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## **ASIA-PACIFIC ECONOMIC SURVEYS: SRI LANKA**

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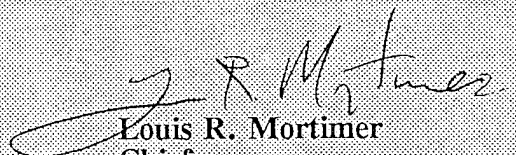
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## ASIA-PACIFIC ECONOMIC SURVEYS: SRI LANKA

### SUMMARY STATEMENT

During 1986 the Sri Lankan economy experienced a slowdown in economic growth, an increase in inflation, and a gradual widening of the current accounts and balance of payments deficits. The poor performance of the economy was largely a function of bad weather conditions and low commodity prices on the international market. The Tamil insurgency in the Northern and Eastern Provinces put an increasing strain on public resources, requiring a major expansion of defense spending. Nonetheless, since the nation's industrial and agricultural base is largely in the central and southern regions, the insurgency had only slight effect on the nation's gross domestic product (GDP) and other macroeconomic indicators. Over the coming year, however, a prolongation of the insurgency and its concomitant defense burden can be expected to lead to an increase in deficit spending, higher inflation, and a reduced ability to meet foreign obligations.

### SLOWER GROWTH PROMPTED BY AGRICULTURAL DOWNTURN

The GDP rose by 4 percent in 1986, down from a 5-percent increase in 1985. The decline in growth was largely due to the lower output of the agricultural sector, which contributes more than one-quarter of GDP and engages over half the labor force. Erratic weather conditions throughout 1986 led to a decrease in tea and rice production, and agricultural exports were down 21.5 percent in the first 10 months of the year. In the early months of 1987, the worst drought since 1951 further threatened agricultural output, producing an early rice crop more than 16 percent below 1986 levels. Tea, Sri Lanka's major export commodity, was reported to be 35 percent below 1986 levels at the beginning of the peak production season in March.

The industrial sector grew by 6 percent in 1986. While this appears to be an improvement over the 5-percent growth of the previous year, the 1985 figure is artificially low because of the temporary closing of the state's petroleum refinery for maintenance in early 1985. If the petroleum sector is discounted, industrial growth for 1985 and 1986 amounted to 9 percent and 6.5 percent respectively. The retrenchment reflects an increasing uncertainty in the business community stemming from ethnic violence in the north.

Without a major improvement in international commodity prices and a dramatic agricultural recovery in the latter part of 1987, GDP growth is likely to continue its downward slide. Total growth for 1987 is projected at or below 2.4 percent.

## SPENDING CUTS AND PRIVATIZATION TO REDUCE DEFICIT

A decline in revenues from tourism and agriculture and the growing costs of fighting the insurgency have forced the government to resort to high levels of deficit spending. In 1985, the deficit was financed primarily by foreign aid and non-bank borrowing. In 1986, for the first time, the government relied on major commercial loans to cover its expenditures; out of a total deficit of Sri Lankan Rupees (SLRs) 28.7 billion (\$1.02 billion), the government borrowed SLRs 5.2 billion (\$186 million) on commercial terms. At the same time, the government attempted to reduce deficit spending by cutting capital expenditure by 15 percent and current expenditure by 5 percent. In addition, in May 1987, the government announced an extensive program of privatization to sell off loss-making public-sector corporations. The telecommunications industry, the National Milk Board, and the State Distilleries Corporation have been targetted as prime candidates for early privatization.

With the direct and indirect costs of the insurgency continuing to rise, the government is likely to rely heavily on deficit spending and commercial borrowing again in 1987. As a result, the nation's debt-service ratio will deteriorate further, making recovery from the current crisis increasingly difficult. After its impressive gains in controlling inflation (down to 1.4 percent in 1985), the government was faced with 7-percent inflation in 1986 and can expect inflation to reach 12 percent or higher in 1987.

