

Chapter 5

EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

5.1 Overview

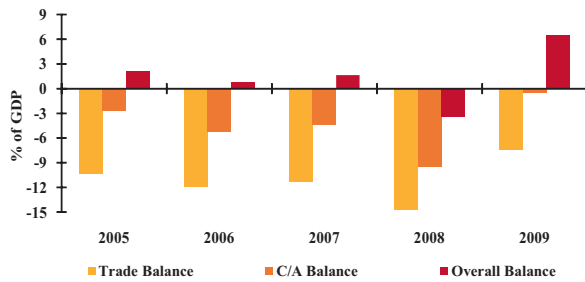
The positive outlook and the increased investor confidence in the domestic economy brought about by the end to the conflict helped Sri Lanka's external sector to recover during the second half of 2009. The overall performance of the external sector in the first half was affected by the spillover effects of the turbulent external economic conditions as well as the global liquidity crunch, which curtailed financial flows to the country and propelled the withdrawal of short-term foreign investments in government securities. However, with the easing of the global financial turmoil and the improvements in the domestic economic environment, capital and financial flows to the country increased significantly in the second half of the year. Accordingly, the gross official reserves, excluding Asian Clearing Union (ACU) receipts, which declined to US dollars 1,082 million by end March 2009, increased almost five fold to a record level of US dollars 5,097 million within the last three quarters of 2009.

The lower current account deficit and the substantially high financial flows led the Balance of Payments (BOP) to record a significantly high surplus in 2009. Like in most other countries, Sri

Lanka's external trade was adversely affected by the global economic downturn. The trade deficit contracted by 47.8 per cent in 2009 owing to the significantly larger reduction in import expenditure relative to the decline in export earnings. Inward workers' remittances increased to US dollars 3,330 million becoming the foremost foreign exchange earner in 2009, and were in excess of the trade deficit. The comparatively lower deficits in the trade and income accounts coupled with higher workers' remittances and surplus in the services account resulted the current account to record a marginal deficit of US dollars 214 million in 2009 compared to the higher deficit of US dollars 3,886 million in 2008. To mitigate the adverse implications of continued repatriation of investments in government securities since late 2008 to early 2009 and to encourage financial flows to the country, several coordinated measures were taken by the government and the Central Bank of Sri Lanka (CBSL) including the arrangement of special funding lines with other countries, promoting investments in government securities among Sri Lankan diaspora and migrant workers, and commencing discussions with the International Monetary Fund (IMF) for a

Chart 5.1

Balance of Payments



Stand-by Arrangement (SBA) facility. A significant improvement in investor confidence following the ending of the conflict, which was further strengthened by the approval of the IMF-SBA facility in July 2009, helped the entire country to turn into a new dimension with enhanced foreign inflows, especially to the government securities market. The impact of these positive developments was manifested through the highly successful issuance of the second international sovereign bond of US dollars 500 million in October 2009 and the revision of the sovereign rating outlook from negative to stable and then, positive. The positive outlook and substantial inflows led to an unprecedented surplus in the BOP, amounting to US dollars 2,725 million in 2009.

The exchange rate policy in 2009 was focused on maintaining the stability in the domestic foreign exchange market in the face of significant foreign exchange outflows during the first few months followed by substantial inflows. The first four months of the year experienced significant outflows from the domestic foreign exchange market and CBSL supplied foreign exchange on a net basis to meet excessive demand for foreign exchange liquidity. The favourable developments in the external environment brought about by the dawn of peace in the country since May 2009, prompted large inflows into the country and exerted pressure on the exchange rate to appreciate sharply. CBSL's intervention in the foreign exchange market by way of net absorption helped reduce the excess supply of liquidity in the domestic foreign exchange market and build up official reserves. The intervention strategy adopted by CBSL helped to maintain a stable exchange rate to a greater extent during 2009.

Chart 5.2

Major Sources of Foreign Exchange Earnings



The external sector is expected to strengthen further in 2010 with the gradual recovery in the global economy, easing of global market liquidity and improved growth prospects in the domestic economy. The global financial crisis has underscored the need to further strengthen the external sector to improve its resilience, competitiveness and responsiveness to changing external conditions. A number of liberalisation measures relating to capital account transactions have been proposed, some of which have already been implemented, to provide additional flexibility in raising financing and investment for private sector activities with a view to enhance the overall competitiveness of the economy. In the area of foreign exchange management, the policy of CBSL would be to continue to prevent any undue volatility in the exchange rate to help facilitate international trade, investment and other financial flows. Measures are also needed to further expand and diversify the export base to ensure steady foreign exchange inflows in the long run.

5.2 External Sector Policies and Institutional Support

The global recession adversely affected external trade in Sri Lanka, like in most other countries. The focus of the external trade strategy of Sri Lanka in 2009 was to assist exporters and importers to overcome the challenges brought about by the global recession. The substantial decline in demand for exports and the lower prices of many export commodities in the international market required the government to take measures to mitigate the adverse impact of such developments on exporters. These included

Table 5.1

Balance of Payments Analytical Presentation (a)

Item	US dollars million					Rs. million				
	2005	2006	2007	2008(b)	2009(c)	2005	2006	2007	2008(b)	2009(c)
Trade Balance	-2,516	-3,370	-3,656	-5,981	-3,122	-253,082	-350,037	-404,703	-647,207	-358,707
Exports	6,347	6,883	7,640	8,111	7,085	638,276	716,579	845,683	878,499	813,911
Imports	8,863	10,253	11,296	14,091	10,207	891,359	1,066,615	1,250,386	1,525,705	1,172,618
Services (net)	338	257	302	401	391	34,043	26,660	33,357	43,557	44,780
Receipts	1,540	1,625	1,775	2,004	1,892	154,877	168,802	196,249	217,180	217,378
Payments	1,202	1,368	1,472	1,603	1,501	120,833	142,142	162,892	173,623	172,598
Income (net)	-299	-389	-358	-972	-488	-30,049	-40,424	-39,054	-105,032	-55,814
Receipts	35	311	449	-32	116	3,629	32,457	50,213	-3,133	13,551
Payments	335	700	807	940	603	33,678	72,881	89,267	101,899	69,365
Goods, Services and Income (net)	-2,478	-3,503	-3,712	-6,552	-3,219	-249,088	-363,801	-410,401	-708,681	-369,740
Current Transfers (net)	1,828	2,004	2,311	2,666	3,005	183,842	208,385	255,684	288,639	345,498
Private Transfers (net)	1,736	1,904	2,214	2,565	2,927	174,542	197,861	245,006	277,711	336,578
Receipts	1,968	2,161	2,502	2,918	3,330	197,968	224,678	276,814	316,091	382,818
Payments	233	257	288	353	403	23,426	26,817	31,808	38,380	46,240
Official Transfers (net)	93	101	97	101	77	9,300	10,524	10,677	10,928	8,920
Current Account	-650	-1,499	-1,402	-3,886	-214	-65,246	-155,416	-154,717	-420,042	-24,242
Capital and Financial Account	1,224	1,808	2,097	1,773	2,594	123,866	190,768	230,978	193,713	299,381
Capital Account	250	291	269	291	233	25,108	30,292	29,669	31,456	26,832
Capital Transfers (net)	250	291	269	291	233	25,108	30,292	29,669	31,456	26,832
Receipts	257	299	278	303	247	25,863	31,171	30,735	32,774	28,465
Payments	7	8	10	12	14	755	879	1,066	1,319	1,633
Financial Account	974	1,517	1,828	1,483	2,361	98,757	160,477	201,309	162,258	272,550
Long-term:	798	907	1,251	1,016	1,304	80,391	95,089	140,054	109,174	149,772
Direct Investment	234	451	548	691	384	23,505	46,985	60,768	74,837	44,112
Foreign Direct Investment (net)	234	451	548	691	384	23,505	46,985	60,768	74,837	44,112
Private Long-term (net)	11	-35	31	74	79	1,054	-3,590	3,314	7,768	9,105
Inflows	197	139	199	265	390	19,739	14,469	22,033	28,693	44,795
Outflows	186	174	168	191	311	18,685	18,058	18,719	20,925	35,691
Government, Long-term (net)	553	491	672	252	840	55,832	51,694	75,971	26,568	96,555
Inflows	747	932	1,290	1,059	1,780	75,309	97,690	144,146	114,658	204,435
Outflows	194	441	618	807	940	19,477	45,996	68,175	88,090	107,880
Short-term:	176	610	577	466	1,058	18,366	65,387	61,256	53,084	122,777
Portfolio Investment (net)	60	51	101	60	-6	6,103	5,377	11,249	6,460	-785
Private Short-term (net)	16	-30	20	594	228	1,640	-3,066	1,868	63,987	26,108
Commercial Bank Assets (net)	-223	297	-281	210	-435	-19,669	23,789	-31,352	17,889	-51,298
Commercial Bank Liabilities (net)	323	293	364	-185	-98	30,292	39,287	38,746	-11,858	-8,836
Government Short-term (net)	-	-	372	-213	1,369	-	-	40,744	-23,395	157,588
Allocations of SDRs (d)	-	-	-	-	508	-	-	-	-	58,353
Valuation Adjustments	-	-	-	-	-	-	-	-	-	-
Errors and Omissions	-72	-105	-165	728	346	-10,494	-1,830	-16,259	80,534	40,082
Overall Balance (e) (f)	501	204	531	-1,385	2,725	48,125	33,523	60,002	-145,795	315,221
Monetary Movements (e) (f)	-501	-204	-531	1,385	-2,725	-48,125	-33,523	-60,002	145,795	-315,221
Annual Average Exchange Rate Rs/US\$						100.50	103.96	110.62	108.33	114.94
Ratio to GDP in Percentages (g)										
Trade Account	-10.3	-11.9	-11.3	-14.7	-7.4	-10.3	-11.9	-11.3	-14.7	-7.4
Current Account	-2.7	-5.3	-4.3	-9.5	-0.5	-2.7	-5.3	-4.3	-9.5	-0.5
Current Account without Grants	-3.0	-5.7	-4.6	-9.8	-0.7	-3.0	-5.7	-4.6	-9.8	-0.7

(a) This presentation conforms as far as possible to the Balance of Payments Manual, 5th Edition (1993) of the International Monetary Fund (IMF). In addition, beginning 1994, Offshore Banking Units have been treated as a part of the domestic banking system.

(b) Revised

(c) Provisional

(d) General and special allocations of Special Drawings Rights (SDR) by the IMF.

(e) US dollar values are converted into rupee values using period average exchange rates.

(f) Due to a change in the classification of external assets, the foreign currency assets of the Central Bank placed with the domestic banks in 2008 were excluded.

(g) Based on GDP at current market prices published by the Department of Census and Statistics.

Source: Central Bank of Sri Lanka

Table 5.2

Average Import Duty
Collection Rate (a)

Item	2005	2006	2007	2008 (b)	2009 (c)
Consumer Goods	10.4	11.2	12.4	12.6	19.4
Food and Beverages	9.6	10.7	13.5	14.8	26.8
Rice	10.6	23.4	3.1	3.1	5.4
Flour	3.8	33.7	31.9	22.6	22.6
Sugar	1.5	1.9	23.9	32.8	26.5
Wheat and Meslin	1.1	5.6	6.3	6.7	32.2
Milk and Milk Products	10.2	9.6	7.7	2.0	29.2
Dried Fish	5.9	5.0	2.9	9.4	10.9
Other Fish Products	9.8	7.8	4.9	8.7	18.3
Other	22.0	24.2	20.8	24.2	27.2
Non-Food Consumer Goods	11.1	11.7	11.2	8.4	6.7
Motor Cars & Cycles	18.9	18.3	16.3	7.7	6.2
Radio Receivers - Television Sets	13.6	7.1	7.7	6.3	7.1
Rubber Tyres & Tubes	26.2	19.2	22.4	19.2	20.1
Pharmaceutical Products	0.5	0.3	0.4	0.4	0.4
Other	8.7	10.3	10.6	13.0	8.6
Intermediate Goods	2.1	1.5	1.5	2.2	5.0
Fertiliser	2.7	2.5	2.7	2.5	2.5
Crude Oil	0.0	0.0	0.0	0.0	0.0
Other Petroleum Products	1.9	2.3	1.6	4.7	19.0
Chemical Elements and Compounds	2.0	1.8	1.9	1.8	1.9
Dyeing, Tanning and Colouring	4.4	2.6	2.5	2.1	2.1
Paper and Paper Boards	6.0	2.4	2.2	2.0	2.1
Textiles	0.1	0.1	0.1	0.2	0.2
Other Intermediate Goods	4.5	3.3	3.3	2.9	4.9
Investment Goods	5.8	5.2	4.8	5.3	4.4
Building Materials	7.8	9.2	7.2	7.2	8.2
Transport Equipment	9.7	7.0	7.1	7.1	3.7
Machinery and Equipment	3.3	3.2	2.7	3.1	2.5
Other Investment Goods	5.3	3.4	4.2	3.9	3.3
Average Import Duty Collection Rate	4.6	4.3	4.1	4.6	7.8

(a) Actual import duty collection (including Special Commodity Levy wherever applicable) as a percentage of total imports (c.i.f. values). Source: Sri Lanka Customs

(b) Revised

(c) Provisional

the implementation of Simplified Value Added Tax Scheme (SVAT) to assist direct and indirect exporters overcome cash flow difficulties, the reduction of VAT from 15 per cent to 12 per cent and the introduction of an economic stimulus package called the Export Development Reward Scheme (EDRS) with the objective of securing existing markets, penetrating new markets and establishing and promoting forward and backward linkages during times of crisis. SVAT scheme enabled direct exporters to purchase raw material, consumables and accessories from indirect exporters under the VAT suspension facility and Rs. 2 billion has been granted under this scheme during 2009. Under the EDRS, concessions have been granted to tea, rubber, cinnamon, garment, leather and tea sectors. However, exporters were required to maintain a requisite level of value addition, export value and employment at the pre-crisis level to be eligible for the reward scheme. As a result, many

exporters were unable to benefit from the EDRS. In addition, the government assisted the tea exporters by purchasing the unsold tea at the Colombo Tea Auction that accumulated due to the sudden drop in demand owing to the global economic crisis. The tea purchased in this manner was re-sold to the market in subsequent auctions without causing a significant disruption to the market. Also, the Sri Lanka Tea Board stipulated stringent measures to curtail the quantity of tea coming into the Colombo auction to prevent an excess supply, until normalcy was restored.

