A strategy for targeted investment promotion based on comparative advantage

Thilan Wijesinghe, chairman/director general, Board of Investment of Sri Lanka, recently spoke on the subject ‘Sri Lanka’s Economy in the Year 2002’. The ideas put forward by him were based on a policy paper written by him in September 1996, which is reproduced below.

Introduction Sri Lanka’s investment promotion strategy must necessarily focus on building national competitiveness which leverages on the country’s core comparative advantages. In the South Asian context, the core comparative advantages of Sri Lanka are as follows:

- **Location:** Situated at the cross-roads of trade and shipping routes to South Asia and far East, Sri Lanka has considerable potential to evolve as a regional hub for transshipment, aviation, distribution, retailing, communication and financial services.
- **Human Resources:** The trainability of the workforce and levels of manual dexterity required for precision production techniques in selected manufacturing processes (e.g. electronics) and services (e.g. software development) are among the best in comparable investment locations.
- **Tourism Potential:** The country’s scenic beauty and bio diversity has been ranked among the best in the world.
- **Investment Policy:** Independent studies have concluded that Sri Lanka’s investment policy in terms of foreign investment entry requirements, legal framework covering investment protection and guarantees, repatriation of profits, company and commercial law is among the most liberal in Asia.

Despite the post 1977 structural transformation of the economy from one with an overwhelming reliance on unprocessed primary products, to one based on industrial products and exports, Sri Lanka has failed to strategically position itself to fully leverage on its core comparative advantages. This point can be illustrated by examining Sri Lanka’s economic achievements over the past decade:

The Current Situation

- **The location advantage remains largely unexploited.** Infact, it could be argued that Sri Lanka is rapidly losing its "identity" or economic relevance within the Subcontinent, especially due to the economic reform process initiated by India, Pakistan and Bangladesh in the early 1990s -much after Sri Lanka's own liberalization pro- gram. As the countries within the Indian subcontinent continue to liberalize access into their large domestic markets, Sri Lanka has very few alter- natives but to focus on attracting investment into the area of knowledge-based manufacturing and services (described later) and positioning the country as a "service hub" for the region. For example, action has to be taken in evolving an action plan to harness Sri Lanka's potential for emerging as a regional hub for shipping, financial, aviation, communications services and distribution and retailing.
- **Sri Lanka's tourism potential remains under- developed:** tourism as a percentage of GDP is a low 1.5%, compared with 8% of Thailand and 5% for Singapore. A main reason for low economic returns is an aging tourism product which caters to the most price-sensitive segment of the market- Western European "package tours." Sri Lanka has not benefited from the rapid growth (over 25% per annum) of intra-Asian tourists, who are also less risk-averse and spend more than European counterparts. (A Targeted approach for promoting tourism is given later in this report.)
- **The growth of manufactured exports has so far exploited only static bases of comparative advantage**-cheap, semi-skilled or unskilled labor and some local natural resources. The export structure of Sri Lanka remains dominated by low value-added, low technology and low-skill products. Much of this activity has weak linkages with domestic industry, and has not led to a diversification of the export base remaining heavily dependent on garments. Hence a targeted approach to promoting industries which are built on "competitive advantage" (as opposed to the "carrot" of quota) is required.

Supply-side Weakness

As argued previously, Sri Lanka's economic growth indices will remain at sub-optimum levels unless a targeted investment promotion and facilitation strategy, taking advantage of the country's core comparative advantages, is adopted. However, the targeted promotion strategy will not succeed unless the strategy itself is used as a tool to minimize Sri Lanka's supply-side weakness.

The fundamental supply-side weakness inhibiting investments are:

- Physical and political risks associated with the targeting of economic infrastructure by the LTTE.
- Economic risks associated with macro-economic imbalances relating to the budget deficit, inflation, etc., caused by exigencies of defense expenditure.
- Consequent under-expenditure in public sector capital formation having the effect of causing physical infrastructure facilities to run down.
- Under-expenditure in human resource development and technology support systems which are vital for providing vital skills and technology to industry and services.
- **Deteriorating labor productivity and labor relations consequent to erosion of real wages through inflation, deteriorating transport infrastructure and wages rigidities due to loss of competitiveness to other low-cost** countries (which in turn motivates the introduction of rigidities to the labor laws in the form of the Work- er's Charter).
- **Inadequate pool of local suppliers and sub-contractors due to lack of supportive measures to form industry linkages and industrial clusters** (e.g., critical mass of local component suppliers is vital for accelerating FDI into the electronics assembly industry).

Due to the above supply-side weakness, despite promotional efforts by various economic development agencies, and having in place some of the most generous investment incentives anywhere in Asia, the anticipated degree of domestic and foreign direct investment has not taken place. Sri Lanka's transition to the next stage of industrialization (i.e., value-added manufacturing including light engineering, electronics, textiles, etc.) has been slow and protracted. Hence the challenge facing economic planners and policy makers today is designing and implementing the most optimum mix of policy initiatives and targeting the types of investment which will result in the alleviation of some of the supply-side weaknesses outlined earlier.

