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Economic Problems and Communal Conflict in Sri Lanka



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An Intelligence Assessment

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NESA 86-10010
February 1986

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Economic Problems and Communal Conflict in Sri Lanka

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An Intelligence Assessment

This paper was written by
 Office of Near Eastern and South
Asian Analysis. Comments and queries are
welcome and may be addressed to the Chief, South
Asia Division, NESAs

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*NESA 86-10010
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[Redacted]

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Economic Problems and Communal Conflict in Sri Lanka [Redacted]

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Key Judgments

Information available as of 28 January 1986 was used in this report.

Two and a half years of mounting communal violence have created economic problems for Sri Lanka:

- Increased defense costs have led to spending cuts in rural development programs, public-sector industrial investment, and social welfare programs.
- The threat of violence has reduced earnings from the tourist industry by nearly 40 percent from a peak in 1982 and contributed to large current account deficits.
- Concern over political stability and the protection of property has made foreign and domestic businessmen reluctant to launch new ventures.
- Preoccupation with the communal violence has contributed to the government's backsliding on economic liberalization and failure to correct the currency's overvalued exchange rate. [Redacted]

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The most important contributors to the Sri Lankan economy—the industrial heartland in the south, the central tea plantations, and the massive Mahaweli Development Program aimed at irrigating Sri Lanka's extensive dry zone—have not been severely damaged. [Redacted]

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The communal violence is fueled in part by Tamil perceptions of economic discrimination by the dominant Sinhalese. Tamils believe the government has denied them a fair share of development funds and restricted their access to government jobs. The settlement of newly irrigated lands—particularly in the Eastern Province, considered a traditional homeland by Tamils—is the most divisive economic issue. Prospects for agreement on economic issues are dimming as overall national economic performance declines. [Redacted]

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If there is no peace settlement within the next six months, we believe the insurgents will take the war to key economic facilities in Sinhalese areas.

[Redacted]

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The threat early this year to contaminate Sri Lanka's tea exports is probably the beginning of militant attempts to hurt Sri Lanka's credibility as a tea supplier. [Redacted]

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Even if a peace settlement is reached, overall economic performance will not improve significantly any time soon. The economy will remain heavily dependent on world prices of agricultural commodities, which show no sign of a dramatic increase. Government protection and structural inefficiencies


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will continue to plague public-sector industries. Foreign investors will probably return only slowly. Repaying the large debt incurred to finance development programs will continue to be a burden for the remainder of the decade, and we expect Colombo to seek additional financial assistance from the United States and other aid donors. 

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Economic Problems and Communal Conflict in Sri Lanka 

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The communal conflict between Sri Lanka's Tamil minority and Sinhalese majority is rooted in deeply contested political and ethnic issues such as power sharing, the preservation of distinct and separate cultures, and the definition of minority rights in a pluralist society. Any lasting settlement to the conflict will require political concessions from both sides. As the conflict continues, economic costs to both communities are mounting, and competition for land, employment, and development assistance is intensifying. Economic issues, thus, are becoming increasingly central to the conflict. 


The Cost of Insurgency

The two-and-a-half-year-old insurgency has taken a toll on the country's economic well-being. Rising government expenditures for defense are forcing a cutback in a wide range of social and economic development projects. Civil strife has stunted the once rapidly growing tourist industry and, we believe, has contributed to the declining confidence of foreign businessmen and aid donors in the government's economic policies. The local economies of the Northern and Eastern Provinces have been imperiled by insurgent attacks on critical rail links and mining of the limited road network. 

Disruption. The insurgency has had its greatest economic impact in the economically backward Northern and Eastern Provinces, where most of the fighting has taken place and where most Tamils live. Embassy reports indicate insurgent attacks on infrastructure targets, such as roadways, railroads, and port facilities; repeated robberies of banks and businesses by Tamil militants; and the general collapse of civil order have crippled economic life in Jaffna, the major city in the north. Products supplied from Jaffna to the rest of the country—fish, salt, and cement—are in short supply throughout Sri Lanka due to the decline in economic activity in the north. 


Fishing, a major part of the economy in the north, has been hit hard. The fish catch dropped by 23 percent in 1984, and the government estimates another 10-percent decline for 1985. Press and Embassy reports

The Insurgency in Operation

Sri Lanka's insurgency is based primarily in rural areas, except on the Jaffna Peninsula, where the militants have control of or access to most of the city, the country's second largest. In the Northern Province, the insurgents have established training camps and stockpiled weapons within striking distance of main rail and road links. In the Eastern Province, they control the outskirts of key towns and coastal areas. They also control jungle areas bordering on sectors of the Mahaweli Development Program. Jungle hideouts have proved so effective that the government is clearing foliage in the Eastern Province as a counterinsurgency measure. 


