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**The Role of Sri Lanka in Enhancing
Connectivity between South Asia and
Southeast Asia**

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Abstract

Improving physical connectivity between South and Southeast Asia has long been recognized as a key element in promoting greater trade and investment linkages within the region. As an island economy, Sri Lanka's regional connectivity has been mainly through its main sea port in Colombo, a transshipment hub port for South Asia. Investments to expand capacity at Colombo port are underway as part of Sri Lanka's renewed efforts to develop its infrastructure following the long internal separatist conflict that ended in 2009. Despite significant improvements in physical infrastructure connectivity, Sri Lanka has made only limited headway in strengthening its trade and investment links with the rest of the region. Moreover, the country has seen a sharp decline in its overall exports-to-gross domestic product (GDP) ratio, which is worrying in view of the growing external debt financing of many large infrastructure projects through state-led investment initiatives. Thus, Sri Lanka needs to focus on two priority areas: engaging private investment in infrastructure by strengthening the country's institutional and regulatory environment; and implementing a more strategic trade policy geared to enhance regional integration efforts.

JEL Classification: F15

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1. INTRODUCTION

Improving connectivity between South and Southeast Asia has long been recognized as a key element in promoting greater intraregional trade and investment linkages. To date, Sri Lanka's own efforts in this direction have been limited, confined primarily to bilateral and regional trade agreements, with some efforts expended toward improving trade facilitation mechanisms. As the country recovers from the end of a 30-year conflict, significant policy attention is being directed to improving physical infrastructure: improving internal connectivity through highways, and external connectivity through expansion of existing ports and airports as well as the construction of new facilities.

This paper explores the developments in physical infrastructure improvements in Sri Lanka and the potential benefits in terms of greater connectivity with the South and Southeast Asia regions. The study also reviews the challenges of financing and sustained implementation of the planned infrastructure development efforts.

Section 2 provides an overview of Sri Lanka's economic performance in recent years, with special reference to its growing trade and investment links with South and Southeast Asia. Section 3 explores Sri Lanka's policy approach toward improving regional connectivity, particularly in the context of bilateral and regional approaches. Section 4 explores the state of crossborder-related physical transport infrastructure, with special reference to Sri Lanka's Colombo port. Section 5 takes a cursory look at the potential for regional energy trade between Sri Lanka and India. Section 6 examines the current state of transport and trade administration as a spur to greater regional trade flows. Section 7 discusses developments in the financial sector and the sustainability of current infrastructure financing. Section 8 concludes with policy recommendations.

2. OVERVIEW OF ECONOMIC PERFORMANCE

Since May 2009, Sri Lanka has seen a significant improvement in gross domestic product (GDP) growth following the end of armed conflict. Higher growth has been accompanied by improvements in many socioeconomic indicators, with the rate of unemployment dropping to 4% in 2012, and a poverty headcount of 8.9% in 2010. In the macroeconomic environment, there has also been an improvement in overall fiscal performance with the fiscal deficit continuing to contract, allowing some degree of price stability to prevail (Table 1). However, there has been a significant weakening of the external trade balance, with a rising deficit curbed only by strong growth in inward remittances that average 8% of GDP, and by improvements in earnings from tourism.

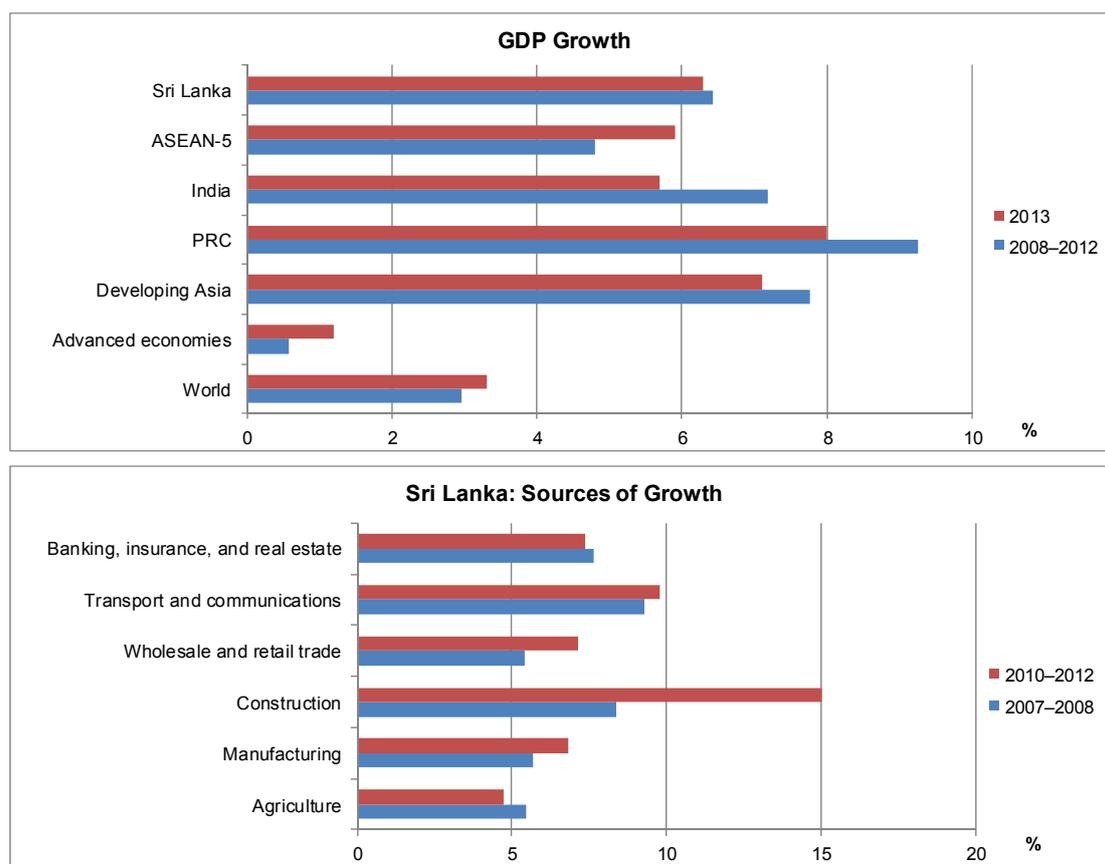
Table 1: Selected Economic Indicators, 2009–2012

	Unit	2009	2010	2011	2012
National Accounts					
GDP	\$ billion	42.3	50.5	57.5	59.6
GDP growth	%	3.5	8.0	8.2	6.4
Agriculture	%	3.2	7.0	1.4	5.8
Industry	%	4.2	8.4	10.3	10.3
Services	%	3.3	8.0	8.6	4.6
External Sector					
Exports	\$ million	7,085	8,626	10,559	9,774
Imports	\$ million	10,207	13,451	20,269	19,183
Trade balance	% of GDP	-7.4	-9.7	-16.4	-15.7
Current account	% of GDP	-0.5	-2.2	-7.8	-6.6
Fiscal Sector					
Fiscal balance	% of GDP	-9.9	-8.0	-6.9	-6.4
Government debt	% of GDP	86.2	81.9	78.5	79.1
Prices and Money					
Rate of inflation	%	3.5	6.2	6.7	7.6
Interest rate	%	10.9	9.3	10.8	14.4
Exchange rate	SLRe/\$	114.9	113.1	110.6	127.6

GDP = gross domestic product, SLRe = Sri Lanka rupee.

Source: Central Bank of Sri Lanka. *Annual Report*. Various issues.

Sri Lanka has been a rising star among emerging market economies. Globally, Sri Lanka's GDP growth performance in the recent past has been creditable, even pulling ahead of its historically outperforming competitors in Southeast Asia (Figure 1).

Figure 1: Sri Lanka's Comparative Growth Performance and Sources of Growth

ASEAN = Association of Southeast Asian Nations, PRC = People's Republic of China, GDP = gross domestic product.

Note: ASEAN-5 includes Indonesia, the Philippines, Thailand, Viet Nam, and Malaysia.

Sources: International Monetary Fund (IMF). *World Economic Outlook*. Various issues; Central Bank of Sri Lanka. *Annual Report*. Various years.

Sri Lanka's most obvious development achievements in its post-conflict phase of growth have been in infrastructure. Since 2006, infrastructure development has been driven by an ambitious public investment program intended to improve connectivity between urban and rural sectors of the economy, in keeping with the government's stated development objectives of rapid and equitable growth. As a result, public investment has been maintained at an average of 6% to 6.5% of GDP from a historical rate of around 4.5%. Not surprisingly, higher economic growth has come from related non-tradable sectors, particularly the expanding construction sector (Figure 1).

A corollary of the shift to non-tradable sector growth has been the declining share of exports in Sri Lanka's GDP, falling to a low of 16% in 2012 from 28% in 2004. Indeed, Sri Lanka has also seen a decline in its global exports market share.

Sri Lanka's policy to strengthen exports has been weak. Over the past 2 decades, its export basket has seen very limited diversification, both in terms of products and markets. The United States (US) and the European Union (EU) continue to be the major export destinations, accounting for well over 50% of total exports; clothing exports continue to dominate with a share of 40% of total exports. Sri Lanka's trade flows with South Asia have increased, largely as a result of greater linkages with India. However, trade intensity with Southeast Asia has remained relatively weak (Table 2).

Table 2: Trade with South and Southeast Asia
(%)

	2002	2007	2012
Export share to SAARC	5.5	8.5	7.8
Export share to ASEAN	2.6	3.0	3.9
Import share from SAARC	15.6	24.9	21.0
Import share from ASEAN	19.1	17.0	18.2

ASEAN = Association of Southeast Asian Nations, SAARC = South Asian Association for Regional Cooperation.

Source: Institute of Policy Studies of Sri Lanka (IPS). *Sri Lanka: State of the Economy*. Institute of Policy Studies of Sri Lanka. Various years.

