EXPORTS & FDI IN SRI LANKA

Current Issues & Future Prospects

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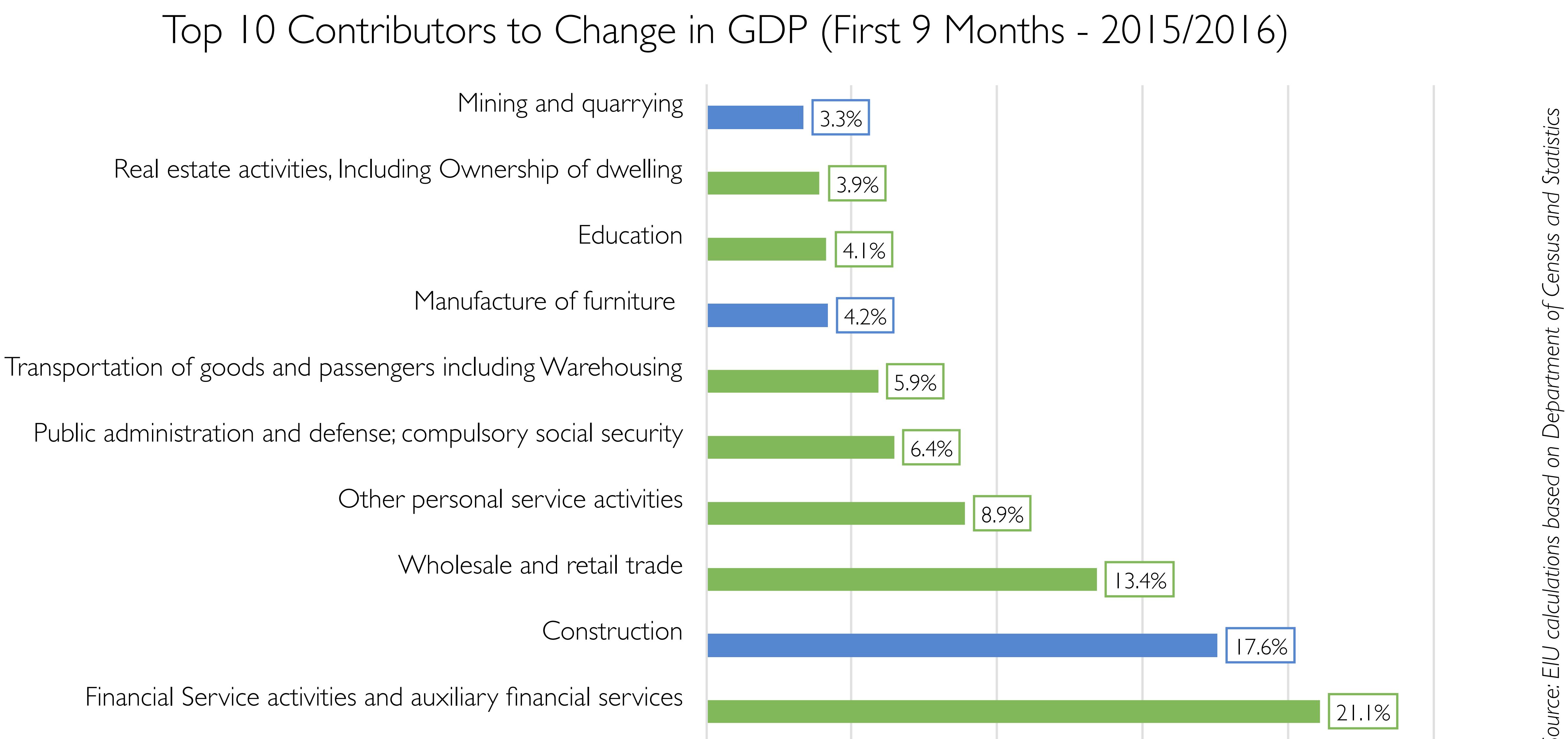
Pains, growing (not 'growing pains')

- Sri Lanka is currently facing a growth problem
  - 2016: 4.4% (our lower bound forecast was 4.5%)
- GDP growth in 2016 was far below the past six years average
- Previously growth model was reliant on debt-fuelled public infrastructure drive, and driven by domestic non-tradables like construction, trading, and financial services
  - *Not a sustainable growth trajectory given the small domestic market*
- Tradable sectors need to drive the economy in order to achieve and sustain higher growth rates

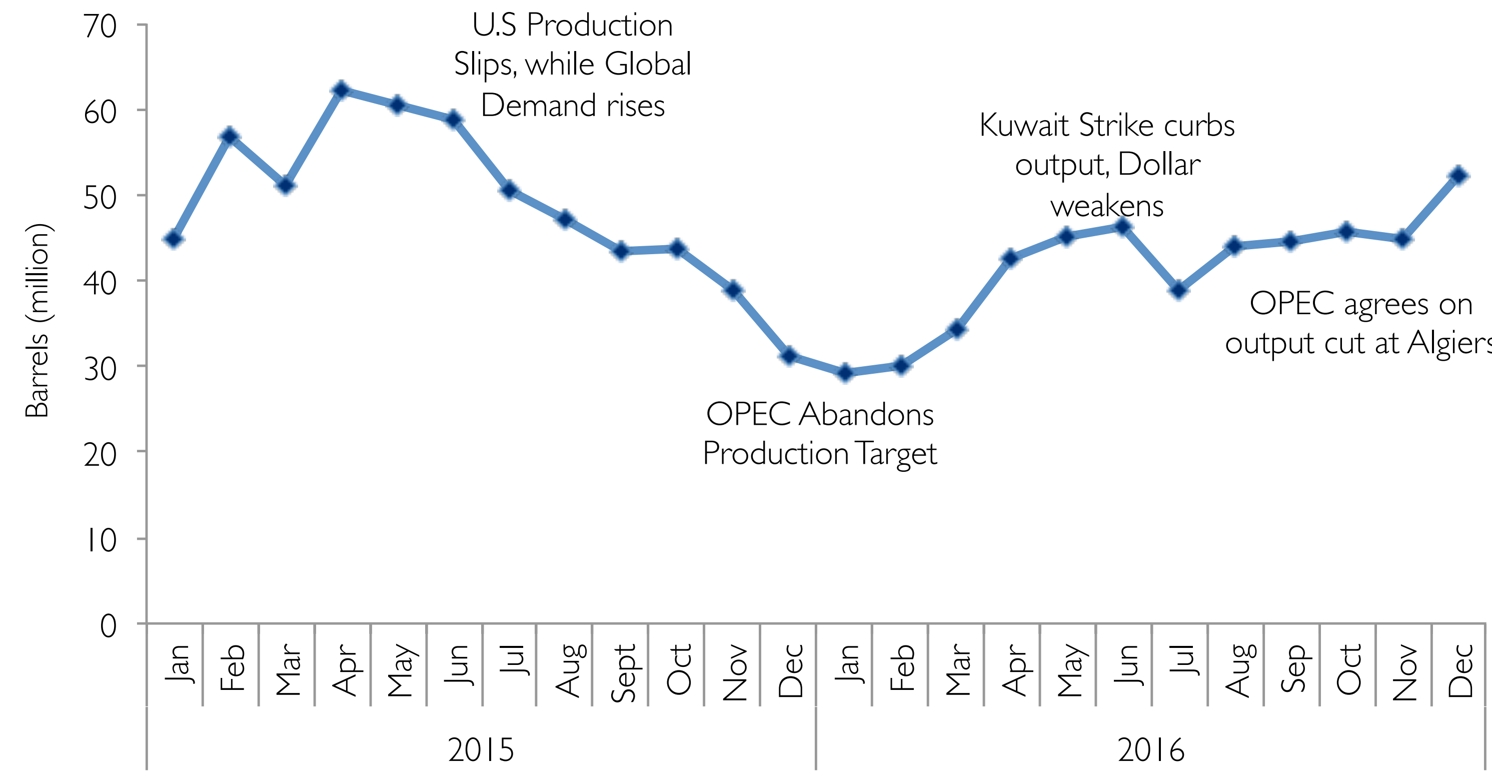
Non-tradable have been driving recent growth