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Insurgent strategy has relied heavily on attacks against central government authority in the Tamil-dominated areas of the north and east. Army camps, police stations, central banks, libraries, railroads and stations, roads, and residences of local government agents reporting to Colombo have been targeted for landmine and grenade attacks by the guerrillas. By avoiding large-scale clashes with government forces, the insurgents have kept their casualties low. Their strategy has provoked frustrated and undisciplined security forces into reprisals against Tamil civilians that frequently include the destruction of homes, villages, farm implements, and vehicles. 

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The insurgents' successes, however, have cost them some Tamil civilian support. According to Embassy reports, economic disruption in Tamil areas is helping to shape Tamil opinion in favor of a negotiated settlement and against continued logistic support to the guerrillas. 

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Figure 1. Tea—the next target? [redacted]

note that the decline in coastal fish catches in the northern and eastern regions results from increased Sri Lankan naval surveillance, Army attacks on fishing villages, and Tamil flight to India—mostly of fishermen. [redacted]

Blocked transport links to Colombo and periodic militant attacks on rice farmers have disrupted production, milling, and marketing in the north and east, resulting in near famine conditions in parts of the Eastern Province. Rice farmers in the Sinhalese south—where food production is concentrated—have been unable to compensate for the disruptions, and the government imported 200,000 metric tons of rice in 1985 to bolster national stocks. [redacted]

In at least one case, Tamil militants may already have engaged in economic warfare against the government. One group in January 1986 claimed to have contaminated an undetermined quantity of Sri Lanka's tea export with potassium cyanide. Although no poisoned tea has been found, the threat prompted one Australian firm to cancel imports of Sri Lankan tea; other buyers are assessing their purchases. Any long-term disruption in Sri Lanka's tea trade, which accounted for approximately 30 percent of Sri Lanka's 1985 export earnings, would have a severe impact on the country's balance of payments and government revenues. [redacted]

Growing Spending Strains. The government's counterinsurgency effort has begun to cut into economic development. Supplementary appropriations by Parliament in 1985 boosted allocations for defense to

The Mahaweli Program

The most ambitious of Sri Lanka's major investment projects is the Mahaweli Development Program. Originally conceived as a 30-year undertaking by the previous government, the project was accelerated when Jayewardene came to power, and we expect that the bulk of construction will be completed by the late 1980s at a cost of well over \$2 billion. [redacted]

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The project involves the construction of four major dams along the Mahaweli Ganga (River) and its tributaries and a network of downstream irrigation canals stretching from the mountainous center of the island in a wide diagonal swath northeast to the Trincomalee region. The dams will provide badly needed hydroelectric power, while irrigation will open up arid areas to intensive agriculture and the resettlement of landless farmers. [redacted]

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about \$230 million—85 percent greater than the original budget and almost 170 percent more than 1984. Defense expenditures—more than half of which are earmarked for Army and police pay—are now the second-largest item in the budget and account for 10 percent of government spending, compared to 3 percent in 1982. Spending on rural development projects, public-sector industries, social welfare programs, and the Mahaweli Development Program has been reduced; and the budget for 1986 indicates additional cuts will be made in these areas. [redacted]

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The government's financial aid to industries damaged by the fighting has put additional, if small, strains on the budget. In 1985, about \$8 million was advanced to the public cement corporation, whose plant on the

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Table 1
Confirmed Sri Lankan
Arms Purchases, 1980-85

Million US \$

	Amount
1980	0.1
1981	0.1
1982	0.0
1983	12.0
1984	11.3
1985 ^a	17.3

^a As of midyear 1985.

