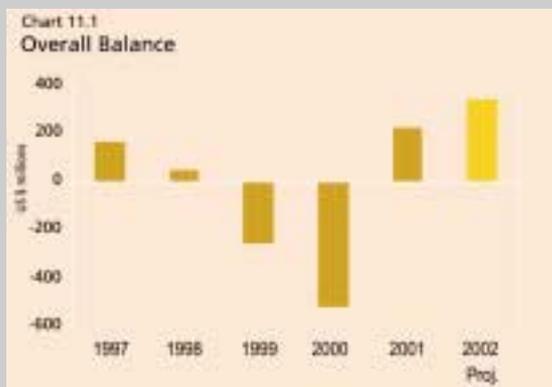


11 BALANCE OF PAYMENTS AND EXCHANGE RATE

Overall performance for the first half of 2002 indicates a recovery in the external sector following the dismal performance in the second half of 2001, which was mainly due to the global slowdown, the attack on the airport and domestic supply shocks caused by the drought and power crisis. Although exports have not recovered to the extent expected at the beginning of the year, the performance thus far in 2002 in areas such as tourism, and private capital inflows in terms of foreign direct investments (FDI) and portfolio investments, have reflected a recovery since the last quarter of 2001. These are indicative of improved investor confidence arising from a more stable political environment, progress in the ongoing peace process and the government's commitment to the speedy implementation of economic reforms. These developments are expected to lead to a surplus in the balance of payments, used to build up external reserves to a stronger position. More stability in the exchange rate is also expected, thereby reducing pressure on domestic price levels generated through currency depreciation.



Sectoral Performance and Prospects

Trade Balance

- ◆ The trade balance which worsened to US dollars 863 million during the first six months is expected to reach US dollars 1,345 million at end 2002 compared with US dollars 1,157 million in 2001.

Services Account

- ◆ Net inflows on the services account declined to US dollars 81 million during the first half of 2002 from US dollars 113 million in the first half of 2001.
- ◆ A recovery is expected in the second half as there are already signs of recovery in tourism, port related services and telecommunications services.
- ◆ Productivity improvements in the port and the removal of the war risk insurance premium have contributed to the recovery in port related services.
- ◆ Net inflows to the services account are expected to be around US dollars 117 million for the year 2002.

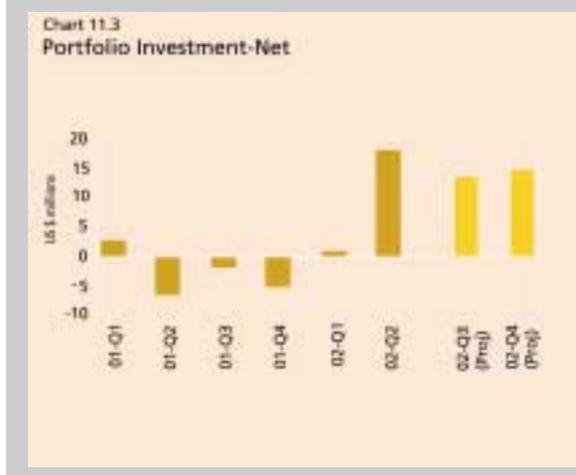
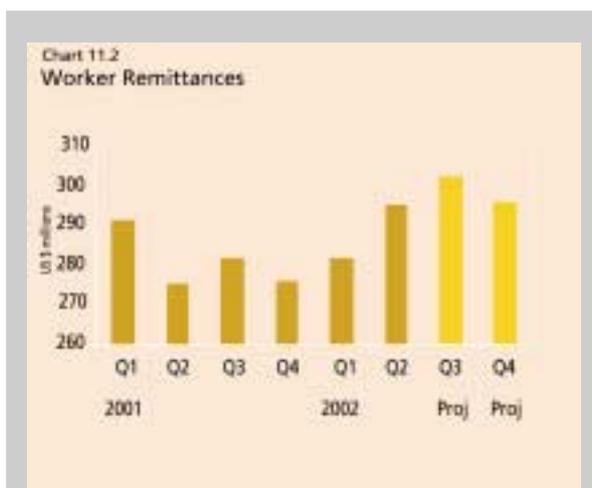
Worker Remittances

- ◆ Worker remittances in the first half of 2002 amounted to US dollars 566 million, almost at the same level as in the first half in 2001, indicating a recovery following the drop in the second half of 2001. The recovery is expected to continue during the second half in 2002, increasing the remittances to US dollars 1,190 million, from US dollars 1,123 million received in 2001.

