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EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

5.1 Overview

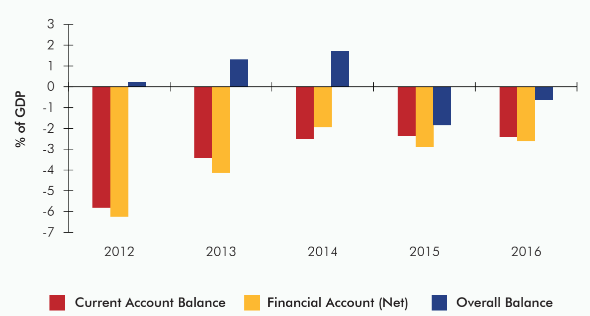
Sri Lanka's external sector continued to be under pressure in 2016, characterised by modest foreign exchange inflows and higher outflows. The pressure experienced in the external sector was a reflection of global as well as domestic developments. On the external front, monetary policy normalisation in the United States, slow pace of economic growth in advanced economies such as the European Union and Japan, and geopolitical uncertainties in the Middle East impacted adversely on Sri Lanka's Balance of Payments (BOP). On the domestic sphere, lack of substantial foreign investment inflows, higher import demand, outflows on account of debt service payments and outflows from the government securities market posed a challenge towards external sector stability during the year.

The BOP in 2016 reflected the subdued performance of the external sector with a widening of the current account deficit and a moderation in the financial account. The current account deficit in 2016 increased marginally to 2.4 per cent of GDP from 2.3 per cent in the previous year. The trade deficit expanded during the year with an increase in import expenditure, particularly with the higher domestic demand for investment goods, while earnings from merchandise exports contracted with the drop in both international commodity prices and export volumes. The deficit in the primary income account also widened during the year as a result of the decline in earnings from reserve assets and continued interest payments amidst outflows on account of reinvested earnings and dividend payments. However, the adverse impact of the trade deficit and the primary income account deficit was dampened to some extent by the surpluses in the services account and the secondary income account. The surplus in the services account continued to increase, particularly with higher earnings from tourism, while the secondary income account benefitted from the moderate expansion in workers' remittances in 2016. Meanwhile, the financial account continued to experience higher outflows amidst modest inflows by way of non-debt creating sources. In particular, lower levels of Foreign Direct Investments (FDI) and capital outflows arising from disinvestment of government securities by non-residents together with continued debt service payments, adversely impacted the financial account in 2016. The lack of non-debt creating inflows to the financial account and the widening of the current account deficit necessitated financing from the rest of the world. Accordingly, the funding requirement of the BOP was met through the issuance of an International Sovereign Bond (ISB) and syndicated loans, while a three year Extended Fund Facility (EFF) arrangement with the International Monetary Fund (IMF) was availed to strengthen the external sector. These developments in 2016, resulted in the overall balance of the BOP recording a deficit of US dollars 500 million. Gross official reserves also declined to US dollars 6.0 billion by end 2016, which was equivalent to 3.7 months of imports.

The developments in the external accounts in 2016 were reflected through heightened pressure in the exchange rate. The exchange rate, which was maintained at relatively stable levels during the first half of 2016 with the support from the supply of foreign exchange liquidity, depreciated at a higher rate during the second half due to the gradual curtailment of foreign exchange supply by the Central Bank. A substantial amount of foreign exchange provided by the Central Bank in the second half of the year was to partially ease exchange rate pressure arising from capital outflows from the government securities market, following the US rate hike due to portfolio rebalancing by non-resident investors. During the year as a whole, the rupee recorded a depreciation of 3.83 per cent against the US dollar over the depreciation of 9.03 per cent in 2015. However, the Real Effective Exchange Rate (REER) indices remained above 100 indicating the need of further adjustment to the exchange rate to be competitive in the international market.

The mismatch in the demand for and supply of foreign exchange emphasises the need for urgent policy measures to address imbalances in the external sector. Restoring external sector stability in a challenging environment requires the building up of external buffers with policies to reduce spill-over effects from adverse developments in other sectors. As such, in addition to allowing the exchange rate to be determined through market forces by aligning it with the movement of REER indices, short to medium term measures are required to strengthen the level of international reserves. Short term measures in building reserves would entail reliance on debt-related sources, such as ISB issuances and foreign exchange swap arrangements. However, these measures need to be supplemented through foreign inflows, such as increased earnings from merchandise and services exports and FDIs to ensure the external stability on a sustainable basis. There is a need to formulate a comprehensive export strategy so as to focus on the diversification of the export base, integration into the global production sharing chains while harnessing the potential to enter global markets through preferential trade agreements. Improving the country's competitiveness, maintaining policy consistency, improving institutional setup and the prioritisation of export promotion in the development agenda is crucial to the creation of a

Chart 5.1
Balance of Payments



Source : Central Bank of Sri Lanka

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Table 5.1
Balance of Payments Analytical Presentation

Item	US$ million		Rs. million	
	2015 (a)	2016 (b)	2015 (a)	2016 (b)
Current Account (net)	-1,883	-1,942	-257,524	-279,712
Trade Balance	-8,388	-9,090	-1,141,035	-1,325,495
Exports	10,546	10,310	1,431,431	1,500,766
Imports	18,935	19,400	2,572,467	2,826,260
Services (net)	2,325	2,879	316,170	423,053
Receipts	6,397	7,138	869,634	1,039,283
Payments	4,072	4,259	553,464	616,230
Primary Income (net)	-2,013	-2,184	-274,740	-317,053
Receipts	127	120	17,253	17,530
Payments	2,140	2,304	291,994	334,583
Secondary Income (net)	6,193	6,453	842,082	939,782
Secondary income: credit	7,007	7,260	952,568	1,057,281
Workers' remittances	6,980	7,242	948,957	1,054,489
Government transfers	27	19	3,610	2,792
Secondary income: debit	814	807	110,486	117,498
Capital Account (net)	46	26	6,256	3,782
Capital account: credit	71	46	9,562	6,795
Capital account: debit	24	21	3,306	3,013
Current and Capital Account (net)	-1,836	-1,917	-251,268	-275,930
Financial Account (net)	-2,312	-2,117	-346,198	-307,793
Direct Investment: Assets	53	237	7,199	34,476
Direct Investment: Liabilities	680	898	93,528	131,992
Portfolio Investment: Assets	...	...	3	-1
Debt securities	...	...	3	-1
Portfolio Investment: Liabilities	686	993	101,935	144,688
Equity	-60	24	-8,185	3,684
Debt securities	747	969	110,121	141,005
Financial Derivatives	-	-	-	-
Other Investment: Assets	503	317	70,962	45,682
Currency and deposits	143	5	21,127	538
Trade credit and advances	116	-67	15,807	-9,678
Other accounts receivable	244	379	34,028	54,821
Other Investment: Liabilities	1,857	308	271,788	45,677
Currency and deposits	1,457	-609	209,324	-87,671
Loans	759	753	105,244	108,636
Central Bank	-507	-123	-68,775	-17,234
Deposit-taking corporations	787	-507	107,301	-75,495
General government	470	1,287	66,126	188,365
Other sectors	9	96	592	13,000
Trade credit and advances	-401	109	-54,437	16,120
Other accounts payable	41	55	11,657	8,592
Special Drawing Rights (SDRs)	-	-	-	-
Reserve Assets	354	-472	42,890	-65,593
Monetary gold	-39	-	-5,156	-
Special Drawing Rights	-2	-5	-302	-685
Reserve position in the IMF	-	-	-	-
Other reserve assets	395	-467	48,348	-64,907
Currency and deposits	116	-1,267	12,566	-183,495
Securities	279	800	35,755	118,582
Net Errors and Omissions	-476	-201	-94,930	-31,862
Overall Balance (c)	-1,489	-500	-129,654	-46,013
As a Percentage of GDP				
Trade Balance	-10.4	-11.2		
Goods and Services	-7.5	-7.6		
Current Account	-2.3	-2.4		
Current and Capital Account	-2.3	-2.4		

(a) Revised
(b) Provisional
(c) Refer Table 5.11 for the derivation of overall balance.

Source: Central Bank of Sri Lanka

more conducive environment for exporters. At the same time, policy initiatives to harness the country's potential as a service exporter, in the areas of Business Process Outsourcing (BPO), Knowledge Process Outsourcing (KPO), tourism and maritime services are crucial to the improvement of the country's share of exports in the global market. A multi-pronged policy initiative is also essential to encourage the attraction of much needed FDI, as non-debt creating inflows are vital to address the chronic BOP issue faced by the economy over several decades.

5.2 External Trade Policies, Developments and Institutional Support

Sri Lanka's external trade policy focused on achieving a higher integration with global markets, by encouraging external trade and international investments to leverage trade investment nexus. This is to be achieved by enhancing market access for Sri Lanka's exports, by entering into preferential trade agreements (PTAs) and free trade agreements (FTAs) with different trading partners, strategic trade promotions and by introducing a coherent national trade policy. National trade policy should focus on market expansion, trade and tariff rationalisation, trade facilitation and attracting export oriented foreign direct investments to expand the export base and improve Sri Lanka's competitiveness in terms of exports and FDI. Anticipated reforms and measures taken for trade facilitation are expected to boost Sri Lanka's share of exports in global markets, driving the growth momentum of the Sri Lankan economy.

The government has recognised the importance of removing prevailing obstacles for external trade in order to promote exports. In this regard, initiatives were taken to regain the European Union's Generalised System of Preferences plus

(EU-GSP+) facility, which was suspended in August 2010 and to adhere to the international rules on fisheries, for the lifting of the ban imposed by the European Commission (EC) on fish exports to the EU. The Department of Commerce (DOC), after a series of consultations and review meetings with the EU and local stakeholders, along with the Inter Ministerial Sub-Committee on Regaining the EU-GSP+ facility, prepared a comprehensive report covering all relevant information on the compliance and the progress made with respect to 27 international conventions specified under the EU-GSP+ regulations. The application for regaining the EU-GSP+ facility and the comprehensive report, along with all supporting annexures, were submitted to the EC in July 2016. After a thorough review process, in January 2017, the EC proposed to reinstate the EU-GSP+ in exchange of Sri Lanka's commitment to ratify and effectively implement 27 international conventions related to human rights, labour rights, protection of the environment and good governance, while allowing the EU Parliament to raise any potential objections within a period of 4 months. In addition, as a result of strong efforts made by the government, the ban imposed in October 2014, with effect from January 2015, on fisheries exports from Sri Lanka to the EU, under Illegal, Unreported and Unregulated (IUU) fishing regulations, was lifted in June 2016. As the EU market is one of the major seafood exporting destinations for Sri Lanka, this can be cited as a significant step towards promoting Sri Lankan seafood exports. Since the removal of the ban, seafood exports to the EU grew by 110 per cent, year-on-year, during the second half of 2016.

The Generalised System of Preferences (GSP) facilities mainly offered by the USA and the EU continued in 2016. The GSP offered by the USA, which provides duty free entry into the USA for nearly 5,000 products, from 122 beneficiary countries, including Sri Lanka, was re-authorised in June 2015 and will be valid until 31 December 2017. Sri Lanka, along with other beneficiaries, submitted a request to the USA to expand the duty-free treatment for travel goods for all GSP beneficiary countries, which is expected to be allowed in 2017. Further, Sri Lanka continued to benefit from the standard EU-GSP, where Sri Lanka's exporters gain concessional duty access to the EU for about 7,200 products. Meanwhile, Sri Lanka's exports under the agreement on the Global System of Trade Preferences (GSTP),[1] which is an agreement among developing countries, marginally declined to US dollars 45 million in 2016 compared to US dollars 49 million in 2015. Under GSTP, Sri Lanka exported cinnamon as the major export, mainly to Mexico and Peru. Sri Lanka also benefitted through GSP schemes granted by several other countries, including Japan and Norway. Earnings from exports under all GSP schemes increased by 9.0 per cent to US dollars 3,394 million in 2016. Although preferential access to high income countries is available through several GSP facilities, the significantly narrow export base prevents Sri Lanka from reaping the full benefit of these schemes.

Identifying the need to tap into the global value chains (GVCs), improve value addition, enhance market access and innovation as the way forward, the government has been proactive in pursuing trade agreements with key potential markets, including Singapore, China, Japan, South Korea, Bangladesh and the growing markets in Africa. The Memorandum of Understanding (MOU) on initiating the negotiations of the China-Sri Lanka Free Trade Agreement (CSFTA) was signed in September 2014. The CSFTA covers trade in goods and services, investment, and economic and technical cooperation.

1 GSTP is an agreement among developing countries, and established in 1989. It is a tariff preferential scheme negotiated under the aegis of the United Nations Conference on Trade and Development (UNCTAD), with a view to increasing South - South trade and economic cooperation.

Further, Sri Lanka and Singapore, in June 2016, announced that both countries are keen to pursue a comprehensive FTA. This FTA expects to focus on export led growth, employment generation, expanding market to attract investments with technical know-how and expertise, and the usage of supply chain linkages of both countries. A feasibility study carried out by both parties was followed by a scoping mission from Singapore in July 2016, for initial discussions with relevant institutions on the scope and coverage of the proposed FTA. The first three rounds of negotiations were held in 2016. FTAs with both China and Singapore are expected to be finalised during 2017. Meanwhile, the 12th council meeting of the Trade and Investment Framework Agreement (TIFA) between the USA and Sri Lanka was held in April 2016 in Washington DC, USA. During the deliberation, the two governments adopted a US-Sri Lanka Joint Action Plan, which focused on reforming Sri Lanka's trade and investment regime to match with world standards, improving the competitiveness of Sri Lanka's current exports and developing new markets to boost trade and investment between Sri Lanka and the USA over a period of five years. An inter-sessional TIFA Council meeting was held in September 2016 in Colombo, with the agreement of a wide-ranging implementation plan, mainly to support Sri Lanka's goal to serve as a regional services hub.

While initiatives were taken to enter into new trade agreements, several measures were implemented to further rationalise the utilisation of existing bilateral trade agreements. Continuous evaluations on developments of FTAs, PTAs and Comprehensive Economic Partnership Agreements (CEPAs), with countries that have an impact on Sri Lanka's trade, were collaboratively carried out by the Ministry of Development Strategies and International Trade (MODSIT), DOC and the Ministry of Industry and Commerce (MOIC). As a result, many review meetings were conducted to address issues arising from FTAs, PTAs and CEPAs, while Joint Commissions were established with countries, such as Russia, Iran, Belarus, Turkey and Bangladesh, to improve bilateral trade relations. Sri Lanka's exports to India, under the India-Sri Lanka Free Trade Agreement (ISFTA), amounted to US dollars 375 million in 2016 compared to US dollars 407 million in 2015. The ISFTA is expected to be reinforced through the inclusion of the services sector and by creating more investment opportunities through the proposed Economic and Technology Cooperation Agreement (ETCA). Both the DOC and MODSIT conducted stakeholder consultations before the preliminary official level discussions that were started in August 2016, where the two parties had only explored the broader scope of ETCA and the areas that would be considered within the framework. A second round of discussions were held in September 2016 where both sides agreed on the importance of Mutual Recognition Agreements (MRAs) on trade in goods and trade in services. Negotiations on the ETCA are expected to deepen the current ISFTA on goods, technology cooperation, economic cooperation, liberalising services and investments. The agreement is expected to be finalised in 2017. Meanwhile, the 6th technical level meeting with regard to the Pakistan-Sri Lanka Free Trade Agreement (PSFTA) was held in January 2016 in Colombo, where both parties discussed to revisit the concession lists under the PSFTA, with a view to pursuing a holistic liberalisation approach. As a result, some of the trade barriers on discriminatory import valuation were removed. However, Sri Lankan exports to Pakistan under the PSFTA continued to be low at US dollars 52 million in 2016, in comparison to US dollars 59 million in 2015. Lack of product diversification and customs issues can be cited as main reasons for this situation.

International trade under GVCs and product sharing networks is increasingly becoming important, highlighting the greater need for regional and multilateral trade agreements. In the context of regional trade agreements, the first phase of the trade liberalisation programme (TLP) of the South Asian Free Trade Area (SAFTA) was completed by Sri Lanka in November 2015 and during the second phase of the TLP, members are expected to reduce their initial sensitive lists by at least 20 per cent by 2020, with Sri Lanka scheduled to complete it by 2018. The total value of exports from Sri Lanka under the SAFTA declined by 67.4 per cent to US dollars 8 million in 2016, with 60 per cent of exports to India, while black pepper and aluminium products were the major items exported. The South Asia Association for Regional Cooperation (SAARC) Agreement on Trade in Services (SATIS), as a further step towards expanding the regional trade in services, is in the process of finalising the national schedules of commitments, while the approval of the Cabinet of Ministers was received for Sri Lanka's Schedule of Specific Commitments under SATIS in June 2016. The Standing Committee of Asia-Pacific Trade Agreement (APTA) gathered for the 49th session, which was held in September 2016 in Thailand, where a roadmap for the implementation of the framework agreement on trade facilitation, investments and services was discussed. The APTA, which was earlier known as the Bangkok Agreement when it was signed in 1975, is the oldest preferential trade agreement among developing countries of the Asia-Pacific region, with Bangladesh, China, India, Laos, South Korea, Mongolia and Sri Lanka as member countries. Exports under the APTA increased by 5.9 per cent to US dollars 126 million in 2016, with black tea, coconut products and selected garments as major export items. Among the APTA members, China and South Korea were the main markets for Sri Lanka, accounting for about 72 per cent and 25 per cent of total exports, respectively, under this agreement. The second ministerial level economic and business conference of the Indian Ocean Rim Association (IORA), a regional forum among countries of the Indian Ocean Rim, was held in April 2016 in Dubai, while the 16th Council of Ministers and associated meetings were held in October 2016 in Indonesia. The TLP related to Sri Lanka on the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) was approved by the Cabinet of Ministers in February 2016.

Sri Lanka continued to engage in multilateral initiatives of the World Trade Organization (WTO). The 10th WTO Ministerial Conference was held in Kenya in December 2015, outlining the package known as the "WTO Nairobi Package". The future plan of the WTO was also adopted at the end of the conference. Sri Lanka became the 81st member to ratify the Trade Facilitation Agreement (TFA) with the WTO in May 2016, which will enable Sri Lanka to improve its competitiveness in global market. The agreement will come into effect when two-thirds of the current membership of the WTO ratifies its Instrument of Acceptance. The TFA is expected to significantly benefit global trade while delivering support, particularly to developing and Least Developed Countries (LDCs). The full implementation of the TFA is expected to achieve a reduction in the cost of trade while improving global economic growth. Furthermore, the 4th Trade Policy Review (TPR) of Sri Lanka was successfully concluded in November 2016 at the WTO head office in Geneva, after a series of consultations conducted by the DOC. Sri Lanka needs to review its trade policy every 6 years in order to facilitate the smooth functioning of the multilateral trading system by enhancing the transparency of trade policies. Meanwhile, the enactment of Anti-Dumping, Countervailing and Safeguard Legislation in Sri Lanka has been long outstanding. The approval of the Cabinet Ministers for a new memorandum in this regard was received in October 2016.

A number of measures were implemented and new measures were proposed by the government with the intention of strengthening institutional support to promote exports. The Agency for International Trade (AfIT) and Agency for Development (AfD) were established under the newly formed MODSIT. The AfIT is expected to act as a high-level forum responsible for policy decisions related to international trade. The AfIT is expected to be the focal point for the formulation, implementation and coordination of international trade policies, while being responsible for promoting and developing international trade. The agency is in the process of drafting a National Trade Policy in order to provide a strategic trade policy framework for Sri Lanka. The AfD is in collaborating with the Harvard Centre for International Development, Millennium Challenge Corporation, International Trade Centre (ITC) and the World Economic Forum, to come up with innovative solutions to boost Sri Lanka's exports and competitiveness, drawing upon modern trade theory, new global trading environments and experiences of the countries which use trade as the engine of growth. The initiation of the National Export Strategy (NES) by the Export Development Board (EDB) and the establishment of the One-Stop-Shop in collaboration with more than 15 stakeholder organisations at the Board of Investment (BOI) are among the solutions implemented towards improving the investment climate of Sri Lanka. Further, Sri Lanka Customs fully automated its cargo consignment clearance procedure by introducing a computer based channel selectivity process. Accordingly, three channels, namely Green, Amber and Red, were introduced with changes in the level of examination required. This automation has reduced the time period required for the clearance of cargo significantly. Further, in order to minimise the disparity in economic development that exists between Colombo suburbs and the rest of the country, several programmes have been planned to spread the development activities through developing economic corridors, such as Kandy, Colombo, Hambantota and Colombo and Trincomalee. Economic zones will be established in Bandaragama, Embilipitiya, Vavuniya, Kuliyapitiya and Eravur while improving the investment climate and export competitiveness of small and medium enterprises (SMEs).