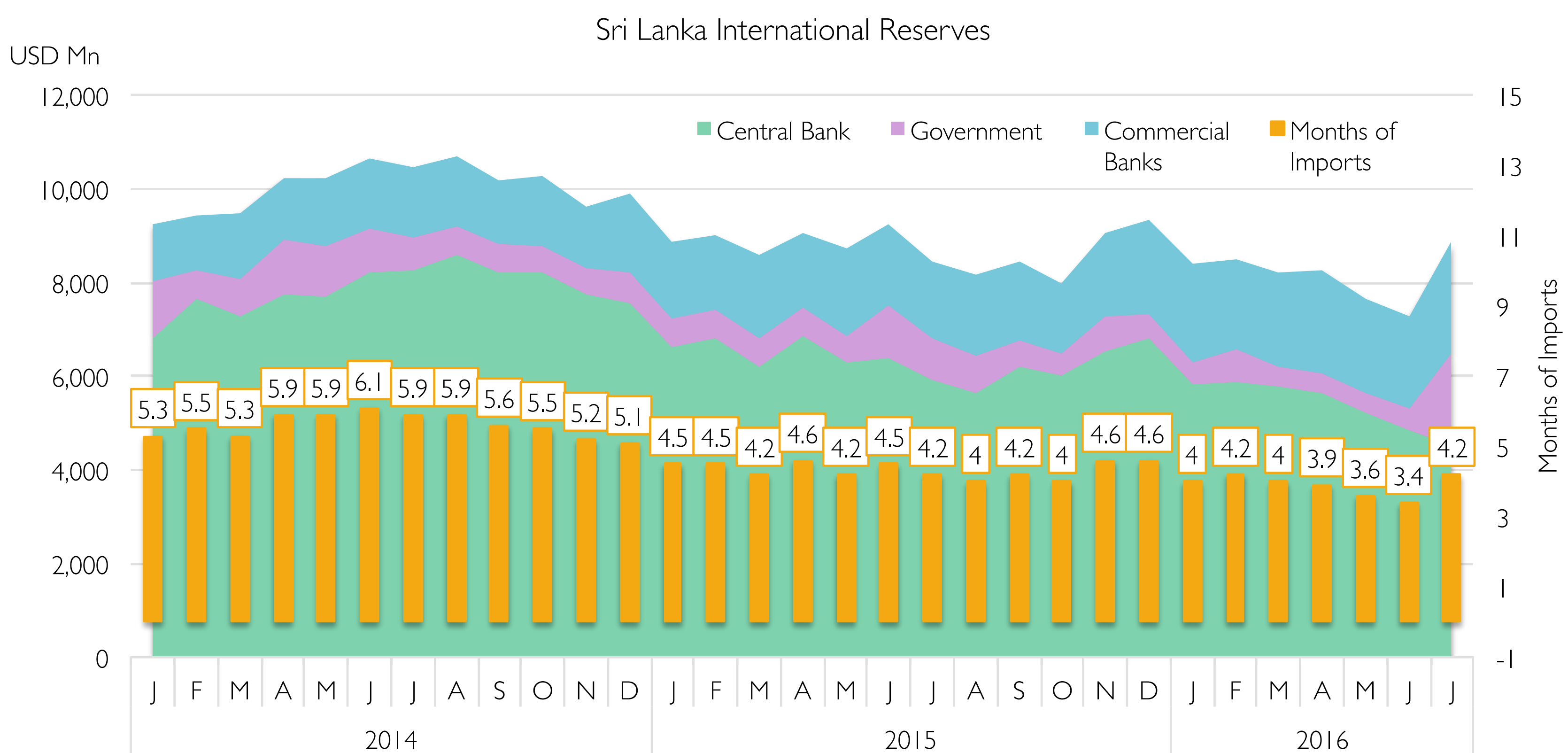
- Domestic non-tradable sectors drove growth in 2016, following the same post-war trend.
- Financial Services was the strongest contributor to GDP growth, followed by Construction, and Wholesale and Retail Trade
- Credit (YoY): Construction (40.1%), Wholesale & Retail Trade (52.4%), Financial Services (70.7%)

Tight External Conditions for Sri Lanka

- Sri Lanka enjoyed a windfall of US$ 2 bn smaller lower oil import bill in 2015 due to low prices
- Higher oil prices amidst declining export revenues will be unsustainable for LK
- Oil prices have edged up to $50/ barrel amidst OPEC decision to cut production



