
Sri Lanka: International Trade

Performance and Prognosis

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Trade Deficit

Introduction

The present review of Sri Lankan trade provides a prognosis based on the last two decades of performance. The Trend of the deficit is that it is driven by declining export performance, even in the post-war period and shows signs of losing global competitiveness.

Apparel and Tea are Sri Lanka’s major exports. While Apparel has weathered the storm to remain competitive with higher end products, the number of firms, employment and export share of the sector is shrinking. Tea remains stable in revenue due to global price windfalls, but highly vulnerable due to lack of value addition and the relatively high unit costs of production.

Three structural issues constrain trade deficit management. (a) Post-war growth has been import driven. (b) Government revenue is import dependent. (c) Exports are heavily reliant on imports.

Four policy moves are analysed in light of the above. (1) Import Substitution (2) Trade Liberalisation (3) Diversifying Export

Markets and (4) Investment Promotion. This review is a summary of the data and implications. More detailed analysis is available on request.

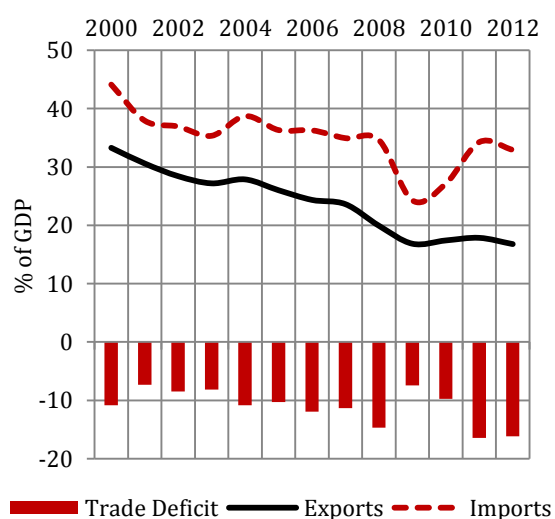
A trade deficit is not always inherently problematic. It is the persistence, size, composition and causes of the deficit that determine if and to what extent the trade deficit should be a matter of concern.

In the present context Sri Lanka’s deficit is a concern for **three reasons**: first, because of the **size**: it is 16% of GDP; second, because of the **causes**: it is driven not only by increasing imports, but also by declining exports; third, because of the **trend**: it has been persistently on the increase for over a decade (Figure 1).

Trends in the Trade Deficit

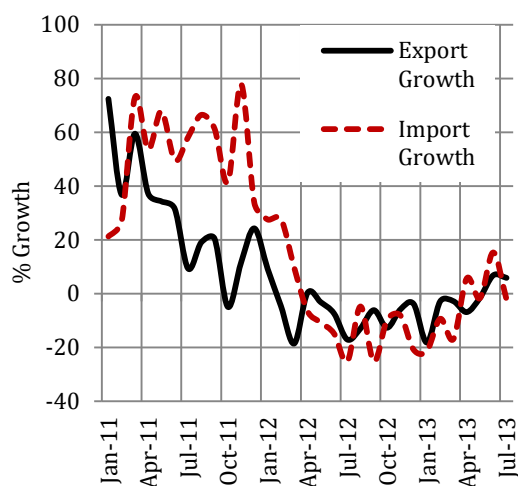
Declining Exports in Sri Lanka, exports as a share of GDP have been on the decline, for now over a decade. In the year 2000 exports was at a record high at 33.3% of GDP. In 2012 exports hit a record low of 16.8% of GDP. The previous low was 17.8% in 2011.

Figure 1: Trends in Exports, Imports and Trade Deficit



In the year since May 2012 exports declined not only as a share of GDP, but also in absolute value (unless otherwise stated absolute trade values are calculated in equivalent USD at the average exchange rate in the period). It picked up briefly in June and July 2013, but total exports in the first two quarters of 2013 were still below that of 2012: down by 2.7% (Figure 2).

