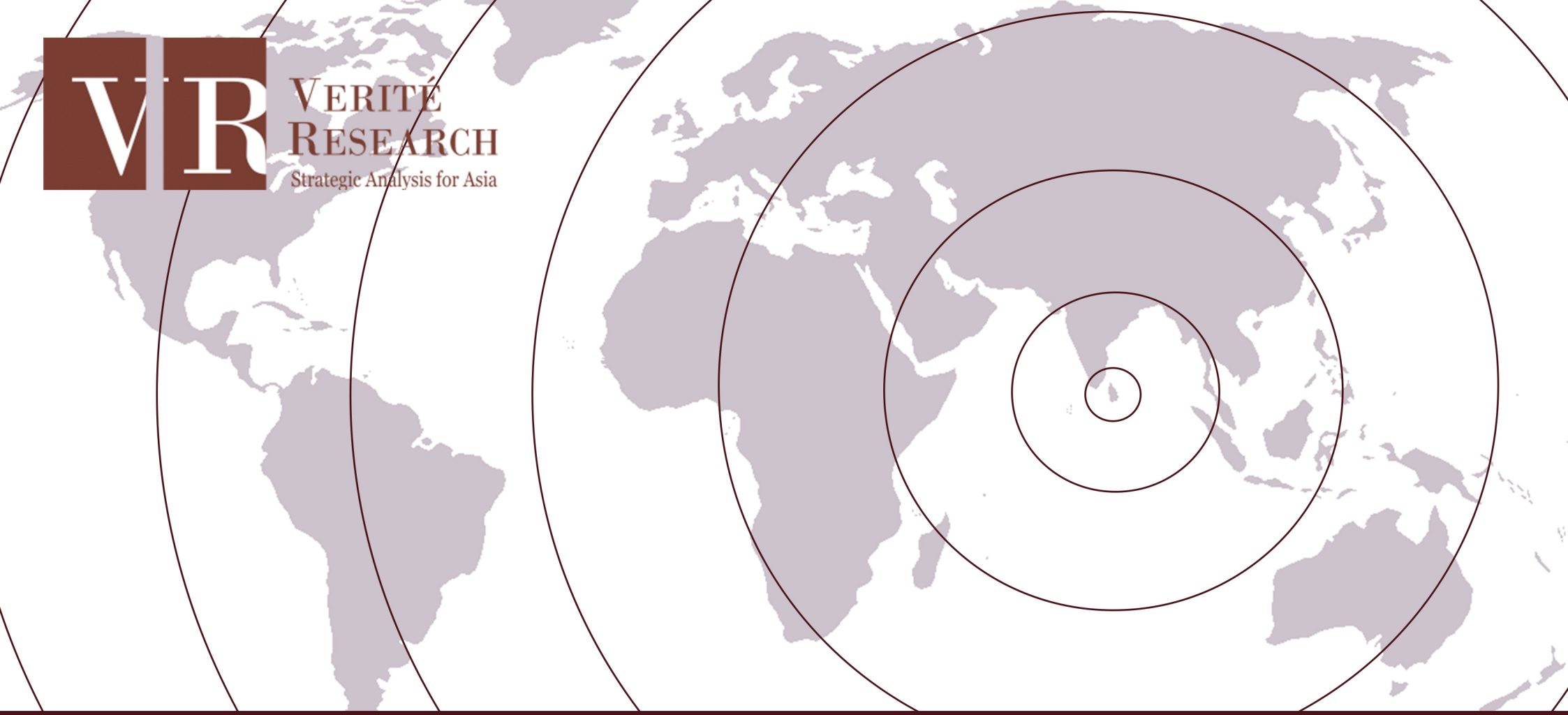

SRI LANKA: INTERNATIONAL TRADE

Performance and Prognosis

Vol. 2, No. 1

VERITÉ RESEARCH
Strategic Analysis for Asia

SRI LANKA – INTERNATIONAL TRADE

Performance and Prognosis

Vol. 2, No. 1

Subhashini Abeysinghe

July 2014

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Verité Research aims to be a leader in the provision of information and analysis for negotiations and policy making in Asia, while also promoting dialogue and education for social development in the region. The firm contributes actively to research and dialogue in the areas of economics, sociology, politics, law, and media, and provides services in data collection, information verification, strategy development, and decision analysis.

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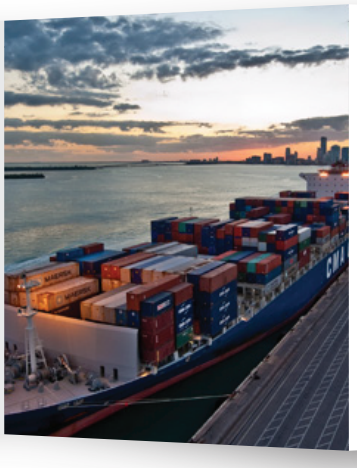
1. HIGHLIGHTS

TRADE DEFICIT DECLINES

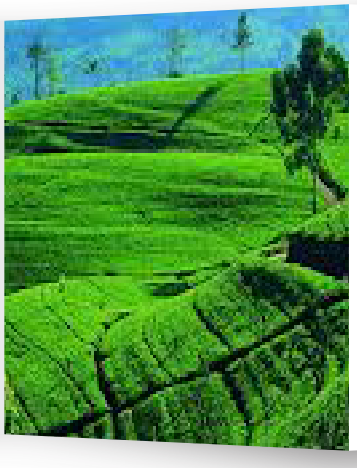


Sri Lanka's trade deficit narrowed to 11.3% of GDP in 2013, after having recorded historically high rates of above 15% of GDP in both 2011 and 2012. The actual trade deficit in 2013 was lower than the projected rate of 12.8% of GDP set out by the Central Bank of Sri Lanka (CBSL) in its *Road Map, 2014.*

The contraction of the trade deficit in 2013 was a result of export earnings picking up marginally by 6.3% after having fallen by 7.4% in 2012, while import expenditure fell by 6.2% in 2013, at a rate higher than that projected (of - 0.7%) by the CBSL in its *Road Map, 2014.*

***

DEMAND FROM KEY MARKETS PICKS UP



Export recovery since June 2013 has been robust due to recovery in demand from major markets. Exports recorded double-digit growth on average from August 2013 to March 2014. The recovery however is driven by *selling at the intensive margin* (more of the same goods to the same markets), with traditional products such as tea and apparel accounting for 98% of export growth and exports to traditional markets such as the USA accounting for 58% of the total increase in exports.

***

VIBRANT GROWTH IN AGRI. EXPORTS

Agricultural exports, which account for 25% of total exports, continue to outperform industrial exports accounting for 75% in terms of growth, but the gap seems to be narrowing. In 2013 agricultural exports recorded 10.7% growth compared to 5% growth recorded by Industrial exports. In 1st Q 2014 agricultural exports recorded growth of 20% compared to industrial export growth of 17%. The sustainability of the growth momentum in agricultural exports however remains in question due to low volumes, low value-addition, and fluctuations in weather and world market prices.

***

HIGHLIGHTS

IMPORT GROWTH REMAINS LOW

Imports declined in 2012 and in 2013, after having recorded an unprecedented growth rate of over 50% in 2011. The cutback in 2013 came largely from fuel, which accounts for nearly 25% of Sri Lanka's total import expenditure. Imports grew again during the 1st Q 2014 by a modest 4% compared to the same period in 2013 where imports declined by 13%.

The combined robust growth in exports and the sluggish growth in imports experienced during the last six months up to March 2014 are encouraging in terms of meeting the deficit target of 11.6% of GDP projected for 2014.

