Brief Overview of the Sri Lankan Economy and International Trade 2000-2022

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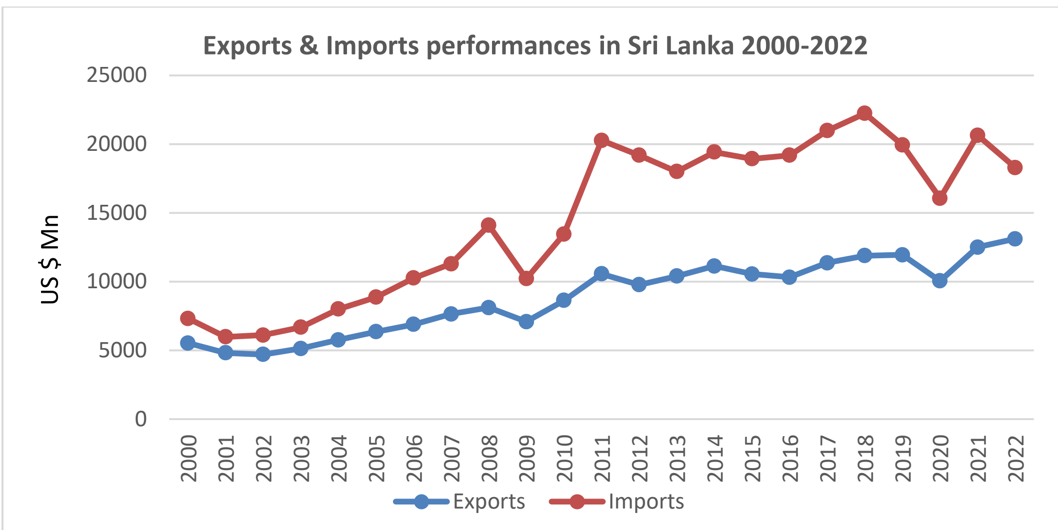
Introduction

This report attempts to analyze the changes of macro-economic environment in Sri Lanka during the last two decades. Sri Lankan economy has experienced various economic challenges/ fluctuations and policy reforms under different political regimes from year of 2000 to 2022.

