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EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

5.1 Overview

Sri Lanka's external sector experienced significant pressure, particularly during the second half of 2018, due to both external and domestic factors, while the policy measures taken helped increase resilience towards the end of the year. On the external front, the broad-based strengthening of the US dollar following the policy interest rate hikes in the USA resulted in foreign investment outflows from emerging markets, including Sri Lanka. On the domestic front, the trade deficit expanded more than expected during the first three quarters of the year, as the growth of import expenditure outpaced the growth of export earnings. Reflecting the impact of the expanded trade deficit and heightened capital outflows on the back of tightening global financial market conditions, the liquidity conditions in the domestic foreign exchange market remained mostly tight during the second half of 2018. Consequently, the Sri Lankan rupee depreciated significantly by end 2018, despite the substantial build-up of official reserves in the early part of

2018. Meanwhile, adverse developments in the political environment towards the end of the year led to subdued investor sentiment, intensifying the pressure in the external sector. Considering these developments, the Central Bank and government initiated measures to curtail non-essential imports by way of increasing tariff and margin requirements, reducing the loan-to-value ratios, suspending the use of permits for vehicle imports, among others. Consequently, the external sector began to witness improved resilience towards the end of the year as the trade deficit decelerated markedly, reflecting the impact of policy measures adopted to curtail imports, while the financial account began to strengthen with some inflows into the government securities market, and the moderation of foreign investment outflows due to an improvement in the external environment as a result of the dovish monetary policy stance of the Federal Reserve of the USA towards the end of 2018, lower oil prices and a reduction in trade tensions.

The current account deficit expanded notably in 2018. The current account deficit increased to 3.2 per cent of GDP in 2018 from 2.6 per cent of GDP in 2017, owing to the widened trade deficit, and a moderation in the secondary income balance, despite a healthy growth in the trade in services balance. In the trade account, higher than expected growth in import expenditure, particularly in categories such as vehicles, fuel and gold in the early part of 2018, outpaced the growth in export earnings, resulting in a considerable widening of the trade deficit. Reflecting the impact of remedial policy measures, the trade deficit declined significantly in November and December 2018, easing the pressure on the exchange rate and the Balance of Payments (BOP). Meanwhile, the primary income account deficit recorded a marginal increase with an increase of interest payments on foreign loans by the government and dividend payments by direct investment enterprises (DIEs), while the reinvested earnings of DIEs declined significantly. However, the surplus in the services account increased during the year, mainly driven by earnings from tourism and the healthy inflows to the transport and computer services sub-sectors. Meanwhile, the surplus in the secondary income account reduced marginally compared to 2017, as workers' remittances, which recorded an increase through the first nine months of the year, moderated in the last quarter of 2018.

The financial account was augmented with higher inflows during 2018. The proceeds of two International Sovereign Bonds (ISBs), receipt of the foreign currency term financing facility, receipt of the fifth tranche of the International Monetary Fund's Extended Fund Facility (IMF-EFF) and foreign direct investment

Table 5.1
Balance of Payments Analytical Presentation

Item	US\$ million		Rs. million	
	2017 (a)	2018 (b)	2017 (a)	2018 (b)
Current Account (net)	-2,309	-2,814	-351,341	-454,308
Trade Balance	-9,619	-10,343	-1,466,133	-1,673,111
Exports	11,360	11,890	1,732,440	1,933,533
Imports	20,980	22,233	3,198,572	3,606,644
Services (net)	3,302	3,766	503,332	611,233
Receipts	7,724	8,374	1,177,281	1,358,881
Payments	4,421	4,608	673,949	747,648
Primary Income (net)	-2,319	-2,399	-352,856	-391,934
Receipts	173	262	26,394	42,620
Payments	2,492	2,661	379,250	434,554
Secondary Income (net)	6,327	6,163	964,316	999,504
Secondary income: credit	7,175	7,023	1,093,607	1,139,324
Workers' remittances	7,164	7,015	1,091,972	1,138,124
Government transfers	11	8	1,634	1,201
Secondary income: debit	848	860	129,291	139,821
Capital Account (net)	11	14	1,667	2,265
Capital account: credit	40	42	6,125	6,702
Capital account: debit	29	27	4,458	4,437
Current and Capital Account (net)	-2,298	-2,799	-349,674	-452,043
Financial Account (net)	-2,123	-3,328	-329,233	-536,943
Direct Investment: Assets	72	68	10,946	11,021
Direct Investment: Liabilities	1,373	1,611	210,027	260,215
Portfolio Investment: Assets	...	...	-12	6
Debt securities	...	...	-12	6
Portfolio Investment: Liabilities	1,771	129	271,165	-2,281
Equity	359	-4	54,606	-3,728
Debt securities	1,413	134	216,559	1,446
Financial Derivatives	-	-	-	-
Other Investment: Assets	82	343	13,268	59,977
Currency and deposits	78	80	12,094	14,605
Trade credit and advances	35	148	5,293	23,941
Other accounts receivable	-31	116	-4,119	21,430
Other Investment: Liabilities	1,916	997	298,832	170,968
Currency and deposits	-228	-632	-33,698	-107,187
Loans	1,889	1,568	293,279	268,661
Central Bank	184	252	28,630	39,999
Deposit-taking corporations	271	697	40,156	120,016
General government	1,223	558	192,174	96,909
Other sectors	211	61	32,319	11,737
Trade credit and advances	195	224	29,436	32,629
Other accounts payable	61	-162	9,815	-23,135
Special Drawing Rights (SDRs)	-	-	-	-
Reserve Assets	2,784	-1,002	426,590	-179,045
Monetary gold	-	-103	-	-16,244
Special Drawing Rights	2	-3	354	-519
Reserve position in the IMF	-	-	-	-
Other reserve assets	2,782	-896	426,236	-162,282
Currency and deposits	393	-1,012	60,087	-169,138
Securities	2,389	122	366,135	6,732
Net Errors and Omissions	175	-529	20,441	-84,899
Overall Balance (c)	2,068	-1,103	330,004	-4,354
As a Percentage of GDP				
Trade Balance	-10.9	-11.6		
Goods and Services	-7.2	-7.4		
Current Account	-2.6	-3.2		
Current and Capital Account	-2.6	-3.1		

(a) Revised

(b) Provisional

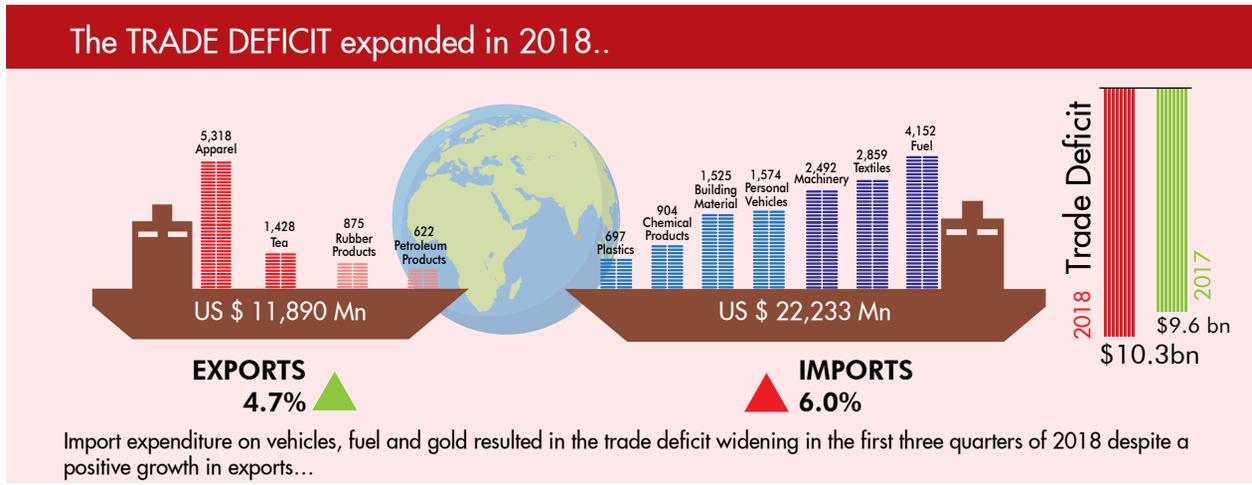
(c) Refer Table 5.13 for the derivation of overall balance.

Source: Central Bank of Sri Lanka

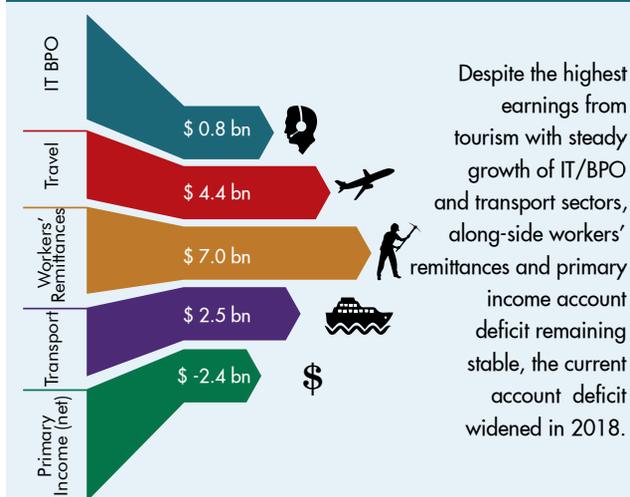
Figure 5.1

External Sector Snapshot - 2018

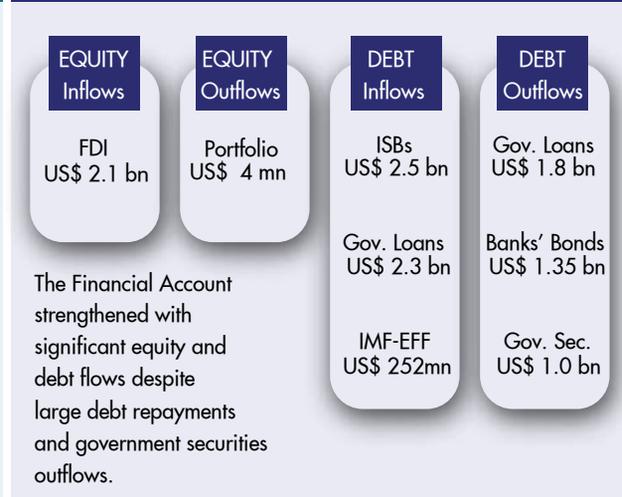
Sri Lanka's external sector experienced significant pressure in 2018, due to both domestic and external factors...



..resulting in a widening of the **CURRENT ACCOUNT** deficit..



..while **FINANCIAL ACCOUNT** received significant inflows



Consequent **POLICY MEASURES** adopted to curtail imports strengthened the external sector in early 2019

Several policy measures were adopted to stabilise imports and mitigate pressure on the exchange rate...

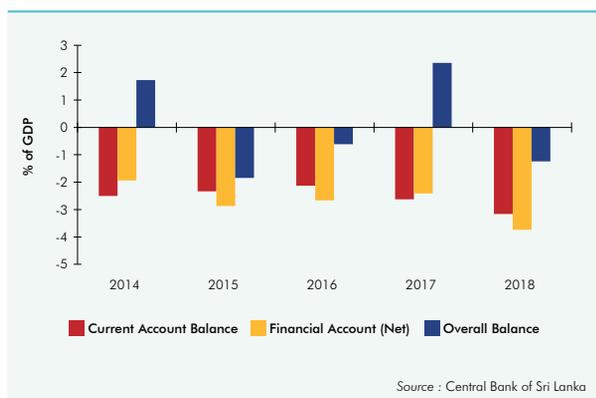
These developments eased the pressure on the external sector, resulting in a notable appreciation of the Sri Lankan rupee by end March 2019.



..resulting in a significant reduction in vehicles and gold imports, containing the trade deficit towards end 2018 and early 2019.



Figure 5.2
Balance of Payments



(FDI) inflows supported the financial account during the year. However, outflows of foreign investments from the government securities market and the Colombo Stock Exchange (CSE) exerted pressure on the financial account. Other major outflows in the financial account were payments relating to the maturity of international bonds issued by the banking sector. With these developments, the gross official reserves, which reached the historically highest level of US dollars 9.9 billion at end April 2018, moderated thereafter and declined to US dollars 6.9 billion by end 2018, mainly reflecting the impact of increased debt service payments and intervention by the Central Bank in the domestic foreign exchange market. Consequently, the overall balance recorded a deficit of US dollars 1,103 million in 2018.

The Central Bank continued to pursue a market based exchange rate policy in 2018, where interventions were limited only to address any undue fluctuations of the rupee. The Central Bank allowed greater flexibility in the determination of the exchange rate during the year amidst tight liquidity conditions in the domestic foreign exchange market, particularly during the second half of the year. The broad-based strengthening of the US dollar globally resulted in substantial

outflows of foreign investments as in a number of other emerging markets, particularly countries with current account deficits. This, coupled with a surge in import expenditure, dried up liquidity in the domestic foreign exchange market, thereby exerting significant pressure on the Sri Lankan rupee. Given the significant intraday volatility in the exchange rate, which intensified in the fourth quarter of 2018, the Central Bank adopted a cautious approach in intervening in the domestic foreign exchange market, while also maintaining the official reserves at a prudent level. Consequently, the Sri Lankan rupee depreciated by 16.4 per cent against the US dollar in 2018, while the Central Bank supplied US dollars 1,120 million to the domestic foreign exchange market on a net basis. Further, the Real Effective Exchange Rate (REER) index, which is an indicator of Sri Lanka's external competitiveness, remained predominantly below the base year level in 2018, signifying Sri Lanka's sustained external competitiveness.

The external sector showed improved resilience towards the end of 2018 and through the first quarter of 2019. The impact of policy measures introduced in curtailing certain non-essential imports, the moderation of outflows from the government securities market and the improved political environment resulted in stabilising the external sector towards the end of 2018. The perceived delay in further rate hikes by the Federal Reserve of the United States, the positive investor outlook resulting from the repayment of US dollars 1 billion ISB in January 2019 by the Government, the extension of the IMF - EFF and the successful issuance of ISBs amounting to US dollars 2.4 billion in March 2019 are some noteworthy developments that contributed in improving resilience in the

external sector during the first quarter of 2019. Consequently, the Sri Lankan rupee, which depreciated significantly during 2018, gained value in the first quarter of 2019, recording an appreciation of over 3 per cent. However, the relatively larger debt servicing obligations and the need to build buffers by augmenting official reserves remain a challenge in the medium term. In this context, reducing the reliance on foreign borrowings to finance the current account deficit, maintaining a sustainable current account deficit and bolstering official reserves through long term non-debt creating capital flows would be major priorities. Attracting FDI into the export oriented manufacturing and services sectors with an annual target of above US dollars 3 billion would be desirable to keep foreign borrowings at a minimum level in financing the current account deficit. Further, the timely implementation of appropriate measures towards harnessing the potential of services exports could ensure much needed foreign exchange inflows to the country over the medium term.

The external sector outlook in 2019 remains positive despite some downside risks. The deficits in the trade and current accounts are expected to contract during 2019 with the anticipated deceleration in imports, while export growth is expected to continue the upbeat momentum in 2019. The surplus in the services account is expected to improve, supported mainly by tourist earnings, albeit the deficit in the primary income account is expected to widen during the year amidst tighter global financial market conditions. Foreign exchange inflows from workers' remittances are expected to remain at a level comparable to 2018, maintaining the recent trend. Meanwhile, the financial account of the BOP is expected to improve with higher FDI inflows, while foreign investment to the CSE and the

government securities market are also expected to stabilise. Further, the recommencement of the IMF - EFF is also expected to strengthen the external sector with improved investor sentiment. The official reserves are expected to remain at adequate levels supported by measures for building up external buffers during the year. Nonetheless, the external sector outlook in 2019 could experience downside risks due to potential vulnerabilities. Particularly, the probable removal of the suspension of permits for importing motor vehicles could result in reversing the favourable adjustment observed in the trade balance. In addition, a rise in global fuel prices, coupled with adverse domestic weather conditions, could result in increasing the expenditure on fuel imports. Further, any unforeseen changes in the pace and magnitude of the interest rate normalisation in advanced economies could destabilise cross border capital flows, affecting the financial account of the BOP.

5.2 External Trade Policies, Developments and Institutional Support

The measures taken towards promoting and facilitating external trade through streamlining and enhancing institutional support helped further strengthen the external trade policy environment in 2018. Sri Lanka signed a bilateral trade agreement with Singapore in January 2018, which came into force in May 2018, marking the first comprehensive bilateral trade agreement of Sri Lanka. Meanwhile, negotiations on comprehensive bilateral trade agreements with Thailand, China and India continued during 2018. The Generalised System of Preferences (GSP) facility offered by the USA to low and middle income countries was extended through end 2020. Several measures were taken to further improve

the utilisation of the GSP facilities of the USA and the European Union (EU). Steps were also taken to implement the New Trade Policy (NTP), which was introduced in 2017, aimed at improving competitiveness through trade liberalisation, while attracting investment to drive Sri Lanka into the global value chains (GVCs). In support of this process, a Trade Adjustment Programme (TAP) was being developed, helping firms and individuals to face competition. Major legislation on promoting best trade practices was passed in Parliament, namely, Anti-Dumping and Countervailing Duties Act and Safeguard Measures Act, thereby guarding the local industry from unfair trade practices. Meanwhile, the National Export Strategy (NES) 2018-2022 was launched in July 2018 to fast track export promotion. Accordingly, four trade supporting functions and six focus sectors have been identified, along with a comprehensive set of plan of actions. Further, as per the Trade Facilitation Agreement (TFA) of the World Trade Organization (WTO), the Trade Information Portal (TIP) was launched in July 2018, while the establishment of the National Single Window (NSW) was in progress. Meanwhile, the Board of Investment (BOI) initiated a web-based single window in order to expedite investment approvals. Reflecting the impact of such measures, Sri Lanka's rank in the Ease of Doing Business Index in 2019 improved to 100 from 111 ranked in 2018, while further improvements are expected along with the implementation of the proposed policy measures during 2019.

Exports under the GSP schemes of the EU and USA and the India - Sri Lanka Free Trade Agreement (ISLFTA) mainly contributed to the export volume under preferential agreements. Since the reinstatement of the EU GSP+ scheme in May 2017, exports to the EU grew notably through this scheme, benefitting from the removal of duties for 66 per cent of total tariff lines. Garments, rubber

products, tea, food, beverages and tobacco, and seafood were the main export categories under the EU GSP+. Sri Lanka has made an effort to enhance utilisation of the EU GSP+ scheme through regional cumulation, by requesting permission to source material from selected regional countries. For instance, a joint request was made by the governments of Sri Lanka and Indonesia to the EU in 2018 seeking permission for the Sri Lankan apparel sector to use imported material from Indonesia, while another proposal was made by Sri Lanka regarding apparel material sourced from South Korea under the extended cumulation rule of the EU GSP+. Exports under the US GSP, which accounted for 15 per cent of total exports under preferential agreements, declined in 2018. Meanwhile, following the decision by the USA to include travel goods in the GSP, all beneficiary countries including Sri Lanka were

Table 5.2
Exports under Preferential Trade Agreements of Sri Lanka

Preferential Agreement	2017		2018 (a)	
	Value (US\$ million)	Value (US\$ million)	Growth (%)	Share (%)
Generalised System of Preferences (GSP) o/w EU (including GSP+) (b)	3,851.2	3,927.7	2.0	82.7
USA	782.1	708.0	-9.5	14.9
Russian Federation (c)	188.3	166.6	-11.5	3.5
Japan	96.4	92.7	-3.8	2.0
Canada	90.5	71.6	-20.9	1.5
Australia	81.4	79.5	-2.4	1.7
Turkey	79.8	79.5	-0.4	1.7
India-Sri Lanka Free Trade Agreement (ISLFTA) Implemented in 2000	442.3	483.5	9.3	10.2
Asia-Pacific Trade Agreement (APTA) (d) Implemented in 1975	151.1	157.0	3.9	3.3
Global System of Trade Preferences (GSTP) Implemented in 1989	81.2	92.6	14.0	1.9
Pakistan-Sri Lanka Free Trade Agreement (PSFTA) Implemented in 2005	60.3	51.0	-15.5	1.1
South Asian Free Trade Area (SAFTA) Implemented in 2006	41.1	35.4	-13.8	0.7
South Asian Preferential Trading Arrangement (SAPTA) Implemented in 1995	4.5	3.5	-21.2	0.1
Total Exports under Preferential Agreements	4,631.7	4,750.7	2.6	100.0
As a share of Sri Lanka's Total Merchandise Exports	40.8	40.0		

(a) Provisional
 (b) The EU-GSP provides preferential access for 66 per cent of the tariff lines on imported goods to the EU, while the EU-GSP+ provides zero duty access to the same tariff lines on imported goods to the EU.
 (c) Includes Russia, Belarus and Kazakhstan
 (d) Earlier known as the Bangkok Agreement

Source: Department of Commerce

eligible for duty free access to export travel goods to the US with effect from 01 July 2018. Sri Lanka continued to benefit from GSP schemes offered by several other developed countries such as the Russian Federation, Japan, Australia, Turkey, Canada and Switzerland, albeit their contribution to exports remained relatively low. Meanwhile, Sri Lanka's exports increased under the Global System of Trade Preferences (GSTP) Agreement in 2018, mainly led by cinnamon exports to Mexico, Peru and Ecuador. The narrow export base and low product penetration prevent Sri Lanka from harnessing the full benefit of such GSP schemes.

