Sri Lanka
State of the Economy Report 2015

Chapter 3
International Environment

by

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3. International Environment

3.1 Introduction

Nearly eight years after the onset of the global financial crisis (GFC), the world economy continues to expand at a fairly modest pace, with ramifications of the financial crisis still visible in many countries. The recovery has been slow and prolonged, with many advanced economies still relying heavily on post-crisis adjustments, and plagued by sluggish unemployment levels, below target inflation rates and geopolitical uncertainties. Among the developed countries, US economic growth is expected to be robust, with factors such as low energy prices, strengthened balance sheets and recovering housing markets expected to sustain growth in 2015 and 2016.[1] The Euro area on the other hand has more problems to contend with in the form of economic and political turmoil within the region, whilst Japan too has seen an uneven recovery, with consumption yet to show sustained growth.

Among emerging and developing economies, China's growth trajectory has changed as a result of a managed slow down, targeting a more sustainable rate of expansion. This has varying impacts on other economies in the Asia-Pacific; Australia, already impacted from falling commodity prices, is likely to be hit further as China's growth slows to a forecast 6.8 per cent in 2015 and further to 6.3 per cent in 2016. On the other hand, India is expected to out-perform China for the first time in 2015 with growth boosted by policy reforms following electoral changes in 2014, rising investments and lower oil prices. Another casualty of falling commodity prices is Russia, already hit by international sanctions. Overall, the global economic outlook for 2015 is centred around changing oil and commodity prices, geo-political uncertainties, and stagnating and low inflation in developed countries.

International trade performance since the GFC has been positive, but weak, attributed mostly to the weak economic growth of advanced economies. Overall capital flows too have been subdued with weak macroeconomic and financial conditions of many economies, slow growth of world trade and deleveraging by banks affecting both demand and supply of capital. While falling oil prices can be

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

[1] IMF (2015), "World Economic Outlook – April 2015", IMF, Washington D.C.

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expected to increase the purchasing power of oil-importing countries boosting trade on the one hand, it can also have implications on the buying power of oil exporting countries, though many of the oil exporting Middle Eastern countries are cushioned by high reserves. Countries exporting substitutes of oil-based products too can be affected to an extent with oil-based products becoming relatively cheaper in the world market.

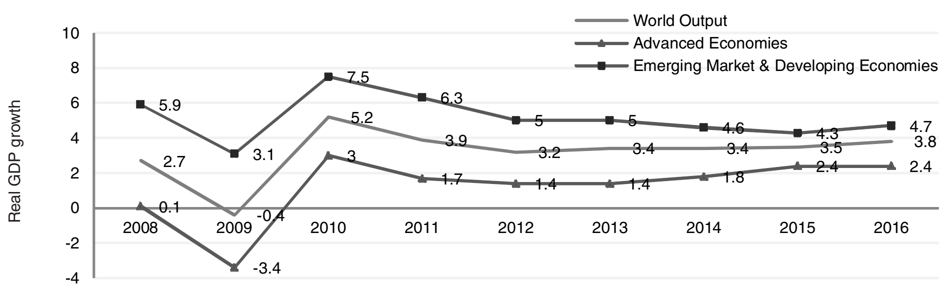
For Sri Lanka, the impacts of the current global economic environment will be channelled mainly through trade, capital, remittances and tourism. The outlook for Sri Lanka's exports is not very positive, given the challenges facing the country's main export markets such as Europe, the Middle East and Russia. On the import side, lower oil prices will ease Sri Lanka's current account deficit, reduce pressure on fiscal accounts and inflation. Remittances and tourism too are expected to grow with no major diversions expected for 2015. The world economic environment and implications for Sri Lanka are examined in detail in the subsequent sections of this chapter.

3.2 Overview of the Global Economy

3.2.1 Economic Prospects for Developed Economies

The world economy grew by 3.4 per cent in 2014 and is expected to grow by 3.3 per cent in 2015. Although emerging and developing economies have been driving world output since the GFC, advanced economies are expected to grow more strongly in 2015 while growth in emerging and developing economies are expected to be weaker (Figure 3.1)

Figure 3.1
Growth of World Output, Advanced and Emerging Economies (2008-2016)



Note: 2015 and 2016 figures are projections.
Source: IMF (2015), “World Economic Outlook (July 2015)”, International Monetary Fund, Washington, D.C.

[2] *Ibid.*

Table 3.1
Projected Output for Selected Countries (2013-2016)

	2013	2014	Projections 2015	2016
Advanced Economies	1.4	1.8	2.1	2.4
US	2.2	2.4	2.5	3.0
Euro area	-0.4	0.8	1.5	1.7
Japan	1.6	-0.1	0.8	1.2
Canada	2.0	2.4	1.5	2.1
Emerging and Developing Economies	5.0	4.6	4.2	4.7
China	7.7	7.4	6.8	6.3
India	6.9	7.3	7.5	7.5
Russia	1.3	0.6	-3.4	0.2
Brazil	2.7	0.1	-1.5	0.7

Source: IMF (2015), "World Economic Outlook (July 2015)", International Monetary Fund, Washington, D.C.

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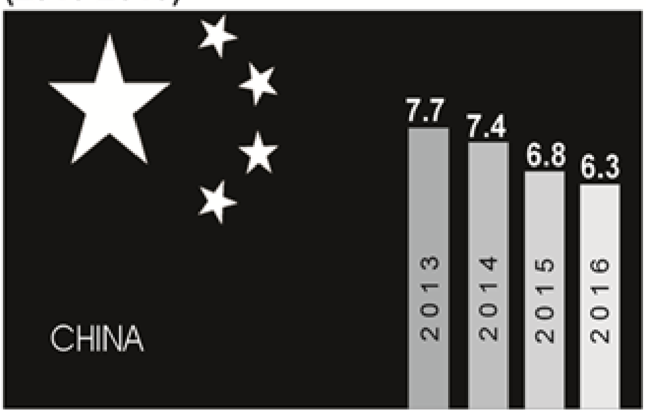
These developments however, are not the same across-the-board; a striking feature among advanced economies has been the growing divergence between US and that of Japan and the Euro area (Table 3.1).

In the US, growth was initially mediocre after the financial crisis but its recent growth momentum has been healthy, supported by positive shale and energy developments and restructuring. The US economy grew by over 2 per cent annually over the past three years (see Figure 3.2). A concern however, has been the slow rate of employment creation, wages and low inflation. The US unemployment rate which was over 8 per cent in 2012 declined steadily to 5.6 per cent by March 2015. Nevertheless, the job creation has been poor in the first quarter of 2015, raising questions about the recovery. Furthermore, the appreciation of the dollar is expected to restrain growth in US exports in 2015 and 2016. However, its impact on exports would depend on the rate at which the dollar stabilizes and the situation among trading partners.[3]

Consumer spending in the US is rising albeit at a very slow rate. The growth in spending is supported by continued job creation and increases in disposable income but it has been sluggish due to consumers opting to save more rather than spending it. However, further analysis of personal consumption expenditure patterns show that spending on

Projected GDP Growth for China (2013-2016)



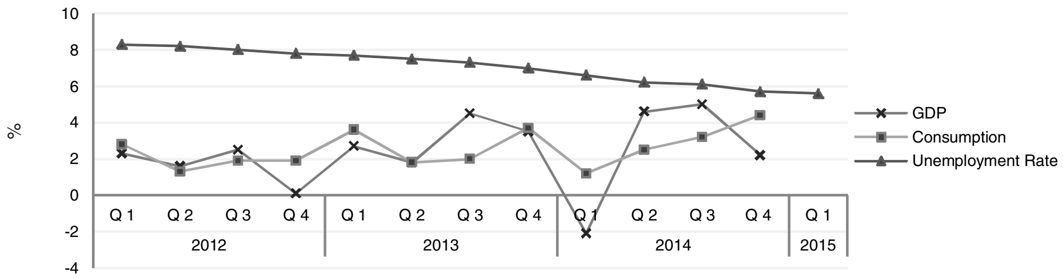
[3] UN (2015), "World Economic Situation and Prospects 2015", United Nations, New York.

durables has gone up while expenditure on non-durables has fallen over the 2013-15 period (first quarter). However, consumption expenditure on clothing and footwear has generally been increasing during this period (see Figure 3.3).

