5

EXTERNAL SECTOR DEVELOPMENTS

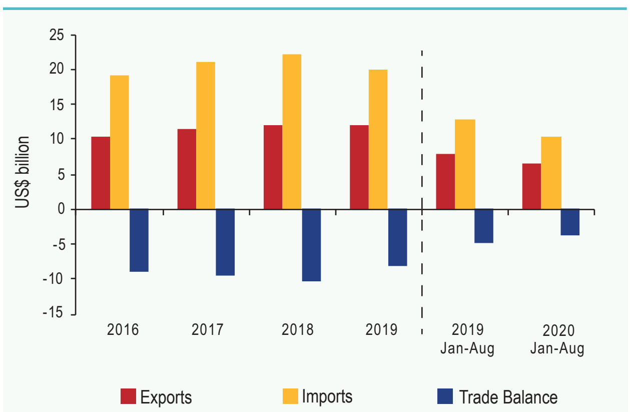
Sri Lanka's external sector was disrupted significantly in the first half of 2020, with the outbreak of the COVID-19 pandemic. However, timely policy measures implemented by the Central Bank and the Government in restricting non-essential merchandise imports and certain outward capital flows as well as lower petroleum import expenditure and the pick up in workers' remittances in recent months helped contain the pressure in the external sector to a great extent. Merchandise exports, which declined with the weakened global demand and disruptions to domestic and global logistical arrangements during the lockdown period in March - May 2020, recovered steadily to pre pandemic levels thereafter. Merchandise imports shrank considerably, with regulatory restrictions on most non essential imports and low global oil prices. As experienced globally, the country was shutdown for international tourists from late March 2020 onwards. Workers' remittances, which also declined in the second quarter of 2020, rebounded and recorded a notable year-on-year growth since June 2020. In the financial account, outflows from the government securities market and the Colombo Stock Exchange (CSE) were observed due to the pandemic driven turmoil in the global financial markets. With heightened global uncertainties, foreign direct investment (FDI) inflows were limited in the first half of the year. Though the exchange rate came under significant pressure in the immediate aftermath of the pandemic related lockdown, swift measures taken by the Central Bank and the Government to limit foreign exchange outflows helped the Sri Lankan rupee to recover within a short period and stabilise thereafter. Resulting improvements in foreign currency liquidity in the domestic foreign exchange market enabled the Central Bank to absorb foreign exchange on a net basis. Alongside the novel issues and challenges created by the pandemic and sovereign rating downgrades, the Central Bank and the Government continued to service the country's foreign currency debt on time. It is expected that investor confidence will improve in the period ahead with the new measures introduced by the Government to promote foreign investments while efforts are also underway to ensure that further foreign financing is available in the short to medium term.

Merchandise Trade and Trade Balance

- **The deficit in the trade account contracted by over US dollars 1 billion during the eight months ending August 2020 in comparison to the corresponding period of 2019**. Both exports and imports contracted during January to August 2020 compared to the same period in 2019, but the decline in the trade deficit was a result of the contraction in imports outpacing the contraction in exports. The decline in expenditure on imports was US dollars 2,628 million while the decline in earnings from exports was US dollars 1,585 million between the said periods. Accordingly, the trade deficit contracted to US dollars 3,812 million during the period under review from US dollars 4,855 million recorded in the corresponding period of 2019.

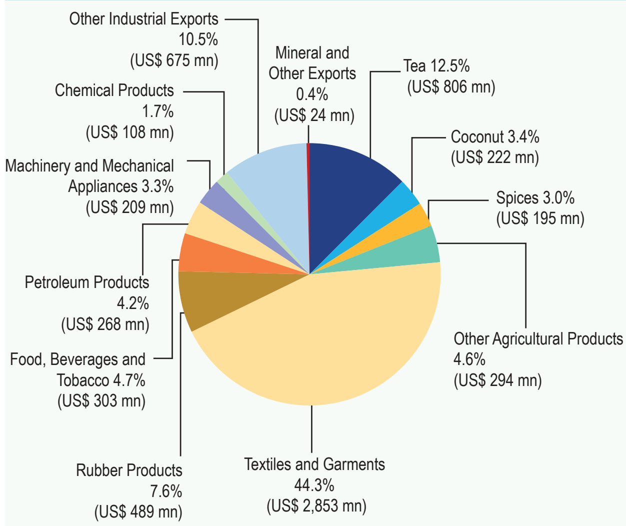
- **Earnings from export of merchandise goods recovered to pre-pandemic levels over the sharp drop observed in April 2020**. Cumulative earnings from exports during the period from January to August 2020 recorded a reduction of 19.7 per cent to US dollars 6,445 million compared to US dollars 8,030 million of the corresponding period of 2019. This reduction stemmed from the disruptions to domestic production of goods and trade related services during the lockdown period and disturbances to domestic and global demand and supply chains due to the COVID-19 pandemic. The decline in exports emanated from all major export categories, but was mainly led by textiles and garments, tea and rubber products. However, two subsectors, namely, personal protective equipment (PPE) and minor agricultural products recorded substantial increases during the period under consideration.

