5

EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

The external sector remained resilient during 2013 despite weak external demand amidst the slow global recovery. The trade deficit narrowed by end August 2013 compared to the same period in 2012, notwithstanding the decline in earnings from exports. The deficit in the external current account contracted by about 27 per cent to US dollars 1,583 million during the first six months of 2013 compared to the corresponding period of 2012, due to the improved trade balance and increased earnings from trade in services and workers' remittances. Net inflows to the capital and financial account increased with noticeable inflows to the private sector. Realised foreign direct investments (FDI), including foreign loans, and foreign investments in government securities increased substantially during the first half of 2013. Reflecting these developments in the balance of the payments (BOP), the overall balance recorded a lower deficit of US dollars 169 million during the first half of 2013 compared to the deficit of US dollars 320 million during the first half of 2012.

As advanced economies continue to regain their growth momentum, the exports in goods and services are expected to increase during the latter part of the year. With the expected contraction of the external current account deficit and increased inflows to the financial account, the BOP is estimated to record a surplus of around US dollars 700 million in 2013, while the provisional data for the first three quarters of 2013 suggests that the BOP registered a surplus of US dollars 585 million. Meanwhile, gross official reserves which stood at US dollars 7.0 billion by end September 2013, despite valuation losses due to excessive cross currency movements and the sharp decline in the price of gold, are expected to improve to over US dollars 7.1 billion by the end of the year. The Sri Lanka rupee showed a modest depreciation of 2.9 per cent by end October 2013 against the US dollar, compared to many regional currencies which witnessed heavy depreciations due to the possible tapering of the quantitative easing programme by the Federal Reserve Bank of the United States.

Trade in Goods and Trade Balance

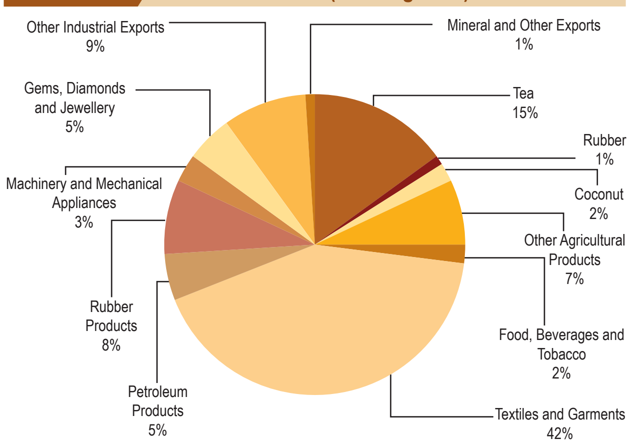
- **The trade deficit which contracted in 2012 in response to the policy package implemented in 2012, continued to contract further during the first eight months of 2013.** Although exports declined due to weak global demand and lower international commodity prices, the decline in imports was larger, resulting in a significant narrowing of the trade deficit during the first eight months of 2013.

- **Earnings from exports recorded positive growth from June 2013, following year-on-year declines recorded from March 2012.** However, cumulative earnings from exports during the first eight months of 2013 declined marginally by 1.0 per cent, year-on-year, to US dollars 6,437 million. This was largely due to the decline in industrial and mineral exports, which together account for more than 75 per cent of total exports.

- **Earnings from agricultural exports recorded healthy growth mainly due to a higher volume of exports of major agricultural commodities.** Earnings from agricultural exports during the first eight months of 2013 increased by 5.8 per cent, year-on-year, reaching US dollars 1,598 million, mainly due to strong growth in the export of tea and spices which accounts for nearly 74 per cent of agricultural exports. Earnings from the export of tea increased by 8.1 per cent to US dollars 963 million, while export earnings from spices increased by 33.7 per cent to US dollars 213 million, due to increases in both the average price and export volumes. The average price of tea exported was US dollars 4.68 per kilogram during the first eight months of 2013, compared to US dollars 4.37 per kilogram recorded during the same period in 2012. A significant increase in the export of tea to Kuwait, UAE and Turkey mainly contributed to the increase in the overall volume of tea exports. The significant growth in earnings from spices was driven by the strong growth in volumes of pepper and cloves, despite the poor performance of cinnamon. However, earnings from the export of rubber and coconut continued to decline during the first eight months of 2013, reflecting the fall in yields as well as the impact of low global demand and declining international prices. The average price of rubber exported during the first eight months of 2013 declined to US dollars 3.15 per kilogram from US dollars 3.57 per kilogram during the corresponding period of 2012, while the average price of coconut kernel products declined to US dollars 0.21 per nut from US dollars 0.23 per nut during the corresponding period of 2012. The volume of rubber and coconut exports also declined significantly. Consequently, earnings from rubber exports declined by 49.4 per cent to US dollars 46.5 million, while export earnings from coconut declined by 15.6 per cent to US dollars 121.5 million. Among other agricultural products, export earnings from vegetables, unmanufactured tobacco, minor agricultural products and seafood increased substantially during the first eight months of 2013, contributing to the overall growth in agricultural exports.

