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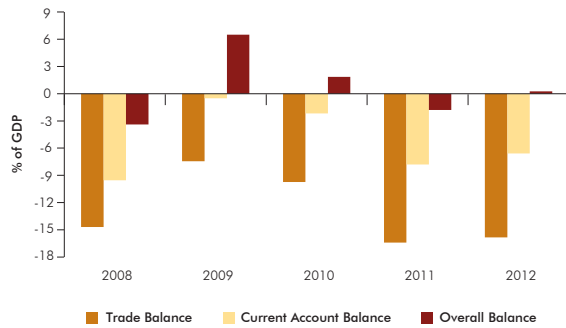
## EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

### 5.1 Overview

**S**ri Lanka's external sector strengthened in 2012 despite the challenging global economic environment, largely supported by the prudent policy package implemented by the Central Bank and the government in early 2012. The widening trade deficit driven by a sharp growth in imports and a slowdown in exports due to weak global demand was a key policy challenge faced at the beginning of 2012. With a view to ensuring macroeconomic stability, the Central Bank and the government implemented a strong policy package, which included allowing greater flexibility in the exchange rate, increasing the policy interest rates, imposing a ceiling on the growth of credit granted by licensed banks and raising customs duties on selected imports. Reflecting the effectiveness of these policy measures, expenditure on imports declined by 5.4 per cent in 2012, with non-fuel imports decreasing at a higher rate of 8.6 per cent. Although greater flexibility in the exchange rate helped augment export competitiveness, the decline in international commodity prices and subdued global demand amidst faltering economic activity in the US and the euro area resulted in exports declining by 7.4 per cent in 2012. In absolute terms however, the

decline in import expenditure was larger than the decline in earnings from exports, and as a result, the trade deficit contracted by 3.1 per cent to US dollars 9.4 billion. As a percentage of the gross domestic product (GDP), the trade deficit declined from 16.4 per cent in 2011 to 15.8 per cent in 2012.

**Supported by the significant improvement in the current account and the continued inflows to the capital and financial account, Sri Lanka's balance of payments (BOP) registered a surplus in 2012.** The higher earnings from tourism and transportation, and a significant increase in workers' remittances coupled with the contraction in the trade deficit led the decline in the current account deficit from US dollars 4,615 million in 2011 to US dollars 3,915 million in 2012. As a percentage of GDP, the current account deficit declined from 7.8 per cent in 2011 to 6.6 per cent in 2012. Meanwhile, inflows to the capital and financial account increased significantly during the year. Foreign inflows to the government continued to remain healthy on account of project financing and investment in government securities. The relaxation of exchange control regulations encouraged banks and the private sector to raise more funds abroad. Following these developments,

**Chart 5.1** Balance of Payments**Chart 5.2** Major Sources of Foreign Exchange Earnings

the BOP recorded a surplus of US dollars 151 million by end 2012 compared to the deficit of US dollars 1,061 million in 2011.

The improvement in the BOP helped strengthen the gross official reserves of the country to US dollars 6.9 billion by end 2012 from US dollars 6 billion at end 2011. In terms of months of imports, gross official reserves were equivalent to 4.3 months by end 2012, a significant improvement compared to the import coverage of 3.5 months recorded in 2011, and well above the standard reserve adequacy norm of 3 months of imports. The higher inflows on account of tourism, workers' remittances, foreign direct investment (FDI), disbursements in relation to foreign funded projects, proceeds of the fifth international sovereign bond and the completion of the Stand-by Arrangement (SBA) of the International Monetary Fund (IMF) with the receipt of the final two tranches helped boost external reserves in 2012. The strengthening of the external position also helped maintain the sovereign ratings of the country. This is noteworthy as many countries were facing the challenge of their ratings being downgraded amidst growing uncertainties in the global economy.

Exchange rate policy in 2012 mainly focused on allowing greater flexibility in the exchange rate and limiting the Central Bank's intervention in the domestic foreign exchange market. The intervention of the Central Bank

during 2012 was limited only to the extent needed to settle a portion of petroleum import bills, mainly during the first few months of the year, while surplus foreign exchange liquidity in the market was absorbed as and when appropriate. Further, to prevent any excessive fluctuations in the exchange rate arising from speculative behaviour in the domestic foreign exchange market particularly in the aftermath of allowing greater flexibility in the exchange rate, the Central Bank took measures in March 2012 by means of imposing restrictions on forward contracts and tightening limits on net open positions (NOP) of commercial banks. Reflecting the initial overshooting after the policy change, the rupee depreciated by 14.56 per cent against the US dollar in the first half of the year. However with increased foreign inflows to the country during the second half of 2012, the rupee gained value and appreciated by 4.83 per cent against the US dollar. Overall, the rupee depreciated vis-à-vis the US dollar by 10.43 per cent during 2012. As the domestic foreign exchange market stabilised during the latter part of the year, the Central Bank relaxed restrictions on forward contracts and NOP limits at the beginning of 2013.

The external sector is expected to strengthen further in 2013 and beyond with the gradual recovery of the global economy and the commensurate improvement in the growth prospects of the domestic economy. Policies

Table 5.1

## Balance of Payments Analytical Presentation(a)

Item	US\$ million					Rs. million				
	2008	2009	2010	2011(b)	2012(c)	2008	2009	2010	2011(b)	2012(c)
<b>Trade Balance</b>	<b>-5,981</b>	<b>-3,122</b>	<b>-4,825</b>	<b>-9,710</b>	<b>-9,409</b>	<b>-647,207</b>	<b>-358,707</b>	<b>-545,350</b>	<b>-1,073,900</b>	<b>-1,195,368</b>
Exports	8,111	7,085	8,626	10,559	9,774	878,499	813,911	974,387	1,167,588	1,245,531
Imports	14,091	10,207	13,451	20,269	19,183	1,525,705	1,172,618	1,519,737	2,241,488	2,440,899
Services (net)	401	391	707	1,099	1,250	43,557	44,780	79,766	121,635	159,321
Receipts	2,004	1,892	2,474	3,084	3,788	217,180	217,378	279,634	340,977	483,502
Payments	1,603	1,501	1,768	1,985	2,538	173,623	172,598	199,868	219,342	324,181
Income (net)	-972	-488	-617	-647	-1,148	-105,032	-55,814	-69,776	-72,041	-148,419
Receipts	-32	116	323	467	321	-3,133	13,551	36,508	51,102	38,675
Payments	940	603	940	1,114	1,469	101,899	69,365	106,284	123,143	187,094
<b>Goods, Services and Income (net)</b>	<b>-6,552</b>	<b>-3,219</b>	<b>-4,735</b>	<b>-9,258</b>	<b>-9,307</b>	<b>-708,681</b>	<b>-369,740</b>	<b>-535,360</b>	<b>-1,024,306</b>	<b>-1,184,466</b>
Current Transfers (net)	2,666	3,005	3,660	4,643	5,392	288,639	345,498	413,885	513,216	688,613
Private Transfers (net)	2,565	2,927	3,608	4,583	5,339	277,711	336,578	407,967	506,630	681,714
Receipts	2,918	3,330	4,116	5,145	5,985	316,091	382,818	465,166	569,103	763,980
Payments	353	403	508	562	646	38,380	46,240	57,199	62,473	82,266
Official Transfers (net)	101	77	52	60	53	10,928	8,920	5,918	6,587	6,899
<b>Current Account Balance</b>	<b>-3,886</b>	<b>-214</b>	<b>-1,075</b>	<b>-4,615</b>	<b>-3,915</b>	<b>-420,042</b>	<b>-24,242</b>	<b>-121,475</b>	<b>-511,090</b>	<b>-495,853</b>
<b>Capital and Financial Account (net)</b>	<b>1,773</b>	<b>2,594</b>	<b>2,877</b>	<b>4,262</b>	<b>4,684</b>	<b>193,713</b>	<b>299,381</b>	<b>322,035</b>	<b>458,639</b>	<b>630,769</b>
<b>Capital Account (net)</b>	<b>291</b>	<b>233</b>	<b>164</b>	<b>164</b>	<b>130</b>	<b>31,456</b>	<b>26,832</b>	<b>18,521</b>	<b>18,126</b>	<b>16,951</b>
Capital Transfers (net)	291	233	164	164	130	31,456	26,832	18,521	18,126	16,951
Receipts	303	247	182	185	146	32,774	28,465	20,599	20,382	18,884
Payments	12	14	19	20	15	1,319	1,633	2,078	2,256	1,933
<b>Financial Account (net)</b>	<b>1,483</b>	<b>2,361</b>	<b>2,713</b>	<b>4,098</b>	<b>4,554</b>	<b>162,258</b>	<b>272,550</b>	<b>303,515</b>	<b>440,513</b>	<b>613,818</b>
Long-term (net)	1,016	1,304	2,379	3,308	2,872	109,174	149,772	268,228	364,307	372,682
Foreign Direct Investment (net)	691	384	435	896	813	74,837	44,112	49,008	99,265	103,456
Private Long-term (net)	74	79	149	175	562	7,768	9,105	17,569	19,489	73,262
Inflows	265	390	580	310	891	28,693	44,795	65,934	34,376	115,351
Outflows	191	311	431	135	329	20,925	35,691	48,365	14,887	42,089
Government, Long-term (net)	252	840	1,796	2,237	1,497	26,568	96,555	201,650	245,553	195,964
Inflows	1,059	1,780	2,460	3,026	2,869	114,658	204,435	276,582	333,307	372,580
Outflows	807	940	665	789	1,372	88,090	107,880	74,932	87,754	176,617
Short-term (net)	441	1,590	-730	-181	486	47,053	182,911	-82,412	-20,073	60,869
Portfolio Investment (net)	60	-6	-230	-171	305	6,460	-785	-26,010	-18,979	38,681
Private Short-term (net)	594	228	-1,032	-243	-663	63,987	26,108	-116,655	-26,887	-82,583
Government Securities (net)	-213	1,369	531	233	843	-23,395	157,588	60,252	25,794	104,772
Commercial Bank (net)	26	-533	1,064	971	1,196	6,031	-60,134	117,699	96,279	180,267
Commercial Bank Assets (net)	210	-435	249	183	-239	17,889	-51,298	33,343	14,724	-46,801
Commercial Bank Liabilities (net)(d)	-185	-98	815	788	1,435	-11,858	-8,836	84,356	81,555	227,067
Allocation of SDRs(e)	-	508	-	-	-	-	58,353	-	-	-
Errors and Omissions	728	346	-881	-708	-617	80,534	40,082	-112,586	-53,399	-62,279
<b>Overall Balance</b>	<b>-1,385</b>	<b>2,725</b>	<b>921</b>	<b>-1,061</b>	<b>151</b>	<b>-145,795</b>	<b>315,221</b>	<b>87,974</b>	<b>-105,850</b>	<b>72,638</b>
Monetary Movements	1,385	-2,725	-921	1,061	-151	145,795	-315,221	-87,974	105,850	-72,638
<b>Annual Average Exchange Rate Rs./US\$</b>						<b>108.33</b>	<b>114.94</b>	<b>113.06</b>	<b>110.57</b>	<b>127.60</b>
<b>Ratio to GDP in Percentages(f),(g)</b>										
Trade Account	-14.7	-7.4	-9.7	-16.4	-15.8	-14.7	-7.4	-9.7	-16.4	-15.8
Current Account	-9.5	-0.5	-2.2	-7.8	-6.6	-9.5	-0.5	-2.2	-7.8	-6.5
Current Account without Grants	-9.8	-0.7	-2.3	-7.9	-6.7	-9.8	-0.7	-2.3	-7.9	-6.6

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

(b) Revised

(c) Provisional

(d) Commercial Bank Liabilities include US dollars 973 million inflows in the form of long term foreign borrowings in 2012.

(e) General and special allocations of Special Drawing Rights (SDRs) by the IMF.

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

(g) Ratios calculated in rupee values and US dollar values differ due to variations in exchange rates during the year.

Sources: Board of Investment of Sri Lanka  
Colombo Stock Exchange  
Department of Census and Statistics  
External Resources Department  
Sri Lanka Customs  
Central Bank of Sri Lanka

are being pursued towards promoting exports of both goods and services and discouraging non-essential imports aiming at narrowing the trade deficit further. Export of services is poised to record a significant improvement over the medium-term with infrastructure development in relation to tourism and transportation taking place on a sizable scale, while rapidly growing education and information technology sectors are also expected to make a significant contribution. Hence, the external current account position is expected to improve to a more sustainable level, while other financial flows including FDI are expected to strengthen external reserves helping withstand any potential external vulnerability. Moreover, the introduction of progressive measures towards further development of the domestic foreign exchange market and the gradual relaxation of exchange control regulations would help deepen the domestic foreign exchange market.

## 5.2 External Trade Policies and Institutional Support

**External trade policy in 2012 encouraged higher domestic value addition, production of globally competitive goods for export, and production of goods that could replace high cost imports.** While institutional support in relation to external trade was strengthened, decisive steps were taken to manage the imbalances in the macroeconomic environment which were caused by external trade.

**The four rate duty structure effective from 1 June 2010 remained.** Presently, all imported items are subject to the duty rates of 0, 5, 15 or 30 per cent. Most raw materials and machinery used for production of goods for export as well as items imported for expanding service industries such as tourism, information and communication technology (ICT), and business process outsourcing (BPO) were placed on zero duty or at the duty free rate.

**In 2012, policy measures aimed at promoting exports focused on strengthening domestic industries so as to enable them to become**

**globally competitive and thereby increase their earnings.** Addressing the need to maintain the high quality of Ceylon tea and sustain its global market position amidst growing competition, support schemes were introduced by the Sri Lanka Tea Board for tea factory modernisation, minimising post-harvest damages, replanting and new planting in estates with more than 10 acres of tea. Further, a project to establish systems standards was undertaken by the Sri Lanka Standards Institute (SLSI) to award product quality certification to tea factories. Sri Lanka Tea Board promoted Pure Ceylon Tea globally, using the moneys raised by way of the promotion and marketing levy imposed on tea for necessary funding in this regard. Meanwhile, joint ventures between tea producers and exporting companies were provided income tax concessions if they exported value added tea under Sri Lankan brand names. The cess on bulk tea exports continued in order to encourage domestic value addition. Cesses on many raw materials, including those used for emerging high value industries, were introduced or increased to discourage the export of raw materials and encourage value added exports. Accordingly, cesses were introduced on exports of raw rubber, cinnamon, and rare soils and minerals including natural sands, quartz, phosphate, ilmanite and mica. However, to reap the benefits of these cesses, necessary investments must be made in developing skilled labour while high-value industries including high-tech industries such as the microchip industry must be promoted. In the meantime, wholesale or retail sale of goods to exporters were exempted from the Nation Building Tax (NBT).

