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EXTERNAL SECTOR DEVELOPMENTS

Sri Lanka's external sector showed signs of improvement in 2017 as the pressure on the Balance of Payments (BOP) continued to ease with higher inflows to the financial account, despite the increased current account deficit. The current account deficit increased to US dollars 1,466 million during the first half of 2017, from US dollars 644 million in the corresponding period of 2016. This expansion in the current account deficit was particularly due to the widened trade deficit owing to higher imports recorded during the first half of the year, amidst the gradual pickup in exports since March, moderate earnings from tourism with the partial closure of the Bandaranaike International Airport (BIA) for resurfacing of the runway as well as health advisories related to an increase in dengue cases and the decline in workers' remittances amidst the slowdown in the Middle Eastern economies. Conversely, the financial account, which was under pressure due to higher foreign exchange outflows during the first quarter of 2017, improved substantially during the second quarter. Increased investor confidence brought about by the successful completion of the Second Review of the IMF Extended Fund Facility (IMF - EFF) and the gradual stabilisation of US bond yields positively contributed to this improvement in the financial account. Accordingly, foreign investment in the government securities market increased substantially in the second quarter of 2017, offsetting the impact of higher withdrawals during the first quarter. The financial account was also augmented by inflows to the Colombo Stock Exchange (CSE), foreign direct investment (FDI), and proceeds of the eleventh International Sovereign Bond (ISB) and the foreign currency term financing facility obtained by the government. Reflecting these developments, the BOP recorded an overall surplus of US dollars 2,037 million by end September 2017. Improved external sector performance facilitated the Central Bank's policy of implementing a more market-based exchange rate. Accordingly, the Central Bank limited its intervention in the foreign exchange market only to build up international reserves with a minimal impact on the exchange rate. With the Central Bank purchases of US dollars 1,161 million from the market, on a net basis during the first nine months of the year, the level of gross official reserves improved to US dollars 7.3 billion, equivalent to 4.2 months of imports, by end September 2017, from US dollars 6.0 billion at end 2016. During the year up to end September, the external value of the Sri Lankan rupee remained relatively stable, depreciating only by 2.2 per cent against the US dollar. However, an adjustment in the current account through an improved trade balance and higher foreign investment inflows, particularly in the form of export-oriented FDI, is needed for the recent positive developments in the external sector to be sustained in the medium term.

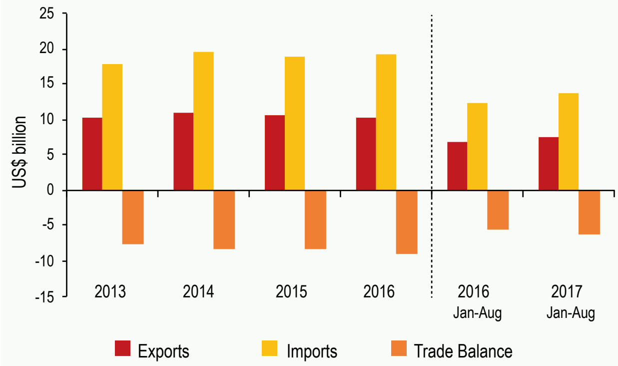
Trade in Goods and Trade Balance

- **External trade, which indicated a sluggish performance during the past two years, rebounded during the first eight months of 2017.** Both earnings from exports and expenditure on imports increased during this period. However, the overall trade deficit expanded during the first eight months of 2017, owing to a significant increase in import expenditure compared to export earnings. Accordingly, the deficit in the trade account widened to US dollars 6,186 million during the first eight months of 2017 from US dollars 5,515 million in the corresponding period of 2016.

- **Benefitting from several positive developments, earnings from exports revived during the first eight months of 2017.** Earnings from exports increased by 7.6 per cent to US dollars 7,413 million during the first eight months of 2017, from US dollars 6,888 million in the corresponding period of 2016. This was owing to the recovery in key export markets, increased commodity prices in the international market, conducive external trade policies together with institutional support, the gradual depreciation of the exchange rate, the removal of the ban on exports of Sri Lankan fisheries products to the European Union (EU) and the reinstatement of the EU GSP+ facility.[1] Exports of all major categories increased during this period and the highest contribution to the growth in exports was from agricultural exports (56.1 per cent), followed by industrial exports (42.8 per cent).

- **Earnings from agricultural exports, which account for about a quarter of total exports, showed a strong performance during the first eight months of 2017, registering a 19.4 per cent year-on-year growth to reach US dollars 1,815 million.** Higher export earnings from tea, spices and seafood largely contributed to this growth. Earnings from tea exports, which declined by 7.3 per cent (year-on-year) during the first eight months of 2016, increased significantly by 20.1 per cent to US dollars 1,003 million during the first eight months of 2017. This was mainly due to high average export prices of tea despite the decline in export volumes by 3.6 per cent. Reflecting the higher tea prices in the international market, the average export price of tea increased by 24.6 per cent to US dollars 5.27 per kg during the first eight months of 2017 compared to US dollars 4.23 per kg recorded in the same period of 2016. Export earnings from spices increased by 28.1 per cent (year-on-year) to US dollars 249 million during the first eight months of 2017 mainly due to the increase in export volumes of cloves and cinnamon. Export earnings from cloves increased more than four-fold during the first eight months of 2017, while earnings from cinnamon increased by 18.7 per cent (year-on-year). Further, earnings from seafood exports rose by 40.4 per cent (year-on-year) to US dollars 155 million during the first eight months of 2017 following the removal of the ban on exports of fisheries products to the EU market in June 2016 together with the regaining of the GSP+ facility. Accordingly, earnings from seafood exports to the EU market increased significantly by 118.3 per cent (year-on-year), benefiting from the high demand from France, the UK, Italy, Germany and Netherlands. In addition, earnings from minor agricultural products, such as betel leaves and fruits as well as rubber and unmanufactured tobacco contributed to the growth in earnings from agricultural exports during this period. Earnings from coconut exports also increased marginally by 0.7 per cent

Chart 5.1
External Trade Performance



Sources : Sri Lanka Customs
Central Bank of Sri Lanka

1 EU GSP+ was granted to Sri Lanka from July 2005. However, the lack of progress in 27 specified international conventions in the fields of core human and labour rights, the environment and good governance led to Sri Lanka losing the GSP+ facility in August 2010. This facility was regained in May 2017 allowing the country to export 66 per cent of its products tax-free to the European market.

