

EXTERNAL SECTOR DEVELOPMENTS

*S*ri Lanka's external sector performance moderated in the first half of 2015 amidst a strong demand for imports and less than expected foreign exchange earnings. The merchandise trade deficit, which widened in the second half of 2014, weakened further in the first half of 2015 as well. The slow growth in advanced economies and Sri Lanka's major export destinations reduced the demand for exports, resulting in a marginal decline in exports during the period. Despite the sharp drop in the fuel import bill, the significantly high domestic demand for imported goods, especially vehicles and other consumer goods, caused a substantial increase in expenditure on imports, resulting in the widening of the trade deficit. However, a notable increase in earnings from tourism helped raise the surplus in the services account amidst marginal growth in earnings from other service exports such as transportation and computer and information services. Meanwhile, the deficit in the primary income account continued to widen due to increased interest and dividend payments. These developments in merchandise trade, services and primary income accounts, together with an unexpected moderation in workers' remittances, resulted in a current account deficit of US dollars 905 million during the first half of 2015, compared to the deficit of US dollars 435 million in the corresponding period of 2014. Meanwhile, inflows to the financial account moderated during the first half of 2015. Net inflows of Foreign Direct Investment (FDI) and foreign investment in the Colombo Stock Exchange (CSE) remained weak during this period, while the anticipated policy tightening by key Central Banks in the world prompted a gradual reversal of foreign investments in government securities. Inflows to the government by way of long term loans also remained low. These developments, together with scheduled debt service payments and the supply of liquidity to the foreign exchange market, resulted in a decline in gross official reserves to US dollars 7.5 billion, equivalent to 4.5 months of imports, by end June 2015. Consequently, the Balance of Payments (BOP) registered a deficit of US dollars 792 million by end June 2015. Meanwhile, the Sri Lankan rupee, which depreciated only by 2.4 per cent against the US dollar during the first eight months of the year, depreciated by 4.5 per cent during the period from 4th September to end October, due to the accommodation of greater flexibility in the determination of the exchange rate. Accordingly, the rupee depreciated against the US dollar by 7.0 per cent during the year up to end October 2015. Following this trend, the Real Effective Exchange Rate (REER) indices also depreciated, indicating an improvement of the country's external competitiveness.

Trade in Goods and Trade Balance

- The trade deficit, which began to widen from the second half of 2014, continued to expand further in the first eight months of 2015, largely due to weak global demand and significantly high domestic demand for imported goods. On a cumulative basis, earnings from exports reached US dollars 7,147 million during the first eight months of 2015, while expenditure on imports amounted to US dollars 12,559 million, resulting in a trade deficit of US dollars 5,412 million up by 5.0 per cent, year-on-year.
- Earnings from exports continued its slow growth momentum during the first eight months of 2015 that began in the fourth quarter of 2014. As a result of the significant drop recorded in both industrial and agricultural exports, overall earnings from exports during the year until August decreased by 3.4 per cent, year-on-year, to US dollars 7,147 million. The continued appreciation of REER indices, political and economic uncertainty in Russia and some countries in the Middle East, that mainly affected tea exports as well as restrictions imposed by the European Union on Sri Lankan fish exports, reduced the demand for Sri Lankan exports. Further, the significant drop in

commodity prices in the international market had an adverse effect on the export earnings of Sri Lanka.

- Industrial exports, which account for about 76 per cent of total exports, remained volatile during the first eight months of 2015. Accordingly, earnings from industrial exports declined marginally by 0.8 per cent, year-on-year, to US dollars 5,446 million during the period under review. The decline recorded in export earnings from textiles and garments, rubber products, and gems, diamonds and jewellery, which account for about 45 per cent, 7 per cent and 3 per cent of total export earnings, respectively, contributed to the decline in exports of industrial products. Accordingly, earnings from the textiles and garments declined by 1.1 per cent, year-on-year, to US dollars 3,219 million during this period. This was mainly due to the 12.9 per cent decline recorded in textiles and garment exports to the EU market despite the 10.5 per cent and 3.4 per cent growth recorded in exports to USA and non-traditional markets, respectively. Export earnings from rubber based products recorded a drop of 12.4 per cent, year-on-year, during the first eight months of 2015, mainly due to lower earnings from the export of tyres. Export earnings from gems, diamonds and jewellery declined significantly by 18.6 per cent. However, export earnings from transport equipment increased by more than two fold, mainly due to the export of a dredger vessel. Export earnings from petroleum products, which mainly comprise bunker and aviation fuel also increased by 21.7 per cent amidst intense competition from major regional players such as India and Singapore.
- Weak performance in agricultural exports contributed to more than 70 per cent of the overall decline in export earnings. During the first eight months of 2015, earnings from agricultural exports declined by 9.8 per cent,

Chart 5.1 External Trade Performance

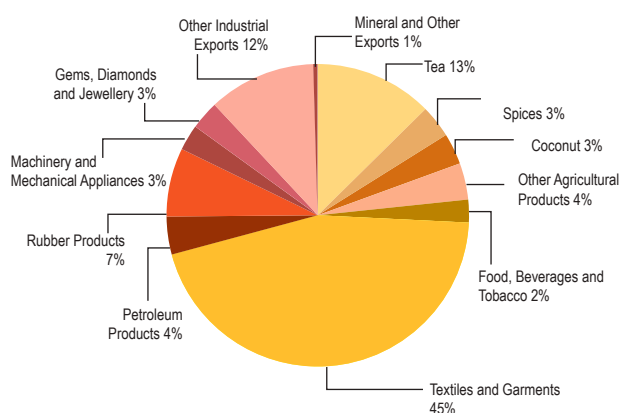


year-on-year, to US dollars 1,668 million, mainly due to the significant drop in tea and sea food exports. Earnings from tea exports during the first eight months of 2015 declined significantly by 16.8 per cent to US dollars 901 million, due to the considerable decline of demand recorded for Ceylon tea from major buyers such as Russia and the Middle East, as a result of the significant depreciation of the Ruble and the substantial decline in oil revenue of those countries. Accordingly, the average price of tea exported from Sri Lanka during this period decreased to US dollars 4.47 per kilogram from US dollars 5.04 per kilogram recorded in the corresponding period of 2014. Export earnings from sea food declined substantially by 36.2 per cent during the first eight months of 2015, mainly due to the decline in sea food exports by 72.8 per cent to the EU market, owing to the restrictions on the access to the EU market, with effect from mid-January 2015. Earnings from rubber exports, which declined last year, continued to weaken during this period, reflecting the impact of the continuous decline in global rubber prices led by lower global demand. However, earnings from exports of spices and coconut kernel products increased, partly offsetting the overall decline in other agricultural exports. Export earnings from spices increased significantly by 54.8 per cent as exports of a majority of the spices, including

