Chapter 9

TRADE, BALANCE OF PAYMENTS AND TOURISM

9.1 Overall Developments

The global external environment deteriorated significantly in 2001. The world economy weakened after the strong performance in 2000. The slowdown was marked by a sharp weakening in the United States, which spearheaded the global economic growth during the past decade, a still fragile economy in Japan, a moderation in growth in the European Union and a significant slowdown in the Newly Industrialised Asian Economies and the ASEAN-4.[1] The drop in demand in industrial countries, particularly in major export markets for developing countries, had adverse repercussions on international trade and growth prospects of developing countries, including Sri Lanka. External sector developments in Sri Lanka during 2001 reflected the adverse global external environment, external shocks, and the uncertain political and economic environment in the country. However, the adverse effects of these developments were mitigated by the country's move to a freely floating exchange rate system in January, 2001.

A sharp decline in international trade in goods and services, significantly lower trade and current account deficits in the balance of payments, a surplus in the overall balance in the balance of payments resulting in a corresponding increase in official external reserves, and a depreciation of the rupee, are the highlights in the external sector developments in 2001. Sri Lanka's external trade dropped significantly by 16 per cent, in response to the sharp decline in global demand. Exports declined by 12.8 per cent, and imports by 14.9 per cent (18.4 per cent without adjustments for the import of aircraft in 2000), resulting in a favourable outcome in the trade deficit, which declined from 10.7 per cent of GDP in 2000 to 7.3 per cent in 2001. The drop in exports was mainly reflected in textiles and garment (14.7 per cent), other industrial products (10.3 per cent) and agricultural products (7.2 per cent). The drop in textile and garment exports alone accounted for over 62 per cent of the decline in total exports. This exhibits the vulnerability of emerging market economies, such as Sri Lanka, to adverse external trade shocks and impels a re-examination of the country's export strategy in two dimensions. First, the concentration of exports in one or two major export markets makes Sri Lanka highly vulnerable to shocks in those markets. The United States, the largest export market for Sri Lanka's garments, accounts for about 64 per cent, while the European Union for about 30 per cent, exposing Sri Lanka to adverse developments in these two markets. Secondly, the country's over dependence on garment exports (garments exports account for over 50 per cent of total exports), makes it highly vulnerable to adverse changes in that sector. These concerns are particularly relevant as the Multifiber Arrangement (MFA) will be phased out by 2005. In a highly trade dependent country like Sri Lanka (with a trade/GDP ratio of over 70 per cent), the risks of over exposure need to be minimised by diversifying exports not only to strengthen the resilience of the economy, but also to exploit its comparative advantage, while keeping in line with changing global market trends.

Meanwhile, the drop in imports was mainly in investment goods (24.9 per cent), petroleum products (18.9 per cent), consumer goods (11.0 per cent), textiles (10.3 per cent) and other intermediate goods (10.4 per cent). The large drop in investment goods throughout the year was a major concern, as it would retard future economic growth prospects. One of the favourable developments of the global slowdown was the drop in crude oil prices, by over 15 per cent during the year, which had a significant positive impact on Sri Lanka's balance of payments. The drop in consumer goods imports was mainly consequent upon the surcharge on non-essential consumer goods imports as a fiscal measure, weak domestic demand and the suspension of the facility given for public servants to import motor vehicles on concessionary terms.

The surplus in the services account stemmed from an inflow of US dollars 90 million to SriLankan Airlines in settlement of insurance claims against aircraft destroyed in the LTTE attack on the Katunayake International Airport. Excluding this inflow, the surplus in the services account dropped by nearly 50 per cent during the year, mainly due to a decrease of 15.5 per cent in receipts from tourism and a slowdown in earnings from related services. Net income payments declined by 8 per cent as the sharp drop in global interest rates reduced interest payments on external debt. Meanwhile, net current transfers declined by 4 per cent, as net private transfers were reduced after the completion in 2000 of compensation payments to workers affected by the Gulf War. Excluding this special item, net private transfer receipts recorded a marginal increase. As a result of these

1. Includes Indonesia, Malaysia, the Philippines and Thailand

TABLE 9.1
Balance of Payments Analytic Presentation
(Incorporating FCBUs of Commercial Banks as Part of the Domestic Banking System) (a)

Item	US dollars million					Rupees million				
	1997	1998	1999	2000	2001(b)	1997	1998	1999	2000	2001(b)
Trade Balance	-1,225	-1,092	-1,369	-1,798	-1,157	-71,833	-69,742	-96,702	-134,176	-102,592
Exports	4,639	4,798	4,610	5,522	4,817	274,194	310,401	325,170	420,114	430,372
Imports	5,864	5,889	5,979	7,320	5,974	346,026	380,142	421,873	554,290	532,964
Services, net (c)	159	145	147	38	108	9,386	9,300	10,342	2,907	9,514
Receipts	875	914	968	953	1,267	51,692	59,084	68,132	72,187	113,071
Payments	716	770	820	915	1,159	42,306	49,783	57,791	69,280	103,557
Income, net (d)	-160	-180	-254	-305	-280	-9,417	-11,556	-17,831	-23,009	-25,011
Receipts	234	214	167	152	93	13,792	13,882	11,810	11,568	8,329
Payments	393	394	421	456	374	23,210	25,437	29,640	34,577	33,340
Goods, Services and Income (net)	-1,225	-1,127	-1,476	-2,064	-1,330	-71,864	-71,997	-104,191	-154,278	-118,089
Private Transfers, net	788	848	887	974	938	46,494	54,843	62,472	73,620	83,716
Receipts (e)	922	999	1,056	1,160	1,125	54,445	64,585	74,356	87,697	100,427
Payments	135	151	169	186	187	7,951	9,742	11,884	14,078	16,710
Official Transfers (net)	44	52	26	24	22	2,625	3,359	1,816	1,801	1,925
Current Account	-393	-226	-563	-1,066	-370	-22,745	-13,795	-39,903	-78,857	-32,448
Capital and Financial Account	602	413	373	443	585	30,691	26,570	30,473	31,827	26,849
Capital Account	87	80	80	50	197	5,140	5,109	5,650	3,795	4,373
Capital Transfers (net)	87	80	80	50	197	5,140	5,109	5,650	3,795	4,373
Receipts (f)	91	84	86	56	203	5,386	5,410	6,018	4,230	4,890
Payments	4	5	5	6	6	246	301	368	435	517
Financial Account	515	334	293	393	389	25,550	21,461	24,823	28,032	22,476
Long-term:	716	398	435	304	164	37,029	25,906	30,985	22,594	14,357
Direct Investment	430	193	177	176	172	25,504	12,379	12,449	13,319	15,271
Foreign Direct Investment	129	137	177	173	82	7,587	8,846	12,449	13,119	7,310
Privatisation Proceeds	301	56	-	3	90	17,918	3,533	-	200	7,961
Private Long-term (net), (c)	47	2	196	82	-257	3,054	352	14,086	5,622	-22,898
Inflows (g)	150	146	361	298	44	8,741	9,686	25,727	22,134	4,012
Outflows (f)	102	145	165	216	301	5,687	9,334	11,641	16,512	26,910
Government, Long-term (net) (h)	239	203	62	47	249	8,471	13,175	4,451	3,653	21,984
Inflows	500	493	381	355	575	24,761	31,896	26,896	26,965	51,193
Outflows	262	290	319	308	326	16,291	18,721	22,445	23,312	29,209
Short-term:	-201	-64	-142	88	225	-11,479	-4,445	-6162	5,438	8,119
Portfolio Investment	13	-24	-13	-45	-11	749	-1,521	-886	-3,355	-1,025
Private Short-term (net), (d)	-20	8	-10	100	-18	-1,195	414	-667	7,569	-1,625
Commercial Bank Assets (net), (d)	-323	180	-19	-141	183	-23,384	5,035	1,766	-18,736	-9,078
Commercial Bank Liabilities (net), (d)	129	-228	-101	174	71	12,352	-8,374	-6,375	19,960	19,846
Government Short-term (net), (d)	-	-	-	-	-	-	-	-	-	-
SDR Allocations										
Valuation Adjustments						-562	8,559	2,103	5,189	22,245
Errors and Omissions	-46	-151	-73	101	5	8,461	-7,534	-6,857	10,902	783
Overall Balance (i)	163	37	-263	-522	220	15,845	13,800	-14,184	-30,939	17,430
Monetary Movements (i)	-163	-37	263	522	-220	-15,845	-13,800	14,184	30,939	-17,430
Exchange Rate Rs/US$						58.99	64.59	70.39	75.78	89.36
Ratio to GDP in percentages										
Trade Account	-8.1	-6.9	-8.7	-10.8	-7.4	-8.1	-6.9	-8.7	-10.7	-7.3
Current Account	-2.6	-1.4	-3.6	-6.4	-2.4	-2.6	-1.4	-3.6	-6.3	-2.3
Current Account without Grants	-2.9	-1.8	-3.7	-6.6	-2.5	-2.8	-1.7	-3.8	-6.4	-2.5

Source: Central Bank of Sri Lanka

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

(b) Provisional

(c) Services receipts in 2001 include US dollars 382.4 mn. received by Sri Lankan Airlines as insurance claims for the aircraft destroyed by the attack on the airport in July 2001, while Services payments in 2001 include US dollars 292.8 mn. paid to the lessors of the aircraft. The net receipt of these insurance claims was US dollars 89.6 mn.

(d) From 1994 onwards Foreign Currency Banking Units (FCBUs) have been treated as a part of the domestic banking system in the compilation of balance of payments statistics. Accordingly, transactions involving FCBUs and non-residents are taken into account in the compilation of balance of payments statistics, while those involving FCBUs and residents are excluded.

(e) Includes US dollars 64 mn., US dollars 78 mn., US dollars 85 mn. and US dollars 45 mn. received in 1997, 1998, 1999 and 2000 as compensation of US dollars 2,500 per person to 26,101, 31,279, 37,343 and 29,323 Sri Lankans, respectively, who lost employment in Kuwait due to the Gulf War in 1990. In addition, US dollars 27 mn. was also received as second round payments of US dollars 1,500 each to 18,244 Sri Lankans in 1999.

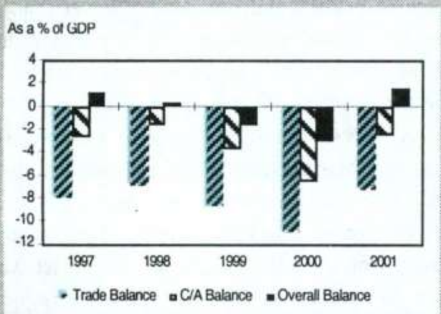
(f) Includes US dollars 147.6 mn. in respect of a technical amotisation under private capital outflows and a corresponding adjustment under capital transfer receipts in 2001 for the remaining capital of the aircraft destroyed by the attack on the airport in July 2001.

(g) Includes adjustment to capital inflows in 1999 and 2000 on account of the import of aircraft for which advance payments had been made in previous years.

(h) Data since 1994 have been revised to incorporate additional information.

(i) All transactions in the Monetary Sector are converted at the end of year exchange rates.

Chart 9.1
Balance of Payments (a) (b)



(a) With the change in classification from BPM4 to BPM5 format changes in commercial banks assets and liabilities are excluded from the overall balance.
(b) Beginning 1994 Foreign Currency Banking Units (FCBUs) have been treated as part of the domestic banking system.

TABLE 9.2
External Trade Performance

Year	Growth in Value (a)		Unit Value Index (1997=100)			As a percentage of GDP	
	Exports	Imports	Exports	Imports	Terms of Trade (b)	Exports	Imports
1999 (c)	-3.9	1.5	114.6	106.4	107.7	29.2	37.9
2000 (c) (d)	19.8	22.4	125.2	123.8	101.1	33.3	44.1
2001 (e)	-12.8	-18.4	139.4	140.5	99.2	30.7	38.1

Sources: Sri Lanka Customs
Central Bank of Sri Lanka

(a) Growth rates are given in US dollar terms
(b) (Export unit value index / Import unit value index) X 100
(c) Import indices in 1999 and 2000 are calculated excluding aircraft imports
(d) Revised
(e) Provisional

Chart 9.2
External Trade

Chart 9.2.1
Trade Balance

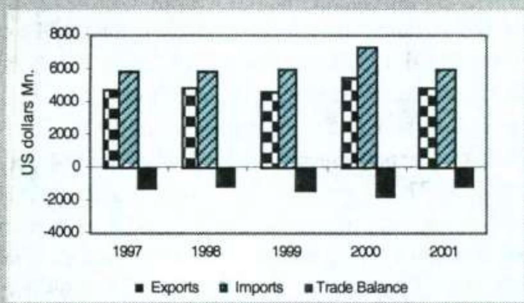


Chart 9.2.2
Export and Import Volume Indices
(1997 = 100)

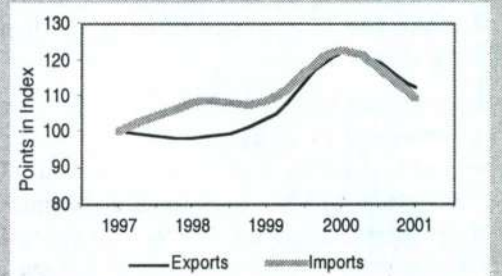


Chart 9.2.3
Unit Value Indices
(1997=100)

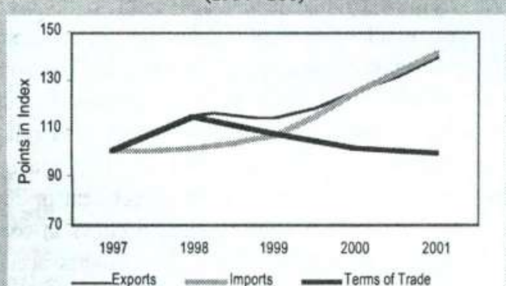
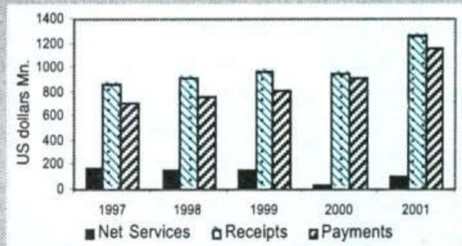


Chart 9.2.4
Trade in Services (a)



(a) With the change in classification from BPM4 to BPM5 format, services exclude Income which now appears as a separate item in the current account.

developments in the trade, services, income and transfers accounts, the deficit in the current account narrowed significantly from 6.4 per cent in 2000 to 2.5 per cent of GDP in 2001, reducing pressure on the exchange rate.