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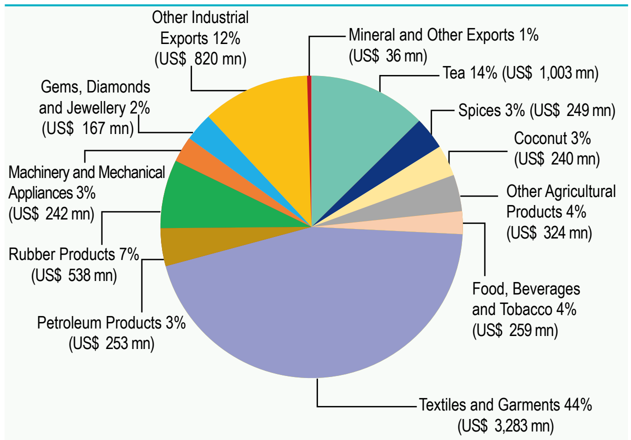
(year-on-year) to US dollars 240 million, owing to an increase in earnings from non-kernel coconut products exports by 7.0 per cent, despite the poor performance registered in coconut kernel products, particularly in desiccated coconut exports.

- **Earnings from industrial exports, which account for around 75 per cent of total exports, increased by 4.2 per cent (year-on-year) to US dollars 5,562 million during the first eight months of 2017.** This was mainly due to higher export earnings from petroleum products, transport equipment, and machinery and mechanical appliances. Earnings from exports of petroleum products increased by 36.3 per cent (year-on-year) during the first eight months of 2017, owing to the increased export volumes and high prices for bunkering fuel in the international market. Earnings from transport equipment increased by 70.7 per cent (year-on-year) to US dollars 138 million during the first eight months of 2017, due to the export of three ships to Singapore. Further, earnings from machinery and mechanical appliances registered a 20.9 per cent growth (year-on-year) during this period due to increases recorded in all sub categories except for electronic equipment. In addition, export earnings from food, beverages and tobacco, rubber products, base metals and articles, and wood and paper products also increased during this period. However, earnings from textiles and garments, which account for more than 44 per cent of total exports, declined by 1.5 per cent (year-on-year) to US dollars 3,283 million during the first eight months of 2017, reflecting the decline in the exports of garments to the EU and USA, the main traditional markets for Sri Lankan garment exports, particularly in the first half of the year. In contrast, garment exports to non-traditional markets such as Canada, Australia, Hong Kong, Mexico and the UAE increased during this period. Although, export earnings from textiles and garments reported a decline in the first eight months of the year, on a cumulative basis, a notable increase was recorded during the months of July and August 2017, signalling the positive impact of the restoration of the GSP+ facility in May 2017. Meanwhile, earnings from gems, diamonds and jewellery, and leather, travel goods and footwear declined by 11.0 per cent and 7.5 per cent to US dollars 167 million and US dollars 107 million, respectively, during the period under review.

Chart 5.2
Composition of Exports (Jan-Aug 2017)



Sources : Ceylon Petroleum Corporation and Other Exporters of Petroleum
National Gem and Jewellery Authority
Sri Lanka Customs
Central Bank of Sri Lanka

- **Earnings from the export of mineral products increased by 24.6 per cent (year-on-year) to US dollars 25 million during the first eight months of 2017.** All sub categories, particularly exports of earths and stones, contributed to the growth in earnings from mineral exports during this period.

- **Expenditure on imports increased by 9.6 per cent (year-on-year) to US dollars 13,599 million during the first eight months of 2017.** High commodity prices in the international market, increased reliance on thermal power generation due to drought conditions and measures taken to import rice to meet the shortage in the domestic supply led to an increase in expenditure on imports during the first eight months of 2017. Meanwhile, expenditure on non-fuel imports grew by 5.0 per cent to US dollars 11,446 million during this period.

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- **Imports of intermediate goods largely contributed to the expansion in expenditure on imports.** Expenditure on intermediate goods, which accounts for more than half of total imports, increased by 15.3 per cent (year-on-year) to US dollars 7,272 million during the first eight months of 2017, mainly driven by high fuel imports. Expenditure on fuel imports increased by 43.4 per cent (year-on-year) to US dollars 2,153 million during this period, mainly due to the increase in import expenditure on refined petroleum products by 54.0 per cent (year-on-year) to US dollars 1,588 million, reflecting the impact of price increases in the international market as well as the increase in import volumes. Import expenditure on crude oil and coal also increased during the period, owing to increased prices in the international market and increased demand from the domestic power generation sector. The average import price of crude oil increased by 25.2 per cent to US dollars 54.38 per barrel during the first eight months of 2017, in comparison to US dollars 43.44 per barrel recorded during the corresponding period of 2016. Meanwhile, import expenditure on diamonds, precious stones and metals grew by 58.6 per cent (year-on-year) to US dollars 475 million during the first eight months of 2017, mainly due to the increase in gold imports by 90.6 per cent to US dollars 403 million, owing to the high volumes imported following the removal of the Port and Airport Development Levy (PAL) on gold imports with effect from January 2016. Increases in expenditure on imports of base metals (41.5 per cent), wheat and maize (36.9 per cent) and food preparation (29.7 per cent) also contributed towards the increase in intermediate goods imports during the first eight months of 2017. Expenditure on textiles and textile articles imports increased marginally by 0.9 per cent (year-on-year) during the first eight months of 2017. In line with the improved performance observed in export earnings from textiles and garments, following the restoration of the GSP+ facility, the import of raw material for textiles and garment industry is expected to increase in the future. However, import expenditure on fertiliser, mineral products and chemical products decreased by 35.4 per cent, 22.4 per cent and 3.2 per cent, respectively, during the period concerned.

