

# 5

## EXTERNAL SECTOR DEVELOPMENTS

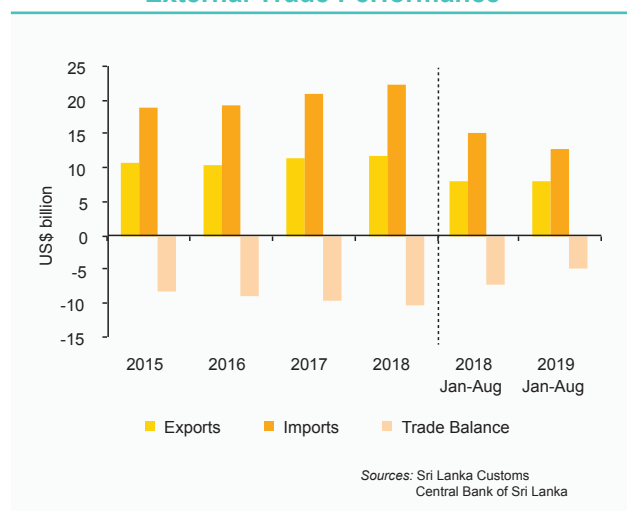
*S*ri Lanka's external sector strengthened in the first half of 2019 recovering from heightened vulnerabilities experienced in the second half of 2018. A substantial contraction in the trade deficit and inflows to the services account resulted in a current account surplus in the first quarter of 2019. However, the current account was adversely affected in the second quarter of 2019 as income from services declined in the aftermath of the Easter Sunday attacks. The trade deficit contracted significantly in the first half of 2019, due to the large reduction in import expenditure by 16.1 per cent and growth in export earnings by 4.7 per cent. Such reduction in import expenditure was driven by a notable contraction in the importation of gold and motor vehicles mainly reflecting the impact of policy measures. The contraction in the trade deficit largely offset the impact on earnings from tourism following the Easter Sunday attacks and the moderation of workers' remittances, thereby resulting in a marginal deficit in the current account in the first half of 2019. The financial account of the Balance of Payments (BOP) recorded a large inflow due to the successful issuance of International Sovereign Bonds (ISBs) amounting to US dollars 4.4 billion, while the government repaid two previously issued ISBs amounting to US dollars 1.5 billion during the first half of 2019. However, other flows to the financial account remained moderate, owing to lower than expected Foreign Direct Investments (FDI) and foreign investments in the Colombo Stock Exchange (CSE), while foreign investments in the government securities market recorded a net outflow during the first half of 2019. Meanwhile, Sri Lanka received the sixth tranche of the International Monetary Fund's Extended Fund Facility (IMF - EFF) in May 2019 and the seventh tranche is expected in early November 2019. Reflecting the impact of sizable inflows to the financial account along with the improvement in the trade balance, the Sri Lankan rupee appreciated by 0.6 per cent by end-October 2019, despite some volatilities observed in April and August. The conducive conditions in the domestic foreign exchange market permitted the Central Bank to purchase foreign exchange on a net basis so far during 2019. Consequently, the gross official reserves improved to US dollars 7.6 billion, equivalent to around 4.6 months of imports by end-September 2019. Several major developments were observed globally in the first half of 2019, which could have some spill-over effects on Sri Lanka. The trade tensions among large economies, Brexit uncertainties along with other geopolitical developments would undermine global growth prospects in the short to medium-term, thereby affecting foreign investment inflows to Sri Lanka. Further, foreign investor sentiment could also be impacted by policy uncertainties due to the upcoming elections in the latter part of 2019 and in 2020.

## Merchandise Trade and Trade Balance

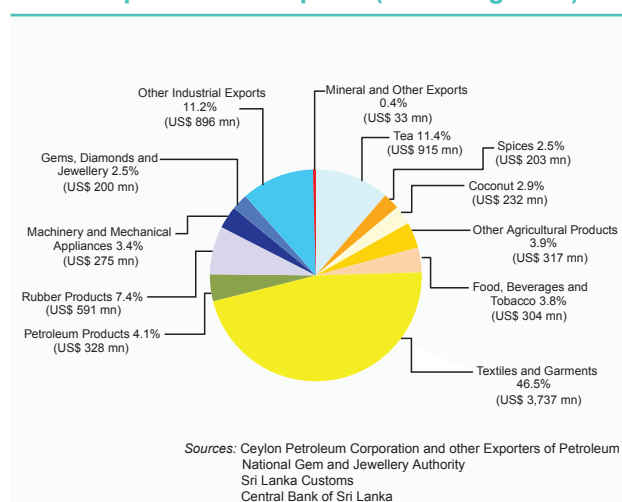
- The deficit in the trade account contracted notably during the first eight months of 2019 in comparison to the corresponding period of 2018.** This was led by a considerable contraction in expenditure on imports and a moderate increase in export earnings. Export earnings grew by 2.4 per cent (year-on-year) during the first eight months of the year while import expenditure declined by 14.6 per cent. Consequently, the trade deficit contracted by US dollars 2,386 million to US dollars 4,854 million during the first eight months of 2019 in comparison to US dollars 7,240 million in the corresponding period in 2018.
- Earnings from merchandise exports increased moderately during the first eight months of 2019.** Export earnings increased by 2.4 per cent to US dollar 8,031 million during the first eight months of 2019 in comparison to 5.8 per cent growth in the corresponding period of 2018. The growth in exports emanated from industrial exports while agricultural and mineral exports declined during the period.
- Earnings from industrial exports increased by 4.0 per cent (year-on-year) to US dollars 6,331 million during the first eight months of 2019, accounting for 79 per cent of total exports.**

