

Chapter 9

TRENDS AND DETERMINANTS OF PRIVATE INVESTMENT IN SRI LANKA

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1. Introduction

Adequate levels of investment are imperative to achieve and sustain economic growth. Private investment, in particular, contributes directly to the country's economic growth and development while enabling it to adopt new technology, expand the economy's production capacity, create employment opportunities and improve the living conditions of its citizens. It also largely determines the rate at which physical capital is accumulated.

Sri Lanka has taken various measures over the years to enhance private investment as an influential tool to promote economic activities and thereby increase economic growth. Private investment, including foreign direct investment (FDI), has responded positively over the years in varying degrees. Meanwhile, public investment has also taken place particularly to improve the infrastructure of the country. Despite the substantial openness since the inception of open-economic policies pursued since 1977, the Sri Lankan economy was able to withstand the fallout of the East Asian financial crisis in late 1990s². Investment did not show any marked deterioration owing to the relatively lower impact of the crisis on the economy. However, the factors that affect investments appear to have changed over the years with the gradual transformation of the economy from a predominantly agricultural economy towards a service-dominated one.

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1. Deputy Director, Economic Research Department, Central Bank of Sri Lanka. The views expressed in this paper are those of the author and are not those of the Central Bank of Sri Lanka. The author wishes to thank Dr. P.N. Weerasinghe, Chief Economist and Director of Economic Research, Central Bank of Sri Lanka, Mr. K.D.Ranasinghe and Mrs. S.Gunaratne, Additional Directors of the Economic Research Department of the Central Bank of Sri Lanka for their valuable comments and suggestions. The author also wishes to thank the research staff of The SEACEN Centre, namely, Dr. John Junggun Oh, Dr. Vincent Lim and Dr. Min B. Shrestha for their helpful comments at the research workshops.
 2. The maintenance of some capital controls, the low exposure to foreign short-term debt, enhanced surveillance of financial market activity and a rise in the short-term interest rates towards the end of 1997 helped Sri Lanka to maintain a reasonable degree of stability in the midst of a volatile and uncertain external environment during the East Asian financial crisis.

Sri Lanka has been receiving a considerable amount of FDI complementing the investment drive of the country with domestic private investment also playing a catalytic role. In the effort of improving investment, it is important to have a broader understanding of the behaviour and underlying factors that affect private investment for the purpose of facilitating future policy formulation and decision making.

This paper aims to identify the trends of private investment in Sri Lanka since 1978, its determinants and challenges with the possible policy options towards further enhancing private investment. Following this introduction, in Section 2, the trends in the major macroeconomic variables and investment flows in Sri Lanka are presented. In Section 3, the major policies related to FDI and domestic investment are highlighted. Sections 4 and 5 discusses the determinants of private investment in Sri Lanka, and identifies the issues and challenges regarding private investment, respectively. Finally, Section 6 concludes the study with some policy recommendations to promote private investment.

2. Trends of Key Economic Variables and Investment

2.1 Key Macroeconomic Indicators

Sri Lanka maintained an average economic growth rate of 4.4% during the post independence period (since 1948). During 1985-1997, the annual growth rate averaged at 4.5% (Table 1) and since 1998, it averaged at 5%. In particular, the economy grew at a moderate rate of 4.7% in 1998 compared to 6.3% recorded in 1997, in comparison to many Asian countries which recorded slower or negative growth rates during the same period.

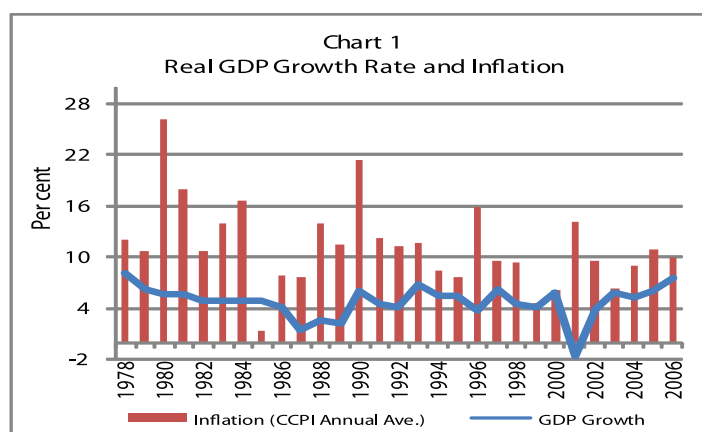


Table 1: Key Economic Indicators

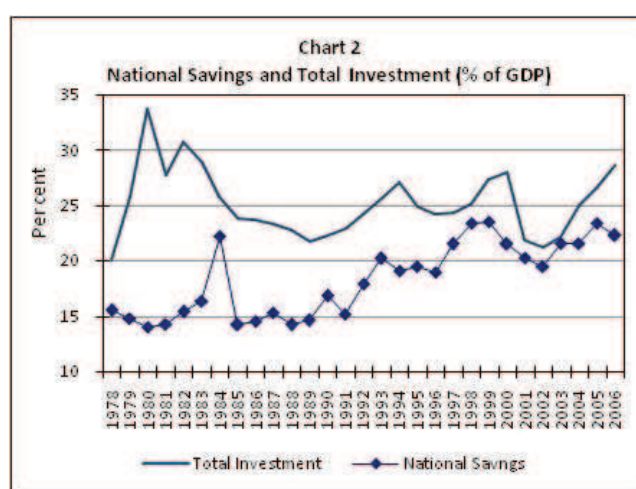
Item	Unit	1985-1997	1998-2007	1985-2007	1985	1997	1998	2000	2005	2006	2007
GDP Growth	%	4.5	5.0	4.7	5.0	6.3	4.7	6.0	6.2	7.7	6.8
Inflation (CCPI)	Annual Ave.	10.9	9.6	10.3	1.5	9.6	9.4	6.2	11.0	10.0	15.8
National Savings	% of GDP	17.1	22.0	19.2	14.2	21.5	23.4	21.5	23.4	22.3	23.3
Total Investment	% of GDP	24.0	25.4	24.6	23.8	24.4	25.1	28.1	26.8	28.0	27.9
Savings - Investment Gap	% of GDP	-6.9	-3.3	-5.4	-9.6	-2.9	-1.7	-6.6	-3.4	-5.7	-4.6
Overall Budget Balance	% of GDP	-10.6	-8.6	-9.8	-11.7	-7.9	-9.2	-9.9	-8.4	-8.0	-7.7
Current Account Balance	% of GDP	-5.5	-3.0	-4.4	-7.0	-2.6	-1.4	-6.4	-2.7	-5.3	-4.2
		1985	1990	1995	1996	1997	1998	2000	2005	2006	2007
Exchange Rate (Rs. Per US\$)	Annual Ave.	27.16	40.06	51.25	55.27	58.99	64.59	75.78	100.50	103.96	110.62
Exchange Rate (Rs. Per US\$)	End Year	27.41	40.24	54.05	56.71	61.29	67.78	80.06	102.12	107.71	108.72
Interest Rate (3M Tbill Rate)	End Year	11.50	17.41	19.26	17.45	9.97	12.01	17.77	10.10	12.76	21.30
CBSL Repo Rate	%	11.30	15.50	16.50	12.75	11.00	11.25	17.00	8.75	10.00	10.50
CBSL Reverse Repo Rate	%	11.50	20.50	16.78	15.93	11.67	15.00	20.00	10.25	11.50	12.00
All Share Price Index	Index	122.0	384.4	663.7	603.0	702.2	597.3	447.6	1,922.2	2,722.4	2,541.0
Milanka Price Index	Index	158.9	680.3	990.5	897.7	1,068.0	923.0	698.5	2,451.1	3,711.8	3,291.9

Source: Central Bank of Sri Lanka (CBSL).

However, in 2001, Sri Lanka recorded a negative growth of 1.5% due to exceptional conditions, including security concerns and the unsettled political environment in the domestic economy, particularly during the latter part of the year, coupled with adverse conditions in the external environment stemming from the September 11 incident in the United States and the subsequent slowdown of the global economy. Since then, the economic growth has recovered gradually and recorded growths of more than 6% during the last four consecutive years, a relatively higher growth compared to the historical average. This reflects the considerable resilience of the Sri Lankan economy in reaction to a series of domestic and external shocks, including the Tsunami disaster, and higher international oil and commodity prices. The economy diversified over the years and the contribution from agriculture has declined with the growing importance of the services sector³. The services sector is now the key driving factor of the economy largely as a result of the economic liberalisation measures and the emergence of new growth areas, such as port services, financial services, information technology and telecommunications. Meanwhile, Sri Lanka's inflation (annual average) was relatively high at an average rate of 10-11% during the period 1985-2007. Inflation exceeded this average rate in the recent years reflecting the impact of a number of factors including high international oil and commodity prices and domestic supply-side constraints.

