5

EXTERNAL SECTOR DEVELOPMENTS

The external sector improved further, benefiting from sustained growth in export of goods and services, modest import growth and enhanced financial inflows. A substantial increase in earnings from export of goods and services helped offset expenditure on imports to a large extent. The export of services, such as tourism, port and airport related services and computer and information services recorded a significant growth. These developments, together with an increase of workers' remittances, helped reduce the external current account deficit to a significantly low level of US dollars 677 million in the first half of 2014 compared to the deficit of US dollars 2,060 million in the corresponding period of 2013. The favourable adjustment of the current account deficit in the third consecutive year reflects the prudent management of external sector policies.

Inflows to the financial account increased significantly on account of inflows to the government as well as the private sector. Foreign Direct Investment (FDI), net inflows to the government securities market, banking sector, and the Colombo Stock Exchange (CSE) strengthened the financial account of the Balance of Payments (BOP). The issuance of international sovereign bonds in January and April 2014 raised US dollars 1.5 billion, while long term loan inflows to the government also made a substantial contribution towards the foreign exchange inflows to the country.

In view of the improvements in both the current and financial accounts, the BOP recorded a surplus of US dollars 1,954 million by end June 2014, compared to the deficit of US dollars 169 million in the corresponding period of 2013. The gross official reserves rose to a historically high level of US dollars 9.2 billion by end August 2014. Reflecting these developments, the Sri Lankan rupee has remained steady against the US dollar throughout the year so far, recording a marginal appreciation by end September 2014. The steady improvement in adequacy of external reserves in terms of both months of imports and short term external liabilities has improved Sri Lanka's resilience to face external shocks in the future.

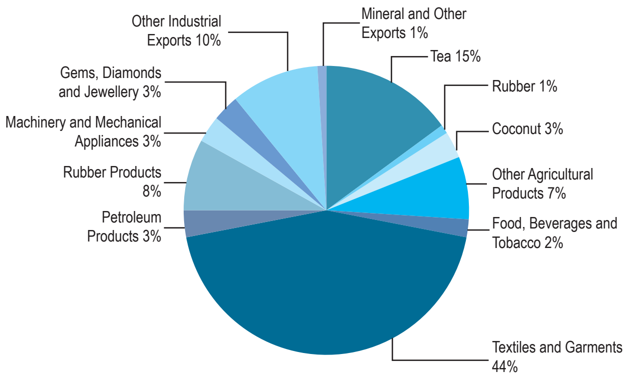
Trade in Goods and Trade Balance

- **Trade in goods performed better during the first eight months of 2014, resulting in a lower trade deficit compared to the same period last year.** On a cumulative basis, earnings from exports increased by 14.8 per cent while expenditure on imports increased at a lower rate of 4.6 per cent resulting in a contraction of the trade deficit by 7.1 per cent during the first eight months of 2014.

- **Earnings from exports have continued to grow since the second half of 2013.** Export earnings increased by 14.8 per cent, year-on-year, to US dollars 7,385 million during the year to August. The largest contribution came from the industrial sector (70 per cent) followed by the agriculture sector (26 per cent). The moderate recovery in the global economy, enhanced regional integration, expansion in domestic economic activity, increased value addition and conducive trade policies together with institutional support, contributed to the higher growth in exports.

- **Industrial exports, which account for about 74 per cent of total exports showed strong performance, led mainly by textiles and garments exports.** Industrial exports grew by 13.8 per cent, year-on-year, to US dollars 5,477 million during the first eight months of 2014. Textiles and garments exports, which contributed for more than 50 per cent of the growth in exports, grew by 18.8 percent, year-on-year, to US dollars 3,256 million during the first eight months of 2014. Garments exports to the EU and USA, the main traditional markets for Sri Lanka, increased by 21.7 per cent and 16 per cent, respectively, while the exports to non-traditional markets grew by 28.1 per cent. A greater emphasis on the use of domestically produced inputs helped the industry to shorten its lead time while the maintenance of safety and other international standards for labour helped the textiles and garments industry to face competition in international markets. The export of rubber products, which is the second major contributor to industrial exports, grew by 10.4 per cent, year-on-year, to US dollars 599 million during the first eight months of 2014 mainly due to an increase in export of rubber tyres. Earnings from the export of leather, travel goods and footwear increased more than twofold during the period under consideration. However, earnings from the export of petroleum products declined mainly due to a decline in the export of bunker and aviation fuel amidst intense competition from regional players, such as India and Singapore.