Sri Lanka's trade policy regime has not helped to foster greater integration. Whilst the increase in tariff protection has been modest in the recent past, the imposition of para-tariffs above the standard customs rates has resulted in an increasingly complex and protectionist trade policy regime. Indeed, a study by Pursell and Ahsen (2011) found that Sri Lanka's total protection rate more than doubled from 2004 to 2009, bringing it well above the average for developing countries (Table 3).

Table 3: Unweighted Average Protection Rates
(%)

	2002	2004	2009	2011
Agriculture	26.3	28.1	49.6	46.8
Industry	10.1	10.7	24.0	19.7
All tariff lines	12.5	13.4	27.9	23.7

Source: Pursell and Ahsen (2011).

Sri Lanka's "Trade Policy Review" of 2010, undertaken by the World Trade Organization (WTO) indicates the unweighted average total protection rate to be as high as 31% compared to the standard customs duty rate of 12%.¹ These changes came about for both revenue purposes as well as through a more "protectionist" stance on trade policy.

Reflecting the above, Sri Lanka's engagements in pursuing preferential trade arrangements (PTAs) have also waned. Whilst it remains a party to regional PTAs such as the South Asia Free Trade Agreement (SAFTA) and the Asia-Pacific Trade Agreement (APTA), and bilateral PTAs such as the India-Sri Lanka Free Trade Agreement (ISFTA) and Pakistan-Sri Lanka Free Trade Agreement (PSFTA), there have been no recent efforts to enter into fresh agreements. In fact, negotiations to convert the ISFTA into a Comprehensive Economic Partnership Agreement (CEPA) have been on hold since 2008 when the Government of Sri Lanka (GOSL) pulled out of signing the framework agreement. Current, fully effective agreements are estimated to cover only 21% of Sri Lanka's total trade.²

As with Sri Lanka's recent export performance, net inflows of foreign direct investment (FDI) have also been relatively stagnant, averaging 1% to 1.5% of GDP, with net FDI in 2012 at a mere \$813 million.³ Despite low FDI, economies in South and Southeast Asia are both important and growing sources of foreign investment for

¹ World Trade Organization (WTO) (2010).

² United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) (2010).

³ Central Bank of Sri Lanka (2012).

the country (Table 4). Much of this investment is in the services sector, in energy, leisure, and telecommunications.

Table 4: Top 10 Investors in Sri Lanka, 2005 and 2011

Rank	Realized FDI (\$ million)			
	Economy	2005	Economy	2011
1	Malaysia	99.6	Mauritius	253.3
2	Singapore	30.6	India	146.8
3	UK	26.4	Hong Kong, China	138.8
4	India	17.9	Malaysia	89.5
5	Luxembourg	17.3	British Virgin Islands	53.5
6	Hong Kong, China	15.5	Singapore	53.0
7	US	12.8	UAE	52.9
8	Italy	10.6	UK	52.0
9	Sweden	10.1	Netherlands	51.4
10	Belgium	8.4	Japan	27.2

FDI = foreign direct investment, UAE = United Arab Emirates, UK = United Kingdom, US = United States.

Source: Institute of Policy Studies of Sri Lanka (2012).

Even with the end of Sri Lanka's conflict—long considered a major deterrent to foreign investment—the overall recovery in FDI has been relatively unimpressive. This is despite a relatively liberal incentive framework, offered either through Automatic Approval Route Projects (AARP) under the Board of Investment (BOI) or under the more recently enacted Strategic Development Projects Act (SDPA) of 2008. Under the former, nine broad sectors have been identified as key investment thrust areas: tourism and leisure, infrastructure, knowledge services, utilities, apparel, export manufacturing, export services, agriculture, and education. Eligible investments qualify for a range of fiscal incentives based on the sector for investment and investment threshold. The current FDI policy also aims to encourage “strategic import replacement” projects such as those related to the manufacture of fabrics, milk powder, cement, and pharmaceutical products.

Under the Strategic Development Projects (SDPs), projects that are estimated to be in the national interest are entitled to considerable discretionary powers for approval. Such projects include those likely to bring economic and social benefits to the country, and those likely to change the landscape of the country, primarily through provision of goods and services of benefit to the public, substantial inflows of foreign exchange, employment, and technology transfer. The BOI, in consultation with the Minister of Economic Development (MOED), may propose a project as a SDP for consideration via gazette notification, i.e., by publishing information relating to the proposed project, by which exemptions may be granted in respect of same. On the expiration of a 30-day period from the date of the gazette notification, the MOED together with the Minister of Finance must inform and seek approval from the Cabinet of Ministers. A project deemed a SDP is eligible for a host of “special investment incentives.” While the intention behind the SDP initiative is to fast-track large investors, Sri Lanka's current policy with regards to the approval process for FDI has, however, become more opaque as a consequence.

There is also a lack of strategic approaches to identifying thrust areas for FDI. Much of the FDI in recent years has been in tourism development (including hotels, condominiums, and shopping malls) rather than in the more crucial manufacturing

and services sector that would bring much needed technology and knowledge transfer to the country's weakening manufacturing export sector and its nascent export services sector such as information communication technology (ICT) and knowledge process outsourcing (KPO).

3. COUNTRYWIDE STRATEGY TOWARD REGIONAL CONNECTIVITY

Sri Lanka's overall development policy framework outlines the intention to promote the country as a strategic hub in five key areas: maritime, aviation, energy, commerce, and knowledge. National physical infrastructure improvements already underway, or planned to be implemented, are designed to meet the needs in some of these areas to improve connectivity and services to the Asian region.

Sri Lanka's strategy toward fostering regional connectivity has focused on strengthening trade with its neighbors in Asia. Since the mid-1990s efforts have been expended to gain market access and domestic export diversification through bilateral and regional preferential trade initiatives. These trade initiatives are considered a means of not only accessing markets and diversifying the export base, but also of providing a small but crucial competitive advantage to attract larger FDI. However, these agreements have generally been very limited in scope and depth of liberalization, confined so far to trade in goods with extensive negative lists of items not considered for tariff reductions. One exception, however, was the initial success of the ISFTA, where Sri Lanka saw a significant improvement in its trade imbalance with India, although it worsened again to some extent from around 2006.⁴ However, the indirect spin-off benefits were important. Sri Lanka saw a significant increase in the volume of Indian FDI in the aftermath of this improved business confidence between the two countries.

Increased trade relations between the two countries, enhanced air travel linkages, as well as the decision by Sri Lanka to extend its "visa on arrival" policy to India in 2003 (extended by Sri Lanka to all SAARC countries in 2004) were key factors in attracting Indian FDI. Tourism has been greatly facilitated with the liberalization of air travel between the two countries after the adoption of a bilateral "open skies" policy in 2003. Sri Lanka has since continued to see its highest number of tourist arrivals from India, accounting for around 18% of total tourists.⁵

Sri Lanka's current economic policy framework, with an emphasis on rural development, agriculture, and support for small and medium enterprises (SMEs), is focused on ensuring a "level playing field" for local entrepreneurs.⁶ As such, a framework agreement to expand and deepen the ISFTA to a CEPA between India and Sri Lanka was abandoned in 2008 owing to intense lobbying by sections of Sri Lanka's industrialists opposed to further liberalization with India. Whilst lobbying against the agreement came from a minority of industrialists engaged in industries competing directly with potential competitors in India, large sections of the country's business community and chambers of commerce are in favor of greater economic connectivity between India and Sri Lanka as evidenced by public support expressed through forums and consultations.⁷

⁴ Weerakoon (2011).

⁵ Central Bank of Sri Lanka. *Annual Report*. Various years.

⁶ Department of National Planning (2010).

⁷ <http://www.lankabusinessonline.com/news/sri-lanka-business-chamber-touts-virtues-of-indian-trade-deal/285706546>

Despite the stalling of the CEPA with India, technical-level negotiations on a CEPA with Pakistan commenced in 2008, while negotiations on a SAARC Agreement on Trade in Services (SATIS) was signed in 2010. APTA also began negotiations in 2009 to extend cooperation in areas of investment, trade facilitation, and services. For Sri Lanka, however, the key to a meaningful integration has been via a bilateral agreement with India, which appears to be on hold for the present.

In contrast to the stalled CEPA with India, Sri Lanka has strengthened its political and economic relations with the People's Republic of China (PRC) in recent years. Political relations were cemented during the last stages of Sri Lanka's armed conflict during 2006–2009 when the PRC provided material assistance—including armaments and military equipment—as well as political and diplomatic support when the country faced charges of human rights violations by sections of the international community. Indeed, the PRC became Sri Lanka's largest source of bilateral development assistance in 2007, bypassing that historical position held by Japan.

The economic involvement of the PRC in Sri Lanka is most visible in the infrastructure sector. PRC loans have financed key development projects such as ports (e.g., Hambantota port), airports (e.g., Mattala International Airport), road development, and Sri Lanka's first coal-fired power plant. PRC financing of the Hambantota port in Southern Sri Lanka has drawn most concern from India, given the strategic significance of sea routes in the Indian Ocean. In addition, PRC investments were also involved in increasing the container terminal capacity of the Colombo port in its latest phase of expansion.

While much of the economic cooperation between the PRC and Sri Lanka has been in development finance, there has been a discernible change in the nature of engagements recently. Unlike India, the PRC has not been a major source of FDI for Sri Lanka. However, in 2013, the PRC emerged as the single largest source of FDI, accounting for a quarter of new agreements approved by the BOI.⁸ These include proposed investments in the leisure and tourism sectors. As a further sign of growing economic relations between the two countries, an agreement was signed in June 2013 to upgrade relations to a “strategic cooperative partnership” covering four main areas: political cooperation, defense and security, economic relations, and cultural matters. The PRC and Sri Lanka have since agreed to negotiate an FTA with the preparatory process expected to be completed in 2014.

