Sri Lanka
State of the Economy Report 2011

Chapter 3
Accelerating Inclusive Growth in Sri Lanka: The Role of the External Sector

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3. Accelerating Inclusive Growth in Sri Lanka: The Role of the External Sector

3.1 Introduction

Sri Lanka's growth cannot be examined in isolation. This is because its economy is intricately interwoven to its neighbours and other countries through commercial, political and cultural links. The sustainability of any growth strategy adopted by the country will depend on the stability of different partnerships and the ability of the country to be resilient to adverse shocks. Given this, any strategy that looks at improving equitable growth will need to take stock of the international environment within which the Sri Lankan economy is functioning.

> ***'Achieving rapid and equitable growth will hinge on the ability of Sri Lanka's export sector to contribute to GDP growth, as well as ensure a healthy earnings of foreign exchange'***

As a small open economy, Sri Lanka is dependent on external demand for its goods and services to sustain domestic growth as well as to earn foreign exchange for its import expenditures. The downturn of the global economy in 2008-09 had its inevitable drag on the country's export earnings, contributing to a lower overall domestic output expansion. However, the global economic recovery in 2010 - with world output growing at 5 per cent compared to a contraction of 0.5 per cent in the previous year, helped by a strong recovery in global trade and investment flows - provided a much more conducive environment for Sri Lanka's own economic expansion. As the country gears up to further strengthen its growth objectives in the medium term, enhanced earnings from the export of goods and services is expected to play an important role in contributing to growth as well as towards a stable external payments position in the medium to longer term.

In this context, the recent decline in Sri Lanka's exports-to-GDP ratio - from 28 per cent in 2004 to 16.7 per cent in 2010 - is a cause for some concern. It suggests that despite the rising earnings from exports in absolute terms, Sri Lanka's higher GDP growth momentum has been coming from sources other than the export sector. Unlike economies with a large domestic market, the extent to which aggregate demand can be stimulated from catering to domestic demand alone remains limited in the case of Sri Lanka. Thus, a renewed effort to encourage faster growth in the export sector is important.

The policy challenges are many. As developed economies - which remain the primary export markets for most developing countries - struggle to recover from the global financial crisis, competition amongst developing country exporters will heighten. Many countries are opting for preferential market access via trading arrangements of one sort or another. Any trade policy reform - be it unilateral, bilateral/regional, or multilateral - will have eventual 'beneficiaries' and 'losers'. Often, adjustment costs for the economy overall are borne in the short term. However, it could well be that long term costs prevail for particular industries or sectors. Thus, the distributional impacts of trade policy cannot be ignored, particularly when Sri Lanka is attempting to achieve not only rapid growth, but a growth process that is both equitable and inclusive to meet its long term post-conflict development objectives. In this context, the Chapter looks at Sri Lanka's recent export performance and future prospects, with a special focus on key export earning sectors in goods and services - viz., garments, tea, and migrant workers.

3.2 Earnings from Exports of Goods and Services: An Overview

Merchandise goods exports saw a strong recovery in 2010 following the downturn in 2009, with overall export earnings growing by 17.3 per cent to record peak earnings of US$ 8,307 million. Industrial exports accounted for nearly 75 per cent of Sri Lanka's total merchandise exports in 2010, with earnings from the textiles and garments subsector accounting for more than 42 per cent. Earnings from the latter grew by 7 per cent despite the loss of tariff benefits from the Generalized System of Preferences (GSP-plus) market access to the European Union (EU) in August 2010. In view of the impending withdrawal of the GSP-plus benefits, industry sources suggest that many manufacturers improved the quality of their products, focusing on higher levels of value addition, and branded products that cater to high-end customers. Sri Lanka's exports of agriculture continue to be dominated by plantation export crops, with tea alone accounting for 16 per cent of total agricultural exports in 2010. The increase in earnings from agricultural exports, led by tea, was mainly due to

Table 3.1
Growth in Goods and Services Exports

	Annual Average Growth		Share[a]
	2005-09	**2010**	**2010**
Agriculture	12.9	18.9	24.6
Tea	13.1	14.1	16.6
Industrial	6.3	14.3	74.3
Food, beverages	26.1	21.8	6.1
Textiles and garments	5.9	5.1	42.2
Services	4.6	30.4	
Transportation	7.4	33.6	46.8
IT	30.0	8.2	10.7

Note: a: Values as a percentage of total goods exports, transportation and IT as a percentage of total services exports.

Source: CBSL, *Annual Report*, various issues.

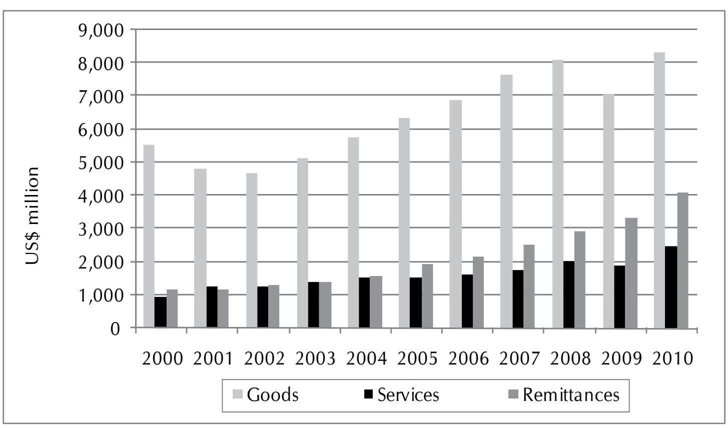
the high prices that prevailed in the international markets throughout the year.

Higher earnings from merchandize goods have been complemented by a rapid growth in services exports, albeit from a lower base. Net earnings from services exports increased by over 78 per cent in 2010 to US$ 698 million, with key sectors such as transportation (accounting for 47 per cent of total services exports) and information technology (IT) showing a rapid recovery. Transportation services growth was attributed to the increase in the number of passengers travelling to Sri Lanka, increase in freight charges collected and improvement in port and airport related other business services. Computer and information services sub-sector also saw gross inflows on account of a pick-up in exports of software, business process outsourcing (BPO) and other IT enabled services (ITES).