The capital and financial accounts showed some improvement with an increase in loan capital to the government and in short-term capital flows. Foreign direct investments declined sharply, due both to the adverse external environment and the uncertain political climate. Portfolio investments recorded a net outflow, but were much smaller than in the previous year. Privatisation proceeds increased over the previous year, but were well below original expectations. These developments in the current account and the capital and financial accounts resulted in a surplus of US dollars 220 million in the overall balance in the balance of payments, reversing the declining trend in external reserves experienced during the previous two years.

The external debt stock of the country declined by 5 per cent to US dollars 8,566 million because of a drop in private sector debt and cross-exchange rate effects. However, in relation to GDP, it increased marginally from 54.5 per cent in 2000 to 54.7 per cent in 2001 as GDP in US dollar terms grew more slowly. The bulk of the debt stock (76 per cent) consisted of concessional debt. Despite the drop in total receipts from goods, services income and current private transfers, the debt service ratio decreased from 12.2 per cent to 11.1 per cent reflecting the drop in global interest rates.

A major change with respect to the exchange rate policy was introduced on 23 January 2001 by moving to an independently floating exchange rate regime. The exchange rate stabilised after a moderate and temporary overshooting immediately after the free flotation. The exchange rate is now determined by market demand and supply conditions with occasional interventions by the Central Bank to minimise excessive fluctuations in the rate. The rupee depreciated by 11.3 per cent against the US dollar during the year as a whole and 8.6 per cent since the introduction of the new exchange rate regime. Meanwhile, the real effective exchange rate of the Sri Lanka rupee against a five currency basket, (i.e. a basket comprising the US dollar, the sterling pound, the Japanese yen, the Deutsche mark and the Indian rupee), appreciated by 1.4 per cent reflecting a higher domestic inflation rate compared with trade partner and competitor countries.

The total gross external assets of the country rose by 5 per cent to US dollars 2,238 million at the end of 2001, and were sufficient to finance 4.5 months of imports in 2001. Meanwhile, gross official reserves at US dollars 1,338 million were 28 per cent higher than that at end-2000 and were sufficient to finance 2.7 months of imports.

9.2 Exports

The export sector suffered a severe setback in 2001 as both the volume of exports and prices were lower than in 2000. Total export earnings, which grew by 3 per cent during the first four months of 2001, began to decline after May 2001 following the economic slowdown in major export markets, particularly, USA and the European Union (EU). The attacks at the Katunayake International Airport and later in USA, and increased competition from Sub Saharan countries for garment exports markets, supported by special tariff concessions, worsened the situation. The impact was felt in all major categories of exports. The recession in the Japanese economy also weakened the market for Sri Lanka's exports, particularly, prawns, other fish produces, gems, jewellery and diamonds. Despite high demand from the Commonwealth of Independent States (CIS) and some European countries, tea prices continued to decline from January 2001 as the global economy slowed down and the supply from major producing countries increased.

Total export earnings, amounting to US dollars 4,817 million, declined by 12.8 per cent over the high base of exports in 2000 (US dollar 5,522 million with 19.9 per cent growth). This decline was the product of lower export volume (a drop of 8 per cent) and decline in prices (5.2 per cent).

Export Structure

Since the economic liberalisation in 1977, industrial exports have expanded significantly and have turned out to be the main contributor to expanding exports, overtaking the share of plantation agricultural commodities in 1986. The share of industrial exports increased gradually from 14 per cent in 1977 to 77 per cent in 2001. This ratio has remained around 75 per cent during the last 9 years. Within industrial exports, textiles and garments became Sri Lanka's largest single item of exports in 1986 and contributed 69 per cent of industrial exports in 2001.

The export structure changed only marginally even after the major setback in 2001. The share of industrial exports in total exports declined from 78 per cent in 2000 to 77 per cent in 2001. The share of textiles and garment exports declined by one percentage point to 53 per cent. The shares of all other major industrial sectors remained virtually unchanged over the previous year. The share of agricultural exports increased from 18 per cent in 2000 to 19 per cent in 2001, reflecting the impact of a relatively smaller decline in tea exports. The share of tea among agricultural products increased from 70 per cent in 2000 to 74 per cent in 2001 due to substantial declines in coconut, natural rubber and pepper exports. Tea exports accounted for 14 per cent of total exports in 2001. Non-plantation agriculture, dominated by cinnamon, un-manufactured tobacco, pepper, cloves, vegetable and fruits has shown

TABLE 9.3
Composition of Exports

Category	US dollars Million					Rs. Million				
	1997	1998	1999	2000(a)	2001 (b)	1997	1998	1999	2000(a)	2001(b)
1. Agricultural exports	1,060	1,088	947	1,005	932	62,667	70,225	66,751	76,271	83,252
Tea	719	780	621	700	690	42,533	50,280	43,728	53,133	61,802
Rubber	79	44	33	29	24	4,640	2,808	2,305	2,179	2,129
Coconut	118	94	129	121	82	6,939	6,110	9,119	9,174	7,348
Kernel products	82	56	84	77	41	4,864	3,632	5,973	5,786	3,639
Other	35	38	45	45	42	2,075	2,478	3,146	3,388	3,709
Minor agricultural products	145	170	165	155	136	8,555	11,027	11,598	11,784	12,174
2. Industrial exports (c)	3,436	3,607	3,551	4,283	3,710	203,114	233,508	250,516	325,931	331,687
Food,beverages and tobacco	91	118	86	152	128	5,354	7,586	6,093	11,573	11,389
Textiles and garments	2,274	2,460	2,425	2,982	2,543	134,455	159,303	171,068	226,930	227,360
Petroleum products	97	73	74	98	68	5,743	4,662	5,210	7,414	6,053
Rubber products	178	178	161	196	172	10,513	11,528	11,350	14,924	15,417
Ceramic products	55	54	49	47	42	3,246	3,478	3,442	3,558	3,791
Leather, travel goods and footwear	183	214	201	176	150	10,812	13,855	14,140	13,391	13,400
Machinery and equipment	204	182	201	244	245	12,076	11,811	14,155	18,594	21,895
Diamond and jewellery (d)	142	131	171	192	185	8,384	8,491	12,064	14,546	16,495
Other industrial exports	212	197	184	197	177	12,531	12,794	12,995	15,001	15,887
3. Mineral exports	90	60	64	97	86	5,271	3,863	4,540	7,352	7,688
Gems	84	56	61	93	82	4,899	3,577	4,326	7,091	7,278
Other mineral exports	6	4	3	3	4	372	286	214	262	390
4. Unclassified (c) (e)	53	43	48	137	88	3,141	2,802	3,363	10,560	7,767
Total exports (c)	4,639	4,798	4,610	5,522	4,817	274,193	310,398	325,171	420,114	430,372

(a) Revised
(b) Provisional
(c) Adjusted
(d) Diamond exports reported by the Sri Lanka Customs in 1999 and 2000 were adjusted for data obtained from the National Gem and Jewellery Authority.
(e) Includes re-exports

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

significant improvements in the last decade surpassing the position held by the rubber and coconut sectors. All non-plantation agricultural exports accounted for 15 per cent of total agricultural products. The share of mineral and other exports stood at 2 per cent each of total exports as in the previous year. Other exports include the re-export of generators, electrical parts and textiles items.

Industrial Exports

In 2001, earnings from industrial exports declined by 13.4 per cent in contrast to the growth of 21 per cent in 2000. The textiles and garment sector, which grew strongly in 2000, suffered from low demand throughout 2001. Emerging garments manufacturers in Sub Saharan countries also posed a challenge to Sri Lankan exporters, as they enjoyed free access and duty concessions in the US market. They also had the advantage of lower cost of labour. The value of textiles and garment exports declined by 14.7 per cent in 2001 as against 23 per cent growth in 2000. The volume of textiles and garment exports declined by 11.5 per cent and prices dropped by 3.6 per cent. Demand was lower in USA and the European countries, particularly, UK, Germany, the Netherlands, France, Belgium and Luxembourg. Garment exports to USA improved marginally during the first half of 2001 but declined sharply during the second half of the year, as slower economic growth in USA impacted on demand. Earnings from garment exports to the USA declined by 10.7 per cent. Garment exports to the EU continued to decline throughout the year resulting in a decline of 20.6 per cent in 2001, although EU removed the quota restrictions on Sri Lanka's textiles and garment imports from 1 January 2001. The share of garments exported to non-quota countries, increased from 4 per cent in 2000 to 34 per cent in 2001. USA and EU countries purchased more than 94 per cent of Sri Lanka's garment exports in 2001. Garment exports to Canada, Japan, Spain, Portugal and Greece increased in 2001. However, the share accounted for by these countries was only 3 per cent of the total garment exports.

Among the sub categories in the textiles and garment sector, garment exports declined by 14 per cent while textiles exports dropped by 38 per cent. Exports of yarn and other made up articles declined by 16 per cent and 19 per cent, respectively. Reflecting the impact of lower prices and reduced margins due to high competition, net foreign exchange earnings from the textiles and garment sector

Chart 9.3
Value of Exports by Major Categories

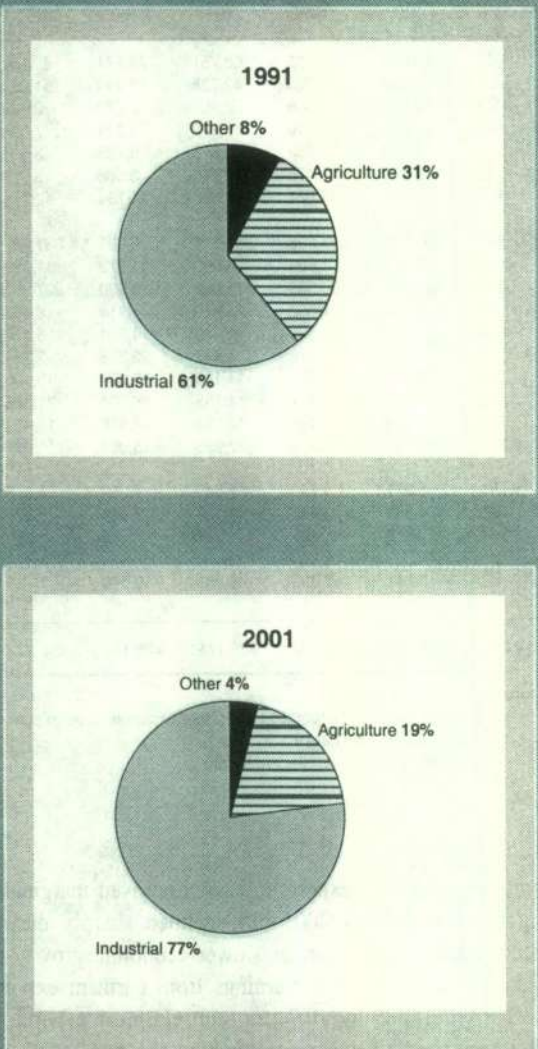
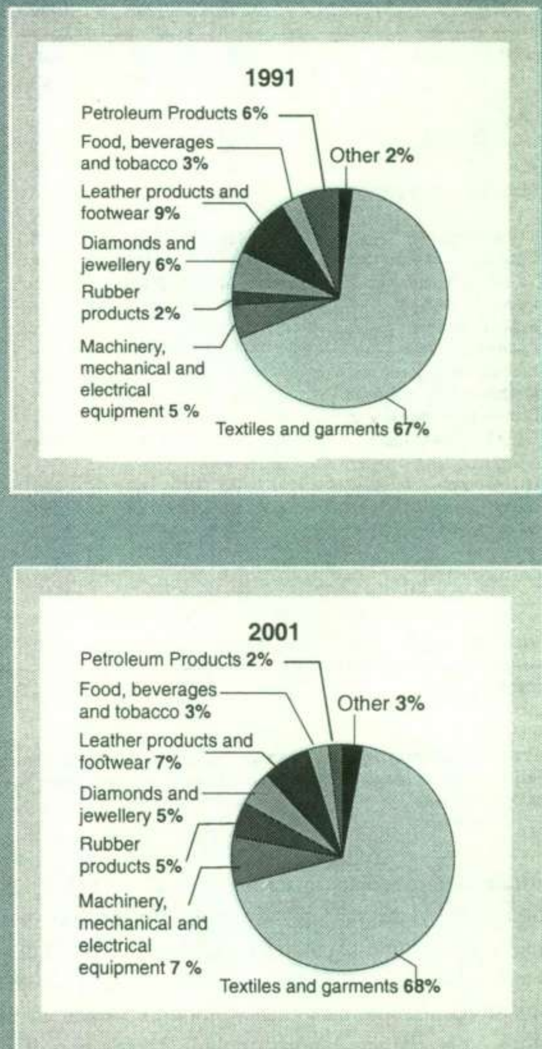


Chart 9.4
Value of Industrial Exports by Major Categories



declined by 19 per cent to US dollars 1,223 million. As in the previous year, more than 90 per cent of textiles and garment exports were from BOI companies. Export earnings in BOI enterprises declined by 15 per cent in 2001 compared to a 24 per cent increase in 2000. Exports by non-BOI enterprises dropped by 13 per cent in 2001 compared to a growth of 17 per cent in 2000.