cloves and pepper, increased. The earnings from exports of coconut kernel based products increased by 10.9 per cent mainly due to the increase in the export of coconut oil.

- **Expenditure on imports during the first eight months of 2015 remained at the same level recorded in the corresponding period of the previous year, despite the significant drop in international commodity prices, especially fuel.** The substantial increase in demand for imported goods, particularly vehicles for investment purposes and personal use, and increased demand for other durable goods, offset the gain from lower international commodity prices. As a result, expenditure on imports during the year up to August amounted to US dollars 12,559 million, compared to US dollars 12,555 million recorded during the same period of 2014.
- **Import expenditure on consumer goods, which accounts for approximately 25 per cent of total imports, increased by 37.3 per cent, year-on-year, to US dollars 3,142 million during the first eight months of 2015.** Import expenditure on food and beverages increased by 12.9 per cent to US dollars 1,124 million, reflecting increases in all sub categories except sugar and confectionary and dairy products. Rice imports recorded a significant growth of 67.8 per cent during the first eight months of 2015 as a result of the shortfall experienced in domestic rice production since April 2014. However, rice imports declined from May 2015 due to the increase of the import related tariff, with effect from May 2015, with the increase of domestic production. Import expenditure on vegetables increased by 33.9 per cent due to the increases recorded in the importation of major categories such as lentils, onions and leguminous vegetables. Meanwhile, expenditure on import of non-food consumer goods increased by 56.1 per cent to US dollars 2,018 million, largely due to the increase in the

Chart 5.2 Composition of Exports (January-August 2015)

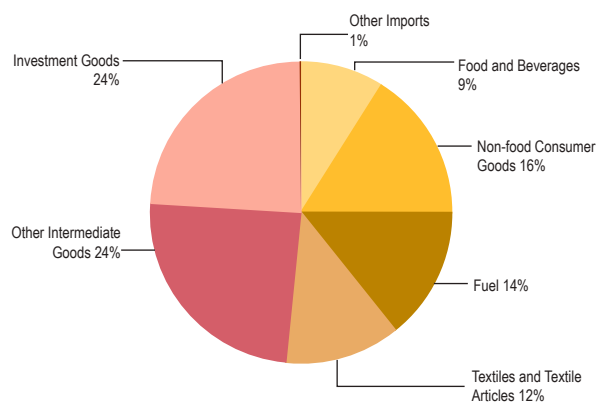


importation of motor vehicles by 89.9 per cent to US dollars 905 million during the first eight months of 2015. Reduction of import related taxes on motor vehicles, especially for motor vehicles with an engine capacity of less than 1000 cc in early 2015, depreciation of the Japanese Yen, low interest rates for leasing facilities and increase in salaries of government employees were the main reasons for the upsurge in motor vehicle imports during the first eight months of the year. Meanwhile, the importation of all other categories of non-food consumer goods, such as clothing and accessories, medical and pharmaceutical products, telecommunication devices and home appliances also increased during this period.

- The importation of investment goods increased by 19.4 per cent to US dollars 3,007 million during the first eight months of the year, led by higher expenditure on imports of transport equipment and machinery and equipment.** Transport equipment imports increased by 117.7 per cent mainly due to the higher level of imports of road vehicles, particularly, auto trishaws and buses. Machinery and equipment imports increased by 8.3 per cent mainly due to the increase in imports of machinery and equipment parts, agricultural machinery, telecommunication devices and other industrial machinery. Meanwhile, import expenditure on building material expanded marginally by 1.0 percent during this period.
- Expenditure on intermediate goods imports declined by 17.3 per cent, year-on-year, to US dollars 6,397 million during the first eight months of 2015 mainly due to a substantial decline in expenditure on fuel imports.** The non-importation of crude oil in March and April 2015 due to the shutting down of the refinery for maintenance purposes and the record low level of fuel prices prevailing in the

international market resulted in a substantial decline in the expenditure on fuel imports. The average import price of crude oil declined to US dollars 61.24 per barrel during the first eight months of 2015, from US dollars 111.45 per barrel recorded during the corresponding period of 2014. Accordingly, expenditure on fuel imports declined by 48.1 per cent to US dollars 1,789 million during the first eight months of 2015, compared to US dollars 3,448 million recorded in the corresponding period of 2014. Further, fuel imports as a share of total imports declined to 14.2 per cent during this period compared to 27.5 per cent recorded in the corresponding period of 2014. Expenditure on wheat and maize and mineral product imports also declined by 20.1 per cent and 10.4 per cent, respectively, year-on-year, mainly due to the decline of prices in the international market. However, the import of textiles and textile articles, chemical products, diamonds, precious stones and metals, and rubber and articles thereof increased during this period. Textiles and textile articles imports grew by 5.3 per cent to US dollars 1,547 million partly due to the domestic demand. Meanwhile, expenditure on chemical imports increased by 14.3 per cent to US dollars 586 million, as a result of a significant growth in the import of inorganic chemical elements. Import expenditure of diamonds,

Chart 5.3 Composition of Imports (January-August 2015)

