Arndt-Corden Department of Economics
Crawford School of Public Policy
ANU College of Asia and the Pacific

Australian National University

Rethinking Sri Lanka's industrialisation strategy: Achievements, lost opportunities and prospects

Prema-chandra Athukorala
Arndt-Corden Department of Economics
Crawford School of Public Policy
Australian National University
Prema-chandra.athukorala@anu.edu.au

June 2021

Working Papers in Trade and Development

No. 2021/14

This Working Paper series provides a vehicle for preliminary circulation of research results in the fields of economic development and international trade. The series is intended to stimulate discussion and critical comment. Staff and visitors in any part of the Australian National University are encouraged to contribute. To facilitate prompt distribution, papers are screened, but not formally refereed.

Copies are available at https://acde.crawford.anu.edu.au/acde-research/working-papers-trade-and-development

Rethinking Sri Lanka's industrialisation strategy: Achievements, lost opportunities and prospects

*Prema-chandra Athukorala**

Abstract

The purpose of this paper is to contribute to the contemporary policy debate in Sri Lanka on industrialization strategy by analysing policy regime shifts and their outcome in terms of export performance, growth and employment during the post-independence era. The analysis is guided by the received body of knowledge relating to the challenges faced by a small economy that takes world prices as given and is unable to affect world demand and supply in designing national industrialisation strategy in this era of economic globalization. The findings demonstrates that the backlash against liberalization reforms in the contemporary Sri Lankan policy debate is largely based on ideological predilections rather factual analysis. The comparative analysis of Sri Lanka's industrialization experience during the state-led import-substitution era and that of the post-reform era (in particular during the first two decades) makes a strong case for reconsidering the merit of the emerging emphasis on combining import substitution with export orientation with a sector specific focus. Selective policies to promote import substitution essentially impose a 'tax' on export producers.

Key words: industrialization, trade policy, foreign direct investment, economic globalisation

JEL codes: O14 O24, O25, O53

* I have drawn on my joint research-in-progress with Aneetha Warusavitarana (Advocata Institute, Colombo) in writing the case study of the 'mini electronics boom' in Section 3 of the paper. I am grateful to Aneetha for excellent research collaboration.

Rethinking Sri Lanka's industrialisation strategy: Achievements, lost opportunities and prospects

1. Introduction

The history of industrialization strategy in Sri Lanka is characterized by abrupt episodes of substantial changes associated with political regime shifts without settling to a stable path required for self-sustained growth. During the first decade after independence in 1948, development of industry was not a policy priority in Sri Lanka, unlike in many other newly independent nations. From about the late 1950s, a combination of the influence of the development thinking at the time and growing balance-of-payments problems induced a policy shift towards state-led import-substitution industrialization. In 1977 Sri Lanka embarked on an extensive economic liberalization reforms process that marked a decisive break with a two decades of state-led import-substitution industrialization strategy.

By the mid-1990s, Sri Lanka ranked amongst the few developing countries that had made a significant policy transition from inward orientation to global economic integration. However, over the past two decades, the merits of industrialization under liberalization reforms have become a hotly debated issue in the Sri Lankan policy circles. The anti-liberalization lobby has begun to portray the failure of reforms to elevate the country to the league of dynamic East Asian economies as an intrinsic flaw of liberalisation reforms, while downplaying (or overlooking) the constraining effects on the reform outcome of the incomplete and staggered nature of the reform process and prolonged civil war. The policy pendulum has therefore begun to shift in favour of combining import substitution with export orientation while 'guiding the markets' by the state. The massive disruption in world trade caused by the Covid-19 pandemic has further strengthened the case for emphasis on economic self-reliance in determining national development priorities.

The paper aims to contribute to the contemporary policy debate in the country on the need for and modalities of redesigning the country's industrialization strategy by analyzing changes and continuities in Sri Lanka's industrialization strategy during the post-independence era. The analysis is guided by the received body of knowledge relating to the challenges faced by a small economy that takes world prices as given and is unable to affect world demand and supply. The paper specifically focusses on factors behind shifts in

industrialization strategy away from and towards global economic integration and the outcomes with respect to export performance, growth and employment generation, while paying attention to rapidly changing global context in this era of economic globalization.

The paper begins with an overview of changes and continuities in Sri Lanka's industrialization strategy during the post-independence era. This is followed by a comparative analysis of Sri Lanka's experience under import substation and export-oriented industrialization strategies, with emphasis on fundamental sources of discontent in the Sri Lankan policy circles with export-oriented industrialization strategy. The final sections summarizes the key findings and their implications for the contemporary policy debate in Sri Lanka.

2. A brief policy history

During the first decade after independence in 1948, Sri Lanka maintained an open-market economy, with a liberal trade and foreign direct investment (FDI) policy regime. Unlike in many other newly independent countries, the development of manufacturing was not a policy priority. The main emphasis of the government's development agenda was reviving domestic food crop agriculture, predominantly rice, mainly based on colonization in the sparsely populated dry zone of the country (Snodgrass, 1966).

A major shift in development strategy towards import substitutional industrialization, with increased government intervention and state monopoly over strategic industries, took place following political regime shift in 1956. At the beginning, the policy shift was consistent with the conventional wisdom of the day in favour of import-substitution industrialization, but from the late 1950s import-restrictions became an integral part of the government response to the worsening external payments situation. The import-substitution rhetoric merely provided an ideological facade that was politically useful as the government was not willing to run the political risk of undertaking structural reforms in response to the balance of payment crisis. Import restrictions, initially imposed to address balance of payment difficulties, became increasingly tight with pervasive state interventions in the economy. The Business Acquisition Bill passed in 1971 allowed the government the takeover of any business enterprise, without providing safeguard against arbitrary takeover. By the mid-1970s, the Sri Lankan economy had become one of the most inward-oriented and regulated economies in the world outside the Communist Bloc. The activities of the private sector remained caught up in a complicated cobweb of state controls (Cuthbertson & Athukorala, 1990).

Export promotion became a key policy focus as an appendage to the control regime in the late 1960s. In 1966, a bonus voucher scheme for non-traditional exports (broadly defined to encompass all exports other than tea, rubber and coconut products) was introduced. During 1968-70, a foreign exchange entitlement certificate scheme (FEECS), a dual exchange rate system with an exchange rate premium of 40% for non-traditional exporters, was part of a mini-trade liberalization episode. The FEECS premium was raised to 65% and a new convertible rupee account (CRA) scheme was introduced in 1972. A white paper of foreign direct investment issued in 1972 assured export-oriented foreign investors complete security of investment, complete compensation in the event of nationalization, and remittance of profit and repatriation of assets on business closure. However, these policies had little impact on averting the worsening external payments conditions of the country because the overall policy and political context was highly unfavourable to private sector activities in general and to export production in particular. Reflecting the cumulative impact of stringent import controls, high export taxes and the overvalued exchange rate, the overall incentive structure of the economy was characterised by a significant 'anti-export' bias throughout this period. In the early 1970s, there was a proposal in the government circles to set up a free-trade port at Trincomalee, but it was not acceptable to the left wing parties in the coalition government (Fitter, 1974).

By the mid-1970s, the state-led import substitution strategy had made the Sri Lankan economy extremely vulnerable to external shocks. Consumer goods imports had gradually converted into essential imports needed to maintain domestic output. There were no longer any compressible import fat left to cushion the economy against unexpected shortages of foreign exchange (Athukorala, 1981). As noted, the expansion of non-traditional exports had only a marginal cushioning effect against the unsatisfactory performance of traditional exports. There was clear evidence exposing the myth that Sri Lanka could develop in isolation from the forces molding the world economy. The groundswell of dissatisfaction of the populace with the government paved the way for a regime change in 1977.

The new government embarked on an extensive economic liberalization process that marked a decisive break with the two decades of protectionist policies. The first round of reforms carried out during 1977-79 included (a) replacing quantitative import restriction with tariffs that provided lower levels of nominal protection for domestic import-substitution industries; (b) opening the economy to foreign direct investment (FDI), with new incentives for export-oriented FDI under an attractive Free Trade Zone (FTZ) scheme and constitutional guarantee against nationalization of foreign assets; (d) abolition of the multiple exchange rate system followed by a sharp devaluation of the unified exchange rate; (e) the introduction of

limits on direct public sector participation in the economy, and (e) a wide ranging export promotion schemes, including a revamped duty rebate scheme for export producers, under a newly established export development board (EDB) (Rajapatirana, 1988, Cuthbertson & Athukorala, 2000).

A 'second wave' liberalization package was implemented during 1990-93. This included abolishing export duties on all plantation products; extension of FTZ privileges to export-oriented firms located outside the EPZs, abolishing import duties on textile in order to help the expansion of the export-oriented garment industry, and significant fiscal consolidation (Dunham and Kelegama 1997). In 1994, Sri Lanka achieved Article VII status of the International Monetary Fund (IMF) after abolishing foreign exchange restrictions on current account transactions, including the foreign exchange surrender requirement on export proceeds.