All in all, despite growth moderating in recent times, the US economy is expected to remain robust. And it is likely that this positive outlook would drive the US to normalize its monetary policy which in turn would have implications for the rest of the world.[4] As such, interest rates are expected to increase during the latter half of 2015; this would have notable repercussions on emerging economies that have been the recipients of large capital inflows in recent times. Nonetheless, emerging economies are better equipped to handle a tapering of quantitative easing (QE) with better reforms in place, larger reserves to cushion the impacts and with experience learnt from the past. On the negative side, capital outflow and an increase in interest rate will raise borrowing costs for both governments and the private sector.

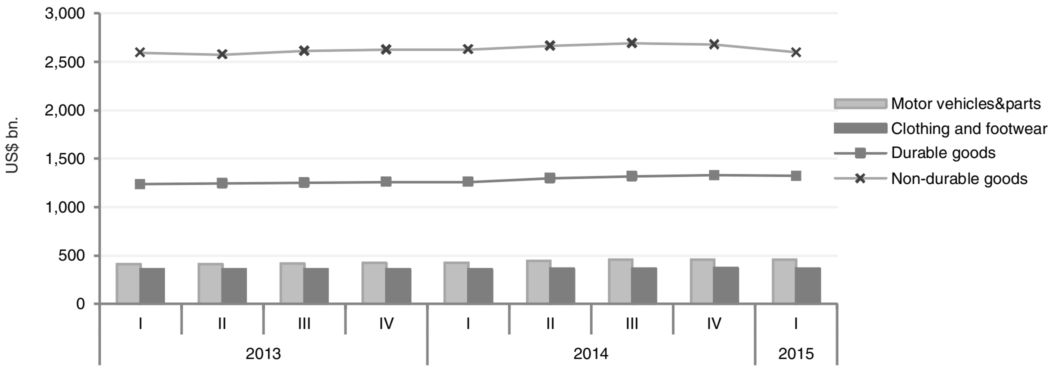
Uncertainty on Greece's long-term place in the Euro area, tensions between Russia and the West over Ukraine, and deflationary pressures in some of the European countries has created concerns over the impact it might have on EU growth. Recovery of the Euro area has been weak and faltering with risks of prolonged low growth and low inflation still present.

Figure 3.2
US Output, Real Personal Consumption Expenditure and Unemployment Rates



Source: US Bureau of Economic Analysis (2015), "National Data"; and US Bureau of Labour Statistics(2015), "Labour Force Statistics".

Figure 3.3
US Personal Consumption Expenditure



Source: US Bureau of Economic Analysis (2015), "National Data".

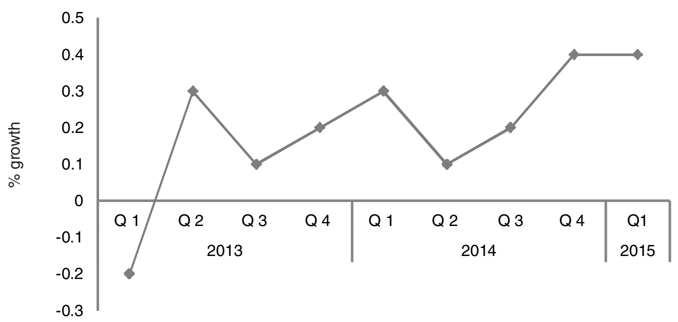
[4] Monetary policy normalization refers to steps undertaken to raise federal fund rates and other short-term rates to more normal levels and to reduce the size of the Federal Reserve's securities holdings.

The strongest growth in the EU in any quarter over the past 2 years has been 0.3 per cent and an annualized growth of 1.1 per cent.

The strongest growth in any quarter over the past two years has been 0.4 per cent and an annualized growth of 1.1 per cent (Figure 3.4). While the economic recovery of the EU is going to be bumpy, the Euro area is predicted to grow at 1.5 per cent in 2015, driven by countries in the core such as in Germany where domestic demand picked up as a result of supportive monetary conditions, good labour conditions and improved confidence. Stronger exports stemming from a weaker Euro and quantitative easing in the region are also expected to support growth in the region.

The growth trajectory of the world's third largest economy, Japan, is of continuing concern. The country was in recession for two quarters in 2014, attributed to an increase in consumption taxes in the country. While it came out of the recession in the last quarter of 2014, the growth was lower than expected, the main reason being the rather mundane increase in household spending (0.3 per cent).[5] Whether Japan can maintain its growth rate is largely dependent on consumption growth; there was positive growth in the last two quarters, possibly indicating that consumers are finally shaking off the effects of the tax increase.[6]

Figure 3.4
Euro Area Real GDP Growth (2013-15)



Source: Statistics Portal (2015), "Growth of Real GDP in the Euro Area from 1st quarter 2013 to 1st quarter 2015", www.statista.com/statistics/226122/gdp-growth-in-the-eu-and-the-euro-area-compared-to-same-quarter-previous-year/.

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

[5] WSJ (2015), "Japan Escapes Recession but Growth Misses Forecasts: Weak Consumption Points to Challenges for Abenomics", *Wall Street Journal* http://www.wsj.com/articles/japan-q4-gdp-worse-than-expected-at-22-1424044641.

[6] *Ibid.*

3.2.2 Outlook on Emerging Economies: Will Growth Continue?

Despite a fall in growth rates over the past six years, Asia has managed to maintain a growth momentum of over 6 per cent during 2008-14. The most striking feature is the slowdown of the Chinese economy, driven by structural reforms, withdrawal of fiscal stimulus and limitation of non-bank credit expansion. China's growth rate of 7.4 per cent in 2014 is its weakest in 24 years, with forecasts suggesting it will fall to 6.8 per cent in 2015 - the first time in a decade where the IMF forecast for the Chinese economy is below 7 per cent.

The slowdown of the Chines economy is, however, deemed to be a desirable and a healthy adjustment, suggesting a more sustainable growth path. China is seen to be embracing what is termed the 'new normal' - slower but higher quality growth. There are nevertheless concerns on how the slowdown would affect other economies. ASEAN countries are likely to experience spillover effects via integrated supply chains; the slowdown will be a further downside risk factor for crude and copper prices; economic activity in Latin America and Africa will weaken from low demand for metal. However, it is noteworthy that the slowdown comes from a big base; in 2014, China's economic output was over US$ 10 trillion, making it the only country to reach this feat after the US. Factors such as a boost in consumption due to healthy rise in wage rates - income in China increased by 8 per cent in 2014 after adjusting for inflation - is not expected to result in deep contagion effects although they would be felt.

