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Sri Lanka's Trade Imperative

Optimism in Sri Lanka following the end of Mahinda Rajapaksa's presidency in 2015 saw civil and political freedoms liberalised, ethnic relations improved, and foreign relations with China and India rebalanced. However, the government's scorecard in managing the economy has been disappointing, with analysts pointing to large excesses in fiscal and monetary policymaking. This has arguably contributed to a slowing economy and mounting debt. This paper emphasises the need for the government to boost exports and foreign investments, revamp the tax system and lower barriers to competition in key domestic sectors to improve the economy.

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Introduction

Sri Lanka should be sitting pretty. Eight years on from the end of a three-decade long civil war, the country must appear to be reaping a peace dividend – growth was initially strong between 2009 and 2014. The new government, elected in 2015, inherited an economy with great potential – Sri Lanka is strategically located within a rising Asia and the Indian Ocean region. However, economic growth is on the decline, falling from a peak of eight per cent in 2009 to 4.8 per cent in 2015 and 4.4 per cent in 2016, according to data from the Department

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of Census and Statistics of Sri Lanka.[2] This is expected to remain stagnant in 2017.[3] The economic recovery in the United States (US) has boosted the country's exports, although the trade deficit has surpassed S$1 billion.[4] Government debt is at 77 per cent of the country's Gross Domestic Product (GDP), which stands at S$112 billion this year, while inflation reached five per cent due to increased domestic consumption. Unemployment, on the other hand, is estimated at four per cent.[5] The budget deficit for this year is expected to reach five per cent, mainly due to government expenditure on bureaucratic salary increases and a drought that severely reduced agricultural output.

Growth is expected to improve gradually over the next two years. The Economic and Social Survey of Asia and the Pacific 2017 released earlier this year by the United Nations Economics and Social Commission for Asia and the Pacific[6] highlights agriculture activity to recover from adverse weather conditions experienced last year and in the early months of this year. The banking sector has loosened regulations for granting loans, while construction is resurging, particularly in areas affected by the recent civil war. The service sector contributes 60 per cent to GDP.[7] However, a major challenge will be the fiscal tightening undertaken by the government that will constrain consumer spending and public investment, according to the report.[8] It concludes that the country's medium-term economic performance is contingent upon the success of reforms designed to reduce stubbornly large fiscal and trade deficits.

The rest of this paper will examine Sri Lanka's trade deficit conundrum in greater detail.

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2 National Account Estimates of Sri Lanka 2016 – http://www.statistics.gov.lk/national_accounts/dcsna_r2/reports/summary_tables_2016_english.pdf. Accessed on 9 August 2017.

3 Economic Outlook 2017/2018, First Capital Research – https://www.firstcapital.lk/wp-content/uploads/2015/06/Mid-Year-Economic-Outlook-Aug-2017.pdf. Accessed on 9 August 2017.

4 Central Bank of Sri Lanka, Annual Report 2016 (12 June 2017) – http://www.cbsl.gov.lk/pics_n_docs/10_pub/_docs/efr/annual_report/AR2016/English/5_Chapter_01.pdf. Accessed on 15 August 2017.

5 Ibid.

6 United Nations' Economic and Social Survey of Asia 2017 – http://www.unescap.org/sites/default/files/SRI per cent20LANKA.pdf. Accessed on 25 August 2017.

7 Sri Lanka: Economic Outline, Lloyds Bank Trade – https://www.lloydsbanktrade.com/en/market-potential/sri-lanka/economy?vider_sticky=oui. Accessed on 25 August 2017.

8 Ibid.

Trade Deficit

Sri Lanka is grappling with a severe trade imbalance, capital outflows and inadequate foreign investment. Due to exports being only a little over half of the country's import expenditure, the large trade deficits of recent years have been an important reason for the country's weak foreign exchange reserves. The trade deficit of S$10.2 billion in 2013 expanded to S$11.4 billion in 2015 and to more than S$12 billion in 2016. In the current account, which is the sum of the trade balance, net income from abroad and other transfers, the trade deficit was offset by remittances of about S$11 billion and tourist earnings of S$4.7 billion.[9] However, these incomings do not paper over the fundamental weakness in the economy of imports being considerably higher than export earnings.

