Sri Lanka
State of the Economy Report 2016

Chapter 3
International Environment

by
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3. International Environment

3.1 Introduction

A first reading of the global economic outlook points towards uncertainty and pessimism dominating the current economic and business environment. On the plus side, discussions have moved away from the likelihood or otherwise of a possible collapse of a nation, like in the instance of Greece in 2015. Though still on the front line, a crisis was averted in Greece with significant bail out programmes. However, the global economy does have more pertinent issues to contend with, including Britain's exit from the EU (Brexit), considerable market turbulence in exchange and stock markets, and falling oil and commodity prices. China's rebalancing and slow growth, though not a surprise, seems to be having considerable spillover effects on the rest of the world, adding further downside pressure on commodity and oil prices, and affecting stock markets across Asia, Europe and the US. Being the second largest economy and the second largest importer of goods and services globally, the spillover effects of China's economic restructuring seem inevitable.

Growth expectations for 2016 have fallen consistently across the board for both advanced and emerging markets, and more so for European economies following Brexit.[1] US economic growth, however, is expected to be resilient; against the background of a recovery,

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[1] Based on IMF (2016), “World Economic Outlook”, International Monetary Fund, Washington, D.C.

there has been a gradual tightening of its monetary policy. The EU, which was initially expected to perform better in 2016, now faces deepened uncertainty with the ramifications of Brexit still unfolding. Furthermore, acts of terrorism and the flow of refugees to the region are creating major economic challenges and testing the EU's political system.[2] Japan, on the other hand, continues to suffer from stagnant growth and low inflation; both Japan and the EU are likely to continue pursuing an accommodative monetary policy stance.

Among emerging and developing economies, India will continue to grow the fastest in the world and according to some forecasts will continue to outdo China till 2024.[3] There are even some suggestions that India which is currently the eighth largest economy in the world is set to become the third largest in less than 15 years.[4] On the other hand, countries like Brazil and Russia continue to have a bleak outlook fuelled by political tensions.

Similar to 2015, the global environment is expected to pose continuing challenges to Sri Lanka, primarily via uncertainty in export and capital markets. Lower commodity prices will help to curtail import expenditures - and overall inflationary pressures in the economy - but the slide in commodity prices has a downside impact on key exports such as tea and rubber. On the export front, a modest recovery in the US, lift of the ban on Sri Lanka's fish exports to the EU, and possible reinstatement of EU GSP-plus offer a glimmer of hope. Overall, the trade balance is also expected to improve, supported by healthy earnings from tourism and remittances, although the latter is expected to show stagnant growth. However, the uncertainty following Brexit is likely to impact Sri Lanka's exports and tourism negatively in the short to medium term. Furthermore, Sri Lanka will find it harder to attract capital inflows in the face of a downgraded sovereign rating, even as foreign investors review the elevated risks of emerging market economies. Nonetheless, conditional financial support from the IMF will allow Sri Lanka some room to manage external sector risks while addressing broader near-term economic challenges.

3.2 Prospects for the Global Economy

3.2.1 Advanced Economies: Adjusting to Lower Growth

The global economy is projected to grow at 3.1 per cent in 2016, at the same rate as 2015 but lower than the average growth of 3.3 per cent over the past 5 year period (Table 3.1). Growth rates are much lower than the pre-financial crisis levels; against a background of high volatility and uncertainty, the outlook is not expected to change significantly in the next couple of years. Emerging and developing countries continue to slow down, while advanced countries are recovering, albeit at a slow pace.

Among the advanced economies, the US is expected to show steady growth with unemployment levels at natural rate and no

[2] *Ibid* – January 2016.

[3] *The Wall Street Journal* (2016), "India Will Be Fastest-Growing Economy for Coming Decade, Harvard Researchers Predict", available at http://blogs.wsj.com/indiarealtime/2016/01/01/india-will-be-fastest-growing-economy-for-coming-decade-harvard-researchers-predict/.

[4] Bloomberg (2016), "These Will Be the World's 20 Largest Economies in 2030:Take A Peek at the New World that Awaits Us", available at www.bloomberg.com/news/articles/2015-04-10/the-world-s-20-largest-economies-in-2030.

threats of high inflation or deflation. The US is projected to grow at 2.2 per cent in 2016 and 2.5 per cent 2017, compared to a growth rate of 2.4 per cent in the past two years. The unemployment rate which was 5 per cent in 2015 - lower than the Fed's target of 6.7 per cent - is expected to fall further to 4.7 per cent in 2016 (Figure 3.1). However, the growth in jobs has been mostly in low paying food and retail industries, with the real unemployment rate estimated at a high 10.1 per cent.[5] As a result, the growth in household income has been weak. Another significant development in the US economy was the rate hike in December 2015, after seven years of near-zero interest rates to stimulate the economy since the financial crisis of 2008. As anticipated, it has affected emerging market economies in terms of capital outflows and exchange rate movements.

Private consumption levels of the three major economies EU, US and Japan are not expected to rise significantly; in fact consumption expenditure in the EU and US are expected to fall while consumption levels in Japan, which is currently below zero, are expected to rise gradually. However, unemployment rates in all three economies are expected to improve during the period 2016-2017.

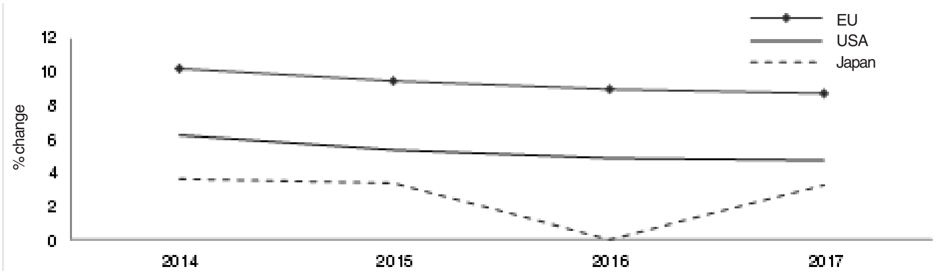
Table 3.1
Overview of World Output (% change)

	2010	2012	2013	2014	2015	2016	2017
World Output	**5.1**	**3.5**	**3.0**	**3.4**	**3.1**	**3.1**	**3.4**
Advanced Economies	**3.1**	**1.2**	**1.2**	**1.9**	**1.9**	**1.8**	**1.8**
US	2.5	2.2	1.5	2.4	2.4	2.2	2.5
Euro Area	2.1	-0.9	-0.3	0.9	1.7	1.6	1.4
Germany	3.6	0.9	0.5	1.6	1.5	1.6	1.2
France	1.4	0.0	0.3	0.6	1.3	1.5	1.2
Japan	4.7	1.7	1.4	0.0	0.5	0.3	0.1
United Kingdom	1.4	0.3	1.8	3.1	2.2	1.7	1.3
Canada	3.2	1.7	2.0	2.5	1.1	1.4	2.1
Emerging & Developing Economies	**7.3**	**5.0**	**4.7**	**4.6**	**4.0**	**4.1**	**4.6**
China	10.3	7.7	7.7	7.3	6.9	6.6	6.2
India	10.1	4.7	4.4	7.2	7.6	7.4	7.4
Russia	4.0	3.4	1.3	0.7	-3.7	-1.2	1.0

Notes: 2016 and 2017 values are projections.
Source: IMF, "World Economic Outlook", 2016 (July).

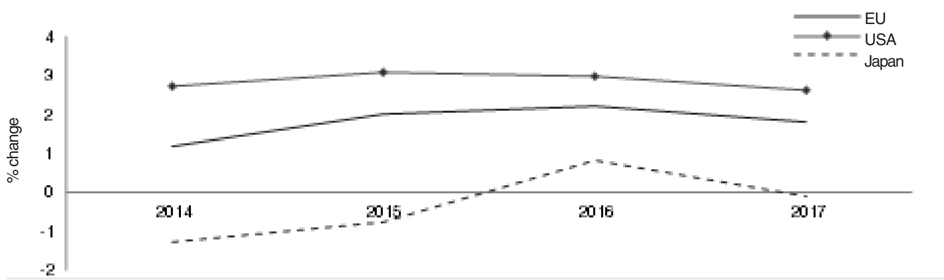
[5] US Bureau of Labour Statistics (2016), "Local Area Unemployment Statistics", available at http://www.bls.gov/lau/stalt16q1.htm.

Figure 3.1
Forecasted Unemployment Rates in EU, US and Japan



Source: European Commission (2016), "European Economic Forecast: Spring 2016", EU.

Figure 3.2
Private Consumption Expenditure - EU, US and Japan



Source: European Commission (2016), "European Economic Forecast: Spring 2016", EU.

Britain and the EU are faced with uncertainty with Britain becoming the first country to vote to leave the EU, following a tense referendum on 23 June 2016. The final result saw the 'Leave' campaign win by a small majority (52 per cent to 48 per cent), resulting in political and economic turmoil in the immediate aftermath.[6] The outcome of the referendum took the money and financial market by surprise; the value of the pound fell dramatically against the dollar and share prices plummeted. Although markets seem to have settled, much uncertainty remains over what form the break up will take and the implications for not only to the UK, but also its many trading partners, including the rest of Europe. Much depends on when Article 50 - the rules for exit - is triggered, after which the UK will have two years to negotiate its exit. There are suggestions that Article 50 will not be invoked till 2017, allowing the UK and other nations a transition period till 2019 (the earliest), while other predictions suggest the negotiations would take much longer. Subsequent to Brexit, UK's growth forecasts for 2016 were revised down from 1.9 per cent to 1.7 per cent in 2016 and from 2.2 per cent to 1.3 per

[6] Prime Minister David Cameron resigned from office while Theresa May, a fellow 'Remain' campaigner, took the reins vowing to make the transition as smooth as possible.

cent for 2017 by the IMF. Forecasts for EU were reduced by 0.1 percentage points. However, growth prospects for emerging and developing economies remain largely unchanged following Brexit.

