

## RESEARCH ARTICLE

# External trade and foreign investment policy reforms in economic growth of Sri Lanka

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**Abstract:** It is a fact that external trade (ET) and foreign direct investments (FDIs) are the two key determinants of the economic growth of a nation state. They are both intrinsically related to the trade and investment policy of the government (Krugman, 1992). Since independence, the external trade and investment policy of Sri Lanka has been one of the main causes of the fluctuations in its economic performance. In the course of time, Sri Lanka has witnessed numerous shifts in its external trade and investment policy, under various circumstances that used to influence the economic activities in the world for different periods of time. As such, a deep understanding of the shifts in Sri Lanka's external trade and investment policy is considered crucial, especially when studying the growth patterns of her economy during the period 1948-2019. Against this background, this study builds a case for understanding the reforms which came into effect in Sri Lanka's external trade and foreign direct investment policy and their impact on her post-independent period economic growth.

**Keywords:** Trade openness, foreign direct investments, economic growth, policy reforms, Sri Lanka

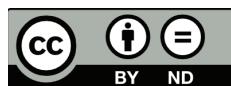
## INTRODUCTION

Among the developing countries, Sri Lanka remains one of the early economic liberalisers (Athukorala, 2012). At its independence from the British crown, Sri Lanka (known as Ceylon) used to be considered an economy with a higher growth level, mainly due to the higher educational level of its population and the developed infrastructural facilities within her terrain. During this period, Sri Lanka inherited a dualistic export economy. It had a plantation sector integrated into international

markets and a backward subsistence agrarian economy catering for the local population. The tea, rubber and coconut plantations were the main earners of foreign exchange while the paddy cultivation received much of the government's attention and had an import substitution strategy (Abeyrathna, 1993).

The government elected in 1956 followed a closed economy with interventionist policies. In contrast with the previous period, the state played a major role in planning and fuelling the economy. The Government introduced high tariff rates and controls on foreign exchange payments as part of its inward-looking strategy and announced several policy packages to attract foreign direct investment in order to ease the pressure on the balance of payments which was not successful at that time (Rajapatirana, 2017). Thus, the government got directly involved in the industry through the allocation of economic resources to the state-owned industries and the establishment of public-sector industrial corporations with the assistance of the Soviet bloc (The communist nations closely allied with the Soviet Union, including Bulgaria, Cuba, Czechoslovakia, East Germany, Hungary, Poland, and Romania, whose foreign policies depended on those of the former Soviet Union) to produce a wide range of goods such as paper, cement, steel, hardware, petroleum products, fertilizers, tires, and textiles. As a result, by the mid-1970s, Sri Lanka became one of the most inward-oriented and regulated economies, outside the communist bloc, characterised by stringent trade and exchange controls and pervasive state interventions

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(Rajapatirana, 2017; Athukorala & Jayasuriya, 1994; More, 1997; Dunham & Kelegama, 1997; Athukorala, 2012).

Sri Lanka shifted away from her inward-looking strategy to an outward-looking strategy in 1977, resulting in a liberalised trade regime where export promotion received priority and the private sector was considered the engine of her economic development (Athukorala, Bandara & Kelegama, 2011). Further, as Rajapathirana (2017) argues, economics alone cannot explain a government's attitudes towards her economic policies which are generally influenced by its politics, ideology, and history. Therefore, this study endeavours to present a systematic evaluation of the regime shifts which took place in Sri Lanka and their policy implications for her progress in trade, foreign direct investment, and economic performance.

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## RESEARCH METHODS

The main method used here comprises library research strategies generally applied to derive information from published sources such as journal articles, reports, books, Central Bank Annual Reports, and web pages. In addition, government authorities such as the Sri Lanka Export Development Board and Board of Investment were consulted to gather the necessary statistics and information and arrange them systematically as guided by the objectives. Further, the analysis was conducted through the creation of data tables and corresponding discussions.

### 1948 – mid 1955: liberal trade regime

After into independence was achieved in 1948, Sri Lanka followed continuously until the mid-1950s, an essentially "*laissez faire*" approach in her trade with almost no restriction on imports, exports and foreign exchange transactions. With this approach, almost no specific incentives were given to the stakeholders to encourage or discourage exports or imports. The United National Party (UNP), being in the ruling power, represented mostly the interests of the colonial bourgeoisie and the elite groups. In the event of independence, the export contribution to gross national product (GNP) was nearly one third and the export economy of Sri Lanka comprised the plantation sector linked to international markets and a backward subsistence agrarian economy. Much of the foreign exchange was generated from the tea, rubber, and coconut exports. Rice production was also considered by the government as a priority sector.

### Mid 1950s – 1964: consolidation of trade controls (import substitution industrialisation - ISI Strategy)

From 1956 to 1964, the thrust of the government policy was to bring about import substitution led industrialisation as there were difficulties in coping with the balance of payment (Jayasuriya & Athukorala, 2004). To this end, imports were limited through high tariffs whereby providing incentives for investment in import substituting industries. There, the state played a major role in economic decision making and the policy contexts did not become favourable for exports, thus creating an anti-export biased situation. It was the belief of the then ruling government headed by the Mahajana Eksath Peramuna that dependence on a few primary commodities was not sufficient to drive the economy. Further, it argued that the private sector did not have sufficient capital for investment and therefore state intervention was highly needed. As a result, the state extended the previous government's strategy of agricultural import substitution to the industrial sector as well. Tariffs on imports were increased and foreign exchange payments were also controlled to reduce the importation of non-essential products (Rajapathirana, 2017).