Jaffna Peninsula had virtually halted operations because of the fighting, so it could meet interest and amortization payments. The government recently announced a plan to bail out hotel owners to help the tourist industry survive the next year or so. The relief package includes a soft loan of \$3.3 million for seriously affected hotels, rescheduling of old debts, and a reduction of the business tax. [redacted]

Backed by hardliners in the Cabinet and supported by his Sinhalese constituents, Jayewardene, in our view, will not significantly cut defense spending until he and the Sinhalese public believe the insurgents no longer pose a major security threat. The government will have to increase nonbank borrowing and domestic commercial bank loans to cover its budgetary shortfall. Domestic commercial bank liquidity is ample because interest rates and poor investment prospects have dampened private demand for funds. [redacted]

Foreign Investment and Aid. Although the militants have not launched attacks against foreign companies operating in Sri Lanka, the general instability has taken a toll on foreign investment. The government maintains that foreign investors continue to express interest in Sri Lanka, although it admits their numbers have been reduced. [redacted]

Table 2
Sri Lanka:
Foreign Participation in
Approved Industrial Investments, 1979-84

Million US \$

	1979	1980	1981	1982	1983	1984
Greater Colombo Economic Commission	52	163	51	56	8	17
Outside Greater Colombo Economic Commission	NA	55	32	16	11	20

[redacted] 25X1

[redacted] 25X1

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Embassy in Colombo reported that a West German and Swiss partnership withdrew a \$10 million commitment to a construction project in Trincomalee in mid-1985 in the wake of growing guerrilla operations in the Eastern Province. [redacted] 25X1

New government incentives for foreign investors suggest the government is trying to offset some of the insurgency's negative impact on investor confidence. In October 1985, Colombo authorized foreign firms to lease readymade factories, exempted their earnings from income tax during certain periods, and allowed each firm to employ an unlimited number of foreign personnel. [redacted] 25X1

Finance Minister Ronnie de Mel echoed concern that new foreign investment might not be forthcoming in his budget speech to Parliament in November 1985. He cited two prerequisites for new foreign investment in economic development programs: peace and the political will and determination to carry through the economic reforms initiated in 1977. [redacted] 25X1

The communal conflict has also caused some cuts in foreign aid. Diplomatic reporting indicates Canada—a major donor to the Mahaweli Development Program—decided in early 1985 to withhold funds earmarked for the next stage of the irrigation network to [redacted] 25X1

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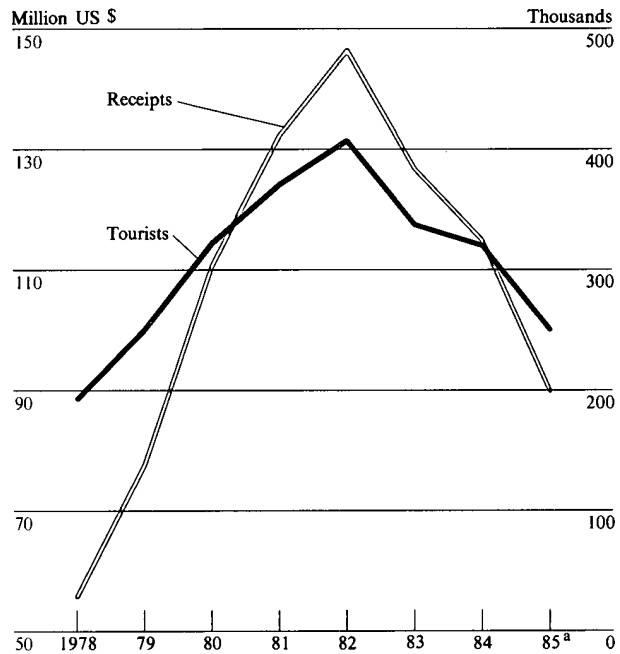
Figure 2. Communal violence frightens investors and tourists.

protest alleged violations of human rights by government security forces against Tamils. In our view, Ottawa will resume its aid, which is targeted for Tamil areas within the program's purview and tied to Saudi and World Bank funding, only if Colombo gives assurances that Tamils will get a fair share of lands to be irrigated. To some degree, the cutback reflects lobbying by Canada's large and well-organized Sri Lankan Tamil community.

Another aspect of the communal conflict—Colombo's search for foreign military expertise—has, in at least one instance, adversely affected foreign aid. In 1984, Saudi Arabia, a major donor to the Mahaweli Program, withheld a \$50 million installment on the program's next irrigation project to protest Colombo's willingness to accept Israeli security assistance. Relations with Israel may also jeopardize trade relations with Arab states that import large quantities of Sri Lankan tea.

Lobbying efforts by vocal Tamil support organizations in Europe threaten to harm Colombo's relations with its principal European donors. [redacted] last June a group tried unsuccessfully to block the renewal of \$580 million in aid to Colombo from a World Bank consortium. The consortium has not linked its development assistance to progress in communal talks, but [redacted] members may be reluctant to meet Colombo's future borrowing needs until the government takes tangible steps toward a political solution. Tamil

Figure 3
Sri Lanka: Tourism, 1978-85



^a Based on January through November arrivals.