The five band tariff structure introduced in 2004 continued into 2009. Based on product categories, Sri Lanka maintained a 5-band tariff structure of zero for imports of essential goods, 2.5 per cent for basic raw materials, 6 per cent for semi-processed goods, 15 per cent for intermediate products and 28 per cent for other finished products. However, several other trade related taxes were imposed during 2009 for revenue generation purposes and to protect domestic industries. Thus, in addition to customs duty, some imports were subjected to Cess, Special Commodity Levy (SCL), Nation Building Tax (NBT) and Value Added Tax (VAT). The government reduced the standard VAT rate from 15 per cent to 12 per cent with effect from January, 2009. Some taxes, such as the 20 per cent VAT applicable on imports of motor vehicles, luxury goods and liquor remained unchanged. The average import duty rate calculated based on total imports and customs duties increased to 7.8 per cent in 2009 from 4.6 per cent in 2008.

With the escalation of prices of certain essential commodities in the domestic market towards the latter part of the year, the government revised taxes on the import of some consumer items to provide relief to domestic consumers. Accordingly, Customs Duty, Port & Airport Development Levy (PAL), NBT, Social Responsibility Levy (SRL), VAT and surcharges on imports of rice, potatoes, red onion, big onion, garlic, sugar and chillies were replaced by a lower SCL, in November 2009 while SCL on rice and sugar were subsequently reduced further in December 2009.

The Sri Lanka Export Development Board (EDB) and the Sri Lanka Standards Institute (SLSI) assisted exporters, producers and processors to maintain the international quality standards of exported goods. The EDB granted assistance on a cost sharing basis to obtain quality certification such as Good Agricultural Practices (GAP), Good Manufacturing Practices (GMP), Hazard Analysis Critical Control Point (HACCP), ISO 22000, GLOBAL GAP certificate based on the market requirements for specific products. The EDB is in the process of setting up a local inspection body and a controlling authority for the certification of organic agricultural activities to cater to a growing international demand.

The SLSI also facilitated international trade by formulating standards, providing product and market related information services, offering product testing facilities, conducting quality management training and certification programmes and granting national quality awards. In addition, the import inspection scheme was continued in 2009 to ensure that 103 products met the specifications as per Sri Lanka Standards.

Sri Lanka expanded its foreign trade relations during the year 2009, through bilateral, regional and multilateral trade agreements. At the multilateral level, Sri Lanka continued to engage in the Doha Round trade negotiations of the World Trade Organisation (WTO) and participated in a

Table 5.3

Trade Indices (a)

Category	1997=100								
	2008 (b)			2009 (c)			Growth Rate (c)		
	Value Index	Volume Index	Unit Price Index	Value Index	Volume Index	Unit Price Index	Value Index	Volume Index	Unit Price Index
EXPORTS									
Agricultural Exports	174.6	130.3	134.0	159.1	122.7	129.7	-8.9	-5.9	-3.2
Tea	176.4	125.4	140.7	164.4	114.8	143.2	-6.8	-8.4	1.8
Rubber	159.0	80.7	196.9	125.4	89.0	140.9	-21.2	10.2	-28.4
Coconut	145.4	123.0	118.2	141.3	119.2	118.6	-2.8	-3.1	0.3
Other Agricultural Exports	198.1	187.8	105.5	165.8	182.8	90.7	-16.3	-2.7	-14.0
Industrial Exports	178.9	162.4	110.2	154.1	139.7	110.3	-13.8	-13.9	0.1
Textiles and Garments	152.2	154.6	98.4	143.7	148.4	96.8	-5.6	-4.0	-1.6
Petroleum Products	261.7	62.9	416.1	138.4	55.0	251.4	-47.1	-12.5	-39.6
Other Industrial Exports	228.3	187.9	121.5	177.8	129.0	137.9	-22.1	-31.4	13.5
Mineral Exports	109.4	134.2	81.5	99.3	122.4	81.1	-9.3	-8.8	-0.5
Gems	92.0	124.3	74.0	83.0	111.8	74.2	-9.8	-10.1	0.3
Other Mineral Exports	338.6	264.3	128.1	314.1	262.1	119.8	-7.2	-0.8	-6.5
Total Exports	174.5	154.4	113.0	152.4	135.4	112.5	-12.7	-12.3	-0.4
IMPORTS									
Consumer Goods	201.5	194.7	103.5	158.0	184.9	85.5	-21.6	-5.0	-17.4
Food and Beverages	177.2	156.2	113.4	153.8	140.7	109.3	-13.2	-9.9	-3.7
Other Consumer Goods	236.9	250.6	94.5	164.2	249.0	65.9	-30.7	-0.6	-30.2
Intermediate Goods	269.5	154.2	174.7	183.2	133.0	137.8	-32.0	-13.8	-21.2
Fertiliser	868.6	197.8	439.2	291.4	135.8	214.7	-66.5	-31.4	-51.1
Crude Oil	500.9	102.3	489.7	368.2	114.1	322.7	-26.5	11.5	-34.1
Other Petroleum	742.7	202.3	367.2	433.6	128.3	337.9	-41.6	-36.6	-8.0
Chemical Elements and Compounds	265.7	181.3	146.6	229.8	176.6	130.1	-13.5	-2.6	-11.2
Wheat and Meslin	272.5	116.4	234.0	188.2	130.0	144.7	-30.9	11.7	-38.2
Textiles (Including Clothing)	122.7	143.6	85.4	104.0	132.5	78.5	-15.3	-7.8	-8.1
Plastics	257.0	180.3	142.5	131.9	120.2	109.7	-48.7	-33.3	-23.0
Diamonds	287.4	128.2	224.2	195.7	96.9	201.9	-31.9	-24.4	-10.0
Other Intermediate Goods	217.1	196.3	110.6	160.2	181.4	88.3	-26.2	-7.6	-20.2
Investment Goods	229.8	215.1	106.9	184.8	201.2	91.8	-19.6	-6.4	-14.1
Building Materials	346.9	246.3	140.9	262.9	186.9	140.7	-24.2	-24.1	-0.1
Transport Equipment	210.9	99.2	212.6	209.7	98.0	214.0	-0.6	-1.2	0.7
Machinery and Equipment	179.0	244.6	73.2	136.2	240.9	56.6	-23.9	-1.5	-22.7
Other Investment Goods	326.2	154.3	211.4	279.1	161.7	172.6	-14.5	4.8	-18.4
Total Imports	240.2	176.3	136.3	174.0	159.0	109.5	-27.6	-9.8	-19.7
Terms of Trade			82.9			102.8			24.0
(a) In terms of US dollars	Sources : Sri Lanka Customs								
(b) Revised	Central Bank of Sri Lanka								
(c) Provisional									

number of key negotiations with a view to protecting and promoting Sri Lanka's trade and economic interests, particularly in the areas of agriculture, non-agricultural market access (NAMA), Trade Related aspect of Intellectual Property Rights (TRIPs), rules and services. However, in view of the sluggish progress of the Doha Round negotiation in 2009, the importance of concluding it by 2010 was reiterated at the seventh WTO Ministerial Conference held in Geneva in December 2009.

Sri Lanka also actively engaged in the negotiations on the proposed Agreement on Trade Facilitation (ATF). A draft consolidated text for harmonizing and regulating trade facilitation was produced following intense negotiations over five years. With the assistance of WTO, a trade facilitation needs assessment was conducted in Colombo, with the participation of all stakeholders in the public and private sectors, to gauge Sri Lanka's capacity to implement the proposed ATF.

Sri Lanka continued to get preferential access to the European market under the GSP+ scheme in 2009. The member states of the European Union (EU) renewed the scheme for the period 2009-2011, subject to a review by the European Commission. On 15 February 2010, the EU announced their decision to withdraw the preferential tariff benefits with effect from 15 August 2010. This decision would be reversed depending on the developments during the six month grace period and the government's actions towards rectifying the concerns of the EU. Accordingly, the government continues to engage in a dialogue with the EU on some of the concerns raised by them. In the meantime, exporters have been cautioned about the repercussions of excessive reliance on non-reciprocal trade concessions and have been advised to enhance their productivity to face global competition (Please refer Box 7).

Although the implementation of the Indo-Sri Lanka Free Trade Agreement (ISLFTA) helped foster trade between India and Sri Lanka, trade between the two countries declined in 2009, in line with global developments. Year-on-year, exports to India declined by 23.1 per cent, to US dollars 322 million in 2009 while imports from India

dropped by 47.2 per cent to US dollars 1,820 million in 2009. However, the limited basket of exports to India at the inception of the ISLFTA, has diversified substantially during the period from 2007 to 2009. Some of the new items that have brought substantial proceeds include animal feed, electrical appliances and accessories, vessels, paper products, glass and plastic products. However, a reduction has been recorded in major exports such as vegetable oil, primary copper and pepper. Meanwhile, the major imports from India in 2009 included petroleum products, iron and steel, cotton, motorcycles and motor vehicles.

Under the Pakistan-Sri Lanka Free Trade Agreement (PSLFTA), Pakistan has implemented the final phasing out of tariffs with effect from March 2009. As a result, Sri Lanka is eligible to export more than 4,500 items to Pakistan on duty free basis. Sri Lanka's final phasing out commitment on tariff is due in June 2010. Under the PSLFTA, Sri Lanka has diversified its export portfolio by exporting industrial products such as porcelain tableware, ceramic tiles, furniture, and mechanical and electrical accessories, etc. in addition to the traditional agricultural exports. Despite the increased access, total exports to Pakistan declined by 22 per cent to US dollars 55 million in 2009. In return, Sri Lanka's imports from Pakistan, which included cement, cotton textile fibres, yarn and fabric, pharmaceutical products, dried fish and rice, etc., increased marginally to US dollars 197 million in 2009.

There is great potential for further growth in bilateral trade and investment under the comprehensive economic partnership agreements (CEPA) with India and Pakistan. Despite the improvement in trade between Sri Lanka and these countries since the inception of the respective free trade agreements, exporters have not fully utilised the benefits available to them. Given the relatively better investment climate in Sri Lanka, it can lure investments using the trade agreements as a platform to capture the vast markets of India and Pakistan. The proposed CEPA with India addresses issues with ISLFTA such as conformity assessment procedures and product standards. However, CEPA with India

Box 7

GSP+ Concessions for Sri Lanka

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EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

Background

The Generalised System of Preferences (GSP) was initiated by the United Nations Commission for Trade and Development (UNCTAD) with the objective of offering tariff concessions to low income developing countries to enhance their export earnings, to promote industrialisation and to raise economic growth. The European Union (EU) commenced implementation of GSP scheme in 1971 and subsequently, many developed countries, such as the USA, Japan, Canada, etc., followed suit by implementing GSP schemes to offer concessions to developing countries. The EU's Generalised Scheme of Tariff Preferences (EU-GSP), is an autonomous trade arrangement, adopted by the 27 countries of the European region. The EU-GSP has been providing non-reciprocal preferential access to products from about 176 developing countries and territories by way of duty free access, duty reductions and duty waivers from the Most Favoured Nation (MFN) tariff rates.¹

GSP+ Scheme

In their efforts to consolidate the formulation of development policy, the EU extended additional preferences to the least developed countries and the developing countries, through a new scheme comprising the standard arrangement and two special arrangements, introduced for a 10-year period from 2006 to 2015, subject to renewal every three years. Of the two special arrangements, one **special arrangement** granted duty free access to the EU market for products of least-developed countries (LDCs) while the other, the **special incentive arrangement** was said to be for "sustainable development" and "good governance", which is commonly known as the GSP+ scheme, was offered for "countries with special development needs that have ratified and effectively implemented key international conventions in the fields of human and labour rights, sustainable development and good governance". The GSP+ scheme is reviewed by the European Commission (EC) every three years.

GSP+ and Sri Lanka

Sri Lanka was granted GSP+ tariff concessions in 2005 for the period of July 2005–December 2008.² Sri Lanka is among the 16 beneficiary countries and the only South Asian country that qualified to receive additional preferences offered under the GSP+ incentive arrangement.³ In December 2008, Sri Lanka's eligibility for the next term, from 2009-2011, was renewed subject to a review by the EU.

The review, which commenced in October 2008 was completed within a year, and its outcome, which was not in favour of Sri Lanka, was conveyed to the government of Sri Lanka in October 2009. Nevertheless, the government submitted its observations and reinstated its position to the EC in November 2009 referring to specific comments made by the EC in their report. However, by 15 February 2010, the EU member countries issued a statement indicating the temporary suspension of the GSP+ facilities for Sri Lanka, effective after a six month grace period. As per the statement, Sri Lanka could take necessary measures to reverse its decision by addressing their concerns. Accordingly, Sri Lankan authorities continued to engage with the EC on GSP+ concessions. In the event these deliberations fall short of producing a positive outcome, Sri Lanka would continue to enjoy preferential access to the EU market, under the standard GSP scheme, from 15 August 2010.

Adapting to an environment sans GSP+ benefits

As stated in the CBSL Annual Report 2007, "the continuation of the non-reciprocal concession beyond the initially offered period depends not only on the successful implementation and ratification of all the conventions, but also on socio-political and trade policies of the EU countries and hence, there always exists a risk on the continuation of preferential concessions." (Box 12 - Preferential Trade Access and its Implications-p.99). It stressed that economic gains realized through free trade agreements tend to be short-term in nature, and that these preferences

¹ Under the scheme, the EU, which includes 27 countries in Europe, grants import-duty free access to 3,300 "non-sensitive" products and a duty reduction of 3.5 percentage points from the Most Favoured Nation (MFN) rates and a 30 per cent duty waiver from specific import duties applicable to 3,900 "sensitive" products. In addition, a 20 per cent tariff reduction from MFN rates is granted for textile and apparel products.

² Although the GSP+ scheme was initiated in 2006, the implementation of the scheme was fast-tracked for Sri Lanka in view of the devastation caused by the tsunami in December 2004.

³ Other beneficiary countries include Armenia, Azerbaijan, Bolivia, Colombia, Costa Rica, Ecuador, El Salvador, Georgia, Guatemala, Honduras, Mongolia, Nicaragua, Paraguay, Peru, and Venezuela.

tend to erode over time as more and more economies seek membership in FTAs. It also cautioned exporters that excessive reliance on short-term trade benefits may lead to a misallocation of productive resources and encouraged domestic industries to enhance their productivity in order to retain their competitiveness in the international arena.

Given the renewable nature of the GSP+ concessions, all stakeholders have been aware that there is an inherent uncertainty regarding the continuation of the facility, particularly since around the second half of 2008. Nevertheless, the GSP+ concessions initially provided an opportunity for Sri Lankan exporters to reach out to the EU market to showcase the high quality of their products and their commitment to timely deliveries. Therefore, the experience and goodwill gained from their participation in these trading arrangements would have strengthened and prepared them to develop their products further, and fine-tune their methods of capturing new markets in their paths towards greater market penetration and productivity.

