5. EXTERNAL SECTOR DEVELOPMENTS

External sector improved in the first eight months of 2005 with a substantial growth in both exports and imports. However, the trade deficit widened despite the faster growth in exports compared to the growth in imports. The deficit was offset with the private transfers, especially worker remittances and transfers to assist tsunami relief and reconstruction. These inflows also led to a moderation in the current account deficit, which was financed through inflows to capital and financial accounts. Consequently, the overall Balance of Payments (BOP) recorded a surplus during the first eight months of 2005, in contrast to the deficit experienced in 2004. This surplus coupled with the expectations of large tsunami-related inflows reduced the pressure on the exchange rate leading to a high degree of its stability during the first eight months of 2005.

Trade in Goods and Trade Balance

- **Sri Lanka's exports continued to expand during the first eight months of the year benefiting from the continuing growth momentum in the global economy.** Export earnings increased by around 12.7 per cent to US dollars 4,051 million during the first eight months of 2005. Modest price gains and substantial improvements in trade volume contributed to the growth in export earnings. Industrial exports accounted for about 78 per cent of overall exports. Agricultural exports and mineral exports contributed about 18 per cent and 2 per cent, respectively, to the overall value of exports. In a quota free environment, textiles and garments continued to grow and accounted for more than 46 per cent of overall exports during the first eight months of 2005. This growth momentum is expected to continue benefiting from the duty free access to the European Union (EU) under the GSP+ scheme, and Free Trade Agreements with both India and Pakistan. For the year as a whole, exports in US dollar terms are expected to grow at a rate of around 11 per cent, compared with 12 per cent in 2004.

- **Imports grew by around 11.3 per cent to US dollars 5,626 million during the first eight months of 2005**

Chart 5.1
Trade Performance and Trade Balance

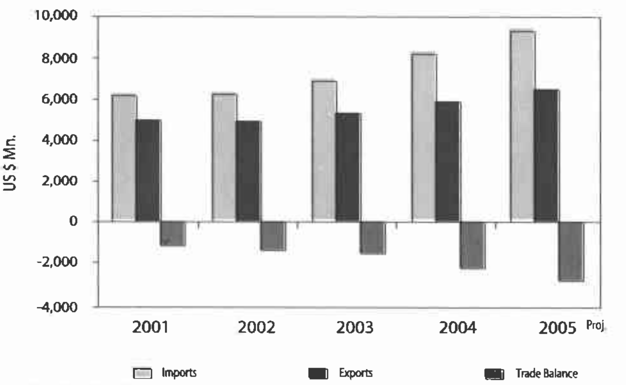
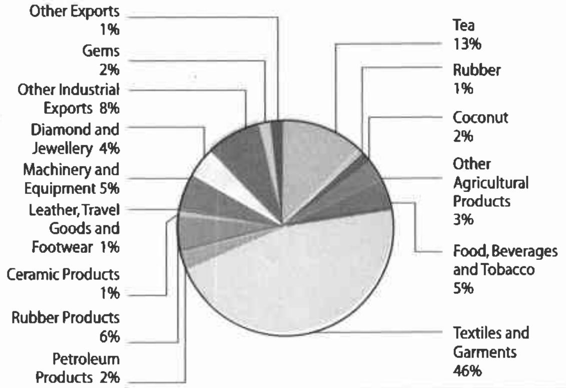


Chart 5.2
Composition of Exports (Jan - Aug 2005)



compared with the significantly higher growth rate of 19.9 per cent in the corresponding period of 2004. The major contributors to the overall imports growth during the first eight months were petroleum (44 per cent), textiles (22 per cent), building materials (13 per cent), fertilizer (7 per cent) and chemicals (7 per cent). However, the imports are expected to grow at a higher rate of around 15 per cent during 2005 with faster implementation of tsunami related reconstruction work.

- **Trade deficit widened by around 7.7 per cent** to US dollars 1,575 million from US dollars 1,462 million during the first eight months of 2004.

- **The terms of trade recorded a deterioration of 2.2 per cent during the first eight months of 2005.** This was mainly resulted from the increases in prices of intermediate goods. Substantial price increases in petroleum, fertilizer and chemical compound were instrumental in increasing the prices of intermediate goods. Prices of consumer goods and investment goods also increased, raising increases in prices of imports, exceeding the increases in prices of exports.

Trade in Services

- **The surplus in the services account increased by around 3.7 per cent to US dollars 170 million in the first half of 2005.** This arose from improvements in transportation services, insurance services and IT exports.

