Chapter 4

INDUSTRY

4.1 Overall Trends

Industrial output, measured as the output of factory industries, grew by 2.8 per cent in 2002 reflecting only a partial recovery from the 3.9 per cent decline in 2001. The output of factory industries, which continued to decline from the second quarter of 2001, regained its growth momentum in the second half of 2002. The main contributory factor for the recovery were the relatively higher export orders received in the second half of 2002 supported by a gradual improvement in global markets, growth in domestic demand reflecting an improved consumer confidence, and the ending of the power cuts by mid 2002. The various measures taken by manufacturers to restructure their enterprises to face the difficult market environment, adoption of modern management techniques and higher investment in advanced technology helped achieve the moderate growth in the industrial sector. The steady decreases in inventories and higher demand from the household sector indicated the gradual recovery in the US market, the largest market for Sri Lanka's exports. However, a full recovery of the US market is expected to take further time due to several uncertainties such as failure of some major companies, bearish equity markets, accounting scandals, uncertain corporate earnings and growing security risks. The output of factory industries, which accounted for 81 per cent of the manufacturing output in Sri Lanka, contributed 10.1 per cent to overall economic growth in 2002.

The output of the main export oriented industries such as apparel, textiles, rubber-based products and ceramic products grew at a relatively higher rate in 2002. The output of the apparel and textile sub-sector, which declined by 8.5 per cent during the first half, grew by 10 per cent in the second half, resulting in a marginal annual growth of 1.2 per cent in 2002. The average international price of apparel and textiles exported by Sri Lanka decreased by 6 per cent in 2002 on account of depressed external markets and built up stocks. Competition in the apparel market was intensified with increased trading under preferential trade agreements in Europe and North America, special concessions granted to some African and Caribbean countries and higher volumes supplied by low cost manufacturing countries, such as China, Vietnam and Bangladesh. China, with its massive production capacity, strong fabric base, continuous improvement of technology and lower labour costs is enjoying a comparative advantage in the apparel industry and poses a severe challenge to other textile and apparel manufacturing countries. With accession to WTO in 2001, China is expected to further intensify its competition.

The ability of major manufacturers to create an up-market image in international markets through design, price, on-time delivery and reputation of the country as a supplier of higher quality products helped mitigate the unfavourable

Chart 4.1
Growth and Composition of Industrial Production

Chart 4.1.1
Growth in Industrial Output

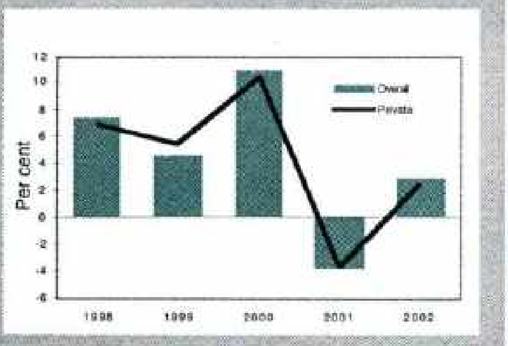
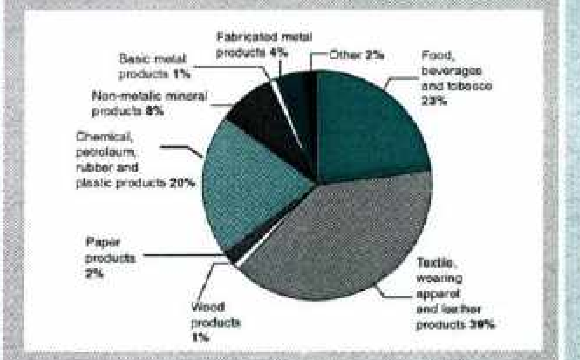


Chart 4.1.2
Composition of Industrial Production - 2002



developments to a certain degree. Export oriented manufacturers also paid greater attention to quality improvement, better order placement, efficient material sourcing, effective marketing, low cost trade financing and other logistical arrangements to face global competition. The output of other export oriented industries such as rubber-based products, ceramic products and processed diamonds, also performed well in 2002. The Free Trade Agreement (FTA) with India was helpful for some industries such as rubber-based products, soap, and plastic products to penetrate the Indian market.

The domestic market oriented industries such as processed food, processed tea, wheat flour, beverages, fertiliser, pharmaceuticals, herbal products, processed meat, beer, liquor, biscuits, processed fruit, animal feed, plastics, ceramics, basic metals and fabricated metals grew relatively faster in 2002. The demand for those products increased with the improvement in consumer confidence, improved commercial activities in the North and the East, falling interest rates, boost in the share market and the reduction or revision of excise duties on certain products. The purchasing power of consumers in agricultural areas has increased with the increased harvest and better prices for their crops. Marketing strategies such as market segmentation, effective advertising focussed on targeted consumers and improved distribution methods also helped expand domestic demand. The manufacturers of beverages, milk products, soap, detergent and processed food paid greater attention to improve the distribution network in the North and the East and appointed new agents in these areas.

The industrial sector activities continued to benefit from intensive utilisation of information technology, which ensured consistency in output and product quality. The use of information technology also helped improve marketing and supply chain management, strategic decision-making and the achievement of greater cost efficiency. Some manufacturers conducted in-house training to educate employees on the challenges emerging in international markets and design counter measures needed to meet them. The formation of multi-disciplinary teams of employees representing cross-functional activities helped process and product improvement and innovation. Manufacturers paid greater attention and invested in more market research to assess consumer needs and in some cases, developed differentiated products to satisfy consumers in specific markets.

TABLE 4.1
Value of Industrial Production
(1990 Constant Prices)

Categories	Rs. million					Percentage change	
	1998	1999	2000	2001	2002 (a)	2001	2002(a)
1. Food, beverages and tobacco products	40,756	41,742	44,241	45,595	47,675	3.1	4.6
Food and other	24,910	26,330	28,094	29,146	30,428	3.7	4.4
Liquor	3,458	3,327	3,397	3,478	3,659	2.4	5.2
Beverages	6,590	6,432	7,210	7,548	7,888	4.7	4.5
Tobacco products	5,798	5,653	5,540	5,423	5,700	-2.1	5.1
2 Textile, wearing apparel and leather products	72,943	78,282	90,716	82,996	83,965	-8.5	1.2
Apparel	62,602	67,861	79,126	72,300	73,211	-8.6	1.3
Textile	7,226	7,197	8,140	7,439	7,699	-8.6	3.5
Leather	3,115	3,224	3,450	3,257	3,075	-5.6	-5.6
3 Wood and wood products	1,378	1,423	1,544	1,487	1,466	-3.7	-1.5
4 Paper and paper products	3,446	3,412	3,624	3,732	3,646	3.0	-2.3
5 Chemical, petroleum, rubber and plastic products	36,223	36,281	41,140	38,849	41,067	-5.6	5.7
Chemicals, paints and fertilisers	5,182	5,571	6,379	6,155	6,426	-3.5	4.4
Rubber based industries	6,015	6,082	6,824	6,104	6,519	-10.6	6.8
Plastic & PVC	3,874	4,292	4,571	5,051	5,258	10.5	4.1
Pharmaceuticals, detergent and other	9,853	10,336	10,956	10,532	10,911	-3.9	3.6
Petroleum	11,299	10,000	12,410	11,007	11,943	-11.3	8.5
6 Non metallic mineral products	14,619	15,740	16,091	16,010	16,315	-0.5	1.9
Diamond processing	4,360	5,049	5,175	5,058	5,304	-2.3	4.9
Ceramic products	1,991	2,029	2,053	1,808	1,877	-11.9	3.8
Cement	4,628	4,785	4,823	4,943	4,869	2.5	-1.5
Building material and other	3,640	3,877	4,040	4,203	4,266	4.0	1.5
7 Basic metal products	1,856	1,917	2,024	2,096	2,155	3.6	2.8
8 Fabricated metal products, machinery and transport equipment	8,235	8,680	9,071	9,261	9,446	2.0	2.0
9 Manufactured products not elsewhere specified	4,093	4,375	4,559	4,627	4,720	1.5	2.0
Total	183,549	191,852	213,010	204,653	210,465	-3.9	2.8

(a) Provisional

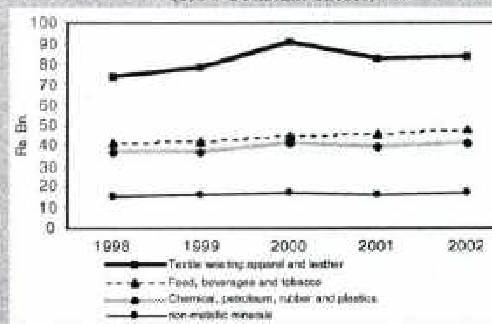
Sources: Central Bank of Sri Lanka
Board of Investment of Sri Lanka

However, manufacturers were prevented from reaping the full benefits in favourable developments in the domestic market due to several impediments that were present. The increase in energy, telephone and other utility prices caused an escalation in the cost of production beyond budgeted amounts. The inability to absorb such costs in the short run resulted in higher prices, which in turn reduced the competitiveness of manufacturers. Power cuts, which were extended to five hours in March 2002, affected activities of several small and medium scale manufacturing industries, which did not have affordable energy sources. Energy intensive industries such as ceramics, cement and glass, faced difficulties in meeting orders on schedule, disturbing production cycles and increasing costs. The industrial sector was also affected by the high litigation costs due to long delays in court proceedings, complexity of existing laws and inefficient record keeping in courts. Emergent trade practices such as the import of used goods and parts, under invoicing and leakage of BOI products to the domestic market made domestic industries face an unfair degree of competitiveness. Rigidities in the labour market prevented flexibility in labour movement and even in difficult circumstances prevented manufacturers from adopting much needed restructuring methods such as reducing excess labour, sub contracting or outsourcing for cost efficiency. In addition to the rigidities in the labour market, manufacturers faced difficulties relating to high labour turnover, skills deficiency and labour union action. Frequent power interruptions and fluctuations in voltage reduced the quality of products, increased the number of rejects and damaged machinery. Insufficient development of infrastructure such as roads, transportation, communications, power and in certain cases, unnecessary regulatory impediments, increased business transactions costs.

Stagnant international prices and in some cases, declining prices for exports forced manufacturers to bring down the cost of production to retain existing markets and profit margins. In this environment, cost reduction initiatives launched in the previous years were pursued with added vigour in 2002. Manufacturers used various measures such as cost-effective production, rationalising administrative procedures, minimising waste, out-sourcing production, merging similar activities and closing down non-profitable business units to bring down the costs of production. In the face of growing energy prices, energy intensive manufacturers made an extra effort to reduce energy costs by utilising energy saving methods and equipment and installing waste energy recovery processes. One example is the conversion of the production process in a major cement factory to use low cost coal, replacing high cost furnace oil. In addition to the effect of falling interest rates, short- term borrowing costs of the industrial sector were brought down further through reduced inventory levels, maximum utilisation of trade credit and reduction of production time and consumer credit. Some manufacturers were able to downsize their operations and restructure production processes to face the sluggish market environment. In order to bring down excess labour in such firms, some manufacturers introduced voluntary retirement schemes, while others granted temporary leave to employees on half-pay with the approval of the Commissioner of Labour.

The capacity of the industrial sector increased only marginally in 2002 as manufacturers deferred major expansions and new projects until international markets recover fully and the peace process brings a lasting political settlement. In spite of the high cost of living, most of the manufacturers were not able to offer wage increases due to growing pressure on profit margins in 2002. Profitability in the industrial sector increased by only 1.5 percentage points to 11.9 per cent in 2002. The minimum wage in industry and commerce increased by 7.3 per cent, lower than the inflation in 2002. In order to avoid labour unrest and improve employer-employee relations, major manufacturers signed collective wage agreements with labour unions. Labour productivity in the industrial sector had only a marginal growth in 2002. The growth of labour productivity in the industrial sector was constrained by stringent labour laws, poor working conditions, the lack of a proper transport network, high labour turnover, insufficient investment in modern technology and strained employer-employee relations.

