5

EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

5.1 Overview

The external sector performed well during 2010, underpinned by the gradual recovery of the global economy, improved international financial market conditions and enhanced investor confidence brought about by the stable domestic macroeconomic environment. External trade rebounded strongly in 2010, reversing the sharp contraction observed in 2009. Supported by the improved investment climate, attractive prices and the gradual recovery of the global economy, the earnings from exports reached a record high, surpassing the previous peak performance in 2008. Despite the withdrawal of the Generalised System of Preferences Plus (GSP+) concessions since August 2010, exports to all major destinations increased. Imports also recovered strongly with significant contributions from consumer and intermediate goods reflecting tariff reductions, higher commodity prices and the strong growth in the domestic economy. As a result, the trade deficit expanded in 2010 subsequent to the sharp contraction in 2009 in view of the lower domestic and global demand. Inward workers' remittances increased substantially and continued to be the foremost foreign exchange earner in 2010. Sri Lanka's travel and tourism industry, which suffered immensely due to the protracted internal conflict, staged a remarkable recovery during the year. The current account deficit in 2010 stood at 2.9 per cent of GDP compared to the 10-year average of 3.5 per cent.

Increased inflows to the financial account supported the Balance of Payments (BOP) to record a significantly high surplus. Sri Lanka's graduation to 'middle-income' economy status by the International Monetary Fund (IMF) in January 2010, from the previously listed category of Poverty Reduction and Growth Trust (PRGT) eligible countries, enabled the country to project itself strongly in international financial markets. The continuation of IMF Stand-By Arrangement (SBA) facility helped strengthen the already positive investor sentiment to a greater extent. Moreover, the

Chart 5.1 Balance of Payments

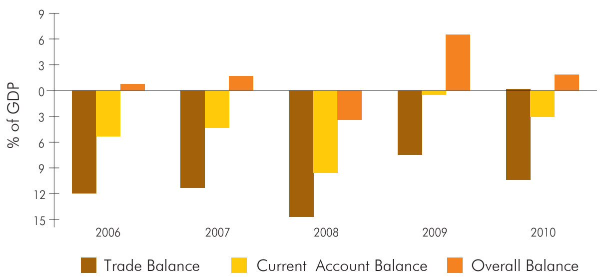
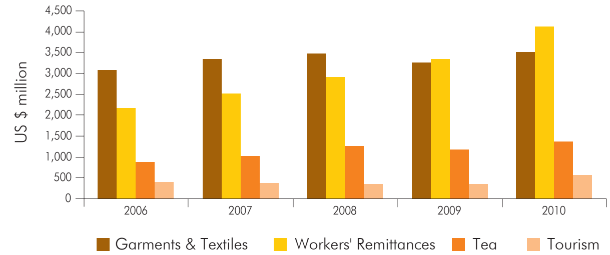


Chart 5.2 Major Sources of Foreign Exchange Earnings



international rating agencies raised their ratings of Sri Lanka. The third international sovereign bond issued in October 2010 was oversubscribed by more than 6 times, and the interest rate was substantially lower, compared to previous issues. Owing to these favourable developments, coupled with long-term capital flows to the government and the private sector, the BOP recorded a surplus of US dollars 921 million by end December 2010, while the gross official reserves (excluding the receipts of the Asian Clearing Union-ACU) reached US dollars 6,610 million, which was equivalent to 5.9 months of imports.

Exchange rate policy in 2010 focused on maintaining stability in the domestic foreign exchange market. The rupee continued to appreciate gradually against the US dollar in the face of significant inflows during the first nine months of the year. The Central Bank purchased foreign exchange from the domestic foreign exchange market to avoid excessive rupee appreciation, and to build up reserves. However, in the last quarter of 2010, the Central Bank supplied foreign exchange to the domestic foreign exchange market, to ensure adequate foreign exchange liquidity in the face of large outflows arising from the settlement of petroleum bills.

The external sector is expected to strengthen further in 2011 with the gradual recovery in the global economy and improved growth prospects of the domestic economy. Several measures were taken towards diversifying the export product portfolio and markets, by focusing more on value added and finished goods, penetrating into emerging markets and strengthening international trade ties. Further, measures were taken to promote tourism and foreign employment, which would attract more foreign exchange into the economy. Precautionary measures need to be in place to maintain resilience of the BOP to any external shock that could emanate from unanticipated commodity price fluctuations and volatility in short-term financial flows. These measures should focus on attracting long-term capital flows, particularly, Foreign Direct Investments (FDI) and non-debt creating financial flows in the context of gradual improvements of macroeconomic conditions. Towards this end, the recent moves announced by the Central Bank to implement major relaxations of foreign exchange controls would help promote financial openness, thereby attracting more financing and investments for the private sector and enhancing the overall competitiveness of the economy.

5.2 External Sector Policies and Institutional Support

External sector policies in 2010 focused on promoting trade through diversifying its export product base and markets. Sri Lanka's potential to achieve its policy targets was demonstrated by the commendations received from the 153 countries at the World Trade Organisation (WTO) during the Third Trade Policy Review of Sri Lanka in 2010 for the efforts taken to double per capita GDP despite the protracted internal strife and the global economic crisis. Continuing the drive towards rapid economic growth, the government took decisive steps to encourage exports of value added and finished goods and to minimise the adverse impact of supply constraints and price increases in international markets on the domestic market.

Table 5.1 Balance of Payments Analytical Presentation (a)

Item	US dollars million					Rs. million				
	2006	2007	2008	2009	2010 (b)	2006	2007	2008	2009	2010 (b)
Trade Balance	**-3,370**	**-3,657**	**-5,981**	**-3,122**	**-5,205**	**-350,110**	**-404,703**	**-647,207**	**-358,707**	**-588,867**
Exports	6,883	7,640	8,111	7,085	8,307	716,579	845,683	878,499	813,911	937,737
Imports	10,253	11,296	14,091	10,207	13,512	1,066,689	1,250,386	1,525,705	1,172,618	1,526,604
Services (net)	257	302	401	391	698	26,660	33,357	43,557	44,780	78,760
Receipts	1,625	1,775	2,004	1,892	2,468	168,802	196,249	217,180	217,378	278,959
Payments	1,368	1,472	1,603	1,501	1,770	142,142	162,892	173,623	172,598	200,199
Income (net)	-389	-358	-972	-488	-572	-40,424	-39,054	-105,032	-55,814	-64,650
Receipts	311	449	-32	116	323	32,457	50,213	-3,133	13,551	36,508
Payments	700	807	940	603	895	72,881	89,267	101,899	69,365	101,158
Goods, Services and Income (net)	**-3,503**	**-3,712**	**-6,552**	**-3,219**	**-5,079**	**-363,874**	**-410,401**	**-708,681**	**-369,740**	**-574,757**
Current Transfers (net)	**2,004**	**2,311**	**2,666**	**3,005**	**3,660**	**208,385**	**255,684**	**288,639**	**345,498**	**413,885**
Private Transfers (net)	1,904	2,214	2,565	2,927	3,608	197,861	245,006	277,711	336,578	407,967
Receipts	2,161	2,502	2,918	3,330	4,116	224,678	276,814	316,091	382,818	465,166
Payments	257	288	353	403	508	26,817	31,808	38,380	46,240	57,199
Official Transfers (net)	101	97	101	77	52	10,524	10,677	10,928	8,920	5,918
Current Account	**-1,499**	**-1,402**	**-3,886**	**-214**	**-1,418**	**-155,489**	**-154,717**	**-420,042**	**-24,242**	**-160,872**
Capital and Financial Account	**1,808**	**2,097**	**1,773**	**2,594**	**2,876**	**190,768**	**230,978**	**193,713**	**299,381**	**322,022**
Capital Account	**291**	**269**	**291**	**233**	**164**	**30,292**	**29,669**	**31,456**	**26,832**	**18,521**
Capital Transfers (net)	291	269	291	233	164	30,292	29,669	31,456	26,832	18,521
Receipts	299	278	303	247	182	31,171	30,735	32,774	28,465	20,599
Payments	8	10	12	14	19	879	1,066	1,319	1,633	2,078
Financial Account	**1,517**	**1,828**	**1,483**	**2,361**	**2,713**	**160,477**	**201,309**	**162,258**	**272,550**	**303,501**
Long-term:	907	1,251	1,016	1,304	2,379	95,089	140,054	109,174	149,772	268,214
Direct Investment	451	548	691	384	435	46,985	60,768	74,837	44,112	49,008
Foreign Direct Investment (net)	451	548	691	384	435	46,985	60,768	74,837	44,112	49,008
Private Long-term (net)	-35	31	74	79	149	-3,590	3,314	7,768	9,105	17,555
Inflows	139	199	265	390	580	14,469	22,033	28,693	44,795	65,934
Outflows	174	168	191	311	431	18,058	18,719	20,925	35,691	48,379
Government, Long-term (net)	491	672	252	840	1,796	51,694	75,971	26,568	96,555	201,650
Inflows	932	1,290	1,059	1,780	2,460	97,690	144,146	114,658	204,435	276,582
Outflows	441	618	807	940	665	45,996	68,175	88,090	107,880	74,932
Short-term:	610	577	466	1,058	334	65,387	61,256	53,084	122,777	35,287
Portfolio Investment (net)	51	101	60	-6	-230	5,377	11,249	6,460	-785	-26,010
Private Short-term (net)	-30	20	594	228	-1,032	-3,066	1,868	63,987	26,108	-116,655
Commercial Bank Assets (net)	297	-281	210	-435	249	23,789	-31,352	17,889	-51,298	33,343
Commercial Bank Liabilities (net)	293	364	-185	-98	815	39,287	38,746	-11,858	-8,836	84,356
Government Short-term (net)	-	372	-213	1,369	531	-	40,744	-23,395	157,588	60,252
Allocation of SDRs (c)	-	-	-	508	-	-	-	-	58,353	-
Valuation Adjustments	-	-	-	-	-	-	-	-	-	-
Errors and Omissions	-105	-165	728	346	-537	-1,756	-16,259	80,534	40,082	-73,176
Overall Balance (d)	**204**	**531**	**-1,385**	**2,725**	**921**	**33,523**	**60,002**	**-145,795**	**315,221**	**87,974**
Monetary Movements (d)	-204	-531	1,385	-2,725	-921	-33,523	-60,002	145,795	-315,221	-87,974
Annual Average Exchange Rate Rs./US$						**103.96**	**110.62**	**108.33**	**114.94**	**113.06**
Ratio to GDP in Percentages (e)										
Trade Account	-11.9	-11.3	-14.7	-7.4	-10.5	-11.9	-11.3	-14.7	-7.4	-10.5
Current Account	-5.3	-4.3	-9.5	-0.5	-2.9	-5.3	-4.3	-9.5	-0.5	-2.9
Current Account without Grants	-5.7	-4.6	-9.8	-0.7	-3.0	-5.7	-4.6	-9.8	-0.7	-3.0

(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.

Source: Central Bank of Sri Lanka

(b) Provisional

(c) General and special allocations of Special Drawings Rights (SDRs) by the IMF.

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

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

Table 5.2 Average Import Duty Collection Rate (a)

percentage (%)

Item	2006	2007	2008	2009	2010 (b)
Consumer Goods	**11.2**	**12.4**	**12.6**	**19.4**	**12.6**
Food and beverages	10.7	13.5	14.8	26.8	12.1
Rice	23.4	3.1	3.1	5.4	2.1
Flour	33.7	31.9	22.6	22.6	40.8
Sugar	1.9	23.9	32.8	26.5	4.0
Wheat and Meslin	5.6	6.3	6.7	32.2	12.4
Milk and Milk products	9.6	7.7	2.0	29.2	6.4
Dried Fish	5.0	2.9	9.4	10.9	12.2
Other Fish Products	7.8	4.9	8.7	18.3	25.0
Other	24.2	20.8	24.2	27.2	19.6
Non-Food Consumer Goods	11.7	11.2	8.4	6.7	13.3
Motor Cars & Cycles	18.3	16.3	7.7	6.2	18.4
Radio Receivers - Television Sets	7.1	7.7	6.3	7.1	20.0
Rubber Tyres & Tubes	19.2	22.4	19.2	20.1	21.6
Pharmaceutical Products	0.3	0.4	0.4	0.4	0.3
Other	10.3	10.6	13.0	8.6	9.7
Intermediate Goods	**1.5**	**1.5**	**2.2**	**5.0**	**1.7**
Fertiliser	2.5	2.7	2.5	2.5	1.0
Crude Oil	0.0	0.0	0.0	0.0	0.0
Other Petroleum Products	2.3	1.6	4.7	19.0	3.2
Chemical Elements and Compounds	1.8	1.9	1.8	1.9	1.1
Dyeing,Tanning and Colouring	2.6	2.5	2.1	2.1	2.1
Paper and Paper Boards	2.4	2.2	2.0	2.1	1.8
Textiles	0.1	0.1	0.2	0.2	0.1
Other Intermediate Goods	3.3	3.3	2.9	4.9	3.2
Investment Goods	**5.2**	**4.8**	**5.3**	**4.4**	**4.8**
Building Materials	9.2	7.2	7.2	8.2	5.9
Transport Equipment	7.0	7.1	7.1	3.7	7.6
Machinery and Equipment	3.2	2.7	3.1	2.5	2.8
Other Investment Goods	3.4	4.2	3.9	3.3	4.0
Average Import Duty Collection Rate	**4.3**	**4.1**	**4.6**	**7.8**	**5.0**

(a) Actual import duty collection (including Special Commodity Levy wherever applicable) as a percentage of total imports (c.i.f. values).
(b) Provisional

Source: Sri Lanka Customs

The main trade policy instrument since 2004, the five band customs duty structure was simplified. The tariff bands of 0, 2.5, 6, 15 and 28 per cent, were reduced to a four band customs duty structure of 0, 5, 15, and 30 per cent, with effect from 1 June 2010. This revision was congruent to the overall policy stance of supporting local industries to increase production for export and domestic markets. The 2.5 per cent customs duty of the earlier five band structure, which was mostly applicable on importation of raw materials and machinery, was abolished and these items were placed at the zero band. Intermediate and finished goods were placed on the middle and upper rates of 5, 15 and 30 per cent. The average import duty rate, calculated based on total imports and customs duties, decreased to 5.0 per cent in 2010 from 7.8 per cent in 2009.

