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EXTERNAL SECTOR DEVELOPMENTS

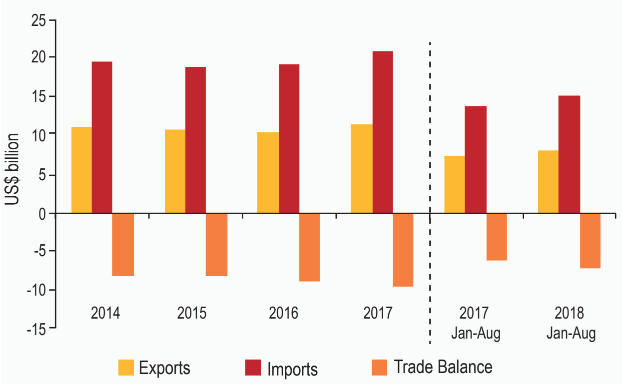
Sri Lanka's external sector continued to be under pressure so far during the year with less than expected foreign exchange inflows to the current account, increased capital outflows and inadequate foreign investments. The current account deficit increased to US dollars 1,813 million during the first half of 2018 from US dollars 1,037 million in the corresponding period of 2017, following the considerable expansion in the trade deficit and the deficit in the primary income account. Despite an increase in export earnings, the trade deficit widened substantially during the first half of 2018 due to the significant growth in import expenditure, particularly driven by higher import of fuel, vehicles and gold. Increased foreign exchange outflows in the form of dividends and interest resulted in an expansion in the deficit of the primary income account. However, surpluses in the services and the secondary income accounts helped to abate a large expansion in the current account deficit. Meanwhile, the financial account of the balance of payments (BOP) was augmented with the proceeds of two International Sovereign Bonds (ISBs), the fifth tranche of the International Monetary Fund - Extended Fund Facility (IMF-EFF) and Foreign Direct Investments (FDIs). However, higher debt service payments and net foreign exchange sales to the domestic foreign exchange market by the Central Bank resulted in the overall balance recording a deficit of US dollars 650 million by end September 2018. Reflecting these developments, gross official reserves amounted to US dollars 7.2 billion, equivalent to 3.8 months of imports as at end September 2018. The exchange rate, which remained relatively stable during the first four months of 2018, underwent significant pressure to depreciate against the US dollar since then, due to both domestic and external factors. In the external front, recent developments in global financial markets, particularly the strengthening of the US economy which prompted an increase in policy rates of the Federal Reserve Bank, resulted in outflows of foreign investments from capital markets in emerging economies. Sri Lanka also experienced continuous foreign investment outflows from the government securities market and the Colombo Stock Exchange (CSE) resulting in low liquidity levels in the domestic foreign exchange market. In the domestic front, lower than expected foreign exchange earnings and higher demand for foreign currency contributed to the depreciation of the rupee. Consequently, the external value of the Sri Lankan rupee depreciated by 9.7 per cent against the US dollar by end September 2018. These conditions necessitated the Central Bank to intervene in the domestic foreign exchange market on instances of excessive volatility of the exchange rate. However, the Central Bank allowed more flexibility in the exchange rate, permitting the exchange rate to depreciate in line with market fundamentals, while maintaining a healthy level of gross official reserves. The government and the Central Bank also adopted several measures to address the undue pressure in the foreign exchange market by imposing customs duty on the importation of gold and a number of short term restrictive measures on the importation of vehicles and certain non-essential consumer goods. Meanwhile, external debt of the country rose necessitating the proactive management of government debt through the implementation of the Active Liability Management Act.

Merchandise Trade and Trade Balance

- **Both earnings from exports and expenditure on imports continued to increase during the first eight months of 2018.** Earnings from exports increased by 5.8 per cent during the first eight months of the year in comparison to the corresponding period of 2017, while import expenditure increased by 10.9 per cent. Accordingly, the deficit in the trade account expanded during the first eight months of 2018 to US dollars 7,240 million from US dollars 6,184 million in the corresponding period of 2017, as import growth outpaced export growth.

- **Maintaining the growth trajectory observed from March 2017, earnings from export of merchandise goods continued to increase during the first eight months of 2018.** Accordingly, export earnings increased by 5.8 per cent to US dollars 7,842 million during the first eight months of 2018, in comparison to US dollars 7,413 million in the corresponding period of 2017. This growth was underpinned by the restoration of the European Union's Generalised System of Preferences plus (EU-GSP+) facility, increased commodity prices in the international market, conducive external trade policies together with strong institutional support and the flexible exchange rate policy maintained by the Central Bank. The expansion in exports emanated from industrial exports, while agricultural and mineral exports declined during the period.