- ◆ The current account deficit is expected to remain at a higher level of 2.9 per cent of GDP during 2002 than in 2001. However, a current account deficit financed by foreign capital would not be a serious concern as it would move the country onto a higher growth path in the medium term, increasing the country's capacity to service external obligations.
- ◆ Net foreign direct investment inflows for the year 2002 have been estimated at US dollars 215 million against US dollars 82 million realised during the year 2001. The number of BOI agreements already signed during the first half confirms the increasing trend, reflecting improved investor confidence in 2002.

Foreign Direct Investment

- ◆ The inflow for the first half of 2002 has been estimated at US dollars 120 million in comparison to the inflow of US dollars 42 million during the first half in 2001.



Portfolio Investment

- ◆ Portfolio investment has recorded a net positive inflow of US dollars 18.7 million during the first half of 2002 against a net outflow of US dollars 3.9 million during the corresponding period in 2001 indicating improved foreign investor confidence. The net inflow had increased further to US dollars 28 million by end September 2002, and is expected to increase to US dollars 47 million by end 2002.
- ◆ This recovery is expected to continue in the second half. However, any uncertainty in the domestic political environment could result in some volatility.

Capital Inflows to the Government

- ◆ Foreign inflows to the government, which are mostly on concessional terms, decreased significantly to US dollars 202 million in the first half of 2002, from US dollars 304 million during the corresponding period in 2001. Meanwhile, repayment of government external debt during the first half of 2002 decreased to US dollars 129 million from US dollars 156 million during the

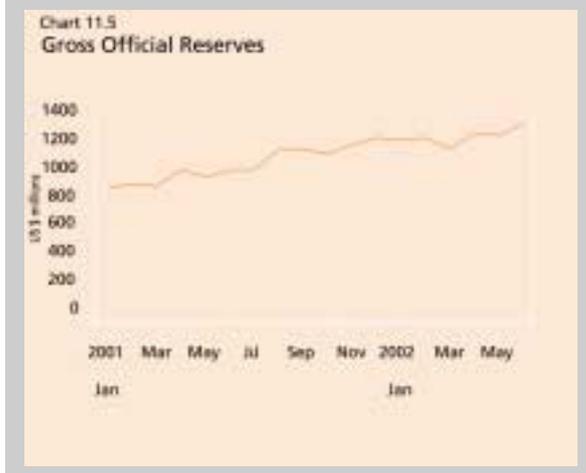
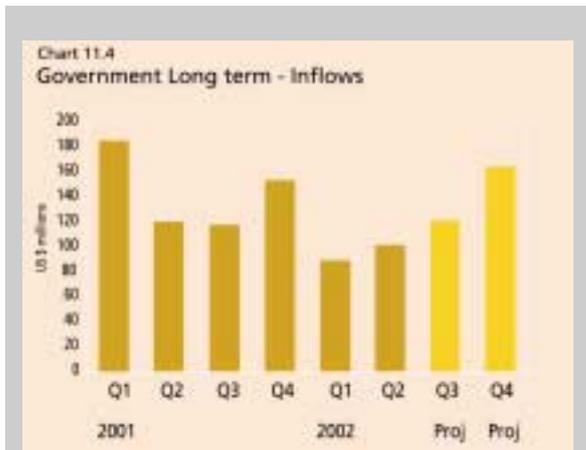
corresponding period in 2001. Delays in project implementation and undertaking structural reforms required under foreign funded programmes are considered to be the main cause for the drop in foreign loan disbursements to the government. This has led to a shortfall in the expected external financing of government expenditure.

- ◆ However, the donor community has already indicated its willingness to provide support for speedy implementation of economic reforms, the proposed programme for poverty reduction and the rehabilitation of the North and East.