**In tandem with export promotion, steps were taken to reduce expenditure on imports of items that could be produced locally.** With the aim of enabling the domestic textile manufacturing industry to produce at least a half of the textile requirement of the domestic garment industry within 5 years, imports of all yarn were exempted from taxes at the

point of importation and an all-inclusive tax of Rs. 75 per kilogram of yarn imported was introduced instead. Additionally, all imports of branded apparel were made subject to an all-inclusive import tax of 35 per cent. Meanwhile, export oriented apparel manufacturers were allowed to release a maximum of 25 per cent of their output to the local market subject to an all-inclusive tax of Rs. 25 per item or bundle as specified. The 2013 Budget extended this provision up to 40 per cent to all export-oriented companies upon the payment of NBT and Value Added Tax (VAT). Further, in order to encourage local value addition in industry, cesses were imposed or increased in relation to imports of items such as dried vegetables and fruit, wheat, thriposha and refrigerators.

**In order to maintain macroeconomic stability, targeted policies were adopted to curb the expansion of expenditure on imports.** The excise duties on motor vehicles, three wheelers, and motor bicycles were increased with effect from 31 March 2012, in order to discourage imports of personal motor vehicles and thereby reduce the trade deficit. The Special Commodity Levy (SCL) on several food items such as potatoes, chillies, coconut oil and onions was revised to protect and promote domestic agriculture. The SCL on sugar imports was increased to support the local sugar industry.

**Continued institutional support was given to exporters with a view to enabling them to seize opportunities arising globally.** Version 2012 of the Harmonized Commodity Description and Coding System (HS codes), which is revised by the World Customs Organization every three years, was adopted by Sri Lanka, by way of maintaining internationally accepted standards in the classification of merchandise goods. The new HS nomenclature includes detailed identification of primary foods, as well as classification of new products with technological developments.

Meanwhile, with the intention of transforming the domestic gem and jewellery industry into a globally competitive industry, steps were taken to remove the NBT on gem imports and instead charge a special fee for hand carried gems for easy customs clearance. The NGJA also promoted the domestic gem and jewellery industry in emerging markets such as China and India to enhance the industry's growth potential and further diversify market risk, as Belgium still remains the biggest market for gems and jewellery exported from Sri Lanka, accounting for more than a half of all gems and jewellery exported in 2012. While the Sri Lanka Export Credit Insurance Corporation (SLECIC) continued to provide insurance against the risk of non-payment by foreign buyers due to commercial or political reasons, the total amount of exports insured by the SLECIC increased substantially in 2012. The UAE was the largest insured market by 2012, especially in relation to tea exports. The Export Development Board (EDB) implemented several programmes to encourage export diversification and value addition in high potential industries such as cinnamon, rubber products and electronics. The EDB took several steps to promote the 'Pure Ceylon Cinnamon' brand by registering the trade mark in the EU region and initiating trade mark and geographical indication registration in other countries as well. The EDB also established 20 'Good manufacturing practices' (GMP) certified cinnamon processing centres. As a key step towards transforming Sri Lanka into a commercial hub, the Finance Act No. 12 of 2012 was passed. This Act will enable entrepot trading, transshipment, provision of front-end services to regional manufacturers, provision of logistical services such as bonded warehouses, multi-country consolidation, and the establishment of operations by global and local buyers in specified customs areas in Sri Lanka, which will not be subject to the provisions of the Customs Ordinance, the Exchange Control Act and the Import and Export (Control) Act.

### Sri Lanka continued to engage in negotiations with a view to increasing market access for exports through trade agreements.

The members decided to re-engage negotiations of the Doha Round of the World Trade Organization (WTO) in 2013 with a view to concluding modalities relating to a few critical areas such as agriculture, non-agriculture market access (NAMA) and services at the 9th WTO Ministerial Conference. However, the delay in this process has prevented developing countries from gaining access to markets particularly in developed countries, for highly protected areas such as agriculture. Negotiations under the Asia Pacific Trade Agreement (APTA) continued as the original offer of 40 per cent of Margin of Preference (MOP) for 40 per cent of the tariff lines offered by the larger members, namely, China, Korea and India, is to be revised downwards to 33 per cent of MOP for 28 per cent of the tariff lines, due to India being unable to commit to the higher threshold of 40 per cent. Sri Lanka and members that are Least Developed Countries (LDCs) are exempt from making these commitments. Despite the Agreement on South Asian Free Trade Area (SAFTA) being in force since 2006, Sri Lanka's exports under the SAFTA in 2012 were approximately US dollars 229,000. The low performance under this agreement can be attributed primarily to the bilateral free trade agreements with Sri Lanka's largest trading partners in South Asia, i.e., India and Pakistan. The schedule of commitments under the SAARC Agreement on Trade in Services (SATIS) is in the process of being finalised.

**Of all trade agreements, bilateral agreements were the most utilised in 2012.** While Sri Lanka's exports to India increased from US dollars 519 million in 2011 to US dollars 567 million in 2012, most items were exported under the India-Sri Lanka Free Trade Agreement (ISFTA). The main items exported from Sri Lanka to India were transport equipment, animal fodder and machinery

and mechanical appliances. The main imports from India were petroleum, transport equipment, textiles and building materials. While duty free access was obtained for most of Sri Lanka's exports to India under the ISFTA, the key items imported from India did not come under the ISFTA. Despite the main imports from India not falling under the ISFTA, price competitiveness of these products created high demand for these products in Sri Lanka. Trade under the Pakistan-Sri Lanka Free Trade Agreement (PSFTA) has been increasing but total exports to Pakistan remained at US dollars 83 million by 2012. Imports from Pakistan amounted to US dollars 353 million in 2012. Amongst the key products exported to Pakistan were tea, natural rubber, kernel products and spices.

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

### Export Performance

**Earnings from exports declined in 2012, largely reflecting the downward movement of commodity prices and subdued global demand in view of faltering economic activity in major economies.** Earnings from exports, which grew at a robust rate in 2011, declined by 7.4 per cent, year-on-year, in 2012 to US dollars 9,774 million, reflecting declines in industrial as well as agricultural exports.

**Chart 5.3 Exports by Commodities - 2012**

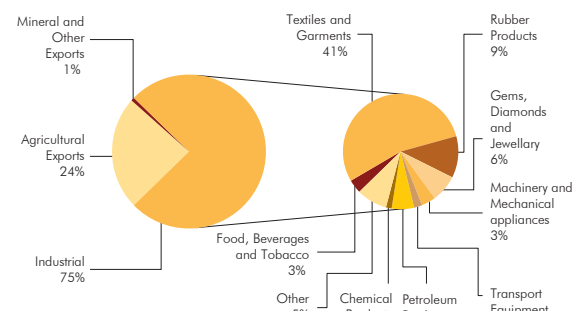


Table 5.2

## Composition of Exports

Category	2011		2012 (a)		Change in Value (a) US\$ million	Y-o-Y Change (a) %	Contribution to change (a) %
	Value US\$ million	Share %	Value US\$ million	Share %			
<b>Agricultural Exports</b>	<b>2,527.8</b>	<b>23.9</b>	<b>2,331.5</b>	<b>23.9</b>	<b>-196.3</b>	<b>-7.8</b>	<b>25.0</b>
Tea	1,490.9	14.1	1,411.9	14.4	-79.0	-5.3	10.1
Rubber	206.4	2.0	125.1	1.3	-81.3	-39.4	10.3
Coconut	266.0	2.5	208.9	2.1	-57.1	-21.5	7.3
Spices	235.2	2.2	256.1	2.6	20.8	8.9	-2.7
Vegetables	16.9	0.2	13.3	0.1	-3.6	-21.2	0.5
Unmanufactured Tobacco	38.4	0.4	42.2	0.4	3.8	9.8	-0.5
Minor Agricultural Products	88.7	0.8	76.0	0.8	-12.7	-14.3	1.6
Sea Food	185.3	1.8	198.0	2.0	12.7	6.9	-1.6
<b>Industrial Exports</b>	<b>7,991.7</b>	<b>75.7</b>	<b>7,371.2</b>	<b>75.4</b>	<b>-620.5</b>	<b>-7.8</b>	<b>79.0</b>
Textiles and Garments	4,191.2	39.7	3,991.1	40.8	-200.1	-4.8	25.5
Rubber Products	884.8	8.4	859.4	8.8	-25.4	-2.9	3.2
Petroleum Products	552.7	5.2	463.0	4.7	-89.7	-16.2	11.4
Gems, Diamonds and Jewellery	531.5	5.0	558.9	5.7	27.4	5.2	-3.5
Food, Beverages and Tobacco	348.2	3.3	284.3	2.9	-63.9	-18.3	8.1
Machinery and Mechanical Appliances	312.2	3.0	297.5	3.0	-14.7	-4.7	1.9
Printing Industry Products	235.1	2.2	41.8	0.4	-193.3	-82.2	24.6
Transport Equipment	225.0	2.1	164.9	1.7	-60.1	-26.7	7.7
Leather, Travel Goods and Footwear	65.1	0.6	55.4	0.6	-9.7	-14.9	1.2
Ceramic Products	38.3	0.4	35.8	0.4	-2.5	-6.6	0.3
Other Industrial Exports	607.5	5.8	619.2	6.3	11.7	1.9	-1.5
<b>Mineral Exports</b>	<b>32.9</b>	<b>0.3</b>	<b>61.3</b>	<b>0.6</b>	<b>28.4</b>	<b>86.4</b>	<b>-3.6</b>
<b>Unclassified</b>	<b>6.5</b>	<b>0.1</b>	<b>9.6</b>	<b>0.1</b>	<b>3.1</b>	<b>48.1</b>	<b>-0.4</b>
<b>Total Exports (b)(c)</b>	<b>10,558.8</b>	<b>100.0</b>	<b>9,773.5</b>	<b>100.0</b>	<b>-785.3</b>	<b>-7.4</b>	<b>100.0</b>
<b>Annual Average Exchange Rate (d)</b>	<b>110.57</b>		<b>127.60</b>				

(a) Provisional

(b) Adjusted

(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

Given the decline in commodity prices in the world market and the softening of global demand, earnings from industrial exports in 2012 declined by 7.8 per cent to US dollars 7,371 million. The decline of around 5 per cent in the earnings from exports of garments contributed significantly to the drop in total export earnings in 2012 as garments account for about 40 per cent of total export earnings. While the sharp decline in international cotton prices from the peak levels recorded by March 2011 resulted in a drop in the average unit price of garments, the slowing down of global economic activity and the consequent dampening of global demand has resulted in lower volumes of exports. Earnings from exports of garments to the European Union, which accounted for about 50 per cent of total garment exports over the past five years declined by 9.2 per cent in 2012, with exports to the United Kingdom, Italy,

Germany and Belgium-Luxembourg, the largest markets for garment exports within the European Union, declining. However, earnings from exports of garments to France and several other countries within the European Union have recorded a growth in 2012. Garment exports to the USA, the second largest market for exports of garments, accounting for about 40 per cent of garment exports over the past five years, declined by 4 per cent in 2012.

#### Earnings from exports of other industrial products recorded varied performance in 2012.

Earnings from exports of gems, diamonds and jewellery, and animal fodder increased in 2012, supporting external sector performance. Export earnings from gems, diamonds and jewellery increased by 5.2 per cent to US dollars 559 million in 2012, along with increases in volumes of both gems and jewellery. While export earnings from petroleum products decreased by 16.2 per

cent to US dollars 463 million, this decline could be attributed to a decline in bunkering services provided as a result of a decline in demand given the prevailing subdued global economic conditions and the rising competition from regional ports. Reflecting the marked decline in rubber prices and lower global consumer demand, export earnings from rubber products such as tyres, surgical gloves and other gloves, declined by 2.9 per cent to US dollars 859 million in 2012. Earnings from the transport equipment sub-category also declined by 26.7 per cent to US dollars 165 million in 2012 as a result of earnings from the export of ships, boats and floating structures as well as other transport equipment decreasing. Meanwhile, export earnings from the food, beverages and tobacco sub-category within industrial exports declined by 18.3 per cent to US dollars 284 million in 2012.

**Earnings from agricultural exports declined in 2012 as earnings from the export of major agricultural commodities declined.** Export earnings from tea, which account for about 15 per cent of total export earnings, declined by 5.3 per cent to US dollars 1,412 million in 2012, due to the export volume of tea declining by 0.9 per cent to 320 million kilograms alongside a drop in the average price of tea exported. Although tea prices remained elevated in the world market since around May 2012 due to adverse weather conditions resulting in lower production in key producer countries, namely, Sri Lanka, Kenya and India, the average price of tea exported during the year was marginally lower at US dollars 4.41 a kilogram compared to US dollars 4.62 a kilogram recorded for 2011, which could be attributed to political instability in major tea markets in the Middle East affecting demand. While the average price of rubber exported declined markedly from US dollars 4.84 a kilogram in 2011 to US dollars 3.35 a kilogram in 2012, earnings from exports of rubber declined from US dollars 206 million in 2011 to US dollars 125 million in 2012, along with a decline of 12.3 per cent in the volume of exports.

Earnings from exports of coconut products declined by 21.5 per cent in 2012 to US dollars 209 million, mainly due to exports of coconut kernel products such as desiccated coconut declining. This decline however was contained by an increase in the export earnings from non-kernal products such as yarn, coconut shells and ekels.

**The increasing trend seen in relation to export earnings from spices, unmanufactured tobacco and seafood continued, while earnings from minor agricultural exports declined in 2012.** Earnings from the export of spices increased by 8.9 per cent in 2012 to US dollars 256 million, led by increased earnings from cinnamon and pepper. Earnings from the export of cinnamon increased by 5.2 per cent in 2012 to US dollars 136 million. Earnings from the export of pepper increased by 118.4 per cent in 2012 to US dollars 70 million, supported by an improvement in pepper production. Earnings from seafood increased by 6.9 per cent during the year to US dollars 198 million, with increased earnings from fresh fish, processed fish, frozen fish as well as molluscs. Meanwhile, earnings from unmanufactured tobacco also increased by 9.8 per cent during the year to US dollars 42 million. However, export earnings from minor agricultural products, which include fruit, cereals and cocoa, declined by 14.3 per cent to US dollars 76 million in 2012 mainly as a result of a significant decline in the prices of many of these commodities.

