Current Issues & Future Prospects

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Pains, growing (not ‘growing pains’)

• Sri Lanka is currently facing a growth problem
  • 2016: 4.4% (our lower bound forecast was 4.5%)
  • GDP growth in 2016 was far below the past six years average
  • Previously growth model was reliant on debt-fuelled public infrastructure drive, and driven by domestic non-tradables like construction, trading, and financial services
    • *Not a sustainable growth trajectory given the small domestic market*
  • Tradable sectors need to drive the economy in order to achieve and sustain higher growth rates
Non-tradable have been driving recent growth

- Domestic non-tradable sectors drove growth in 2016, following the same post-war trend.
- Financial Services was the strongest contributor to GDP growth, followed by Construction, and Wholesale and Retail Trade.
- Credit (YoY): Construction (40.1%), Wholesale & Retail Trade (52.4%), Financial Services (70.7%)

Top 10 Contributors to Change in GDP (First 9 Months - 2015/2016)

- Mining and quarrying: 3.3%
- Real estate activities, Including Ownership of dwelling: 3.9%
- Education: 4.1%
- Manufacture of furniture: 4.2%
- Transportation of goods and passengers including Warehousing: 5.9%
- Public administration and defense; compulsory social security: 6.4%
- Other personal service activities: 8.9%
- Wholesale and retail trade: 13.4%
- Construction: 17.6%
- Financial Service activities and auxiliary financial services: 21.1%

Source: EIU calculations based on Department of Census and Statistics
Tight External Conditions for Sri Lanka

- Sri Lanka enjoyed a windfall of US$ 2 bn smaller lower oil import bill in 2015 due to low prices
- Higher oil prices amidst declining export revenues will be unsustainable for LK
- Oil prices have edged up to $50/barrel amidst OPEC decision to cut production

• Precarious external position amidst declining exports, pull out of foreign funds from LK treasuries, remittances growing at a slower pace
• Reserves are currently roughly 3.5 months of import cover

Source: International Energy Agency
Recent external trade performance

- Weak export performance continues to characterise the external sector
- Exports indicated a bright spark in August 2016 reversing an 18 month decline, which continued in September, but then declined again.
- Heavy reliance on a handful of products and the dynamics in those products that are beyond our control
  - e.g. Tea exports (3rd highest export) vulnerable to adverse weather (like drought in 2016 and continuing) and demand conditions in Middle East and Russia
  - e.g. Rubber - gains when oil prices are high, loses when low, and benefits from adverse conditions in competitor markets (e.g. now with Thai floods)
Export concentration

- USA + UK = nearly 1/3rd of our exports
- Ten countries account for 2/3rd of all exports

<table>
<thead>
<tr>
<th>Product Concentration</th>
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<tbody>
<tr>
<td>Description</td>
<td>FOB Value (Rs.)</td>
<td>% of Total Exports</td>
</tr>
<tr>
<td>Articles of Apparel and clothing</td>
<td>393.7</td>
<td>26.5</td>
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<tr>
<td>Articles of Apparel and clothing</td>
<td>276.0</td>
<td>18.6</td>
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<tr>
<td>Coffee, tea, mate and spices</td>
<td>222.1</td>
<td>14.9</td>
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<td>Rubber and articles thereof.</td>
<td>116.5</td>
<td>7.8</td>
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<tr>
<td>Electrical machinery and equipment and</td>
<td>32.0</td>
<td>2.1</td>
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<tr>
<td>Natural or cultured pearls, precious or</td>
<td>31.3</td>
<td>2.1</td>
</tr>
<tr>
<td>Edible fruits and nuts; peel of citrus fruit or</td>
<td>28.1</td>
<td>1.9</td>
</tr>
<tr>
<td>Fish and crustaceans,molluscs</td>
<td>26.5</td>
<td>1.8</td>
</tr>
<tr>
<td>Miscellaneous edible Preparations</td>
<td>25.3</td>
<td>1.7</td>
</tr>
<tr>
<td>Mineral fuels, mineral oils and products of</td>
<td>23.8</td>
<td>1.6</td>
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<tr>
<td>Other Exports</td>
<td>312.3</td>
<td>21.0</td>
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</table>

<table>
<thead>
<tr>
<th>Market Concentration</th>
<th>Country</th>
<th>Export Value (Rs.Bn)</th>
<th>% of Total Exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.A</td>
<td>408.8</td>
<td>27.5</td>
<td></td>
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<tr>
<td>U.K.</td>
<td>151.9</td>
<td>10.2</td>
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<tr>
<td>India</td>
<td>80.3</td>
<td>5.4</td>
<td></td>
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<tr>
<td>Germany</td>
<td>73.6</td>
<td>4.9</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>62.3</td>
<td>4.2</td>
<td></td>
</tr>
<tr>
<td>Belgium</td>
<td>49.2</td>
<td>3.3</td>
<td></td>
</tr>
<tr>
<td>U.A.E.</td>
<td>40.0</td>
<td>2.7</td>
<td></td>
</tr>
<tr>
<td>Netherland</td>
<td>30.3</td>
<td>2.0</td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>29.1</td>
<td>2.0</td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>29.0</td>
<td>1.9</td>
<td></td>
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<tr>
<td>Total Exports to the World</td>
<td>1487.7</td>
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Source: EIU calculations based on Sri Lanka Customs
Only apparel exports showing growth

- Among the top ten exports, only the apparel sector has shown steady growth - roughly around 8-9% on average during this period.
- So even within the concentrated export basket, it is just a handful of categories that are really performing well.