- **With respect to the consumer goods category, import expenditure on food and beverages increased during the first eight months of 2017, while expenditure on non-food consumer goods declined**. The overall import expenditure on consumer goods, which accounts for around 22 per cent of total imports, increased by 4.5 per cent to US dollars 2,952 million during the first eight months of 2017 from US dollars 2,825 million in the corresponding period of 2016. Import expenditure on food and beverages increased by 15.9 per cent to US dollars 1,204 million, mainly due to the high expenditure on rice and dairy products. A continuous increase in rice imports was recorded since January 2017, as a result of the measures taken by the government to encourage rice imports to meet the shortage in the domestic supply. Accordingly, the import volume of rice increased to 446 million kg during the first eight months of 2017 from 18 million kg recorded during the corresponding period of 2016. The import expenditure on dairy products also increased by 29.2 per cent (year-on-year) during the first eight months of 2017, reflecting to a larger extent higher average import prices for milk powder that prevailed in the international market amidst global supply disturbances. In addition, expenditure on fruits, and oils and fats contributed towards the higher import outlays on food and beverages during the period. However, import expenditure on spices and vegetables declined during the first eight months of 2017. Meanwhile,

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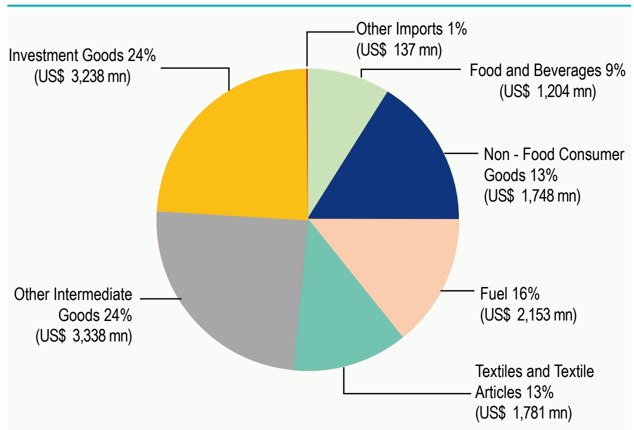
Chart 5.3
Composition of Imports (Jan-Aug 2017)



Sources : Ceylon Petroleum Corporation
Lanka IOC PLC
Sri Lanka Customs
Central Bank of Sri Lanka

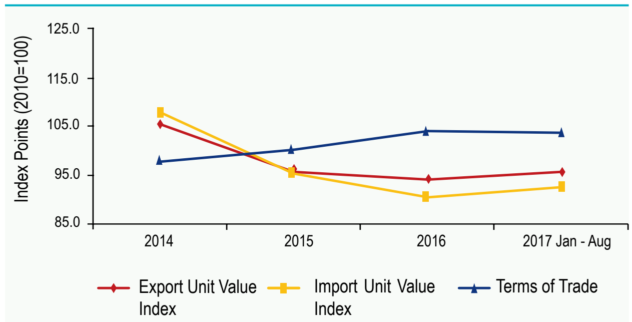
expenditure on non-food consumer goods imports declined by 2.1 per cent (year-on-year) to US dollars 1,748 million, mainly due to the decline in vehicles for personal use, and medical and pharmaceutical items. However, import expenditure on telecommunication devices, and clothing and accessories increased during the period under review.

- **Expenditure on investment goods imports declined marginally during the first eight months of 2017**. Expenditure on imports of investment goods decreased by 0.7 per cent to US dollars 3,238 million during the first eight months of 2017 due to reduced imports of machinery and equipment, which declined by 4.2 per cent (year-on-year). This was driven by a reduction in the imports of machinery for the textile industry and agricultural activities, electric motors and generating sets, turbines and telecommunication devices, despite the increase in imports of engineering equipment as well as machines for office work. However, import expenditure on building materials increased by 2.8 per cent to US dollars 1,055 million during the first eight months of 2017, due to higher import expenditure on iron and steel, aluminium articles, wood products, and insulated wires and cables. Import expenditure on transport equipment also increased by 5.9 per cent, due to higher imports of tankers, bowsers and vans.

Terms of Trade

- **The terms of trade, on average, increased during the first eight months of 2017 in comparison to the corresponding period in 2016, reflecting a higher increase in the export price index relative to the increase in the import price index**. The overall export price index rose moderately by 1.5 per cent (year-on-year) to 95.8 index points during the first eight months of 2017 due to increases in prices of agricultural exports. The export price index for agricultural products increased by 13.1 per cent (year-on-year) during the first eight months of 2017, mainly on account of a 23.3 per cent increase in tea prices, in line with the high prices

Chart 5.4
Terms of Trade and Trade Indices



Source : Central Bank of Sri Lanka

prevailing in the international market. However, the export price index for industrial products decreased by 1.8 per cent (year-on-year) due to the decline in the average price of many sub categories, particularly transport equipment, machinery and mechanical appliances, base metals and articles, wood and wood products, and plastics and articles. Reflecting higher fuel prices in the international market, the price index of petroleum product exports increased substantially by 27.4 per cent during the first eight months of 2017. Meanwhile, the overall import price index increased marginally by 0.4 per cent during the first eight months of 2017, due to higher prices of intermediate goods despite the decline in prices of investment and consumer goods. The intermediate goods import price index increased by 2.9 per cent, reflecting a 21.6 per cent increase in the fuel price index, despite the reduction in prices of most of the other intermediate goods imports, particularly fertiliser, mineral products, plastic and articles thereof, and diamonds, precious stones and metals. Meanwhile, the price index for investment goods imports declined during the first eight months of 2017, indicative of lower prices in machinery and equipment, and building materials. The price index for consumer goods declined during the period as a result of lower prices, on average, for food and beverages, and non-food consumer goods. Accordingly, the terms of trade improved by 1.0 per cent to 103.7 index points during the first eight months of 2017 over the corresponding period in 2016. Further, excluding oil-related products, the terms of trade recorded an increase of 2.8 per cent.

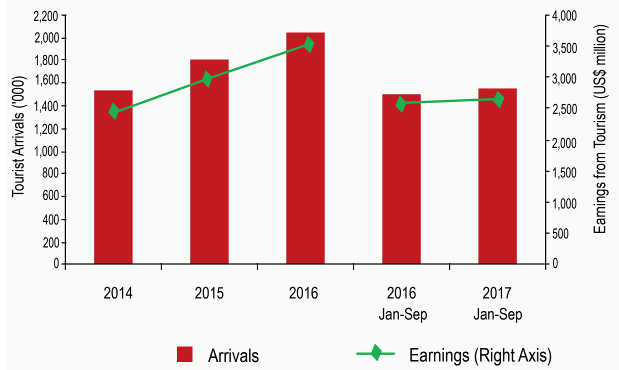
Trade in Services

- **The surplus in the services account increased during the first half of 2017, as earnings from services exports outgrew expenditure on services imports**. Accordingly, the services account of the BOP, which mainly consists of travel, transport and telecommunication, computer and information services, recorded a surplus of US dollars 1,407 million during the first half of 2017 compared to a surplus of US dollars 1,314 million during the corresponding period of 2016.