- **Most major industrial products exports as well as mineral exports contracted during the first eight months of 2013, mainly due to weak global demand.** Earnings from industrial

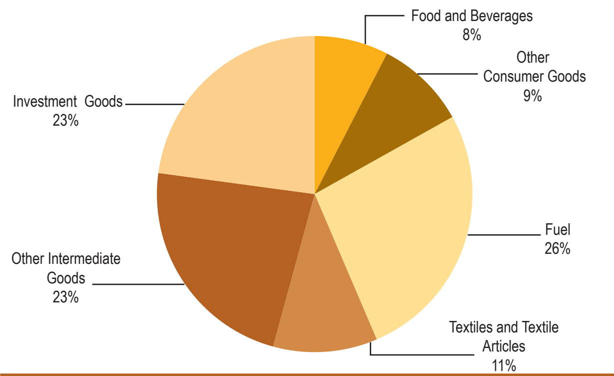
Chart 5.1 Composition of Exports (Jan-Aug 2013)



exports, which account for about three fourths of total export earnings, declined by 2.8 per cent to US dollars 4,815 million, despite the improved performance in textiles and garments. Earnings from the export of textiles and garments, which account for more than 40 per cent of total export earnings, increased by 2.6 per cent to US dollars 2,740 million during this period. Market diversification and greater emphasis on activities in the higher end of the value chain contributed to the robust performance in the textiles and garments industry. Poor performance in the export of rubber products and gems, diamonds and jewellery mainly contributed to the decline in industrial exports. Export earnings from rubber products declined by 7.6 per cent to US dollars 543 million, while gems, diamonds and jewellery exports declined by 25 per cent to US dollars 301 million mainly due to the significant decline in the international prices of rubber and gold, respectively. With respect to other industrial exports, all major categories recorded negative growth except transport equipment, ceramic products and leather, travel goods and footwear. The export of mineral products also declined by 54.7 per cent to US dollars 15.4 million during the first eight months of 2013.

- **Expenditure on all major categories of imports continued to decline during the first eight months of 2013 in response to policy measures adopted in 2012 and a decline in global commodity prices.** Expenditure on imports declined by 3.3 per cent, year-on-year, to US dollars 12,435 million during the period. With respect to the composition of imports, the expenditure on consumer goods marginally grew by 0.7 per cent, however expenditure on intermediate and investment goods which constitutes more than 83 per cent of total import expenditure declined by 3.2 per cent and 6.1 per cent, respectively. Expenditure on non-fuel imports during this period declined by 3.6 per cent to US dollars 9,122 million.

Chart 5.2 Composition of Imports (Jan-Aug 2013)



- **Expenditure on the import of consumer goods, which accounts for about 16 per cent of the total import expenditure increased marginally by 0.7 per cent to US dollars 2,100 million during the first eight months of 2013 compared to the corresponding period of 2012.** Import expenditure on food and beverages increased by 4.3 per cent to US dollars 942 million due to higher expenditure on the importation of vegetables, seafood and oils and fats. However, expenditure on the importation of sugar and confectionery, dairy products and beverages declined during the period under review. Meanwhile, expenditure on imports of non-food consumer goods declined by 2.1 per cent to US dollars 1,158 million largely due to the decline in the importation of motor vehicles by 7.5 per cent. Even though, the expenditure on importation of motor vehicles declined during the first five months, responding to policy measures adopted to discourage such imports, import expenditure on motor vehicles increased during the period June to August 2013 due to the significant depreciation of the Japanese yen and the Indian rupee against the US dollar.