These initiatives were taken by the government to ease the pressure on the issues of the balance of payments and to protect the local producers from foreign competition. In order to control the situation, a foreign exchange budget committee was established in 1963, and thereby the Ministry of Finance allocated foreign exchange to external trade, on the basis of national priorities. Also, foreign banks presence in the country were restricted while Bank of Ceylon was nationalised. These initiatives made the economy a highly regulated one by the mid-1960s (Jayasuriya & Athukorala, 2004).

### 1965 – 1969: partial import liberalisation with export incentives

The government that was in place between 1968 and 1969 (headed by the United National Party) partially opened up the economy by reducing some of the controls on imports and by attempting to encourage exports (Jayasuriya & Athukorala, 2004). The Sri Lankan rupee was devalued by twenty per cent against the UK sterling pound in 1967. However, this initiative did not ease the pressure on the balance of payments, and foreign currencies were sold at higher rates in an informal market. However, in 1968, the government introduced some trade liberalisation policies. The major policies for encouraging exports consisted of introducing a bonus voucher scheme (BVS)

and a foreign exchange entitlement certificate (FEEC) scheme. The BVS provided exporting industrialists with an import entitlement quota of twenty per cent (20%) of the free-on-board (FOB) value of exports. The FEEC scheme allowed a higher rate of exchange (40% to 65%) on exports of non-traditional goods. Imports of many types of raw materials and machinery were allowed freely under open general licenses (OGLs) but at a higher foreign exchange entitlement certificate (FEEC) exchange rate. A new tariff structure was also introduced. As a result, free movement of most essential items was allowed, whereas for non-essential items, tariff rates varied between 10 to 300 per cent, depending on their importance as a need to the society. One main objective of the ruling government in this era was to make Sri Lanka self-sufficient in rice. Therefore, these liberalisation policies were partially expected to meet the government's objective as well. However, the government collected a significant tax revenue from exports. These anti-export biased actions placed a considerable burden on the exporters. Therefore, the government excluded some products such as tea, rubber, and coconut from the FEEC scheme.

#### **1970 – 1976: reversing liberalisation and tightening controls (regulated economic policies)**

Policies during this period of the Sri Lanka Freedom Party (SLFP) led Government were once again inward-looking and geared towards owned encouraging import substitution. As a result, state-owned enterprises embarked on managing the banking, agriculture, industry and trade sectors. It led to the open general licenses (OGLs) being abolished, although the FEEC scheme was allowed to continue operation. A few fiscal incentives, such as tax holidays and tax rebates, were offered to industrialists within the closed economy. Tariffs on imports were increased and foreign exchange payments were controlled, and certain industries were nationalised. However, the government welcomed FDIs into the country. With all these trade practices, by the end of this period, Sri Lanka became one of the most inward-looking economies outside the Soviet bloc.

#### **1977 – 1989: open economic policies and the first wave of liberalisation**

The focus of policies during the post-1977 period was to open up the economy and to encourage export-led industrialisation. The private sector played there a major role in the economic development process. The key policies which were put in place during the period to lower the trade barriers and promote international trade and investment include: abolishing most of the price

controls; removing virtually all quantitative restricting of imports; reducing and simplifying the tariff structure; unifying the exchange rate and setting up a realistic rate; discouraging state investment in new commercial enterprises; encouraging the private sector to take a greater role in the economy; actively promoting foreign direct investments (FDI); establishing the Greater Colombo Economic Commission (GCEC), which was later renamed as Board of Investments (BOI) in 1990, and setting up the Export Development Board (EDB) to promote and develop exports from Sri Lanka.

In its effort to promote exports in the post-1977 period, the government also provided a range of incentives to the exporters and introduced several programmes designed to support and expand exports. Some of the major incentives / support schemes that were in place during the 1990s were import duty concessions, tax incentives, financial assistance schemes, export credit insurances, market development support, product development support, the export development investment support scheme (EDISS), the export productive village scheme (EPV), special incentives to attract FDI, and establishment of export processing zones (EPZs) in Katunayake and Biyagama.

#### **1990 – mid 2000s: open economic policies and second wave liberalisation**

The reform process that started in 1977 (with the elimination of Quota Restrictions (QRs) and the gradual reduction of tariffs with new export incentives) lost its momentum in the early 1980s for two main reasons: the unfortunate shift in policy priorities towards politically appealing glamorous investment projects and the ethnic conflict. Further, the unfavourable movement in real exchange rates during the 1980s negatively affected the performance of the Sri Lanka's export sector. It is scientifically established that, in the 1980s, the real exchange rate used to be overvalued, and it ultimately resulted in an anti-export bias (Abeyratne, 1993). Thereafter in the 1990s the government introduced the second wave liberalisation package with the privatisation program that led to further tariff cuts and the simplification of the tariff structure by removing exchange controls on the current account transactions combined with other market-oriented reforms. As a result, in 1994, Sri Lanka achieved Article VIII status of the International Monetary Fund (IMF), becoming one of the most open economies in the developing world. Thereafter the new government that was elected in 1994, followed almost a similar pattern having no change in the main direction of the economy (Athukorala, 2012). The new government proposed further tariff reform and

introduced harmonising the tariff structure towards a single band over the medium term. The UNP (United National Party) led government in 2001-2002 introduced a more globalisation-friendly open economic policy but did not continue for long.