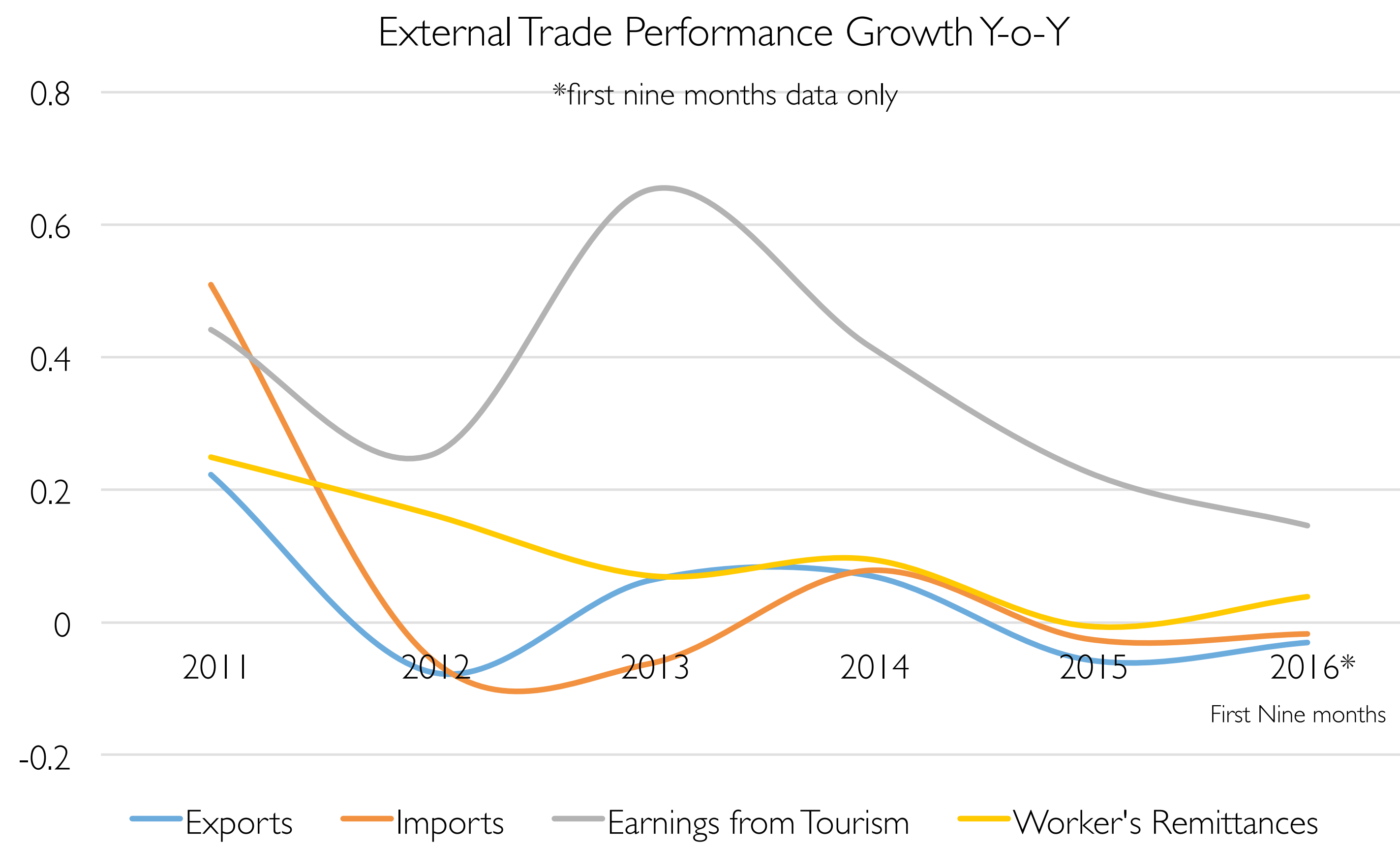
Source: International Energy Agency

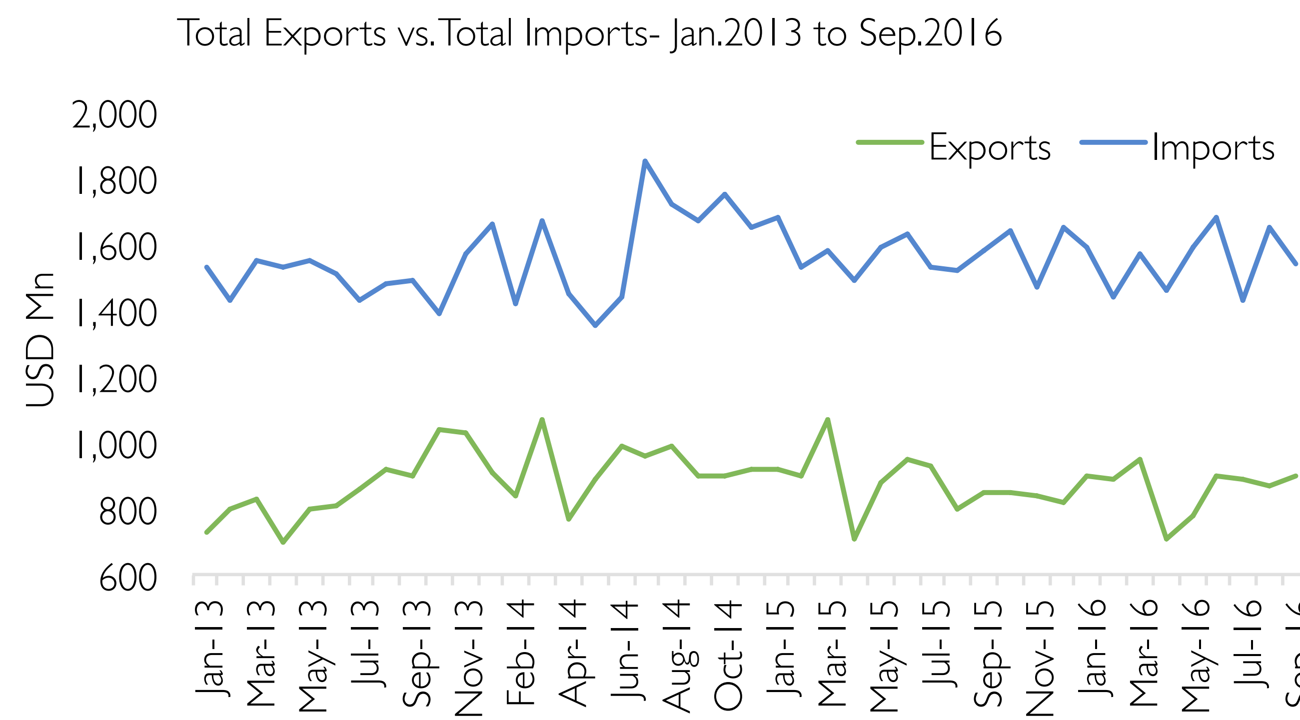


- Precarious external position amidst declining exports, pull out of foreign funds from LK treasuries, remittances growing at a slower pace
- Reserves are currently roughly 3.5 months of import cover

Recent external trade performance

- Weak export performance continues to characterise the external sector
- Exports indicated a bright spark in August 2016 reversing an 18 month decline, which continued in September, but then declined again.
- Heavy reliance on a handful of products and the dynamics in those products that are beyond our control
    - e.g. Tea exports (3rd highest export) vulnerable to adverse weather (like drought in 2016 and continuing) and demand conditions in Middle East and Russia
    - e.g. Rubber - gains when oil prices are high, loses when low, and benefits from adverse conditions in competitor markets (e.g. now with Thai floods)
- The privilege of a low import bill enjoyed during 2015/2016 period is unlikely to cushion Sri Lanka's low export performance during 2017.





Source: EIU calculations based on CBSL

Export concentration

- **USA + UK = nearly 1/3rd of our exports**
- **Ten countries account for 2/3rd of all exports**

