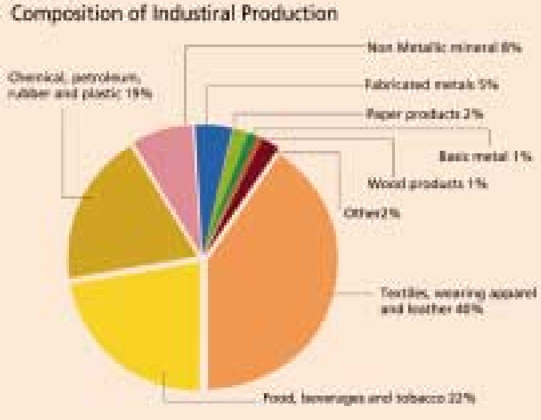
7. INDUSTRY

Despite the moderate recovery in domestic market oriented industries, the output of the industrial sector declined by 2.4 per cent in the first half of 2002 mainly due to the lower performance in export market oriented industries. Output in the latter category declined as a result of increased competition, from low cost producing countries, which negated the impact of a moderate improvement in major international markets in the first half of 2002. However, on the basis of confirmed export orders received by the major manufacturers and expected expansion of domestic demand, industrial output is estimated to increase by 8.1 per cent during the second half, resulting in a 2.9 per cent annual growth in 2002.

Chart 7.1
Composition of Industiral Production



Overall Trends

- The domestic market oriented industries have shown signs of recovery with higher production in industries such as food processing, beer, milk products, meat processing, biscuits, commercial tyres, processing of wheat flour and tobacco and pharmaceuticals.

- The decline in industrial output in the first half of 2002 was entirely attributed to the reduction of output in export oriented industries such as apparel, textiles, ceramics, footwear and industrial tyres.

- The prices of export items manufactured in Sri Lanka declined substantially due to the depressed external market environment that prevailed during the latter part of 2001 and the higher volumes supplied by low cost manufacturing countries, including China, Vietnam and Bangladesh, to international markets.

- In addition to declining prices, competition in the global apparel market has intensified with the increase in trading activities under preferential trade agreements in Europe and North America.

- Mexico, which received tariff and quota free access in USA under NAFTA, expanded its market share in USA causing severe competition to other exporting countries including Sri Lanka. The Caribbean, and more recently, Sub-Saharan African countries, facilitated by the trade preference agreements in the US market, have posed new challenges.

- The competitiveness of Chinese apparel products continued to strengthen with their massive production capacity, strong fabric base, high level of technology and relatively low labour cost.

- Power cuts until mid-May 2002, affected industrial activities of several small and medium scale manufacturing industries and energy intensive industries such as ceramics, cement and glass, causing difficulties in meeting orders on schedule, disturbing production cycles and increasing costs.

Chart 7.2
Growth in Industrial Output
(1990 Constant Prices)

Chart 7.3
Performance in Major Industrial Sub Sectors
(1990 Constant Prices)

- Profit margins of export market oriented industries have been severely affected as price declines in the international markets came at a time when the local costs such as fuel and electricity and other utility costs showed substantial increases. However, the depreciation of the rupee by 3.1 per cent against US dollar during the first half of 2002 softened this unfavourable situation to a certain degree.

- Industrial sector activities were also affected by several structural impediments such as long delays in court proceedings, unfair trade practices such as the import of used goods and parts, under invoicing and leakage of BOI products to the domestic market and in certain cases, unnecessary regulatory impediments.

- The output of domestic market oriented industries such as processed food, processed tea, wheat flour, pharmaceuticals, processed meat, milk products, processed fruit, animal feed, PVC and plastics, concrete products and fabricated metal products registered relatively higher growth rates during the first half of 2002.

- The domestic demand for those products increased with increased consumer and investor confidence resulting from the on going peace process, the removal of the corporate tax surcharge and the reduction or revision of excise duties on certain products. Marketing strategies such as market segmentation, effective advertising focussed on targetted consumers, and improved distribution methods also helped expand domestic demand.

- The sector benefited from several measures initiated by industrialists. The cost reduction initiatives launched in the previous years were pursued with added vigour during the first half of 2002. These measures included cost-effective production, rationalisation of maintenance and administrative procedures, minimisation of waste, utilisation of energy saving methods and equipment, out-sourcing of production and closing down non-profitable business units.