Institutional support was extended further towards the implementation of strategies on external trade during 2016. The EDB, in line with its updated strategic plan for 2016-2020, implemented a number of programmes aimed at promoting exports, with an ambitious goal to achieve US dollars 20 billion worth exports by 2020. Further, in their annual action plan, various activities have been recognised to increase exports, including promotion of diversification and value addition, targeted brand promotion, introduction of new technology, research and development assistance and conducting of training and awareness programmes. Accordingly, a practical approach in the form of conducting seminars and workshops to address issues identified in major export markets, participation of exporters at trade fairs to build Sri Lanka's image abroad and improving market access are strategies to be adopted in achieving the export target set by its strategic plan. During 2016, the EDB conducted several trade fairs while participating in international trade fairs abroad. The 16th World Export Development Forum (WEDF), a flagship event of the ITC, was held in Sri Lanka in October 2016, with the participation of 600 local and foreign delegates. In addition, the EDB conducted National Exporters' Forums to resolve on-going issues related to exports, the Presidential Export Awards Ceremony and many E-marketing activities, using its E-market place during 2016. Further, the EDB has initiated the preparation of a NES in collaboration with the ITC. The NES is a joint effort of the government and the private sector, to provide a detailed and prioritised five-year action-oriented framework for the development of trade and competitiveness. The NES will provide a clear direction for sustainable export-led growth, to make Sri Lanka a key trade hub in the Indian Ocean. In addition, Budget 2017 proposed to appoint a National Trade Prosecutor, who will be entrusted with the responsibility of ensuring proper enactment of trade and the commercial agreements that are expected to be undertaken.

Trade and tariff policies in 2016 were focused on rationalising and simplifying the tax regime to promote fair trade. Accordingly, the budget 2017 proposed to abolish the fee on the import and export control on tea, tea packing and logo registration, to support the tea industry. Also, action to ease regulations on the import of certain types of tea for re-export was proposed. The government also expects to gradually phase out the para-tariffs that are applicable in the tax system, with the view of promoting Sri Lanka for foreign investments. In line with this, duty rates of 96 tariff lines have been adjusted according to Sri Lanka's bound rate commitments to the WTO. Further, with a view to facilitating industries, the duty on industrial raw materials has been reduced.

To ease challenges that exporters are expected to face due to the sluggish global demand, the government has proposed several initiatives. Accordingly, the budget 2017 proposed tax benefits for exporters and the establishment of an EXIM bank for trade facilitation. Further, establishment of free trade zones, mainly targeting rubber based products, pharmaceuticals, fabric, mineral, chemical and automotive industries, and export villages, mainly targeting information technology (IT), robotics, fashion, high end apparel and boat manufacturing as well as government support for backward integration, especially on textiles and garments industry, were proposed.

The global and domestic challenges on international trade highlighted the need for a clear and proactive trade policy for the country. The trade policy needs to carefully plan for the future, addressing the possible impact of "Brexit" and impact of the foreign trade policy changes by the new government of the USA. Despite Sri Lanka’s anticipation on the reinstatement of the EU-GSP+ facility, the concessional access to most of the markets will be limited, as Sri Lanka is approaching an upper middle-income country status with a higher per capita income. Therefore, institutional support will be crucial to enable exporters to withstand intensifying global competition and access new markets and technologies, while preserving the competitiveness of existing markets. Hence, the National Trade Policy and the NES that is being formulated need to emphasise on the improvement of the competitiveness of exports and introduction of new export products, to diversify the export product basket from traditional goods and diversify the export destinations of Sri Lanka. Aligning the country’s industrial policy towards export promotion by reorienting the manufacturing sector to focus on more technology intensive products with high value addition is essential to facilitate entry into global production value chain and thereby to the growth of merchandise exports. Streamlining the functions of the different institutions overseeing export promotion is also vital for the formulation of an efficient and consensual export strategy. Further, an import policy entailing the liberalisation of import tariffs can help induce reciprocal benefits from import source countries. In turn, this can enable Sri Lanka to better position itself in the GVC and pave way for the broadening of the country’s product sharing network.

5.3 Trade in Goods, Trade Balance, Terms of Trade and Direction of Trade

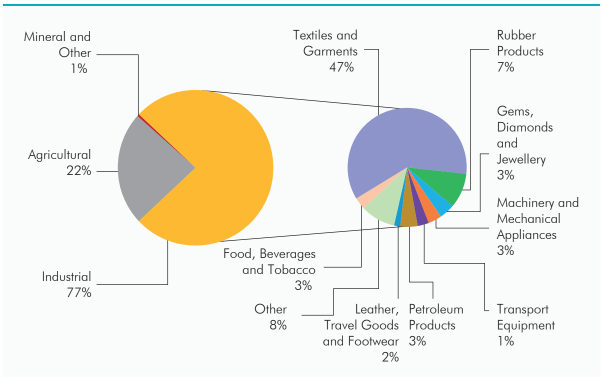
5.3.1 Export Performance

Earnings from exports contracted in 2016 for the second consecutive year, mainly owing to the downward movement in commodity prices in the international market and modest economic recovery in Sri Lanka's major export destinations. Despite the positive growth recorded in the latter part of 2016, earnings from exports at US dollars 10,310 million reflected a decline of 2.2 per cent, from US dollars 10,546 million in 2015, led by the declines in agricultural and industrial exports during the first seven months of the year.

Export earnings declined mainly due to lower agricultural exports, which account for around one fourth of total exports. Earnings from agricultural exports declined by 6.3 per cent to US dollars 2,326 million in 2016, reflecting lower exports of many categories under agricultural products. Earnings from tea exports, which declined by 17.7 per cent in 2015, reduced further by 5.3 per cent in 2016 to US dollars 1,269 million, recording the lowest level since 2009. The total volume of tea exported declined by 5.9 per cent to 289 million kilograms, due to lower production and lower demand. Tea production declined in 2016 due to adverse weather conditions and trade union activities in the plantation sector. The demand for tea contracted mainly due to the lower demand by major tea export destinations, especially Middle East and Russia, as a result of lower income levels experienced by these countries due to relatively low oil prices and increased geopolitical tensions. However, the average export price of tea increased marginally by 0.6 per cent to US dollars 4.39 per kilogram in 2016, despite the 6.3 per cent (year-on-year) decline recorded during the first half of the year. The reduction in export earnings from spices and minor agricultural products also contributed significantly to the lower earnings from agricultural exports. Export earnings from spices declined by 16.0 per cent to US dollars 317 million in 2016, as against an increase of 42.7 per cent recorded in 2015, due to significant reduction in export volumes of pepper and cloves, by 50.8 per cent and 66.6 per cent, respectively. However, both export volumes and prices of cinnamon, and nutmeg and mace increased during the year. Earnings from minor agricultural products declined by 28.9 per cent to US dollars 114 million, as export volumes of arecanuts and rice decreased substantially by 54.4 per cent and 54.2 per cent, respectively.

Export earnings from coconut, rubber and seafood increased during the year partly offsetting the contraction in agricultural exports. Earnings from the exports of coconut products increased by 4.0 per cent to US dollars 366 million due to increased non-kernel products, such as fresh nuts, fibre and coconut shells and ekels, despite a significant decline in earnings from coconut oil exports, under kernel products, owing to lower prices. Despite the decline recorded in rubber export prices, earnings from rubber exports, which declined continuously since 2012, increased by 25.0 per cent to US dollars 33 million in 2016, reflecting an increase in export volumes, by 55.8 per cent to 16 million kilograms. Export earnings from seafood, which declined significantly in 2015 due to restrictions on market access to the EU since January 2015, increased by 4.0 per cent to US

Chart 5.2
Composition of Exports - 2016



Source : Sri Lanka Customs

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dollars 170 million in 2016, after the lifting of the ban on seafood exports from Sri Lanka to the EU in June 2016.

Earnings from industrial exports, which account for around three fourths of total export earnings, contracted by 1.0 per cent to US dollars 7,940 million in 2016 in comparison to the previous year. Lower export earnings on transport equipment, petroleum products, and gems, diamonds and jewellery largely contributed to this decline. Export earnings from transport equipment recorded a 46.0 per cent decline to US dollars 131 million in 2016, mainly due to the significantly higher level of exports recorded in 2015, owing to the export of two dredger vessels that were imported in 2013 and 2014 for the use of the Colombo Port City Development Project. Export earnings from petroleum products, which mainly comprise bunker and aviation fuel, declined by 23.3 per cent to US dollars 287 million in 2016, partly due to higher competition from other regional players, such as Singapore and India. Export earnings from gems, diamonds and jewellery declined by 17.4 per cent to US dollars 274 million in 2016 in comparison to the previous year, reflecting lower global demand. Further, export earnings from animal fodder, printing industry products, ceramic products and chemical products also declined during the year.

Table 5.2
Composition of Exports

Category	2015 (a)		2016 (b)		Change in Value US$ million	Y-o-Y Change %	Contribution to Change %
	Value US$ million	Share %	Value US$ million	Share %			
Agricultural Exports	**2,481.5**	**23.5**	**2,326.1**	**22.6**	**-155.4**	**-6.3**	**65.6**
Tea	1,340.5	12.7	1,269.0	12.3	-71.5	-5.3	30.2
Rubber	26.1	0.2	32.7	0.3	6.5	25.0	-2.8
Coconut	351.7	3.3	366.0	3.5	14.2	4.0	-6.0
Spices	377.4	3.6	317.1	3.1	-60.3	-16.0	25.5
Vegetables	30.5	0.3	26.5	0.3	-4.0	-13.0	1.7
Unmanufactured Tobacco	31.8	0.3	31.2	0.3	-0.6	-2.0	0.3
Minor Agricultural Products	160.4	1.5	114.1	1.1	-46.3	-28.9	19.6
Seafood	163.1	1.5	169.6	1.6	6.5	4.0	-2.8
Industrial Exports	**8,017.1**	**76.0**	**7,940.1**	**77.0**	**-77.0**	**-1.0**	**32.5**
Textiles and Garments	4,820.2	45.7	4,884.1	47.4	63.9	1.3	-27.0
Rubber Products	761.2	7.2	767.9	7.4	6.7	0.9	-2.8
Petroleum Products	373.9	3.5	286.9	2.8	-87.1	-23.3	36.8
Gems, Diamonds and Jewellery	331.7	3.1	273.9	2.7	-57.8	-17.4	24.4
Food, Beverages and Tobacco	306.8	2.9	323.7	3.1	16.9	5.5	-7.1
Machinery and Mechanical Appliances	293.8	2.8	317.6	3.1	23.8	8.1	-10.1
Printing Industry Products	45.7	0.4	42.4	0.4	-3.3	-7.2	1.4
Transport Equipment	243.7	2.3	131.5	1.3	-112.2	-46.0	47.4
Leather, Travel Goods and Footwear	135.7	1.3	165.6	1.6	29.9	22.0	-12.6
Ceramic Products	35.2	0.3	34.4	0.3	-0.8	-2.2	0.3
Other Industrial Exports	669.4	6.3	712.2	6.9	42.8	6.4	-18.1
Mineral Exports	**28.4**	**0.3**	**29.0**	**0.3**	**0.6**	**2.1**	**-0.3**
Unclassified Exports	**19.5**	**0.2**	**14.5**	**0.1**	**-5.0**	**-25.5**	**2.1**
Total Exports (c)	**10,546.5**	**100.0**	**10,309.7**	**100.0**	**-236.8**	**-2.2**	**100.0**
Annual Average Exchange Rate (d)	**135.94**		**145.60**				

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

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

BOX 07

National Strategy towards Export Promotion

Introduction

The link between export growth and economic growth is highly debated in economic literature. Although the common notion is that there is a bi-directional relationship between export growth and economic growth, this relationship has not been seen in relation to Sri Lanka. This was experienced between 2000-2016, wherein GDP grew by a Compound Annual Growth Rate (CAGR) of 10.4 per cent, while exports grew by only 4.0 per cent (CAGR). Sri Lanka's economic growth during the recent past has mainly been pushed by the expansion of domestic demand rather than increased exports.

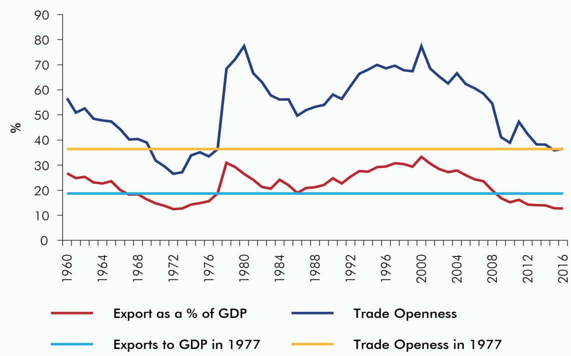
The high level of economic growth witnessed during the period 2005-2012, which was mainly due to the expansion in domestic demand, started to stagnate within a 4-5 per cent band from 2013 onwards, emphasising that external demand is paramount for a sustained pace of economic growth in a small economy like Sri Lanka. The widening trade and current account deficits and an increase reliance on unsustainable levels of foreign borrowings were an inevitable consequence of growth which was dependent on non-tradables and domestic demand. This provides compelling evidence that comprehensive strategies, which focus on the promotion of high-value exports, are essential to achieve a sustainable external current account balance and high growth. In addition, the generation of higher export revenues will also serve as a buffer for the accumulated stock of medium and short term foreign liabilities, and can also be utilised for the stabilisation of the exchange rate, thereby contributing to the building up of a sustainable level of reserves that can help improve the country's economic resilience. Furthermore, a renewed focus on exports can help divert investments to more efficient sectors of the economy, thus raising productivity. Growth in exports also entails several other benefits, such as inflow of new technology, employment creation, greater economies of scale and expansion of the productive resource base of the economy.

Sri Lanka was ahead of its regional peers in liberalising the economy in 1977. The adoption of liberal economic policies, such as private sector driven development, export led growth and encouragement of Foreign Direct Investment (FDI), led to the immediate realisation of notable improvements in foreign trade and trade openness.[1] Trade openness, which was 36.4 per cent in 1977 nearly doubled to 72.2 per cent by 1979, while exports as a percentage of GDP, which was 18.7 per cent in 1977 increased significantly to 29.2 per cent by 1979. This change in policy direction resulted in substantial improvements in export earnings. Export earnings increased from US dollars 767 million in 1977 to US dollars 5,522 million in 2000. However, the growth in exports has not been very encouraging since 2000. Earnings from exports in 2016 have increased to US dollars 10,310 million, while expenditure on imports increased to US dollars 19,400 million. As a result, the trade deficit expanded to US dollars 9,090 million by 2016. In spite of the turnaround seen in the immediate aftermath of the adoption of liberal policies, Sri Lanka's international trade performance has been lacklustre, regressing to levels that were seen during the pre-liberalisation era. In 2016, Sri Lanka's trade openness was 36.5 per cent, while exports relative to GDP reduced to a level of 12.7 per cent. Malaysia had an export to GDP ratio of 67.5 per cent, Thailand 54.2 per cent and Vietnam 83.7 per cent in 2015.

1. Trade openness is measured by the sum of merchandise export and merchandise import as a percentage of GDP.

Chart B 7.1

Trade Openness and Export to GDP of Sri Lanka



Source: Central Bank of Sri Lanka

The post liberalised period has witnessed a change in Sri Lanka's export composition from primarily an agriculture based export structure to a more value added labour-intensive product structure. Despite the change in composition, exports continue to be concentrated on two traditional products, namely, garments and tea, which account for more than half of the export basket, reflecting the limited product diversification of the export sector. The export sector also shows a lack of diversification in terms of markets. Europe and the USA continue to account for approximately two-thirds of total exports. Further, approximately 70 per cent of tea exports are to the Middle-East and Commonwealth of Independent States (CIS), for which demand is sensitive to income earned through oil exports. The lack of product and market diversification indicates the vulnerability of the export sector.

Regional competitors have rapidly expanded their external trade and have emerged as exemplary models of export led growth. The Export Value Index[2] presented

2. The Export Value Index is presented by the World Bank using current value of exports (f.o.b) sourced from UNCTAD's data, which is converted to US dollars and expressed as a presentage of the average for the base period (2000).

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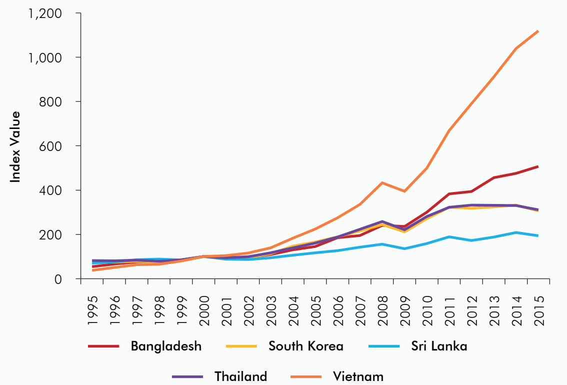
Chart B 7.2
Comparison of Export Value Index (2000=100)



Source: World Bank

by the World Bank (Chart B 7.2) shows the extent to which the Sri Lankan export sector has been lagging in comparison to its regional counterparts during the period from 2000 to 2015. Sri Lanka has only increased its exports by 1.9 times, while Vietnam and Bangladesh have increased by 11.2 times and 5.1 times, respectively, and South Korea and Thailand which displayed export led growth from 1990s, each had 3.1 times of exports in 2015 when compared with exports of 2000.

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Table B 7.1
GDP, Merchandise Exports and Imports of Selected Regional Countries

Country	Indicator	Values in US$ billion				CAGR (%)
		1985	1995	2005	2015	1985-2015
Bangladesh	GDP	22.3	37.9	69.4	195.1	7.5
	Exports	1.0	3.5	9.3	32.4	12.3
	Imports	2.5	6.7	13.9	39.5	9.6
South Korea	GDP	103.7	559.3	898.1	1,377.9	9.0
	Exports	30.3	125.1	284.4	526.8	10.0
	Imports	31.1	135.1	261.2	436.5	9.2
Thailand	GDP	38.9	169.3	189.3	395.2	8.0
	Exports	7.1	56.4	110.9	214.4	12.0
	Imports	9.2	70.8	118.2	202.7	10.8
Vietnam	GDP	14.1	20.7	57.6	193.6	9.1
	Exports	0.7	5.4	32.4	162.1	19.9
	Imports	1.9	8.2	36.8	166.1	16.2
Sri Lanka	GDP	6.0	13.0	24.4	80.6	9.1
	Exports	1.3	3.8	6.3	10.5	7.2
	Imports	2.0	5.3	8.9	18.9	7.7

Note: Data for Sri Lanka are from national sources. Data for other countries are from the World Bank

A similar trend is observed also when analysing the performance of external trade and GDP of several selected Asian countries for the past three decades. While the performance of all countries seems to be similar to each other, Sri Lanka's performance has fallen well behind with lower CAGR in exports[3] and imports despite commendable performance in GDP.