### Import Performance

**Responding to the policy measures adopted to discourage non-essential merchandise imports and thereby contain the expansion of the trade deficit, expenditure on imports declined steadily from around April 2012.** Total expenditure on imports declined by 5.4 per cent to US dollars 19,183 million in 2012 while expenditure on non-fuel imports declined by 8.6 per cent to US dollars 14,146 million, indicating the effectiveness of the policy measures adopted.



Table 5.3

## Composition of Imports

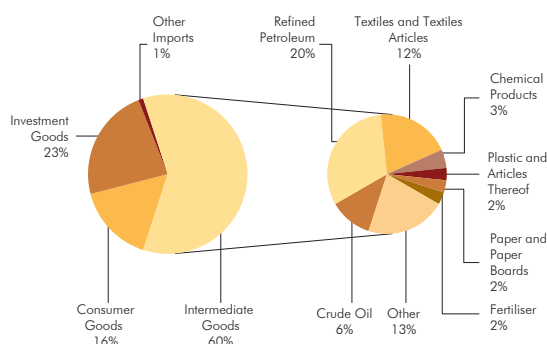
Category	2011		2012 (a)		Change in Value (a) US\$ million	Y-o-Y Change (a) %	Contribution to Change (a) %
	Value US\$ million	Share %	Value US\$ million	Share %			
<b>Consumer Goods</b>	<b>3,653.6</b>	<b>18.0</b>	<b>2,995.2</b>	<b>15.6</b>	<b>-658.4</b>	<b>-18.0</b>	<b>60.6</b>
Food and Beverages	1,566.9	7.7	1,304.4	6.8	-262.5	-16.8	24.2
Rice	18.4	0.1	24.4	0.1	6.0	32.7	-0.6
Sugar and Sugar Confectionery	427.6	2.1	346.7	1.8	-81.0	-18.9	7.5
Dairy Products	345.2	1.7	307.3	1.6	-37.8	-11.0	3.5
Lentils	116.9	0.6	69.0	0.4	-47.9	-41.0	4.4
Other	658.8	3.3	557.0	2.9	-101.8	-15.4	9.4
Other Consumer Goods	2,086.7	10.3	1,690.8	8.8	-396.0	-19.0	36.5
Vehicles	881.0	4.3	495.1	2.6	-385.9	-43.8	35.5
Medical and Pharmaceuticals	348.2	1.7	372.2	1.9	24.0	6.9	-2.2
Home Appliances	227.9	1.1	218.5	1.1	-9.4	-4.1	0.9
Clothing and Accessories	141.8	0.7	174.5	0.9	32.8	23.1	-3.0
Other	487.9	2.4	430.5	2.2	-57.4	-11.8	5.3
<b>Intermediate Goods</b>	<b>12,275.3</b>	<b>60.6</b>	<b>11,569.9</b>	<b>60.3</b>	<b>-705.3</b>	<b>-5.7</b>	<b>64.9</b>
Fuel	4,794.9	23.7	5,037.0	26.3	242.1	5.0	-22.3
Textiles	2,320.7	11.4	2,266.4	11.8	-54.3	-2.3	5.0
Diamonds and Precious Metals	1,075.7	5.3	587.7	3.1	-488.0	-45.4	44.9
Chemical Products	702.0	3.5	669.7	3.5	-32.3	-4.6	3.0
Wheat and Maize	429.4	2.1	363.8	1.9	-65.6	-15.3	6.0
Fertilizer	407.2	2.0	311.0	1.6	-96.2	-23.6	8.9
Other Intermediate Goods	2,545.3	12.6	2,334.4	12.2	-210.9	-8.3	19.4
<b>Investment Goods</b>	<b>4,286.1</b>	<b>21.1</b>	<b>4,589.8</b>	<b>23.9</b>	<b>303.7</b>	<b>7.1</b>	<b>-28.0</b>
Building Materials	1,076.1	5.3	1,237.4	6.5	161.3	15.0	-14.8
Transport Equipment	1,064.6	5.3	991.9	5.2	-72.7	-6.8	6.7
Machinery and Equipment	2,141.4	10.6	2,356.0	12.3	214.6	10.0	-19.8
Other Investment Goods	4.0	0.0	4.5	0.0	0.5	12.3	0.0
<b>Unclassified Imports</b>	<b>53.9</b>	<b>0.3</b>	<b>27.7</b>	<b>0.1</b>	<b>-26.2</b>	<b>-48.6</b>	<b>2.4</b>
<b>Total Imports (b) (c)</b>	<b>20,268.8</b>	<b>100.0</b>	<b>19,182.6</b>	<b>100.0</b>	<b>-1,086.2</b>	<b>-5.4</b>	<b>100.0</b>
<b>Annual Average Exchange Rate (d)</b>	<b>110.57</b>		<b>127.60</b>				

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

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

**Expenditure on intermediate goods imports declined in 2012, mainly as a result of lower expenditure on imports of gold.** In contrast to the sharp increase recorded in relation to gold imports in 2011, expenditure on imports of gold declined by 71.8 per cent in 2012 to US dollars 170 million. Food preparations including fats and oil,

Chart 5.4 Imports by Commodities - 2012



fertilizer, wheat and maize, paper and paperboard and articles thereof, rubber and articles made of rubber, and textiles and textile articles were other items classified under intermediate goods which made a notable contribution towards bringing down import expenditure in 2012. The decline in the prices of agricultural commodities including rubber and cotton also contributed to the decline in import expenditure. Expenditure on imports of fuel increased by around 5 per cent in 2012 to US dollars 5,037 million as oil prices in the world market were higher, on average, in 2012, while increased thermal power generation necessitated higher imports of diesel and furnace oil. However, expenditure on fertilizer imports declined by 23.6 per cent, owing to reduced application due to the drought that prevailed during the second half of 2012.

**Table 5.4** Volume of Major Imports

Item	MT '000				
	2008	2009	2010	2011	2012(a)
<b>Rice</b>	<b>84</b>	<b>52</b>	<b>126</b>	<b>28</b>	<b>36</b>
1st Quarter	41	3	121	8	15
2nd Quarter	28	3	2	2	7
3rd Quarter	12	2	2	9	10
4th Quarter	3	44	1	9	4
<b>Wheat (b)</b>	<b>919</b>	<b>1,026</b>	<b>1,051</b>	<b>1,242</b>	<b>1,084</b>
1st Quarter	272	288	352	322	353
2nd Quarter	312	229	171	455	235
3rd Quarter	153	220	292	254	291
4th Quarter	182	289	236	211	205
<b>Sugar</b>	<b>571</b>	<b>466</b>	<b>548</b>	<b>606</b>	<b>569</b>
1st Quarter	163	123	145	163	158
2nd Quarter	130	110	145	170	135
3rd Quarter	164	142	154	124	114
4th Quarter	114	92	104	149	162
<b>Petroleum (Crude Oil) (b)</b>	<b>1,853</b>	<b>2,065</b>	<b>1,819</b>	<b>2,070</b>	<b>1,486</b>
1st Quarter	229	559	332	557	558
2nd Quarter	525	417	541	555	413
3rd Quarter	544	416	541	410	137
4th Quarter	555	673	405	547	379
<b>Refined Petroleum (b)(c)</b>	<b>2,396</b>	<b>2,162</b>	<b>2,882</b>	<b>3,501</b>	<b>3,950</b>
1st Quarter	781	411	789	702	1,036
2nd Quarter	585	607	881	807	903
3rd Quarter	468	567	507	1,022	997
4th Quarter	562	577	705	970	1,014
<b>Fertilizer</b>	<b>773</b>	<b>462</b>	<b>649</b>	<b>801</b>	<b>640</b>
1st Quarter	125	46	88	131	129
2nd Quarter	223	83	238	207	176
3rd Quarter	216	110	165	266	226
4th Quarter	208	223	158	197	108

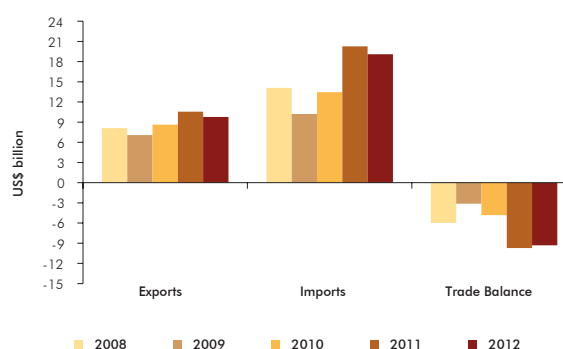
(a) Provisional  
(b) Adjusted  
(c) Excluding coal

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

With respect to expenditure on consumer goods, expenditure on food and beverages as well as non-food items declined considerably in 2012. As a consequence of the higher import tariff imposed on vehicle imports and the depreciation of the rupee, expenditure on motor vehicle imports declined by 43.8 per cent to US dollars 495 million in 2012, in contrast to the sharp increase recorded in 2011. This made a key contribution towards lowering expenditure on imports in 2012. Other consumer goods which helped bring down import expenditure were vegetables, and sugar and confectionary. Import expenditure on vegetables declined from US dollars 312 million in 2011 to US dollars 206 million in 2012 while import

expenditure on sugar and confectionary declined from US dollars 428 million in 2011 to US dollars 347 million in 2012. A special commodity levy (SCL) was imposed on several food items imported including sugar, dhal, garlic, peas, fish, palm oil, sunflower oil and coconut oil, with the intention of promoting domestic agriculture and fishing, which is likely to have discouraged imports of these items. Meanwhile, partly as a result of the upward revision to the import duty applicable to milk powder imports with a view to encouraging domestic milk production, imports of dairy products decreased by around 11 per cent in 2012 and amounted to US dollars 307 million.

In view of the ongoing development of infrastructure, expenditure on investment goods imports increased in 2012. Investment goods imports increased by 7.1 per cent in 2012 to US dollars 4,590 million. Increased expenditure on investment goods imports in 2012 was driven by higher expenditure on building materials, and machinery and equipment. Import expenditure on machinery and equipment, which comprise engineering equipment, electronic equipment, telecommunication devices, office machinery, medical and laboratory equipment and machinery for industrial purposes, increased by 10 per cent in 2012 to US dollars 2,356 million. Expenditure on imports of building materials, which mainly comprise cement, iron and steel, aluminium articles

**Chart 5.5** Exports, Imports and the Trade Balance

and mineral products, increased by 15 per cent in 2012 to US dollars 1,237 million. Increased expenditure on these items could be attributed largely to the infrastructure development projects carried out by the government and the construction activities of the private sector. However, import expenditure on transport equipment, classified under investment goods, which comprise vehicles for transport of passengers and goods, heavy-duty vehicles and small scale ships and boats, declined by 6.8 per cent to US dollars 992 million in 2012.

## Trade Balance

As envisaged, the trade deficit narrowed in 2012 in response to the policy measures adopted earlier in the year. As the decline in

expenditure on imports in absolute terms was larger than the decline in earnings from exports, the deficit in the trade balance contracted by 3.1 per cent in 2012 to US dollars 9,409 million. As a per cent of the GDP, the deficit in the trade balance decreased to 15.8 per cent in 2012 from 16.4 per cent in 2011.

## Terms of Trade

The terms of trade declined marginally to **89.7 in 2012 from 90.9 in 2011**. Reflecting the decline in prices of both agricultural products and industrial products exported, Sri Lanka's export price index declined by 7.1 per cent in 2012. The export price index pertaining to agricultural products exported declined by 2.3 per cent in 2012,

Table 5.5

Trade Indices (a)

Category	2010 = 100								
	Value Index			Volume Index			Unit Price index		
	2011	2012(b)	Y-o-Y Change (%)	2011(c)	2012(b)	Y-o-Y Change (%)	2011(c)	2012(b)	Y-o-Y Change (%)
<b>EXPORTS</b>									
<b>Agricultural Exports</b>	<b>109.7</b>	<b>101.1</b>	<b>-7.8</b>	<b>97.5</b>	<b>92.0</b>	<b>-5.6</b>	<b>112.5</b>	<b>109.9</b>	<b>-2.3</b>
Tea	103.5	98.1	-5.3	98.2	93.5	-4.8	105.4	104.9	-0.5
Rubber	119.2	72.2	-39.4	83.1	69.6	-16.3	143.5	103.9	-27.6
Coconut	160.6	126.1	-21.5	116.3	110.0	-5.4	138.1	114.6	-17.0
Minor Agricultural Products	124.2	106.4	-14.3	144.2	132.9	-7.8	86.1	80.0	-7.1
<b>Industrial Exports</b>	<b>131.2</b>	<b>121.0</b>	<b>-7.8</b>	<b>118.2</b>	<b>119.9</b>	<b>1.4</b>	<b>111.0</b>	<b>100.9</b>	<b>-9.1</b>
Textiles and Garments	125.0	119.0	-4.8	113.5	109.8	-3.3	110.1	108.4	-1.6
Petroleum Products	210.0	175.9	-16.2	134.8	115.3	-14.5	155.8	152.6	-2.1
Rubber Products	159.0	154.4	-2.9	117.0	112.6	-3.8	135.9	137.1	0.9
<b>Mineral Exports</b>	<b>135.7</b>	<b>252.9</b>	<b>86.4</b>	<b>110.0</b>	<b>106.7</b>	<b>-3.0</b>	<b>123.3</b>	<b>237.0</b>	<b>92.2</b>
<b>Total Exports</b>	<b>122.5</b>	<b>113.4</b>	<b>-7.4</b>	<b>110.2</b>	<b>109.7</b>	<b>-0.4</b>	<b>111.2</b>	<b>103.3</b>	<b>-7.1</b>
<b>IMPORTS</b>									
<b>Consumer Goods</b>	<b>147.7</b>	<b>121.0</b>	<b>-18.0</b>	<b>125.6</b>	<b>111.9</b>	<b>-11.0</b>	<b>117.6</b>	<b>108.2</b>	<b>-7.9</b>
Food and Beverages	118.4	98.6	-16.8	108.5	100.1	-7.7	109.1	98.5	-9.8
Other Consumer Goods	181.2	146.8	-19.0	145.2	125.3	-13.7	124.8	117.2	-6.1
<b>Intermediate Goods</b>	<b>152.5</b>	<b>143.8</b>	<b>-5.7</b>	<b>123.3</b>	<b>118.2</b>	<b>-4.1</b>	<b>123.7</b>	<b>121.6</b>	<b>-1.7</b>
Fertilizer	169.5	129.5	-23.6	122.9	97.0	-21.1	137.9	133.5	-3.2
Fuel	157.7	165.6	5.0	121.1	120.5	-0.5	130.2	137.4	5.6
Chemicals	135.0	128.8	-4.6	115.8	116.9	1.0	116.6	110.2	-5.5
Wheat and Maize	161.8	137.1	-15.3	117.9	102.0	-13.5	137.2	134.4	-2.1
Textiles	128.3	125.3	-2.3	111.7	114.3	2.3	114.8	109.6	-4.5
Plastics	123.7	114.7	-7.3	110.8	116.9	5.5	111.7	98.1	-12.1
Diamonds and Precious Metals	284.9	155.7	-45.4	200.4	134.4	-32.9	142.2	115.8	-18.5
<b>Investment Goods</b>	<b>155.6</b>	<b>166.6</b>	<b>7.1</b>	<b>128.3</b>	<b>156.1</b>	<b>21.7</b>	<b>121.2</b>	<b>106.7</b>	<b>-12.0</b>
Building Materials	131.0	150.6	15.0	121.2	137.6	13.5	108.0	109.5	1.3
Transport Equipment	179.7	167.4	-6.8	144.4	147.6	2.2	124.4	113.4	-8.8
Machinery and Equipment	160.1	176.2	10.0	125.6	171.4	36.5	127.5	102.8	-19.4
Other Investment Goods	120.6	135.4	12.3	118.9	131.0	10.2	101.4	103.3	1.8
<b>Total Imports</b>	<b>151.2</b>	<b>143.1</b>	<b>-5.4</b>	<b>123.6</b>	<b>124.2</b>	<b>0.5</b>	<b>122.3</b>	<b>115.2</b>	<b>-5.8</b>
<b>Terms of Trade</b>							<b>90.9</b>	<b>89.7</b>	<b>-1.3</b>