1. **Macro-Economic Overview in Sri Lanka (2000-2022)**

1.1 Performance of International Trade

Figure1.1: Performance of International Trade

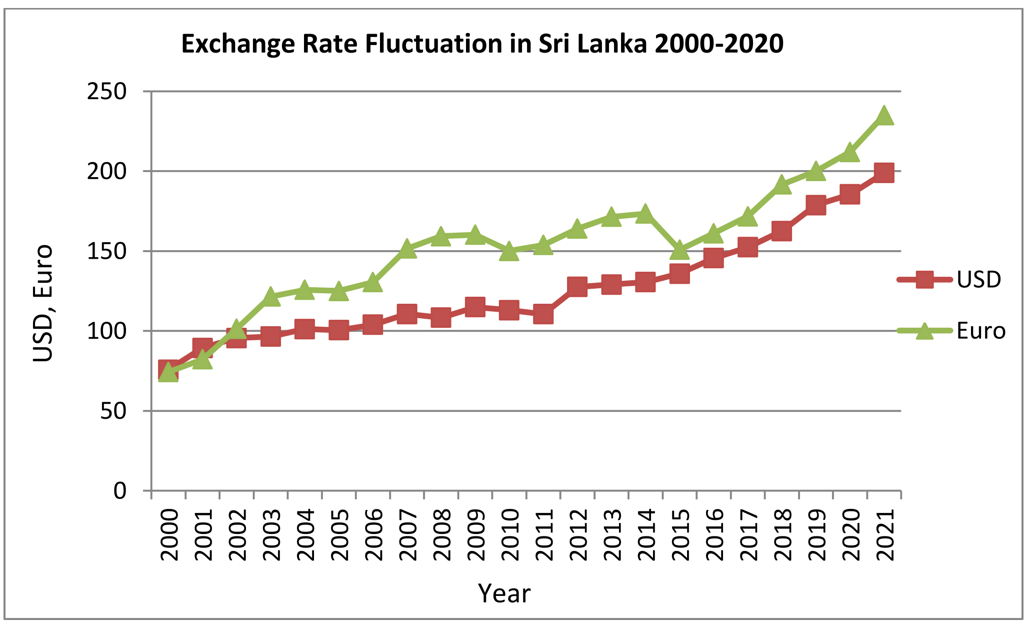


Source: Central Bank of Sri Lanka, Different Years

Figure 1.1 represents the exports and import performance in Sri Lanka during the last two decades. After the trade was fully liberalized in 1977, the import expenditure of the country has increased steadily in comparison to exports income. This scenario has stimulated rise in trade deficit in Sri Lanka since then. However, this graph shows a slight decrease in both exports and imports sectors from 2000-2001 due to the foreign exchange crises with low domestic reserves. But, after the year 2022, both exports and imports started to going up. The main reason for that increment of the export sector in the 2000-2008 was the development of service exports since the year 2000. After 2000, the service export sector was expanded further with the addition of new export services sectors such as ICT, Transportation, Logistics, Constructions, Education, Printing and packaging, marine offshore services & etc. Those sectors directly impacted to uplift the Sri Lankan export performance after 2001. Sri Lankan economy faced the global economic crisis again in 2007. It caused to sharp decline of both exports and imports in 2008. Especially, there is a gradual increment of both exports and imports after the period of civil war due to the cutting down of war expenditure and favorable economic environment. But, the import and export gap was widening after 2010 in the country. This period Sri Lanka imported more consumer goods and intermediate goods with the improvement of the SME related production sectors in the country including, northern province. However, this steady growth of export and imports were not continued anymore. In 2019, there was a sudden decrease of international trade due to the Easter Sunday attack. After that, economy moved towards its recovery period very slowly. Further, the Covid-19 pandemic has aggravated the economic downturn in 2022.

1.2 Exchange rate Fluctuations

Figure1.2: Exchange rate Fluctuations

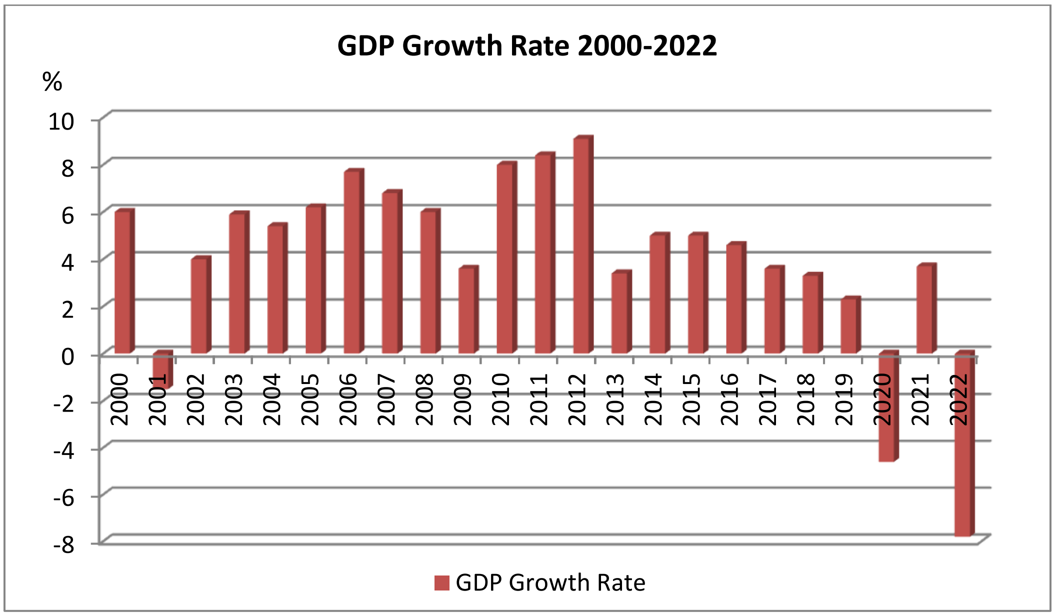


Source: Central Bank of Sri Lanka, Different Years

Figure 1.2 shows two main exchange rates fluctuations in Sri Lanka during the last two decades. Both Euro and US dollar have increased its value over the period in comparison to the Sri Lankan rupee. Other interesting pointing is that, the value of Euro has increased more than the US dollar after the year 2000. Value of the foreign exchange rate is determined by the demand and supply for a currency. As discussed above, there were many reasons caused to change in demand and supply for these two currencies. However, this figure disclosed that Sri Lankan rupee is still depreciating its value against the Euro and USD. This situation is healthy for an economy as the country can increase its exports quantity. But it also makes imports expensive and being a country with a significant dependency of imports, the adverse effects are greater for Sri Lanka.