Chart 4.2
Performance in Major Industrial Sub Sectors
(1990 Constant Prices)



On the policy front, the private sector led, export oriented industrial policy was continued in 2002. The focus of the government's role in industrial sector development continued to change from regulator to facilitator. Accordingly, the industrial policy of the government was directed towards removing impediments and unnecessary controls in conducting business, improving the business environment, facilitating global trade, enhancing competitiveness and improving corporate governance. Industrial policies of the government also focussed on diversifying and widening Sri Lanka's industrial base, as the current narrow base is too vulnerable to external shocks. In order to promote regional growth, a new BOI Act was passed in 2002 to create five Economic Zones (EZ) in the country. To enhance the capabilities and competitiveness of SMEs, the government launched the 'Sahanya' credit scheme in 2002 with funding assistance from the Asian Development Bank (ADB). This scheme is expected to provide for capital needs for start-up, expansion, modernisation and relocation at concessional interest rates and flexible repayment periods with technical assistance. The Factory Ordinance was amended in 2002, extending overtime hours of female employees from 100 hours per year to 720 hours. This amendment helped manufacturers to employ female labour for long-overtime hours without violating labour laws. In order to facilitate future growth and remove impediments, the government set up 15 Sectoral Task Forces in 2002 with private sector participation to recommend short and medium-term development plans for selected industrial sectors. A permanent Tariff Advisory Council was appointed to identify anomalies and distortions in the current tariff structure that impede the economic growth. The government also brought down the surcharge on import duty from 40 per cent to 20 per cent with effect from 15 April 2002, which reduced costs of imported raw materials.

Issues that need to be addressed to achieve a sustained high growth include distortions in the tariff structure and labour market, inadequate and poor quality industrial infrastructure, problems in the development of small and medium scale industries, inefficiencies in the legal system, unfavourable terms and conditions in international trade, excessive and unnecessary controls/regulations and unfair trade practices.

The environmental pollution created by industrial waste especially in the rubber, plastic, metal, wood, polythene and food processing industries, and the lack of proper legal provisions to protect the environment are becoming causes for concern. Many companies have invested in environmental pollution control methods such as water treatment plants, air emissions, sewerage disposal systems and recycling of waste to minimise pollution and to increase the efficient management of waste generation.

4.2 Production

The growth in factory industries was estimated based on information collected from the Industrial Production Survey 2002 of the Central Bank of Sri Lanka, production data of public sector industries and export data relating to BOI enterprises. These estimates covered only factory industries, the largest sub-sector in manufacturing industries. Output of the other two sub sectors of the manufacturing sector, i.e., agriculture processing and small-scale industries, was estimated separately. The output of factory industries grew by 2.8 per cent in real terms and 10.1 per cent in nominal terms, resulting in an implicit price deflator of 7.0 per cent for the output of factory industries in 2002.

The growth of industrial output was the combined outcome of a 2.5 per cent growth in private sector industries and a 7.5 per cent in public sector industries. The contribution of the latter to total industrial output was marginal, with the private sector accounting for 95 per cent of total output. Similarly, private sector industries accounted for 86 per cent of the growth in 2002. In the private sector industries, 1.0 per cent growth in 2002 came from the BOI industries and the balance 4.4 per cent came from the non-BOI industries. The impetus for growth in industrial output in 2002 came mainly from three out of the nine industrial categories, viz., food, beverages and tobacco products, textiles, apparel and leather products, and chemical, petroleum, rubber and plastic products. These categories accounted for 92 per cent of the growth in the industrial sector in 2002.

Private Sector Industries

Output in private sector industries grew by 2.5 per cent in 2002; it had declined by 3.7 per cent in 2001. The output growth in BOI industries was estimated at 1.0 per cent in 2002, recording a turnaround. However, the recovery was still low in comparison to the 7.5 per cent decline in the previous year. The output in the non-BOI sector grew by 4.4 per cent in 2002, compared to 1.5 per cent in 2001. The Industrial Production Survey 2002 of the Central Bank indicated an expansion of production capacity by 1.9 per cent in the non-BOI sector, as compared to 4.5 per cent in the previous year. The production capacity in the industrial categories of non-metallic mineral products, chemical rubber and plastic products, and fabricated metal products expanded in 2002. The rate of capacity utilisation increased marginally to 81 per cent in 2002 as compared to 80 per cent in 2001. The capacity utilisation increased in ceramics, wheat flour processing and fertiliser. Employment in non-BOI industrial sector increased, by 1 per cent in 2002. Labour productivity in the non-BOI industries increased by about 1 per cent during the year.

Performance in Major Sectors

Textile, wearing apparel and leather products

Output in the textile, wearing apparel and leather products category, the largest sub-sector in factory industries, grew marginally by 1.2 per cent in 2002 compared to the sharp decline of 8.5 per cent in 2001. The output of the apparel and textile sub sector in this category grew by 1.3 per cent and 3.5 per cent, respectively, in 2002. The output in the leather products sub sector declined by 5.6 per cent the result of the loss of some export markets. The textile, apparel and leather products category contributed 22 per cent to the growth of output in private sector industries in 2002.

The global demand for textile and apparel, which had been declining since the first quarter of 2001, showed signs of recovery during the second half of 2002. However, the full recovery of the sector will depend on the recovery in international markets as more than 90 per cent of apparel products are manufactured for export. Available information indicates that the recovery in the international markets will be delayed further due to market and geopolitical uncertainties. In the sluggish global market environment, Mexico consolidated its market share in the US market with tariff benefits under NAFTA. The Caribbean, and more recently, Sub-Saharan

African countries, facilitated by trade preference in the US market, have posed new challenges for South Asian countries including Sri Lanka. Low cost manufacturing countries such as China, Vietnam and Bangladesh which offered competitive prices, have attracted more buyers. China, with massive production capacity, strong fabric base and continuing improvement in technology, has expanded its market share in the US and EU markets.

Lower demand and built up stock exerted pressure on apparel prices in global markets. The international prices of textile and apparel exported from Sri Lanka declined by 6.0 per cent in 2002. Declining prices came at a time when local costs increased sharply driven by increases in energy, telephone and other utility prices, causing further difficulties. This has increased not only the factory processing cost, but also the cost of local raw materials such as polythene bags, thread, cartons and other packing materials. In order to face this unfavourable market environment, a few apparel manufacturers reduced their scale of operations and restructured their factories. Excess employees in these factories were granted temporary leave, on a half-day basis, with the approval of the Commissioner of Labour. A few factories that faced financial problems negotiated with their bankers to re-schedule existing loans and obtain new loans for factory modernisation.

Some manufacturers were able to mitigate these unfavourable market developments to a certain extent by rationalising production costs, improving product quality, reducing waste, reducing turnaround time and finding new markets. Greater attention was paid to the selection of fabrics, design and strengthening relations with existing buyers and offering them high quality products at competitive prices. Improvements in supply chain integration helped reduce working capital tied up in inventory and stock handling, improved efficiency and reduced procurement costs. As Sri Lankan manufacturers do not have their own international brands, they attempted to supply their products to reputed brand name holders in international markets to obtain the advantage of the growing popularity of brand named products.

The quota availability in the US market decreased by 7.9 per cent to 360.2 million pieces in 2002 due to the gradual phasing out of quota under the WTO agreement. The quota access to the Canadian market also declined by 9.6 per cent to 13.4 million pieces in 2002. Sri Lanka exported 30 different apparel and textiles items to the US market and 11 items to the Canadian market in 2002. The utilisation of quotas in the US market declined by 8.9 per cent from 285.7 million pieces in 2001 to 260.3 million pieces in 2002. In addition to the reduction of total quota availability, the quota utilisation rate also declined to 72.2 per cent in 2002. The utilisation rate of apparel quotas declined from 80.1 per cent in 2001 to 75.2 per cent, while that of fabrics declined from 13.9 per cent to 4.8 per cent. The quota utilisation in respect of dresses, knit shirts and

TABLE 4.2
Private Sector Industrial Production Index

1990=100

Categories	Index					Percentage change	
	1998	1999	2000	2001	2002(a)	2001	2002(a)
1 Food, beverages and tobacco products	186	193	205	211	221	3.1	4.6
Food and other	196	207	218	225	235	3.5	4.4
Liquor	207	199	203	208	219	2.4	5.2
Beverages	226	221	248	259	271	4.7	4.5
Tobacco	121	118	116	113	119	-2.1	5.1
2 Textile, wearing apparel and leather products	269	289	335	306	310	-8.5	1.2
Apparel	297	322	375	343	348	-8.6	1.3
Textile	199	198	224	205	212	-8.6	3.5
Leather	196	203	217	205	194	-5.4	-5.6
3 Wood and wood products	163	168	178	180	177	1.1	-1.5
4 Paper and paper products	269	292	314	324	316	3.0	-2.5
5 Chemical, petroleum, rubber and plastic products	286	299	326	318	333	-2.6	4.8
Chemicals, paints and fertilisers	240	258	292	282	294	-3.5	4.4
Rubber based industries	274	279	313	280	299	-10.6	6.9
Plastic & PVC	227	252	268	297	309	10.5	4.1
Pharmaceuticals, detergent and other	297	312	331	318	329	-3.9	3.6
6 Non metallic mineral products	267	288	294	296	301	0.5	1.9
Diamond processing	237	274	281	274	288	-2.3	4.9
Ceramic products	195	199	201	177	184	-11.9	3.8
Cement	276	285	287	294	290	2.5	-1.5
Building materials and other	241	257	268	279	283	4.0	1.5
7 Basic metal products	399	412	435	451	463	3.6	2.8
8 Fabricated metal products, machinery and transport equipment	197	208	217	222	226	2.1	2.0
9 Manufactured products not elsewhere specified	262	280	292	296	302	1.6	2.0
All Categories	246	259	286	276	282	-3.7	2.5

(a) Provisional

Sources: Central Bank of Sri Lanka
Board of Investment of Sri Lanka

blouses, skirts, nightwear, trousers and underwear was over 90 per cent during the year. The utilisation rate was below 25 per cent in of playsuits, fabric poplins and spun cell, suit-type coats, dressing gowns, coats-non-suit, play suits, coveralls and overalls due to the slowing down of the US market. Quota restrictions in the EU market were removed following the agreement signed by the government and the European Union in 2001. The quota utilisation rate in the Canadian market declined from 42.3 per cent in 2001 to 33.3 per cent in 2002. The most popular quota items in the Canadian market were winter outwear, trousers, overalls and shorts, shirts, underwear and blouses. In the Canadian market, the quota utilisation rate was below 5 per cent in respect of swimwear, baby garments and bed-sheets.

The competition in the apparel industry is expected to intensify further with the abolition of the quota system in 2005 and the entry of low cost manufacturers to the global market. It appears that the industry has now begun to realise the challenges in a quota-free world after 2005 and is developing strategies to face them. Apart from improvements in technology, supply chain integration, rationalisation of the cost of production, improvements in product quality and delivery speed, the maintenance of high labour standards, environment friendly production, aggressive marketing and lobbying skills and the development of a domestic inputs base would be essential to remain competitive in the future.

The liberalisation of textile imports in 1998 forced domestic market oriented manufacturers to up-grade technologies and install modern machinery to face import competition. In order to encourage domestic textile manufacturers to undertake the modernisation of their textile mills and apply technology, the government in Budget 1998 introduced the Textile Restructuring Programme. Under this 130 firms submitted modernisation proposals for updating technology in the textile industry in 2002. Of them, 127 were considered for relief under this programme. At end December 2002, 34 factories had commenced implementation of restructuring projects.

The output of the footwear industry declined by 5.6 per cent in 2002 following the decline of 5.4 per cent in the previous year. The footwear industry faced higher competition from cheaper imports from China and other low cost manufacturing countries. To protect the industry from cheap imports, the government brought down the tariffs on major raw materials used for manufacturing footwear in 2002. The domestic demand for footwear has been growing recently with improvements in living standards of consumers, and consumers anticipate frequent changes in design and styles. However, manufacturers have not carried out sufficent research to assess consumer needs or invested adequately in modernisation and product improvement.

Food, beverages and tobacco products

The output of the food, beverages and tobacco category increased by 4.6 per cent in 2002 as compared with 3.1 per cent in 2001. Production increased in all sub sectors of tobacco products (5.1 per cent), liquor (5.2 per cent), beverages (4.5 per cent) and food processing (4.4 per cent). Output growth in the food, beverages and tobacco category contributed 48 per cent to industrial sector growth in 2002.

The output of the food sub-sector increased in 2002 due to higher production in processing wheat flour and meat products, food processing, biscuits, fruits and vegetable processing, chocolate and toffees and animal feed. The growth of these industries can be attributed mainly to the expansion of domestic demand with rising consumer expenditure, lower interest rates, increased trading activities in war affected areas, expansion of the distribution network and advanced marketing strategies. The major manufacturers continued to carry out research to assess consumer needs and the findings of these studies, together with the installation of new machines, helped upgrade product quality and product diversification.