The data paints a vivid picture of Sri Lanka and its overreliance on imports and inability to boost exports – an issue that stretches back decades. One major reason is the rising cost of producing goods domestically. In simple terms, as Sri Lanka upgraded to a middle income status country,[10] the wages of labourers rose, making it difficult for Sri Lanka to compete internationally, as production costs are lower in countries like Bangladesh. On the other hand, Sri Lanka has yet to move up the chain in terms of producing higher value products for export. There are several important factors that make it difficult to reduce the reliance on imports. Verité Research, an independent think tank that covers the Asia Pacific region, identifies three structural issues that constrain trade deficit management: post-war growth has primarily been import driven, government revenue is import dependent and exports are heavily reliant on imports. Around 50.9 per cent of imports are intermediate goods, on which the majority of the exports are dependent.[11]

Sri Lanka exports mostly textiles and garments (40 per cent of total exports) and tea (17 per cent). Its main export partners are the US, the United Kingdom, Germany, Belgium and Italy. Petroleum, textile fabrics, foodstuff and machinery and transportation equipment are the main imports, primarily from India, China, Iran and Singapore.[12]

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[9] Central Bank of Sri Lanka, Annual Report 2016 (12 June 2017), op. cit.

[10] "SL's economy to face real test from 2019", *The Daily Mirror,* 17 August 2017.

[11] Sri Lanka: International Trade Performance and Prognosis – www.veriteresearch.org/download-pdf_spreport.cfm?pdf_id=24. Accessed on 18 August 2017.

[12] "Sri Lanka's Balance of Trade 2003-2017". Trading Economics – https://tradingeconomics.com/sri-lanka/balance-of-trade?embed. Accessed on 18 August 2017.

External Sector

As a small island economy with a population of 21 million, Sri Lanka depends heavily on foreign direct investment (FDI) and the export sector to catalyse economic growth. A noted economist, Professor Razeen Sally, who chairs the country's Institute of Policy Studies, said recently that Sri Lanka simply does not have the market size to generate and sustain economic growth at a reasonable rate without external trade, inward investments and the lowering of barriers to competition in key domestic sectors.[13] He estimates that Sri Lanka, as an emerging economy, realistically needs to grow at 7-8 per cent annually, which is the level needed to increase real incomes across the population and boost other economic indicators. To support this, he estimates that FDI of between US$3-5 billion (S$4.1-6.8 billion) a year is needed, as opposed to the US$500 million (S$681 million) it currently attracts.[14]

The tight control on key sectors of the economy by local business elites and the cumbersome bureaucratic red tape for foreigners to invest are strong barriers to enticing greater foreign investments. Sri Lanka's FDI slumped 54 percent last year to reach S$610 million, compared with S$1.3 billion in the previous year.[15] Not only is FDI lagging, it has almost entirely been confined to the construction and real estate sectors, while manufacturing and services have been largely neglected. An important reason for Sri Lanka seeking to attract such capital is the belief that such inflows, besides enhancing foreign exchange reserves in the short run, would enhance the competitiveness of its industry, such as exportable manufacturing, which will increase exports and render the balance of payments (BOP) sustainable in the medium and long term.

In recent years, much of the FDI has come from China for massive infrastructure deals. An unexpected setback to the country's BOP account was the suspension of expected Chinese investment in the Hambantota development projects, following the election of the new government in 2015. President Maithripala Sirisena initially sought to put distance on the cosy relations with China developed by the previous Rajapaksa regime. However, the dire debt situation has brought a recalibration in thinking, as evidenced by the green-lighting of the S$2 billion capital injection from Chinese companies to finance Hambantota, which has

13 Email correspondence with Professor Razeen Sally, 7 September 2017.
14 Ibid.
15 SL's legal process delays FDI-Investment Chief, *Reuters*, 5 April 2017.

brought some relief to the government's debt servicing efforts. Going forward, Sri Lanka can expect substantial investments as part of China's One Belt One Road initiative.[16]

The government is increasingly turning towards broader engagement with East Asia and, in doing so, recognising the country's pivotal position as a strategic asset to both India and China. Considerable measures have been taken over the past two years to demonstrate a willingness to balance both Indian and Chinese interests by granting China access to an industrial park and management of the Hambantota Deep Sea Port and International Airport, while working with India to develop a war-era oil tank farm in Trincomalee, a strategically-located port to the east of the island.[17] It is also hoping to finalise free trade agreements (FTAs) with many of the major regional powers in the next six months. Among these are the Economic and Technology Cooperative Agreement with India and FTAs with China and Singapore. If these succeed, Sri Lanka will have preferential access to India, one of the fastest-growing economies in the world, and it will also be a key investment hub for the Chinese maritime silk route.[18]