Figure 5.1
External Trade Performance



Sources: Sri Lanka Customs
Central Bank of Sri Lanka

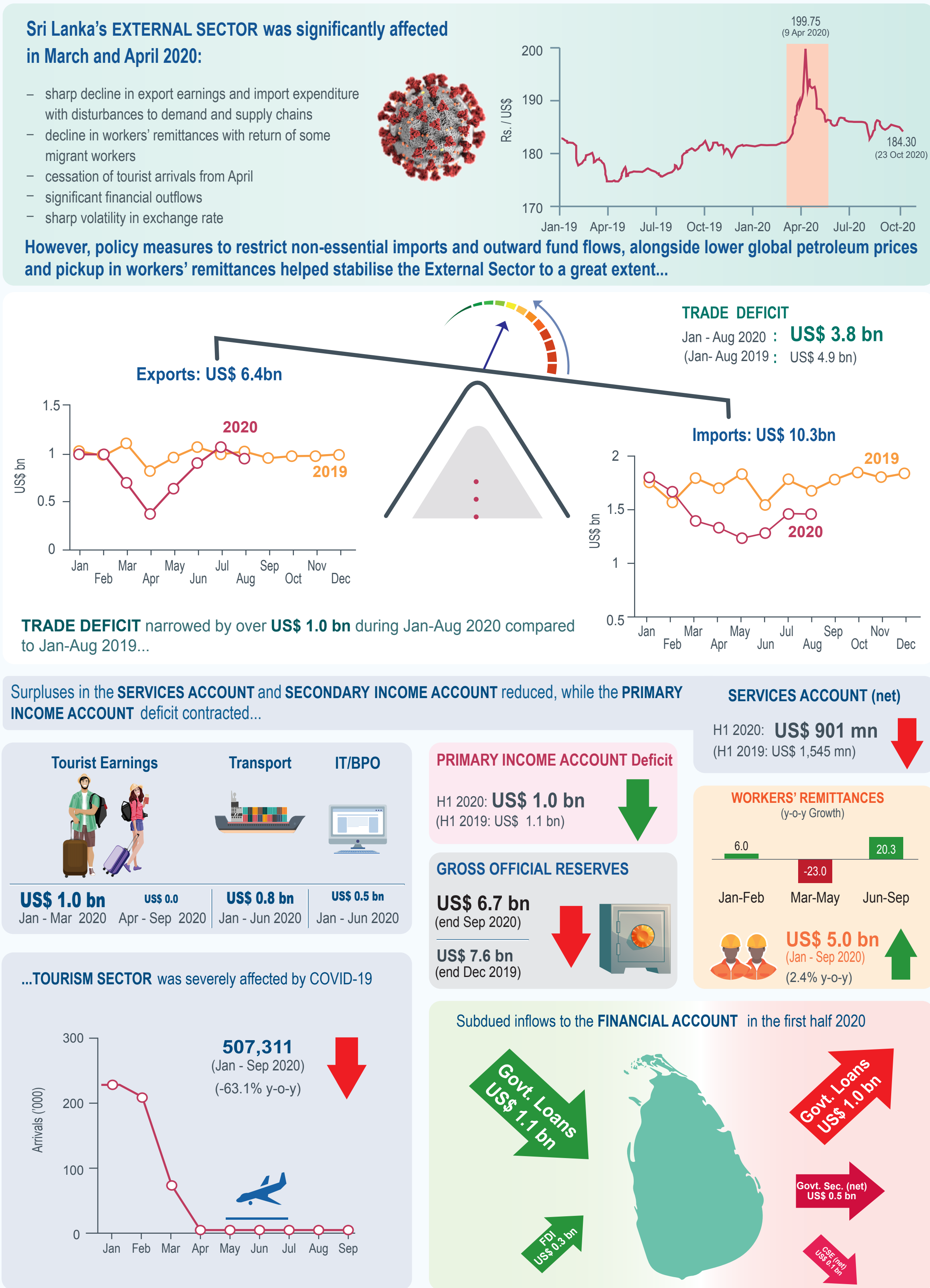
Figure 5.2
Composition of Exports (Jan - Aug 2020)



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

- **Earnings from industrial exports, which accounted for about 76 per cent of total exports, declined by 22.5 per cent on a year-on-year basis to US dollars 4,905 million during the eight months ending August 2020.** Export earnings from textiles and garments mainly contributed to this decline, with a 23.6 per cent decline to US dollars 2,853 million. In addition, earnings from rubber product exports declined by 17.3 per cent during January to August 2020 to US dollars 489 million. The USA and the EU, which are the main markets for Sri Lankan garments and rubber products, were severely affected by COVID-19 related disruptions. However, the drastic decline in earnings from textiles and garments and rubber product exports in April 2020 recovered to a great extent thereafter, with increased demand for PPEs such as face masks, surgical and other gloves and diversion of export orders from COVID-19

Figure 5.3
External Sector Performance



affected regional suppliers such as India and Bangladesh to Sri Lanka. Export earnings from all other subcategories under industrial products also declined during the period under review compared to the corresponding period in 2019, except the export of plastics and articles thereof (mainly plastic clothing articles).

- **Earnings from agricultural exports, which accounted for about 24 per cent of total exports, declined by 9.1 per cent on a year-on-year basis to US dollars 1,516 million during the eight months ending August 2020.** However, earnings from agricultural exports partly recovered after recording low values in March and April 2020. This recovery was led mainly by the export of tea, coconut, spices and minor agricultural products. Overall, earnings from tea exports declined by 12.0 per cent on a year-on-year basis during January to August 2020 to US dollars 806 million with a decline in both volumes and average export prices by 11.3 per cent and 0.8 per cent, respectively. Earnings from seafood exports declined by 27.8 per cent to US dollars 133 million during the eight month period resulting from reduced demand for seafood from major export destinations including the USA. The decline in earnings from coconut exports during the period under review was 4.6 per cent to US dollars 222 million, due to the weak performance of both kernel and non-kernel products. However, export earnings from liquid coconut milk and coconut cream, which are categorised under industrial exports, increased notably during January to August 2020 in comparison to the same period of 2019. Export earnings from spices declined by 4.4 per cent to US dollars 195 million mainly due to lower export volumes of cloves, nutmeg and mace although earnings from cinnamon increased. In contrast, export earnings from minor agricultural products increased notably by 43.2 per cent to US dollars 100 million during the eight months ending August 2020 in comparison to the corresponding period of 2019 led by exports of arecanuts to India under the Indo-Sri Lanka free trade agreement.

- **Earnings from mineral exports declined by 33.1 per cent to US dollars 14 million during the eight months ending in August 2020.** Under this category, export earnings from ores, slag and ash recorded a considerable decline.

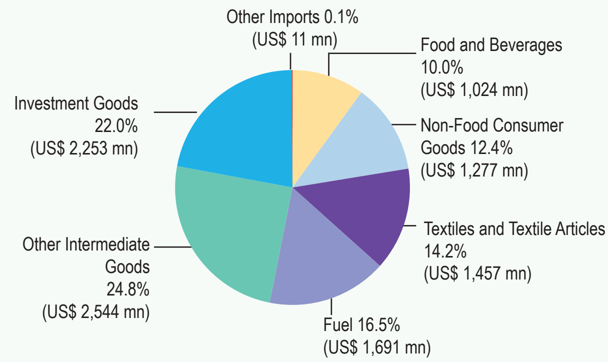
- **Expenditure on imports declined considerably during the period from January to August 2020 as a result of policy measures implemented to curb non-essential imports since March 2020 and lower outlays on fuel and textiles and textile articles imports.** Expenditure on imports declined by 20.4 per cent to US dollars 10,257 million during the eight months ending in August 2020 in comparison to US dollars 12,886 million recorded in the corresponding period of 2019. In order to ease the pressure on the exchange rate and prevent financial market panic with the COVID-19 outbreak, the Government and the Central Bank took several urgent measures, including temporarily suspending the import of selected goods since March 2020. In addition, lower global crude oil prices and lower expenditure on textiles and textile articles due to supply and demand chain disruptions supported the decline in import expenditure. As a consequence, a sharp decline was recorded in all major import categories. Meanwhile, import expenditure excluding fuel declined by 16.9 per cent to US dollars 8,566 million during the period under consideration, compared to US dollars 10,309 million during the same period of 2019.

