Identifying Growth Opportunities: 
The Challenges of Export Expansion and Diversification of Products and Markets

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EXECUTIVE SUMMARY

This paper sets out to understand current challenges faced by the export sector of Sri Lanka and identify the key factors that constrain its diversification and expansion. It will also propose policy recommendations that would help restore export growth and ensure its sustainability.

The paper is divided into five sections. Section one is a detailed analysis of Sri Lanka’s export performance in comparison to other developing countries in the region. Section two looks at developments in global trade and their impact on the country’s export over the last few decades. Section three analyze barriers to expand export capacity and competitiveness faced by exporters inside the country. Section four looks into the lessons that can be drawn from the East Asian experience of export-led growth. The concluding section reviews potential growth opportunities available for Sri Lanka to accelerate growth in exports by diversifying products and markets.

Export Performance

Sri Lanka’s share of world exports, along with its ratio of exports to GDP, has declined steadily over the years. The absolute value of exports has continued to show negative growth since June 2012 till mid-2013. Weak growth in industrial exports, which account for over 70% of total exports, is the main setback faced by the export sector. The decline in the apparel sector contribution to growth has a significant negative impact on industrial export growth. Although the share of agricultural exports has increased due to better prices, volumes have been stagnant, and value addition remains low. The price driven growth in agriculture exports is not sustainable. Post war the services exports have picked up because of the revival of the travel and tourism sector.

The export sector continues to have high product and market concentrations. The apparel and tea sectors account for over 50% of merchandise exports and service exports are dominated by Travel and IT/BPO sectors. Five countries account for over 50% of exports. These high degrees of product and market concentrations are the result of exports growing at the intensive margin; i.e. selling more of the same products to the same markets. Certain degree of diversification has taken place within the same product sectors, especially apparel where export products have moved up in the value chain. Meanwhile, growth at extensive margin; i.e. selling new products to new markets, remains low.

Global Trends

Changing patterns in global trade have an impact on export performance. Sri Lanka’s exports have slowed down at a time the world trade has recorded exponential growth in exports. Intermediate products trade resulting from global fragmentation of production to small components and tasks or the emergence of Global Value Chains (GVCs) is the reason for this high rate of growth. Sri Lanka, which is predominantly an exporter of primary and consumer products, has not been able to cash in on this growth.

The service intensity in manufacturing or service inputs that goes into production process has seen a significant increase over the years. As a result, the value of actual manufacturing as a
percentage of the total value of the final product has declined dramatically. At the same time, the advancements in technology have enabled trade in services. As a result, the share of services in world trade has increased. Sri Lanka is yet to recognize the importance of services exports. The policy and institutional support provided for exports in the country is heavily biased towards promotion of export of goods.

Trade has shifted from North to South and developing Asia has been at the center of this change. Despite being strategically located in Asia, exports from Sri Lanka are heavily dependent on a few Western markets, and exports to Asia remains low. With the advent of the World Trade Organization (WTO) and the recent rise in regional/bilateral trade agreements, international trade rules have changed. The former limits policy space for countries like Sri Lanka and the latter negatively affects competitiveness of countries that are not members of trade agreements.

The role of foreign direct investment (FDI) in the growth of international trade has increased over the years. However, the FDI inflows into Sri Lanka continue to be low and FDI inflows into export-oriented sectors are lower. Analysis of global trade patterns shows that the export sector of the country has been somewhat isolated from these global developments and as a result failed to benefit from them.

**Export Capacity and Competitiveness**

The domestic environment characterized by resources, institutions and policies play a critical role in determining capacity and competitiveness of exports of a country. The leading exports from Sri Lanka; tea and apparel are losing their cost based comparative advantage but the country depends heavily on these products for its export income. The policy, regulatory and institutional weaknesses constrain the ability of the current exports to move from low priced, high volume, mass markets to high priced, low volume, niche markets. The same weaknesses are preventing the ability of the country to diversify into new products and new markets.

Labour has become a costly and a scarce resource. The education system fails to generate the skills required to make the transition from low cost labour intensive industries into skill intensive industries. The outdated regulations stifle productivity growth. Policy instability undermines predictability of the business environment. The export promotion agencies dating back to colonial or import substitution era functions within outdated concepts and regulatory frameworks. Sri Lanka has fared poorly in terms of attracting export oriented FDI. The trade agreements and trade promotion agencies have failed to bring down the market access barriers effectively. Both the quantity and quality of bilateral and regional trade agreements of the country is low and the trade promotion agencies tend to be largely activity oriented than result oriented. All these factors undermine the capacity and competitiveness of exports from Sri Lanka.

**East Asian Experience**

Many developing countries adopted an export led growth strategy inspired by the success of four East Asian tiger economies; South Korea, Taiwan, Singapore and Hong Kong. The experience of these countries therefore provides valuable lessons for countries striving to expand exports.
The success of East Asia critically depended on the ability to diversify into new sectors, when the traditional sectors became uncompetitive. This was made possible by the long term commitment at all levels of government and private sector to continuously build capacity and competitiveness of products and services. These include creation of a sound foundation to enable exports to take off by ensuring macroeconomic stability and investing in infrastructure and education. Effectiveness of government policy and interventions, pragmatic approaches to economic liberalization, ability to attract export oriented FDI and regional integration are other factors that led to higher levels of export growth.

The South East Asian nations such as Malaysia and Thailand that followed failed to achieve the level of success of the East Asian Tigers despite seeing higher rates of economic growth. The reasons identified for the delay in transition of these countries from middle income to high-income status are inability to separate economic decision-making from political interventions, failure to invest in upgrading education and poor planning and over-investment in unnecessary and wasteful mega projects. The failures of South East Asia highlight the possible pitfalls a country need to avoid in its attempt to accelerate economic growth.

**The Way Forward**

The strategy to revive the export sector of the country is divided into three broad categories; upgrading current products and markets, developing new products and services and expanding into new markets.

Scarcity, high cost and low productivity of labour and land and resulting decline in comparative advantage of the current lading exports such as apparel, tea and spices demands an upgrade from low value, high volume, mass markets to high value, low volume niche markets. This shift however requires adopting an innovative approach towards value addition that goes beyond increasing local content and physical transformation of raw materials into final products. New dimensions of value addition requires focusing on aspects such as production process (e.g. organic, ethical), brand value, product features (e.g. design), increasing quality of services that goes into manufacturing and moving up the value chain from low value to high value activities.

Upgrading the existing products and markets will not be sufficient to achieve higher rates of export growth on a sustainable basis. When developing new products and services, the important factors to consider are the world demand and the comparative and competitive advantage the country has to provide the products or the services for which the demand is increasing. The emergence of GVCs has created demand for high quality, low cost value added port and logistics services that go beyond mere handling of transshipment cargo. Sri Lanka has a natural comparative advantage arising from its strategic location in close proximity to main sea routes to be a provider of these services. The recent large scale investments made to upgrade the port infrastructure also is an advantage. The country however faces intense competition from existing providers of these services in Asia. Therefore while location and infrastructure is necessary it will not be sufficient to succeed in this intensely competitive market. It is important to have in place the correct technology, skills, institutes and policies to be competitive.
Sri Lanka need to expand its exports into emerging developing country markets in Asia. The primary strategy the country is focusing on to achieve this diversification is to enter into trade agreements with Asian countries. The success of trade agreements depends on two critical factors; first is the capacity and competitiveness of products and services the country can export and second is the extent to which the partner country reduces the barriers to potential exports. Sri Lanka fares poorly in both; the analysis of current export structure clearly demonstrates severe shortcomings in terms of capacity and competitiveness of exports and existing trade agreements have failed to provide effective market access to potential exports. The proposed agreements therefore need to take measures to address these weaknesses if they are to help expand exports into Asian markets.

While trade agreements can reduce entry barriers and improve market access, information barriers can severely undermine the survival of new products in new markets. Trade promotion institutions can play a critical role in reducing information barriers faced by exporters. The current trade promotion institutional framework is highly fragmented and has proven to be ineffective. It is important to restructure the institutional framework and make them performance oriented.

Sri Lanka is well positioned to export port and logistics services and become a strategic location for regional headquarters for global companies interested in tapping into the growing markets in the Indian Sub-Continent (ISC). The presence of leading global logistics and manufacturing firms is critical to become a successful maritime and logistics hub in the region. The success of leading logistics hubs in the world such as Rotterdam and Singapore had been their ability to attract global firms to set up office on their shores. There is intense competition in the region to attract headquarters of global firms. The export and FDI strategy need to recognize the role export of port and logistics services can play in Sri Lanka.

The changes that have taken place in the global trade landscape, developments in technology and the developments in international trade rules demands countries to think innovatively when adopting an export led growth strategy. The Mahinda Chinthana Development strategy of the government based on the five-hubs does not recognize exports as a central pillar of growth. There has not been any attempt to recognize the synergy between exports and the efforts taken to develop Sri Lankan into a maritime and logistics hub. The outdated definition of exports restricts the country from thinking innovative and recognizing the role services exports can play in increasing export earnings of the country. As a result the export strategy and the maritime and logistics hub strategy of the government are implemented in isolation from one another. Recognizing the synergy and complementarity between the two is critical to be able to achieve the objectives of both strategies.
INTRODUCTION

The perception of the role of exports in economic growth changed with the unprecedented rates of economic growth achieved by the four Asian Tigers; South Korea, Taiwan, Hong Kong and Singapore with the adoption of an aggressive export oriented industrialization (EOI) strategy. Inspired by the success of these countries, other developing countries followed their footsteps. Only few countries in South East Asia; Malaysia, Thailand, Indonesia, Philippines succeeded to accelerate economic growth through export led growth strategy, many failed. The recent success achieved by countries like Vietnam and China following the same strategy however, confirms the relevance of exports to sustain economic growth even in today's context.

