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UNIVERZITA KARLOVA


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Bachelor's thesis

# Analysis of the Effects of Sri Lankan 1977 External Economic Liberalization Policy on Foreign Direct Investment

2022

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# Analysis of the Effects of Sri Lankan 1977 External Economic Liberalization Policy on Foreign Direct Investment

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1. The author hereby declares that he compiled this thesis independently, using only the listed resources and literature.

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Prague 01.08.2022 Senya Tennakoon

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# Abstract

The Synthetic Control Method (SCM) provides a comparative case-study evaluation of Sri Lanka and other 18 countries in this research paper. The external economic liberalization policy implemented in 1977 has significant changes in the Inward Foreign Direct Investments in the state. Focusing on the 18 countries, the methodology is being carried out comparing the Inward Foreign Direct Investment towards the level of countries without similar pre-treatment characteristics and liberalization policy effects. The final results show that there is a positive impact of the inward foreign direct investments towards the economic growth through the external economic liberalization policy. Additionally, we identified global and domestic economic shocks affecting the late 20th-century international trade and foreign direct investments. The methodology was performed successfully through a gradual increase in foreign direct investments in the results which were developed towards the policy suggestions.

**JEL Classification:** F21, F43

**Keywords:** Foreign direct investments, synthetic control method, liberalization

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# Acronyms

| | |
|---|---|
| ASEAN: | Association of Southeast Asian Nations |
| EU: | European Union |
| FDI: | Foreign Direct Investment |
| FGP: | Flying Geese Paradigm |
| GATT: | General Agreement on Tariffs and Trade |
| GDP: | Gross Domestic Product |
| IFDI: | Inward Foreign Direct Investment |
| IPZ: | Investment Promotion Zone |
| JVP: | Janatha Vimukthi Peramuna (Political Party in Sri Lanka) |
| MTN: | Multilateral Trade Agreements |
| RMSPE: | Root Mean Square Prediction Error |
| SAARC: | South Asian Association for Regional Cooperation |
| SCM: | Synthetic Control Method |
| SLFP: | Sri Lanka Freedom Party |
| USSR: | Union of the Soviet Socialist Republics |

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# Bachelor's thesis proposal

Politics, Philosophy and Economics

Faculty of Social Sciences

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**Proposed Topic:**

**Analysis of the Effects of Sri Lankan 1977 External Economic Liberalization Policy on Foreign Direct Investment**

**Motivation towards the topic:**

There have been significant changes in the characteristics of the Sri Lankan economy during the times from 1948 operational changes from the colonial features to the economic liberalizations towards the implementations After the implementation of the 1977 economic liberalization policy, the main explanations mention regarding the implementation of export-import orientated industrial policies and outward-orientated economic policies, implementing the floating exchange rate system by removing fixed exchange rates. Additionally, it is attractive to see the determinacies of the market prices through demand and supply forces in the economy with an elimination of controlling policies. According to the 1977 government authority, they introduced the External Economic liberalization policy. The main motivation towards this intervention is, how it affects the inwards foreign direct investments and to what extent does it interfere in a comparative perspective with the countries mentioned in the methodology under the assumptions considered.

**Hypotheses:**

The main hypothesis: After the 1977 External Economic Liberalization Policy although there is an increase in the IFDIs towards the Sri Lankan economy, inquiring the contemporary economic issues in Sri Lanka there are significant fluctuations in the current IFDIs.

Factors affecting the fluctuations:

1. Political environment quality and stability of the government in Sri Lanka
2. Trade openness
3. Huge costs of the Northern-Eastern civil war

**Contribution:**

Regarding the data sources, I will use IFDI of Sri Lanka from 1970-1990 onwards to identify the significant changes. Theoretically, after the 1977 external economic liberalization policy, I will mainly focus upon the political structure of Sri Lanka too using qualitative data. I will develop my methodology through quantitative data in the selected countries with the variables. For this analysis I will get the information from the Sri Lanka's annual reports, BOI Reports and Economic and Social Statistical Reports of the Central Bank of Sri Lanka for the comparison of the time series data. Concerning the regional or country comparison I will collect the data from World Development Indicators such as the World Bank. Analyzing global and domestic influences, I will further develop policy suggestions.

**Methodology:**

The researcher will further use the Synthetic Control Method (SCM) in order to analyze the treatment effect on Sri Lanka inwards foreign direct investments during the pre-intervention and the post-intervention time. The synthetic control approach which is a method commonly used in the public policy and economic areas is an estimator which is implemented in the Synth package in the computing software programming and econometrics. The synthetic control method is a statistical approach which evaluates a quantitative treatment effect by comparing the outcome of a treatment-affected unit's outcome variable to the outcome of a synthetic control group's outcome variable. I will use 18 countries and Sri Lanka for the selected donor pool observation.

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# Chapter 1

# Introduction

The era of the open economy was a massive movement towards a market economy that emphasized the liberalization and globalization of the world. Post-independent Sri Lanka could be considered one of Asia's most promising new nations in regard to economic development when achieving independence from British colonial rule. It became a prosperous, stable economy with high literacy, educational standards, commercial lines, and a stable macroeconomy compared to other Asian countries (Kelegama, 2000, p. 1477) and one of the most open economies in South Asia (World bank, 2003). However, there have been several economic and political complications resulting in fluctuations in the overall economy. In 1977, Sri Lanka embarked on an extensive economic liberalization policy process under the new policy measures.

In this thesis research, the political atmosphere focuses on how the policy regime is implemented and conducted. The liberalization setup includes measures such as export-oriented industrial policies, outward-looking economic policies, investment promotion zones (IPZs), and the implementation of the floating exchange rate system by removing the fixed exchange rate systém, which resulted in new structural changes. Furthermore, I will further analyze the data using the Synthetic Control Approach to examine the effects of the Net Foreign Direct Investments after the 1977 external economic liberalization policy. Considering this method, the trade analysis shows whether the liberalization of the economy in the given years has led to a high-growth performance in terms of foreign direct investments. The comparative perspective of the analyzed data shows how significant the effects are through the performance of the liberalization policy.

In this introductory section, there will be only the introductory description and the organization of the thesis overview structure. The first part of my thesis is the context of the research background which I will explain the brief history of the Sri Lankan economy after 1948, 1977 external economic liberalization policy and the political analysis of the political aspects of the policy. The second part of the thesis is the literature review which focuses upon the review of referenced books, factors, and the overview of the FDIs in Sri Lanka. Furthermore, the assumptions of the hypotheses will be further explained. The third part is based upon the methodology and the data analysis. The SCM approach, the empirical data analysis of the Sri Lankan FDIs and the external liberalization impact through the SCM will be explored. Moreover, The next part will focus upon the policy suggestions, further research area possibility, the final conclusion and my point of view.

# Chapter 2

# Research background

The first chapter will further give an overview of the Sri Lankan economy in the post-independence era. The 1977 external economic liberalization policy will be explained focusing on the implementations and the political aspect.

## 2.1 A brief history of the Sri Lankan economy after 1948

In the beginning of the 20th century. Sri Lanka was under the British colony, which after the British East India Company conquered it, was named Ceylon. As time went by, Ceylon citizens' nationalism grew and as a result, the Ceylon National Congress was created. Under colonial rule, the Ceylon National Congress united and developed a strong bond between Sinhalese and Tamil citizens of the nation. After the 1947 constitution came into effect, it proclaimed that Sri Lankans would gain independence in 1948. So, the British agreed to make Sri Lanka a dominion. After various rebellions, revisions to the constitution, and formulations of political parties, significant changes took place in the country. But after the 1977 constitution was introduced, the Tamils were not satisfied with it. As a result, in 1983, a civil war broke out between the Tamil and Sinhalese communities. This ended in 2009 with a glorious victory for the Sinhalese community. Despite wars and economic lows, in 1986 Sri Lanka was a self-sufficient economy that grew prosperously through a market economy after the 1977 reforms.

As the main periods, the categorization will be upon the years 1948-1960, 1961-1977, 1977-1994 and 1994-2010 in which the main characteristics could be identified. Before Sri Lanka's independence, the decline of its kingdom led to British colonial rule. Independent Sri Lanka experienced promising economic advancement since 1948. From 1948 through 1960, the main characteristics of the economy will be described as follows: the economic development strategy focused more on agricultural improvements, industry, broad welfare programs, and the founding of state-owned enterprises which later expanded toward international markets.

Towards 1961-1977, a pattern of inward-looking economic policy implementation can be identified. Further characteristics included exchange rate reform, the redistribution of property and assets, controlling foreign exchange and the operation of a dual exchange rate system, controlling imports which occurred because of the exchange rate crises, and so on.

After implementing the 1977 economic liberalization policy, the main explanations state the implementation of export-import oriented industrial policies and outward-oriented economic policies, implementing the floating exchange rate system by removing fixed exchange rates. Additionally, it is attractive to see the determinacies of the market prices through demand and supply forces in the economy with elimination of control policies. The policy reforms will be further discussed in the next sub-topic.

There have been fluctuations in the economy since 1994, such as the limitation of foreign direct investments, slow-down in the operation of the share market, direct towards foreign debt, and so on. However, implementing open economic policies tends to strengthen the domestic economy through reforms, too.

