Sri Lanka
State of the Economy Report 2010

Chapter 3
Developments in the External and its Role in Post-conflict Development

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3. Developments in the External Economy and its Role in Post-conflict Development

3.1 Overview

The global economy is in transition from a period of recession to recovery following the greatest financial and economic crisis since the Second World War. The recovery kicked off early, with the economic crisis easing off in the latter half of 2009. The resultant stronger-than-expected performance in 2009 - with emerging economies recording high growth rates in particular - has seen a progressive normalization of conditions at the global level. Correspondingly, economic performance forecasts for 2010 have been pushed upwards from what was predicted at the initial stages of the crisis; the global economy is now expected to grow at 4.6 per cent in 2010, largely supported by extensive coordinated stimulus efforts by governments.

Nevertheless, the level of recovery as well as prospects for recovery has varied considerably among countries. Among the advanced economies, the US had a better start than many countries in the European Union (EU) or Japan, due to larger stimulus packages, larger policy rate cuts, a non-financial sector which relies less on the banking sector and other factors. Countries like Japan have, however, taken longer to recover, strained by lower domestic demand and the large appreciation of the yen which have weighed down the recovery of their exports.[1]

There also remain some other important downside risks which do not allow for complacency. Many developed economies are burdened by rising fiscal deficits and growing volumes of public debt. As already evident, the fiscal crises in many European economies (Greece, Portugal, Italy and Spain) can threaten to destabilize financial markets in the region and beyond, along with threats of overheating, asset bubbles and inflation in emerging market economies. Thus, despite the fact that many multilateral agencies have revised their global growth forecasts upward, the depth of the crisis will mean that its consequences will be long felt in the global markets.

Although largely insulated from the global financial crisis, Sri Lanka was exposed to the impact of the crisis when the effects spread to the real sector of the country's main export markets in the US and the EU. The credit crunch (which affected trade finance), lower consumption and shifts in taste to cheaper product sources affected Sri Lanka in different ways, inter alia, by bringing down the export volumes and earnings of the country, and consequently the loss of jobs in export and related sectors. The external sector performance has nevertheless been changing since the latter stages of 2009, driven by recovery of global demand and an improved domestic economic climate. The end of the long-drawn conflict in the country has been a catalyst for economic optimism, opening access to previously untapped resources, drawing in foreign investment to the country, and boosting performance in sectors such as tourism. This Chapter will assess the role of the external economy in supporting post-conflict development in Sri Lanka.

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[1] Lower demand is a result of the re-emergence of deflation, weak labour market, etc.

3.2 Global Economic Environment

Global GDP which fell in three consecutive quarters began recovering as production and trade bounced back in the latter half of 2009. The uncertainty with regard to the depth and duration of the crisis saw constant revisions to the global economic outlook in the interim (Table 3.1). Indeed, as predicted, 2009 recorded the worst global economic performance since the Great Depression with world output and growth rates of advanced economies contracting by 0.6 and 3.2 per cent, respectively. The advanced economies faced the brunt of the economic crisis with the growth rates in the US contracting by 2.4 per cent, UK by 4.9 per cent, and the Euro area by 4.1 per cent in 2009. The emerging market economies and developing countries were on the other hand, able to combat the economic crisis to an extent through buoyant domestic consumption and government stimulus measures, in spite of the slump in demand from their traditional export markets in the developed world. These economies grew by 2.5 per cent in 2009 - albeit at a much slower pace than the 6.1 per cent rate of growth recorded in 2008. However, despite the overall poor performance, 2009 ended on a positive note with many economies rebounding faster than expected. Factors such as large stimulus and financial rescue packages, inventory building, and Asia's quick recovery helped tow the rest of the world to recovery.

The world economy is now expected to grow by 4.6 per cent, and advanced economies by 2.6 per cent in 2010 (Table 3.2). The speed and magnitude of recovery differs across regions and countries, based on factors such as initial conditions, external shocks, and policy responses of countries. In many of the advanced countries, growth is expected to be sluggish compared to pre-crisis levels, with high unemployment, consumer debt and constrained credit conditions likely to prevail for the next couple of years. Given the financial instability of Greece and its implications on the Euro zone, the projections made for the advanced economies are likely to be under constant review. In the context that the EU and the US are Sri Lanka's main export markets, attracting 38 per cent and 22 per cent of Sri Lanka's total exports in 2009, developments in these economies are of particular relevance.

3.2.1 Outlook for the US Economy

Despite being at the centre of the economic crisis, the US recovered relatively faster than other advanced economies, spurred by large government incentives and a robust inventory cycle. The US provided a crisis related discretionary fiscal stimulus equal to 2.9 per cent of its GDP in 2010. Its stimulus package of US$ 787 billion comprised of US$ 212 billion worth of tax cuts while the remainder of US$ 575 billion translated into an increase in government spending. In response to these factors, the economy which fell four consecutive quarters from the third quarter of 2008 - hitting a low of -6.4 per cent in early 2009 - has been expanding for three successive quarters since (see Figure 3.1).

Table 3.1
2010 Economic Performance Projections, January 2009-July 2010

	2009 January	2009 April	2009 July	2009 October	2010 January	2010 April	2010 July
World output projections for 2010	3.9	1.9	2.5	3.1	3.9	4.2	4.6

Source: International Monetary Fund, *World Economic Outlook*, various issues.

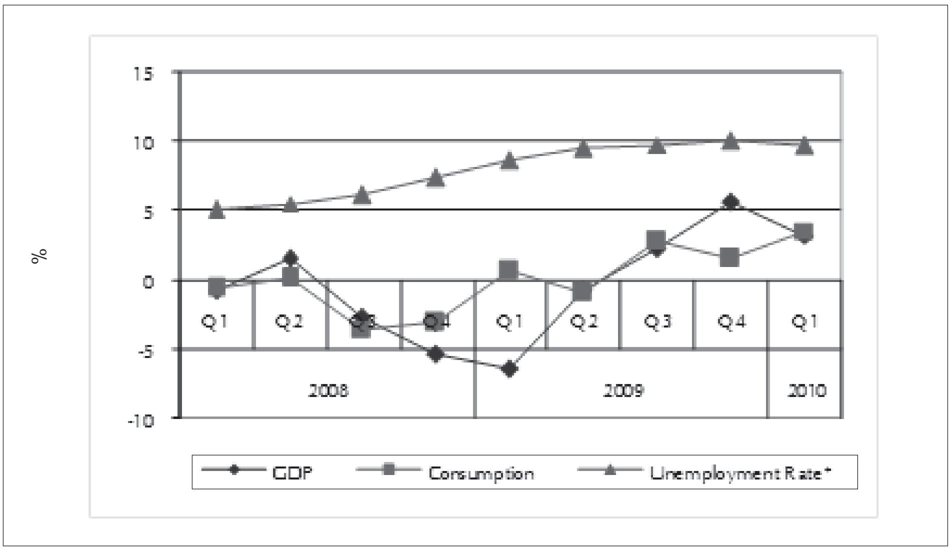
Table 3.2
Projected World Output (2009-11)

		Projections		
	2008	**2009**	**2010**	**2011**
World output	**3.0**	**-0.6**	**4.6**	**4.3**
Advanced economies	**0.5**	**-3.2**	**2.6**	**2.4**
US	0.4	-2.4	3.3	2.9
UK	0.5	-4.9	1.2	2.1
Euro area	0.6	-4.1	1.0	1.3
Japan	-1.2	-5.2	2.4	1.8
Canada	0.5	-2.5	3.6	2.8
Emerging and developing economies	**6.1**	**2.5**	**6.8**	**6.4**
India	6.4	5.7	9.4	8.4
China	9.6	9.1	10.5	9.6
Russia	5.6	-7.9	4.3	4.1
Brazil	5.1	-0.2	7.1	4.2
Middle East & North Africa	5.3	2.4	4.5	4.9
ASEAN-5	4.7	1.7	6.4	5.5

Source: International Monetary Fund, *World Economic Outlook*, July 2010.

Nonetheless, the pace of growth in the first quarter of 2010 of 3.7 per cent was relatively lower than the 5 per cent growth in the previous quarter and was slightly below the forecasts. A weak housing market, spending cuts by state and local governments, and negative net exports of goods and services put pressure on the rate of growth.