Further efforts were made to reach potential markets through new bilateral FTAs while achieving better positioning in the GVCs. After eight rounds of negotiations, the Sri Lanka - Singapore Free Trade Agreement (SLSFTA) was signed in January 2018 and enforced in May 2018. The SLSFTA was Sri Lanka's first comprehensive FTA covering trade in goods and services, investment promotion, trade remedies, telecommunications, e-commerce, government procurement, competition, intellectual property rights (IPR) and transparency. Despite the broad coverage of the SLSFTA, Sri Lanka is mainly expected to benefit from business opportunities from trade in services and investments from Singapore, since Singapore generally offers duty-free market access for over 99 per cent of tariff lines of goods. Under the first phase of the Tariff Liberalisation Programme (TLP) of the SLSFTA, Sri Lanka liberalised 50 per cent (3,719) of tariff lines. However, amidst concerns raised by several stakeholders over the SLSFTA, a committee of experts was appointed in order to further review and submit a report on the SLSFTA. Consequently, further discussions on such concerns and the way forward of the SLSFTA will be determined at joint committee meetings that are to be held

in the future. Sri Lanka is also expected to enter into a comprehensive FTA with China. Six rounds of negotiations have already been completed and further negotiations are expected in 2019. The proposed China - Sri Lanka Free Trade Agreement (CSFTA) is expected to cover trade in goods and services, investment promotion, technical barriers to trade, trade facilitation, and economic and technological cooperation. Meanwhile, a scoping session for a comprehensive FTA between Sri Lanka and Thailand (SLTFTA) was held in May 2018 and two negotiation rounds were held in July and September 2018. During these negotiations, nine working groups were established and the scope of the working groups and a work plan were discussed. Meanwhile, negotiations on the proposed Economic and Technology Cooperation Agreement (ETCA) between India and Sri Lanka continued during the year and 11 rounds were completed by September 2018. The ETCA is also a comprehensive agreement that extends the existing ISLFTA, thereby, covering the areas of trade in goods and services, investment promotion and economic and technological cooperation. One of the major objectives of the ETCA would be to resolve issues that were encountered in the implementation of the ISLFTA. Moreover, the ETCA gives special attention to non-tariff barriers (NTBs), such as quality standards and sanitary and phyto-sanitary (SPS) measures, which were identified as major hindrances in current bilateral trade. Further, since India terminated its bilateral investment treaties in March 2017, the investment chapter of the ETCA is expected to promote investment flows between the two countries. Also, the chapter on economic and technological cooperation is expected to strengthen cooperation in several sectors of the economy, such as agriculture, education, tourism, transport, aviation and ports, energy, science, technology and

research. Further, during 2018, initial studies and discussions were held with Malaysia, Indonesia and Bangladesh in order to explore avenues for potential FTAs.

Several measures were taken to further enhance the use of existing bilateral trade agreements, considering the low trade volumes under these FTAs despite the higher utilisation rates. The ISLFTA, which has been in effect since 2000 was the major bilateral FTA contributing to the growth in Sri Lanka's exports. Exports under the ISLFTA have increased, in 2018, with the utilisation of the ISLFTA favouring Sri Lanka. About 62 per cent of Sri Lanka's exports to India were channeled through the FTA, led by animal feed, base metals and articles, and garments, compared to about 6 per cent of imports from India that took place under the FTA. The government continued to engage in resolving the implementation issues related to the ISLFTA, such as quantitative restrictions on apparel and black pepper, procedures on Customs clearance and sample testing, especially on tea, excessive documentation charges and delays. Meanwhile, exports under the Pakistan - Sri Lanka Free Trade Agreement (PSFTA) declined during 2018. The major products exported by Sri Lanka under the PSFTA included betel leaves and medium-density fibre (MDF) boards. In terms of utilisation, exports through the PSFTA remained high at about 67 per cent, while imports through the PSFTA were low at about 10 per cent, indicating gains from the utilisation of the PSFTA during 2018 despite lower trade volumes. Accordingly, it is evident that as regards to ISLFTA and PSFTA, Sri Lanka has maintained a favourable trade balance under both FTAs.

At a time when there is an impasse in the Doha Round of multilateral trade negotiations, engagement with regional preferential trade

agreements needs to be further strengthened given the importance of enhancing cooperation among regional trade and services networks.

The Agreement on the South Asian Free Trade Area (SAFTA), which was entered into in 2006, aimed at furthering the South Asian Association for Regional Cooperation (SAARC) regional economic integration through the promotion of preferential trade, by replacing the South Asian Preferential Trading Arrangement (SAPTA). This has resulted in a decline in the usage of the SAPTA over time, while the utilisation of the SAFTA also remained low in 2018. The first and second phases of the TLP of the SAFTA were completed by Sri Lanka in 2015 and 2018, respectively. Exports under the Asia - Pacific Trade Agreement (APTA) increased in 2018, including mainly black tea, activated carbon, garments and coconut products mainly to China. Participating countries of APTA agreed to implement the fourth round of concessions from 01 January 2018, as per the decision taken at the 51st Standing Committee held in September 2017, and Sri Lanka implemented these concessions in March 2018. Meanwhile, at the 21st Trade Negotiation Committee of the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC), held in November 2018, an agreement was reached to expedite the implementation of the BIMSTEC FTA on merchandise goods.

Sri Lanka's engagement with the WTO continued in 2018, along with the implementation of the WTO's Trade Facilitation Agreement (TFA). Sri Lanka ratified the TFA in May 2016, which came into effect in February 2017. Since then, Sri Lanka has notified its commitments to the WTO as specified under the categories "A", "B" and "C". In fulfilment of Sri Lanka's commitments under the TFA, the Trade Information Portal (TIP) was launched in July 2018, which contained trade related

regulatory information on a single web portal. The TIP, which is supported by 43 stakeholders and managed by the Department of Commerce (DOC), serves as a major step in facilitating cross border trade to ensure the smooth flow of trade. The other major initiative of the TFA, the NSW, is in progress with the assistance of the World Bank, where the blueprint is being finalised. Following the 11th WTO Ministerial Conference held in December 2017, new subject issues increasingly relevant to the trade agenda in the current global context emerged, albeit a consensus on the proceedings of these subject issues are yet to be reached. Such new issues include e-commerce, investment facilitation, micro, small and medium enterprises (MSMEs) and domestic regulation in services.

Several major initiatives were implemented in 2018, aimed at strengthening policy and institutional support for export promotion.

Measures under the New Trade Policy (NTP) were initiated in the areas of trade liberalisation, investment promotion and participation in product sharing networks. A Trade Adjustment Programme (TAP) was introduced in support of a smooth transition of firms and workers to the new market conditions, which could indirectly affect domestic industries through the reforms proposed by the NTP. With the objective of enabling the implementation of the TAP in a productive manner, the Cabinet approved to establish the Trade and Productivity Commission and a Joint Steering Committee in March 2019. Meanwhile, the Ministry of Development Strategies and International Trade (MODSIT), together with the Export Development Board (EDB) implemented the NES 2018-2022 in July 2018 and the action plan under the NES has already been operationalised (refer Box 2 for further details of NES 2018-2022). The MODSIT developed several strategies such as “National Quality Infrastructure” and “Innovation and

Entrepreneurship Strategy 2018-2022”, in order to address issues of low export products and market diversification. Further, the MODSIT coordinated activities of eight task forces under the road map for investment climate reforms, introduced in 2017 with the aim of improving the overall ranking of Sri Lanka’s Ease of Doing Business to 70 by 2020. These task forces streamlined and expedited several activities during 2018, which helped improve the Ease of Doing Business Ranking for 2019 by 11 points to 100. In addition to launching the NES 2018-2022 and related activities of its action plan, the EDB initiated several new measures while continuing a number of programmes already initiated towards export promotion. The EDB commenced several new programmes, such as the market access support scheme, IT initiative, multinational corporation outreach programme for electrical and electronic components sector, establishment of infrastructure facilities and development of a regulatory framework for the boat building sector, establishment of an EDB owned trade promotion platform (eMARKETPLACE) and the “Arambama” credit scheme as initiated in the Budget 2018. In addition, national programmes to transform 2,000 regional small and medium enterprises (SMEs) as new export champions, promote women entrepreneurs and set up farmer clusters on selected value added products under the “One Village One Product” concept were further expanded, creating direct and indirect new exporters in identified regions. The selected new exporters benefitted from awareness programmes, domestic and foreign trade fair visits and technical assistance. Further, routine activities in relation to market access, trade promotion and facilitation, such as participation in recognised foreign trade fairs, facilitation of inward and outward trade delegations, conducting the Exporters’ Fora to solve trade related issues and appreciation of

exporters through award ceremonies continued during 2018. The Trade Chambers also contributed towards export promotion throughout the year, which was helpful in connecting the state and private sector stakeholders in areas such as policy making, grievance handling and negotiating trade agreements. The Trade Chambers were involved in stakeholder consultations, awareness campaigns and capacity building programmes for exporters. Meanwhile, the Sri Lanka Customs (SLC) streamlined its activities further in relation to container handling, automation and clearing, examining and monitoring processes.

The budget 2019 announced several new proposals to promote exports while enacting trade supportive legislation during 2018. The Budget 2019 proposed to further continue phasing out para-tariffs on selected items over a 5-year period. Further, measures to facilitate trade through the Export Market Access Programme and the TAP were introduced. In line with NES and the NTP, the private sector will be encouraged to establish new research facilities and trading houses in priority sectors as well as to rehabilitate harbour facilities. Meanwhile, the launch of an enterprise innovation programme was proposed in order to support the development of innovative products. Further, two industrial zones are to be established in Bingiriya and Wagawatte, while several industrial estates in the North and the East are proposed. Meanwhile, para-tariffs and customs duties on importation of selected products such as construction material and goods used for hotel refurbishment were reduced with a view to lowering the cost of production. In order to rationalise imports of motor vehicles, excise duty on selected motor vehicles was revised upward, while the margin deposit requirements against the letters of credit (LCs) were removed.

Newly initiated strategies, policy reforms, institutional support and the competitive

exchange rate are expected to bolster trade performance in the period ahead, while global developments and unresolved domestic impediments would continue to challenge the sustainability of the trade performance.

The record high export earnings and FDI inflows, improvement in the Doing Business Index, enforcement of a new bilateral FTA, launching the NES 2018-2022 and TIP, enactment of trade remedies and maintaining a flexible exchange rate regime were the main achievements that underpinned the external trade performance in 2018. The reinstatement of the EU GSP+, in 2017, and removal of the ban on the export of fisheries products to the EU market, in 2016, have yielded positive results. However, the record high imports, lower competitiveness led by lower productivity and high cost of production, impact of climate change etc. remain as major domestic challenges for a sustainable trade performance. In addition, the protectionist trade policies by developed countries leading to trade disputes especially between the US and China, and the resulting spillover effects on global trade and growth, the Brexit, geopolitical tensions among major trading partners, low participation in GVCs, high and volatile crude oil prices and the risk of losing preferential access due to the graduation of the country to upper-middle income status remain as major concerns. However, new strategies introduced to facilitate trade liberalisation and reforms such as the NTP, the NES 2018-2022, Investor Roadmap have identified the major issues and challenges to the external trade sector and remedial measures are being implemented. The timely implementation of identified strategies is imperative. However, the full implementation of the remedial measures would take considerable time given the structural nature of the issues. Priority should be given to removing supplyside constraints such as high production costs and lack of required labour, creation of an export

culture supported by Research and Development (R&D) led innovation and the rationalisation of the institutional framework to create a trade and investor friendly environment. Further efforts to enhance market access through new FTAs as well as increased economic cooperation would be necessary. Although the graduation of Sri Lanka to an upper-middle income country status would be beneficial, the country should be prepared to face the risks attached to graduation, such as removal of preferential market access and adjustment should be planned in advance for a smooth transition.

5.3 Trade in Goods, Trade Balance, Terms of Trade and Direction of Trade

5.3.1 Export Performance

Earnings from merchandise exports, which rebounded strongly in 2017, continued to maintain its growth momentum in 2018. The restoration of the EU GSP+ facility, conducive external trade policies together with strong institutional support and the flexible exchange rate policy maintained by the Central Bank underpinned the performance of export earnings. Accordingly, earnings from exports increased by 4.7 per cent to US dollars 11,890 million in 2018, from US dollars 11,360 million in 2017. Earnings from industrial

exports contributed to the expansion in export earnings in 2018, while earnings from agricultural and mineral exports declined.

Earnings from industrial exports increased in 2018, mainly with the support of the restoration of the EU GSP+ facility. Industrial exports, which accounted for around 78 per cent of total exports, increased by 8.4 per cent to US dollars 9,258 million, in 2018, in comparison to the previous year. Higher performance registered in earnings from textiles and garments, petroleum products, rubber products, food, beverages and tobacco, and machinery and mechanical appliances mainly contributed to this increase. Reflecting the positive impact of the restoration of the EU GSP+ facility, since May 2017, export earnings from textiles and garments increased by 5.7 per cent, on a year-on-year basis, to US dollars 5,318 million in 2018. Despite a decline in demand from the UK, which was the largest market in the EU region, earnings from garment exports to the EU market increased by 3.6 per cent to US dollars 2,053 million during the year, owing to the higher demand from Germany, Italy, Netherlands and Sweden. Further, earnings from garment exports to the USA increased by 6.0 per cent, while earnings from non-traditional markets such as India, Japan, Australia and Mexico increased by 3.5 per cent in

Figure 5.3
Composition of Exports - 2018

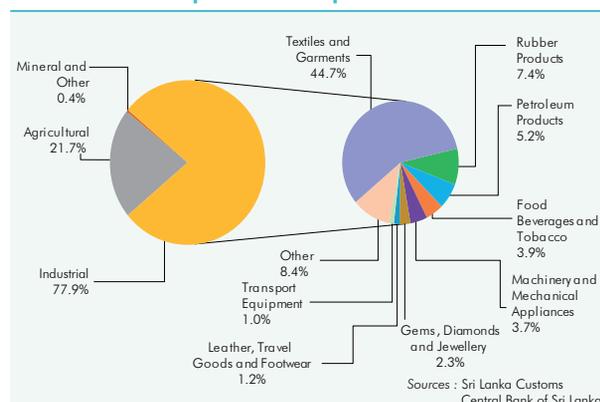
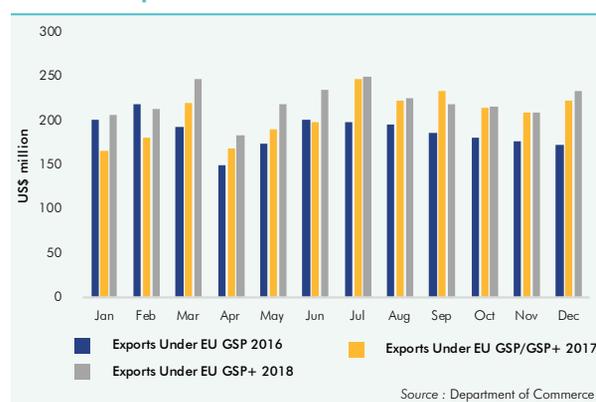


Figure 5.4
Exports under EU GSP/GSP+ Scheme



5

2018. Due to increased demand for textiles and made up textile articles from the EU market, the USA, India, Vietnam and Turkey, export earnings from those categories also increased by 26.6 per cent and 10.9 per cent, respectively, in 2018. Export earnings from petroleum products increased significantly by 43.2 per cent in 2018, due to the combined impact of higher export volumes and prices of bunker and aviation fuel. Export prices of bunker and aviation fuel increased considerably by 29.4 per cent, in line with the higher oil prices that prevailed in the international market during the year. Earnings from exports of rubber products increased by 4.8 per cent to US dollars 875 million during the year, compared to the previous year,

mainly due to the improved performance in rubber tyre exports. Further, export earnings from food, beverages and tobacco rose by 17.7 per cent to US dollars 462 million in 2018, owing to the improved performance of all sub categories except cereal preparations. Also, export earnings from machinery and mechanical appliances increased by 17.3 per cent, on a year-on-year basis, in 2018 due to increased performance registered in almost all sub categories, particularly in electronic equipment and insulated wires, cables and conductors. In addition, earnings from gems, diamonds and jewellery, base metals and articles, chemical products and animal fodder contributed to boost industrial exports during the year. However,

Table 5.3
Composition of Exports

Category	2017		2018 (a)		Change in Value US\$ million	Y-o-Y Change %	Contribution to Change %
	Value US\$ million	Share %	Value US\$ million	Share %			
Agricultural Exports	2,767.2	24.4	2,579.3	21.7	-187.9	-6.8	-35.5
Tea	1,529.8	13.5	1,428.5	12.0	-101.3	-6.6	-19.1
Rubber	38.9	0.3	31.6	0.3	-7.3	-18.8	-1.4
Coconut	347.9	3.1	311.0	2.6	-36.9	-10.6	-7.0
Spices	406.2	3.6	360.2	3.0	-46.0	-11.3	-8.7
Vegetables	28.5	0.3	28.2	0.2	-0.2	-0.8	...
Unmanufactured Tobacco	36.5	0.3	35.6	0.3	-0.9	-2.5	-0.2
Minor Agricultural Products	138.7	1.2	118.4	1.0	-20.3	-14.7	-3.8
Seafood	240.6	2.1	265.8	2.2	25.2	10.5	4.8
Industrial Exports	8,541.9	75.2	9,258.2	77.9	716.2	8.4	135.3
Textiles and Garments	5,031.9	44.3	5,317.7	44.7	285.7	5.7	54.0
Rubber Products	835.4	7.4	875.3	7.4	39.9	4.8	7.5
Petroleum Products	434.3	3.8	622.1	5.2	187.8	43.2	35.5
Gems, Diamonds and Jewellery	257.5	2.3	278.0	2.3	20.5	8.0	3.9
Food, Beverages and Tobacco	392.7	3.5	462.3	3.9	69.6	17.7	13.2
Machinery and Mechanical Appliances	370.8	3.3	434.8	3.7	64.0	17.3	12.1
Printing Industry Products	48.8	0.4	31.7	0.3	-17.2	-35.2	-3.2
Transport Equipment	162.3	1.4	120.3	1.0	-42.0	-25.9	-7.9
Leather, Travel Goods and Footwear	158.4	1.4	147.7	1.2	-10.7	-6.8	-2.0
Ceramic Products	33.7	0.3	31.3	0.3	-2.5	-7.3	-0.5
Other Industrial Exports	816.1	7.2	937.1	7.9	121.1	14.8	22.9
Mineral Exports	34.5	0.3	34.4	0.3	-0.1	-0.4	...
Unclassified Exports	16.9	0.1	17.8	0.1	1.0	5.8	0.2
Total Exports (b) (c)	11,360.4	100.0	11,889.6	100.0	529.2	4.7	100.0
Annual Average Exchange Rate (d)	152.46		162.54				

(a) Provisional
(b) Excludes re-exports
(c) Adjusted
(d) Rupee/US dollar exchange rate

Sources: Ceylon Petroleum Corporation and Other Exporters of Petroleum
National Gem and Jewellery Authority
Sri Lanka Customs
Central Bank of Sri Lanka

earnings from transport equipment declined by 25.9 per cent to US dollars 120 million, in 2018, mainly due to the base effect, as three ships were exported to Singapore in 2017. Further, export earnings from leather, travel goods and footwear declined by 6.8 per cent, while earnings from printing industry products and ceramic products declined by 35.2 per cent and 7.3 per cent, respectively, during the year, in comparison to the previous year.

Performance of agricultural exports deteriorated in 2018. Agricultural exports, which accounted for about 22 per cent of total exports, declined by 6.8 per cent, year-on-year, to US dollars 2,579 million in 2018 due to poor performance in almost all sub categories except seafood. Earnings from tea exports, which grew significantly in the previous year with the support of favourable international tea prices, declined by 6.6 per cent to US dollars 1,428 million in 2018, due to the combined impact of lower average export prices and reduced exported volumes of tea. Although the higher volume of black tea production and exports, particularly from Africa, resulted in a decline in the international tea prices at the Mombasa and Kolkata auctions, prices of Sri Lankan Orthodox tea remained relatively strong due to the limited supply. However, despite an increase observed in the first quarter of 2018, the average export price of one kilogram of tea declined during the year to US dollars 5.06, in comparison to US dollars 5.29 in 2017, due to restricted trade with Iran and Russia following the imposition of sanctions on these countries. The volume of tea exported declined by 2.3 per cent in 2018, compared to the previous year, with the lower production owing to work stoppage due to wage negotiations as well as adverse weather conditions that prevailed in some months. In 2018, Turkey continued to be the number one importer of Sri Lankan tea, in value terms, followed by Russia, Iraq and Iran, jointly

contributing for about 41 per cent of earnings from tea exports. Despite an increase observed in export earnings from non-kernel coconut products, earnings from coconut exports declined by 10.6 per cent to US dollars 311 million in 2018, due to the significant decline in export earnings from coconut kernel products. In 2018, export earnings from coconut kernel products decreased by 21.3 per cent mainly due to lower exported volumes of desiccated coconut and coconut oil with the reduced production of coconut during the first half of 2018, owing to the lagged effect of adverse weather conditions. Export earnings from coconut non-kernel products increased by 2.3 per cent owing to higher performance in fibre exports. Further, export earnings from spices reduced by 11.3 per cent to US dollars 360 million in 2018, compared to the previous year, led by the poor performance in almost all categories of spices, except cinnamon. While earnings from most of the spices such as cloves, pepper and nutmeg and mace declined with the reduction in exported volumes due to poor harvest, earnings from cinnamon exports increased with high export volumes. Further, export earnings from minor agricultural products declined by 14.7 per cent to US dollars 118 million during the year due to the lower performance of most categories particularly arecanut, betel leaves and fruit. In addition, export earnings from rubber, vegetables and unmanufactured tobacco also declined in 2018. However, earnings from seafood exports continued to rise by 10.5 per cent, to US dollars 266 million in 2018, benefitting from the removal of the ban on the exports of fisheries products to the EU and the restoration of GSP+ facility. Accordingly, seafood exports to the EU market increased significantly by 37.5 per cent to US dollars 92 million during the year, due to the higher demand from France, Italy, Germany, Spain and Netherlands.

