

International Trade

Present Status and Future Directions

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At independence Sri Lanka inherited a classic open economy with dualistic features - a modern plantation sector and a subsistence agriculture sector. For the next three decades, trade policy bounced back and forth between closed, inward looking policies and open economic policies. From 1977 till today Sri Lanka has gradually been opening up its economy. Over the past fifty five years the composition of exports changed from domination by the agricultural sector to domination by the industrial sector. In imports, intermediate goods became more important than consumer goods. However, the composition of exports has not changed much during the last ten years and is concentrated in two major products. Export markets too are concentrated in a few large economies in the West. Origins of imports are relatively diversified, but more concentrated in the Asian region.

Sri Lanka, which remained an exporter of primary products for nearly three decades after independence, experienced significant changes after the economic liberalisation in 1977. Subsequent to the initial phase of reforms, trade reforms were instituted in the late 1980s and in the 1990s. Export duties were withdrawn by 1992 except on a few items. Quantitative controls on exports and imports were totally eliminated, with the exception of a few items that were kept under licensing for non-economic reasons. Sri Lanka's exports grew by 8.3 per cent annually during the period 1978-2002. Thus, Sri Lanka was able to attain a market share of 0.08 per cent of total world exports by 2002. Sri Lanka's imports grew annually by 10.3 per cent during the last two and half decades. International trade became a dynamic force in

the economy, assisting in the growth of income and employment opportunities. However, during the last 5 years, both export and import sectors grew at a slower rate than in the previous two decades. Since liberalization, the export structure has become diversified with industrial exports, led by textiles and garments, becoming the largest contributor to export earnings, accounting for 77 per cent of total exports in 2002. The composition of imports also changed significantly from consumer goods to growth oriented intermediate and investment goods. Imports and exports in 2002 accounted to 65 per cent of GDP compared with 35 per cent in 1977 and 71 per cent in 1990.

World Outlook

During the first decade after liberalisation, Sri Lanka's exports grew at a slower rate than world exports (Table 1). The growth of exports was slower than in Asian and non-oil exporting countries as well. However, Sri Lanka's imports increased at much faster rate. During the second decade, i.e. 1988-1997, Sri Lanka's exports and imports grew at a faster rate than world export growth. However, during 1998-2002 both Sri Lanka's exports and world exports grew at a slower rate than in previous periods. During this period Sri Lanka's export growth rate was lower than that of the world, non-oil developing countries and Asian countries.

The degree of openness (trade dependency) increased gradually after economic liberalisation but declined during the last three years (Table 2). Sri Lanka's total external trade as a percentage of GDP was 77.5 per cent in 2000 compared to 34.7 per cent in 1977. This declined to 65.3 per cent in 2002. However, Sri Lanka's share of the world export market increased marginally from 0.07 per cent in 1977 to 0.08 per cent in 2002.

Domestic Trade and Tariff Policy

Soon after the independence, the economy of Sri Lanka benefited from very high prices for rubber and tea resulting from the Korean war boom. The balance of payments was in surplus and restrictions were somewhat relaxed on foreign trade and payments. However, a regime of import substitution began to emerge with the balance of payment problems experienced in the late 1950s with the sharp drop in commodity prices in the world market. The unrestricted trade regime in place was changed drastically with the introduction of restrictive policies and practices. The Government resorted to protectionist measures such as exchange and import controls. The restrictive measures became more stringent with the introduction of import quotas and licences. Import tariffs too were gradually increased and the coverage expanded, as more items of imports were brought under tariff control. A highly differential import tariff structure came into being with rates varying from 10 per cent to 500 per cent. The economy during 1960-1977 was characterised by inward looking policies even though the 1965-1970 period saw an effort to implement a partial trade liberalisation. The period 1970-1977 saw the most stringent trade restrictions ever to be introduced in Sri Lanka.

The development strategy hitherto pursued under the import substitution policy was shifted to an export promotion policy with the changes introduced after 1977. As a result, export industries were supported with generous incentives in the forms of tax concessions, credit at low rates of interest, infra-structure facilities and institutional support. During the early export promotion phase, steps were taken to encourage foreign investment. Institutions and policy reforms were implemented to facilitate more private sector participation in economic activities. Export licensing requirements and export duties were removed gradually, while export duties on all minor agricultural commodities and marine products were abolished in 1988 and duties on traditional export crops, i.e. tea, rubber, coconut, were removed in 1992. Only a few categories of exports, namely wood and article of wood (ebony), ivory and ivory prod-

Table 1

Growth Rates

	Export Growth (%)				Import Growth (%)			
	78-02	78-87	88-97	98-02	78-02	78-87	88-97	98-02
World ¹	8.8	8.9	11.7	2.8	7.6	8.9	8.6	3.1
Non-Oil Developing Countries	12.2	14.5	13.5	4.7	12.0	13.9	14.5	3.2
Asian Countries	9.9	11.6	11.0	4.3	9.3	9.9	12.0	2.6
Sri Lanka	8.3	7.2	13.1	0.8	10.3	13.6	11.2	1.6

¹World imports and exports may not tally as they are recorded in c.i.f and f.o.b values, respectively.

Sources: IFS Data Base and Central bank of Sri Lanka

Table 2 Trade Dependency Ratios

Item	1977	1987	1997	2002
Exports as a % of GDP	18.3	20.9	30.5	28.4
Imports as a % of GDP	16.5	30.8	38.9	36.9
Exports as a % of World Exports	0.07	0.06	0.08	0.08
Imports as a % of World Imports	0.07	0.08	0.10	0.09

Sources: Central Bank of Sri Lanka, IFS Data Base

ucts, some mineral products and passenger motor vehicles first registered in Sri Lanka prior to 1945 continued to remain under licence, with the objective of environmental protection and preservation of antiques.