Figure 5.1
External Trade Performance



Sources: Sri Lanka Customs
Central Bank of Sri Lanka

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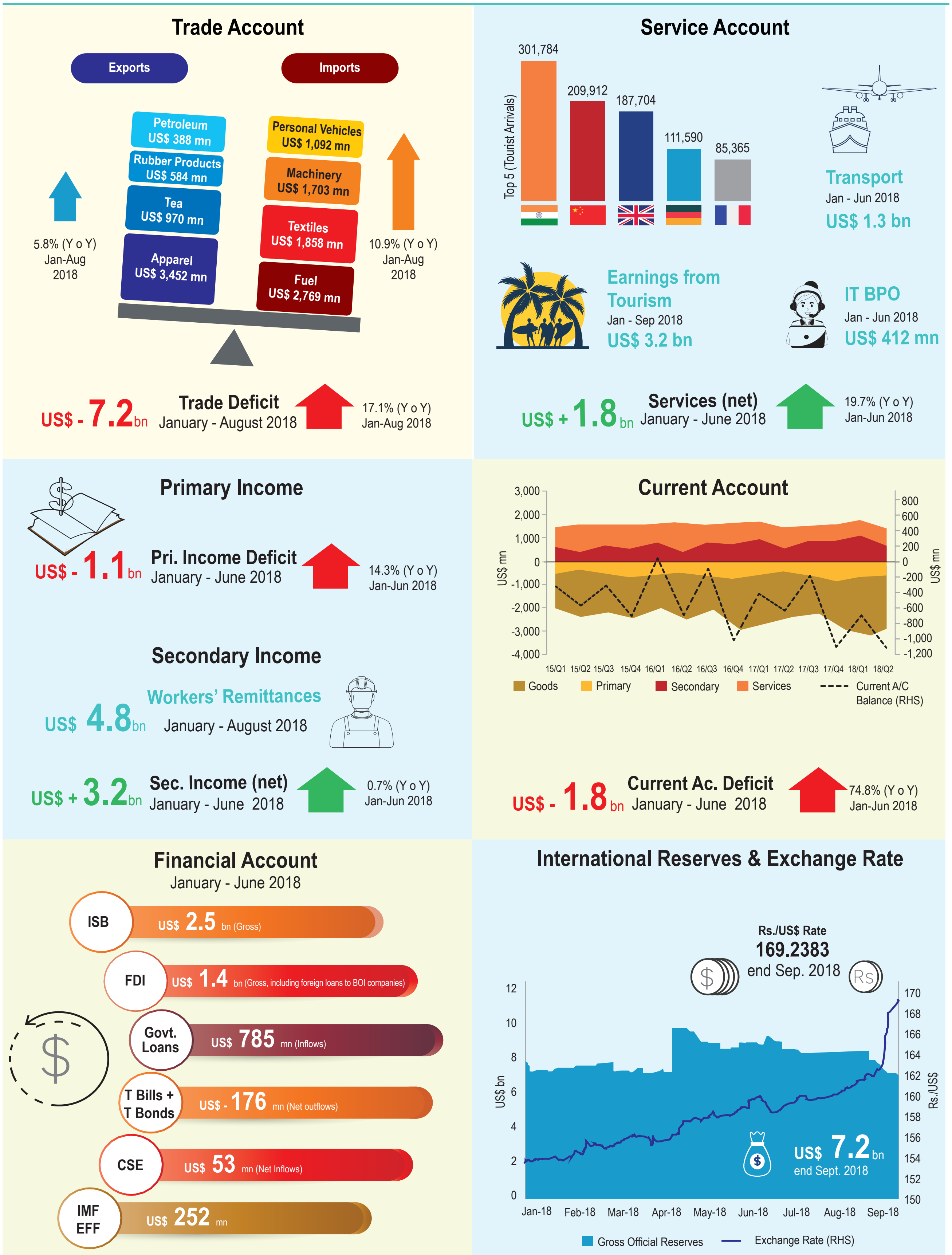
- **Earnings from industrial exports, which account for around 78 per cent of total exports, increased by 9.4 per cent to US dollars 6,085 million during the first eight months of 2018, in comparison to the corresponding period of 2017.** This increase was mainly driven by the higher performance registered in earnings from textiles and garments, rubber products, petroleum products, food, beverages and tobacco, and machinery and mechanical appliances. Export proceeds from textiles and garments increased by 5.1 per cent to US dollars 3,452 million during the first eight months of 2018 with the support of the restoration of the EU-GSP+ facility since May 2017. Accordingly, earnings from garment exports to the EU increased by 4.8 per cent to US dollars 1,373 million during the first eight months of the year, owing to the higher demand from Germany, Italy, Netherlands and Sweden, despite the decline in demand from the UK. Meanwhile, earnings from garment exports to the USA and non-traditional markets such as India, Japan, Mexico and Indonesia increased by 4.7 per cent and 1.8 per cent, respectively, during the period under consideration. Export earnings from rubber products increased by 8.6 per cent to US dollars 584 million during the first eight months of 2018, reflecting an improved performance in rubber tyre exports. Export earnings from petroleum products increased significantly by 53.5 per cent, year-on-year, during the first eight months of 2018, due to the combined impact of higher export volumes, and prices of bunker and aviation fuel. Further, export earnings from food, beverages and tobacco rose by 20.1 per cent to US dollars 311 million during the first eight months of the year, owing to the improved performance in manufactured tobacco and vegetable, fruit and nuts preparations, in particular coconut related products. Export receipts from machinery and mechanical appliances also increased by 22.1 per cent during the first eight months of 2018, mainly due to higher receipts from electronic equipment. In addition, earnings from gems, diamonds and jewellery, base metals and articles, chemical products and animal fodder contributed towards the increase in industrial exports during the first

Figure 5.2
External Sector: Balance of Payments, International Reserves and Exchange Rate

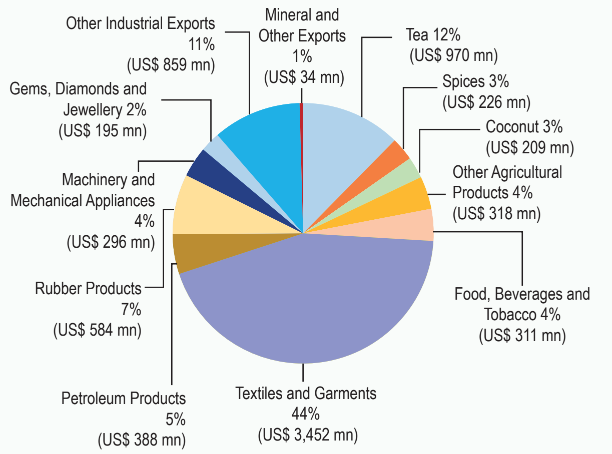


eight months of 2018. However, earnings from transport equipment declined significantly by 34.0 per cent, year-on-year, to US dollars 91 million during the first eight months of 2018, mainly due to the base effect, as three ships were exported to Singapore during the first eight months of 2017. Additionally, export earnings from leather, travel goods and footwear, ceramic products and printing industry products also declined during the period under review.

- **Agricultural exports, which account for about 22 per cent of total exports, declined by 5.0 per cent to US dollars 1,723 million during the first eight months of 2018 due to poor performance in almost all sub categories except seafood and unmanufactured tobacco**. Earnings from tea exports declined by 3.2 per cent to US dollars 970 million during the first eight months of 2018, due to the combined impact of lower average export prices and export volumes of tea. Despite an increase recorded in the first quarter, the average export price of one kilogram of tea declined during the first eight months of the year to US dollars 5.20 from US dollars 5.27 in the corresponding period of 2017. The volume of tea exported also declined by 1.9 per cent during the period under consideration with poor production. Russia, Turkey, Iraq and Iran were the major buyers of Sri Lankan tea during the first eight months of 2018, contributing nearly 41 per cent to earnings from tea exports. Earnings from coconut exports declined by 12.8 per cent to US dollars 209 million during the first eight months of the year, mainly due to the drop in volumes of desiccated coconut, coconut oil and copra exports, despite higher average export prices recorded for coconut kernel products. Lower production of coconut owing to the lag effect of adverse weather conditions affected the decline in export volumes of coconut kernel products. Export earnings from spices reduced by 9.3 per cent to US dollars 226 million during the first eight months of 2018, mainly due to the significant reduction in export of cloves and nutmeg and mace, despite higher earnings received from cinnamon and pepper exports. However, earnings from seafood exports rose by 9.0 per cent, year-on-year, to US dollars 169 million during the period, 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 55.4 per cent to US dollars 60 million during the first eight months of 2018, due to the higher demand from Italy, France, Germany and Netherlands.