Earnings from mineral exports declined marginally by 0.4 per cent, year-on-year, to US dollars 34 million in 2018. Despite an increase in export earnings from ores, slag and ash, earnings from mineral exports decreased during the year due to reductions in earnings from earths and stones, and precious metals.

5.3.2 Import Performance

The substantial growth in expenditure on merchandise imports which was experienced in the first half of 2018, gradually decelerated during the second half of the year due to the implementation of macroprudential measures by the Central Bank and the Government together with a relatively sharper depreciation of the Sri Lankan rupee. Accordingly, expenditure on imports increased by 6.0 per cent to US dollars 22,233 million, in 2018, in comparison to US dollars 20,980 million in 2017. The higher expenditure incurred on fuel, personal motor vehicles, textiles and textile articles, and fertiliser mainly contributed to the growth in imports during 2018. Meanwhile, expenditure on non-fuel imports also increased by 3.0 per cent to US dollars 18,081 million during the year, compared to the previous year.

Expenditure on intermediate goods imports, which accounted for about 56 per cent of total imports, contributed largely to the expansion in import expenditure in 2018. Accordingly, expenditure on intermediate goods imports increased by 9.2 per cent, year-on-year, to US dollars 12,488 million in 2018. Expenditure on fuel imports increased substantially by 21.1 per cent to US dollars 4,152 million, in 2018, compared to the previous year, mainly due to the significant increase in average import prices of both refined petroleum products and crude oil, as well as a moderate growth

of imported volumes of those items. The average import price of crude oil increased by 31.9 per cent to US dollars 76.25 per barrel during the year, from US dollars 57.79 per barrel, in 2017, reflecting the higher oil prices in the international market. Meanwhile, import expenditure on coal declined by 9.5 per cent to US dollars 237 million, in 2018, compared to the previous year, due to a reduction in the imported volume of coal with the decline in coal power generation. Further, in line with the high demand for textiles and garment exports, expenditure on the import of textiles and textile articles increased by 4.9 per cent in 2018, led by an increase in almost all sub-categories, particularly in fabric and yarn imports. Import expenditure on fertiliser increased considerably, in 2018, due to the combined impact of higher imported volumes and average import prices of fertiliser. Imported volumes of fertiliser increased significantly by 116.2 per cent, in 2018, partly due to the base effect of lower demand for fertiliser in 2017, owing to reduced agricultural activity as a result of the adverse weather conditions that prevailed in 2017 and the extended cultivated area of paddy in 2018 with better weather, together with the reintroduction of the fertiliser subsidy instead of cash grants. The average import price of fertiliser increased during the year in line with higher fertiliser prices in the international market.

Figure 5.5
Composition of Imports - 2018

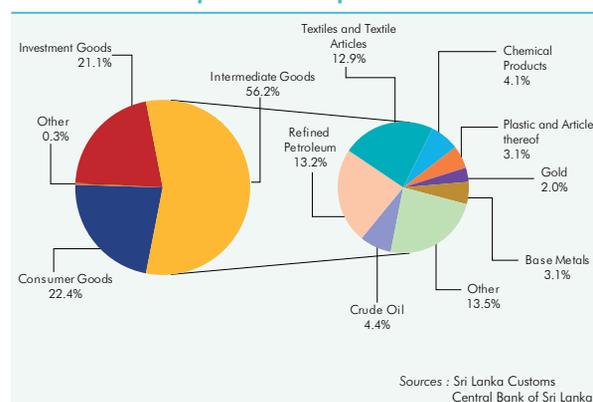


Table 5.4
Composition of Imports

Category	2017		2018 (a)		Change in Value US\$ million	Y-o-Y Change %	Contribution to Change %
	Value US\$ million	Share %	Value US\$ million	Share %			
Consumer Goods	4,502.5	21.5	4,979.7	22.4	477.1	10.6	38.1
Food and Beverages	1,841.1	8.8	1,606.1	7.2	-235.0	-12.8	-18.8
Rice	300.9	1.4	106.8	0.5	-194.1	-64.5	-15.5
Sugar and Confectionery	258.0	1.2	249.7	1.1	-8.3	-3.2	-0.7
Dairy Products	315.8	1.5	332.3	1.5	16.5	5.2	1.3
Lentils	114.4	0.5	78.6	0.4	-35.8	-31.3	-2.9
Other	851.9	4.1	838.7	3.8	-13.2	-1.5	-1.1
Non-Food Consumer Goods	2,661.5	12.7	3,373.6	15.2	712.1	26.8	56.8
Vehicles	772.7	3.7	1,573.5	7.1	800.8	103.6	63.9
Medical and Pharmaceuticals	520.0	2.5	532.0	2.4	12.0	2.3	1.0
Home Appliances	258.2	1.2	232.2	1.0	-25.9	-10.1	-2.1
Clothing and Accessories	369.0	1.8	310.3	1.4	-58.8	-15.9	-4.7
Other	741.6	3.5	725.6	3.3	-16.0	-2.2	-1.3
Intermediate Goods	11,435.8	54.5	12,488.0	56.2	1,052.3	9.2	84.0
Fuel	3,427.9	16.3	4,151.9	18.7	724.0	21.1	57.8
Textiles and Textile Articles	2,724.2	13.0	2,858.5	12.9	134.3	4.9	10.7
Diamonds, Precious Stones and Metals	772.4	3.7	572.7	2.6	-199.7	-25.9	-15.9
Chemical Products	834.5	4.0	904.2	4.1	69.7	8.4	5.6
Wheat and Maize	356.6	1.7	373.5	1.7	16.9	4.7	1.3
Fertiliser	102.8	0.5	261.6	1.2	158.8	154.4	12.7
Other Intermediate Goods	3,217.3	15.3	3,365.6	15.1	148.3	4.6	11.8
Investment Goods	4,894.7	23.3	4,690.4	21.1	-204.3	-4.2	-16.3
Building Materials	1,591.4	7.6	1,524.5	6.9	-66.8	-4.2	-5.3
Transport Equipment	674.9	3.2	668.1	3.0	-6.8	-1.0	-0.5
Machinery and Equipment	2,620.6	12.5	2,491.6	11.2	-129.0	-4.9	-10.3
Other Investment Goods	7.8	...	6.1	...	-1.7	-22.4	-0.1
Unclassified Imports	146.8	0.7	74.6	0.3	-72.1	-49.1	-5.8
Total Imports (b)(c)	20,979.8	100.0	22,232.7	100.0	1,252.9	6.0	100.0
Annual Average Exchange Rate (d)	152.46		162.54				

(a) Provisional
(b) Excludes re-imports
(c) Adjusted
(d) Rupee/US dollar exchange rate

Sources: Ceylon Petroleum Corporation
Lanka IOC PLC
Sri Lanka Customs
Central Bank of Sri Lanka

In addition, import expenditure on chemical products, plastic and articles thereof, base metals and paper, paperboard and articles thereof increased during the year, contributing towards the higher expenditure on intermediate goods.

The sharp decline in gold imports following the policy measures, as well as lower imports of rubber and articles thereof and mineral products contributed to decelerating import expenditure on intermediate goods in 2018. Import expenditure on diamonds, precious stones and metals declined considerably by 25.9 per cent in 2018 compared to 2017, due to a decline of 32.5 per cent reported in the importation of gold,

reflecting the impact of the imposition of customs duty by the government on the importation of gold. Expenditure on gold imports increased substantially by 126.5 per cent to US dollars 437 million during the first four months of 2018. Considering the possible illicit arbitrage resulting from the tariff differential between India and Sri Lanka on gold imports, due to a 10 per cent customs duty in India and zero per cent in Sri Lanka, the Government of Sri Lanka re-imposed a 15 per cent customs duty on the importation of gold, since April 2018. As a result, import expenditure on gold declined considerably since May 2018, amounting to a marginal value of around US dollars 1 million during

the remaining eight months of the year. Meanwhile, import expenditure on rubber and articles thereof decreased by 6.6 per cent due to lower import of rubber in primary forms, while import expenditure on mineral products also declined by 14.0 per cent owing to reduced import expenditure on cement clinker. Expenditure on food preparations also decreased in 2018.

Expenditure on consumer goods, which accounted for 22 per cent of total imports, increased in 2018 due to high expenses that were incurred on non-food consumer goods despite the decline in expenditure on food and beverages. Accordingly, expenditure on

consumer goods increased by 10.6 per cent, year-on-year, to US dollars 4,980 million, compared to US dollars 4,503 million in 2017. Import expenditure on food and beverages declined by 12.8 per cent to US dollars 1,606 million in 2018, mainly due to the reduction in expenditure on rice imports. Despite an increase in average import prices of rice, in line with the higher price in the international market, expenditure on rice imports decreased significantly by 64.5 per cent to US dollars 107 million in 2018, in comparison to US dollars 301 million in 2017, due to the decline in imported volumes of rice with the increased domestic supply of rice following a recovery in the paddy harvest. Accordingly, rice import volumes declined to 249 million kilograms, in 2018, from 748 million kilograms in 2017. Further, expenditure on vegetables also declined considerably by 17.4 per cent, in 2018, owing to lower imports of most vegetable categories such as lentils, onions, leguminous vegetables and potatoes. Also, import expenditure on seafood, and sugar and confectionary declined by 9.3 per cent and 3.2 per cent, respectively. However, import expenditure on spices, dairy products, beverages and fruit increased in 2018.

Expenditure on the importation of personal motor vehicles contributed significantly to the increase in expenditure on non-food consumer goods imports in 2018. Accordingly, import expenditure on non-food consumer goods increased substantially by 26.8 per cent, year-on-year, to US dollars 3,374 million in 2018. Reflecting the impact of the revised tax structure for vehicle imports in the Budget 2018, expenditure on personal motor vehicle imports increased noticeably by 116.3 per cent during the first eight months of the year, mainly due to the increase in the importation of vehicles with small engine capacity, hybrid and electric

Table 5.5
Volume of Major Imports

Item	MT '000				
	2014	2015	2016	2017	2018 (a)
Rice	600	286	30	748	249
1st Quarter	6	176	6	259	203
2nd Quarter	102	91	9	79	37
3rd Quarter	145	9	6	160	2
4th Quarter	348	9	8	250	7
Wheat	1,179	1,208	948	1,250	1,297
1st Quarter	271	242	171	291	412
2nd Quarter	324	342	326	334	329
3rd Quarter	291	373	271	359	285
4th Quarter	292	251	179	265	271
Sugar	520	624	651	498	645
1st Quarter	131	169	147	108	205
2nd Quarter	162	161	144	158	166
3rd Quarter	152	156	179	101	119
4th Quarter	75	137	181	132	154
Crude Oil (b)	1,824	1,763	1,685	1,591	1,674
1st Quarter	548	369	372	282	283
2nd Quarter	365	355	456	376	459
3rd Quarter	462	472	384	464	461
4th Quarter	449	567	473	469	471
Refined Petroleum (b)	3,385	3,321	3,885	4,895	4,959
1st Quarter	970	799	830	1,275	1,382
2nd Quarter	762	952	1,163	1,123	1,207
3rd Quarter	1,006	744	749	1,336	1,317
4th Quarter	647	826	1,142	1,161	1,054
Fertiliser	765	873	527	399	861
1st Quarter	202	163	139	78	256
2nd Quarter	190	244	135	73	154
3rd Quarter	95	189	126	129	225
4th Quarter	277	277	127	119	226

(a) Provisional
(b) Adjusted

Sources: Ceylon Petroleum Corporation
Lanka IOC PLC
Sri Lanka Customs
Central Bank of Sri Lanka

Table 5.6
Major Policy Measures Taken to Curtail Vehicle Imports

Date	Policy Measure
01.08.2018	- Excise duty applicable on the importation of cars with less than 1,000 cylinder capacity (cc), hybrid and electric vehicles was revised upward.
19.09.2018	- 100 per cent margin deposit requirement was imposed against letters of credit (LCs) on non-commercial vehicle imports.
29.09.2018	- Opening of LCs for importation of vehicles using the concessionary permits was suspended. - Procurement of vehicles for government institutions was suspended.
01.10.2018	- The margin deposit requirement against LCs on non-commercial vehicle imports was increased to 200 per cent - The loan to value (LTV) ratio for credit facilities granted in respect of hybrid motor vehicles was reduced to 50 per cent from 70 per cent.
26.11.2018	- Minimum cash margin of 100 per cent applicable on opening of LCs foreign currency for the importation of motor vehicles was imposed.

Note: Margin requirements against LCs for importation of motor vehicles were withdrawn with effect from 07.03.2019.

vehicles. Therefore, considering the pressure on the external sector and mainly on the exchange rate from increased vehicle imports, both the Central Bank and the Government introduced several policy measures during the period from August to November 2018, with the intention of curtailing high vehicle imports (Refer Table 5.6). However, the immediate effect of policy measures was not visible during the months of September and October 2018 as a result of changes in the structure of the issuance of vehicle permits to public officials and the anticipation of possible duty hikes from the Budget 2019 in November 2018. Nevertheless, reflecting the lag effect of these policy measures, expenditure on vehicle imports began to decline from November 2018 and continued through December 2018, with such expenditure averaging around US dollars 91 million per month, in comparison to an average expenditure of US dollars 139 million per month reported in the first ten months of the year. Consequently, expenditure on personal motor vehicle imports increased by 103.6 per cent to US dollars 1,574 million in 2018, in comparison to US dollars 773 million in 2017. Meanwhile, with the intention

of reducing the pressure on imports further, the Central Bank took policy measures to discourage non-essential consumer goods imports such as refrigerators, washing machines, mobile phones, rubber tyres and perfumes. Accordingly, a 100 per cent margin deposit requirement was imposed against LCs for certain non-essential consumer goods imports, with effect from 01 October 2018 and a 100 per cent margin deposit requirement was also imposed on the invoiced value of imports under documents against acceptance (DA) terms for such non-essential consumer goods imports, with effect from 11 October 2018. Also, authorised dealers were directed not to release foreign exchange for making payments for the importation of such non-essential consumer goods under advance payment terms with effect from 10 October 2018, while a 100 per cent minimum cash margin applicable for opening of LCs through foreign currency for the importation of non-essential goods was imposed with effect from 26 November 2018. Subsequently, margin requirements against LCs for the importation of non-essential consumer goods were withdrawn with effect from 07 March 2019, while the margin requirement for importation under DA terms was removed with effect from 12 March 2019. Expenditure on clothing and accessories, and household and furniture items declined by 15.9 per cent and 9.0 per cent, respectively, in 2018. However, expenditure on medical and pharmaceuticals increased during 2018.

Expenditure on investment goods declined in 2018, reflecting lower imports of all sub categories. Expenditure on investment goods imports, which accounted for around 21 per cent of total imports, contracted by 4.2 per cent to US dollars 4,690 million in 2018, in comparison to US dollars 4,895 million in 2017. Import expenditure on machinery and equipment

declined by 4.9 per cent to US dollars 2,492 million in 2018, compared to the previous year, due to the reduction in imports of engineering equipment, electrical machinery and equipment, printing machinery, medical and laboratory equipment and electronic equipment. Further, import expenditure on building materials decreased by 4.2 per cent to US dollars 1,525 million, due to a decline in cement, iron, steel and articles, and mineral products. Import expenditure on transport equipment also declined by 1.0 per cent, due to lower imports of commercial vehicles such as lorries, buses, vans, agricultural tractors, and tankers and bowsers.

5.3.3 Trade Balance

The deficit in the trade account widened in 2018, albeit at a slower pace as the year progressed, reflecting the impact of prudent policy measures introduced by the Central Bank and the Government. The trade deficit widened significantly during the first half of the year owing to high import expenditure incurred on gold, fuel and personal motor vehicles along with modest export performance. However, the sharp depreciation of the Sri Lankan rupee together with policy measures to curtail import expenditure during April 2018 through November 2018 resulted

in a moderation in the expansion of the trade deficit during the second half of the year. The trade deficit widened to US dollars 10,343 million in 2018 from US dollars 9,619 million in 2017. The trade deficit as a percentage of GDP increased to 11.6 per cent in 2018 from 10.9 per cent in 2017.

5.3.4 Terms of Trade

The terms of trade, which represents the ratio between Sri Lanka's export prices and import prices, remained broadly unchanged in 2018. The export price index increased by 4.2 per cent to 100.4 index points, while the import price index increased by 4.1 per cent to 95.1 index points during the year. With these developments, the terms of trade improved marginally to 105.6 index points in 2018, in comparison to 105.5 index points in 2017.

Reflecting higher prices of industrial exports, the overall export price index rose in 2018. The export price index for industrial exports increased by 6.7 per cent during the year, mainly due to a 30.4 per cent increase in the price index in relation to petroleum products, with high oil prices in the international market. Further, the export price indices in respect of textiles and garments, and gems, diamonds, and Jewellery increased by 3.6 per cent and 25.2 per cent, respectively, in

Figure 5.6
Exports, Imports and Trade Deficit (US\$ billion)



Figure 5.7
Terms of Trade and Trade Indices

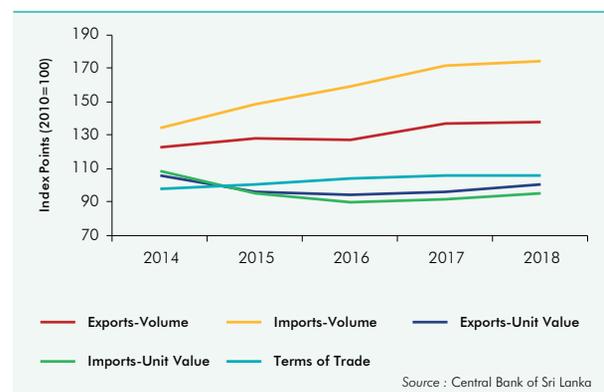


Table 5.7
Trade Indices (a)

Category	2010 = 100								
	Value Index			Volume Index			Unit Value Index		
	2017	2018 (b)	Y-o-Y Change %	2017	2018 (b)	Y-o-Y Change %	2017	2018 (b)	Y-o-Y Change %
EXPORTS									
Agricultural Exports	120.0	111.9	-6.8	96.5	92.6	-4.0	124.3	120.8	-2.9
Tea	106.2	99.2	-6.6	87.4	85.5	-2.2	121.6	116.0	-4.6
Rubber	22.5	18.2	-18.8	31.4	26.7	-15.1	71.6	68.4	-4.4
Coconut	210.0	187.8	-10.6	154.5	132.8	-14.0	136.0	141.4	4.0
Spices	196.1	173.9	-11.3	132.2	120.5	-8.9	148.3	144.3	-2.7
Minor Agricultural Products	194.2	165.7	-14.7	169.8	162.0	-4.6	114.4	102.3	-10.6
Industrial Exports	140.2	152.0	8.4	156.3	158.7	1.5	89.7	95.7	6.7
Textiles and Garments	150.0	158.6	5.7	129.8	132.4	2.0	115.6	119.8	3.6
Petroleum Products	165.0	236.3	43.2	228.5	251.1	9.9	72.2	94.1	30.4
Rubber Products	150.1	157.2	4.8	109.4	111.4	1.8	137.2	141.1	2.9
Mineral Exports	142.4	141.8	-0.4	105.6	99.3	-5.9	134.8	142.8	5.9
Total Exports	131.8	137.9	4.7	136.7	137.3	0.5	96.4	100.4	4.2
IMPORTS									
Consumer Goods	182.0	201.3	10.6	167.4	183.4	9.6	108.7	109.7	0.9
Food and Beverages	139.2	121.4	-12.8	146.7	129.5	-11.8	94.8	93.8	-1.1
Non-Food Consumer Goods	231.1	293.0	26.8	191.0	245.3	28.4	121.0	119.4	-1.3
Intermediate Goods	142.1	155.2	9.2	158.6	162.2	2.3	89.6	95.6	6.8
Fuel	112.7	136.5	21.1	150.7	152.5	1.2	74.8	89.5	19.7
Fertiliser	42.8	108.9	154.4	53.7	136.0	153.3	79.7	80.1	0.4
Chemical Products	160.5	173.9	8.4	161.6	165.2	2.2	99.3	105.3	6.0
Wheat and Maize	134.4	140.7	4.7	134.0	134.2	0.2	100.3	104.8	4.5
Textiles and Textile Articles	150.6	158.0	4.9	137.6	144.3	4.9	109.4	109.5	0.1
Plastics and Articles thereof	149.6	164.9	10.2	160.5	166.9	4.0	93.2	98.8	6.0
Diamonds, Precious Stones and Metals	204.6	151.7	-25.9	232.2	169.1	-27.2	88.1	89.7	1.8
Investment Goods	177.7	170.2	-4.2	208.7	208.2	-0.3	85.1	81.8	-3.9
Building Materials	193.7	185.5	-4.2	220.1	212.1	-3.7	88.0	87.5	-0.6
Transport Equipment	113.9	112.8	-1.0	112.8	109.3	-3.1	101.0	103.1	2.2
Machinery and Equipment	195.9	186.3	-4.9	244.2	249.6	2.2	80.2	74.6	-7.0
Other Investment Goods	234.1	181.7	-22.4	224.6	181.9	-19.0	104.2	99.9	-4.2
Total Imports	156.5	165.8	6.0	171.3	174.3	1.8	91.3	95.1	4.1
Terms of Trade							105.5	105.6	0.02
(a) In terms of US dollars									Source : Central Bank of Sri Lanka
(b) Provisional									

2018. In addition, export price indices of chemical products, ceramic products, rubber products and leather, travel goods and footwear increased during the period. However, price indices pertaining to plastics and articles thereof, machinery and mechanical appliances, transport equipment, base metals and articles, and food, beverages and tobacco, which are categorised under industrial exports, declined in 2018. Meanwhile, the export price index of agricultural exports declined by 2.9 per cent in 2018, owing to price declines reported in many categories such as tea, minor agricultural products, rubber and spices. However, export price indices of coconut, seafood and unmanufactured tobacco increased during the year.