The performance of the Japanese economy is seen to be paradoxical by some analysts, with a high per capita income and low unemployment rate (3.3 per cent compared to 5 per cent in US and 10 per cent in the Euro Zone) on the one hand, and deflation, high government debt (230 per cent of GDP) and a rising fiscal deficit (7 per cent) on the other.[7] It has made a moderate recovery supported by fiscal stimulus, low oil prices and rising incomes, but against the backdrop of a sharp decline in private consumption, it is expected to grow by just 0.5 per cent in 2016; consumption fell year-on-year for the second consecutive year in 2015 by 1.2 per cent. Despite the Bank of Japan announcing a move towards negative interest rates in early 2016 with the aim of spurring investment and keeping the yen low, these were not realized with the economy still faced with low inflation and weak growth.

3.2.2 Emerging Economies: Navigating the Challenging Global Backdrop

The Chinese economy is expected to grow at 6.6 per cent in 2016 and 6.2 per cent in 2017. The Chinese economy is undergoing a triple transition, moving from industry to services, shifting focus from exports to the domestic market and from investments to consumption. The spillover effects of the transition to other economies in the world have been significant, both in terms of demand for imports and impacts on commodity prices. In 2014, China accounted for over 12 per cent of global merchandise exports and around 10 per cent of global imports; over 20 per cent of the slowdown in import growth of developing economies and economies in transition during 2014-15 is apportioned to the China factor.[8] Although the transition was not a surprise, markets appear uncertain of the magnitude of the effects; this

China's transition has translated into lower oil and commodity prices with spillover effects felt by both developed and developing economies.

[7] Feldstein, M. (2016) "Japan's Economic Quandry", available at https://www.project-syndicate.org/commentary/japan-budget-cuts-deflation-risk-by-martin-feldstein-2016-04.

[8] UN (2016), "World Economic Situation and Prospects 2016", United Nations, New York.

had contributed to volatility and uncertainty in world financial markets as well.

India and the rest of emerging Asia is generally expected to grow robustly, despite some countries being buffeted by China's economic rebalancing. With growth of 7.4 per cent, India is expected to be the fastest growing economy in 2016 as well as in 2017.

The outlook for Middle Eastern countries is not encouraging given low oil prices and deepening conflicts in the region. The region as a whole is expected to grow by 3.1 per cent in 2016 backed by increased oil productions in Iraq and lifting of sanctions on Iran. The IMF estimates oil exporting nations in the Middle East to have lost US$ 390 billion due to lower oil prices in 2015.[9] While some countries in the region have responded by enforcing capital spending cuts (i.e., UAE, Saudi Arabia), others have focused on finding new sources of revenue (i.e., Oman, Bahrain and Iran).[10] Losses from lower oil prices are expected to increase to over US$ 500 billion in 2016, translating into budget deficits and slower economic growth, particularly in countries that are highly dependent on oil exports such as Saudi Arabia.

For Sri Lanka, India's strong growth can be expected to have positive spillover effects in terms of higher investment as well as stronger trade ties between the two countries. However, the weak outlook for Middle Eastern countries is of concern, given the region's importance to Sri Lanka as a destination for exports like tea and a key source of remittances.

3.3 World Trade Flows and Commodity Prices

3.3.1 Weaker World Trade Growth[11]

World trade performance has been sluggish in recent years both in terms of value and volumes of trade. Despite positive volumes of trade, the value of trade has fallen, pulled down by shifting exchange rates and falling commodity prices.[12] World trade grew by only 2.1 per cent on average (in terms of value) over the past five years (2011-15), compared to 9.1 per cent in the period before that (2006-10). In fact, 2015

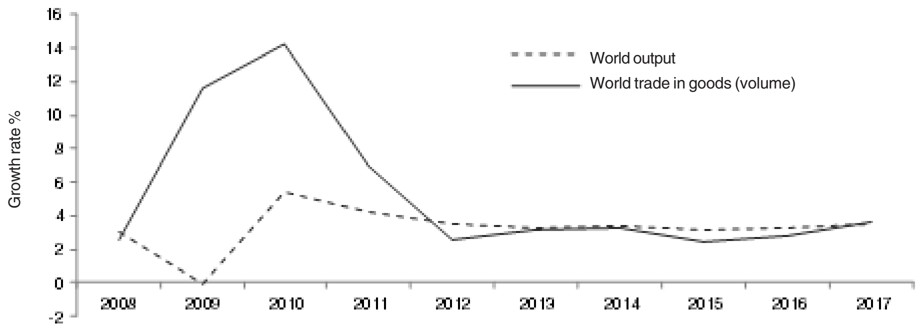
[9] IMF (2016), "Regional Economic Outlook Update: Middle East and Central Asia (April 2016)", International Monetary Fund, Washington, D.C.

[10] *Ibid*.

[11] The focus in this section is on merchandise trade and as such, the figures refer to trade in goods only.

[12] WTO (2016), “Trade Statistics and Outlook (April 2016)”, World Trade Organization, Geneva.

Figure 3.3
Comparison of Growth in World Output and Trade in Goods



Note: Values for 2016 and 2017 are projections.
Source: IMF, "World Economic Outlook", 2016 (April).

recorded a negative growth of 13.7 per cent, the lowest recorded since the financial crisis of 2008 (Figure 3.4). In volume terms too, world trade has been stagnant, indicating a slowdown in demand. Growth remained at 2.8 per cent in 2014 and 2015 and is expected to grow at the same rate in 2016 as well. A comparison with world GDP shows that world trade has grown at a lower rate than world GDP from 2012 onwards (see Figure 3.3). This is a turnaround from the pre-crisis levels of trade which grew on average twice as fast as world GDP.[13] Analysts attribute the current slowdown in trade to both cyclical and structural factors: the Eurozone crisis and the slowdown of the Chinese economy which has affected consumption and commodity prices are some of the cyclical factors; structural factors include China's lower dependency on imported inputs for its exports and developments in the US' shale market which has reduced oil imports into the country.[14]

Unlike in the recent years where weak import demand stemmed from developed economies, in 2015 the downturn is traced back to emerging economies; emerging Asia accounted for 94 per cent of the decline in the slowdown of world import volumes.[15] Among the top importing and exporting countries, the largest reductions in demand for imports were reported from Japan and China in 2015, while Germany, US and Netherlands experienced the largest slowdown in exports (Table 3.2). Among others, notable countries whose exports have been hit are Saudi Arabia (39 per cent), Kuwait (-41 per cent) and Qatar (-45 per cent) in the Middle East and Russia (-33 per cent) where export earnings have been severely affected by plummeting oil prices.

In terms of product category, over a half of the decline in trade values in 2015 can be attributed to declines in fuel and mining products.[16]

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13 Stratford, K. (2015), "Why has World Trade been So Weak in Recent Years?", available at, https://bankunderground.co.uk/2015/10/28/why-has-world-trade-been-so-weak-in-recent-years/.

14 *The Economist* (2015), "What Slowing Trade Growth Means for the World Economy", available at, www.economist.com/blogs/economist-explains/2015/09/economist-explains-10.

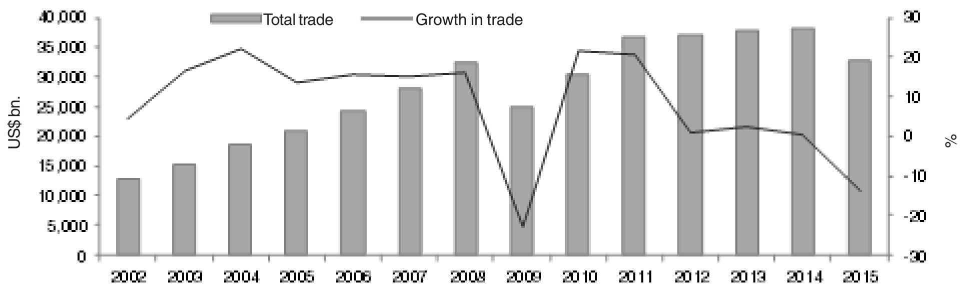
15 Constantinescu, C., *et. al*., (2016), "Global Trade Watch: Trade Developments in 2015", World Bank, Washington, D.C.

16 WTO (2016), "Trade Statistics and Outlook (April 2016)", World Trade Organization, Geneva.

Nevertheless, there has been a significant slowdown of trade in manufacturing and agricultural products as well. Among manufacturing products, office and telecom equipment, chemicals and other machinery (including investment goods and durables other than automobiles) have shown notable declines.

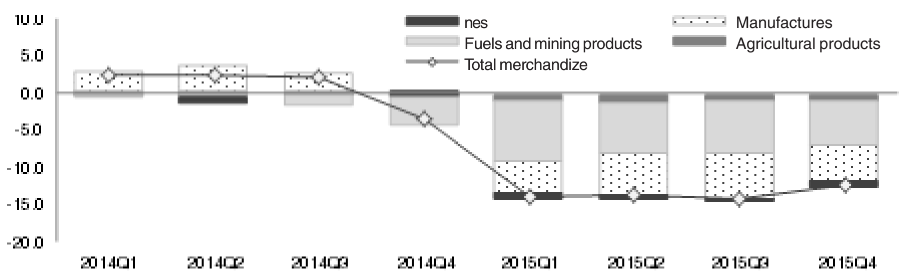
The outlook for 2016 and 2017 predicts exports of both developed and developing nations to grow at around the same rate in 2016 (2.9 per cent and 2.8 per cent, respectively) and 2017 (3.8 per cent and 3.3 per cent), with Asia taking the lead. However, a considerable divergence in terms of imports is expected. Demand for imports by developed countries is expected to grow by 3.3 per cent compared to that of developing and emerging economies which is estimated to grow by only 1.8 per cent in 2016; a trend that can be observed from 2014 which is a sharp reversal of what was observed during 2012-2013.

Figure 3.4
World Trade and Growth in World Trade (in Value)



Source: Compiled using Trade Map Data, 2016.

Figure 3.5
Contributions to Year-on-Year Growth in World Merchandise Trade by Product



Source: WTO (2016), 'Press Release: Trade Growth to Remain Subdued in 2016 as Uncertainties Weigh on Global Demand', available at https://www.wto.org/english/news_e/pres16_e/pr768_e.htm.