Figure 5.3

Composition of Exports (Jan - Aug 2018)



Sources: Ceylon Petroleum Corporation and other exporters of petroleum
National Gem and Jewellery Authority
Sri Lanka Customs
Central Bank of Sri Lanka

- **Earnings from mineral exports declined by 9.4 per cent, year-on-year, to US dollars 22 million during the first eight months of 2018, in comparison to the 24.6 per cent growth registered in 2017.** This decline was mainly due to the poor performance in exports of earth and stone and ores, slag and ash.

- **Expenditure on imports continued to increase during the first eight months of 2018, mainly due to higher importation of fuel, vehicles for personal use, and textiles and textile articles.** Accordingly, expenditure on imports increased by 10.9 per cent, year-on-year, to US dollars 15,083 million during the first eight months of 2018. Meanwhile, import expenditure excluding fuel grew by 7.6 per cent to US dollars 12,314 million during this period. However, both the government and the Central Bank introduced several policy measures with the intention of mitigating the pressure on the exchange rate arising from the expansion in the expenditure on imports.

- **Expenditure on intermediate goods imports, which account for more than a half of total imports, contributed largely to the expansion in import expenditure during the first eight months of 2018**. Expenditure on intermediate goods imports increased by 14.9 per cent, year-on-year, to US dollars 8,357 million during the first eight months of the year, mainly driven by high expenses incurred on the importation of fuel. Expenditure on fuel imports increased significantly by 28.6 per cent from a year earlier to US dollars 2,769 million during the first eight months of 2018, owing to higher import volumes and elevated prices of both refined petroleum products and crude oil. Reflecting the increasing trend of oil prices in the international market, the average import price of crude oil increased by 40.7 per cent to US dollars 76.49 per barrel during the period under review from US dollars 54.38 per barrel in the corresponding period of 2017. Further, in line with the high demand for textiles and garment exports, expenditure on import of textiles and textile articles increased by 4.3 per cent, year-on-year, during the first eight months of 2018 due to the increase in fabric and yarn imports. On a year-on-year basis, expenditure on plastics and articles thereof increased by 15.6 per cent due to high expenditure incurred on all sub categories, while expenditure on base metal imports increased by 17.7 per cent mainly due to high imports of iron and steel. Further, expenditure on chemical products and fertiliser imports contributed towards the increase in intermediate goods imports during the first eight months of the year. Import expenditure on diamonds, precious stones and metals increased by 9.2 per cent, year-on-year, during the first eight months of 2018 due to high gold imports recorded during the first four months of the year. Considering the possible illicit arbitrage resulting from the tariff differential between India and Sri Lanka on gold, as India maintains a customs duty of 10 per cent for gold in the absence of taxation on gold imports in to Sri Lanka, the Government of Sri Lanka imposed a 15 per cent customs duty on the importation of gold in April 2018. As a result, import expenditure on gold declined considerably since May 2018. Meanwhile, import expenditure on rubber and articles thereof decreased by 9.8 per cent during the period under review.

- **Despite the reduction in import expenditure on food and beverages, higher expenditure on consumer durables led to an increase in expenditure on consumer goods imports during the first eight months of 2018**. Overall, import expenditure on consumer goods increased by 16.7 per cent to US dollars 3,441 million during the first eight months of 2018 from US dollars 2,950 million in the corresponding period of 2017. However, import expenditure on food and beverages declined by 4.7 per cent to US dollars 1,148 million during the first eight months of 2018, mainly due to the reduction in expenditure on rice imports. Increased domestic supply of rice following a recovery in the paddy harvest during the 2017/18 Maha and 2018 Yala seasons led to a decline in rice imports to 241 million kilograms during the first eight months of 2018, from 446 million kilograms during the corresponding period of 2017. Meanwhile, import expenditure on vegetables and seafood decreased by 6.5 per cent and 7.9 per cent, respectively, during the first eight months of 2018 from a year earlier. Import expenditure on non-food consumer goods increased significantly by 31.4 per cent, year-on-year, to US dollars 2,293 million, mainly driven by imports of personal motor vehicles, which registered a more than two-fold growth with a substantial increase in the importation of small engine capacity vehicles, hybrid and electric vehicles. During the first eight months of the year, personal motor vehicle imports increased by 116.3 per cent to US dollars 1,092 million as a result of the revised tax structure for vehicles in the 2018 Budget. However, considering the pressure on the BOP from increased imports, both the Central Bank and the government took several measures aimed at curtailing high vehicle imports. Accordingly, taxes applicable on the importation of cars with less than 1,000 cylinder capacity (cc), hybrid and electric vehicles were revised upward with effect from 01 August 2018 and a 100 per cent margin deposit requirement was imposed against letters of credit (LCs) on non-commercial vehicle imports with effect from 19 September 2018. Further, the margin deposit requirement against LCs on non-commercial vehicle imports was increased to 200 per cent, while 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, with effect from 01 October 2018. Concessionary vehicle permits were also suspended for a limited period. To discourage non-essential consumer goods imports, 100 per cent minimum cash margins against LCs / documents against acceptance (DA) terms for certain non-essential consumer goods imports were introduced, while authorised dealers were prohibited to release foreign exchange that involved conversion of Sri Lankan rupees for making payments for those goods under advance payments. Meanwhile, expenditure on medical and pharmaceuticals and telecommunication devices increased during the period.