The overall import price index increased in 2018 mainly due to higher prices of intermediate goods followed by a marginal price increase in consumer goods. The import price index of intermediate goods increased by 6.8 per cent largely due to fuel, which registered a 19.7 per cent rise, in terms of the price index. Further, the import price index of paper and paperboard increased by 6.8 per cent, while that of chemical products and plastic and articles increased by 6.0 per cent each in 2018. Import price indices pertaining to wheat and maize, vehicle and machinery parts, diamonds, precious stones and metals, and fertiliser also increased during the year. Meanwhile, import price indices

of food preparations, agricultural inputs, rubber and articles thereof and unmanufactured tobacco categorised under intermediate goods, declined in 2018. The price index in respect of consumer goods in 2018 increased marginally by 0.9 per cent compared to the previous year. Prices of vehicles, clothing and accessories, printed materials and stationary, seafood, beverages, and cereals and milling industry products were higher, while price indices of home appliances, sugar and confectionery, vegetables, spices, fruits and dairy products declined during the year. However, the import price index for investment goods decreased in 2018, reflecting lower prices of machinery and equipment, and building materials, despite an increase registered in the price index of transport equipment.

5.3.5 Direction of Trade

Sri Lanka's major trading partners broadly remained unchanged in 2018, in comparison to 2017. India remained Sri Lanka's major trading partner, in 2018, followed by China and the USA. As in 2017, total trade with India exceeded US dollars 5 billion, while trade with China and the USA exceeded US dollars 4 billion and US dollars 3 billion, respectively, in 2018, with a share of 14.7 per cent, 12.8 per cent and 10.6 per cent. In addition, the United Arab Emirates (UAE), Japan, Singapore, the UK and Germany were the other major trading partners accounting for trade to the value of more than US dollars 1 billion each in 2018. However, trade with India declined in 2018 due to a reduction in imports from India, while total trade with Singapore dropped owing to a significant decline in exports to Singapore. Contrastingly, trade with China, the USA, the UAE, Japan, the UK and Germany increased during the year in comparison to the previous year. Among Sri Lanka's export destinations, advanced countries, mainly the USA and the UK, continued to account for the largest

share, while among Sri Lanka's sources of imports, Asia, mainly India and China, accounted for a major share.

The USA retained its position as the major export destination, accounting for 25.9 per cent of Sri Lanka's exports, followed by the UK (8.2 per cent) and India (6.5 per cent). Export earnings from the USA increased by 6.0 per cent, year-on-year, to US dollars 3,085 million in 2018, mainly due to garments, rubber products and machinery and mechanical appliances exports, which accounted for about 85 per cent of total exports to the USA. The USA continued to be the largest single garment export destination for Sri Lanka, accounting for about 46 per cent of total garment exports in 2018. Exports of garments, rubber products, machinery and mechanical appliances, food, beverages and tobacco, tea and chemical products to the USA increased during the year, while exports of seafood, spices and coconut kernel products declined. Export earnings from the UK, the second largest export destination, recorded a decline of 5.4 per cent, in 2018, due to a reduction in the export of garments, rubber products, leather, travel goods and footwear and tea. However, textiles and other made up textile articles, food, beverages and tobacco, machinery and mechanical appliances, and coconut non-kernel product exports to the UK increased in 2018. Of the total exports to the UK market, garments comprised 75 per cent, which was about 15 per cent of Sri Lanka's total garment exports in 2018. Total exports to India, which is the third largest buyer of Sri Lanka's exports, increased to US dollars 777 million in 2018 from US dollars 691 million in 2017, due to the increase in export earnings from animal fodder, textiles and garments, base metals and articles, machinery and mechanical appliances, and food beverages and tobacco. However, spices, wood and paper products, transport

equipment and minor agricultural product exports to India declined in 2018. Meanwhile, exports to Germany, which accounted for 5.2 per cent of total exports, increased by 13.7 per cent in 2018. Garments, rubber products and machinery and mechanical appliances, which accounted for around 66 per cent of total exports to Germany, largely contributed to increase export earnings from Germany in 2018. Exports to Italy increased by 9.1 per cent in 2018, mainly due to a rise in garment, rubber products and seafood exports, which accounted for about 92 per cent of total exports to Italy. The EU region, the most dominant regional market for Sri Lankan exports, which accounted for about 29 per cent of total exports, increased by 5.3 per cent to US dollars 3,474 million in 2018. Higher export earnings from garments, rubber products, food, beverages and tobacco, and sea

food, which accounted for 76 per cent of total exports to EU, largely contributed to this increase, reflecting the positive impact of the restoration of the EU GSP+ facility and the removal of the ban on exports of fisheries products to the EU. In 2018, the Middle East and Russia were the main export destinations for Sri Lanka's tea exports. They contributed 43.7 per cent and 10.8 per cent, respectively, of total tea exports, despite a decline registered in tea exports to these countries.

India continued to be the largest source of imports although there was a reduction in its share to 19.0 per cent of total imports in 2018 from 21.6 per cent in 2017. Import expenditure from India declined by 6.5 per cent to US dollars 4,231 million in 2018 mainly due to lower imports of petroleum products, building materials, vehicles, machinery and equipment and transport equipment, which contributed to around 44 per cent of total

Figure 5.8
Exports by Destination

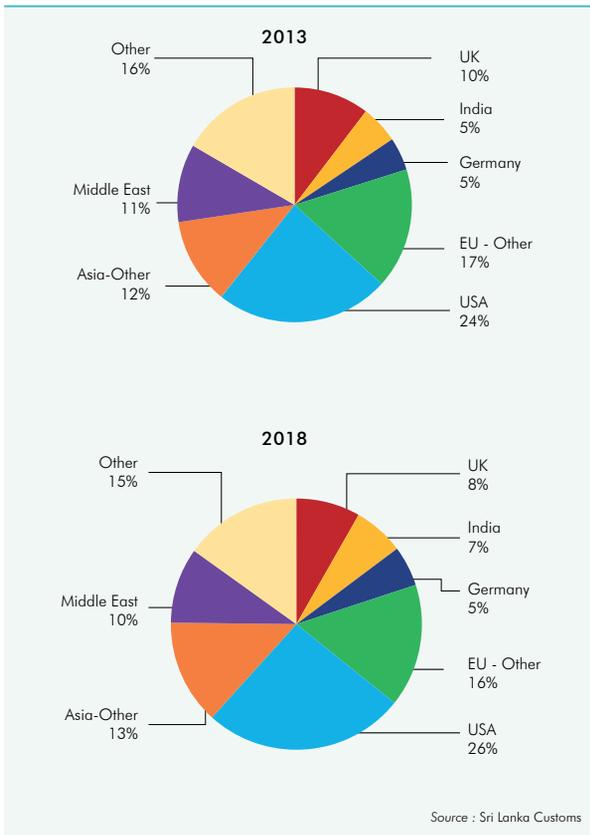
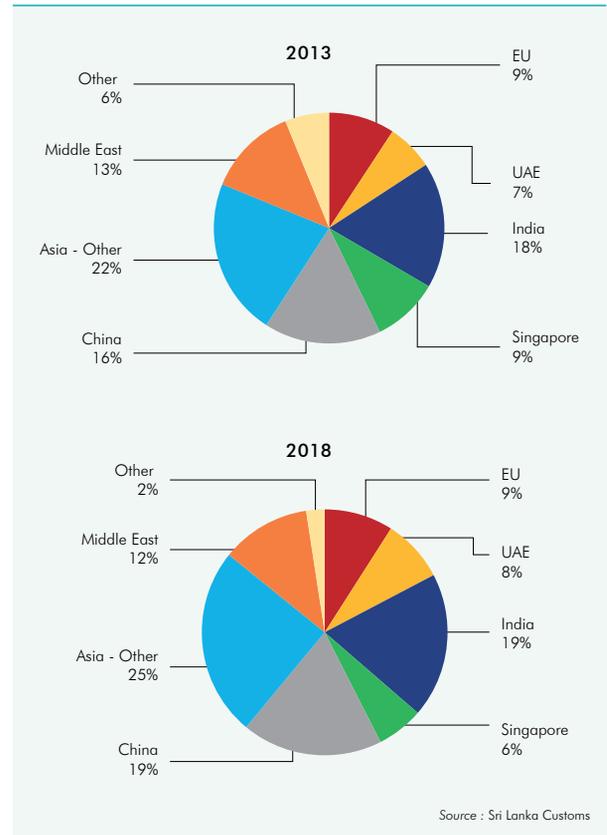


Figure 5.9
Imports by Origin



imports from India. China and the UAE were the second and third largest import origins, accounting for 18.5 per cent and 8.3 per cent of total imports, respectively. Main imports from China comprised textiles and textile articles, machinery and equipment, and building materials, which accounted for 61 per cent of total imports, while major imports from the UAE were petroleum products and diamonds, precious stones and metals, accounting for 87 per cent of total imports from the UAE. Japan and Singapore were the fourth and fifth largest import sourcing countries, accounting for 7.1 per cent and 6.2 per cent of total imports, respectively. Expenditure on imports from Japan rose significantly by 52.6 per cent to US dollars 1,585 million in 2018, while increasing its share of total imports to 7.1 per cent from 4.9 per cent in 2017, mainly due to the considerable growth registered in vehicle imports. Import expenditure on Japanese vehicles accounted for around 62 per cent of total imports from Japan and 62.4 per cent of vehicles imported to Sri Lanka in 2018. Meanwhile, import expenditure from Singapore increased marginally by 1.5 per cent in 2018 mainly due to higher imports of petroleum products. Diamonds, precious stones and metals, machinery and equipment and chemical products were the other main items imported from Singapore in 2018. However, imports of diamonds, precious stones and metals, machinery and equipment, and chemical products from Singapore declined during the year.

5.4 Current and Capital Account

5.4.1 Trade in Services

Trade in services recorded a notable growth in 2018, supporting the external current account. Earnings from tourism recorded a strong growth, while transportation and computer services also grew notably during 2018. Reflecting these developments, earnings from export of services increased by 8.4 per cent to US dollars 8,374 million in 2018 from US dollars

Table 5.8
Current and Capital Account

Item	US\$ million					
	2017 (a)			2018 (b)		
	Credit	Debit	Net	Credit	Debit	Net
Goods and Services	19,084	25,401	-6,317	20,264	26,841	-6,577
Goods	11,360	20,980	-9,619	11,890	22,233	-10,343
General merchandise	11,360	20,330	-8,970	11,890	21,794	-9,904
Non-monetary gold	-	650	-650	-	439	-439
Services	7,724	4,421	3,302	8,374	4,608	3,766
Transport	2,340	1,688	652	2,486	1,737	750
Sea transport	1,064	790	274	1,134	819	315
Freight	1,064	790	274	1,134	819	315
Air transport	1,277	898	379	1,353	918	435
Passenger	1,158	810	348	1,227	827	400
Freight	118	88	30	126	91	35
Travel (c)	3,925	1,599	2,326	4,381	1,660	2,721
Construction	69	32	37	65	33	32
Insurance and pension services	123	94	29	130	97	33
Financial services	263	415	-152	242	447	-205
Telecommunications and computer services	926	455	471	995	484	511
Telecommunications	140	110	30	147	112	35
Computer services	786	345	440	848	372	475
Other business services	44	69	-25	40	75	-34
Government goods and services n.i.e.	34	69	-35	35	75	-41
Primary Income	173	2,492	-2,319	262	2,661	-2,399
Compensation of employees	26	96	-70	28	102	-74
Investment income	147	2,395	-2,249	234	2,560	-2,325
Direct investment	27	915	-888	23	790	-767
Dividends	14	414	-400	13	565	-552
Reinvested earnings	13	500	-487	10	225	-215
Portfolio investment	-	954	-954	-	1,059	-1,059
Equity	-	82	-82	-	92	-92
Interest	-	873	-873	-	967	-967
Short term	-	6	-6	-	4	-4
Long term	-	866	-866	-	963	-963
Other investment	55	526	-471	88	711	-623
Reserve assets	64	-	64	123	-	123
Secondary Income	7,175	848	6,327	7,023	860	6,163
General government	11	-	11	8	-	8
Workers' remittances	7,164	848	6,316	7,015	860	6,155
Current Account	26,432	28,741	-2,309	27,549	30,363	-2,814
Capital Account	40	29	11	42	27	14
Capital transfers	40	29	11	42	27	14
General government	20	-	20	14	-	14
Corporations and households	20	29	-9	28	27	...
Current and Capital Account	26,472	28,770	-2,298	27,590	30,390	-2,799

(a) Revised

Source: Central Bank of Sri Lanka

(b) Provisional

(c) Passenger services provided to non-residents are included in transport services.

7,724 million in 2017. Meanwhile, outflows on account of services increased by 4.2 per cent to US dollars 4,608 million during the year, stemming from the rising demand for services in freight transportation, passenger fares and personal travel abroad. Accordingly, the surplus in the services account, improved to US dollars 3,766 million in 2018 from the surplus of US dollars 3,302 million recorded in 2017.

Transport Services

The expansion of the surplus in transport services in 2018 strengthened the services account. Gross inflows of transportation services, which consist of passenger fares, freight charges, port and airport related activities, registered a growth of 6.2 per cent, to reach US dollars 2,486 million during the year. Meanwhile, outflows of transportation services increased by 2.9 per cent to US dollars 1,737 million in 2018, as a result of increased payments by domestic airlines abroad and increased payments to non-resident shipping lines by Sri Lankan importers. Accordingly, net inflows from the transport sector increased to US dollars 750 million during 2018 from US dollars 652 million in 2017.

The inflows on account of passenger fares increased during 2018. Such increase in passenger fares can be primarily attributed to the increased number of passengers travelling to Sri Lanka and increased air ticket pricing. The earnings from passenger fares increased by 5.9 per cent to US dollars 1,227 million in 2018. This improvement was supplemented by the effective and timely management of aircraft deployment and flight frequencies on the basis of market dynamics by SriLankan Airlines. SriLankan Airlines continued to operate to 39 destinations, which also included higher flight frequencies to markets such as London, Melbourne, Dubai, Abu Dhabi, Doha and Delhi.

The earnings from freight services increased in 2018. With the expansion in port related activities, the inflows on account of freight charges with respect to both port and airport related activities increased in 2018, resulting in a growth of 6.6 per cent to US dollars 1,260 million, reflecting increased cargo, container and transshipment volumes handled at the port of Colombo. During the year, the port of Colombo

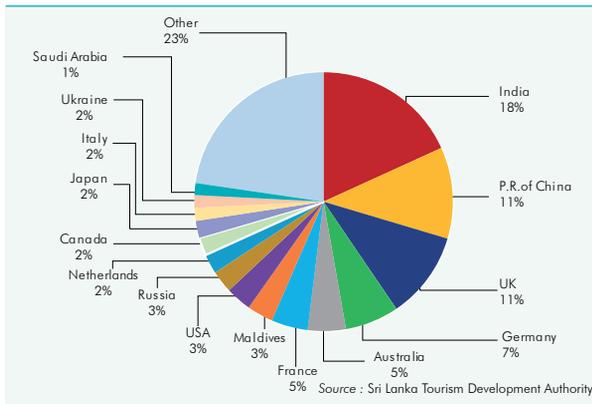
marked the achievement of handling over 7 million TEUs for the first time in history, contributing towards the expansion of the maritime services sector. Meanwhile, the port of Colombo was ranked the first among the top 30 container ports in the world, in terms of container growth for 2018 by the Alphaliner global port rankings. This is a significant achievement as it is the first time in history that the port of Colombo has reached the top of a global maritime ranking.

Travel and Tourism

Earnings from tourism continued to be a major source of foreign exchange to the country, supported by a healthy growth in tourist arrivals during 2018. Tourist arrivals grew by 10.3 per cent to 2,333,796 in 2018, recording the highest annual tourist arrivals during a year. The endorsements and accolades received from reputed international tourism organisations, aggressive promotion campaigns, the significant increase in investment in the tourism industry, improved quality of service delivery and better connectivity through air and sea routes mainly contributed to the enhanced performance in the tourism industry in 2018.

Tourist arrivals from all major regions, except East Asia and the Middle East, increased in 2018. Western Europe continued to be the largest tourist origin for Sri Lanka, which grew at 23.5 per cent to 840,956 arrivals, with a share of 36.0 per cent of total tourist arrivals. Tourist arrivals from South Asia, the second largest tourist origin of Sri Lanka, increased by 4.8 per cent to 543,160 arrivals. However, tourist arrivals from South Asia, as a share of total arrivals, fell to 23.3 per cent in 2018, from 24.5 per cent in 2017. The share of tourist arrivals from East Asia, which increased steadily since 2011, on the back of an impressive growth of arrivals from China up to

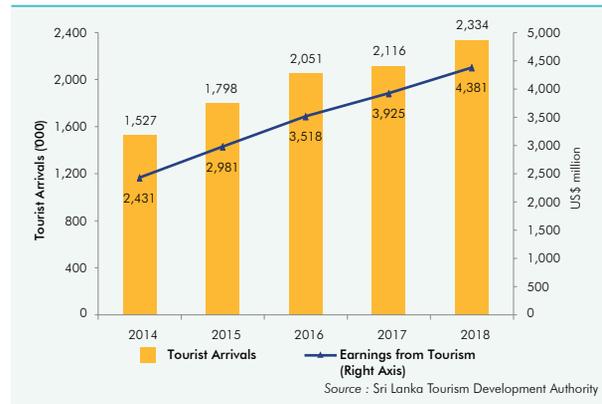
Figure 5.10
Tourist Arrivals by Country - 2018



2016, also declined to 18.1 per cent, registering a 4.7 per cent decline in arrivals. However, tourist arrivals from Australasia recorded a significant growth of 35.9 per cent, increasing its share in total arrivals to 5.4 per cent in 2018 from 4.3 per cent in 2017. Such a growth was mainly driven by increased arrivals from Australia, partly attributable to the commencement of direct flights between Sri Lanka and Australia. On the basis of tourist arrivals by country, India remained at the top with 424,887 arrivals, while China remained the second largest origin albeit recording a marginal decline, followed by the UK, Germany and Australia. The top five inbound tourist origins collectively accounted for 52.0 per cent of the total tourist arrivals to Sri Lanka in 2018. In terms of the purpose of visit, a majority of tourists (84.8 per cent) visited the country for leisure, while 3.1 per cent for business purposes. The share of tourist arrivals for other purposes, such as visiting friends and relatives, religious and cultural purposes, health, education and sports, was 12.1 per cent of total arrivals in 2018.

Earnings from tourism recorded a healthy growth during the year, supported by the record high tourist arrivals and increased average spending by tourists. Earnings from tourism increased by 11.6 per cent to US

Figure 5.11
Tourist Arrivals and Earnings from Tourism



dollars 4,381 million in 2018, in comparison to US dollars 3,925 million in 2017. In 2018, the average spending per tourist rose to US dollars 173.8 per day from US dollars 170.1 per day in 2017, according to the latest annual survey on tourist spending and duration of stay conducted by the Sri Lanka Tourism Development Authority (SLTDA). Further, the average duration of stay by a tourist was estimated at 10.8 days in 2018, in comparison to 10.9 days in 2017. The steady growth in tourist earnings is expected to continue over the medium-term, complemented by targeted promotion campaigns and continued investment in upgrading and expanding tourism related infrastructure in the country. Meanwhile, outflows related to travel are also estimated to have increased to US dollars 1,660 million, recording an increase of 3.8 per cent in 2018. Consequently, the surplus in the travel and tourism sub sector increased from US dollars 2,326 million in 2017 to US dollars 2,721 million in 2018.