Product Concentration

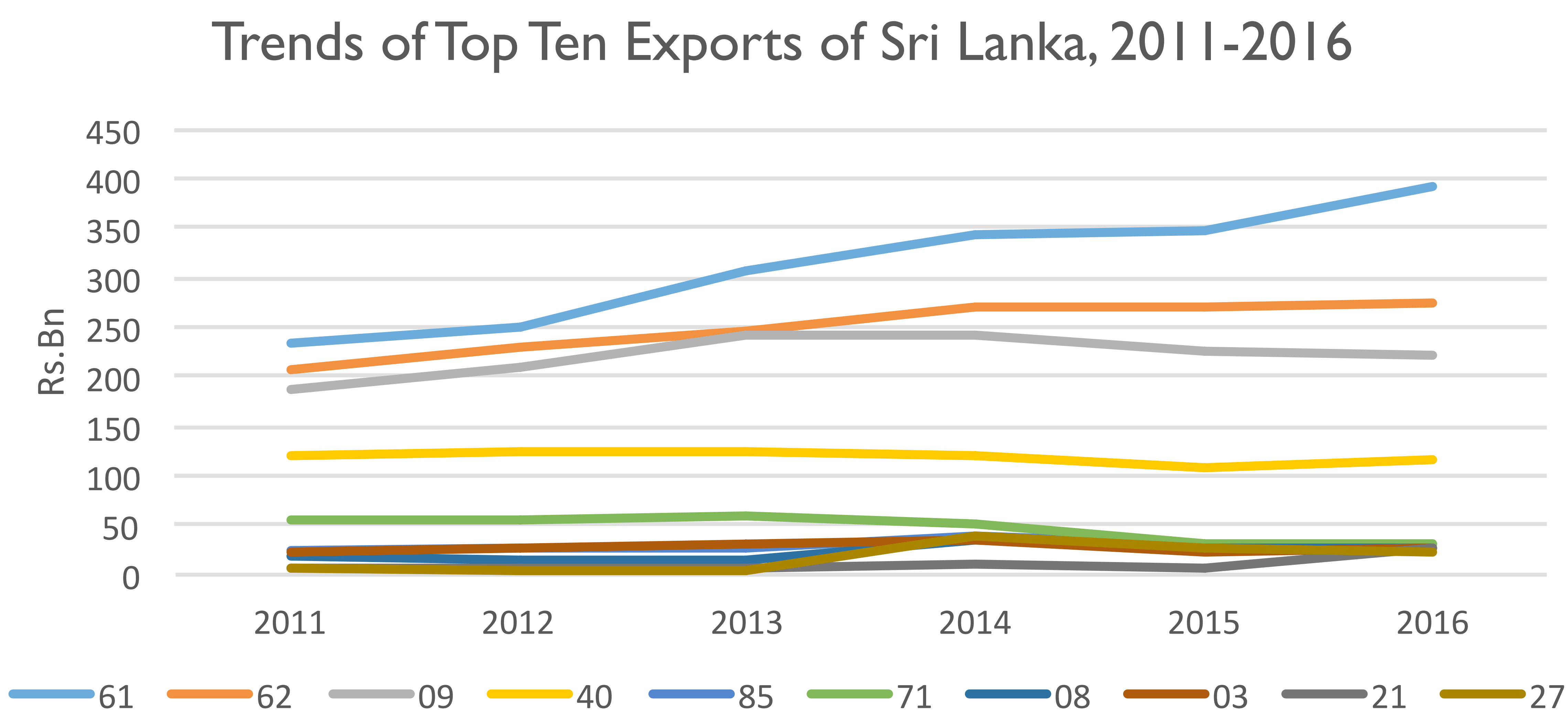
Description	FOB Value (Rs.)	% of Total Exports
Articles of Apparel and clothing	393.7	26.5
Articles of Apparel and clothing	276.0	18.6
Coffee, tea, mate and spices	222.1	14.9
Rubber and articles thereof.	116.5	7.8
Electrical machinery and equipment and	32.0	2.1
Natural or cultured pearls, precious or	31.3	2.1
Edible fruits and nuts; peel of citrus fruit or	28.1	1.9
Fish and crustaceans,molluscs	26.5	1.8
Miscellaneous edible Preparations	25.3	1.7
Mineral fuels, mineral oils and products of	23.8	1.6
Other Exports	312.3	21.0

Source: EIU calculations based on Sri Lanka Customs

Market Concentration

Country	Export Value (Rs.Bn)	% of Total Exports
U.S.A	408.8	27.5
U.K.	151.9	10.2
India	80.3	5.4
Germany	73.6	4.9
Italy	62.3	4.2
Belgium	49.2	3.3
U.A.E.	40.0	2.7
Netherland	30.3	2.0
Japan	29.1	2.0
China	29.0	1.9
Total Exports to the World	1487.7	

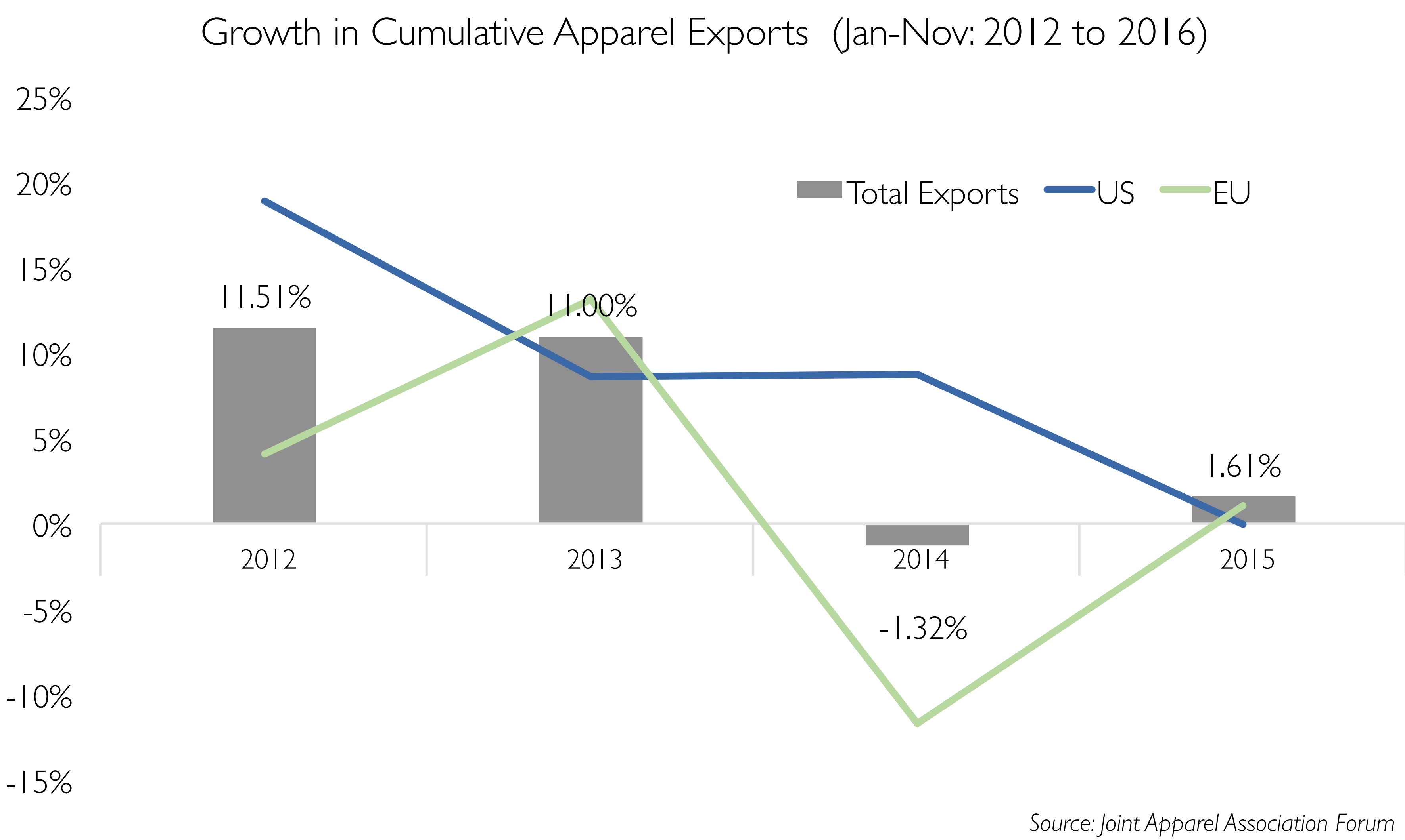
Only apparel exports showing growth



- Among the top ten exports, only the apparels sector has shown steady growth - roughly around 8-9% on average during this period
- So even within the concentrated export basket, it is just a handful of categories that are really performing well