Chart 5.1 Composition of Exports (January-August 2014)

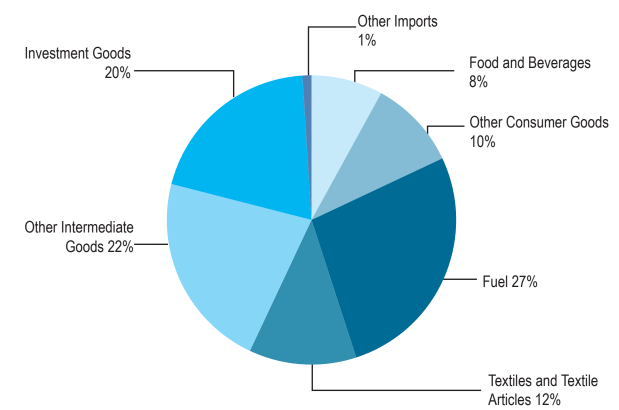


- **Export earnings from tea and coconut grew steadily during the first eight months of 2014.** Earnings from tea exports increased by 12.5 per cent to US dollars 1,083 million during this period, reflecting an increase of volume by 4.4 per cent and an increase of average prices by 7.8 per cent. Earnings from the export of coconut increased by 92.4 per cent to US dollars 234 million during the first eight months of 2014 reflecting an increase in both kernel and non-kernel product exports. Favourable weather conditions which prevailed during 2013 mainly contributed to the increase in coconut production. Export earnings from minor agricultural products and seafood also recorded noticeable growths. However, earnings from spices declined by 24.3 per cent, year-on-year, to US dollars 161 million during the period under review due to the relatively lower harvest of pepper and cloves compared to the previous year.

- **Expenditure on imports increased by 4.6 per cent to US dollars 12,555 million during the first eight months of 2014 compared to the corresponding period of 2013.** A substantial increase of intermediate and consumer goods imports resulted in a larger expenditure on imports while investment goods imports declined during this period. Expenditure on non-fuel imports declined marginally by 0.2 per cent to US dollars 9,106 million during this period.

- **Imports of consumer goods, which account for about 18 per cent of total import expenditure, increased by 9.0 per cent to US dollars 2,288 million during the first eight months of 2014, compared to the corresponding period of 2013.** Import expenditure on food and beverages increased by 5.7 per cent to US dollars 996 million as import expenditure of rice and dairy products soared due to lower domestic production of rice and higher import prices of milk powder. Meanwhile, expenditure on non-food consumer goods increased by 11.6 per cent to US dollars 1,293 million, largely due to motor vehicles imports, up by 29.3 per cent. Imports of other categories of non-food consumer goods, such as clothing and accessories and telecommunication devices also increased during this period.

Chart 5.2 Composition of Imports (January-August 2014)

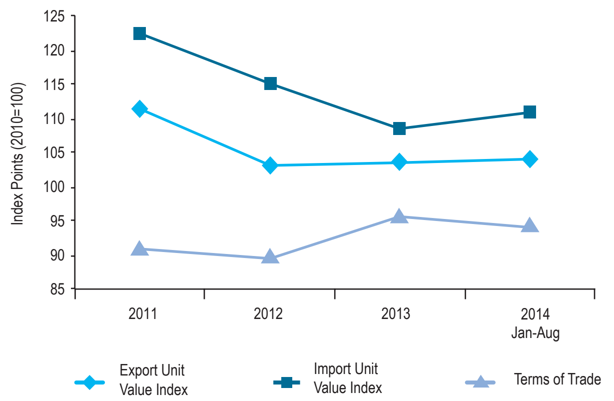


- **Imports of intermediate goods, which account for around 62 percent of the total import expenditure, increased by 9.8 per cent, year-on-year, to US dollars 7,739 million during the first eight months of 2014.** Higher expenditure on fuel, textiles and textile articles and paper and paperboards largely contributed to the increase in intermediate goods imports. Expenditure on fuel, which accounts for around 27 per cent of total imports, increased by 19.9 per cent to US dollars 3,448 million as thermal power generation increased owing to the dry weather conditions which prevailed in the county and growing domestic economic activity. In line with the substantial growth recorded in textiles and garments exports, expenditure on textiles and textile articles imports grew by 10.6 per cent to US dollars 1,470 million during the period. However, the textiles and garments industry's dependency on imported raw materials reduced to around 44 per cent during the first eight months of 2014 from around 52 per cent during the same period of 2013 reflecting a substantial increase in backward integration. Expenditure on paper and paperboards imports increased by 26.1 per cent to US dollars 298 million reflecting enhanced activities in the printing industry. However, import expenditure of diamonds, precious stones and metals declined by 76.8 per cent to US dollars 95 million during the first eight months of 2014 driven by a substantial decline in gold imports.

- **Imports of investment goods declined by 11.4 per cent to US dollars 2,519 million during the first eight months of 2014 with reductions recorded in all sub categories.** A build-up of inventories during the last few years is likely to have reduced the import of investment goods in

Chart 5.3 External Trade Performance

Chart 5.4 Terms of Trade and Trade Indices



2014. Accordingly, expenditure on machinery and equipment imports declined by 8.6 per cent whereby some major machinery categories such as electronic equipment, telecommunication devices, office machines, agricultural machinery and textile industry machinery recorded lower imports, while the imports of engineering equipment, turbines and electric motors and generating sets increased. Expenditure on building materials such as cement, articles of aluminum, mineral products and insulated wires and cables declined during the first eight months of 2014. Transport equipment declined by 27.9 per cent due to lower imports of all sub categories except auto-trishaws, buses and ships and boats.