Sri Lanka is the first country in South Asia to adopt EOI model in 1977. The country like many others failed to achieve the expected export and economic growth targets. The ethnic conflict in the North as well as political instability in the South derailed the process of EOI in the 80s. For nearly three decades since mid-80's the country despite introducing additional reforms to the economy failed to achieve higher growth rates envisaged. The prevailing policy, regulatory and institutional framework also undermined the potential increase in exports.

This paper sets out to understand current challenges faced by the Sri Lanka's export sector and identify factors that constrain its expansion. It concludes proposing policy recommendations that would help restore export growth and ensure its sustainability.

Weak export performance of the country is often associated with conflict related costs (e.g. security risk, unpredictability), heavy dependence on few products and few markets and depressed demand in the main markets for Sri Lankan exports caused by weak world economic growth. Other than the services sector driven by the revival of travel and tourism, end of conflict in 2009 is yet to show its positive impact on the export sector in general. The continuing weak performance in exports is an indication that conflict related costs is not the main factor that undermines export performance.

The other leading barrier to export growth highlighted is the policy, regulatory and institutional weaknesses and the heavy concentration on few products and few markets. Need to address these have been at the centre of policy debate and discussion for many years but have failed to move beyond that into action.

This paper attempts to take a different approach from this conventional analysis of export performance. First deviation is the analysis of lack of diversification not as the cause but the result of weak export performance of the country. The cause is the poor capacity and competitiveness of products. Therefore, to diversify products and markets, the policy should focus on enhancing capacity and competitiveness of products and services.

Second deviation is the focus on changes that has occurred in the global trading environment and its impact on Sri Lanka's export performance. The current discussion is heavily biased towards the issues related to the domestic economic, policy, regulatory and institutional
environment. Whenever the international environment comes to focus, it is limited to discussions on demand for current exports in the leading markets. Analysis of exports from Sri Lanka against the developments that has taken place in the world exports clearly demonstrate that the export strategy of the country has failed to respond effectively to these developments. In comparison, other emerging developing Asian economies recording dynamic export growth are the countries that have been sensitive to these developments and adjusted their strategies to enhance the capacity of their exporters face challenges and to exploit opportunities that emerge with these changes.

The revival of exports of Sri Lanka therefore depends on developing policies, regulations and institutions that will enable the country to generate products and services with the capacity and competitiveness to face challenges emerging with the changing global trading environment and benefit from emerging opportunities.

The paper is organized as follows; section one takes stock of the export performance of the country and section two and three captures the developments in external and internal environment that influence export performance; former looks into global trends and latter looks into internal barriers to export capacity and competitiveness. Section four look at the lessons that can be drawn from the export led growth experience of East Asia. Final section concludes with policy recommendations on the way forward to develop a dynamic export sector.
1. EXPORT PERFORMANCE

This section analyses the performance of the export sector by looking into the overall growth, sectoral composition, product and market composition and sources of export growth.

a) Exports as a % of World Exports

Exports from Sri Lanka as a % of world exports have been steadily declining. With the shift in growth strategy from import led to export led in the 70s, a number of Asian countries saw a rapid increase in their world market share. Sri Lanka experienced marginal recovery in its world market share for a short period with the adoption of Export Oriented Industrialization (EOI) policies in 1977 but thereafter the share has been steadily declining. The gap between Sri Lanka and many other countries in Asia, including countries that adopted EOI policies later than Sri Lanka such as Vietnam (Figure 1) have widened over the years.

Figure 1: Exports from selected Asian Countries (as a % of World Exports)

Source: World Trade Organization

b) Exports as a % of Gross Domestic Product (GDP)

Exports to GDP share of the country have also declined. The East Asian countries experienced rapid increase in the exports to GDP ratio during periods of high economic growth. Sri Lanka’s exports to GDP ratio increased during the 1986 – 2000 period from 19% to 33%, but have been steadily declining thereafter. In 2012 exports to GDP ratio stood at 17% (Figure 2). Countries that adopted the export led growth strategy later than Sri Lanka, such as Vietnam, Cambodia have experienced higher rates of export growth compared to Sri Lanka. The Least Developed Countries (LDCs) in South Asia like Bangladesh are also catching up (Figure 3).

Figure 2: Exports as a % of GDP

Figure 3: Exports as a % of GDP
c) Export Growth

Export growth of the country is slowing down. During the last decade, the growth had been lower than that experienced by other emerging developing countries (Figure 5). Since May 2012 for 12 months in a row, the value of exports recorded negative growth as well (Figure 4). The recent slowing down of the world economy and resulting depressed demand from USA and EU is considered the key reason for this low growth. A comparison with the export growth experienced during 2010-12 indicates that other countries have weathered the negative impact of depressed world demand better than Sri Lanka (Figure 5).

**Figure 4: Monthly Exports (% Growth)**

![Chart showing monthly exports growth](image)

Source: Central Bank of Sri Lanka

**Figure 5: Annual Average Export Growth (%)**

![Chart showing annual average export growth](image)

Source: World Trade Organization

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d) Sectoral Composition

Industrial exports account for over 70% of total merchandise exports, agriculture and mineral exports account for the balance. The slow growth in exports experienced in the last decade is mainly due to the decline in industrial exports growth. As a percentage of GDP, industrial exports have declined from 22% in 2005 to 13% by 2012 (Figure 7). The share of industrial exports as a percentage of total exports has also declined from 79% in 2005 to 75% by 2012 (Figure 8). The recent recovery in exports experienced since June 2013 is largely driven by the recovery in agricultural exports led by increasing prices. The industrial export growth continues to be sluggish.
Agriculture exports earnings had been the driving force in export earnings as of recent. The exports to GDP share of agriculture exports have remained stable at 4-5% of GDP share in exports has increased from 18% in 2005 to 24% by 2012 indicating healthy growth (Figure 7). Average export growth of industrial exports has been 8% and agriculture 11% during the last decade.

The growth in value of agricultural exports has been the result of buoyant prices (Table 1). The volume of exports had been stagnating and value addition is low. For example, value added tea exports account for less than 10% and value added spices account for less than 5% of the total exports.
As countries migrate from a low income country status into a middle income country status, the normal trend is to see a decline in the share of agricultural exports as a percentage of total exports. The heavy reliance on agriculture exports increase vulnerability of a country due to frequent commodity price fluctuations in the world. The recent trend experienced by Sri Lanka where agriculture exports share in exports increasing while the industrial share is declining therefore is a concern.

Services exports have gained momentum post war resulting from the growth in travel and tourism sector. Services exports also declined from 7% to 4% during 2003-2009 but regained its share by 2012. Services exports growth was as low as 5% up to 2009, but shows strong post war recovery of over 25% (achieving an average growth of 12%). IT/BPO sector has recorded a steady growth as well.

e) Product Composition

Export earnings of the country are heavily dependent on few products. Figure 10 show the level of product concentration and during 2005-2012 the contribution of first ten and first fifteen products at HS 4 digit level has records a marginal increase.

Tea and apparel still account for 52% of exports. Although the share of Apparel has dropped from 48% to 38% during 2002-2012 it is still the leading industrial export accounting for over 60% of total industrial exports. The slowing down in the growth in apparel is the main reason for the declining share of industrial exports as well as overall export growth. Apparel sector increased at an annual average growth of 13% during 1992-2001 and during 2002-2011 the rate of growth dropped to 6%. The other exports have failed to fill the gap and as a result annual average growth of exports dropped from 10% during 1992-2001 to 9% during 2002-2011.
Growth momentum in services exports have picked up faster than other sectors during the post war period, driven by the growth in travel and hotel services sector (Figure 12). Services export earnings increased from 29% to 39% as a percentage of merchandise exports in just one year during 2011-12. The other services sector recording high rates of growth is the IT/BPO Sector. Lack of services trade statistics by country and by sector however makes it difficult to assess the real contribution of services sector to export earnings of the country.

f) Export Markets

Export earnings of the country are heavily dependent on few markets. Despite the significance decline on the reliance on USA over the years, it remains the single largest export destination accounting for 20% of total exports. The share of exports to EU has remained relatively high and stable. The growth in exports to Asia is slow (Figure 13). Market concentration of exports has declined over the years, but remains high with just five countries accounting for 51% of total exports (Figure 14). The diversification of products away from EU and USA is a positive trend. Detailed analysis also shows that even within EU, the heavy concentration of exports to U.K. is declining. The diversification of markets has been the result of the decline in the share of apparel exports. The market concentration in Sri Lanka is closely linked to heavy dependence on apparel. For example, over 80% of exports to U.S.A. is apparel and with the decline in apparel to exports ratio, the US share has come down. The same is true for U.K. where over 60% was apparel and with diversification of apparel into other markets in Europe, the market concentration on UK has declined.
In terms of export markets, the country is moving in the right direction but has plenty of room to improve. For example in terms of exporting to Asia, the South Asian neighbors like India and Pakistan have made much headway compared to Sri Lanka (Figure 15).