Benefitting from the restoration of the European Union's Generalised System of Preferences Plus (EU - GSP+) facility and some trade diversion due to the US - China trade tensions, export earnings from textiles and garments registered a growth of 8.3 per cent (year-on-year) to US dollars 3,737 million. Earnings from garment exports to the EU increased by 5.9 per cent to US dollars 1,454 million during the first eight months of 2019 supported by higher demand from Germany, Netherlands and the UK while garment exports to the USA increased by 7.7 per cent to US dollars 1,539 million. Export earnings from rubber products also increased registering a 1.2 per cent growth to US dollars 591 million with improved performance in exports of surgical and other gloves. Earnings from transport equipment increased significantly by 32.3 per cent, year-on-year, to US dollars 121 million during the first eight months of 2019 mainly due to the supply of a naval craft to Japan in June 2019. Further, export earnings from printing industry products, base metals and articles and gems, diamonds and jewellery also contributed to the growth in export performance during the period. However, export earnings from petroleum products, machinery and mechanical appliances, leather, travel goods and footwear and food, beverages and tobacco declined during the first eight months of 2019 compared to the corresponding period of 2018.

**Figure 5.1**  
**External Trade Performance**



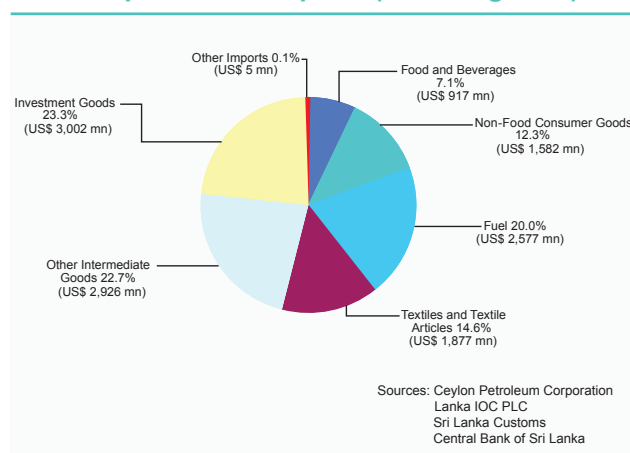
**Figure 5.2**  
**Composition of Exports (Jan - Aug 2019)**



- **Agricultural exports, which accounted for about 21 per cent of total exports, decreased by 3.2 per cent (year-on-year) to US dollars 1,667 million during the first eight months of 2019.** Earnings from tea exports declined by 5.7 per cent (year-on-year) to US dollars 915 million during the first eight months of 2019 due to low prices despite an increase in volumes by 5.1 per cent. The average export price of tea declined by 10.3 per cent to US dollars 4.66 per kg during the first eight months of 2019 compared to US dollars 5.20 per kg recorded in the same period of 2018. Export earnings from spices declined by 9.8 per cent to US dollars 203 million mainly due to lower earnings from cinnamon and pepper. Export earnings from rubber and minor agricultural products also declined during the first eight months of 2019. However, earnings from coconut exports increased by 10.9 per cent to US dollars 232 million during the first eight months of 2019 in comparison to the corresponding period of 2018. Further, earnings from seafood exports rose by 8.9 per cent (year-on-year) to US dollars 184 million during the period with an increase of 23.8 per cent in exports to the EU market.

- **Earnings from mineral exports amounted to US dollars 21 million during the first eight months of 2019 registering a decline of 4.0 per cent.** Under this category, export earnings from ores, slag and ash increased while earnings from earth and stone exports declined.
- **The declining trend observed in import expenditure during the latter part of 2018 following the policy measures implemented to mitigate non-essential imports continued through the first eight months of 2019.** Accordingly, expenditure on imports declined by 14.6 per cent to US dollars 12,886 million during the first eight months of 2019 in comparison to US dollars 15,083 million recorded in the first eight months of 2018. Such reduction in imports was mainly due to the sharp decline in imports of

**Figure 5.3**  
**Composition of Imports (Jan - Aug 2019)**



intermediate goods followed by consumer goods. Meanwhile, import expenditure excluding fuel declined by 16.3 per cent to US dollars 10,309 million during the period under consideration.

- **Expenditure on imports of intermediate goods, which accounted for the largest share of around 57 per cent of total imports, declined by 11.7 per cent (year-on-year) to US dollars 7,380 million during the first eight months of 2019.** Lower outlays in all categories, except textiles and textile articles and mineral products, contributed to this reduction. Expenditure on fuel imports decreased by 6.9 per cent to US dollars 2,577 million during the first eight months of 2019 mainly due to lower volumes of refined petroleum and coal despite an increase in volumes of crude oil by 17.2 per cent. The prices of all fuel products remained relatively low during the period under review. The average price of crude oil imported by the Ceylon Petroleum Corporation (CPC) declined to US dollars 69.13 per barrel during the first eight months of 2019 from US dollars 76.49 per barrel during the first eight months of 2018. Expenditure on diamonds, precious stones and metal imports decreased by 77.2 per cent to US dollars 118 million during the first eight months of 2019 compared to the corresponding period of 2018. This was due to lower imports of gold following the imposition of a 15 per cent customs duty in April 2018 to prevent

the possible illicit arbitrage resulting from the tariff differential between India and Sri Lanka. Further, import expenditure on chemical products, plastic and articles thereof, fertiliser, base metals, wheat and maize and paper and paperboard and articles thereof decreased during the period. Meanwhile, import expenditure on textiles and textile articles increased by 1.0 per cent to US dollars 1,877 million due to the increase in yarn and fibres. Imports of mineral products led by cement clinkers also increased by 5.7 per cent during the first eight months of 2019.