Import tariffs were substantially revised to mitigate the impact of external supply shortfalls on consumers, promote trade and support small and medium industries. The customs duty and Special Commodity Levy (SCL) applicable on selected consumer and intermediate goods such as petrol, diesel, milk powder, maize, palm oil, wheat grain, malt extract and PVC leather cloths, were reduced to stabilise price fluctuations in the domestic economy. Customs duties on the import of gold were also removed with effect from 1 March 2010. It is envisaged that this will facilitate more imports through formal channels and boost jewellery manufacturing and exports. The 15 per cent surcharge on customs duty payable on imported goods, was removed with effect from 1 June 2010, while import duties on motor vehicles were reduced by 50 per cent. In order to promote Sri Lanka as an attractive shopping destination and improve the living standards of the people, import duties on electronic goods and internationally branded products, such as mobile phones, wristwatches and cameras were reduced by 90 per cent.

The Budget 2011 supported the efforts to move towards the export of value added and finished goods from the traditional primary products. Accordingly, a Cess was imposed on all exports of raw and semi-processed items while exports of finished goods were exempted. Further, duties and taxes on machinery, equipment and raw materials were reduced to enable enterprises to have more affordable access to world class technologies and thereby increase domestic production. Income tax was reduced from 15 per cent to 10 per cent for industries with domestic value addition in excess of 65 per cent and Sri Lankan brand names with patent rights reserved in Sri Lanka. Several tariff concessions were granted to promote export industries such as gem and jewellery, apparel, leather and footwear. Further, in a move to encourage exports in general, income tax applicable on all export companies was reduced from 15 per cent to 12 per cent.

Trade promotion activities were targeted at improving both, demand and supply side issues that were hindering the rapid growth of trade. Integrated supply chain development programmes which focus on improving stakeholder coordination and all stages of the export process were initiated by the Export Development Board (EDB) for key agricultural and industrial exports and professional services. Further, the EDB continued the Simplified Value Added Tax scheme (SVAT) which helps reduce cash flow difficulties of non-apparel sector exporters, generating an estimated benefit of Rs. 18 billion to 740 registered direct and indirect exporters. The National Gem and Jewellery Authority (NGJA) embarked on a three pronged strategy in 2010, comprising of supply and demand development and capacity building, to achieve the export target of US dollars 1 billion by year 2016 for gem and jewellery. This is supported by the Budget 2011 proposal to increase the foreign exchange allowances for imports of raw gem stones from US dollars 10,000 to US dollars 50,000 per person with effect from November 2010.

Sri Lanka continued strengthening its trade ties by actively engaging in negotiations at multilateral, regional and bilateral levels. At the multilateral level, Sri Lanka continued its active engagement in the current negotiations of the Doha

Table 5.3 Trade Indices (a)

1997=100

Category	2009			2010 (b)			Growth Rate (b)		
	Value Index	Volume Index	Unit Price Index	Value Index	Volume Index	Unit Price Index	Value Index	Volume Index	Unit Price Index
EXPORTS									
Agricultural Exports	159.1	122.7	129.7	192.2	134.5	142.8	20.8	9.7	10.1
Tea	164.4	114.8	143.2	190.8	127.9	149.1	16.1	11.4	4.2
Rubber	125.4	89.0	140.9	216.6	83.8	258.4	72.8	-5.8	83.3
Coconut	141.3	119.2	118.6	147.6	104.1	141.8	4.4	-12.7	19.6
Other Agricultural Exports	165.8	182.8	90.7	222.0	219.5	101.1	33.9	20.1	11.5
Industrial Exports	154.1	139.7	110.3	179.3	146.3	122.6	16.3	4.7	11.2
Textiles and Garments	143.7	148.4	96.8	153.7	141.6	108.6	7.0	-4.6	12.2
Petroleum Products	138.4	55.0	251.4	222.1	68.2	325.7	60.5	23.9	29.6
Other Industrial Exports	177.8	129.0	137.9	230.0	163.4	140.8	29.3	26.7	2.1
Mineral Exports	99.3	122.4	81.1	103.7	126.1	82.2	4.4	3.0	1.4
Gems	83.0	111.8	74.2	84.6	114.7	73.8	1.9	2.6	-0.6
Other Mineral Exports	314.1	262.1	119.8	354.4	276.1	128.4	12.8	5.3	7.1
Total Exports	152.4	135.4	112.5	178.7	143.2	124.9	17.3	5.7	10.9
IMPORTS									
Consumer Goods	158.0	185.2	85.3	241.1	223.3	108.0	52.6	20.6	26.5
Food and Beverages	153.8	140.7	109.3	215.7	157.3	137.1	40.3	11.8	25.5
Other Consumer Goods	164.2	249.7	65.8	278.0	319.2	87.1	69.3	27.8	32.4
Intermediate Goods	183.2	133.0	137.8	239.6	150.2	159.5	30.8	13.0	15.8
Fertiliser	291.4	135.8	214.7	362.3	160.5	225.7	24.3	18.2	5.1
Crude Oil	368.2	114.1	322.7	402.6	100.3	401.4	9.4	-12.1	24.4
Other Petroleum	433.6	128.3	337.9	710.1	182.4	389.2	63.7	42.2	15.2
Chemical Elements and Compounds	229.8	176.6	130.1	286.7	199.6	143.6	24.8	13.0	10.4
Wheat and Meslin	188.2	130.0	144.7	186.7	132.6	140.8	-0.8	2.0	-2.7
Textiles (Including Clothing)	104.0	132.5	78.5	124.9	131.7	94.8	20.1	-0.6	20.8
Plastics	131.9	120.2	109.7	190.8	158.1	120.7	44.6	31.5	10.0
Diamonds	195.7	96.9	201.9	206.2	93.8	219.9	5.4	-3.3	8.9
Other Intermediate Goods	160.2	181.4	88.3	217.5	237.2	91.7	35.8	30.7	3.9
Investment Goods	184.8	202.9	91.1	223.9	217.8	102.8	21.2	7.3	12.9
Building Materials	262.9	186.9	140.7	297.9	183.9	162.0	13.3	-1.6	15.2
Transport Equipment	209.7	98.0	214.0	308.6	109.4	282.0	47.2	11.7	31.8
Machinery and Equipment	136.2	243.9	55.9	162.2	267.6	60.6	19.1	9.7	8.5
Other Investment Goods	279.1	161.7	172.6	303.0	166.5	182.0	8.6	2.9	5.5
Total Imports	174.0	159.4	109.1	230.4	180.1	127.9	32.4	13.0	17.2
Terms of Trade			103.1			97.6			-5.3

(a) In terms of US dollars
(b) Provisional

Sources: Sri Lanka Customs
Central Bank of Sri Lanka

Development Round in the World Trade Organisation (WTO), which members committed to conclude in 2011. Negotiations were held on agriculture and Non-Agricultural Market Access (NAMA), aimed at ensuring flexibilities for Sri Lanka as a Net-Food Importing Developing Country (NFIDC) and improved market access through lowering of high tariffs prevalent in key markets for main exports, particularly in the garments and fisheries sectors. With regard to NAMA, Sri Lanka remained exempted from having to undertake tariff reduction commitments. Increased protection for geographical indications, traditional knowledge and biodiversity resources were negotiated under Trade Related aspects of Intellectual Property Rights (TRIPS). Sri Lanka continued to participate in negotiations on a new Agreement on Trade Facilitation (ATF), aimed at harmonising customs and other trade facilitation procedures and regulations. The third round of the Global System of Trade Preferences (GSTP) initiated to increase South–South Trade and Economic Cooperation, concluded in 2010 with the signing of the Sao Paulo Round Protocol. However, due to the similarities in the current structure of exports, many developing countries are effectively competitors. Further, since many countries have regional or bilateral trade agreements with major trading partners in the GSTP, they already enjoy lower tariffs than offered under the GSTP. Thus, only 22 members out of 43 members have shown interest in engaging in on-going negotiations. Sri Lanka engaged in advancing its interests in the rules of origin negotiations in the third round and is currently reviewing the option to join the Protocol.

Sri Lanka's exports remained resilient despite the withdrawal of the GSP+ scheme. On 15 February 2010, EU member states announced the temporary withdrawal of preferential tariff benefits that Sri Lanka received under the GSP+ scheme. Sri Lankan authorities were engaged in a dialogue with the European Commission relating to the suspension of the scheme since February 2010. However, the EU withdrew the concessions with effect from 15 August 2010, resulting in exporters accessing the EU market under the general GSP scheme, which is nevertheless below the Most Favoured Nation (MFN) rates. The focused, long-term preparations to face global competition sans GSP+ benefits, such as firm level actions taken towards differentiating and diversifying products as well as markets, improving the quality of products, branding products, negotiating with buyers, enhancing productivity and reducing finance and input costs together with, changes in global supply and improving macroeconomic conditions ensured a relatively smooth transition for exports from GSP+ access to general GSP access. As a result, Sri Lankan exporters were able to record higher than projected earnings from key export industries.

Asia-Pacific Trade Agreement (APTA), which is the only trade agreement that links Sri Lanka to East Asia, reaped expected results as trade, especially exports to China and South Korea, increased due to the preferential access it provided. It is important to increase the utilisation of this agreement as it will provide preferential market access at 40 per cent margin of preference (MOP) on 40 per cent of the tariff lines, to emerging markets such as China, India and South Korea upon the full implementation of the fourth round of negotiations. Sri Lanka is however exempted from making the above commitments along with the least developed countries (LDCs) as it is a smaller trading nation compared to China, India and South Korea. Given that APTA is the only trade agreement that jointly links Sri Lanka with foremost emerging economies, there is immense potential for it to expand trade with these large markets which have rapidly growing buying power.

The first phase of reducing negative lists and customs duties under the trade liberalisation programme under the South Asian Free Trade Agreement (SAFTA) was implemented with effect from November 2010. Negotiations on the reduction of negative lists by 20 per cent by each member continued and Sri Lanka will reduce customs duties to 0 – 5 per cent in six equal instalments by 2014 for products from the other member states. However, utilisation of the SAFTA and South Asian Preferential Trade Agreement

(SAPTA) has been slow as Sri Lanka's foremost regional trading partners, India and Pakistan, trade mainly under separate bilateral agreements with Sri Lanka. Supporting the significant increase in trade in services, the South Asian Association for Regional Co-operation (SAARC) Framework Agreement on Trade in Services was signed at the 16th SAARC Summit in April 2010. Sri Lanka, India and Bangladesh have already ratified the agreement. Negotiations on the schedules of commitments under the agreement are expected to begin to enable its implementation.

Trade under bilateral agreements demonstrated a significant improvement in 2010. Trade with India and thus, under the India-Sri Lanka Free Trade Agreement (ISFTA), recovered considerably after a decline in 2009 due to the impact of the global economic slowdown. Interest in the Pakistan-Sri Lanka Free Trade Agreement (PSFTA), which came into force in 2005, is gradually gaining momentum as exporters in both countries have identified its potential. In order to strengthen the present bilateral economic relations with India and Pakistan, Sri Lanka is in the process of negotiating Comprehensive Economic Partnership Agreements (CEPA) with both countries. In addition to trade in goods, the CEPA framework encompasses trade in services, investment and economic cooperation.

As Sri Lanka is a member of several trade agreements, it is important to consider if access gained is fully utilised and advanced. Lack of knowledge regarding access provided and benefits to exporters and importers stands as a key obstacle to widening the usage of tariff concessions and liberalised trade between trading partners. Thus, extensive and comprehensive awareness programmes regarding the opportunities created by these agreements must be implemented in all member countries. This would be beneficial as international trade would enable people to consume better quality products and services at lower prices and increase export earnings which will, in turn, raise the standards of living in member countries.

5.3 Trade in Goods, Trade Balance and Terms of Trade

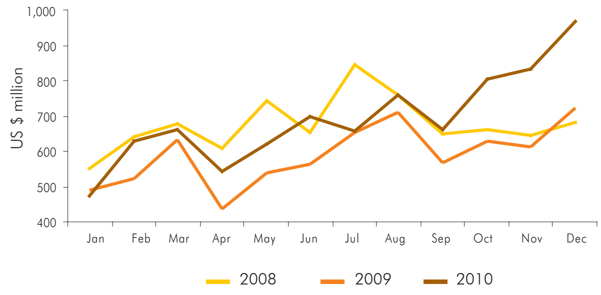
Export Performance

Earnings from exports increased by 17.3 per cent to US dollars 8,307 million in 2010 compared to that of 2009. External trade, which was affected by the global economic crisis in 2009, rebounded strongly during 2010 with the better investment climate, attractive prices, gradual recovery in external demand and the removal of the marine war risk premium on re-insurance. Although earnings were relatively low during the early part of the year amidst the slow global recovery, it recovered strongly towards the latter part of the year. The largest contribution to the growth in earnings came from industrial exports (70.9 per cent), followed by the agricultural exports (28.7 per cent).

Earnings from industrial exports increased by 16.4 per cent to US dollars 6,173 million in 2010, reflecting growth in all sub-sectors, mainly due to the recovery of global demand. The largest contribution to the growth in industrial exports came from textiles and garments, rubber products and machinery and equipment. Earnings from exports of food and beverages, and petroleum products also performed well.

