

PN-ACD-575

98827

Sri Lanka Competitiveness Study

Final Report

U.S. Agency for International Development

Prepared for USAID/Sri Lanka

Prepared by J E Austin Associates, Inc and
SRI International

Sponsored by Private Enterprise Development
Support Project III
Contract No PCE-0026-Q-00-3031-00
Delivery Order No 836
Prime Contractor PricewaterhouseCoopers
LLP

September 1998

PRICEWATERHOUSECOOPERS 

Sri Lanka Country Competitiveness Study

Table of Contents

List of Acronyms

Executive Summary

Page

Introduction

1-1

Main Report The Emerging Competitiveness of Sri Lanka

1

I Locating Sri Lanka on the Map of Competitiveness

1-1

II Defining Competitiveness

1-4

III Applying Competitiveness to Sri Lanka

1-10

IV Creating a Common Vision for the Future

1-14

Exhibits

Annex I Benchmarking Sri Lanka's Competitiveness

I-1

1 1 The Investment Quality (IQ) "Snapshot"

I-1

1 2 Development Web Model

1-2

1 3 Benchmarks of Competitiveness

1-4

1 4 Summary

1-7

Exhibits

Annex II Macro Environment for Competitiveness

11-1

2 1 Brief Historical Overview

11-1

2 2 Current National Output

11-5

2 3 Review of Current Fiscal and Monetary Policies

11-6

2 4 Assessment of Vulnerability to Asian Financial Crisis

11-10

Annex III	Micro-Economic Environment	111-1
3 1	The Commercial Policy Model	111-1
3 2	Application of Commercial Policy Model to Sri Lanka	111-6
3 3	Comparing Sri Lanka Versus Other High Growth Countries	111-10
3 4	The Competitiveness Balance Sheet	111-17
3 5	Summary	III-2 1

Annex IV Industry and Firm-Level Competitiveness

4 1	Introduction	IV-1
4 2	Tea <i>Something Brewing?</i>	1v-2
4 3	Rubber <i>Bouncing Beyond the Basics</i>	1v-6
4 4	Electronics Industry <i>Unplugged</i>	IV-10
4 5	Apparel <i>Naked Before the Storm?</i>	1v-14
4 6	T oy Story	1v-19
4 7	Tourism <i>Venturing Forth?</i>	1v-26
4 8	The Gem Industry <i>Lost Jewels</i>	1v-33
4 9	Service and Knowledge-Based Exports	1v-37

Exhibits

Appendix 1 Sri Lanka's Macroeconomic-Level Competitiveness (SRI International)

Appendix 2 Bibliography

Appendix 3 Scope of Work for the Sri Lanka Country Competitiveness Study

LIST OF ACRONYMS

BOI	Board of Investment
BOO	Build-Own-Operate
BOT	Build-Operate-Transfer
CAD	Computer-Aided Design
CCC	Ceylon Chamber of Commerce
CINTEC	Computer Information Technology Council
CSSL	Computer Society of Sri Lanka
CTB	Ceylon Tourist Board
DRC	Discounted Resource Cost Analysis
EDB	Economic Development Board
FDI	Foreign Direct Investment
FTP	File Transfer Protocol
GDI	Gross Domestic Investment
GDP	Gross Domestic Product
GIS	Geographic Information Systems
GKCC	Golden Key Credit Card Co ,Ltd
GNP	Gross National Product
GOSL	Government of Sri Lanka
GST	Goods and Services Tax
HTML	Hyper-Text Machine Language
IBM	International Business Machines
ICOR	Incremental Capital-Output Ratio
ICRG	International Country Risk Guide
ICSID	International Center for Settlement of Investment Disputes
IMD	Institute for Management Development (Switzerland)
IMF	International Monetary Fund
INTELSAT	International Telecommunications and Satellite Organization
IPZ	Investment Processing Zone
IQ	Investment Quality Analysis
IT	Information Technology
ITMIN	Industrial, Technology and Market Information Network
JAA	J E Austin Associates, Inc
KwH	Kilowatt Hour
MFA	Multi-Fibre Agreement
MIGA	Multilateral Investment Guarantee Agency
NIC	Newly Industrialized Countries
NTT	Nippon Telephone & Telegraph (Japan)
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation & Development
PCS	Policy Category Scores
PEDS	Private Enterprise Development Support Project
SDRs	Standard Drawing Rights
SIERA	Share Investment External Rupee Accounts

SLR	Sri Lankan Rupee
SLT	Sri Lanka Telecom
SOE	State-Owned Enterprise
SRI	Stanford Research Institute
TS	Total Score
UNCTAD	UN Conference on Trade and Development
UNIDO	United Nations Industrial Development Organization
USAID	U S Agency for International Development
USTR	U S Trade Representative
VAT	Value-Added Tax
VSAT	Very Small Aperture Terminal
WEF	World Economic Forum
WTO	World Trade Organization

EXECUTIVE SUMMARY

In cooperation with the Government of Sri Lanka (GOSL) and with the sponsorship of USAID/Colombo, J E Austin Associates (JAA) was requested to implement a Country Competitiveness Exercise in Sri Lanka. JAA, in turn, invited SRI International to assist in this effort. The exercise included the following components and produced the results summarized here.

A comparative analysis of Sri Lanka relative to other countries of the world demonstrated that Sri Lanka has achieved impressive economic results despite being hampered by a persistent ethnic conflict. Sri Lanka was in the top 15% of countries worldwide in terms of growth in income per capita. However, the analysis performed by SRI International revealed that while economic performance is high, Sri Lanka scores relatively low in its competitiveness ranking. This raises the concern that the underlying sources of competitiveness for the future must be examined, especially the over-reliance on government incentives.

This report defines competitiveness not as abundant natural resources, cheap labor or better incentives but rather as sustainable growth in productivity, a theme that the GOSL should be commended for stressing in recent years. However, competitiveness (and productivity) is not merely greater efficiency based on working harder or even "working smarter". It is not merely doing things better but doing better things. It requires firms that know how to capture greater value in the marketplace not just by being more efficient at what they do and improving quality but also choosing where to compete, and adding service dimensions and innovating with new product characteristics.

Creating a national platform for competitive clusters of firms and industries requires a stable macro-economic environment, an excellent micro-economic environment and excellent firm level strategies and industry leadership. The review of the macro-economic environment, conducted by SRI International, gave the GOSL high marks in fiscal policy, monetary policy, foreign exchange stability and other macro-economic areas. The main weakness is the inability of the GOSL to invest in infrastructure given the twin pressures of the ongoing conflict and keeping budget imbalances to reasonable levels. Private investment and management has not filled the large gap in infrastructure investment and related service provision.

The analysis of the micro-economic environment revealed a more mixed picture. Commercial policies, while not as attractive as those of Ireland or Singapore for example, are still relatively good and have delivered tangible results in terms of investment and export growth. In areas related to human resources, success in health and literacy is balanced by only average achievements at the secondary level and in providing the mix of talents and capabilities most in demand in the private sector. Most infrastructure indicators are weak, although there have been excellent improvements recently in telecommunications, resulting from partial privatization. Partial privatization in the plantation sector has also led to improved productivity. Liberalization in maritime

shipping has also helped competitiveness as time required for textile exports to the USA dropped from 31 days to 19 days - although there are still complaints about the costs and service of port and customs procedures. Significant labor market rigidities are also a constraint.

Competitiveness can really only be understood at the firm and industry level. The exercise provided a "window" on the slowly emerging competitiveness of a number of Sri Lankan industries.

Only 10% of tea is exported as tea bags or instant tea. Most tea continues to be exported in bulk form, although one company has achieved brand name recognition for tea bags in foreign markets. In rubber, there has been a more rapid transition in the 1990s where most of the value now goes out in the form of more complex exports such as surgical gloves, rubber mattresses and solid rubber tires for the specialty heavy equipment market.

Although there are some success stories, including one Sri Lankan manufacturer with in-house design capability, the electronics industry has never "taken off". The industry lacks strong "anchor firms" with international strength and consumer base. Civil strife kept two such firms from investing, and production has instead been located in other countries. The industry cluster is weak, with inadequate supporting industries.

In textiles, the industry faces the challenge of expiration of MFA quotas in 2005. Although many firms have developed the ability to make more complex and higher value products and to structure long-term relationships, 70% of exports go out under quota and industry leaders estimate that only half the industry would survive if quotas were lifted today. But even if the entire industry survives, it is unlikely that the textile sector will continue to provide the dynamism behind Sri Lanka's growth in investment, manufacturing output and exports.

Toy manufacture has been a moderate success story. The wooden toy segment lacks strong anchor firms and has little knowledge of customer demand. Rigid labor laws have caused problems for emerging companies. Skill levels and design capabilities exist, but technology is basic. The soft toy segment does have the advantage of an anchor firm, which has attracted additional investment. The industry is very concentrated on a small group of related firms, however. The industry cluster is fairly strong and there is a self-managed quality standard. There would appear to be eventual opportunity for local supply of components, if a larger group of exporters were to become established in Sri Lanka.

In tourism, business strategies have responded to incentives but largely compete in the undifferentiated "sun and sand" segment of the market, depending on charter tour operators to provide volume. The result is that the industry receives only \$58/day per tourist. The country also struggles to manage its image abroad. Infrastructure/service constraints and lack of cohesive strategies for providing higher-value tourists with desired experiences and levels of service need to be dealt with in order to upgrade industry competitiveness. The industry has not yet developed strong associations, and

has not yet taken on responsibility for standards and sector management. The quality of public-private dialogue and collaboration is still mediocre.

Blessed with an excellent resource of raw gems and a workforce that can be trained to an excellent level of production and design performance, Sri Lanka remains essentially only an exporter of raw gems. Quality international players have not located processing or manufacture in the country, at least partially because of lack of respect and enforcement of intellectual property rights. Laws restricting imports of jewelry components (gold and other gems) have also been a barrier to industry growth. The quality of training facilities is poor.

Service and knowledge-based exports, with a fast-growing and potentially huge world market, is a new industry in Sri Lanka and would appear to offer opportunity. Sri Lanka's high level of literacy and cost advantages should help Sri Lanka to gain a foothold. Telecommunications service has improved, but still needs to be brought to top-level international standard. Some companies are established and the industry cluster is beginning to develop positive collaboration. There are both local and international success stories to learn from.

The team found a high level of awareness of, interest in and readiness to tackle the above challenges - as demonstrated by the participation of more than 600 private and public sector leaders who attended the 26 briefings and presentations.

The conclusions of this exercise focus more on process than on the well-known priorities of improving education, infrastructure, labor markets and other policies. Process improvements would include the following:

- Establish an annual competitiveness report to benchmark country performance in key areas,
- Create competitiveness technical assistance teams within key industry associations,
- Improve the capacity of the private sector to analyze competitiveness weaknesses and advantages,
- Support "neutral broker" local institution with proven analytical capabilities,
- Help link small and medium enterprises with sources of intelligence on markets, competition, technologies, processes and partners, and
- Provide specialized assistance to analyze future competitiveness of key industries

INTRODUCTION

In 1997-98, J E Austin Associates (JAA) developed and implemented a Country Competitiveness Analysis methodology for USAID with technical assistance from Monitor Company of Boston, a **firm** associated with competitiveness expert Michael Porter of Harvard. In mid-1998, the United States Agency for International Development, Colombo (USAID/Colombo) requested a country competitiveness analysis of Sri Lanka as part of its ongoing program of economic assistance to the Government of Sri Lanka (GOSL). Under the prime contract Private Enterprise Development Support (PEDS) III, PriceWaterhouseCoopers requested JAA to conduct a competitiveness study in Sri Lanka. JAA requested that SRI also participate in this effort so that this competitiveness exercise would include the recently developed Web Model and the Commercial Policy Matrix.

Objectives of the Exercise

The objectives of this exercise are

- 1 To define competitiveness,
- 2 To evaluate Sri Lanka's recent performance,
- 3 To analyze constraints to competitiveness,
- 4 To conduct competitiveness workshops with stakeholders in Sri Lanka, and
- 5 To provide recommendations and priorities for improving future competitiveness.

It should be immediately clarified that the objective of this exercise is **not** to try and pick "winners" and "losers" for Sri Lanka. As an exercise that is limited in time and scope, it is intended to provide a comprehensive competitiveness analysis of any particular industry much less an entire in-depth analysis of the entire economy. This exercise was limited in duration to a 90-day period between mid-June and mid-September, 1998. It is meant to serve as a stimulus rather than a substitute for the strategic **thinking** that must take place at the **firm** and industry level.

An independent study such as this cannot substitute for the development of local capacity by firms, industry associations and policy groups to analyze and constantly improve the underlying sources of Sri Lanka's competitiveness. Such an institutionalized capacity leads to ongoing private-public dialogue on competitiveness. Unfortunately, this dialogue is not yet taking place in any institutionalized and ongoing way. The usefulness of this current exercise will be quite limited if it is yet another study conducted in a much-studied country. This exercise will only have lasting utility if it serves as a catalyst for institutionalizing such capacity for effective analysis and dialogue between the private and public sector. The exercise focuses on active presentations. The utility of the exercise is that of providing stimulus and initial frameworks, tools and benchmarks to contribute to the process of creating and facilitating this dialogue.

Definition of Competitiveness and Study Methodology

To define competitiveness, it is useful to say what competitiveness is not. Competitiveness is not having cheaper labor than other countries. It is not achieved by constantly depreciating currency. The most competitive economies are ones where real income growth is high and rising and where the currency, while market-driven, is at least stable if not rising in value.

Competitiveness is defined for the purpose of this study as sustained growth in productivity resulting in rapid growth in income and purchasing power for the average citizen.

Some authors refer to competitiveness as the sum of a country's performance indicators even though countries do not compete in the sense that companies compete. While the team does not technically agree with this definition of "competitiveness," it nonetheless understands the need to have comparative performance indicators and benchmarks. As private sector executives well know, "if you can't measure it you can't manage it." The team has thus provided several such benchmarking exercises for Sri Lanka in *Annex I*.

Others refer to competitiveness as the macro-economic and policy variables that facilitate growth. These authors identify and monitor policy variables that are highly correlated with economic growth. The macro-economic foundations for growth will be analyzed in *Annex II* of this report, which also presents an overview of the Sri Lankan economy and its recent evolution.

More recently, competitiveness specialists such as Michael Porter have demonstrated that the micro-economic environment for growth may be just as important as the macro-environment. Analysts such as Dr. James Austin have developed tools analyzing the macro-micro linkages and enterprise-level impacts of government policies, institutions and operations in the economy. Sri Lanka's micro-economic environment is analyzed in *Annex III* of this report, which applies the Commercial Policy Matrix and other tools to the Sri Lankan context.

Competitiveness, however, can only be truly understood at the level of firms and industries for it is they that actually compete for growth, market share and resources. These are the economic units that, at the end of the day, must deliver the increased productivity to the economy. Upon their performance depend improved incomes and living standards. A government can allocate resources, reduce friction in the economy and create a conducive national platform for competitiveness. But it is the firms themselves which must invest, employ, innovate, export and create wealth. The team has sought to listen very carefully to private sector firms and industries in Sri Lanka and to present their stories in *Annex IV*.

The above findings were presented in a series of intensive workshops with industry clusters and government leaders, details of which are found in the Annexes

Limitations of the Exercise

The purpose of the study is not to conduct a domestic resource cost analysis (DRC). The team believes that the exercise has utility in some circumstances. However, we must not confuse “competitiveness” with a race to see who can stay poorest the longest on the basis of cheaper costs. Competing on the basis of cost in commodity markets is not a very attractive competitive strategy for companies or countries. Today, more and more of the increased value (and profits) now come from identifying and serving specialized markets, adding unique product features, adding value and service dimensions to export products, and developing complex exports that are not as easily replicable. It is generally recognized that countries now build upon their natural comparative advantages and build competitive advantage through superior economic and business strategies.

For the macro-economic section, the team relied heavily on SRI International, which was part of the team. For the micro-economic section, the team relied heavily on the methodologies developed by Michael Porter of Harvard and by Monitor Company of Boston. Monitor assisted in the development and field testing of the USAID competitiveness exercise. Dr. Porter’s competitive diamond was used as an analytical tool to assess the competitiveness of local industry clusters. The team also drew upon recent work by Michael Fairbanks in which he applied these tools to developing countries in Latin America². Brief case studies on individual companies also enriched the exercise. For connecting the macro and micro approaches, the team drew upon the published work of Dr. James E. Austin, including tools for analyzing the impacts of policy on firm-level activity and operations³.

To prepare this report, the team gathered data and studies on eight industry clusters in Sri Lanka. Interviews with industry leaders and meetings with representatives from these industries were held to enrich the statistical data with qualitative inputs. The team also hired industry experts in tourism, electronics, apparel, tea, and information services to provide separate analyses. Site visits to companies and interviews with their executives provided brief case studies for illustrative examples.

The team believes that the incremental value of an additional study in a much-studied country is limited. Rather, the team believes that the value of the exercise is in stimulating action. But this will depend entirely on whether the moment is right for local stakeholders to coalesce around a consensus regarding private and public sector priorities to respond to the competitiveness challenges. To stimulate good dialogue on

¹ See The Competitive Advantage of Nations, Michael Porter, **NY** The Free Press, **1990**

² The team expresses its gratitude to Michael Fairbanks and Monitor Company for helping to develop the methodology for this exercise.

³ These can be found in Managing in Developing Countries NY The Free Press, **1990**

competitiveness issues, it is first necessary to have good information and to be able to see clearly how the country ranks amongst the nations of the world

12

MAIN REPORT:
THE EMERGING COMPETITIVENESS OF SRI LANKA

THE EMERGING COMPETITIVENESS OF SRI LANKA

The objectives of this report are

- 1 To define competitiveness,
- 2 To locate Sri Lanka on the world “map” of competitiveness,
- 3 To apply competitiveness analysis to Sri Lanka, and
- 4 To assist the private and public sector leadership of Sri Lanka in their effort to create a common vision for the future competitiveness of the country

I LOCATING SRI LANKA ON THE MAP OF COMPETITIVENESS

The purpose of this section is to provide an objective and independent assessment of Sri Lanka's economic achievements and the current comparative evaluation of key factors leading to those achievements. This section is based on the analysis presented in **Annex I** of the Sri Lanka Competitiveness Study. The annotated exhibits refer to the exhibits presented at the end of this section.

Is Sri Lanka on the World “Map” of Competitiveness?

There are two major annual “competitiveness” rankings of countries. Neither the *World Competitiveness Report* of the *World Economic Forum* nor the *Global Competitiveness Report* of the *Institute for Management Development (IMD)* provides a satisfactory definition of competitiveness. Instead, they refer to comparative country performance indicators related to public policy, infrastructure, human resources and other factors viewed as critical to the optimum performance of private enterprise and to attracting domestic and international investment. Unfortunately, Sri Lanka has not yet been deemed to warrant inclusion in either of these reports even though its recent performance in per-capita income growth is amongst the top 25 countries in the world, and even though some Asian countries that are smaller in population have been included. Were Sri Lanka to make competitiveness part of national policy, it is possible that this situation could be changed. Inclusion in such reports would bring the country to the attention of the international community, distinguish it from other South Asian economies and place Sri Lanka on the “Competitiveness Map”.

Excellent Economic Results But Weak Competitiveness (Exhibit 1)

In the meantime, Sri Lanka will have to depend on other published sources and on exercises such as this to provide an independent assessment of its relative performance. *SRI International* has recently published *Global Benchmarks*, which ranks countries along a variety of development vectors including economic performance, competitiveness, health, education, environment, and democracy and freedom. The diamond-shaped area represents Sri Lanka's scores along these six vectors, with the white dotted line

representing the average score of the countries of the world. Sri Lanka scores relatively well for “health” and slightly above average for “education” and “environment”. It scores below average for “democracy” and “freedom”. However, the lowest score achieved is that of “competitiveness”, at only **34** out of a possible 100. This is all the more surprising in light of the fact that the country scored an 80 for “economic performance”. The drastic difference between economic performance and underlying foundations of competitiveness should be cause for concern. It provides even greater relevance for this competitiveness exercise. The full report by SRI International on the “Development Web” and its application to Sri Lanka is provided in **Annex II** of this report.

Sri Lanka Stuck Between South and East Asia (Exhibit 2)

Another way to visualize Sri Lanka on a “map” of countries is through the *Investment Quality Analysis (IQ Analysis)*. The IQ Analysis was developed by *J E Austin Associates (JAA)* to simultaneously illustrate the level of investment and the quality of investment.¹ This analysis helps countries identify if their problem is a *level of investment problem* or an *investment quality problem*. Some countries, such as those of the former Soviet Union, have high levels of aggregate investment, but this investment is not efficiently utilized. Other countries, such as Haiti and Madagascar, have problems mobilizing investment and providing a business environment for turning such investment into growth. They have a serious problem on both levels and have very poor economic track records. Still other countries seem to be able to translate investment into economic growth but are unable to mobilize the levels of investment that lead to rapid economic growth. This has been the trap of most South Asian countries over the last 20 years and is also characteristic of some African countries, such as Ghana, which, despite many years of reform, still has among the lowest private investment rates in Africa. Sri Lanka’s 20-year performance demonstrates that it has escaped the South Asian trap of low investment levels but has not attained the East Asian investment levels needed to achieve the levels of GDP growth that have been set by the GOSL. Sri Lanka is achieving above-average performance, with 20 year investment levels well above 20% of GDP. Conversion rates have been relatively good at **5.1**. But the country is still “stuck in the middle” - between the South Asian and East Asian performance.

Sri Lanka Among Top 20 in Growth in Income Per-Capita (Exhibit 3)

JAA took 20 key indicators related to economic performance, human resources and infrastructure and ranked countries worldwide in terms of their performance over a 20-year time period. Sources included the United Nations (UN), World Bank, U.S. Department of Commerce (USDOC) and the Economist Intelligence Unit (EIU), and other specialized sources of information. JAA then provided Sri Lanka’s score along with benchmark performance based on the 20 top performing countries in each category. This analysis revealed a very mixed picture for Sri Lanka. On the one hand, it ranked Sri Lanka at the 85th percentile (number 20 out of approximately 140 countries) for GDP growth

¹ It evaluates the extent to which investment contributes to economic growth or the efficiency and productivity with which investment resources are utilized.

with benchmark performance based on the **20** top performing countries in each category. This analysis revealed a very mixed picture for Sri Lanka. On the one hand, it ranked Sri Lanka at the 85th percentile (number 20 out of approximately 140 countries) for GDP growth per-capita from 1975-95. Only 15% of the countries of the world recorded a better performance. This is a performance Sri Lanka can be proud of and provides objective evidence that, despite ethnic conflict, strong economic results have been achieved. This would seem to vindicate previous economic strategy decisions based on private sector development **and** outward-oriented and export-led growth.

Most Economic Indicators Are Strong (Exhibit 4)

Sri Lanka ranks in the top 20th percentile in terms of GDP growth in real terms (but not per-capita) terms. It is also among the top 25% of countries in terms of export growth. However, the country's 20-year history of promoting FDI is only average (although this has recently improved). Sri Lanka is not yet rated by either *Standard and Poors* or *Moody's* (emphasizing the problem of getting on the world map). In lieu of this, this exercise used the *Euromoney Risk Ratings*, and Sri Lanka scores below average in these ratings. The poorest showing is that of *domestic savings rates*, for which the country is close to falling into the lowest one-third of the countries of the world.

Human Resource Benchmarks are Mixed (Exhibit 5)

Sri Lanka has an excellent distribution of income, ranking among the top 25% of countries worldwide. In *life expectancy* and *adult literacy*, it is amongst the top 40% of all countries. Despite a strong record in education, Sri Lanka is now only slightly above average in terms of *secondary school enrollment*. Other countries have caught up to Sri Lanka and this is no longer a source of particularly unique advantage. Also, even though Sri Lanka's population is highly literate, practical, private sector-oriented skills and English language skills are lacking. Furthermore, human resource indicators that involve infrastructure, such as *access to safe water*, drop the country very low - Sri Lanka ranks amongst the lowest 25% of all countries.

Physical Infrastructure (Exhibit 6)

Sri Lanka ranks very low in most indicators related to physical infrastructure. Despite excellent *port facilities* (not ranked here), *road density* is poor, placing the country in the lowest 40% of nations. *Power consumption per capita* is even lower, with Sri Lanka among the lowest 20%. Indicators related to the *availability of computers* are also among the lowest in the world, although *Internet connectivity* is near the average. It seems that Sri Lankans may have fewer computers but they are using them to connect with the world. *Phone lines per 1,000 people* showed poor ratings for 1995, the last year for which comparative country rankings were available. However, this indicator has showed dramatic improvement in the last few years, as the number of phone lines has doubled.

11 DEFINING COMPETITIVENESS

Why Competitiveness is Emerging as a Priority

Leaders around the world, whatever their political beliefs, are focusing more and more on competitiveness as a priority. There are several reasons for this:

- The 132 members of the World Trade Organization have agreed to new “rules of the game”,
- National governments are moving quickly to liberalize and open their economies,
- Globalization of technology through networked computers, communication and transport is causing profound transformations,
- The end of the Multi-Fibre Agreement (MFA) in 2005 is causing anxiety amongst apparel exporting countries,
- The sharp rise in private capital flows internationally creates new problems and opportunities, and
- Official development assistance (ODA) flows are declining

In this context, private companies, industry groups and governments are questioning old assumptions and seeking to gain the knowledge and insight that will help them position themselves for to respond to these changes.

Defining Competitiveness By What It Is Not

Competitiveness as a concept is used by many people in many ways that are often mutually exclusive. Competitiveness has often been defined in ways that are no longer valid. Competitiveness is not

- Abundant natural resources,
- Cheap labor,
- Constant currency depreciation, or
- Better government “incentives” or subsidies

Michael Fairbanks, author of *Plowing the Sea*, has said, “*An economic strategy based on ago-exports, free trade zone labor and sun-and-sand tourism is a strategy for staying poor*”²

Agriculture – Competitiveness Is Not Abundant Natural Resources (Exhibit 7)

There is a high correlation between natural resource dependency and low per-capita income. Even countries blessed with abundant natural resources, such as Venezuela, have

² Fairbanks, Michael and Lindsay, Stace, *Plowing the Sea: Nurturing the Hidden Sources of Growth in Developing Countries*, Harvard Business School Press, Cambridge 1997

gotten poorer over the last 20 years. This is because of the considerable price pressure on natural resource commodities. There was an era when such commodities generated substantial wealth. But these are now mature industries that face relentless cost pressures.

Manufacturing Relying on Relative Costs of Labor is Also Dangerous

Strategies based on labor cost advantages are not a sustainable source of competitive advantage. There is always another country, such as China, willing to provide even cheaper labor. Competing on the basis of labor costs is a race among countries to see who can stay poorest the longest. Even if it wanted to, Sri Lanka is not in a position to compete on the basis of cheap labor. The growth in the labor force is already slowing and will flatten out within about 10 years, according to recent projections by the IPS. This will put price pressure on wages, a phenomenon already being felt on tea estates.

Services Sun-and-Sand Tourism Does Not Provide Sustainable Competitive Advantage (Exhibit 8)

Sri Lanka currently receives only \$58/day per tourist, which is low by world standards. The industry is still largely dependent on foreign tour operators to fill hotels. The country struggles to manage its image. Meanwhile, tastes among high-income tourists are evolving. There are many countries that offer sun and beaches – “sun-and-sand tourism” is a highly replicable strategy that does not offer prospects for rapid growth in income of those working in this sector.

Incentives Are No Longer a Sustainable Source of Competitive Advantage

The active and creative use of fiscal policy by the GOSL to mobilize investment and boost exports has contributed to the strong record presented in the benchmarking section of this exercise. However, more and more countries are offering such incentives. Any country can copy this strategy. Incentives also result in businesses looking to government when competitiveness requires them to focus scarce time and resources on customers and competitors. Other governments can offer more attractive incentives and engage in a bidding war for foreign investment. Some incentives will no longer be allowed under the rules of WTO. Finally, businesses that rely on such incentives will always be vulnerable to policy change.

Defining Competitiveness

“*Competitiveness*” can be defined as “*sustainable increases in productivity resulting in the improvement of the standard of living of the average citizen of a country*”. Growth in productivity is, at the end of the day, delivered by the private sector through real companies competing in real industries.

Competitiveness and Productivity

The recent focus of the GOSL on productivity is commendable and goes to the heart of competitiveness. However, productivity must be defined and understood broadly. It is not simply doing things better, but doing better things. It is not just working harder and working smarter, but also choosing where to work. Another way to understand the paradox of productivity is to analyze the following two questions. If Firm A hires an employee from Firm B and doubles the salary for the same amount of work, is the employee now twice as productive? Most people would say no. But if a Sri Lankan exporter found a Japanese company to pay them double for a product currently sold to the U S A, would it be more productive? The latter would show up as such in the national income statistics.

The New Competitiveness Paradigm (Exhibit 9)

The new competitiveness paradigm presented by Michael Porter illustrates the importance of the political, legal and macro-economic context, and also the quality of the microeconomic business environment and the sophistication of company operations and strategy. As countries develop, the quality of private sector business decisions seems to become relatively more important in achieving company, industry and national competitiveness. But this is an area often neglected. Many countries that have engaged in difficult macro-economic reforms have been disappointed by the slow response of private investment. In Sri Lanka, the data on economic growth and exports reveal a relatively quicker response time to economic reforms introduced in the late 1970s and the early 1990s. The GOSL has always focused on the macro as well as the micro environments. However, future progress may depend more heavily on business strategy and private sector leadership.

Growth and Equity The Virtuous Cycle (Exhibit 10)

As private companies focus on more complex exports, greater wealth is generated for the nation. It also creates a dynamic in which private companies invest in human capital to create the skills and innovation that allow them to maintain the competitive edge in these complex exports. These exports depend on higher skill levels and lead to higher income levels. Poor competitive strategies based solely on cost in undifferentiated product and service areas create the opposite incentive (i.e., for lower wages, cheaper costs and devaluation).

How to Recognize a “Competitive” Country

A “competitive” country is easily recognized as having progressively higher real wage levels - but driven by productivity rather than government fiat. A competitive country is characterized by increasingly strong currency levels, based on market forces and good policy rather than artificial exchange controls. Competitive countries are characterized by

the ability of the average citizen to increase his/her purchasing power both domestically and internationally

The Competitive Diamond

The oft-cited model for competitiveness is the *Competitive Diamond* developed by Michael Porter on the basis of extensive industry research. The “diamond” represents the competitive environment faced by firms. It is used by companies to develop strategy and by governments to improve the national platform for competitiveness. The elements of the diamond include

- Demand conditions,
- Factor conditions,
- Strategy, structure and rivalry within industries,
- The cluster of related and supporting industries, and
- The influence of government (and sometimes chance events) on the above

However, the key to the analysis is not in understanding the elements of the analysis, but in the interactions between them

An Illustration of the Competitive Diamond

Colombia has, on the surface, an attractive set of factor conditions for exporting cut flowers. Studies have shown that the area around Bogota is perhaps the world’s best growing environment for carnations. Temperatures, sunlight and day length are near-perfect all year round. Land and water have been plentiful and, until recently, were available at low cost. The firms in Colombia forward integrated to take over the brokerage functions in Miami. However, it is Holland and not Colombia that enjoys leading market share and higher profitability - despite an unfavorable climate, high labor costs, high energy costs and expensive land. Unlike Colombia, Holland is more closely in touch with the needs of demanding consumers. The strategy in Holland is to produce differentiated products for which the consumer pays more. Instead of relying on basic factor conditions, the Dutch have created research institutes and have invested in excellent transport logistics. They have a strong position in breeding and propagation. Innovation and information pass quickly through the Dutch network.

Key Competitiveness Questions

Some of the key questions raised by the diamond include

- How close are we to demanding consumers?
- How much competition is there in our industry, driving relentless upgrading?
- Are we building upon and moving beyond our basic factors?
- Is there a cluster of related and supporting industries being developed?
- What are the interactions among these various forces?

7 Opportunities for Building Competitiveness

Recent work applying competitiveness to developing countries highlighted a number of opportunities for achieving or improving competitiveness³

- 1 Improving customer learning,
- 2 Exploring forward integration,
- 3 Innovating,
- 4 Cooperating with a cluster of related firms,
- 5 Understanding competitive position,
- 6 Avoiding an over-reliance on basic factors for competitiveness, and
- 7 Building effective private-public dialogue

1 Improving Customer Learning

Firms and industries that rely on intermediaries for their knowledge of customers and market trends are in a relatively weak position to adapt to change - whether they be in the tea business, the textile business or the tourism business. Industry strategies relying on intermediaries for market knowledge involve greater risk. Businesses need direct access to sources of intelligence on markets and need ways of identifying trends among demanding consumers and clients. Industry associations can do much to help their member firms to improve their access to market intelligence. For example, hotel companies in Sri Lanka would do well to understand that there are at least 32 different segments among European and U S tourists with regard to their motive for travel. Understanding this differentiation, they could then make strategic choices regarding which type of tourist to target and attract to Sri Lanka. This would lead to an improvement in capabilities to obtain and analyze information related to the profiles of high-income consumers, the packages they need, and the ideal marketing channels to reach them.

2 Exploring Forward Integration

Firms should also selectively and carefully explore opportunities for forward integration. An example may be taken from a client of JAA that is a cut flower exporter from Colombia. The firm was not content to simply forward integrate into brokerage functions in the USA. The flower exporter visited U S supermarkets and found that it could be far more profitable by assembling bouquets, adding cellophane, printing bar codes for the supermarket and shipping the flowers with dry-pack technology to the supermarket door. The supermarket saved on local labor and logistics costs while the consumer received a fresher flower.

³ See Michael Farbanks, 1998, for a fuller treatment of the 7 Opportunities

3 Innovating

Compames often compete on a two-dimensional matnx of cost versus quality Successful compames often invent a thurd dimension and define competitiveness through innovation For example, Bancafe in Uganda decided not to be just “one more exporter of basic coffee” The owner, Stephen Banya, decided to create gourmet coffeeshouses in a nation of tea dnkners He invested in high quality roasting machinery and created a supply network amongst farmers producing high quality coffee, paying these farmers a prermum He has been very successful and has created the foundations for a future export mche for prermum coffee

4 Cooperating with the Cluster of Related Industries

Competitiveness is a regional phenomenon Clusters of competitive firms often emerge in close proximity This is not the result of any one government policy Competitive clusters emerge in the very different policy contexts of Japan, the USA, Germany, Sweden and Italy This often involves cooperation among a supporting network of suppliers, distnbutors, packagers, and business service providers

5 Understanding Competitive Position (Exhibit 11)

Many firms in developing countries suffer from a syndrome referred to by *Gabriel Garcia Marquez* as “*100 years of solitude*” For many years, state ownership, import substitution and protectionism served to isolate firms from international competitive forces As a result, many compames in these countries lack a solid grasp of their competitive position Much can be done to improve information and intelligence on competitive positionng One example cited by *Monitor Company* is that of the fishmeal industry in Peru The industry was satisfied with its ability to increase its sales and market share in this particular industry What it did not understand is that, although the Peruvian compames were “adding value”, they were doing so in a relatively unattractive segment of the broader fish industry Meanwhile, their major competitor, Chile, took the oportumty to rmgrate out of fishmeal and move to more attractive segments achieving superior sales and profits in the process

6 Avoiding Over-Reliance on Basic Factors

The recent work of Michael Fairbanks highlights the importance of moving beyond basic factor advantages For example, while Sri Lanka has ideal conditions for creating excellent quality tea, it must move beyond these basic advantages to capture additional value In tounsm, it must not simply rely on the natural environment for eco-tounsm or on its historical and cultural sites (many countries offer these), but build packages that combine other features attractive to high-income consumers

7 Building Effective Private-Public Dialogue

Competitive companies and industries have turned away from defensiveness and paternalistic relationships with government, and are building effective private-public dialogue. Competitive countries are characterized by ongoing and institutionalized dialogue between the two sectors on issues that are vital to long term competitiveness.

III APPLYING COMPETITIVENESS TO SRI LANKA

Macroeconomic Environment (Annex II)

To assess the macroeconomic environment in Sri Lanka, JAA asked *SRI International* to review the country's economic and macroeconomic policies. The review gave Sri Lanka high marks for its macroeconomic policies. In general, the GOSL has done well, given the circumstances, in restraining budget deficits, controlling inflation, liberalizing the economy, moving towards more open trade policies and providing an overall framework for private sector development.

Microeconomic Environment (Annex III and Exhibit 12)

JAA also asked SRI International to review the microeconomic environment, including a comparative review of Sri Lanka's commercial policies relative to other countries. This analysis revealed a more mixed picture. On the one hand, Sri Lanka aggressively uses incentives to encourage investment and exports, and many of these incentives are attractive relative to those offered by other countries. On the other hand, other policies are not as attractive as those of some of the leading countries, such as Singapore and Ireland. There are also some severe deficiencies in the areas of human resources and infrastructure. While literacy is quite high, the private sector needs people fluent in English, with appropriate technical and management skills. Transport and energy constraints are keenly felt. Continued state involvement in the plantation and banking sectors acts as a brake on further competitiveness. On the other hand, the recent liberalization of shipping has reduced the transit time of Sri Lanka's textile exports from 31 days to 19 days, although complaints continue regarding port charges and procedures. Labor relations and regulation continue to be controversial, especially when related to strikes, holidays, productivity-based remuneration and procedures for terminating employment.

Overview of Current Sri Lankan Exports (Exhibit 13)

Analysis of the value added content of Sri Lankan exports reveals the strategic importance of garments and tea in Sri Lanka's exports. In importance these are followed by industrial products, gems and processed diamonds, agricultural products and rubber.

Tea 'Something Brewing' (Exhibit 14)

Approximately half (by value) of Sri Lanka's tea exports are in bulk form, and packeted tea has remained constant at about 40% of export values. However, 10% of exports are now accounted for by tea bags and instant tea, providing one example of Sri Lanka's slowly emerging competitiveness. Sri Lanka has one exporter, who has established a national brand that now has acceptance in the market place. The industry is divided on the wisdom of allowing the importation and blending of tea. While this might allow processors and exporters to expand their market share and offer wider variety, producers fear they will be hurt by imported substitutes and a few exporters fear the dilution of the pure Ceylon image. This is a key competitive issue that requires objective analysis. Future dynamism in this sector will not come from expansion in plantings or land area, so new sources of capturing value will come from adding product features, specialization, adding value, pursuing specific niches and exporting tea-related service features.

Rubber Bouncing Beyond the Basics (Exhibit 15)

The rubber industry provides an example of a more rapid emergence into competitive performance. Starting in 1991, exports of manufactured products based on rubber began a rapid growth and have outstripped export values of basic rubber products. Instead of exporting just block rubber, latex or even crepe, firms now export more complex products such as surgical gloves and pure rubber mattresses that are known for their superior characteristics vis-a-vis foam mattresses. Sri Lanka has about 2% of the global market for basic rubber and is a price taker subject to price swings. However, it now has 15% of the world market for solid rubber specialty tires used for heavy construction and other equipment. The upgrading of the rubber export industry would appear to be a Sri Lankan success story.

Gem Industry The Lost Jewels (Exhibit 16)

Although Sri Lanka has a long tradition of jewelry craftsmanship and is a leading supplier of sapphires, star sapphires, rubies and other gems, the diamond cutting and jewelry export industry has never taken off in Sri Lanka. The restriction on the import of gold and gems for many years inhibited the development of this industry, while countries in which such imports were allowed (Hong Kong, Thailand) experienced a rapid rise in jobs and exports. Although policies have changed recently, change has come at a time when other countries already have an established presence in the market and when the Asian crisis has severely dampened the demand. As a result, Sri Lanka has relied far too heavily on the export of gems. Another issue that has deterred at least one high-end manufacturer from sourcing jewelry production in Sri Lanka has been the lack of protection for intellectual property rights, including jewelry design. Meanwhile, high-end companies like *Bulgari*, *Cartier* and *Tiffany* continued to source gems from Sri Lanka.

Apparel Naked Before the Storm⁹ (Exhibit 17)

Approximately one-third of total industrial value added in Sri Lanka now comes from the apparel industry. The industry has also been the leading export and a leading source of new foreign investment and new jobs. Much of the growth in exports, jobs and investment has come from this sector. The early competitive strategy was based on quotas, incentives, competitive labor costs and free trade zones. In 1997 about 70% of textile exports went out under quota. Industry experts in Sri Lanka estimated that about 40-50% of the industry would be competitive without quotas today. But even if all companies survive, where will future growth in investment, exports and jobs come from? Even a flattening of the growth curve in apparel would affect future performance. The garment industry in Sri Lanka is nervous but is asking the right questions. The industry needs to understand more profoundly what it will have to be doing to survive after 2005 and whether it is doing the right things today to move in that direction.

Tourism Venturing Forth? (Exhibit 18)

Although ethnic conflict is partly to blame for stunting the growth of tourism, local firms must take a look at their strategies if they are to improve their performance in the future. While the numbers of arrivals are only now reaching levels prior to the outbreak of conflict, this does not explain the low value of \$58 per tourist that the country is currently receiving. The strategy has so far been based on undifferentiated "sun-and-sand tourism" through intermediary channels of tourism packagers abroad, who are relied on to provide volume to fill hotels. Nonetheless, the theme of slowly emerging competitiveness is repeated in this industry as entrepreneurs begin to convert tea factories to hotels and to promote eco-tourism and cultural tourism. The industry still lacks intimate knowledge of relevant consumer segments and the ability to package and market a set of services that will attract high income tourists. The industry has over-relied on government incentives, but is demonstrating an interest in taking greater control over its future by proposing a private sector-led tourism promotion body.

Toy Story

Sri Lanka entered the export markets for wooden and cloth toys, the latter being more attractive and commanding higher values. In both instances, a large initial champion was important in creating these opportunities, which were then emulated by many other firms that entered the business. As the cluster developed, supporting industries also developed. The stories of two companies reveal a compelling message. One of the larger firms positioned itself as an order-taker, executing designs and producing toys to order for international manufacturers. At one point it had more orders than it could fill. Later there was a downturn in orders and the company sought to lay off some workers. This created further problems and eventually the company went bankrupt. Another toy exporter decided to have a presence in New York and to follow the latest toy designs, even introducing new designs in the process. This exporter is still in business. The former company relied on basic factors (cost-based production) and performed a back office

function while the latter company has sought to move closer to the consumer and to innovate so as to capture more of the front office value

Electronics Unplugged

Despite efforts to attract investment in the electronic assembly sector, the industry has not taken off. The story is often told of the selection of Sri Lanka by *Motorola* and *Harris* as a base for their operations. Ethnic conflict caused them to go elsewhere and they established themselves in Malaysia. The industry was “unplugged” and has never “reconnected”, despite the presence of 12 export-oriented firms, some of which produce sophisticated products. The example of Harris and Motorola is unfortunate, but somehow fails to convince. It does not explain the lack of success in subsequent years. A site visit to the Kandy free trade zone illustrates the continued deficiency of infrastructure that hampers the operations of the companies there.

Software

The emerging software industry in Sri Lanka has shown a remarkable ability to create new products, such as the clearing software for the Colombo Stock Exchange (subsequently exported to two other countries) and software related to port clearance. However, the industry is struggling to gain a presence and recognition in the US market, where credibility and presence could lead to an expansion of high-value software products. There is shortage not only of programmers but more critically of project managers and this inhibits the potential expansion of the industry.

Service Exports (Exhibit 19)

Sri Lanka has the potential to move beyond the export of agriculture and manufactured goods to export services. It already exports labor and receives remittances. But the opportunities for exporting services without having to suffer exile is even more compelling and ultimately far more attractive for the country. Global service exports currently represent \$230B per year with projected growth rates of 15-20% annually. Of this amount, developing countries are already exporting about \$33B per year in software development, information processing, data entry and computer-aided design. A typical recent investment used \$2M to install a satellite-connected earth station, a PBX and 600 telephones. It employed 1,800 people and generated anywhere between \$12-18M in export revenues depending on the types of services exported.

Sri Lanka's Skills are Transferable (Exhibit 20)

There is considerable experience in Sri Lanka in establishing industrial parks, managing a labor force, producing on a timely basis, satisfying customers, controlling quality, gaining client loyalty and finding buyers. These are all skills transferable from industrial parks to knowledge parks and from manufacturing to knowledge-based exports. Furthermore, it is

an investment in people. It offers a potential solution to the problem posed by the expiration of garment quotas.

IV CREATING A COMMON VISION FOR THE FUTURE

Moving Sri Lanka from the “Back Office” to the “Front Office”

The key conclusion of this exercise is that Sri Lanka is slowly moving from the “back office” to the “front office” in its competitiveness strategy. This is a theme repeated in industry after industry. An illustration will help explain the underlying conclusion. Hearing that Sri Lanka was the world’s quality location for sapphires, the Team Leader went to a jewelry shop while in Colombo. After negotiating the price, he bought a set of sapphire earrings and a pendant to take back home to his wife. The money made in that transaction was made by the owner and by the salesperson in the front office on the basis of the value created in the mind of the buyer. Meanwhile, the remuneration paid to the artisan in the back office workshop was not based on the value extracted from the buyer but on the prevailing wage rates for artisans in Colombo. The artisan surely made much less in the deal.

Examples of Sri Lanka’s Slow Emergence from the Back Office

In the global market, Sri Lanka is like the artisan in the above story, who has slowly awakened to the potential value of his work and is now seeking to move to capture some of the front office value. Not content with exporting bulk tea for offshore blending, companies are beginning to develop new products and create a brand name. Not content to export basic rubber, companies are creating more complex and sophisticated products. Not happy with sun-and-sand tourism, some companies are struggling to move upscale and closer to more demanding customers. Not content to provide toys per specification, some companies are closely following design trends. Ceramics companies are exporting sophisticated products. Software companies are developing with unique offerings.

Competitiveness Will Require More Sophisticated Company Strategies

There is no law that says Sri Lanka must be relegated to the role of back office supplier. Moving beyond this will require better company strategies based on customer learning, market intelligence, competitive positioning, constant innovation and upgrading of skills.

Competitiveness Also Requires Industry Leadership

Industry associations can play a role to assist member companies in getting access to information and in fostering appropriate dialogue. This will require a common vision and a coherent industry strategy. Industry associations can do much to promote

competitiveness But this will require investing in better analytical and support capabilities

Competitiveness Requires Effective Dialogue (Exhibit 21)

J E Austin Associates has kept a catalogue of effective and ineffective approaches to private and public sector dialogue from its 360 projects in 72 countries From this it has found that ineffective dialogue is characterized by individual companies approaching government with ad-hoc complaints involving problems at the operational level Effective dialogue is characterized by industry-wide approaches with a comprehensive vision at the strategy level Ineffective dialogue focuses on concessions rather than co-responsibility Ineffective dialogue produces “laundry lists” of undifferentiated complaints based on anecdotal evidence Effective dialogue, however, approaches the government with a few key priorities based on good data, sound analysis, concrete proposals and estimates of the costs and benefits of implementation Ineffective dialogue is characterized by business, labor and government being on opposite sides of the table Effective dialogue is characterized by a realization that they are on the same side of the table and facing competitors “out there,” and not amongst each other

Can Sri Lanka Accelerate Its Competitiveness? (Exhibit 22)

The GOSL can only do “so much” to accelerate the emerging competitiveness of Sri Lanka Equal emphasis must be placed on the role of the private sector In the end, the country’s “competitiveness” will depend on thousands of companies understanding the true sources of their competitiveness and designing and implementing better strategies and operations In this effort, industry associations can do much to promote the tools of competitiveness and to create a common vision for the future competitiveness of their industry The GOSL can encourage this process by its openness to institutionalizing the dialogue process and by acting on initial high-priority areas Industry groups that move to create a strategic plan, gather market information, and understand the competitive position of their industry will most likely find willing collaborators, provided they themselves demonstrate financial commitment and ownership of the process

Two Views of Competitiveness

Dialogue is influenced by perceptions regarding competitiveness One view sees competitiveness as going after a fixed pie This is often the perception among those competing in mature markets for basic commodities It is also the view of those who must compete for the limited capacity to provide incentives Another view holds that competitiveness involves a growing pie It is associated with an ultimately unlimited potential to provide new products and services and create as well as receive value The latter view drives human progress and creates the basis for rapid increases in standards of living The former view sees little benefit from cooperation whereas the latter view thrives on it

Summary

To summarize, Sri Lanka has achieved excellent economic results over the past 20 years. However, the past drivers of that growth will not be sufficient for the future. Future competitiveness will depend less on government policies, incentives, quotas, and basic factors such as quality raw materials and low labor costs. It will depend far more on the quality of private sector strategy and industry leadership. It will also require more effective private-public dialogue. Finally, it will require better access to market intelligence, competitive positioning and technology. This will require forging a common consensus within the national leadership--perhaps the most difficult but most important task that Sri Lanka faces.

Exhibit 1

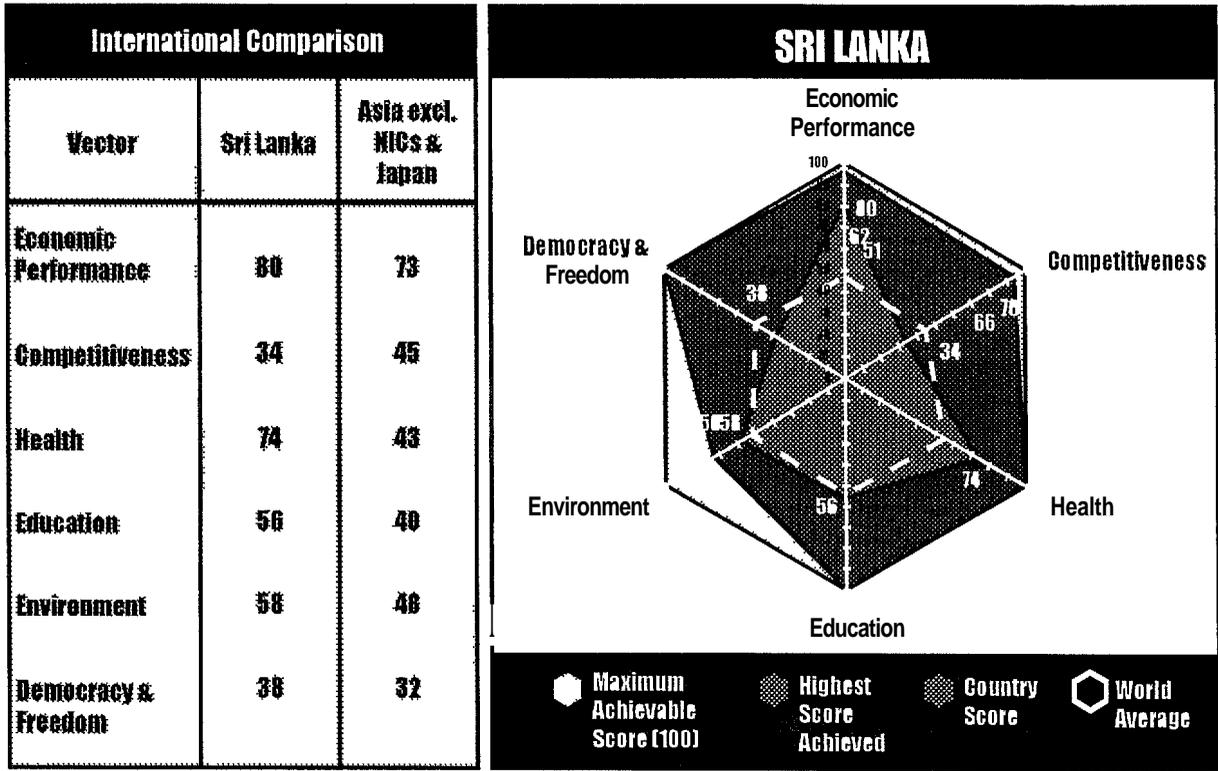


Exhibit 2

INVESTMENT/OUTPUT RATIO

<p>Bulgaria Russia Poland Switzerland France Japan Canada</p>	<p>Singapore China Thailand Botswana South Korea Hong Kong Indonesia SRI LANKA (5:1)</p>
<p>Haiti Sierra Leone Madagascar</p>	<p>Nepal Pakistan Myanmar Ghana Bangladesh Chad Uganda</p>
<p>171</p>	<p>61</p>
<p>20%</p>	<p>21</p>

GDI as % GDP

GDI/GDP as % GDP GROWTH

GNP PER CAPITA GROWTH = 85th percentile

SRI LANKA'S SCORE:	
GNP/Capita Growth:	3.3%
World Rank:	20/137 countries
Percentile Rank:	85th percentile
Suggested Benchmark:	4-6%

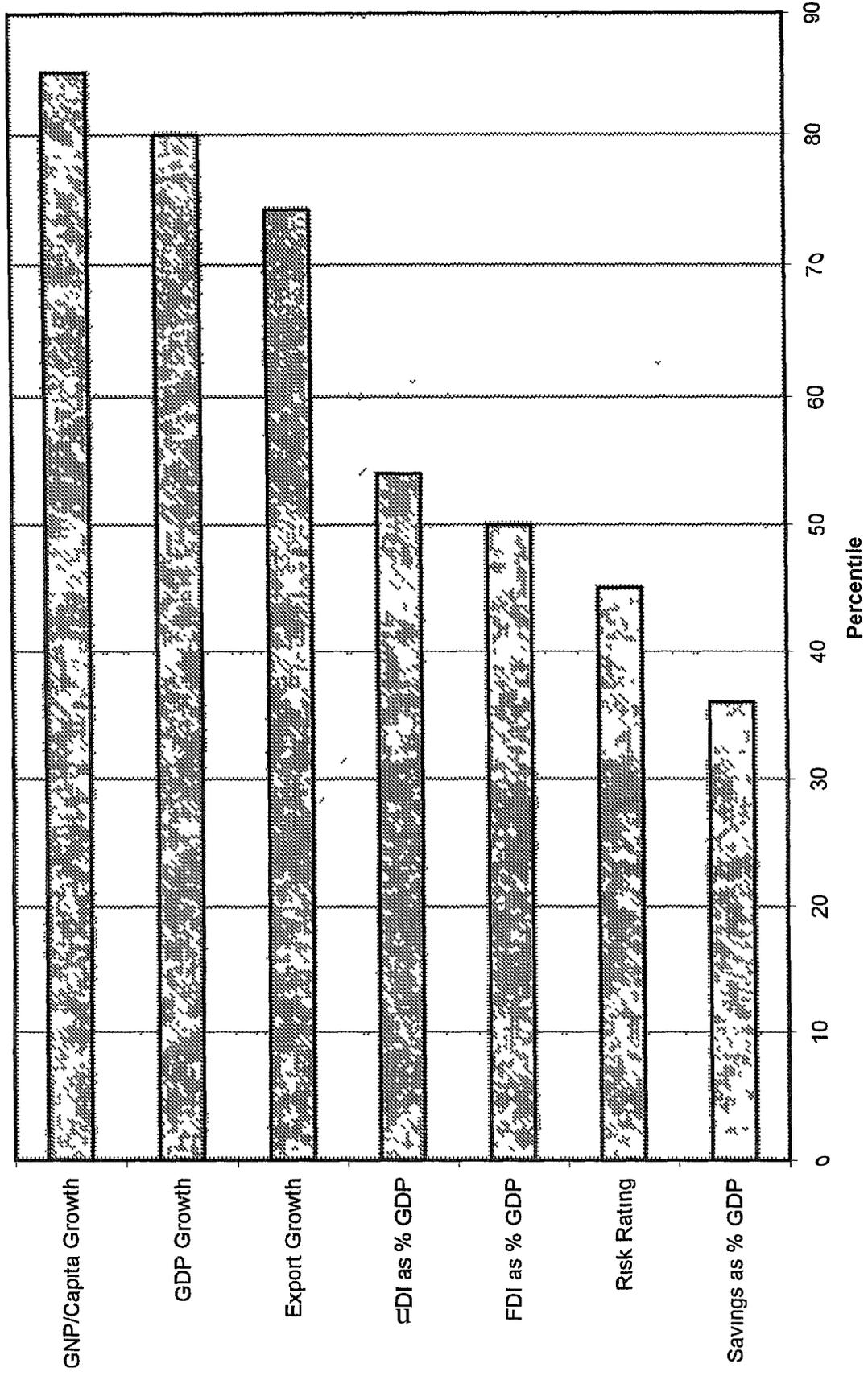
Country	%	Rank
South Korea	9.92	1
China	7.73	2
Cyprus	6.36	3
Malta	6.00	4
Cape Verde	5.95	5
Botswana	5.81	6
Singapore	5.78	7
Thailand	5.78	8
Antigua and Barbuda	5.47	9
Hong Kong	5.46	10
Bhutan	5.04	11
Indonesia	4.97	12
St Kitts and Nevis	4.91	13
Suriname	4.78	14
Oman	4.42	15
Malaysia	4.32	16
St Vincent & Gren	3.89	17
Egypt, Arab Rep	3.53	18
Mauritius	3.37	19
Sri Lanka	3.32	20

Note figures represent 1975-1995 annual average

Source World Development Indicators 1997 World Bank

Exhibit 4

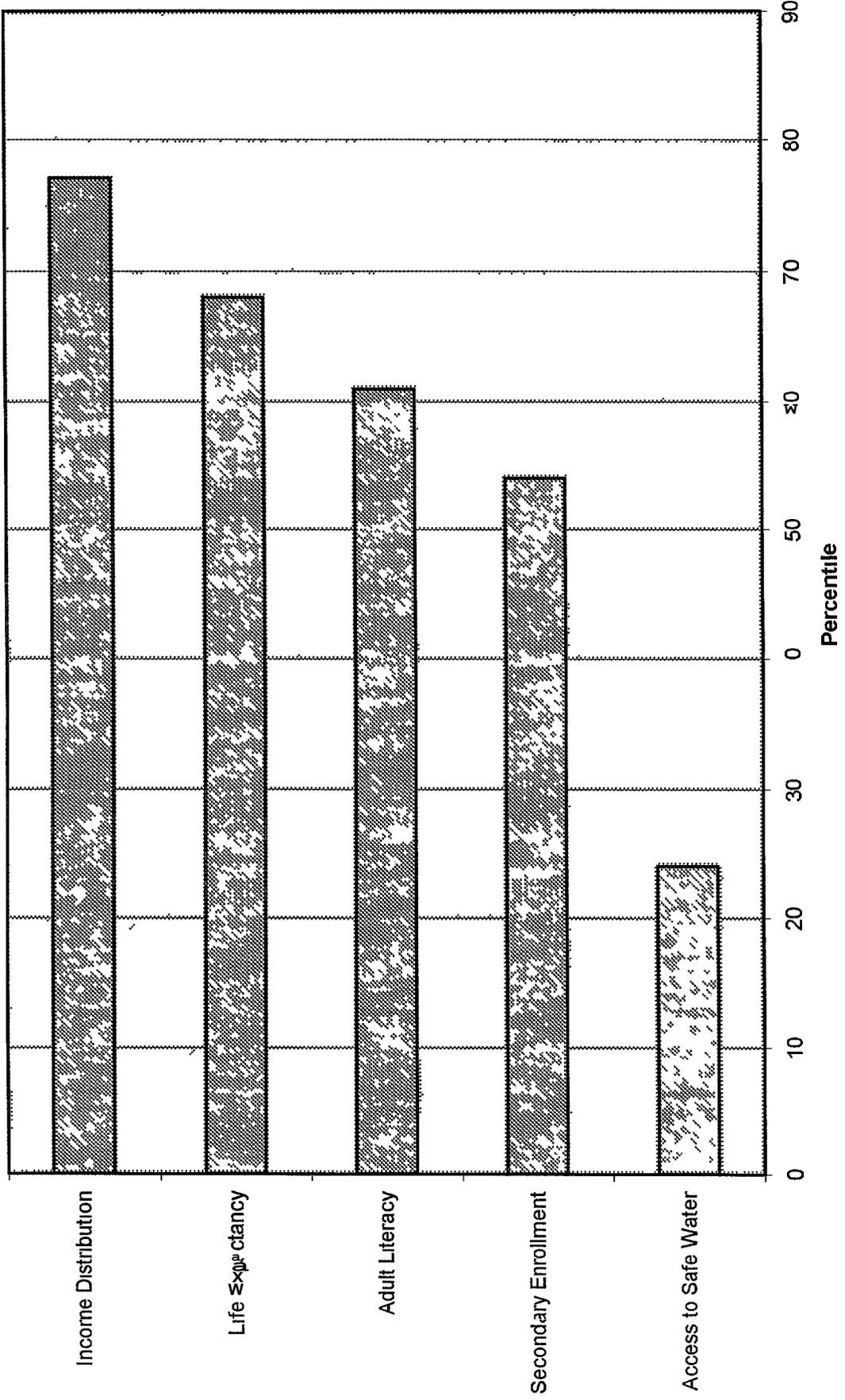
Sri Lanka Percentile Rankings: Economic Achievement



Source: J E Austin Associates 1998. Note: data based on Sri Lanka vs. performance in selected indicators over 20-year period.