- **Gross inflows on account of transport services, which consist of passenger fares, freight charges, and port and airport related activities, grew moderately during the first half of the year 2017**. Accordingly, gross earnings from transport services registered a growth of 3.9 per cent to reach US dollars 1,182 million during this period. Meanwhile, outflows on account of transportation services increased at a higher rate of 5.3 per cent to US dollars 872 million, largely due to the increased port and airport related service payments, particularly the higher spending incurred on freight and air travel services. Inflows relating to passenger fares increased by 2.9 per cent to US dollars 568 million during the first half of 2017. The slowdown of earnings from passenger fares particularly in the first quarter of the year could be mainly attributed to the drop in the number of passengers travelling to Sri Lanka as a result of the partial closure of the Bandaranaike International Airport (BIA) during January to April 2017 for the re-laying of the runway. Meanwhile, with the expansion in port related activities, inflows on account of freight charges, with respect to both port and airport related activities, increased during the first half of 2017. Gross inflows from freight charges increased by 4.9 per cent to US dollars 614 million, mainly due to the increased cargo, container and transhipment volumes handled at the port of Colombo.

Chart 5.5

Tourist Arrivals and Earnings from Tourism



Sources : Sri Lanka Tourism Development Authority
Central Bank of Sri Lanka

- **The tourism industry indicated some moderation during the first nine months of 2017 while remaining a major foreign exchange earner to the country**. Although tourist arrivals crossed the 2 million milestone for the first time in 2016, the performance of the industry during the first nine months of 2017 was moderate, as tourist arrivals recorded a subdued growth of 2.9 per cent (1,551,931 arrivals) over the corresponding period of 2016. Flight cancellations and delays at the BIA until April 2017, caused by partial operations of the airport owing to the repair and upgrade of the runway, and the breakout of dengue epidemic partly contributed to the sluggish performance in the tourism industry. Tourists from Western Europe dominated arrivals, followed by South Asia and East Asia. However, tourist arrivals from the South Asian region recorded a marginal decline compared to the first nine months of 2016, mainly due to the decline in arrivals from Maldives by 17.3 per cent. In terms of country origin, arrivals from India, the major tourist origin for Sri Lanka, increased by 6.1 per cent to 267,601, while a moderate decline was recorded in arrivals from China.

- **Following the trend in tourist arrivals, earnings from tourism[2] recorded a moderate growth during the first half of 2017**. On a cumulative basis, earnings from tourism increased by 4.8 per cent to US dollars 1,733.6 million during the first

2 This provisional estimate 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 2017.

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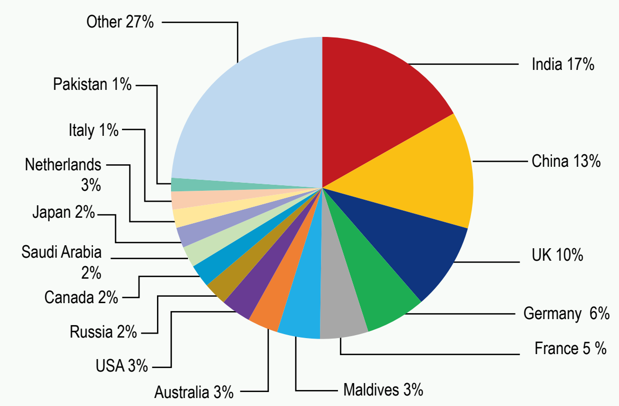
Chart 5.6
Tourist Arrivals by Country (Jan-Sep 2017)



Source : Sri Lanka Tourism Development Authority

half of 2017. Earnings from tourism during the period from January to September 2017 grew by 2.9 per cent to US dollars 2,662.6 million from US dollars 2,587.9 million in the corresponding period of 2016.

- **The tourism industry has attracted a substantial amount of investments during the first eight months of 2017**. Since the initiation of the One Stop Unit (OSU) at the Sri Lanka Tourism Development Authority (SLTDA) in 2010, a centralised promotion and facilitation centre established to assist potential investors interested in investing in the tourism industry, 597 project proposals have been received. Out of these, 497 hotel projects with 28,783 rooms were approved, totalling an investment of US dollars 5,137 million. Among those, proposals for 53 new hotel projects worth US dollars 261 million, with room capacity of 1,966 were received during the first eight months of 2017, while approvals were granted for 26 projects worth US dollars 314 million with a capacity of 1,550 rooms. In addition, 17 hotel projects commenced operations, adding 1,190 rooms during this period. These developments will help cater to the expected 4 million tourist arrivals by 2020.

- **Earnings from telecommunication, computer and information services, the main contributor to growth in the services account, continued to grow steadily during the first half of 2017**. Earnings from the export of telecommunications, computer and information services amounted to US dollars 457 million in the first half of 2017, compared to US dollars 442 million during the corresponding period of 2016. The growth in this sub sector was mainly driven by increased inflows from the export of software and Information Technology Enabled Services (ITES), including Business Process Outsourcing (BPO) and Knowledge Process Outsourcing (KPO).

Primary Income

- **The deficit in the primary income account continued to expand in the first half of 2017, albeit marginally, mainly due to interest payments on International Sovereign Bonds (ISBs).** The deficit in the primary income account was US dollars 1,038 million during the first half of the year in comparison to US dollars 971 million in the corresponding period of 2016. However, withdrawal of dividends by direct investors and reinvestment of earnings with respect to direct investments remained at similar levels during the period under review vis-a-vis the first half of 2016. There is a gradual increase in interest payments on government borrowings with new issuances of ISBs as well as borrowings from the foreign currency term financing facility, as the increase in global interest rates affected the cost of borrowing of both the government and private sector.

Secondary Income

- **The secondary income account, which consists of private and government transfers, recorded a notable decline in its surplus during the first half of 2017 with reduced workers' remittances**. Net inflows to the secondary income account declined by 9.4 per cent, year-on-year, to US dollars 2,904 million in the first half of 2017, from US dollars 3,204 million in the corresponding period of 2016. As observed in the last year, the sluggish performance of the Middle Eastern economies, as a result of relatively low oil prices and geopolitical uncertainties, adversely affected the growth in workers' remittances during 2017 as well. Moreover, according to data provided by the Sri Lanka Bureau of Foreign Employment, labour migration for foreign employment under each skill category declined, reducing the overall labour migration rate significantly by 14.6 per cent during the first half of 2017, in comparison to the corresponding period of the previous year. This may have also contributed towards the decline of workers' remittances. Meanwhile, workers' remittances have declined by 7.4 per cent to US dollars 4,985 million during the first nine months of 2017 compared to US dollars 5,382 million recorded during the corresponding period in 2016.