Earnings from textile and garments exports amounted to US dollars 3,504 million in 2010, reflecting a 7.0 per cent growth during the year, and accounted for nearly 42 per cent of total export proceeds. In view of the impending withdrawal of the GSP+ benefits, many

Chart 5.3 Export Performance



EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

5

Table 5.4 Composition of Exports

Category	2009 Value US dollars million	2009 Share %	2010 (a) Value US dollars million	2010 (a) Share %	Change in Value (a) US dollars million	Growth Rate (a) %	Contribution to Growth (a) %
Agricultural Exports	**1,690.3**	**23.9**	**2,041.4**	**24.6**	**351.1**	**20.8**	**28.7**
Tea	1,185.1	16.7	1,375.4	16.6	190.3	16.1	15.6
Rubber	98.6	1.4	170.4	2.1	71.8	72.8	5.9
Coconut	166.2	2.4	173.6	2.1	7.4	4.4	0.6
Kernel Products	58.2	0.8	55.4	0.7	-2.8	-4.7	-0.2
Other	108.0	1.5	118.2	1.4	10.1	9.4	0.8
Other Agricultural Products	240.4	3.4	322.0	3.9	81.6	33.9	6.7
Industrial Exports	**5,305.4**	**74.9**	**6,172.8**	**74.3**	**867.3**	**16.4**	**70.9**
Food, Beverages and Tobacco	406.1	5.7	503.4	6.1	97.3	24.0	8.0
Textiles and Garments	3,274.2	46.2	3,504.1	42.2	229.9	7.0	18.8
Petroleum Products	134.7	1.9	216.3	2.6	81.5	60.5	6.7
Rubber Products	384.7	5.4	567.6	6.8	182.9	47.5	15.0
Ceramic Products	36.4	0.5	39.1	0.5	2.7	7.3	0.2
Leather, Travel Goods and Footwear	13.6	0.2	17.1	0.2	3.6	26.3	0.3
Machinery and Equipment	330.3	4.7	487.8	5.9	157.5	47.7	12.9
Diamond and Jewellery	329.8	4.7	334.7	4.0	4.9	1.5	0.4
Other Industrial Exports	395.6	5.6	502.7	6.1	107.1	27.1	8.8
Mineral Exports	**88.7**	**1.3**	**92.6**	**1.1**	**3.9**	**4.4**	**0.3**
Gems	68.9	1.0	70.3	0.9	1.3	1.9	0.1
Other Mineral Exports	19.8	0.3	22.4	0.3	2.6	12.8	0.2
Unclassified	**0.0**	**0.0**	**0.3**	**0.0**	**0.2**	**...**	**0.0**
Total exports (b)(c)	**7,084.5**	**100.0**	**8,307.0**	**100.0**	**1,222.5**	**17.3**	**100.0**
Annual Average Exchange Rate (d)	114.94		113.06				

(a) Provisional
(b) Excludes re-exports
(c) Adjusted
(d) Rs. / US dollar exchange rate

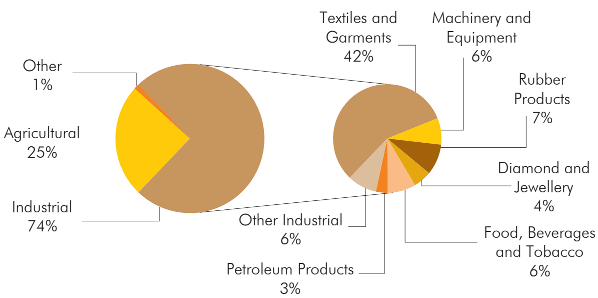
Sources: Sri Lanka Customs
Ceylon Petroleum Corporation and Other Exporters of Petroleum
National Gem and Jewellery Authority
Central Bank of Sri Lanka

manufacturers improved the quality of their products and enhanced productivity enabling them to face the new competition. They achieved higher levels of value addition by incorporating design aspects into the production process, focusing on branded products and catering to the high end customers. As a result, garments exports to EU, which constituted approximately 50.7 per cent of total apparel exports, increased by 3.0 per cent to US dollars 1,678 million in 2010. Garments exports to USA, Sri Lanka's second largest market, increased by 5.5 per cent to US dollars 1,356 million in 2010.

Earnings from other categories of industrial exports such as rubber products, food, beverages and tobacco, machinery and equipment, and diamonds and jewellery increased during 2010. Rubber product exports increased by 47.5 per cent in 2010 to US dollars 568 million and consisted mainly of solid tyres and rubber gloves. Earnings from exports of food, beverages and tobacco category increased by 24.0 per cent to US dollars 503 million, in 2010, which comprised mainly of fish (US dollars 163 million), animal fodder (US dollars 76 million) and processed fruits and vegetables (US dollars 30 million). Machinery and equipment exports, which comprised mainly of transport equipment such as boats and bicycles, and electrical equipment such as transformers, static converters, inductors and insulated cables increased by 47.7 per cent to US dollars 488 million in 2010. Exports of processed diamonds and jewellery increased by 1.5 per cent to US dollars 335 million in 2010. Earnings from mineral exports increased by 4.4 per cent in 2010 to US dollars 93 million led by precious and semi-precious stones.

Earnings from agricultural exports increased by 20.8 per cent to US dollars 2,041 million in 2010 mainly due to the high prices that prevailed in the international market throughout the year. The contribution of tea exports to total export growth was 15.6 per cent followed by minor agricultural products (6.7 per cent), rubber (5.9 per cent) and coconut (0.6 per cent).

Chart 5.4 Exports by Commodities - 2010



Earnings from tea exports increased by 16.1 per cent to US dollars 1,375 million, due to both the increased volumes and high prices. Ceylon tea continued to fetch the highest prices in the major auction centres of the world in 2010 mainly due to the fine quality of Ceylon tea and the high international demand for orthodox tea. The average export price of tea rose by 7.0 per cent to US dollars 4.38 per kg in 2010. There was a shortage of black tea in the international market due to drought conditions and high local consumption in other major tea producing countries. However, in Sri Lanka, tea production surpassed historically high levels in 2010, owing to overall good weather, timely application of fertiliser and good agricultural practices. As a result, export volume of tea increased by 8.5 per cent to 314 million kg in 2010. Sri Lanka remained the third largest tea exporter in the world after Kenya and China. The Middle Eastern countries and the Commonwealth of Independent States (CIS) continued to be major destinations for Ceylon tea exports in 2010. To encourage high value added tea exports, government increased the Cess on bulk tea to Rs.10 per kg with effect from 23 November 2010.

Earnings from minor agricultural exports, rubber, and coconut showed a healthy growth in 2010. Earnings from minor agricultural exports grew by 33.9 per cent to US dollars 322 million in 2010 due to higher international prices fetched by cocoa products, cardomons and essential oil and increased export volumes of sesame seeds, cocoa products and pepper. Increased export earnings of certain spices, such as cloves, nutmeg and mace, were due to both, higher volumes and prices. Earnings from rubber exports increased significantly by 72.8 per cent in 2010 to US dollars 170 million. Lower production in major natural rubber producing countries due to adverse weather conditions and higher demand for natural rubber from China and India exerted upward pressure on rubber prices throughout the year. As a result, export prices of rubber reached historically high levels in 2010. The average export price of rubber increased by 87.9 per cent to US dollars 3.31 per kg in 2010. Despite the higher export prices, export volume of rubber decreased by 8.1 per cent in 2010 since most of the rubber production was absorbed by domestic industries to produce value added exports. To encourage value added rubber exports, the government increased the Cess on the export of raw rubber from Rs. 4 per kg to Rs. 8 per kg with effect from 23 November 2010. Earnings from coconut exports increased by 4.4 per cent to US dollars 174 million in 2010 due to the high values fetched by coconut based products such as coconut oil and coir fibre products.

Import Performance

Expenditure on imports grew by 32.4 per cent, year-on-year, to US dollars 13,512 million in 2010 compared to US dollars 10,207 million in 2009, reflecting the high international commodity prices and increased import volumes led by the upsurge in domestic economic activities. All major categories of imports, consumer, intermediate and investment goods increased during the year. The largest contribution to the growth in imports of 55.3 per cent came from intermediate goods while the contributions from consumer goods and investment goods were 27.2 per cent and 15.7 per cent, respectively.

Chart 5.5 Import Performance

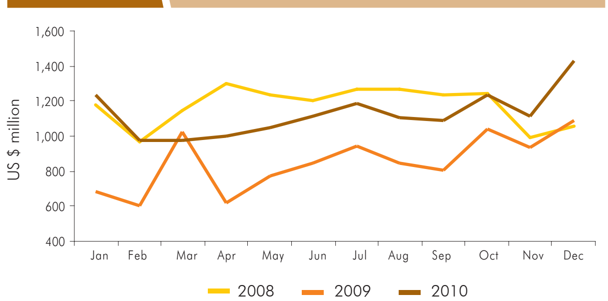


Table 5.5 Composition of Imports

Category	2009 Value US dollars million	2009 Share %	2010 (a) Value US dollars million	2010 (a) Share %	Change in Value (a) US dollars million	Growth Rate (a) %	Contribution to Growth (a) %
Consumer Goods	**1,971.8**	**19.3**	**2,870.3**	**21.2**	**898.5**	**45.6**	**27.2**
Food and Beverages	1,246.2	12.2	1,641.8	12.2	395.6	31.7	12.0
Rice	22.9	0.2	59.0	0.4	36.1	158.1	1.1
Sugar	218.7	2.1	363.3	2.7	144.6	66.1	4.4
Wheat	259.3	2.5	257.2	1.9	-2.0	-0.8	-0.1
Other	745.4	7.3	962.3	7.1	217.0	29.1	6.6
Other Consumer Goods	725.6	7.1	1,228.5	9.1	502.9	69.3	15.2
Intermediate Goods	**5,669.2**	**55.5**	**7,495.9**	**55.5**	**1,826.7**	**32.2**	**55.3**
Petroleum	2,166.6	21.2	3,018.7	22.3	852.1	39.3	25.8
Fertiliser	193.4	1.9	240.5	1.8	47.1	24.3	1.4
Chemicals	312.5	3.1	389.9	2.9	77.4	24.8	2.3
Textiles and Clothing	1,442.0	14.1	1,732.3	12.8	290.3	20.1	8.8
Other Intermediate Goods	1,554.7	15.2	2,114.5	15.6	559.9	36.0	16.9
Investment Goods	**2,450.8**	**24.0**	**2,969.6**	**22.0**	**518.7**	**21.2**	**15.7**
Machinery and Equipment	1,012.8	9.9	1,205.9	8.9	193.1	19.1	5.8
Transport Equipment	436.3	4.3	642.2	4.8	205.9	47.2	6.2
Building Materials	714.5	7.0	809.6	6.0	95.1	13.3	2.9
Other Investment Goods	287.3	2.8	311.9	2.3	24.6	8.6	0.7
Unclassified Imports	**114.8**	**1.1**	**175.9**	**1.3**	**61.1**	**53.2**	**1.9**
Total Imports (b)(c)	**10,206.6**	**100**	**13,511.7**	**100.0**	**3,305.0**	**32.4**	**100.0**
Annual Average Exchange Rate (d)	**114.94**		**113.06**				

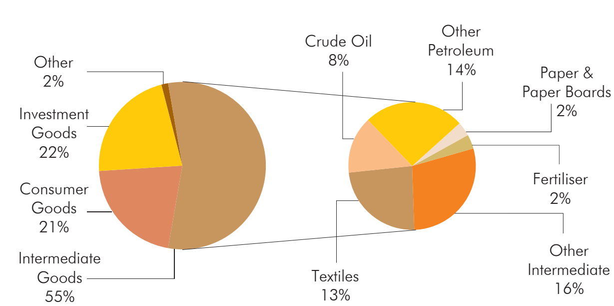
(a) Provisional
(b) Excludes re-imports
(c) Adjusted
(d) Rs. / US dollar exchange rate

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 imports of intermediate goods increased by 32.2 per cent to US dollars 7,496 million in 2010, led by higher petroleum imports. The price of crude oil in the international market which rose towards the end of 2009 along with the global economic recovery, continued to increase in 2010. The average import price of crude oil increased by 24.4 per cent to US dollars 79.52 per barrel during the year, compared to US dollars 63.93 per barrel in 2009. As a result, the expenditure on petroleum imports rose by 39.3 per cent to US dollars 3,019 million in 2010. Imports of textiles and clothing, which amounted to US dollars 1,732 million, recorded a 20.1 per cent increase over that of 2009, reflecting the growth potential in apparel exports. Meanwhile, the expenditure on fertiliser imports increased by 24.3 per cent to US dollars 240 million in 2010, led by higher prices and increased import volumes. Urea, which is used extensively for paddy cultivation, accounted for over 63 per cent of the fertiliser imports in 2010. Imports of other intermediate goods, such as chemicals and paper, also increased during the year.

Expenditure on imports of consumer goods increased by 45.6 per cent in 2010 to US dollars 2,870 million, with non-food imports contributing more than 15.2 per cent to this increase. The non-food consumer goods category comprised mainly of motor cars and motor cycles which recorded a significant growth of 246.9 per cent in 2010. This was mainly due to improved economic activity and the reduction in taxes on imports of personal motor vehicles. Imports of rubber tyres and tubes also increased by 49.9 per cent in 2010.

Chart 5.6 Imports by Commodities - 2010



Food imports increased by 31.7 per cent mainly owing to the higher expenditure incurred on imports of sugar and milk products. International sugar prices reached historical highs in 2010 amidst supply constraints in major sugar producing countries. The average import price of sugar rose by 38.6 per cent, as a result of which, expenditure on sugar imports increased by 66.1 per cent to US dollars 363 million in 2010. Expenditure on milk product imports increased by 56.2 per cent to US dollars 259 million in 2010, reflecting high international prices. However, expenditure on wheat imports decreased marginally in 2010 compared to 2009.

Imports of investment goods increased by 21.2 per cent to US dollars 2,970 million in 2010, led by higher expenditure incurred on imports of transport equipment and machinery. Expenditure on transport equipment imports grew by 47.2 per cent, mainly due to increased economic activities. Transport equipment imports comprised of motor vehicles for transport of goods and passengers and related vehicle parts. Imports of machinery and equipment increased by 19.1 per cent to US dollars 1,206 million. This comprised mainly of automatic data processing machines, transmission apparatus, and electrical transformers. However, expenditure incurred on imports of building materials such as portland cement, iron bars and rods and asbestos increased by 13.3 per cent to US dollars 810 million during the year reflecting expansion in construction activities.

Trade Balance

The accelerated growth in expenditure on imports relative to earnings from exports contributed to the expansion in the trade deficit in 2010. Subsequent to the sharp contraction in 2009, the overall trade deficit expanded by 66.7 per cent in 2010 to US dollars 5,205 million from US dollars 3,122 million in 2009. As a percentage of GDP, the trade deficit was 10.5 per cent in 2010.