### **Trade and investment policies since mid- 2000 (protectionist reversal followed by a liberal approach)**

By the end of the 1990s, the planned reduction of tariffs into a single band had been abandoned, and Sri Lanka had a protectionist approach to trade and investment policies since 2005, with a greater level of government involvement in economic decision making followed by an import substitution strategy. In fact, it could be evident that tariffs changed frequently in an ad hoc manner (Athukorala, 2012). As a result the ratio of exports to GDP fell sharply during this period. In 2009, the Sri Lankan government defeated the 30-year-long LTTE separatist war and managed to restore complete peace within the territory (Athukorala, 2012). At this time, Sri Lanka had nine para tariffs applicable for imports (Athukorala, 2012), out of which, five had no domestic tax equivalent. With all such complex para tariff systems, the country's level of protectionism became even more complicated (Pursell & Ahsan, 2011). The government that was elected in 2015 took steps towards liberalisation such as the gradual removal and abolition of various para tariffs and until 2019 a more liberal and globalisation friendly approach could be witnessed (Athukorala & Jayasuriya, 2015).

### **Economic performance since independence**

Since independence, Sri Lanka inherited a dualistic export economy with a plantation sector integrated into international markets and a backward subsistence agrarian economy. Due to the World War II price boom, Sri Lanka's financial assets got accumulated, resulting in some measure of prosperity. Yet, the industrial sector attracted less attention from the state mainly because at that time, the economy could sustain only with primary commodities. From 1950 to 1951, about twenty per cent of the government expenditure was on subsidies. The export prices started declining and, relative to that, the import prices started increasing (Abeyratne & Rodrigo, 2002). After 1953, the export duties were increased, and relative to that, the import duties also went up, thus generating some revenue. As a result, until 1955 the growth rate remained at 4.3 per cent on average. In addition, the fiscal revenue and expenditure to GDP was about 20-22 per cent with a low debt service ratio to GDP of 2.18 per cent. Further, a low inflation of 0.17 per cent was recorded in this period.

However, with the declining commodity prices for primary products in the world market, deterioration in the terms of trade and depletion of assets resulted. Consequently, economic growth fell significantly to an average of 3.2 per cent during the period from 1956 to 1964, while recording a minimum of 0.7 per cent in 1956 (Ravinthirakumaran, 2014) and low inflation of 1.24 per cent with a widening of the fiscal revenue and expenditure to GDP. However, the debt service ratio to GDP declined to an average of 1.67 per cent. Until the mid-1960s, Sri Lanka's FDI policy remained liberal. This allowed multinational enterprises (MNEs) to establish operations and produce locally. But the strategy of import substituting MNEs started to create balance of payment problems. Therefore, export-oriented investments and ventures were encouraged by introducing incentives and maintaining a relaxed foreign exchange control for export-oriented FDIs. Further, the welfare impact of growth in an open economy can decline any gain from export growth might be offset by deterioration in terms of trade, resulting in undermining growth (Bhagawati, 1968).

From 1965 to 1969, the government partially opened the economy by reducing some of the controls on imports and by attempting to encourage exports. As a result, the economy was growing at a rate of 4.84 per cent from 1965 to 1969, registering a maximum growth of 8.2 per cent in 1968. Yet, inflation started to rise to an average of 3.10 per cent, and the government revenue and expenditure to GDP both fell marginally, but the debt service ratio went up to 7.66 per cent on average.

However, this growth momentum did not continue as expected. The government-regulated economic policies adopted within the period 1970-1976 were more inclined towards an import substitution strategy (Rajapathirana, 2017). It made the average growth rate remains at a low of 2.91 per cent. The adverse impact of youth insurrection, the global energy, food and exchange rate crises, as well as bad weather conditions prevailed during the same period contributing to inflation that continued to rise to an average of 6.39 per cent. It was observed that the government revenue and expenditure to GDP remained almost the same compared to the previous period, but the debt service ratio shot up to 21.10 per cent on average.

The policy shift in 1977 towards opening up the economy with a more globalisation-friendly approach has resulted in a reasonable increase in the average growth rate of the country to an average of 5.61 per cent throughout the period from 1977 to 1985. However, the macroeconomic and political instability that existed in the late 1980s had a negative impact on the growth prospects

of the economy, resulting in poor growth of 2.7 per cent on average from 1986 to 1989. Thereafter, in the 1990s with the introduction of the second wave liberalisation package with the privatisation program, further tariff cuts and simplification of the tariff structure, removing exchange controls on current account transactions, *etc.* made Sri Lanka one of the most open economies in developing world. Since then, the economy was able to regain its growth momentum to a moderate level. The government expenditure on GDP shows a significant rise to 33.06 per cent on average. However, the debt service ratio declined to 19.18 per cent from the previous 21.10 per cent.

With the continuation of the open economic policies by the then elected SLFP government 1994-2000, the economy was growing at a moderate rate of 5.17 per cent, leaving the inflation to remain at a level of about 8.8 per cent. But both fiscal revenue and income declined significantly and so did the debt service ratio to the GDP.

The political shift in the 2001-2002 period experienced a very low growth rate along with an increasing inflation rate of 9.6 per cent. However, the fiscal revenue and expenditure continued to decline along with a falling debt service ratio.

The political change of 2003-2004 recorded a 5.65 per cent GDP growth with a declining inflation of 7.65 per cent on average. Like the previous period, the fiscal revenue and expenditure continued to decline along with a falling debt service ratio.

The government of 2005-2015 recorded a growth of 6.28 per cent with a marginal rise in inflation of 8.71 per cent. The debt service ratio during this period shows a significant rise to 18.22 per cent. However, the country's economic performance was negatively affected by the surge in world food and oil prices during 2007 and the huge impact of the tsunami. The GDP per capita rose significantly, due to the growth in the non-tradable sectors such as construction, transport, utilities, *etc.* This confirms the premature de-industrialisation hypothesis of Dani Rodrik (Rodrik & Rodríguez, 2001) which explains that many developing countries are turning into service economies without having gone through a proper experience of industrialisation. The trade performance since the 2000s has been driven by policy and investment deficiencies, resulting in increased protectionism, including tariffs and especially on extensive use of para-tariffs (Pursell & Ahsan, 2011; Liyanaarachchi, Bandara & Naranpanawa, 2015). Furthermore, the low performance of the FDIs has reinforced poor outcomes within the trade volume.