- With a view to reducing financial costs, many companies focussed on reducing inventory levels, maximum utilisation of trade credit, reducing production time and consumer credit.

- Improvements in technology ensured consistency in manufacturing and enhanced product quality. Extensive use of information technology applications facilitated strategic decision-making, marketing and supply chain integration, thus helping to achieve greater cost efficiency.

- The Free Trade Agreement (FTA) with India was helpful for some industries such as rubber-based products, soap and plastic products to penetrate the Indian market.

- Employees were educated on the challenges emerging in international markets and strategies needed to meet them. Team based initiatives were undertaken by cross function groups to bring about process improvements, innovations and higher productivity.

Performance of major sub-sectors

Textiles, apparel and leather products

- The output of the apparel and textiles industry, the largest industrial sub sector in the factory industry sector, declined by 9.4 per cent in the first half of 2002 compared to a 3.4 per cent decline in the first half of 2001. On the basis of confirmed export orders received by major manufacturers, the textiles and apparel sector is estimated to grow by 13.3 per cent in the second half of 2002, realising a 2.0 per cent annual growth in 2002. This is a result of the expected recovery in the global markets and relatively lower level of output in 2001.

- Global competition in the textiles and apparel industry has intensified over the years with the entrance of new manufacturing countries to the global market, gradual improvement of modern technologies by existing manufacturers and expansion of preferential trade. Low cost manufacturing countries that offered competitive prices have attracted more buyers.

- The increased fuel, telephone and other utility costs during the first half of 2002 not only increased the factory costs but also increased costs of domestically manufactured raw material such as polythene bags, cartons, thread and other packing materials.

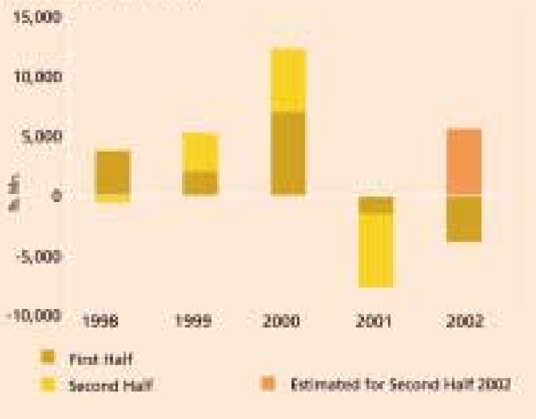
- Some manufacturers were able to overcome these unfavourable developments to a certain extent with their ability to create an up-market image in international markets through design, price and quality.

- In order to strengthen competitiveness, major manufacturers have paid greater attention to managing the production process, quality control, order placement, material sourcing, marketing, trade financing and other logistic arrangements.

- A few apparel manufacturers have downsized their operations and restructured their factories to face future competition. The excess employees in these factories have been granted temporary leave, on a half-day basis with the approval of the Commissioner of Labour.

- The competition in the apparel industry is expected to intensify further with the expected phasing out of the MFA in 2005. It appears that the industry has now begun to realise the challenges in the quota-free world after 2005 and is developing strategies to face them.

Chart 7.4
Output Growth in Textiles, Apparel and Leather Products (1990 Constant Prices)



- While continuously looking for new markets, Sri Lankan manufacturers will need to strengthen their relationships with existing buyers and offer them high quality products at competitive prices. The selection of fabrics, designs and delivery speed also play a vital role in attracting foreign demand. Launching effective marketing strategies will be a key requirement.

- The amalgamation of small-scale factories to achieve economies of scale and strong lobbying to get duty and tariff concessions from major global importing countries are also essential to face future challenges.

- The footwear industry continued to face higher competition from cheaper imports from China and other low cost manufacturing countries. With the increased domestic cost of production and growing demand for imported items, some manufacturers began to import footwear to supplement domestic production.

Food, beverages and tobacco products

- The output of the food beverages and tobacco category increased by 2.8 per cent during the first half of 2002. The production increased in the major sub sectors of tobacco products (8.2 per cent), liquor (4.1 per cent), beverages (2.0 per cent) and food processing (1.6 per cent).