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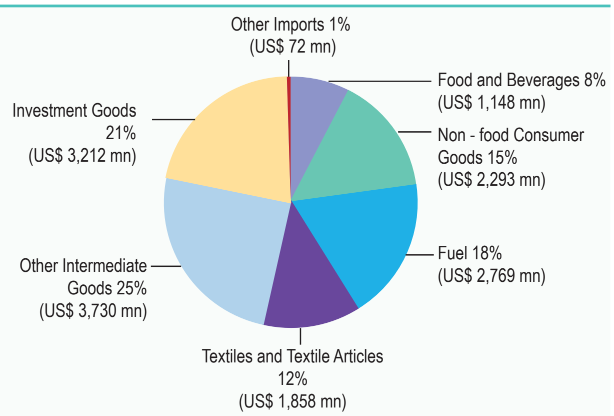
- **Expenditure on investment goods declined marginally by 0.8 per cent to US dollars 3,212 million during the first eight months of 2018, due to lower expenditure that incurred on machinery and equipment and building material**. Outlays on machinery and equipment declined by 2.0 per cent, year-on-year, to US dollars 1,703 million, owing to the reduction reported in engineering equipment, printing machinery, electrical machinery and equipment, and electric motors and generating sets. Further, import expenditure on building material decreased by 4.0 per cent, year-on-year, due to a drop in iron, and steel and articles, cement and mineral products imports. However, import expenditure on transport equipment increased by 12.2 per cent, due to higher imports of commercial vehicles such as commercial cabs, auto-trishaws and buses as well as four ships.

Figure 5.4
Composition of Imports (Jan - Aug 2018)

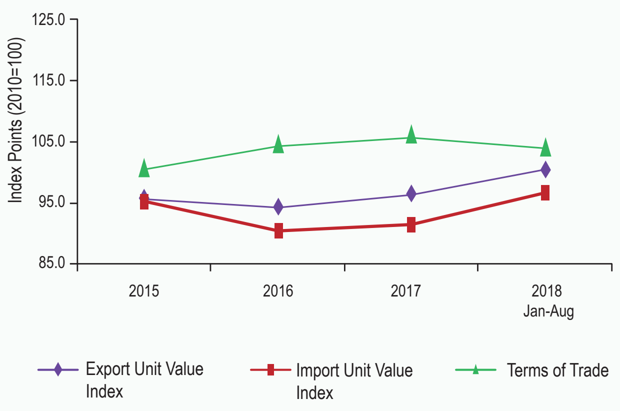


Sources: Ceylon Petroleum Corporation
Lanka IOC PLC
Sri Lanka Customs
Central Bank of Sri Lanka

Terms of Trade

- **On average, the terms of trade, deteriorated marginally during the first eight months of 2018, in comparison to the corresponding period of 2017, reflecting a higher increase in the import price index relative to the increase in the export price index**. The overall export price index rose by 4.4 per cent, year-on-year, to 100.5 index points during the first eight months of 2018 due to the increase in prices of industrial exports. The export price index for industrial exports increased by 6.4 per cent during the first eight months of 2018, mainly on account of a 27.9 per cent increase in the price index pertaining to petroleum products. In addition, price indices pertaining to textiles and garments, chemical products, ceramic products and rubber products increased during the period. However, the agricultural export price index declined marginally by 0.2 per cent in comparison to the corresponding period of 2017, owing to the decline in price indices pertaining to tea, minor agricultural products, spices, vegetables and rubber. Meanwhile, export price indices of coconut and seafood categorised under agricultural exports increased during the first eight months of 2018. The overall import price index increased by 5.0 per cent during the first eight months of 2018 mainly due to the increase in prices of fuel, paper and paperboard, plastic and articles, chemical products, and wheat and maize, categorised under intermediate goods. The price index

Figure 5.5
Terms of Trade and Trade Indices



Source: Central Bank of Sri Lanka

pertaining to consumer goods also increased marginally supported by high prices of vehicles, clothing and accessories, seafood, rubber products, and oils and fats. However, the import price index for investment goods decreased during the first eight months of 2018, reflecting lower prices of machinery and equipment, and building materials. Accordingly, the terms of trade deteriorated by 0.6 per cent to 103.9 index points during the first eight months of 2018 from 104.5 index points in the corresponding period of 2017. However, excluding oil-related products, the terms of trade improved by 2.3 per cent, year-on-year, during the first eight months of the year.

Trade in Services

- **The higher surplus in the services account helped finance the widened trade deficit to a certain extent during the first half of the year**. Net inflows to the services account increased by 19.7 per cent to US dollars 1,838 million in the first half of 2018, in comparison to US dollars 1,535 million in the first half of 2017. The main growth drivers in the services account were tourist earnings followed by earnings from transport services and computer services. Earnings from tourism[1] increased by 15.3 per cent, year-on-year, during the first half of 2018 to US dollars 2,160 million, as the moderate growth in tourist arrivals that was experienced in the first half of 2017 was reversed. Meanwhile, earnings from the transport sector grew by 9.5 per cent, year-on-year, primarily propelled by increased activity in the Colombo and Hambantota ports, with all three terminals in the Colombo Port recording a healthy growth in container handling and transshipments during the period. Earnings from the export of computer services also recorded an increase of 8.1 per cent during the first half of 2018 vis-a-vis the first half of 2017.

- **The Sri Lankan tourism industry continued to be a major foreign exchange earner in the economy**. During the first nine months of 2018, tourist arrivals increased by 11.6 per cent to 1,731,922 arrivals, in comparison to a growth of 2.9 per cent during the corresponding period of 2017. Reflecting the increase in tourist arrivals in the first nine months of 2018, earnings from tourism amounted to US dollars 3,212 million compared to US dollars 2,878 million during the corresponding period of 2017. Improved quality of service delivery, targeted tourist promotion campaigns as well as the low base for tourist arrivals in the previous year contributed to the higher growth witnessed in the tourism industry in 2018. While Western Europe dominated tourist arrivals, South Asia and East Asia followed. However, tourist arrivals from East Asia declined marginally by 1.3 per cent, year-on-year, during this period, mainly due to lower arrivals from

Figure 5.6
Tourist Arrivals and Earnings from Tourism

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

1 This provisional estimate may be revised once the Sri Lanka Tourism Development Authority releases its survey results on average stay period and average spending per day estimates for 2018.

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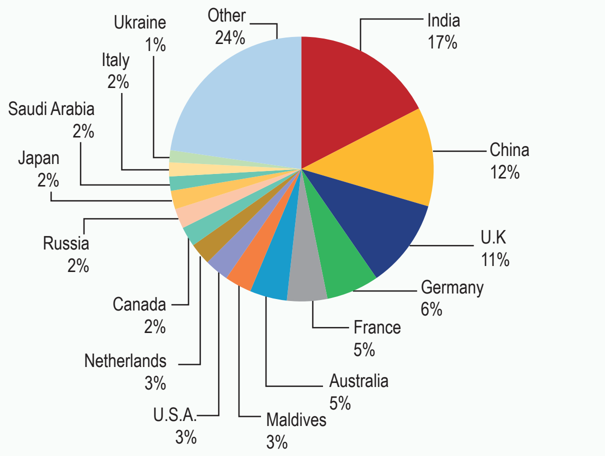
Figure 5.7
Tourist Arrivals by Country (Jan - Sep 2018)



Source: Sri Lanka Tourism Development Authority

Indonesia. In terms of country of origin, arrivals from India, the major tourist origin for Sri Lanka, increased significantly by 12.8 per cent to 301,784, while arrivals from China, the second largest tourist origin, recorded a marginal growth.