Figure 2: Export, Import, Growth Fluctuations

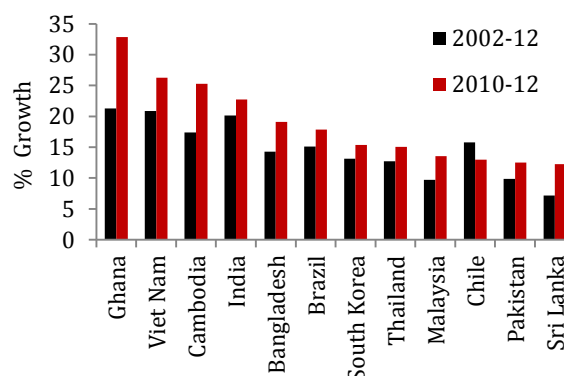


Source: Central Bank of Sri Lanka

Uneven Post-war Rebound: In the last two years of the war, imports declined from 35% of GDP to 24%, and in the first two years post-war it bounded back to 34%. However exports which had dropped from 24% of GDP to 17%, between 2007 and 2009, did not see a post-war re-bounce.

Losing Competitiveness: In Sri Lanka, the negative external environment is blamed for the decline in exports. But there is more to the story. Sri Lanka’s *share* of world exports is declining as well. From 0.08% in 2000 it was down to 0.06% in 2011, and further down to 0.05% in 2012. Many competing countries have achieved higher rates of export growth despite the negative external environment (Figure 3).

Figure 3: Comparative Export Growth (%)



Source: World Trade Organization

Immediate Prognosis

Multiple measures were taken to curtail import demand in 2012-2013: hiking vehicle taxes, imposing ceilings on credit, and making a sharp and sudden downwards adjustment to the managed exchange rate. Imports declined by 5%. But simultaneously exports also declined by 7% (all in USD).

Exports could have performed better through more competitive pricing, if exchange rate management had been less erratic. The 14% currency depreciation meant that in *LKR terms* exports increased by 7%.

In the last quarter of 2013 and the first quarter of 2014 this trend is likely to reverse. Exports are expected to rebound somewhat because of economic recovery in the USA and EU. But simultaneously, monetary policy easing and interest rates cuts are likely to boost import demand.

Both the **double decline** and the expected **double incline**, mean that the trade deficit itself will not alter significantly, though the drivers will be different.

Apparel and tea together account for 52% of Sri Lanka’s exports. They are analysed here separately, because the trajectory of each has a critical impact on the overall prognosis for Sri Lankan trade.

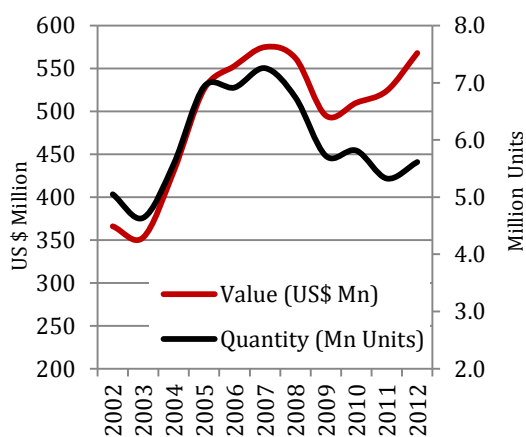
Apparel Exports

Apparel exports have become the “feather in the cap” of Sri Lanka’s export growth story. The sector has weathered increasing global competition and been the largest contributor to export earnings for decades. There are reasons for the success as well as challenges ahead.

Reasons for Success

Increased value despite decline in volume: Analyzing the top 5 apparel products exported to USA (at HS 6 digit level) indicates that the growth is driven largely by increase in unit price. In fact the volumes have been declining since 2005. This means that after the end of the Multi Fibre Agreement (MFA) Sri Lanka has weathered global competition not by competing on price, but by moving up the value chain (Figure 4).

Figure 4: Top five products exported to the USA



Source: United States International Trade Commission

Sri Lanka’s apparel exports to the US market, under HS code¹ 62 (not knitted or crocheted), has declined from 64% of total exports of apparel to USA in 2005 to 50% in 2012. In contrast, the higher valued knitted

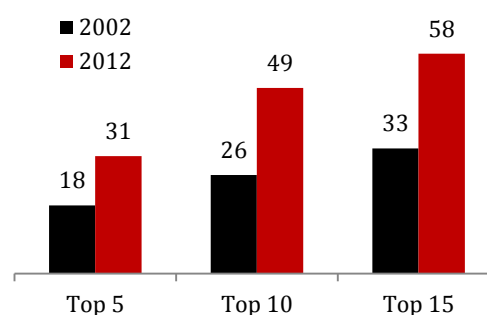
¹¹ HS codes refer to codes under the Harmonized System of Classification (HSC) of products done by the World Customs Organization

or crocheted apparel (HS code 61) from Sri Lanka increased from 36% to 50% of apparel exports to USA during the same period.