- The output of this category is estimated to grow by 5.2 per cent in the second half of 2002 due to continuous improvement in consumer and investor confidence encouraged by the peace process and uninterrupted supply of power during the second half of the year. Accordingly, its output is estimated to grow by 4.0 per cent in 2002.

- The output of the food sub sector increased in the first half of 2002 reflecting higher production in meat products, food processing, milk products, wheat flour processing and animal feed. The growth of these industries can be attributed mainly to the expansion of domestic demand with improvements in distribution, marketing, product quality and packaging.

Chart 7.5
Output Growth in Food, Beverages and Tobacco Products
(1990 Constant Prices)

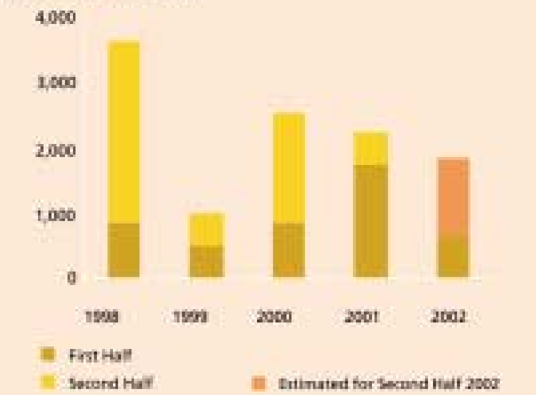
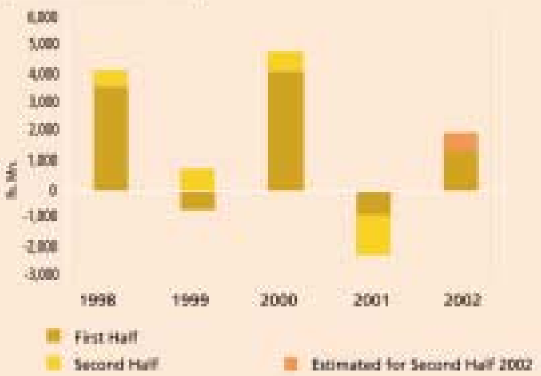


Chart 7.6
Output Growth in Chemical, Petroleum, Rubber and Plastic Products
(1990 Constant Prices)



- Cigarette production increased partly due to the restructuring of the excise tax, which reduced the prices of cigarettes popular among low-income consumers. The export demand for cigarettes improved with more export orders received from new markets such as the Maldives and East Africa. This has helped to reduce the high dependency on traditional Middle East markets.

- The reduction of excise duty on beer boosted domestic demand. The major beer manufacturers exported their products to highly competitive markets in Japan, UK, the Maldives and the USA, with the help of the establishment of overseas distributing networks, extensive market research and promotional activities.

- Biscuit manufacturers have introduced new products to the domestic market and have also entered the highly competitive Chinese market during the period under review, in addition to their foothold in other Asian markets.

Chemical, rubber, petroleum and plastic products

- The output of chemical, petroleum, rubber and plastic products grew by 7.3 per cent in the first half of 2002 reflecting higher output in petroleum refinery products, soap and detergent, fertilisers, pharmaceuticals, rubber based products and chemical products. The output of this category is estimated to grow by 3.4 per cent in the second half, realising a 5.3 per cent annual growth in 2002.

- The output of oil refinery products increased significantly during the first half of 2002 mainly due to the uninterrupted production in the Ceylon Petroleum Corporation as compared with 2001. In early 2001, the oil refinery had been closed down for routine maintenance work for two months.

- The manufacturers of rubber gloves were forced to cut prices, particularly in the lower market segment, to retain business in the face of stiff competition from Malaysia and new manufacturers from China. However, this was partly offset by exports of high value gloves.

- The reduction in export to the US market was compensated by greater market penetration in South America, Africa, the Middle East and Asia.