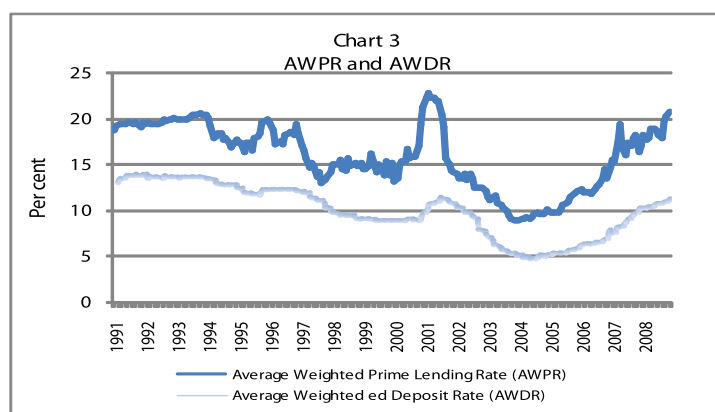
3. The services sector in the Sri Lankan economy contributes the largest share of the GDP of around 60%. The services sector has expanded over the years, fueled primarily by growth in telecommunications, transport, trading and financial services. The industry sector accounts for 28% of the GDP, with manufacturing as the largest industrial subsector (18% of GDP) and followed by the construction sector (6% of GDP). Meanwhile, the agriculture sector has gradually declined in relative importance in the Sri Lankan economy. Although it employs 31% of the working population, it accounts for only about 12% of the GDP.

Domestic savings was on average 14.1% of the GDP during the 1985-1997 period and increased gradually to 17.1% in the 1998-2007 period. National savings also averaged 17.1% of the GDP during the period 1985-97 and increased to an average of 22% during the subsequent period. Total investments averaged 24.6% of the GDP during 1985-2007. Consequently, the savings-investment gap, which on average was 6.9% of the GDP prior to 1997, lowered substantially to 3.3% during the subsequent decade. The lower level of savings was mainly due to the government dis-savings, as the government's revenue was not sufficient to meet the entire recurrent expenditure of the government.

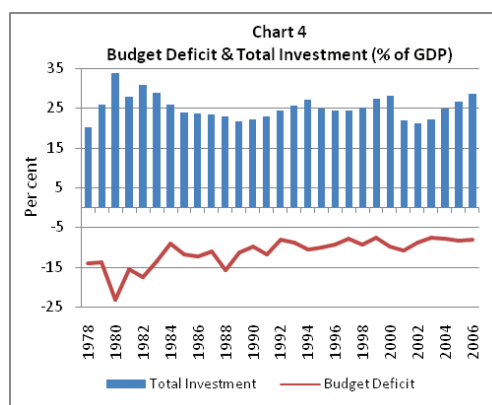


The Average Weighted Deposit Rate (AWDR), which is the weighted average of the interest rates on all outstanding interest deposits of commercial banks, declined gradually until end 1997 and remained relatively stable until 2000. A significant increase was seen in the average weighted prime lending rate (AWPR), particularly since the latter part of 2000, following the rising trend in the market interest rates. The increase in market interest rates during this period was mainly driven by higher public sector borrowings, decline in the rupee liquidity as a result of a significant deficit in the balance of payments and tightening of the monetary policy by the Central Bank of Sri Lanka (CBSL) with a view to containing the pressure on exchange rate. However, the AWPR declined from mid 2001 following the downward movement of market interest rates with the greater stability in the domestic foreign exchange and money markets, and reduced inflationary pressures. It started to increase again from early 2005, reflecting the general trend in the market interest rates, which experienced a rising trend as a result of the tight monetary policy measures implemented by

the CBSL in the wake of rising inflation and inflation expectations, and higher public sector credit demand. The Average Weighted Prime Lending Rate (AWPR), which is the average weighted lending rate charged by commercial banks on loans to their most creditworthy (prime) customers, also showed a similar trend.



The overall budget deficit increased significantly during the early 1980s, induced by the high public investment expenditure incurred by the government in infrastructure development projects. The gradual completion of those projects by late 1980s resulted in a decline in the budget deficit. The subsequent high budget deficit of about 9% of GDP during 1990s was mainly a result of the increased recurrent expenditure mainly as a result of high defense expenditure and expenditure on subsidies and transfers. The deficit during 2000s also averaged at 8.5%. However, it was mainly reflected in the increased capital expenditure, particularly during the more recent years. Accordingly, a considerable change in the structure of the expenditure budget was seen since 2005 where the total capital expenditure to GDP ratio was maintained at around 6% compared to the relatively lower level experienced in the 1990s.



Even though the external current account recorded an average deficit of 5.5% of the GDP during period 1985–1997, it has gradually declined since then and averaged to about 3%. On average, however, the current account deficit hovered around 4.4% of the GDP during this entire period. The relatively high current account deficit in the recent years (4.2% of the GDP in 2007) was mainly attributed to the high international oil and commodity prices. However, higher private remittances from Sri Lankans working abroad helped ease the country's Balance of Payments position, along with substantial Tsunami related fund inflows during the period 2005-2006.

The Sri Lankan rupee has been depreciating, on average, by around 5% against the US dollar. The rupee recorded a very high depreciation of 17.4% in 1989. After this peak, it depreciated by 14.1% in early 2001, the year in which Sri Lanka moved to a freely floating exchange rate regime from the managed float system hitherto followed. Since then, the exchange rate has been relatively less volatile. However, with the intensification of global financial crisis since September 2008, the exchange rate came under heavy pressure to depreciate, particularly during the latter part of 2008.

As for the performance of the Colombo Stock Exchange (CSE), the two price indices, which measure the market developments, the All Share Price Index and Sensitive Price Index/Milanka Price Index, indicate a strong performance particularly since 1990, except during 1995- 2000 period where the two indices declined gradually. The better performance was mainly due to the higher economic growth and the resultant higher corporate sector profitability, increased activities of domestic retail investors in the market and the strategic buying by the foreign investors in certain years.

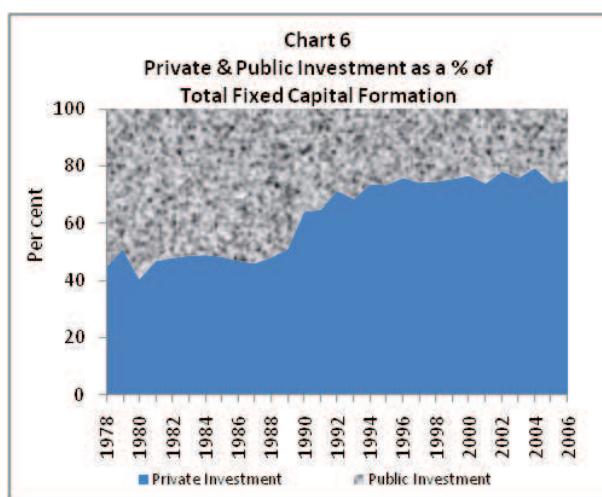
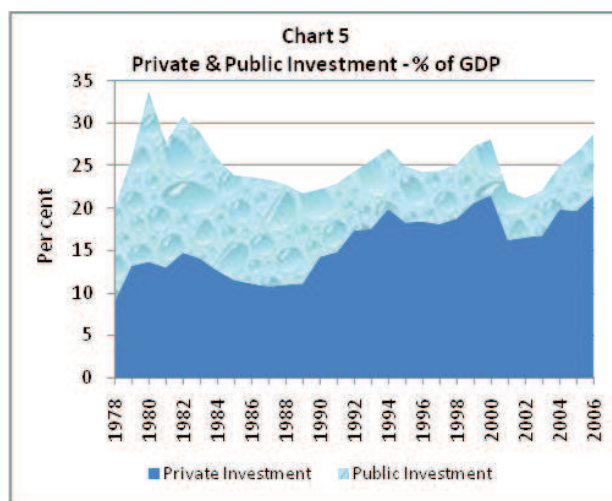
2.2 Trends in Total Investment

Over the last 30 years, the total investment (Gross Domestic Capital Formation) in Sri Lanka was characterised by considerable swings. A significant increase was seen in total investments in early 1980s supported by the increase in public investment, which included the implementation of a number of infrastructure development projects soon after the liberalisation of the economy in 1977⁴. During the first four years of liberalisation, the total investments averaged at 27% of the GDP with the highest investment ratio of 33.8% in 1980⁵. This

4. In this paper, public investment refers to investment by the government, government institutions and public corporations.

5. The high increase was due to the implementation of three lead projects, viz., the Accelerated Mahaweli Development Programme, Export Processing Zones and the Housing and Urban Development Programme introduced in 1978.