Increasing specialization of products:

The increased specialization and consolidation of the product base can be detected by the narrowing range of exported products. Half of all the apparel exports from Sri Lanka are to the USA. The top 15 products accounted for only one third of USA exports in 2002. But in 2012 they accounted for almost three fifths (Figure 5).

Figure 5: Percentage Share of Leading Apparel Items Exported to USA from Sri Lanka



Source: United States International Trade Commission

Challenges Ahead

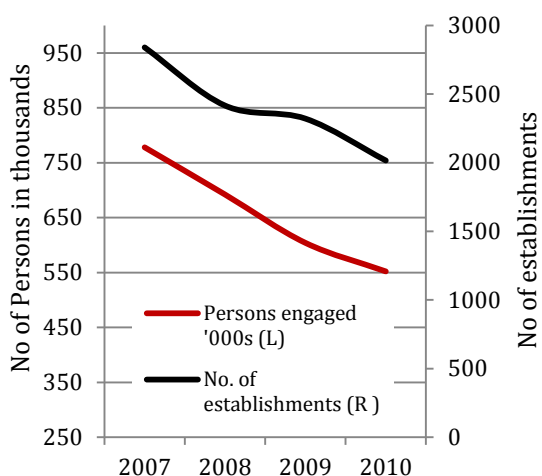
Declining players and employment: As the sector consolidates and specialises, the number of surviving firms is on the decline. It indicates that only the more productive and innovative firms are weathering the quota free global competition. Likewise the employment in the sector has also been in sharp decline since 2005 (Figure 6).

Labour Supply and Cost Constraints:

While the Consolidation would imply a reduced demand for labour, there is also a reduction in the supply. Presently, the industry reports a shortage in excess of 30 thousand. As supply shortfalls have exceeded the drop in demand there is

upward pressure on the cost of labour as well.

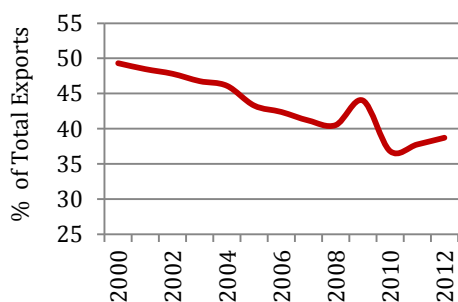
Figure 6: Firms and Employment in Apparel



Source: Department of Census and Statistics

Share of Apparel Exports Declining: The share of apparel is declining over the years in Sri Lanka’s export composition (Figure 7). This means that while export growth has been slow overall, growth in Apparel exports has been even slower. While the industry has weathered global competition, and survived, it has ceased to be a driver of Sri Lanka’s export growth as it was in the past. For example, consider the last two decades. From 1992-2001 apparel exports was the driving force behind export growth recording an annual average growth of 13% while other exports growth was only 7%. In contrast during 2002-2012, annual average growth in apparel declined to 5% while other exports grew by 9%.

Figure 7: Share of Apparel Exports from Sri Lanka



Source: Central Bank of Sri Lanka Annual Reports

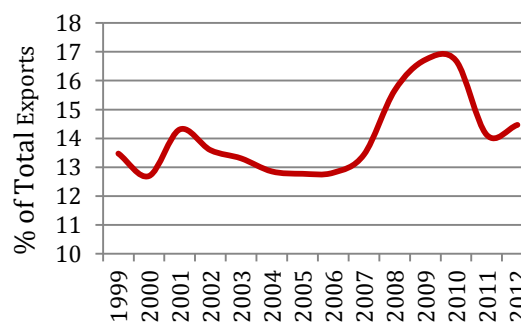
Immediate Prognosis

The increasing labour costs and increasing global competition post MFA have led the sector to make a strategic turn towards niche products with higher value addition. The Joint Apparel Association Forum (JAAF), the apex body for the sector, is now stipulating that the next growth wave, of an additional growth of USD one billion, will come from providing hub services to the sector: that is, not from the traditional manufacturing, but from adding value to what has been manufactured elsewhere.