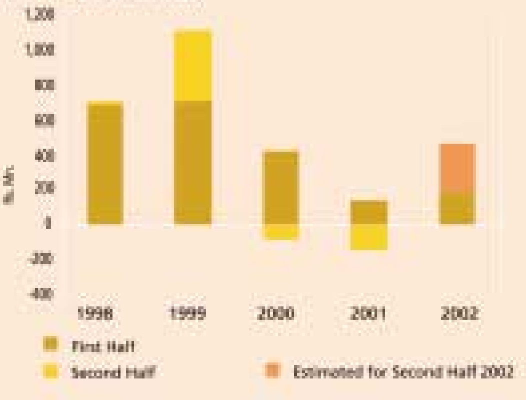


Chart 7.7
Output Growth in Non - Metalic Mineral Products (1990 Constant Prices)

- Despite the impact of increases in fuel and electricity prices, the industry was able to contain production costs due to the implementation of cost cutting strategies. The lower price of latex, a major raw material, has been a significant contributor in restraining cost increases.

- In addition to higher domestic sales, the tyre-manufacturing industry began to export commercial tyres to India under the Indo Lanka Free Trade Agreement. The opening up of transport activities in the Northern Province has boosted domestic demand for locally manufactured tyres.

- The activated carbon industry benefited substantially from the waste energy recovery processes, both for stream production and electricity generation in the context of recent increases in electricity tariffs and oil prices. However, lower harvest in coconut production is likely to push up raw material prices. The Philippines and India are becoming highly competitive countries for activated carbon in international markets.

- The output of the soap and detergent industry declined marginally in the first half of 2002. However, a large firm in the soap manufacturing industry began to export 'soap chips' to India under the FTA. Sri Lanka has now become a competitive source of soap chips, as Indian importers have to pay only 50 per cent as normal import duty.

Non-metallic mineral products

- The output of non-metallic mineral products declined by 2.4 per cent in the first half 2002 reflecting lower production in ceramic products, cement and glass. On the assumption that moderate output growth in export market oriented products and relatively higher growth in domestic market oriented products will be experienced in the second half of the year, the annual growth of this category is estimated at 0.5 per cent in 2002.

- The ceramic industry continued to suffer from increased competition in the international markets. With the expansion of factories in China and other Asian and the Eastern European countries, there has been a considerable oversupply of ceramic products in the world market. This, together with a change in consumer preference towards low-priced non-durable items, reduced the demand for ceramic products manufactured in Sri Lanka.

- The ceramic industry launched a programme to save energy, which accounts for a substantial share of the cost of production, in an effort to remain competitive in the face of growing competition from Asian rivals.

- With increased competition in the global market, some manufacturers have been successful in expanding their domestic market share through image building campaigns, improving marketing links, introduction of sub-brands and other means of sales promotion.

- The output of the cement industry declined due to the higher imports of cement in bulk form, and only a marginal recovery in the construction industry.

Other products

- The output of fabricated metal products declined by 2.9 per cent in the first half of 2002 with the decline in output in electronic parts, fabricated metals, ferrite cores, computer parts and transformers.

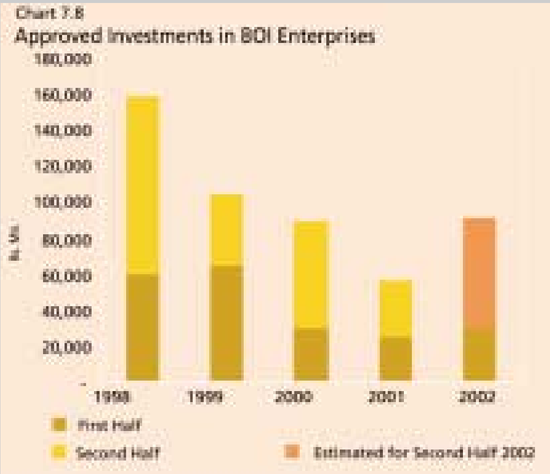
- The ship repairing industry is facing severe competition from other shipyards in the region, especially in China, which has become the most competitive ship repair centre in the region. The sluggish economic environment in the region has resulted in many of the ship owners postponing routine dry dock repairs, resulting in a drop in repair jobs carried out in the first quarter of 2002. However, the industry has received several orders to manufacture high-speed boats from the government and neighbouring countries.