Table 5.6 Volume of Major Imports (a)

'000 mt

Item	2006	2007	2008	2009	2010 (b)
Rice	12	88	84	52	126
1st Quarter	3	4	41	3	121
2nd Quarter	2	7	28	3	2
3rd Quarter	3	3	11	2	2
4th Quarter	4	74	4	44	1
Wheat	1,200	952	919	1,026	1,052
1st Quarter	287	204	272	288	352
2nd Quarter	321	388	312	229	171
3rd Quarter	331	274	153	220	292
4th Quarter	261	87	182	289	236
Sugar	525	481	575	467	559
1st Quarter	112	112	163	123	145
2nd Quarter	137	138	131	110	156
3rd Quarter	127	118	167	142	154
4th Quarter	149	113	114	92	104
Petroleum (Crude Oil)	2,151	1,938	1,853	2,066	1,819
1st Quarter	592	272	229	559	332
2nd Quarter	535	557	525	417	541
3rd Quarter	582	559	544	416	541
4th Quarter	442	550	555	674	405
Refined Petroleum	2,302	2,314	2,386	2,154	2,873
1st Quarter	540	597	778	409	786
2nd Quarter	587	646	583	605	879
3rd Quarter	479	517	465	564	504
4th Quarter	696	554	560	576	703
Fertiliser	633	569	772	501	649
1st Quarter	166	62	125	46	88
2nd Quarter	203	171	223	109	238
3rd Quarter	119	131	216	123	165
4th Quarter	146	205	208	223	158

(a) Adjusted
(b) Provisional

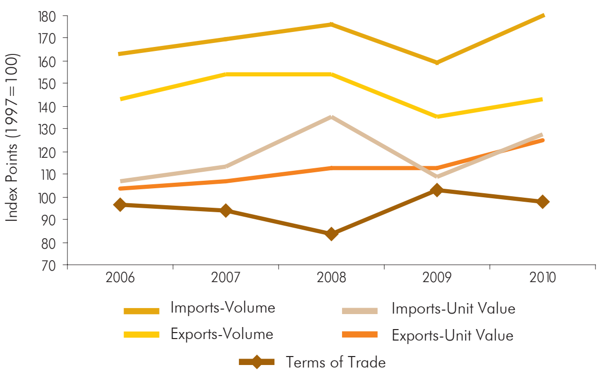
Sources: Sri Lanka Customs
Ceylon Petroleum Corporation
Lanka IOC PLC
Prima Ceylon Limited
Serendib Flour Mills (Pvt) Ltd
Central Bank of Si Lanka

Terms of Trade

The terms of trade weakened by 5.3 per cent in 2010 due to the significant increase in import prices, over export prices. Commodity export prices in the international market increased substantially in 2010 with the gradual recovery of the global economy. As a result, the price index of exports grew by 10.9 per cent in 2010. The export price index of rubber increased by 83.3 per cent due to exceptionally high international and local demand. The tea export price index increased further by 4.2 per cent in 2010. Industrial export price index also increased by 11.2 per cent in 2010, reflecting price increases in all sub-categories, especially the textile and garment sub-category where prices increased by 12.2 per cent.

The price index of imports grew at a higher rate of 17.2 per cent in 2010 reflecting price increases in all major import categories. Among

Chart 5.7 Terms of Trade and Trade Indices



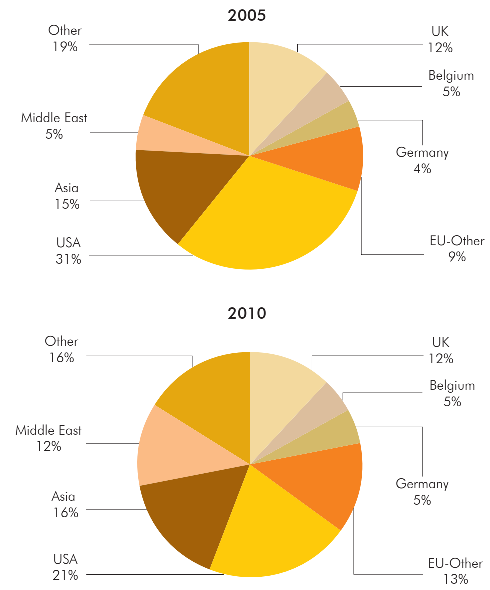
consumer goods, the import price index of food and consumer durables increased significantly by 25.5 per cent and 32.4 per cent, respectively. The import price index of intermediate goods increased by 15.8 per cent mainly due to the 24.4 per cent increase in crude oil prices. The price index of fertiliser imports also rose by 5.1 per cent in 2010. In line with this trend, price indices of almost all other sub-categories of intermediate goods also increased. Import price index of investment goods also increased by 12.9 per cent in 2010, reflecting increases in prices of nearly all sub-categories.

Direction of Trade

The western countries continued to be Sri Lanka's major export destinations despite their weakened economies in 2010 while India, Singapore and China were the foremost import-originating countries in 2010. India emerged as the largest trading partner in 2010 by accounting for nearly 20 per cent of Sri Lanka's imports and 5.6 per cent of its total exports.

USA, which is the major export market for Sri Lanka, accounted for 21.1 per cent of exports, followed by UK and India. Garments remained the largest export to USA and UK. The major exports to India were rubber and rubber products, and animal fodder. Exports to EU countries accounted for 35.0 per cent of total exports in 2010. Among these, UK, Italy, Germany and Belgium remained the main destinations representing 12.3 per cent,

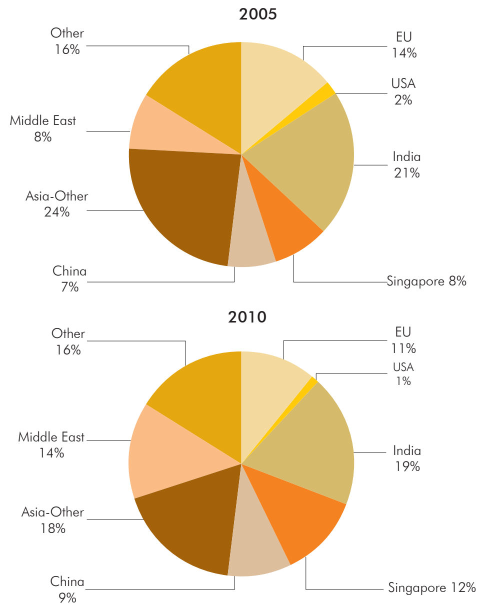
Chart 5.8 Exports by Destinations



5.6 per cent, 4.8 per cent and 4.8 per cent of total exports, respectively. Nearly 16.3 per cent of the country's garments were exported to Germany and Italy and approximately 72.6 per cent of Sri Lanka's processed diamonds were exported to Belgium. Russia and Iran, which accounted for nearly 15.9 per cent and 10.1 per cent of total tea exports, respectively, continued to be the major destinations for tea in 2010. The Middle Eastern region was the foremost export destination for Sri Lanka's tea, accounting for 48.1 per cent of total tea exports.

India, which continued to be the largest source of imports, accounted for nearly 19.0 per cent of imports in 2010. 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 petroleum products, milk and milk products while the major imports from China were machinery, mechanical appliances and cotton. Iran and Japan remained the fourth and fifth largest import source countries for Sri Lanka. The major import from Iran was crude oil while that of Japan was motor vehicles.

Chart 5.9 Imports by Origin



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

Trade in Services

With the expansion of economic activity and recovery of the global economy, trade in services recorded a significantly higher surplus during 2010. The services account, mainly consisting of transportation, travel, communications, computer and information, construction and insurance services registered a surplus of US dollars 698 million during 2010. All sub-sectors of the services account performed remarkably well during the year showing the country's potential to achieve a steady growth in coming years.

Transportation Services

Transportation services, the main contributor to the services account, performed well during the year. The gross inflows on account of transportation services consisting of passenger fares, freight charges, port and airport related activities increased at a higher rate of 33.6 per cent to US dollars 1,156 million compared to the previous year. This growth was attributed to the increase in the number of passengers travelling to Sri Lanka, increase in freight charges collected and improvement in port and airport related other business services. Meanwhile, outflows on account of transportation services increased by 30 per cent during 2010 compared to the previous year, with increased international trade and expenditure by Sri Lankans on foreign travel.

Gross inflows on account of passenger fares increased by 15.8 per cent to US dollars 468 million in 2010 compared to the previous year. Gross inflows improved as a result of the increase in the number of passengers travelling to Sri Lanka for both business and leisure, and the increase in airfare by the national carrier, SriLankan Airlines, mainly due to the fuel surcharge imposed in 2010. SriLankan Airlines purchased two new aircraft in 2010 and plans to purchase more in the future to increase its current fleet of aircraft from 14 to 20 by 2012. Inflows are expected to improve further over the medium term as a result of the planned acquisition of new aircraft, expansion of flight destinations and the increase in frequency of flights by the national carrier.

Table 5.7 Net Services, Income and Current Transfers (a)

Item	US dollars million		Rs. million	
	2009	2010 (b)	2009	2010 (b)
1. Transportation Services	235	336	26,822	37,963
2. Travel	-61	123	-7,094	13,778
3. Communications Services	26	27	3,004	3,106
4. Computer and Information Services	245	265	28,161	29,962
5. Construction Services	34	36	3,936	4,037
6. Insurance Services	28	31	3,247	3,481
7. Other Business Services	-100	-102	-11,450	-11,591
8. Government Expenditure n.i.e.	-16	-17	-1,846	-1,976
Total Net Services	**391**	**698**	**44,780**	**78,760**
1. Compensation of Employees	-11	-11	-1,233	-1,235
2. Direct Investment	-223	-377	-25,573	-42,603
3. Interest and Other Charges	-254	-184	-29,007	-20,812
Total Net Income	**-488**	**-572**	**-55,814**	**-64,650**
1. Private	2,927	3,608	336,578	407,967
2. General Government	77	52	8,920	5,918
Total Net Current Transfers	**3,005**	**3,660**	**345,498**	**413,885**

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

Gross inflows on account of freight, port and airport related services increased by 49.2 per cent to US dollars 688 million during 2010. The growth was primarily led by the significant increase in container handling at the Port of Colombo, particularly the substantial increase in transshipment container handling, which resulted from the increase in international trade volumes in the region. With the expected enhancement of capacity of local ports and the improvement in external trade, it is expected that this sector will improve further in 2011 and beyond.

Travel and Tourism

Sri Lanka's tourism industry rebounded strongly in 2010 due to post-conflict peaceful environment. Tourist arrivals increased to 654,476 in 2010, surpassing the previous record of 566,202 in 2004. The relaxation of travel advisories issued by major tourist originating countries such as USA, UK, Germany, Australia and Japan in view of the improved security situation in the country and the accolades Sri Lanka received as one of the best travel destinations resulted in this sharp rise in the number of arrivals. The largest number of arrivals was recorded from India (126,882) followed by UK (105,496), Germany (45,727), the Maldives (35,791), Australia (33,456) and France (31,285). Tourist arrivals from Middle Eastern countries also increased. Nearly 78.9 per cent of tourists arrived in Sri Lanka for holiday purposes, 12.7 per cent for business purposes, 5.4 per cent for visiting friends and relatives, while 1 per cent arrived for conventions and meetings and 0.8 per cent for religious and cultural purposes.

Earnings from tourism increased by 64.6 per cent to US dollars 576 million in 2010, compared to US dollars 350 million in 2009. Sri Lanka Tourism has earmarked 2011 as the "Visit Sri Lanka" year and launched a promotional campaign comprising "12 tourism themes for 12 months" to showcase the country's diverse attractions. The Sri Lanka Tourism Development Authority (SLTDA) initiated a programme to fast-track infrastructure development programmes in some of the most popular tourist locations such as Passikudah, Arugam Bay, Trincomalee, Nilaveli, Vakarai, Verugal and Kalkudah. Furthermore, SLTDA also approved a number of internationally acclaimed hotels to be set up within Colombo as well as in the periphery and is in the process of attracting several other world renowned hotel chains. To complement proposals to position Sri Lanka as an attractive shopping destination, a Chinese enterprise is expected to invest in a large scale hotel/shopping complex in the heart of Colombo.

Several measures were taken to expedite investments further to cater to the 2.5 million tourist arrivals anticipated in 2016. SLTDA has set

Table 5.8 Tourism Performance

Item	2006	2007	2008	2009	2010 (a)	Growth Rate (%) 2009	Growth Rate (%) 2010 (a)
Tourist Arrivals (No.)	559,603	494,008	438,475	447,890	654,476	2.1	46.1
Pleasure	392,766	331,238	321,079	358,188	516,538	11.6	44.2
Business	96,981	52,116	37,261	38,473	83,270	3.3	116.4
Other	69,856	110,654	80,135	51,229	54,668	-36.1	6.7
Tourist Guest Nights ('000)	5,794	4,940	4,166	4,076	6,548	-2.2	60.7
Room Occupancy Rate (%)	47.8	46.2	43.9	48.4	70.1	10.3	44.8
Gross Tourist Receipts (Rs. million)	42,586	42,571	37,094	40,133	65,018	8.2	62.0
Per Capita Tourist Receipts (Rs.)	76,100	86,175	84,598	89,605	99,344	5.9	10.9
Total Employment (No.)	133,558	145,238	123,134	124,970	132,055	1.5	5.7
Direct	55,649	60,516	51,306	52,071	55,023	1.5	5.7
Indirect	77,909	84,722	71,828	72,899	77,032	1.5	5.7

(a) Provisional

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

up a one-stop-shop, where all tourism development applications are processed by a special team and approved within two to three weeks provided there are no environmental issues. In order to improve the institutional framework by devolving the powers of the SLTDA at the center to the provinces, to enhance localised tourism related infrastructure services in the Eastern Province, to extend the product content and develop supply chains ensuring that they are aligned with sustainable tourism, the SLTDA together with the Ministry of Tourism embarked on a Sustainable Tourism Development Project, funded by the World Bank. Since the end of the conflict, several airlines have resumed flights to Colombo and a number of new airlines and cruise operators have expressed interest in developing closer relations with Sri Lanka. Sri Lanka's tourism industry, which was highly dependent on the tour operators for business during times of conflict, is now relying more on direct advertising to reach out to tourists via internet and other mass media. However, if Sri Lanka is to live up to its tag line, 'The Wonder of Asia', the Government and the private sector would need to work together in partnership to promote the diverse array of tourist attractions in post conflict Sri Lanka.

