13

Sri Lanka's External Trade Relations

Mrs. M.K. Jayawardena
Senior Economist, Economic Research Department

Introduction

Sri Lanka's central location in the Indian Ocean, straddling trade routes from the East to the West, made it a popular trading hub in ancient times, where spices, gems and elephants were exchanged for fabrics, metals and other goods. Even today, over 200 vessels navigate along this path daily, as the government tries to reclaim Sri Lanka's hub status in the Indian Ocean, amidst a shift in the center of economic gravity from the West to the East, as India and China show signs of re-emerging as major propellers of global economic growth.

Sri Lanka's external trade relations during the last 6 decades have changed considerably. In general, it is a story about embracing an outward-oriented trade regime, in order to expand overseas market access for its products and services at the bilateral, regional and multilateral fronts, interspersed with brief periods when it looked inwards. The outward looking policies encompassed an inclination for the use of price based measures such as tariffs rather than quantitative measures and preference for private enterprise over public enterprise. The reduced intervention in trade allowed the country to allocate resources in line with its comparative advantages which in turn enabled Sri Lanka to prosper. Those policies that looked inwards comprised preference for quantity based measures rather than tariffs, excessive government intervention in economic activities, ranging from stringent import controls to heavy protection of domestic industries, which shrunk Sri Lanka's share in world trade, particularly since East

Asian countries began to dominate world trade due to the liberalisation of their trade regimes starting in the mid-1960s. Given its small size, Sri Lanka was also vulnerable to fluctuations in the international commodity markets. It was also susceptible to a range of internal and external shocks during the last 6 decades, which helped shape Sri Lanka's trade structure to what it is today.

Trade at the time of Independence

Sri Lanka was an open economy at the time of regaining independence in 1948, but with a tariff based preference to products of the British Empire. Having inherited a well-organised plantation economy from the British raj, Sri Lanka continued to rely heavily on exports of tea, rubber and coconuts and imports of rice, sugar, fertiliser and investment goods. Aided by fertile land, supportive infrastructure and foreign entrepreneurship, the plantation sector performed well and the agricultural commodities accounted for 90 per cent of total exports. The main export destinations were the United Kingdom (UK), India and the United States of America (USA), all of which had made significant investments in support of the plantation sector, including energy, transport, banking and insurance services. Manufacturing turned out to be unattractive given its small domestic market and the increased competition in potential export markets from established suppliers elsewhere. (Rajapatirana, 1988) Incentivised by a system of tariff preference for products of the British Empire, the UK and India were the primary source of Sri Lanka's imports. The trade account registered a surplus for eight consecutive years after independence, led by high rubber prices during the Korean War (1950-52) and high tea prices triggered by a shortfall of tea in the international market during 1954-55.

Move towards the Socialist Bloc

In an effort to diversify trade with the rest of the world, Sri Lanka entered into an agreement with China in 1952 to exchange rubber for rice. This was followed by a series of trade and payments agreements with a range of other countries amidst concerns about over-specialisation and over-dependence on the traditional exports.[1] Politics also appeared to play a role here, since the Government at the time wanted to develop close relations with the Soviet Bloc. However, Sri Lanka lost valuable ground for two reasons. First, some countries exchanged their industrial products for tea and then sold the tea to other countries which in turn, re-sold it to yet other countries, thereby depriving Sri Lanka direct foreign exchange earning opportunities. Second, the industrial goods Sri Lanka imported under the payment agreements were reported to be not up to the standards of similar products imported from the West. Nevertheless, Sri Lanka remained committed to the neutral trade regime until 1957, when it displayed a tendency towards the use of

1 Trade and payment agreements entered into with the Union of Soviet Socialist Republic (USSR), Bulgaria, Czechoslovakia, Hungary, Ireland, Italy, Poland, Romania, Yugoslavia and Spain between 1956 and 1960 lapsed in 1977.

import duties as "a tool of promoting import substitution by way of imposing protective tariffs for some infant industries and raw materials." (Athukorala, 1980) Thus began Sri Lanka's first bout of import substituting industrialisation policy.[2] Nevertheless, GDP growth averaged 5 per cent per annum during the period from 1948 to 1960, which has been attributed to the strong performance of the agricultural export sector. Export duties were a major source of government revenue during this time.