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groups recognize that nonmilitary development assistance eases Colombo's budgetary constraints, giving the government a freer hand to boost defense spending.

Tourism Hard Hit. The tourist industry, cited not long ago as the success story of Asian tourism, has been a major casualty of the insurgency. Earnings from the tourist industry have declined from a peak of almost \$150 million in 1982—before the conflict worsened—to about \$90 million in 1985. The number of tourists declined from 407,000 in 1982 to about 250,000 in 1985.

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Figure 4
Principal Ethnic Groups in Sri Lanka



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[redacted] the large charter agencies, particularly in Western Europe, are canceling Sri Lankan tours because of the continuing communal conflict. Western Europe has accounted for over half of tourist arrivals for the last decade, and West European tourists were the only group to show an increase in 1984. The biggest

cutback in arrivals since the fighting has been among Asians, predominantly Indians. Tourism is likely to remain a depressed sector until a lasting communal settlement is reached and Sri Lanka repairs its reputation as an island paradise. [redacted]

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Economic Issues in the Communal Conflict

The insurgency is fueled in part by Tamil perceptions of Sinhalese economic discrimination. Tamils claim that, since the early 1970s, successive Sinhalese governments have denied Tamil areas a fair share of central government development outlays, restricted access to government jobs, and denied Tamils the benefits of newly irrigated lands. In our view, the failure of the Jayewardene government over the last four years to address these economic grievances and to fulfill promises of limited autonomy to Tamil areas has heightened Tamil frustrations and strengthened Tamil civilian support for the insurgency. [redacted]

Prospects for reconciliation on these economic issues are dimming as overall national economic performance declines. Weak demand in the labor-intensive construction and tourism industries in the last two years has reduced job opportunities in the Sinhalese south, [redacted] this will lead to increased unemployment. We believe Jayewardene will be reluctant to make concessions to Tamils on employment in state-run industries or in the government as long as rising unemployment threatens his Sinhalese constituency. [redacted]

Tamil demands for central government outlays will face even tougher opposition from the government in the face of foreign aid cuts. A study by a prominent US academician using interviews with Tamil political leaders indicates that most Tamils have considered Colombo's investment policy biased in favor of Sinhalese areas since the late 1970s. In cases where the government has decided to invest in Tamil areas or to permit foreign investment, such as in Jaffna's cement factory and in fish-processing plants in the Eastern Province, Sinhalese and foreign personnel have often been employed at the expense of local Tamils. Faced with diminished resources, the government is even more likely to continue its preferential development strategy and will probably be reluctant to allot new funds to Tamils. [redacted]

Land Settlement. The settlement of newly irrigated lands is the most divisive economic issue between the government and Tamils. Jayewardene's decision in 1977 to accelerate the Mahaweli Program underscores the government's desire to find new land for



Figure 5. Who gets the newly irrigated lands?
[redacted]

Sinhalese farmers and to resettle them in sparsely populated areas of Sri Lanka's extensive dry zone, which is to be irrigated by the program. It is intended to promote both domestic food production and production of crops for export—both important political demands of the government's Sinhalese constituency. [redacted]

With the core of its electoral support anticipating benefits from the Mahaweli Program, Colombo is determined to keep control of the settlement issue. As lands have become arable under the program, Jayewardene has financed and armed Sinhalese settlements in areas regarded by Tamils as their traditional homeland. The Tamil militants want jurisdiction over land settlement to establish control over the Eastern Province. Tamils consider the area a traditional homeland, but they constitute only 42 percent of the population there. A US Embassy source suggests no Colombo government responsive to Sinhalese interests could cede authority over settlement of these areas to local administrative units—a key Tamil demand. [redacted]

Tamils have argued publicly that Colombo's land settlement perpetuates economic discrimination against them. As long as Colombo retains a monopoly on both the best lands in the south and on newly irrigated lands in the north and east, Tamil farmers