- **The tourism industry has attracted a substantial quantum of investments during the first eight months of 2018**. During the first eight months of 2018, the One Stop Unit (OSU) at the Sri Lanka Tourism Development Authority (SLTDA) received investment proposals for 100 new hotel projects entailing an investment value of US dollars 830 million and the addition of 3,182 rooms upon completion of these projects. From the proposals received so far, the final approvals were granted for 29 hotel projects with 1,016 rooms, with a total value of US dollars 104 million during the first eight months of 2018. In addition, 24 hotel projects commenced operations, adding 878 rooms during this period.

Primary Income

- **The deficit in the primary income account during the first half of 2018 widened with an increase in interest payments by the government and higher dividend and re-invested earnings by foreign direct investment enterprises**. Accordingly, the deficit in the primary income account widened to US dollars 1,139 million in the first half of 2018 compared to US dollars 997 million in the first half of 2017. With the increase in foreign direct investments (FDI) received by Board of Investment (BOI) companies, re-invested earnings increased to US dollars 114 million in the first half of 2018, from US dollars 105 million in the first half of 2017. Dividend payments to foreign investors also increased to US dollars 265 million in the first half of 2018 compared to US dollars 218 million in the corresponding period of 2017. Moreover, interest payments on debt securities and foreign loans increased during the first half of 2018 to US dollars 462 million and US dollars 327 million, respectively. This increase was mainly due to coupon and interest payments on account of new issuances of International Sovereign Bonds (ISBs) and foreign loans obtained by the government in 2017. Interest payments on borrowings made by the government and the private sector in the first half of 2018 were also impacted by the gradual increase in global interest rates.

Secondary Income

- **The surplus in the secondary income account increased marginally, with a gradual rebound in workers' remittances in the first half of 2018**. Workers' remittances in the first half of 2018 increased marginally by 0.9 per cent to US dollars 3,624 million, in comparison to US dollars 3,591 million during the first half of 2017, showing signs of recovery from the contraction observed in the previous year. However, by the end of the first eight months of 2018, on a cumulative basis, workers' remittances declined by 0.9 per cent to US dollars 4,777 million, in comparison to the corresponding period of 2017, with moderate inflows recorded in July and August 2018. Nevertheless, in the medium term, a rebound in workers' remittances is expected with the gradual recovery in global economic growth including that of the Middle East. The increase in international oil prices may also contribute to the stabilisation of the Middle Eastern economies, thereby contributing to the gradual pick up in workers' remittances.

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Current Account Balance

- **The external current account deficit widened significantly in the first half of 2018**. The current account deficit widened to US dollars 1,813 million in the first half of 2018 from US dollars 1,037 million in the first half of 2017, primarily due to the significant expansion of deficits in the trade and primary income accounts. The trade deficit widened during the first half of 2018, mainly due to higher import expenditure driven by fuel, personal vehicles and gold imports despite the pickup in export earnings. The deficit in the primary income account continued to expand due to increased re-invested earnings and dividend payments by FDI companies and interest payments by the government. However, the increase in foreign exchange earnings on services exports, mainly from tourist earnings and the surplus in the secondary income account, helped cushion the current account deficit to a certain extent.

Capital Account Balance

- **Inflows to the capital account remained modest during the first half of 2018**. On a net basis, inflows to the capital account recorded a marginal decline to US dollars 9 million in the first half of the year from US dollars 12 million in the first half of 2017, reflecting the diminishing trend in capital grants receipts.

Financial Account

- **Significant inflows to the financial account were recorded with some outflows from equity and bond markets in the first half of 2018**. Inflows to the financial account were augmented mainly by the proceeds of two ISBs issued by the government and FDIs. Sri Lanka issued two new ISBs to the value of US dollars 1.25 billion each in April 2018, which constituted major inflows to the financial account in the first half of 2018. Sri Lanka also received significant inflows of FDI amounting to US dollars 1,353 million, including foreign loans to BOI companies during the first half of 2018. The receipt of the fifth tranche of the IMF-EFF of US dollars 252 million, trade credits of US dollars 345 million received by the private sector and state owned business enterprises (SOBEs) and net foreign loan inflows of US dollars 199 million received by the private sector were the other major inflows to the financial account of the BOP during the first half of 2018.

- **FDI, which include foreign borrowings of BOI companies, increased significantly during the first half of 2018**. Accordingly, total FDI inflows, including foreign loans received by companies registered with the BOI, amounted to US dollars 1,353 million in the first half of 2018, in comparison to US dollars 567 million in the corresponding period of 2017. FDIs, excluding foreign loans obtained by BOI companies, also recorded a noteworthy increase, amounting to US dollars 1,071 million in the first half of 2018, in comparison to US dollars 365 million in the corresponding period in 2017. FDI inflows during the first half of 2018 were mainly received by the Hambantota International Port Group (Pvt) Ltd amounting to US dollars 682 million. On a sectoral basis, major inflows were channelled to ports, telecommunications, housing and property development and hotel sectors. In addition, the manufacturing sector received a moderate quantum of FDI during the period. Based on the origin of the immediate investor, China, India, Hong Kong, Malaysia and Sweden were the top five source countries of FDIs in the first half of 2018.

- **Foreign loans received by Sri Lankan residents recorded a net outflow in the first half of 2018 compared to a net inflow in the first six months of 2017**. Inflows to the government on account of long term loans during the first half of 2018 amounted to US dollars 785 million, in comparison to US dollars 1,139 million in the first half of 2017. The significantly higher inflow recorded in the first half of 2017 was due to the proceeds of a foreign currency term financing facility of US dollars 450 million. However, repayments of foreign loans in the first six months of 2018 amounted to US dollars 1,039 million, in comparison to US dollars 617 million during the first half of 2017. This significant increase in 2018 can be attributed to the repayment of US dollars 473 million of foreign currency term financing facilities that were obtained in 2016 and 2017. As a result, foreign loans to the government recorded a net outflow of US dollars 254 million in the first half of 2018, in comparison to a net inflow of US dollars 522 million during the corresponding period of 2017.