Exhibit 5

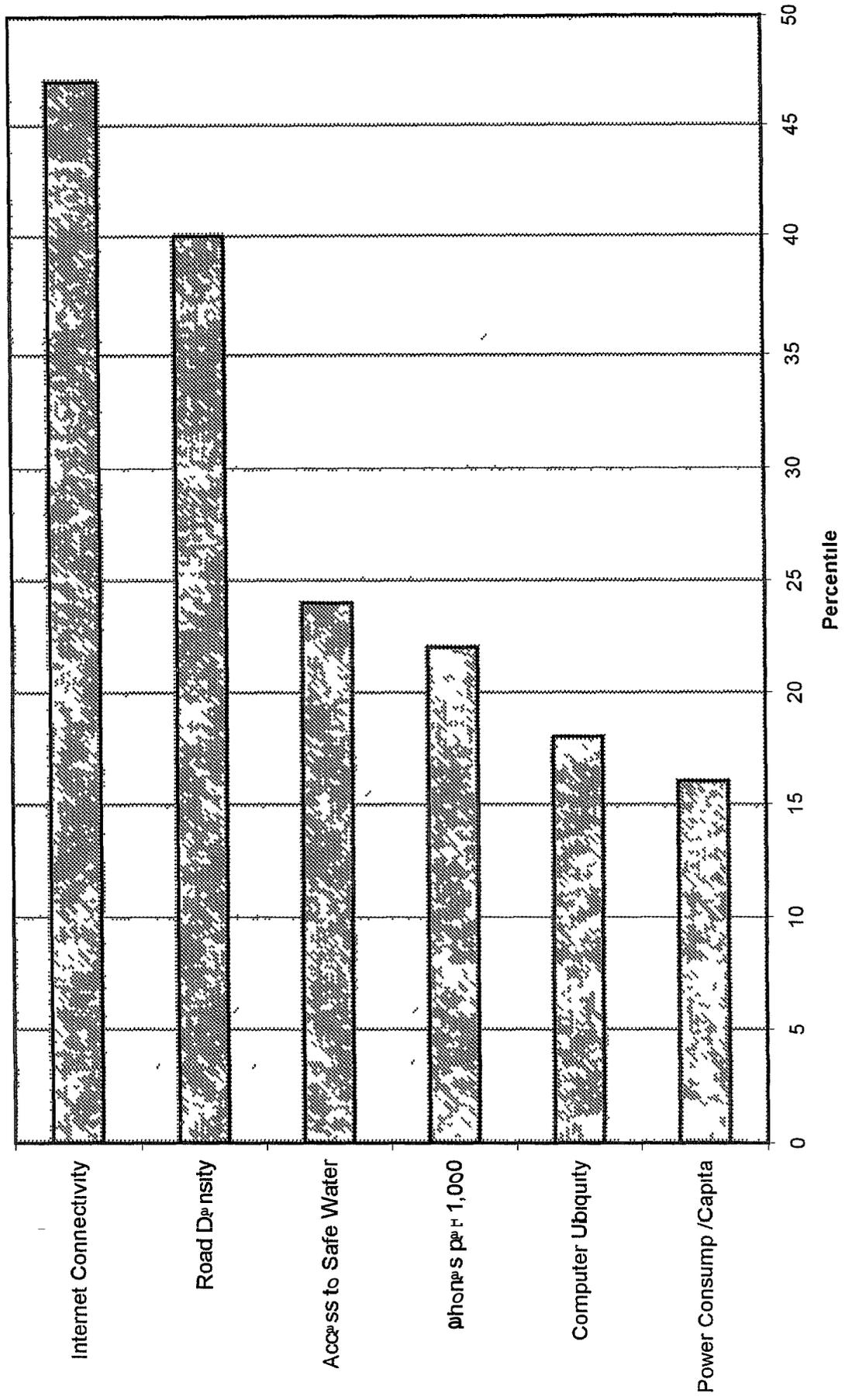
Sri Lanka Percentile Rankings Human Resources



W

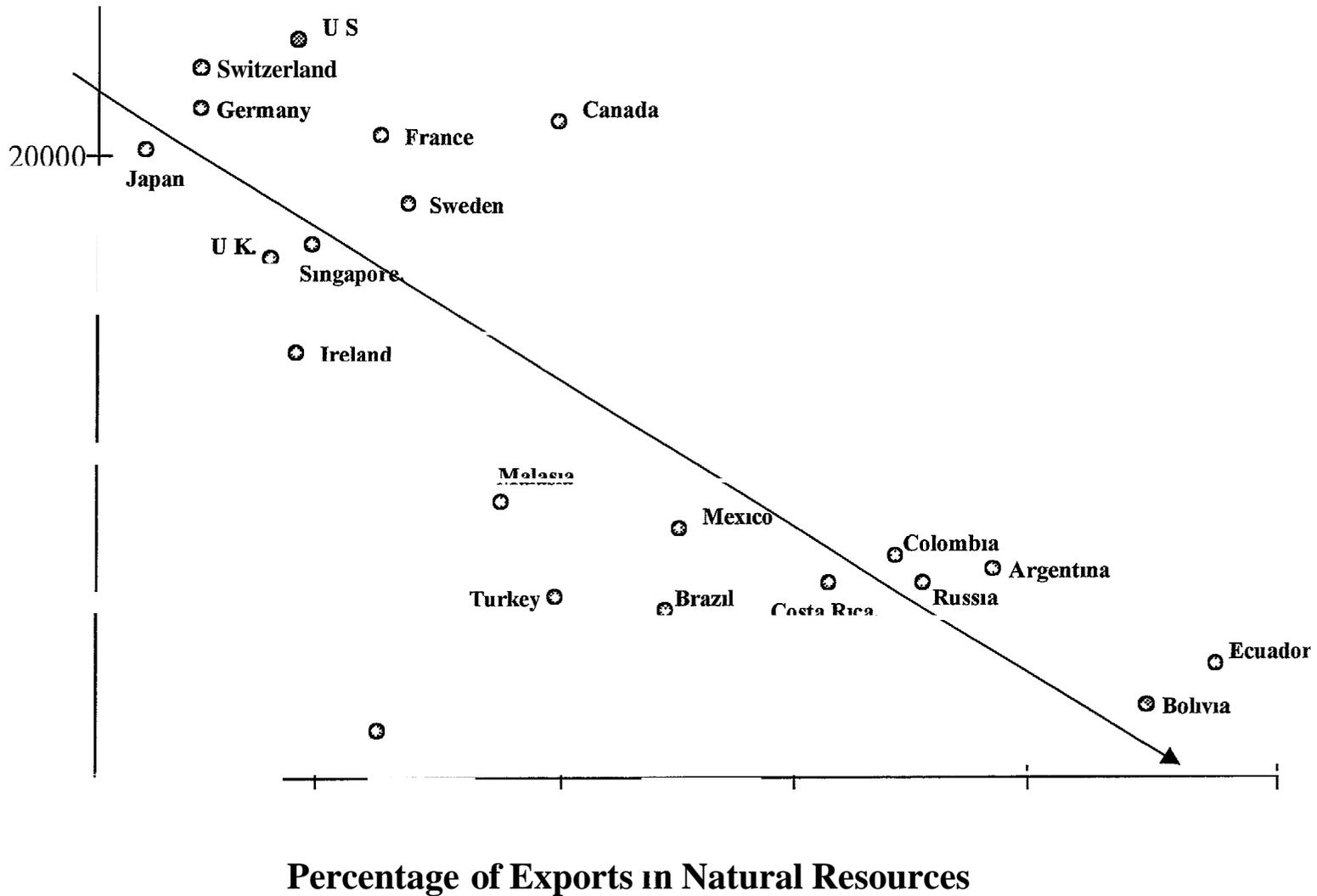
Exhibit 6

Sri Lanka Percentile Rankings. Physical Infrastructure



Relationship Between Natural Resource Exports and Wealth

Percentage Of Nation's Exports In Natural Resources Versus Purchasing Power Parity (PPP) Per Capita, 1992



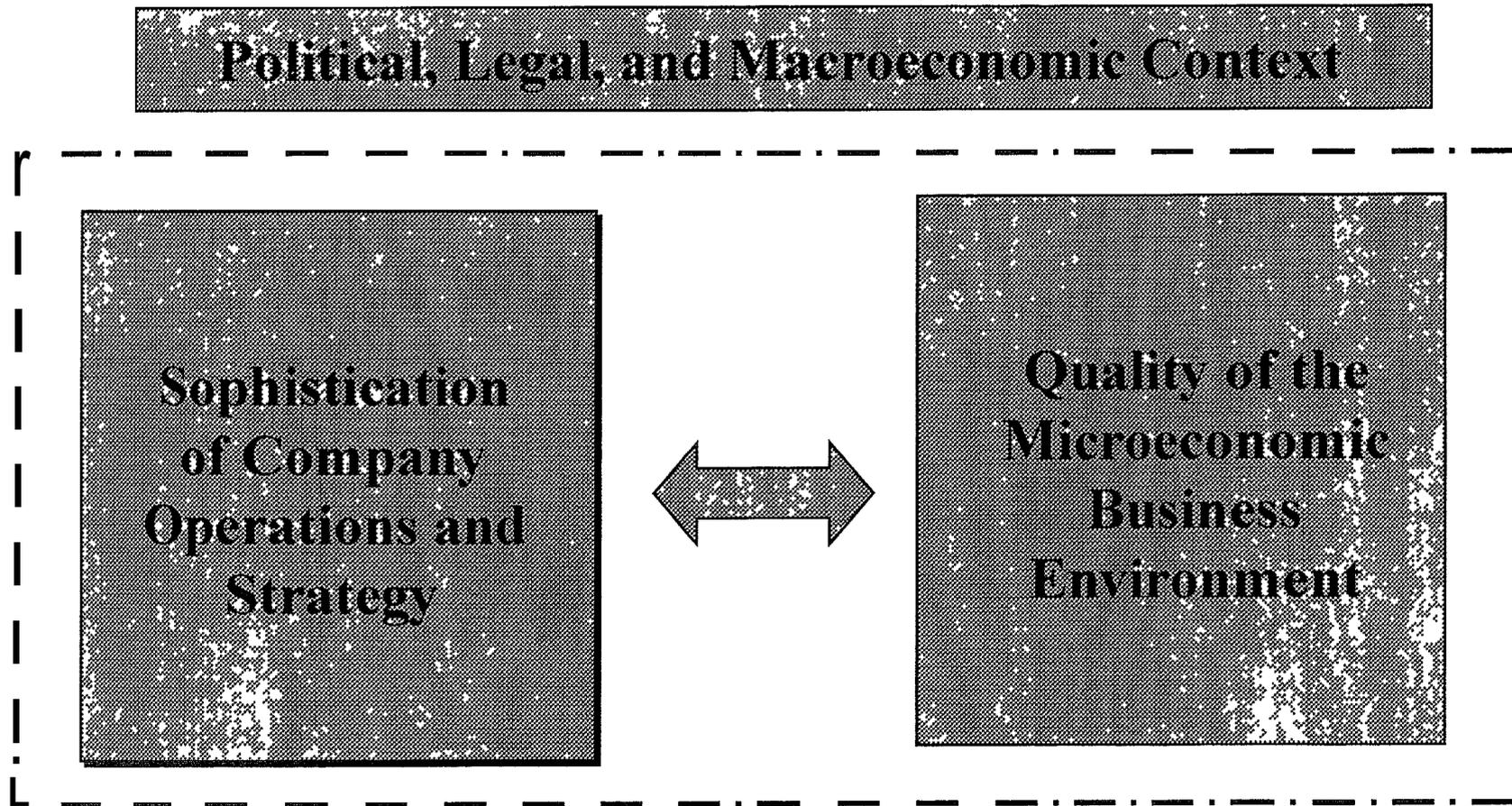
Source Monitor Company, 1998

36

SUN AND SAND TOURISM

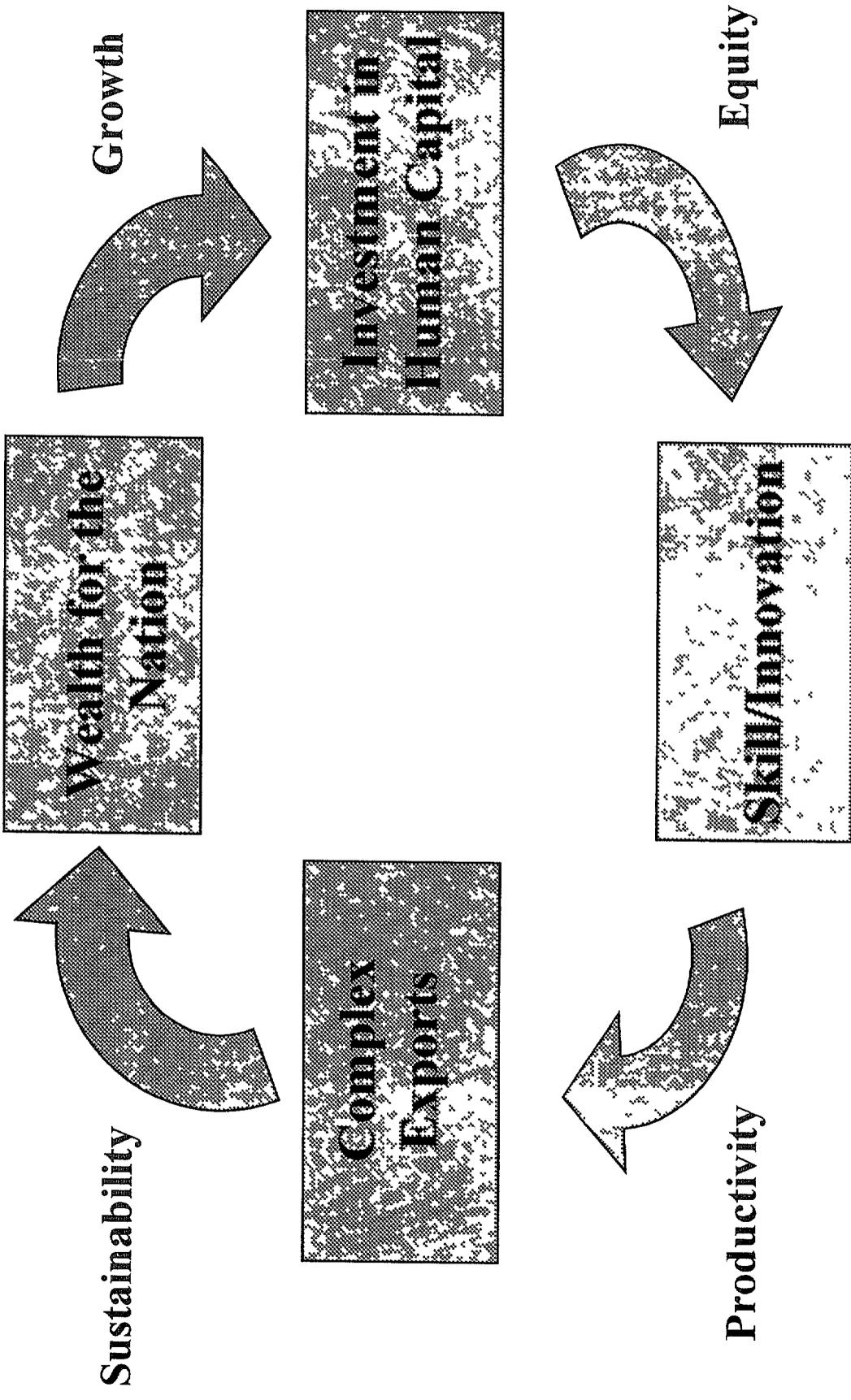
- \$58/day per tourist in Sri Lanka
- Dependent on charter operators
- Struggles to manage image
- Easily replicable strategy
- OECD tastes evolving beyond this

THE NEW COMPETITIVENESS PARADIGM



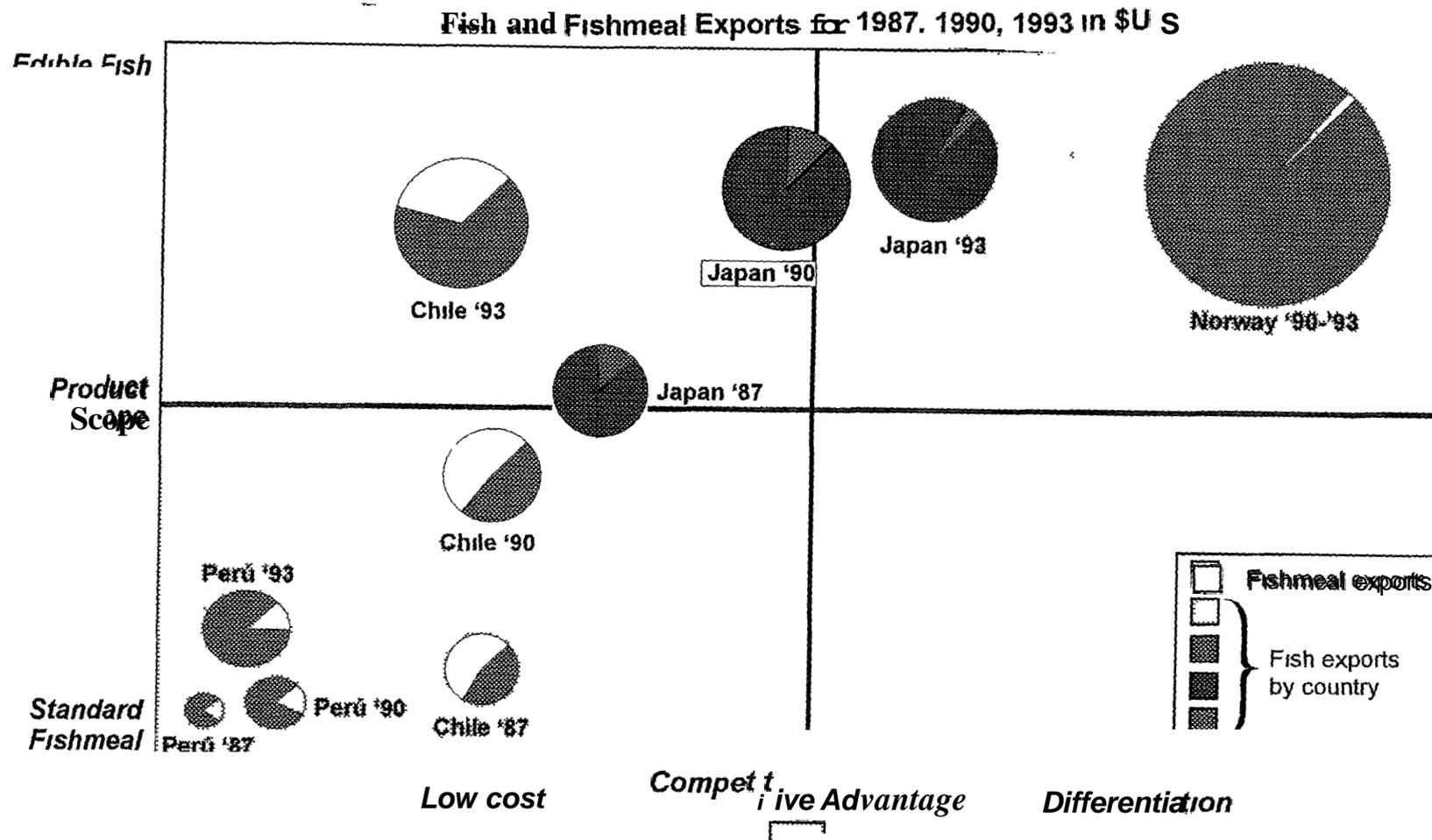
Microeconomic Foundations

GROWTH AND EQUITY: THE VIRTUOUS CYCLE



Strategic Choice Positioning in the Fish Industry

PRELIMINARY



While Peruvian manufacturers are very competitive within the fishmeal segment, other producers have increased total fish export volume by migrating toward more edible fish production

SOURCES UNITED NATIONS TRADE STATISTICS, NATIONAL MARINE FISHERIES SERVICE
 MANEDSSTATITIKK OVER UTENRIKSHANDELEN MONITOR ANALYSIS

USAID 198

= \$1 Billion in Total Fish Exports

Copyright © 1997 Monitor Company Inc. — Confidential — THE/BNK

8

COMMERCIAL POLICY ASSESSMENT: SRI LANKA

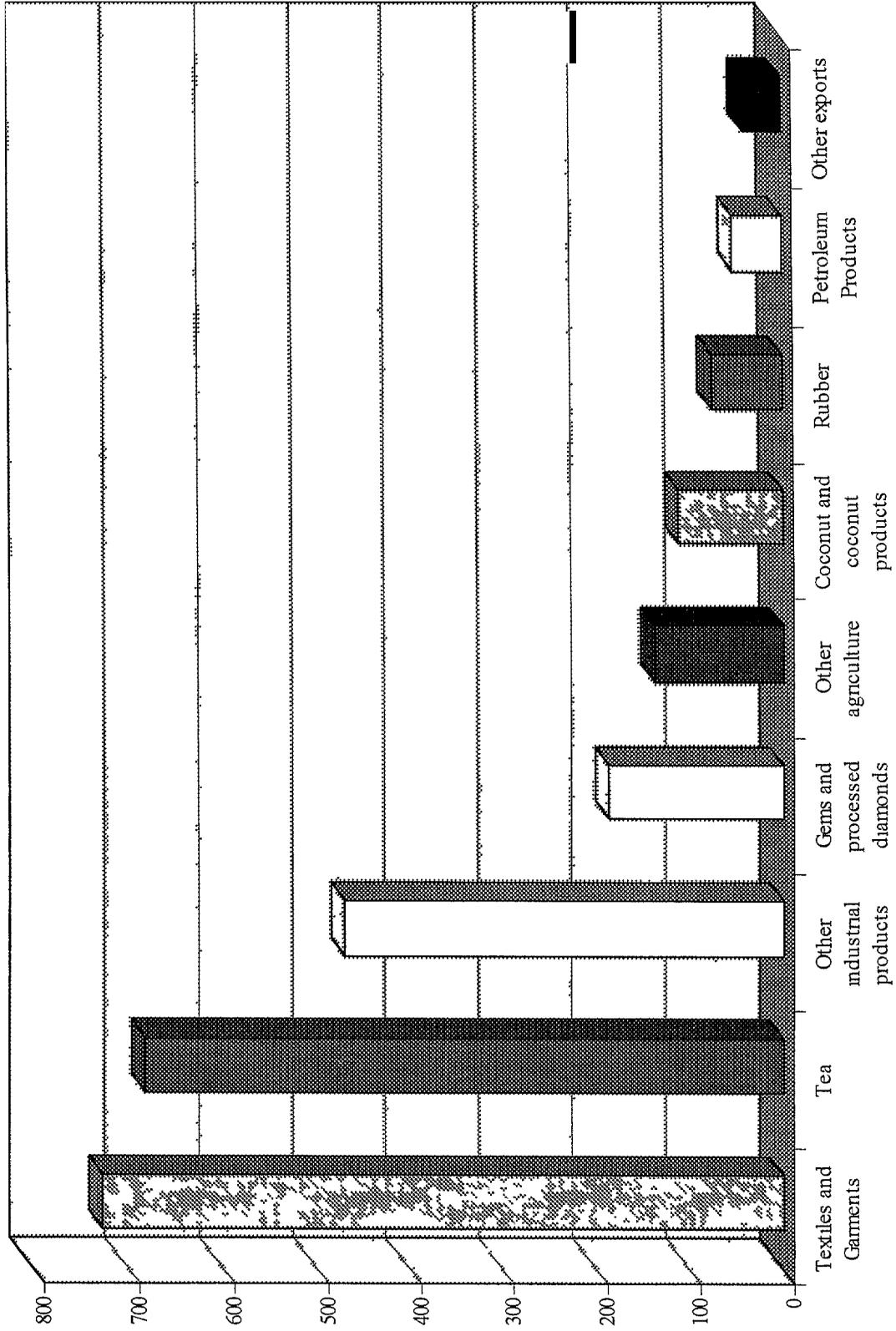
Policy Category	Sri Lanka	Maximum
1 FDI Restrictions	8	8
2 Investment Incentives	7	8
3 Export Policies	7	8
4 Business Start-up	6	8
5 Import Policies	12	16
6 Foreign Exchange	12	16
7 Tax Policies	8	16
8 Pricing/Interest Rates	6	12
9 Labor Policies	4	8
TOTAL SCORE	70	100



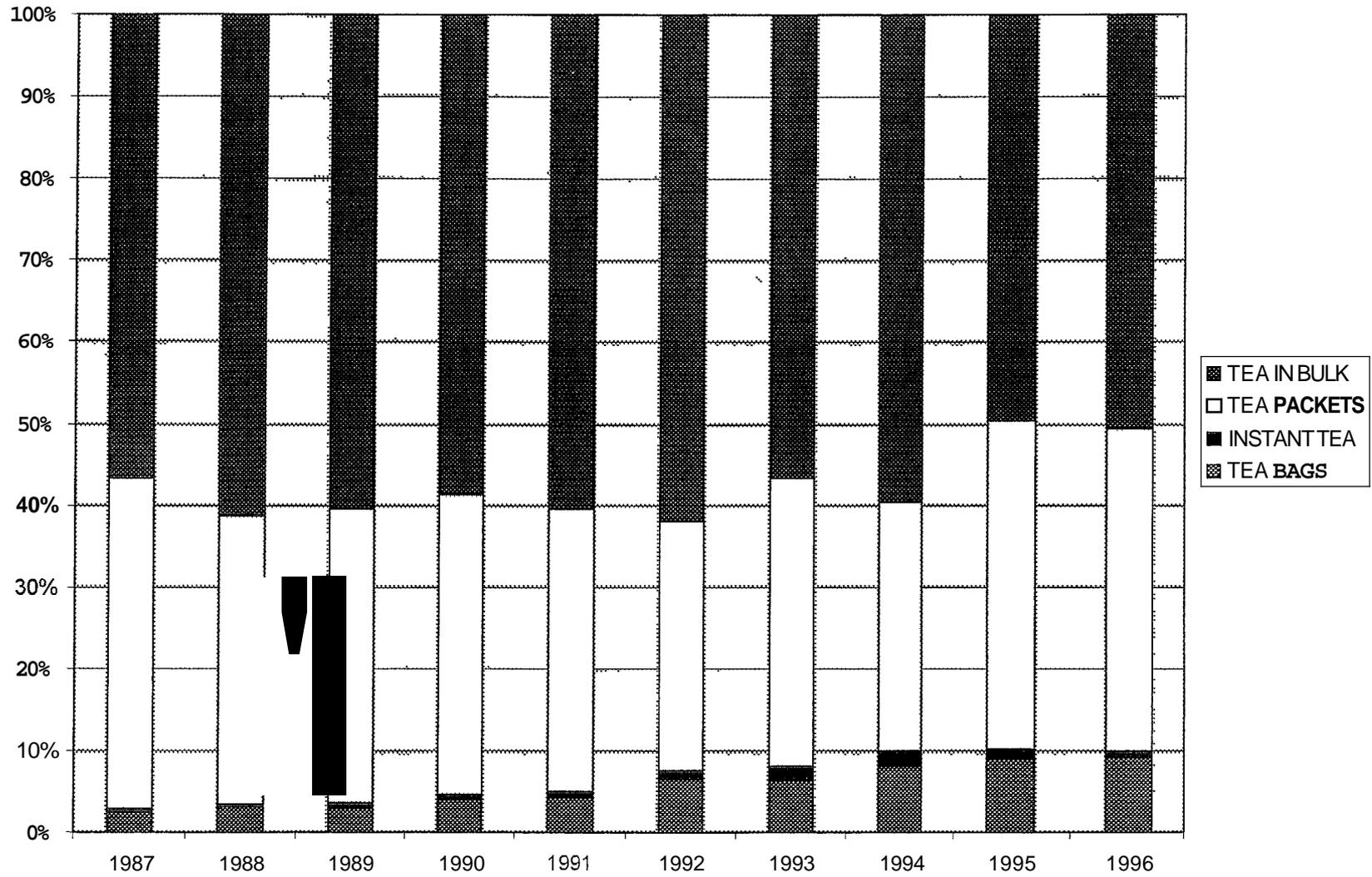
Considerable policy improvement in Sri Lanka due to recent reforms

Source SRI International, Commercial Policy Model, 1998

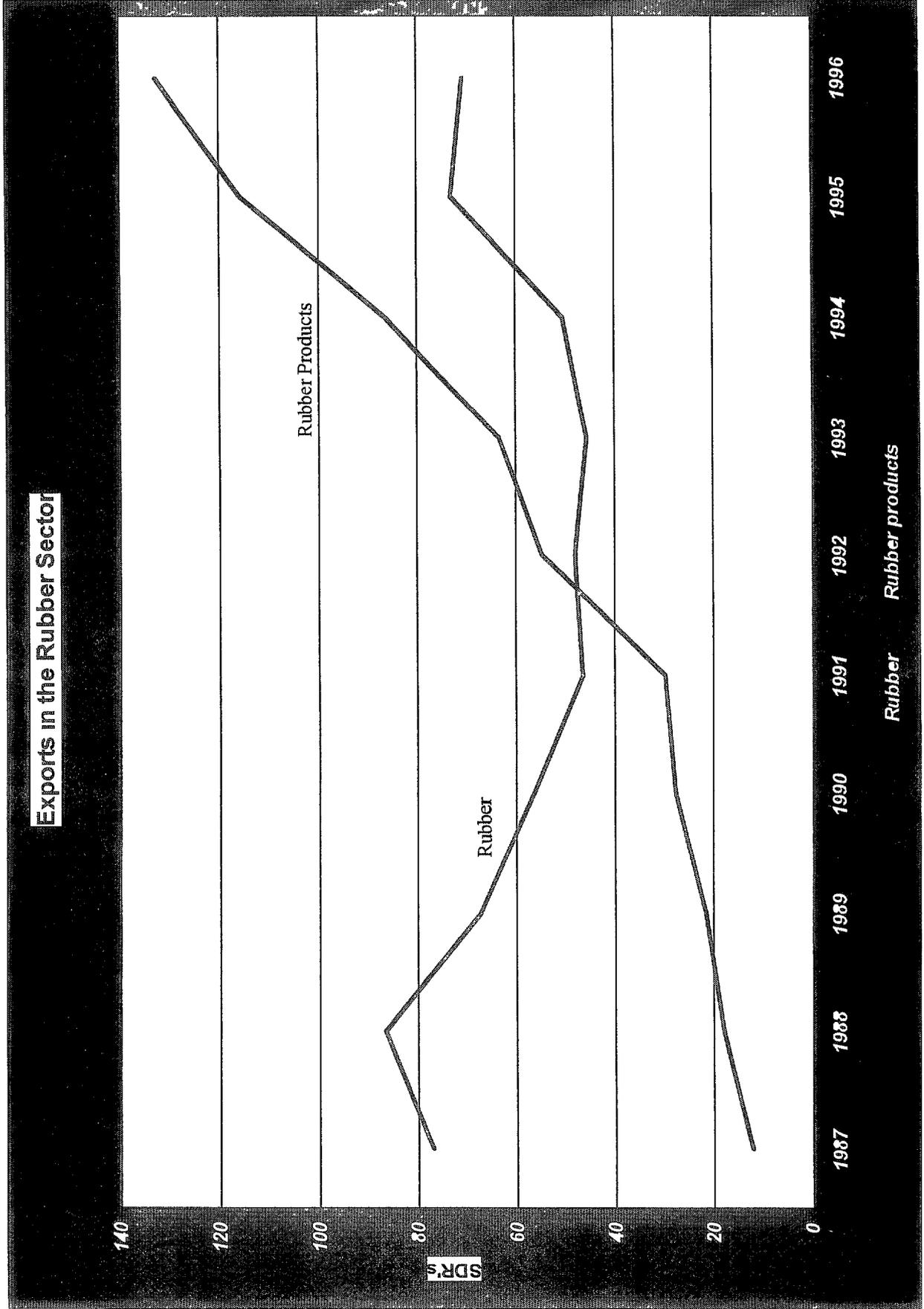
VALUE COMPONENT OF SRI LANKAN EXPORTS



EXPORT OF TEA BY PRODUCT CATEGORY

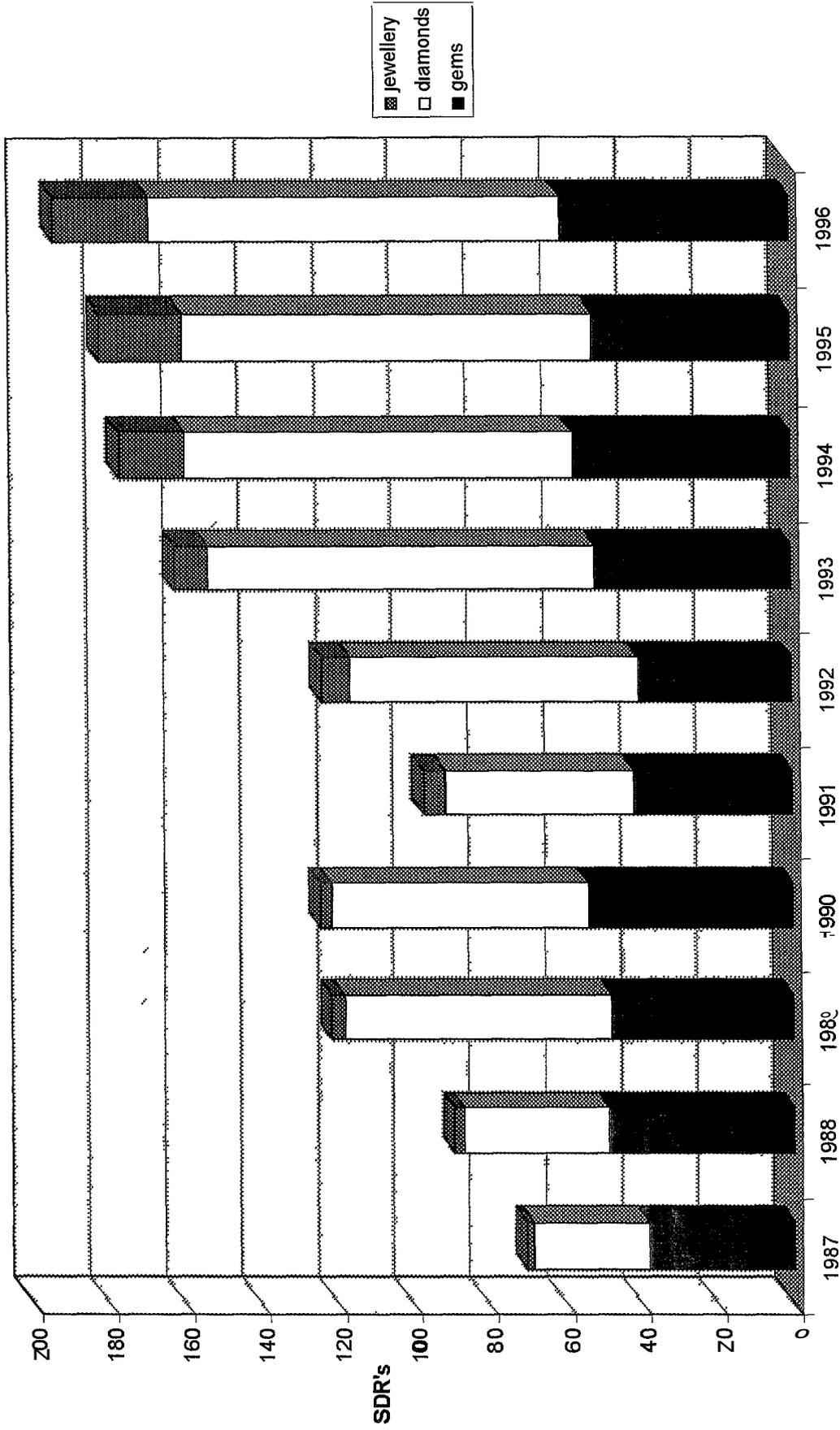


43

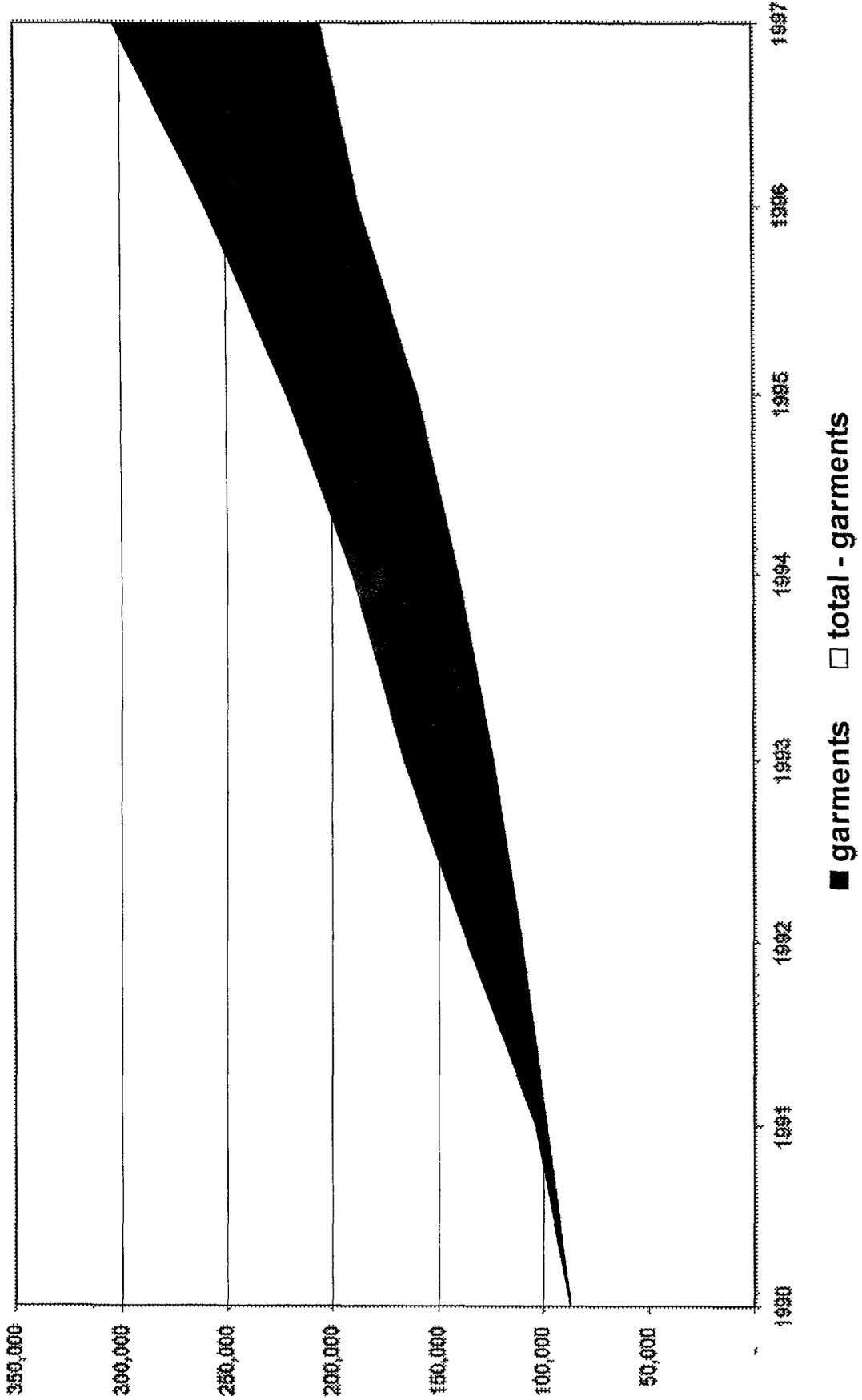


5/18

Exports in Gem and Jewellery Sector



Industrial Production



Sri Lanka Vs. World Tourism Trends

Year	<u>World Total</u>		<u>South Asia</u>		<u>Sri Lanka</u>	
	mn	change	mn	change	th	change
1987					182 6	
1988	394		2 9		182 7	0% (trough)
1989	426	8Yo	3	3%	184 7	1Yo
1990	458	8Yo	3 2	7%	297 9	61Yo (recovery)
1991	463	1Yo	3 3	3%	317 7	7%
1992	502	8Yo	3 6	9Yo	393 7	24% (boom)
1993	518	3%	3 5	-3Yo	392 3	0Yo
1994	550	6Yo	3 9	11Yo	407 5	4% near peak
1995	564	3%	4 2	8Yo	403 1	-1Yo
1996	595	5%	4 4	5Yo	302 3	-25Yo (contraction)
1997	613	3%	4 6	5%	366 2	21Yo (recovery)

Sources: CTB Annual Statistical Report 1997, p 12, WTO South Asia 1998 Edition, p 2 & 28



Implication Strong recoveries in tourism in peaceful times

57

SERVICE EXPORT INDUSTRY

Software Development	\$141B
Information Processing	\$ 43B
Computer-Aided Design	\$ 44B
Data Entry	<u>\$ 1B</u>
Total:	\$230B
LDC Informatics Exports in '97 =	\$ 33B
Projected Growth Rate =	15-20%

JB

TRANSFERABLE SKILLS? TEXTILES SERVICES

Industrial Parks	==>	Knowledge Parks
Managing Labor	==>	Service Workers
On-Time Delivery	==>	Digital Delivery
Delivery/Specs	≡≡>	Delivery/Specs
Quality Control	==>	Quality Control
Client Loyalty	==>	Client Upgrading
Finding Buyers	==>	Finding End Users?

67

DIALOGUE WITH GOVERNMENT

INEFFECTIVE

Operational level ↔
Individual company ↔
Ad hoc complaints ↔
Concessions
Laundry lists
Opposite sides
Anecdotal evidence ↔

EFFECTIVE

Strategy level
Industry-wide
Comprehensive vision
Co - responsibility
Priorities
Same side of table
Data and analysis

50

COMPETITIVENESS

Better Private Sector Strategies
Calls for Industry Leadership
Needs Common and Coherent Vision
Requires Effective Dialogue
Will Take Coordinated Effort

ANNEX I:
BENCHMARKING SRI LANKA'S COMPETITIVENESS

I BENCHMARKING SRI LANKA'S COMPETITIVENESS

The following section presents a series of analyses that provide “snapshots” and benchmarks of Sri Lanka’s competitiveness. The annotated exhibits refer to the exhibits at the end of this Annex.

1.1 The Investment Quality (IQ) “Snapshot”

The chart in **Exhibit 5** presented at the end of this Annex reveals Sri Lanka’s position relative to the world with regard to investment quantity and quality over a 20-year time period¹. By definition, growth in GDP is equal to the level of investment multiplied by the ratio of incremental investment to output. On the one hand, Sri Lanka has escaped the South Asian trap of very low investment levels. It has also achieved very strong gross capital-output per unit of investment and this has remained stable over a 20-year, 10-year and 5-year period. However, Sri Lanka has not attained the combined levels of GDP growth and returns to investment achieved by high growth countries (especially the Asian “tiger” economies) over a 20-year period. While this is a very crude initial benchmark, it does provide a visual picture of Sri Lanka’s positioning as “above average” but not yet a “champion”.

The challenge for Sri Lanka will be whether it joins the ranks of the high-performing economies by improving both the quantity and quality of investment (upper right quadrant in the chart), or slips back to the performance levels of most South Asian countries (bottom right). This is an even more urgent question in light of the impending expiration of the Multi-Fibre Agreement and the East Asian crisis. Asian investment in export-oriented apparel industries has helped fuel Sri Lanka’s recent growth in exports and currently accounts for almost half of total exports from Sri Lanka. (It must be noted that there is large import content in these exports. Value added in the industry is between thirty to forty percent.)

Will Sri Lanka’s current competitiveness be sustained? The answer will depend on the underlying sources of competitiveness. How can competitiveness be measured? Where does Sri Lanka rank in the hierarchy of internationally competitive countries? What are the roles of the private and public sectors in achieving this? What benchmarks should be used? What really drives the emergence of competitive clusters of companies? Despite these pressing questions, there seems to be no visible institutional dialogue on this issue between the private and public sectors. It is hoped that this exercise may contribute to such a dialogue.

¹ Incremental capital output ratios were calculated by taking GDP growth divided by gross domestic fixed investment as a percentage of GDP over a multi-year period. It is preferable to use net investment rather than gross investment although the latter is often used for convenience. This is only a crude initial indicator and is meant for illustrative purposes only. GDP growth results from multiple factors including labor force growth and total factor productivity in addition to the level of investment. It is meant to offer an initial relative indicator.



1 2 Development Web Model

The second benchmarking exercise presents Sri Lanka's performance along 6 dimensions related to a broad variety of desirable development objectives. The "development web" and database were created by SRI International in response to the increasing interest expressed by the development community for a more comprehensive and balanced development measurement system. The model was designed to cover not only traditional indicators of economic development, but also variables which capture new factors that have emerged as important inputs to and outputs of the development process. SRI analyzed 48 different variables gathered for each of 108 countries. A full description of the variables, methodology, scoring system and findings of the Web Model, as well as in-depth analysis of Sri Lanka's performance, is presented in **Annex II**.

Out of the six indicators examined by the Web Model, Sri Lanka scored the highest in "economic performance" and "health". Out of a possible score of 100, Sri Lanka scored 80 in economic performance and 74 in health. Its high economic performance score was based on GNP per capita growth, investment and export growth, and strong foreign exchange reserves. Its score in health was the highest in Asia after the Newly Industrialized Countries (NICs) and Japan, based largely on strong performance in life expectancy and infant mortality.

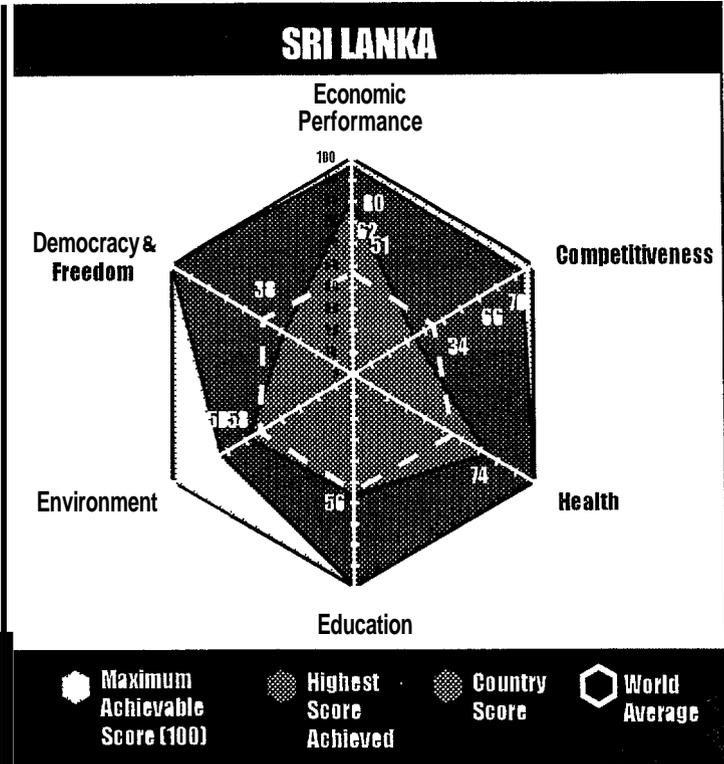
Sri Lanka scored slightly above the median in "education" and "environment," but higher than the non-NIC Asian average. Its educational performance (56 out of 100) reflects high literacy and school enrollment rates. Its better-than-average score for environment (58 out of 100) is primarily due to low levels of greenhouse gas emissions, yet still reflects lack of access to safe water and a high prevalence of industrial waste.

Sri Lanka is under-performing in the area of "democracy and freedom". With a score of only **38**, the current rating of the country is largely related to the ongoing ethnic conflict, a situation in which some civil liberties are restricted.

Sri Lanka scored well below average on "competitiveness foundations," with a score of only **34**. The competitiveness vector included indicators relating to domestic savings, openness of the economy, foreign direct investment, government budget deficits, country risk ratings, inflation, availability of scientists and engineers, foreign exchange policy, and infrastructure indicators. Poor indicators relating to budget deficits, inflation and infrastructure led to an indication of poor performance in this area.

The fact that one independent and objective source has rated Sri Lanka low on competitiveness is a cause for concern. In part, this may reflect the choice of indicators and the period covered. Comparative data for so many countries is only available with a lag time of **2-3** years and may not reflect the significant improvements recently implemented by the GOSL. In the long run, important overall economic, political and social objectives are dependent on the underlying competitiveness of the economy. The low scores provide further impetus to examine in-depth the competitiveness of Sri Lanka.

International Comparison		
Vector	Sri Lanka	Asia excl. NICs & Japan
Economic Performance	80	73
Competitiveness	34	45
Health	74	43
Education	56	40
Environment	58	48
Democracy & Freedom	38	32



SS

1.3 Benchmarks of Competitiveness

If private and public leaders wished to establish a benchmarking system to continually assess Sri Lanka's macro-level competitiveness, how might they go about this? To answer this question, the team selected 20 indicators often viewed as key to a country's competitiveness. The team then gathered information on all countries for which data was available. The top 20 scores for the top 20 countries were illustrated to provide a range of achievable performance over the sustained period of 20 years. The selection of 20 countries and a 20-year time horizon was made to demonstrate sustainable performance, hence credible benchmarks for excellent performance. The team gave Sri Lanka a percentile ranking based on its performance versus other countries in each of the 20 indicators. The 99th percentile would indicate the best performance while the 1st percentile would indicate the lowest performance. As in the case of the Web Model, many of Sri Lanka's indicators have improved in recent years and this is not fully reflected in current scores. The recent improvements are nonetheless captured in the other sections of this chapter. The purpose of the following exercise is to provide an objective and comparative review of Sri Lanka's relative performance over time.

Amongst all countries in the world, Sri Lanka ranks on average at the 52nd percentile for the 20 indicators included in the analysis. Strong scores for GDP growth, per capita income growth, export growth and investment quality were dragged down by very low scores in infrastructure. Although human resource indicators were well above average, Sri Lanka ranked low on access to safe water. A summary of Sri Lankan performance relative to benchmark indicators is presented in **Exhibit 1** to this Annex.

Sri Lanka ranks high, on the 85th percentile, for GNP growth per-capita over the 20 year period. This is the only benchmark in which Sri Lanka ranked amongst the top 20 countries worldwide with a per capita growth rate of 3.3% annually (**Exhibit 2**). This places Sri Lanka close to top-performing countries such as Mauritius and Malaysia. Sri Lanka ranks amongst the world's 20 fastest-growing economies in terms of per capita income growth between 1965-96, according to the World Bank.

Sri Lanka ranks slightly lower (80th percentile worldwide) for real GDP growth, which has averaged almost 5% annually since 1975 (**Exhibit 3**). This places Sri Lanka amongst the top 30 countries worldwide in terms of GDP growth and not far behind the suggested benchmark range of 5-7% annually.

Sri Lanka's investment rates, historically average, are approaching the benchmark range (**Exhibit 4**). Gross domestic investment (GDI) has averaged just under 24% of GDP over the last 20 years, ranking Sri Lanka in the 54th percentile worldwide. The target benchmark range, based on the performance of the top 20 performing countries, is 27-35% of GDP annually.

Sri Lanka has demonstrated very strong investment/output ratios over the last 20 years, averaging; about 5 units of investment for every unit of GDP growth (**Exhibit 5**). The

investment/output ratio is a crude measure of investment productivity, a critical driver of competitiveness. If Sri Lanka sustains this ratio of investment to GDP growth, it will have to invest about 35-40% of GDP annually in order to achieve a target growth rate of 7-8%

Domestic savings rates are very low (Exhibit 6) Gross domestic savings have averaged just 13.6% of GDP since 1975, ranking Sri Lanka in the 36th percentile worldwide. Savings rose to about 17% of GDP in 1996. The benchmark range based on the leading countries is 25-33% of GDP annually.

Foreign direct investment averaged under 1% of GDP (Exhibit 7) FDI has averaged under 1% of GDP over the last 20 years and over the last decade, ranking Sri Lanka in the 50th percentile worldwide. The target benchmark range, achieved by the top 20 performing countries, is 2-4% of GDP (or more) annually.

Private investment levels, as a percentage of GDP, have been strong over the last 5 years (Exhibit 8), averaging over 18% of GDP since 1993. This is well within the benchmark range of 15-20% of GDP achieved by the top performers worldwide.

Sri Lanka is considered a risky environment for investment (Exhibit 9) A recent survey by Euromoney gave Sri Lanka a credit-worthiness/risk rating of just 46.3 out of a possible 100 in terms of its overall environment for investment and private business, ranking Sri Lanka in the 45th percentile worldwide.

Sri Lankan exports have witnessed strong growth in value over the last 20 years, growing almost 10% annually and ranking Sri Lanka in the 74th percentile worldwide (Exhibit 10) The benchmark range is between 14-30% annually. This is a strong indicator of export competitiveness and value creation in key industries.

Life expectancy in Sri Lanka is high at 72 years, ranking Sri Lanka in the 68th percentile worldwide (Exhibit 11) This is a strong achievement, especially considering Sri Lanka's per capita income level. Amongst the top 20 countries worldwide, life expectancy averages between 76-79 years. Most of these top performers are OECD countries and Japan.

Some 90% of Sri Lanka's adult population is literate, ranking Sri Lanka in the 61st percentile worldwide (Exhibit 12) Amongst the top 20 countries, literacy rates average between 98-100%. Universal primary education and high primary enrollment and completion rates account for Sri Lanka's highly literate population.

Secondary enrollment rates are less favorable at 74%, ranking Sri Lanka in only the 54th percentile worldwide (Exhibit 13) The target benchmark range is 90-100%. Improvement in secondary and higher education is critical to ensure that Sri Lanka's population has the more advanced skills necessary to meet the needs of business.

Access to safe water in Sri Lanka is severely restricted, available to just over half of the country's population (Exhibit 14) This places Sri Lanka in only the 24th percentile worldwide. This is a serious infrastructure problem with strong implications for sustainable human development.

Income appears rather broadly distributed in Sri Lanka (Exhibit 15) Sri Lanka has a GINI index of 30.1, ranking the country in the 77th percentile worldwide. The benchmark range for countries with the least inequality is 19-30, with scores closest to zero reflecting greater income equality. Strong GNP per capita growth over the last 20 years has, in part, contributed to a more favorable distribution of income in a number of Asian countries, dispelling the myth about the supposed trade-off between growth and equity.

Access to telecommunications infrastructure for the 20-year period placed Sri Lanka at the 22nd percentile (Exhibit 16) However, there has been a dramatic rise in the number of landlines, mobile, cellular and wireless connections over the last few years.

Access to computers is limited with only 3.3 personal computers per 1,000 people (Exhibit 17) This places Sri Lanka in only the 18th percentile worldwide in terms of computer ubiquity. The benchmark range for the top 20 countries is 150-350 computers per 1,000.

Internet connectivity is very low at just 0.33 Internet hosts per 10,000 people, but Sri Lanka ranks in the 47th percentile, higher than many other countries (Exhibit 18) The benchmark range, based on the top 20 countries worldwide, is between 80-400 Internet hosts per 10,000 people.

Electricity consumption per capita is low at only 208 kWh (compared to over 5,000 kWh per capita amongst the top 20 countries), ranking Sri Lanka in only the 16th percentile worldwide (Exhibit 19)

Sri Lanka's road infrastructure is underdeveloped (Exhibit 20) Road density in Sri Lanka in 1992, the latest year for which data was available, was 536 km/million, ranking Sri Lanka below average in just the 40th percentile worldwide.

In addition to gathering its own data on the 20 benchmarks presented above, the team collected and calculated percentile scores for Sri Lanka from the sources below.

The Commercial Policy Assessment of Sri Lanka undertaken by SRI International (Exhibit 21) ranked Sri Lanka 24th out of 70 countries surveyed, equivalent to a 66th percentile ranking. This was a considerable improvement from Sri Lanka's overall policy score in 1995 (52 out of 100) according to the same SRI survey². This gives some idea of the achievements of the GOSL in introducing policy reforms, achievements that are noticed in international assessments.

² Sri Lanka's Commercial Policy Environment² based on data and findings from SRI's Commercial Policy Model, SRI International July 1998.