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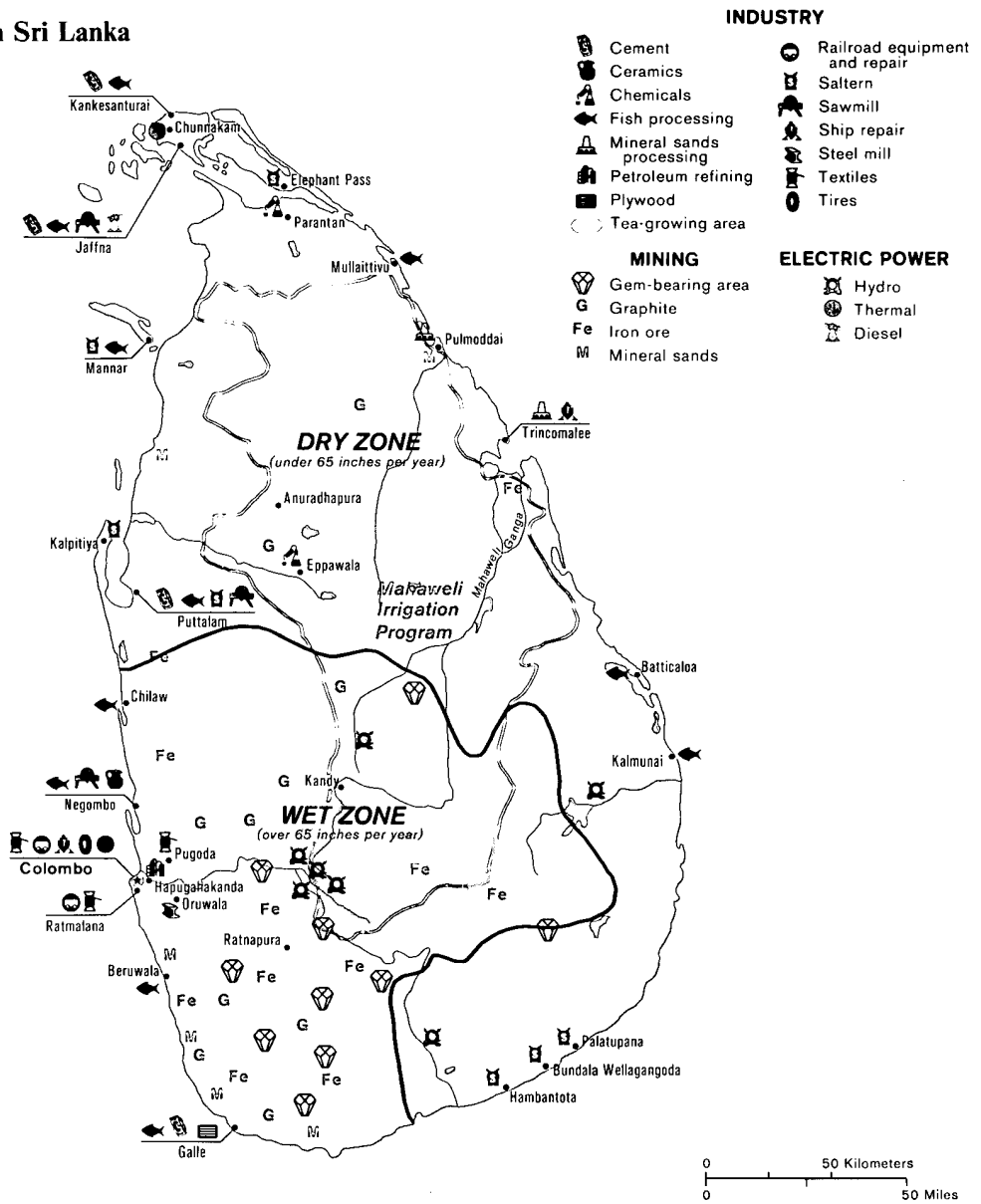
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Figure 6
Economic Activity in Sri Lanka



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will be forced to cultivate the economically less productive land. Embassy reports indicate that, while new Sinhalese settlements have drawn frequent insurgent attacks, the militants have not attacked the Mahaweli Program's network of canals and dams, suggesting they are reluctant to sabotage an economic asset that could be vital to Tamils.

More Problems Down the Road

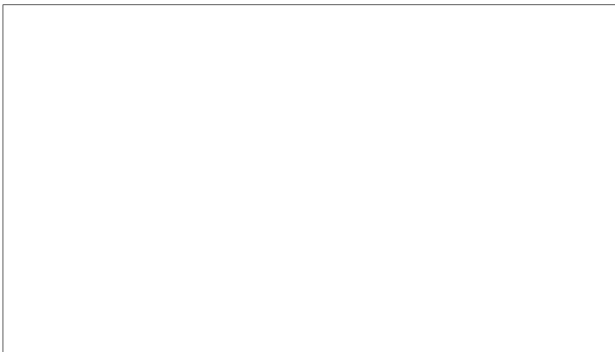
We see two likely scenarios for the Sri Lankan economy in 1986. In the first and less likely case, Indian mediation efforts could lead to a partial settlement between the government and moderate Tamil

