5 EXTERNAL SECTOR DEVELOPMENTS

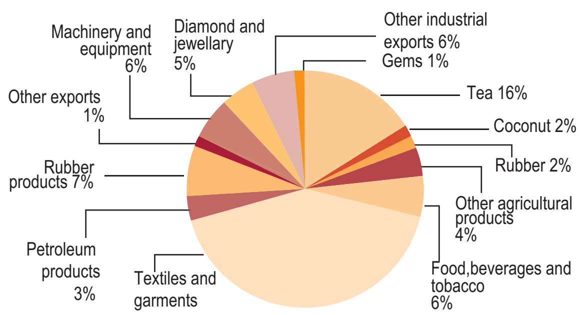
The external sector performed well during the first half of 2008 recording a balance of payments (BOP) surplus despite the inevitable downturn in the global economic activities. The exports continued to grow amidst uncertainties of sustaining future growth prospects. However, the unprecedentedly higher petroleum and commodity prices that prevailed in the international markets led imports to grow substantially higher, widening the trade deficit during the first eight months of 2008. This was partly offset by the increased private remittances, which helped to contain the current account deficit to some extent. Nevertheless, the surplus in the capital and financial account, in the form of net foreign inflows to the government and the private sector, was more than sufficient to finance the higher current account deficit. Reflecting these developments, the BOP recorded an overall surplus, enhancing gross official reserves of the country. Meanwhile, the rupee strengthened against most of the major currencies during the first nine months of 2008.

Trade in Goods and Trade Balance

- **Earnings from exports continued to increase during the first eight months of 2008.** Exports grew by 12.7 per cent to US dollars 5,498 million, in the first eight months of 2008. The agricultural sector provided the major impetus for export growth through its persistently strong performance, reflecting the impact of the sharp increases in international commodity prices, driven by tight supply conditions, low inventories, and weather related factors.

- **Tea, rubber as well as minor agricultural products fetched historically high prices in the international markets during the first eight months of 2008.** The average prices of tea and rubber rose in 2008 to US dollars 4.01 and US dollars 2.73 per kilogram respectively; higher than the average prices of US dollars 3.10 and US dollars 2.09 per kilogram fetched in the corresponding period of 2007. In terms of export volumes, the tea sector expanded by 9.9 per cent to 220.7 million kilograms whereas the rubber sector contracted by 10.3 per cent to 31.6 million kilograms during the first eight months of 2008. Exports of minor agricultural products, particularly cinnamon, cloves, fruits and vegetables, and betel leaves, have performed better in recent months, in response to the attractive prices they fetched in the international arena.

Chart 5.1
Composition of Exports (January - August 2008)



- **Industrial product exports recorded a modest growth of 5.3 per cent in the first eight months of 2008, partly due to the decelerating demand for apparel products.** This could be attributed mainly to the economic slowdown and heightened competition in the USA, the largest market for Sri Lanka's exports of apparel. The declining growth trend in the US market in recent years was negated to a certain extent by the remarkable expansion in apparel exports to the EU, the second largest market for Sri Lanka's exports of apparel.

- **The growth in exports to the EU was supported by the GSP+ scheme, which provides duty free market access to Sri Lankan exporters.** The impact of the scheme is reflected in the expansion of market share, particularly in the UK, Italy, Germany, France and the Netherlands, as well as the product diversification in exports to the EU. The current GSP+ scheme is scheduled to be reviewed and the decision with regard to Sri Lanka's eligibility for an extension from 2009-2011 would be made in December 2008. The new EU regulations of the GSP Scheme will come into force with effect from 1 January 2009.