***

SUSTAINING EXPORTS IS CHALLNGING

The 1st Q 2014 export growth of 16% is a promising start for Sri Lanka's trade account. With the recovery in demand from main import markets, exports are likely to record double-digit growth in 2014. However, sustaining the growth momentum at 18% per annum, as projected, to reach US$ 16.9 billion by 2016 seems ambitious in the context of a slow recovery in world trade and heavy reliance on few products and few markets to generate the required growth.

***

CURTAILING IMPORTS IS COSTLY

The import growth in 2013 being lower than projected by the government combined with continuing policy thrust to curtail imports and resulting sluggish growth in imports experienced in 1st Q 2014 makes the import target of US$ 21 billion set for 2014 feasible.

Increasingly, however, policy interventions on international trade adversely affect government revenue. The government is adjusting the new taxes on trade in a non-systematic manner in order to curtail the trade deficit and arrest declining tax revenues. However, the trade deficit is still over 10% of GDP and tax revenue hit a historically low-level of 11.6% of GDP in 2013.

***

2. EXPORT PERFORMANCE

2.1 EXPORTS RECOVER AT THE INTENSIVE MARGIN

Exports began to pick up during the second half of 2013, after having experienced negative growth for over 14 consecutive months from April 2012 to May 2013 (see Figure 1). Export recovery is robust with exports recording double-digit growth on average from August 2013 to March 2014 (except in February 2014). Monthly export value of Sri Lanka has generally remained below US$ 1 billion. During the last 6 months however, the monthly export value has exceeded US$ 1 billion three times.

Sri Lanka recorded its highest export value to date in 2011 of US$ 10559 million. Export value declined in 2012 by 8% and picked up in 2013 recording a growth rate of 6%. However, the value recorded in 2013 wasUS$ 164 million lower than that recorded in 2011.

Exports recorded a healthy recovery in the first quarter 2014 after experiencing an 11% drop in the first quarter 2013 (Figure 2). The average monthly export growth recorded in the first quarter is 19%. In terms of value, the 1st Q 2014 exports exceeded the value recorded in 1st Q 2011 (the previous highest quarterly growth recorded) by 3%.

Export growth can result from selling at the intensive margin, which is selling more of the traditional products to the traditional markets or by selling at the extensive margin, which is selling new products and entering new markets. The recovery of exports in 2013 and 1st Q 2014 was spurred by selling more of the traditional goods, such as apparel and tea, to traditional markets, such as the USA (i.e., selling at the intensive margin).

Apparel and tea are Sri Lanka's leading exports, accounting for over 50% of the total export value. The growth in exports experienced in 2013 was almost entirely accounted for by an increase in these traditional exports. While the country's total exports in 2013 exceeded the export value recorded in 2012 by US$ 621 million, the combined value of tea and apparel exports increased by US$ 611 million over the same period. As such, tea and apparel together accounted for 98% of export growth in 2013 (see Figure 3).

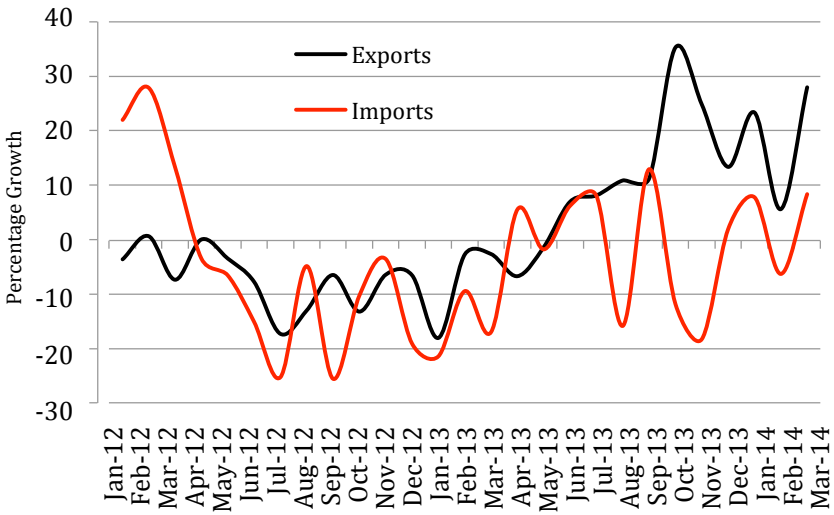
In terms of the direction of exports, the recovery in 2013 was led by increased exports into traditional markets, in particular the USA (see Figure 4). Exports to the USA increased by US$ 382 million in 2013 compared to 2012. Thus, the growth in exports to the USA accounted for 58% of the total increase in exports in 2013. According to US import statistics imports from Sri Lanka have increased by 14% during the first quarter of 2014 compared to 9% decline experienced in the same period in 2013 (Figure 5). Over 80% of exports to USA from Sri Lanka consist of apparel.

Exports to the Middle East[1] – a leading market for Ceylon tea- also picked up following the growth of tea exports. As previously noted therefore, exports in 2013 grew on the back of traditional products and traditional markets, with Sri Lanka continuing to struggle in terms of product and market diversification.

2.2 ROBUST RECOVERY IN INDUSTRIAL EXPORTS IN 1ST Q 2014

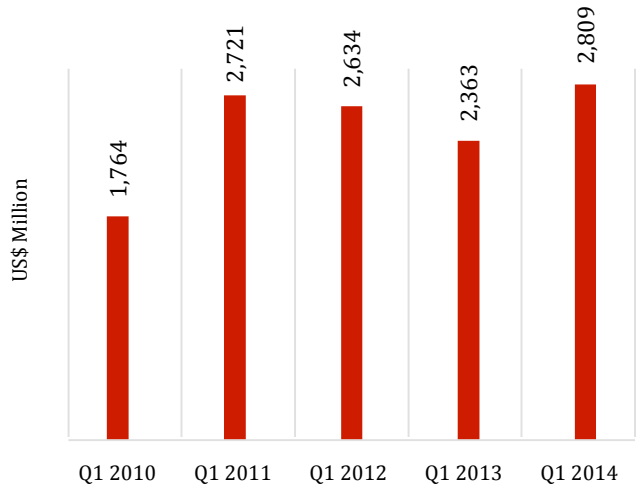
Industrial exports, which account for 75% of Sri Lanka's total export basket, declined by 6% in the 1st

Figure 1: Growth in Value of Exports and Imports



Source: Central Bank of Sri Lanka, Monthly External Sector Performance

Figure 2: Highest First Quarter Export Value Recorded in 2014



Source: Central Bank of Sri Lanka, Monthly External Sector Performance

Q 2012 and further declined by 8% during the same period in 2013. During the 1st Q 2014, the industrial exports recorded a robust growth of17%. Recovery in industrial exports is the main reason behind the exceptional export performance in 1st Q 2014.

Quarterly industrial export value exceeded US$ 2 billion for the first time in 2011 and the country has repeated the same feat again in 1st Q 2014. Despite the robust recovery, in terms of value, exports in 1st Q 2014 recorded only a marginal improvement of 1.4% compared to the same period in 2011 (see Figure 6).

On an annual basis, in 2013, industrial exports recorded 5% growth but failed to fully recover from the dip experienced in 2012. In value terms, industrial exports in 2013 were US$ 242 million less than that recorded in 2011 (Figure 7).

In 2013, the industrial exports grew largely on the back of apparel exports – which account for over 60% of Sri Lanka's total industrial exports. Apparel exports recorded a 13% increase in 2013 compared to 2012, while the other products in the country's industrial export basket performed poorly. Rubber products (Sri Lanka's second largest industrial export accounting for 11% of the total) increased by a mere 3.3%; gems, diamonds and jewellery declined by 20%. During 1st Q 2014, while apparel exports continued to grow by 20%, the growth of other industrial products also recovered by 12% compared to the same period in 2013.

