Globalization 6

Globalization and Sri Lanka

By Kanes

The economy of Sri Lanka has been liberalized gradually over the last 20 years. Tariffs, trade restrictions and taxes have been reduced, prices have been decontrolled, business has been deregulated, state sector has been emasculated and a plethora of incentives and concessions have been offered to foreign capital mainly under the guidance of the IMF. The enabling environment for private investment, in particular foreign investment was thereby created. The government further announced in no uncertain terms that the private sector would be the engine of growth and doors would be wide open for foreign capital to flow into the country. The underlying objective of the government was to integrate the country with the global market in order to reap the much-advertised benefits of trade and investment. Has the country reaped these benefits?

Low Economic Growth

The best index of prosperity is the rate of economic growth, and it appears that Sri Lanka has experienced only a moderate rate of growth in the years of liberalization. The average economic growth in the entire period of 19 years of the open economy from 1980 to 1998 was only 4.7 per cent and this was at a time when the world economy was growing and world trade was expanding rapidly. Actually, average growth was 4.2 per cent in the 10 years 1980- 1989 and rose to 5.2 per cent only in the last nine years 1990-1998. By contrast, South Korea, Taiwan, Hong Kong and Singapore -the Asian Tigers - had sustained growth of around 9 per cent a year for about 37 years 1960-1996 and South East Asian countries 8 per cent.

The major cause of this moderate growth was the low level of investment, particularly foreign investment. Sri Lanka's average domestic investment in the last five years was around 25 per cent of GDP whereas it was 35 to 40 per cent of GDP in East and South East Asian countries. The average annual inflow of foreign direct investment in the last five years 1994-1998 was $105 million or about 3 per cent of the total domestic investment and 0.75 per cent of GDP. By contrast, average annual foreign direct investment in Malaysia in the five years 1991-1995 (before the crisis) was as much as $4870 million or 46 times the amount received by Sri Lanka. In 1996 for instance, foreign direct investment inflow to Sri Lanka was $80 million which was equal to 0.6 per cent of GDP while in Malaysia it was $4500 million or 4.5 per cent of GDP. Thus, Sri Lanka has not attracted much foreign investment as it expected from liberalization.

The little foreign investment that flowed into the country appears to have gone mainly into the garments export industry, partly because of low wages and partly because of the country's unutilized garments export quotas in US. Thus, the country's industrial exports rose from 19 per cent of the total exports to 75 per cent in the last 15 years; it is significant that 62 per cent of the industrial exports consisted of garments and 7 per cent textiles. Industrial exports (mainly garments) did well as they rose by eight times in the last ten years. Globalization may have thus helped to expand the textile and garments industry but, it failed to develop other industries to diversify the export base. Garments and textile exports which formed 62 per cent of the country's industrial exports in 1988 increased to 69 per cent in 1998 making Sri Lanka excessively dependent on one industry. In the Philippines, by contrast, electronic and electrical products rose from 21 per cent of total exports to 58 per cent between 1988 and 1998 while the share of garments fell from 19 per cent to 8 per cent.

The excessive dependence on one export - garments - was brought home in 1998 and in the first half of 1999. Sri Lanka's textile and garments exports had risen in value by 20 per cent in 1997 but increased by only 8 per cent in 1998. The situation deteriorated further in the first half of 1999 when the value of textile and garments exports was 4.1 less than in the first half of 1998. This contributed to the decline in total of overall economic growth in the first half of 1999.

Poor Performance of Commodity Exports

If globalization helped to expand the garments industry, it has clearly failed to stimulate agricultural exports. While industrial exports rose in value by eight times, agricultural exports have increased by only three times in the last ten years. The modest increase in agriculture exports was mainly due to one export crop - tea. While the production of tea increased by 35 per cent in the last ten years, that of coconuts rose marginally by 3 per cent and that of rubber actually declined by 14 per cent. The picture is a little different if we take the last five years 1994-1998; tea production increased by 16 per cent but coconut production fell by 3 per cent and rubber production fell by 9 per cent. The volume of exports of several minor agricultural crops too declined in the last five years: vegetables by 53 per cent, fruits 38 per cent, coffee 64 per cent cinnamon 15 per cent, cardamom 38 per cent, betel leaves 28 per cent, manufactured tobacco by 26 per cent and other minor agricultural products by 68 per cent. The overall picture in the last five years is that industrial exports rose in volume by 32 per cent while agricultural exports increased by only 10 per cent.