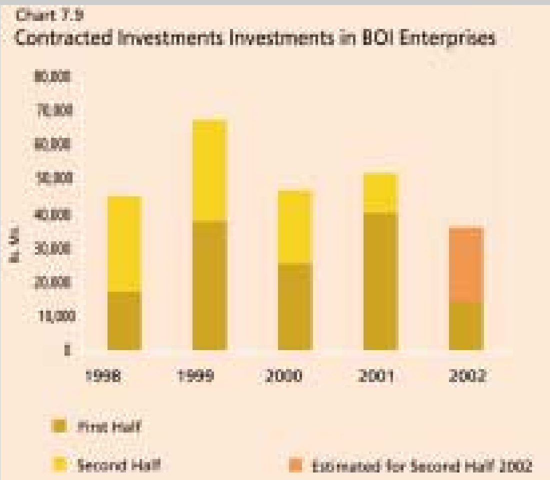
- With the successful penetration into new markets in Asia, the mattress fibre industry registered a higher output growth in the first half of 2002. However, adverse weather that affected coconut production, and higher transport costs have resulted in an increased price for husks.

- The competitiveness of the fibre industry was also affected by the inconsistency of the quality of products exported by Sri Lanka, reliability of delivery and competition from synthetic materials.

Investment in BOI Industries

- Despite the depressed international investment environment, the Board of Investment of Sri Lanka (BOI) has approved 180 projects with an investment commitment of Rs 30,207 million in the first half of 2002 as compared with 143 projects with an investment commitment of Rs. 24,413 million in the first half of 2001.





However, not all projects, which have signed agreement with BOI, can be considered as investment flows. According to past experience, about 80-85 per cent of the approved investments usually sign agreements with BOI and approximately 60 per cent of these investments are realised.

- The investment approvals by BOI in the first half of 2002 indicated that the majority of new investments moved into diversified activities, away from the apparel sector. These included information technology, education, livestock and agriculture, aviation, fertiliser, silica quartz, housing projects, metal ceiling panels and grid systems, fabricated metal and jewellery.

- The foreign investment component of approved projects increased from Rs.10,513 million in the first half of 2001 to Rs.14,299 million in 2002, while the domestic investment component increased from Rs. 13,900 million to Rs. 15,908 million during this period.

- Investments in contracted BOI projects declined substantially to Rs. 14,539 million in the first half of 2002 from Rs. 40,475 million in the first half of 2001. Although the foreign component of contracted projects increased from Rs. 4,372 million to Rs. 6,371 million during this period, the domestic component declined sharply from Rs. 36,103 million to 8,167 million.

- Under Section 16 of the BOI Law (normal law), the BOI has approved 66 projects during the first half of 2002. The investment potential of these projects amounted to Rs. 3,483 million in 2002 compared to Rs 1,172 million in the first half of 2001.

- The direct employment potential of approved and contracted projects was estimated at 38,513 and 13,992 persons, respectively.

Industrial Policy

- Export-oriented industrialisation led by the private sector continued to be the main strategy adopted by the government to accelerate economic growth, employment and income generation, effective and full utilisation of domestic physical and human capital and the promotion of regional industrialisation. The government has offered a wide range of incentives to industrialists to encourage investment and acquire modern technology to enhance productivity with the objective of improving competitiveness. Special emphasis was placed on productivity improvement as a measure for increasing efficiency and competitiveness.

- The De-regulation Committee, which was set up in 2001 under the Industrial Promotion Act No.46 of 1990, concluded that outdated regulation and rigid administrative procedures imposed by public sector institutions raised costs and discouraged dynamism in trade and industry. The government, therefore, decided to embark on de-regulation in the main areas of Customs and tariffs, tax administration, labour laws and land and land titles, by simplifying and unifying existing procedures. The deliberations of this committee will have far reaching implications on tax regimes and other regulatory mechanism affecting manufacturing sector activities in Sri Lanka.

- The government has also set up fifteen Sectoral Task Forces with private sector participation to recommend short and medium term sectoral development plans for selected industrial sectors.

- The government has appointed a Tariff Advisory Council to inquire into and advise the government on various tariff issues confronted by the business sector. The Council would also analyse the current tariff structure in order to identify anomalies and distortions, which impede the economic growth of the country. Among the areas to be reviewed by the Advisory Council are the implications of and the need for prevailing duty exemptions and waivers, the impact of VAT, excise duties and export trade and tariff policy, export incentive schemes and the use of export cess.