Success Stories from International Experience

An analysis of export growth in countries such as South Korea, Thailand, Vietnam and Bangladesh, shows that broadly similar export development policies have been adopted by all these countries. Comprehensive export promotion programmes such as export subsidies, export credit schemes with preferential interest rates and tax incentives have been implemented to promote exports. These strategies were complemented by the creation of a conducive macroeconomic environment with low and stable inflation, low interest rates and a competitive exchange rate. Stakeholder engagement was also a central aspect of the overall promotion strategy. Accordingly, regular export promotion meetings were held with stakeholders, including the government, industry professionals, trade facilitators and business personnel so as to make cohesive decisions in a timely manner. An appropriate regulatory environment was also created wherein laws that recognised private ownership were introduced to encourage the private sector to evolve as the engine of growth. New laws that enabled the liberalisation of the capital account and encouraged foreign investment were also introduced, resulting in a surge in FDI flows. An open door policy, introduced as a result of the liberalisation of the economy, paved the way for these countries to develop synergies with developed economies, while gaining assistance on various fronts from international organisations such as the World Trade Organization (WTO) and the World Bank.

In terms of domestic production, policies were designed to prioritise initiatives that would facilitate import substitution so that the domestic consumption demand would be fulfilled. Such initiatives included the adoption of technological innovation and the expansion of the manufacturing capacity. When domestic industries acquired the capacity to compete in the international market, the emphasis shifted to the implementation of export expansion policies that encouraged the export of labour-intensive industrial products such as textiles and garments. Once a sustainable level of export growth had been reached, the key thrust of these countries' industrial policies shifted to reorienting export industries

3. Nevertheless it must also be noted that, earnings from services exports in Sri Lanka have recorded a notable growth in the recent past. Service exports have increased rapidly since 2009, with significant increases recorded in tourism, transport and ICT/BPO exports. Services imports also have followed the same trend. Although services exports, in net terms, have increased over the years, such increase has not offset the shortfall in merchandise exports.

from labour-intensive ones to industries with high value-addition, in order to align the export sector with rising wage levels and to accommodate the overall growth process. As a result, the share of value added industries increased in tandem with product diversification, while the share of labour-intensive industrial and agricultural exports declined. Export strategies also comprised many country-specific aspects. For example, Vietnam, which was a centrally planned agro-based economy, initiated several economic reform policies in 1986, which led to a transformation of the export sector and the economy as a whole. Although Vietnam introduced several reforms to its large agricultural sector by way of policies related to the development of high-value agro industrial products, such as coffee and rubber and privatisation of state-owned land, the reform agenda prioritised the industrial sector. Although these led to a reduction in share of agricultural exports and the sectoral contribution of GDP, the efficiency of the agriculture sector improved, resulting in the country's transformation from a net importer to a net exporter of the agricultural products. In the case of Vietnam and other countries, such as South Korea and Thailand, after a substantial level of growth in exports was achieved, policy priorities shifted away from sector-oriented support towards function-oriented support. This led to comprehensive assistance for Research and Development (R&D), which eventually led to significant leaps in technological innovation, resulting in the increase in exports of technology-based products. However, over the long term, the South Korean government withdrew much of the focused assistance provided to the export sector in order to strengthen the market mechanism and to enable domestic players to compete on a level playing field. On the other hand, although Bangladesh's exports had grown by more than 5 times since 2000 with the benefit of EU-EBA[4] facility, resulting in the steady improvement of exports to GDP and trade openness, product diversification continued to remain neglected, where garments currently account for about 90 per cent of total exports. Similar to Sri Lanka, Bangladesh's main export destinations are the USA and the EU, making its external sector highly vulnerable to unfavourable developments in these regions. The experiences of these countries also highlight the importance of policy consistency to enable all stakeholders to make sustainable decisions for the long-term. However, such polices have also been flexible enough to adapt to current and future developments in the domestic and global environment.

National Strategy towards Export Promotion

A systematic country diagnostic of Sri Lanka conducted by the World Bank in 2016 using a hybrid framework combining the Hausmann, Rodrik and Velasco growth diagnostics model and the Bussolo and Lopez-Calva (2014) assets-based framework, identifies a set of constraints and growth drivers to progress towards the twin goals of "Ending Poverty" and "Shared Economic Prosperity". This highlights the areas that require immediate attention to unleash Sri Lanka's export growth potential by a significant extent, such as revision of Sri Lanka's trade-related policies, provision of more resources and quality enhancing management to the education sector in order to expand the skilled workforce and promotion of innovation by establishing linkages between R&D institutions and networks of entrepreneurs. In developing a strategy to promote exports, the following aspects need to be taken into consideration.

4. The EU's Everything But Arms' arrangement (EBA) was born in 2001 to give all LDCs full duty free access to the EU for all their exports with the exception of arms and armaments.

Macroeconomic Policies to Facilitate Trade

Interest and exchange rates are the key prices in an economy that provide incentives for producers and consumers to engage in economic activities in the international and domestic arenas. As financing cost is one of the key factors affecting both production and export activity, maintaining low interest rates in the economy would support to sustain the country's competitive edge in export markets. A low and stable inflation environment would ensure the maintenance of low interest rates. Moreover a subdued and stable inflation environment is also essential for investors to make informed long-term decisions. Given that exchange rate policy is closely linked to the trade outcome, a good trade outcome cannot be expected from a misaligned exchange rate. Sri Lanka has endured prolonged periods of over-valued exchange rates that created a bias against exports. Keeping the nominal exchange rate overvalued, has led to large Balance of Payments (BOP) deficits and loss of reserves that have led the government to recourse to borrowings at commercial interest rates thereby increasing external debt. The Central Bank of Sri Lanka (CBSL) has already announced its intention to maintain flexibility in the nominal exchange rate, which reflects a competitive Real Effective Exchange Rate (REER) Index eventually being around 100. Such a policy will ensure that the exchange rate is fairly valued and is largely determined by market forces while facilitating the conduct of monetary policy of the country. It is important to highlight that achieving fiscal sustainability is crucial for maintaining low nominal interest rates and a competitive exchange rate.

Continuation of Liberalised Foreign Policy to Facilitate Trade

Considering the high level of competition in the international market, Sri Lanka should exploit existing bilateral and multilateral trade agreements while continuously exploring the potential for new trade opportunities through economic partnership agreements. The initiatives taken towards strengthening bilateral relations and maintaining diplomatic balance by the government are noteworthy. It is important to continue trade negotiations with a view to expanding preferential access to new markets, particularly to the fast growing Asian economies. At the same time, Sri Lankan missions abroad could play an increased role by providing market information to exporters based on market surveys in order to get the right product to the right place.

Revision of Sri Lanka's Trade-related Policies

Greater trade openness would enable export growth and diversification of the economy. A more outward-oriented trade policy can amplify the gains from rebalancing towards a stronger role for the private sector in the economy, and enhancing overall economic growth. Using trade measures (tariff and non-tariff measures) to bring about domestic price stability leads to greater uncertainty inhibiting production planning and supporting import substituting activities. Import restrictions cannot correct an imbalance in the current account deficit of the BOP in the long run unless county accepts lower growth, employment and incomes (ie the low growth, high unemployment and stagnation in real income seen prior to the 1977 liberalisation package). In addition, import restrictions can contribute to widening the trade deficit by discouraging exports as import restrictions are a tax on exports. The restricted trade regime had led to lower production capacity and lower competitiveness in all sectors of the economy, leading to lower comparative advantage for Sri Lankan products, resulting in Sri Lanka losing ground in the international arena.

Improvement in Logistics

Continued investments in logistics, especially sea ports and airports, will continue to play a key role in ensuring competitiveness. Current policies to establish free trade zones, economic corridors, economic zones as well as export villages need to be coordinated with upcoming logistic hubs to reduce transaction cost. Future policies must focus on improving the quality and accessibility of infrastructure under government's national development plan since infrastructure serve as an input in the production process, which will contribute towards increasing competitiveness of exports.

Role of Small and Medium Enterprises (SMEs) in Export Promotion

The increased focus on SMEs by successive governments to promote inclusive growth, can be exploited in favour of the renewed export promotion strategy, as their cost-effective outputs can be marketed as niche exports or as inputs for larger international firms, thereby enabling firms to build linkages with global markets. The modernisation of the services sector is also important, as the production flow process is now largely dominated by services. Specifically, SMEs can be encouraged to engage in services industries, as these do not require high levels of capital or raw materials.

FDI for Export Promotion

FDI will enable Sri Lanka to develop its current export base, which is highly concentrated on a few low tech products, to high tech manufacturing products. FDI is not only a source of foreign funds, but also a source of foreign technology and knowledge. Such initiatives will complement the presence of a highly skilled and knowledgeable workforce and will thereby further increase Sri Lanka's attractiveness as a Business Process Outsourcing (BPO) and Knowledge Process Outsourcing (KPO) destination and enable Sri Lanka to enter into global value chains. In attracting FDI, Sri Lanka needs to focus on improving its national competitiveness. To this end, Sri Lanka needs to launch a rigorous reform agenda to address the bottlenecks that hinder the attraction of FDI.

Encourage R&D and Innovation

Innovation leads to diversify the production base, adds more value to the final product, improves the cost competitiveness helping countries to attain a higher share of exports in the global market. A sustained increase in R&D spending and promoting innovation will have a long term effect on competitiveness. The government needs to take necessary initiatives to connect the entrepreneur networks to existing R&D facilities as the private sector involvement in R&D and innovation is critical in commercialising research outcomes.

Way Forward

It is evident that for the export sector to emerge as a key driver of economic growth, formulating a strategic plan to drive the export sector within the overall development strategy of the government is important. Several measures, spearheaded by the Ministry of Development Strategies and International Trade (MODSIT) and the Export Development Board (EDB) are currently underway. The National Export Strategy, initiated by the EDB, is a collaborative effort of the state and the private sector and provides a five-year action-oriented framework for the development of trade and competitiveness. Simultaneously, a National Trade Policy has been drafted with the objective of attracting more export-oriented FDI, to improve trade logistics, to make customs procedures more transparent and efficient, and to implement other measures to boost a firm's ability to compete in the global market. By recognising the need for broad-based institutional support, the government has already taken steps to create two agencies, the Agency for International Trade (AfIT) and the Agency for Development (AfD). The AfIT is rectifying issues in existing trade pacts with the Indian subcontinent while exploring an economic partnership agreement with India, to use Sri Lanka's improved investment climate to attract investment that caters to the entire market of the subcontinent. The AfIT is also pursuing new bilateral and multilateral trade opportunities beyond the subcontinent especially with China, Singapore, the EU and the USA, which cater to a market of about 3 billion, complying with the non-aligned foreign policy of the government. The AfD, on the other hand, is expected to contribute to development efforts by collaborating with the private sector to identify constraints on the development process and by building multi-functional teams that can work across sectors to resolve issues to enable the private sector to enhance capabilities, engage in product development and foster export growth. The government will need to play a proactive and unyielding role in creating economic transformation to revitalise the export sector, allowing the private sector to drive the growth momentum. Enhancing exports would reduce the trade deficit and help to shrink the current account deficit of the BOP. The successful countries of East and Southeast Asia have driven their growth process through surplus in the current account. Priority must be attached to eliminate chronic external sector imbalances experienced by Sri Lanka for several decades.

The revival of the external sector will depend on the development of farsighted yet practical, strategies of a cohesive nature. All relevant stakeholders have to reach a consensus on the creation of a well-coordinated industrial and trade policy that is aligned with macroeconomic policy and the overall strategic direction of the government. This can serve as the foundation for an export promotion policy, which is consistent, practical and well-accepted by all stakeholders. Initiatives already taken by the government are expected to provide necessary policy direction and support for the revitalisation of the country's export sector.

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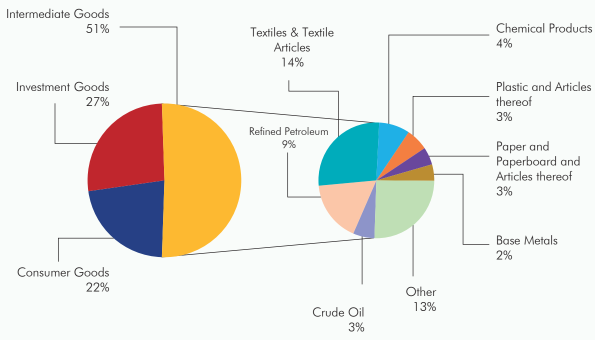
Earnings from textiles and garments exports, which account for 47 per cent of total exports, increased by 1.3 per cent to US dollars 4,884 million in 2016, mitigating the impact of lower industrial exports to some extent. The USA and the EU continued to be the two largest buyers of Sri Lankan garments, in both volume and value terms. Earnings from these two markets in 2016 amounted to US dollars 2,104 million and US dollars 1,905 million, respectively, that jointly contributes to 87.1 per cent of total earnings from garments. Meanwhile, garment exports to non-traditional markets including Canada, China, Australia and the UAE increased by 7.9 per cent in comparison to a 4.6 per cent growth recorded in 2015. Export earnings from base metals and articles increased significantly by a 60.5 per cent in 2016 due to higher earnings from articles of iron and steel, aluminium and copper. Global prices for base metals, including aluminium and copper, were on an increasing trend in 2016 although their average price levels remained lower compared to 2015. Export earnings from leather products also increased by 22.0 per cent, mainly due to a significant increase in the export earnings of footwear. Export earnings from rubber products increased marginally by 0.9 per cent as a result of higher earnings from rubber gloves and rubber tyres. Machinery and mechanical appliances, and food and beverages were the other industrial goods that recorded higher export earnings.

Earnings from the export of minerals rose marginally by 2.1 per cent in 2016, contributing to only 0.3 per cent of the total export earnings in 2016. Earnings from the export of earth and stones increased, while earnings from ores, slag and ash decreased.

5.3.2 Import Performance

Expenditure on imports increased in 2016 mainly due to the significant increase in expenditure on imports recorded in the last quarter of 2016. Increase in the imports of investment goods and non-fuel intermediate goods contributed to the growth in import expenditure, negating the favourable impact of the decline in import expenditure on other categories, such as fuel and non-food consumer goods. Import expenditure on food and beverages remained broadly unchanged from the level recorded in 2015. Despite low commodity prices prevailing in the international market and prudent policy measures adopted by the government and the Central Bank to rationalise imports, higher economic activities in the country led to increased expenditure on overall imports. Accordingly, the total expenditure on imports

Chart 5.3
Composition of Imports - 2016



Source : Sri Lanka Customs

rose moderately by 2.5 per cent to US dollars 19,400 million in 2016, while non-fuel import expenditure increased by 4.2 per cent to US dollars 16,919 million.

The increase in expenditure on import of investment goods was the major contributory factor for the increase in the overall expenditure on imports. Expenditure on investment goods, which accounts for 27 per cent of total expenditure on imports, increased by 13.8 per cent to US dollars 5,198 million in 2016, reflecting growth in the imports of major investment good categories, except transport equipment. Import expenditure on machinery and equipment increased by 20.3 per cent to US dollars 2,741 million in 2016, reflecting significant increases in all subcategories. Electronic equipment, machinery and equipment parts, telecommunication devices and agricultural machinery were the key contributors to the growth

Table 5.3
Composition of Imports

Category	2015 Value US$ million	2015 Share %	2016 (a) Value US$ million	2016 (a) Share %	Change in Value US$ million	Y-o-Y Change %	Contribution to Change %
Consumer Goods	**4,713.5**	**24.9**	**4,319.0**	**22.3**	**-394.5**	**-8.4**	**-84.8**
Food and Beverages	1,627.8	8.6	1,627.4	8.4	-0.4	…	-0.1
Rice	135.1	0.7	12.8	0.1	-122.3	-90.5	-26.3
Sugar and Confectionery	254.4	1.3	344.6	1.8	90.2	35.5	19.4
Dairy Products	250.9	1.3	249.3	1.3	-1.6	-0.6	-0.3
Lentils	148.0	0.8	139.4	0.7	-8.6	-5.8	-1.8
Other	839.4	4.4	881.3	4.5	41.9	5.0	9.0
Non-Food Consumer Goods	3,085.7	16.3	2,691.5	13.9	-394.1	-12.8	-84.7
Vehicles	1,359.6	7.2	794.8	4.1	-564.9	-41.5	-121.4
Medical and Pharmaceuticals	459.8	2.4	525.8	2.7	66.0	14.3	14.2
Home Appliances	221.0	1.2	270.7	1.4	49.7	22.5	10.7
Clothing and Accessories	390.1	2.1	365.8	1.9	-24.3	-6.2	-5.2
Other	655.0	3.5	734.4	3.8	79.3	12.1	17.0
Intermediate Goods	**9,638.2**	**50.9**	**9,870.0**	**50.9**	**231.8**	**2.4**	**49.8**
Fuel	2,699.6	14.3	2,481.0	12.8	-218.6	-8.1	-47.0
Textiles and Textile Articles	2,296.2	12.1	2,704.9	13.9	408.7	17.8	87.8
Diamonds and Precious stones and Metals	161.5	0.9	514.4	2.7	352.9	218.5	75.8
Chemical Products	870.3	4.6	856.3	4.4	-14.0	-1.6	-3.0
Wheat and Maize	357.2	1.9	249.2	1.3	-108.0	-30.2	-23.2
Fertiliser	289.6	1.5	136.9	0.7	-152.8	-52.7	-32.8
Other Intermediate Goods	2,963.7	15.7	2,927.3	15.1	-36.5	-1.2	-7.8
Investment Goods	**4,567.0**	**24.1**	**5,198.0**	**26.8**	**631.0**	**13.8**	**135.6**
Building Materials	1,352.0	7.1	1,568.7	8.1	216.7	16.0	46.6
Transport Equipment	930.9	4.9	880.2	4.5	-50.8	-5.5	-10.9
Machinery and Equipment	2,278.1	12.0	2,740.7	14.1	462.6	20.3	99.4
Other Investment Goods	5.9	…	8.5	…	2.5	42.3	0.5
Unclassified Imports	**15.9**	**0.1**	**13.1**	**0.1**	**-2.9**	**-17.9**	**-0.6**
Total Imports (b)	**18,934.6**	**100.0**	**19,400.1**	**100.0**	**465.5**	**2.5**	**100.0**
Annual Average Exchange Rate (c)	**135.94**		**145.60**				

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

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

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of machinery and equipment imports. Import expenditure on building materials increased by 16.0 per cent to US dollars 1,569 million in 2016. Import expenditure on all subcategories of building materials, except insulated wires and cables, increased substantially. Imports of cement, articles of iron and steel, ceramic products, and wood products were the largest contributors for the growth in import expenditure on building materials. Meanwhile, import expenditure on transport equipment declined by 5.5 per cent to US dollars 880 million, mainly due to the reduction in the importation of auto-trishaws and buses.

Import expenditure on intermediate goods increased by 2.4 per cent to US dollars 9,870 million in 2016, accounting for 51 per cent of the country's total import bill. Expenditure on textiles and textile articles imports was the largest expenditure category, surpassing fuel imports, and increased by 17.8 per cent to US dollars 2,705 million in 2016, in line with the increase in the export of textiles and garments. Import expenditure on gold increased significantly to US dollars 374 million in 2016 from US dollars 42 million in 2015, owing to an increase in the volume of gold imported. Prices of gold in international commodity markets exhibited an increasing trend during the first three quarters of 2016, but declined during the last quarter.