2.3 THE VIBRANT GROWTH IN AGRI. EXPORTS IS NOT SUSTAINABLE

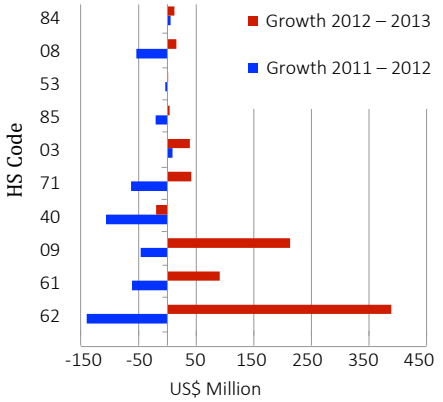
Agricultural exports continued to outperform industrial exports in 2013 and during 1st Q 2014. In 2013, the annual growth was 10.7% and in 1st Q 2014 it was 20%. The average growth in agricultural exports over the past decade (2004-2013) stood at 11% compared to an 8% growth in industrial exports. As a result, the share of agricultural exports as a percentage of total exports also increased from 18% to 25% during the same period.

A combination of favourable domestic weather conditions and higher prices in international markets, contributed to the growth in agricultural exports in 2013 as well as in 1st Q 2014. While the value of agricultural exports has increased, the volumes have been stagnating. Tea, accounting for almost 60% of Sri Lanka's total agricultural exports, saw an increase of 108% in terms of value during the last ten years, while the volume of tea exports increased by only 6% (Figure 8).

In 2013 and in the 1st Q 2014 however, in terms of growth the export of other agricultural exports (including spices, fruits and vegetables) outpaced the growth in tea exports. For example in 2013, tea exports grew by 9% whereas the other agricultural exports grew by 13%. During 1st Q 2014, tea increased by 20% and other agri. exports increased by 26%.

A troubling aspect of the growth in the value of agricultural exports however, is that it is not driven by value-addition. For instance, the percentage of value-added tea remains less than 10% of the total volume of tea exported. Sri Lanka, however, has reduced the volume of bulk tea exports from 64% to 41% during the last five years, while tea exported in packets has increased from 27% to 49% over the same period. This trend has led some stakeholders in the industry as well as government to conclude that over 50% of tea exported from Sri Lanka is value-

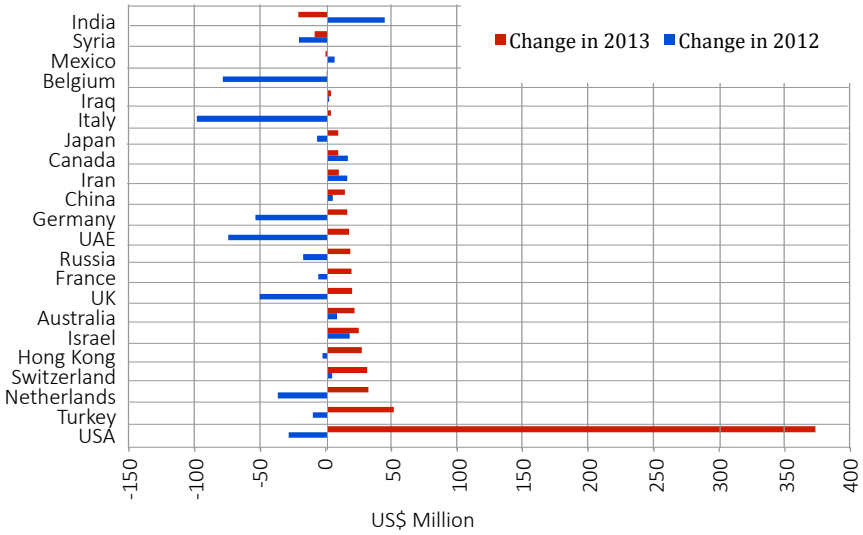
Figure 3: Change in Value of Exports (US$ Million)



HS	Description
62	Apparel knitted or crocheted
61	Apparel not knitted or crocheted
09	Coffee, tea, mate and spices
40	Rubbers and articles thereof
71	Precious stones
03	Fish
85	Electrical machinery and parts
53	Vegetable textile fibres
08	Edible fruits and nuts
84	Machinery and mechanical appliances

Source: Export & Import Statistics 2013, Sri Lanka Customs

Figure 4: Increase/Decrease in Exports in 2012 and 2013

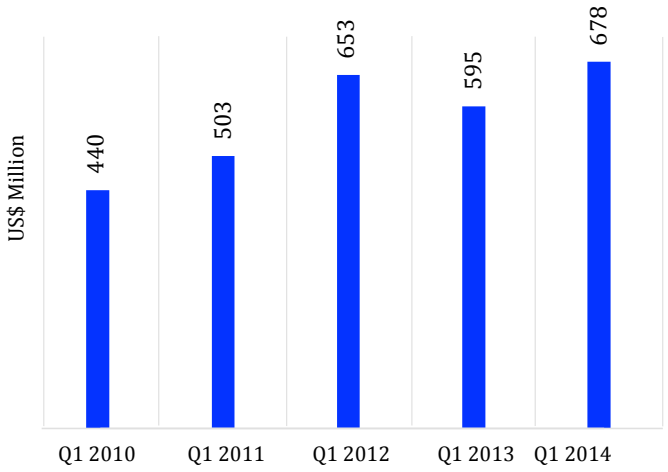


Source: Import and Export Statistics, various years, Sri Lanka Customs

added. However, given that the objective of value-addition is to enhance the value received per Kg of tea exported, the small price difference between bulk tea and packeted tea does not justify tea exported in packets being classified as value-added tea.

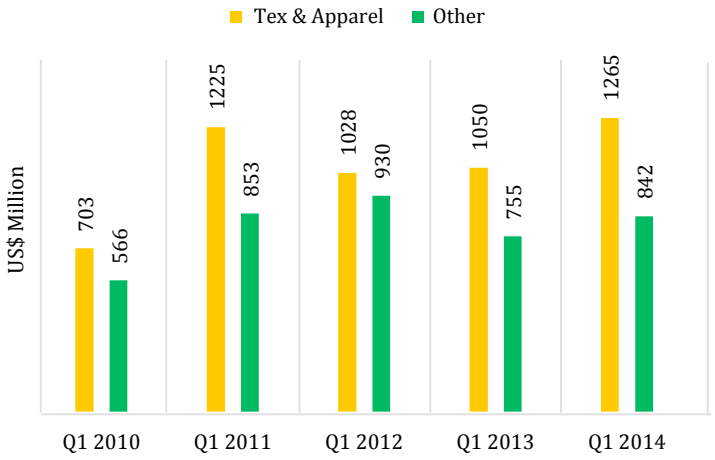
The case of tea exports highlights two key weaknesses in the country's agricultural exports that challenge the sustainability of the growth momentum experienced: first, is low volumes; and, second is low value-addition. It is important to note that these two weaknesses are not confined to tea exports, but apply across the board to all agricultural exports. For example value added spices account only for about 5% of total spices exports of the country.
In addition to these supply side weaknesses, adverse weather conditions as well as price fluctuations in the international market, which is common with respect to agricultural products, threaten sustainability of the growth in agricultural exports. ■