A strategy for minimizing supply-side weakness is described in the next chapter.

Policy Options & Investment Targeting Strategies for Minimizing Supply-side Weakness

It has been argued previously that if Sri Lanka is to accelerate the process of economic growth, a private sector-led investment targeting strategy needs to be

implemented to improve supply-side factors which by definition are deterrents to growth in the first place. This point is elaborated below.

There is no doubt events subsequent to July 1983 have seen an escalation of "perceived country risk," resulting in Sri Lanka failing to attract a sufficient quantity of "durable," "blue chip" investors. (For example, if the planned investment by Motorola in a semiconductor plant had taken place in 1983, many of its competitors and suppliers would have invested in the country.) How do we attract blue chip investors to commit large amounts of capital into a country with a high perceived risk? Several options are summarised below.

Attracting large multinationals into the infrastructure sector where rates of return are ad- equate for private investment. Infrastructure projects in the power, ports, telecom and transport sectors, generate sufficient surpluses for private investment and provide adequate safeguards against political, economic and market risks. For example, mechanisms such as power purchase agreements and force majeur clauses provide safe- guards against political and economic risk. There- fore, attracting private sector investments into the infrastructure sector must be treated as a matter of national priority not only to help supplement deficiencies in state expenditure into upgrading physical infrastructure, but as a conscious strategy of building a critical mass of investments by leading international blue chip companies into Sri Lanka. Large scale foreign investments into infrastructure would then generate sufficient momentum and perception changes leading to increased investment flows in the manufacturing and services sectors.

Create Concentrated areas of economic activity in the form of Industrial Townships. A major supply-side disadvantage faced by investors is the difficulty in obtaining industrial land with adequate infrastructure within 40-50 km from Colombo. As such, creating enclaves of economic activity-i.e., industrial park, employee and expatriate housing, leisure facilities, training centres, etc. would have the impact of creating a sense of "security" for investors. It is also recommended that as much as possible, private sector alliances should be sought in developing/managing industrial townships. Furthermore, such town- ships should be developed in rural areas with fiscal incentives so designed to provide enhanced benefits to companies locating in difficult areas. **Facilitate the development of industrial clusters encompassing an integrated supply, distribution and manufacturing network.** The concept of industry cluster-based development is increasingly seen as a way to build long-term competitiveness. By targeting core ancillary industries, specialized service providers, and infrastructure and technology

foundation institutions, the competitiveness of a given industry will be enhanced. Access to such an integrated network of suppliers and service providers will be a powerful attraction to international companies seeking locations which minimize total costs of manufacturing and distribution. Targeted investment promotion-directed at enhancing intermediate goods and services suppliers, and key economic foundation providers can play a significant role in enhancing the long-term competitiveness.

These approaches offer the potential to turn current disadvantages into strategic investment opportunities, build investment momentum, and offset supply-side weakness.

Targeted Investment Promotion in Manufacturing and Services

In tandem with this deliberate strategy of targeted investment promotion directed at the supply-side weakness, is the adoption of a pro-active investment promotion effort directed at industrial and services targets selected on the basis of Sri Lanka's comparative and competitive advantages. Global experience with other countries suffering from the adverse impact of political and civil strife – such as the Philippines and Ireland has shown that industry targets have to be carefully selected, and investment generation approaches company-focused, for investment promotion efforts to yield results. Certain industrial and serv. ices investment opportunities offer a longer-term potential, when political and economic stability is restored, adequate infrastructure in place, and major policy reforms undertaken. But other opportunities offer attractive and immediate potential for focused investment promotion efforts. These can be divided. into **those engaged in selected areas of manufactur ing; those capitalizing mainly on Sri Lanka's stra tegic location; and a variety of specialized tourism and recreational activities. Manufacturing Activities**; Sri Lanka is competitive in a range of manufacturing segments which include:

- **Electronic Components:** Sri Lanka is ideally suited for operations with low to medium skill intensity high levels of manual dexterity, limited technological sophistication, and low rates of technological change. Among the most promising product segments are electronic components assembly (e.g. printed circuit boards, transformers, power supplies, magnetic heads); precision assembly (watches, calculators, scientific instruments); computer peripherals and telecommunications components (e.g. fixed disk drives, keyboards, etc.) Major operations are relocating from Thai- land, Malaysia, Taiwan and

elsewhere due to rising labor shortages and declining productivity.