- **Expenditure on intermediate goods imports, which accounts for about 60 per cent of total imports, declined by 3.2 per cent to US dollars 7,484 million, year-on-year, during the first eight months of the year.** Reduction in import expenditure on textile and textile articles, fertilizer and petroleum products largely contributed to the overall decline in import expenditure. The expenditure on the imports of textile and textile articles which accounts for over 10 per cent of total imports declined by 9.3 per cent to US dollars 1,329 million, due to a reduction in volumes and a decline in international prices. Expenditure on fertilizer imports declined substantially by 47.1 per cent to US dollars 123 million as a combined outcome of the reduction in import volume and decline in import prices. The decline in the volume of fertilizer imports was partly due to the use of existing stocks and government commitment to encourage balanced usage of inorganic and organic fertilizer. Expenditure on fuel imports, which accounts for more than one fourth of total import expenditure declined by 2.4 per cent to US dollars 3,313 million mainly due to lower thermal power generation during the first eight months of 2013, compared to the corresponding period of 2012.

- **Expenditure on the importation of investment goods declined by 6.1 per cent to US dollars 2,842 million during the first eight months of 2013.** Responding to the policy measures taken in 2012 to discourage imports, the expenditure on imports of transport equipment declined by 43.8 per cent to US dollars 431 million. Accordingly, expenditure on road vehicles such as lorries, buses, commercial cabs, agricultural tractors, and auto-trishaws, and ships and boats classified under transport equipment declined significantly. However, the import of machinery and equipment and building materials increased by 2.9 per cent to US dollars 1,499 million and 13.8 per cent to US dollars 909 million, respectively, reflecting the mixed developments projects being undertaken by the private sector together with the on-going mega infrastructure development projects carried out by the government.

Chart 5.3 Trade Performance and Trade Balance

- **The trade deficit for the first eight months of 2013 contracted as the cumulative expenditure on imports declined by more than the decline in cumulative earnings from exports.** The trade deficit declined by 5.6 per cent on a year-on-year basis to US dollars 5,998 million, compared to an increase of 7.8 per cent recorded during the first eight months of 2012.

Terms of Trade

- **The terms of trade for the first eight months of 2013, on average, improved to a favourable level from the level recorded during the same period in 2012.** The improvement in the terms of trade was underpinned by falling prices across a range of key import categories which more than offset the deterioration in prices in

Chart 5.4 Terms of Trade and Trade Indices

Sri Lanka's exports. The import price index declined by 4.0 per cent during the first eight months of 2013, due to the decline in the price of all major import categories. Reflecting the decline in price of industrial exports and mineral exports, Sri Lanka's export price index declined by 2.3 per cent during the first eight months of 2013. As a result of these trends, the terms of trade for the period January to August 2013 improved by 1.8 per cent to 90.5 points, on average, compared to the same period in 2012.

Chart 5.5 Tourist Arrivals and Earnings from Tourism

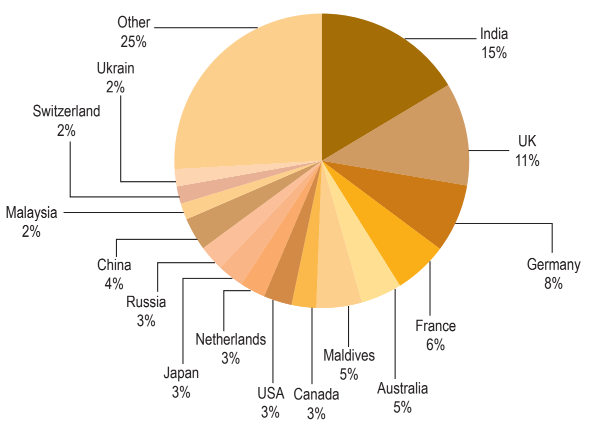
Trade in Services

- **The surplus in the services account continued to grow during the first half of 2013.** Improved performance in the transport, travel, and computer and information services sub sectors contributed to the increase in the surplus in the services account by 32.1 per cent to US dollars 787 million during the first half of the year, from US dollars 596 million during the corresponding period of 2012. Gross earnings from transportation services, which consist of passenger fares, freight charges, and port and airport related activities, marked a satisfactory growth of 10.8 per cent to US dollars 906 million during the first half of the year. Inflows on account of passenger fares increased by 19.2 per cent with an increase in the number of passengers flown by SriLankan Airlines and other airlines and an increase in airfares by SriLankan Airlines. Earnings from freight, and other port and airport related activities increased by 4.1 per cent due to improved performance in trans-shipments and other related activities. Sri Lanka's second international gateway, the Mattala Rajapaksa International Airport commenced operations in March 2013, expecting more benefits to the aviation industry, business, trade and leisure activities in Sri Lanka. Meanwhile, the new container terminal of the Colombo South Port was completed in August 2013, adding 2.4 million twenty foot equivalent container units (TEUs) to the existing system. More inflows are expected in the coming years with the government's initiatives to declare the Colombo and Hambantota ports as "free ports" and the Mattala Rajapaksa International Airport as a "bonded area".