TABLE 4.3

Value of Industrial Production (a)

Categories	Rs. million					Percentage change	
	1998	1999	2000	2001	2002(b)	2001	2002(b)
1 Food, beverages and tobacco products	86,994	94,687	105,671	120,359	136,173	13.9	13.1
2 Textile, wearing apparel and leather products	165,443	176,844	215,686	224,898	240,712	4.3	7.0
3 Wood and wood products	2,511	2,715	3,084	3,272	3,529	6.1	7.9
4 Paper and paper products	5,593	5,854	6,516	7,369	7,528	13.1	2.2
5 Chemical, petroleum, rubber and plastic products	59,724	62,590	74,670	78,553	90,250	5.2	14.9
6 Non metallic mineral products	23,830	26,830	28,198	31,892	35,106	13.1	10.1
7 Basic metal products	2,841	3,046	3,378	3,888	4,323	15.1	11.2
8 Fabricated metal products, machinery, and transport equipment	13,241	14,305	15,678	17,638	19,360	12.5	9.8
9 Manufactured products not elsewhere specified	8,137	9,002	9,939	10,361	11,450	5.3	10.5
Total	368,314	397,873	462,720	498,230	548,432	7.7	10.1

(a) Value of production is estimated on the basis of ex-factory value of production
(b) Provisional

Sources: Central Bank of Sri Lanka
Board of Investment of Sri Lanka

Box 11

Future Challenges of the Apparel Industry

The apparel industry in Sri Lanka has grown rapidly during the last two decades, supported by the steady demand through quota availability, liberalised market policies adopted by the government, foreign participation in the industry and the availability of low cost labour. The industry has assumed a great significance in Sri Lanka's economy. Exports of textiles and garments accounted for 53 per cent of total export earnings of the country and amounted to 5.3 per cent of GDP in 2002. There are over 1,000 large and medium scale garment factories in Sri Lanka, providing over 330,000 direct employment opportunities. Among these, the 50 largest factories accounted for over 50 per cent of total output of the industry.

After two decades of growth, the apparel industry is now facing several challenges. The foremost challenge is the expected end to the quota system in 2005, increasing competition from China, expansion of rival trading blocks causing trade diversion, entering of low cost manufacturers to the global market, and slow progress in domestic infrastructure development affecting external competitiveness.

The Phasing out of Quota System with the Multi Fibre Arrangement (MFA) by 2005

A prime challenge of the industry is the phasing out of the quota system by 2005. The quota system has benefited developing countries by guaranteeing a ready market and protection from competition. Its removal will increase competition and will favour countries with lower costs of production and efficient infrastructure. With the loss of quota protection, it is expected that several small-scale manufacturers will lose market share to their more efficient large-scale manufacturers. However, the removal of the quota system will also provide opportunities for efficient and dynamic manufacturers to enhance their export volumes, as this will remove quantity restrictions.

Sri Lanka's dependence on quotas has declined over the years. Quota-based exports have declined from 63 per cent in 1996 to 53 per cent in 2002. This trend would continue at a higher rate during the next three-year period as the industry is preparing for a quota free trading environment after 2005. Furthermore, the dependence on quota in Sri Lanka is significantly lower than in its South Asian counterparts (Table 1).

Recent data indicate that output and employment in the apparel industry in Sri Lanka are highly concentrated in a few large-scale manufacturers. The top 12 per cent exporters account for about 72 per cent of exports, while the top 28 per cent account for 62 per cent of the employment in the industry (Tables 2 and 3). Many large-scale manufacturers have already established strong marketing links with foreign buyers and they do not seriously depend on quota availability. Therefore, the loss of exports following the abolition of the quota system may not be as high as many argue. In the extreme case, even if it is assumed that all small-scale garment industries and 50 per cent of medium scale industries face problems after 2005, the total loss of exports due to dismantling of quota would be only 17 per cent. On the same basis, loss of employment after phasing out of quotas is estimated to be 20 per cent. However, actual loss of exports and employment would be lower than this, because most of the small and medium scale industries may engage in sub-contracting for large-scale industries with their existing machines and expertise. Similarly, large-scale industries may absorb the larger portion of job losers, as these industries can increase production volume a quota free trading environment.

TABLE 1

Quota Exports of Garments from South Asia

Country	Quota-based exports (per cent)
Bangladesh	95
India	73
Nepal	80
Pakistan	90
Sri Lanka	55

Source: Gopal Joshi, " Garment in South Asia", International Labour Organisation, April 2002.

It has been indicated that non-tariff barriers became more effective in governing international apparel trade after the phasing out of quotas in 2005. International labour standards may play a vital role in governing apparel exports. These international labour standards include non-discrimination among workers on the basis of sex, race or religion, prohibition of child labour, prohibition of forced labour, health and safety measures, wages and benefits and hours of work. Sri Lanka is in an advantageous position as these labour standards in Sri Lanka are relatively higher than its competitors, including China and India.

All textile and garment manufacturers in the country have been aware of the post - 2005 problem for the last 10 years, and most of them are developing strategies to face the post- 2005 challenges. Large companies in Sri Lanka have already taken steps in the areas of product specialisation, technology transfer and marketing strategies to face the challenges of abolition of quota. The government, in collaboration with the private sector and academic institutions has prepared a five year strategy for the future development of the apparel industry. The objective of this

Box 11 (contd.)

TABLE 2

Classification of Manufactures by Export Value in 2001

Category	Number of manufacturers		Exports	
	Number	Percentage	Value (Rs. mn)	Percentage
Small (Rs. 0.25 mn - Rs. 100 mn)	549	64	10,335	5
Medium (Rs.101 mn - Rs.250 mn)	204	24	48,936	23
Large (Rs. 251 mn and above)	106	12	149,362	72
Total	859	100	208,633	100

Source: Sri Lankan Apparel Industry: 5 Year Strategy

TABLE 3

Classification of Manufacturers by Employment in 2001

Category	Number of manufacturers		Employment	
	Number	Percentage	Number	Percentage
Small (1-100 employees)	157	19	10,501	3
Medium (101-250 employees)	438	53	118,679	35
Large (Over 251 employees)	235	28	209,524	62
Total	830	100	338,704	100

Source: Sri Lankan Apparel Industry: 5 Year Strategy

was to consolidate and strengthen the Sri Lankan apparel industry and ensure its success beyond 2005.

China's Entry into the WTO

China's accession to WTO in 2001 has enabled it to enjoy the benefits of being a member of WTO and expand market share in the future. With a strong fabric base, continuous improvements of technology and relatively low labour cost, China is becoming the most competitive and low-cost clothing producer in the world. Some research findings suggest that the real wages in China will remain low during the next two decades due to the massive supply of labour. Even before 2001, China was not discriminated against by other WTO members as it enjoyed Most Favoured Nation status from major countries such as USA. Therefore, China's accession to the WTO will not increase Chinese exports significantly in the short run as China has already been holding a higher market share in these markets without WTO membership. The accession of China to WTO would also provide opportunities for other countries to access the massive Chinese market as Chinese trading activities are now subject to the same rules and regulations of WTO applicable to other members.

Increased Competition from Low Cost Manufacturers

During the last decade, a large number of low cost Asian countries such as Vietnam, Cambodia, Laos and Myanmar, and East European countries expanded their market share in the international markets. These countries may create a severe competitive threat, especially in the lower market segments by Sri Lanka. With higher labour productivity, and lower labour costs, these countries have eliminated the competitive advantage Sri Lanka enjoyed earlier. Furthermore, these countries have either their own fabric and accessory base or are located in close proximity to supply sources enabling them to supply export orders within a short period of time. Therefore, a reduction in the cost of production and turn-around time, improvement of marketing links in major markets and improvement of technology would be required from Sri Lankan manufacturers to meet the competition arising from these low cost manufacturers.

Growing Regional Trading Blocks

A growing trend in formation of regional trading blocks has become a significant challenge to expanding exports by many developing countries. The formation of bi-lateral and regional trading blocks such as the North American Free Trade Agreement (NAFTA), the Caribbean Basin Initiative (CBI) and the African Growth and Opportunities Act (AGOA) have intensified the competition in garment exports to the US market. Countries which benefit from trading agreements may have price advantages and a secure market in the US, causing severe competition to other exporters to the US market, including Sri Lanka.

Changes in Supply Chain Management

The lack of strong sourcing channels of raw materials domestically and the distance from major markets have resulted in a high turn-around time to service the US and EU markets. The turn-around time in Sri Lanka is estimated to be 90 days in the case of the US market, compared with less than 30 days in Mexico. This problem was aggravated further with recent change in the sourcing pattern of inputs in the international markets. The traditional pre-season ordering system of wholesalers is now replaced with just-in-time ordering. Retail traders now prefer to keep smaller quantities for shorter period rather than keeping large stocks. This trend requires manufacturers to locate their factories within close proximity to major markets in order to reduce the turn-around time. The change in sourcing patterns requires manufacturers to invest in technology to

Box 11 (contd.)

speed up material sourcing, production processes and the supply chain.

Weak Backward Linkages

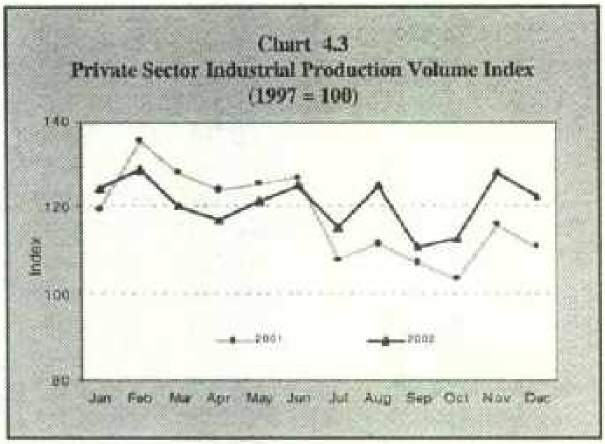
The high dependence on imported raw materials in the Sri Lankan apparel industry is becoming a severe impediment for future growth. It is estimated that imported fabrics account for nearly 85-90 per cent of the fabrics used by exporters. Further, accessories such as buttons, zips, labels and packing material are mainly imported. This results in long turn-around times to meet export orders and keeps low the net foreign exchange earning of the garment industry, which is estimated to be about 30 per cent of the export value. The local textile industry is unable to supply the type of fabrics demanded by the export garment industry due to technical handicaps.

High Market Concentration

At present, Sri Lanka's apparel exports are heavily concentrated in a few markets. In 2002, over 93 per cent of apparel and textile products were exported to US and EU markets. So far, sufficient efforts have not been made to increase market shares in other markets such as Japan, Australia and India. Entering the Japanese market is a challenge because the East Asian countries and China have been better placed to take advantage of the much more quality conscious Japanese market. Sri Lankan manufacturers have hitherto not obtained maximum advantage of the tariff concessions offered under the FTA with India. As concentration in a few markets increases business risk, the diversification of export markets remains an important challenge.

Strategies

- In the face of intensifying competition from other exporters such as Mexico, China, Vietnam and Bangladesh, who have lower costs of production and are in closer proximity to both input and output markets, Sri Lanka should focus on moving up in the value ladder by supplying niche markets. Concentration on quality, price, speed of delivery, developing own brand names and transforming from being mere manufacturers to fully integrated service providers would be helpful to face future competition.
- The future growth of the apparel industry will depend mainly on the marketing ability of manufacturers. The promotion of Sri Lankan brands and Sri Lanka's image in the industry through launching intense international marketing campaigns in targetted markets and obtaining recognition for high labour standards in Sri Lanka would be vital to capture high market shares.
- Specialisation in identified product categories to gain a reputation as a superior manufacturer of specific product categories would be an important strategy to expand market share. It would also help streamline the manufacturing process and product development.
- Establishment of business links with international fashion designers and obtaining feedback from buyers on sourcing strategies would be vital to meet rapidly changing designs in the international markets. In this regard, improvement of information technology is essential in responding quickly to the changes in the markets.
- The selling price of apparel items is estimated to be significantly higher than the manufacturing cost and a substantial proportion of the price goes to middlemen as commissions and for other charges for logistic services. The marketing chain involves several layers of middlemen before goods move from the manufacturer to the final consumer: manufacturer, wholesaler, semi whole-saler, exporter, trading houses, retailers and so on. It is estimated that in the domestic market, the final consumer price is 80 - 100 per cent higher than the factory gate price, whereas in the international market, the mark up price is 200 - 300 per cent higher than the factorygate price. Therefore, manufacturers should pay more attention to building up close links with final links in marketing chain, to get higher prices for their products.
- Growing preferential trade in the international market is becoming a severe threat to small middle income countries like Sri Lanka. To face this challenge, the government should take initiatives by strong lobbying for preferential trade concessions from major markets such as USA and EU countries, forming regional trading blocks and entering into bilateral trade agreements with identified countries. Lobbying and negotiating skills would play a vital role in obtaining better terms and conditions in trade agreements. In this regard, the government has already taken several measures to remove quota restrictions in the EU market and has initiated discussions to obtain preferential treatment from the US market.
- Improving productivity is a key requirement for enhancing the international competitiveness of the apparel industry. In this regard, there is need for developing productivity based incentives and better compensation packages. Manufacturers should also invest in training, improving working conditions, transport and welfare facilities, while providing opportunities for personal advancement.



