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Between homefront policies and global developments: Sri Lanka's External Sector Outlook

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Feature

Having weathered a challenging period marked by a deep economic crisis, Sri Lanka is now demonstrating positive signs of an economic upturn. Still, amidst limited homefront policy alternatives against an unfavourable global backdrop, a critical question arises: How will Sri Lanka's external sector cope in the face of these challenges?

Notably, import controls, initially imposed in response to the dearth of foreign exchange liquidity in the domestic market, are being largely eased. The government is actively seeking to forge partnerships with regional giants, aiming to strengthen trade relations through Free Trade Agreements (FTAs). Nevertheless, in the broader global context, the rise of geopolitical rivalries, slow growth and contracting demand in key markets create multiple uncertainties for Sri Lanka's external sector recovery.

**Global economic developments:
A complex web of uncertainties**

Globally, there are promising signs of economic progress in the near-term. Supply chain disruptions, which significantly impacted various industries, have largely returned to pre-pandemic levels. Energy and food prices, having peaked during conflict-induced periods, have substantially subsided, alleviating global inflationary pressures faster than anticipated.

However, the global economic landscape remains overshadowed by a complex web of uncertainties. Political dysfunction in key economies and ongoing geopolitical rivalries present challenges. The United States' imposition of bans on certain exports to Chinese firms exemplifies the extant geopolitical tensions. This growing inclination towards trade interventions through industrial policies, subsidies, and import restrictions, driven by national security and environmental considerations, has the potential to impact the trajectory of globalisation. These developments carry substantial implications for emerging and developing economies, particularly those deeply reliant on a globally integrated economy, foreign direct investment (FDI), and technology transfers. Economies contending with burgeoning sovereign debt overhangs in particular, are expected to face heightened vulnerabilities. Having defaulted in early 2022, Sri Lanka is among the countries particularly affected by these global economic shifts.

Sri Lanka's vulnerable export sector

In 2022, Sri Lanka recorded its lowest merchandise trade deficit since 2011, primarily due to reduced imports and an uptick in exports. Merchandise exports expanded by 4.9 per cent in 2022 compared to the previous year, while import expenditure decreased by 11.4 per cent in 2022 relative to 2021. The decrease in import expenditure stems from a combination of import restrictions and foreign exchange liquidity constraints.

However, as import controls ease and the economy gradually improves, a marginal increase in import expenditure is observed from June 2023 onwards. While improving consumer welfare and food security, this move may negatively impact the trade deficit this year, especially as global demand for Sri Lanka's primary exports, like tea and garments face a downturn – the former triggered by high production costs and the latter by contracting foreign demand.

Sri Lanka's key export markets for garments, particularly in the US and Europe, are experiencing low growth and weakened demand since the fourth quarter of 2022. Consequently, monthly earnings from garment exports in August 2023 indicates a 26 per cent decline compared to August 2022. Notable decreases in the import of Ceylon tea by prominent Sri Lankan tea importers in 2022 relative to 2021, including Russia (by 9.6 per cent), the UAE (by 2.5 per cent), and Turkey (by 47 per cent), also highlight the vulnerability of Sri Lanka's export sector to external shocks. The tea market's condition has seen a modest improvement in 2023, though it has not been entirely resolved.

The concentration of Sri Lanka's exports in terms of products and markets has long been a source of concern, rendering the economy exceedingly susceptible to sector-specific shocks.

Tourism and worker remittances: A silver lining

In a positive trajectory, 2023 has witnessed a notable increase in monthly tourist arrivals compared to the previous year, signalling a discernible recovery trend. Cumulative tourist arrivals from January to August 2023 amounted to 904,318, compared to 496,430 arrivals recorded during the corresponding period in 2022. Overcoming the challenges within this sector necessitates a coordinated effort from various stakeholders, including the government and the private sector, as Sri Lanka endeavours to reconstruct its brand identity as a secure and preferred destination.

Worker remittances, representing another crucial source of foreign exchange earnings, have exhibited promise. In the first half of 2023, worker remittances grew to US$2.8 billion, however it remains below the pre-pandemic level of $3.6 billion recorded in the first half of 2018. While West Asia remains a vital destination for Sri Lankan workers, alternative destinations offering employment across various job categories have emerged, including South Korea, Singapore, Japan, and several European countries. Notably though, the large-scale migration of workers, including white-collar employees, raises concerns regarding long-term economic repercussions due to brain drain.

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