Source: EIU calculations based on Sri Lanka Customs.
Apparel industry further insights

- Exports to US have been in decline but forecast is for strong uptick in 2017 and beyond (US economic recovery, Trump’s expansionary fiscal policy).
- Exports to EU recovered to mild positive territory but forecast to remain soft demand due to continued uncertainty and weak consumer demand. Regaining GSP Plus will give a short-term boost.

- Sri Lankan apparel firms have moved up the value chain - engaging in higher productivity, higher skilled, and higher technology activities.
- Innovation and strong retailer relationships is driving the top tier apparel firms.
- SL apparel firms catering to shorter lead times, collaboration on designs, new trends like ‘ath-leisure’,
Some recent issues facing exports

- Anti-export bias
  - Artificially overvalued exchange rate; high interest rate to finance government debt; high border tax protection for domestic/import-substituting industries

- Adverse policy stances that are not conducive to exporters
  - e.g. Introducing archaic restrictions on export proceeds - exporters must repatriate export proceeds within 90 days “of the date of exportation” (Later revised to 120 days)
  - e.g. Abolishing of SVAT by 1st January (now 1st April) and reintroducing VAT refunds - highly problematic, refunds mechanism not working, large pending refunds

- Shortages in labour in key growing sectors like apparel

Source: CBSL Weekly Economic Indicators
FDI inflows have been disappointing

- FDI inflows during first 9 months of 2016 are 37% lower than same period 2015
- LK FDI inflows less than 1.5% of GDP and in decline

Technical note: If a foreign investor owns over 10% or more voting shares in a Sri Lankan company, any such foreign investment is categorized as direct investment as per the BPM6. Further, foreign loans received by Direct Investment Enterprises (DIEs) from any non-related source are excluded from FDI and recorded under loans.
FDI high in real estate & property development

- A defining feature of post-war FDI has been the concentration in domestic non-tradable sectors - real estate, property development, condominiums, retail and office space, etc.

- This trend continues, as the majority of forthcoming projects are in these sectors; in addition to power and energy and leisure

- Encouragingly, new apparel FDI are in the pipeline. This can be further catalysed with the SL-China FTA and the halting of TPP

Source: EIU calculations based on BOI Data
Recent issues in FDI

• Sri Lanka has had a history of promoting FDI, dating back to 1977 when first wave of liberalisation occurred
  • Japanese ‘flying geese’ FDI showed interest - including IBM, Sony, Sanyo, Matsushita Corp
  • But full benefits could not be reaped due to outbreak of war in 1983
• Institutional mechanisms like GCEC and FIAC
  • Establishing EPZs and fostering apparel manufacturing with FDI
• Next wave of reforms in 1990s - setting up of BOI and new incentives regimes
  • Steady uptick in FDI, but hampered due to war

• Investment promotion, industrial strategy and overall macroeconomic policy have not worked together for some time

• Policy instability and lack of clear promotion strategy with sectoral focus

• Halting of incentives regime in April 2016, and taking a while to establish new regime
  • Shift of strategy from tax holidays to capital allowances
Towards an FDI push

• Need to make clear what Sri Lanka’s value proposition is, what sectors show promise, and demonstrate policy consistency

• Institutional reforms need to take root - for instance, establishment of Agency for Development and Development Special Provisions Act; and/or reform of EDB and BOI

• Accelerate new efforts that identify new growth sectors, new export competencies, and new FDI opportunities
  • e.g. Harvard’s Centre for International Development, World Bank, International Trade Centre, Commonwealth Secretariat

• Push through reforms to outdated legislation and regulations
  • Exchange Control Act — Exchange Management Act
  • Customs Ordinance — Customs Act
  • Implementing E-signatures, E-documentation hub, digital payments
  • Full and early implementation of commitments under Trade Facilitation Agreement
Emerging FDI Opportunities

• **Large development projects**
  • Megapolis and Western Region Development + other Urbanisation projects
  • Hambantota Port-Airport-Industrial Zone - China project
  • Colombo-Trincomalee Economic Corridor Project (ADB funded)

• **Sectors**
  • Freight and logistics industry (including regional e-commerce)
  • Renewable energy, climate-friendly technologies
  • Food processing - Budget 2016 and 2017 + projects by WB and ITC supporting agri modernisation, investing in equipment and technology,
  • and Tourism, of course
Leveraging on Sri Lanka’s strategic location

- Investors are very keen to use Sri Lanka as a regional base - springboard to India and the rest of South Asia + link between Asia and Africa
- At recent Sri Lanka Investment Summit in Hong Kong - “A Sri Lanka play is essentially a regional play”
- Investors like Sri Lanka’s:
  - geographical location
  - compliance standards
  - trainable workforce
  - laws written in English

Source: EIU calculations based on survey of 154 respondents
Leveraging on trade-investment nexus

• Several investors have told us - “Do your FTAs soon, and we can convince manufacturing investments in Sri Lanka”

• 2016 Investor Conclave - interest from countries ranging from Chile, China, Jordan, Bahrain, Korea, Norway, South Africa, Japan

21% were interested in ‘export manufacturing’
Prospects for export-oriented FDI

- Mainly in medium- to large-scale (around 300-700 workers) niche manufacturing but high value capture in SL
  - Many in parts and components manufacture, plugging in to global production networks (a.k.a. global supply chains)

- Vehicle impact sensors for air bags and seat belts (Lanka Harness)
- Smart weighing solutions (Rinstrum)
- Patented shoe ‘upper’ (Nike-MAS ‘Flyknit’)
- Patented elastics for apparels (Stretchline)
- Precision electronics (Vario Systems)
- Electrical panels (KIK Lanka)