Trade liberalisation was a vital part of the open economy policies that were put in place in 1977. Under these policy reforms, the stringent controls that were in force on imports were removed gradually. Exchange controls were relaxed gradually and by 1994 all such controls on current account transactions were removed. As a part of the open economy policy, the multiple exchange rates in force were unified in 1977 and the exchange rate regime became a managed float. The next fundamental change with respect to the exchange rate regime was taken on 23 January 2001, by moving to an independent float. The exchange rate is now determined by market demand and supply conditions with occasional interventions by the Central Bank to build up reserves and to minimize excessive fluctuations in the exchange rate.

Most of the controls on imports and prices were removed, while the tariff structure was rationalised and simplified. The public sector monopoly on imports was reduced gradually and by 2001, such commodities were limited to crude oil and defence related items that were kept under state control. Quantitative restrictions on imports were eliminated. Although a few such measures were retained for explicit protection purposes, and most of the licensing requirements after 1977 were for strategic and security purposes. A total of 300 items at 6 the digit level of Harmonised System Code (HSC) remained under import controls by the end of 2002.

A major tariff reform came into effect in 1995 with the implementation of the recommendations of the Presidential Tariff Commission Report -1990. The tariff structure, which had rates ranging from 10 per cent to 500 per cent and more than 19 major tariff bands prior to 1977, was reduced to 13 bands in 1990 and to 4 bands in 1991. A three band tariff structure with 10, 20

and 35 per cent bands was introduced in 1995 and was further simplified to a two band system with 10 and 25 per cent bands in 2000. A few items of imports remained outside the two band system. By mid 2002, import duty on selected agricultural products such as green gram, cowpea etc. re-

mained at 35 per cent as a temporary measure to allow the domestic agricultural sector to adjust to a lower tariff regime over the medium term. The items considered as essential for the maintenance minimum living standards are kept at zero tariff. A limited number of items, namely potatoes, sugar, rice, big onions, tobacco and liquor, were brought under specific rates outside the two-band system.

The simplicity of the tariff structure was disturbed by the introduction of surcharges and grant of duty waivers on certain products in 2001. A 40 per cent surcharge on import duty under Section 10(A) of the Customs Ordinance was imposed on 21 February 2001. Imports with zero duty (such as pharmaceuticals, fertiliser, tractors, lorries etc.) were automatically exempted from this surcharge, while a number of essential products such as potatoes, edible oil, sugar, infant milk food, infant food and selected items of milk and cream products, coconut oil and copra were also exempted from the

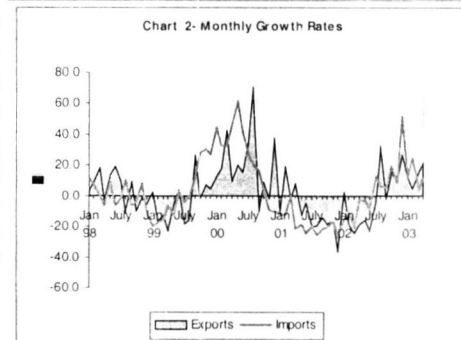
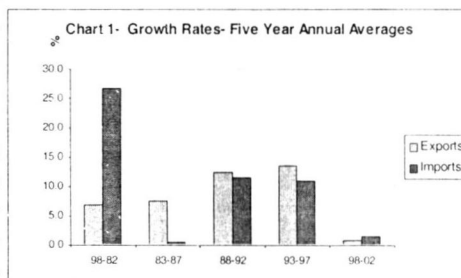
surcharge, in view of cost of living considerations. The entire range of textiles and garment items (Chapter 50-63) was also exempted from this additional surcharge. The surcharge was reduced to 20 per cent with effect from 15 April 2002.

The tariff regime became more complex with the introduction of new tariff bands between 2 and 20 per cent in November 2002. Items in the zero per cent bands were brought under the 2 per cent and 10 per cent bands, with the majority of items being placed under 2 per cent band, except for crude oil, textiles and wheat. Textiles and wheat remained duty free while some petroleum products, which were under the 10 per cent or 25 per cent bands were made duty free. Duty rates on a few items were increased from 10 per cent to 20 per cent or from 5 per cent to 10 per cent. However, distortions to the tariff regime by way of duty waivers, exemptions and surcharges were maintained at a minimum level. A Tariff Advisory Council was set up in 2002 to examine and correct anomalies and distortions in the tariff structure and to address representations made by importers and industrialists.

Growth Performance

Sri Lanka's exports in US dollar terms grew by 8.3 per cent while imports grew by 10.3 per cent annually during the period 1978-2002. The export sector showed fairly steady growth during the first two decades after liberalisation and became a dynamic force in the economy, assisting in the growth of income and employment opportunities. The export sector grew by about 6.7 per cent during the first five years after liberalisation. Imports increased at a much faster rate during the first five years of liberalization due to the high demand for consumer products that emerged immediately after liberalisation and rapid increase in investment and intermediate goods imports. However, the high oil bills resulting from second oil price shock and the associated world recession adversely influenced imports during 1979 and 1980, resulting in a large trade deficit. Subsequent increases in commodity prices too contributed to the growing imports during this period (Chart 1)

During 1983-1984 Sri Lanka benefited from favourable tea prices but export growth was negative in the following two years. The export sector recovered again in 1987. However, expenditure on imports rose at a much slower rate during 1983-1987 due to sluggish economic growth attributable to escalation of civil disturbances.



Both exports and imports recorded higher growth rates during the second decade after liberalisation. Export earnings increased by 13 per cent, while imports grew by 11 per cent during this period. Export growth was driven by significant growth

in garment exports. A high growth in imports reflected a higher level of intermediate and investment goods as well as increased direct private capital inflows. High defence expenditure too contributed to this high growth in imports. Though exports increased at a higher rate than imports, import expenditure was higher than exports earnings in absolute terms, resulting in continuing deficits in the trade account.

