View Point – 3

By The Pathfinder Foundation

Can Sri Lanka Win by Being a Bridge for Indo – China Economic Relations?

Historical Perspective

The end of the civil conflict, a government with a decisive majority and economic geography combine to provide Sri Lanka with an unprecedented opportunity to shift to a higher trajectory of growth and development.

It can be argued that the country currently enjoys the most propitious set of internal and external circumstances since the late- 1950's. The first decade after Independence was characterized by an agrarian economy dominated by three export crops (tea, rubber & coconut) and paddy. Two commodity booms sustained the liberal economic policy stance during this period. However, the authorities were not able to take advantage of the favourable external environment to diversify the structure of the economy.

A dramatic secular decline in the terms of trade marked the next two decades. At the same time, there was considerable demographic pressure as the population grew rapidly, through the combined effects of the control of malaria in the initial post-Independence period, subsequent reductions in infant and maternal mortality and increased access to health services. The Governments of the day responded to these twin pressures by progressively intensifying inward-looking *dirigiste* policies. A shift in ideology also steered this process. By the mid-1970's, there was low investment, sluggish growth and high unemployment, as the State sought to control the commanding heights of the economy.

There was wide ranging liberalization and deregulation of the economy in 1977, followed by further waves of reforms in 1981 –91 and 2001-02, as well as incremental change in-between. The economy moved to a higher growth trajectory. Growth, which averaged 2.9% per year during 1971-77' when dirigiste policies were most intense, increased to 5% in the post-liberalization period. However, the capacity to secure fully the potential gains from liberalization was severely curtailed by the onset of the civil conflict.

The Benign Current Environment

As mentioned above, major "drags" on the economic prospects of the country and the civil conflict were major contributory factors to Sri Lanka's economic underperformance. A country, which had enjoyed better economic and social indicators than South Korea, Singapore and Malaysia, at the time of Independence, has now fallen well behind them.

At present, there are no major "drags" on the economy of the sort experienced in the past. Robust growth in the emerging market economies has meant that the world is in the midst of a secular upswing in commodity prices, the current threats to global growth notwithstanding. In addition, Sri Lanka is in a demographic sweet spot with a peak in the share of the population in the economically active age group, prior to the onset of the ageing and a renewed increase in the dependency ratio. In addition, the civil conflict has ended. Above all, economic geography is favourable for Sri Lanka as a result of the recent changes in the global economic landscape. These factors combine to offer a transformative opportunity for developing the country.

Taking Advantage of the Resurgence of Asia

The Government has set a growth target of 8% - 10%. To achieve this on a sustained basis, private investment, domestic and foreign, has to increase from 21% of GDP to 28%. The Government is committed to maintaining public investment at 6%-7% of GDP. The increased private investment needs to support significantly enhanced export performance. The size of the domestic economy precludes a domestic demand-driven strategy for achieving the growth targets.

In this connection, full cognizance should be taken of the shift in the global economic centre of gravity from the West to the East. This offers Sri Lanka two major opportunities that can be capitalised upon:

1. Close proximity to the rapidly-growing Indian economy;

2. Excellent relations with China from the time of the Rubber/Rice Pact (1952?)

At present, almost 60% of Sri Lanka's exports are directed to the sluggish markets in Europe and North America. Less than 10% go to India, China and Japan. Increasing exports to South, South East and East Asia should be integral to any growth strategy for the country. Exporting finished products to these markets is likely to prove extremely challenging. Instead, there should be a focus on plugging into the dynamic supply chains in Asia. At present, Asian cross border intra-firm trade is the most dynamic component of the international trading system. The vertical integration of modern production processes permits the manufacturing of components in more than one country. The rapid growth in the BPO sector has also meant that services are sourced across borders. Sri Lanka has no presence in the supply chains of Asian manufacturers and a very limited presence in the region's BPO activity.

