

Outward-oriented Policy Reforms and Industrialisation: The Sri Lankan Experience

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Abstract

This article examines Sri Lanka's industrialisation experience following the policy reforms initiated in 1977, with a view to informing the contemporary debate on the role of outward-oriented trade and investment policy in industrialisation in developing countries. There is strong evidence that improved performance of domestic manufacturing through greater export orientation has brought about significant improvement in output and total factor productivity growth, employment generation and terms of trade gains. The Sri Lankan experience also highlights the complementary role of investment liberalisation for exploiting the potential gains from trade liberalisation. The reform outcome is particularly impressive given that it occurred during a period of persistent civil strife and macro-economic instability. Thus, this article, makes a strong case for firm commitment to an export-led growth strategy as the main pillar of national development policy while guarding against possible policy back-sliding emanating from the new-found enthusiasm for state activism.

INTRODUCTION

The role of trade policy in the design of policies for industrialisation and economic development remains a subject of continuing debate. In the 1950s and 1960s there was a broad consensus in the economic profession that import substitution industrialisation—promotion of industries oriented towards the domestic market by using import restrictions, or even import prohibition—was the key to economic development. From about the late 1970s there was, however, a decisive shift in development thinking and policy away from the entrenched import substitution view and in favour of outward-oriented (export-oriented) trade strategy, underpinned by a 'substantial neo-classical revival in the applied trade and development literature' (Diaz-Alejandro 1975: 94). Consequently, policy transition toward greater outward orientation of the trade regime and fairly uniform incentives for production across exporting and import substituting goods became the

centrepiece of the mainstream policy advocacy of economic policy reforms. While other accompanying reforms to achieve macroeconomic prudence and to unshackle domestic product and factor markets were also considered necessary, trade opening was considered pivotal for achieving sustained and equitable growth (Krueger 1997; Little 1994; Srinivasan and Bhagwati 2001). Recent years have seen a 'revisionist' backlash against this mainstream policy advocacy as part of the new empirical growth literature (Rodriguez and Rodrik 2001; Rodrik 2003). Based largely on cross-country growth empirics, supplemented by case histories of a few (arbitrarily) selected countries, the revisionists argue that, contrary to mainstream interpretations, import substitution policies in much of the developing world in the early post-war period were indeed quite successful and that openness is only one element of a wider list of 'proximate' and 'deeper' determinants of sustained economic growth.

There is a clear need for in-depth analyses of the experiences of individual countries that have undergone significant liberalisation reforms in order to inform this debate. Cross-country regression analysis, which by its very nature attempts to uncover a unique, homogenous relationship across a diverse list of countries, is not the best tool for analysing the linkage between trade and growth (Panagariya 2004; Srinivasan and Bhagwati 2001). Sri Lanka provides an ideal case study of the issue at hand because it has experimented with a wide variety of policy regimes. During the first decade after independence it continued with a liberal trade regime, until growing balance of payments problems induced a policy shift towards protectionist import substitution policies. By the mid-1970s the Sri Lankan economy had become one of the most inward-oriented and regulated outside the group of centrally planned economies, characterised by stringent trade and exchange controls, and pervasive state interventions in all areas of economic activity. In 1977 Sri Lanka responded to the dismal economic outcome of this policy stance by embarking on an extensive economic liberalisation process, becoming the first country in the South Asian region to do so. Despite major macroeconomic problems, political turmoil and government changes, outward-oriented reforms have been sustained and broadened over almost two decades. With this rich reform history, Sri Lanka is now considered perhaps the most convincing case of trade and industrial transformation of a low-income country through market-friendly policy reforms (World Bank 2004).

In this article we examine the implications of outward-oriented policy reforms on manufacturing industry performance against the backdrop of experiences under the protectionist policy regime, with particular attention to the synergistic interaction between the trade opening and the liberalisation of the foreign direct investment regime, and drawing out the implications for broader economic growth. The structure of the article is as follows. The next section briefly chronicles industrial policy in Sri Lanka since independence, followed by a discussion on the key elements of trade and investment policy reforms initiated in 1977. This is followed by an examination of the industrialisation experience since 1977 from a historical

perspective, placing emphasis on aspects such as patterns of industrial growth, export orientation, factor productivity growth, terms of trade gains and employment generation. The next section analyses the response of foreign direct investors to the significant trade-cum-investment liberalisation reforms and the pivotal role they played in the process of export-oriented industrialisation. The final section presents the key inferences.

THE POLICY CONTEXT

During the first decade after independence in 1948, Sri Lanka (commonly called Ceylon until 1972) continued to remain an open trading nation with only relatively minor trade or exchange rate restrictions and liberal domestic policies.¹ Since the late 1950s a combination of change in political leadership and balance of payments difficulties led to the adoption of a state-led import substitution development strategy. Import restrictions that were initially introduced in response to growing balance of payments difficulties soon transformed into key instruments for directing private sector production activities in line with (perceived) national priorities. Following a hesitant and mild liberalisation attempt during 1968–70, the period 1970–77 saw further government intervention in the economy under the guise of creating a ‘socialist society’. Significant and ever-increasing segments of trade, industry, agriculture and banking were owned and managed by state-owned enterprises (SOEs). By the mid-1970s the Sri Lankan economy was one of the most inward-oriented and regulated economies outside the communist block, characterised by stringent trade and exchange controls and pervasive state interventions in all areas of economic activity.

The foreign investment policy continued to remain extremely liberal until the mid-1960s, permitting many MNEs to set up affiliates within Sri Lanka to undertake the domestic production of items previously supplied from their overseas production centres. However, as the import substitution industrialisation strategy was reaching a crisis point by the mid-1960s, the view (which was widely held among development economists at the time) that ‘import-substituting MNEs worsen countries’ balance of payments’ began to dominate Sri Lanka’s policy towards FDI. This view resulted in a dualistic foreign investment policy characterised by stringent restrictions on import substitution projects and favoured treatments for export-oriented ventures. A white paper on foreign investment issued in 1966 emphasised the important role that MNEs can play in the process of manufactured export expansion by providing easy access to foreign markets and bringing in experience and expertise in many complex facets of product development and international marketing. On these grounds, the white paper introduced various tax concessions for export-oriented foreign ventures and relaxed foreign exchange restrictions on the remittance of dividends, interest and profit originating in such ventures. The government’s commitment to the promotion of export-oriented foreign direct investment (EOFDI) was reaffirmed and further production and tax incentives were introduced by the Five-Year Plan, 1972–77 (Government of Sri Lanka 1972).

However, this policy shift in favour of EOFDI occurred in an overall policy and political context that was highly unfavourable to private sector activities in general and to export production in particular. Reflecting the cumulative impact of stringent trade controls, high export taxes and the overvalued exchange rate, the overall incentive structure of the economy was characterised by a significant 'anti-export bias' throughout this period (Athukorala and Rajapatirana 2000). There was an import duty rebate scheme (designed to provide export-oriented manufacturers with access to global inputs at border prices) in operation from 1964. But because of stringent performance requirements and bureaucratic red tape in operation, the scheme played virtually no role in removing the anti-export bias of the restrictive trade regime. Moreover, during the period from 1970 to 1977, widespread nationalisation measures and threats, coupled with various economic controls, effectively marginalised the private sector in the economy.