Speaking in Singapore last year, Sri Lankan Prime Minister Ranil Wickremesinghe promoted the idea of a tri-nation economic pact between Sri Lanka, Singapore and the five southern states of India. This idea is based on Sri Lanka's proximity to these five southern Indian states and their 300-million strong consumer market and supply chain clusters.[19] For India, Sri Lanka's unique geo-strategic location at the crossroads of major shipping routes is important. For Singapore, the proposed arrangement will help to expand its importance and capacity for business networking in the region. The Singapore-Sri Lanka FTA is expected to be signed by early next year[20] although progress has been slow, mainly due to capacity limitations amongst Sri Lankan policymakers – Sri Lanka has not negotiated an FTA in over a decade. Yet, there appears to be enough goodwill on both sides to get the deal done.

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[16] China's One Belt One Route Initiative: Implications for Sri Lanka, Institute of Policy Studies – http://www.ips.lk/talkingeconomics/2016/06/22/chinas-one-belt-one-road-initiative-implications-for-sri-lanka/. Accessed on 15 September 2017.

[17] Kithmina Hewage, "Sri Lanka's New Regionalism", *South Asian Voices*, July 4 2017.

[18] "Budget deficit the root cause for Lanka's woes: CB chief", *Daily FT*, 20 August 2017.

[19] "Opportunities for Convergence: Key Note Address at the South Diaspora Conference 2016", Ministry of Foreign Affairs – http://www.mfa.gov.lk/index.php/en/media/statements/6537-sadc-pm. Accessed on 20 September 2017.

[20] Email correspondence with Razeen Sally, op cit.

The Colombo Port City is the most ambitious of the myriad infrastructure projects bankrolled by China. Since renamed the Colombo International Finance Centre (CIFC), it aims to be a special zone along the lines of Dubai's International Financial Centre. At an initial cost of S$2 billion and rising to S$11 billion, the CIFC is expected to be the largest FDI project in the country to date. The financial backing and development is provided by the state-owned China Harbour Engineering Corporation, although, in what could signal a new phase in Sino-Indian economic relations, China has invited India to also participate. The offshore financial centre aims to attract more than S$17 billion[21] in FDI from investors, including international banks, hotels and malls, with China being the lead promoter.[22]

India has also been a leading investor in Sri Lanka, with investments topping US$1 billion since 2003, although this pales in comparison to the size of China's involvement in Sri Lanka over the same period. Indian interests are in such diverse areas as petroleum retail, information technology, financial services, real estate, telecommunication, hospitality and infrastructure development (railway, power, water supply). A number of proposals involving Indian companies are still in discussions such as the Tata Housing Slave Island Development project, done in cooperation with the Urban Development Authority of Sri Lanka. A landmark development is the 'Colombo One', ITC's S$540 million hotel, residential and leisure complex which is under construction.[23]

Conclusion

As a small economy, Sri Lanka needs an aggressive external trade policy to fuel its resurgence. Its trade hovers at around 50 per cent of GDP. Economies in Southeast and East Asia with similar populations, such as Malaysia, have trade to GDP ratios of between 100-200 per cent of GDP.[24] It also needs a more diversified export basket beyond garments and cash crops and foreign investment into the more productive manufacturing and services sectors with links to global value chains.

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21 "Sri Lanka's $US15 Billion "Port City Colombo" Marked For Completion In 2041", *The Urban Developer*, 12 August 2017.

22 Ibid.

23 "Bilateral Brief on India-Sri Lanka Relations", Ministry of External Affairs – https://www.mea.gov.in/Portal/ForeignRelation/Sri_Lanka_December_2016.pdf. Accessed on 18 September 2017.

24 Email correspondence with Razeen Sally, op cit.

The persistent large trade deficits are a serious concern that must be addressed in the medium- to long-term. In this context, the government's strategic shift towards East Asia, given an increasingly inward-looking American foreign and economic policy and the consequent shift in global economic power towards Asia, increases opportunities for Sri Lanka to be a strategic economic hub within the Indian Ocean region.[25] The change in focus, however, could pose potential challenges in terms of balancing Indian and Chinese interests as both nations consider Sri Lanka a strategic asset.

The next budget, expected to be announced in November 2017, is seen by some analysts as a key litmus test for the country to achieve genuine economic reforms.

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[25] Kithmina Hewage, "Sri Lanka's New Regionalism", op. cit.