



Pathfinder Economic Flash

Export Expansion and Diversification in Sri Lanka: Towards a New Paradigm?

Missed Opportunities.

After the disastrous consequences of the anti-export bias and import substitution policies, Sri Lanka, since 1978, has implemented many strategies and programmes to promote export oriented industries and agriculture. Nevertheless the country's export performance during the four decades that have ensued has been disappointing. This is partly due to the widespread violence and disturbances which discouraged foreign investors and buyers. In spite of this lackluster performance, a few initiatives and a couple of sectors have proved successful. This includes the performance of the apparel sector and the establishment of export processing zones.

Although the dawn of peace has created a more investor friendly environment the competitive edge Sri Lanka enjoyed during the 80's in attracting FDI's has been substantially eroded with the emergence of other low-cost Asian economies. In this context the conventional thinking of attracting large scale assembly operations, light engineering industries and the like will be a difficult dream to realize.

Towards a New Paradigm.

Demonstrating a clear departure from earlier strategies, since 2009 the government has invested heavily on infrastructure development in critical areas of the economy. This has resulted in unprecedented development and modernization of Sri Lanka's sea ports, airports, highways and ICT network. These major infrastructure initiatives and the recent Ministry of Finance declaration of Colombo and Hambantota as free ports and Katunayake, Koggala and Mirijjawila Export Processing Zones and Mattala Airport as bonded warehouses indicate a direction towards a new paradigm. The country is gearing for a wider spectrum of service exports to drive the next stage of its development utilizing improved infrastructure as the platform.

. The logistics sector, in particular, now has significant opportunities. Ports and shipping services, as well as airports and aviation services have considerable scope for expansion. The World Bank has indicated that the ICT/BPO sector has the potential to become a \$1 billion export industry by 2015 and attain \$10 billion in a decade. (It is currently worth about \$450 million). Sri Lanka also has the institutions and expertise to develop financial and accountancy

services as a major source of service exports, particularly in a regional context. New markets, such as Africa and the Middle East, should also be explored in this connection.

Tourism offers extremely attractive growth prospects. Sri Lanka's diversity in such a compact geographical space is unique. However, challenges exist in terms of competitive pricing, introducing new leisure activities, effective promotion and training of staff.

The new paradigm aims to bring about a qualitative improvement in export expansion and diversification. The prospects for FDI-driven export growth have improved significantly as this approach has been tried and tested with much success in a number of countries.

The Case for Diversifying and Expanding Exports.

As is well known, exports as a percentage of GDP has declined sharply and Sri Lanka's share of global exports have also fallen. In addition, the exports of goods have declined by 6.6% in Jan – May 2013. However, This is incompatible with an accelerated growth trajectory for a country with a population of 20 million. The experience since the end of the conflict, in 2009, has shown that a policy framework favouring growth driven by expansion in the non-tradable sector (construction, retail/wholesale trade and public administration) is not sustainable.. It has, therefore, become clear that accelerated growth can only be sustained by implementing prudent demand management policies supported by a dynamic export development strategy.

Pro-Export Macroeconomic Policy Framework.

High interest rates and an overvalued real effective exchange rate have all combined will create an anti-export bias in the macroeconomic policy framework. The problems have been compounded by the slowdown in Sri Lanka's two major markets: EU and US. These columns have argued on many occasions that fiscal consolidation is a prerequisite for achieving low interest rates and a competitive/stable exchange rate. In this connection. the Treasury's commitment to reduce the budget deficit to 4% of GDP and eliminate public dis-savings by generating a 2% of GDP surplus in the current account of the budget, by 2015, is to be highly commended. Every effort should be made to support these much needed efforts. The trajectory of fiscal consolidation envisaged will serve to reduce excess demand in the system paving the way for less inflationary pressure, low interest rates and a competitive exchange rate.