Expenditure on fuel imports declined by 8.1 per cent to US dollars 2,481 million, due to reduced expenditure on both crude oil and refined petroleum imports, while expenditure on coal imports increased. The volume of crude oil imports declined by 4.5 per cent in 2016 while the average price paid per barrel declined to US dollars 46.30 from US dollars 54.80 per barrel in 2015. Import prices of refined petroleum also declined by 19.9 per cent, while import volumes rose by 17.0 per cent during this period, partly due to increased thermal power generation owing to drought conditions in the country. Expenditure on coal imports increased by 23.9 per cent in 2016 mainly due to the significant increase in coal based power generation. Accordingly expenditure on fuel imports, as a share of total import expenditure, further declined to 12.8 per cent in 2016 from 14.3 per cent in 2015 and 23.7 per cent in 2014. Meanwhile, import expenditure on fertiliser declined by 52.7 per cent, due to a reduction in both prices and volumes, while expenditure on wheat and maize imports declined by 30.2 per cent. Import expenditure relating to certain other categories of

Table 5.4
Volume of Major Imports

MT '000

Item	2012	2013	2014	2015	2016 (a)
Rice	36	23	600	286	30
1st Quarter	15	9	6	176	6
2nd Quarter	7	6	102	91	9
3rd Quarter	10	4	145	9	6
4th Quarter	4	4	348	9	8
Wheat (b)	1,084	895	1,179	1,208	948
1st Quarter	353	197	271	242	171
2nd Quarter	235	326	324	342	326
3rd Quarter	291	170	291	373	271
4th Quarter	205	201	292	251	179
Sugar	569	548	520	624	651
1st Quarter	158	126	131	169	147
2nd Quarter	135	175	162	161	144
3rd Quarter	114	118	152	156	179
4th Quarter	162	129	75	137	181
Crude Oil (b)	1,486	1,743	1,824	1,763	1,685
1st Quarter	558	482	548	369	372
2nd Quarter	413	545	365	355	456
3rd Quarter	137	315	462	472	384
4th Quarter	379	401	449	567	473
Refined Petroleum (b)	3,961	2,907	3,385	3,321	3,885
1st Quarter	1,036	673	970	799	830
2nd Quarter	903	756	762	952	1,163
3rd Quarter	997	791	1,006	744	749
4th Quarter	1,025	687	647	826	1,142
Fertiliser	640	600	765	873	527
1st Quarter	129	61	202	163	139
2nd Quarter	176	139	190	244	135
3rd Quarter	226	187	95	189	126
4th Quarter	108	214	277	277	127

(a) Provisional
(b) Adjusted

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

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intermediate goods, including food preparations, unmanufactured tobacco, base metals, chemical products, and mineral products, also declined during 2016 compared to the previous year.

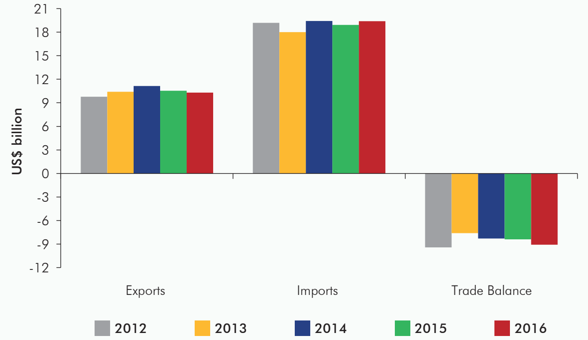
Import expenditure on consumer goods declined by 8.4 per cent to US dollars 4,319 million in 2016 in comparison to the previous year, due to a reduction in the expenditure on the import of non-food consumer goods. Import expenditure on non-food consumer goods declined by 12.8 per cent to US dollars 2,692 million, mainly led by the reduction in imports of vehicles for personal use. The increase in import taxes on the importation of motor vehicles by the government, together with macro prudential measures adopted by the Central Bank imposing a maximum Loan to Value (LTV) ratio in respect of loans and advances granted to purchase motor vehicles by banks and financial institutions were the main reasons for this decline. Import expenditure on clothing and accessories, printed material and stationery, and rubber products also declined in 2016. In contrast, import expenditure on medical and pharmaceutical items recorded an increase of 14.3 per cent to US dollars 526 million. Home appliances and household and furniture items also increased by 22.5 per cent and 21.5 per cent, respectively. Thus, import expenditure on consumer goods, excluding food and beverages, contributed to 14 per cent of the total import expenditure.

Import expenditure on food and beverages in 2016 remained broadly unchanged from the level recorded in 2015. Import expenditure on sugar increased by 35.6 per cent to US dollars 343 million in 2016, mainly due to the increase in sugar prices rather than the volume. Import expenditure on beverages, spices, seafood and fruits also recorded increases with higher import volumes. Meanwhile, a reduction in the import volume of rice, and thereby its import expenditure, contributed largely to offset the increases in import expenditure. Upward revisions in import tariffs applicable to rice in 2015 and early 2016, to discourage imports due to increased supply of rice in the domestic market, contributed to the decline in rice imports to 29,524 metric tons in 2016, from 285,604 metric tons in 2015. Import expenditure on dairy products declined marginally by 0.6 per cent to US dollars 249 million in 2016 owing to a significant decline in the average import price of milk powder despite an increase in volume. The import expenditure on onions, lentils and potatoes also declined during 2016.

5.3.3 Trade Balance

The deficit in the trade account, which contracted during the first four months of 2016, on cumulative basis, expanded thereafter, resulting in an expansion during the year 2016. Decline in earnings from exports during 2016 compared to 2015 and the substantial increase in import expenditure on intermediate and investment goods, particularly during the last quarter of 2016, expanded the trade deficit. The trade deficit widened to US dollars 9,090 million in 2016 compared to US dollars 8,388 million recorded in 2015. The trade deficit as a percentage of GDP increased to 11.2 per cent in 2016 compared to 10.4 per cent in 2015.

Chart 5.4
Exports, Imports and Trade Balance



Source : Sri Lanka Customs

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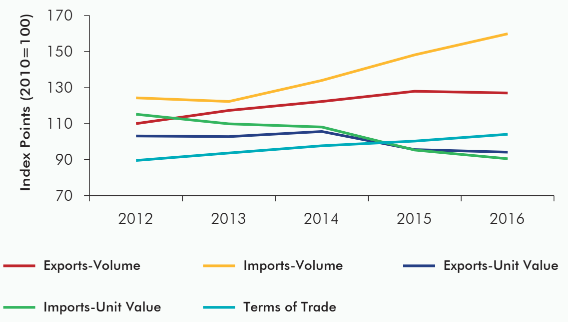
5.3.4 Terms of Trade

Terms of trade improved in 2016. Significant reduction observed in the import price index, in comparison to the reduction observed in the export price index resulted to increase terms of trade by 3.7 per cent. Accordingly, the terms of trade index increased to 104.0 index points in 2016 from 100.3 index points in 2015.

The overall export price index declined by 1.5 per cent in 2016 with a reduction in price indices pertaining to all major categories of exports. The price index for agricultural exports reduced by 1.3 per cent in 2016 compared to 2015,

Chart 5.5
Terms of Trade and Trade Indices



Source : Central Bank of Sri Lanka

with low prices that prevailed in the international commodity market, particularly during the first half of the year. Despite the lower export prices

Table 5.5
Trade Indices (a)

2010 = 100

Category	Value Index 2015	Value Index 2016 (b)	Value Index Y-o-Y Change %	Volume Index 2015	Volume Index 2016 (b)	Volume Index Y-o-Y Change %	Unit Value Index 2015	Unit Value Index 2016 (b)	Unit Value Index Y-o-Y Change %
EXPORTS									
Agricultural Exports	107.6	100.9	-6.3	95.6	90.8	-5.0	112.6	111.2	-1.3
Tea	93.1	88.1	-5.3	91.3	86.2	-5.5	102.0	102.2	0.2
Rubber	15.1	18.9	25.0	21.0	27.2	29.3	71.8	69.4	-3.3
Coconut	212.3	220.9	4.0	159.4	174.1	9.3	133.2	126.9	-4.8
Spices	182.2	153.0	-16.0	118.3	100.3	-15.2	154.0	152.6	-0.9
Minor Agricultural Products	224.6	159.7	-28.9	205.3	149.6	-27.1	109.4	106.8	-2.4
Industrial Exports	131.6 (c)	130.3	-1.0	144.4	144.9	0.4	91.1 (c)	89.9	-1.3
Textiles and Garments	143.7	145.6	1.3	126.4	127.1	0.5	113.7	114.6	0.8
Petroleum Products	142.1	109.0	-23.3	208.6	185.8	-10.9	68.1	58.6	-13.9
Rubber Products	136.7	137.9	0.9	96.9	104.2	7.5	141.1	132.4	-6.2
Mineral Exports	117.2	119.7	2.1	82.4	88.9	7.9	142.2	134.6	-5.4
Total Exports	122.3 (c)	119.6	-2.2	128.0	127.0	-0.7	95.6 (c)	94.1	-1.5
IMPORTS									
Consumer Goods	190.5	174.5	-8.4	177.9	156.5	-12.0	107.1	111.5	4.1
Food and Beverages	123.1	123.0	...	128.1	124.1	-3.1	96.0	99.1	3.2
Non-Food Consumer Goods	268.0	233.7	-12.8	235.0	193.8	-17.5	114.0	120.6	5.8
Intermediate Goods	119.8	122.6	2.4	128.7	142.5	10.8	93.1	86.0	-7.6
Fuel	88.8	81.6	-8.1	116.6	129.5	11.1	76.2	63.0	-17.3
Fertiliser	120.6	57.0	-52.8	129.5	68.6	-47.1	93.1	83.1	-10.7
Chemical Products	167.4	164.7	-1.6	155.6	163.4	5.1	107.6	100.8	-6.3
Wheat and Maize	134.6	93.9	-30.2	121.3	92.7	-23.6	110.9	101.3	-8.7
Textiles and Textile Articles	126.9	149.5	17.8	120.4	138.2	14.7	105.4	108.2	2.7
Plastics and Articles thereof	145.5	146.1	0.4	142.6	155.7	9.2	102.0	93.8	-8.0
Diamonds and Precious Stones and Metals	42.8	136.2	218.5	49.1	155.0	215.4	87.1	87.9	1.0
Investment Goods	165.8	188.7	13.8	179.7	215.6	20.0	92.2	87.5	-5.1
Building Materials	164.5	190.9	16.0	167.8	206.2	22.9	98.1	92.6	-5.6
Transport Equipment	157.1	148.5	-5.5	156.5	142.0	-9.2	100.4	104.6	4.2
Machinery and Equipment	170.3	204.9	20.3	197.3	253.9	28.7	86.3	80.7	-6.5
Other Investment Goods	178.4	253.9	42.3	184.6	262.0	41.9	96.7	96.9	0.3
Total Imports	141.2	144.7	2.5	148.2	159.9	7.9	95.3	90.5	-5.1
Terms of Trade							100.3 (c)	104.0	3.7

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

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

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of tea during the first seven months of the year, the export price index for tea increased by 0.2 per cent due to high prices being recorded since August 2016. The export price indices for rubber and coconut declined by 3.3 per cent and 4.8 per cent, respectively, during this period. The export price indices for minor agricultural products and seafood also declined while the export price index for vegetables recorded an increase. The price index for industrial exports declined by 1.3 per cent with significant reductions in export price indices for many sub categories. The export price index for petroleum products declined by 13.9 per cent due to low petroleum prices prevailed in the international market in 2016. However, the export price indices for textiles and garments, ceramic products and leather, travel goods and footwear, increased by 0.8 per cent, 2.5 per cent and 1.0 per cent, respectively.

The overall import price index declined by 5.1 per cent in 2016 mainly due to low petroleum prices in the world market when compared to 2015, despite the gradual increase in petroleum prices during the latter part of 2016. However, the import price index relating to textiles and textile articles increased by 2.7 per cent, partly owing to the increase in prices of cotton in the world market during 2016. Similarly, the import price index relating to diamonds, precious stones and metals increased, reflecting the increase in prices of gold in the global markets. Price indices for all other categories under intermediate goods declined. The price indices for machinery and equipment and building materials, categorised under investment goods declined, while that of transport equipment increased. In contrast to price indices for intermediate and investment goods, the price index for consumer goods increased, reflecting price increases in both food and beverages and non-food consumer goods. Under food and beverages, the import price index for sugar, oil and fats, fruits and seafood increased significantly. However, the import price index relating to cereals and milling industry products recorded a decline during the year.

5.3.5 Direction of Trade

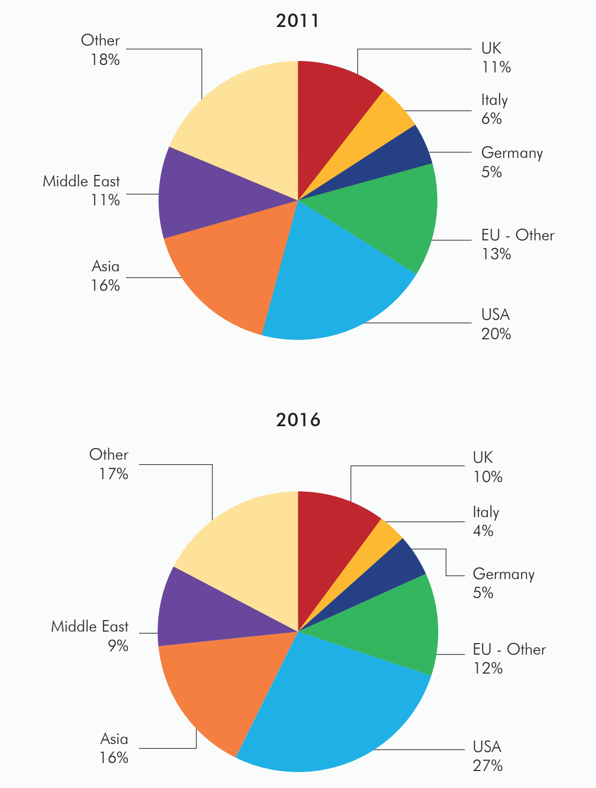
Main destinations for Sri Lankan exports and the type of goods exported to such destinations broadly unchanged in 2016 in comparison to 2015, while China became the main source of imports in 2016, surpassing India which was the main import source since 2001. The USA and the UK continued to be the two main export destinations accounting for 37 per cent of total export earnings in 2016. China, India and the USA were the main trading partners of Sri Lanka as total trade with China and India exceeded US dollars 4 billion, while trade with the USA exceeded US dollars 3 billion contributing 14.9 per cent, 14.7 per cent and 11.3 per cent, respectively to total external trade. Meanwhile, the trade with UAE, Singapore, Japan and the UK exceeded US dollars 1 billion each. Trade with India and Japan declined substantially in 2016 compared to 2015 with a reduction in both imports from and exports to these two countries, while trade with China, Singapore, Germany, Italy and the USA increased significantly.

The USA remained the main export destination in 2016, accounting for 27.3 per cent of total export earnings. Exports to the USA totalled US dollars 2,810 million, of which 74.9 per cent was derived from garment exports and 8.7 per cent from rubber products. Earnings from garment exports to the USA remained broadly unchanged in 2016, accounting for 45.7 per cent of total garment exports. The UK continued to be the second largest export destination, registering 10.1 per cent of total export earnings and one third of export earnings from the EU. Garments and rubber products were the main export items, accounting for 79.1 per cent and 2.8 per cent, respectively, of receipts from the UK. Total earnings from garment exports to the

EU in 2016 amounted to US dollars 1,905 million, accounting for 41.4 per cent of total export earnings from garments. The main export destinations within the EU, other than the UK, were Germany, Italy, Belgium, Netherlands and France. Garments, rubber products, tea, food, beverages and tobacco, and spices were the main exports to Germany and Italy, which were the fourth and fifth largest export destinations. Total exports to India, which is the third largest export destination, declined to US dollars 554 million in 2016 from US dollars 643 million in 2015, due to the reduction in export earnings from tea, minor agricultural products, spices, transport equipment and animal fodder. Iran emerged as the top buyer of Sri Lankan tea in 2016 surpassing Russia. Other major buyers for tea were Iraq, Turkey and the UAE. These countries together contributed to 45.2 per cent of earnings from the export of tea in 2016.

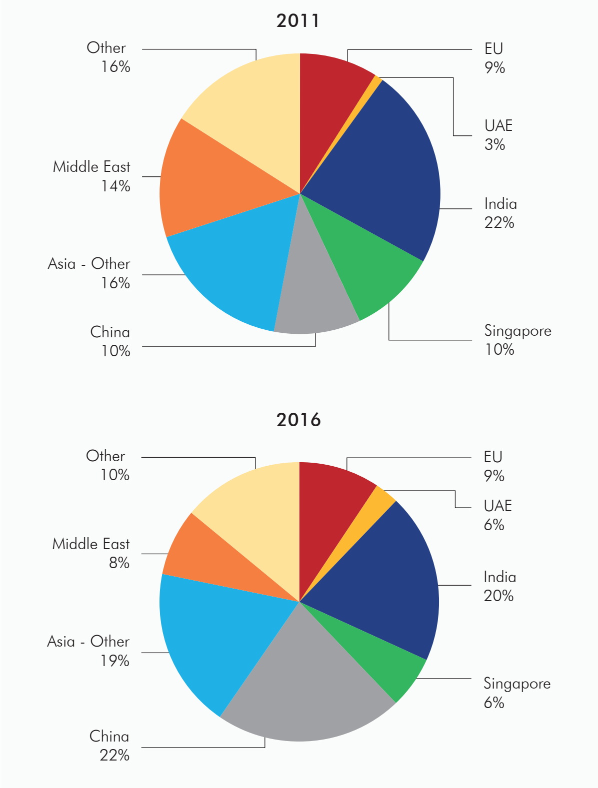
China became the main import origin of Sri Lanka in 2016, accounting for 21.7 per cent of the total expenditure on imports. Expenditure incurred on Chinese imports increased by 13.6 per cent to US dollars 4,215 million in 2016, with increased expenditure on textiles and articles, machinery and equipment, building material, transport equipment and chemical products. India, the second largest import origin in 2016, accounted for only 19.7 per cent of total imports, registering a decline of 10.6 per cent, due to the reduction in import expenditure on petroleum products and vehicles, such as auto-trishaws and motor cars. Singapore, the third largest import origin accounted for 6.1 per cent of total imports. Imports from Singapore mainly comprised petroleum products, machinery and equipment, and diamonds and precious stones. The UAE was the fourth largest import source with imports from UAE, consisting of

Chart 5.6
Exports by Destination



Source : Sri Lanka Customs

Chart 5.7
Imports by Origin



Source : Sri Lanka Customs

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petroleum products, diamonds and precious stones and base metals. Expenditure incurred on imports from Japan, which is the fifth largest import origin, declined by 31.6 per cent due to a reduction in the imports of vehicles, despite higher expenditure incurred for the import of vehicle and machinery parts and machinery and equipment from Japan.

5.4 Current and Capital Account

5.4.1 Trade in Services

Sri Lanka's export of services continued to record a satisfactory growth in 2016, supporting the external current account during the year. Earnings from exports of services grew by 11.6 per cent to US dollars 7,138 million in 2016, in comparison to US dollars 6,397 million in 2015. The key growth driver within trade in services was earnings from tourism, followed by exports of transport and telecommunications, computer and information services. Meanwhile, outflows on account of services also increased by 4.6 per cent to US dollars 4,259 million during the year, due to the rising demand for services imports, particularly in the travel sector. Overall, the surplus of the services account amounted to US dollars 2,879 million, which is an increase of 23.8 per cent compared to that of 2015.

Transport Services

The expansion of transport services contributed favourably towards the services account in 2016. Gross inflows on account of transportation services, which comprise passenger fares, freight charges, port and airport related activities, registered a growth of 6.9 per cent, to reach US dollars 2,250 million during the year. Meanwhile, outflows on account of transportation services also increased by 2.5 per cent to US dollars 1,618 million in 2016, as a result of increased port and airport related service payments driven by the expansion in import activities and the increase in Sri Lankans travelling abroad. Consequently, net inflows from the transport sector increased to US dollars 632 million during the year compared to US dollars 526 million in 2015.

