



Pathfinder Economic Flash

Sino-Lankan Economic Relations: A Dynamic and Forward Looking Perspective

Can there be a great leap forward for Sri Lanka?

A previous Pathfinder Foundation (PF) Economic Alert (64) argued that the Sino-Lanka FTA has the potential to be the 'Jewel in the Crown' in the bilateral economic relationship. It can have a transformative impact not just on market access for Sri Lanka's exports to China but also on inward investment and technology transfer. Internal trends within China also reinforce the prospects for an encouraging future in the bilateral economic relationship. Furthermore, China's Maritime Silk Road initiative provides a framework for a multifaceted strengthening of the partnership. High priority should be attached to taking advantage of the existing close bilateral Sino-Lanka relationship to shape the economic links between the two countries to serve Sri Lanka's development priorities. It is important to elaborate briefly on these themes.

Benefiting from the trade/investment nexus between Sri Lanka and China

The FTA, which is expected to be completed this year, will increase market access for Sri Lankan exports, such as high value apparel, value added tea, coir, rubber products and gems and jewellery. Sri Lanka is already globally competitive in these products. As a result, the incremental benefits in terms of increased exports through the Sino-Lanka FTA related market access would be relatively limited, particularly as there are some binding constraints in bringing about large increases in the supplies of some of these products (e.g. tea, rubber, coconut and gems and jewellery). It is important, therefore, to adopt a dynamic rather than static approach to trade under the Sino-Lanka FTA.

The full potential of this FTA can only be realized if Sri Lanka is able to catalyse Chinese (and other) FDI to produce far greater supplies of a competitive and diversified range of products which can take advantage of the FTA – enabled preferential access to the large Chinese market. As mentioned above, this requires large scale inflows of FDI with its technology, branding, management skills and market access. This trade – investment nexus is crucial for realising the full potential of the Sino – Lanka FTA. This is also the way to address Sri Lanka's large trade deficit with China.

In seeking to attract large inflows of Chinese FDI, it is important to recognize that Sri Lanka is no longer able to leverage low-labour costs. It cannot compete with countries like Bangladesh, Cambodia, Laos and Myanmar on this front. Priority should, therefore, be

attached to identifying higher value exports servicing niche markets. On the Sri Lankan side, the challenge is to provide a conducive investment climate (the Chinese like to operate within industrial parks) and the necessary human resources. In the short-run it may be necessary to relax visa regulations to attract the required skilled labour.

‘Push’ and ‘Pull’ factors: change within China

On the Chinese side, there are a number of internal trends which give cause for optimism. Chinese companies are being encouraged to go abroad to overcome the competitiveness challenges emerging from rising domestic costs (including wages), as well as the expected appreciation of the Yuan in the medium-term. The prospects of large-scale export of capital from China over the next few years offer Sri Lanka the opportunity to attract some of it. The PF has consistently advocated the need for a significant increase in FDI inflows. No other country offers greater potential in terms of capital that is available to be deployed abroad. This should be taken into account when managing the bilateral relationship.

In addition, China’s strategy to rebalance its economy from external to domestic demand, combined with rising incomes, will result in a change in the composition of imports. There will be less of an emphasis on raw materials and more on consumer goods and services. This means that the opportunity exists for Sri Lanka to take advantage of both outflows of capital from China and the rising Chinese domestic demand for imported consumer goods and services. There are, therefore, both ‘push’ and ‘pull’ factors which create a set of propitious circumstances.

Triggering FDI flows and export expansion

As pointed out in previous PF articles, the upside scenario would be to attract Chinese FDI to produce competitive supplies which can be exported back into the Chinese market on preferential terms. In addition, the potential also exists to export into the Indian market using the Indo-Lanka FTA, particularly if the scale of production is already being established for selling into the Chinese market.

This process can be facilitated by Sri Lanka’s Commercial Hub Legislation which has created entrepôts at Hambantota and Katunayake, as well as bonded areas for ‘offshore operations’ for FDI – driven exports.

The combination of the bilateral FTA and Chinese FDI provides a framework to trigger the export expansion, which is crucial for achieving sustained growth to improve the lives of the Sri Lankan people by generating higher value employment.