- **Foreign investments in the government treasury bill and bond market witnessed a net outflow in the first half of 2018**. Foreign investments to the government treasury bills and bond market recorded a net outflow of US dollars 176 million in the first half of 2018 when compared to a net outflow of US dollars 153 million in the first half of 2017. Further, the government opted to issue two ISBs to the value of US dollars 2.5 billion in the first half of 2018 compared to US dollars 1.5 billion in the first half of 2017.

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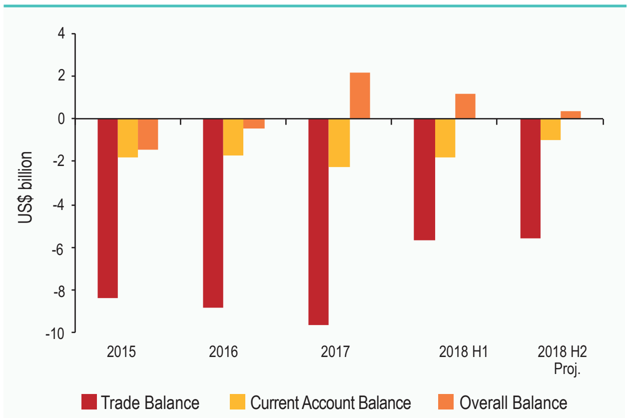
- **Portfolio investments in the form of equity recorded a net inflow in the first half of 2018**. Equity investments, primarily received by companies listed in the CSE, recorded a net inflow of US dollars 135 million during the first half of 2018. This is the combined effect of a net inflow of US dollars 74 million to the secondary market and an inflow of US dollars 61 million to the primary market. Further, in the context of foreign capital flows to the CSE, which consist of both portfolio and direct investments, net inflow of portfolio investments amounted to US dollars 135 million while FDI recorded a net outflow of US dollars 82 million, resulting in a total net inflow of US dollars 53 million.

Figure 5.8
Balance of Payments



Source: Central Bank of Sri Lanka

- **Foreign loans to the banking sector recorded a net outflow, while foreign loans to the private sector recorded a net inflow in the first half of 2018**. Foreign loans to the banking sector recorded a net outflow of US dollars 204 million in the first half of 2018 in comparison to a significant net inflow of US dollars 626 million in the first half of 2017. Meanwhile, foreign loans to the private sector and state owned business enterprises (SOBEs), recorded a net inflow of US dollars 199 million in the first half of 2018. There were no foreign loan disbursements to SOBEs during the period concerned, while the private sector recorded a loan inflow of US dollars 280 million. In terms of repayments, SOBEs and the private sector corporations recorded repayments of US dollars 68 million and 13 million, respectively, in the first half of 2018.

- **Overall, the financial account was supported by significant government borrowings and direct investments from divestiture proceeds of Hambantota Port in the first half of 2018**. The funding requirement created by a widening current account deficit, repayment of government foreign debt and budgetary financing has necessitated the government to continue to borrow from international sources. The need to continue borrowing from abroad was further aggravated by the gradual withdrawal of foreign investments from the government securities market and the CSE during the first half of the year in the wake of tightening global liquidity conditions.

International Investment Position (IIP)

- **Sri Lanka's external asset position with non-residents, as reflected in the International Investment Position (IIP), increased at end June 2018, in comparison to the asset position at end 2017**. The stock position of external assets increased primarily as a result of the increase in gross official reserves. The reserve asset position, which stood at US dollars 7,959 million at end December 2017 increased to US dollars 9,267 million at end June 2018, consequent to the receipt of the proceeds of the issuance of two ISBs, proceeds from the divestiture of the Hambantota Port and the receipt of the fifth tranche of the IMF-EFF. The outstanding asset position of trade credits and advances given by Sri Lankan exporters and deposit-taking corporations increased marginally by end June 2018, in comparison to the position at end 2017. Meanwhile, the asset position of direct investments at end June 2018 also increased marginally.

- **Sri Lanka's total liability position to non-residents, as reflected in the IIP, increased significantly by around US dollars 2.1 billion by end June 2018, from the beginning of the year**. The total liability position increased from US dollars 60,721 million as at end December 2017 to US dollars 62,830 million at end June 2018. This significant increase can be primarily attributed to the rise in outstanding government debt securities and the expansion in the total direct investment stock position compared to the beginning of the year. The outstanding liability position of government debt securities rose significantly by end June 2018 following the issuance of two new ISBs amounting to US dollars 2.5 billion in April 2018. Further, the outstanding portfolio investment liability position of deposit taking corporations reduced significantly with the maturity of an international bond of US dollars 500 million by the Bank of Ceylon (BOC) in April 2018. The total direct investment liability position also increased to US dollars 12,637 million at end June 2018, with increased FDI inflows to BOI companies and the proceeds from the divestiture of the Hambantota Port. The outstanding liability position of government loans, which constitutes the largest liability component of IIP, decreased from US dollars 19,201 million at end December 2017 to US dollars 18,913 million at end June 2018, as a result of net loan outflows. Further, there was an increase in the liability of outstanding trade credits of the private sector and SOBEs, with an increase in trade credits received by the Ceylon Petroleum Corporation during the first half of 2018. The outstanding loan liability position of the Central Bank also increased by end June 2018 with the receipt of the fifth tranche of the IMF-EFF. Meanwhile, the liability position of banks in terms of currency and deposits reduced significantly, while there was a moderate decrease in the outstanding liability position of foreign loans of the banking sector during the first half of 2018.

- **Sri Lanka's net international investment position, which takes into consideration the difference between the external total asset and liability positions, recorded an increase at end June 2018**. Despite a steady build-up of reserve assets in the first half of 2018, increased government borrowings in the form of ISBs, rise in direct investment position and other debt inflows have resulted in the total net international investment position rising from a net liability position of US dollars 48.4 billion at end December 2017 to a net liability position of US dollars 49.5 billion at end June 2018. This gradual build-up of Sri Lanka's net liability position is particularly driven by the government debt accumulated throughout the past few years.