Tea Exports

Next to apparel, tea is the most significant product accounting for nearly 15% of total exports. Unlike apparel, tea has maintained its export share, which though volatile, has seen an overall increase during 2007-10, the share has declined thereafter (Figure 8).

Figure 8: Tea Exports as a percent of Total Exports

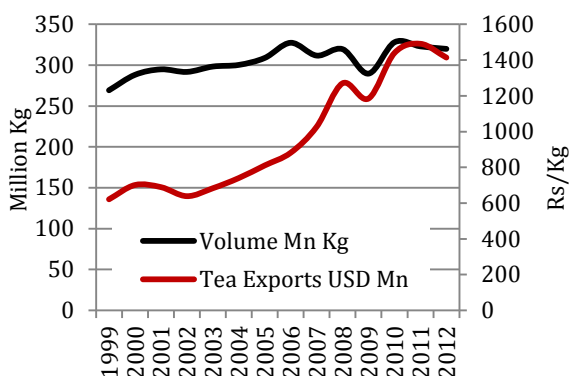


Source: Central Bank of Sri Lanka Annual Reports

Challenges Facing the Industry

Growth driven by price, not quantity: the tea export earnings have been driven by higher prices. The export volume has been stagnating at around 300–325 million Kg’s (Figure 9).

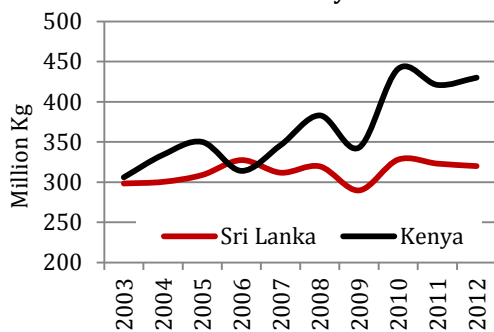
Figure 9: Tea Exports (Price and Volume)



Source: Central Bank of Sri Lanka Annual Reports

Quantity stagnation, however, is not a global phenomenon. Kenya, for instance, has increased volume by almost 30% since 2000; while Sri Lankan volumes have grown only 7% in the same period (Figure 10).

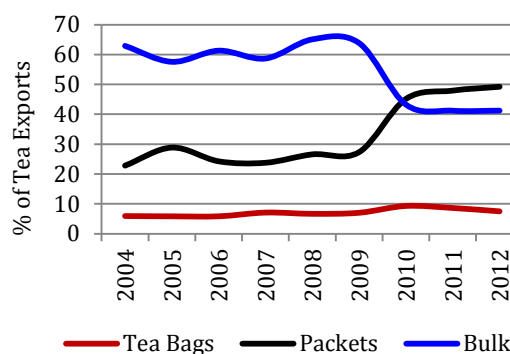
Figure 10: Volume of Tea Exports: Sri Lanka & Kenya



Source: Global Tea Brokers

Slow growth in value added teas: Neither is the price increase of Sri Lankan tea driven by increased value addition. For instance, packaging as *Tea-Bags* results in the highest value per Kg. However share of *Tea-Bags* in total exports has stagnated below 10%. The second highest value per Kg is fetched by *Instant-Tea*. But it accounts for less than 1% of total tea exports (Figure 11 & 12).

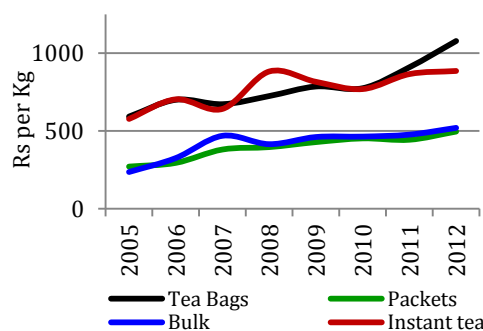
Figure 11: Composition of Tea Exports



Source: Central Bank of Sri Lanka Annual Reports

Therefore, the growth in tea exports driven by commodity prices remains highly vulnerable to external shocks.