In the event the concessions are discontinued, it could impact industries in different ways. Some industries, which relied heavily on concessions and did not effect any changes in the manner of carrying on their businesses, may be affected to a greater extent. However, those industries which have prudently taken measures to adjust to an environment sans GSP+ benefits, by increasing the efficiency of the production processes through better management practices as well as through the adoption of new technologies, would be now well positioned to meet the challenge. The apparel industry, in particular, has made significant strides in establishing itself as a competitive apparel sourcing base with world class facilities and infrastructure. While emerging as a balanced vertically integrated industry, the apparel industry has also incorporated design aspects as well as green and lean concepts into the production process to compete effectively with their competitors.

remains stalled after thirteen rounds of technical level negotiations and three rounds of negotiations at Commerce Secretary Level. CEPA with Pakistan is in a similar fate after receiving approval of the Cabinet of Ministers to proceed with negotiations in January 2008. Efforts would need to be taken to derive the benefits offered by trade agreements and to move ahead towards forming more economic partnerships.

The way forward

The end to the three decades long conflict has enabled Sri Lanka to embark on a higher growth path through the development of infrastructure and other productive resources. The improved business and investment climate of the country and the favourable macroeconomic environment are bound to help businesses to prosper. The low levels of inflation have reduced the pressure on input costs and the lower interest rates have reduced the cost of borrowing. The improved foreign exchange position, with the highest ever level of foreign reserves, and the improved rating outlooks of the country, have facilitated borrowing from foreign banks at competitive rates. The behaviour of the exchange rates also assisted exporters remain competitive in the international market, with significant depreciation of the Sri Lanka rupee against some major currencies. Hence, the continuation of a trade concession must not be viewed as the only imperative to maintain a competitive edge of the Sri Lankan products in the international markets.

Sri Lankan exporters have proven their resilience amidst difficulties on earlier occasions. The apparel sector, in particular, resisted strong competition from low cost garment producers of other countries during the phasing-out of the Multi-Fibre Arrangement. At that time, not only did they adjust to the new and challenging circumstances, but actually emerged stronger to appropriately deal with the various risks and expand their share in the world market. In a similar manner, with preparatory measures introduced gradually over the past 18 months, it is likely that Sri Lankan industries would overcome a possible non-GSP+ challenge too, and emerge stronger. Accordingly, it is likely that the possible discontinuation of the GSP+ concessions would prompt industrialists and exporters to be more productive by increasing the efficiency of the production processes to retain their competitive advantages, as well as compel them to diversify their range of products, and seek new markets, thus making Sri Lanka's exports more competitive in the long run.

The Joint Council under the United States -Sri Lanka Trade and Investment Framework Agreement (TIFA) provided an useful institutional arrangement for promoting trade between the two countries. It provided regular high level contacts among the trade officials of the two countries enabling them to identify and address any barriers, which hamper trade between the two countries. The seventh meeting of the TIFA was held in Colombo in

October 2009. In the context of the TIFA, Sri Lanka primarily aims at securing enhanced market access for its exports, in particular apparel, through either special trade preferences or the USA's Generalised System of Preferences (US GSP) facility with additional flexibilities on product coverage and rules of origin etc. and pursuing US cooperation in areas such as intellectual property rights and trade capacity building in WTO agreements.

The four sessions of Standing Committee Meetings under the fourth round of negotiations of the Asia-Pacific Trade Agreement (APTA) was concluded by the six member countries, China, Bangladesh, India, Republic of Korea, Lao People's Democratic Republic and Sri Lanka, in December 2009. The consolidated concessions list, comprising 4,270 products compiled at the end of the third round, is expected to be widened in terms of product coverage and the proposed tariff cuts are expected to be deepened in the fourth round. APTA has also adopted modalities for extending negotiations into other areas such as non-tariff measures and framework agreements on trade facilitation, trade in services and investment. The Framework Agreement on Trade Facilitation and Investment was signed at the third Ministerial Council held in December 2009 in Korea.

The fourth meeting of the South Asian Free Trade Area (SAFTA) Ministerial Council (SMC), the highest decision making body of SAFTA and the highest authority responsible for the administration and implementation of the agreement, was held in Kathmandu, Nepal in October 2009. The Trade Ministers of member states noted the progress in the implementation of the SAFTA agreement and agreed that the member states should implement SAFTA in order to expand and strengthen the regional trade linkages.

5.3 Trade in Goods, Trade Balance and Terms of Trade

Export Performance

In line with the global trends, export earnings declined by 12.7 per cent to US dollars 7,085 million in 2009 compared to that of 2008. All major sectors reflected declines in growth while the largest

contribution to the decline in overall exports was from the industrial sector (83.1 per cent) followed by the agricultural sector (16.0 per cent).

Earnings from agricultural exports, which accounted for 23.9 per cent of total export earnings, declined by 8.9 per cent to US dollars 1,690 million in 2009. However, there was an improvement in the performance of agricultural exports during the last quarter, led by the high prices of tea, rubber and some minor agricultural commodities in the international markets. Tea exports accounted for 16.7 per cent of earnings in 2009 followed by minor agricultural products (3.4 per cent), coconut (2.4 per cent) and rubber (1.4 per cent).

Earnings from tea exports declined by 6.8 per cent to US dollars 1,185 million in 2009 due to a drop in export volumes caused by supply shortages, despite the significant price increases during the latter part of the year. Sri Lanka remained the third largest exporter of tea in the world after Kenya and China. The supply

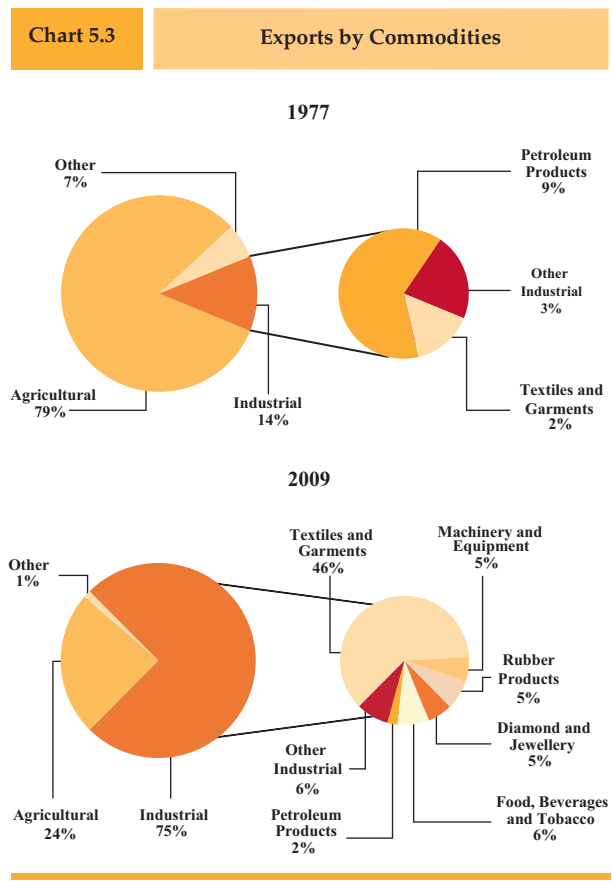


Table 5.4

Composition of Exports

Category	2008 (a)		2009 (b)		Change in Value (b) US dollars million	Growth Rate (b) %	Contribution to Growth (b) %
	Value US dollars million	Share %	Value US dollars million	Share %			
Agricultural Exports	1,854.8	22.9	1,690.3	23.9	-164.5	-8.9	16.0
Tea	1,271.5	15.7	1,185.1	16.7	-86.4	-6.8	8.4
Rubber	125.1	1.5	98.6	1.4	-26.5	-21.2	2.6
Coconut	171.0	2.1	166.2	2.4	-4.8	-2.8	0.5
Kernel Products	82.4	1.0	58.2	0.8	-24.2	-29.3	2.4
Other	88.7	1.1	108.0	1.5	19.4	21.8	-1.9
Other Agricultural Exports	287.3	3.5	240.4	3.4	-46.9	-16.3	4.6
Industrial Exports	6,158.0	75.9	5,305.4	74.9	-852.5	-13.8	83.1
Food, Beverages and Tobacco	458.3	5.7	406.1	5.7	-52.2	-11.4	5.1
Textiles and Garments	3,468.7	42.8	3,274.2	46.2	-194.5	-5.6	19.0
Petroleum Products	254.9	3.1	134.7	1.9	-120.1	-47.1	11.7
Rubber Products	541.9	6.7	384.7	5.4	-157.2	-29.0	15.3
Ceramic Products	49.0	0.6	36.4	0.5	-12.6	-25.7	1.2
Leather, Travel Goods and Footwear	16.7	0.2	13.6	0.2	-3.1	-18.7	0.3
Machinery and Equipment	461.0	5.7	330.3	4.7	-130.7	-28.3	12.7
Diamond and Jewellery	434.5	5.4	329.8	4.7	-104.6	-24.1	10.2
Other Industrial Exports	473.1	5.8	395.6	5.6	-77.6	-16.4	7.6
Mineral Exports	97.8	1.2	88.7	1.3	-9.1	-9.3	0.9
Gems	76.4	0.9	68.9	1.0	-7.5	-9.8	0.7
Other Mineral Exports	21.4	0.3	19.8	0.3	-1.5	-7.2	0.2
Unclassified	0.0	0.0	0.0	0.0	0.0	-74.7	0.0
Total Exports (c)(d)	8,110.6	100.0	7,084.5	100.0	-1,026.1	-12.7	100.0
Annual Average Exchange Rate (e)	108.33		114.94				

(a) Revised
 (b) Provisional
 (c) Excludes re - exports
 (d) Adjusted
 (e) Rupee/US dollar exchange rate

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

shortages in the world market as well as measures introduced by the relevant authorities to retain the high quality associated with Ceylon tea augured well for Sri Lanka's tea industry as Ceylon tea continued to attract premium prices during 2009. The average export price of tea reached a record high of US dollars 4.65 per kg in October 2009. However, Sri Lanka continues to export a major portion of tea (57.8 per cent) in bulk form, which fetched an average price of US dollars 3.67 per kg in 2009, whereas the prices of tea exports in value added forms i.e., tea bags, instant tea and green tea from Sri Lanka ranged higher, between US dollars 5.36-7.53 per kg. Efforts would be needed to enhance value addition locally to fetch better prices. To assure the sustainability of the tea industry, the government stipulated a Cess of Rs. 4.00 per kg on imported teas to prevent blending Sri Lanka tea with low quality imported varieties. Since Sri Lanka has already carved out a niche market for the high quality associated with Ceylon tea, efforts should be made to maintain the standards in the industry and

facilities should be provided to develop Sri Lanka as a tea hub amongst the major tea producing countries in the region.

Earnings from other agricultural exports also declined in 2009. Earnings from rubber exports decreased by 21.2 per cent during 2009, despite a 15.1 per cent increase in export volumes, largely due to a significant decline in rubber prices in the international market. Decline in synthetic rubber prices in line with the decline in crude oil prices was the main contributory factor to this situation. Earnings from coconut exports also declined mainly due to the low prices of kernel products. However, the large demand for coconut fibre and fibre based products from China, Japan, South Korea and Germany helped to develop the coconut fibre industry to an unprecedented level. Export earnings from minor agricultural products also declined mainly due to a significant decline in prices of many of these commodities in the wake of the reduced global demand. However earnings from minor agricultural crop exports improved towards the latter part of the year. The growing global demand for

tropical fruits and other fresh produce has provided an opportunity for Sri Lanka to engage in large scale agricultural pursuits, particularly in the Northern and Eastern provinces.

Earnings from industrial exports declined by 13.8 per cent to US dollars 5,305 million in 2009 reflecting contractions in all sub-sectors owing mainly to lower global demand. However, the textile and garment exports, which accounted for 46.2 per cent of the total exports, emerged relatively unscathed. Other industrial exports, such as food, beverages and tobacco, rubber, diamonds and jewellery, and machinery and equipment, which together accounted for another 20.5 per cent of the total exports, contracted in 2009, despite some improvement shown towards the latter part of the year.

Earnings from textile and apparel exports, which is the main category of industrial exports, stood at US dollars 3,274 million in 2009, reflecting a decline of 5.6 per cent. These exports, which performed well during the first quarter of 2009, were affected by the global recession during the second quarter, as was expected by the industry. However, the export performance during the second half of the year was encouraging. Therefore, when the overall developments during the year are considered, Sri Lanka's textile and garment sector was the least affected of the industrial exports in 2009. The strength of the apparel industry lies in its entrepreneurial foresight and the willingness to adapt to the changing environment. Sri Lanka has world class manufacturing facilities and adopted ethical manufacturing practices, which have helped to earn an international reputation as a reliable supplier of high quality clothing. The major players in the industry introduced eco-friendly manufacturing mechanisms in response to global market developments.

Exports of cocoa, fishery products and animal fodder grew in 2009, despite the decline of export earnings by 11.4 per cent in the category of food, beverages and tobacco. The exports of fish and fishery products increased from US dollars 165 million in 2008 to US dollars 171 million in 2009. Removal

of security restrictions on fishing off the Northern and Eastern coasts towards the latter part of the year and the capacity expansion through the development of fishery infrastructure have helped increase earnings from the sector. There is a tremendous potential for the fisheries export sector to grow into an industry capable of generating US dollars 1 billion per annum.

The global economic downturn and the high level of uncertainty over world market conditions adversely impacted Sri Lanka's exports of rubber products, diamonds and jewellery, as well as machinery and equipment. The earnings from exports of rubber products recorded a negative growth mainly due to lower exports of tyres, resulting from the severe crisis in the industrial and automotive sectors in North America and Europe. Comparatively, exports of gloves and other hand protections performed better showing resilience in a shrinking market. Exports of processed diamonds, jewellery, cycles, wires, cables, electrical transformers and static converters, also decreased substantially in 2009. Despite the contraction in all major sub-categories of industrial exports in 2009, exports of ships emerged as prominent export in the category of other industrial exports. Sri Lanka built and exported 2 ships in 2009, generating export proceeds of US dollars 57 million. Meanwhile, export earnings from precious and semi-precious stones as well as other mineral exports, including graphite declined.

Import Performance

Expenditure on imports in 2009 amounted to US dollars 10,207 million, reflecting a sharp decline of 27.6 per cent from that of the previous year, due to reductions in both volumes and prices. All major categories of imports i.e., consumer, intermediate and investment goods, declined. Sluggish growth in the major economies around the world led to lower international commodity prices, including oil prices, and the slowdown in the domestic economic activities resulted in a drastic drop in import volumes, leading to an overall decline in import expenditure. However, the relative share of consumer goods to total imports increased to 19.3 per cent in 2009, lowering the shares of intermediate and investment goods imports.