Sri Lanka's economy changed its course in the 1960s by adopting a restrictive trade regime in response to balance of payments difficulties, at a time when other countries such as Hong Kong, Singapore, South Korea and Taiwan, pursued liberal trade regimes to attain their development goals. In general, the tariff structure and quantitative restrictions adopted by Sri Lanka during this time tended to discriminate in favor of final goods and against intermediate goods. "By 1962, all imports except foodstuffs, petroleum, fuel, fertilizer and pharmaceuticals were subject to licenses" (Rajapatirana, 1988). Tariff rates on imports ranged from 10 per cent to 500 per cent, based on the level of competition with domestic import substitutes. Agricultural goods, in particular, were affected by price controls and centralised distribution mechanisms. It has been surmised that it was Sri Lanka's commitment to consumer welfare during this time, through government intervention in the health, education and food sectors, which prevented it from embarking on an outward oriented development approach (Rajapatirana, 1988). The Government's decision to nationalise the oil companies led to a rift in Sri Lanka's relations with the West, which however, improved temporarily from 1965-70 as the UK and the USA re-emerged as Sri Lanka's major trading partner countries accounting for over 45 per cent of exports and more than 40 per cent of imports.

Brief Attempt at Trade Liberalisation

An attempt at trade liberalisation was made in 1965 with the devaluation of the currency by 20 per cent, which followed British and Indian devaluations. A dual exchange rate system was adopted in 1968 to discourage the so called "non-essential" imports by charging a premium of Rs. 44 per Rs. 100 over the official exchange rate on the c.i.f. value. The premium was subsequently raised to Rs. 55 per Rs. 100 in July 1969. "Non-essential" imports were brought under an Open General Licenses system while "essential" imports were tax exempt. Some items such as liquor, tobacco and luxury vehicles were subjected to a tax of 300 per cent. The two tier exchange rate system that promoted non-traditional exports and implicitly taxed traditional exports distorted the prices of a larger proportion of exports. Thus, the benefits of trade liberalisation did not bear fruit as the balance of payments did not improve and the Sri Lankan economy slipped back to a rigid control system.

2 Import substituting industrialisation policy included Government owned steel, tyre, hardware, sugar, salt, cotton yarn, brick and tile, chlorine and ilmenite factories, some of which were inaugurated during the Second World War to meet domestic shortages.

Back to Controls amidst External Shocks

Sri Lanka's trade relations with the West oscillated in response to a series of shocks that rocked the economy in the 1970s. The first oil price shock in 1973 led to higher expenditures on petroleum and fertilizer imports. The commodity price boom around the same time resulted in higher expenditures on rice, wheat and sugar imports, which were only partially offset by the earnings generated from higher export prices of tea, rubber and coconuts. However, ties with the West ebbed to the lowest levels in the 1970s with the nationalisation of the oil and plantation companies in 1971 and the government takeover of trading and agency houses in 1975. By then, China and Pakistan had emerged as the major buyers of Sri Lankan exports. Together, they accounted for about 20 per cent of export earnings. In the meantime, Iraq and other Middle Eastern countries were treading their way up as significant trading partners as importers of Ceylon tea. Saudi Arabia accounted for 12 per cent of total imports, followed by Japan, Australia, France and Thailand, which together accounted for about 30 per cent of total imports.

The restrictive policies that followed were supported by an overvalued exchange rate, differential interest rates which favored domestic industries, state entry into commerce through selective nationalisation and various forms of interventions in the labor market.[3] However, these inward looking policies failed as government bureaucracy could not reap the desired profits or maintain the expected standards. A general shortage of foreign exchange during this time led to foreign exchange budgeting to allocate limited resources on priority basis. As a result, there were frequent bouts of excess capacity in industry as capacity utilisation became dependent on the availability of foreign exchange required to import intermediate goods and raw materials (Rajapathirana, 1988). There was also a switch in imports from consumer goods to intermediate goods, giving rise to severe shortages of basic requirements such as food and medicine. These protectionist measures, which became increasingly complex over time, distorted prices which in turn impacted trade and investment, as a result of which, Sri Lanka's exports suffered, as the economy stagnated.

Renewed Attempt at Trade Liberalisation

The failure of the rigidly regulated economy, the hope of international support and the impressive performance of the Newly Industrialised Countries (NICs) since the mid 1960s provided the basis for a renewed attempt at trade liberalisation in 1977. Not only was it supported by a strong political and public commitment for reform but it was also supported by tangible benefits in terms of immediate availability of durable consumer goods made possible by large aid flows. The trade liberalisation package included placing bulk of import trade under general licensing, unifying the dual exchange rates, adopting a floating exchange rate regime, relaxing exchange controls, removing many of the price controls, rationalising the tariff structure, encouraging

3 Interventions in the Labour Market comprised of minimum wage laws, restrictions on firing and social security legislation.

foreign investment and permitting the repatriation of profits. The removal of price controls and trade licensing were instrumental in resurrecting private sector participation in economic activity. The exchange rate became a key instrument that determined trade performance. These policies which helped generate a more competitive economic environment, sparked off the revival of the manufacturing sector led by the private sector, as operations of state monopolies were gradually scaled down. Industrial policy aimed at export oriented industrialisation and foreign investment was encouraged. The first Export Processing Zone (EPZ) was set up in Katunayake in 1978 and the Export Development Board was established in 1979 to support the promotion and development of exports. Trade relations with the west regained importance. With the rapid expansion in industrial activities and the diversification of the export structure, USA became the single largest buyer of Sri Lanka's exports by 1979. Japan also became one of Sri Lanka's major trading partners by 1979.[4]