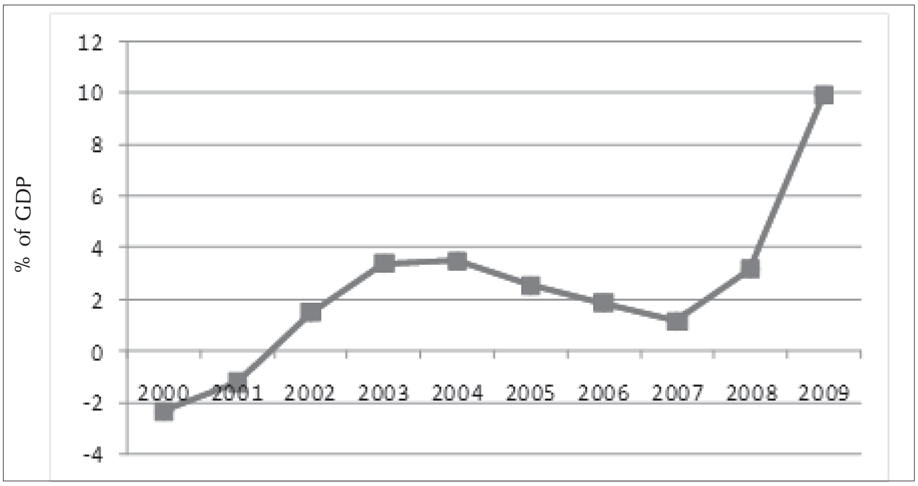
Figure 3.1
US Output, Unemployment and Consumption Rates



Notes: Figures for unemployment are end of period values.

Source: Compiled using data of the Bureau of Economic Analysis and the United States Bureau of Labour Statistics.

Figure 3.2
US Budget Deficit (2000-09)



Source: http://www.usgovernmentspending.com/federal_deficit_chart.html.

Encouragingly, consumption expenditure grew by 3.6 per cent in the first quarter of 2010, the best quarterly performance since 2007. The consumption of non-durable items has increased by about 4 per cent in the last quarter of 2009 and the first quarter of 2010. This is heartening given that about 80 per cent of Sri Lankan exports to the US are in the non-durable items of garments. However, there are concerns about the sustainability of growth, with a possibility of consumer spending declining after government incentives are withdrawn from the economy. Furthermore, the labour market remains weak with a high unemployment rate of 9.5 per cent. The number of jobs available has been increasing with the economic recovery - adding the highest number of jobs in April 2010 after a four year hiatus. However, owing to a large number of persons re-entering the labour force, unemployment also increased in April 2010 and an estimated 14.6 million people were classified as unemployed by mid-2010. Weak labour market conditions can act as a drag on consumer spending. Unemployment in the US is likely to reduce very slowly as structural changes in the labour market (job losses were largely in manufacturing whilst new job opportunities are largely in services) will take time to adjust.

Furthermore, the fiscal positions of many of the advanced countries are deteriorating, and the US is no exception. With many of the governments in developed countries being forced to recapitalize banks, undertake large parts of the debt of ailing financial institutions and having to introduce large stimulus packages to revive demand, fiscal deficits have expanded and debt levels have risen substantially. In the US, the fiscal deficit ballooned in the aftermath of the crisis, and the country is now faced with significant fiscal challenges. The US fiscal deficit has run into a massive US$ 1.4 trillion in 2009 or around 10 per cent of its GDP - the highest since the end of the Second World War. This has resulted in a substantial increase in gross financing needs of the government - i.e., the new overall borrowing requirement as well as debt maturing - that is set to exceed 30 per cent of GDP in 2010, while gross debt is expected to be 83.2 per cent of GDP (see Table 3.3).

Table 3.3
Gross Financing Needs of Advanced Economies (2010)

% of GDP	Maturing Debt	Fiscal Deficit	Gross Financing Needs	Debt (2009)	Average Maturity (years)
US	21.2	-11.0	32.2	83.2	4.4
UK	8.6	-11.4	20.0	68.2	12.8
Japan	54.2	-9.8	64.0	217.7	5.2
France	16.9	-8.2	25.1	77.4	6.5
Germany	10.2	-5.7	15.9	72.5	6.0
Portugal	13.0	-8.8	21.8	77.1	6.2
Spain	10.3	-10.4	20.7	55.2	6.7
Greece	13.4	-8.1	21.5	115.1	7.4
Italy	21.2	-5.2	26.4	115.8	6.7

Source: International Monetary Fund, *Fiscal Monitor 2010*.

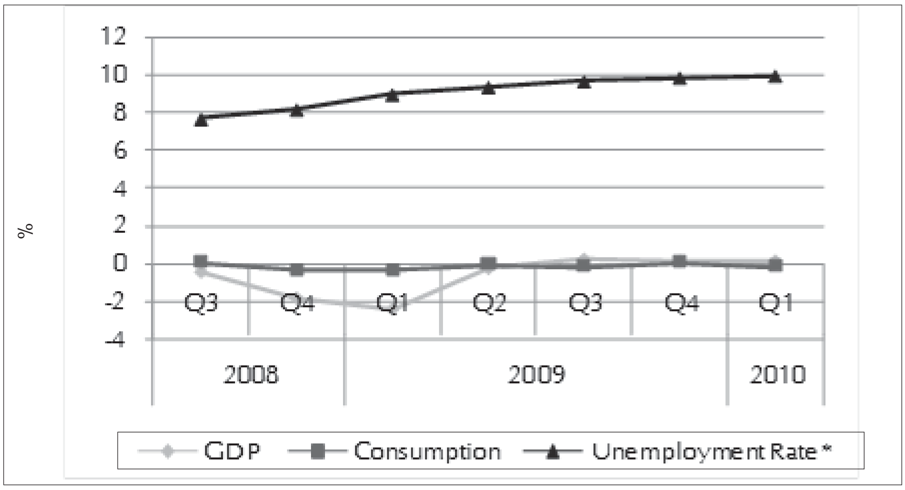
Greater fiscal challenges mean that fiscal stimulus initiatives will need to be withdrawn before long. It is unlikely that US growth can continue at the current pace without the stimulus spending and the ending of the inventory cycle. The short to medium term downturn in the US should not, however, detract from the fact that the country continues to display the fundamentals for long term growth - for instance, its strengths in higher education, the ability to attract the best global talent, and a legal environment to encourage innovation and technological development.

3.2.2 Outlook for the EU Region

Entering the crisis with substantial imbalances, Europe as a region was hit the hardest by the crisis. As a result, Europe's recovery has faced more significant stumbling blocks, with the region growing at a slow pace of 0.2 per cent in the last quarter of 2009 and into the first quarter of 2010. When compared with the US, consumption levels, as well as growth in output remain well below. While large stimulus packages supported the recovery of many countries in the region - the initial fiscal stimulus package of • 200 billion equal to 1.5 per cent of EU GDP was injected to the economy in 2009 - private demand is yet to show a strong pick up. Furthermore, large current account imbalances as well as domestic imbalances led to considerable losses of output in some EU member countries.

Unemployment levels in the euro area have been rising from 2008, reaching a seasonally adjusted high of 10.1 per cent in April 2010, which is the highest level of unemployment since 1999. An estimated 15.9 million are still unemployed. Nevertheless, compared to a loss of half a million jobs a month during the worst times of the crisis, April 2010 recorded the second lowest number of job losses in over two years in the Euro zone. With the temporary agency work market in large EU economies recording double-digit growth rates, unemployment is expected to have peaked, and peaked at a level below the 10.5-11 per cent previously expected. While the number of unemployed has been reducing for the 11th consecutive month in the largest economy of the bloc, Germany, temporary staff working hours have increased in March 2010 by 12 per cent in France, 24 per cent in Germany and 20 per cent in Italy, signalling a positive recovery of the economy. This, together with the larger-than-expected rise in industrial production, boosts hope of the economic recovery gaining momentum in the region. Decreasing unemployment will

Figure 3.3
EU Output, Unemployment and Consumption Rates



Notes: Figures for unemployment are end of period values.
Source: Eurostat database.

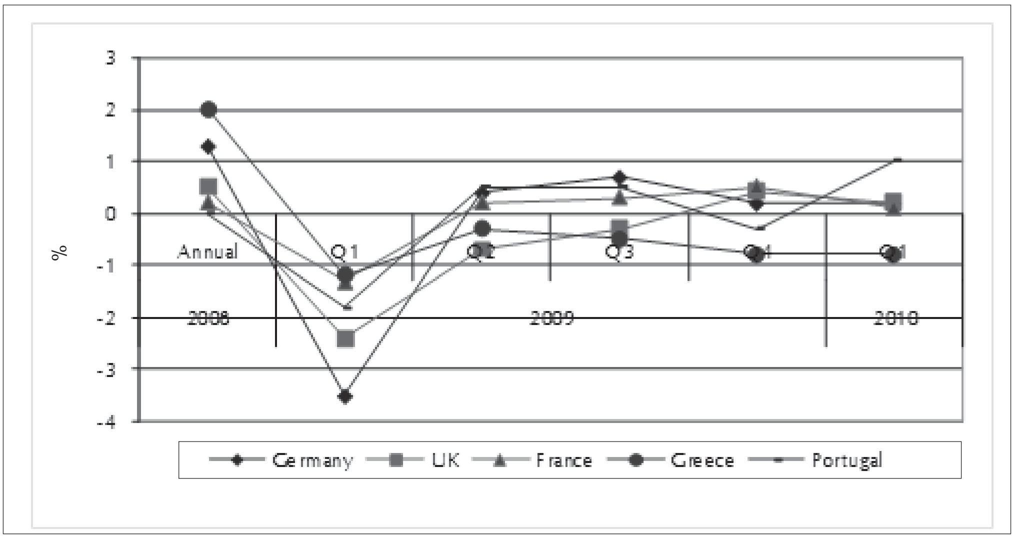
improve consumption levels, the benefits of which would trickle down to countries like Sri Lanka, which is dependent on EU as an export destination.