- **Expenditure on consumer goods imports declined during the first eight months of 2019 with lower outlays on both food and beverages and non-food consumer goods.** Accordingly, imports of consumer goods declined by 27.4 per cent to US dollars 2,499 million during the first eight months of 2019 from US dollars 3,441 million in the corresponding period of 2018. Import expenditure on non-food consumer goods, which accounts for 63 per cent of consumer goods imports, declined by 31.0 per cent (year-on-year) to US dollars 1,582 million. Such reduction was mainly driven by lower imports of personal vehicles which declined by 54.6 per cent to US dollars 496 million reflecting the impact of policy measures implemented during August through November 2018 to discourage larger expenditure on imports of personal motor vehicles. However, such restrictions were removed in March 2019 while increasing the excise duty on selected personal motor vehicle categories. The removal of restrictions particularly relating to the use of concessionary permits for motor vehicle imports has contributed to an increase in motor vehicle imports in the recent months. Imports of clothing and accessories, household and furniture items, home appliances and telecommunication devices also declined significantly during the period under review. However, expenditure on medical and pharmaceuticals imports increased marginally by 0.4 per cent during this period. Import expenditure

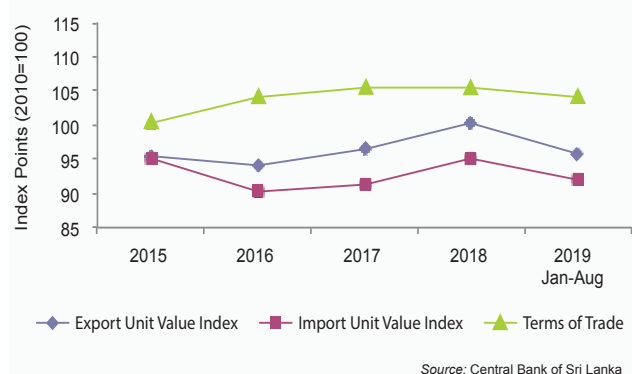
on food and beverages declined by 20.1 per cent (year-on-year) to US dollars 917 million during the first eight months of 2019 mainly due to the decline in expenditure on cereals and milling industry products. Imports of cereals and milling industry products declined by 80.4 per cent, owing to the decline in rice imports reflecting the improved domestic supply resulting from the bumper harvest in the 2018/19 Maha season. Import expenditure on other categories under food and beverages such as sugar, vegetables, dairy products, oils and fats also declined.

- **Expenditure on investment goods imports declined by 6.6 per cent (year-on-year) to US dollars 3,002 million during the first eight months of 2019 due to the decline in all major categories.** Expenditure on transport equipment declined by 22.7 per cent as reflected in lower imports of commercial vehicles such as tankers and bowzers, commercial cabs and buses as well as ships and boats. A major part of such reductions can be attributed to the base effect of importing four ships during the first eight months of 2018. Import expenditure on building materials declined marginally by 0.6 per cent, mainly due to lower importation of iron and steel, cement and wood products. Meanwhile, importation of machinery and equipment decreased by 5.4 per cent reflecting lower imports of machinery and equipment parts, printing machinery, office machines, textile industry machinery, electronic equipment and telecommunication devices. The decline in imports of investment goods reflects the modest activity during a major part of the first eight months in 2019.

### Terms of Trade

- **The terms of trade deteriorated marginally during the first eight months of 2019 compared to the corresponding period of 2018 as export prices declined at a faster pace than the**

**Figure 5.4**  
**Terms of Trade and Trade Indices**



**decline in import prices.** The overall export price index declined by 5.0 per cent during the first eight months of 2019 in comparison to the corresponding period of 2018 mainly due to price reductions in textiles and garments, gems, diamonds and jewellery, machinery and mechanical appliances, food, beverages and tobacco and base metals and articles categorised under industrial exports as well as low prices of all sub categories under agricultural exports, except vegetables. The overall import price index decreased by 4.9 per cent during the same period mainly due to price reductions in all major categories of imports. Under imports of intermediate goods, lower prices of fuel, textiles and textile articles, diamonds, precious stones and metals, plastic and articles thereof, rubber and articles thereof and agricultural inputs mainly contributed to the decline in the import price index. The price index pertaining to investment goods declined owing to lower prices of machinery and equipment and building material while price index of consumer goods declined with the lower prices of vegetables, sugar and confectionery, dairy products, home appliances and telecommunication devices. Accordingly, the terms of trade deteriorated by 0.1 per cent to 104.2 index points during the first eight months of 2019 from 104.3 index points in the corresponding period of 2018. Meanwhile, the terms of trade excluding oil-related products declined by 0.5 per cent (year-on-year) during the first eight months of the year.