Current Account Balance

- **Sri Lanka's current account deficit further widened in the first half of 2017, deviating from the expected improvement for the year, mainly due to increased drought related imports, slower pick up in exports, moderation in tourist earnings and decline in workers' remittances**. The trade balance deteriorated significantly despite the pickup in export earnings since March 2017, as exports proceeds were insufficient to offset the substantial increase in import expenditure. The increase in import expenditure during the first half of the year was mainly due to higher expenditure on drought related imports of fuel and rice. The higher importation of gold also contributed to the increase in import expenditure during the period under review. Moreover, the deficit in the primary income account widened during the year up to end June, driven mostly by increased interest payments. The surplus in the services account also moderated during the period primarily due to the subdued performance of the travel and transport subsectors, while inflows to the secondary income account, which mainly consists of workers' remittances, declined considerably, exerting more pressure on the current account of the BOP. As a result, the current account deficit widened to US dollars 1,480 million in the first half of 2017, from a deficit of US dollars 644 million in the corresponding period of 2016.

Capital Account Balance

- **Net inflows to the capital account remained modest in the first half of 2017**. Net inflows to the capital account amounted to US dollars 8 million in the first half of the year from US dollars 1 million in the first half of 2016. The significance of the capital account in the overall context of the balance of payments has diminished over the past few years as capital grants to the government have reduced with Sri Lanka's elevation to a lower middle-income country status in 2010.

Financial Account

- **The financial account recorded a mixed performance in the first half of 2017**. The financial account witnessed significant outflows in the first quarter of 2017, primarily due to considerable foreign investment outflows from the government securities market. Low foreign investments in the CSE as well as low levels of direct investments during the first quarter of the year also affected the performance of the financial account. However, a reversal in financial flows was witnessed in the second quarter of the year, with increased investor confidence brought by the continuation of the IMF-EFF program as well as the gradual stabilisation of US government bond yields. Consequently, there were steady inflows to the government securities market in the second quarter of the year, while net foreign inflows to the CSE were also witnessed during this period. The eleventh international sovereign bond (ISB) and the foreign currency term financing facility obtained by the government were the major sources of foreign inflows to the financial account of the BOP.

- **Foreign Direct Investment (FDI) inflows improved substantially in the first half of 2017 compared to the first half of 2016**. Total FDI inflows, inclusive of foreign loans to BOI companies, amounted to US dollars 711 million during the first half of 2017, in comparison to US dollars 293 million in the corresponding period of 2016. Meanwhile, FDI excluding foreign loans to BOI companies, increased to US dollars 509 million during the first half of 2017, from US dollars 173 million during the comparable period of 2016. Tourism, telecommunication and infrastructure sectors attracted a major share of the FDI inflows during the first half of 2017. Attracting FDI to Sri Lanka is crucial since they are non-debt creating and long term in nature. Hence, Sri Lanka needs to attract FDI by accelerating reforms to enhance competitiveness, while assuring consistency in policies and political stability. There were several proposals in the Budget 2017 to reach a higher level of FDI, including initiatives such as an allocation to brand Sri Lanka and establish the Agency for Development to facilitate foreign investments, with the objective of providing clearance for BOI projects within 50 days. The government introduced 'Roadmap for Improving Investment Climate' in July 2017 with technical assistance of the World Bank Group, to improve the ease of doing business in Sri Lanka. This road map proposes a single window for new business registration, which will drastically reduce the difficulties in starting-up new businesses.

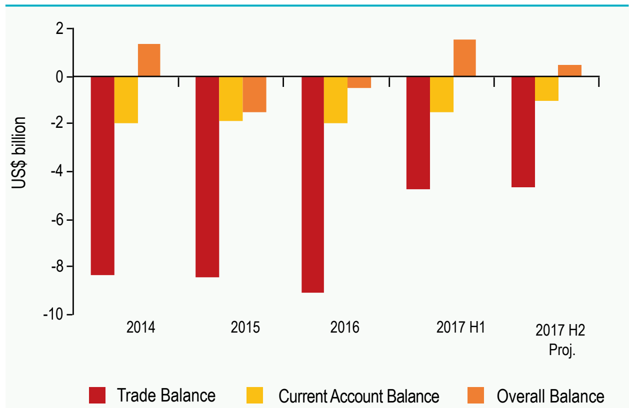
- **Sri Lanka also settled the foreign currency SWAP arrangement with the Reserve Bank of India (RBI) as well as the remaining balance of the IMF-SBA facility obtained in 2009 during the year**.The outstanding amount of the RBI swap facility of US dollars 400 million, which was the only remaining international swap arrangement as at end 2016, was fully settled in March 2017. Further, the Central Bank fully settled the IMF-SBA facility in July 2017.

- **The overall developments in the financial account resulted in a net inflow to the financial account in the first half of 2017**. As a result, the net incurrence of liabilities amounted to US dollars 2,353 million, while the net acquisition of assets amounted to US dollars 1,057 million in the first half of 2017. Consequently, the net inflow to the financial account amounted to US dollars 1,295 million during the period under review.

- **Reflecting movements in financial account inflows, gross official reserves, which declined to US dollars 5.1 billion at the end of the first quarter of 2017 from US dollars 6.0 billion as at end 2016, increased to US dollars 7.0 billion by June 2017.** Continuous outflow of foreign investments from government securities in the first two months of the year prompted the Central Bank to intervene in the domestic foreign exchange market significantly during this period, which led to a drain in reserves. However, with the reversal in the trend of foreign investment inflows during the second quarter, the Central Bank was able to purchase foreign exchange from the market gradually from March 2017 onwards, thereby improving the level of reserves during the second quarter of 2017. Gross official reserves increased further with the proceeds of the ISB issuance, foreign currency term financing facility and the receipt of the third tranche of the IMF- EFF by the end of the third quarter of 2017.

- **In the backdrop of the unfavourable global economic environment that prevailed in 2016 and continued pressure on external sector stability, Sri Lanka obtained a three year EFF from the IMF in June 2016**. The facility was obtained with the aim of improving Sri Lanka's BOP position and supporting the government's

Chart 5.7
Balance of Payments



Source : Central Bank of Sri Lanka

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economic reform agenda. The total value of the facility at SDR 1.1 billion (approximately US dollars 1.5 billion), is equivalent to 185 per cent of the country's current quota with the IMF. The first tranche under the EFF amounting to SDR 119.9 million (approximately USD 169 million) was made available to Sri Lanka in June 2016. Two more tranches have been disbursed thereafter, with the latest being the third tranche received in July 2017. Consequently, Sri Lanka has received SDR 360 million (approximately US dollars 500 million) from the IMF-EFF program as at end September 2017 and the fourth tranche is to be disbursed in December 2017. The remaining portion of the facility is expected to be disbursed in three more tranches over the next two years, with the final tranche expected in April 2019.