The output of wheat flour processing continued to increase in response to higher demand for wheat flour based food arising from changes in food habits, especially in urban areas, and from high rice prices. The manufacturers of wheat flour introduced new varieties to the market in 2002 following the liberalisation of wheat and wheat flour imports in 2001. The processed meat industry continued to grow, helped by the high price of fish, as well as demand from hotels with the improvement in the tourist industry in 2002. Manufacturers launched new varieties in the market in 2002. The improvement of production technologies and automation of production processes reduced human intervention in production helping the industry to acquire globally accepted standards for hygiene and safety. Despite the increase in prices, the packing and domestic production of milk powder continued to increase. This industry grew by 5.5 per cent with the increased availability of fresh milk and consumer preference for domestic milk powder due to the price advantage and improved quality. The output of biscuits continued to grow due to higher domestic demand and penetration into foreign markets. Major manufacturers entered into the highly competitive Chinese market in 2002, in addition to their foothold in other Asian and European markets.

The output of desiccated coconut declined substantially in 2002. The industry faced problems with the loss of key overseas markets and skilled workers moving out of the sector owing to the shortage of raw materials to operate DC mills as a result of the drought that has reduced the coconut crop. Competitors such as the Philippines and Indonesia captured some overseas markets previously supplied by Sri Lankan millers due to the prevailing production shortfall. The demand for poultry feed continued to increase in response to high derived demand coming from the growing domestic poultry farming industry. The demand for chicken as a source of protein by the public has increased gradually over the years due to favourable prices compared to its substitutes.

Output of cigarettes increased by 5.1 per cent in 2002 due to increased demand from both domestic and international markets. New export orders from the Maldives and East Asia helped reduce the high dependence on traditional Middle East markets. Manufacturers launched various promotional campaigns to popularise specific brands. The application of advanced techniques, better work practices and effective management helped improve production volumes, while the signing of collective salary agreements with labour unions restored industrial peace. The revision of excise duty on tobacco reduced the prices of cigarettes that were popular among low-income consumers and this has boosted demand for legally manufactured cigarettes as their relative costs compared to manufactured white cigarettes have declined. Despite this switch, domestic demand for cigarettes has not increased significantly in recent years as a result of the greater awareness, especially among youth of tobacco related health problems.

Major beer manufacturers continued to export their products to highly competitive markets such as Japan, UK, the Maldives and USA in 2002. The establishment of overseas distribution networks, higher investment on market research, and promotional activities helped expand the overseas market shares. The downward revision of excise duties on beer stimulated domestic demand. The output of liquor spirits also increased by 5.2 per cent in 2002. The downward revision of excise duty on liquor in 2002 helped to bring down prices and attract consumers to legally manufactured liquor from illicit liquor. Strict enforcement of excise laws is essential to minimise illicit liquor production in the country. In order to reduce growing counterfeits, the major manufacturers introduced new shapes for bottles, new labelling and new bottle caps.

Despite the increase in prices, demand for carbonated soft drinks increased due to the improvement of commercial activities in the country and the dry weather conditions, especially during the first half of the year. The soft drink industry has had an added stimulus with increased demand arising from the North and the East with the progress in the peace process. In 2002, a major soft drink manufacturer began offering its popular brands in aluminium cans to the local market, particularly targetting hotels, super markets, cinemas and bars.

Chemicals, petroleum, rubber and plastic products

The output of chemical, petroleum, rubber and plastic products grew by 4.8 per cent in 2002, reflecting higher output levels in major sub sectors of rubber based products (6.9 per cent), chemical and fertiliser (4.4 per cent), plastics and PVC (4.1 per cent) and pharmaceuticals and detergents (3.6 per cent). This category contributed 25 per cent to the growth in private sector industries in 2002.

The output of export-market-oriented rubber gloves and industrial tyres which declined in the first half 2002, regained its growth momentum during the second half with the gradual improvement of global demand. Despite the impact of increases in fuel and electricity prices, the rubber-based industry was able to contain production costs with cost rationalisation strategies. The lower price of latex, particularly in the first half of 2002, was a significant contributor in restraining costs.

The output of rubber surgical gloves, which had stagnated for several years, grew in 2002 with increased demand form European and Middle Eastern countries. However, manufacturers of rubber gloves were forced to lower prices, particularly in the lower market segment, to retain market share in the face of stiff competition form Malaysia and new manufacturers from China. However, this was partly offset by price gains in high value gloves exported to European countries. The reduction of exports to the US market in 2002 was compensated by market penetration in South America, Africa, the Middle East and Asia.

In addition to higher domestic sales, the tyre manufacturing industry began to export truck and bus tyres to India with the duty concession received under the Indo Lanka Free Trade Agreement (FTA). The complete elimination of customs duty under FTA in January 2003 will further enhance export potential in the Indian market. Manufacturers also exported commercial tyres to the other countries in the SAARC region, as well as Dubai, Singapore, USA, the Philippines, Uganda and Nigeria in 2002. The opening up of roads in the North and the East has boosted domestic demand for locally manufactured commercial tyres, bicycle tyres and tubes. Other rubber-based product exports, such as resin rubber shoes and soling sheets, to India and Pakistan also increased in 2002.

The output of soap and detergent continued to grow with higher domestic demand and with new demand from the North and the East following the restoration of peace. Sri Lanka has now become a competitive source of soap chips, as Indian importers pay lower duties under FTA. Manufacturers of toothpaste, shampoo and perfumes captured market segments of low-income consumers through the introduction of mini-packs with special prices. The output of herbal soap and cosmetics grew by 8 per cent in 2002. The growing popularity of natural products stimulated the demand for these products. Domestic herbal soaps and cosmetics were popular, especially among urban consumers, despite several similar products being imported from India. Manufacturers of these products invested substantially in modern technology and continued to improve product quality and packaging to meet consumer expectations.

In the chemical sub-sector, output grew in fertiliser, paints, mosquito coils, chemicals and insecticides. Fertiliser production in 2002 increased with higher utilisation of fertiliser in the paddy and coconut sectors. Better crop prices and favourable weather, especially during the second half of 2002, stimulated the demand for fertiliser. Domestic demand for mosquito coils continued to increase, especially in urban areas. In addition to growing domestic demand, manufacturers continued to export mosquito coils to several countries, including Pakistan, South Africa and Kenya.

The output of activated carbon declined due to the adverse weather that affected the coconut crop in 2002. The lower harvest of coconut and slowdown in the desiccated coconut industry pushed up raw material prices. In addition to the escalating cost of production, international prices of activated carbon declined in 2002 due to higher competition in the global market. The Philippines and India are becoming highly competitive countries for activated carbon in international markets. However, the activated carbon industry continued to benefit from waste energy recovery in the form of electricity generation in the context of recent increases in electricity tariffs and oil prices.

The plastics industry registered a moderate growth of 3.2 per cent in 2002, reflecting lower output in PVC products. However, the short supply and higher price of timber encouraged substitution of plastic for timber for manufacturing furniture and packing material. There was higher demand for plastic furniture, household items, building materials and packing materials due to the price advantage. The manufacturers of plastic furniture began to export their products to India and other neighbouring countries. The output of PVC products grew only moderately due to stagnation of the construction industry. BOI industries manufacturing lamps and plastic components, camping tents, travel bags and haversacks, PVC rain wear and bags and plastic headers registered relatively high growth during the year.

Non-metallic mineral products

The output of non-metallic mineral products increased by 1.9 per cent in 2002 compared with a marginal growth of 0.5 per cent in 2001. The output of ceramic products, processed diamonds and concrete products registered relatively higher growth in 2002. The output of export oriented ceramic products, which had declined since the second quarter of 2001, showed a turnaround, registering a relatively higher growth during the second half of 2002. However, the ceramic industry continued to suffer from increased competition from low cost manufacturers in international markets. In order to compete with the large-scale manufacturers in China and Eastern European countries, ceramic manufacturers in Sri Lanka focussed on securing niche markets in the Netherlands, the United Kingdom and Belgium. In an effort to remain competitive, the ceramics industry launched a programme to save energy, which accounts for a substantial share of the cost of production.

The domestic demand for ceramic tiles continued to grow with the growing popularity of ceramic tiles in the construction industry. Despite increased imports, domestic manufacturers expanded their market share with better quality products. A leading tile manufacturing company made a large investment in 2002 to expand capacity to meet growing demand. The traditional ceramic manufacturing bases have now begun to move from Europe, Japan and the US, to areas in the East and South Asia. In this changing environment, Sri Lanka has a good opportunity to consolidate its market share in Western countries and leverage on key strengths available in the ceramics industry. With growing enthusiasm for a pollution free environment and the tendency to consume more natural products, the demand for ceramic products is expected to grow in the future. However, to reap the full benefits of these trends, greater attention should be paid to research and development to improve product quality and reduce the cost of production. The over exploitation of essential raw material stocks such as China clay will be a major problem for the ceramics industry in the long run. Looking for new resources and effective utilisation of raw materials are major challenges facing the ceramics industry.

The output of the cement industry increased marginally in 2002 due to imports of cement in bulk form and the slowing down of the construction industry, especially large scale construction projects. Imports of cement from India continued to increase with lower duty under the FTA. The cement manufacturing industry paid greater attention to reducing costs of production. Major manufacturers set up a coal grinding plant in 2002 to replace the use of expensive heavy fuel oil. In addition to saving energy costs, the new plant has substantially improved the quality of clinker when compared with oil-fired techniques.

The stagnating construction industry did not generate sufficient demand for building materials such as asbestos, concrete products, roofing sheets, aluminium products and glass. As a result, output of asbestos roofing and ceiling sheets declined by 4.5 per cent in 2002. Despite an output drop, the glass industry invested significantly to improve efficiency and product quality. The major manufacturer of aluminium products began to export its products to India under the FTA. As most of the Indian aluminium industries are located in the North, Sri Lankan manufacturers have a competitive advantage in the South Indian market because of lower transport costs and shorter transportation time.

Fabricated metal products

The output of fabricated metal products increased by 2 per cent in 2002 close to the growth in the previous year. Output in the non-BOI industries manufacturing agricultural machinery, light bulbs, cables, metal products, electrical items, kitchen appliances, television sets, boats and aluminium products grew relatively faster in 2002.

Increased income in the agricultural areas stimulated the demand for television sets, electrical items, kitchen appliances and agricultural machinery such as water pumps and sprayers. The expansion of rural electrification also helped boost demand for electrical appliances. Marketing strategies such as interest free payment schemes, and improved quality stimulated demand for television sets. The manufacturers of refrigerators enhanced product quality and introduced new designs in keeping with market trends.

The sluggish international economic environment resulted in many ship owners postponing routine dry dock repairs. However, the boat building industry received new orders in 2002 from both local and overseas clients, especially for the construction of high-powered tugboats and high-speed aluminium boats. The installation of new machines and the construction of new shipbuilding yards improved efficiency in the industry.

The output of steel office and household furniture continued to increase with the switch from wood furniture to metal furniture on account of price advantage and durability. The fabrication of motor coaches and lorries continued to decline as a result of lower domestic orders and the importation of fabricated buses and lorries from India.

Other products

The output of paper and paper products declined by 2.5 per cent in 2002 reflecting lower output in corrugated cartons and packing materials. Items that performed well in this category were exercise books, labels, books and magazines, and posters. Demand for magazines and tabloids, especially in fields such as sports, politics, business and leisure activities continued to increase and a few new magazines were introduced in 2002. The export-oriented manufacturers showed a tendency to use domestically manufactured corrugated cartons, labels and paper boxes for packing because of the price advantage and easy availability. Techniques in the printing industry continued to improve with the installation of advanced machinery and modern technology to the industry. The circulation of newspapers declined in 2002 due to increased prices. The output of BOI industries manufacturing photo albums, paper sacks and periodicals declined in 2002 because of sluggish environment in the international markets.