- **Expenditure on the importation of intermediate goods, which accounted for around 55 per cent of total imports, declined during the eight months ending August 2020, with lower outlays recorded in most subcategories.** Accordingly, expenditure on intermediate goods declined by 22.9 per cent, year-on-year, to US dollars 5,692 million during the period under review. Expenditure on fuel imports declined by 34.4 per cent to US dollars 1,691 million during January to August 2020, led by lower expenditure on crude oil and refined petroleum imports with lower prices that prevailed in the international market and lower import volumes. The average import price of crude oil declined to US dollars 45.53 per barrel during the period from January to August 2020 from US dollars 69.13 per barrel during the corresponding period of 2019. However, expenditure on coal imports increased driven by higher volumes imported during the period. In line with the reduced export demand for textiles and garments and disruptions to supply chains, import expenditure on textiles and textile articles declined by 22.4 per cent to US dollars 1,457 million during the eight months ending in August 2020 compared to the same period of 2019. In addition, expenditure on base metals, plastic and articles thereof and vehicle and machinery part imports declined during the period under review, reflecting the slowdown in economic activity due to COVID-19 and the impact of import restrictions. However, import expenditure on wheat and maize, food preparations (mainly palm oil), unmanufactured tobacco and agricultural inputs (mainly animal fodder) increased during the period.

- **Expenditure on investment goods declined notably by 24.9 per cent, year-on-year, to US dollars 2,253 million during the period from January to August 2020, with a decline in all major categories.** The decline in expenditure on investment goods reflects subdued economic activities during the pandemic and the impact of import control measures imposed by the Government. Machinery and equipment imports declined by 17.7 per cent to US dollars 1,325 million reflecting lower imports of engineering equipment, telecommunication devices and medical and laboratory equipment. Expenditure on the import of building material declined by 33.3 per cent to US dollars 671 million with lower imports of iron, steel and steel articles, and cement. Expenditure on transport equipment declined by 32.8 per cent to US dollars 255 million in line with the decline of imports of commercial vehicles such as tankers, bowsers, auto trishaws and commercial cabs. In contrast, expenditure on machinery and equipment parts,

Figure 5.4

Composition of Imports (Jan - Aug 2020)



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

machinery and mechanical appliances, turbines, mineral products (mainly asbestos) and railway equipment, increased on a year-on-year basis during the period under review.

- **Import expenditure on consumer goods declined during the period from January to August 2020, driven by lower expenditure on non-food consumer goods, while import expenditure on food and beverages increased.** Accordingly, overall imports of consumer goods declined by 8.0 per cent to US dollars 2,300 million during the eight months ending in August 2020 from US dollars 2,499 million in the corresponding period of 2019. Import expenditure on non-food consumer goods declined by 19.3 per cent, year-on-year, to US dollars 1,277 million driven by lower imports of personal vehicles. On a year-on-year basis, personal vehicle imports declined by 43.4 per cent to US dollars 281 million during the period from January to August 2020 with lower expenditure on all personal vehicle categories. Except for medical and pharmaceuticals and telecommunication devices (mainly mobile phones), all other non-food consumer goods categories also declined during the period concerned, reflecting the impact of import restrictions imposed since March 2020. Import expenditure on food and beverages increased by 11.6 per cent, year-on-year, to US dollars 1,024 million during January to August 2020 mainly

Table 5.1
Impact of the Measures Taken to Restrict Import Expenditure

US$ million

Item	Change in Value during April - August 2020 Over the Same Period in 2019					
	Total Imports	Items with Import Restrictions				Items with No Import Restrictions
		Temporarily Suspended	Mandatory Credit Requirement	Import License Requirement	Total	
Consumer Goods	-252.7	-266.0	-41.4	1.4	-305.9	53.2
Food and Beverages	15.0	-7.6	15.2	-9.4	-1.8	16.8
Non-Food Consumer Goods	-267.7	-258.4	-56.5	10.8	-304.1	36.4
o/w Personal Vehicles	-202.1	-200.6	-	-0.5	-201.1	-1.0
Intermediate Goods	-1,458.8	-11.8	-19.5	...	-31.3	-1,427.5
o/w Fuel	-815.2	-	20.6	-	20.6	-835.7
Textiles and Textile Articles	-353.1	-6.6	-	-	-6.6	-346.5
Investment Goods	-603.5	-135.8	-299.0	-3.0	-437.9	-165.6
Total Imports	**-2,314.0**	**-413.6**	**-359.9**	**-1.6**	**-775.1**	**-1,538.9**

Source: Central Bank of Sri Lanka

due to the increase in expenditure on vegetables (mainly big onions, lentils, potatoes), sugar, oils and fats (mainly coconut oil), spices (mainly chillies) and dairy products (mainly milk powder). However, expenditure on import of beverages (mainly alcoholic beverages) and fruits (mainly apples and grapes) declined during the period under review.

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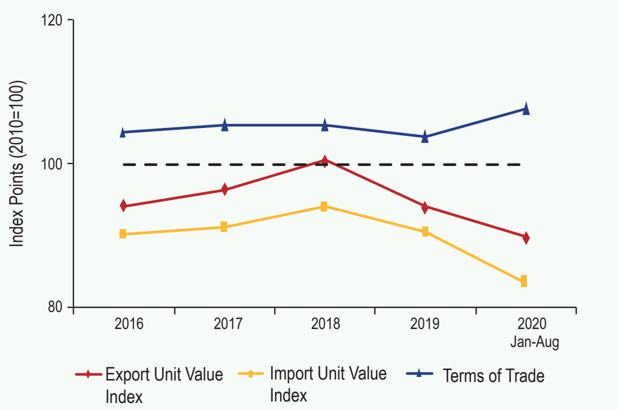
- **Imposing restrictions on the importation on non-essential goods helped ease the pressure on the exchange rate and the balance of payments to a great extent.** The reduction in import expenditure on items subject to import restrictions accounted for about 33 per cent (about US dollars 775 million) of the decline in overall import expenditure during April to August 2020 when compared with the corresponding period of 2019. This suggests that the decline in import expenditure during the period concerned was mostly driven by items that were not subject to import restrictions such as fuel (crude oil and refined petroleum) and textiles and textile articles. However, considering the relatively lower coverage of the import restrictions, which primarily cover non essential goods such as non-food consumer and investment goods, the above reduction in import expenditure due to import restrictions was substantial (the bulk of the food and beverages categorised under consumer goods and most of intermediate goods are not subject to import restrictions).