International Investment Position (IIP)

- **In terms of the International Investment Position (IIP), Sri Lanka's external asset position and the liability position increased at end June 2017 from the position at end 2016.** The stock position of assets increased primarily as a result of the increase in gross official reserves. The reserve asset position, which stood at US dollars 6,019 million at end December 2016, increased to US dollars 6,959 million by end June 2017, as a result of continuous foreign exchange purchases from the market by the Central Bank in addition to proceeds from the ISB and the foreign currency term financing facility. Further, the outstanding position of trade credit and advances given by Sri Lankan exporters increased marginally while the outstanding position of other accounts receivable of deposit-taking corporations declined at end June 2017 in comparison to end 2016. The asset position of direct investments also increased marginally during the period.

- **Sri Lanka's total external liability position at end June 2017 registered an increase from the previous year**. The increase in external liabilities was primarily an outcome of the issuance of the ISB of US dollars 1.5 billion as well as the increase in the outstanding government foreign loans position with the proceeds of the foreign currency term financing facility. Consequently, the total external liability position increased from US dollars 55,036 million at end December 2016 to US dollars 58,094 million at end June 2017. The stock position of direct investments increased due to the increase in the outstanding position of direct investment equity and investment fund shares as at end June 2017. The increase in the stock position of equity and investment fund shares can be attributed to higher direct investment transactions during the period and the valuation gains, particularly of companies listed in the CSE. The total outstanding position of portfolio investments increased with the issuance of the ISB and moderate inflows to the CSE during the first half of 2017. Continuous foreign investment inflows to the primary and secondary markets of the CSE resulted in increasing the equity stock position during the first half of 2017, despite valuation losses in market prices in publicly listed companies. The portfolio investment stock position of debt securities increased with the issuance of the ISB as well as the marginal increase in outstanding rupee denominated debt securities in the form of treasury bills and treasury bonds.

- **The total outstanding position of foreign loans increased with the foreign currency term financing facility obtained by the government in June 2017 and other project loans to the government as well as the increase in long term loans by deposit taking corporations during the first half of 2017**. The outstanding position of government foreign loans, which represent the largest component of the outstanding liability position of the IIP, increased with higher government project loans, including the foreign currency term financing facility obtained during the first half of the year. The outstanding position of foreign loans obtained by deposit taking corporations has also increased,

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particularly due to the increase in long term loan facilities obtained by the banking sector. Meanwhile, the Central Bank completed paying off the IMF-SBA facility obtained in 2009 by July 2017.

- **The outstanding position of currency and deposit liabilities and other payables declined while payables on trade credit and advances increased during the first half of 2017.** The outstanding currency and deposit liability position of deposit taking corporations declined significantly with deposit taking corporations opting for higher foreign loan liabilities during the period. Outstanding trade credit and advances increased during the period particularly due to an increase in trade credit obtained by the Ceylon Petroleum Corporation (CPC).

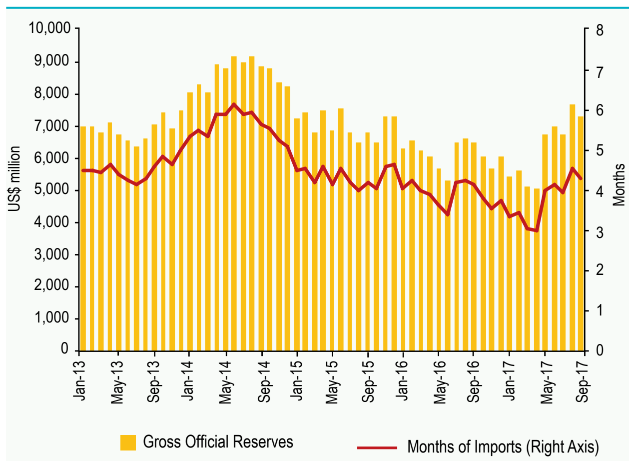
External Debt Position

- **Sri Lanka's external debt increased during the first half of 2017.** Consequently, the total external debt stock increased from US dollars 46.6 billion as at end 2016 to US dollars 49.1 billion at end June 2017. The external debt position of the government, which is the major component of external debt of the country, increased to US dollars 29,697 million as at end June 2017 from US dollars 27,197 million at end 2016, primarily due to the proceeds of the eleventh ISB issuance of US dollars 1.5 billion and proceeds from the first tranche of the foreign currency term financing facility of US dollars 450 million. Project loan inflows to the government also increased, contributing to the higher government external debt position. However, the outstanding external debt position of the Central Bank reduced with the settlement of the currency swap agreement with the RBI amounting to US dollars 400 million, net repayment of the Asian Clearing Union (ACU) liabilities amounting to US dollars 50 million and IMF-SBA payments amounting to US dollars 187 million during the first half of 2017. Meanwhile, the external debt stock of deposit taking corporations increased primarily due to higher inflows of long term loans. Further, the external debt position of the private sector also increased mainly due to the increase in trade credit and advances.

Reserve Asset Position

- **Gross official reserves of the country increased to US dollars 7.3 billion at end September 2017 from US dollars 6.0 billion at the end of 2016.** This significant increase was observed at end of first nine months of 2017, amidst the settlement of US dollars 400 million under the RBI currency swap agreement in March 2017, foreign currency debt service payments of around US dollars 1.3 billion, IMF-SBA principal payment of around US dollars 187 million and net ACU outflows of around US dollars 319 million. Apart from the receipt of the ISB, proceeds of the foreign currency term financing facility and net borrowings through Sri Lanka Development Bonds, the Central Bank's net absorption of US dollars 1,161 million from the domestic foreign exchange market contributed to the significant increase in gross official reserves during the first nine months of the year. Consequently, the level of gross official reserves increased to US dollars 7.3 billion by end September 2017, equivalent to 4.2 months of imports. This, in turn, enabled the Central Bank to build up reserves to meet the Net International Reserve (NIR) targets under the

Chart 5.8
Gross Official Reserves and Months of Imports



Source : Central Bank of Sri Lanka

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IMF-EFF. The build-up of reserves through direct market purchases and the reduction in short-term liabilities led to a qualitative improvement in international reserves during the year. As such, the reserve adequacy as a percentage of short-term debt and liabilities improved to 62 per cent by end September 2017 from 52 per cent at end 2016.