Nevertheless, the recovery has been uneven among countries in the EU region. The biggest Euro zone economies like Germany, France, Spain and Italy barely managed to record a positive output in the first quarter of 2010 (see Figure 3.4). Greece, in the face of a spiralling deficit and deep recession, has failed to report a positive output since the last quarter of 2008. Its growth rate has been falling steadily and stood at a negative 0.8 per cent in the first quarter of 2010. More alarmingly, there has been substantial fiscal and current account imbalances in Greece, as well as in some other countries in the bloc such as Ireland, Italy, Portugal and Spain, threatening to spread to the entire European region and prolong its recovery (see Table 3.3). In the UK, the fiscal deficit has increased to a towering US$ 235 billion in the fiscal year 2009-10, which is equivalent to about 11.4 per cent of GDP. The situation in the UK is of concern, with the IMF predicting that its budget deficit will be the highest among the G-7 countries both in 2010 and 2011. The expected deficit will also be the highest recorded in the UK since the Second World War.

The EU and IMF provided Greece, the most vulnerable member, with a significant rescue package of US$ 145 billion in May 2010, but the underlying macroeconomic stresses remain. If aggressive fiscal measures are not undertaken to cut deficits in countries such as Portugal, Ireland, Italy and Spain, it will be near impossible for the EU to afford similar bail outs in these countries. The repercussions of such a degree of contagion would be massive, both for Europe and for the stability of the global economy as a whole.

The EU remains Sri Lanka's most significant export market, and a further contraction in the region would result in a major negative shock to Sri Lanka's external sector. For example, stemming from the debt crisis in several EU countries, the euro fell to a four-year low in 2010. By mid-2010, the Sri Lankan rupee had already appreciated by over 17 per cent against the euro as against the previous year. The steep appreciation of the rupee

Figure 3.4
GDP Growth Rates of Select EU Countries



Source: Eurostat database.

against the euro could have considerable negative repercussions on Sri Lanka's export earnings. While exporters to the EU could see a drop in their export earnings due to the reduction of the value of the euro, the demand for Sri Lankan exports can also be affected with the exports being more expensive for European consumers. With the impact of a currency appreciation having similar repercussions on most countries exporting to EU, the competition for Sri Lankan exports would be more from their European competitors. Furthermore, tourist earnings as well as remittances generated from the EU will be affected due to the depreciation of the euro. Due to the uncertainties in the EU region, there can also be a possibility of capital being withdrawn from developing countries like Sri Lanka which will in turn affect the availability of credit and their growth performances.

3.2.3 Outlook for Emerging Economies

There have been marked differences in the growth levels of advanced and developing countries during the downturn. Countries like India and China have witnessed a steady recovery, supported by strong domestic demand and large fiscal and monetary stimulus packages. Substantial accumulated reserves and healthy macroeconomic fundamentals in these countries left them with sufficient policy space to engage in a fiscal and monetary stimulus. China led growth in Asia, posting a double-digit growth rate of 10.7 per cent in the last quarter of 2009. The re-stocking of inventories in the US as well as domestic inventory rebuilding is expected to provide a strong boost to Asia's exports and industrial production, although the volumes will be lower than pre-crisis levels except for countries like China and South Korea.

Thus, the outlook for emerging economies is much brighter, with growth levels expected to reach 6.8 per cent in 2010 and 6.4 per cent in 2011 led by the key emerging economies of China, India, Indonesia and South Korea. China's growth - which exceeded the government's target of 8 per cent in 2009 - is expected to be 10.5 per cent in 2010, and

Table 3.4
Growth Rates of Some Selected Countries in Asia

		Projections	
Country	**2009**	**2010**	**2011**
Developing Asia	6.9	9.2	8.5
China	9.1	10.5	9.6
India	5.7	9.4	8.4
ASEAN-5	1.7	6.4	5.5
Indonesia	4.5	6.0	6.2
Thailand	-2.2	7.0	4.5
Philippines	1.1	6.0	4.0
Malaysia	-1.7	6.7	5.3
Vietnam	5.3	6.5	6.8

Source: International Monetary Fund, *World Economic Outlook*, July 2010.

India which grew by 5.7 per cent in 2009 is expected to grow by 9.4 per cent in 2010. India has recorded an impressive 8.5 per cent growth in the first quarter of 2010. As opposed to the US and the EU, strong external reserves and fiscal positions of many of the emerging countries give them the flexibility to make policy changes.

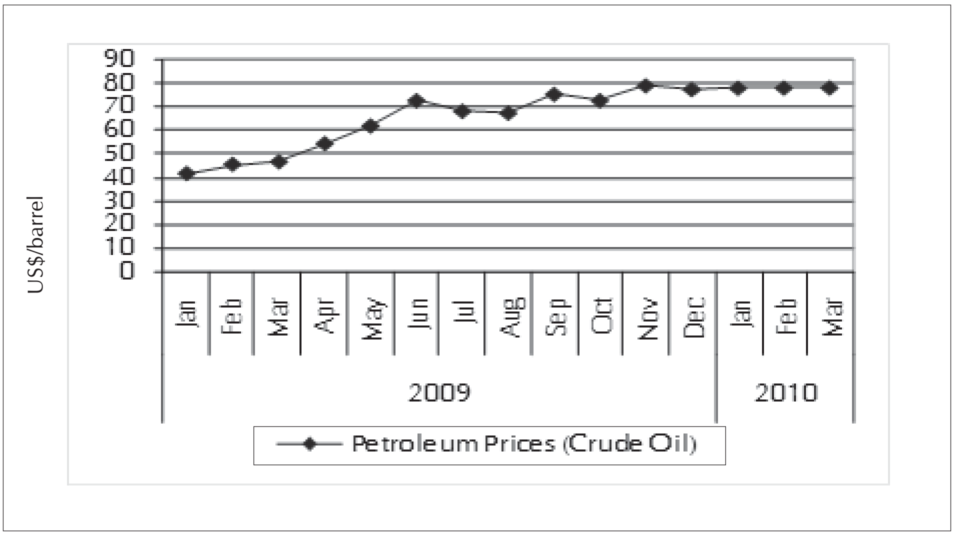
Despite the fact that emerging economies have been resilient to the crisis thus far, there remain potential downside risks in these markets as well. The risk of overheating of these economies is important and this calls into question the sustainability of growth, particularly of China. One concern has been the fact that the loose monetary policy employed to support growth in Europe and the US has encouraged capital inflows into emerging markets seeking higher returns, and in turn causing potential asset price bubbles to emerge in these countries. Such a scenario calls for macroeconomic policy tightening, which could slow down growth rates in emerging economies and thus inhibit overall recovery in the global economy. Furthermore, with Europe being an important export market of emerging economies such as China and ASEAN, fiscal issues in the EU as well as tight policies adopted in the region can negatively affect demand stemming from the region. This could bring down the growth rates of the emerging economies in the coming years.

3.3 Sri Lanka's External Sector

Sri Lanka was no exception in suffering external sector distress as a result of the global economic downturn. Export earnings contracted by 12.7 per cent in 2009 owing to the fall in exports of all major products. Imports also contracted by 27.6 per cent due to the reductions in both volumes and prices. Due to the significantly large reduction in import expenditure compared to the decline in export earnings, the trade deficit contracted by 47.8 per cent in 2009.

However, the trade deficit has been expanding steeply since the beginning of 2010 largely due to increased import expenditure on all major categories, particularly in consumer goods and intermediate goods. The global recovery and the corresponding rise in international commodity prices, particularly oil prices, will bear heavily on Sri Lanka's import bill. The country's trade deficit increased sharply to US$ 1,461.3 million in the first quarter of 2010, a 119.7 per cent increase over the same period in 2009. As domestic economic activity re-starts in the second half of 2010, import expenditures will

Figure 3.5
Crude Oil Prices (January 2009-March 2010)



Source: Central Bank of Sri Lanka, *Selected Monthly Economic Indicators*, various issues.

rise. The general relaxation of import duties and other charges - particularly on vehicles - will also add to the import expenditure bill.

Thus, the trade deficit can be expected to expand by end 2010 once again, creating a strain on the balance of payments (BOP) if the inflow of foreign capital is not large enough to offset the deficit.