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

Sources: Sri Lanka Customs  
Central Bank of Sri Lanka

along with the export prices of several agricultural products including tea, rubber, coconuts as well as vegetables, declining. The average export price index of tea declined marginally by 0.5 per cent, while price indices of rubber and coconut declined significantly by 27.6 per cent and 17 per cent, respectively. The export price index pertaining to industrial products also declined in 2012, by 9.1 per cent, mainly due to the export price index of textiles and garments declining by 1.6 per cent. Export price indices of several other items exported such as transport equipment, and machinery and mechanical appliances, classified under industrial exports, also declined in 2012. However, the export price indices of gems, diamonds and jewellery and food, beverages and tobacco increased during the year.

**The import price index declined by 5.8 per cent in 2012, reflecting the decline in the prices of all major import categories.** The import price index pertaining to imports of consumer goods fell by 7.9 per cent in 2012, with the import price indices of food as well as other sub-categories of consumer goods declining. Although petroleum prices increased in 2012, the import price index pertaining to intermediate goods declined by 1.7 per cent as prices of many intermediate goods imported including textiles, fertiliser, wheat and maize declined during the year. Despite the average import price index pertaining to imports of building materials increasing in 2012, the import price index

pertaining to imports of investment goods declined by 12 per cent as the import prices of machinery and equipment as well as transport equipment fell during the year.

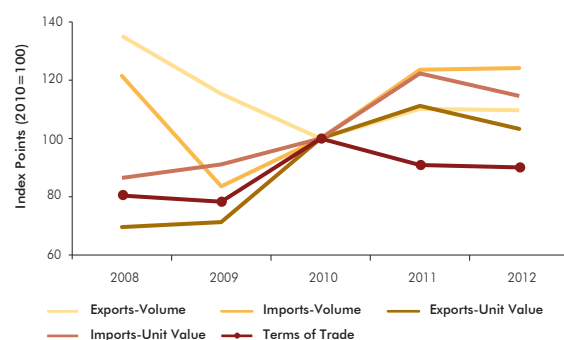
## Direction of Trade

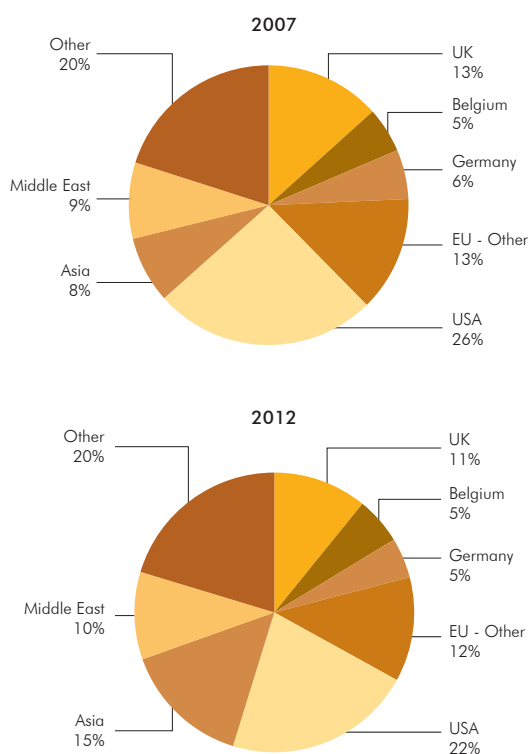
**India continued to be Sri Lanka's largest trading partner in 2012, followed by China and the USA.** Singapore, the UAE and the UK were other countries that had trade amounting to more than US dollars 1 billion with Sri Lanka in 2012. USA remained the largest export destination, followed by the UK and India. India remained the largest import origin in 2012 followed by China and Singapore.

**USA being the largest export destination, accounted for about 22 per cent of total exports and about 40 per cent of garments exported in 2012.** UK, as the second largest export destination, accounted for over 10 per cent of Sri Lanka's exports, with more than 20 per cent of garments manufactured in Sri Lanka being exported to the UK. Meanwhile, exports to Belgium, Luxembourg, Italy and Germany accounted for about 15 per cent of Sri Lanka's total exports. The most significant amongst exports to Belgium and Luxembourg were gems, diamonds and jewellery. Exports to Italy and Germany comprised mainly of garments. The India-Sri Lanka Free Trade Agreement has resulted in diversification of products exported to India, encouraging the export of industrial products to India. It has become the third largest export destination by 2012, accounting for 5.8 per cent of Sri Lanka's exports in 2012. Transport equipment, animal fodder, machinery and mechanical equipment and spices were the major items exported to India.

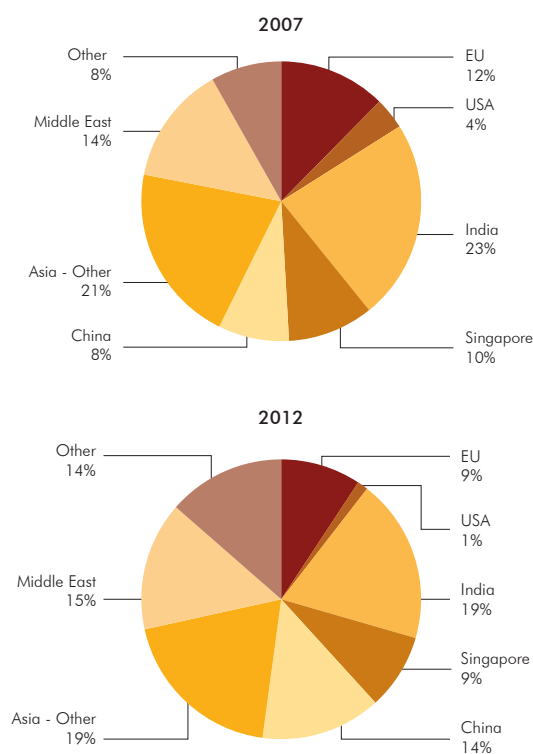
**The largest source of imports in 2012 was India, with a share of 19 per cent in total imports.** When petroleum product imports are excluded, India's share in imports in 2012 was

**Chart 5.6** Terms of Trade and Trade Indices



**Chart 5.7 Exports by Destinations**

15.6 per cent. While petroleum remains the most significant item amongst the items imported from India, other items of significance amongst imports from India were transport equipment, textiles and textile articles and building materials. Price competitiveness had enabled India to secure a significant market for these items, of which, most do not have duty free access under ISFTA. Despite an overall decline in imports in 2012, imports from China, the second largest import origin by 2012 with a share of around 14 per cent in total imports, increased on a year-on-year basis. Imports of machinery and equipment, textiles and textile articles as well as building materials led the increase in expenditure on imports from China in 2012. While Singapore, the third largest import origin in 2012, had a share of around 9 per cent in total imports, petroleum products were the most significant amongst imports from Singapore followed by machinery and equipment.

**Chart 5.8 Imports by Origin**

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

### Trade in Services

Trade in services recorded a healthy surplus during 2012 despite the slow recovery of the global economy. The surplus in the services account increased by 13.8 per cent to US dollars 1,250 million in 2012 from US dollars 1,099 million in 2011. The improvement in the services account was mainly driven by enhanced performance in the transportation, and computer and information services sub sectors, while travel, telecommunications, construction and insurance sub-sectors also recorded higher receipts for 2012.

### Transportation Services

Transportation services, the largest category within the services sector, primarily led the improvement in the services account. The transportation sector, which consists of passenger

fares, freight, port and airport related earnings increased substantially by 17.4 per cent to US dollars 1,634 million during the year 2012. This growth was attributed to the increase in the number of passengers travelling to Sri Lanka, the increase in passenger fares and the improvement in port and airport related activities. Meanwhile, outflows on account of transportation also increased at a rate of 23 per cent, with an increased number of Sri Lankans travelling abroad. The higher passenger and freight charges that prevailed in the international markets during a major part of the year also contributed to the increase in outflows in the transportation sector.

**The increase in the number of passengers travelling to Sri Lanka and the increase in airfares due to the fuel surcharges resulted in gross inflows on account of passenger fares increasing by 21.3 per cent in 2012.** The increase in the number of destinations, flying hours and flying frequency by SriLankan Airlines and the

increased operations of the national budget carrier Mihin Lanka created additional space for carrying more passengers. By end 2012, SriLankan Airlines expanded its fleet to a total of 22 aircraft and its global route network was expanded to 60 destinations in 33 countries, with Shanghai, Guangzhou, Kochi, Moscow and Zurich being added to the network of destinations.

**With the expansion of port and airport related activities, inflows on account of freight, port and airport related services showed satisfactory performance in 2012.** Gross inflows on account of these services increased by 14.5 per cent to US dollars 917 million during 2012. Transshipment cargo handling and ship arrivals also increased in 2012 when compared to 2011. The opening of the Mattala Rajapaksa International Airport for commercial operations in March 2013 and the expected completion of construction of the Magam Ruhunupura Mahinda Rajapaksa Port-Phase II, Bandaranaike International Airport-Phase II, and the Mattala Rajapaksa International Airport-Phase II by 2015 are expected to generate more foreign inflows, thereby strengthening the services account further.

**Table 5.6** Net Services, Income and Current Transfers (a)

Item	US\$ million		Rs. million	
	2011(b)	2012(c)	2011(b)	2012(c)
1. Transportation Services	439	462	48,521	58,776
2. Travel and Tourism(d)	329	328	36,518	41,755
3. Communication Services	29	41	3,173	5,206
4. Computer and Information Services	355	436	39,251	55,770
5. Construction Services	36	41	4,012	5,213
6. Insurance Services	35	43	3,895	5,448
7. Other Business Services	-108	-77	-11,854	-9,738
8. Government Expenditure n.i.e.	-17	-24	-1,882	-3,108
<b>Total Net Services</b>	<b>1,099</b>	<b>1,250</b>	<b>121,635</b>	<b>159,321</b>
1. Compensation of Employees	-11	-20	-1,224	-2,500
2. Direct Investment	-375	-430	-41,580	-55,098
3. Interest and Other Charges	-261	-699	-29,237	-90,820
<b>Total Net Income</b>	<b>-647</b>	<b>-1,148</b>	<b>-72,041</b>	<b>-148,419</b>
1. Private	4,583	5,339	506,630	681,714
2. General Government	60	53	6,587	6,899
<b>Total Net Current Transfers</b>	<b>4,643</b>	<b>5,392</b>	<b>513,216</b>	<b>688,613</b>

(a) This presentation conforms as far as possible to the Balance of Payments Manual, 5<sup>th</sup> Edition (1993) of the International Monetary Fund (IMF).

(b) Revised

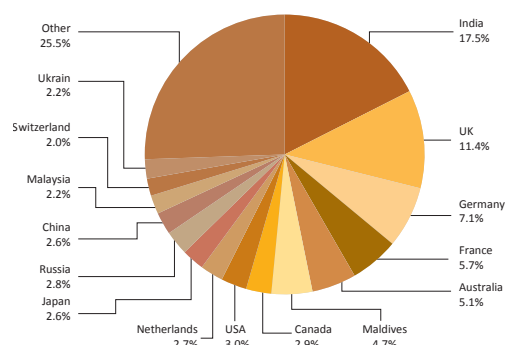
(c) Provisional

(d) Passenger services provided for non-residents are included in transportation services.

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

## Travel and Tourism

**Continuing the post-conflict growth momentum, Sri Lanka attracted more than one million tourists in 2012.** Tourist arrivals in 2012 surpassed its target of 950,000 to record 1,005,605 arrivals, an increase of 17.5 per cent, over 855,975 arrivals in 2011. The highest ever number of tourist arrivals for a month, which was 122,252, was recorded in December 2012. When considering tourist arrivals in terms of regions, Western Europe remained the foremost source of tourists accounting for 37.1 per cent of total arrivals in 2012 compared to 36.8 per cent in 2011. South Asia, the second major regional market, accounted for 24.6 per cent of arrivals. Arrivals from Eastern

**Chart 5.9** Tourist Arrivals in 2012 by Country

Europe, East Asia, and Australasia increased significantly due to promotional activities and new air routes that connected Sri Lanka to these markets. This has resulted in the gradual diversification of Sri Lanka's tourism markets. With regard to arrivals from individual countries, India remained the leading country of origin of tourists followed by the UK, Germany, France and Australia. These five countries together accounted for 46.8 per cent of tourists to Sri Lanka in 2012. Over 74 per cent of tourists arrived in Sri Lanka for holiday purposes, while 9 per cent arrived for business purposes in 2012 and others visited friends and relatives, conventions and meetings (MICE tourism) and for religious and cultural purposes.

**Earnings from tourism increased substantially in 2012.** Supported by the increase in tourist arrivals and the average spending per

tourist, earnings from tourism increased by 25.1 per cent to US dollars 1,039 million in 2012 compared to US dollars 830 million recorded in 2011. Average tourist spending per night increased to US dollars 103 in 2012 from US dollars 97 recorded in 2011, reflecting the increase in arrivals of high spending tourists as well as improved facilities. Employment generation by the tourism industry recorded a significant increase of 17.4 per cent, indicating increases in both direct and indirect employment. Meanwhile, outflows on account of travel also increased in 2012.