India on the other hand, is expected to maintain or improve on its 2014 growth, backed by structural reforms and an improved investment climate. With a change of government, economic growth is high on the priority list. Indeed, with forecast growth of 7.5 per cent in 2015, it is expected to be the world's fastest growing emerging economy. With a half of the country's population under the age of 25 years, and with 12 million entering the labour force each year, India is well positioned to reap the benefits of a demographic dividend. It is poised to have the world's youngest population by 2020 with an average age of 29 years.[7] Whilst India is indeed a 'bright spot' in the region, India is still far from the economic power of China; India's economic output is around US$ 2 trillion compared to China's US$ 10 trillion output.

Other emerging economies are expected to grow at a much slower pace, with Russia expected to grow

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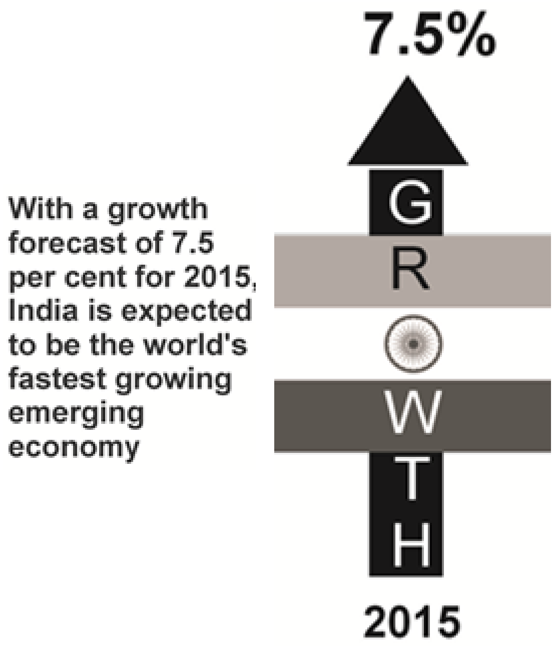
[7] Ernst & Young (2014), "Reaping India's Promised Demographic Dividend", Ernst & Young and Federation of Indian Chambers of Commerce and Industry, New Delhi.



at a negative 3.8 per cent. Toward the end of 2014, the Russian economy contracted due to a decline in oil prices, depreciation of the ruble, high interest rates and the impact of Western sanctions. In order to protect key sectors of the economy and to provide a cushion against a potential economic collapse, the government announced an 'anti-crisis' plan in January 2015. Both Standard & Poor's and Moody's cut Russia's sovereign credit rating to junk status citing the conflict in Ukraine, low oil prices and the slide of the ruble. There is the possibility of further sanctions as well from the US and EU member states.

3.3 Policy Responses and Outlook for Recovery

Although many central banks reduced interest rates to encourage investment and boost economic activity, the measures failed to spark a sustained recovery. With near zero interest rates, conventional monetary policy was ineffective, prompting central banks and governments to adopt unprecedented steps in the form of quantitative easing (QE). This is an unconventional form of monetary policy employed by central banks to pump money directly to the economy, where new money is created electronically to buy financial assets like government bonds. The expanded bank reserves in turn is expected to encourage more loan growth to businesses and people, boosting consumption and employment growth over time.

The US Federal Reserve, the Bank of England and the Bank of Japan pursued QE from early on, achieving varying levels of success. In the US, QE which started in November 2008 came to an end in October 2014 after adding about US$ 4 trillion to the Fed's balance sheet in four rounds of QE (see Table 3.2). It was the largest economic stimulus programme in world history. The UK started its QE programme in early 2009 together with a reduction in interest rates to as low as 0.5 per cent. It has added a total of £375 billion to the economy since the programme was initiated. The effectiveness of QE is inconclusive, yet it does appear to have had at least some modest success, particularly in the US and UK which were early adopters of QE and are currently doing better than most other advanced economies.

Japan on the other hand - the first country to use QE way back in 2001- started its recent QE programme in April 2013 as part of a set of policies popularly termed 'Abenomics'. The country initially planned to add US$ 1.4 trillion, spending US$ 70 billion a month and doubling the country's money supply. Japan's QE programme is large in scale, considering the US$ 85 billion a month pumped by the US Federal Reserve in an economy that is three times as large as that of Japan. In 2014, with recovery faltering, Japan expanded its QE programme substantively in a bid to keep deflation at bay. There are concerns regarding Japan's high debt levels and the IMF has warned of potential risks of postponing structural reforms.

More recently in March 2015, the European Central Bank (ECB) embarked on QE, which will inject 1 trillion euro as a stimulus. The ECB will inject •60 billion a month by purchasing national government

Table 3.2
Comparison of Quantitative Easing Programmes

	UK[a]	Japan	US	Eurozone
Amount	£ 375 billion	¥ 125 trillion	$ 2 trillion ($ 4 trillion)[b]	€ 836 billion (€ 1140 billion)[c]
% of GDP	21%	26%	12% (25%)	9% (12%)
% of bond market	27%	16%	18%	14%
% of annual gross issuance	91%	69%	26%	54%

Notes: a: Amount refer to cash amount/market value rather than the nominal value of bonds bought; b: Including mortgage-backed securities purchases; c: Including covered bonds, asset-backed securities, and European Institution debt. Amount refers to cash amount/market value rather than the nominal value of bonds bought.

Source: https://www.stratfor.com/analysis/how-quantitative-easing-differs-japan-and-europe

bonds from member states. There have been debates on the channels via which QE stimulates economies and one possible channel is 'confidence'. Some economic signals in the first quarter of 2015 following the QE has been positive. Share prices have risen since the announcement of QE and bond yields have fallen sharply. There has been a steep fall in the euro against the US dollar hence, with the appreciating dollar affecting company earnings and making the EU more attractive to US investors. Furthermore, the weaker euro can stimulate exports, thereby driving the region's GDP; it will also raise the import bill and help raise inflation.

However, QE alone will not be enough to sustain recovery in the EU. Structural reforms that can change labour and product markets and enhance productivity and competitiveness in the region are vital. For the EU, political hurdles in implementing reforms across the member states are an ongoing problem. Stringent fiscal austerity measures – involving policies to reduce government spending and/or introduce higher taxes with the objective of reducing government budget deficits – have created a 'north-south' conflict within the EU, most evident from the sharp divisions and tensions in dealing with Greece, Portugal and Spain. Greek debt rescheduling and a possible exit from the euro are adding to the uncertainty surrounding sustained recovery in the Euro area (Box 3.1).

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Box 3.1
The Greek Crisis

Greece has approached the climax of its debt crisis - it defaulted on IMF payments, the first developed country to do so; banks were closed for weeks to prevent bank runs; the Greek government went for a referendum where the public strongly rejected the terms of a new bailout; and EU countries had to take extensive measures to keep Greece from collapsing. Despite the outcome of the referendum, on 16 July 2015, the Greek government had to accept the reforms put forward by the other Euro zone countries to receive further bailout funds. IMF estimates the financing needs through end- 2018 to be • 85 billion and debt in the next two years to reach close to 200 per cent of GDP.