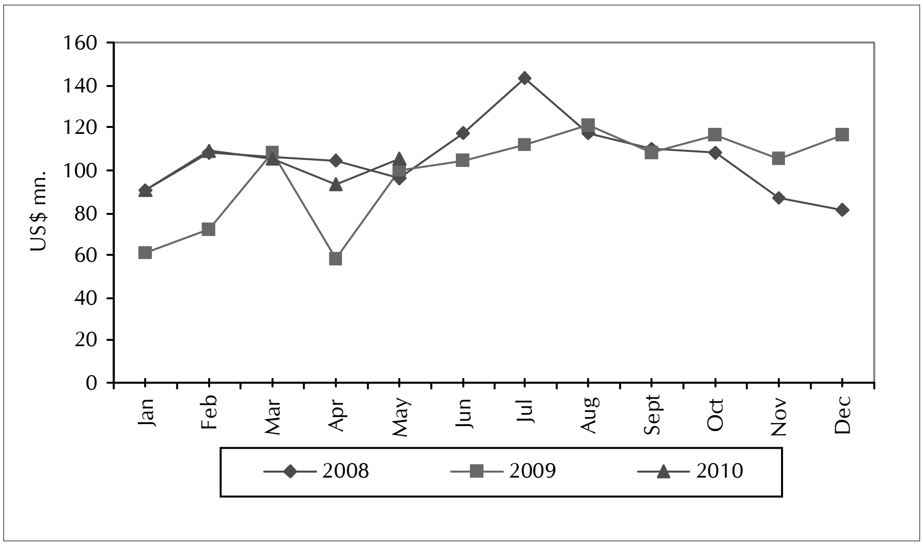
Sri Lanka faced a near crisis in its BOP at the beginning of 2009, with gross official reserves declining to US$ 1,272 million by March 2009 as exports declined and foreign investments in government securities were withdrawn with the financial crisis deepening in the fourth quarter of 2008. Foreign investor sentiments towards government securities and equity markets improved significantly in the immediate aftermath of the ending of the conflict in May 2009. Moreover, the approval of the IMF Stand-by-Arrangement (SBA) facility of US$ 2.6 billion in July 2009 further boosted investor confidence. Remittances and tourism receipts also increased significantly after the first quarter of 2009, resulting in a BOP surplus of US$ 2.2 billion and gross official reserves of US$ 4.2 billion by September 2009.

In terms of sector-wise performance, textiles and garments, tea, and rubber and rubber products have been the largest contributors to Sri Lanka's exports earnings. Textiles and garments exports accounted for US$ 3,274 million, securing a 46 per cent share of total exports in 2009. Tea exports accounted for 16.7 per cent of total exports (US$ 1,185 million) while exports of rubber and rubber products took a share of 6.8 per cent (US$ 483 million) in 2009.

3.3.1 Tea

Earnings from agricultural exports declined by 8.9 per cent to US dollars 1,690 million in 2009 from US$ 1,854 million in 2008 mainly due to the reduction in demand for tea, rubber and coconut products and liquidity constraints in importing countries. Yet, during the fourth quarter of 2009 and in the first quarter of 2010, global supply shortages resulted in higher prices and higher export

Figure 3.6
Tea Exports (January 2008-May 2010)



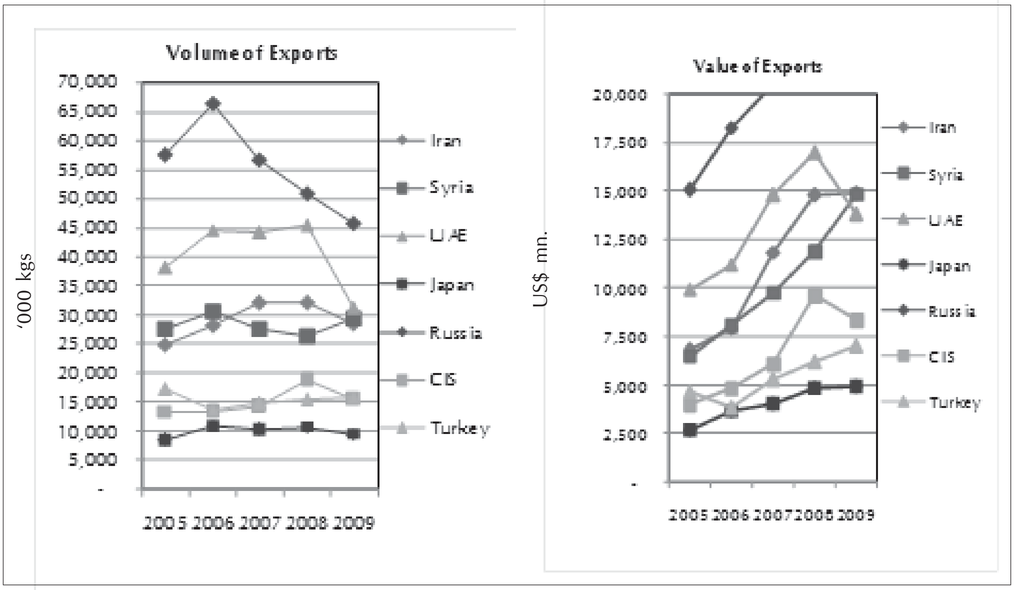
Source: Central Bank of Sri Lanka, *Selected Monthly Economic Indicators*, various issues

earnings in tea, rubber and some minor agricultural commodities. The upswing can be mainly attributed to the global supply shortage created by the production deficit in Kenya, India and Sri Lanka due to unfavourable weather conditions. Furthermore, strong demand from the Middle East for Sri Lankan low grown teas and rising demand led by the gradually reviving global economy also strengthened the price increase.

Though tea exports declined during 2008 and into the first quarter of 2009, exports picked up from mid-2009 (Figure 3.6). Hence, earnings from tea exports increased from US$ 58.2 million in April 2009 to US$ 105.5 million in March 2010. However, although the value of tea exports has increased over the past five years owing to the high prices, the volumes have depicted a declining trend. Sri Lanka's main export destinations for tea are Russia, United Arab Emirates (UAE), Iran and Syria. While there have been a significant drop in demand for Ceylon tea from countries like Russia even prior to the pre-crisis period, the situation was aggravated by the financial crisis in 2008 (Figure 3.7).

However, Russia's economy is on the road to recovery that has led to improved private consumption. Private consumption in Russia has grown at an average rate of 0.4 per cent since November 2009, driven mainly by an improving wage growth in the real sector and slowing inflation. Though Russia's growth is substantially lower than the 1 per cent growth achieved in 2005-08, it is a positive signal for the post-crisis period. Thus, as the largest export destination of Sri Lankan tea, an increase in demand from Russia can be expected in the coming years if proper marketing strategies of Sri Lankan tea are in place. Sri Lanka needs to put into action effective promotional tools in retaining and improving its market share as it has faced tough competition in the Russian tea market due to aggressive promotional strategies of Kenyan tea.

Figure 3.7
Sri Lanka's Major Export Markets for Tea



Source: Central Bank of Sri Lanka, *Annual Report* 2009.

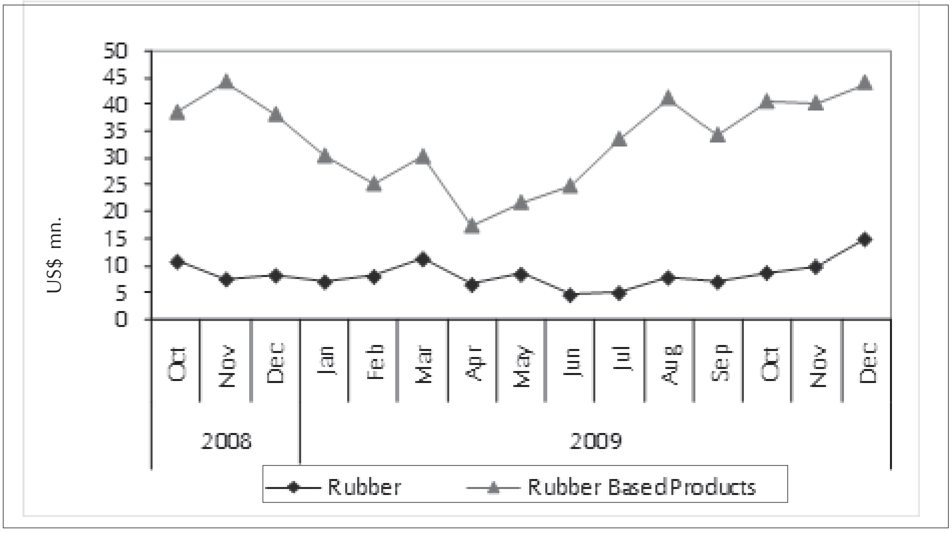
Furthermore, with Iran, the fourth largest importer of Sri Lankan tea, expecting to double its tea purchases from Sri Lanka in 2010 - from 28.6 kilos in 2009 to 50 million kilos in 2010 - a strengthening of the export earnings of the tea sector can be projected. Moreover, with the growing concern towards consumption of healthier beverages, demand for high grown tea is expected to improve especially in the EU and Middle Eastern countries.

