



POLICYINSIGHTS

INSTITUTE OF POLICY STUDIES OF SRI LANKA

INTERNATIONAL ECONOMIC ENVIRONMENT

From the IPS flagship publication 'Sri Lanka: State of the Economy 2018 Report'



During 2017, the global economy appeared to be recovering from the pessimism and uncertainty that persisted for nearly a decade since the onset of the financial crisis, on the back of 'synchronised growth' in major advanced economies. However, recent political tensions, especially in regards to trade wars between the US and China, along with policy uncertainty in the US and Europe on several significant political-economic fronts, can raise future global economic and geopolitical risks.

Improvements in the global economy have had some positive impacts on Sri Lanka. Export revenue increased in 2017 while the country also attracted higher volumes of foreign direct investment

(FDI) compared to preceding years. However, Sri Lanka's trade imbalance continues to grow as rising oil prices, combined with other factors, inflate import costs. Thus, even though some progress is being made by Sri Lanka's external sector, the economy continues to be exposed to significant risks. These

include the impacts on external borrowing viz. interest rate adjustments in international capital markets and implications on the currency from an appreciating US dollar.

World trade experienced its largest increase in six years in 2017, driven

mainly by cyclical factors, especially in increased investment and consumption expenditure. This momentum is expected to be sustained during 2018 as well through to 2019. However, these positive expectations for continuous improvements in trade growth are significantly tempered by the recent escalation of tensions in trade policy between the US and China. A cycle of retaliatory tariff increases outside the scope of the World Trade Organisation (WTO) dispute settlement mechanism, has increased the threat of a trade war and thus affected business confidence and future investment decisions.



Implications of External Environment

Developments on

Sri Lanka

Since 2015, Sri Lanka has been aiming to shift to an outward oriented, export led, FDI driven economy, whilst relying on development finance from international capital markets. In this respect, external environment developments have a direct bearing on the country's progress. Apart from Sri Lanka's dependency on external markets to drive export growth and bring steady investment inflows into the country, Sri Lanka also remains vulnerable to external shocks such as oil prices and international capital market trends as a result of a high debt overhang and a low buffer stock of reserves.

While prospects in the US and EU region remain crucial to Sri Lanka as these are the primary source of exports as well as investments in sovereign bonds, developments in East Asia are becoming increasingly critical as a source of FDI and development loans for Sri Lanka. For this reason, prospects in both the US/EU as well as East Asia have a significant bearing on the success of the outward oriented growth path that Sri Lanka envisions, and is currently in the process of implementing. In this context, the policy thrust is aimed at securing market access for goods via GSP+ schemes and FTAs, encouraging inward investments by better positioning in global value chains, along with domestic reforms to provide the necessary institutional support.

Sri Lanka's external sector performance shows some notable improvements in 2017 compared to previous years. Export performance has picked up in line with the global uptick in merchandise trade; however, import performance shows a concurrent increase, which has resulted in a worsened trade balance compared to previous years.

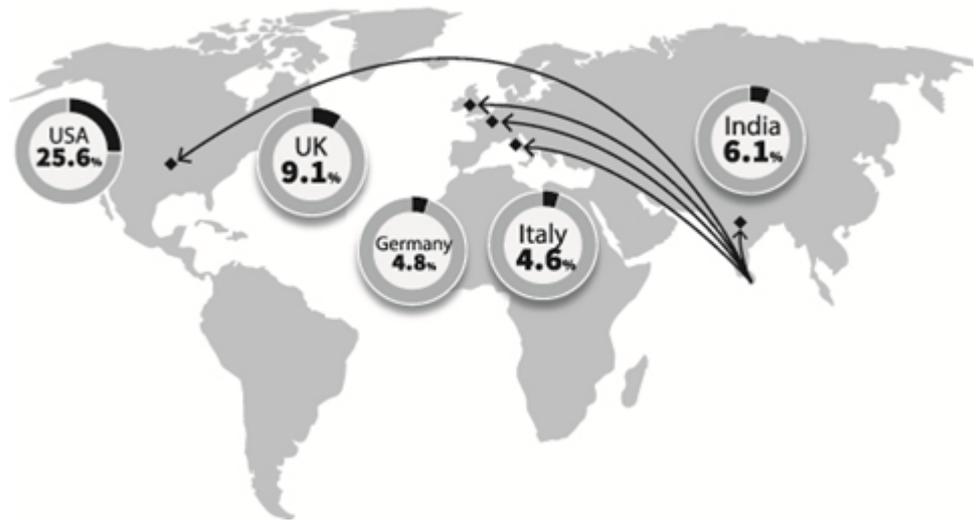
Sri Lanka's current trade position is not

an entirely comfortable one; an increasing import bill is putting/exerting pressure on the trade balance, despite moderate gains in export growth. However, on a positive note a supportive policy environment that embraces an export-led development strategy is emerging. A National Trade Policy (NTP) has been formulated with several policies to attract more export oriented FDI, improve trade logistics and to make customs procedures more efficient and transparent. In addition, the signing of the FTA with Singapore was among the favorable developments in Sri Lanka's regional integration efforts. Further, the EU-GSP plus facility which provides

negotiations with India, China, and Singapore. Thus far, Sri Lanka has also made statements regarding the possibility of a FTA with Malaysia, Vietnam, and Bangladesh, among others, while potentially updating its existing FTA with Pakistan as well.

Sri Lanka's network of bilateral FTAs with South, Southeast Asian economies, and China, along with an emphasis to gain observer status at the Association of Southeast Asia Nations (ASEAN) is being pursued with the end objective of establishing the necessary political and economic frameworks to eventually join the RCEP process.

Sri Lanka's largest export markets



duty free access to approximately 7,200 tariff lines was renewed in May 2017. Along with the phasing out of para-tariffs and negotiation of trade agreements, some policy efforts to minimise potential negative effects from trade liberalisation have also been taken; an Anti-Dumping and Countervailing Duties Act has been passed along with Safeguard Measures to address import surges.

Sri Lanka's Efforts towards Regional Integration

In conjunction with its new National Trade Policy and Sri Lanka's Vision 2025 - which aims to position the country as an export-oriented economic hub in the Indian Ocean, Sri Lanka embarked on a triumvirate of FTA

This Policy Insight is based on the comprehensive chapter on "International Economic Environment" in the 'Sri Lanka: State of the Economy 2018 Report' - the flagship publication of the Institute of Policy Studies of Sri Lanka (IPS). The complete report can be purchased from the publications section of the IPS, located at 100/20, Independence Avenue, Colombo 7. For more information, contact the Publications Unit on 0112143107/0112143100.



100/20, Independence Avenue, Colombo 7, Sri Lanka
T: +94 11 2143100 / 2665068,
F: +94 11 2665065
www.ips.lk