- **Earnings from most categories of industrial exports such as rubber products, machinery and equipment, and diamonds and jewellery, expanded during the first eight months of 2008.** Nevertheless, the sub category "food, beverages and tobacco" recorded a negative growth as a result of the significant decline in exports of vegetable fats, namely, 'vanaspathi', to India, due to the erosion of preferential advantage to Sri Lanka following tariff adjustments by India. The CEPA, which is expected to take the Indo-Sri Lanka Free Trade Agreement (ISFTA) one stride further, towards greater economic integration between the two countries by reducing the respective negative lists further and incorporating trade in services, facilitated resolving some differences in trade matters between the two countries. Although, both countries concluded the discussions on the CEPA Framework Agreement, the finalisation process is expected to take some more time in view of the stressing need for further consultations with all stakeholders to accommodate their views.

- **The sharp increases in international commodity prices since the latter half of 2007 led to significantly higher expenditures on imports during the first eight months of the year 2008.** Imports grew by 35.3 per cent to US dollars 9,529 million in first eight months of 2008 compared to US dollars 7,043 million during the corresponding period of 2007.

- **All major categories contributed to the growth of imports.** Within the consumer goods category, expenditure on food and beverages outweighed the growth in other consumer goods, particularly on account of increases in the prices of wheat, milk and rice. Concerns about the global supply outlook coupled with lower stocks in major producing countries, not only raised the prices of these products, but also increased price volatility. Substantial increases in the oil prices continued to dominate the behaviour of the intermediate goods category and raised expecnditures with respect to imports of petroleum, fertiliser and chemical products. For the first eight months of 2008, the average import price of oil was US dollars 115.52 per barrel, which is more than 76 per cent higher than its respective price during the corresponding period last year.

Chart 5.2
Composition of Imports (January- August 2008)

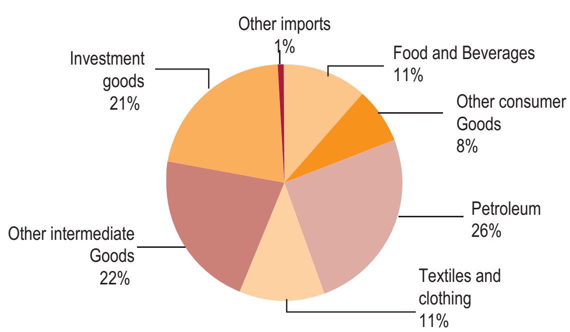
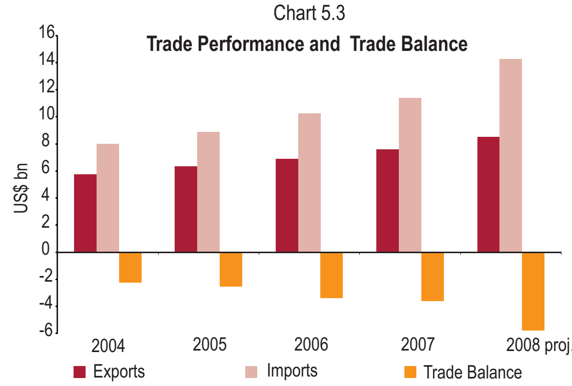


Chart 5.3
Trade Performance and Trade Balance



- **The increasing trend in the import of investment goods continued further, with marked increases in imports of building materials, machinery and equipment.** The growth in investment goods amid the challenging times in the domestic and international markets reflects the resilience of the economy to the various shocks it has had to endure and in that context, it is important to foster both, the industrial and services sectors, to guide them towards a path of sustainable development.

- **As a result of higher growth of imports over the growth of exports, the trade deficit in the first eight months of 2008 widened to US dollars 4,031 million from US dollars 2,166 million recorded in the corresponding period of 2007.**

Trade in Services

- **The surplus in the services account increased during the first half of 2008 mainly due to the increased earnings from the transportation sector.** Gross earnings from the transportation sector, which consists of passenger fares, freight and port related earnings, increased by 17.4 per cent to US dollars 461 million during the first half of 2008. Gross inflows of passenger fares increased mainly due to the increase in airfares led by the fuel surcharges and the marginal increase in the number of passengers carried by the SriLankan Airlines. Gross inflows on

Chart 5.4
Tourist Arrivals and Earnings

account of port-related activities increased as a result of increased transhipment cargo handling activities attributable to the growing linkages to India's booming economy and the improved service delivery at the Port of Colombo.