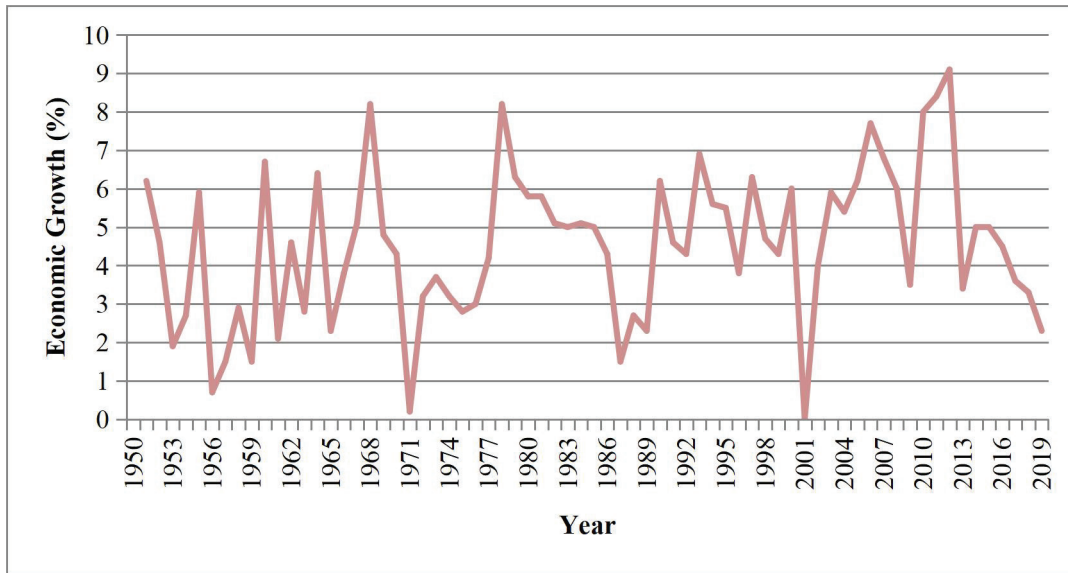
The growth of the economy during 2015-2019 was below the previous period recording 3.74 per cent growth, but the inflation remained low at 4.28 per cent. The fiscal revenue and expenditure remained almost the same compared to the previous period. However, the debt service ratio was relatively at 27.26 per cent. The low growth was partially due to the Easter Sunday terror attack that took place on April 21, 2019, affecting the economy.

**Table 1:** Policy regime shifts and their implications on selected economic performance indicators

	1948- 1955	1956- 1964	1965- 1969	1970- 1976	1977- 1993	1994- 2000	2001- 2002	2003- 2004	2005- 2015	2015- 2019
<b>National Income and Prices</b>										
GDP Growth <sup>1</sup>	4.26	3.24	4.84	2.91	4.90	5.17	1.25	5.65	6.28	3.74
Inflation <sup>2</sup>	0.17	1.24	3.10	6.39	12.31	8.84	9.60	7.65	8.71	4.28
<b>Government</b>										
Revenue to GDP <sup>1</sup>	20.50	22.13	21.8	21.03	22.95	19.30	17.00	15.45	14.27	13.46
Expenditure to GDP <sup>1</sup>	22.77	28.03	27.96	27.20	33.06	27.59	25.40	22.85	20.62	20.14
Debt Service Ratio to GDP <sup>1</sup>	2.18	1.67	7.66	21.10	19.18	14.57	13.20	11.60	18.22	27.26

<sup>1</sup> Average of the Period

<sup>2</sup> Average of the Trade to GDP ratio



**Figure 1:** Trends in economic growth: 1950 to 2019

Source: Central Bank of Sri Lanka annual reports 1972, 1980, 1998 & 2020

Table 1 summarises some of the economic indicators relevant to the policy shifts that took place since independence.

Further, Figure 1 shows the annual economic growth, indicating a highly volatile trend since 1948, ranging from a maximum of 9.1 per cent (in 2012) to a minimum of -1.5 per cent (in 2001). The growth rate of -1.5 per cent was due to several factors such as the political unrest that prevailed along with circumstances such as the terror attack at the Katunayaka International Airport, prolonged drought and subsequent power cuts, the terror attack on the World Trade Centre, and the subsequent global recession.

### Trade openness and external trade since independence

When analysing the openness and growth link since 1948, it is evident that throughout the early 1950s, the Trade Openness Index (Trade Openness Index was calculated as a ratio of Trade to GDP) remained considerably high (68.14) due to the *laissez faire* regime that prevailed with almost no barriers to trade. Exports to GDP were as high as 35.8 per cent, and the country recorded a positive trade balance to GDP of 3.5 per cent which could only be evident in that period.

The import substitution industrialisation (ISI) strategy that prevailed during 1956–1964, shows a direct impact on the openness index during that period. It could

be evident that the openness index has been falling continuously during that period and shows an average of 58.36 which is a decline of 14.35 per cent compared to the previous era. Further, exports to GDP fell sharply to 27.41 per cent and the trade balance recorded a negative 3.55 per cent on average. This pattern could be evident during the period from 1965 -1969 period even though the economy was partially opened to create a more globalisation friendly environment.