![Figure 15: Exports to Selected Asian Countries (% of Total Exports)
(China, S. Korea, Hong Kong, Malaysia, Indonesia, Singapore)](source: Trade Map of ITC (www.trademap.org))

### g) Sources of Export Growth

Exports of a country can grow at the intensive margin; i.e. by selling more of existing products to existing markets and at the extensive margin; i.e. by selling new products and to new markets. Most developing countries find it easier to grow at the intensive margin.

The analysis of statistics show that export growth in Sri Lanka has also come from growth at the intensive margin. There has been a shift within the same product categories; for example, the share of apparel **not** knitted or crocheted has declined and the share of apparel knitted and crocheted has increased. There has been a decline in some traditional exports such as gems and jewelry and in exchange, some other traditional exports such as rubber, tea and spices have gained ground.

The trend shows signs of diversification within the same product category, which is a positive development. This is mostly visible in the apparel sector and the rubber sector. For example, there has been a reduction in apparel in low value added categories and an increase in high value categories. In rubber sector, the share of natural rubber exported has declined and the share of value added rubber products exports have increased.

Few new products are gaining ground, such as processed food products, wood products and electrical parts and ships/boats (Figure 16). The annual average export growth of these products during 2006-2012 is encouraging; the new sectors have recorded higher rates of growth compared to established sectors (Figure 17). The share of the three leading export destinations USA, UK and India have decreased during 2005-2012. Despite the decline in export share to UK, the share to EU remains high. This is due to increase in exports to other European markets; especially to Italy and Belgium. Similar to products, the markets are also seeing diversification within the same geographical region. The new geographical locations that are gaining ground are China and other East Asian countries like Indonesia and Malaysia (Figure 18).
Figure 16: Shift in Product Composition: 2005 & 2012 (Change as a % of Exports)

-6.0 | -4.0 | -2.0 | 0.0 | 2.0 | 4.0
62 | 61 | 39 | 63 | 84 | 24
95 | 44 | 87 | 89 | 11 | 53

Figure 17: Annual Average Growth (%): 2006 - 2012

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<td>Plastics/articles thereof</td>
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<td>61</td>
<td>Apparel – not Knitted or crocheted</td>
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<td>71</td>
<td>Precious stones</td>
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<td>63</td>
<td>Made up textile articles</td>
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<td>Tea and spices</td>
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<td>Machinery and parts</td>
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<td>40</td>
<td>Rubber and articles thereof</td>
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<td>08</td>
<td>Coconuts/fruits</td>
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<td>85</td>
<td>Electrical machinery and parts</td>
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<td>Preparations vegetables, fruits</td>
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<td>Residues from food industry/animal feed</td>
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<td>49</td>
<td>Printed books, papers, pictures</td>
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The analysis shows that Sri Lanka is losing its share of exports in the world market. The country is also experiencing a decline in its exports to GDP ratio. Since mid-2012, the absolute value of exports also recorded negative growth for over 12 months. Apparel sector accounts for 38% of total exports, and over 60% of industrial exports. The slowing down of growth in apparel exports has led to the decline in the share of industrial exports. Agriculture share has increased due to buoyant prices, however, volume has been stagnating, and value addition remains low. Services sector is the only sector that showed exceptional growth post war, driven by the revival of travel and tourism sector.

Product and market concentration continues to be high. Apparel and tea account for over 50% of exports and services exports is dominated by travel and IT/BPO exports. Just five countries account for over 50% of exports. The growth has resulted at the intensive margin; selling more of the same products to same markets. Although there has been some level of diversification taking place within the same product sector and same market, growth at extensive margin; i.e. selling new products to new markets remain low.

The analysis reveals that the potential of the current export structure to generate the required increase in export earnings is limited. The increasing dependence on price driven agriculture commodity exports threatens the sustainability of export earnings. This calls for a deeper analysis of factors that undermine export potential of the country. The next two sections of the paper focus on identifying the external and internal factors that constrain export growth.
2. GLOBAL TRENDS

The changes that occur in the global trading environment have a significant impact on export performance of a country. This section therefore focuses on global trends and how well Sri Lanka fares in comparison to these developments. Analysis shows that Sri Lanka’s exports have grown out of synergy with the developments that has taken place in world exports during the last two decades and this is a key reason for its slow growth.

a) World Export Growth

The growth momentum of world exports during the last decade has been exponential. World exports have doubled in just 6 years to reach US$ 16 Trillion in comparison to 13 years taken to double from US$ 2 – 4 Trillion, and another 13 years to reach US$ 8 Trillion (Figure 20). The growth in trade has been higher than world output growth. As a share of global output, trade is now at almost three times the level it was in the early 1950’s1.

![Figure 20: World Exports (US$ Trillion)](source)

![Figure 21: Trade in Intermediate Products](source)

b) Composition of Exports

Intermediate products trade has been the driving force behind this exceptional export performance. The reduction in trade barriers, improvements in transport and logistics services, and developments in information and communication technology (ICT) has enabled global manufacturing companies to fragment production chain across borders into components and tasks. As indicated in Figure 21 intermediate components trade growth has far exceeded the growth in trade of primary, consumer and capital goods during 2002-2011 and accounts for 50% of the world trade today.

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1International Monetary Fund, Changing Patterns of Global Trade, Strategy, Policy and Review Department, 15 June 2011
Exports from Sri Lanka consist of primary and consumer goods. The country is yet to tap into the global value chains and engage in the trade of intermediate products. This is possibly a key reason behind the decline in world market share of Sri Lanka has seen at a time the world has seen an exponential growth in exports.

The world trade has also shifted from resource intensive and low-skilled labour intensive products to skill and technology intensive products. Statistics show that the share of high technology and medium technology product as a percentage of total merchandise trade has increased in the last three decades, the share of resource based, and low technology products share has declined. Exports from Sri Lanka are mainly resource intensive and low skilled labour intensive products. The transition into technology and skill intensive industries is undermined by the domestic constraints faced by the exporters, which are discussed in detail in the following section.

The Services, considered a “non-tradable” sector in the past, has become tradable with the developments in the information and communication technology and services trade has grown fast during the last two decades (Figure 22).

The value of world services exports stands at USD 4 Trillion and as a percentage of total merchandise trade at 25%. This figure is however heavily understated given the intangible nature of the exports and the mode of exchange (e.g. internet), the countries still find it difficult to accurately record the value of services trade. The share of developing country exports in services has increased considerably over the last two decades from 20% to 30%.

The policy and institutional support for exports in Sri Lanka is heavily biased towards promoting goods as opposed to services.

c) Increasing Service Intensity of Production

The recent developments in international trade discussed above have made traditional value added as envisaged by the traditional trade models of Ricardo and Hecksher Ohlin less important. The service content of manufacturing has increased significantly over the years. As far as GVCs are concerned, services are ubiquitous. Not only do most aspects of GVC operations rely critically on producer services such as finance, transport, logistics, electronic communications, distribution and business services, but dozens of other services are implicated in different ways along supply chains.

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Figure 22: Growth in World Exports in Services

Source: UNCTAD Services Trade Statistics

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ibid
The actual manufacturing or the physical transformation of production in today’s context is the lowest form of value addition to the final product. According to research, manufacturing accounts for only 9% of the value of a suit made in China that is sold in the USA, the invisible assets such as services (retail, logistics, banking), intellectual property, profit etc. account for 91%\(^5\). Another research on Nokia95 phone state that parts account for 33%, assembly account for 2% and internal support services account for 31%, licenses 4%, distribution 4%, retailing 11% and profit 16%\(^6\).

These developments require new thinking. For example in Sri Lanka, value addition is still perceived as physical transformation of raw materials into final products. This is increasingly becoming an outdated concept. The services inputs that goes into manufacturing receives little attention during discussions on exports.

d) Geography

The world trade is gradually shifting from North to South. The share of imports and exports of developing countries has rapidly increased during the last two decades. The developing world accounts for 45% of world exports and 41% of world imports. This growth is driven by developing Asia that account for 35% of exports and 31% of imports (Figure 25).

With the shift of trade to Asia, intra-Asian trade as well as South-South trade is increasing at a rapid rate. This development will have tangible implications for global transport and trade patterns. One recent analysis predicts that in 2015, China will be the top exporter and importer and by 2030 the world’s largest trade corridor will not involve the United States or Europe, but will instead extend from the advanced to the emerging Asia of Thailand and Viet Nam. It is forecasted that by 2050, 60% percent of exports from advanced Asia will go to emerging Asia, thus reinforcing the move eastwards and South–South trade\(^7\) (Figure 26).

Global supply chains although called global are in fact largely regional; “Factory Asia” having Japan as the hub and “Factory North America” having USA as the hub and “Factory Europe” having Germany as the hub\(^8\). The fastest growth in intermediate product trade within supply chains is taking place in Asia led advanced East Asian countries.

Sri Lanka is still heavily dependent on developed country markets for its exports. The country despite being located in Asia and having the locational advantage of being close to major sea routes in the world, has failed to benefit from the Asian growth story.

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\(^6\) Ali-Yrkko et al (2011) quoted by ibid


\(^8\) Baldwin(2012) quoted in p (31)
The services trade, specially the travel and tourism is also shifting to Asia. According to ITB, Asia is propelling the growth of the global travel and tourism industry. The Asia Pacific travel market ousted Europe to become the world's biggest regional travel market in 2012, earning gross bookings of $326.2 billion and the impressive figure is expected to grow another 8% in 2013. According to UN World Tourism Organization, the market share of emerging economies increased from 30% in 1980 to 47% in 2012, and is expected to reach 57% by 2030, equivalent to over one billion international tourist arrivals. Between 2010 and 2030, arrivals in emerging destinations are expected to increase at double the pace of that in advanced economies. Sri Lanka is still focused on Europe for its tourism; the shift to Asia has been slow.