- **Since the end of the war, Sri Lanka has seen a steady increase in tourist arrivals.** Continuing the past trend, tourist arrivals from all regions have increased so far during 2013. The number of tourists visiting Sri Lanka during the first nine months of 2013 amounted to 801,210, recording a 15.5 per cent year-on-year increase. Western Europe remained the largest tourist generating market for Sri Lanka, accounting for 38 per cent of all tourist arrivals during the first nine months of 2013. Tourist arrivals from Western Europe increased by 14.4 per cent to 307,831 during the first nine months of 2013 from 269,169 during the same period in the previous year, reflecting considerable increases from the UK, Germany, France and the Netherlands. However, tourist arrivals from India, the largest tourist generating country for Sri Lanka, grew at a comparatively lower rate of 7.8 per cent. The highest growth of tourist arrivals of 25.2 per cent was recorded from East Asia, with significant increases from China and Japan.

- **Various measures have been taken by the authorities concerned to achieve a target of 2.5 million tourist arrivals in 2016 and a targeted**

Chart 5.6 Tourist Arrivals by Country (Jan - Sep 2013)



annual income of US dollars 3.6 billion from tourism by 2016. The main strategies adopted to reach this goal include the development of domestic infrastructure facilities, strategic investments by global hotel chains, promotional campaigns, new tourist attractions and identifying zones in the Northern and Eastern provinces for tourism development activities. To accommodate the expected increase in tourist arrivals, 268 projects, which are expected to add around 17,788 rooms to the existing capacity were in the pipe line by end June 2013, of these, final approval was granted for 136 projects. Tourism Development Zones in Kalpitiya, Kuchchaveli and Yala are being promoted for investment with a view to develop tourism based on different themes. Shangri-La Asia Limited, one of Asia Pacific's luxury hotel chains, as well as several other international hotel chains such as Hyatt, Movenpick and Sheraton are under construction and are expected to commence operations in Sri Lanka in the near future. A three-day mega promotional campaign named "Get Sri Lankan'ed", was launched in May 2013, followed by a high profile media conference, which was the first event lined up under the "Get Sri Lankan'ed" promotional campaign of Sri Lanka Tourism. The main aim of this campaign is to position Sri Lanka as the most preferred travel destination among emerging markets. In addition, promotional exhibitions have been held in Europe and Japan and emerging high potential markets such as China.

- **Earnings from tourism during the first nine months of 2013 recorded a growth of 24.2 per cent year-on-year, amounting to US dollars 883 million, compared to the cumulative earnings of US dollars 711 million received during the corresponding period of 2012.** Tourist earnings are expected to increase during the latter part of the year with a higher number of tourist arrivals expected during the peak tourist season and the Commonwealth Heads of Government Meeting (CHOGM) in November 2013. However, to maximise the potential of the tourism industry, it is vital to have competitive pricing, upgrade existing hotels, add more capacity and promote home stay tourism, while taking initiatives to ensure the availability of skilled labour for the industry.

- **The computer and information services sector continued to record steady inflows.** Software and Information Technology Enabled Services (ITES) such as Business Process Outsourcing (BPO) and Knowledge Process Outsourcing (KPO) have emerged as a sector with high growth potential. Despite the slowdown in global economic activity, gross inflows to the computer and information services sub sector increased by 17 per cent to US dollars 248 million during the first half of 2013, compared to US dollars 212 million recorded during the corresponding period of 2012. The emergence of Sri Lanka as a centre for Information Technology (IT), BPO and KPO services, by expanding beyond traditional "software development", to large scale IT processing centres in the areas of accounting, engineering, communication as well as KPOs in the fields of architecture and legal services has contributed to this development. However, the industry needs to build more capacity, promote the country brand, attract investors to new ventures and strengthen IT infrastructure to ensure continuous expansion of the sector.