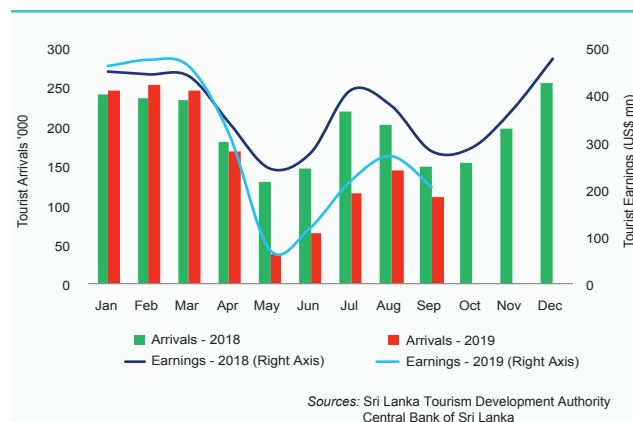
## Trade in Services <sup>1</sup>

- Despite the improved performance in the first quarter, the services account suffered a setback in the second quarter in the aftermath of the Easter Sunday attacks. There was a significant reduction in earnings from tourism in May and June 2019. The reduction in tourist arrivals also impacted earnings from passenger services in the transport sector. Further, the contraction in imports may have weighed on freight transport during the first half of 2019. However, the computer services sector continued its robust growth recording an increase of 10.7 per cent in the first half of 2019 compared to the same period of the previous year. Consequently, the surplus in the services account contracted to US dollars 1.6 billion in the first half of 2019 compared to US dollars 1.9 billion in the first half of 2018.

## Developments in the Tourism Sector

- Sri Lanka's tourism industry is recovering at a faster pace than expected following the Easter Sunday attacks, benefiting from prompt actions taken by the relevant authorities. The tourism industry, which recorded the highest ever quarterly arrivals with 4.6 per cent growth during the first quarter of 2019, was badly affected by the

**Figure 5.5**  
**Tourist Arrivals and Earnings from Tourism**



<sup>1</sup> Except for merchandise trade data which cover the first eight months of 2019, most of other data in Balance of Payments would cover only the first half of 2019 in this report.

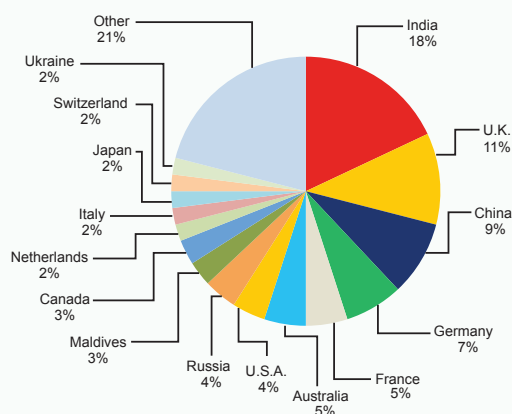


Easter Sunday attacks. Accordingly, performance of the industry during the first nine months of 2019 significantly deteriorated registering a 20.5 per cent decline to 1,376,312 tourist arrivals. In line with the decline in tourist arrivals, earnings from tourism are estimated at US dollars 2,583 million during the first nine months of 2019. Appropriate and timely remedial measures taken at policy level, improvement in security conditions, financial support for businesses in the tourism sector and tourism promotion helped revive tourist arrivals faster than anticipated. Softening of travel advisories on Sri Lanka by major tourist origins, in May and June 2019, complemented the initiatives taken by the Sri Lankan authorities to recover from the setback. The monthly decline in tourist arrivals improved markedly over the recent months although a deterioration was registered in September. With respect to regions, tourists from Western Europe, who accounted for about 18 per cent of total arrivals, declined by 17.5 per cent (year-on-year) during the first nine months of 2019 while arrivals from South Asian countries declined by 20.4 per cent. In terms of country wise analysis, tourist arrivals from India declined by 19.9 per cent to 241,666 arrivals while arrivals from China declined more sharply by 41.3 per cent to 123,220 during the first nine months of 2019 compared to the corresponding period of 2018.

- The tourism industry continued to attract notable investments during the first half of 2019, despite the setback in tourist arrivals.** During the first half of 2019, the Investor Relations Unit (IRU) at the Sri Lanka Tourism Development Authority (SLTDA) granted approvals for 32 hotel projects worth US dollars 26 million. Accordingly, since the initiation of the IRU (formerly known as the One Stop Unit) in 2010, approvals were granted for 382 hotel projects by end June 2019 with a capacity of 19,218 rooms entailing a total investment of US dollars 2,981 million. Of these, 107 projects with 6,797 rooms were under construction while 207 projects with 10,211 rooms had commenced operations by end June 2019. During the first half of 2019, new proposals worth US dollars 107 million for 66 hotels were received, and upon completion of these projects, 1,407 rooms will be added to the industry. It should be noted that 25 new proposals worth US dollars 19 million have been received after the Easter Sunday attacks indicating the continued interest of investors on the potential of the tourism industry of Sri Lanka.
- Several measures were taken to rebuild the tourism industry after the Easter Sunday attacks while policy initiatives introduced under the Tourism Strategic Plan (TSP) 2017-2020 continued.** Special emphasis was placed on tourism promotion, financial and fiscal support in order to mitigate the adverse impact of the Easter Sunday attacks. Accordingly, an economic relief package was introduced, including a debt moratorium, in May 2019, valid till 31 March 2020 on both capital and interest payments related to loans taken by registered businesses in the tourism industry. In addition to the debt moratorium, a separate relief package was introduced by the Ministry of Finance, in May 2019, focusing mainly on informal sector stakeholders of the tourism sector. Further, Value Added Tax (VAT) on registered hotels and tour operators was reduced to 7 per cent from 15 per cent for the period of 01 June 2019 to 31 March 2020 while removing import duty on security related products such as metal detectors. Meanwhile, the Sri Lanka