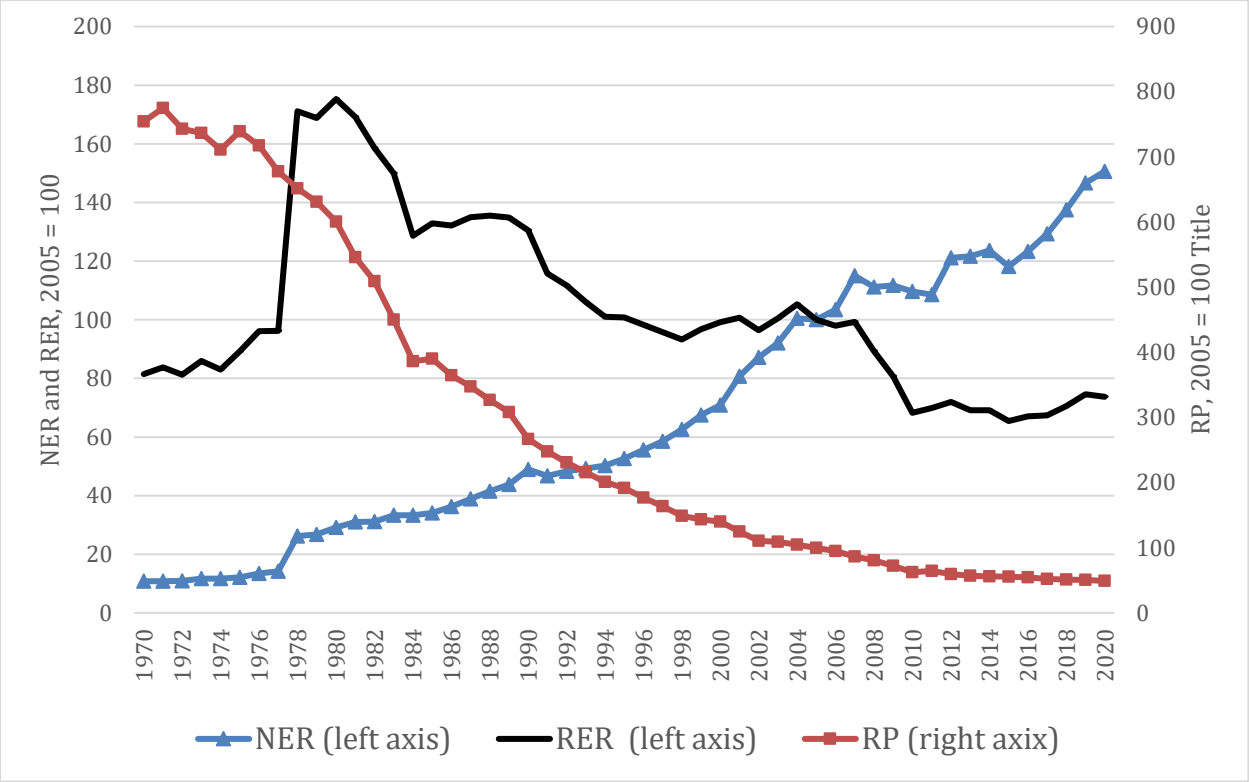
The liberalisation reforms made a clear departure from the state-led import substitution policy posture. However, the reform process was incomplete in terms of the standard prerequisites for a market-oriented economy (Krueger, 1997). First, while some loss-making public enterprises were either shifted to the private sector or closed down, a number of them continued to operate with heavy dependence on budgetary transfers. Second, a gazetted bill to reform the labour legislation to achieve greater labour market flexibility was abandoned in face of widespread opposition by the trade unions.

Third, the complementarity between macroeconomic management and trade liberalization required for maintaining competitiveness of tradable production in the liberalized economy was missing. The original reform package of 1977 was formulated with emphasis on the complementarity between macroeconomic management and trade liberalization. The dual exchange rate system, which had been in operation since 1968, was abolished and the new unified exchange rate was allowed to adjust in response to foreign exchange market conditions. However, from about 1979 the Central Bank began to deviate gradually from the original plan and to intervene in the foreign exchange market to use the nominal exchange rate as an 'anchor' to contain domestic inflation. The policy emphasis on fiscal prudence, too, was short-lived. The main source of macroeconomic instability was a massive public-sector investment program that included the Mahaweli river basin development scheme, a large public housing program, and an urban development program (Jayasuriya, 2004). The real exchange rate (RER) (the standard measure of international competitiveness of an economy), which significantly depreciated showing improved international competiveness during the first few years following the economic opening, tended to appreciate during the ensuing years. Mild depreciation of the nominal exchange rate under the managed floating

system was more than counterbalanced by the rate of increase in domestic prices that was far greater than that of Sri Lanka's trading partners. There was a notable reversal in RER appreciation during the second wave liberalization, but it quickly dissipated (Figure 1).

Reaping gains from liberalization reforms was also seriously hampered by the escalation of the ethnic conflict from the early 1980s. The conflict virtually cut off the Northern Province and large parts of the Eastern Province (which together account for one-third of Sri Lanka's total land area and almost 12% of the population) from the national economy. Even in the rest of the country, the prospects for attracting foreign investment, particularly in long-term ventures, were seriously hampered by the lingering fear of sporadic attacks by the rebels. The government's preoccupation with the civil war also hampered capturing the full benefits of economic opening through delays and inconsistencies in the implementation of the reform processes.

Figure 1: Real Exchange Rate and Its Component[1] (2005 =100), 1970-2020



Note: 1. NER is export-weighted nominal exchange rate (measured as rupees per foreign currency unit) relating to Sri Lanka's top six manufacturing export destination countries (which together account for over 90% of the country's total manufacturing exports). RER is NER adjusted for relative price level of Sri Lanka (measured by the GDP deflator) and the six destination countries (measured by the producer price index). An increase (decrease) in RER shows an improvement (a deterioration) in international competitiveness.

Source: Compiled from data extracted from World Bank, *World Development Indicator* database and Central bank of Sri Lanka, *Annual Report* (various years).

Despite the incomplete implementation and the debilitating effect of the civil war, the reforms significantly transformed the economic landscape of Sri Lanka (next section). The economic gains from reforms was substantial to make economic liberalization by-patrician policy in the 1990s (Kumaratunga, 1994). However, as early as the late 1990s, the trade liberalization process suffered a setback because of the pressure for raising additional revenue from import tariffs to finance the ballooning war budget. The planned reduction of tariffs into a single band was abandoned and from then on tariffs were adjusted frequently in an ad hoc manner. The protectionist tendencies soon received added impetus from the growing discontent amongst the electorate propelled by the crisis economic conditions as the civil war accelerated.

The backlash against liberalization reforms gained added impetus as the country returned to a state of normalcy at the end of the three-decade old civil war in May 2009 (Athukorala & Jayasuriya, 2015; Pursell & Ahsan, 2011; Kaminski & Ng, 2013). The government begun to emphasize the role of the state in 'guiding the markets' with a view to redressing perceived untoward effects of economic globalization. Privatization of key state enterprises (banking, power, energy, transport, and ports) was explicitly ruled out, while conspicuously avoiding any reference to trade policy reforms (GSL, 2010).

By 2009 the Sri Lankan tariff schedule included nine import taxes in addition to the standard customs duty. Of these nine taxes, five were 'para-tariffs': taxes which are only applied to imports and hence compounded protection provided to domestic production by customs duties. The total nominal protection rate (customs duty + para-tariff) more than doubled (13.4% to 27.9%) between 2004 and 2009 (Pursell & Ahsan, 2011). During the ensuing years, there were also many *ad hoc* duty exceptions and case-by-case adjustment of duties on many manufacturing imports which directly compete with domestic production. By 2015 the average effective rate of protection for manufacturing production had increased from 47% in 2000 to 63%, and production for the domestic market was over 70% more profitable compared to production for exporting (World Bank, 2005; DCS, 2018).

In 2008 the parliament passed a *Strategic Development Projects (SDP) Act*, empowering the minister in charge of the BOI to grant exemptions to 'strategic development projects' from all taxes for a period of up to 25 years. In the Act, a strategic development project meant 'a project which is in the national interest and likely to bring economic and social benefits to the country and which is also likely to change the landscape of the country,

primarily through provision of goods and services which will be of benefit to the public, substantial inflow of foreign exchange, substantial employment, and technology transfer' (GSL, 2008). This definition left a great deal of room for the minister's discretion in the investment approval process, thus undermining the role of the BOI. A *Revival of Underperforming Enterprises and Underutilized Assets Act* was passed in November 2011 empowering the government to acquire and manage 37 'underperforming' or 'underutilized' private enterprises. The list included seven enterprises with foreign capital participation. Two major credit rating agencies (the Fitch Group and Moody Corporation) warned that the bill would erode investor confidence and affect Sri Lanka's investment rating (Goodhand 2012).

The period from 2015 to 2019 was an era of policy inaction. In spite of the promised commitment to outward-oriented development strategy, no attempt was made to redress policy reversals. The government was active in preferential trade liberalization by entering into free trade agreements (FTAs), overlooking the fact that Sri Lanka's lackluster export performance was primarily rooted in unilateral policy reversals and other supply-side impediments. There was also an undue emphasis on achieving 'sophistication of the export composition' within the 'global product space' while ignoring the country's unexploited opportunities for export expansion by specializing in task within global production networks that fit with the country's own comparative advantage advantage (Thompson and Athukorala 2020).

The present government has not so far come up with a definitive industrial development policy. However, according the manifesto issued at the presidential election (*Vistas of Prosperity and Spender*), the envisaged policy choice is a 'mixed-economy' model that combines selective import substitution with export-orientation. In April 2019, the government appointed a Presidential Task Force on Economic Reveal and Poverty Eradication (PTFERPE) to recommend establishing 'a people-centric economy that encourages local industrialists and entrepreneurs, blending new technologies with expansion of import substitution products, local farmer products, agricultural products and other small and medium scale industries to encourage exports and reduce the trade gap by devising measures to diversify the production economy' (GSL, 2020, p. 5A).

The Task Force has come up with a list of potential winning industries, 'pharmaceuticals, rubber products, coconut related products, spices, electronics and electrical components, ship and boat building, food and beverages, cosmetics, toys, machinery and machinery appliances, and ceramic products among others' for selective policy intervention (CBSL, 2021, p 20). The Central Bank endorsed that '*the novel economic policy framework* of the government is expected to address impediments to growth and

promote domestic production especially though the agricultural sector and earmarked manufacturing and export industries, while enhancing non debt creating foreign exchange inflows' (CBSL 2021, p 3). The Bank further stated that ' ... in the short term, prioritizing winning industries of the country, will drive the overall export performance, while enhancing domestic production ... [and] resolve the numerous *legacy issues* that straddle the performance of the export sector' (emphasis added) (CBSL 2021, p. 20), without spelling out what the so-called 'legacy issues' are.

3. Manufacturing performance

Growth of manufacturing in the Sri Lankan economy, as reflected in the national accounts, was lackluster during the stet-led import substitution era. In the 1960s, at the early stage of import-substitution industrialization (ISI), the average annual manufacturing growth rate was around 8.5%, but it propped to a mere 3% in 1970-76 (Table1). By that time, unanticipated curtailment of imported intermediate inputs in response to foreign exchange scarcity had become a binding constraint on industrial expansion (Athukorala, 1981).