Figure 12: Average Price per Kg

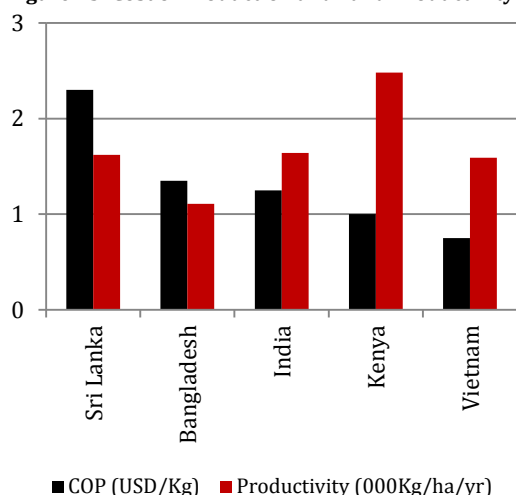


Source: Sri Lanka Customs Statistics

High Cost, Low Productivity: The geography of estates (Kenyan lands are flatter compared to Sri Lanka), input costs and technology used (Sri Lanka is labour intensive) and low land productivity (older plantations as have lower yields) imply higher costs of production in Sri Lanka compared to other tea producing nations.

Declining labour force, increasing cost: Retaining labour in tea estates has become a challenge. This results from a combination of factors such as the low social status of the work, improved education among the younger generation and other more dignified and lucrative employment opportunities outside of the tea estates.

Figure 13: Cost of Production and Land Productivity



Source: Statistical Information on Plantation Crops

Immediate Prognosis

Export markets The Middle East is the largest market for Sri Lankan tea and accounted for 43% of tea exports in 2012. Iran is the largest single importer, with 13%, followed by Syria with 7%. So far, tea exports have not been affected by the economic sanctions on Iran and political turmoil in Syria. But the price vulnerability discussed above remains a significant factor of concern for the industry.

Tea hub: With low productivity, low value addition and increasing costs, sustainability of the tea industry in its current form is at risk. One option to revive the sector that is being vigorously debated is that of a tea hub, where teas from other origins are imported for blending, value addition and re-export. But government concerns about small-holder sales as well private sector concern on large-scale “cheating” (passing off cheaper other origin teas as Ceylon tea), which would debase the brand of “Ceylon Tea” has kept this idea from being moved forward as a policy for the country. The private sector concerns indicate a low confidence in regulatory institutions of the country. The government concerns reflect mainly, a lack of imagination on economic instruments that can be used to ensure

equal or greater sales by Sri Lankan small-holders. In both issues the low ability of the public sector is the constraining factor.

Structural Issues

Several structural aspects of the Sri Lankan economy constrain how the Trade deficit can be managed. In brief, like narcotics to a drug addict, despite high trade-deficits creating future problems, critical immediate economic gains are import dependent; and, industrial exports are also heavily reliant on imported inputs.

(i) Post war growth was import driven

Sri Lanka recorded impressive growth rate of over 8% during 2010 and 2011 although it dipped to 6.4% in 2012.

The main two sectors that fuelled post war growth was construction and services associated with import trade and both are associated with imports. The total share of these two sectors in the economy is around 16% with each sector accounting for roughly about 8% each. As the figure 15 shows services in import trade which is a sub component in services sector (sale of imports minus value of imports) has been driving services sector growth.

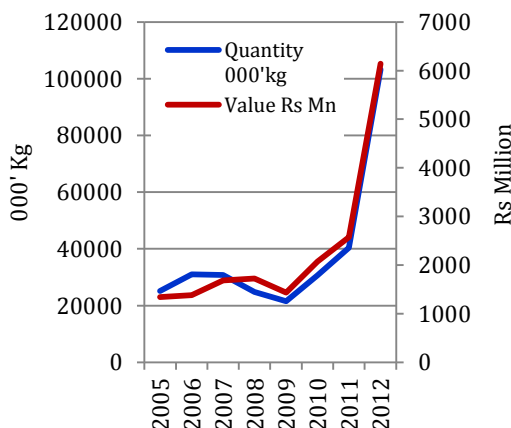
Construction sector is a sub component of the industrial sector. The growth in industry has been mainly driven by construction sector growth and in 2012 when services growth dipped in reaction to the dip in import trade; it is the construction sector that has come to the rescue.