Figure 5.6

## Tourist Arrivals by Country (Jan - Sep 2019)



Source: Sri Lanka Tourism Development Authority

Tourism Promotion Bureau (SLTPB) continued promotional activities in identified markets. Several promotional activities, such as a short-term global PR campaign and special packages targeting the Indian market, were carried out during the post-terrorist attacks period. The reconfirmation by *Lonely Planet* highlighting Sri Lanka as the number one destination in the world to visit in 2019 and the recognition by *Travel + Leisure* magazine noting Sri Lanka as the number one island to visit in the world in 2019 helped speed up the recovery in the tourism industry.

### Primary Income

- **The deficit in the primary income account widened with higher repatriation of dividends and re-invested earnings by foreign direct investment enterprises.** The primary income account deficit amounted to US dollars 1,097 million in the first half of 2019 compared to US dollars 992 million in the first half of 2018. Direct investment enterprises repatriated higher dividends and also reinvested a higher amount compared to the first half of 2018. Interest payments on foreign loans were higher in the first half of 2019 compared to the first half of 2018. However, interest payments on debt securities were marginally lower during the period mainly due to the repayment of over US dollars 1 billion of international bonds held by the banking sector in 2018. Income on gross official reserve assets was also marginally lower in the first half of 2019 compared to the corresponding period of 2018. Meanwhile, net income receipts on foreign investment remained marginal during the first half of 2019.

### Secondary Income

- **The surplus in the secondary income account moderated in the first half of 2019.** Workers' remittances reduced by 9.8 per cent to US dollars 3,270 million in the first half of 2019 compared to US dollars 3,624 million in the first half of 2018. Despite the slowdown in workers' remittances

observed in the first quarter of 2019 a gradual recovery was observed in April and June 2019. Workers' remittances are likely to be impacted by the economic growth prospects of the Middle Eastern economies amid volatility in international petroleum prices. Workers' remittances during the first nine months of 2019 reduced by 6.6 per cent to US dollars 4,930 million compared to US dollars 5,277 million during the first nine months of 2018.

### Current Account Balance

- **The current account recorded a marginal deficit in the first half of 2019, as the surplus observed in the first quarter was offset by the larger deficit in the second quarter.** Accordingly, current account recorded a deficit of US dollars 225 million in the first half of 2019 compared to the deficit of US dollars 1,609 million recorded in the first half of 2018. The contraction in the trade deficit due to a significant reduction in imports and a steady growth in exports mainly contributed to lowering the current account deficit. The trade deficit declined by US dollars 2,112 million to US dollars 3,597 million in the first half of 2019 compared to US dollars 5,709 million in the first half of 2018.

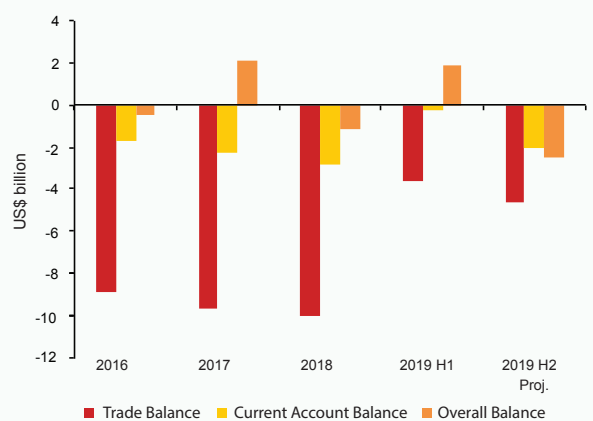
### Capital Account Balance

- **Inflows to the capital account remained modest during the first half of 2019.** On a net basis, inflows to the capital account declined marginally to US dollars 8 million in the first half of the year compared to US dollars 10 million in the first half of 2018, reflecting a moderation in the receipt of capital grants.

### Financial Account

- **The net incurrence of liabilities amounted to US dollars 2,315 million in the first half of 2019, compared to US dollars 2,723 million in the first half of 2018.** The changes to liabilities of the financial account were largely explained

**Figure 5.7**  
**Balance of Payments**



by the issuance and repayment of ISBs by the government in the first half of 2019. The government successfully issued ISBs in March and June 2019, amounting to US dollars 4.4 billion while repaying US dollars 1.5 billion of maturing ISBs. However, most of the other inflows to the financial account remained moderate in the first half of 2019. Foreign direct investments (FDI), including foreign loans received by companies registered with the Board of Investment (BOI), amounted to US dollars 501 million in the first half of 2019. This was significantly lower than the FDI receipts of US dollars 1.4 billion in the first half of 2018 which included the proceeds from the long-lease of the Hambantota Port. The major FDI inflows in the first half of 2019 were recorded in sectors such as property development, telecommunications, hotels and ports and container terminals. Portfolio investments in the form of equity recorded a net inflow of US dollars 9 million in the first half of 2019, compared to a net inflow of US dollars 150 million in the first half of 2018. Foreign investments in Treasury bills and Treasury bonds recorded a net outflow of US dollars 96 million in the first half of 2019 compared to a net outflow of US dollars 176 million in the first half of 2018. Government securities market recorded a net inflow in the first quarter of 2019. However due to some volatility observed in the aftermath of the Easter Sunday attacks, particularly in April and May of 2019, foreign investments in government securities recorded a

net outflow in the first half of the year. Meanwhile, foreign loan liabilities declined by US dollars 645 million in the first half of 2019, reflecting net repayments by the government, deposit-taking corporations, the private sector and state-owned business enterprises (SOBEs). However, the liabilities of the Central Bank increased with the receipt of the sixth tranche of the IMF - EFF of US dollars 164 million. The private sector trade credits increased marginally, mainly due to an increase in outstanding trade credits of the CPC while Central Bank's liabilities with the Asian Clearing Union reduced during the first half of 2019.