Table 1: Manufacturing Sector in the Sri Lankan Economy, 1960-19 (%)

Period	GDP growth[1]	Manufacturing output (value added)[2]	Manufacturing share in GDP (%)
1960-69	4.7	8.3	9.7
1970-77	3.0	1.1	12.7
1978-84	7.0	4.6	13.1
1985-89	3.3	5.9	15.3
1990-94	6.2	8.9	15.1
1995-99	4.4	7.1	16.3
2000-04	5.0	0.8	16.9
2005-09	6.0	5.1	18.9
2010-14	6.8	5.8	17.0
2015-19	3.7	3.4	16.5
2020	-3.6	-5.0	15.5

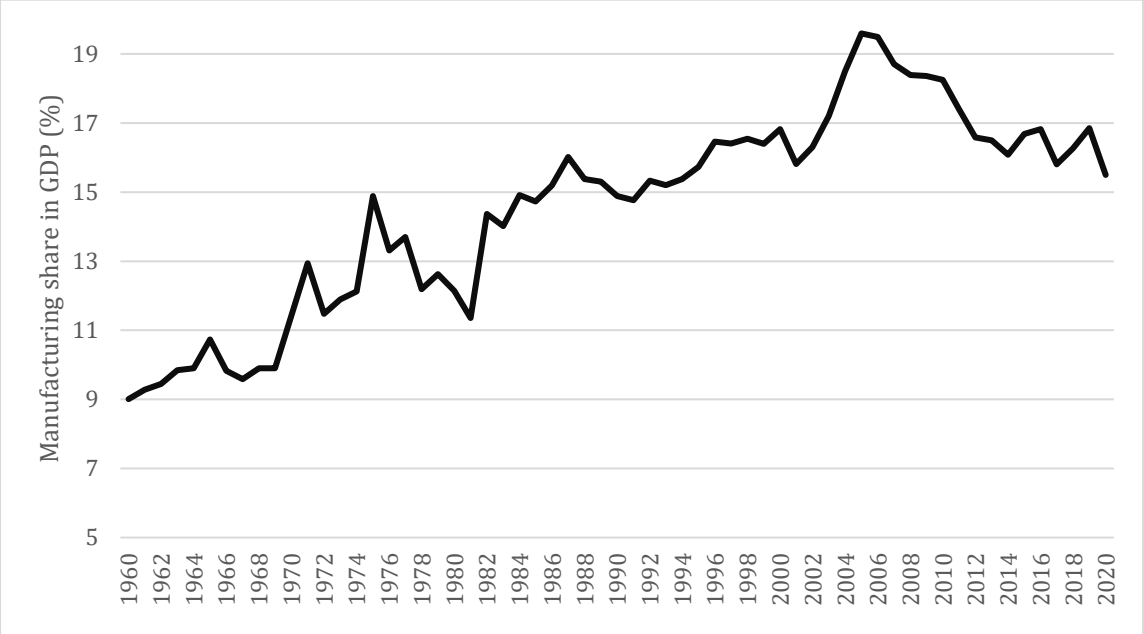
Notes
(1) Computed using GDP at constant (2010) prices.
(2) Computed from real valued added using the 'implicit manufacturing deflator' (2010 = 100) derived from national accounts.
Source: Data compiled from The Central Bank, Annual Report (various issues)

The manufacturing sector entered a distinct growth phase following the liberalization reforms. Contrary to the gloomy predictions by the critics of reforms, the lifting of import

controls did not result is a sudden massive contraction. Free availability of imported inputs and capital goods in the liberalized economy, the cushioning effect against import competition provided by moderate tariffs, and the exchange rate depreciation help domestic manufacturing to face import completions, although there was some business failures (in particular virtual disappearance of the handloom industry). Following initial adjustments to the new competitive market setting, manufacturing growth surpassed that of other sectors during most years during the next two decades.

From the late 1970s to about the late 1990s, manufacturing grew at an average annual rate of about 6.5%, compared to an overall GDP growth rate of 5.3%. The manufacturing share of GDP therefore recorded an almost two fold increased, from 10% to nearly 20% by the early 2000s. Since then the trend has reversed, reflecting the faster growth the non-tradable sectors propelled by the post-civil war construction boon and the slowing of manufacturing growth. The share of manufacturing in GDP declined from 19% in the early 2000s to 15% in 2019 (Figure 2).

Figure 2: Manufacturing share in GDP, 1960-2000 (%)



Source: Date complied from Central Bank of Sri Lanka, *Annual Report* (various issues)

The expansion of manufacturing sector has also been underpinned by a dramatic shift in its ownership structure. The share of SOEs in manufacturing output dropped from about 70% in the mid-1970s to less than 3% by the turn of the century.

The immediate drivers of manufacturing output growth in the liberalized economy were the unrestraint availability of important inputs, increase in foreign direct investment, and

access to a vast pool of cheap but trainable labour force that had been bottled up in the economy during the dirigisme era. However, there is evidence that total factor productivity (TFP) growth (increase in output over and above the use of inputs) played a significant role in the output growth. Almost 24% of total output growth between 1981 and 1993 came from TFP growth (Athukorala and Rajapatirana, 2000, Chapter 8). According to a recent study, TFP grew at an annual rate of 3.8 percent during 1990-02 (Bandara & Liyanaarachchi, 2020). However, there has been a notable decline in productivity improvement during the ensuing years: TFP growth declining to 1.7 percent during 2003-09 and further plummeted to a mere 0.5 percent during 2010-2016. Disaggregated industry level analysis in both studies have identified a statistically significant association between TFP growth and trade policy reforms, export-orientation and FDI. The shrinking of the role of SOE also had a salutary effect on productivity improvement in the manufacturing sector: during the ISI era SOEs dominated most domestic intermediate goods producing industries, with virtually exclusive access to imported inputs. Inefficiency of SOEs therefore spilled over to private sector manufacturing through both high prices charged by SOEs and poor quality of inputs (Wanigatunga, 1987; Sirisena, 1975).

There has been a notable increase in manufacturing employment. At the time when the reforms started, the manufacturing sector accounted for about 10% total employment in the country (Table 2, Figure 3). This increased continuously to over 18 percent by the mid-2010s, but has virtually stagnated around that figure from about the mid-2010s. The increase in manufacturing employment came from private sector with the share of employment in manufacturing SOEs declining sharply. Disaggregated data show that the export- oriented garment industry contributed to over 35% of total employment in organised manufacturing by the mid-1990s (DCS, 1978 – various years). This share declined slowly in subsequent years reflecting the expansion of other export oriented industries such as rubber products, ceramics, and travel goods. Total employment in the enterprises approved by the BOI, which are fully export oriented, increased from 11 thousands in 1980 to nearly a half a million by 2015.[1] The employment impact of new export-oriented industries would look even more impressive if employment in small-scale manufacturing were appropriately accounted for. Many export-oriented firms have production subcontracting arrangements with small-scale producers in the unorganised sector.

With the expansion of export-oriented labour-intensive manufacturing, there was a significant shift in the occupational composition in manufacturing, in favour of unskilled and

[1] The BOI has stopped reporting employment data to the Central Bank from 2016.

semi-skilled workers and the share of female worker. The share of semi-skilled and unskilled workers in organised manufacturing increased from about 40 percent to over 70 percent, and the share of female workers from 32% to over 60% between the early 1980s the early 2000s (DCS, various issues). Most, if not all, of these workers come from low-income households. Growth of manufacturing employment growth, coupled with these compositional changes in employment, would have contributed to decline in absolute poverty (World Bank, 2005).

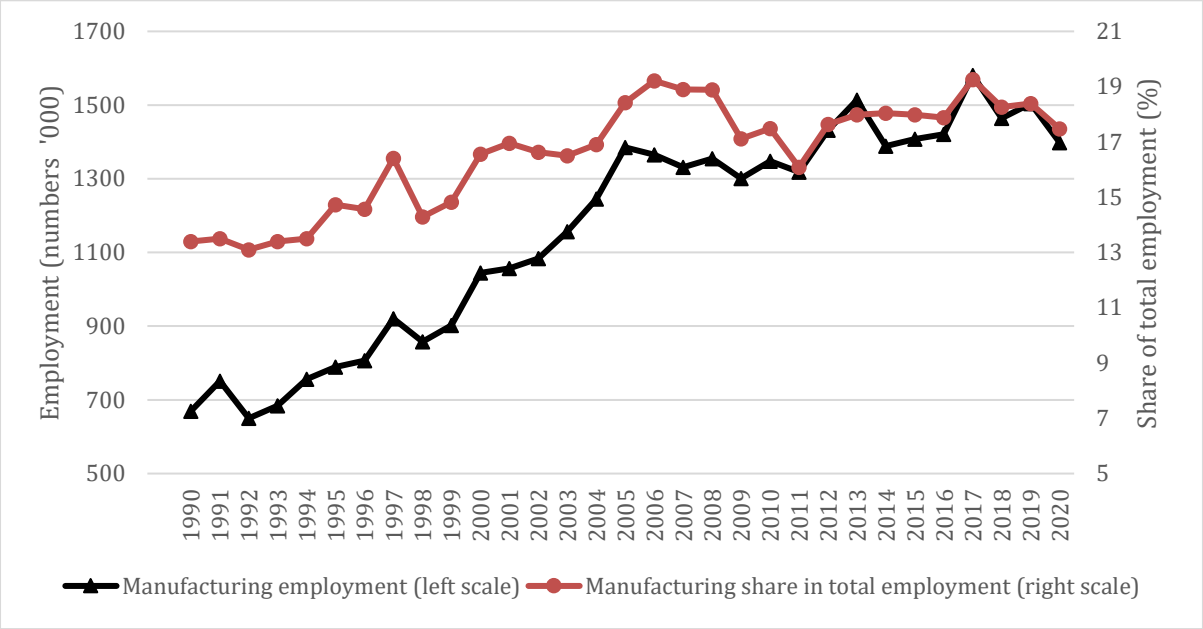
Table 2: Employment in the Manufacturing Sector,1960-2020

Selected years	Number employed ('000)			Manufacturing share of total employment (%)
	SOE[1]	BOI[2]	Manufacturing[3]	
1960	---	---	56	1.8
1965		---	134	4.2
1970	27	---	270	8.2
1975	48	---	417	10.5
1980	---	11	537	12.1
1985	---	36	648	12.6
1990	45	71	669	13.4
1995	40	233	789	15.3
2000	34	368	1045	16.6
2005	24	411	1385	18.4
2010	11	426	1348	17.5
2015	12	491	1408	18.0
2019	11	---	1504	18.4
2020	11	---	1398	17.5

Notes: (1) State-owned manufacturing enterprises
(2) Board of Investment approved firms
(3) Including SOE and BOI employment
--- Data not available.

Source: Data for 1960 and 1965 are from Hallett (1983); for other years: compiled from Central Bank of Sri Lanka, *Annual Report* and the *Monthly Bulletin of Statistics* (various issues).