- **The trade deficit continued to contract further during the first eight months of 2014.** As the increase in cumulative earnings from exports outweighs the increase in cumulative expenditure on imports, the trade deficit narrowed further. Accordingly, the trade deficit contracted by 7.1 per cent to US dollars 5,170 million during the first eight months of 2014 from US dollars 5,568 million in the corresponding period of 2013.

Terms of Trade

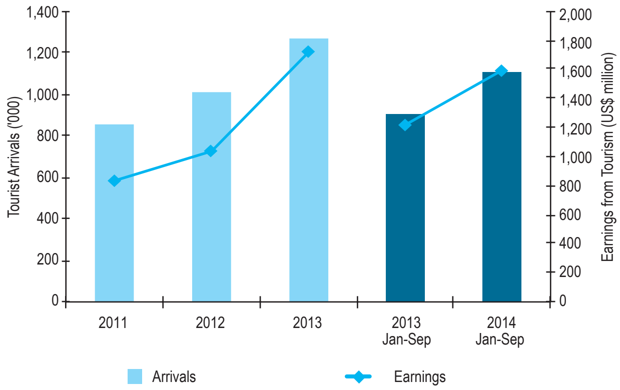
- **The terms of trade for the first eight months of 2014 fared better compared to the same period in 2013.** The improvement in the terms of trade was underpinned by the moderate increase in the prices of exported goods compared to the marginal increase in the prices of imported goods. Reflecting the increase in prices of all major export categories, Sri Lanka's export price index rose by 2.5 per cent to 104.0 index points during the first eight months of 2014 compared to the corresponding period of 2013. The overall import price index increased marginally by 0.5 per cent to 110.6 index points during the period, mainly due to the increase in prices of consumer and intermediate goods despite the decline in prices of investment goods. Accordingly, the terms of trade rose by 2.0 per cent on average to 94.0 index points during the first eight months of 2014 over the corresponding period in 2013. Excluding oil-related products, the terms of trade recorded an increase of 10.7 per cent.

Trade in Services

- **Trade in services continued to grow during the first half of 2014.** The services account of the BOP recorded a surplus of US dollars 817 million during the first half of 2014 compared to the surplus of US dollars 545 million in the corresponding period of 2013. As the main contributor to Sri Lanka's services exports, gross earnings from transport services consisting of passenger fares, freight charges and port-airport related activities recorded a growth of 16.1 per cent to US dollars 1,024 million during the first half of the year. In May 2014, SriLankan Airlines became a part of the 'One World' global airline group, being the first carrier from the Indian subcontinent to join such group, thereby increasing Sri Lanka's connectivity with the rest of the world. Meanwhile, earnings from freight on port and airport related activities increased as a result of an increased volume of cargo and container handling during the first half of the year. Higher inflows are expected during the latter part of the year with expanded capacity in the Colombo South Port, commissioned bunkering facilities at the Magam Ruhunupura Mahinda Rajapaksa Port (MRMRP) and the declaration of the Colombo and MRMRP ports as free ports and the Mattala Rajapaksa International Airport as a bonded area.

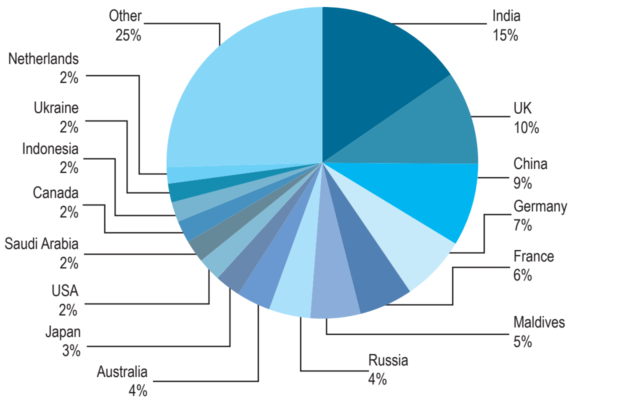
- **The tourism industry continued to grow as one of the highest foreign exchange earners for Sri Lanka.** Tourist arrivals increased by 22.4 per cent to 1,107,178 during the first nine months of 2014 over the corresponding period in 2013. Western Europe continued to be the largest tourist generating market for Sri Lanka with the number of tourist arrivals increasing by 14.2 per cent to 355,154. However, the share of Western Europe fell to 32 per cent during the first nine months of 2014 from 34 per cent in the corresponding period of 2013, reflecting a significant improvement in tourist arrivals from non-traditional countries. The share of tourist arrivals from East Asia and Eastern Europe increased, supported by the effective promotional campaigns conducted in some countries in those regions. India, the largest tourist generating country for Sri Lanka recorded an impressive growth of 18 per cent in tourist arrivals to 170,671. Meanwhile, the highest growth of 141.4 per cent of tourist arrivals to 94,994 was recorded from China, followed by Oman (72.2 per cent) and Russia (60.3 per cent), reaching 10,772 and 47,645 arrivals, respectively.