Sri Lanka ranks in the 47th percentile in terms of its “economic freedom”, according to the Fraser Institute in Canada, a leading economic policy group³ This ranking was based on performance between 1993-95 in a number of areas, including regulatory environment, money and inflation, taxes and exchange rates **As** the data is based on 1993-95 performance, the Fraser survey does not capture the full impact of more recent policy reforms and thus may understate Sri Lankan performance In ordinal rankings, the country was 54 out of 102 countries analyzed

A similar recent survey conducted by the Heritage Foundation ranked Sri Lanka much higher at the 74th percentile (37 out of 140 countries) in terms of its “economic freedom” and the quality of its overall policy environment (Exhibit 22)⁴ Sri Lanka’s percentile ranking is considerably higher in the Heritage survey than the Fraser survey due to differences in methodology and, in part, because the Heritage survey is based on more recent performance

Sri Lanka is at the 45th percentile (72 out of 132 countries worldwide) in terms of its overall credit-worthiness rating measuring investment risk⁵ Sri Lanka’s credit-worthiness rating was 46.3 out of 100, with a score of “100” being the least risky for investment The International Country Risk Guide (ICRG) recently gave Sri Lanka a moderate composite risk rating of 64.3 out of 100 (scores below 50 = very high risk), measuring 22 different categories of political, financial and economic risk

1.4 Summary

Sri Lanka has recorded an above-average performance in economic achievement But indicators related to future competitiveness provide some cautionary alarms, especially in areas related to infrastructure and human resources The policy environment ranks high on paper, although there are still serious questions regarding implementation

Sri Lanka is not included in either the IMD or WEF annual competitiveness reports There is no comprehensive competitiveness benchmarking system in place in Sri Lanka that could assist policy makers and concerned private sector leaders to track key variables related to competitiveness Also, Sri Lanka has few institutionalized or ongoing mechanisms for dialogue between private and public sector leaders on issues related to competitiveness It is hoped that these initial benchmarks are useful to those interested in measuring and tracking the country’s progress over time

Having provided comparative indicators of Sri Lanka’s performance, the next step is to analyze the drivers of that performance, beginning with the macro-economic environment

³ Economic Freedom of the World 1975-1995,” co-published by 11 institutes including the Fraser Institute (Vancouver, ~~Canada~~) Cato Institute (Washington D C) and the Institute of Economic Affairs (London) 1996

⁴ Heritage Foundation Index of Economic Freedom Washington DC 1996

⁵ Euromoney Country Credit-Worthiness Ratings 1997 World Development Indicators 1998 World Bank

**BENCHMARKS FOR GROWTH:
PROFILE OF SRI LANKA'S PERFORMANCE (1975-1995)**

Key Indicator	Benchmark	Sri Lanka	Percentile Rank
<i>Economic Achievement</i>			
1 GNP/Capita Growth	4-6%	3.3%	85th
2 GNP/Capita (\$)	N/A	\$740	37th
3 GDP Growth	5-7%	4.7%	80th
4 GDI as % GDP	32-38%	23.8%	54th
5 Investment/Output Ratio	6:1 or less	5:1	76th
6 Savings as % GDP	28-35%	13.6%	36th
7 FDI as % GDP	2-4%	0.7%	50th
8 Risk Rating*	92-95	46.3	45th
9 Export Growth (value)	14-19%	9.5%	74th
10 Policy Composite**	1.7-2.1	2.65	74th
<i>Human Resources</i>			
11 Life Expectancy	76-79 years	72 years	68th
12 Adult Literacy	98-100%	90.0%	61st
13 Secondary Enrollment	90-100+ %	74.0%	54th
14 Access to Safe Water	100%	53.0%	24th
15 Income Distribution	19-30 (GINI)	30.1 (GINI)	77th
<i>Physical Infrastructure</i>			
16 Phone Lines per 1,000	450-750 lines	11.3 lines	22nd
17 Computer Ubiquity	150-350 per 1,000	3.3 per 1,000	18th
18 Internet Connectivity	80-400 hosts	0.33 per 10,000	47th
19 Power Consump /capita	5,300-13,000 kWh	208 kWh	16th
20 Road Density (km/M)	8,000-15,000 km	536 km/million	40th
Composite:			53rd

* 100 = least risky, 0 = most risky for investment, Euromoney Country Creditworthiness Rating 1997

**Heritage Foundation Index of Economic Freedom, policy rankings, countries scored 1-5, 1=most free

Sources World Development Indicators 1997 and 1998, Central Bank of Sri Lanka, 1997, JAA calculations

GNP PER CAPITA GROWTH = 85th percentile

SRILANKA'S SCORE:	
GNP/Capita Growth:	3.3%
World Rank:	20/137 countries
Percentile Rank:	85th percentile
Suggested Benchmark:	4-6%

Country	%	Rank
South Korea	9.92	1
China	7.73	2
Cyprus	6.36	3
Malta	6.00	4
Cape Verde	5.95	5
Botswana	5.81	6
Singapore	5.78	7
Thailand	5.78	8
Antigua and Barbuda	5.47	9
Hong Kong	5.46	10
Bhutan	5.04	11
Indonesia	4.97	12
St Kitts and Nevis	4.91	13
Suriname	4.78	14
Oman	4.42	15
Malaysia	4.32	16
St Vincent & Gren	3.89	17
Egypt, Arab Rep	3.53	18
Mauritius	3.37	19
Sri Lanka	3.32	20

Note figures represent 1975-1995 annual average

Source World Development Indicators 1997 World Bank

GDP GROWTH = 80th percentile

SRI LANKA'S SCORE:	
GDP Growth:	4.74%
World Rank:	28/141 countries
Percentile Rank:	80th percentile
Suggested Benchmark:	5-7%

Country	%	Rank
China	9.25	1
Botswana	9.07	2
South Korea	8.51	3
Brunei	7.99	4
Thailand	7.88	5
Singapore	7.64	6
Hong Kong	7.35	7
Cyprus	7.31	8
Indonesia	7.08	9
Malaysia	7.01	10
Malta	6.90	11
Cape Verde	6.80	12
Solomon Islands	6.70	13
United Arab Emirates	5.89	14
Egypt, Arab Rep	5.81	15
Pakistan	5.80	16
Lesotho	5.71	17
Antigua and Barbuda	5.49	18
Syrian Arab Republic	5.42	19
Belize	5.26	20

Note: figures represent 1975-1995 annual average

Source: World Development Indicators 1997, World Bank

GDI as % GDP = 54th percentile

SRI LANKA'S SCORE: —	
GDI as % GDP:	23.8%
World Rank:	64/140 countries
Percentile Rank:	54th percentile
Suggested Benchmark:	32-38% of GDP

Country	%	Rank
Lesotho	52 18	1
Mongolia	50 46	2
Kiribati	44 87	3
Cape Verde	44 21	4
Singapore	40 30	5
St Kitts and Nevis	38 36	6
Grenada	36 82	7
Gabon	35 92	8
Algeria	35 79	9
China	35 49	10
Mozambique	35 14	11
Bhutan	34 23	12
Sao Tome & Prin	33 70	13
Romania	33 60	14
Western Samoa	33 16	15
Bahrain	32 95	16
Botswana	32 27	17
Thailand	32 19	18
South Korea	31 88	19
Malaysia	31 16	2c

Note figures represent 1975-1995 annual average

Source World Development Indicators 1997, World Bank

Exhibit 5

INVESTMENT/OUTPUT RATIO

**GDI as
% GDP**

20%

<p>Bulgaria Russia Poland</p> <p>Switzerland</p> <p>France</p> <p>Japan</p> <p>Canada</p>	<p>Singapore</p> <p>China</p> <p>Botswana</p> <p>Thailand</p> <p>South Korea</p> <p>Hong Kong</p> <p>Indonesia</p> <p>SRI LANKA (5.1)</p>
<p>Haiti</p> <p>Sierra Leone</p> <p>Madagascar</p> <p>Rwanda</p>	<p>Nepal</p> <p>Pakistan</p> <p>Myanmar</p> <p>Ghana</p> <p>Bangladesh</p> <p>Chad</p> <p>Uganda</p>
<p>71</p>	<p>41</p>

GDI/GDP as % GDP GROWTH

DOMESTIC SAVINGS as % GDP = 36th percentile

SRI LANKA:	
Savings as % GDP:	13.6%
World Rank:	85/133 countries
Percentile Rank:	36th percentile
Suggested Benchmark:	28-35% of GDP

Country	Ø	Rank
UAE	52 37	1
Gabon	48 01	2
Libya	46 46	3
Bahrain	43 42	4
Singapore	40 32	5
O-man	38 69	6
China	35 59	7
Saudi Arabia	34 52	8
Algeria	34 42	9
Malaysia	33 72	10
Hong Kong	33 30	11
Japan	31 92	12
Romania	31 85	13
South Korea	31 17	14
Indonesia	30 63	15
Kuwait	30 00	16
Bulgaria	29 55	17
Botswana	28 96	18
Thailand	27 98	19
Trinidad and Tobago	27 78	20

Note figures represent 1975-1995 annual average

FDI as % GDP = 50th Percentile**SRI LANKA'S SCORE:**

FDI as % GDP:	0.72 %
World Rank:	51/103 countries
Percentile Rank:	50th percentile
Suggested Benchmark:	2-4% GDP

Country	%	Rank
St Lucia	11.18	1
St Kitts and Nevis	8.95	2
Antigua and Barbuda	8.52	3
Vanuatu	7.61	4
Seychelles	6.91	5
Swaziland	5.74	6
Grenada	5.38	7
St Vincent & Gren	4.43	8
Solomon Islands	4.40	9
Malaysia	4.38	10
Dominica	3.58	11
Papua New Guinea	3.46	12
Trinidad and Tobago	3.22	13
Botswana	3.21	14
Malta	2.42	15
Costa Rica	2.33	16
Maldives	2.29	17
Egypt, Arab Rep	2.26	18
Liberia	2.19	19
Fiji	2.02	20

Note: figures represent 1975-1995 annual average

Source: World Development Indicators 1997 World Bank

RISK RATING = 45th percentile

SRI LANKA:	
Risk/Credit Rating:	46.3
World Rank:	72/132 countries
Percentile Rank:	45th percentile
Suggested Benchmark:	92-95

Country	Rating	Rank
United States	100 0	1
Netherlands	98 0	2
United Kingdom	97 6	3
Norway	96 6	4
Canada	95 4	5
Germany	95 4	6
Denmark	95 1	7
Austria	94 4	8
Ireland	93 8	9
Singapore	93 7	10
Switzerland	93 7	11
France	93 0	12
Japan	93 0	13
Finland	92 8	14
Belgium	92 2	15
New Zealand	92 2	16
Australia	91 5	17
Spain	91 3	18
Portugal	91 1	19
Sweden	90 7	20

"Sources Euromoney Country Credit-Worthiness Ratings 1997
 World Development Indicators 1998 World Bank
 Note Ratings are from 0-100, 0=most risky, 100=least risky for investment

EXPORT GROWTH (value) = 74th percentile

SRI LANKA:	
Export Growth (value):	9.5%
World Rank:	43/166 countries
Percentile Rank:	74th percentile
Suggested Benchmark:	14-19%

Country	%	Rank
Benin	41.64	1
Lao PDR	34.57	2
Kuwait	29.20	3
French Guiana	22.59	4
Vietnam	21.31	5
Bermuda	18.79	6
Kiribati	18.78	7
Comoros	18.72	8
Equatorial Guinea	18.20	9
Guinea-Bissau	16.76	10
French Polynesia	16.49	11
Thailand	16.20	12
Hong Kong	16.01	13
China	15.39	14
Turkey	15.36	15
South Korea	14.47	16
Maldives	14.35	17
Dominica	14.10	18
Cape Verde	13.92	19
Nepal	13.56	20

Note: figures represent 1981-1995 annual average growth, no earlier data available

Source: World Development Indicators 1997, World Bank

LIFE EXPECTANCY = 68th percentile**SRI LANKA'S SCORE:**

Life Expectancy:	72 years
World Rank:	34/105 countries
Percentile Rank:	68th percentile
Suggested Benchmark:	76-79 years

Country	Years	Rank
Iceland	79	1
Japan	79	2
Canada	78	3
France	78	4
Greece	78	5
Hong Kong	78	6
Italy	78	7
Netherlands	78	8
Norway	78	9
Sweden	78	10
Switzerland	78	11
Australia	77	12
Austria	77	13
Costa Rica	77	14
Cyprus	77	15
Israel	77	16
Spain	77	17
United States	77	18
Belgium	76	19
Cuba	76	20

Note 1994 figures

Source World Bank, 1998

ADULT LITERACY = 61st percentile

SRI LANKA'S SCORE:	
Adult Literacy :	90%
World Rank:	38/97 countries
Percentile Rank:	61st percentile
Suggested Benchmark:	98-100%

Country	%	Rank
Australia	100	1
Austria	100	2
Belgium	100	3
Canada	100	4
Denmark	100	5
Finland	100	6
France	100	7
Germany	100	8
Ireland	100	9
Italy	100	10
Japan	100	11
South Korea	100	12
Netherlands	100	13
New Zealand	100	14
Norway	100	15
Sweden	100	16
Switzerland	100	17
United Kingdom	100	18
United States	100	19
Guyana	98	20

Note adult population 15+, 1995 figures

Source World Bank, 1998

SECONDARY SCHOOL ENROLLMENT = 54th percentile**SRI LANKA'S SCORE:**

Secondary Enrollment: 74%
World Rank: 47/103 countries
Percentile Rank: 54th percentile
Suggested Benchmark: 90-100+ %

Country	%	Rank
Finland	119	1
Norway	116	2
Spain	113	3
Austria	107	4
France	106	5
New Zealand	104	6
Germany	101	7
Tajikistan	100	8
Bahrain	99	9
Sweden	99	10
United States	97	11
Cyprus	95	12
Uzbekistan	94	13
Korea, Rep	93	14
Netherlands	93	15
Belarus	92	16
Estonia	92	17
Bahamas, The	91	18
Switzerland	91	19
Kazakstan	90	20

Note 1993 figures, no later data available

Source World Development Indicators 1997, World Bank

ACCESS TO SAFE WATER = 24th percentile**SRI LANKA'S SCORE:**

Safe Water:	53%
World Rank:	67/88 countries
Percentile Rank:	24th percentile
Suggested Benchmark:	96-100%

Country	1993*	Rank
Bahrain	100 0	1
Barbados	100 0	2
Denmark	100 0	3
Finland	100 0	4
North Korea	100 0	5
Mauritius	100 0	6
Monaco	100 0	7
Netherlands	100 0	8
Qatar	100 0	9
Singapore	100 0	10
Tonga	100 0	11
United Kingdom	100 0	12
Israel	99 0	13
Spain	98 7	14
Cuba	98 0	15
UEA	98 0	16
Bahamas, The	97 0	17
Jordan	97 0	18
Seychelles	97 0	19
'Ukraine	96 5	20

*latest year for which data was available

Source World Development Indicators 1997 World Bank

JAA calculations

INCOME DISTRIBUTION = 77th percentile

SRI LANKA'S SCORE:	
GINI Index:	30.1
World Rank:	21/92 countries
Percentile Rank:	77th percentile
Suggested Benchmark:	25-30

COUNTRY	GINI	RANK
Slovak Rep	19.5	1
Belarus	21.6	2
Austria	23.1	3
Denmark	24.7	4
Belgium	25.0	5
Sweden	25.0	6
Norway	25.2	7
Romania	25.5	8
Finland	25.6	9
Ukraine	25.7	10
Czech Republic	26.6	11
Luxembourg	26.9	12
Latvia	27.0	13
Poland	27.2	14
Hungary	27.9	15
Germany	28.1	16
Bangladesh	28.3	17
Rwanda	28.9	18
Slovenia	29.3	19
India	29.7	20

Note: data taken from different years between 1985 and 1996

Rankings are based on either per capita income or consumption

0 = total income equality, 100 = total income inequality

Source: World Development Indicators 1998 World Bank

TELEPHONE MAINLINES per 1,000 = 22nd percentile**SRI LANKA'S SCORE:**

Telephone Mainlines:	11.3 lines
World Rank:	132/170 countries
Percentile Rank:	22nd percentile

Country	Lines	Rank
Bermuda	739 40	1
Sweden	681 05	2
United States	627 09	3
Switzerland	613 42	4
Denmark	612 57	5
US Virgin Islands	589 08	6
Luxembourg	564 98	7
France	558 03	8
Norway	556 35	9
Iceland	554 76	10
Finland	550 12	11
Hong Kong	529 70	12
Netherlands	525 23	13
Faeroe Islands	512 57	14
Australia	509 58	15
United Kingdom	502 11	16
Germany	493 47	17
Greece	493 24	18
Japan	487 17	19
New Zealand	478 51	20

Source **World Development Indicators 1997 World Bank**
JAA calculations

COMPUTER UBIQUITY = 18th percentile

SRI LANKA'S SCORE:	
Computer Ubiquity:	3.3 per 1,000
World Rank:	74/90 countries
Percentile Rank:	18th percentile

Country	#	Rank
Switzerland	408 50	1
United States	362 40	2
Australia	311 30	3
Denmark	304 10	4
Bulgaria	295 20	5
Norway	273 00	6
New Zealand	266 10	7
Germany	233 20	8
Netherlands	232 00	9
Singapore	216 80	10
Sweden	214 90	11
United Kingdom	192 60	12
Canada	192 50	13
Slovak Rep	186 10	14
Finland	182 10	15
Belgium	167 30	16
France	150 70	17
Hong Kong	150 50	18
Austria	148 00	19
Ireland	145 00	20

Note personal computers per 1,000 people, 1996

Source World Development Indicators 1998, World Bank

INTERNET CONNECTIVITY: 47th percentile

SRI LANKA'S SCORE:	
Internet Hosts per 10,000:	0.33
World Rank:	78/147 countries
Percentile Rank:	47th percentile

Country	Hosts	Rank
Finland	653 61	1
Norway	474 63	2
United States	442 11	3
New Zealand	424 34	4
Australia	382 44	5
Sweden	321 48	6
Denmark	259 73	7
Canada	228 05	8
Netherlands	219 01	9
Switzerland	207 98	10
Singapore	196 30	11
United Kingdom	149 06	12
Austria	108 25	13
Germany	106 68	14
Israel	104 79	15
Ireland	90 89	16
Slovenia	85 66	17
Belgium	84 64	18
Japan	75 80	19
Hong Kong	74 84	20

Source World Development Indicators 1998, World Bank
 Note data as of July 1997

POWER CONSUMPTION per capita = 16th percentile**SRI LANKA'S SCORE:**

Electricity Consumption: 208 kWh
World Rank: 101/120 countries
Percentile Rank: 16th percentile

Country	kWh	Rank
Norway	23892	1
Canada	15147	2
Sweden	14096	3
Kuwait	13185	4
Finland	12785	5
United States	11571	6
New Zealand	8504	7
Australia	8033	8
UAE	7752	9
Japan	6937	10
Switzerland	6916	11
Belgium	6752	12
Singapore	6018	13
Denmark	5975	14
France	5892	15
Austria	5800	16
Germany	5527	17
Netherlands	5374	18
United Kingdom	5081	19
Hong Kong	4850	20

Source World Development Indicators 1998, World Bank

Note figures are for 1995, no later data available

ROAD DENSITY = 40th percentile**SRI LANKA'S SCORE:**

Road Density:	536 km per million
World Rank:	68/113 countries
Percentile Rank:	40th percentile

Country	km	Rank
Ireland	24468	1
Australia	16221	2
New Zealand	15725	3
Norway	14698	4
United States	14453	5
Austria	13954	6
Denmark	13741	7
France	13008	8
Belgium	12909	9
Sweden	11747	10
Canada	11451	11
Greece	10341	12
Switzerland	10299	13
Venezuela	10269	14
Lithuania	9529	15
Finland	9429	16
Spain	8540	17
Hungary	7756	18
Kazakhstan	6747	19
Japan	6426	20

Source World Development Report 1995, World Bank

Note 1992 data, no later data available

COMMERCIAL POLICY ASSESSMENT: SRI LANKA

Policy Category	Sri Lanka	Maximum
1 FDI Restrictions	8	8
2 Investment Incentives	7	8
3 Export Policies	7	8
4 Business Start-Up	6	8
5 Import Policies	12	16
6 Foreign Exchange	12	16
7 Tax Policies	8	16
8 Pricing/Interest Rates	6	12
9 Labor Policies	4	8
TOTAL SCORE	70	100



Considerable policy improvement in Sri Lanka due to recent reforms

Source SRI International, Commercial Policy Model 1998

Exhibit 22

Comparative Policy Analysis Sri Lanka vs Top 20 Countries = 74th Percentile

Country	Trade	Tax	GC	MP	FI	Banking	W/P	PR	Reg	BM	Score	Rank
Hong Kong	1	15	1	2	1	1	2	1	1	1	125	1
Singapore	1	3	1	1	1	2	1	1	1	1	13	2
Bahrain	2	1	4	1	2	2	2	1	1	1	17	3
New Zealand	2	35	2	1	2	1	2	1	2	1	175	4
Switzerland	2	3	2	1	2	1	2	1	3	1	18	4
Netherlands	2	45	2	1	2	1	2	1	2	1	185	6
USA	2	4	2	1	2	2	2	1	2	1	19	7
Denmark	2	35	4	1	2	2	1	1	2	1	195	8
Luxembourg	2	45	2	1	2	2	2	1	2	1	195	8
Taiwan	2	25	2	1	3	3	2	1	2	1	195	8
UK	2	45	2	1	2	2	2	1	2	1	195	8
Bahamas	5	1	2	1	3	2	2	1	1	2	2	12
Canada	2	4	2	1	3	2	2	1	2	1	2	12
Czech Rep	1	4	2	2	2	1	2	2	1	3	2	12
Austria	2	45	3	1	2	1	2	1	3	1	205	15
Japan	2	45	1	1	3	3	2	1	2	1	205	15
Australia	2	4	3	1	2	1	2	1	3	1	21	17
Belgium	2	5	2	1	2	2	2	1	3	1	21	17
Germany	2	5	2	1	2	2	2	1	3	1	21	17
UAE	2	1	3	1	4	3	3	1	2	1	21	17
Ireland	2	5	2	1	2	2	2	1	2	3	22	21
SRI LANKA	4	35	1	2	3	2	1	3	3	4	265	37

Source Heritage Foundation Index of Economic Freedom 1996,

140 countries are ranked from 1-5, "1" being most free, "5" being least free

Note GC=govt consumption, MP=monetary policy, FI=foreign investment, W/P=wages/prices, PR=property rights, BM=black market

ANNEX II:
MACRO ENVIRONMENT FOR COMPETITIVENESS

11 MACRO ENVIRONMENT FOR COMPETITIVENESS

Having presented the benchmarks ranking Sri Lanka versus other countries of the world, the team then analyzed the drivers of this performance. These include the macro-economic environment, the micro-economic environment and the quality of business strategies at the industry and firm level. To analyze the first of these, SRI International was asked to present the following assessment of the macro-economic environment in Sri Lanka. This section reviews the evolution of the economy, current output, fiscal and monetary policies, and recent government growth strategies. It also evaluates the susceptibility of the economy to events similar to the East Asian financial crisis.

2.1 Brief Historical Overview

The current competitiveness of Sri Lanka does not take place in a vacuum but is partly the result of its historical evolution. Therefore, a brief overview of this evolution can provide perspective.

Agriculture and Agro-Industry

Prior to independence in 1948, Sri Lanka's economy was built on plantation agriculture -- tea, sugar and coconuts. The colonial plantation system played a role in shaping Sri Lanka's ethnic makeup.

From 1948 through the 1960s, economic development focused on tea, rubber, coconuts, and other agricultural products. Industrial development was primarily small in scale and concentrated in the greater Colombo area. Amongst the important industries were tea, rubber and coconut processing, lumber, gems and jewelry.

Import Substitution and Nationalization

From 1970-77, the Sri Lankan government engaged in strongly socialist domestic economic programs, along with nationalistic and non-aligned international policies, through which the government acquired the principal commercial plantations and nationalized the banks, utilities and transportation facilities. Government adherence to a strong import substitution policy led to the nationalization of the steel, sugar, cement, petroleum refining and other industries. The government exerted increasing control over land ownership and pricing. The end result was that nearly 80 percent of Sri Lanka's land as well as other factors of production were either state-owned or controlled. Government commitment to social welfare did lead to marked improvements in health and literacy but at the cost of creating a stagnant and inefficient economy.

The Shift to Private Sector Development

Starting in 1977, the new United National Party government adopted a policy of encouraging private sector development. This turn in economic policy was appropriate, but until fairly recently the reform process has been slow. Compounding economic

but until fairly recently the reform process has been slow. Compounding economic difficulties, ethnic strife between the Sinhalese majority and Tamil minority erupted in the mid-1980s into an active civil war, generating substantial economic and social costs for Sri Lanka.

Privatization

The drive for massive job creation, increased export earnings and economic growth took two paths. The first was privatization to reduce the state's role in the economy. Sales of state-owned enterprises reduced the share of publicly-owned value-added manufacturing from 60 percent in 1981 to 15 percent in 1991. Nevertheless, state-owned enterprises (SOEs) remain significant within the economy.

The largest SOE in terms of output value is the Ceylon Petroleum Corporation, the country's oil refinery, representing as much as 90 percent of total public enterprise output. Important agricultural commodities are government-controlled through such institutions as the Sri Lanka State Plantations Corporation, the Sri Lanka Tea Board, the Rubber Development Department, the Coconut Development Authority and the National Fertilizer Secretariat.

Privatization of the management of government-owned plantations boosted output and productivity in tea and rubber substantially, although the sugar sector has not experienced similar results. Some agricultural production is still manipulated by the government through protective tariffs. However, fertilizer subsidies, price and production controls, tariff protection and other forms of direct government involvement have been cut back substantially.

Privatization efforts continue. In 1996, Steel Company Ltd. was sold to private interests. Of great importance to the economy has been permission for private investment in the energy field. Incentives granted to industries contributed to the importation of generators by 248 companies, increasing installed power generation capacity by 108 MVA. Concessions to foreign power companies on a BOO (Build-Operate-Own) basis have resulted in significant investments in new thermal power plants with close to 100 megawatts capacity when completed. Two mini-hydroelectric plants have also started operations. Finally, a new, privately-owned, multimillion-dollar oil refinery is in development.

Total sales of public enterprises in 1997 exceeded US\$380 million. Key elements were

- The sale of a 35 percent equity position (and a management contract) in Sri Lanka Telecom Limited to NTT of Japan,
- The sale of convertible debentures, mostly to overseas investors, in the National Development Bank, which when converted, will represent a controlling interest,

- The sale of 51 percent equity positions in seven plantation companies and 19 percent shares in five other plantation companies,
- The sale of 90 percent equity shares in Puttalam Salt Limited and Lanka Salt Limited,
- The sale of a 1733 percent equity share in Lanka Ceramic Limited, and
- Mattegama Textile Mill Limited, acquired from its bankrupt founders, was reconstructed, rehabilitated and sold in its entirety to another private company

Export-Oriented Investment Promotion and the Board of Investment (BOI)

The second approach has been an aggressive government-sponsored investment promotion effort. Reorganized and expanded in 1992, Sri Lanka's Board of Investment (BOI) has combined a package of economic incentives with the active development of industrial parks into a program that has successfully attracted hundreds of foreign manufacturers. The BOI invested public funds in basic industrial park infrastructure and then added a package of incentives to investors which included duty free entry for inputs and capital goods used solely for export production, accelerated depreciation schedules, waivers of turnover taxes and income tax holidays.

Through June 1997, the BOI counted 825 enterprises in commercial operation. These included 94 located in the Katunayake Investment Promotion Zone, 49 in the Biyagama Investment Promotion Zone, 10 in the Koggala IPZ, 1 in the Malwatte Export Processing Park, 2 in the Kandy Investment Park and 669 outside the zones. About two-thirds of the investments represented by these enterprises came from foreign sources. BOI enterprises employed over 270,000 people in 1997.

Sri Lanka's industrial growth over the past four years has been highly concentrated in the apparel/textile industry. This industry represents 5.1 percent of current GDP and 41 percent of all industrial output. Apparel is the largest single category in Sri Lanka's current exports, approaching US\$2 billion annually. Sustained by imported fabric and other inputs, Sri Lanka's net value added for these exports is over 30 percent. While the gross exports of the apparel industry are three times that of tea, the net value added and employment generated by the apparel industry is only slightly ahead of tea production and exportation. With continued growth in apparel assembly and diversification into electronics and other products, the balance could well shift from agriculture in favor of manufacturing in 1998.

Efforts by the BOI to develop the electronic assembly industry have shown more limited success. The BOI now administers an Advanced Technology Incentive Scheme, which offers incentives in exchange for new investment in imported equipment and machinery. The BOI has also extended export industry incentives to small and medium enterprises.

Waivers of up to 100 percent of duties and turnover taxes are available to companies which export over 50 percent of their production

New Development Review Committees have been established to look into specific aspects of Sri Lanka's industrialization. Committee findings are provided to an "Industrialisation Commission" headed by the Secretary of the Treasury. A Presidential Tariff Commission has also been established to look at matters affecting the existence of domestic manufacturing industries. The BOI has been planning an ambitious program of further industrial park development including two new industrial parks and as many as 23 additional industrial estates located throughout the Republic.

Other manufacturing is principally geared to serve the domestic market and includes rubber products, paint, chemicals, some pharmaceuticals, footwear and soft toys. Export production has developed to include products using latex and natural rubber. In recent years, as much as \$70 million in foreign direct investment has been made to develop rubber-based products for export. Exports of latex products (e.g., disposable gloves), solid rubber tires and rubber footwear are growing and now approach US\$200 million.

Other Positive Developments

Sri Lanka's dependence on exportable commodities led to investment in port facilities, especially the port of Colombo, which in 1997 handled over 20 million metric tons of cargo, 75 percent of which represented transshipments. Road and rail connections were developed but now are inadequate to meet demand and act more as a brake on development than as facilitating factors.

Tourism is a major source of foreign exchange earnings -- some US\$200 million in 1997. Tourism investment is targeted at the coastal areas along the southern coast and the archeological and cultural sites in central Sri Lanka.

The gem industry also makes a positive contribution to Sri Lanka's economy. The production of cut diamonds from imported raw stones has become increasingly important to the nation's already significant gem cutting industry. Sri Lanka has a variety of mineral resources that are exploited, including graphite, zircon, silica quartz and dolomite. Graphite is produced in deep mines and is relatively expensive. Silica, quartz, zircon and other minerals are found in sand deposits, which are mined and exported. Offering the greatest potential for value-added processing are the country's noted deposits of a rich variety of gemstones such as sapphires, rubies, tourmalines, topaz, garnets, moonstones, cats' eyes and chrysoberyl. Gems have been a significant export product, but the sharp downturn in Asian economies in 1997 has had a strong negative impact on this sector.

The recent emergence of software engineering firms also raises the prospect of a future industry based on services and knowledge-based exports.

In sum, Sri Lanka has successfully made the transition from an economy based largely on plantation agriculture to a balanced economy where industry plays a major role. Industrial exports now account for almost two thirds of total exports from Sri Lanka. It should be noted that this industrial base is almost exclusively light industry, with labor content representing the principal Sri Lankan input. This is further complemented by growth in services, most notably tourism.

The benefits of a liberalized economy and an open industrial policy began to take effect in the 1990s with unemployment declining significantly. A severe drought in 1996 adversely affected Sri Lanka's economy and growth prospects. The drought affected not only agriculture but also industry, as the water shortage impeded hydroelectric power generation leading to recurrent power outages. Overcoming these events, Sri Lanka achieved solid economic performance in 1997 and, despite economic problems amongst its East Asian neighbors, 1998 began well.

Government intervention in the economy is still substantial, especially in the areas of non-plantation agriculture, infrastructure and commercial banking. However, strong encouragement of private investment in manufacturing, privatization of a number of state-owned enterprises and relatively good fiscal and monetary management bode well for future development while the expiration of the Multi-Fibre Agreement (MFA) is a potential threat looming on the horizon.

2.2 Current National Output

The Central Bank of Sri Lanka announced that the country's gross domestic product exceeded US\$15 billion in 1997. With a population calculated at 18.6 million, this gives Sri Lanka a per capita GDP of slightly over US\$800. Growth in real terms in 1997 was 6.4 percent, a sharp recovery from the 2.6 percent rate recorded in 1996.

Sri Lanka enjoyed its most rapid economic growth during its first attempt at economic liberalization, 1978-82, when GDP grew in real terms at about 8 percent annually. This contrasted with the earlier rate of GDP growth of about 2 percent annually from 1971-77 and with the 3-4 percent range experienced later in the years from 1983 to 1992. Sri Lanka's rate of population growth has declined substantially over this period and now averages 1.2 percent a year. Real economic growth as a result translates almost directly to increased per capita income. At its present income level, the country is approaching the status of a "middle income" nation and one for which concessional financial assistance from multilateral donors will become increasingly scarce.

The major thrust leading to growth in Sri Lanka's economy in 1997 came from the manufacturing sector and, within the sector, from the apparel assembly industry. Since 1978, manufacturing's share of GDP has increased from 15.3 percent to 21.5 percent. The services sector has grown from 45.3 percent to 51.4 percent. The primary economic activities of agriculture, forestry and fishing have lost share, from 28.7 percent to 17.8 percent, with mining staying constant at 2.5 percent and construction declining

marginally from 8.3 percent to 6.8 percent. Agriculture remains the principal activity in Sri Lanka's rural areas where low-income levels and widespread poverty still exist.

Within the "services sector," it should be noted that government expenditures for defense purposes is in excess of five percent of GDP and is a significant portion of the government's budget. Foreign exchange earnings from tourism have regained their importance with the reduction in violence since 1995. Foreign visitor arrivals recorded in 1997 exceeded 370,000. In addition, remittances from Sri Lankans employed outside the country are significant. Remittances in 1997 contributed approximately US\$750 million to the national economy, or 5.2 percent of estimated gross national product.

Gross domestic savings in Sri Lanka have ranged between 15-16 percent of GDP in recent years. In 1997, the savings rate reached 17.3 percent, approximately US\$2.6 billion. Adding in net foreign direct investment, net official foreign loans, grants and remittances brought the total for 1997 national savings to US\$3.2 billion, or 21.4 percent of GDP.

Compared to its neighbors, Sri Lanka's average annual growth in GDP, per capita GNP, gross domestic investment and exports during the 1990s exceeded those of India, Pakistan and Bangladesh, but through mid-1997 fell significantly below the rates achieved by Southeast Asian countries like Thailand, Indonesia, Malaysia and Singapore. Sri Lanka during calendar 1997 and thus far in 1998 has avoided the economic collapse of its principal Southeast Asian rivals and, while not exempt from some of the negative consequences, appears currently to be in a stronger economic position than many of its neighbors.

2.3 Review of Current Fiscal and Monetary Policies

Fiscal Policies

The Government of Sri Lanka has recently focused more strongly on improving its fiscal management, and as a result, its fiscal performance in 1997 was better than during the previous year. In its drive to correct existing weaknesses in fiscal management, government efforts have been directed at

- Sanitizing public accounts,
- Rationalizing off-budget transactions,
- Strengthening financial controls and accountability,
- Improving revenue collections,
- Reducing wasteful expenditures,
- Eliminating corruption, and
- Consolidating social expenditures

Public expenditures in Sri Lanka have consistently exceeded revenues, and the resulting annual deficits have been a major factor in the country's historically high rate of

inflation During the period between 1978 and 1984, annual inflation rates varied from a low of 11 percent to a high of 26 percent

After coming under relative control in 1985/1987, inflation rates again increased in the period from 1988 to 1993 to an annual range between 11 percent and 22 percent Modest rates in 1994 and 1995 gave way to a rate of 16 percent in 1996, which was brought down to 9 percent in 1997 Projections for 1998 are for 9 percent as well, but the government admits that desirable macroeconomic policy would look to achieve a rate of inflation as low as 5 percent

Government revenues expressed as a percentage of GDP have remained fairly consistent at around 20 percent

Government Revenues as a Percentage of GDP

Year	1980	1985	1990	1993	1994	1995	1996	1997
Revenue/GDP	198	223	211	197	190	204	190	184
Real GDP index	=100						≈200	

At the equivalent of 184 percent of GDP, revenues were 169 billion SL rupees (US\$2.9 billion) in 1997, down slightly as a percentage of GDP from 1996 and two percentage points from 1995 The revenue decline in 1997 as compared to 1996 was attributed to lower customs revenues due to continued import duty incentives

The largest single source of tax revenue is the general sales and turnover tax, which contributes over 30 percent of the government's total tax revenues Nearly 45 percent of this tax is generated from turnover taxes on imported goods apart from import duties Turnover taxes are also applied to services, and this segment has been growing rapidly

The next largest tax revenue category is that of excise taxes, principally on liquor and tobacco products In 1997, excise taxes comprised 19 percent of total taxes, with tobacco accounting for nearly 60 percent of this amount Import duties collected by Customs made up 16 percent of government tax revenue, and a National Defense Levy on goods and services brought in an additional 12 percent License fees paid to the government contributed about one percent of tax revenue

Income tax collections rose despite an increase in the basic income exemption and a flattening of tax rate bands Corporate and personal income taxes now account for over 12 percent of tax collections, or over US\$350 million, slightly more than the defense levy but less than the excise taxes Taxes on property generated another 5 percent of total tax take, and a tax on Treasury bills held in the Central Bank produced 1.5 percent of total collections

Non-tax revenues, consisting of income from state-owned property and public enterprises, Central Bank profits, and rent, interest and dividends paid to the central government, added an additional sum equivalent to 14 percent of tax revenues and reflect the government's still important role in the economy

Current government expenditures in 1997 were 184 billion SL rupees (US\$3.1 billion), the equivalent of 20.7 percent of GDP, down two percent from 1996. This reduction was credited to a reduction in expenditures for defense from 5.8 to 5.1 percent and declines in subsidies, transfers and interest expenses. In sum, the fiscal deficit was reduced to 7.9 percent of GDP in 1997 from 9.4 percent in 1996. Within the total figure for current government expenditures, payroll expenses for government employees account for 26 percent, up from 24 percent in 1996 as a result of significant pay increases granted early in 1997.

Historically, current expenditure levels by the government of Sri Lanka have exceeded government revenues (as measured by percentage of GDP) by rather modest amounts, averaging about 3 percent. For example, in 1996, current expenditures were calculated to be 22.8 percent of GDP as against 19.0 percent for revenues, and in 1997 at 20.7 percent of GDP as compared to 18.4 percent.

In the past, the major fiscal policy problem was the government's capital spending and net lending. In 1980, public expenditures for the acquisition of real assets, capital transfers, lending and other non-current expenses equaled 23.3 percent of GDP, 4.8 percent greater than current expenditures registered for that year, producing a total of government expenditures equal to 41.8 percent of GDP and an overall fiscal deficit (before foreign grants) of 22.2 percent of GDP.

About 40 percent of this deficit was financed from foreign loans and grants, but 60 percent had to be financed domestically, the bulk from the banking system. Major improvements have been achieved in this area. Specifically, policies leading to liberalization of the economy and the sharp reduction in the role of the state in the economy have brought about the nearly complete elimination of the government's capital and net lending expenditures.

Fiscal Deficits

(Figures as percent of GDP)

	<u>1980</u>	<u>1985</u>	<u>1990</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
Cap Spending/Net Lending	(23.3)	(13.9)	(8.7)	(7.6)	(7.0)	(6.9)	(5.0)	(3.1)
Current Exp Balance	<u>1.1</u>	<u>2.2</u>	<u>(1.2)</u>	<u>(0.8)</u>	<u>(2.9)</u>	<u>(2.7)</u>	<u>(3.8)</u>	<u>(2.2)</u>
Overall Deficit	(22.2)	(11.7)	(9.9)	(8.7)	(10.5)	(10.1)	(9.4)	(7.9)
Deficit After Privatization Proceeds	(22.2)	(11.7)	(9.9)	(8.4)	(10.0)	(9.6)	(8.8)	(5.3)

Combining current and government expenditures with the capital expenditures and net lending in 1997 indicates public expenditures as a share of GDP of 23.8 percent, a figure far lower than is the case in most developed economies. It should also be kept in mind that government expenditures equivalent to 5.1 percent of GDP are allocated towards prosecuting an active war that, in turn, impedes social and economic development, especially in the eastern and northern provinces.

With good economic growth rates, lower and stabilized interest rates and a general confidence in the economy, it is now possible for the government to finance a deficit in the range of 5 percent of GDP in a non-inflationary manner. Total public debt exceeds 758 billion SL rupees (US\$12.6 billion), an increase of 7 percent in 1997, but a decline to 85 percent of GDP from 92 percent in 1996. The debt is split in almost equal portions between domestic and foreign debt. Of the foreign debt, 96 percent is concessional debt extended by foreign governments and multilateral financial institutions.

The government's debt management policies have included resort to foreign commercial debt markets, through issuance of \$50 million (3 billion SL rupees) of floating rate notes in early 1997 for infrastructure projects, and the shifting of domestic debt from relatively high interest-bearing, short-term instruments to those with medium-term maturities and lower rates of interest. This latter policy was highlighted by the successful issue of a medium-term marketable Treasury bond valued at 10 billion SL rupees (US\$169 million) sold to banks and other investors. Even larger sales are scheduled for 1998. At present, the portion of the government's domestic debt held in short-term instruments is about 39 percent, down slightly from 1996.

Major holders of government debt in the form of rupee-denominated loans are the Employees' Provident Fund and the National Savings Bank. Already holding 87 percent of the government's loans, these two institutions continue to invest funds in government paper. The government's assumption that inflation rates will continue to decline has led it to offer long-term debt instruments, principally to these two institutions, at interest rates of 12 to 14.5 percent depending on the maturity of the bonds, which vary from two to seven years. Sri Lanka continues to receive concessional financing and some foreign aid grants, and appears to be in no danger of failing to cover its foreign debt obligations.

Monetary Policies

Assessing the current status of Sri Lanka's monetary policies is complicated by the rapidly changing situation in Southeast Asia, which can cause severe consequences for Sri Lanka's financial system almost overnight. However, inasmuch as the economy of Sri Lanka has remained resilient over the last year in the midst of the region's economic troubles points to the sound monetary practices of the Sri Lankan government

- Sri Lanka's strong economic performance is attributed to a relaxed monetary policy adopted by the Sri Lanka government in 1997. Monetary expansion continues at a moderate rate. Interest rates remain low, creating a favorable investment environment.
- Compared with other countries in the region, Sri Lanka's monetary policies are stable and sound.
- The Central Bank adopts a managed float exchange rate regime, which is less vulnerable to speculative attacks than the fixed or pegged exchange system.
- A fully liberalized current account allows up to 100 per cent ownership in foreign direct investments, and up to 49 per cent ownership in financial institutions without any restrictions on repatriation of capital, capital gains and dividends.
- The banking system is relatively transparent and credible with strict supervision of the entry, operation and exit of commercial banks. The Central Bank operates with a prime goal of maintaining price stability and low inflation, which are favorable to capital markets and investment.
- However, problems remain. The most immediate is the heavy reliance of state banks on the government to finance their losses. The second most urgent concern is the high ratio of non-performing bank loans, which can have serious ramifications in the wake of the financial crisis in the region. Actions are necessary to increase the level of independence of the state banks from the government. Stricter loan provisioning may be needed to hedge against any potential damage caused by the financial crisis in Southeast Asia.

2.4 Assessment of Vulnerability To Asian Financial Crisis

The recent financial crisis in Southeast Asia has underscored the importance of a credible central banking system and sound monetary policies. The spillover effects from financial crises taking place in Indonesia, Thailand and Malaysia have triggered a greater need for countries to reassess their own exchange and banking fundamentals. Fortunately, Sri Lanka is not materially affected by the region's economic turmoil.

The firm financial position of the country poses several important questions. Is Sri Lanka's economic and financial stability attributed to a strong banking system and sound macro monetary policies or is it merely good luck? Can the nation continue to prevail over serious economic challenges or is the relatively encouraging macroeconomic picture for Sri Lanka likely to change as the spillover effects finally take their toll?

The next section provides an overview of Sri Lanka's current monetary policies and banking system. It is followed by a brief discussion of recent developments in the government's interest rate and money expansion policies. Sri Lanka's financial performance is weighed against those of other countries including Pakistan, Bangladesh, India, Malaysia, Vietnam and Thailand, which are considered Sri Lanka's potential competitors in terms of attracting foreign investment. The section will conclude with some policy implications.

Sri Lanka's macroeconomic performance indicators have been impressive despite some serious setbacks in 1996. While it is still early to make conclusive predictions about the country's future prospects, the current course of the economy is sound. It is reported that Sri Lanka's real GDP growth rate in 1997 was 5.8 per cent, up from 3.8 per cent in 1996. Inflation is down from 15.9 per cent in 1996 to 9.6 per cent in 1997¹.

The Sri Lanka government manages the exchange rate through buying and selling of currency by the Central Bank within a range of two percent. The value of the Sri Lanka rupee declined about 4 percent during 1997 in relation to the U.S. dollar, but on average, appreciated in value as compared to its trading partners due to the collapse in dollar values of several of the Asian currencies. Gross official foreign assets exceed US\$2 billion, enough to cover nearly four months of imports. Adding in commercial bank foreign assets, total reserves are sufficient to cover 5.4 months of exports, up from 5.0 months in 1996. Although the rupee has depreciated against the U.S. dollar, it has gained significantly on the Deutsche mark and marginally on the pound sterling². This suggests that the rupee will not depreciate swiftly as many other currencies have in recent months.

On the monetary policy front, Sri Lanka has pursued a moderate monetary expansion approach with moderate interest rates to encourage domestic investments. The rate of growth of the broad money supply (M2) was estimated at 13.8 percent by the end of 1997, close to the Central Bank's expected rate of 14-16 percent. There was a slight reduction in net government credit, which led to a moderate easing of M2 growth in the last quarter of 1997.

The real interest rate fell from 4.8 percent in 1996 to only 0.5 percent in 1997³. Furthermore, the government is targeting a robust growth of 17 percent in private sector borrowing, suggesting that the real interest rate has to decline even further. All these recent developments in the monetary area show a strong commitment on the part of the Sri Lanka government to create a favorable investment climate.

¹ EIU Country Report 2nd quarter 1998

² Central Bank of Sri Lanka, *State of the Economy - 1997*

³ World Bank, *World Development Indicators, 1998*

Growth in Banking Credit to the Private and Public Sectors in Sri Lanka

	<u>1996</u>	<u>1997</u>	<u>1998</u>
% Growth in Net Credit to the Private Sector	7.5	11.4	17.0
% Growth in Net Credit to the Public Sector	4.3	6.9	NA

Source: EIU Country Report 2nd Quarter 1998

Sri Lanka's key macro financial indicators compare well with those of other countries in the region. The currencies of Malaysia, Indonesia and Thailand depreciated by more than 30% against the U.S. dollar within a year, the Sri Lankan rupee has depreciated only 2%. With regard to interest rates, Sri Lanka's real interest rate has plunged by more than 4 percent from the nation's already low interest rate (by regional standards), particularly in comparison with the high prevailing rates in Malaysia, Indonesia and Bangladesh. Simply put, Sri Lanka's reduction in inflation, improved fiscal discipline and the ability to maintain relatively stable domestic financial markets, particularly in the context of a highly uncertain international environment, have combined to generate lower interest rates, which in turn create a more favorable investment climate.

Key Macro Financial Indicators

Country	Nominal Exchange Rate Depreciation (% change)		Money and Quasi Money Growth		Gross Domestic Credit Growth		Real Interest Rate	
	1996	1997	1996	1997	1996	1997	1996	1997
Sri Lanka	4.9	6.9	10.5	14.4	10.7	6.0	4.8	0.5
Thailand	1.7	5.67	12.6	18.1	-18.5	32.9	N/A	N/A
Bangladesh	4.2	7.1	10.8	10.7	12.3	13.8	8.0	11.8
India	2.1	7.3	18.7	N/A	19.7	N/A	8.4	6.1
Indonesia	3.2	5.31	27.2	18.9	22.7	2.8	9.7	11.6
Malaysia	-0.5	3.83	N/A	N/A	N/A	N/A	0.8	N/A

Source: World Development Indicators 1998

Unlike some of its regional neighbors, Sri Lanka has avoided speculative attacks on its currency ignited by heavy short-term international borrowings, high-risk exposure of banks to real estate lending, a highly overvalued currency and an open capital account⁴. The Central Bank of Sri Lanka has employed a managed float exchange system whereby

⁴ *State of the Economy - 1997*, Central Bank of Sri Lanka

occasional government interventions are warranted to reduce excessive volatility of rates with a band of 2 percent between its buying and selling rates

With the currency crisis looming over Southeast Asia, there is increasing criticism of the fixed or pegged exchange rate regime, which deprives central banks of one of the most fundamental instruments in stabilizing financial markets. The “rigidity” problem of fixed exchange rate regimes is exacerbated when the country does not hold large foreign currency reserves to defend its currency. Sri Lanka’s choice of a managed float exchange rate regime is appropriate given the country’s small size and the limited amount of U S dollar reserves it holds.

Another positive aspect of Sri Lanka’s financial policies is its fully liberalized current account transactions. Despite being cautious in its move towards capital account liberalization, Sri Lanka is considered freer than many other developing countries. Foreign fund managers are allowed to invest in the stock market with the right to repatriate capital, capital gains and dividends, although transactions have to go through special accounts named “Share Investment External Rupee Accounts” (SERA). Foreign direct investment is permitted up to 49 percent ownership in financial institutions without any limit on the repatriation of capital, profits and dividends.⁵

Compared with its neighbor developing countries such as Bangladesh and Pakistan, Sri Lanka’s banking system is more credible. The Banking Act No 3 of 1988 clearly set forth a regulatory framework governing the entry, operation and exit of commercial banks. Such a framework establishes the authority of bank supervisors to analyze the financial condition of banks, evaluate management, curb unsound practices, and force the exit of insolvent commercial banks.

The banking system and other industries benefit from the Central Bank’s pursuit of price stability. High inflation usually leads to currency depreciation, which raises the cost of production and erodes industry profitability. Many socially oriented capitalist countries often set curbing unemployment as their primary objective rather than curbing inflation.

Despite these strengths, problems remain in the banking system. First, the state bank system continues to rely on government financing in bad times. The government had in the past paid for the losses of two state banks through high taxes or extra borrowing. This sometimes triggered higher inflation with results borne by consumers. This problem should be addressed in order to restore public confidence in the banking system. Complete independence may be too ambitious a goal, but clearly some actions are necessary to give state banks more autonomy.

Second, the high ratio of non-performing loans can cause serious problems in the wake of the financial crisis in Southeast Asia. Currently, banks carry 20 percent provisioning on non-performing loans after six months, and 100 percent for loans outstanding after 18 months.⁶ The Central Bank should tighten this norm to full provisioning within a year of

⁵ *Central Bank of Sri Lanka Annual Report - 1997*

⁶ *EIU Country Report 2nd Quarter 1998*

default Such efforts have met strong resistance on the part of the commercial banks, which argue that the high cost of providing security and ineffective debt recovery laws have contributed to this high ratio of non-performing loans

Notwithstanding these problems, Sri Lanka's overall monetary policies are sound and are supportive of the nation's long-term growth prospects By adopting a "managed float" exchange rate regime, maintaining price stability, allowing liberalized current account transactions, and agreeing to have commercial banks subject to unprecedented scrutiny, the Central Bank of Sri Lanka has gained a high degree of credibility with investors and consumers Although the economy has shown a tremendous amount of resilience over the past 12 months, further Central Bank action is required to increase the transparency, oversight and effectiveiiness of Sri Lanka's banking system

ANNEXIII:
MICRO-ECONOMIC ENVIRONMENT

III MICRO-ECONOMIC ENVIRONMENT

The micro-economic environment refers to those elements in the national environment that either facilitate or inhibit firm-level operations. Factors that inhibit firm-level operations force businesses to focus their strategies on mitigating these constraints rather than on outward-looking market competitiveness. These include, but are not limited to, the impacts of government and public sector activities. They include human resources, infrastructure, the presence or absence of monopoly or anti-competitive industry structures, the quality and effectiveness of institutions, and a host of other elements that affect the day-to-day operations of firms and industries. Several approaches have been taken to analyze this. The first is the Commercial Policy Model, developed by SRI International. The second is a competitiveness "balance sheet" which captures some elements not part of this model. More importantly, many of the constraints in the micro-economic environment are presented later in the report with feedback from specific industries and companies in Sri Lanka.

3.1 The Commercial Policy Model

Importance of Commercial Policies for Competitiveness

Over the past ten or fifteen years, governments have been replacing statist commercial laws, institutions and policies with more market-oriented economic policies based on competition and the primary role of the private sector as the engine of growth. This rejection has been spurred by the recognition that past economic approaches which relied heavily on state intervention, government-owned enterprises, import protection, subsidies and price controls were failing to deliver results in terms of dynamic economic growth. There now exists a strong consensus in developing and developed countries alike that sound commercial policies based on market forces lead to increased capital formation, greater efficiency and more rapid economic growth.

Of all the countries in South Asia, Sri Lanka has embarked on perhaps the most significant restructuring of its economy to attain long-term sustainable growth through macro-economic reforms and measures to improve private sector performance. Sri Lankan policy-makers have recognized the need for a sound commercial and economic policy environment to maximize productivity and employment. To place this development into context, it is useful to stand back from the process to evaluate the strengths and remaining weaknesses in Sri Lanka's legal, institutional and commercial policy environment.

This section describes the relevance and competitiveness impacts of commercial policies, and summarizes the methodology of the Commercial Policy Model. This is followed by a scoring of Sri Lanka's commercial policies and a benchmarking of Sri Lanka's policies against those of other nations.

One major dimension of national economic competitiveness is the extent to which commercial policies are "market friendly." A country's commercial policy environment sets the "rules of the game," the regulatory and policy climate in which businesses operate. "Market friendly" policies

reduce distortions in the economy, allow businesses and firms to respond to market signals, and encourage investment and development. Sound commercial policies help to reduce risks to investors, increase business confidence and allow countries to develop their true comparative advantages.

Commercial policies affect the business operating environment at the firm level in many ways and ultimately determine how efficiently a company will use inputs in the production of goods and services. For this reason, it is useful to examine how commercial policies affect the business operating environment from the perspective of an individual enterprise. Policies affect all economic processes, beginning with the initial stage of registration and approval, moving through to actual production using factor inputs, and ending with the sale and distribution of goods and services in foreign and domestic markets. The next section explores the effects of commercial policies at each stage of this cycle.

Commercial Policy Model Methodology

The Commercial Policy Model was developed by SRI International (SRI) to identify those policy practices that are conducive to private sector development and sustained economic growth. The methodology is designed to allow cross-country comparisons of overall commercial policy regimes through summary country policy scores, which describe the degree to which commercial policies are business-friendly as well as competition-based.

To examine the commercial policy environment, 36 policy variables were selected as the basis for international comparison based on the ability to quantify policy differences and based on the following criteria:

- Their importance in forming the overall commercial policy environment,
- The availability of up-to-date information,
- The objectivity and reliability of data sources, and
- The country coverage available.

The SRI team then collected and compiled data from the World Bank, International Monetary Fund (IMF), United Nations Conference on Trade and Development (UNCTAD), Office of the U.S. Trade Representative (USTR), U.S. Department of Labor, International Center for the Settlement of Investment Disputes (ICSID), foreign embassies, major accounting houses and other sources.

The policy variables analyzed were classified under nine categories:

1	Business start-up	6	Domestic investment
2	Pricing/Interest	7	Foreign investment
3	Import	8	Labor
4	Export	9	Taxation
5	Foreign exchange		

The policy variables were categorized so that they could be assessed as policy groups in forming the overall commercial policy environment. Such classification can also accommodate cross-country comparison in each individual policy category. (See the box below for the variables included under each policy category) A rating system was established to assign summary policy scores to each nation. These scores describe the degree to which the commercial policy regimes are business-friendly and competition-based.

POLICY VARIABLES INCLUDED IN THE DATA SET

Import	Mean Trade-Weighted Tariff Tariff Variance All Non-tariff Barriers
Export	Export Taxes Export Restrictions Export Income Tax Exemptions Duty Free Imports
Tax	Minimum Corporate Income Tax Rates Top Corporate Income Tax Rates Minimum Personal Income Tax Rates Top Personal Income Tax Rates Sales Taxes + Value-Added Tax Rates
Domestic Investment	Income Tax Holidays Duty Exemptions Other Incentives Accelerated Depreciation Investment Allowance R&D Incentives
Foreign Investment	Direct Investment Restrictions Expatriate Employment Restrictions Differential Treatment
Business Start-up	Business Licensing Business Registration Approvals
Pricing & Interest	Price Controls Price System Interest Controls Credit Allocation
Foreign Exchange	Exchange Rate System Foreign Exchange Level Foreign Exchange Restrictions Profit Repatriation Restrictions Capital Repatriation Restriction

Under this system, both quantitative and qualitative information is converted into a set of policy scores. For each policy variable, a numerical value -- variable score (VS) -- is assigned to a specific policy condition. For example, the variable "Mean Tariff" in the Import Policy category is assigned a VS ranging from 0 to 4, depending on the range into which the mean tariff falls.

<u>Ranee</u>	<u>Variable Score (VS)</u>
$0 \leq \% \leq 15$	4
$15 < \% \leq 25$	3
$25 < \% \leq 30$	2
$30 < \% \leq 40$	1
$40 < \% \leq 50$	0

For variables that are not strictly quantifiable, other means of measurement are utilized. For example, duty exemptions for machinery, raw materials, and other imported inputs are an important factor in attracting investment. The variable "Duty Exemptions" is assigned a VS of "1" if duty exemptions exist, and "0" if otherwise. The scoring system is described in detail as an Appendix to this report.

The scores of the policy variables within the same policy category were then summed and harmonized according to a conversion scale to yield Policy Category Scores (PCSs), which fall into a range of 1-4. This is to ensure that the scoring system will not be biased towards the policy categories in which more data and information are available. The PCSs are then given weights which reflect their relative importance in forming the overall commercial policy environment (see the Appendix for the weights assigned to each policy category).

The Total Score (TS) for each country was obtained by summing the weighted scores from all the policy categories. The maximum achievable Total Score for a country is 100. Total Scores can be compared across countries as a summary description of the commercial policy environment. In addition, comparisons and benchmarking can be conducted in each policy category by comparing the Policy Category Scores across all countries or groups of countries. Perhaps more importantly, the correlation between the Total Scores, Policy Category Scores and economic performance across countries can be observed and analyzed.

It should be noted that the country which has the most competition-based commercial policy environment will not have a perfect score of 100. This is due to the fact that for certain policy variables, higher scores are assigned to countries that have adopted special incentives specifically to encourage investment or trade, such as income tax exemptions for exporters, or income tax holidays for investors. In many countries, such special incentives are often provided to investors and exporters to counteract the restrictive commercial policies in other areas.