All other categories of industrial exports, as a group, declined by 10 per cent as against a 16 per cent growth in 2000. Among those categories, exports of machinery and mechanical and electrical equipment increased marginally. This category accounted for 7 per cent of the total industrial exports. Earnings from rubber based product exports declined by 12 per cent to US dollars 172 million in 2001 reflecting a 20 per cent decline in all grades of tyres (retreaded, solid and cushion). These exports continued to decline after May 2001, due to the global economic slowdown and subsequent reduction in European demand. Exports of examination, surgical and industrial gloves declined by 9 per cent reflecting lower demand. These categories of gloves accounted for 33 per cent of the total rubber based products in 2001. Other rubber based products such as inner tubes and emerging products such as machine parts, clothing accessories and pharmaceutical items continued to expand in 2001. However, all these products together accounted for only 8 per cent of the total rubber based product exports.

Earnings in the food, beverages and tobacco sector declined by 16 per cent in 2001 due to a sharp drop in the export of crustaceans, molluscs and other fish products, which contributed 74 per cent of this sub category (84 per cent in 2000) in 2001. Earnings from the export of prawns declined by 25 per cent due to weak demand in 2001. Fish exports too declined by 27 per cent. Exports of crustaceans, molluscs and other fish products were concentrated in Japan and the EU markets. Lower consumer demand in those countries affected the prices of the fish products, reducing the turnover from the exports. Demand for these products from Singapore, Hong Kong and the East Asian countries remained stable throughout the year. Among other food exports, cocoa preparations, tinned or bottled fruit, fruit and vegetable juices, manufactured tobacco, coconut milk powder, coconut cream, malted milk, sweet biscuits, mineral water and animal fodder reported improvements over 2000.

Diamond exports declined by 7 per cent in 2001 reflecting lower demand from the major trading centres such as Belgium, Israel, Vietnam, USA and Japan. Buyers in these markets had retained large stocks of processed diamonds. The jewellery market, which showed a steady recovery showing a growth of 25 per cent in 2000, improved further in 2001. Jewellery exports increased by 46 per cent in 2001. However, jewellery producers were affected by the introduction of the National Security Levy (NSL) on the gem and jewellery industry in April 2001. This reduced the competitive advantage the industry had had over other producing countries. However, the demand for diamonds and gems in the local market remained high due to the growth in the jewellery industry. The Export Development Board took initiatives to improve the skills of craftsmen, the quality of jewellery manufactured by small producers, skills of jewellery designers, gem skills in stone setting, through workshops, seminars and consultations. Assistance was provided to new and existing exporters to enter the international market, while opportunities were given to some exporters to participate in local and international trade fairs and exhibitions. Selected exporters were provided with free web page and advertising facilities. USA continued to be the largest buyer of jewellery from Sri Lanka followed by Germany, UK, United Arab Emirates (UAE) and Switzerland.

Earnings from the export of petroleum products declined by 31 per cent in 2001 due to a drop in export volumes. Lower prices in international markets too influenced exports after September 2001. The export volume of petroleum products declined by 20 per cent in 2001. This reduction was largely in bunkering fuel, as local production had to cater to increased demand locally for electricity generation and industrial activities. The production of petroleum products in the first quarter of 2001 was lower, due to the closure of the refinery for routine maintenance and contributed to reducing the volume of exports.

Exports earnings from all other major categories, including travel goods, footwear and other leather products, ceramic products, plastics, chemical products, articles of wood, toys, articles of copper, quartz, brooms, brushes, and string musical instruments declined, particularly during the latter half of the year.

Plantation Crops

Earnings from all three plantation crops declined by 6.3 per cent in 2001. International tea prices recorded a decline during most of the year and recovered towards the end of 2001. The prices of tea continued to remain lower than in the previous year after April 2001. The decline was due to the revival of Kenyan tea production (25 per cent growth) and drop in demand due to the slowdown in the global economy. The average export price of tea declined from US dollars 2.43 per kg in 2000 to US dollars 2.34 per kg in 2001. Despite the decline in production, the volume of tea exports increased by 6.7 million kg to 295 million kg in 2001 reflecting a draw-down of stocks. Tea production declined by 10.8 million kg to 295 million in 2001. The overall quality and quantity of tea produced in Sri Lanka were affected by labour related problems that prevailed during the first quarter of 2001 and by adverse weather conditions.

Of total tea exports, 60 per cent was in bulk form, while 34 per cent was in packed form. The rest was in higher value added forms such as tea bags, tea blended with foreign teas, instant and green teas. Orthodox tea accounted for more than 99 per cent of Sri Lankan tea exports, while Cut, Tear and Curl (CTC) tea was produced in small quantities. Sri Lanka imported 3.6 million kg of tea for blending purposes, which was only 1 per cent of the domestic production in 2001. Russia continued to be the largest buyer (22 per cent) in 2001. UAE became the second largest buyer (12 per cent), while Syria (8 per cent) continued to hold the third position. Other major buyers were Libya and Turkey (6 per cent each) and Iran and Iraq (4 per cent each). However as a group, Middle East countries bought 46 per cent of total tea exports while the CIS countries bought 22 per cent and the EU bought 10 per cent in 2001.

Earnings from the three major coconut products declined by 47 per cent in 2001. Export quantities of desiccated coconuts and coconut oil declined by 40 per cent and 27 per cent, respectively. Following international price trends, average prices of the three major coconut products have declined since November 1999. This was caused by a continuous improvement in world coconut production since the last quarter of 1999. World copra production increased by 8.5 per cent to 5.74 million metric tons while coconut oil production increased by 9 per cent to 3.57 million metric tons in 2001. However, world coconut production is expected to fall in 2002 and prices are expected to improve in 2002. Sri Lanka reported a harvest of 2,796 million nuts in 2001 compared to 3,096 million nuts (decline of 10 per cent) in 2000 due to unfavourable weather. The lower production of nuts resulted in lower quantities of coconut oil and desiccated coconut exports. In 2000, when coconut oil prices were low, the government decided to impose a 25 per cent surcharge on the prevailing 25 per cent duty on 17 July 2000 to reduce competition from imported edible oils. This surcharge was changed to a specific surcharge of Rs. 20 per kg for the period 12 January - 31 December 2001 even when production shortfalls and higher prices prevailed in the market. As a result, imports of edible oil declined by 17.3 million kg in 2001 putting further pressure on domestic coconut prices. Responding to lower supply in the market, prices for fresh nuts (retail price) increased by about 12 per cent over 2000 thus increasing the cost of inputs to the coconut oil and desiccated coconut industry. World production of other edible oils such as soya bean, corn, olive and palm oil increased and helped to reduce the prices of close substitutes.

Earnings from other coconut products declined by 7 per cent in 2001 reflecting lower international prices. Despite lower production of fresh nuts which provided inputs for other coconut products, the exported quantity of coir fibre mattresses increased by 3 per cent attributable to stocks carried forward from the previous year. However, the prices declined to neutralise the positive impact of higher quantities. Except for coir yarn, prices of all other coir products were lower in 2001 than in 2000. Total export earnings from coconut based products were less than 1 per cent of total exports of the country.

Rubber production fell during the first nine months of the year and rose in the last quarter of the year. However, the production of 86 million kg in 2001 was the lowest recorded production for the last five decades. This was 2 per cent lower than the 88 million kg in 2000. Local intermediary consumption of rubber declined from 55 million kg to 54 million kg as the rubber based manufacturing sub-sector contracted. In order to meet input requirements, only 726,865 kg of natural rubber were imported by the domestic manufacturing industry in 2001 compared to 3,291,878 kg in 2000.

Export prices of natural rubber (NR) continued to decline after December 2000, recording a decline of 16 per cent in 2001. Similarly, the volume of rubber exports declined by 1 per cent in 2001. Accordingly, earnings from NR exports declined by 17 per cent. Production surpluses in major producing countries, lower demand for NR in the world market, particularly in USA, contributed to the lower rubber prices. Earnings from rubber exports accounted for less than 1 per cent of total exports earnings.

Other Agricultural Products

Earnings from other agricultural exports declined for the third consecutive year, by 12 per cent to US dollars 136 million in 2001. Earnings from this sub-category, which recorded its highest earnings of US dollars 170 million in 1998, declined at an accelerating rate over the last three years due to a combination of factors such as untimely weather conditions, lower prices resulting from high global production and international competition. Earnings from cinnamon exports declined due to lower prices which offset the positive impact of increased volume. Cinnamon prices continued to remain low throughout the year but the export quantities were higher except in the second quarter when prices were relatively low. This compelled producers to hold back their production. Earnings from un-manufactured tobacco declined by 6 per cent due to lower prices and lower demand from Austria, Belgium, UK and Spain. Cloves became a significant commodity among minor agricultural product in 2001. Prices of cloves remained steady throughout the year due to high demand from India. Export quantities and prices of pepper remained at significantly lower levels in 2001. Pepper prices continued to decline since early 2000 due to worldwide high production. These four products together accounted for 71 per cent of total other agricultural products. Despite a bumper harvest in India, cardamom prices continued to remain high during the last three quarters of 2001 due to the shortfall in Guatemalan supply. However, the export quantities remained low due to supply constraints originating from low local production. An increased volume of exports of dry and fresh vegetable resulted in a higher export value despite lower prices. Export earnings from arecanut, coffee, nutmeg and mace, betel leaves, sesame seeds and essential oils declined over 2000. Other oil seeds and cashew nuts exports recorded substantial gains although they were small in absolute value.

Mineral Products

Earnings from the export of mineral products declined by 10.8 per cent in 2001. Gem exports, which covered 95 per cent of mineral exports, declined by 12 per cent against a 52 per cent increase in 2000. Gem exports performed well during the first five months of 2001, but were adversely affected by the lower demand from major importing countries during the latter part of the year. The attack on the Katunayake International Airport in July 2001 shut out the retail sales of gems to foreigners adversely. The attacks in USA in September 2001, affected the global gem and jewellery industry, reducing global demand. In addition to adverse implications on the international front, the government introduced the NSL on the imports of gems and jewellery, jewellery manufacturing and cutting and polishing of gems with effect from 1 April 2001. The consequent rise in costs reduced the competitive edge that Sri Lanka's exporters had over producers in India, Indonesia, Malaysia, and the Philippines. Despite those negative developments, Sri Lanka continued to supply top quality blue sapphires of natural colour to the world market and the prices of these products grew steadily during the year. Demand for calibrated blue, pink and yellow sapphires in the European and USA markets remained stable during the early half of the year. Demand from USA for rubies and sapphires remained stable. Hong Kong has emerged as the centre for fine gems and jewellery in the Asia pacific region. Japan also continued to be a major market for Sri Lankan gems while Switzerland, France, UK and Germany were among the major buyers in the European market. On the supply side, the removal of the suspension imposed on the auction of government and estate owned lands for gem mining, resulted in improving the supply of raw gems in 2001. Earnings from other mineral exports grew by 26 per cent due to higher earnings from metallic ores and iron pyrites.

9.3 Imports

Expenditure on imports in 2001 was US dollars 5,974 million, a 18.4 per cent decline over 2000. When adjusted for the three aircraft imported in 2000 under the SriLankan Airlines re-fleeting programme, the imports indicated a lower decline of 14.9 per cent. The decline in imports was largely attributable to low demand due to slower economic growth, the surcharge imposed on imports and lower petroleum prices.

All three major categories of imports, consumer, investment and intermediate goods declined in 2001. Imports of consumer goods declined by 11 per cent, intermediate goods by 12 per cent and investment goods declined by 38 per cent. Even with adjustments for the aircraft imports in 2000, investment good imports dropped by 25 per cent.

The reduction in the value of imports is a composite result of a 4 per cent drop in average import prices and an 11 per cent decline in volume. Lower international prices of major inputs such as petroleum, textiles and some investment goods contributed to the decline in average import prices. Lower import volumes of food and consumer durables (sugar, wheat, milk products, motor vehicles, radios and television sets), intermediate goods (petroleum products, textiles, diamonds, chemicals and plastics) and investment goods (building materials and machinery) were the major reasons for the low volume.

TABLE 9.4
End-Use Classifiction of Imports

Category	US dollars Million					Rs. Million				
	1997	1998	1999	2000 (a)	2001(b)	1997	1998	1999	2000(a)	2001 (b)
1. Consumer goods	1,223	1,255	1,242	1,388	1,235	72,062	80,956	87,505	105,403	110,059
Food and drink	781	723	661	693	654	45,996	46,543	46,562	52,584	58,466
Rice	73	42	46	4	11	4,331	2,621	3,290	288	969
Sugar	184	129	106	141	115	10,788	8,384	7,448	10,777	10,289
Wheat	139	127	111	127	110	8,128	8,133	7,792	9,625	9,783
Other	385	425	398	421	419	22,749	27,405	28,032	31,894	37,425
Other consumer goods	442	532	581	696	581	26,066	34,413	40,943	52,819	51,593
2. Intermediate goods	3,096	2,982	3,057	3,789	3,321	182,754	192,494	215,658	287,196	296,522
Petroleum	539	345	500	901	731	31,828	22,275	35,344	68,381	65,190
Fertiliser (c)	66	62	66	80	67	3,916	3,989	4,690	6,059	6,047
Chemicals	136	143	136	147	142	8,024	9,241	9,590	11,152	12,647
Textiles and clothing	1,386	1,397	1,320	1,471	1,320	81,816	90,099	93,105	111,386	117,993
Other intermediate goods (d)	969	1,035	1,035	1,190	1,081	57,170	66,890	72,929	90,218	94,645
3. Investment goods	1,325	1,477	1,565	1,737	1,081	78,232	95,322	110,599	130,889	96,185
Machinery and equipment	742	786	678	787	610	43,853	50,592	47,736	59,538	54,287
Transport equipment (e)	208	264	523	529	129	12,276	17,098	37,191	39,489	11,469
Building materials	272	303	260	305	249	16,030	19,590	18,296	23,087	22,145
Other investment goods	103	124	105	116	93	6,073	8,042	7,376	8,776	8,285
4. Unclassified imports	220	176	115	406	337	12,978	11,367	8,126	30,802	30,198
Total imports (f)	5,864	5,890	5,980	7,320	5,974	346,026	380,138	421,888	554,290	532,964

(a) Revised
(b) Provisional
(c) From 1997 onwards Customs data on fertiliser have been used instead of data obtained from Ceylon Fertiliser Co. Ltd. & other major importers of fertiliser.
(d) Diamond imports reported by the Sri Lanka Customs in 1999 and 2000 were adjusted for data obtained from major importers.
(e) Includes the value of 3 aircraft imported by SriLankan Airlines in 1999 and 2000.
(f) Adjusted

Sources : Sri Lanka Customs
Co-operative Wholesale Establishment
Ceylon Fertiliser Co. Ltd. & Other major importers of fertiliser
Ceylon Petroleum Corporation
Major importers of diamonds
Central Bank of Sri Lanka
Prima Ceylon Ltd.