Chart 5.5 Tourist Arrivals and Earnings from Tourism



- **Several important measures were implemented to further expand the tourism industry in Sri Lanka**. The Sri Lanka Tourism Development Authority (SLTDA) initiated the development of three new Tourism Resort Projects in Kalpitiya, Kuchchaweli and Yala under the themes of 'Island Resort', 'Beach Resort' and 'Wildlife Resort', respectively. Meanwhile, as of end September 2014, investment proposals for 44 hotel projects were received which would add 2,618 rooms, thereby expanding the capacity further. Final approval was granted for 31 hotel projects during the first nine months of 2014 and 15 new hotel projects commenced operations adding 999 rooms to the industry. The Sri Lanka Tourism Promotion Bureau (SLTPB) initiated the 'Global Mega Promotional Campaign' this year under the guidance of the Ministry of Economic Development. As a part of this campaign 1,200 taxis are being branded featuring key tourism attractions of Sri Lanka in major destinations around the world including UK, France, Germany, Korea and Japan. A joint mega tourist promotional campaign 'Sri Lanka Shines in Shanghai' was held in Shanghai, China and a tourism and trade promotional business forum was initiated to attract more tourists and trading partners. Reflecting the impact of positive developments in Sri Lanka's tourism industry, Sri Lanka was recognized as the 'Best Travel Destination' by the Travel and Leisure Magazine of China at the annual travel award ceremony held in January 2014.

Chart 5.6 Tourist Arrivals by Country (January-September 2014)



- **Earnings from tourism continued its steady growth momentum.** Earnings from tourism recorded a healthy growth of 31.4 per cent to US dollars 1,600 million during the first nine months of 2014, compared to US dollars 1,217 million in the corresponding period of 2013. This notable increase was mainly driven by the continuous upward momentum in tourist arrivals and higher spending by tourists. Also the tourism promotional activities which are being conducted worldwide aiming to brand Sri Lanka as a value for money destination helped attract more tourists into the country. Earnings from tourism are expected to increase during the latter part of the year as a higher number of tourist arrivals are expected to be recorded during the peak tourist season together with the ongoing tourism promotional campaigns in the UK, Germany and other countries.

- **Earnings from computer and information services increased by 13.4 per cent to US dollars 337 million during the first half of 2014, compared to US dollars 297 million in the corresponding period of 2013.** This was mainly driven by an increase of earnings from Information Technology (IT) and Business Process Management (BPM) services. Computer and information sector has been identified as a booming industry in Sri Lanka and has a huge potential to generate more income in the country. However, the industry needs more expertise in research and development and further improvement in infrastructure facilities. With such aims the Sri Lanka Association of Software and Services Companies (SLASSCOM) launched the 'Campus Direct Link', an online network to bring together the academia and the corporate sector of IT and BPM industries, enabling them to actively engage in IT related research. Moreover, the government granted special tax benefits in the budget 2014 for new partnerships or firms engaged in international IT services to support and sustain the industry's growth.

Primary Income

- **The higher dividend payments, reinvestment of retained earnings and interest payments resulted in a higher deficit in the primary income account during the first half of 2014.** The deficit in the primary income account during the first half of 2014 was recorded at US dollars 918 million compared to US dollars 813 million recorded in the corresponding period of 2013. Inflows to the primary income account increased as a result of the higher income earned on investment of reserve assets while inflows on account of compensation of employees, dividends on direct investments and other investment income remained largely unchanged. Outflows on account of dividend payments and reinvestment of retained earnings increased substantially by 27.7 per cent to US dollars 365 million indicating the higher profits earned by direct investment enterprises. The interest payments increased primarily on account of the coupon payments on bonds issued by the licensed commercial and licensed specialised banks amounting to US dollars 69 million during the first half of 2014. Interest payments on loans obtained by the government declined to US dollars 134 million during the first half of 2014 from US dollars 143 million recorded in the corresponding period of 2013.

Secondary Income

- **Net inflows to the secondary income account continued its steady increase during the first half of 2014.** Secondary income, which consists of workers' remittances and government transfers, increased by 12.2 per cent to US dollars 2,970 million in the first half of 2014, compared to US dollars 2,646 million in the corresponding period of 2013. Workers' remittances, which account for a greater share of secondary income recorded a growth of 10.6 per cent to US dollars 3,360 million during the first six months of 2014 and increased further recording a cumulative growth of 10.0 per cent to US dollars 4,515 million by end August 2014. An increase of labour migration under the professional and skilled categories by 7.7 per cent, availability of more facilities and enhanced awareness on remitting money through formal channels as well as the introduction of new web based money transferring systems by banks were among the main factors that contributed to the increase in workers' remittances during this period. Meanwhile, labour migration under unskilled categories including domestic workers decreased by 10.9 per cent during the first six months of 2014 compared to the decrease of 4.1 per cent in the first half of 2013. This decrease in unskilled labour migration is partly attributed to increasing employment opportunities locally due to lowering unemployment in Sri Lanka.