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groups that would grant some autonomy to Tamils but not enough to defuse insurgent demands for a separate state. A partial settlement would have only a limited positive impact on the Sri Lankan economy. In our view, Colombo would be forced to maintain high defense expenditures to protect against militants who reject the settlement, as well as to rebuild the central government presence in the Northern and Eastern Provinces. Even if the government makes significant concessions on autonomy, we doubt all major militant groups can reconcile their internal rivalries and accept an agreement. With some Tamil militants still likely to launch antigovernment operations, we doubt that investors and tourists would return quickly to Sri Lanka. [redacted]

The second and more likely scenario entails a collapse of negotiations between the government and Tamil leaders and a resumption of full-scale fighting. Under these conditions, the economic costs of the insurgency to the government would probably grow. The government would probably continue a military buildup, forcing higher budget deficits and further cuts in economic development programs. Damage to Sri Lanka's agricultural output, fish production, economic infrastructure, tourist industry, and foreign investor and donor confidence would become more pronounced. [redacted]

In either scenario, the most hardline Tamil groups are likely to attack economic centers in the Sinhalese south to force further concessions from Colombo.



sabotage of foreign-owned businesses or attacks on hotels in the south could erode Sinhalese confidence in the regime and jeopardize the country's efforts to rejuvenate its economic liberalization and diversification programs. [redacted]

Even in the unlikely event that a political settlement is reached and communal violence subsides quickly, the Sri Lankan economy faces longer term structural problems. Domestic economic growth will continue to be plagued by insufficient public funds for domestic investment. The government has not shown the will to broaden the tax base and is likely to continue the inefficient structure that relies heavily on export and import taxes. Colombo is also faced with the burden of paying for past borrowing from foreign commercial banks and domestic banking and nonbanking sources to cover budget deficits. Debt service is now the largest item in the budget, accounting for 20 percent of expenditures. [redacted]

The long-term imbalance in Sri Lanka's foreign payments, obscured in 1984 by an improvement in exports, reappeared in 1985. The country's ability to pay its foreign trade debts is highly dependent on volatile world commodity prices, and the government is doing little to stimulate new items for export. Sri Lanka's "managed floating" exchange rate has not reflected the high rate of domestic inflation, and most financial observers consider the currency overvalued. The open market value of the rupee has appreciated almost continuously since 1977, adversely affecting the competitiveness of nontraditional exports and import-substituting industries. [redacted]

Implications for the United States

Continuing violence, whether the result of an untidy settlement or widespread new fighting, is likely to make Sri Lanka even more dependent on US and other foreign aid to offset mounting defense expenditures and a worsening foreign payments position. Even if the insurgency subsides, Colombo will almost certainly request additional development assistance from the United States and others to help fund recovery costs and to meet international debt commitments. [redacted]

Prospects for renewed foreign investment will depend not only on the status of the insurgency, but also on the development of new investment opportunities. Even if domestic peace can be restored, Colombo will have to resume its economic liberalization program to attract investment. [redacted]

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Table 3
Sri Lanka: Balance of Payments, 1980-85

Million US \$

	1980	1981	1982	1983	1984	1985 ^a
Current account	-798	-610	-732	-644	-220	-570
Trade account	-987	-818	-983	-856	-436	-750
Exports, f.o.b.	1,065	1,065	1,013	1,062	1,475	1,260
Tea	374	335	305	353	620	370
Garments and textiles	109	156	168	201	296	375
Imports, c.i.f.	2,051	1,883	1,996	1,918	1,911	2,010
Services, net	52	6	-14	-61	-62	-100
Tourist receipts	111	132	147	127	115	90
Interest payments	-59	-121	-128	-173	-180	-190
Private transfers, net	137	203	265	274	277	280
Overall balance	-216	-31	-20	0	304	-20