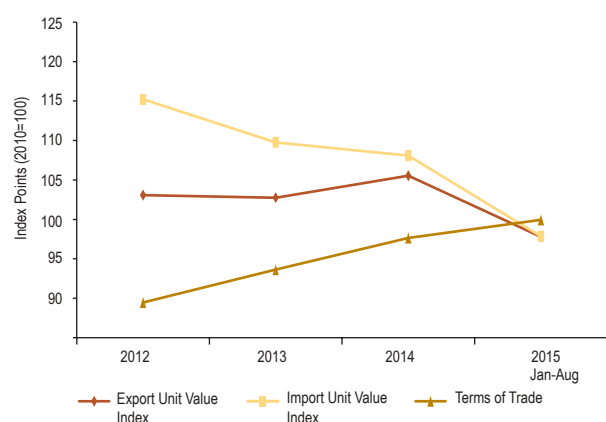


precious stones and metals increased by 37.8 per cent to US dollars 131 million, mainly due to the significant increase in gold imports. Import of rubber and articles thereof increased by 81.3 per cent due to the substantial decline in rubber prices in the international market compared to domestic prices.

Terms of Trade

- **The larger decline in the import price index in proportion to the lower decline in the export price index resulted in an improvement in terms of trade during the first eight months of 2015 compared to the same period in 2014.** The substantial decline in the international market price of fuel, the largest import commodity of Sri Lanka, mainly contributed to the decrease in overall import price index by 11.6 per cent, year-on-year, to 97.8 index points. Meanwhile, the export price index declined by 6.1 per cent, year-on-year, during this period, reflecting declines in the prices of all major export categories. Accordingly, the terms of trade rose by 6.2 per cent, on average, to 99.9 index points during the first eight months of 2015, from 94.1 index points recorded during the corresponding period in 2014.

Chart 5.4 Terms of Trade and Trade Indices



Trade in Services

- **The surplus on trade in services account increased marginally during the first half of 2015, as earnings from services outgrew expenditure on services imports.** Accordingly, the services account of the BOP recorded a surplus of US dollars 1,003 million during the first half of 2015, compared to a surplus of US dollars 898 million during the corresponding period of 2014. Higher inflows to the services account were mainly received from tourism.
- **Both inflows and outflows on account of transport services grew moderately during the first half of 2015.** Inflows from transport services grew by 4 per cent to US dollars 998 million during this period. Earnings from sea and port related transportation activity moderated with the slowdown in goods exports during the period. The increase in passenger arrivals, however, contributed favourably towards the increase in inflows from transportation services. Meanwhile, outflows on account of transportation services grew by 6 per cent during the first half of 2015, to US dollars 771 million, largely due to the increased port and airport related service payments, particularly the higher spending on freight and air travel services. The higher spending on freight also coincides with the increase in goods imports during the period.
- **Higher growth momentum observed in the tourism industry after the dawn of peace in 2009, continued during the first nine months of 2015 as well, reflecting a substantial increase in tourist arrivals.** The number of tourists visited Sri Lanka during the first nine months of 2015 grew by 18.8 per cent to 1,315,839 over the corresponding period in 2014, led by increased arrivals from India and China. During this period, tourist arrivals from China increased by 73.6 per cent, becoming the second largest tourist origin country surpassing United

Chart 5.5 Tourist Arrivals and Earnings from Tourism

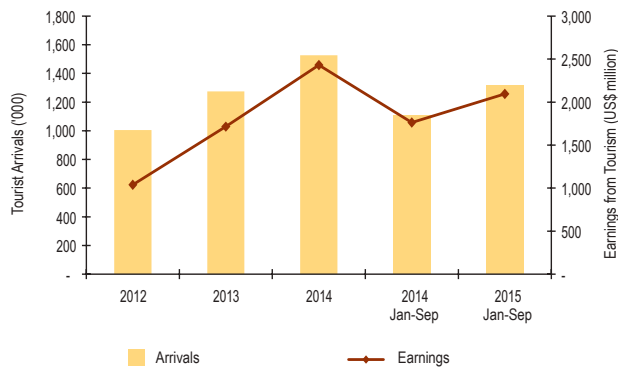
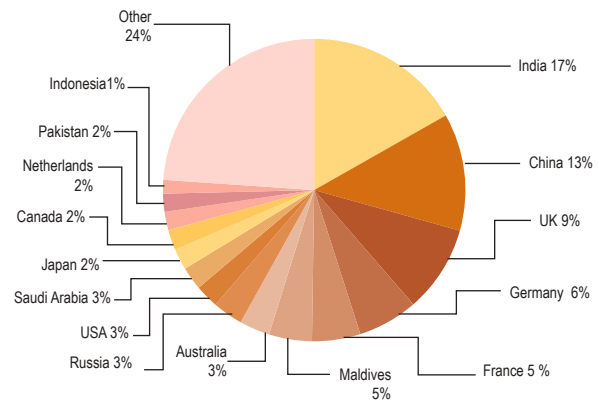


Chart 5.6 Tourist Arrivals by Country (January-September 2015)



Kingdom, while contributing for around 34 per cent of the overall growth in tourist arrivals. India, the largest tourist generating country, recorded a significant growth of 29.4 per cent in tourist arrivals, contributing for about 24 per cent for the overall growth during this period. Western Europe continued to be the largest tourist generating market for Sri Lanka with the number of tourist arrivals increasing by 16.3 per cent to 413,069 during the first nine months of 2015. Tourist arrivals from East Asia and South Asia also increased by 32.5 percent and 24.2 per cent, respectively, during this period. However, tourist arrivals from Eastern Europe declined by 5.5 per cent during the first nine months of 2015 with lower arrivals from Russia and Ukraine due to the lower income as a result of the significant decline in oil prices and geo-political uncertainties.