Terms of Trade

- **Terms of trade improved during the eight months ending in August 2020, compared to the corresponding period of 2019, as import prices declined at a faster pace than the decline in export prices.** During the period under review, the overall export price index declined by 6.3 per cent, mainly due to the price reductions recorded in industrial exports including transport equipment, base metals and articles, petroleum products, wood and paper products and animal fodder. However, the export prices of textiles and garments, plastics and articles thereof and food, beverages and tobacco improved. Prices of agricultural and mineral exports increased, led by minor agricultural products, coconuts, seafood and spices, although prices of tea exports declined marginally. Meanwhile, the overall import price index decreased by 9.2 per cent during the period from January to August 2020, with price declines being recorded in all major import categories. Lower prices recorded in fuel, agricultural inputs, fertiliser, base metals and mineral products categorised under intermediate goods, contributed mainly to the decline in the import price index. However, import prices of textiles and textile articles increased marginally during the period. The price index for investment goods declined with lower prices of machinery and equipment, although prices of transport equipment and building material increased. The price index pertaining to

Figure 5.5
Terms of Trade and Trade Indices



Source: Central Bank of Sri Lanka

consumer goods declined owing to lower prices of all subcategories under non food consumer goods except personal vehicles and household and furniture items. In contrast, import prices of food and beverages increased, including prices of spices, vegetables, dairy products, seafood, beverages, and sugar and confectionery. Overall, terms of trade improved by 3.3 per cent, year-on-year, to 107.6 index points during the period from January to August 2020 from 104.2 index points in the corresponding period of 2019. Meanwhile, the terms of trade excluding oil-related products improved by 0.4 per cent, year-on-year, during the period under review.

Trade in Services

- **The services account was severely affected in the first half of 2020 due to the impact of the COVID-19 pandemic.** Although the tourism industry recovered from the effect of Easter Sunday attacks at a faster pace than anticipated by end 2019, foreign tourist arrivals came to a standstill with airports and sea ports being shut down for tourist arrivals since the latter part of March 2020. Travel outflows, which represent expenditure incurred by Sri Lankans traveling abroad, also declined sharply with departures being limited to only migrant workers and Sri Lankans living abroad. The cessation of air travel also resulted in a significant reduction in earnings and expenditure on account of air transport passenger services. Meanwhile, sea and air transport related freight services were also interrupted, with delays in global logistical arrangements and due to the reduction in merchandise trade. All other services, including construction services, insurance and financial services, were disrupted significantly during the period, thereby reducing foreign exchange earnings. However, inflows to the computer services sector continued to record a positive growth during the first half of 2020, supported by a significant increase in cross border transactions for services related to the use of online web applications by local and international web based service providers. With these developments, the surplus in the services account contracted to US dollars 901 million in the first half of 2020 compared to US dollars 1,545 million in the first half of 2019.

Developments in the Tourism Sector

- **Tourist arrivals, which recovered faster than expected from the Easter Sunday attacks by the end of 2019, came to a standstill with the suspension of issuing visas for foreign visitors from mid March 2020 due to the COVID-19 pandemic**. Tourist arrivals during the first three months of 2020 significantly deteriorated to 507,311 while no tourist arrivals were recorded from 18 March 2020. In line with such developments in tourist arrivals, earnings from tourism, which are estimated based on arrivals, remained at US dollars 956 million during the year up to September 2020. With the suspension of all passenger flights and ship arrivals, Sri Lanka Tourism, in collaboration with the Ministry of Foreign Relations, SriLankan Airlines and other respective diplomatic missions, made special arrangements for about 18,000 tourists who were in Sri Lanka by end March 2020, either to return their home countries or to stay in Sri Lanka for an extended period. As such, the Department of Immigration and Emigration extended the validity periods of visas issued to all foreigners who decided to stay in Sri Lanka for an extended period.

Figure 5.6
Tourist Arrivals and Earnings from Tourism

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

- **At the turn of the year, the tourism industry attracted substantial interest from potential investors.** During January to September 2020, the Sri Lanka Tourism Development Authority (SLTDA) granted approvals for twelve projects worth US dollars 19.9 million. During the nine months ending September 2020, the SLTDA received new proposals worth US dollars 720.7 million for 42 projects, which includes a theme park project. Meanwhile, during the nine months of 2020, the SLTDA made progress with the development of four key resorts in Kalpitiya, Kuchchaweli, Yala (Palatupana) and, Dedduwa and Bentota under unique themes. The Kalpitiya Integrated Tourism Resort Project is targeted to bring 'Ocean Based Island Resort' as the main concept while the Kuchchaweli Beach Resort Project is targeted as an up-market tourism project in the Eastern region.

- **In addition to the current debt moratorium on the loans granted to the tourism sector, a special relief package was implemented by the Ministry of Tourism and the SLTDA to assist the tourism industry.** With a view to meeting the challenges faced by the tourism industry due to the Easter Sunday attacks and the outbreak of COVID-19, the Central Bank implemented debt moratorium schemes for businesses and individuals in the tourism sector since April 2019, and later extended the scheme till 31 March 2021 considering the ongoing travel restrictions and disruptions to economic activity. Meanwhile, in June 2020, the SLTDA introduced a special relief measures package to the SLTDA registered tourists' establishments and personnel affected by the COVID-19 pandemic. It is estimated that 144,000 tourism stakeholders who are registered with the SLTDA and are directly involved in the tourism industry will benefit by these measures. This relief package included a one-time payment for registered tour guides and tourist drivers, a leeway on utility bill payments of the SLTDA registered accommodation providers and license fee waivers for SLTDA registered tourist service providers and tour guides for 2021. In addition, a provisional license for six months was issued for informal sector establishments and the registration fees were relaxed by the SLTDA.