Sri Lanka has also benefitted historically from earnings from migrant worker remittances. Unlike other inflows, worker remittances remained relatively healthy during the downturn of 2009 and posted a strong growth of 23.6 per cent. The record inflow of US 4.1 billion in 2010 was in part due to an increase by 8 per cent in the numbers of migrant workers leaving for employment overseas in 2010, compared to a contraction of 1.4 per cent of total placements in the previous year.

However, despite the absolute increase in export earnings, it is of some concern that Sri Lanka's export earnings as a percentage of GDP - a measure of how much export-led an economy is - has been falling continuously in more recent years (Figure 3.2). The exports-to-GDP ratio which stood at 30 per cent in 2000 had declined to 16.7 per cent by 2010. Indeed, Sri Lanka's export penetration - i.e., its share of global merchandise exports - has mirrored this decline, falling from 0.09 per cent in 2000 to 0.05 per cent in 2008.[1] Sri Lanka's export performance vis-à-vis competitors in the Asian region have not been impressive. For instance, in 1990, exports from both Vietnam and Sri Lanka amounted to US$ 2 billion, but by 2008, exports of Vietnam amounted to US$ 61 billion while Sri Lankan exports amounted to approximately US$ 8 billion.[2]

Figure 3.1
Trends in Export Earnings



Source: Compiled using data from the CBSL, *Annual Report 2010*.

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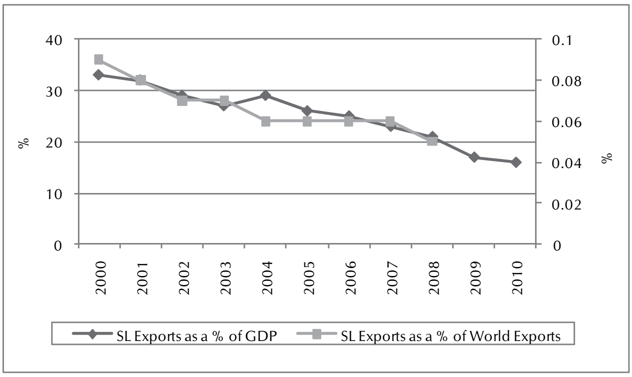
[1] IMF, *Direction of Trade Statistics 2009*.

[2] Kelegama, S., 2011, "WTO Trade Policy Review - Sri Lanka 2010", *Economic Review,* Vol. 36, Nos. 11 & 12, People's Bank.

Figure 3.2
Sri Lanka's Export Share (2000-2010)



Sources: CBSL, *Annual Report 2010,* and IMF, *Direction of Trade Statistics 2009.*

Being a trade dependent country with limited scope to expand aggregate demand through domestic demand alone, Sri Lanka needs to pay careful attention to policies that will over time, raise productivity and thus the competitiveness of the country's exports in international markets. A related issue remains the undiversified nature of both its exports and export markets. If Sri Lanka is to raise its exports and increase its global share, new products as well as new products markets have to be explored and penetrated.

3.3 Emerging Global Economic Environment and Prospects for Exports

The recent global financial crisis and the resultant global economic downturn in 2008/09 is changing the dynamics of the global economy. It has had a debilitating impact on the strength and dynamism of the Western economies. The balance of economic power is shifting decidedly from West to East, with China, India, and East Asian 'Tiger' economies leading the global economic recovery. Global production hubs are shifting to China and India, not only

Table 3.2
Projected World Output (2011-12)

				Projections	
	2008	2009	2010	2011	2012
World output	3.0	-0.5	5.0	4.4	4.5
Advanced economies	0.5	-3.4	3.0	2.4	2.6
US	0.4	-2.6	2.8	2.8	2.9
UK	0.5	-4.9	1.3	1.7	2.3
Euro Area	0.6	-4.1	1.7	1.6	1.8
Japan	-1.2	-6.3	3.9	1.4	2.1
Canada	0.4	-2.5	3.1	2.8	2.6
Emerging & developing economies	6.1	2.7	7.3	6.5	6.5
India	7.3	6.8	10.4	8.2	7.8
China	9.6	9.2	10.3	9.6	9.5
Russia	5.6	-7.8	4.0	4.8	4.5
Brazil	5.1	-0.6	7.5	4.5	4.1
Middle East & North Africa	5.3	1.8	3.8	4.1	4.2
ASEAN-5[a]	4.7	1.7	6.9	5.4	5.7

Note: a: Indonesia, Malaysia, Philippines, Thailand and Vietnam.

Source: IMF, *World Economic Outlook*, April 2011.

because of lower costs, but also increasingly because it is being complemented by improved industrial and technological capabilities.

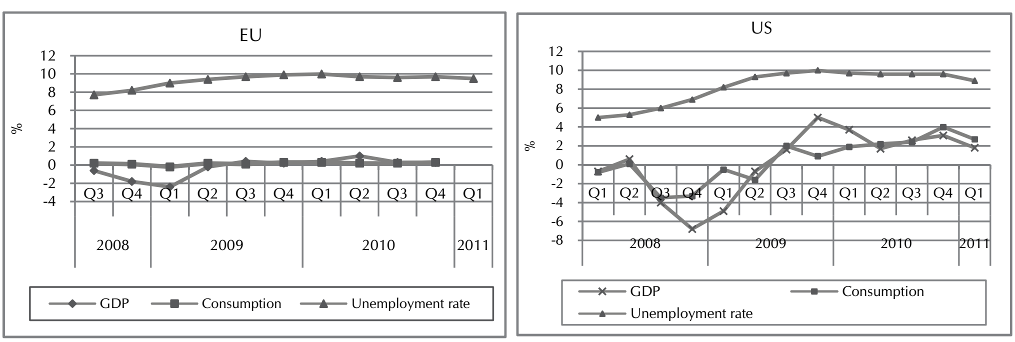
Growth in global economic output is expected to fall from 5 per cent in 2010 to 4.4 per cent in 2011, with both advanced and emerging developing economies expected to see slower growth. The most recent available forecasts suggest that the outlook for 2012 remains unchanged from that of 2011.