A significant impact on external trade was evident during the 1970-1976 period with the closed economic policy of the government led by the Sri Lanka Freedom Party. Exports to GDP further declined to 14.06 on average and trade openness declined significantly to 31.07 per cent indicating a more inward-looking approach. However, this strategy resulted in a negative trade balance of 2.95 per cent due to the trade restrictions in the country.

However, the extensive liberalisation process introduced in 1977 made a clear diversion restoring the country's trade openness at a considerably higher position of nearly 60 per cent. Exports to GDP recorded a significant comeback of 23.47 per cent. This movement continued until 2002 because of the open economic policies with more globalisation-friendly policies of governments. However, especially during the 2004-2015 period with the United Peoples' Freedom Alliance

party-led government’s economic policy which was characterised by partially open but interventionist policies has resulted in a contraction in the trade openness index down to 37.13 per cent with a gradual decline in exports to GDP ratio to 17.60 per cent. This decline was not sufficiently recovered during the period 2015-2019, even though the government introduced various trade liberalisation attempts. This could be partly attributed to the Easter Sunday terror attack that took place in 2019. However, Krugman (1992) and Rodrik & Rodríguez (2001) argue that the effect of openness on growth is doubtful. According to Krugman, the effect of openness on economic growth could be, at best, very tenuous, and at worst, doubtful. Further, Krugman (1992) highlights that the degree of trade openness, particularly the magnitude of tariff and non-tariff barriers only can affect the volume of trade, not necessarily the

link between exports, imports, and economic growth. Rodrik and Rodríguez (2001) argue that methodological problems with the empirical strategies employed in openness-led growth literature leave the results open to diverse interpretations.

Generally, there has been an increase in the trade dependency ratio since the introduction of the trade liberalisation policy in 1977. Figure 2 depicts the behavioural pattern of economic growth and openness (calculated based on the widely used trade to GDP ratio from 1950- 2019). It could be evident that a minimum level of 27 per cent was recorded in 1972 and the highest openness index of 80 per cent, in 1951.

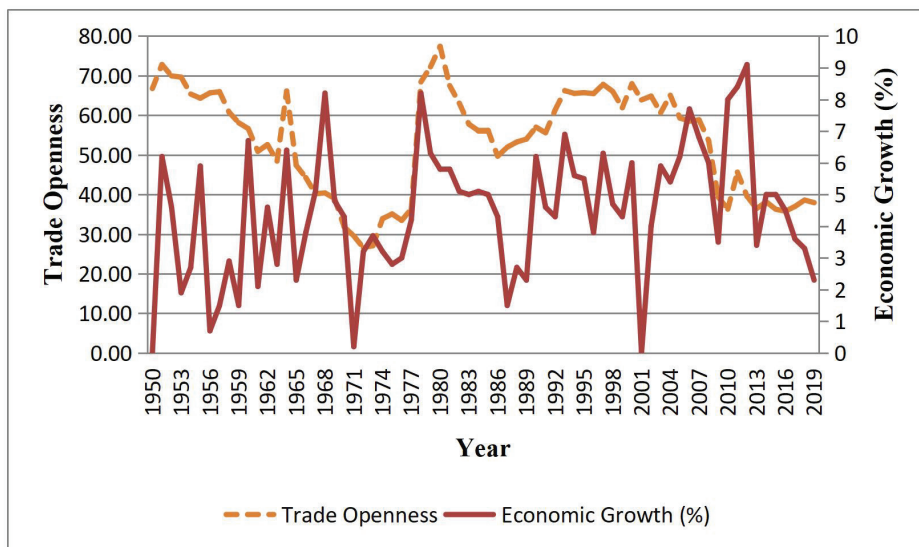
Furthermore, within the period 1977-2019, the total merchandise trade of Sri Lanka increased from

**Table 2:** Policy regime shifts and their implications on selected trade performance indicators

	1948-1955	1956-1964	1965-1969	1970-1976	1977-1993	1994-2000	2001-2002	2003-2004	2005-2015	2015-2019
<b>External Sector</b>										
Exports to GDP <sup>1</sup>	35.81	27.41	19.33	14.06	23.47	29.46	28.32	26.55	17.60	13.17
Trade Balance to GDP <sup>1</sup>	3.47	-3.55	-3.58	-2.95	-12.14	-6.86	-8.22	-9.78	-10.44	-10.78
Trade Openness <sup>2</sup>	68.14	58.36	42.25	31.07	59.07	65.78	64.37	62.87	45.65	37.13

1 Average of the Period

2 Average of the Trade to GDP ratio



**Figure 2:** Trade Openness and economic growth: 1950 to 2019

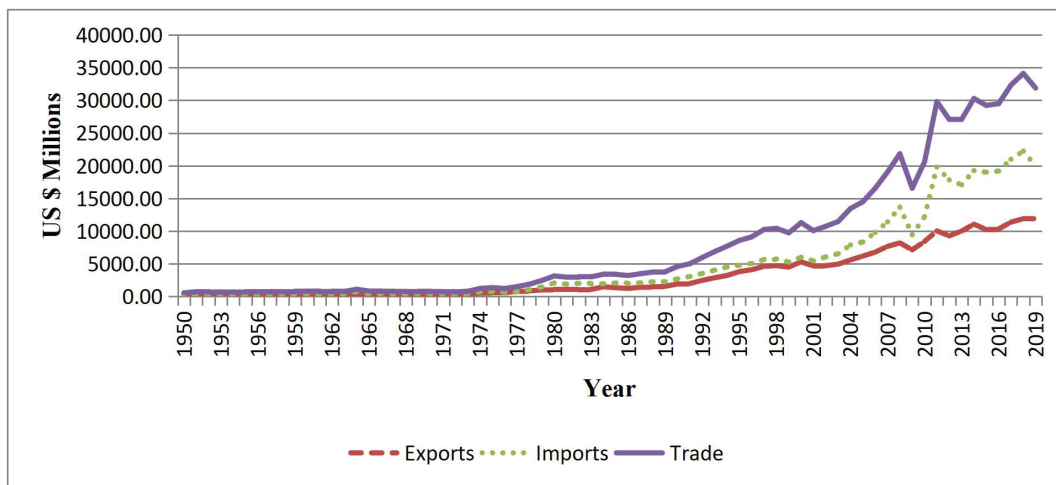
Source: Central Bank of Sri Lanka annual reports 1972, 1980, 1998 & 2020