- **Services exports are vital in cushioning the deficit in the current account and hence it is imperative to exploit the full potential of services exports.** In this context, in addition to tourism, computer services including information technology (IT) enabled business process outsourcing services (BPOs), knowledge process outsourcing services (KPOs), construction services, financial services, consultation services, research and development services have become emerging sectors with significant potential in the services industry. This was evident with earnings from IT/BPO sectors recording a healthy growth with undisrupted functioning of these services, even at the time of the COVID-19 pandemic. However, there exists a notable data gap with respect to identifying the inflows and outflows of foreign exchange related to these service industries. Currently, these statistics are compiled by survey based estimations. Hence, recognising the importance of obtaining high frequency statistics with enhanced coverage, the Central Bank is currently in the process of introducing a new data collection system called the 'International Transactions Reporting System (ITRS)'. This system will be implemented through the banking sector and will ensure the availability of timely data on inflows and outflows of all cross border transactions and foreign currency transactions, with particular emphasis on enhancing the coverage of the services sector. The ITRS system is expected to facilitate reporting of granular level data based on the purpose of the transaction through a unique purpose code system, enabling the enhancement of services sector statistics while significantly improving the quality of data. The ITRS system is planned to be operational by the end of 2021.

Primary Income

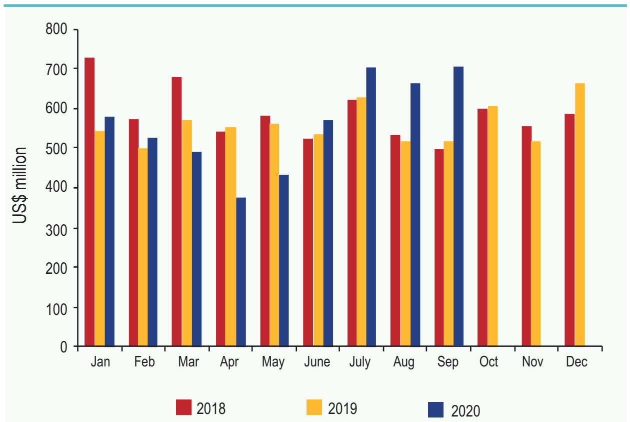
- **The deficit in the primary income account contracted in the first half of 2020**. The primary income account deficit amounted to US dollars 1,041 million in the first half of 2020 compared to a deficit of US dollars 1,119 million in the corresponding period of 2019. This was mainly due to a reduction in reinvested earnings related to FDI and a reduction in dividends repatriated by Direct Investment Enterprises (DIEs). Further, a reduction in interest expenditure on foreign loans obtained by the Government and the private sector was also observed, primarily due to the reduction in variable interest rates with the sharp decline in London Interbank Offered Rate (LIBOR) in line with the reduction in the US Federal Funds Rate. Interest and coupon payments on portfolio investments increased to US dollars 515 million in the first half of 2020, compared to US dollars 436 million in the first half of 2019, with the notable increase in coupon payments on international sovereign bonds (ISBs). However, the coupon payments on foreign holdings of Treasury bonds and Treasury bills reduced significantly due to the low outstanding foreign investment position in the rupee denominated government securities market. Meanwhile, investment income of the banking sector reduced, while income on investment of gross official reserves by the Central Bank remained at similar levels recorded in the first half of 2019.

Secondary Income

- **Despite a moderation seen in the period from March to May 2020 as a result of the COVID-19 pandemic, workers' remittances recorded a higher than expected growth thereafter**. Workers' remittances in the first half of 2020 declined by 8.9 per cent to US dollars 2,980 million compared to US dollars 3,270 million in the first half of 2019. With some migrant workers returning to the country and reduced compensations as well as job losses faced by some migrant workers abroad, a significant decline was recorded in workers' remittances in the period from March to May 2020. However, healthy year-on-year growth rates in workers' remittances were observed thereafter. Nevertheless, the lack of job opportunities in all migrant destinations, including the Middle East, due to global economic slowdown has resulted in increased uncertainty in relation to the short to medium term growth path of workers' remittances.

- **The COVID-19 pandemic reemphasised the vulnerabilities associated with workers' remittances and the need for preparedness to face possible uncertainties in the future**. As a direct result of the pandemic, some migrant workers lost their livelihoods as well as lives while some continue to work with reduced

Figure 5.7
Workers' Remittances



Source: Central Bank of Sri Lanka

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compensations. Considering the national importance of this sector and its susceptibility to various geopolitical and economic shocks, more protection is needed to support the stakeholders of the sector. Hence, more targeted policy measures are of importance, including a properly developed insurance scheme for the workers who may lose their jobs during unforeseen events as well as in tragic events such as physical abuse, permanent disability or even loss of life during their stay abroad. Such schemes and other policy initiatives to support migrant workers would ensure the future sustainability of remittances as one of the most important sectors that supports Sri Lanka's balance of payments (BOP).

Current Account Balance

- **The external current account deficit widened significantly in the first half of 2020, compared to the corresponding period in 2019, with the impact of the adverse developments of the COVID-19 pandemic**. The current account deficit was US dollars 792 million in the first half of 2020 compared to US dollars 351 million in the first half of 2019. Merchandise exports reduced by 26.4 per cent while imports reduced by 20.0 per cent during the first half of the year, compared to the corresponding period of 2019. Overall, the trade deficit contracted by US dollars 335 million in the first half of 2020 compared to the first half of 2019. With the adverse impact of the pandemic on tourism in particular, the surplus in the services account contracted by US dollars 645 million in the first half of 2020 compared to the first half of 2019. The reduction in workers' remittances in March to May resulted in a reduced surplus in the secondary income account. A reduction in the deficit in the primary income account was observed mainly due to the reduction in reinvested earnings related to FDI and a marginal reduction in dividends repatriated by DIEs.

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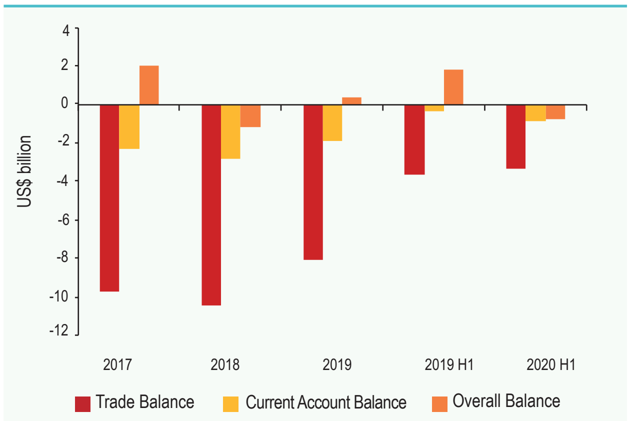
Capital Account Balance

- **Inflows to the capital account remained modest during the first half of 2020**. On a net basis, inflows to the capital account declined to US dollars 4 million in the first half of 2020 compared to US dollars 18 million in the first half of 2019, mainly due to the reduction in capital grants received by the Government.