Figure 3: Employment in the Manufacturing Sector, 1990-2020

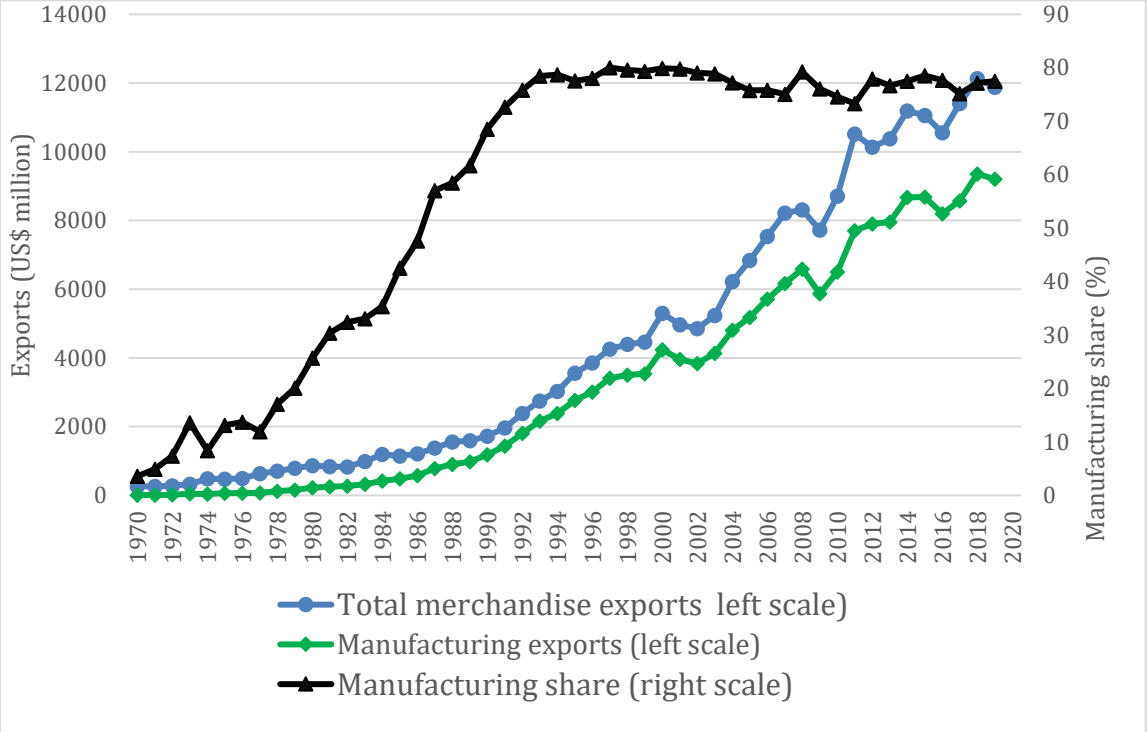


Source: Data compiled from Central Bank of Sri Lanka, *Annual Report* and the *Monthly Bulletin of Statistics* (various issues).

Export performance

Following the 1977 policy reforms, the export structure of the economy has undergone a remarkable shift from the traditional 'primary trio' (tea, rubber and coconut products) to labour-intensive manufacturing. Exports of manufactured goods grew (in current United States dollar terms) at an annual compound rate of over 30% during 1978–2000, lifting their share in total merchandise exports to over 70%. However, since then the rate of expansion of manufacturing exports has lagged behind that of primary commodity exports, with the manufacturing share in total exports varying in the range of 70% to 68% (Figure 4).

Figure 4: Sri Lanka's Merchandise Exports[1], 1970 - 2020



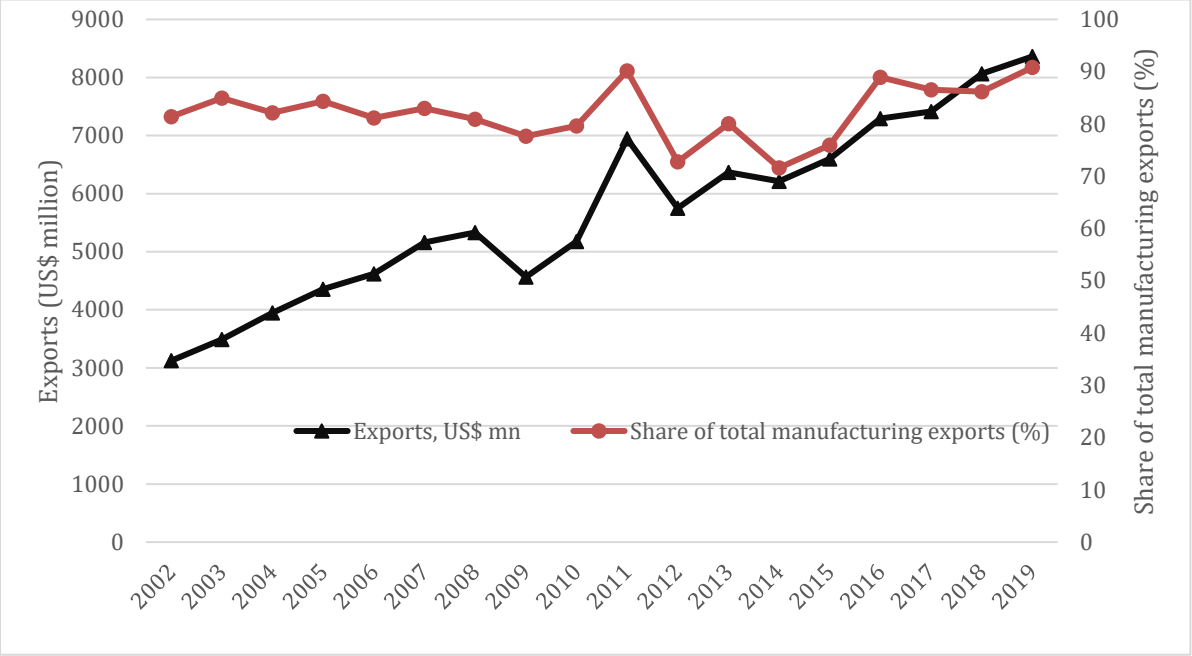
Note: Manufacturing products are defined as those belonging to product codes 5 through 8 of the Standard International Trade Classification excluding Code 68 (non-ferrous metals).

Source: Data compiled from UN *Comtrade* database.

The entry of foreign investors into export-oriented manufacturing played a pivotal role in the growth of manufacturing export. The share of foreign-invested enterprises (FIEs) in total manufacturing exports increased from 24% in 1977 to over 80% in mid-1995 (Athukorala & Rajapatirana, 2000, Table 6.8). Data for more recent year's show that the dominance of FIEs manufacturing exports has continued in the ensuing years: the share of BOI approved enterprises[2] varied in the rage of 82% to 90% during 2002-19 (Figure 5). Most of the foreign investors operate under joint venture arrangements with local entrepreneurs. FDI has, therefore, been an effective vehicle for transferring managerial practices and entrepreneurial skill to the local economy. A recent analysis of BOI records has found that the departure of some foreign investors contributed to slowing of manufacturing exports over the past ten years or so. The number of BOI approved firms in operation had dropped from 1150 in 2005 to 851 in 2015 (Athukorala, 2017).

[2] Over 90 percent of the BOI approved projects.

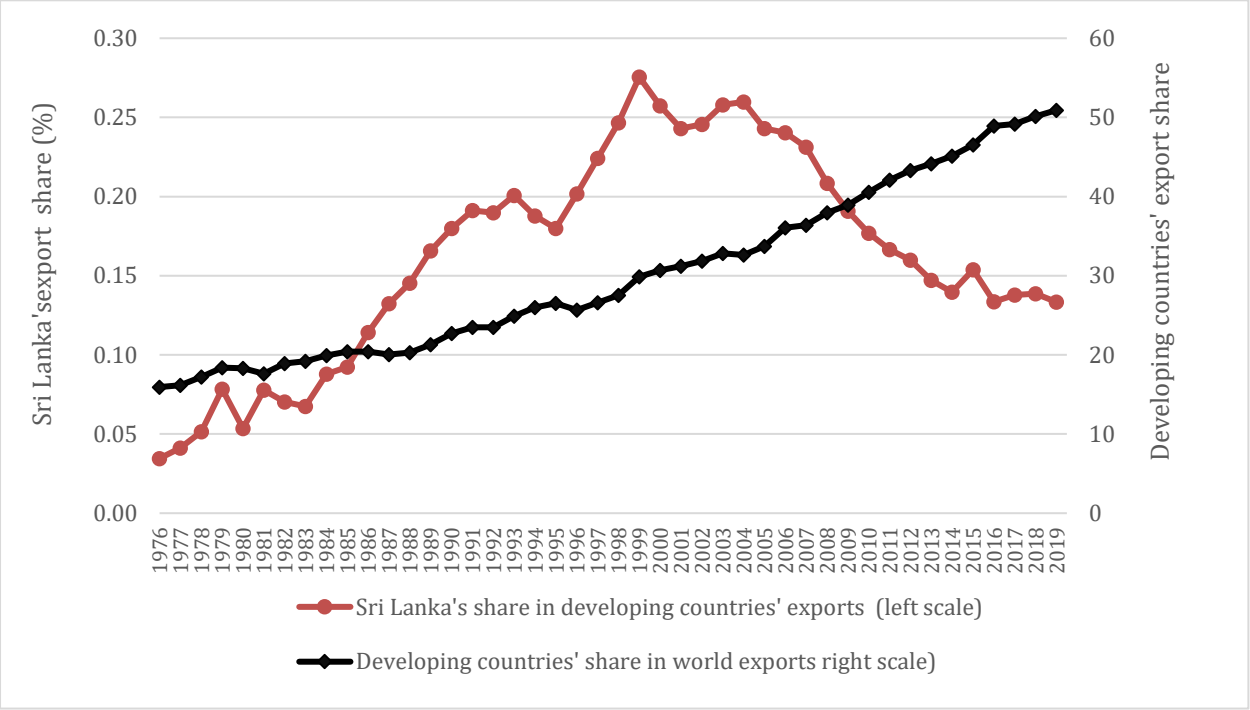
Figure 5: Exports from BOI approved firms, 2002-2019



Source: Data compiled from Central *Bank Monthly Bulletin of Statistics* and *The Annual Report* (various issues)

Since about the later 1960s, there has been a dramatic shift in the origin of world manufacturing exports from the mature industrialized countries to developing countries: the share of developing countries share in world manufacturing exports surged from less tha10% in the 1970s to over 50% by the late 2010s (Figure 6). Sri Lanka's ability to reap gains from this structural shift in global manufacturing was virtually precluded by the dirigiste policy regime. Following the regime shift in 1977, there were some promising signs of regaining lost grounds. Sri Lanka's share in total manufacturing exports from developing countries increased from a mere 0.02 in 1976 to over 0.28% by the early 2000s, but the figure has plummeted since then, reverting to the level in the late 1980s of about 0.13%. This overall pattern suggests that slowing of Sri Lanka's export growth during the last two decades has been driven primarily by domestic supply-side factors which had constrained exploiting opportunities for world market penetration.