The policy makers in Sri Lanka, like their counterparts in other developing countries, expected import substitution industrialisation to set the stage for self-sustained growth by reducing the heavy dependence of the economy on imports. The reality was quite different, however. While consumer goods imports were reduced substantially, this was achieved at the expense of increased reliance on imported capital goods and raw materials, resulting, contrary to expectation, in an even more rigid dependence on imports. Given these structural features, the growth dynamism of the newly established industrial sector tended to show a close functional relationship with the fortunes of the traditional export industries. Thus, unanticipated import curtailments brought about by foreign exchange scarcity turned out to be the main constraint on industrial expansion since the late 1960s. Moreover, the 'inefficiency slipover effects' of SOEs involved in intermediate goods production on private sector end-user industries were quite substantial, particularly since import compression policies were implemented with a distinct bias towards SOEs in the allocation of foreign exchange (Athukorala and Jayasuriya 1994: 100). The manufacturing share in GDP increased from 6 per cent in the 1950s to 10 in the mid-1960s and remained around that level for the ensuing decade. By the mid-1970s the manufacturing sector contributed to a mere 8 per cent of total formal employment, and the unemployment rate had risen above 20 per cent (the highest recorded in Sri Lanka's post-independence history) by the mid-1970s.²

As a reaction to the dismal economic outcome of the inward-looking policy, Sri Lanka embarked on an extensive economic liberalisation process in 1977, becoming the first country in the South Asian region to do so. The reform process lost momentum in the early 1980s, first because of an unfortunate shift in policy priority towards politically appealing investment projects, and subsequently due to the onset of the ethnic conflict. There was, however, no retreat to the old control regime. In a decisive move to infuse momentum into the unfinished reform process, a significant 'second-wave' liberalisation package was implemented in the early 1990s. By the late 1990s there was a convergence in broad economic policies among the major political parties and groupings on maintaining greater openness in trade

and FDI. Given this policy convergence, coupled with a palpable shift in development thinking in favour of greater outward orientation the world over, a sharp reversal of policies to embrace more closed-door policies appeared unlikely in the near future. However, in recent years the political climate has become more volatile and receptive to calls for more 'nationalistic' and protectionist policies underpinned by growth of popular disenchantment with the mainstream political parties.

Trade and Investment Liberalisation

Trade and foreign direct investment reforms were the key element of the liberalisation reforms. In November 1977 quantitative import restrictions on imports, which were near universal, were supplanted by a revised system of tariff, retaining only 280 items under licence. As part of the 'second-wave' liberalisation reforms initiated in the late 1980s, import tariffs were further reduced with the aim of moving towards a three-band tariff structure involving rates of 10, 20 and 35 per cent. In 1997 tariffs on textiles were abolished and those on clothing imports were substantially reduced, with a view to facilitating further expansion of the booming garment industry.

Trade liberalisation suffered some setback, because of additional fiscal pressures following the escalation of the civil war in the latter part of the 1990s and during the economic downturn of 2001 which infused a new lease of life to the domestic protectionist lobby. A 40 per cent across-the-board tariff surcharge (subsequently reduced to 20 per cent in 2001) was introduced in 2000. There were also many ad hoc duty exceptions and case-by-case adjustment of duties on many industrial imports that directly compete with domestic production. The tariff structure also became more complex with the introduction of preferential tariffs under the South Asian Preferential Trading Agreement (SAPTA) and the India–Sri Lanka Free Trade Agreement (ISLFTA). However, these changes have not resulted in a significant reversal in the trends of economic opening maintained over the past two decades.

The effective duty rate on total imports (duty collection as a percentage of CIF import value) increased from about 14 per cent during 1978–80 to 18.6 per cent by the mid-1980s, and then declined continuously over the ensuing years reaching 4.6 per cent by 2002 (Table 1). The share of dutiable imports in total imports ranged between 52 and 77 per cent during 1978–84, and declined continuously during the ensuing years. By the late 1990s only 30 per cent of imports (in value terms) were subject to duties.³

The sharp reduction in average import duty over the past decade and a half has come predominantly from reductions (or elimination) of tariffs on intermediate goods. During the post-reforms period until about the mid-1980s, tariffs on intermediate goods were generally higher than those on final goods (consumer goods and investment goods). From then on, tariffs on intermediate goods have declined at a much faster rate compared to those on final goods. In the early 1990s, consumer goods tariffs were on average about two times higher than tariffs on intermediate goods. Given this pattern of tariff escalation, the effective protection for domestic

Table 1
*Import Duty Collection Rates and the Share
of Dutiable Imports, 1978–95 (%)*

	<i>Import duty rate*</i>				<i>Share of dutiable imports**</i>
	<i>Consumer goods</i>	<i>Intermediate goods</i>	<i>Capital goods</i>	<i>Total imports</i>	
1978–80	10.8	17.9	15.0	13.9	76.8
1981–83	12.8	18.6	14.7	15.2	59.4
1984–86	22.8	19.1	17.4	18.6	68.8
1987–89	22.9	8.8	15.9	14.5	58.9
1990	12.5	9.1	18.6	12.3	52.9
1991	16.2	8.0	17.0	12.4	51.5
1992	23.2	7.9	17.5	14.3	45.8
1993	20.0	5.5	15.7	11.1	40.1
1994	13.7	5.2	14.6	9.1	36.5
1995	11.7	4.7	10.2	7.9	39.5
1996	10.3	6.0	7.6	8.5	38.7
1997	11.8	5.9	7.0	7.7	36.4
1998	12.7	4.7	6.0	7.4	35.7
1999	12.8	4.1	4.4	7.0	34.0
2000	11.5	2.9	4.0	4.5	29.3
2001	13.3	1.7	5.3	4.9	25.0
2002	13.3	1.6	5.5	4.6	28.0

Source: Compiled from Sri Lanka Customs Department, Customs Returns (for the period 1978–97) and Central Bank of Sri Lanka, *Annual Report* (various years).

Notes: * Actual import duty (including surcharges and cesses) as a percentage of total import value (cif).

** Total dutiable imports as a share of total imports.

manufacturing continued to remain much higher than the nominal tariff on final goods (Table 2). However, throughout the post-reform period the trade regime in Sri Lanka continued to provide export producers with free access to intermediate inputs under the Export Processing Zone (EPZ) scheme and an all-encompassing duty rebate scheme for non-EPZ firms. In addition, EPZ firms benefitted from a wide range of financial incentives. Therefore, the continuing high effective protection for domestic market-oriented production was not presumably a major deterrent to export expansion.

The most important aspect of the new FDI policy was the setting up of the Greater Colombo Economic Commission (GCEC) in 1978 with wide-ranging power to establish and operate EPZs.⁴ As an important part of the FDI policy, steps were also taken to enter into investment protection agreements and double taxation relief agreements with the major investing countries. A guarantee against nationalisation of foreign assets without compensation was provided under Article 157 of the new Constitution of Sri Lanka adopted in 1978. Until 1990 there was no

Table 2
*Nominal and Effective Protection to Import-competing
 Manufacturing, 1981, 1991, 1994 and 2002*

ISIC no.	Industry	1981	1991		1994		2002	
		ERP	NRP	ERP	NRP	ERP	NRP	ERP
31	Food, beverages and tobacco	72	50	61	47	68	21	36
32	Textiles, wearing apparel and leather products	78	45	58	46	84	25	54
33	Wood, wood products and furniture	79	43	96	37	52	25	57
34	Paper, paper products and printing		50	93	46	106	22	53
35	Chemicals, rubber and plastic products	56	38	118	42	69	25	125
36	Non-metallic mineral products		32	91	35	59	18	41
37	Basic metal products	28	40	273	41	104	22	85
38	Fabricated metal products, machinery and transport equipment	107	48	132	45	95	25	86
39	Other manufacturing		55	122	50	115	20	25
3	Total manufacturing	90	45	77	43	70	23	56

Source: Ministry of Finance (1994), (Table 5.4) (data for 1981 and 1994) and estimates provided by the Tariff Advisory Committee for the other two years.

Notes: NRP: Nominal protection rate (the difference between domestic price and border [world] price as a percentage of the latter).

EPR: Effective protection rate (the percentage increase in value added under the existing trade policy intervention over value added at border price).

major change in the policy towards non-EPZ foreign ventures. Majority local ownership continued to be the general rule for approving such projects. Even though more liberal ownership criteria (even up to 100 per cent foreign ownership) were applied in approving export-oriented firms, these firms were not eligible for the lucrative incentives offered to EPZ firms. As part of the second-wave liberalisation, a new Investment Policy Statement was announced in 1990 with several important changes to the foreign investment policy framework in line with the increased outward orientation of the economy. Activities of the Foreign Investment Advisory Committee, which was responsible for the approval of non-EPZ projects, and the GCEC were brought together under a new Board of Investment (BOI) in order to facilitate and speed up investment approval within a unified policy framework applicable to both import substituting and export-oriented investors. Restrictions on the ownership structures of joint venture projects outside EPZs were abolished. EPZ privileges were extended to local investors who established new export-oriented projects in all parts of the country (in addition to the area demarcated EPZs). This provision, which was initially applicable only to investors who

were prepared to implement their projects prior to 30 September 1991, was extended in February 1993 to local investors starting new export ventures as well as existing companies that set up production facilities outside the Western Province. Since then, this has become a permanent feature of the BOI approval procedure.