Figure 5: Imports into USA from Sri Lanka



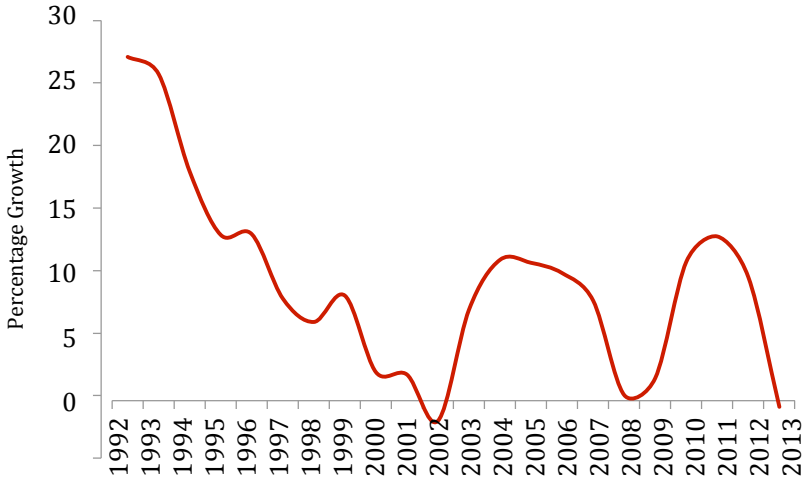
Source: United States International Trade Commission, Monthly Import Statistics

Figure 6: Value of Industrial Exports



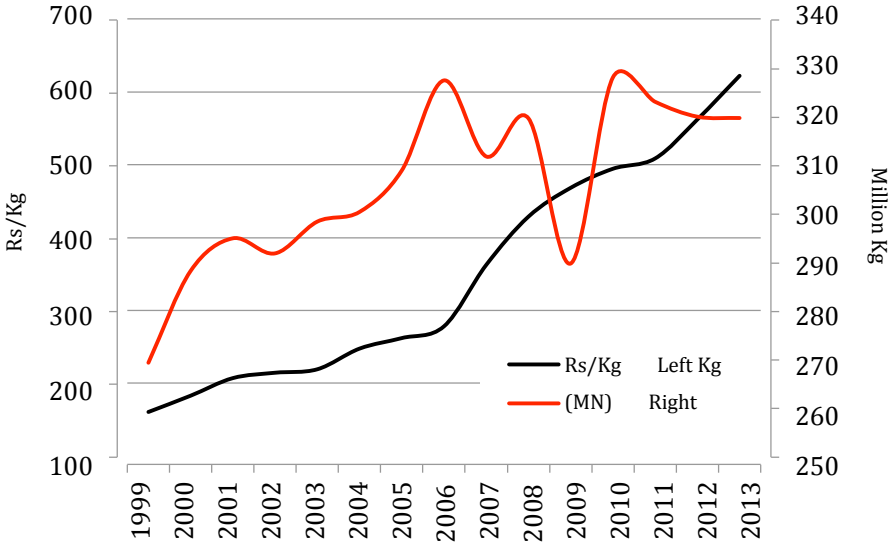
Source: Central Bank of Sri Lanka: Monthly External Sector Performance Statistics

Figure 7: Growth in Industrial Exports (3-Year Moving Average)



Source: Calculated using Industrial Export Statistics published in the Central Bank Annual Report, various years

Figure 8: Volume and Price of Tea Exports



Source: Central Bank of Sri Lanka, Annual Report, various years

3. EXPORT TARGETS

3.1 EXPORT TARGETS SET FOR 2014-2016 ARE AMBITIOUS

The Central Bank of Sri Lanka's (CBSL) *Road Map 2014* launched in January, projects exports to increase from US$ 10.4 billion in 2013 to reach US$ 12 billion by 2014. The underlying assumption is that exports will grow by 16% in 2014. The 1st Q 2014 exports recording 16% growth is a promising start. Sustaining the growth at this rate however is challenging due to slow recovery in world trade and supply side constraints faced by the export sector (discussed in Section 2).

Since 2000, Sri Lanka has recorded annual export growth rates that come close to the targeted rate of 16% only twice: in 2010 and in 2011. During these two years, exports grew by 22% per annum. Moreover, the 2010 episode points to recovery rather than growth, since exports recorded a steep decline of 13% in 2009. As such, even with the exceptional growth record during 2010 and 2011, the average annual growth in exports during the last decade stands at 8.8%.

"*Mahinda Chinthana*", Development Framework launched in 2010 projected exports to reach US$ 18 bn by 2016.[2] CBSL *Road Map 2014* has downgraded the projections set in *Mahinda Chinthana* by forecasting the value of exports to reach US$ 16.9 billion by 2016 (see Figure 10). To reach the new target the exports are expected to grow by 18% a year during 2014-2016 (see Figure 8). An export growth rate that comes close to this target for over three years consecutively, was last recorded in the period 1992-95. During these years, exports recorded an average annual growth rate of 17%. As such, based on previous growth trends, the projected export growth rate of 18% appears to be ambitious.

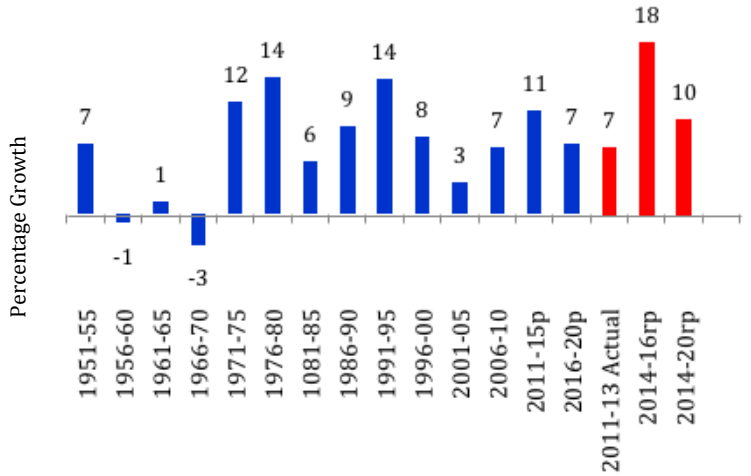
3.2 SLOW RECOVERY IN WORLD TRADE WILL UNDERMINE EXPORT GROWTH

The slow recovery in world trade also makes the export targets set by the CBSL challenging. According to a recent report released by the World Trade Organization (WTO),[3] growth in world trade was sluggish in 2012 and 2013, recording an average rate of only2.2%. In 2013, the dollar value of world merchandise trade stood at $18.8 trillion.

World trade is poised to record a broad-based but modest upturn in 2014, and further consolidation of this growth is expected in 2015. The WTO forecasts trade to grow by a modest 4.7% in 2014.The growth rate envisaged for 2014 however, is still below the 20-year average of 5.3% (1983-2013). The growth is expected to advance at a slightly faster rate of 5.3% in 2015.