- **The tourist arrivals during the first nine months of 2008 dropped by 9.5 per cent to 317,546 compared to the same period in 2007,** mainly due to the travel advisories issued by some major tourist generating countries in view of the security situation in the country. Consequently, tourist earnings in the first nine months of 2008 declined to US dollars 248 million from US dollars 274 million recorded in the corresponding period of 2007.

Inflows and Outflows of Income

- **Deficit in the income account narrowed down to around US dollars 278 million during the first half of 2008 from US dollars 303 million in the corresponding period of 2007.** This was mainly driven by the higher interest income earned from the investment of increased level of international reserves, higher capital gains from the trading of securities and a modest decline in interest payments on accumulated foreign loans due to a decline in global interest rates. However, the increase in income from management of external reserves was partly offset by the repatriation of profits and dividends by foreign investors.

Current Transfers

- **Stemming from higher workers' remittances, the net private current transfers increased by around 22.6 per cent during the first eight months of 2008.** Workers' remittances by Sri Lankan migrants increased significantly by around 21.8 per cent to US dollars 1,975 million in the first eight months of 2008. The remittances helped finance almost half of the trade deficit in the same period. Departures for foreign employment increased by 23.3 per cent during the first half of 2008 to 127,224 reflecting a marked increase in labour migration to South Korea and the Middle Eastern countries. Meanwhile, current transfers to the government decreased by 41.0 per cent during the first seven months of 2008.

Current Account Balance

- **The current account deficit more than doubled to US dollars 1,910 million in the first half of 2008 from US dollars 802 million in the first half of 2007.** However, with the exception of the trade balance, all the sub-accounts showed some improvements during this period. The historically high petroleum and commodity prices were attributed to the higher trade deficit, which was partly offset by the higher inflows of workers' remittances, the relatively higher surplus in the services account and the narrowing down of the deficit in the income account.

Capital and Financial Inflows and Outflows

- **Foreign Direct Investment (FDI) realised during the first half of 2008 is estimated to have increased to US dollars 425 million from US dollars 259 million in the first half of 2007.** This consisted of equity capital of US dollars 78 million, loans and advances from the shareholders of US dollars 42 million, intra company borrowings of US dollars 58 million, foreign loans of US dollars 65 million and the reinvestment of retained earnings of US dollars 182 million. The increase in reinvestment of retained earnings depicts the confidence of the foreign investors on the future economic performance of the country and the improvement in the security situation. Foreign investment commitment of projects approved by BOI has increased in the first half irrespective of the modest decline in the number of projects approved, mainly due to the approval of large scale projects by BOI. The highest FDI inflow was recorded from Malaysia amounting to US dollars 127 million. The telecommunication industry has attracted most of the Malaysian FDI inflows.

- **Meanwhile, the value of outward FDI increased to US dollars 47 million during the first half of 2008** mainly due to the realisation of outward FDI projects approved during the previous years. Consequently, the net FDI inflows during the first half of 2008 rose to US dollars 313 million from US dollars 219 million in the corresponding period of 2007.

- **Loan inflows to private sector increased sharply in the first half of 2008.** The higher inflows to the private sector were mainly due to the foreign borrowings by the BOI companies from the non-related parties to benefit from low global interest rates.

- **Gross portfolio investment inflows increased substantially during the first seven months of 2008 to US dollars 495 million.** The companies in the automobile, banking and finance, insurance and telecom sectors attracted higher foreign investments as they earned relatively higher profits. Outright sale of a major shareholding of Associated Motorways (AMW) PLC attracted higher inflows on account of portfolio investments. Gross portfolio investment outflows also increased to US dollars 444 million partly due to the selling of Sri Lanka Telecom's shareholdings by Nippon Telecommunication & Telegraph Ltd of Japan. The net inflows on account of portfolio investment amounted to US dollars 50 million during the first seven months of 2008 compared to around US dollars 20 million received in the corresponding period of 2007.