Inflows relating to passenger fares increased by 7.6 per cent in 2016 over the previous year to US dollars 1,073 million. The improvement in inflows from passenger fares can be mainly

Table 5.6
Current and Capital Account

US$ million

Item	2015 (a)			2016 (b)		
	Credit	Debit	Net	Credit	Debit	Net
Goods and Services	16,943	23,006	-6,063	17,448	23,659	-6,211
Goods	10,546	18,935	-8,388	10,310	19,400	-9,090
General merchandise	10,546	18,892	-8,346	10,310	19,026	-8,716
Non-monetary gold	-	42	-42	-	374	-374
Services	6,397	4,072	2,325	7,138	4,259	2,879
Transport	2,105	1,579	526	2,250	1,618	632
Sea transport	997	762	234	1,059	779	281
Freight	997	762	234	1,059	779	281
Air transport	1,108	816	292	1,191	840	351
Passenger	997	732	266	1,073	753	320
Freight	111	85	26	118	87	31
Travel (c)	2,981	1,420	1,561	3,518	1,542	1,977
Construction	60	30	30	63	29	34
Insurance and pension services	119	92	27	121	89	32
Financial services	254	380	-126	252	403	-151
Telecommunications and computer services	805	429	375	858	443	416
Telecommunications	128	102	26	134	105	29
Computer services	677	327	349	724	337	387
Other business services	42	63	-21	42	67	-25
Government goods and services n.i.e.	31	79	-48	33	68	-35
Primary Income	127	2,140	-2,013	120	2,304	-2,184
Compensation of employees	19	83	-63	16	67	-51
Investment income	108	2,058	-1,950	105	2,238	-2,133
Direct investment	17	787	-771	12	953	-941
Dividends	17	435	-419	12	504	-491
Reinvested earnings	-	352	-352	-	450	-450
Portfolio investment	-	844	-844	-	831	-831
Equity	-	80	-80	-	75	-75
Interest	-	764	-764	-	756	-756
Short term	-	27	-27	-	1	-1
Long term	-	737	-737	-	755	-755
Other investment	25	426	-401	45	453	-408
Reserve assets	66	-	66	47	-	47
Secondary Income	7,007	814	6,193	7,260	807	6,453
General government	27	-	27	19	-	19
Workers' remittances	6,980	814	6,167	7,242	807	6,434
Current Account	24,078	25,960	-1,883	24,829	26,771	-1,942
Capital Account	71	24	46	46	21	26
Capital transfers	71	24	46	46	21	26
General government	50	-	50	35	-	35
Corporations and households	21	24	-3	11	21	-10
Current and Capital Account	24,148	25,985	-1,836	24,875	26,792	-1,917

(a) Revised
(b) Provisional
(c) Passenger services provided to non-residents are included in transport services.

Source: Central Bank of Sri Lanka

attributed to the increase in number of passengers travelling to Sri Lanka. The number of destinations served by SriLankan Airlines expanded during the year. These destinations included Middle East, Far East and several Asian countries. This has also contributed towards the expansion in earnings from passenger fares during the year. Meanwhile, SriLankan Airlines took over operations of Mihin Lanka in 2016 and absorbed nine short haul routes and three aircrafts. However, the discontinuation of some flight destinations by SriLankan Airlines as well as the downward revision of airfares during 2016 restricted the growth in earnings from passenger fares. The resurfacing of the runway at the Bandaranaike International Airport will enhance the capacity of the runway, supporting the realisation of the growth potential in this sector in the long run.

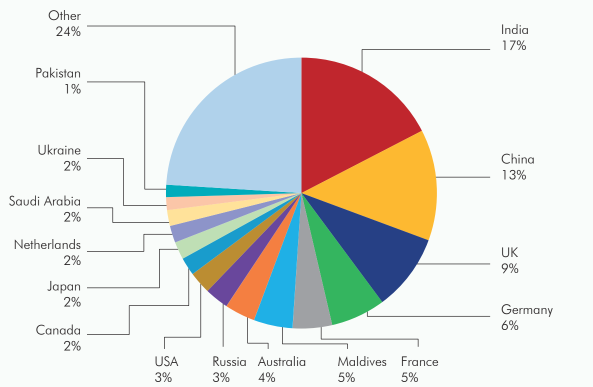
With the expansion in port related activities, inflows on account of freight charges, with respect to both port and airport related activities increased in 2016. Gross inflows from these services increased by 6.3 per cent to US dollars 1,177 million in 2016, mainly due to increased cargo, container and transhipment volumes handled at the port of Colombo. The major contributor to this expansion was increased operations at the Colombo International Container Terminals (CICT), which surpassed the milestone volume of over 2 million TEUs in container handling during its second year of operations at full scale. Meanwhile, recognizing Sri Lanka's maritime capacity in the global arena, South Asia Gateway Terminals (SAGT) was awarded the "Best Terminal in South Asia" by the Singapore based Global Ports Forum in February 2017.

Travel and Tourism

The Sri Lankan tourism industry, a major foreign currency earner in the economy, continued its growth momentum during 2016. Tourist arrivals crossed the 2 million milestone for the first time in the history, reaching 2,050,832 arrivals, recording an impressive annual growth of 14.0 per cent in 2016. The significant increase in tourism related infrastructure development and investments, increased connectivity through the operation of new airlines and cruise lines, together with country specific promotional campaigns have contributed to this impressive growth. Increased geo-political tension in major tourist destinations of the world also helped Sri Lanka to attract tourists.

Tourist arrivals from all major regions, except Africa, increased in 2016. Western Europe continued to be the largest region of tourist origin for Sri Lanka, representing 31.4 per cent, with the number of tourist arrivals increasing by 16.5 per cent to 643,333. The share of tourist arrivals from East Asia has increased continuously since 2010, accounting for 20.7 per cent of total arrivals in 2016 compared to 10.5 per cent in 2010, contributed by the impressive growth recorded in tourist arrivals from China. India remained the largest country of tourist origin with 356,729 arrivals in 2016, while China remained second, followed by the UK, Germany and France. These 5 largest tourist source destinations together have accounted for 51.0 per cent of tourist arrivals to Sri Lanka in 2016, reflecting the market concentration of tourism. The highest contribution to growth was recorded

Chart 5.8
Tourist Arrivals by Country - 2016



Source : Sri Lanka Tourism Development Authority

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from China with 271,577 tourist arrivals, followed by India and the UK. In terms of the purpose of visit, a majority of tourists (83.4 per cent) visited the country for holidays. Tourist arrivals for business purposes was 1.8 per cent, while the share of tourist arrivals for other purposes, such as visiting friends and relatives, religious and cultural purposes, official, MICE (Meetings, Incentives, Conferences & Events), health, education and sports, was 14.8 per cent of total arrivals in 2016.

Earnings from tourism continued its growth momentum in 2016, contributing towards the strengthening of the services account. As a result of the increase in tourist arrivals, together with higher spending and the increased duration of stay by tourists, earnings from tourism grew by 18.0 per cent to US dollars 3,518 million in 2016, in comparison to US dollars 2,981 million in 2015. According to the latest annual survey on tourist spending and duration of stay, conducted by the Sri Lanka Tourism Development Authority (SLTDA), the average spending per day by a tourist increased to US dollars 168.2 in 2016 from US dollars 164.1 in 2015. Further, the average duration of stay by a tourist was estimated at 10.2 days in 2016, which was a marginal improvement in comparison to 10.1 days in 2015. The healthy growth in earnings from tourism can be mainly attributed to extensive tourism promotional activities and hotel and other

Chart 5.9
Tourist Arrivals and Earnings from Tourism

Source : Sri Lanka Tourism Development Authority

related infrastructure development during the post conflict era. The upward trend in the performance of the tourism sector is expected to continue in the coming years, with efforts to uplift Sri Lanka's brand value through tactical marketing campaigns and continued investments in enhancing the tourism infrastructure of the country. Meanwhile, outflows related to travel are also estimated to have increased by 8.6 per cent to US dollars 1,542 million in 2016. Given these developments, the travel and tourism sub sector recorded a surplus of US dollars 1,977 million.

The tourism sector investment expanded further in 2016. During 2016, approval was granted for 41 new hotel projects with 1,526 rooms with an investment of US dollars 126 million compared to 37 projects approved in 2015. Several international hotels, including Shangri-La, RIU and Best Western, commenced their operations adding 1,569 rooms to the industry, while several major hotel projects, such as Hyatt, Sheraton, ITC and NEXT continued their construction work during the year. Further, supplementary establishments, which include boutique villas, guest houses, home stays, heritage homes, bungalows and rented apartments, increased in 2016 by 149 to 1,558, with a total room capacity increased by 833 rooms to 11,535. These new hotel projects will help the government to achieve its target of building 75,000 rooms to cater to 4.5 million tourist arrivals by 2020.

The tourism industry in the Eastern and Northern provinces of the country continued to grow with local and foreign investors, focusing their attention on harnessing the high potential for tourism in these provinces. Reflecting this development, many new projects related to tourism have been completed in the Eastern and Northern provinces, particularly in Passikudah, Nilaweli and Jaffna, since the end of the conflict. In addition, proposals have been made to establish new tourism projects in islands of Jaffna and Mannar, Mullativu,

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and Kuchchaweli in the North and East. Further, proposals have been made to develop integrated tourism resort projects in Kalpitiya and a resort and recreation development in Dedduwa by the BOI.

Coordinated efforts were taken to improve the standards of Sri Lanka's tourism industry. A new classification for tourist hotels was introduced by the SLTDA in April 2016, replacing the earlier classifications created in 1968 and 1999. Under the new classification requirement, all tourist hotels registered with SLTDA are required to have a star classification, which will have to be reclassified every 3 years. Further, as per the budget 2016, a programme for the absorption of the informal sector into the formal tourism sector was launched for the purpose of regulating and improving the quality of service. "Sri Lanka Tourism", which comprises SLTDA, Sri Lanka Tourism Promotion Bureau (SLTPB), Sri Lanka Institute of Tourism and Hotel Management, and Sri Lanka Convention Bureau, celebrated its golden jubilee in May 2016, and organised many activities on par with this event. The SLTDA, together with other tourism institutions, organised a tourists' holiday festival, with cultural shows, seasonal events, food festivals, exhibitions and entertainment to cater to peak tourist arrivals in December 2016. Recognising the growth potential in the tourism industry, the budget 2017 introduced several proposals mainly to increase the quality of the tourism industry and tourist attractions, construction of a convention centre to develop MICE tourism and financial support schemes for tourist organisations aiming towards the sustainable development of the tourism industry of Sri Lanka.

Targeted promotion campaigns launched by the SLTPB helped Sri Lanka to position itself as a leading and one of the most attractive tourist destinations in the world. Recognising the importance of tourism promotion, the SLTPB continued its country specific strategic marketing plan in 2016 and carried out activities, such as participating in travel fairs, conducting road shows and advertising campaigns in key markets. This also included global outdoor promotional activities, such as advertising at the UK underground, advertising in reputed global telecasts such as National Geographic and BBC Wildlife. In addition the SLTPB increasingly utilised web based promotional activities in 2016 conducting visiting bloggers' programmes, online advertising campaigns, digital advertising through web banners, dedicated emails and social media programmes, especially targeting high end tourists. These promotional campaigns have assisted to increase the value of the Sri Lankan nation brand computed by Brand Finance, a leading independent business valuation company, to US dollars 74 billion at a country ranking of 55 in 2016 upgraded from 57 in 2015. In addition, many travel related entities have endorsed Sri Lanka as one of the best destinations to travel in 2016 and 2017, as a result of effective and continuous promotions carried out by the SLTPB.

Although vigorous promotional campaigns carried out during the last few years and initiatives taken to develop infrastructure related to the tourism industry helped attract tourists, Sri Lanka has not yet tapped into its full potential in the global market. While Sri Lanka attracted 2 million tourists in 2016, some countries in the South East Asian region, such as Singapore, Taiwan and Hong Kong, have recorded tourist arrivals of more than 10 million per year. Sri Lanka can explore its potential in the areas of medical tourism and eco-tourism as the country is already competitive in providing Ayurvedic medicine and high quality private healthcare facilities. A proper mechanism needs to be designed as a Public Private Partnership (PPP), to train workers for the hospitality industry as the labour shortage may hinder the growth momentum of the industry in the near future. Training courses on hospitality management need to be promoted at the regional level, combined with internship programmes. Further, measures taken to improve

Table 5.7
Performance in the Tourism Sector

Item	2012	2013	2014	2015	2016 (a)	Y-o-Y Change (%) 2016
Tourist Arrivals (No.)	1,005,605	1,274,593	1,527,153	1,798,380	2,050,832	14.0
Arrivals by Purpose of Visit						
Pleasure	748,436	915,208	1,037,644	1,198,240	1,710,027	42.7
Business	90,040	67,946	20,270	23,323	37,121	59.2
Other	167,129	291,439	469,239	576,817	303,684	-47.4
Tourist Guest Nights ('000)	10,056	10,909	15,119	18,163	20,918	15.2
Room Occupancy Rate (%)	71.2	71.7	74.3	74.5	74.8	0.4
Gross Tourist Receipts (Rs. million)	132,427	221,720	317,479	405,492	512,373	26.4
Per Capita Tourist Receipts (Rs.)	131,688	173,954	207,889	225,476	249,837	10.8
Total Employment (No.) (b)	162,869	270,150	299,890	319,436	335,659	5.1
Direct Employment	67,862	112,550	129,790	135,930	146,115	7.5
Indirect Employment	95,007	157,600	170,100	183,506	189,544	3.3

(a) Provisional
(b) Estimates

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

the room capacity also need to be continued. Since home stays are gaining popularity among budget tourists, it is important to standardise informal sector accommodation as higher standards are required to maintain the country's competitiveness in the long run. At the same time, policy initiatives are needed to diversify the availability of tourist activities in Sri Lanka, where more emphasis should be paid towards lagging sectors of the tourism industry, such as leisure tourism and recreational tourism in order to increase average guest nights, which is currently stagnated.

Telecommunications, Computer and Information Services

Earnings from telecommunications, computer and information services recorded a growth in 2016. Gross inflows on account of telecommunications, computer and information services grew by 6.6 per cent to US dollars 858 million in 2016 in comparison to US dollars 805 million in 2015. The telecommunications sub sector grew at a moderate rate during the year with total earnings increasing to US dollars 134 million from US dollars 128 million in 2015. The expansion in earnings was supported by the increase in the usage of internet based communication services, whilst the decline in the usage of International Direct Dialling (IDD) services dampened the growth of the sector. Due to the continued technological innovations in the telecommunications industry in areas such as digitisation, usage of broadband internet connections, satellite and cable TV services improved during 2016, supporting higher revenue generation in the sector. The opening of the cable landing station of South East Asia - Middle East - Western Europe 5 (SEA-ME-WE 5) in Matara marked a significant milestone in the telecommunications industry in 2016.[2] This project will enhance the reliability of Sri Lanka's global connectivity, thereby improving the performance of the telecommunications industry in the medium to long run.

Meanwhile, the computer and information services sub sector continued its growth trajectory in 2016. Earnings from computer and information services improved by 7.0 per cent to US dollars 724 million in 2016. The growth in this sector was mainly driven by the rapid expansion of Software and Information Technology Enabled Services (ITES) that includes Business Process Outsourcing (BPO) and Knowledge Process Outsourcing (KPO). Sri Lanka was ranked 63rd among 139 countries in the 2016 "Networked Readiness Index" published by the World Economic Forum, which measures

2 The SEA-ME-WE 5 is a state-of-the-art undersea cable system that connects sixteen countries across three continents.

how economies use the opportunities offered by information and communications technologies in enhancing competitiveness and well-being. Recognising the growth potential of the industry, the government is expected to revise existing labour laws related to flexible working hours, contract employment and performance based wages to complement the prerequisites of the ITES industry as proposed in the National Budget 2017. It is also imperative to develop a highly talented skill pool, comprehensive regulatory framework and modern infrastructure facilities in order to unleash the full potential of this industry.

5.4.2 Primary Income

The deficit in the primary income account widened in 2016. This was mainly due to the decline in earnings from reserve assets coupled with continued interest payments and outflows in terms of reinvestment of earnings and dividend payments. Accordingly, the deficit in the primary income account increased by 8.5 per cent to US dollars 2,184 million during the year, in comparison to a deficit of US dollars 2,013 million in 2015. Inflows to the primary income account, which amounted to US dollars 127 million in 2015, declined to US dollars 120 million in 2016. The fall in inflows was primarily due to the reduction in earnings from reserve assets, in line with the decline in gross official reserves during the year. Meanwhile, the total outflow from the primary income account amounted to US dollars 2,304 million in 2016 in comparison to US dollars 2,140 million in 2015. Compared to the previous year, a significant increase in the repatriation of profits as dividends as well as an increase in the reinvestment of earnings from profits of direct investment enterprises by foreign investors were observed in 2016. Consequently, dividend payments and reinvestment of earnings by direct investment enterprises, which stood at US dollars 787 million in 2015, increased to US dollars 953 million in 2016. Meanwhile, interest payments on portfolio investments declined during the year due to the reduction in the outstanding stock of Treasury bonds held by non-residents. This resulted in a modest decline of interest payments related to portfolio investments, from US dollars 764 million in 2015 to US dollars 756 million in 2016. However, interest payments on ISBs continued to rise as a result of the new issuance. Further, primary income outflows in the form of other investments, which consist of interest payments on foreign loans, increased moderately during 2016. The increase in interest payments on account of foreign loans could be attributed to the gradual increase in the interest payments of loans obtained by State Owned Business Enterprises (SOBEs), as a result of increased foreign loan liabilities of these enterprises. However, interest payments for government project loans remained broadly unchanged from levels observed in the previous year.

5.4.3 Secondary Income

The secondary income account, which consists of private and government transfers, recorded a modest growth in 2016, recovering to some extent from the marginal decline in 2015. Workers' remittances, which account for the majority of inflows to the secondary income account as the key source of private transfers, grew at a modest rate of 3.7 per cent to US dollars 7,242 million, as against the decline of 0.5 per cent observed in 2015. Meanwhile, receipts in the form of government transfers declined in 2016. Consequently, inflows to the secondary income account grew by 3.6 per cent amounting to US dollars 7,260 million in 2016, in comparison to US dollars 7,007 million in the previous year. The relatively low growth in workers' remittances can be attributed to the fall in the income levels in countries in the Middle Eastern region as a result of persistently low oil prices and geopolitical uncertainties. Further, a decline of 8.6 per cent in labour migration under the categories, such as skilled, semi-skilled and unskilled, including housemaids, during 2016 would also have contributed to the deceleration of workers' remittances. The decline in labour migration under the semi-skilled and unskilled categories, including housemaids, was due to concerted efforts by the Sri Lanka Bureau of Foreign Employment (SLBFE) to streamline migration of low skilled female labour. This decline could also be attributed to the restrictions imposed to discourage foreign labour through labour market nationalisation policies of Saudi Arabia, which is a key destination for Sri Lankan migrant workers. However, according to the data released by the SLBFE, labour migration under the professional category increased by 5.1 per cent during the year, continuing the compositional transformation in workers' remittances observed over the past few years.

5.5 Current Account Balance

The current account deficit widened in 2016 amidst the deterioration of the trade account and the primary income account, despite the surpluses in the services and the secondary income accounts. A significant deterioration of the trade balance was witnessed as a result of increased import expenditure on intermediate and investment goods amidst a decline in earnings from exports. However, increased inflows to the services account, which was primarily driven by the substantial increase in earnings from tourism and the surplus in the secondary income account, consisting mainly of workers' remittances, helped in cushioning the deficits in the trade and primary income accounts of the current account to a certain extent. As a result, the current account deficit widened marginally to US dollars 1,942 million in 2016, compared to US dollars 1,883 million in 2015. Accordingly, the current account deficit as a percentage of GDP increased marginally to 2.4 per cent of GDP in 2016 in comparison to 2.3 per cent of GDP in 2015.

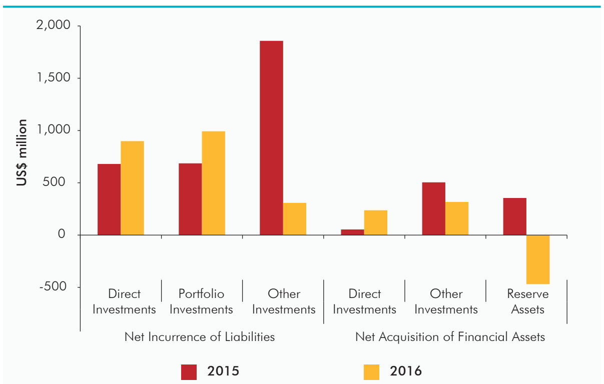
5.6 Capital Account Balance

The capital account recorded a marginal surplus of US dollars 26 million in 2016 in comparison to a surplus of US dollars 46 million in 2015. This was the combined result of a decline in capital transfers received by the government and the decline in capital outflows from the private sector in 2016.