However, while Sri Lanka's economic and political relations with the PRC are on the rise, Sri Lanka's relations with India are under stress. On the economic front, lack of progress in finalizing the CEPA is one factor. Politically, India went against its policy of not voting in country-specific resolutions at multilateral fora when, in 2012 and again a year later, it voted in favor of a US resolution against Sri Lanka at the United Nations Human Rights Council (UNHRC). The resolution called for accountability from Sri Lanka on alleged human rights violations at the conclusion of the 30-year conflict. In November 2013, the Indian Prime Minister decided against attending the Commonwealth Heads of State Summit (CHSS) hosted by Sri Lanka, largely due to domestic pressures from its southern constituent states. Against this current backdrop, not surprisingly, Sri Lanka is looking increasingly to cement its political and economic relations with the PRC, which could place further strain on India–Sri Lanka relations.⁹

⁸ <http://www.ft.lk/2013/12/04/china-cheer-in-record-fdi/>

⁹ Gabrielson and Johnson-Freese (2012).

4. STATE OF CROSSBORDER-RELATED PHYSICAL TRANSPORT INFRASTRUCTURE

Since 2006, Sri Lanka's economic development efforts have focused on an ambitious physical infrastructure connectivity program, primarily via public investment-led initiatives. This has encompassed major projects, especially in seaport, airport, and road network development. The most significant of these are set out below in Table 5.

Table 5: Major Infrastructure Projects

Seaport and Airport Development	Colombo south port expansion
	Hambantota port development
	Expansion of Katunayake International Airport
	New Mattala International Airport
Road Network	Southern highway (126 km)
	Colombo–Katunayake expressway (25 km)
	Outer Circular highway (28 km)
	Colombo–Kandy highway (98 km)

Source: <http://www.development.lk/>

Over the years, the availability and quality of transport infrastructure has remained one of the key problem areas for Sri Lanka. However, with focused investments in physical infrastructure, there has been a steady improvement in global indices tracking availability and quality of transport infrastructure, as exemplified by the Enabling Trade Index (ETI).¹⁰ In terms of availability and quality of transport infrastructure, Sri Lanka fares much better than South Asia and Southeast Asian economies apart from Thailand, Malaysia, and Singapore. Sri Lanka leads South Asia in terms of percentage of paved roads, quality of air transport infrastructure, quality of roads, and quality of port infrastructure, while it is ranked second in South Asia (following India) in terms of quality of railroad infrastructure.

Table 6: The Enabling Trade Index of Sri Lanka: Transport Infrastructure

	2008	2010	2012
Transport and communications infrastructure ^a	3.1	3.3	3.6
Availability and quality of transport infrastructure ^a	3.9	4.2	4.4
Airport density, number per million population	0.4	0.1	0.0
Transshipment connectivity, index ^b	52.0	78.4	81.7
Paved roads, % of total	81.0	81.0	81.0
Quality of air transport infrastructure ^a	4.5	4.8	4.9
Quality of railroad infrastructure ^a	2.8	3.4	3.8
Quality of roads ^a	3.1	3.9	4.5
Quality of port infrastructure ^a	4.1	4.8	4.9

^a Based on a score of 1–7 where 1 = extremely underdeveloped and 7 = extensive and efficient by international standards.

^b 0 = low connectivity and 100 = high connectivity.

Source: World Economic Forum. *The Global Enabling Trade Report*. Various years.

¹⁰ <http://reports.weforum.org/global-enabling-trade-report-2012/>

The quality of railroad infrastructure has, over the years, scored lowest in availability and quality of transport infrastructure, and there is unlikely to be any significant change in view of greater emphasis placed on the development of roads, airports, and seaports in the current infrastructure programs. Underlining these developments, it is not surprising to note that the quality of roads, port infrastructure, and air transport infrastructure has shown a marked improvement over the years as reflected by their improved ETI scores (Table 6).

4.1 Road Network

The road network of Sri Lanka comprises highways (class A and E) and feeder roads (class B and C). Out of a total national highway network of 12,165 km of class A and B roads maintained by the Road Development Authority (RDA) in 2012, 4,220 km consisted of class A roads while 7,945 km consisted of class B roads.

The Highway Development Plan of the RDA is two-pronged. The first strategy deals with the rehabilitation of existing national highways, while the second aims to add alternative highways to supplement the existing trunk road system.¹¹ The selection of projects for rehabilitation is based on the level of traffic, road conditions, and connectivity.

Box 1: Connectivity through Expressways

The Southern Expressway, 126 km long, is Sri Lanka's first ever access-controlled expressway, linking the Western Province to the Southern Province. The first phase of the project commenced operations in November 2011, funded by the Government of Sri Lanka (GOSL), the Japan International Cooperation Agency (JICA), and the Asian Development Bank (ADB). The second-phase extension is currently underway. Upon completion, the Southern Expressway will connect the port of Colombo with the port of Hambantota. Funding of the final section is being provided by the GOSL together with the EXIM Bank of the PRC. The Southern Expressway is expected to play a pivotal role in improving both intra-country and crossborder connectivity, as it links the three principal ports of Sri Lanka together.

The Colombo–Katunayake expressway, which is 25.8 km long, is intended to reduce the travel time between Colombo and Katunayake International Airport. The expressway is expected to be open to traffic in October 2013, with construction implemented by a loan facility offered to the GOSL by the PRC.

4.2 Seaports

The strategic position of the port of Colombo along the sea routes of the Indian Ocean has since its inception led to the port serving as a port of call for funneling and other shipping services. The port of Colombo is considered today as a transshipment hub for South Asia. Transshipment volumes currently account for around 74% of container throughput in the port, and remain the primary revenue source among both state-owned and private terminals. Thus, much of the success of Sri Lanka's port sector hinges on devising suitable strategies to reinforce the position of Sri Lanka as a transshipment hub.

The development of the ports sector is viewed as a critical and integral element of Sri Lanka's growth strategy, particularly in relation to developing a global logistics hub port in the country. The ports sector has seen significant investments and improved

¹¹ Road Development Authority. Highway Development Plan (online). Available at: http://www.rda.gov.lk/source/highway_development_plan.htm

performance during recent years, with total container handling increasing from 3.4 million 20-foot equivalent container units (TEU) in 2007 to 4.2 million TEU in 2012 (Table 7). Furthermore, total cargo handling increased from 46 million TEU in 2007 to 65 million TEU in 2012.

Table 7: Performance of the Port Sector

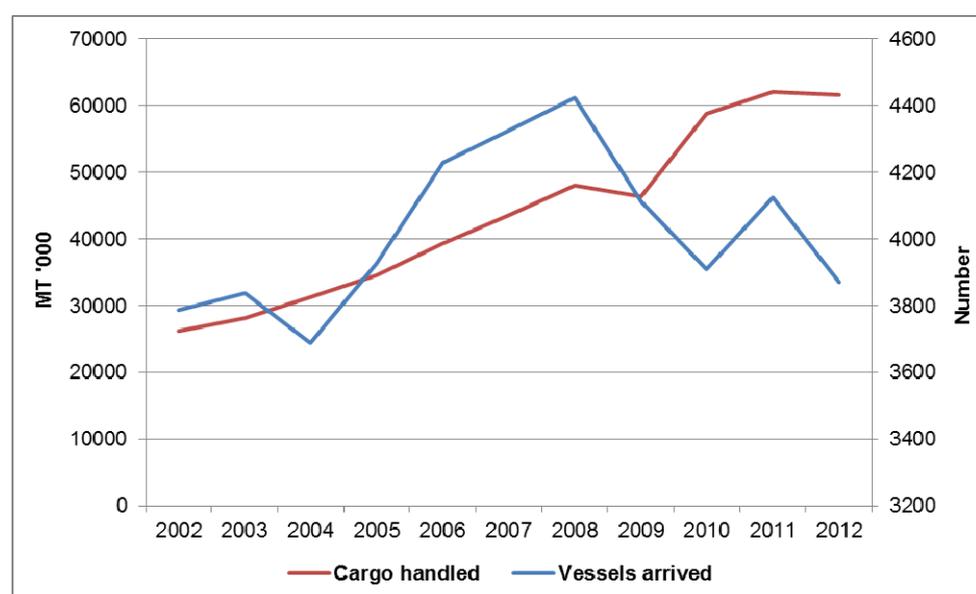
Year	2007	2008	2009	2010	2011	2012
Total Container Traffic (TEU thousand)	3,381	3,687	3,464	4,137	4,263	4,187
Transshipment Container (TEU thousand)	2,578	2,785	2,712	3,205	3,216	3,167
Total Cargo Handled (MT thousand)	46,344	50,582	48,778	61,240	65,069	65,070
Vessels Arrived (number)	4,710	4,814	4,456	4,067	4,332	4,134

TEU = twenty-foot equivalent container unit, MT = megaton.

Source: Central Bank of Sri Lanka. *Annual Report*. Various years.

It should be noted that the total number of vessels arriving at ports across Sri Lanka has seen a gradual decline (see Figure 2). However, the declining trend in the number of vessels arriving is a reflection of the increased use of larger-sized vessels, indicating higher per vessel carrying/handling tonnage/TEU.

Figure 2: Cargo Handling and Vessels Arrived at Colombo Port



Note: MT = metric tons (cargo weight).

Source: Central Bank of Sri Lanka. *Annual Report*. Various years.