Table 5.5

Composition of Imports

Category	2008 (a)		2009 (b)		Change in Value (b) US dollars million	Growth Rate (b) %	Contribution to Growth (b) %
	Value US dollars million	Share %	Value US dollars million	Share %			
Consumer Goods	2,559.6	18.2	1,971.8	19.3	-587.8	-23.0	15.1
Food and Beverages	1,513.0	10.7	1,246.2	12.2	-266.8	-17.6	6.9
Rice	44.3	0.3	22.9	0.2	-21.4	-48.4	0.6
Sugar	206.4	1.5	218.7	2.1	12.3	5.9	-0.3
Wheat	375.5	2.7	259.3	2.5	-116.2	-30.9	3.0
Other	886.8	6.3	745.4	7.3	-141.4	-15.9	3.6
Other Consumer Goods	1,046.6	7.4	725.6	7.1	-321.0	-30.7	8.3
Intermediate Goods	8,344.3	59.2	5,669.2	55.5	-2,675.1	-32.1	68.9
Petroleum	3,368.2	23.9	2,166.6	21.2	-1,201.6	-35.7	30.9
Fertiliser	576.6	4.1	193.4	1.9	-383.2	-66.5	9.9
Chemicals	361.4	2.6	312.5	3.1	-48.9	-13.5	1.3
Textiles and Clothing	1,702.0	12.1	1,442.0	14.1	-260.0	-15.3	6.7
Other Intermediate Goods	2,336.1	16.6	1,554.6	15.2	-781.5	-33.5	20.1
Investment Goods	3,047.9	21.6	2,450.8	24.0	-597.1	-19.6	15.4
Machinery and Equipment	1,330.7	9.4	1,012.8	9.9	-317.9	-23.9	8.2
Transport Equipment	438.8	3.1	436.3	4.3	-2.5	-0.6	0.1
Building Materials	942.6	6.7	714.5	7.0	-228.1	-24.2	5.9
Other Investment Goods	335.9	2.4	287.3	2.8	-48.6	-14.5	1.3
Unclassified Imports	139.4	1.0	114.8	1.1	-24.6	-17.6	0.6
Total Imports (c)(d)	14,091.2	100	10,206.6	100.0	-3,884.6	-27.6	100.0
Annual Average Exchange Rate (e)	108.33		114.94				

(a) Revised
(b) Provisional
(c) Excludes re-imports
(d) Adjusted
(e) Rupee/US dollar exchange rate

Sources : Sri Lanka Customs
Ceylon Petroleum Corporation
Lanka IOC PLC
Prima Ceylon Limited
Serendib Flour Mills (Pvt) Ltd
Central Bank of Sri Lanka

Expenditure on consumer goods imports declined by 23.0 per cent to US dollars 1,972 million in 2009. Expenditure on imports of both, food and consumer durables, declined largely on account of the lower import prices. The significant decline in wheat prices was the main contributor for the decline in expenditure on food imports. Despite the increase in import volumes, expenditure on wheat declined by 30.9 per cent. Total rice imports declined by 37.9 per cent to 523,000 metric tons in 2009 despite the high import volumes recorded towards the latter part of the year when tariffs on rice were revised several times to encourage imports to address domestic supply constraints. International sugar prices increased rapidly during 2009, recording the highest levels during the last three decades, due to global supply constraints. As a result, the average import price of sugar rose by 30.6 per cent and expenditure on sugar imports increased by 5.9 per cent to US dollars 219 million in 2009. Imports of milk products declined by 44.0 per cent to US dollars 166

million in 2009, approximately 95.0 per cent of which comprised of milk powder. In the durable consumer goods category, there was a substantial reduction in imports of personal motor cars (71.7 per cent), motorcycles (22.5 per cent) and electrical equipment (52.7 per cent) in 2009.

Expenditure on imports of intermediate goods declined by 32.1 per cent to US dollars 5,669 million in 2009, mainly due to a decline in expenditure on petroleum product imports. The significant decline in petroleum prices in the international market led to the reduction in the petroleum import expenditure by 35.7 per cent to US dollars 2,167 million compared to that of the previous year. The average import price of crude oil was US dollars 63.93 per barrel in 2009 compared to US dollars 97.00 per barrel in 2008. However, prices of crude oil increased gradually towards the end of the year along with the global economic recovery. As a result, the average import price of crude oil rose to around US dollars 76.52 per barrel during the last

quarter of 2009. The expenditure on fertiliser imports declined by 66.5 per cent to US dollars 193 million in 2009, due to the lower prices that prevailed in the international market and the reduced import volumes. Import expenditure on textiles, diamonds and chemicals, for processing and re-exporting purposes, also declined in 2009, reflecting the depressed world market conditions.

Expenditure incurred on imports of investment goods declined by 19.6 per cent to US dollars 2,451 million, in 2009. This decline was largely reflected by lower imports of machinery and equipment as well as building materials. The slowdown in domestic economic activities affected the construction sector, thereby reducing demand for building materials as well as machinery and equipment, thus declining the expenditure on imports of those items by 24.2 per cent and 23.9 per cent, respectively. Although import expenditure on transport equipment escalated towards the latter part of 2009, due to the of importation of heavy vehicles for reconstruction and development activities in the Northern and Eastern provinces, expenditure on transport equipment indicated a marginal decline for the year as a whole.

Chart 5.4

Imports by Commodities

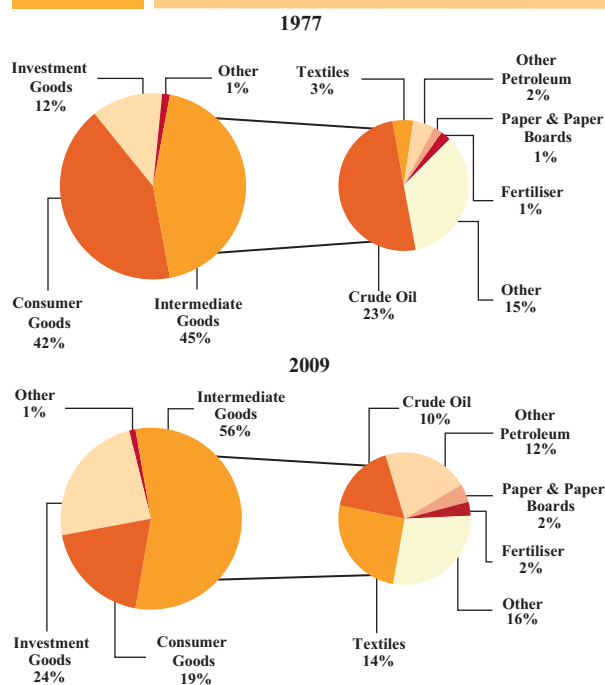


Table 5.6

Volume of Major Imports (a)

Item	' 000 mt				
	2005	2006	2007	2008 (b)	2009 (c)
Rice	52	12	88	84	52
1st Quarter	43	3	4	41	3
2nd Quarter	4	2	7	28	3
3rd Quarter	2	3	3	11	2
4th Quarter	3	4	74	4	44
Wheat	864	1,200	952	919	1,026
1st Quarter	272	287	204	272	288
2nd Quarter	191	321	388	312	229
3rd Quarter	174	331	274	153	220
4th Quarter	227	261	87	182	289
Sugar	418	525	481	575	467
1st Quarter	49	112	112	163	123
2nd Quarter	167	137	138	131	110
3rd Quarter	94	127	118	167	142
4th Quarter	108	149	113	114	92
Petroleum (Crude Oil)	2,008	2,151	1,938	1,853	2,066
1st Quarter	586	592	272	229	559
2nd Quarter	581	535	557	525	417
3rd Quarter	246	582	559	544	416
4th Quarter	595	442	550	555	674
Refined Petroleum	1,823	2,302	2,314	2,386	2,154
1st Quarter	314	540	597	778	409
2nd Quarter	396	587	646	583	605
3rd Quarter	711	479	517	465	564
4th Quarter	402	696	554	560	576
Fertiliser	529	633	569	772	501
1st Quarter	168	166	62	125	46
2nd Quarter	111	203	171	223	109
3rd Quarter	142	119	131	216	123
4th Quarter	107	146	205	208	223

(a) Adjusted
(b) Revised
(c) Provisional

Sources: Sri Lanka Customs
Ceylon Petroleum Corporation
Lanka IOC PLC
Prima Ceylon Limited
Serendib Flour Mills (Pvt) Ltd
Central Bank of Sri Lanka

Trade Balance

The trade deficit contracted sharply in 2009. The trade deficit narrowed by 47.8 per cent to US dollars 3,122 million in 2009 from US dollars 5,981 million in 2008 reflecting substantially lower expenditure on imports in 2009 despite the decline in earnings from exports. As a percentage of GDP, the trade deficit improved to 7.4 per cent in 2009.

Terms of Trade

The significant reduction in import prices over the export prices resulted in an improvement in the terms of trade by 24.0 per cent in 2009. The prices of exports declined marginally by 0.4 per cent in 2009, mainly as a result of 3.2 per cent reduction in prices of agricultural exports. Prices of rubber, coconut products, vegetables, fruits and spices in the international market declined during the year.

Box 8

Role of Exim Banks in Economic Development

Export-Import Banks, commonly referred to as Exim Banks, offer a wide range of financial products and services for the purpose of promoting a country's international trade and facilitating cross border investments. These specialised institutions, whose focus has been beyond commercial banking, has played a key role in enhancing foreign trade of these countries. Although their objectives, as well as their products and services vary from one country to another, almost all Exim Banks promote exports by providing trade financing facilities such as pre-shipment loans, packing credits, export credit financing, working-capital loans, export bills discounting, etc. They extend lines of credit to overseas financial institutions, foreign governments and their agencies to encourage the importation of goods and services from the lending country. Some Exim Banks facilitate foreign investments and overseas acquisitions, provide financial support to local investors who undertake overseas projects such as manufacturing, infrastructure development and other development projects. Other activities undertaken by some Exim Banks include the provision of value added information, advisory services and other support services, export credit insurance, international guarantees and letters of credit to facilitate international trade.

Developed as well as developing countries have established Exim Banks to finance and promote international trade. USA was the first country to establish an Exim Bank called USExim in 1935. Other countries, such as Japan and Korea, followed suit by setting up the Exim Japan in 1950 and Exim Korea in 1976. Although a larger proportion of international trade occurs between developed countries, the share of developing countries in merchandise trade has been increasing over the past two decades. India was one of the first developing nations to establish an Exim Bank (Exim Bank of India) in March 1982. Other countries that have set up Exim Banks since then include Nigeria, Malaysia, Turkey, Thailand and China. The Government of Sri Lanka has obtained a number of foreign loans and credit facilities from the Exim Banks of India, China, Korea, Hungary and Malaysia to finance various development projects in Sri Lanka.

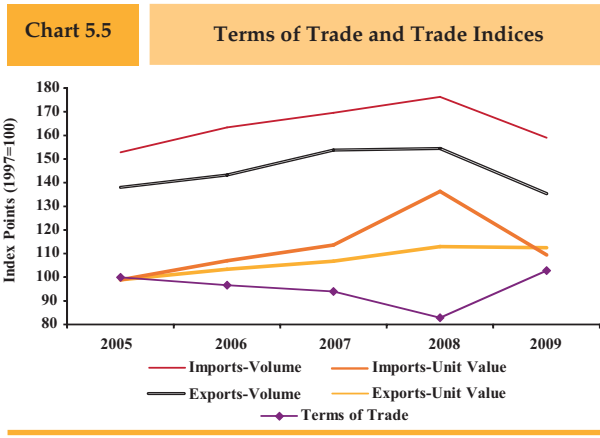
The increasing share of Asia in the global trade will be the key driving force of the world's economic growth. As the dawn of peace has availed Sri Lanka an opportunity to embark on a strong economic growth path in the coming years, it is important to strengthen the links of the Sri Lankan economy with the global economy. An Export-Import Bank could play a useful role in integrating Sri Lanka's economy with the rest of the world by promoting, financing and facilitating international trade

and investments. Accordingly, the Central Bank of Sri Lanka has taken the initiative to establish an Exim Bank in Sri Lanka to provide financial assistance to exporters and importers, and to promote international trade in goods, services and capital, and thereby enhance growth, employment and the real income of the country.

Exim Banks do not compete with other institutions established to facilitate international trade, including other lending institutions. They conduct their activities by following a set of common rules and regulations set out for banking institutions by the regulator. In Sri Lanka, in addition to commercial banks that provide trade financing, there are several institutions such as the Export Development Board (EDB), Sri Lanka Export Credit Insurance Corporation (SLECIC), which facilitate international trade in a limited way. The proposed Exim Bank is expected to take on a product centric approach during the formative years and gradually evolve into a more customer centric approach which would offer a range of products and services to cater to all aspects of trade finance that do not come within the purview of existing institutions.

The Exim Bank could assist exporters and investors at various stages of the development process. In the short-term, it could assist the development of export markets and help expand export production capacity through a variety of short-term financing products. In the medium term, it could also help exporters enhance their production capacity by financing the infusion of new technologies and promoting exports of service projects. In the long run, the Exim Bank could take on a trade facilitating role by financing research and development activities to support exports and provide advisory and information services to enhance knowledge building and market expansion to supplement its financing programmes.

Sri Lanka would be able to reap significant benefits through the facilities provided by an Exim Bank. Sri Lankan exporters will be able to compete in overseas markets on an equal footing with their government-supported competitors from other countries. Further, an Exim Bank will encourage the exports of services for the development and expansion of infrastructural facilities, plant and buildings abroad by providing necessary financing to purchase the required inputs. It will create more employment opportunities, especially for the highly educated professionals such as computer and mechanical engineers, which would help generate more foreign remittances to the country. Therefore, the establishment of the Exim Bank is expected to enhance the country's growth opportunities through trade and investment.



However, the average export prices of Ceylon tea increased continuously since December 2008 and reached the highest ever recorded levels in October 2009 due to constraints in the global supply. Tea prices declined marginally during the last two months of the year. As a result, the annual average tea export price index for the year 2009, increased by 1.8 per cent. Meanwhile, the prices of textile and garment exports, as indicated by the external trade indices, reflected a decline of 1.6 per cent.

The general decline in import prices by 19.7 per cent was reflected in all major import categories. Among consumer goods, prices of wheat and rice declined substantially while sugar and lentil prices increased significantly, owing to supply shortages in the world market. Average prices of intermediate goods declined by 21.2 per cent mainly due to the 34.1 per cent reduction in crude oil prices. Prices of fertiliser imports also fell by 51.1 per cent in 2009. In line with this trend, prices of all other sub-categories of intermediate goods declined substantially. Prices of investment goods imports declined by 14.1 per cent in 2009, reflecting the decline in prices in almost all sub-categories, largely owing to the lower global demand. However, the import prices of construction materials, particularly cement, declined by more than those of other investment goods.

Direction of Trade

The western countries, continued to be the major destinations for Sri Lankan exports in 2009 as well, while the Asian countries towered over the rest with respect to Sri Lanka's imports.

While the USA and the UK remained the largest export destination countries, India, Singapore and China were the foremost import-originating countries in 2009. India, emerged as the largest trading partner country in 2009 by accounting for nearly 17.8 per cent of Sri Lanka's imports.