Table 3.2
Contributions to World Trade (in Value) by Top Exporting and Importing Countries, 2015

Largest Exporters	Exports: % Contribution to Total Exports	Exports: Growth 2014-2015	Largest Importers	Imports: % Contribution to Total Imports	Imports: Growth 2014-2015
China	12.5	-3	USA	14.0	-4
USA	8.3	-7	China	10.2	-14
Germany	7.3	-11	Germany	6.4	-13
Japan	3.4	-9	United Kingdom	3.8	-9
Netherlands	3.1	-16	Japan	3.8	-23

Source: Compiled using Trade Map Data, 2016.

3.3.2 Adjusting to Lower Commodity and Oil Prices

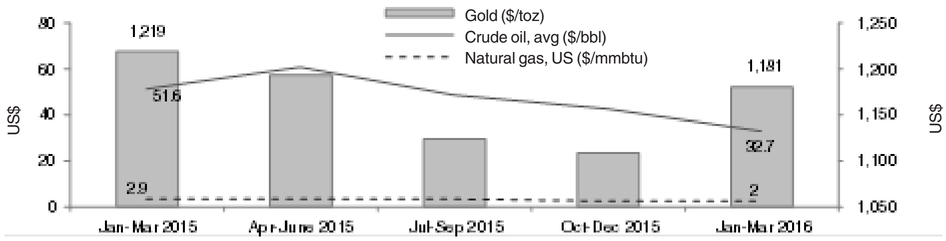
Commodity prices have continued to fall during 2015-16 with prices generally lower in the first quarter of 2016 compared to a year back (Figure 3.6). Oil prices in particular have been persistently low, falling below predicted levels to US$ 32.7 a barrel in the first quarter of 2016. This is about a 65 per cent (or US$ 70) drop in prices compared to June 2014.[17] While oil prices were pushed down mainly owing to excess supply, analysts predict a tightening of supply over 2016 will boost prices. However, lifting of Iran's sanctions may increase OPEC's crude oil production while a stronger dollar is also pushing down prices. Further, with oil being priced in dollars, higher interest rates in the US are pushing the value of the dollar up, making oil a less attractive investment. Nevertheless, compared to a year back, oil prices are now more responsive to supply disruptions (i.e., wildfire in Canada in May and escalating tensions in Libya) which according to analysts are a sign of recovery. However, the futures market anticipates oil prices to increase only up to US$ 50/barrel by the end of the decade.

World rubber prices and world tea prices - which have important implications for Sri Lanka - have continued to fall steadily in recent years (Figure 3.7). Compared to prices in 2013, current rubber prices are lower by over US$ 1. The slump in rubber prices is likely to continue with manufacturing in both China and US slowing down; leading producers of rubber, such as Thailand has been severely hit with the government stepping in to purchase rubber in order to assist struggling producers.

Tea prices, though lower compared to the levels in 2012 (the year till which prices consistently rose), have not seen as steep a drop in price as rubber. The FAO (2015) attributes weaker tea prices to CTC auction prices, which it warns if not corrected, would continue to contribute to

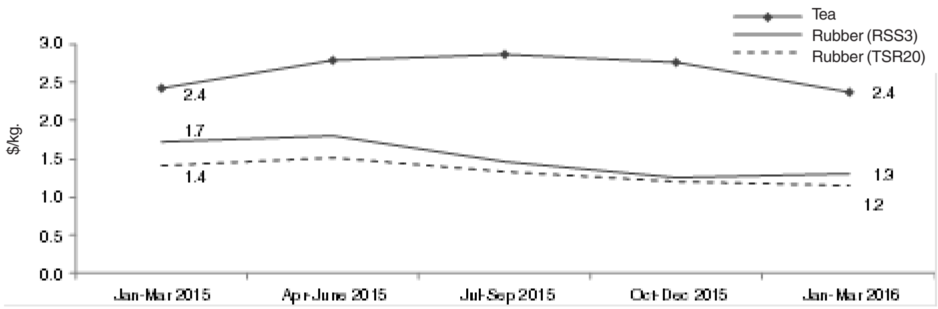
[17] Obstfeld, M., *et.. al*. (2016), "Oil Prices and the Global Economy: It's Complicated", available at https://blog-imfdirect.imf.org/2016/03/24/oil-prices-and-the-global-economy-its-complicated/.

Figure 3.6
Trends in Oil, Gold and Gas Prices



Source: Compiled using World Bank (2016), Commodities Price Data (The Pink Sheet) – May 2016.

Figure 3.7
Trends in Selected Commodity Prices



Source: Compiled using World Bank (2016), Commodities Price Data (The Pink Sheet) – May 2016.

the downward trend. Sri Lanka is predominantly an orthodox tea producer and prices of orthodox tea is predicted to be higher; developments in export markets like Russia and the Middle East can dampen the sentiments though. Lower tea prices (overall) are a result of relatively high supplies whereas consumption has been increasing with growth in demand for green and specialist tea segments.[18] Projections suggest demand and supply of black tea to be at equilibrium in 2023, selling at a nominal price of US$ 2.81 per kilo.

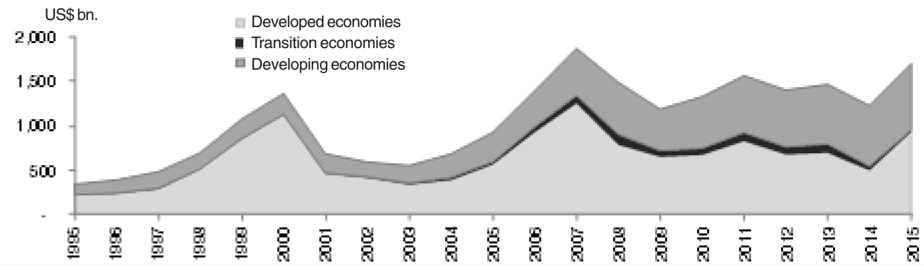
3.4 Access to International Capital

3.4.1 Trends in International Capital Flows

In 2015, the anticipated rate hike in the US prompted foreign investors to reduce their emerging market exposures in favour of developed economies. This propelled a strong growth in flows into the EU as well as the US where FDI quadrupled to US$ 384 billion (albeit

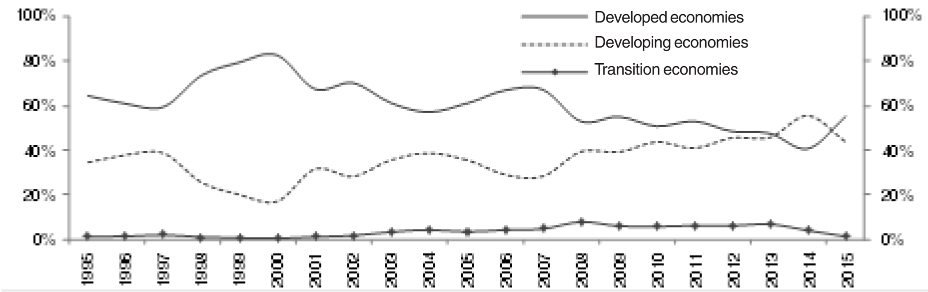
[18] FAO (2015), "World Tea Production and Trade: Current and Future Development", Food and Agriculture Organization, Rome.

Figure 3.8
FDI Inflows: Global by Group of Economies 1995 - 2015



Source: UNCTADstat and Global Investment Trends Monitor 2016.

Figure 3.9
FDI Inflows: Percentage Inflows by Group of Economies 1995 - 2015



Source: UNCTADstat and Global Investment Trends Monitor 2016.

from a historically low level in 2014). Overall, the pattern of FDI shifted back in favour of developed countries which now account for 55 per cent of global FDI flows compared with 2014 where 56 per cent of global inflows were to developing economies.[19]

Nevertheless, in absolute terms, FDI to developing countries reached a new high of US$ 741 billion, 5 per cent higher than that recorded in 2014. Of the developing economies, Developing Asia remained the largest recipient region in the world, accounting for one-third of global FDI flows. In total, FDI flows to Developing Asia surpassed half a trillion US dollars, rising by 15 per cent to US$ 550 billion, a new high. Hong Kong (China) and mainland China saw increases in FDI flows to US$ 163 billion and US$ 136 billion, respectively. FDI flows to India nearly doubled, reaching an estimated US$ 59 billion. The losers were Africa and Latin America and the Caribbean with flows faltering, reflecting the plummeting prices of their principal commodity exports.

[19] UNCTAD (2016), "Global Investment Monitor No.22", January 2016.

Table 3.3
FDI Inflows, by Major Regions

	2014	2015a	Growth Rate (%)
World	**1,245**	**1,699**	**36.5**
Developed Economies	**493**	**936**	**89.9**
European Union	254	426	67.6
North America	146	429	193.5
Developing Economies	**703**	**741**	**5.3**
Africa	55	38	-31.4
Latin America and the Caribbean	170	151	-11.2
Developing Asia	475	548	15.5
Transition Economies	**49**	**22**	**-54.1**

Source: UNCTAD, "Global Investment Trends Monitor 2016".

Although FDI into Developing Asia has remained robust, international portfolio investment inflows were much weaker across the year (Table 3.4). These flows look at investments in shares and bonds as opposed to longer-term capital investments and tend to be more responsive to shifts in sentiment.

Table 3.4
Portfolio Inflows, Selected Countries, 2008 - 2015

US$ mn.	2008	2009	2010	2011	2012	2013	2014	2015
Bangladesh	92	127	19	(32)	169	431	875	386
China	9,654	29,613	31,681	13,391	54,170	58,244	93,244	6,739
India	(15,030)	17,931	37,986	2,711	30,110	7,027	38,008	19,386 [a]
Indonesia	3,059	10,480	15,713	4,996	14,673	12,145	23,556	17,705 [a]
Malaysia	(21,083)	6,048	22,270	14,778	27,635	9,381	(3,194)	(4,961)
Pakistan	(243)	(582)	(114)	(37)	174	77	3,785	935
Singapore	(14,644)	1,183	8,005	(6,336)	5,120	(2,290)	3,180	(6,874)
Sri Lanka	(488)	(382)	(1,049)	828	2,116	2,068	2,065	689
Thailand	(8,559)	10,255	7,810	3,887	10,319	(1,474)	(4,704)	(12,733)
Vietnam	(578)	128	2,383	1,064	1,263	1,386	93	(65)
US	523,684	357,352	820,434	311,626	747,014	511,984	701,861	250,937
Total ex. US	**(47,819)**	**74,802**	**124,705**	**35,250**	**145,750**	**86,997**	**156,909**	**21,207**

Notes: a: Estimates.
Source: IMF, "Balance of Payments and International Investment Statistics".

