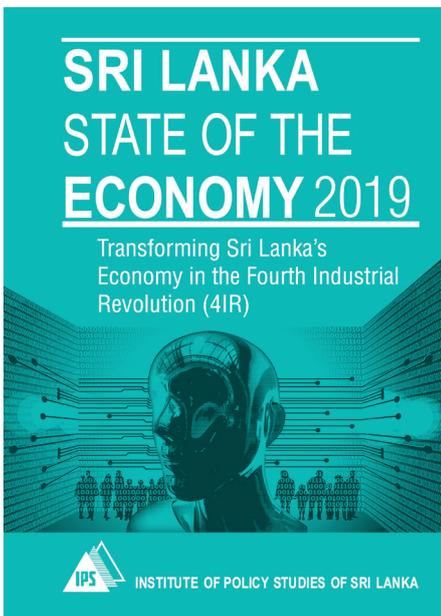


INTERNATIONAL ENVIRONMENT AND IMPACTS ON SRI LANKA

From the IPS flagship publication 'Sri Lanka: State of the Economy 2019'



Global economic activity slowed over the course of the year in 2018, with the sluggish momentum continuing through to 2019. Escalating trade tensions between the US and China, coupled with President Trump's protectionist stance have been the biggest contributor to the dip in economic sentiment, globally. To add to concerns, China's economic growth rate is slowing due to regulatory tightening and trade tensions with the US, while the Euro area faces more challenges than expected. In addition, the unclear terms of exit of the UK from the European Union (EU) has heightened uncertainty in the global economic environment.

Under such toxic external conditions, Sri Lanka's external sector faces a multitude of challenges, including the spillover impacts of the ongoing trade wars, as it seeks to increase exports via several reform packages. A largely stagnant export basket, as well as overreliance on mar-

kets in the US and EU for exports do not help, as demand from these destinations could slow due to unfavorable external conditions. Other key revenue generating sources such as remittance earnings are also slowing down; the April 2019 terror attacks derailed what was otherwise a promising performance in tourism earnings. Thus, while the country's external sector resilience has marginally improved by mid-2019, much remains to be done to strengthen Sri Lanka's position, to effectively cushion against external shocks.

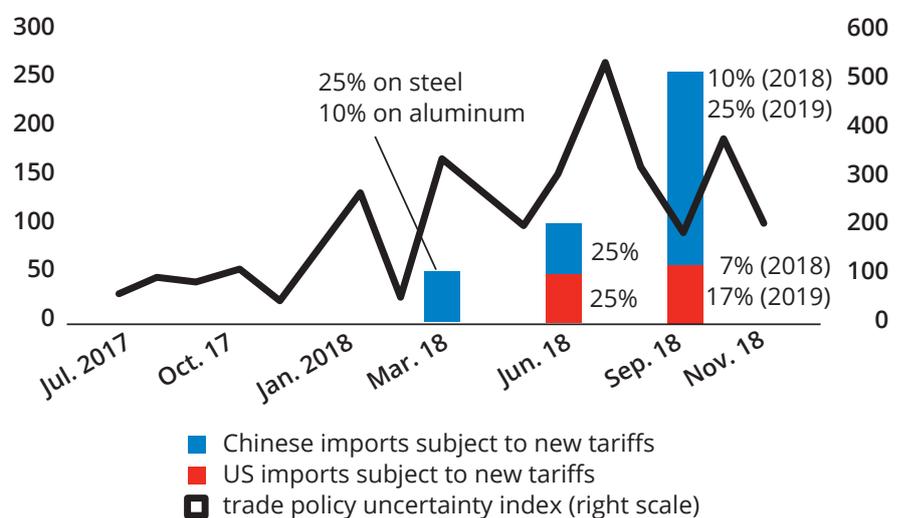
Prospects for the Global Economy

Although the global economy experienced an upbeat start in 2018, global expansion (albeit continuing) has weakened since the latter part of 2018. Growth projections by the International Monetary

Fund (IMF) have been revised downwards, with the global economy projected to grow at 3.5 per cent in 2019 – down from 3.7 per cent in 2018 – with only a marginal pick up to 3.6 per cent in 2020.

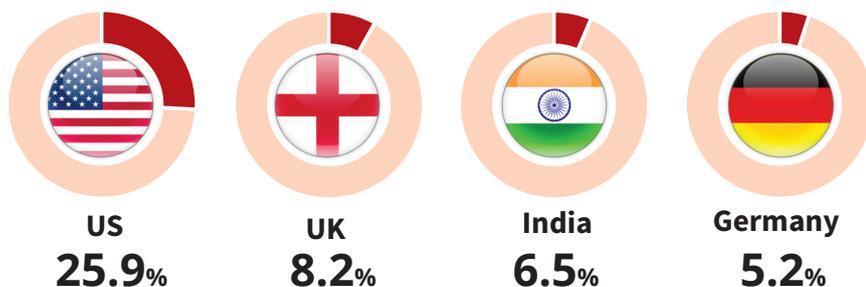
Advanced economies are projected to grow at 2 per cent in 2019, following an estimated growth of 2.3 per cent in 2018. A host of factors have slowed the growth momentum and heightened risks in advanced economies. The repercussions of tariff increases enacted in the US and China in 2018-2019 are being felt. Financial risks experienced in Italy, the introduction of new fuel emission standards in Germany and natural disasters experienced in Japan have also weighed on economic activity in large economies. Meanwhile, consistent with trends in recent years, emerging and developing economies

Trade Tensions (billion US dollars)



Source: International Monetary Fund (2018)

Sri Lanka's largest export destinations



Source: Central Bank of Sri Lanka (2018)

continue to be the main drivers of global economic growth. Growth in these economies is expected to dip slightly to 4.5 per cent in 2019, and recover again in 2020 to a rate of 4.9 per cent.