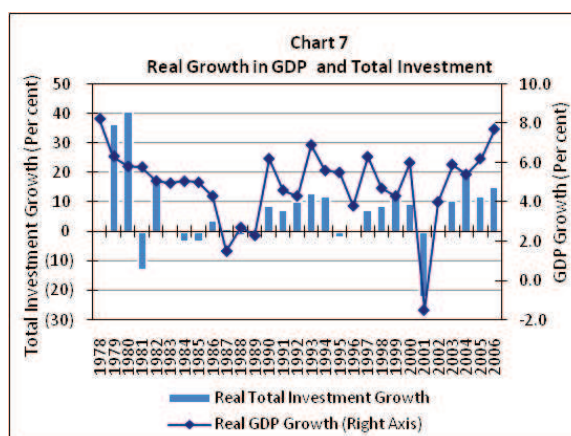
was supported by the higher FDI inflows during this period⁶. With the completion of the lead projects, the total investment declined since 1982. The decline was prominent since 1983 mainly as a result of the escalation of the internal conflict and the unsettled political situation during which the economic activities were severely affected. This resulted in the decline in total investment from 23.8% of the GDP in 1985 to 21.7% in 1989.



6. Given the relatively lower level of domestic savings, the savings-investment gap was largely financed through higher foreign financing mainly through foreign concessional loans and grants.

A gradual reversal was experienced in the declining trend of total investment since early 1990s with the improvements in the political situation supported by structural reforms, which helped rebuild the confidence of the private sector. The increase in total investment was mainly supported by private investment, which was increased gradually and accounted for 76% of the total investment in 2000 compared to 44% in 1978 and total investment reached 28% of the GDP in 2000. Meanwhile, no significant decline was experienced in investment during the Asian Financial crisis period.

However, adverse events took place in the domestic and international fronts in 2001, the year in which the economy recorded a negative growth, severely affecting the level of investment in Sri Lanka, particularly the private sector investment. This resulted in a significant decline in total investment to 21.9% of the GDP, a sudden drop of about 6% of GDP within just one year. However, with the improvements in the economic environment and the restoration of political stability, investment rebounded gradually and reached 28.7% of the GDP by 2006, supported by increases in both public and private investments.



2.3 Foreign Direct Investment

FDI inflows to Sri Lanka indicate a gradual increase as a result of investment favourable policies adopted by successive governments. The promotion of export-oriented FDI in manufacturing has been on the national economic policy agenda since the mid-1960s. The favorable investment climate created for private investment after the liberalisation policies adopted since 1977 and the increased openness of the economy provided a new boost to FDI inflows, particularly in the early 1980s. FDI played an important role in developing many industries particularly the garments industry. The FDI also brought in a number of positive

benefits including technology, new management practices, etc. into the country, which subsequently spilled over to the domestic industries as well. The annual FDI was relatively low before 1990s. Nevertheless, the privatisation programme, implemented in 1990s under the IMF-supported structural adjustment programmes, had a positive impact in enhancing FDI inflows. The annual value of FDI to Sri Lanka increased since the beginning of 1990s when compared to 1980s.

Table 2: Foreign Direct Investment: 1985-2007 (US\$ Million)

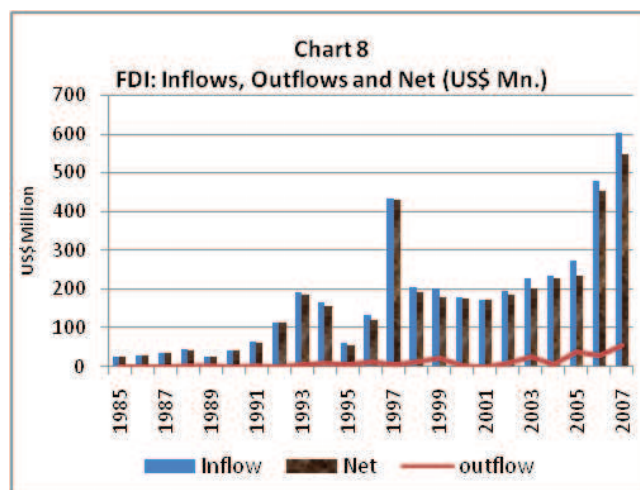
Item	1985-1997 ^{a/}	1998-2007 ^{a/}	1985-2007 ^{a/}	2005	2006	2007 ^(b)
Inflows	105.4	277.3	180.1	272.0	480.0	603.4
Outflows	4.2	20.5	11.3	38.0	29.0	55.0
Net	101.2	256.8	168.9	234.0	451.0	548.4

^{a/} Period average.

Sources: Board of Investment (BOI)

^{b/} Excluding foreign loans of BOI companies.

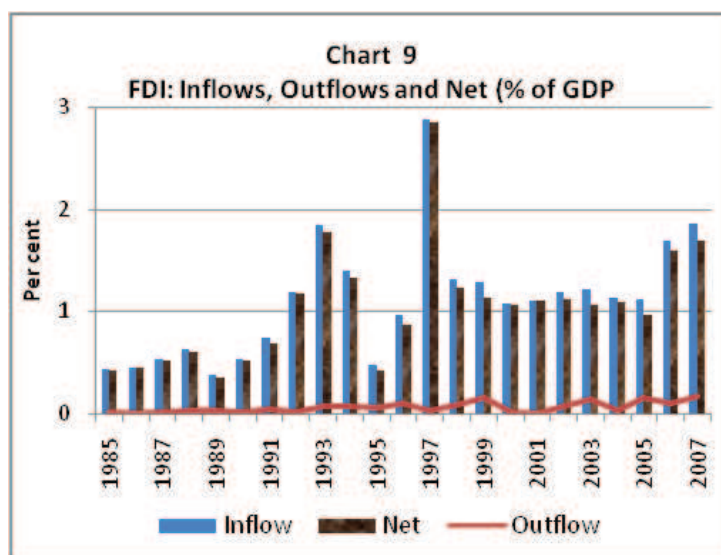
Central Bank of Sri Lanka



The FDI increased considerably in 1997 owing to higher receipt of foreign privatisation proceeds⁷. Sri Lanka was able to attract relatively higher amount of FDI (US\$193 million) in 1998 as well despite the Asian financial crisis. Since then, this trend continued until 2001 where there was a slowdown in FDI inflows due to the set-back in economic activities. However, with the increased stability in both political and economic fronts, FDI rebounded and continued thereafter. In the more recent years, FDI to Sri Lanka has increased considerably reaching a record level of US\$603 million in 2007 (excluding loans obtained by BOI

7. The sale of 35% of Sri Lanka Telecom Limited to Nippon Telegraph and Telephone Corporation of Japan for US\$225 million was among the major privatisation deals took place in 1997.

companies). Meanwhile, the annual outflow of FDI during the period 1985-2007 averaged at US\$ 11.3 million. The restrictions on capital transactions could be cited as a major reason for lower FDI outflows of the country. However, in the recent years, investment by local companies in overseas is encouraged by the government on a case-by-case basis.



2.4 Trends in Private Investment

Private investment accounts for about 80% of the total investment in Sri Lanka. Private investment was predominantly in the construction sector, which accounted for 37% of the total fixed capital formation in 1985 and subsequently increased to 52% by 2006. Domestic private investment in plant and machinery has remained almost at around 19% of the total. Meanwhile, the real private investment increased in many years, with the exception of the year 2001 which recorded a notable decline⁸.

8. Real private investment has been arrived at deflating the nominal private investment by GDP deflator (1978=100). Real public investment has also been obtained by using the same deflator.