Of the countries sampled, Malaysia, Singapore, Thailand and Vietnam all have net negative inflows in 2015. On an aggregate level, total inflows declined by 85 per cent year-on-year. Similar lows were last seen in 2011 as the Euro Zone crisis unfolded and many developed economies experienced a double-dip recession.

Overall capital market performance across Asian economies reflected these negative trends. Vietnam was the only market in the Southeast Asian region to post gains in 2015 of

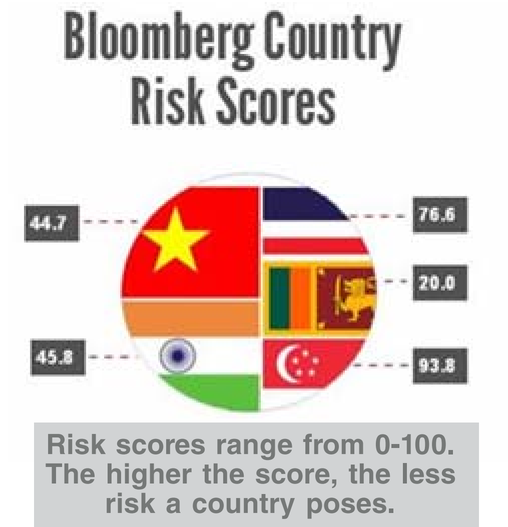
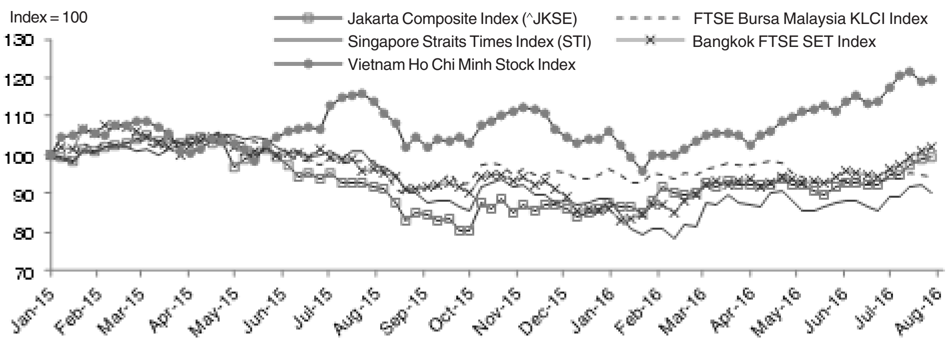
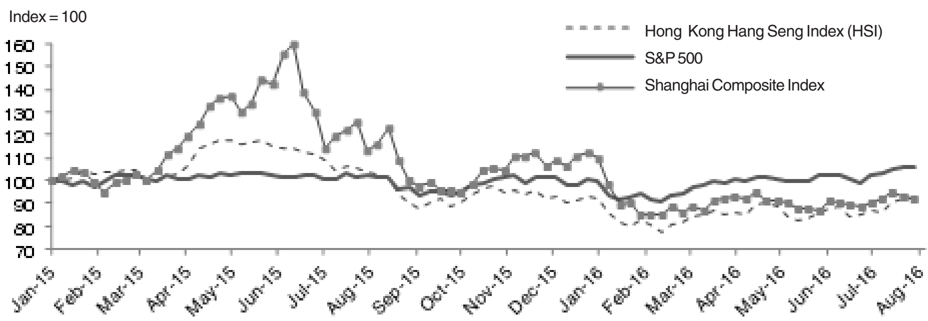


Figure 3.10
Stock Market Performance Southeast Asian Economies



Source: Bloomberg.

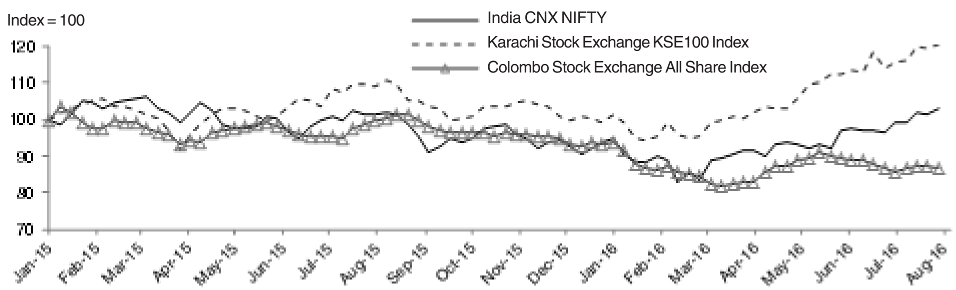
Figure 3.11
Stock Market Performance East Asia



Source: Bloomberg.

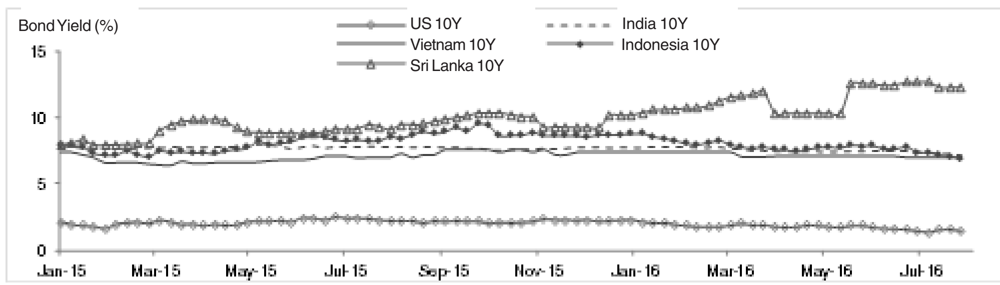
4 per cent (Figure 3.10). Other Southeast Asian stock markets performed poorly, with Thailand and Indonesia - the joint worst performers - losing -14 per cent over the year. Singapore also lost ground down -12 per cent, whilst Malaysia was the least badly hit at -5 per cent. The Southeast Asian economies suffered due to combined concerns over the effect of the US rate-hiking cycle on capital flows, and the impact of the slowing Chinese economy on the region's growth. Vietnam was somewhat shielded from this due to resilient growth despite the regional slowdown.[20] Estimates suggest that investors pulled US$ 6.7 billion from Thai, Indonesian and Philippine equity markets over 2015.[21] More recently in 2016, Southeast Asian markets have recovered somewhat with Malaysia the only market to continue a modest negative performance of -2 per cent.

Figure 3.12
Stock Market Performance South Asia



Source: Bloomberg.

Figure 3.13
Bond Yields



Source: Bloomberg.

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[20] Bloomberg (2015), "Vietnam Stocks Are Giving Asia's Best Returns", http://www.bloomberg.com/news/articles/2015-09-28/china-no-bar-to-vietnam-bulls-backing-asia-s-best-stock-returns.

[21] *Straits Times* (2015), "Singapore Stocks Headed for 15 per cent Tumble in 2015", http://www.straitstimes.com/business/companies-markets/singapore-stocks-headed-for-15-tumble-in-2015.

The Chinese market experienced large gains and losses over 2015, triggered by a number of key events (Figure 3.11). A rate cut in early 2015 saw the equity market rally strongly until June, rising 1.5 times over the previous year. However, the narrative of China's weakness in the real economy began to gain traction in the second half of the year and the change in sentiment saw a 40 per cent drop in the stock market, reaching a low in August 2015.[22] Despite the turmoil, the Shanghai Composite was up 12 per cent over the year. In 2016, momentum has again turned negative with a -16 per cent fall in the first quarter of 2016. This was driven by currency concerns, poor communication from policy makers and fresh signs of slowing economic growth. During the first week of 2016, the People's Bank of China allowed the biggest fall in the Yuan in five months, twice triggering a circuit breaker that saw markets close early.[23] The Hang Seng Index (Hong Kong) lost -8 per cent over 2015 and 2016 with a consistent downward trend over the period. Much of this was a contagion effect from the struggling Chinese markets.[24] By contrast, the US S&P 500 was up +6 per cent over the period.

In South Asia, India and Sri Lanka both suffered losses in 2015 of -6 per cent and -7 per cent, respectively (Figure 3.12). However, whilst India has remained comparatively stable in 2016, Sri Lanka has continued to underperform. The outcome of these divergent trends is that India has gained +3 per cent since the beginning of 2015 compared to Sri Lanka's underperformance of -13 per cent. Pakistan outperformed its peers, gaining +21 per cent over the period.

Data from the Institute of International Finance (IIF) on cross border non-resident portfolio flows showed similar capital outflow patterns from emerging market economies. According to the IIF, net inflows flows turned negative in July 2015 and continued for the remainder of the year. However, while outflows from equities have continued into 2016, the trends in the bond market reversed with flows to debt instruments recording positive flows for the three months to January 2016.[25]

Bond yields capture the capital movements in and out of fixed income investments for a given market and maturity; as investors increase their investments in a particular bond, prices increase and yields (which move inversely) fall. The yield on a debt instrument incorporates five broad compensation concepts. The first two are the real risk-free rate and expected inflation. Combined, these two rates give the risk-free return which is often proxied in the real world by US Treasury bonds. Bond yields also incorporate a default premium that compensates investors for the risk that the issuer may default. The yield also incorporates a liquidity premium, which factors in how

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22 *Financial Times* (2015), "China Stock Market Outperforms S&P Despite Wild Swings", http://www.ft.com/cms/s/0/7cb450ce-a000-11e5-85ae-8fa46274f224.html#axzz48zCm8X3P.

23 CNBC (2016), "China Stocks Saw Worst Jan Since 2008", http://www.cnbc.com/2016/02/01/china-stocks-post-worst-monthly-performance-since-2008.html.

24 Bloomberg (2015), "Asian Stocks Fall as Equities in Hong Kong, Seoul Join Selloff" http://www.bloomberg.com/news/articles/2016-02-11/asian-stocks-fall-as-equities-in-hong-kong-seoul-join-selloff.