1.3 Changes in Economic growth rate

Figure1.3: Changes in Economic growth rate

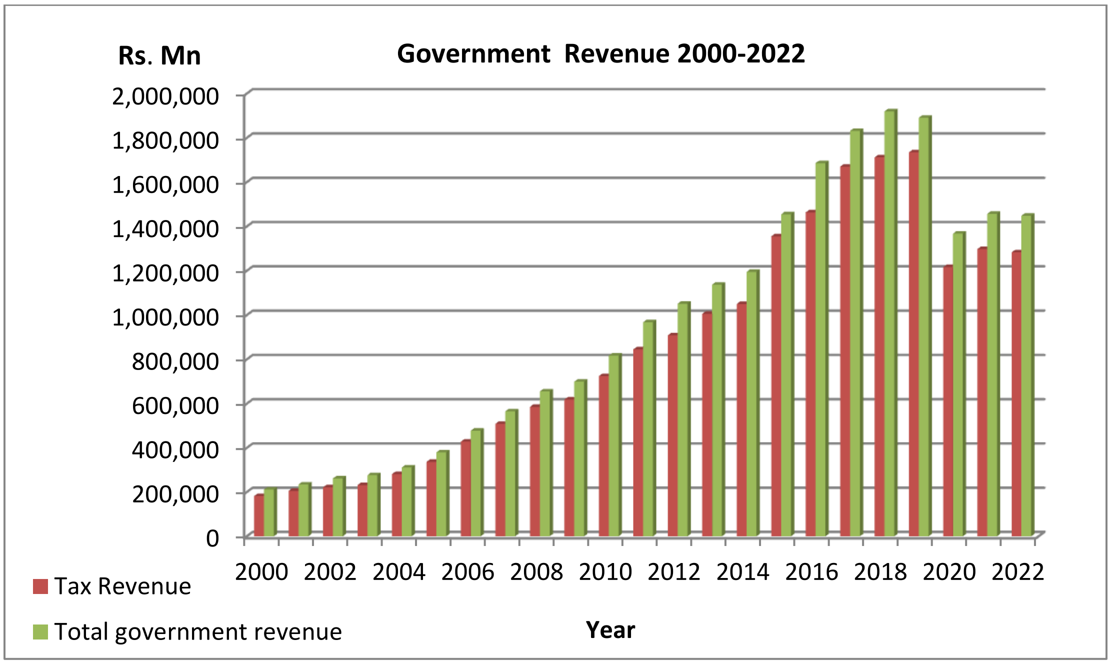


Source: Central Bank of Sri Lanka, Different Years

Figure 1.3 shows the annual growth rate of gross domestic products in Sri Lanka from 2000 to 2022. Considering the above graph, it is clearly revealed that the highest GDP value as 9.1% has achieved in 2012 with the healthy economic environment after the post war period. During this period, country's production was climbed up in the north-east province. Especially, decreasing unemployment rate, increasing start-ups businesses in northern and eastern provinces were noticeable and increasing FDIs, exports and SME led economic growth policies were mainly attributed to achieve this high growth rate. The low GDP growth rate reported in 2001 was mainly due to the global oil crises. The crude oil imports decreased and it affected to decline the local production process and exports as well. However, the worst period for the GDP was reported in 2020 and 2022 years in Sri Lankan history. With the Easter Sunday attack in 2019, Sri Lanka became vulnerable socially, economically and politically. Easter Sunday attack created this short term economic recession and it discouraged FDI inflows, exports production sectors and other business activities. But this recession was not continued further and economy turned to its recovery. Unfortunately, the country had to face Covid-19 pandemic at the beginning of 2020. These two situations lead to significant economic shrinkage in last two years. As a result, GDP growth rate in 2022 declined to -7.8%.