During 1998-2002, Sri Lanka's imports increased at much slower annual average growth rate of 1.6 per cent while exports increased only by 0.8 per cent. This slowdown in external trade during the last five years was largely attributable to weak performances in 1999, 2001 and 2002. The recent trends clearly indicate positive relation between exports and imports. As more than 75 per cent of imports were in the form of intermediate and investment goods, exports follow the trend in imports with 4-6 weeks lag (Chart 2).

The recent slowdown in both exports and imports was due to a number of factors, both domestic local and international. Following the 13.3 per cent growth in exports and 7.7 per cent growth in imports in 1997, both exports and imports slowed down during the second half of 1998 and recorded lower growth rates of 3.4 per cent and 0.4 per cent, respectively, in 1998. This trend continued until the third quarter of 1999, resulting in a 4 per cent decline in exports in 1999 compared to the already low growth in 1998. Imports declined by 5 per cent in 1999. This decline was associated with the

Table 3 Sri Lanka's Balance of Trade (US\$ Mn.)

Item	1977	1987	1997	1998	1999	2000	2001	2002
Exports	751	1,397	4,648	4,798	4,610	5,522	4,817	4,699
Imports	677	2,056	5,864	5,890	5,980	7,320	5,974	6,105
Balance of Trade	74	-657	-1,216	-1,092	-1,370	-1,798	-1,157	-1,406

Source: Central Bank of Sri Lanka

lower aggregate global demand and increased competition from East Asian countries for industrial products. Meanwhile, tea exports suffered due to world production surpluses and the Russian currency crisis that began in mid August 1998. However, during the last quarter of 1999, both exports and imports showed signs of recovery. This was attributable to robust economic growth in USA and the European countries. The recovery in the East Asian countries from the currency crisis and the appreciation of their currencies improved Sri Lanka's competitiveness in rubber based products and garments. Tea prices also showed a recovery in the last two months of 1999 due to lower production in major tea producing countries and high demand from the Commonwealth of Independent States (CIS) in the Colombo market. The positive trend continued through out 2000 leading to a high growth rate of 19.8 per cent in 2000. Imports too followed the same trend, achieving a 23.6 per cent growth in 2000.

Exports began to decline after May 2001 following the economic slowdown in major export markets, particularly, USA and the European Union (EU). The sharp weakening in the US economy, slower growth in the EU a fragile economy in Japan, a significant slowdown in newly industrialized Asian economies and ASEAN-4² together contributed to the slower growth in trade. The drop in demand in these countries, particularly in major export markets for developing countries, including Sri Lanka, had adverse repercussions on foreign trade in 2001 and the early part of 2002. Two terrorist attacks that took place at the Katunayaka International Airport in Sri Lanka on 24 July 2001 and in the USA on 11 September 2001 too had serious impact on international trade in Sri Lanka during this period. Import expenditure declined continuously till May 2002, and then showed a recovery thereafter. Exports too showed a recovery after August 2002. Eventhough uncertainty prevailed in the Middle East and disruptions to oil production in Venezuela raised oil prices and reduced the demand for developing country exports in general, Sri Lanka benefited from the recovery in the global economy, the peace initiative commenced by the government in early 2002 and macro economic adjustments undertaken during this period. The positive trends in both imports and exports continued during the second half of 2002.

Balance of Trade

The balance of trade is the difference between the value of merchandise exports and imports. As the outlays on imports were in excess

of export earnings, this has been in deficit for nearly two and a half decades after 1977. The trade account registered surpluses (in US dollar terms only once in 1977), during the tea boom in 1976 and 1977. This deficit, which exceeded US dollars 1,550 in 1994, narrowed down gradually during 1995-1998 due to relatively lower growth in imports than in exports. However, it reached its highest level in 2000, but has remained lower than US dollars 1,500 in recent years.

Terms of Trade

Terms of trade is a measure of relative movement of export and import prices. There is no uniform series of trade indices available in Sri Lanka for a long period as several base years have been used for different series. The methodologies used for constructing these different series of indices have also been different. According to the most recent series of trade indices published by the Central Bank, Sri Lanka's terms of trade have been favourable during the period 1997-2002, except 2001, i.e. prices of Sri Lanka's exports have increased at a faster rate than the prices of imports.

Fluctuations in the export price index were closely linked with the price movements in the prices of garments and tea, while the import price index moved with petroleum, fertiliser, textiles, wheat, rice and sugar.

Structural Changes

Exports

Following the introduction of liberalisation policies in 1977, the export structure of the economy changed drastically from an agricultural base to an industrial base by 1995, but no significant change has been seen thereafter. Industrial exports have become more significant since the early 1980's and as a result, the share of agricultural exports declined from 79 per cent in 1977 to 20 per cent in 2002 (Table 5). Industrial exports are the major contributor to exports, its share increasing from 14 per cent in 1977 to 77 per cent in 2002. This ratio has remained around 75 per cent during the last 10 years. Textiles and garments, which became the Sri Lanka's largest single item of exports in 1986, continues to maintain its position,

Table 4 Sri Lanka's Terms of Trade Performance

Year	(1997=100)		
	Export Price Index	Import Price Index	Terms of Trade (a)
1996	91.5	97.7	93.6
1997	100	100	100
1998	114.9	101.3	113.4
1999	114.6	106.4	107.7
2000	125.2	123.8	101.1
2001	139.6	139.9	99.8
2002	143.1	138.2	103.5

Sources: Central Bank of Sri Lanka

(a) Export Unit Value Index/Import Unit Value Index¹ x 100

increasing its share from 28 per cent in 1986 to 52 per cent in 2002 (Chart 3) Although the gross earnings from the textile and garment sector are high, tea remained the country's largest net foreign exchange earner till 1991. The textiles and garment sector has become Sri Lanka's largest net foreign exchange earner since 1992 (Chart 4), partly attributable to a shift from low value added garments to high value added garments and the rapid expansion of this sector as a whole.