Sri Lanka benefitted from a brief upturn in global economic conditions in 2017; improved business confidence, a healthy appetite for investment, favourable oil prices and growth in key markets for Sri Lanka such as the US and EU, allowed the country some space to manoeuvre through its weak macroeconomic conditions. However, over the course of 2018-2019, the external environment has proved to be less conducive. Tighter global financial conditions, a resurgence in oil prices, riskier economic and political environments in key export markets (US, UK) and slower growth in major source

economies for FDI/development loans (East Asia) have been some of the contributing factors. Given Sri Lanka's significant medium-term spike in foreign debt settlements from 2019, a more disadvantageous external environment makes it all the more challenging.

In this climate, Sri Lanka is attempting a concerted push to drive up its exports. Yet, the trade deficit continued to balloon and began to ease only with the sharp depreciation of the currency as imports started to decline. In addition, key sources of foreign exchange such as worker remittances are also showing signs of a decline, while the tourism sector – performing more impressively in 2018 and early 2019 – suffered an unexpected setback following the April 2019 terror attacks.

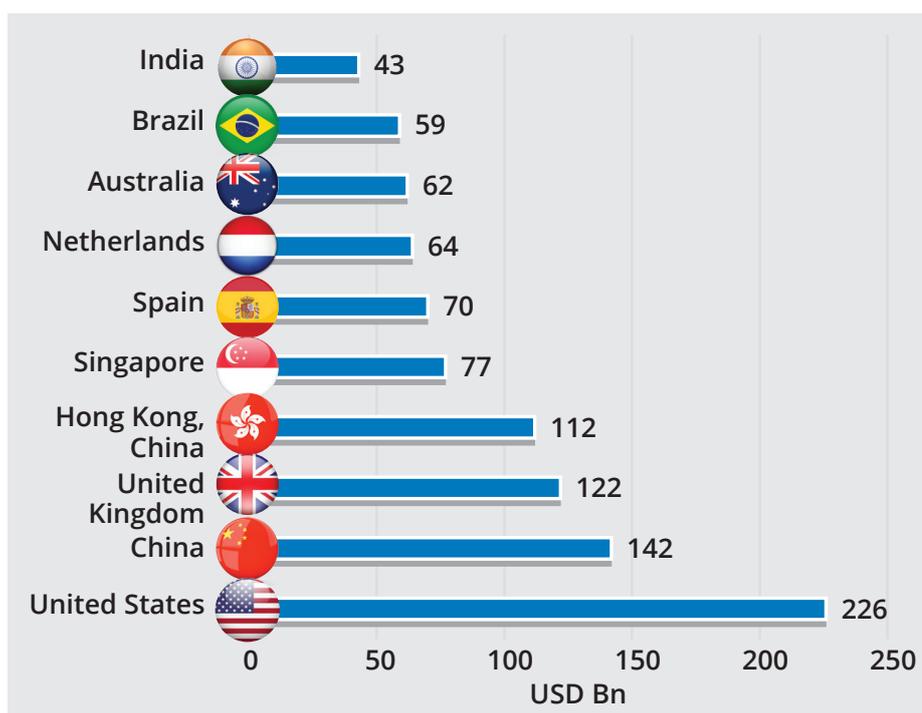
Sri Lanka's Positioning

Sri Lanka is already a straggler in regional economic growth. To add to this mix, it is a heavily indebted country facing unprecedented levels of foreign debt settlements over the next few years. In the absence of adequate foreign financing, Sri Lanka, like many other developing countries is increasing engagements in China's ambitious BRI project. This comes with its own set of challenges for the country, as Sri Lanka's historic ties to India comes under pressure with country's seeming 'tilt' towards China. Having said this, relations with the West and India have improved, which manifested in the reinstatement of EU GSP Plus, grant funds received from the US Millennium Challenge Corporation (MCC) and short-term swap arrangements from the Reserve Bank of India (RBI) in times of stress on Sri Lanka's foreign reserves.

Against this backdrop, engagements with regional neighbours through FTAs are being negotiated as a strategy to move away from dependency on Western markets and to 'piggyback' on Asian economic prowess. However, in the short run, Sri Lanka continues to draw the same type of investments into infrastructure, export low-value goods, and rely on economies that are facing a degree of volatility as its key sources of export markets and foreign capital. The faster these aspects – FDI, exports, export markets – are diversified, the faster will be a steadier flow of earnings that can better cushion the Sri Lankan economy from unfavorable external conditions.

This Policy Insight is based on the comprehensive chapter on "International Environment and Impacts on Sri Lanka" in the 'Sri Lanka: State of the Economy 2019 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.

Estimated FDI Flows (USD billions) - Top 10 Host Economies 2018



Source: United Nations Conference on Trade and Development (2019)


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