Current Account Balance

- **The current account deficit decreased substantially to US dollars 677 million during the first half of 2014 from the deficit of US dollars 2,060 million during the corresponding period of 2013.** Improved performance in merchandise trade, trade in services and secondary income contributed to this improvement in the current account. Trade deficit decreased by 20.1 per cent during the first half of 2014 due to the increase of export earnings and decrease of import expenditure. Further, the services account recorded higher earnings mainly from the transport and tourism sectors. The significant increase in workers' remittances also helped to cushion the current account deficit substantially during the first half of 2014. A further reduction in the current account deficit is expected by year end with the expected higher earnings on account of services and secondary income during the second half of the year. Accordingly, the current account deficit is expected to reduce to around 2.1 per cent of GDP in 2014 from 3.9 per cent of GDP in 2013.

Capital Account Balance

- **The surplus in the capital account declined as a result of lower capital grants received by the government.** The capital account recorded a net inflow of US dollars 34 million in the first half of 2014 compared to US dollars 28 million in the corresponding period of 2013. The capital grants received by the government continued to decline with the graduation of Sri Lanka to lower middle income country status.

Financial Account

- **The financial account of the BOP recorded a net acquisition of assets of US dollars 2.8 billion and a net incurrence in liabilities of US dollars 3.2 billion, resulting in a net inflow of US dollars 374 million during the first half of 2014.** Two sovereign bond issuances amounting to US dollars 1.5 billion by the government, significant foreign loan inflows to the private sector and state owned enterprises and the international bond issuance by SriLankan Airlines resulted in a significant increase in the net incurrence of liabilities during the first half of 2014. An increase of net purchases of fixed income securities and currency and deposits held by the Central Bank contributed mainly to the increase in net acquisition of financial assets during the period.

- **Foreign Direct Investment[1] (FDI) inflows, including foreign loans received by BOI companies increased substantially during the first half of the year.** The total inflows to the BOI companies amounted to US dollars 853 million while a net direct investment outflow of US dollars 3 million was recorded in CSE registered companies during the first half of 2014. Consequently, total FDI related inflows amounted to US dollars 850 million during the first half of the year compared to US dollars 549 million received in the corresponding period of 2013. An increase of 54.8 per cent of FDI during the first half of 2014 reflects enhanced investor confidence, as well as an increase of capital requirements of export oriented BOI industries. The inflows to BOI companies consisted of US dollars 70 million of equity and shareholder advances, US dollars 88 million of intra company borrowings, US dollars 145 million of reinvestment of retained earnings, US dollars 376 million of foreign loans and inflows from debt issuances of US dollars 175 million.

- **A number of key projects continued to attract higher foreign investments during the first half of 2014.** The major recipients of foreign direct investments include the SriLankan Airlines (foreign loan receipt of US dollars 150 million and proceeds from the international bond issuance of US dollars 175 million), Colombo International Container Terminals (US dollars 113 million), Waterfront Properties (US dollars 52 million) and Sri Lanka Telecom (US dollars 34 million). The key FDI sources are the United Kingdom, China and the Netherlands during the period.

- **Portfolio investments, which comprise equity and investment fund shares and debt securities recorded a significant increase in net inflows during the first half of 2014.** Net foreign investments in the CSE gradually increased during the year, to September, recording a net inflow of US dollars 47.2 million as of end September 2014. Net inflows to the CSE included US dollars 42.8 million to the secondary market and US dollars 4.4 million to the primary market. Meanwhile, Sri Lanka launched two international sovereign bonds in January and April 2014 amounting to US dollars 1 billion and US dollars 500 million, respectively. Further, foreign investments in Treasury bills and Treasury bonds recorded a net inflow of US dollars 100.3 million during the first nine months of 2014 compared to US dollars 485 million during the same period of 2013. The relatively low investments in government securities in 2014 so far were mainly due to the limited space available for foreign investments, as constrained by the 12.5 per cent threshold allowed for non-residents. Under debt securities issued by the corporate sector, the international bond issuance by SriLankan Airlines of US dollars 175 million in June 2014 attracted a yield of 5.3 per cent per annum, the lowest ever bond yield achieved by a Sri Lankan corporate or bank to date.

- **Transactions of currency and deposits related assets increased, while liabilities on the same decreased during the first half of 2014.** Currency and deposits recorded a net increase in assets of US dollars 128 million in the first half of 2014 due to the increase in currency and deposits asset position of deposit taking corporations compared to a net decrease of US dollars 304 million in the corresponding period of 2013. Further, currency and deposits liabilities recorded a net decrease of US dollars 137 million in the first half of 2014 as a result of a reduction in the liabilities of deposit taking corporations during the period.

- **Foreign loans to the government and the private sector remained at almost the same levels.** Inflows to the government on account of long term loans for the first half of 2014 amounted

1 In the Balance of Payments statistics, the foreign loans received by Direct Investment Enterprises (DIEs) from any non-related source are excluded from FDI and recorded under loans while issuance of debt securities is also separately recorded under debt securities. If a foreign investor owns over 10 per cent or more voting shares in a Sri Lankan company, any such foreign investment is categorised as direct investments.