US \$ 1,494 million to US \$ 31,240 million. In 1977, the total exports were US \$ 767.1 million which was a higher figure compared to the import value of US \$ 726.2 million. Thereafter imports have continuously recorded a higher value compared to the exports of the country. The continuous rapid increase in exports and imports highlights the importance of external trading activities for the Sri Lankan economy (Athukorala & Jayasuriya, 2005). As mentioned above, this clear diversion of the trade sector activities is mainly attributed to the liberalised economic policies introduced in 1977.

**Extensive uses of tariffs and para tariffs**

International trade performance (especially since 2000s) was driven by policy and investment deficiencies resulting in increased protectionism, including tariffs and extensive use of para-tariffs (Pursell & Ahsan, 2011 cited

by Liyanaarachchi *et al.*, 2015). Especially, after 2000, distortions of the tariff structure became evident with several para tariffs that had been introduced at different stages. By the year 2009, the country had nine para tariffs applicable for imports (Athukorala, 2012), of which, five had no domestic tax equivalent (namely; port and airport levy of 5 per cent, customs surcharge of 15 per cent, export development board CESS levy of 10 per cent to 35 per cent, regional development levy applicable for automobile components of 5 per cent, 7.5 per cent or 10 per cent) and four had a domestic tax equivalent (namely; value added tax (VAT) of 12 per cent to 20 per cent, social responsibility levy of 1.5 per cent, nation building tax of 3 per cent and excise duty of 10 per cent ). With all such complex systems of para-tariffs, the country’s level of protectionism became even more complicated (Pursell & Ahsan, 2011).



**Figure 3:** External trade of Sri Lanka: 1950 to 2019  
 Source: Central Bank of Sri Lanka annual reports 1972, 1980, 1998 & 2020

**Table 3.0:** Average total rate of protectionism from 2000 -2015

Year	Total rate of protectionism	Average tariffs	Average para tariffs
2002	12.5	9.6	2.9
2003	12.5	9.6	2.9
2004	13.4	11.3	2.1
2005	13.4	11.3	2.1
2006	13.4	11.3	2.1
2007	13.4	11.3	2.1
2008	13.4	11.3	2.1
2009	27.9	12.4	15.5
2010	27.9	12.4	15.5
2011	23.7	11.5	12.2
2012	23.7	11.5	12.2
2013	28.58	12.85	15.73
2014	28.58	12.85	15.73
2015	28.58	12.85	15.73

The distortions of the tariff structure during the period 2005-2015 have significantly reduced the country's exports to GDP to 17.6 per cent from 26.55 per cent recorded previously. Further, the trade balance has also increased from the previous negative 9.78 per cent to the negative 10.44 to GDP during the same period.

However, Krueger (1997) noted that growth prospects for developing countries are greatly enhanced through an outer – oriented trade region and fairly uniform incentives for production across exporting and import substituting goods and further stresses that changing trade policy is vital for improvement in economic performance.

The government assumed power in 2015 and took steps towards liberalisation such as the gradual removal of Export Development Board CESS duties for various items, revision of port and airport levy (PAL) and economic service charge (ESC duties) and amendments of certain legislations such as the Inland Revenue Act. In addition, the government took steps to abolish the ESC & NBT duties while reducing the corporate income tax for the export sectors (Weerakoon & Jayasuriya, 2017).

#### Foreign direct investments since independence

Until the mid-1960s, Sri Lanka's FDI policy remained liberal. This allowed MNEs to establish operations within the country and produce locally. But the ruling government's strategy of import substituting MNEs, started to create a balance of payment problems. Therefore, export-oriented investments and ventures were encouraged by the government. Further, incentives and relaxed foreign exchange control were maintained for export oriented FDIs. Furthermore, the country