The EU is Sri Lanka's largest export market, accounting for slightly over 30% of the country's total exports. Imports into the EU from countries outside the EU (extra-EU trade) trended down throughout 2013, sapping global demand. While imports into the USA and Japan were generally rising at 3.3% and 1.2% respectively, extra-EU imports continued to decline by 1.5% (see Figure 8). According to the WTO report exporters will find little relief until EU imports recover substantially from their current depressed state. EU merchandise imports represent 32% of world imports including intra-EU trade (trade amongst EU countries), and 15% of world imports excluding it. Achieving the higher rates of export growth targeted by the

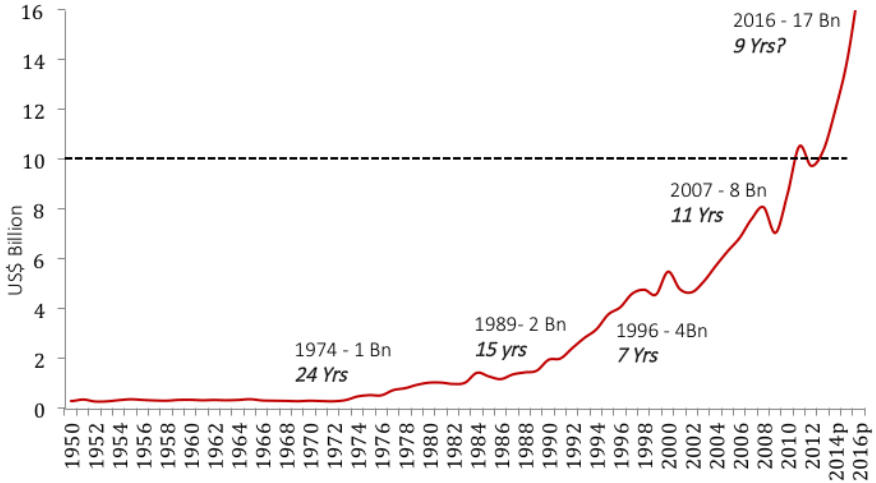
Figure 9: 5-Year Average Export Growth



p – projections, rp – revised projections

Source: Central Bank of Sri Lanka, Annual Report, various years, and Central Bank *Road Map 2014*

Figure 10: Can Sri Lanka Reach US$ 17 Bn by 2016?



Source: Central Bank of Sri Lanka, Annual Report, various years, and Central Bank *Road Map 2014*

CBSL will be challenging given an external environment of sustained sluggish demand in Sri Lanka's main export market.

Since the 1990s, world trade has been growing about twice as fast as world GDP when measured at market exchange rates. According to the WTO in 2012 trade growth fell to the same rate as GDP, and these indicators remained at matching rates in 2013, prompting the question whether the previous relationship will continue to hold.

In contrast to world trade, Sri Lanka's average trade growth has been lower than its GDP growth rate at market prices for over a decade. The CBSL export growth projections suggest that Sri Lanka's policy makers are attempting to reverse this trend at a time when world export growth is poised to grow at the same rate of world GDP or lower. According to the CBSL *Road Map 2014* forecast of GDP and inflation for 2014-2016, nominal GDP is expected to grow at an annual average of 12.7% and trade (exports plus imports) is expected to grow at an average of 18% during 2014-2016. However, the global trends outlined above, present substantial challenges for Sri Lanka in realizing these ambitious targets.

3.3 EXPORT TARGETS: SRI LANKA VS. THE REGION

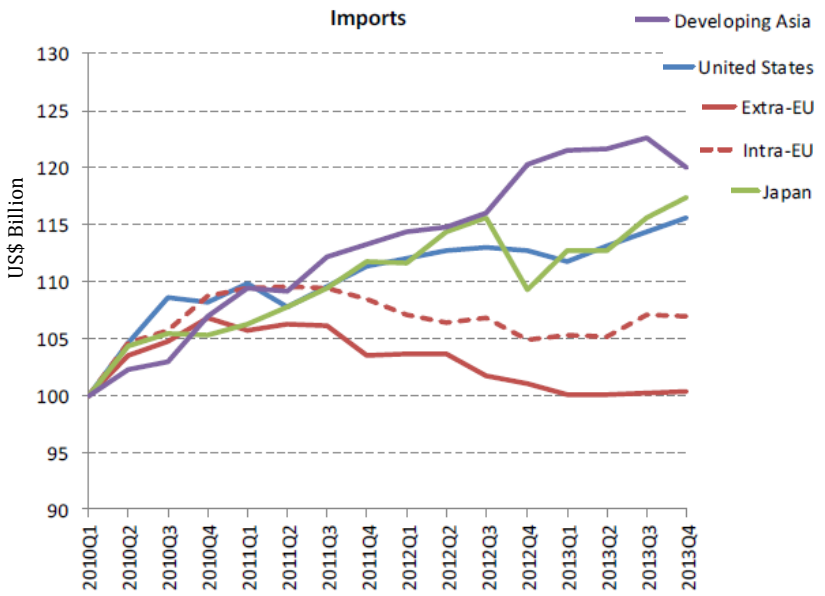
Ministry of Industry and Commerce in 2011 projected exports from Sri Lanka to reach US$ 20 billion by 2020. This once again is lower than the export growth projections set in *Mahinda Chinthana* 2010, which expects industrial exports alone to exceed US$ 25 bn by 2020.[4]

Although reaching US$ 16.9 billion by 2016 seem ambitious, as evidenced in the analysis set out earlier on in this Review, getting to US$ 20 billion by 2020 still looks a modest target compared to the export performance of a number of emerging economies in the region. In order to reach US$ 20 billion by 2020, exports need to grow at an annual rate of 10% during 2014-2020 (see Figure 10). Neighbouring countries in South and East Asia have recorded export growth rates of over 10% on average in most years (see Table 1). Countries like Vietnam for instance, have shown sustained export growth rates of over 10%, including in periods during which world export growth has been sluggish.

Sri Lanka reached its US$ 10 billion export target in 2011; reaching a target of US$20 billion by 2020 requires a doubling of the value of exports over a period of 9 years. As indicated in Table 2, a number of emerging economies in the region have managed to double their exports in less than 10 years. For example, Vietnam has seen its exports double almost three times in just 12 years (2001-2012).

While a slow recovery in world trade can hamper export growth, Sri Lanka's export growth is also constrained by a number of internal factors, including the heavy dependence on a few products and a few markets to generate growth (see Section 2.1 above). Countries that have achieved higher rates

Figure 11: Import Growth in Selected Countries/Regions (US$ Bn)



Source: World Trade 2013, Prospects for 2014, World Trade Organization

Table 1: 5-Year Average Export Growth for Selected Countries in the Region

	1976-80	1981-85	1986-90	1991-95	1996-00	2001-05	2006-10
World	18	-1	12	9	5	11	9
Bangladesh	18	6	12	16	13	8	16
India	15	2	15	12	7	19	19
Malaysia	28	4	15	20	6	8	8
Thailand	24	2	27	20	4	10	13
Vietnam	16	16	31	19	22	18	18
Sri Lanka	14	6	9	14	8	3	7

Source: Calculated using export statistics published by the World Trade Organization (accessed March 13, 2014) http://stat.wto.org/Home/WSDBHome.aspx?Language

EXPORT TARGETS CONT.

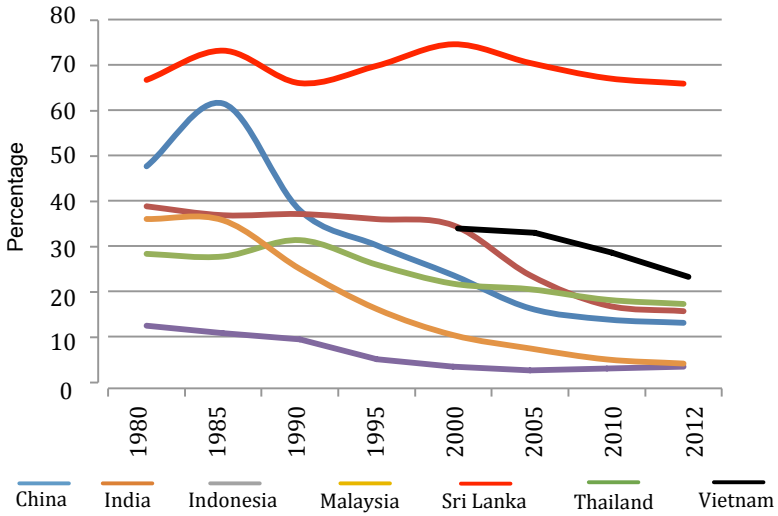
of export growth have done so by growing at the extensive margin (as opposed to growing at the intensive margin), which is exporting new products and entering new markets. For example, while Sri Lanka continues to be heavily dependent on apparel exports, some other Asian economies have successfully diversified their manufacturing base away from apparel into other sectors (see Figure 12), allowing for higher export growth rates. In addition, Sri Lanka continues to depend heavily on a handful of developed country markets while other emerging economies in the region are increasingly trading with each other (see Figure 13).■