5.7 Financial Account

Both net incurrence of liabilities and net acquisition of financial assets of the financial account of the BOP remained subdued in 2016. Accordingly, net incurrence of liabilities amounted to US dollars 2,199 million in 2016, in comparison to US dollars 3,223 million recorded in 2015. Meanwhile, net acquisition of assets amounted to US dollars 82 million in comparison to US dollars 911 million in 2015. Lower level of inflows to the financial account reflected the continued moderation of capital inflows, particularly in the form of FDIs and foreign investments to the Colombo Stock Exchange (CSE). Furthermore, Sri Lanka experienced significant capital outflows in 2016, especially from the rupee denominated government securities market, in the backdrop of increasing global interest rates and a stronger growth momentum in the United States economy.

Chart 5.10
Financial Account



Source : Central Bank of Sri Lanka

Table 5.8.A
Financial Account

US$ million

Item	2015 (a) Net acquisition of financial assets	2015 (a) Net incurrence of liabilities	2016 (b) Net acquisition of financial assets	2016 (b) Net incurrence of liabilities
Financial Account	911	3,223	82	2,199
Direct Investment	53	680	237	898
Equity and investment fund shares	53	439	235	709
Equity other than reinvestment of earnings	53	87	235	260
Direct investor in direct investment enterprise	53	87	235	260
BOI companies	-	36	-	107
Other companies	-	51	-	153
Reinvestment of earnings	-	352	-	450
BOI companies	-	249	-	318
Other companies	-	103	-	131
Debt instruments	-	241	2	189
Direct investor in direct investment enterprise	-	241	2	189
BOI companies	-	202	-	195
Shareholder advances	-	126	-	111
Inter-company borrowings	-	76	-	84
Other companies	-	145	-	81
Debt repayments	-	-107	-	-87
Portfolio Investment	...	686	...	993
Equity and investment fund shares	-	-60	-	24
CSE companies	-	-60	-	24
Debt securities	...	747	...	969
Deposit-taking corporations	...	-	...	-
Long term	...	-	...	-
General government	-	747	-	969
Short term (Treasury bills)	-	-392	-	36
Long term	-	1,139	-	932
Treasury bonds	-	-701	-	-361
Sri Lanka Development bonds	-	190	-	-207
Sovereign bonds	-	1,650	-	1,500
Financial Derivatives	-	-	-	-
Other Investment	503	1,857	317	308
Currency and deposits	143	1,457	5	-609
Central Bank	-	1,098	-	-701
Short term	-	-2	-	-1
Long term	-	1,100	-	-700
Deposit-taking corporations	143	359	5	92
Short term	152	359	-4	92
Long term	-9	-	9	-

Continued on page - 175

Memorandum Items	2015 (a)	2016 (b)
Total net inflows to the CSE	4	19
Direct investment	64	-5
Portfolio investment	-60	24
Net Investments in Treasury Bills and Bonds	-1,093	-325
Foreign purchases	1,211	1,237
Foreign sales	2,304	1,562

(a) Revised
(b) Provisional

Source: Central Bank of Sri Lanka

Continued capital outflows, high debt repayments and moderate inflows to the financial account in 2016 necessitated foreign financing during the year. Accordingly, the financial account was supported by the issuance of ISBs amounting to US dollars 1.5 billion, a new international currency swap arrangement of US dollars 400 million, following the maturity of international currency swaps amounting to US dollars 1.1 billion and foreign currency term financing facilities amounting to US dollars 700 million. Sri Lanka also entered into an EFF with the IMF in order to support the BOP and the government's reform agenda. Consequently, Sri Lanka received two tranches of the EFF, amounting to US dollars 332 million, during the year. Despite these measures, inflows to the financial account remained moderate in 2016 with foreign investors in the rupee denominated government securities unwinding their holdings. Amidst these imbalances, servicing scheduled debt obligations along with the provision of liquidity to the domestic foreign exchange market by the Central Bank resulted in a significant decline in gross official reserves in 2016.

5.7.1 Direct Investment

Foreign Direct Investment (FDI) inflows remained at moderate levels in 2016. Total FDI inflows, inclusive of foreign loans to BOI companies, amounted to US dollars 1,079 million, while direct investments that exclude foreign borrowings of BOI companies amounted to US dollars 898 million in 2016. In comparison, total FDI inflows with foreign loans in 2015 amounted to US dollars 1,160 million, while the same excluding foreign loans amounted to US dollars 680 million. While the low level of FDI inflows have been a chronic issue in the Sri Lankan economy, FDI inflows during 2016 were affected by the evolving global economic outlook, in the backdrop of the interest rate hike by the US Federal Reserve. In addition, the significant increase in wage rates and other costs of production compared to peer countries in the region would have been disadvantageous in attracting foreign investments to the country. Of the total FDI inflows in 2016, US dollars 260 million was in the form of equity, US dollars 450 million was reinvested earnings, US dollars 276 million was shareholder advances and intra company loans, while repayment of shareholder advances and intra company debt amounted to US dollars 87 million. During the year, BOI companies received US dollars 181 million of foreign loans from non-related lenders.

FDI inflows in 2016 were mainly channelled to the tourism, telecommunication and manufacturing sectors. The top five countries of direct investments, based on immediate country of investment, were Malaysia, India, Netherlands, China and United Arab Emirates. Meanwhile, direct investments abroad by Sri Lankan investors increased in 2016 to US dollars 237 million, compared to US dollars 53 million in 2015. The notable increase in direct investments abroad was mainly due to investments by the Sri Lankan apparel industry abroad. Foreign investments abroad by Sri Lankan companies were primarily made in India, Vietnam, Bangladesh, Fiji and Maldives.

5.7.2 Portfolio Investment

5

Equity

Foreign investments in equity, which reflect foreign inflows to the CSE excluding direct investments, remained subdued in 2016. Similar to direct investments, subdued investor sentiments on capital markets of emerging economies continued to affect equity investments and resulted in a moderate net inflow of US dollars 24 million in 2016. The net inflow of foreign investment to the CSE in 2016 consisted of a net inflow of US dollars 10 million to the secondary market and an inflow of US dollars 14 million to the primary market. This is a continuation of modest foreign investments in companies listed in the CSE from the previous year, where a net outflow of US dollars 60 million was recorded in 2015.

Debt Securities

Sri Lanka continued to tap international markets through the issuance of ISBs. In July 2016, Sri Lanka successfully issued a dual tranche ISB of US dollars 1.5 billion, with US dollars one billion to be matured in 10 years and US dollars 500 million to be matured in five and a half years. This was Sri Lanka's 10th ISB issuance and the country's first dual tranche offering in the international market. Both tranches were priced below the initial price guidance, reflecting continued confidence of foreign investors in Sri Lanka's medium term outlook despite a challenging global economic environment. However, foreign investments in Treasury bonds and Sri Lanka Development Bonds (SLDBs) continued to record an outflow in 2016. Consequently, net outflows from Treasury bonds and SLDBs amounted to US dollars 361 million and US dollars 207 million, respectively, in 2016. Meanwhile, foreign investments in Treasury bills amounted to a moderate net inflow of US dollars 36 million in 2016. Hence, on a cumulative basis, government securities other than ISBs recorded a net outflow of US dollars 531 million in 2016, in comparison to a net outflow of US dollars 903 million in 2015.

5.7.3 Other Investment

Currency and Deposits

Net incurrence of liabilities in the form of currency and deposits recorded a significant decrease, while net acquisition of assets as currency and deposits marginally increased in 2016. Currency and deposit related liabilities decreased primarily as a result of the settlement of the international swap facility arrangement, amounting to US dollars 700 million in June 2016. The balance portion of the international swap facility of US dollars 400 million also matured in December 2016, but a new swap facility for the same amount was obtained within the same month. Meanwhile, currency and deposits liabilities held by deposit taking corporations increased by US dollars 92 million in 2016. Consequently, total net incurrence of liabilities in the form of currency and deposits decreased by US dollars 609 million in 2016, in comparison to an increase of US dollars 1,457 million in 2015. Further, transactions relating to the acquisition of assets in the form of currency and deposits by deposit taking corporations increased by US dollars 5 million in 2016, in comparison to an increase of US dollars 143 million in 2015.

Loans

Net loan inflows in 2016 remained at a similar level in comparison to the previous year. This was mainly due to higher repayments of foreign loan liabilities by the Central Bank, deposit taking corporations and SOBEs, despite significant foreign loan inflows to the government during the year. Consequently, net inflows from foreign loans amounted to US dollars 753 million in 2016 compared to US dollars 759 million in 2015.

Net inflows to the government in the form of foreign loans, recorded a significant increase in 2016. Accordingly, the net inflow to the government amounted to US dollars 1,287 million in 2016 compared to a net inflow of US dollars 470 million in 2015. This comprised total long term loan inflows of US dollars 2,163 million and repayments amounting to US dollars 876 million during the year. Of total loan inflows, US dollars 1,278 million was in the form of project loans, US dollars 700 million was from two foreign currency term financing facilities and US dollars 185 million was in the form of programme financing. Major project loan inflows to the government in 2016 included the loans obtained for the construction of extension of Southern expressway section 1 and 2, integrated road investment program-tranche 2, Hambantota hub development project and Metro Colombo urban development project. The two loans in the form of programme financing consisted of US dollars 85 million from the Government of Japan as a development policy loan and US dollars 100 million from the International Development Association of the World Bank, as development policy financing on competitiveness, transparency and financial stability. These programme financing facilities were conditional upon the proposed enactment of policy actions by the local implementing agencies.

Table 5.8.B
Financial Account

US$ million

Item	2015 (a)		2016 (b)	
	Net acquisition of financial assets	Net incurrence of liabilities	Net acquisition of financial assets	Net incurrence of liabilities
Other Investment (Continued from page - 173)				
Loans	-	759	-	753
Central Bank	-	-507	-	-123
Credit and loans with the IMF	-	-507	-	-123
Stand by Arrangement	-	-507	-	-455
Extended Fund Facility	-	-	-	332
Deposit-taking corporations	-	787	-	-507
Short term	-	657	-	-608
Long term	-	131	-	100
General government	-	470	-	1,287
Long term	-	470	-	1,287
Other sectors (c)	-	9	-	96
Long term	-	9	-	96
Trade credit and advances	116	-401	-67	109
Deposit-taking corporations	-30	-	-3	-
Short term	-30	-	-3	-
Other sectors (d)	146	-401	-64	109
Short term	146	-401	-64	109
Other accounts receivable/payable	244	41	379	55
Central Bank	-	41	-	55
Short term (e)	-	41	-	55
Deposit-taking corporations	244	-	379	-
Short term	244	-	379	-
Special Drawing Rights		-		-
Reserve Assets	354		-472	
Monetary gold	-39		-	
Special Drawing Rights	-2		-5	
Reserve position in the IMF	-		-	
Other reserve assets	395		-467	
Currency and deposits	116		-1,267	
Claims on monetary authorities	369		-1,365	
Claims on other entities	-253		98	
Securities	279		800	
Debt securities	279		800	
Long term	279		800	
Financial Account (net)	-2,312		-2,117	
Memorandum Items				
Long term loans to the government (net)		470		1,287
Inflows (Disbursements)		1,268		2,163
Project Loans		1,268		1,278
Foreign Currency Term Financing Facilities		-		700
Program Financing Loans		-		185
Repayments		798		876

(a) Revised
(b) Provisional
(c) Include State Owned Business Enterprises (SOBEs) and private sector companies.
(d) Include trade credits received by the Ceylon Petroleum Corporation (CPC) and other private companies.
(e) Net transactions of Asian Clearing Union (ACU) liabilities

Source: Central Bank of Sri Lanka

In June 2016, the Executive Board of the IMF approved a three year EFF of SDR 1.1 billion, approximately US dollars 1.5 billion, to Sri Lanka. The EFF, which is equivalent to 185 per cent of the country's current quota with the IMF, is aimed at supporting the BOP and the government's reform agenda. The first tranche under the EFF, amounting to SDR 120 million (approximately US dollars 169 million), was made available to Sri Lanka in June 2016 and a similar amount was made available as the second tranche in November 2016, upon the successful completion of the first programme review. Further, the Central Bank continued to repay liabilities to the IMF under the Stand-By Arrangement (SBA) facility obtained in 2009, with total repayments amounting to US dollars 455 million in 2016. Repayments under the IMF SBA facility are to conclude in mid-2017.

Table 5.9
Major Projects Financed with Foreign Borrowings during 2016

Lender and Project	Amount Disbursed US$ million
Government Projects - Total	**1,278**
of which;	
Asian Development Bank	**337**
of which;	
Intergrated Road Investment Program -Tranche 2	64
Clean Energy and Network Efficiency Improvement Project	31
Integrated Road Investment Program	31
Integrated Road Investment Program - Tranche 3	23
Local Government Enhancement Sector Project	17
Sustainable Power Sector Support Project	14
The Export-Import Bank of China	**320**
of which;	
Construction of Extension of Southern Expressway Section 1 from Matara to Beliatta	97
Construction of Extension of Southern Expressway Section 2 from Beliatta to Wetiya Project	49
Hambantota Hub Development Project	48
Construction of Outer Circular Highway Project Phase III from Kerawalapitiya to Kadawatha	48
Construction of Extension of Southern Expressway Section 4 from Mattala to Hambantota	24
International Development Association	**136**
of which;	
Additional Financing for Dam Safety & Water Resources Planning Project	24
Second Health Sector Development Project	21
Additional Financing for North East Local Services Improvement Project	20
Climate Resilience Improvement Management- CRIP	17
International Bank for Reconstruction and Development	**114**
Metro Colombo Urban Development Project	102
Disaster Risk Mgt. Development Policy loan	12
Government of Japan	**67**
of which;	
Major Bridges Construction Project of the National Road Network	15
Greater Colombo Transmission and Distribution Loss Reduction Project	13
Co-op Centrale Raiffeisen-Boerenleenbank	**48**
Construction of 463 Rural Bridges	48
Government of India	**44**
of which;	
Procurement of Two Advanced Offshore Patrol Vessels	40
Deutsche Bank AG	**36**
Construction of 537 Steel Beam Bridges	36
International Fund for Agricultural Development	**23**
of which;	
National Agribusiness Development Programme	13
Kingdom of Spain	22
Supply of three Flyovers in Ganemulla,Polgahawela & Rajagiriya	22
State Owned Business Enterprises - Total	**21**
Hambanthota port development - Phase II	21

Source: External Resources Department of Ministry of National Policies and Economic Affairs

Foreign loans obtained by deposit taking corporations recorded a net repayment, while foreign loans of private corporations and SOBEs recorded a net inflow in 2016. Net foreign loan inflows to deposit taking corporations, which consist of licensed commercial banks (LCBs), licensed specialised banks (LSBs) and licensed finance companies (LFCs), recorded a net repayment of US dollars 507 million, compared to a net inflow of US dollars 787 million in 2015. This is a sharp reversal from the previous years where the banking sector continuously received foreign financing for their business operations. Further, private corporations and SOBEs, classified under the other sector in the financial account of the BOP, recorded a net inflow of foreign loans amounting to US dollars 96 million. Foreign loan inflows to the other sector consisted of loan inflows of US dollars 637 million to private corporations and US dollars 21 million to SOBEs in 2016. Meanwhile, repayments of existing foreign loans consisted of US dollars 362 million by private corporations and US dollars 200 million by SOBEs in 2016. The majority of debt repayments by SOBEs were related to loans of the Puttalum Coal Power Plant, the Mattala International Airport, the Hambantota port project and SriLankan Airlines.

Trade Credit and Advances and Other Accounts Receivable / Payable

Trade credit and advances received by residents increased, while trade credit and advances given to non-residents declined in 2016. The trade credit received increased by US dollars 109 million in 2016, compared to a decrease of US dollars 401 million in 2015. The net incurrence of liabilities through trade credits received included US dollars 95 million received by the Ceylon Petroleum Corporation and US dollars 14 million received by private corporations during the year. Meanwhile, net acquisition of assets on trade credit and advances given by Sri Lankan exporters to their trading partners and by the banking sector decreased by US dollars 67 million in 2016. This comprised a decline in trade credits given by private corporations and the banking sector amounting to US dollars 64 million and US dollars 3 million, respectively. Further, other accounts payable, mainly consisting of Asian Clearing Union (ACU) liabilities managed by the Central Bank recorded a net increase of US dollars 55 million, while other accounts receivable to LCBs recorded a net increase of US dollars 379 million in 2016.

5.7.4 Reserve Assets

Transactions related to reserve assets recorded a decline in 2016, in line with the decrease in the stock of the reserve assets during the year. Reserve transactions declined by US dollars 472 million in 2016, on a net basis, compared to the increase of US dollars 354 million in 2015. In addition, reserve transactions during the year consisted of the decline in currency and deposits by US dollars 1,267 million, the decline in Special Drawing Rights (SDR) by US dollars 5 million and an increase in debt securities by US dollars 800 million.

5.8 Overall Balance

The overall balance of the BOP, which reflects the change in net international reserves during the period under review, recorded a deficit in 2016. The overall balance recorded a deficit of US dollars 500 million in 2016, in comparison to a deficit of US dollars 1,489 million recorded in 2015. As such, net international reserves also declined to US dollars 4,529 million as at end 2016, from US dollars 5,029 million as at end 2015, with both the reserve asset position and the reserve related liability position declining during the year. The deficit in the overall balance reflects the continuous pressure on the depletion of gross official reserves, contributed by a widening current account deficit, foreign currency debt repayments and significant intervention by the Central Bank in the foreign exchange market in 2016.