## WIDENING BALANCE OF PAYMENTS DEFICIT

A declining export performance, combined with a growing dependence on imported rice and military equipment, sent the trade deficit up in 1986. Sri Lanka's two leading export items, tea and textiles, both met with unfavorable market conditions; international tea prices stagnated at low levels during the first three quarters of the year, while American textile quotas sharply limited the export capacity of the apparel industry. Stagnation in the economies of the Middle East brought a drop in overseas remittances, while tourism continued to decline because of the fear of insurgent sabotage. Over the same period, instability in the north and east brought rice production down as much as 40 percent in some areas, forcing the government to rely on food imports for a previously self-sufficient market.

Despite a rapidly growing trade deficit, the government was able to attract sufficient foreign aid and investment to end the year with only a slight deterioration in the balance of payments. (Sri Lanka continues to have one of the highest per capita levels

of foreign aid.) A May 1986 terrorist attack on a Japanese cement plant in the port city of Trincomalee caused widespread fear that multinationals would cut off the flow of investment capital. Nonetheless, 1986 witnessed a record number of new foreign investment projects approved by the government (80, as opposed to only 30 in 1985).

Even if Sri Lanka is successful in drawing continued support and investment in 1987, export problems are likely to cause a further widening of the balance of payments deficit. International tea prices in mid-1987 hovered close to, and in some cases below, the production costs of the government's tea estates (SLRs 28-30/kilo). In addition, the acceleration of terrorist attacks outside of the Northern and Eastern Provinces guarantees a further deterioration of the tourist industry.

#### UNITED STATES DOMINATES SRI LANKAN EXPORT MARKET

According to 1986 trade figures, the United States was the largest single importer of Sri Lankan products, accounting for 25 percent of the market. West Germany was a distant second at 7 percent, followed by the United Kingdom at 6 percent. Aside from tea and textiles (which together made up more than half the nation's exports), Sri Lanka sold refined petroleum products, rubber, and coconut.

Imports included crude oil, machinery, food, and textiles, while the major supplier was Japan, with 16 percent of the market. The United States was the second largest supplier, at 6 percent; the United Kingdom, the United Arab Emirates, and Taiwan each accounted for 5 percent of the import market.

#### INSURGENCY A MAJOR LONG-TERM ECONOMIC THREAT

Although the ethnic conflict had only a marginal and indirect effect on the economy in 1986, it can be expected to play an increasingly important role in determining the nation's economic prospects. In addition to disrupting trade and agriculture in the north, the conflict has caused enormous damage to the infrastructure--roads, railways, bridges, and army installations--and has produced thousands of refugees who require government assistance. These indirect costs of the conflict are only beginning to appear in the national budget, and will persist long after a settlement has been reached. The loss of government revenues and continuing high military expenditures guarantee further deficit spending, growing inflation, and a neglect of critical development projects.

On the international front, a continuation of the violence is likely to discourage foreign investment and, over the short term,

make international development organizations question the immediate usefulness of further aid. Any broader disruption of agriculture could seriously damage the country's ability to meet its international obligations. Particularly vulnerable is the tea industry, which alone accounts for one-third of export earnings. The tea-growing region in central Sri Lanka is dominated by Indian Tamils, a group that has so far shown no sympathy toward the Jaffna Tamil insurgency to the north. Nonetheless, actual or threatened sabotage of the tea industry could substantially cut the nation's access to foreign currency.

#### IMPORTANCE TO THE UNITED STATES

From a trade perspective, the Sri Lankan market is of minimal importance to the United States. Nonetheless, within the Third World, Sri Lanka has served as a high-profile model of successful development policies within a pro-Western government. In this regard, a resumption of economic growth would serve to strengthen a friendly regime and at the same time further US economic interests elsewhere in the world.

#### DEFENSE SPENDING

The 1986 defense budget was SLRs 8.6 billion (\$307 million), which represented 11.7 percent of total government outlay. This was up from SLRs 6.2 billion in 1985 (\$228 million, 10 percent of government spending). The increase was used to upgrade military hardware with purchases from Italy, Israel, South Africa, and China. The Air Force was the primary beneficiary of the modernization program, purchasing SIAI-Marchetti trainer planes from Italy and Bell helicopters from the United States, while the Army received small arms and armored personnel carriers.

In the absence of a political settlement with the Tamil insurgents, the military budget is expected to continue rising in 1987, consuming approximately SLRs 10.6 billion (\$366 million), or 15.2 percent of government spending.