The port of Colombo functions as the principal port in Sri Lanka with the largest container, cargo, and transshipment handling capacity. The pre-eminence of the port of Colombo dates back to the 15th century, and it has continued to serve as the principal port in the country, accounting for around 93% of vessels arriving to the country and around 95% of total cargo handled.¹² In 2012, the total cargo handling of

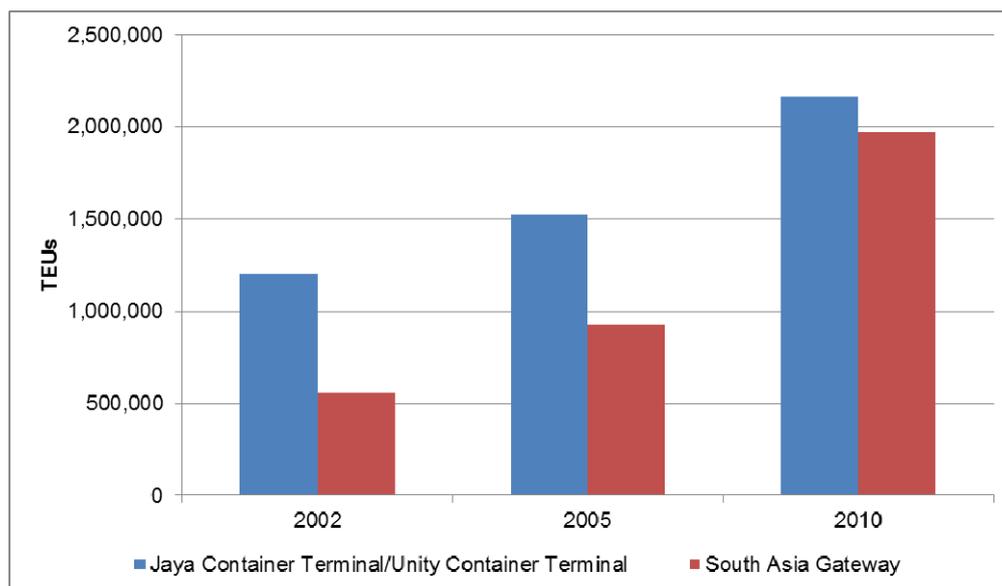
¹² Central Bank of Sri Lanka (2012).

the Colombo port was 62 million TEU, compared to 0.5 million, 2.8 million, and 0.02 million for the ports of Galle, Trincomalee, and Hambantota, respectively.

The main container facility of the port, the Jaya Container Terminal (JCT), constructed during 1983–1997, is owned and operated by the state-owned Sri Lanka Ports Authority (SLPA). With the decision of the GOSL to liberalize the shipping industry in 1990, an agreement was signed between South Asia Gateway Terminal (SAGT)—a consortium of private investors comprising local and international investors and the SLPA—to build a fully fledged container terminal. Following this, Sri Lanka’s first modern private container terminal was developed on a 30-year build, own, and transfer (BOT) basis and became fully operational in 2003. The Unity Container Terminal (UCT), another state-owned terminal, was opened by the SLPA in 2004 as a satellite terminal for the JCT.

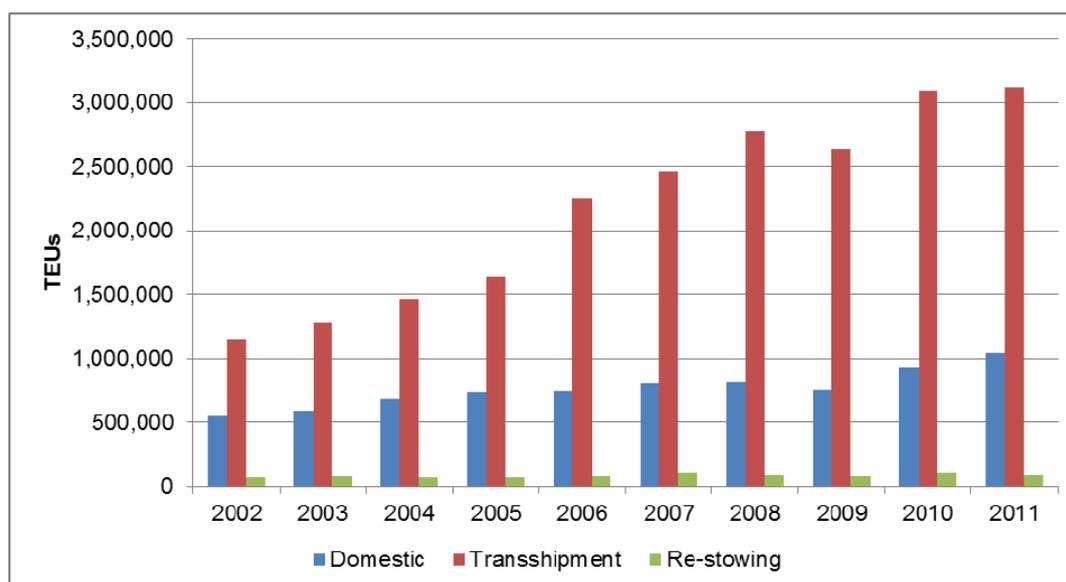
Hence, container traffic has markedly improved, spurred on by the promising developments in port infrastructure, although it dipped following the onset of the global financial crisis of 2008–2009. Whilst the state-owned container terminals continued to dominate container traffic levels at the port of Colombo during the initial years after the entry of the private terminal, this gap narrowed as traffic levels at the SAGT grew substantively. By 2010, container traffic levels at the JCT/UCT amounted to 52.4% of total container traffic of the port, while SAGT accounted for 47.6% (Figure 3). Figure 4 shows the steady increase in container traffic.

Figure 3: Container Traffic Levels of the Terminals of the Port of Colombo



TEU = twenty-foot equivalent container unit.

Source: Compiled based on data obtained from the Sri Lanka Ports Authority (SLPA) available at: http://www.slpa.lk/expansionproject/current_situation.asp and SLPA (2011).

Figure 4: Container Throughput of the Port of Colombo

TEU = twenty-foot equivalent container unit.

Source: Central Bank of Sri Lanka (CBSL) (2012). *Economic and Social Statistics of Sri Lanka 2012*. Colombo: Central Bank of Sri Lanka.

Sri Lanka's geographical position has given it an advantage over other hub port nations in the region. The country has a competitive edge, with deviations from the main shipping route being among the lowest in the region in terms of time and cost (Table 8).

Table 8: Estimated Mainline Vessel Deviation Cost (per 4000 TEU Vessel) Calling at Selected Hub Ports in the Region

Port	Deviation Time (days)	Vessel Deviation Time Cost (\$)
Chennai	1.10	24,750
Chittagong	2.25	50,625
Cochin	0.13	2,925
Colombo	0.06	1,350
Jawaharlal Nehru Port/Nhava Sheva	0.85	19,125
Karachi	1.33	29,925
Mundra	1.30	29,950
Tuticorin	0.09	2,025

TEU = twenty-foot equivalent container unit.

Source: Shiplink International. *Guide to Sri Lankan Port and Shipping*. Available at <http://www.shiplink.lk/>.

The port of Colombo fares better in terms of container traffic than all other ports of South Asia excluding the Jawaharlal Nehru (Nhava Sheva) port of India (Table 7). Additionally, the port of Colombo seems to fare well in performance compared to the Indian ports in terms of turnaround time and service time. As far back as 2005, the turnaround time of JCT was noted to be 16 hours,¹³ while the turnaround time of Indian ports was 45 hours in 2012.¹⁴ Furthermore, the average service time of the

¹³ ADB (2007).

¹⁴ Jayaprakash and Gunasekaran (2012).

JCT was 13.8 hours in 2005, compared to a service time of 28.8 hours for Indian ports in 2012.

However, Sri Lanka seems to be lagging behind in performance compared to some of the major ports of Southeast Asia including the ports of Singapore, Port Kelang, Tanjung Pelepas, and Laem Chabang, and container traffic levels at these ports largely exceed those of the port of Colombo (Table 9).

Table 9: Ranking of Selected Ports in Asia by Container Traffic (2010)

Container Traffic	Economy	Rank	TEU
Shanghai	PRC	1	29,069,000
Singapore	Singapore	2	28,431,100
Hong Kong, China	PRC	3	23,669,242
Dubai	UAE	9	11,575,775
Port Kelang	Malaysia	13	8,871,745
Tanjung Pelepas	Malaysia	17	6,298,734
Laem Chabang	Thailand	22	5,068,076
Tanjung Priok	Indonesia	24	4,714,857
Tokyo	Japan	25	4,284,944
Jawaharlal Nehru (Nhava Sheva)	India	26	4,269,811
Colombo	Sri Lanka	28	4,000,000
Ho Chi Minh City	Viet Nam	30	3,856,000
Manila	Philippines	37	3,154,702
Keelung	Taipei, China	61	1,962,896
Chennai	India	73	1,522,068
Bangkok	Thailand	77	1,452,829
Karachi	Pakistan	78	1,370,000
Chittagong	Bangladesh	84	1,328,976
Penang	Malaysia	89	1,106,098
Bin Qasim	Pakistan	112	779,000

PRC = People's Republic of China, TEU = twenty-foot equivalent container unit, UAE = United Arab Emirates.

Source: American Association of Port Authorities. Available at: <http://aapa.files.cms-plus.com/Statistics/WORLD%20PORT%20RANKINGS%202010.pdf>

Although the performance of the port of Colombo seems to be satisfactory in the context of South Asia, several issues that may jeopardize its competitive position continue to loom. For instance, the port is at risk of being dependent on a single cargo base, as 80% of the transshipment volume it handles either originates from or is destined for an Indian port.¹⁵ Thus, connectivity for the larger Asian region via the Colombo port hinges on transshipment cargo trade with India. At present, the Colombo port handles 16% of India's total transshipment of 10 million TEU, and it is projected that Indian volumes will be the mainstay of the port of Colombo for some years to come. This remains a critical issue given the rapid development of Indian ports, i.e., being driven by the motive to provide direct shipping services for Indian

¹⁵ Wickramasnghe, T., "Port of Colombo - The Way Forward", available at: <http://www.ft.lk/2011/07/04/port-of-colombo-%E2%80%93-the-way-forward/>

cargo. In addition, the performance of the Indian economy also has a strong bearing on such transshipment activity. Hence, it remains imperative that Sri Lanka focuses on diversifying its shipping markets in order to sustain its future prospects.