to US dollars 994 million compared to US dollars 950 million during the corresponding period of 2013. This includes US dollars 292 million received from the China Development Bank (CDB) for the priority roads development project. Major inflows to the government projects included the reconstruction of the railway line connecting Omanthai-Pallai, Madhu-Tallaimannar and Medawachchiya, Greater Colombo Urban Transport Development Project and Restoration of Northern Railway Services. Further, foreign loan inflows to the government during the first eight months of 2014 were US dollars 1,173 million compared to US dollars 1,156 million in the same period of 2013. Total long term loan inflows to the private sector, which include foreign loans received by the State Owned Enterprises (SOEs), BOI companies and other private sector companies, amounted to US dollars 553 million in the first half of 2014 compared to US dollars 458 million in the corresponding period of 2013. Foreign loan inflows to SOEs were US dollars 97 million while loan inflows to private sector companies including BOI companies were US dollars 456 million (excluding the bond issuance of SriLankan Airlines) during the first half of 2014, compared to US dollars 170 million and US dollars 288 million, respectively, in the first half of 2013. Meanwhile, the repayment of the IMF-SBA facility by the Central Bank amounted to US dollars 346 million during the first half of 2014. Also, loan liabilities of deposit taking corporations recorded a net increase of US dollars 64 million in the first half of 2014 compared to a net increase of US dollars 119 million in the first half of 2013.

- **Total foreign currency debt service payments increased in the first half of 2014**. Total foreign currency debt service payments, which consist of principal and interest payments, increased by 61 per cent to US dollars 1,558 million in the first half of 2014 from US dollars 969 million in the corresponding period of 2013. As a percentage of export of goods and services, foreign debt service payments increased to 19 per cent during this period from 14 per cent in the corresponding period of 2013. This increase can be primarily attributed to repayments of the IMF-SBA facility, government long term borrowings, private sector loan liabilities and maturities of Treasury bonds as well as the increase of interest payments. By end August, foreign currency debt service payments amounted to US dollars 2,206 million compared to US dollars 2,091 million in the corresponding period of 2013.

- **Trade credits receivable decreased while trade credits payable increased during the first half of 2014**. Net trade credits given to non-resident enterprises recorded a decrease of US dollars 108 million, while net trade credits received by Sri Lankan companies increased by US dollars 261 million in the first half of 2014. Further, other accounts payable, which are primarily the Asian Clearing Union (ACU) liabilities settled by the Central Bank recorded a net increase of US dollars 54 million, while other accounts receivable, which are receivables to Licensed Commercial Banks' (LCB) Offshore Banking Units (OBUs) recorded an increase of US dollars 285 million in the first half of 2014.

- **Transactions in reserve assets registered a significant increase in the first half of 2014**. Supported by continuous inflows to the government and private sector, Central Bank reserve asset transactions recorded a substantial increase amounting to US dollars 2.5 billion in the first half of 2014 compared to a net outflow of US dollars 21 million in corresponding period of 2013. Reserve assets in the form of currency and deposits recorded a significant increase of US dollars 868 million while fixed income securities recorded a net purchase of US dollars 1.6 billion in the first half of 2014 compared to a net sale of US dollars 135 million of currency and deposits and a net sale of US dollars 177 million of debt securities in the first half of 2013.

Meanwhile, monetary gold and special drawing rights recorded a net outflow of US dollars 29 million and US dollars 7 million, respectively. This higher level of increase in reserve assets resulted in the Central Bank reserve asset position to surpass the historical benchmark of US dollars 9 billion.

Balance of Payments

- **BOP recorded an overall surplus of US dollars 1,954 million during the first half of 2014.** The substantial improvement in the current account and an increase of inflows to the financial account contributed to a larger surplus in the overall balance, compared to a deficit of US dollars 169 million recorded in the first half of 2013.

Reserve Asset Position

- **The improvement in the external sector helped strengthen the gross official reserves of the country to reach US dollars 9.2 billion at end August 2014 from US dollars 7.5 billion at end 2013.** In terms of number of months of imports, this level of reserves is equivalent to 5.9 months, a significant improvement compared to the 5 month import cover at end 2013. With improved performance in accumulating reserves, the adequacy of external reserves in terms of short term debt and liabilities, with and without Treasury bonds is estimated to have improved to 76 per cent and 103 per cent, respectively, by end August 2014. The proceeds of international sovereign bond issuances in January and April 2014, disbursements under foreign funded projects and absorption of excess liquidity in the foreign exchange market mainly helped foreign exchange reserves to improve, despite outflows on account of foreign debt service payments, IMF-SBA payments and other foreign outflows during the first eight months of the year. Apart from the increase in gross official reserves, the build-up of foreign assets of deposit taking corporations contributed to the increase in total foreign assets to US dollars 10.7 billion as at end August 2014 from US dollars 8.6 billion at end 2013. In terms of months of imports, total foreign assets at end August 2014 were equivalent to 6.9 months of imports, compared to 5.7 months at end 2013.