Source: EIU calculations based on Sri Lanka Customs

Apparel industry further insights



- Exports to US have been in decline but forecast is for strong uptick in 2017 and beyond (US economic recovery, Trump's expansionary fiscal policy)
- Exports to EU recovered to mild positive territory but forecast to remain soft demand due to continued uncertainty and weak consumer demand. Regaining GSP Plus will give a short-term boost

- Sri Lankan apparel firms have moved up the value chain - engaging in higher productivity, higher skilled, and higher technology activities.
- Innovation and strong retailer relationships is driving the top tier apparel firms
- SL apparel firms catering to shorter lead times, collaboration on designs, new trends like 'ath-leisure',

Some recent issues facing exports

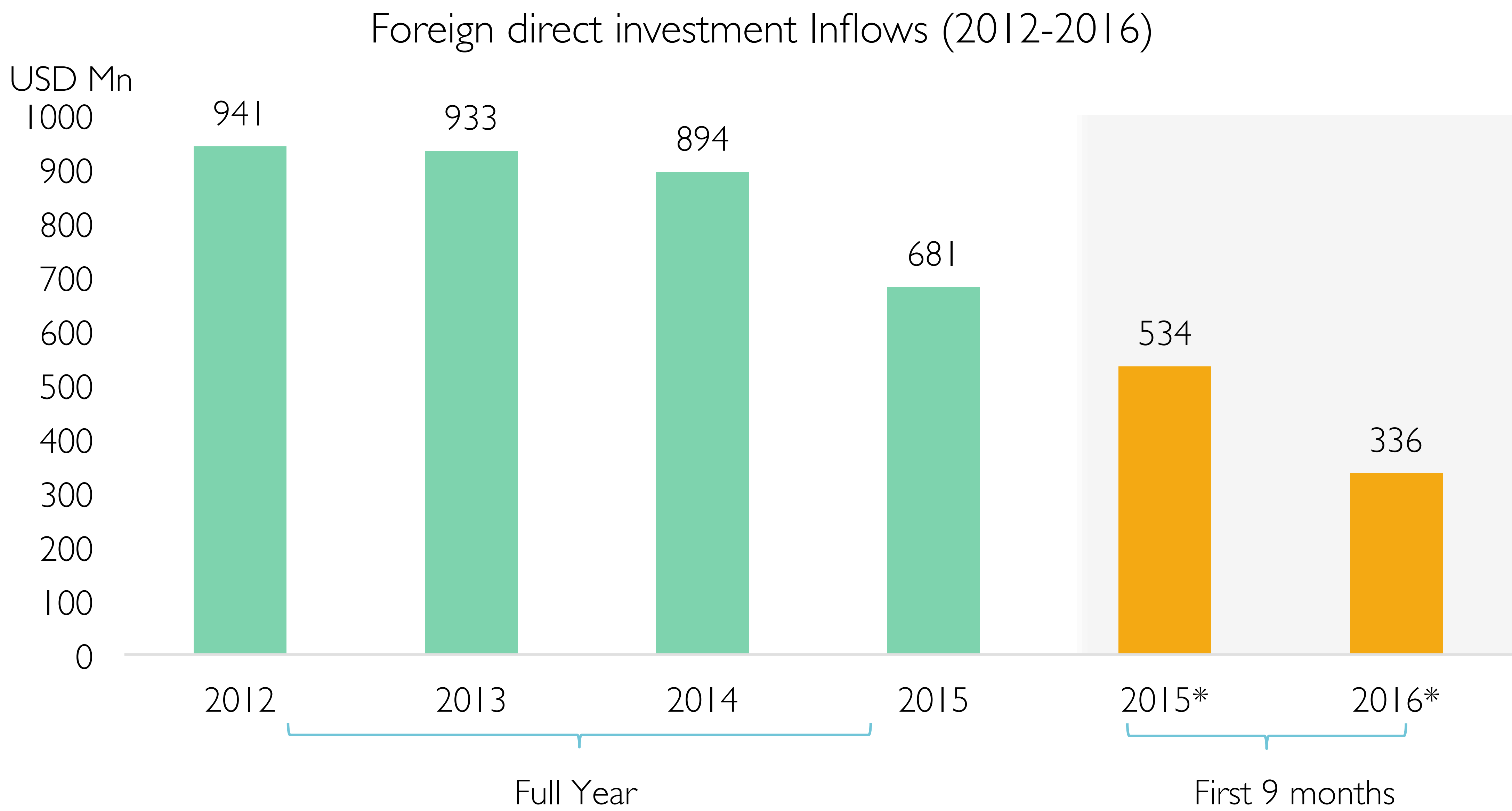
- Anti-export bias
  - Artificially overvalued exchange rate; high interest rate to finance government debt; high border tax protection for domestic/import-substituting industries

- Adverse policy stances that are not conducive to exporters
  - e.g. Introducing archaic restrictions on export proceeds - exporters must repatriate export proceeds within 90 days "of the date of exportation" (Later revised to 120 days)
  - e.g. Abolishing of SVAT by 1st January (now 1st April) and reintroducing VAT refunds - highly problematic, refunds mechanism not working, large pending refunds