The total value of export earnings in the sector was at US dollars 2,424 million accounting for 52 per cent of the total export earnings in 2002. The contribution to the Gross Domestic Product (GDP) from this industry was 5.3 per cent in 2002. This industry provides more than 330,000 direct employment opportunities or 5 per cent of the country's total employment through more than 1,060 garment factories.

Sri Lanka's textile and garment exports have concentrated on a few export markets. The USA accounted for 63 per cent of the total garment exports while the share of the EU was 31 per cent in 2002. Canada, accounted for 2 per cent of total garment exports. More than ninety countries, including Australia, Japan, Switzerland and Israel accounted for the balance 4 per cent. Even though the USA and the EU accounted for more than 94 per cent of Sri Lanka's garment exports Sri Lanka accounts for only 2.3 per cent and 0.9 per cent of the USA and EU garment markets, respectively.

The composition of the textile and garment exports has shown only a marginal change over the past 2 decades. Garment exports accounted for more than 96 per cent of total textile and garment export in 1980. Textiles, other made up articles and yarn emerged as export items in the early 1990s and increased their shares to 3 per cent each, while garment exports ac-

Table 5 - Composition of Exports

Category	Exports (US\$ Mn.)				Percentage Share (%)			
	1977	1987	1997	2002	1977	1987	1997	2002
1. Agricultural exports	593.4	592.0	1,060.0	938.0	79.3	42.4	22.8	20.0
Tea	395.0	362.0	719.0	660.0	52.8	25.9	15.5	14.0
Rubber	105.0	99.0	79.0	27.0	14.0	7.1	1.7	0.6
Coconut	56.0	73.0	117.0	84.0	7.5	5.2	2.5	1.8
Kernel products	37.8	48.0	82.0	41.0		3.4	1.8	0.9
Other	18.1	25.0	35.0	42.0		1.8	0.8	0.9
Minor agricultural products	51.0	58.0	145.0	168.0	6.8	4.2	3.1	3.6
2. Industrial exports	106.1	679.0	3,436.0	3,631.0	14.2	48.6	74.1	77.3
Food, beverages and tobacco			91.0	123.0	0.0	0.0	2.0	2.6
Textiles and garments	16.0	438.0	2,274.0	2,424.0	2.1	31.4	49.0	51.6
Petroleum products	67.3	88.0	97.0	73.0	9.0	6.3	2.1	1.6
Rubber products			178.0	182.0	0.0	0.0	3.8	3.9
Ceramic products			55.0	42.0	0.0	0.0	1.2	0.9
Leather, travel goods and footwear			183.0	84.0	0.0	0.0	3.9	1.8
Machinery and equipment			204.0	226.0	0.0	0.0	4.4	4.8
Diamond and jewellery			142.0	205.0	0.0	0.0	3.1	4.4
Other industrial exports		153.0	212.0	231.0	0.0	11.0	4.6	4.9
3. Mineral exports	35.7	60.0	90.0	90.0	4.8	4.3	1.9	1.9
Gems	33.1	49.0	84.0	86.0	4.4	3.5	1.8	1.8
Other mineral exports	2.6	11.0	6.0	5.0	0.3	0.8	0.1	0.1
4. Unclassified	13.0	66.0	53.0	41.0	1.7	4.7	1.1	0.9
Total exports	748.2	1397.0	4639.0	4700.0	100.0	100.0	100.0	100.0

Source: Central Bank of Sri Lanka

counted for more than 93 per cent of total textile and garment export in 2002. Sri Lanka expanded its product coverage from four items (shirts, blouses, trousers and jackets) in 1977 to a broad base of more than 50 items in 2000 but still highly concentrated in a few product categories, particularly casual ware for men and women. The quota restrictions imposed by the major importing countries limit most of these popular items.

Several industrial sectors showed a significant improvement in the last decade, further diversifying the export composition and hence strengthening the resilience in the economy. Those were machinery, mechanical and electrical appliance including spare parts and electronics, diamonds, rubber based

products, crustaceans and molluscs, leather products such as footwear and travel goods, jewellery, petroleum products, canned food, fruits and fish products, chemical products and handicrafts. Exports of mineral products, dominated by gems, also improved after 1977. The contribution by all those products taken together, increased from 22 per cent in 1977 to 28 per cent in 2002 surpassing the relative position held by plantation sector products.

During the last five years, large number of new products such as dried prawns, meat, soya based products, jaggery, sweet meats, wall tiles, statues, printing and writing papers, packing materials, printed books, geo textiles, parts and accessories of refrigerators, cutting blades

Table 6 Country-wise Classification of Garment Exports

Country	Percentage Share			Average growth 1997-2002
	1990	1995	2002	
USA	66.3	60.7	63.3	6.0
9+EU	27.0	34.2	31.0	3.8
O/w: UK	6.2	13.7	19.9	12.2
Germany	9.6	9.0	3.4	-8.7
Netherlands	3.4	3.8	1.5	-7.9
Canada	2.2	1.7	1.8	13.4
Other Countries	4.5	3.4	3.9	6.7
O/w: Australia	0.2	0.3	0.4	13.4
Japan	1.0	0.7	0.6	4.6