Greece became the center of the Euro area debt crisis following the 2008 financial crisis. In October 2009, Greece announced that it had been understating its deficit figures for years which shut them out from financial market borrowings and led them to near bankruptcy. In order to avoid a financial meltdown, Greece was bailed out by the IMF, ECB and the European Commission. These of course came with harsh conditions and resulted in steep tax increases and budget cuts. Despite the funds, the Greek economy did not pick up with most of the funds spent on repaying loans rather than being directed to the economy. The economy shrunk by a quarter and unemployment rates spiraled to over 25 per cent. On the one side, as a country party to the euro, Greece was not able to undertake certain measures to boost the economy like any other country would - i.e., by depreciating the currency. On the other, creditors like Germany maintain that Greece has not undertaken the required economic reforms. Nevertheless, in exchange for a new bail out, Greece has agreed to what many consider to be 'tough economic reforms': changes to the tax system and public pensions, overhaul of the civil justice system, labour market reforms, etc.

The exposure of the global financial system to the crisis in Greece is expected to be contained given that most investors and banks retracted their investments at the initial stages of the crisis. Additionally, the situation in Greece has prompted other vulnerable economies like Spain, Portugal and Ireland to overhaul their economies. Even if there is an exit from the currency union, it is not expected to have contagion effects, given the safeguards put in place by Europe.

For Sri Lanka, the euro zone crisis will be felt mostly through trade as Europe is Sri Lanka's largest export destination. The crisis will be felt largely in terms of the depreciation of the euro. Partly attributed to the Greek crisis, euro's nominal effective exchange rate has depreciated by 10 per cent in the 12 months leading up to May 2015. A depreciation of the euro can translate into lower export earnings for Sri Lanka, especially for the main export items like T&G and seafood. Further depreciation can also affect the profit margins of Sri Lankan exporters to the EU. The exposure of the Sri Lankan economy to the EU through other channels will be limited with dependence of Sri Lanka on the EU for remittances assessed to be medium, low for FDI, and low for aid dependence.

Source: ECB (2015), "The International Role of the Euro", European Central Bank, Germany; IMF (2015), "Greece: An Update of IMF Staff's Preliminary Public Debt Sustainability Analysis", IMF Country Report No. 15/186; Massa, I., et. al., (2012), "The Euro Zone Crisis and Developing Countries', Overseas Development Institute, London.

3.4 World Trade, Commodity Prices and Financial Flows

3.4.1 World Trade

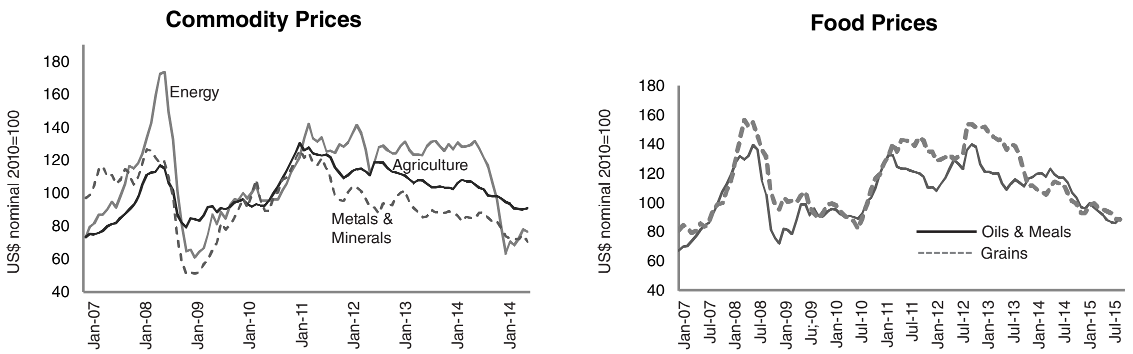
Growth of world trade has been weak in recent times, growing at an annual average of 3.4 per cent in the 2012-2014 period,[8] which is lower than average growth of trade in the past 20 years (5.2 per cent in the 1993-2013 period).[9] World trade growth slowed to 3.4 per cent in 2014, pulled back by weakened import demand and a stagnant Europe. The slowdown is also attributed to structural factors where slower expansions of global supply chains and shift in demand to less-import intensive items have made trade become less responsive to global income changes.[10] Further, growth in import demand from developing countries was the lowest since 2008. In 2015, trade is expected to pick up to 4 per cent but with high possibility of downside risks arising from developing geo-political tensions, and faltering economic recovery.

3.4.2 Commodity/Oil Prices

The fall in commodity prices has been broad-based with prices of energy, metal, minerals and agricultural raw materials declining from the second half of 2014. The drop in prices is due to ample supplies, weak global growth prospects and an appreciating dollar. The weakening in commodity prices is expected to continue through 2015 before a modest turn around in 2016. Oil prices saw the most dramatic decline, while prices of other commodities such as food also saw a fall (Figure 3.5).

Oil prices began to fall from the second half of 2014, bringing to an end a four year period of stability. The price of a barrel which was around US$ 105 over the past four years plummeted by more than 50 per cent, reaching below US$ 50 a barrel for the first time since May 2009 (Figure 3.6).[11] This fall is

Figure 3.5
Commodity and Food Price Indices



Source: World Bank (2015), "World Bank Commodity Price Data".

8 World Bank (2015), "Global Economic Prospects", World Bank, Washington, D.C.

9 WTO (2014), "WTO Lowers Forecast after Sub-par Trade Growth in First Half of 2014", https://www.wto.org/english /news_e/pres14_e/pr722_e.htm.

10 World Bank (2015).

11 Devarajan, S., and L. Mottaghi (2015), "Plunging Oil Prices", Middle East and North Africa Quarterly Economic Brief, World Bank, Washington, D.C.

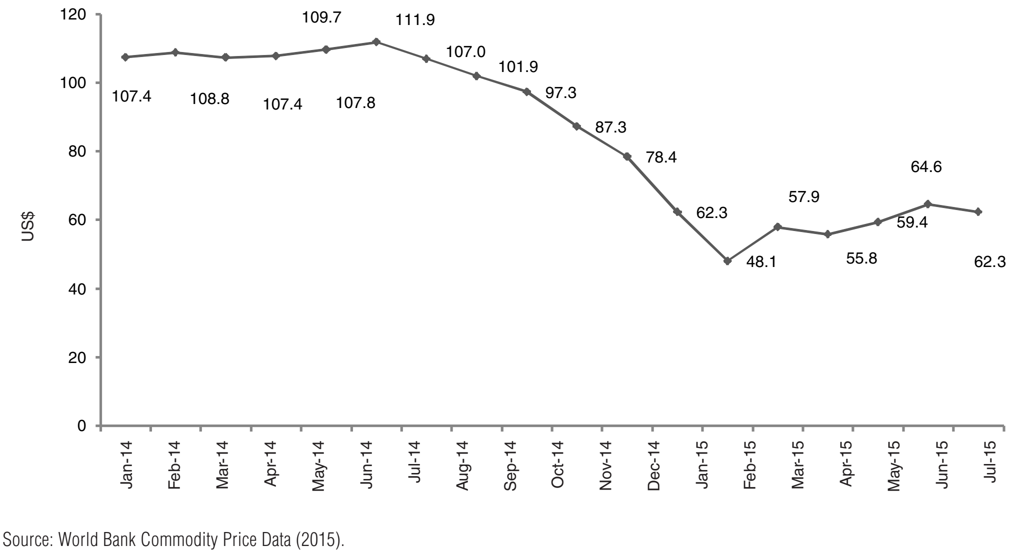
largely attributed to demand and supply factors - domestic production of oil in the US has nearly doubled in the past six years, recording the highest oil supplies in 80 years in March 2015. Consequently, countries such as Saudi Arabia, Nigeria and Algeria which once sold oil to the US are now competing for markets in Asia, pushing prices down. Furthermore, oil production in countries like Canada and Iraq has increased, adding to the supply glut. The refusal of the Organization of Oil Producing Countries (OPEC) to cut down on supply has also been a vital factor in the sharp drop in prices. While some OPEC countries have expressed their unwillingness to reduce production citing fears of losing market share, others argue that OPECs decision is an effort to squeeze American shale producers.

