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POLICYINSIGHTS

INSTITUTE OF POLICY STUDIES OF SRI LANKA

INTERNATIONAL ENVIRONMENT

Six years after the onset of the global financial crisis (GFC), the world economy continues to expand at a fairly modest pace, with ramifications of the financial crisis still visible in many countries. The recovery has been slow and prolonged, with many advanced economies still relying heavily on post crisis adjustments, and countries plagued by sluggish unemployment levels, below target inflation rates and geopolitical uncertainties.

Among the developed countries, US economic growth is expected to be robust, with factors such as low energy prices, strengthened balance sheets and recovering housing markets expected to sustain growth in 2015 and 2016. The euro area on the other hand has more problems to contend with in the form of economic and political turmoil within the region, whilst Japan too has seen an uneven recovery, with consumption yet to show sustained growth. Among emerging and developing economies, China's growth trajectory has changed as a result of a managed slowdown, targeting a more sustainable rate of expansion. This has varying impacts on other economies in the Asia-Pacific; Australia, already impacted from falling commodity prices. Another casualty of falling commodity prices is Russia, already hit by international sanctions.

International trade performance since the GFC has been positive, but weak, attributed mostly to the weak economic growth of advanced economies.

For Sri Lanka, the impacts of the current global economic environment will be channeled mainly through trade, capital, remittances and tourism. In the import side, lower oil and commodity prices will ease Sri Lanka's current account deficit, reduce pressure on fiscal accounts and inflation. Remittances and tourism too are expected to grow with no major diversions expected for 2015.

This Policy Insight is based on the SOE 2015 chapter "International Environment", which examines the world economic environment and implications for Sri Lanka in detail.

Overview of the Global Economy

Economic Prospects for Developed Economies

The world economy grew by 3.4% in 2014 and is expected to grow by 3.3% in 2015. Although emerging and developing economies have been driving the world output since the GFC, advanced economies are expected to grow more strongly in 2015 while growth in emerging and developing economies are expected to be weaker. These developments however, are not the same across-the-board; a striking feature among advanced economies has been the growing divergence between US and that of Japan and the euro area.

"India is expected to outperform China for the first time in 2015 with growth boosted by policy reforms following electoral changes in 2014, rising investments and lower oil prices."

Despite growth moderating in recent times, the US economy is expected to remain robust. And it is likely that this positive outlook would drive the US to normalize its monetary policy which in turn would have implications for the rest of the world. Meanwhile, the growth trajectory of the world's third largest economy, Japan, is of continuing concern. The country was in recession for two quarters in 2014, attributed to an increase in consumption taxes in the country. While it came out of the recession in the last quarter of 2014, whether Japan can maintain its growth rate is largely dependent on consumption growth.

Outlook on Emerging Economies: Will Growth Continue?

Despite a fall in growth rates over the past six years, Asia has managed to maintain a growth momentum of over 6% during 2008-14. The most striking feature is the slowdown of the Chinese economy, driven by structural reforms, withdrawal of fiscal stimulus and limitation of non-bank credit expansion. The slowdown of the Chinese economy is, however, deemed to be a desirable and a healthy adjustment, suggesting a more sustainable growth path. There are nevertheless concerns on how the slowdown would affect other economies.

India on the other hand is expected to maintain or improve on its 2014 growth, backed by structural reforms and an improved investment climate. With a change of government, economic growth is high on the priority list. Whilst India is indeed a 'bright spot' in the region, India is still far from the economic power of China; India's economic output is around US$ 2 trillion compared to China's US$ 10 trillion output.

Other emerging economies are expected to grow at a much slower pace, with Russia expected to grow at a negative 3.4%.