The global economic recovery in 2010 was assisted by rising consumption expenditures that was in part helped by stimulus measures that were undertaken by advanced economies. However, despite the growth in consumption expenditures, many advanced economies are grappling with high levels of unemployment. In the US, for instance, the rate of unemployment remained at 9.6 per cent in 2010. For much of the EU, similar rates of unemployment prevailed in 2010.

In many of the advanced countries, output remains far below potential with high unemployment levels and deteriorating fiscal positions plaguing the recovery process. Debt ratios in most advanced countries have been rising with the average general government gross debt-to-GDP ratio projected to breach the 100 per cent threshold for the first time since the aftermath of World War II.[3] On the other hand, in emerging markets where fiscal and financial positions were much stronger at the outset of the crisis, exports have largely recovered. However, the better economic prospects and relatively high interest rates are seeing increasing volumes of foreign capital flowing to these economies. Growing inflationary pressures - amidst rising oil prices at a record two-year high, spurred by social and political turmoil in the Middle Eastern and North African regions - pose challenges to emerging and developing countries. The threats to economic stability in these countries are exacerbated by rising food prices where food consumption makes for a relatively larger share of household consumption. Tighter monetary policies to rein in threats of inflationary build-up are expected to slow down growth in 2011.

The slow recovery in the US and EU is troubling for Sri Lanka. They continue to be the largest importers of Sri Lankan products,

Figure 3.3
EU and US: GDP, Consumption and Unemployment Rates

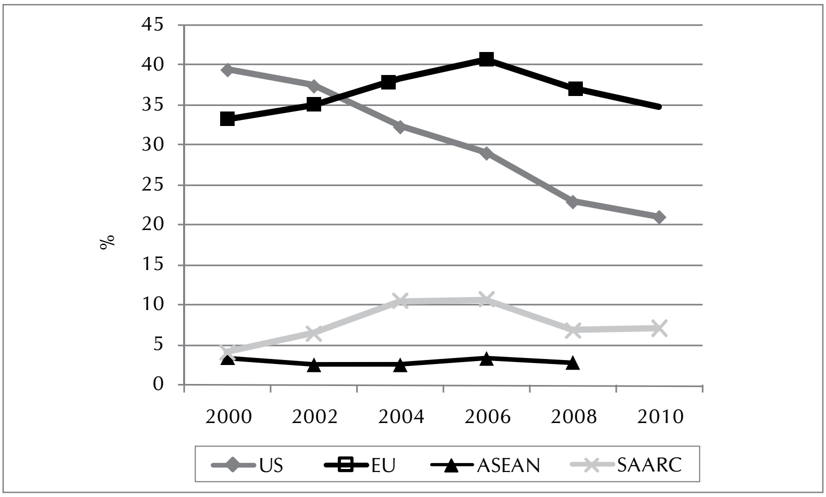


Note: Figures for unemployment are end of period values.

Sources: Euro stat/US Department of Commerce/US Department of Labour.

[3] IMF, *Fiscal Monitor 2011*.

Figure 3.4
Sri Lanka's Share of Exports to US, EU, ASEAN and SAARC



Source: CBSL, *Annual Report*, various issues; and IMF, *Direction of Trade Statistics*, various issues.

attracting 56 per cent of the country's total exports in 2010. Nevertheless, Sri Lanka's share of exports to the US declined from 31 per cent in 2005 to 21 per cent in 2010, while its exports share to the EU has seen a more marginal decline. The increase in share of exports to other Asian economies has been slow, while exports to the Middle East grew faster - rising from 5 per cent in 2005 to 12 per cent in 2010.

It is clear that 2011 is likely to see a lethargic recovery in both US and EU markets and it is something Sri Lankan exporters need to be vigilant of. The country is yet to effectively 'plug in' to the dynamic growth centres that are emerging in its vicinity - India, East and South East Asia, and China. Sri Lanka needs to look at developing stronger linkages with these healthier economies of Asia, explore new trading opportunities, and move away from the excessive dependence on the US and EU. To this end, it is notable that India regained its position in 2010 as the third largest single market for Sri Lankan products, a position it held last in 2007. Stronger links with the other Asian giant, China, would also help. Although Sri Lanka has seen a marginal increase in its exports to China - rising from 0.4 per cent in 2006 to 0.9 per cent by 2010 - much more needs to be done to strengthen export penetration to this rapidly growing market.

Sri Lanka needs to be acutely aware of the tectonic shifts in the centre of gravity of global economic power that are gradually taking place. Although earlier touted as the new platform for international economic co-operation, the G20 - the grouping of the richest Western economies and the most commercially important emerging economies set up as a joint initiative to tackle the global economic crisis - does not appear to have much longevity beyond the crisis response efforts it originally mandated itself to do. Rather, what is now emerging as a key power bloc is the BRIC (Brazil, Russia, India, and China) group. The BRIC countries, which showed strong resilience during the global economic crisis, account for 45 per cent of the world's population, 25 per cent of global GDP, and an estimated 60 per cent of the world's foreign currency reserves. In its most recent summit in April 2011, South Africa was invited to join the grouping (and expanding the 'BRIC' to 'BRICS'), further solidifying the grouping as a powerful player on the global stage. BRICS have agreed to lend to each other in their own currencies, rather than dollars, and have managed to successfully lobby for greater representation in supranational bodies like the IMF and World Bank.

This gradual emergence of the BRIC could, eventually, provide an effective platform for developing countries as a whole to rally around, link up productively through its own, albeit relatively weak, G-15 group, and thus find a stronger voice in the global economic arena. This has direct implications for smaller developing economies like Sri Lanka. Despite being unassociated with the initial financial markets crisis, developing countries like Sri Lanka were badly hit by the global downturn that followed, and therefore has a strong desire to see the developing world gain a stronger voice in reforming the world economic order. By finding ways to strategically link up to this type of new, stronger 'South-South' cooperative voice, Sri Lanka could create more avenues to seek support for its economic goals internationally.