Domestic Agriculture

The last five years have witnessed a deterioration of domestic agriculture, mainly as a result of globalization and free trade. The liberalization of imports by reduction or removal of tariffs and non-tariff restrictions has resulted in a flood of imports, which has undermined domestic agriculture. Production of the major food crops has either fallen or stagnated as shown in the table. The staple food crop paddy has virtually stagnated in the last five years, production in 1998 of 2,692 million metric tons being almost the same as in 1994. Sugar production has fallen by 15 per cent in the same period - to 61,549 metric tons; it met only 10-12 per cent of domestic consumption. The biggest fall in production was in subsidiary food crops which had to face competition from liberalized imports. Production fell by more than half in Big onions, Red onions, Potatoes, Chillies, Groundnuts and Soyabeans; it fell almost by half in maize and significantly in black gram, cowpea, green gram and kurakkan as shown in Figure 1

Fig. 1: Production of Food Crops 1994 - 1998 (MT' 000)

	1994	1998	% Change
Paddy	2,684	2,692	0.3
Sugar	72	62	-14.8
Big Onions	81	17	-78.6
Red Onions	82	38	-53.8
Potatoes	71	26	-63.3
Chillies	32	16	-51.1
Maize	67	23	-49.6
Kurakkan	5	4	-13.7
Green Gram	23	16	-31.9
Cowpea	18	13	-25.6
Black Gram	15	8	-43.4
Groundnuts	16	6	-61.4
Soyabean	3	1	-81.3

Production of Food Crops 1994-1998 (MT' 000)

Sri Lanka has the potential to be self-sufficient in all these food crops provided the "enabling environment" is created to stimulate the farming population. The policy of trade liberalization to integrate with the global market or to globalize however prevents the creation of this enabling environment. The liberalized imports in accordance with this policy may keep the consumer happy but is disrupting domestic food production, and impoverishing the rural production with frightening social consequences. The rural farmers are unable to produce these goods at prices competitive with imports without protection. Free imports are adversely affecting other food items too: recently tomato producers blamed the free import of tomato juice for the unremunerative prices they receive and poultry and egg producers protested against the policy of importing these products and depressing their prices. Unrestricted imports of fruits - apples, oranges, mandarins and grapes - and fruit juices - apple juice, orange juice and grape juice - are threatening the country's horticultural and fruit processing activities; already, the influx of cheap oranges has virtually driven out the local green oranges from the market.

Domestic Industry

Import liberalization has also undermined several domestic industries such as handloom textiles, electrical appliances, fabricated metal products, chemicals, bicycle tyres, spectacle frames, printing paper and dairy products. The recent abolition of the 35 per cent tariff on textiles dealt a crushing blow to the local textile industry which if protected and upgraded could save Rs. 82 billion spent annually on textile imports to the garments industry. The depreciating rupee has given some protection to local industries but not to those dependent on imported inputs which have increased in price with depreciation. The unrestricted imports of electrical appliances such as refrigerators, has led to the closure of one local refrigerator maker; the import of wooden and cane furniture has adversely affected the sale of high-class local furniture; bathroom fittings, water taps, sanitary ware, hardware are hardly produced locally now on account of cheap imports; tea machinery which was made here and exported to Kenya and Indonesia is now being imported from India. Coconut oil mills are being closed on account of the free import of palm oil whose tariff has been reduced from 35 per cent to 5 per cent. Several small-scale manufacturers have found it more profitable to import and sell goods than to manufacture them locally. Instead of encouraging and supporting both export- oriented development and import-substitution the authorities appear to have overemphasized export growth and neglected import substitution.