Figure 6: Sri Lanka's Export Performance in a Global Context, 1976-2019



Note: Classification of developing countries is based on the UN *Standard International Country Classification:* https://www.un.org/en/development/desa/policy/wesp/wesp_current/2014wesp_country_classification.pdf

Source: Data compiled from UN *Comtrade* database.

Product composition of exports

Date on the composition of Sri Lanka's manufacturing exports is summarized in Table 3. Garments (articles of apparel and clothing accessories) has been Sri Lanka's single largest export product. The share of garments in total merchandise exports increased from 1.3% in the early 1980s to over 60% (76% of total manufacturing exports) by the late 1990s. Since then the share has gradually declined to about 47% of total merchandise exports (70% of manufacturing exports) reflecting a modest diversification of the commodity composition to other labour-intensive products, such as leather goods, footwear, toys, plastic goods, and diamond cutting and jewelry, and domestic resource-based manufacturing, in particular ceramics and rubber.

Table 3: Sri Lanka: Commodity Composition of Exports, 1965-2020[1] (%)

Product groups [2]	**1969-70**	**1974-75**	**1979-80**	**1980-85**	**1989-90**	**1994-95**	**1999-00**	**2004-05**	**2009-10**	**2014-15**	**2019**	**2020**
Primary products (0 + 1 + 2 + 3+ 4 + 68)	96.6	89.7	77.6	62.9	39.3	22.5	19.8	21.9	24.9	22.2	22.3	33.7
Primary products excluding petroleum (0 to 4 +68) – 33	95.9	86.0	75.0	59.6	38.2	22.0	19.3	21.8	24.7	21.8	22.0	33.4
Manufacturing (5 + 6 + 7 + 8) - 68	3.4	10.3	22.4	37.1	60.7	77.5	80.2	78.1	75.1	77.8	77.7	66.3
Chemicals and related products (SITC 5)	0.4	0.6	0.5	0.7	1.0	0.9	0.7	1.0	1.4	1.8	1.9	2.2
Manufactured goods classified by material (SITC 6 - 68)	2.3	6.9	8.8	6.2	16.8	15.0	14.4	16.0	13.0	14.8	11.7	13.1
Rubber manufactures (62)	0.1	0.1	0.3	0.5	1.6	2.3	3.2	4.9	4.9	6.4	2.7	5.3
Textile yarn and fabrics (65)	0.2	0.4	0.6	1.2	2.2	4.2	4.9	2.1	1.9	2.2	1.3	4.2
Non-metallic mineral products[2] (66)	1.8	5.9	7.3	4.3	12.2	7.8	5.7	5.7	5.5	4.8	3.6	2.2
Machinery and transport equipment[3] (SITC 7)	0.3	1.7	0.6	2.5	1.2	3.3	4.7	5.2	6.9	7.5	10.0	3.9
General industrial machinery and equipment[3] (74)	---	---	0.1	0.2	0.1	0.2	0.2	0.6	0.8	1.1	1.2	0.7
Office and data-processing machines[3] (75)	---	---	0.0	0.1	0.0	0.6	1.6	0.6	1.4	2.2	2.0	0.0
Telecomm and sound recording equipment[3] (76)	---	---	0.0	0.1	0.1	0.2	0.2	0.1	0.1	0.2	0.1	0.0
Electrical machinery and appliances[3] (77)	---	---	0.2	0.1	0.6	1.4	1.5	2.1	2.0	1.9	2.4	2.4
Road vehicles[3] (78)	---	---	0.0	0.0	0.1	0.1	0.3	0.5	1.3	0.5	0.6	0.6
Other transport equipment[3] (79)	---	---	0.0	1.3	0.1	0.0	0.3	0.2	0.8	0.9	2.7	0.0
Miscellaneous manufacturing (8)	0.4	1.1	12.6	27.6	41.8	58.2	60.4	55.9	53.8	53.7	54.1	47.0
Articles of apparel and clothing accessories (84)	0.2	0.7	11.9	26.2	38.5	50.6	52.8	51.9	50.6	50.3	50.4	43.2
Footwear (85)	0.0	0.1	0.1	0.4	0.6	1.2	1.0	0.3	0.3	0.5	0.2	0.2
Professional, scientific and controlling equipment[3] (87)	0.0	0.1	0.1	0.1	0.1	0.1	0.8	0.5	0.5	0.6	0.7	0.7
Total exports	100	100	100	100	100	100	100	100	100	100	100	100
US$ million	260	496	850	1210	1772	3326	4770	6569	8219	11126	11787	10047

Notes: (1) Two-year averages (except for 2019 and 2020) (2) Standard International Trade Classification (SITC) codes are in bracket. (3) Mostly ceramics and porcelain

(4) Parts and components

Source: Data compiled from UN Comtrade database.

Among the non-garments products, rubber-based products, in particular pneumatic (airless and solid) tires, have shown impressive growth. Sri Lanka's share in world exports of pneumatic tires (SITC 62594) increased from 6.0% in 1990-91 to 22.3% in 2018-19. Two Sri Lankan joint ventures, with Camso (a Canadian multinational enterprise) and Tellobrog (a Swedish multinational enterprise), account for the country's entire production of pneumatic tires. The share of natural rubber (Sri Lanka's second largest traditional export) in total exports has declined sharply as a result of the rapid growth of rubber-based manufacturing industries. Currently, more than 80% of the country's total natural rubber production is absorbed by the export-oriented rubber-based manufacturing, a notable achievement of domestic resource based industrialization under trade-cum-investment liberalization.

Garments[3]

In the Sri Lankan policy circles, garment is often treated as a 'traditional' products; its dominance is considered a structural weakness of the export structure of the country. However, in reality, the Sri Lankan garment industry has evolved to become a strong modern industry that has shown remarkable agility to thrive in a highly competitive global market setting, notwithstanding its conspicuous absence on priority lists prepared for the country's export development strategy.

Sri Lanka's 1977 liberalization reforms coincided with the tightening of import quotas allocated under the Multi-Fibre Arrangement (MFA) by the major importing countries to the three major garment producers in Asia, Hong Kong, Taiwan and South Korea. Given this happy coincidence, 'quota hopping' investors from these countries, and international buyers who followed them, played a pivotal role in the garment export boom in Sri Lanka.

The implications of the abolition of the MFA with effect from 31 December 2004 was, therefore, a key concern in the Sri Lankan policy circles. In the lead up to the MFA abolition, Sri Lanka was among the countries expected to experience significant contraction of garment exports during the post-MFA free era (Nordas, 2009). This gloomy prediction has not materialized, however. The average annual Sri Lankan garments exports during 2005–2019 was US$ 5.7 billion compared to $2.8 million during the preceding 5 years (2000–2004), a two-

[3] This section draws on Athukorala (2018) and Athukorala and Ekanayake (2018).

fold increase. Sri Lanka's share in total garments exports from developing countries increased from about 1.1% during 2000–2004 to 1.8% in 2018-19.

The MFA quota system certainly helped in bringing international investors and buyers to Sri Lanka's apparel industry. But, it was the trade-cum-investment liberalization that set the stage for Sri Lanka to exploit thither to unexploted comparative advantage in this global industry. The arrival of international investors and global byers opened the door for the local entrepreneurship that remained dormant during the dirigisme era to benefit from having access to trainable labour force at competitive wages. Through joint-venture arraignments with foreign investment partners and, more importantly, trade linked forged with international buyers, the Sri Lankan apparel industry has well settled into a smaller core of firms, which are well prepared to operate under competitive market conditions in the post-MFA era.[4]

The industry has developed a well-developed customer base including well-known brand names such as Abercrombie and Fitch, Gap, Hunkemoller, Liz Claiborne, Marks and Spencer, Nike, Pierre Cardin, Ralph Lauren, Sainsbury's, Tesco, Tommy Hilfiger, and Victoria's Secret. Large Sri Lankan apparel firms (at least the top 10 companies) have established their own design centers that work closely with design teams of brand owners. These firms have invested in computer-aided design and manufacturing, and in electronic fitting, which enables design decisions by visualizing the garment digitally, skipping fit-on sessions with models. Some of the large firms are now multinational enterprises in their own right with subsidiary companies in other apparel exporting countries, such as Bangladesh, India, Jordan, Kenya, Madagascar, Vietnam and Ethiopia. These firms have the ability to coordinate production within their global production networks to meet orders from their strategic buyers, reminiscent of the triangular manufacturing practices of the East Asian firms during the MFA era.

Given the country's long-standing commitment to providing universal free education, the workers seeking employment in the garment industry have a much higher level of formal education (on average 10 years of schooling) than in most other apparel exporting countries. Therefore, a worker who joined the labour force as a "helper" in an apparel factory takes only 2 to 3 months to become a machine operator, compared to 3 to 6 months taken by a Bangladeshi

[4] An analysis of firm-level Customs records indicates that there were 817 garment-exporting firms in Sri Lanka in 2004 (using an export value of $10,000 as the minimum cut-off point). The number declined to 450 in 2011, with the largest three firms accounted for over 35% of total exports in 2011 (13% in 2004) and the top 20 firms accounting for more than two-thirds of exports (39% in 2004) (Athukorala & Ekanayake, 2018).

counterpart. In addition, the managerial and technical capability of Sri Lanka's apparel industry has improved notably during the past 4 decades, with public–private partnerships playing a pivotal role. Initially, the Sri Lankan apparel industry was heavily dependent on textile technicians from Hong Kong. The dependence on foreign textile technicians had virtually disappeared by the dawn of the new millennium. Sri Lanka has also become a supplier of textile technicians and managers to other apparel-producing countries in the region and beyond.