5.9 International Investment Position

With regard to the country's International Investment Position (IIP), the external liability position increased while the foreign asset position declined as at end 2016. The total foreign asset position declined to US dollars 10,086 million, primarily due to the reduction in the reserve asset position, despite an increase in asset positions in direct investment and the other accounts receivable. Meanwhile, the total liability position increased to US dollars 55,036 million as at end 2016, an increase of US dollars 1,295 million from the total liability position as at end 2015. The outstanding liability position increased primarily due to the new issuance of an ISB by the government, foreign loan inflows to the government, trade credits received by residents and a modest increase in the ACU liabilities of the Central Bank. Meanwhile, the outstanding liability position of direct investments, currency and deposits of the Central Bank, outstanding foreign loans of deposit taking corporations and the Central Bank declined during the year. Reflecting the decline in the foreign

Table 5.10
International Investment Position

US$ million
(End period position)

Item	2015 (a) Assets	2015 (a) Liabilities	2016 (b) Assets	2016 (b) Liabilities
Direct Investment (c)	817	10,022	1,136	9,745
Equity and investment fund shares	814	7,408	1,131	6,943
Debt instruments	3	2,613	5	2,802
Portfolio Investment	0.1	12,331	0.1	13,772
Equity and investment fund shares		1,492		1,507
Other sectors		1,492		1,507
Debt securities (d)	0.1	10,839	0.1	12,265
Deposit-taking corporations	0.1	2,140	0.1	2,190
Long term	0.1	2,140	0.1	2,190
General government		8,534		9,903
Short term		33		80
Long term		8,501		9,823
Other sectors		164		172
Long term		164		172
Financial Derivatives	-	-	-	-
Other Investment	2,614	31,387	2,931	31,519
Currency and Deposits	701	3,051	706	2,442
Central Bank		1,105		403
Short term		5		3
Long term		1,100		400
Deposit-taking corporations	701	1,946	706	2,039
Short term	539	1,946	535	2,039
Long term	162		171	
Loans		25,936		26,530
Central Bank		692		554
Credit and loans with the IMF		692		554
Deposit-taking corporations		5,070		4,562
Short term		3,816		3,209
Long term		1,253		1,354
General government		16,147		17,295
Long term		16,147		17,295
Other sectors (e)		4,028		4,119
Long term		4,028		4,119
Trade Credit and Advances	677	1,375	610	1,483
Deposit-taking corporations	96		93	
Short term	96		93	
Other sectors (f)	581	1,375	517	1,483
Short term	581	1,375	517	1,483
Other Accounts Receivable/Payable	1,236	478	1,615	533
Central Bank (g)		478		533
Short term		478		533
Deposit-taking corporations	1,236		1,615	
Short term	1,236		1,615	
Special Drawing Rights		548		532
Reserve Assets	7,304		6,019	
Monetary gold	760		830	
Special Drawing Rights	7		2	
Reserve position in the IMF	66		64	
Other reserve assets	6,470		5,122	
Currency and deposits	3,911		2,644	
Claims on monetary authorities	2,167		802	
Claims on other entities	1,745		1,842	
Securities	2,559		2,478	
Debt securities	2,559		2,478	
Total Assets / Liabilities	10,734	53,740	10,086	55,036
Net International Investment Position		-43,006		-44,949
Memorandum Items				
IIP- Maturity-wise breakdown	10,734	53,740	10,086	55,036
Short term	7,190	9,146	6,299	8,853
Long term	3,544	44,595	3,788	46,182

(a) Revised
(b) Provisional
(c) Includes direct investment position of BOI, CSE and other private companies
(d) Foreign currency debt issuances are based on market value while domestic currency issuances are based on book value.
(e) Includes loans outstanding position of project loans obtained by State Owned Business Enterprises (SOBEs).
(f) Includes outstanding trade credit position of Ceylon Petroleum Corporation and the private sector companies.
(g) Outstanding position of ACU liabilities managed by the Central Bank

Source: Central Bank of Sri Lanka

asset position and the increase in the foreign liability position, the net liability position of the IIP increased from US dollars 43,006 million as at end 2015 to US dollars 44,949 million as at end 2016. Sri Lanka's net IIP continued to worsen, reflecting the continuous dependence of foreign financing to finance the current account deficit, in the backdrop of relatively low inflows in the form of direct investments and other non-debt creating inflows to the financial account.

5.9.1 Direct Investment Position

The direct investment asset position increased while the direct investment liability position declined in 2016. The direct investment asset position increased from US dollars 817 million as at end 2015 to US dollars 1,136 million as at end 2016, reflecting the increase in investments in equity and investment fund shares by Sri Lankan companies abroad. Meanwhile, the direct investment liability position declined to US dollars 9,745 million by end 2016, despite the BOP recording a net inflow of direct investments in 2016. This was primarily due to the reduction in the direct investment equity position, as a result of market price reduction of around US dollars 1.2 billion incurred by most of the publicly listed companies in 2016. This loss is around 10 per cent of Sri Lanka's total direct investment position, which is in line with the decline in the All Share Price Index (ASPI) of the CSE by a similar percentage during the year. The top five sources in terms of direct investment liability stock position as at end 2016 were the Netherlands, India, Malaysia, China and Switzerland. However, the liability position of debt instruments increased, reflecting the increase in advances by direct investors.

5.9.2 Portfolio Investment Position

The portfolio investment liability position increased with the proceeds from the issuance of the dual-tranche ISB, while equity inflows remained subdued in 2016. The portfolio investment liability stock position, which consists of the outstanding equity and debt securities, increased from US dollars 12,331 million as at end 2015 to US dollars 13,772 million as at end 2016. The portfolio investment equity position increased to US dollars 1,507 million, while the debt securities position increased to US dollars 12,265 million as at end of the year. The outstanding debt securities of the government increased due to the issuance of an ISB. However, with the anticipation of, and the subsequent increase in the interest rates in the United States, there were significant outflows of foreign investments from rupee denominated government securities and SLDBs held by non-residents. This resulted in a moderation of the increase in outstanding total government debt securities held by non-residents as at end 2016. Meanwhile, the debt security liability position of deposit taking corporations recorded a marginal increase by the end of the year due to changes in market prices of international bonds issued by the Bank of Ceylon and the National Savings Bank.

5.9.3 Other Investment Position

Currency and Deposits

The currency and deposits asset position increased marginally while the liability position recorded a decline as at end 2016. The currency and deposit liability position of the Central Bank declined from US dollars 1,105 million as at end 2015 to US dollars 403 million as at end 2016, primarily due to the settlement of the international swap arrangement of US dollars 700 million during the year. The currency and deposit liability position of deposit taking corporations increased to US dollars 2,039 million from US dollars 1,946 million recorded as at end 2015. The currency and deposits asset position, which comprises the asset position of the deposit taking corporations, increased marginally to US dollars 706 million as at end 2016.

Loans

The foreign loan liability position in the IIP increased as at end 2016 primarily due to the increase in the foreign loan liability position of the government. The foreign loan liability position increased from US dollars 25,936 million as at end 2015 to US dollars 26,530 million as at end 2016. The increase in the foreign loan liability position of the government to US dollars 17,295 million was a result of new project loans, two new foreign currency term financing facilities and two new programme loans obtained by the government. The outstanding foreign loans of deposit taking corporations decreased for the first time in the last five years, as a result of moderate loan inflows to the banking sector amidst continuous loan repayments. The outstanding liability position of the Central Bank declined due to the net effect of decrease in liabilities related to the IMF SBA facility, despite an increase in liabilities due to the first two tranches of the IMF EFF facility. The foreign loan liability stock position of the other sector, which includes the private sector and SOBEs, increased marginally with an increase in both disbursements and repayments during the year.

Trade Credit and Advances

The trade credit and advances asset position declined while the liability position increased in 2016. The outstanding trade credit and advances liability position, which consists of trade credit and advances of the private sector, increased from US dollars 1,375 million as at end 2015 to US dollars 1,483 million as at end 2016. The outstanding asset position of trade credit and advances, which reflects the trade credit and advances given by deposit taking corporations and the private sector declined to US dollars 610 million as at end 2016 from US dollars 677 million as at end 2015.

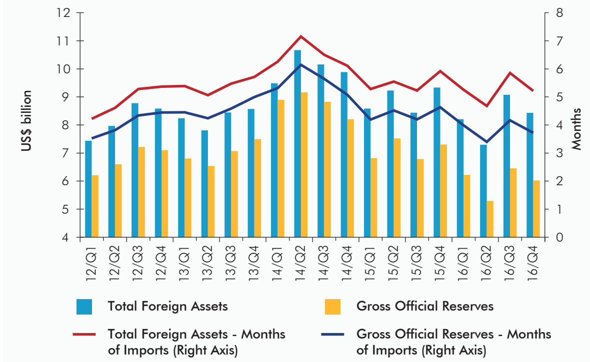
Other Accounts Receivable/Payable and Special Drawing Rights

The outstanding position of other accounts receivable as well as other accounts payable increased in 2016. The outstanding position of other accounts receivable, of deposit taking corporations, increased from US dollars 1,236 million as at end 2015 to US dollars 1,615 million as at end 2016. Meanwhile, the outstanding position of other accounts payable also increased to US dollars 533 million as at end 2016, with the increase in ACU related liabilities of the Central Bank. Further, the SDR liability position declined marginally to US dollars 532 million as at end 2016.

5.9.4 Reserve Asset Position

Sri Lanka's gross official reserve assets position declined as at end 2016 to US dollars 6.0 billion from US dollars 7.3 billion recorded at end of 2015. The gross official reserve assets at end 2016 was equivalent to 3.7 months of imports of goods and 3.1 months of imports of goods and services. The decline in gross official reserves was mainly due to the foreign currency debt service payments, settlement of a portion of the foreign currency swap arrangement, repayments of the IMF SBA and the supply of liquidity to the domestic foreign exchange market through Central Bank intervention. The total foreign assets, which comprise gross official reserves and foreign assets of deposit taking corporations, declined to US dollars 8.4 billion at end 2016, from US dollars 9.3 billion at end 2015. The increase in foreign assets of deposit taking corporations during the year abated a large depletion of total foreign

Chart 5.11
Quarterly Gross Official Reserves and Total Foreign Assets



Source : Central Bank of Sri Lanka

Table 5.11
Gross Official Reserves, Total Foreign Assets and Overall Balance

(End period position)

	US$ million					Rs. million				
	2012	2013	2014	2015	2016 (a)	2012	2013	2014	2015	2016 (a)
1. Government foreign assets	631	465	635	470	289	80,209	60,857	83,262	67,690	43,303
2. Central Bank foreign assets	6,475	7,030	7,573	6,834	5,730	823,375	919,171	992,438	984,489	858,352
3. Gross official reserves (1+2)	7,106	7,495	8,208	7,304	6,019	903,584	980,028	1,075,700	1,052,178	901,655
4. Foreign assets of deposit-taking corporations	1,481	1,078	1,676	2,033	2,414	188,195	141,008	219,641	292,916	361,601
5. Total foreign assets (3+4) (b)	8,587	8,573	9,884	9,337	8,433	1,091,779	1,121,036	1,295,342	1,345,095	1,263,252
6. Reserve related liabilities (c)	2,943	2,347	1,691	2,275	1,490	373,984	306,825	221,593	327,725	223,214
7. Net International Reserves (NIR) (3-6)	4,163	5,148	6,517	5,029	4,529	529,600	673,203	854,107	724,453	678,437
8. Overall balance (d)	151	985	1,369	-1,489	-500	72,619	143,603	180,904	-129,654	-46,017
9. Gross official reserves in months of										
9.1 Import of goods	4.4	5.0	5.1	4.6	3.7					
9.2 Import of goods and services	3.9	4.2	4.3	3.8	3.1					
10. Total foreign assets in months of										
10.1 Import of goods	5.4	5.7	6.1	5.9	5.2					
10.2 Import of goods and services	4.7	4.8	5.1	4.9	4.3					

(a) Provisional
(b) Excludes foreign assets in the form of 'Direct investment abroad' and 'Trade credit and advances granted'
(c) The total outstanding debt of the Central Bank, excluding outstanding Special Drawing Rights (SDRs)
(d) Change in NIR position during the period

Source: Central Bank of Sri Lanka

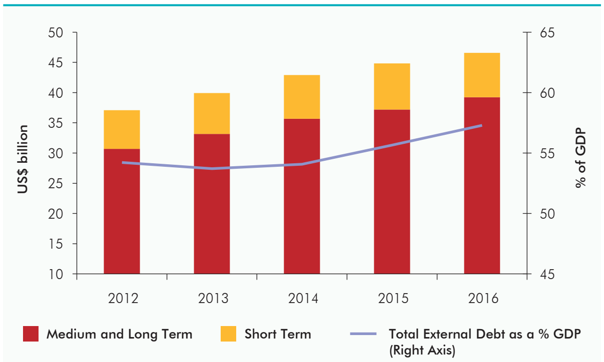
assets to some extent. Total foreign assets were equivalent to 5.2 months of imports of goods and 4.3 months of imports of goods and services.

5.10 External Debt and Debt Servicing

5.10.1 External Debt

The total external debt of the country increased by US dollars 1.7 billion in 2016. Consequently, the total external debt stock increased from US dollars 44.8 billion as at end 2015 to US dollars 46.6 billion as at end 2016. The increase in external debt was primarily due to the increase in government external debt by US dollars 2.5 billion in 2016. External borrowings by the government increased in 2016 due to the issuance of an ISB, two foreign currency term financing facilities and project and programme loans, although there were disinvestments by foreign investors in the government securities market. Meanwhile, the outstanding external debt of the Central Bank reduced by US dollars 801 million with the repayment of a portion of the foreign currency swap liability and the repayment of the IMF SBA. Further, outstanding external debt of deposit taking corporations, private corporations and SOBEs, and intra company debt of direct investment enterprises amounted to US dollars 8,790 million, US dollars 5,774 million and US dollars 2,802 million, respectively, in 2016.

Chart 5.12
External Debt



Source : Central Bank of Sri Lanka

Table 5.12
Outstanding External Debt Position

US$ million (End period position)

Item	2015(a)	2016(b)
General Government	**24,681**	**27,197**
Short term	**33**	**80**
Debt securities	33	80
Treasury bills (c)	33	80
Long term	**24,647**	**27,118**
Debt securities	8,501	9,823
Treasury bonds (c)	1,811	1,440
Sri Lanka Development bonds (d)	265	58
International sovereign bonds (e)	6,425	8,325
Loans	16,147	17,295
Central Bank	**2,823**	**2,022**
Short term	**483**	**536**
Currency and deposits	5	3
Other accounts payable	478	533
Asian Clearing Union liabilities	478	533
Long term	**2,340**	**1,486**
Special Drawing Rights (SDRs) allocation	548	532
Currency and deposits	1,100	400
Loans	692	554
Credit and loans with the IMF	692	554
Stand-By Arrangement	692	232
Extended Fund Facility	-	322
Deposit-taking Corporations	**9,156**	**8,790**
Short term	**5,762**	**5,247**
Currency and deposits (f)	1,946	2,039
Commercial banks	1,946	2,039
Loans	3,816	3,209
Commercial banks	3,816	3,209
Long term	**3,393**	**3,543**
Debt securities (e)	2,140	2,190
Commercial banks	1,112	1,128
Other deposit-taking corporations	1,028	1,062
Loans	1,253	1,354
Commercial banks	1,240	1,339
Other deposit-taking corporations	13	14
Other Sectors (g)	**5,567**	**5,774**
Short term	**1,375**	**1,483**
Trade credit and advances (h)	1,375	1,483
Long term	**4,192**	**4,291**
Debt securities (e)	164	172
Loans	4,028	4,119
Private sector corporations	1,604	1,876
State owned business enterprises and public corporations	2,423	2,242
Direct Investment: Intercompany Lending (i)	**2,613**	**2,802**
Gross External Debt Position	**44,839**	**46,586**
As a Percentage of GDP		
Gross external debt	55.7	57.3
Short term debt	9.5	9.0
Long term debt	46.2	48.3
As a Percentage of Gross External Debt		
Short term debt	17.1	15.8
Long term debt	82.9	84.2
Memorandum Items		
Debt Securities-Sectorwise Breakdown at Face Value	**11,299**	**12,219**
General government	9,024	9,944
Treasury bills	35	86
Treasury bonds	2,074	1,650
Sri Lanka development bonds	265	58
International sovereign bonds	6,650	8,150
Deposit-taking corporations, except the Central Bank	2,100	2,100
Commercial banks	1,100	1,100
Licensed specialised banks	1,000	1,000
Other sectors	175	175

(a) Revised
(b) Provisional
(c) Based on book value
(d) Based on face value
(e) Based on market prices
(f) Includes deposits of non-resident foreign currency holders
(g) Includes private sector and state owned business enterprises
(h) Includes trade credits outstanding of the Ceylon Petroleum Corporation and private sector companies
(i) Includes inter-company borrowings and shareholder advances on BOI registered companies

Source: Central Bank of Sri Lanka

The total outstanding external debt as a percentage of GDP increased to 57.3 per cent as at end 2016 compared to 55.7 per cent as at end 2015, primarily due to the increase in government external debt. The outstanding position of government external debt amounted to 58.4 per cent of total external debt as at end 2016, compared to 55.0 per cent recorded as at end 2015. Further, long term debt, as a percentage of total external debt, increased to 84.2 per cent as at end 2016, compared to 82.9 per cent as at end 2015, indicating a gradual trend in moving towards longer term maturities. The continued rise in Sri Lanka's external debt remains a concern in the external sector, particularly in view of the expected increase in the cost of borrowing as a result of likely increase in the global interest rates.

5.10.2 Foreign Debt Service Payments

Capital payments on Sri Lanka's external debt obligations moderated while interest payments increased in 2016. Capital repayments on external debt amounted to US dollars 3,157 million in 2016 compared to US dollars 3,435 million

Table 5.13
External Debt Service Payments

Item	US$ million					Rs. million				
	2012	2013	2014	2015 (a)	2016 (b)	2012	2013	2014	2015 (a)	2016 (b)
1. Debt Service Payments	**2,675**	**4,040**	**3,479**	**4,626**	**4,366**	**341,382**	**521,626**	**454,248**	**628,641**	**585,628**
1.1 Amortisation	**1,795**	**2,982**	**2,323**	**3,435**	**3,157**	**229,049**	**384,942**	**303,347**	**467,546**	**410,937**
General Government	1,490	1,555	1,296	1,976	1,040	190,088	200,705	169,150	265,662	151,236
Project Loans	862	836	793	798	876	109,975	107,906	103,540	107,536	127,396
Debt securities	628	719	503	1,178	164	80,114	92,799	65,610	158,126	23,840
Central Bank	57	653	719	907	1,555	7,268	84,285	93,917	125,686	177,396
IMF	57	453	719	507	455	7,268	58,463	93,917	68,775	17,234
Swap and other liabilities	-	200	-	400	1,100	-	25,822	-	56,911	160,162
Private sector and deposit taking corporations	248	774	309	553	562	31,692	99,952	40,280	76,199	82,304
Foreign loans	248	774	309	553	562	31,692	99,952	40,280	76,199	82,304
1.2 Interest Payments	**880**	**1,059**	**1,156**	**1,190**	**1,209**	**112,333**	**136,685**	**150,901**	**161,095**	**174,690**
General Government	702	832	876	870	862	89,547	107,357	114,368	117,496	124,042
Project Loans	294	255	260	266	264	37,464	32,982	33,883	36,024	38,440
Debt securities	408	576	616	604	597	52,083	74,376	80,485	81,472	85,602
Central Bank	43	35	20	13	10	5,512	4,507	2,546	1,693	1,436
IMF	36	33	20	10	8	4,593	4,313	2,546	1,395	1,179
Swap and other liabilities	7	2	-	2	2	919	194	-	298	257
Private sector and deposit taking corporations	135	192	260	307	338	17,274	24,820	33,986	41,907	49,212
Foreign loans	135	145	118	148	179	17,274	18,663	15,470	20,128	26,026
Debt securities	-	48	142	159	159	-	6,157	18,517	21,779	23,186
2. Earnings from Export of Goods and Services	**13,573**	**15,079**	**16,735**	**16,943**	**17,448**					
3. Receipts from Export of Goods, Services, Income and Current Transfers	**19,754**	**21,639**	**23,936**	**24,078**	**24,829**					
4. Debt Service Ratio										
4.1 As a percentage of 2 above										
Overall Ratio	19.7	26.8	20.8	27.3	25.0					
Excluding IMF transactions	19.0	23.6	16.4	24.2	22.4					
4.2 As a percentage of 3 above										
Overall ratio	13.5	18.7	14.5	19.2	17.6					
Excluding IMF transactions	13.1	16.4	11.4	17.1	15.7					
5. Government Debt Service Payments										
5.1 Government debt service payments (c)	2,191	2,386	2,172	2,846	1,901					
5.2 As a percentage of 1 above	81.9	59.1	62.4	61.5	43.5					

(a) Revised
(b) Provisional
(c) Excludes transactions with the IMF

Source : Central Bank of Sri Lanka

in 2015. There was a notable decline in capital repayments of government securities compared to the previous year, since the repayment of government securities in 2015 included an ISB of US dollars 500 million in 2015. However, repayments of the Central Bank increased with the settlement of foreign currency swaps along with the repayments for the IMF SBA in 2016. Interest payments on outstanding external debt obligations increased from US dollars 1,190 million in 2015 to US dollars 1,209 million in 2016. The increase in interest payments was mainly due to the expansion in interest payments made by the private sector and deposit taking corporations.

Total external debt service payments as a percentage of export of merchandise and services declined in 2016. As a result of the decline in total debt service payments, coupled with an increase in export of goods and services, debt service payments as a percentage of export of goods and services declined to 25.0 per cent in 2016 compared to 27.3 per cent in 2015. Meanwhile, global interest rates are expected to gradually rise with the increase in the interest rates by the US Federal Reserve, thus leading to higher borrowing costs in the coming years.