Accompanying Policy Reforms

It is evident from the foregoing discussion that the liberalisation reforms initiated in 1977 resulted in a significant opening of the Sri Lankan economy. The reform process has been successful in virtually eliminating quantitative restrictions and reinforcing tariffs as the main instruments for regulating import trade. Before proceeding to assessing the impact of these significant reforms, it is important to consider the other elements of the reform process that have a bearing on manufacturing performance. While there is no consensus on the timing and sequencing of these accompanying reforms, it is generally believed that the ability of a country to capture the full benefit of trade and investment liberalisation depends crucially on the concurrent liberalisation of domestic commodity, financial and labour markets, and maintaining macroeconomic stability (Krueger 1997; Michaely et al. 1991; Srinivasan and Bhagwati 2001).

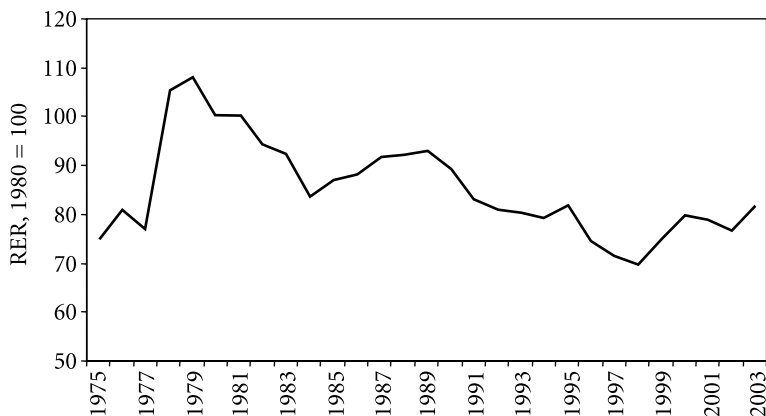
The liberalisation reforms in Sri Lanka involved dismantling of various price controls and state trading monopolies. The proposed privatisation/rationalisation of state-owned manufacturing enterprises lost much of its rigour in the process of implementation for political economy reasons, but was successfully implanted as part of the second-wave liberalisation. With the privatisation of most SOEs, a major impediment to trade liberalisation and a source of pressure on policy reversal weakened. However, implementations of reforms in other areas fell well short of what was proposed in the original reform package.

The 1997 reform package was formulated with due emphasis on the complementarity between macroeconomic management and the trade liberalisation outcome. Thus, trade liberalisation was accompanied by a significant exchange rate reform. The dual exchange rate system, which had been in operation since 1968, was abolished and the new uniform rate was placed under a managed float. The exchange rate was planned to be adjusted daily to reflect changes in foreign exchange market conditions. The other elements of the macroeconomic policy mix included a significant interest rate reform and a number of measures to ensure fiscal prudence. The latter measures included attempts to reduce the budget deficit (which had been the major source of macroeconomic imbalance) through significant cuts in various consumer and producer subsidies, restraints on budgetary transfers to SOEs and limits on inflationary financing of the budget deficit.

The policy commitment to sound macroeconomic management was short-lived, however. Government policies soon resulted in the generation of inflationary pressures. The chief source of macroeconomic instability and pressure on the real exchange rate in the early post-reform period was a massive public sector investment

programme that included the Mahaweli scheme, a billion-dollar multipurpose irrigation project, a large public housing programme and an urban development programme (Athukorala and Jayasuriya 1994). The Central Bank intensified intervention in the foreign exchange market and eventually abandoned (in November 1982) the practice of determining the exchange rate daily. From the mid-1980s the escalation of the civil war begun to hamper the government's attempt to maintain macroeconomic stability (Arunatilake et al. 2003). As the widening budget deficit became the major source of macroeconomic instability, the Central Bank succumbed to using the nominal exchange rate as an 'anchor' for inflation control. Consequently, the significant real exchange rate depreciation achieved in the immediate aftermath of the economic opening gradually dissipated in the ensuing years, with the exception of a short-lived improvement achieved through greater nominal exchange rate flexibility during 1990–94 and again since 2002 (Figure 1). A key lesson from the exchange rate experience in Sri Lanka over the past three decades is that there is no guarantee of long-term stability in the exchange rate regime without changes in underlying macroeconomic fundamentals. Adjustment in nominal exchange rate alone cannot determine the course of the real exchange in the long run when fiscal policy systematically undermines macroeconomic stability.

Figure 1
The Real Exchange Rate (RER)



Source: Based on data compiled from Central Bank of Sri Lanka, *Annual Report* (various issues).

Notes: $RER = [NER * WPI] / CPI$

Where,

NER: Trade-weighted wholesale nominal exchange rate (measured as domestic currency price of foreign currency) vis-à-vis the five major trading partner countries;

WPI: Trade-weighted wholesale price of the five major trading partner countries; and

CPI: Domestic (Sri Lanka) consumer price index.

Trade weight used in compiling *NER* and *WPI* relate to the year 2002.

Sri Lanka has a long history of trade union organisation and worker militancy.⁵ After the emergence of Marxists-influenced political parties in the 1930s, trade union movement evolved in close association with left-wing politics, giving a distinct political favour to much of trade union activity. Under the Termination of Employment Act of 1953 (as amended in 1971), the employer has to obtain prior written consent of the employee, or the permission of the commissioner of labour for the termination of an employee on non-disciplinary grounds (for example, closure of business, rationalisation of business, ill-health of employee and incompetence of employee). Under the Industrial Dispute Act of 1950, the employee has the right to appeal against a dismissal to a labour tribunal. Failure of the employer to justify his decisions results in an order by the commissioner of labour for reinstatement with compensation (even if the worker was in his employment only for a few days).

As part of the liberalisation reforms initiated in 1977, the government made some attempts to reform the labour legislation to achieve greater labour market flexibility. The original Bill proposed to exempt firms set up under the GCEC from general labour legislations applicable to workers in the rest of the country. The Bill specified that the Industrial Dispute Act and the Termination of Employment Act had no application to any GCEC enterprise unless expressly provided otherwise in the Agreement entered into by the enterprise with the Commission. This Bill was challenged before the constitutional court by the unions on the grounds that the exemptions granted in the Bill was discriminatory. The constitutional court upheld this objection and those 'discriminatory' sections were excluded from the Bill. In January 1978 the government came up with another Bill, the Employment Relation Law, which provided for the repeal of the Termination of Employment Workmen (Special provisions) Act and those sections of the Industrial Dispute Act that placed restrictions on the termination of employment. However, in the face of widespread opposition by trade unions, the government shortly abandoned the already gazetted Bill.

Following these failed attempts, the government adopted 'informal' strategies to resolve the contradiction between the existing rigid labour law and the need to provide GCEC enterprises with greater flexibility in labour management. First, greater care was taken in the recruitment of employees into the enterprises within the EPZs. As per the agreement entered into by the Commission with each enterprise, local employees were recruited from applicants who were registered with the Commission after prior police screening. Second, a tight inspection process was introduced by the GCEC for monitoring daily entry of workers to EPZs. This process enabled firms located in FTZs to terminate employment of workers simply by issuing instructions to the security guards at the entry gate not to allow them to enter the premises.

These 'informal' strategies proved workable because of the special political circumstances of the country at the time. Following the crushing defeat of the centre-left parties in 1977, the trade union movement was in disarray and membership became increasingly associated with the ruling party. The government was, therefore,

able to control labour relations and the labour movement remained relatively peaceful in Sri Lanka through 1993. Firms in the private sector did not face significant costs in terms of labour conflicts and real wages remain remarkably low (see Table 2) and the related discussion in the section on manufacturing employment). Nominal wage increases were limited only to moderate periodic adjustments introduced under the wages board mechanism and there were no periodic wage surges resulting from union activism. Such an informal approach proved less effective following the change of political leadership in 1994. During 1994–2000 there were 603 strikes and a loss of 1,261,000 man-days. This compares with only 74 and 873,000 respectively during 1989–93. Apparently, a number of foreign firms left the country during this because of prolonged labour market disputes. The promulgation of a Workers' Charter in 1995 by the new government and attempts to 'sell' the Charter 'as a victory to the working class' contributed to further worsening the industrial relations atmosphere.