Source: Central Bank of Sri Lanka

Chart 4 Net Earnings from Textile & Garments vs Tea

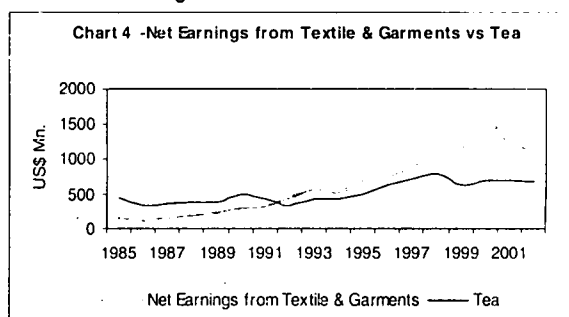


Table 7**Structure of Textile and Garment Exports**

(Percentage Share)			
Product	1990	1995	2002
Textiles	0.4	2.8	2.8
Garments	96.5	89.3	92.6
Yarn	...	2.4	1.1
Made up articles	2.1	3.5	19
Other	1.0	2.0	1.6
Total	100	100.0	100

Source: Central Bank of Sri Lanka

of mechanical equipment, air and vacuum pipes, static converters, primary cells, codeless telephone sets, turbo propellers, various glass products, articles of iron, copper, steel, stain steel, aluminum and nickel, parts of clocks and cameras, bathing caps, handles of umbrellas, pencils, crayon paint or artistic brushes and various chemical products have exported to various destinations.

Although the relative contribution of agricultural exports has declined over the years, diversification of products from plantation crops to other agricultural products has been evident in the

recent past. Within the agricultural product category nonplantation agricultural products, dominated by cinnamon, un-manufactured tobacco and pepper, took the place of rubber and coconut. Export earnings from agricultural products declined by 2 per cent during last 5 years.

Tea, the largest plantation commodity contributed 70 per cent to total agricultural product exports. Earnings from tea declined by about 1 per cent during the last 5 years. Out of Sri Lanka's total tea exports, 64 per cent is still in bulk form, while 29 per cent was in packed form. The rest was in higher value added forms such as tea bags, tea blended with foreign teas, instant and green teas. Orthodox tea accounted for more than 99 per cent of Sri Lankan tea export, while Cut, Tear and Curl (CTC) tea was produced in small quantities. Sri Lanka imported 3 million kg of tea for blending purposes, which was only 1 per cent of the domestic production in 2002. The tea industry should be forward looking and produce more value added forms of tea and find new markets away from conventional markets. Russia continued to be the largest buyer (19 per cent) in 2002. UAE became the second largest buyer (11 per cent), while Syria (10 per cent) continued to hold the third position. Other major buyers were Iraq and Turkey (6 per

cent each), Iran (4 per cent), Jordan and Saudi Arabia (3 per cent each). However as a group, the Middle East countries were on top, accounting for 44 per cent of total tea exports while the CIS countries were second (24 per cent) followed by the EU (10 per cent) in 2001. Egypt, which was a popular destination for Sri Lanka's tea in the late 1990s declined gradually with the formation of COMESA³ in 1994. Tea exports to Pakistan too declined gradually over the years due to competition from Kenya and India. Sri Lanka is now negotiating with Egypt and Pakistan too enter into free trade agreements. Such developments may help Sri Lanka to regain its export market for tea in these countries.

Exports of natural rubber have declined both in absolute and relative terms over the years. In the recent past, except in 2002, international rubber prices have been declining trend and therefore, total export earnings declined significantly. However, this decline was partly attributable to improvements in domestic rubber based product industries which resulted in an increase in rubber based product exports. Sri Lanka now produces large varieties of rubber based products such as tyres and tubes, surgical and industrial gloves, pharmaceutical articles, apparel and floor covering articles etc. and exports them to USA, Belgium, UK, Germany and France

Contribution from coconut products to total exports has declined over the years but this industry too showed product diversification over the years. The share of three major kernal products, only desiccated coconut, coconut oil and copra, declined from 53 per cent in 1996 to 35 per cent in 2001. New kernal products such as coconut milk powder, coconut cream, and defatted coconut, as well as coir and coconut fiber based products are now replacing the traditional products.

Imports

A significant change in the import structure in favour of intermediate and investment goods has been observed following the economic liberalisation. Expansion in the industrial sector called for higher imports of intermediate goods, increasing their relative importance in total imports. The share of intermediate goods increased from 42 per cent in 1977 to 57 per cent in 2002. Developments in infrastructure facilities and the construction and transport sectors, combined with increased use of advanced technology, enhanced the imports of investment goods. The share of investment goods increased from 12 per cent in 1977 to 24 per cent in 2000. The share of consumer goods in total imports de-

Table 8- Composition of Imports

Category	Imports (US\$ Mn.)				Percentage Share (%)			
	1977	1987	1997	2002	1977	1987	1997	2002
1. Consumer goods	285.0	542.0	1,223.0	1,319.0	42.1	26.4	20.9	21.6
Food and drink	262.0	327.0	781.0	696.0	38.7	15.9	13.3	11.4
Rice	103.0	23.0	73.0	18.0	15.2	1.1	1.2	0.3
Sugar	22.0	81.0	184.0	132.0	3.2	3.9	3.1	2.2
Wheat	121.0	76.0	139.0	130.0	17.9	3.7	2.4	2.1
Other	16.0	147.0	385.0	415.0	2.4	7.2	6.6	6.8
Other consumer goods	22.0	215.0	442.0	623.0	3.2	10.5	7.6	10.2
2. Intermediate goods	299.0	1,102.0	3,084.0	3,492.0	44.2	53.6	52.7	57.2
Petroleum	162.0	296.0	539.0	789.0	23.9	14.4	9.2	12.9
Fertiliser	6.0	36.0	54.0	76.0	0.9	1.8	0.9	1.2
Chemicals	14.0	53.0	136.0	155.0	2.1	2.6	2.3	2.5
Textiles and clothing	17.0	274.0	1,386.0	1,321.0	2.5	13.3	23.7	21.6
Other intermediate goods	100.0	443.0	969.0	1,151.0	14.8	21.6	16.6	18.9
3. Investment goods	84.0	385.0	1,325.0	1,170.0	12.4	18.7	22.6	19.2
Machinery and equipment	32.0	225.0	742.0	640.0	4.7	10.9	12.7	10.5
Transport equipment	26.0	48.0	208.0	151.0	3.8	2.3	3.6	2.5
Building materials	15.0	24.0	272.0	272.0	2.2	1.2	4.6	4.5
Other investment goods	11.0	88.0	103.0	108.0	1.6	4.3	1.8	1.8
4. Unclassified imports	9.0	26.0	220.0	125.0	1.3	1.3	3.8	2.0
Total imports	677.0	2,055.0	5,852.0	6,106.0	100.0	100.0	100.0	100.0

Source: Sri Lanka Customs

Table 9- Changes in the Direction of Foreign Trade (a)

US\$ Mn.