3.4 Inclusive Growth: The Distributional Impacts of Trade

Sri Lanka's trade policy continues to be aimed at achieving greater integration into the global economy through multilateral, regional and bilateral trade arrangements, through an incentive regime consisting of rationalization of tariffs geared to encouraging exports and attracting foreign direct investments, and a number of development programmes to improve infrastructure, with the twin objectives of enhancing competitiveness and market access.

In the more recent past, Sri Lanka has seen its tariff regime become more opaque with an increase in the number of tariff bands as well as the introduction of para-tariff measures on an increasing number of imported products.[4] In June 2010, and thereafter through the 2011 Budget announced in November 2011, the government relaxed the import tariff regime to a limited extent by lowering some import tariff rates, restructuring tariff bands, and removing some indirect taxes. Nonetheless, the import tariff regime continues to be riddled with para-tariffs. In addition to unilateral tariff reforms, Sri Lanka's commitments under its bilateral and regional free trade agreements have required the adjustment of import tariffs for related trade partners.

Trade reforms create distributional impacts, depending on how different sectors in the economy are affected. Some sectors will benefit from improved competitiveness and greater market access - i.e., by reducing distortions in relative prices, and allowing those activities with a comparative advantage to expand. However, there will be other sectors that will be adversely affected by international competition - the removal of trade barriers leads to a decline in the value of assets of protected industries and the loss of jobs in those industries. Trade policies will create 'winners' and 'losers' - benefitting some, while in the short term adversely affecting others, with attendant adjustment costs and distributional effects.

The primary focus of literature that examines the distributional aspects of trade has been on identifying the means by which trade and poverty are linked through economic growth. Trade can affect poverty and distributional outcomes through multiple channels including economic growth, prices of goods and services consumed by households, livelihoods of the poor and income earning ability, vulnerability to shocks and effects on government revenue.

[4] Pursell, Garry and F.M. Ziaul Ahsen, 2011, "Sri Lanka's Trade Policies: Back to Protectionism", ASARC Working Paper 2011/03.

During the past five decades, developing countries have experienced important changes in their trade policies, providing a useful source of empirical evidence on the nexus between trade, growth and poverty.[5] Some evidence suggests that trade openness triggers growth, and that growth is a central driver of poverty reduction. But there is also evidence that suggests that economic integration into the world economy can be the result of successful and inclusive growth and development, rather than a prerequisite for it - i.e., that inclusive growth processes can lead to trade openness and economic integration into global markets.[6]

There is little doubt that changes in trade flows, directly or indirectly, affect the welfare of households. The impact of trade reform on poverty and distributional outcomes appears to depend on a combination of pre-existing conditions - such as geography, market size, and institutional capacity - and complementary policies (education, infrastructure, financial and macroeconomic policies) designed to help the poor participate in the positive opportunities that emerge while protecting them from the most harmful consequences.

For Sri Lanka, greater trade openness has had many positive impacts, including the generation of significant employment and income earning opportunities. The benefits in aggregate in sectors such as garments are clear. It provided useful foreign exchange earnings and opened new channels of employment opportunities to young, unskilled female labour. Similarly, 73 per cent of outgoing migrant workers in Sri Lanka is estimated to be from outside the Western Province, while 67 per cent were either unskilled workers or housemaids.[7] The experiences of both the garments sector and migrants suggest that a large proportion of workers from rural or poor backgrounds benefitted. Indeed, the presence of a family member abroad is estimated to have a significant marginal effect in reducing the likelihood of a household being poor.[8] Remittances are also found to have helped increase expenditure and investment in health and education of beneficiary households and have provided security from external shocks.[9]

However, outcomes in other export sectors are less clear. Whilst tea exports have historically provided much needed foreign exchange earnings, the estate sector population has remained mired in poor socio-economic conditions. Additionally, those sectors most open to trade and investment opportunities - centred in urbanized settings - have also led to widening output gaps and related poverty indicators across sectors and provinces of the country. Thus, complementary policies to address the distributional implications of external trade promotion should not be ignored.

3.4.1 Pro-Poor Growth: Manufacturing or Services Sector?

Growth that is driven by expansion of output in manufacturing is often considered to have beneficial impacts on addressing poverty and inequity given its potential to

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[5] See Dollar, D., and A. Kraay, 2004, "Trade, Growth and Poverty", *The Economic Journal*, 144(493), pp. 22-49; Ravallion, M., 2005, "Looking Beyond Averages in the Trade and Poverty Debate", Policy Research Working Paper 3461, World Bank, Washington, D.C.

[6] Chang, H.J., 2007, *Bad Samaritans,* London: Random House Business Books; Rodriguez, F. and D. Rodrik, 1999, "Trade Policy and Economic Growth: A Skeptic's Guide to the Cross-Country Evidence", Discussion Paper Series 2143, CEPR, London.

[7] Sri Lanka Bureau of Foreign Employment, *Annual Statistical Report 2009*.

[8] World Bank, 2007, *Sri Lanka Poverty Assessment*, World Bank, Washington, D.C.

[9] Arunatilake, N., P. Jayawardena and D. Weerakoon, 2011, "Sri Lanka" in Kelegama, S., (ed.), *Migration, Remittances and Development in South Asia*, Sage Publications, New Delhi.

generate employment for unskilled labour - an abundant factor of production in many developing economies where a sizeable proportion of such workers are considered to represent low-income segments of the population.