Exchange Rate Movements

- **The exchange rate policy in 2014 is focused on allowing exchange rate flexibility, while absorbing excess liquidity in the foreign exchange market in order to prevent undue appreciation of the Sri Lankan rupee.** Such intervention helped the central bank to accumulate official reserves and smoothen short term volatility of exchange rates. The Sri Lankan rupee gradually appreciated throughout the year

Chart 5.7 Balance of Payments

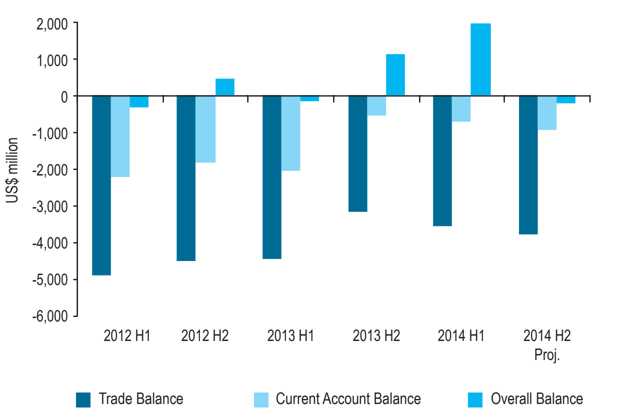
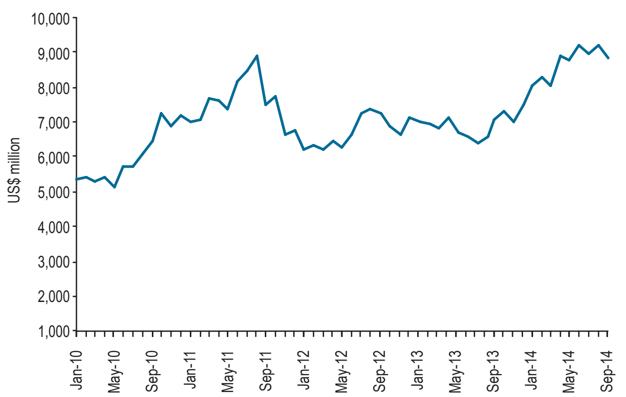


Chart 5.8 Gross Official Reserves

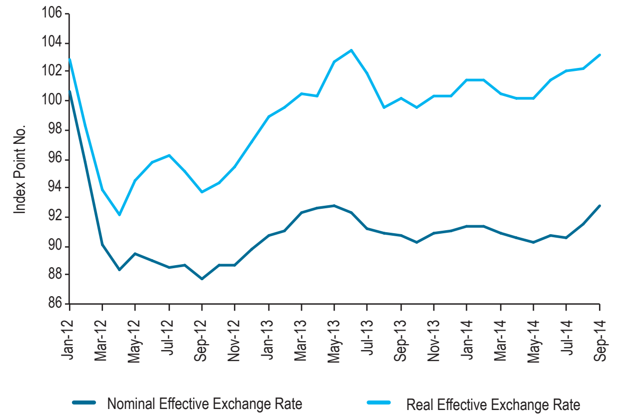


amidst steady foreign exchange inflows by way of increasing export earnings from both goods and services, higher workers' remittances and inflows to the financial account in the form of the issuance of international sovereign bonds, foreign inflows to the government securities market, foreign direct investments, foreign loan inflows to the government and private sector and foreign investments in the CSE. Accordingly, the Sri Lankan rupee appreciated by 0.3 per cent against the US dollar by end September 2014. Meanwhile, reflecting the cross currency exchange rate movements, the Sri Lankan rupee appreciated against the pound sterling (1.8 per cent), euro (9.1 per cent) and Japanese yen (4.5 per cent), while depreciating against the Indian rupee (0.3 per cent) by end September 2014. However, during the month of September, the Sri Lanka rupee depreciated marginally by 0.13 per cent in the backdrop of increasing imports and volatility in the equity and government securities markets.

- **Higher foreign inflows to the domestic foreign exchange market eased pressure on the external value of the Sri Lankan rupee.** Central Bank intervention in the domestic foreign exchange market was limited only to absorb excess liquidity in order to prevent undue appreciation of the Sri Lankan rupee, which also resulted in a building-up of gross official reserves. Accordingly, the Central Bank absorbed US dollars 985 million from the foreign exchange market during the first nine months of 2014, on a net basis. During this period the Central Bank supplied US dollars 387 million to ease temporarily, demand pressure which emerged from time to time.

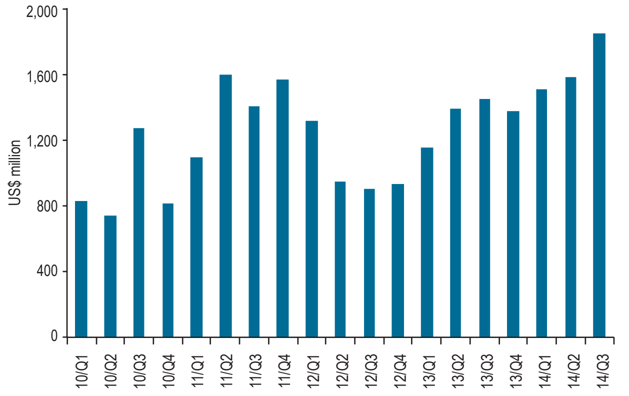
- **Effective exchange rate indices appreciated during the first nine months of the year.** Reflecting cross currency exchange rate movements and the nominal appreciation of the Sri Lankan rupee against most of the currencies in the currency basket, both the 5-currency and the 24-currency Nominal Effective Exchange Rate (NEER) indices appreciated by 3.2 per cent and 2.9 per cent, respectively, by end September 2014. The Real Effective Exchange Rate (REER) indices which take into account the inflation differentials amongst countries in addition to the variation to the nominal exchange rates also appreciated during this period by 6.0 per cent and 5.4 per cent, respectively. This appreciation of the REER could be attributed to the appreciation of the NEER and relatively higher domestic inflation compared to Sri Lanka's trading partners and competitors.