- **Total international reserves, which comprise gross official reserves and foreign assets of commercial banks, increased to US dollars 9.8 billion at end August 2017 from US dollars 8.4 billion at end 2016.** The increase was a combined effect of the increase in gross official reserves by US dollars 1,675 million and the decrease in holdings of commercial bank foreign assets by US dollars 276 million. By end August 2017, the coverage of total international reserves was equivalent to 5.7 months.

Balance of Payments (BOP)

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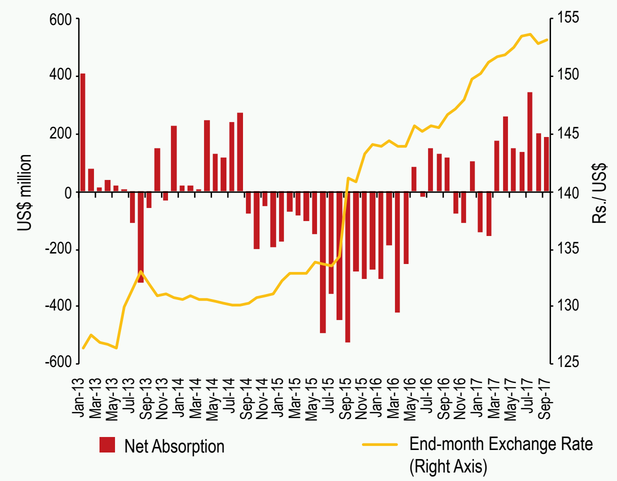
- **The BOP recorded an overall surplus of US dollars 1,563 million during the first half of 2017 against an overall deficit of US dollars 1,186 million recorded during the corresponding period of 2016**. The BOP surplus is estimated to have further improved to US dollars 2,027 million at end September 2017. Reflecting the pressure on the external sector, the BOP was in deficit during the past two years and in the first quarter of 2017, but turned in to a surplus during the second quarter of the year. The receipt of the proceeds of the ISB amounting to US dollars 1.5 billion, foreign currency term financing facility of US dollars 1.0 billion, net borrowing of around US dollars 410 million through Sri Lanka Development Bonds, the net absorption of US dollars 1,161 million from the domestic foreign exchange market and the receipt of the third tranche of the IMF-EFF at US dollars 167 million in mid-July helped strengthen the external position throughout the year up to end September 2017.

Exchange Rate Movements

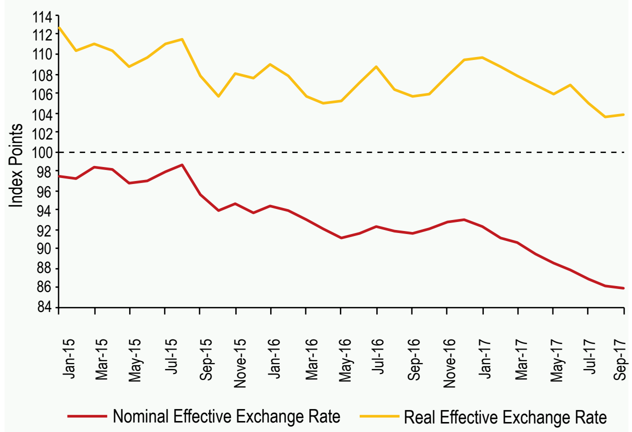
- **As stated in the Road Map 2017, the Central Bank implemented a more market based exchange rate policy during the year, which limited the Central Bank intervention in the foreign exchange market only to build-up international reserves with a minimal impact on the exchange rate**. Accordingly, the external value of the Sri Lankan rupee remained relatively stable during the year up to end September 2017 amidst substantial absorption of foreign exchange liquidity by the Central Bank. The significant depreciation pressure on the rupee that existed particularly during the first quarter of 2017, was mainly due to continued outflows in terms of import expenditure, debt service payments and unwinding of foreign investments in the government securities market. The depreciation pressure that prevailed during the first two months of the year necessitated the Central Bank to supply foreign currency liquidity to the domestic foreign exchange market to defend the external value of the Sri Lankan rupee. However, this situation turned around since March 2017, particularly with increased foreign investments in the CSE and the government securities market and the conversion of export proceeds, and provided an opportunity for the Central Bank to absorb foreign exchange liquidity from the market. This contributed towards the relative stability of the rupee against the US dollar during the period March to September 2017. The depreciation pressure on the rupee further eased gradually from May onwards with the issuance of the ISB, the receipt of the foreign currency term financing facility and the disbursement of the third tranche of the IMF-EFF programme, which helped improve investor confidence. Overall, the Sri Lankan rupee depreciated by 2.2 per cent against the US dollar during 2017 up to end September. The Sri Lankan rupee also depreciated by 10.4 per cent against the pound sterling, 5.3 per cent against the Japanese yen, 12.5 per cent against the euro and 5.7 per cent against the Indian rupee, based on cross currency movements.

Chart 5.9
Central Bank Intervention in the Domestic Foreign Exchange Market and the Exchange Rate



Source : Central Bank of Sri Lanka

Chart 5.10
Effective Exchange Rate Indices : 24 - Currency (2010 = 100) (a)



(a) With the rebasing of CCPI (2013=100) REER indices have been recalculated.

Source : Central Bank of Sri Lanka

- **The Central Bank intervened in the domestic foreign exchange market to ease the pressure on the exchange rate by supplying foreign exchange to the market on a net basis during the first two months of 2017, while absorbing on a net basis thereafter**. Accordingly, the Central Bank supplied US dollars 292 million, on a net basis, during the months of January and February 2017, while absorbing US dollars 1,453 million during the period from March to September 2017. Consequently, the Central Bank absorbed US dollars 1,161 million, on a net basis, during the first nine months of 2017, in comparison to US dollars 693 million supplied during the corresponding period of 2016, which contributed towards replenishing the level of official international reserves. The implementation of a more market-based exchange rate policy along with foreign currency inflows has helped the external value of the rupee to be relatively stable during the first nine months of the year. As such, the rupee which depreciated by 1.0 per cent against the US dollar during the first two months, depreciated only by another 1.2 per cent during the period from March to end September, even with the absorption of a significant amount of foreign exchange liquidity from the market. Notably, the rupee appreciated albeit marginally, against the US dollar in August and September.