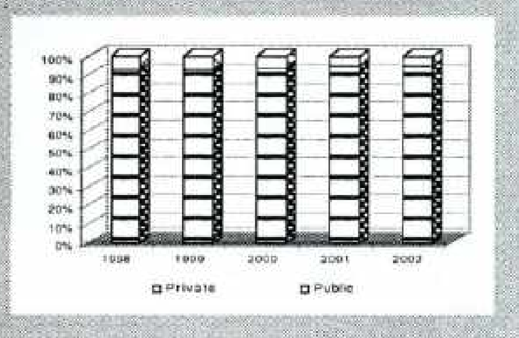
The output of the wood and wood products category declined by 1.5 per cent in 2002 compared with a 1.1 per cent growth in the previous year. The demand for domestically manufactured wood furniture continued to decline, as substitutes such as steel and plastic furniture were preferred. Imports of furniture from Europe and East Asian countries also affected the local furniture manufacturing industry. The local wood and wood product industry continued to face problems relating to inadequate supply and high price of raw materials and scarcity of skilled labour. However, the techniques in the industry are improving gradually with the use of modern machines in place of manual tools. Improvements were also seen in the chemical treatment of wood for durability and the painting of furniture. The export oriented industries manufacturing sports equipment, educational items, wooden toys, and gift items registered relatively higher growth in 2002.

Output of coir fibre grew relatively faster in 2002 with improved quality and marketing. The output of industrial fibre such as rubberised, stretched pads and curled fibre and twine used in industry, horticulture and erosion control increased in 2002. Reduced demand for mattress fibre from the traditional US market was offset by new demand from Asian countries and Australia. Despite relatively lower prices, manufacturers successfully penetrated new markets in Asia during the year. Adverse weather that affected the coconut crop resulted in increased prices for husks and coir. A voluminous material like coir fibre was affected adversely by the increase in transportation costs resulting from fuel price hikes. Traditional scraper mats faced vigorous price competition in the global markets and counterfeiters threatened patented products. The use of natural fibres is likely to increase in future and coir fibre has a potential to maintain its global market share. However, greater attention should be paid to marketing, improvement of product quality and innovation. The competitiveness of the industry was affected by inconsistency in the quality of products exported from Sri Lanka and weaknesses such as reliability of delivery, irregular supplies and high ocean freight rates and competition from synthetic materials.

Public Sector Industries

The output of public sector industries increased by 7.5 per cent in real terms in 2002 recovering partially from the drop of 11.3 per cent in 2001. The output of the Ceylon Petroleum Corporation (CPC), which accounts for over 90 per cent of public sector industrial output, increased by 8.5 per cent in 2002. Uninterrupted production at the CPC throughout the year was the major reason for the increase in the output of public sector industries. The petroleum refinery was closed down for about two months in the previous year for routine maintenance. However, public sector industrial output, excluding petroleum products, decreased by 21.8 per cent in 2002.

Chart 4.4
Private and Public Sector Share in Industrial Production



The output of Sevanagala Sugar Industries Ltd. decreased by 29.1 per cent in 2002 because of a drop in crop yield and the sugar recovery rate that resulted from the prolonged drought in the previous year and early part of 2002 in the sugarcane cultivation areas. The destruction of sugarcane by bush fires also adversely affected the sugar industry.

The output of the State Timber Corporation increased by 12.4 per cent in 2002, mainly due to higher felling operations with the allocation of a large extent of forest areas for felling operations by the Forest Department and private sector forest plantations. The accumulated stocks and rainy weather during harvesting time adversely affected salt production in 2002. The output of Lanka Phosphates Ltd. grew in 2002 to meet higher demand for fertiliser coming especially from the coconut and paddy sectors. The output of Sri Lanka Rubber Manufacturing and Exports Corporation Ltd. increased in 2002 as a result of capacity expansion.

4.3 Value Addition and Capacity Utilisation

Value added in the industrial sector in nominal terms grew by 10.9 per cent in 2002. However, in real terms value added registered only a 2.9 per cent growth in 2002 as compared with a 3.8 per cent decline in 2001. Value added, as a ratio of the total value of production, increased marginally from 36.0 per cent in 2001 to 36.3 per cent in 2002. The introduction of modern techniques and various measures adopted by manufacturers, such as efficient utilisation of raw materials, reduction of waste and recycling of waste materials and energy-saving methods for cost reduction had a beneficial effect on value addition. However, increased energy and other utility prices and continuation of structural impediments in the

TABLE 4.4
Public Sector Major Industry Output Index

1997=100

	Categories	Index					Percentage Change	
		1998	1999	2000	2001	2002(a)	2001	2002(a)
1	Food, beverages and tobacco products	105.6	106.5	139.8	128.1	91.8	-8.4	-28.3
2	Textile, wearing apparel and leather products	-	-	-	-	-	-	-
3	Wood and wood products	119.2	126.5	213.3	127.9	143.8	-40.0	12.4
4	Paper and paper products	74.3	38.2	29.6	40.6	26.0	37.1	-36.0
5	Chemical, petroleum, rubber and plastic products	98.3	84.4	104.9	93.0	101.6	-11.3	9.2
	Petroleum products	95.2	84.4	104.9	93.2	101.1	-11.2	8.5
6.	Non metallic mineral products	143.0	70.5	82.6	83.4	86.7	1.0	4.0
7.	Basic metal products	-	-	-	-	-	-	-
8.	Fabricated metal products, machinery, and transport equipment	-	-	-	-	-	-	-
	All Categories	97.9	83.1	103.2	91.5	98.4	-11.3	7.5
	Excluding Petroleum	93.5	68.5	82.8	78.0	61.0	-5.8	-21.8

(a) Provisional

Source: Central Bank of Sri Lanka

TABLE 4.5
Value Added in Industry (Current Prices)

	Categories	Rs. million					Percentage change	
		1998	1999	2000	2001	2002(a)	2001	2002(a)
1	Food, beverages and tobacco products	40,452	44,503	49,031	54,282	61,550	10.7	13.4
2	Textile, wearing apparel and leather products	47,482	55,263	69,451	71,263	77,028	2.6	8.1
3	Wood and wood products	1,313	1,390	1,554	1,639	1,736	5.4	6.0
4	Paper and paper products	2,578	2,664	2,808	3,103	3,124	10.5	0.7
5	Chemical, petroleum, rubber and plastic products	14,274	13,832	17,771	19,245	22,653	8.3	17.7
6	Non metallic mineral products	12,463	13,817	14,240	16,010	17,273	12.4	7.9
7	Basic metal products	710	777	959	1,131	1,306	17.9	15.5
8	Fabricated metal products, machinery, and transport equipment	6,779	7,367	7,714	8,731	9,698	13.2	11.1
9	Manufactured products not elsewhere specified	3,426	3,799	3,965	4,154	4,695	4.8	13.0
	Total	129,477	143,412	167,493	179,557	199,063	7.2	10.9

(a) Provisional

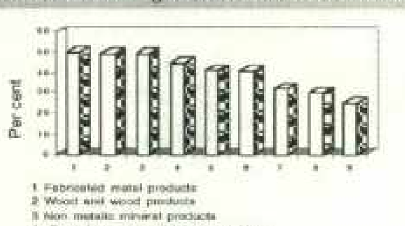
Source: Central Bank of Sri Lanka

economy retarded the potential growth of value addition in the industrial sector.

The value added ratio increased in the industrial categories of food, beverages and tobacco; chemicals, rubber and plastic products and fabricated metal products, in 2002. Reductions in value added ratios were observed in the industrial categories of wood and wood products; paper and paper products and non-metallic mineral products. Value added ratios were above 45 per cent in the industrial categories of food, beverages and tobacco products wood and wood products non-metallic mineral products and fabricated metal products. The lowest value added ratio of 25.1 per cent was in the industrial category of chemicals, rubber and plastic products.

The installed capacity of the industrial sector expanded marginally by 1.9 per cent in 2002. Despite lower interest rates in 2002, investors delayed capacity expansion projects due to weak export demand and political uncertainty. Production capacity in ceramics, food processing, rubber based and plastic products increased in 2002 to meet growing demand in the domestic market. Capacity in export-oriented industries such as processed tea, accessories for apparel industry, vehicle seats, artificial flowers, ornamental ceramics, synthetic gem stones,

Chart 4.5
Value Added Percentages in Industrial Production - 2002



and copper wires also expanded in 2002. Capacity expansion was relatively high in the industrial categories of paper and paper products (3.0 per cent) and non-metallic mineral products (4.2 per cent). Overall capacity utilisation in the industrial sector increased marginally from 80 per cent in 2001 to 81 per cent in 2002, mainly reflecting the impact of weak export demand.

4.4 Cost of Production, Profitability and Employment

The average ex-factory profit in the non-BOI sector increased marginally by 1.5 percentage point to 11.9 per cent in 2002. The profit ratio of the industrial sector is estimated on the basis of excess ex-factory value of production over the total cost of production. Although, the profitability of the industrial sector was affected adversely by higher energy and other utility prices, slower increase in other costs such as wages and imported raw materials and lower interest rates helped to contain cost increases. A part of the cost increase was passed down to consumers. In the case of export oriented and import substitution industries, the depreciation of the rupee helped improve profit margins. Other factors that helped improve profitability were better management of working capital, waste reduction, energy saving, optimal use of raw materials and closing down of non-profitable business units by manufacturers. Profitability in the non-BOI industrial sector ranged from 14.8 per cent in the textiles, wearing apparel and leather products category to 9.9 per cent in the other manufacturing product category. The profitability in the industrial sub sectors of ceramics, rubber based products, processed food, soap and detergents, ayurvedic drugs and herbal products, shipbuilding and tea processing improved in 2002.

The wage bill in the industrial sector increased by 7.5 per cent in 2002. However, the share of the wage bill in the total cost of production declined from 12.0 per cent in 2001 to 11.7 per cent in 2002 due to higher increases in other input costs.

TABLE 4.6
Ex - Factory Profit Ratios of Non - BOI Private Sector Industries (a)

Categories	Total Cost of Production (Rs. mn.)		Total Value of Production (Rs. mn.)		Factory Profit Ratio (percentage)	
	2001	2002(b)	2001	2002(b)	2001	2002(b)
1 Food, beverages and tobacco products	60,507	[illegible]	67,081	73,277	9.8	11.8
2 Textile, wearing apparel and leather products	16,620	16,262	19,576	19,087	15.1	[illegible]
3 Wood and wood products	1,126	1,244	1,268	1,410	11.2	11.8
4 Paper and paper products	4,074	4,511	4,651	5,105	10.5	11.2
5 Chemical, petroleum, rubber and plastic products	25,252	27,180	27,790	[illegible]	9.1	11.2
6 Non metallic mineral products	15,843	17,890	17,629	20,125	10.1	12.1
7 Basic metal products	1,825	2,095	2,023	2,325	9.8	10.0
8 Fabricated metal products, machinery, and transport equipment	11,464	12,840	12,752	[illegible]	10.1	[illegible]
9 Manufactured products not elsewhere specified	2,644	3,100	2,908	[illegible]	9.1	[illegible]
Total	139,356	152,784	155,562	173,427	10.4	11.8

(a) Based on information received from 480 non-BOI private sector firms
(b) Provisional

Source: Central Bank of Sri Lanka

Although there was growing pressure for a wage hike on account of the rising cost of living, tight profitability did not make it possible to accommodate salary increases. The difficult market environment that prevailed, especially in the first half of the year, encouraged manufacturers to bring down labour costs through out sourcing of non-economic production activities, reducing overtime bills and even reducing excess labour by offering voluntary retirement schemes in few cases. In certain instances, companies recruited school leavers and unemployed graduates as apprentices at low salaries for short periods. Given the stringent labour laws, some manufacturers opted for recruiting more temporary and casual labour, which helped contain the total wage bill. The share of labour costs in the industrial categories of textiles, wearing apparel and leather products, fabricated metal products and paper and paper products declined in 2002. The share of labour costs was over 15 per cent in the industrial categories of wood and wood products and non-metallic mineral products. The labour cost sin the industrial categories of food, beverages and tobacco and basic metal products, were relatively low, in 2002.