- Budget 2002 proposed to rationalise tax incentives. While existing exemptions will be honoured, no new exemption will be granted after 31 March 2002. However, new enterprises engaging in non-traditional exports, agriculture, information technology and allied services, electronics, industrial and machine tool manufacture, food processing, other designated enterprises or investments in excess of Rs.500

million in specified industrial and agricultural services will be exempted from tax during the first three years and will be subject to a 10 per cent tax during the following two years.

- To assist domestic garment and textile industries, Budget 2002 proposed to exempt fabric from GST with effect from 1 April 2002 to facilitate the free flow of fabric from a factory in the Export Processing Zone to a factory outside the Zone without cumbersome documentation. The Budget also imposed a flat fee of Rs.25 per unit on items sold in the local market by BOI enterprises, replacing the existing complex tracking mechanisms.

- To promote regional growth, Budget 2002 proposed to create five Economic Zones (EZ) and set up an Economic Commission for each Zone. In this respect, a new BOI Act will be enacted incorporating necessary provisions for the establishment of BOI investment promotion offices in these EZs.

- Under the Restructuring Programme for the Domestic Textile Industry, a total of 130 applications have been received by end June 2002, and of these 127 applications have been considered for relief measures. Upon finalisation of the Tripartite Agreement for Debt Recovery, the total debt outstanding of 108 manufacturers, amounting to approximately Rs.3,386 million, was transferred to the Textile Debt Recovery Fund, by end June 2002. By end June 2002, 112 enterprises had submitted restructuring/ modernisation proposals, of which their banks have already endorsed 34 enterprises for financial facilities required for the implementation of restructuring/modernisation proposals. During the first half of the year, banks/financial institutions have granted loan facilities amounting to Rs.222 million to these 34 enterprises to implement their restructuring/ modernisation proposals.

- The government has already embarked upon entering into bilateral preferential free trade agreements with several trading partners to boost industrial exports, especially apparel exports, in the context of the elimination of the global apparel quota system in 2005.

Expected Developments in 2003

- The output in the industrial sector is expected to grow by about 7 per cent in 2003 with the expected recovery in international markets, continuous expansion of domestic demand and further progress in the peace process. Contributions to growth will arise from expansion of BOI industries yielding a growth of 9 per cent and non-BOI industries growing at 6 per cent. The output of public sector industries is estimated to decline by 9 per cent due to the closure of the oil refinery in 2003 for routine maintenance work. The growth of the industrial sector in 2003 is expected to come mainly from the industrial categories of textiles, apparel and leather products, food, beverage and tobacco products and non-metallic mineral products.

- Output in the textiles, apparel and leather product category is expected to grow by 10.5 per cent in 2003 with the recovery in international markets, continuous expansion of product quality and build up of close relations with buyers in the international markets. Initiatives taken by manufacturers to reduce costs of production, coupled with the extensive use of information technology applications which facilitate strategic decision-making, marketing and supply chain integration, the creation of an up-market image in international markets with improved design, price and quality would help expand export demand in 2003.

- With domestic demand arising from increased consumer and investor confidence and prospects for peace, the output of food, beverage and tobacco products is estimated to increase by 6 per cent in 2003. Excise duty revisions on tobacco and liquor, and innovative marketing and distribution strategies adopted by manufacturers would also help output growth in 2003. The output of wheat flour processing, biscuits, liquor, beer, milk products, food processing, animal feed and cigarette in this category is expected to grow at a higher rate in 2003.

- The output of chemical, rubber, petroleum and plastic products is expected to grow at a slower pace of 1 per cent mainly due to the expected closure of the oil refinery in 2003 for routine maintenance work. However, the output of rubber gloves and commercial tyres, chemicals, pharmaceuticals, soap and detergent, plastic and PVC products would grow faster in 2003 with increased domestic demand.

- The output of non-metallic mineral products is expected to grow at 6 per cent in 2003 with higher production levels expected from ceramic products, concrete products and cement. The domestic demand for ceramic products is expected to increase in 2003 with the expansion of construction work and introduction of new designs by major manufacturers.

- The investments flows to BOI industries is expected to increase at a higher rate in 2003 with the build up of investor confidence as a result of peace prospects, expected recovery in the international markets and gradual improvements in infrastructure, especially in the areas of telecommunications, information technology and ports. The proposed Free Trade Agreements with USA and Pakistan would also help increase investment flows in 2003.