## 2.2 External Liberalization Policy in 1977

After the amendment to the 1972 new republican constitution of Sri Lanka, the first election happened in 1977, after which the United National Party (Samaraweera, 1977, p. 1202) came to power under the new prime minister Hon. J. R. Jayewardene. The amendment to the 1972 constitution was passed in 1977.

According to the 1977 Constitution, Hon. J. R. Jayewardene (Warnapala, 1980, p. 916) was sworn in as the first Executive President of Sri Lanka, and Hon. R. Premadasa as the Prime Minister. The new constitution introduces an executive president and a unicameral parliament system instead of the Westminster-style parliamentary system. Afterward, the country was renamed The Democratic Socialist Republic of Sri Lanka. It appeared that the government intended to make constitutional changes within the parameters of the 1972 Constitution when it established a presidential form of government in February 1978 based on the Second Amendment (Warnapala, 1980, p 914).

Chapter XX explains the features related to foreign direct investments in the constitutional status in Sri Lanka, which refers to straightforward principles for state policy (Warnapala, 1980, p. 927). Constitutional provisions included in Section 157 were necessary due to the government's economic policies and to create a Free Trade Zone with foreign investment. According to President Jayawardene, these regulations are required to draw in international investment and attract FDIs. In Sri Lanka, any agreement or treaty approved by Parliament with a two-thirds majority and deemed "important for the growth of the national economy" is enforceable (Warnapala, 1980, p.927).

Regarding the fundamental and extensive economic reforms proposed in the 1977–1978 Budget Speech, the Central Bank claimed that they nearly reversed Sri Lanka's prior policies (Central Bank of Ceylon, 1977). There was a change in the foreign trade patterns, domestic trade patterns, the design and structure of the industry, banking systems, economic institutions, and the economy's financial sector because of the new government power in 1977. The policy prohibiting foreign banks from building branches in Sri Lanka, which had been in place since the early 1960s, was altered in 1977 (Warnapala, 1980, p. 928), and ten new foreign banks opened branches in 1979 and 1980 alone. Great tax advantages were provided to stimulate foreign direct investment. In 1978, the Greater Colombo Economic Commission was founded by statute with powers necessary for the economy's development and revival.

Imports and payments were also liberalized, as were price restrictions and other administrative controls, to allow the market process to function. With economic liberalization, the notion of the privatization of state assets was introduced as an alternative method for boosting private sector activity in the economy.

The economy's direction altered in 1994 as the economic policy changed with the shift of government power. As a result, several changes occurred, including a slight reduction in the economy's openness, adjustments to privatization policies, price stability policies, the removal of unemployment issues, and the strengthening of law and peace.

According to the 1977 government authority, they introduced comprehensive economic reform. The initial phase of the reform will be discussed as follows (Rajcoomar et al., 1996):

- Removing most import licensing requirements, dismantling trade and payment restrictions.
- Unification of currency rates and allowing them to take account of changes in the balance of payments.
- Restructuring the agricultural goods and services prices and export taxes to reduce the import dependencies. Additionally, this may increase resources for the main crop sectors.
- Restructuring and adjusting the prices of necessary consumer goods and services, factors of production inputs, and public services towards the liberalization process.
- Reforming the governance arrangements to promote investments in the state.

- To encourage the saving and a more sensible distribution of credit, liberalizing interest rates and central bank lending should be reduced towards a more rational allocation of credits and promote savings.

According to the economic response to the 1977 liberalization, the economic policies implemented in the first half of the 1980s were mainly meant to advance macroeconomic stability. The government introduced further stabilization packages, supported by a standby arrangement with the IMF (Rajcoomar et al., 1996). Furthermore, to stabilize and adapt, the authorities had anticipated advancements throughout 1987. However, their economic objective was to cut the entire deficit of GDP spending by 1.5–2%. As with its central policies, the government actively used the exchange rate policy for the stabilization program. Second, to reduce their reliance on credit restrictions, reserve requirements, and administered interest rates as the primary policy instruments, the authorities started using market-related monetary policy instruments (Rajcoomar et al., 1996). Mainly open-market operations were conducted. In 1988, the government further developed a medium-term adjustment to reduce domestic and external macroeconomic imbalances. This may have further pointed toward growth. The three-year arrangement supported this under the IMF's Structural Adjustment Facility (SAF) (Rajcoomar et al., 1996).

One of the main objectives of the open economic policy in Sri Lanka is to achieve a higher level of financial performance through outward-looking development strategies. Furthermore, it is essential that the government assign reforms to three main Free Trade Zones as investment promotion zones. These three leading projects were the Free Trade Zone (FTZ), the Accelerated Mahaweli Development (AMD), and the Housing and Urban Development Program. These investment zone initiatives would significantly impact the creation of jobs, the expansion of agriculture and food self-sufficiency, the production of hydropower, exports, and increased foreign exchange revenues (Rajcoomar et al., 1996). However, the main concentration is on creating a new and dynamic export-oriented industrial sector. In addition, this is also assisted by foreign capital with local collaborations with the Katunayake Investment hub, which expanded to different cities in Sri Lanka (Rajcoomar et al., 1996).

# Chapter 3

# Literature review

In the literature review, I will convey to the reader the overview of FDIs, and the introduction of the FDIs in Sri Lanka. Then we proceed to how the factors influence the IFDIs. Moreover, I will provide how the assumptions and the hypotheses developed. The last section will focus on the awakening of the FDIs through trade openness and liberalization toward the economic growth of a state.

## 3.1 Colonialization towards a structural change in the economy

Sri Lanka has been a trading hub since its early history, as it was situated in the middle of the maritime silk route from China to Europe. Trade was based on products such as jewelry and textiles, cinnamon, cloves, pepper, cardamom and other spices, elephant and horse trade, tea, coconut, rubber, and so on. During the British colonial era in the early 20th century, Sri Lankan citizens created plantations for the main crops of tea, coconut, and rubber. As the world developed due to the prevailing economic conditions, transportation improved. As a result, it was much easier to continue with domestic industries with the emergence of new technological progress.

Under the British colony, the British powers tried to get maximum use out of exports, exporting a range of natural-resource-based products. But after the independence in 1948, there were further reforms and measures. Sri Lanka has contracted since 1948 with the General Agreement on Tariffs and Trade (GATT). Sri Lanka has bound all tariffs on agricultural products. Moreover, for many years there have been tariffs and import duties as a source of government revenue and as a means of being instrumental for speedy economic growth, supporting and protecting some selected domestic industries. Another fact we can identify in the few years after gaining independence is that there were high barriers to trade, for instance, during 1950 to 1955 the import of crops needed to be accompanied by government-allowed import permits which were rarely given in order to protect the domestic agricultural industry. As a result of promoting trade liberalization in the world, different tariff structures were modified. According to the GATT objectives, Sri Lanka tends to liberalize imports and exports as a developing country for the purpose of earning foreign currency. Additionally, the export of goods and services during the late 20th century increased revenues and further increased job opportunities, which raised the living standard of the citizens.

State interventionism refers to a policy in favor of government intervention in the economy. Under state interventionism, expropriation refers to a process in which the state takes property from its owner for the public welfare. The Sri Lankan community in the 20th century used different levels of state interventionism policies in order to deal with the problems of crop damage. Some implemented interventionist solutions can include the Pigouvian tax on the animals, cattle and buffalos, also there were regulations implemented regarding the liability for crop damage to the farmers including provisions to enforce the liability via state intervention. Additionally, there were laws and regulations that forbade livestock keeping in cropping areas and other forbidden areas.

One main result of the expropriation process was that in 1961, the parliament of Sri Lanka created a state petroleum corporation, and it became competitive. This corporation competed with American and British companies. It gained competitiveness through the expropriation of some facilities of the foreign organizations. After this, there was a confrontation with the oil companies, other financial institutions, financial companies, the world bank, British government and the United States government as Ceylon went against The Hickenlooper Amendment and was the only country that was against it. The Ceylon government required the suspension of foreign aid to any country expropriating American property without any compensation.

The 1972 reforms concerning land rules and regulations were revolutionary for the Ceylonese. Since the early 20th century, land has been under the control of the state through different ordinances and acts, legislations and regulations. The land policies were introduced in order to increase growth and development. The aim of these land policies and reforms was that the liberalization of the land market would further increase the efficient usage of land. This could further motivate private sector investment and, as a result, the government would earn high economic returns and could create the potential to improve income distribution. The first ordinance was in 1935 during the colonial period and it said that the land commissioner's department has their own right to control and alienate the use of lands. There were additional acts that affected the facilitation of irrigation requirements, dry zone land developments, soil conservation, rubber and tea lands and also the land owned by the temples. After Sri Lanka's independence, reforms were focused on state lands relating to individual cultivation, agricultural productivity, economic liberalization policies, implementations of new lands to the new farmers, granting lands, permitting mortgages of lands, the sale of land and so on.

State ownership means that the government or public body owns the assets and resources. After the incitement of globalization and liberalization, the privatization of state-owned plantations was implemented in the year 1995. Under the British colonialists, state ownership and resource ownership were handed to the Europeans, Semi-Europeans, high-class Buddhist Sinhalese, Burghers and Tamils. After the independence movement and as a result of the global shift, the command-based economies became market economic systems. Privatization was one of the most important strategies. According to the three dimensions of privatization, the main components are ownership, competition and regulation. It can be argued that as a market economy, the Sri Lankan government utilizes private ownership as the ownership of resources and as the means of production.

