of tertiary educated individuals.[62] Amongst 103 countries for which data is available, only 20 countries had emigration rates higher than that of Sri Lanka.

High skilled migration may adversely affect some sectors. For instance, the migration of health service workers is particularly detrimental to the countries of origin. These concerns are also true for Sri Lanka. In the health sector, compared to other countries in the region, Sri Lanka has the highest expatriation rate of doctors and the third highest expatriation rate of nurses to OECD countries.[63] In a database of 157 countries, Sri Lanka

[60] Sri Lanka Bureau of Foreign Employment, *Annual Statistical Report of Foreign Employment 2009*.

[61] See Arunatilake et. al., "Impact of Remittances on the Household of the Emigrant and on the Economy of the Migrant's Country: Sri Lanka", in S. Kelegama (ed.), *Migration, Remittances and Development in South Asia*, Sage Publications (forthcoming).

[62] Ibid.

[63] Ibid.

had the 37th highest expatriation rate of doctors, the corresponding rank for nurses was 66th. These statistics indicate that the brain drain of health sector workers to OECD countries is particularly high for Sri Lanka. This is of further concern given the short supply of several categories of specialist doctors and nurses in the country.

6. Conclusions

Sri Lanka has witnessed a considerable reduction of its unemployment rate over the past decade. Whilst an annual average GDP growth in the range of 5 per cent has helped to generate employment and livelihoods opportunities, other developments in the country's demography and labour force have also contributed. The employed population grew at roughly the same rate (1.5 per cent per annum on average) as the 10 years and above population from 2000 to 2009. However, this trend has not been consistent over this period. There have been some setbacks in the growth in employment over the last three years, possibly due to the global financial crisis. Overall, economic growth seems to have helped employment. But, employment growth is explained more by growth in public sector employment and in more informal types of employment (such as own-account workers), than in private sector employment.

Sri Lanka's macroeconomic environment over the decade can be argued to have contributed to the developments in the labour market. For the private sector, long-term investment decision-making can be constrained by volatility and unpredictability in macroeconomic fundamentals. These pertain particularly to movements in inflation, the exchange rate and interest rates. Economic uncertainty was compounded by socio-political flux in the midst of a long drawn armed separatist conflict in the country. Inevitably it acted as a drag on long-term investment planning on the part of both domestic and foreign investors. Thus, it is not surprising that what employment occurred was in contractual and/or self-employment activities. Contractual employment arrangements provide the necessary flexibility to adjust to a changing economic environment. This is particularly relevant in the context of fairly stringent labour laws in the country that can prove costly to employers in the event of attempting to terminate employees.

Weaknesses in public finance management have been a recurring problem in attempting to maintain macroeconomic stability. High and rising defence expenditures were partly to blame; not only did the conflict erode business confidence and exact an economic cost in terms of lost social capital and infrastructure, etc., but it also imposed a degree of uncertainty on fiscal planning. With the end of the conflict in May 2009, Sri Lanka has renewed efforts to catch up on its lost years of development, with the primary focus on rebuilding the country's physical infrastructure as a first step. The government's overall development drive also focuses heavily on revitalizing the rural agrarian economy and promoting the small and medium enterprise sector. All these should have positive employment and livelihood outcomes. Indeed, as Sri Lanka comes out of the economic downturn of 2009 with a sharp recovery in GDP growth, amidst a stable macroeconomic environment, the near term outlook for sustained growth and employment creation is promising.

The primary aim should be to ensure prudent macroeconomic management so that Sri Lanka can retain the policy flexibility to respond appropriately to its own development priorities. These include especially the delivery of rapid and broad-based growth that will generate livelihood opportunities for the conflict-affected populations of the North and East of the country. Indeed, it may mean tolerating moderate inflation and budget deficits in the pursuit of broader socio-political objectives in post-conflict Sri Lanka. Under more normal circumstances, an IMF programme of the kind that Sri Lanka entered into in July 2009 would have left the country with little room for policy manoeuvrability of this nature. Even with a more flexible arrangement, Sri Lanka is expected to achieve a fairly tight fiscal deficit target of 5 per cent of GDP by 2012. Such a conditionality-driven policy setting

underlines the importance of ensuring that countries adopt prudent economic policies in the first instance to avoid the necessity for ‘bailouts’.

With a fiscal deficit target of 7 per cent for 2011, moderate inflation averaging 6-7 per cent and a fairly healthy external reserves position, Sri Lanka does have the opportunity to gear its macroeconomic policies more explicitly towards productive employment generation. The expected increase in revenue generation should be complemented by attempts to reduce recurrent expenditures in loss-making public enterprises, uneconomic transfers and subsidies, etc., so that resources are released for capital investment in infrastructure and spending on key sectors such as health and education. This will allow Sri Lanka to lower its borrowing requirements, particularly the more risky and costlier foreign-currency denominated debt, and shield the economy from emerging external shocks *vis-à-vis* fluctuations in international commodity and food prices.

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