25 Reuters (2016), "Emerging Markets Set for $448 billion Outflows This Year –IIF", http://www.reuters.com/article/emerging-markets-flows-idUSL9N0WZ025 and Financial Times (2016), "Emerging market portfolio flows hit 21-month high", https://next.ft.com/content/cceb110e-f596-11e5-96db-fc683b5e52db.

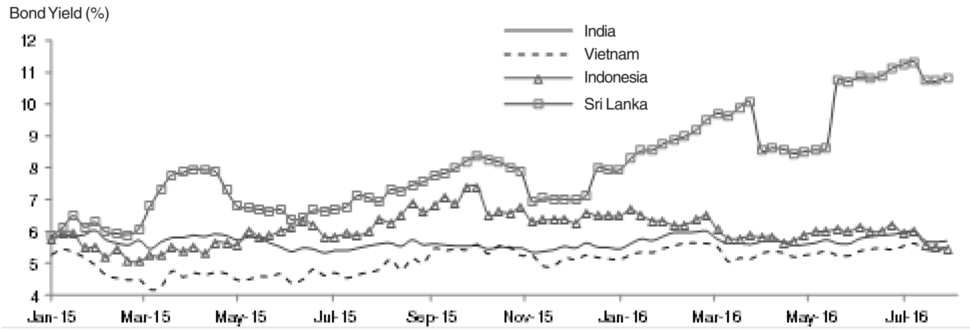
tradable the bond is and, therefore, how easy it is to monetize the asset. For less frequently traded issues, the holder is compensated by a higher interest rate. Finally, a maturity premium must also be added, as longer-tenured bonds are more sensitive to interest rate fluctuations and therefore carry more risk.

Positive inflows into Treasury bonds are reflected in the downward movement in bond yields in the latter part of 2015 (Figure 3.13). Across the year, bond yields rose in most Asian economies, peaking in the second half of the year and then moving in a downward trend that has continued into the start of 2016. Sri Lanka is the clear exception to this trend. Domestic worries, exacerbated by limited liquidity, caused exaggerated upward movements in yields, increasing by 431 basis points since the first week of 2015. There was some short-term relief at the end of April 2016, following the announcement of a possible US$ 1.5 billion loan from the IMF. However, yields have since returned to their previous levels.

Overall, in 2016, capital markets in most emerging economies are exhibiting signs of resilience after their losses in 2015. Singapore, Indonesia and Thailand have begun to reverse 2015 equity market declines whilst the remaining economies (excluding China and Sri Lanka) have seen a slowdown in persistent declines. Bond yields give a clearer picture with all countries (excluding Sri Lanka) recording a decline in bond yields since the start of 2015.

Sri Lanka's higher bond yields are an indication of a higher cost of capital compared to peers. As cost of capital rises, the number of viable projects in a given selection reduces. This is because creating value requires investing in capital projects that generate a return greater than the project's cost of capital. When comparing developed and developing nations, a good proxy is an estimate of the country risk premium. An approximate estimate is the spread between a US government bond yield and that of the respective country (Figure 3.14).

Figure 3.14
Sovereign Yield Spread (vs US Govt. Bonds)



Source: Bloomberg.

Comparisons show Sri Lanka to be faced with higher bond yields, indicating a higher cost of capital compared to regional peers and also higher risk.

Again, Sri Lanka is an outlier in terms of sovereign yield spread. Whilst other spreads have remained flat or even narrowed, Sri Lankan bond yields have diverged indicating a sizeable increase in the cost of capital.

This conclusion is corroborated by Bloomberg's Country-Risk Score Index (see Table 3.5). The user-based risk score ranges from 0-100. A high score denotes a lower level of perceived risk.

Table 3.5
Bloomberg User-Based Country Risk Scores

Country	Bloomberg Country Risk Score
Singapore	93.8
United States	86.9
Thailand	76.6
Malaysia	73.6
India	45.8
Vietnam	44.7
Indonesia	40.7
Sri Lanka	20.0
Pakistan	17.3

Source: Bloomberg.

Of a mix of countries examined, Sri Lanka has a risk score of 20, the second highest risk score in the group. Of the model determinants, Sri Lanka scores particularly poorly on EIU banking risk and external balance and foreign exposure risk.

Prompted by a number of these external balance factors, Fitch downgraded Sri Lanka's credit rating in March 2016. The new rating of B+ puts Sri Lanka below Vietnam for the first time (Table 3.6).

Many Asian countries are currently looking to international capital markets for additional funding, including countries such as Indonesia and Vietnam. Whilst both of these countries also have high levels of public debt, their current domestic yields are at 7.8 per cent and 7 per cent, respectively, considerably lower (5 per cent) than Sri Lanka's domestic bond yield.

Table 3.6
Fitch Ratings Changes

	2010	2011	2012	2013	2014	2015	2016
US	AAA	AAA	AAA	AAA	AAA	AAA	AAA
India	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-
Vietnam	B+	B+	B+	B+	BB-	BB-	BB-
Pakistan						B	B
Bangladesh					BB-	BB-	BB-
Indonesia	BB+	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-
Malaysia	A-	A-	A-	A-	A-	A-	A-
Singapore	AAA	AAA	AAA	AAA	AAA	AAA	AAA
Sri Lanka	B+	BB-	BB-	BB-	BB-	BB-	B+
Thailand	BBB	BBB	BBB	BBB+	BBB+	BBB+	BBB+

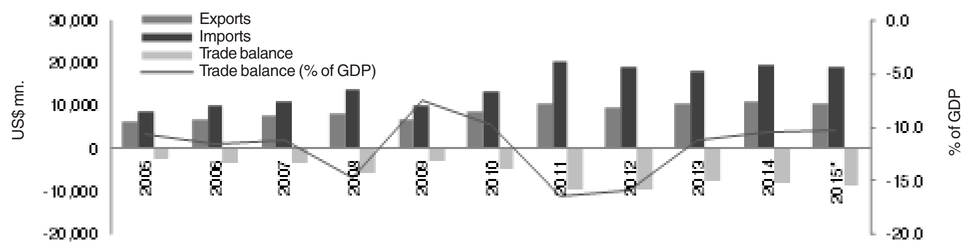
Source: Bloomberg.

3.5 Implications of External Environment Developments on Sri Lanka

3.5.1 Overview of Sri Lanka's Performance in Merchandise Trade

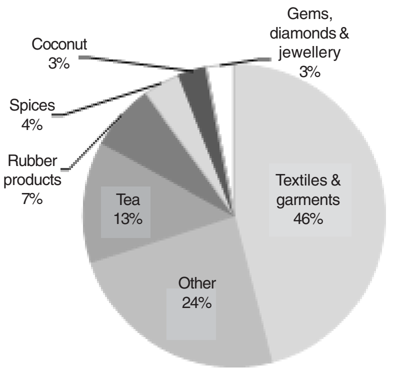
Sri Lanka's external sector performance in 2015 is largely reflective of the world economic and trade performance, including that of falling commodity prices. Export earnings which grew by 7.1 per cent reaching US$ 11 billion in 2014, declined by 5.6 per cent in 2015 to US$ 10.5 billion. The decline comes from all three major categories of exports, agriculture (-11.2 per cent), industrial exports (-3.5 per cent) and mineral exports (-52.3 per cent). The industrial sector continues to increase its contribution to exports, accounting for 76 per cent of total exports; the share of agriculture in total exports declined to 23.6 per cent in 2015 compared to 25.1 per cent in 2014, owing largely to falling commodity prices. Among agriculture exports in 2015, spices managed to record a marked increase in exports, growing by 43 per cent. Sri Lanka continues to be largely dependent on textile and garments, which accounted for 46 per cent of the country's total exports and 60 per cent of industrial exports.

Figure 3.15
Sri Lanka's Trade Performance



Source: CBSL, *Annual Report,* various years.

Figure 3.16
Sri Lanka's Main Exports as a % of Total Exports



Source: CBSL, *Annual Report,* various years.

There was a decrease in Sri Lanka's import expenditure in 2015 largely due to low oil prices and restrictions on vehicle imports via taxes and changes to loan-to-value ratio for leasing in the latter part of 2015. Sri Lanka's expenditure on fuel imports which accounted for 24 per cent of the country's total import bill in 2014 fell to 14.3 per cent in 2015. This is a reduction of US$ 1,898 million or a 41.3 per cent decline year-on-year. Notable increases in import expenditure were that of vehicles, which increased by over 50 per cent due to the reduction of import tariffs on selected motor vehicles in January 2015 and the depreciation of the Japanese yen (Table 3.7). Given the outlook on global prices of fuel and commodity prices, expenditure on fuel as well as food and beverage items cannot be expected to rise sharply. Furthermore, the depreciation of the rupee, which results in imports being more expensive, can be expected to curtail imports in 2016.

Table 3.7
Sri Lanka's Main Imports, 2015

Category	Value US$ mn. (2014)	Value US$ mn. (2015)	Share in Total Imports (2015)	Y-o-Y Change % (2014-2015)
Consumer Goods	**3,852.5**	**4,713.5**	**24.9**	**22.3**
Food and beverages	1.633.7	1,627.8	8.6	-0.4
Non-food consumer goods	2,218.8	3,085.7	16.3	39.1
Vehicles	896.7	1.359.6	7.2	51.6
Medical & pharmaceuticals	380.5	459.8	2.4	20.8
Clothing & accessories	282.7	390.1	2.1	38.0
Intermediate goods	11,397.7	9,638.2	50.9	-15.4
Fuel	4,597.3	2,699.6	14.3	-14.3
Textiles and textile articles	2,327.6	2,296.2	12.1	-1.3
Chemical products	808.2	870.3	4.6	7.7
Investment goods	4,152.2	4,567.0	24.1	10.0
Machinery & equipment	2,131.0	2,278.1	12.0	6.9
Building materials	1,308.9	1,352.0	7.1	3.3
Transport equipment	707.3	930.9	4.9	31.6

Note: This table comprises only main import products.
Source: Compiled using CBSL (2016), *Annual Report 2015*.

The following section looks at the performance of the garment industry, and the tea and rubber industries in more detail.