With the end of the conflict, Sri Lanka's tea plantation sector too has attracted FDI with companies like Bogowantalawa Tea Plantations Corporation establishing joint ventures with foreign investors. With one of the major barriers in enhancing productivity and profitability in tea plantations in Sri Lanka being the use of out-dated technology, these FDI receipts, which will be followed by technological transfers, could be utilized to enhance productivity and profitability of tea plantations. Thus, the prospects for the development of the plantation sector and thereby improving the level of exports will be much better.

3.3.2 Rubber and Rubber Products

Rubber products have been of great importance to Sri Lankan export earnings as it is the second largest industrial export, though natural rubber production levels are not at impressive heights. Despite a 15.1 per cent increase in export volumes, earnings from rubber exports reduced by 21.2 per cent to US$ 98.6 million in 2009 from US$ 125.1 million in 2008 (Figure 3.8). This result was attributed largely to the decline in synthetic rubber prices in line with the decline in crude oil prices, which resulted in a significant decline in rubber prices in the international market. Due to the severe crisis in the industrial and automobile sectors in North America and Europe, which was a result of the economic downturn, the earnings from exports of rubber products, largely tyres and tubes, recorded negative growth from November 2008 until April 2009. There has been a gradual increase since.

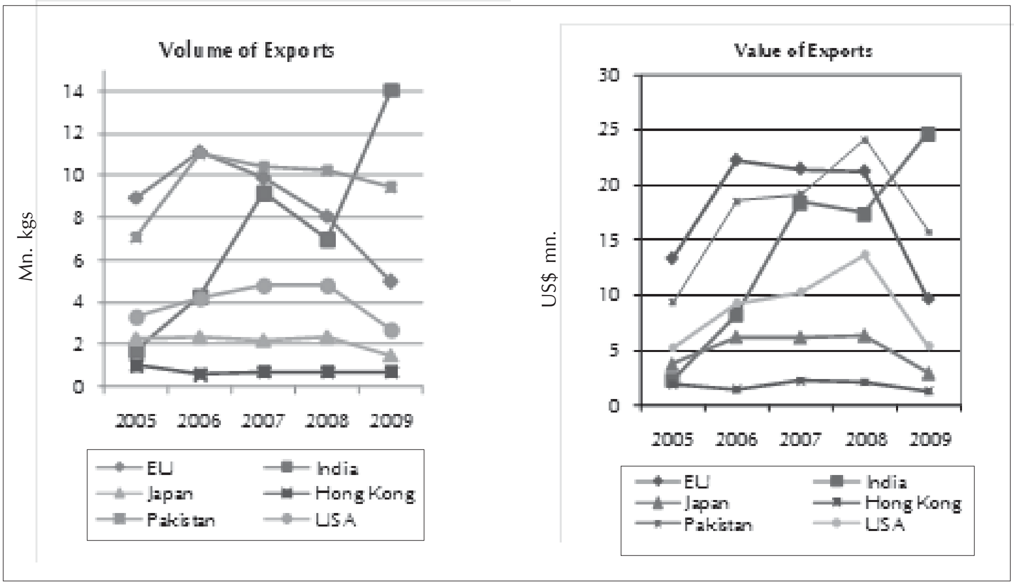
Figure 3.8
Exports of Rubber and Rubber Based Products (October 2008-December 2009)



Source: Central Bank of Sri Lanka, *Selected Monthly Economic Indicators*, various issues.

With the industrial nations demanding higher volumes of natural rubber together with the East Asian countries like Thailand, Indonesia, Malaysia, Vietnam and China switching from rubber to less labour intensive oil palm production, the global natural rubber industry is experiencing a supply deficit which is expected to last beyond 2011. This would pave the way to further strengthen demand for Sri Lankan rubber.

Figure 3.9
Sri Lanka's Major Export Markets for Rubber



Source: Central Bank of Sri Lanka, *Annual Report* 2009.

With the demand for natural rubber largely depending on tyre sales for manufacturing of vehicles and replacement tyres, the outlook for natural rubber exports looks positive.[2] With the global economic recovery under way, Sri Lanka can expect a boost in demand for natural rubber from leading automobile manufacturers like Japan, India and the EU in the near future.

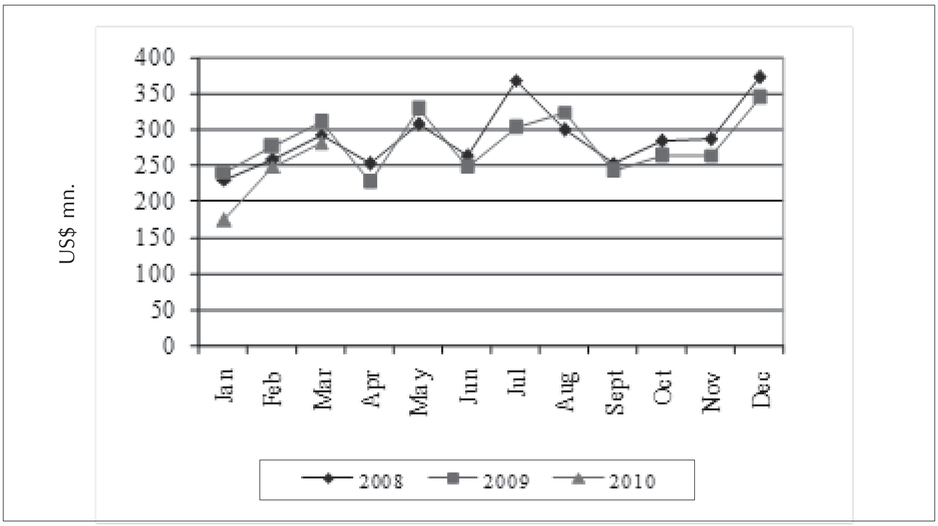
Nevertheless, with tyres and tubes from Sri Lanka being exported to EU countries like Belgium, Germany, Holland and Poland, the suspension of GSP-plus concessions can have a negative impact on Sri Lanka's export earnings.[3] Industry sources claim that the GSP-plus dispute has already affected the sentiments of the buyers in EU over Sri Lankan products and some have already shifted to alternative producers with lower prices. Thus, Sri Lankan tyres and tube industry faces the prospect of market share erosion in the EU with the loss of GSP-plus preferential concessions.

3.3.3 Textile and Garments

Although the garment-sector seemed fairly resilient in the first quarter of 2009, the lagged effects of the global crisis affected the performance of the sector in the following quarters, especially in the latter half of 2009 (Figure 3.10). Earnings from textile and garments exports contracted by 3.1 per cent to US$ 3,364 million in 2009, primarily due to lower global demand. In the first quarter of 2010, apparel exports decreased by 14.9 per cent to 703.2 million US dollars from that of the same period in 2009.

While the bigger players in the industry were better able to withstand the crisis due to their established links with buyers, niche markets and international reputation as reliable

Figure 3.10
Exports of Textiles and Garments (January 2008-March 2010)



Source: Central Bank of Sri Lanka, *Selected Monthly Economic Indicators*, various issues.

[2] The tyre sector consumes approximately 65 to 70 per cent of the annual global production of natural rubber.

[3] In February 2010, the EU announced the suspension of GSP+ concessions to Sri Lanka for a period of 6 months. However, Sri Lanka was to continue to receive preferential access to the EU market during the period until a final decision was to be arrived at. In July 2010, Sri Lanka declined to meet the conditions set down by the EU to renew concessions from August 2010.

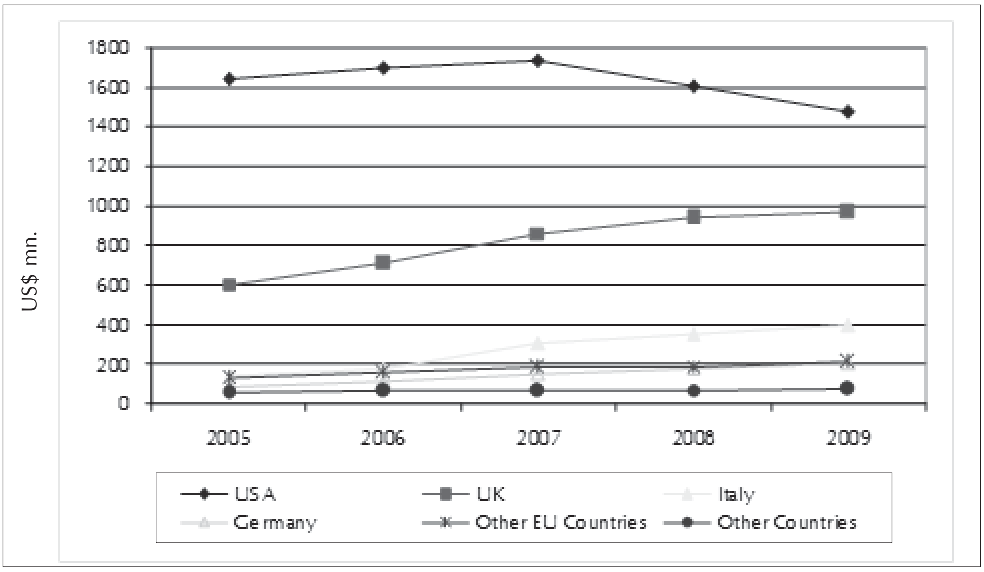
supplier of high quality markets, the small and medium players were adversely affected. The bigger players also took measures to cut down their overhead costs in order to meet the price cuts in their main export destinations. With the withdrawal of GSP-plus concessions by the EU, it is important that the government undertakes measures to weather the negative impact on small and medium players. Exports earnings of the textile and garment industry fell by 15 per cent in the first quarter of 2010, mainly due to lower global demand with industry sources mentioning that GSP-plus related uncertainties have also played a role. The impact of the withdrawal of concessions is expected to be reflected in export levels in the coming months.