Figure 14: Percentage Contribution to Change in GDP



The growth in both these sectors are heavily import dependent. It turns out that access to imported raw materials was a major factor in the growth of the construction sector. In the three years 2010-2012 the importation of construction material has quadrupled in quantity and value (Figure 16).

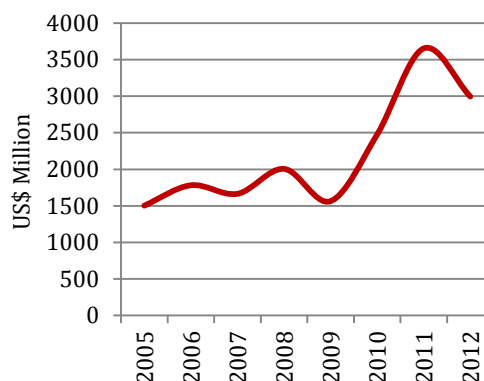
Figure 15: Construction Material (HS Ch. 68) Imports



Source: Sri Lanka Customs Statistics

Services in Import trade relates to retail and wholesale of imported consumer goods. In the two years 2010 and 2011, consumer-goods imports increased by over 130% (Figure 17); and trying to reduce imports in this sector, as done in 2012, had implications: it took a bite off economic growth as well.

Figure 16: Consumer Goods Imports



Source: Central Bank of Sri Lanka Annual Reports

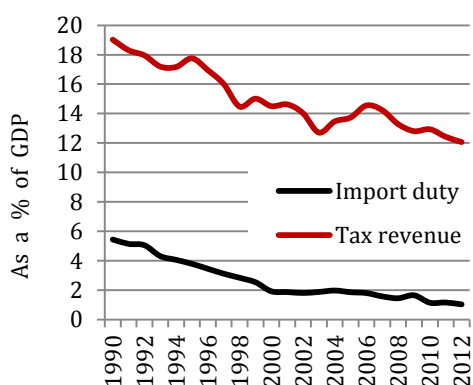
(ii) Government tax revenue is import dependent

Sri Lanka continues to be increasingly dependent on import taxes for government revenue. The contribution of trade taxes to total tax revenue has increased from 14% in 2002 to 25% by 2012. Furthermore, nearly 50% of the revenue from the major VAT sales tax is from the sale of imported goods.

Therefore, liberalizing trade or reducing import taxes erodes this revenue base. High income countries tend to recover all of the revenue lost from reducing import taxes through other indirect taxes; middle income countries recover only 45-60% and low income countries recover as little as 30%². Sri Lanka’s experience is akin to a low-income country, where government tax revenue tends to decline quite significantly with the reduction import-taxes, and presently, total tax revenue of the government of under 12% of GDP in 2012 is at a low ebb.

² Baunsgaard, Thomas ; Keen, Michael, Tax Revenue and (or?) Trade Liberalization, IMF Working Paper No. 05/112, June 01, 2005, <http://www.imf.org/external/pubs/ft/wp/2005/wp05112.pdf>

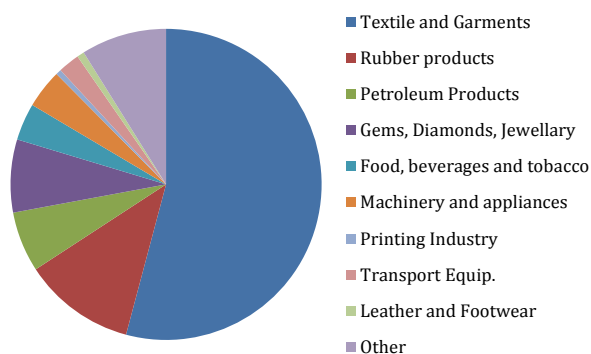
Figure 17: Import Duties and Total Tax Revenue



Source: Central Bank of Sri Lanka Annual Reports

(iii) Industrial Exports are Reliant on Imported inputs

Figure 18: Composition of Industrial Exports



Industrial exports account for 75% of total exports of Sri Lanka. Of this **Garment** exports is nearly half and are sustained by imported textiles.

Rubber Products is the second largest export category. But supply of rubber in Sri Lanka is not adequate for this industry, resulting in significant importation of natural and synthetic rubber to sustain the industry.

Petroleum Products (bunkers and aviation fuel) is the third largest export. It is predominantly import dependent as Sri Lanka imports all its petroleum.