Until about the mid-1990s, the domestic content of apparel exports from Sri Lanka was basically equivalent to the labour content: about 20% (Kelegama & Foley 1999). At that time, the industry was treated as a glorified tailor-shop with little linkages with the rest of the economy: a symbol of dependent development (Lakshman, 1989). Since then, the three largest firms (MAS Holdings, Brandix and Hidramani, in that order) have set up plants to produce textiles (mostly knitted fabric and elastic) and ancillary inputs (hangers, brassier mounding, packaging material, labels, and buttons) to be used mostly in their own apparel plants, but also to meet the requirements of other apparel producers in the country. Currently, about 60% of fabric used in apparel production (about 80% of fabrics used in knitted apparel and about 20% of woven apparel) and the bulk of the ancillary inputs are produced domestically. Domestic availability of high quality inputs, which reduces the transport costs of inputs, delays, and the management time needed to coordinate a fragmented supply chain, is a key determinant of a firm's manufacturing flexibly is a highly competitive market.

With these preconditions, Sri Lanka's garment exports have undergone a remarkable compositional shift, away from 'basic apparel' and to 'fashion-basic apparel' [5]. The degree of concentration of Sri Lankan garment exports in the latter category had increased over time, reaching over 90 percent by mid-2010s. The share of women's apparel, which generally contain a higher fashion content, increased from 44% to nearly 60%. The two most rapidly expanding categories within this product group are brassieres and panties. In 2018-19, Sri Lanka accounted for 8.5% of total world exports of women's and girls' panties, up from 2.2% in 2003-04. Sri Lanka's world market share of brassieres increased from 3.2% to 7.8% in the same interval.

[5] Basic apparel products are the standard apparel products that remain in a retailer's collection for many seasons, such as men's shirts, trousers, and underwear. Fashion-basic products are variants on basic products that contain some fashion elements (such as stone-washed jeans, pants with pleats or trim, and lingerie and intimate wear) Abernathy et al. (1999)

This compositional shift in the product mix has been the source of the industry's remarkable resilience to the MFA abolition. In basic apparel products, labour cost is the major determinant of international competitiveness; low-wage nations, especially those with access to inexpensive textiles, have the potential for major market share gains in the post-MFA era. By contrast, in fashion-basic products, exporting is more than a simple price-cost game; product designing, speed and flexibility are crucial capabilities for firms wrestling with product proliferation in competitive markets.

Missed opportunities and prospects

As noted, the heavy concentration of the export composition in garments has been a major concern in the Sri Lankan policy circles. However, the important issues of why the export success in garment industry did not take place in other industries as in the export-oriented economies in East Asia has not received due attention in this debate.

A comparison of Sri Lankan export composition with that of the high performing East Asian Economies (HPEAEs) vividly indicates that this lopsided nature of the export structure reflect Sri Lanka's missed opportunity to engage in 'production sharing' within vertically integrated global industries such as data-processing machines, telecommunication and sound recording equipment, electrical machinery and appliances, and professional and scientific equipment (broadly labelled as electronics and electrical industries). Global production sharing—cross-border dispersion of manufacturing processes that opens opportunities for countries to participate in different stages of the production process of a given product— has been the prime mover of shifting manufacturing production in these industries from mature industrial countries to developing countries. This phenomenon opens up opportunities for countries to engage in specific segment in the global manufacturing value chain (GMVC) depending on their relative cost advantage, intend of producing a good from the beginning to end within its national boundaries. The bulk of manufacturing exports from the HPEAEs, over two thirds of exports in some of these countries, take place within GMVCs (Athukorala 2014a).

In garments and other standard defused-technology industries, local entrepreneurs in a given country have the opportunity to penetrate global markets through links forged with international byers, with or without FDI involvement manufacturing, depending of course if the other preconditions are satisfied (as in the case of Sri Lankan garment industry). However, in

GMVCs in electronics and electrical industries, production sharing takes place through intra-firm linkages, rather than in an arms-length manner. Intra-firm linkages are vital for preserving technological secrecy and/or to ensure quality/precision of parts and components produced in a given location, which is vital to maintain quality standards of the final product. Therefore, FDI plays a vital role in a country's participation in GMVCs in these industries.

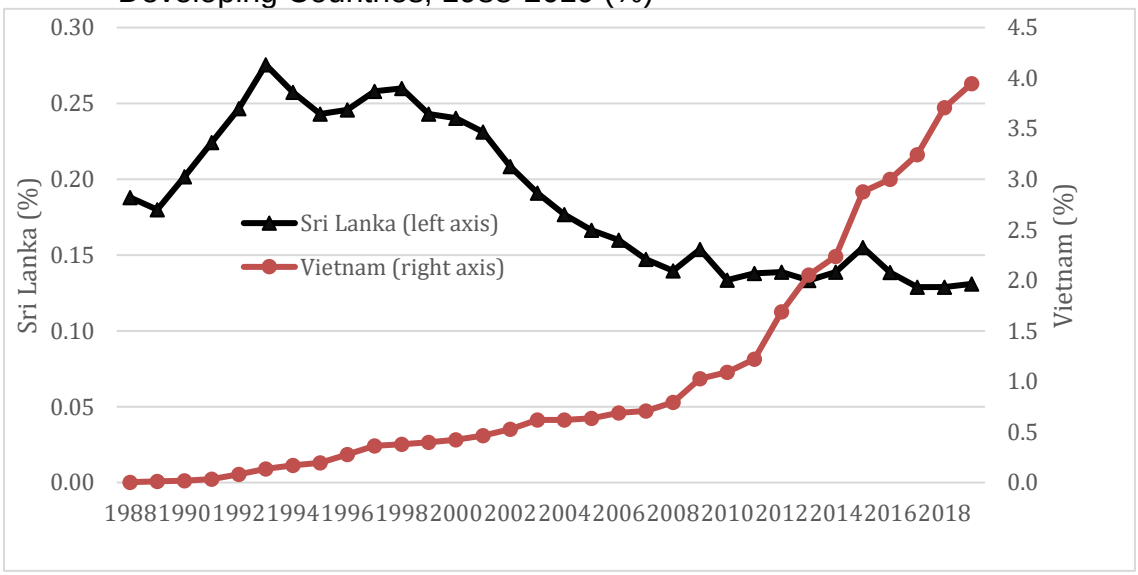
The investment promotion campaign of the Greater Colombo Economic Commission (GCEC, later renamed BOI) placed emphasis during the early stage at attracting FDI into electronics and electrical assembly. In fact, the GCEC was successful in bringing two major electronics multinationals, Motorola and Harris Corporation, to the Katunayake Export Processing Zone (KEPZ). Motorola registered a fully-owned subsidiary in October 1980 to establish an assembly plant with an initial employment capacity of 2,624 workers. Motorola's decision to come to Sri Lanka was motivated by Sri Lanka's incentive package and perceived political stability of the country at the time, which handsomely compensated for the inherent locational disadvantage (long distance from the USA) (Weigand 1983). Harris Corporation registered a fully-owned subsidiary and even started building a plant in KEPZ with an initial employment capacity of 1,850 workers. Motorola left Sri Lanka in 1983 flowed by Harris Corporations in 1984 to locations in Malaysia as the political climate begun to deteriorate in Sri Lanka.[6] As of 2013, Motorola plant in Penang was employing 6500 workers; Motorola's operations in Penang has spawned a sizeable cluster of local subcontracting firms, some of which have become independent companies with even foreign operations on their own (Athukorala 2004b).

There is evidence of a "herd mentality" in site selection by multinational electronics firms: if the "first-comer" is a major player in the industry (Wheeler & Mody, 1992). If the Motorola and Harris Corporation projects had succeeded, other multinationals would have followed suit (Snodgrass 2008). Moreover, the entry of large players in vertically integrated global industries naturally sets the stage for the emergence of local small and medium scale firms supplying ancillary components and services, as in the case of Motorola's operation in Penang (Athukorala 2014b).

[6] On signing the investment agreement with the Greater Colombo Economic Commission in 1980, W.D. Douglas, a vice-president of Motorola, said: 'Political stability is number one on our list wherever we go', quoted in Wijesinghe (1976)

Perhaps the best way to understand how the missed opportunities in global production sharing dictated Sri Lanka's lopsided export performance is to compare the Sri Lankan export record with that of Vietnam, a latecomer to export-led industrialization that has already begun to show promising signs of growing by joining GMVCs. Vietnam embarked on market oriented reforms (transition from 'plan to market') much later than Sri Lanka (in the late 1980s). Since then until about the mid-1980s, Vietnam's export volume (in US$) was smaller than that of Sri Lanka (Figure 7). In 2005-06, when the export volumes of the two countries were more or less in size, garments accounted for the lion's share of exports (nearly two thirds) in both countries (Table 4). Since then, Vietnam has made a notable departure from Sri Lanka in export performance. By the end of 2010s, Vietnam accounted for over 5% of manufacturing exports from developing countries compared to a mere 0.13% share of Sri Lanka. Vietnam's meteoric rise as a dynamic export has been underpinned by a notable shift in the commodity composition towards dynamic products within GMVC, in particular electronics and electrical goods. In 1918-19 garments accounted for just 13% of total manufacturing exports from Vietnam. The process of dramatic structural transformation in Vietnam gathered momentum following the arrival of Intel Corporation in 2006 to set up an assembly and testing plant in Ho Chi Ming City (Athukorala & Kien, 2020).

Figure 7: Vietnam and Sri Lanka: Share of manufacturing exports from Developing Countries, 1988-2019 (%)



Source: Data compiled from the UN Comtrade database.

Table 4: Sri Lanka and Vietnam: composition of manufacturing exports, 1995-96 and 2018-19[1] (%)

Product group[2]	Sri Lanka		Vietnam	
	1995-96	2018-19	1995-96	2018-19
Chemicals and related products (SITC 5)	2.63	2.42	2.52	2.12
Manufactured goods classified by material (SITC 6 - 68)	15.29	15.00	15.15	9.35
Machinery and transport equipment[3] (SITC 7)	10.43	7.39	8.92	46.87
General industrial machinery and equipment[3] (74)	0.22	0.16	0.19	31.65
Office and data-processing machines[3] (75)	3.30	2.87	3.09	5.26
Telecomm and sound recording equipment[3] (76)	0.11	0.16	0.13	8.36
Electrical machinery and appliances[3] (77)	0.75	0.75	0.75	1.17
Road vehicles[3] (78)	6.02	3.43	4.73	0.26
Other transport equipment[3] (79)	0.03	0.02	0.03	0.17
Travel goods (83)	0.06	0.05	0.06	1.73
Articles of apparel and clothing accessories (84)	60.37	64.55	62.44	13.69
Footwear (85)	0.31	0.31	0.31	9.93
Professional, scientific and controlling equipment[3] (87)	0.88	0.94	0.91	1.51
Toys and sport goods (894)	1.09	1.08	1.08	1.02
Unclassified	5.65	5.74	5.70	10.08
Total manufacturing	100	100	100	100
US$ billion	2.9	9.3	2.8	237.1

Note: (1) Two-year average. (2) Standard International Trade Classification (SITC) codes are in brackets. (3) Mostly parts and components.