Financial Account

- **The net incurrence of liabilities reduced by US dollars 935 million in the first half of 2020, compared to an increase of US dollars 2,406 million in the first half of 2019**. The decline in liabilities in the first half of 2020 was mainly due to the higher outflows of foreign investment from the rupee denominated government securities market, net outflows of foreign investment from the equity market and the reduction in currency and deposits held by the banking sector. Apart from the receipt of foreign currency term financing facility of US dollars 500 million from the China Development Bank in March 2020, inflows to the financial account during the first half of 2020 remained subdued. FDI, including foreign loans to DIEs, amounted to US dollars 345 million in the first half of 2020, which was notably lower than the

Figure 5.8
Balance of Payments



Source: Central Bank of Sri Lanka

receipts of FDIs of US dollars 535 million in the first half of 2019. Major FDI inflows in the first half of 2020 were recorded in property development, hotels and telecommunications sectors, but most of those were reinvested earnings of established DIEs rather than equity receipts for new FDI projects. Portfolio investments in the form of equity, which are equity investments by non FDI investors in the CSE, recorded a net outflow of US dollars 108 million in the first half of 2020, compared to a net inflow of US dollars 9 million in the first half 2019. Due to the pandemic, the rupee denominated government securities market experienced significant outflows of foreign investments resulting in a net outflow of US dollars 492 million in the first half of 2020 compared to net outflow of US dollars 96 million in the first half of 2019. Meanwhile, foreign loan liabilities increased by US dollars 795 million in the first half of 2020, mainly reflecting the net loan inflows to deposit taking corporations. Trade credit and advances given by non residents declined significantly with the repayments of trade credits by the Ceylon Petroleum Corporation (CPC) in the first half of 2020. Further, other accounts payable, mainly consisting of Asian Clearing Union (ACU) liabilities managed by the Central Bank also reduced during the first half of 2020.

- **The net acquisition of financial assets declined by US dollars 1,359 million in the first half of 2020 compared to an increase of US dollars 1,819 million in the first half 2019**. The decline in financial assets was mainly due to the decline in gross official reserves by US dollars 1,515 million in the first half of the year, with significant foreign debt service payments made during the period. Moreover, net supply of foreign exchange by the Central Bank to the domestic foreign exchange market to curb the excessive volatility of the exchange rate due to the COVID-19 pandemic related outflows from the government securities market during March-April 2020 also contributed to this decline. Currency and deposit assets of the banking sector recorded a marginal increase of US dollars 22 million in the first half of 2020. Trade credit and advances given to non residents by deposit taking corporations declined while trade credit and advances given to non residents by the private sector increased in the first half of the year, with Sri Lankan exporters also giving concessions to their buyers due to payment difficulties caused by the pandemic.

- **A number of measures have been taken by the Government and the Central Bank to revive inflows to the financial account since the outbreak of the COVID-19 pandemic**. Inflows to the financial account remained limited upto end September of the year. Despite a downgrade of sovereign rating by Moody's Investors Service, Sri Lanka has been steadfast in honouring all foreign debt obligations, maintaining an immaculate foreign debt repayment record, which was further orchestrated by the repayment of US dollars 1 billion ISB in the first week of October 2020. A conducive environment for foreign investors to invest in the country is being created with a new swap arrangement introduced by the Central Bank to facilitate foreign investment without being subject to any exchange rate risks. Further, the Government has made significant progress in ensuring future financing, including a syndicated foreign loan facility as well as seeking the possibility of issuing ISBs in non traditional markets. Moreover, the introduction of Special Deposit Accounts (SDA) has also enabled further foreign inflows to the country. These measures, alongside significant efforts to boost merchandise exports while ensuring the curtailment of non essential imports, are expected to provide the necessary stability to the external sector amidst significant challenges that lie ahead.

International Investment Position (IIP)

- **As reflected in the International Investment Position (IIP), Sri Lanka's external asset position with non residents declined to US dollars 12,189 million at the end of June 2020 from US dollars 12,985 million as at the end of 2019**. The stock position of external assets decreased primarily as a result of the decline in gross official reserves to US dollars 6,695 million at end June 2020 in comparison to US dollars 7,642 million at end December 2019. The reserve asset position declined, mainly with the sizable foreign debt service payments made during the first half of the year and relatively low foreign exchange inflows. Major inflows to the gross official reserves during this period included the receipt of foreign currency term financing facility of US dollars 500 million in March 2020. Meanwhile, the direct investment asset position that represents direct investments abroad by Sri Lankan residents, increased marginally to US dollars 1,511 million at end June 2020 in comparison to US dollars 1,497 million at end 2019. The asset position in the form of currency and deposit and other accounts receivable of deposit taking corporations increased by end June 2020 compared to the beginning of the year resulting in a net increase in the foreign asset position of the banking sector during the first half of 2020. Meanwhile, the outstanding asset position of trade credit and advances, which reflects the trade credit and advances given to non residents by deposit taking corporations and the private sector, increased at end June 2020 compared to end 2019 with the increase in trade credit and advances given by Sri Lankan export companies.

- **Sri Lanka's total liabilities position to non residents, as reflected in the IIP, recorded a significant decline by US dollars 6.1 billion by end June 2020 from the beginning of the year.** The total liability position declined to US dollars 59,152 million as at end June 2020, compared to US dollars 65,252 million at end December 2019. This significant decline is only of technical importance, resulting from valuation losses due to a significant decline in market prices of Sri Lanka's outstanding ISBs, as the IIP statement is compiled based on the market price valuation of tradable instruments of the Financial Account of the BOP. The outstanding liability position of Sri Lanka's existing ISBs was valued at US dollars 15.6 billion as at end 2019 and were valued at US dollars 11.0 billion as at end June 2020, coinciding with high secondary market yields due to the uncertainty in international capital markets exaggerated by the COVID-19 pandemic. The direct investment liability position of DIEs also reduced due to the significant reduction in market prices of DIEs listed in the CSE. However, there was a notable increase in foreign loan liabilities of deposit taking corporations, while foreign loan liabilities of the Government also increased marginally during the first half of 2020. Further, outstanding trade credits received by Sri Lankan importers declined with significant repayments of trade credits by the CPC, while outstanding liabilities of the Central Bank also declined with a reduction in the ACU liability position during the first half of 2020.