- ◆ If the progress already achieved in economic reforms and peace process continues, donor agencies may commit a significant amount of additional capital inflows during the second half of 2002, a bulk of which will materialise in 2003.
- ◆ Government borrowings for 2002, including the proposed commercial borrowing of about US dollars 250 million, are expected to increase to US dollars 715 million in 2002, from US dollars 575 million in 2001.

Gross Official Reserves

- ◆ The increase in gross official reserves observed since the flotation of the rupee in January 2001, continued in 2002.
- ◆ During the first half of 2002, the successful completion of the first and second reviews of the Stand By Arrangement (SBA) enabled the disbursement of US dollars 60 million to build up gross reserves. The receipt of the final tranche of the SBA in September 2002 increased gross official reserves further by US dollars 60 million.
- ◆ In addition, gross official reserves were also built up by the purchase of foreign exchange from the market by the Central Bank and the new issue of the Sri Lanka Development Bonds worth US dollars 92 million.
- ◆ As a result, the overall balance in the balance of payments recorded a surplus of US dollars 110 million during the first half of 2002.

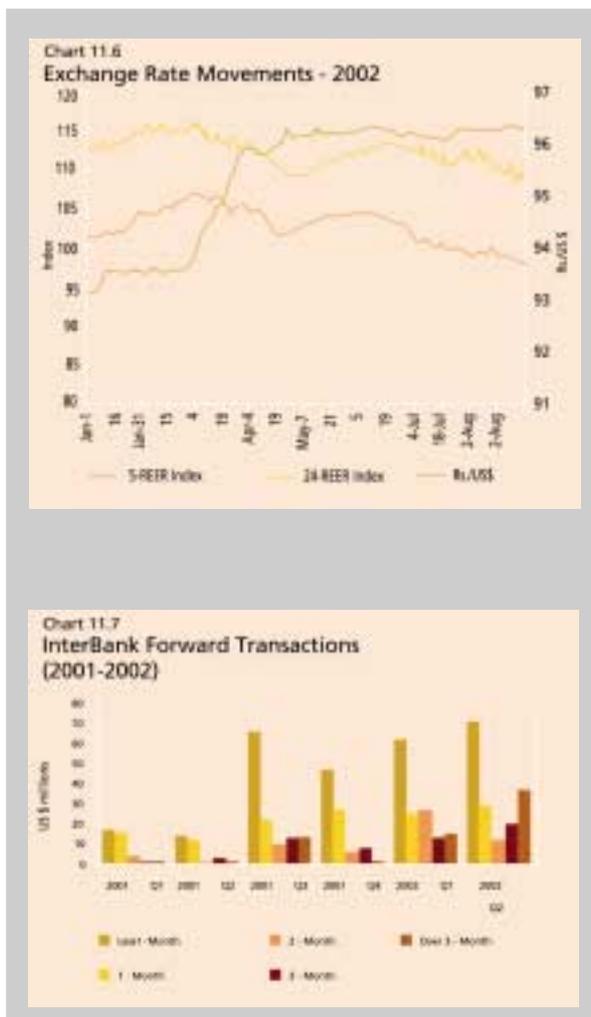


- ◆ Gross official reserves as at end June 2002 stood at US dollars 1,449 million, which was sufficient to cover 2.9 months of imports as compared to the 1.9 months of imports at end June 2001.
- ◆ Continuation of foreign exchange purchases by the Central Bank from the forex market will further improve gross official reserves during the second half of 2002. Gross official reserves at end 2002 are expected to increase to a level that is sufficient to cover 3.6 months of import.
- ◆ Total gross external reserves are expected to increase by a larger amount than the increase in

official reserves due to the expected increase in foreign assets of the commercial banking system.

Exchange Rate

- ◆ The independently floating exchange rate regime introduced in January 2001 helped to improve external sector stability and to maintain external competitiveness by depreciating the currency broadly in line with inflation differentials between Sri Lanka and its trading partner countries.
- ◆ The real effective exchange rate (REER) based on a five-currency basket remained almost at the same level during the first six months of 2002, while the REER based on a 24 currency basket depreciated by about one percent during the same period.
- ◆ The rupee depreciated against the US dollars at a lower rate (3.1 per cent) in comparison to other major currencies. It depreciated against the euro (13.4 per cent), the Japanese yen (11.8 per cent), the pound sterling (8.1 per cent) and the Indian rupee (2.0 per cent) during the same period.