Group of Countries	1980		1990		1995		2000		2002	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
Industrial Countries	525	926	1,177	1,049	2,877	1,782	4,110	2,249	3,446	1,813
Of which										
United Kingdom	78	194	115	137	345	243	737	311	590	263
United States of America	118	90	493	208	1,354	173	2,192	255	1,764	219
Developing Countries	483	1,058	617	1,563	777	2,967	1,108	4,032	1,044	4,216
Of which										
Africa	25	65	23	115	43	57	37	35	39	35
Asia	180	437	191	1,073	351	2,382	474	3,333	493	3,225
Europe	17	23	31	50	57	48	79	23	60	28
Middle East	247	483	334	303	271	349	438	603	380	882
Western Hemisphere	14	50	39	21	54	132	80	37	72	46
Eastern Europe	33	11	45	12	93	15	145	8	172	11
Of which										
U.S.S.R./Russia (b)	31	11	41	3	82	8	128	2	127	3
Memo:										
European Union (c)	226	479	506	402	1,204	852	1,518	951	1,395	899
C.I.S. Countries (d)					91	9	143	6	172	8

(a) Unadjusted data

(b) Data for 1980 and 1990 include trade with U.S.S.R

(c) Countries in the European Union are Austria, Belgium-Luxembourg, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal, Sweden, Spain and U.K.

(d) The C.I.S. countries are Russia, Armenia, Azerbaijan, Belarus, Georgia, Kasakastan, Kyrgyz Republic, Moldova, Tajikistan, Turkmenistan, Ukraine, Uzbekistan, and Baltic countries i.e. Estonia, Latvia, and Lithuania.

clined from 42 per cent in 1977 to 22 per cent in 2002.

Direction of Trade

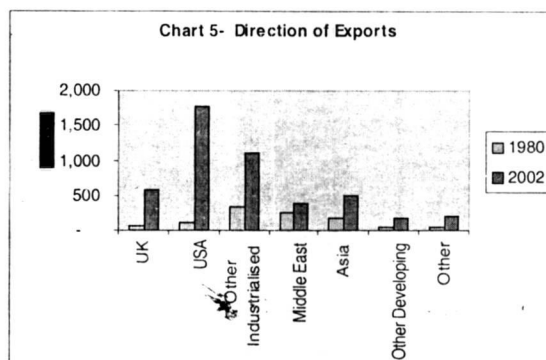
As shown in the Table 9, the direction of trade in Sri Lanka changed dramatically over the last 25 years although it has not changed significantly over the last 5 years. The 1977 policy reforms opened a new chapter in a move towards open free trade with all countries. With the rapid expansion in industrial activities and the diversification of the export structure, USA became the largest single buyer of Sri Lanka's exports after 1979. In 2002, USA, which imported garments, tea, rubber and rubber products, coconut and other industrial products, accounted for 38 per cent of the total exports from Sri Lanka. The UK, the second largest buyer, and Germany, the third largest buyer, accounted for 14 per cent and 4 per cent of Sri Lanka's exports, respectively. Garments accounted for 79 per cent of goods exported to the UK. Japan is one of Sri Lanka's major markets for crustaceans, machinery parts and accessories, tea, fish products and precious stones. Out of the total exports to Germany, garments and tea accounted for 43 per cent and 29 per cent, respectively. As a result, the industrialised countries taken together as a group, which had lost importance since the early 1970s, re-gained their position as the major export partner.

These countries accounted for 74 per cent of the total exports in 2002. The heavy concentration of Sri Lanka's exports to Western industrial countries made them, as a group, Sri Lanka's largest trading partner.

Industrialised countries together as a group, which dominated Sri Lanka's import markets until 1990, have since then fallen into second place behind Asian countries (excluding Japan). This shift is directly related to the heavy inflow of foreign capital into Sri Lanka's manufacturing sector from the East Asian industrialised countries such as Korea, Hong Kong and Singapore in recent years. Consequently, raw material imports to such industries from these countries have grown significantly in recent years. The emergence of India as the largest exporter to Sri Lanka was due to heavy imports of transport equipment, vehicles and parts,

Chart 5

Direction of Exports



cotton, iron and steel, cement, machinery, pharmaceutical products and food items such as rice, onion, red lentils etc. The relatively low cost of these items in relation to those imported from industrialised countries due to the devaluation of the Indian rupee in March 1993 led to a growth in imports further increasing its share of 4.5 per cent in 1990 to 10 per cent in 2000. Benefiting from the Free Trade Agreement with India, imports from India increased to 14 per cent in 2002. Accordingly, Asian countries, as a group, continued to be the major origin of Sri Lanka's imports.

The relative importance of Middle East countries for exports has declined in recent years due to the emergence of CIS countries as major importers of Sri Lanka's tea. Since 1993, the CIS countries as importers of Sri Lanka's tea have re-captured the position held by the former USSR. The CIS countries, the major buyer of Sri Lanka's tea, accounted for 4 per cent of total exports in 2002.