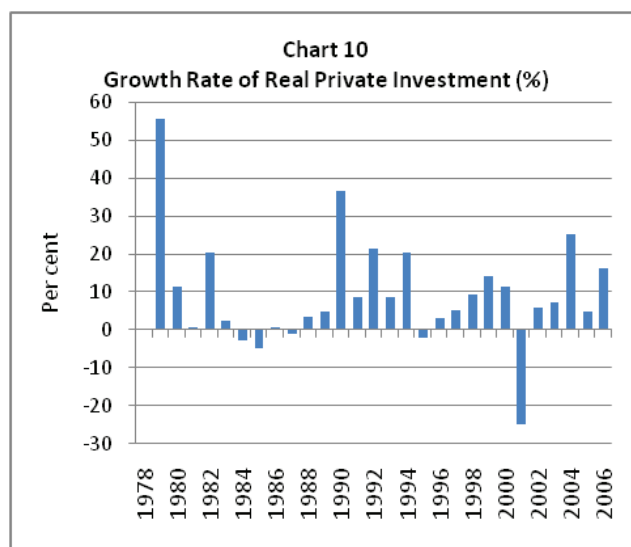


Table 3: Gross Domestic Capital Formation (% of GDP)^{i/}

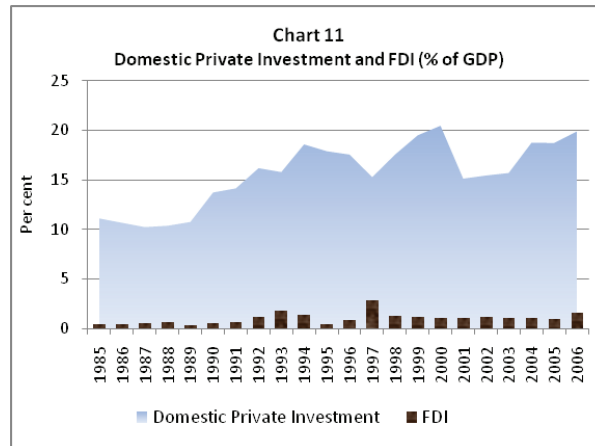
Item	1970	1980	1985	1990	1997	1998	1999	2000	2001	2005	2006
A. Gross Domestic Fixed Capital Formation	17.3	31.3	23.7	22.3	24.4	25.1	27.3	28.0	22.0	26.5	28.7
1. Private Sector and Public Corporations	13.1	24.3	18.9	18.1	21.0	21.8	24.1	24.8	19.0	22.3	24.8
1.1 Planting, replanting and land development	0.7	0.4	0.4	0.4	0.1	...	...	...	...	...	...
1.2 Building and other construction	7.3	9.4	8.8	9.3	11.2	11.4	11.5	11.2	11.5	13.2	14.9
1.3 Plant and machinery	2.4	5.8	5.0	4.0	6.1	6.0	5.4	6.2	5.1	4.9	5.3
1.5 Transport equipment	1.8	6.8	2.3	1.7	2.9	3.4	6.3	6.5	1.7	2.8	2.8
1.5 Other capital goods	1.0	1.8	2.3	2.7	0.8	0.9	0.8	0.9	0.7	1.4	1.8
2. Government and Public Enterprises	4.2	7.1	4.8	4.2	3.4	3.3	3.2	3.3	3.0	4.2	3.8
B. Changes in Stocks	1.7	2.4	0.1	0.3	...	...	...	...	...	...	...
1. Private Sector and public corporation	0.3	1.5	0.0	...	...	...	...	...	...	...	...
2. Government and public enterprises	1.4	1.0	0.1	0.3	...	...	...	...	...	...	...
C. Gross Domestic Capital Formation (A+B)	18.9	33.8	23.8	22.6	24.4	25.1	27.3	28.0	22.0	26.5	28.7
1. Private	10.7	13.7	11.5	14.4	18.1	18.8	20.6	21.5	16.3	19.7	21.5
2. Government, Public Enterprises and Public Corporations	8.2	20.1	12.3	8.2	6.3	6.4	6.7	6.5	5.7	6.9	7.2

Note: '...' denotes very small number.

Source: Central Bank of Sri Lanka.

^{i/} Based on the GDP estimates compiled by the Central Bank of Sri Lanka. With effect from 2007, GDP estimates are compiled by the Department of Census and Statistics. Hence, the data may differ from the data in Table 1.

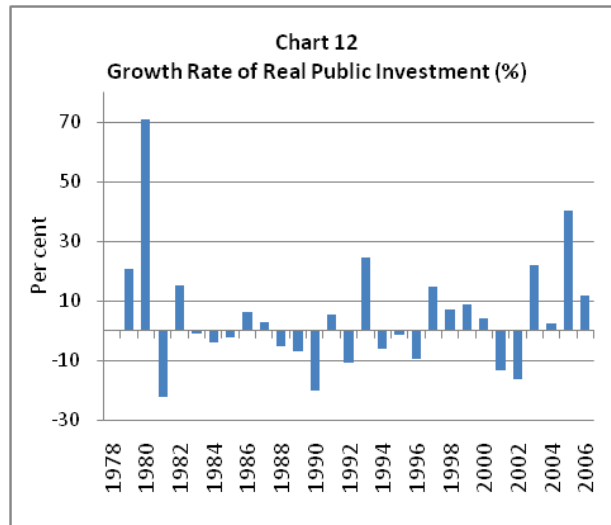
Although FDI was given prominence in the overall economic policy strategy, about 96% of the private investment came from the other sources, mainly by the domestic private sector, in the mid-1980s. However, with the increase in FDI, this share declined gradually to around 93% by mid-2000.



With the liberalisation policies introduced in 1977, private sector investment responded positively and increased gradually by increasing investments to about 12% of the GDP. The investment performance in the 1980s was adversely affected by the unfavourable business environment created by the internal conflict in 1983 and the prevailing political issues in the country, particularly during the late 1980s. Domestic private investment commenced to increase since 1990 and continued to trend upward thereafter. However, a marked deterioration was observed in 2001 mainly due to the slowdown in economic activities, weak business confidence, high interest rates, and the prevailing political uncertainty in the country. Since then, a gradual recovery was experienced and private investment reached 21.5% of the GDP in 2006 with the strengthened business confidence supported by political stability. The improved external and domestic demand, which resulted in the high capacity utilization, also helped this increase.

2.5 Trends in Public Investment

Meanwhile, the public investment, which was relatively high until the end of 1980s mainly due to the implementation of key infrastructure development projects, recorded a gradual decline over the years since then. Public investment, in real terms, increased significantly by about 70% in 1980. Since then it increased at varying rates recording negative real growth in many years. However, since 1997, the real growth remained positive except during 2001 and 2002. A significant increase was recorded in the real public investment in the recent years with the enhanced investments by the public sector on infrastructure development, including post-Tsunami rehabilitation and reconstruction activities.



3. Major Policies related to FDI and Domestic Investment

3.1 General Economic Policy Developments

The economic policy reforms introduced in 1977, shifting to an outward-looking strategy, constitute a significant landmark in the country's efforts to enhance private investment. The main objective of this policy shift was to increase exports to enhance economic activities and generate income as an alternative to the inward-looking economic policies hitherto practiced through the establishment of outward-oriented industries, harnessing of private foreign capital to supplement domestic resource flows; and diversification of the sources of foreign exchange earnings. The private sector was expected to play an increasingly important role in relation to this policy strategy in contrast to the hitherto implemented government led protectionist policies. Actions were also taken after 1977 to promote both public and private investment with a view of stimulating private sector economic activities.

At the initial stage of the reform process during the period 1977-79, the emphasis was placed on the liberalisation of foreign trade by the gradual elimination of quantitative restrictions, including import licenses and quotas. In order to reduce the protection levels and encourage exports, the tariff structure was revised with reduced tariff levels on many items. As a result, the level of tariff protection given to local industries was reduced in order to make them competitive. Furthermore, the restrictions on the importation of raw materials and machinery and equipment were reduced gradually. The tariff structure was

modified from time to time in order to facilitate the promotion of foreign trade and with the objective of reducing import duties to improve economic activities to make industries more competitive. The reforms introduced in the trade policy were initially aimed at promoting exports in manufacturing, especially textiles and clothing.

Sri Lanka also introduced a managed floating exchange rate system in 1977 by unifying the dual exchange rate system hitherto followed, under the Foreign Exchange Entitlement Certificate Scheme (FEECS)⁹. Under this system, the exchange rate was largely determined on the basis of demand and supply conditions in the market. The restrictions on the current international transactions were also removed gradually. With the introduction of these policies, price controls and rationing as a key policy device in the pricing policy was abandoned in an environment where the competition in the importation and distribution was enhanced. Meanwhile, the flexible exchange rate regime, which is in place since 2001, was introduced mainly to maintain the international competitiveness of the country.

In addition, the privatisation of state-owned enterprises was also introduced during the mid-1980s with a view of improving the efficiency and management of the public enterprises, promoting competitiveness, attracting foreign investment and downsizing the public sector in the economy and engaging greater private sector participation. The privatisation programme was implemented at a rapid pace after 1989 with the second wave of liberalisation and structural adjustment policies¹⁰. Particular emphasis was also placed on the complementarity of trade and FDI policies in promoting private foreign investments, particularly in the export-oriented manufacturing sector by offering various incentives, minimising administrative problems and delays. Under these reforms, restrictions on foreign investment were reduced while a new incentive regime for export-oriented foreign investment was introduced.

The *Industrial Policy Statement*, which was presented by the government in 1987, included an overall industrial strategy which provided a framework within which the industrial development and expansion was based on. The new

9. According to the dual exchange rate system operated under FEECS, an 'official' exchange rate was applied on essential imports and non-traditional exports while a 'higher' exchange rate was applied on other exports and imports. The objectives of this policy included the diversification of exports and compression of imports.

10. During the first stage of privatisation, poorly performing industrial enterprises were privatised and during second stage, profit making enterprises were transferred to the private sector. The third stage, commenced after 1994, involved in privatising large scale public enterprises.

framework incorporated measures in a number of areas, including the manufacturing sector and protection, providing for assistance to import-competing industries, assistance to export industries, special incentives, the role of public industrial enterprises, industrial finance, foreign investment, science and technology, research and development and labour practices and legislation, land and minerals and infrastructure. The subsequent developments in the industrial policy, which was conducive for private investment, were mainly based on this policy framework.

The decentralisation of industries was encouraged since 1990 with the provision of various specific incentives to locate industries in the remote areas¹¹. In 1995, the government introduced a new industrialisation strategy for Sri Lanka. The objectives in this strategy included: (1) expansion, diversification and upgrading of the industrial base; (2) efficient management of physical and manpower resources; (3) employment and income generation in both rural and urban sectors; (4) export orientation; and (5) regional industrialisation. The government, in 1996, also announced an incentive package which included various tax incentives and other concessions. A ‘Productivity Decade: 1997-2006’ was also announced to improve the productivity in the industrial sector.