- Colonial economic policy under the British commonwealth (1900-1948)

Under British colonization, the colonial economic policy was based on the reform of welfare policies and the worldview of colonial administrators and local political elites which was impacted by the ideological milieu of British colonial policies (Sinfield et. Al, 1977). Moreover, the 20th century late colonial policies were especially influenced by social liberalism and early Fabianism.

In my point of view, the expansion of European capitalist modes of production were not developed in countries such as Sri Lanka as third world countries because they were too accustomed to the existing modes of production. However, according to the research, the factors of production depended on labor specialization and were influenced by the monarchic system in Sri Lanka in the early 90s. The main elements of European feudalism, such as subinfeudation and the connection between land tenure and military service, did not exist in Sri Lanka (Silva, 2005, p.44). The researcher identifies it as a notion which relates to modernity and development. He further develops the statement that in the first two decades after independence, administrations of all party stripes continued to conceive of a "welfarist" vision of the functions of government and an egalitarian liberalism (Jayasuriya, 2001, p.11). Additionally, the development of a civil society during the final decades of colonial rule, the period of partial self-rule, was a reflection of the late colonial state's relative autonomy and gave rise to a radicalized working class, trade unions, and a variety of nationalist and religious organizations (Jayasuriya, 2001, p.53). Again, it could be deduced that the features show partial democratization through universal franchise and limited indirect rules on the economic and political reforms. Furthermore, regarding the agricultural and manufacturing sector, the reforms maximized repatriable revenues and direct government expenditure to meet the infrastructural demands of the plantation sector, such as transportation and communication, greatly influencing the policies of the colonial state (Shanmugaratnam, 1981, p.73). The Donoughmore Commission's suggested constitution came into effect in 1931 onwards (Jupp, 1970, p.74) in which the following characteristics were mainly reformed.

1. Reduction of the governor's authority.

2. Community representation was eliminated.
3. The creation of a cabinet and the Executive Committee System
4. Expansion of the territorial representation
5. The State Council's formation.

- Substitute economic policy

This study explained follows will be based upon the economic reforms between the period of 1948 to mid-1970 which orientates from a capitalist economy to a planned economy. Throughout the first three decades following independence, the colonial export structure remained largely unchanged. In which the author shows that only 4% of all exports in 1977 came from manufacturing (excluding petroleum items), with the remainder coming from traditional goods like tea, rubber, coconut, and other basic commodities (Athukorala et al., 2017, p.115). Because of the improvement in the balance of payments position brought on by the increase in commodity prices during the Korean War, the colonial government's import restrictions were lifted in the early 1950s (Athukorala et al., 2017, p. 7). It can be deduced that several global economic dimensions affected the economic fluctuations in Sri Lanka.

S. W. R. D. Bandaranaike's government was comparatively similar with British reforms when it came to power, and political participation had clear strategic and financial advantages. However, sociocultural phenomena aiming towards nationalism became the main platform on which the party was built. There was a further environment of alienation, transformed gradually into one of discrimination (p.291). A coalition government was created, which resulted in economic difficulties which, in turn, made the tendency for discriminating politics worse (p.291).

This coalition further developed towards economic polarization. Kadirgamar argues that the United Front government (1970–1977), a coalition that included the SLFP and the other left-leaning parties, not only put an end to the JVP uprising but also implemented policies that increased ethnic polarization. After joining the ruling coalition, the left used the SLFP's majoritarian political philosophy to further its economic agenda (Kadirgamar, 2020, p. 57).

Arguably, the citizens in Sri Lanka had the thought of being suffered under the colonization, however, according to the evidence, the instrumentalist views of the state insist that the nationalist enterprise was reconstructed (Krishna, 1996, p.314). Accordingly, this further developed towards a majoritarian postcolonial nationalism. In addition, author states that with the instrumentalist view of the state, the nationalist enterprise re-defined and reconstructed political relations of the state in such a way that ethnic relations would be reordered in a new hierarchical pantheon soon after the independence in 1948.

Considering the main policy mentioned, this policy is a 10-year plan imposed based upon socialist reforms. This substitution economic policy was created to maximize the manufacturing sector and to propose an import substitution strategy to initiate industrial growth achieving a socialist society (Nithiyanandam, 2010, p.292). Furthermore, the author Kadirgamar argues that, The Sri Lanka Freedom Party (SLFP) allied with the Soviet Union, including through active interaction in the Non-Aligned Movement, and substituted pro-Western economic measures with import substitution strategies (Kadirgamar, 2020, p. 55).

However, with the influence of ethnic politics, Sri Lankan economy resulted in disastrous consequences in unconventional methods in salvation, economic reforms failing one after the other, wanting of supportive measures, so on. The Warnapala further explains how declined the policy effect was stating that the unemployment level was as expected as an under-developed semi-colonial economy which is still dominated by capitalist interests (Warnapala, 2011, p. 236). Furthermore, the leading political parties eventually realized how serious the issue was and Welfare measures were essential if they were to maintain their popularity and increase their prospects of winning reelection. On the other hand, the very presence of these policies stands in contrast towards effective economic management (Nithiyanandam, 2010, p.293). Comparing and contrasting the substitution economic policy brought out important contradictions within constituencies, including between Colombo-centered elites and regional elites and other effects. But The SLFP promoted nationalist policies, which accelerated up the development of Tamil nationalism and increased Tamil demands for autonomy under a federal system which created political conflicts (Kadirgamar, 2020, p. 55).

- Towards a structural change and neoliberalism?

Identifying the deficiency of the previous governmental systems mentioned in previous section, the constitution identified it requires a structural transformation. Drawing connections towards colonialism and neoliberalism, President J.R Jayawardana made the structural shift towards the

1977 external economic liberalization policy shifting away from the socialist orientated market system. In addition, Shastri mentions that liberalization initiatives in Sri Lanka have been regarded as executing a boundary shift away from the state's central authority resource allocation and in favor of the market (Shastri,1997, p.487).

## 3.2 Overview of FDIs

Global FDIs are showing a strong rebound in the current world as a result of induced globalization, as FDI is a major driver of globalization. According to the OECD definition of FDI (OECD benchmark definition of foreign direct investment – fourth edition), the FDI refers to an investment in which an investor resident in one economy establishes a lasting interest in management and control over an enterprise resident in another economy. The OECD suggests defining a direct investment enterprise as an incorporated or unincorporated business where a foreign investor holds 10% or more of the voting power or common shares of an incorporated business, or its equivalent in an unincorporated business.

In simple terms, it refers to when a company takes controlled ownership in another entity of another foreign state. This investment in another entity could be done indirectly or as a direct investment too. According to the author Froot, he states that between the past decade, there is a major increase of international capital transfer (Froot, 1993, p 1) between countries flowing FDIs as cross-border expenditures to acquire or expand the management and control of productive assets.

Different types of FDIs are a broad topic and will not be the main focus of this paper. I will briefly explain what authors say about FDIs as an introduction and the arguments for it. Kurtovic, Borislav and Jokic discuss horizontal foreign direct investments in developed countries. As a critical overview, it is interesting how this type of FDI can be identified even in less-developed countries and other transition economies too. The definition of a horizontal form of foreign direct investment is one that avoids traditional trade flows by having a parent business start manufacturing in several different nations from which local markets are supplied (Kurtovic, Radevic and Jokic, 2012, pp 370-378) . Kurtovic, Borislav and Jokic mention that this method is mostly used in developed countries where there is a similarity of economic development and market size. This could benefit less-developed countries in ways such as a technological transfer, transferring business philosophy and mobility of workers. However, vertical FDI occurs when the investment is made within the supply chain, indirectly in the same industry. Braconier, Norback and Urban, state that despite this, relative factor costs are important (Braconier, Norback and Urban, 2002, p.25) when it comes to the types of FDI patterns in which countries invest. With vertical FDIs, countries stress the relative factor costs and fragmentation of production between countries. In a situation such as a joint venture, a conglomerate FDI method arises as a company invests in a foreign business that is unrelated to the core business. In free-trade areas based on low-cost locations, export platform FDI can be recognized. Nguyen and Minda investigate how the Vietnamese economy integrates through this export-platform FDI strategy based on factors such as relative labor costs, regional transport costs and market size.

## 3.3 Research in influencing factors of FDIs through empirical evidence

The openness and liberalization of an economy affects foreign direct investments. When it comes to fast-growing economies, developed economies and developing economies, the factors influencing foreign direct investments can differ. Over the past several years, different authors have used empirical evidence, qualitative and quantitative research to investigate the relationship between the determinants of IFDI towards the economic growth of a state.

According to the scholars who study FDIs, the main factors which influence FDIs in a state are government stability, market strength, institutional policies, law and policy implementations, technological advancements, market scale and market size and infrastructure. According to the World Investment Report, UNCTAD 2018 and 2002, the classification of the main FDI determinants will be summarized as follows in table 1.