In the recent past, Sri Lanka's export structure has diversified to a certain extent, by moving from primary agricultural products, which are subject to irregular and frequent fluctuations, to relatively broad based industrial exports. However, 52 per cent of total exports or about 70 per cent of industrial exports are yet from the textile and garment industry. In 2002, 38 per cent of raw materials imported were used by this industry. With all these changes in the composition of exports, Sri Lanka still remains vulnerable to external shocks as the move was mainly from three primary commodities to one single industrial commodity. In the case of imports, the trade direction moved from industrial countries to Asian countries but export markets remained virtually unchanged over last several years.

International Trade Relations

After regaining Independence, Sri Lanka became a member of several bilateral, regional and multilateral groupings. Following the establishment of the Central Bank, Sri Lanka became a member of the International Monetary Fund (IMF) and the World Bank on 29 August 1950. Since 1955, Sri Lanka has been a member of United Nations (UN), and a large number of UN related organizations.⁴ The Generalized Agreement on Trade and Tariff (GATT) established in 1944, later graduated to a fully fledged World Trade Organization (WTO). Sri Lanka has been a member since the inception of WTO in 1994.

Sri Lanka became a member of G-77, a group established at the United Nations Conference on Trade and Development (UNCTAD) in 1964. The purpose of this group is to look after the special interests of poorer nations. A sub-group called G-24 was set up in 1972, to look after the interests of the poorest and the most vulnerable countries. Sri Lanka is one of the founder members of G-24. A similar grouping, G-15, operates to promote South-South consultation and co-ordination, where the South represents poorer developing countries. Sri Lanka became a member of G-15 in 1998.

Sri Lanka receives preferential tariff under the Generalized System of Preferences (GSP) as well as from the Global System of Tariff Preferences (GSTP). Under GSP Sri Lanka and other developing countries receive concessional tariff rates from participating developed countries. Under GSTP Sri Lanka exchanges tariff concessions with other participating developing countries.

Sri Lanka's first regional preferential trading agreement is the Bangkok Agreement established in 1975.⁵ Sri Lanka became a founder member of the Asian Clearing Union (ACU), in 1975.⁶ The ACU is basically a settlement system that promotes trade among the members. With the establishment of the South Asian Association for Regional Cooperation (SAARC) in 1985, Sri Lanka embarked on regional cooperation encompassing economic, social and cultural aspects. The South Asian Preferential Trading Arrangement (SAPTA) was established in 1995 with the objective of extending tariff concessions among members.⁷ Related to SAARC is the SAARCFNANCE, an organisation of Governors of South Asian Central Banks and Secretaries of Ministries of Finance established in 1998, whose major objective is cooperation on financial issues. Sri Lanka is also a member of the Indian Ocean Rim Association for Regional Cooperation (IOR-ARC)⁸ established in 1997 and Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Cooperation (BIMST-EC), which was established in 1998. Plans are underway to establish a South Asian Free Trade Agreement (SAFTA) in the future.

Sri Lanka continues to have bilateral economic cooperation agreements with a large number of countries in various parts of the world, e. g., Western and Eastern Europe, North America, Latin America, Africa and Asia.

Sri Lanka's most far reaching agreement was the Free Trade Agreement with In-

dia established in 1998. The agreement is to remove tariff on freely tradable goods between the two countries. The duty removal will be in full with respect to selected items and partial with respect to a large number of other items. Duty will not be removed with respect to agricultural produce as well as some items with significant domestic production. The agreement was made operational with effect from February 2000.

The Framework Agreement for a Sri Lanka - Pakistan Free Trade Agreement was signed on 1 August 2002 in Colombo with the objective of establishing a free trade area for movement of goods and services. Annexes containing offers of both countries and Rules of Origin criteria were to be finalised in due course after the signing of this agreement.

Sri Lanka signed a Trade and Investment Framework Agreement (TIFA) with USA on 25 July 2002. The TIFA creates a legal and institutional foundation for a permanent trade policy dialogue spanning a wide range of bilateral and international trade issues. The broad objectives of the Agreement are to create an environment conducive to international trade, investment and economic cooperation and work towards facilitating greater access to the markets of both countries. Sri Lanka is in the process of entering into a bi-lateral agreement with Egypt. The first round of negotiations on the proposed FTA with Egypt was held during 8-9 April 2003 in Colombo.

Both regional and bi-lateral trading agreements are moving at a faster pace than the multilateral trading systems in the area of trade liberalisation and market access. They have contributed positively to the integration of developing countries into global economy. These agreements can promote economic growth through increased competition and creative destruction, to the extent that a country is willing to accept rapid change, and its physical, social and legal infrastructure is conducive to acquiring benefits from liberalisation. Under these agreements, participating countries demand

greater access to the domestic market. Similarly, those agreements pave the way for Sri Lanka's entrepreneurs to have access to their markets. To derive tangible benefits from those agreements and resulting market access opportunities, domestic industries should be sufficiently competitive, and Sri Lanka's macro-economic environment and infrastructure should facilitate improving the country's competitiveness. If factors supporting competitiveness are lacking, the agreements generate asymmetric benefits at the expense of the less competitive partners. The benefits that Sri Lanka has already achieved through most of those international arrangements are not very substantial, but Sri Lanka's involvement in multilateral, regional and bi-lateral agreements can be considered a positive development toward reaching the ultimate objective of integrating into the global economy.

Future Directions

Both imports and exports continued to improve during the first four months of 2003, maintaining the growth momentum achieved in late 2002. Exports and imports increased by 13 per cent each during the first four months of 2003. The global recovery strengthened the market for Sri Lankan products, particularly garments, machinery, mechanical and electrical equipment, rubber based products, diamonds, crustaceans and molluscs, fish products and plastics. Towards the second quarter of 2002, all major export categories, except tea, indicated faster recovery, while the volumes of intermediate and investment categories of imports showed a gradual improvement, indicating signs of potential growth in future exports.