- **The net acquisition of financial assets amounted to US dollars 1,730 million in the first half of 2019 compared to US dollars 1,034 million in the first half 2018.** This increase in financial assets was due to the increase in gross official reserves by US dollars 1.8 billion in the first half of the year. This was mainly due to the net impact of ISB issuances and repayments. Meanwhile, net purchases of foreign exchange by the Central Bank from the domestic foreign exchange market also helped augment gross official reserves in the first half of 2019. The increase in gross official reserves was reflected in an increase in currency and deposits of US dollars 2.2 billion, while investments in fixed income securities decreased by US dollars 363 million. Currency and deposits assets of the banking sector also recorded an increase of US dollars 41 million in the first half of 2019. Meanwhile, trade credits and advances given to non-residents by deposit-taking corporations and the private sector recorded a decline in the first half of the year. Further, a moderate level of direct investment outflows was also recorded in the first half of the year.

#### International Investment Position (IIP)

- **Sri Lanka's external asset position with non-residents, as reflected in the International Investment Position (IIP), increased by US dollars 1.9 billion at the end of June 2019**



**from end-2018.** The stock position of external assets increased primarily as a result of the increase in gross official reserves which stood at US dollars 8.9 billion at end-June 2019 in comparison to US dollars 6.9 billion at end-December 2018. The reserve asset position increased due to the receipt of ISB proceeds, net purchase of foreign exchange by the Central Bank in the domestic foreign exchange market and the receipt of the sixth tranche of the IMF - EFF. Meanwhile, the direct investment asset position, which represents direct investments abroad by Sri Lankan residents, slightly increased by end-June 2019 in comparison to end-2018. The currency and deposit asset position and the outstanding position of other accounts receivable of deposit-taking corporations also increased marginally at end-June 2019. 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, declined marginally during the period.

- **Sri Lanka's total liabilities position to non-residents, as reflected in the IIP, increased significantly by around US dollars 1.5 billion by end-June 2019.** The total liability position increased from US dollars 62.5 billion as at end-December 2018 to US dollars 64.0 billion at end-June 2019. This notable increase was mainly due to the net increase in outstanding liabilities of ISBs issued by the government. In 2019, the government issued ISBs amounting to US dollars 4.4 billion while repaying previously issued ISBs amounting to US dollars 1.5 billion. Further, direct investment liabilities recorded a marginal increase with the increase in direct investment flows, while there were also some notable valuation losses of some direct investment enterprises listed in the CSE. The outstanding portfolio investment liability position of the commercial banks and the private sector in the first half of 2019 remained at the same level with no new issuances or maturities of international bonds. Meanwhile, the

total foreign loan liabilities recorded a decline from US dollars 30.4 billion at end-2018 to US dollars 29.9 billion at end-June 2019. This was primarily due to a notable reduction in outstanding loan liabilities of commercial banks while outstanding loan liabilities of the government and the private sector also reduced. Meanwhile, outstanding trade credit liabilities of the private sector and SOBEs increased marginally, with an increase in outstanding trade credits of the CPC. Further, there was a reduction in outstanding payables by the Central Bank, with the reduction in outstanding liabilities with the Asian Clearing Union.

- **Sri Lanka's net international investment position, which is the difference between Sri Lanka's total assets and liabilities positions held with non-residents, recorded an increase in the net liability position as at end-June 2019.** Despite an increase in reserve assets during the first half of 2019, higher government borrowings in the form of ISBs together with the rise in the direct investment liability position, resulted in the overall net international investment position reducing marginally from a net liability position of US dollars 50.4 billion at the end of December 2018 to a net liability position of US dollars 50.0 billion at end-June 2019.

### External Debt Position

- **Sri Lanka's outstanding external debt increased during the first half of 2019.** The external debt stock increased to US dollars 55.5 billion as at end-June 2019 from US dollars 52.3 billion at end-2018, mainly due to the increase in the external debt securities of the government. Despite the reduction in outstanding project loans of the government and the maturity of two ISBs amounting to US dollars 1.5 billion, the outstanding external debt of the government increased considerably by US dollars 3.5 billion mainly due to the issuance of two new ISBs

of US dollars 2.4 billion in March 2019 and US dollars 2.0 billion in June 2019. The outstanding external debt of the Central Bank also increased with the receipt of the sixth tranche of the IMF - EFF facility while the outstanding liabilities with the ACU balance decreased compared to end-2018. The external debt outstanding of the banking sector decreased during the first half of the year in line with the reduction in currency and deposits and outstanding foreign loans. Meanwhile, the outstanding external debt of the private sector and SOBEs increased marginally during the first half of 2019 with an increase in trade credits and advances received by Sri Lankan importers. Further, intercompany borrowing of Direct Investment Enterprises (DIEs) recorded an increase during the first half of the year, with a number of major DIEs receiving intercompany loans and shareholder advances during the period.