3.2 Application of Commercial Policy Model to Sri Lanka

This section presents Sri Lanka's "scores" in each of the nine categories of the Commercial Policy Model. These scores are based on current policy structures. They provide an indication of areas in which attention should be drawn for potential policy reform activities. The table below summarizes Sri Lanka's overall scores.

Policy Category	Sri Lanka's Scores	Maximum Possible Scores
Import Policies	12	16
Export Policies	7	8
Tax Policies	8	16
Investment Incentives	7	8
FDI Restrictions	8	8
Business Start-up Procedures	6	8
Pricing/Interest Policies	6	12
Foreign Exchange Policies	12	16
Labor Policies	4	8
Total Policy Scores	70	100

As one can see, Sri Lanka shows an overall commercial policy score of 70 out of a possible 100. The highest overall score is 90, achieved by Singapore. The lowest is 31, posted by Zaire. Sri Lanka's score places it in the upper one half of all nations scored. Of particular note is the fact that Sri Lanka's overall score has risen from 52 when it was assessed in 1995, indicating that the commercial policy environment has been improving.

The following section summarizes Sri Lanka's scores in each of the policy categories. It becomes clear that the areas deserving greatest attention are import, tax, pricing/interest, foreign exchange and labor policies.

Import Policies Score 12 out of a possible 16

Sri Lanka's trade regime has been gradually liberalized over the past decade. Currently, the country has a three-band tariff schedule, at 10, 20, and 35 percent. Most agricultural products, consumer goods, chemicals and other intermediate goods are subject to a 35 percent tariff, which is below the 50 percent bound by the World Trade Organization. The exceptions are liquor and cigarettes, which are subject to high levels of duties that essentially keep out foreign competition.

Non-tariff barriers have also been liberalized significantly in the past few years. Import licensing on a number of agricultural commodities (e.g., potatoes, onions, chilies) was removed in 1996. Only a small number of imports are presently subject to import license controls, mostly for health and national security reasons (e.g., remote controls, toxic and hazardous chemicals, pesticides, firearms, ammunition).

Export Policies 7 out of a possible 8

Sri Lanka received a high export policy score due to the lack of export taxes, liberal export restrictions, as well as the granting of relatively generous export incentives. Export control is minimal, and export licenses are required for four products mainly for environmental reasons and for the protection of antiques. They include coral shanks and shells, timber and wood products, ivory products, and antiques over 50 years old.

Generally, export income is subject to a reduced tax rate. The government's 1998-99 budget provides for a 10-year tax holiday and other incentives for new investment made in selected industries (e.g., electronic assembly, ceramic and glass products, rubber-based products, light and heavy engineering, gems, diamond cutting and polishing, and jewelry). To qualify for the tax holiday, the investment must be over SLRs 50 million (approximately \$1 million), and 90 percent of output must be exported. Export-oriented projects also benefit from duty-free imports.

Tax Policies 8 out of a possible 16

Sri Lanka's tax score is only half of the maximum score mainly due to its relatively high corporate income tax rate. Although the government was widely anticipated to lower the corporate income tax rate to 30 percent in 1998, the 35 percent rate has been retained in the latest budget due to revenue shortfall. Several some priority sectors are entitled to a preferred corporate tax rate of 15 percent. The top marginal personal income tax rate remained at 35 percent. However, expatriate employees are usually eligible for favorable tax treatment.

The government planned to introduce a goods and services tax (GST) of 12.5 percent (exempted for exports) on April 1st 1998, which will replace the turnover tax. The turnover tax has been recently exempted from locally manufactured dairy products and medical services, and reduced from 2 percent to one percent on banking and financial institutions.

Investment Incentives 7 out of a possible 8

The package of investment incentives offered by Sri Lanka is quite generous. However, incentives are mostly linked to the sector, the size of the project, and whether it is an export-oriented investment. The most recent budget identified agriculture, tourism, textiles, and gems and jewelry as "priority" sectors, eligible for generous incentives including tax holidays, investment tax allowance, duty-free imports and exemption from turnover taxes. The government provides a 10-20 year tax holiday for investments ranging from \$10 million to \$100 million. Companies utilizing advanced technology with a minimum investment of \$1 million are also eligible for a five-year tax holiday.

In addition, machinery and equipment imported for projects approved for the investment incentives are free from customs duties. Special allowance is also granted to eligible investments, and it can be applied to accessible income. Depreciation allowance for plant, equipment, machinery and software has also become more generous in the 1998 budget.

FDI Restrictions 8 out of a possible 8

Foreign investors in Sri Lanka enjoy a relatively liberal investment regime. The Board of Investment (BOI) gives automatic approval for most foreign investments. Foreign equity participation of up to 100 percent is allowed in many sectors, and ceilings in restricted sectors have been relaxed in 1998. Non-deposit-taking financial services, including investment and merchant banking and venture capital companies, are now open to foreign investment.

Foreign equity investment in retail and wholesale trade are now also allowed, subject to a minimum investment of \$150,000. Investment in certain restricted sectors (shipping and travel agencies, mining, growing and primary processing of tea, rubber, coconut, rice, cocoa, sugar, and spices, professional services, education, transportation, telecommunications) are approved on a case-by-case basis where foreign equity exceeds 40 percent.

Expatriates generally do not experience significant problems in obtaining work or residence permits, particularly when they are affiliated with BOI-approved ventures. Foreign investors who make an equity investment of \$50,000 can qualify for a resident visa. Approval for expatriate employment is granted when there is a demonstrated shortage in local labor in that field. Most foreign investors do not experience discriminatory treatment in obtaining investment approvals or incentives.

Foreign investments are guaranteed protection by the Constitution of Sri Lanka. The government has entered into 20 investment protection agreements with foreign governments, including the United States, and is a founding member of MIGA (Multilateral Investment Guarantee Agency). The Government has ratified the provisions of the Convention on Settlement of Investment Disputes, which provides the mechanism and facilities for international arbitration through the International Center for the Settlement of Investment Disputes (ICSID) of the World Bank.

104

Business Start-up 6 out of a possible 8

Foreign investment approval is automatic. However, laws pertaining to taxation, labor and labor standards, exchange controls, customs, environmental norms, building and construction standards are not always transparent, allowing room for bureaucratic discretion and sometimes corruption. Corruption appears most severe in customs clearance and in government procurement and tendering.

Pricing/Interest Policy 6 out of a possible 12

Sri Lanka's pricing and interest policy regimes are only partially liberalized. Price controls remain in place for politically sensitive commodities such as bread, electricity, petroleum, rail and bus fares, and they are determined administratively. In addition, wheat flour, utilities and fertilizers are routinely subsidized so their prices are below market prices. The wheat subsidy was reduced in 1996, raising market prices for bread. In addition, the Government is gradually moving to allow more private sector participation and competition in the utilities sector, privatize state enterprises, and end some of the state monopolies.

The Government does not control interest rates directly but uses other instruments, such as reserve requirements and sales of Government assets to influence market interest rates. The two largest banks (Bank of Ceylon and Peoples Bank) are state-owned and carry a large portfolio of non-performing assets, which results from lending to some public corporations, farmers, university students and other entities under the direction of the Government. In both 1993 and 1996, the Government had to intervene to improve the banks' balance sheets by injecting capital (through state bonds) into the two state banks. Other private banks generally follow more prudent policies and have not been forced to make loans to public institutions.

Foreign Exchange Policy 12 out of a possible 16

Sri Lanka's foreign exchange regime has been considerably liberalized in recent years. Its exchange system is characterized as a "managed float," with the Central Bank of Sri Lanka announcing the daily spot buying and selling rates (against the U.S. dollar) for transactions with commercial banks and trading at those rates within margins of 2 percent.

Exchange controls on current account transactions are fully liberalized. In general, there are no barriers, legal or otherwise, to the expeditious remitting of corporate profits, dividends, management fees, royalties, licensing fees, funds for debt service, and capital gains overseas. Portfolio investors are also permitted to invest in the share market with the freedom to repatriate capital, capital gains and dividends through special accounts known as "Share Investment External Rupee Accounts (SERA)".

105

Labor Policy 4 out of possible 8

Labor policy is moderately restrictive in Sri Lanka. There is a legal minimum wage, but no wage controls. Most permanent, full-time workers are covered by laws pertaining to minimum hours of work, minimum wage, leave the right of association, and safety and health standards. The Termination of Employment Act creates a significant legal barrier to fire or lay off workers who have been employed more than six months for any reason other than serious, well-documented disciplinary problems. Collective bargaining is not very common, and only 29 percent of the labor force in industry and the services sector is unionized.

This section compares Sri Lanka's commercial policy scores with those of selected other countries. The countries were chosen as competitors or models against which Sri Lanka can be benchmarked in terms of "policy competitiveness." Each section displays the commercial policy scores, provides selected country examples and describes how these countries' scores compare to those of Sri Lanka.

3.3 Comparing Sri Lanka Versus Other High Growth Countries

The other countries selected for benchmarking include Indonesia, Ireland, Malaysia, Singapore and Turkey. These nations were chosen as representative of different types of economies (size, level of development, etc) and as models of private sector growth. All have good overall commercial policy scores, ranging from 73 to 92 points. Indonesia and Turkey have the lowest scores. Singapore is the only country to score above 90 points. Sri Lanka's overall score of 70 falls below all of those benchmarked.

Commercial Policy Scores Sri Lanka and Selected Countries

Country	Imports	Exports	Tax	Investment	Foreign Inv.	Business Start-up	Pricing/Interest Rates	Foreign Exchange	Labor	Total
Singapore	16	8	12	6	8	8	12	14	8	92
Ireland	16	8	4	8	8	8	12	16	6	86
Malaysia	12	6	12	8	6	6	9	12	8	79
Indonesia	12	6	12	6	6	6	9	12	4	73
Turkey	12	8	4	8	8	6	9	12	6	73
Sri Lanka	12	7	8	7	8	6	6	12	4	70
Average	13.3	7.2	8.7	7.2	7.3	6.7	9.5	13.0	6.0	78.8

Sri Lanka's import, export, tax, foreign investment, and foreign exchange policies rank highly in this grouping. However, its pricing/interest and labor policy scores are not comparable to the other nations' scores. Sri Lanka's score of six for pricing and interest policy is substantially below the group's average of 9.5. Each of these policies will now be analyzed in turn.

Import Policy

Country	Sri Lanka	Indonesia	Ireland	Malaysia	Singapore	Turkey
Score	12	12	16	12	16	12

These countries have fairly open trade regimes and therefore score well in the import policy category. All of these nations earned twelve points or more out of a possible sixteen points. The group average of 13.3 reflects their governments' efforts to lower tariffs and ease import restrictions. Ireland and Singapore both enjoy perfect scores of sixteen. Ireland has a comparatively open economy. In-shore importers face an average tariff of only seven percent. This, plus the absence of significant non-tariff barriers, helps Ireland earn its perfect score. Several factors give Singapore its high score for import policy. Singapore is firmly committed to an open trade and investment environment. The country's average tariff rate of two percent is exceptionally low. Moreover, Singapore allows almost 99 percent of all imports into the country duty free. It has no import quotas, negligible non-tariff barriers and does not require import licenses.

Export Policy

Country	Sri Lanka	Indonesia	Ireland	Malaysia	Singapore	Turkey
Score	7	6	8	6	8	8

With the exception of Sri Lanka, Indonesia and Malaysia, all of the countries in this group have perfect scores for their export policies. A high group average of 7.2 reflects their focus on enhancing growth through exports. Most of the countries in this group have no export taxes. They also allow duty free imports and export income exemptions for exporting businesses.

Ireland has exemplary export policies. It does not impose export taxes and has minimal export restrictions. It also allows the duty free import of inputs. These policies give Ireland a high score of eight for this category. Historically an agriculturally based economy, the country has become a center for the production of advanced consumer electronics products. Ireland, with gross exports of 80 percent of its GDP, has achieved significant export growth over the last five years. The average annual growth in the value of its exports from 1990 to 1995 was almost thirteen percent. In 1996, the country had annual export growth of over 11 percent¹.

Malaysia provides another good example of how a country can create an export policy environment which is conducive to growth. In addition to taking advantage of regular incentives, an investor operating in an export sector in Malaysia has other benefits. These include export credit refinancing, abatement incentives, an export allowance, training incentives, and a double deduction of export credit insurance. The country has over a dozen free zones.

¹ Source: World Bank, *World Development Indicators* 1997

These zones are designed for manufacturing companies that produce or assemble goods mainly for export. Malaysia's export policies have helped it to maintain solid export growth. During the period from 1990 to 1995, the value of Malaysian exports grew at an average annual rate of 20 percent. Despite all of the benefits available to exporters, Malaysia does not have a perfect score in this category. It still imposes export duties on several commodities. These commodities include petroleum, timber, rubber, palm oil and tin.

Tax Policies

Country	Sri Lanka	Indonesia	Ireland	Malaysia	Singapore	Turkey
Score	8	12	4	12	12	4

While the group has a respectable average of 8.7, individual country scores for tax policy range from very low scores of 4 for Ireland and Turkey, to scores of 12 for the other nations. High value-added taxes and sales tax rates account for some of the divergence in scores. However, the wide range in the tax policy scores mainly reflects the higher corporate tax rates applicable in some countries.

A few countries in the group, such as Singapore and Malaysia, possess a neutral and efficient flat corporate tax rate. Singapore has a flat corporate tax rate of 26 percent. In addition to this rate, its low minimum personal tax rate of 30 percent and a VAT of two percent give Singapore a twelve for tax policy.

Other countries, such as Ireland and Turkey, have higher corporate tax rates. They use more targeted tax incentives to stimulate investment. Ireland has relatively high corporate tax rates. Companies in Ireland not eligible for reduced tax rates face a minimum corporate tax of 30 percent, higher than Singapore's maximum rate of 26 percent. Ireland also has high personal income tax rates, ranging from 27 to 48 percent, and a VAT of 21 percent. These high tax rates earn Ireland an extremely low score of four in this policy category.

Domestic Investment Incentives

Country	Sri Lanka	Indonesia	Ireland	Malaysia	Singapore	Turkey
Score	7	6	8	8	6	8

All of the countries in this group offer several investment incentives and therefore score well in this category. The group average of 7.2 is high. Three of the countries in this group, Ireland, Malaysia and Turkey, have perfect scores of eight because they offer several different incentives. The incentives offered vary, but usually include the following:

- Some type of tax holiday or reduced tax rate,
- Customs duty exemptions, and
- Other incentives such as accelerated depreciation

The following table highlights the major incentives offered by these countries

Selected Incentives Offered

Country	Tax Holiday	Export/Income Tax Exemption	Duty-Free Imports	Accelerated Depreciation	Investment Allowance
Indonesia	X	X	X		X
Ireland	X		X	X	
Malaysia	X	X	X		X
Singapore	X	X	X		X
Turkey	X	X	X		X

Tax holidays or tax reduction remains an important investment incentive tool for most of the countries in this group. Singapore provides various tax holidays to approved financial institutions, companies operating in pioneer industries, and companies involved in expanding an established enterprise. Similarly, Malaysia offers income tax holidays for promoted activities or products, as well as for project expansion and other specific investments. It also provides exemptions on customs duties as well as investment and research and development allowances. Turkey's investment incentives include exemptions on corporate and value-added taxes, and on customs fees and duties, as well as soft loans for investments in research and development.

Ireland, which has a perfect score of eight, does not offer a 100 percent tax holiday. The country's investment law gives qualifying companies a reduced tax rate of ten percent until the year 2005. This rate applies to companies operating in the following priority industries: electronics, engineering, healthcare, consumer products, financial services and international services. Ireland also exempts companies from paying import duties, permits accelerated depreciation, and provides research and development incentives.

Foreign Direct Investment Restrictions

Country	Sri Lanka	Indonesia	Ireland	Malaysia	Singapore	Turkey
Score	8	6	8	6	8	8

Scores for the foreign direct investment category, which focuses on the treatment of foreign investors, are very good. The group average is 7.3 out of a possible eight. Three out of the five countries, including Sri Lanka, earned a perfect score. These high scores reflect a commitment to increasing investment, whether domestic or foreign, in these countries. Foreign investors in all of these nations usually receive equal treatment and are barred from only the standard "strategic" industries. They face little or no limits on the employment of expatriates. These countries take dispute settlement very seriously. All of these countries are members of the International Centre for the Settlement of International Disputes (ICSID) and most are signatories to the New York Convention on International Dispute Settlement.

Singapore provides a good example. Singapore has a reputation for being one of the world's most open investment regimes. It actively encourages foreign investment, especially in leading-edge technologies. The government has instituted several policies that facilitate the formation of strategic partnerships between domestic companies and multinational corporations. In 1995, foreign investments totaling US\$3.4 billion accounted for roughly 71 percent of total manufacturing commitments.² Singapore has a perfect score of eight in the FDI category. Restrictions on foreign direct investment are minimal. When an investment is made, it receives national treatment and, when a dispute arises, the foreign company can go to ICSID for a settlement.

Turkey also provides a good example of a nation with policies designed to attract foreign direct investment. It also has a perfect score of eight in this category. Since the early 1980s, Turkey has made concerted efforts to liberalize its economy. The Turkish government considers foreign direct investment to be a crucial part of the nation's economic development and has tried to increase the level of foreign investment in the country. Foreign investors receive national treatment, and almost all of the sectors open to the Turkish private sector are fully open to foreign investment. However, foreign investors still can only own up to a 49 percent share in both the aviation and maritime transportation industries. In 1980, foreign direct investment as a percentage of gross domestic investment was less than 0.1 percent. By 1995, this number had risen to over 2.0 percent.³

² Source: U.S. Department of Commerce.

³ Source: World Bank, *World Development Indicators*, 1997.

Business Start-up Procedures

Country	Sri Lanka	Indonesia	Ireland	Malaysia	Singapore	Turkey
Score	6	6	8	6	8	6

With an average of 6.7, most countries score well in the business start-up category. Two countries -- Ireland and Singapore -- have perfect scores. Both nations have excellent investment agencies to assist investors in starting a business. They have transparent investment laws and simple business licensing procedures. Businesses investing in either Ireland or Singapore face little or no red tape to slow down the process.

In Singapore, the Economic Development Board (EDB) offers a true "one-stop shop" for foreign investors. The EDB provides accurate, timely information to prospective investors and helps them to obtain the necessary business licenses. The agency has received praise worldwide for helping investors navigate the start-up process and for its responsiveness to changing business needs. It is well respected for its efficiency and accuracy as well as the timeliness of its assistance.

It is well known that a "one-stop-shop" does not guarantee efficient business start-up procedures. Indonesia and Turkey both have agencies designed as one-stop-shops for investors but the actual process for starting up a business can take longer than predicted. Indonesia's Capital Investment Coordinating Board promotes investment and approves project applications as a one-stop shop but investors sometimes find that they still need to spend significant time at other government agencies and regional and local authorities before they can complete their investments.

Turkey's one-stop agency is the General Directorate of Foreign Investment. In 1996, this agency was praised as one of the most successful promotion agencies in Europe. However, investors have found that despite this agency's excellent promotion skills, red tape can sometimes make the business start-up process lengthy.

-Pricing and Interest Rate Policies

Country	Sri Lanka	Indonesia	Ireland	Malaysia	Singapore	Turkey
Score	6	9	12	9	12	9

All of the countries in this group (except Sri Lanka) have good scores for the pricing category. The group averages 9.5. All of these countries have either little or no price or interest controls. Ireland and Singapore lead the group with twelve points. In these countries, the market determines all prices, including interest rates.

116

Turkey, Indonesia and Malaysia have some limited controls on prices and therefore scored nine out of twelve points. Turkey has a very competitive banking system with no controls on interest rates. However, it does maintain a few official price controls on selected commodities. Moreover, the government indirectly controls other prices by setting the wholesale prices of the products of several, large state-owned enterprises. Similarly, Malaysia allows the market to determine most prices, but it does regulate prices for certain goods including fuel, public utilities, motor vehicles, rice, flour, sugar and tobacco.

Foreign Exchange Policy

Country	Sri Lanka	Indonesia	Ireland	Malaysia	Singapore	Turkey
Score	12	12	16	12	14	12

Foreign exchange scores range from twelve to Ireland's perfect score of sixteen. The country average is 13.0. None of these countries have a free-floating system. However, the good policy scores reflect minimal exchange, profit and capital repatriation restrictions.

Foreign Exchange Regimes

Country	Foreign Exchange System
Sri Lanka	Managed Floating
Indonesia	Managed Floating
Ireland	EMS
Malaysia	Managed Floating
Singapore	Managed Floating
Turkey	Managed Floating

Source: IMF, *Exchange Arrangements 1997*

Labor Policy

Country	Sri Lanka	Indonesia	Ireland	Malaysia	Singapore	Turkey
Score	4	4	6	8	8	6

The purpose of commercial policy reform is to create an environment characterized by increasing wage levels driven by productivity rather than regulations, where labor conditions improve but disruptions are minimal. Country scores for labor policy vary. Malaysia and Singapore both have perfect scores of eight, while Sri Lanka and Indonesia (4 points) have the lowest score in this category. Both Malaysia and Singapore possess perfect scores because neither country has minimum wages or wage controls. Indonesia has a minimum wage but does not control wages. Creating more jobs is one of the Indonesian government's key objectives. Roughly 75 percent of its 83 million workers are between the ages of 15 and 34, and 30 percent of the labor force is underemployed. Indonesia does not control wages nor does it impose any official restrictions on hiring and firing workers. However, in practice, firing workers can be problematic. Often the termination of employees results in harmful labor strikes. Since 1992, the number of these strikes has become significant. Indonesia's low score of four reflects this problem.

3.4 The Competitiveness Balance Sheet

In addition to reviewing comparative performance indicators and recent macro-economic and commercial policy reforms, it is important to review the other competitive assets of Sri Lanka. These economic "assets" and "liabilities" affect the overall competitiveness of a country's firms. They include human resources, finance and infrastructure.

Human Resources

Among Sri Lanka's accomplishments since independence has been the extension of education to cover the entire population. There is almost universal literacy (although emphasis on the English language has been lacking) with the possible exception of the northeastern provinces, the principal site of the Tamil insurgency. Educational opportunities were not matched with employment opportunities, however, and high unemployment rates have been a major problem. However, since 1990, the measured unemployment rate has declined from 16 percent to about 11 percent. Increasing employment opportunities, especially in export manufacturing, have combined with outward migration to contribute to this trend.

Overall population growth has declined over the past 20 years to a current rate of 1.1 percent per year. Nevertheless, with 18.6 million inhabitants, Sri Lanka confronts not only the problem of high unemployment but also issues related to high population densities and fragmented land ownership. Declines in fertility and improvements in life expectancy have led to a process very well established in the developed world -- an

increase in the old age dependency ratio. From a 5.9 percent dependency ratio at the time of independence, it has reached 7.4 percent in 1997 and is expected to reach 17.4 percent by 2021. Projections of current demographic trends indicate that the number of youth entering the job market will peak in 2020 and decline thereafter. Labor force growth is expected to stabilize by 2010 and remain static thereafter. This implies an era of labor scarcities beginning as early as the first decade of the new century.

At present, however, rural poverty remains widespread. With the objectives of alleviating poverty and upgrading economic and social conditions of the poor, the government has launched the *Samurdhi* program. Its major activity has been financial, extending income supplements to poor and displaced families. Over 400,000 families have benefited from the first phases of the program, while food rations were extended to 180,000 families displaced by the war in the northern and eastern provinces. Mandatory savings programs and small loans are also part of the program, for which costs have run around US\$800 million.

Sri Lanka's major competitive advantage in attracting offshore assembly industries has been the availability of a literate but low-cost labor force. Sri Lankan wage rates were significantly lower than those of its Asian economic rivals. With the collapse in currency values, especially acute in Indonesia, this advantage has largely dissipated, at least temporarily. Wages remain low by international standards at \$50-60 a month for government employees and a minimum of \$1.30 per day for tea plantation workers.

Sri Lanka's educational system has up to now offered little in the way of technical training. So while there is an ample supply of unskilled workers, there is a shortage of workers with computer, telecommunications or other skills required for higher technology manufacturing. Combined with the lack of technical skills, employers also face rigidities imposed by labor legislation, especially with respect to severance or layoffs. One consequence is the tendency for employers to resort to short-term, but renewable labor contracts. Labor turnover rates are also significant, for example, garment worker turnover was estimated at 70 percent in 1996.

With Sri Lanka's economic growth strategy based on the aggressive promotion of labor-intensive export industries, existing skills shortages and an impending tightening of the labor market pose challenges. Movement away from assembly operations to information technology, computer and offshore banking services offers opportunities but is limited by the lack of trained personnel as well as a highly competitive global environment.

Financial Resources

The amount and terms of capital and credit available to private sector firms in Sri Lanka have been strongly affected by the government's financial policies. In the past, chronic deficits substantially "crowded out" private borrowers, but financial market conditions have recently improved. In recent years, the government has reduced expenditures and

obtained financial resources from privatization, thereby improving financial market conditions and access to capital and credit

Price inflation was brought down from 16 percent in 1996 to 9 percent in 1997. The relatively high rate experienced in 1996 was blamed largely on the effects of the drought, which caused shortages of a number of commodities and a resultant increase in price. Government fiscal policy is directed at keeping the inflation rate to no more than 9 percent in 1998.

The government permits the free exchange of foreign currencies for most transactions, including portfolio investment in the Colombo stock exchange. Repatriation of profits and conversion of export earnings is permitted. Private foreign investment and outflows of enterprises not covered by BOI incentives are allowed but only with approval. These modest controls, together with control exercised over the short-term foreign exposure of commercial banks, are credited with protecting Sri Lanka's economy from much of the spillover effects of the Asian economic crisis.

Reduction in statutory bank reserves from 15 to 12 percent permitted increases in available capital for lending to private borrowers. Current loan rates in rupees run about 20 percent, although the "prime rate" is 14.5 percent. Commercial banking has largely been liberalized, although the two state-owned commercial banks still control some 60 percent of the commercial banking market.

There are now a total of 26 commercial banks active in the market, several of which are foreign-owned. In this competitive market, individual banks are modernizing their operations and introducing new products. In addition, there are two private development banks, the National Development Bank and the Development Finance Credit Corporation, which have access to concessional funding from abroad and which compete with the commercial banking system.

The Colombo Stock Exchange is one of the older and better-established equity markets in the region. Its capitalization is estimated at US\$1.9 billion, and it has proved to be a source of equity capital for local firms. Foreign portfolio investors have also been active in the stock exchanges' share trading.

Physical Infrastructure

Physical infrastructure is a major constraint to Sri Lanka's long-term development prospects. Part of the problem has been state ownership of virtually all infrastructure, which has combined weak management with deficient investment in modernization and expansion.

Some 10% of Sri Lanka's exports are transported by air and 90% by sea. The international airport near Colombo is large and modern, but the national airline, Air

Lanka, is state-owned and not regarded as very efficient. The recent involvement of Air Emirates may improve this situation somewhat.

Colombo's port facilities are ranked 26* in the world in terms of volume, handling 12 million metric tons of freight in 1997, of which 73 percent represented transshipments. The GOSL has formulated a National Ports and Shipping Policy with the goal of positioning the country as a premier shipping center for South Asia. The policy calls for expanding container capacity at Colombo, developing the infrastructure at secondary ports, and promoting greater involvement of the private sector in providing ancillary port facilities. The Port Authority responsible for Colombo and the other two small ports is a public agency and there are questions as to efficiency of operations and strength of management. Potentially competitive ports, especially several in South India, are worse by comparison.

Electric power generation and distribution were recently monopolies of the Central Electricity Board, a public enterprise, and was highly dependent upon hydroelectric power. The severe drought in 1996 created serious problems in electric power supply. This has been overcome through three measures: (1) investment by the state in thermal power plants, (2) economic incentives for export industries to import equipment and generate their own power, and (3) concessions to foreign private firms to invest in new power generation facilities. Available electric power expanded in 1997 and the level of service was generally satisfactory. More plants coming into service should enable the country to meet its power needs for the medium term. However, power distribution is still a public sector monopoly.

Telecommunications service, managed by another state monopoly, was historically inadequate, with only one telephone installed for every 90 Sri Lankans. Waiting times for new telephone service were as long as ten years and only 40 percent of local calls were successfully completed. Recent liberalization brought in two foreign companies to provide cellular telephone service, which, combined with substantial investment by Sri Lanka Telecom in satellite technology, digitalization and new lines, has alleviated the problem to a certain degree. After the sale of a 35% share of Sri Lanka Telecom to NTT of Japan, together with a contract to NTT to provide management, the number of new telephone connections grew to more than 70,000, an increase of 23% over existing total land lines.

Roads and land transport remain serious problems. Sri Lanka Rail is experiencing serious capital shortages and efficiency problems. Whether because of insufficient capital to purchase new rolling stock or poor operating efficiency, the rail company is unable to meet demand. Actual freight loadings in 1997 declined 13 percent compared to 1996 despite expanded economic activity, reflecting lack of rolling stock and operational problems. While passenger traffic increased slightly in 1997, service is notoriously poor.

Most urban and inter-urban passenger traffic is carried by buses. Here again, government intervention has left the system in poor condition. Most of the service is provided by “peopled” services which have been unable to maintain previous levels of service let alone expand to meet demand. The road network consists of 97,000 kilometers, but only one-third is paved. Basically, it is old and not well-maintained. The Road Development Authority is responsible for national roads but local and regional roads are left to local governments. In sum, the poor quality of land transport facilities in Sri Lanka acts as a major constraint to development. The government is aware of the problem and has created an Infrastructure Development Board charged with exploring the use of BOT/BOO mechanisms to attract private capital investment in infrastructure projects.

Water and drainage in major urban areas is the responsibility of the National Water Supply and Drainage Board. Water is a serious problem in terms both of supply and quality. Reliable supplies of water in the volume needed for many industrial processes are not available.

Finally, despite new legislation, several plans and considerable publicity, Sri Lanka suffers from severe environmental problems. These range from the deterioration of coastal areas, including coral reefs, and severe shortages of acceptable waste treatment facilities, both solid and liquid. Over half of the country’s energy is still derived from charcoal, wood, other plant and animal waste. There are few effective controls over industrial pollution and little public understanding of the value of protecting the environment. Failure to bring these problems under control threatens the fisheries industry as well as tourism.

3.5 Summary

This chapter has provided an analysis of the policy and institutional factors affecting the micro-economic environment. Sri Lanka has established a pro-active commercial policy including reforms, investment promotion and export promotion. The strategy is to be amongst the forefront of countries pursuing aggressive strategies for export growth and to serve as a regional gateway to South Asia. But Sri Lanka has serious infrastructure problems, despite recent improvements in telecommunications. Energy, transport, safe water and indicators related to computers and the Internet are areas where Sri Lanka is weakest. Government budgets are constrained so innovative ways to involve the private sector in building, owning and operating must not only be planned but also implemented.

The statistics presented in the first three annexes provide the overall environment in which competitive behavior is either enhanced or constrained. Competitiveness, however, can best be examined at the industry and firm level from the case studies of real companies and sectors.

ANNEX IV:
INDUSTRY AND FIRM-LEVEL COMPETITIVENESS

4.1 Introduction

Competitiveness can only be truly understood at the level of firms **and** industries - for it is they that actually compete for growth, market share and resources. These are the economic units that, at the end of the day, must deliver the increased productivity to the economy. Improved incomes and living standards depend upon their performance. A government can allocate resources, reduce friction in the economy and create a national platform conducive to competitiveness. But it is the firms themselves which must invest, employ, innovate, export **and** create wealth.

The team has sought to listen very carefully to private sector firms and industries in Sri Lanka. The stories of 8 industries are briefly presented in this section. The section provides brief industry surveys or descriptions that are neither meant to be comprehensive nor to recommend "winners" or courses of action.

The purpose of presenting these industry situations is to examine the issues that firms and industries in Sri Lanka face in their quest for competitiveness, to suggest alternative lines of strategic thinking, and to provoke business to consider new ways of being competitive.

The industries examined in this section include

- Tea,
- Rubber,
- Electronics,
- Apparel,
- Toys,
- Gems and Jewelry,
- Tourism, and
- Service and Knowledge-Based Exports

The exhibits at the back of this Annex present the *Porter Diamonds* and *Austin Policy Matrices* for each of the industries.

4.2 Tea *Something Brewing?*

Industry Background and Performance

The Sri Lanka tea industry dates from 1867 with an original 19 acres of planting after devastation hit the coffee plantations. Exports began in 1873 and public tea auctions in Colombo go back to 1883. Ceylon tea earned record prices in the London tea auction as early as 1891. In 1925, the Tea Research Institute was established. In 1963, Sri Lanka began producing and exporting instant teas. By 1965, Sri Lanka had become the world's largest tea exporter.

In 1975, tea estates were nationalized, which unfortunately drove several private companies and individuals to establish operations in competing countries like Kenya, now Sri Lanka's major competitor. Although the process of nationalization was reversed in the early 1990s, the state sector still accounted for 46% of total tea production in 1997 - although much of it was under private management.

Tea plantings cover 189,000 hectares and generate \$685M in export revenues with a very high domestic content. Sri Lanka is the third largest tea producer after India and China but, with Kenya, is the largest tea exporter. Sri Lanka and Kenya each accounted for about 22% of world tea production in 1995. Tea is the only major export for which Sri Lanka enjoys leading market share, often being the #1 exporter.

Factor Conditions

The possibilities for expanding tea production are quite limited in Sri Lanka. Total land area under tea cultivation has been reduced from 222,000 hectares in 1992 to 187,000 hectares in 1995¹. The country's plantations are older and yields are below some of the other leading countries. Also, the industry's machinery is old, and traditional processes are still used.

Tea from Sri Lanka, however, is considered to be of high quality, and continues to command premium prices in its target markets².

The industry faces a major cost challenge as wages increase. State involvement in the tea sector is still substantial, imposing both policy/regulatory and managerial constraints.

¹ Central Bank of Sri Lanka, 1995 statistics

² Although the recent World Bank study on Sri Lanka's tea industry noted that Sri Lankan tea commanded lower prices on the London Tea Auction, this is not the relevant reference point as the London auction was mainly used as a residual market.

Demand Conditions

Demand for black tea is growing at a rate of less than one percent per year worldwide, although there is strong regional variation. Demand for black tea in Asia and Latin America grew 16% from 1986-95. Growth in tea demand in Europe has averaged around 1% per annum³. Per capita tea consumption has fallen in the UK but is increasing in the Middle East, former Soviet Union, North Africa and South Asia -- regions that offer the greatest long-term prospects for Sri Lankan black tea exports.

Sri Lanka is expected to be amongst the top 3 world suppliers of black orthodox tea in the year 2000, with a projected global market share of 32%. Its market share for CTC tea, the other major black tea variety, is projected significantly lower at around 5% in 2000.

Global demand for instant tea is expected to increase in coming years, particularly in European markets (including CIS countries). Specialty teas also offer growing demand in specific markets.

Firm Strategy, Structure and Rivalry

The growth of Sri Lankan tea exports has been fueled by higher prices and by upgrading of products. Export of bulk tea has barely increased and exports of packeted tea has grown by 14% over the last decade. On the other hand, over the same period, the export of tea bags grew by 176% and instant tea by 156% over the last decade, although these products still account for only a small portion of Sri Lanka's total tea exports. About 49% of tea exports are non-bulk in nature, up from 43% in 1987.

Sri Lankan tea exporters have nevertheless generally been slow to upgrade their products. While some firms have added value by branding and selling packeted or specialty teas, the major opportunity for the industry is to more aggressively upgrade from bulk tea to branded teas, tea bags, blended teas, health and specialty tea products, and instant tea. This would require, and also help the industry get closer to the consumer and to monitor and react to consumer trends. It would allow the industry to capture more of the value between the farm and the consumer table. Such actions would require greater marketing knowledge and skill.

About 6% of Sri Lankan tea exports take place through direct market channels (called ex-garden sales) with the rest through auction. The advantage of direct marketing is faster payment, less uncertainty regarding price and sales, and the avoidance of warehousing and logistical costs associated with the auction. For buyers, ex-garden sales improve delivery time and product quality.

³ Ali Ridwan Choudhry Yusuf A. Lister Douglas W. "Sri Lanka's Tea Industry: Succeeding in the Global Market." World Bank Discussion Paper No. 368. World Bank, 1997.

The Industry Cluster

Sn Lanka has a Tea Research Institute, which is reputed to be of good caliber. The Colombo auction is well-known around the world, and the tradition and reputation of Ceylonese tea have been excellent.

After 300 years, the London Auction closed in June 1998, creating interest in the possibility of Sn Lanka becoming an international auction center, thus adding a service dimension (availability) to the product. Establishing an international auction center would require an automated auction system, good infrastructure and communications facilities, possibility of trading in foreign currency, and the free import and export of tea from other countries. Technological sophistication for blending would also be required.

Any decision regarding an auction should, however, begin with an analysis of the declining volumes in London - which dropped by half in the 1970s partly because of the Calcutta and Colombo auctions. More recently, there has been a tendency towards direct transactions between buyers and farms, enhanced by improved communications.

As a blending center, value could be added. Blending involves sophisticated skills and quality control, and this is therefore not an easy task to master. The taste of tea varies according to the water that is used, so blending to taste with Sn Lankan water may not give the desired result in terms of taste in the final market.

Role of Government

Privatization in the tea industry has yielded substantial benefits. However, although the nationalization process has been reversed and many of the state-owned plantations are privately managed, Government involvement in the tea sector is still substantial, and creates constraints and inefficiencies.

One issue affecting competitiveness is the prohibition on importing teas from other countries, except limited volumes of CTC tea. Sn Lanka is primarily a producer of orthodox tea. This prohibition is currently the focus of debate within the industry. The rationale for this policy is to ensure that there is adequate demand for tea from existing rural producers. The government also pre-determines the prices that must be paid to local producers. However, this policy inhibits the sector from processing and re-exporting larger volumes of tea, thereby capturing a larger share of the market. This would seem to be a key area for further study.

Looking Ahead

The analysis of the tea industry reveals a number of opportunities for improvement. Privatization has been a beneficial process and should continue. There is considerable

room for improvements in the related and supporting industries and institutions, and to improve the interactions within the cluster

Specialization, differentiation, branding and improved marketing offer the greatest opportunities for capturing higher value and increasing prices. Such efforts will have to go hand-in-hand with investment in plantations, processing equipment and methods, and in active efforts to fully understand and stay abreast of consumer preferences.

The following table presents several examples of opportunities for the Sn Lankan tea industry

Opportunity	Method
1 Comprehensive Positioning	Opportunity: Increasingly upgrade quality and specialization to seek a higher-priced branded and niche market. Make Sri Lankan tea a mark of quality. Invest in upgrading old plantations.
2 Customer Learning	Opportunity: Understand customer tastes and niches as basis for selectively marketing Sn Lankan tea.
3 Innovation	Opportunity: Possibility of blending teas. Invest in modern equipment and processes. Investigate possibility of creating a Sri Lanka auction.
4 Human Capital Investment	Opportunity: Increase skills through training in step with introduction of new strategies and new processes.
5 Cluster Cooperation	Opportunity: Develop a common strategic direction with focus on quality and image. Introduce quality gradings and standards. Collectively examine the opportunities for local auction and for blending. Cooperate on building market knowledge of Sri Lankan tea. Government to work with industry to consider facilitating changes in laws and regulations (e.g. reimportation of teas). Continue privatization to increase productivity.
6 Forward Integration	Opportunity: Possibility of Sn Lankan auction, and of blending. More active marketing of a product identified as Sn Lankan. Continue to develop new packaging approaches.
7 Strategies and Attitudes	Opportunity: Move from cost-based competition to one of higher quality and greater value added with an identified Sri Lankan image. Will require comprehensive introduction of elements supporting the strategy, and review of protectionist regulation and State ownership, allowing Sn Lankan companies the freedom to compete internationally.

4.3 Rubber *Bouncing Beyond the Basics*

Industry Background and Performance

The story of the rubber industry in Sri Lanka is focussed on the recent but substantial jump in export earnings based not on the export of raw materials but on forward integration and upgrading the industry to more complex exports

In 1987, only 14% of Sri Lanka's rubber exports were in manufactured form. In 1996, manufactured rubber exports had surpassed basic products and represented 66% of the total. Whereas rubber exports declined at an average rate of -2.5% per annum from 1987-96, manufactured rubber products grew at an average rate of 27%. In 1996, Sri Lanka exported \$104M in sheet rubber, block rubber and crepe rubber, but exported \$169M in the form of manufactured rubber products. This represents a gradual successful movement towards more complex exports. Rubber manufactures grew from about 0.1% of total manufactured exports in 1980 to 5.3% of such exports in 1995.

Factor Conditions

Sri Lanka is amongst the world's lowest cost producers of rubber, largely due to low labor costs. While traditionally low, productivity has also improved. Total factor productivity (TFP) for manufactured rubber products has responded dramatically to the improved macro-economic and micro-economic environment in recent years. Whereas TFP was negative (-3.4) from 1981-88, it jumped to 9.9% for the period 1988-93.

New technology for rubber extraction and processing are available in Sri Lanka, offering the potential for further cost reductions, improved productivity and product quality.

Sri Lankan smallholder rubber producers lack adequate technical and managerial skills, a major constraint to innovation, adoption of new technology and productivity. However, new owners of the recently privatized rubber estates are slowly incorporating new techniques and upgrading skills.

The Sri Lankan government continues to maintain strict labor regulations in the rubber sector, governing the hiring and firing of workers on rubber estates, minimum wages, wage rates and the movement of labor between plantations. This is also a key constraint to more efficient rubber production in Sri Lanka.

Demand Conditions

World market demand for natural rubber from 1989-95 grew by only 2% per annum, exhibiting the tendencies of a mature market. Some 65% of natural rubber is used in the

tire industry and 80% of world tire sales are in the hands of 9 companies, giving these companies a strong bargaining position

Meanwhile, a more attractive market exists for specialty rubber tires (for forklifts and heavy equipment), surgical products, contraceptives and other clinical uses, and for a variety of consumer goods for which rubber is amply suited. World demand for specialty tires is about \$250M per year

Firm Strategy, Structure and Rivalry

Sri Lanka has only 2% of the world market for basic rubber, although it is the 5th largest producer. As a result, Sri Lanka tends to be a "price taker" with respect to basic rubber, and sells into markets such as Pakistan and Iran, although also to Germany, Italy and the UK. Sri Lankan rubber exports tend to be sold to mid-level dealers and through bi-weekly auctions, channels better-suited for low quality rubber than for specialty rubber

Thailand, Indonesia and Malaysia account for 91% of the global supply of rubber. Malaysia managed to compete in this industry despite the fact that Malaysian wages were five times the level in Sri Lanka (prior to devaluation). The cost of production in Sri Lanka's state sector is almost twice that of the private sector although much of the state plantation sector has been privatized over the last decade⁴. The state sector produced about 1/3 of Sri Lanka's rubber in 1992. Sri Lanka has 15% of the world's solid tire manufacturing capability, a better relative position than that of raw rubber

The strong improvement in total factor productivity for manufactured rubber products is a dramatic illustration of the lessons of competitiveness. This increase was not entirely due to getting labor to work harder or even smarter. Rather, it represents the ability of companies to command superior prices in the international market by identifying market needs and innovating in product development. Anecdotal evidence supports this. For example, Sri Lanka has a 15% market share in the world market for specialty solid rubber tires for heavy equipment. Other companies have begun exporting surgical gloves and rubber mattresses. A case study (on following page) will illustrate

⁴ World Bank, 1997, p 27

These products are manufactured per specification of compames providing the link to the market Even more advanced compames reported hamng limited ability to follow consumer trends and to innovate with new product offenngs launched directly to the end-use consumers

Case Study Solid rubber foam mattresses are regarded as superior because they last longer, are more resilient and provide for a better sleep They do not require a **box** spring and are only six inches wide The Richard Pieris company received technical assistance under the USAID-funded TIPS program that helped it identify a market in the **USA** with a high-end mattress manufacturer After identifying the market opportunity, the company received technical assistance to find and obtain appropriate equipment in the UK and Germany to establish a production line Sales jumped from zero to close to \$5M in the **first** few years and growth prospects are good

The Industry Cluster

The industry cluster for rubber in Sri Lanka is underdeveloped and lacks a coordinated strategy There is little inter-agency cooperation amongst the major government agencies responsible for development of the industry (i e , Rubber Research Institute, Industrial Development Board, Ceylon Institute of Scientific Research), and their actions are not well-coordinated with private enterprise Smallholder producers lack adequate institutional capacity for effective rubber marketing A key competitiveness challenge for the Sri Lankan rubber cluster will be to develop and strengthen customized marketing channels to market Sn Lankan rubber and rubber products in selected market ruches worldwide, rather than the current reliance on mid-level dealers

Role of Government

The GOSL has promded incentives for replanting rubber plantations and BOI incentives apply to manufactured rubber products

Domestic use of rubber has grown from 11% of total production in 1985 to 35% in 1995 as a result of government incentives and private sector strategy to target more complex exports based on rubber Most duties and taxes were elimnated although a cess is imposed to pay for replanting subsidies Private comparues have responded with better strategies for target markets and product development The result is that manufactured products have now surpassed basic rubber as an export-earner

Looking Ahead

The Sn Lankan rubber industry has made significant stndes towards capturing a higher-value, more complex market position Additional efforts to identify high-value ruches, and worlung with customers to develop products and related services, will strengthen the

126

position of the rubber industry The sale of basic rubber, with relatively high factor costs and strong buyer power, will not lead to greater wealth or sustainable market position

It is desirable that privatization efforts continue, adding efficiency and market responsiveness to a large segment of the industry Further development of the industry cluster in Sri Lanka, particularly greater linkages amongst smallholder producers, manufacturers and marketing and distribution channels, will be critical for the future competitiveness of the industry

The following table presents several examples of opportunities for the Sri Lankan rubber industry

Opportunity	Method
1 Competitive positioning	Opportunity Continue to develop specialized and value added products increasing productivity, adding value Move further from cost-based competition
2 Customer Learning	Opportunity Work with downstream vendors to develop products and channels, understand quality requirements Develop strategic partnerships to access market knowledge and distribution
3 Innovation	Opportunity Through strategic partnerships, continue to introduce new products and technologies
4 Human Capital Investment	Opportunity Investing in the training to support increasing value added, product design and market responsiveness
5 Cluster Cooperation	Opportunity Continue to develop industry associations, dialogue, research and training Continue privatization to increase productivity and responsiveness
6 Forward Integration	Opportunity Develop strategic alliances with organizations requiring customized or specialized products
7 Strategies and Attitudes	Opportunity Work closely with the market to identify product opportunities and respond quickly

4 4 **Electronics Industry *Unplugged***

Industry Background and Performance

The electromcs industry at one time appeared to offer a likely follow-on to Sn Lanka's early success in apparel. The industry seemed to offer enormous potential when the major U S -based multinationals, Motorola and Hams Semıconductors, entered into agreements with the G C E C (now BOI). However, communal riots in 1983 reportedly affected their planning, and both international giants abandoned their operations just before start-up and relocated to Malaysia and elsewhere. Thereafter, the electronics industry never became established, and, as of today, has not generated significant production volumes, export values or employment creation. Given the worldwide growth of the industry, however, there may still be potential to develop this industry in Sri Lanka.

Factor Conditions

Positive factor conditions for the electromcs industry in Sn Lanka include a highly trainable workforce, ample land, free trade zone facilities, and favorable BOI incentives. These are basic factors affecting comparative advantage, however, advanced factor conditions are limited.

With very few "home grown" export-oriented electromcs firms in Sn Lanka that design their own products, there are few oportunties for product design engineers.

One important constraint is the non-availability of raw material, parts and components, or elements of a supporting industry. The industry must import essentially all necessary raw material, finished/semi-finished parts, components, and in some cases, even indirect materials and consumables. Relative cost and response times are higher in Sri Lanka, due to the need to transport by air, and the distances involved. Most electromc parts are light and small in nature, and due to their sensitivity to environmental conditions, they are usually air-freighted. Sn Lanka lacks adequate air cargo transport facilities or service. Passenger airline cargo rates are not competitive and the frequency of flights is inadequate. While, Sri Lanka is ideally situated for sea cargo transshtpmnts, this is at present not true for air cargo.

Sri Lanka's geographical location is thus not favorable for development of a basic electronics industry. Thailand, Malaysia and Singapore can easily carry out their inter-factory production and/or procuring of raw material, finished/semi-finished parts, and components or consumables, and transport these back and forth.

Demand Conditions

BOI compames sell their products to relatively demanding clients in Japan, Korea, Sweden, Germany, Switzerland, U K and the U S A Sales are therefore generally not to the end user Foreign buyers provide product specifications and requirements, and may even send their own technical experts to set up production lines and conduct trial production runs

The recent EDB-sponsored “Business Intensification Program in the Umited Kingdom,” with financial and techntcal assistance from the Commonwealth Secretanat in London, gave local manufacturers opportumties to meet new potential buyers on a “one to one” basis, and also provided follow-up service

Firm Strategy, Structure and Rivalry

There is little real competition among the different players within Sri Lanka The industry is mostly limted to the manufacture of component parts for foreign parent compames or contractors The South Asian Association of Regional Cooperation (SAARC), comprised of seven countries of the region, will at some point likely open up its markets for inter-trading of products with special tax preferences (SAPTA), and this may eventually be followed by a free trade agreement (SAFTA) While this represents a potential opportumty, it also bnngs a threat that more competitive players may enter the market, displacing local firms supplying the domestic market

The Industry Cluster

Apart from local assemblers of radios, TV’s and other products for the domestic market, there are only 12 export-onented electromcs factories despite vigorous investment promotion efforts in this sector by the Government The major players are foreign-owned and operate under B O I status Some, like Tanden Industries, are making some of the computer industry’s most sophisticated products The Japanese-owned FDK Lanka is the largest and best equipped manufacturer in Sn Lanka Among the 12 manufacturers, I E Technics, a fully Sn Lankan-owned business, is the only manufacturer with consumer electromc products that are designed in-house

The general view in Sn Lanka is that had Motorola and Harris provided the anchor for this industry, many other firms would have followed either as suppliers or manufacturers because of the demonstration effect of the growing image that the country would be a force in the world of electromcs Sn Lanka is not currently recogmzed as a key location for the electromcs industry

The supporting industries for electromcs development in Sn Lanka are well behind international standards and thus the quality of the electromc innovations cannot meet world expectations The development of Sri Lanka’s electromcs industry with its own

designed products is seriously handicapped due to inadequacies within the sub-contract services sector. There is an absolute shortage of precision engineering workshops, and the plastic molding facilities fall short of the standards necessary to sustain the export markets. There are no electronic part component manufacturers or **PCB** manufacturers producing adequate quality products for the application of Integrated Circuits and Surface Mount Technology [SMT]. There is also a lack of locally produced (or even stocked) specialty wire for industry requirements.

To enhance Sri Lanka's consumer electronic manufacturing export potential, it is important to focus on test measurements, type approvals, safety and environmental assessments. Operating performance is determined by realistic practical tests. "Quality" is a factor of the underlying quality assurance system, backed-up by type approval and environmental testing. Consumers have become accustomed to highly reliable and fault-free equipment that are robust enough to withstand the "use and abuse" inflicted by both operators and the environment in which they are used and transported. Therefore, it is necessary for Sri Lanka to establish its own in-house testing facilities, with national standards that invite international recognition.

It is very unlikely that the current electronics industry could fund such an investment, and therefore some form of initial government sponsorship may be needed. A common electronic testing house facility could be established on a commercial basis, perhaps independently, or perhaps attached to the Sri Lanka Standards Institute or CISIR. As added value, this facility could ensure the testing of imported electronic consumer products so that Sri Lankan consumers can purchase certified, quality assured products.

Role of Government

During the past 20 years, the government and its related institutions made several attempts to promote the sector, but without much success. In order to attract new investments into electronic projects, the Government of Sri Lanka (B O I) offered special incentives (including grants of up to Rs 30 million) to assist with training, product development and quality control. However, even these incentives failed to attract new entrepreneurs to this sector.

As mentioned, initial Government support for a common electronic test house facility may be desirable.

Looking Ahead

At first glance, the opportunity for establishing a strong electronics industry may not seem great. However, there may be opportunities for entrepreneurs who know the industry and its demand requirements. Other opportunities may arise as international patterns and comparative advantages change. Improvements in infrastructure and related services appear to be underway. If the upgrading of telecommunications, water and power is

carried through, more of the basic facilitating infrastructure that is important to the industry may be put in place

As the electronics industry is relatively high-cost and high-risk in terms of investment, it will be important for this type of industry to have some established “anchor” player – to promote some sense of security and to promote the clustering effect and additional investments

Several examples and opportunities for the Sri Lankan electronics industry are discussed below

Opportunity	Method
1 Competitive Positioning	Example Bartleets took off thanks to collaboration with Japanese manufacturers (but which subsequently failed, reportedly due to labor problems) Opportunity Establishing backward linkages for basic materials required in electronics manufacture, such as wires built to specification, plugs, connectors and resistors
2 Customer Learning	Example Business intensification program launched by the EDB with the help of the Commonwealth Secretariat in London, which brought local producers in contact with prospective European partners Opportunity Regular programs such as the above
3 Innovation	Example Improving technological capacity and market access through foreign collaboration such as I E Technics with solar technology Opportunity Establishing reliable and durable testing capacity in Sri Lanka for consumer electronics
4 Human Capital Investment	Example In-house training through absorbing electronics and design engineers Opportunity Linking training in schools with employers in industry
5 Cluster Cooperation	Example Creation of electronics manufacturers and exporters association (in process) Opportunity Creating awareness of local manufacturing capabilities in order to reduce redundant investment and increase the utilization of existing potential
6 Forward Integration	Example I E Technics has progressed into the consumer electronics market Opportunity Moving towards the manufacture of products that serve the consumer electronics market rather than being limited to electronic components
7 Strategies and Attitudes	Example FDK's current strategy of locally sourcing required materials in order to produce cheaper products for international markets Opportunity Attracting established market leaders in the industry to set up operations in Sri Lanka in order to promote investor confidence and cluster formation

4 5 Apparel *Naked Before The Storm?*

“Only 40-60% of this industry will survive the Year 2005 ”

Apparel Industry Executive, July 1998

Industry Background and Performance

The apparel industry in Sri Lanka began in 1975 **with** about 5-6 factories. In 1977, the industry recorded exports of only US\$9.9M. By 1997, the industry had 951 factories that recorded exports of US\$2,052M. Of the 951 factories, about half (445) are serviced by the Ministry of Industrial Development and the other half (506) by the Board of Investment (BOI) of Sri Lanka. The apparel industry has, over the past 15 years, become the major export income generator for Sri Lanka. After gradual and slow progress in the early 1980s, the apparel industry has since grown at about twice the pace of the world market.

Since 1994, the industry has accounted for an average of 43.1% of total merchandise exports from Sri Lanka, although its share of the world apparel market is only 1.04%.

Factor Conditions

Factor conditions such as low-cost land and a skilled and literate workforce provide the industry with some measure of comparative advantage.

But offsetting these advantages have been the concentration of population in certain key areas and lack of adequate infrastructure for expansion into rural areas. The geographical location of Sri Lanka (which is very distant from the main export markets) has resulted in long lead times, which is a great disadvantage in an industry where ‘quick response’ is crucial to keep pace with fast-changing fashion demands. Sri Lanka and the Indian sub-continent currently have relatively high lead times compared to Western markets.

Demand Conditions

Demand conditions provide a mixed picture. Companies sell to wholesale markets, direct to retail vendors, and through trading houses, liaison offices and buying officers. The major markets for Sri Lanka are currently USA 60%, EU 34%, and Canada 2%. Of the EU component, UK is 56%, Germany 16%, BENELUX 14%, France 6%, and Italy 2%.

The industry obtains details about its markets sometimes directly from buyers and at other times from buying and liaison offices located in Sri Lanka. There are still opportunities to expand awareness of markets through international buying officers and

“Cyber” marketing through the Internet. However, the industry seems to lack the financial resources for outbound market research, designed to identify, explore and develop new markets.

The industry has increased its market access through the formation of strategic alliances with buyers and strengthening relations with suppliers. Investing in building buyer confidence has been, and probably will continue to be, essential for expanding Sri Lanka's position in the market.

Firm Strategy, Structure and Rivalry

Through building strategic alliances with buyers, which has resulted in the inflow of capital investment, the introduction of advanced technology and the dissemination of the best manufacturing and managerial practices, the Sri Lankan industry has *created* many advantages. In-house training of workers and specialized training for middle management through training institutes has helped to upgrade the knowledge and skills of the workforce.

The industry is a mix of highly quota-dependent firms that target the low value-added mass market and firms that show high growth in non-quota sectors targeting high value-added niche markets. About 60% of the industry is driven by quota markets and about 40% by non-quota markets. Over a third of export earnings are generated by the top 25 firms that do not rely on quotas for the growth of their businesses.

Those in the industry have estimated, taking into account the rate of upgrading and improvement now underway, that when MFA quotas end, only 40-60% of the industry in Sri Lanka will survive.

The Industry Cluster

Sri Lanka has strong training institutes for the apparel industry. These are the *Clothing Industry Training Institute*, the *Department of Textile & Clothing Technology* of the *University of Moratuwa* and the *Phoenix College of Clothing Technology* (a private sector organization) all of which provide specialized training for middle management.

Related and supporting industries in Sri Lanka are, however, weaker than in countries with larger textile and apparel industries, and this poses threats for Sri Lanka after the expiry of the MFA in 2005.

Documentation requirements cause delays and add to lengthy lead time. Lead time could be reduced by expediting the installation of the EDI (Electronic Data Interchange) links to the *ASYCUDA ++* of Sri Lanka Customs. The operation of Sri Lanka Customs is of vital importance and is being upgraded with the introduction of *ASYCUDA ++* (Automated System for Customs Data Analysis).

The Textile Quota Board has been in charge of managing and distributing quotas. It has been operating in a satisfactory manner until recent uncertainty caused by the government-sponsored "50 Garment Factory Program". The delay in implementing this program has caused delays in the distribution of quotas to the rest of the industry.

Port charges at the Sri Lanka Ports Authority are perceived to be high, and there has been criticism of the Port for low productivity and other problems. The apparel industry advocates increasing and adequately staffing the entry and exit points to the Colombo Port in order to provide both maximum security and greater efficiency. The industry believes that this would serve to reduce delays, which would help reduce lead times.

The recently established customs *InFac* (Investor Facilitation Centre) has considerably reduced documentation processing delays at customs. However, non-BOI firms are unable to benefit from this facility due to the structure of the industry.