External Effects

The integration with the global economy has increased Sri Lanka's exposure to the world market forces and made its economy more vulnerable. The export-led growth has suffered a setback from the economic recession caused by the East Asian currency crisis. The country's exports as mentioned earlier are falling in value partly owning to reduced external demand arising out of the recession and partly owing to the increased competition from South East and East Asian countries with depreciated currencies. The most seriously affected are the garment exports, which contributed to high export growth in recent years. Economic growth in most countries in 1999 will be lower than in 1998 and this includes the developed countries. Sri Lanka's principal export market is USA whose lower growth is expected to reduce the demand for Sri Lanka's exports such as garments while the recession in Japan has already reduced the demand for Sri Lanka's exports such as diamonds. The depreciated currencies of East and South East Asian countries in addition have made their exports more competitive and this has affected the competitiveness of Sri Lanka's exports such as garments, rubber and coconuts. Consequently, the value of total exports which had increased by 13.3 per cent in 1997 rose by only 2.1 per cent in 1998 and export volume which increased by 11 per cent in 1997 rose marginally by only 0.1 per cent in 1998. The prospects have become even more unfavourable with the exports in the first half of 1999 being 9 per cent lower than those in the first half of 1998. The country's external assets, reflecting the fall in exports, have declined by 7.6 per cent in the first six months of 1999.

The integration of financial markets, by liberalizing exchange restrictions, transmitted through the contagion effect, the Asian financial crisis to other countries and regions. Sri Lanka was also affected but not much because of the limited role foreign funds play in the share market and commercial lending. Portfolio investment of foreigners which had risen by Rs 356 million in 1996 and Rs. 749 million in 1997 reversed in 1998 and was withdrawn to the extent of Rs. 1521 million. This appears to have been the main cause of the fall in the CSE all share price index from 782 in April 1998 to 597 in December 1998; it fell further in 1999 to 563 in the third week of August. The Director General of the Colombo Stock Exchange himself has stated in the newspaper that the fall in share prices is due to the withdrawal of foreign funds on account of Sri Lanka's poor economic fundamentals. It should be noted that foreign investors are free to invest in the Colombo Share Market and free to repatriate their capital gains and dividends; there is no restriction as such only that such transactions have to be channelled through special accounts called "Share Investment External Rupee Accounts".

Functional Classification of Capital Expenditure as % of GDP

	1994	1995	1996	1997	1998
Total Capital Expenditure	7.5	7.4	5.7	5.7	6.8
Economic Services	5.1	5.4	4.1	3.6	4.4
Agriculture and Irrigation	0.9	0.9	0.6	0.4	0.6
Transport	2.5	2.8	1.6	1.5	1.9
Energy	1.0	0.7	0.8	0.8	0.9
Social Services	1.3	1.5	1.3	1.3	1.5
Education	0.5	0.5	0.6	0.5	0.6
Health	0.3	0.3	0.3	0.3	0.4

Pruning Capital Investment

The strategy of economic development which globalization demands appears to have failed to make Sri Lanka another "Asian Tiger". We have shown the relatively low economic growth in the last five years, the poor response of foreign capital to our inducements, the poor performance of agricultural exports, the decline in domestic food production, the undermining of import-substitution industries, the slowing down of export growth and the fall in stock market prices in the last twelve months as evidence of the limited benefits and negative results of globalization. The development strategy of making the private sector the engine of economic growth resulted in the emasculation of the public or state sector, but the private sector's poor response meant a stagnation in overall investment and slow economic growth. The government reduced its investment expecting the private sector to more than make it up but as private investments showed only limited response, the economy fell between two stools as shown in Figure 2

The government weakened itself in this process by deliberately reducing the financial resources that were available to it through lowering taxes. Total revenue from declined 19.0 per cent of GDP in 1994 and 20.4 per cent in 1995 to 17.3 per cent in 1998: tax revenue fell from 17.2 per cent of GDP in 1994 and 17.8 per cent in 1995 to 14.5 per cent in 1998; income tax revenue declined from 2.6 per cent of GDP in 1994/1995 to 2.0 per cent in 1998; revenue from sales and turnover taxes fell from 5.6 per cent of GDP in 1994 to 3.9 per cent in 1998 and revenue from import duties declined from 3.9 per cent to 2.8 per cent of GDP. These reductions in taxes were designed to stimulate private investment and to provide relief to taxpayers. As shown above it provided little incentive to private investment. Relief to taxpayers was unwarranted as the war against terrorism demanded not a reduction but an increase in taxes which the taxpayers would have borne as a necessary contribution to the war effort. It should also be noted that in the free market economy of USA, tax revenue was 28.5 per cent of GDP in 1996 and the current corporate tax rate is 40 per cent.