Weak global demand from the European, Asian and Latin American markets, and the increasing use of energy efficient and less oil intensive energy consumption which has resulted in reduced oil-intensity of global GDP are some of the demand factors which have contributed to low oil prices. However, unlike in the 2008 oil price crash, this time around, prices have been pushed down mainly by supply factors.

The impact of lower oil prices will be mixed with wide-ranging direct and indirect impacts on oil producing and oil importing countries. Understandably, oil producing economies will face financial and other economic challenges such as higher job cuts. On the other hand, oil importing economies will benefit from improvements in their current accounts through lower oil bills and fiscal accounts via lower fuel subsidies. However, the implications are likely to be more complex; some oil producing countries are also important export markets for many other countries, and see lower demand for their goods and services as a result. Lower oil prices may also lead to lower prices of substitutes (e.g., synthetic rubber will be cheaper than natural rubber and exporters of the latter can be negatively affected). Some oil producing nations such as those of the Gulf Cooperation Council (GCC) are also important sources of finance in the form of aid, investment, remittances and tourism revenue. On the other hand, they have ample reserves and are in a much better position to cushion any adverse impacts.

Predicting the oil market is not straightforward given the supply/demand, geo-political and other factors that could affect prices. However, prices are

Figure 3.6
Brent Monthly Prices (dollars per barrel)



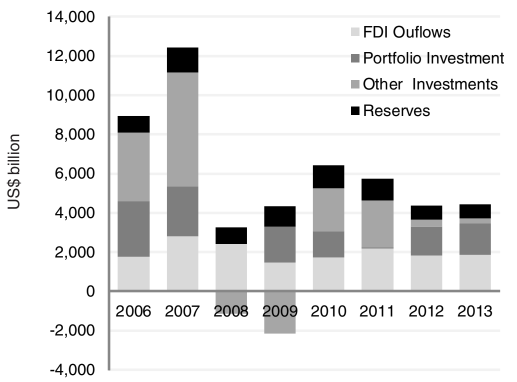
Source: World Bank Commodity Price Data (2015).

expected to rise in the latter half of 2015; the World Bank predicts oil prices to average at US$ 53 per barrel in 2015, with prices expected to rise only modestly in 2016 by about US$ 4 per barrel.[12]

3.4.3 Cross Border Capital Flows

Global cross border capital flows, especially from the banking sector which increased markedly in the decade before the financial crisis, have declined to about one-third their size in 2007.[13] Capital flows from all channels, except that from FDI, have reduced compared to pre-crisis levels (Figure 3.7). The reduction has come mainly from lower lending by banks and a marked reduction in portfolio investment in debt and equity securities (Table 3.3). These reductions are attributed to weak macroeconomic and financial conditions of many economies which has affected both demand and supply of capital, slow growth of world trade, and

Figure 3.7
Annual Global Capital Flows (2006-2013)[a]



Notes: a: Gross capital outflows, excludes financial derivatives and 'other investments' includes flows related to international banking transactions.

Source: Compiled from IMF (2015), "Summary of International Transactions", http://elibrary-data.imf.org/DataReport.aspx?c=23964394&d=33061&e=170784

Table 3.3
Global Capital Flows[a]

% of GDP	Yearly Average			
	1980-1989	1990-1999	2000-2007	2008-2012
FDI	1.0	1.5	2.9	2.9
Portfolio investment	1.2	2.3	4.2	1.4
Other investment[b]	2.7	1.9	5.0	0.4
Reserves	0.8	0.5	1.2	1.5
Total	5.7	6.2	13.3	6.2

Notes: a: Gross capital outflows; excluding financial derivatives; b: Includes flows related to international banking transactions.
Source: James, E., *et al.* (2014).

deleveraging by banks.[14] Direct investment flows on the other hand, have remained relatively stable, suggesting that it has been less volatile than other sources of inflows in the aftermath of the crisis. In terms of geographical distribution of capital flows, almost the entire decline in capital flows is due to a decreased lending among advanced economies, especially within Europe.[15] Capital flows to emerging economies have on the other hand, increased.

In terms of FDI flows, recent data indicate that 56 per cent of the global inflows were to developing economies recording a new high of around US$ 700 billion (Table 3.4). A regional breakdown shows that the increase was driven by developing Asia while flows into Africa remained flat and flows to Latin America and the Caribbean declined. Interestingly, four of the five top FDI recipients in 2014 were developing countries - China (US$ 128 bn.), Hong Kong, China (US$ 111 bn.), Singapore (US$ 81 bn.) and Brazil (US$ 62 bn.). Notably, FDI flows to transition economies fell by over 50 per cent mainly due to the conflicts and sanctions. India continues to attract sizeable investments, the only South Asian country among the top 20 host countries.

[12] World Bank (2015), "Commodity Markets Outlook – January", World Bank, Washington, D.C.
[13] Broner, F. *et al.*, (2013), "Gross Capital Flows: Dynamics and Rises", *Journal of Monetary Economics*, 60(1): 113–133.
[14] James, E., *et al.*, (2014), "Cross-border Capital Flows since the Global Financial Crisis", RBA Bulletin, Reserve Bank of Australia.
[15] *Ibid.*

Table 3.4
FDI Inflows, by Major Regions (2012-14)

US$ bn.	2012	2013	2014	Growth Rate 2013-14 (%)
World	1324	1363	1260	-8
Developed Economies	590	594	511	-14
Europe	310	225	305	36
European Union	282	235	267	13
North America	213	302	139	-54
Developing Economies	650	677	704	4
Africa	55	56	55	-3
Latin America & the Caribbean	178	190	153	-19
Developing Asia	414	427	492	15
West Asia	48	46	44	-4
East Asia	217	220	254	16
South Asia	32	35	43	23
South East Asia	116	127	151	19
Transition Economies	84	92	45	-51

Source: Adopted from UNCTAD (2015), "Global Investment Trends Monitor", UNCTAD, Geneva.