Overall, employment growth in Sri Lanka's industrial sector has been better than that of the services sector in recent years.[10] However, productivity in the former has lagged behind that of the latter, which is clearly a concern in terms of the ability of the industrial sector to generate productive employment opportunities. Nonetheless, the export-oriented manufacturing sector has been an important source of job creation. Indeed, the industry is estimated to provide over 300,000 in direct employment as well as another 1 million in indirect employment. The industry expects to create job opportunities for a further 20-30,000 over the next five years in the face of an anticipated expansion of factories. A further positive approach is the stated intention of the Joint Apparel Association Forum (JAAF) to employ rural youth in regional factories. In turn, this is likely to address long recognized problems associated not only with rural employment, but also living conditions for factory workers who are often forced to move in search of employment and make such job opportunities more attractive.

The government's focus on promoting small and medium enterprises (SMEs), if effective, will also help in generating manufacturing output and employment. SMEs have gained wide recognition as a critical source of employment, especially for the poor. In Sri Lanka, SMEs make up more than 80 per cent of all businesses, account for about 35 per cent of employment and about 20 per cent of total industrial value added.[11] Whilst they may not always be direct exporters - in the garments industry, for instance, around 80 per cent of factories are categorized as SMEs according to the value of exports, but they account for less than 30 per cent of total export earnings - SMEs are an important source of inputs for many export industries. However, nearly 80 per cent of SMEs are estimated to be located in the Western Province inhibiting its contribution to promote a more regionally balanced development process.[12]

Besides the industrial sector, the services sector has also been a significant contributor to economic growth in Sri Lanka in the recent past. Unlike manufacturing, however, the services sector tends to generate employment for higher skilled workers, which may in part account for the greater productivity gains in the services sector at the aggregate level. The most rapidly expanding services sector has been in telecommunication, banking, IT, finance, etc. As Sri Lanka turns increasingly to promote services-oriented export activities - including efforts to develop the country as a hub for select services - the employment opportunities that will be generated will most likely require a higher skills profile that could have broader distributional and equity issues in the country.

3.4.2 Trade and Gender Linkages

Trade openness can create economic opportunities, but because of different endowments, control over resources, access to labour markets and varying roles within the household, there can be significant gender differences in any accruing benefits.[13] Sri

[10] See Chapter 4 of this report on "Imperatives of Inclusive Growth".

[11] World Bank, 2005, International Finance Corporation (IFC) Survey 2005.

[12] Munisada, K.L.D.H, 2008, *Best Practices on SME Development and Management in Sri Lanka*, Asian Development Bank Institute,Tokyo.

[13] Maurizio, Busoolo and E. De Hoyos Rafael, 2009, *Gender Aspects of the Trade Poverty Nexus: A Micro-Macro Approach*, World Bank, Washington D.C.

Table 3.3
Informal Private Tea Sector Daily Wages by Gender

Year	Annual Average (Rs.)		Percentage Change			
			Nominal		Real[a]	
	Male	Female	Male	Female	Male	Female
2006	333	234	10.9	7.9	-2.8	-5.8
2007	375	263	13.8	11.5	-3.7	-6.0
2008	440	305	17.4	16.1	-4.2	-5.2
2009	488	356	10.9	16.5	7.2	12.6
2010	543	391	11.3	9.9	5.0	3.7

Note: a: Real wage changes are based on CCPI (2002 = 100).

Source: CBSL, *Annual Report*, various issues.

Lanka is an interesting case study of gender dimensions of trade and poverty, given the fact that women from rural areas and deprived communities dominate the labour force of the significant export earning activities - garments, migration and tea. At present, women account for over 70 per cent of the labour force in the export garments sector and over a half of the labour migrants are women. There is clear indication that greater employment opportunities for women have had a significant impact on patterns of employment in Sri Lanka. The female labour force participation rate increased substantially from 25.8 per cent in 1980 to 39.5 per cent by 1990 and stood at 32.1 per cent in 2010.

However, a majority of these women are to be found in low skilled categories where wages are relatively low. Furthermore, even though significant employment opportunities for females are present, opportunities for upward mobilization of labour is extremely limited or almost non-existent. In the garments industry, for instance, it has been found that female career development has been trapped at low level employment categories, whereas male workers have more opportunities for upward mobility and access to upper or middle level employment categories.[14]

Males continue to dominate in senior and middle manager categories accounting for 85 and 69 per cent of employment, respectively.[15] Thus, the garment sector provides a good example of a case where men and women appear unable to take equal advantage of trade opportunities. The same is true of the estate tea export sector as well. Even though it generates significant employment for female workers, it is mostly very low-skilled employment that yields low incomes. Gender wise informal private sector daily wages in the tea sector show that not only do males earn higher wages than females, but that males tend to also enjoy a higher percentage increase in both nominal and real wages compared to females (Table 3.3). However, trade policy alone is not to blame. The structure of the industry, as well as the incentives and contracts that govern relations between employees and employers, matter. The nature of 'resident labour' in the estate sector as opposed to tea smallholders - where socio-economic outcomes are much better - lends support to this argument.

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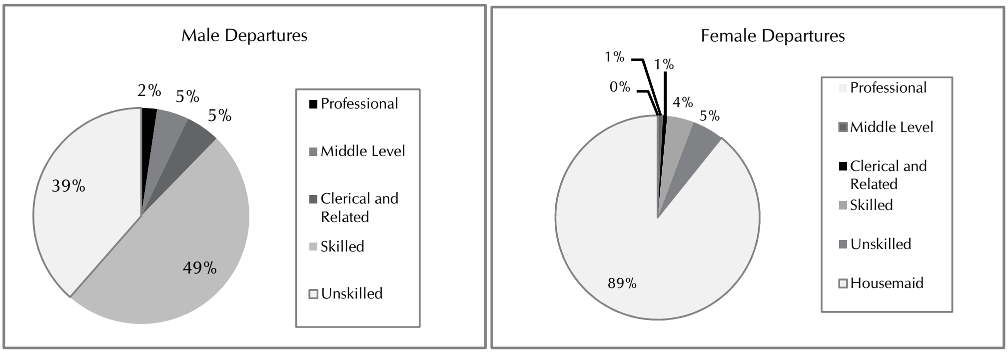
14 Jayaweera, S., 2005, "Continuity and Change: Women Workers in Garment and Textile Industries in Sri Lanka", [http://reseau.crdi.ca/en/ev-58039-201-1-DO_TOPIC.html]

15 Chandrasiri, S., 2009, *Promoting Employment-Intensive Growth in Sri Lanka: Policy Analysis of the Manufacturing and Service Sectors,* International Labour Organization, Geneva.