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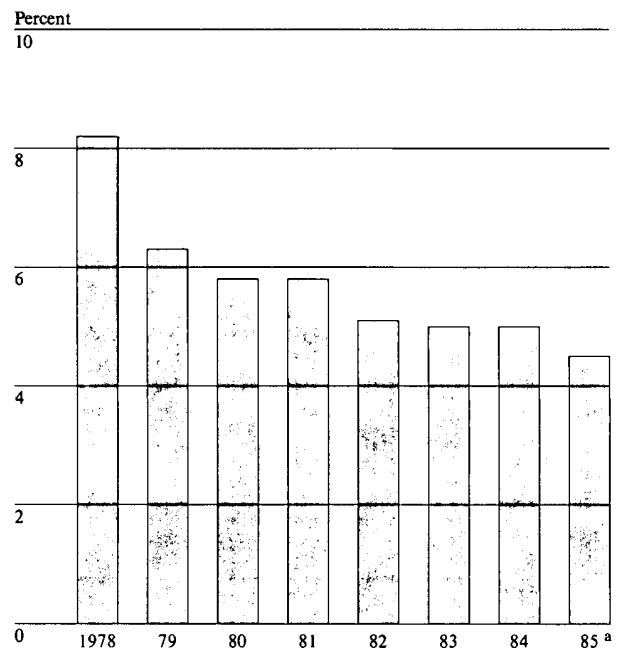
Economic Conditions Under Jayewardene

Following his election in 1977, President J. R. Jayewardene undertook a free market approach to economic development. He eliminated foreign trade and currency controls, devalued the rupee, liberalized imports, introduced investment tax incentives, and reduced consumer subsidies on essential commodities. His policies encouraged an increased flow of foreign aid to help finance development projects. Official foreign aid grew from about \$130 million in 1976 to \$530 million in 1984. In particular, the government accelerated public investment in the Mahaweli Development Program to enable Sri Lanka to reach food-grain self-sufficiency and to increase electrical power supplies by the end of the decade. [redacted]

Jayewardene's program stimulated rapid economic growth in sectors providing quick returns on investment and yielding high profits. During 1978-81, annual real growth rates averaged about 6.5 percent, compared to less than 3 percent under the left-of-center government led by Sirimavo Bandaranaike from 1970 to 1977. The most dramatic growth occurred in the private sector in construction, real estate, trade, and tourism. Nontraditional exports, particularly textiles and garments, also registered impressive increases. New jobs created by higher investment reduced the unemployment rate from a peak of 24 percent during the Bandaranaike period to about 14 percent in 1983. One of the most successful ventures was the free trade zone established near Colombo, which accounts for more than 90 percent of Sri Lanka's foreign investment. The government reports 30 countries have so far invested \$350 million in over 200 projects in the zone. [redacted]

Economic liberalization produced only mixed results in the agricultural sector. By paying higher prices for rice, promoting new seed varieties, increasing fertilizer subsidies, and removing a myriad of controls, the government successfully encouraged farmers to increase rice production dramatically. Output in recent years has averaged 60 percent above the 1970s, and Sri Lanka is now nearly self-sufficient in rice. [redacted]

Figure 7
Sri Lanka: GDP Growth, 1978-85



^a Estimated.

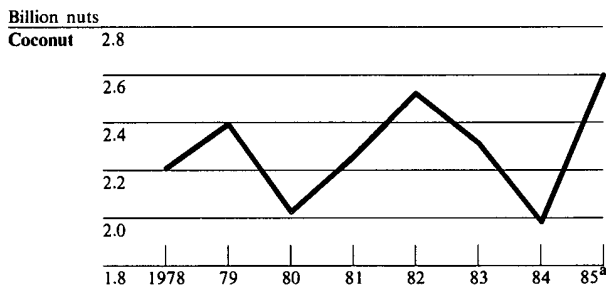
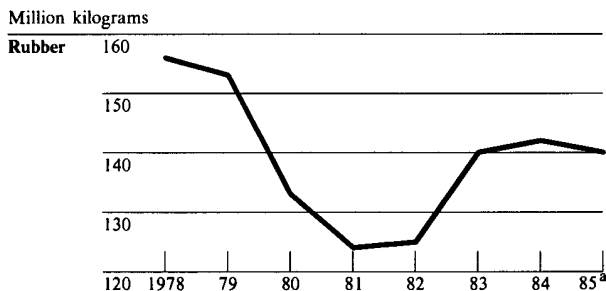
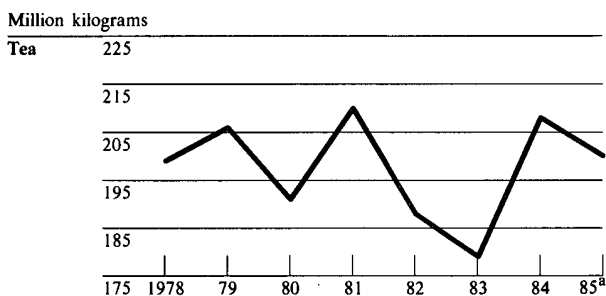
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Production of traditional cash crops, however, remained sluggish. Output of tea, coconut, and rubber, which accounts for about half of export earnings, continued the trend of stagnation that followed the nationalization of plantations in the early 1970s. The Jayewardene government maintained state ownership and control and did little to improve management or spur new investment. Instead, high export taxes were

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Figure 8
Sri Lanka: Agricultural
Production, 1978-85



^a Estimated.