**e) Trade Rules**

International trade rules have changed significantly over the last three decades. During 1970s and 80s the international regulatory framework under General Agreement on Tariffs and Trade (GATT) was weak. Since the advent of World Trade Organization (WTO) in 1995 the international regulatory framework has become relatively strong. This development has imposed restrictions on policy space countries have to design trade policies and on the ability to pursue some of the trade promotion strategies followed by the East Asian NICs. While WTO rules established in 1995 are still relevant, fresh rounds of negotiations thereafter have failed to further liberalize world trade by writing a new set of rules. As a result a secondary layer of international rules have come into existence to govern trade between countries with increasing number of regional and bilateral trade agreements.

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10 World Tourism Organisation, Tourism Highlights, 2013
WTO has 159 member countries and average number of trade agreements of a WTO member is as high as 13. At the beginning of 2013 the number of trade agreements notified to WTO amounted to 546, out of which 354 were in force and others were being negotiated. With the world trade share of Asia increasing, the number of trade agreements in Asia has also increased simultaneously. Currently nearly 100 agreements have been signed and are in effect in Asian countries while an additional 150 are being negotiated (Figure 6).

Simple trade agreements that emerged for the purpose of governing goods trade have today have become complex incorporating rules governing services trade as well as other issues that affect trade such as investment, competition, government procurement and intellectual property. This expansion has created a complex international trade regime where exports from countries that are not members of trade agreements are discriminated in terms of market access vis a vis imports from others that are members of the trade agreement.

The number of trade agreements of Sri Lanka are few (only five agreements are in effect) and market access given and received through these agreements remains low. The scope of agreements is narrow being restricted to only trade in goods.

f) **Foreign Direct Investments (FDI)**

Increasingly, FDI and trade are perceived as complementary to each other. This may be because affiliates or subsidiaries are used as "export platforms" by foreign investors – where investment in production capacity results in exports from that country to other third-country markets in its proximity. With the growth in income and consumption in Asia, there is high level of interest among developed country manufacturing firms to locate their production facilities in Asia to serve the fast growing Asian market.

The higher levels of research and development taking place in developing countries and the high technology content of developing country exports have resulted from FDIs. There is a close relationship between movement of FDI inflows to Asia and exports from Asia. Research has confirmed that FDI can boost trade and that exports in turn also boost FDI\(^1\) (Figure 26). FDI has helped developing countries catch up with the developed world.

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\(^1\) World Trade Organization, *World Trade Report*, 2013
The analysis of changing global trade landscape shows that the world trade has undergone significant shifts over the last two decades. World exports recorded exponential growth driven by intermediate products. This has been the result of global fragmentation of production to small components and tasks creating GVCs. With the emergence of GVCs service intensity of production process has increased challenging the traditional concepts of value addition. The advancement of technology has led to increase in trade in services. The trade has shifted from North to South and the developing Asia has been at the center of this change. With the advent of WTO and recent rise in regional/bilateral trade agreements, the rules of trade have changed. FDI has come to play a central role in the growth of international trade. The product and market composition of exports discussed in section one of the report clearly indicate that Sri Lanka has failed to fall in line with these developments and as a result has failed to benefit from the emerging opportunities. This is a critical factor causing exports to perform poorly but has received little or no attention in the discussion on the fate of exports of the country.

The next section focuses on another dimension of the export story of Sri Lanka, which has received much attention; the policy, institutional and regulatory barriers.
3. EXPORT CAPACITY AND COMPETITIVENESS

This section focuses on barriers faced by exporters inside the country such as resources, institutions, policies and regulations that affects export capacity (volume) and competitiveness (value). Weak performance is the result of poor capacity and competitiveness. Understanding and addressing factors that constrain export growth therefore is critical to develop the sector. Figure 29 provides a summary of the barriers that undermine the capacity and competitiveness of exports in a country.

The barriers can be policy induced or natural. Policy induced barriers are relatively easier to address but natural barriers are more difficult. Examples of policy induced and natural export barriers that undermine capacity and competitiveness of exports are given below.
This section highlights the main capacity and competitiveness barriers faced by exporters within the country in detail.

a) Labour

The leading agricultural exports of the country such as tea, rubber and spices came to be established in the country during the colonial era partly due to availability of abundant low cost labour or the ability to import low cost labour (e.g. plantation workers). In late 1970s and 80s, investments flowed into apparel also attracted by the availability of low cost labour.

The country no longer has a comparative advantage in low cost labour and all sectors are faced with labour shortages. This is further compounded by increasing number of Sri Lankans migrating to work abroad. The low salary combined with low self-esteem associated with jobs in some sectors has compelled the unskilled workers to look for employment outside the country. At present stock of migrant workers are estimated to be 2 million and out of this nearly 64% are unskilled workers. When numbers are few, increasing productivity can help reduce cost. Outdated labour regulations however undermine productivity. Examples are restrictions on hours of work; where Sri Lanka has a maximum 57.5 hour work week with overtime compared to Bangladesh at 60 and Vietnam at 65 hours, high number of official holidays and restrictions on employing females working at night.

b) Land

In addition to low cost labour, the plantation crops such as tea, rubber and cinnamon came into the country due to the abundance of fertile land at low or no cost. Sri Lanka no longer has a comparative advantage in land. Capacity of all agricultural crops is severely restricted by the shortage of land and the cost of land is high.

Land productivity is low compared to competing countries as a result of land fragmentation and poor agricultural practices. Large variations in terms of yields can be observed as a result even within the same sector; for example in the tea sector yields can vary from 615 kg/ha in poorly maintained plantations to 2250 kg/ha in well maintained plantations. According to department of export agriculture with the adoption of good agriculture practices the current yields of
pepper and cinnamon can be more than doubled. Irregularities in land allocation, lack of accountability and transparency of procedures coupled with not having a data base on land available for investment, cultivation, mining etc. also contribute to poor utilization of available land.

c) Technology and skills:

The leading exports are facing erosion of comparative advantage in low skilled labour intensive production. Upgrading existing products or migrating into new products is constrained by shortage of technology and skills. This in turn undermines international competitiveness of products and the capacity to expand supply. For example although Sri Lanka is ranked 21st out of 50 countries in the Global Locations Index ranking destinations for global outsourcing, in terms of availability of people and skills the country fares poorly being ranked at 33 out of 50 countries. Sri Lanka is ranked 74 out of 140 countries in terms of Travel and Tourism Competitiveness Index, in terms of availability of qualified labour the country is ranked low at 112 out of 140 countries. Shortage of labour and skills has been identified as the highest problem faced by the businesses in the country.

Access to higher education is limited. According to Ministry of Education (MOE) only 12% of students qualified GCE A/L enter university, due to limitations in capacity. Only 32% have access some form of higher education. State dominated higher education system of the country has failed to equip the graduates with the skills and competencies demanded by the private sector. According to Ministry of Higher Education (MOH) out of the total number of graduates 51% have studied Arts only 23% studied science.

Employability of Arts graduates is 32% compared to 96% for engineering graduates. As a result at a time the private sector is facing shortage of skilled workers, an already bloated public sector is expanding further by absorbing the unemployed graduates. Skill deficiencies are also the result of a supply driven education system insensitive to the developments in the economy.

While ad-hoc attempts are being made to reform the education sector, the problems still remain.

The public and private sector expenditure on education is low and recent past has been declining. Use of technology still is low and expenditure on research and development remains equally low and is declining. As a % of GDP Sri Lanka’s gross expenditure on R&D was just

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0.21% in 2004, 0.17% in 2006, and 0.11% in 2008.13 India has three universities on the top 100 Asian universities list14 but not a single university in Sri Lanka has made it to the list.

d) Border Management

International trade in any country is regulated by the government and government agencies administer these regulations. Traders have to comply with these regulations when importing inputs and machinery as well as exporting products and these are referred to as border agencies which include seaports, airports, customs, standards institutes, plant quarantine, department of import and export control etc. The delays and inefficiencies of these agencies increase cost of trading. Time and cost efficiency of delivering the services by these agencies is critical for export competitiveness. Poor coordination, communication between agencies, resource and skill deficiencies, outdated regulations and procedures, corruption experienced severely undermine competitiveness by increasing the transaction costs in terms of both time and money.

Information and Communication Technology (ICT) can play a critical role to increase the efficiency of border administration. While some progress is being made in introducing ICT to border agencies the time taken is too long and implementation had been partial and ad hoc. Levels of corruption are relatively high in institutions involved in administering trade, hence there is resistance to simplify procedures and introduce ICT and as a result automation of the border agencies has made little progress.

e) Macroeconomic & Policy Stability

Inflation and exchange rate are critical macroeconomic indicators that determine international competitiveness of exports. Cost of capital also undermines investments. Studies on experience of countries have confirmed exchange rate misalignment and exchange rate variability have significant impacts on export performance15. Maintaining highly appreciated exchange rate over a long period of time like that experienced in 2010 & 2011 at a time when the currencies of other competing countries depreciated undermine the competitiveness of exports from Sri Lanka. Inflation in Sri Lanka has come down from historically high double digit level to single digit level, but still fares poorly in comparison with low rates of below 5% achieved by East Asian countries during the high growth era and at present. Policy instability is identified by the exporters as critical constraints that undermine their competitiveness16. This refers to both ad hoc changes to taxes17 on trade and regulations and poor stakeholder consultation.