Total energy costs in the non-BOI industrial sector increased by 17.5 per cent in 2002. Energy costs as a percentage of the total cost of production increased to 5.5 per cent in 2002 from 5.1 per cent in 2001 reflecting the impact of the higher electricity, gas and petroleum prices. Various measures taken by manufacturers to bring down energy costs, such as the utilisation of energy saving methods and equipment and installation of waste energy recovery processes, were not

TABLE 4.7
Domestic Cost Structure of Non - BOI Private Sector Industries (a)
(As a percentage of total cost of production)

Categories	Domestic Cost (percentage)							
	Power & Fuel		Wage		Raw Materials		Interest	
	2001	2002(b)	2001	2002(b)	2001	2002(b)	2001	2002(b)
1 Food, beverages and tobacco products	2.8	[illegible]	9.6	10.4	36.1	[illegible]	1.9	1.6
2 Textile, wearing apparel and leather products	3.7	4.2	14.8	13.7	13.6	[illegible]	2.9	2.5
3 Wood and wood products	6.1	6.9	16.1	15.7	35.2	[illegible]	4.8	[illegible]
4 Paper and paper products	3.0	3.4	12.6	12.1	16.1	[illegible]	4.3	[illegible]
5 Chemical, petroleum, rubber and plastic products	4.8	5.1	12.9	12.0	27.1	29.1	4.3	[illegible]
6 Non metallic mineral products	17.1	17.9	16.3	15.2	28.1	27.8	2.8	[illegible]
7 Basic metal products	6.5	5.9	10.9	10.4	34.2	34.8	4.0	[illegible]
8 Fabricated metal products, machinery, and transport equipment	3.6	4.1	11.5	[illegible]	23.9	25.2	5.0	[illegible]
9 Manufactured products not elsewhere specified	4.1	4.6	13.1	[illegible]	34.2	[illegible]	2.3	[illegible]
Total	5.1	5.5	12.0	[illegible]	29.2	30.2	2.9	[illegible]

(a) Based on information received from 480 non-BOI private sector firms
(b) Provisional

Source: Central Bank of Sri Lanka

sufficient to prevent an increase in the total energy bill. Higher energy consuming industries, such as cement, and ceramics, used low cost energy sources e.g. coal replacing high cost petroleum and electricity. The share of energy costs in the total cost of production increased in many industrial categories in 2002. The share of energy costs was relatively low in the industrial categories of food, beverages and tobacco (3.0 per cent) and paper and paper products (3.5 per cent).

Interest costs as a percentage of the total cost of production declined to 2.5 per cent in 2002 from 2.9 per cent in the previous year. A gradual reduction in lending rates in commercial and development banks and improvements in working capital management helped to contain interest costs. Manufacturers took several measures such as reducing inventories, maximum utilisation of trade credit, reducing production time and consumer credit, to bring down working capital requirements. In order to reduce cost of funds, some manufacturers resorted to alternative low cost borrowing sources such as the issue debentures and commercial papers.

Labour Productivity in Industry

Labour productivity in non-BOI enterprises, estimated as the change in real value added per man-hour, increased marginally by 0.9 per cent in 2002, recovering partially from a 2.5 per cent decline in 2001. The adoption of better working practices, on the job training and better management techniques helped improve labour productivity. In some instances, the reduction of labour through voluntary retirement schemes contributed to raise labour productivity. However, the growth potential of labour productivity was constrained by several factors, including stringent labour laws, poor working conditions, lack of a proper transport network, high labour turnover and strained employer-employee relations. Improvements in labour productivity was evident in many industrial categories, particularly in food, beverages and tobacco (3.2 per cent) chemical, rubber and plastic products (2.2 per cent), and non-metallic mineral products (1.5 per cent). However, labour productivity declined in the industrial categories of textile, wearing apparel and leather, wood and wood products and paper and paper products in 2002.

Chart 4.6
Labour Productivity in Industry (1995=100)

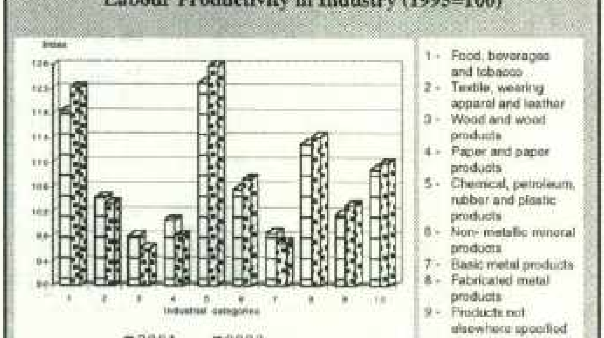


TABLE 4.8
Labour Productivity Index in the Non-BOI Private Sector (a)

1995 = 100

Categories	2001	2002(b)	% Change
1 Food, beverages and tobacco products	118.6	122.4	3.2
2 Textile, wearing apparel and leather products	104.4	103.6	-0.8
3 Wood and wood products	98.2	96.2	-2.0
4 Paper and paper products	100.8	98.3	-2.5
5 Chemical, petroleum, rubber and plastic products	123.2	125.9	2.2
6 Non metallic mineral products	105.8	107.4	1.5
7 Basic metal products	98.6	97.1	-1.5
8 Fabricated metal products, machinery and transport equipment	113.1	114.2	1.0
9 Manufactured products not elsewhere specified	101.8	103.3	1.5
Total	109.1	110.1	0.9

Source: Central Bank of Sri Lanka

(a) Based on information received from 480 non-BOI private sector firms.
(b) Provisional

Employment

The employment in the non-BOI industries increased marginally by 1.0 per cent reflecting the slower growth in the industrial output in 2002. The employment in the industrial categories of textiles, wearing apparel and leather products (0.5 per cent) and non-metallic mineral products (2.4 per cent) declined in 2002. The modernisation of factories with automated systems in the food processing, plastic, chemical and wood product industries contributed to reduce labour requirements during the year. Some manufactures offered attractive voluntary retirement schemes to retrench excess labour while others reduced excess contract and casual labour in order to face difficult market environment. However, the

TABLE 4.9
Employment in Non-BOI Private Sector Industries (a)

Categories	2001	2002(b)	% change
1 Food, beverages & tobacco products	24,578	25,192	2.5
2 Textile, wearing apparel and leather products	28,174	28,033	-0.5
3 Wood & wood products	1,289	1,257	-2.5
4 Paper & paper products	5,431	5,512	1.5
5 Chemicals, petroleum, rubber and plastics products	21,200	21,645	2.1
6 Non metallic minerals products	8,871	8,658	-2.4
7 Basic metal products	762	774	1.6
8 Fabricated metal products, machinery and transport equipment	11,392	11,620	2.0
9 Manufactured products (n.e.s.)	4,065	4,150	2.1
All Categories	105,762	106,843	1.0

Source: Central Bank of Sri Lanka

(a) Based on information received from 480 non-BOI private sector firms.
(b) Provisional

manufactures were not able to reduce their permanent labour in line with the market trends due to stringent labour laws. The employment in the industrial categories of food, beverage and tobacco, chemical, rubber and plastic products and fabricated metal products increased in 2002 reflecting the moderate improvement in capacity utilisation.

4.5 Investment

Foreign Investment

Foreign investment inflows to Sri Lanka, which showed a declining trend in the last two years, rose in 2002, with the peace initiative. The ongoing peace process, with strong support from the international community, will further encourage foreign investors in 2003. Policy measures and incentives announced in Budgets 2002 and 2003 will also help to attract more foreign investment. The BOI, the one-stop foreign investment facilitation agency of the government, approved 300 projects under Section 17 and 204 projects under Section 16 of the BOI Act in 2002, amounting to total investment commitments of Rs.64,598 million and Rs.6,006 million, respectively. The foreign investment component of the projects approved under Section 17 increased to Rs.31,955 million in 2002 from Rs.30,661 million in 2001, while that of projects approved under section 16 increased to Rs.4,878 million from Rs.2,018 million in 2001.

During the year, BOI undertook a number of foreign and local investment promotion activities. The outward promotion missions with business delegation from Sri Lanka visited a number of countries and conducted investment seminars and one-to-one business meetings with major investor communities in those countries. The countries visited include India, Malaysia, Australia, USA, UK, Japan, China and Middle East countries. In addition, BOI officials participated in four overseas investments promotion programmes in India, Japan and Saudi Arabia. Meanwhile, several foreign delegations visited Sri Lanka in search of new investment opportunities. Inward missions came from India, USA, Malaysia, the Maldives, Japan, Singapore, Croatia, Pakistan, Australia, China, Taiwan, EU and Israel. Five delegations came from India, four from EU countries, three each from USA and Japan and two from Malaysia and one each from the other countries. Among these delegations, two ministerial delegations from Malaysia and Singapore were expected to be of special importance to the infrastructure and information technology developments in the country. These investment missions are expected to generate more capital inflows in the coming years, provided that the peace process and political stability continue.

Under Section 17, BOI approved 300 projects in 2002, of which 76 were fully foreign owned, 77 were joint ventures between foreign investors and Sri Lankans and the rest were fully owned by Sri Lankans. The share of foreign investment in approved projects declined to 49.5 per cent in 2002 from 55.2 per cent in 2001. Of the 300 projects approved in 2002, 177 projects, or 60 per cent were in the industrial sector, while the others were in the services and agricultural sectors. Within the industrial sector, 72 projects were approved in the textiles, wearing apparel and leather products category, 25 in fabricated metal, machinery and transport equipment category, 23 in the food, beverages and tobacco products category, 13 in non-metallic mineral products category, 12 in the chemical, petroleum, rubber and plastic product category and 3 in the wood and wood products category. Up to end December 2002, BOI had approved 3,904 projects under Section 17 of the BOI Act, since the commencement of its operations.

The number of projects contracted by BOI also increased in 2002. However, the value of contracted investments in BOI projects declined to Rs.31,568 million in 2002 on account of a substantial reduction in the domestic investment component. The share of foreign investment in total contracted projects increased from 16.2 per cent in 2001 to 50.5 per cent in 2002.

TABLE 4.10

Realised Investments in BOI Enterprises (a)

Categories	No. of Enterprises		Foreign Investment (Rs. mn)		Total Investment (b) (Rs. mn)	
	2001(c)	2002(d)	2001(c)	2002(d)	2001(c)	2002(d)
1 Food, beverages and tobacco products	146	143	5,058	8,732	11,088	14,679
2 Textile, wearing apparel and leather products	458	460	22,006	25,437	32,823	30,976
3 Wood and wood products	22	22	1,300	2,751	1,646	3,161
4 Paper and paper products	21	23	517	567	744	1,577
5 Chemical, petroleum, rubber and plastic products	126	129	10,178	11,040	14,101	16,011
6 Non metallic mineral products	57	64	3,183	3,674	6,042	6,763
7 Fabricated metal products, machinery, and transport equipment	41	67	3,769	5,582	5,116	7,230
8 Manufactured products not elsewhere specified	156	158	5,924	6,212	8,322	9,399
9 Services	535	559	89,355	101,019	127,695	142,684
Total	1,561	1,643	141,290	164,894	206,079	241,470

(a) Cumulative as at end year

(b) Projects approved under Section 17 of the Board of Investment Act

(c) Revised

(d) Provisional

Source: Board of Investment of Sri Lanka

TABLE 4.11

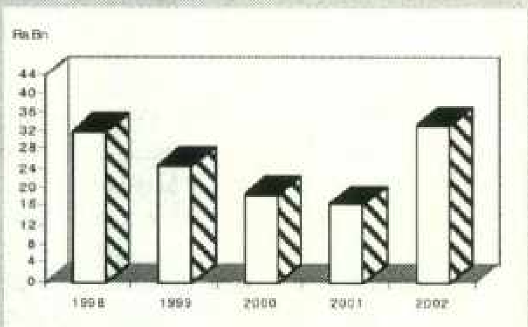
Employment and Export Earnings of BOI Enterprises

	Categories	Employment (End Dec.)		Gross Export Earnings (Rs.mn) (fob)	
		2001	2002(a)	2001	2002(a)
1	Food, beverages and tobacco products	15,112	14,448	12,907	13,311
2	Textile, wearing apparel and leather products	257,515	280,234	174,701	189,937
3	Wood and wood products	1,857	1,950	421	749
4	Paper and paper products	1,605	2,065	845	1,248
5	Chemical, petroleum, rubber and plastic products	31,880	31,716	30,299	28,394
6	Non metallic mineral products	12,598	13,547	9,614	8,901
7	Fabricated metal products, machinery, and transport equipment	4,466	5,793	2,402	9,748
8	Manufactured products not elsewhere specified	32,449	32,443	20,389	18,706
9	Services (b)	28,552	34,560	23,924	24,177
	Total	386,034	416,756	275,502	295,171

(a) Provisional
(b) Excluding SriLankan Airlines

Source: Board of Investment of Sri Lanka

Chart 4.7
Realised Investment of the BOI



Of the total contracted investment in 2002, the industrial sector absorbed about 51.1 per cent and the services sector absorbed around 48.9 per cent. Within the industrial sector, the largest share was accounted for by the fabricated metal, machinery and transport equipment category (Rs.5,707 million), followed by the textiles, wearing apparel and leather products category (Rs.3,779 million).