Communications Services

Communications services sector reflected improved performance during the year. Gross foreign exchange inflows on account of communications services increased by 3.8 per cent to US dollars 83 million during the year. This was driven by the increase in earnings on International Direct Dialling (IDD) for voice calls and increase in rental receipts for data transmission through leased circuits. Due to rapid expansion of communications services with improved technology, the usage of broadband internet connections, satellite and cable TV have improved notably during 2010. Further, lower call rates offered by both mobile and fixed line operators for IDD have encouraged generation of more IDD calls from Sri Lanka, resulting in outflows on account of communications services to increase at a parallel rate.

Computer and Information Services

Computer and information services sub-sector showed a satisfactory improvement in 2010. Gross inflows on account of exports of software, Business Process Outsourcing (BPO) and other IT enabled services (ITES) increased by 8.2 per cent to US dollars 265 million during 2010. Meanwhile, inflows on account of Knowledge Process Outsourcing (KPO) which is classified under 'other business services' of the services account, also increased substantially during the year. Given the continuous improvement of macroeconomic conditions, Sri Lanka is being increasingly recognised as one of the leading outsourcing hubs and hence, the ITES, BPO and KPO industries have been identified as sectors with high growth potential. The government also has taken a number of initiatives to fast track the development and expansion of the sector by providing fiscal and other incentives. The stable political, legal and economic environment coupled with the availability of skilled human capital is highly conducive for the establishment of niche competent BPO-KPO centres and promoting Sri Lanka as a site for disaster recovery and business continuity for other regional countries.

Inflows and Outflows of Income

The income account recorded a deficit of US dollars 572 million during 2010, compared to the deficit of US dollars 488 million recorded in 2009. Despite the low international interest rates, interest earned from the investment of higher level of reserves and profits earned on trading of foreign currency, foreign securities and gold contributed to the inflows in the income account. The inflows on account of interest and other charges increased three fold to US dollars 307 million in 2010. However, this was offset by the substantial increase in the interest payments on foreign loans of the government and private sector. Of the interest payments on foreign loans of US dollars 491 million, interest paid on long and medium term loans by the government, the private sector companies and public corporations accounted for around 70 per cent. Given the increase in net foreign liabilities of commercial banks, the net interest payments on foreign financial liabilities of commercial banks increased significantly during the year. Meanwhile, outflows on account of direct investments increased by 67.8 per cent to US dollars 386 million, mainly due to the repatriation of profits and dividends by the foreign enterprises. However, a substantial portion of the repatriated profits and dividends have been reinvested by foreign enterprises for the expansion of existing operations.

Current Transfers

The net current transfers in 2010 increased significantly to US dollars 3,660 million from US dollars 3,005 million in 2009. The inward workers' remittances continued to be the foremost foreign exchange earner in 2010. The inward workers' remittances which account for a larger portion of current transfers, increased significantly by 23.6 per cent to US dollars 4,116 million, compared to US dollars 3,330 million in 2009. Sri Lankan authorities entering into collective agreements with employers for higher wages and salaries, expansion of the exchange houses network by commercial banks, encouragement for skilled labour migration to take up high-earning overseas jobs, government's on-going initiative to promote inward remittances through formal channels and financial penetration in the Northern and Eastern Provinces through the opening up of new bank branches, were instrumental in attracting a higher level of workers' remittances. Further, remittances inflows for reconstruction and establishment of new livelihoods in the Northern and Eastern Provinces contributed to the notable increase in inward workers' remittances. The economic recovery in several key remittance-originating countries, especially in the Middle Eastern region, resulted in an increase in the demand for migrant workers in 2010.

Current Account

The current account recorded a deficit of US dollars 1,418 million or 2.9 per cent of GDP in 2010. The current account deficit widened due to a larger trade deficit, as a result of increased import demand supported by the recovery of domestic demand and expansion of economic activity. Particularly, the demand for investment goods for infrastructure projects increased during the year. Meanwhile, substantial inflows to the current account in the form of services and private transfers helped curtail the deficit in the current account. As a percentage of GDP, the current account deficit of 2.9 per cent in 2010 was well below the average deficit of the previous few years, with the exception of 2009, which recorded a deficit of 0.5 per cent of GDP, reflecting weak global and domestic demand in the context of the global recession.

5.5 Capital and Financial Flows and Balance of Payments

Foreign Direct Investment (FDI)

The FDI, including loans, during 2010 decreased to US dollars 516 million from US dollars 601 million in 2009. As FDI is long-term in nature, the impact of the global financial crisis on foreign equity and debt inflows continued to have an effect on the FDI. However, the increase in the reinvestment of retained earnings indicates signs of recovery in FDI. Highest FDI inflows amounting to US dollars 110 million were recorded from India followed by Malaysia and the United Arab Emirates (U.A.E) amounting to US dollars 72 million and US dollars 66 million, respectively. Further, as observed in the previous years, the telecommunications industry has attracted most of the FDI inflows during 2010. The FDI inflows in 2010 consisted of equity capital of US dollars 44 million, loans and advances of US dollars 112 million by the shareholders, intra-company borrowings of US dollars 126 million, foreign loans of US dollars 39 million and reinvestment of retained earnings of US dollars 195 million by the existing companies. Meanwhile, FDI outflows increased to US dollars 43 million in 2010 from US dollars 20 million in 2009. Consequently, the net FDI inflows during 2010 declined to US dollars 473 million from US dollars 581 million recorded in 2009. Investment commitment of contracted projects has increased in 2010 compared to 2009 along with the increase in the number of projects contracted, indicating future prospects for realisation of new FDIs.

BOX 10 Trends in Global Foreign Direct Investment (FDI) Flows and Prospects for Attracting FDI to Sri Lanka

Foreign Direct Investment (FDI) is a long-term and non-debt creating financial flow that helps to increase aggregate investment of a country. Unlike other capital flows, FDI embodies many desirable features such as transfer of technology and development in human capital through transferring managerial and marketing skills etc. Further, FDI helps facilitate global integration, infrastructure development, and technology innovation, while creating employment opportunities and new markets.

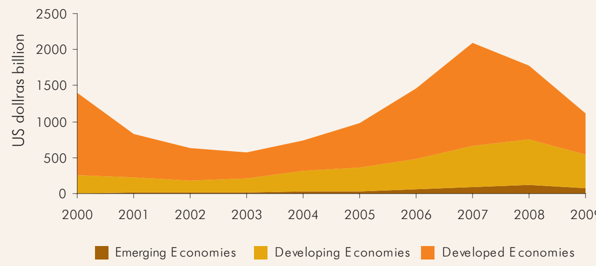
Trends in Global FDI Flows

During the past decade, FDI flows gathered momentum as a key channel of global economic integration. This surge in capital flows is attributed, mainly, to strong global economic growth; favourable financial conditions supported by ample global liquidity due to sustained low interest rates; rising commodity prices; and market oriented economic reforms by FDI recipient countries. In 2007, that is, prior to the peak of the global financial crisis, there has been an unprecedented increase in global FDI inflows amounting to US dollars 2.1 trillion, which is an increase of about 50 per cent compared to global FDI inflows during 2000. Further, the last decade witnessed an impressive growth in emerging markets, resulting in a rapid expansion of FDI linkages across the globe. FDI flows from these emerging economies constituted a substantial share of inflows to developing economies, albeit advanced economies continued to play a major role in determining global FDI flows. However, on the onset of the global financial crisis which hindered economic activity in all major advanced economies, the increasing trend of FDI flows was reversed drastically. For instance, according to the UNCTAD[1] statistics, global FDI flows have declined by 16 per cent to US dollars 1.8 trillion in 2008, and by some 37 per cent to US dollars 1.1 trillion in 2009. As Chart B 10.1 depicts, FDI inflows have declined sharply in 2009 in all major groupings, namely, developed, developing, and emerging economies, reflecting weak economic performance across the world owing to the global financial crisis.

According to the *World Investment Report* (2010), the sharp decline in FDI inflows in 2009 was evident in all FDI components, which consisted of equity investments, reinvested earnings, and other capital

[1] United Nations Conference on Trade and Development.

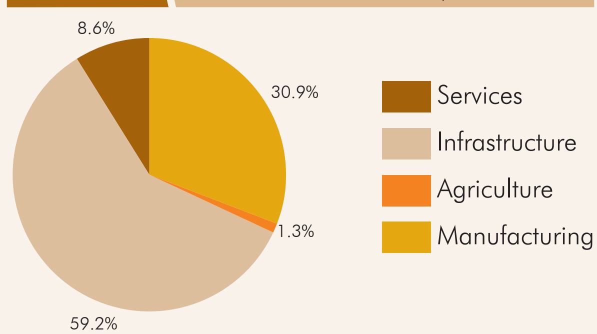
Chart B 10.1 FDI Inflows by Groups of Economies, 2000-2009



Source: UNCTAD FDI Statistics Database (http://www.unctad.org/fdistatistcs)

flows (mainly intra-company loans). Particularly, equity investments squeezed due to weak cross-border mergers and acquisitions (M&As) during 2009, reflecting the curtailment of financing following the collapse of financial markets. Also, reinvested earnings declined due to substantial contraction of profits of transnational corporations (TNCs), thus draining their internal resources. Further, the decline in FDI inflows in 2009 was apparent not only in industries more sensitive to business cycles (such as automobile and chemical industries), but all sectors, across primary, manufacturing and services.[2] Meanwhile, FDI inflows to Sri Lanka during 2010, has fallen by about 14 per cent to US dollars 516 million, from US dollars 601 million during 2009. Such a reduction may not entirely be unexpected given the adverse effects of the financial crisis on global financial flows. Data on Sri Lanka's FDI inflows in 2010 reveals that about 59 per cent came into infrastructure development projects, while manufacturing and services sectors attracted about 31 per cent and 9 per cent, respectively, and that in agriculture was marginal (Chart B 10.2).

Chart B 10.2 Sector-wise Composition of FDI in Sri Lanka, 2010



Source: Board of Investment of Sri Lanka.

[2] The primary sector includes agriculture, fishing, mining, forestry, quarrying and petroleum etc.

Rising of Developing and Emerging Economies as Major FDI Recipients

During the past few years, FDI flows to the developed economies fell sharply, while developing and emerging economies fared relatively better (Chart B 10.3). For instance, FDI flows to developed economies recorded a staggering 44 per cent drop in 2009, while developing and emerging economies recorded a decline of only 24 per cent. A relatively smaller decline in FDI flows to developing and emerging economies could be attributed, mainly, to increasing growth prospects over the years and market-oriented reforms towards increased financial openness. According to UNCTAD data, developing and emerging economies collectively accounted for nearly half of global FDI inflows, during 2009 (Chart B 10.4). Further, some developing and transition economies have been able to rank among the top 20 FDI recipients in global rankings by 2009, in which, China was the second most popular FDI destination, while the US topped the list (Chart B 10.5). Also, the presence of India, Brazil, Russian Federation, Singapore and Hong Kong among the largest FDI destinations confirmed the emergence of developing and emerging economies, while the rankings of some European countries slide in 2009. Another interesting development observed during the past few years was that investors from emerging economies tend to prefer investing in other emerging economies. For instance, over 50 per cent of emerging economies' capital flows (in terms of M&As) have been directed at other emerging economies during the first half of 2010 (*OECD Investment News* -Nov 2010).

Recent data suggests that global FDI flows started bottoming out since the latter half of 2009, supported by a modest recovery in the world economy. Rising corporate profits, improvements in global stock

Chart B 10.3 Shares in Global FDI Inflows 2000-2009

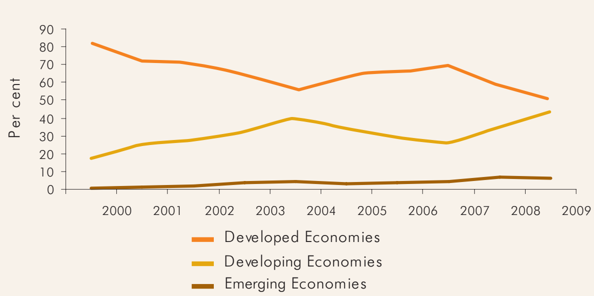


Chart B 10.4 Shares of Global FDI Inflows 2009

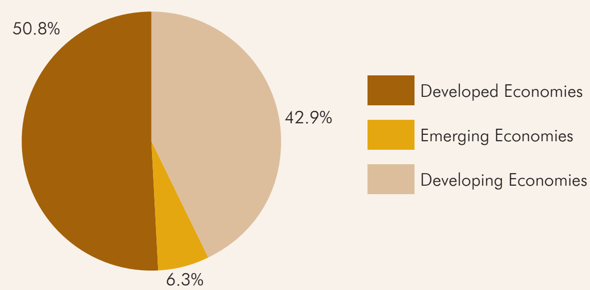
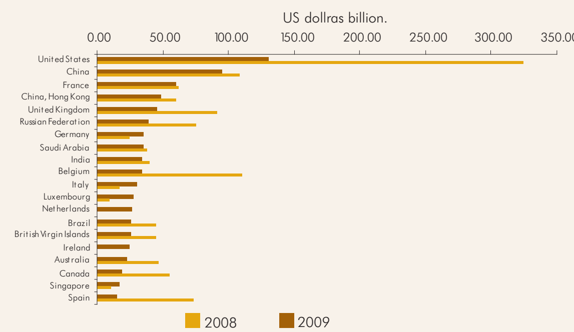


Chart B 10.5 Global FDI Inflows, Top 20 Recipients 2008-2009*



Source: UNCTAD FDI Statistics Database (http://www.unctad.org/fdistatistcs)
* Ranked on the basis of 2009 FDI Inflow data.

market performance, and implementation of policies promoting financial openness contributed towards this development. According to the *World Investment Report* (2010), global FDI inflows are estimated to have picked up to US dollars 1.1-1.3 trillion, and the projections for 2011 and 2012, are US dollars 1.3-1.5 trillion and US dollars 1.6-2.0 trillion, respectively.