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14 Asia University Rankings 2013, http://www.timeshighereducation.co.uk/world-university-rankings/2012-13/regional-ranking/region/asia
16 Business outlook Survey, The Ceylon Chamber of Commerce
17 For example was the sudden change made to tax (cess) on export of tea which took exporters by surprise and delayed shipments (refer Daily Mirror, 31st January 2013 http://www.dailymirror.lk/business/other/25439 cess-increase-worsens-tea-industry-worries.html)
f) Value addition and Industrial Upgrading

When sectors compete on cost and volume in the mass market, branding and enhancing value is not a critical requirement. However, when countries lose cost and volume based comparative advantage, investing in brands and value creation becomes essential for survival. Sri Lanka has been exporting products that are unique to Sri Lanka and is world renowned; e.g. Ceylon tea and Ceylon cinnamon. For long the country has been exporting in bulk to global brands and there has been very low levels of value addition and creation of local brands. In tea, export of tea bags and instant tea account for less than 10% of total tea exports and spices value added products is around 5% of total exports.

Apparel sector has made progress in value addition, sectoral branding (garments without guilt) as well as product branding (Avirate and Amanté) and industrial upgrading from being a volume based mass market producer to value based niche market producer. This is however largely an achievement of handful of large companies, and is the exception not the general trend. The experience of apparel however highlight the potential companies can achieve even within the constraints imposed by the policy environment. Therefore, industry complacency is also responsible for poor progress made in terms of value creation and industrial upgrading.


g) Concepts, regulations and institutions

Export strategies of the country have failed to deliver expected results because they are based on outdated concepts, models, and are administered by outdated regulations and an institutional framework. Outdated concepts refer to for example overemphasis on local content and processing as the main source of value addition. The changes in global production networks as well as consumer preferences have made local physical content less important in value. The term "value" is discussed in detail in the final section.

The export strategy is driven within an outdated regulatory framework; for example some of the labour regulations date back to colonial times, and the same is true of education system of the country. The institutional framework governing export sector both public and private dates back to colonial period or the import substitution period and have not changed since then. Despite the declining share of agricultural products in the overall exports and the economy; each sector is governed by a plethora of government institutes e.g. tea sector has a Ministry, a Government Board and a Government Research Institute, the same is true for rubber, coconut and fisheries. The number of agricultural research institutes in the country is vast, but the level of productivity and innovation in the sector is very low.

As a result the policies, regulations and strategies to promote exports set by these institutes based on outdated concepts, models and regulations have failed to take into consideration the global changes and respond effectively. In contrast new sectors that emerged during the last three decades such as apparel and IT/BPO that are not administered by a plethora of government institutes have performed better. Having no industry specific public institute or research institute dedicated to set and drive policies, regulations and strategies for them, these sectors have taken the onus themselves and as a result the strategies are based on modern concepts, models and the sectors work towards reforming regulations to suit today’s challenges. The organizations that drive these sectors such as JAAF and SLAASCOM are young and more sensitive to international developments and have been more successful in shaping sectoral
policies and regulations compared to private sector organizations that have their roots in the colonial or import substitution era.

h) Export Oriented FDI

Export success of East Asia and recent experience of China and Vietnam as well as global trends in FDI confirm the important role FDI can play in promoting exports. Sri Lanka has fared poorly in this respect. The analysis of the export performance and barriers to enhance capacity and competitiveness, clearly show that foreign investor are unlikely to find leading export sectors with declining comparative advantage as an attractive investment opportunity.

The skill and technology intensive exports from East Asia is largely driven by FDI into these countries; for example Toyota auto exports from Thailand where the Toyota of Japan has invested in manufacturing and using Thailand as an export platform to serve the growing Asian market.

Figure 28: Composition of FDI into Sri Lanka

Source: Board of Investment of Sri Lanka

Two factors that attract FDI of this nature are skilled workforce and efficient institutes/border management and excellent transport and logistics facilities. Low cost labour is no longer what attracts FDI into East Asia; it is the skills, speed and predictability. The track record of Sri Lanka in attracting export oriented FDI has been poor and end of war has not yet made a significant impact on the inflow of FDI.

The value of FDI still remains below US$ 1 billion, as a % of GDP around 1.5% and the inflows are heavily concentrated on investments into infrastructure and services (Figure28)

i) Trade Agreements

Trade agreements can increase export competitiveness of products by reducing the cost of entry in to the export market. The cost of entry results from tariff and non-tariff barriers. The number of trade agreements of Sri Lanka in comparison to competing developing countries is low (Figure29) and the quality of the agreements measured in times of product and trade coverage, rules of origin, depth of tariff concessions, provisions to address non-tariff barriers and sectoral coverage is low. For example product and trade coverage is both very low in agreements like Global System of Trade Preferences (GSTP) and Asia Pacific Trade Agreement (APTA) and the percentage of tariff reduction for liberalized products is equally low. In agreements where product coverage is comprehensive such as the India Sri Lanka FTA, trade coverage is low, the agreement restricts export of apparel which account for 40% of exports from Sri Lanka through a quota and restrictive rules of origin criteria that limit the utilization of the given quota. None of the agreements have provisions to address non-tariff barriers (NTBs). All agreements only cover trade in goods, in contrast to modern agreements signed between countries that extend beyond to cover services, investments etc.
As a result the level of success achieved in terms of increasing exports under existing trade agreements has been limited. For example total exports to Pakistan are 0.8%, to Maldives 0.5%, Bangladesh 0.6%, China 1.2% and South Korea 0.5% of total exports.

FTA with India has been a relative success in comparison to other agreements. With FTA coming into effect in 2000, the exports to India increased from US$ 59 million to US$ 560 million, and as a % increased from less than 1% of total exports to account for 9% of total exports in just five years, but the value has stagnated at that level since then, for example in 2012 value of exports accounted for US$ 567 million and the % contribution to total exports declined to 5%. This stagnation is a combined result of weaknesses in the agreement (e.g. NTBs and poor trade coverage) and weaknesses in export capacity of the country where the number of exportable products (in terms of both capacity and competitiveness) remain low.

j) Trade promotion infrastructure

Information barriers faced in importing countries is a critical capacity and competitiveness constraint faced by exporters. The severity of these barriers increase when entering new markets (especially developing country markets) and introducing new products. Trade promotion organizations can help reduce the time and money spent by exporting firms searching for reliable and updated information such as business contacts, market conditions, and consumer preferences, level of competition, domestic taxes, rules and regulations. The support of such organizations is important for Small and Medium Exporters (SMEs) than for large exporters. Trade promotion organizations (TPOs) and Business support organizations (BSOs) can be both public and private. In Sri Lanka there are sectoral public sector organizations that also function as a TPO for that sector such as Sri Lanka Tea Board (SLTB), Sri Lanka Tourism Development Authority (SLTDA) and general TPOs like the Export Development Board (EDB) and Department of Commerce (DOC). There are private sector organizations such as chambers of commerce, sectoral trade and industry associations that also function as TPOs/BSOs.

The main allegations against the current trade promotion framework (both public and private) are lack of professionalism, poor coordination with the industry, lack of understanding of
business needs, information provided being too general, inability to give insights to general practice of government agencies such as the extent of bureaucratic red tape, time taken get approvals, level of corruption, reliability etc. There are also allegations of corruption and lack of impartiality (e.g. helping personal contacts and selling information for money under personal arrangements).

Further the institutions function with a short term vision and micro focus. The strategies are driven by budget for the year, than by targets for the sector. Thus the strategies are activity oriented than result oriented; for example the strategy focus on the number of delegations, how many exhibitions, how many countries to be covered etc. than about the increase in volume and value of exports of existing and new products to existing markets and new markets.

Further politicization of the public sector TPOs and frequent change of heads of the organizations such as SLTB, SLTDA and EDB has weakened the policy direction and demotivated the officials. Multitude of private sector TPOs/BSOs that are competing with each other and at times work in tangent with each other is not very helpful either.

This section gives a detailed list of main barriers frequently highlighted by exporters in the country. These barriers severely undermine capacity and competitiveness of exports. Despite the decline in comparative advantage of the leading exports i.e. availability of low cost labour and fertile land at low cost, the country continues to depend heavily on these products for its export income. Investments in education as well as research and development are low and the current education system fails to generate skills required by the economy. This constrains the ability to develop skill and technology intensive products. Administration of international transactions at the border is still largely manual and resulting delays and inefficiencies further impede competitiveness. The macroeconomic and policy instability increase costs and reduce predictability of the trading environment.

Although the country produces some world renowned products, value addition and brand creation remains low. The export promotion agencies dating back to colonial or import substitution era functions within outdated concepts and regulations. Sri Lanka has fared poorly in terms of attracting export oriented FDI. The trade agreements and trade promotion agencies have failed to bring down the market access barriers. Both the quantity and quality of bilateral and regional trade agreements of the country is low and the trade promotion agencies are not result oriented.
4. EAST ASIAN EXPERIENCE

The four tigers of East Asia; Singapore, Taiwan, Hong Kong, South Korea were the first to succeed in achieving higher levels of economic growth on a sustainable basis and join the industrialized country group by adopting export led growth strategies. These countries experienced rapid increase in their share of exports to the world and share of exports to GDP during the high growth era.

Inspired by their success many other developing countries followed suit, few were relatively successful but many failed and none managed to replicate their success and reach high income country status. The relative success stories are found in South East Asia; Thailand, Malaysia, Indonesia and Philippines and recently China and Vietnam. Compared to the four tigers, the performance is modest but far exceeds the rest of the developing world in terms economic growth.