Additionally, the trend toward using larger vessels may impose adverse competitive pressure from established ports such as Singapore and Dubai, as the shift toward larger vessels indicates that transshipment ports with larger hinterlands that these vessels can serve are more favorable.¹⁶ Hence, improving the efficiency of the port of Colombo to match levels of more established ports remains critical.

It has been recognized for some time that investment in port infrastructure is needed to increase container-handling capacity and alleviate infrastructure constraints faced by the Colombo port. As per the SLPA, the container-handling demand of the country is expected reach 10 million TEU by 2020.¹⁷ As such, the existing capacity of the Colombo port of 4.8 million TEU is inadequate to cater to this projected demand. In addition, with a depth of 15 m, the Colombo port cannot berth the latest generation of container ships, in contrast to competitor ports such as Dubai and Singapore. Therefore, given the trend toward larger container ships, if Colombo is to develop as a hub port, upgrading the infrastructure to handle these larger vessels is critical.

Hence, the Colombo Port Expansion Project (CPEP) was commissioned with a vision of transforming Sri Lanka into a center of maritime excellence. The CPEP is expected to increase the capacity of the Colombo port by 7.2 million TEU. A key feature of this is the proposed capacity expansion of the port by building a new breakwater and additional berths south of the existing harbor.

The main features of the proposed Colombo South Harbor Development (CSHD) are to build 6.8 km of main breakwater, 18 m turning base depth, 570 m access channel width; and three terminals, each 1,200 m in length with facilities to accommodate three berths.¹⁸ The first phase of the CPEP consists of three stages that involve the development of basic infrastructure. The second stage involves the development of the Colombo South Container Terminal (CSCT) and the third stage involves the development of the East and West Terminals. The first phase of the CPEP was commissioned in August 2013. The estimated cost of the first phase is \$400 million, of which \$300 million was funded by ADB and \$100 million by the GOSL.

The CSCT, the first of the three terminals to be accommodated on the breakwater and providing an additional capacity of 2.4 million TEU, started operations in August 2013. The terminal is operated by the Colombo International Container Terminal (CICT), a joint venture between China Merchant Holdings International (CMHI) and the SLPA on a 35-year BOT basis. The terminal is considered to be the most advanced international transshipment hub in South Asia, able to accommodate the largest container ships of 18,000 TEU. Moreover, Colombo's port is in an optimal position to strengthen its performance as the transshipment hub between the West and the East, especially for markets in the Indian subcontinent and East Africa. The total cost of the project is estimated at \$500 million.

The next step of the CPEP will involve the completion of the East and West Terminals. When fully operational by 2020, as anticipated, the three terminals are expected to add a combined container handling capacity of 7.2 million TEU to Colombo's existing port operations.

¹⁶ ADB (2007).

¹⁷ IPS Key Informant Interview conducted with the Project Director/Chief Engineer, Planning and Development Division, Sri Lanka Ports Association.

¹⁸ http://www.slpa.lk/colombo_south_harbour.asp?chk=4

However, Colombo port is likely to face stiff competition, particularly from India with its planned investments in port infrastructure. To mitigate the loss of cargo to Indian ports and other competitors, Sri Lanka will need to lower the charges on transshipment cargo and upgrade the port to a free port, i.e., enable port users to operate without additional charges other than port handling and rent or lease charges. This was announced in July 2013, as part of a policy decision to designate four ports, including Colombo, as free ports, to lure foreign investment by extending attractive tax incentives to port users. However, such concessions need to be balanced against the need to repay foreign loans obtained by the GOSL to develop port infrastructure.

In addition to the CPEP, the GOSL invested in a second international seaport with the construction of the Hambantota port, and situated in southern Sri Lanka to take advantage of the Asia–Europe shipping route. The port of Hambantota was also conceived as a measure to ease the long berthing delays experienced by roll-on–roll-off (Ro–Ro) vessels at the port of Colombo.

In 2010, two breakwaters, a 210 m wide entrance channel, a 600 m turning circle, a 17 m deep basin area, a 600 m general purpose berth, a 610 m oil quay, a 105 m service berth, as well as various roads and associated buildings were completed and became operational. Construction of the second phase commenced in November 2012 and is scheduled for completion by the end 2015. The total cost, \$360 million for the first phase of the project, was largely funded by the EXIM Bank of the PRC, while the cost of the second phase—estimated to be \$800 million—is to be funded by the government of PRC and the EXIM Bank. The port also provides bunkering facilities with 14 oil and gas tanks. The third stage will involve the construction of a container oil terminal 300 m long and 17 m deep, four container berths, one oil wharf, and two feeder berths. This final phase is expected to be completed by 2023.

The Hambantota port will operate predominantly as a transshipment port. During 2011–2012, the port received only 24 vessels. In an apparent bid to increase the shipping traffic, in 2012, the GOSL announced that all vessels carrying motor vehicles, except heavy vehicles, would be directed to the Hambantota port, citing berthing delays and space constraints at the port of Colombo. As a result, the port attracted approximately 75 vessels during the first 7 months of 2013. However, besides such enforced traffic, the port has yet to attract a large numbers of vessels.

5. STATE OF ENERGY TRADING

The energy market of Sri Lanka mainly facilitates the exchange of electricity, petroleum, and biomass. Currently, the total primary energy supply is met by biomass (43.7%), petroleum (43.4%), coal (2.9%), major hydro (8.5%), and new renewable energy (1.6%), while electricity remains the main secondary source of energy, 59.1% of which is generated from thermal power plants (oil and coal), 34.5% from major hydro, and 6.2% from new renewable energy sources such as biomass, wind, and solar.¹⁹

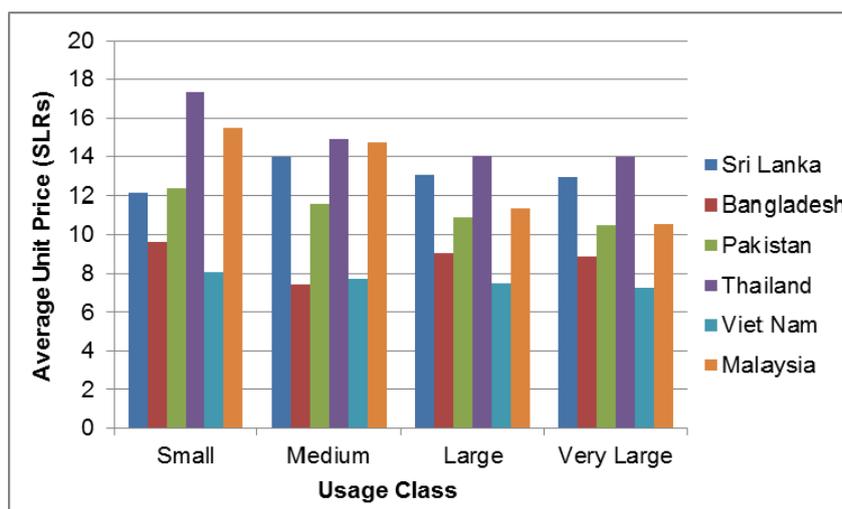
Some of the major energy sources, such as petroleum and coal, are fully imported. Sri Lanka's petroleum product requirements are met partly through direct imports of refined products and partly by processing imported crude oil at the country's single oil refinery, which supplies approximately half its needs. The Ceylon Petroleum Corporation (CPC) purchases most of its oil products in the open market. Improved participation in state-to-state contracts between the government and state-owned oil-

¹⁹ Sri Lanka Sustainable Energy Authority (2011).

importing companies across Asia has proven to be cost effective, as oil can be purchased at advantageous prices under such agreements (footnote 19).

Sri Lanka's bid to raise GDP growth to 8% in the medium-to-long term is expected to pose significant challenges with regard to the rapidly increasing demand for energy. Electricity demand in 2010 stood at 9,286 gigawatt-hours (GWh) and the projected demands for 2015 and 2020 are 12,941 GWh and 17,489 GWh, respectively.²⁰ Indeed, the power sector is estimated to require an annual addition of 100 megawatts (MW) to the grid to meet the annual demand.²¹

Figure 5: Industrial Electricity Tariffs, 2012



Source: T. Siyambalapatiya. 2013. Five Year (2013-2017) Road Map for the Revival of the Electricity Industry. Cited in IPS (2013). Sri Lanka: State of the Economy 2013.

Sri Lanka's energy generation mix at present is dominated by oil (50%), followed by hydro (40%), coal (9%), and non-conventional renewable energy (1%). As the country exhausted its hydro energy capacity—with planned additions to the grid amounting to only 354 MW—Sri Lanka was scheduled to have commissioned its first coal power plant in 2005. However, failure to implement the scheduled long-term generator expansion plans resulted in fuel-fired thermal power purchases by the CEB through independent power producers. As a result, Sri Lanka has high electricity tariffs relative to its neighbors in South and Southeast Asia (Figure 5). Future grid expansion is expected to be dominated by coal-fired power plants.

Sri Lanka's potential for crossborder energy trade lies with its immediate neighbor, India. The proposal for bilateral energy trade has centered around the proposed India-Sri Lanka High Voltage Direct Current (HVDC) grid interconnection project, aimed to link the national grids of India and Sri Lanka. The project involves the construction of a HVDC connection between Madurai in southern India, and Anuradhapura in central Sri Lanka, through the Palk Strait. The link would be 285 km long, including 50 km of submarine cables. The identified project implementers are the Power Grid Corporation of India Limited (PGCIL) and CEB of Sri Lanka, with an estimated construction period of 3 years in total. The connection is to be developed in two phases: the first phase would enable the transmission of 500 MW between the

²⁰ Ceylon Electricity Board (2011).