Inflows and Outflows of Income

- **The deficit in the income account widened to US dollars 666 million during the first half of 2013 from US dollars 526 million during the first half of 2012.** This was mainly due to the higher interest payments which increased to US dollars 568 million during the first half of 2013 from US dollars 477 million in the corresponding period of 2012. The higher interest payments were mainly in the form of coupon payments on Treasury bonds and interest payments on long term loans of the government. With regard to the inflows to the income account, the trading profits of Fixed Income Securities (FIS) owned by the Central Bank declined during the first half of 2013, while interest earnings on the Central Bank's reserves remained unchanged, contributing to a decrease in total earnings of the Central Bank. During the period under review, the dividends paid to non-resident investors of foreign direct investment enterprises amounted to US dollars 191 million. However, a considerable portion of dividends received by non-resident investors has been reinvested in those enterprises, facilitating the expansion of existing operations.

Current Transfers

- **Workers' remittances continued to be an important and stable source of foreign exchange earnings.** Gross earnings from workers' remittances increased by 11.4 per cent to US dollars 4,922 million during the first nine months of 2013 from US dollars 4,419 million during the corresponding period of 2012. Increased labour migration under the professional and skilled categories, improved awareness among migrant workers on the benefits of remitting money through formal channels as reflected in the increase in the number of new Non Resident Foreign Currency (NRFC) accounts, and the introduction of new web based money transferring systems were among the main factors that contributed to the increase in workers' remittances during the first nine months of 2013. In addition, the opening of new bank branches in the Northern and Eastern provinces, increasing the number of exchange houses, ATM networks and Business Promotion Offices of commercial banks encouraged migrant workers to use formal channels to remit money. Concerted efforts made by Sri Lanka to encourage skilled migrants resulted in a composition change in departures for foreign employment by gender and manpower categories. During the first half of 2013, the number of males leaving for foreign employment recorded a significant increase of 22 per cent against the 7 per cent decline recorded in the female category. The number of migrant workers leaving for foreign employment under the skilled and professional categories increased by 14.2 per cent. Meanwhile, total departures in the housemaid category declined by 9 per cent during the first half of 2013 against the 22.8 per cent increase recorded during the corresponding period of 2012.

Current Account Balance

- **The current account balance improved year-on-year during the first half of 2013 with the deficit contracting to US dollars 1,583 million from a deficit of US dollars 2,180 million during the corresponding period of 2012.** The narrowing of the deficit in the current account was primarily due to the shrinking of the deficit in the trade account as a result of the faster decline in imports compared to the relatively slower decline of exports. While the policy measures which were introduced in early 2012 to curb burgeoning import expenditure were successful, earnings from exports declined during the first half of the year as a result of low external demand due to slow recovery of the global economy. A significant increase in inflows to the services account by way of earnings from tourism, transportation, computer and information services, and workers' remittances helped strengthen the current account balance during the first half of the year, with workers' remittances alone helping to cushion more than 70 per cent of the trade deficit. With the gradual global recovery, earnings on exports are expected to increase during the remaining period of the year, thereby improving the trade balance further, despite a marginal pick up of imports due to seasonal demand in the coming months. With the receipt of more inflows to the services account and increased workers' remittances, the trade deficit is expected to be cushioned to a great extent resulting in an improvement in the current account deficit to around 4.3 per cent of GDP in 2013, from 6.6 per cent of GDP in 2012.

Capital and Financial Flows

- **Realised foreign direct investments (FDI), including foreign loans to BOI companies, increased to US dollars 540 million during the first half of 2013 from US dollars 452 million during the same period of 2012.** In terms of sector wise investments in the first half of 2013, investments in infrastructure, manufacturing, and services sectors recorded the majority of FDI inflows. Major sources of FDI inflows were China (US dollars 125 million), Hong Kong (US dollars 79 million), Singapore (US dollars 55 million), the Netherlands (US dollars 48 million) and India (US dollars 47 million). During this period, US dollars 49 million were recorded as FDI outflows. Consequently, the net inflow of FDI during the first half of 2013 amounted to US dollars 491 million compared to US dollars 411 million during the corresponding period in 2012. More FDI flows are expected during the second half of the year with the finalisation of negotiations and the granting of approvals for a number of projects that have been in the pipeline. Indicating the prospects for realising new FDIs in the future, the number of investment commitments of contracted projects under FDIs increased during the first half of 2013 from the corresponding period in 2012.