In sum, liberalisation reforms in Sri Lanka since 1977 have clearly been partial in nature in terms of the standard 'Washington Consensus' on economic policy reforms (Williamson 1990). While trade and investment liberalisation marked a clear departure from the historic import substitution policy posture, these reforms were not accompanied by liberalisation, comprehensive reforms or a firm commitment to macroeconomic prudence. Moreover, the eruption of the ethnic uprising in the early 1980s ushered in an era of political instability. Quite apart from the direct debilitating effect of political risk on investor perception, the civil war hampered the capturing of the full benefits of economic opening through delays and inconsistencies in the implementation of reform process and macroeconomic instability emanating from massive war financing. Thus, Sri Lanka provides us with an interesting case study to examine whether an outward-oriented trade and investment policy regime could yield a superior industrialisation outcome compared to a controlled regime, even in the absence of required complementary reforms and under severe strains political instability.

MANUFACTURING PERFORMANCE

The manufacturing sector entered a rapid growth phase following the 1977 reforms. During 1978–2003 manufacturing output grew at an average annual rate of 8.2 per cent, compared to 4.8 per cent during the decade preceding the reforms (Table 3). As a result, the manufacturing share in GDP increased from 11 per cent in the early 1980s to 18 per cent by the late 1990. Since the mid-1980s there has been an increasingly close relationship between manufacturing growth and GDP growth.⁶ However, manufacturing growth has not been uniform over the past two decades. There was considerable volatility and periodic fluctuation in growth, reflecting policy shifts and changes in the overall investment climate (mostly associated with the course of the protracted civil war). The most impressive growth performance was in the first half of the 1990s when there was firm political commitment to

Table 3
Key Indicators of Manufacturing Performance, 1965–96 (%)**

	GDP growth	Growth of manufacturing (value added)	Manufacturing share in GDP	Capacity utilisation in manufacturing	Growth of manufacturing exports**	Export–output ratio in manufacturing
1950–59	3.7	1.3	7.2	—	—	—
1960–64	4.5	7.8	6.2	—	—	—
1965–69	4.9	11.5	10.6	—	—	—
1970–76	2.9	3.6	11.4	54	68.4	4.1
1978–80	6.1	6.3	11.2	72	55.8	18.4
1981–83	5.3	5.2	11.1	75	17.3	27.9
1984–86	4.8	9.3	12.1	75	18.1	35.0
1987–89	2.1	6.3	13.7	79	11.1	41.1
1990–92	5.0	10.4	16.2	82	24.6	50.8
1993–95	6.0	9.2	17.7	84	10.2	62.5
1996	3.8	7.2	16.5	83	18.1	60.3
1997	6.3	10.0	16.6	84	15.0	62.9
1998	4.7	7.5	16.8	84	6.1	63.4
1999	4.3	4.5	16.4	83	-2.2	63.0
2000	6.0	10.0	16.8	85	19.1	70.4
2001	-1.5	-3.8	16.0	80	-11.9	66.6
2002	4.0	2.6	15.9	81	-2.3	63.4
2003	5.5	5.1	15.6	85	9.5	—

Source: Compiled from various issues of Central Bank, *Review of the Economy and Annual Report*.

Notes: * Manufacturing excluding primary processing of plantation crops. Capacity utilisation and export–output ratio relates to ‘organised’ manufacturing only. Others are economy-wide indicators.

** In current US\$ terms, excluding petroleum products.

— Data not available.

reforms, macroeconomic conditions were relatively favourable, and the debilitating effect of the civil war had been temporarily brought under control through an informal truce.

The major immediate cause of output expansion in the liberalised economy was the free availability of imported inputs, which contributed to greater capacity utilisation. However, output continued to expand at an increasing rate even after capacity utilisation reached an average stable rate of about 70 per cent by the late 1980s. Quite apart from greater input usage, growth of factor productivity seems to have played a significant role with some time lag.

The results of a simple growth accounting procedure undertaken to decompose manufacturing output growth into the relative contributions of factor accumulation and total factor productivity (TFP) growth are reported in Table 4.⁷ The estimates clearly point to the adverse productivity implications of the increased restrictiveness in the trade regime between 1966 and 1974. In the early post-liberalisation period (1977–81) output growth emanated predominantly from factor accumulation facilitated by the free availability of imported inputs and capital goods in the liberalised economy. In particular, the availability of intermediate inputs contributed to output growth through greater capacity utilisation. There was, however, a significant improvement in TFP growth between 1981 and 1995, recording an annual average rate of 7.5 per cent. TFP growth accounted for almost 30 per cent of total output growth between these years. However, TFP growth slowed to an annual average rate of 1.2 per cent during 1995–2000, reflecting the adverse domestic and external factors already noted.

Table 4
Total Factor Productivity Growth (TFPG)
*in Private Sector Manufacturing**

	Contribution of			TFPG	
	Growth of gross output (G_O)	Labour ($S_L G_L$)	Capital ($S_K G_K$)		Intermediate inputs ($S_M G_M$)
1966–74	0.8	0.5	-1.3	4.6	-3.0
1974–81	4.0	0.2	3.0	1.6	-0.8
1981–88	14.0	0.6	3.6	8.5	1.2
1988–95	17.4	1.5	4.9	1.3	9.7
1995–2000	3.5	-0.1	0.7	1.8	1.2
1981–2000	12.5	0.7	3.3	4.1	4.3

Source: Athukorala and Rajapatirana (2000: Table 8.1), updated using the same methodology and data sources.

Notes: * Estimated using the formula:

$$TFPG = G_O - S_L G_L - S_K G_K - S_M G_M$$

where, TFPG is total factor productivity growth; G_O , G_L , G_K , G_M denote annual compound growth of gross output, labour, stock of capital and intermediate input between the two given years; and S_L , S_K and S_M denote the average value shares of labour, capital and material in output.

At the time of market-oriented policy reforms in 1977, SOEs accounted for over 60 per cent of manufacturing output and 50 per cent of manufacturing employment. This public sector dominance continued virtually unchanged until about the mid-1980s. From about the mid-1980s the position of SOEs continuously eroded in face of rapid output growth in private sector ventures and privatisation of an increasing number of SOEs in the 1990s. SOEs accounted for less than 3 per cent of total manufacturing output by the turn of the century.

Trends and Patterns of Manufactured Exports

The overall export orientation of manufacturing tended to increase sharply from the mid-1980s. By the time of the 1977 policy reform, the share of manufactures in total merchandise exports was only 5 per cent. Since then manufactured goods have emerged as the most dynamic element in the export structure. Exports of manufactured goods grew (in current US\$ terms) at an annual compound rate of over 30 per cent during 1978–2003, lifting their share in total exports to over 70 per cent. The value of total manufacturing exports increased from a mere \$5 million in the mid-1960s to over \$4 billion by the late 1990s. The export coefficient (ratio of exports to gross manufacturing output) increased from 3 per cent in the late 1970s to over 50 per cent by the late 1980s and over 70 per cent by the late 1990s (Table 3).

Manufactured exports of Sri Lanka have continued to remain heavily concentrated in a single standard labour-intensive consumer good, clothing (Table 5). However, from the late 1980s onwards there has been a noticeable increase in exports of other labour-intensive products such as electronics (included under the commodity category of ‘machinery’), leather goods, footwear, toys, plastic products, jewellery and resource-based products related to the traditional agricultural exports (tea, rubber and coconut fibre). Reflecting this ongoing pattern of commodity diversification, the share of clothing in total manufacturing exports declined from 72 per cent in the early 1980s to 60 per cent in the mid-1990s (Table 5). The share of natural rubber (the second largest of the traditional ‘trio’) in total exports has declined sharply (reaching less than 1 per cent in 2002) as a result of rapid growth of rubber-based manufactured products.