World Trade, Commodity Prices and Financial Flows

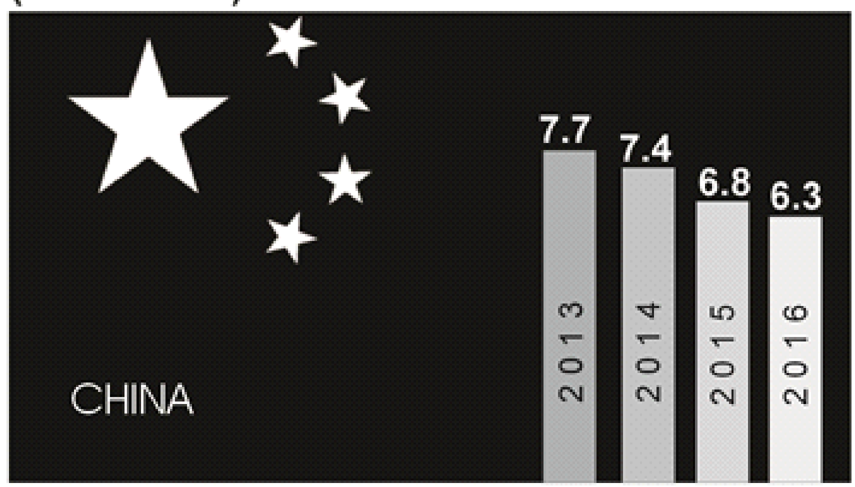
World Trade growth slowed to 3.4% in 2014, pulled back by weakened import demand and a stagnant Europe. The slowdown is also attributed to structural factors where slower expansions of global supply chains and shift in demand to less-import intensive items have made trade become less responsive to global income changes. In 2015, trade is expected to pick up to 4% but with high possibility of downside risks arising from developing geo-political tensions, and faltering economic recovery.

Meanwhile, the fall in **Commodity Prices** has been broad-based with prices of energy, metal, minerals and agricultural raw materials declining from the second half of 2014. The drop in prices is due to ample supplies, weak global growth prospects and an appreciating dollar. Oil prices saw the most dramatic decline, while prices of other commodities such as food also saw a fall. The weakening in commodity prices is expected to continue through 2015 before a modest turn around in 2016.

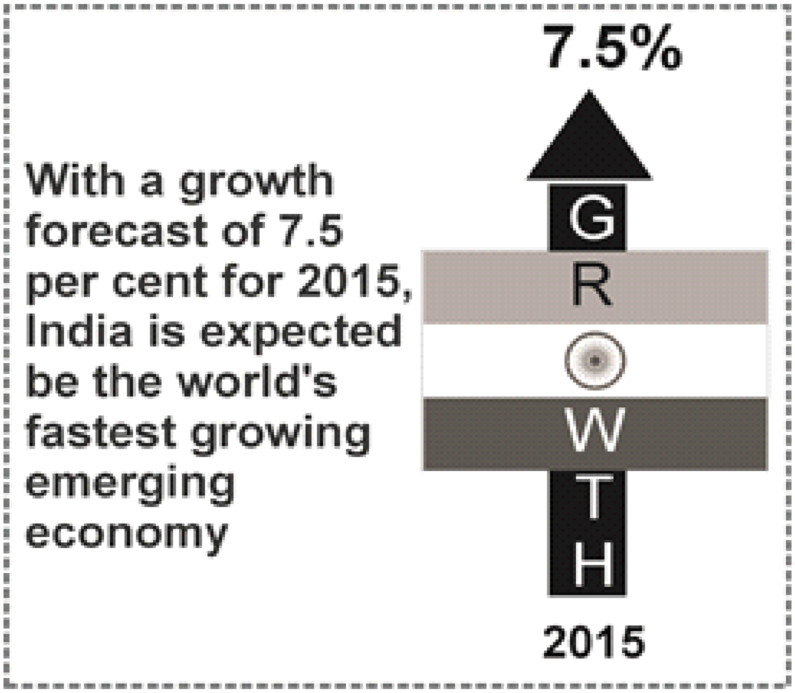
Global cross border **Capital Flows** especially from the banking sector, which increased markedly in the decade before

The strongest growth in the EU in any quarter over the past 2 years has been 0.4 per cent and an annualized growth of 1.1 per cent.

Projected GDP Growth for China (2013-2016)



"China is seen to be embracing what is termed the 'new normal' – slower but higher quality growth."



the financial crisis has declined to about one-third their size in 2007. Capital flows from all channels, except that from FDI, have reduced compared to pre-crisis levels and the reduction has come mainly from lower lending by banks and a marked reduction in portfolio investment in debt and equity securities. In terms of geographical distribution of capital flows, almost the entire decline in capital flows is due to a decreased lending among advanced economies, especially within Europe. Capital flows to emerging economies have on the other hand increased.