The USA, the major export market for Sri Lanka, accounted for 22.2 per cent of exports, followed by the UK and Italy. Textile and apparel were the main items exported to these markets. Among the European countries, in addition to the UK (14.4 per cent), Italy (6.2 per cent), Belgium-Luxembourg (5.1 per cent) and Germany (4.9 per cent) continued to be the main destinations in the export market. Nearly 16.9 per cent of the country's textile and apparel products were exported to Germany and Italy and almost 75.8 per cent of Sri Lanka's processed

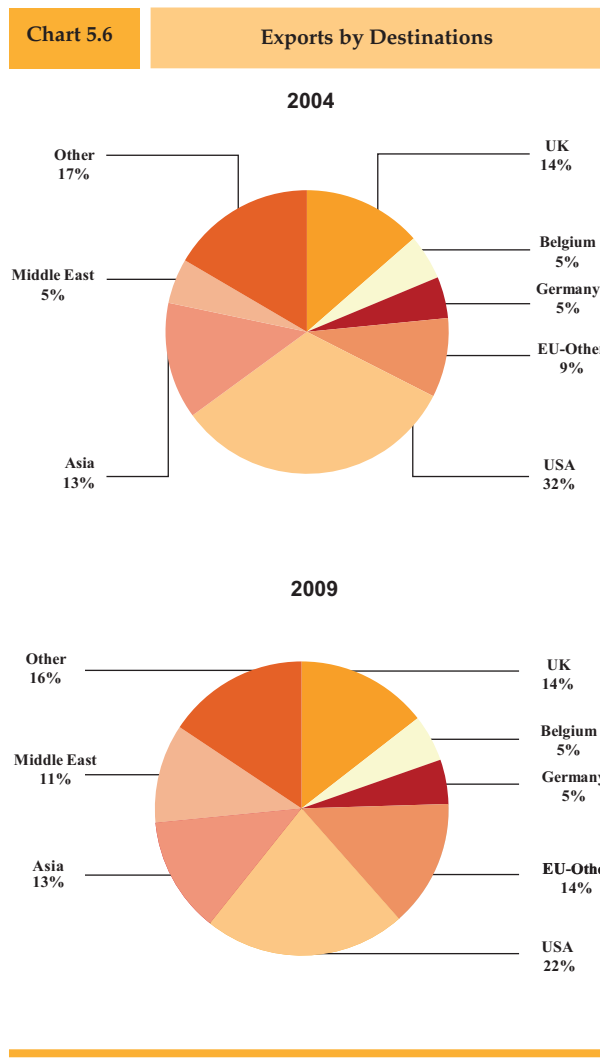
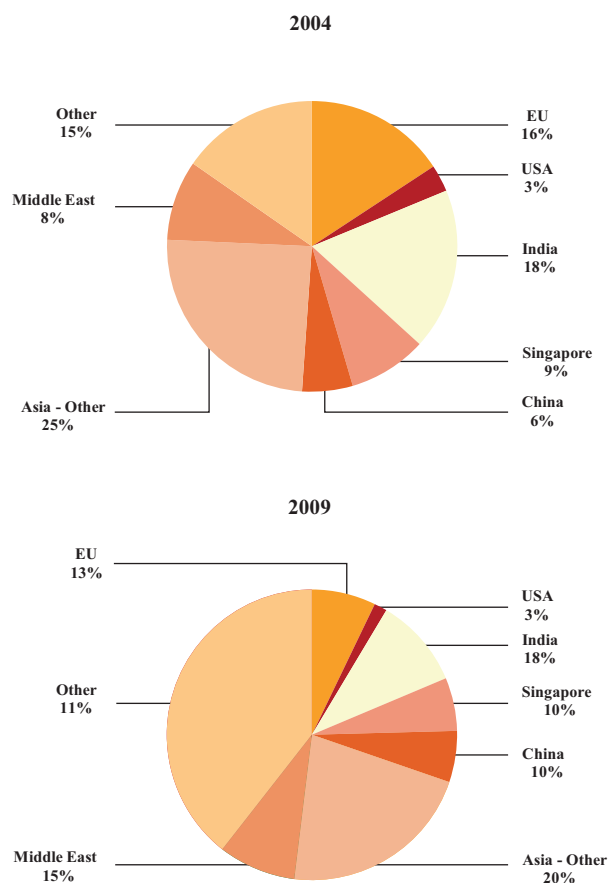


Chart 5.7

Imports by Origin



diamonds were exported to Belgium, one of the world's leading trading centres for diamonds. Sri Lanka's exports to India increased dramatically following the implementation of the Indo-Sri Lanka Free Trade Agreement in 2000 and by 2009, it accounted for about 4.5 per cent of Sri Lanka's total exports. Russia and Iran, which accounted for nearly 15.1 per cent and 10.9 per cent of total tea exports, respectively, continued to be the major destinations for tea exports in 2009. Taken together, the Middle Eastern region featured high as the foremost export destination for Sri Lanka's tea.

India continued to be the largest source of imports in 2009 and accounted for nearly 17.8 per cent of imports in 2009. The main imports from India included refined petroleum products, motorcycles and auto-trishaws. Singapore and

China followed as the second and third largest import source countries. Main imports from Singapore comprised of fertiliser and petroleum products while the major import from China was cotton. Iran and Hong Kong remained the fourth and fifth largest import source countries for Sri Lanka. Imports from Iran and Hong Kong comprised mainly of crude oil and fabrics.

5.4 Trade in Services, Income, Current Transfers and Current Account Balance

Trade in Services

With the improvement in the local business climate brought about by the end to the conflict and the gradual recovery of the global economy, the services account registered a surplus in 2009. Although the surplus in the services account contracted rapidly during the first half, due to the slowdown in transportation, travel, telecommunication and construction services sectors, the tapering off in the contraction during the second half resulted in an overall surplus of US dollars 391 million in the services account for 2009.

Transportation Services

Transportation, the key sector within the services account showed a satisfactory recovery during the second half of the year from the drawback shown during the first half. The gross inflows on account of transportation services consisting of passenger fares, freight charges and other port related activities reported a substantial decline of 19 per cent during the first half compared to the corresponding period of 2008. However, as all sub-sectors of transportation services performed relatively well during the second half of the year, the gross inflows on account of transportation services reached US dollars 865 million in 2009. Nevertheless, the gross inflows to this sub-sector for the year as a whole, declined by 13.5 per cent. Meanwhile, outflows on account of transportation declined by 10.1 per cent in line with the decelerated international trade and decreased expenditure by Sri Lankans on foreign travel for leisure, employment and education etc.

Gross inflows on account of passenger fares reported a decline of 12.3 per cent to US dollars 404 million in 2009 compared to the previous year. Even though the number of passengers travelling to Sri Lanka for both business and leisure increased during the second half, the gross inflows on account of passenger fares decreased compared to the second half of 2008, due to the lower air fares subsequent to the withdrawal of fuel surcharges in 2009.

Though gross inflows on account of freight and port-related activities suffered a setback during the first half due to the global economic downturn, this sub-sector demonstrated a recovery in the second half of the year. The downfall in trade volumes in whole of Asia and the rest of the world resulted in Sri Lanka's port services recording a drop in volumes during the year. However, port-related activities including bunkering services improved following the end to the conflict, resulting in an increase in the number of ships calling at the Port of Colombo. Consequently, gross inflows on account of freight and port-related activities, which declined by 32.3 per cent in the first half of the year, improved to report a decline of 14.5 per cent in 2009.

Port-related activities are expected to make great strides in the medium-term with the construction of new ports and improvement of existing ports making the presence of Sri Lanka strong in the international maritime trade. Phase I of Hambantota Port, which is much closer to the international shipping lanes, is scheduled to be completed in 2011. It will generate more foreign inflows by facilitating bulk and general cargo carriers and would generate employment opportunities. The anticipated de-listing from the "Listed Areas" maintained by the Society of Lloyd's of London¹, in connection with hull war, strikes, terrorism and related perils would also create a more conducive environment for foreign investments and maritime business while attracting more ships to Sri Lankan ports.

¹ Lloyd's of London is the oldest and the most active insurance market in the world.

Table 5.7

Net Services, Income and Current Transfers (a)

Item	US dollars million		Rs. million	
	2008	2009(b)	2008	2009(b)
1. Transportation Services	298	235	32,335	26,822
2. Travel	-86	-61	-9,297	-7,094
3. Telecommunication Services	26	26	2,756	3,004
4. Computer and Information Services	230	245	24,917	28,161
5. Construction Services	35	34	3,774	3,936
6. Insurance Services	22	28	2,337	3,247
7. Other Business Services	-109	-100	-11,757	-11,450
8. Government Expenditure n.i.e.	-14	-16	-1,508	-1,846
Total Net Services	401	391	43,557	44,780
1. Compensation of Employees	-14	-11	-1,483	-1,233
2. Direct Investment	-464	-223	-50,256	-25,573
3. Interest and Other Charges	-495	-254	-53,293	-29,007
Total Net Income	-972	-488	-105,032	-55,814
1. Private	2,565	2,927	277,711	336,578
2. General Government	101	77	10,928	8,920
Total Net Current Transfers	2,666	3,005	288,639	345,498

Source: Central Bank of Sri Lanka

(a) This presentation conforms as far as possible to the Balance of Payments Manual, 5th Edition (1993) of the International Monetary Fund.
(b) Provisional

Travel and Tourism

The end of the internal conflict has opened up new vistas for the travel and tourism industry in Sri Lanka. The tourist arrivals increased by 2.1 per cent, year-on-year, despite the sharp drop during the first few months. The arrivals, which had been declining, year-on-year, at an average rate of 18.3 per cent during the first five months of 2009, increased significantly with the end of the conflict in May and grew, year-on-year, at an average rate of 20.4 per cent in the subsequent 7 month period. Adverse travel advisories issued by some countries were subsequently retracted or relaxed as the circumstances changed. The largest number of tourist arrivals was recorded from India (83,634), followed by the UK (81,594), the Maldives (31,916) and Germany (29,654) in 2009. Increases were also noted from the Middle East, France, Australia, Singapore and Malaysia. Nearly 80.0 per cent of tourists visited for holiday and pleasure, while 8.6 per cent came for business purposes. The global economic recession and the outbreak of contagious diseases in some countries, such as the swine flu, deterred people from travelling during 2009.

Table 5.8

Tourism Performance

Item	2005	2006	2007	2008 (a)	2009 (b)	Growth Rate	
						2008 (a)	2009 (b)
Tourist Arrivals (No.)	549,308	559,603	494,008	438,475	447,890	-11.2	2.1
Pleasure	382,321	392,766	331,238	321,079	358,188	-3.1	11.6
Business	92,879	96,981	52,116	37,261	38,473	-28.5	3.3
Other	74,108	69,856	110,654	80,135	51,229	-27.6	-36.1
Tourist Guest Nights ('000)	4,754	5,793	4,940	4,166	4,076	-15.7	-2.2
Room Occupancy Rate (%)	45.4	47.8	46.2	43.9	48.4	-5.0	10.3
Gross Tourist Receipts (Rs. million)	43,151	42,586	42,571	37,094	40,133	-12.9	8.2
Per Capita Tourist Receipts (Rs.)	66,223	76,100	86,175	84,598	83,740	-1.8	-1.0
Total Employment (No.)	125,004	133,558	145,239	124,456	125,153	-14.3	0.6
Direct	52,085	55,649	60,516	51,857	52,147	-14.3	0.6
Indirect	72,919	77,909	84,723	72,599	73,006	-14.3	0.6

(a) Revised
(b) Provisional

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

Earnings from tourism increased by 2.2 per cent to US dollars 350 million in 2009. The hotel room occupancy rate, which dropped to around 40 per cent during the conflict, gradually increased towards the end of the year. In view of the increased demand, Sri Lanka's star class hotels increased their charges for accommodation. However, Sri Lanka remains very competitive compared to similar international tourist destinations. As the number of tourist arrivals in 2010 is expected to grow by 28.4 per cent to 575,000 arrivals, surpassing the previous record of 566,000 arrivals in 2004, measures will be taken to increase the number of hotel rooms and upgrade tourism related infrastructure and facilities to cater to the requirements of the larger number of arrivals. In view of the vast income generation potential of the tourism industry, Sri Lanka Tourism Development Authority (SLTDA) has taken several measures to develop the tourism sector in the Northern and Eastern provinces, which were affected by the conflict, as well as other selected areas of the island as prime tourist destinations. The government intends to promote the coastal cities of the Eastern province, such as Arugam Bay, Passekudah and Trincomalee as premier recreational centres in the Eastern province as it is known to have the best beaches in the island. Kalpitiya and other selected inland islands are also expected to be developed into attractive tourist resorts. SLTDA is also promoting a series of festivals to cater to the various segments of tourists.

Telecommunication and Information Technology Services

Gross inflows on account of telecommunication services, which decreased during the first half of 2009, performed well in the second half with the gradual recovery of the global economy. Nevertheless, during the year as a whole, the gross earnings and gross outflows on account of telecommunication services, reported marginal declines of 1.0 per cent and 2.7 per cent, respectively. The country's telecommunication industry has a large growth potential, especially in the mobile industry sector that recorded a tremendous growth during the recent past. The planned acquisition of satellite technology after setting up of the proposed Sri Lanka Space Agency will enable and facilitate Sri Lanka to harness its full potential to grasp the opportunities. With the convergence of technological innovation, the utilisation of International Direct Dialling, broadband internet, satellite and cable TV has improved. As a result, the outflows on account of telecommunication services are also expected to grow.

Exports of software and IT Enabled Services (ITES) such as IT-related Business Process Outsourcing (BPO) and Knowledge Process Outsourcing (KPO) continued to be a sector with significant growth potential. Sri Lanka possesses

a competitive advantage in IT and ITES due to the availability of qualified IT engineers, high literacy rates, strong English language skills, sound legal framework for IT development and liberalisation of the international telecommunications gateway. Despite the economic slowdown of its major market destinations like Europe and North America, this sector has showed a marginal growth of around 6.5 per cent in 2009.

Inflows and Outflows of Income

The income account improved significantly with the deficit contracting to US dollars 488 million in 2009 from US dollars 972 million recorded in 2008. This was driven mainly by the increase in interest income on the highest ever foreign exchange reserves accumulated during the year coupled with the reduction in interest payments on foreign loans partly due to the decline in global interest rates. In addition, appreciation of major reserve holding currencies such as Euro and Sterling pound against US dollar resulted in higher valuation and exchange gains from the mark-to-market valuation of trading securities in US dollar terms. Net interest earnings on foreign financial assets of the private sector including commercial banks also showed a positive development, as the net foreign assets of commercial banks improved during the year. Meanwhile, outflows in the income account decreased by 35.8 per cent to US dollars 603 million mainly due to the significant reduction in repatriation of profits and dividends by the foreign enterprises. Although a considerable portion of profits and dividends of these enterprises has been reinvested for the expansion of existing operations during 2009, the amount reinvested was lower than 2008.