- **Sri Lanka's net IIP, which is the difference between Sri Lanka's total assets and liabilities positions held with non residents, improved as at end June 2020**. This was mainly due to valuation losses of market prices of Sri Lanka's outstanding ISBs, reduction in market prices of DIEs listed in the CSE as well as the reduction in the asset position due to the decline in gross official reserves.

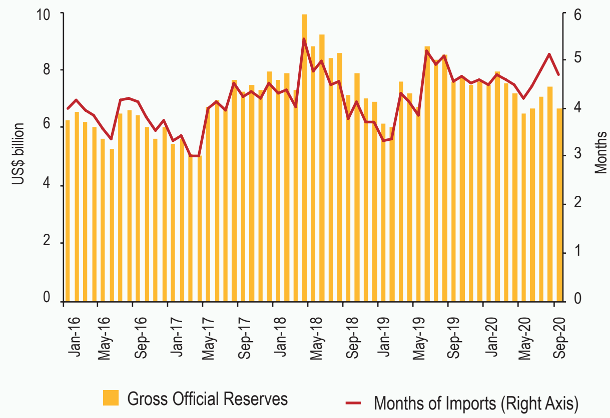
External Debt Position

- **Sri Lanka's total outstanding external debt position declined significantly during the first half of 2020**. The external debt stock position declined to US dollars 50.8 billion at end June 2020 from US dollars 55.9 billion at end 2019, mainly due to the significant decline in market prices of Sri Lanka's outstanding ISBs and the decline in the non resident holding of rupee denominated government securities with the withdrawal of foreign investments during the period. However, the outstanding amount of foreign loans obtained by the Government increased during the period under consideration. Meanwhile, the outstanding external debt of the Central Bank decreased, as the ACU liabilities managed by the Central Bank declined by end June 2020 compared to the beginning of the year. However, the external debt outstanding of the banking sector increased marginally during the first half of the year due to the combined effect of the increase in outstanding foreign loans and the reduction in currency and deposits. In contrast, the outstanding external debt of the private sector and state owned business enterprises (SOBEs) declined during the first half of 2020 with the reduction in foreign loans of SOBEs, the reduction in market prices of outstanding debt securities, and trade credit and advances received by Sri Lankan importers. Further, intercompany borrowing of 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

- **Gross official reserves decreased to US dollars 6.7 billion by end September 2020, compared to US dollars 7.6 billion recorded at end 2019.** Foreign currency debt service payments, mainly principal payments of foreign project loans, foreign currency term financing facility repayments, Sri Lanka Development Bonds (SLDB) and Foreign Currency Banking Units (FCBU) loan repayments and interest payments, were the main reasons for the decline in gross official reserves during the nine months ending September 2020. Further, the repayment of a matured ISB of US dollars 1 billion was also facilitated by utilising gross official reserves in early October 2020. Main inflows to supplement reserves were the receipt of foreign currency term financing facility of US dollars 500 million, FCBU loans of US dollars 670 million, and the receipt of SAARCFINANCE swap arrangement of US dollars 400 million. Accordingly, gross official reserves were sufficient to cover 4.6 months of imports and 49 per cent of the country's short term debt and liabilities by end September 2020. Meanwhile, total international reserves, which comprise gross official reserves and foreign assets of the banking sector decreased marginally to US dollars 10.3 billion by end August 2020 from US dollars 10.4 billion at end 2019 (data available for end August 2020). This decrease was a combined effect of a decrease in gross official reserves by US dollars 212 million during the eight months ending in August 2020 and an increase in holdings of commercial bank foreign assets by US dollars 156 million. By end August 2020, the import coverage of total international reserves was equivalent to 7.2 months.

Figure 5.9
Gross Official Reserves and Months of Imports



Source: Central Bank of Sri Lanka

Overall Balance

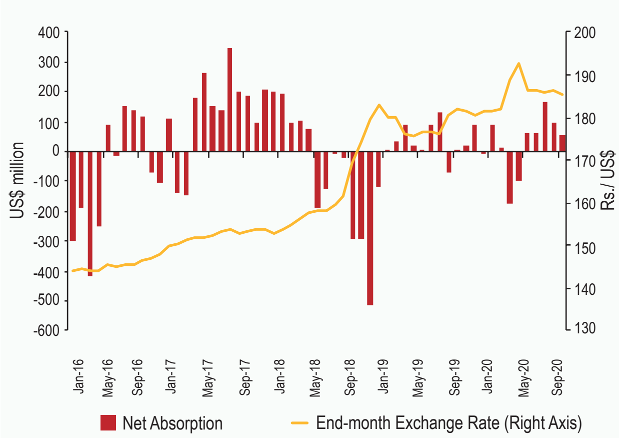
- **Wider current account deficit and reduced inflows to the financial account led to a deficit of the overall balance of BOP during the nine months ending in September 2020**. Reflecting the decline in the reserve position primarily due to debt repayments, the overall balance recorded a deficit of US dollars 1,104 million by end September 2020, in comparison to a surplus of US dollars 377 million at end 2019.