BOI provides many incentives for a large segment of the apparel industry. The industry sees the need for world-class manufacturers of fabric and trims, and believes that the BOI should attempt to attract such firms to set up manufacturing plants in Sri Lanka or to establish warehouses for speedy supply of industry requirements to shorten Sri Lankan lead times.

Role of Government

Of the 951 apparel factories, almost half (445) are serviced by the Ministry of Industrial Development and the other half (506) by the Board of Investment (BOI) of Sri Lanka.

The Government recognized the potential of the industry as a source for employment generation and launched the 200 Garment Factory Program in 1992. This program offered Government assistance to the industry by way of fiscal incentives for investors, and offered quota allocations, especially for difficult areas.

Sri Lanka has made progress in backward integration through the manufacturing of fabric and accessories, as well as the manufacture of packaging material. The BOI investment incentives have helped in the development of these backward linkages. The BOI needs to be guided by the industry if it is to attract and invite investors in the products and services most required by the industry. While most investors should be welcomed, the industry advocates that BOI investment strategies be more concerned with inviting investors in key products and services that would help to develop the existing industries or launch new industries best suited for the country.

The BOI-supported firms enjoy considerable concessions and facilities that were not available to the firms under Ministry of Industrial Development jurisdiction. This created an anomaly within the industry. However, measures have been taken to reduce the discrepancies in treatment in the recent past.

134

The Export Development Board (EDB), through marketing missions abroad, helped to increase Sri Lankan exports to non-quota markets. This is a key area to concentrate on in order to reduce over-dependence on quotas. The EDB, however, does not appear to be taking an active role in further developing this strategy. Its activities in this area seem to have slackened since 1996.

Looking Ahead

The Sri Lankan apparel industry has achieved substantial growth and learning over the past two decades. However, the post-quota era is fast approaching, and the Sri Lankan industry will have to adapt if it is to compete openly in the international marketplace. The industry will have to work hard to continue to improve its understanding of and responsiveness to demand, to reduce lead times, to improve quality, and to strengthen its industry cluster. The industry should advocate loudly for “unusual” or “unnecessary” costs, such as high telecommunications costs and high port charges, to be rationalized.

The industry has had a significant dependence on government, and still looks to government as the means to achieve technological upgrading, other industry improvements, or to resolve issues. It is also highly dependent on apparel quotas, soon to expire. The industry increasingly needs to find more ways to help itself.

Productivity in the industry could be enhanced and costs could be managed through automation, improved process and design, vigilant supply and chain management, improved service levels, and benchmarking against industry leaders worldwide. Strategic alliances could be forged with strong vendors and retailers (i.e., Victoria's Secret example). As mentioned, Sri Lanka's deficient raw material and accessory base could be improved by encouraging investment in such areas, and by developing Sri Lanka as a sourcing center for the region. Higher quality products could be manufactured through the use of advanced technology and greater/improved training, particularly for consumer electronics. The allocation of quotas may be managed to encourage specialization or long-term investment.

The following table presents several examples and opportunities for Sri Lanka's apparel industry.

Opportunity	Method
1 Comprehensive positioning	<p>Example Ocean Lanka, Haley's Knit Fabrics (which produce knit fabric) DTM Buttons Ltd Stretchline Pvt Ltd (which produce elastic) Manchester Yarn & Thread Ltd Coats Tootal Ltd (which produce thread) are some of the new investors in backward and lateral linkage which have helped the comprehensive positioning of the industry</p> <p>Opportunity Reducing lead times by attracting world class fabric producers and accessory manufacturers to Sri Lanka Sri Lanka and India have the highest lead times at 19-45 days as compared to the competing countries such as Mexico (6-8 days) and other Central American countries (6-12 days) If the delays involved with sourcing raw material requirements from abroad could be eliminated, the present long lead times could be reduced dramatically</p>
2 Customer Learning	<p>Example Local company now making higher quality products for Victoria's Secret</p> <p>Opportunity Industry-wide effort to identify segments likely to be comprehensive after 2005 and to facilitate transition of firms to serve those segments</p>
3 Innovation	<p>Example Introduction of ASYCUDA ++ at Sri Lanka Customs</p> <p>Opportunity Establishment of effluent and waste disposal system</p>
4 Human Capital Investment	<p>Example Clothing Industry Training Institute (CITI) Phoenix College of Clothing Technology, and the Department of Textile and Clothing Technology of the University of Moratuwa pay special attention to development of design through their links with other universities and design institutes in UK and other countries</p> <p>Opportunity Investing in the training of people in design marketing and management</p>
5 Cluster Cooperation	<p>Example Sri Lanka Apparel Exporters Association, which disseminates information to all members and conducts meetings, seminars and workshops for the industry</p> <p>Opportunity Eliminate the current division of BOI and non-BOI firms, bringing the entire industry on one "level playing field"</p>
6 Forward Integration	<p>Example Moratuwa University is concentrating on developing the designer capabilities of entrepreneurs Some of the larger enterprises have their own design development divisions working on this aspect of forward integration</p> <p>Opportunity For exporters to set up warehouses in the buyer markets for mass markets and move closer to end-user needs through computer-aided design and production facilities</p>
7 Strategies and Attitudes	<p>Example Successful performance of non-quota-dependent companies in recent years</p> <p>Opportunity Weaning the industry off its dependence on the quota system</p>

46 Toy Story

*“The world has accepted Sri Lankan-made **soft** toys because of C & H ”*

Toy Industry Executive, July 1998

Industry Background and Performance

The growth of the Sri Lankan toy industry is less than 20 years old and its brief history is a tale of two types of toys – wooden and soft, both manufactured almost exclusively for export. Soft toys represent 85% of the toy export value. Some 13 soft toy manufacturing companies operate in Sri Lanka today and employ 7,500, of which 6,500 work in the free trade zones. Exports were valued at about \$3M rupees, of which \$2.6M were soft toys. Toys are a small portion of total Sri Lankan exports, and export values have not grown much in recent years. The Sri Lankan toy industry is also represented by the tales of two companies, which we will call Company A, the pioneer in wooden toys, and C&H, the pioneer in soft toys.

1 Wooden Toys

Wooden toy products have a wide product mix comprised of puzzles, “pull-along” and “push” toys, mobiles, jumping jacks, games, utilities such as clothes hangers, book ends, height measuring devices, children’s furniture, jewelry boxes and Christmas decorations.

Case Study - Company A. In the 1980s, when producers of wooden masks for the German market saw their market shrinking, they turned to wooden toys as a natural way of continuing to export. The leading company was Company A. The basis of Company A’s strategy was basic subcontracting. Company A had very little direct market access. Its strategy was to do subcontracting work for any foreign firm that had a need for reliable supplies. The foreign firm would usually provide the design specifications and the order. The basis of strategy was, according to one close observer, “lots of low-cost labor.” At one point, the managers of the company commented, “we have all the business we can handle.”

Two years later, Company A was bankrupt. After losing a few orders, Company A had to lay off workers. Labor problems, combined with high financing costs, led to a downward spiral. While the team did not have access to financial data for the company, it is often the case that this kind of **business** operates on high volume and low margins, a situation that places **firms** at higher risk in the case of a downturn. Also, the difficulty in shedding jobs during a downturn contributed to the eventual elimination of all jobs associated with this company.

Another lesson was “look for partners not buyers.” Selection of long-term strategic partners is key if one does not have one’s own market presence. Lack of market access (or partners who have the same) puts one at risk. The chief failing of the **firm**, according to expert observers, was its failure to understand and be connected to its market.

Case Study – Company B Company B, which also produced wooden toys, is a contrasting example. The company attended trade shows, developed its own designs and hired international designers. The company also had an agent in the marketplace to promote designs and to identify new design trends. This helped shorten the lead time between market trends and product response time. The company was interested in the intellectual property rights of its own designs, had an in-house design staff and took the lead, employing hundreds of small subcontractors. The firm went bankrupt in the mid-1990s, however, reportedly because of “management issues,” high financing costs and labor problems.

Sri Lanka’s exports of wooden toys fell by 50% in 1996 largely because of this second collapse. About 25 companies remain in the industry, yet they experience slow growth having only limited exposure to new trends in the international marketplace and limited ability to design new products.

Factor Conditions

The industry benefits from the availability of plantation rubber wood, chemically treated to obtain a hard wood which has the qualities of valuable timber such as teak. Sri Lanka also has a workforce capable of painting detailed and intricate designs on timber.

Companies such as Company A and others in the industry try to take advantage of the low cost of Sri Lanka’s labor. Company B tried to also take advantage of more advanced factors, such as design capability.

Both Company A and Company B reportedly suffered from labor problems and high cost of financing.

Demand Conditions

The Sri Lanka wooden toy industry sells largely through wholesalers or importers in Europe, Scandinavia, USA, Australia and Japan. The firms in the industry have limited direct contact with the trends and preferences of end-users (parents and grandparents in OECD countries). Products are manufactured either to buyer requirements or manufacturers’ designs. The buyers decide what should be manufactured, and manufacturers have little or no knowledge of end user tastes and preferences.

Local firms believe that the cost of market research in target markets and of exhibiting in trade fairs abroad is prohibitive.

Firm Strategy, Structure and Rivalry

The technology used in this industry is very basic. Market opportunities thus far appear limited and the companies have not yet found attractive niche markets that could provide better returns.

Competitive positioning for Sri Lanka is weak. Although Sri Lanka is the 6th largest exporter of wooden toys, its competition includes China, Thailand, Indonesia, the Philippines and Eastern Europe. To the extent that it can compete, Sri Lanka will do so on quality and designs, rather than cost.

The basis of Company A's strategy was basic subcontracting and low-cost production. It was dependent on the buyer for market knowledge and for design. Its lack of strategic partners left Company A exposed to reductions in the number of orders.

Company B's strategy brought the company much closer to the market and demand, through its participation in trade shows, and its market-based agent. It attempted to develop a more proprietary product, incorporating its own designs. It also lured international expertise, and promoted its designs. Its production was based on employing hundreds of small subcontractors, rather than an in-house labor force.

The Industry Cluster

Related and supporting industries for wooden toys include saw milling, boron treating, non-toxic paint manufacture and machinery (fret saws, sanders, planers, routers). The first three are largely domestic whereas the machinery is imported, although some local producers exist. A few local companies have established backward integration by setting up their own sawmills and boron treatment plants with kilns. There are no particular minimum standards set by either the government or the industry for quality or safety of toys exported from the country. Value addition for wooden toys is about 60-75%. The current strategy adopted by the industry for future growth is product diversification and quality enhancement.

While there is cooperation amongst Sri Lankan wooden toy companies through an industry association, this is said to focus largely on lobbying the government for incentives and donor agencies for marketing assistance rather than developing strategies for the future of the industry in the international marketplace.

Role of Government

The Government supported the wooden toy industry by removing the restriction of transporting rubber wood timber within the Western Province as cutting and transporting hard timber is prohibited without permits. The government also provided product development and marketing assistance through the incentives of the EDB. However, since 1997, these assistance schemes have been reduced. **Only** one of the current 25 companies in the sector has **BOI** status.

ii Soft Toys

Industry Background and Performance

The combination of economic reforms, the development of free trade zones and incentives to attract foreign investors resulted in attracting one of the world's leading soft toy manufacturers to Sri Lanka. The Korean-based C&H established C&H Lanka and was followed by many of its closely associated subcontractors. A number of Sri Lankan companies also then emerged, as Sri Lankans who worked with the international companies began their own ventures.

As this industry stabilized in Sri Lanka towards the end of the 1980s, other local entrepreneurs started investing in this business, employing staff trained in the Korean companies. Technology for these projects was sourced from Korea and virtually all of the necessary raw materials were imported.

With the further development of the industry in the mid 1990s, two accessory and fabric manufacturing companies from Korea established manufacturing facilities in Sri Lanka to supply material to the local industry as well as for export.

Another soft toy segment has evolved in Sri Lanka which uses only indigenous material such as hand loom textiles, natural filling material (kapok), and 100% local designs. These products are catered to niche markets which are generally low volume, high priced, up-scale markets. The manufacture of these products is also highly labor-intensive. This sector occupies a very small fraction of the soft toy industry.

Factor Conditions

Soft toy manufacturing is a highly labor-intensive operation involving the assembly of a large number of components by stitching them together in uniform patterns which should appear identical for each product. The soft toy manufacturing process is similar to that of the apparel industry. The Sri Lankan workforce had the talent to acquire these skills quickly and adapt to manufacturing soft toys at a higher level of productivity than other countries in the region.

The workforce in Sri Lanka has the ability to acquire the necessary skills quickly in assembly line operations to make identical products. The skill level of Sri Lankan personnel has been evidenced in their ability, for example, to develop three dimensional products (samples) when given guidance by way of two dimensional sketches or drawings.

Upgrading of human resources in design, management and quality control has resulted in replacing Koreans with Sri Lankans, but machinery, equipment and stuffing materials are still acquired from Korean sources.

Some indigenous materials are being used in soft toys – e.g. hand loom textiles and natural filling material (kapok). Some designs are 100% local.

Demand Conditions

Large global toy compames out-source a sigmificant share of toy production to low-cost developing country manufacturers such as China and Mexico Sn Lankan soft toys face intense price competition from these countries Sri Lanka's cost structure for soft toys makes it only a small player in this market However, prospects for higher quality toy exports that serve distinct market niches are good, given Sri Lanka's strong design and handicraft capabilities Specialized buyers of higher quality toys could be attractive market segments less subject to cost-based competition, allowing Sn Lanka to capture greater value

Firm Strategy, Structure and Rivalry

There are four main players in Sri Lanka's soft toy industry - C&H Lanka (Pvt) Ltd , Joy Lanka (a subsidiary of C&H), Panorama and DSL Lanka (Pvt) Ltd , the latter being a Sri Lankan-owned company that originally started as a joint venture that now exports its own designs All four are located in the Biyagama Free Trade Zone The other producers are all within a range of 30 kilometers from Colombo The four compames account for over 75% of Sn Lankan soft toy exports

There appears to be little direct contact by local firms with end users (children up to about the age of 10 years and their parents) or retailers Market knowledge is mainly obtained through trade shows and buyers The industry sells to importers, agents or wholesalers in the key markets

Companies cite the high cost of market research as an obstacle to developing further awareness of consumer demand characteristics

Internationally, there is very strong competition in the soft toy industry from China, Indonesia and Thailand However, Sri Lankan soft toys have an advantage over other competitors in terms of quality, design capability and turnaround time

The "indigenous" toy segment cater to mche markets which are generally low volume, high priced, up-scale markets The manufacture of these products is also highly labor-intensive This sector occupyes a very small fraction of the soft toy industry

The Industry Cluster

A cluster of related and supporting industries has emerged to provide formerly imported inputs such as fabric, accessories (noses and eyes), and basic packaging Stuffing and specialty fabnc is still imported from East Asia

There has been little forward integration into more sophisticated packaging Current packaging is usually done in individual polyethylene bags and packed in bulk cartons rather than packaging ready for display on retail shelves Most design work has been done in-house with very limited involvement of the Sn Lanka National Design Centre or Institute of Packaging

There is reportedly very good cooperation amongst local companies in terms of sharing information and knowledge. There are two associations that look into the interests of the industry, especially with regard to marketing.

There is no regulatory structure for the industry, but each manufacturer conforms to EN 71 standards which are generally accepted internationally and for which local testing facilities exist. Almost every facility has metal detecting devices, ultrasound eye and nose fixing machines, dehumidifying and cleaning equipment for stuffing, pull testing devices, and fire safety measuring devices.

Role of Government

Some assistance is provided by the EDB through bilateral agreements with the International Trade Centre (ITC) Geneva, CBI of the Netherlands, GTZ of Germany and SIDA of Sweden. This assistance is mainly focused on product development, adaptation and marketing access through trade fairs and special promotions.

Looking Ahead

The “toy story” in Sri Lanka shows the critical importance of an industry leader in establishing a new industry. The decision of C&H was critical for the origin and development of the soft toy industry in Sri Lanka. Once established, a cluster of supplying firms developed rapidly. However, without good business strategy and management, even a flagship firm, as in the case of Company A, can also suffer losses, hurting the entire industry in the process.

In both wooden and soft toys, there is a lack of understanding of competitive positioning and Sri Lanka seems stuck in the middle between low-cost Chinese and high-quality Eastern European suppliers. As a result, it is not surprising that the cost pressures have created stress for management and labor.

The wooden toy sector also may demonstrate the difficulties that rigid labor practices and restricted financial markets can cause to a manufacturer. The impact of poor infrastructure and services such as roads and port services is also felt in the toy sector, and improvements will have a demonstrable effect.

The following table presents several examples of opportunities for the Sri Lankan toy industry.

Opportunity	Method
1 Competitive Positioning	Opportunity Because of transport costs and increasing labor costs focus on quality design capability responsiveness to market Continue to incorporate local designs to create recognition
2 Customer Learning	Opportunity Work with market and intermediaries as strategic partners to develop understanding of quality requirements and intermediaries' needs Work closely with ultimate vendors and large companies as strategic partners to develop designs Try to identify specialty and niche markets
3 Innovation	Opportunity Continual design Upgrade technology Use of local products Develop capacity to quickly respond to new requirements
4 Human Capital Investment	Opportunity Build on capable workforce to improve design capability management capability market knowledge
5 Cluster Cooperation	Opportunity Work with materials' suppliers to define quality requirements Industry-training institution collaboration Develop quality standards Work with Government to offer advantages to investors, and to ensure a service-oriented platform
6 Forward Integration	Opportunity Develop strategic alliances to identify opportunities for forward integration, including specialized or dedicated packaging
7 Strategies and Attitudes	Opportunity Strong industry focus on quality and providing a strong platform Continued focus on design strength responding to market knowledge

4.7 Tourism Venturing Forth⁷

*“Sri Lanka is known as a cheap destination ”
“Government incentives have helped the industry a lot ”*

Industry Background and Performance

Tourism generated \$212M in gross foreign exchange earnings in 1997 and provided 34,000 direct and 47,600 indirect jobs. The lodging increase of 770 rooms in 1997 represented about \$39M in capital investment⁵ by the private sector, with further construction due in 1998 showing some level of optimism. But the \$58 average daily tourist expenditure⁶ is evidence of the prevalence of low-cost beach, VFR (visiting friends and relatives) and *shoestring* tourism, with small shares for businesses, officials and MICE (meetings, incentives, conventions and exhibitions) segments. Visitation numbers and revenues at various national parks⁷, preserves and shrines around the island are rising sharply, indicating the key role of these resources for the island's tourism.

Sri Lanka is classified in the international tourism industry as a long-haul exotic destination, specializing in the beach and culturally motivated segments of tourism. It is a *long-haul* destination due to its remoteness from OECD countries, and is an *exotic* one because of the appealing combination of distinctive non-western cultures in a tropical island setting. As such, Sri Lankan tourism faces global competition, especially in the beach segment. The majority of tourists in Sri Lanka are European and Sri Lanka is a competitive destination in terms of travel time from Europe.

The volatile pattern of visitor arrivals over the past 15 years indicates the high sensitivity of tourism to the civil strife in Sri Lanka, and also testifies to the resilience of the industry once peaceful conditions prevail. The trend of drastic downturns in arrivals, falling from just over 400,000 annual arrivals in 1983 to levels below 190,000 (late 1980s), was followed by a recovery in 1993-94 with arrivals again exceeding the 400,000 threshold. This pattern is in stark contrast to the world tourism trend, which shows a very steady growth rate, averaging 6% per year from 1988 to 1997. The Sri Lankan growth rate is well above the world growth rate because the base year of 1988 was in a period of severely low tourist volume in the country.

⁵ Assumes common construction cost per room of US\$50,000 (excluding land cost, soft costs, interest during construction)

⁶ CTB 1997, landscape table on page 43

⁷ Note on national parks. They are **all** closed except Yala because of rebel activity within **them**. Nevertheless **as** they become available again for normal purposes, park development plans will be needed for the key ones, and a management framework needs to be developed to manage them as they come back **into** use. The park service could undertake this planning now. See also entrance fee statistics in CTB 1997.

The strong growth rates over the last ten years probably indicate an upswing in travel to Sri Lanka, rather than a new tourism dynamic. During the depressed years, many business travelers, those visiting friends and relatives (VFR), and other tourists entirely avoided non-essential travel to the island. This explains the strong recovery of visitors when hostilities subside. Although the Government estimates that over 90% of arrivals are tourists (per landing card responses), the World Tourism Organization Master Plan (1993)⁸ reported that only 75% of arrivals are tourists. The UK segment of visitors exceeded the German segment.

The room occupancy rate for the island improved substantially in 1997 (49% versus 40% in 1996), enabling the lodging industry to cut its losses drastically. Foreign guest nights⁹ are concentrated in and around Colombo (41%) with the South Coast sector capturing nearly as large a share (39%). The poor security situation in the North and the East prevents these regions from attracting more foreign visitors.

Factor Conditions

Factor conditions include a number of strengths, such as the unique combination of Hindu and Buddhist shrines and monuments, the refurbished tea factories, national parks¹⁰ and wildlife preserves, beaches, and the high name recognition of Ceylon. Sri Lanka has cultural appeal to foreign travelers, with an appealing combination of distinctive non-western cultures. The industry seems to be upgrading facilities in recognition of world trends.

Recent hotel openings and expansions demonstrate sufficient private funding, assisted with tax incentives, to expand hotel capacity. Returning workers trained in Asian or Arab countries represent a pool of labor with foreign experience that can promote hotels, resorts and tour operating firms with skills currently lacking in Sri Lanka, enabling a rapid expansion in lodging and tourism businesses. One can build on this by developing marketing know-how, an Internet presence, and attracting more foreign hotel management staff.

Sri Lanka has suffered from considerable civil strife. The poor security situation in the North and the East prevents these regions from attracting more foreign visitors.

⁸ World Tourism Organization - Sri Lanka Tourism Master Plan 1983

⁹ See table of tourist-nights by nationality in *CTB 1997*

¹⁰ Note on national parks. They are all shut except Yala because of rebel activity within them. Nevertheless as they become available again for normal purposes park development plans will be needed for the key ones and a management framework needs to be developed to manage them as they come back into use. The park service could undertake this planning now. See also entrance fee statistics in *CTB 1997*

Demand Conditions

The pattern of visitor arrivals in Sri Lanka is in stark contrast to the world tourism trend, which shows a very steady growth rate, averaging 6% per year from 1988 to 1997

As people in OECD countries age, there is less demand for sun-and-sand based tourism and more demand for cultural, ecological and special interest tourism (such as golf). The Sri Lankan tourist industry must get closer to the end-user, identify attractive segments, choose which kind of tourist they wish to attract, design their products accordingly and publicize and promote through specialized channels to influence the decisions made by these targeted groups

A few relevant tourism sub-segments include

- academic/study tours,
- nature lovers, bird watchers,
- educational & self-improvement tourism (language, civilization, cooking courses),
- religious pilgrimages (to revered holy places such as Kandy's Tooth Temple), and
- walkers & hikers in parks & protected areas

Generally older in age and more educated, these types of visitors demand enriching, stimulating experiences from their travel, which requires different mechanisms of presentation and interpretation (e.g., exhibitions, signage, guidebooks, docents, park trail systems). These groups will travel to all parts of any destination having cultural resources. Of the three types of tourism demand, this is the most demanding from the standpoint of planning and infrastructure. Sri Lanka possesses excellent potential for growth in this market

Sri Lanka has captured only a limited share of the market for meetings and conventions, which is very demanding in terms of infrastructure. Similarly, it attracts some cruise ship activity despite its distance from the most popular ports in Southeast Asia

In the interest of long term competitiveness, Sri Lanka will need to expand its offerings of the attractions that best showcase its outstanding resources such as

- national parks, preserves/sanctuaries for flora & fauna, and protected shorelines,
- cultural & religious shrines, monuments and temples,
- ancient towns and estates,
- tea plantations and related agricultural activities, and
- golf and country clubs, botanical gardens

Public agencies such as the park service, tourist board, tourism ministry and cultural preservation agency need to improve and manage resources for sustainable growth in visitation. Sufficient funding is critical if these agencies are to perform their planning and

oversight functions adequately. The private sector can develop other attractions (the latter 3 items above) along standard business principles. Both sectors need to be fully aware of the dual effort needed for product diversification and for a general upgrading of the tourism industry.

The low daily expenditure level may reflect increasing price competition points for the OECD leisure/beach market from diverse points such as Cuba, the Dominican Republic, Tunisia and Southeast Asia. It may also suggest that Sri Lanka does not offer particularly good shopping opportunities, an aspect that boosts tourism receipts.

After peace is established throughout the island, visitors will be more likely to visit the cultural and scenic attractions in the Eastern and Northern regions, bringing much needed capital and economic benefits into these areas.

Firm Strategy, Structure and Rivalry

Over 60% of local tourism is undifferentiated "sun and sand" tourism, serving a low-budget market.

There is awareness in the industry of the need to move from being known as a cheap destination that emphasizes market volume to one that focuses on a more discerning market. There is also an awareness of a potentially lucrative market amongst the middle and high-income group in India, especially if tourism were combined with duty-free shopping.

There is also an effort underway to become qualified as a "Green Globe Destination" by the environmental arm of the World Travel and Tourism Council after the Kandalama Hotel won the Green Globe Award in each of the last three years. Experts will be sent to do a SWOT analysis of Sri Lanka's potential in this niche market, and develop a two-year plan. This status would carry with it a distinct marketing advantage for Sri Lankan tourism.

The Industry Cluster

The most critical constraint in terms of supporting industries is limited international air access as only British Airways, amongst OECD carriers, flies directly to Colombo (August 1998). No other European, Australian or Japanese carriers serve the market on a scheduled basis. The industry is dependent on charter operations.

The recent partial takeover of Air Lanka by Emirates¹¹ to improve Air Lanka technically and to boost its capacity is a key recent development. Since Air Lanka grew as a protected flag carrier, technical improvements are certainly needed. However, the airline needs an intimate understanding of the OECD markets for intercontinental travel to devise

¹¹ Mr Mohan Samarasinghe at the Ottawa embassy said Emirates bought a 49% stake in this takeover.

its future marketing innovations, which Emirates, even as a strong Arab airline, may not be able to provide. Therefore, there may still be scope for a marketing alliance with a carrier from an OECD country.

There is an increasing awareness in the industry of opportunities in the higher-income, cultural, and nature-oriented segments of tourism. Public and private initiatives are improving the facilities for these markets. The pleasure cruise industry can be encouraged to bring high-income tourists for a brief look at the island. There may also be some potential in the more affluent segment of tourists from countries in the region.

Role of Government

The GOSL, in its last budget, recognized the tourism sector as one of the “thrust sectors” and provided a number of incentives. Turnover tax on hotel accommodation was exempted and hotel accommodation charges were exempted from GST for 2 years. Duty free imports were allowed on items such as automobiles for tourist use. The corporate income tax on the tourist industry was reduced to 15% to further boost the industry. These developments explain some of the investment resilience of the sector. However, incentives are not long-term sources of competitive advantage as they are easily replicable by other governments and do not necessarily motivate the industry to rapidly upgrade quality or strategy. The concessions are examples of the generous and targeted strategy of government and the selective use of fiscal policy to prime the pump of investment in leading industries. They also create a dynamic within the industry of looking to government for the incentives and solutions.

Public-private dialogue has been fairly ad-hoc, according to industry representatives who met with the team. The Presidential Task Force had some private participation and the Ceylon Tourism Board has played a leading role and has included private sector participation. The private sector has proposed forming a Tourism Promotion Authority, with majority private sector governance. This would replace the marketing function of the CTB. The idea is to have a board that is more self-reliant and funded from a cess on the industry. It was proposed 3 years ago and is still working its way through the Government. The private sector wants to work closely with the government on this initiative rather than creating it independently. There is interest in looking at the Singapore Tourism Board as a model. The industry noted that scheduled carriers to the country have decreased from 26 airlines to 20 airlines, although, in part, this was due to deregulation and price competition from charters.

Looking Ahead

The challenge facing the tourism industry in Sri Lanka is that of developing its own strategic vision, helping members to upgrade and diversify, and developing dialogue based around priorities critical to moving the industry upscale.

The following table presents several examples of opportunities for the Sri Lankan tourism industry

Opportunity	Method
1 Comprehensive positioning	Opportunity Move from undifferentiated “sun and sand” tourism to tourism dedicated to identified and higher-value niches
2 Customer Learning	Opportunity Develop understanding of customer requirements on a niche-specific basis Develop image on this basis, and implement improvements to ensure expectations are met
3 Innovation	Opportunity Improved market analysis Duty-free opportunities Develop sites that will be of interest to tourists
4 Human Capital Investment	Opportunity Train service-providers to understand and respond to niche requirements Work with strategic partners (travel companies) to identify needs and respond to these needs Strengthen resource managers (e.g. parks department, historic preservation office) to offer responsive service
5 Cluster Cooperation	Opportunity Develop industry associations implement quality standards Encourage knowledgeable entrants to the market Work to open and improve international and internal transportation and telecommunications Industry should ensure quality of training institutions Actively promote a unique, high-value experience Improve public-private dialogue Increase self-reliance of private sector
6 Forward Integration	Opportunity Firms can develop alliances with local and foreign partners, invest in attractions provide full-service experience
7 Strategies and Attitudes	Opportunity Focus on the needs and desires of tourism niches If high-value tourism is the focus ensure high-quality service provision

The following opportunities address some of the specific issues raised from the interaction with leaders in the sector and from a review of the current situation

- International Air Traffic Rights—Airlines must observe the minimum pricing of Air Lanka A more liberal air rights policy could make the cost of air travel to Sri Lanka cheaper Tickets bought internationally are much cheaper than those bought within Air Lanka Competition from in-bound charter traffic has also put pressure on commercial carriers that contributed to the pullout of the remaining OECD carrier, British Air Reciprocal arrangements with India are also sub-optimal

1998

- a Roles of CTB, Ministry and private sector Tourism Marketing Board--The division of labor between the tourism ministry and Ceylon Tourist Board¹² needs to be clarified, and reforms to make the Board more autonomous may be needed. It could then raise more funding and conduct more vigorous international promotions than at present. A specific reform is to privatize the hotel rating system, or to eliminate it completely. The private sector needs to assume more responsibility, according to the consensus expressed by industry leaders.
- Improved Market Analysis--CTB or the private sector equivalent needs to produce more detailed market analysis on specific market sub-segments, such as specialist tour operators, clubs & associations, and appropriate marketing channels for the senior citizen market. This would lead to more effective promotional tools for each target market, selection of trade fairs, trade media representation, and a framework of the Indian travel trade. It must then communicate this information to the country's travel sectors via workshops and newsletters to enable them to focus their marketing efforts accordingly.
- a Institutional Strengthening for Resource Management--The parks department, wildlife conservation department, and historic preservation office all need to be sensitized to the benefits of increased tourism, and given the resources to manage the process. It is these resources, critical for the country's essential product diversification, that will increase its competitiveness in the long run and enable it to bring in higher-income visitors.
- a Returnee Worker Incentives--Incentives to attract expatriate Sri Lankans with experience in the hospitality industry to live in the country can be considered to secure the benefit of their foreign experience for local businesses.
- Legal & Financial Reforms for Non-Traditional Lodging--A review of the existing legal environment governing ownership rights for different types of lodging (timesharing, intervals, condominiums) for both local citizens and for foreigners is recommended to identify any needed reforms.
- Duty Free Shopping--The possibility of permitting the duty-free importation of certain items for resale to visitors should be studied to see if it could stimulate any regional tourism.

¹² This is a very delicate area, that of division of labor between the ministry and Tourist Board. In general the ministry must define policy and regulate the Board must focus on international promotion & image building. To work well, the Board should be run by the private sector with minimal government interference. The government knows little about good promotion. "Retrograde thinking," common in Europe and in many developing countries, still supports substantial tourism ministries and heavy regulation (airlines, hotels, travel agencies, tour guides), where minimal regulation suffices.

4 8 The Gem Industry *Lost Jewels*

"We have some of the finest gems in the world, but we never managed to upgrade and become a major presence in gem-cutting or jewelry manufacturing"

Executive, Sri Lankan Jewelry Manufacturer

Industry Background and Performance

Total Sri Lankan gem, diamond and jewelry exports have grown considerably over the past decade, increasing by 300% from about SDR 65 million in 1987 to SDR 190 million in 1996. Exports of gems accounted for 66% (SDR 43 million) of the total exports for the industry in 1987, and 30% (66 million) in 1996. Diamonds were 31% (SDR 20 million) in 1987, and 56% (SDR 107 million) in 1996. Jewelry exports grew quickly during this period, from only 3% (SDR 2 million) in 1987 to 14% (SDR 26 million) in 1996.

Factor Conditions

Sri Lanka has positive basic factor conditions based on its natural advantage as a key source of high-quality sapphire, and of other gems. Sri Lanka has been known as a source of sapphires for centuries. More than 50 varieties of known gems are found in Sri Lanka, but only 7-8 are in commercial quantities. But these include bigger sapphires, star sapphires and star rubies. (Star sapphires are chemically the same as regular sapphires, but display six rays by the interaction of the light on the structure)

The most exclusive companies, such as Cartier, Tiffany and Bulgari, come to Sri Lanka to buy sapphires. Sri Lanka is sometimes referred to as the only known consistent source with a good quantity of sapphires. Although Burma, Vietnam, Tanzania, Malawi and Cambodia also produce sapphires, they are not always as reliable.

Despite the recent expansion of exports, Sri Lanka is not known as a jewelry supplier. There are only 3-4 companies that produce and export jewelry on a commercial scale. The world's major jewelry exporters are Italy, Switzerland, UK, Hong Kong, Thailand and the United States. Sri Lanka ranks only 36th worldwide in terms of jewelry exports.¹³

Demand Conditions

The most demanding consumers are said to be the Japanese. The best design centers are in France and Italy, although most large developed countries have centers in places like London, New York, Los Angeles and Tokyo. Wealthy people want the Bulgari, Tiffany, Chanel or Cartier name. At the moment, there is little chance of exporting excellent gems.

¹³ Malwatte Indira "Economic Development of the Lapidary and Jewellery Industry " Sri Lanka Economic Development Board, 1997

in cut form directly from Sri Lanka. There may, however, be some opportunity to sell to the companies mentioned above. However, these companies jealously guard their designs. Intellectual property rights are a key issue.

Firm Strategy, Structure and Rivalry

as jewelry manufacturers. More recently, India and China have begun to emerge as players. Cartier was producing in Sri Lanka in the late 1970s and early 1980s but has ceased its operations. Another company was looking to produce in Sri Lanka but was reportedly dissuaded because of intellectual property

Case Study Some 10 years ago, a Japanese manufacturer came to a Sri Lankan company and said, “why not manufacture for us?” The company now employs 100 people with peak production of about 18,000 pieces per month. But the gold, diamonds and most colored gems are unreported because of the volume. The company succeeded because it already had some knowledge of how to cut the stones and employed inexpensive labor, according to its representatives. But this business is divorced from the gem export business with only a very limited overlap.

The Industry Cluster

While there is the Gemological Institute of America (GIA) in California, Guild Hall University in the UK and training institutes in Thailand and Hong Kong, the training institutes in Sri Lanka are said to be deficient. These include the Sri Lanka Technical College and Maradana, which was established about 15 years ago by the EU with Belgian instructors and trains about 20-30 people a year. The Export Development Board has a school on the outskirts of Colombo. The National Gem and Jewelry Authority has courses in gemology in Galle and Kandy. However, “the quality of the training is very poor,” said one industry expert. “The trainers get paid government wages while a skilled craftsman can easily get \$600-\$700 in the Middle East or \$300-\$500 in Sri Lanka. No one who *knows* the job will work for the salary paid to instructors.”

Another said, “it takes me about 1-1½ years for me to get these people where I want them.” Another commented, “it’s better than nothing. They have some basic knowledge.” Others noted that students attend training to get a certificate to improve their chances of getting a job abroad. “A lot of people are doing this to get a good job abroad. A certificate helps them do this.” But the gem industry lacks its own funds to set up a training institute. One company has brought in foreign consultants to train their

152

people “We hire people from overseas for 4 months to train our people in design and manufacturing But this costs \$30,000”

Role of Government

Many companies look to produce in Asia, but there is a fear of lack of respect for the intellectual property rights of designs and of the enforcement of contracts Potential investors reportedly have this fear with respect to Sri Lanka

It was reported, for example, that one company subcontracted production in Sri Lanka, but found that their designs were being sold to others Consequently, the company stopped production

Improvement of such protections would undoubtedly assist this and other industries Also, the easing of restrictions of importation of gems and gold (see below) will also be important in encouraging growth of the industry

Looking Ahead

The Government of Sri Lanka recently liberalized the movement and import of raw materials, including gems and gold The ability to import stones is a beginning, although it comes late As one jewelry exporter put it, “We waited too long (to liberalize) Other people got ahead of us The market is flooded” If the embryonic gem-cutting and jewelry-making industry could develop a design center or gain the trust of companies such as Bulgari, Cartier and Chanel on the high end, or even groups like Zales and Macy’s at the medium end, more extensive employment and exports could be generated in this sector

The following table (next page) presents several examples of opportunities for the Sri Lankan gem industry

Opportunity	Memo
1 Competitive positioning	Opportunity Move from providing raw gems to greater value added through design, cutting and production Identify desired niches (e.g. high-end, middle-level)
2 Customer Learning	Opportunity Identify the key international companies and understand their needs It will be important to attract "anchor firms," which will require responsiveness of the cluster
3 Innovation	Opportunity Innovation through design and ability to respond to international firms' design and quality requirements
4 Human Capital Investment	Opportunity Develop design and technical capabilities Develop understanding of, requirements for confidentiality and enforce adherence
5 Cluster Cooperation	Opportunity Develop industry associations implement quality standards Develop understanding of requirements for confidentiality, and enforce adherence Improve training resources to international standards Import of raw materials now seems to be permitted
6 Forward Integration	Opportunity Develop alliances with international merchandisers
7 Strategies and Attitudes	Opportunity Understand the needs of international merchandisers eventual anchor firms – and make responsiveness a priority

154

4.9 Service and Knowledge-Based Exports

The “service and knowledge-based exports” industry has been analyzed in more detail and greater depth than the other industries because of its potential to provide a response to the challenges facing the country in the apparel industry, and because it offers the possibility of developing what Michael Porter refers to as “complex exports” This is a new and emerging industry world-wide, and therefore provides unique opportunity

The potential demand for knowledge-based services exports from developing countries is enormous and growing Globally, the information services industry at present is estimated to be close to US\$1 trillion The global markets for the more narrowly-defined informatics industry can be segmented into four categories 1) software development, 2) information processing, 3) CAD/CAM design, and 4) data entry

The estimated annual global market for these areas as of end-1997 are

Software Development	US\$141.45 billion
Information Processing	US\$ 43.70 billion
CAD/CAM Design	US\$ 44.29 billion
Low-level Data Entry	<u>US\$ 0.92 billion</u>
Informatics (narrowly-defined)	US\$230.36 billion
Total Global Market (Informatics-broadly defined)	US\$ 1.00 trillion
Total U S Market	US\$400.00 billion
Emerging Markets (Total Services Export '97)	US\$197.00 billion
Emerging Markets (Estimated Informatics Exports '97)	US\$ 32.86 billion

The global market is expected to increase at an annual rate of approximately 15% (with some informatics sub-sectors expected to reach annual growth rates of 20% during the next decade) The professional services segment of the market, which includes project management, software requirements analysis and design, contract programming, data processing, education and training, is expected to increase at an average annual growth rate of 15% through the year 2000¹⁴

The broadly-defined informatics industry is estimated to be over US\$400 billion in North America alone More than 10 million workers are now employed in higher-skill electronic publishing, claims processing, technical writing and other “back-office” operations

Operations requiring specialized technical expertise in design, analysis and project management of high value-added software and services are amongst the fastest growing

¹⁴Figures were taken from Schwabe Robert and Hume, Susan *“Prospects for Information Service Exports from the English-Speaking Caribbean”* Informatics and Telecommunications, Industry and Energy Department Finance and Private Sector Development Division Latin American and Caribbean Region The World Bank, March 1996

155

segments of the market. Acute skills shortages in North America are raising salaries to levels six to eight times higher than those found in many emerging market countries.

In response to these market trends, offshore locations are increasingly moving to establish favorable conditions for labor-intensive information processing services, much as they earlier succeeded in attracting millions of jobs in manufacturing and assembly operations.

Successful Examples

Tens of thousands of jobs in labor-intensive export information processing operations are now located in developing countries. Outsourcing employs workers in offshore call centers, secretarial service bureaus, translation centers, software development facilities, and engineering operations. India and Costa Rica have been amongst the pioneers in offshore service exports to date.

- **India** Six years ago, India's software exports were about \$33 million. In 1994, the figure was well beyond \$350 million. The software industry has enjoyed phenomenal growth of 45% in exports over the last six years. A recent World Bank report projected that India's software exports will soon reach \$1 billion.
- **Costa Rica** A policy of low-cost telecommunications for export service firms has recently enabled Costa Rican free zones to attract clients such as Acer and Microsoft to establish customer service and technical support "call centers." Employment at these two companies alone is projected to grow from 400 to more than 1000 workers, as a result of more than 60 percent net savings in comparison with their North America-based operations.

Driving Forces

The move to source services globally has been driven by several factors:

- **Labor savings** The first is the labor cost advantage. Many offshore sites offer skilled or highly trainable workforces at salaries one half to one tenth those prevailing in developed countries. Another driving force is workforce retention. While onshore companies engaged in "back office" operations such as claims processing and customer service suffer high turnover rates (up to 80 percent in some telemarketing operations), offshore counterparts have proven far more committed to their employers.
- **Declining telecommunications prices** Affordable telecommunications enable firms to flourish wherever local conditions permit. Barriers of distance are falling away as telecommunications costs plunge and as service quality rises. The cost of telecommunications technology has decreased by approximately 30% per annum.

since 1994 and annual decreases of similar magnitudes are likely to continue as advances in chip, satellite and telecommunications technologies evolve rapidly. In the near future, the volume of information processing work moving overseas will swell. A crossover point is now approaching with international telecommunications prices with regard to offshore information processing operations. At present, developing countries have approximately a 10 cent/minute labor cost savings in comparison with developed countries for typical telecommunications-intensive information processing jobs such as answering services and customer/technical support. Labor cost savings for these sectors have been offset by the high costs of making international calls.

This telecommunications barrier is rapidly falling. Already, competitive forces have brought international dial-up call rates between the US and the United Kingdom to below 10 cents/minute. Microsoft's head of advanced technology, Nathan Myrthold, predicts that telecom costs will be dropping by orders of magnitude in deregulated markets in coming years, declining even more rapidly than the prices of computers. This will allow developing countries to successfully compete for millions of service jobs that have remained onshore to date.

Inhibitors to Growth

Notwithstanding political concerns over job losses, developed countries are virtually powerless to prevent information processing jobs from migrating to overseas locations. Telecommunications advances and powerful encryption will make it all but impossible for regulatory authorities to constrain the global movement of labor-intensive work to favorable climates.

Substantial constraints remain, however, in developing countries. The following are the principal barriers to the creation of large-scale information processing employment in emerging markets:

- High telecommunications prices to date have kept many offshore operations dependent upon air freight delivery for source materials and completed files,
- Complex business climates deter both multinational firms and local entrepreneurs from setting up export operations, and
- Skills delivery systems in emerging economies often fail to keep up with market needs.

Profiles & Market Segments

The following market segments offer opportunities for countries such as Sri Lanka

- **Image Processing** (This segment also includes fast-turnaround document conversion and claims processing) These firms provide service by relying on high-speed scanning operations to bypass the need to physically send paper documents offshore. Rather than rely on air freight services, compressed image files (including Group III and Group IV facsimile output) can be sent by dial-up or dedicated lines at rates ranging from three to twelve cents per page.

Estimated by Forbes Magazine to be a US\$35 billion market, image processing is being given top priority by such companies as Kodak, IBM, Wang and 3M. Near-term target clients will be insurance and financial companies that see imaging as integral to timely and cost-effective claims processing operations.

Offshore service bureaus specializing in labor-intensive operations are now growing rapidly, providing such services as post-scan image enhancement and editing, manual keyboarding of the imaged text/numeric/graphic material, oversight of optical character recognition/intelligent character recognition processing, and editing/interpretation/indexing of the electronic files. As international telecommunications services reduce the turnaround time of offshore data entry operations to that of the fastest onshore service bureaus (i.e., 24 hours or less), offshore image processing service bureaus are able to command premium prices for their work.

- **Remote Secretarial Services** Remote secretarial services offer an enormous potential for growth. Within the U.S. alone, approximately six million secretaries are now employed at an average salary of US\$16,000 per annum. The proliferation of facsimile equipment and call forwarding capabilities in the U.S. make it possible for message taking, word processing and dictation services to be cost effectively provided by overseas business center tenants.

For example, in the case of the Dominican Republic, material faxed to offshore secretaries for word processing has been returned within as little as half an hour via modem, at a net cost savings approaching 50% relative to in-house secretarial services in the U.S. This segment has few barriers to entry for overseas entrepreneurs with strong English or Romance language capabilities and potentially large employment gains assuming adoption of highly competitive international telecommunications pricing.

- **Voice Center Operations** (including Customer Service and Technical Support) In the U.S., the number of operators in reservations centers, order fulfillment centers, customer support centers, technical support centers and answering

services now exceeds 2.5 million. Market research has found high levels of interest on the part of North American hotels, airlines and car rental agencies in establishing offshore telemarketing (toll free number) operations. The interest is greatest in establishing offshore English-speaking service bureaus (contingent upon international telecommunications costs for this sector falling to within US\$ 05 to US\$ 10 per minute of the prevailing domestic U.S. toll free number rates).

- **Multimedia and Hypermedia Services** A new generation of multimedia computers is becoming standard in global markets. For multimedia systems to achieve their potential, however, a wide range of paper manuals, guidebooks and text-only databases will require conversion to multimedia/hypermedia formats. Offshore service bureaus have a significant opportunity to offer design, formatting, illustration/jammation, and database development services. (Export-oriented animation services are already established and growing rapidly in countries such as Korea, Ireland, Poland and the Philippines). Importantly, developing countries will be in an excellent position to introduce hypertext links of related material, enabling users to navigate via pre-designated paths through all material in a library.
- **Electronic Publishing/Pre-Press** The U.S. printing and publishing industry is a US\$172 billion a year market. Within this market, the electronic publishing segment over the past 10 years has been the fastest growing at rates exceeding 20% per annum. Labor intensive operations in this sector include design, illustration, keyboarding/typesetting, editing/proofreading, composition, layout, pre-press preparation and printing. Export-oriented typesetting operations for books, magazines and commercial publications are now occurring in Barbados, Jamaica, Korea and numerous other countries in the Far East. The advent of electronic publishing systems and powerful graphics programs for personal computers is now also making possible remote editorial, graphic design, illustration, color separation and production services.
- **Computer-Aided Design (CAD) and Geographic Information Systems (GIS)** Thousands of companies in the U.S. are utilizing CAD systems, enabling engineers and architects, at low costs, to do their drafting and design work with graphic display screens rather than with pen and paper. The full productivity gain from such systems, however, can only be achieved if existing documents are converted to computer-readable images.

Among utility companies, government organizations, financial firms and manufacturing companies in the U.S., an enormous backlog exists of maps and facility plans that must be converted from paper to electronic form. The labor-intensive process of "backfile conversion" typically counts for one-half to two-thirds of CAD/GIS systems development, which is estimated to become a US\$40 to US\$50 billion market opportunity in the coming decade. Digitizing and vectorizing operations, as well as manual inputting of text/numeric data linked to graphic objects, can provide employment for thousands of offshore workers.

- **Software Development and Professional Services** Countries such as India, the People's Republic of China, Taiwan, Mexico, Peru and the Philippines are now active as centers of export-oriented systems analyses, programming and integration services. Companies such as Texas Instruments, Arthur Anderson, Boeing, IBM, DEC, AT&T and Computer Associates rely heavily on systems analysts and/or coders in these countries.

Operations suited for offshore operations include production of packaged software, client-customized systems analyses and programming (including training and program maintenance), offsite processing of client-supplied data, and support for dial-up or online databases. As international telecommunications rates continue to decline, collaborative computing software, performance support systems, object oriented programming systems, offshore software development and services firms are likely to have exceptional competitive opportunities.

Factor Conditions

- **Labor** Sri Lanka's literacy rate of 90 percent compares well with other countries in South Asia (Bangladesh's 35 percent, Bhutan's 38 percent, India's 48 percent, Nepal's 26 percent and Pakistan's 35 percent), providing a favorable position to compete in global markets for knowledge-based services. Sri Lanka's per capita GDP (measured in PPP terms) of \$3,030 is just one-sixth of Singapore's, although high by comparison with closer neighbors (with Bangladesh's \$1,350, Bhutan's \$1,475, India's \$1,280, Nepal's \$1,165, Maldives' \$1,373 and Pakistan's \$2,235). The country's unemployment rate stands at about 13 percent, signifying a pool of available workers for labor-intensive operations.

Offshore operations can provide substantial labor costs savings relative to prevailing compensation rates in industrialized countries¹⁵

Country	Secretarial Wage/Hour	Data Entry Wage/Hour	Voice Operator Wage/Hour	CAD Wage/Hour	Software Development Wage/Hour
United States	\$8.50-\$10.00	\$7.00-\$8.00	\$8.00-\$12.00	\$10.00 - \$17.50	\$20.00 - \$35.00
Jamaica	\$1.75	\$0.50-\$1.00	\$1.10	\$4.00 - \$7.00	\$6.00 - \$10.00
Costa Rica	\$2.75 - 3.40	\$2.30 - \$2.65	\$2.60 - \$4.00	\$3.50-\$5.80	\$6.50 - \$11.50

¹⁵Labor costs and job figures taken from Schwabe, Robert and Hume Susan *Viewpoint* The World Bank Industry and Energy Department, FDP Note No. 17, July 1994 page 2

160

- **Telecommunications** Sri Lanka has significant telecommunications constraints. As of 1995, it had a tele-density of 13 per 100 people. Only about 12 percent of these telephone lines are outside the Colombo area. This contrasts with Singapore's tele-density of 50 phones per 100 people and Taiwan's 36.3 in Taiwan.

High telecommunications costs are also a substantial barrier. As recently as 1995/6, a TI connection cost prospective Internet users about Rs. 1 million a year (\$21,000).

More than 80 percent of the telecom system, however, is fully digital. And prices have been declining as a result of the privatization of SLT, the national telephone company. Today, its shareholders include the government, Nippon Telegraph and Telephone Corporation (NTT) of Japan, and employees.

Submarine cables extend from Sri Lanka to Indonesia and Djibouti. Currently, there are two INTELSAT earth stations over Sri Lanka in the Indian Ocean. MCI Communications has started commercial service on its TAT-12 fibre optic cable between the USA and Europe, and with the system in place, MCI can now offer additional fibre optic connectivity to Sri Lanka, Slovakia and Hungary. The TAT-12 is owned by a consortium of over 50 telecommunications carriers from 38 countries and spans 6,500 km in two optical pairs for 300,000 two-way channels.

Satellite links have become a key part of the country's telecommunications infrastructure. Ceylinco joined with COMSAT to launch Sri Lanka's first satellite services network. The project, which envisages linking Sri Lankan offices and even homes to multiple sources of information via satellite, will be the island's first network to use satellite exclusively, say its promoters, Ceycom Global Communication Ltd., a collaboration of the Ceylinco Group and Comsat Corporation, the major shareholder of the global INMARSAT & INTELSAT satellite networks. A Rs. 2 billion (US\$40M) initial investment, the Ceycom network has promised to provide, in addition to the traditional needs of data and image transmission and Internet services, an exciting array of new applications such as distance education, tele-medicine, video conferencing, private networks and mobile data services. This is expected to catapult Sri Lanka into a new age of information technology.

Through a joint venture with Hughes Network Systems, Ceycom will establish an Island Wide Communication network using VSAT (Very Small Aperture Terminal) equipment, and also offer International Point-to-Point Corporate Data Circuits to the Sri Lankan market. Apart from this, Ceycom will also provide a comprehensive spectrum of services to Sri Lanka and the sub-continent. These would include E-Mail and Internet Services, Basic Data Transmission, Store & Forward Facsimile, Video Conferencing, Distance Education, Tele-Medicine, and Disaster Recovery Centre Facilities.

Demand Conditions

Sri Lanka is entering into a market with clear demand and growth opportunities. The World Bank, amongst others, estimates a potential \$120 billion market opportunity for emerging economies in coming years to export information processing services because of compelling labor cost advantages. It foresees hundreds of thousands of new jobs being created to meet the global demand for long-distance service providers.

Developing country and emerging market shares of the global information industry's (broadly-defined) US\$1 trillion market is estimated at \$32.86 billion, or, just 3.3% of the total global market. Their share is approximately 14.3% of the total informatics industry when narrowly-defined. They are servicing 8.3% of the US\$400 billion US market, and informatics exports represent 16.7% of total emerging market non-manufactured service exports of US\$197 billion.¹⁶

As emerging markets and developing countries continue to de-monopolize their telecommunication services and liberalize their trade-in-services regimes, the base of activity will continue to shift from the manufacture of goods to the provision of knowledge-based services for export. Those countries' share of the informatics services industry is anticipated to grow faster than the market itself, at rates of 20% to 25%, capturing additional market share of a comparatively slower growing global market.

Industry Cluster

Enterprising commercial entities (e.g., Lanka Internet Services Ltd and Information Laboratories Ltd) have now emerged to strengthen Internet connections, in addition to Internet services provided by Sri Lanka Telecom Corporation.

LISL began with a database service and received technical help from its United States venture partner, International Internet Services, Inc. Three Sri Lankan companies also fund the venture: Lanka Ventures, Central Finance and Development Finance Corporation of Ceylon. A connection to the Internet is made through a 64-Kb/second line leased from Sri Lanka Telecom. It is not a quality service, and the company is planning to change its connection. LISL offers services such as worldwide e-mail connectivity, international store-and-forward fax, and other Internet systems such as FTP (file transfer protocol), Telenet, Gopher, Archie, Veromca, Jughead, On-line merchandising, hotel and airline reservations, and on-line video conferencing.

¹⁶Emerging market *gross* services export figures extrapolated from the World Bank's 1997 "World Development Indicators" using IFC's Emerging Market Database, which includes 45 emerging markets. Informatics and information industry gross figure calculations, market potentials and growth rates were based upon information derived from the World Bank's report on the *Prospects for Information Service Exports from the English-Speaking Caribbean* March 1996 and extrapolated from figures therein.

Industry Strategy, Structure and Rivalry

Professor Shelton Gunaratne of Moorhead University (Minnesota) says, "*Sri Lanka should take advantage of its highly literate workforce to engender 'brain-power' industries related to the third communication revolution. This transformation clearly entails making Sri Lanka a sort of Silicon Valley just as Bangalore in India and Putrajaya in Malaysia have lately succeeded in doing*"

Professor V K Samaranayake, Chairman of the Council for Information Technology, is also quoted as saying "*We believe we can make Information Technology a strategic industry for Sri Lanka*" DOI has targeted electronics industries as a key growth sector

The Computer and Information Technology Council (CINTEC), the apex government agency for information technology, and Sri Lanka Telecom are aiming to connect academic, business and government activities to the Internet (Sunday Times, March 19, 1995). CINTEC has helped LEARN, a wide-area network covering the island's universities, to access the Internet despite the "astronomical" cost involved, with a subsidy of Rs 1 million for the initial year. The University Grants Commission has put in Rs 5 million for the project, an undertaking of the University of Moratuwa. On the recommendation of CINTEC, the Ministry of Education has set up more than 10 regional computer centers out of a planned total of 300 centers by the year 2000 to prepare students for the National Certificate in Computer Applications. CINTEC is also collaborating with the Computer Society of Sri Lanka (CSSL) to conduct the National Examination in Computer Studies.

Moreover, under the guidance of CINTEC, the Federation of Information Technology Industry in Sri Lanka (FITIS) has emerged as the national organization representing the country's IT industry (Daily News, Feb 27, 1996). FITIS represents software industries, computer vendors and computer trainers. Other interest groups, such as CSSL and the Computer Land and Informatics Institute of Computer Studies, have also emerged as part of LEARN.

The Computer and Information Technology Council and the Arthur C. Clarke Center for Modern Technologies have demonstrated considerable forward thinking and innovation. LAcNet, a nonprofit organization funded by expatriate Sri Lankans to propel the country's computing development, can play a very important role in helping Sri Lanka move toward an information-based economy.

Several local universities and institutes offer Bachelors' and Masters' degree courses in Computer Science and Engineering as well as post-graduate diploma courses. In addition, there are numerous private institutes and organizations which train thousands of Sri Lankans in computers and computer programming. Thus, there is a supply of skilled, qualified people for IT projects and enterprises.

More than 3,000 expatriate Sri Lankans, irrespective of their location in the world, are now able to receive and transmit news and information on their mother country through a moderated electronic mailing list called Sn Lanka Net, funded and administered by LAcNet since 1988. Sn Lanka can actively seek the expertise of the LAcNet volunteers, as well as those experts connected to SLNet, on the best and the fastest way to reach the portals of information society.

Role of Government

The Government, as discussed above, has already taken major steps to create connectivity and to provide skills development and education. Other examples of a proactive Government role include

- **Public-Private Dialogue** Within Sri Lanka itself, an important development is the establishment of the Industrial, Technology and Market Information Network (ITMIN), a collaboration between the state and private sectors, to serve as Sri Lanka's first information brokerage service (Sunday Observer, Jan 28, 1996). The UNDP and UNIDO are supporting this network, a conduit for technology transfer and a clearinghouse for information on business, industry, technology and markets. ITMIN, which connects 10 state and private organizations, will also provide access to the Internet.
- **Capturing Additional Value** The Sri Lanka Export Development Board (EDB), with the assistance of the Sn Lanka Embassy in Germany, organized a national stand at the CeBIT '96, the International Exhibition for Information and Telecommunication in Hanover. Four Sn Lankan software companies -- Informatics (Pvt) Ltd, DMS Software Engineering Ltd, Jagath Robotics (Pvt) Ltd and Golden Key Co Ltd -- displayed their software packages developed for hotels, banks, hospitals and plantations, along with their packages for vehicle management, hire purchase and cellular telephone billing systems.

Looking Ahead

Sri Lankan Informatics Export Sector Development to Date

According to Dr Maya Sittampalam Rainford, a computer expert at Colombo's Open University, in 1993 between 5,000 to 8,000 people were employed by electronics, computers and communications companies.

As of 1996, seven of Sn Lanka's 30 software companies were exporters. Export Development Board officials report that Sri Lanka now earns about Rs 100 million (\$2 million) annually from computer software exports. Government incentives for investors setting up electronics export industries include up to 10 years' tax holiday, duty free imports and venture capital financing.