Current Transfers

The inward remittances remained strong in 2009 even in the face of the global economic slowdown. Private transfers mainly consisting of workers' remittances became Sri Lanka's foremost foreign exchange earner in 2009. Even though workers' remittances have shown a marginal decline during the first quarter of the year, the ending of the protracted conflict encouraged Sri Lankan diaspora to send more money home. As a result,

the workers' remittances inflows grew by 14.1 per cent to US dollars 3,330 million in 2009 compared to the growth of 16.7 per cent in 2008. These remittances helped to completely offset the deficit in the trade account. The initiatives taken by CBSL and commercial banks to promote the inflow of workers' remittances through formal channels have also helped in recording a higher level of remittances in 2009. With the expansion of the bank branch network in the Northern and Eastern provinces, higher inflows of remittances are expected to be received in 2010 and beyond through formal channels. The net current transfers improved to US dollars 3,005 million in 2009 on account of the improvement in private transfers despite the decline in transfers to the government.

Current Account Balance

The current account, which recorded a surplus of US dollars 339 million for the first nine months of the year, turned around to record a marginal deficit for 2009, largely due to the higher level of investment goods imports in the last quarter of 2009. In 2009, the current account recorded a marginal deficit of US dollars 214 million compared to the large deficit of US dollars 3,886 million in 2008. In terms of GDP, the current account deficit improved from 9.5 per cent of GDP in 2008 to 0.5 per cent of GDP in 2009. The reduction in expenditure on all major categories of imports being much greater than the reduction in export earnings, the trade deficit as a whole narrowed down significantly in 2009. The comparatively low deficits in the trade account and income account were largely offset by the higher inflows of workers' remittances and surplus in the services account, resulting in a marginal deficit in the current account.

5.5 Capital and Financial Flows and Balance of Payments

Foreign Direct Investments (FDI)

The realised FDI including loans during 2009 decreased to US dollars 601 million after reaching a record high of US dollars 889 million in 2008, mainly due to the impact of the global financial crisis on the foreign financial flows. The global

financial downturn resulted in the drying-up of new equity investments and foreign loans channeled to the FDI enterprises. The highest FDI inflow was recorded from China amounting to US dollars 145 million followed by UK and India amounting to US dollars 80 million and US dollars 78 million, respectively, during 2009. The telecommunications and, power and energy industries attracted most of FDI inflows from China, UK and India. FDI inflows in 2009 consisted of equity capital of US dollars 19 million, loans and advances of US dollars 121 million by the shareholders, intra-company borrowings of US dollars 110 million, foreign loans of US dollars 197 million and the reinvestment of retained earnings of US dollars 154 million by the existing companies. Meanwhile, FDI outflows decreased to US dollars 20 million in 2009 from US dollars 62 million in 2008 mainly due to the lower realisation of the outward FDI projects approved in previous years reflecting the impact of the global financial crisis. The net FDI inflows during 2009 declined to US dollars 581 million from US dollars 827 million recorded in 2008. Meanwhile, investment commitment of contracted projects has increased during the year as compared to 2008 despite the decline in number of projects contracted.

FDI flows are long-term in nature and hence less volatile, reducing the risk of sudden withdrawal especially during a crisis situation. In contrast to FDI, short-term financial flows such as foreign investments in government securities and portfolio investments are volatile and subject to the risk of sudden withdrawal especially during a crisis situation. With the positive outlook brought about by the end to the conflict, FDI flows are expected to improve more favourably in the medium-term. In addition, more new FDI are expected to be realised with the initiation of the development work in the North and East, especially in the tourism, agricultural and manufacturing sectors.

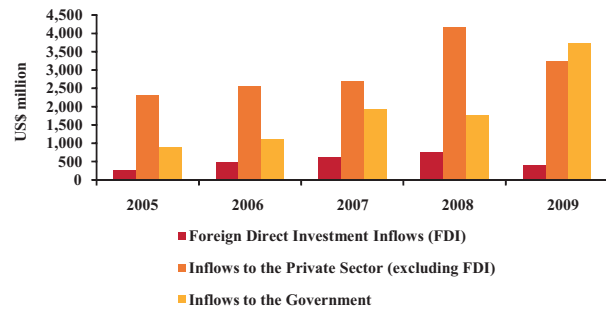
Foreign Capital to the Government

Medium and Long-term Capital

Even though the foreign financial inflows to the government declined considerably during the first half of the year due to the global

Chart 5.8

Inflows to the Capital and Financial Account



financial crisis, a strong recovery in inflows was seen during the second half. With the ending of the conflict and the approval of the IMF-SBA facility, the foreign financial flows to the government increased significantly in the second half of the year. Sri Lanka's second international sovereign bond issue of US dollars 500 million was successfully completed in October 2009. The over subscription of the offering by more than thirteen times at a lower price compared to the first issue, reflected the confidence placed by foreign investors in the economy of Sri Lanka. Accordingly, the long-term inflows to the government including the sovereign bond of US dollars 500 million and grants, increased to US dollars 2,001 million in 2009 from US dollars 1,347 million in 2008.

During the year, the total long and medium-term loan inflows to the government, excluding the proceeds of the international sovereign bond, amounted to US dollars 1,280 million compared to US dollars 1,059 million in 2008. Of these loan receipts, US dollars 673 million (53 per cent) was received on concessional terms while US dollars 607 million (47 per cent) was on non-concessional terms. The concessional loan inflows were mostly directed towards the continuation of already commenced infrastructure projects such as Hambantota Port, Expansion of Colombo Port, Upper-Kotmale Hydro Power Plant, Southern Highway Construction and Puttalam Coal Power Project etc. The total receipt of grants, consisting both of a current and capital nature, decreased to US dollars 221 million in 2009 from US dollars 288

million in 2008. However, the government continued to receive a reasonable amount of grants during 2009 for the rebuilding of tsunami affected areas and, health and education sector development projects.

With the faster implementation of major projects, the foreign aid utilisation rate² increased significantly in 2009 to 24.1 per cent from 20.5 per cent in 2008, largely due to a substantial increase in disbursements for new projects during the year. Meanwhile, long-term loan repayments amounted to US dollars 940 million in 2009 mainly due to the settlement of syndicated loans of US dollars 225 million, and the continuation of repayment of the accumulated debts obtained during the past.

Short-term Capital

Short-term net foreign inflows on account of investments in Treasury bills and bonds reached a record level of US dollars 1,369 million during 2009, compared to the net outflows of US dollars 213 million in 2008. However, during the first half of the year, the investment in Treasury bills and bonds by foreigners recorded a net outflow due to the withdrawal of investments amidst the global financial crisis. The renewed confidence, stable exchange rate and comparatively lower international interest rates have attracted higher foreign inflows to the government securities market, especially during the second half of the year, reversing the trend witnessed in the early part of 2009. During the second half of the year, the government received US dollars 1,587 million worth of foreign inflows on account of Treasury bills and bonds and most of these investments were received for Treasury bonds with tenures of 4-6 years. All inflows on government securities were absorbed by CBSL to facilitate and cushion the impact of any sudden withdrawals by the foreign investors, without exerting any undue pressure on the domestic foreign exchange market.

² The foreign aid utilisation rate is the ratio of disbursements during 2009 to committed undisbursed balances as at end June 2009.

Table 5.9

Major Projects Financed with Foreign Borrowings during 2009

Lender and Project	Amount Disbursed US dollars million
AB Svensk Export Credit Corporation	22.0
of which; Fourth Rural Electrification Project - Euro Portion	11.6
Ratmalana & Ja-Ela Wastewater Treatment Facilities Project	10.4
Asian Development Bank	243.5
of which; Colombo Port Expansion Project	48.7
National Highways Sector Project	28.7
Power Sector Development Project	19.6
Secondary Towns & Rural Community Water/Sanitation	17.4
Secondary Towns & Rural Community Water/Sanitation Supplementary 1	15.6
Southern Transport Development Project - Supplementary	14.9
Distance Education Modernisation Project	11.2
European Investment Bank	21.2
of which; Post-Tsunami Line of Credit - Contract A	14.1
Government of France	19.4
of which; Trincomalee Integrated Infrastructure Project [TIIP]	17.1
Government of India	30.0
of which; Upgrading of Railway Line Colombo - Matara	27.3
Government of Japan	295.1
of which; Southern Highway Construction Project	57.7
Southern Highway Construction Project (II)	45.9
Upper Kotmale Hydro Power Project	45.1
Greater Colombo Transport Development Project	24.0
Lunawa Environment Improvement & Community Development Project	20.6
Colombo City Electricity Distribution Development Project	12.8
Pro-Poor Rural Development Project	11.8
Pro-Poor Economic Advancement & Community Enhancement (PEACE) Project	11.6
Pro-Poor Eastern Infrastructure Development Project	11.2
Provincial Road Improvement Project	10.5
Government of the People's Republic of China	291.4
of which; Hambantota Port Development Project	153.4
Puttalam Coal Power Project - Preferential Buyer's Credit	129.3
HSBC Bank PLC (United Kingdom)	98.0
of which; Regional Bridge Project	71.1
The Development of the Dikkowita Fisheries Harbour	22.9
International Development Association	148.1
of which; Additional Financing for Road Sector Assistance Project	65.0
Road Sector Assistance Project	14.5
Second North-East Irrigated Agriculture Project	10.4
Additional Financing for Health Sector Development Project	10.1
Nordea Bank Denmark A/S	24.8
of which; Oluvil Port Development Project	13.4
Kelani Right Bank Water Treatment Plant	11.4

Source: External Resources Department

Foreign Capital to the Private Sector and Public Corporations

Long-term Capital

Foreign loan inflows to the private sector increased significantly by 47 per cent to US dollars 390 million in 2009, mainly due to the increase in foreign borrowings by the Board of

Investments (BOI) companies as well as other private enterprises. Foreign loan inflows to BOI companies reached US dollars 197 million during 2009 as compared to US dollars 137 million in 2008. The foreign borrowings by the private sector in 2009 were mainly for investments in telecommunication, power and energy, and aviation industries.

Short-term Capital

Private short-term capital inflows consisted of portfolio investments, trade credits and changes in assets and liabilities of commercial banks. During 2009, the short-term net capital inflows decreased substantially to US dollars 311 million, from US dollars 679 million in 2008, largely due to the repayment of the credit facilities obtained from Iran by the Ceylon Petroleum Corporation (CPC) and the reduction in value of trade credits due to the lower international commodity prices including oil prices, that prevailed during 2009. CPC received net trade credits of US dollars 299 million including US dollars 193 million under the Iranian line of credit for oil imports in 2009, as compared to US dollars 601 million of net trade credits in 2008.

Despite the higher level of foreign inflows to the Colombo Stock Exchange (CSE) during the second half of the year, the gross portfolio investments decreased substantially in 2009 to US dollars 375 million from US dollars 548 million in 2008. This was mainly due to the impact of the global financial crisis that affected many stock markets around the world. Accordingly, the net portfolio investments during 2009 recorded an outflow of US dollars 6 million compared to the net inflow of US dollars 60 million in 2008.

The foreign assets of commercial banks increased by US dollars 435 million in 2009, led by the conversion of domestic assets to liquid foreign currency assets and invested abroad in the face of lower domestic credit demand. Meanwhile, the foreign liabilities of commercial banks decreased by US dollars 98 million in 2009 mainly due to the decrease in foreign currency deposits in the Offshore Banking Units (OBU).

Balance of Payments

The overall balance in BOP recorded an unprecedented surplus of US dollars 2,725 million in 2009 compared to the deficit of US dollars 1,385 million in 2008. The global financial crisis continued to have adverse implications on the country's external sector performance during the first quarter of 2009. By the end of the first quarter, the deficit in BOP reached US dollars 688 million raising concerns over the stability in the external sector. Several urgent measures were adopted during the first quarter of 2009 to address the concerns. CBSL negotiated for currency Swap facilities with a few central banks in the region and under such arrangements, CBSL received US dollars 200 million. CBSL also carried out a promotional programme on investment in Treasury bills and bonds among Sri Lankan diaspora and migrant workers. To encourage the inflows of foreign exchange earnings, a bonus interest of 20 per cent was paid in rupee terms, on interest earned on Non-Resident Foreign Currency (NRFC) and Resident Foreign Currency (RFC) deposits. In addition, the Inland Revenue Act was amended to provide tax concessions on foreign income and profits earned through the provision of services to non-residents. Some flexibility in the exchange rate was allowed to increase export competitiveness and an economic stimulus package was also announced by the government to offer relief to export oriented industries. Supported by the foreign inflows into the country including the receipts of the general and special allocations of Special Drawings Rights (SDR) by IMF and the proceeds of the second international sovereign bond issue have helped the country's BOP to record the highest ever surplus of US dollars 2,725 million by end 2009.

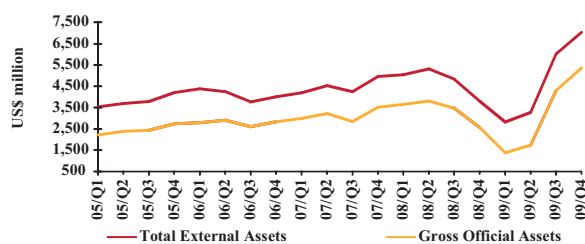
External Reserves

The gross official reserves excluding ACU receipts rose to its highest ever level of US dollars 5,097 million by end 2009 compared to US dollars 1,594 million recorded in 2008. This was equivalent to 6.0 months of imports compared to 1.4 months of import cover in 2008. Reserves that started to decline during the last quarter of 2008 owing to

the settlement of oil import bills and repatriation of short-term investments, continued to drop throughout the first quarter of 2009. Consequently, by end March 2009, the reserves reached a low level of US dollars 1,082 million. However, with the ending of the conflict, the external reserves position started improving since the second quarter of 2009. The situation further improved with the approval of the IMF-SBA facility of SDR 1.65 billion (equivalent to US dollars 2.6 billion) on July 24, 2009 as BOP support (please refer Box 9). The first two tranches of the IMF-SBA facility amounting to US dollars 652 million was received in July and November 2009. Further, the boost in investor confidence attracted a higher level of foreign investments into the Treasury bills and bonds market. In addition, under IMF's general and special allocation of SDR, Sri Lanka received SDR 324 million (equivalent to US dollars 508 million) in August 2009, while the proceeds of the second international sovereign bond issue of US dollars 500 million was received in October 2009, strengthening the country's official reserves position to US dollars 5,097 million by end 2009. Meanwhile, the total external reserves, excluding ACU receipts, increased to US dollars 6,770 million due to commercial banks building up their foreign assets with a substantial increase in foreign currency deposits abroad, and was sufficient to cover 8 months of imports.