Table 2: Time Taken to Double Exports: World Exports and Exports of Selected Asian Countries

World	**Time taken**	8 Yrs	10 Yrs	7 Yrs
	Value (US$)	2-4 Tn	5-10 Tn	9-18 Tn
Bangladesh	**Time taken**	6 Yrs	6 Yrs	5 Yrs
	Value (US$)	3 – 6 Bn	6-12 Bn	12-24 Bn
India	**Time taken**	9 Yrs	3 Yrs	4 Yrs
	Value (US$)	25 – 50 Bn	75-150 Bn	150-300 Bn
Malaysia	**Time taken**	5 Yrs	9 Yrs	5 Yrs
	Value (US$)	25- 50 Bn	50-100 Bn	100-200 Bn
Thailand	**Time taken**	5 Yrs	10 Yrs	6 Yrs
	Value (US$)	25-50 Bn	50-100 Bn	100-200 Bn
Vietnam	**Time taken**	4 Yrs	3 Yrs	4 Yrs
	Value (US$)	15-30 Bn	30-60 Bn	50-100 Bn

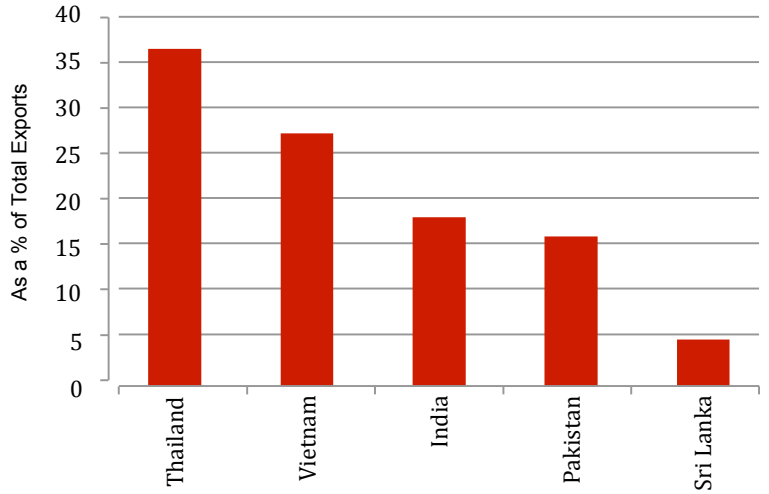
Source: Calculated using export statistics published by the World Trade Organization (accessed March 13, 2014), http://stat.wto.org/Home/WSDBHome.aspx?Language

Figure 12: Textile and Garments (% of Manufacturing)



Source: Compiled using WTO statistics, (accessed March 13, 2014), http://stat.wto.org/Home/WSDBHome.aspx?Language

Figure 13: Exports to Selected Asian Countries 2012*



***China, S. Korea, Hong Kong, Malaysia, Indonesia, Singapore**

Source: www.trademap.org (accessed, March 14, 2014).

4. IMPORT PERFORMANCE 2013

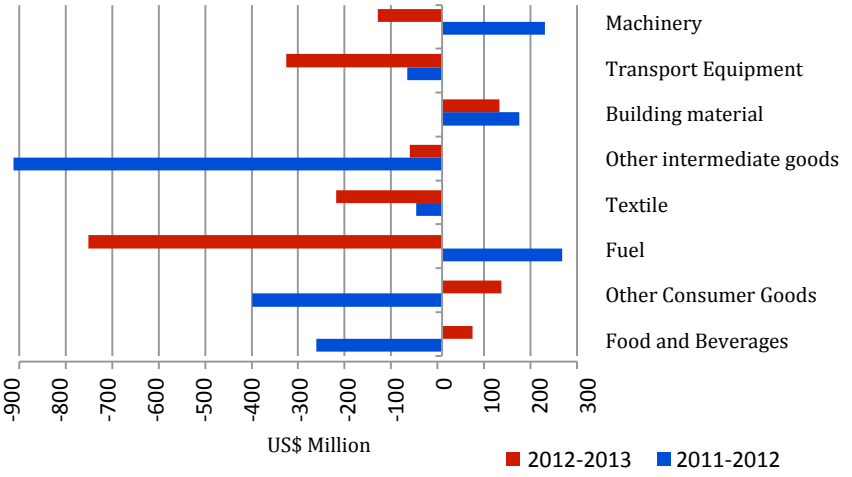
4.1 IMPORTS DECLINE FOR THE SECOND CONSECUTIVE YEAR

Imports declined in 2012 and in 2013, after having recorded an unprecedented growth rate of over 50% in 2011. The cutback in 2013 came largely from fuel, which accounts for nearly 25% of Sri Lanka's total import expenditure. Expenditure on fuel decreased by US $ 736 million in 2013 (see Figure 12), representing 62% of the total decline in import expenditure in 2013. The reduction in fuel imports was facilitated by favourable domestic weather conditions that reduced the country's reliance on thermal power as well as a fall in global petroleum prices in 2013. Thermal power, which accounted for 71% of the total power generated in 2012 – a drought year – came down to 40% of the total in 2013, reducing the demand for fuel imports.

Machinery imports declined in 2013 for the first time since 2009. While consumer goods imports recovered in 2013 compared to the drop in 2012, intermediate goods imports[5] continued to decline in 2013. Demonstrating the sustained growth in the country's construction sector, the only import category that continued to record positive growth in 2012 and 2013 has been building material imports (see Figure 14).

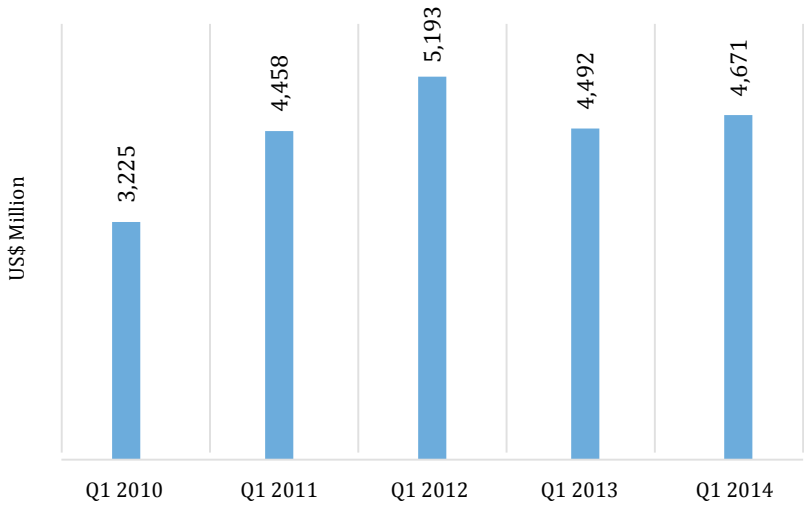
Import growth recovered during the first quarter of 2014 by a modest 4% compared to the same period in 2013 where imports declined by 13%. The fuel imports have surged in the first quarter of 2014 by 26.8%. Other consumer goods (including vehicles) have also increased by 16% during the same period. A worrisome development however is the decline in investment goods by 15% as it is a possible indication of slowing down of economic activity. Driven by the boom in the construction sector, building material imports has been steadily increasing. For the first time, however, building material imports, (which is a sub category in investment goods) have also recorded a decline of 18.7% during the first quarter of 2014. ■

Figure 14: Difference in Import Value Recorded in 2011-2012 and 2012-2013



Source: Central Bank of Sri Lanka, Annual Report, various years

Figure 15: Value of Imports



Source: Central Bank of Sri Lanka, Monthly External Sector Performance Statistics

5. IMPORT TARGETS

5.1 CURTAILNG IMPORT GROWTH WILL BE CHALLENGING

The unprecedented expansion in imports during 2010-2011 was largely policy-driven. The simplification of the import duty structure, an appreciation of the Sri Lankan rupee resulting from CBSL interventions and the low interest rate regime fuelled demand for imports. The subsequent contraction in imports experienced in 2012-2013 is also partly policy-driven: policy measures such as increasing taxes on international trade, curtailing credit and allowing the currency to depreciate contributed to the decline.