Forward Market

- ◆ Activities in the forward market increased significantly during the first half in 2002 by recording total transactions worth US dollars 320 million, in comparison to US dollars 69 million recorded the first half in 2001. This trend is expected to continue in the second half of 2002.

- ◆ The maturity in forward transactions was extended, indicating improved market confidence. Improvements in the forward market helped reduce the volatility in the exchange rate, as an active forward market provides another instrument to hedge against foreign exchange risks.
- ◆ In the recent past, the forward premium has been marginally lower than the interest rate differential, indicating market expectations of further stability in the exchange rate and lower domestic interest rates in the near future.

Debt Service Payments

- ◆ Total external debt service payments in 2002 were estimated at US dollars 809 million compared to US dollars 811 million in 2001. The debt service payments as a percentage of receipts from merchandise exports, services and income are expected to increase marginally from 13.3 per cent to 14.1 per cent, while as a percentage of receipts from goods, services, income and private transfers, are estimated to remain at the same level of about 11 per cent as in 2001.

External Sector in 2003

- ◆ External sector developments will be sensitive to changes in the international economy. The projections for the external sector in 2003 are based on the assumptions of a strong recovery in the global economy, unchanged oil prices in the international market and the peace process

progressing during the year. A recovery in industrial countries, in particular, the US and the European Union, Sri Lanka's major export markets, is vital for a recovery in exports. Sri Lanka being an oil importing country, its balance of payments position is highly sensitive to oil price changes.

- ◆ The trade deficit is expected to widen somewhat to 9.3 per cent of GDP from 8.2 per cent of GDP in 2002 as imports are expected to recover at a faster rate than exports in 2003,.
- ◆ The service account is expected to record a surplus in 2003. Inflows to the services account in terms of tourism, port related services and telecommunications services would continue to grow in 2003 with the continuation of the peace process and expected improvements in ports and telecommunications services.
- ◆ The current account deficit is expected to widen in 2003, mainly due to the expected higher trade deficit. However, such a widening is not a serious concern as it would be driven by higher investment related imports and financial facilities will be available at concessional rates to cover part of the additional import demand.
- ◆ FDI and portfolio investment inflows are expected to continue to increase in 2003 with the continuation of political stability and progress in the peace process.
- ◆ The level of government borrowing would depend mainly on the extent of the government's

ability to address problems in fiscal management, and increase efficiency in aid utilisation.

- ◆ Borrowing under concessional terms and conditions could be expected to be higher with progress in the peace process as donor agencies have expressed their willingness to support the reconstruction process. However, the government's foreign commercial borrowings have to be minimised in order to ensure long term external sector sustainability.
- ◆ Meanwhile, obtaining a sovereign rating will expand the government's foreign borrowing sources and facilitate private sector foreign borrowings particularly for infrastructure investments.
- ◆ Reflecting the favorable developments in the external sector, external assets of the country are expected to improve further in 2003, increasing the level of external reserves to a comfortable level of about 5.8 months of imports.
- ◆ The level of external debt as a ratio of GDP is expected to decline somewhat in 2003.
- ◆ With the expected economic growth and higher receipts from goods and services exports and low international interest rates, the external debt service payments as a percentage of exports of goods, services and income is expected to decline from 13.7 per cent to 12.1 per cent in 2003.
- ◆ Projections for 2003 depend heavily on the assumption about the external sector mentioned earlier and the government undertaking structural reforms needed to revitalise the economy.
- ◆ Any deviation from these assumptions would have adverse implications on economic growth and external sector developments.
- ◆ The IMF, in its latest projections (World Economic Outlook 2002 September), has revised world economic growth for 2003 downwards to 3.7 per cent from its earlier projection of 4.0 per cent.
- ◆ Delays in the global economic recovery would be felt on both exports and imports and on capital flows.
- ◆ Sri Lanka's external sector developments depend much on movements in the international prices of commodities. In particular, an increase in oil prices could dampen the prospects of a recovery in the external sector.