Pathfinder Economic Alert

Sri Lanka – China FTA: The Jewel in the Crown.

A Results – Oriented Visit

President Xi's visit to Sri Lanka delivered an array of concrete outcomes across a wide range of activities. A total of 27 agreements were signed in important areas.

The Jewel in the Crown.

The visit has provided an opportunity to celebrate the excellent relations between Sri Lanka and China. This article seeks to look forward by addressing the question of how Sri Lanka can best take advantage of China's economic rise in the context of the vibrant bilateral relationship between the two countries. Of all these outcomes of President Xi's visit to Sri Lanka, the Free Trade Agreement (FTA), expected to be completed next year, could be the 'Jewel in the Crown'. It has the potential to have a transformative impact on the country's prospects and the people's quality of life.

As highlighted in previous Pathfinder Foundation (PF) articles, the key challenge for Sri Lanka is to embark upon FDI – driven export expansion to attain a sustained accelerated growth path which touches the lives of the people. The Sino – Lanka FTA can serve to create the framework for achieving this objective.

Since the end of the conflict, the Chinese have played a major role in supporting the government's unprecedented infrastructure development program, largely through loans from the China Development Bank and Exim Bank of China. The conditions are now ripe for moving from borrowing to FDI using the FTA as the trigger.

Transforming from Debt - Led Infrastructure to FDI-Driven Export Growth.

At present, Sri Lanka lacks the competitive supplies to take advantage of preferential access to the massive Chinese market arising from the bilateral FTA. Other than high value apparel, value added tea, rubber products and gems and jewellery (coir is currently the largest export to China accounting for about 20% of the total), it is difficult to identify products, which can make an impact in the Chinese market. Other than possibly apparel, supply constraints will make it difficult to achieve substantial increases in the export volumes of the other products. The massive potential of the Sino – Lanka FTA can only be realised if Sri Lanka is able to attract Chinese and other FDI to produce far greater supplies of a diversified range of products which can take advantage of the FTA – enabled preferential market access. This can only be achieved by a sharp increase in FDI, with its technology, branding, management skills and market access. Unless this is done, the Sino-Lanka FTA is likely to remain largely an empty shell.

It is worth noting the transformative impact that FDI – led export growth has had on the economies of countries like China, Malaysia, Thailand and Vietnam. In this respect, the Sino-Lanka FTA has the potential to create a conducive framework for replicating this in Sri Lanka with Chinese FDI in the vanguard.

Causes of Optimism.

There are a number of positive factors which give cause for optimism. China was already the number one source of FDI in Sri Lanka by last year. On the Chinese side, domestic costs, including wages, are rising. In addition, the Yuan is expected to appreciate steadily as this is likely to be an integral component of China's strategy to rebalance its economy from external to domestic demand. As a result, the Chinese authorities have begun encouraging their enterprises, which are experiencing competitiveness challenges, to go abroad. It has been estimated that about 80 million jobs may have to be relocated from China to other destinations. Sri Lanka is well positioned to take advantage of this opportunity both directly and indirectly with the Sino-Lanka FTA acting as the catalyst.

In assessing the potential for attracting this Chinese FDI, it is important to recognise that Sri Lanka is no longer a low labour cost investment destination. It cannot compete with the likes of Bangladesh, Cambodia, Laos and Myanmar on that front. Priority should therefore be attached to identifying higher value exports where it can be competitive. Noritake and Colombo Dockyard are good examples of such product lines developed in the past with Japanese FDI. In this connection, priority should be given to a major training and skills development effort to complement a major Chinese investment drive into the country. Given that it is manufacturing capacity which is going to be relocated, developing the human resources necessary for light engineering would be a prerequisite for attracting Chinese investors who are moving offshore. Providing land for industrial parks favoured by the Chinese is another issue which should be addressed. It is crucial that both the government and businesses adopt a dynamic and outward looking perspective which goes beyond the current weak export structure. Chinese FDI can play a crucial role in driving the diversification which is essential to realise the full potential of the Sino-Lanka FTA.

The massive commercial opportunities generated during President Xi's visit to India, particularly in manufacturing and infrastructure can also be a game-changer for Sri Lanka. China's role in boosting India's manufacturing sector (agreements have been signed to build two Industrial Parks) will create opportunities for plugging into new supply chains, particularly if the proposed infrastructure development reduces transport/transaction costs. Todate, poor infrastructure in both countries has constrained Sri Lanka's ability to take advantage of its proximity to the large Indian market. China's role in improving infrastructure in both countries would address an important impediment to increasing Sri Lankan exports to India, including supply chain based items.

The Goldilocks Scenario.

Sri Lanka is in an unique position in the region through its FTAs with both China and India. Preferential access to a market of 2.5 billion people can act as an engine for transforming the export structure of the country. The 'Goldilocks Scenario' would be to attract Chinese FDI to produce exportable supplies back into their domestic market on preferential terms. In addition, they can also export to India using the Indo-Lanka FTA, particularly if scale is already been established for selling into their own market. Equally, Indian FDI can locate in Sri Lanka to sell to China and back into their own market on a preferential basis using the two FTAs. All options should be on the table: goods (finished products and plugging into supply chains) as well as services.