Of the contracted projects under Section 17 of the BOI Act, 131 projects commenced commercial operation in 2002, as compared to 118 projects in 2001. Of these projects, 87 were in the industrial sector and the others in the services and agricultural sectors. Within the industrial sector, the textile, wearing apparel and leather products category continued to be the dominant sub-sector with 49 projects. Up to end December 2002, BOI had signed agreements in respect of 2,411 projects since the commencement of its operations. Of these, 1,338

Chart 4.8
Approved and Contracted BOI Projects

Chart 4.8.1
Approved and Contracted Investments

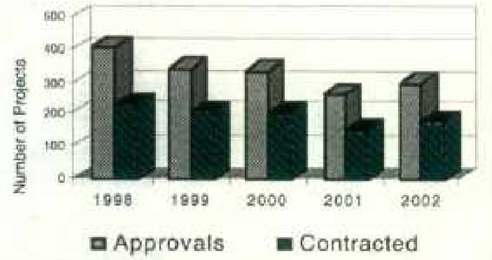


Chart 4.8.2
Approved and Contracted Investments

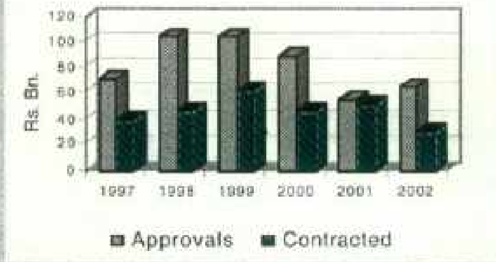


TABLE 4.12

Approved and Contracted Investment and Employment in BOI Projects

Categories	2001				2002(a)			
	No of projects	Estimated Investment (Rs. mn.) Foreign	Local	Employment	No of projects	Estimated Investment (Rs. mn.) Foreign	Local	Employment
Projects Approved under section 17	263	30,681	24,868	35,010	300	31,965	32,644	62,057
Projects Contracted under section 17	149	6,406	43,472	20,913	177	15,842	15,626	31,708
Projects Approved under section 16	119	2,016	477	3,469	204	4,878	1,128	7,259

(a) Provisional

Source: Board of Investment of Sri Lanka

projects with an estimated investment of Rs.241,323 million were in commercial operation at end December 2002. The foreign investment component of these projects was Rs.135,445 million or 56.1 per cent of the total investment. Out of these operating projects, about 1,113 projects or 83.2 per cent of the projects are located outside the export processing zones and only 225 projects are located in the exclusive industrial locations such as Export Processing Zones, Information Technology Park and Industrial Parks. Of the 1,338 projects, 481 were in the services and agricultural sectors and the other 857 were in the industrial sector. Among the industrial sector projects that were in commercial operation at end 2002, 317 were in the textile, wearing apparel and leather products category, 120 in the food, beverages and tobacco products category, 119 in the chemical, rubber and plastics products category and the rest in other categories. These projects together were estimated to generate employment for about 353,545 persons with about 182,120 in the textiles, wearing apparel and leather products category.

TABLE 4.13

Enterprises in Commercial Operation under BOI

Zone/Park	2001	2002(a)
Katunayake Export Processing Zone	89	88
Biyagama Export Processing Zone	59	69
Koggala Export Processing Zone	10	13
Kandy Industrial Park	4	4
Mirigama Export Processing Zone	9	10
Malwatte Export Processing Park	5	5
Seetawaka Industrial Park	12	4
Watupitiwala Export Processing Zone	11	12
Mirijjawela Export Processing Zone	1	1
Mawathagama Export Processing Zone	2	3
Polgahawela Export Processing Zone	1	3
Horana Export Processing Zone	3	8
Information Technology Park - WTC	4	5
Outside the Export Processing Zone	1,053	1,113
Total	1,263	1,338

(a) Provisional

Source: Board of Investment of Sri Lanka

Of the 204 projects approved under Section 16 of the BOI Act in 2002, 109 projects were entirely foreign owned, while the others were joint ventures between Sri Lankans and foreign investors. Of the 204 projects, 160 were in the services sector and the other 44 were in the industrial sector, with 14 projects in the food, beverages and tobacco products category. These projects are expected to generate employment for about 2,060 persons. Of the projects approved under Section 16, about 599 projects were in commercial operation as at end December 2002 with a total estimated investment of Rs.26,467 million. The foreign investment component of these projects was Rs.14,941 million or about 56.4 per cent of total investment. These projects were expected to create employment for about 36,601 persons with the 247 industrial sector projects creating employment opportunities for about 23,638 persons.

Local Investment

The local component of the projects approved under Section 17 of the BOI Act increased by 31.3 per cent, mainly due to a significant increase in the approval of projects owned by Sri Lankan investors. As a result, the share of local investment in total approved investment rose to 50.5 per cent in 2002 from 44.7 per cent in 2001. Of the approved local investment component, the services and agricultural sectors absorbed about Rs.16,041 million, while the industrial sector absorbed Rs.16,602 million with the textile, wearing apparel and leather products category absorbing a large share. However, the local component of investment in the contracted projects declined sharply by 64.1 per cent in 2002. The local component of the projects approved under Section 16 of the BOI Act also increased by over 136 per cent, mainly due to a significant increase in the approval of joint venture collaborations between foreign investors and Sri Lankans. The local investments in the services and agricultural sectors increased from Rs.205 million in 2001 to Rs.954 million in 2002. The local component of the projects in the industrial sector under Section 16 was Rs.11,524 million in 2002 compared to Rs.11,526 million in 2001.

According to the Ministry of Enterprise Development, Industrial Policy and Investment Promotion, 1,507 enterprises had been registered with the Ministry at end 2002. Investment in these projects was estimated at Rs.107,856 million and these

TABLE 4.14

Financial Assistance to the Industrial Sector by the NDB and DFCC Bank - 2002 (a)

Categories	NDB										DFCC Bank				Grand Total	
	Refinance Approved under SMILE 2		Direct Finance Assistance (b)		Equity		Total		Loan Approvals		Equity		Total			
	No	Amount Rs. mn.	No	Amount Rs. mn.	No.	Amount Rs. mn.	No.	Amount Rs. mn.	No.	Amount Rs. mn.	No.	Amount Rs. mn.	No.	Amount Rs. mn.	No.	Amount Rs. mn
1 Food, beverages and tobacco products	191	162	108	419	-	-	299	581	109	1,615	1	150	110	1,765	409	2,346
2 Textile, wearing apparel and leather products	50	30	42	213	1	56	93	299	50	452	-	-	50	452	143	751
3 Wood and wood products	54	35	26	45	-	-	80	80	23	48	-	-	23	48	103	128
4 Paper and paper products	36	42	2	2	-	-	38	44	22	197	-	-	22	197	60	241
5 Chemical, petroleum, rubber and plastic products	28	54	107	590	-	-	135	644	38	734	-	-	38	734	173	1,378
6 Non metallic mineral products	-	-	-	-	-	-	-	-	16	458	-	-	16	459	16	459
7 Basic metal products	-	-	9	258	-	-	9	258	5	17	-	-	5	17	14	276
8 Fabricated metal products, machinery and transport equipment	65	56	-	-	1	1	66	57	51	518	-	-	51	518	117	575
9 Manufactured products not elsewhere specified	228	127	378	1,004	-	-	606	1,131	-	-	-	-	-	-	606	1,131
Total	662	506	672	2,531	2	57	1,326	3,094	314	4,040	1	150	315	4,190	1,641	7,284

(a) Provisional
(b) Project and equipment finance loans only

Sources: DFCC Bank
National Development Bank

enterprises have a capacity to generate employment for about 264,652 persons. A larger share of these investments was in the chemical, petroleum, rubber and plastic products category (Rs. 28,965 million), followed by food, beverages and tobacco products (Rs.23,107 million in 169 enterprises), textile, wearing apparel and leather products (Rs.19,476 million in 385 enterprises), non-metallic mineral products (Rs.10,890 million in 75 enterprises) and fabricated metal products, machinery and transport equipment (Rs.9,613 million in 265 enterprises). Of these 1,507 enterprises were registered with the Ministry. About 1,103 enterprises with an estimated investment of Rs.96,463 million, were located in the Colombo District, followed by 190 enterprises with an investment of Rs.6,869 million in the Gampaha District. Accordingly, these two districts account for about 85.8 per cent of the enterprises registered with the Ministry and for 95.8 per cent of total investment.

4.6 Availability of Credit to the Industrial Sector

The industrial sector continued to receive long and short-term credit from commercial and development banks. Commercial banks provided short and medium-term credit at market rates, while the development banks, National Development Bank (NDB) and DFCC Bank, provided long and medium-term credit at subsidised rates under special credit schemes in the form of direct loans and equity participation.

Credit approved by NDB decreased significantly from Rs 5,982 million in 2001 to Rs. 3,092 million in 2002 mainly due to weak credit demand. However, NDB continued to grant credit under the second stage of the Small and Micro Industries Leader and Promotion Project (SMILE 2), which commenced in 2001 with financial assistance from the Japan Bank for International Co-operation (JBIC). Credit amounting Rs.506 million was granted in 2002 under SMILE 2. NDB also granted Rs 2,531 million under direct financial assistance to the industrial sector in 2002. Of the total credit approved by NDB in 2002, 19 per cent was granted in respect of 299 projects in the food, beverages, tobacco products category, 21 per cent in respect of 135 projects in the chemical, petroleum, rubber and plastic products category and 9.7 per cent in respect of 93 projects in the textile, wearing apparel and leather products category.

Credit approved by DFCC Bank in 2002 increased by 47 per cent to Rs. 4,190 million from Rs. 2,432 million in 2001 mainly due to the launching of new credit lines in 2002 and the availability of funds to DFCC Bank under refinance schemes. In 2002, the DFCC Bank approved Rs. 1,765 million in respect of 110 projects in food, beverages and tobacco products; Rs.734 million in respect of 38 projects in chemical, petroleum, rubber and plastic products; Rs. 459 million in respect of 16 projects in non metallic mineral products and Rs. 452 million in respect of 50 projects in the textiles, wearing apparel and leather products.

According to the Quarterly Survey of Commercial Bank Advances and Deposits conducted by the Central Bank of Sri Lanka, commercial bank credit to the industrial sector increased substantially by 11.1 per cent during the first nine months of 2002 to Rs. 37,002 million from Rs. 33,309 million in 2001, mainly due to increased demand for credit on account of higher economic activity and lower interest rates.

4.7 Industrial Policy

Export-oriented industrialisation continued to be the main policy strategy adopted by the government. In order to encourage both domestic and foreign investment to the industrial sector and strengthen regional industrialisation, the government offered a series of incentives, while creating an environment conducive to investment. In addition, the government offered a wide range of incentives to industrialists to encourage them to acquire modern and sophisticated technology in production processes to raise productivity and improve competitiveness. Even after continuation of an export-oriented industrialisation strategy during the last 25 years and provision of various fiscal incentives, the industrial base is narrowly concentrated on a few products, particularly apparel. A diversification of the industrial base on a priority basis is required to face the immediate challenges that will emerge with the end of the Multi-Fibre Agreement in 2005 and to expand the current level of industrial output and employment in the future. It is also important to develop both economic and social infrastructure facilities to international standards to attract foreign investment to upgrade and diversify the industrial base. In the meantime, domestic investment in the industry should also be vigorously encouraged by restricting excessive domestic borrowing by the government, which raises interest rates and crowds out private sector investment, thereby increasing the cost of production and reducing the external competitiveness of domestic manufacturers. It is vital that all provisions in the Fiscal Management (Responsibility) Act enacted in 2002 are strictly followed without slippage to ensure that the government fiscal deficits do not exceed the statutory limit.

The government announced a series of measures during the first half of 2002 to revitalise the economy, especially the industrial sector. It was proposed in Budget 2002 to set up a permanent Tariff Commission to examine and remove anomalies and distortions in the prevailing tariff structure to enhance international competitiveness of Sri Lankan products. As ad hoc changes to the import tariff structure adversely affect the investment and production decisions of the investors, it is crucial that this Commission brings out a clear-cut tariff structure after effective deliberations with industrialists. The tariff regime should be transparent and reveal the future direction of tariff reforms clearly, so that the investors can make well-informed decisions. In order to increase local value addition in the industrial sector and promote backward linkages in the economy, the tariff policy should encourage vertical integration in the industrial sector, rather than encourage industrialists to produce final products with imported raw materials.