Given the dominance of textile and clothing in domestic manufacturing and the important role played by ‘quota-hopping’ investors in the expansion of the industry, the likely implications of the abolition of the MFA has become a key concern in Sri Lanka. However, it appears that while some exporting firms are still involved in the production of low-end products for quota-protected markets; overall, the Sri Lanka textile and clothing industry appears now to be relatively well positioned to cope with the new challenges. Concurrent liberalisation of trade and FDI regimes created an investment environment that was highly conducive for improvement of product quality and marketing skills needed for penetrating the brand-name-dominated high end of global markets. Through marketing links

Table 5
Composition and Growth of Merchandise Exports, 1975-2002

	Composition (%)*										Growth (%)**		
	1975-76	1980-81	1985-86	1990-91	1995-96	2001-2	1975-89	1990-2000	1975-2002				
Primary products	85.5	67.1	57.1	42.0	29.9	22.8	2.5	3.7	2.7				
Tea	46.0	32.7	29.7	23.6	13.9	14.2	1.7	5.5	3.0				
Rubber	17.4	14.2	7.3	3.6	2.0	0.5	-1.3	-9.6	-0.5				
Coconut products	11.0	6.9	7.2	3.6	2.2	1.7	0.6	3.5	0.1				
Manufactured goods, including petroleum product	14.5	32.9	42.9	58.0	70.1	77.2	17.2	10.6	15.1				
Petroleum products	9.7	16.9	8.9	4.6	2.2	1.5	1.7	0.5	0.5				
Manufactured exports, excluding petroleum products	4.8	16.1	34.0	53.4	67.9	75.7	25.4	11.1	19.1				
Food, excluding fish	0.2	0.4	0.4	0.6	1.3	1.9	12.1	19.7	17.3				
Fish products	1.1	1.5	1.5	1.1	0.7	0.8	9.1	1.1	4.7				
Textile	0.2	0.4	1.1	1.6	3.8	4.1	25.3	16.4	22.4				
Clothing	1.0	12.2	24.1	35.2	40.0	48.1	32.4	10.8	26.6				
Footwear	0.1	0.0	0.4	0.5	1.2	0.5	23.8	10.3	20.1				

(Table 5 contd.)

(Table 5 contd.)

	Composition (%)*										Growth (%)**		
	1975-76	1980-81	1985-86	1990-91	1995-96	2001-2	1975-89	1990-2000	1975-2002				
Ceramics	0.4	0.4	0.3	0.7	0.9	0.9		14.2	14.2***				
Rubber goods	0.0	0.0	0.0	2.1	4.1	3.7		11.9	11.9***				
Cut/polished diamond	0.0	0.0	0.0	2.3	4.0	3.8		3.2	3.2***				
Non-electrical machinery	0.1	0.2	0.4	0.8	1.3	2.2	16.7	18.8	17.1				
Electrical machinery	0.0	0.1	0.1	0.7	1.5	3.2	28.8	23.2	21.0				
Travel goods	0.0	0.0	0.0	0.1	1.4	1.7	23.2	38.4	20.8				
Toys and sports goods	0.0	0.0	0.1	0.2	1.0	1.0	30.4	19.6	20.6				
Jewellery	0.1	0.1	0.1	0.3	0.7	0.3	19.5	5.5	17.9				
Other manufactured goods	1.6	0.8	5.4	11.8	6.0	3.5	38.1	11.9	14.6				
Total exports	100	100	100	100	100	100							
US\$ million	567.5	1,078.8	1,274.5	1,950.1	3,955.1	4,758.8	6.9	8.5	8.6				

Source: Compiled from, Central Bank of Sri Lanka, *Annual Report* (various years).

Notes: * Computed for two-year average exports.

** Annual compound rates estimated by fitting a logarithmic trend.

*** Estimates for 1990-2002.

forged through foreign investors and international buyers, pure local firms also have made significant progress in moving 'up market' (Athukorola and Rajapatirana 2000: chapter 6).

Table 6 provides comparative data on movements in export value, volume and unit value of garment exports for Sri Lanka and five other competing countries in the region during 1985–2001. The patterns emerging from this comparison are consistent with the view that Sri Lanka has been relatively more successful in moving into the high-quality segments of the market. During the period under study both volume expansion and increase in unit value have contributed significantly to the expansion in export revenue. Interestingly, among the five countries, Sri Lanka is the only one to record a significant increase in unit value (6.6 per cent per annum). In the other five countries export revenue increase has *solely* come from volume expansion in the face of stagnation or decline in export unit value.

Table 6

*Growth of Volume, Unit Value and Value of Garment Exports from Bangladesh, China, Indonesia, Sri Lanka and Thailand, 1985–2001**

	<i>Volume</i>	<i>Unit value (US\$)</i>	<i>Value (US\$)</i>
Bangladesh	21.22 (20.9)**	0.22 (0.1)	24.02 (2.9)**
People's Republic of China	15.13 (8.1)***	-1.53 (0.8)	13.53 (13.6)**
India	8.7 (6.2)***	0.3 (1.2)	7.2 (3.5)**
Indonesia	11.6 (8.1)***	0.2 (0.3)	11.3 (5.2)**
Sri Lanka	8.3 (12.0)***	3.8 (6.6)***	12.2 (14.2)***
Thailand	2.2 (3.2)**	-1.6 (1.3)	0.6 (0.5)

Source: Based on data compiled from UN Comtrade database.

Note: * The estimates cover exports of garments belonging to the following three-digit Standard International Trade Classification, Revision 3 (SITC, Rev. 3) categories: men's and boys' outerwear, textile fabrics not knitted or crocheted (SITC 842); women's, girls' and infants' outerwear, not knitted or crocheted (843), and outerwear knitted or crocheted (845)). Growth rate estimated by fitting a logarithmic trend line. T-ratios are given in brackets, with the statistical significance denoted as: ** 5 per cent, *** 1-per cent.

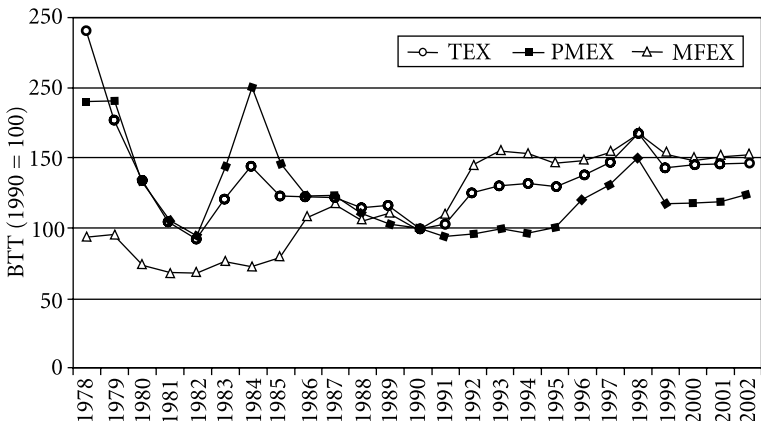
Terms of Trade

For over three decades following the tea price boom in the 1950s, the Sri Lankan economy suffered from a precipitous fall in both barter terms of trade (export price relative to import price) (BTT) and income terms of trade (purchasing power of export earnings) (ITT), with only a few spikes. Sri Lanka's two major exports,

tea and rubber, were among the commodities that experienced the sharpest price falls in world markets during this period. The adverse impact of the resultant deterioration in BTT was compounded by sluggish export volume growth reflecting supply problems faced by these export industries. Consequently, BTT and ITT exhibited remarkably similar downward trends.