It is worth recalling how the apparel sector was developed and transformed in Sri Lanka. It was a combination of the quota system under the now extinct Multi Fibre Agreement and the role of Martin Fine in partnering some of the most successful apparel exporters which led to the creation of a multibillion dollar export industry. The combination of Chinese FDI and the FTAs provides a similar framework to trigger export expansion.

China is currently negotiating a trilateral FTA involving Japan and South Korea. It may be worthwhile to explore whether this can serve as a template for similar triangulation involving Sri Lanka, China and India, particularly as Sino – Indian economic ties deepen. This could be a medium-term objective based on Sri Lanka's excellent 'all-weather' bilateral relationship with China and India's strategic interest in Sri Lanka based on geographical proximity.

Logistics Hub.

Sri Lanka can also benefit indirectly by serving as a logistic hub for the increased Sino-Indian trade which is expected to materialise in the future. As domestic costs increase, and incomes rise, China's import structure will shift more towards consumer goods. Given the Modi government's increased emphasis upon economic reforms and on the development of the manufacturing sector, there is every likelihood that China will import more and more consumer goods from India. Sri Lankan ports, particularly Colombo, are already very engaged in India's transhipment trade (about 70% of the tonnage handled by Colombo Port entails Indian transhipment trade). The increased capacity of the Colombo Port, including the new Chinese-constructed capacity to handle the latest generation of the largest container ships in the world, as well as the extremely strategic location of the Hambantota Port (built by the Chinese) provides an excellent basis for Sri Lanka to become a major logistics hub for servicing increasing Sino-Indian trade. The increasing potential of Sri Lanka as a shipping hub can best be realised by attracting the major global logistics players to establish operations in Sri Lanka, ideally through joint ventures with local players.

Maritime Silk Route.

Sri Lanka is also well placed to take advantage of China's new initiative to build a maritime silk route. Sri Lanka was one of the first countries to welcome the plan. The underlying rationale behind this Chinese initiative is based on win-win economic gains and the security of sea lanes, based on the principle of mutual respect. The Maritime Silk Route seeks both to build trust and bring together China, India and Indonesia as well as to provide a platform for upgrading China's ongoing strategy of engaging with smaller countries along the route. Sri Lanka is well placed to benefit both directly from the gains of greater engagement with China as well as indirectly from stronger Sino-Indian economic relations.

Exponential Increase in Chinese Tourism.

There is also enormous potential for increasing increase tourist arrivals from China. Soon there will be 100 million outbound tourists per year from China. Chinese tourists have now become the largest spenders worldwide. Chinese visitors to Sri Lanka are already growing rapidly from a low base. The potential exists to increase numbers exponentially.

The New Paradigm.

A shift from debt-driven infrastructure development to FDI- led export growth, enabled by the Sino – Lanka FTA, as well as a rapid increase in Chinese tourism, could be the twin engines which will move the already excellent China-Sri Lanka bilateral economic relationship to a new level. President Xi's visit has provided the opportunity to give momentum to this process.

The Sino-Lanka FTA has enormous transformative potential. It can create the framework to strengthen the growth prospects of the economy by attracting not only Chinese investment but also inflows from other sources. In addition, it can transmit the benefits of this growth to a broader cross section of people by generating productive higher value employment. It would be wrong, however, to assume that the mere signing of the FTA would be sufficient to trigger these benefits. An enormous effort would be needed on several fronts – unprecedented in Sri Lanka's post-independence history – to make full use of the opportunities that could be created by the Sino – Lanka FTA.

Adopting a 'business as usual' attitude and focusing only on the current export structure would be a grave mistake. A complementary effort should focus on several areas to improve the investment climate. The commitment to strong macroeconomic fundamentals should be maintained and reinforced. The progress made in improving Sri Lanka's rankings in global indices, such as the World Bank's 'Doing Business Index' and the World Economic Forum's 'Global Competitiveness Index' has stalled. This should be addressed effectively. Factor markets (land, labour and capital) need to work more effectively. The land should be available for a large infusion of FDI. Above all, the currently binding constraint of human resources needs to be addressed quickly and decisively, particularly in areas which can benefit from the Sino – Lanka FTA (e.g. light engineering). As previously advocated by the PF, a package of reforms should be introduced, at the appropriate time in the electoral cycle, to signal Sri Lanka is 'open for business' in order to make maximum use of the opportunities which will be created by the Sino – Lanka FTA. It is important to shift from a static and inward looking mentality to a dynamic regional and global perspective with innovation and productivity/competitiveness at the front and centre. The government and business should operate as Sri Lanka Incorporated in pursuit of a very ambitious vision. In this connection, it is worth paraphrasing Prime Minister Modi from his recent Republic Day Speech: 'Sell anywhere but produce in Sri Lanka'.

This is the Sixty Fourth Economic Alert of Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org