Import Structure

A gradual move from consumer goods to intermediate and investment goods in the import composition has been observed during the last 24 years following the economic liberalisation in 1977. An improvement in the domestic supply of rice and other food items helped to contain the food imports. Expansion in the industrial sector required higher imports of intermediate goods while improvements in infrastructure facilities and the construction and transport sectors, combined with increased use of advanced technology, increased imports of investment goods. The import structure in 2001 showed a marginal shift towards consumer goods reflecting the slower economic activity. When compared with 2000, the relative importance of intermediate and investment goods together declined from 75 per cent (without aircraft) to 74 per cent, while consumer goods increased from 20 per cent to 21 per cent. The share of other imports (including defence related imports) remained at the same level as in 2000.

Consumer Goods

Expenditure on both food and consumer durable imports declined in 2001. Imports of food items continued to increase till July 2001 and then started to decline at an increasing rate, resulting in a drop of 5 per cent in food and drink imports. Food items were not affected seriously by the imposition of the surcharge on imports as essential food items were excluded from the surcharge. Wheat grain imports declined to 760,416 metric tons in 2001 compared with 921,653 metric tons in 2000. Even when a shipment containing 58,513 metric tons of wheat, which was expected in December 2001 but arrived in January 2002, is taken into account, wheat imports were low due to depressed demand from the local bakery and confectionery industry and the reduction in domestic stocks. Although flour imports increased to 34,706 metric tons in 2000 after the liberalisation of wheat and flour imports at end February 2000, they declined to 6,338 metric tons in 2001. Sugar imports too declined due to relatively higher international prices. Despite the reduction in the rice harvest, the government continued to keep the import of rice under import control after 21 July 2000, limiting the importation of rice only to high quality varieties. Rice imports were liable to a 35 per cent import duty until the government announced a duty waiver on rice imports on 22 November 2001 as domestic prices rose. During the first eleven months of 2001, rice imports amounted to 12,810 metric tons; in December 2001, 39,133 metric tons were imported. Lower income levels and higher domestic prices reduced the demand for milk and fish products. Potato imports were low due to high import duties and increased local production. Import of onions, chillies and other food items was low due to the higher cost of imports on account of the import surcharge.

In the durable consumer goods category, imports of motor cars and motor cycles continued to decline after February 2001 following the removal of the partial duty waiver granted to public sector employees. During 2000, 11,767 cars were imported under the duty concession while only 1,206 were imported in 2001. Imports of radio receivers and television sets declined by 20 per cent in 2001, while the import of rubber tyres and tubes declined by 28 per cent. Imports of medical and pharmaceutical products declined marginally. Other consumer durables imports which decreased in 2001 were fibre glass, paper and paper board, footwear, cartons and boxes, toys, padlocks and locks and ceramic sinks. All these items were subject to the surcharge of 40 per cent on import duties from 21 February 2001.

Intermediate Goods

The value of imports of intermediate goods declined by 12 per cent in 2001 due to lower prices of petroleum products, textiles, diamonds and other intermediate goods. Prices of crude oil declined gradually and were relatively low during the last quarter of 2001 compared with the pervious year. The volume of crude oil imports declined from 17.3 million barrels in 2000 to 14.4 million barrels in 2001, due to the routine closure of the petroleum refinery for about five weeks in 2001. The average price of crude oil declined from US dollars 28.77 per barrel to US dollars 24.47 per barrel (15 per cent) between these two years. Despite the higher import of refined products to meet domestic requirements, lower prices reduced the cost of these imports by 6 per cent. Consequently, the total cost of petroleum products declined by 19 per cent. However, intermediate goods imports excluding petroleum products, declined by 10 per cent responding to negative growth in the industrial sector.

Textile imports accounted for 40 per cent of intermediate goods imports in 2001. In line with lower demand for garment exports, the quantity of textile imports declined till August 2001 and increased gradually thereafter, indicating potential improvements in future garment exports. However, expenditure on textiles imports declined by 10 per cent due to lower international prices. Diamond imports too declined by 10 per cent reflecting the depressed world market for diamonds. Other intermediate goods imports declined by 10 per cent, marked by lower imports of inputs for soap, garments, chemicals and rubber based manufacturing industries. Imports of edible oils declined considerably due to the imposition of the surcharge on these items from 17 July 2000.

Investment Goods

Imports of investment goods declined by 38 per cent in 2001. When adjusted for the import of three aircraft in 2000, investment goods imports declined by 25 per cent in

2001. Imports of transport equipment (excluding aircraft) and machinery and equipment (excluding a high cost power generator worth US dollar 84 million imported in 2000) dropped by 44 per cent and 13 per cent, respectively, in 2001. Imports of building materials declined by 18 per cent despite expanding construction activities. Import duty on cement was reduced on 12 October 2001. Imports of other major investment goods too declined due to a decline in investment activity.

TABLE 9.5

Volume of Major Imports (a)

'000 mt

Item	1997	1998	1999	2000	2001(b)
Rice	306	168	214	15	52
1st Quarter	104	136	24	7	3
2nd Quarter	9	12	12	7	7
3rd Quarter	12	2	31	...	2
4th Quarter	181	18	146	1	40
Wheat	789	880	859	922	760
1st Quarter	302	340	207	266	231
2nd Quarter	172	155	263	210	229
3rd Quarter	168	126	189	247	177
4th Quarter	147	259	200	199	123
Sugar	545	444	479	562	420
1st Quarter	176	79	152	128	100
2nd Quarter	163	129	64	185	127
3rd Quarter	83	99	138	85	109
4th Quarter	123	137	125	164	84
Petroleum (Crude oil)	1,814	2,156	1,832	2,347	1,954
1st Quarter	299	567	244	608	237
2nd Quarter	389	431	503	583	539
3rd Quarter	606	662	548	613	624
4th Quarter	520	496	537	543	554
Fertiliser	391	440	539	559	460
1st Quarter	56	109	97	149	66
2nd Quarter	87	98	158	102	183
3rd Quarter	87	82	129	174	83
4th Quarter	161	151	155	134	128

(a) Adjusted
(b) Provisional

Sources: Sri Lanka Customs
Co-operative Wholesale Establishment
Ceylon Petroleum Corporation
Prima Ceylon Ltd.

Direction of Trade

Industrialised countries continued to be the main destinations of Sri Lankan exports in 2001. However, the market share of these countries declined from 77 per cent in 2000 to 75 per cent in 2001. The share of developing countries increased from 20 per cent to 21 per cent while the share of Eastern European countries too rose from 3 per cent to 4 per cent. Developing countries, the major origins of Sri Lanka's imports, secured 67 per cent of the Sri Lankan market while industrial countries shared 33 per cent. Comparable market shares of developing countries and developed countries were 64 per cent and 36 per cent, respectively, in 2000. European countries in transition accounted for a negligible share of 0.2 per cent in 2001.

Countries in the South Asian Association for Regional Co-operation (SAARC) accounted for 3 per cent of the total exports and 13 per cent of total imports. In the SAARC region, India was Sri Lanka's largest export destination (2 per cent of total exports) and the largest country of import origin (11 per cent of total imports). The EU accounted for 27 per cent of total exports and 16 per cent of total imports in 2001. In EU, UK was the most important export destination (share of 12 per cent) and country of import origin (share of 4 per cent). Exports to CIS countries increased by 28 per cent with higher tea exports to Russia. The CIS countries accounted for 4 per cent of Sri Lanka's export market.

USA has continued to be the largest single buyer of Sri Lanka's exports since 1979. The market share of USA (41 per cent) remained unchanged in 2001. However, the value of exports to USA declined by 12 per cent in 2001. Textiles and garment exports accounted for 78 per cent of total exports to the USA. However, garment exports to USA declined by 11 per cent in 2001. UK, the second largest buyer, recorded a share of 12 per cent, followed by Germany and the Netherlands (4 per cent each). Garments and tea accounted for 78 per cent and 3 per cent of goods exported to UK, respectively. Japan was one of Sri Lanka's major markets for crustaceans, machinery parts and accessories, tea, fish products and precious stones. Out of the total exports to Germany, garments and tea accounted for 39 per cent and 6 per cent, respectively. Accordingly, western industrial countries as a group continued to be Sri Lanka's largest trading partner in 2001.

Once again, India was the largest single exporter to Sri Lanka (11 per cent), while Hong Kong (9 per cent) and Singapore (8 per cent) became the second and the third largest exporters to Sri Lanka in 2001 overtaking Japan (6 per cent). Imports from Japan declined by 48 per cent attributable to a substantial drop in motor vehicle imports in 2001. Imports from Hong Kong (decline of 3 per cent) and Singapore (decline of 17 per cent) also declined in 2001. Imports from India increased marginally by 0.2 per cent in 2001. Pharmaceuticals, food items such as lentils, chillies and big onions, auto trishaws and textiles were among the major items imported from India. Fabrics and accessories for the garment industry were the major items imported from Hong Kong. Petroleum gases, sewing machines, telephone equipment and data processing machines and parts were among the major items imported from Singapore. Other major exporters to Sri Lanka were the Republic of Korea and Taiwan (6 per cent each) and USA and the UK (4 per cent each). Accordingly, Asian countries, as a group, continued to be the main origin of Sri Lanka's imports increasing their market share from 53 per cent in 2000 to 56 per cent in 2001. However, in absolute value terms, imports from Asian countries declined by 9.5 per cent, as a result of lower imports from the East Asian countries.

9.4 Services and Income

The surplus in the services account was boosted by an inflow of US dollars 90 million to SriLankan Airlines as insurance payments for the aircraft destroyed in the LTTE attack on the Katunayake International Airport in July 2001. Excluding this extraordinary inflow, the surplus in the services account dropped by about 50 per cent in 2001. This was mainly the result of a sharp decrease in receipts from tourism after the July attack, further aggravated by the September 11 attack on several strategic places in the US. Receipts from tourism, which recovered strongly during the first half of the year with a growth of 11 per cent, declined by 44 per cent during the second half to drop by 15.5 per cent during the year. Meanwhile, despite an increase of 2.5 per cent in transshipment cargo handling, transportation service receipts declined by 2 per cent, as the volume of international trade fell. Transportation service payments declined by 9 per cent. Net telecommunication service payments increased as receipts declined at a higher rate than payments.

TABLE 9.6

Net Services, Income and Transfers (a)

Item	US dollars Million		Rs. Million	
	2000	2001(b)	2000	2001(b)
1. Transportation	69	90	5,237	7,922
2. Travel	8	-32	553	-3,022
3. Telecommnication Services	-1	-5	-127	-457
4. Insurance Services (c)	19	109	1,438	9,773
5. Other Business Services	-50	-49	-3,714	-4,322
6. Government Expenditure n.i.e.	-6	-4	-479	-380
Total Services	**38**	**108**	**2,907**	**9,514**
1. Compensation of Employees	-2	-2	-159	-186
2. Direct Investment	-108	-102	-8,194	-9,119
3. Interest and other charges (d)	-194	-176	-14,656	-15,706
Total Income	**-305**	**-280**	**-23,009**	**-25,011**
1. Private (e)	974	936	73,620	83,716
2. General Government	24	22	1,801	1,925
Total Current Transfers	**998**	**959**	**75,421**	**85,641**

Source: Central Bank of Sri Lanka.

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

(b) Provisional

(c) Services receipts in 2001 include US dollars 382.4 mn. received by SriLankan Airlines as insurance claims for the aircraft destroyed by the attack on the airport in July 2001, while Services payments in 2001 include US dollars 292.8 mn. paid to the lessors of the aircraft. The net receipt of these insurance claims was US dollars 89.6 mn..

(d) From 1994 onwards Foreign Currency Banking Units (FCBUs) of commercial banks have been treated as a part of the domestic banking system in the compilation of balance of payments statistics. Accordingly, transactions involving FCBUs and non-residents are taken into account in the compilation of balance of payments statistics, while those involving FCBUs and residents are excluded.

(e) Includes US dollars 45 mn. received in 2000 as compensation of US dollars 2,500 per person to 29,323 Sri Lankans, who lost employment in Kuwait due to the Gulf War in 1990.

The deficit in the income account narrowed by 8 per cent in 2001 owing to a larger drop in gross interest payments than in interest income. The sharp drop in global interest rates reduced interest payments by US dollars 79 million (24 per cent), while interest income on external assets declined by US dollars 60 million (44 per cent) during the year. The drop in global interest rates helped reduce interest payments only partially, as Sri Lanka's external debt comprises mostly of concessional loans, generally with more or less a fixed low interest rate. In contrast, the drop in interest rates was fully reflected in the reduced interest income on external assets.

9.5 Current Transfers

Total net current transfers dropped by 4 per cent during the year owing to declines in current official transfers as well as current private transfers. The latter was the result of the completion of compensation payments in 2000 to Sri Lankan workers who were displaced during the Gulf War. Private transfer receipts, excluding these payments in 2000, reflected an increase of 1 per cent, a sharp moderation from the previous year's 18 per cent growth. This decrease is attributed to the drop in income in oil exporting countries because of lower oil prices during the year and the political uncertainty in the West Asian region in the aftermath of the September 11 attacks on the US, and the war in Afghanistan. Private transfer receipts, at US dollar 1,125 million in 2001, the second largest foreign exchange earner after net garment exports, were sufficient to cover almost the entirety of the deficit in the trade account and 85 per cent of the deficit in the goods, services and income accounts.