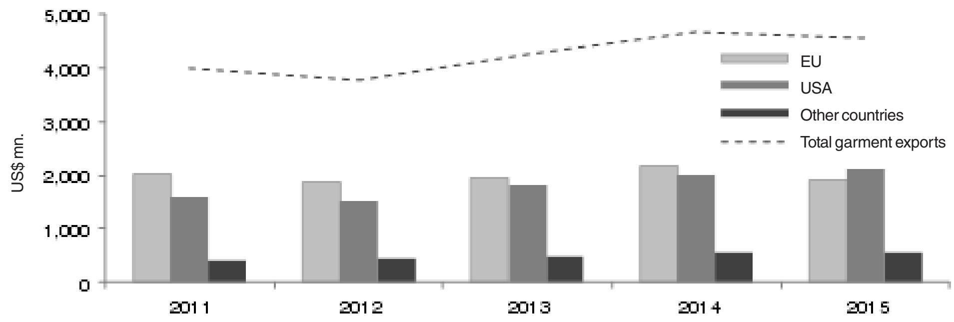
3.5.2 Garment, Tea and Rubber Industries

Exporting US$ 4.8 billion and accounting for 46 per cent of Sri Lanka's total exports in 2015, the apparel industry is Sri Lanka's second largest foreign exchange earner. 2015 saw a 2.2 per cent decline in textile and garment export earnings. Though garment exports to US and other non-traditional markets grew, exports to the EU dropped by 12.5 per cent in 2015 (Figure 3.17). In the EU, notable declines were noted in exports to UK, France and Italy. Consequently, US surpassed EU as the largest market for garment exports for the first time after 2007, accounting for 46.3 per cent of total garment exports in 2015.

The first six months of 2016 saw a recovery of garment exports, growing at 4.5 per cent. However, the garment industry is likely to feel the impacts of a weakened pound and the prevailing uncertainty in the EU. Nevertheless, Sri Lanka is fairly confident of regaining GSP-plus concessions to the EU, particularly in the aftermath of the lifting of the EU fisheries ban and this is likely to cushion to an extent the negative effects of Britain's exit from the EU.

Earnings from tea exports in 2015 were US$ 1.3 billion and remain the country's fourth largest export earner. However, shifting from a period of steady increase in exports over 2011-14, Sri Lanka saw a decline in both its volume and prices of tea exports in 2015 - export volumes declined by 6 per cent and prices by 12 per cent compared to 2014 (Figure 3.18). Earnings continued to contract by 9.5 per cent in the first six months of 2016. The fall in tea exports is underpinned by the fall in demand in traditional orthodox tea markets in the Russian Federation, EU and the Middle East (Table 3.8). Political issues between Russia and Ukraine, low oil prices facing the Middle East followed

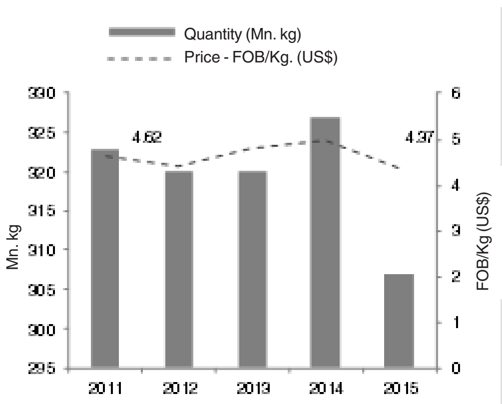
Figure 3.17
Garment Exports 2011-2015



Source: CBSL, *Annual Report 2015.*

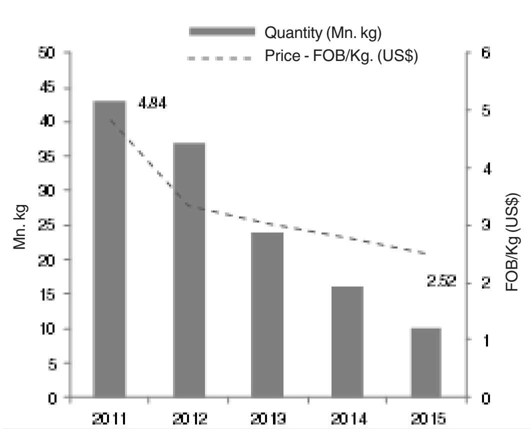
by currency depreciations brought down tea prices at the Colombo auctions. With the top 10 importers of Sri Lankan tea, with the exception of Japan relying on oil and gas for economic stability,[26] and with trends of rising demand for green and specialist tea segments globally,[27] it is imperative that Sri Lanka diversifies its presence in other segments of the market in

Figure 3.18
Tea Export Volumes and Prices



Source: CBSL, *Annual Report 2015.*

Figure 3.19
Rubber Export Volumes and Prices



Source: CBSL, *Annual Report 2015.*

[26] Forbes and Walker Tea Brokers (2016), 'Tea Industry's Performance in 2015 and Prospects for 2016', Daily FT, http://www.ft.lk/article/516083/Tea-industry-s-performance-in-2015-and-prospects-for-2016

[27] FAO (2015), 'World Tea Production and Trade: Current and Future Development', FAO: Rome.

terms of products (i.e., organic and value added teas) as well as new markets. Currently, 98 per cent of Sri Lanka's tea export volumes are in black tea while green tea makes up 1.5 per cent of total exports and instant tea accounts for 0.7 per cent. Further, over 40 per cent is exported in bulk form.

The fall in rubber exports has been more dramatic with export volume dropping by 37 per cent and prices by 9 per cent in 2015 compared to a year ago. Compared to 5 years back, the drop in volumes and prices is a staggering 77 per cent and 48 per cent, respectively (Figure 3.19). The slowdown in 2015 has stemmed mainly from the Pakistan, EU and Japanese markets. Year-on-year, there has been a contraction of rubber export earnings by 6.5 per cent during January-July 2016.

Declines in export volumes as well as export prices were visible in Sri Lanka's major export categories in 2015.

Table 3.8
Sri Lanka's Main Tea and Rubber Export Markets and Performance

Country/ Region	Tea Exports			Country/ Region	Rubber Exports		
	Share in Total Tea Export (Volume)	Growth in Volume (2014-2015)	Growth in Value (2014-2015)		Share in Total Rubber Exports (Volume)	Growth in Volume (2014-2015)	Growth in Value (2014-2015)
Middle East	49	-5	-17	EU	29	-30	-40
CIS countries	18	-17	-31	Japan	16	-2	-15
EU	8	-11	-18	Pakistan	13	-43	-48
Other	6	-10	-16	Vietnam	10	-10	-18
Industrialized countries[a]							
Other countries[b]	20	6	-3	USA	5	-33	-38

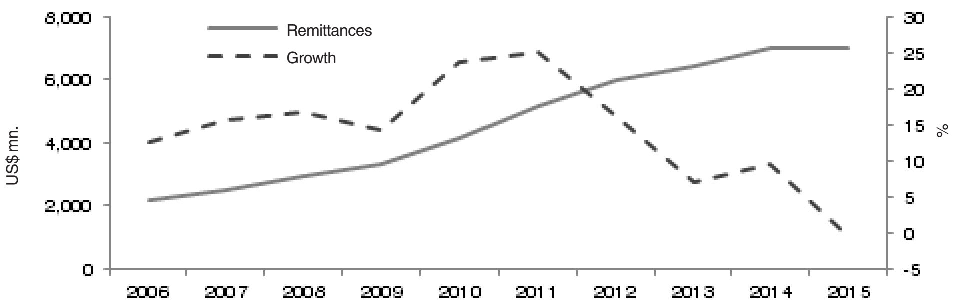
Note: a: Countries include Australia, Canada, Japan, New Zealand, US and others.
b : Includes Chile, China, Egypt, Hong Kong, India, Lebanon, Libya, Taiwan and others.

Source: Compiled using CBSL, *Annual Report 2015.*

3.5.3 Remittances and Tourism

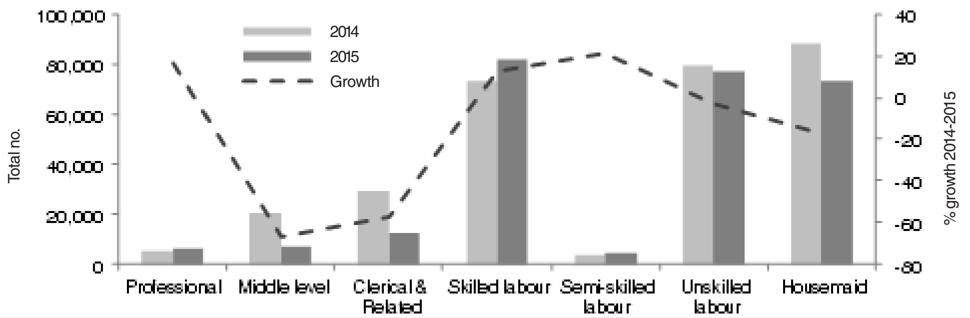
Worker remittances which saw a 9.5 per cent growth in 2014 stagnated at US$ 7 billion in 2015 (Figure 3.20). There was also a sharp decline in the departure of middle level migrants, and clerical and related job categories by 67 per cent and 57 per cent, respectively (Figure 3.21). Remittance inflows in the short-term can be expected to stagnate as the Middle East which accounts for half of Sri Lanka's migrant worker earnings is experiencing a fall in both revenue and growth due to low oil prices. Furthermore, despite undertaking policy measures at the domestic level to discourage the departure of low-skilled workers, with the absence of substitute income sources (i.e., high export earnings), a prolonged fall in remittances is likely to affect the country's economy negatively, leading to lower current account receipts, lower reserves and weaker credit profiles. Despite challenges faced by workers at the household level, foreign employment has been an important source of income with studies suggesting that migration of women for example, helps poor households catch up with the non-migrant households in the long-run.[28]

Figure 3.20
Total Remittance Inflows and Growth of Inflows Year-on-Year



Source: CBSL, *Annual Report,* various issues.

Figure 3.21
Departure for Foreign Employment by Manpower Category and Growth, 2014-2015



Source: CBSL, *Annual Report,* various issues.