- **Transportation services increased by around 10 per cent,** reflecting the increase in the number of tourist arrivals, increased external trade and increased number of transhipment container handling, which grew by around 13 per cent in the first eight months of 2005. As several insurance companies received claims on property damaged by the tsunami from their re-insurers abroad, net inflows on account of insurance showed a sharp rise.

- **Tourist arrivals increased by around 12 per cent to 362,049 during the first eight months of 2005** from 324,105 in the corresponding period in 2004. However, the value of inflows on account of travel and tourism have decreased to US dollars 209 million from US dollars 236 million, due to lower room

Chart 5.3
Composition of Imports (Jan - Aug 2005)

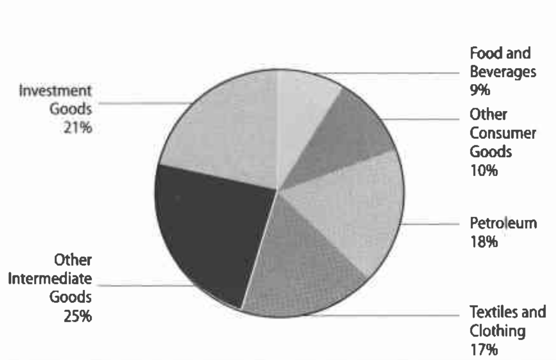
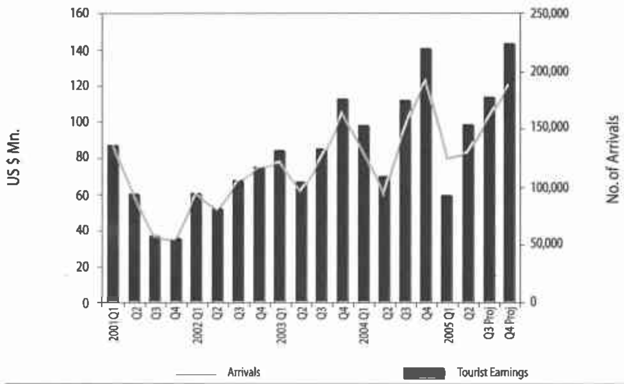


Chart 5.4
Tourist Arrivals and Earnings



occupancy rates during the first eight months of 2005. With the sharp increase expected in the tourist arrivals during the second half, the number of arrivals is projected to reach 600,000 by the end of 2005.

Inflows and Outflows of Income

- **Deficit in the income account widened significantly during the first half** mainly due to higher interest payments on external debt arising from higher global interest rates and decline in gains from exchange rate movements, although there was some relief on interest payments under the debt relief. Reflecting these, the income account deficit widened to US dollars 104 million from US dollars 78 million in the first half of 2004. However, this deficit is expected to narrow down during the second half of 2005 with expected rise in external reserves resulting from disbursement of further tsunami related assistance by the donors.

Current Transfers

- **Net current transfers increased by around 22 per cent to US dollars 1,120 million** during the first eight months of 2005. In the aftermath of tsunami destruction foreign governments, citizens and non-governmental organisations have made a fair amount of donations both in kind and cash. The tsunami related cash inflows by way of current and capital transfers to the private sector through the banking system, amounted to around US dollars 118 million. Worker remittances by Sri Lankan migrants also increased significantly by around 16 per cent to US dollars 1,178 million, almost doubling the historical growth. Current transfers to the government are expected to increase during the remainder of the year with the disbursement of pledged grants by the donors.

Current Account Balance

- **The current account deficit narrowed down to US dollars 285 million in the first half of 2005** from a deficit of US dollars 352 million in the first half of 2004. The surplus in services account and a sharp rise in current transfers helped contain the current account deficit. However, with the commencement of the reconstruction and rehabilitation of tsunami-hit infrastructure facilities during the second half of the year, the imports for reconstruction activities are expected to increase considerably widening the current account deficit. The increased current account deficit is expected to be financed through concessionary donor funds.

Inflows and Outflows in the Financial Account

- **Foreign Direct Investment (FDI) is estimated to have increased** during the first half with the implementation of a large number of projects signed during 2004. Though the number of projects signed during the first half has increased, the number of projects approved during this period has declined significantly, reflecting the strict screening process implemented by the Board of Investment of Sri Lanka

(BOI) in approving new projects. However, it is expected to result in faster realisation of investment from the large number of projects approved.