Box 3.2
AIIB and BRICS Development Bank: Perceived Benefits for Asia and Developing Countries

The last two years have seen the advent of two new multilateral lending agencies, the Asian Infrastructure Investment Bank (AIIB) and the BRICS Development Bank. In October 2014, the Memorandum of Understanding on establishing the AIIB was signed among 21 countries including Sri Lanka who will now be a founder member of the AIIB. Initiated by China, 57 countries have applied to be founding countries of the AIIB (including UK, Australia, India, France and Germany). There has been however, a notable absence of support from US and Japan, who have flagged concerns of standards and governance of the bank, but are probably more concerned with US' strategic rivalry with China. The AIIB will nonetheless open up new channels of credit to finance Asia's increasing infrastructure needs which an ADB study estimates to be US$ 800 million annually. The statutory capital of the AIIB is US$ 100 billion. The bank's Articles of Agreement are expected to be completed by end 2015.

In March 2013, the BRICS leaders (from Brazil, the Russian Federation, India, China and South Africa) also approved the creation of a new development bank. The BRICS Development Bank is expected to commence operations in 2016 with its head office in Shanghai. The focus of the BRICS Development Bank is largely to mobilize funds for infrastructure and sustainable development projects in BRICS and other emerging and developing countries.

The creation of these institutions can be expected to be a win-win situation. They will provide more access and choice of additional resources for developing countries while exerting competitive pressure on other multilateral agencies to improve their operations and governance. It would also provide more space for other multilateral agencies to focus on development areas such as health and education while the new banks could focus on infrastructure. Furthermore, there is a large accumulation of reserves in Asia and the creation of AIIB would provide a platform for these funds to be directed to infrastructure projects. It is hoped that such an institution would streamline loans and grants already given by countries like China to developing countries, which are sometimes critiqued as being opaque. It is vital that development finance from these organizations come with terms and conditions which ensure transparency and proper utilization of funds.

It is argued that the concerns of the US and Japan are the very reasons they should be part of the AIIB - to ensure a strong foundation is laid for a healthy and professional regional bank; it might be particularly important for Japan given the influence the AIIB is going to have in the region's future economic architecture and security. It is only hoped that these multilateral agencies would be complementary and cooperative rather than being a substitute to the existing multilateral lending agencies.

3.5 International Environment and Implications on Sri Lanka

3.5.1 International Trade and Capital Flows

Given the dependency of the Sri Lankan economy on external trade, the future of the country's economic growth and development hinges to a great extent on its ability to strengthen its export performance. In 2014, Sri Lanka's exports were just above US$ 11 billion, growing at an annual average of about 7 per cent over the past decade. However, Sri Lanka's export performance since 2000 has not been satisfactory with a sharply declining export-to-GDP ratio - from 28 per cent in 2004 to a low of 14.8 per cent in 2014 - and falling shares in world exports, indicative of its failure to keep up with competitors (Figure 3.8).

Sri Lankan exports have also been gradually losing out on the world market. Exports of Sri Lanka's competitors like Vietnam and Bangladesh who were respectively, on par and behind Sri Lanka exporting just US$ 2 billion and US$ 1.6 billion, respectively in 1990,[16] exported US$ 120 billion and US$ 30 billion worth of products respectively in 2013 (compared to Sri Lanka's US$ 10 billion exports in 2013). Vietnam in particular has made significant strides in increasing their export share in the world

Exports of Sri Lanka's competitors like Vietnam and Bangladesh who were respectively, on par and behind Sri Lanka exporting just US$ 2 billion and US$ 1.6 billion, respectively in 1990, exported US$ 120 billion and US$ 30 billion worth products respectively in 2013 (compared to Sri Lanka's US$ 10 billion exports in 2013)

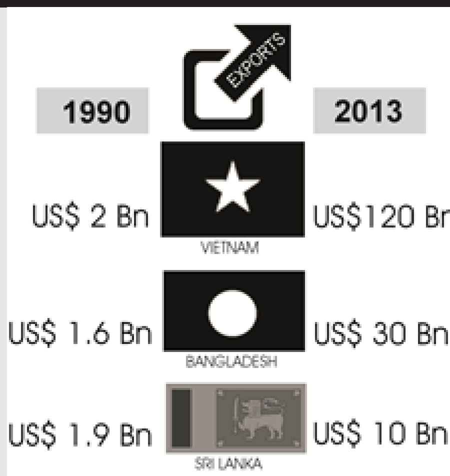
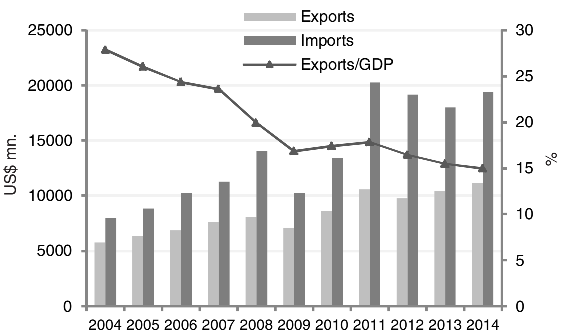
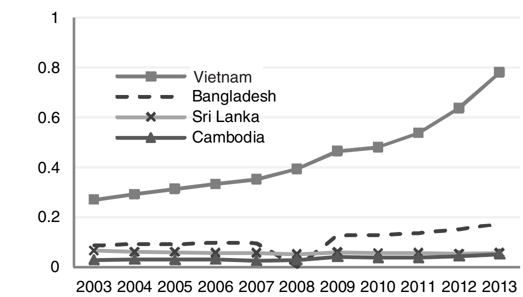


Figure 3.8
Sri Lanka's Trade Performance (2004-2014)



Source: CBSL, *Annual Report*, Central Bank of Sri Lanka, Colombo, various years.

Figure 3.9
Share in World Exports (2003-2013)



Source: Based on ITC, "Trade Map" data, International Trade Centre, Geneva.

[16] Kelegama, S., (2014), "What Will It Take Sri Lanka to Build a World Class Export Economy", presentation made at the CMA Annual Conference, 19 June 2014, http://www.ips.lk/staff/ed/news/2014/18_06_2014_beyond_fast_tracking_ips/world_class_export_kelegama.pdf.

market - from 0.27 in 2003 to 0.78 in 2013 compared to a fall in Sri Lanka's world market share from 0.06 to 0.05 in the same period (Figure 3.9). In terms of Sri Lanka's main export product of T&G, competitors like Vietnam and Bangladesh have been able to improve their market shares more strongly than Sri Lanka in both the US and EU (Table 3.5). Similarly in the case of tea, Kenya seems to be increasingly penetrating Sri Lanka's key tea markets such as Russia and Turkey.

Sri Lanka's lacklustre performance in exports cannot be attributed to world market conditions, but appears to be fundamentally homegrown. The export structure which changed from a predominantly agriculture base in the 1960s to a light manufacturing base (exporting garments and rubber products) has not seen any strong growth in other industrial sectors. Furthermore, despite the long identified need to diversify markets, this too has not changed significantly over time - over 50 per cent of exports go to the EU and US, although over the past decade reliance on the US has reduced (Figure 3.10).[17]

In analyzing the implications of the international environment on Sri Lanka's trade, the positive outlook for the US economy is encouraging given that it is the second most important destination for Sri Lankan exports - with T&G and rubber articles being the main export products. On the other hand, a still weak Euro zone is not heartening for Sri Lanka's main exports to the region of T&G (46 per cent of T&G exports), rubber (30 per cent) and fish and crustacean exports (40 per cent).