The empirical evidence harnessed by Athukorala (2004) clearly suggests that diversification into manufactures from structurally weak conventional primary commodities under the market-oriented policy reforms has enabled the country to escape from the unequal exchange relations in world trade. A gradual stabilisation and then an improvement occurred in both BTT and ITT during the post-reform era. BTT recorded an annual compound rate of 1.8 per cent during 1978–2002 (compared to 2.6 per cent deterioration during the pre-reform period from 1948 to 1977) despite near zero growth in BTT for primary products. In a clear departure from the historic patterns of close co-movements in BTT and ITT, the latter has increased at a much faster rate during the post-reform years. The compound growth rate of ITT during this period (7.9 per cent) was almost three times of that of BTT, despite the stagnation of agricultural export volume (Figures 2 and 3). This comparison suggests that market-oriented policy reforms can generate a superior ITT outcome by improving supply elasticity of exports. From the point of view of development, measured by per capita income, ITT is of course the more relevant concept to consider than BTT. Thus, the Sri Lankan experience with manufactured export expansion clearly rebut the so-called *new terms of trade pessimism* about the gains from diversification into manufactured exports in a traditional primary exporting country.⁸

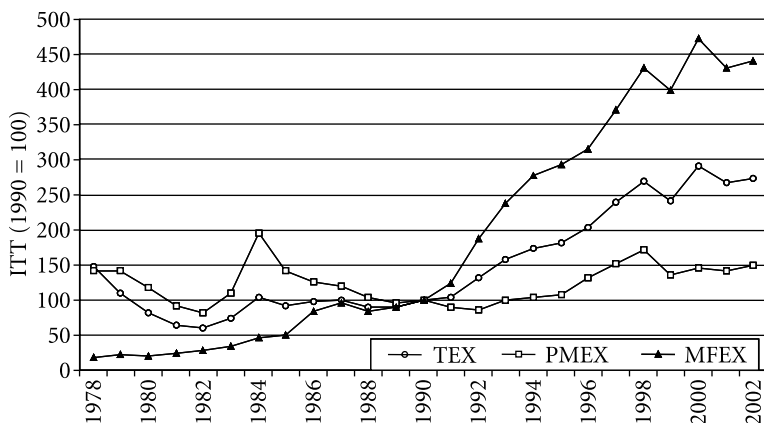
Figure 2
Barter Terms of Trade (BTT) for Total,
Primary and Manufacturing Exports, 1978–2002



Source: Athukorala (2004).

Notes: TEX: Total exports (excluding petroleum products); PMEX: Primary exports; and MFEX: Manufactured exports (excluding petroleum products).

Figure 3
*Income Terms of Trade (ITT) for Total, Primary
 and Manufacturing Exports, 1978–2002*



Source: Athukorala (2004).

Notes: TEX: Total exports (excluding petroleum products); PMEX: Primary exports; and MFEX: Manufactured exports (excluding petroleum products).

Employment

In determining the effects of industrial growth on employment in Sri Lanka, one is handicapped by relatively poor data. The coverage of the available employment and wage data is limited to production units in the organised (formal) manufacturing sector. Even for that sector, consistent data series of adequate length (encompassing both pre- and post-reform years) are not available. Nevertheless, several interesting facts do emerge from the scanty data (Table 7).

The post-reform years witnessed an impressive increase in manufacturing employment. According to data from the Annual Survey of Industry conducted by the Department of Census and Statistics (CDS), total employment in organised manufacturing (that is, firms employing more than five workers) increased from 14,000 in 1978 to over 500,000 by the late 1990s (Table 8). According to the CDS Labour Force Survey, islandwide manufacturing employment increased from 648,000 in 1985 to 788,000 by the mid-1990s and passed the 1 million mark in 2000. The share of manufacturing employment in total employment increased from around 10 per cent in the early 1980s to over 17 per cent by the end of 1990s (Table 8). The manufacturing sector contributed over 36 per cent of the increase in total employment in the economy between 1990–91 and 2001–2. The increase in manufacturing employment has come primarily from private sector manufacturing, in a context where employment in SOEs declined sharply, first because of output contraction caused by import competition, and subsequently by closure and privatisation.

Table 7
Manufacturing Employment and Related Data

	Employment (no. of workers)			Real earning per worker	Labour productivity (1980 = 100)	Wage share in value added (%)	
	CDS QLS	CDS-MFS	SOE				BOI
1978		142,347	63,530	261	118.3	96.6	26.6
1979		160,816	75,150	5,876	111.8	85.7	28.01
1980		161,844	70,371	10,538	100.0	100.0	25.7
1981		151,549	66,355	19,727	95.0	112.2	24.2
1982			71,255	24,926	80.9	97.3	19.4
1983		202,100	70,182	27,805	81.1	121.3	17.9
1984		212,332	64,292	32,725	83.6	110.4	17.6
1985	648,000	210,465	58,446	35,786	101.5	135.1	17.3
1986		217,146	54,332	45,047	101.7	131.5	17.2
1987		212,223	54,049	50,743	105.8	130	16.7
1988		219,278	52,050	54,626	105.9	137.3	17.6
1989		243,705	52,611	61,429	100.1	134.2	17.5
1990	669,000	281,114	45,283	71,358	95.0	137.8	17.6
1991	751,000	315,582	40,066	85,457	102.5	142.7	19.5
1992	650,000	289,155	41,394	104,220	100.4	160.1	19.3
1993	684,000	356,950	39,902	122,165	106.6	165.0	20.8

1994	756,000	520,596	36,714	205,660	92.3	149.6	20.5
1995	788,000	514,561	40,436	223,367	94.0	148.0	20.0
1996	807,000	499,052	40,175	241,970	88.6	151.8	19.1
1997	920,000	458,032	38,804	285,663	87.7	165.2	17.7
1998	858,000	462,358	37,698	294,381	88.4	173.6	17.8
1999	902,000	469,132	36,154	327,059	92.5	181.3	17.5
2000	1,045,000	500,366	33,947	367,849	93.6	164.7	19.5
2001	1,057,000		33,513	386,034			
2002	1,092,000		32,140	416,756			
2003	1,117,000		31,567	431,050			

Sources: CDS QLS: Data from the *Quarterly Labour Force Survey* conducted by the Department of Census and Statistics (covers total manufacturing employment).

CDS ASI: Data from the *Annual Survey of Industry* conducted by the Department of Census and Statistics (covers employment in firms employing more than five workers).

SOE: Employment in state-owned manufacturing enterprises, from Central Bank, *Annual Report* (various issues).

BOI: Employment in firms set up under Section 17 of the BOI Law.

Real earning per worker, real labour productivity and wage share in value added were compiled using data from the Department of Census and Statistics, *Annual Survey of Industry* (various issues).

Table 8
Sectoral Composition of Employment (%)

	Source	Agriculture	Industry		
			Total	Manufacturing	Services
1963	Census of population, DCS	52.6	12.1	9.1	35.3
1971	Census of population, DCS	50.1	12.5	9.3	37.4
1981	Census of population, CDS	45.3	14.1	10.1	40.7
1981–82	Consumer finance and socio-economic survey, CBSL	50.5	19.0	12.3	30.4
1985–86	Labour force and socio- economic survey, DCS	49.3	18.4	12.6	32.3
1986–87	Labour force and socio- economic survey, DCS	47.7	21.0	13.4	31.3
1990	Quarterly labour force survey, DCS	46.8	18.7	13.3	34.5
1992	Quarterly labour force survey, DCS	42.1	19.5	13.1	38.4
1994	Quarterly labour force survey, DCS	39.5	19.2	14.3	41.3
1996	Quarterly labour force survey, CDS	37.3	21.7	14.7	41.0
1998	Quarterly labour force survey, DCS	36.2	21.9	14.8	41.9
2000	Quarterly labour force survey, DCS	37.4	24.5	17.2	38.1
2002	Quarterly labour force survey, DCS	34.1	21.2	16.8	45.8

Note: DCS: Department of Census and Statistics; CBSL: Central Bank of Sri Lanka.

Export-oriented manufacturing accounts for the bulk of new employment opportunities. Total local employment in export-oriented BOI firms increased from around 10,000 in the early 1980s to over 416,000 in 2002 (or 40 per cent of total manufacturing employment). The export-oriented garment industry contributed to over 35 per cent of total employment in organised manufacturing by the mid-1990s. This share has declined slowly in subsequent years reflecting the rapid expansion of other export-oriented industries such as rubber products, ceramics, and footwear and travel goods. The employment impact of new export-oriented industries would look even more impressive if employment in small-scale manufacturing were appropriately accounted for. Many export-oriented firms in garments, toy and shoe industries have production subcontracting arrangements with small-scale producers in the unorganised sector.

The increase in manufacturing employment has not been accompanied by an increase in real manufacturing wages. Real wages either declined or stagnated throughout the post-reform period. At the same time, labour productivity recorded

(real value added per worker) impressive growth over this period. The combined outcome of these developments has somewhat shifted the distribution of total factor income in favour of employers. The share of employee remuneration (wages and other benefits) in manufacturing value added declined from over 20 per cent in the early 1970s to about 17 per cent since the mid-1980s. These patterns in the distribution of factor income and the real wage behaviour are much in line with what the theory predicts about the process of industrial adjustment in a labour-surplus economy under export-led industrialisation (Chow and Papanek 1981; Fei et al. 1979).