- **Net long term loan inflows to the private sector increased substantially during the first half of 2013.** Foreign loan inflows to the State Owned Enterprises (SOEs) classified under the private sector were US dollars 104 million, BOI companies were US dollars 196 million and for other private corporates were US dollars 60 million, during the first half of 2013, compared to US dollars 114 million, US dollars 17 million, and US dollars 45 million, respectively, for the first half of 2012. Consequently, long term loan inflows to the private sector were US dollars 360 million during the first half of 2013. Positive investor sentiment and continued expansion of domestic economic activity coupled with the relaxation of foreign exchange regulations on certain capital account transactions helped the private sector to mobilise more foreign funds. Further, strengthening the presence of local banks in the international securities market, two Sri Lankan banks raised US dollars 1.25 billion from issuance of debt securities in international markets i.e., US dollars 500 million by Bank of Ceylon in April 2013 and US dollars 750 million by National Savings Bank (NSB) in September 2013. Portfolio investments recorded a net inflow of US dollars 156 million during the first nine months of 2013, albeit lower than the net inflow of US dollars 250 million recorded during the corresponding period of 2012.

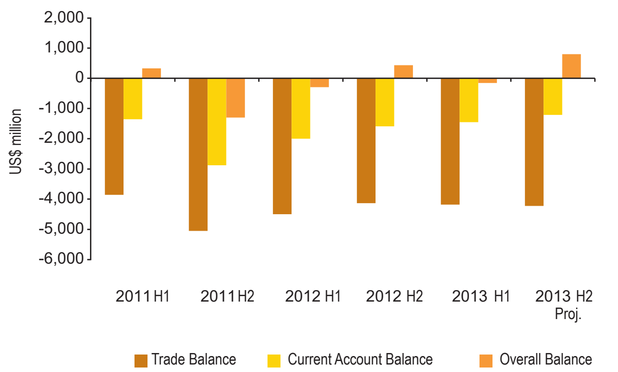
- **Net foreign inflows to the government moderated during the first nine months of 2013.** Net foreign inflows to the government, which consist of long term loans, investment in Treasury bills and bonds, and grants to the government amounted to US dollars 1,178 million during the first nine months of 2013 compared to US dollars 2,838 million during the same period in 2012, which included the international sovereign bond of US dollars 1 billion. During the first nine months of 2013, the government received a net inflow of US dollars 485 million on account of foreign investments in Treasury bills and bonds compared to US dollars 821 million during the corresponding period in 2012. This decline occurred as further foreign investments in government securities could not be accommodated due to the full utilisation of the foreign investment threshold of the outstanding government securities.

- **External debt service payments, which include principal and interest payments, increased during the first half of 2013.** As a percentage of exports of goods and services, external debt service payments increased to 25.7 per cent during the first half of 2013 from 14.7 per cent during the corresponding period of 2012. The main reasons for this increase include increased maturities and interest payments of government securities of US dollars 611 million, increased repayments of government long term loans of US dollars 786 millon, repayments relating to the IMF-Stand-By Arrangement (SBA) facility of US dollars 157 million, as well as the reduction in exports by 4.5 percent during the first half of 2013.

Balance of Payments

- **The overall balance of the BOP improved to register a surplus by end September 2013, although it recorded a deficit of US dollars 169 million during the first half of 2013 compared to a deficit of US dollars 320 million recorded during the corresponding period of 2012.** The BOP surplus of US dollars 585 million recorded by end September 2013 can be mainly attributed to increased inflows to the banking and corporate sectors including the proceeds of the bond issue by the NSB as well as improved performance in exports, tourism and other trade in services, and workers' remittances in the third quarter of 2013. With estimated inflows to the banking sector and improvements in export of goods and services, including high tourist earnings with the commencement of the peak tourist season, the BOP is expected to improve further to record a surplus of US dollars 700 million by end 2013.

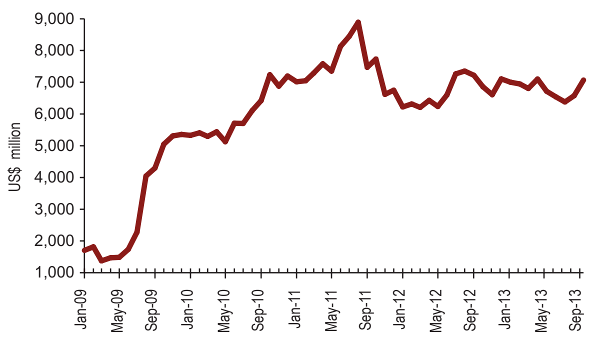
Chart 5.7 Balance of Payments



International Reserves

- **Gross official reserves of the country increased to US dollars 7.0 billion at end September 2013, from US dollars 6.9 billion at end 2012.** During the period concerned, foreign exchange drains due to debt service payments including IMF-SBA repayments along with the modest pick up of import demand in the recent months impacted on the level of gross official reserves. Also, the value of reserves on marked-to-market basis was subject to some fluctuations due to valuation changes stemming from excessive cross currency movements and the sharp decline in the price of gold. However, with the placement of the proceeds of the NSB bond issue with the Central Bank and other receipts, gross official reserves increased to US dollar 7.0 billion at end September 2013.