²¹ Institute of Policy Studies of Sri Lanka (2013).

two countries. The second phase would enable the target capacity of 1,000 MW transmission.²²

However, the viability of the project has come under scrutiny on the basis of the limited potential for electricity trade and the high cost that may be incurred in terms of the infrastructure. The latter relates to the high cost of submarine cable through which the electricity will be transferred. Thus, the economic workability of the project is expected to critically depend on the size of the envisaged project under tight commercial and technical conditions.

6. STATE OF TRANSPORT AND TRADE ADMINISTRATION

Besides the gains from expansion of physical infrastructure, efficiency gains through more productive usage of facilities can add considerably to overall improvements in crossborder connectivity. This is necessary in today's highly competitive globalized world, where access to efficiently produced critical backbone services and inputs are pivotal to competitiveness.

Table 10: Enabling Trade Index 2012 (Ranking/132)

South Asia			Southeast Asia		
	ETI Rank ^a	ETI Score ^b		ETI Rank ^a	ETI Score ^b
Bangladesh	109	3.46	Cambodia	102	3.52
India	100	3.55	Indonesia	58	4.19
Nepal	124	3.07	Malaysia	24	4.90
Pakistan	116	3.39	Philippines	72	3.96
Sri Lanka	73	3.95	Singapore	1	6.14
			Thailand	57	4.21
			Viet Nam	68	4.02

ETI = enabling trade index.

^a Rank among 132 economies

^b Based on a score of 1–7, where 1 = extremely underdeveloped and 7 = extensive and efficient by international standards.

Source: World Economic Forum (WEF). 2012. *The Global Enabling Trade Report 2012: Reducing Supply Chain Barriers*. Geneva: World Economic Forum.

Weak transport and trade facilitation, such as lack of or poorly maintained transport services, and complex import and export procedures, result in increased transaction costs that in turn adversely impact competitiveness. As a region, South Asia still lags behind its competitors in terms of effective trade administration and trade facilitation. Nevertheless, Sri Lanka seems to fare well among its South Asian counterparts as shown by its relatively higher rankings in competitiveness indices such as the ETI. However, the performance of Sri Lanka compared to Southeast Asian economies such as Singapore and Malaysia lags well behind in many trade facilitation and enabling indicators (Table 10).

²² CEB. 2011. *Interconnection of India-Sri Lanka Electricity Grid*. Available at: http://www.sari-energy.org/PageFiles/What_We_Do/activities/HVDC_Workshop_Sep_2011/presentations/Sri%20Lanka%20Preparations%20for%20Interconnection%20with%20India.pdf

The quality of trade and transport infrastructure and the efficiency of customs and border administration have been identified by the Global Enabling Trade Report (GETR) 2012, of the WEF and the World Bank's Logistics Performance Index (LPI) to be the most severe bottlenecks impeding trade facilitation in Sri Lanka (Tables 11 and 12). However, there has been a general improvement over time, with Sri Lanka receiving an overall ranking of 81 out of 150 economies in 2012.

Table 11: Logistics Performance Index

	2007		2012	
	Rank ^a	Score	Rank ^a	Score
Overall LPI	92	2.40	81	2.75
Customs ^b	91	2.25	71	2.58
Infrastructure ^b	106	2.13	89	2.50
International shipments ^c	112	2.31	50	3.00
Logistics competence ^b	85	2.45	68	2.80
Tracking and tracing ^b	75	2.58	86	2.65
Timeliness ^d	113	2.69	110	2.90

LPI = logistics performance index.

^a Rank out of 150 economies.

^b Scored on 1 = very low and 5 = very high.

^c Scored on 1 = very difficult and 5 = very easy.

^d Scored on 1 = hardly ever and 5 = nearly always.

Source: World Bank. *The Logistics Performance Index*. Various years.

Table 12: The Enabling Trade Index of Sri Lanka: Transport Services

Year	2008	2010	2012
Availability and quality of transport services ^a	3.3	3.0	3.4
Liner shipping connectivity index ^b	42.4	34.7	41.1
Ease and affordability of shipment ^c	2.3	2.5	3.0
Logistics competence ^c	2.5	2.1	2.8
Tracking and tracing ability ^c	2.6	2.2	2.7
Timeliness of shipments in reaching destinations ^c	2.7	3.0	2.9

^a Based on a score of 1–7, where 1 = extremely underdeveloped and 7 = extensive and efficient by international standards.

^b Refers to the quantity of services provided by liner companies (maximum value in 2004 = 100).

^c Scored on 1 = very low and 5 = very high.

Source: World Economic Forum. *The Global Enabling Trade Report*. Various years.

The availability and quality of transport services continues to be an area that needs significant improvement in Sri Lanka. Factors such as ease and affordability of shipment, logistics competence, and tracking and tracing capability continue to receive low scores despite headway made in other areas.

According to the Organisation for Economic Co-operation and Development (OECD) trade facilitation indicators, in terms of trade administration, Sri Lanka performs better than the average Asian and lower middle-income countries in terms of involvement of the trade community, appeal procedures, and simplification and harmonization of documents. However, Sri Lanka's performance in information availability, automation,

and internal border agency co-operation is below average for Asian and lower middle-income countries.²³

The “trading across borders” indicator of the World Bank’s *Doing Business* report measures the time and cost (excluding tariffs) associated with exporting and importing a standardized cargo of goods by ocean transport. While Sri Lanka performs relatively well in all three sub-indicators with respect to other South Asian countries, it still lags behind Southeast Asian economies (Table 13).

Table 13: Trading Across Borders

	Documents for Exports and Imports (number)		Time to Export and Import (days)		Cost to Export and Import (\$ per container)	
	2007	2013	2007	2013	2007	2013
	Bangladesh	23	14	92	59	2,189
India	25	20	68	36	2,108	2,320
Pakistan	20	16	43	39	2,002	1,365
Sri Lanka	21	12	52	39	1,586	1,495
Malaysia	18	11	42	19	909	855
Thailand	21	10	46	27	1,890	1,335
Viet Nam	15	14	71	42	1,588	1,210
Cambodia	20	19	81	48	1,552	1,655
Lao PDR	28	20	144	52	3,110	4,265

Lao PDR = Lao People’s Democratic Republic.

Source: World Bank. *Doing Business*. 2007 and 2013.

Much support is needed to improve these indicator rankings, especially with respect to expediting clearance procedures. Studies have shown that Sri Lanka lags behind in clearance procedures, as it takes 2–6 days to clear import consignments in Sri Lanka compared to 15 minutes in ports such as Singapore; Hong Kong, China; Dubai; and many other European ports.²⁴ Hence, it is timely to focus on improving clearance procedures.

As in other developing countries, the importance of streamlining trade administration and customs procedures in facilitating trade has been a frequently discussed component of Sri Lanka’s trade policy. Sri Lanka’s performance in trade administration remains promising as the country has shown noteworthy improvements in trade administration indicator rankings. For example, the number of days required for imports and the number of documents needed for exports have declined in recent years (Table 14). These significant achievements could be attributed to the automation of customs procedures in the country.

²³ OECD (2013).

²⁴ De Silva (2010).

Table 14: The Enabling Trade Index of Sri Lanka: Trade Facilitation

	2008	2010	2012
Efficiency of customs administration ^a	3.4	3.4	3.8
Burden of customs procedures ^b	4.0	3.7	4.4
Customs service index ^c	4.2	5.1	5.1
Efficiency of import-export procedures	4.9	4.7	5
Efficiency of clearance process ^a	2.3	2.0	2.6
No. of days to import	21	20	19
No. of documents to import	6	6	6
Cost to import, \$ per container	844	745	745
No. of days to export	n.a.	21	21
No. of documents to export	n.a.	8	6
Cost to export, \$ per container	n.a.	715	715
Transparency of border administration ^a	3.2	3.0	2.9
Irregular payments in imports and exports ^d	3.6	3.1	2.8

^a Based on a score of 1–7, where 1 = extremely underdeveloped and 7 = extensive and efficient by international standards.

^b 1 = extremely inefficient and 7 = extremely efficient.

^c Maximum score = 12.

^d 1 = common and 7 = never occurs.

Source: World Economic Forum. *The Global Enabling Trade Report*. Various years.

The automation of customs procedures in Sri Lanka began with the introduction of the Automated System for Customs Data (ASYCUDA) in 1992. The ASYCUDA, a computerized customs management system, was introduced to enhance the efficiency of customs services through the automation of import and export procedures. The ASYCUDA was first introduced to the imports section and later extended to the exports and bonds division in 1993. The ASYCUDA system was upgraded to ASYCUDA++ in 1998. Although the implementation of ASYCUDA++ was a significant milestone in automating customs procedures, it still required a customs officer to manually enter the customs declaration (CUSDEC), bill of lading, and delivery order.²⁵ This was known to be a cumbersome and time-consuming procedure, as the CUSDEC alone has 54 entries to be keyed in. Furthermore, Customs House Agents (CHA) were required to go to the “long room” in the Customs Department in order to lodge a CUSDEC. It was to circumvent these administrative delays and red tape procedures that a decision was taken to introduce the ASYCUDA World electronic data interchange system in 2008. With the implementation of ASYCUDA World in 2013, CHAs can submit CUSDECs and other required documentation electronically to the Customs Department, bypassing the cumbersome manual keying-in process. Additionally, the assessment of relevant duties and payments, which was done manually during the ASYCUDA++ era and taking as much as two or three hours, is now done electronically in a matter of minutes. Thus, the introduction of ASYCUDA World seems to have expedited customs procedures.