1.4 Government Revenue changes

Figure1.4: Government Revenue changes

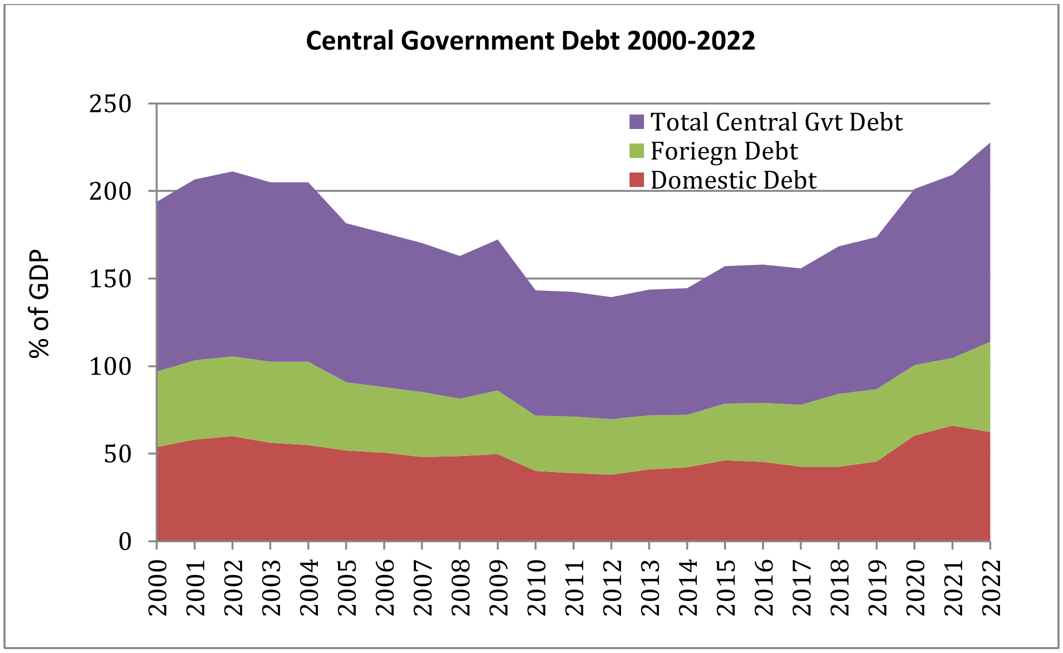


Source: Central Bank of Sri Lanka, Different Years

Sri Lanka's tax revenue performance has deteriorated sharply in 2020 (Figure 1.4). Sri Lanka has substantial scope to mobilize revenue by strengthening income taxes and VAT. Total tax revenue was fairly stable at around 10 to 12 percent of GDP over the period 2000 to 2019. It was resilient to plunges in output growth in 2001, 2009, and 2013. However, during the recession in 2020 caused by the COVID-19 pandemic, total tax revenue fell sharply to 8 percent of GDP, due to the tax cuts, cyclical effects, suspension of non-priority imports, and lockdown measures. Throughout this period, Sri Lanka's tax-to-GDP ratio was below the average across its comparators, and this revenue underperformance has been rising. However, from an international perspective, persistently large fiscal deficits in Sri Lanka reflect relatively low tax revenues, not excessively high government expenditures.