Source: Compiled for UN *Comtrade* database.

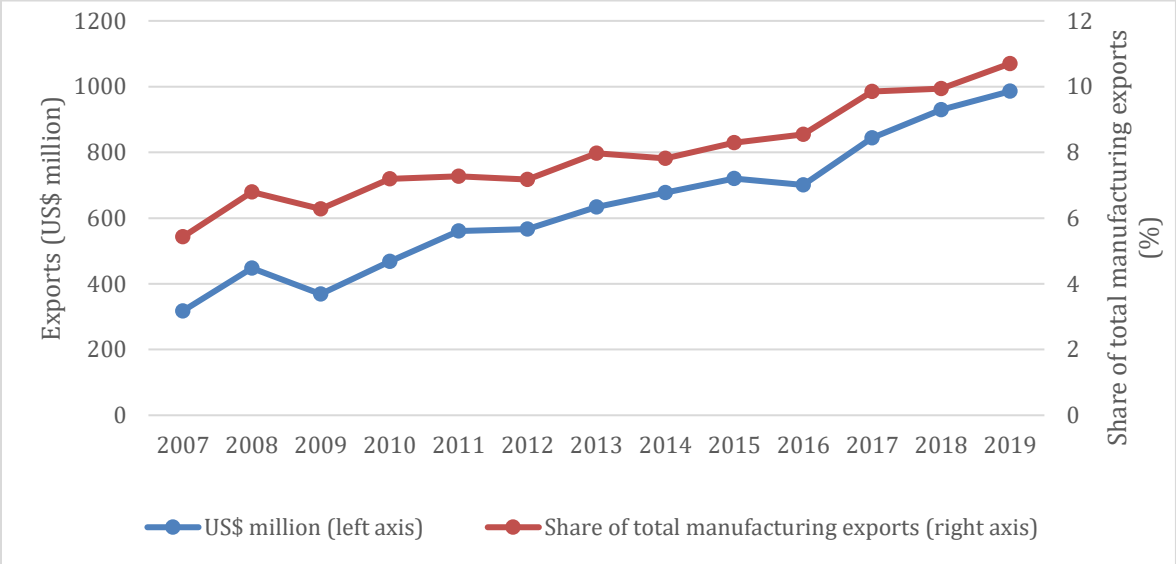
Mini electronics boom

Even though large electronics MNEs shunned Sri Lanka because of the country risk, a sizeable number (over 30, according to BOI records) of fully export-oriented medium scale FIEs have been successfully operating in electronics, electrical goods, and auto part industries in the country for many years now. These firms currently employ over 20,000 workers (SLEDB, 2014).

These firms produce (mostly assemble) a wide range of parts and components ranging from sensors for the Airbus and weighing components for baby incubators. Total exports of these products increased from US$247 million (6.1% of total manufacturing exports) in 2007-08 to US$958 million (10.3% of total manufacturing exports) in 2018-19 (Figure 8). The annual growth rate of exports has been much rapid in more recent years: average annual growth rate of over

15% during 2015 -2019 compared 9% during 2007-2015. These are the fastest growing group of products in Sri Lanka's export composition during this period. Surprisingly this important development, which is relevant for any discussion of the country's export future, remain obscured in the Sri Lankan trade policy documents and policy debate.[7]

Figure 8: Sri Lanka's Exports of Electronic and electrical parts exported from Sri Lanka, 2007-2019



Source: Data compiled from UN *Comtrade* database.

As part of our on-going research, we have put together basic information for 13 companies through internet search and interviews conducted with company executives (Table 6). All these firms are FIEs, with full or partial foreign ownership. The foreign parent companies of these FIEs are 'Nano' multinational enterprises (NMNEs) with operations in a few countries. They specialize in specific parts and component production and assembly within GMVCs through close, but alms' length, relations with original-manufacturing MNEs or large contract manufactures (CMs). Japan is by far the largest home country of these investors.

[7] In the Central Bank *Annual Report*, these dynamic products remain hidden in various sub categories under the broader category of machinery and transport equipment (Table 81 in the *2020 Annual Report*)

Table 6: Sri Lankan Firms in electronics, electrical good s and auto part industries

Serial number	Year of establishment	**Ownership**	**Product**	**Employment**
1	1982	Germany	Magnetic heads and electronic components	
2	1986	Japan/SL	Electronics component, auto wire harnesses and LED/CFL lighting	250
3	1992	Japan/SL	Magnetic head, printed circuits, optical insulators	686
4	1997	Japan/SL	Printed circuit board/auto harnesses	250
5	1988	Japan/SL	Censor switches for seat belts and airbags	330
6	2008	Japan/SL	Electric components, crystal display modules, LED lighting devices	644
8	2010	USA/Sweden/ UK	Sensors for Airbus	2000 (planned)
9	2012	EU/India	Specialised, customised cables	NA
10	2012	EU	Customised cable harnesses	NA
11	2001	Switzerland/U SA	Printed circuit board/auto harnesses	600
12	2011	EU	Metal components	NA
13	1991	Sweden	Weighing cells for medical devices (including baby incubators) and heavy machinery	650

Source: Based on interviews and data compiled from Company websites.

These investors have come to Sri Lanka based on personal contacts in the Sri Lankan business community, rather than in response to the investment promotion campaign of the BOI. All executives we interviewed stated that a trusted local relationship acts as a cushion against political risk and help attending with ease administrative commitments to various

government bodies. The owner-manager of a highly successful auto part making company has written that,

> 'For decades, the Sri Lankan government through the BOI has embarked on many investment promotion missions to Japan and other countries. The writer participated in two such investment promotion missions to Japan in 2007 and 2013. These investment promotions impose a heavy financial burden on the national coffers. But the fact is that the BOI has failed to attract even a single substantial Japanese investor since the last Japanese investor came to Sri Lanka in 2002 that too on the initiative of the writer, not as a result of BOI promotion missions. Easjay Electromag, Tos Lanka, Laka Harness, Areosense, Cable Solutions, Metal Component Services, Lanka Precision Works, Nipon Maruchi were all established in Sri Lanka through a strong local relationship that was trusted by the foreign investor ...'. Pallewatta (2018, p 245)

Availability of trainable labour and complementary supervisory manpower is the major attraction of Sri Lanka as a production location for these investors. Contrary to the popular perception among policy makers in the country, none of the executives we interviewed complained about a human capital constraint. The majority of firms are in the hands of local managers and all workers and supervisors have been trained on the job within the firm. Some firms send their new recruits to their home countries for training.

We found no evidence to suggest that the advent of the so-called Fourth Industrial Revolution (IR4)[8] would put an end to the type of activities undertaken by these firms. In principle, almost all production processes can be robotised or automated, but, in reality, the actual replacement of labour with this IR4 technology depend on the relative cost of doing so, which depends on both complexity of the production process and the bulkiness of the given product. Automation or robotisation does not seem to be a cost effective alternative for the human touch involved in intricate assembly processes undertaken by these firms. According to our firm-level surveys, the Sri Lankan firms involved in assembling weighing cells, auto wire harnesses, sensors for aircrafts and optical insulators have long-term plans to expand production. Recently UK-based major player in the global aircraft component industry bought a Sri Lankan US-Sweden-UK joint venture firm producing sensors for Airbus as part of its production expansion program. The new owner has plans to expand the Sri Lankan operation

[8] Industrial advancement based on the convergence of digital technology with breakthroughs in material science and biotechnology: artificial intelligence (AI), robotics, internet of things (IoT) 3D printing (additive manufacturing), autonomous vehicles and nanotechnology (Schwab, 2016).

to a projected employment capacity of 2000 workers, up from the current employment of 60 workers.

4. Concluding remarks

The backlash against liberalization reforms in the contemporary Sri Lankan policy debate is largely based on defunct ideological predilection rather than factual analysis. The comparative analysis of Sri Lanka's industrialization experience during the state-led import-substitution era and that of the post-reform era (in particular during the first two decades) in this paper makes a strong case for reconsidering the merit of the emerging emphasis on combining import substitution and export orientation with a state-guided sector specific focus. Selective policies to promote import substitution essentially impose a 'tax' on export producers.

The economic liberalization reforms initiated in 1977 have brought about far-reaching changes in the structure and performance of the Sri Lankan manufacturing sector. The reforms helped transform the classical export economy of Sri Lanka inherited from the colonial era into a one in which manufacturing plays a significant role. The achievements of liberalization reforms are all the more remarkable when we allow for the fact that the proposed reform package was not fully implemented and that the country failed to capture the full benefits of reforms undertaken because of the protracted civil war that damaged the investment climate and undermined macroeconomic stability.

The experience under liberalization reforms demonstrated the complementarity of trade and investment liberalization in the process of export-oriented industrialisation: trade liberalization increased the potential returns to investment by capitalizing on the country's comparative advantage, while liberalization of foreign investments permitted international firms to take advantage of such profit opportunities. There is compelling evidence that the entry of foreign firms is vital for a "latecomer" to export successfully. In addition to foreign-invested enterprises' direct contribution to export expansion, their positive spillovers have contributed to the success of local exporting firms.

The Sri Lankan garment industry has successfully consolidated its position as a dynamic player in a highly competitive global market in the post-MFA era, contrary to the popular perception that treat it as a traditional sun-set industry. Sri Lanka missed the opportunity to gain export dynamism by entering into global manufacturing value chains in

vertically integrated electronics and other related industries because of the debilitating country risk caused by the civil war and policy uncertainty. However, a small but dynamic parts and component assembly industry has emerged during that period through trustworthy personal links between international investors and the Sri Lankan business community. There are indications that this industry has the potential to become the harbinger of export dynamism in the post-civil war era, depending of course on the country's commitment to continue with reforms to facilitate global integration of domestic manufacturing.