Importantly, the global trends observed during the pre-crisis period are expected to continue over the next few years. In particular, developing and emerging economies are expected to be major FDI destinations, with China, Brazil and India leading the way, among others. Further, the BRIC economies (Brazil, Russia, India and China), being host countries as well as home countries, contribute substantially towards recovery of global FDI flows. According to the *World Investment Prospects Survey* - 2010/2012, developing countries are set to attract more FDI, mainly in the developing Asia and Latin America, while the FDI growth prospects are considered to be higher for primary and services sectors, than for the manufacturing sector.

FDI Prospects for Sri Lanka

Sri Lanka has substantial scope for improvement of FDI inflows into the services and agriculture sectors, in the context of recovering trends in global FDI flows. As the *World Investment Prospects Survey* - 2010/2012 highlights, the FDI growth prospects are higher for primary and services sectors in coming years. As Sri Lanka has already embarked on a programme to promote tourism in the post-conflict era, tourism related FDI needs to be strengthened further. In the meantime, more FDI needs to be attracted to areas such as education and, research and development (R&D) in order to ensure sustainable economic growth over the medium- to long-term.

The agriculture sector seems to have been largely unexplored, so far, as a potential investment area in Sri Lanka. There is growing interest among the international organizations in promoting investment opportunities in the agriculture sector, as they begin to foresee some likely threats, given the forecasts of the United Nations on world population growth (reaching 7 billion by 2012 and 9 billion by 2050). Such projections of the world population growth point towards toughest policy challenges in feeding the world, particularly, in the context of increasing scarcity in land and water, let alone any adverse effects due to climate change. Meanwhile, potential in the manufacturing sector could also be enhanced, by directing FDI towards more focused areas such as information and communication technology, and low-carbon industries; not only because there is growing interest among transnational companies into these areas, but also these can facilitate the expansion of productive capacity and upgrade export competitiveness, which are key to achieving sustainable economic growth.

The essential requirements towards realisation of these FDI prospects seem to be already in place, supported by, on one hand, benign growth prospects of the world economy, rising corporate profits of TNCs and improved global equity market performance, and; on the other hand, strengthening macroeconomic environment domestically, coupled with policy initiatives taken to further liberalise the investment regime. Sri Lanka has taken several progressive measures in order to promote financial openness and to enhance the investment climate, moving beyond more conventional measures such as offering costly tax concessions, supplying of unskilled labour at low cost etc. Policy focus has shifted towards implementing proper investment promotion strategy, underpinned by various factors such as political and social stability, improved infrastructure, low tax regime, skilled labour, and efficient government institutions. Especially, the Central Bank announced some major relaxation of foreign exchange transactions recently, while various legislation are in the pipeline to facilitate an investment friendly climate, such as strategic investment law.

However, there still are some concerns over FDI prospects across the globe because of the fragility in global economic recovery. Further, while the liberalisation policies may certainly help attract FDI inflows, the fiercely competitive environment among FDI recipient countries, would be a challenge. As such, emphasis is needed on continous basis to strengthen the macroeconomic performance of all sectors of the economy, leading to a sustainable economic growth over the medium to long-term.

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World Investment Report (2010), United Nations Conference on Trade and Development, United Nations.

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Medium and Long-term Capital to the Government

The medium and long-term loan inflows to the government increased during 2010 compared to 2009. The long-term loan inflows to the government, excluding the proceeds of the sovereign bond of US dollars 1 billion and grants, increased to US dollars 1,460 million in 2010 from US dollars 1,280 million in 2009. The higher foreign loan inflows in 2010 reflect the faster disbursement for ongoing projects during the year and as a result, the foreign aid utilisation rate[1] increased marginally in 2010 to 24.8 per cent from 24.1 per cent in 2009.

[1] The foreign aid utilisation rate is the ratio of disbursements during 2010 to committed undisbursed balance as at end June 2010.

The loan inflows were mostly directed towards the continuation of infrastructure projects such as the Mahinda Rajapaksa Port in Magampura, Colombo Port Expansion Project and Southern Highway Construction Project. Sri Lanka's third international sovereign bond to the value of US dollars 1 billion was successfully issued in October 2010. The oversubscription of the offering by more than six times reflected the confidence placed by foreign investors on the economy of Sri Lanka. The total receipt of grants, consisting of both current and capital in nature, decreased to US dollars 150 million in 2010 from US dollars 221 million in 2009.

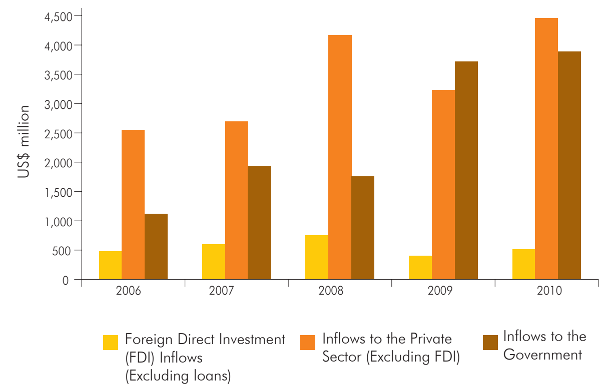
Short-term Capital to the Government

The net foreign inflows on account of Treasury bills and bonds in 2010 were US dollars 531 million. The outstanding value of government securities issued to foreigners reached its maximum level of 10 per cent of the total outstanding value of the government securities. All inflows on Treasury bills and bonds were absorbed by the Central Bank to cushion and facilitate any sudden withdrawals by the foreign investors, in order to avoid any undue pressure on the domestic foreign exchange market.

Long-term Capital to the Private Sector and Public Corporations

Foreign loan inflows to the private sector increased significantly by 48.7 per cent to US dollars 580 million in 2010. This was mainly due to the inflows from Exim Bank of China to Lanka Coal Company Limited amounting to around US dollars 450 million for the Puttalam Coal Power Project. However, foreign loan inflows to the Board of Investment (BOI) companies decreased to US dollars 39 million during 2010 as compared to US dollars 197 million in 2009, reflecting the decrease in FDI. The foreign borrowings by the private sector in 2010 were mainly for investment in telecommunication, power and energy sectors. The gradual recovery of the global economy and positive investor sentiments are expected to provide impetus for greater foreign inflows to the private sector in 2011 and beyond.

Chart 5.10 Inflows to the Capital and Financial Account



Short-term Capital to the Private Sector and Public Corporations

Short-term capital flows to the private sector consisted of portfolio investments, trade credits and changes in assets and liabilities of commercial banks. The short-term net capital outflows decreased substantially to US dollars 198 million in 2010, from US dollars 311 million in 2009. This was largely due to the decrease in foreign assets and increase in foreign liabilities of the commercial banks during 2010, irrespective of the repayment of large oil import credits by Ceylon Petroleum Corporation (CPC) during 2010. CPC received net trade credits of US dollars 1,490 million including US dollars 968 million of Iranian line of credit for oil imports in 2010 compared to US dollars 1,582 million received in 2009, and settled around US dollars 1,300 million during 2010.

Despite increased gross foreign inflows to the Colombo Stock Exchange (CSE) during 2010 of US dollars 819 million compared to US dollars 375 million in 2009, the net portfolio investment recorded a net outflow of US dollars 230 million in 2010 as compared to US dollars 6 million in 2009. This was mainly due to the higher sales of shares by foreigners to gain profits from rising stock prices and the impact of one-off selling by an international investment fund.

Table 5.9 Major Projects Financed with Foreign Borrowings during 2010

Lender and Project	Amount Disbursed US dollars million
AB Svensk Export Credit Corporation	**28.5**
of which; Ratmalana & Ja-Ela Wastewater Treatment Facilities Project	19.0
Asian Development Bank	**306.3**
of which; Colombo Port Expansion Project	72.3
Financial Markets for Private Sector Development Project	40.0
National Highways Sector Project	35.4
Southern Transport Development Project - Supplementary	18.7
Calyon Credit Agricole CIB	**17.1**
of which; Rehabilitation of Wimalasurendra and New Laxapana Power Stations Project	17.1
China Development Bank Corporation	**152.8**
of which; Rehabilitation and Improvement of Priority Roads Project	152.8
Export-Import Bank of China	**692.2**
of which; Puttalam Coal Power Project - Phase II	451.5
Hambantota Port Development Project	115.0
Supply of 13 Nos. Diesel Multiple Units to Sri Lanka Railway Project	30.3
Bunkering Facility & Tank Farm Project at Hambantota	26.8
Colombo - Katunayake Expressway (CKE) Section A1	19.4
Colombo - Katunayake Expressway (CKE) Section A4	18.5
Colombo - Katunayake Expressway (CKE) Section A2	17.6
Government of France	**50.2**
of which; Trincomalee Integrated Infrastructure Project [TIIP]	35.4
Government of Japan	**302.9**
of which; Upper Kotmale Hydro Power Project	58.4
Greater Colombo Transport Development Project	52.0
Water Sector Development Project	45.8
Southern Highway Construction Project (II)	30.4
Colombo City Electricity Distribution Development Project	24.8
Pro-poor Economic Advancement & Community Enhancement (PEACE) Project	18.4
Pro-poor Eastern Infrastructure Development Project	14.0
Government of the Republic of Korea	**36.7**
of which; Ruhunupura Water Supply Development Project	15.4
Government of the People's Republic of China	**103.7**
of which; Puttalam Coal Power Project - Buyer's Credit Facility	103.7
HSBC Bank PLC (United Kingdom)	**77.4**
of which; Emergency Purchase of Container Handling Equipment - Jaya Terminal	35.0
Development of the Dikkowita Fisheries Harbour	23.0
Regional Bridge Project	16.9
International Development Association	**144.5**
of which; Emergency Northern Recovery Project	23.4
Additional Financing for North-East Housing Reconstruction Project	17.4
Provincial Roads Project	15.3
Second Community Development and Livelihood Improvement Project	15.2
Nordea Bank Denmark A/S	**30.8**
of which; Oluvil Port Development Project	19.0

Source: External Resources Department

Foreign assets of commercial banks decreased by US dollars 249 million in 2010 compared to an increase of US dollars 435 million in 2009. Meanwhile, foreign liabilities of commercial banks increased by US dollars 815 million during 2010 from a decrease of US dollars 98 million in 2009. Accordingly, the decrease in foreign assets and increase in foreign liabilities have resulted in net foreign liabilities of the commercial banks to increase by US dollars 1,064 million to US dollars 1,154 million in 2010. The increase in net foreign liabilities of commercial banks during the year was mainly due to the conversion of foreign assets and increase in foreign liabilities, to generate foreign exchange to finance domestic foreign currency lending to CPC by around US dollars 450 million, and other private sector enterprises, as well as to finance the investment in Sri Lanka Development Bonds.

Balance of Payments

The overall balance in BOP in 2010 recorded a surplus of US dollars 921 million, following an unprecedented surplus of US dollars 2,725 million, in 2009. Despite the increase in the current account deficit due to the widened trade deficit, higher inflows to the capital and financial account resulted in BOP recording a surplus. The financial inflows to the government from the third international sovereign bond issue of US dollars 1 billion in October 2010 and increase in private long-term investments, contributed to the surplus in the BOP. The gradual recovery of the global economy, improved financial market conditions and increased investor confidence brought about by the stable macroeconomic environment helped attracting higher inflows to the capital and financial account. To strengthen BOP in the medium to long-term, non-debt creating and long-term financial flows such as FDI need to be encouraged. Towards this end, progressive measures have already been taken to promote financial openness and enhance the investment climate, which include adoption of an investment promotion strategy by the BOI and relaxation of foreign exchange transactions.

External Reserves

The gross official reserves (excluding ACU receipts) increased substantially and recorded US dollars 6,610 million by end 2010, compared to US dollars 5,097 million at end 2009. Disbursements under the foreign funded projects,

Table 5.10 External Assets of Sri Lanka (a)

Ownership	US dollars million (b)					Rs. million				
	2006	2007	2008	2009 (c)	2010 (c) (d)	2006	2007	2008	2009 (c)	2010 (c) (d)
1. Government	128	99	101	113	88	13,789	10,768	11,411	12,920	9,747
2. Central Bank	2,709	3,409	2,301	5,244	7,109	291,747	370,640	260,297	599,880	788,722
3. Total Official Assets (1+2)	2,837	3,508	2,402	5,357	7,196	305,536	381,408	271,708	612,799	798,469
4. Commercial Banks	1,169	1,448	1,238	1,673	1,424	125,867	157,454	140,075	191,373	158,031
5. Total External Assets (3+4)	4,005	4,956	3,640	7,030	8,621	431,403	538,862	411,783	804,173	956,500
6. Gross Official Assets in Months of										
6.1 Import of Goods	3.3	3.7	2.0	6.3	6.4					
6.2 Import of Goods and Services	2.9	3.3	1.8	5.5	5.7					
7.Total Assets in Months of										
7.1 Import of Goods	4.7	5.3	3.1	8.3	7.7					
7.2 Import of Goods and Services	4.1	4.7	2.8	7.2	6.8					

Source: Central Bank of Sri Lanka

(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	2006	2007	2008	2009	2010
Rs. per US dollar (year end)	107.71	108.72	113.14	114.38	110.95

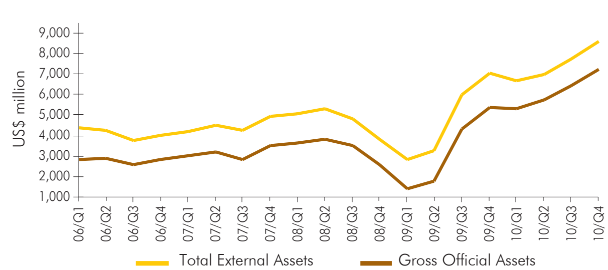
(c) Excludes foreign exchange agreements (FX Swaps) outstanding as at end December 2009 and 2010 amounting to US dollars 245 million and US dollars 97 million, respectively.
(d) Provisional

the receipt of three tranches under the IMF-SBA facility, the proceeds of the third international sovereign bond and inflows to the private sector contributed mainly in building up foreign reserves in 2010. On October 4, 2010, gross official reserves reached a record high level of US dollars 7,173 million which was equivalent to 6.7 months of imports. However, in the last quarter of 2010, official reserves declined slightly as the Central Bank supplied foreign exchange to the domestic foreign exchange market to ensure adequate foreign exchange for settling the high level of petroleum bills and to prevent any undue volatility in the exchange rate. Accordingly, as of end 2010, gross official reserves excluding ACU receipts, stood at US dollars 6,610 million, which is equivalent to 5.9 months of imports. Meanwhile, total external assets excluding ACU receipts increased to US dollars 8,035 million in 2010 (equivalent to 7.1 months of imports), compared to US dollars 6,770 million in 2009.