External Debt Position

- **Sri Lanka's outstanding external debt continued to rise during the first half of 2018**. The external debt stock of the country increased from US dollars 51.8 billion at end 2017 to US dollars 53.5 billion at end June 2018. This increase in the debt stock was primarily driven by the external debt of the government, which accounts for around 60 per cent of Sri Lanka's total external debt. The outstanding external debt of the government increased to US dollars 32.6 billion at end June 2018 from US dollars 31.4 billion at end 2017, primarily due to the issuance of two new ISBs amounting to US dollars 2.5 billion despite the marginal decrease in the stock of foreign project loans. The outstanding external debt of the Central Bank increased marginally with the receipt of the fifth tranche of the IMF-EFF. The stock of external debt of the banking sector decreased significantly during the first half of the year with the maturity of an international bond raised by the BOC and reduced currency, deposits and foreign loans. Further, the external debt stock of the private sector and state-owned business enterprises increased during the first half of 2018 with the rise in trade credits and advances received by Sri Lankan importers as well as the increase in outstanding foreign loans of the private sector. Related party outstanding debt of direct investment enterprises also increased during the first half of 2018 with increased FDI inflows to BOI companies during the period.

Reserve Asset Position

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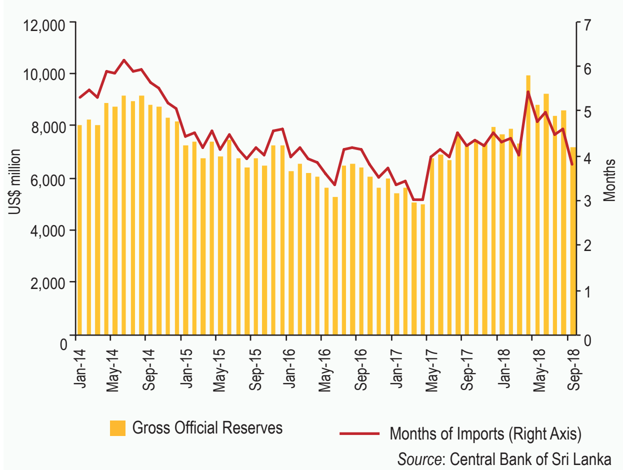
- **Reflecting higher inflows to the financial account, gross official reserves, which increased to a historic high level of US dollars 9.9 billion by end April 2018, declined to US dollars 7.2 billion by end September 2018**. The accumulation of reserves was mainly supported by inflows of ISB issuances amounting to US dollars 2.5 billion, proceeds from the divestiture of the Hambantota Port at US dollars 682 million and the receipt of the fifth tranche of IMF-EFF of US dollars 252 million. However, main outflows in terms of foreign project loan repayments including both interest and capital repayments and interest payments of ISB, capital repayments of foreign currency term financing facilities, net Asian Clearing Union (ACU) payments and supply of foreign exchange to the domestic foreign exchange market led to the decline of reserve position by end September 2018. Consequently, the level of gross official reserves by end September 2018 was equivalent to 3.8 months of imports. In addition, the gross reserve asset position covered 54 per cent of the country's short-term debt and liabilities as at end September 2018.

Figure 5.9
Gross Official Reserves and Months of Imports



Source: Central Bank of Sri Lanka

- **Total international reserves, which comprise gross official reserves and foreign assets of commercial banks, increased to US dollars 11.0 billion by end August 2018 from US dollars 10.4 billion as at end December 2017.** The increase was the combined effect of an increase in gross official reserves by US dollars 626 million and a decrease in holdings of commercial bank foreign assets by US dollars 82 million. By end August 2018, the import coverage of total international reserves was equivalent to 5.9 months.

Overall Balance

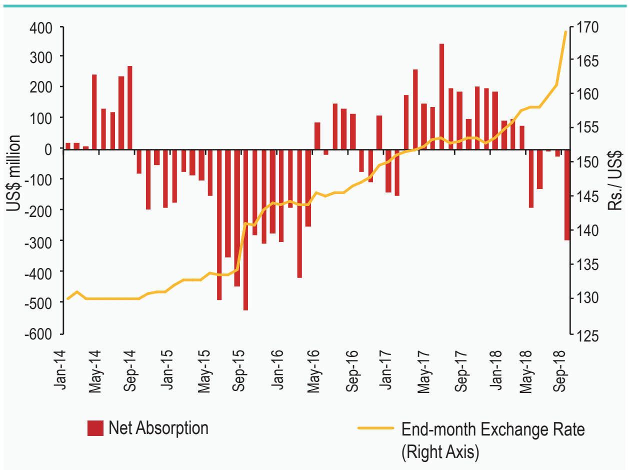
- **The overall balance, which recorded a surplus up to mid-September 2018, turned to a deficit by end September 2018.** Reflecting the decline in the reserve position primarily due to debt repayments and supply of foreign exchange by the Central Bank to the domestic foreign exchange market, the overall balance recorded a deficit of US dollars 650 million by end September 2018, in comparison to a surplus of US dollars 2,027 million during the corresponding period of 2017.

Exchange Rate Movements

- **The exchange rate, which remained relatively stable during the first four months of 2018, was under significant pressure thereafter**. 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 reversed from May 2018 onwards, as a result of both external and domestic factors. In the external front, the strengthening of the US economy prompted an increase in policy rates of the Federal Reserve Bank, accompanied by the announcement of a higher number of possible interest rate hikes for 2018 and 2019. These developments resulted in outflows of foreign investments from capital markets in emerging economies. This impact was also felt in Sri Lanka, with continuous foreign investment outflows from the government securities market and the CSE resulting in low liquidity levels in the domestic foreign exchange market. In the domestic front, lower than expected foreign exchange earnings and higher demand for foreign currency contributed to the depreciation of the rupee. These conditions necessitated the Central Bank to intervene in the domestic foreign exchange market by supplying foreign exchange liquidity to mitigate undue depreciation of the Sri Lankan rupee. However, the Central Bank allowed more flexibility in the exchange rate, permitting the exchange rate 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 185 million on a net basis during the first nine months of 2018, with a 9.7 per cent depreciation of the Sri Lankan rupee against the US dollar during the period. Reflecting cross currency exchange rate movements by end September 2018, the Sri Lanka rupee depreciated against the pound sterling (7.1 per cent), the Japanese yen (9.0 per cent), the euro (7.4 per cent) and appreciated against the Indian rupee (2.3 per cent).