9.6 Capital Movements

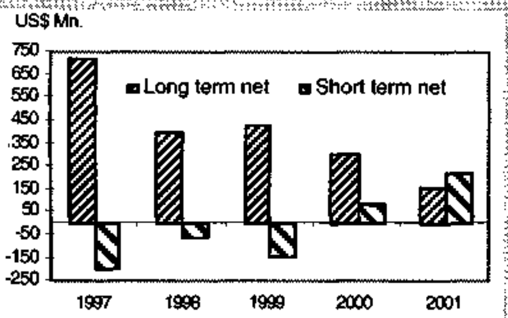
During the year, net capital transfers declined marginally, reflecting a drop in official capital transfers. The flow of private capital to emerging market economies increased during the year, but was concentrated in a few countries including China. The flow of private capital to other emerging market economies suffered a set-back, particularly after the September 11 attack on the US. International investors became cautious, resulting in an increase in the risk premia factored into bond issues by emerging market economies, especially those with security concerns. These adverse developments compelled the postponement of the intended borrowing of US dollars 200 million in international markets. The unfavourable external environment also led to a further delay in the sale of an additional stake in Sri Lanka Telecom in 2001.

Net capital and financial flows improved in 2001 mainly due to higher loan capital to the government, though less than expected in Budget 2001, and a sharp increase in short-term capital flows mainly due to a drop in net foreign assets of commercial banks. As a result, the overall balance in the balance of payments registered a surplus of US dollars 220 million in 2001, in comparison to a deficit of US dollars 522 million registered in 2000.

Long-Term Capital

Net private capital flows to Sri Lanka declined sharply from an inflow of US dollars 82 million in 2000 to an out-flow of US dollars 257 million.[1] Long-term borrowing by the private sector and public corporations dropped and Foreign Direct Investments (FDI) declined sharply.

Chart 9.5
Capital Flows



Notes :

(a) With the change in classification from BPM4 to BPM5 format, private and government capital transfers are classified as long term capital flows, which were previously included in the current account, and changes in assets and liabilities of commercial banks are classified as short term capital flows, which were previously included in the monetary sector.

(b) Beginning 1994, Foreign Currency Banking Units (FCBUs) have been treated as part of the domestic banking system.

Long term capital flows to the private sector and public corporations fell short of expectations as only a few public corporations and private sector institutions utilised foreign capital for investment. Many private sector institutions resorted to a wait and see approach as investor confidence was low. As the demand for credit in the domestic market was growing at a slow pace, some of the development financial institutions postponed their borrowing plans in international markets. Long term capital flows to the private sector and public corporations consisted mainly of loans received for the AES Kelanitissa Power Project (US dollars 15 million), long term trade credits received by BOI firms (US dollars 15 million), loans to Ceylon Petroleum Corporation (CPC) for its Muthurajawela Oil Tank Farm Project (US dollar 10 million) and the long-term trade credits received under the Indian Line of Credit (US dollars 2.6 million). The use of credit by the CPC under the Muthurajawela Oil Tank Farm Project was limited because of a delay in project implementation, while the use of credit under the Indian Line of Credit was slow due to administrative complexities. The latter, in particular, highlights the need for institutional development and better co-ordination and understanding (among those directly involved on both sides), for the effective translation of good political intentions into practically workable strategies.

Meanwhile, FDI flows to Sri Lanka faced a major setback in 2001 due to a host of factors including adverse external environment, security concerns and the uncertain political environment, particularly during the latter part of the year. Gross FDI inflows, at US dollars 82 million, reflected a drop of 52 per cent in 2001. In the fourth quarter the inflow was no more than US dollars 2 million. The inflow of FDI was mainly for power (27 per cent), textiles, wearing apparel and leather products (22 per cent), chemicals (21 per cent) and communications (12 per cent). The textile and garments sector continued to attract a major share of foreign direct investment flows to the country. As highlighted before, this sector is vulnerable to external shocks. The continued encouragement of foreign investment in the apparel sector could make matters worse in the years to come, particularly with the phasing out of the MFA in 2005. Moreover, unless Sri Lanka progresses from being an apparel exporter, to focus on the fast growing sectors, in particular, information technology sector and manufacturing, it may be difficult to move to a sustainable higher growth path. As such, it is desirable to re-examine the country's investment promotion policy to maximize capital inflows and diversify investments into sectors that will bring faster economic growth in a competitive global environment while strengthening the resilience of the economy.

Privatisation receipts amounted to US dollars 90 million in 2001, with the change in status of the Prima flour mill agreement from Build, Own and Transfer (BOT) to Build, Own and Operate (BOO) for US dollars 65 million, and the receipt of US dollars 25 million, being the balance of privatisation proceeds of SriLankan Airlines. In comparison, proceeds from privatisation in 2000 amounted to only US dollars 3 million. The expected sale of an additional stake in Sri Lanka Telecom did not materialise during the year, as the external environment, particularly in respect of the telecommunications sector, was not favourable.

Long-term loan capital inflows to the government increased by 20 per cent, mainly due to long-term suppliers' credit for security related imports. Excluding these suppliers' credit, capital flows to the government increased only marginally. The adverse external environment, which caused a general decrease in official development assistance

1. The remaining capital value of the two aircraft (US dollars 148 million) destroyed by the LTTE attack on the airport, which were under lease financing has been amortized (reflected as a capital repayment under private long term borrowing), while a counter adjustment has been made in capital transfers so that the net effect on the capital and financial account is zero.

Box 11

Prospects for Capital Account Liberalisation in Sri Lanka

Capital account liberalisation allows free movement of capital between countries. This provides more investment opportunities for investors in countries where savings exceed investment enabling them to earn a higher rate of return on their investments. Conversely, this process fills the investment-savings gap of countries where domestic savings are not sufficient to finance all the investment required to achieve the desired rate of economic development. If this process operates according to the principles of market forces, both parties, i.e., the investor country and investment recipient country, would be better off. In order to exploit the advantages of this process, resource poor countries should build up confidence in investors that their investment would generate a higher risk adjusted rate of return. This basic principle explains to a large extent why some of the countries in East Asia had been able to attract steady and continuous flows of foreign savings over long periods of time before the recent crisis and achieve "miracle" growth, while most African countries still depend on official development assistance from developed countries and inter-governmental institutions. Most of these countries also allowed free movement of capital, which boosted investor confidence. In fact, with the rapid economic development in these countries over a long period, some of them gradually became net capital providers from being net capital recipients.

However, a liberalised capital account also implies that capital can flow out, as quickly as it flows in and therefore confidence in the system is vital. During the East Asian Crisis, the worst hit countries such as Indonesia, Thailand, Malaysia and South Korea experienced huge capital outflows within a short time period. However, some countries such as Singapore, Hong Kong and Taiwan weathered the crisis fairly well. It has been argued that the differences in their responses to the crisis are largely attributed to differences in the degree of soundness of the financial system. Strong investor confidence, which attracted large capital inflows, was common to all countries in the region. However, the financial systems of some of the countries were not sound and adequately regulated. Capital inflows moved into unprofitable speculative activities such as real estate causing asset price bubbles. These countries were most affected by the crisis. In these countries, liberalisation of the domestic financial sector was not complemented with adequately strong prudential regulation and supervision, permitting in an increase in weak financial institutions. These institutions received mostly short-term capital, which very often financed long-term investments. Their earnings were in domestic currencies. Consequently there was a currency mismatch. When the flows reversed swiftly as investors lost confidence at the height of speculative attacks on the currencies, the institutions collapsed, causing much damage to the financial sector.

Another cause for the crisis in the region was the maintenance of intermediate exchange rate regimes with fully open capital accounts. The maintenance of exchange rate pegs which were practically fixed, and the use of interest rates to achieve price stability encouraged the influx of short term foreign capital to exploit the advantage of high interest rate differentials. When the pegged exchange rate regimes became unsustainable, currencies were subject to speculative attacks. At the height of speculative attacks, capital inflows were suddenly reversed, a currency crisis and recession followed.

The experience of the recent crises has taught several lessons to both capital providers and capital recipients. Capital providers are now more cautious about their investment decisions. Investor sentiment has changed and countries with unstable macroeconomic and political fundamentals are unlikely to attract foreign capital. Opening up the capital account in such countries is fraught with the danger of large capital outflows. Developing countries that are planning to open up their capital account with the intention of attracting foreign capital would need to fulfill certain preconditions to liberalisation. Even multilateral institutions such as the IMF that were advocates of fully open capital accounts now recognise the need for a more cautious approach.

Macroeconomic stability has been prescribed as the first precondition. A competitive and efficient financial system is the second. Both banks and non-bank financial institutions should be subjected to prudential regulation and supervision to avoid the emergence of weak financial institutions in a more liberalised environment. Financial institutions should improve their risk management. At the same time, the development of domestic capital and money markets should be undertaken. The crises highlighted the risks involved in the over-dependence on the banking sector for intermediating funds. It has also been suggested that restrictions on long-term capital flows be liberalised ahead of short-term flows. As capital account

Box 11 *(Contd.)*

liberalisation progresses, greater exchange rate flexibility is preferred to temper capital inflows that seek to exploit interest rate differentials.

Prospects for Sri Lanka

With proper sequencing of reforms, Sri Lanka can also benefit from an open capital account. In Sri Lanka, the capital account has been partially liberalised. With the introduction of the economic liberalisation process in 1977, a gradual process of partial liberalisation of the capital account was started in 1978 with commercial banks being permitted to maintain Non Resident Foreign Currency (NRFC) accounts. The establishment of Foreign Currency Banking Units (FCBUs) which were permitted to extend loans and advances to any non-resident or approved resident enterprise such as BOI companies was a further step in the process. Thereafter the process of capital account liberalisation slowed down.

The second phase of the process introduced in the early 1990s achieved a faster progress of capital account liberalisation. The major developments were:

(a) In 1990, foreign investors were permitted to increase their investments in shares in listed companies from 40 per cent of the issued share capital up to 100 per cent, subject to exclusions, limitations and conditions set out by the Controller of Exchange. The 100 per cent transfer tax on share purchases by foreign investors was abolished.

(b) In 1990, commercial banks were permitted to open and operate Share Investment External Rupee Accounts (SIERA) for foreign investors to facilitate investment in the Colombo Stock Exchange.

(c) In 1994, the repatriation and surrender requirements in respect of export proceeds were abolished.

(d) In 1995, commercial banks were permitted to obtain foreign loans up to 15 per cent of their capital and reserves.

(e) In 1996, permission was also granted to private sector firms to undertake investments more freely in foreign countries on a case by case approval basis.

(f) In 2001, non-residents were permitted to invest in dollar denominated government securities.

(g) The budget 2002 proposed to relax most restrictions on FDI inflows subject to rules of the relevant regulatory authorities.

Regulations on capital flows are still maintained only in the following major areas in Sri Lanka.

1. Non resident investments in fixed income securities issued by the private sector such as corporate debentures.
2. Short term and long-term private borrowings from abroad.
3. Investment abroad by residents.

Full liberalisation of the capital account would be the logical conclusion to the liberalisation process, which commenced in 1977. However, recent experience and crises have demonstrated very clearly, the importance of moving towards this objective with caution. Therefore, a steady process towards liberalisation of capital account is needed to reap the full benefits of the liberalisation while taking precautionary measures to avoid any adverse impacts from volatile international capital flows. In a crisis situation, countries have the right to impose necessary controls to avoid any adverse impacts. Malaysia imposed selected controls to reduce destabilising effects of volatile short-tem capital movements during the crisis. IMF's Article VI of the Articles of Agreement also allows member countries to regulate international capital movements without imposing restrictions on the current account. Therefore, any further liberalisation of the capital account does not imply that restrictions cannot be re-imposed, if necessary. Under a fully liberalised current account, restrictions on capital outflows are less effective. The existing restrictions are likely to reduce potential inflows as international investors are reluctant to invest if there are restrictions on outflows.

Full liberalisation of the capital account may provide market incentives for the development of the domestic financial sector and discipline in macroeconomic management. Weak domestic financial institutions would not be able to face the competition subsequent to opening up the capital account. Domestic interest rates cannot be allowed to rise substantially. They provide market discipline for the implementation of both fiscal and monetary policies. Therefore, a proper sequencing of the liberalisation of capital account should provide time sufficient for domestic financial institutions to adapt and brace themselves for the more competitive and liberalised environment. It would also

Box 11 *(Contd.)*

provide a market discipline for a greater fiscal stability, which is required prior to the liberalisation of the capital account.

In sequencing the relaxation of existing controls, first the existing limitations on inward foreign direct investments may be removed while developing necessary regulatory systems in some sectors. Secondly, the private sector may be allowed to borrow long-term from international capital markets on the basis of their credit worthiness and non-residents may be allowed to invest in fixed income securities such as corporate debentures. Finally, investment abroad by residents and short-term borrowings could be liberalised. The sequencing should provide sufficient time for the domestic financial sector to prepare for a more competitive and liberalised environment. Prior to the opening up of the capital account for short-term flows, political and macroeconomic stability is desirable. In this context, a credible fiscal sustainability programme has to be implemented to reduce macroeconomic imbalances. Meantime, authorities must continue their efforts to strengthen the financial sector regulations and supervisory systems and develop sophisticated systems to monitor capital flows.

(ODA) to developing countries, the uncertain political environment that prevailed during the second half of the year, and delays in project implementation due to institutional weaknesses and administrative complexities are the factors contributing to slow growth in capital flows to the government. Institutional weaknesses and administrative complexities have become a major obstacle to the effective utilisation of foreign concessional assistance, underscoring the necessity of urgent corrective measures.