A De-regulation Committee was set up in 2001 under the Industrial Promotion Act No.46 of 1990 to study and promote deregulation to make the country attractive to foreign investment. This Committee made several recommendations to the government to overcome bottlenecks that affect business activity and competitiveness of domestic products. The government decided to undertake programmes to deregulate the customs, tariffs and tax administration, labour laws and land and land tittles by simplifying and unifying existing procedures. As the deregulation is a continuous process, the government re-appointed the Committee in 2002 to examine other areas that need to be de-regulated and to monitor the implementation of the recommendations that had been made earlier. It is essential that the recommendations of the De-regulation Committee are effectively implemented, while continuously reviewing the effectiveness of existing regulations. The Deregulation Committee has been integrated into the implementation and monitoring institutional structure of the government's main programme, i.e., Regaining Sri Lanka.

The Master Plan Study of Industrialisation and Investment Promotion, conducted with the assistance of JICA and UNIDO in 1999 to formulate an industrial development plan for the period of 2000-2010, had recommended a series of strategies and programmes for the development of the industrial sector. One such programme was to develop a Techno Park to promote IT related industry, which is considered to be a driving force in the economy in the future. JICA undertook a follow-up study in early 2002 to work out an operational plan for the implementation of the Techno Park in the Greater Colombo Area. The final report of the follow-up study was submitted to the government in March 2002. This report recommended setting up the Techno Park on 158 acres of land at Diyagama in the Homagama electorate. The park will consist of a cluster of IT service industries and electronic/electrical industries, all with close linkages to academic and research institutions.

As almost all manufacturers in the apparel industry employed their workforce beyond the legally stipulated hours, apparel importers in US and EU countries have been insisting that Sri Lankan manufacturers should not flout the labour laws in Sri Lanka to meet buyers' deadlines. In some instances, foreign buyers diverted their purchasing orders to manufacturers in other countries. To overcome this legally stipulated barrier, the government in 2002 amended the Factories Ordinance Act of 1942 (FOA) to permit a female employee to work 60 hours as overtime per month (per annum 720 hours) compared with 100 hours of overtime per annum permitted earlier. Further, in 2002, the government also took steps toward amending the Termination of Employment of Workmen Act No. 45 of 1971 (TEWA), the Industrial Disputes Act of 1950 (IDA) and the Employment of Women, Young Persons and Children Act of 1956 (EWYCA) to make in the labour market more flexible and meet the demand coming from changing market conditions.

In order to overcome the problem of a scarcity of skilled labour in some major industries, the government set up a Skills Development Fund in 1999 with the key objectives of encouraging employers to conduct job entry training, upgrading and re-training their employees and to improve enterprise based training. The government in Budget 2003 proposed to replace this Fund with the Human Resources Endowment Fund with one billion rupees. The objectives of the Fund are to provide tertiary education and vocational training to students and youth who fulfill stipulated criteria, and to upgrade skills such as IT among corporate employees.

There has long been a demand made by the industrialists to formulate a legal framework and set up a special institution to revitalise sick enterprises. Budget 2003 proposed to establish a fund, named, 'Sri Lanka Infrastructure and Corporate Restructuring Fund' to be managed jointly by the public sector and private sector. This proposed Fund would mobilise two tranches of US dollars 75 million each to promote investment in infrastructure and to help restructure distressed companies. The government expects to raise about half the financial requirement from international capital markets. It will receive approximately US dollars 10 million currently in the Private Sector Infrastructure Development Corporation. However, this Fund by itself cannot deal with restructuring sick enterprises in the absence of an effective and efficient legal framework with provisions to deal with the all aspects of restructuring and liquidation.

Under WTO rules and regulations in importing countries, it has become necessary that the manufacturers of export products conform to a variety of standards, especially environment and labour. It is important to educate domestic manufacturers about the rules and regulations that govern international trade and assist them to prepare to face successfully the new trading environment. A National Cleaner Production Centre was inaugurated in May 2002 with the assistance of the Norwegian government and UNIDO. Under this project, 8 workshops and seminars were held in 2002 to create awareness on cleaner production, 12 audits were carried out in factories, and 4 programmes on cleaner production were implemented in 4 industrial estates.

Incentives to the Industrial Sector

It had been alleged that the preferential tax rates offered by the government in the past had benefited only a few enterprises and had resulted in unexpected anomalies. Consequently, it was proposed to rationalise the tax incentives. It was announced in the Budget 2002 that, while existing exemptions would be honoured, no new exemptions would be granted after 31 March 2002. However, new enterprises engaging in non-traditional exports, agriculture, information technology and allied services, electronics, industrial and machine tools manufacture, food processing and other designated enterprises or investments in excess of Rs.500 million in specified industrial and agricultural services, will be exempted from tax during the first three years and will be subject to a 10 per cent tax during the following two years.

In order to assist the domestic garment and textile industries, Budget 2002 proposed to exempt fabric from VAT with effect from 1 April 2002 to facilitate the free flow of fabric from factory to factory or from a factory in an Export Processing Zone to a factory outside such Zone without cumbersome documentation. The exemption of fabric from VAT was expected to simplify procedures and eliminate delays, allowing apparel exporters to respond to buyers promptly. Budget 2002 also announced the imposition of a flat fee of Rs.25 per garment sold in the local market by BOI enterprises, in place of the existing complex mechanisms. Budget 2003 proposed the establishment of a private-public partnership forum of the Sri Lanka Apparel Association to face challenges posed by the abolition of the Multi-Fibre Agreement and to prepare a plan to promote the industry. The government will provide initial capital for design and product development, market support and factory modernisation.

In Budget 2002 the government announced a levy of 1 per cent, called the Ports and Airports Development Levy, on all cargo imported into Sri Lanka. Subsequently, this levy was reduced to 0.75 per cent of cif value for all imports used in processing for re-export, and it was further reduced to 0.5 per cent in Budget 2003 to minimise the effects on the competitiveness of exports.

In order to promote regional growth, it was proposed in Budget 2003 to create five Economic Zones (EZs) out of the 25 administrative districts and set up an Economic Commission for each Zone. A new Board of Investment Act was passed in 2002 by repealing Board of Investment of Sri Lanka Law, No.4 of 1978 to provide for the establishment of the BOI and for the establishment of the proposed five Regional Economic Commissions. A special fiscal incentive package was announced in Budget 2003 for enterprises approved under the new BOI Act, based on regional location. For this purpose, the whole island is classified into two regions - the Western region as Region I and all other regions as Region II. Accordingly, an enterprise in Region I, engaged in the manufacture and export of goods (non-traditional) that has a minimum investment of US dollar 150,000 and exports a minimum of 80 per cent of output will be eligible for a 3 year tax holiday, a concessionary tax rate of 10 per cent for the following two years and 15 per cent tax from the sixth year onwards. In contrast, an enterprise in Region II will be eligible for a 5 year tax holiday, a concessionary tax rate of 10 per cent for the following two years and 15 per cent tax from the eighth year onwards. The expansion of existing undertakings within Region I, with a minimum investment of Rs.100 million or relocation to Region II with a minimum investment of Rs.50 million, will be eligible for a 2 year tax holiday, provided that the investment is fully made before 31 March 2004. Enterprises engaged in industrial tool and machinery manufacturing in Region I, with a minimum investment of US dollars 150,000, will be eligible for a 3 year tax holiday, while similar enterprises in Region II will be eligible for a 5 year tax holiday. In all cases, the tax holiday period will commence from the year of commencement of commercial operations. Similarly, rehabilitated non-performing or under performing industries in Region I and II will be eligible for a 3 year tax holiday and a 15 or 20 per cent tax rate from the fourth year onwards, depending on the activity subject, to the completion of the investment before 31 March 2004.

Budget 2003 permitted unlimited rupee credit facilities to BOI enterprises approved under Section 17 of the BOI Act and controlled directly or indirectly by persons resident outside Sri Lanka. Such credit can be granted only by licensed commercial banks, the NDB or DFCC Bank. The liberalisation also permitted credit facilities up to 360 days to buyers resident in Sri Lanka, by a supplier of goods and services not resident in Sri Lanka, at a rate of interest not higher than international market rates, if the supplier insisted on payment of interest.

Under the 'Restructuring Programme for the Domestic Textile Industry' introduced in 1998 to encourage domestic manufacturers to modernise mills and introduce advanced technology in production processes, a total of 130 applications had been received by end December 2002. Of these, 127 applications had been considered for relief measures. Upon finalisation of the Tripartite Agreement for Debt Recovery, the total debt outstanding of 108 manufacturers, amounting to approximately Rs.3,386 million, was transferred to the Textile Debt Recovery Fund, by end December 2002. By end December 2002, 112 enterprises had submitted restructuring/modernisation proposals. Of these, 34 enterprises had been endorsed by their banks for financial facilities required for the implementation of restructuring/ modernisation proposals. During the year, banks/financial institutions granted loan facilities amounting to Rs.222.5 million to these 34 enterprises to implement restructuring/ modernisation proposals.

4.8 Industry Location

The industrial policy of the government gives priority to minimising excessive concentration of industries in the Western Province and to encouraging the setting-up of industries in backward areas of the country to promote regional industrialisation. Recently, the government took several policy measures to encourage regional industrialisation. However, most of the industries in the country are still located in the Western Province due to various factors such as proximity to the harbour and airport, and close access to product and labour markets. Inadequate infrastructure facilities in other provinces have discouraged the regional dispersion of industries. By end 2002, 86 per cent of all enterprises registered in the Ministry of Industrial Development were located in the Gampaha and Colombo districts. Subsequently, 73 per cent of all enterprises registered under BOI in 2002 were also located in the Colombo and Gampaha districts. Excessive concentration of industries in these two districts has created problems of scarcity of labour, road congestion, escalation of real estate prices, enviromental pollution and congestion in the main cities. The government has taken several steps to assist industry dispersion including the improvement of infrastructure facilities in the remoter districts, under the Industrial Parks/Estates Development Programme, the Dedicated Economic Centre Programme, the Industrial Township Programme and the Mini-EPZ Programme.

BOI has established regional Mini-EPZ's in Mirigama, Walupitiwella, Mirijjawela, Mawathagama, Polgahawella, Horana and Export Processing Parks in Malwatte, Seetawaka and Kandy by providing infrastructure facilities. The total investment under the Mini-EPZ's Programme is estimated at Rs. 5,854 million at end 2002. The employment generation capacity of these industries is estimated at 7,845 persons. Total investments in projects located in the Industrial Parks are estimated at Rs.7,822 million and these enterprises are expected to generate 12,714 employment opportunities. The Information Technology Park located at the World Trade Centre will facilitate IT and software development in the country. The total investment commitment of this project is estimated at Rs.157 million and the employment generation potential is estimated at 807 persons by end 2002. The government has also proposed to set up a Techno Park at Diyagama to promote IT related industries in 2002.

The Ministry of Industrial Development launched a programme to develop Industrial Estates outside Colombo by providing basic infrastructure facilities. This programme was launched to encourage investors to set up industrial units outside the Western Province. Under this programme, the Ministry set up 30 industrial estates in various parts of the country to create employment opportunities for unemployed youth in the regions. The allocation of blocks of land to potential investors to set up industrial units in some industrial estates such as Dankotuwa, Makadura, Kuruwita, Belliatta, Madawala, Lakshauyana, Nawagampura, Kollonnawa, Minuwangoda, Templeburg, Dambadeniya, Ratmalana, Udukawa, Karandeniya and Badulla has commenced. So far, nearly 230 blocks of land have allocated to potential investors. Of these, 110 projects were in commercial operation, employing 9,650 persons.

Under the Two Hundred-Garment Factory Programme, 189 garment factories were in commercial operation in 21 districts at end December 2002, compared with 162 as at end 2001. Of these, 153 factories or 81 per cent were located outside the Colombo and Gampaha districts. The notable feature of this programme was the establishment of factories in difficult areas such as Vavuniya, Battticaloa, Trincomalee, Ampara and Polonnnaruwa. At end December 2002, there were 11 factories in the Anuradhapura District, 15 in the Ratnapura District and 11 in Nuwaraliya Districts, 14 in the Puttlam District and 13 in the Kurunagala District in commercial operation. Under the Fifty-Garment Factory Programme introduced in Budget 1998, approvals had been given for 60 garment factories, by end 2002. Approved projects under this programme were provided with apparel quota and BOI incentives. The criterion for selection of these projects was the intensity of unemployment in the area where the projects were to be located.