Even if the expansion of manufacturing worsened relative poverty though an increase in relative share of profits in total factor income as noted,⁹ rapid manufacturing employment growth, coupled with the compositional changes in employment, would have led to a decline in absolute poverty. Reflecting the rapid expansion of export-oriented light manufacturing the share of female workers in total manufacturing employment increased from 32 per cent in the early 1980s to over 60 per cent by the mid-1990s. There has also been a significant shift in occupational composition in manufacturing, in favour of unskilled and semi-skilled workers. Manual workers (unskilled, semi-skilled and skilled workers) accounted for over 90 per cent of total employment in BOI firms in 2002.¹⁰

Linkages

Manufactured exports from Sri Lanka are characterised by a high degree of import intensity and therefore limited linkages with the rest of the economy. Of course, the greater the linkages between the export sectors and the rest of the economy, the greater the benefits to the economy from export expansion (provided such linkages are the natural outcome of industrial deepening). However, attempts to create linkages through direct policy intervention, as argued by some, in a labour-abundant economy whose initial comparative advantage essentially lies in standard light manufactured goods and simple assembly activities can stifle the evolution of the export structure in line with changing patterns of internationalisation of production. This in turn will frustrate the achievement of employment and income growth objectives.

Some consider the high import intensity of export-oriented industries to be an intrinsic feature of export-led industrialisation through neutral incentives and argue for policy intervention to shift exports towards products with a higher proportion of domestic value added. This view ignores the fact that forging domestic linkages by export-oriented manufacturing producers is essentially a time-dependent process linked to quality improvement in domestic input production industries. Producing what is sought in competitive international markets, in contrast to producing import substituting products for a shortage-ridden supplier's market, calls for a vector of imported inputs meeting exacting quality requirements and specifications. Substitution with inferior locally produced inputs may lead to significant

market losses, and the costs of correcting the defects at a further stage may be prohibitive. Hence, it is often unrealistic to expect export producers to source many inputs from local suppliers at the formative stage of export-oriented industrialisation. It is important to note that the share of domestic inputs in total inputs in the garment industry has recorded a modest increase in recent years. Until the mid-1980s local purchases by export producers were limited only to packaging material, but more recently local procurement of yarn has begun to increase following enhanced efficiency of the local textile industry with privatisation and the entry of some foreign firms (Kelegama and Foley 1999).

Resource allocation considerations make a strong case for the development of footloose (loosely linked) export industries in a labour-abundant economy (Athukorala and Santosa 1996; Little 1981, Riedel 1974). In an open economy the factor intensity of production depends not only upon the technology in the final and intermediate stages of domestic production, but also upon the technology that underlies the structure of foreign trade. This is because participation in international trade provides the economy with the opportunity to specialise in products in which it has comparative advantage (that is, labour-intensive products in the case of a surplus labour economy), while relying on world trade for the procurement of intermediate inputs. Intermediate goods industries are typically more capital intensive than final goods industries. The importation of intermediate inputs for export production, therefore, involves an implicit substitution of labour for relatively capital-intensive intermediate products in the production process. For instance, when an economy imports capital-intensive inputs such as machinery, synthetic fibre and industrial chemicals with foreign exchange earned by exporting labour-intensive products such as garments, footwear and toys, it is implicitly substituting labour-intensive goods for capital-intensive goods in the production structure. This would enhance the labour intensity of the overall production process.

THE ROLE OF FDI

Foreign direct investment has played a pivotal role in export-led industrialisation in Sri Lanka. Standard labour-intensive manufacturing has been the main attraction to foreign investors (Table 9), with a heavy concentration in the garment industry. During the early stages the dominant factor behind the surge of clothing exports through FDI participation was the quota restrictions imposed by the major importing countries on imports from 'traditional' developing country producers in East Asia under the Multi Fibre Arrangement (MFA). This was clearly evident from the predominance of firms from Hong Kong (the major developing country exporter of garments) in Sri Lanka's export-oriented garment industry.

Since the later 1980s there has been a noticeable increase in the number of foreign firms in other labour-intensive activities, in particular footwear, travel goods, plastic products, and diamond cutting and jewellery. There has also been an increase in the processing of primary products that were previously exported in raw form,

Table 9
*Industry Composition of Export Oriented Foreign Manufacturing Firms,
 1982, 1995 and 2002**

	1982		1995		2002	
	No. of firms	Export (%)	No. of firms	Export (%)	No. of firms	Export (%)
	4	3.3	58	11.5	151	16.4
1 Food and beverages			15		61	2.1
1.1 Tobacco			2		2	2.2
1.2 Natural rubber-based products	1	2.8	16	3.2	28	9.3
1.3 Ceramics/granite products	1	0.2	10	2.3	23	2.0
1.4 Coir products	1	0.3	6	0.5	20	0.5
1.5 Wood products			2	0.1	7	0.1
1.6 Gem-cutting			7	0.2	6	0.1
1.7 Other					4	0.0
2 Standardised consumer goods	27	94.9	155	79.6	321	71.1
2.1 Textile and garments	21	86.9	81	59.4	152	51.6
2.1a Handloom and textile products	0	0	8	8.1	15	6.0
2.1b Textile fabric, knitted and woven	3	1.1	10	9.5	23	6.3
2.1c Garments	18	85.8	63	41.8	114	39.2
2.3 Leather goods	1		7	3	6	0.3
2.4 Plastic goods	1	0.4	16	2.8	30	2.1
2.5 Footwear	2	1	6	2.5	5	1.3
2.6 Sport goods			31	2.8	21	4.9
2.7 Diamond-cutting and jewellery	2	6.6	17	8.9	21	3.4
2.7 Other			7	1.2	86	7.4
3 Component production/assembly	3	1.8	32	8.9	97	12.5
3.1 Electronics and electrical goods	1	1.6	19	4.2	19	5.6
3.2 Fabricated metal products, and machinery and transport equipment	2	0.2	1.3	4.7	78	6.9
Total	34	100	303	100	569	100

Source: Compiled from official records of the Board of Investment.

Note: * Firm approved under Section 17 (special export provision) of the BOI Law.

notably rubber-based products (heavy-duty tyres, rubber bands and surgical gloves) and ceramics. Initially, the surge of FDI in the garment industry responded to the imposition by developed countries of quota restrictions on garment imports from

traditional East Asian developing countries under the MFA. However, by 1983 garment exports from Sri Lanka also had come under quota restrictions, and the BOI stopped approval of new investors in quota-restricted product categories. Since then new foreign firms predominantly involved in the production of non-quota garments have increased. According to BOI firm-level data, there were 23 non-quota garment producing foreign firms, which accounted for 10 per cent of total garment exports by BOI-approved firms. By 2002 these figures had increased to 36 and 42 per cent respectively. Another important recent development is the setting up of a number of yarn and textile producing factories by foreign firms to supply inputs to the garment industry.

The investment promotion campaign of the GCEC (and BOI) aimed at attracting FDI into assembly activities in high-tech industries ('Component production/assembly' in Table 9). However, it seems that the increase in political risk, following the eruption of ethnic conflict in 1983, has prevented a positive response. Foreign firms involved in vertically integrated assembly activities, unlike those involved in light consumer goods industries, view investment risk from a long-term perspective because output disruption in a given location can disturb production plans for the entire production chain. In fact, two electronics multinationals, Motorola and Harris Corporation, abandoned plans to set up assembly plants in Sri Lanka in the early 1980s as the political climate began to deteriorate. There is evidence that there is something of a herd mentality in the site selection process of electronics multinational firms, particularly if the first on the scene is a major player in the industry. If the two projects of Motorola and Harris Corporation had been successful, other multinationals would have probably followed suit (Athukorala and Rajapatirana 2000; Snodgrass 1998). Instead, today only a handful of small-scale firms from Germany, the USA, Japan and Korea are involved in electronics assembly activities in Sri Lanka.