One of the leading exporters is Ecode. Ecode Lanka was created in 1994 by Datika International, began exporting in 1995, and received BOI incentives in 1998. The firm has 25 professionals and exports syndicate management and pre-sales support system software to Belgium, Luxembourg, the Netherlands, France and Switzerland. Amongst its current priorities are the development of an Enterprise Resource Planning (ERP) solution, an advertising and promotional management system, and an online catalogue maintenance system.

Other local export firms include Informatics International (Pvt) Ltd, which provides offshore software development and software conversions, and DMS Software Engineering (Pvt) Ltd, specializing in payroll processing, high volume data entry, image capture and processing, and "Year 2000" services.

International firms that have used Sri Lanka as a base for information technology and/or electronics export operations have included Golden Systems Inc, Innodata Corp, NEC Corp and Pacific Dunlop.

In recent months, Sri Lanka has made important moves to create a foothold in electronic commerce, with the establishment of an on-line "shopping mall" by members of the Ceylinco Consolidated companies. The mall, called "Avakasa Kade," or the "shop of opportunity," is being promoted and marketed by the Golden Key Credit Card Co Ltd (GKCC) and hosted by Ceycom Global Communication, the Ceylinco Group's satellite communications company, and ITMIN Internet Services Ltd. The mall enables shoppers to both browse and place orders on-line. It offers electronic catalogues, ordering, pricing, promotions and online customer support. Supported payment options include cash, checks and credit cards.

"Best Fit" Future Opportunities

The following are amongst the key market opportunities for Sri Lanka to stake out a leadership position in information service exports:

- **Customer and Technical Support** North American and European software companies, including web authoring/site management tool providers, need cost-effective customer/technical support centers as they seek to expand in international markets. Sri Lanka can rapidly win standing as a strategic resource for such firms that face intensive competitive pressures to improve global service while reducing support center operating costs. North American software firms average 50 percent of sales at present to export markets, and incur per-call costs averaging \$25 per technical support call with English-speaking operators.
- **On-Demand Learning Market** Owners of high quality training courses, on audio and videotape, are awakening to the potential value of their content once it

is converted into digital form for delivery on-line. Translating/re-purposing technical training materials for high prestige companies and institutions can become a major source of contract revenue for Sri Lankan information export firms, and can also lead to royalty-based joint ventures with brand name clients for translation, enhancement, and migration of globally marketable courses onto CD-ROM, DVD and web platforms (Distance learning networks in North America alone are estimated to have more than 15,000 hours of videotaped courses that are candidates for re-purposing, if cost-effective services are available). Using onshore personnel, costs per hour for finished course conversion average US\$20-30,000. Successful entry in this market can yield other benefits by ensuring Sri Lankan firms an ongoing "inside track" for obtaining state-of-the-art technical skills.

Amongst the most marketable services in this segment are

- transcription of videotapes to facilitate full-text searches,
 - conversion, proofreading, and formatting of imaged documents,
 - multidimensional indexing and cross indexing for hypertext and multimedia databases,
 - translations and dubbing into other major international languages,
 - graphic art services (including illustrations and animations to enhance multimedia courseware production values),
 - "chunking" of information (segmenting information into easily absorbed pieces tailored to user frames of reference),
 - abstracting of business, scientific, engineering, and other technical textual narratives,
 - rewriting of narratives to improve their style, sequencing, and organization, especially to facilitate on-line delivery,
 - digitizing/vectorizing of technical drawings, and
 - HTML and/or SGML tagging to make basic text files conform to Internet display and electronic publishing conventions
- **Web Commerce Services** As electronic commerce accelerates on the Internet, companies are upgrading their web sites to become venues for electronic commerce and making them accessible to international as well as North American

consumers Sri Lanka can become a leader in providing web commerce development services Establishing international leadership in advanced web services can also reinforce Sri Lanka's position in the previously mentioned high growth market segments, given the demand for web sites as delivery vehicles for customer support/tech support and on-demand learning

Policy Implications

Key policy considerations to spur development of Sri Lanka as a leading center for offshore industries include the following

- **Awareness Building**
 - Hold workshops to mobilize the entrepreneurs Need in-country private sector champions for reform
 - Also, prepare the entrepreneurs to respond to a range of relationships India software exports have typically taken one of the three routes Many companies like Swissair and Lufthansa have outsourced all or a major part of their IT needs to Indian companies The second route is the joint venture, which usually services the domestic market as well as produces software solutions for export back to the West The third route consists of Indian software house exporting solutions directly using western companies as intermediaries
- **General Incentives Reform**
 - Radical simplification Sri Lanka should have Hong Kong/Singapore style simple, immediate procedures "The ministry's efforts to help make the Board of Investment (BOI) a one-stop service center for investors is highly commendable red tape often is a turn-off for prospective investors "
 - Online registry is another opportunity for Sri Lanka to take leadership in incorporating and registering firms in the information economy
 - Moving to performance-linked compensation Singapore has transformed a once-lethargic civil service into a highly efficient body through introduction of "flexi-wage" incentives, in which annual bonuses for public sector employees are keyed to the country's economic growth This will ensure an alignment of interests on the part of regulatory regime personnel with creation of an open and transparent business climate

- **"Software Park" Concessions**

A further step to promote development of the offshore information services sector would be to prepare for international tender to private developers one or more concessions for software parks. Such parks could become "locations of choice" for knowledge industries by offering the following advantages:

- free zone business climates of unsurpassed simplicity and clarity, featuring no customs duties, taxes, or foreign exchange controls,
- completely deregulated **and** de-monopolized telecommunications (see "Telecommunications Sector Reform" discussion below), resulting in international prices 60 to 80 percent lower than now prevailing in most countries, and
- on-demand learning, using affordable satellite links and courseware to offer continuously updated training in skills valued in the global marketplace

Sri Lanka to date has limited precedents for such parks in the form of five operational and/or designated export processing zones, which have provided an effective export platform for assembly and manufacturing industries. At present, however, Sri Lanka lacks any office park-style complexes for information industries comparable to the Software Technology Parks of India or the emerging informatics-oriented free zones of the Caribbean Basin and Latin America.

These areas can be highly profitable as private sector real estate developments, given their free zone status plus partial or full exemptions from telecommunications monopoly constraints. They have generated tens of thousands of jobs in labor-intensive information services as multinational firms with paperwork processing requirements, including American Airlines, GTE, and Westinghouse. In response to targeted telecommunications liberalization in these zones, private investors have financed dozens of "teleports" -- satellite earth stations offering tenants an opportunity to bypass the high costs, low capacity, and questionable reliability of the public telephone system. Although such teleport facilities once cost millions of dollars, rapid technological advances have brought the price of entry-level facilities to less than **US\$ 500,000**.

To maximize information industry response, terms of the tender for software parks in Sri Lanka could call for the developers to ensure that international telecommunications prices offered to zone users would match or surpass levels set by the world's most competitive teleports. Benchmark prices (set by the Montego Bay Free Zone Teleport in Jamaica) include \$1850/month for 64 kbs half circuit per month, \$3.00/minute for switched **384** kbs service (videoconferencing), \$0.56 -

0.90/minute for switched 64 kbs service, and \$0.22-0.56/minute for switched inbound/outbound 9.6 kbs service

- **Telecommunications Sector Reform**

Special steps should be made to ensure that Sri Lanka offers to service export firms international telecommunication links that are second to none. The following measures can be applied to software technology park-style areas:

- **Monopoly Exemption** No commercial governmental monopolies should apply within the designated boundaries of the Software Parks. Developers of such parks should have full authority to issue licenses for commercial international satellite earth stations, microwave links, cable connections, switching equipment, and other network systems for use by zone tenants. The licenses should commit operators of private systems to conform with technical non-interference and interconnection standards of the Government of Sri Lanka.
- **International Coordination Assistance** In cases where the private park developer, or its chosen commercial telecommunications provider, desires to obtain services from (or coordinate alternative satellite system usage with) multilateral organizations such as INTELSAT and INMARSAT, the Government of Sri Lanka should commit to assist the park's telecommunications provider in its requests for such services or coordination.
- **Pricing Pass-Through** The Government should pass through to the Park developer (or its assignees as applicable) the most favorable rates for dedicated and dialup circuits available to national signatories for INTELSAT and INMARSAT international telecommunications services, with a markup equivalent to no more than ten (10) percent of the respective circuit charges paid by the Government of Sri Lanka signatory.
- **Removal of Constraints** All Government taxes, fees, mandatory equipment provisions, and price and margin controls affecting telecommunications and other utilities or commercial services should be fully removed in the Software Parks.
- **Interconnection** The national telecommunications provider and the Park developer (or its designated telecommunications partner(s)) should grant mutual rights of interconnection to their respective communications systems, on condition that the terms and conditions for such interconnection are cost-based and reasonable, and that the net amounts owed in settlements are paid on a monthly basis.

- **Noninterference** The national telecommunications systems of Sri Lanka and that of any Software Park should be constructed and operated in such a way that avoids interfering technically in an injurious manner with that of the other
- **Privatization of Unused Spectrum** The Park developer(s) should receive a negotiated portion of the unused electromagnetic spectrum assigned to Sri Lanka by the International Telecommunications Union. Half of this should be used on an exclusive 24 hour basis by the Park developer and its tenants. The other half should be offered in whole or in part at auction arranged jointly by the Park developer and the Government of Sri Lanka. Proceeds from such auction sales should be allocated to widening opportunities for the Sri Lankan public to gain skills of their choosing in the information economy

- **Skills Formation**

Areas benefiting from low-cost, de-monopolized telecommunications can move Sri Lanka into the forefront of international areas competing for offshore information industry investment

Virtual classrooms are spreading North American and European-markets. Universities and corporations are turning to affordable telecommunications networks to interactively link lecturers and students with best practice. Material from these broadcast courses is also being converted to "just-in-time learning" formats for anytime/anywhere delivery in multiple languages to users at their moments of need.

Given order-of-magnitude reductions in telecommunications prices in Sri Lanka, leading overseas distance learning providers can for the first time reach global audiences with top-notch interactive courses at low cost -- and graduates of these courses can establish themselves in the global electronic marketplace. Liberalized telecommunications areas provide a gateway for such distance learning providers to deliver marketable skills to an immense untapped market in Sri Lanka. They can open an affordable path for tens of thousands of Sri Lankans to have access to a smorgasbord of world-class courses, certifications, and employment opportunities.

Initial courses could include

- Web page design and development,
- Visual Basic, Java, C++,
- Fundamentals of online marketing,
- Secretarial, transcription, and call center opportunities, and
- Computer graphics and animation

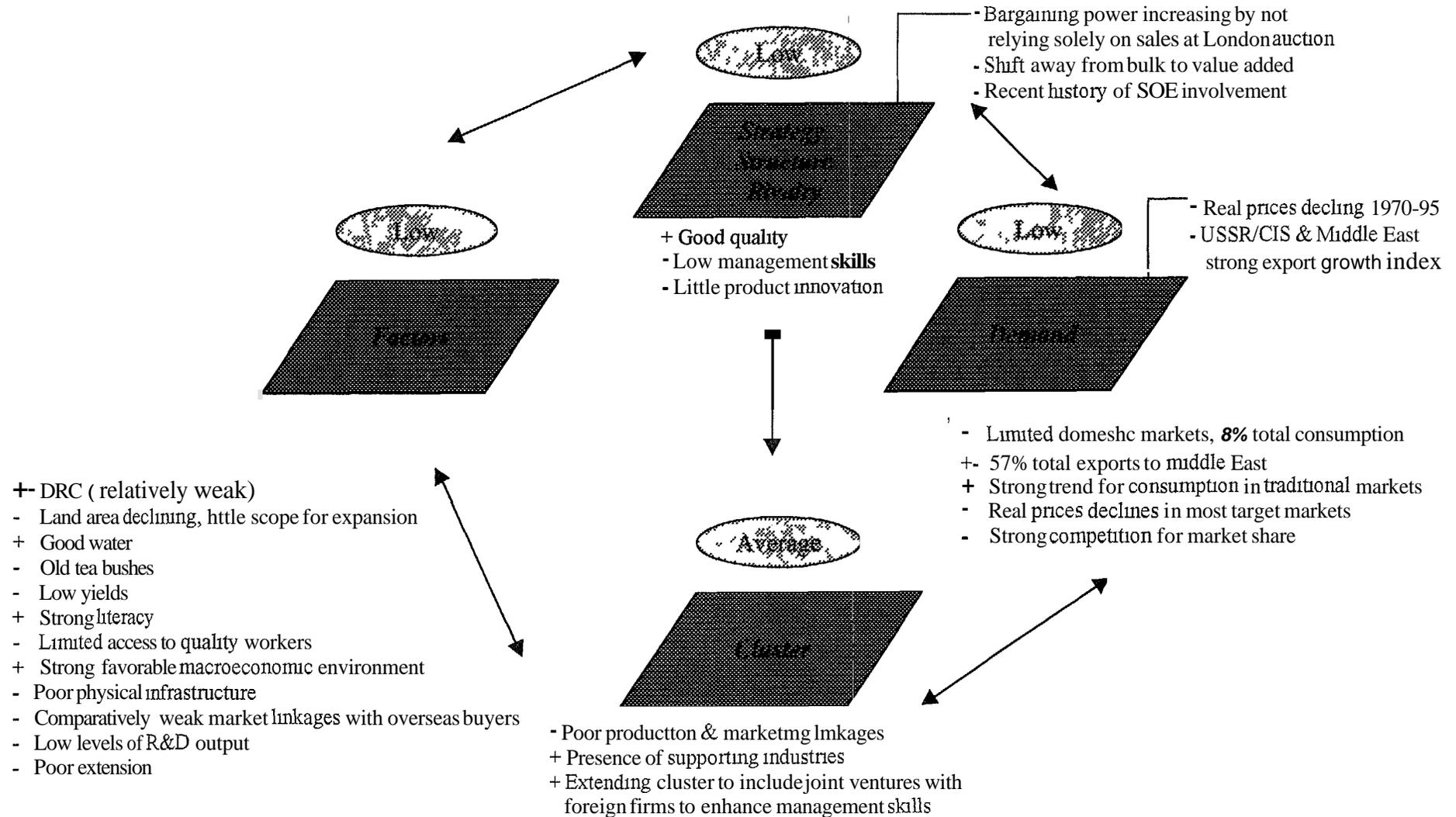
The new courses and certification opportunities, moreover, can be offered on both a real-time and on-demand basis. Service companies in Sri Lanka can focus on capturing and converting live distance learning events into digital formats for subsequent on-demand delivery in multiple languages, in a manner sensitive to the preferred learning style and pace of the user.

At primary and secondary school levels, Sri Lanka can also focus on building English-language skills. As Yukthi K. Gunasekera of the University of Minnesota Law School notes, "equally important is to make English a compulsory subject in the curriculum from grades 1 through 10. The pragmatic option right now is to make sure that students obtain at least a functional knowledge of English, so that they may be better able to compete in the global economy, which conducts itself primarily in English, not Sinhala or Tamil." If Sri Lanka succeeds in making English less elite, it has a better chance of carving itself into a more elite economy.

The following table presents several examples of opportunities for the Sri Lankan service and knowledge-based exports industry.

opportunity	Method
1 Compehhve positioning	Opportunity This is a new industry, requiring skills, responsiveness and cost management. Position Sri Lanka as a location offering easy access and top quality of service, with a strong infrastructure/service platform.
2 Customer Learning	Opportunity Work with strategic customers to understand needs and respond to them.
3 Innovahon	Opportunity High-quality telecommunications capability is a must.
4 Human Capital Investment	Opportunity Training in technology. Facilitate entrepreneurship and new entry into the industry. Maximize technology transfer.
5 Cluster Cooperation	Opportunity Develop industry associations. Implement quality standards. Encourage entrants to the market. Work improve telecommunications service and increasing access and openness.
6 Forward Integrahon	Opportunity Firms can develop alliances with foreign partners and customers. Move from service provision to software development.
7 Strategies and Attitudes	Opportunity This is an emerging market, and Sri Lanka can establish itself as a quality service provider offering outstanding telecommunications platform.

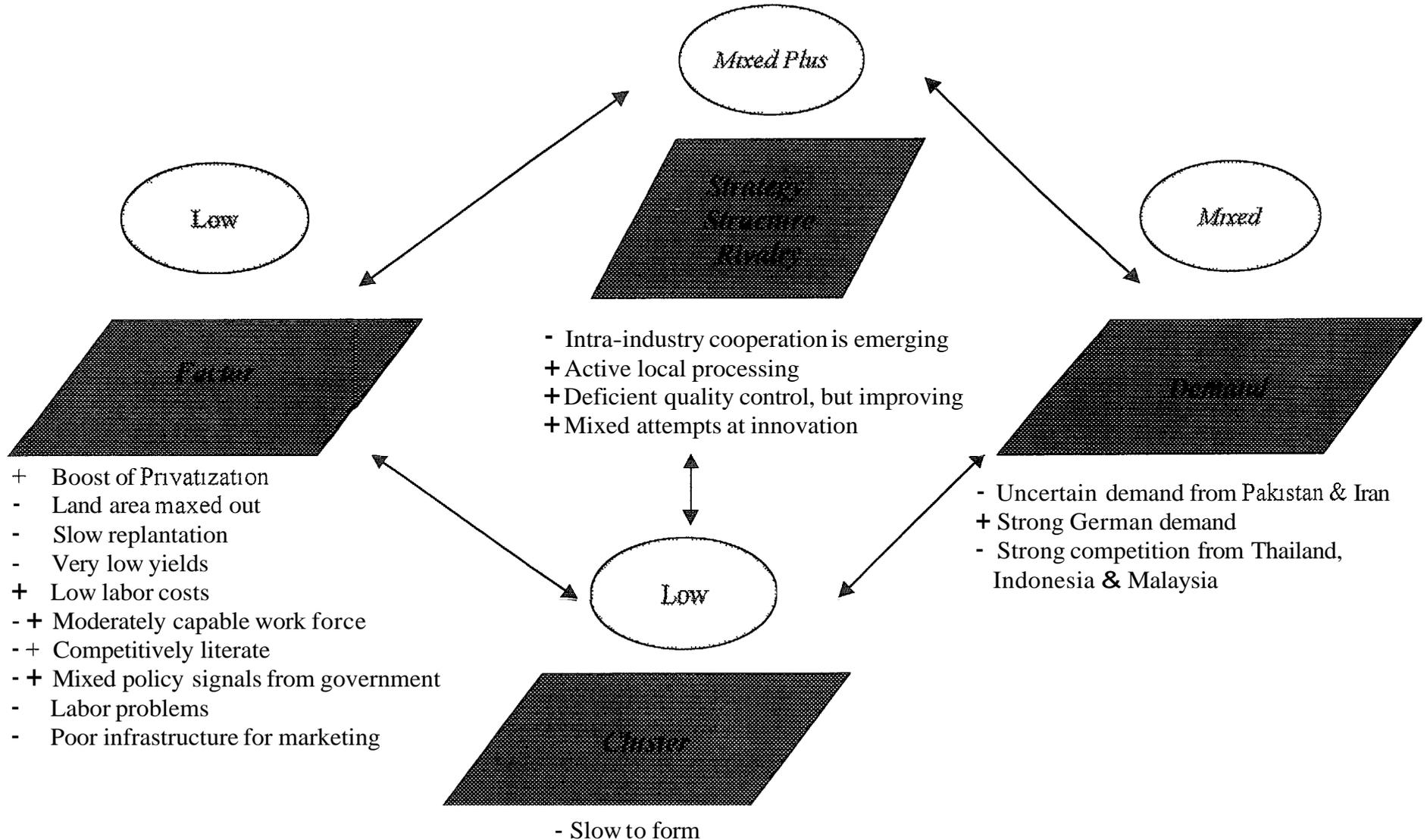
TEA: SRI LANKA'S COMPETITIVENESS DIAMOND



Source: Ridwan Ah, Yusuf A Choudry, Douglas W Lister "Sri Lanka's Tea Industry: Succeeding in the Global Market" World Bank Discussion Paper No. 368, 1997
 JAA 1998

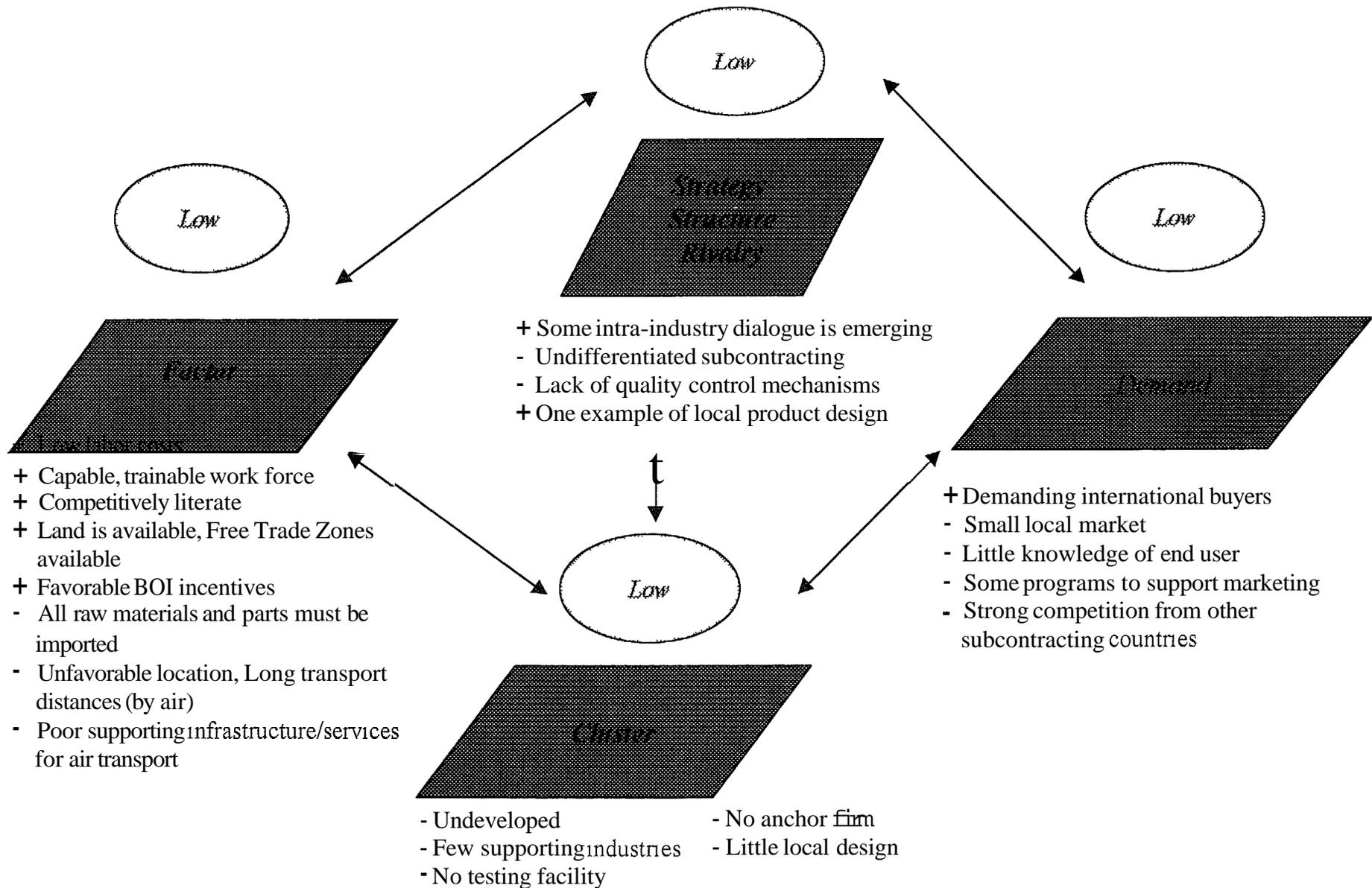
177

RUBBER: SRI LANKA'S COMPETITIVENESS DIAMOND



113

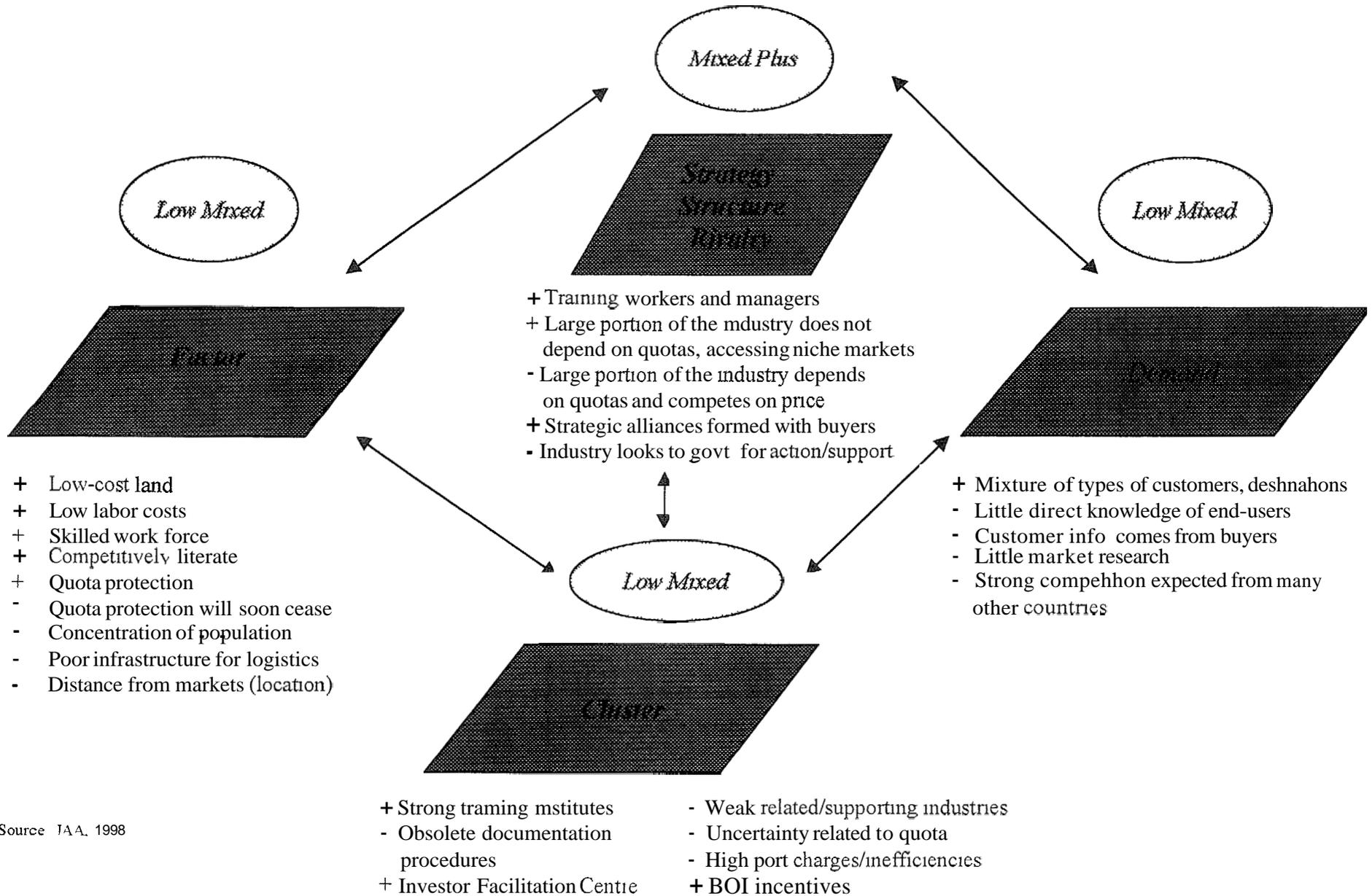
ELECTRONICS: SRI LANKA'S COMPETITIVENESS DIAMOND



Source JAA, 1998

174

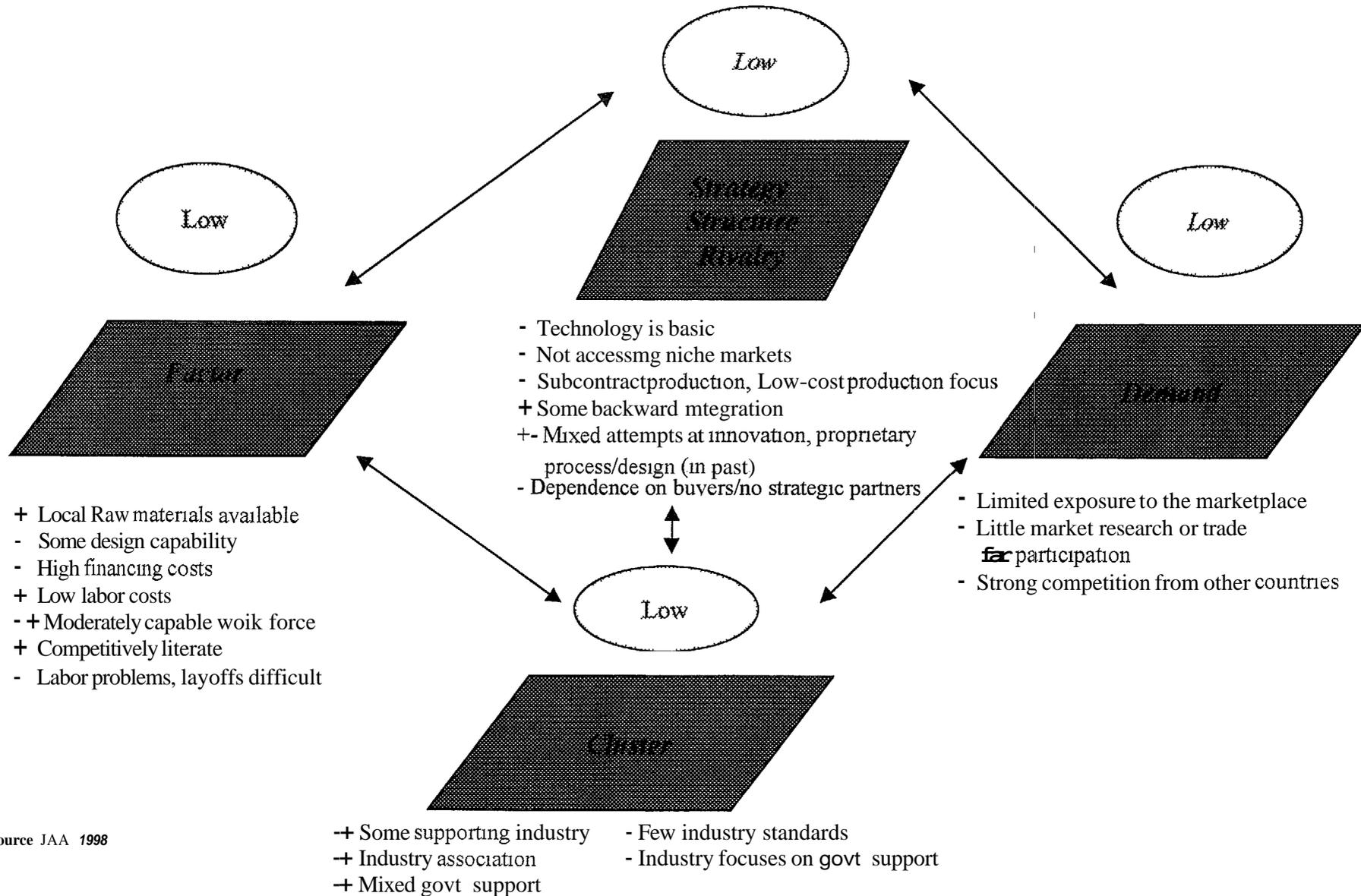
GARMENTS: SRI LANKA'S COMPETITIVENESS DIAMOND



Source JAA, 1998

175

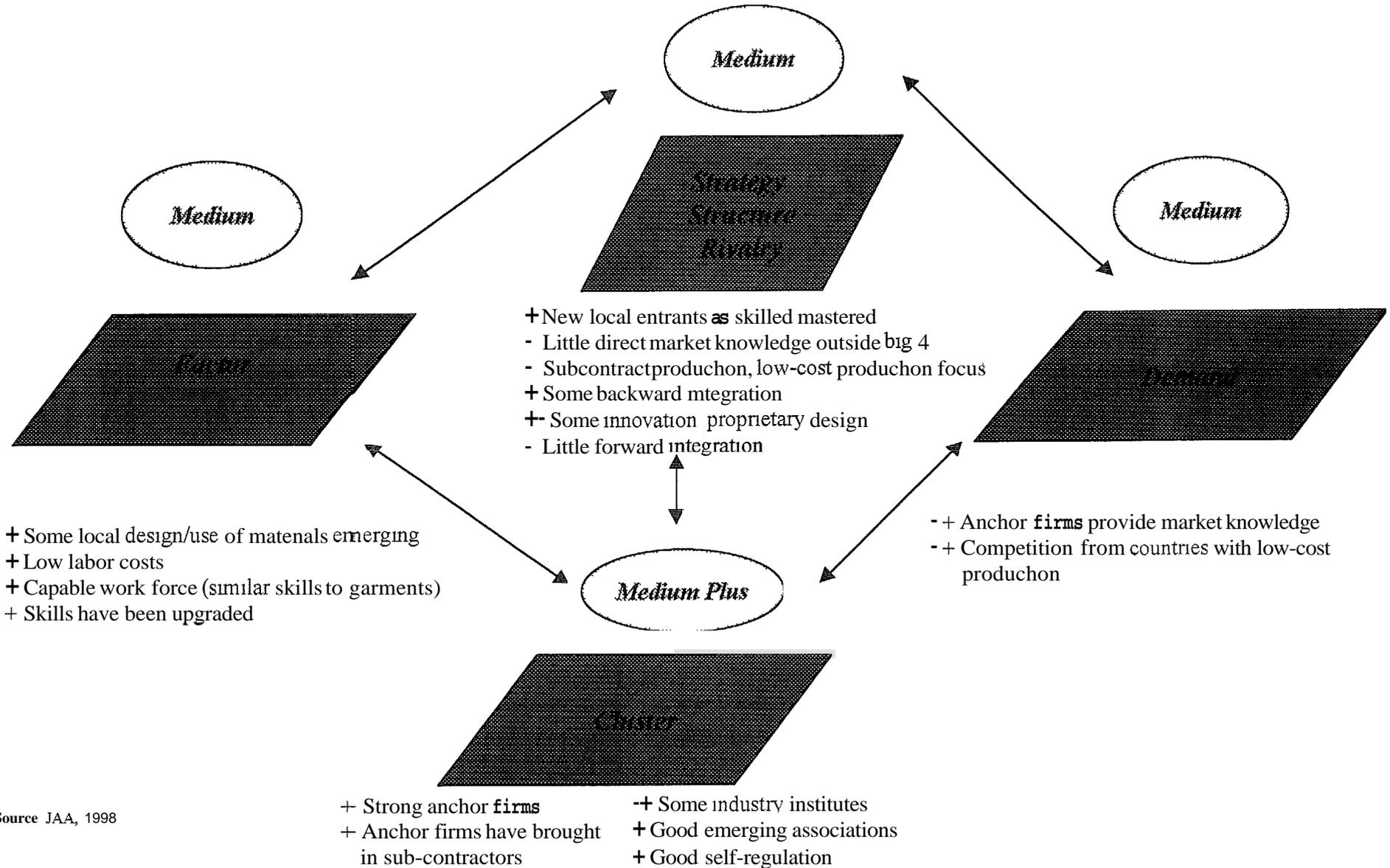
WOODEN TOYS: SRI LANKA'S COMPETITIVENESS DIAMOND



Source JAA 1998

17/9

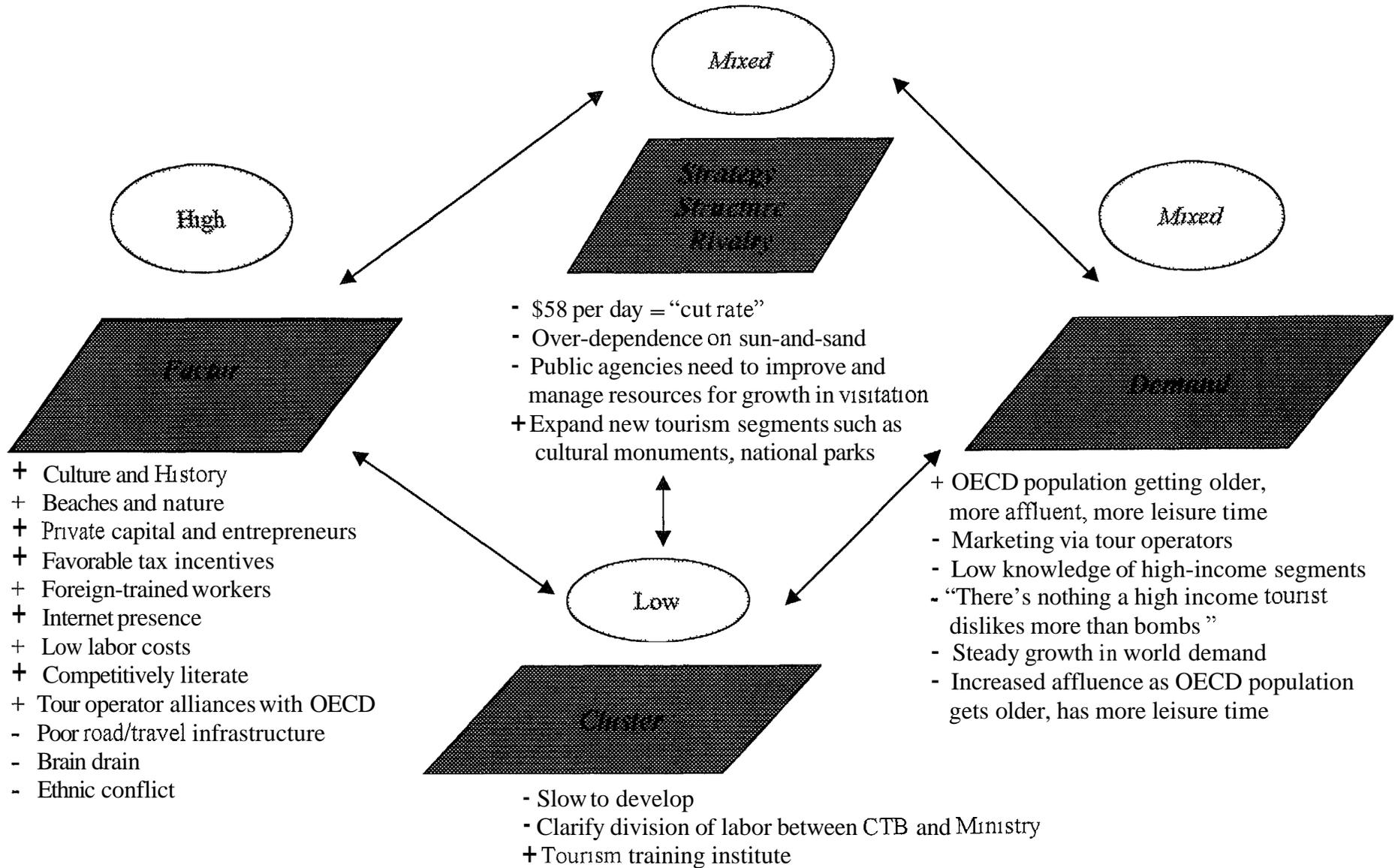
SOFT TOYS: SRI LANKA'S COMPETITIVENESS DIAMOND



Source JAA, 1998

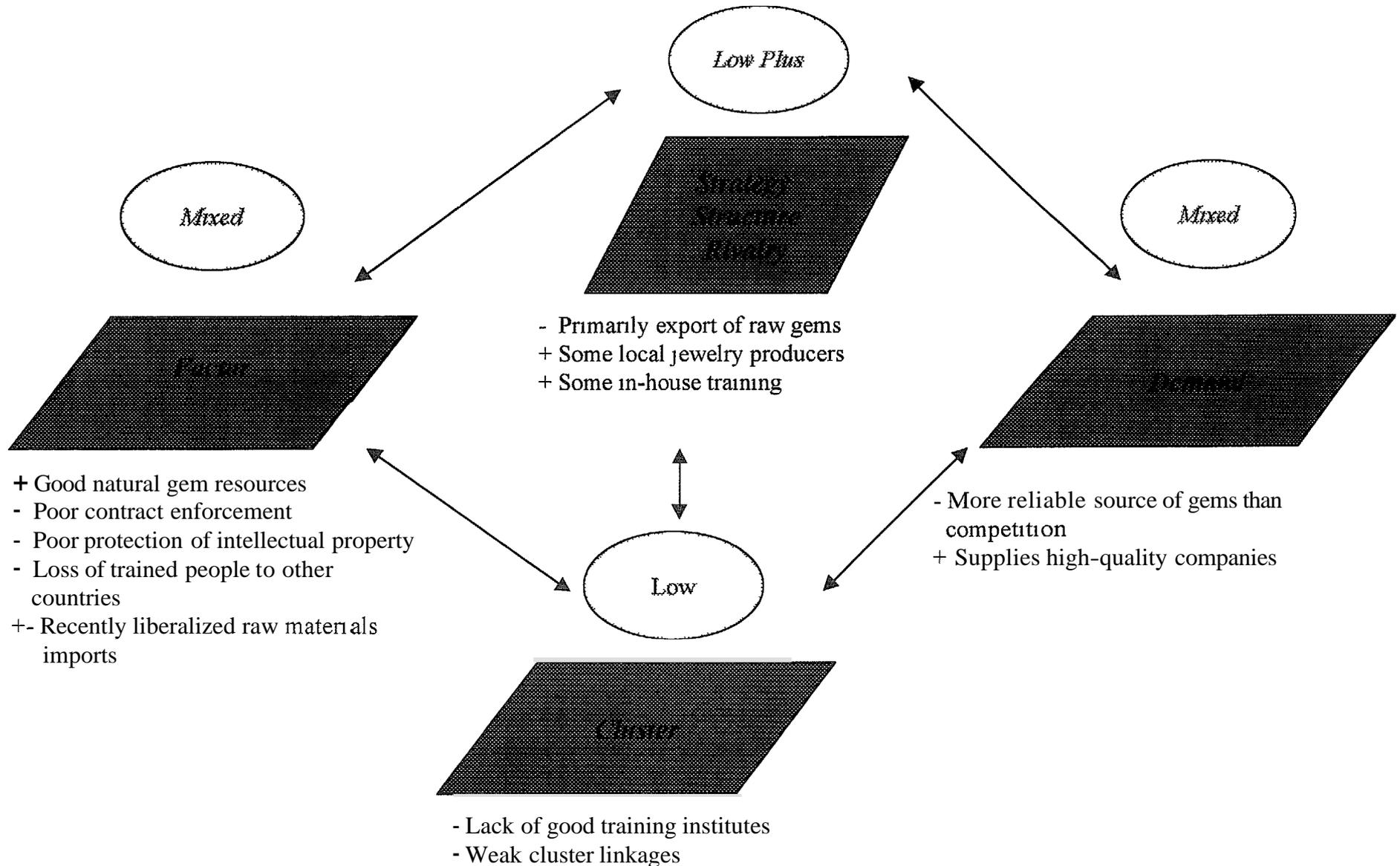
177

TOURISM EXPORTS: SRI LANKA'S COMPETITIVENESS DIAMOND

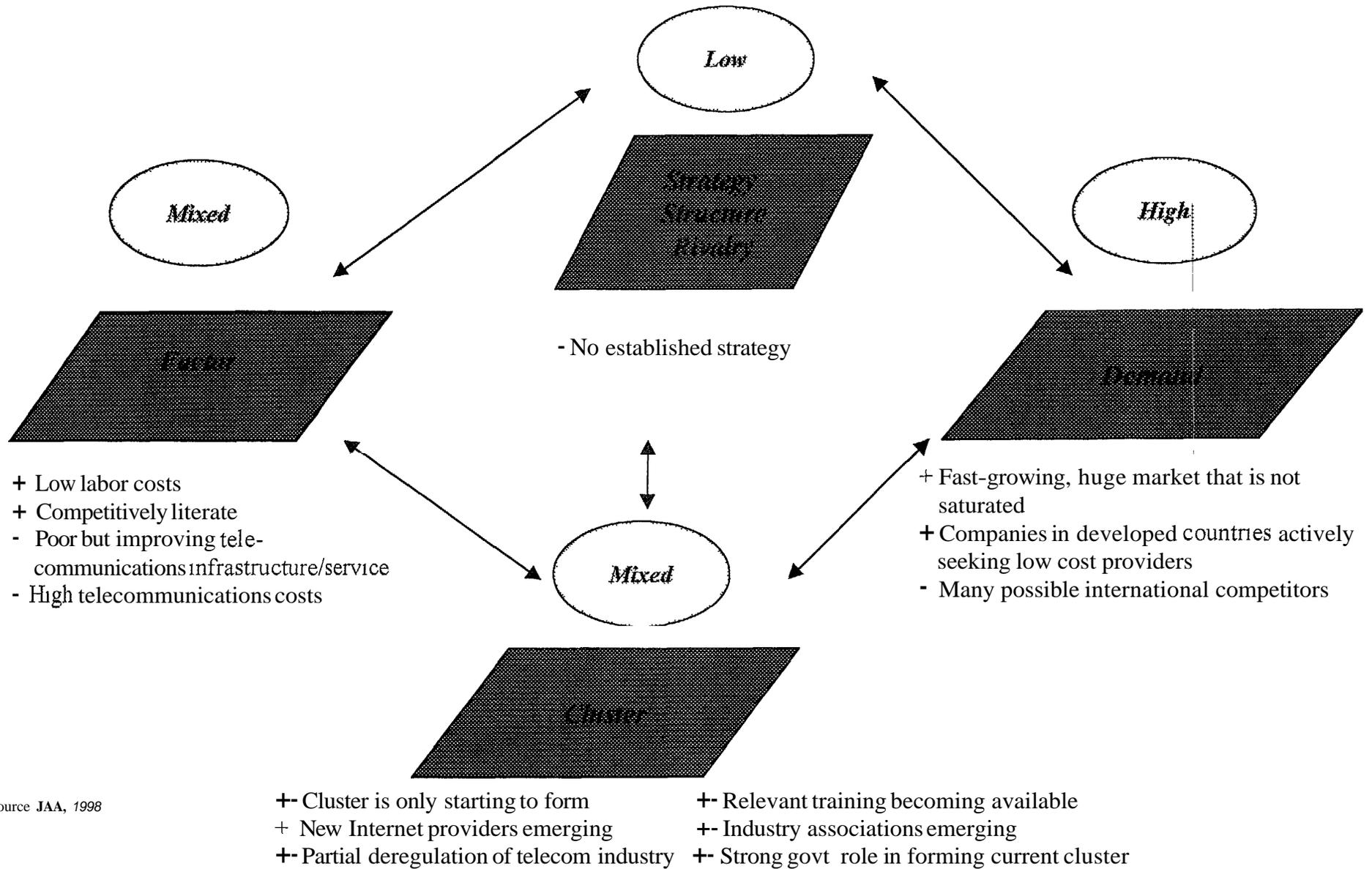


178

GEMS: SRI LANKA'S COMPETITIVENESS DIAMOND



SERVICE/KNOWLEDGE EXPORTS: SRI LANKA'S COMPETITIVENESS DIAMOND



Source JAA, 1998

180

Exhibit IV-2 1

Tea

Platform (Policy, etc) Impact Points

Category	Platform element	Company Impact Points			
		Finance	Marketing	Prodn	Org'n & Staffing
Macroeconomic Policies					
	Monetary	X			
	Fiscal	X		X	
→	Trade	X	X	X	
	Labor - minimum wage			X	X
	Labor - expatriates				X
	Capital - ownership	X			X
	Capital - repatriation	X			X
Legal and Institutional Enabling Environment					
	Appropriate commercial legislation	X	X		X
	Functioning judiciary or arbitration mechanisms	X		X	X
	Productive civil service			X	X
	Tax collection	X			X
	Customs	X	X		
	Health and sanitary				n/a
	Business licensing	X			X
	Investment promotion	X		X	
	Government procurements and contract awards				n/a
→	Privatization		X		
Infrastructure - Cost and Service					
	Safe water			X	
	Telecommunications		X		
	Informatics		X		
	Energy			X	
	Transport		X	X	
Human Resources					
	Literacy		X		X
	Education level		X	X	X
	Technical and Managerial Training		X	X	X
	Productivity			X	X
	Health Initiatives				n/a

Exhibit IV-2 2

Rubber

Platform (Policy, etc) Impact Points

<i>Category</i>	<i>Platform element</i>	<i>Company Impact Points</i>			
		<i>Finance</i>	<i>Marketing</i>	<i>Prod n</i>	<i>Org'n & Staffing</i>
Macroeconomic Policies					
	Monetary	X			
	Fiscal	X		X	
	Trade	X	X		
	Labor - minimum wage			X	X
	Labor - expatriates				X
→	Capital - ownership	X			X
	Capital - repatriation	X			X
Legal and Institutional Enabling Environment					
	Appropriate commercial legislation	X	X		X
	Functioning judiciary or arbitration mechanisms	X		X	X
	Productive civil service		X	X	X
	Tax collection	X			X
	Customs	X	X		
	Health and sanitary			X	
	Business licensing	X			X
→	Investment promotion	X		X	
	Government procurements and contract awards				n/a
	Privatization		X		
Infrastructure - Cost and Service					
	Safe water			X	
	Telecommunications		X		
	Informatics		X		
	Energy			X	
	Transport		X	X	
Human Resources					
	Literacy		X		X
	Education level		X	X	X
→	Technical and Managerial Training		X	X	X
	Productivity			X	X
	Health Initiatives				n/a

Exhibit IV-2 3

Electronics

Platform (Policy, etc) Impact Points

Category	Platform element	Company Impact Points			
		Finance	Marketing	Prod'n	Org n & Staffing
Macroeconomic Policies					
	Monetary	X			
	Fiscal	X		X	
→	Trade	X		X	
	Labor - minimum wage			X	X
	Labor - expatriates			X	X
	Capital - ownership	X			X
	Capital - repatriation	X			X
Legal and Institutional Enabling Environment					
	Appropriate commercial legislation	X		X	X
	Functioning judiciary or arbitration mechanisms	X		X	X
	Productive civil service		X	X	X
	Tax collection	X			X
	Customs	X	X	X	
	Health and sanitary				X
	Business licensing	X			
	Investment promotion	X		X	
	Government procurements and contract awards				n/a
	Privatization	X		X	
Infrastructure - Cost and Service					
	Safe water			X	n/a
	Telecommunications		X	X	
	Informatics		X	X	
	Energy			X	
→	Transport	X	X	X	
Human Resources					
	Literacy			X	X
	Education level		X	X	X
→	Technical and Managerial Training		X	X	X
	Productivity			X	X
	Health Initiatives				n/a

Exhibit IV-2 4

Apparel

Platform (Policy, etc) Impact Points

Category	Platform element	Company Impact Points			
		Finance	Marketing	Prod'n	Org'n & Staffing
Macroeconomic Policies					
	Monetary	X			
	Fiscal	X		X	
→	Trade	X	X	X	
	Labor - minimum wage			X	X
	Labor - expatriates			X	X
	Capital - ownership	X			X
	Capital - repatriation	X			X
Legal and Institutional Enabling Environment					
	Appropriate commercial legislation	X		X	X
	Functioning Judiciary or arbitration mechanisms	X		X	X
→	Productive civil service			X	X
→	Tax collection	X			X
	Customs	X		X	
	Health and sanitary			X	
	Business licensing	X			X
	Investment promotion	X		X	
	Government procurements and contract awards				n/a
	Privatization	X		X	
Infrastructure - Cost and Service					
	Safe water			X	n/a
→	Telecommunications		X	X	
	Informatics		X	X	
	Energy			X	
→	Transport	X	X	X	
Human Resources					
	Literacy			X	X
	Education level		X	X	X
→	Technical and Managerial Training		X	X	X
	Productivity			X	X
	Health Initiatives				

Exhibit IV-2 5a

Wooden Toys

Platform (Policy, etc) impact Points

Category	Platform element	Company Impact Points			
		Finance	Marketing	Prod'n	Org'n & Staffing
Macroeconomic Policies					
	Monetary	X			
	Fiscal	X		X	
→	Trade	X	X		
	Labor - minimum wage			X	X
	Labor - expatriates				X
	Capital - ownership	X			X
	Capital - repatriation	X			X
Legal and Institutional Enabling Environment					
	Appropriate commercial legislation	X			X
	Functioning judiciary or arbitration mechanisms	X		X	X
	Productive civil service		X	X	X
	Tax collection	X			X
	Customs	X	X		
	Health and sanitary		X	X	
→	Business licensing	X		X	X
→	Investment promotion	X		X	
	Government procurements and contract awards				n/a
	Privatization		X		
Infrastructure - Cost and Service					
	Safe water			X	
	Telecommunications		X		
	Informatics		X		
	Energy			X	
	Transport		X	X	
Human Resources					
	Literacy		X		X
	Education level			X	X
	Technical and Managerial Training			X	X
	Productivity			X	X
	Health Initiatives				n/a

Exhibit IV-2 5b

Soft Toys

Platform (Policy, etc) Impact Points

<i>Category</i>	<i>Platform element</i>	<i>Company impact Points</i>			
		<i>Finance</i>	<i>Marketing</i>	<i>Prod'n</i>	<i>Org'n & Staffing</i>
Macroeconomic Policies					
	Monetary	X			
	Fiscal	X		X	
→	Trade	X	X		
	Labor - minimum wage			X	X
	Labor - expatriates				X
	Capital - ownership	X			X
	Capital - repatriation	X			X
Legal and Institutional Enabling Environment					
→	Appropriate commercial legislation	X			X
	Functioning judiciary or arbitration mechanisms	X		X	X
	Productive civil service		X	X	X
	Tax collection	X			X
	Customs	X	X		
	Health and sanitary		X	X	
	Business licensing	X			X
	Investment promotion	X		X	
	Government procurements and contract awards				n/a
	Privatization		X		
Infrastructure - Cost and Service					
	Safe water			X	
	Telecommunications		X		
	Informatics		X		
	Energy			X	
	Transport		X	X	
Human Resources					
→	Literacy		X		X
→	Education level			X	X
→	Technical and Managerial Training			X	X
	Productivity			X	X
	Health Initiatives				n/a

Tourism

Platform (Policy, etc) Impact Points

Category	Platform element	Company Impact Points			
		Finance	Marketing	Prodn	Org'n & Staffing
Macroeconomic Policies					
	Monetary	X			
	Fiscal	X		X	
	Trade	X	X		
	Labor - minimum wage	X		X	X
	Labor - expatriates		X		X
	Capital - ownership	X			X
	Capital - repatriation	X			X
Legal and Institutional Enabling Environment					
	Appropriate commercial legislation	X			X
	Functioning judiciary or arbitration mechanisms	X			X
	Productive civil service		X	X	X
	Tax collection	X			X
	Customs	X	X	X	
	Health and sanitary		X	X	
	Business licensing	X			X
	Investment promotion	X	X		
	Government procurements and contract awards				n/a
	Privatization		X		
Infrastructure - Cost and Service					
	Safe water		X	X	
	Telecommunications		X	X	X
	Informatics		X		
→	Energy		X		
→	Transport	X	X	X	X
Human Resources					
	Literacy		X	X	X
	Education level		X	X	X
	Technical and Managerial Training		X	X	X
	Productivity	X		X	X
	Health Initiatives				X

Exhibit IV-27

Gems

Platform (Policy, etc) Impact Points

<i>Category</i>	<i>Platform element</i>	<i>Company Impact Points</i>			
		<i>Finance</i>	<i>Marketing</i>	<i>Prod'n</i>	<i>Org'n & Staffing</i>
Macroeconomic Policies					
	Monetary	X			
	Fiscal	X		X	
→	Trade	X	X		
	Labor - minimum wage				X
	Labor - expatriates				X
	Capital - ownership	X			X
	Capital - repatriation	X			X
Legal and Institutional Enabling Environment					
	Appropriate commercial legislation	X	X	X	X
→	Functioning Judiciary or arbitration mechanisms	X		X	X
	Productive civil service				X
	Tax collection	X			X
	Customs	X	X		
	Health and sanitary				n/a
	Business licensing	X			X
	Investment promotion	X		X	
	Government procurements and contract awards				n/a
	Privatization			X	
Infrastructure - Cost and Service					
	Safe water			X	
	Telecommunications		X		
	Informatics		X		
	Energy			X	
	Transport		X	X	
Human Resources					
	Literacy		X		X
	Eaucarion levei		X	X	X
→	Technical and Managerial Training		X	X	X
	Productivity			X	X
	Health Initiatives				n/a

Service and Knowledge-based Exports

Platform (Policy, etc) Impact Points

<i>Category</i>	<i>Platform element</i>	<i>Company Impact Points</i>			
		<i>Finance</i>	<i>Marketing</i>	<i>Prod'n</i>	<i>Org n & Staffing</i>
Macroeconomic Policies					
	Monetary	X			
	Fiscal	X		X	
	Trade	X	X		
	Labor - minimum wage			X	X
	Labor - expatriates				X
	Capital - ownership	X			X
	Capital - repatriation	X			X
Legal and Institutional Enabling Environment					
	Appropriate commercial legislation	X	X		X
	Functioning judiciary or arbitration mechanisms	X		X	X
	Productive civil service		X		X
	Tax collection	X			X
	Customs	X			
	Health and sanitary				n/a
	Business licensing	X			X
	Investment promotion	X		X	
	Government procurements and contract awards				n/a
→	Privatization		X		
Infrastructure - Cost and Service					
	Safe water				n/a
→	Telecommunications		X	X	
→	Informatics		X	X	
	Energy		X	X	
	Transport				n/a
Human Resources					
→	Literacy		X	X	X
	Education level		X	X	X
→	Technical and Managerial Training		X	X	X
	Productivity			X	X
	Health Initiatives				n/a

APPENDIX 1:

**SRI LANKA'S MACROECONOMIC-LEVEL
COMPETITIVENESS**

(SRI International)

Appendix 2

SRI LANKA'S MACROECONOMIC-LEVEL COMPETITIVENESS

All levels of any economy are affected by their competitiveness. That is, the ability of individual firms, industries, regions and nations to operate and hopefully to grow is closely related to the degree to which those economic "units" can compete with other such units in the marketplace. Economic entities vie for resource inputs and for market shares, both nationally and internationally.

If a seller cannot offer an attractive package in terms of **quality** (high) and price (low) for its product or service in relation to that offered by its competitors, it will lose market share. Similarly, if a buyer cannot offer competitive **terms** for products or services, it will not be able to acquire them. This simple "market reality" holds for both companies and nations. It is possible to apply competitiveness to many economic levels and processes.