While post-war import performance has been largely determined by government policy than by demand for imports generated by the economy under normal conditions, there are exceptions. For example in 2013, the decline in the fuel bill which led to a decline in imports was not driven by concerted policy efforts but by domestic weather and international market conditions. As a result of this development, imports in 2013 were lower than projected by the CBSL in its *Road Map 2014*. In 2013 actual import value was US$ 19 bn. This is a bonus for the government making the import target of US$ 21 billion for 2014 (leaving room for an increase of 17%) seem more realistic. Imports are expected to slow down to 10% per annum during 2015 and 2016 as per the CBSL *Road Map 2014* which projects import value to reach US$ 25.5 bn by 2016.

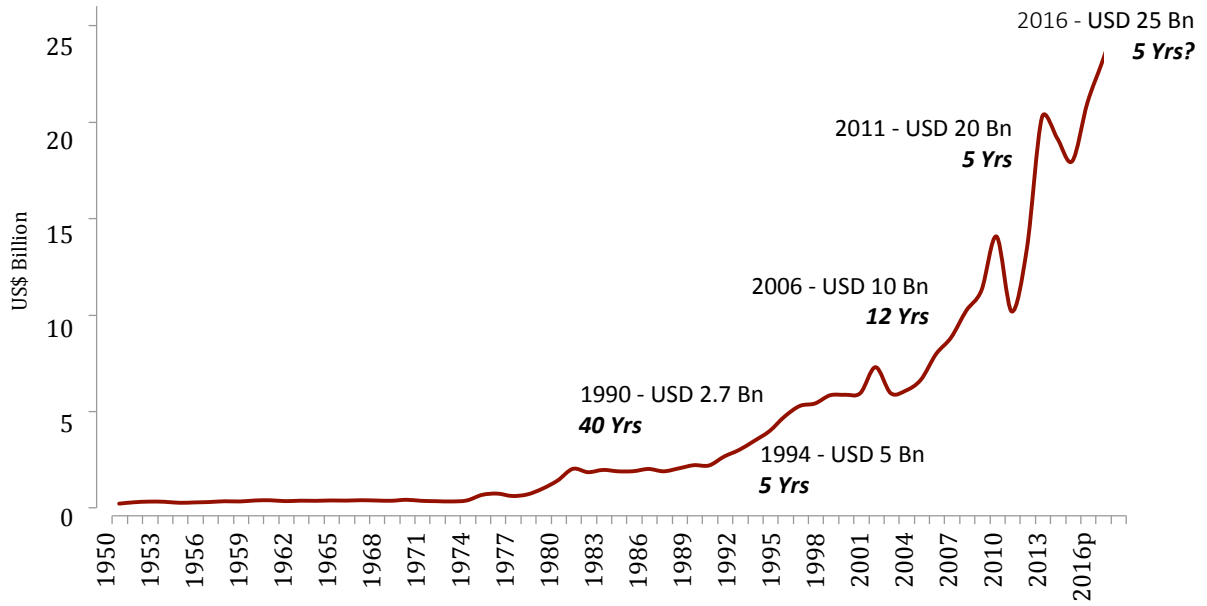
Restricting imports is doable by adopting policies that increase the cost of imports as was done by the Government in 2012 and 2013. However, this will be at a cost to both economic growth and government revenue. For example when investment goods imports slow down, it is an indication of slowing down investments in the country. The implications of *ad-hoc* and extensive use of trade policies on government revenue and international trade is discussed in detail in the next section.

5.2 IMPORT TARGETS AND GOVERNMENT REVENUE

Sri Lanka, like many other developing countries, relies heavily upon taxes on international trade to generate government revenue. More recently, this dependence has increased with several new taxes being introduced in addition to the import duty. At present, around 20% of the country's tax revenue comes from taxes on international trade (see Figure 17). Up to 2008, the revenue collected from import duties was over 50% of the total revenue collected from taxes on international trade. Since 2009 however, this trend has been reversed, with the share of revenue collected from taxes on international trade other than import duties now accounting for over 50% of the total.

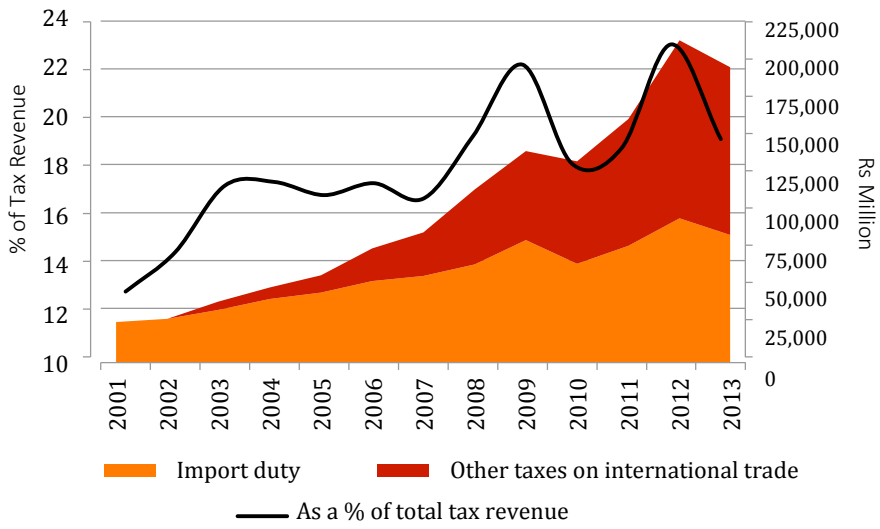
If the import performance (increase or decrease) was driven by developments in the economy and not fuelled by shifting policies

Figure 16: Can Sri Lanka Limit Import Value to USD 25 Bn by 2016?



Source: Central Bank Annual Report, various years, and Central Bank *Road Map 2014* (**p – projected**)

Figure 17: Tax Revenue Collected from Taxes on International Trade



Source: Central Bank of Sri Lanka, Annual Report, various years

(e.g. lowering import duty) it is expected that an increase in imports will also lead to an increase in tax revenues collected from trade taxes. When imports are policy-driven, and if the policies are adjusted in an *ad-hoc* manner[6] to achieve multiple objectives[7], this relationship gets complicated, and predicting imports and tax revenues becomes more problematic (Figure 18). This has been Sri Lanka's experience during the last four years as discussed below.

The government lost control over both import and revenue targets in the 2010-2011 period. While import growth far exceeded the expectations of the government, the growth in tax revenue collected from taxes on international trade fell far short of the expected target. As such, the prevailing policy environment at that time (refer section 5.1) had an adverse impact on both the trade deficit and the fiscal deficit of the government.