Strengthening Sri Lanka – China ties further

There are also two additional points related to strengthening the Sino-Lanka commercial relationship.

- China has been extremely supportive in building much needed infrastructure in Sri Lanka. In the next phase, it can play an important role in using and marketing these

facilities, such as the Hambantota port and airport. This would be mutually beneficial as it would also assist in servicing the financing received from China for these facilities.

- The stronger Sino-Indian relations become, the more room for manoeuvre there is for the other South Asian countries to benefit from their commercial relations with China. In this connection, President Xi's successful visit to India and other high level bilateral contacts are encouraging, as is the cooperation which is taking place within the BRICs framework.

The multifaceted benefits of the Maritime Silk Road (MSR)

The MSR is designed to generate win-win economic gains and promote the security of vital sea-lanes based on the principles of mutual respect and sovereign equality among nations. The bilateral commercial Sino-Lankan relations can be given a significant boost through the MSR initiative at a number of levels.

- The MSR can strengthen the conditions for taking advantage of the China – Sri Lanka Strategic Partnership by generating considerable benefits for Sri Lanka's development prospects. This country's strategic location, being equidistant from East Asia, the Middle East and Africa is particularly significant for taking advantage of the improved connectivity in the Asian region which is a major objective of the MSR.
- The connectivity facilitated by the MSR can support the trade and investment opportunities which will be created by the Sino-Lanka FTA; as well as open up new commercial prospects for Sri Lankan enterprises in other Asian countries.
- The MSR is complementary with Sri Lanka's services-based strategy, which focuses, inter alia, on the maritime and commercial sectors.
- It offers considerable potential for cooperation in the areas of maritime connectivity, fisheries, marine research, marine environmental protection and disaster management.
- The MSR also creates a conducive environment for taking advantage of historical, cultural and social ties to promote people-to-people contacts, particularly tourism from China, which has been growing at an exponential rate.
- In parallel with the MSR, the combination of China's massive external reserves, as well as the strengthening and internationalization of the Yuan, offers opportunities for greater financial integration.

Avoiding pitfalls and being proactive: Recommendations for economic team of new government.

1. This is a crucial period for the new Government of Sri Lanka. It has gained power primarily on a platform of good governance and the rule of law. Therefore the major focus is on constitutional reform, anti-corruption, transparency and a

level playing field. Newspaper reports and statements from various quarters have sometimes sent mixed signals regarding the future of the ongoing large-scale infrastructure development such as the Colombo port city development, southern expressway expansion etc. The Pathfinder Foundation strongly recommends that the new Government takes very early decisions regarding the implementation of these projects in accordance with declared screening procedures so as to avoid uncertainty among foreign and local investors, contractors.

2. Another recommendation for the new Government is to take considered decisions on unsolicited proposals for development. These are a very commonly accepted means of attracting foreign and local investors who have creative ideas for business development. Priority should be attached to the expeditious development of procedures for accepting and evaluating of such proposals without divulging details to competitor businesses.
3. As the current economic team has vision, expertise and experience it is also recommended that a portfolio of business proposals is developed early for the attention of investors from China, India or the West.

While appreciating the promises from many other sources we must remember that the bird in hand is a million times more valuable than hundreds flying over in the horizon.

Postscript

The time is ripe for concerted action to boost Sri Lanka's economic and commercial relations with China to a higher level through taking advantage of the trade – investment nexus which will be opened up with the signing of the bilateral FTA. The MSR provides a framework to foster these commercial ties further. It can be useful in supporting the transition from debt to FDI flows which is necessary to strengthen Sri Lanka's growth model.

Chinese style of Economic Relations

Historically, China has maintained economic and other relations with countries and not with specific regimes. Sri Lanka can benefit greatly if the new leadership can master the art of working with this rising global economic power for the benefit of the country. In this context, it is important to recognize that China's worldview and ways of doing business are different, particularly from the West. If there is mutual trust and confidence, there is a great deal Sri Lanka can gain, inter alia, from multifaceted linkages in areas such as technology transfer, non-conventional energy, maritime industries and related businesses.

This is the Fifty Eighth Economic Flash of Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org