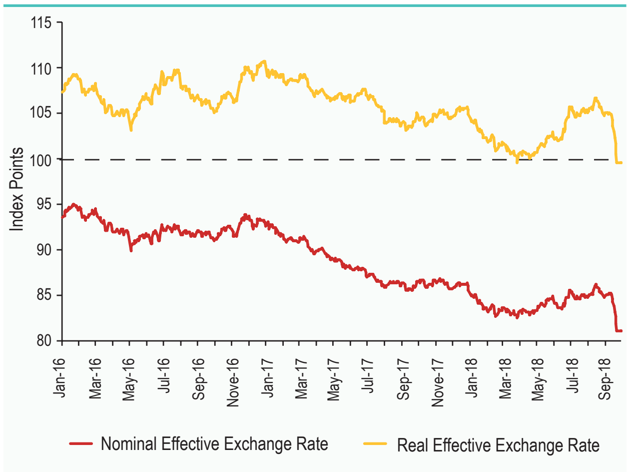
- **The broad-based strengthening of the US dollar in line with interest rate hikes in the US resulted in the depreciation of other major currencies against the US dollar**. Accordingly, the Indian rupee (11.7 per cent), the Japanese yen (0.8 per cent), the pound sterling (2.7 per cent) and the euro (2.5 per cent) depreciated against the US dollar as at end September 2018.

Figure 5.10
Central Bank Intervention in the Domestic Foreign Exchange Market and the Exchange Rate



Source: Central Bank of Sri Lanka

Figure 5.11
Effective Exchange Rate Indices: 24 - Currency (2010 = 100)



Source: Central Bank of Sri Lanka

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- **Both the 5-currency and 24-currency Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) indices declined during the first nine months of 2018**. NEER indices, which measure the value of the Sri Lankan rupee relative to the majority of its most significant trading partners, declined, reflecting the nominal depreciation of the Sri Lankan rupee against some major currencies together with the movements in cross currency exchange rates. Accordingly, 5-currency and 24-currency NEER indices dropped by 5.46 per cent and 4.93 per cent, respectively, during the year up to end September 2018. Meanwhile, 5-currency and 24-currency REER indices, which indicate Sri Lanka's external competitiveness that considers the inflation differentials between countries in addition to the variation in nominal exchange rates, dropped by 4.43 per cent and 4.88 per cent, respectively. REER indices remained marginally under the threshold of 100 index points, indicating an improvement in Sri Lanka's external competitiveness, in comparison to the rates that prevailed in the base year 2010.

- **Spot and forward transactions in the domestic foreign exchange market declined during the first three quarters of 2018**. Total volume of spot transactions, which amounted to US dollars 6,193 million during the first nine months of 2017, decreased to US dollars 3,964 million during the corresponding period of 2018. Total volume of forward transactions also decreased to US dollars 4,978 million during the first nine months of 2018, from US dollars 6,557 million recorded during the corresponding period of 2017. By end September 2018, the one-month forward premia remained above the level of average interest rate differential, while the Net Open Position (NOP) of commercial banks stood at a positive level. The movements in the forward premia and NOP during the first three quarters of 2018 reflected foreign exchange market participants' near-term expectations of the further depreciation of the exchange rate.

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Expected Developments

- **Challenges faced by the external sector, especially with a widened trade deficit, is expected to weigh down the current account of the BOP in 2018, but the measures taken to address the expansion of the trade deficit, together with a more competitive exchange rate, are expected to have a positive impact on the external current account in 2019**. The widening of the trade account is expected to decelerate during the latter part of the year with the anticipated decline in imports following the measures introduced by the government and the Central Bank to discourage imports. Meanwhile, exports are expected to pick up gradually. The growth momentum in export earnings is expected to accelerate in 2019, supported by the establishment of trade relations with new trading partners, conducive external trade policies, strong institutional support and a more competitive exchange rate. The ongoing trade war between the United States and China is not expected to pose an imminent threat to Sri Lanka as most of the products subject to higher tariffs are not major export or import items of Sri Lanka, but the possible slowdown in global trade may have some indirect impact on Sri Lanka's export earnings. Meanwhile, import expenditure is also projected to grow in 2019, but at a slower pace compared to that of 2018. Ongoing trade liberalisation measures such as removal of para tariffs, higher commodity prices in the international market, particularly that of oil prices, and projected rise in exports are expected to increase import expenditure. However, higher import prices due to the adjustment of the exchange rate is expected to reduce the demand for non-essential consumer goods imports to some extent. Outflows from the primary income account in terms of interest payments, dividend payments and reinvested earnings are projected to increase in 2019 with the rise in global interest rates, further expansion of the stock of external debt and higher foreign direct investments, resulting in the expansion of the primary income account deficit. Meanwhile, earnings from export of services and workers' remittances are expected to finance a substantial portion of the trade and primary income deficits, thereby contributing to an improvement in the current account in 2019. Services exports are expected to increase particularly with earnings from tourism, transportation and IT/BPO services. Services sector is expected to be further strengthened with the realisation of the initiatives taken under the National Export Strategy (NES), which is expected to be implemented through a series of action plans as included in the National Plan of Actions 2018-2022 by the Export Development Board (EDB). Workers' remittances are also expected to revive, partly benefitting from the pickup in oil prices and the anticipation of more demand from the Middle Eastern region for Sri Lankan migrant workers.

- **Although outflows from the government securities market and the CSE are anticipated during the remainder of the year, with the ongoing portfolio rebalancing strategy of foreign investors, the financial account of the BOP is expected to be augmented with the realisation of expected foreign exchange inflows in 2019**. These inflows include FDIs, the planned issuance of Panda and Samurai bonds, US dollar denominated Sovereign Bonds and foreign currency swap facilities with some Middle-Eastern countries. There is a possibility of higher FDIs in the second half of 2018 and beyond, particularly with investments in the Colombo Port City project and the industrial zone related to the Hambantota Port. Though challenging, the bunching of external debt service payments over the period of 2019-2023 is planned to be managed prudently, with the implementation of the Active Liability Management Act (ALMA) and the Medium Term Debt Management Strategy (MTDS). However, Sri Lanka relying on debt flows, such as ISBs, syndicated loans and other long-term loans, to finance the current account deficit to build up international reserves is not a sustainable strategy in the long run. The solution to addressing persistent issues in the external sector, such as the large deficits in the trade and primary income accounts, and the accumulation of external debt, lies in focusing on curtailing the current account deficit through encouraging the production economy and export of merchandise goods and services, while creating an investor friendly environment to attract higher FDIs.