Sri Lanka's textile and apparel industry has remained fairly resilient over the years, weathering the ending of the quota regime administered under the Multi-Fibre Arrangement (MFA) in 2005. Some of the leading apparel manufacturers have emerged as regional players. For instance, Brandix Lanka Limited has opened a 1,000-acre 'Apparel Park' in India to serve as a hub for manufacturers and suppliers in the south Asian region. The facility near the eastern Indian port city of Vishakhapatnam when fully occupied will accommodate up to 20 apparel manufacturing plants, three fabric mills, eight accessories manufacturers and a finishing plant. Development of these backward linkages may help Sri Lankan apparel exporters to remain competitive. However, in order for the small and medium manufacturers to survive, it is essential that the government takes measures to mitigate the impacts of the loss of GSP-plus to some degree.

3.3.4 Remittances

Inward worker remittances became the prime foreign exchange earner in 2009, rising by over 14 per cent to US$ 3,330 million. Remittance inflows have consistently helped Sri Lanka to manage its current account deficit on the BOP. As shown in Figure 3.12, even though workers' remittances have

Figure 3.11
Major Export Markets for Textiles and Garments in Sri Lanka



Source: Central Bank of Sri Lanka, *Annual Report* 2009.

shown a marginal decline during the first quarter of 2009, the ending of the three-decade long conflict saw a significant increase in remittance transfers to Sri Lanka in the following months. Indeed, the large Tamil diaspora can become a significant source of inward remittances to the country as households in the Northern and Eastern Provinces gear up to rebuild their livelihoods and social capital.

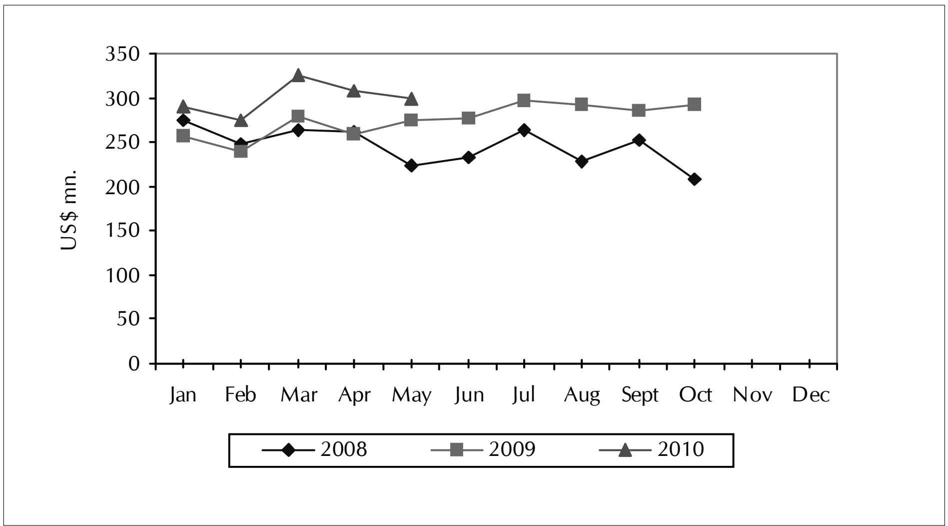
Remittance inflow from the Middle Eastern countries, which accounts for more than 60 per cent of Sri Lanka's total remittances, has been on an upward trend since 2005, despite speculation regarding some reduction in wages and loss of employment during 2008-09 on the back of falling oil prices and sluggish growth rates. Similarly, remittance flows from the EU has been increasing, but at a slower rate from 2007. Despite the recession, remittance flows from the EU countries have held steady which may be due to the higher incomes and the stock of high-skilled workers in these countries who were less adversely affected by the loss of jobs. Furthermore, the CBSL together with commercial banks took additional measures in 2009 to promote the inflow of workers' remittances through formal channels which may be reflected in the increasing flows of remittances. Higher inflows of remittances are expected to be received in 2010 and beyond through formal channels with the expansion of the bank branch network in the Northern and Eastern Provinces as well.

For many South Asian countries, including Sri Lanka, prospects for higher inflows of worker remittances are improving in oil-producing countries as well as in higher-income Asia. However, jobless economic recovery and unpredictable exchange rate movements in some of the developed nations may adversely affect remittance inflows in 2010 with lagged effects.

3.3.5 Tourism

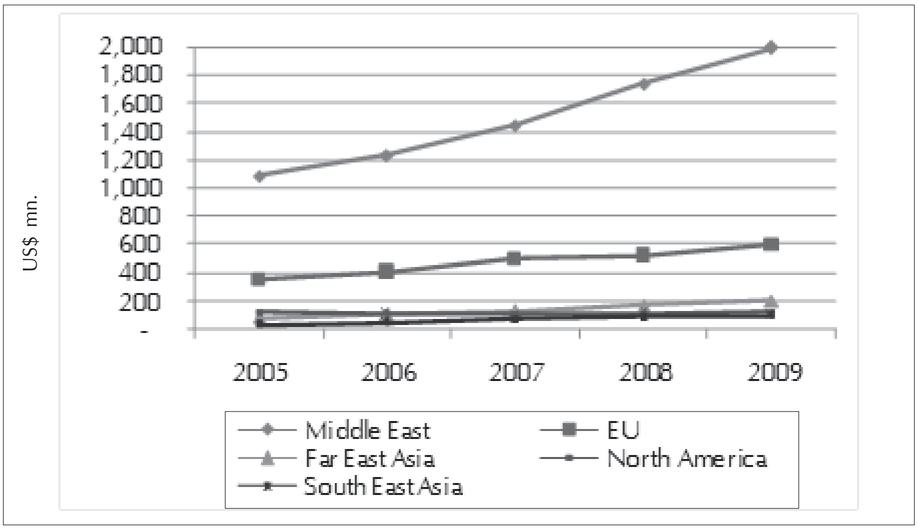
The end of the conflict in Sri Lanka has paved the way for the travel and tourism industry to flourish. Despite the sharp drop in tourist

Figure 3.12
Monthly Private Remittances (January 2008-May 2010)



Source: Central Bank of Sri Lanka, *Selected Monthly Economic Indicators*, various issues.

Figure 3.13
Private Remittances by Country of Origin

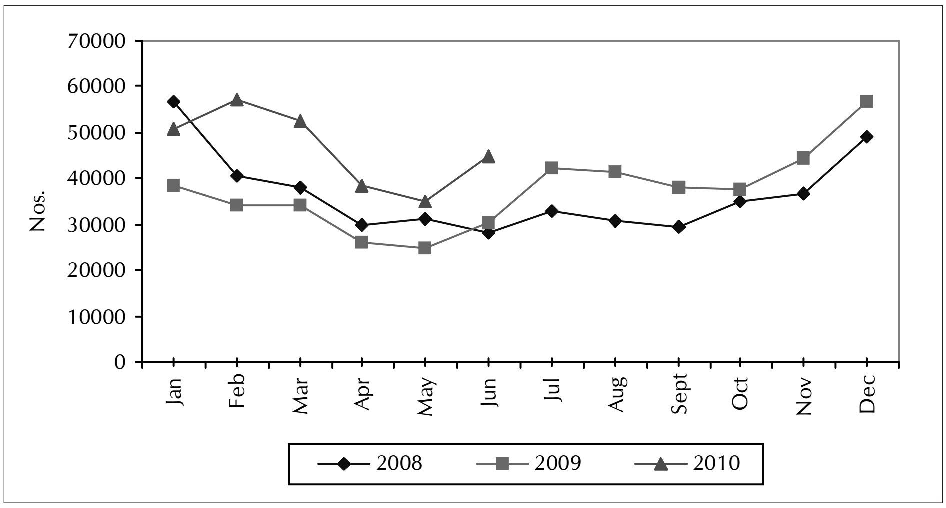


Source: Central Bank of Sri Lanka, *Annual Report 2009*.

arrivals until mid-2009, arrivals increased from June 2009 onwards (Figure 3.14). Adverse travel advisories issued by some countries were subsequently withdrawn or relaxed as the circumstances changed. As a result, there has already been a sharp increase in tourist arrivals in 2010 - an increase of 48.4 per cent in the first six months of the year compared to the same period last year.