**The Sri Lanka Tourism Development Authority (SLTDA) continued to operationalise its role in National Tourism Strategy introduced in 2011 to develop the tourism sector.** The aim of attracting 2.5 million tourists and recording earnings of US dollars 2.75 billion from tourism by 2016 remained the main focus of the industry. Consequently, promotional activities were conducted in 25 trade and travel fares worldwide with travel industry participation in direct market promotions that were held in the UK, China, Germany, India and the Netherlands among others. The development of domestic infrastructure facilities, strategic investments by global hotel chains, promotional campaigns, new tourist attractions and identified zones in the Northern

**Table 5.7** Tourism Performance

Item	2008	2009	2010	2011	2012 (a)	Y-o-Y Change (%)	
						2011	2012(a)
Tourist Arrivals (No.)	438,475	447,890	654,476	855,975	1,005,605	30.8	17.5
Pleasure	321,079	358,188	516,538	663,343	748,436	28.4	12.8
Business	37,261	38,473	83,270	68,097	90,040	-18.2	32.2
Other	80,135	51,229	54,668	124,535	167,129	127.8	34.2
Tourist Guest Nights ('000)	4,166	4,076	6,548	8,559	10,056	30.7	17.5
Room Occupancy Rate (%)	43.9	48.4	70.2	77.1	71.2	9.8	-7.7
Gross Tourist Receipts (Rs. million)	37,094	40,133	65,018	91,926	132,427	41.4	44.1
Per Capita Tourist Receipts (Rs.)	84,598	89,605	99,344	107,393	131,688	8.1	22.6
Total Employment (No.)	123,134	124,970	132,055	138,685	162,869	5.0	17.4
Direct	51,306	52,071	55,023	57,786	67,862	5.0	17.4
Indirect	71,828	72,899	77,032	80,899	95,007	5.0	17.4

(a) Provisional

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

**Chart 5.10** Tourist Arrivals and Earnings from Tourism



and Eastern provinces for tourism development activities, gave Sri Lanka a stronger stand in international promotions.

**Industry-wide investments were made to enhance the capacity to accommodate the growing number of tourists in the country.** Tourism Development Zones in Kalpitiya, Kuchchaveli and Yala are being promoted for investment with a view to developing tourism on different themes. A hotel coming under the Kuchchaveli tourism development project was completed with an investment of Rs. 850 million adding 48 rooms in 2012. The ongoing Kalpitiya integrated tourism development project and the resort development project Passikudah with an investment of over Rs. 10 billion to develop 11 new facilities to cover 764 rooms are expected to be completed in 2013. Several new and refurbished star class hotels commenced operations in 2012 while new hotels are under construction in different parts of the country. Shangri-La Asia Limited, one of Asia Pacific's leading luxury hotel chains, has already commenced construction of a 650 room luxury hotel complex in Colombo with high end retail facilities and deluxe apartments, and is scheduled to commence operations in 2015. The Shangri-La group started developing a second property, a 50-villa and 400-room beach resort on the southern coast in Hambantota, and

this too is scheduled to commence operations in 2015. International hotel chains such as Hyatt, Movenpick, and Sheraton are also expected to be commencing their operations in Sri Lanka in the near term. Meanwhile, the SLTDA together with the Urban Development Authority (UDA) continued its tourism zone identification process in the districts of Mulativu, Mannar and Jaffna in the Northern Province. The 'home stay' programme of the SLTDA further enhanced the tourism industry's capacity and became popular among tourists and the travel trade. The SLTDA refurbished and upgraded 25 resorts coming within its purview in addition to the new registration of 150 home stay units in 2012.

### Communication, and Computer and Information Services

**The communication services sector continued to expand during 2012.** Gross inflows from communication services increased by 27.8 per cent to US dollars 109 million in 2012. However, with increased utilisation of email, broadband internet, satellite TV and international direct dialing (IDD), outflows on account of telecommunication services also increased although at a slow pace. The telecommunication industry is undergoing a rapid transition to meet the increasing demand in the growing digital and mobile related markets.

**Earnings from information technology enabled services (ITES) such as business process outsourcing (BPO) and knowledge process outsourcing (KPO) increased further in 2012.** Gross inflows into the computer and information services sub sector increased by 22.9 per cent to US dollars 436 million during 2012. Inflows on account of KPO, which is classified under 'other business services' also increased in 2012, and exports of BPO and KPO services are estimated to have exceeded US dollars 600 million in 2012. Positive socio-economic developments



in the country, relatively better IT infrastructure facilities, the availability of a skilled workforce, price competitiveness, and reliable and efficient services delivery helped sustain the growth in the industry. During 2012, Sri Lankan IT companies which provide software solutions to overseas clients, especially to the Middle East and the African region performed well with earnings growing by 12 per cent. Sri Lanka possesses a comparative advantage in BPO and KPO industries due to the availability of qualified professionals in fields such as finance and accountancy, engineering, law and architecture. The *AT Kearney Global Services Location Index (GSLI) - 2011* ranked Sri Lanka 21<sup>st</sup> in its index which identifies the leading outsourcing destinations globally, while Sri Lanka is featured among the top 30 in the *Gartner Ranking*. Meanwhile, the *Tholons Top 100 Outsourcing Destination Report -2013* ranked Colombo among the top 20 leading outsourcing destinations internationally. The *Lanka BPO Academy*, a recognised BPO training provider, plans to train more than 2,000 students and BPO professionals annually, thereby ensuring the availability of skilled labour required for the industry.

### Inflows and Outflows of Income

**The higher interest payments on outstanding government loans resulted in the deficit in the income account widening in 2012.** The deficit in the income account increased to US dollars 1,148 million in 2012 from the deficit of US dollars 647 million in 2011. Interest earned from the investment of reserves and profits earned from trading of foreign currency and foreign securities contributed to the receipts in the income account in 2012, although this was lower compared to 2011 due to lower global interest rates. Appreciation of major reserve holding currencies such as the euro and the pound sterling against the US dollar resulted in higher valuation and exchange gains from mark-to-market valuation of trading securities in US dollar

terms. Meanwhile, outflows in the income account increased by 31.9 per cent to US dollars 1,469 million mainly due to the increased interest payments on foreign loans obtained by the government. Given the increase in net foreign liabilities of commercial banks, the net interest payments on foreign financial liabilities of commercial banks also increased. Further, repatriation of profits and dividends by FDI enterprises increased during the year in tandem with higher earnings from their investments. However, a considerable portion of the repatriated profits and dividends has been reinvested in those enterprises facilitating the expansion of the existing operations.

### Current Transfers

**Workers' remittances which constitute a major portion of current transfers, continued to be the foremost foreign exchange earner in Sri Lanka.** Net current transfers increased to US dollars 5,392 million in 2012 from US dollars 4,643 million in 2011. Inward workers' remittances in 2012 increased by 16.3 per cent to US dollars 5,985 million compared to US dollars 5,145 million recorded in 2011. The number of migrant workers leaving for foreign employment increased by 6.3 per cent to 279,482 in 2012, with a notable increase in departures in the professional and domestic aid categories. The increase in professional labour migration for foreign employment, further expansion of formal channels for remitting money including the increased number of exchange house networks set up by local commercial banks in major labour receiving countries, diversification of destinations and expansion of banking facilities in Sri Lanka, particularly in Northern and Eastern provinces, contributed in attracting higher remittances in 2012. Fiscal incentives provided by the government in the Budget for 2013 such as granting of housing loans to workers returning from employment abroad, setting up of two new technical colleges at a cost of Rs. 300 million to enhance skills of migrant aspirants and

implementing a low interest loan scheme for those wishing to start small businesses are expected to enhance remittances from foreign employees in the future. Meanwhile, workers' remittances are estimated to have accounted for about 64 per cent of the trade deficit in 2012, which helped narrow the current account deficit, substantially.

## Current Account Balance

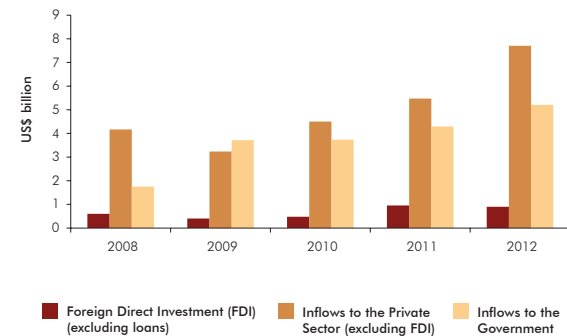
The current account deficit narrowed to US dollars 3,915 million in 2012 from US dollars 4,615 million recorded in 2011. During the first quarter of 2012, the current account deficit amounted to US dollars 1,316 million due to the widening trade deficit driven by the sharp growth in imports of intermediate and investment goods and a slowdown in exports due to weakening global demand. However, as a result of the prudent policy measures implemented at the beginning of the year, the trade deficit improved gradually. This, supported by the higher earnings from service exports and steady growth in receipts of workers' remittances led to a narrowing of the current account deficit in 2012. As a percentage of GDP, the current account deficit contracted to 6.6 per cent in 2012 from 7.8 per cent in 2011, reflecting a corresponding improvement in the savings-investment gap.

## 5.5 Capital and Financial Flows and the Balance of Payments

### Foreign Direct Investment

FDI continued to be a major inflow to the financial account of the BOP despite sluggish global economic performance. FDI, including loans received by the Board of Investment (BOI) approved companies, recorded the highest ever inflow for a year in 2012, amounting to US dollars 1,338 million, compared to US dollars 1,066 million in 2011. Continued investor confidence in the long-term investment potential in key emerging sectors and underlying macroeconomic stability in the

Chart 5.11 Inflows to the Capital and Financial Account



country helped Sri Lanka achieve this record level of FDI in 2012. Investor confidence was further enhanced by the continuous improvement made by Sri Lanka in its business environment as reflected in the *Global Competitiveness Index* rankings and World Bank Group's *Ease of Doing Business Index*. The FDI inflows consisted of equity capital of US dollars 71 million, loans and advances by shareholders of US dollars 364 million, intra-company borrowings of US dollars 217 million, reinvestment of retained earnings of US dollars 246 million and foreign loans of US dollars 440 million. Also, FDI in 2012 included an investment of US dollars 59 million in Aviva NDB Holdings Lanka (Pvt) Limited which is a non-BOI company. The number of contracted projects for 2012 as well as projects in the pipeline for 2013 increased considerably compared to that of previous years. Accordingly, FDI inflows are expected to improve over the medium-term from the current level of 2.3 per cent of GDP to over 4 per cent of GDP by 2016.

The sector-wise composition of FDI inflows continued to reflect increased investments in large scale development projects and emerging sectors. Infrastructure sector received the highest share of FDI (44.6 per cent) with major investments in ports and container terminals, telephone and telecommunication networks, power generation and housing and property development, while the services sector attracted 31.9 per cent of FDI in 2012, including a share of 8.8 per cent for the

tourism sector. Meanwhile, the manufacturing sector attracted 23 per cent of FDI in 2012. With the continuous expansion of the tourism industry and increased emphasis on foreign investment in education, communication and information technology sectors, more direct investment is expected in 2013 and beyond. Meanwhile, FDI outflows increased to US dollars 85 million in 2012 from US dollars 60 million in 2011.

## Medium and Long-term Capital Flows to the Government

**Loan inflows to the government moderated in 2012.** Medium and long-term loan inflows to the government amounted to US dollars 2,869 million compared to US dollars 3,026 million in 2011 (including the proceeds of the sovereign bond issue of US dollars 1 billion each in 2012 and 2011). Most of these inflows were directed to the continuation of major infrastructure projects which commenced in 2010 and 2011. Out of the total loan inflows of US dollars 2,869 million in 2012, US dollars 1,460 million were obtained on concessional terms and conditions, while the remainder consisted of non-concessional loans, commercial loans and export credits. Meanwhile, the foreign funds utilisation rate<sup>1</sup> decreased in 2012 to 22.3 per cent from 38.2 per cent in 2011, due to the increase in committed undisbursed borrowings as of end June 2012 as well as the marginal decrease in disbursements of foreign borrowings during 2012 compared to 2011.

## Investment in Government Securities

**Net foreign inflows on account of investment in Treasury bills and Treasury bonds increased substantially in 2012.** Net foreign investment in government securities in 2012 was US dollars 843 million compared to the net inflow of US dollars 233 million in 2011, reflecting continued interest on

<sup>1</sup> The foreign funds utilisation rate was computed as the ratio of disbursements during 2012 to the committed undisbursed balance as at end June 2012.

**Table 5.8** Major Projects Financed with Foreign Borrowings during 2012

Lender and Project	Amount Disbursed US\$ million
<b>The Export-Import Bank of China</b>	<b>615</b>
of which; Magam Ruhunupura Mahinda Rajapaksa Port Development Project-Phase I and II	193
Puttalam Coal Power Project-Phase II	129
Northern Road Rehabilitation Project	55
Mattala Rajapaksa International Airport Project	51
Supply of 13 Nos. Diesel Multiple Units to Sri Lanka Railway Project	28
<b>Government of Japan</b>	<b>367</b>
of which; Greater Colombo Transport Development Project-Phase II	71
Upper Kotmale Hydro Power Project	67
Southern Highway Construction Project-Phase II	50
Greater Colombo Transport Development Project-Phase I	42
Water Sector Development Project	23
<b>Asian Development Bank</b>	<b>292</b>
of which; Colombo Port Expansion Project	52
Northern Road Connectivity Project	38
Conflict-Affected Region Emergency Project	36
Clean Energy and Access Improvement Project	34
National Highways Sector Project	26
<b>Government of India</b>	<b>261</b>
of which; Railway Line Omanthai-Pallai, Madhu-Tallaimannar & Medawachchiya	93
Restoration of Northern Railway Services	66
Greater Dambulla Water Supply Project-Phase I	33
Upgrading of Railway Line Colombo Matara-Phase II	33
<b>China Development Bank Corporation</b>	<b>229</b>
of which; Improvement and Rehabilitation of Priority Roads Moragahakanda Development Project	165
	64
<b>International Development Association</b>	<b>166</b>
of which; 2 <sup>nd</sup> & 3 <sup>rd</sup> Additional Financing for Community Livelihood in Conflict Affected Areas	27
Additional Financing for Road Sector Assistance Project	24
Emergency Northern Recovery Project	20
<b>Export Development Bank of Iran</b>	<b>49</b>
of which; Uma Oya Hydro Electric and Irrigation Project	27
Implementation of Rural Electrification Project VIII	22
<b>Government of the Republic of Korea</b>	<b>43</b>
of which; Improvement of Padeniya-Anuradhapura Road Project	23
<b>European Investment Bank</b>	<b>33</b>
of which; DFCC Global Loan II	33

Source: External Resources Department

the part of foreign investors to invest in Sri Lanka's government securities. Out of total net inflows to government securities, US dollars 38 million was received on account of Treasury bills, while US dollars 805 million was received on account of Treasury bonds, reflecting the increased investor appetite for longer term investments. During the year, the threshold level of 12.5 per cent imposed on foreign holdings of the outstanding value of government securities was maintained.