On numerous occasions these bottlenecks have been the cause of cancelling foreign funded projects. Addressing these issues is vital for the effective utilisation of concessional foreign assistance, particularly at a time when the resources available on concessional terms and conditions are shrinking. Sri Lanka, with its relatively high per capita income and favourable socio-economic indicators in comparison with other developing countries, no more qualifies for purely concessional financing under IDA lending or from ADB. It is essential to streamline aid utilisation procedures if debt service payments are to be kept at sustainable levels. It may be useful to implement a post evaluation process to ensure that foreign funds are used effectively and productively. Such a system would also facilitate future project identification and resources allocation.

The majority of the resources received by the government were for power generation, telecommunications, education, infrastructure development, irrigation, small and medium scale industries, and private sector development. Major projects financed by multilateral agencies during the year included the Private Sector Development Project (US dollars 25.9 million), the Urban Development and Low Income Housing Sector (US dollars 13.5 million), the Second Power System Expansion Project (US dollars 8.3 million) funded by the Asian Development Bank (ADB), and the Second General Education Project (US dollars 11.9 million) financed by the International Development Association (IDA). Projects funded by Japan included the Kelanitissa Combined Cycle Power Plant (US dollars 58.6 million), the Regional Telecommunications Development Project (US dollars 24 million), the Kukule Ganga Hydroelectric Power Project (US dollars 23.2 million), the Small and Micro Industry Leader and Entrepreneur Project (US dollars 22.7 million), the Baseline Road Project (US dollars 22.4 million), and the Telecommunications Network Expansion Project in Colombo (US dollars 12.9 million).

ADB and IDA continued to be the major multilateral donor agencies in 2001. The total disbursements by ADB and IDA during 2001 were US dollars 93 million and US dollars 40 million, respectively. Japan provided US dollars 223 million in project aid during 2001, maintaining its position as the largest bilateral donor. Japan's contribution for Sri Lanka's external financing accounted for 53 per cent of total concessional aid, while ADB and IDA accounted for 22 per cent and 9 per cent, respectively, during the year.

Short-Term Capital

A sharp increase in net short-term capital was seen in 2001. This was mainly a reflection of a drop in foreign assets of commercial banks by US dollars 183 million and an increase in foreign liabilities by US dollars 71 million, a drop of US dollars 254 million in net foreign assets of commercial banks. The purchase of US dollars 155 million worth of dollar denominated Sri Lanka Development Bonds using their own foreign assets and borrowings from abroad, and foreign currency lending by FCBUs to the government, contributed to the drop in net foreign assets of commercial banks.

Meanwhile, private short-term trade credits indicated a net outflow, reflecting the sharp drop in imports during the year. The outflow from the Colombo Stock Market continued, albeit at slower pace than in the previous year, as both economic and political uncertainties gathered momentum, and corporate profits declined. Foreign investors also tended to capitalise on the temporary upward movements in the market by profit taking, particularly after the general election held on 5 December.

9.7 Foreign Exchange Market Developments

With the subdued inflationary pressures worldwide in the wake of the global economic slowdown, international foreign exchange markets, in general, remained relatively stable throughout the year, although, some volatility in key international currencies was seen. Despite the sharp economic slowdown in the United States, the dollar strengthened against all major currencies during 2001, as the most sought after reserve currency in the world. The Japanese yen was subject to some volatility throughout the year and depreciated by 12.6 per cent against the US dollar, reacting to mixed signals regarding the status of the already fragile economy and reforms in the banking sector. The euro, which depreciated at a fast rate in 2000, showed some stability with an annual deprecation of 4.9 per cent against the US dollar in 2001. The pound sterling depreciated by 2.8 per cent, while the Indian rupee weakened by 3.2 per cent. The Singapore dollar depreciated at a relatively faster rate of 6.3 per cent during the year in response to the sharp economic slowdown in that country. The Korean won and the Thai baht were more stable recording depreciations of 4.5 per cent and 1.8 per cent, respectively, against the US dollar. The Indonesian rupiah, and the Philippines peso, which were subject to high volatility in 2000, remained stable in 2001, with annual depreciation of 7.6 per cent and 3.1 per cent, respectively. The Malaysian ringgit remained fixed at 3.8 per US dollar during the year.

Independent Flotation of the Rupee

On 23 January 2001, the foreign exchange rate regime moved from a managed float to an independent float. In fact, Sri Lanka had moved from a fixed exchange rate system to a flexible exchange rate system in November 1977. From time to time, the exchange rate regime was liberalised, moving towards the ultimate goal of having an independently floating regime. A large balance of payments deficit and a heavy drain on official external reserves, particularly during the latter part of 2000, caused the Central Bank to float the rupee independently after a series of adjustments to the exchange rate band to release the market pressure. The change to an independently floating regime halted the drain of official reserves, greatly reduced market expectations of a large depreciation and helped to stabilise the exchange rate improving the market confidence. Had the Central Bank continued to resort to periodic adjustments to the exchange rate band instead of independent flotation, the country may well have further lost official reserves, with severe adverse implications on the stability of both the exchange and money markets. The stabilisation of the rupee within a relatively short period after the flotation eliminated public concerns of possible adverse effects on the rate of inflation.

Chart 9.6
Effective Exchange Rate Indices

Chart 9.6.1
Real Effective Exchange Rate Indices
(1995=100)

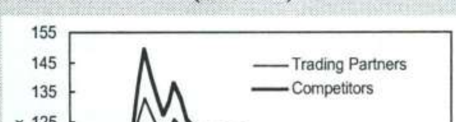


Chart 9.6.2
Nominal Efective Exchange Rate Indices
(1995=100)

Box 12

Foreign Exchange Forward Market in Sri Lanka

In foreign exchange forward are contracts two parties agree to buy or sell one currency against another currency and determine the price today for future delivery and payment. Forward prices[1] are usually determined by the cost of carrying the underlying asset, i.e. the cost that is incurred by the holders of underlying asset from the time of the transaction until maturity and the interest rate differential between two currencies that are exchanged. The difference between spot and forward rates represents interest rate differential plus a risk premium. The risk premium is determined by the uncertainty in the economy, the volatility in the foreign exchange market, swap cost, administration and transaction costs, whether the commercial bank has excess foreign exchange or is short, the amount of the contract and credibility of the customer.

There are, broadly, three general types of participants in a forward market:- hedgers, speculators and financial intermediaries. Hedgers buy and sell forwards to hedge the exchange rate risk. Speculators attempt to make profits by forecasting the future exchange rate. Financial intermediaries, especially commercial banks, engage in hedging and/or speculative activities, their major role being buying and selling forward contracts. Their profit is the spread between forward bid and forward asked prices.

Sri Lanka's forward market for foreign exchange is thin compared to its spot market. For example, the average monthly volume of forward transactions during the past five years was US dollars 69 million, which accounted to 25 per cent of the total forex transactions in the inter-bank foreign exchange market. The forward market was particularly inactive in the last quarter of 2000 and in the first half of 2001. The uncertainty in the foreign exchange market in the latter part of 2000 greatly reduced forward transactions. Similarly, the precautionary measures introduced with the flotation of the Rupee in January 2001, although provided stability to the foreign exchange market discouraged forward market activity. The relaxation of most of these precautionary measures subsequently activated operations and expanded forward market activity.

Total forward transactions was at its lowest in February 2001, when they amounted US dollar 2.78 million. With the restoration of stability through measures introduced by the CBSL, the forward market is now more active and the inter-bank forward transaction volume increased to US dollar 56 million in February 2002.

The forward market transactions indicated an excess demand in the latter part of 2000 and during the year 2001. This was evident by the higher volume of customer originated forward sales than the customer originated forward purchases. It also evident that most

1. Forward exchange rate can be calculated as follows;

$$F_t = S_t + v_t$$

Where $v_t = r_t + u_t$

F_t = forward exchange rate S_t = spot exchange rate

r = interest differential u = risk premium

TABLE - 1

Monthly, Average Foreign Exchange Transactions

(US dollars Million)

	January,1996 to September 2000		Before floating (Oct. -Dec. 2000)		After Floating (Jan. – June 2001)		After Removal / Relaxation of Precautionary Measures (After July 2001)	
Inter-bank total average - monthly transactions		269		171		138		134
Minimum	(Feb. 1996)	64	(Oct 2000)	115	(Apr. 2001)	118	(Dec. 2001)	105
Maximum	(Sep. 1997)	729	(Dec. 2000)	257	(Mar. 2001)	169	(Jul. 2001)	179
Forward transactions		72		18		12		38
Minimum	(Jan. 1999)	18	(Oct. 2000)	13	(Feb. 2001)	3	(Nov. 2001)	17
Maximum	(Dec. 1997)	223	(Nov. 2000)	24	(Mar. 2001)	22	(Feb. 2002)	56
Forward as a percentage of total transactions (%)		25.9		11.8		8.8		28.9
Commercial banks' forward purchases from exporters		n.a.		n.a.		5.4		10.8
Commercial banks' forward sales to importers		n.a.		n.a.		13.7		18.9

Source: Central Bank of Sri Lanka

Box 12 *(Contd.)*

of the importers tried to cover their positions in anticipating of further depreciation of the Rupee.

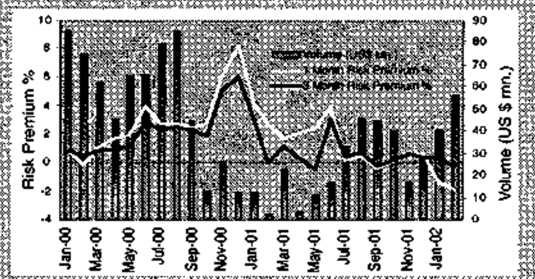
There is a direct negative relationship between the length of the maturity period and the uncertainty in forward transactions. In a system in which exchange rates are determined by market forces, the participants face difficulties in estimating the future spot rates when macroeconomic variables are unpredictable. In such situations, this preference is for shorter duration contracts. Immediately after the flotation of the Rupee, forward transactions for a period "less than one month" dominated in the forward market, while "one month" forward transactions decreased and "over three months" category became negligible.

Under the efficient market hypothesis, today's forward exchange rate should be equal to the spot exchange rate on the maturing day. Today's exchange rate already incorporates all the relevant information and the only reason the exchange rate would change between today and tomorrow is the receipt of news or unanticipated events taking place. If the difference between today's forward rate and tomorrow's spot rate were known, the unpredictable component of the forward premium would disappear. In a managed floating exchange rate regime, this difference would be narrower and the market would be able to predict the future spot rate more accurately, as spot rates would be adjusted by central banks to avoid significant volatility. Immediately after the flotation of the rupee, the unpredictable component of the forward rate became much larger and the difference between the one-month forward rate and the spot rate on the maturing day of the one-month forward transaction was positive, thereby indicating a higher depreciation of the exchange rate than expected at the time of the forward contract.

Theoretically, uncertainty in the foreign exchange market is positively related to the demand for forward contracts and negatively to the supply. Accordingly, the relationship between uncertainty and the volume of forward contracts depends on which forces dominate the market (i.e. supply or demand). The Sri Lankan experiences during the last one and half years has been in line with this theory. When uncertainty arises, the difference between the forward premium and the interest differential increases and the volume of forward transactions becomes smaller. It is evident that the foreign exchange forward market is dominated by suppliers and the supply side has become the crucial factor for the development of the market in Sri Lanka. Conversely, when uncertainty decreases, the premium depends mainly on the interest differential and the increase in the volume of forward transactions.

In the recent past though, the reverse had held true and the actual depreciation has been less than the implied depreciation on the forward rate. Under this situation, exporters may attempt to hedge their foreign exchange earnings and importers may opt not to cover their import bills through the forward market.

Chart I
Variation of Forward Risk Premium and Volume
(In the Inter-Bank market)



As the exposure limits were narrow and any uncovered position reduces the bank's ability to hold foreign exchange for essential needs including maintaining Nostro accounts, banks cannot afford to keep uncovered positions unless it is essential. Therefore, banks do not quote forward prices in the market unless they have covered spot or forward positions. The increase in the net open position, initially to 10 per cent of capital and reserves on March 2001 and subsequently to 15 per cent on March 2002 would have helped develop the forward market. Another prudential measure that restricted the activities of the forward market was the requirement of a fifty per cent rupee deposit to back the commercial bank's forward sales of foreign exchange to their customers. Although this restriction helped remove speculative forward dealings, it also discouraged forward contracts among participants in the foreign exchange market. The effect of the subsequent removal of the margin was clearly seen in the increase in forward transactions.

Information asymmetry in the forward market may also affect the forward rates in two ways. If customers do not know the forward market mechanism and the information that influences the forward prices, they may not be encouraged to cover their exchange rate risk on trade bills through the forward market. Large corporate customers are well aware of the price mechanism in the forward market, while medium and small-scale importers and exporters may not have access to the same information. On the other hand, if dealers do not

Box 12 *(Contd.)*

assimilate all available information, they may fail to calculate the forward premium accurately, resulting in losses. If the risk premium is highly variable, the forward premium will be a poor indicator of expected changes in the spot rate. Thus, increasing awareness among market participants is an important element in market development.

If market participants assimilate all available relevant information, such as inflation path, interest rate forecast, economic growth, balance of payments and foreign reserves they would be in a better position to predict future exchange rates more accurately. Information asymmetry in the forward market can thus be reduced by providing more information to the market, including information on forward buying and selling rates for customers quoted by commercial banks on a daily basis.

At present, exporters are not allowed to enter into swap contracts with commercial banks, where they borrow local currency against foreign exchange deposits of the bank. Permitting such transactions could encourage repatriation of export proceeds, and in turn would stimulate the forward market. This also could help to mitigate the short-term liquidity problem in the foreign exchange market and improve prudential asset management in the exporters' balance sheets. Further, speculators also play a major role as risk takers by entering forward contracts. Hence, limited speculative activity is also needed to develop foreign exchange markets.