There is a close association between the growth of manufactured exports and the share of foreign firms (Table 10). The share of foreign firms in total manufacturing exports increased from 24 per cent in 1977 to over 65 per cent in mid-1995. Over 80 per cent of the total increment in export value (in US\$ terms) between 1980 and 1995 came from foreign firms. There has been a decline in the FDI share in recent years, but it remained high at over 47 per cent by 2002. This decline mostly reflects the success of 'pure' local firms in expanding exports of standard light manufactured goods (mostly garments) benefiting from the market links established though their links with foreign firms. Foreign firms still dominate 'non-traditional' product areas such as travel goods, heavy-duty tyres, surgical gloves and electronics assembly. In 2002 these firms accounted for over 80 per cent of total non-garment manufactured exports.¹¹

Apart from the 'direct' contribution captured in this data, there is evidence that the presence of foreign firms generates significant positive spillover effects on the export success of local export producing firms (Athukorala 1995). Following the

Table 10
*Foreign Firms' Contribution to Manufacturing Export Expansion,
 1976–95 (three-year averages)*

	<i>US\$ million</i>	<i>Average annual growth</i>	<i>Manufacturing share in total merchandise exports</i>	<i>Share of foreign firms in manufactured exports</i>
1975–77	25	14.5	4.0	23.2
1978–80	103	63.6	10.4	30.2
1981–83	235	23.0	22.1	43.7
1984–86	421	24.1	31.9	47.4
1987–89	654	14.8	44.2	58.2
1990–92	1,083	32.8	56.6	65.8
1993–95	2,248	13.5	71.8	62.3
1996–98	3,269	13.1	72.2	46.1
1999–2001	3,750	1.7	75.6	47.5
2002	3,562	-2.3	75.7	47.0

Source: Athukorala (1995: Table 4), updated using the same data sources.

entry of foreign firms into clothing and other light consumer goods industries in Sri Lanka, many international buying groups that had long-established market links with these firms also set up buying offices in the country. These buying offices have subsequently begun to play a crucial role in linking local firms with highly competitive international markets for these products. Moreover, over 80 per cent of export-oriented foreign firms in Sri Lanka operate through joint ventures set up with local entrepreneurs, who seem to make use of joint venture operations with foreign investors as a means of acquiring production and marketing skills required for the successful operation of their own (independent) production units (Athukorala 1995, Lal and Wignaraja 1992). There are also many cases of the local partner taking over the entire production operation and continuing to thrive in the export business after an initial stage of joint venture operation. What all this reasoning suggests is that the spillover effects of the presence of foreign firms have, to a significant extent, contributed to the 'export success' of local firms.

CONCLUDING REMARKS

The state-led import substitution industrialisation pursued vigorously in the 1960s and 1970s in Sri Lanka failed to achieve self-sustained industrialisation. This strategy resulted in an increase, rather than a reduction, in the country's vulnerability to external shocks and led to an abysmal growth employment outcome.

The liberalisation reforms initiated in 1977 have resulted in a significant opening of the Sri Lankan economy. The reform process has been successful in virtually eliminating quantitative restrictions and reinforcing tariff as the main instruments

for regulating import trade. Tariff levels have also come down over the years, and export producers have enjoyed duty-free access to imported inputs from the very beginning of the reform process. Liberalisation of the foreign investment regime has gone hand in hand with trade liberalisation. These reforms, notwithstanding the half-hearted nature of accompanying reforms on the domestic front and policy slippage in macroeconomic management, have ushered in far-reaching changes in the structure and performance of the manufacturing sector. The manufacturing sector has become increasingly export-oriented, and it is no longer reliant on the fortunes of the traditional primary export industries to obtain required imported inputs. Diversification of exports into manufactured goods yields significant gains in terms of trade. With the gradual erosion of the dominant role of SOEs, the private sector has been largely responsible for the growth of manufacturing in recent years. Despite some output disruption in the immediate aftermath of the removal of trade restrictions, the manufacturing sector has turned in an improved performance in terms of output, productivity and employment, confounding the predictions of pessimists who expected trade liberalisation to set in a process of deindustrialisation.

The Sri Lankan experience highlights the complementary role of investment liberalisation for exploiting the potential gains from trade liberalisation. Internationalisation of production through FDI participation has been central to the rapid integration of developing countries in the global manufactured goods trade system. In this context there is limited room for a small developing economy to enter manufactured goods trade solely through local entrepreneurial initiatives. Foreign investment not only provides the initial stimulus for a rapid expansion in exports and the associated increase in employment, but is also a vehicle for the forging of links between local firms and international markets.

Sri Lanka's achievements under outward-oriented policy reforms are particularly noteworthy given the partial nature of reforms and the civil war that had been persisting for much of the period. Apart from the direct debilitating effect of political risk on investor perception, the civil war hindered capturing the full benefits of economic opening because of delays and inconsistencies in the implementation of reform process and macroeconomic instability resulting from massive war financing. In this context the Sri Lankan experience with export-led industrialisation can so far be explained as the joint outcome of trade liberalisation that increased the potential returns to investment that capitalise on the country's comparative advantage. Investment liberalisation permitted the entry of international firms that had the capacity to take advantage of such profit opportunities. Despite political risk and policy uncertainty, rapid export growth was consistent with this policy configuration as it ensured a handsome profit in labour-intensive export production in a labour-abundant economy, which is usually characterised by a short payback period. In sum, the Sri Lanka experience over the past two decades, as analysed in this article, makes a strong case for firm commitment to outward-oriented reforms as the main pillar of national development policy.

NOTES

1. Sri Lanka's post-independence policy history has been well documented. See, for instance, Snodgrass (1998), Lal and Rajapatirana (1989), Athukorala and Jayasuriya (1994) and Athukorala and Rajapatirana (2000).
2. The data used in this article, unless otherwise indicated, come from the Central Bank of Sri Lanka, *Annual Report*.
3. The significant decline in the share of dutiable imports reflects the expansion of manufactured exports. Firms operating under EPZ provisions are eligible to import all inputs duty-free, and other firms producing for exports are provided duty-free access to imported inputs through the duty rebate scheme or the bonded warehouse facility.
4. The first EPZ, at Katunakaye near the Colombo International Airport (henceforth KEPZ), was opened in 1978. Its remarkable success paved the way for setting up a second in Biyagama (BEPZ) in 1982 and a third in Koggala (KGEPZ) in June 1991.
5. Joan Robinsion, who visited Sri Lanka in 1958 as an adviser to the newly formed National Planning Council, commented on the constraining effect of the system of labour relations on the country's effort to design a national development strategy to absorb rapidly growing labour force as flows:

‘Ceylon has imported from the advanced capitalist countries (along with a modernised death-rate) ... the ideals of the welfare state, and her trade union movement has imported the conception that belongs to unions in a developed economy, whose business is to keep profits in check and secure an acceptable share of national output for the workers. ... *Ceylon has tasted the fruit before she has planted the tree. Her trade unions are anxious to share in profits but the energetic, enterprising and thrifty capitalist for them to share with have not yet appeared.* (Robinson 1958: 40–41); emphasis added.

Ironically, despite policy reforms over the years, Robinsion's characterisation still remains a valid depiction of Sri Lanka's labour market situation.

6. The correlation coefficient between two annual growth rates for the period 1986–2000 is 0.72, compared to 0.35 for 1960–96.
7. The estimates are based on the Tornquist method. The only assumption required to justify its use is that firms pursue profit maximisation and/or cost minimisation, and hence market return is a good approximation to the marginal product of a factor. No assumption about the properties of the underlying production function is required: production parameters are taken to be subsumed in expenditure (input) and revenue (output) (Harberger 1996).
8. The new terms of trade pessimism due to Han Singer (as against the old Prebisch–Singer thesis of deteriorating terms of trade for primary products) postulates that export diversification from primary products to manufactures may not necessarily bring about terms of trade gains for commodity-dependent developing countries because labour-intensive manufactured exports are by and large similar to primary commodities in terms of their world market conditions. For details on this debate and references, see Athukorala (2004).
9. This is not a certainty given the high level of foreign capital participation in export-oriented industries.

10. Calculated using data provided by the Board of Investment.
 11. Estimated using data provided by the Board of Investment.

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