Investments in the tourism sector expanded further in 2018. During 2018, the SLTDA received proposals for 141 hotel projects amounting to US dollars 919 million, in comparison to 95 projects with a total investment of US dollars 314 million in 2017. The final approvals were granted for 44 hotel projects with 1,302 rooms in 2018, entailing

an investment worth US dollars 201 million. In addition, 35 hotel projects have commenced operations in 2018, adding 1,125 rooms during this period. Meanwhile, several projects were carried out by the SLTDA in collaboration with the provincial councils to improve facilities in popular tourist attractions. The Budget 2019 introduced several tax incentives in order to reduce the up-front costs for businesses and investments related to the industry and facilitate refurbishment of hotels and import of tourism related equipment. Further, the Budget 2019 proposed to remove the Nation Building Tax (NBT) on foreign currency receipts by tourist hotels. The registration process of hotels at the SLTDA is to be streamlined, thereby encouraging the informal sector in the tourism industry to be a part of the mainstream. Going forward, the major priorities for the tourism industry are the improvement of infrastructure and other facilities, and enhancement of the skill level of the workforce, preferably through the collaboration of vocational training centres and industry partners.

Several policy measures were initiated and numerous promotional campaigns were implemented in 2018 to harness the potential of Sri Lanka's tourism industry. The implementation

of the new Tourism Strategic Plan (TSP) 2017-2020, which was introduced in 2017, continued in 2018. The Sri Lanka Tourism Promotion Bureau (SLTPB) carried out country specific promotional activities in 34 identified markets in 2018, including participation in trade fairs, road shows, and consumer and food festivals. In addition, the SLTPB strengthened the web based promotional activities, in 2018, by continuing visiting bloggers' programmes, online advertising campaigns in reputed international media such as CNN, digital advertising through web banners and social media programmes. In support of these promotional activities, the SLTPB launched a new brand identity "So Sri Lanka" in November 2018. Many travel related entities including Lonely Planet, National Geographic have endorsed Sri Lanka as one of the best destinations to travel to in 2019, as a result of effective and continuous promotions carried out by the SLTPB. Meanwhile, around 86,000 passengers from 50 cruise ships arrived at the Colombo port. Further, several internationally popular adventure sports events, such as Ironman 70.3 and Raid Amazons were held in Sri Lanka, in 2018, organised by the SLTPB to promote Sri Lanka as a diverse tourist destination in the

Table 5.9
Performance in the Tourism Sector

Item	2014	2015	2016	2017	2018 (a)	Y-o-Y Change 2018
Tourist Arrivals (No.)	1,527,153	1,798,380	2,050,832	2,116,407	2,333,796	10.3
Arrivals by Purpose of Visit						
Pleasure	1,037,644	1,198,240	1,710,027	1,744,149(b)	1,979,819	13.5
Business	20,270	23,323	37,121	70,683(b)	71,255	0.8
Other	469,239	576,817	303,684	301,575(b)	282,722	-6.3
Tourist Guest Nights ('000)	15,119	18,163	20,918	23,068	25,205	9.3
Room Occupancy Rate (%)	74.3	74.5	74.8	73.3	72.8	-0.7
Gross Tourist Receipts (Rs. million)	317,479	405,492	512,373	598,143	711,961	19.0
Per Capita Tourist Receipts (Rs.)	207,889	225,476	249,837	282,622	305,066	7.9
Total Employment (No.) (c)	299,890	319,436	335,659	359,215	388,487	8.1
Direct Employment	129,790	135,930	146,115	156,369	169,003	8.1
Indirect Employment	170,100	183,506	189,544	202,846	219,484	8.2

(a) Provisional

(b) Revised

(c) Estimates

Sources: Sri Lanka Tourism Development Authority
Central Bank of Sri Lanka

region. Meanwhile, several projects aimed at increasing the safety and comfort of tourists, such as tourist friendly tuk tuks, establishment of new life saving units and mobile tourist police divisions, were initiated during 2018. Cabinet approval was granted to award the contracts for the digital promotional campaign to position Sri Lanka as a preferred destination in the UK, Germany, France, India and China. Meanwhile, the SLTPB is to support the internationally acclaimed adventure sporting event “Adventure Racing World Championship” that is scheduled to be held in December 2019, the first international expedition adventure race hosted by Sri Lanka.

Sri Lanka’s potential in the global tourism market remains largely untapped. Sri Lanka has the capacity to cater to a wider tourist market, in comparison to regional small island nations such as Singapore, Hong Kong and Taiwan who are doing exceptionally well in tourism. For example, Singapore, being a country 91 times smaller than Sri Lanka, catered to about 6.6 times more tourists while earning 5 times higher in 2017. A recent study by the United Nations World Tourism Organization (UNWTO) specified 11 strategies and 68 measures to understand and manage visitors’ growth in cities. Accordingly, with the guidance of the TSP (2017-2020) and with enhanced infrastructure and other facilities, Sri Lanka would be able to cater to a much higher number of tourists without reaching the ‘carrying capacity of tourism’, which implies the maximum number of tourists a destination can accommodate without harming its environmental, social and cultural resources. A coordinated effort is needed between the government and tourism industry stakeholders, through Public Private Partnership (PPP) ventures, to achieve sustainable tourism targets of the TSP by 2020. The well-known tourists’ attractions of Sri Lanka and

some national parks become overcrowded during the peak season, requiring smart solutions and coordinated approaches, such as a quota based online ticketing system, cable car system, high and efficient public transport connectivity covering the entire country by land, air and waterways.

Telecommunications, Computer and Information Services

The earnings from telecommunication, computer and information services continued its steady growth in 2018. Total earnings from the export of telecommunications, computer and information services grew by 7.5 per cent to US dollars 995 million in 2018. Earnings from telecommunications services sub-sector increased during the year to US dollars 147 million from US dollars 140 million in 2017. This growth mainly originated from increased usage of internet based communication facilities, supported by broadband data services as reflected in the increase in fixed and mobile broadband subscriptions during the year. In view of enhancing high speed connectivity for customers, Sri Lanka Telecom PLC launched a state-of-the-art Tier 3 Data Centre, recognised as the “National Data Centre”, which enhances the provision of a secure and reliable data hosting facility and Cloud computing services in Sri Lanka.

The computer and information services sub-sector continued its growth trend in 2018. Accordingly, inflows to computer and information services grew from US dollars 786 million in 2017 to US dollars 848 million in 2018. The rapid expansion of Information Technology Enabled Services (ITES) that include Business Process Outsourcing (BPO) and Knowledge Process Outsourcing (KPO) continued to contribute towards the healthy growth in this sector in addition to software development services. In this regard, Sri Lanka unveiled the national brand for the Sri Lankan Information

and Communication Technology and Business Process Management (ICT/BPM) sector with a tagline, “Island of Ingenuity - Sri Lanka Knowledge Solutions” in April 2018, highlighting the ability of Sri Lankan Information Technology (IT) companies to deliver top quality solutions on a global scale. It also focuses on enabling global companies to set up Captive Innovation Centres and leverage Sri Lanka to be the ‘Digital Gateway to Asia’.

5.4.2 Primary Income

The deficit in the primary income account recorded a marginal increase in 2018. The deficit in the primary income account amounted to US dollars 2,399 million in 2018, compared to US dollars 2,319 million in 2017, with increased interest payments on account of ISBs and project loans of the government and dividend payments by direct investment enterprises (DIEs). Profitable DIEs opted for higher dividend payments, resulting in significantly higher dividend payments in 2018, compared to the previous year. However, the reinvested earnings recorded a notable decline in 2018, with the realisation of comparatively lower profits by some large DIEs, particularly publicly listed companies. Further, interest payments on portfolio investments increased due to the increase in coupon payments on ISBs issued by the government, with coupon payments on the new issuances of ISBs in May 2017 and April 2018 being made during the year in addition to the coupon payments on the ISBs issued previously. However, coupon payments for international bond issuances by the banking sector reduced with the maturity of international bonds amounting to US dollars 1.35 billion in 2018. The interest payments on government foreign loans, which constitute the main portion under interest payments of other investments in the primary income account, increased as a result of the new foreign currency term financing facilities and project loans obtained by the government. The

interest payments on foreign loans by the banking sector increased significantly in 2018, as a result of increased global lending rates in 2018. Meanwhile, inflows to the primary income account increased during the year to US dollars 262 million, primarily due to the increase in investment income of official reserve assets.

5.4.3 Secondary Income

Workers’ remittances continued to be moderate in 2018, resulting in a subdued performance of the secondary income account during the year. Workers’ remittances, which account for the majority of inflows in the secondary income account, declined by 2.1 per cent to US dollars 7,015 million in 2018 after decelerating by 1.1 per cent in 2017. Such continued moderation in workers’ remittances can be largely attributable to the prevailing geopolitical uncertainties in the Middle Eastern region, due to fluctuations in oil prices and sluggish global growth. Further, as per the data provided by the Sri Lanka Bureau of Foreign Employment, overall labour migration for foreign employment has continued its declining trend during 2018. The decline in departures for foreign employment can be attributed largely to improved opportunities in the domestic labour market and continuation of several government measures to discourage migration of certain categories of female unskilled labour. Meanwhile, a marginal decline was recorded in inflows in the form of government transfers during the year. With these developments, inflows to the secondary income account declined by 2.1 per cent to US dollars 7,023 million in 2018. Meanwhile, personal transfers and related payments by non-residents living in Sri Lanka recorded a marginal increase in 2018. Consequently, net inflows to the secondary income account amounted to US dollars 6,163 million in 2018, in comparison to the net inflow of US dollars 6,327 million recorded in the preceding year.

BOX 6

Implementation of an International Transactions Reporting System (ITRS)

Introduction

The Central Bank of Sri Lanka (CBSL) is currently in the process of introducing a new data collecting system called the International Transactions Reporting System (ITRS), recognizing the need to implement a comprehensive cross border transactions and foreign currency transactions monitoring system through the banking sector, including Licensed Commercial Banks (LCBs) and Licensed Specialised Banks (LSBs). ITRS is used in many countries around the world, including regional economies in Asia such as India, Indonesia, Malaysia and Thailand.

The project is expected to aid the monitoring process of several key departments of the CBSL by ensuring the availability of timely data on inflows and outflows at a granular level of all cross-border transactions and foreign currency transactions. This is expected to facilitate an effective data reporting framework for regulatory supervision, more comprehensive compilation of external sector statistics as well as effective macroeconomic policy formulation.

1. Conceptual design and main components of an ITRS system

Data from an ITRS system mainly consists of transaction-wise data on all cross-border transactions, domestic transfers between foreign currency accounts, deposits and withdrawals from foreign currency accounts as well as cross border transactions made by non-account

holders via the banking system. The conceptual design involves development of an integrated system whereby all different types of transactions are captured and reported through a single reporting platform. The reporting platform consists of two reporting formats, namely a 'Client ITRS' and a 'Bank ITRS', as depicted in Figure B 6.1, based on a 'Closed ITRS' reporting system.

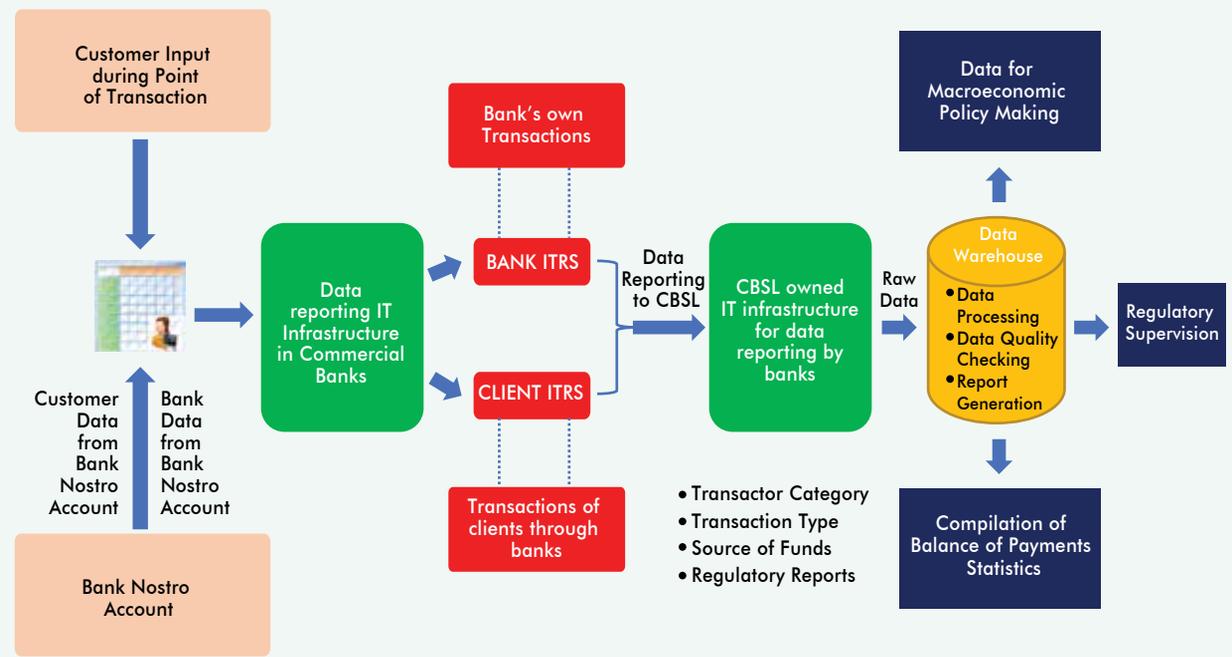
Client ITRS: A 'Client ITRS' system is expected to report all transactions of customers of the banking sector on all cross-border transactions (to both foreign currency accounts and rupee accounts) and all foreign currency transactions originating from foreign currency accounts held by customers.

Bank ITRS: The 'Bank ITRS' is expected to capture all transactions of the bank, enabled through each bank's foreign currency Nostro accounts on a transaction-wise basis.

Closed ITRS reporting system: The reports generated through the Client ITRS and the Bank ITRS system will be reconciled with the balances of different foreign currency Nostro accounts of each commercial bank to ensure the full coverage of data reported through the total ITRS system.

Different types of transactions that initiate as cross border transactions (international transactions) and domestic transactions are categorized for ITRS reporting based on different transaction types, flows, sources of funds and types of accounts, etc used as indicated below.

Figure B 6.1
Proposed ITRS Reporting Mechanism

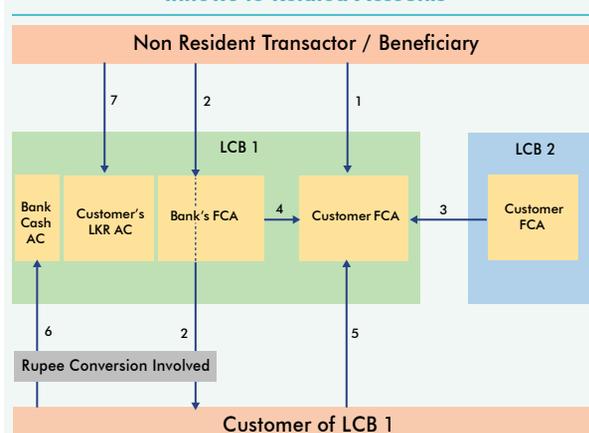


5

- **Transaction Type:** International or Domestic transaction
- **Transaction flow:** Inflows (credit) or Outflows (debit)
- **Transaction initiation account:** Customer’s foreign currency account (FCA); Bank’s foreign currency account; Bank’s cash account, etc.
- **Source of funds:** Foreign beneficiary; Customer’s foreign currency account; Bank’s foreign currency account; Bank’s physical cash account

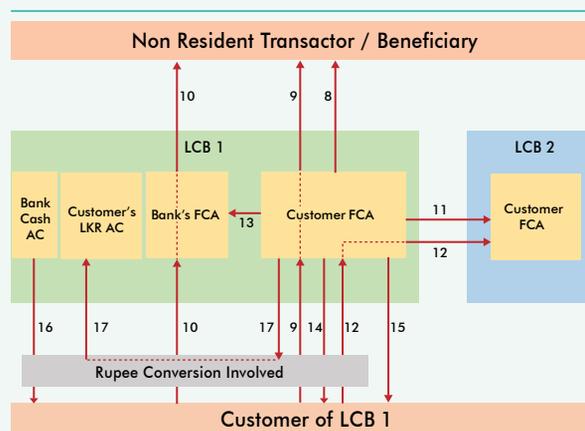
A threshold limit will be used to capture some specific information regarding transactions, including the purpose of the transaction, type of the transactor and beneficiary details. The purpose of the transaction will be based on an ITRS purpose code which will be introduced alongside the ITRS reporting framework. A description of the different types of transactions which are expected to be reported through an ITRS system is described in Figure B 6.2 and Figure B 6.3.

Figure B 6.2
International and Domestic Foreign Currency Transaction Categories - Inflows to Related Accounts



Nature of Transaction	Example
1 Cross border receipt to customer FCA	Receipt of export proceeds to customer FCA
2 Cross border foreign currency (FC) receipt without a customer FCA converted to Sri Lankan rupees (LKR)	Inward workers’ remittances received through an international money transfer service
3 Domestic inward transfer to customer FCA	Receipt of FC funds to a customer FCA through a fund transfer from another customer FCA
4 Domestic credits by bank to customer FCA	Interest receipts to customer FCA
5 Deposit of FC to customer FCA	Customer depositing FC in own FCA
6 Purchase of FC by the bank	Customer selling FC to bank in receipt of LKR
7 LKR receipt to customer LKR account from a non resident party	Inward Remittances in LKR by a Sri Lankan migrant worker

Figure B 6.3
International and Domestic Foreign Currency Transaction Categories - Outflows from Related Accounts



Nature of Transaction	Example
8 Cross border payments from customer FCA	Import payments by an exporter through own FCAs
9 Cross border payment from customer FCA after currency conversion	A customer making a payment through own FCA after converting rupees to FC and thereafter depositing FC in FCA
10 Cross border FC payment without a customer FCA	Customer importing a vehicle after opening a letter of credit (LC) and making the payment
11 Domestic outward transfer from customer FCA	Transferring FC funds from one customer FCA to another
12 Domestic payment from customer FCA after currency conversion	Customer depositing FC in own FCA after converting LKR and transferring FC to another customer FCA
13 Domestic debits by bank from customer FCA	Bank charges deducted from customer FCA
14 Withdrawal of cash from a customer FCA in LKR	Customer withdrawing LKR from own FCA
15 Cash withdrawal from customer FCA in FC	Customer withdrawing FC from own FCA
16 Sale of FC for international transactions	Customer purchasing FC from bank for foreign travel
17 Transfer of funds from customer FCA to customer LKR account	Fund transfers between customer FCA and LKR accounts

2. The usefulness of an ITRS system

The uses of ITRS data include; providing data for regulatory supervision, obtaining data for compilation of Balance of Payments (BOP) statistics and provision of supplementary information for policy decisions.

2.1 Data reporting framework for regulatory supervision

The proposed ITRS system can be effectively used for monitoring the nature of cross border transactions and domestic foreign currency transactions through the banking system. The expected further liberalisation of



cross border capital transactions through the new Foreign Exchange Act will also go hand in hand with strengthened monitoring, as many countries have adopted ITRS during their capital account liberalisation process. Some of the expected benefits of an ITRS system for effective regulatory supervision can be highlighted as follows.

- **Fulfilment of the majority of international and foreign currency related transactions data reporting requirements of the banking sector through a single platform:** The proposed system will facilitate the reporting of almost all regulatory reporting requirements of domestic banking units (DBU) and off-shore banking units (OBUs) through a single data reporting platform. The proposed system will avoid duplication of the reporting of similar data for different regulatory requirements.
- **Timely and secured reporting of regulatory data reports:** The new platform will ensure timely and secured reporting of regulatory data with higher frequencies with more sophisticated error detection criteria. It is expected to ease the burden of commercial banks in reporting data while ensuring more detailed, comprehensive data is reported for regulatory purposes. The data reported through the ITRS system can be used for strengthening the Anti Money Laundering and Countering the Financing of Terrorism regimes as well.
- **Ease of accommodating new amendments to regulatory requirements and new regulatory reporting:** The proposed system can be effectively used for new amendments of existing regulatory requirements and to accommodate new regulatory reporting of international transactions and domestic transactions facilitated through foreign currency accounts.
- **Verification of effectiveness of current regulations:** The system can be effectively used for verification of the effectiveness of regulations adopted with regard to foreign currency related transactions. This will aid in making appropriate changes to existing policies and in adopting new policies when necessary.
- **Monitoring reporting of export proceeds:** The ITRS system could be used in conjunction with data from Sri Lanka Customs to monitor the requirement for exporters to repatriate their export proceeds within a certain period, as per the regulations issued under the Foreign Exchange Act.

- **More customer oriented database for commercial banks for targeted research and marketing:** Commercial banks will also benefit from improving their databases for more customer and transaction purpose oriented data gathering and analysing.

2.2 Compilation of Balance of Payments Statistics

The ITRS data will be primarily used to supplement the compilation of BOP statistics. This is achieved by aggregating data based on the purpose of the transaction. The ITRS system will use a unique purpose code system which is in line with the international standardized reporting categories in BOP statistics. The ITRS would be the major source in identifying recipients and senders of specific types of transactions that need to be further monitored through direct surveys. All major types of transactions in the services account can be compiled through an ITRS system. Some improvements in the compilation of BOP statistics envisaged through the implementation of an ITRS system are highlighted below.