- **Earnings from tourism accounted for the largest share of inflows from trade in services.** Inflows on account of tourism amounted to US dollars 1,321 million during the first half of 2015, recording a growth of 14.1 per cent over the corresponding period of 2014.¹ Based on the

latest data, cumulative earnings from tourism grew by 18.8 per cent to US dollars 2,095 million during the first nine months of 2015, in comparison to US dollars 1,763 million earned during the same period in 2014. The growth in earnings from tourism can be attributed to the increase in tourist arrivals and expenditure, supplemented by high-spending tourists. The gradual diversification of the tourism industry into niche markets and the development of non-traditional areas such as MICE (Meetings, Incentives, Conferences and Exhibitions) tourism are also expected to have contributed towards the growth of the sector. Meanwhile, outflows also grew, albeit at a lower rate than inflows, with the increase in foreign travel by Sri Lankans for leisure, education and health purposes.

- **Investment in the tourism sector also expanded further during the first nine months of 2015.** Sri Lanka Tourism Development Authority (SLTDA) continued to develop three new Tourism Resort Projects, namely Yala Wildlife Resort, Kuchchaweli Beach Resort and Kalpitiya Island Resort. In addition, new tourism zones in the areas of Nuwara Eliya, Mannar and Jaffna are proposed to be established. Further, in order to accommodate the increasing tourist arrivals,

¹ These provisional estimates may be revised once the Sri Lanka Tourism Development Authority releases its survey results on average stay period and average spending per day estimates for 2015.

investment proposals were received for 40 hotel projects during the first nine months of 2015, to add 1,835 rooms to the tourism industry. During the same period, final approvals were granted for 28 hotel projects from the investment proposals received up to September 2015 with a room capacity of 1,784. Meanwhile, 11 new hotel projects commenced their operations adding 362 rooms to the industry during the first nine months of 2015. In addition, 24 projects were under construction by end September 2015. The Tourism Marketing Plan 2015 prepared by the Sri Lanka Tourism Promotion Bureau (SLTPB), included the push strategy of marketing, which consisted of Sri Lanka's participation at key travel and tourism exhibitions together with the private sector, and business to business meetings coupled with road shows in the key cities of focused countries. In terms of the pull strategy, the visiting journalist programme from key markets was implemented on the theme "08 wonderful experiences in 08 wonderful days" by the journalists who came to Sri Lanka and shared their experience in the chosen media. The key persons of the tourism sector, including the Minister of Tourism for each country have begun visiting the respective country for a one to one dialogue with the tourism hierarchy, key media personalities and tour operators, in order to market Sri Lanka as a destination of choice for global travelers. Cutting edge product developments such as "Sri Lanka - Colombo city rated as No. 1 tourism growth city in the world", the identification of approximately 350-500 blue whales on shores of Kalpitiya by a whale expert, the visit of Miss World 2014 to Sri Lanka and the drive towards increasing the forest cover in the country, were highlighted in the global press.

- **Continued inflows from telecommunications, computer and information services also supported trade in services during the first half of 2015.** The growth momentum in the

sector continued with an inflow of US dollars 413 million during the first half of 2015 in comparison to US dollars 397 million received during the first six months of 2014. The brand recognition received by a number of companies, particularly in software development, highlights the emerging importance of the sector. Meanwhile, outflows on account of telecommunications, computer and information services also grew by 5 per cent to US dollars 216 million during the first half of the year.

Primary Income

- **The deficit in the primary income account increased in the first half of 2015 mainly due to higher outflows on account of dividend and interest payments.** The deficit in the primary income account increased to US dollars 839 million during this period, from US dollars 768 million recorded in the first half of 2014. Inflows to the primary income account declined marginally, mainly due to the decline in earnings on investment of reserve assets. Nevertheless, outflows on account of dividend payments on direct investments increased significantly to US dollars 167 million, indicating increased profits earned by direct investment enterprises during the period. Interest payments increased primarily on account of coupon payments on the International Sovereign Bonds and bonds issued by the licensed banks. However, interest payments on loans obtained by the government remained broadly unchanged during the first half of 2015. Reinvested earnings of BOI companies declined to US dollars 119 million during the period, compared to US dollars 143 million in the first half of 2014. Consequently, total outflows in the primary income account increased to US dollars 909 million in the first six months of the year, compared to US dollars 845 million in the corresponding period of 2014.

Secondary Income

- The surplus in the secondary income account, which comprises workers' remittances and government transfers, grew at a slow pace in the first half of 2015 with the slowdown in workers' remittances. Inflows to the secondary income account amounted to US dollars 3,440 million during the first half of 2015, a growth of 2.0 per cent compared to the growth of 11.0 per cent in the corresponding period of 2014. Government transfers were virtually unchanged, but workers' remittances which account for most of the secondary income inflows, recorded an increase of only 2.0 per cent, a sharp moderation from the growth of 10.6 per cent observed in the first half of 2014. This deceleration could be partly attributed to the decline in petroleum prices and the resultant drop in the income of oil exporting Middle Eastern countries. Further, a decline in labour migration by 14.8 per cent during the first half of 2015, due to the discouragement of migration of workers in unskilled categories and the prevailing geopolitical developments in the Middle East might have also contributed to the deceleration in remittance inflows from the Middle Eastern region. Data released by the Sri Lanka Bureau of Foreign Employment illustrates that labour migration under the skilled category, including professionals, had increased by 8.3 per cent during the first half of 2015 although migration under the semi-skilled and unskilled categories, including house-maids, had declined by 22.7 per cent during this period. The continuation of this trend in labour migration would lead to a composition change in workers' remittances in coming years. On a cumulative basis, workers' remittances up to September 2015 amounted to US dollars 5,182 million, registering a growth of 1.8 per cent, over the corresponding period of 2014.

Current Account Balance

- The external current account deficit remained elevated during the first half of 2015. In nominal terms, the current account deficit widened to US dollars 905 million in the first half of 2015, from a deficit of US dollars 435 million during the corresponding period of 2014. Widening deficits in the trade and primary income accounts, as well as the sharp moderation in the growth of workers' remittances in the secondary income account were the main contributors to the large current account deficit during the first half of the year. However, inflows to the services account and the surplus in the secondary income account cushioned the deficits in the trade and primary income accounts, thereby easing the pressure on the external current account to some extent. With the envisaged expansion in economic activity and policy measures taken by the Central Bank and the government, an improvement in the current account balance is expected during the latter part of the year. Accordingly, the current account is expected to record a lower deficit of 2.3 per cent of GDP in 2015 compared to the deficit of 2.6 per cent of GDP recorded in the previous year.