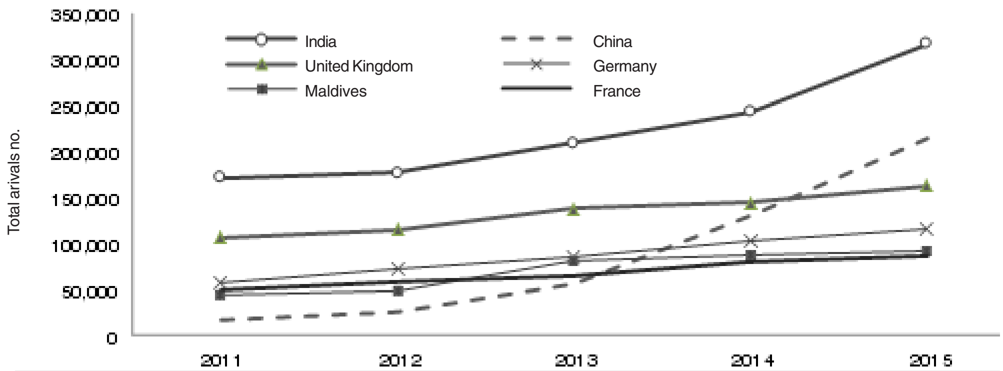
[28] De Silva, S. (2013), "Long-Term Benefits from Temporary Migration: Does the Gender of the Migrant Matter?", Levy Economics Working Paper No. 756, Bard College, US.

Sri Lanka's tourism industry on the other hand has been one of the fastest growing sectors of the country in the post-war period. It is the third largest foreign exchange earner and recorded 1,798,380 tourist arrivals in 2015, close to the revised target of 1.8 million for the year. This is a four-fold increase compared to that of 2009 at the time the war ended where the number of arrivals was limited to 448,000; 2015 also saw a 17 per cent growth in arrivals compared to that of 2014. Tourist earnings increased more rapidly, by over eight times over the period 2009-2015 to stand at nearly US$ 3 billion in 2015.

India continues to be the largest source of tourist arrivals accounting for 18 per cent of total arrivals, followed by China (12 per cent), UK (9 per cent) and Germany (6 per cent). The highest growth of arrivals in 2015 was recorded from China at 68 per cent, which surpassed the UK in 2015 to become the second largest source of tourists for the country (Figure 3.22). Overall, tourist arrivals from all major regions improved with the exception of Eastern Europe with arrivals from crises-ridden Russia and Ukraine declining notably in 2015 by 11 per cent and 20 per cent, respectively.

Sri Lanka aims at attracting over 2.5 million tourists in 2016 and 4 million by 2020. The country also aims to increase average daily expenditure of a tourist -- currently US$ 165 - to US$ 250, and total tourism revenue to US$ 5 billion by 2020. The industry expects growth to come from the regional markets of India and China. Sri Lanka tourism is planning on implementing a Nation Branding Campaign. In addition to the trade promotional activities such as participating in travel fairs, conducting roadshows and outdoor promotions, trade familiarization tours and media familiarization tours are expected to be major components of the promotional campaign.

Figure 3.22
Tourist Arrivals from Major Source Countries, 2011- 2015



Source: CBSL (2016), *Annual Report 2015*, Central Bank of Sri Lanka.

Box 3.1
Impact of Britain's Exit from EU on Sri Lanka

Britain's exit from the EU will slow down the economic activities of both the UK and other members of the EU, and is likely to impact Sri Lanka through different channels. Despite the timeframe and terms of withdrawal still being unclear, it is likely to affect Sri Lanka's exports, given the dependence on both the UK and EU as key export destinations. The EU is currently the largest export destination, taking up 28.8 per cent (US$ 3 billion) of Sri Lanka's total exports. The UK accounts for 10 per cent of total exports (US$ 1 billion) and 34 per cent of Sri Lanka's total exports to the EU. Garments are the main export product from Sri Lanka to the UK (accounting for about 80 per cent of Sri Lanka's total exports to the UK); UK also accounts for 43 per cent of Sri Lanka's total garment exports to the EU.

The immediate effect of Brexit on Sri Lanka will be felt through the depreciation of the pound; as of mid-July 2016, the pound had weakened by 10 per cent against the US dollar. The depreciation of the pound makes Sri Lankan imports into the UK market more expensive and this is likely to affect the sales and profit margins of Sri Lankan exports. There was significant volatility in the capital markets following the referendum that raised concerns that Sri Lanka's debt raising capacity would be hindered by falling investor confidence. In fact, investors fled to the safety of gold and dollar investments immediately after the referendum thereby raising the price of gold to its highest in two years. However, Sri Lanka is somewhat buffered by its limited foreign debt exposure to the European market (Euro-denominated debt of only 5 per cent and negligible exposure to sterling).

Sri Lanka went back to the international capital markets in July, with a Dual-Trance ISB issuance. Despite uncertainty following the referendum, there was a high level of interest and the bond was oversubscribed. Final pricing was well within the initial price guidance. Furthermore, volatility in the markets has stalled the Fed's rate hiking cycle, meaning that Sri Lanka's bonds remain attractive at their current yields.

Tourism is a sector that is likely to be affected in the short-run. Nearly 40 per cent of tourist arrivals into Sri Lanka are from EU, of which 9 per cent are from UK - making it the third largest source of tourists. The depreciation of the pound following Brexit will make overseas travel and stay more expensive, and this may affect inflows of tourists from UK. It may also affect their average duration of stay which was 13 nights in 2014; in comparison, the average stay of Chinese tourists was 9.8 nights.

Furthermore, if Sri Lanka is successful in regaining EU GSP-plus, the country will have preferential access to the UK only until it leaves the EU. Subsequent to that, if Sri Lanka wants preferential access to the UK market it will have to negotiate a bilateral agreement with the UK. Nevertheless, given that there is a two year period of negotiations between the UK and the EU following the trigger of Article 50, Sri Lankan companies should not be affected deeply in the short-run, unless uncertainty prevents UK companies from placing orders and benefitting from the concessions GSP-plus would offer in the future.

Overall, it is clear that while the ramifications of the exit are still unfolding, the multidimensional nature of the EU and the significance of the British market are likely to influence the global political economy. Therefore, Sri Lanka needs to closely watch the post-Brexit developments both in the UK and EU and accordingly adjust policies to minimize losses and maximize gains to the country.

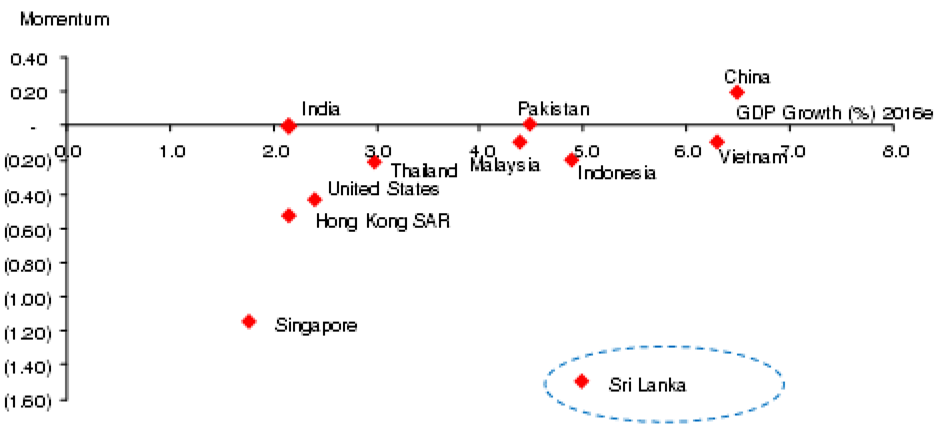
3.5.4 Capital Flows

Sentiment in Sri Lanka is decidedly worse compared to Asian peers. Despite concerns around the US tightening cycle affecting the entire region, the downward revisions to Sri Lanka's economic outlook is exerting an additional dampening sentiment. The lack of appetite for Sri Lankan investments is a country-specific issue that has arisen due to the deterioration in public finances, looming balance of payment crisis, declining foreign reserves and moderation in the country's growth outlook. As indicated in Figure 3.19, the IMF (April 2016) growth outlook for Sri Lanka saw a downward revision from 6.5 per cent to 5 per cent, representing the largest downward revision of Asian peers (-1.5 per cent).

In order to meet external financing requirements, Sri Lanka will have to return to international capital markets. However, the deterioration in investor sentiment leaves Sri Lanka exposed; the country will have to rely on the IMF for external liquidity support to generate investor confidence in the economy.

In 2015, there were net outflows from the government securities market of US$ 1,093 million. Foreign investments in the secondary market of the Colombo Stock Exchange (CSE) recorded a net outflow of US$ 32.3 million in 2015. This trend is continuing strongly into 2016 with a further outflow of US$ 366 million from T-bills and T-bonds,[29] and an outflow of US$ 40 million from the equity markets recorded in the first half of the year.[30]

Figure 3.23
Growth Expectations Momentum



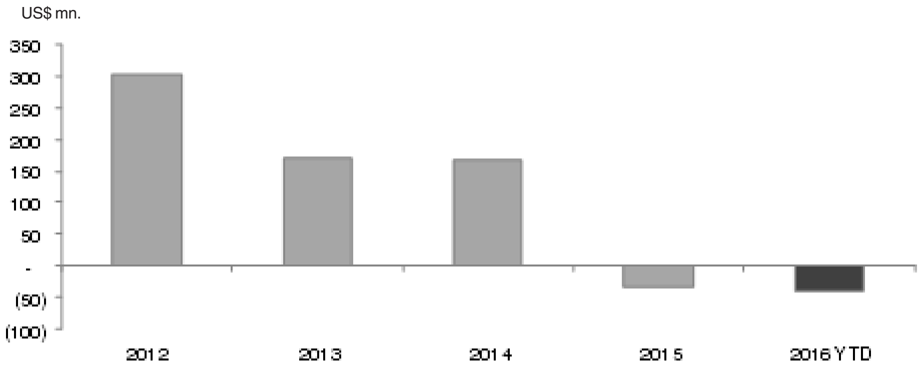
Note: Momentum is the change in forecast from the October 2015 WEO database release to the April 2016 WEO database release

Source: IMF WEO database.

29 CBSL, "Weekly Economic Indicators", Central Bank of Sri Lanka, Colombo.

30 CSE, "Monthly Trading Statistics", Colombo Stock Exchange, Colombo.

Figure 3.24
Stock Market Net Foreign Flows



Source: Colombo Stock Exchange.