- **Overall improvement in BOP statistics:** The proposed system is expected to significantly improve the BOP statistical compilation framework in terms of data coverage. The new data is expected to identify different types of potential transactions which should be included in the BOP compilation process. The data from the ITRS system will potentially be used for selected transaction types in the Services, Primary Income and Secondary Income accounts while supplementing existing surveys in the Financial Account of the BOP.
- **Enhanced coverage of the services sector:** All major types of transactions in the services account can be compiled through an ITRS system. The statistics of the services account is currently being compiled by estimations based on annual and bi-annual surveys. The quality of such data can be significantly improved through an ITRS system. The specific areas include receipts of the IT/BPO sector, expenses by Sri Lankans traveling abroad, transportation, telecommunications and insurance services. Moreover, data on emerging services sub sectors such as research and development, consultancy, patent rights and other such service transactions can also be covered under an ITRS system.
- **Enhanced coverage of current external sector surveys:** The ITRS system will significantly enhance the coverage of existing surveys, particularly the surveys conducted on the Financial Account of the BOP. The ITRS system could effectively be used

to develop the potential survey framework by identifying all related transactions relating to the specific financial account transactions.

- **Improved statistics on workers' remittances:** With the introduction of the new Foreign Exchange Act, all Resident Foreign Currency (RFC) and non-resident Foreign Currency (NRFC) accounts have been amalgamated to Personal Foreign Currency Accounts (PFCA) along with other non-workers' remittances related transactions. The new system will capture workers' remittances flows separately in accordance with the newly introduced Foreign Exchange Act. The proposed ITRS system will be beneficial in obtaining both inward and outward workers' remittances flows.
- **Data inputs to National Account Statistics:** The improvements in the BOP statistical framework will also facilitate more granular level data for compilation of the national accounts by the Department of Census and Statistics.

2.3 Supporting information for macroeconomic policy making

Data from an ITRS system could also be used as supporting information for macroeconomic policy decisions. The ITRS system can complement macroeconomic policy making in the following manner.

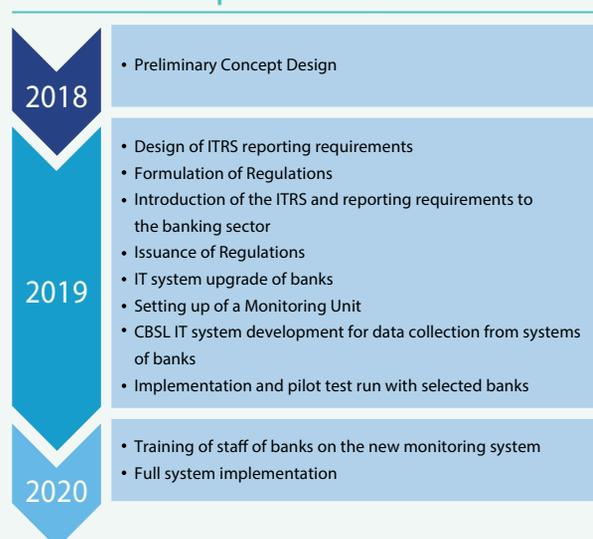
- **Provide early warning signals on external imbalances:** The ITRS system facilitates retrieval of real time data on cross border transactions. For example, data on foreign investments in real estate/ condominium sectors can be obtained from an ITRS system thus enabling to identify the possibility of any real estate bubbles created by foreign investments.
- **Providing inputs to assess the viability of policy initiatives:** In order to save time and resources, it is important to assess the feasibility of policy initiatives before they are implemented. An ITRS system serves this purpose as it provides a comprehensive coverage of data on a timely and frequent manner. For example, information on potential saving of foreign exchange by establishing local branches of foreign universities can be obtained through an ITRS system.

- **Facilitating to ensure financial system stability:** Through the data obtained from the ITRS system, most vulnerable sectors with liquidity issues in domestic foreign exchange market could be identified, thereby providing data inputs to policy decisions on ensuring the financial system stability.

3. ITRS Implementation Framework

The introduction of the ITRS reporting system to commercial banks is expected to commence in the second half of 2019 and it is expected to be fully implemented by the first half of 2020. The Central Bank is currently in the process of designing ITRS reporting requirements and the initial drafting of the regulatory framework.

Figure B 6.4
Key Milestones in the
ITRS Implementation Framework



The lead collaborative departments of the CBSL are currently conducting technical level discussions on the implementation of the ITRS system, taking into consideration the existing reporting channels and technical infrastructure. Going forward, the CBSL will introduce the system to the banking sector and coordinate closely with the banking sector in the processes of introducing reporting requirements, upgrading the IT systems of banks and providing required training to bank staff.

5.5 Current Account Balance

The current account deficit widened significantly in 2018. The current account deficit widened as a result of a significant expansion of the trade deficit, deficit in the primary income account and a marginal decline in the secondary income

balance, despite a notable increase in the services account. Although merchandise exports recorded a satisfactory growth during the year, the trade deficit widened due to the higher growth in imports. The upsurge in import expenditure was mainly driven by personal motor vehicles, gold and fuel imports. The surplus in the services account continued

its positive momentum during 2018 with a strong growth in earnings from tourism, transport and computer services sub-sectors. The deficit in the primary income account widened marginally during the year with increased dividends and interest payments and a notable decline in reinvested earnings of DIEs. The current account was further burdened by the decline in workers' remittances during the year. Consequently, the current account deficit widened to US dollars 2,814 million in 2018, in comparison to US dollars 2,309 million in 2017. As a percentage of GDP, the current account deficit, in 2018, was 3.2 per cent, in comparison to 2.6 per cent in 2017.

5.6 Capital Account Balance

The inflows to the capital account remained subdued in 2018. Capital transfers to the government declined, while those to the private sector recorded an improvement, in 2018, in comparison to the previous year. Consequently, the capital account recorded a surplus of US dollars 14 million in 2018 compared to a surplus of US dollars 11 million in 2017.

5.7 Financial Account

The net incurrence of liabilities and net acquisition of assets decreased in 2018, compared to 2017. Nevertheless, the significant

Figure 5.12
Financial Account

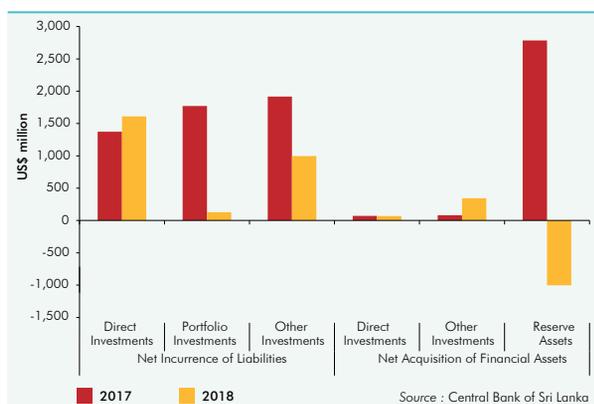


Table 5.10.A
Financial Account

Item	US\$ million			
	2017 (a)		2018 (b)	
	Net acquisition of financial assets	Net incurrence of liabilities	Net acquisition of financial assets	Net incurrence of liabilities
Financial Account	2,938	5,061	-591	2,737
Direct Investment	72	1,373	68	1,611
Equity and investment fund shares	68	532	58	463
Equity other than reinvestment of earnings	55	32	48	238
Direct investor in direct investment enterprise	55	32	48	238
Reinvestment of earnings	13	500	10	225
Debt instruments	4	840	10	1,148
Direct investor in direct investment enterprise	4	840	10	1,148
Portfolio Investment	...	1,771	-	129
Equity and investment fund shares	-	359	-	-4
Debt securities	...	1,413	-	134
Deposit-taking corporations	...	-500	-	-1,350
Long term	...	-500	-	-1,350
General government	-	1,913	-	1,484
Short term (Treasury bills)	-	81	-	-96
Long term	-	1,832	-	1,580
Treasury bonds	-	360	-	-894
Sri Lanka Development bonds	-	-28	-	-26
Sovereign bonds	-	1,500	-	2,500
Financial Derivatives	...	-	-	-
Other Investment	82	1,916	343	997
Currency and deposits	78	-228	80	-632
Central Bank	-	-402	-	-1
Short term	-	-2	-	-1
Long term	-	-400	-	-
Deposit-taking corporations	78	173	80	-631
Short term	11	173	-189	-631
Long term	67	-	268	-
Continued on page - 175				
Memorandum Items				
Foreign direct investment (FDI)				
Equity		32		238
Reinvestment of earnings		500		225
Intercompany loans		959		1,574
Intercompany loan repayments		-119		-426
Total FDI (1)		1,373		1,611
Loans to BOI companies (2)		538		525
Total FDI, including loans to BOI companies (1 + 2)(c)		1,910		2,136
Total net inflows to the CSE		279		-55
Direct investment		-80		-51
Portfolio Investment		359		-4
Net Foreign investments in rupee denominated government securities (Treasury Bills and Bonds)		441		-990
Foreign purchases		1,667		706
Foreign sales		1,226		1,696

(a) Revised
(b) Provisional
(c) The difference with the BOI estimates is due to differences in coverage and compilation methodologies.

Source: Central Bank of Sri Lanka

inflows to the financial account outweighed outflows, resulting in an accretion of liabilities on a net basis during 2018. During the year, major inflows to the financial account were the issuance

of two ISBs of US dollars 2.5 billion, the foreign currency term financing facility of US dollars 1 billion and FDI inflows of US dollars 2.1 billion, which includes foreign loans to BOI companies. Major outflows from the financial account consisted of maturity of international bonds issued by the banking sector, amounting to US dollars 1.35 billion, and net outflows from the rupee denominated government securities market of US dollars 990 million. Meanwhile, depletion of gross official reserves amidst intervention in the domestic foreign exchange market and foreign debt service payments by the government led to a considerable decline in the net acquisition of assets during the year. Accordingly, net incurrence of liabilities amounted to US dollars 2,737 million, while net acquisition of assets declined by US dollars 591 million in 2018. During the first four months of 2018, relatively stable conditions prevailed in the domestic foreign exchange market, enabling the Central Bank to absorb foreign exchange from the domestic foreign exchange market to build up external buffers. This, together with the proceeds from two ISBs issued by the government amounting to US dollars 2.5 billion, in April 2018, complemented the build up of gross official reserves to a record high level of US dollars 9.9 billion as at end April 2018. However, the tightening of global financial market conditions and the resultant reversal of capital flows from the government securities market and the CSE exerted significant pressure on the domestic foreign exchange market, requiring the Central Bank to supply foreign exchange to the market since end April 2018. These developments, together with the outflows on account of foreign debt service payments, resulted in the gross official reserves declining to US dollars 6.9 billion, while the overall balance recorded a deficit of US dollars 1,103 million at end 2018.

5.7.1 Direct Investment

FDI, including foreign borrowings of BOI companies, increased considerably, reaching the historically highest level in 2018. Total FDI inflows, inclusive of foreign loans received by companies registered with the BOI, amounted to US dollars 2,136 million, in 2018, in comparison to US dollars 1,910 million in 2017. Meanwhile, FDI, excluding foreign loans obtained by BOI companies, also increased notably to US dollars 1,611 million, in 2018, from US dollars 1,373 million in 2017. FDI inflows, excluding foreign loans to BOI companies, comprised US dollars 1,148 million of net intercompany debt, US dollars 225 million of reinvested earnings and US dollars 238 million of net investments in equity during the year. A notable reduction in reinvested earnings was recorded in 2018 compared to the previous year implying relatively less profits declared by DIEs during the year. In addition, there were a significant repayment of intercompany debt amounting to US dollars 426 million in 2018, negatively impacting net FDI inflows during the year. Foreign loans obtained by BOI companies from non-related parties amounted to US dollars 525 million, in 2018, compared to US dollars 538 million in 2017. FDI inflows in 2018 were mainly received by the Hambantota International Port Group (Pvt) Ltd, amounting to US dollars 828 million, of which US dollars 682 million was received by the government as proceeds of the long lease of Hambantota port during the year. In 2018, FDI inflows were channeled largely to projects related to ports, telecommunications, housing and property development and hotels, while FDI inflows to the manufacturing sector remained moderate. Based on the country of immediate investor, the top five source countries of FDI in 2018 were China, Hong Kong, India, Malaysia and the United

Kingdom. Meanwhile, direct investments made by Sri Lankan companies in foreign countries, which resulted in a net acquisition of assets, amounted to US dollars 68 million, in 2018, in comparison to US dollars 72 million in 2017.

5.7.2 Portfolio Investment

Equity

Portfolio investments in equity, which reflect foreign equity investment inflows excluding direct investments, recorded a marginal net outflow in 2018. Portfolio investments in equity consist of foreign investments in the CSE other than direct investment transactions, and account for investments by non-residents, holding less than 10 per cent of the total shareholding of a Sri Lankan enterprise. Reflecting the subdued global investor appetite in capital markets of emerging economies, portfolio investment in the form of equity recorded a net outflow of US dollars 4 million in 2018. This comprised a net outflow of US dollars 82 million from the secondary market and an inflow of US dollars 78 million to the primary market. There was a sharp moderation of net inflows to the CSE in 2018, in comparison to 2017 which recorded a net foreign inflow to the CSE amounting to US dollars 359 million, including net inflows to the secondary market amounting to US dollars 202 million and primary market inflows amounting to US dollars 157 million.

Debt Securities

The issuance of two ISBs by the government, which represented the largest annual offshore bond offering by Sri Lanka, was the major inflow on account of debt securities, while a number of international bonds issued by the banking sector matured in 2018. Successful issuance of two ISBs with

5 year and 10 year maturities valued each at US dollars 1.25 billion in April 2018, marked Sri Lanka's twelfth US dollar benchmark offering in the international bond markets since 2007. These ISBs were priced well within the initial price guidance reflecting continued investor confidence in Sri Lanka. With the policy rate hikes of the Federal Reserve Bank, there were significant outflows of foreign investment from the government securities market. Accordingly, foreign investment in Treasury Bonds and Treasury Bills recorded net outflows amounting to US dollars 894 million and US dollars 96 million, respectively, in 2018. Meanwhile, foreign investments in Sri Lanka Development Bonds (SLDB) also recorded a net outflow of US dollars 26 million in 2018. The main outflow with respect to debt securities, during 2018, was the maturity of several international bonds totaling US dollars 1,350 million issued by the banking sector, which included US dollars 500 million issued by the Bank of Ceylon, US dollars 750 million issued by the National Savings Bank and US dollars 100 million issued by the DFCC Bank.

5.7.3 Other Investment

Currency and Deposits

Currency and deposits in the form of assets increased, while the currency and deposit liabilities recorded a notable decline in 2018.

This was mainly due to the increase in assets and decrease in liabilities related to currency and deposits of deposit taking corporations. Accordingly, currency and deposits in the form of assets of deposit taking corporations increased by US dollars 80 million, while currency and deposit liabilities declined by US dollars 632 million in 2018. The notable decline in currency and deposits liabilities of the banking sector could possibly be due to the significant pressure in the domestic foreign exchange market, which may have reduced deposit liabilities of non-residents held with

Table 5.10.B
Financial Account

Item	US\$ million			
	2017 (a)		2018 (b)	
	Net acquisition of financial assets	Net incurrence of liabilities	Net acquisition of financial assets	Net incurrence of liabilities
Other Investment (Continued from page - 172)				
Loans	-	1,889	-	1,568
Central Bank	-	184	-	252
Credit and loans with the IMF	-	184	-	252
Stand by Arrangement	-	-235	-	-
Extended Fund Facility	-	419	-	252
Deposit-taking corporations	-	271	-	697
Short term	-	-280	-	844
Long term	-	551	-	-146
General government	-	1,223	-	558
Long term	-	1,223	-	558
Other sectors (c)	-	211	-	61
Long term	-	211	-	61
Trade credit and advances	35	195	148	224
Deposit-taking corporations	17	-	-10	-
Short term	17	-	-10	-
Other sectors (d)	18	195	157	224
Short term	18	195	157	224
Other accounts receivable/payable	-31	61	116	-162
Central Bank	-	61	-	-162
Short term (e)	-	61	-	-162
Deposit-taking corporations	-31	-	116	-
Short term	-31	-	116	-
Special Drawing Rights	-	-	-	-
Reserve Assets	2,784		-1,002	
Monetary gold	-	-	-103	-
Special Drawing Rights	2	-	-3	-
Reserve position in the IMF	-	-	-	-
Other reserve assets	2,782	-	-896	-
Currency and deposits	393	-	-1,012	-
Claims on monetary authorities	859	-	466	-
Claims on other entities	-465	-	-1,478	-
Securities	2,389	-	122	-
Debt securities	2,389	-	122	-
Long term	2,389	-	122	-
Other Claims	...	-	-6	-
Financial Account (net)	-2,123		-3,328	
Memorandum Items				
Long term loans to the government (net)		1,223		558
Inflows (Disbursements)		2,544		2,329
Project Loans		1,544		1,204
Foreign Currency Term Financing Facilities		1,000		1,000
Programme Financing Loans		-		125
Repayments		1,320		1,771

(a) Revised Source: Central Bank of Sri Lanka

(b) Provisional

(c) Include State Owned Business Enterprises (SOBEs) and private sector companies.

(d) Include trade credits received by the Ceylon Petroleum Corporation (CPC) and other private companies.

(e) Net transactions of Asian Clearing Union (ACU) liabilities

commercial banks and may also be due to possible reduction in export proceeds, particularly in the latter part of 2018.

Loans

Net loan inflows to the financial account moderated in 2018. The reduction in net loan inflows was mainly due to reduced net loan

inflows to the government, while short-term foreign loans obtained by the banking sector recorded a significant increase during the year. Accordingly, the net inflow of loans to the financial account amounted to US dollars 1,568 million in 2018, compared to US dollars 1,889 million in 2017.

Net foreign loan inflows to the government moderated due to significant repayments of foreign loans during 2018. The net foreign loan inflows to the government amounted to US dollars 558 million, in 2018, compared to US dollars 1,223 million in 2017. This comprised US dollars 2,329 million of foreign loan disbursements and US dollars 1,771 million of foreign loan repayments during the year. Of the total foreign loan disbursements, US dollars 1,204 million was on account of project loans, US dollars 1,000 million was a foreign currency term financing facility and US dollars 125 million was for programme loans. Major project loan inflows to the government, in 2018, included the loans obtained for the Construction of Extension of Southern Expressway Section 1 from Matara to Beliatta Project, Construction of Outer Circular Highway Project Phase III from Kerawalapitiya to Kadawatha, New Bridge Construction Project over the Kelani River and Integrated Road Investment Program - Tranche 3. The foreign currency term financing facility was obtained from the China Development Bank, while the programme loan was obtained from the Asian Development Bank. In terms of loan repayments, US dollars 1,158 million was on account of repayment of foreign project loans, while US dollars 613 million was for repayment of foreign currency term financing facilities. The government's foreign loan repayment obligations have increased over the years, resulting in a gradual decline in foreign loans to the government on a net basis.

Foreign loans obtained by deposit taking corporations, private corporations and State Owned Business Enterprises (SOBEs) and the Central Bank also recorded a net inflow in



Table 5.11
Major Projects Financed with Foreign
Borrowings during 2018

Lender and Project	Amount Disbursed US\$ million
Government Projects - Total	1,204
of which;	
The Export - Import Bank of China	315
of which;	
Construction of Extension of Southern Expressway Section 1 from Matara to Beliatta	109
Construction of Outer Circular Highway Project Phase III from Kerawalapitiya to Kadawatha	70
Construction of Extension of Southern Expressway, Section 4 from Mattala to Hambantota via Andarawewa Project	37
Construction of Extension of Southern Expressway, Section 2 from Beliatta to Wetiya Project	24
Hambantota Hub Development Project	21
Asian Development Bank	276
of which;	
Integrated Road Investment Program - Tranche 3	46
Small and Medium-Sized Enterprises Line of Credit	37
Small and Medium Enterprises Line of Credit - Additional Financing	25
Integrated Road Investment Program - Tranche 4	20
Second Integrated Road Investment Program- Tranche 1	18
Government of Japan	157
of which;	
New Bridge Construction Project over the Kelani River	48
Greater Colombo Transmission and Distribution Loss Reduction Project	35
Kandy City Wastewater Management Project	16
Landslide Disaster Protection Project of the National Road Network	16
Major Bridges Construction Project of the National Road Network	12
International Development Association	125
of which;	
Second Health Sector Development Project	24
Water Supply and Sanitation Improvement Project	21
Strategic Cities Development Project	15
Calyon Credit Agricole	57
Implementation of Kelani Right Bank Water Supply Project- Phase II	38
Implementation of Greater Matale Water Supply Project	19
Government of India	49
of which;	
Procurement of Two Advanced Offshore Patrol Vessels	27
China Development Bank Corporation	41
of which;	
Improvement and Rehabilitation of Priority Roads Project 3 (Phase II)	19
Co-op Centrale Raiffeisen-Boerenleenbank	32
of which;	
Construction of 463 Rural Bridges	9

Source: External Resources Department of Ministry of Finance

2018. Net foreign loan inflows to deposit taking corporations, which consist of licensed commercial banks (LCBs), licensed specialised banks (LSBs) and licensed finance companies (LFCs) amounted to US dollars 697 million, compared to US dollars 271 million in 2017. This increase was mainly driven by significant increase in short-term loan inflows to the banking sector. Further, the net foreign loan inflows to the other sector amounted to US dollars 61 million, which consisted of loan inflows of

US dollars 657 million to private corporations, while no foreign loans were received by SOBEs during the year. The total foreign loan repayments by the private corporations and SOBEs amounted to US dollars 596 million, which consisted of foreign loans repayment of US dollars 186 million by SOBEs and US dollars 410 million by private corporations. Meanwhile, foreign loans to the Central Bank recorded a net inflow of US dollars 252 million with the receipt of the fifth tranche under the IMF-EFF during the year.