Under the IMF-SBA facility, a total of SDR 1.65 billion (approximately US dollars 2.6 billion) was approved in July 2009. The first two tranches amounting to US dollars 652 million were received in July and November 2009. Following the completion of the second and third reviews of the SBA facility in June 2010, the programme period was extended by another year, and the future disbursements were re-phased to be in seven equal tranches. Thus, during 2010, three tranches amounting to US dollars 620 million were received. Meanwhile, the sixth tranche of US dollars 217 million was received in February, 2011 (Box 11).

In January 2010, Sri Lanka graduated to 'middle-income' economy status from the previously listed category of PRGT eligible countries (Box1). This helped foster investor confidence in international financial markets. The third sovereign bond of US dollars 1 billion of 10-year tenure was oversubscribed by over 6 times, indicating a strong investor confidence in the Sri

Chart 5.11 Quarterly External Assets



BOX 11 Progress of the IMF-SBA Facility

IMF approved a 20-month Stand-By Arrangement (SBA) facility of SDR 1.65 billion (approximately US dollars 2.6 billion) on 24 July 2009 to Sri Lanka, as a Balance of Payments (BOP) support. This accounts for 400 per cent of the country's current quota with the Fund and is the highest ever facility offered by the IMF to Sri Lanka. The facility was originally planned to be disbursed in 8 equal instalments of approximately SDR 206.7 million each (Box Article 9: Stand-By Arrangements Facility, Central Bank Annual Report 2009).

The SBA facility has progressed successfully, within its framework. Thus far, IMF has conducted six quarterly reviews and released six tranches under the SBA facility totalling US dollars 1.5 billion.

A staff mission from IMF visited Colombo in February 2011 to conduct the sixth review of the SBA Facility. Accordingly, the seventh tranche is expected in April 2011. The seventh review is expected in May 2011.

Table B 11.1 Timeline of the Reviews and Disbursements of the SBA Facility

Date of the Board Meeting	Review No.	Tranche No.	Amount	
			SDR mn.	USD mn.
24 July 2009	-	First	206.7	322.0
06 November 2009	First	Second	206.7	329.0
28 June 2010 (a)	Second & Third	Third & Fourth	275.6	407.8
24 September 2010	Fourth	Fifth	137.8	212.5
02 February 2011	Fifth	Sixth	137.8	216.6
Total			964.6	1487.9

(a) The programme was extended by one-year and the future disbursements were rephased into seven equal instalments of SDR 137.8 million each.

Lankan economy. The coupon rate of this bond was 6.25 per cent per annum, which is substantially lower, compared to previous sovereign bond issues (i.e., 7.4 per cent per annum in 2009 and 8.25 per cent per annum in 2007, each amounting to US dollars 500 million with a 5-year tenure). While Sri Lanka will continue to receive funding from the World Bank's concessional arm, the International Development Association (IDA), the graduation of Sri Lanka to middle-income status and the latest creditworthiness assessment of the World Bank has confirmed Sri Lanka's eligibility to receive financing from its non-concessional International Bank for Reconstruction and Development (IBRD) window, as well. The larger pool of resources that would be available to Sri Lanka would help raise investment to a level required to sustain a high growth momentum.

International rating agencies raised their ratings of the country in 2010. The Standard & Poor's (S&P) raised the long-term foreign currency rating to 'B+' from 'B' and the local-currency rating to 'BB-' from 'B+'. The Fitch Ratings Agency has affirmed long-term foreign and local currency Issuer Default Rate at 'B+' and revised the outlook to 'Positive' from 'Stable', while Moody's Investor Services, covering Sri Lanka for the first time, assigned 'B1' sovereign rating with a 'Stable' outlook.

The reserve adequacy as measured by the ratio of gross official reserves to short-term liabilities increased to 95.2 per cent by end 2010, from 81 per cent, recorded at end 2009. This is due to the increased reserve levels, supported by the financial inflows to the country, over the increase in short-term debt. The absorption of foreign inflows to the government securities market by the Central Bank into official reserves has facilitated in improving the reserve adequacy ratio.

With the expectation of improving investor confidence and stabilising the foreign exchange market, the Central Bank decided to relax certain restrictions, gradually, on foreign exchange transactions. Accordingly, opening and maintaining bank accounts abroad for certain specific reasons were permitted; provisions to enter into forward contracts in foreign currency to cover foreign exchange transactions were granted; margin requirements against advance payments on selected imports were removed; suspension of prepayment of import bills was lifted and unification of different investor accounts maintained by non-residents in commercial banks was allowed, with effect from March 11, 2010. Meanwhile, with effect from November 22, 2010, a range of relaxations were implemented, which mainly include, permission for foreigners to invest in Rupee Denominated Debentures issued by local companies, permission for foreign companies to open places of business in Sri Lanka, approval for companies to borrow from foreign sources. Moving forward, further relaxations were announced to be made effective from January 1, 2011, such as permission to Sri Lankan resident individuals, corporate and unincorporated bodies to invest in equity of overseas companies.

5.6 External Debt and Debt Service

External Debt

The total external debt of the country, which consists of medium and long-term, and short-term debt decreased to 43.3 per cent of GDP in 2010 from 44.4 per cent in 2009. However, in US dollar terms, the total external debt increased by 14.9 per cent to US dollars 21.4 billion in 2010 from US dollars 18.7 billion in 2009. While the increase in medium and long-term debt amounted to approximately, US dollars 3.3 billion, the increase in the total outstanding debt moderated owing to the decline in short-term debt. The reduction in short-term debt was primarily due to the settlement of trade credits of CPC during the year. Meanwhile, the medium and long-term debt increased mainly due to the higher level of inflows to the government, including US dollars 1 billion sovereign bond, and disbursements under IMF-SBA facility, and inflows to the private sector, particularly, on account of Puttalam Coal Power Project. On the currency composition of total external debt outstanding, SDR and US dollar shares were 31.4 per cent and 29.8 per cent, respectively, while 27.9 per cent was denominated in Japanese yen. The banking sector external liabilities have increased, substantially, by about 51 per cent to US dollars 3.4 billion by end 2010. This was mainly due to the increase of commercial bank liabilities to US dollars 2.6 billion by end 2010, compared to US dollars 1.8 billion by end 2009, as a result of increased import credits by commercial banks to corporate borrowers, particularly the CPC. Meanwhile, the ACU liabilities increased to US dollars 586 million by end 2010, from US dollars 261 million by end 2009, owing to deferred settlement by the year end. Accordingly, the total external debt and liabilities as a percentage of GDP increased marginally to 50.1 per cent by end 2010, from 49.7 per cent in 2009.

A major share of external debt was accounted for by the government. Of the medium to long-term debt, the government debt accounted for 85.4 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 71 per cent by end 2010, compared to 81 per cent by end 2009. Access to concessional loans from multinational institutions has declined with the categorisation of Sri Lanka as a middle-

Chart 5.12 External Debt

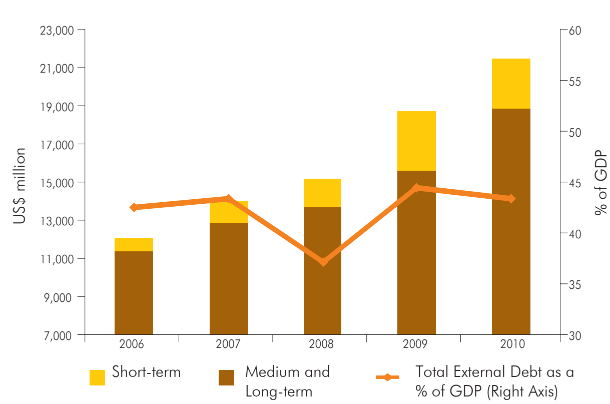


Table 5.11 Outstanding External Debt and Banking Sector External Liabilities

Item	US dollars million					Rs. million				
	2006	2007	2008	2009	2010 (a)	2006	2007	2008	2009	2010 (a)
1. Medium and Long-term Debt	**11,347**	**12,879**	**13,646**	**15,564**	**18,823**	**1,222,175**	**1,400,883**	**1,543,952**	**1,780,313**	**2,088,449**
1.1 Government	10,245	11,744	12,593	13,769	16,076	1,103,418	1,276,846	1,424,729	1,574,933	1,783,729
1.2 Public Corporations and Private Sector with Government Guarantee	465	345	251	110	517	50,065	37,501	28,429	12,608	57,398
1.3 Public Corporations and Private Sector without Government Guarantee	393	539	634	967	919	42,376	58,553	71,715	110,570	101,913
1.4 IMF Drawings (b)	244	251	169	719	1,311	26,316	27,933	19,079	82,201	145,410
2. Short-term Debt	**634**	**1,111**	**1,460**	**3,098**	**2,615**	**68,286**	**120,748**	**165,207**	**354,341**	**290,150**
2.1 Government (c)	-	457	212	1,622	2,171	-	49,641	24,006	185,534	240,856
2.2 Other (d)	634	654	1,248	1,476	444	68,286	71,107	141,201	168,808	49,294
3. Banking Sector External Liabilities	**1,994**	**2,493**	**2,669**	**2,251**	**3,393**	**214,802**	**271,063**	**301,950**	**257,575**	**376,418**
3.1 Central Bank (e)	3	2	1	227	228	284	219	64	26,042	25,322
3.2 Commercial Banks (f)	1,681	2,046	1,861	1,763	2,578	181,040	222,389	210,531	201,696	286,052
3.3 ACU Liabilities	311	446	808	261	586	33,478	48,454	91,355	29,837	65,044
4. Total External Debt (1+2)	**11,981**	**13,989**	**15,107**	**18,662**	**21,438**	**1,290,461**	**1,521,581**	**1,709,159**	**2,134,654**	**2,378,599**
5. Total External Debt and Liabilities (1+2+3)	**13,976**	**16,483**	**17,775**	**20,913**	**24,830**	**1,505,263**	**1,792,643**	**2,011,109**	**2,392,229**	**2,755,017**
MEMORANDUM ITEMS										
Medium and Long-term Debt										
Project Loans	9,087	10,002	11,148	11,914	13,174	978,356	1,087,359	1,261,304	1,362,806	1,461,729
Non-Project Loans	867	1,064	740	708	1,516	93,331	115,697	83,703	81,025	168,151
Suppliers' Credits	435	679	705	1,146	1,838	46,877	73,790	79,722	131,103	203,889
IMF Drawings (b)	244	251	169	719	1,311	26,316	27,933	19,079	82,201	145,410
Other Loans (g)	718	884	885	1,077	985	77,295	96,054	100,145	123,178	109,271
Short-term Debt and Banking Sector External Liabilities	**2,628**	**3,604**	**4,129**	**5,349**	**6,008**	**283,088**	**391,811**	**467,157**	**611,916**	**666,567**
As a Percentage of GDP (h)										
Total External Debt	42.4	43.2	37.1	44.4	43.3	43.9	42.4	38.8	44.1	42.5
Total Banking Sector External Liabilities	7.1	7.7	6.6	5.4	6.8	7.3	7.6	6.8	5.3	6.7
Total External Debt and Liabilities	49.4	51.0	43.7	49.7	50.1	51.2	50.1	45.6	49.5	49.2
Short-term Debt	2.2	3.4	3.6	7.4	5.3	2.3	3.4	3.7	7.3	5.2
Short-term Debt and Banking Sector External Liabilities	9.3	11.1	10.1	12.7	12.1	9.6	10.9	10.6	12.7	11.9
As a Percentage of Total Debt and Liabilities										
Short-term Debt	4.5	6.7	8.2	14.8	10.5	4.5	6.7	8.2	14.8	10.5
Short-term Liabilities	14.3	15.1	15.0	10.8	13.7	14.3	15.1	15.0	10.8	13.7
Short-term Debt as a Percentage of Official Reserves	**22.4**	**31.7**	**60.8**	**57.8**	**36.3**	**22.4**	**31.7**	**60.8**	**57.8**	**36.3**

Sources: External Resources Department
Central Bank of Sri Lanka

(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 mn from 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.

income country. Nonetheless, Sri Lanka will continue to receive funding from the World Bank's concessional arm, IDA. Further, the ratio of short-term to total debt declined to 12.2 per cent by end 2010, compared to 16.6 per cent by end 2009, mainly due to the reduction in trade credits of the CPC.

Foreign Debt Service Payments

The total foreign debt service payments, consisting of amortisation and interest payments, declined in nominal terms to US dollars 1,633 million in 2010 from US dollars 1,702 million in 2009. Further, as a percentage of export of goods and services, total foreign debt service payments decreased to 15.2 per cent in 2010, compared to 19 per cent in 2009. The higher debt service ratio in 2009 was due to the settlement of syndicated loans of US dollars 225 million, whereas in 2010 the syndicated loan settlements were only US dollars 25 million. Also, the full settlement of the rescheduled loan obligation due to moratorium granted after the tsunami in 2004, has resulted in lower debt service ratio, in 2010.