- Shortages in labour in key growing sectors like apparel

Source: CBSL Weekly Economic Indicators

FDI inflows have been disappointing

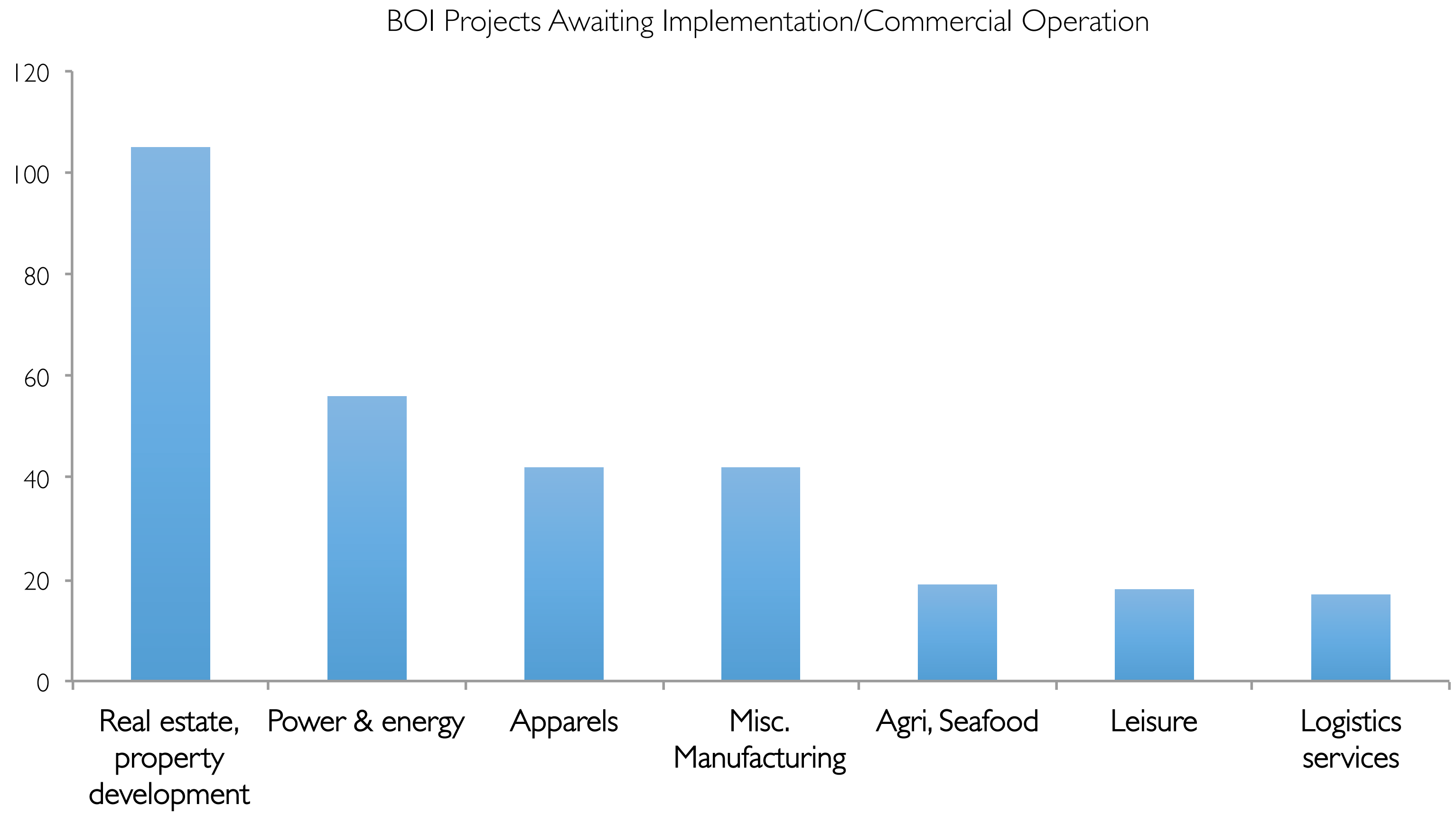


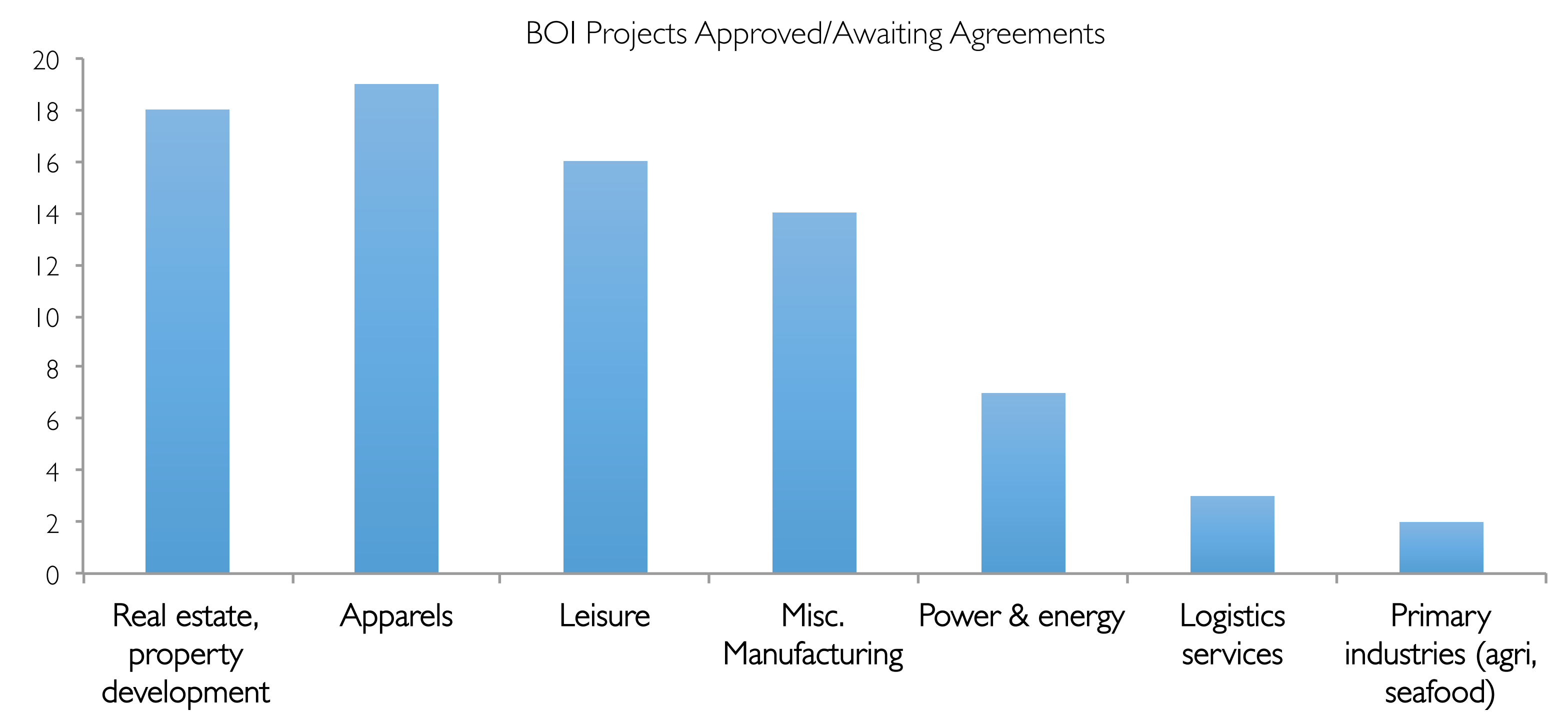
Source: EIU calculations based on CBSL Data

- FDI inflows during first 9 months of 2016 are 37% lower than same period 2015
- LK FDI inflows less than 1.5% of GDP and in decline

Technical note: If a foreign investor owns over 10% or more voting shares in a Sri Lankan company, any such foreign investment is categorized as direct investment as per the BPM6. Further, foreign loans received by Direct Investment Enterprises (DIEs) from any non-related source are excluded from FDI and recorded under loans.

FDI high in real estate & property development





- A defining feature of post-war FDI has been the concentration in domestic non-tradable sectors - real estate, property development, condominiums, retail and office space, etc.
- This trend continues, as the majority of forthcoming projects are in these sectors; in addition to power and energy and leisure
- Encouragingly, new apparel FDI are in the pipeline. This can be further catalysed with the SL-China FTA and the halting of TPP

Source: EIU calculations based on BOI Data

Recent issues in FDI

- Sri Lanka has had a history of promoting FDI, dating back to 1977 when first wave of liberalisation occurred
- Japanese 'flying geese' FDI showed interest - including IBM, Sony, Sanyo, Matsushita Corp
  - But full benefits could not be reaped due to outbreak of war in 1983
- Institutional mechanisms like GCEC and FIAC
  - Establishing EPZs and fostering apparel manufacturing with FDI
- Next wave of reforms in 1990s - setting up of BOI and new incentives regimes
  - Steady uptick in FDI, but hampered due to war

- Investment promotion, industrial strategy and overall macroeconomic policy have not worked together for some time