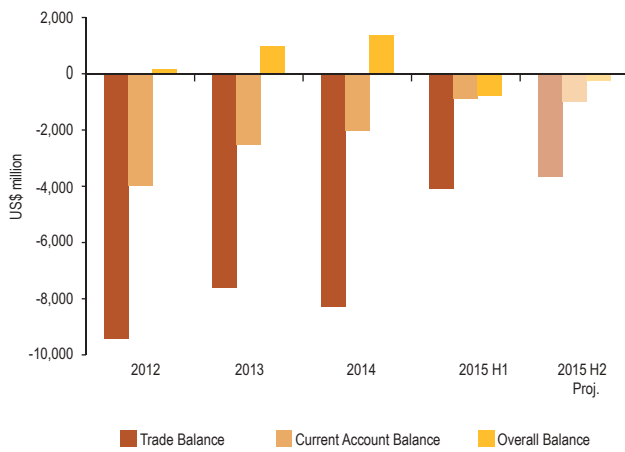
Capital Account Balance

- The surplus in the capital account declined in the first half of 2015. Capital grants received by the government decreased to US dollars 24 million in the first half of 2015 from US dollars 51 million in the corresponding period of 2014. As a result, net inflows to the capital account declined from US dollars 41 million in the first half of 2014 to US dollars 16 million during the first half of 2015.

Financial Account

- Both the net incurrence of liabilities and the net acquisition of financial assets in the financial account were considerably lower in the first half of 2015 than in the corresponding period of 2014. However, the net incurrence of liabilities was significantly higher than the net acquisition of financial assets, which resulted in the financial account recording a net inflow of US dollars 613 million during the first half of 2015. The net incurrence of liabilities in the first half of 2015 amounted to US dollars 848 million compared to US dollars 2,908 million in the corresponding period of 2014, and the net acquisition of assets amounted to US dollars 235 million in the first half of 2015 compared to US dollars 2,969 million in the first half of 2014. Net inflows to the financial account, which finance the current account deficit, were supplemented primarily by sources other than net foreign borrowing by the government. Foreign borrowings by the government remained low during the first half of 2015 with the main source of borrowing being the International Sovereign Bond issued in June 2015, amounting to US dollars 650 million. However, the five year Sovereign Bond of US dollars 500 million which matured in January 2015, reduced the net inflows to the financial account. The other primary source of financing of the current account deficit during the first half of the year, was the foreign currency swap arrangement of US dollars 400 million entered into with the Reserve Bank of India (RBI).
- Net inflows to the government, by way of foreign investments in government securities and foreign loans, declined during the first half of the year, while reserve related transactions remained moderate. The anticipated rate hike by the US Federal Reserve prompted many foreign investors to withdraw their investments from emerging markets, the effect of which was felt by Sri Lanka as well. Consequently, foreign investments in Treasury bills and Treasury bonds recorded a net outflow of US dollars 237 million in the first half of 2015, compared to a net inflow of US dollars 196 million in the first half of 2014. Meanwhile, net inflows to major public investment projects decelerated to US dollars 107 million during this period, compared to a net inflow of US dollars 609 million recorded in the first half of 2014. The low levels of foreign loan inflows were mainly due to the policy adopted by the government to review investment projects and foreign loan facilities. Further, reserve assets related transactions were significantly less when compared to the first half of 2014, with transactions of reserves amounting to a net inflow of US dollars 222 million in the first half of 2015, compared to a net inflow of US dollars 2,463 million in the first half of 2014.
- Non-debt creating financial flows of the BOP also moderated during the first half of 2015. Non-debt creating financial flows, which primarily comprise FDI and equity investments in the CSE, were below expectations mainly due to the subdued global capital flows. Foreign investments in listed companies in the CSE moderated further with a net inflow of US dollars 16 million in the first half of 2015 compared to US dollars 51 million a year earlier. Total FDI related inflows, which include foreign borrowings of BOI companies for investment purposes, declined by 35.6 per cent to US dollars 544 million during the first half of 2015. Excluding foreign borrowings of BOI companies, FDI inflows amounted to US dollars 278 million during the period, a deceleration of 5.6 per cent over the corresponding period in 2014. The deceleration in FDI flows could also be attributed to investors delaying investments until the end of national elections. As in the previous years, a larger share of FDI related inflows during this period were channeled to the infrastructure and services sectors. Meanwhile,

Chart 5.7 Balance of Payments



FDI outflows in the first half of 2015 amounted to US dollars 28 million compared to US dollars 34 million recorded in the corresponding period of 2014.

Balance of Payments (BOP)

- The country's BOP recorded a deficit of US dollars 792 million during the first half of 2015. The widening of the current account deficit and the comparatively low level of inflows to the financial account during the period under review contributed to the deterioration of the BOP position to a deficit of US dollars 792 million, in comparison to the surplus of US dollars 1,954 million recorded during the corresponding period of 2014. Meanwhile, the BOP is estimated to have recorded a deficit of US dollars 2.3 billion by end September 2015.