The experience of these countries provide valuable insights into critical factors required to succeed in following a growth strategy based on exports. This section looks into the key characteristics of the growth strategies of these countries. The objective is to understand the lessons Sri Lanka can draw from the experience of East Asia.

- **Diversification of industrial exports**
  
The East Asian countries also commenced their export-oriented industrialization with low skilllabour intensive industries like apparel. However, they were quick to develop capacity and competitiveness to diversify into other sectors when faced with declining comparative advantage in terms of low cost labour(Figure 30). The same trend can be observed in exports of Vietnam, a recent success story of a country adopting export led growth strategy (Figure 31). What is important to note here is that despite the decline in share of apparel in Vietnam, the value of apparel has continued to increase. In contrast, Sri Lanka has failed to diversify its industrial base. The country is highly dependent on apparel for its export earnings.
- Policy Direction and Long Term Commitment: When the governments of East Asian countries officially adopted export led industrialization (EOI) as the growth strategy and officials at all levels of government and private sector were highly committed to implement this strategy over a long period of time. The current growth strategy of Sri Lanka which rests of developing five hubs; aviation, naval, commercial/logistics, energy and knowledge acknowledges the importance of exports, but does not recognize it as a major growth pillar. As discussed in detail in the previous section, the institutional structure supporting exports is highly fragmented and frequently exporters find the measures taken by these institutions to be detrimental to export growth.

- All strategies were not equally effective: Some of the strategies adopted by East Asian countries in fact were detrimental and wasteful. Studies point out “most of the industries set up under HICOM (Heavy Industries Corporation of Malaysia) were “born losers” which were artificially spawned with subsidies\(^{18}\). The heavy and chemical industry (HCI) drive in South Korea also resulted in enormous economic inefficiency\(^ {19}\). Apart from the direct economic cost, the inefficient heavy industry projects (which were mostly in investment and intermediate goods industries) burdened downstream industries, which were forced to pay higher prices for the protected products\(^ {20}\). Vietnam industry specific policy regimes found to be quite inimical to international competitiveness and was not a reason for export success\(^ {21}\). There is mention of promoting heavy industries such as steel in Sri Lanka in the budget of the government of Sri Lanka\(^ {22}\). The experience of East Asia cautions of possible negative impact of such strategies on overall economy.

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\(^{19}\) Harvie, C., & Lee, H.H., Export Led Industrialization and Growth – Korea’s Economic Miracle 1962-89, Faculty of Business, University of Wollongong, 2003, P18


\(^{22}\) Government of Sri Lanka, Budget Speech (2011)
- **Limitations in following some strategies**: The developments in the world economy and governing structure today consisting of international organizations such as the WTO and International Labor Organization (ILO) restricts ability of countries from following the exact incentive and regulatory regime followed by the East Asians. Examples are strategies followed by Malaysia such as focusing more on job creation than to protect rights of workers through labour legislation\(^{23}\), prohibition on the right to strike in "essential services", banning unions in the most important export-oriented industry - electronics - until 1988. The Thai export orientation policies built on low wages, both to create competitive advantages for the national producers, as well as to attract FDI from higher wage countries is another example. The Thai government followed a policy of controlling wage increases, mainly through its conservative minimum wage policy. In addition to that one of the instruments used by the Thai government to control the price level are price controls on essential products, which have been made possible with the passage of the Price Setting and Anti-Monopoly Act of 1979. In addition, export controls were also used to lower the prices\(^{24}\). Ability to provide export subsidies like those dished out by the East Asians is also restricted by the advent of the WTO rules.

- **Exports expanded despite negative external environment**: The poor performance of exports from Sri Lanka is often attributed to negative developments in the world economy. However, the export performance of East Asian countries was not necessarily governed by the external environment. The countries achieved higher levels of growth even during periods the world economy was in recession. For example beginning 1987 real GDP growth in Malaysia accelerated to over 8 percent a year on average over the nine years up to 1995 and interestingly, this outstanding economic performance combined with rapid growth in exports was achieved in the context of a depressed world economic environment\(^{25}\). Vietnam saw rapid increase in its apparel at a time where it was virtually excluded from the enormously important US market. The US commercial embargo ended only in early 1994\(^{26}\).

- **Pragmatic approach to liberalization**: the newly industrializing countries in East Asia—have systematically followed a pragmatic approach that combines a gradual exposure to external markets with an effective collaboration between the private and the public sector towards building dynamic long-term competitiveness. Their experiences suggest that neither protectionism nor abrupt liberalization is the best strategy for achieving high and sustained rates of economic growth.

- **Education upgrading at all levels**: Export growth in all the countries was accompanied by extensive investment in human resources. In South Korea total expenditure, both public and private, on education regularly exceeded 10 percent of GDP, the highest level among all the developing countries during the high growth era. The percentage of high school graduates advancing to colleges or university during the period of the 1980s was the second highest in

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the world after the US\textsuperscript{27}. In 1971, for example, the average number of engineers per 1,000 of the population among all middle income countries was 4.6. In Singapore and Taiwan, the corresponding figures were 10 and 8\textsuperscript{28}. In contrast, Sri Lanka's public expenditure on education as a \% of GDP is at its lowest since independence and the higher education system is heavily biased towards producing Arts graduates.

- **Infrastructure upgrading**: The East Asian countries invested on developing infrastructure. (Cuyvers, 1997). An example is the development of the new coastal container port of LaemChabang by Thailand. The port of Bangkok (KlongToey) seems to have become a bottleneck involving significant delays and costs for exports. Because of port-hinterland transport difficulties, lacking port infrastructure, congestion, inefficiency and other barriers, there were already visible indications of investment diversion to Malaysia and Indonesia, where port liberalization and upgrading of port activities have been in place since 1987-88\textsuperscript{10}.

Sri Lanka has done well in terms of upgrading infrastructure in recent years. A comparison however, between the four tigers and the other South East Asian countries that followed their footsteps, cautions against wasteful expenditure on infrastructure development. A study points out that East Asia (i.e. the four tiger economies) used public resources efficiently when building infrastructure and that the infrastructure decisions were largely made by technocrats insulated from political pressure. In contrast, South East Asia (e.g. Malaysia, Indonesia) shows propensity to over-invest in high-profile “mega-projects” that too often have proven unnecessary and wasteful and public investment decisions were oftentimes political decisions\textsuperscript{29}. These inefficiencies has adversely affected the economic growth potential of these countries.

- **Smart effective states**: The governments of East Asian countries played a critical role in the development of the export sector. Compared to rest of the developing world they were rewarded for efficient usage of public resources for infrastructure development and education; population control. Implementing incentive schemes of the Government strictly based on merit had been a critical factor that determined the success of the export sector; while the companies that met or exceeded government export rewards were extensively rewarded by numerous benefits such as preferential credit and loans, administrative support, tax incentives; the incentives were taken away from companies that failed\textsuperscript{30}. The countries political structures also increased the ability of the governments to make decisions; for example in South Korea there was the determination of the military leadership to attain a high rate of growth, and a virtual lack of constraints on its ability to make decisions and to carry them out\textsuperscript{31}.

\textsuperscript{28} John F. Kennedy School of Government, (2008), Choosing Success: The Lessons of East and South East Asia and Vietnam's Future, Asia Programs, Harvard University, 2008
\textsuperscript{29} John F. Kennedy School of Government, (2008), Choosing Success: The Lessons of East and South East Asia and Vietnam's Future, Asia Programs, Harvard University, 2008
\textsuperscript{31} Lin, Kenneth. S., Lee, HSIU Yun., \& Huang BO Yi., The role of Macroeconomic Policy in Export Led Growth: The experience of Taiwan and South Korea, National Bureau of Economic Research (NBER), 1994
A key ingredient of success of the East Asian States had been their capacity to construct a firewall between economic and political power. In contrast, the failure of South East Asian states had been their inability to achieve a clear separation of economic from political power. This is a good lesson for Sri Lanka, where the separation of economic from political power is increasingly becoming blurred. The politicization of policies and institutions is a major problem faced by the country. In addition, the incentive schemes of Sri Lanka are structured to protect the poor performers and penalize the higher performers, which is the exact opposite of the strategy followed by East Asians.

- **Macroeconomic stability:** All the East Asian countries retained higher levels of macroeconomic stability compared to other developing countries. Studies on Taiwan and South Korea have found that sound fiscal policy for example had been crucial determinant on the ability of the government to decide policies to promote exports. For example, when the government is under pressure to offer greater fiscal incentives to compensate exporting firms for profit losses caused by temporary external shocks, the governments that can offer such incentives by running a temporarily high level of budget deficits are those that have sound fiscal discipline. The ability to keep the exchange rate stable and competitive and maintain low levels of inflation had been important for export success. For example studies show that even though the central banks in Taiwan and South Korea are not independent compared to their counterparts in developed countries the sound fiscal policy allowed these central banks to play a more active role in promoting exports without immediately jeopardizing price stability. Ensuring macroeconomic stability within a weak fiscal policy framework is a challenge faced by Sri Lanka.