The issue of competitiveness can also be approached from different functional perspectives. This report examines Sri Lanka's competitiveness according to several dimensions which are crucial to the nation's economic future.

- 1 **Firm-Level and Industry-Level** competitiveness,
- 2 **Export Competitiveness**, or the ability of Sri Lanka to compete with other nations for overseas export markets,
- 3 **Investment Competitiveness**, or the capacity of Sri Lanka to attract new productive investment from both domestic and international sources, and
- 4 **Macroeconomic Competitiveness**

Competitiveness at the "macro" or national level can be addressed from two different perspectives. In one sense, macroeconomic competitiveness represents the ultimate culmination of competitiveness at all levels within a country. As such, it is the end result of all internal economic activities.

At the same time, however, macroeconomic competitiveness does provide the overall operating environment -- which can be either nurturing or constraining -- for economic units at "lower" levels. Conditions and trends that emerge at the macro level, including overall growth rates, consumer/producer demand, inflation, interest rates, balance of payments and other factors, all serve as "drivers" of conditions felt at the regional or local levels. In addition, governments apply policies that affect these variables throughout their nations.

This chapter begins with a summary overview of Sri Lanka's recent macroeconomic performance to provide a context within which the nation's competitiveness can be examined. This is followed by a **benchmarking** of Sri Lanka's macro (national level) development performance in economic growth, competitiveness foundations, health, education, the environment, and freedom and democracy. This analysis is based on the "Development WEB Model" developed by SRI International, and compares Sri Lankan performance with that of regional competitors and global best practices. The next section explores the current status, strengths and weaknesses of Sri Lanka's macro monetary and fiscal policies. The final section of this chapter examines the nation's commercial policy **framework**, using SRI's Commercial Policy Matrix and international data base.

Macroeconomic Overview

Historical Framework

Prior to its independence in **1948**, Sri Lanka's economy was built on plantation agriculture -- tea, sugar and coconuts. The colonial plantation system played a role in shaping Sri Lanka's ethnic makeup. Historically, the country's population was and remains predominantly Sinhalese, but Tamil settlers from south India occupied the northern part of the island for centuries. During the colonial period, British plantation management introduced even more Tamils as indentured labor.

From 1948 through the 1960s economic development focused on tea, coconuts rubber and other agricultural products. Industrial development was primarily small in scale and concentrated in the greater Colombo area. Among the industries were tea, rubber and coconut processing, lumber, gems and jewelry.

Starting with the entry into power of the Sri Lanka Freedom Party in 1956, subsequent Sri Lankan governments engaged in strongly socialistic domestic economic programs – along with nationalistic and non-aligned international policies -- through which the government acquired the principal commercial plantations and nationalized the banks, utilities and transportation facilities. Government adherence to a strong import substitution policy led to the nationalization of the steel, sugar, cement, petroleum refining and other industries. The government exerted increasing control over land ownership and pricing. The end result was that nearly 80 percent of Sri Lanka's land as well as other factors of production were either state-owned or controlled. Government commitment to social welfare did lead to marked improvements in health and literacy but at the cost of creating a stagnant and inefficient economy.

Starting in 1977, the new United National Party government adopted a policy of encouraging private sector development. This turn in economic policy was appropriate but until fairly recently the reform process has been slow. Compounding economic difficulties, ethnic strife between the Sinhalese majority and Tamil minority erupted in the mid-1980s into an active civil war, generating substantial economic and social costs for Sri Lanka.

The benefits of a liberalized economy and an open industrial policy began to take effect in the early 1990s but a resurgence in the level of insurgency in 1995 and a severe drought in 1996 adversely affected Sri Lanka's economy and growth prospects. The drought affected not only agriculture but also industry as the water shortage impeded hydroelectric power generation leading to recurrent power outages. Overcoming these events, Sri Lanka achieved solid economic performance in 1997 and, despite economic problems among its East Asian neighbors, 1998 should prove a reasonably good year as well.

Government intervention in the economy is still substantial, especially in the areas of non-plantation agriculture, infrastructure and commercial banking. However, strong encouragement of private investment in manufacturing, privatization of a number of state-owned enterprises and relatively good fiscal and monetary management bode well for future development.

National Output

The Central Bank of Sri Lanka announced that the country's gross domestic product exceeded US\$15 billion in 1997. With a population calculated at 18.6 million, this gives Sri Lanka a per capita GDP of slightly over US\$800. Growth in real terms in 1997 was 6.4 percent, a sharp recovery from the 2.6 percent rate recorded in 1996.

Sri Lanka enjoyed its most rapid economic growth during its first attempt at economic liberalization, 1978-82, when GDP grew in real terms at about 8 percent annually. This contrasted with the earlier rate of GDP growth of about 2 percent annually from 1971-77 and with the 3-4 percent range experienced later in the years from 1983 to 1992. Sri Lanka's rate of population growth has declined substantially over this period and now averages 1.2 percent a year. Real economic growth as a result translates almost directly to increased per capita income. At its present income level, the country is approaching the status of a "middle income" nation and one for which concessional financial assistance from multilateral donors will become increasingly scarce.

The major thrust leading to growth in Sri Lanka's economy in 1997 came from the manufacturing sector and, within the sector, from the apparel assembly industry. Since 1978, manufacturing's share of GDP has increased from 15.3 percent to 21.5 percent. The service sector has grown from 45.3 percent to 51.4 percent. Primary economic activities of agriculture, forestry and fishing have lost share from 28.7 percent to 17.8 percent, with mining staying constant at 2.5 percent and construction declining marginally from 8.3 percent to 6.8 percent. Agriculture remains the principal activity in Sri Lanka's rural areas where low income levels and widespread poverty still exist.

Within the "services sector" it should be noted that government expenditures for defense purposes are the equivalent of five percent of GDP and are a significant portion of the government's budget. Foreign exchange

earnings from tourism have regained their importance with the reduction in violence since 1995. Foreign visitor arrivals recorded in 1997 exceeded 370,000. In addition, remittances from Sri Lankans employed outside the country are significant. Remittances in 1997 contributed approximately US\$750 million to the national economy or 5.2 percent of estimated gross national product.

Gross domestic savings in Sri Lanka have ranged between 15-16 percent of GDP in recent years. In 1997 the savings rate reached 17.3 percent, approximately US\$2.6 billion. Adding in net foreign direct investment, net official foreign loans and grants and remittances brought the total for 1997 national savings to US\$3.2 billion, or 21.4 percent of GDP.

Compared to its neighbors, Sri Lanka's average annual growth in GDP, per capita GNP, gross domestic investment and exports during the 1990s exceeded those of India, Pakistan and Bangladesh, but through mid-1997 fell significantly below the rates achieved by Southeast Asian countries like Thailand, Indonesia, Malaysia and Singapore. Sri Lanka's performance during calendar 1997 and so far in 1998 has avoided the economic collapse of its principal Southeast Asian rivals and while not exempt from some of the negative consequences, appears currently to be in a stronger economic position than many of its neighbors.

Industrial Profile and Development Efforts

Sri Lanka has made a transition from a predominantly agricultural economy dependent on a few, selected commodities to a far more diversified one in which manufactured exports now exceed agricultural products in value. The traditional agricultural base for Sri Lanka's economy consisted of the production of tea, sugar, copra, rubber and some spices. The sale of semi-precious gemstones and cut gems supplemented agricultural output. The country has generally been self-sufficient in foodstuffs.

Policies related to import substitution led to industrialization mostly in the greater Colombo area and involving the production of cement, steel, processed sugar and other foodstuffs and oil refining. The industrial base by 1977 was inefficient, high cost and largely state owned.

Sri Lanka's dependence on exportable commodities led to investment in port facilities, especially the port of Colombo, which in 1997 handled over 20 million metric tons of cargo, 75 percent of which represented transshipments. Road and rail connections were developed but now are inadequate to demand and act more as a brake on development than as an incentive.

The government's response to the country's need for massive job creation, increased export earnings and economic growth took two paths. The first was privatization to reduce the state's role in the economy. Sales of state-owned enterprises reduced the share of publicly-owned value added manufacturing from 60 percent in 1981 to 15 percent in 1991. Nevertheless, state-owned enterprises (SOEs) remain significant within the economy.

The largest SOE in terms of output value is the Ceylon Petroleum Corporation, the country's oil refinery representing as much as 90 percent of total public enterprise output. Other SOEs include the Sri Lanka Rubber Manufacturing and Export Corporation, Ltd., Ceylon Mineral Sands Ltd., the State Timber Corporation and National Salt Ltd. Sri Lanka's three major sugar refineries are also state-owned, as is Lanka Phosphate Ltd. Other important agricultural commodities are government-controlled through such institutions as the Sri Lanka State Plantations Corporation, the Sri Lanka Tea Board, the Rubber Development Department, the Coconut Development Authority and the National Fertilizer Secretariat.

Agricultural production in general is manipulated through protective tariffs, price and production controls, grants and fertilizer subsidies. Some liberalization in tariff protection has taken place and import competition in some food products, e.g. edible oils, and -- during the 1996 drought -- potatoes, onions and chilies, has occurred.

Privatization efforts continue. In 1996 Steel Company Ltd. was sold to private interests. Of great importance to the economy has been permission for private investment in the energy field. Incentives granted to industries contributed to the importation of generators by 248 companies, increasing installed power generation capacity by 108 MVA. Concessions to foreign power companies on a BOO (Build-Operate-Own) basis have resulted in significant investments in new thermal power plants with close to 100 megawatts capacity when

completed Two mini-hydroelectric plants have also started operations Finally a new, privately-owned, multimillion dollar oil refinery is in development

Total sales of public enterprises in 1997 exceeded US\$380 million Key elements were

- The sale of a 35 percent equity position (and a management contract) in Sri Lanka Telecom Limited to NTT of Japan,
- The sale of convertible debentures, mostly to overseas investors, in the National Development Bank which when converted will represent a controlling interest,
- The sale of 51 percent equity positions in seven plantation companies and 19 percent shares in five other plantation companies,
- The sale of 90 percent equity shares in Puttalam Salt Limited and Lanka Salt Limited,
- The sale of a 17.33 percent equity share in Lanka Ceramic Limited, and
- Mattegama Textile Mill Limited, acquired from its bankrupt founders, was reconstructed, rehabilitated and sold in its entirety to another private company

The second approach has been an aggressive government-sponsored investment promotion effort Reorganized and expanded in 1992 Sri Lanka's Board of Investment (BOI) has combined a package of economic incentives with the active development of industrial parks into a program that has successfully attracted hundreds of foreign manufacturers Starting with a moderate but low cost labor and relatively easy access to world markets by both sea and air, the BOI invested public funds in basic industrial park infrastructure and then added a package of incentives to investors which included duty free entry for inputs and capital goods used solely for export production accelerated depreciation schedules, waivers of turnover taxes and income tax holidays

Through June 1997, the BOI counted 825 enterprises in commercial operation These included 94 located in the Katunayake Investment Promotion Zone 49 in the Biyagama Investment Promotion Zone 10 in the Koggala IPZ, 1 in the Malwatta Export Processing Park, 2 in the Kandy Investment Park and 669 outside the zones About two-thirds of the investments represented by these enterprises came from foreign sources BOI enterprises employed over 270,000 people in 1997

Sri Lanka's industrial growth over the past four years has been highly concentrated in the apparel/textile industry This industry represents 51 percent of current GDP and 41 percent of all industrial output Apparel is the largest single category in Sri Lanka's current exports, approaching US\$2 billion annually Sustained by imported fabric and other inputs, Sri Lanka's net value added for these exports runs nearly 30 percent While the gross exports of the apparel industry are three times that of tea, the net value added and employment generated by tea production and exportation is still slightly ahead With continued growth in apparel assembly and diversification into electronics and other products, the balance could well shift in favor of manufacturing in 1998

Efforts by the BOI to develop the electronic assembly industry have shown some success The BOI now administers an Advanced Technology Incentive Scheme which offers incentives in exchange for new investment in imported equipment and machinery The BOI has also extended export industry incentives to small and medium enterprises Waivers of up to 100 percent of duties and turnover taxes are available to companies which export over 50 percent of their production

New Development Review Committees have been established to look into specific aspects of Sri Lanka's industrialization and their findings provided to an "Industrialisation Commission" headed by the Secretary of the Treasury A Presidential Tariff Commission has also been set up to look at matters affecting the existence of domestic manufacturing industries The BOI has been planning an ambitious program of further industrial park

development including two new industrial parks and as many as 23 additional industrial estates located throughout the Republic

Along with agricultural production, tourism is a major source of foreign exchange earnings -- some US\$200 million in 1997. Tourism investment is targeted at the coastal areas along the southern coast and the archeological and cultural sites in central Sri Lanka.

The production of cut diamonds from unsorted raw stones has become increasingly important to the nation's already significant gem cutting industry. Aside from imported diamonds, Sri Lanka has a variety of mineral resources that are exploited including graphite, zircon, silica quartz and dolomite. Graphite is produced in deep mines and is relatively expensive. Silica, quartz, zircon and other minerals are found in sand deposits which are mined and exported. Offering the greatest potential for value added processing are the country's noted deposits of a rich variety of gemstones such as sapphires, rubies, tourmalines, topaz, garnets, moonstones, cats' eyes and chrysoberyl. Gems have been a significant export product but the sharp downturn in Asian economies in 1997 has had a sharply negative impact on this sector.

Other manufacturing is principally geared to serve the domestic market and includes rubber products, paint, chemicals, some pharmaceuticals, footwear and soft toys. Export production has developed from the domestic industry base in products using latex and natural rubber. In recent years as much as \$70 million in foreign direct investment has been made to develop rubber-based products for export. Exports of latex products (disposable gloves etc.), solid rubber tires and rubber footwear are growing and now approach US\$200 million.

In sum, Sri Lanka is shifting its economic base from overwhelmingly plantation agriculture to a balance in which industry will in time play a major role. It should be noted that this industrial base is almost exclusively light industry, with the labor content representing the principal Sri Lankan input. There is little in the way of heavy industry and only modest development of industry utilizing Sri Lankan natural resources.

With privatization of estates and the increased liberalization of the economy, Sri Lanka's agricultural base should become more productive, and thus more competitive in world markets. It is thus likely that agriculture will continue to provide an anchor for the economy while the industrial base expands and diversifies.

International Trade

Historically, Sri Lanka's principal export was tea. Tea was supplanted by garments exports, beginning in 1993. Exports of both tea and garments increased significantly in 1997. Other significant exports are cut diamonds, refined petroleum products and rubber products. Major imports are textiles (to support the export garment industry), machinery and equipment, transport equipment, crude petroleum, building materials and sugar. Major destinations for clothing are the United States, the United Kingdom and Germany. Tea is being sold in increasing amounts to Eastern Europe and the Middle East. Principal import sources are Japan, India, South Korea and Hong Kong.

SRI LANKA'S MERCHANDISE EXPORTS
(US\$ Millions)

Category	1996 Exports	1997 Exports	% Increase
Total Exports	3,450	4,066	18
Agricultural Exports	823	937	14
Tea	526	608	16
Rubber	115	98	(15)
Coconut	84	112	33
Other	98	118	20
Industrial Exports	2,510	3 009	20
Textiles/Garments	1583	1970	24
Rubber Products	148	161	9
Diamonds	123	130	9
Machinery/Electrical Equipment	109	169	55
Petroleum Products	101	70	(31)
Food/Beverages/Tobacco	93	86	(8)
Footwear/Luggage	92	153	66
Jewelry	36	15	(58)
Paper/Wood/Ceramic Products	59	72	22
Other Manufactures	165	183	11
Minerals Exports	86	95	11
Unclassified Exports	31	25	19

Category	1996 Imports	1997 Imports	Y_o Increase
Total Imports	4 767	5,828	22
Consumer Goods	1,049	1 249	19
sugar	131	229	75
Wheat	217	158	(27)
Rice	14	56	400
Other Commodities	329	381	16
Other Consumer Goods	358	424	18
Intermediate Goods	2,493	3,075	23
Textiles/Clothing	1,074	1,399	30
Petroleum	404	535	32
Chemicals	126	132	5
Fertilizer	68	50	(26)
Investment Goods	1,023	1 285	26
Machinery/Equipment	530	720	36
Building Materials	242	248	2
Transport Eqtupment	153	206	35
Unclassified Imports	202	219	8

Sri Lanka's trade deficit grew from US\$1.3 billion in 1996 to US\$1.8 billion in 1997. The services account remained slightly negative as tourism, port services and remittances from overseas did not cover outbound private transfers. The current account deficit in 1997 improved to the equivalent of 2.5 percent of GDP from the figure of 4.5 percent for 1996. Proceeds from privatization, foreign direct investment and the floating of an external debt issue generated sufficient foreign exchange to produce a positive balance of payments for the year.

Imports of sugar reflect the failure of state-owned sugar plantations to recover production lost in the 1996 drought, with the resulting deficit in domestic supply covered by imports. Exports of coconut, rubber products and gem stones showed signs of weakening in late 1997 owing to economic declines in East Asia, which both depressed regional markets and raised competitive pressures. Economic problems in Asia have not thus far affected Sri Lanka's trade in garments or tea.

Sri Lanka historically utilized import quotas, export and import licensing, high external tariffs, subsidies and other incentives to protect its domestic agriculture and to stimulate industrial development. With economic liberalization, overall levels of protection have been sharply reduced. There are three basic import tariff levels: 35 percent, 10 percent and 5 percent. Virtually all of the BOI-sponsored investors in export-oriented manufacturing have benefitted from duty free entry of machinery, equipment and necessary inputs. For most capital and consumer goods imports, the trade rules are well established and trade flows freely.

The one significant area in which government intervention remains is in non-plantation agriculture. In other words, agriculture outside of tea and rubber is still protected and controlled by the government through high protective tariffs, price controls, specific incentives and subsidies. The government also regulates the hydrocarbon market, setting prices and retaining ownership of the nation's only refinery and is heavily involved in infrastructure and transport activities. The Port Authority which operates the three seaports is a government agency. Bus lines are publicly held, the railroad is state-owned, and the government, in addition to controlling prices, is the largest single supplier of electrical power.

Macroeconomic "Balance Sheet" Assessment

Comprehensiveness is felt primarily at the firm and industry levels. However, a nation's overall economic "assets" and "liabilities" in key input categories can clearly influence firm-level access to resources (in terms of both quantity and quality), thereby affecting competitiveness. In Sri Lanka, human resources, finance and infrastructure are critical resource categories.

Human Resources

Among Sri Lanka's accomplishments since independence has been the extension of education to cover the entire population. There is almost universal literacy with the possible exception of the northeastern provinces, the principal site of the Tamil insurgency. Educational opportunities were not matched with employment opportunities and high unemployment rates have been a major problem. However, since 1990 the measured unemployment rate has declined from 16 percent to about 11 percent. Increasing employment opportunities, especially in export manufacturing, have combined with out-migration to contribute to this trend.

Overall population growth has declined over the past 20 years to a current rate of 1.1 percent per year. Nevertheless, with 18.6 million inhabitants, Sri Lanka confronts not only the problem of high unemployment but also issues related to high population densities and fragmented land ownership. Declines in fertility and improvements in life expectancy have led to a process very well established in the developed world -- the increase in the old age dependency ratio. From a 5.9 percent dependency ratio at the time of independence, it has reached 7.4 percent in 1997 and is expected to reach 17.4 percent by 2021.

Projections of current demographic trends indicate that the number of youth entering the job market will peak in 2020 and decline thereafter. Labor force growth is expected to stabilize by 2010 and remain static thereafter. This implies an era of labor scarcities beginning as early as the first decade of the new century.

At present, however, rural poverty remains widespread. With the objectives of alleviating poverty and upgrading economic and social conditions of the poor, the government has launched the *Samurdhi* program. Its

major activity has been financial, extending income supplements to poor and displaced families. Over 400,000 families have benefitted from the first phases of the program while food rations were extended to 180,000 families displaced by the war in the northern and eastern provinces. Mandatory savings programs and small loans are also encompassed by the program for which costs have run around US\$800 million.

Sri Lanka's major competitive advantage in attracting offshore assembly industries has been the availability of a literate but low-cost labor force. Sri Lankan wage rates were significantly lower than those of its Asian economic rivals. With the collapse in currency values, especially acute in Indonesia, this advantage has largely dissipated at least temporarily. Wages remain low by international standards - \$50-60 a month for government employees, and \$1.30 a day minimum for tea plantation workers.

Sri Lanka's educational system has up to now offered little in the way of technical training. So while there is an ample supply of unskilled workers, there is a shortage of workers with computer telecommunication or other skills required for higher technology manufacturing. Combined with the lack of technical skills, employers also face rigidities imposed by labor legislation, especially with respect to severance or layoffs. One consequence is the tendency for employers to resort to short term, but renewable labor contracts. Labor turnover rates are also significant, for example, garment worker turnover was measured at 70 percent in 1996.

With Sri Lanka's economic growth strategy based on the aggressive promotion of labor intensive export industries, existing skills shortages and an impending tightening of the labor market pose challenges. Movement away from assembly operations to information technology, computer and offshore banking services offers opportunities but is limited by the lack of trained personnel as well as a highly competitive global environment.

Financial Resources

The amount and terms of capital and credit available to private sector firms in Sri Lanka have been strongly affected by the government's financial policies. In the past, chronic deficits substantially "crowded out" private borrowers, but financial market conditions have recently improved. In recent years, the government has reduced expenditures and obtained financial resources from privatizations, thereby improving financial market conditions and access to capital and credit.

Price inflation was brought down from 16 percent in 1996 to 9 percent in 1997. The relatively high rate experienced in 1996 was blamed largely on the effects of the drought which caused shortages of a number of commodities and a resultant increase in price. Government fiscal policy is directed at keeping the inflation rate to no more than 9 percent in 1998.

The government permits the free exchange of foreign currencies for most transactions including portfolio investment in the Colombo stock exchange. Repatriation of profits and conversion of export earnings is permitted. Private foreign investment and outflows of enterprises not covered by BOI incentives are allowed but only with approval. These modest controls together with control exercised over the short-term foreign exposure of commercial banks are credited with protecting the Sri Lanka economy from much of the spillover effect of the Asian economic crisis.

Reduction in statutory bank reserves from 15 to 12 percent permitted increases in available capital for lending to private borrowers. Current loan rates in rupees run about 20 percent, although the "prime rate" is 14.5 percent. Commercial banking has largely been liberalized although the two state-owned commercial banks still control some 60 percent of the commercial banking market.

There are now a total of 26 commercial banks active in the market, several of which are foreign owned. In this competitive market individual banks are modernizing their operations and introducing new products. In addition, there are two private development banks, the National Development Bank and the Development Finance Credit Corporation, which have access to concessional funding from abroad and which compete with the commercial banking system.

The Colombo Stock Exchange is one of the older and better established equity markets in the region. Its capitalization is estimated at US\$1.9 billion, and it has proved to be a source of equity capital for local firms. Foreign portfolio investors have also been active in the stock exchanges' share trading.

Physical Infrastructure

In general, physical infrastructure is a major constraint to Sri Lanka's long-term development prospects. Part of the problem has been state ownership of virtually all infrastructure which has combined weak management with deficient investment in modernization and expansion.

The international airport near Colombo is large and modern, but the national airline, Air Lanka, is state-owned and is not regarded either well managed or very efficient. About 10 percent of Sri Lanka's export shipments are transported by air and the rest by sea. Colombo's port facilities are ranked 26th in the world in terms of volume, handling in 1997 12 million metric tons of freight, of which 73 percent represented transshipments. But the Port Authority responsible for Colombo and the other two small ports is a public agency and there are questions as to efficiency of operations and strength of management. Fortunately, potentially competitive ports, especially several in South India, are even more poorly managed and equipped.

Electric power until recently was a monopoly of the Central Electricity Board, a public enterprise, and was highly dependent upon hydroelectric power. The severe drought in 1996 created serious problems in electric power supply. This has been overcome through three measures: (1) investment by the state in thermal power plants, (2) economic incentives for export industries to import equipment and generate their own power, and (3) concessions to foreign private firms to invest in new power generation facilities. Available electric power expanded in 1997 and the level of service was generally satisfactory. More plants coming into service should enable the country to meet its power needs for the medium term.

Telecommunications service, managed by another state monopoly, was historically inadequate with only one telephone installed for every 90 Sri Lankans. Waiting times for new telephone service were as long as ten years and only 40 percent of local calls were successfully completed. Recent liberalization brought in two foreign companies to provide cellular telephone service, which combined with substantial investment by Sri Lanka Telecom in satellite technology, digitalization and new lines, has alleviated the problem to a certain degree. The recent sale of a 35 percent equity position in Sri Lanka Telecom, together with a contract to "TT" of Japan to provide management, is expected to hasten further the modernization and expansion of Sri Lanka's telecom capacity.

Roads and land transport remain serious problems. Sri Lanka Rail is experiencing serious capital shortages leading to lack of locomotives and other rolling stock. It is operating about 50 percent fewer trains than needed to meet demand. Actual freight loadings in 1997 declined 13 percent compared to 1996 despite expanded economic activity, reflecting lack of rolling stock and operations problems. While passenger traffic increased slightly in 1997, service is notoriously poor.

Most urban and inter-urban passenger traffic is carried by buses. Here again, government intervention has left the system in poor condition. Most of the service is provided by "peopled" services which have been unable to maintain previous levels of service let alone expand to meet demand. The road network consists of 97,000 kilometers, but only one-third is paved. Basically it is old and not well maintained. The Road Development Authority is responsible for national roads but local and regional roads are left to local governments. In sum, the poor quality of land transport facilities in Sri Lanka acts as a major constraint to development. The Government is aware of the problem and has created an Infrastructure Development Board charged with exploring the use of BOT/BOO mechanisms to attract private capital investment in infrastructure projects.

Water and drainage in major urban areas is the responsibility of the National Water Supply and Drainage Board. Water supply is a serious problem in terms both of supply and quality. Reliable supplies of water in the volume needed for many industrial processes is not available.

Finally, despite new legislation, several plans and considerable publicity, Sri Lanka suffers from severe environmental problems. These range from the deterioration of coastal areas including coral reefs and severe shortages of acceptable waste treatment facilities, both solid and liquid. Over half of the country's energy is still derived from charcoal, wood, other plant and animal waste. There are few effective controls over industrial

pollution and little public understanding of the value of protecting the environment. Failure to bring these problems under control threatens the fishery industry as well as tourism.

2 Benchmarking Sri Lanka's Development Performance

The "development web" and database were created by SRI International in response to the increasing interest expressed by the development community for a more comprehensive and balanced development measurement system. The model was designed to cover not **only** traditional indicators of economic development, but also variables which capture new factors that have emerged as important inputs to and outputs of the development process.

The combination of innovative information technologies and the need for comparative analysis has led more and more organizations, both public and private, to produce and utilize new performance indicators. In the emerging information age, new forms of objective, quantitative indicators increasingly are being developed and applied as strategic inputs: best practice and competitiveness benchmarking, management tools, and progress monitoring systems.

The objectives of the web model include the following:

- 1 To measure development performance across a broad range of indicators which address different aspects of human welfare, using **objective** criteria and quantitative indicators.
- 2 To evaluate national and regional performance, and benchmark nations against best practices in the region, within similar income groupings, or worldwide.
- 3 To provide a management tool for identifying and assessing priorities for national and donor development programs.
- 4 To monitor progress over time and adjust initiatives to meet changing circumstances.
- 5 To establish a framework for examining relationships among important but different aspects of development.

The name "development web" is based on the premise that development progress for a country or region can be plotted on a hexagonal web. Each of the six axes on the web represents a different cluster or **vector** of development indicators. In other words, there will be separate vectors for (1) Economic Performance, (2) Competitiveness, (3) Education, (4) Health, (5) Environment, and (6) Democracy and Freedom.

The progress of a country in each development cluster is indicated on the corresponding vector on a scale of 1-100, with a score of 100 indicating perfect performance in that category. Thus, each country is represented by its own web, with its progress depicted on a multi-dimensional scale.

Individual country web scores can be benchmarked against regional averages, the world average, or competitor country web scores to assess the country's performance in each development category. Inferences can then be drawn as to whether the country is achieving "balanced" development, or alternatively as to which development area(s) should receive more attention from policymakers and the development community. For example, a country web may illustrate that a country performing very well in economic growth can score below the regional averages for the health and democracy vectors. In addition, observations can be made on the development paths taken by different countries or groups of countries as they make progress on each vector.

As an objective measurement tool, the development web can be utilized by a nation's policymakers or donor organizations to assess their progress *vis-a-vis* their neighbors or competitors. The web can also be used to track a country's development progress over time, which will be indicated by the expansion of the web, or shrinkage in the case of deteriorating conditions.

Variable Selection

A key step in the model design was the determination of variables that constitute each of the **six** vectors. To the extent possible, quantitative and **objectively** measurable variables were considered and used. Initially 115 variables were considered, out of which **48** were eventually selected to comprise the six vectors. Due to the importance of using the appropriate variables in the web model, a three-step process involving several screens, described below, was carried out to make the indicator selection process as objective and rigorous as possible.

- **Reliability/Accuracy** Data must come from reputable sources and be viewed as generally accurate.
- **Acceptability** Variables for each vector should be the generally accepted and commonly used indicators of progress by specialists in the pertinent development domain.
- **Neutrality** Variables should be as unbiased as possible, and not favoring or disfavoring certain groups of countries due to their development characteristics.
- **Comparability** Data for the same variable **must** be available from a single, reliable source or from separate organizations of similar caliber.

The indicators selected for each vector are presented below.

Indicator Selection for the Development Web

Vector	Indicators Selected
Economic Performance	<ul style="list-style-type: none"> - Average Annual GDP Growth 1990-94 - Average Annual GNP Growth Per Capita 1985-94 - Per Capita GNP Measured by Purchasing Power Parity 1994 - Average Annual Growth of Gross Domestic Investment 1990-94 - Average Annual Growth of Exports 1990-94 - M2 (Money+ Quasi Money)/GDP 1994 - Gross International Reserves (Months of Import Coverage) 1994
Competitiveness Foundations	<ul style="list-style-type: none"> - Gross Domestic Savings as % of GDP 1994 - Openness of Economy (Export as % of GDP) 1994 - Foreign Direct Investment as % of GDP 1993 - Government Budget Surplus/Deficit as % of GDP (latest three year average) - S&P's Long-Term Sovereign Bond Rating 1997 - Average Annual Rate of Inflation 1984-94 - R&D Scientists & Engineers Per Million Population (latest available) - R&D Technicians Per Million Population (latest available) - Foreign Exchange Freedom (Fraser Institute Ratings 1995) - Infrastructure Indicators (latest available) <ul style="list-style-type: none"> - <i>Production of Electricity (kwh/person)</i> - <i>Electricity Power System Loss (% of total output)</i> - <i>Telephone Main Lines (per 1000 persons)</i> - <i>Road density (km/million persons)</i>
Health	<ul style="list-style-type: none"> - Life Expectancy at Birth 1994 - Contraceptive Prevalence (latest available) - Total Fertility Rate 1994 - % of Births Attended by Trained Health Professionals latest available) - Maternal Mortality Ratio 1993 - Infant Mortality Rate 1994 - Under 5 Mortality Rate 1994 - % of One-Year-Olds Immunized Against Measles (latest available) - % of One-Year-Olds Immunized Against Tuberculosis (latest available) - Annual Natural Rate of Population Increase (latest available) - HIV Prevalence Among Adults % 1995
Vector	Indicators Selected
Education	<ul style="list-style-type: none"> - Adult Illiteracy Rates 1995 - Primary Level Enrollment (latest available) - Secondary Level Enrollment (latest available) - Tertiary Level Enrollment (latest available) - % of Primary School Children Reaching Grade 5, (latest available) - Primary Repeaters as % of Primary Enrollment (latest available) - Secondary Repeaters as % of Secondary Enrollment (latest available)

Environment	<ul style="list-style-type: none"> - Access to Safe Water 1993 - Per Capita CO2 Emissions 1992 - Other Greenhouse Gas Emissions Per Capita 1991 - Number of Environmental NGOs Registered 1996 - Participation in Major Global Environmental Conventions 1993 - Urban Center Solid Wastes Per Capita 1993 - % Change in Forest and Woodland 1983-93
Democracy and Freedom	<ul style="list-style-type: none"> - Civil Liberties (Freedom House 1996) - Political Rights (Freedom House 1996) - Equal Protection Under the Law and Access to Non-Discriminatory Judiciary (Fraser Institute 1995)

The Variable Scoring and Weighting Systems

Data for 108 selected countries were collected for each of the 48 variables in the six vectors. Following compilation of the data, a scoring system was designed. Under this system, indicators for each variable were assigned scores ranging from 0-4. For each variable, the base scores are determined by ranges set according to acceptable standards of well-being or measurements of progress. This scoring process was repeated for all 48 variables.

Following the scoring process, a weighting system was applied to the indicators in each vector. The weighting system is designed so that the sum of the maximum weighted base scores for each vector equals 100. The weights for each variable were determined by several factors:

- The relative importance of the variable in determining the overall achievement in that vector
- The quality of the data obtained for that variable and
- The available country coverage

In summary, this development web model provides weighted scores of development performance in each of the six categories noted above. How does Sri Lanka fare? In order to benchmark the country, we must first examine the average scores of several regions.

Regional Web Scores

The development web scores are strongly consistent with consensus opinions regarding development performance at least at the regional level. For purposes of comparison, countries are assigned to "regions". They include Africa (AFR), the Asian NICs (Newly Industrializing Countries), Asian countries excluding the NICs and Japan Industrialized countries (ICs), Latin American and the Caribbean countries (LAC), countries in the Middle East (ME) and middle-income European countries (MIE). In this report, in order to "benchmark" Sri Lanka, we will only use the following regions for comparison: Industrialized countries, developing countries, and Asian countries excluding the NICs.

Overall, in the Economic Performance and Competitiveness Foundations vectors, the Asian Newly Industrializing Countries (NICs) received the highest scores as a group. For most other vectors, industrialized countries are the top performers. African countries tend to rank in the bottom in most development categories, while countries in non-NIC Asia, Latin America, middle-income Europe and the Middle East mostly fall somewhere in between.

Exceptions to these general findings can be found in two vectors: Environment, and Democracy and Freedom. Middle-income European countries on average received the highest scores in Environment, a slightly better performance than the industrial countries. In the Democracy and Freedom vector, Middle Eastern countries attained the lowest scores.

Combining vector scores into the development web, one can see that the global mean scores for all six vectors are close to 50. Most vectors have high scores of 100 or the high 90's. The only exception is in Environment, where the highest score attained is only 73.

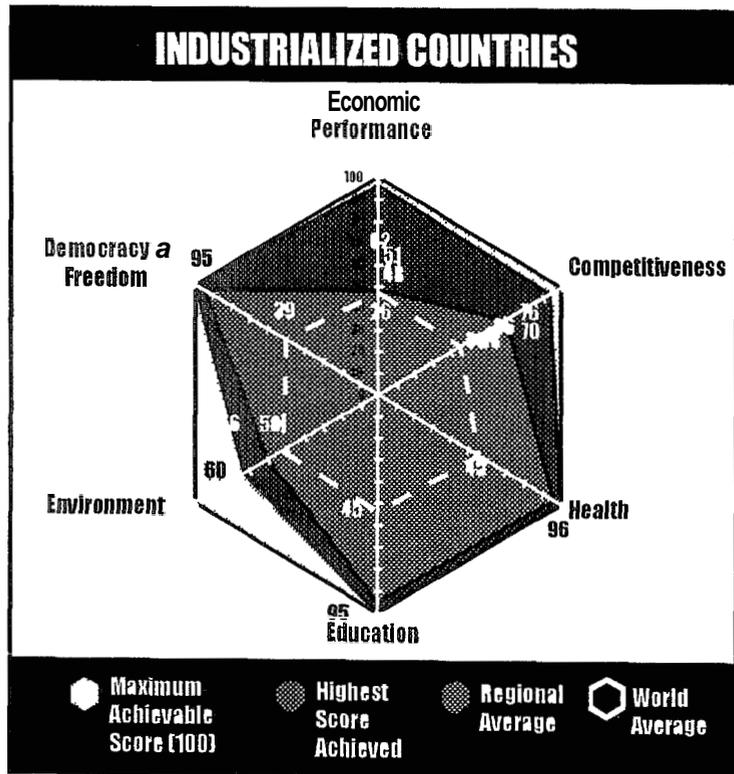
Industrialized Countries

1

Africa includes Benin, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Congo, Cote d'Ivoire, Djibouti, Ethiopia, Ghana, Kenya, Madagascar, Malawi, Mali, Mauritania, Mauritius, Morocco, Mozambique, Rwanda, Senegal, Sierra Leone, South Africa, Sudan, Swaziland, Tanzania, Togo, Tunisia, Uganda, Zambia, and Zimbabwe. **Asia excluding the NICs and Japan** includes Bangladesh, Bhutan, Cambodia, China, Fiji, Hong Kong, India, Indonesia, Korea, Malaysia, Pakistan, Papua New Guinea, Philippines, Singapore, Sri Lanka, and Thailand, the **Asian NICs** include Hong Kong, Korea, and Singapore. Taiwan was omitted due to the lack of comparable economic data from international organizations. **Industrialized (or industrial) countries except the NICs** include Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Iceland, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, and the United States. **Latin America and the Caribbean** includes Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, and Venezuela. **Middle East** includes Bahrain, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Saudi Arabia, Syrian Arab Republic, and the United Arab Emirates. **Middle Income Europe** includes Cyprus, Greece, Hungary, Poland, Romania, and Turkey.

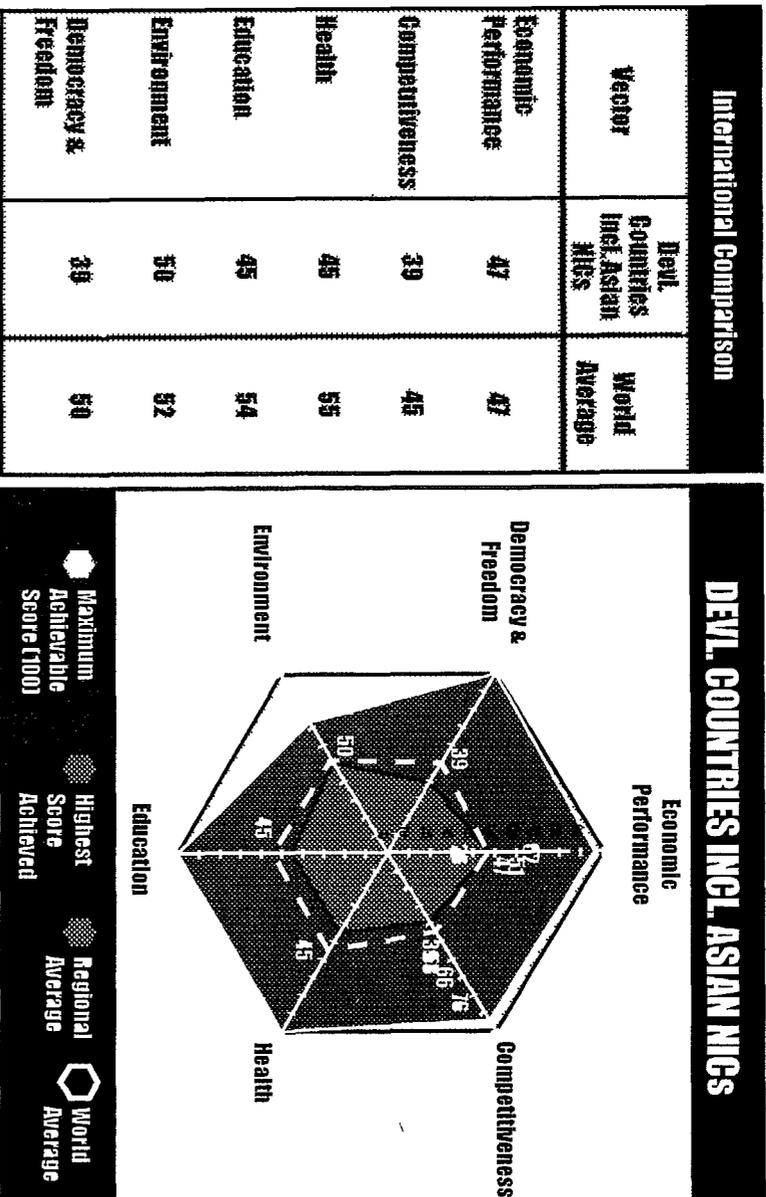
Among industrial countries the score for Economic Performance is just above the world average. Their scores in every other vector are significantly higher than the world average. The highest scores are in the Education, Health, and Democracy and Freedom vectors.

International Comparison		
Vector	Indust. Countries	World Average
Economic Performance	48	47
Competitiveness	70	45
Health	96	55
Education	95	54
Environment	60	52
Democracy & Freedom	95	50



Developing Countries (including the Asian NICs)

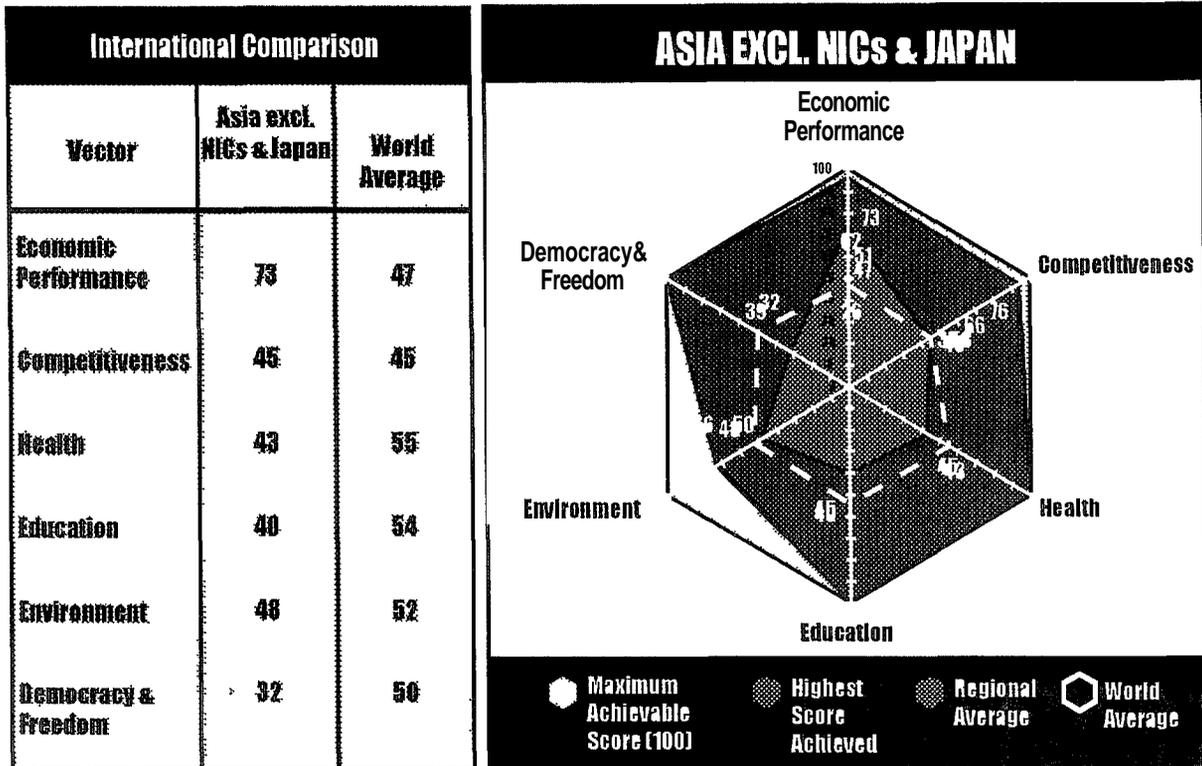
For developing countries², the average scores in most vectors are under the world average. The only exception is the Economic Performance score which is the same as the world average. The highest average scores are in the Environment vector.



² This group includes countries in all regions with the exception of industrialized countries

Non-NIC Asian Countries

The Economic Performance score for non-NIC Asian countries is well above the world average. Other vector scores are either at or slightly below the world average. The lowest score is in the Democracy and Freedom vector. The average Democracy and Freedom score has been lowered by scores of zero for several countries in this group. Scores in other non-NIC Asian countries range from the 30s to the 60s.



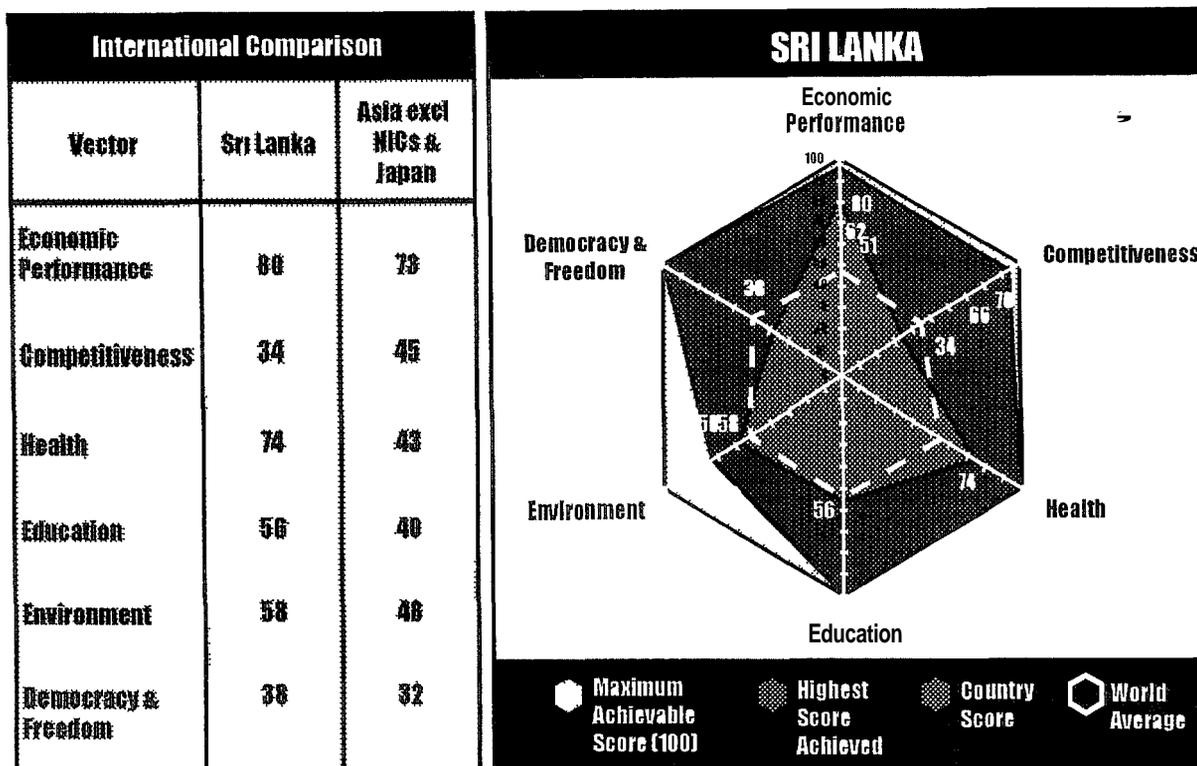
The results of the web model indicate that while balanced development is attainable, it is not easily achievable. Out of 108 countries included in the model, only two ranked in the top 20 for at least five vectors: Austria and Switzerland. Neither country made it into the top 20 list for the Economic Performance vector. Seven other countries ranked in the top 20 in at least four vectors. None of those have high scores in Economic Performance either. Since all nine of the more "balanced" countries are high-income countries and members of the OECD, it may be more difficult for them to achieve the high growth rates possible for countries starting at a lower per capita income base.

The web model also shows that unbalanced developments may come in all forms. For example, the United Arab Emirates, which has one of the highest per capita incomes in the world, ranked third place worldwide in Competitiveness Foundations, placed in the top one-third in Health, ranked above average in Education, but ranked in the bottom third in Economic Performance, Environment, and Democracy and Freedom.

Perhaps more importantly, the web model demonstrates that countries can develop in a somewhat "balanced" fashion even at modest per capita income levels. For example, Costa Rica, with a per capita income of under \$3,000, ranked in the top one-third in four vectors: Economic Performance, Health, Environment, and Democracy and Freedom. Another example is Sri Lanka, which at a per capita income level of only half of the world average (of the countries in the web model) ranked in the top half in four vectors: Economic Performance, Health, Education, and Environment.

Sri Lanka's Development Web Scores

The following chart shows the scores of Sri Lanka in each of the six categories of progress included in the Development WEB.



Economic Development

Sri Lanka received a high score of 80 in Economic Performance, due to strong indicators including per capita GDP growth, gross investment growth, export growth, and a healthy level of foreign exchange reserves until year end 1994. In Competitiveness, Sri Lanka scored much lower at 34, well below the Asian average, due to a large and persistent government deficit averaging 7 percent over three years, a high inflation rate of 11 percent in 1984-1994, and poor infrastructure compared to the rest of Asia.

Social Development and the Environment

The Sri Lankan government's solid commitment to improving its social conditions is demonstrated in the country's very impressive social indicators, which match those of higher-income economies. Life expectancy at birth is now 72 years, and infant and child mortality rates are very low for a country at its income level. Illiteracy is under 10 percent, and primary education is nearly universal. Primary completion rates are high. Sri Lanka has also made significant progress in reducing poverty, although 22 percent of households are still below the poverty line. Sri Lanka scored 74 in Health, the highest score in Asia after the NICs. In Education a score of 56 kept Sri Lanka above the Asia average.

Industrial discharge and improper sewage disposal have caused severe water pollution problems in Sri Lanka. More than two-thirds of the population have no access to safe water. Other environmental problems in the country include deforestation, coastal pollution and degradation, and wildlife destruction. Sri Lanka scored 58 in Environment, higher than the Asian average of 49, mainly because of low levels of greenhouse gas emissions.

Democracy and Freedom

Sri Lankans are able to choose their government through democratic means. However, the country continues to be ravaged by a long civil conflict waged by the Tamil minority. The war has created approximately 700,000 refugees, of which only 19,000 were eligible to vote in the last elections. Both the army and the Tamil guerrilla forces are responsible for massive human rights violations against unarmed civilians. A state of emergency remains in effect in Colombo, allowing the government to detain suspects indefinitely without trial. Citizens enjoy

freedom of assembly and religion. Among the most serious problems affecting the country are violence against women and child prostitution. Sri Lanka scored 38 in Democracy and Freedom, just above an average of 36 in Asia.

3 Assessment of Sri Lanka's Macroeconomic Policies

Fiscal Policies

The Government of Sri Lanka has recently focused more strongly on improving its fiscal management, and as a result its fiscal performance in 1997 was better than during the previous year. In its drive to correct existing weaknesses in fiscal management, government efforts have been directed at

- Sanitizing public accounts,
- Rationalizing off-budget transactions,
- Strengthening financial controls and accountability,
- Improving revenue collections,
- Reducing wasteful expenditures,
- Eliminating corruption, and
- Consolidating social expenditures

Public expenditures in Sri Lanka have consistently exceeded revenues, and the resulting annual deficits have been a major factor in the country's historically high rate of inflation. During the period between 1978 and 1984, annual inflation rates varied from a low of 11 percent to a high of 26 percent.

After coming under relative control in 1985/1987, inflation rates again increased in the period from 1988 to 1993 to an annual range between 11 percent and 22 percent. Modest rates in 1994 and 1995 gave way to a rate of 16 percent in 1996, which was brought down to 9.0 percent in 1997. Projections for 1998 are for 9 percent as well, but the government admits that desirable macroeconomic policy would look to achieve a rate of inflation as low as 5 percent.

Government revenues expressed as a percentage of GDP have remained fairly consistent at around 20 percent.

Government Revenues as a Percentage of GDP

<u>1980</u>	<u>1985</u>	<u>1990</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
198	223	211	197	190	204	190	184

At the equivalent of 18.4 percent of GDP, revenues were 169 billion SL rupees (US\$2.9 billion) in 1997, down slightly as a percentage of GDP from 1996 and two percentage points from 1995. The revenue decline in 1997 as compared to 1996 was attributed to lower customs revenues as a result of continued import duty increases.

The largest single source of tax revenue is the general sales and turnover tax, which contributes over 30 percent of the government's total tax revenues. Nearly 45 percent of this tax is generated from turnover taxes on imported goods apart from import duties. Turnover taxes are also applied to services, and this segment has been growing rapidly.

The next largest tax revenue category is that of excise taxes, principally on liquor and tobacco products. In 1997, excise taxes comprised 19 percent of total taxes, with tobacco accounting for nearly 60 percent of this amount. Import duties collected by Customs made up 16 percent of government tax revenue, and a National Defence Levy on goods and services brought in an additional 12 percent. License fees paid to government contributed about one percent of tax revenue.

Income tax collections rose despite an increase in the basic income exemption and a flattening of tax rate bands. Corporate and personal income taxes now account for over 12 percent of tax collections or over US\$350 million, slightly more than the defence levy but less than the excise taxes. Taxes on property generated another 5 percent of total tax take and a tax on Treasury bills held in the Central Bank produced 1.5 percent of total collections.

Non-tax revenues consisting of income from state-owned property and public enterprises, Central Bank profits, and rent, interest and dividends paid to the central government, added an additional sum equivalent to 1.4 percent of tax revenues and reflect the government's still important role in the economy.

Current government expenditures in 1997 were 18.4 billion SL rupees (US\$3.1 billion), the equivalent of 20.7 percent of GDP, down two percent from 1996. This reduction was credited to a reduction in expenditures for defense from 5.8 to 5.1 percent and declines in subsidies, transfers and interest expenses. In sum, the fiscal deficit was reduced to 7.9 percent of GDP in 1997 from 9.4 percent in 1996. Within the total figure for current government expenditures, payroll expenses for government employees account for 26 percent, up from 24 percent in 1996 as a result of significant pay increases granted early in 1997.

Historically, current expenditure levels by the government of Sri Lanka have exceeded government revenues (as measured by percentage of GDP) by rather modest amounts averaging about 3 percent. For example in 1996 current expenditures were calculated to be 22.8 percent of GDP as against 19.0 percent for revenues and in 1997 at 20.7 percent of GDP as compared to 18.4 percent.

In the past, the major fiscal policy problem was the government's capital spending and net lending. In 1980 public expenditures for the acquisition of real assets, capital transfers, lending and other non-current expenses equaled 23.3 percent of GDP, 4.8 percent greater than current expenditures registered for that year producing a total of government expenditures equal to 41.8 percent of GDP and a overall fiscal deficit (before foreign grants) of 22.2 percent of GDP.

About 40 percent of this deficit was financed from foreign loans and grants, but 60 percent had to be financed domestically, the bulk from the banking system. Major improvements have been achieved in this area. Specifically policies leading to liberalization of the economy and the sharp reduction in the role of the state in the economy have brought about the nearly complete elimination of the government's capital and net lending expenditures.

Fiscal Deficits
(figures as percent of GDP)

	1980	1985	1990	1993	1994	1995	1996	1997
Cap Spending/Net Lending	(23.3)	(13.9)	(8.7)	(7.6)	(7.0)	(6.9)	(5.0)	(3.1)
Current Exp Balance	<u>-1.1</u>	<u>2.2</u>	<u>(1.2)</u>	<u>(0.8)</u>	<u>(2.9)</u>	<u>(2.7)</u>	<u>(3.8)</u>	<u>(2.2)</u>
Overall Deficit	(22.2)	(11.7)	(9.9)	(8.7)	(10.5)	(10.1)	(9.4)	(7.9)
Deficit After Privatization Proceeds	(22.2)	(11.7)	(9.9)	(8.4)	(10.0)	(9.6)	(8.8)	(5.3)

Combining current and government expenditures with the capital expenditures and net lending in 1997 indicates public expenditures as a share of GDP of 23.8 percent, a figure far lower than is the case in most developed economies. It should also be kept in mind that government expenditures equivalent to 5.1 percent of GDP go towards prosecuting an active war that in turn impedes social and economic development, especially in the eastern and northern provinces.

With good economic growth rates, lower and stabilized interest rates and a general confidence in the economy it is now possible for the government to finance a deficit in the range of 5 percent of GDP in a non-inflationary manner. Total public debt exceeds 758 billion SL Rupees (US\$12.6 billion), an increase of 7 percent in 1997, but a decline to 85 percent of GDP from 92 percent in 1996. The debt is split in almost equal portions between domestic and foreign debt. Of the foreign debt, 96 percent is concessional debt extended by foreign governments and multilateral financial institutions.

The government's debt management policies have included resort to foreign commercial debt markets, through issuance of \$50 million (3 billion SL rupees) of floating rate notes in early 1997 for infrastructure projects, and the shifting of domestic debt from relatively high interest-bearing, short-term instruments to those with medium term maturities and lower rates of interest. This latter policy was highlighted by the successful issue of a medium-term marketable Treasury bond valued at 10 billion SL rupees (US\$169 million) sold to banks and other investors. Even larger sales are scheduled for 1998. At present the portion of the government's domestic debt held in short term instruments is about 39 percent down slightly from 1996.

Major holders of government debt in the form of Rupee-denominated loans are the Employees' Provident Fund and the National Savings Bank. Already holding 87 percent of the government's loans these two institutions continue to invest funds in government paper. The government's assumption that inflation rates will continue to decline has led it to offer long term debt instruments, principally to these two institutions, at interest rates of 12 to 14.5 percent depending on the maturity of the bonds, which vary from two to seven years. Sri Lanka continues to receive concessional financing and some foreign aid grants and appears to be in no danger of failing to cover its foreign debt obligations.

Monetary Policies

Assessing the current status of Sri Lanka's monetary policies is complicated by the rapidly changing situation in Southeast Asia, which can cause severe consequences for its financial system almost overnight. However, inasmuch as the economy of Sri Lanka has remained resilient over the last year in the midst of the region's economic troubles points to the sound monetary practices of the Sri Lankan government.

-- Sri Lanka's strong economic performance is attributed to a relaxed monetary policy adopted by the Sri Lanka government in 1997. Monetary expansion continues at a moderate rate. Interest rates remain low, creating a favorable investment environment.

- Compared with other countries in the region, Sri Lanka's monetary policies are stable and sound
- The Central Bank adopts a managed float exchange rate regime, which is less vulnerable to speculative attacks than the fixed or pegged exchange system
- A fully liberalized current account transactions allows up to 100 per cent ownership in foreign direct investments, and up to 49 per cent ownership in financial institutions without any restrictions on repatriation of capital, capital gains and dividends
- The banking system is relatively transparent and credible with strict supervision of the entry, operations, and exit of commercial banks. The Central Bank operates with a prime goal of maintaining price stability and low inflation, which are favorable to capital markets and investment
- However, problems remain. The most immediate is the heavy reliance of the state banks on the government to financial their losses. The second most urgent concern is the high ratio of non-performing bank loans, which can have serious ramifications in the wake of the financial crisis in the region. Actions are necessary to increase the level of independence of the state banks from the government. Stricter loan provisioning may be needed to hedge against any potential damage caused by the financial crisis in Southeast Asia

The Regional Setting The recent financial crisis in Southeast Asia has underscored the importance of a credible central banking system and sound monetary policies. The spillover effects from financial crises taking place in Indonesia, Thailand, and Malaysia have triggered a greater need for countries to reassess their own financial and monetary fundamentals. Fortunately, Sri Lanka is not materially affected by the region's economic turmoil.