Figure 3.5
Departures for Foreign Employment by Sex and Manpower Levels: 2009



Source: SLBFE, *Annual Statistical Report 2009*.

Trends in foreign employment in Sri Lanka also demonstrate notable differences between males and females. In 2009, while almost a half (46.8 per cent) of migrant males were skilled workers, the corresponding figure for females was a mere 4.2 per cent. Housemaids were the dominant source of female migration, accounting for 89 per cent of the total. This gives an indication of the higher earning potential as well as the better working and living conditions of male migrants compared to females.

3.5 Trade and Inclusive Growth in Sri Lanka: Tea, Garments and Remittances

As Sri Lanka looks to raise its long term GDP growth rate to 8 per cent and above, the country's export sector will be expected to play a critical role. Three of the country's main foreign exchange earners through the export of goods and services - garments, tea and remittances - will also hold significant distributional implications for the economy as a whole. The rest of the section will analyze the emerging global environment for each of the sectors and Sri Lanka's potential to further raise export earnings in the coming years.

3.5.1 Garment Sector

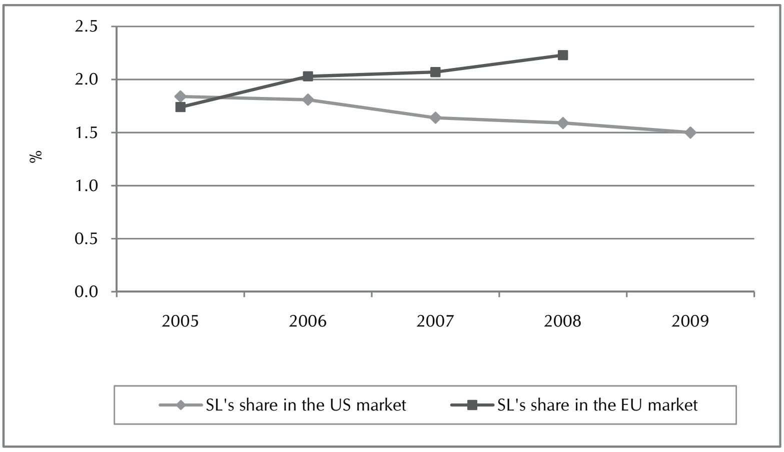
As previously noted, the textile and garments (T&G) sector accounts for 42 per cent of Sri Lanka's total exports. The garments sector alone is estimated to provide employment to 351,762 workers, making up 41 per cent of total industrial employment in the country.[16] However, 74 per cent of garment industry firms and 73 per cent of employment in such firms is to be found within the Western Province.[17]

Despite the withdrawal of GSP-plus concessions by the EU in August 2010, earnings from T&G exports increased by 7 per cent to US$ 3,504 million in 2010. The EU attracted almost 51 per cent of Sri Lanka's total garment exports in 2010 while the US attracted 41 per cent. The increase in garment export earnings despite a decline in the volume exported, suggests the export of high value products to niche markets. This seems to support suggestions that the industry is aiming to improve the quality of products and productivity in order to face stiffer competition, especially in view of the loss of GSP-plus concessions in the lucrative EU market. Other measures include attempts to

[16] DCS, *Annual Survey of Industries 2009*.

[17] *Ibid.*

Figure 3.6
Sri Lanka's Export Share in the US and EU T&G Markets: 2005-09



Source: International Textiles and Clothing Bureau.

cater to high end customers and focus on branded products.

Nonetheless, the steady inroads that Sri Lankan garments exporters had been making into the EU market may see a slowdown with the withdrawal of the tariff concessions. Indeed, the increase in export earnings over the years has been due largely to a shift in Sri Lankan garments exports from the US to the EU. In contrast to Sri Lanka's success in penetrating the EU market, Sri Lanka has been seeing a steady decline in its market share in the US, from 1.8 per cent in 2005 to 1.5 per cent in 2009. For the longer term interests of the industry, it is imperative that market diversification takes place. In this respect, Sri Lanka has made rapid inroads into new markets such as Turkey and Slovakia (Table 3.4).

For Sri Lanka, of immediate concern is the slow recovery in key markets of the US and EU. After having declined by over 5 per cent in 2009, the US apparel market regained momentum with a 2 per cent increase for

Table 3.4
Top Ten Destinations of Sri Lanka's Garment Exports

Rank	2005		2009	
	Country	Value (US$ mn.)	Country	Value (US$ mn.)
1	US	1633	US	1285
2	UK	603	UK	844
3	Italy	139	Italy	349
4	Germany	85	Germany	178
5	Belgium	58	Belgium	69
6	France	44	Netherlands	59
7	Canada	40	France	57
8	Netherlands	28	Canada	42
9	Spain	19	Turkey	29
10	Japan	12	Slovakia	20

Source: Export Development Board, 2010, *Export Performance Indicators 2000-2009*.

2010.[18] In the year ending June 2010, EU clothing imports is estimated to have fallen in value to their lowest level since 2006 (and to the lowest in volume terms since 2005).[19] Also, the average import price fell after rising a year earlier. Sri Lanka will face stiffer price competition in these markets, even as apparel exporters to the EU from Bulgaria, Kosovo, Macedonia and other Balkan countries enjoy a number of competitive advantages, including quicker transportation time, lower transportation costs and zero duty on entry to the EU.