Chart 5.8 Gross Official Reserves



This was equivalent to 4.4 months of imports compared to the internationally accepted norm of 3 months. With the forecasted BOP surplus of US dollars 700 million, gross official reserves are estimated to increase to US dollars 7.1 billion by end 2013, which would be equivalent to 4.5 months of imports. Meanwhile, total international reserves which comprise gross official reserves and foreign assets of commercial banks stood at US dollars 8.3 billion at end September 2013. This was equivalent to 5.3 months of imports.

Sovereign Ratings

- **Fitch Ratings reaffirmed Sri Lanka's Foreign and Local Currency Issuer Default Ratings (IDRs) at "BB-", while the outlook for both ratings remains "Stable".** The Country Ceiling has also been affirmed at "BB-", and the Short-Term Foreign Currency IDR at "B". As per the ratings of Standard & Poor's, Sri Lanka's "B" short-term sovereign credit rating outlook remains "Stable" and the country's long-term sovereign rating remains at "B+". However, Moody's revised the outlook on Sri Lanka's "B1" Foreign Currency Sovereign Rating from "Positive" to "Stable" in July 2013, overlooking the measures taken by the government and the Central Bank to strengthen Sri Lanka's performance on the fiscal, monetary and the external fronts.

Exchange Rate Regime and Exchange Rate Movements

- **The exchange rate policy in 2013 was focused on maintaining flexibility in the determination of the external value of the Sri Lanka rupee.** Following an initial overshooting triggered by the policy change introduced in early 2012, the Sri Lanka rupee gradually stabilised against the US dollar until early June 2013. Accordingly, the rupee appreciated by 0.55 per cent vis-à-vis the US dollar from January 2013 to the first week of June 2013. However, from the second week of June through end August, the rupee depreciated by 5.01 per cent against the US dollar, primarily due to increased import demand in June and July, and the expectation of unwinding by foreign investors from the government securities market in anticipation of possible tapering of the US bond buying programme. Nonetheless, the Sri Lanka rupee fared better compared to many regional currencies such as the Japanese yen, the Indian rupee, and the Indonesian rupiah which witnessed heavy depreciations following the announcement of possible tapering of the quantitative easing programme by the Federal Reserve Bank of the US. Since beginning of September through end October, the Sri Lanka rupee gained value by 1.45 per cent against the US dollar, mainly supported by increased inflows to the banking sector, including the NSB bond issue in September 2013, which strengthened market expectations. Overall, the rupee depreciated by 2.94 per cent against the US dollar by end October 2013. Reflecting cross currency exchange rate movements, the Sri Lanka rupee appreciated against several major currencies. The rupee appreciated against the Indian rupee (8.74 per cent), the Australian dollar (6.24 per cent) and the Japanese yen (11.19 per cent), while depreciating against the euro (6.55 per cent) and pound sterling (2.19 per cent) by end October 2013.

- **Following the policy decision taken in early 2012, the Central Bank limited its intervention in the domestic foreign exchange market only to mitigate the excessive volatility in the exchange rate.** Accordingly, the Central Bank intervened in the domestic foreign exchange market by absorbing US dollars 879 million, while supplying US dollars 640 million during the first ten months of the year. Overall, the Central Bank absorbed US dollars 239 million from the market on net basis this year, up to 31 October.

- **During the first ten months of 2013, the Nominal Effective Exchange Rate (NEER) reflected a marginal depreciation, while the Real Effective Exchange Rate (REER) witnessed a modest appreciation.** Both the 5-currency and 24-currency NEER indices depreciated by around 0.24 per cent and 0.11 per cent, respectively, by end October 2013, reflecting the nominal depreciation of the Sri Lanka rupee against the US dollar and major currencies such as the pound sterling and the euro. Meanwhile, as the inflation differential has increased due to relatively higher domestic inflation compared to that of trading partner and competitor countries, both the 5-currency and 24-currency REER appreciated by 1.22 per cent and 1.53 per cent, respectively, by end October 2013 compared to end 2012.