- **Loan inflows to private sector increased to around US dollars 100 million in the first half of 2005** from US dollars 12 million in the corresponding period in 2004 mainly due to the utilisation of loan facilities under the Indian Line of Credit by the Ceylon Petroleum Corporation.

- **Net inflows on account of portfolio investment are estimated to have increased to around US dollars 30.3 million** during the first eight months of 2005 from US dollars 4.9 million in the corresponding period in 2004. In spite of rising global interest rates, net inflows to the stock market increased significantly, especially during the month of July, led by the initial share offer made by Dialog Telekom Ltd. The foreign investors have subscribed by more than 12 times of the allocation. This share issue is likely to increase the net foreign inflows to share market during the second half of the year as well, as foreign investors are expected to be net purchasers in the secondary market.

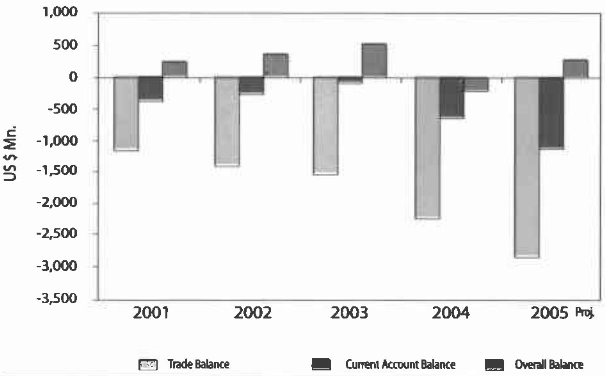
- **Financial flows to government are estimated to have increased substantially during the first half,** mainly due to grants received especially for the provision of relief to tsunami victims and reconstruction of tsunami-hit infrastructures. Although grants increased, the loan inflows to the government during the first seven months of 2005 have declined to US dollars 341 million from US dollars 394 million in the corresponding period of 2004, mainly due to the delay in implementation of certain structural reforms. Loan inflows to the government are expected to increase during the rest of the year with the continuation of receipts of tsunami related inflows.

- **Repayment of government external debt during the first seven months of 2005 decreased to around US dollars 113 million** from US dollars 180 million in the first seven months of 2004. This resulted mainly from the debt moratorium granted by the several members of the Paris Club and G8 countries. The debt moratorium will yield a lower debt repayment in 2005.

Balance of Payments

- **Net inflows to the capital and financial accounts during the first half were more than sufficient** to offset the narrowing current account deficit. Consequently, the overall BOP recorded a surplus of around US dollars 174 million during the first half of 2005, compared to a deficit of US dollars 223 million in the first half of 2004. The overall BOP is projected to record a surplus of around US dollars 295 million

Chart 5.5
Balance of Payments



by the end of 2005 in contrast to the deficit of US dollars 205 million experienced in 2004.

External Reserves

- **Gross official reserves increased to US dollars 2,367 million (3.3 months of imports) at the end of August 2005** from US dollars 2,196 million (3.3 months of imports) at the end of December 2004. The receipt of around US dollars 157 million emergency assistance from IMF, programme loan of US dollars 25 million from ADB, mobilisation of foreign currency loan of US dollars 210 million from a local commercial bank, debt moratorium and tsunami related inflows have contributed to improve the official reserves.

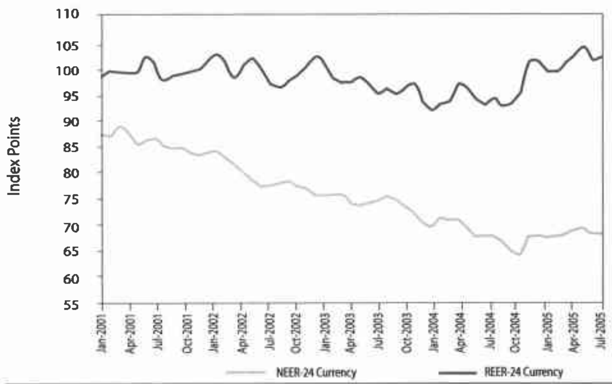
- **The total external reserves of the country increased to US dollars 3,655 million (5.1 months of imports) at the end of August 2005,** from US dollars 3,438 million (5.2 months of imports) at the end of December 2004. The total foreign reserves of commercial banks have increased from US dollars 1,243 million at end 2004 to US dollars 1,288 million at end August 2005.