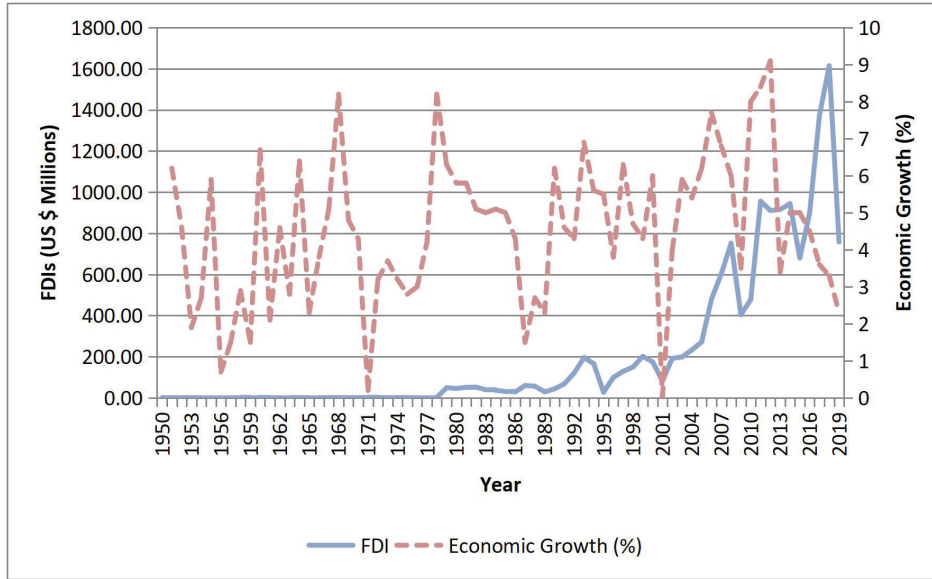
suffered from internal and external shocks during the period 1970-1976 such as the oil price shock, the increases in the prices of the main food imports, and the declining outputs of the major agricultural crops. In such a background, the government introduced a white paper to encourage FDIs coming into the country. But this was not generating positive results as the investment climate did not look so encouraging for investors. Similarly, the Exchange Control Act of 1971 introduced several measures such as to declare any asset owned abroad by Sri Lankans, prohibiting residents from having overseas bank accounts, *etc.* Therefore, since independence, FDI to GDP did not show a significant increase until 1977. It remained below 0.1 per cent during the period 1948-1976.

As part of the liberalisation reforms that took place in 1977, FDIs showed a significant increase from 1978 to 1985, recording a growth rate of 19.34 per cent. Further, foreign direct investment in export-oriented activities played a particularly important role in the development of the clothing and tourist industries. The declining share of publicly owned enterprises in manufacturing value added from almost 60 per cent in 1981 to less than 15 per cent in 1991, may be attributed both to these initiatives and to the strong growth in the private sector, especially in the clothing industry (WTO Policy review, 2010). However, the macroeconomic and political instability that existed in the late 1980s had a negative impact on the FDI growth, resulting in a negative growth of 16.90 per cent. During the period 1990-2019, with the government's introduction of the second wave liberalisation package that included a simplification of the tariff structure and removal of the exchange controls on current account transactions, an investor-friendly environment emerged

**Table 4:** Policy regime shifts and their implications on foreign direct investments

	1948- 1955	1956- 1964	1965- 1969	1970- 1976	1977- 1993	1994- 2000	2001- 2002	2003- 2004	2005- 2015	2015- 2019
<b>FDI to GDP<sup>1</sup></b>	0.06	0.07	0.06	0.05	0.81	0.93	1.16	1.09	1.31	1.25

<sup>1</sup> Average of the Period



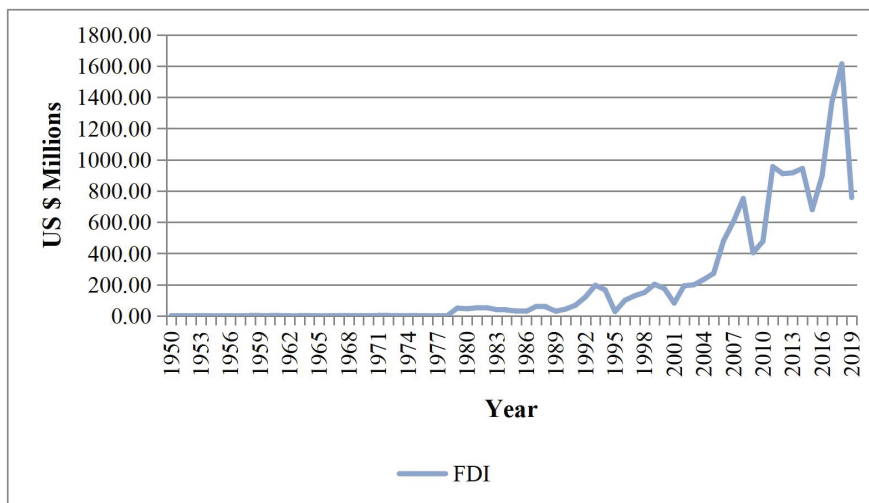
**Figure 4:** FDIs & Economic Growth: 1950 to 2019

Source: Central Bank of Sri Lanka annual reports 1972, 1980, 1998 & 2020 Board of Investment Sri Lanka 2010, 2015, 2020

and resulted in a moderate growth of FDIs, recording an average rate of 10 per cent.

FDIs in Sri Lanka include equity capital, reinvested earnings, and other capital used in various intra-company

debt transactions which include only the funds provided but not the funds estimated or committed. FDIs increased from US \$ 2 million to US \$ 1,614 million during the period 1977-2018, but a significant drop was experienced in 2019. After 2006, FDIs started to increase rapidly



**Figure 5:** Total inward FDIs of Sri Lanka: 1950 to 2019

Source: Board of Investment Sri Lanka 2010, 2015, 2020

mainly due to the FDI receipts in the manufacturing and infrastructure development sectors as shown below.

As per Samarappuli & Tharanga (2009), the above FDI statistics are understated. The Board of Investment of Sri Lanka considers only the FDI of BOI companies. This is because currently, the BOI considers only the flows of FDI to compile the balance of payments. The BOI captures all the FDI flows since its establishment in 1978. However, the reinvested earnings of the companies that qualified as FDI which were incorporated prior to 1978, are not captured as FDI. These companies are considered non-BOI and unlisted. Therefore, according to the present methodology used in measuring the FDIs in Sri Lanka, the FDI flows are understated in the BOP statistics (Samarappuli & Tharanga, 2009).