For Sri Lanka, infrastructure investment that is currently under way is expected over time to improve road and rail linkages, make available cost-effective and reliable supply of energy, etc. Such efforts will be critical to enhance the price competitiveness of the country's exports in the medium to longer term. Indeed, the critical need to invest in efforts to improve trade facilitation is well recognized. Recent studies, for instance, have suggested that a 10 per cent reduction in delays in exports by a country can see its exports rising by as much as 4 per cent.[20]

The benefits or otherwise of other forms of support offered by the government - investment incentives and a number of established and fully serviced industrial zones, estates and parks - are yet to be fully determined. The industry too is attempting to do its share with the undertaking of several campaigns such as 'Garments without Guilt' (for good labour conditions) and the introduction of 'Green Garments' to exploit Sri Lanka's other comparative advantages vis-à-vis its competitors.

3.5.2 Tea

The tea sector recorded its highest ever annual production of 329 million kgs in 2010, surpasing the previous all time high of 319 million kgs in 2008. Correspondingly, Sri Lanka earned a record US$ 1,375 million. Despite Kenya exporting a higher volume of tea than Sri Lanka, higher prices for 'Ceylon tea', and value addition helped

Table 3.5
Main Export Markets for Sri Lankan Tea

Country	2010 ('000 kg.)	2005 ('000 kg.)	Export Share (%) 2010	Export Share (%) 2005
Russia	50,172	57,648	16	19
UAE	30,201	38,180	10	12
Iran	28,675	24,948	9	8
Syria	27,186	27,670	9	9
CIS countries[a]	26,259	13,430	8	4
Turkey	19,032	17,241	6	6
Jordan	17,620	12,057	6	4
Iraq	13,899	10,784	4	3
Kuwait	11,470	3,012	4	1
Japan	10,855	8544	3	3

Note: a: CIS countries excluding Russia.

Source: CBSL, *Annual Report*, various issues.

[18] International Trade Administration, Office of Textiles and Apparel.

[19] *Ibid.*

[20] Djankov et al., 2008, "Trading on Time", available at http:espanol.doingbusiness.org/Documents/ TradingOnTime_APR08.pdf.

Sri Lanka obtain higher export earnings. Encouragingly, a higher percentage of exports of nearly 65 per cent consisted of value added teas, while the rest were in bulk form. In the global tea market, Sri Lanka retained its position as the third largest exporter in volume terms after Kenya and China.

Middle Eastern countries, Russia and the other Commonwealth of Independent States (CIS) are the main tea export markets for Sri Lanka (Table 3.5). Globally, Russia, UK, US, UAE and Egypt are the largest buyers of tea. However, Sri Lanka's market share for tea in some of the key export markets has shown an indifferent performance. In the case of Russia, while Sri Lanka remains the primary supplier, the market share has declined from 41.9 per cent in 2006 to 29.9 per cent in 2010 (Figure 3.7). Similarly, Sri Lanka's market shares in UAE and in Iran have also gradually decreased. However, while Sri Lanka is losing its market share in its larger export markets, it may be gaining in relatively smaller markets. For example, in the case of Turkey, the market share has increased from 58.7 per cent in 2005 to 62.6 per cent in 2009. While seeking new markets, Sri Lanka must also ensure that it is not losing ground in major tea consuming countries.

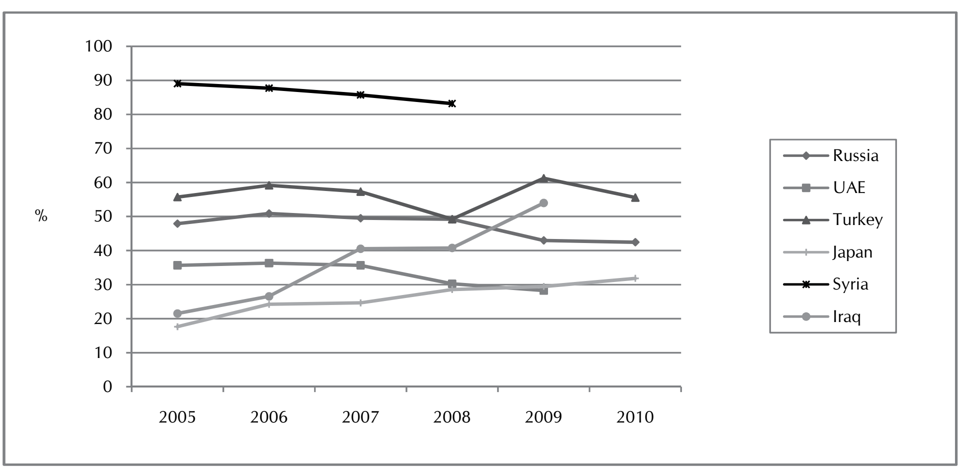
Sri Lanka's tea industry should also take cognizance of emerging trends in consumer preferences. In the EU, for instance, the trend towards convenience and smaller portions has led to an increasing demand for products like instant tea pods, tea-for-one bags, and iced tea. Increasing environmental and social awareness has directed more consumer attention to 'sustainable' tea. Health concerns have also seen the growth of organic products, along with market demand for organic certification.

Additionally, European consumers are calling for more variety and specialties, including a rise in demand for green tea. While Sri Lanka's green tea production has risen in recent years - from 2.2 million kg in 2006 to 3.3 million kg to 2010 - it is still of marginal importance. Herbal tea consumption is also on the rise. Other trends include a growing demand for tea packs containing various flavours, particularly in markets such as the EU.

3.5.3 Remittances

Inward worker remittances continued its position as the prime foreign exchange earner in 2010, recording inflows of US$ 4.1 billion - an increase of 23.6 per cent

Figure 3.7
Sri Lanka's Market Share in Major Tea Markets: 2005-2010



Source: ITC Trade Map data.

compared to the previous year. The number of outbound migrant workers increased by 8 per cent compared to the 1.4 per cent decline of total placements in the previous year. On a global scale, remittance flows to developing countries are estimated to have fully recovered to the pre-crisis level of US$ 325 billion in 2010.[21] In line with a recovering but still fragile global economy, remittance flows to developing countries are expected to increase in 2011-13, but at lower rates compared to the pre-global crisis period.