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



- **The domestic foreign exchange market continued to expand during the first nine months of 2014.** The total volume of spot transactions increased to around US dollars 7,327 million by end September 2014, compared to US dollars 6,308 million recorded during the corresponding period of 2013. This is attributable to the increase in inflows of foreign exchange into the domestic foreign exchange market supported by an increase in international trade, tourism, and other inflows to the current and financial accounts. Meanwhile, following the trend in the spot market, the total volume of forward transactions also increased to US dollars 4,936 million by end September 2014 compared to US dollars 3,998 million during the corresponding period in 2013.

Chart 5.10 Quarterly Inter-Bank Forward Transaction Volumes



- **The forward premia for one-month, three-month and six-month remained well below the interest rate differential during the first nine months of 2014**. Interest rate differentials still remain high compared to international benchmark interest rates despite the falling domestic interest rates since end 2012. Meanwhile, commercial banks have maintained the net open positions (NOP) at negative levels, on average.

Prospects for 2015

- **Exports are projected to grow by 15.0 per cent in 2015 with expansions in all major export categories.** Higher levels of value addition, diversification of export products and markets, gradual recovery of the world economy and enhanced trade through deeper economic integration with the regional countries are expected to help enhance export performance. Meanwhile, import expenditure is projected to grow by 12.6 per cent in 2015 with higher imports in all major import categories. Demand for imports is expected to increase with a higher level of domestic economic activity, mega infrastructure development projects, tourism sector developments, input requirements for exports and improved living standards. Accordingly, the trade deficit is expected to expand by 8.7 per cent, year-on-year, in 2015 and is estimated to be around 9.0 per cent of the GDP.

- **The services sector is expected to expand substantially in 2015, supported by the development in key thrust areas relating to "5 + 1" hub development strategy**. Port and airport related earnings are expected to increase substantially in 2015 with capacity development projects of Colombo South, Galle, Oluvil, Trincomalee and Kankesanthurai harbours and the maximum utilisation of Magam Ruhunupura Mahinda Rajapaksa Port for vehicle imports and transshipment activities. Meanwhile, commissioning of bunkering facilities at the Hambantota port in June 2014 would also contribute to the expected expansion in port related activities. Earnings from tourism as well as passenger fares are expected to increase further with the expected higher number of tourist arrivals. Tourist arrivals are expected to exceed 2 million in 2015. Meanwhile, the IT-BPO industry is expected to generate about US dollars 1 billion revenue in 2015 supported by various measures being introduced by the private sector as well as the government by way of tax incentives and commissioning of fully fledged IT Parks in the country. These developments in the major sub-categories of the services account will result in boosting the surplus of the services account in 2015 and beyond.

- **Workers' remittances, which grew fast during the recent years, are expected to moderate in 2015 in line with the developments in the domestic labour market.** The decline in unemployment rate to record low levels and the opening of alternative domestic employment opportunities especially in emerging sectors such as tourism, construction and port related services, IT-BPO and KPO services are expected to reduce the number of workers seeking employment abroad. The recent trend of declining number of foreign employment under unskilled categories such as domestic workers is also a supporting factor for the expected moderate growth in workers' remittances. However, remittances per worker would be higher due to increase in skilled worker migration compared to recent years. Consequently, workers' remittances are expected to grow in 2015 albeit at a lower rate compared to the expected growth in 2014.

- **The current account deficit is projected to decline further to around 1.0 per cent of GDP in 2015, improving from 2.1 per cent projected for 2014.** The expansion in exports is expected to offset the growth in import expenditure to a greater extent, thereby curtailing the trade deficit to around 9 per cent of GDP in 2015. Meanwhile, the higher surplus in the services account and inflows of workers' remittances are expected to cushion the external current account deficit significantly.

- **Higher inflows to the financial account are expected during the next year and beyond.** FDI inflows are expected to increase further with the gradual relaxation of exchange controls on capital account transactions and the ongoing large development projects such as the Hambantota industrial zone and the Colombo port city project which will open up diverse investment opportunities in coming years. The CSE is expected to record higher net inflows during the next year compared to 2014, and foreign investment in the government securities market is expected to continue at the threshold of 12.5 per cent allowed for non-residents.

- **The BOP is expected to generate an overall surplus of around US dollars 2.2 billion in 2015 from the projected surplus of US dollars 1.8 billion in 2014.** Gross official reserves are expected to increase to a higher level of around US dollars 10 billion by 2015, supported by foreign exchange inflows to the country. However, due to the expected increase in import expenditure partly on account of imports for ongoing large scale development projects would result in an import cover of gross official reserves to be around 5.7 months, which is nonetheless far above the standard requirement of 3 months.