### Export diversification

Export diversification generates benefits for countries, such as reducing vulnerability to external shocks (Haddad, Lim, Pancaro, & Saborowski, 2013), leading to increases in economic growth (Al-Marhubi, 2000; Herzer & Nowak-Lehmann, 2006; Hesse, 2008). In order to analyse that, Herfindahl-Hirschman Index (HHI) was constructed based on Sri Lanka's total export market data and export product data for the period 1990-2019, to measure the export diversification in terms of product diversification and market diversification. This period was specifically selected due to the availability of country-wise export product data of Sri Lanka. Herfindahl-Hirschman Product Concentration Index and Herfindahl-Hirschman Market (HHM) Concentration Index are used to determine the annual aggregate export diversification index. The HHM concentration index varies from 0 to 100 (in percentage terms), where a zero index depicts the lowest possible concentration, that is the

reporting country is trading equally with all the countries and 100 depicts that the exports are concentrated on one market.

During the period the 1950s-1976, evidence suggests that, in Sri Lanka, export diversification was limited due to the slow growth in international trade. However, with the extensive liberalisation process that started in 1977 with the opening of the economy for FDIs (Athukorala, 2012) together with various schemes to promote FDI and international trade, targeting higher economic growth, Sri Lanka experienced a rapid industrial and export diversification and an improved rate of economic growth in the post-reform period, in general (Weerakoon & Thennakoon, 2008).

During the period 1990-2004, generally the product concentration was declining gradually. However, during the 2005-2015 period, this increased from 11.53 per cent to 12.71 per cent. This would have been a result of introducing various para-tariffs as explained before. Since 2016, product concentration has declined to 11.95 per cent mainly owing to the steps taken to liberalise trade.

A higher market concentration of the country is evident from 1990 to the early 2000s. This has then been gradually decreasing since the mid-2000s and continued to remain between 25 per cent to 26 per cent since then. A major reason for this development was the FTAs that came into effect when Sri Lanka entered and due to increased utilization of FTAs over time with the increased awareness of their benefits to Sri Lankan exporters.

In general, the total concentration of the country, which is calculated here as an average of product and market concentration ratio of Herfindahl-Hirschman Index (HHI), shows a decline over the time, indicating

**Table 5:** Export diversification of Sri Lanka

	1990- 1993	1994-2000	2001-2002	2003-2004	2005-2015	2016	2017	2018	2019	2016-2019
	Avg.	Avg.	Avg.	Avg.	Avg.					Avg.
Product Concentration	14.73	11.79	12.05	11.53	12.71	11.94	12.27	11.88	11.51	11.95
Market Concentration	28.46	35.39	36.37	34.10	25.39	26.34	24.85	25.27	25.54	25.68
Total Concentration	21.60	23.59	24.21	22.81	19.05	19.14	18.56	18.58	18.52	18.82

that the country is moving towards diversification but at a slower rate.

## CONCLUSION

This paper traces the policy shifts and their implications on the performance of Sri Lanka's trade, investments and economy focusing especially on the post-independent period scenario. The review highlights different regimes such as the liberal trade (*laissez faire*) regime 1948-1954, consolidation of trade controls (import substitution industrialisation) that was implemented from the mid-1950s to 1967, partial import liberalisation 1968-1969, regulated economic policies 1970-1977, open economic policies 1977-1989 followed by a second wave of liberalisation in 1990, and finally discusses the trade and investment policies in operation since 2000. As highlighted above, inconsistencies in the trade and investment policy of Sri Lanka since independence are evident. The combined impacts of the trade and investment policy reforms have had a direct impact on her economic growth performance. More liberal trade regimes show positive impacts on the growth aspect and vice versa. However, persistent growth could not be achieved due to inconsistent policy changes in the long run which were fluctuating between the liberal and the protectionist approaches owing to the political ideologies of the elected parties. Being a multi-ethnic state, political cleverness is very crucial, and the post-independence economic performance also shows that maintaining ethnic harmony for a sustainable growth path is essential and it is evident that there are large ideological gaps between the main political parties, especially the UNP and SLFP. These ideological differences have been a barrier to formulating globalisation-friendly economic policies to benefit the economy.

It is also noteworthy that, whatever Sri Lanka achieved under its liberalisation reforms, it did along with a protracted separatist war within her terrain. In addition to the direct debilitating effect the separatist war had on the political risk of the investor perception, it constrained the possibility of capturing the full benefits of the economic opening through the delays and inconsistencies in the implementation of the reform process and the macroeconomic instability emanating from a massive war financing. (Athukorala & Jayasuriya, 1994). Further, Sri Lanka's ability to capture benefits from the policy transition in 1977 was seriously hampered by the escalation of civil strife. During the period from 1983-2009 (Central Bank of Sri Lanka Annual Report, 2015), the economy continued to be burdened by the massive military expenditure from 1 per cent to 9 per cent of the GDP between 1984 and 2008.

The Northern Province and large parts of the Eastern Province (which together account for one-third of Sri Lanka's total land area and almost 12 per cent of the population) remained largely remote from the national economy. Even in the rest of the country, prospects for attracting foreign investment, particularly in long-term ventures were seriously hampered by the lingering fear of sporadic attacks by terrorists. Furthermore, the country's economic performance was also severely affected by the surge in world food and oil prices in 2007, the impact of the Tsunami in 2004 and the Easter Sunday terror attack in 2019. Finally, Sri Lanka's economic performance and its connectivity with the rest of the world have been largely affected by the decisions of the major political parties. National-level policies were decided based on the political, economic, ideological, and social beliefs of the politicians and the economic outcomes were based on such decisions.

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