The development of an active forward forex market would have a significant effect in reducing market volatility when large bills are presented. Given the thinness of Sri Lanka's market, large bills, if settled on a spot basis, would resulted in high volatility and could lead to instability in the market, whereas with a developed forward market, the requirement could be built up over a period of time, thus avoiding destabilising the market.

The processes and the techniques of the forward market are more complex than those of the spot market. If the market participants, including commercial bank foreign exchange dealers, have access to better knowledge of the processes and the techniques, they may be able to stimulate forward market activities. In this background, the relevant institutions could conduct training programmes and seminars to train their staff as well as the public and increase their awareness on the importance of forward markets and how they operate.

The forward market is an extremely important element in providing depth and stability to the foreign exchange market. Hence, developing this market is essential to create a stable foreign exchange market in the current environment of an independently floating exchange rate regime.

TABLE-2

Inter-Bank Foreign Exchange Transactions

US dollars Million

Month	Spot	Tom	Cash	SubTotal	Fwd.	Total	Fwd. as a %
Jan. 00	164.0	17.2	15.3	196.5	81.2	277.7	29.2
Feb-00	100.0	20.6	11.4	132.0	73.0	205.0	35.6
Mar-00	178.5	14.2	13.2	205.9	62.3	268.2	23.2
Apr-00	116.5	22.9	21.5	160.8	43.8	204.5	21.4
May-00	79.0	14.6	13.5	107.1	59.5	166.6	35.7
Jun-00	111.7	6.4	5.2	123.3	54.4	177.7	30.6
Jul-00	213.1	11.4	4.6	229.1	64.8	293.9	22.0
Aug-00	286.8	12.7	14.4	313.9	82.2	396.0	20.7
Sep-00	228.6	26.6	7.1	262.3	43.6	305.9	14.3
Oct-00	148.1	9.7	5.2	162.9	13.0	175.8	7.4
Nov-00	163.6	28.4	9.6	201.6	24.6	226.2	10.9
Dec-00	125.1	124.5	14.8	264.4	16.5	280.9	5.9
Jan-01	128.8	18.0	6.5	153.3	15.6	168.9	9.2
Feb-01	118.0	11.9	4.0	133.8	2.8	136.5	2.0
Mar-01	146.0	12.6	9.8	168.4	21.8	190.3	11.5
Apr-01	91.3	14.2	8.9	114.4	5.2	119.5	4.3
May-01	93.4	16.2	11.7	121.3	11.5	132.7	8.6
Jun-01	75.5	25.2	18.2	118.9	17.2	136.1	12.6
Jul-01	120.1	17.1	17.6	154.7	34.3	189.0	18.2
Aug-01	137.8	13.4	5.8	157.0	46.2	203.1	22.7
Sep-01	102.0	10.0	9.2	121.2	44.6	165.8	26.9
Oct-01	100.2	6.6	8.9	115.6	39.9	155.5	25.7
Nov-01	76.7	11.1	20.1	107.9	16.9	124.8	13.5
Dec-01	74.0	8.9	13.8	96.7	28.3	125.0	22.6
Jan-02	83.4	14.0	14.5	111.8	40.5	152.3	26.6
Feb-02	73.2	16.1	11.9	101.2	56.3	157.4	35.7

Source: Central Bank of Sri Lanka

As anticipated, the exchange rate overshot immediately after the flotation. However, the overshooting was much lower in magnitude and shorter in duration, than experienced in many other countries that floated their currencies.

In anticipation of the initial overshooting, the Central Bank introduced some precautionary measures in consultation with commercial banks and foreign exchange dealers with a view to maintaining stability in the exchange market. Commercial banks were required to limit the net open position on daily working balances in foreign exchange, to ensure settlement of export credit by exporters by using export proceeds within a given period, to limit their forward market operations only to trade related transactions, impose a deposit margin requirement on forward sales of foreign exchange and restrict pre-payment of import bills. These measures and intervention in the market on one or two occasions by the Central Bank established stability in the exchange market, while ensuring external competitiveness. These measures were intended to be of short-term duration and most of them have been either removed or relaxed with the gaining of experience by the market players under the new regime improving the stability in the foreign exchange market.

In this backdrop, the Sri Lanka rupee depreciated against all major currencies, except the yen, during 2001. It depreciated by 11.3 per cent against the US dollar, the intervention currency, and by 8.8 per cent and 6.7 per cent against the pound sterling and the euro, respectively, while appreciating against the yen by 1.5 per cent. The rupee also depreciated against the SDR, the composite unit of account by 7.9 per cent during the year; 5.5 per cent since 23 January 2001.

The nominal effective exchange rate of the Sri Lanka rupee against a five currency basket showed a depreciation of 7.1 per cent while against a twenty four currency basket, which includes both trading partners and competitor countries, it depreciated by 7.3 per cent. The real effective exchange rate against the five currency basket appreciated by 1.4 per cent, while against the twenty four currency basket it appreciated by 2.0 per cent during 2001. With a market determined exchange rate there was little change in the level of competitiveness during 2001.

Continued uncertainty in the foreign exchange market and the introduction of prudential regulations to contain excess volatility in the exchange market immediately after the flotation of the rupee in January 2001, discouraged forward transactions. The monthly average of forward transactions, which increased from US dollars 38 million in 1999 to US dollars 52 million in 2000, declined to US dollars 24 million in 2001. Monthly average forward transactions dropped sharply to US dollars 12 million during the first half of 2001. Forward market activity recovered somewhat after the removal of the deposit margin in July 2001. The premium for one month forward transactions remained high during the first half of 2001, on account of high interest rate differentials between the domestic short-term interest rates and international rates for the dollar (represented by six-month LIBOR) and the risk premium. The forward premium declined significantly after July in response to the relaxation in prudential regulations as well as lower interest rates during the second half of 2001. Reflecting the improved stability, the spread between the buying and selling rates of foreign exchange in the interbank and forward markets dropped significantly by the end of the year.

9.8 External Assets

Sri Lanka's total external assets and gross official reserves increased substantially during 2001, in contrast to a severe drain on reserves in 2000. The increase was the outcome of the reduced import demand, the drop in international prices of crude oil and other petroleum products, the use of IMF resources under a Stand-By Arrangement (SBA) and the independent flotation of the rupee. Significant purchases from the domestic forex market by the Central Bank and the issue of dollar denominated Sri Lanka Development Bonds were also instrumental in augmenting official reserves.

The drop in international prices of crude oil by 15 per cent saved approximately US dollars 170 million on oil imports during 2001. The independent flotation of the rupee, along with the introduction of fiscal measures (40 per cent surcharge and the suspension of the duty concessions for vehicle imports) and prudential measures, had a positive impact on the trade account, mainly through lower imports. The drawings under the Stand-By Arrangement with the IMF in April, amounting to US dollars 131 million, added to gross official reserves. While the independently floating exchange rate regime facilitated the purchase of foreign exchange by the Central Bank (US dollars 126 million on a net basis); the issue of dollar denominated Sri Lanka Development Bonds (SLDBs) raised US dollars 158 million during the year. The issue of SLDBs (except for US dollars 3 million invested by foreigners) did not have an impact on total reserves of the country as these transactions reflected only a shift in foreign exchange reserves from commercial banks to the Central Bank. It will improve the country's total external reserves only when banks off-load SLDBs to foreign investors.

Consequently, total gross external reserves of the country rose by 5 per cent to US dollars 2,238 million at the end of the year. This was the combined outcome of an increase in gross official reserves, consisting of foreign assets held by the Central Bank, and the government by 28 per cent to US dollars 1,338 million and a drop in gross

TABLE 9.7
Exchange Rate Movements

Currency	In Rupees per unit of Foreign Currency						Percentage Change Over Previous Year (a)			
	End of Year Rates			Annual Average			Point to Point		Annual Average	
	1999	2000	2001	1999	2000	2001	2000	2001	2000	2001
Deutsche Mark	37.09	39.23	42.07	38.39	35.76	40.90	-5.5	-6.7	7.4	-12.6
French Franc	11.06	11.70	12.54	11.45	10.66	12.19	-5.5	-6.7	7.4	-12.5
Indian Rupee	1.66	1.77	1.93	1.64	1.68	1.89	-6.4	-8.2	-2.6	-11.2
Japanese Yen	0.71	0.72	0.71	0.62	0.70	0.74	-2.0	1.5	-11.7	-5.4
Pound Sterling	116.72	123.23	135.06	113.91	114.78	128.66	-5.3	-8.8	-0.8	-10.8
US Dollar	72.12	82.65	93.16	70.39	75.78	89.36	-12.7	-11.3	-7.1	-15.2
SDR	98.87	107.69	116.97	96.25	99.90	113.75	-8.2	-7.9	-3.7	-12.2

Source: Central Bank of Sri Lanka.

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

Chart 9.7
Exchange Rate Movement - 2001

Chart 9.7.1
Exchange Rate 2001 - Rs./US$

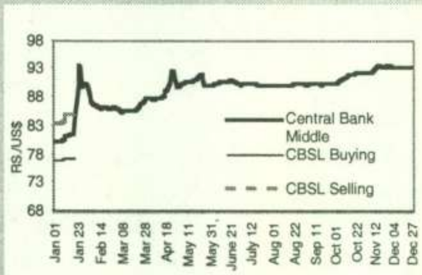


Chart 9.7.2
Inter Bank Forward Transactions-2001

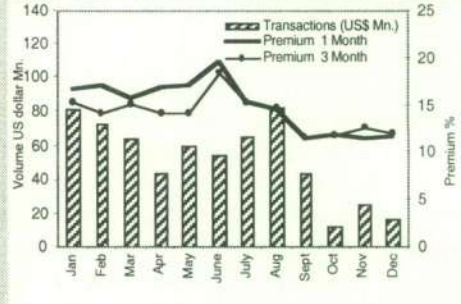
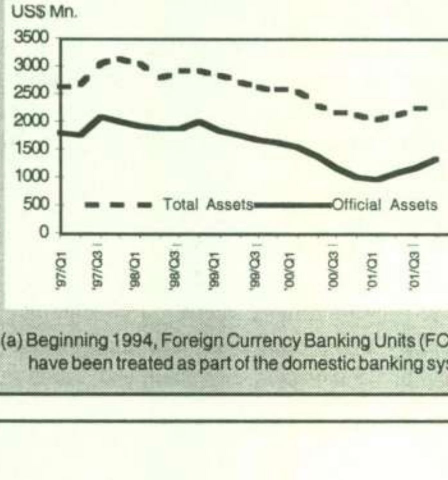


Chart 9.8
Quarterly External Assets (a)



(a) Beginning 1994, Foreign Currency Banking Units (FCBUs) have been treated as part of the domestic banking system.

external assets of commercial banks by 17 per cent to US dollars 900 million. The increase in foreign assets of the Central Bank was reflected in a build up of liquid balances held abroad and foreign securities holdings. The drop in foreign assets of commercial banks was reflected in deposits held abroad by domestic banking units.

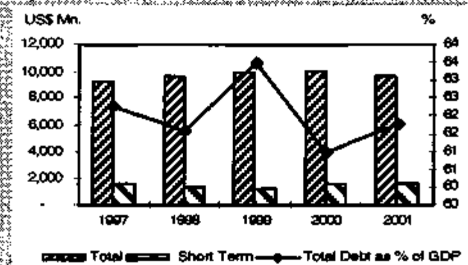
Foreign liabilities of commercial banks increased by 8 per cent to US dollars 1,009 million. As a result, net foreign assets of commercial banks declined by US dollars 254 million. Meanwhile, gross official liabilities increased by US dollars 70 million reflecting a net increase of US dollars 48 million to the IMF, and the contingent liability of the government on account of war risk insurance claims to the extent of US dollars 50 million. Consequently, the net official reserves increased by US dollars 220 million, which is reflected as a surplus in the overall balance in the balance of payments. The country's total gross reserves, at US dollars 2,238 million at the end of the year, indicated an improvement in the import coverage from 3.5 months to 4.5 months. Gross official reserves were sufficient to finance 2.7 months of imports in 2001, an increase from 1.7 months at end 2000.

9.9 External Debt

Sri Lanka's total external debt liabilities at the end of 2001 dropped by 5 per cent from that at end 2000. The drop was mainly accounted for by a decline in private sector debt by 24 per cent due to amortisation of the remaining capital value of the two aircraft destroyed by the LTTE attack at the Airport, and cross rate changes among major international currencies, in particular the depreciation of the yen by 12.6 per cent against the US dollar. Of the external total debt stock, about 30 per cent was yen denominated and the depreciation of the yen alone resulted in a reduction of about US dollars 100 million in external debt.

Medium and long-term debt consisted of 81 per cent of concessional debt and 19 per cent of non-concessional debt, including trade credit. Central government debt, which accounted for 85 per cent of the total medium and long-term debt stock, decreased by 3 per cent over 2000. This was the outcome of a reduction in concessional debt of the central government by 3 per cent and an increase in commercial debt by 10 per cent, due to an increase in defence related trade credit. Meanwhile, government guaranteed debt of public corporations and the private sector declined by 28 per cent, mainly due to a technical amortisation of the debt of SriLankan Airlines (US dollars 148 million) on account of the remaining capital value of the two aircraft destroyed in July 2001. External debt of public corporations and the private sector, not guaranteed by government, declined by 11 per cent. Meanwhile, liabilities to the IMF increased by US dollars 48 million, reflecting the purchase of SDR 103 million (US dollars 131 million) under the Stand-By Arrangement in April, and repayments on account of borrowings under the Structural Adjustment Facility (SAF) and the Enhance Structural Adjustment Facility (ESAF).