International Investment Position (IIP)

- Sri Lanka's external asset position, as well as the liability position moderated as at end June 2015 from the positions observed as at end 2014. The total external liability position as at end June 2015 amounted to US dollars 52.8 billion, a decline from US dollars 53.2 billion as

at end 2014. The total asset position declined from US dollars 10.9 billion as at end 2014 to US dollars 10.3 billion as at end June 2015. Out of the total liability position as at end June 2015, foreign loans, portfolio investments and direct investments accounted for 49 per cent, 24 per cent and 19 per cent, respectively. The remainder was in the form of currency and deposits, trade credits received, other accounts payable and special drawing rights (SDRs). Despite a net inflow of US dollars 278 million in transactions, as recorded in the BOP, the total stock position of direct investments declined by US dollars 505 million during the first half of the year. This was due to the valuation adjustments in relation to publicly listed companies, as a result of changes in their share prices during the period. As the effect of the new issuance of an International Sovereign Bond of US dollars 650 million was dampened by the repayment of a matured International Sovereign Bond of US dollars 500 million, the outstanding portfolio investment position remained largely unchanged during the first half of 2015. Meanwhile, the net loan inflows to the government amounted to US dollars 107 million during the first half of the year. Consequently, the outstanding position of government loans increased only marginally during the period. Repayments by the Central Bank to the IMF on account of the SBA facility obtained in 2009 resulted in the outstanding Central Bank liability position to the IMF decreasing to US dollars 969 million as at end June 2015. Despite this, the Central Bank experienced an increase in its foreign liability position during this period, by US dollars 400 million due to the foreign currency swap arrangement between the Central Bank and the RBI.

- The reserve asset position managed by the Central Bank accounted for 73 per cent of Sri Lanka's total foreign assets. The total asset position declined to US dollars 10.3 billion as

at end June 2015 from US dollars 10.9 billion as at end 2014. However, a moderate decline in the reserve asset position was witnessed from US dollars 8.2 billion as at end 2014 to US dollars 7.5 billion by end June 2015. Other variations in the asset positions were due to changes in the direct investment asset position, outstanding position of trade credit and advances extended by exporters, and fluctuations in outstanding currency and deposit position in the banking sector.

Outstanding External Debt Position

- Sri Lanka's total outstanding external debt position increased marginally during the first half of 2015.** As at end June 2015, the outstanding total external debt position as a percentage of estimated GDP remained broadly unchanged from the level recorded at end 2014, indicating the growth of external debt in tandem with the nominal GDP growth. As at end June 2015, the outstanding external debt of the government amounted to 56 per cent of the total external debt of the country. The structure of external debt of the government has changed during the past few years with the government meeting more of its foreign financing requirements through the issuance of International Sovereign Bonds, and more recently by promoting Sri Lanka Development Bonds amongst foreign investors. Both outstanding Treasury bills and Treasury bonds held by non-residents declined during the first half of the year, with continued outflows of foreign investments from the government securities market. The impact of these were reduced to some extent by the government issuing SLDBs to foreign investors and issuing the new International Sovereign Bond of US dollars 650 million, while repaying the matured Sovereign Bond of US dollars 500 million that was issued in 2009. The outstanding foreign loans of the government increased only marginally as the
- inflow of government loans remained subdued and scheduled repayments continued during the period. However, the total outstanding liability position is estimated to have increased with the issuance of the International Sovereign Bond of US dollars 1.5 billion by end October 2015.
- Despite scheduled repayments under the IMF-SBA arrangement, the outstanding liability position of the Central Bank increased with the new currency swap arrangement with the RBI.** The outstanding liability of the Central Bank on the IMF-SBA reduced with the continuation of scheduled repayments by the Central Bank. The repayments under the IMF-SBA will be completed by July 2017. Meanwhile, the receipt of US dollars 400 million, out of the currency swap arrangement of US dollars 1,500 million with the RBI, created an additional outstanding currency and deposit liability during the first half of the year. The remainder of this arrangement amounting to US dollars 1,100 million was obtained in early September, 2015. The ACU liabilities of the Central Bank remained relatively unchanged at US dollars 424 million by end June 2015, compared to the position recorded at the beginning of the year.
- Outstanding liabilities of deposit taking corporations increased while the outstanding debt stock of the private sector declined during the first half of 2015.** The outstanding liability position of deposit taking corporations increased primarily due to an increase in short term loans obtained by licensed commercial banks (LCBs) during this period. A large portion of the long term outstanding debt of deposit taking corporations comprised international bonds issued by the Bank of Ceylon (US dollars 1 billion), the National Savings Bank (US dollars 1 billion) and the DFCC Bank (US dollars 100 million). The outstanding debt liability of the private sector lessened during the period, as

trade credit and advances obtained by the CPC reduced considerably with the settlements of oil bills being higher than new purchases during the period. However, long term loans obtained by the private sector, particularly by companies registered with the BOI, increased during the first half of 2015. Further, intercompany lending of BOI companies recorded a gradual increase during the period. The main characteristic of intercompany lending of BOI companies is that most loan liabilities can be regarded as permanent debt liabilities by parent companies, most of which have no specific loan repayment schedules.

Reserve Asset Position

- Gross official reserves amounted to US dollars 6.8 billion by end September 2015, compared to US dollars 8.2 billion at end 2014. In the first nine months of the year, foreign exchange outflows, which were primarily driven by the settlement of the matured International Sovereign Bond, IMF-SBA repayments, foreign currency debt service payments and the supply of liquidity to the domestic foreign exchange market had an impact on the level of gross official reserves. However, in terms of the number of months of imports, this level of reserves was equivalent to 4.2 months of imports, well

above the internationally accepted benchmark of 3 months of imports. Meanwhile, with the proceeds of the ninth International Sovereign Bond issuance of US dollars 1.5 billion in late October, 2015, gross official reserves are estimated to have improved further. Total international reserves, which comprise gross official reserves and foreign assets of deposit taking corporations, stood at US dollars 8.4 billion as at the end of September 2015. This was equivalent to 5.2 months of imports.