- **Financial flows to the government increased substantially during the first eight months of 2008** mainly due to the disbursement of foreign loans by bilateral and multilateral development partners and foreign investment in Treasury bills and bonds. The Treasury bill market was opened for foreign investors in May 2008, where investments were permitted upto 10 per cent of the value of outstanding Treasury bills at any given point of time. Gross inflows to the Government including loans, grants and proceeds of Treasury bills and bonds during the first eight months of 2008 amounted to US dollars 1,306 million. These inflows consist of foreign loans of US dollars 768 million, grants of US dollars 114 million and proceeds of the sale of Treasury bills and bonds to foreign investors equivalent to US dollars 424 million. During the same period of 2007 total foreign inflows to the government amounted to US dollars 1,057 million. Loan inflows to the government, excluding grants and inflows from the Treasury bills and bonds, increased to US dollars 768 million during the first eight months of 2008 compared to US dollars 521 million in the corresponding period of 2007. These higher foreign loan inflows reflect the faster implementation of externally funded projects such as the construction of the Southern Expressway, Hambantota Port, and the expansion of Colombo Port etc. Meanwhile, inflows in the form of grants to the government decreased to US dollars 114 million during the first eight months of 2008 from US dollars 172 million in the corresponding period of 2007, mainly due to the reduction in disbursement of funds for tsunami related projects, most of which have been completed.

- **Government external debt service payments, which includes repayment of loan principal, settlement of Treasury bills and bonds and interest payments,** increased substantially by around 44 per cent during the first half of 2008 mainly due to accumulation of new loans and outflows on account of Treasury bills and bonds.

- **The Central Bank has relaxed the exchange control rules for emigrants with effect from July 02, 2008 as a measure of liberalizing the exchange control regulations.** This initiative was taken with a view to promote international investor confidence, to secure comparative advantages by moving to global financial markets and to further mobilize foreign savings to address the country's domestic savings-investment gap. According to the new rules, past emigrants could repatriate the balances lying in blocked accounts as at July 01, 2008 without any restrictions. For new emigrants, a maximum of US dollars 150,000 could be taken at the time of emigration while any excess to be deposited in a blocked account and a maximum of US dollars 20,000 to be remitted each year.

Balance of Payments

- **The balance of payments (BOP) recorded an overall surplus of US dollars 390 million during the first half of 2008,** compared to a surplus of US dollars 192 million in the first half of 2007. The proceeds of the syndicated loan of US dollars 150 million mobilised in June 2008, foreign inflows on account of Treasury bills and bonds amounting to US dollars 268 million, project loans to the government amounting to US dollars 592 million and suppliers' credit extended by Iran to CPC for oil imports, resulted in an overall BOP surplus during the first half of 2008.

Chart 5.5
Balance of Payments

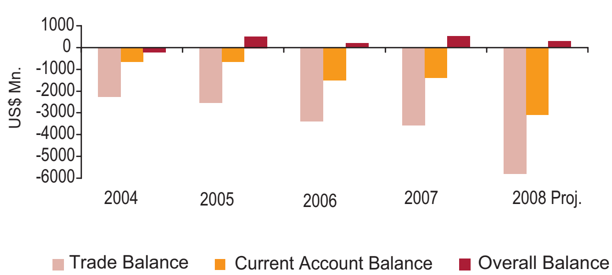
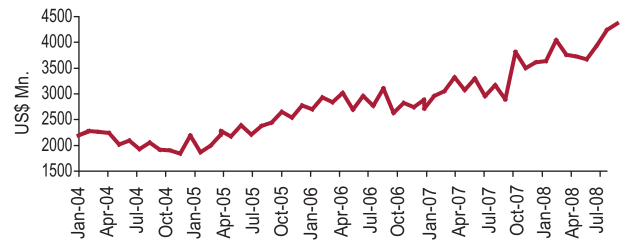