- **Textiles and Garments:** The large number of garment producers in the country themselves represent large and relatively untapped market for producers of textile fabric, yarns, and accessories. In particular, dyeing and knitting operations, and printing and finishing activities offer immediate investment opportunities.
- **Non Metallic Minerals:** Sri Lanka possesses high- quality supplies of graphite, quartz and other non metallic minerals which are currently exported in unprocessed form. The opportunities for value- added processing operations are substantial, and profitable within the current environment. Leading opportunities include ceramic products, graphite and graphite products, and glass and glassware.
- **Rubber-Based Industries:** Similar opportunities to move up the production value-chain also exist in the rubber industry. Sri Lanka is not only one of the world's largest natural producers, but also has significant rubber wood resources which can be tapped on a sustainable basis. Investment opportunities in healthcare product, surgical gloves, rubber tyres, automotive components (hoses, pipes, belts, etc.) are growing
- **Gems and Jewelry:** The gem industry in the country has the potential to become the major recipient of foreign investment in the Indian subcontinent. As costs rise in established centers in Thailand and Hong Kong the strong skills and presence of the industry in Sri Lanka are increasingly attractive. With appropriate policies, the country could also become a distribution and trading hub in gold and precious gems.
- **Food Processing:** The country's unique micro climates and agricultural resources provide the strong potential for food and tea processing activities. High potential is notable especially in regard to fruit and vegetable canning, dehydration operations and condiments bottling.

Location-Based Investment Opportunities: Investment prospects based primarily on the country's strategic geographical location are numerous. The most important of bottling.

- **Shipping Services:** With the impending expansion of Colombo port, immediate opportunities in ship repair, maintenance transshipment, bunkering and chandelling operations arise. With the addition of dry docks, the scope for foreign investment in ship repair and maintenance activities is substantial. Many Singaporean, Korean and Japanese companies are seeking facilities to

accommodate both routine maintenance activities, and specialized operations such as the double hulling of tanker vessels. Ship breaking also holds enormous potential, so long as environmental safeguards are built in.

- **Aviation Services:** Sri Lanka has a near-term potential to be an aviation hub for the subcontinent. By providing liberal policies and an efficient regulatory environment, Colombo airport could develop as a regional air cargo and distribution hub. A variety of specialized repair, maintenance and other aviation related services could be attracted.
- **Financial Services:** As political and economic stability enhances, a number of specialized off- shore financial services activities may be attractive investment possibilities. These include asset management, cross border leasing, corporate registry, banking and insurance.
- **Printing and Publishing:** Sri Lanka could also emerge as a counterpoint for offshore printing and publishing operations, especially directed at the Indian sub-continent. With appropriate support, this industry could rival Singapore, China, and Hong Kong.
- **Reconditioning of Vehicles**: As has already happened with the skanska operation, Sri Lanka's location is a strategic point for automotive repair, maintenance, reconditioning and distribution operations.
- **Regional Operating Headquarters:** In the medium-term, with the appropriate policy frame- work and good telecommunication linkages, the country could develop into an attractive location for corporate headquarters operations, rivaling Thailand and Singapore.
- **Retailing:** The potential for Sri Lanka to emerge as regional center for retailing in garments, gold, jewelry (requires further liberalization of these sectors), and duty-free shopping is considerable. Expansion of these activities will strongly support tourism and lowering of the country risk perception.
- **Information Technology**: In addition to segments of the packaged and applications software industry, the potential for accelerating investments in lower technology operations such as computer-aided digitizing and vectorising, image processing, geographical information systems, animation, and the like. These require semi- skilled and literate workers, and good telecom- munications systems. Sri Lanka is already at- tracting some investment in these areas, but growth could be accelerated. Deregulating satel- lite communications will further the scope for the country to become a regional communications hub.

Tourism and Recreation: The country's near-term potential to re emerge as a

leading tourism destination is indisputable, as the perception of country risks gradually improves. However, there are attractive niche investment opportunities in the tourism and leisure area, even under existing conditions.

- **High-End Resorts:** The potential to develop specialized tourism accommodations and recreational facilities targeted at high-end customers is substantial. High-end resorts catering to affluent Asian tourists, combining golfing and other activities are viable even under current circumstances. Tourists could be flown to remote, self- contained locations, offering world-class amenities and facilities. Infrastructure requirements will be minimal, allowing even relatively remote locations to participate. A large number of Asian hotel and resort chains are looking for these exclusive investment opportunities, and some have already evaluated the scope of Sri Lanka.
- **Niche Recreational Facilities:** Niche opportunities such as amusement and theme parks, and gaming and international sporting events, are also very attractive, given current tourism growth rates and spending parts. Tapping the ultra- Asian tourism phenomenon is the key to realizing these opportunities.

The identification of concrete opportunities based on Sri Lanka’s comparative and competitive advantages is only one step, realizing these opportunities requires carefully developing and conducting an investment generation strategy focused on individual company targets. Firm specific, customized investment promotion approaches have been used successfully by many East Asian countries concerned not only with the quantity, but also quality of investments.