International Environment and Implications on Sri Lanka

Developments of the world economy on Sri Lanka's external trade will be mixed. As an oil importing country, it will benefit from the fall in oil prices with improvements in the current and fiscal accounts. The improved economic outlook for the US and EU is positive – albeit with slow recovery in consumption – and will help Sri Lanka's major export industries. However, this will be balanced by falling prices and demand for some of the country's key exports such as tea and natural rubber.

Given the country's small market size and dependence on international trade for economic development, it is only prudent that Sri Lanka undertakes measure to boost its export competitiveness and exportable products. This will require a strategic and focused national export development plan that identifies and addresses both demand and supply side constraints, as well as institutional and regulatory obstacles in the way of an attractive business environment for private investors.

Remittances are Sri Lanka's largest source of foreign exchange and continue to help the country manage its current account deficit. Remittance inflows have been increasing over the years and amounted to US$ 7 billion in 2014 or 9.4% of GDP. With numbers of migrants and their skills composition remaining relatively unchanged, increased inflows to former conflict-affected households in the in the immediate post-war period is perhaps a key reason for the recorded higher inflows.

Sri Lanka's **Tourism** earnings have also shown strong growth in the post-war period, with substantive investments in the leisure industry and supportive infrastructure development. Tourist arrivals increased to over 1.5 million in 2014, with earnings of US$ 2,431 million. The largest tourist sending countries for Sri Lanka at present are India, UK, Germany, France and China. A notable feature has been the sharp increase recorded in number of tourist arrivals from China during 2013-14, claiming the third highest source of arrivals after India and the UK.

"With a half of the country's population under the age of 25 years, and with 12 million entering the labour force each year, India is well positioned to reap the benefits of a demographic dividend. It is poised to have the world's youngest population by 2020 with an average age of 29 years."

World Trade, Commodity Prices and Financial Flows

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Global cross border **Capital Flows** especially from the banking sector, which increased markedly in the decade before the financial crisis has declined to about one-third their size in 2007. Capital flows from all channels, except that from FDI, have reduced compared to pre-crisis levels and the reduction has come mainly from lower lending by banks and a marked reduction in portfolio investment in debt and equity securities. In terms of geographical distribution of capital flows, almost the entire decline in capital flows is due to a decreased lending among advanced economies, especially within Europe. Capital flows to emerging economies have on the other hand increased.

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The **Emerging Opportunities for External Engagements** will also have implications on the Sri Lankan Economy. A change of government following the Presidential election of January 2015 has signaled a shift in approach to Sri Lanka's external engagements that can hold implications for its strategic trade, finance and investment initiatives. The signaling indicates an effort to 'rebalance' Sri Lanka's relationship vis-ŕ-vis India and China, both in political and economic spheres. On the economic front, where Sri Lanka's economic relations with China have progressed considerably in the recent past – from becoming the largest source of development finance and funding many large scale infrastructure projects to beginning negotiations on a possible trade deal – Sri Lanka's economic relations with India suffered a set-back with the sidelining of the Comprehensive Economic Partnership Agreement (CEPA) in 2008.

Re-affirming Sri Lanka's close political and economic relations with India whilst maintaining friendly ties with China seems to be the new approach – signaled by a visit of an Indian PM in March 2015 to Sri Lanka, the first in 28 years. Another signal in change of approach has been a renewal interest on the part of Sri Lanka to re-apply for the EUs Generalized System of Preferences (GSP-plus) trade concessions that were withdrawn in 2010. Whilst Sri Lanka's exports to the EU continued to grow even after the loss of GSP-plus, a resumption of concessions, which provide duty free access to the EU will no doubt provide a boost to exporters and assist the country in its development process.

This Policy Insight is based on the comprehensive chapter on "International Environment" in the 'Sri Lanka: State of the Economy 2015 Report' (SOE 2015). The State of the Economy Report is the flagship publication of the Institute of Policy Studies of Sri Lanka. The complete report can be purchased from the publications section of the IPS, located at 100/20, Independence Avenue, Colombo 7. For more information, contact the Publications Unit on 0112143100.

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