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imposed as the most expedient method of buttressing government revenues, and public expenditures were directed toward other crops.

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Growth Stalls

After a short initial burst, economic growth began to slow and probably fell below 4.5 percent in 1985—the lowest level since 1977. The ambitious public investment program was not accompanied by adequate incentives for private domestic savings or exports. The budget regularly included large deficits, inflation hit almost 40 percent compared to less than 10 percent in the early 1970s, and the current account deficit widened to more than six times the level of the 1970s. Fiscal and monetary restraints, started in 1982 under pressure from the IMF, were the primary causes for the economic slowdown. The flagging international trade environment, drought, and the expanding communal conflict have also been major contributing factors in the faltering growth rates.

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With the exception of the textile and garment industries, which the government has actively promoted, growth in the industrial sector has slowed. Colombo has been unwilling to make the personnel and other changes needed to improve the poor performance of the politically entrenched state-run enterprises. Instead, it has continued to provide subsidies for inefficient industries that are having difficulty competing in a more open domestic economy. The government also has been unable to reverse a five-year decline in the development of new private-sector industries. Some of the problems can be attributed to a lack of lucrative investment opportunities and to infrastructure weaknesses such as poor communications. They can also be traced to the government's failure to build upon earlier reforms and to maintain the momentum of the liberalization program. The Jayewardene government has not pursued policies to encourage investment in new areas and has done little to correct the rupee's overvalued exchange rate.

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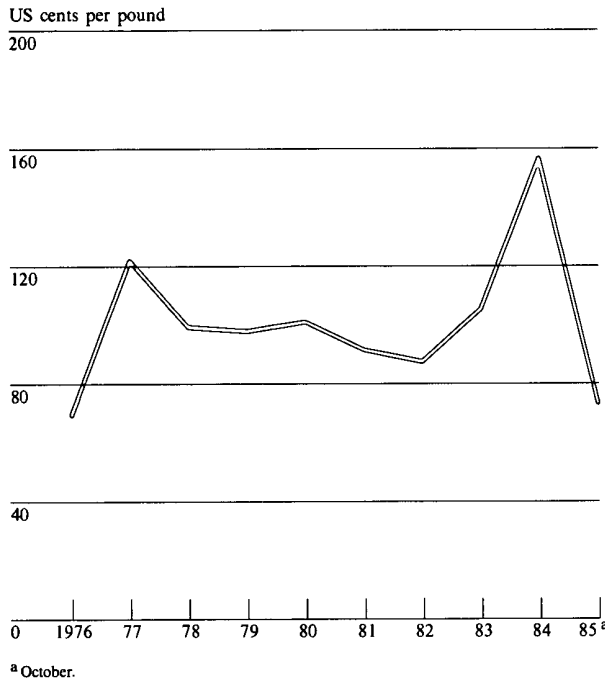
Sri Lanka's foreign payments position, which has been in deficit throughout most of Jayewardene's tenure because of the high level of imports, improved in 1984. Colombo's trade deficit was nearly half that

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Figure 9
World Tea Prices, 1976-85



and even rivaling tea as the top money earner, face stiff competition from other exporters and growing protectionist sentiment from importing countries. Slow export growth, a growing debt burden, and falling tourist receipts might compel the government to impose controls on imports and will make it difficult for Colombo to meet foreign debt repayments. The government probably will turn to aid donors and the IMF for additional loans.

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of 1983, and, by the first quarter of 1985, foreign financial reserves had increased by almost 85 percent over the previous year—to \$540 million—and were equivalent to about three months' imports. Record world tea prices enabled Sri Lanka to almost double the value of foreign tea sales, which amounted to more than 40 percent of total exports in 1984. Textiles, which contributed only 7 percent of export earnings in 1979, had by 1984 nearly tripled their share to 20 percent—largely because of exports to the United States.

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We expect the foreign payments position will deteriorate again in 1986. Tea earnings are likely to drop by more than 40 percent because of lower world prices; the volume of exports will probably grow slowly. Exports of textiles and garments, while still growing

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