Fig. 2: Stagnant Investment as % of GDP

Year	Total Investment	Private Investment	Public Investment
[illegible]	25.6	17.6	8.0
[illegible]	[illegible]	20.0	[illegible]
1995	25.7	17.8	7.9
1996	24.2	18.0	6.2
1997	24.4	18.3	6.1
1998	25.4	19.3	6.1

By making unnecessary tax cuts, the government denied itself the opportunity of raising new revenue to finance increasing defence expenditures, and the rising defence expenditure was largely met not by new taxes but by cutting essential economic and social development: government's capital expenditure fell from 7.5 per cent of GDP in 1994 and 7.4 per cent in 1995 to 5.7 per cent in 1997 and 6.8 per cent in 1998. Capital expenditure on economic services as a proportion of GDP fell from 5.1 per cent in 1994 and 5.4 per cent in 1995 to 4.4 per cent in 1998; that on agriculture and irrigation declined from 0.9 per cent in 1994 to 0.6 per cent in 1998 that on transport from 2.5 per cent of GDP to 1.9 per cent and that on energy from 1.0 per cent of GDP to 0.9 per cent. Actually, the expenditure on agriculture and irrigation in 1998 was less than that in 1995 in absolute terms. Thus, capital investment on essential agriculture and irrigation, transport and energy has not been made in the last four or five years because of the wrong policy of reducing taxation when the situation demanded the opposite.

Investment in social services on the other hand, seems to have stagnated in the four years 1994 to 1997 and risen slightly only in 1998. It remained almost constant at 1.3 per cent of GDP in 1994 to 1997 and rose to 1.5 per cent in 1998: investment in education remained virtually constant at 0.5 per cent of GDP and on health almost constant at 0.3 per cent of GDP. Investment in social services would have been much larger and the number of new hospitals and schools much higher, if the government had not denied itself funds by lower taxation.

In addition to a relative reduction in capital investment in economic and social development, there has also been a relative reduction in current expenditure on the maintenance of existing economic and social services of the country. Thus, current expenditure on social services fell from 8.6 per cent of GDP in 1995 to 6.3 per cent in 1998; that on schools declined from 2.4 per cent to 2.0 per cent and on health from 1.3 per cent to 1.0 per cent. Current expenditure on economic services fell from 1.21 per cent of GDP in 1995 to 1.0 per cent in 1998: expenditure on agriculture and irrigation fell from 0.57 per cent to 0.54 per cent, on transport from 0.30 per cent to 0.29 per cent and on energy from 0.15 to 0.07 per cent. Thus, maintenance of social and economic services too has suffered from the financial constraint caused by lower taxation.

Passive State

The state cannot entrust the important task of economic development to the free market and wait patiently for the magic wand of private enterprise to deliver the goods as globalization demands. In a developing economy like Sri Lanka, where private enterprise is still inadequately developed, the state has a responsibility to shoulder directly-a good part of the burden of economic development. By following a policy of laissez faire, we are missing the opportunities of creating projects and programmes for rapid economic growth and employment creation. Public investment in developing countries complements rather than displaces or crowds out private investment. In a growing economy, there is ample room for both to co-exist. The crucial role a dirigiste state can play in economic development is illustrated by France which was highlighted by *The Economist* of June 5th, 1999 as follows:

"To most Frenchmen, the dirigiste model remains a source of pride not resentment. This owes much to the part the state played in the 30 years of spectacular economic growth after the Second World War, which propelled a heavily rural economy into the modern industrial age. It turned France into the world's fourth largest industrial power after America, Japan and Germany, and its fourth biggest exporter. In terms of income per head, France overtook Britain in 1969, and has retained that lead to this day. Despite the heavy state, private enterprise has flourished. France is home to a host of profitable world class firms...".