### Reserve Asset Position

- **Higher inflows to the financial account resulted in an increase in gross official reserves as at end-September 2019.** Gross official reserves increased to US dollars 7.6 billion by end-September 2019 from US dollars 6.9 billion at end-2018. The receipt of the ISB proceeds, purchase of foreign exchange by the Central Bank from the domestic foreign exchange market and the receipt of the sixth tranche of the IMF - EFF during the first half of 2019 largely

contributed to enhance the gross official reserve position by end-September 2019. The country's gross official reserves at end-September 2019, were sufficient to finance 4.6 months of imports while also covering 64 per cent of the country's short-term debt and liabilities as at end-September 2019. Meanwhile, total international reserves, which consist of gross official reserves and foreign assets of commercial banks, also increased from US dollars 9.6 billion at end-2018 to US dollars 11.3 billion by end-August 2019. This was sufficient to finance 6.8 months of imports.

### Overall Balance

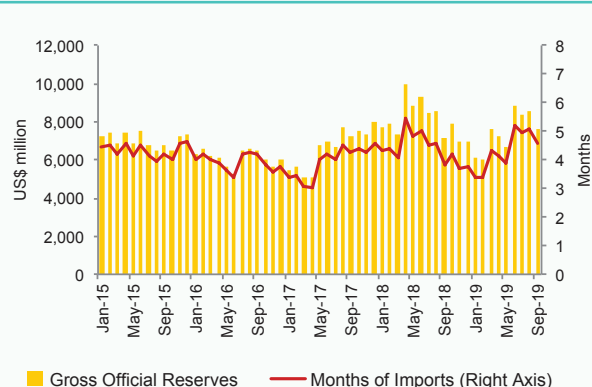
- **The strengthening of financial account together with a lower current account deficit, enabled the BOP to record a surplus in the overall balance of US dollars 789 million during the first nine months of 2019.** The net receipt of US dollars 2.9 billion from the two ISBs and the net absorption of US dollars 285 million from the domestic foreign exchange market helped augment the overall balance in the first nine months of 2019.

### Exchange Rate Movements

- **The exchange rate which significantly depreciated in 2018 showed a correction in 2019 amid some pressures from the global and domestic developments.** The exchange rate strengthened during the first four months of 2019 supported by a significant contraction in the trade deficit and an increase of financial flows resulting in an appreciation of 4.6 per cent prior to the Easter Sunday attacks. Such conducive liquidity conditions prevailed in the domestic foreign exchange market enabled the Central Bank to absorb foreign exchange from the market, on a net basis. However, the exchange rate experienced some pressure in the second half of April following the Easter Sunday attacks and again in the second half of August reflecting the impact of heightened uncertainties in the global markets, which resulted in some unwinding of foreign investments in the government securities market. Nevertheless, the

Figure 5.8

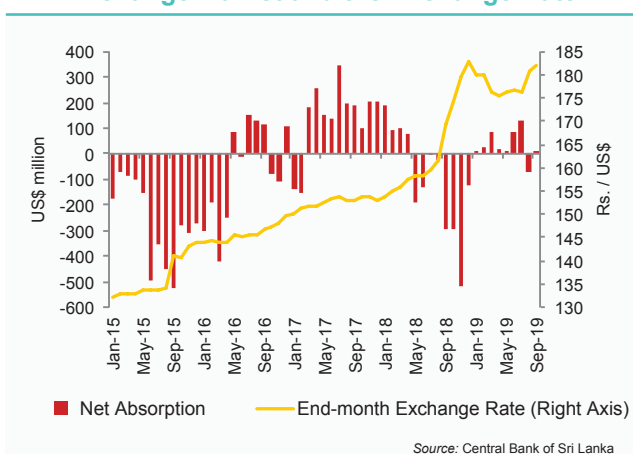
### Gross Official Reserves and Months of Imports



Source: Central Bank of Sri Lanka

Figure 5.9

### Central Bank Intervention in the Domestic Foreign Exchange Market and the Exchange Rate

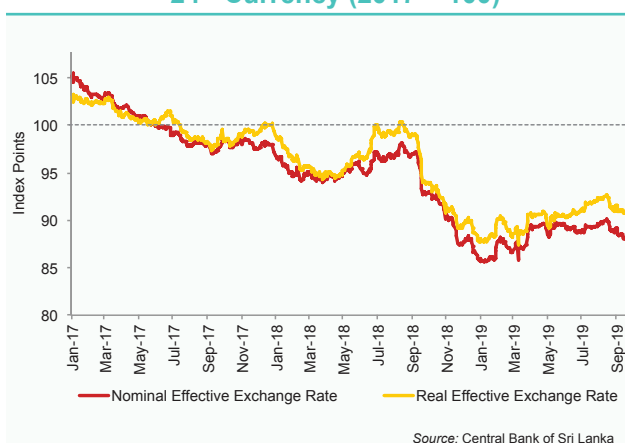


subsequent improvement of liquidity conditions in domestic foreign exchange market helped stabilise the exchange rate. Consequently, the rupee recorded an appreciation of 0.6 per cent by end-October 2019. Meanwhile, the Central Bank absorbed US dollars 284.8 million on a net basis during the year up to end-September 2019 compared to a net supply of US dollars 184.6 million up to end-September 2018. Reflecting cross currency exchange rate movements up to end-October 2019, the Sri Lanka rupee appreciated against the Indian rupee (3.5 per cent), the euro (3.1 per cent) and depreciated against the pound sterling (1.2 per cent), the Japanese yen (1.0 per cent).