Trade Credit and Advances and Other Accounts Receivable / Payable

Trade credit and advances received by residents as well as trade credit and advances given to non-residents increased in 2018. Trade credits received, of which a major component was received by the Ceylon Petroleum Corporation (CPC), increased during 2018. This resulted in an increase of net incurrence of liabilities of trade credits received by US dollars 224 million, compared to an increase of US dollars 195 million in 2017, mainly driven by higher fuel imports during the year. Meanwhile, the net acquisition of assets on trade credit and advances, which represent trade credits given by Sri Lankan exporters to their overseas trading partners and deposit taking corporations, increased to US dollars 148 million in 2018, compared to an increase of US dollars 35 million in 2017. Further, other accounts payable, mainly consisting of Asian Clearing Union (ACU) liabilities managed by the Central Bank, recorded a net decrease of US dollars 162 million, while other accounts receivable of LCBs recorded a net increase of US dollars 116 million in 2018.

5.7.4 Reserve Assets

Transactions related to reserve assets recorded a notable decline in 2018, in line with the decrease in the stock of the reserve assets

during 2018. Reserve transactions declined by US dollars 1,002 million in 2018, on a net basis, compared to the significant increase of US dollars 2,784 million recorded in 2017. During the year, currency and deposits of the Central Bank reduced by US dollars 1,012 million while the Central Bank's investment in foreign debt securities increased by US dollars 122 million. Further, the Central Bank reduced its monetary gold holdings by a net sale of US dollars 103 million during 2018.

5.8 Overall Balance

The overall balance, which reflects the change in net international reserves during the period under review, recorded a deficit in 2018. The overall balance recorded a deficit of US dollars 1,103 million in 2018, in contrast to the surplus of US dollars 2,068 million recorded in 2017. Despite significant inflows to the financial account during the year in terms of proceeds of the two ISBs, receipt of the foreign currency term financing facility and proceeds from the long lease of Hambantota port, net international reserves declined to US dollars 5,495 million as at end 2018, from US dollars 6,597 million as at end 2017, mainly due to continued foreign currency debt service payments and the net supply of foreign exchange by the Central Bank to the domestic foreign exchange market in 2018.

5.9 International Investment Position

Sri Lanka's external liability position increased, while the external asset position declined as at end 2018. The total foreign asset position declined to US dollars 12,065 million from US dollars 12,704 million as at end 2017, primarily due to the reduction in the reserve asset position, despite an increase in asset positions in direct investments, currency and deposits and trade credits and advances given to

Table 5.12
International Investment Position

Item	US\$ million (End period position)			
	2017 (a)		2018 (b)	
	Assets	Liabilities	Assets	Liabilities
Direct Investment (c)	1,375	10,755	1,433	12,757
Equity and investment fund shares	1,366	7,423	1,414	8,351
Debt instruments	9	3,332	19	4,406
Portfolio Investment	...	15,620	...	14,629
Equity and investment fund shares	...	1,533	...	1,824
Other sectors	...	1,533	...	1,824
Debt securities (d)	...	14,087	...	12,805
Deposit-taking corporations	...	1,666	...	249
Long term	...	1,666	...	249
General government	...	12,244	...	12,385
Short term	...	167	...	60
Long term	...	12,077	...	12,326
Other sectors	...	177	...	171
Long term	...	177	...	171
Financial Derivatives	-	-	-	-
Other Investment	3,371	34,186	3,714	35,100
Currency and Deposits	784	2,213	864	1,581
Central Bank	...	1	...	...
Short term	...	1	...	...
Long term	...	-	...	-
Deposit-taking corporations	784	2,212	864	1,580
Short term	546	2,212	357	1,580
Long term	238	-	507	-
Loans	...	28,884	...	30,382
Central Bank	...	765	...	992
Credit and loans with the IMF	...	765	...	992
Deposit-taking corporations	...	4,833	...	5,530
Short term	...	2,929	...	3,772
Long term	...	1,904	...	1,758
General government	...	19,111	...	19,623
Long term	...	19,111	...	19,623
Other sectors (e)	...	4,175	...	4,237
Long term	...	4,175	...	4,237
Trade Credit and Advances	1,002	1,930	1,150	2,154
Deposit-taking corporations	109	109	100	100
Short term	109	109	100	100
Other sectors (f)	893	1,930	1,050	2,154
Short term	893	1,930	1,050	2,154
Other Accounts Receivable/Payable	1,584	594	1,700	432
Central Bank (g)	...	594	...	432
Short term	...	594	...	432
Deposit-taking corporations	1,584	-	1,700	-
Short term	1,584	-	1,700	-
Special Drawing Rights	...	563	...	550
Reserve Assets	7,959	...	6,919	...
Monetary gold	928	...	819	...
Special Drawing Rights	4	...	1	...
Reserve position in the IMF	68	...	67	...
Other reserve assets	6,958	...	6,032	...
Currency and deposits	3,037	...	2,026	...
Claims on monetary authorities	1,660	...	2,126	...
Claims on other entities	1,377	...	-100	...
Securities	3,921	...	4,006	...
Debt securities	3,921	...	4,006	...
Total Assets / Liabilities	12,704	60,561	12,065	62,486
Net International Investment Position	...	-47,857	...	-50,421
Memorandum Items	...	...	...	...
IIP- Maturity-wise breakdown	12,704	60,561	12,065	62,486
Short term	7,166	9,367	6,118	9,824
Long term	5,538	51,194	5,947	52,663

- (a) Revised
(b) Provisional
(c) Includes direct investment position of BOI, CSE and other private companies
(d) Foreign currency debt issuances are based on market value while domestic currency issuances are based on book value.
(e) Includes loans outstanding position of project loans obtained by State Owned Business Enterprises (SOBEs).
(f) Includes outstanding trade credit position of Ceylon Petroleum Corporation and the private sector companies.
(g) Outstanding position of ACU liabilities managed by the Central Bank

non-residents. Sri Lanka's total liability position to non-residents increased to US dollars 62,486 million as at end 2018, an increase of US dollars 1.9 billion from the beginning of the year. This increase was primarily due to the rise in direct investment stock position and the outstanding foreign liabilities of commercial banks and the government, compared to the beginning of the year. With these developments, Sri Lanka's net international investment position, which takes into consideration the difference between the total external asset and liability positions, deteriorated from a net liability position of US dollars 47,857 million at end 2017 to a net liability position of US dollars 50,421 million at end 2018. This gradual build-up of Sri Lanka's net liability position is mainly driven by the increase in outstanding external debt of the government and the gradual build-up of the direct investment liability position of DIEs.

5.9.1 Direct Investment Position

The direct investment asset position as well as the direct investment liability position increased in 2018. The direct investment liability position increased to US dollars 12,757 million as at end 2018, compared to US dollars 10,755 million as at end 2017, with noteworthy inflows of FDI to BOI companies and the proceeds from the long lease of the Hambantota Port during the year. There was a significant negative impact to the direct investment liability position due to valuation losses of publicly listed direct investment enterprises. Further, there were notable debt to equity swap transactions of some major corporates, resulting in an increase in equity positions with an equal reduction in debt positions of these companies. Meanwhile, there were key mergers of some large corporates with significant direct investments, resulting in consolidation of equity and debt positions of these companies as well. Despite a significant reduction

in debt positions due to debt to equity swaps of some large DIEs, the liability position of debt instruments of DIEs increased overall, reflecting the increase in advances by direct investors. The top five sources in terms of direct investment liability stock position as at end 2018 were China, Netherlands, India, Singapore and Malaysia. Meanwhile, the direct investment asset position which represents direct investments abroad by Sri Lankan residents stood at US dollars 1,433 million as at end 2018, compared to US dollars 1,375 million as at end 2017.

5.9.2 Portfolio Investment Position

The portfolio investment liability position reduced in 2018. With significant reduction in market prices of outstanding government ISBs, outflows of foreign investments from the Treasury Bills and Treasury Bonds market, and a number of maturities of international debt securities of the banking sector, the outstanding portfolio investment liability position declined as at end 2018, despite the issuance of the two ISBs by the government. Accordingly, the portfolio investment liability stock position declined to US dollars 14,629 million as at end 2018, from US dollars 15,620 million as at end 2017. The portfolio investment equity position increased to US dollars 1,824 million by end 2018, compared to US dollars 1,533 million as at end 2017. Meanwhile, portfolio investment debt securities position recorded a notable decline to US dollars 12,805 million by the end 2018, compared to US dollars 14,087 million as at end 2017. This was mainly due to a significant reduction in market prices of the currently outstanding ISBs as at end December 2018, possibly as a result of investor sentiment in secondary markets due to the political uncertainty in the latter part of 2018. Due to the deteriorated market sentiment, secondary market yields of the outstanding ISBs

increased notably, also resulting in a significant decline in the market prices of the existing ISBs. Despite the increase in outstanding liability position of ISBs issued by the government with the issuance of new ISBs during the year, significant outflows from rupee denominated government securities and SLDBs held by non-residents as well as the reduction in market prices of existing ISBs resulted in a moderation of the increase in outstanding total government debt securities held by non-residents as at end 2018. Meanwhile, the debt security liability position of deposit taking corporations recorded a significant decline by the end of the year due to the settlement of international bonds issued by several banks, amounting to US dollars 1,350 million.

5.9.3 Other Investment Position

Currency and Deposits

The currency and deposits asset position increased marginally, while the liability position recorded a notable decline as at end 2018.

The currency and deposit liability position of deposit taking corporations declined to US dollars 1,581 million as at end 2018, from US dollars 2,213 million recorded as at end 2017, primarily with the reduction in deposit liabilities of non-residents and exporters. The currency and deposits asset position, which comprises the asset position of the deposit taking corporations, increased marginally to US dollars 864 million as at end 2018, from US dollars 784 million at the beginning of the year.

Loans

The foreign loan liability position in the IIP increased as at end 2018. The total outstanding loan liabilities increased due to the increase in the foreign loan liability position across all the sectors including the government, the Central Bank, deposit

taking corporations and the other sector that comprise the private sector and SOBEs. Consequently, the foreign loan liability position increased to US dollars 30,382 million as at end 2018 from US dollars 28,884 million as at end 2017. The increase in the foreign loan liability position of the government to US dollars 19,623 million was a result of new project loans, a new programme loan and the new foreign currency term financing facility obtained by the government. The outstanding foreign loans of deposit taking corporations increased with an increase in short term foreign loans. The outstanding loan liability position of the private sector recorded a moderate increase with an increase in foreign loans of some major corporates and BOI companies while the liability position of SOBEs declined as a result of debt repayments and no new loan disbursements during 2018. The outstanding liability position of the Central Bank increased with the receipt of the fifth tranche of the IMF-EFF facility.

Trade Credit and Advances

The trade credit and advances asset position as well as the liability position increased in 2018. The outstanding trade credit and advances liability position, which consists of trade credit and advances of the private sector and SOBEs, increased from US dollars 1,930 million as at end 2017 to US dollars 2,154 million as at end 2018, mainly due to the increase in outstanding trade credits of the CPC. Meanwhile, the outstanding asset position of trade credit and advances, which reflects the trade credit and advances given by deposit taking corporations and the private sector increased to US dollars 1,150 million as at end 2018, from US dollars 1,002 million as at end 2017.

Other Accounts Receivable / Payable and Special Drawing Rights

The outstanding position of other accounts receivable increased while other accounts

payable declined in 2018. The outstanding position of other accounts receivable of deposit taking corporations increased to US dollars 1,700 million as at end 2018 from US dollars 1,584 million as at end 2017. Meanwhile, the outstanding position of other accounts payable declined to US dollars 432 million as at end 2018, with a reduction in ACU related liabilities of the Central Bank. Further, the outstanding Special Drawing Rights (SDR) liability position declined marginally to US dollars 550 million, with changes in the exchange rate as at end 2018.

5.9.4 Reserve Asset Position

Sri Lanka's gross official reserve assets position declined as at end 2018 to US dollars 6.9 billion from US dollars 8.0 billion recorded at end 2017. The level of gross official reserves of the country at end-2018 was equivalent to finance 3.7 months of imports of goods. The relatively stable domestic foreign exchange market conditions enabled the Central Bank to absorb US dollars 459 million from the market on a net basis during the first four months of the year. This, together with the proceeds from two ISBs issued by the government totaling US dollars 2.5 billion in April 2018 supplemented the build up of gross official reserves to reach a record high level of US dollars 9.9 billion

Figure 5.13
Quarterly Gross Official Reserves
and Total Foreign Assets

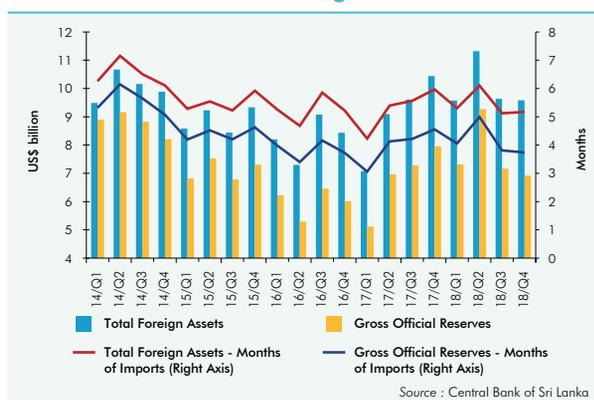


Table 5.13
Gross Official Reserves, Total Foreign
Assets and Overall Balance

	(End period position)				
	US\$ million				
	2014	2015	2016	2017	2018 (a)
1. Government foreign assets	635	470	289	488	817
2. Central Bank foreign assets	7,573	6,834	5,730	7,470	6,102
3. Gross official reserves (1+2)	8,208	7,304	6,019	7,959	6,919
4. Foreign assets of deposit-taking corporations	1,676	2,033	2,414	2,478	2,664
5. Total foreign assets (3+4) (b)	9,884	9,337	8,433	10,436	9,583
6. Reserve related liabilities (c)	1,691	2,275	1,490	1,361	1,425
7. Net International Reserves (NIR) (3-6)	6,517	5,029	4,529	6,597	5,495
8. Overall balance (d)	1,369	-1,489	-500	2,068	-1,103
9. Gross official reserves in months of					
9.1 Import of goods	5.1	4.6	3.8	4.6	3.7
9.2 Import of goods and services	4.3	3.8	3.1	3.8	3.1
10. Total foreign assets in months of					
10.1 Import of goods	6.1	5.9	5.3	6.0	5.2
10.2 Import of goods and services	5.1	4.9	4.3	4.9	4.3

(a) Provisional

Source: Central Bank of Sri Lanka

(b) Excludes foreign assets in the form of 'Direct investment abroad' and 'Trade credit and advances granted'

(c) The total outstanding debt of the Central Bank, excluding outstanding Special Drawing Rights (SDRs)

(d) Change in NIR position during the period

at end April 2018. In addition, proceeds from the long lease of the Hambantota port, receipt of the fifth tranche of the IMF-EFF and proceeds of the foreign currency term financing facility supported the accumulation of gross official reserves during the year. However, the tightening of global financial conditions and the resultant reversal of capital flows from the government securities market and the CSE exerted significant pressure on the domestic foreign exchange market, requiring the Central Bank to supply foreign exchange to the market since end April 2018. These developments, together with outflows on account of foreign debt service payments caused the gross official reserves to decline to US dollars 6.9 billion by end 2018. The gross official reserves were sufficient to cover 50 per cent of the country's short-term debt and liabilities as at end-2018. Meanwhile, total foreign assets, which consist of gross official reserves and foreign assets of deposit taking corporations, also decreased to US dollars 9.6 billion at end

2018, which is equivalent to finance 5.2 months of imports, from US dollars 10.4 billion as at end-2017. This decline was primarily due to the depletion of gross official reserves, while foreign assets of the banking sector remained at similar levels by end 2018, compared to end 2017.

5.10 External Debt and Debt Servicing

5.10.1 External Debt

Sri Lanka's outstanding external debt increased by US dollars 706 million in 2018.

Sri Lanka's total outstanding external debt increased to US dollars 52,310 million by end 2018 from US dollars 51,604 million by end 2017, mainly due to the increase in the external debt of the general government, private sector corporations and DfEs. The increase in government's external debt by US dollars 654 million during 2018 reflects the impact of repayment of project loans, foreign investment outflows from the government securities market despite the issuance of new ISBs during the year. The government's external borrowings were mainly financed by the issuance of two ISBs totalling US dollars 2.5 billion, project loan inflows of US dollars 1.2 billion and foreign currency term financing facility of US dollars 1 billion during the year. Meanwhile, the Central Bank received the fifth tranche of the IMF - EFF while the outstanding

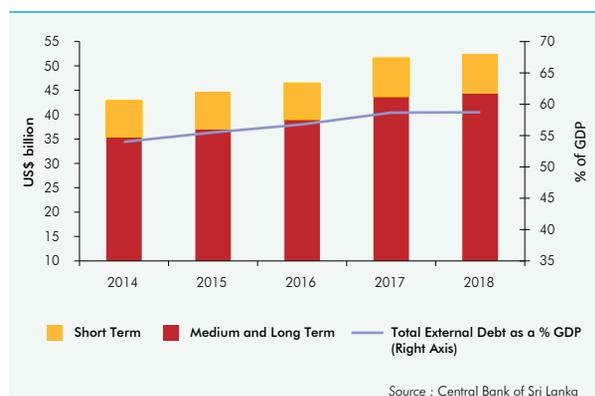
Table 5.14
Outstanding External Debt Position

Item	US\$ million (End period position)	
	2017(a)	2018(b)
General Government	31,355	32,009
Short term	167	60
Debt securities	167	60
Treasury bills (c)	167	60
Long term	31,188	31,949
Debt securities	12,077	12,326
Treasury bonds (c)	1,700	728
Sri Lanka Development bonds (d)	30	4
International sovereign bonds (e)	10,347	11,594
Loans	19,111	19,623
Central Bank	1,924	1,975
Short term	596	432
Currency and deposits	1	...
Other accounts payable	594	432
Asian Clearing Union liabilities	594	432
Long term	1,329	1,542
Special Drawing Rights (SDRs) allocation	563	550
Currency and deposits	...	...
Loans	765	992
Credit and loans with the IMF Extended Fund Facility	765	992
765	992	
Deposit-taking Corporations	8,711	7,359
Short term	5,140	5,353
Currency and deposits (f)	2,212	1,580
Commercial banks	2,212	1,580
Loans	2,929	3,772
Commercial banks	2,929	3,772
Long term	3,571	2,007
Debt securities (e)	1,666	249
Commercial banks	613	-
Other deposit-taking corporations	1,053	249
Loans	1,904	1,758
Commercial banks	1,886	1,643
Other deposit-taking corporations	19	115
Other Sectors (g)	6,282	6,562
Short term	1,930	2,154
Trade credit and advances (h)	1,930	2,154
Long term	4,352	4,407
Debt securities (e)	177	171
Loans	4,175	4,237
Private sector corporations	1,919	2,167
State owned business enterprises and public corporations	2,256	2,070
Direct Investment: Intercompany Lending (i)	3,332	4,406
Gross External Debt Position	51,604	52,310
As a Percentage of GDP		
Gross external debt	58.6	58.7
Short term debt	8.9	9.0
Long term debt	49.7	49.7
As a Percentage of Gross External Debt		
Short term debt	15.2	15.3
Long term debt	84.8	84.7
Memorandum Items		
Debt Securities-Sectorwise Breakdown at Face Value	13,566	13,448
General government	11,791	13,023
Treasury bills	180	65
Treasury bonds	1,930	804
Sri Lanka development bonds	30	4
International sovereign bonds	9,650	12,150
Deposit-taking corporations, except the Central Bank	1,600	250
Commercial banks	600	-
Licensed specialised banks	1,000	250
Other sectors	175	175

Source: Central Bank of Sri Lanka

- (a) Revised
(b) Provisional
(c) Based on book value
(d) Based on face value
(e) Based on market prices
(f) Includes deposits of non-resident foreign currency holders
(g) Includes private sector and state owned business enterprises
(h) Includes trade credits outstanding of the Ceylon Petroleum Corporation and private sector companies
(i) Includes inter-company borrowings and shareholder advances on BOI registered companies

Figure 5.14
External Debt



liabilities with the ACU managed by the Central Bank decreased compared to the beginning of the year. A notable decrease in the outstanding external debt of deposit taking corporations was observed as a result of the maturity of outstanding international bonds by the Bank of Ceylon, National Savings Bank and the DFCC Bank, amounting to US dollars 1.35 billion during 2018. Outstanding external debt of SOBEs recorded a notable increase with the increase in trade credits of the CPC during 2018 despite significant repayments of foreign loans by other SOBEs. Further, intercompany borrowing of DIEs recorded an increase of around US dollars 1.1 billion during 2018, with a number of major DIEs in ports, telecommunications and hotels sectors receiving intercompany loans and shareholder advances during the year.

The total outstanding external debt of the country as a percentage of GDP remained at similar levels during 2018. The total outstanding external debt as a percentage of GDP stood at 58.7 per cent by end 2018, compared to 58.6 per cent by end 2017, as the modest increase in outstanding external debt remained similar to the increase in nominal GDP during 2018. The total external debt with long term maturity also remained at similar levels by end 2018, compared to the beginning of the year. Further, the outstanding government foreign debt, which remains the largest portion of the total external debt, increased to 61.2 per cent of total external debt by end 2018 compared to 60.8 per cent at end 2017.