Meanwhile, the export duties, a major source of government revenue, were abolished in 1998 with a view of lowering the factor costs of production of export-oriented producers, thus raising competitiveness in the international market. Various programmes in assisting export-oriented Small and Medium Enterprises (SMEs) were also introduced by the government to expand their production and promote entrepreneurship. The government also provided various credit guarantees, particularly to assist SMEs, which do not have access to credit facilities from the normal channels. Various other measures, such as vocational training, were also provided with a view of strengthening their performance.

In order to complement the above measures, reforms introduced in the financial sector after 1977 were directed towards supporting economic activities by the private sector. In particular, the commercial banking system underwent significant changes. Accordingly, the establishment of branches of foreign commercial banks was encouraged and establishment of Foreign Currency Banking Units (FCBUs) by all banks was permitted. In addition, policies were also geared towards introducing other financial institutions, such as long-term

11. The Regional Industrial Park Programme was one such programme introduced with a view of regionalising industries.

lending institutions, insurance firms, deposit-taking institutions, contractual saving institutions and other financial service institutions, including merchant banks, leasing companies, venture capital companies and money brokers, of which many of them were established by the private sector. Meanwhile, the activities of the Colombo Stock Exchange (CSE), which is the only authorised market for securities transactions in Sri Lanka, was strengthened by liberalising stock market investments, provision of fiscal incentives, opening of the market for foreign investors and introduction of modern technology. This, in turn, boosted the domestic enterprises in raising funds for their investment purposes.

The monetary policy framework of the country was re-aligned to meet the challenges emanating from the new economic policies introduced after 1977. The gradual elimination of direct controls was introduced in fulfilling this need while relying more on market-based instruments in creating a conducive environment for efficient allocation of resources. In line with this, among other things, interest rates were allowed to move freely, depending on the demand and supply conditions in the market, so that the real interest rate will also be determined based on the market conditions. Some major changes were introduced to the Monetary Law Act (MLA) of the country to enable the CBSL to deal more effectively with the economic structure of the country and its needs. Accordingly, the core objective of the CBSL was designated as ‘economic and price stability’ as the price stability depends crucially on stable macroeconomic conditions.

Meanwhile, the need for improving the economic infrastructure facilities in the country has been a longstanding issue in which successive governments have taken various measures to address it. As a result, some areas, such as the telecommunication and ports infrastructure, have reflected a satisfactory improvement over the years. Nevertheless, other facilities, such as roads, highways and passenger transportation, still require further improvements. Hence, the government made a renewed effort in the recent past to address this issue and thereby create conducive environment to stimulate economic activities.

3.2 Current Account and Capital Account Liberalisation

Since independence until 1994, Sri Lanka imposed controls in some areas in current account transactions. However, when the Article VIII status with IMF was accepted in 1994, its current account was fully liberalised and all foreign exchange restrictions on current account transactions were removed. Since then, there were neither surrender requirement for export proceeds nor

restrictions on current payments and the rupee became fully convertible for all current transactions. Multiple currency practices were abandoned and restrictions on repatriation of earnings withdrawn. Sri Lanka has been pursuing a cautious approach moving towards capital account liberalisation and the capital account presently is only partially liberalised, though the regulations related to several transactions were liberalised recently.

3.3 Specific Policies Related to FDI

At the inception of the open-economic policies, a series of measures were introduced to promote foreign investment. Accordingly, EPZs were established in 1978. The Board of Investment (BOI) (which was set up to replace the Greater Colombo Economic Commission), an autonomous statutory body, acts as a facilitator for investment. The BOI is structured to provide most of the required services for foreign investors has been structured under one roof and is vested with a wide range of powers of tax relief and administrative discretion for larger or priority investors. There are no restrictions on the repatriation of capital, profits and dividends. All enterprises under Section 17 of the BOI Act are permitted to borrow from the Offshore Banking Units (OBUs) of commercial banks¹². In many sectors of the economy, the foreign equity participation of up to 100% is allowed. Generally, the approval for most of the foreign investment projects is granted without any delay while the investment in certain restricted areas is subjected to screening.

Sri Lanka offers a series of incentives for foreign investors through the BOI Act. The main incentives include the importation of the capital equipment, raw materials or other intermediate products free of taxes and duties, subject to differing requirements with respect to minimum investment. The concessionary corporate income tax rates, exemption of tax on dividends to non-resident shareholders, exemption of income tax on salaries and other payments made to foreign employees are also included in the incentives given to foreign investors. A new series of incentives were introduced in the recent past to attract more investors to develop regions other than the Western Province, which to date has received the largest share of FDI.

3.4 Policies Implemented to Promote Domestic Investment

The general economic policy pursued since 1977 has provided a conducive environment for private investment. In addition, successive governments have granted many incentives to encourage and stimulate private sector investment

12. OBUs were formerly known as Foreign Currency Banking Units (FCBUs).

in the country. As far as incentives are concerned, any local or foreign investor who does not qualify for incentives granted under Section 17 of the BOI Act, is provided with various incentives under the normal law of the country. Section 16 of the BOI Act also specifies a series of incentives to such enterprises.

Under the above mentioned legal framework, Sri Lanka offers a plethora of tax incentives for investment through both the normal tax and customs legislation. In the context of domestic investment, tax incentives include tax holidays, concessionary corporate income tax rates, generous depreciation allowances, exemption of dividends from taxation and import and excise duty exemptions. The tax incentives provided under the Inland Revenue Act cover a number of areas: the manufacture and export of goods, particularly non-traditional exports; agriculture, fisheries and agro processing; industrial tools and machinery; small and large scale infrastructure projects; the rehabilitation of under-performing industries; and companies engaged in research and development. Depending on the sector, the incentives usually take the form of tax holidays of 2-12 years. On the expiry of the tax holidays, lower corporate tax rates are applied for specified periods.

4. Determinants of Private Investment in Sri Lanka

Considering the factors that affect private investment, the investment function in the following section is estimated using Engle Granger Two-Step Error Correction Mechanism (ECM) to analyse the behavior of private investment in Sri Lanka.

4.1 Empirical Study: Determinants of Private Investment in Sri Lanka

4.1.1 Model and Methodology

Among the factors that would affect the investment, the following are identified as the determinants that have an impact on private investment in Sri Lanka. Hence, the investment function for the empirical analysis is specified as follows:

$$RPI = f [RGDP, RDC, RIR, RER, RGI, OPEN, SEC] \dots\dots\dots (1)$$

Where:

- RPI = Real private investment
- RGDP = Real Gross Domestic Product
- RDC = Real domestic credit to the private sector

RIR = Real interest rate
 RER = Real effective exchange rate
 RGI = Real public investment
 OPEN = Openness of the economy
 SEC = Security situation

The equation (1) can also be written as;

$$RPI = \alpha + \beta_1 RGDP + \beta_2 RDC + \beta_3 RIR + \beta_4 RER + \beta_5 RGI + \beta_6 OPEN + \beta_7 SEC + u_t \quad (2)$$

After taking logarithm of all the variables, except real interest rates, equation (3) could be obtained.

$$\ln(rpi) = \alpha + \beta_1 \ln(rgdp) + \beta_2 \ln(rdc) + \beta_3 \ln(rir) + \beta_4 \ln(rer) + \beta_5 \ln(rgi) + \beta_6 \ln(open) + \beta_7 \ln(sec) + u_t \quad (3)$$

4.1.2 The Determinants

This section discusses the factors that have been identified in equation (2) as determinants of private investment in Sri Lanka along with the expected signs of the coefficients in equation (3).

A. Real GDP: ($\beta_1 RGDP > 0$)

The real GDP plays an important role in private investment. The growth and the level of the GDP provide an indication about the investment opportunities open to the private sector. The notion here is that when the real GDP is growing at a higher rate, the private sector will flourish due to the opportunities created in the economy. If the economy exhibits an increasing real growth, the potential increase in profits will drive investors to make more investments. The investors will be able to generate more funds through the higher consumption demand as well as higher savings, thereby making more investments. Accordingly, the (increasing) real GDP, and increasing per capita income for that matter, is expected to have a positive impact on real private investment with a positive coefficient.

B. Real Domestic Credit to Private Sector: ($\beta_2 RDC > 0$)

In Sri Lanka, the private firms are largely dependent on bank credit as a source of financing. The gradual improvement experienced in the financial system in the country has created various avenues for meeting the financing needs of

the private sector. Therefore, the higher availability of credit to the private sector is expected to have a positive impact on investment.

C. Real Interest Rate: (β RIR < 0)

3

The interest rate is the user cost of capital. In general, the level of real interest rate can affect the private sector investment mainly in two ways. First, if the real interest rates are high, it raises the real user cost of capital and affects the investor's decisions, thereby having a dampening impact on private investment. Second, if the financial market is not developed adequately and the access to foreign financing is not sufficient to finance private investment projects, then private investment will be constrained largely by domestic savings. In such a situation, higher real interest rate will promote domestic savings and thereby enhancing the available funds for private investment. In the Sri Lankan context, a negative relationship is expected between real interest rates and real private investment assuming the former relationship would prevail.