- **Success in attracting FDI:** Foreign direct investment (FDI) has been the engine of manufactured export expansion in countries like Taiwan, Malaysia and Thailand. For example between 1987 and 1991, foreign capital inflows to Malaysia have increased by almost ten-fold. The electronic industry (which is almost completely foreign owned) alone contributed to over 63 percent of total exports in Malaysia in 1994. FDI facilitated upgrading of the quality of exports; by bringing in the technology and increasing the content of skill and technology intensive exports from the region. The success of textile and apparel exports in Vietnam had been largely driven by FDI. The declining comparative advantage in labor-intensive activities in the more advanced Asian newly industrialized economies (NIEs) has triggered a massive international relocation of the textile and garment industry, principally within the East Asian region. Foreign investors in textiles and garments have come overwhelmingly from East Asia, with Korea and Malaysia dominating. The conflict lasting for three decades had been a critical constraint faced by Sri Lanka in this area.

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However, four years after the end of conflict, the FDI flows into the country has fallen short of expectations.

- **Regional Integration:** Increased trade and investment flows within the region played a key role in increasing exports. However, research clearly shows that it is important not to overstate the importance of the regional locomotive and demonstration effects of trade agreements and that they are effective only if the domestic commercial and policy environment is attractive \(^{38}\). Exports from Sri Lanka are highly dependent on few western markets and exports to Asia remains low.

There are many lessons Sri Lanka can draw from the experience of both East Asian and South East Asian countries. The success of East Asia depended on the ability to diversify into new sectors, when the traditional sectors became uncompetitive and this was possible due to the long term commitment at all levels of government and private sector to continuously build capacity and competitiveness of the products and services. These include ability to create a sound foundation to enable exports to take off by ensuring macroeconomic stability and investing in infrastructure and education. Effectiveness of government policy and interventions, pragmatic approach to economic liberalization, ability to attract export oriented FDI and integration with the region are other factors that led to higher levels of export growth. All strategies adopted were not equally effective, in fact some proved to be detrimental, especially promotion of heavy industries.

There are valuable lessons that can be learnt from the failure of South East Asian nations that followed to replicate the success of Singapore, Hong Kong, Taiwan and South Korea. The possible pitfalls that will delay the transition from low income to middle income status are failure to separate economic decision making from political interventions, failure to invest in upgrading education and poor planning and over-investment in unnecessary and wasteful mega projects.

\(^{38}\) ibid
5. THE WAY FORWARD

The preceding sections of the report identify the reasons for weak export performance of the country. Based on the analysis, Figure 32 summarizes the status of export sector of the country.

**Figure 32: Reasons for Weak Export Performance**

![Diagram of Reasons for Weak Export Performance]

Sri Lanka’s export sector is facing a dilemma. Despite the decline in comparative advantage of leading exports such as tea and apparel, the country continues to depend on these products for its export income. The export sector has failed to respond effectively to the changes that has taken place in the global trading environment. Number of barriers exporters face within the country undermines their capacity and competitiveness. This concluding section is an attempt to provide some insight into areas that the country need to focus to revive the export sector.

The key lesson to take away from East Asian experience is that exports cannot be developed overnight and it requires long term commitment from all levels of government and the private sector.

Diversification of exports depends on the speed and efficiency with which the barriers identified in section three that constrain capacity and competitiveness are addressed. The ability to retain rates of growth even during times where world demand is slowing down is determined by the capacity and competitiveness of exports to respond to global challenges.

**Figure 33: Export Diversification & Expansion**

![Diagram of Export Diversification & Expansion]

The main weakness in the export sector of the country is its bias towards supporting existing companies, existing products and existing markets. The policy and institutional structure and the limited resources are used to protect and promote the current export structure. While there
is potential to increase export earnings by increasing current exports to current markets, the analysis in section two on global trend clearly highlight its limitations. If Sri Lanka is to see higher growth in its exports on a sustainable basis, the country has to find new exports and new markets. The way forward for the exports for Sri Lanka therefore is divided into three sections; upgrading current products and markets, developing new products and services, expanding into new markets.

**Upgrading current products and markets**

The declining comparative advantage in labour and land and resulting increase in costs makes it increasingly difficult for the current exporters to compete in the world market based on cost. Therefore, the way forward is to differentiate products from Sri Lanka from similar products available in the market based on upgrading the value of the products in the eyes of the buyer. Apparel has already moved in this direction and is reaping the benefits, yet the same cannot be said of other export sectors.

**Figure 34: Growing at the Intensive Margin**

Market diversification can take place within the same markets by shifting products from high volume, mass markets to low volume niche markets. These changes however requires change of mindset and willingness to invest in skills, technology and branding.

a) **Value creation, enhancement and capture**

The shift to high value niche markets requires an innovative approach towards value addition. In Sri Lanka both public and private sector (with few exceptions) defines the value addition in terms of increasing local content by processing raw materials into final product within a single country. This is an outdated concept and attempting to promote exports based on this thinking can be detrimental. Value is how the product is perceived by the consumer which is not necessarily determined by the level of processing; for example strawberries with a well-known brand name labeled “organic” can fetch a higher price than an unknown bottle of strawberry jam.

Sensitivity to changing patterns of consumer preferences is critical to succeed in high value niche markets. The increasing demand for healthy, safe, green, ethical, innovative products provides opportunity to add value without physically transforming the product; Value can be created by changing the production process; for example “organic Ceylon tea” or “ethical Ceylon tea” is valued more than just “Ceylon tea”.

Value can be enhanced through brand names; for example a packet of tea with a well-known brand name like “Dilmah” can fetch a higher price compared to a packet of tea with an unknown brand name, products made by internationally known local brands can bring higher export earnings as opposed to products made for international brands owned by foreigners.
Value can be captured by moving up the "supply chain" from low value activities to high value activities; for example in apparel, moving up from manufacturing others designs to creating designs for others.

Increasing service content of products enables adding value by upgrading the quality of services inputs that goes into manufacturing. The ability to create, enhance and capture value requires simultaneous removal of outdated thinking and policy induced barriers to capacity and competitiveness of the existing sectors. Figure 35 sums up different ways value can be enhanced in a product.

**Developing New Products/Services**

**b) Looking beyond apparel**

The ability to increase and sustain export growth purely by upgrading existing products and markets is limited. The apparel sector is an example for this. The sector has weathered competition from low cost competitors by diversifying within the same product sector, but the growth is slowing down. Hence, developing new products and services is essential to achieve higher levels of export growth.

The current export promotion strategies still rely heavily on existing products to sustain export growth. For example increasing exports to India under FTA still rest on the removal of quota restriction on apparel, the success of China Sri Lanka FTA proposed rests on the ability increase apparel exports and even the success of commercial hub rests on the US$ 1 bn to be generated by the apparel sector. The apparel has done well for the country and will continue to contribute to export growth. However, apparel story is a limited story of a handful of companies in one sector. The analysis of international trends, experience of other countries as well as sector performance clearly indicates the time has come to look beyond apparel.

Figure 36 captures in essence the factors that need to be looked into when developing new product and services. Two critical elements are the world demand and the comparative and competitive advantage a country has to supply the products for which there is a robust growth in demand.
c) Transport and value added logistics services exports

The discussion on global trends revealed that intermediate products have been the driving force behind exponential world trade growth and this has been the result of the emergence of GVCs. This in turn has created demand for high quality, low cost transport and value added logistics services. For example, empirical estimates show that a delay of one week in shipments can reduce the volume of exports by as much as 7 per cent or raise the delivered price of goods by 16 per cent and for extra timesensitive goods, such as parts and components, by as much as 26 per cent.

The value added logistics services refer to services that go beyond mere handling of transshipment cargo. These include services such as receiving goods, breaking shipments, preparing for shipment, returning empty packaging, simple storage, distribution, order picking, countrylizing and customizing, adding parts and manuals, assembly, repair, reverse logistics, quality control and testing of products. Some of the value added logistics activities involve parts of production as well. The value added logistics services therefore are a service for which the world demand is increasing.

In terms of comparative advantage, Sri Lanka has a natural comparative advantage compared to many other countries in Asia to be an exporter of these services; i.e. the geographical location, the country is located in Asia in close proximity to major sea routes and to a large and growing producer and consumer market which is India. The country has done well in terms of developing physical infrastructure and is on right track in terms introducing regulations providing tax incentives.

These however are not sufficient to compete in the market for value added logistics services where competition is intense and gap between existing service providers in Asia and Sri Lanka is wide. Sri Lanka is ranked 81 out of 155 countries in the World Bank Logistics Performance Index (LPI) and is behind a number of ports in both East and South Asia. Sri Lanka ranks very poorly in critical areas required to succeed in supply chains, e.g. timeliness, being ranked at 108, use of ICT (tracking and tracing) at 86 and border management (customs) at 72.

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39 World Trade Organization, World Trade Report, 2013
At a time where leading supplier of logistic services such as Singapore is being challenged by emerging competitors (e.g. Shanghai), Sri Lanka needs to acquire host of other dynamic comparative advantages (Figure 37) to face the intense competition from the other countries in Asia. When production of a good is highly dependent on supply of components and completion of different tasks in several countries, speed, cost and predictability a country has in moving components from one location to another relative to other countries determines the competitive advantage a country has over others. These factors become even more important to plug into Asian supply chains where goods in process cross borders several times, before reaching their final destination. In contrast, in other regions, almost all foreign input is imported directly from the hub—the United States in NAFTA and EU15 in Europe. The greater dispersion of production in the Asian supply chain renders it potentially more vulnerable to disruptions and delays in trade flows.