Trade Liberalisation amidst Industrialisation

The 1980s were characterised by the second oil price hike, which led the international economy into recession. Nevertheless, the massive private and public capital inflows that accompanied trade liberalisation led the nominal exchange rate to appreciate, reflecting a phenomenon commonly referred to as the Dutch Disease. It also led to a considerable increase in imports of investment goods. However, the large public investments led to burgeoning budget deficits, which fuelled inflation. Together, they eroded Sri Lanka's export competitiveness, achieved through trade liberalisation supported by generous tax concessions. Liberalising the trade regime while increasing public expenditures turned out to be inconsistent. Meanwhile, the adverse terms of trade reduced the volume of exports and affected Sri Lanka's trade balance. However, the Government continued to encourage export orientation of industries by gradually eliminating export licensing requirements and export duties over the period 1988 - 1994 and ensuring free current account convertibility since 1994. It set up more EPZs, offered financial assistance and duty rebates to small and large scale exporters and developed capacity in an effort to diversify exports. It also encouraged "decentralisation" of garment factories that helped change the composition of Sri Lanka's exports. Industrial exports accounted for 71 per cent of total exports by 2010, over half of which comprised of apparel exports. Trade liberalisation helped attract quota-hopping East Asian garment exporters to invest in Sri Lanka's rudimentary garment industry, capturing incentives offered by export quotas, despite the lack of cloth and accessories manufacturing bases to facilitate backward integration (Kelegama, 2005). Notwithstanding the elimination of the textile quota system in 2001, the apparel industry grew rapidly, harnessing increasingly higher levels of value addition. Although the share of agricultural exports declined over the years to 27 per cent in 2010, earnings from tea exports, which accounted for 17 per cent of total exports, continued to play a dominant role in the economy as it acquired a reputation for its superior quality. With respect to imports, while the relative share of consumer and investment goods declined over the years, the share of intermediate goods imports increased, driven by petroleum.

4 Japan remained Sri Lanka's major trading partner from 1979-1995.

External and Internal Shocks

Shocks to the economy thereafter ranged from commodity price booms and busts, terrorism, natural disasters, and economic crises. Sri Lanka's economy weathered prolonged droughts (el nino), the tsunami disaster, frequent flash flooding and a series of insurgencies, including 3 decades of terrorism which heightened into war status, a number of times. The impact of the oil price increases during the Gulf crisis on the trade balance was off-set to some extent by the higher earnings from exports, particularly tea.[5] The impact of the Asian financial crisis on Sri Lanka's economy was minimal, largely due to the lower trade exposure to the region, flexibility of currency and the relatively closed capital and financial accounts compared to those of some East Asian economies. Trade with the rest of the world became expensive in 2001, in view of the higher premium charged on freight insurance, due to an increase in perceived risk brought about by the terrorist attack on the country's only international airport. The setback caused by the September Attack on the USA also contributed towards the decline in trade in 2001. Later, the global economic recession triggered by the "Sub-prime" crisis had a significant impact on Sri Lanka's external trade, as both, exports and imports dropped. This may be attributed to the increased exposure to the USA and the European Union (EU), which accounted for 22.2 per cent and 38.5 per cent of Sri Lanka's exports, respectively, in 2009. Industrial exports in particular, were severely affected, as earnings declined by 13.8 per cent, year-on-year, reflecting contractions in all sub-sectors. However, these trends reversed quickly with the global economy gradually recovering in 2010, led by agricultural exports which fetched better prices in the international market.

Trade in Services

Trade in services was in deficit at the time of independence owing to the significant foreign participation in the economy. Outflows comprised mainly those related to transport services on account of charges imposed by foreign shipping companies. In an effort to manage the foreign exchange outflows to contain the burgeoning balance of payments deficit arising from the sluggish export volumes and adverse terms of trade, services such as public transport, port and insurance were nationalized in the 1960s. The Ceylon Tourist Board was established in 1966 to reap higher earnings from travel. Exchange control regulations imposed in the 1970s included restrictions on outbound travel, which were subsequently relaxed in the 1980s. Earnings during this time comprised mainly of tourism and bunkering services, both of which performed well and helped generate a surplus in the services account of the balance of payments from 1973 to 1981. However, earnings from tourism remained subdued thereafter, due to various disturbances including ethnic strife. All remaining restrictions on payments and settlements pertaining to services were relaxed when current account transactions were made freely convertible in 1994. With the expansion in international trade in goods, the services sector also developed. More recently, transportation, information technology and travel services have become important sources of foreign exchange earnings.