D. Real Exchange Rate: (β RER?)

4

As Sri Lanka pursues open-market policies and the economy is considerably open to the rest of the world, the real exchange rate plays an important role in determining private investment, particularly in the area of the tradable sector. This is more relevant to the industries, which are dependent on imported capital and intermediate imported inputs. Therefore, the direction of real exchange rate could have a considerable impact on the level of private investment. Accordingly, the depreciation of the exchange rate increases the return on investment production of tradable goods while the appreciation would reduce the return on investment thereby lowering the private investment in export-oriented and import-competing areas. Based on this proposition, the sign of the real effective exchange rate is not expected before hand and it is expected to be derived from the model.

E. Public Investment: (β RGI > 0)

5

Private investment would flourish in a supportive environment of cost reductions in power, transport and communications, which are often provided through public investment. Generally, these two are seen as having a complementary impact on one another. However, it is likely that public investment may crowd out private investment if the additional investment is financed by running a budget deficit and borrowings from the domestic sector, which reduces the available funds for private sector investment. It could also lead to an increase

in the domestic market interest rates. In addition, the burden of tax could also be increased if a significant part of the additional requirement is financed through taxation. However, the Sri Lankan experience reveals that a significant part of the public investment is financed through foreign financing, which are received at concessionary terms and conditions. Therefore, the relationship between total private investment and total public sector investment is expected to be positive.

F. Openness to Trade: ($\beta_{OPEN} > 0$)

6

Trade openness generally has a positive influence on the export-oriented industries. Sri Lanka, being an open economy with greater emphasis on export promotion, trade openness could be an important determinant of private investment, including FDI. In general, trade openness increases competition while enabling investors to get access to the various overseas markets. As exports play a key role in the Sri Lankan economy, trade openness also plays a significant role in investor decisions. Therefore, trade openness is expected to have a positive impact on private investment.

G. Security Situation: ($\beta_{SEC} < 0$)

7

Sri Lanka is having an internal conflict, which has escalated from time to time, particularly since 1983. It is widely accepted that the conflict has affected the economic activities of the country in many ways, including the investment decisions of the private sector. In particular, it is said that the security situation has a significant negative impact on foreign investment and tourism and the uncertainty regarding the security situation has discouraged private investment, both domestic and foreign. The conflict has incurred an enormous drain in terms of both human and material resources while suppressing the growth potential of the economy. Nevertheless, it is apparent that the investment activities have continued albeit at below the desired level. Hence, it could be argued that, in the absence of internal conflict in Sri Lanka, the private investment would have exceeded the levels experienced over the years. In order to test this phenomenon, this variable was included and the deterioration of the security situation is expected to have a negative impact on the private investment.

4.1.3 Sources of Data and Methods of Derivation

The equation (3) is estimated using the annual data for 1978-2006. All the real data are derived by using GDP Deflator calculated by the CBSL. The GDP figures, which are compiled by CBSL and published in its Annual Reports, are

used in this study¹³. In line with the above reasons, the data related to private and public investment are also obtained from the CBSL Annual Reports. Private investment is measured by the gross fixed private capital formation while the public investment is measured by the gross fixed government capital formation, including government institutions and public corporations. The source for domestic credit to the private sector is the Monetary Survey, which is published by the CBSL in its Annual Reports. The real interest rate is based on the weighted average yield rate of the Treasury bills and is obtained by subtracting annual inflation as measured by the Colombo Consumer's Price Index (CCPI)¹⁴. The real exchange rate (RER) refers to the real effective exchange rate index, which is prepared using the 24 currency basket index and published by the CBSL. The data for various base years is adjusted for the base year 2006 with a view of obtaining a consistent data series throughout the sample period. In order to calculate trade openness, the import and export data is obtained from the CBSL Annual Reports. The trade openness is proxied by the ratio of total merchandise trade (import + export) to GDP¹⁵. The security situation is proxied by the total defence expenditure, including the expenditure on public order and safety, as a percent of GDP during the sample period and is obtained from the Ministry of Finance and Planning.

4.1.4 Estimation Procedure

The time series properties of the variables are tested before the estimation of Equation (3). Then, the study applies cointegration and ECM techniques via the Engle-Granger Two-Step method to deal with the time series properties of the data¹⁶. The cointegration technique is used in order to obtain the possible long-run relationship between the private investment and the explanatory variables.

13. It is noteworthy that the Department of Census and Statistics (DCS) is the official agency responsible for the compilation and dissemination of the National Income Accounts in Sri Lanka. Nevertheless, in the past, both the DCS and CBSL had been compiling and disseminating national income statistics. In order to avoid this duplication of effort, the CBSL decided to use the statistics compiled by the DCS commencing from 2007. However, as the historical data compiled on the basis of expenditure approach is not available, this study uses the data published by the CBSL up to 2006.

14. It is noteworthy that as the base year for this CCPI has been 1952, the DCS has replaced it with a new CCPI. The base year of the new CCPI is 2002. However, given the unavailability of the historical data for this new index before 2002, the data related to the previous index is used in this study.

15. The trade openness was calculated as: $OPEN = [(Exports + Imports) / GDP] \times 100$.

16. There is a dynamic error correction representation of the data if cointegrating relationships exist among a set of $I(1)$ variables. Under these circumstances, an ECM can be constructed to take the short-run dynamics of all variables in the cointegrating regression into account.

The short-run dynamics are explored through the ECM, as it allows the capturing of possible lagged response of private investment in Sri Lanka. The limitations that would be imposed in the econometric procedure arising from various problems including data limitations and constraints posed by the limited number of observations are recognised¹⁷.

4.1.5 Empirical Results

A. Unit Root Test Results

The ADF results to check the null hypothesis of the presence of a unit root in the variables are given in Table 4. According to these results, all the variables are I(1) confirming the presence of a unit root. Therefore, these variables are non stationary, which would yield a spurious result unless these properties are taken into consideration in the estimation of equation (3). The presence of I(1) variables in the equation therefore facilitates the estimation of an ECM for the entire set of variables.

Table 4: ADF Unit Root Test Results

Variable	Level				1 st Difference			
	Includes	t-Statistic	Critical Value at 1%	Order of Integration	Includes	t-Statistic	Critical Value at 1%	Order of Integration
lnrpi	C	-1.28	-3.69	I(1)	C	-5.71*	-3.70	I(0)
lnrgdp	C	-0.98	-3.69	I(1)	C	-4.13*	-3.70	I(0)
lnrdc	C	-1.39	-3.69	I(1)	C	-4.06*	-3.70	I(0)
rir	C & T	-3.55	-4.32	I(1)	C & T	-7.94*	-4.34	I(0)
lnrer	C	-2.03	-3.69	I(1)	C	-5.03*	-3.70	I(0)
lnrgi	C	-2.74	-3.69	I(1)	C	-5.68*	-3.70	I(0)
lnopen	C	-1.63	-3.69	I(1)	C	-5.29*	-3.70	I(0)
lnsec	C	-3.21	-3.69	I(1)	C	-5.77*	-3.70	I(0)

Notes: C = Constant, T = Trend

* denotes that estimates are significant at 1% level.

B. Long Run Cointegration Equation of Private Investment

Given the variables are non stationary, it is necessary to examine the cointegration of these variables in which the results are given in Table 5. As the next step, the stationarity of the error term in the cointegration equation also has to be checked. The results related to this in Table 6 indicate that the presence of a unit root in the error term can be rejected at 1% level. This implies that

17. The statistical package used in the study is Econometric views (E-views) version 5.0.

there exists a stable long run cointegrating relationship among the variables in equation (3).

The results in Table 5 also reveal that the enhancement of the long term private investment in Sri Lanka is mostly stimulated by business opportunities created by the increasing economic activities in the country and the openness of the economy. The real interest rate has a negative impact on investment and is significant. The appreciation of the REER has a significant negative relationship with private investment. The credit to the private sector has a positive relationship although it is not significant. Meanwhile, public investment is found to be negatively related with private investment, pointing to the fact that, in the long run, if the public sector increases its investment through domestic borrowings, it would crowd out the private investment. Meanwhile, the security situation has a negative and significant impact on the private investment, confirming the fact that the country's internal conflict has resulted in the loss of important investment opportunities. In summary, the study highlights that the improvement in the macroeconomic environment will be one of the key requirements towards fostering greater investor confidence and thereby promoting investment with complementary developments in the other key areas that affect private investment.