- **Other major currencies depreciated against the US dollar owing to the broad-based strengthening of the US dollar.** Accordingly, the the euro (2.4 per cent) and the Indian rupee (2.8 per cent) depreciated against the US dollar whilst pound sterling (1.8 per cent), the Japanese yen (1.6 per cent) appreciated against the US dollar as at end-October 2019.
- **During the period up to end-September 2019, both the 5-currency and 24-currency Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER)**

Figure 5.10

### Effective Exchange Rate Indices: 24 - Currency (2017 = 100)



**indices increased.** The NEER indices increased reflecting the nominal appreciation 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 increased by 2.48 per cent and 2.19 per cent, respectively, during the year up to end-September 2019. Meanwhile, Real Effective Exchange Rate indices, an indicator of Sri Lanka's external competitiveness taking into account the inflation differentials among countries in the basket in addition to the variation in nominal exchange rates, increased by 3.55 per cent and 3.25 per cent, respectively, for the 5-currency and 24-currency REER indices. However, the REER indices remained below the base year level, supporting the country's trade competitiveness.

### Expected Developments

- **The trade deficit is expected to contract in 2019 in comparison to 2018, benefiting from the notable contraction observed during the first eight months of 2019.** Continuing the growth momentum observed since March 2017, export earnings are projected to increase in 2019 and over the medium term. The establishment of trade relations with new trading partners, conducive trade policies, strong institutional support together with a more competitive exchange rate

are expected to drive the growth momentum in exports. The withdrawal of the US - GSP facility from India may also have a positive impact on Sri Lankan exports. The trade tensions between the USA and China are not expected to impact largely on Sri Lanka's trade performance as most of the products, which are subject to higher tariffs, are not major export or import items of Sri Lanka. Nevertheless, the possible slowdown in global trade and global growth could have a negative spill-over effect on export earnings. Meanwhile, import expenditure is projected to decline in 2019 reflecting the contraction observed in imports during the first eight months of the year due to policy measures taken by the Central Bank and the government. However, certain categories of imports could increase during the latter part of the year due to possible seasonal demand and the possible increase in vehicle imports under concessionary permits. Import expenditure is expected to increase in 2020 due to higher imports of consumer goods, particularly personal vehicles and intermediate goods. Consequently, the trade deficit which is expected to contract in 2019, is projected to increase in 2020.

- **The current account deficit, which is expected to be around 2.6 per cent of the estimated GDP in 2019, is projected to increase to around 3.1 per cent of GDP in 2020 primarily due to the envisaged expansion in the trade deficit.** The trade deficit, which is expected to contract in 2019, is projected to increase in 2020 since the envisaged increase in export earnings could be outpaced by the increase in import expenditure demanded by higher level of economic activity. Meanwhile, the surplus in the services account, which is expected to decline in 2019 primarily due to the projected decline in earnings from tourism, is expected to improve in 2020 with higher inflows, particularly on account of tourism, Information Technology (IT), Business Process Outsourcing (BPO) and transport services. The IT related exports are expected to continue their

robust growth while earnings from transportation are expected to rise with enhanced external trade, accelerated development in the Hambantota Port and enhanced activities in the Colombo Port. The deficit in the primary income account is projected to increase with higher interest payments, dividend payments and reinvested earnings with the expansion of the stock of external debt and foreign direct investments. The workers' remittances are expected to remain modest, in 2020, reflecting the trend in recent years. Despite the expected improvement in the surplus in services and secondary income accounts, the combined effect of the projected widening of the trade deficit and the primary income account deficit is expected to widen the external current account balance in 2020.

- **Receipts to the financial account are projected to improve in 2020 due to expected FDI inflows, particularly with the long term development projects in the Colombo Port City and Hambantota industrial zone as well as FDI expected through Public Private Partnership (PPP) initiatives of the government.** Further, net foreign investments to the CSE and the government securities market are also expected to improve with the widespread monetary policy easing across the globe and the enhanced policy certainty envisaged in the post-election period in the country. In addition, the extension of the IMF - EFF programme is expected to improve investor confidence. Envisaged inflows to the financial account would contribute to reinforce international reserves at satisfactory levels. Despite the expected improvement in FDI inflows, bunching of debt service payments over the period 2019-2023, would require substantial external financing, especially in the form of ISBs, syndicated loans and proceeds from active liability management operations. Meanwhile, the financial position of commercial banks is expected to strengthen with the expected gradual improvement of liquidity

in the domestic foreign exchange market. It is expected that a flexible and competitive exchange rate would be maintained within the envisaged flexible inflation targeting regime.

- **The IMF - EFF facility is expected to continue until mid-2020.** The Executive Board of the IMF completed the Fifth Review of Sri Lanka's EFF and approved the disbursement of the sixth tranche while extending the arrangement by

one year, until June 2020, and rescheduling the remaining disbursements. Sri Lanka achieved Net International Reserves targets for June 2019 under the EFF facility. With the successful completion of the sixth review, the receipt of the seventh tranche under the facility is expected in early November 2019. The extension of the EFF programme is expected to contribute towards improving the external sector outlook, thereby bolstering investor confidence.