## Long-term Capital Flows to the Private Sector and State-Owned Enterprises

**Long-term loans to the private sector and state-owned enterprises (SOEs) increased substantially in 2012.** The private sector and SOEs received long-term inflows amounting to US dollars 891 million in 2012, compared to US dollars 310 million in 2011. This amount consisted of US dollars 374 million received by SOEs and US dollars 517 million received by the private sector. Inflows to the SOEs in 2012 included US dollars 129 million to Lanka Coal Company Limited for the Puttalam Coal Power project, US dollars 51 million to Airport and Aviation Services (Sri Lanka) Limited for the Mattala Rajapaksa International Airport project, US dollars 193 million to the Sri Lanka Ports Authority for Phase I and II of the Magam Ruhunupura Mahinda Rajapaksa Port. Of the foreign loan inflows to the private sector, BOI companies received US dollars 440 million compared to US dollars 110 million in 2011 while non-BOI companies received US dollars 77 million in 2012, compared to US dollars 78 million in 2011. Meanwhile, of the total loan disbursements to the private sector and SOEs, loans extended on government guarantees accounted for 61 per cent. Foreign borrowings by the private sector were mainly for investments in aviation, manufacturing, telecommunications and financial services sectors. With the gradual relaxation of exchange control regulations effected by the Central Bank, 28 private sector companies were granted approvals in 2012 for raising foreign funding.

## Short-term Capital to the Private Sector and Public Corporations

**Private short-term capital consisting of portfolio investments and short-term trade credits showed a satisfactory performance in 2012.** Reflecting improved investor confidence in the equity market in Sri Lanka, net foreign inflows to the companies listed in the Colombo Stock Exchange (CSE) increased substantially

to US dollars 305 million in 2012 compared to the net outflow of US dollars 171 million in 2011. Corporations in the financial services sector and conglomerates listed on the CSE received major inflows during the year. Meanwhile, private short-term trade credits recorded net outflows of US dollars 663 million in 2012, compared to net outflows of US dollars 243 million in 2011, mainly due to the increased settlement of trade credits by the Ceylon Petroleum Corporation during the year.

## Commercial Banks

**With the relaxation of some exchange control regulations, foreign borrowings of commercial banks increased notably during the year.** Foreign liabilities of commercial banks increased by US dollars 1,435 million to US dollars 4,801 million by end 2012. Of the total liabilities mobilised by commercial banks, long-term financing, including the US dollars 500 million bond issuance by the Bank of Ceylon, amounted to US dollars 973 million. Meanwhile, foreign assets of commercial banks increased by US dollars 239 million to US dollars 1,480 million by end 2012. Accordingly, net foreign liabilities of commercial banks increased to US dollars 3,321 million by end 2012, compared to US dollars 2,125 million by end 2011, recording a net inflow of US dollars 1,196 million in 2012.

## Balance of Payments

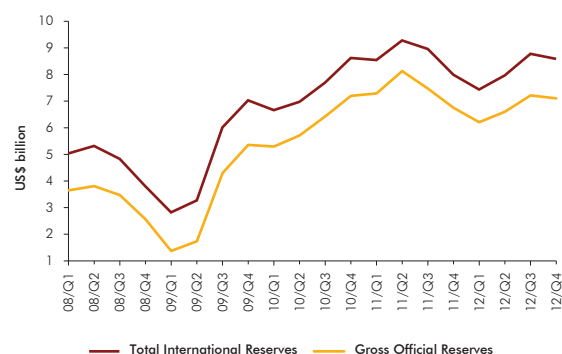
**The BOP recorded a surplus of US dollars 151 million in 2012, in view of the policy measures implemented during the year to strengthen the external sector.** The positive outlook brought about by these policy measures was witnessed since the second quarter of 2012, marked by a substantial deceleration in the trade deficit owing to the reduction in import expenditure. This, together with the increased receipts on account of trade in services and current transfers, led the current account deficit to contract substantially. The

improvement in the current account coupled with the balances in the capital and financial accounts helped the BOP to record a surplus of US dollars 151 million by end 2012, compared to the deficit of US dollars 1,061 million in 2011.

## International Reserves

Gross official reserves and total external assets of the country continued to increase in 2012. Implementation of the policy package in early 2012, relaxing of exchange control regulations, encouraging banks and corporates to raise funds abroad and maintaining the elevated threshold on foreign investment in government securities helped attract foreign inflows to the country. With the intention of building up international reserves, the Central Bank absorbed the surplus foreign exchange received on account of tourism, workers' remittances, proceeds of the fifth international sovereign bond, disbursements under foreign funded projects and the two tranches under the IMF-SBA facility. Accordingly, gross official reserves (excluding Asian Clearing Union (ACU) balances) increased to US dollars 6.9 billion by end of 2012, from US dollars 6 billion recorded in 2011. In addition to the increase in gross official reserves, the improvement in gross external assets of

**Chart 5.12** Quarterly International Reserves (Including ACU balances)



commercial banks resulted in the total international reserves of the country (excluding ACU balances) increasing to US dollars 8.4 billion at the end of 2012, from US dollars 7.2 billion in 2011.

Indicators of reserve adequacy show that the increased level of official reserves has reduced the country's vulnerability to external shocks. The import coverage of gross official reserves (excluding ACU balances) was 4.3 months in 2012, compared to the internationally accepted norm of 3 months of imports. Reserve adequacy, as measured by the ratio of gross official reserves to short-term external debt (with remaining maturity of one year or less) improved to 63 per cent by end 2012 from 60.6 per cent recorded at

**Table 5.9**

**International Reserves of Sri Lanka(a)**

Ownership	US\$ million(b)					Rs. million				
	2008	2009	2010	2011	2012(c)	2008	2009	2010	2011	2012(c)
1. Government	101	113	88	615	631	11,411	12,920	9,747	70,088	80,209
2. Central Bank	2,301	5,244	7,109	6,133	6,474	260,297	599,880	788,722	698,528	823,256
3. Total Official Reserves (1+2)	2,402	5,357	7,196	6,748	7,105	271,708	612,799	798,469	768,616	903,465
4. Commercial Banks	1,238	1,673	1,424	1,241	1,480	140,075	191,373	158,031	141,394	188,195
5. Total International Reserves (3+4)	3,640	7,030	8,621	7,989	8,585	411,783	804,173	956,500	910,010	1,091,660
6. Gross Official Reserves in Months of										
6.1 Import of Goods	2.0	6.3	6.4	4.0	4.4					
6.2 Import of Goods and Services	1.8	5.5	5.7	3.6	3.9					
7. Total Reserves in Months of										
7.1 Import of Goods	3.1	8.3	7.7	4.7	5.4					
7.2 Import of Goods and Services	2.8	7.2	6.8	4.3	4.7					

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

(b) Converted at the year end Rs./US\$ exchange rates, except for certain items in the international reserves of the Central Bank of Sri Lanka which were converted at the representative rate agreed with the International Monetary Fund.

(c) Provisional

Source: Central Bank of Sri Lanka

end 2011. Despite the significant improvement in reserves, the relatively high increase in short-term debt, particularly the increase in investment in Treasury bills and Treasury bonds, resulted in the reserve adequacy ratio improving only marginally. According to international classification, short-term external debt used in assessing reserve adequacy should include Treasury bonds, even though their tenor is over 1 year. In this context, as of end 2012, 80 per cent of the total foreign holding of the Treasury securities portfolio consisted of Treasury bonds with tenors ranging from 1 to 20 years. At the same time, since the opening up of the Treasury bonds market in November 2006 up to end 2012, the total foreign investment in Treasury bonds amounted to US dollars 4,255 million, of which, only 15.3 per cent (US dollars 652 million) has been prematurely withdrawn, within a period of 1 year. This ratio was relatively high mainly due to the rapid liquidation of Treasury bonds during the intense global financial crisis in the latter part of 2008, resulting in a premature repatriation of Treasury bonds worth US dollars 307 million. Accordingly, if the impact of the global financial crisis of 2007 and 2008 is excluded, the respective ratio for the four year period from 2009 to 2012 will improve to 8.3 per cent from 15.3 per cent, reflecting the fact that the majority of Treasury bond investors prefer to hold their investments until maturity. Therefore, if the Treasury bonds with tenors from 1 year up to 20 years are excluded from short term debt, the reserve adequacy ratio will improve to 81.7 per cent in 2012, from 73.7 per cent recorded in 2011.

**The SBA facility that Sri Lanka obtained from the IMF in July 2009 was successfully completed in July 2012.** Sri Lanka achieved the key objectives of the SBA programme by rebuilding international reserves to cover more than 3.5 months of imports, containing the budget deficit, maintaining inflation at single digit levels and ensuring stability of the financial system. Accordingly, Sri Lanka received the entire amount of SDR 1.7 billion (approximately

**Table 5.10** Disbursement Details of the IMF-SBA Facility-2009

Date of Disbursement	Tranche No.	Amount	
		SDR million	USD million
24 July 2009	First	206.7	320.6
6 November 2009	Second and Third	206.7	330.8
28 June 2010	Fourth	275.6	407.8
24 September 2010	Fifth	137.8	212.5
3 February 2011	Sixth	137.8	216.6
4 April 2011	Seventh	137.8	218.5
2 April 2012	Eighth	275.6	425.9
20 July 2012	Ninth	275.6	414.3
<b>Total</b>		<b>1,653.6</b>	<b>2,546.9</b>

Sources: International Monetary Fund  
Central Bank of Sri Lanka

US dollars 2.6 billion), approved under the SBA in 2009. The completion of the SBA marked the longest engagement Sri Lanka had with the IMF and the single largest facility Sri Lanka ever obtained from a multilateral institution. The repayment of the SBA commenced in October 2012, and is expected to be completed by April 2017.

## 5.6 Sovereign Ratings, External Debt and Debt Servicing

### Sovereign Ratings

**The sovereign credit ratings of the country were maintained at improved levels in 2012, whereas the ratings of many countries were downgraded during this period.** Fitch Ratings affirmed Sri Lanka's foreign and local currency Issuer Default Ratings (IDRs) at 'BB-'. The outlook for both ratings remained 'Stable'. Moody's Investor Services outlook of Sri Lanka's foreign currency sovereign rating remained at 'B1' with a 'Positive' outlook. Although, Standard & Poor's (S&P) revised

**Table 5.11** Sri Lanka's Sovereign Credit Rating and Country Outlook

	Standard & Poor's		Fitch		Moody's	
	Rating	Outlook	Rating	Outlook	Rating	Outlook
2009	B	Negative	B+	Negative	-	-
2010	B+	Stable	B+	Positive	B1	Stable
2011	B+	Positive	BB-	Stable	B1	Positive
2012	B+	Stable	BB-	Stable	B1	Positive

Sources: Standard & Poor's, Fitch and Moody's rating agencies

## BOX 9

## A New Approach for Assessing the International Reserve Adequacy

**Conventional Measures for Assessing International Reserve Adequacy and their Drawbacks**

In the aftermath of the Asian financial crisis in the late 1990s and the recent global financial crisis, many countries have recognised the importance of maintaining an adequate level of reserves to withstand unexpected external turbulences and also to reinforce performance of the external sector through exchange rate stability. Although substantial reserve accumulation entails several benefits as well as direct and indirect costs, holding excess reserves for long periods of time has become an important policy consideration associated particularly with the high opportunity costs and welfare losses.

Even though there is no single commonly accepted standard benchmark for estimating adequacy of reserves, countries broadly adopt three major conventional measures, namely, reserves to imports, reserves to short-term external debt (STD) and reserves to monetary aggregates (for example  $M_2$ ), with international benchmarks under these three measures being 3 months of imports, 100% coverage of STD and 20% of  $M_2$ , respectively. Among these, 100% coverage of STD is considered the most decisive indicator as it describes the external vulnerability of countries with greater market-access for foreign financing. However, these standards are informal rules of thumb based on general economic intuition rather than rigorously derived theoretical models, and therefore, such measures focus only on specific aspects of external vulnerability. Yet, these conventional measures are often used individually or in combination, due to their simplicity and transparency.

During the recent crisis, many countries have observed that there had been no vibrant relationship between the adequate levels of reserves as indicated by the standard conventional measures to guard themselves against external shocks. This has led countries to move away from closely following such conventional benchmarks in their reserve holding decisions and as a solution, the International Monetary Fund (IMF) has recently recommended a more broad-based risk-weighted metric approach to assess reserve adequacy of countries, taking into account the drains of foreign exchange during crisis episodes emanating from external shocks.

**New Risk-Weighted Reserve Adequacy Metrics Proposed by the IMF**

The IMF (2011) has proposed a two-stage 'risk-weighted' methodology to assess reserve adequacy of Emerging Market Economies (EMEs), which could also

be applied to Sri Lanka. The scope of this new metrics has entirely been focused on the precautionary aspect of holding reserves, reflecting the availability and liquidity of reserves for potential balance of payments needs.