Gems Diamonds and Jewelry is the fourth largest, and diamonds account for 75% of the exports within this category; and almost 70% of the export value is accounted for by imported diamonds.

Policy Analysis

With exports performing poorly and the leading export sectors lagging in growth the strategy adopted for curtailing the trade deficit has been to curb import demand: first by discouraging imports, and second by adopting import substitution policies.

However, the structural issues discussed mean that *Import Substitution over Export Promotion* can adversely impact economic growth, government revenue and even the export sector. While imports have come down from the high of 44% of GDP in 2000 (presently 35%) the Sri Lankan economy is still very much dependent on imports.

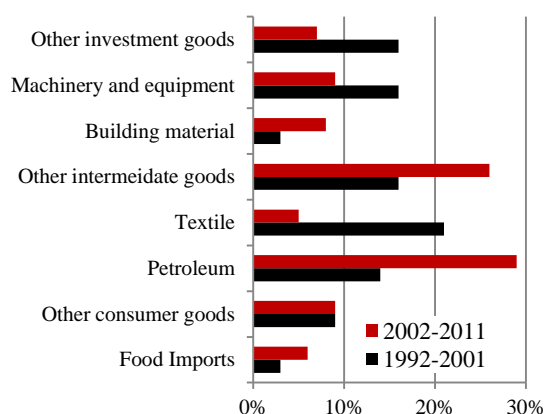
(i) Import Substitution Policy

Wrong Focus and Strategy: Examining the composition of imports and the major sectors contributing to import growth makes it clear that current import substitution policies will not substantially succeed in reducing the trade deficit.

Presently, import substitution in agriculture is pursued as a means of improving food security as well as reducing the trade deficit. This focus will not deliver on the trade deficit front because food-imports are relatively negligible. The share of food imports has declined from 13% to 7% from 1992 to 2012. Food has contributed only 6% to overall import growth during 2002-2012 (Figure 19).

In contrast, *Intermediate Imports* account for nearly 60% of all imports, and investment goods account for 24%. Over the last two decades the share of fuel imports has increased substantially from 10% in 1992 to 26% by 2012, and is presently the highest contributor to growth in imports (nearly 30% of import-growth in 2002-2012).

Figure 19: Contribution to Growth in Imports



Source: Central Bank of Sri Lanka Annual Reports

As past Verité Insight articles and the final section on Structural Issues above make clear, the present strategy of import substitution is like trying to deflate a balloon by squeezing on one side: the reduction in importation of final goods simply reappears as increases in intermediate and investment goods.

(ii) Liberalizing Trade

Sri Lanka has been an early mover in trade liberalisation amongst developing countries and reaped due benefits in the 80s and 90s. But that trend has been reversed in the last decade.

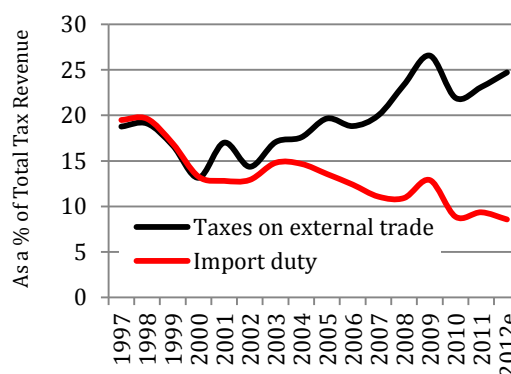
One reason for the reversal has been the policy decision to put economic growth eggs in the basket of import substitution. The second reason has emerged from that.

The structural dependency of economic growth and revenue on imports has meant that quantitative and regulatory measures

taken to curtail the trade deficit by reducing imports have significantly affected the economic growth and government revenue.

Therefore, the second reason for reversing trade liberalization is to arrest the declining revenue. As such the government has introduced a range of additional taxes on imports: e.g. port and airport development levy (PAL), special commodity levy (SCL), import cess. As a result although the contribution to revenue of the transparent “import duty” has declined, effective taxes have been increased and total earned from imports continue to be an ever increasing share of tax revenue (Figure 20). In short, liberalisation is being reversed.