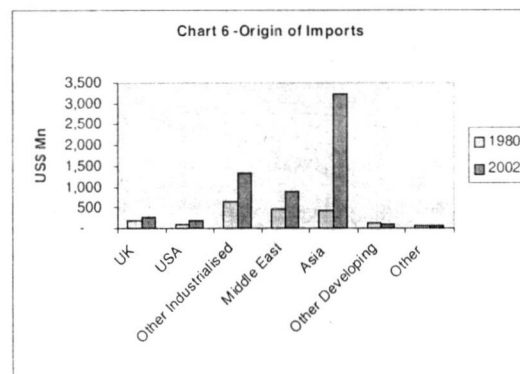
All major categories of industrial exports are expected to increase during the second half of the year. With continuing growth in coconut and minor agricultural products, better prices in rubber and the expected recovery in tea exports, agricultural exports are expected to record a higher growth during the second half of 2003. Tea production in Sri Lanka was lower than expected during May and June, lowering the projection for total tea production for 2003. However, production is expected to recover during the latter half of 2003. With these developments, total exports are expected to record positive growth in 2003 as against the 2.4 per cent drop in 2002.

The continuous growth in international petroleum prices and rising prices of other commodities will raise the import bill, although at slightly lower rate during the sec-

Contd. on Page 14

Chart 6

Origin of Imports



one half of 2003. In addition, the expected expansion in exports will require an increase in the volume of imported raw materials and investment goods. As growth in many sectors, including textiles and garments, are expected to continue in the future, demand for raw materials and energy consumption will be higher. Rehabilitation and reconstruction work in flood affected areas too could create demand for building materials. Therefore, the demand for intermediate and investment goods is expected to increase during the rest of 2003. Hence, total expenditure on imports is also expected to record much higher growth in 2003 as against the 2.2 per cent growth in 2002.

The current trade and tariff policy is to facilitate export led economic growth by creating an environment conducive to enhancing competitiveness in the export sector. The tariff structure was simplified and tariff rates were reduced. Non tariff barriers and lists of exemptions are maintained at a minimum level. The policy direction towards simplified, liberal and less protective tariff policy regime has been maintained even though the simplified tariff policy regime was disturbed from time to time by imposition of duty surcharges, changing tariff rates, granting adhoc duty waivers and exemptions etc. The current policy thrust is to continue in the same direction and achieve a low and single rate tariff structure with minimum distortions.

The export structure diversified from primary agricultural products to industrial products during the first one and a half decades after economic liberalisation, but little significant change has occurred thereafter. Textiles and garments and tea yet dominate the export sector. Export markets too are heavily concentrated in a few large regions. These features make Sri Lanka vulnerable to external shocks. External factors

were identified as the major contributor to the economic slowdown in 2001. According to past experience, Sri Lanka's economy is sensitive to the changes in tea prices, demand in the USA and the EU for garments and petroleum prices. Some diversification of products and destinations can be seen in the recent past but at a very slower pace. Therefore, diversification of products as well as markets should be a major part of future plans for the development of external trade.

With the expected developments in the industrial, construction and service sectors and large inflows of foreign capital inflows, imports of raw material and investment goods will increase in the future. The increase in income levels will rise the demand for consumer goods too. In the long run Sri Lanka's policies should be directed towards developing industries which are based on domestic raw materials and to encourage local or foreign partnerships to export more value added products rather than primary forms of agricultural products. This will help Sri Lanka to increase net foreign exchange earnings and improve the trade balance.

Sri Lanka's major export product, garments is confronted with numerous challenges. Since the late 1970s Sri Lanka's garment exports have largely been governed by the Multi Fibre Arrangement (MFA). However, under the Uruguay Round Agreement on Textile and Clothing, textiles and garment exports are expected to fully integrated to normal rules of the World Trade Organisation (WTO) by 2005. Sri Lanka as a garment exporter has shown signs of positive improvement in many aspects, but, even at present, more than 52 per cent of their country's garment exports are under quota. However, Sri Lanka's dependence on quota is very much lower than other South Asian countries. Besides the dependence on quota, remaining weaknesses in the domestic industrial and export structure, labour markets rigidities and the strong competition in the international trading environment are also major issues that need urgent attention for sur-

vival in a quota free market environment. Hence, the future of the garment industry will depend on the competitive edge that Sri Lanka has among her competitors in Asia, Latin and Central American and emerging producers in Africa and Eastern European which benefit from favorable trading arrangements with major markets. Therefore, Sri Lanka must use its international goodwill to build trade relations with major partner countries to enhance the benefit of international trade relations. Accordingly Sri Lanka's future trade relations are focussing more on major trading partners, such as USA, EU, Russia and Pakistan with an aim to benefit from preferential treatment and to improve market access.

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Rupa Dheerasingh, Senior Economist/ Head, Trade and Commodity Studies Division, Central bank of Sri Lanka

Footnotes

- ¹ Excluding two aircraft imported under the re-fleeting programme of Sri Lankan Airlines.
² Includes Indonesia, Malaysia, the Philippines and Thailand
³ The Common Market for Eastern and Southern Africa (COMESA) with 21 members signed on 5 November 1993 and ratified on 8 December 1994.
⁴ The UN was established in 1944. The IMF and World Bank were established in 1945
⁵ The member countries of the Bangkok Agreement are India, Bangladesh, South Korea, Laos, and China.
⁶ The member countries of the ACU are Bangladesh, India, Iran, Nepal, Pakistan, Sri Lanka and Myanmar.
⁷ SAARC members are Bangladesh, Bhutan, India, Nepal, Maldives, Pakistan and Sri Lanka
⁸ The member countries of the IOR-ARC are Bangladesh, India, Iran, Nepal, Pakistan and Sri Lanka.