However, despite the new automation processes, Sri Lanka has yet to fully implement the “Single Window” facility that allows parties involved in trade and transport to lodge standardized information and documents with a single entry point

²⁵ IPS Key Informant Interview conducted with Superintendent, ICT Division, Sri Lanka Customs (31 July 2013).

to fulfill all import, export, and transit-related regulatory requirements. For successful implementation of the Single Window system, it is important that all parties involved in cargo clearance should be able to exchange information. The Single Window is generally managed by a lead agency, usually Customs, enabling the appropriate governmental authorities to access the relevant information.

While the automation of import and export procedures has now been fully completed, Key Informant Interviews (KIIs) with relevant officials identified the following vital areas in need of improvement to enhance the automation of customs procedures in Sri Lanka.²⁶

- (i) Implementation of the Single Window concept in which all relevant government ministries and agencies are connected through one single entry point (ASYCUDA World). The Single Window concept has so far been partially implemented, with the Ministry of Finance and Planning already linked to the ASYCUDA World system. Other stakeholders, including the Inland Revenue Department, Department of Motor Traffic, and Sri Lanka export Development Board, are to be connected to ASYCUDA World in the near future.
- (ii) Connecting all commercial banks of Sri Lanka to the customs online payment platform so that the payment of duties and levies are not limited to the state-owned Bank of Ceylon and People's Bank. Although the recent introduction of the People's Bank to the online customs payment platform was a step in the correct direction, much effort is still needed to enable other commercial banks to enter the customs payment platform.
- (iii) Creating awareness among traders and CHAs of the electronic system as the majority of customs procedures are still lodged manually, despite the availability of an electronic system.

In terms of trade finance, Sri Lanka's banking sector, consisting of 24 Licensed Commercial Banks (LCBs), provides an array of trade finance facilities to traders. These banks offer a package of trade finance services including export bill purchase, export bill collection, letters of credit, foreign exchange contracts (forward/spot), offshore banking, trade advisory services, and issuance of guarantees.²⁷ With a reasonable banking density of 10.8 branches per 100,000 persons in 2012, it is evident that problems pertaining to trade finance cannot be attributed to the lack of trade finance services, as such services are available through the widespread bank branch network across the country.

The findings of KIIs carried out with two of Sri Lanka's leading domestic commercial banks reveal the following factors to be the key constraints in providing trade finance services in Sri Lanka: (i) the existence of high interest rates in the country; (ii) the lack of collateral among traders (especially among exporters); and (iii) lack of trust in existing trade insurance agents.²⁸

The existence of high interest rates has been noted as a major impediment in obtaining export credit in Sri Lanka. As revealed through the KIIs, the tight monetary policy maintained by the central bank has limited the amount of credit provided to traders. However, reducing interest rates in the context of the country's growing trade

²⁶ IPS KII conducted with Superintendent, ICT Division, Sri Lanka Customs.

²⁷ Information on trade finance was collected through telephone interviews with customer service agents of banks.

²⁸ The People's Bank and Seylan Bank were chosen for the KIIs due to their differences in ownership structure and size; one being a large state-owned bank (People's Bank) and the other being a small private bank. They were chosen in order to understand the problem of trade finance from these different perspectives.

deficit and unsound macroeconomic environment may impose significant macroeconomic imbalances. Hence, measures such as offering low interest rates for export credit while maintaining credit ceilings on import credit, could be feasible policy options in this regard.

The KIIs also revealed that lack of collateral among traders can be addressed through the establishment of effective trade insurance institutions. Although the Sri Lanka Export Credit Insurance Corporation (SLECIC) functions as a government body offering insurance services, there seems to be a lack of confidence in the existing insurance institutions among traders.²⁹ Hence, the need to establish effective trade insurance institutions remains a key area for improvement.

7. STATE OF THE FINANCIAL SECTOR

Sri Lanka has suffered from decades of weak public finances, with limited room for domestic resource mobilization to finance the government's ambitious infrastructure development program (Table 15). Most worryingly, while expenditure needs have risen, the country has faltered in addressing constraints in revenue mobilization, with the revenue-to-GDP ratio falling to 13% in 2012, its lowest to date (the norm for low middle-income economies is in the region of 18%–20% of GDP).

Table 15: Fiscal Trends
(% of GDP)

Year	2008	2009	2010	2011	2012
Revenue	14.9	14.5	14.6	14.3	13.0
Current expenditure	16.9	18.2	16.7	15.4	14.4
Fiscal deficit	-7.0	-9.9	-8.0	-6.9	-6.4
Government debt	81.4	86.2	81.9	78.5	79.1
Foreign	32.8	36.5	36.1	35.6	36.5
Domestic	48.5	49.8	45.8	42.9	42.6

Source: Central Bank of Sri Lanka. *Annual Report*. Various years.

With limited domestic resource mobilization and fiscal constraints, Sri Lanka has seen a significant development in foreign funding, particularly from international financial markets and bilateral partners. Project loans have been sought from bilateral sources, especially from the PRC. Since obtaining its first sovereign credit rating in December 2005, Sri Lanka has issued five sovereign bonds valued at \$4 billion during 2007–2012. There has also been an incremental opening up of the government securities market to foreign investors.³⁰ In addition, regulations governing foreign borrowing by Sri Lanka's corporate sector, including LCBs have also been eased.³¹

²⁹ Findings from IPS Key Informant Interviews (KII) with two selected commercial banks.

³⁰ The threshold limit of 5% of treasury bonds outstanding, introduced in 2006, was relaxed to 10% in 2007. In 2008, Sri Lanka opened its treasury bill market to foreign investors with a threshold limit of 10%. In December 2011, the threshold limit was further increased to 12.5% for outstanding treasury bills and treasury bonds stock.

³¹ For example, in the 2013 budget presented in November 2012, LCBs were permitted to borrow up to \$50 million each year for 3 years without the approval from the Exchange Control Department. Similar allowances were offered to corporate entities, with a borrowing limit of \$10 million each year for 3 years without exchange control approval.

Table 16: Net Receipts of Foreign Assistance
(\$ million)

	2006	2007	2008	2009	2010	2011	2012
Loans	645.1	1171.9	74.0	962.1	1867.2	1945.9	2102.4
ADB	176.6	75.4	155.5	147.6	198.8	139.3	160.5
PRC	1.0	152.4	31.8	282.9	98.2	5.5	649.6
IDA	80.5	25.0	38.7	91.2	84.9	130.1	98.3
India	15.1	-0.4	-4.7	20.2	-0.6	195.9	251.1
Japan	146.7	-5.2	2.4	25.9	91.7	114.1	112.4
Grants	396.8	275.8	288.2	225.5	149.6	170.2	154.5
ADB	29.8	25.0	34.7	40.4	35.6	20.4	9.7
Japan	45.3	32.5	15.1	15.6	22.7	18.8	28.2
UN	66.8	15.7	0.0	8.4	26.3	72.4	56.3

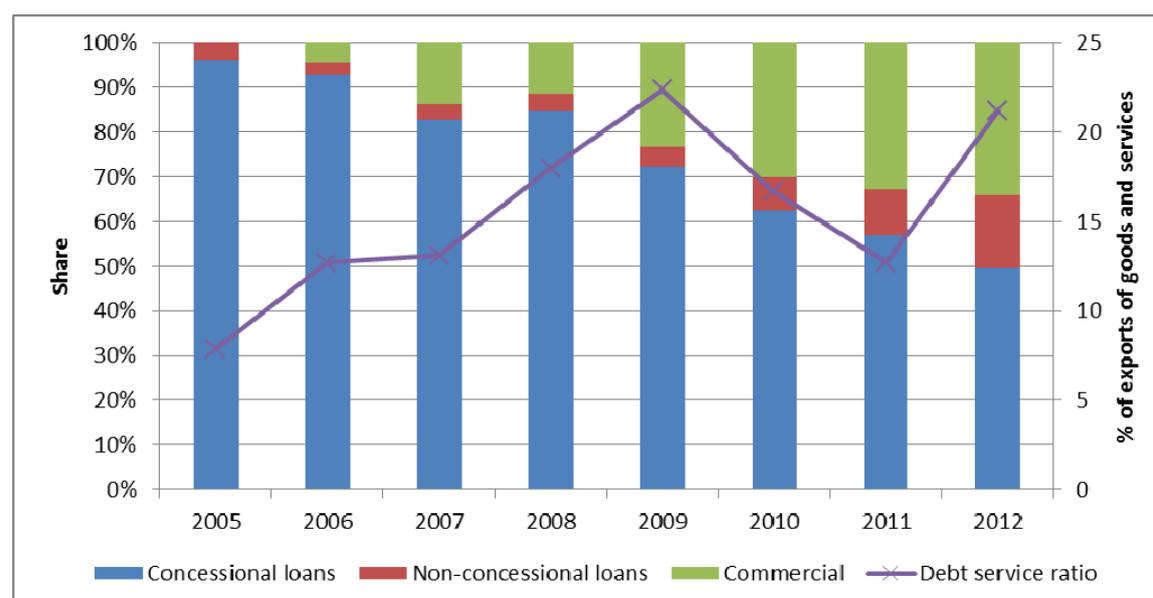
ADB = Asian Development Bank, PRC = People's Republic of China, IDA = International Development Association, UN = United Nations.

Source: Central Bank of Sri Lanka. *Annual Report*. Various years.