Trade-cum-investment policy reforms has the potential to set the stage for new exporting industries and exporting firms to emerge in a global context in which factors of production—capital, technology, and marketing and managerial knowhow—are mobile across national boundaries. Developing human capital base and building the country's innovative capabilities should of course be among the government's long-term policy priorities, but there is no need to wait to achieve these objectives in order to link domestic manufacturing into global production networks. The human capital constraint on export success is vastly exaggerated in the Sri Lankan policy debate.

When talking about sector/industry specific approach to industrialization, we should not forget the fact that the Post-World War II economic history of developing countries, including that of Sri Lanka, is littered with cases of costly failure. Or course there were a few seemingly successful cases in some countries, but the available evidence clearly supports the view that these 'successes' were rooted in three fundamental traits of the industrialization policy regimes of these countries. First, the incentives given to the specific industries were strictly time bound; second, export performance requirement was strictly imposed on the beneficiary firms; and thirdly selective intervention was undertaken in the context of an overall economic setting that was conducive for private sector operations. It is pertinent to quote here the founding father of the Korean economic miracle:

> 'The economic planning or long-range development programme must not be allowed to stifle creativity or spontaneity of private enterprises. *We should utilize to the maximum extent the merit usually introduced by the price mechanism of free competition*, thus avoiding the possible damages accompanying a monopoly system. There can be and will be no economic planning for the sake of planning itself' (emphasis added) Park (1970, p. 214).

Selecting a large number of industries for preferential treatment and promising to add even more to the 'wish list' (CBSL 2021, p. 20) is a recipe for strengthening the hands of the domestic lobby that clamor for trade protection and government support. The few known successful cases of selective intervention world over were based on selecting a few cases based on systematic assessment of world market conditions and potential for gaining dynamic comparative advantage within an overall economic environment that is conducive for unhindered private sector operation. If there is uncertainty, the best practice is to rely on market forces. To quote Lee Kuan Yew:

> '[W]e left most of the picking of winners to the MNEs that brought them to Singapore. A few such as ship repairing, oil refining and petrochemicals banking and finances were picked by the EDB or Sui Sen, our minister of finance or myself personally… When we were unsure how new research and development would turn out, we spread our bet. Our job was to plan the broad economic objectives and target periods within which to achieve them (Lee, 2000, p.85).

In sum, the analysis of regime shifts and economic performance under state-led import substitution strategy and liberalisation reforms in this paper makes a strong case for averting backsliding in policy, continuing the market-oriented reforms agenda that was left incomplete in the late 1990s, and setting up institutional safeguards to avert further policy backsliding.

References

Abernathy, F., Dunlop, J., Hammond, J., & Weil, D. (1999). *A Stich in Time: Lean Retailing and the Transformation of Manufacturing: Lessons from the Apparel and Textile Industries*. New York: Oxford University Press.

Athukorala, P. (1981). Import substitution, structural transformation and trade dependence: A case study of Sri Lanka. *The Developing Economies*, 24(2), 119-42.

Athukorala, P. (2014a). Global production sharing and trade patterns in East Asia', in I. Kaur and Singh, N. (eds.) *Oxford Handbook of Pacific Rim Economies*. New York: Oxford University Press, 334-360.

Athukorala, P. (2014b). Growing with global production sharing: The tale of Penang export hub, Malaysia.', *Competition & Change* 18 (, no. 3 (2014): 221-245.

Athukorala P. (2018). Industrial upgrading in apparel value change: The Sri Lankan experience, in Natha, D., Tewari, M. and Sarkar, S. (eds.), *Challenges of Upgrading*

and Innovation: Asian Firms in GVCs. Cambridge: Cambridge University Press, pp. 193-228.

Athukorala, P., & Ekanayake, R. (2018b). Repositioning in the Global Value Chain in the Post-MFA Era: Strategic Issues and Evidence from Sri Lanka. *Development Policy Review*, 36, O247-O26

Athukorala, P. & Jayasuriya, S. (2015). 'Victory in War and Defeat in Peace: Politics and economics of post-conflict Sri Lanka. *Asian Economic Paper*, 14(3), 22-54.

Athukorala, P. & S. Rajapatirana (2000) *Liberalization and Industrial Transformation: Sri Lanka in International Perspective*. Delhi and Oxford: Oxford University Press.

Athukorala, P. & Kien, N. T. (2020). Transition to a market economy, Foreign direct investment and export performance in Vietnam, in London. J. (ed.), *Routledge Handbook of the Vietnamese Economy.* London: Routledge (forthcoming).

Bandara, J.S. & Liyanaarachchi, T.S. (2019). Total factor productivity and its determinants in Sri Lanka. A study undertaken for World Bank Sri Lanka. Nathan: Griffith University, Business School (unpublished manuscript).

Central Bank of Sri Lanka (CBSL) (2021). *Annual Report 2020*. Colombo: CBSL.

Cuthbertson, A.G. & Athukorala, P. (1990). Sri Lanka, Part 3 in Papageorgiou, D. M Michaely, M. and Choksi, A.M. (eds) *Liberalising Foreign Trade: Indonesia, Pakistan and Sri Lanka*, Oxford: Basil Blackwell, pp 283-411.

Department of Census and Statistics (DCS) (2019). Effective rate of protection estimates. http://www.statistics.gov.lk/NationalAccounts/StaticalInformation/SNA_Accounts (accessed on 5 May 2021)

Department of Census and Statistics (DCS) (1978 – various years). *Annual Survey of Industry*, Colombo: DCS.

Dunham, D. & Kelegam, S. (1997). Does leadership matter in the economic reform process? Liberalization and governance in Sri Lanka, 1989–1993. *World Development* 25 (2), 179-190.

Fitter, J. (1970). Ceylon on the road to long-term decline?. *Intereconomics*, 1, 25-27.

Goodhand, J. (2012). Sri Lanka in 2011: consolidation and militarization of the post-war regime. *Asian Survey*, 52(1), 130-137.

Government of Sri Lanka (GSL) (2008). Strategic Development Project Act, No. 14 of 2008. Colombo: The Department of Government Printing.

Government of Sri Lanka (GSL) (2010). *Sri Lanka: The Emerging Wonder of Asia: Mahinda Chintana vision for the future*. Colombo: Department of National Planning.

Government of Sri Lanka (GSL) (2020). Gazette Extraordinary No. 2171/9, 20th April, Colombo: The Department of Government Printing.

Hallett, A.J.H. (1983). Employment, investment and production in Sri Lanka 1959-80: Reflections on what he figures reveal. *Marga Quarterly Journal*, 7(1),78-100.

Jayasuriya, S. (2004). Exchange rate, in Kelegama, S. (ed), *Economic Policy in Sri Lanka: Issues and Debates (A festschrift in honor of Gamani Corea)*, New Delhi: Sage Publication, 177-194.

Kaminski, B. & Ng, F. (2013). Revival of inward-orientation and its impact on Sri Lanka's performance in global markets. *WSiZ Policy Research Working Papers 2*. Washington DC: World Bank..

Kelegama, S., & Foley, F. (1999). Impediments to promoting backward linkages from the garment industry in Sri Lanka. *World Development* 27(8), 1445–60.

Krueger, A. O. (1997). Trade policy and economic development: how we learn. American Economic Review, 87(1), 1-22.

Kumaratunga, C.B. (1994). *Economic Policy Statement of the Government of Sri Lanka*. Colombo: The Board of Investment of Sri Lanka.

Lakshman, W. D. (1989). Lineages of dependent development: From state control to open economy in Sri Lanka, in Wignaraja, P. and Hussain, A. (eds), *The Challenge in South Asia: Development, Democracy, and Regional Cooperation*, New Delhi: Sage, pp. 105-138.

Lee, K.Y. (2000*). From Third World to the First: The Singapore Story: 1965-2000*, Singapore: Singapore Press Holding.

Nordas, H. (2009). *The Global Textile and Clothing Industry Post the Agreement on Textiles and Clothing*. Geneva: World Trade Organization.

Pallewatta, R. (2018). Global production system: Sharing Sri Lanka's experience', in Fonseka, T. (ed), *Essays in International Business*. Colombo: Postgraduate Institute of Management, pp. 249-258.

Park, C.H. (1970). *Our Nation's Path: Ideology for Social Reconstruction*, 2nd Edition, Seoul: Hollym Corp.

Pursell, G. & Ahsan, F.M.Z. (2011). Sri Lanka's trade policies: Back to protectionism. *Australia South Asia Research Centre Working Paper 2011/03*, Canberra: Australian National University.https://socialpolicy.crawford.anu.edu.au/acde/asarc/pdf/papers/2011/WP2011_03.pdf

Rajapatirana, S. (1988). Foreign trade and economic development: Sri Lanka's experience. *World Development* 16 (10), 1143-1157.

Sirisena, P.T. (1975). An Evaluation of the Efficiency, Foreign Exchange Saving ands and the Welfare Impact of the Steel Industry. *Staff Studies: Central Bank of Ceylon*, 5(2), 15-32.

Sri Lanka Export Development Board (SLEDB). 2015. *Electronics Sector Baseline Survey*. Colombo: SLEDB.

Snodgrass, D. R. (1967). *Ceylon: An Export Economy in Transition*, Homewood, Illinois: Richard D. Irvin.

Snodgrass, D. R. (2008). The economic development of Sri Lanka: A tale of missed opportunities, in Rotberg, R.I. (ed.), *Creating Peace in Sri Lanka: Civil War and Reconciliation*. Washington DC: Brookings Institution Press, 89-107.

Schwab, K. (2016). *The Fourth Industrial Revolution*. New York: Portfolio Penguin.

Thomson, R. & Athukorala, P. (2020). Global production networks and the evolution of industrial capabilities: does production sharing warp the product space? *Oxford Economic Papers* 72 (3), 731-747.

Weigand, R. (1983), 'International Investment: Weighing the Incentives', *Harvard Business Review*, 61, 146-152)

Wanigatunga, R.C. (1974). Tyre Industry. *Staff Studies: Central Bank of Ceylon*, 4(3), 33-52.

Wheeler, D. and Mody, A. (1992). International investment location decisions: The case of US firms. *Journal of international economics,* 33 (1-2), 57-76.

Wijesinghe, M. (1976). *The Economy of Sri Lanka, 1948-1975*. Colombo: Ranco Printers.

World Bank (2005). *Sri Lanka Development Policy Review 2004*. Washington DC: World Bank.