In the first stage, the metrics is developed based on risk-weights estimated primarily on the drains of foreign exchange observed during periods of Exchange Market Pressure (EMP)<sup>1</sup>. This exercise has been done separately for both fixed and floating exchange rate regimes. The IMF has identified four specific sources of such drains: falling 'export earnings' (X), sudden termination of rolling-over opportunities of 'short-term debt' (STD), outflows from 'other portfolio liabilities' (OPL) and capital flight from the country as measured by 'broad money' ( $M_2$ ). Accordingly, the required levels of reserves under the risk-weighted metrics (R-Requirement) for the respective exchange rate regime are defined as follows:

$$R\text{-Requirement}_{(Fixed)} = 10\% \text{ of } X + 30\% \text{ of } STD + 15\% \text{ of } OPL + 10\% \text{ of } M_2 \quad (1)$$

$$R\text{-Requirement}_{(Floating)} = 5\% \text{ of } X + 30\% \text{ of } STD + 10\% \text{ of } OPL + 5\% \text{ of } M_2 \quad (2)$$

The second stage of the IMF's approach is to determine the reserve coverage (R-Adequacy ratio), which is the ratio of the actual level of gross official reserves (GOR) a particular country should hold relative to the risk-weighted metrics. The R-Adequacy ratios for the respective exchange rate regimes are given by the following two equations:

$$R\text{-Adequacy Ratio}_{(Fixed)} = \{GOR / R\text{-Requirement}_{(Fixed)}\} * 100 \quad (3)$$

$$R\text{-Adequacy Ratio}_{(Floating)} = \{GOR / R\text{-Requirement}_{(Floating)}\} * 100 \quad (4)$$

In order to estimate the benchmark for R-Adequacy ratio under the new metrics, the IMF has focused on episodes of past crises and used three approaches based on crisis prevention, crisis mitigation and observed reserve losses to derive the adequate levels of reserves to be held by a country. Accordingly, the IMF suggests a coverage in the region of 100%–150% of the metrics can be regarded as adequate for a typical EME.

**International Reserve Adequacy of Sri Lanka based on the New Risk-Weighted Metrics**

Applying the IMF's risk-weighted metrics to assess the reserve adequacy of Sri Lanka, (Samaratunga and Perera (forthcoming)) annual data for the period from 2003 to 2012 for X, STD, OPL and  $M_2$  were selected. The variable X captures earnings from exports of merchandise goods, while for  $M_2$ , broad money is considered. In estimating the STD, in addition to Treasury bills and bonds, trade credits, banking sector liabilities, all medium and long-term debt of the government and the private sector with

<sup>1</sup> See Weymark (1995) for details on EMP.

a remaining maturity of one year or less have also been considered. OPL mainly includes the foreign equity holdings at the Colombo Stock Exchange. Table B 9.1 presents the GOR, R-Requirement (estimated from Eq. (1) and (2)) and R-Adequacy Ratio (estimated from Eq. (3) and (4)) for Sri Lanka.

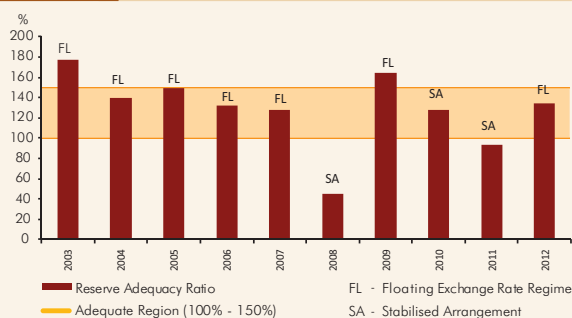
**Table B 9.1 Reserve Adequacy under Fixed & Floating Exchange Rate Regimes**

Year	Gross Official Reserves (GOR) (USD Mn)	Reserve Requirement (USD Mn)		Reserve Adequacy Ratio (%)	
		Fixed	Floating	Fixed	Floating
2003	2,147	1,789	1,212	120.0	177.1
2004	1,834	1,962	1,308	93.5	140.2
2005	2,458	2,407	1,641	102.1	149.7
2006	2,526	2,795	1,917	90.4	131.7
2007	3,063	3,371	2,398	90.8	127.7
2008	1,594	3,542	2,497	45.0	63.9
2009	5,097	4,221	3,097	120.7	164.5
2010	6,610	5,186	3,744	127.5	176.6
2011	5,958	6,397	4,714	93.1	126.4
2012	6,877	6,867	5,125	100.2	134.2

Sources: Central Bank of Sri Lanka  
Estimates by Samaratunga and Perera (forthcoming)

Although Sri Lanka follows a *de jure* floating exchange rate regime since 2001, the IMF's Annual Reports on Exchange Arrangements and Exchange Restrictions (2003-2012), which carry out an in depth analysis of the exchange rate regimes of its member countries, have classified Sri Lanka as having followed a stabilised exchange rate system in certain years. A country is said to be following a stabilised arrangement, if the exchange rate fluctuates within a narrow margin of  $\pm 1\%$  around a central rate for at least six months. From the analysis carried out for Sri Lanka, it was observed that in the year 2008, 2010 and 2011, the daily spot exchange rate of LKR/USD has fluctuated within a margin of  $\pm 1\%$ , and therefore it is reasonable to say that during these three years Sri Lanka's exchange rate system has been a rather stabilised arrangement. R-Adequacy ratios

**Figure B 9.1 Reserve Adequacy Ratios as per the New Risk-Weighted Metrics**



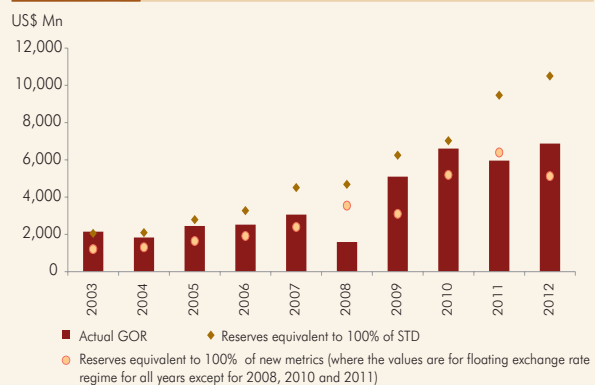
selected accordingly from Table B 9.1 (fixed exchange rate regimes for the years 2008, 2010 and 2011, while floating for remaining years) are illustrated in Figure B 9.1 (along with a label for identifying the exchange rate system for respective years).

Figure B 9.1 demonstrates Sri Lanka has had reserves in excess of the minimum adequacy level of 100% throughout the period, except in 2008 and 2011. The lower ratio in 2008 was owing to the decline in the country's reserves amidst the global financial crisis. In 2011, the drop was mainly due to the utilisation of reserves to ease the heavy foreign exchange demand in the domestic market, which emanated from the high volume of petroleum import bills due for settlement (CBSL Annual Report, 2011).

### Comparison of Conventional and Risk-Weighted Reserve Adequacy Measures for Sri Lanka

In order to assess Sri Lanka's international reserve adequacy relative to the conventional and new methods, actual reserves of the country are compared with the 100% of STD and reserve requirement equivalent to 100% of the new risk-weighted metric, as depicted in Figure B 9.2.

**Figure B 9.2 Actual Reserves against Conventional Measure and New Risk-Weighted Metrics**



Accordingly, even though actual reserves of the country were low throughout in comparison to the conventional measure of 100% of STD, in terms of the new IMF's risk-weighted metrics, actual reserves in Sri Lanka have been in excess of the 100% benchmark, except for the two exceptional years, 2008 and 2011. Hence, according to the new IMF metrics, Sri Lanka has broadly held adequate levels of foreign exchange reserves throughout the recent past.

#### References:

1. International Monetary Fund, 2011, "Assessing Reserve Adequacy", Washington DC.
2. Samaratunga, Dimuthu and Perera, Anil, (forthcoming) "Demand for and Adequacy of International Reserves in Sri Lanka", *Staff Studies*, Central Bank of Sri Lanka.
3. Weymark, Diana, 1995, "Estimating Exchange Market Pressure and the Degree of Exchange Market Intervention for Canada," *Journal of International Economics*, 39: 273-295



Sri Lanka's foreign currency sovereign rating outlook from 'Positive' to 'Stable', the country's long-term foreign currency rating was affirmed at 'B+'.

## External Debt

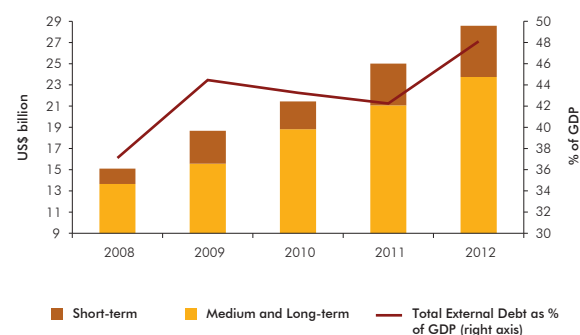
**Total external debt of the country consisting of medium and long-term debt, and short-term debt increased in 2012.** In US dollar terms, total external debt increased by 13.8 per cent to US dollars 28.4 billion, while as a percentage of GDP, total external debt was 47.9 per cent in 2012, compared to 42.2 per cent of GDP in 2011. The increase in total debt was primarily due to higher foreign inflows to the government in the form of medium and long-term loans and inflows to the Treasury securities market. Of the medium and long-term debt, government debt accounted for about 81 per cent. The government debt stock increased by 7 per cent in 2012, primarily due to larger disbursements to major development projects and the proceeds of the fifth international sovereign bond. Meanwhile, concessional debt as a percentage of total government external debt decreased to 60 per cent in 2012, from 66 per cent in 2011. With respect to the currency composition of the total government debt outstanding, the share of SDR and US dollar denominated debt accounted for 26 per cent and 41 per cent, respectively, while 22 per cent was denominated in Japanese yen.

**Sri Lanka successfully issued the fifth international sovereign bond of US dollars 1 billion in July 2012.** With a comparatively low yield of 5.875 per cent per annum and a maturity of 10 years, the bond issue attracted an order book of over ten and a half times, reflecting continued investor confidence in Sri Lanka's economy. Further, as the largest number of investors and the largest order book were recorded in relation to this bond issue, it can be viewed as a considerable achievement, given the volatility that persisted in global capital markets in the months leading up to the bond issue.

**Medium and long-term debt obtained by public corporations and the private sector, with government guarantee, increased significantly.** This was primarily due to high loan disbursements to SOEs, namely, Lanka Coal Company Limited (for the Puttalam Coal Power project), Airport and Aviation Services (Sri Lanka) Limited (for the Mattala Rajapaksa International Airport project), and Sri Lanka Ports Authority (for Phase I and II of the Magam Ruhunupura Mahinda Rajapaksa Port project). With the disbursement of the final two tranches of the IMF-SBA facility, outstanding IMF drawings also increased to US dollars 2.5 billion by end 2012 from US dollars 1.7 billion by end 2011. Further, short-term debt increased by 23 per cent compared to 2011, primarily due to the increase in the outstanding stock of Treasury securities in 2012. However, 80 per cent of the total foreign holding of the Treasury securities portfolio accounted for Treasury bonds, with a tenor ranging from 1 to 20 years.

**Total external debt and liabilities, which consist of total external debt and external liabilities of the banking sector increased to 56.7 per cent of GDP in 2012 from 49.7 per cent of GDP in 2011.** In 2012, commercial banks were encouraged to raise borrowings abroad and as a result, banking sector external liabilities increased to US dollars 5.2 billion by end 2012 from US dollars 4.4 billion in 2011. The outstanding liabilities of the banking sector included the bond issuance of US dollars 500 million by Bank of Ceylon in May 2012.

**Chart 5.13** External Debt



**Table 5.12** Outstanding External Debt and Banking Sector External Liabilities

Item	US\$ million					Rs. million				
	2008	2009	2010	2011(a)	2012(b)	2008	2009	2010	2011(a)	2012(b)
<b>1. Medium and Long-term Debt</b>	<b>13,646</b>	<b>15,564</b>	<b>18,823</b>	<b>21,065</b>	<b>23,604</b>	<b>1,543,952</b>	<b>1,780,313</b>	<b>2,088,449</b>	<b>2,535,643</b>	<b>3,138,860</b>
1.1 Government	12,593	13,769	16,076	17,808	19,054	1,424,729	1,574,933	1,783,728	2,092,132	2,484,877
1.2 Public Corporations and Private Sector with Government Guarantee	251	110	517	903	1,444	28,429	12,608	57,398	72,480	75,653
1.3 Public Corporations and Private Sector without Government Guarantee	634	967	919	636	595	71,715	110,570	101,913	175,338	259,324
1.4 IMF Drawings(c)	169	719	1,311	1,718	2,510	19,079	82,201	145,410	195,693	319,006
<b>2. Short-term Debt</b>	<b>1,460</b>	<b>3,098</b>	<b>2,615</b>	<b>3,937</b>	<b>4,837</b>	<b>165,207</b>	<b>354,341</b>	<b>290,149</b>	<b>448,376</b>	<b>615,025</b>
2.1 Government Securities	212	1,622	2,171	2,367	3,131	24,006	185,534	240,855	269,654	398,088
2.1.1 Treasury bills	56	353	517	616	631	6,358	40,410	57,317	70,123	80,184
2.1.2 Treasury bonds	156	1,269	1,654	1,752	2,500	17,647	145,124	183,538	199,531	317,904
2.2 Other(d)	1,248	1,476	444	1,569	1,706	141,201	168,808	49,294	178,723	216,936
<b>3. Banking Sector External Liabilities</b>	<b>2,669</b>	<b>2,251</b>	<b>3,393</b>	<b>4,385</b>	<b>5,233</b>	<b>301,950</b>	<b>257,575</b>	<b>376,418</b>	<b>499,507</b>	<b>665,472</b>
3.1 Central Bank(e)	1	227	228	229	205	64	26,042	25,322	26,047	26,024
3.2 Commercial Banks(f)	1,861	1,763	2,578	3,366	4,801	210,531	201,696	286,052	383,427	610,494
3.2.1 Short-term and Long-term Debt	1,112	937	1,538	2,263	3,227	125,797	107,224	170,636	257,803	411,595
Short-term Debt	-	-	-	-	2,127	-	-	-	-	271,307
Long-term Debt	-	-	-	-	1,100	-	-	-	-	140,288
3.2.2 Other Liabilities	749	826	1,040	1,103	1,574	84,734	94,471	115,415	125,624	198,899
3.3 Asian Clearing Union Liabilities	808	261	586	790	228	91,355	29,837	65,044	90,032	28,954
<b>4. Total External Debt (1+2)</b>	<b>15,107</b>	<b>18,662</b>	<b>21,438</b>	<b>25,002</b>	<b>28,441</b>	<b>1,709,159</b>	<b>2,134,654</b>	<b>2,378,598</b>	<b>2,984,019</b>	<b>3,753,884</b>
<b>5. Total External Debt and Liabilities (1+2+3)</b>	<b>17,775</b>	<b>20,913</b>	<b>24,830</b>	<b>29,387</b>	<b>33,674</b>	<b>2,011,109</b>	<b>2,392,229</b>	<b>2,755,015</b>	<b>3,483,526</b>	<b>4,419,356</b>
<b>MEMORANDUM ITEMS</b>										
<b>Medium and Long-term Debt</b>										
Project Loans	11,148	11,914	13,174	14,482	15,251	1,261,304	1,362,806	1,461,729	1,649,492	1,939,381
Non-Project Loans	740	708	1,516	426	313	83,703	81,025	168,151	112,387	101,660
Suppliers' Credits	705	1,146	1,838	2,899	3,490	79,722	131,103	203,888	330,253	443,836
IMF Drawings(c)	169	719	1,311	1,718	2,510	19,079	82,201	145,410	195,693	319,006
Other Loans(g)	885	1,077	985	1,539	2,039	100,145	123,178	109,271	247,818	334,976
<b>Short-term Debt and Banking Sector External Liabilities</b>	<b>4,129</b>	<b>5,349</b>	<b>6,008</b>	<b>8,322</b>	<b>10,070</b>	<b>467,157</b>	<b>611,916</b>	<b>666,566</b>	<b>947,883</b>	<b>1,280,497</b>
<b>As a Percentage of GDP(h), (i)</b>										
Total External Debt	37.1	44.4	43.3	42.2	47.9	38.8	44.1	42.4	45.6	49.5
Total Banking Sector External Liabilities	6.6	5.4	6.8	7.4	8.8	6.8	5.3	6.7	7.6	8.8
Total External Debt and Liabilities	43.7	49.7	50.1	49.7	56.7	45.6	49.5	49.2	53.2	58.3
Short-term Debt	3.6	7.4	5.3	6.7	8.1	3.7	7.3	5.2	6.9	8.1
Short-term Debt and Banking Sector External Liabilities	10.1	12.7	12.1	14.1	16.9	10.6	12.7	11.9	14.5	16.9
<b>As a Percentage of Total Debt and Liabilities(i)</b>										
Short-term Debt	8.2	14.8	10.5	13.4	14.4	8.2	14.8	10.5	12.9	13.9
Banking Sector External Liabilities	15.0	10.8	13.7	14.9	15.5	15.0	10.8	13.7	14.3	15.1
(a) Revised	Sources: External Resources Department									
(b) Provisional	Central Bank of Sri Lanka									
(c) Includes drawings under the International Monetary Fund Stand-by Arrangement facility of 2009.										
(d) Includes Iranian line of credit of the Ceylon Petroleum Corporation and other trade credits.										
(e) Includes Currency Swaps of US dollars 200 million from 2009 onwards.										
(f) Foreign liabilities of commercial banks including those of Offshore Banking Units.										
(g) Includes long-term loans of public corporations and private sector institutions.										
(h) Based on GDP at current market prices published by the Department of Census and Statistics.										
(i) Ratios calculated in rupee values and US dollar values differ due to variations in exchange rates during the year.										