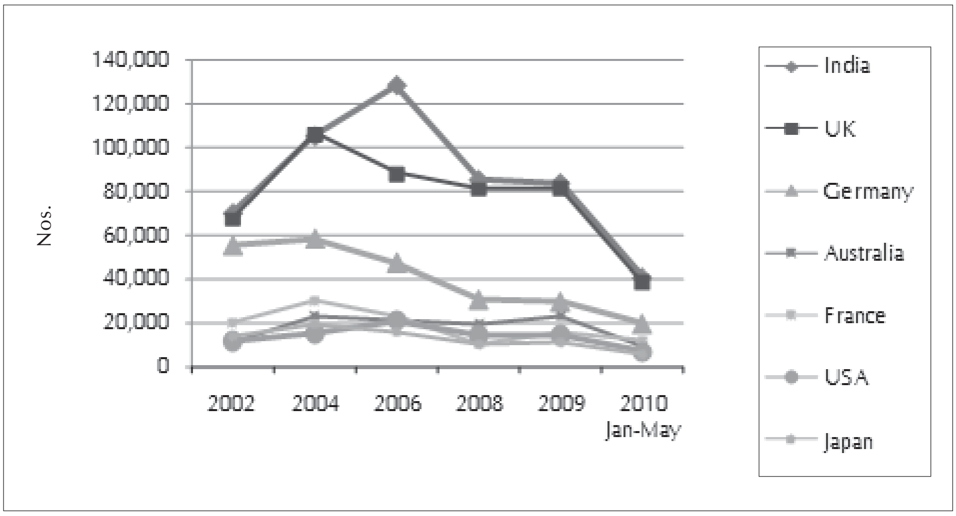
Sri Lanka's global attractiveness as a tourist destination will undoubtedly increase in the coming years with the end of the conflict. This will bring about both opportunities and challenges. The management of tourism will require a great deal of policy dexterity to ensure that economic benefits of tourism are

Figure 3.14
Tourist Arrivals (January 2008-June 2010)



Source: Central Bank of Sri Lanka, *Selected Monthly Economic Indicators*, various issues; and Sri Lanka Tourism Development Authority.

Figure 3.15
Tourist Arrivals by Country



Source: Central Bank of Sri Lanka, *Selected Monthly Economic Indicators*, various issues; and Sri Lanka Tourism Development Authority.

reaped, the infrastructure to handle tourism is in place, and most importantly that the industry grows in a manner that is sustainable. These issues will be dealt with in later chapters.

The highest number of tourist arrivals was recorded from India (83,634), followed by the UK (81,594), the Maldives (31,916) and Germany (29,654) in 2009. Moreover, an impressive number of tourist arrivals were recorded from Middle East, France, Australia, Singapore and Malaysia. The higher numbers of tourist arrivals from emerging economies can be anticipated in the future with the emerging economies expected to play a major role in boosting international travel with China alone expected to provide almost 95 million visitors for other destinations by 2020.[4]

3.3.6 Capital Flows

Global FDI inflows fell drastically in all developed, developing and transition economies in 2009 as a result of weak economic performances in many parts of the world. Total FDI inflows amounted to US$ 1,114 billion, declining by 37 per cent compared to the previous year. Outflows too fell by 43 per cent to record US$ 1, 101 billion.[5]

The crisis changed the investment landscape with developing and transition economies' absorbing almost half of total FDI inflows in 2009 while inflows to developed economies fell by 44 per cent. Although the developing and transition economies suffered a decline of inflows as well, they performed better than the developed economies. China climbed the ranks to become the second largest FDI recipient, with the US securing the largest amounts of FDI inflows in 2009. In terms of the South, East and South-East Asian countries, there has been a drop of 17 per cent in FDI inflows in 2009 (to US$ 233 billion), the largest decline of FDI flows since 2001. Nevertheless, these regions have been the first to rebound and are expected to pick

[4] World Travel and Tourism Council, http://www.wttc.org/

[5] UN, World Investment Report 2010.

pace and lead the global recovery. Developing and transition economies are expected to attract higher levels of investments due to their high growth rates, and increased openness to FDI and international production.[6]

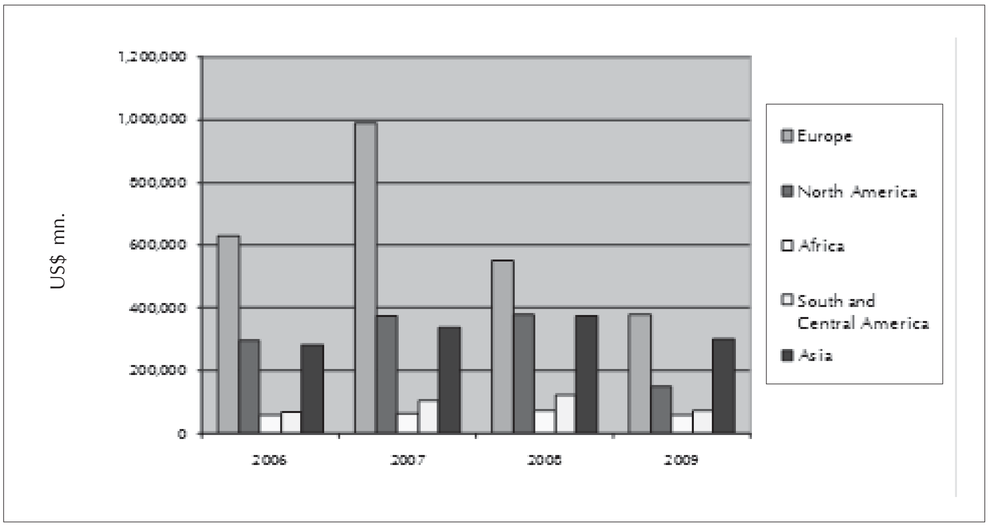
In terms of FDI outflows, although the funds flowing out of the developed countries fell steeply in 2009, the region still remains the largest source of FDI and their outflows exceed inflows. Nevertheless, the developing and transition economies increased their share of FDI outflows - from 19 per cent in 2008 to 25 per cent in 2009 - and are expected to further strengthen their position as emerging sources of FDI with investments abroad.

In South Asia, India is the major recipient accounting for 83 per cent of total FDI inflows to the region. India is expected to continue to attract increasing amounts of FDI in the coming years. At the global level, a slow recovery of FDI flows is expected in 2010, with a more robust performance in 2011.

With a conducive political environment for investment in the aftermath of the conflict, Sri Lanka too is expected to attract more investment. With the onset of the global economic crisis, Sri Lanka suffered a drop in FDI inflows, with net inflows declining from a high of US$ 691 million in 2008 to US$ 384 million in 2009.[7] Gross inflows too recorded a downturn in 2009, falling from US$ 889 million in 2008 to US$ 601 million in 2009, with China, UK and India injecting the largest amount of funds, especially to the telecommunications and the power and energy industries. This is similar to trends in the recent past with the services/infrastructure sectors attracting the highest amount of FDI to the country - 72 per cent of total FDI inflows in 2009 (Table 3.5).

This trend is expected to change in 2010 with more funds coming in to the tourism and leisure sectors. While FDI inflows to the textile, wearing, apparel and leather sector may

Figure 3.16
Direction of World Investment Inflows (2006-08)



Source: UN, *World Investment Report 2010.*

[6] Ibid.

[7] Central Bank of Sri Lanka, *Annual Report 2009*.

decline in response to the withdrawal of concessions under the EU GSP-plus scheme, renewed positive investor sentiment and recovery of the external sector can strengthen foreign capital inflows into other areas. These include infrastructure related projects, information technology (IT) and business process outsourcing (BPO), agriculture and food processing, fisheries, gems and jewellery, and rubber-based products. Around US$ 250 million is estimated to have already come into Sri Lanka in the first quarter of 2010, compared to the US$ 601 million inflow for the whole of 2009.

3.4 Prospects for Regional Integration

The economic crisis reinforced the need for Sri Lanka to diversify its export markets. The recessionary conditions and sluggish recovery of its traditional markets, the loss of GSP-plus preferential concessions, and the resilience of emerging economies to the crisis and their large markets make it only rational for Sri Lanka to consider opportunities in major emerging economies in Asia such as India, China and the emerging ASEAN countries. Strong growth in India, China and ASEAN countries will have positive spillover effects on their neighbouring countries, particularly in terms of FDI inflows and export opportunities. Therefore, it is important for export driven economies like Sri Lanka to penetrate these markets in order to diversify and develop its export income and growth.