5

Exchange Rate Movements

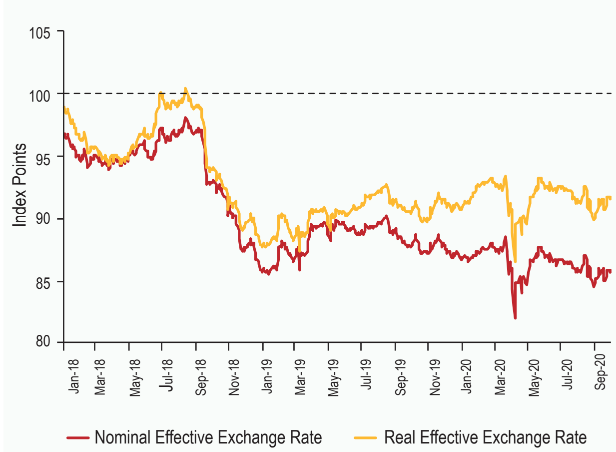
- **The Sri Lankan rupee has remained broadly stable thus far in 2020, in spite of a sharp depreciation experienced in March and April due to speculative pressure driven by uncertainties associated with the COVID-19 pandemic**. The exchange rate, which remained around the same level as recorded at the end of 2019 until mid March 2020, depreciated heavily in the immediate aftermath of the pandemic related lockdown, which adversely affected the liquidity in the domestic foreign exchange market and market sentiments. With the depreciating pressure that prevailed from mid March to mid April 2020, the exchange rate peaked at Rs. 199.75 per US dollar on 09 April 2020 recording a depreciation of 9.07 per cent against the US dollar. This necessitated active intervention by the Central Bank to curb excessive volatility in the domestic foreign exchange market. The Central Bank supplied foreign currency liquidity, on a net basis, amounting to US dollars 272.4 million during March and April 2020. Meanwhile, the Central Bank introduced a sell-buy foreign exchange SWAP arrangement for licensed commercial banks to provide foreign currency liquidity on a short term basis. During this period, access to external liquidity sources was severely restricted due to uncertainties that emerged in the global financial market in the face of the pandemic. However, there has been a turnaround of the situation since mid April 2020, due to policy measures taken to restrict non essential imports and to limit some foreign exchange outflows. These measures contributed towards the strengthening of the exchange rate since then and enabled the Central Bank to absorb foreign exchange from the market on a net basis. By end September 2020, the net absorption of the Central Bank amounted to US dollars 255 million. Meanwhile, the depreciation of the rupee against the US dollar from the beginning of the year to end September was limited to 2.1 per cent. Reflecting cross currency exchange rate movements by end September 2020, the Sri Lanka rupee depreciated against the euro (6.6 per cent), the Japanese yen (4.8 per cent), the pound sterling (0.1 per cent) and appreciated against the Indian rupee (1.3 per cent). The rupee further appreciated in the first three weeks of October 2020, reflecting continuous inflows to the domestic foreign exchange market, also enabling the Central Bank to absorb foreign currency from the domestic foreign exchange market supplementing the gross official reserves.

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 (2017 = 100)



Source: Central Bank of Sri Lanka

- **Nominal Effective Exchange Rate (NEER) indices and the 5-currency Real Effective Exchange Rates (REER) index declined during the year up to end September 2020**. NEER indices declined reflecting nominal depreciation of the Sri Lankan rupee against currencies of some major trading partners together with the movements in cross currency exchange rates. Accordingly, 5-currency and 24-currency NEER indices have declined by 2.69 per cent and 1.09 per cent, respectively, by end September 2020. Meanwhile, REER indices, that take into account the inflation differentials with other countries in addition to the variation in nominal exchange rates, declined by 0.61 per cent for the 5-currency basket and increased by 1.10 per cent for the 24-currency basket. The increase in the 24-currency basket can be mainly attributed to high domestic price levels compared to some trading partners. Despite the mixed performance in REER indices compared to the beginning of the year, both 5-currency and 24-currency REER indices remained below the threshold of 100 index points, indicating that the exchange rate remained supportive of the country's trade competitiveness. A widening gap between NEER and REER was observed in 2020 mainly due to the increase in the inflation differential between Sri Lanka and its major trading partners. This is mainly due to substantial moderation in inflation in other main trading partners compared to the relatively stable level of inflation in Sri Lanka.

Expected Developments

- **The outlook of the external sector, which is largely driven by the trade deficit, will depend on the global economic impact of the COVID-19 pandemic and the domestic policy responses**. The trade deficit is expected to contract in 2020 in comparison to 2019, benefiting from the higher than expected decline in expenditure of imports compared to the decline in earnings from exports. Somewhat lower earnings from exports are likely with a significant impact on the global demand for key Sri Lankan exports and the weak performance of exports during the lockdown period. Meanwhile, import expenditure is expected to be low due to the sharp decline in global crude oil prices, the drop in export oriented import demand, and the policy driven curtailment of vehicle and other non essential imports. The removal of the US GSP facility from India may have a positive impact on Sri Lankan exports, while the Brexit, which was originally set to be fully implemented from 2021, is not expected to disturb exports of Sri Lanka. The ongoing trade dispute between the USA and China could result in some increase of exports through trade diversion. Consequently, the trade deficit, which was 9.5 per cent of GDP in 2019, is projected to improve to around 6.6 per cent of GDP in 2020. In the medium term, the ongoing drive to enhance domestic production, the establishment of trade relations with new trading partners, efforts to diversify product basket, strong high level institutional support as evidenced by the establishment of the Export Development Council, together with a more competitive exchange rate are expected to drive the growth momentum in exports. Enhanced domestic production is also expected to reduce import expenditure through import substitution achieved by higher domestic value addition.

- **The current account deficit is expected to improve considerably in 2020**. This expected improvement will be largely driven by higher than anticipated reduction in trade deficit and the decline in the primary income account deficit despite the contraction in the services account surplus on account of lower earnings from tourism. Workers' remittances are also expected to continue the growth momentum experienced since June 2020, for the rest of the year and support the BOP. However, in 2021, the trade deficit could widen since the projected increase in import expenditure is expected to outpace the increase in export earnings. Further, it is expected that tourist earnings will resume in 2021. IT related exports and earnings from transportation are expected to strengthen the services account. However, the primary income account deficit is projected to increase in 2021 with higher interest payments resulting from adverse global market developments as well as increased dividend payments and reinvested earnings with the expected increase in FDI. The recovery in workers' remittances could continue in 2021 with the gradual normalisation of economic activity in the main source countries and expected gradual increase in migration for employment. The financial account is anticipated to strengthen in 2021 and beyond, despite the setback in 2020 due to the COVID-19 pandemic related financial rigidities. FDI inflows are predicted to pick up from 2021, particularly on account of inflows to the Colombo Port City and the Hambantota industrial zone projects. High foreign currency debt service payments falling due in 2021 and over the medium term will continue to be a major concern in the external sector. The Government's efforts to rationalise foreign funded projects and utilise domestic resources to finance a large part of the budget deficit are likely to limit the increase in foreign currency debt stock further. To maintain the country's external debt at sustainable levels, the ongoing efforts to maintain a relatively low level of current account deficit by enhancing merchandise exports and thereby reducing the trade deficit must be continued, while attracting a higher level of non debt creating inflows in the form of FDI over the medium term.