International Sovereign Bond (ISB) issues have also seen yields edge upwards. The two ISB issuances in 2015 (US$ 650 million and US$ 1,500 million) in 2015 were priced at 6.125 per cent and 6.85 per cent, respectively, and were deemed successful at the time due to both being oversubscribed. However, since issuance, the yields on these instruments have increased to 6.93 per cent and 7.05 per cent, respectively, reflecting waning demand. Fitch estimates Sri Lanka's external debt service to be close to US$ 4 billion for the rest of 2016, compared with foreign reserves of US$ 6.3 billion (end-January 2016) meaning that the country will need to issue debt in order to meet its obligations. The CBSL announced intentions to issue up to US$ 3 billion in ISBs in 2016. However, the limited investor appetite suggests that this will come at a significant cost that will impact Sri Lanka's servicing burden in future years.

The IMF announcement of a US$ 1.5 billion Extended Fund Facility (EFF) will go some way to alleviating these pressures, particularly in terms of external funding. Firstly, the loan will provide external liquidity to ease immediate financing pressures. It will cushion the decline in foreign exchange reserves and reduce Sri Lanka's vulnerability to a potential drying up in the availability of capital inflows. Secondly, the terms of the loan are more favourable than the costs demanded by the international capital market, thereby reducing the anticipated increase in the debt-servicing burden. Finally, the agreement will assuage investor concerns around the economy and restore confidence in Sri Lanka's policy framework that could kick-start FDI flows into the country.

Assisted by the IMF announcement, Sri Lanka was able to return successfully to international capital markets in July, with its first dual-tranche ISB issue. The issuance saw strong interest globally, raising US$ 500 million 5.5-year bonds at a yield of 5.75 per cent and US$ 1 billion 10-year bonds at a yield of 6.825 per cent. Both were priced well inside the initial price guidance of 6.125 per cent and 7.125 per cent, respectively, but nonetheless reflect the trend of increasing yields in the domestic market.

3.6 Conclusion

The outlook for the global economy remains uncertain underlined by low growth and high volatility in financial markets. Much of this uncertainty stems from the slow-down in the Chinese economy and Britain's exit from the EU. China's transition has translated into lower oil and commodity prices with spillover effects felt by both developed and developing economies. While growth in developed economies is expected to be robust, emerging economies are confronted by capital outflows and exchange rate fluctuations due to US Federal Reserve rate hikes.

Sri Lanka's external sector performance in 2015 has been subdued with export earnings falling by over 5 per cent during the year. Declines in export volumes as well as export prices were visible in Sri Lanka's major export categories in 2015. While the tourism sector saw a boost in arrivals, remittances which are crucial for the Sri Lankan economy in many ways were stagnant. Impact of lower oil prices on oil exporting countries such as the Middle East translated into lower demand for exports such as tea. However, garments, remittances and tourism are expected to see positive growth in 2016 despite probable short to medium term effects of Brexit on the garment and tourism sectors. The lifting of the EU fisheries ban, developments in regaining GSP-plus concessions and a stronger US market will provide a boost to exports in 2016. The government has also stated its interest in pursuing preferential trading agreements in a number of countries, and if realized, this would provide an impetus to the country's export prospects (see Boxes 3.2 and 3.3).

While world trade is declining overall, an analysis of capital market performance suggest Sri Lanka will face the more pertinent issues in attracting capital. Comparisons show Sri Lanka to be faced with higher bond yields, indicating a higher cost of capital compared to regional peers and also higher risk. Deterioration in public finances with a widening fiscal deficit and a weakening BOP with declining foreign reserves - with a consequent downgrade to the sovereign credit rating - suggests that Sri Lanka will struggle to attract capital into the country. The remedy lies with domestic economic reforms and signalling of intentions to address them.

Sri Lanka needs to closely watch the post-Brexit developments both in the UK and EU and accordingly adjust policies to maximize gains to the country.

Box 3.2
The Trans-Pacific Partnership Agreement (TPP): Changing the Landscape of International Trade and the Multilateral Trading System

On 4 February 2016 USA and 11 other countries in the Pacific Rim - Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, US and Vietnam - signed the TPP, an agreement considered to be groundbreaking in terms of coverage, scope and the membership. The 12 member countries account for 36 per cent of world GDP, one quarter of world trade and account for a population of 800 million. The TPP goes beyond a standard trade agreement and apart from services and investment, covers areas such as electronic commerce, intellectual property, SOEs, environment, SMEs, labour, trade facilitation and customs procedures, and government procurement amongst others. The Agreement which include 30 chapters runs into over 5,000 pages outlining country commitments and carve outs.

In terms of tariff reductions, all member countries would need to eliminate customs duties on exports of manufacturing goods and nearly all agricultural products based on agreed schedules. The majority of the tariff elimination will be immediate when the Agreement comes into effect with some tariffs eliminated over agreed timeframes. Furthermore, countries will not be able to impose para tariffs or cess. It is estimated that TPP would eliminate 98 per cent of tariffs in the TPP region (DFAT, 2015). The Agreement will come into force 60 days after all members complete their respective domestic treaty ratification processes within a two year timeframe or in the event of a lapse, when at least six members that account for 85 per cent of the combined GDP ratify the Agreement.

For Sri Lanka, the TPP markets account for 33.5 per cent of total exports and 23 per cent of total imports. A majority of Sri Lanka's trade with TPP is with the US (40 per cent) and Singapore (17 per cent). The formation of TPP clearly gives rise to concerns regarding its implications, as well as opportunities that such arrangements hold for Sri Lanka in terms of accession in the future. The most immediate impacts of TPP for Sri Lanka will be by way of preference erosion in accessing TPP markets through US GSP scheme and greater competition from improved market access offered to competitor countries such as Vietnam under TPP. Sri Lanka's major exports to the US are currently T&G products and rubber. However, the impact of the TPP on Sri Lankan industries will depend on a number of factors. Among the TPP members, Sri Lanka competes with Vietnam, Mexico, Peru and Canada on T&G. However, the latter three countries already have FTAs with the US. While the TPP would provide Vietnam a considerable tariff advantage, restrictions such as the 'yarn forward' rule in the TPP (requiring TPP nations to use TPP-member produced yarn in textiles) may affect the cost-structures and limit the benefits.

The Sri Lankan government has already expressed interest in exploring the possibility of joining the TPP. However, the pros and cons of joining should be carefully analyzed. Apart from tariffs, significant commitments would have to be made in a number of areas mentioned above, many of which Sri Lanka has little experience in - i.e., handling a negative list approach in services or compiling exceptions. Significant regulatory changes will also be required in a number of areas. Some analysts predict that that the TPP may become the template in future FTAs, including for any bilateral FTAs with the US. While international rules on environment, labour, etc., would be beneficial, others are also wary of using the trade regime as a general tool of global governance for these sectors.

References: IPS (2016), "TPP and Implications on Sri Lanka", Institute of Policy Studies of Sri Lanka, Colombo (unpublished); Barbee, I. and S. Lester, S., (2014), "The TPP and The Future of Trade Agreements", *Latin American Journal of International Trade Law*, 2(1).

Box 3.3
Forging Ahead with Trade Agreements

Compared to its neighbours in South and Southeast Asia, Sri Lanka has lagged behind in pursuing trade agreements which are vital for small market economies in order to benefit from large, emerging markets, and to attract FDI. The new government elected in 2015, has been clear of its intention of prioritizing trade and investment, and has been actively pursuing trade agreements under the aegis of the Ministry of Development Strategies and International Trade. It has expressed its intent of signing an Economic and Technology Cooperation Agreement (ETCA) with India as well as two free trade agreements with China and Singapore by the first quarter of 2017.

The Framework Agreement on ETCA between India and Sri Lanka is expected to provide a broader economic partnership with India, the fastest growing economy in the world. Resulting from opposition of various bodies, the government made a statement recently, declaring that it will not allow for the movement of natural persons under the agreement. Instead, entry of foreign professionals will remain tied to investments. ETCA is expected to strengthen economic exchange and cooperation with an 'Early Harvest Programme' that is expected to address issues such as non-tariff measures, trade remedies and rules of origin issues which have negative implications on trade in goods.

China-Sri Lanka FTA negotiations began with a memorandum signed by the respective governments announcing the launch of official negotiations in September 2014. Following two rounds of negotiations and a joint feasibility study which reported substantial economic and trade benefits to be accrued to both countries, the new government has restored talks with China on the FTA. China is Sri Lanka's second largest trading partner (over US$ 4 billion) and the second largest source of imports with potential for Sri Lanka to expand trade with China given the sheer size of the Chinese market and its share of world trade. However, if Sri Lanka is to gain from preferential access to the world's second largest and second fastest growing market, it is key that negotiations take into account the asymmetries of the size of the two markets and sensitivities of the domestic industries to imports from China.

Negotiations on the Singapore-Sri Lanka FTA were officially launched in July 2016 with the trade ministers of the two countries signing the joint statement and Prime Ministers Lee Hsien Loon and Ranil Wickremesinghe witnessing the event. Sri Lanka's current exports to Singapore account to US$ 85 million (less than 1 per cent of the country's total exports), while imports amount to US$ 923 million. Singapore is in fact, Sri Lanka's fifth largest source of imports accounting for 5 per cent of the country's total imports. While Sri Lanka's top exports to Singapore include petroleum oils (other than crude), tea, rubber tyres and previous/semi-precious stone the main import products are petroleum products, machinery, electronic equipment, chemicals and plastic. While a FTA with Singapore is expected to boost bilateral trade between the two countries, more significantly, it is expected to provide Sri Lanka a gateway to a larger ASEAN market given that many of the region's companies are headquartered in Singapore. It is also likely to increase FDI from Singapore which is currently Sri Lanka's fourth largest investor. Inclusion of services is likely to provide access to the Singaporean market in which telecommunications, banking, financial, education, and environmental services are liberalized. However, labour mobility is restricted under Singapore's FTAs.

References: Wijayasiri, W. and Pandey, A. (2016), 'Benefits of a Potential Singapore-Sri Lanka Free Trade Agreement', accessed at, http://www.ips.lk/talkingeconomics/2016/07/20/benefits-of-a-potential-singapore-sri-lanka-free-trade-agreement/.