Table 5: Long Run Cointegration Equation of Private Investment

Dependent Variable: lnRPI

Variable	Coefficient	Std. Error	t-Statistic	Probability
Constant	-5.065	2.362	-2.144	0.047**
lnrgdp	1.308	0.411	3.179	0.006*
lnrdc(-1)	0.098	0.307	0.318	0.754
rir(-2)	-0.008	0.003	-2.785	0.013**
lnrer(-1)	-0.514	0.248	-2.071	0.054***
lnrgi(-2)	-0.445	0.148	-3.008	0.008*
lnopen	1.246	0.204	6.105	0.000*
lnsec(-4)	-0.106	0.058	-1.818	0.087***

Adjusted R² = 0.98

Note: *, ** and *** denotes that estimates are significant at 1%, 5% and 10% level, respectively.

Table 6: ADF Unit Root Test Results of the Error Term

Variable	t-Statistic	Critical Value at 1%	Order of Integration
Error Term	-4.03	-3.75*	I(0)

Note: * denotes that estimate is significant at 1% level.

C. Short Run Dynamics of Private Investment

In order to examine the short-run dynamics of the private investment, the ECM model given in equation (4) is estimated using general-to-specific modeling method with only the significant variables in the long run cointegration equation and the results are given in Table 7.

$$\Delta \ln(\text{rpi}_t) = \alpha + \beta_1 \text{EC}_{t-1} + \beta_2 \Delta \ln(\text{rgdp}_{t-1}) + \beta_3 \Delta \text{rir}_{t-1} + \beta_4 \Delta \ln(\text{rer}_{t-1}) + \beta_5 \Delta \ln(\text{rgi}_{t-1}) + \beta_6 \Delta \ln(\text{open}_{t-1}) + \beta_7 \Delta \ln(\text{sec}_{t-1}) + u_t \quad (4)$$

Table 7: Short Run Dynamics of Private Investment

Dependent Variable: $\Delta \ln \text{RPI}$				
Variable	Coefficient	Std. Error	t-Statistic	Probability
Constant	-0.065	0.041	-1.563	0.138
EC(-1)	-0.690	0.233	-2.965	0.009*
$\Delta(\ln \text{rgdp})$	2.812	0.811	3.469	0.003*
$\Delta(\text{rir}(-2))$	-0.006	0.002	-2.640	0.018**
$\Delta(\ln \text{rer}(-1))$	-0.637	0.235	-2.713	0.015**
$\Delta(\ln \text{rgi}(-2))$	-0.408	0.113	-3.611	0.002*
$\Delta(\ln \text{open})$	0.977	0.218	4.477	0.001*
$\Delta(\ln \text{sec}(-4))$	-0.120	0.061	-1.945	0.070***

Adjusted $R^2 = 0.70$

Note: *, ** and *** denotes that estimates are significant at 1%, 5% and 10% level, respectively.

The results derived from the ECM estimates indicate that all the variables in equation (4) are significant. The error correction term, which represents the speed of adjustment to restore the equilibrium in the dynamic model following a disturbance, is negative and significant implying that 69% of the deviation from equilibrium is adjusted back within a period of one year. In other words, the deviation from the long run real private investment path is corrected by 69% over the following year after deviating from the long-run equilibrium in response to shocks¹⁸. The negative and significant error term also confirms the reliability of the long-run cointegration estimations in Table 5.

18. Accordingly, it takes only about one and half years to adjust the errors.

5. Issues and Challenges Regarding Private Investment

In the above context, a number of formidable issues and challenges remain to be addressed in further enhancing private investment in Sri Lanka. In particular, the real interest rate, which is an important determinant of private investment, tends to fluctuate widely mainly reflecting the relatively high and volatile inflation. The high inflation also tends to appreciate the REER in contrast to the need for maintaining it at an appropriate level to improve the competitiveness with complementary measures to improve the productivity. In this context, it is important to maintain the inflation at a desirable lower level as high inflation is the root cause for these developments, which will be a challenging task. The overall budget deficit, which has remained at a relatively high level, is one of the major factors for the high inflation in the country. Therefore, it is necessary to reduce the budget deficit gradually to a more sustainable level, through continued fiscal discipline and improved budget management, to contain the inflationary pressures. This is to be supported by a complementary monetary policy as well. Meanwhile, the maintenance of appropriate growth in the private sector credit to meet the private sector borrowing requirement is also an important area that needs attention. In addition, the credit is to be available at a reasonable cost so that private investment will be encouraged.

Over the years, Sri Lanka has introduced a number of measures in the process of liberalising the capital account and regulations on capital flows are now maintained only in a few major areas. The gradual liberalisation has provided investment and borrowing opportunities to both domestic and foreign institutions, including the government. The borrowings from foreign sources are expected to reduce the pressure on the domestically available resources. The resultant lessening of competition among the public and private sectors for the limited resources will facilitate the private sector to get more domestic resources, which would lead to a crowding-in of resources as against the crowding-out effect observed in the empirical evidence in this study¹⁹. At the same time, the borrowings from foreign sources, by both private and public sectors, have to be utilised for investment in projects with higher rate of return so the future repayment capacity of the economy would be improved and there would be no pressure on making the repayments. However, the full opening of the capital account may not be possible until the pre-requisites, such as the maintenance of macroeconomic stability and the introduction of measures to further strengthen the financial system stability in the country, are well in place.

19. However, the importance of cautious and prudent approach in further liberalising the capital account in Sri Lanka cannot be over emphasised as the opening up of the capital account without pre-requisites, such as the macroeconomic stability and a competitive and efficient financial system, would be fraught with the danger of large capital outflows.

As discussed earlier, the empirical evidence in this study supports the notion that openness to trade has a positive and significant impact on the private investment in the country. The international trade-related activities of Sri Lanka accounts for about 60% of the GDP. In addition, the country depends considerably on imported raw materials for export-related industries while exports are a significant part of the trade activities, particularly items like garments, tea and other agricultural and industrial products. As far as openness is concerned, it is also observed that Sri Lanka's trade openness has gradually declined over the years suggesting that the country is now concentrating more on the domestic non-tradable sector. Nevertheless, the focus should be on the improvement of competitiveness as well as the diversification of trade towards obtaining more benefits from the open-economic policies adhered by the country. It is evident that Sri Lanka has recently taken measures to strengthen its trade relations particularly with rapid integration with countries in the Asian region²⁰. Nevertheless, there are various issues that need to be addressed in the medium to long run if the trade is to be diversified and enhanced opportunities are to be created for private investors in the country. As identified in the government's *Ten-year Vision*, '*the country's regulatory system dealing with the external trade has not been upgraded commensurate both with progress made in this respect elsewhere and the country's own trade policy improvements*'²¹. Therefore, given the intensely competitive nature of the external trade and *ad hoc* changes in tariff and imposition of various cesses in the domestic front, maintenance of the certainty in the future direction of trade policy will be a challenging task.

Despite the decade long internal conflict, the country has been able to maintain an average economic growth rate of about 4.7% during the period since 1983, reflecting the resilience of the economy to the shocks of this nature. It shows the high potential growth trajectory of Sri Lanka should the conflict be brought to an end and lasting peace established in the country. The government has clearly enunciated its strategy that the defeating of terrorism is the priority. In pursuit of this end, the government continues to allocate high and increased resources in strengthening national security. This is expected to be complemented by a political solution, which is still at the discussion stage. Therefore, this will be a major challenge to the government in the next few years in its efforts to

20. Significant moves in the regional trade include the Indo-Sri Lanka Free Trade Agreement (ISFTA), Pakistan-Sri Lanka Free Trade Agreement (PSLFTA) and South Asian Free Trade Agreement (SAFTA).

21. It also reveals that 'many gaps do exist in the laws, institutions and enforcement with regard to trade inspection, certification, standards, facilitation, etc., rendering the domestic manufacturer and the consumer at a disadvantageous position'.

create a more investor-friendly environment in the country with enhanced business opportunities.

In addition to the above factors, several other factors could also be cited as challenges in enhancing private investment in Sri Lanka, which are elaborated below. It appears that some of these are being addressed while others still remain problematical.

- *Incentive Regime:* As revealed in the study, Sri Lanka offers various incentives with a view of promoting and enhancing both FDI and domestic investment. Nevertheless, it is unclear to what extent these incentives have been a decisive factor in influencing investment. It is also argued that the incentive regime has cost the government substantially in the loss of tax revenues²². In addition, for many years, various claims have been made about the present system of investment incentives as having anomalies, the system is discriminatory and entail arbitrary surcharges, exemptions, and waivers. Hence, it is necessary to introduce appropriate changes and move towards a simpler and transparent system of incentives.
- *Financial Sector:* It is evident that, at present, Sri Lanka has a relatively developed banking system compared to the past. Nevertheless, the public sector banks are still dominant in the banking system. There are other areas to be improved in the financial sector, including the corporate bond market. In addition, although there is considerable progress achieved in capital-market development and financial deepening in Sri Lanka, the progress has been slow compared to other countries. Sri Lanka needs to deepen the financial sector by undertaking further financial sector reforms to increase competition and to further develop financial markets while strengthening the regulatory and supervisory activities to preserve the financial stability that would facilitate savings and investment.
- *Higher Domestic Resources:* Over the years, Sri Lanka has been dependent upon inflows of foreign savings to finance the country's savings investment gap. However, in the wake of declining access to concessional borrowings owing to the increase in per capita income of the country, Sri Lanka will need to resort to borrowings at commercial terms and conditions in the future. In the meantime, a higher level of domestic savings will also be necessary to meet the private sector investment requirement. This could be met through the reduction of government domestic borrowings by making

22. This issue needs to be explored in a separate study. Meanwhile, the provision of tax incentives to promote investment has become a debating issue in recent policy discussions.

savings in the current account of the budget, which will leave more funds for the private sector investment. Given the current conditions, the government will have to implement a strong fiscal consolidation programme to make this a reality.