Hence, Sri Lanka needs to look beyond location, physical infrastructure and tax incentives to be able to succeed; skills, technology, institutions and policies are equally or more important to remain competitive. The countries with the right location, infrastructure, skills, technology, institutions and policies in place to move components from one location to the other at highest speed, with lowest cost and with greatest certainty are the service providers that will be in demand. Shifts in comparative advantage however are not always the default position and are often shaped by government policies and business decisions. Acquiring these competitive advantages in providing value added logistics services and plugging into GVS will help increase export earnings and at the same time help increase competitiveness of other exports by reducing the transaction costs.

Expanding into New Markets

Diversifying markets has been a long felt need in Sri Lanka to reduce vulnerability of export earnings to external shocks as well as to accelerate export growth. The country is located in Asia.

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40 Shanghai overtook Singapore as the leading port in the world in terms of TEU’s handled in 2010, Journal of Commerce, Top 50 Ports in the World
41 International Monetary Fund, Changing Patterns of Global Trade, Strategy, Policy and Review Department, 15 June 2011
42 Park, A., Nayyar, G., & Low, P.,, Supply Chain Perspectives and Issues: A Literature Review, World Trade Organization, 2013 (p 33)
where the highest rates of growth in consumer demand is experienced, thus is well positioned to access the growing Asian markets.

d) Trade Agreements

There is growing interest in Sri Lanka to use trade agreements as a trade policy tool to increase exports to Asia. The success of trade agreements as a tool to promote exports rests on number of factors (Figure 38):

i. Capacity to exports defined in terms of number of products and volumes and

ii. the competitiveness of products defined in terms of cost and quality

iii. Product and trade coverage of the agreement

iv. Rules of Origin

v. Effectiveness in reducing tariff and non-tariff barriers (NTBs)

Even if the agreement has very high level of product and trade coverage, simple rules of origin criteria, and is effective in reducing tariff and non-tariff barriers, if the first two factors i.e. capacity and competitiveness are absent the agreement will fail to lead to increased exports. The research shows that while regional integration within East Asia facilitated increase in exports, trade agreements is not the critical factor that increased integration. The success has been due to measures taken to build capacity to exploit emerging opportunities. Further according to World Bank although developing countries are members of a large number of trade agreements, they have failed to lead to increased exports from these countries, and this is mainly due to supply side constraints that undermine their export competitiveness. Therefore having products and services with the capacity and competitiveness to succeed in the partner country market is an essential determinant of the success of trade agreements as policy to capture new markets.

e) Trade Promotion

While trade agreements can reduce entry barriers and improve access, information barriers can severely undermine survival of products in the market. Therefore TPOs can promote the "sustainability margin" of products in new markets by providing information on reliable business contacts, consumer preferences, level of competition and regulatory framework etc. However, the level of dissatisfaction expressed by the exporters in terms of current TPO framework is low; therefore, it is important find ways of improving the services provided by TPOs. Given below are few suggestions.

i. Creating commercial sections in countries with potential to trade, at present the commercial sections are only found in countries where the country already has

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significant volume of trade. Information barriers are large in new markets hence there is need for more assistance.

ii. Outsourcing some of the functions of the trade promotion to private sector firms in that country; specially in terms of conducting market research, compiling regulations, finding business contacts etc. The private firm has an incentive to deliver and if they do not can easily discontinue or find a new firm, which is not the case with public employees.

iii. Commercial sections in large countries like India, China need to be equipped with enough manpower to do the research and the networking or enough funds and flexibility to outsource work.

iv. Collective efforts by the private sector to generate information, for example through chamber and trade/industry association networks can complement the efforts of the government. While these do happen at present on a small scale, there is ample room to improve.

**f) Exporting to South India**

Despite being in close proximity to India, having cost advantage in terms of transporting products to South India through Colombo and having a FTA, increasing exports to India remains a challenge. Capacity, competitiveness of products coupled with NTBs and Information barriers have constrained growth. Plugging into Indian supply chains come forth as a possible mode to increase exports to India. Although India is an emerging producer of products such as automobiles and electronics, the production networks are not as dispersed across countries, like the networks of East Asia. Further unlike in the case of East Asia, where Japan experienced increasing cost of labour compelling it to look at opportunities in other countries such as South Korea to supply labour intensive inputs, India has a comparative advantage over Sri Lanka in terms of labour intensive manufacturing activities.

Sri Lanka however is well positioned to export value added port and logistics services to both Indian and foreign companies doing business with countries in the Indian Sub-Continent. Sri Lanka has an opportunity to capitalize on strong consumer demand in India and proximity and cost advantage the country has in functioning as an export platform to serve the Indian market. For example, Colombo can strive to be the place to set up regional headquarters of companies that want to serve the Indian Sub-Continent, specially the Southern Indian market. At present however, Colombo is still to gain recognition as a potential destination to set up regional headquarters. For example Sri Lanka is not in list of top 15 Asian locations identified by European multinationals, but New Delhi is. Sri Lanka ranked 128 among 140 countries is behind several Indian cities in the EIU livability index. There is intensive competition in Asia to attract regional headquarters business. East Asian countries, including China is dishing out lavish incentives to global companies to set up business on their shores.

**A New Approach to Export Oriented FDI**

FDI is attracted by comparative advantages countries has such as market size (population, income levels), natural resources (e.g. minerals, land) and efficiency (e.g. skills, technology, institutions). Sri Lanka does not have the market size, or the natural resources to make it an attractive investment destination for companies seeking these. Efficiency however, unlike
market size and natural resources can be acquired with the right investments. Transparency, accountability of regulations, institutions and policies are critical to attract efficiency seeking FDI. Even if a country has a comparative advantage (e.g. location), the red tape, corruption, lack of transparency, professionalism in the investment regime and the resulting costs and delays can be a disincentive for investors.

The success of Colombo becoming a commercial/logistics hub and reviving exports of Sri Lanka also depends on the ability to attract global manufacturing and logistics firms’ to be present in Colombo. These firms will create demand for value added logistics and port services. Their presence will increase commercial significance of Colombo and will help promote the destination. Leading logistics hubs in the world has been successful mainly due to their ability to attract leading global firms to establish at the location. For example according to UNESCAP Rotterdam which is the leading logistics hub in Europe has more than 6,700 foreign global companies operations located in the Netherlands. Among the estimated total 955 European Logistics Centres (ELCs), more than half of all American and Asian ELCs are located in the Netherlands. Rotterdam today is the centre of business headquarters, distribution centres, call centres, R&D Centres of foreign global companies44.

The same is true for Singapore; whose main marketing tool is the fact that global companies use their location to manage their business in the Asian region. For example Singapore economic development board (EDB) markets itself as a strategic home base for global logistics and supply chain management companies to expand their footprint in Asia; EDB says 17 of today’s top 25 global third-party logistics providers (3PLs) have established significant activities such as regional headquarters and regional hub operations in Singapore and Global leaders in key growth sectors (e.g. biomedical sciences, chemicals, energy, technology, consumer goods) have established Singapore as their key global and regional manufacturing base in Asia. If Sri Lanka is benchmarking to be a leading logistics/commercial hub in Asia, attracting global players to establish operations in Colombo is critical.

Increasingly global companies are moving their regional headquarters as well as final assembly facilities to Asia to serve the growing Asian consumer market, and countries are not only used as manufacturing places, but also as export platforms. According to European Regional Headquarter Survey conducted by European Chamber of Commerce the trend of shifting headquarters to Asia is a trend that has accelerated during the last decade. Sri Lanka as discussed in the preceding sub section has the potential to be an export platform for the South Indian market, but the country has lot of ground to cover to catch up with the existing regional hubs in Asia; according to the European Chamber “Headquarter Survey”, Shanghai tops the list of Asian cities the European multinationals prefer to have their regional headquarters, Hong Kong comes second and Singapore third.Sri Lanka need to take measures to be an attractive destination to house regional headquarters of companies interested in serving Asia and specially the Indian Sub-Continent.

**Hub Strategy & Exports**

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44 United Nations Economic and Social Commission for the Asia and the Pacific (UNESCAP), Commercial Development of Regional Hubs as Logistics Centres, 2002
The current “MahindaChinthana” development framework has identified the five hubs (naval, aviation, commercial/logistics, knowledge and energy) as the growth strategy of the country. While the development policy framework acknowledges the importance of exports to economic growth, it is not recognized as a central pillar of the overall growth strategy. In fact, the ten-year development policy as well as the subsequent budgets have given more emphasis and extended support to import substitutions over export promotion. Exports, however, are critical for the success of three hubs: naval, aviation, commercial/logistics.

This neglect of exports as a vital component for the success of the hub strategy is the result of outdated thinking; firstly, exports are still mostly perceived as “goods” (with the exception of IT/BPO sector), the importance of “services” or the importance of “services content” in exports has received little attention. Secondly, value-added exports are still defined in terms of physical transformation of products and increasing local content, lastly, the misconception that without low-cost, abundant labour, Sri Lanka cannot be part of the intermediate products trade/Global Value Chains (GVCs).

While value-added logistics and port services are definitely the focus of the five-hub strategy of the government including tourism (five plus one), these are not recognized as exports. As a result, these initiatives have become the agenda of sector-specific institutes. The institutes established to support and promote exports for example do not feel that it is in their mandate to get involved. The export promotion officials for example at the Export Development Board or the commercial sections of Sri Lankan embassies abroad are not knowledgeable and not trained to promote Sri Lanka as a maritime and logistics services exporter. In essence, the export strategy and the five-hub strategy of the government are implemented in isolation from one another. Recognizing the synergy and complementarity between the two is critical to be able to achieve the objectives of both strategies.
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