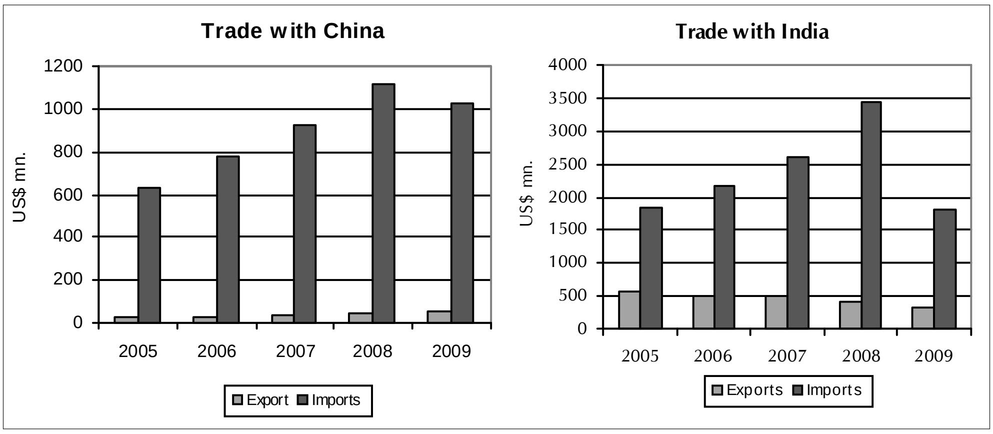
Sri Lanka has preferential access to both India and China under the Indo-Sri Lanka Free Trade Agreement (ISFTA) and the Asia Pacific Trade Agreement (APTA). Under the ISFTA, Sri Lanka has enjoyed considerable success in terms of expanding export earnings as well as diversification of its export basket. Following the ISFTA, India is now the sixth largest export destination of Sri Lanka. Furthermore, several Sri Lankan exporters in sectors such as furniture, garments, ships, animal feed, rubber gloves,

Table 3.5
Foreign Direct Investment by Sector (2007-09)

		US$ Million		
	Sector	**2007**	**2008**	**2009**
1.	Food beverages & tobacco	25.9	14.7	10.1
2.	Textile, wearing apparel & leather	62.6	72.3	51.4
3.	Wood & wood products	0.8	2.2	1.7
4.	Paper & paper prod., printing & publishing	0.00	0.8	20.8
5.	Chemicals, petroleum, coal, rubber & plastics	49.0	39.9	15.4
6.	Non-metallic mineral products	4.7	12.8	11.2
7.	Fabricated metal, machinery & transport equip.	12.5	14.4	14.0
8.	Manufactured products (NES)	18.4	32.0	38.6
9.	Agriculture	0.4	2.6	3.7
10.	Services/infrastructure	559.9	697.1	434.3
	TOTAL	**734.4**	**888.9**	**601.2**

Source: Board of Investment of Sri Lanka.

Figure 3.17
Sri Lanka's Trade with China and India



Source: Central Bank of Sri Lanka, *Annual Report 2009*.

rubber tyres, food products, and electrical machinery among others, have been able to successfully penetrate the Indian market. Completion of the first decade of the operation of ISFTA in March 2010, has set a platform to review and rectify the impediments faced during its implementation, addressing inefficiencies at both ends, conflicting interests, domestic policies, high tariffs and non-tariff barriers, etc.

Although the ISFTA does not cover investments, increased business confidence as a result of the agreement has also given a boost to Indian investments in Sri Lanka, making it the third largest investor in 2009. With India pursuing stronger economic relations with the wider Asian region, closer economic integration with India would open doors for new opportunities in both goods and services for the Sri Lankan economy. India has already signed Comprehensive Economic Cooperation Agreements (CECAs) with Singapore and South Korea, and a Trade in Goods Agreement with ASEAN. India has also begun negotiations on a FTA with the Gulf Cooperation Council (GCC) and the EU. In this background, enhanced economic integration with Sri Lanka's emerging global economic neighbour would open doors to tap into the growth potential of India as well as the rest of the world. Similarly, if preferences provided in APTA could be effectively utilized, Sri Lanka can reap the benefits of market access to China, the world's fastest growing economy. Box 3.1 further discusses the prospects of APTA for Sri Lanka.

3.5 Conclusion

Although the recovery of the global economy has been moving forward - with emerging and developing economies moving more rapidly towards a solid recovery - important downside risks remain. With fiscal crisis in some EU countries threatening contagion effects on Europe and the global economy, Sri Lanka should be wary as Europe remains a key market for Sri Lanka. Deteriorating fiscal positions and rising public debt may leave little room for policy maneuver in the developed world, and thereby undermine financial stability and hold back the world economic recovery. While economic stress in Europe can undermine Sri Lanka's export performance, the issue is compounded by the loss of GSP-plus preferential access as well.

While the post-conflict recovery and the lagged effects of expansionary fiscal and

Box 3.1
APTA and Prospects for Sri Lanka

The preferential trade agreement, APTA, which includes the countries of Bangladesh, China, India, the Republic of Korea, Sri Lanka and the Lao PDR has been in force from 1 July 2006. It is one of the largest regional trading arrangements (RTA) blocs in terms of market size in the Asia-Pacific region, covering a total population of over 2.5 billion. APTA offers substantial tariff concessions and wide product coverage for Sri Lanka. At the fourth round of negotiations held in December 2009, it was decided to go into areas beyond traditional tariff concessions in order to deepen trade cooperation and integration. APTA members are currently negotiating three framework agreements on trade facilitation, trade in services, and investments. In addition, APTA members are exchanging information on non-tariff measures.

Sri Lanka's current major export items to the member countries of APTA include desiccated coconut, coconut fibre, copra, coconut oil, natural rubber, tea, cloves and crude glycerine. The consolidated national lists of the member countries have offered concessions on items of export interest to Sri Lanka in addition to the above products in spices (pepper, nutmeg, mace), cashew nuts, essential oils, natural graphite, rubber products (tyres, gloves, mats, rings) floor tiles, ceramic tableware/kitchenware, glassware, semi-precious stones, gems and jewellery, stuffed toys, cut flowers, footwear, biscuits, apparel, fresh fruits and juices, wooden furniture, ornamental fish, fresh/frozen fish and fisheries products.

Given the expertise of member countries, and the complementary resources available in Sri Lanka, APTA can also pave the way for the promotion of investments and joint ventures in Sri Lanka on projects such as manufacture of microwave ovens, electronic/video games, motorcycles, telecommunication apparatus, copper items, fans, marble, computers, aluminium products, telephone sets, garments and footwear.

Sri Lanka's trading relationship with China, as the largest member of the APTA, is quite significant when examining the prospects of APTA for Sri Lanka. While Sri Lankan exports to China have grown over the past few years, imports from China have grown at a much faster rate. For instance, Sri Lanka's exports to China increased from US$ 29 million in 2005 to US$ 56 million in 2009 (rising marginally from 0.5 of total exports to 0.8 per cent), while imports from China increased from US$ 631 million to US$ 1,029 million (rising from 7.1 per cent of imports to 10.1 per cent) over the same period.

Sri Lanka's major exports to China include raw coconut coir, apparel items, tea, natural rubber, diamonds and other precious stones, titanium ores and concentrates, and bicycles and other cycles. Sri Lanka's major imports from China include electrical machinery and equipment, boilers and machinery and parts, cotton, iron or steel and its articles, man-made staple fibres, knitted or crocheted fabrics, fertilizers, railway locomotives and inorganic chemicals.

Under APTA, China already provides tariff concessions for over 1700 products that are imported from Sri Lanka at a margin of preference (MOP) of 27 per cent, which covers around 50 per cent of total exports to China from Sri Lanka. These concessions are expected to increase up to 2000 export products within the next 2 years. Yet, the utilization of tariff concessions by Sri Lankan exporters is reportedly very low, with Sri Lanka utilizing less than 5 per cent of preferential tariff lines granted by China. Out of APTA eligible exports, 15 per cent is still completely untouched by Sri Lankan exporters.

APTA provides ample opportunities for business expansion and attracting FDI into Sri Lanka. Presently, 16 Chinese businesses have invested in garment, leather, telecom and electronics manufacturing facilities in the country. These sectors have significant importance to Sri Lanka's economy as export items and as potential means of going into higher value added exports in the coming years.

monetary policy would drive economic growth in the short term, in order for this to be sustainable over the long run, it is important for Sri Lanka to diversify its markets and to look at new opportunities, especially in emerging economies. Sri Lanka holds the advantage of having preferential access to the strongly emerging economies of India and China through the ISFTA and APTA, respectively. If the thrust areas of exports to these countries are identified and preferential access available under such agreements is fully utilized, Sri Lankan exporters would be able to reap substantial benefits from export opportunities.

Expanding Sri Lanka's export earnings is critical for long term sustainability of the external current account, particularly with imports expected to increase steeply in the coming months. Sri Lanka will be assisted in managing its BOP through improved inflows of capital. Investments flowing in to areas such as tourism and the leisure sector look promising, while remittances from migrant workers and tourism earnings are also expected to cushion a widening trade imbalance. Nonetheless, the key to ensuring a comfortable external current account position will hinge on the country's ability to continually raise its earnings from exports of goods and services.