The current economic environment of Russia and the Middle East are also likely to have adverse effects on Sri Lanka's exports. Around 75 per cent of Sri Lanka's tea exports go to the Middle East, North Africa, Russia and CIS countries. Economic and political uncertainty in Sri Lanka's key tea export markets like Russia, Iran and Syria, and sharp currency depreciations such as that of the ruble have already affected the country's tea export prices and earnings (see Figure 3.11). Notably, tea is also the country's fourth largest foreign exchange earner after remittances, garments and tourism. Furthermore, it is likely that the export price and

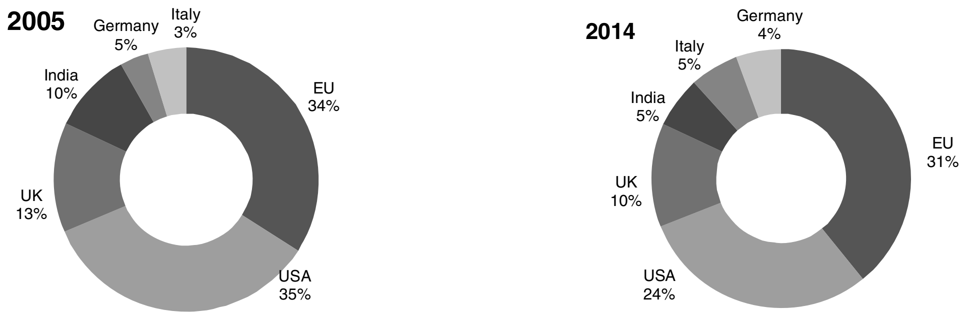
Table 3.5
Performance of Sri Lanka and Competitors in Main Export Products and Markets

Product	Export Market	Market Share	2010	2011	Year 2012	2013	2014
Garments	USA	Sri Lanka	1.8	1.9	1.9	2.1	2.3
		Vietnam	8.0	8.3	9.0	10.0	11.1
		Bangladesh	5.4	5.6	5.6	6.0	5.7
	EU	Sri Lanka	1.2	1.2	1.3	1.3	1.2
		Vietnam	1.5	1.7	1.9	2.0	1.7
		Bangladesh	6.5	7.8	8.7	9.6	8.4
Tea	Russia	Sri Lanka	42.6	45.1	40.0	38.2	37.9
		Vietnam	5.3	4.2	3.6	3.3	3.3
		Kenya	18.7	21.0	25.8	26.8	34.4
	Turkey	Sri Lanka	55.6	39.4	33.8	44.7	40.8
		Vietnam	4.5	17.0	3.5	3.5	4.8
		Kenya	13.2	18.9	36.9	30.2	24.8

Source: Calculated using ITC, “Trade Map” data, International Trade Centre, Geneva.

[17] See Chapter 5 of this report on “Reforming Sri Lanka’s Trade and Investment Policies for Export Growth”.

Figure 3.10
Sri Lanka's Main Export Markets (2005 and 2014)

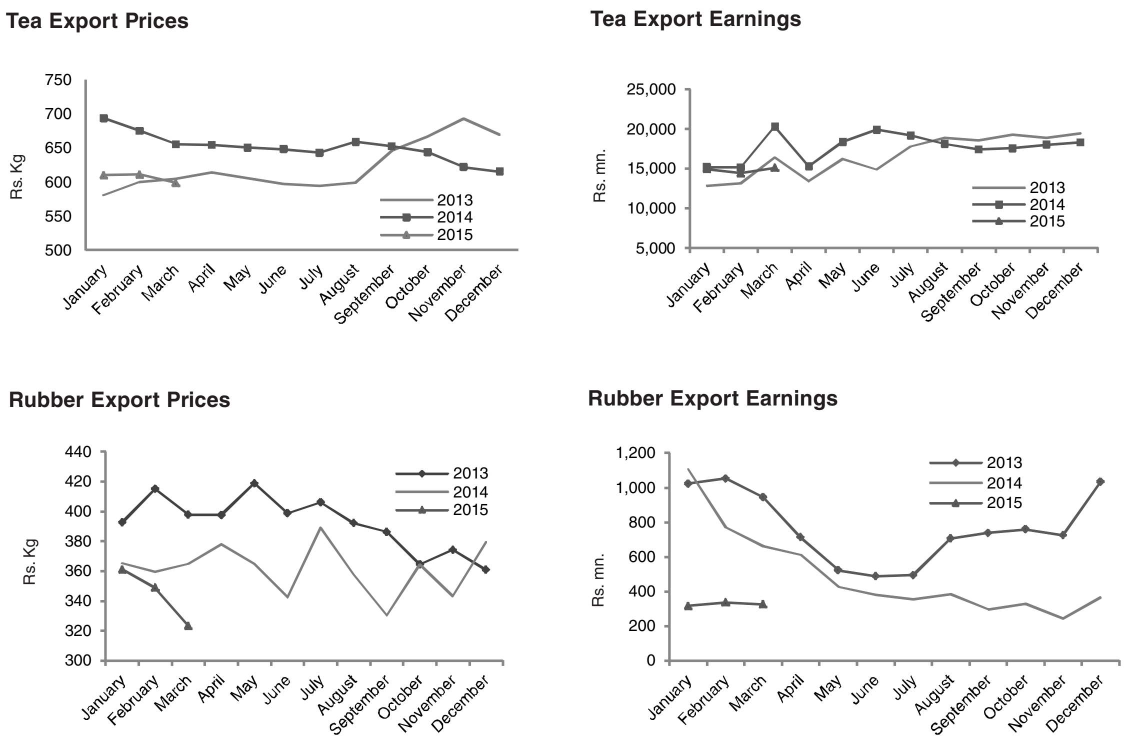


Notes: Percentage of total exports.

Source: CBSL, *Annual Report*, Central Bank of Sri Lanka, Colombo, various years.

volume of natural rubber and related products would see some decline in 2015 as synthetic rubber/ products would become cheaper as a result of low oil prices. Earnings from tea have fallen in the latter half of 2014 as well as in 2015. The fall in rubber earnings has however, been more pronounced, declining by 36.5 per cent in 2014 due to reduced demand for natural rubber and higher global supply.[18]

Figure 3.11
Export Prices and Earnings of Tea and Rubber (2013-15)



Source: CBSL, "Monthly Economic Indicators", Central Bank of Sri Lanka, Colombo, various issues.

[18] CBSL, *Annual Report 2014*, Central Bank of Sri Lanka, Colombo.

In terms of capital flows, the effects of a normalization of US monetary policy on Sri lanka is expected to be limited, given the country's rather limited exposure to global financial flows via portfolio investments and government debt securities. However, Sri Lanka may be affected through higher borrowing rates if it pursues with Sovereign bond issues. The dispersion of investors for these suggests that a majority are from the US; for example, Sri Lanka's last US$ 1 billion Sovereign bond issue in 2014 saw the US take 62 per cent, Europe 26 per cent and Asia 12 per cent.