Table 1:

| **The main determining variables** | **Examples under the main variables** |
| --- | --- |
| Policy variables | Tax policy, trade policy, privatization policy, macroeconomic policy |
| Business-related variables | Investment incentives |
| Market-related economic determinants | Market size, market growth, market structure |
| Resource-related economic determinants | Raw materials, labor cost, technology |

| | |
|---|---|
| Efficiency-related economic determinants | Transport and communication costs, labor productivity |

Source: UNCTAD (2002) and UNCTAD (2018)

### 3.2.1 Market scale and market size

According to Akpal, Asongu and Isihak, market size is an important determinant of IFDI for BRICS and MINT countries as the GDP coefficient is positive according to their research in the panel analysis procedure using data from 2001 to 2011 (Akpal, Isihak and Asongu, 2014,p.2). Market size is a factor which directly affects investment returns and profitability. According to the author Ho, larger market growth indicates potential for a larger market and more promising prospects for products produced (Ho, 2013, p.3). According to the model developed by the author Ho, FDI flows in China are significantly impacted by market size. Greater market size would draw international investors looking for new markets in China (Ho, 2013, p.9). In addition, the authors Agosin and Machado quantify the degree of openness of 111 developed, developing, and transitional nations, and provide an ordinal indicator of that openness (Agosin & Machado, 2007, p.1235). They further assert that FDI is made possible by openness. By applying multiple regression analysis, the authors Petrović-Ranđelović, Janković-Milić and Kostadinović state that statistically, the variable population size had the biggest relative influence on foreign direct investment inflows (beta coefficient of 0.569), although market size and market growth had statistically significant impact on those inflows (Petrović-Ranđelović, Janković-Milić and Kostadinovic, 2017, p. 102).

In Malaysia, China, and Russia, market size significantly influences FDI, but not in the other nations (Ho, 2013, p.10). In the majority of BRICS nations as well as Malaysia, market size, interest rate, literacy rate, economic independence, and infrastructure quality are crucial characteristics that influence FDI (Ho, 2013, p.10). Empirical research by Bevan and Estrin from 2004 using a panel dataset and a random effect states that unit labor costs, country size, and proximity between host and home countries can all have differing effects on FDI between established Western countries and transitional nations.

### 3.2.2 Trade openness of the economy

The authors Wilhelms and Witter mention that trade openness is essential (Wilhelms and Witter, 1998, p. 33) and as a result, there will be less or no direct rules and regulation, especially no controls on currency exchange, imports, or exports (Wilhelms and Witter, 1998, p. 33). Trade volume and FDI have a strong, positive correlation according to their research upon regression analysis in econometric cross-section across 67 emerging economies. In addition, Hussain and Haque investigate yearly time series data from 1973 to 2014 through the Vector Error Correction Model (VECM), this study examines the link between foreign direct investments, trade, and Bangladesh's growth rate of per capita GDP. They came to the conclusion that the study demonstrates that trade openness, FDI, and economic growth have good effects on Bangladesh. Moreover, Farshid et al. (2009) using the augmented production function (APF) growth model, concluded that rising levels of foreign direct investment have a favorable influence on the economies of Thailand, Korea, and China. However, Malaysia and the Philippines are negatively impacted by this. The effect of trade on economic growth achieves the same outcome as the influence of FDI. In addition, Thanh, Canh and Schinckus argue that according to their findings, the combined effect of inward FDI with trade openness has a substitute effect on the economic growth, but a positive impact if taken separately. Additionally, the combined impacts of free trade and foreign direct investment have a major impact on enhancing economic growth. The link between economic institutions, FDI, and trade may be addressed by designing macroeconomic policies with the support of these results. The findings encourage decision-makers to think broadly about an economic growth plan. They considered the approach of GMM using a two-step approach on a sample of 63 Vietnamese provinces from 2005 to 2015 (Thanh, Canh and Schinckus, 2019, pp. 244-259).

Another very strong conclusion is that FDI is discouraged by high taxes, particularly trade tariffs in developing nations (Wilhelms and Witter, 1998, p. 33). These findings show that selecting a free trade and investment policy may bring a nation significant FDI benefit (Wilhelms and Witter, 1998, p. 33).

### 3.2.3 Infrastructure

Furthermore, in relation to infrastructure there is a positive robust correlation with FDI which offers another way for governments to attract more foreign direct investment, specifically through infrastructure development (Wilhelms and Witter, 1998, p. 33). In addition, the authors examine the relationship between FDI input and India's overall infrastructure, as well as its different sub-indices of infrastructure and sectoral FDI inflows through Granger causality and both linear and nonlinear cointegration. Additionally, the empirical findings suggest that higher

FDI inflows in India's primary sector, services sector, and industrial sector are most likely to occur in the long term with increased quality and availability of infrastructure stocks. Furthermore, according to the authors results they identified that there is a long-run, bidirectional link between infrastructure and FDI by using the ARDL cointegration approach in which the sectoral distribution of FDI in China is positively impacted by infrastructure (Mehmood et. al, 2021, p.171). According to infrastructure indicators, the author uses, infrastructure indicators, such as fixed telephone, fixed broadband, mobile cellular, railways, rail lines, air transport and liner shipping connectivity and then get into a result in which it indicates higher infrastructure levels resulting with higher levels of foreign direct investment. This finding holds true even after we included additional infrastructure-specific factors in the models (Unver & Koyuncu, 2016, p.815-822).

### 3.2.4 Economic and political stability

Through the macroeconomic stability of a country, without sudden fluctuations, investors gain confidence in the investment. The author Shah identifies that instability in the macroeconomy of the state discourages foreign investors through an annual panel data analysis of 90 developing countries (Shah, 2014, pp. 10-11).

As the author Biswas mentions, the final decision of the investor will be based on the integrity and stability of the country’s economic and political climate to a large extent (Biswal, 2002, p. 501) according to the empirical evidence. However, the authors Akpal, Asongu and Isihak mentions that by making more investments in their human capital, RICS and MINT countries must also make sure that their economies absorb significant skills and technology spillovers from IFDI.

This will help to create sustainable long-term economic growth towards the human capital (Akpal, Isihak and Asongu, 2014, p.2).

Additionally, Biswas explains two methods of determinants categorized as traditional variables and non-traditional variables (Biswas, 2002, p. 492) which influence FDI in a country. The author further mentions that according to her final research, the final investment equation of the theoretical model includes both traditional and nontraditional determinants interactively, suggesting that the traditional and nontraditional factors interact and jointly affect FDI (Biswas, 2002, p.496). Other than that, state-based factors and non-state based factors can affect IFDIs in a country.

# 3.4 IFDI Sri Lanka

It can be observed that Sri Lanka introduced different reforms after the changes in the government in 1977. According to the table attached below, it can be deduced that IFDI rapidly increased. As a less-developed country, the determinants of the IFDI may vary compared to other countries that are developed and newly-emerging transition economies. The growth rate as a percentage of GDP is an important indicator of how an economy is performing. Foreign direct investment, net inflows (% of GDP) in Sri Lanka after the liberalization policy in the year of 1979 is 1.4 depicted in the below graph, which is a drastic increase compared to the pre-treatment era.

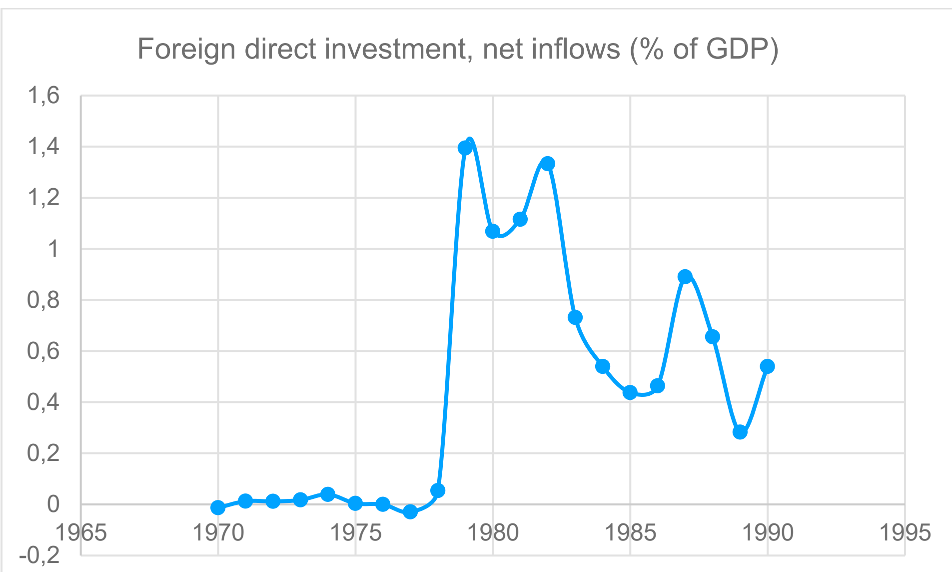
After the 1977 economic liberalization policy, the results depicted in the table show a strong increase of the IFDI. In 1976, the IFDI inflows according to current US$ are approximately 1,000 which further increased to 1, 474, 392 by the year 1978. According to the state adjustments and reforms, the IFDI further increased to 46, 911, 742 by the year of 1979. The above figures are depicted according to the current US$ value. The results are depicted in the table.

The Fully modified least squares (FM-OLS) regression model suggests that GDP growth rate, government expenditure, the lending interest rate, the trade balance and the corporate income tax rates are the significant determinants of the FDI during the time period from 1975 in which the data is analyzed (Jayasekara, 2014, pp. 10-11).