The firm financial position of the country poses several important questions. Is Sri Lanka's economic and financial stability attributed to a strong banking system and sound macro monetary policies or is it merely good luck? Can the nation continue to prevail over serious economic challenges or is the relatively encouraging macroeconomic picture for Sri Lanka likely to change as the spillover effects finally take their toll?

The next section provides an overview of Sri Lanka's current monetary policies and banking system. It is followed by a brief discussion of recent developments in the government's interest rate and money expansion policies. Then Sri Lanka's financial performance will be weighed against those of other countries including Pakistan, Bangladesh, India, Malaysia, Vietnam, and Thailand, which are considered Sri Lanka's potential competitors in terms of attracting foreign investments. The section will conclude with some policy implications.

Overview of Sri Lanka's Current Monetary Policies Sri Lanka's macroeconomic performance indicators have been impressive despite some serious setbacks in 1996. While it is still early to make conclusive predictions about the country's future prospects, the current course of the economy is sound. It is reported that Sri Lanka's real GDP growth rate in 1997 is 5.8 per cent, up from 3.8 per cent in 1996. Inflation is down from 15.9 per cent in 1996 to 9.6 per cent in 1997³.

The Sri Lanka government manages the exchange rate through buying and selling of currency by the Central Bank within a range of two percent. The value of the Sri Lanka rupee declined about 4 percent during 1997 in relation to the U.S. dollar but on average appreciated in value as compared to its trading partners due to the

³ EIU Country Report 2nd quarter 1998

collapse in dollar values of several of the Asian currencies. Gross official foreign assets exceed US\$ 2 billion, enough to cover nearly four months of imports. Adding in commercial bank foreign assets, total reserves are sufficient to cover 5.4 months of exports, up from 5.0 months in 1996. Although the rupee has depreciated against the U.S. dollar, it has gained significantly on the Deutsche mark and marginally on the pound sterling.⁴ This suggests that the rupee will not depreciate swiftly as many other currencies have in recent months.

On the monetary policy front, Sri Lanka has pursued a moderate monetary expansion approach with moderate interest rates to encourage domestic investments. The rate of growth of the broad money supply (M2) was estimated to close at 13.8 per cent by the end of 1997, close to the Central Bank's expected rate of 14-16 per cent. There was a slight reduction in net government credit, which led to a moderate easing of M2 growth in the last quarter of 1997.

⁴ Central Bank of Sri Lanka *State of the Economy - 1997*

215

The real interest rate fell from 4.8 per cent in 1996 to only 0.5 per cent in 1997⁵. Furthermore, the government is targeting a robust **growth of 17** per cent in private sector borrowing, suggesting that the real interest rate has to decline even further. All these recent developments in the monetary area show a strong comment on the part of the Sri Lanka government to create a favorable investment climate.

⁵ World Bank, *World Development Indicators, 1998*

Growth in Banking Credit to the Private and Public Sectors in Sri Lanka

	<u>1996</u>	<u>1997</u>	<u>1998</u>
Growth in Net Credit to the Private Sector (Yo)	7.5	11.4	17
Growth in Net Credit to the Public Sector (%)	4.3	6.9	N/A

Source: EIU Country Report 2nd Quarter 1998

Sri Lanka's key macro financial indicators compare well with those of other countries in the region. While the currencies of Malaysia, Indonesia, and Thailand depreciated by more than 30 percent against the US dollar within a year, the Sri Lankan rupee has depreciated only 2 per cent.

With regard to interest rates, Sri Lanka's real interest rate has plunged by more than 4 percent from the nation's already low interest rate (by regional standards), particularly in comparison with the high prevailing rates in Malaysia, Indonesia and Bangladesh. Simply put, Sri Lanka's reduction in inflation, improved fiscal discipline and the ability to maintain relatively stable domestic financial markets, particularly in the context of a highly uncertain international environment, have combined to generate lower interest rates which in turn creates a more favorable investment climate.

Key Macro Financial Indicators

Country	Nominal Exchange Rate Depreciation (% change)		Money and Quasi Money Growth		Gross Domestic Credit Growth		Real Interest Rate	
	1996	1997	1996	1997	1996	1997	1996	1997
Sri Lanka	4.9	6.9	10.5	14.4	10.7	6.0	4.8	0.5
Thailand	1.7	56.7	12.6	18.1	-18.5	32.9	N/A	N/A
Bangladesh	4.2	7.1	10.8	10.7	12.3	13.8	8.0	11.8
India	2.1	7.3	18.7	N/A	19.7	N/A	8.4	6.1
Indonesia	3.2	53.1	27.2	18.9	22.7	2.8	9.7	11.6
Malaysia	-0.5	38.3	N/A	N/A	N/A	N/A	0.8	N/A

Source: World Development Indicators 1998

Assessment of Sri Lanka's Monetary Policies Unlike some of its regional neighbors Sri Lanka has avoided speculative attacks on its currency ignited by heavy short-term borrowings high risk exposure of banks to real estate lending and a highly overvalued currency⁶ The Central Bank of Sri Lanka has employed a managed float exchange system whereby occasional government interventions are warranted to reduce excessive volatility of rates with a band of 2 per cent between its buying and selling rates

With the currency crisis looming over in Southeast Asia there is increasing criticism of the fixed or pegged exchange rate regime which deprives central banks of one of the most fundamental instruments in stabilizing financial markets The "rigidity" problem of fixed exchange rate regimes is exacerbated when the country does not hold large foreign currency reserves to defend its currency Sri Lanka's choice of a managed float exchange rate regime is appropriate given the country's **small** size and the limited amount of U S dollar reserves it holds

Another positive aspect of Sri Lanka's financial policies is its fully liberalized current account transactions. Despite an initial cautious move towards capital account liberalization, it is considered freer than those in many other developing countries. Foreign fund managers are allowed to invest in the stock market with the right to repatriate capital, capital gains and dividends, although transactions have to go through special accounts named "Share Investment External Rupee Accounts" (SERA). Foreign direct investment is permitted up to 49 per cent ownership in financial institutions without any limit on the repatriation of capital, profits, and dividends.

Compared with its neighbor developing countries such as Bangladesh and Pakistan, Sri Lanka's banking system is more credible. The Banking Act No 3 of 1988 clearly set forth a regulatory framework governing the entry, operation, and exit of commercial banks. Such a framework establishes the authority of bank supervisors to analyze the financial condition of banks, evaluate management, curb unsound practices, and force the exit of insolvent commercial banks.

Second, the high ratio of non-performing loans can cause serious problems in the wake of the financial crisis in Southeast Asia. Currently, banks carry 20 percent provisioning on non-performing loans after six months and 100 percent for loans outstanding after 18 months.⁸ The Central Bank should tighten this norm to full provisioning within a year of default. Such efforts have met strong resistance on the part of the commercial banks which argue that the high cost of providing security and the ineffective debt recovery laws have contributed to this high ratio of non-performing loans.

Notwithstanding these problems, Sri Lanka's overall monetary policies are sound and are supportive of the nation's long-term growth prospects. By adopting a managed floating exchange rate regime, by being willing to maintain price stability by allowing liberalized current account transactions, and by agreeing to have commercial banks subject to unprecedented scrutiny, the Central Bank of Sri Lanka has gained a high degree of credibility with investors and consumers. Although the economy has shown a tremendous amount of resilience over the past 12 months, however, further actions of the Central Bank are required to increase the transparency and effectiveness of the banking system of Sri Lanka.

ASSESSMENT OF SRI LANKA'S COMMERCIAL POLICY ENVIRONMENT

The Importance of Commercial Policies in Determining Competitiveness

Over the past ten or fifteen years, government intervention and statist policies have become increasingly rejected throughout the world. These policies are now being replaced by market-oriented economic policies based on competition. This rejection has been spurred by the recognition that past economic approaches which relied heavily on state intervention, government-owned enterprises, import protection, subsidies, and price controls were fundamentally incompatible with dynamic economic growth. There now exists a strong consensus in developing and developed countries alike that sound commercial policies based on market forces lead to increased capital formation, greater efficiency, and more rapid economic growth.

Amidst these monumental developments, Sri Lanka has embarked on a restructuring of its economy to attain long-term sustainable growth through macro-economic reforms and measures to improve private sector performance. As in most parts of the world, Sri Lankan policy-makers have recognized the need for a sound commercial and economic policy environment which maximizes competitiveness, efficiency, and the creation of productive employment. To place this development in context, it is useful to stand back from the process to evaluate the strengths and remaining weaknesses in Sri Lanka's commercial policies.

This section describes the relevance and competitiveness impacts of commercial policies, and summarizes the methodology of the Commercial Policy Model. This is followed by a scoring of Sri Lanka's commercial policies, and a benchmarking of Sri Lanka's policies against those of other nations.

One major dimension of national economic competitiveness is the extent to which commercial policies are market friendly.⁹ A country's commercial policy environment sets the "rules of the game" -- the regulatory and policy climate in which businesses operate. "Market friendly" policies reduce distortions in the economy, allow businesses and firms to respond to market signals, and encourage investment and development. Sound commercial policies help to reduce risks to investors, increase business confidence, and allow countries to develop their true comparative advantages.

Commercial policies affect the business operating environment at the firm level in many ways and ultimately determine how efficiently a company will use inputs in the production of goods and services. For this reason, it is useful to examine how commercial policies affect the business operating environment from the perspective of an individual enterprise. Policies affect all economic processes, beginning with the initial stage of registration and approval, moving through to actual production using factor inputs, and ending with the sale

⁸ EIU Country Report 2nd Quarter 1998

distribution of goods and services foreign and domestic markets. The key question which arises is, how do commercial policies affect each stage of this cycle? The next section explores the impacts of various policies

1 Business Start-up

The registration and approval process is a critical hurdle for businesses and entrepreneurs since it is the initial step before a business can invest in new or expanded operations. Complicated registration requirements and a lengthy approval process delay start-up operations and discourage potential investors, especially those with neither the money nor personnel to proceed through a circuitous screening process. Smaller firms are particularly likely to be dissuaded by the investment in time and money required to proceed through demanding and uncertain registration and screening processes. A simpler, more automatic process that minimizes "red tape," discretion and waiting time allows investors to realize potential investment opportunities.

Registration and approval begins with business policies governing procedures for company formation and extends to other areas such as taxation requirements, permits to purchase land and construct buildings, and licenses to use natural resources or hire labor. How quickly investors receive the necessary approvals for start-up can depend largely on a country's policy environment. The arduous process of company registration and investment approval in the Ivory Coast is highlighted in the box below. Until recently in Kenya, final approval for investment projects took up to a year for clearance because investors were required to visit each of the government ministries overseeing the approval process and submit separate applications to each ministry. By contrast, Singapore and Hong Kong have centralized all decision making for investment screening and permit approval. In those countries investors can receive approval for projects in as little as 24 hours.

2 Pricing Policy Inputs

All businesses of every size, whether they produce for local or export markets, require a steady flow of inputs to keep the company running. One of the key policy instruments affecting the cost and availability of inputs is pricing policy. Guaranteeing an adequate flow of raw materials to industry requires pricing policies that provide adequate incentives for suppliers. Artificially low prices that do not reflect the true value of inputs can lead to a lack of sufficient production, whereas overpriced inputs represent an excess cost to be borne by industry.

3 Import Policies

An important tool for eliminating the disadvantages that industrial producers in developing countries may face in competing in the world market is guaranteed access -- at reasonable cost -- to the imported raw materials and intermediate inputs used in industrial activities that generate value added. Access in this case means that such imports are free of import and foreign exchange restrictions as well as free from excessive tariffs and indirect taxes.

Free trade status can be achieved economy-wide. As can be seen in the examples of Singapore, Hong Kong and Mauritius, in these countries all producers are subject to zero taxes or duties on imported inputs and exports. Achieving free trade status by eliminating restrictions and duties on all imports is a desirable and rational objective for many developing countries. Such an objective, while certainly a worthwhile long-term goal, can only be achieved on a gradual basis, however. This is due to a number of political and economic factors. If adopted immediately, economy-wide free trade could encourage imports to replace significant amounts of local production. Special interest opposition often prevents full and immediate removals of protection for locally-manufactured goods. In addition, immediate trade liberalization which is not fully compensated for by exchange rate adjustments can increase trade deficits.

Rather than opening their borders immediately to free trade, many developing countries establish free trade regimes for exporting while maintaining protected regimes for production in the local market during the transition period. Free trade status is often given first to exporters as a first step toward the first-best solution of economy-wide free trade.

4 Financial Market Policies Interest Rates

As indicated pricing policies are essential for guaranteeing the efficient allocation of inputs used by enterprises in the production process. Similarly, interest rates which represent the price of financial resources in the capital market, will determine the efficient allocation of capital resources. Sound interest rate policies will (1) provide incentives for mobilizing international and domestic capital (2) allocate credit to enterprises which can earn the highest economic return, and (3) signal a stable and predictable financial system which encourages investment, savings and development.

The experiences of many developing countries suggest that positive real interest rates most often result from policies that allow interest rates to respond to changes in the business cycle to adjust to fluctuations on the foreign exchange market, and to reflect the relative risk of investment opportunities. Government policies that restrict interest rate movements, impose heavy reserve requirements, or limit the market allocation of credit all combine to "repress" the financial system and reduce an investor's incentive to hold assets in domestic financial institutions. Coupled with high inflation, these practices can lead to negative real interest rates which distort both investment and production decisions.

Under ideal conditions, positive real interest rates provide an incentive to hold assets in domestic financial instruments, thus creating a pool of savings which can in turn be lent to firms wishing to invest in new plant and machinery. This linkage between real interest rates, savings, and investment also affects economic growth rates. A study of thirty-three developing countries by the World Bank found that countries with positive real interest rates experienced higher annual GDP growth rates than those with moderately or strongly negative real interest rates.¹⁰

Policies that lead to negative real interest rates effectively break the linkages among savings, investment and growth. Investors find it more profitable to hold their resources in real assets such as land or to place them in financial institutions abroad. Over the long term, savings rates will drop, and so will the available pool of funds for domestic investment.

Interest rate manipulations also affect economic efficiency. Controlled interest rates create a bungled incentive structure that fails to match resources with the most productive investment opportunities. When the cost of money is not used to allocate credit to its most efficient uses, other less efficient techniques are used to guide resource use. One commonly used non-market technique to allocate capital in such cases is directed credit allocation programs. These programs tend to bias credit use towards larger, more prestigious, capital-intensive projects or other kinds of projects that often do have the highest economic payoffs to the country.

It should be noted, however, that while negative real interest rates can be a substantial deterrent to savings and financial intermediation, excessively high interest rates can often be just as problematic. Excessively high real interest rates that exceed the marginal return to capital raise the cost of borrowing and reduce the level of private investment. Some countries have tried to soften the impact of high interest rates following financial sector liberalization by phasing in reforms and maintaining moderate interest rate controls.

5 Exchange Rate Policy

A nation's exchange rate is also an essential price that will determine the cost of imports, the competitiveness of exports, and ultimately the cost and availability of capital. Methods of determining exchange rates vary by country and are distinguished by their degree of flexibility. The most prevalent regimes are

- ◆ Independently floating currencies, which respond directly to market forces and are characteristic of countries with developed financial markets which are fully integrated into world financial markets.

⁹
¹⁰ Real interest rates are defined as the difference between the nominal rate of interest and inflation. World Bank, World Development Report 1989, p. 30. The Bank's study found that countries with positive real interest rates attained an annual GDP growth rate of 7.3% from 1965 to 1973 and 5.6% from 1974 to 1985. Countries with strongly negative real rates of interest grew at annual rates of 4.6% and 1.9% in the respective periods.

- ◆ Managed float systems under which the central bank sets the official exchange rate and manages foreign exchange transactions on a daily basis
- ◆ Pegged currencies systems, whereby the currency's value is tied to the value of another currency like the U S dollar, to a basket of foreign currencies representing the country's major trading partners, or to a composite index like the IMF's Special Drawing Right (SDR) Pegged currencies may be revalued after several months of being fixed at one rate (adjusted peg) or according to a preannounced schedule (crawling peg)

The choice of a particular regime over another is not so important as the necessity of maintaining an appropriately valued and stable real exchange rate. Studies by the World Bank have found that on average, countries with misaligned real exchange rates exhibit poorer growth performance than countries with appropriately valued ones.¹¹ Undervalued currencies make imported capital excessively expensive and can restrict an enterprise's ability to import essential capital inputs. Conversely, an overvalued exchange rate can lead to capital flight by making foreign financial assets relatively more attractive than domestic ones, thus encouraging investors to place their assets abroad rather than investing them in the domestic economy.

6 Foreign Investment Policy

Investment is widely recognized as a primary catalyst of long-term, broad-based sustainable economic growth, and guaranteeing a steady flow of investment funds depends critically on a supportive policy and regulatory environment. Worldwide experience in investment promotion has found that the most important features in attracting prospective investors, both foreign and domestic, are policy stability and clear "rules of the game"

7 Labor

As a primary factor of production, labor is particularly susceptible to government policies that in turn directly impact a firm's profitability and competitiveness. Government regulations that determine minimum wages, labor mobility, the hiring and firing of employees and the use of expatriate personnel, all of which are intended to protect workers can in fact have counterproductive effects on industrial development and long-term job creation.

No one should argue against the societal goal to provide adequate wages for workers particularly at the lower income levels. However, successful economies provide reasonable wages through market mechanisms rather than through government fiat.

Excessive government-imposed minimum wages can represent a major constraint to new investment. High administered wage rates discourage labor-intensive production in which many developing countries have a comparative advantage and encourage the substitution of capital for labor in industrial production. The higher the mandated wage level relative to the level that would prevail in a free market and the greater the elasticity of demand for labor, the greater the loss of employment in the short term. Over the long term, firms substitute capital-intensive methods of production for high cost labor. New investment and entry are deterred, and those seeking work migrate from rural to urban areas in search of the scarce, high-paying jobs with consequent social problems. The net result of the high wage policy on industrial development is slower growth and fewer jobs created.

East Africa presents an interesting example of high legislated minimum wages. After independence, several East African countries (Zambia, Kenya, Uganda and Tanzania) all made conscious efforts to raise minimum wages in urban areas. During that same period (1959-1964) all of these countries actually experienced declines in nonagricultural employment. As a result they decided to abandon their high-wage minimum wage policies and turned to a market-based wage policy aimed at encouraging higher levels of employment.

8 Taxation

Taxation is a key policy instrument which affects government fiscal balances and business profitability. In every country there is an important balance between raising sufficient government revenues to provide adequate

¹¹ World Bank, Exchange Rate Misalignment in Developing Countries, 1988

public services and to **maintain** infrastructure and providing ample incentives to the private business to invest and obtain satisfactory returns on capital

To the business community, high corporate taxes result in reductions in net cash flow and the profitability of investments. High corporate taxes can act as a drag on economic growth and also can provide strong inducements for tax evasion. The countries with the lowest levels of corporate taxes including Hong Kong, Korea, Taiwan, Chile, and Mauritius enjoyed high levels of private investment and economic growth. Experience in these and other countries suggests there is a strong link between tax levels and economic growth.

In addition to corporate income taxes there are a number of taxes which affect business profitability. These include, among others, import duties, sales taxes, value added taxes, payroll taxes, social security, capital gains taxes. There has been a general movement in many countries throughout the world towards lower, broader-based taxes. This type of tax regime provides adequate incentives for longer-term economic growth, while also being low enough to reduce incentives for evasion.

9 Export Policy

In the export area, there are a number of policy pre-conditions which need to be met in order for countries to compete internationally and rapidly increase production. Experience from successful export-led-growth countries has shown that exporters need a policy environment that contains the following elements:

- ◆ **Maintenance of a competitive exchange rate** An exchange rate system that maintains a competitive exchange rate is the single most effective export promotion instrument.
- ◆ **Access to inputs at internationally competitive prices** Meeting this condition requires liberalized trade regimes, elimination of monopolies and price controls, and the introduction of policies which encourage domestic competition.
- ◆ **Absence of export restrictions** This requires the absence or elimination of all restrictions on exporters including export taxes, export licensing, and quantitative controls.
- ◆ **Access to credit and other financial services at internationally competitive rates** In general the economy does not benefit from special below market rates of credit for exporters, but rather from policies that ensure exporters credit at internationally competitive rates adjusted for risks associated with local economic and political conditions. In many countries with tightly controlled financial markets, formal credit is unavailable at any price for non-traditional exporters. This represents a serious policy impediment to exporting.

Commercial Policy Model Methodology

Given the importance of a business-friendly commercial policy environment for private sector development, it is imperative for policymakers to identify feasible policy alternatives and to assess their effectiveness. To this end, cross-country experiences can be utilized to examine specific policy approaches and the lessons learned from their successes and failures in enhancing economic performance. Cross-country data is also useful for conducting policy benchmarking, which is an effective technique for assessing the comparative position of a country's commercial policy regime against its competitors in attracting international investment and trade.

Although comparative assessments of economic policies have been conducted in the past, in most cases the comparison is limited to a few countries and confined to a specific policy area, such as the foreign investment policy regime. In order to assess the commercial policy practices of a large number of countries across a broad range of policy areas (such as trade, investment, tax, foreign exchange, etc.), it is necessary to identify an analytical framework within which commercial policies can be examined in a systematic and objective manner.

The Commercial Policy Model was developed by SRI International to identify those policy practices which are conducive to private sector development and sustained economic growth. The methodology is designed to allow cross-country comparisons of overall commercial policy regimes through **summary** country policy scores, which describe the degree to which commercial policies are business-friendly as well as competition-based.

Research Methodology

Data Collection and Classification To examine the commercial policy environment 36 policy variables were selected as the basis for international comparison. To the extent possible, quantifiable measurements of policy differences were utilized. The variables were selected based on the following criteria:

- ◆ Their importance in forming the overall commercial policy environment,
- ◆ The availability of up-to-date information,
- ◆ The objectivity and reliability of data sources, and
- ◆ The country coverage available

The SRI team then collected and compiled data from the World Bank, International Monetary Fund (IMF), United Nations Conference on Trade and Development (UNCTAD), Office of the U.S. Trade Representative (USTR), U.S. Department of Labor, Center for International Settlement of Investment Dispute (CISID), foreign embassies, major accounting houses, and other sources.

The policy variables analyzed were classified under nine categories:

- | | | | |
|---|-------------------|---|---------------------|
| 1 | Business start-up | 6 | Domestic investment |
| 2 | Pricing/interest | 7 | Foreign investment |
| 3 | Import | 8 | Labor |
| 4 | Export | 9 | Taxation |
| 5 | Foreign exchange | | |

The policy variables were categorized so that they could be assessed as policy groups in forming the overall commercial policy environment. Such classification can also accommodate cross-country comparison in each individual policy category. See the box below for the variables included under each policy category.

Data Analysis A rating system was established to assign summary policy scores to each nation. These scores describe the degree to which the commercial policy regimes are business-friendly and competition-based.

225

POLICY VARIABLES INCLUDED IN THE DATA SET

Policy Category

Policy Variable

Import	Mean Trade Weighted Tariff Tariff Variance All Non-tariff Barriers
Export	Export Taxes Export Restnctions Export Income Tax Exemptions Duty Free Imports
Tax	Minimum Corporate Income Tax Rates Top Corporate Income Tax Rates Minimum Personal Income Tax Rates Top Personal Income Tax Rates Sales Taxes + Value-Added Tax Rates
Domestic Investment	Income Tax Hohdays Duty Exemptions Other Incentives Accelerated Depreciation Investment Allowance R&D Incentives
Foreign Investment	Direct Investment Restrictions Expatriate Employment Restnctions Differenhal Treatment between Domestic and Foreign Investment Dispute Settlement Mechanisms
Busness Start-up	Busness Licensing Business Registration Approvals
Pricing & Interest	Price Controls Price System Interest Controls Credit Allocation
Foreign Exchange	Exchange Rate System Foreign Exchange Level Foreign Exchange Restnctions Profit Repatnation Restnctions Capital Repatriation Restnchon
Labor	Hiring/Firing Flexibility Minimum Wage Wage Controls

Under this system both quantitative and qualitative information is converted into a set of policy scores. For each policy variable, a numerical value -- variable score (VS) -- is assigned to a specific policy condition. For example, the variable "Mean Tariff" in the Import Policy category is assigned a VS ranging from 0 to 4, depending on the range into which the mean tariff falls.

<u>Range</u>	<u>Variable Score (VS)</u>
$0 \leq \% \leq 15$	4
$15 < \% \leq 25$	3
$25 < \% \leq 30$	2
$30 < \% \leq 40$	1
$40 < \%$	0

For variables that are not strictly quantifiable, other means of measurement are utilized. For example, duty exemptions for machinery, raw materials, and other unreported inputs are an important factor in attracting investment. The variable "Duty Exemptions" is assigned a VS of "1" if duty exemptions exist, and "0" if otherwise. The scoring system is described in detail as an Appendix.

The scores of the policy variables within the same policy category were then summed and harmonized according to a conversion scale to yield Policy Category Scores (PCSs), which fall into a range of 1-4. This is to ensure that the scoring system will not be biased towards the policy categories in which more data and information are available. The PCSs are then given weights which reflect their relative importance in forming the overall commercial policy environment (see the Appendix for the weights assigned to each policy category).

The Total Score (TS) for each country was obtained by summing the weighted scores from all the policy categories. The maximum achievable Total Score for a country is 100. Total Scores can be compared across countries as a summary description of the commercial policy environment. In addition, comparisons and benchmarking can be conducted in each policy category by comparing the Policy Category Scores across all countries or groups of countries. Perhaps more importantly, the correlation between the Total Scores, Policy Category Scores, and economic performance across countries can be observed and analyzed.

It should be noted that a country which has the most competition-based commercial policy environment will not have the perfect score of 100. This is due to the fact that for certain policy variables, higher scores are assigned to countries that have adopted special incentives specifically to encourage investment or trade, such as income tax exemptions for exporters, or income tax holidays for investors. In many countries, such special incentives are often provided to investors and exporters to counteract the restrictive commercial policies in other areas.

COMMERCIAL POLICY ASSESSMENT OF SRI LANKA

This section presents Sri Lanka's scores in each of the nine categories of the Commercial Policy Model. These scores are based on current policy structures. They provide an indication of areas in which attention should be drawn for potential policy reform activities. The table below summarizes Sri Lanka's overall scores.

Policy Category	Sri Lanka's Scores	Maximum Possible Scores
Import Policies	12	16
Export Policies	7	8
Tax Policies	8	16
Investment Incentives	7	8
FDI Restrictions	8	8
Business Start-up Procedures	6	8
Pricing/Interest Policies	6	12
Foreign Exchange Policies	12	16
Labor Policies	4	8
Total Policy Scores	70	100

As one can see, Sri Lanka shows an overall commercial policy score of 70 out of a possible 100. The highest overall score is 90 achieved by Singapore. The lowest is 31 posted by Zaire. Sri Lanka's score places it in the upper one half of all nations scored. Of particular note is the fact that Sri Lanka's overall score has risen from 52 when it was assessed in 1995, indicating that the commercial policy environment is improving.

The following section summarizes Sri Lanka's scores in each of the policy categories. It becomes clear that the areas deserving greatest attention are import, tax, pricing/interest, foreign exchange and labor policies.

Import Policies Score 12 out of a possible 16

Sri Lanka's trade regime has been gradually liberalized over the past decade. Currently, the country has a three-band tariff schedule, at 10, 20, and 35 percent. Most agricultural products, consumer goods, chemicals and other intermediate goods are subject to a 35 percent tariff, which is below the 50 percent bound by the World Trade Organization. The exceptions are liquor and cigarettes, which are subject to high levels of duties that essentially keep out foreign competition.

Non-tariff barriers have also been liberalized significantly in the past few years. Import licensing on a number of agricultural commodities (e.g., potatoes, onions, chilies) was removed in 1996. Only a small number of imports are presently subject to import license controls, mostly for health and national security reasons (e.g., remote controls, toxic and hazardous chemicals, pesticides, firearms, ammunition, etc.).

Export Policies 7 out of a possible 8

Sri Lanka received a **high** export policy score due to the lack of export taxes, liberal export restrictions, as well as the **granting** of relatively generous export incentives. Export control is **minimal**, and export licenses are required for four products mainly for environmental reasons and for the protection of antiques. They include coral shanks and shells, timber and wood products, ivory products, and antiques over 50 years old.

Generally, export income is subject to a reduced tax rate. The government's 1998-99 budget provides for a 10-year tax holiday and other incentives for new investment made in selected industries (e.g., electronic assembly, ceramic and glass products, rubber-based products, light and heavy engineering, gems and diamond cutting and polishing, and jewelry). To qualify for the **tax** holiday the investment must be over SLRs 50 million (approximately \$1 million) and 90 percent of output must be exported. Export-oriented projects also benefit from duty-free imports.

Tax Policies 8 out of a possible 16

Sri Lanka's tax score is only half of the **maximum** score mainly due to **its** relatively high corporate income tax rate. Although the government was widely anticipated to lower the corporate income tax rate to 30 percent in 1998, the 35 percent rate has been retained in the latest budget due to revenue shortfall. Several prominent sectors are entitled to a preferred corporate **tax** rate of 15 percent. The top **marginal** personal income tax rate remained at 35 percent. However, expatriate employees **are usually eligible for favorable tax treatment**—

The government planned to introduce a goods and services tax (GST) of 12.5 percent (exempted for exports) on April 1st 1998, which will replace the turnover tax. The turnover tax has been recently exempted from locally manufactured dairy products and medical services and reduced from 2 percent to one percent on banking and financial institutions.

Investment Incentives 7 out of a possible 8

The package of investment incentives offered by Sri Lanka is quite generous. However, incentives are mostly linked to the sector, the **size** of the project, and whether it is an export-oriented investment. The most recent budget identified agriculture, tourism, textiles and gems and jewelry as "prominent" sectors eligible for generous incentives including tax holidays, investment tax allowance, duty-free imports and exemption from turnover taxes. The government provides a 10-20 year tax holiday for investments ranging from \$10 million to \$100 million. Companies utilizing advanced technology with a minimum investment of **\$1 million** are also eligible for a five year tax holiday.

In addition, machinery and equipment imported for projects approved for the investment incentives are free from customs duties. Special allowance is also granted to eligible investments, and it can be applied to accessible income. Depreciation allowance for plant, equipment, machinery and software has also become more generous in the 1998 budget.

FDI Restrictions 8 out of a possible 8

Foreign investors in Sri Lanka enjoy a relatively liberal investment regime. The Board of Investment (BOI) gives automatic approval for most foreign investments. Foreign equity participation of up to 100 percent is allowed in many sectors and ceilings in restricted sectors have been relaxed in 1998. Non-deposit-taking financial services, including investment and merchant banking, and venture capital companies are now open to foreign investment.

Foreign equity investment in retail and wholesale are **now** also allowed, subject to a minimum investment of \$150,000. Investment in certain restricted sectors (shipping and travel agencies, mining, growing and primary processing of tea, rubber, coconut, rice, cocoa, sugar and spices, professional services, education, transport and telecommunications) are approved on a case-by-case basis where foreign equity exceeds 40 percent.

Expatriates generally do not experience significant problems in obtaining work or residence permits, particularly when they are affiliated with BOI-approved ventures. Foreign investors who make an equity investment

of \$50 000 can qualify for a resident visa Approval for expatriate employment is granted when there is a demonstrated shortage in local labor in that field Most foreign investors do not experience discriminatory treatment in obtaining investment approvals and incentives

Foreign investments are guaranteed protection by the Constitution of Sri Lanka The government has entered into 20 investment protection agreements with foreign governments including the United States and is a founding member of MIGA (Multilateral Investment Guarantee Agency) The Government has ratified the provisions of the Convention on Settlement of Investment Disputes, which provides the mechanism and facilities for international arbitration through the International Center for the Settlement of Investment Disputes of the World Bank

Business Start-up 6 out of a possible 8

Foreign investment approval is automatic However, laws pertaining to taxation, labor and labor standards, exchange controls, customs, environmental norms, building and construction standards are not always transparent allowing room for bureaucratic discretion and sometimes corruption Corruption appears most severe in customs clearance and in government procurement and tendering

Pricing/Interest Policy 6 out of a possible 12

Sri Lanka's pricing and interest policy regimes are only partially liberalized Price controls remain in place for politically sensitive commodities such as bread, electricity, petroleum, rail and bus fares and they are determined administratively In addition wheat flour utilities, and fertilizers are routinely subsidized so their prices are below market prices The wheat subsidy was reduced in 1996 raising market prices for bread In addition, the Government is gradually moving to allow more private sector participation and competition in the utilities sector privatize state enterprises, and end some of the state monopolies

The Government does not control interest rates directly but uses other instruments such as reserve requirements and sales of Government assets to influence market interest rates The two largest banks (*Bank of Ceylon* and *Peoples Bank*) are state-owned and carry a large portfolio of nonperforming assets which results from lending to some public corporations, farmers, university students and other entities under the direction of the Government In both 1993 and 1996 the Government had to intervene to improve the banks' balance sheets by injecting capital (through state bonds) into the two state banks Other private banks generally follow more prudent policies and have not been forced to make loans to public institutions

Foreign Exchange Policy 12 out of a possible 16

Sri Lanka's foreign exchange regime has been considerably liberalized in recent years Its exchange system is characterized as a managed float, with the Central Bank of Sri Lanka announcing the daily spot buying and selling rates (against the U S dollar) for transactions with commercial banks and trading at those rates within margins of 2 percent

Exchange controls on current account transactions are fully liberalized In general, there are no barriers legal or otherwise, to the expeditious remitting of corporate profits, dividends, management fees royalties, licensing fees, funds for debt servicing, and capital gains overseas Portfolio investors are also permitted to invest in the share market with the freedom to repatriate capital capital gains and dividends through special accounts known as 'Share Investment External Rupee Accounts (SIERA)

Labor Policy 4 out of a possible 8

Labor policy is moderately restrictive in Sri Lanka There is a legal minimum wage, but no wage controls Most permanent, full-time workers are covered by laws pertaining to minimum hours of work, minimum wage leave the right of association and safety and health standards The Termination of Employment Act creates a significant legal barrier to fire or lay off workers who have been employed more than six months for any reason

other than serious well-documented disciplinary problems. Collective bargaining is not very common and only 29 percent of the labor force in industry and the service sector is unionized.

BENCHMARKING SRI LANKA'S COMMERCIAL POLICY SCORES

This section compares Sri Lanka's commercial policy scores with those of selected other countries. The countries were chosen as competitors or models against which Sri Lanka can be benchmarked in terms of "policy competitiveness". Each section displays the commercial policy scores, provides selected country examples and describes how these countries' scores compare to those of Sri Lanka.

Overall Country Scores

The other countries selected for benchmarking include Indonesia, Ireland, Malaysia, Singapore and Turkey. These nations were chosen as representative of different types of economies (size, level of development, etc.) and as models of private sector growth. All have good overall commercial policy scores, ranging from 73 to 92 points. Indonesia and Turkey have the lowest scores. Singapore is the only country to score above 90 points. Sri Lanka's overall score of 70 falls below all of those benchmarked.

Commercial Policy Scores, Including Sri Lanka

Country	Imports	Exports	Tax	Investment	Foreign Inv.	Business Start-up	Pricing/ Interest Rates	Foreign Exchange	Labor	Total
Singapore	16	8	12	6	8	8	12	14	8	92
Ireland	16	8	4	8	8	8	12	16	6	86
Malaysia	12	6	12	8	6	6	9	12	8	79
Indonesia	12	6	12	6	6	6	9	12	4	73
Turkey	12	8	4	8	8	6	9	12	6	73
Sri Lanka	12	7	8	7	8	6	6	12	4	70
Average	13.3	7.2	8.7	7.2	7.3	6.7	9.5	13.0	6.0	78.8

This group has high average scores in all of the policy categories. The investment incentives, investment and foreign direct investment categories display the best averages for the group. The policy category with the lowest average score compared to the total possible score is tax policy.

Sri Lanka's import, export, tax, foreign investment and foreign exchange policies rank highly in this grouping. However, its pricing/interest and labor policy scores are not comparable to the other nations' scores. Sri Lanka's score of six for pricing and interest policy is substantially below the group's average of 9.5.

Import Policy

Country	Sri Lanka	Indonesia	Ireland	Malaysia	Singapore	Turkey
Score	12	12	16	12	16	12

These countries have fairly open trade regimes and therefore score well in the import policy category. All of these nations earned twelve points or more out of a possible sixteen points. The group average of 13.3 reflects their governments' efforts to lower tariffs and ease import restrictions.

Ireland and Singapore both enjoy perfect scores of sixteen. Ireland has a comparatively open economy. Irish importers face an average tariff of only seven percent. Thus, plus the absence of significant non-tariff barriers, helps Ireland earn its perfect score.

Several factors give Singapore its high score for import policy. Singapore is firmly committed to an open trade and investment environment. The country's average tariff rate of two percent is exceptionally low. Moreover, Singapore allows almost 99 percent of all imports into the country duty free. It has no import quotas, negligible non-tariff barriers, and does not require import licenses.

Turkey has a low average tariff but not a perfect score. Despite an average tariff rate of four percent, its non-tariff barriers are high. The government has abolished the need to obtain permission before importing most goods. However, importers of some goods, such as cars, household electronic goods, office equipment, TV and video equipment, and heaters, must still obtain an import certificate. Moreover, before a business can sell any imports, it must obtain an import certificate. Obtaining this certificate can sometimes be a significant administrative and financial burden. The presence of this and other non-tariff barriers earn Turkey twelve points.

Export Policy

Country	Sri Lanka	Indonesia	Ireland	Malaysia	Singapore	Turkey
Score	7	6	8	6	8	8

With the exception of Sri Lanka, Indonesia and Malaysia, all of the countries in this group have perfect scores for their export policies. A high group average of 7.2 reflects their focus on enhancing growth through exports. Most of the countries in this group have no export taxes. They also allow duty free imports and export income exemptions for exporting businesses.

Ireland has exemplary export policies. It does not impose export taxes and has minimal export restrictions. It also allows the duty free import of inputs. These policies give Ireland a high score of eight for this category. Historically an agriculturally based economy, the country has become a center for the production of advanced consumer electronics products. Ireland, which exports 80 percent of its GDP, has achieved significant export growth over the last five years. The average annual growth in the value of its exports from 1990 to 1995 was almost thirteen percent. In 1996 the country had annual export growth of over 11 percent.¹²

Malaysia provides a good example of how a country can create an export policy environment which is conducive to growth. In addition to taking advantage of regular incentives, an investor operating in an export sector in Malaysia has other benefits. These include export credit refinancing, abatement incentives, an export allowance training incentives, and a double deduction of export credit insurance. The country has over a dozen free zones. These zones are designed for manufacturing companies which produce or assemble goods mainly for export. Malaysia's export policies have helped it to maintain solid export growth. During the period from 1990 to 1995, the value of Malaysian exports grew at an average annual rate of 20 percent.

Despite all of the benefits available to exporters, Malaysia does not have a perfect score in this category. It still imposes export duties on several commodities. These commodities include petroleum, timber, rubber, palm oil and tin.

Tax Policies

Country	Sri Lanka	Indonesia	Ireland	Malaysia	Singapore	Turkey
Score	8	12	4	12	12	4

While the group has a respectable average of 8.7 individual country scores for tax policy, range from very low scores of four for Ireland and Turkey to scores of twelve for the other nations. High value-added taxes and sales tax rates account for some of the divergence in scores. However, the wide range in the tax policy scores mainly reflects the higher corporate tax rates applicable in some countries.

¹²

Source: World Bank, World Development Indicators, 1997

A few countries in the group, such as Singapore and Malaysia possess a neutral and efficient flat corporate tax rate. Singapore has a flat corporate tax rate of 26 percent. In addition to this rate, its low minimum personal tax rate of 30 percent and a VAT of two percent give Singapore a twelve for tax policy.

Other countries such as Ireland and Turkey have higher corporate tax rates. They use more targeted tax incentives to stimulate investment. Ireland has very high corporate tax rates. Companies in Ireland not eligible for reduced tax rates face a minimum corporate tax of 30 percent. This rate is higher than Singapore's maximum rate of 26 percent. Ireland also has high personal income tax rates ranging from 27 to 48 percent and a VAT of 21 percent. These high tax rates earn Ireland an extremely low score of four in this policy category.

Domestic Investment Incentives

Country	Sri Lanka	Indonesia	Ireland	Malaysia	Singapore	Turkey
Score	7	6	8	8	6	8

All of the countries in this group offer several investment incentives and therefore score well in this category. The group average of 7.2 is high. Three of the countries in this group, Ireland, Malaysia, and Turkey, have perfect scores of eight because they offer several different incentives. The incentives offered vary, but usually include the following:

- ✓ Some type of tax holiday or reduced tax rate,
- ✓ Customs duty exemptions and
- ✓ Other incentives such as accelerated depreciation.

The following table highlights the major incentives offered by these countries:

SELECTED INCENTIVES OFFERED

Country	Tax Holiday	Export Income Tax Exemption	Duty-Free Imports	Accelerated Deprec.	Investment Allowance
Indonesia	✓	✓	✓		✓
Ireland	✓		✓	✓	
Malaysia	✓	✓	✓		✓
Singapore	✓	✓	✓		✓
Turkey	✓	✓	✓		✓

Tax holidays or tax reduction remains an important investment incentive tool for most of the countries in this group. Singapore provides various tax holidays to approved financial institutions, companies operating in pioneer industries, and companies involved in expanding and established enterprise. Similarly, Malaysia offers income tax holidays for promoted activities or products, as well as for project expansion and other specific investments. It also provides exemptions on customs duties as well as investment and research and development allowances. Turkey's investment incentives include exemptions on corporate and value-added taxes and on customs fees and duties, as well as soft loans for investments in research and development.

Ireland, which has a perfect score of eight, does not offer a 100 percent **tax** holiday. The country's investment law gives qualifying companies a reduced **tax** rate of ten percent until the year 2005. This rate applies to companies operating in the following priority industries: electronics, engineering, healthcare, consumer products, financial services and international services. Ireland also exempts companies from paying import duties, permits accelerated depreciation, and provides research and development incentives.

Foreign Direct Investment Restrictions

Country	Sri Lanka	Indonesia ^a	Ireland	Malaysia	Singapore	Turkey
Score	8	6	8	6	8	8

Scores for the foreign direct investment category, which focuses on the treatment of foreign investors, are very good. The group average is 7.3 out of a possible eight. Three out of the five countries earned a perfect score. These high scores reflect a commitment to increasing investment, whether domestic or foreign, in these countries. Foreign investors in all of these nations usually receive equal treatment and are barred from only the standard "strategic" industries. They face little or no limits on the employment of expatriates. These countries take dispute settlement very seriously. All of these nations are members of the International Centre for the Settlement of International Disputes (ICSID) and most are signatories to the New York Convention on International Dispute Settlement.

Singapore provides a good example. Singapore has a reputation for being one of the world's most open investment regimes. It actively encourages foreign investment, especially in leading-edge technologies. The government has instituted several policies which facilitate the formation of strategic partnerships between domestic companies and multinational corporations. In 1995, foreign investment totaling US\$3.4 billion accounted for roughly 71 percent of total manufacturing commitments.¹³ Singapore has a perfect score of eight in the FDI category. Restrictions on foreign direct investment are minimal. When an investment is made, it receives national treatment and, when a dispute arises, the foreign company can go to ICSID for a settlement.

Turkey also provides a good example of a nation with policies designed to attract foreign direct investment. It also has an eight in this category. Since the early 1980s, Turkey has made concerted efforts to liberalize its economy. The Turkish government considers foreign direct investment to be a crucial part of the nation's economic development and has tried to increase the level of foreign investment in the country. Foreign investors receive national treatment, and almost all of the sectors open to the Turkish private sector are fully open to foreign investment. However, foreign investors still can only own up to a 49 percent share in both the aviation and maritime transportation industries.

¹³ Source: U.S. Department of Commerce

235

Turkey has increased the level of foreign investment in its country. In 1980 foreign direct investment as a percentage of gross domestic investment was less than 0.1 percent. By 1995, this number had risen to over 2.0 percent.⁴

Business Start-up Procedures

Country	Sri Lanka	Indonesia	Ireland	Malaysia	Singapore	Turkey
Score	6	6	8	6	8	6

With an average of 6.7, most countries score well in the business start-up category. Two countries -- Ireland and Singapore -- have perfect scores. Both nations have excellent investment agencies to assist investors in starting a business. They have transparent investment laws and simple business licensing procedures. Businesses investing in either Ireland or Singapore face little or no red tape to slow down the process.

In Singapore, the Economic Development Board (EDB) offers a true "one-stop shop" for foreign investors. The EDB provides accurate, timely information to prospective investors and helps them to obtain the necessary business licenses. The agency has received praise worldwide for helping investors navigate the start-up process and for its responsiveness to changing business needs. It is well respected for its efficiency and accuracy as well as the timeliness of its assistance.

It is well known that a "one-stop-shop" does not guarantee efficient business start-up procedures. Two countries, Indonesia and Turkey, have six out of a possible eight scores despite the existence of agencies designed as one-stop-shops for investors. In both countries, the actual process for starting up a business can take longer than predicted. Indonesia's Capital Investment Coordinating Board promotes investment and approves project applications. Although the Board's role is to act as a one-stop service, investors sometimes find that they still need to spend significant time at other government agencies and regional and local authorities before they can complete their investment.

	Sri Lanka			Malaysia	Singapore	Turkey
Score	6	9	12	9	12	9

All of the countries in this group (except Sri Lanka) have good scores for the pricing category. The group averages 9.5. All of these countries have either little or no price or interest controls in place. Ireland and Singapore lead the group with twelve points. In these countries, the market determines all prices, including interest rates.

Turkey, Indonesia, and Malaysia have some limited controls on prices and therefore have nine out of twelve points. Turkey has a very competitive banking system with no controls on interest rates. However, it does maintain a few official price controls on selected commodities. Moreover, the government indirectly controls other prices by setting the wholesale prices of the products of several, large state-owned enterprises. Similarly, Malaysia allows the market to determine most prices, but it does regulate prices for certain goods including fuel, public utilities, motor vehicles, rice, flour, sugar, and tobacco.

Foreign Exchange Policy

¹⁴ Source: World Bank, *World Development Indicators*, 1997

Country	Sri Lanka	Indonesia	Ireland	Malaysia	Singapore	Turkey
Score	12	12	16	12	14	12

Foreign exchange scores range from twelve to Ireland's perfect score of sixteen. The country average is 13.0. None of these countries have a free floating system. However, the good policy scores reflect the minimal exchange and profit and capital repatriation restrictions which these countries exert.

FOREIGN EXCHANGE REGIMES

Country	Foreign Exchange System
Sri Lanka	Managed Floating
Indonesia	Managed Floating
Ireland	EMS
Malaysia	Managed Floating
Singapore	Managed Floating
Turkey	Managed Floating

Labor Policy

Country	Sri Lanka	Indonesia	Ireland	Malaysia	Singapore	Turkey
Score	4	4	6	8	8	6

Country scores for labor policy vary. Malaysia and Singapore both have perfect scores of eight, while Sri Lanka and Indonesia (4 points) have the lowest score in this category. Both Malaysia and Singapore possess perfect scores because neither country has neither minimum wages or wage controls.

Indonesia has a minimum wage but does not control wages. Creating more jobs is one of the Indonesian government's key objectives. Roughly 75 percent of its 83 million workers are between the ages of 15 and 34, and 30 percent of the labor force is underemployed. Indonesia does not control wages nor does it impose any official restrictions on hiring and firing workers. However, in practice, firing workers can be problematic. Often the termination of employees results in harmful labor strikes. Since 1992 the number of these strikes has become significant. Indonesia's low score of four reflects this problem.

APPENDIX 2:
BIBLIOGRAPHY

BIBLIOGRAPHY

- Annual Report 1997, Central Bank of Sri Lanka, Colombo, Sri Lanka, 1997
- “Annual Statistical Report 1997,” Ceylon Tourist Board, Colombo, Sri Lanka, 1997
- Business Today, Sri Lanka, various articles, 1998
- “Commercial Policy Model Sri Lanka,” SRI International, Washington, DC, 1998
- “Direction of Trade Statistics Quarterly,” International Monetary Fund, December 1997
- Economist Intelligence Unit, “Country Profile, Sri Lanka, 1997-98,” London, 1998
- Economist Intelligence Unit, “Country Report, Sri Lanka, First Quarter 1998,” London, 1998
- “Foreign Direct Investment,” Lessons of Experience No 5, International Finance Corporation, Washington, DC, 1997
- “Global Trends and Competitiveness Factors in the Apparel Industry,” SRI International, 1998
- Heritage Foundation Index of Economic Freedom 1996, Heritage Foundation, Washington, DC, 1996
- Heritage Foundation Index of Economic Freedom 1997, Heritage Foundation, Washington, DC, 1997
- Key Indicators of Developing Asian and Pacific Countries 1996, Economics and Development Resource Center, Asian Development Bank, Manila, Philippines, 1996
- Lindsay, Stace and Fairbanks, Michael, Plowing the Sea Nurturing the Hidden Sources of Growth in Developing Countries, Harvard Business School Press, 1997
- Malwatte, Indira, “Investment Opportunities in Modern Jewellery,” Sri Lanka Economic Development Board, June 11, 1996
- “Product Profile on Gold & Silver Jewellery,” Product Management Division, Sri Lanka Export Development Board, Colombo, Sri Lanka, May 1998
- “Sri Lanka Private Sector Assessment,” Private Sector Development and Finance Division, Country Department I, South Asia Region, World Bank, March 1995
- “Sri Lanka Travel Planner 1998,” Ceylon Tourist Board, Colombo, Sri Lanka, 1998

“Sri Lanka’s Rubber Industry Succeeding in the Global Market,” World Bank Discussion Paper No 370, World Bank, Washington, DC, 1997

“Sri Lanka’s Tea Industry Succeeding in the Global Market,” World Bank Discussion Paper No 368, World Bank, Washington, DC, 1997

The Global Competitiveness Report 1998, World Economic Forum and Harvard Institute for International Development, Geneva, Switzerland, 1998

The World Competitiveness Yearbook 1998, Institute for Management Development, Geneva, Switzerland, 1998

“Tounsm Master Plan Sri Lanka Final Report,” United Nations Development Programme (UNDP) and World Tourism Organization (WTO), Madrid, 1993

World Development Indicators 1996, World Bank

World Development Indicators 1997, World Bank

World Development Report 1996, World Bank

World Development Report 1997, World Bank

World Investment Report 1997, UNCTAD, New York, 1997

Yeung, Ophelia M , Mathieson, John A , Global Benchmarks Comprehensive Measures of Development, SRI International, Brookings Institution Press, Washington, DC, 1998

APPENDIX 3:

**SCOPE OF WORK FOR THE SRI LANKA
COUNTRY COMPETITIVENESS STUDY**

Appendix 4

SRI LANKA COMPETITIVENESS STUDY

SCOPE OF WORK

1 Background

In recent years, Sri Lanka has moved from an inward-looking trade and development strategy with extensive government ownership and control of economic activity towards more outward-looking and market oriented policies. Sri Lanka has substantially liberalized government controls on business and implemented macro-economic reform programs for achieving rapid, sustained and broad-based economic growth led by the private sector. However, there is need to provide an objective assessment of the comparative and competitive advantage of areas of opportunity for domestic private sector as well as international investors to expedite the investment and economic growth of the country.

A number of new tools now exist which can help policy-makers and business leaders identify the areas of opportunity within their economy for generating new employment and exports, and achieving a sustainable competitive advantage. Some of these are based on experiences of high-growth East Asian countries. Others are based on the work of noted economists. Still others have been developed by groups such as IMD and the World Economic Forum in Switzerland, Michael Porter at Harvard and the Boston-based Monitor Company. USAID has recently sponsored an initial competitiveness study that has utilized these tools and approaches.

It would be helpful to provide business leaders, government officials and potential international investors with an objective analysis of the competitive strategies and issues relating to Sri Lanka based in part on economic sectors in which the host country is likely to have particular focus and opportunity. It is important to point out that it is companies that directly compete with other companies, and cause economic growth. Countries do not "compete" with other countries in the same sense, although the macro platforms that countries put in place is crucial to the "competitiveness" of both countries and companies. Trade among countries tends to generate significant benefits. Countries at times compete for scarce donor resources and even for specific multinational direct investments, but they do not go out of business when they fall behind. As a result, a focus needs to be placed on helping local leaders identify the actions that create an environment conducive to the growth and success of competitive firms.

2 Objectives

The general objective is to assist in achieving rapid, broad-based and sustainable growth by stimulating private investment, employment, economic growth and trade through the provision of analysis of business strategy development, based on a focus on selected key, illustrative sectors and industries in which the host country is likely to have competitive opportunity, and on the linkages between business strategy and the macro platform

The specific objectives are

a For the Host Government To identify and examine the macro-level influence on the strategies of businesses in economic sectors and industries in which Sri Lanka is likely to have competitive opportunity and which have potential for making large impact on employment, GDP growth, export generation, and private investment mobilization To ascertain those supportive actions (policy, infrastructure, education, regulatory, etc) which can best support the achievement of this competitive potential Of special interest is Sri Lanka's inter-regional trade linkages, e.g. SAPTA and other partners in Asia or elsewhere The effort will focus on identifying current obstacles which could be removed by government and which most affect the competitiveness of firms operating in the country

b For domestic private sector To examine between 3 and 5 indicative sectors/industries which are currently important or which may be particularly promising for local business in terms of achieving sustainable competitive advantage and those sectors which may provide the best opportunities for investment The effort will focus on identifying constraints to or inadequacies in the nature of business strategy, and action that the private sector must take, individually or through their representative associations, to achieve greater competitiveness

c For International Investors To identify particularly attractive advantages in the host country for international investors and highlight sectors or subsectors that provide attractive opportunities

d. For USAID and other donors To develop analysis and an agenda for action that can provide concrete input to the development of USAID's economic growth strategy for Sri Lanka Also, to further develop the prototype for an analytical framework related to competitiveness that can be of use in other countries or in other contexts

3 Tasks and Activities

a The team will first develop a detailed methodology for the Country Competitiveness analysis based on the lessons learned and the analytical work done in recent years and present this to USAID and the Sri Lanka Mission for comment and review

b A preliminary analysis, from data readily available in the U S , will be carried out by the team. Inputs such as Country Rankings, GEM analysis, trade data and others would be used. This “revealed analysis” will provide an initial picture of Sri Lanka’s competitive situation.

c The field team will travel to Sri Lanka and meet with the USAID Mission, Government, private sector leaders and other donors to determine the specific interests of stakeholders in this study, set up dates and plans for subsequent presentation of the findings, and listen to guidance and feedback from the stakeholders who will be consulted about the local objectives, interests and points of view regarding the methodology and the final product. An initial presentation of the study, its purpose and methodology, may be made to stakeholders to foster dialogue and participation. Industry-specific workshops will be held to develop understanding of competitiveness and competitive business strategy, and to obtain information on the strategies adopted by Sri Lankan business.

d The study team members based in the U S will gather data from the World Bank, UN, Department of Commerce, Internet and other sources and then prepare a competitiveness analysis based on a number of potential analytical tools, such as Policy Impact Framework, Comparative Policy Analysis, Investment-Output Analysis, Private Sector Mapping, the Michael Porter methodologies, and methodologies used by SRI, IMD and World Economic Forum Competitiveness Rankings. The result would be a Country Competitiveness Analysis illustrating particular strengths and weaknesses of host country and highlighting those sectors and industries that offer attractive opportunities for investment and for achieving a sustainable competitive advantage. Recommendations for the public and private sectors, for the USAID program, and for other lenders and donors will also be made.

e The Team Leader will travel to Sri Lanka and present this study to private and public sector leaders and to local donors, including USAID. The Team Leader will facilitate sessions with stakeholders in which they would develop an action agenda based on the findings of the studies. This action agenda will include measures that must be taken by the government, by the private sector, by non-governmental organizations and by donors to improve the competitiveness of firms operating in the country.

f The team will prepare the final report, which will include stakeholder feedback and input from those who attended the presentations in the host country.

4 Deliverables

These would include

- (a) two to four presentations which will focus on business strategy, micro-macro linkages that impact competitiveness, and creating an action agenda in host country on the basis of approximately 50 slides, and

- (b) a Final Report of approximately 50 pages of text, 50 exhibits, and annexes. A draft report will be provided for the Mission's review. A Final Report which incorporates final Mission feedback also will be provided.

5 Level of Effort and Qualifications

The level of effort includes the following:

Team/Leader/Private Sector Specialist 15 years relevant experience, familiarity with competitiveness methodologies and with private sector development internationally and in Asia)

Macro Competitiveness Analysis Specialists (2) Familiarity with SRI and other macro-level methodologies for competitiveness analysis, and experience doing similar kinds of competitiveness studies in other countries. The Senior Specialist should be highly experienced in issues of macro competitiveness, he/she will be supported by a specialist with a minimum of 10 years experience in related analysis.

Micro Competitiveness Analysis Specialist Familiarity with Porter methodologies and experience doing similar kinds of competitiveness analysis in other countries.

Private Sector Specialist (locally-based) Knowledge of Sri Lankan business and industry, micro-macro linkages, and private sector development.

Export/Investment Specialist Familiarity with issues relating to private sector-based investment and trade, and the impact of macro and micro competitiveness issues on investment and trade.

Research and Industry Analysts Ability to access needed data, familiarity with computers, ability to communicate via Internet, background in economics or business, ability to do written and quantitative analysis. The local Analyst should have the ability to access to locally available data, access to business and public leaders, and ability to help organize subsequent dialogue event. Industry Specialists shall have required depth of experience in specific business sectors.

6 Timing

The effort will take place over a period of approximately four months. Within three weeks of signing the task order the methodology and proposed outline of the report would be developed and the field team would commence work in Sri Lanka.

The study would then be completed over the next two months. Upon completion of the draft report, the Team Leader would return to present the report at a series of presentations lasting approximately 10 days in the host country. Feedback would be

obtained in the field, additional interviews carried out, and additional feedback from USAID would be awaited

The Final Report will be provided within three weeks of receiving final feedback