With the government promoting skilled labour migration, there is a notable growth in the number of migrants in the categories of professionals, middle level, clerical and skilled workers (Table 3.6).[22] Correspondingly, Sri Lanka has seen a decrease in the share of housemaids leaving for foreign employment over time; in turn, this has also had the impact of changing the gender composition of the migrant labour force away from women and towards more male migrants. Typically, females make up only a very small share of the more skilled categories of migrant workers. The change in the skills profile of migrant workers is expected to lead to higher remittance inflows in the coming years.

Middle Eastern countries continue to attract a majority of workers, accounting for 90 per cent of total departures in 2010 and 60 per cent of workers' remittances (Figure 3.8). The Maldives, Cyprus, South Korea, Singapore and Malaysia are the other emerging host countries, particularly for semi-skilled workers.

Despite the current political and social unrest in the Middle East, it is not expected to have a notable impact on remittances as the major destination countries of Sri Lankan workers in the Middle Eastern region remain stable. An escalation of oil prices that raises the living standards of oil producing countries in the Middle East may also help increase remittance inflows via enhanced employment opportunities, especially in skilled and professional labour, as well as the prospect of higher wages. In addition to external factors, Sri Lanka has also taken measures to improve working conditions for its migrant population by entering into collective agreements with employers. The post-conflict development of financial services in the North and East of the country is also expected to yield significant benefits in terms of adding to remittance flows in the coming years.

Table 3.6
Departures for Foreign Employment by Manpower Levels and Sex: 2005 & 2009

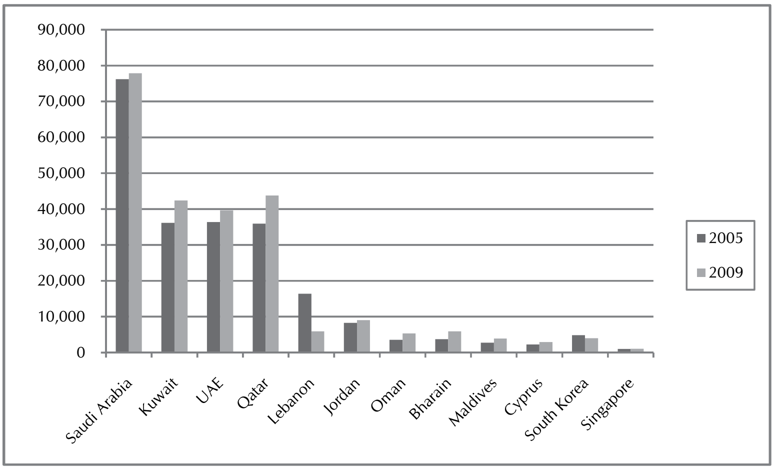
	2005		2009	
	Male	**Female**	**Male**	**Female**
Professional	1,324	97	2,689	133
Middle level	7,150	892	5,407	985
Clerical and related	6,988	754	5,869	837
Skilled labour	39,882	6,806	55,846	5,384
Unskilled labour	38,552	3,352	43,791	6,367
Housemaid		125,493		113,777

Source: SLBFE, *Annual Statistical Report of Foreign Employment 2009*.

[21] World Bank, 2010, *Migration and Remittances Factbook 2011*.

[22] It should be noted that this is likely to be an underestimate. It is mainly unskilled workers and housemaids that register with the SLBFE, while workers migrating independently do not necessarily register themselves.

Figure 3.8
Top Destinations of Labour Migrants from Sri Lanka by Country



Source: SLBFE, *Annual Statistical Report of Foreign Employment 2009*.

Whilst the policy approach to send higher skilled workers is appropriate, Sri Lanka also needs to ensure that domestic labour market conditions are taken into consideration. For instance, it is estimated that Sri Lanka has the highest expatriation rate of doctors and the third highest expatriation rate of nurses to the OECD.[23] This is in spite of recognized skills shortages in the country in certain health care services. Therefore, while recognizing the potential for trained labour to earn higher remittances, it is also important to consider the downside impact on equitable access to services domestically.

3.6 Conclusion

The success or otherwise of achieving Sri Lanka's long term post-conflict development objectives - rapid and equitable growth - will hinge in no small measure on the ability of the country's export sector to contribute to GDP growth, as well as ensure a healthy earnings of foreign exchange for the country. In this respect, the strong recovery in key export earning sectors in 2010 - in merchandise goods, services, tourism, and migrant remittances - is a positive development. However, it is also noteworthy that Sri Lanka's recent export performance overall is of some concern. Rising export earnings in absolute terms has not been commensurately matched by an increase in the country's exports-to-GDP ratio. It suggests that despite higher GDP growth in the interim, growth has not been led by exports which can be problematic for a small open economy that clearly has a very limited domestic market to support a sustained expansion of aggregate demand. Notably, Sri Lanka has also been losing ground in penetrating export markets vis-à-vis its competitor countries, seeing a gradual lowering of its share of global trade in recent years.

The policy challenges to provide a conducive environment to promote an export-push are many. A key area of concern in this regard is ensuring that export competitiveness is not adversely affected by an appreciating real exchange rate. Sri Lanka's nominal

[23] Dumont, J.C. and P. Zurn, 2007, *Immigrant Health Workers in OECD Countries in the Broader Context of Highly Skilled Migration*, International Migration Outlook, Paris.

exchange rate movements in the recent past have been dominated by capital account transactions that have little bearing on aggregate demand for the country's goods and services overseas. Additionally, while the ongoing accelerated infrastructure development in the country will certainly ease some of the constraints - in energy, transport, telecommunications, etc., - more needs to be done to provide a supportive regulatory environment, be it in developing a dynamic SME sector or attracting export and knowledge-enhancing inflows of FDI. Efforts to ensure that investors find the necessary pool of skilled labour, flexible and efficient labour market conditions, transparent governance structures, etc., will prove as critical as a stable policy and political environment to encourage the export sector. Higher earnings from the country's historical channels of foreign exchange and emerging new areas hold the potential to not only support growth, but also to meet the government's efforts to ensure that the benefits of that growth are equitably distributed.