Exchange Rate Movements

- During the first eight months of the year, the Sri Lankan rupee remained at relatively stable levels with increased intervention by the Central Bank, until the recent decision of the Central Bank to allow greater flexibility in the determination of the exchange rate. Throughout this period, the pressure on the exchange rate continued with increased demand for foreign exchange, primarily driven by high expenditure on imports and lower than expected inflows to the current and financial accounts as well as scheduled debt service payments. Meanwhile, the expectation of policy normalisation of the United States aggravated the situation for emerging market currencies to depreciate against the US dollar. Despite this, the supply of liquidity to the foreign exchange market by the Central Bank helped prevent a significant depreciation of the Sri Lankan rupee. Accordingly, the Central Bank had supplied US dollars 1.9 billion, on a net basis, during the first eight months of the year, and the Sri Lankan rupee depreciated by only 2.4 per cent against the US dollar by end August 2015.
- At the beginning of September 2015, the Central Bank limited its intervention in the domestic foreign exchange market and decided to allow more flexibility in determination of the exchange rate. This policy decision is expected to curtail the import demand and

Chart 5.8 Gross Official Reserves and Months of Imports

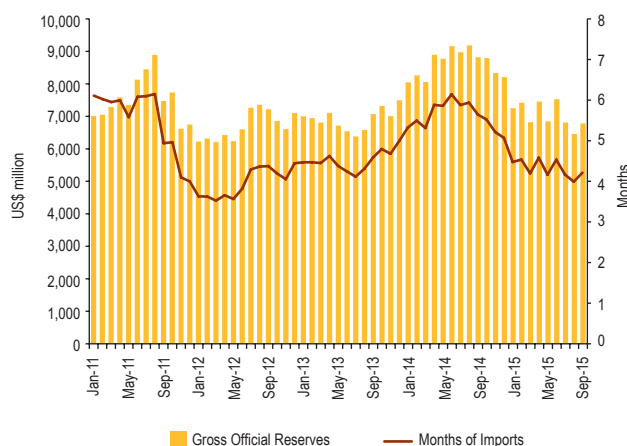


Chart 5.9

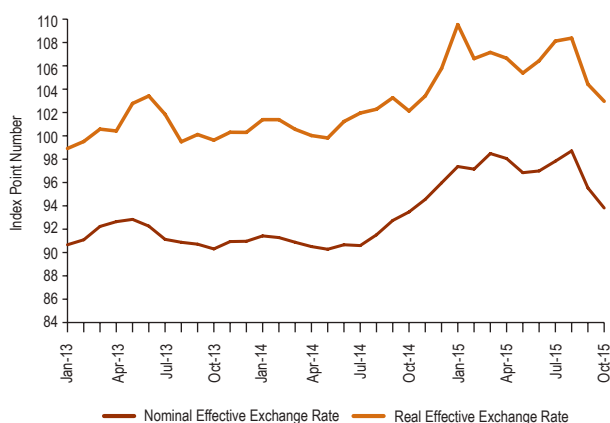
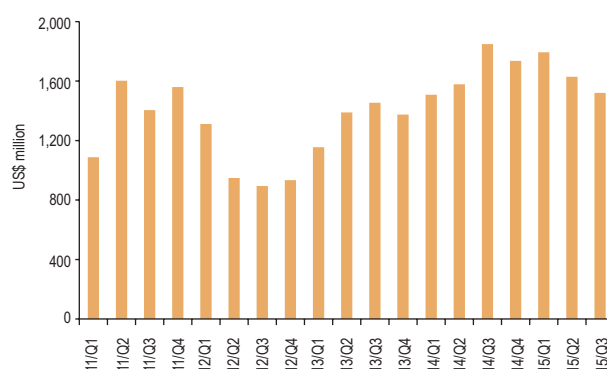
Effective Exchange Rate Indices:
24 - Currency (2010 = 100)

Chart 5.10

Quarterly Inter-Bank Forward
Transaction Volumes

facilitate the maintenance of gross official reserves at a healthy level. The adjustments in trade and investment flows caused by this decision are expected to improve external sector stability significantly towards the end of the year and thereafter. Since this policy adjustment on 04 September 2015, the rupee has depreciated against the US dollar by 4.5 per cent, leading to a depreciation of 7.0 per cent against the US dollar during the year, by end October 2015. Meanwhile, reflecting the cross currency exchange rate movements, the Sri Lankan rupee has depreciated against the pound sterling (5.4 per cent), the Japanese yen (5.8 per cent) and the Indian rupee (4.1 per cent), while appreciating against the euro (3.1 per cent) during the year, by end October 2015.

- **The 5-currency and the 24-currency effective exchange rate indices depreciated during the first ten months of 2015.** The depreciation of the Sri Lankan rupee against some of the major currencies as well as movements in cross currency exchange rates resulted in the 5-currency and the 24-currency Nominal Effective Exchange Rate (NEER) to depreciate by 3.0 per cent and 2.2 per cent, respectively, by end October 2015. The Real Effective Exchange Rate (REER), which takes into account the inflation differential of respective countries in addition to variations in

the nominal exchange rates, also depreciated during this period. Accordingly, both the 5-currency and the 24-currency REER indices depreciated by 2.2 per cent and 2.8 per cent, respectively, by end October 2015. This depreciation of the REER indices reflected the depreciation of the NEER indices and the relatively low levels of domestic inflation compared to those of trading partners and competitors. The depreciation of the REER indices reflect that Sri Lanka is regaining its competitiveness in terms of exchange rates in the international market.

- **The domestic foreign exchange market displayed a mixed performance during the first ten months of 2015.** The total volume of spot transactions declined to US dollars 5.4 billion by end October 2015, compared to US dollars 7.9 billion during the corresponding period of 2014. This may be attributed to the moderation of inflows to the foreign exchange market as a result of the decline in exports, moderate growth of workers' remittances and slow growth in inflows to the financial account. Meanwhile, the total volume of forward transactions increased marginally to US dollars 5.6 billion during the year up to end October 2015 from US dollars 5.5 billion during the corresponding period of 2014.

- **The movements in forward premia and net open positions (NOP) of commercial banks during the first ten months of the year reflected continued pressure in the foreign exchange market.** The one-month and three-month forward premia remained above the interest rate differential on average, while commercial banks maintained their NOP at positive levels on most occasions.