Chart 5.6
Gross Official Reserves



External Reserves

- **Gross official reserves (excluding ACU receipts) increased to US dollars 3,424 million by end of August 2008 from US dollars 3,063 million at end 2007.** The receipt of the cash component of project loans and grants amounting to US dollars 227 million, receipts of proceeds of the syndicated loan amounting to US dollars 150 million and the net domestic foreign currency borrowings amounting to US dollars 60 million and the net absorption of foreign exchange from the domestic foreign exchange market, have contributed to the improvement in the level of official reserves. However, reserve adequacy as measured by import coverage declined from 3.3 months of imports as at end 2007 to 3.0 months of imports by end August 2008, mainly due to the higher import expenditure resulting from higher oil and commodity prices.

- **The total external reserves of the country, excluding ACU receipts, increased to US dollars 4,746 million by end August 2008** as commercial banks built up their foreign assets with a substantial increase in foreign currency deposits and increase in official reserves of the country.

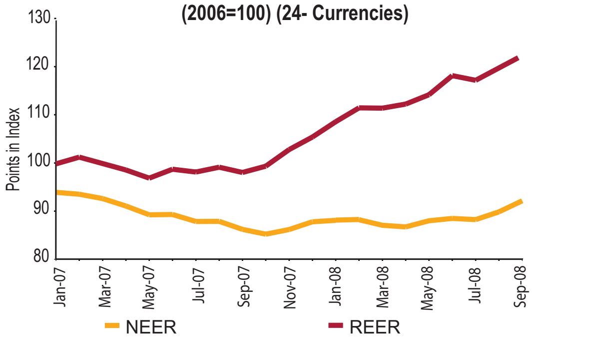
Exchange Rate Regime and Exchange Rate Movements

- **The rupee strengthened during the first nine months of 2008.** The rupee-dollar exchange rate, which remained at Rs. 108.72 per dollar by end 2007, has appreciated by about 0.75 per cent to Rs. 107.91 per dollar by end September 2008. The rupee appreciated by a higher rate of 11.72 per cent against the Sterling pound and 18.41 per cent against the Indian rupee. Higher foreign inflows, the suppliers' credit extended to CPC by Iranian oil suppliers and the weakening of the US dollar in the international markets largely contributed to the appreciation of rupee during the first nine months of 2008.

- **The Central Bank intervention in the foreign exchange market by way of net absorption of foreign exchange** during the first nine months of 2008 amounted to US dollars 104 million, compared to net supply of US dollars 111 million for the same period in 2007, helped mitigate higher volatility and prevent rapid appreciation of the rupee. The continuous healthy growth in workers' remittances, inflows to the country in the form of both direct investments and portfolio investments, official financial flows to the government and the higher cost of domestic borrowings, resulted in foreign exchange earners to liquidate their foreign currency positions and provided impetus to create a market perception in support of strengthening the rupee in the foreign exchange market.

Chart 5.7

Nominal and Real Effective Exchange Rate Indices (2006=100) (24- Currencies)



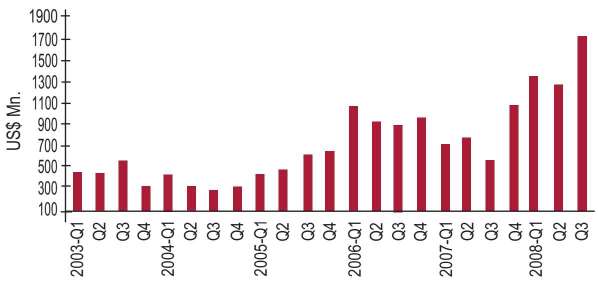
- **Reflecting the cross currency movements, both, the 5 currency and 24 currency Nominal Effective Exchange Rate (NEER) indices appreciated** by around 7.1 per cent and 5.3 per cent, respectively during the first nine months of 2008. The Real Effective Exchange Rate (REER) based on both, the 5 currency and 24 currency baskets, appreciated at a higher rate mainly due to the appreciation of the rupee against other currencies irrespective of higher domestic inflation than those of Sri Lanka's major trading partners and competitors.