According to many researchers, market scale is one of the main long-run factors which determines the IFDI. The portion of the prediction variation that may be attributed to GDP innovation grows gradually over time. This demonstrates that FDI inflows into the host country are significantly influenced by market size (Wijeweera and Mounter, 2008, p. 196). In addition, he states that wage rate is also a vital determinant of the IFDI according to the vector autoregressive methods (VAR) model in relation to the macroeconomic variables. It is important that the author identifies growth in labor productivity is essential for Sri Lanka to maintain this comparative advantage, nevertheless. Increases in wage rates would eventually affect Sri Lanka's appeal as a location for international investment. However, the market size and the growth of the economy will have a positive impact on the IFDI inflows in the long run in which in the short run a strong positive relationship cannot be identified (Wijeweera & Mounter, 2008, p.195).

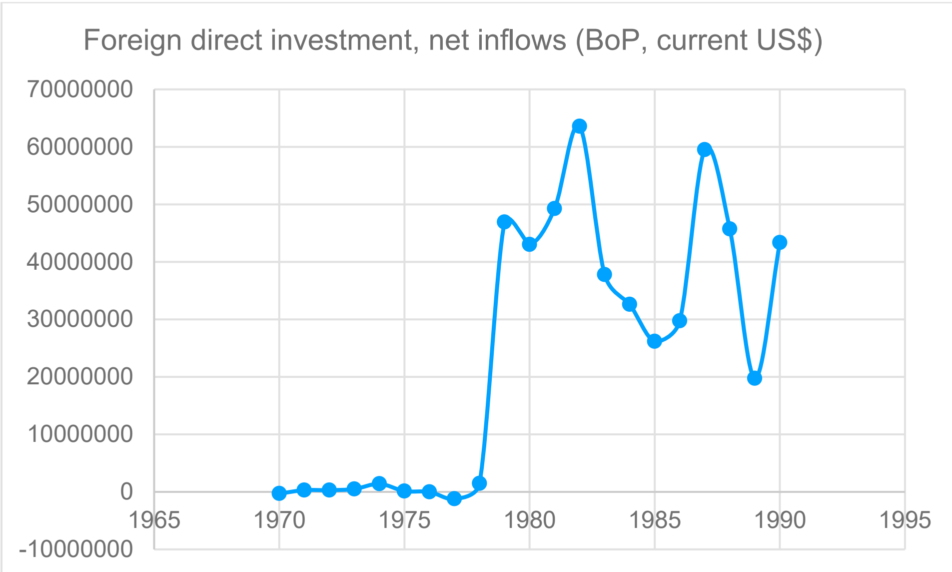
Exchange rate and inflation were the main determinants of the final results conducted by the regression model. However, military expenses were also an independent variable in the analysis. The goal of the methodology was to determine how FDI inflows were impacted by GDP growth, the exchange rate, inflation, and military spending. The significance of all four factors in predicting FDI inflows was established (Amarasinghe, 2019, pp.8-9). According to my point of view, the defense budget influenced the relationship between the war conflict and IFDI through the inter-war period.

Figure 1:




The figure 1 and figure 2 depicts the gradual increase of the inward FDIs as a percentage of the Sri Lankan GDP and as the (BoP, current US$). The time period shown in the figure is from 1970 to 1990 in which the main liberalization effect is being identified.

Figure 2:




## 3.5 Assumptions and hypotheses

As the main hypothesis of the research is that there will be an increase in the IFDI in Sri Lanka after the implementation of the liberalization policy. Additionally, the primary causal hypothesis which is explained in the following table explains the interference with the IFDI effects.

There will be four hypotheses that will be determining the final effects of the research. The following qualitative analysis and assumptions are based on the literature review and the particular circumstances of comparable nations.

Table 2:

| Hypothesis | Correlation with IFDIs |
|---|---|
| 1. Political environment quality and stability of the government in Sri Lanka | Positive |
| 2. Trade openness: The new trends and the economic development which occur in the world economy | Positive (Explained in the next sub-sector) (not a part of the literature review) |
| 3. Huge costs of the Northern-Eastern civil war | Negative |

- As explained in the section above, the economic stability and the political environment highly determine the IFDI growth. However, there had been several domestic shocks which resulted in IFDI fluctuations. In the 1950s, Sri Lanka had a capitalist framework and in the 1960s, it adopted elements of a planned economy. In the middle of the 1970s, Sri Lanka began using market-based growth strategies (Nithiyanandam, 2010, p.283). Further, he argues how the achievements of such slight policy changes are inefficient and ineffective. However, he identifies the main cause as that Lanka's ethnic politics, which it has been involved in since colonial authority ended. The political stability was affected by the JVP, when they launched an abortive insurrection which further made power by force in 1989 onwards (Moore, 1993, p. 593). However, as consequences, the human costs, societal consequences and extirpation were corresponding greater (Moore, 1993, p. 593).

As this movement of the accumulation of state power in 1988 and 1989, conflicts among the political parties aroused.  In global economics, researchers state that there is an increase of internal political conflict and consequent civil war in developing and emerging nations (Abeyratne 1998, Bardhan 1997, Gurr 1993) in their articles. Another evidence for the instable political and economic arena in Sri Lanka is that the 10-year plan which is discussed in the literature review, it is reviewed as an effective long-term growth strategy. However, many reforms of the plan was not implemented. Furthermore, the author demonstrates how the plan got entangled with nationalism and ethnic politics (Nithiyanandam, 2010, p.292). In addition, according to the overall impact of the 10-year planned reforms, it led to discrimination against and deprivation of the Tamil ethnicity in Sri Lanka which further affected to the socio-economic status (Nithiyanandam, 2010, p.293). During the postcolonial period, the nationalism and majoritarianism contributed to the ethnic polarization as discussed in the previous chapters. Towards the unstable politics and economic, the polarization undermined the impartiality and effectiveness of Sri Lankan institutions which the institutions affect the democracy of the country. Political parties are under a substantial pressure to support ethnonationalism as a result of polarizing circumstances (Kadirgamar, 2020 p. 61).

- The violence of the continued polarization and consolidation resulted in the civil war between the government and the rebels (Sonia, 2022, pg. 6) affecting the micro and macroeconomics in the state. Kadirgamar comments upon how the LTTE wiped out all opposition within the Tamil community and took sole control of the nation, while nationalist and militarized factions ascended within the Sinhala community (Kadirgaman, 2020, p. 58).

- Civil war declines and affects an economy through, increase in the military spending. Through the method of financing the wars, it will determine the war impact upon the factors influencing the growth of a country. (Grobar and Gnanaselvam, 1993, p. 398). Through war or other factors could influence upon government debt. For instance, the government will increase the funds through loans, central bank, domestic and abroad funds, NGOs.

# Chapter 4

# The methodology and the data analysis

In this section, the Synthetic Control Methodology explains and evaluates the effect of the Sri Lankan liberalization policy. There will be main subsections of this chapter which will focus upon the introduction to synthetic control method (SCM), an overview of comparative case study in which the SCM was used and the empirical data analysis of the case study which is being investigated in Sri Lanka.

# 4.1 Introduction to the Synthetic Control Method

The synthetic control method is a statistical approach which evaluates a quantitative treatment effect by comparing the outcome of a treatment-affected unit's outcome variable to the outcome of a synthetic control group's outcome variable. The weighted outcome of all alternative comparison units that most accurately captures the features of the situation under investigation provides the missing counterfactual outcome. (Abadie et. al, 2010, pp. 494-500).

In the comparative case study selection in the research, the effect of the liberalization policy in Sri Lanka is analyzed. In which, it is a comparative analysis of the liberalization and open economy effect level in Sri Lanka which introduced the reform of external-economic liberalization policy with the weighted countries in which there has not been countries with the similar pre-event characteristics as Sri Lanka. To proceed further, the mathematical model of the Synthetic Control Method will be explained as follows.

Assume that there is a panel of $j + 1$ units which can be countries, regions firms, aggregate entities or administrative areas. This balanced panel depicts the county indexed by $j$ in which $j = 1$ is the case study of interest (the treated unit) and the potential comparisons of the panel of countries dataset named as "donor pool". The units which are $j = 2$ to $j = J + 1$ is the balanced panel of data which are not affected by similar characteristics. It can be assumed that the data panel is balanced, longitudinal and all the units are examined by the same time period in which the model measures the effect of the intervention of interest upon the post-period outcome of the intervention. The values and the equations can be identified as follows.

$$\alpha_{it} = Y_{it}^{I} - Y_{it}^{N}$$

(1)

The time periods can be observed as $t = 1, \ldots\ldots T$. Assuming that $T_0$ is the numerical value of the pre-treatment era with towards $1 \leq T_0 < T$. In the above equation, the SCM estimates that $Y_{1t}^{N}$ is the weighted average of the donor pool under synthetic control. The $Y_{it}^{I}$can be identified as the outcome at a given time $t$ for the unit $i$, if the $i$ unit is exposed towards the policy intervention from $T_0 + 1$ to $T$. The $t = T_0$, $J_{1t}$ is the main outcome of the country $j = 1$ in which $Y_{it}^{N}$ is the outcome that will be observed to the region $j = 1$ at the time where $t > T_0$ and the observation of the absence of the policy. Assuming that there is no effect towards the outcome before the treatment, $t \in \{1, \ldots, T_0\}$ and $i \in \{1, \ldots, N\}$. From this we could obtain the following.

$$Y_{it}^{I} = Y_{it}^{N}$$

(2)

Furthermore explained, assuming that $D_{it}$ as an indicator if unit $i$ is exposed to the intervention at time $t$, the indicator takes value one; otherwise, it takes value zero. The result that was seen for unit $i$ at time $t$ is derived as follows.

$$Y_{it} = Y_{it}^N + \alpha_{it} D_{it} .$$

(3)

As the state of interest is exposed to the intervention treatment after the period of $1 \leq T_0 < T$, this can be derived as follows: $D_{it} = \{ \begin{matrix} 1 \\ 0 \end{matrix}$ if $i = 1$ and $t > T_0$ and otherwise. Moreover, the estimator of $\alpha_1$ at the given time period $t$ is determined by the difference between the treated unit's and the synthetic control's results at that time as the following:

$$\alpha_{1t} = Y_{1t}^I - Y_{1t}^N = Y_{1t} - Y_{1t}^N.$$

(4)

Assuming the $Y_{1t}^N$ is given by the factor model,

$$Y_{it}^N = \delta_t + \theta_t Z_i + \lambda_t \mu_i + \epsilon_{it},$$

(5)

The following will be the explanations which identifies each variable.