Table 5.12 External Debt Service Payments

Item	US dollars million					Rs. million				
	2006	2007	2008	2009	2010 (a)	2006	2007	2008	2009	2010 (a)
1. Debt Service Payments	1,080	1,232	1,525	1,702	1,633	112,670	136,521	165,511	195,727	184,610
1.1 Amortization	759	791	1,075	1,346	1,142	79,227	87,731	116,702	154,713	129,121
(i) To IMF	144	5	77	95	46	15,276	789	8,582	10,941	5,238
(ii) To Others	615	786	998	1,251	1,096	63,952	86,942	108,120	143,772	123,883
1.2 Interest Payments	321	441	450	357	491	33,443	48,790	48,809	41,014	55,490
(i) To IMF	14	14	11	6	7	1,452	1,509	1,173	644	803
(ii) To Others	307	427	440	351	484	31,991	47,281	47,636	40,370	54,687
2. Earnings from Exports of Goods and Services	8,508	9,415	10,115	8,977	10,775	885,380	1,041,932	1,095,679	1,031,289	1,216,697
3. Receipts from Export of Goods, Services, Income and Private Transfers	10,980	12,365	13,001	12,423	15,215	1,142,515	1,368,959	1,408,637	1,427,658	1,718,370
4. Debt Service Ratio (b)										
4.1 As a Percentage of 2 above										
(i) Overall Ratio	12.7	13.1	15.1	19.0	15.2	12.7	13.1	15.1	19.0	15.2
(ii) Excluding IMF Transactions	10.8	12.9	14.2	17.8	14.7	10.8	12.9	14.2	17.9	14.7
4.2 As a percentage of 3 above										
(i) Overall Ratio	9.8	10.0	11.7	13.7	10.7	9.9	10.0	11.7	13.7	10.7
(ii) Excluding IMF Transactions	8.4	9.8	11.1	12.9	10.4	8.4	9.8	11.1	12.9	10.4
5. Government Debt Service Payments										
5.1 Government Debt Service Payments (c)	610	813	1,066	1,166	922	63,368	89,924	115,508	134,019	104,240
5.2 As a Percentage of 1 above	56.4	66.0	69.9	68.5	56.5	56.2	65.9	69.8	68.5	56.5

Source: Central Bank of Sri Lanka

(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).

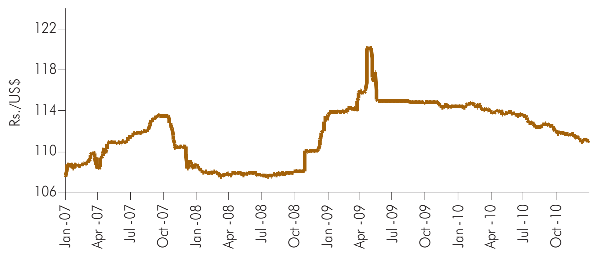
5.7 Exchange Rate Regime and Exchange Rate Movements

Exchange rate policy in 2010 focused on maintaining stability in the domestic foreign exchange market. Amidst the favourable developments in the external environment and improved investor confidence, the resulting appreciating trend in the exchange rate subsequent to the dawning of peace in the country in May 2009, continued during 2010. The recovery of commodity prices in the international markets resulted in the US dollar losing its value during the second half of 2010. Supported by steady foreign currency inflows from services sector, workers' remittances and financial flows from the third international sovereign bond issue and short-term investments in Treasury bills and bonds, the rupee appreciated gradually by 3.09 per cent to Rs. 110.95 per US dollar during 2010. Meanwhile, the annual average exchange rate in 2010 was Rs. 113.06 against the US dollar compared to Rs. 114.94 in 2009. In the face of continued foreign exchange inflows into the domestic market, the Central Bank regularly absorbed foreign exchange to mitigate excessive volatility in the exchange rate and to ensure that the competitiveness of the export sector is unaffected by an undue appreciation of the rupee, while strengthening the reserve position. However, during the last quarter of 2010, the Central Bank supplied foreign exchange to the domestic market to ensure adequate foreign exchange liquidity in the face of large outflows arising from the settlement of petroleum bills. Accordingly, during 2010 the Central Bank purchased US dollars 753 million from the domestic foreign exchange market while supplying US dollars 820 million, leading to a net supply of US dollars 67 million.

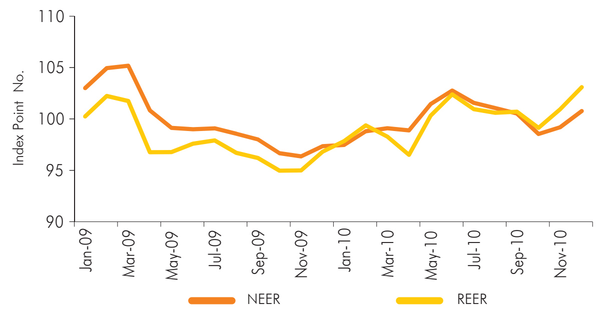
The rupee appreciated at a relatively higher rate against some other major currencies during 2010. It appreciated against the Euro (10.95 per cent) and Pound sterling (6.03 per cent). However, the rupee depreciated against the Japanese yen (8.80 per cent) and Indian rupee (0.73 per cent). Meanwhile, several international currencies depreciated due to measures taken by respective countries to boost exports. Accordingly, reflecting

Chart 5.13 Exchange Rate Movements

Exchange Rate Movements - Rupees per US$



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



the movements of major currencies against the US dollar in the international markets, the rupee appreciated against the SDR by 4.58 per cent during 2010.

Nominal and Real Effective Exchange Rates

During 2010, both the Nominal Effective Exchange Rate and the Real Effective Exchange Rate appreciated, reversing the depreciating trend observed in 2009. Reflecting a nominal appreciation of the Sri Lanka rupee against most of the major currencies in the currency baskets, the nominal effective exchange rate (NEER) of the Sri Lanka rupee, based on the 5-currency basket, (which includes the US dollar, Pound sterling, Euro, Japanese yen and Indian rupee) appreciated by 4.1 per cent, while the NEER based on the nominal exchange rates of 24 trading partners and competitors appreciated by 2.4 per cent. The higher nominal appreciation of the rupee and the relatively high domestic inflation as compared to that of trading partners and competitors, resulted

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	
	2008	2009	2010	2008	2009	2010	2009	2010	2009	2010
Euro	159.45	163.72	147.56	159.32	160.21	150.10	-2.60	10.95	-0.56	6.73
Indian Rupee	2.36	2.46	2.48	2.52	2.39	2.49	-4.13	-0.73	5.52	-3.91
Japanese Yen	1.25	1.24	1.36	1.05	1.23	1.29	0.89	-8.80	-14.60	-4.55
Pound Sterling	163.28	181.75	171.41	200.73	179.87	174.81	-10.16	6.03	11.60	2.90
US Dollar	113.14	114.38	110.95	108.33	114.94	113.06	-1.09	3.09	-5.75	1.66
SDR	174.27	178.67	170.84	171.24	177.22	172.50	-2.46	4.58	-3.37	2.73
Effective Exchange Rate Indices (b) (c) (2010=100)	**Monthly Index**			**Annual Average**			**Percentage Change over Previous Year**			
							Monthly Index		Annual Average	
	Dec. 2008	Dec. 2009	Dec. 2010	2008	2009	2010	2009	2010	2009	2010
NEER - 24 currencies	101.85	98.12	100.49	100.06	99.85	100.00	-3.67	2.42	-0.21	0.16
REER - 24 currencies (d)	99.35	97.57	102.82	95.64	97.75	100.00	-1.79	5.38	2.20	2.32

(a) Changes computed on the basis of foreign currency equivalent of Sri Lanka rupees. A minus sign indicates depreciation.
(b) The Nominal Effective Exhange 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) The exchange rates have been defined in terms of indices so that the appreciation/depreciation of the rupee relative to other currencies is directly reflected by a rise/fall in the values of the effective exchange rate indices.
(d) CCPI was used for REER computation.

Source: Central Bank of Sri Lanka

BOX 12

Revision of Effective Exchange Rate Indices

Effective Exchange Rate Indices

The exchange rate measures the value of a reference currency in terms of the other. The effective exchange rate assesses the value of a currency against a group of other currencies and is generally expressed as an index.[1] Usually the group of foreign currencies represents the major trading partners of the reference country. The Central Bank of Sri Lanka prepares two effective exchange rate indices, namely the Nominal Effective Exchange Rate (NEER) and the Real Effective Exchange Rate (REER). The NEER is the weighted geometric average of major bilateral nominal exchange rates, with weights based on the proportion of bilateral trade to Sri Lanka's total foreign trade. The REER is obtained by adjusting the NEER for inflation differentials between domestic and respective foreign countries and used as an indicator of the country's external competitiveness

NEER

NEER is the weighted geometric average of the bilateral nominal exchange rates of the domestic currency in terms of a basket of foreign currencies.

$$NEER = \prod_{i=1}^{n} (e/e_i)^{w_i}$$

where e: Exchange rate of the Sri Lankan rupee against the US dollar (US dollars per rupee in indexed form)

e_i: Exchange rates of currency *i* against the US dollar (US dollars per currency *i* in indexed form)

w_i: Weights attached to the country/currency *i* in the index

REER

REER is the inflation adjusted NEER.

$$REER = \prod_{i=1}^{n} [(e/e_i)(P/P_i)]^{w_i}$$

where P: Consumer Price Index (CPI) of Sri Lanka compared to the base period index

P_i: CPI of country *i*

[1] A detailed description of exchange rates, exchange rate regimes, effective exchange rate indices and compilation methodology are available in the Pamphlet Series No3: Exchange Rates, published by the Central Bank of Sri Lanka, 2006.

The Central Bank has been preparing NEER and REER indices based on a 5-currency basket and a 24-currency basket since 1989. The recent series of these indices were prepared with the base year as 2006.[2] Rather than observing the movements of the exchange rate against one foreign currency only, this would enable market participants to track the movement of the Sri Lanka rupee against a basket of currencies. A rise in the NEER index value implies an appreciation of the rupee relative to other countries, and vice versa. The REER index is used as an indicator of export competitiveness or currency misalignment.

Revision of the Effective Exchange Rate Indices

The trade patterns change over time. The importance of some countries could diminish, while trading with some other countries could increase. Hence, the effective exchange rate indices are revised regularly to capture new developments once in every 4-5 years. Accordingly, the base year of the 5-currency indices and 24-currency indices are revised to the year 2010. The 5-currency NEER and REER indices capture the

Table B 12.1 Revised Trade Weights

(per cent)

Country	New Weight
United States	19.74
India	15.57
United Kingdom	9.86
China	6.41
Germany	5.88
Japan	4.99
Italy	4.83
Belgium	4.45
Hong Kong	3.63
France	2.93
Malaysia	2.36
Russia	2.18
Thailand	2.15
Netherlands	2.11
Canada	1.96
Pakistan	1.80
Singapore	1.79
Indonesia	1.73
Turkey	1.52
Taiwan	1.51
Korea	1.17
Australia	0.97
Bangladesh	0.36
Kenya	0.10
	100.00

[2] The methodology of the computation of NEER and REER since January 2000 by the Central Bank is available in the Box 16 of the Central Bank of Sri Lanka Annual Report, 2003.

movement of the value of the rupee against five major currencies; the US dollar, Euro, Pound sterling, Japanese yen and Indian rupee. The weights derived from relative importance of trading currencies to Sri Lanka in terms of both exports and imports have been normalised in computing 5-currency NEER and REER indices. Similarly, the 24-currency NEER and REER indices are now being computed with some new trading partners reflecting recent developments in the external sector. Accordingly, from the 2006 basket of countries, Denmark, the Philippines, South Africa and Sweden have been replaced by Australia, Pakistan, Russia and Turkey in creating the 2010 basket of countries, based on the importance of trade with those countries. The computational methodology remains unchanged.

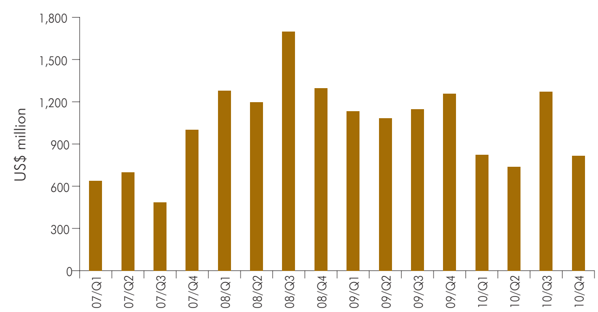
The price index used in the computation of REER should ideally be the measure of producer prices of respective countries. However, due to practical considerations such as non availability of all countries in the basket and differences in preparation, CPI is used as a proxy for the REER calculation. Given the time lag in obtaining consumer price indices from all countries, the REER index based on actual data is published with an eight week time lag. In order to ensure up to date information, the NEER and REER indices have already been published in the Central Bank of Sri Lanka web site. The newly computed NEER and REER indices are also published in Table 5.13 and Statistical Appendix Table 87.

in the real effective exchange rate (REER) based on both 5-currency and 24-currency baskets, appreciating by 7.4 per cent and 5.4 per cent, respectively, during 2010.

Developments in the Domestic Foreign Exchange Market

The domestic foreign exchange market expanded in 2010 amidst the mixed impact from the developments in the external sector. Given the expansion in trade, steady inflows into the domestic foreign exchange market from export proceeds, increased workers' remittances inflows, and the stability in the exchange rate, the total volume of spot transactions increased to around US dollars 7,416 million in 2010 (67 per cent of total transactions), compared to US dollars 6,335 million recorded during 2009. However, the total volume of forward transactions has deviated from the trend seen in the spot market with the transaction volume decreasing to US dollars 3,649 million during 2010 compared to US dollars 4,624 million recorded during 2009. The relatively stable spot market exchange rates as well as the expectations of steady inflows into the market have reduced the demand for forward booking of foreign exchange requirements. Accordingly, the total inter-bank foreign exchange transaction volume has increased only marginally to US dollars 11,065 million during 2010 from US dollars 10,959 million during 2009.

Chart 5.14 Quarterly Inter - Bank Forward Transaction Volumes



The forward premia for one-month, three-month and six-month remained slightly lower than the interest rate differentials throughout 2010. This indicates the market expectation of continued future inflows into the domestic foreign exchange market in the short-term. Despite declining domestic interest rates, it being comparatively higher than the international benchmark interest rates, has resulted in higher interest rate differentials. Coupled with the increased investor confidence in the domestic economy, the higher interest rate differential further supplemented in attracting foreign investment into the domestic Treasury bill and bond market.