5.11 Exchange Rate Movements

The external value of the Sri Lankan rupee continued to depreciate in 2016. The Sri Lankan rupee, which depreciated by 0.82 per cent in the first half of the year, depreciated at a higher rate of 3.04 per cent in the second half. The relatively low depreciation of the rupee in the first half was supported by the supply of foreign exchange liquidity by the Central Bank, amounting to US dollars 1,093 million, on a net basis. However, the rupee depreciated at a higher rate with the curtailment in intervention by the Central Bank with a net absorption of US dollars 325 million during the second half of the year. A substantial amount of the foreign exchange supplied during the second half was to partially ease the pressure arising due to the disinvestment by non-resident investors in the government securities market, particularly during the last quarter of the year. This outflow from the government securities market was driven by the expectation and the subsequent increase in interest rates by the US Federal Reserve Bank. Throughout the year, with these developments, the rupee depreciated by 3.83 per cent against the dollar from Rs. 144.06 as at end 2015, to Rs. 149.80 as at end 2016. In addition, the annual average exchange rate depreciated by

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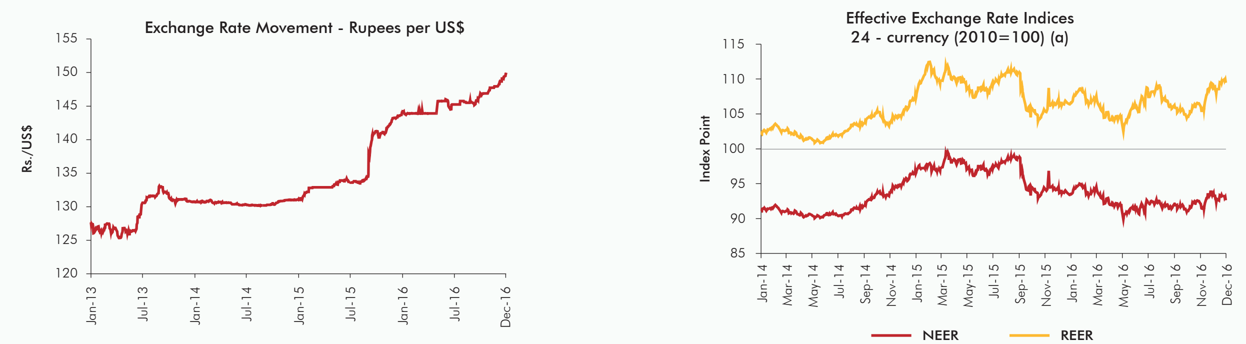
Chart 5.13
Exchange Rate Movements



Source : Central Bank of Sri Lanka

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

6.64 per cent to Rs. 145.60 against the dollar in 2016. This trend of depreciation was consistent to some extent with the demand and supply conditions in the domestic foreign exchange market as the modest levels of inflows with the decline in exports of goods and the moderate growth in workers' remittances were insufficient to meet the demand arising from higher imports and foreign debt service payments. As such, the supply of foreign exchange by the Central Bank resulted in the depletion of reserves. Therefore, the replenishing of international reserve level is vital in reducing the country's vulnerability to external shocks.

In 2016, the rupee depreciated against all major currencies except the pound sterling, which depreciated substantially following the Brexit vote on 23 June 2016. Accordingly, reflecting the movements in the cross currency exchange rates against the US dollar in international markets, the rupee depreciated against the euro by 0.32 per cent, the Indian rupee by 1.72 per cent, the Japanese yen by 7.05 per cent, while appreciating against the pound sterling by 16.04 per cent. Consequently, the rupee also depreciated against the SDR by 0.87 per cent during the year.

5.11.1 Nominal and Real Effective Exchange Rates

The 5-currency and the 24-currency Real Effective Exchange Rate (REER, 2010=100) indices appreciated during the year, reflecting an erosion in the external competitiveness of the currency. REER indices, which take the variation in nominal exchange rates in the baskets into account, as well as the inflation differentials among countries, were recalculated using the newly rebased Colombo Consumer Price Index (2013=100). Accordingly, both

Table 5.14
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	
	2014	2015	2016	2014	2015	2016	2015	2016	2015	2016
Euro	159.42	157.37	157.87	173.47	150.84	161.16	1.30	-0.32	15.00	-6.40
Indian rupee	2.07	2.17	2.21	2.14	2.12	2.17	-4.62	-1.72	1.12	-2.25
Japanese yen	1.10	1.20	1.29	1.24	1.12	1.34	-8.20	-7.05	10.08	-16.48
Pound sterling	204.04	213.57	184.04	215.16	207.99	197.15	-4.46	16.04	3.45	5.50
US dollar	131.05	144.06	149.80	130.56	135.94	145.60	-9.03	-3.83	-3.96	-6.64
SDR	189.86	199.63	201.38	198.35	190.16	202.39	-4.89	-0.87	4.31	-6.04
Effective Exchange Rate Indices (b) (c) (2010=100)	End Year Index			Annual Average Index			Percentage Change over Previous Year			
							End Year Index		Annual Average Index	
	2014	2015	2016	2014	2015	2016	2015	2016	2015	2016
NEER 24-currencies	96.44	93.53	92.64	91.99	96.61	92.46	-3.02	-0.95	5.02	-4.29
REER 24-currencies (d)	107.87	107.28	110.18	103.77	109.50	106.94	-0.55	2.70	5.52	-2.34

(a) Changes computed on the basis of foreign currency equivalent of Sri Lanka rupees. The sign (-) indicates depreciation of Sri Lanka rupee against each currency, respectively.
(b) The Nominal Effective Exchange Rate (NEER) is a weighted average of nominal exchange rates of 24 trading partner and competitor countries. Weights are based on the trade shares reflecting the relative importance of each currency in each of the currency baskets. The Real Effective Exchange Rate (REER) is computed by adjusting the NEER for inflation differentials with respect to each currency in the basket. A minus sign indicates depreciation. CCPI was used for REER computation.
(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, respectively.
(d) With the rebasing of CCPI (2013=100), REER indices have been recalculated.

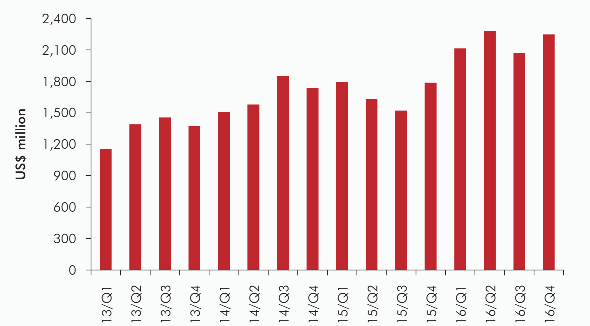
Source: Central Bank of Sri Lanka

5-currency and 24-currency REER indices recorded an appreciation of 2.83 per cent and 2.70 per cent, respectively, by the end of the year. The relatively high level of domestic inflation in Sri Lanka, in comparison to the overall inflation level of its trading partners and competitors, has largely contributed towards the appreciation of the REER indices in 2016. Meanwhile, the Nominal Effective Exchange Rate (NEER) index for the 5-currency basket appreciated marginally by 0.23 per cent, while the same for the 24-currency basket recorded a marginal depreciation of 0.95 per cent during the year.

5.11.2 Developments in the Domestic Foreign Exchange Market

The transaction volumes in the domestic foreign exchange market grew in 2016. Accordingly, the volume of inter-bank foreign exchange transactions at US dollars 14,780 million during 2016 grew, when compared to US dollars 13,600 million in 2015. Although the total volume of spot transactions decreased to US dollars 6,072 million (41.1 per cent of total transactions) in 2016, in comparison to US dollars 6,867 million in 2015, the total volume of forward transactions increased significantly to US dollars 8,709 million in 2016 from US dollars 6,732 million in 2015. Meanwhile, the Central Bank intervened in the domestic foreign exchange market by supplying US dollars 768 million on a net basis in 2016 as to abate a significant depreciation of the exchange rate, amidst a large mismatch in supply and demand for foreign exchange. This included an absorption of US dollars 1,132 million and a supply of US dollars 1,900 million during 2016. However, the Central Bank intervention in 2016 was lower when compared to the previous year, in which the Central Bank sold US dollars 3,429 million and purchased US dollars 179 million. The lower level of net supply was particularly due to the improvement in the second half of 2016, where the Central Bank limited its intervention largely due to the demand arising from non-resident foreign investors in the government securities market.

Chart 5.14
Quarterly Inter - Bank Forward Transaction Volumes



Source : Central Bank of Sri Lanka

During 2016, participants in the domestic foreign exchange market indicated depreciation expectations of the exchange rate in the near term, as reflected in the movements of forward premia and the Net Open Position (NOP) of commercial banks. Accordingly, reflecting market expectations of a depreciation in the exchange rate, the forward premia for one-month contracts remained above the average interest rate differentials during 2016. However, forward premia for three-months and six-months remained below interest rate differentials during the year, indicating expectations of an improvement in foreign exchange earnings. Meanwhile, the NOP of commercial banks also remained at a positive level on average during the year, indicating near-term depreciation expectations of the market.

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BOX 08
Sri Lankan Experience in Foreign Exchange Transactions - Evolution of Exchange Controls, Relaxations and Way Forward

1. Introduction

The openness of a country to the global economy, i.e., the extent to which the free flow of foreign exchange is allowed, is a specific macroeconomic policy because it is neither feasible nor practical for most of the countries to be self-sufficient. Accordingly, the extent of the purchase/ sale of foreign currencies by residents or purchase/ sale of local currencies by non-residents is decided by government policy, with a view to protecting a country's currency and its external reserves, which results in either foreign exchange controls or relaxations.

2. Sri Lankan Experience

Sri Lanka introduced exchange controls in 1944. The Department of Exchange Control was set up during World War II. It underwent several changes according to the varying needs of such time. Its operations were merged with the Department of Imports and Exports in two instances and the responsibilities of both departments were placed with one official. At the time of setting up the Central Bank it has been considered wiser to let exchange control remain the ultimate responsibility of the government, as it impinges directly upon and affects so pervasively the privacy of the general public. Hence, it was recommended to the Minister of Finance that Central Bank assumes the Ministry's functions of the then Exchange Control Department as agent of the government. Accordingly, in 1950, when the Central Bank was set up the Department of Exchange Control came under the Central Bank. The Exchange Control Act, No. 24 of 1953 (ECA), which is the current law for exchange controls, was enacted on 15 August 1953. Accordingly, as of date, provisions of the ECA govern the matters relating to foreign exchange. Key provisions of ECA are as follows:

a. The Central Bank of Sri Lanka, as the agent of the government, is responsible for carrying out the provisions of the ECA under directions issued by the Minister of Finance.

b. The Exchange Control Department (ECD) was established for the purpose of carrying out the provisions of the ECA. Accordingly, the Controller of Exchange (CE), as the head of the ECD, or another designated officer is empowered on his behalf to exercise or perform any powers, duties and functions authorised or required to be exercised or performed by the Central Bank, by any provision of ECA, subject to the direction and control of the Governor.

c. The CE can delegate the granting of permission under the ECA to an Authorised Dealer (AD) by issue of Directions to such effect. Any commercial bank may be authorised by the Minister of Finance to act as an AD.

d. Prior permission should be obtained for transactions between residents in Sri Lanka and residents outside Sri Lanka, and transactions associated with foreign exchange made within and outside Sri Lanka. Such permissions cover gold, currency, securities, debts, payments, property and import/export transfers.

e. In most instances such permission should be granted by the Central Bank, while on few occasions by the Minister of Finance.

f. Any permission, consent or authority under the ECA can be general or special, absolute or conditional, with an expiry date, unless renewed and varied or revoked.

g. The Central Bank should be informed of any holding/acquisition/disposal of foreign assets.

h. The CE can call for information and search premises with respect to matters falling within the purview of the ECA.

i. The Central Bank can investigate any alleged violations of the ECA and either impose fines or take legal action against such offenders.

j. The Minister of Finance may make regulations as necessary for carrying out the principles and provisions of the Act.

k. Anyone who is dissatisfied with a decision of the Central Bank can appeal to the Minister.

3. Key Milestones of Liberalising Exchange Controls in Sri Lanka

3.1. With a view of addressing the problems associated with the Balance of Payments, a rigorous system of exchange controls was introduced in 1961. Accordingly, licenses that acted as exchange permits were issued by the Controller of Imports and Exports. All imports and exports were subject to certain regulations. Only the goods classified as essential were permitted to be imported.

3.2. From 1970 to 1977, a dual exchange rate system was prevailed in addition to exchange and import controls. Under this system, essential imports were allowed under an official rate and other imports had to be done at higher rates.

3.3. In November 1977, the exchange rate system was liberalised as part of the new government's economic reforms, introduced under open economic policies. This is considered as the commencement of the current phase of liberalising the current account.

3.4. The liberalisation of the current account was accelerated since 1993 and in 1994 all current account transactions were liberalised, as a consequence of accepting Article VIII of the IMF Articles of Agreement in 1994. Accordingly, Licensed Commercial Banks (i.e. Authorised Dealers in foreign exchange) were permitted to release foreign exchange for such transactions, free of any exchange restrictions.

3.5. Subsequent to the liberalisation of the current account, the Central Bank has gradually relaxed capital account transactions with the objective of achieving greater efficiency in the conduct of international financial transactions.

4. Relaxations under the ECA as of Date[1]

4.1. Authorised Dealers (ADs), i.e., licensed commercial banks, are permitted to release foreign exchange without restriction for all current (non-capital) transactions after satisfying themselves with the bona-fides of the requests. Current account transactions include payment for merchandise imports and exports, payments for services, such as travel abroad for any purpose, including education and medical treatment, remittances to dependents resident abroad, remittances of profits, dividends, interest, rental income, etc., payments relating to shipping, airline and freight forwarding.

4.2. Retention and possession of foreign exchange up to US dollars 10,000 if such money is obtained for travel purposes and brought back to Sri Lanka unutilised, received outside Sri Lanka, earned for services rendered to a person outside Sri Lanka or withdrawn by holders of Non Resident Foreign, Currency Accounts (NRFC), Resident Foreigns Currency Accounts (RFC), Resident Non-Nationals' Foreign Currency Accounts (RNNFC) and Foreign Exchange Earners' Accounts (FEEA) from their respective accounts.

4.3. Residents in Sri Lanka to accept foreign currency in payment from non-residents against goods and services. The moneys so accepted may be retained in their possession up to 7 days from the date of sale and thereafter, be credited into a FEEA or sold to an AD.

4.4. Persons who maintain FEEAs are eligible to borrow in foreign currency for any purpose and migrant workers who maintain NRFC accounts, dual citizens and permanent residency visa holders in another country can borrow in foreign currency for housing purposes. Migrant workers who maintain NRFC accounts are also permitted to borrow in Sri Lanka Rupees for any purpose.

1. The relevant operating instructions/directions/circulars should be referred to ascertain full details and terms and conditions of such relaxations

4.5. Any person is permitted to bring into Sri Lanka any amount of foreign currency subject to declaration to Customs if the value exceeds US dollars 15,000 in aggregate or if such person intends to take back foreign currency notes exceeding US dollars 5,000.

4.6. A person resident in Sri Lanka can take out from Sri Lanka any amount of foreign currency subject to declaration to Customs if the value exceeds US dollars 10,000 in aggregate or US dollars 5,000 in currency notes.

4.7. A person resident in Sri Lanka can export and import Sri Lanka currency up to Rs. 20,000/- per person.

4.8. Following persons can open, operate and maintain accounts outside Sri Lanka:

a. A person resident in Sri Lanka who has temporarily left Sri Lanka for business, studies or medical purposes.

b. An individual or a company/firm registered in Sri Lanka who provides professional or vocational services outside Sri Lanka.

c. An individual or a company/firm registered in Sri Lanka which has been permitted by the Minister of Finance to invest outside Sri Lanka.

d. An exporter of merchandise goods.

e. A person who has obtained a valid permanent residency permit from another country.

f. A dual citizen.

g. A person resident in Sri Lanka who intends to proceed outside Sri Lanka for studies in a country where such person is required by the visa granting authority to open and maintain an account in such country for the purpose of obtaining the student visa.

4.9. Residents to transact with non-residents, in Sri Lanka

a. To make and receive payments to/from non-residents in relation to issuance and transfer of shares.

b. To purchase, transfer and make payments in respect of transactions related to Sri Lanka Rupee denominated bonds, by permitted persons.

c. To make payments to or for the credit of citizens of foreign states, corporate bodies incorporated outside Sri Lanka and foreign institutional investors, with respect to Rupee denominated Treasury bills.

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d. To purchase, transfer and make payments in respect of Sri Lanka Development Bonds issued by the Government of Sri Lanka by permitted persons.

e. To issue, transfer and make payments with respect to units in Unit Trusts, operated with a license issued under the Securities and Exchange Commission of Sri Lanka Act to persons specified in the Gazette.

f. To issue and transfer Sri Lanka Rupee denominated redeemable preference shares in a company classified as a specified business enterprise as per the Sri Lanka Accounting and Auditing Standards Act, to persons resident outside Sri Lanka as specified in the Gazette.

g. To issue and transfer listed and non-listed debentures denominated in Sri Lanka Rupees in a company incorporated in Sri Lanka to non-resident investors.

h. To make payments in Rupees to non-residents with respect to immovable property.

i. Holders of NRFC, RFC, RNNFC and FEEA to make payments outside Sri Lanka for any purpose, i.e., to acquire securities and any other capital or current transactions.

4.10. Residents to make payments in foreign exchange to persons resident outside Sri Lanka using credit/ debit cards for personal use.

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4.11. Overseas companies to carry on business in Sri Lanka subject to exclusions and limitations in engaging in certain business activities.

4.12. Locally incorporated companies to obtain loans from residents outside Sri Lanka.

4.13. Residents to invest outside Sri Lanka subject to prescribed limits and permitted investments.

4.14. Companies and partnerships registered in Sri Lanka to remit funds for the purpose of setting up and maintaining overseas offices.

4.15. Repatriation of funds in Blocked Accounts

a. A Sri Lankan who has acquired permanent residency in another country:

- An initial migration allowance of US dollars 150,000 and subsequent annual allowance of US dollars 20,000.
- Superannuation benefits including EPF, ETF, Gratuity and current income to be freely transferred through a Blocked Account.

b. Non-nationals to remit US dollars 20,000 annually.

4.16. Any person in Sri Lanka to buy, sell, import into and export Gold from Sri Lanka subject to a declaration to the Director General of Customs of the quantity, value and purpose of such gold imported and/or exported.

4.17. Sri Lankans who have proceeded outside Sri Lanka for educational purposes, to borrow from banks, financial institutions, universities or educational institutions in foreign countries and to repay such loans by remitting funds from Sri Lanka through an authorized dealer.

4.18. Non-nationals employed in Sri Lanka to accept credits to permitted foreign currency accounts held by them, being payments to them which include salaries, wages and other benefits.

5. Way Forward

Consequent to the liberalisation of economic and trade policies since late 1970s, Sri Lanka has gradually opened up opportunities for cross-border capital flows. Increased capital inflows, in particular, supplement financing for domestic investment while providing opportunities for integrating with international capital markets. The attractiveness of a country as a preferred destination for foreign investment *inter-alia* depends on the degree of openness of that county's capital account. Hence, the ability to remit in and remit out funds without prior approvals, cumbersome and time consuming procedures and restrictions is an important factor in promoting and attracting foreign investments.

As summarised above, foreign exchange regulations related to the capital account have been relaxed gradually with the objectives of achieving greater efficiency in the conduct of international financial transactions and further facilitating economic activities. However, there is still a general perception that capital inflows to and outflows from the country are quite restrictive. In order to address this situation, the Government in its recent Budget announcements has declared that a new law will be introduced. Accordingly, the preparatory work to introduce a new foreign exchange management framework is currently in progress and the new Foreign Exchange Bill has been published in the Government Gazette Notification before presenting to the Parliament.

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