Exchange Rate Regime and Exchange Rate Movements

- **The foreign exchange market remained relatively stable during the first half of 2005** with some volatility occurring by the end of the second quarter, which continued in to the third quarter. The rupee/US dollar rate, which began to appreciate by the end of December 2004 after depreciating at a higher rate during the most part of 2004, appreciated sharply in January 2005. The rupee/US dollar rate, which was at Rs.104.61 at end 2004, appreciated to Rs.99.41 and Rs.100.01, respectively, at end March and June 2005, by around 5.2 per cent and 4.6 per cent, respectively. However, the rate reached Rs.101.31 by end September, thus decelerating the appreciation to 3.3 per cent, mainly due to higher demand for import expenditure. The Central Bank intervention in the foreign exchange market mitigated the excessive volatility. During the first nine months of 2005, the rupee also strengthened against almost all other major currencies, e.g. euro (16.6 per cent), the Japanese yen (13.6 per cent), the sterling pound (12.8 per cent) and the Indian rupee (3.9 per cent).

Chart 5.6
Gross Official Reserves

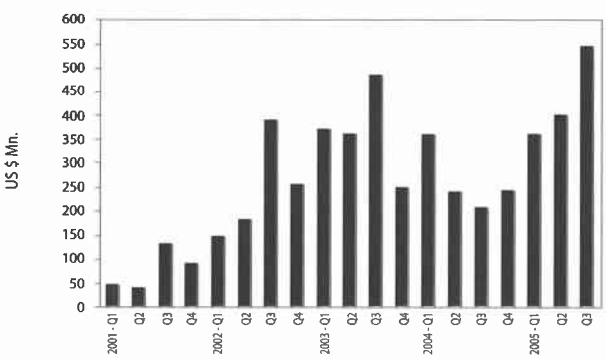
Chart 5.7
Nominal and Real Effective Exchange Rate Indices (1999=100)



- **Reflecting the currency movements, the rupee appreciated** against SDR as well as in terms of effective exchange rates. Against the SDR the rupee appreciated by 10.6 per cent and the effective exchange rates based on both 24 currency and 5 currency Nominal Effective Exchange Rate (NEER) indices appreciated by around 7.9 percent and 7.6 per cent, respectively, during the first nine months of the year. The Real Effective Exchange Rate (REER) based on 24 currency and 5 currency indices appreciated by around 8.5 per cent and 8.4 per cent, respectively, due to the relatively higher domestic inflation compared with that of trading partners during the first nine months of the year.

- **The foreign exchange market was less volatile, especially during the first quarter,** due to high export growth, moderation in imports, increasing remittances and expectation of tsunami related foreign aid inflows. Reflecting these developments, activities in the forward market were comparatively higher during the first nine months of 2005 than in 2004. The total volume of forward transactions amounted to around US dollars 1,287 million during the first nine months. When compared to the first nine months of 2004, the total volume has increased by US dollars 498 million or by 63 per cent.

Chart 5.8
Forward Transactions in the Inter-Bank Market



Prospects for 2006

- **The external sector is projected to record a surplus for the second consecutive year in 2006** building upon on the strong performance in 2005. Realisation of foreign funds pledged for the reconstruction of tsunami hit infrastructure facilities and housing, increases in private remittances, earnings from tourism and export earnings will contribute to this performance. However, high and volatile oil prices and global imbalances could pose downside risks to this projection.

- **The exports are projected to grow strongly by around 10 per cent in 2006** benefiting from the GSP+ scheme offered by the EU, strengthening of the bilateral free trade agreements with both India and Pakistan, and continuing global recovery, especially in the US, Sri Lanka's major export destination.

- **Imports are also projected to grow by around 13 per cent in 2006** mainly due to surge in imports resulting from donor funded tsunami reconstruction and rehabilitation activities and increased demand for investment goods by both private and public sectors. Reflecting these developments, the trade account is projected to widen in 2006.

- **The surplus in the services account is expected to improve further in 2006** reflecting the recovery in tourism sector, increased revenue from port related activities resulting from continuous growth in international and regional trade and rise in IT exports including Business Process Outsourcing (BPOs).

- **Net current transfers are projected to increase substantially in 2006** with more foreign employment opportunities in oil producing Middle Eastern countries and some emerging market economies in Asia. The surpluses in both services and transfers accounts will not be sufficient to offset the widening current account deficit resulting from increased imports, especially tsunami reconstruction related imports and increased oil imports bill. However, since the tsunami reconstruction activities will be largely financed through the foreign grants and loans, the current account deficit will be more than offset by such foreign inflows resulting in an overall balance of payments surplus in 2006.