While a competitive exchange rate, low interest rates and a conducive trade policy are necessary for export expansion, they are not sufficient. They need to be supported by a strategic vision and consistent/predictable policy actions. In this connection, one must applaud again the government's decision to establish free ports and bonded areas. This will open up new opportunities in manufacturing, services and agriculture. The combination of tax incentives, the

free trade agreements providing preferential access to the large Indian and Pakistan markets (as well as the FTA's being negotiated with China and Japan) and improved connectivity/logistics provided by rapid infrastructure development have created a new paradigm for export expansion.

Window of Opportunity for Industrial Relocation

The declaration of free ports and bonded areas also signals Sri Lanka's greater openness to FDI especially in areas such as manufacturing, agribusiness and higher education.

In this regard the conditions are conducive for attracting investment from China, India, Japan and other East Asian countries to drive Sri Lanka's export growth.

China is currently in a similar position to Japan in the 1980's. The appreciation of the Yen and increase in other factor costs have created the opportunity for Sri Lanka to attract Chinese light engineering industries. Our close proximity to the expanding Indian market and Free Trade Agreements with India and Pakistan will also be crucial determinants for attracting Chinese enterprises.

Recent bilateral discussions with India also have identified sectors such as automotive components and pharmaceuticals with high potential for setting up in Sri Lanka with Indian investor participation. Further liberalization of trade and removal of non tariff barriers will create opportunities for Sri Lanka to expand and diversify exports to this growing market.

Japan has been Sri Lanka's the leading bilateral donor over the last 35 years. However, now that Sri Lanka has lost eligibility for foreign aid, with graduation to lower-middle-income country status, the Japanese are seeking to substitute investment flows for ODA.

Agriculture

The challenges that exist regarding production levels in the traditional three crop export sector needs to be addressed, including the limited time now left on the leases granted to the plantation companies. The establishment of bonded areas and free ports also create new conditions for consideration of developing Sri Lanka as a international hub for reprocessing and export of certain agricultural products. There is now the danger of over-production in paddy, with farmers experiencing a sharp fall in prices for their produce. There seems to be a case for a more diversified crop-mix, particularly in Yala season, with scope for producing more high value cash crops for export.. Issues related to supplies (regularity and quality) have also constrained the

growth of fruit and vegetable exports. Potential also exists for penetrating the Middle Eastern markets, particularly as the recent reforms are likely to drive improvements in logistics. Sri Lanka is the world's largest producer of cinnamon. There is considerable potential for value addition in this sub-sector

Next Steps: How to Walk the Talk

The potential now exists for a new dawn in export performance. The combination of infrastructure development, the new free port/bonded area arrangements, the FTAs with India and Pakistan (as well as those being negotiated with China and Japan); and the incentives available under the Strategic Development Act have created a new paradigm for export expansion and diversification. It is now also up to the private sector to take advantage of the opportunities created. Equally, it is incumbent upon the government to deliver the essential public goods in the form of stable macroeconomic fundamentals; consistent and predictable policies; expeditious legal processes, particularly in relation to contracts..

Necessary Condition for Success and Greater Benefits

The fundamental prerequisite of establishing service based exports to ensure availability of skilled man power in respect of specific sectors – ports, shipping, aviation and related services, ICT, etc. However, the current practice is to “export” skilled Sri Lankans. It is therefore a necessary condition to introduce demand driven skilled development programs and create an environment for talented Sri Lankans to engage in emerging service industries. With the emergence of Sri Lanka as a service hub incentive may also be provided to encourage reverse brain drain. Until and unless the required skills are available locally it may be advisable to permit “import” the necessary personnel as an interim measure.

Next Steps

Establishing free ports and bonded areas will create transformative opportunities. The PF hope that early action to create the necessary conditions for taking advantage of them will be taken by the authorities. These include:

- The establishment of legal and administrative frameworks to give effect for the Free Port declaration.
- To introduce checks and balances to maintain the integrity of the bonded areas and
- International promotion and marketing of facilities under schemes of free port and bonded areas.

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