$\delta_t$ = An unknown common factor with constant factor loadings across units

$\theta_t$ = $(1 \times r)$ vector of unknown parameters

$Z_i$ = $(r \times 1)$ vector of observed covariates, which were not affected by the treatment

$\lambda_t$ = $(1 \times F)$ vector of unobserved common factors

$\mu_i$ = $(F \times 1)$ vector of factor loadings

$\epsilon_{it}$, = Error term

Each specific value of the vector W, or a certain weighted average of control zones, indicates a potential synthetic control. For each artificial control indexed by W, the value of the outcome variable could be defined by the equation as follows. Each of the potential vectors W represents a potential synthetic control, as noted by (Abadie et al. in 2010). Each synthetic control's outcome variable is indexed by W.

$$\sum_{j=2}^{J+1} w_j\, Y_{jt} = \delta_t + \boldsymbol{\theta_t} \sum_{j=2}^{J+1} w_j\, \boldsymbol{Z_j} + \boldsymbol{\lambda_t} \sum_{j=2}^{J+1} w_j\, \boldsymbol{\mu_j} + \sum_{j=2}^{J+1} w_j\, \epsilon_{jt}.$$

*( 6 )*

Additionally, assuming the equation of $w_2^*, \ldots .\, w_{J+1}^*$ the following set of weight equations could be gained as the following.

$$\sum_{j=2}^{J+1} w_j^*\, Y_{j1} = Y_{11}\,, \quad \sum_{j=2}^{J+1} w_j^*\, Y_{j2} = Y_{12}\,, \quad \ldots,$$

$$\sum_{j=2}^{J+1} w_j^*\, Y_{jT0} = Y_{1T0}\,, \qquad and \ \sum_{j=2}^{J+1} w_j^*\, Z_j = Z_1 \ .$$

*( 7 )*

Furthermore, according to Abadie et.al (2010) proves that when the equation $\sum_{t=1}^{T_0} \lambda_t' \lambda_t$ is non-singular, the following equation can be derived.

$$Y_{1t}^N - \sum_{j=2}^{J+1} w_j^*\, Y_{jt} = \sum_{j=2}^{J+1} w_j^* \sum_{s=1}^{T_0} \lambda_t \left( \sum_{n=1}^{T_0} \lambda_n' \lambda_n \right)^{-1} \lambda_s' (\varepsilon_{js} - \varepsilon_{1s}) - \sum_{j=2}^{J+1} w_j^* (\varepsilon_{jt} - \varepsilon_{1t}).$$

*( 8 )*

Taking $\alpha_1$ as an estimator for a $t$ time period, the following equation can be gained by the difference between the treated unit's and the synthetic control's results at that time. This equation denotes as the estimator of the treatment effect.

$$\hat{\alpha}_{1t} = Y_{1t} - \sum_{J=2}^{J+1} w_j^* Y_{jt}$$

*( 9 )*

Through the equation, it can be deduced that the weights which is mentioned by $w_i^*$ are identified as the predictors in Sri Lanka as the treated unit in which is the best to produce the characteristics of the synthetic control.

In the following equation, the $X_{1k}$ can be identified as a pre-event value as *k* as the IFDI predictor for the treated unit. When the $X_{0k}$ could be identified as the vector of the pre-event values as the same variable of the *k* for the units in the donor pool, the $W^*$ is identified to reduce the following equation in which the weights given to each control unit are chosen. The $v_k$ depicts the predictive power of the variable which we mentioned as *k*.

$$\sum_{k=1}^{K} v_k (X_{1k} - X_{0k} W)^2$$

*( 10 )*

In the final plot presentation, the MSPE is depicted which indicates the pre-event period's result variable. In other words, the smaller the MSPE, the more closely the synthetic control resembles the identification of the treated unit (Abadie et al. 2010). MSPE measures the expected squared distance between the result of the treated unit and the outcome of the synthetic control in the pre-event period. The nested optimization approach, which looks through all V matrices and sets of W weights for the best-fitting convex combination of the units in the donor pool, is used to reduce MSPE.

## 4.2 The data analysis of the Sri Lankan IFDIs and the external liberalization impact through the Synthetic Control Method

In the case study of the liberalization policy effect upon the economic growth in Sri Lanka, how the economic growth and the effect of IFDIs will have an impact in the absence of the policy. The time period applied in this data which is from 1970 to 1990 is taken as a result of global and domestic affairs which will be discussed in the section. Additionally, in the case of Sri Lanka, the methodology as an optimization algorithm specifically for panel data with a single treated unit which is Sri Lanka, and multiple potential control units.

**Selection of the donor pool**

The countries used in the donor pool will be named from the country code and the id mentioned in the following table. In order to proceed further, the main two elements will be needed which is mentioned as follows:

1. The counterfactual units

The list of potential counterfactual units will be named as the donor pool in which to observe the evolution of the outcome before and after the treatment. As main concerns of the data selection, for this group of prospective comparison units, data accessibility, and where Sri Lanka introduced the liberalization policy, in which all the nations for which there are statistics that were unaffected by the treatment event. The potential control nations will be summarized as follows except the *country id* 1 which is LKA as Sri Lanka.

Table 3:

| **Overview of the data** | | |
|---|---|---|
| **country** | country name | id |
| **LKA** | Sri Lanka | 1 |
| **THA** | Thailand | 2 |
| **BDI** | Burundi | 3 |
| **BOL** | Bolivia | 4 |
| **BFA** | Burkina Faso | 5 |
| **CMR** | Cameroon | 6 |
| **IRN** | Iran | 7 |
| **KEN** | Kenya | 8 |
| **MAR** | Morocco | 9 |
| **SEN** | Senegal | 10 |
| **NER** | Niger | 11 |
| **DOM** | Dominican Republic | 12 |
| **DZA** | Algeria | 13 |
| **ECU** | Ecuador | 14 |
| **GAB** | Gabon | 15 |
| **GMB** | Gambia | 16 |
| **TGO** | Togo | 17 |
| **MDG** | Madagascar | 18 |
| **RWA** | Rwanda | 19 |

2. Predictors

Additionally, the outcome predictors for these counterfactual units will be required. We are looking for factors that will make it possible to forecast how the synthetic control group will respond to the treatment in 1977. Moreover, the synthetic control group with average values for these variables are comparable to those of the treated unit. The predictors will be summarized as follows:

Table 4:

| ***Predictors*** | ***Information*** | ***Source*** |
|---|---|---|
| ***ifdi*** | [Foreign direct investment, net inflows (BoP, current US$) | World Development Indicators (World Bank 2015) |
| ***gdp*** | GDP (current US$) | World Development Indicators (World Bank 2015) |
| ***inflation*** | Inflation, consumer prices (annual %) | World Development Indicators (World Bank 2015) |
| ***trade*** | Trade (% of GDP) | World Development Indicators (World Bank 2015) |
| ***gdpcap*** | GDP per capita (current US$) | World Development Indicators (World Bank 2015) |
| ***gcf*** | Gross capital formation (% of GDP) | World Development Indicators (World Bank 2015) |
| ***consumption*** | Final consumption expenditure (current US$) | World Development Indicators (World Bank 2015) |
| ***erate*** | Official exchange rate (LCU per US$, period average) | World Development Indicators (World Bank 2015) |

**Selection of predictors**

The predictors used in the methodology is based upon the factors influencing GDP growth and IFDI growth. In addition, the synthetic control method requires the availability of data upon the outcomes and predictors of the outcome for the exposed which is Sri Lanka to the intervention of interest and a set of comparison units (Abadie, 2021, p.412). In the previous chapters, a sufficient pre-intervention qualitative information of the local political and the economic situation of Sri Lanka is being discussed from the capitalist market, planned economy towards the market-orientated liberalized economy.

**Selection of the time period**

The selected time period of the intervention is from 1970 to 1990. This time period is being determined based upon the following factors. The pre-intervention period will be 7 years and the post-intervention period will be 13 years.

- The treatment was introduced in the 1977 and the practical application on Sri Lanka was effective on the years 1977-1988 onwards. In order to get the clear interference of the effect through the statistical approach, the data of the countries prior to the applied treatment year (before 1977) will be important. Abadie mentions the fact that when the SCM is being created to the data analysis, it is important to collect data which is qualitative and quantitative for the affected unit and the donor pool for a large pre-invention window. This is further explained because the synthetic control tracks the trajectory of the outcome variable for the affected unit during the pre-treatment period (Abadie et.at, 2010, p.495-504).