5 The period after liberalisation has been interspersed with tea booms (1979-82, 1983-84, 1990, 1996, 2008, 2010)

Trade Cooperation

Sri Lanka entered the multilateral level trade forum in 1948 as one of the 23 founding members of the General Agreement on Tariff and Trade (GATT). As trade in services and international investment expanded over the years, new issues arose which led to a series of multilateral trade negotiations that culminated in the Uruguay Round and set the stage for GATT to be replaced by the World Trade Organization (WTO) agreement in 1995, ratified by the bulk of the world's trading nations as the sole provider of legal ground-rules for international commerce.

Although trade policy changed from time to time, since the trade liberalisation in 1977, successive governments have pursued market oriented trade policies and measures aimed at developing more balanced, global partnerships. In 1975, Sri Lanka entered into its first regional trade agreement, the Bangkok Agreement, (subsequently renamed as the Asia Pacific Trade Agreement (APTA) in 2005), which links Sri Lanka to China and South Korea among other countries in the Asia Pacific region. Meanwhile, Sri Lanka pursued the South Asian Preferential Trading Arrangement (SAPTA) in 1995 intended to promote preferential trade and the South Asian Free Trade Agreement (SAFTA) in 2006 to enhance economic integration in South Asia by fostering regional trade. Trade with India and Pakistan increased significantly with the implementation of the India-Sri Lanka Free Trade Agreement (ISLFTA) in March 2000 and the Pakistan Sri Lanka Free Trade Agreement (PSLFTA) in June 2005. A Comprehensive Economic Partnership Agreement (CEPA) with India, which is in the process of being negotiated, aims at further economic integration by incorporating trade in services and investment and accommodating the movement of people.

Sri Lanka benefited from tariff concessions offered under the Generalised System of Preferences (GSP) schemes of the EU and the USA since 1971 and 1976, respectively. Access to the Special Incentive Arrangement (GSP+) concessions from the EU since 2005 helped expand market share in the EU as it surpassed the USA as Sri Lanka's prime export destination by 2006. This facility which was withdrawn in 2009, helped develop Sri Lanka's exports considerably.[6] Taken separately, however, the USA and the UK, remained the foremost export destinations, while imports were dominated by India, Singapore, China and Iran.[7]

Conclusion

Sri Lanka, being a small economy, was strongly susceptible to external shocks. It was also subjected to a range of internal shocks over the last six decades. External trade remained an important instrument that promoted economic growth as the country alternated between inward and outward orientation. The periods of stringent controls reduced heavy dependence of the

6 Apart from apparel, the GSP+ Arrangement helped foster the growth in exports of fisheries products, ornamental fish, fruits and vegetables, ceramic products, bicycle components, rubber products, etc.

7 Imports from India and Singapore comprised mainly of refined petroleum products while Iran was the main supplier of crude oil. The major import from China was cotton.

economy on external trade. However, state commitment to large scale consumer welfare programs reduced the availability of resources to support commerce. Interventions in the economy may have been costly and counterproductive, as they misallocated resources from their optimum uses. Interventions have also been time consuming to turn around, perhaps depriving the country of opportunities to stride forward. The trade structure also changed over the years. The post 1977 liberalisation efforts, in particular, marked greater dependence on intermediate goods and reduced the importance of finished goods imports. The direction of trade also swung between the East and the West. Despite these vacillations, Sri Lanka remained resilient amidst the numerous internal and external shocks. Although, trade with the West exceeds that with Asia by far, more recently, trade with Asia has taken on an increasing trend. Perhaps, the pendulum is beginning to swing again, as Sri Lanka seeks to diversify external trade, in terms of goods as well as markets, to become a trading hub of the Indian Ocean.

References

Athukorala, Premachandra. "Import Substitution, Structural Transformation, and Import Dependence - a Case Study of Sri Lanka." 9th Conference of the Economic Society of Australia and New Zealand. Brisbane, 1980.

Athukorala, Premachandra, and Sisira Jayasuriya. Macroeconomic Policies, Crises, and Growth in Sri Lanka, 1969–90. Washington, D.C.: The World Bank, 1994.

Central Bank of Sri Lanka. Annual Report, Various Issues.

---. Economic Progress of Independent Sri Lanka. Colombo: Central Bank of Sri Lanka, 1998.

Kelegama, Saman. "Ready-Made Garment Industry in Sri Lanka: Preparing to Face the Global Challenges." Asia Pacific Trade and Investment Review 1.1 (2005): 51-67.

Rajapatirana, Sarath. Foreign Trade and Economic Development: Sri Lanka's Experience. Washington D.C.: The World Bank, 1988.