- Policy instability and lack of clear promotion strategy with sectoral focus

- Halting of incentives regime in April 2016, and taking a while to establish new regime
  - Shift of strategy from tax holidays to capital allowances

Towards an FDI push

- Need to make clear what Sri Lanka's value proposition is, what sectors show promise, and demonstrate policy consistency

- Institutional reforms need to take root - for instance, establishment of Agency for Development and Development Special Provisions Act; and/or reform of EDB and BOI

- Accelerate new efforts that identify new growth sectors, new export competencies, and new FDI opportunities
    - e.g. Harvard's Centre for International Development, World Bank, International Trade Centre, Commonwealth Secretariat

- Push through reforms to outdated legislation and regulations
    - Exchange Control Act — Exchange Management Act
    - Customs Ordinance — Customs Act
    - Implementing E-signatures, E-documentation hub, digital payments
    - Full and early implementation of commitments under Trade Facilitation Agreement

Emerging FDI Opportunities

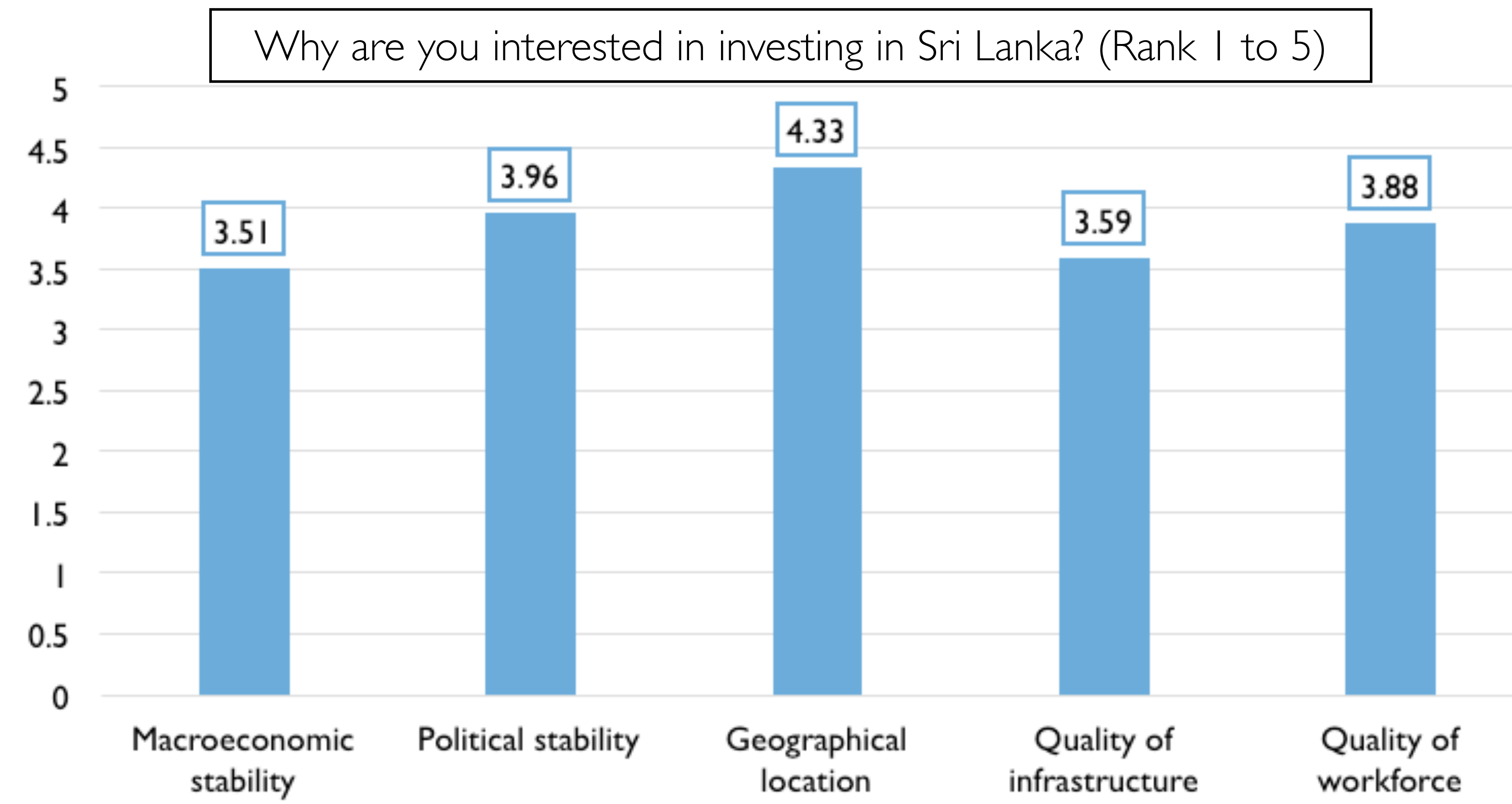
- **Large development projects**
  - Megapolis and Western Region Development + other Urbanisation projects
  - Hambantota Port-Airport-Industrial Zone - China project
  - Colombo-Trincomalee Economic Corridor Project (ADB funded)

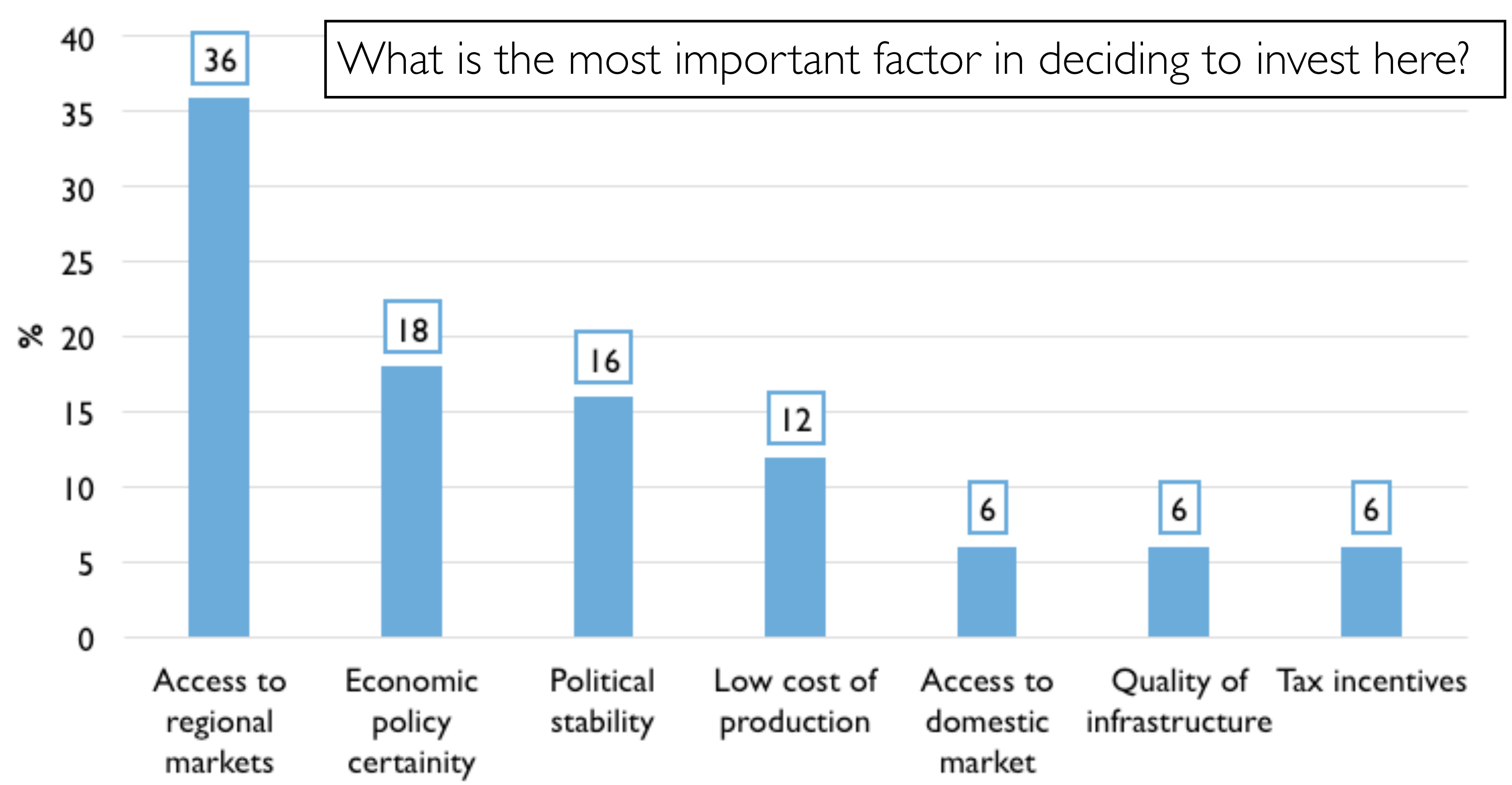
- **Sectors**
  - Freight and logistics industry (including regional e-commerce)
  - Renewable energy, climate-friendly technologies
  - Food processing - Budget 2016 and 2017 + projects by WB and ITC supporting agri modernisation, investing in equipment and technology,
  - and Tourism, of course