5.10.2 Foreign Debt Service Payments

Sri Lanka's external debt service payments increased in 2018 with higher capital repayments and interest payments. Capital repayments on external debt increased to US dollars 4,188 million in 2018, compared to US dollars 3,167 million

in 2017 with significant repayments of foreign liabilities by the government, the banking sector, private corporations and SOBEs. Debt servicing of the government recorded a notable increase with the repayment of foreign currency term financing facilities amounting to US dollars 613 million and project loan repayments of US dollars 1,158 million during 2018. Further, the banking sector repaid US dollars 1,350 million of international bonds which matured during the year. Capital repayments of foreign loans by the private sector and SOBEs also recorded a significant increase during the year. The interest payments on outstanding total external debt increased to US dollars 1,678 million in 2018, compared to US dollars 1,399 million in 2017. The increase in interest payments was mainly due to the increase in interest payments of the government due to larger coupon payments of ISBs and interest payments on foreign loans by the government. The increased interest payments by government, commercial banks and the private sector could also be attributed to the increase in global interest rates triggered by the interest rate hikes of the Federal Reserve Bank of the United States. Meanwhile, total external debt service as a percentage of exports of merchandise goods and services increased during 2018. The increase in debt service payments outweighed the increase in the growth of export of merchandise goods and services, resulting in total external debt service as a percentage of exports of merchandise goods and services increasing to 28.9 per cent in 2018 from 23.9 per cent in 2017.

Sri Lanka would likely face significant challenges in foreign debt servicing in the medium term. With annual external debt repayment commitments being around US dollars 4 to 5 billion from 2019 onwards, there is a significant borrowing need in the form of ISBs and other financing facilities from international financial markets. The cost of such borrowings could also be higher with the possibility of rising

Table 5.15
External Debt Service Payments

Item	US\$ million					Rs. million				
	2014	2015	2016	2017 (a)	2018 (b)	2014	2015	2016	2017 (a)	2018 (b)
1. Debt Service Payments	3,635	4,772	4,461	4,566	5,866	474,527	648,541	648,315	695,690	954,971
1.1 Amortisation	2,479	3,580	3,243	3,167	4,188	323,626	487,275	472,270	482,750	682,374
General Government	1,296	1,976	1,040	1,354	1,815	169,150	265,662	151,236	206,531	294,845
Project Loans	793	798	876	1,320	1,771	103,540	107,536	127,396	201,430	287,381
Debt securities	503	1,178	164	34	45	65,610	158,126	23,840	5,101	7,464
Central Bank	719	907	1,555	635	-	93,917	125,686	226,118	96,584	-
IMF	719	507	455	235	-	93,917	68,775	65,956	35,601	-
Swap and other liabilities	-	400	1,100	400	-	-	56,911	160,162	60,983	-
Private sector and deposit taking corporations	464	698	648	1,178	2,373	60,559	95,928	94,916	179,635	387,528
Foreign loans	309	553	559	559	596	40,280	76,199	81,944	85,242	97,270
Debt securities	-	-	-	500	1,350	-	-	-	76,169	217,384
Intercompany debt of direct investment enterprises	155	145	88	119	426	20,279	19,729	12,972	18,225	72,874
1.2 Interest Payments	1,156	1,192	1,219	1,399	1,678	150,901	161,266	176,045	212,419	270,209
General Government	876	870	862	1,063	1,280	114,368	117,496	124,042	161,458	207,905
Project Loans	260	266	264	332	425	33,883	36,024	38,440	50,652	68,847
Debt securities	616	604	597	731	855	80,485	81,472	85,602	110,806	139,057
Central Bank	20	13	10	16	30	2,546	1,693	1,436	2,119	4,834
IMF	20	10	8	12	24	2,546	1,395	1,179	1,897	3,833
Swap and other liabilities	-	2	2	3	6	-	298	257	222	1,001
Private sector and deposit taking corporations	260	309	347	311	354	33,986	42,077	50,567	47,433	57,441
Foreign loans	118	148	179	169	242	15,470	20,128	26,121	25,775	39,498
Debt securities	142	159	159	142	112	18,517	21,779	23,186	21,658	17,943
Intercompany debt of direct investment enterprises	-	1	9	9	15	-	170	1,260	1,409	2,388
2. Earnings from Export of Goods and Services	16,735	16,943	17,448	19,084	20,264					
3. Receipts from Export of Goods, Services, Income and Current Transfers	23,936	24,078	24,835	26,432	27,549					
4. Debt Service Ratio										
4.1 As a percentage of 2 above										
Overall Ratio	21.7	28.2	25.6	23.9	28.9					
Excluding IMF transactions	17.3	25.1	22.9	22.6	28.8					
4.2 As a percentage of 3 above										
Overall ratio	15.2	19.8	18.0	17.3	21.3					
Excluding IMF transactions	12.1	17.7	16.1	16.3	21.2					
5. Government Debt Service Payments										
5.1 Government debt service payments (c)	2,172	2,846	1,901	2,417	3,095					
5.2 As a percentage of 1 above	59.7	59.6	42.6	52.9	52.8					

(a) Revised

(b) Provisional

(c) Excludes transactions with the IMF

Source : Central Bank of Sri Lanka

global interest rates in the medium term. A long-term approach to rebalance the current account as well as to ensure more non-debt creating inflows in the form of FDIs and equity investments to the financial account would be needed to keep foreign borrowings at sustainable levels.

5.11 Exchange Rate Movements

The exchange rate, which remained relatively stable during the first four months of 2018, came under significant pressure

thereafter, particularly during the latter part of 2018. During the first four months, the influx of foreign exchange to the domestic foreign exchange market enabled the Central Bank to absorb foreign exchange amounting to US dollars 459 million, on a net basis. However, this favourable condition was reversed since May 2018 onwards, as a result of both external and domestic factors. On the external front, the strengthening of the US economy prompted an increase in the policy rate of the Federal

Table 5.16
Exchange Rate Movements

Currency	In Rupees per unit of Foreign Currency						Percentage Change over Previous Year (a)			
	End Year Rate			Annual Average Rate			End Year		Annual Average	
	2016	2017	2018	2016	2017	2018	2017	2018	2017	2018
Euro	157.87	182.49	208.99	161.16	171.73	191.71	-13.49	-12.68	-6.16	-10.42
Indian rupee	2.21	2.39	2.61	2.17	2.34	2.38	-7.54	-8.72	-7.48	-1.47
Japanese yen	1.29	1.36	1.65	1.34	1.36	1.47	-5.10	-18.05	-1.12	-7.58
Pound sterling	184.04	205.54	231.86	197.15	196.47	216.67	-10.46	-11.35	0.35	-9.32
US dollar	149.80	152.85	182.75	145.60	152.46	162.54	-2.00	-16.36	-4.50	-6.20
SDR	201.38	217.69	253.51	202.39	211.49	229.90	-7.49	-14.13	-4.31	-8.00
Effective Exchange Rate Indices (b) (c) (2017=100)	End Year Index			Annual Average Index			Percentage Change over Previous Year			
							End Year Index		Annual Average Index	
	2016	2017	2018	2016	2017	2018	2017	2018	2017	2018
NEER 24-currencies	105.00	97.17	85.81	104.89	100.00	94.08	-7.46	-11.69	-4.66	-5.92
REER 24-currencies	103.05	99.34	87.81	100.79	100.00	95.49	-3.60	-11.60	-0.78	-4.51

(a) Changes computed on the basis of foreign currency equivalent of Sri Lanka rupees. The sign (-) indicates depreciation of Sri Lanka rupee against each currency, respectively. Source: Central Bank of Sri Lanka

(b) The Nominal Effective Exchange Rate (NEER) is a weighted average of nominal exchange rates of 24 trading partner and competitor countries. Weights are based on the trade shares reflecting the relative importance of each currency in each of the currency baskets. The Real Effective Exchange Rate (REER) is computed by adjusting the NEER for inflation differentials with respect to each currency in the basket. A minus sign indicates depreciation. CCPI was used for REER computation.

(c) The exchange rate have been defined in terms of indices so that the appreciation/depreciation of the rupee relative to other currencies is directly reflected by a rise/fall in the values of the effective exchange rate indices, respectively.

5 Reserve Bank, accompanied by the expectation of a number of possible interest rate hikes for 2018 and 2019. These developments resulted in continuous foreign investment outflows from the government securities market and the CSE, resulting in low liquidity levels in the domestic foreign exchange market. On the domestic front, an increased demand for foreign exchange by importers, lack of dollar conversions by exporters and unfavourable political developments contributed to the depreciation of the rupee, particularly in the latter part of 2018. With the Central Bank allowing greater flexibility in the exchange rate, the exchange rate was permitted to depreciate in line with market fundamentals, while intervening in the domestic foreign exchange market by providing liquidity only to mitigate excessive volatility of the exchange rate. This resulted in the Central Bank supplying US dollars 1,120 million on a net basis to the foreign exchange market during 2018, while the Sri Lankan rupee depreciating against the US dollar by 16.4 per cent during the year.

Other major currencies depreciated against the US dollar in line with the broad-based strengthening of the US dollar, amidst rate hikes by the US Federal Reserve Bank. Accordingly, the exchange rate of the Sri Lankan rupee depreciated against the euro by 12.68 per cent, the Indian rupee by 8.72 per cent, the Japanese yen by 18.05 per cent, and the pound sterling by 11.35 per cent. With the combined effect of the depreciation of the rupee against major currencies, the Sri Lankan rupee also depreciated against the SDR by 14.13 per cent during the year.

5.11.1 Nominal and Real Effective Exchange Rates

Both 5-currency and 24-currency Nominal Effective Exchange Rate (NEER) and REER indices (2017=100) declined during the year.¹ NEER indices declined, reflecting the nominal

¹ NEER and REER indices have been rebased to 2017 from 2010. More details on the rebasing of the indices can be found in Box Article 7.

BOX 7

Rebasing of the Real Effective Exchange Rate

1. Introduction

The Central Bank of Sri Lanka has been preparing the Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) indices based on 5-currency and 24-currency baskets since 1989 with periodical revisions introduced to the base year. The effective exchange rate indices¹ are revised regularly since the relative share of bilateral trade between certain countries could vary over time. For instance, the European Central Bank and Bank for International Settlements update base periods of their REER indices every three years. The base year of Sri Lanka's existing REER and NEER indices was 2010, and it was brought forward to 2017 to better reflect any changes in the relative share of trading partners. Following the base year revision to 2017, the current indices of 5-currency and 24-currency NEER and REER are calculated backward to start from January 2013 onwards.

2. Selection of the Base Year

The base year of NEER and REER reflect the contemporary trade patterns through the relative weights assigned for each country. As such, it is necessary to have the base year periodically updated in order to maintain realistic weights. When choosing the base year for determining the relative weights, several factors need to be considered, such as reflecting the recent trade patterns and stability in the exchange rates. If the structure of the foreign trade of a country is subject to frequent changes, updating should be made in shorter time intervals. When comparing the trade weights based on Sri Lanka's bilateral trade with trading partners between 2010 and 2017, some notable changes are observed. For instance, the relative share of Sri Lanka's bilateral trade with China and India has increased, while the relative share of Sri Lanka's bilateral trade with the UK, Belgium,

France, Germany and Hong Kong has reduced during the period from 2010 to 2017. The increase in bilateral trade share with China was mainly due to the increase in imports of textiles, machinery, building materials and telecommunication devices, while the increase in bilateral trade share with India was mainly due to the increase in imports of textiles, machinery, building materials and vehicles. The relative share of bilateral trade with most of other countries has been adjusted accordingly [the revised trade weights are shown in Table B 7.1]. Therefore, rebasing the NEER and REER from 2010 to 2017 would adequately capture the change in trade patterns with trading partners over time. With regard to the exchange rate, the year should not have experienced excessive volatility. Hence, the year 2017 was considered to be more appropriate, where the exchange rate remained relatively stable.

Table B 7.1
Comparison of 24 Currency NEER/REER Trade Weights

Country	Weights used for base year 2017 (%)	Weights used for base year 2010 (%)	Difference (%)
USA	19.30	19.74	(0.44)
India	16.65	15.57	1.08
China	14.26	6.41	7.85
UK	7.18	9.86	(2.68)
Japan	4.66	4.99	(0.33)
Germany	4.60	5.88	(1.29)
Italy	4.18	4.83	(0.64)
Hong Kong	2.42	3.63	(1.22)
Belgium	2.36	4.45	(2.09)
Singapore	2.17	1.79	0.38
Malaysia	2.16	2.36	(0.20)
Canada	2.02	1.96	0.06
Thailand	2.01	2.15	(0.14)
Australia	1.96	0.97	0.98
Taiwan	1.87	1.51	0.36
Russia	1.85	2.18	(0.33)
Turkey	1.70	1.52	0.17
Netherlands	1.60	2.11	(0.51)
Pakistan	1.59	1.80	(0.20)
France	1.57	2.93	(1.36)
Indonesia	1.47	1.73	(0.26)
South Korea	1.43	1.17	0.25
Bangladesh	0.89	0.36	0.53
Kenya	0.13	0.10	0.03
Total	100.00	100.00	

¹The effective exchange rate measures the value of a currency against a basket of other currencies and is generally expressed as an index. Typically, the basket of foreign currencies comprises the currencies at major trading partners of the reference country. The NEER is the weighted geometric average of major bilateral nominal exchange rates, with weights based on the proportion of bilateral trade in Sri Lanka's total foreign trade: $NEER = \prod_{i=1}^n [e_i]^{w_i}$, where e_i = exchange rate of the foreign currency i against the home currency in indexed form, w_i = trade weights, n = no. of countries in the basket. The REER is obtained by adjusting the Nominal Effective Exchange Rate for inflation differentials between domestic and respective foreign countries and used as an indicator of the country's external competitiveness. The REER index is typically used as an indicator of export competitiveness or currency misalignment: $REER = \prod_{i=1}^n [e_i \cdot (P/P_i)]^{w_i}$, where P = consumer price index (CPI) of Sri Lanka compared to the base period index, P_i = CPI of country i compared to the base period index.

3. Implications of the Rebasing of the REER

The Figure B 7.1 compares the REER index based on the previous base year of 2010 and the revised base year of 2017. As the Figure shows, the base year revision leads to a downward shift in the newly calculated REER in parallel to the previous index as the trend in both indices remains broadly intact. The downward shift in the REER with the rebasing to 2017 indicates that the real exchange rate in 2017 was more competitive than it was reflected in the base year of 2010. Further, the relatively parallel shift reflects the fact that, the methodology and underlying assumptions on calculating the REER were kept the same, while the trade weights between 2017 and 2010 have not changed significantly for majority of trading partners.

Figure B 7.1
Comparison of REER 24 (2010=100)
and REER 24 (2017=100)

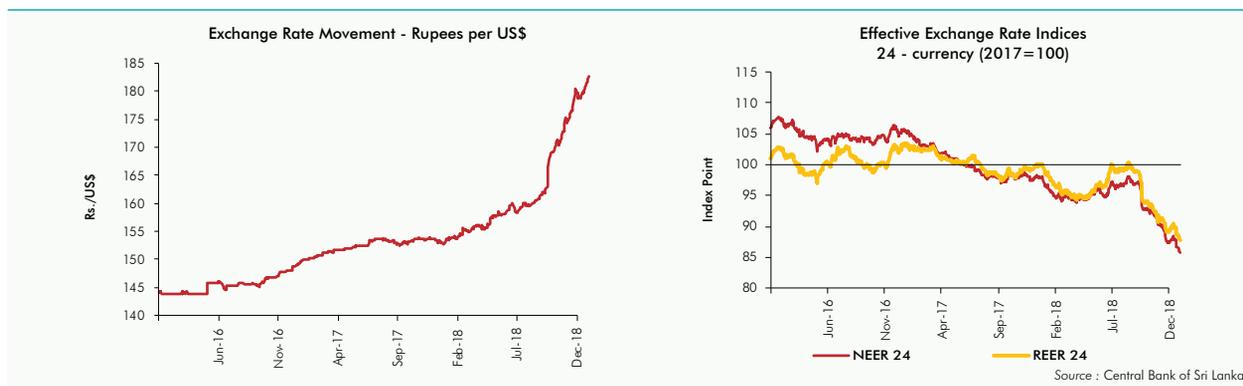


depreciation of the Sri Lankan rupee against selected major currencies together with the movements in cross currency exchange rates. Accordingly, the 5-currency NEER index depreciated by 12.74 per cent, while the 24-currency index depreciated by 11.69 per cent in 2018. Meanwhile, the 5-currency and 24-currency REER indices, which indicate Sri Lanka’s external competitiveness implied by the inflation differential between countries along with the variation in nominal exchange rates, also dropped during the year, by 12.46 per cent and 11.60 per cent, respectively. REER indices remained predominantly below the base year level in 2018, indicating the continued competitiveness of the Sri Lankan rupee.

5.11.2 Developments in the Domestic Foreign Exchange Market

In 2018, the spot market continued to remain active in response to the more market-based exchange rate policy, while the volume of forward transactions declined. With the increase in spot market transactions, the total volume of transactions in the domestic foreign exchange market increased during the year to US dollars 17,402 million, from US dollars 16,451 million in 2017. The volume of spot transactions increased markedly to US dollars 10,770 million (61.9 per cent of total transactions) in 2018 from

Figure 5.15
Exchange Rate Movements



5

Figure 5.16
Quarterly Inter - Bank Forward Transaction Volumes



US dollars 8,426 million in 2017. However, the total volume of forward transactions decreased to US dollars 6,632 million in 2018 from US dollars 8,025 million in 2017. Meanwhile, the intervention by the Central Bank in the domestic foreign exchange market during the year resulted in a supply of US dollars 1,120 million, on a net basis, in 2018. This included a supply of US dollars 1,677 million and an absorption of US dollars 557 million. In contrast, during 2017 the Central Bank purchased foreign exchange liquidity amounting to US dollars 2,214 million while supplying US dollars 550 million. The higher level of net supply in 2018 was due to the increase in foreign exchange outflows particularly in the second half of the year, which necessitated the Central Bank's intervention in supplying liquidity to the foreign exchange market to stabilise the Sri Lankan rupee.

5.12 External Sector Outlook

The external sector outlook in 2019 remains positive despite some downside risks. The deficit in the trade account is expected to contract during 2019 with the anticipated deceleration in imports supported by the changes introduced in the import related taxes and the potential impact of the sharp depreciation of the rupee in 2018. The growth momentum in export earnings is expected to accelerate in 2019, supported by the

enhancements of trade relations with new trading partners, conducive external trade policies, strong institutional support and a more competitive exchange rate. The surplus in the services account is expected to improve in 2019 supported by higher inflows, particularly on account of tourism, IT, BPO and transport services. The workers' remittances are expected to remain at current levels while the deficit in the primary income account is expected to widen with an increase in interest payments amidst relatively tighter global financial market conditions. Meanwhile, the financial account of the BOP is expected to improve with higher FDI inflows into the long-term development projects in the Colombo Port City and the Hambantota industrial zone, among others. Further, the foreign investments to the CSE and the government securities market are also expected to stabilize with the sluggish pace of interest rate normalization in advanced economies. In addition, the recommencement of the IMF - EFF is also expected to strengthen the external sector with improved investor sentiment. The expected reduction in the current account deficit and the accompanying financial account flows are expected to contribute to the gradual strengthening of the exchange rate and an accumulation of official reserves during the year.

The external sector outlook in 2019 could experience downside risks due to potential vulnerabilities. On the domestic front, the net impact of removal of import curtailing measures introduced in the second half of 2018 and the tariff adjustments introduced in imports subsequent to the 2019 Budget along with the potential removal of the suspension of using permits for vehicle imports during the year could result in an increase in the demand for vehicle imports, potentially reversing some of the gains observed in the trade balance. On the external front, the import expenditure on fuel could also rise in the case of an increase

of global fuel prices due to a potential supply restriction by oil producing countries and other geopolitical factors. In addition, some pressure on the exchange rate could materialize in 2019 with political developments during elections towards the second half of 2019. Further, the perceived uncertainty in the pace and magnitude of interest rate normalisation of advanced economies could affect cross-border capital flows, thereby weighing on envisaged foreign investments in the CSE and government securities market.

The projected rise in foreign currency debt service payments remains a major concern in 2019 and over the medium term. With annual external debt repayment commitments of over US dollars 5 billion on average, mainly including the maturity of several ISBs and capital repayments of foreign currency term financing facilities falling due in 2019 and beyond, Sri Lanka could face

heightened refinancing risks, unless managed by prudent debt management measures. In this context, reducing the reliance on foreign borrowings in financing the current account deficit, maintaining a sustainable current account deficit and bolstering international reserves through long term non-debt creating capital flows would be major priorities. The government's plans to attract FDI into the export oriented manufacturing and services sectors need to ensure FDI inflows of at least US dollars 3 billion per annum over the medium-term in order to keep foreign borrowings at a minimum level, thereby containing the vulnerability of external debt. Further, the timely implementation of measures towards harnessing the potential of services exports, particularly as envisaged in the National Export Strategy of the government could ensure higher inflows of foreign exchange in 2019 and over the medium term.