1.5 Central Government Debt 2000-2022

Figure1.5: Central Government Debt 2000-2022

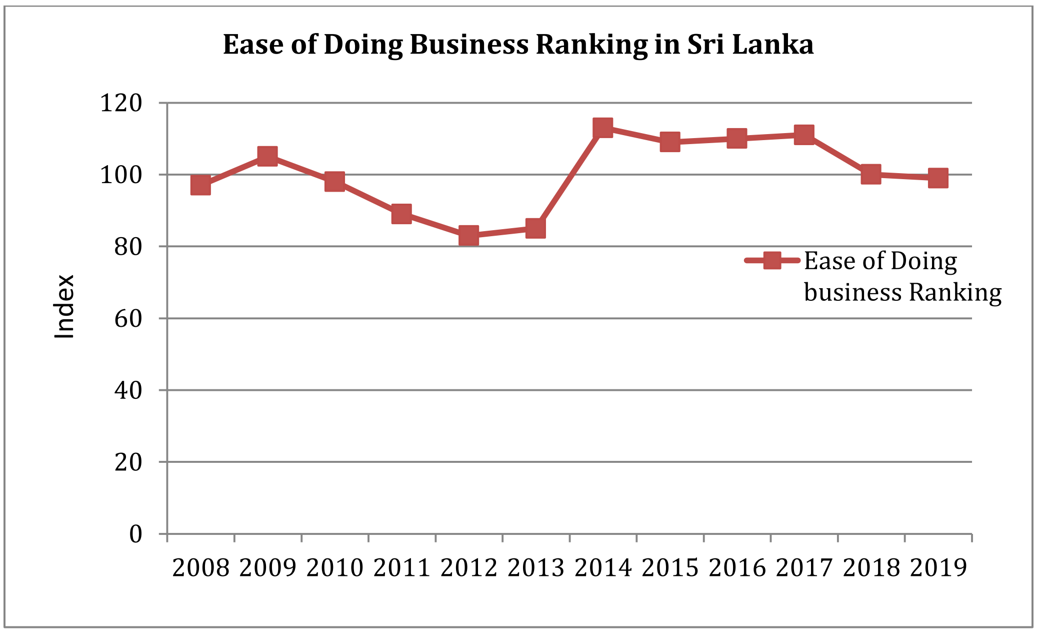


Source: Central Bank of Sri Lanka, Different Years

The rapid increase in the government debt stock during the period under consideration is depicted in the figure 1.5. However, after the 2008, total government debt stock increased from 81.8 % of GDP to 113.8% of GDP in years 2008 to 2022 respectively. This rapid increase was due to new borrowings to finance the government's aggressive infrastructure development drive since 2008 that resulted in persistent budget deficits. The public-sector investments, mainly in such infrastructure as roads, telecommunication, electricity, ports and airports, and water etc. was increased to around 6.5 to 7.0 per cent of GDP during the period under review compared to about less than 3 per cent of such investments before. Sri Lanka experienced a 30-year internal conflict, ended in May 2009, and there was little or no visible investment made in country's infrastructure during this period. More importantly, soon after the ending of the conflict, the government had to make a substantial investment in infrastructure and social programmes in the conflict affected areas that represents about one third of the land area of the country. In addition to the new borrowing, factors such as discount effect - issuances of Treasury bills and Treasury bonds at discounts- depreciation in local currency resulting a substantial increase in local currency value of foreign currency denominated debt issued to domestic sources also caused the rapid increase in the central government debt in Sri Lanka. More than 40 per cent of total public debt obtained from foreign sources and with high concentration on USD, any adverse development, including adverse exchange rate movements and shifts in global credit conditions, is likely to have negative implications on the government's ability to access further foreign commercial financing. Further, as per the currency composition of the foreign debt stock of the government, it has a substantial concentration on USD denominated debt obligations which is increasing.

1.6 Ease of doing business rankings in Sri Lanka

Figure1.6: Ease of doing business rankings in Sri Lanka



Source: Central Bank of Sri Lanka, Different Years

Ease of doing business index is an aggregate figure that includes different parameters which define the ease of doing business in a country. When preparing the ease of doing business index, it considers the construction permits, registration, getting credit, tax payment mechanism and etc. Lower value rankings indicate a better environment to establish a business. According to the figure 1.6, Sri Lanka currently ranks 99th on the World Bank rankings for Ease of Doing Business. With the recent economic crises Sri Lanka is with a poor rank as 99 among 190 economies. Sri Lanka needs to significantly move up the ease of doing business rankings if it is to increase Foreign Direct Investment coming into the country.

2. High - Tech Exports of Sri Lanka

Sri Lanka's export structure is concentrated in terms of product composition. When exports are highly concentrated on a few products, it is believed that a country will experience more volatile real exchange rates than other countries and this discourages investment in tradable goods or services.