Expected Developments

- **Sri Lanka's external sector performance is expected to improve during the latter part of 2015 and beyond.** The policy decisions taken by the Central Bank and the government, especially to address the pressure on the external sector due to the increased demand for foreign exchange and lower than expected foreign exchange inflows, are expected to support the improvement in the balance of payments. Specific policies such as the Central Bank's decision to accommodate greater flexibility in the determination of the exchange rate from early September 2015 and the reduction in loan to value ratio (LTV), as well as the initiative taken by the government to change the custom valuation method for motor vehicles are expected to strengthen the external sector. This will mainly be realised through the improvement of the trade account and financial account, leading to the strengthening of the country's gross official reserves position during the remaining period of 2015. With the realisation of envisaged improvements in the current and financial accounts of the BOP, Sri Lanka's external sector performance is expected to gather momentum in 2016. Overall, the BOP is projected to record a surplus of around US dollars 700 million in 2016, thereby augmenting the country's gross external reserves to US dollars 8.4 billion. However, the recovery of advanced economies, stability in commodity prices including oil, improvement of foreign investor confidence, realisation of project related foreign financing, attraction of FDIs and effective utilisation of available foreign assistance are critical in ensuring the realisation of these expectations.
- **Exports are projected to grow by around 1.1 per cent in 2015 and by around 8.5 per cent in 2016, mainly supported by the expansion in industrial exports.** The deceleration in agricultural exports is projected to continue during the latter part of the year due to the lower performance of tea and seafood exports, resulting from geopolitical issues and economic sanctions in main markets. Industrial exports are projected to grow due to the expected increase in exports of textiles and garments, albeit at a lower rate, petroleum products and leather, travel goods and footwear. The expected growth and improvements in bilateral trade relations with main trading partners, especially with the EU, will support the growth in exports in 2016. Garment exports are projected to record a healthy growth with the expected restoration of the GSP+ facility, which provides concessional access to the EU market. Tea exports, which were adversely affected by lower demand from the Middle East and Russia in 2015, are expected to grow in 2016 as a result of the removal of economic sanctions against Iran and the expected gradual increase in demand for tea from the Middle East. The ban on fish exports to the EU by the European Commission is expected to be lifted by end 2015, favouring fish exports in 2016. These factors, together with the strong growth projected for main export markets, such as the US and the EU, are expected to help enhance the performance of exports. With the saving of around US dollars 2 billion on the importation of fuel, resulting from lower international oil prices, the expenditure on imports is expected to decline

by around 2.1 per cent in 2015. The growth in vehicle imports is expected to decline during the last two months of 2015 due to the recent policy measures adopted by the government to curtail vehicle imports. Meanwhile, expenditure on imports is projected to grow at around 4.1 per cent in 2016 mainly as a result of the expansion in intermediate goods imports with the expansion in domestic economic activity. Accordingly, the trade balance is projected to improve by around 2.2 per cent in 2016, year-on-year, which is estimated to be around 8.5 per cent of GDP.

- **The services account is expected to perform well during the remaining period of 2015 and 2016.** The growth momentum in the tourism sector is anticipated to continue during the latter part of the year 2015, due to the expected increase in tourist arrivals from the start of the peak tourist season in November and with the support of various tourism promotion activities which are currently being conducted by the Sri Lanka Tourism Development Authority (SLTDA). The growth momentum in the tourism sector is also expected to continue in 2016 and beyond, supporting the services account of the BOP. Passenger air fares are also projected to increase with the expected growth in arrivals of high spending tourists. Ongoing mega projects in the hotel sector are expected to gradually raise the capacity of the industry to meet the requirements of the projected tourist arrivals. Further, promotional campaigns in untapped potential markets are expected to attract tourists from a wider geographical base, thereby strengthening the resilience of the industry. Meanwhile, outflows on account of travel are projected to increase at a higher rate due to the expected increase in travel by Sri Lankans for education, health, business and leisure purposes. The expected establishment

of the nationwide LTE(4G)-speed internet connectivity and the launch of Google's balloon-based Internet network (Google Loon) are likely to lead to further reductions in the cost of provision of IT services, thereby facilitating the expansion of the IT and telecommunication industry in 2016 and beyond.

- **Workers' remittances, which witnessed a high growth during the recent years, are expected to moderate during the balance period of 2015 in line with developments in the domestic and foreign labour markets.** Further, workers' remittances are expected to grow, albeit at a slower pace in 2016, due to relative conditions in domestic and foreign labour markets. Policies to discourage women's migration under the unskilled category, due to associated social issues and increased geo political uncertainty in the Middle East, while encouraging the migration of skilled and semi-skilled persons to high income economies, such as South Korea and Singapore, would contribute to a change in the composition of workers' remittances in the medium term. Although the increase in migration of professionals for employment is expected to contribute towards higher foreign exchange inflows by way of workers' remittances in the medium term, the decline in the unemployment rate to record low levels and the opening up of alternative employment opportunities, especially in emerging sectors such as tourism, construction and IT-BPO and KPO sectors, are expected to reduce the number of workers seeking employment abroad.
- **The current account deficit is projected to be around 2.3 per cent of GDP in 2015 and is expected to reduce to around 1.8 per cent of GDP by end 2016.** The continued increase in earnings from tourism, other service exports and workers' remittances are expected to significantly contribute to the

narrowing of the external current account deficit in 2016, although the improvement in the trade balance is expected to be moderate. However, the anticipated moderate growth in remittances in the medium term suggests that excessive dependence on remittances to curtail the current account deficit would not be sustainable in the long run. Therefore, the adoption of more sustainable measures is vital to reduce the current account deficit. Such measures include improvement of trade balance through the enhancement of exports and improvement in services exports, with greater focus on tapping the unutilised resources in goods and services exports, enhance productivity and the diversification of products and export destinations.

- **Inflows to the financial account are projected to increase with improving business confidence following the expected implementation of broader macroeconomic policy.** Inflows to the government in the form of foreign loans are estimated to increase with the implementation of new projects, reversing the decline observed during 2015. Inflows to the private sector, including FDI, are expected to increase in 2016 with the realisation of focused efforts of the government to attract non-debt creating capital flows. However, attracting and retaining a sufficient amount of FDI to finance the savings-investment gap depends on the implementation of a prudent medium term national strategy to promote Sri Lanka as an attractive destination for foreign investments.