- The time period 1970-1990 is taken further as the limitation of the data access of less-developed countries during the early to mid-20th century and the post-intervention period depicts a combination of domestic and global shocks affecting the IFDI inflows which will be discussed further.

**Results table**

Table 5:

| *$tab.pred* | | | |
|---|---|---|---|
| | *Treated* | *Synthetic* | *Sample Mean* |
| *gdp* | 3.007506e+09 | 3.890942e+08 | 4.625289e+09 |
| *gdpcap* | 2.256950e+02 | 1.361080e+02 | 4.342370e+02 |
| *consumption* | 2.566742e+09 | 3.486265e+08 | 3.340561e+09 |
| *erate* | 6.619000e+00 | 1.243910e+02 | 1.020880e+02 |
| *special.inflation.1970.1976* | 6.395000e+00 | 6.878000e+00 | 9.350000e+00 |
| *special.trade.1970.1976* | 5.525900e+01 | 5.496800e+01 | 5.209200e+01 |
| *special.gcf.1976* | 1.621000e+01 | 1.732200e+01 | 2.408600e+01 |

Table 6:

| | |
|---|---|
| *$tab.v* | |
| | *v.weights* |
| *gdp* | 0 |
| *gdpcap* | 0.002 |
| *consumption* | 0 |
| *erate* | 0.001 |
| *special.inflation.1970.1976* | 0.097 |
| *special.trade.1970.1976* | 0.763 |
| *special.gcf.1976* | 0.137 |

Table 7:

| *$tab.w* | | | |
|---|---|---|---|
| | *w.weights* | *unit.names* | *unit.numbers* |
| *2* | 0.000 | THA | 2 |
| *3* | 0.000 | BDI | 3 |
| *4* | 0.000 | BOL | 4 |
| *5* | 0.502 | BFA | 5 |
| *6* | 0.000 | CMR | 6 |
| *7* | 0.000 | IRN | 7 |
| *8* | 0.000 | KEN | 8 |
| *9* | 0.000 | MAR | 9 |
| *10* | 0.000 | SEN | 10 |
| *11* | 0.000 | NER | 11 |
| *12* | 0.000 | DOM | 12 |
| *13* | 0.000 | DZA | 13 |
| *14* | 0.000 | ECU | 14 |
| *15* | 0.000 | GAB | 15 |
| *16* | 0.498 | GMB | 16 |
| *17* | 0.000 | TGO | 17 |
| *18* | 0.000 | MDG | 18 |
| *19* | 0.000 | RWA | 19 |
| | | | |
| | | | |
| *$tab.loss* | | | |
| | *Loss W* | *Loss V* | |
| *[1,]* | 0.004634753 | 1.387959e+12 | |

Figure 3:

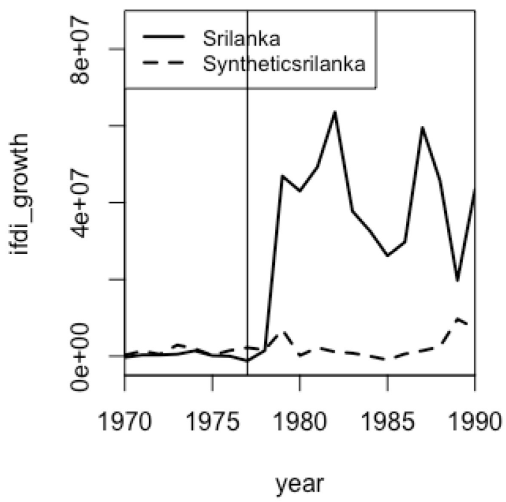



Figure 4

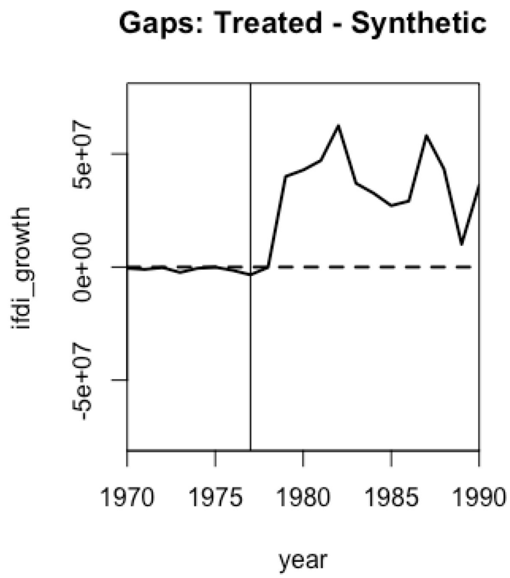



Figure 5:

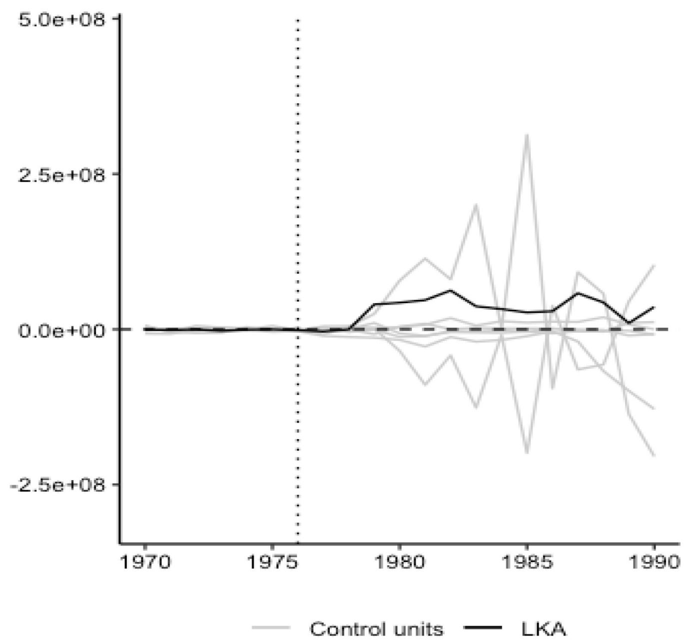
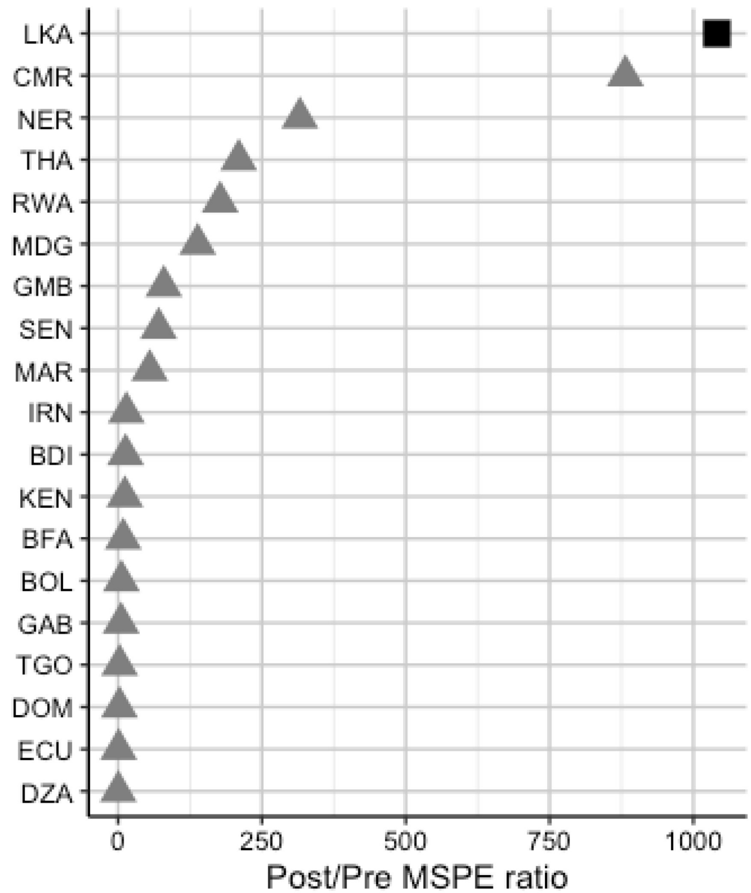


Figure 6:



LKA
CMR
NER
THA
RWA
MDG
GMB
SEN
MAR
IRN
BDI
KEN
BFA
BOL
GAB
TGO
DOM
ECU
DZA
0
250
500
750
1000
Post/Pre MSPE ratio

# Chapter 5

# Result interpretation

## 5.1 Results and the evaluation

According to the results, the case study of Sri Lanka presents time-series data from 1970-1990 as a single treated unit with multiple set con control units. The table 5 which is indicated as ***$tab.pred*** identifies whether the SCM was effective in producing a synthetic control that, for all selected predictors in terms of the treated unit. The predictor variables which is in the research are averaged with the pre-treatment years which are from 1970 to 1976. According to the three columns, the synthetic control, the means for each variable in the pre-treatment era, and the unweighed sample mean for controls can be identified. Moreover, in terms of synthetic Sri Lanka and actual Sri Lanka, a slight similarity could be identified except for the variable *erate*. In addition, it can be deduced that the liberalization treatment effect with the pre-treatment and post-treatment, depicts a significant performance through the decennial averages, synthetic and treated values. The weights of the selected predictors are shown in the 6th table *$tab.v*. according to the case study of Sri Lanka, the values 0.097, 0.763 and 0.137 depicts the weights of 9.7%, 76.3% and 13.7% according to the special predictors. According to the *$tab.w* this depicts the weight of the donor pool in which, each controlled state obtains under the synthetic control. The weights produced by the SCM are quite minor weights. Several nations are given a weight larger than 0. It can be further analyzed that the synthetic counterfactual for the case study in Sri Lanka IFDI after the liberalization of the treatments (Synthetic Sri Lanka), is 50.2% of Burkina

Faso's IFDI growth level. Moreover, Sri Lanka's IFDI level is 49.8% of Gambia's level in terms of synthetic counterfactualization. All other countries in the donor pool obtain zero weights.