Increasing specialization in high-tech exports is highly desirable for the development of a country. Asian economies such as Malaysia, South Korea, Taiwan and Singapore moved towards a technology-driven high-tech production-based pattern of development. High-technology products are those products with high R&D content. Industries such as Aerospace, Computers, office machinery, Electronics-communications and Pharmaceuticals are classified as High – Tech industries. Singapore, Malaysia and South Korea are among the countries exporting the most amounts of hi-tech products as a percentage of the GDP. In Europe, Hungary and the Czech Republic are among the largest exporters in relative terms, as a result of the immense FDI investment made in R&D over the last two decades.

Table 2.1: High – Tech Exports as a Share Of Manufactured Exports

Region	2021
World	20%
East Asia & Pacific	33%
European Union	15%
Middle East & North Africa	8%
South Asia	10%
Low & middle income	22%
Low income (2020)	4%
Sri Lanka	**1%**

Source: World Bank, 2021

Sri Lanka's research and development capacity is at very low ebb and industrial research being carried out is not demand driven. Entrepreneurs in many instances are not aware of new technologies available or if they are, they do not have access to that technology. Usually, there is a time lag to get the new technology. A major contributory factor of this noticeable weakness is poor linkages between the industrial sector, business community, research institutes and universities.

2.2 Exports of Raw materials used in High – Tech industries by Sri Lanka to the world (US $ Thousands)

The following table shows the raw materials exported by Sri Lanka to the world from 2016 to 2022. For instance, in 2022, we have exported these important raw materials worth over US $ 45 million to the world. However these are used by other countries to produce technologically advanced products which are worth billions of dollars. For instance, Silica is used as the main raw material for silicon chips and it is also the main component in glass, foundry and ceramics industries. Graphite could be used to produce carbon nano - tubes using the nano - technology. Mica is a main component of electronic items (capacitors), cosmetic, plastics and paints. Therefore we should start producing technologically advanced products to reap the maximum out of these non- renewable resources for the betterment of the country.

Table2.2: Raw materials exported by Sri Lanka to the world from 2016 to 2022

Product	Exports (US thousands)						
	2016	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**
Silica & Quarts	10,004	13,019	**11,855**	9,502	10,335	11,601	10,597
Graphite	4,522	4,709	5,463	4,680	3,530	5,468	5,126
Mica & Mica Waste	738	731	694	624	410	257	428
Mineral Sands	10,749	11,760	12,371	14,651	8,299	22,292	29,663
Titanium ores and concentrated - Ilmanite	2,313	5,980	5,033	5,092	2,787	14,758	-
Titanium ores and concentrates - Rutile	1,556	1402	2,497	5,144	3,439	3,149	-

Source: Sri Lanka Export Development Board Statistics, different years

3. Role of EDB in facilitating Trade Across Boarders and enhancing Ease of Doing Business

Export Development Board, as the apex agency in promoting exports of the country is mainly involved in export promotional and development activities in collaboration with the stakeholders through its core functional areas viz Policy Advisor, Monitor, Facilitator, Knowledge Provider and Promoter.

EDB has developed efficient mechanisms to obtain exporter feedback on the bottlenecks faced by them during exports through the Advisory Committees, Exporter Help Desk established at EDB, online system developed to obtain issues to the Exporter Forum and also through direct communication with them.

In the National Export Strategy (NES) development process the areas considered in the Ease of Doing Business ranking were discussed and issues faced by the export sectors in the given areas were identified. Accordingly the issues were included in the NES Plan of Actions (PoAs) and shared among 47 lead implementing agencies for implementation. The expected level of support was not received by the EDB to address issues highlighted in the NES Plan of Actions and currently the EDB is in process of revisiting the NES to be implemented in the coming years. Parallel to that, EDB facilitates to address existing concerns effectively through various platforms such as the EDB Exporter Forum, Advisory Committees meetings and focused group meetings with relevant Ministries and institutions.

EDB has developed a network with Sri Lanka & foreign missions, Trade Promotion Organizations, NGOs & Donor Agencies to facilitate cross border trading and also to provide up to date market intelligence in collaboration with the Foreign Ministry & the Department of Commerce.

As the premier export promotion organization, EDB is keen to enhance the country's rank in the 'Ease of Doing Business' Index. EDB has already implemented initiatives in relation to promoting online systems, reducing human involvement, reducing time spent as much as possible to facilitate exports such as the "**eMARKETPLACE**" which is Sri Lanka's ecommerce window to the world.