For example in 2010, although imports increased by 32%, the revenue collected from taxes on foreign trade declined by 4%. The government collected 17% less revenue from trade taxes compared to the budgeted revenue. In 2011, while imports skyrocketed growing at 50%, the tax revenue collected from trade taxes increased by only 20% – at a rate lower than the growth in revenue recorded in years where import growth was much lower (see Figure 18). In 2011, the revenue collected from trade taxes remained 11% lower than budgeted.

The same trend continued in 2012 and 2013. For example in 2012, when consumer goods imports (which generate a large portion of tax revenue) declined by 6%, the revenue collected from trade taxes increased by 14%. In 2013, consumer goods imports increased by 8%, but the revenue collected from trade taxes increased by only 4%. In 2013, the revenue realized from taxes on international trade was Rs. 49 billion or 20% less than what was budgeted.

As indicated in Figure 18, a strong correlation (of 0.95) can be observed between the growth in consumer goods imports and growth in revenue collected from taxes on international trade, during the 2001-2008 period. During this period import duty was the main instrument of trade policy. Thereafter with the growing importance of various other types of taxes on international trade and frequent revisions of these taxes, this relationship has failed to hold. In the post-war years, the relationship between import performance and performance of tax revenue collected from taxes on international trade has not been clear. Tax revenue has increased at a higher rate in instances where trade volumes have been low and decreased or grew at a lower rate when trade has been high. This is the result of the government tweaking the new taxes introduced on trade in an *ad-hoc* manner to achieve dual objectives simultaneously: to curtail the trade deficit and to arrest declining tax revenues. Unfortunately, the government has not been very successful in achieving either of these objectives. The trade deficit is still over 10% of GDP and tax revenue has continued to decline, hitting a historical low level at 11.6% of GDP in 2013.

A worrisome development is that in the process the government made taxes governing international trade more complex, with a number of new taxes[8] being introduced in addition to import duties (see Figure 17). Moreover, tax rates and products subject to taxation have become unpredictable because of frequent policy changes made to both.[9] ■

Figure 18: Annual Rate of Growth in Consumer Goods Imports and Taxes on International Trade

Source: Calculated using statistics published in the Central Bank Annual Report, various years

6. TRADE DEFICIT

Sri Lanka recorded a historically high trade deficit of above 15% of GDP, in 2011 and 2012 (Figure 19). With exports picking up and imports declining, the deficit has come down to 11.3% of GDP in 2013. In value terms, the deficit in 2013 declined by US$ 1804 million.

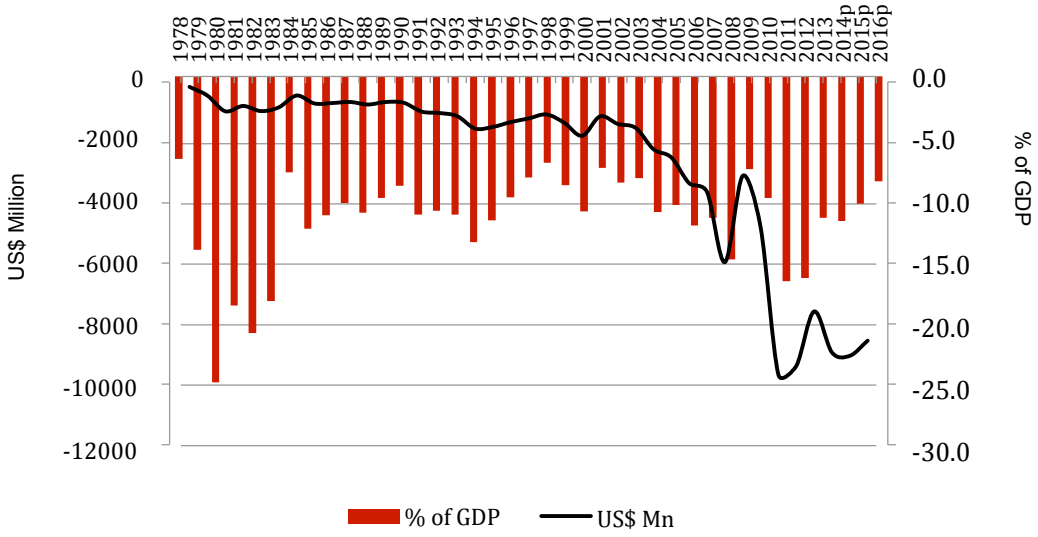
In January this year, when the CBSL released its *Road Map 2014,* the trade deficit in 2013 was projected to be 12.8% of GDP. As such, the actual trade deficit recorded, of 11.3% of GDP, was lower than predicted. This was the result of import expenditure in 2013 being lower than expected, as mentioned in Section 5 of this Review. Therefore, the import projections for 2014 as they stand when compared with the actuals are realistic. The lower than expected level of actual imports in 2013, has provided space for a 17% growth rate in imports in 2014, compared to the 10% growth expected in the *Road Map 2014*.

With the recovery in the world economy and revived demand from Sri Lanka's main export destinations, the USA in particular, export growth may reach double-digits in 2014, but may be lower than the 16% rate of growth projected by the government (and referred to in sub-Section 3.1 above). Overall, this means that the government has room to curtail imports and still meet the deficit target of 11.6% of GDP projected for 2014 (slightly higher than the deficit recorded in 2013), even if exports fall short of the expected target. The robust growth in exports and the sluggish growth in imports experienced in 1st Q 2014 is encouraging in terms of meeting deficit targets.

It is important to note however the limitations of policy driven import and deficit management in Sri Lanka. As indicated, the imports and the deficit were both lower than expected in 2013 owing to favourable weather conditions that led to lower dependence on thermal power, lower imports of fuel and the decline in international oil prices. Hence, fluctuations in weather and international prices, which are beyond the control of the policy makers can positively and negatively impact export and import performance of the country. This is especially relevant for a country like Sri Lanka where main exports (e.g. tea) as well as imports (e.g. food and fuel imports) are highly sensitive to both.

The deficit target of 8.4% of GDP in 2016 shown in Figure 16 even under normal circumstances is still too ambitious, as this requires exports to grow at an average of 18.4% and imports to grow at an average of 10% during 2015-2016. ■

Figure 19: Trade Deficit – Value and Percentage of GDP



p – projections

Source: Central Bank Annual Report, various years, and Central Bank *Road Map 2014*

END NOTES

[1] The Middle Eastern markets for Sri Lankan tea exports are: Bahrain, Iran, Iraq, Israel, Jordan, Kuwait, Oman, Palestine, Qatar, Saudi Arabia, Syria, Turkey, UAE and Yemen.

[2] Department of National Planning, Ministry of Finance, "*Mahinda Chinthana, Vision for the Future, The Development Policy Framework*", 2010.

[3] World Trade Organisation, *World Trade 2013, Prospects for 2014*, 4 April 2014**.**

[4] Department of National Planning, Ministry of Finance, "*Mahinda Chinthana, Vision for the Future, The Development Policy Framework*", page 84, Table 3.5.1, 2010.

[5] Intermediate goods include fuel, textiles, diamonds and precious metals, wheat and maize, fertilizer and other intermediate goods.

[6] For example, during Nov 2013 (where revisions were made in Budget 2014) to May 2014, import taxes have been amended 13 times.

[7] For example, taxes on international trade is revised with multiple and sometimes conflicting objectives such as manage cost of living, protect domestic industry, curtail trade deficit and enhance gov. revenue etc.

[8] Special Commodity Levy (SCL) was introduced in 2008 and the number of products covered and rates have been revised upwards frequently since then, port and airport Development Levy (PAL) which was introduced in 2002 was increased from 3 to 5 percent in 2009 increasing its importance in terms of revenue. The number of products and the rates applied with respect to Cess on imports increased significantly post war.

[9] Refer End note 7 and 9.

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