Path plot in the figure shows how the implementation of the liberalization policy in Sri Lanka resulted in an increase in IFDIs in actual Sri Lanka and lower in Synthetic Sri Lanka. The gaps plot depicts the liberalization policy gap in Sri Lanka. According to the case study, it can be deduced that there is a significant effect showing after the treatment in 1977. Starting from the straight horizontal line at 0 (the synthetic control), the treatment has affected a direct upward sloping straight line achieving significant changes.

Furthermore, the development of the methodology is continued towards the placebo treatment which tests the statistical significance of an effect. Two types of placebo tests could be identified such as placebos in space and placebos in time. According to the in-space placebos which are used in the research, Sri Lanka's (treated unit) and the treated unit's synthetic control is denoted by the black line. The gray line depicts the distance between one country in the donor pool and the same country's synthetic control. Moreover, it can be deduced that Sri Lanka depicts the confidence that the result of Sri Lanka implies there is a significant change increase of IFDI, in relation with the controlled units which was not exposed towards the intervention.

The Post/Pre MSPE ratio figure shows the pre 1977 intervention RMSPE and the pre-1977 RMSPE for the case study of Sri Lanka and the donor pool countries. According to Abadie, the RMSPE measures the magnitude of the gap in the outcome variable of interest between each country and its synthetic counterpart (Abadie et.al, 2015, p.505). According to the results figure, Sri Lanka shows a clear result of the highest RMSPE ratio.

According to the overall result tables and figures, the liberalization policy effect on Sri Lanka resulted in a gradual increase of IFDIs during the policy effect, which was applied in 1977.

## 5.2 Inquiries of the economic issues and policies reasoning fluctuations in the post-treatment period

According to the overall results of the SCM, different fluctuations in the economy of the treated unit and the controlled units are recognized. In referring to this context, mainly the reasons behind the fluctuations can be categorized into two, which are the global phenomenon and the domestic phenomenon. Additionally, the research in this paper on the period in which the analysis is being continued is from 1970 to 1990, in which the period after 1990 depicts economic incidents which affect the overall trade and economic effects in countries.

→ **Global phenomenon**

**General Agreement on Tariffs and Trade (GATT) in 1993**

The GATT talks, known as the Uruguay rounds the 8$^{th}$ round of the MTN, which is created on the framework of the General Agreement on Tariffs and Trade (GATT), was completed in December 1993 (Purnell, 1994, p.213). By helping developing countries benefit from global trading, the IFDI and international trade opportunities can differ from country to country. Moreover, industrial countries could identify a sizeable effect after the GATT talks, which may directly or indirectly affect developing countries (Anderson et al., 2011, p 6).

**Influence of the Soviet blocs**

The dissolution of the Soviet Union is an internal disintegration within the USSR. This breakup of the Soviet Union in the early 1990s brought remarkable democratic reforms across the world economy. According to researchers, they insist that there are many analyses of the effects of the dissolution of the Soviet blocs upon the political reforms and democratization on economic growth, mainly for the Asian-Pacific region or Latin American countries (Gurgul & Lach, 2012).

Furthermore, the fall of the Soviet Union mainly affected the eastern European economy, foreign trade with other countries, socio-economic changes, and USA power dominion. Applying this to the countries selected in the donor pool, 15% of the Soviet foreign trade was with third-world countries.

**Liberalization of other nations**

Not only Sri Lanka but other countries were also getting significantly more open at about the same time. As less-developed countries, most of the countries in the donor pool were adopted with the following trade models.

- Flying Geese Paradigm (FG)

  The flying geese theory was developed by the Japanese economist Kaname Akamatsu (1897-1974) of Hitotsubashi in relation to the technological advancements in Japanese industries. This further evolved into Southeast Asian sectors too. Akamatsu's third flying geese paradigm (FGP) was a model based upon dynamic comparative advantage. According to his three central FG patters, Import Substitution-Cum-Export Promotion, structural upgrading, and

Alignment of Countries at Different Stages of Development could be identified (Ozawa, 2010, pp.3-4). In relation to this research the first generation of newly industrialized Asian countries was becoming relatively affluent, by that time was opening more opportunities for other countries such as Sri Lanka. This method involves learning and growing from economic interactions between states. According to the case study in this research, it can be stated that the comparative advantage could result in fluctuations in FDI gaining more positive impacts too.

- The Eclectic Theory of International Production

According to the developed model of the paradigm, this method could be applied in terms of FDI. Variations within them may explain by structural variables as identified by empirical research showing that significant variables influencing all import substitution FDIs. The author states that there can be additional factors, such as Swedish investment in the Thai car industry (Dunning, 1988, p. 11 and p.26). In relation with to this research, this theory implies the advantages of the ownership and internalization of FDIs.

Other than these factors, the 1997 financial crisis in the East Asian and Southeast Asian regions, the Cold war, which ended in 1991, and other combinations of shocks may affect the fluctuations of IFDI growth.

→ **Domestic phenomenon**

As discussed in previous chapters, there had been significant changes in the economy and political atmosphere in Sri Lanka, which affected the fluctuation in the differences in IFDI growth analysis. Mainly, fluctuations in government power, war, and crisis can be the main factors.

Since 1983, Sri Lanka has been accumulating foreign debt, which affected several growth factors in the country's economy (Grobar and Gnanaselvam, 1993, p. 398). Furthermore, this could affect Sri Lanka's debt/GDP ratio, and even in recent years the rate has been affecting negative results. Domestic factors will directly and indirectly affect Sri Lanka's macroeconomic and microeconomic sectors.

# Chapter 6 Concluding remarks

## 6.1 Conclusion

In this concluding chapter, the key results will be summarized. Using the Synthetic Control Method of comparative case study analysis, the effect of the liberalization policy in Sri Lanka, which was implemented in 1977, was analyzed. Beginning with a capitalist economic structure, there was an economic decline in the mid-1960s under a planned financial system (Nithiyanandam, 2010, p.283). By the 1977 economic reforms, the Sri Lanka economy proposed market-orientated growth policies toward liberalization. This introduction to neoliberalism in Sri Lanka led to a gradual increase in economic growth in Sri Lanka.

Moreover, through the qualitative data and information from the pre-intervention period, the political conditions of Sri Lanka were studied. According to the path plot and gap plot results, starting from the straight horizontal line at 0, the treatment has affected a direct upward sloping straight line achieving significant changes. Developing the argument through the methodology of the placebo tests, the researcher evaluates the effect estimation towards Sri Lanka as the treated and controlled units. According to the placebos, the post-treatment depicts that Sri Lanka positively performed after the liberalization intervention related to other synthetic controlled units in the donor pool.

The overall results of the SCM imply that there is a positive effect, and further it supports my central hypothesis of the research. There is a significant positive impact on IFDIs in Sri Lanka through the 1977 external economic liberalization policy.

The researcher analyses that domestic and global factors could influence fluctuant changes in the world economy especially in southeast Asia, Asian region as a result of the combination of economic shocks after 1988.

In concluding remarks, there is visibility proven by the methodology that there is a sharp and apparent increase in inward foreign direct investments through the implementation of the 1977 liberalization policy.

# 6.2 Key policy recommendations

According to the in-state changes, the main issue is that the local government management in Sri Lanka is weak, which significantly influences the country's development. Moreover, Acemoglu and Robinson suggest how economic institutions determine a state's financial performance and distribution of resources (Acemoglu and Robinson,2006). Furthermore, they suggest how constitution are respected as in most functioning towards democracies and growth.

**Improving the quality and the structure of reforms complemented with political stabilization.**

Further, I will contribute policy suggestions in relation with the political stability resulting in growth of the economy in the state.

The author, Grobar and Gnanaselvam proves that investment-savings data indicate that Sri Lanka has remained heavily dependent on foreign savings as a source of investment finance (Grobar and Gnanaselvam, 1993, p.401). This could create the risk of an economic decline in the long-term economic growth. The current Sri Lanka's economic and financial crisis was a result of the government debt.

Since independence in Sri Lanka, there has been several macro-politics negative effects affecting the economic growth. Furthermore, as discussed about the political and economic stability influencing the IFDI investment by foreign investors, past research evidences suggest that there is a poor political stability in the state. As a suggestion, the government could imply a structural change in the reforms understanding the global movements in the world. The latest amendments in the constitution of Sri Lanka depicts negative effects of implementing reforms. If this continues further, there will be a long-term economic decline in Sri Lanka as a result of government mismanagements, management of the foreign debt and power struggle within the state authorities. As a structural change the government could take a step such as institutional change in the system in order to increase the stability of the politics and economics in the state.

→ For instance: institutional changes (Constitutional reform implications)

→ Active measure to promote trade and domestic industries

Systematic reform changes in Sri Lanka will lead to an increase in IFDI and long-term growth.

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