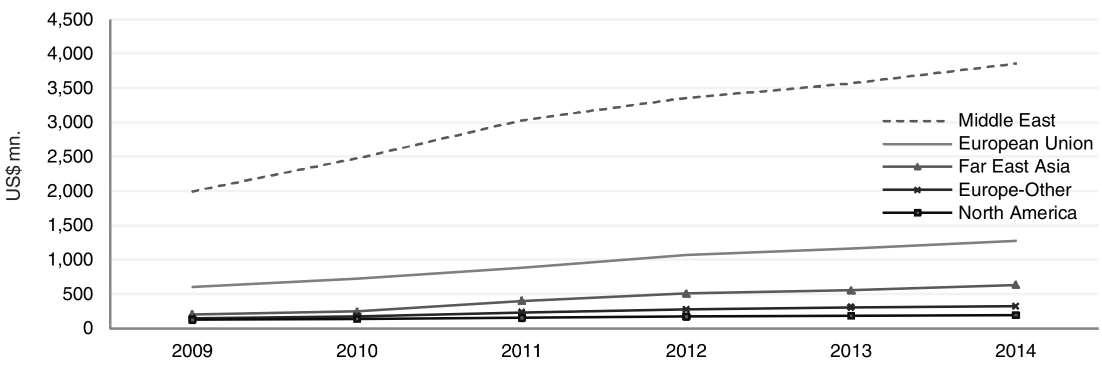
3.5.2 Remittances and Tourism

Remittances help reduce the deficit in the current account and along with investments help increase national savings. Remittances are Sri Lanka's largest source of foreign exchange and continue to help the country manage its current account deficit. Remittance inflows have been increasing over the years and amounted to US$ 7 billion in 2014 or 9.4 per cent of GDP. However, it must be noted that remittance growth has slowed to an annual average of around 9 during 2013-14 compared to 22 per cent annual average growth during 2010-12. With numbers of migrants and their skills composition remaining relatively unchanged, increased inflows to former conflict-affected households in the immediate post-war period is perhaps a key reason for the recorded higher inflows.

Global remittance flows to developing countries are expected to moderate in 2015 owing to conditions in Russia and tighter immigration controls in Europe. However, there are no immediate risks to Sri Lanka given that the Middle East continues to be the predominant source of remittances, accounting for over 55 per cent. The drop in oil prices is not expected to dampen demand for migrant workers in lower skill services sectors such as housemaids and construction workers - the predominant sourcing of workers from Sri Lanka.

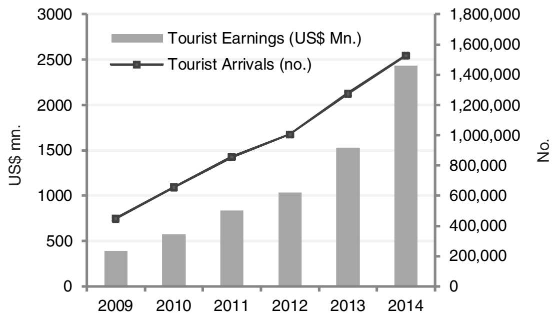
Like remittance earnings, Sri Lanka's tourism earnings have also shown strong growth in the post-war period, with substantive investments in the leisure industry and supportive infrastructure development. Tourist arrivals increased to over 1.5 million in 2014, with earnings of US$ 2,431 million (Figure 3.13). The largest tourist sending countries for Sri Lanka at present are India, UK, Germany, France and China. A notable feature has been the sharp increase recorded in number of tourist arrivals from China during 2013-14, claiming the third highest source of arrivals after India and the UK.

Figure 3.12
Remittance Inflows (2005-2014)



Source: CBSL, *Annual Report,* Central Bank of Sri Lanka, various years.

Figure 3.13
Tourist Arrivals and Earnings (2009-2014)



Source: CBSL, *Annual Report,* Central Bank of Sri Lanka, various years.

3.5.3 Emerging Opportunities for External Engagements

A change of government following the Presidential election of January 2015 has signalled a shift in approach to Sri Lanka's external engagements that can hold implications for its strategic trade, finance and investment initiatives. The signalling indicates an effort to 'rebalance' Sri Lanka's relationship vis-à-vis India and China, both in political and economic spheres. On the economic front, where Sri Lanka's economic relations with China have progressed considerably in the recent past - from becoming the largest source of development finance and funding many large scale infrastructure projects to beginning negotiations on a possible trade deal - Sri Lanka's economic relations with India suffered a set-back with the sidelining of the Comprehensive Economic Partnership Agreement (CEPA) in 2008. While Sri Lanka's political relations with China continued to strengthen, relations with India became more contentious as the latter voted for a US resolution against Sri Lanka in 2012 and 2013 at the UN Human Rights Council.

Re-affirming Sri Lanka's close political and economic relations with India whilst maintaining friendly ties with China seems to be the new approach - signalled by a visit of an Indian Prime Minister in March 2015 to Sri Lanka, the first in 28 years. At the same time, Sri Lanka has halted work on some large Chinese investment projects - e.g., the Colombo Port City project worth US$ 1.4 billion - and put other Chinese funded infrastructure projects under close scrutiny. As the country aims to strike a delicate balance between the two regional powers, there are positive signals that proposed trade deals with both countries will get renewed policy attention.

Another signal in change of approach has been a renewal of interest on the part of Sri Lanka to re-apply for the EUs Generalized System of Preferences (GSP-plus) trade concessions that were withdrawn in 2010. In February 2010, the EU Council of Ministers took the decision to withdraw GSP-plus concession from Sri Lanka, citing shortcomings with respect to the country's human rights conditions stemming from the final stages of the war in 2009. The EU offered to delay the withdrawal by a further 6 months in which it sought "tangible and sustainable progress on a number of outstanding issues" including a firm commitment to address 15 principal outstanding issues. The Sri Lankan government position was that the 'conditions' infringed on the country's internal affairs and failed to respond to the deadline, as a result of which Sri Lanka lost access to the EU under GSP-plus concessions in August 2010.

Whilst Sri Lanka's exports to the EU continued to grow even after the loss of GSP-plus, a resumption of concessions which provide duty free access to the EU will no doubt provide a boost to exporters and assist the country in its development process. In March 2015, an EU delegation visited Sri Lanka to re-evaluate the country's eligibility, widely considered to be dependent on a high degree of commitment to improve on issues of governance, rule of law and human rights. Even as Sri Lanka gets ready for a sign-on, the country must not view trade preferences - particularly preferences such as GSP-plus that can be withdrawn unilaterally - as a panacea for its export ills. Rather, should the country regain preferential access to the EU, it should be used as a stepping stone to enter the market whilst ensuring that exports will remain competitive with or without preferential tariff treatment in the medium to long run.

3.6 Conclusion

Baseline forecasts of international organizations suggest that the advanced economies would perform better than emerging economies with growth in the latter slowing down. Nonetheless, there are a number of complex forces that shape the world economy. Macroeconomic risks seem to have reduced, especially with the risks of a recession in the Euro zone decreasing. However, financial and geo-political risks seem to have risen, with large movements in relative prices (i.e., commodities, exchange rates) creating winners and losers; and a possible crisis in Greece and turmoil in Ukraine and the Middle East. With the Euro zone embarking on QE, following other developed economies, monetary policy is been exploited widely while there seems to be limited space for fiscal policy.

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

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