- *Structural Reforms*: The reforms to be introduced in the economy are well known for many years. The identified reforms are in the areas of markets, infrastructure, public service and institutions. Among these areas, most reforms are aimed at promoting private sector involvement in economic activities. In this context, the government has announced its policy of not privatising state-owned enterprises. Furthermore, the government in its *Ten-year Vision* has declared its willingness to undertake certain reforms, such as public administration reforms, which are being implemented gradually. Nevertheless, the slow progress of the necessary reforms is questionable given the status of many public sector entities. This is a key area of concern that has to be addressed by the government in its efforts to enhance the private investment in the country, as both the strengthening of the already instituted reforms and the introduction of new reforms in response to the changing economic environment are a vital necessity.
- *Labour Market Rigidities and Labour Laws*: The free movement in the labour market in Sri Lanka is hindered by its rigid labour laws, which do not give a sufficient weight to the investor concerns. Hence, rigidity of the labor market will have to be relaxed gradually thereby allowing enterprises to determine appropriate staffing levels for effective management. At the same time, the linking of wage increases to productivity gains and the promotion of flexible wage systems linked to incentives are also cited as measures to maintain international competitiveness.
- *Environment for Doing Business*: The doing business rankings, published by the World Bank, points to several important areas that need attention in the context of the business environment in Sri Lanka. According to these rankings, out of 181 economies, Sri Lanka ranks at a relatively better position in starting a business, getting credit and protecting investors (Appendix Table 1)²³. Nevertheless, there are several areas, particularly the paying of taxes, which remain in want of improvement. The Global Competitiveness Report

23. According to the World Bank, “The Doing Business methodology has limitations. Other areas important to business such as an economy’s proximity to large markets, the quality of its infrastructure services (other than those related to trading across borders), the security of property from theft and looting, the transparency of government procurement, macroeconomic conditions or the underlying strength of institutions, are not studied directly by Doing Business”.

also ranks the tax rates and tax regulations as among the most problematic areas in doing business in Sri Lanka (Appendix Chart 1). Among these factors, both inflation and corruption play a key role in influencing investor's decision to continue business. These findings, although need care in analysing, point to the need for regular assessment of the various policy areas from the investor point of view and introducing appropriate policies. It also suggests that the priority and importance of the various components are likely to vary substantially among investors themselves. Hence, the regular assessment of the various policy areas should involve balanced representations from the various investors and from consumer and other stakeholder groups.

- *Public Private Partnerships (PPPs)*: Inadequate infrastructure facilities remain one of the biggest impediments to Sri Lanka's progress. Reliable infrastructure is paramount for further economic development, especially for export-oriented activities, such as manufacturing and tourism, while the need for reliable power supply, road network, transport systems, telecommunication capacity, urban infrastructure and port and aviation facilities is strong²⁴. This situation has adversely affected the enhancement of private sector involvement in economic activities. It appears that, while identifying these deficiencies, the government has given the highest priority in resolving these issues by significantly increasing the public investment. However, as the higher public investment would increase the pressure on the tight budgetary conditions, private sector involvement in the infrastructure development projects is to be promoted through PPPs. Although the government enunciated its policy in promoting PPPs, the progress has been lagging. Accordingly, the importance, advantages and risks involved in PPPs should be clearly identified. At the same time, the relevant stakeholders and the general public have to be effectively convinced.
- *Promoting Investment in Newly Liberated Areas*: The liberation of the resource rich Northern and Eastern Provinces of Sri Lanka will provide new opportunities to private investors while taking the country into a new development path. The effective management of this newly emerged situation will be a challenging task given the devastation inflicted in those areas by the decade long internal conflict. Nevertheless, the government has already shown its commitment in developing these two Provinces, which will help create an enabling environment to commence new investments in the future.

24. Sri Lanka New Development Strategy, 2004.

Given the above key factors, it is the private sector's responsibility also to actively participate in order to improve the level of investment. First, private sector entrepreneurs need to demonstrate their willingness to change the attitudes and embrace modern management and production efficiency as many of them still depend on government subsidies, concessions and protection in conducting their businesses. Second, it is the responsibility of the private sector investors to increase the transparency and accountability of their activities. Third, the private sector should gear up to face the challenges emanating from the new global economic and financial landscape which is being created as a result of the global financial crisis. In the process, the improvement of productivity and active engagement in research and development in improving the technological needs of industries, and attaining the standards related to the price and quality in international markets are equally important.

6. Conclusion and Policy Recommendations

This paper examined the determinants of real private investment in Sri Lanka, paying particular attention to testing the long-run cointegrating relationships between the variables that are under consideration complemented by the Engle-Granger Two-Step ECM. The main objective of the paper is to improve our understanding of the determinants of private investment and point to policy measures aimed at further strengthening the ongoing efforts to increase private investment in Sri Lanka. The results of this study provide strong support for the hypothesis that private investment in Sri Lanka is largely affected by the behaviour of the macroeconomic variables that are important in investment decisions while revealing important policy implications.

Over the years, Sri Lanka has managed to enhance private investment amidst many challenges. However, Sri Lanka cannot be complacent about its achievement in the investment front as she has not been able to increase the investment towards the required level to accelerate the growth process during the last few decades. Sri Lanka expects to maintain a GDP growth of around 7% in the medium term. In order to generate this level of growth it is necessary to expand the physical capital formation in the country as one of the fundamental requirements for economic growth. The total investment of the country needs to be increased to around 30% of the GDP from the average of 25% during the last three decades, given the current state of technology, infrastructure, human capital, and other structural factors that determine the efficiency of the economy. This higher investment ratio is expected to come mainly through higher private investments.

As an average investment level of around 25% of the GDP would not sufficient to provide the basis for accelerated growth in the medium to long term, the impediments to growth in private investment need to be addressed effectively. The areas identified as requiring urgent attention include the maintenance of a sound macroeconomic environment, resolution of infrastructure bottlenecks, seeking of an early solution to end the civil conflict and achievement of a lasting peace, and encouragement and facilitation of the private sector to undertake major projects under PPP to reduce the pressure on the government budget. In addition, the efforts to implement the identified reforms, while strengthening governance, have to be intensified to create a stronger and a more resilient economy which is conducive for higher level of private investment.

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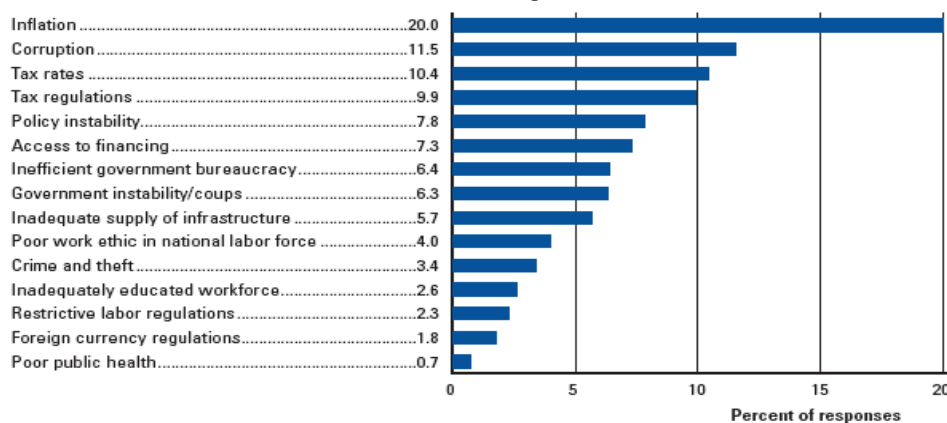
Appendix Table 1
Sri Lanka's Ranking in Doing Business - 2009

Rank	Doing Business 2009
Ease of Doing Business^{1/}	102
Starting a Business	29
Dealing with Construction Permits	161
Employing Workers	110
Registering Property	141
Getting Credit	68
Protecting Investors	70
Paying Taxes	164
Trading Across Borders	66
Enforcing Contracts	135
Closing a Business	43

Source: Doing Business 2009, The World Bank (2008)

1/ Comparing regulation in 181 economies.

Appendix Chart 1
Most Problematic Factors in Doing Business in Sri Lanka



Source: The Global Competitiveness Report 2008-2009

Note: From a list of 15 factors, respondents were asked to select the five most problematic for doing business in their country and to rank them between 1 (most problematic) and 5. The bars in the figure show the responses weighted according to their rankings.