Positive prospects for FDI and Exports (1)

Leveraging on Sri Lanka's strategic location

- Investors are very keen to use Sri Lanka as a regional base - springboard to India and the rest of South Asia + link between Asia and Africa
- At recent Sri Lanka Investment Summit in Hong Kong - *"A Sri Lanka play is essentially a regional play"*
- Investors like Sri Lanka's:
    - geographical location
    - compliance standards
    - trainable workforce
    - laws written in English



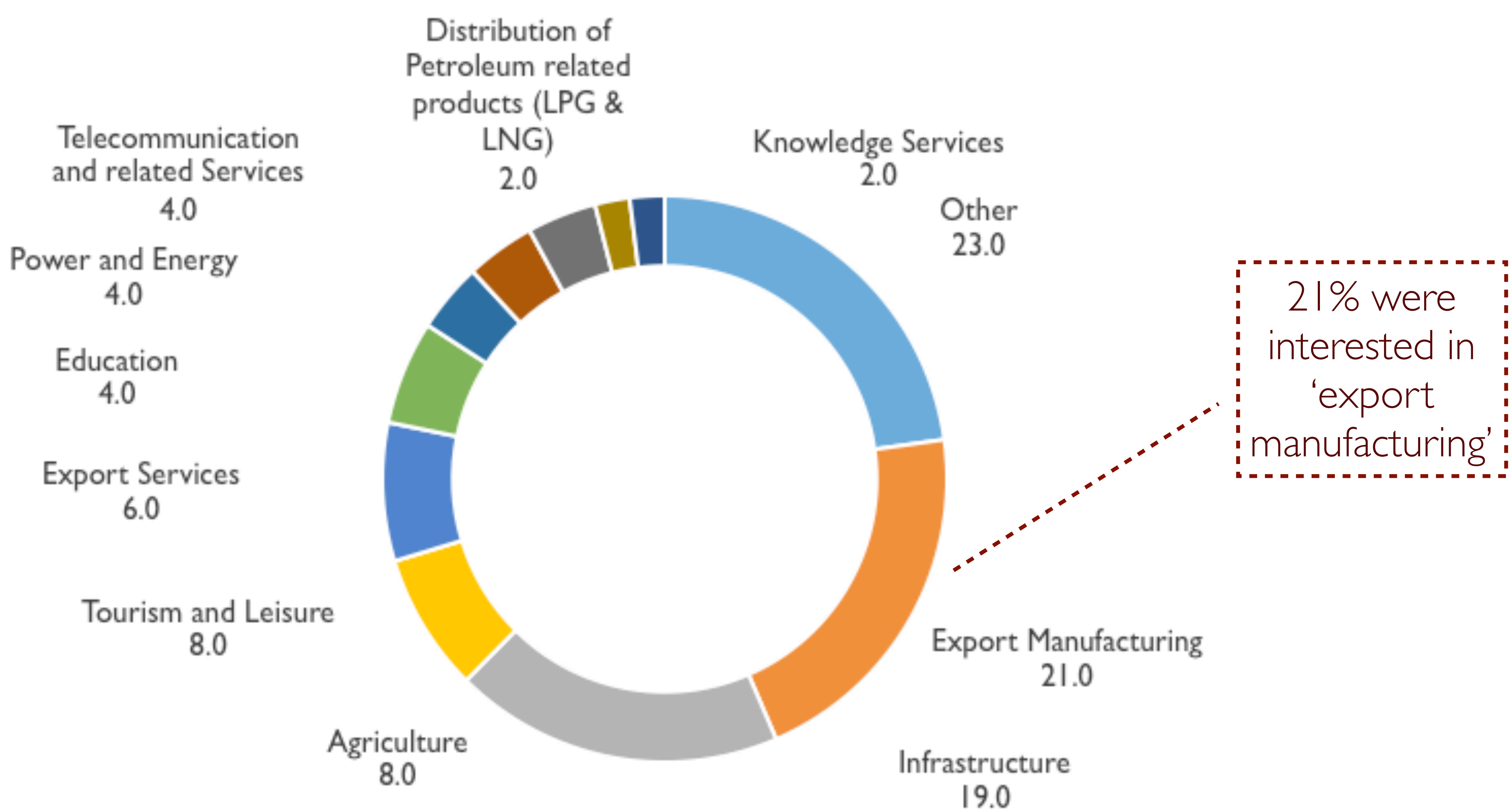


Source: EIU calculations based on survey of 154 respondents

Positive prospects for FDI and Exports (2)

Leveraging on trade-investment nexus

- Several investors have told us - *"Do your FTAs soon, and we can convince manufacturing investments in Sri Lanka"*
- 2016 Investor Conclave - interest from countries ranging from Chile, China, Jordan, Bahrain, Korea, Norway, South Africa, Japan



Source: EIU calculations based on survey of 154 respondents

Prospects for export-oriented FDI

- Mainly in medium- to large-scale (around 300-700 workers) niche manufacturing but high value capture in SL
  - Many in parts and components manufacture, plugging in to global production networks (a.k.a. global supply chains)

  - Vehicle impact sensors for air bags and seat belts (Lanka Harness)
  - Smart weighing solutions (Rinstrum)
  - Patented shoe 'upper' (Nike-MAS 'Flyknit')
  - Patented elastics for apparels (Stretchline)
  - Precision electronics (Vario Systems)
  - Electrical panels (KIK Lanka)

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