Chart 5.9 Effective Exchange Rate Indices: 24 - Currency (2010 = 100)

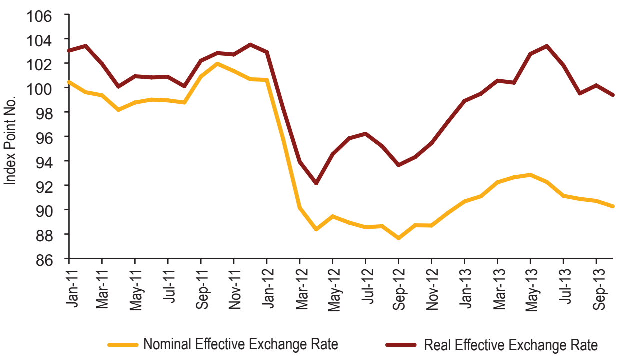
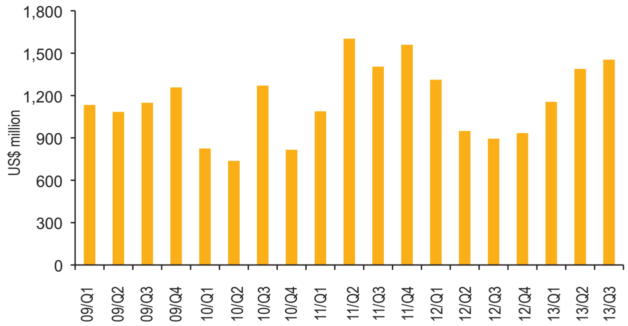


Chart 5.10 Quarterly Inter - Bank Forward Transaction Volumes



- **The domestic foreign exchange market recorded mixed performance during the first ten months of 2013 compared to the corresponding period in 2012.** The total volume of spot transactions declined to US dollars 6,979 million by end October 2013, from US dollars 8,107 million during the corresponding period of 2012. The slowdown in external trade resulting from weak global demand contributed to this decline. Meanwhile, the total volume of forward transactions increased to US dollars 4,399 million during this period from US dollars 3,568 million during the corresponding period of 2012.

- **The forward premia for three-month and six-month contracts, on average, were marginally lower than interest rate differentials until mid-June 2013.** Since then, forward premia started to increase, on average, in response to the depreciation of the rupee. However, both the three-month and six-month forward premia remained lower than the interest rate differentials indicating the market expectation of an appreciation of the rupee in the near-term.

Prospects for 2014

- **Sri Lanka's external trade outlook and growth prospects for 2014 are projected to improve with the gradual improvement in the global and domestic economy.** Earnings from exports are expected to record steady growth with the recovery of the global economy, especially with the projected recovery of the US and the euro area, the major trading partners of Sri Lanka. However, the projected high domestic economic growth is likely to increase import demand in 2014, particularly the importation of investment goods required to sustain the growth momentum. Therefore, as a percentage of GDP, the deficit in the trade account is projected to increase marginally to 13.8 per cent in 2014.

- **Growth in the services sector is expected to gather momentum in 2014, facilitated by rapid infrastructure development projects in key thrust areas.** Earnings on account of freight and other port and airport related activities are expected to increase substantially in 2014 with the expansion of the capacity of existing ports such as the Colombo South, Galle and Oluvil ports and the declaration of Colombo and Hambantota ports as "free ports" and Mattala Rajapaksa International Airport as a "bonded area". Earnings from tourism are projected to reach US dollars 2 billion in 2014 with the expected growth of tourist arrivals. Workers' remittances are expected to grow, albeit at a slower pace compared to the last several years, due to changing domestic labour market conditions.

- **The current account deficit is projected to contract further by end 2014 to around 3.2 per cent of GDP, from a deficit of 4.3 per cent projected for 2013.** Expected improvement in the trade account following a recovery in global economic activity, together with a continued increase in workers' remittances and higher earnings from tourism, are expected to contribute considerably to narrow the external current account deficit in 2014.

- **Inflows to the financial account are expected to increase further in 2014.** Inflows to the government in the form of foreign loans and grants are estimated to be around US dollars 2,350 million in 2014. Inflows to the private sector, including FDI, are also expected to increase with the relaxation of certain foreign exchange controls on capital account transactions and the private sector being encouraged to raise funds internationally.

- **The overall balance of the BOP in 2014 is expected to generate a surplus of around US dollars 1,125 million from the anticipated surplus of US dollars 700 million in 2013.** Accordingly, gross official reserves are expected to increase to US dollars 7.6 billion in 2014, which would be equivalent to 4.2 months of imports.