Sri Lanka's reliance on overseas development assistance (ODA) in the form of grants has diminished over time, reiterated by the country's graduation to a middle-income economy in January 2010. The PRC has emerged as a significant source of bilateral foreign assistance, in particular by providing loans through its export-import bank (Table 16). Such loans and funds raised through issuance of sovereign bonds have made up the bulk of Sri Lanka's infrastructure financing in recent years. Hence, not only has net foreign financing of the government's fiscal deficit increased significantly in recent years, but more critically, such foreign resources have been obtained largely on non-concessional and commercial terms. In 2012, for example, the share of non-concessional funding stood at 60% of the overall net foreign financing of the budget deficit.³²

The overall result of the above developments has been a rapid change in the composition of Sri Lanka's external debt profile, with the share of non-concessional and commercial borrowing rising to 50.5 % of total external debt in 2012, from 7.2% in 2006 (Figure 6). The stress that costlier borrowing can exert on the external payments position is clear, especially so in an environment where Sri Lanka is seeing a rapid shrinking of its exports-to-GDP ratio. In fact, the ratio of debt service to exports of goods and services jumped to 21.2% in 2012 as the repayment of the first sovereign bond of \$500 million, issued in 2007, came up for settlement. Unless there is a sustained improvement in foreign exchange earnings capacity, reliance on foreign commercial borrowing to drive the infrastructure program is not a tenable option in the medium-to-long term.

³² Central Bank of Sri Lanka (2012).

Figure 6: Sri Lanka's External Debt Dynamics

Note: Commercial = commercial loans; share = % share of total external debt (left axis); debt service ratio is % share of exports of goods and services (right axis).

Source: Central Bank of Sri Lanka. *Annual Report*. Various years.

The option for co-opting private investors for infrastructure development through public-private partnerships (PPPs) has not been seriously pursued to date. Indeed, even though government investment levels have risen in the recent past, domestic private investment growth has been lackluster overall (Table 17). FDI inflow has also been disappointing. Although a larger share of FDI in 2012, for instance, went into infrastructure (44.6%), with services (31.9%) and manufacturing (23%) drawing smaller shares, net FDI remains low, at only 1.4% of GDP in 2012.³³

Table 17: Savings and Investment
(% of GDP)

	2008	2009	2010	2011	2012
Domestic savings	13.9	17.9	19.3	15.4	17.0
Investment	27.6	24.4	27.6	30.0	30.6
Private	21.1	17.9	21.4	23.7	23.7
Government	6.5	6.6	6.2	6.3	6.9
Net FDI	1.7	0.9	0.9	1.5	1.4

FDI = foreign direct investment.

Source: Central Bank of Sri Lanka. *Annual Report*. Various years.

In the past, Sri Lanka has had some successes in infrastructure development with PPPs. One of the most successful was the private sector consortium that in 1999 was allowed to lease and convert the existing mixed-use Queen Elizabeth Quay (QEY) into a dedicated container terminal—the South Asia Gateway Terminal (SAGT)—on a build, own, operate, and transfer (BOOT) basis. By and large, however, PPPs in infrastructure development have failed to take off, either due to weakening government commitment and/or lack of sufficient funding and expertise in structuring the transactions.

³³ Central Bank of Sri Lanka (2012).

Sri Lanka faces financial constraints in pursuing PPPs for large-scale infrastructure programs. The country's banking sector is dependent on deposits of a relatively short-term nature that restricts the ability to tie up large volumes of resource for long-term investments. The issuance of debentures and tapping international banks are two ways of overcoming these constraints. Sri Lanka's debenture market is still relatively underdeveloped, although more private entities are now following this route. Similarly, the relaxing of exchange controls on foreign borrowing by banks announced in the 2103 budget is seen as a measure to encourage the participation of domestic private entities in larger investment projects.

Despite such moves, and policy pronouncements that PPPs will be harnessed as an option for investment in infrastructure, progress has been slow.³⁴ The private sector has been largely shut out from the recent infrastructure development boom, where different agencies of the government have struck up partnerships directly with foreign governments or firms. The government's own political-economy leanings appear to favor a strong state presence in Sri Lanka's economic development. This is underpinned by the government's policy stance clearly opposing any notion of future privatization of state-owned enterprises (SOEs), and indeed has promulgated legislation that has returned previously privatized SOEs back to the state.³⁵ Other privatized entities, such as Sri Lankan Airlines and Sri Lanka Telecom reverted to majority state ownership when existing agreements with private investors failed to be renewed for various reasons. In addition, several public interest litigations in recent years have seen intervention by the courts, resulting in the cancellation of the original privatization agreements. Examples include the case of Sri Lanka Insurance Corporation, Lanka Marine Services, and land alienation by the Urban Development Authority.

Aside from the above, Sri Lanka's regulatory environment has also undergone changes over time that are likely to have weakened the promotion of PPPs. The Public Enterprise Reform Commission (PERC), set up in 1996 to handle the privatization of several important SOEs, was abolished in 2010. A new institution—the Strategic Enterprise Management Agency (SEMA)—came into operation in 2006 and was instead given the task of ensuring the efficient management of SOEs that are not to be privatized, but managed as independent commercial enterprises. However, its role—as well as that of the multisector regulator, the Public Utilities Commission of Sri Lanka (PUCSL)—has come under criticism for overt political influence and lack of operational effectiveness.³⁶ For instance, recommendations of the PUCSL on energy pricing were revised in 2013 following intervention by the executive on the back of consumer protests.

Thus, the overall political-economy environment affects the growth PPP in infrastructure development. Given the large investment risks involved, any ambiguities regarding the perceived role of the private sector in the economy, government regulatory intervention in areas such as pricing, and the legal framework governing such agreements, can weaken investor confidence.

³⁴ Ministry of Finance and Planning (2006).

³⁵ Under the Revival of Underperforming Enterprises and Underutilized Assets Act passed in 2011, applicable to 37 identified entities, the government is allowed to appoint a competent authority to control, administer, and manage the enterprise or asset to ensure its revival by restructuring or entering into a management contract.

³⁶ IPS. 2008. *Reforming the State-Owned-Enterprise Sector: The Political Economy Dilemma in Sri Lanka: State of the Economy 2008*. Colombo: Institute of Policy Studies of Sri Lanka.

8. POLICY IMPLICATIONS AND RECOMMENDATIONS

Sri Lanka has made significant strides in improving its physical infrastructure connectivity, particularly its roads, seaports, and airports, making up for decades of underinvestment. Such projects have long been recognized as necessary to strengthen the country's efforts to emerge as a regional services hub, raise the competitiveness and efficiency of its export earnings capacity, and contribute to long-term development objectives.

Whilst Sri Lanka has undertaken an ambitious infrastructure development program, some projects are more likely than others to immediately and effectively boost regional connectivity, raise export earnings and contribute to overall economic growth. The most significant and important infrastructure development project underway is the expansion of the Colombo port. It handles over 95% of cargo channeled through ports in Sri Lanka, and will continue to play a key role in providing hub services in the South Asia region. Other important infrastructure programs include the construction of new expressways and road connectivity to improve internal logistics for the transport of goods and support of broader policy goals such as the expansion of tourism. The current efforts to expand capacity handling at Sri Lanka's primary international airport are also important in this context. However, there are other large-scale infrastructure projects such as the new Hambantota port and Mattala International Airport, in close proximity, that are unlikely to generate economic returns for some time.

It is anticipated that better infrastructure in roads, seaports, and airports will improve running costs and cut down on delays, and that this will filter through to all parts of the economy to increase overall efficiency. For Sri Lanka, such returns are quite critical in view of its reliance on foreign loans raised on commercial terms as the preferred mode of financing many of its infrastructure projects. In part, the options open to the GOSL are limited, as traditional sources of concessionary funding for large-scale infrastructure projects become less accessible as countries graduate to middle-income status, as Sri Lanka did in January 2010. In view of heavy infrastructure financing needs and competing demands, project selection has to be based on sound economic feasibility assessment. It is also imperative that foreign currency-denominated debt for infrastructure financing be confined as much as possible to projects that can, either directly or indirectly, generate the foreign exchange needed to service the debt.

Domestic resource mobilization efforts toward supporting infrastructure investment have been poor. Moreover, there has been very little private participation through PPPs. Not only do PPPs ease the financial burden on the state, but they may also play an important role in improving productivity and efficiency, i.e., private investor entry is more likely to weed out politically expedient but financially unsound projects from being implemented. If PPPs are to be the way forward in Sri Lanka, building effective regulatory agencies will be the prime catalyst for attracting private investment, but here too, Sri Lanka lags behind other nations in the region in establishing the required formal institutions. Thus, the country must pay more attention to strengthening its institutional and regulatory environment if it is to encourage more private sector participation in large infrastructure projects.

Another lacuna is the lack of policy attending to tackling competitiveness and efficiency in Sri Lanka's export sector. Despite higher growth, Sri Lanka is witnessing a continued decline in its export-to-GDP ratio, as well as in its global export market share. If productive use of current investments in infrastructure is to be made, then the constraints holding back export growth need to be addressed. These include predictability and consistency in trade policy setting, especially with regard to Sri

Lanka's tariff structure. Of late, the introduction of numerous para-tariffs and other *ad hoc* charges has reversed the tariff liberalization measures achieved in the past.

Finally, Sri Lanka has been slow to integrate its economy through bilateral and regional economic cooperation agreements. At present, these are confined to four agreements, limited in their depth and breadth of coverage. Indeed, Sri Lanka has not undertaken to enter into fresh agreements since the SAFTA agreement came into force. In particular, expanding the current bilateral free trade agreement with India into a broader agreement to cover services and investment has been kept on hold since 2008. In the interim, many of the country's competitors in the Asian region have moved swiftly to negotiate market access through a host of such beneficial deals. For Sri Lanka, outward orientation of the economy through closer integration with India, and incremental integration into the broader Asian region, has not received much policy attention. This is partly due to the current ideological framework that has placed emphasis on promoting the growth of import-substituting industries as opposed to promoting import competition to improve productivity, efficiency, and competitiveness of domestic manufacturers. Policy consistency, predictability, and transparency in setting tariff policy are essential. Sri Lanka must also tap into strategic economic integration opportunities, particularly with India, and revise the stalled CEPA process. The country's prospects for benefitting from greater connectivity with South and Southeast Asia remains firmly embedded in pursuing closer economic integration with its neighbors.

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