Plugging into Indian Supply Chains

Located a mere 20 miles away, Sri Lanka has an unprecedented opportunity to plug into the fast-growing supply chains in India, particularly in the Southern sub-region. The rise of first Japan and then China transformed the prospects and performance of East and South East Asian countries. Increased supply – chain based trading has been a major part of their success story. The potential exists for Sri Lanka to benefit in a similar way from the accelerated growth in India.

In this connection, it is noteworthy that for India to record 8%-9% growth, the four States of the Southern sub-region (Andhra Pradesh, Karnataka, Kerala and Tamil Nadu) must be achieving double-digit growth to offset the poor performance of "lagging states" further North. In addition, as agriculture in the Southern States is growing at much lower rates, services and manufacturing must be recording growth rates comfortably into double digits. This means that there is a rapid increase in the middle-class and disposable incomes of a population in excess of 250 million. In fact, India is projected to become the most populous country in the world by 2025. The challenge is to position the Sri Lankan economy to plug into the supply chains of Indian companies and multinationals operating particularly in the Southern sub-region. For instance, there are 270 Japanese companies in Tamil Nadu alone. Sri Lankan companies need to become sufficiently competitive to break into these supply chains, tapping into foreign investment through joint ventures, where necessary. The road ahead is far from easy. However, the rewards are likely to be considerable as India becomes an increasingly important player on the global economic stage.

Attracting Chinese Foreign Direct Investment (FDI)

Chinese companies have been investing abroad for some years now. Initially, they focused on securing access to natural resources in Africa and then Latin America. More recently, they have begun acquiring assets in the West to increase their presence in these markets. The stock of Chinese FDI stood at $250 Billion (2010). This figure is dwarfed by the $ 1 to 2 trillion that Chinese companies are expected to invest abroad over the next 10 years.

China is expected to pursue a path that has already been followed by Japan. In the mid-1980's Japan revalued the Yen following the Plaza and Louvre G7 Accords. The increased strength of the Yen drove a concerted plan to export capital, particularly to South East Asia. Indonesia, Malaysia and Thailand were able to enjoy a step – jump in their development trajectories as a result of this. The Yuan is likely to appreciate steadily as the Chinese rebalance their economy to depend more on domestic demand and less on the sluggish export markets in the US and Europe.

Sri Lanka was not able to take advantage of Japan's drive to export capital in the 1980's due to the conflict. China has provided a considerable amount of loans to support the Government's ambitious infrastructure development programme. The proposed Shangri – La and CATIC investments constitute large non-debt creating FDI flows. There seems to be a major opportunity

to attract considerably more such flows, as Chinese companies step-up their programmes of overseas investment.

Sri Lanka's attraction as an investment location for Chinese companies can be greatly enhanced if it can position itself as a bridge for Chinese companies seeking to access South Asian markets. The Free Trade Agreements (FTA's) with India and Pakistan provide an attractive framework for pursuing this agenda.

The vast and rapidly growing Indian market would be of particular interest to Chinese companies. In addition, while China has excellent relations with Pakistan, the security situation there may make Sri Lanka a viable option for serving that market as well.

Conclusion

If one adopts a 10 – 15 year perspective, the "Dream Scenario" for Sri Lanka's growth and development should have two strategic pillars:

(1) plugging into Indian supply chains, both local companies and MNCs; and

(2) attracting Chinese investment to take advantage of the potential access to the Indian market provided by the Indo – Sri Lanka FTA. This advantage would be amplified if the Comprehensive Economic Partnership Agreement (CEPA) is finalized.

Such a strategy, particularly the role of acting as a bridge between India and China, would need to be supported by extremely pro-active and sophisticated diplomacy. It would be imperative to reconcile India's strategic interests and the commercial interests of the two countries in a transparent and predictable manner, in order to bring about win-win outcomes for all the three parties concerned: Sri Lanka, India and China. This would undoubtedly be extremely challenging. Any successful strategy would also need to be based on a stable macro-economic framework and an enabling environment that incentivizes both domestic and foreign investment. If Sri Lanka is able to plug into Indian supply chains and be a bridge for Indo – China economic relations, it can truly become the "Wonder of Asia".

Readers' comments via email to pm@pathfinderfoundation.org are welcome.