- **Both the 5-currency and 24-currency Nominal and Real Effective Exchange Rate indices depreciated during the first nine months of 2017**. Nominal Effective Exchange Rate (NEER) indices depreciated, reflecting the nominal depreciation of the Sri Lankan rupee against some of the major currencies together with the movements in cross currency exchange rates. Accordingly, 5-currency and 24-currency NEER indices depreciated by 7.6 per cent and 6.7 per cent, respectively, during the year up to end September 2017. Meanwhile, Real Effective Exchange Rate (REER) indices, an indicator of Sri Lanka's external competitiveness that takes into account the inflation differentials among countries in addition to the variation in nominal exchange rates, also depreciated based on 5-currency and 24-currency REER indices, by 4.2 per cent and 4.7 per cent, respectively. However, REER indices remained above the threshold of 100 index points, indicating the need for further depreciation of the external value of the rupee, to arrive at the level of external competitiveness that prevailed in 2010, given the relatively high inflation experienced by the country at present.

- **During the first three quarters of 2017, the domestic foreign exchange market recorded an expansion in terms of spot and forward transactions**. By end September 2017, the

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total volume of spot transactions was US dollars 6,193 million in comparison to US dollars 4,779 million during the corresponding period of 2016. Meanwhile, the total volume of forward transactions also increased to US dollars 6,557 million during the first nine months of 2017 from US dollars 6,462 million during the corresponding period of 2016. The average forward premia for one-month transactions remained above the level of average interest rate differential, while the average NOP of commercial banks stood at a positive level by end September 2017.

Expected Developments

- **With the envisaged adjustments in the current account of the BOP and the continuation of inflows to the financial account, the external sector is expected to improve further during the latter part of 2017 and in 2018**. The overall BOP, which recorded a surplus by end September 2017, is expected to be maintained at similar levels by end 2017 and improve further in 2018. Accordingly, the overall BOP is projected to record a surplus of around US dollars 1.5 billion and international reserves are expected to remain at around US dollars 7.3 billion by end 2017. However, sluggish global growth, possible increase in commodity prices including crude oil, lower than expected FDI inflows, declining trend in workers' remittances and geopolitical tensions in Sri Lanka's trading partners are downside risks to the envisaged path in the external sector accounts.

- **Reversing the lacklustre performance experienced during the past two years, exports are projected to continue their increasing trend in the remainder of 2017 and 2018**. The trade deficit is expected to remain at 11.2 per cent of GDP in 2017 with the envisaged increase in both exports and imports. As per the forecast of World Trade Organization (WTO) in April 2017, the volume of world merchandise trade is expected to increase in a range of 1.8 - 3.6 per cent in 2017 and 2.1 - 4.0 per cent in 2018. Improved global trade, the reinstatement of the EU GSP+ facility from May 2017, enhanced trade relations expected through multilateral trade agreements, strong institutional support and consistent policies that will result in increased domestic and foreign investments in export oriented industries, are expected to drive the momentum in exports. The revival of fish exports, following the removal of the ban on fisheries products by the EU for Sri Lankan fish exports with effect from mid-2016, is expected to yield a strong growth in fish exports. With the gradual recovery of global commodity prices, earnings from tea and spices are also expected to increase in 2018. Meanwhile, import expenditure is projected to grow moderately in 2018. Higher commodity prices in the international market, particularly petroleum prices, would affect the expenditure on imports as well. In addition, import volumes are also expected to increase in 2018 in line with the expected growth of exports and domestic economic activities. Reflecting these developments, the trade deficit is estimated to improve to around 10.8 per cent of GDP in 2018.

- **The services account of the BOP is expected to expand further during the second half of 2017 and beyond**. The tourism sector is expected to rebound with the expansion in the number of arrivals complemented by the resumption of full-scale operations of the BIA. The growth in earnings from tourism would be supported by efforts to uplift Sri Lanka's brand value through targeted promotional campaigns and continued investments in enhancing the tourism infrastructure of the country. Foreign investments are expected to contribute towards the expansion in services exports, particularly transportation and IT/BPO, by capitalising on Sri Lanka's strategic location and availability of skilled work force. Moreover, earnings from computer and information services are also projected to improve further, with a move towards mobile and cloud based applications beyond traditional software development and leveraging the trend. Gaining momentum from these positive developments, the services account is expected to expand further in 2018.

- **The growth in workers' remittances is expected to moderate in the period ahead**. The declining trend observed in workers' remittances is expected to revive during 2018, albeit at a lower rate, with improvements in economic activity in source countries. Even though an upward trend in labour migration under skilled and professional categories was witnessed during the past few years, there exists a large mismatch between the international demand for jobs and Sri Lanka's supply capabilities, especially with regard to specific skills demanded by the foreign employers. Therefore, investments in competency development through vocational training, providing high quality training on par with international standards, is beneficial in securing employment opportunities with higher earnings. In addition, attention should also be drawn to improving the language proficiency of migrant employees. It is equally important to explore new labour markets and enter into bilateral agreements with other advanced economies, including Singapore, Japan and European countries, rather than relying on the Middle Eastern countries, in the backdrop of rising economic and geopolitical uncertainties in the region.

- **The current account deficit as a percentage of GDP is projected to widen in 2017 to 3.0 per cent of GDP, but is expected to improve to 2.5 per cent of GDP in 2018.** The trade deficit is expected to widen only moderately in the second half of the year with an expected increase in exports and a moderate growth in imports, compared to the corresponding period in 2016. The rebalancing of the trade account is expected to continue and improve further in 2018. Inflows to the services account are expected to grow at a faster rate in 2018, although it grew at a lower rate in 2017 due to lower growth in tourist earnings. Growth in workers' remittances, which are projected to be lower in 2017 as a result of adverse economic and geopolitical conditions in the Middle Eastern region, are expected to exhibit some improvement in 2018. Limited diversification of exports, greater reliance on tourist earnings and workers' remittances to finance the trade and primary income account deficit will remain challenges in curtailing the current account deficit.

- **The financial account is expected to remain strong during 2017 and beyond**. Thus far during the second half of 2017, the financial account was strengthened with proceeds from the foreign currency term financing facility and inflows to the government securities market. The current positive momentum in inflows to the government securities market is expected to continue in 2018, while the CSE is expected to attract more foreign investments. The financial account is expected to be further strengthened in 2018 with higher non-debt creating inflows by way of FDI, supplemented by policy consistency, political stability and stable macro-economic conditions. However, expected developments around the world, including probable interest rate hikes and tax policy reforms in the United States, may pose challenges in attracting financial flows.