4. Way forward

One of the main concerns of having lower score in the Ease of Doing Business of Sri Lanka is mainly attributed to the involvement of many authorities in the approval process and stringent regulatory requirements to qualify for approvals. Since the export development process requires collective effort, EDB expects efficient delivery of services from all other agencies to increase exports & enhance the rank of Sri Lanka in the Ease of Doing Business.

Sri Lanka requires wide-ranging economic reforms for long-term sustainable growth to service its debt obligations and to emerge from this crisis stronger. A stable monetary policy is important to keep macroeconomic stability and confidence in the local currency. The current economic crisis Sri Lanka is facing makes it very evident that an independent Central Bank is of the utmost importance for a serious fiscal consolidation. Tax reforms are essential for revenue-based fiscal consolidation which is another prerequisite for economic sustainability.

Reforms are also needed to reduce the current account deficits that Sri Lanka has been experiencing for decades. Shifting the country toward an export-oriented economy should be the goal. Sri Lanka has one of the highest tariff rates in the region, which protects Sri Lankan industries with a focus on import substitution. Sri Lanka is a small nation with a GDP of around $80 billion. Trying to produce many products entirely in Sri Lanka for the Sri Lankan market means reduced economies of scale, resulting in products that are of lower quality and/or higher prices. Reducing tariff rates for the short term is not an option due to the forex crisis, but as the economy stabilizes, a strategy to transform the nation into an export-driven economy should be implemented. Even if tariff rates are high, lifting quantitative restrictions would be recommended to address the issue of shortages in the country (Abeyratne & Rafi, 2022).

Sri Lanka needs to go with the global trend in manufacturing, which is to be part of global supply chains. An effective way for Sri Lanka to increase its exports is to find niche value additions it can undertake in the supply chains of multinational companies, which has been a strategy of developing countries such as Vietnam. For Sri Lanka to mesh with global supply chains, the country needs to have trade liberalization, export-focused FDI, increased FTAs, and improved trade facilitation. Sri Lanka only has three FTAs while Vietnam, which opened its economy much later, has 26. Sri Lanka can also strategize to utilize its existing FTAs further, especially the one with India to drive exports.

FTAs are also needed to draw in export-targeted FDIs; Sri Lanka has a strategic location that it can leverage. Improving ease of doing business is essential as Sri Lanka ranks 99th in the world when it comes to the World Bank's ease of doing business rankings. Sri Lanka ranked 164th in the world in 2020 on enforcing contracts, which has to be improved.

Factor market reforms are crucial. The Sri Lankan government owns 82 percent of the land in the country, which severely restricts land usage for the private sector. Land fragmentation is also a major issue as it leads to a lack of large tracts of land for major development projects. A proper valuation system for land is also crucial in attracting investments.

Labor reforms are needed to make the economy more competitive. Sri Lanka has one of the highest retrenchment costs, making it extremely unattractive to investors. For better labor output, the labor force should be developed through education and training with a focus on developing future skills such as analytical thinking and innovation for a future ready workforce.

4.1Overcoming the Twin Deficits

Sri Lanka's economic performance has been influenced more by "spending performance" (internal finance) than by "trade performance" (external finance). The twin-deficit hypothesis suggests that such countries would end up with unsustainable deficits in both accounts (government budget and international trade), while countries focused on external finance tend to improve both.

Thus, Sri Lanka continued to aggravate its over-spending problem by widening its fiscal deficit and trade deficit, which were financed increasingly with domestic and foreign borrowings. As a result, tradable sector growth slowed down against non-tradable sector growth, which was financed primarily by government spending and was unsustainable in the long-run. The fundamental problem that the government had to face was on how to pay dollar-denominated loans while earning rupee-denominated income from non-tradable sector growth.

Sri Lanka has to improve its forex earning capacity in order to achieve debt sustainability as well as to move beyond and above recovery. Fiscal consolidation is needed as a medium-term measure, but the reforms should be extended to eliminate the country's anti-export and anti-FDI biases. A crisis is an unprecedented opportunity to carry out the necessary reforms – one that should not be missed (Abeyratne & Rafi, 2022).

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