## Foreign Debt Service Payments

**Total foreign debt service payments consisting of amortisation and interest payments increased in 2012.** In nominal terms, debt service payments increased to US dollars 2,879 million, primarily due to increased capital repayments in relation to long-term loans by the government, particularly the repayment of the US dollars 500 million debut sovereign bond, and the increase in repayments of Treasury bills and Treasury

bonds. Further, the first installment of the IMF-SBA facility amounting to US dollars 40 million was also repaid in October 2012. The substantial increase in interest payments on government medium and long-term debt outstanding, including interest and coupon payments in respect of Treasury bills and Treasury bonds also contributed to the increase in debt service payments. Consequently, debt service payments as a percentage of export of goods and services increased to 21.2 per cent in 2012 from

Table 5.13

## External Debt Service Payments (a)

Item	US\$ million					Rs. million				
	2008	2009	2010	2011(b)	2012(c)	2008	2009	2010	2011(b)	2012(c)
1. Debt Service Payments	1,826	2,009	1,853	1,739	2,879	277,297	230,616	208,984	192,613	368,115
1.1 Amortisation	1,375	1,652	1,234	1,030	1,889	228,488	189,621	138,941	114,285	242,341
(i) To IMF	77	95	46	11	60	8,582	10,941	5,238	1,238	7,100
(ii) To Others	1,298	1,557	1,188	1,018	1,829	219,906	178,680	133,703	113,047	235,241
Government, Medium and Long-term	807	940	665	789	1,372	166,433	107,880	74,932	87,754	176,617
Government Securities	300	307	92	95	128	32,548	35,109	10,406	10,406	16,535
Public Corporations and Private Sector	191	311	431	135	329	20,925	35,691	48,365	14,887	42,089
1.2 Interest Payments	450	357	619	709	991	48,809	40,995	70,043	78,328	125,774
(i) To IMF	11	6	7	10	36	1,173	644	803	1,081	4,707
(ii) To Others	440	351	612	700	954	47,636	40,351	69,240	77,247	121,067
2. Earnings from Export of Goods and Services	10,115	8,977	11,100	13,643	13,562	1,095,679	1,031,289	1,254,021	1,508,565	1,729,033
3. Receipts from Export of Goods, Services, Income and Current Transfers	13,102	12,500	15,592	19,314	19,921	1,419,565	1,436,578	1,761,613	2,135,356	2,538,587
4. Debt Service Ratio(d)										
4.1 As a Percentage of 2 above										
(i) Overall Ratio	18.0	22.4	16.7	12.7	21.2	25.3	22.4	16.7	12.8	21.3
(ii) Excluding IMF Transactions	17.2	21.3	16.2	12.6	20.5	24.4	21.2	16.2	12.6	20.6
4.2 As a percentage of 3 above										
(i) Overall Ratio	13.9	16.1	11.9	9.0	14.5	19.5	16.1	11.9	9.0	14.5
(ii) Excluding IMF Transactions	13.3	15.3	11.5	8.9	14.0	18.8	15.2	11.5	8.9	14.0
5. Government Debt Service Payments										
5.1 Government Debt Service Payments(e)	1,361	1,497	1,219	1,474	2,202	226,399	171,834	136,411	162,507	281,982
5.2 As a Percentage of 1 above(d)	74.5	74.5	65.8	84.8	76.5	81.6	74.5	65.3	84.4	76.6

(a) External debt service payments were reclassified to capture debt servicing of government securities (i.e. foreign holding of Treasury bonds) in accordance with the External Debt Statistics Manual (2003) of the International Monetary Fund (IMF).

(b) Revised

(c) Provisional

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

(e) Excludes transactions with the IMF

Sources : External Resources Department  
Central Bank of Sri Lanka

12.7 per cent in 2011, mainly due to the increase in debt service payments in nominal terms as well as due to the marginal decline in earnings from the export of goods and services in 2012 compared to 2011.

## 5.7 Exchange Rate Policy and Exchange Rate Movements

**Exchange rate policy in 2012 mainly focused on allowing greater flexibility in the exchange rate by limiting the Central Bank's intervention in the domestic foreign exchange market, as announced in February 2012.** As a result, the rupee depreciated by 14.56 per cent vis-à-vis the US dollar in the first half of 2012, due to initial overshooting after the major policy change. Subsequently, the rupee appreciated by 4.83 per cent in the second half of 2012, supported by

increased foreign currency inflows in the form of workers' remittances, earnings from tourism, and inflows to the government securities market and the CSE. Further, the increasing trend in domestic interest rates and the curtailment of import growth eased pressure on the rupee towards the end of the year. Accordingly, by end 2012, the rupee depreciated against the US dollar by 10.43 per cent to Rs. 127.16, while the annual average exchange rate stood at Rs. 127.60 against the US dollar in 2012 compared to Rs. 110.57 in 2011.

**Reflecting cross currency exchange rate movements, the rupee depreciated against all other major currencies during 2012.** The rupee depreciated against the pound sterling (14.61 per cent), the euro (12.31 per cent), and the Indian rupee (7.45 per cent) while it depreciated moderately against the Japanese yen (0.88 per

**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	
	2010	2011	2012	2010	2011	2012	2011	2012	2011	2012
Euro	147.56	147.42	168.13	150.10	153.86	164.01	0.09	-12.31	-2.45	-6.18
Indian rupee	2.48	2.15	2.33	2.49	2.39	2.39	15.01	-7.45	4.27	-0.34
Japanese yen	1.36	1.47	1.48	1.29	1.39	1.60	-7.21	-0.88	-7.06	-13.26
Pound sterling	171.41	175.45	205.47	174.81	177.23	202.28	-2.30	-14.61	-1.37	-12.38
US dollar	110.95	113.90	127.16	113.06	110.57	127.60	-2.59	-10.43	2.26	-13.35
SDR	170.84	174.87	195.31	172.50	174.54	195.38	-2.31	-10.47	-1.17	-10.67

Effective Exchange Rate Indices(b) (c)	End Year Index			Annual Average Index			Percentage Change over Previous Year			
	End Year Index			Annual Average Index			End Year Index		Annual Average Index	
	2010	2011	2012	2010	2011	2012	2011	2012	2011	2012
NEER - 24 currencies	100.50	101.44	90.33	100.00	99.84	90.44	0.93	-10.95	-0.16	-9.41
REER - 24 currencies	102.20	104.30	97.82	100.00	101.87	95.91	2.05	-6.21	1.87	-5.85

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

Source: Central Bank of Sri Lanka

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

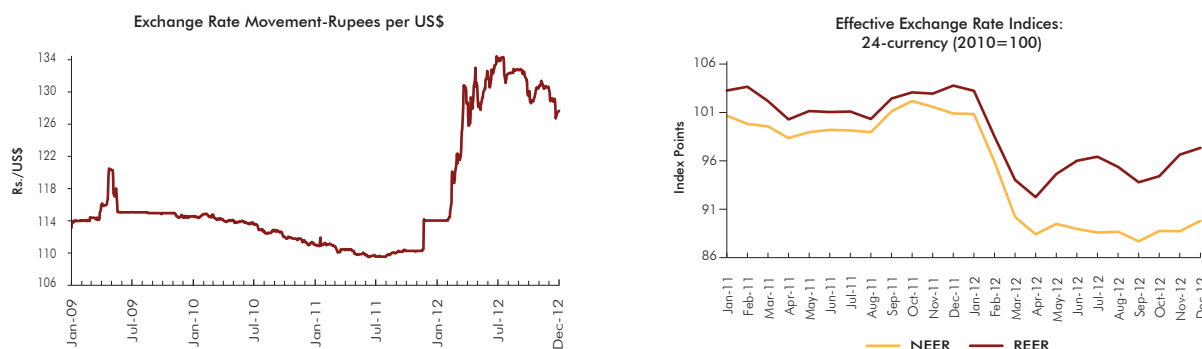
(c) The exchange rates have been defined in terms of indices so that the appreciation/depreciation of the rupee relative to other currencies is directly reflected by a rise/fall in the values of the effective exchange rate indices.

cent) with the slowdown in activity in Japan. The rupee depreciated against the SDR by 10.47 per cent during 2012 reflecting movements of major currencies against the US dollar in international markets.

## Nominal and Real Effective Exchange Rates

During 2012, both the Nominal Effective Exchange Rate (NEER) and the Real Effective Exchange Rate (REER) depreciated substantially, compared to the appreciation observed in 2011. The nominal depreciation of the Sri Lanka rupee against all major currencies in the currency basket

resulted in a depreciation of the NEER. The NEER based on the 5-currency basket which includes the US dollar, the pound sterling, the euro, the Japanese yen and the Indian rupee, depreciated by 10.49 per cent, while the NEER based on the nominal exchange rates of 24 trading partners and competitors depreciated by 10.95 per cent. Meanwhile, the inflation differential was higher due to relatively higher domestic inflation compared to that of trading partners and competitors. However, nominal depreciation of the rupee was larger than the inflation differential, resulting in a depreciation of the REER based on both 5-currency and 24-currency baskets by 6.55 per cent and 6.21 per cent, respectively, during 2012.

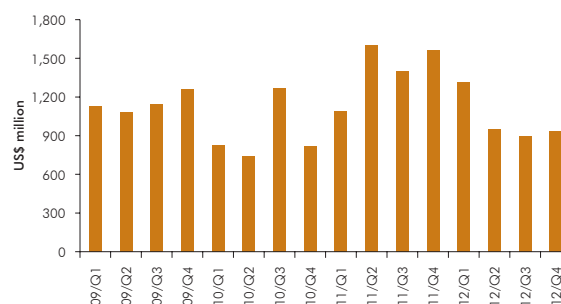
**Chart 5.14** Exchange Rate Movements

## Developments in the Domestic Foreign Exchange Markets

Reflecting weaker global demand, the volume of transactions in the domestic foreign exchange market contracted, albeit marginally, during 2012. The total volume of spot transactions declined to US dollars 9,331 million in 2012 (70 per cent of total transactions) compared to US dollars 10,787 million recorded in 2011, attributing mainly to the slowdown in external trade, limits imposed on forward contracts on foreign exchange transactions to a maximum of 90 days, and the downward revision of the exposure limits on NOPs. Consistent with the trend observed in the spot market, the total volume of forward transactions also decreased to US dollars 4,089 million in 2012 from US dollars 5,655 million in 2011. Accordingly, the total inter-bank foreign exchange transaction volume decreased substantially to US dollars 13,420 million during 2012 from US dollars 16,442 million in 2011. With the implementation of the policy package including the Central Bank's decision in February 2012 to limit the supply of foreign exchange only to the extent needed to settle a part of the petroleum import bills, the supply of foreign exchange to the domestic foreign exchange market declined considerably. Of the US dollars 1,797 million supplied to the market in 2012, US dollars 1,155 million were supplied in the first quarter of 2012, mainly to settle a part of the high oil import bills. Meanwhile, the Central Bank absorbed US dollars 631 million from the domestic market in 2012.

**Forward premia in the foreign exchange market reflected the change in exchange rate policy in 2012.** The forward premia for three-months and six-months contracts remained slightly lower than interest rate differentials during a

**Chart 5.15** Quarterly Inter-Bank Forward Transaction Volumes



major part of the year. This indicated the market expectation of continued inflows into the domestic foreign exchange market. The higher interest rate differential resulting from lower international interest rates on account of several quantitative easing programmes by major central banks and the relatively stable exchange rate, particularly during the second half of 2012, helped attract foreign investments into Treasury bills and Treasury bonds during the year. Following the downward revision of exposure limits on NOP on 02 March 2012, commercial banks have maintained NOP at minimum but positive levels, on average, during 2012, partly indicating a somewhat weak market expectation of rupee depreciation in the short-term, as also reflected in the one-month forward premia.

**In order to allow more flexibility in the exchange rate, in January 2013, the Central Bank took further measures with regard to forward contracts and NOP limits of commercial banks.** Accordingly, commercial banks were directed to relax the restrictions on forward market transactions, while increasing exposure limits on NOPs in order to provide more flexibility in managing their foreign exchange transactions.