Chart 5.9

Quarterly External Assets



The favourable developments towards the latter part of the year resulted in the rating agencies, Standard & Poor's (S&P) and Fitch Ratings, upgrading the sovereign rating outlook. S&P, which inexplicably revised Sri Lanka's sovereign rating outlook from 'stable' to 'negative' within days of the end of the conflict, reversed it once again to 'stable' and further to 'positive' in October 2009. S&P affirmed the long-term foreign currency Issuer Default Ratings (IDR) at 'B'. Fitch Ratings also revised Sri Lanka's sovereign ratings outlook to 'stable' from 'negative' in October and affirmed the long-term foreign and local currency IDR and the country ceiling at 'B+' and the short-term IDR at 'B'.

In order to strengthen the long-term stability of Sri Lanka's external reserves and to diversify the external asset portfolio, CBSL increased its gold holdings by purchasing 10 metric tons from

Table 5.10

External Assets of Sri Lanka (a)

Ownership	US dollars million (b)					Rs. million				
	2005	2006	2007	2008(c)	2009(d)(e)	2005	2006	2007	2008(c)	2009(d)(e)
1. Government	131	128	99	101	113	13,417	13,789	10,768	11,411	12,920
2. Central Bank	2,604	2,709	3,409	2,301	5,244	265,873	291,747	370,640	260,297	599,880
3. Total Official Assets (1+2)	2,735	2,837	3,508	2,402	5,357	279,290	305,536	381,408	271,708	612,799
4. Commercial Banks	1,466	1,169	1,448	1,238	1,673	149,656	125,867	157,454	140,075	191,373
5. Total External Assets (3+4)	4,201	4,005	4,956	3,640	7,030	428,946	431,403	538,862	411,783	804,173
6. Gross Official Assets in Months of										
6.1 Import of Goods	3.7	3.3	3.7	2.0	6.3					
6.2 Import of Goods and Services	3.3	2.9	3.3	1.8	5.5					
7. Total Assets in Months of										
7.1 Import of Goods	5.7	4.7	5.3	3.1	8.3					
7.2 Import of Goods and Services	5.0	4.1	4.7	2.8	7.2					

(a) Calculated at market value and includes Asian Clearing Union receipts.

(b) Converted at the following year end rates, except for certain items in the International Reserves of the Central Bank of Sri Lanka which were converted at the representative rate agreed with the International Monetary Fund.

Year
Rs. per US dollar (year end)

2005	2006	2007	2008	2009
102.12	107.71	108.72	113.14	114.38

(c) Due to a change in the classification of external assets, the foreign currency assets of the Central Bank placed with the domestic banks in 2008 were excluded.

(d) Excludes foreign exchange agreements (FX Swaps) outstanding as at end December 2009 amounting to US dollars 245 million.

(e) Provisional

Source: Central Bank of Sri Lanka

Box 9

Stand-by Arrangement Facility

Introduction¹

The Stand-by Arrangement (SBA) is a lending facility of the International Monetary Fund (IMF) which is designed to facilitate countries to overcome their short-term Balance of Payments (BOP) problems. Since its inception in June 1952, SBA has been used regularly by member countries and it has been IMF's major lending instrument to emerging and developing countries. As BOP crisis is a situation that needs to be addressed without any delay, SBA framework is designed in such a way that permits IMF to respond quickly to the countries' external financing needs, and to support policies designed to help them emerge from crisis and restore sustainable growth. Further, unlike other multilateral and bilateral lenders who lend to the governments, SBA funds are lent to the central banks of the countries for the purpose of building up reserves and therefore, it does not have any impact on the domestic money supply. SBAs may also be acquired on a precautionary basis, where countries choose not to draw upon approved amounts though they retain the option to execute if the conditions deteriorate. Owing to the global financial turmoil triggered by the sub-prime mortgage crisis in 2007, SBA has become the most widely used facility of IMF at present. In 2009, IMF has broadened the scope of SBA facility to be more flexible and responsive to members' requirements, where conditions were streamlined and simplified, and the borrowing limits were enhanced.

In consideration of the acuteness of the current global economic crunch, IMF has reformed the conditions of its lending to focus on criteria that are measurable and observable. This is broadly categorized into Quantitative Performance Criterion (QPC) and Structural Benchmarks (SB). QPC typically are macroeconomic policy variables such as monetary aggregates, fiscal balances and international reserves etc. Under QPC, the member country's progress is monitored and the continuation of disbursements is based on the achievement of such targets that are consistent with programme goals. SB include measures to strengthen the financial sector and public financial management. The performance under SBA programme is assessed through regular reviews.

The reasons for requesting an SBA facility by Sri Lanka

With the intensification of the global financial crisis towards the second half of 2008, the trade deficit of the country widened due to increased import expenditure with the escalation in oil and other commodity prices. Further, the sudden withdrawal of foreign investments in government securities, the hasty claims on short-term credit facilities that were freely available for petroleum imports, the acute drying-up of commercial financing required for counterpart funds for the implementation of foreign funded projects under the public investment programme and severe valuation losses arising from the sharp depreciation of major international currencies against the US dollar resulted in a substantial decline in external reserves of the country. Among several precautionary measures adopted to overcome this, Sri Lanka sought assistance from IMF in the form of an SBA in March 2009. Following the standard due diligence procedure to assess the impact of the global financial crisis on Sri Lanka and the country's ability to correct BOP imbalances with an SBA facility, a 20-month SBA facility amounting to Special Drawing Rights (SDR) 1.65 billion (equivalent to US dollars 2.6 billion), 400 per cent of the country's current quota, was approved by the Executive Board of IMF on July 24, 2009. This is the highest ever facility approved by IMF to Sri Lanka.

Terms associated with SBA facility-2009

SBA loan facility totalling SDR 1.65 billion was scheduled to be disbursed in 8 equal instalments of SDR 206.7 million each. The first instalment was released immediately after the approval of SBA facility in July 2009. The loan is expected to be repaid in four years commencing from April 2012. The rate of interest of SBA facility is composed of two components viz., the service charge and the fixed margin. The service charge is calculated weekly, based on SDR rate which is published and updated weekly on IMF's website. The fixed margin is 1 per cent per annum for the outstanding loan amount up to 300 per cent of the quota. When the outstanding loan amount exceeds 300 per cent of the quota, a surcharge of 2 per cent per annum is to be levied. Further, when the outstanding loan amount exceeds 300 per cent of the quota for more than 3 years, a surcharge of 3 per cent per annum will be added. SDR rate that prevailed at the

¹ Based on the information published by the International Monetary Fund.

time of approving SBA facility (i.e., as of 24 July 2009) was 0.3 per cent per annum. Accordingly, the effective interest rate at the time of approving the facility was 1.3 per cent per annum which was significantly lower than the market rates that prevailed.

The key objectives of this facility are to rebuild the external reserves, strengthen the fiscal position, maintain monetary stability and fortify the domestic financial system. Similar to any other country, Sri Lanka too has to observe the programme targets indicated under QPC and policy actions specified under SB. Sri Lanka is required to achieve three QPCs at each test date, scheduled before the disbursement of each tranche. The three QPC are the 'Net International Reserves' (NIR), 'Reserve Money' (RM) of the Central Bank and the 'Net Domestic Financing' (NDF) of the government. Under NIR target, it is expected to strengthen the country's external reserves enabling to meet any unexpected

foreign currency outflows. The main objective under RM target is to maintain an adequate level of liquidity that is required to facilitate the smooth functioning of economic activities, while maintaining inflation at a low and stable level. The purpose of NDF target is to maintain the government's budget deficit at a desirable level. The policy actions associated with SB under the current facility encompasses strengthening the structure of the local financial system, a revitalizing programme on loss making state institutions and designing of the government's policy to be consistent with the overall program objectives. Broadly, all three QPC and SB are set with the objective of attaining macroeconomic and financial sector stability in the Sri Lankan economy. Under the programme, two tranches amounting to US dollars 652 million were received in July and November 2009.

A schedule of IMF facilities obtained by Sri Lanka since 1990 is set out in Table B 9.1.

Table B 9.1

IMF Loans Obtained by Sri Lanka since 1990 (a)

Year	Description	SDR million	
		Amount Approved	Amount Drawn
1991	Poverty Reduction & Growth Facility	336.0	280.0
2001	Stand-by Arrangement (b)	200.0	200.0
2003	Poverty Reduction & Growth Facility (c)	269.0	38.4
2003	Extended Fund Facility	144.4	20.7
2005	Emergency Assistances for Natural Disasters (Tsunami)	103.4	103.4
2009	Stand-by Arrangement	1,653.6	413.4 (d)

(a) Details relating to previous loans obtained from IMF are available in the Box 4.4.1 of the Economic Progress of Independent Sri Lanka, published by Central Bank of Sri Lanka, 1998. Source: Central Bank of Sri Lanka

(b) Details of the facility is available in Box 3 of Central Bank of Sri Lanka Annual Report, 2001.

(c) Details of the facility is available in Box 4 of Central Bank of Sri Lanka Annual Report, 2002.

(d) Includes the two instalments received in 2009.

IMF in November 2009. It is expected that gold holdings will provide a stable and long-term cushion against any potential volatility in major international currencies and financial instruments in international financial markets.

The reserve adequacy as measured by the ratio of gross official reserves to short-term liabilities also increased to 81 per cent by end 2009 from 33 per cent at end 2008 due to greater expansion in reserves over the increase in short-term debt. The absorption of the entire proceeds of foreign inflows to the government securities market by CBSL into official reserves has negated the impact of the

increase in short-term liabilities, thereby facilitating the improvement in the reserve adequacy ratio.

With the expectation of improving investor confidence and stabilising the foreign exchange market, CBSL decided to gradually relax certain restrictions on foreign exchange transactions. Accordingly, with effect from March 11, 2010, CBSL has relaxed certain restrictions on foreign exchange transactions, namely, permitting to open and maintain bank accounts abroad for specified reasons, allowing to enter into forward contracts in foreign currency to cover foreign exchange transactions related to trade in goods and services, remittances and

approved foreign lending and borrowings, removal of margin requirements against advanced payments on the invoice value of selected imports, lifting of the suspension on pre-payment of import bills and permitting of the unification of different investment accounts maintained by non-residents in commercial banks. As announced in the "Road Map 2010", CBSL also plans to relax several other restrictions such as, allowing Sri Lankans to invest in equity or short-term debt instruments in overseas companies, allowing foreigners to invest in rupee denominated debentures issued by local companies, allowing insurance companies to invest a part of their assets of the general

fund or technical reserves in foreign assets, allowing listed companies to enlist in foreign stock exchanges and allowing certain foreign companies to open places of business in Sri Lanka. It is expected that these steps will facilitate greater expansion in economic activities and pave the way to further integrate the Sri Lankan economy with the rest of the world.

5.6 External Debt and Debt Service

External Debt

The total external debt consisting of medium and long-term, and short-term debt of the country increased to 44.5 per cent of GDP in

Table 5.11

Outstanding External Debt and Banking Sector External Liabilities

Item	US dollars million					Rs. million				
	2005	2006	2007	2008	2009(a)	2005	2006	2007	2008	2009(a)
1. Medium and Long-term Debt	10,690	11,347	12,879	13,646	15,564	1,091,644	1,222,175	1,400,883	1,543,952	1,780,313
1.1 Government	9,354	10,245	11,744	12,593	13,769	955,207	1,103,418	1,276,846	1,424,729	1,574,933
1.2 Public Corporations and Private Sector with Government Guarantee	567	465	345	251	110	57,912	50,065	37,501	28,429	12,608
1.3 Public Corporations and Private Sector without Government Guarantee	388	393	539	634	967	39,588	42,376	58,553	71,715	110,570
1.4 IMF Drawings (b)	381	244	251	169	719	38,937	26,316	27,933	19,079	82,201
2. Short-term Debt	664	634	1,111	1,460	3,098	67,759	68,286	120,748	165,207	354,341
2.1 Government (c)	-	-	457	212	1,622	-	-	49,641	24,006	185,534
2.2 Other (d)	664	634	654	1,248	1,476	67,759	68,286	71,107	141,201	168,808
3. Banking Sector External Liabilities	1,666	1,994	2,493	2,669	2,251	170,170	214,802	271,063	301,950	257,575
3.1 Central Bank (e)	1	3	2	1	227	131	284	219	64	26,042
3.2 Commercial Banks (f)	1,388	1,681	2,046	1,861	1,763	141,753	181,040	222,389	210,531	201,696
3.3 ACU Liabilities	277	311	446	808	261	28,286	33,478	48,454	91,355	29,837
4. Total External Debt (1+2)	11,354	11,981	13,989	15,107	18,662	1,159,403	1,290,461	1,521,581	1,709,159	2,134,654
5. Total External Debt and Liabilities (1+2+3)	13,020	13,976	16,483	17,775	20,913	1,329,573	1,505,263	1,792,643	2,011,109	2,392,229
MEMORANDUM ITEMS										
Medium and Long-term Debt										
Project Loans	7,416	9,087	10,002	11,148	11,914	757,262	978,356	1,087,359	1,261,304	1,362,806
Non-Project Loans	1,655	867	1,064	740	708	169,038	93,331	115,697	83,703	81,025
Suppliers' Credits	283	435	679	705	1,146	28,907	46,877	73,790	79,722	131,103
IMF Drawings (b)	381	244	251	169	719	38,937	26,316	27,933	19,079	82,201
Other Loans (g)	955	718	884	885	1,077	97,500	77,295	96,054	100,145	123,178
Short-term Debt and Banking Sector External Liabilities	2,330	2,628	3,604	4,129	5,349	237,929	283,088	391,811	467,157	611,916
As a Percentage of GDP (h)										
Total External Debt	46.5	42.4	43.2	37.1	44.5	47.3	43.9	42.4	38.8	44.2
Total Banking Sector External Liabilities	6.8	7.1	7.7	6.6	5.4	6.9	7.3	7.6	6.8	5.3
Total External Debt and Liabilities	53.3	49.4	51.0	43.7	49.8	54.2	51.2	50.1	45.6	49.6
Short-term Debt	2.7	2.2	3.4	3.6	7.4	2.8	2.3	3.4	3.7	7.3
Short-term Debt and Banking Sector External Liabilities	9.5	9.3	11.1	10.1	12.7	9.7	9.6	10.9	10.6	12.7
As a Percentage of Total Debt and Liabilities										
Short-term Debt	5.1	4.5	6.7	8.2	14.8	5.1	4.5	6.7	8.2	14.8
Short-term Liabilities	12.8	14.3	15.1	15.0	10.8	12.8	14.3	15.1	15.0	10.8
Short-term Debt as a Percentage of Official Reserves (i)	24.3	22.4	31.7	60.8	57.8	24.3	22.4	31.7	60.8	57.8

(a) Provisional

(b) Includes drawings under the International Monetary Fund (IMF) Stand-by Arrangement facility of 2009.

(c) Includes outstanding Treasury bills and bonds issued to non-residents.