- **The US dollar remained subdued in the international foreign exchange markets during the first nine months of 2008,** mainly due to concerns of slowing US economy and spillover effects of sub-prime led financial market concerns, especially against the Euro and the Japanese yen. The Euro zone was somewhat spared compared to the UK with respect to financial market stress as a result of which they concentrated on fighting inflation than the resulting economic slowdown. The Japanese yen was boosted by the resurgence of the Japanese economy and the continuous current account surplus. However, the movement of the US dollar since July 2008 against Sterling pounds and Euro has been in favour of strengthening the US dollar amidst concerns of recovery in the US economy and slowing Euro zone.

- **The total volume of spot transactions increased to around US dollars 3,547 million by end September 2008, compared to US dollars 2,720 million recorded during the first nine months of 2007.** The overall increase in foreign exchange spot market transactions was a reflection of the higher foreign inflows to the country and the foreign exchange earners, including exporters, liquidating their foreign currency earnings due to high domestic market interest rates and expectation of further appreciation of rupee.

- **The total volume of forward transactions followed the trend seen in the spot market** with the transactions volume reaching US dollars

Chart 5.8
Forward Transactions in the Inter-Bank Market (Volume)



4,175 million by end September 2008, compared to US dollars 1,823 million recorded during the first nine months of 2007.

- **The forward premium for one-month, three-month and six-month, remained significantly below the interest rate differentials** throughout the first nine months of 2008, indicating market expectations of further appreciation of rupee in the short-term. The higher interest rate differentials were as a result of lower international benchmark interest rates and domestic market interest rates remaining comparatively high. The higher interest rate differentials were further supplemented by attracting foreign investments into the domestic Treasury bills and bond markets.

Prospects for 2009

- **The external sector is projected to record a surplus in 2009 building on the healthy performance in 2008.** Realisation of foreign funds pledged for infrastructure projects and power projects, increase in private remittances and earnings from tourism will contribute to this performance. However, high and volatile oil prices and global imbalances may pose downside risks to this projection.

- **Exports are projected to grow by 10.1 per cent in 2009.** The growth is expected to be led by better performance of apparel, tea, rubber based products, food and beverages and petroleum products. Risk of non-renewal of EU-GSP+ scheme, slowing global growth, especially in Sri Lanka's major export markets such as US and the EU and the rising competition in the international apparel market are posing downward risks to this export outlook. Further, the removal of US quotas on some categories of Chinese apparel at the end of this year may aggravate the competition faced by the apparel exporters to the US market.

- **Imports are expected to grow by 7.8 per cent in 2009.** A lower growth rate in imports is anticipated due to the large base of imports arising from the high import growth recorded in 2008. The growth is expected to be led by the higher imports of investment and intermediate goods.

- **The services account is expected to record a higher surplus in 2009** reflecting the increased revenue from port related activities resulting from continuous growth in international and regional trade, rise in IT exports including BPOs and recovery in the tourism sector.

- **Net current transfers are projected to increase substantially in 2009** with more foreign employment opportunities in oil producing Middle Eastern countries and some emerging market economies in Asia. The increased current transfers, especially workers' remittances are expected to finance a larger part of trade deficit and contain the current account deficit.

- **Capital and financial accounts are projected to record a surplus in 2009** with expected higher foreign direct investment and higher inflows to the government. Inflows to the government by way of loans and grants are projected to increase in 2009 with the implementation of several major infrastructure projects such as highways, irrigation, port development, power etc.