Figure 20: Taxes on External Trade



In summary, keeping Sri Lanka’s traditional posture towards Trade Liberalisation faces pushback on two fronts. First, liberalisation is disproportionately increasing imports and adding to the trade deficit, which increases pressure on the exchange rate. Second, when other non-tariff measures to reduce import quantities are successful, they seriously impact government revenue, resulting in complex hidden tariffs, which have been proliferating and once again retarding liberalisation.

(iii) Expanding export markets

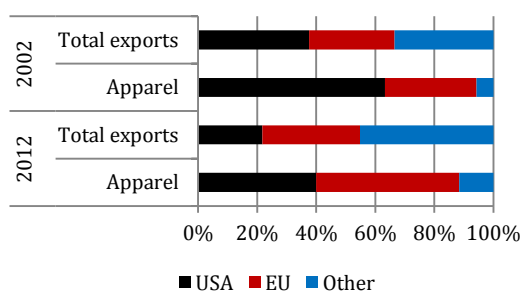
If import substitution does not work to curtail imports very much and curtailing imports has knock on effects on government revenue and economic growth, the way forward that remains is a policy of export promotion. In addition to the standard measures of export promotion Sri Lanka will also need to focus on two specific issues (1) lack of diversification of export products and markets (2) lack of investment in export oriented industries.

Product and Market Concentration: an overlapping problem: EU and USA still account for over 50% of exports from Sri Lanka. The current decline in exports can be partly explained in terms of over concentration in these two regions where import demand has declined with the economic decline experienced by these countries.

The product concentration of Sri Lanka’s export sector is connected to its market concentration. For instance, over 80% of exports to USA and over 60% of exports to UK are apparel. This means that the challenge of product diversification is linked to the challenge of market diversification.

In the last decade the export market share (concentration) to the USA has declined in line with the decline in apparel export share to the USA (Figure 21).

Figure 21: Direction of Exports



Source: Central Bank of Sri Lanka Annual Reports

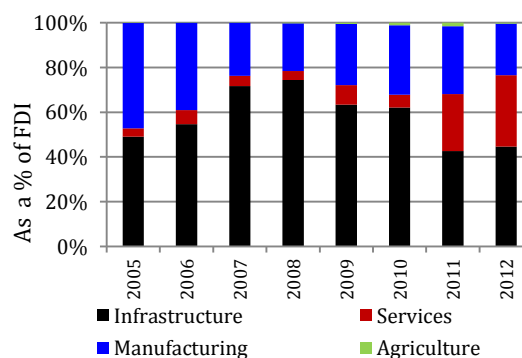
(iv) Investment Promotion

Export oriented *Foreign Direct Investments* (FDI) has played a key role in creating a dynamic, fast growing export sector in the *Newly Industrialized Countries* (NICs) of East Asia, but Sri Lanka has not been successful in tapping into this vein.

Weak FDI track record: Overall FDI inflows to Sri Lanka have been low. FDI has increased in the post-war period, but by very little. At present, it remains under USD 1 billion. Recent FDI into Sri Lanka is heavily concentrated on infrastructure and services.

Traditional sectors are less attractive: The declining competitiveness of leading export sectors; apparel and tea makes investing in these sectors less attractive for both local and foreign investors. The composition of FDI inflows into export oriented manufacturing/agriculture has been on the decline (Figure 22).

Figure 22: Composition of FDI



Source: Board of Investment of Sri Lanka

Poor Execution of Policies: The Board of Investment in Sri Lanka, together with the Strategic Development Projects (SDP) Act of 2008 provides the government with wide powers to grant tax and other concessions to attract investments that can boost the economy. But the policy makers and bureaucrats managing it are failing to

deliver a push towards export oriented investment.

In summary, managing the deficit by curtailing imports is challenged by the structure of the economy, where industrial exports, government revenue and overall economic growth are all dependent on imports.

These have affected the direction and result of existing policy measures. Trade liberalization is being pushed back both to reduce imports and the trade deficit and also to prevent denting government revenue. Import substitution is being attempted, but failing to dent the deficit because of poor targeting and the high dependency of the economy on imported intermediate (e.g. oil) and investment goods.

That yet leaves two opportunities for policy. One is Export Promotion through focus on expanding export markets in terms of both regions and products (to extricate exports from the current over-concentration). Two is to target the existing investment promotion policy tools on export oriented investment. This too is an opportunity that is currently being neglected.