(d) Includes Iranian line of credit of the Ceylon Petroleum Corporation and other trade credits.

(e) Includes currency Swaps of US dollars 200 million in 2009.

(f) Foreign liabilities of commercial banks including those of Offshore Banking Units.

(g) Includes long-term loans of public corporations and private sector institutions.

(h) Based on GDP at current market prices published by the Department of Census and Statistics.

(i) Official reserves for 2008 were revised due to a change in the classification of external assets.

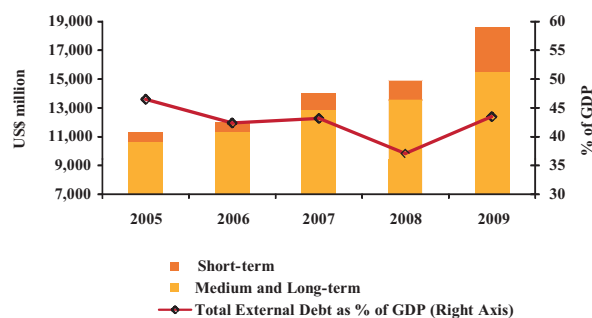
Sources: Central Bank of Sri Lanka
External Resources Department

2009 from 37.1 per cent in 2008. In US dollar terms, the total external debt increased by around 23.5 per cent to US dollars 18,662 million in 2009. Higher foreign inflows to the government securities market, sovereign bond proceeds as well as the disbursements under the IMF-SBA facility during the year resulted in a higher increase in the outstanding external debt in 2009. Of the total external debt outstanding, 36.8 per cent was denominated in SDR, 29.4 per cent in Japanese yen while 21.5 per cent was in US dollars. Though total banking sector external liabilities have declined, the total external debt and liabilities, which consist of total external debt and banking sector external liabilities, increased as a percentage of GDP in 2009 to 49.8 per cent from 43.7 per cent in 2008 owing to the higher external debt inflows indicated above. The banking sector external liabilities have decreased by 15.7 per cent to US dollars 2,251 million by end 2009. Despite the increase in new liabilities due to the currency Swap facility, the substantial decline in ACU liabilities as at end 2009 has resulted in the decline in the overall external liabilities of the banking sector.

The government debt continued to account for a major share of external debt. Of the total

Chart 5.10

External Debt



medium and long-term debt, the government debt accounted for 88.5 per cent, while the remainder represented borrowings of the private sector and public corporations, and debt obligations to IMF. Out of the total government external debt outstanding, the concessional debt accounted for 81 per cent by end 2009 compared to that of 86 per cent recorded in 2008. The elevation of the country to the lower middle income status has reduced the availability of concessional loans from multilateral lending institutions, compelling the government to seek non-concessional loans to finance various development projects.

Table 5.12

External Debt Service Payments

Item	US dollars million					Rs. million				
	2005	2006	2007	2008	2009 (a)	2005	2006	2007	2008	2009 (a)
1. Debt Service Payments	623	1,080	1,232	1,525	1,702	62,577	112,670	136,521	165,511	195,727
1.1 Amortization	419	759	791	1,075	1,346	42,075	79,227	87,731	116,702	154,713
(i) To IMF	39	144	5	77	95	3,902	15,276	789	8,582	10,941
(ii) To Others	380	615	786	998	1,251	38,173	63,952	86,942	108,120	143,772
1.2 Interest Payments	204	321	441	450	357	20,502	33,443	48,790	48,809	41,014
(i) To IMF	10	14	14	11	6	973	1,452	1,509	1,173	644
(ii) To Others	194	307	427	440	351	19,530	31,991	47,281	47,636	40,370
2. Earnings from Export of Goods and Services	7,887	8,508	9,415	10,115	8,977	793,153	885,380	1,041,932	1,095,679	1,031,289
3. Receipts from Export of Goods, Services, Income and Private Transfers	9,891	10,980	12,365	13,001	12,423	994,751	1,142,515	1,368,959	1,408,637	1,427,658
4. Debt Service Ratio (b)										
4.1 As a Percentage of 2 above										
(i) Overall Ratio	7.9	12.7	13.1	15.1	19.0	7.9	12.7	13.1	15.1	19.0
(ii) Excluding IMF Transactions	7.3	10.8	12.9	14.2	17.8	7.3	10.8	12.9	14.2	17.9
4.2 As a Percentage of 3 above										
(i) Overall Ratio	6.3	9.8	10.0	11.7	13.7	6.3	9.9	10.0	11.7	13.7
(ii) Excluding IMF Transactions	5.8	8.4	9.8	11.1	12.9	5.8	8.4	9.8	11.1	12.9
5. Government Debt Service Payments										
5.1 Government Debt Service Payments (c)	268	610	813	1,066	1,166	26,927	63,368	89,924	115,508	134,019
5.2 As a Percentage of 1 above	43.0	56.4	66.0	69.9	68.5	43.0	56.2	65.9	69.8	68.5

(a) Provisional

(b) Debt service ratios calculated in rupee values and US dollar values differ due to variations in exchange rates during the year.

(c) Excludes transactions with the International Monetary Fund (IMF).

Source: Central Bank of Sri Lanka

Foreign Debt Service Payments

Amortisation and interest payments, which constitute the total foreign debt service payments, increased to 19.0 per cent as a percentage of exports of goods and services in 2009 compared to 15.1 per cent in 2008. In US dollar terms, the debt service payments increased by 11.6 per cent in 2009. The final payment under the rescheduled debt obligation due to the moratorium granted after the tsunami was made in November 2009. The increase in debt service payments was mainly due to the repayment of syndicated loans amounting to US dollars 225 million while the effect of the reduction in earnings from exports of merchandise goods and services during the year caused in debt service ratios to increase substantially.

5.7 Exchange Rate Regime and Exchange Rate Movement

The exchange rate policy in 2009 was focused on maintaining the stability in the domestic foreign exchange market, both in the face of significant foreign exchange outflows during the first few months and substantial inflows subsequently. The repatriation of foreign investments in government securities, the settlement of high petroleum bills and the acute drying up of sources of commercial financing during the first four months of the year resulted in a heavy demand for foreign exchange in the domestic market. During this period of the year, the rupee exchange rate against the US dollar moved with greater flexibility while the excessive market volatility was prevented through cautious intervention by CBSL. As a result, the rupee depreciated gradually during the first four months of 2009, to its lowest level of Rs. 120.25 against the US dollar by April 24, 2009.

Large capital inflows following the increased investor confidence after the ending of the conflict caused the gradual appreciation of the rupee. The rupee appreciated to Rs. 114.93 against the US dollar by end May 2009. To mitigate excessive volatility in the foreign exchange market and to ensure that the competitiveness of the export sector

is unaffected by an undue appreciation of the rupee, CBSL absorbed foreign exchange from the domestic foreign exchange market, thereby strengthening its reserves position. Although the exchange rate remained relatively steady at around Rs. 114.80 against the US dollar until end October 2009, as a result of the strong external sector performance during the latter part of 2009 and benefiting from further investments in Treasury bills and bonds, and the issuance of the second sovereign bond of US dollars 500 million, the rupee appreciated further against the US dollar.

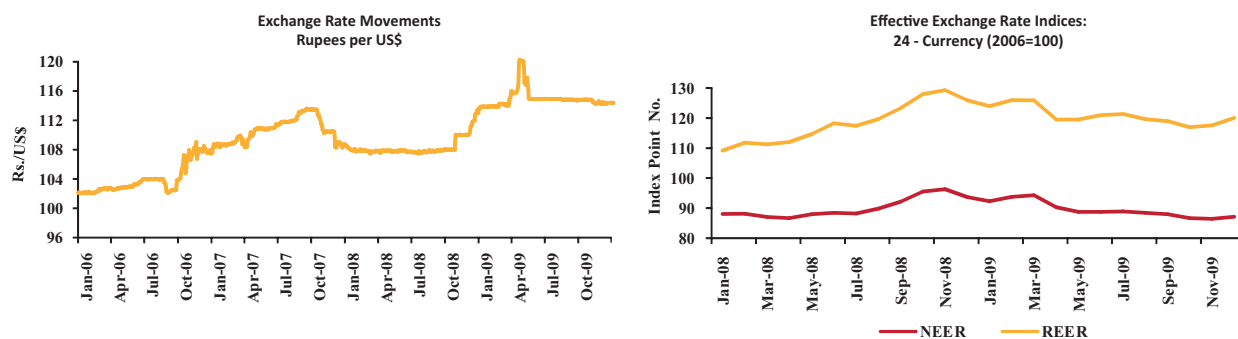
By end 2009, the rupee appreciated to Rs. 114.38 resulting in an overall depreciation of 1.09 per cent against the US dollar when compared to a depreciation of 3.91 per cent in 2008. Meanwhile, the annual average exchange rate in 2009 was Rs. 114.94 against the US dollar when compared with Rs. 108.33 recorded in 2008. During the year, the rupee depreciated against the Euro (2.60 per cent), Indian rupee (4.13 per cent) and the Sterling pound (10.16 per cent), while it appreciated against the Japanese yen (0.89 per cent).

Nominal and Real Effective Exchange Rates

During 2009, both the Nominal Effective Exchange Rate (NEER) and the Real Effective Exchange Rate (REER) depreciated, reversing the appreciating trend observed in 2008. Reflecting a nominal depreciation of the Sri Lanka rupee against most of the major currencies in the currency basket, NEER of the Sri Lanka rupee, based on both the 5-currency and the 24-currency baskets, depreciated during 2009. Meanwhile, REER which takes into account the inflation differentials amongst countries in addition to the variations in nominal exchange rates, too depreciated during 2009, indicating improvement in the competitiveness of Sri Lanka's exports. Although this is a reversal of the appreciating trend observed during the last two years, REER has still not depreciated to the pre-crisis levels. The depreciation of REER could be attributed to the relatively higher reduction of domestic inflation compared to those

Chart 5.11

Exchange Rate Movements



of the trading partners and the appreciation of the exchange rates of competitor currencies against the US dollar while the rupee remained at a depreciated level throughout 2009. Although the computation of REER takes into account the inflation movements of the countries in the currency baskets, it does not however capture other developments such as productivity improvements which increase the export competitiveness.

Developments in the Domestic Foreign Exchange Market

Despite the substantial foreign inflows observed during the second half of the year, the slowdown in external trade resulting from the slowdown in

global demand and the uncertainty that prevailed during the first four months of 2009, resulted in the decrease in the level of activity in the inter-bank foreign exchange market in 2009. Although the market activity picked up towards the latter part in 2009, the total volume of spot transactions decreased to around US dollars 6,335 million during 2009 compared to US dollars 8,660 million recorded in 2008. Following the trend in the spot market, the forward transaction volume declined to US dollars 4,624 million during 2009, compared to US dollars 5,472 million in 2008. The prudential measures that were introduced and tightened in October 2008 to curtail importation of certain categories of vehicles and other selected non-essential items and to

Table 5.13

Exchange Rate Movements

Currency	In Rupees per unit of Foreign Currency						Percentage Change over Previous Year (a)			
	End Year Rate			Annual Average Rate			End Year		Annual Average	
	2007	2008	2009	2007	2008	2009	2008	2009	2008	2009
Euro	160.27	159.45	163.72	151.63	159.32	160.21	0.51	-2.60	-4.82	-0.56
Indian Rupee	2.77	2.36	2.46	2.69	2.52	2.39	17.54	-4.13	6.73	5.52
Japanese Yen	0.97	1.25	1.24	0.94	1.05	1.23	-22.44	0.89	-10.51	-14.60
Pound Sterling	217.15	163.28	181.75	221.46	200.73	179.87	32.99	-10.16	10.33	11.60
US Dollar	108.72	113.14	114.38	110.62	108.33	114.94	-3.91	-1.09	2.11	-5.75
SDR	171.57	174.27	178.67	169.37	171.24	177.22	-1.55	-2.46	-1.10	-3.37

Effective Exchange Rate Indices (b) (c) (2006=100)	Monthly Index						Percentage Change over Previous Year (a)			
	Monthly Index			Annual Average			Monthly Index		Annual Average	
	Dec. 2007	Dec. 2008	Dec. 2009	2007	2008	2009	2008	2009	2008	2009
NEER - 24 currencies	87.79	93.71	87.20	89.23	90.20	89.52	6.74	-6.95	1.09	-0.76
REER - 24 currencies	106.05	125.89	119.61	100.27	118.41	120.85	18.71	-4.98	18.09	2.07

(a) Changes computed on the basis of foreign currency equivalent of Sri Lanka rupees. A minus sign indicates depreciation.

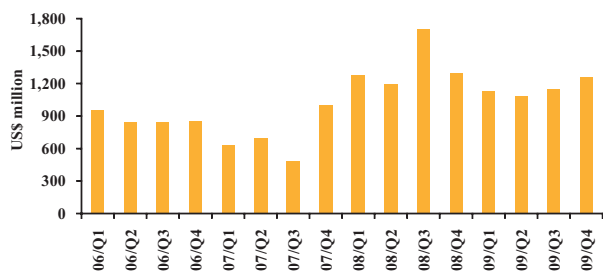
Source: Central Bank of Sri Lanka

(b) The Nominal Effective Exchange Rate (NEER) is a weighted average of nominal exchange rates of 24 trading partner and competitor countries. Weights are based on the trade shares reflecting the relative importance of each currency in each of the currency baskets. The Real Effective Exchange Rate (REER) is computed by adjusting the NEER for inflation differentials with the countries whose currencies are included in the basket. A minus sign indicates depreciation.

(c) CCPI was used for REER computation.

Chart 5.12

Quarterly Inter - Bank Forward Transaction Volumes



prevent speculative trading in the domestic foreign exchange market too have contributed towards this decline. Although these measures were withdrawn in May 2009, the foreign exchange transaction volumes have not increased to the level that prevailed in 2008 due to the low performance in external trade.

During 2009, CBSL intervened in both sides of the foreign exchange market, which helped prevent erratic and undue movements in the exchange rates, to ensure adequate liquidity in the domestic foreign exchange market and to

build official reserves. During the first four months of 2009, CBSL supplied foreign exchange to the domestic foreign exchange market on a net basis to prevent excessive exchange rate volatility as well as to ensure adequate foreign exchange liquidity in the domestic market in view of the repatriation of short-term investments in Treasury bills and bonds and settlement of high valued petroleum bills. During this period, CBSL supplied US dollars 650 million to ease the pressure on foreign exchange transactions. Considering the increase in foreign investments in government securities and inward workers' remittances since the ending of the conflict, CBSL intervention in the foreign exchange market was by way of net absorption of foreign exchange which prevented the rupee from further appreciating against the US dollar during the remaining months of the year. During 2009 CBSL supplied and absorbed US dollars 830 million and US dollars 3,122 million, respectively, to and from the domestic foreign exchange market resulting in a net absorption of US dollars 2,292 million.