Chart 9.9
External Debt (a)



(a) Beginning 1994 Foreign Currency Banking Units (FCBUs) have been treated as part of the domestic banking system

The short-term debt stock of the country, at US dollars 557 million at end 2001, was lower by 3 per cent. This was because trade credit utilised by the private sector fell as imports declined sharply during the year. The share of short-term debt in the total debt stock remained unchanged at around 6 per cent. Short-term debt as a percentage of official reserves declined from 54.8 per cent to 41.6 per cent at the end of the year reflecting an improvement in a major external sector vulnerability indicator. The total debt to GDP ratio increased from 54.5 per cent in 2000 to 54.7

TABLE 9.8
External Assets of Sri Lanka

Ownership	US dollars Million (a)					Rupees Million (a)				
	1997	1998	1999	2000	2001	1997	1998	1999	2000	2001
1. Government (b)	19	20	20	22	78	1,192	1,372	1,441	1,767	7,302
2. Government Agencies	-	-	-	-	-	-	-	-	-	-
3. Central Bank (c)	2,009	1,964	1,619	1,026	1,260	123,093	132,900	116,571	81,819	117,365
4. Total Official Assets	2,029	1,984	1,639	1,049	1,338	124,286	134,272	118,013	83,585	124,668
5. Commercial Banks (d)	1,103	923	942	1,083	900	67,596	62,561	67,946	86,682	83,815
6. Total External Assets	3,132	2,907	2,582	2,131	2,238	191,881	196,833	185,958	170,268	208,482
7. Gross Official Assets in Months of										
7.1 Merchandise Imports	4.2	4.0	3.3	1.7	2.7					
7.2 Import of Goods and Services	3.7	3.6	2.9	1.5	2.3					
8. Total Assets in Months of										
8.1 Merchandise Imports	6.4	5.9	5.2	3.5	4.5					
8.2 Import of Goods and Services	5.7	5.2	4.6	3.1	3.8					

Source: Central Bank of Sri Lanka.

(a) Converted at the following end year rates except for certain items in the International Reserve of the Central Bank which were converted at the representative rate agreed with the IMF

Year	1997	1998	1999	2000	2001
Rs. per US dollar	61.29	67.78	72.12	80.06	93.16

(b) Figures since 1985 have been revised to include the DST's Special Revolving Credit Balances

(c) Figures since 1993 have been revised to include foreign currency deposits of commercial banks maintained with the Central Bank as reserve requirement on their foreign currency deposits.

(d) From 1994 onwards Foreign Currency Banking Units (FCBUs) of commercial banks have been treated as a part of the domestic banking system in the compilation of balance of payments statistics. Accordingly, transactions involving FCBUs and non-residents are taken into account in the compilation of balance of payments statistics, while those involving FCBUs and residents are excluded.

per cent in 2001 because of the decrease in gross domestic product in US dollar terms.

9.10 Debt Service Payments

Total debt service payments, consisting of both amortisation of long-term and medium-term debt and interest payments on all foreign debt, declined by 15 per cent during the year due to a reduction in amortization of medium and long-term debt by 10 per cent and in interest payments by 24 per cent during the year.

The bulk of the amortisation payments (58 per cent) was on account of government debt, a major part of it (64 per cent) being on concessional terms and conditions. Total debt service payments by the government, at US dollars 449

TABLE 9.9

Outstanding External Debt and Banking Sector External Liabilities (a)

Item	US dollars Million					Rupees Million				
	1997	1998	1999	2000	2001(b)	1997	1998	1999	2000	2001(b)
1. Medium and Long-term Debt	7,719	8,264	8,613	8,456	8,009	473,043	557,530	620,274	676,045	746,122
1.1 Government (c)	6,346	6,902	7,125	6,989	6,808	388,925	467,798	513,785	559,544	634,255
1.2 Public Corporations and Private Sector with Government Guarantee (c)	670	718	944	1,028	744	41,061	48,673	68,105	82,302	69,310
1.3 Public Corporations and Private Sector without Government Guarantee (c)	270	277	286	278	248	16,521	18,789	20,618	22,257	23,094
1.4 IMF Drawings	433	367	258	161	209	26,536	22,271	17,766	11,943	19,463
2. Short-term Debt	478	484	475	575	557	29,323	32,833	34,240	46,034	51,876
2.1 Government	-	-	-	-	-	-	-	-	-	-
2.2 Other(CPC and other trade credit) (c),(d)	478	484	475	575	557	29,323	32,833	34,240	46,034	51,876
3. Banking Sector External Liabilities (e)	1,202	958	885	1,076	1,119	73,638	64,926	63,838	86,132	104,201
3.1 Central Bank	1	...	...	...	2	65	24	7	33	172
3.2 Commercial Bank	1,094	865	765	938	1,009	67,030	58,656	55,142	75,101	94,030
3.3 ACU Liabilities	107	92	121	137	107	6,543	6,247	8,689	10,998	9,999
4. Total External Debt (1+2)	8,197	8,749	9,088	9,031	8,566	502,366	590,363	654,514	722,079	797,998
5. Total External Debt and Liabilities (1+2+3)	9,399	9,707	9,973	10,106	9,684	576,004	655,289	718,352	808,211	902,200
Memorandum Items										
Medium and Long-term Debt										
(1) Project Loans	4,530	5,150	5,517	5,346	5,385	277,637	349,043	397,882	427,965	481,186
(2) Non-Project Loans	1,612	1,656	1,612	1,426	1,144	98,788	112,237	116,247	114,174	102,214
(3) Suppliers' Credits	343	251	182	338	316	21,015	17,020	13,146	27,074	29,411
(4) IMF Drawings	433	367	258	161	209	26,536	22,271	17,766	11,943	19,463
(5) Other Loans (f)	801	840	1,043	1,185	956	49,067	56,960	75,233	94,890	113,849
Short-term Debt and Banking Sector Liabilities	1,680	1,442	1,360	1,651	1,675	102,961	97,759	98,078	132,166	156,077
Total External Debt as a percentage of GDP	54.3	55.5	57.8	54.5	54.7	56.4	58.0	59.2	57.5	57.0
Total Banking Sector External Liabilities as a percentage of GDP	8.0	6.1	5.6	6.5	7.1	8.3	6.4	5.8	6.9	7.4
Total External Debt and Liabilities as a percentage of GDP	62.3	61.6	63.5	61.0	61.8	64.7	64.4	65.0	64.4	64.4
Short-term Debt as a percentage of GDP	3.2	3.1	3.0	3.5	3.6	3.3	3.2	3.1	3.7	3.7
Short-term Debt and Banking Sector External Liabilities as a percentage of GDP	11.1	9.2	8.7	10.0	10.7	11.6	9.6	8.9	10.5	11.1
Short-term Debt as a percentage of Total Debt	5.1	5.0	4.8	5.7	5.7	5.1	5.0	4.8	5.7	5.7
Short-term liabilities as a percentage of Total Debt	12.8	9.9.	8.9	10.6	11.5	12.8	9.9	8.9	10.7	11.5
Short-term Debt as a percentage of Official Reserves	23.6	24.4	29.0	54.8	41.6	23.6	24.5	29.0	55.1	41.6

Sources: Central Bank of Sri Lanka
External Resources Department

(a) From 1994 onwards, Foreign Currency Banking Units (FCBUs) of commercial banks have been treated as a part of the domestic banking system in the compilation of balance of payments statistics. Accordingly, transactions involving FCBUs and non-residents are taken into account in the compilation of balance of payments statistics, while those involving FCBUs and residents are excluded.

(b) Provisional

(c) Data since 1994, have been revised to incorporate additional information.

(d) Includes acceptance credits of Ceylon Petroleum Corporation and other trade credit.

(e) ACU debits and foreign liabilities of commercial banks including those of FCBUs.

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

TABLE 9.10
External Debt Service Payments (a)

Item	US dollars Million					Rs. Million				
	1997	1998	1999	2000	2001(b)	1997	1998	1999	2000	2001(b)
1. Debt Service Payments	733	759	846	953	811	42,645	48,773	59,321	74,554	69,267
1.1 Amortisation	430	469	550	621	558	24,764	30,076	38,472	49,410	46,665
(i) To IMF	66	83	100	97	78	3,290	5,100	6,813	9,700	3,770
(ii) To Others (c)	364	387	451	524	480	21,475	24,975	31,658	39,711	42,894
1.2 Interest Payments	303	289	296	332	253	17,881	18,697	20,850	25,144	22,603
(i) To IMF	6	7	5	5	4	361	443	376	410	348
(ii) To Others (c)	297	282	291	326	249	17,520	18,254	20,474	24,734	22,255
2. Earnings From Merchandise Exports and Services	5,514	5,712	5,578	6,476	6,084	325,885	369,484	393,303	492,301	543,442
3. Receipts From Merchandise Exports, Services, Income and Private Transfers	6,670	6,925	6,801	7,787	7,302	394,122	447,951	479,469	591,567	652,198
4. Debt Service Ratio (d)										
4.1 As a percentage of 2 above										
(i) Overall Ratio	13.3	13.3	15.2	14.7	13.3	13.1	13.2	15.1	15.1	12.7
(ii) Excluding IMF Transactions	12.0	11.7	13.3	13.1	12.0	12.0	11.7	13.3	13.1	12.0
4.2 As a percentage of 3 above										
(i) Overall Ratio	11.0	11.0	12.4	12.2	11.1	10.8	10.9	12.4	12.6	10.6
(ii) Excluding IMF Transactions	9.9	9.7	10.9	10.9	10.0	9.9	9.7	10.9	10.9	10.0
5. Government Debt Service Payments										
5.1 Government Debt Service Payments (e)	393.4	419.5	449.0	437.0	448.6	24,060	27,126	31,613	33,100	40,121
5.2 As a percentage of 1 above	53.7	55.3	53.1	45.9	55.3	56.4	55.6	53.3	44.4	57.9

Source: Central Bank of Sri Lanka

(a) From 1994 onwards, Foreign Currency Banking Units (FCBUs) of commercial banks have been treated as a part of the domestic banking system in the compilation of balance of payments statistics. Accordingly, transactions involving FCBUs and non-residents are taken into account in the compilation of balance of payments statistics, while those involving FCBUs and residents are excluded.
(b) Provisional.
(c) Data since 1994 have been revised to incorporate additional information.
(d) Debt service ratios calculated in rupee values and US dollar values differ due to variations in exchange rates during the year.
(e) Excludes IMF transactions.

million, accounted for 55 per cent of the total debt service payments. Interest payments accounted for only 31 per cent of the total debt service payments, reflecting the high concessionality of a major part of the existing debt stock.

Debt service payments as a percentage of receipts from merchandise exports and services declined from 14.7 per cent to 13.3 per cent during the year. As a percentage of receipts of goods and services, income and private transfers, debt service payments declined from 12.2 per cent to 11.1 per cent. Although debt service payments at present are not critical in Sri Lanka due to the majority of the debt being on concessional terms and conditions, the increasing trend in non-concessional debt highlights the need for more prudent debt management policies.

9.11 External Trade Environment and Policy

Import and Export Controls

In 2001, trade and tariff policy continued to facilitate export led economic growth by creating an environment conducive to enhancing competitiveness in the export sector. Tariffs were reduced within the framework of the two band tariff structure introduced in 2000. However, the existing simplified, liberal and less protective tariff policy regime was disturbed by ad hoc policy decisions taken to protect domestic agricultural products and a few industries in 2001.

Some restrictions were relaxed by removing licensing requirement on a few products such as new and used dentist's and barber's chairs, while several products such as motor vehicle bodies and parts were brought under licensing on 9 March 2001. With the objective of protecting the local cigarette industry from illicit cigarettes and to detect illicit cigarette producers and regularise their industries, the import of cigarette paper was brought under import control licence on 28 September 2001. Cashew nuts in shell were also brought under import control licensing on 12 December 2001. With these revisions, a total of 300 items at 6 digit level of Harmonised System of Codes (HS Code) remained under import control at the end of 2001.

Only four categories of exports, i.e. coral chunk and shells, wood and articles of wood (ebony), ivory and ivory products and vintage passenger motor vehicles (first registered in Sri Lanka prior to 1945) continued to remain under licence. With the addition of components imported for the local manufacture of milk chilling tanks and cold rooms to the list of exemptions, the number of items in the list grew to 41 with effect from 9 March 2001.

Tariffs and Taxes on External Trade

The two band tariff system with 10 and 25 per cent rates imposed on imports, which has been effective since February 2000, continued in 2001. However, the simplicity of the tariff structure was disturbed by the introduction of surcharges and grant of duty waivers on certain products in 2001. A 40 per cent surcharge on import duty under Section 10(A) of the Customs Ordinance was imposed on 21 February 2001 and this was effective until 31 December 2001. Imports with zero duty (such as pharmaceuticals, fertiliser, tractors, lorries etc.) were automatically exempted from this surcharge while a number of essential products such as potatoes, edible oil, sugar, infant milk food, infant food and selected items of milk and cream products, coconut oil and copra etc. were also exempted from the surcharge, in view of cost of living considerations. The entire range of textiles and garment items (Chapter 50-63) was also exempted from this additional surcharge.

TABLE 9.11

Average Import Duty Collection Rate (a)

Item	1997	1998	1999	2000	2001(b)(c)
Consumer goods	11.8	12.7	12.8	11.5	13.3
Food and drink	11.5	12.6	13.6	11.7	15.3
Rice	6.3	2.4	16.4	30.0	21.2
Flour	...	...	-	6.2	13.3
Sugar	17.8	20.8	21.3	15.9	16.2
Wheat and meslin	...	...	0.3	...	0.0
Milk and milk products	11.8	11.5	11.6	10.6	15.3
Dried fish	1.6	1.1	1.2	1.3	2.0
Other fish products	4.9	4.8	4.8	5.1	6.3
Other food items	17.9	20.5	19.9	18.7	25.4
Non-food consumer goods	12.2	12.8	12.0	11.3	10.9
Motor cars & cycles	24.5	23.6	20.1	16.6	21.1
Radio receivers & television sets	11.5	12.4	11.9	6.8	8.3
Rubber tyres & tubes	33.5	32.0	28.4	23.5	29.6
Medicinal & pharmaceutical products	1.3	0.9	0.6	0.5	0.6
Other non-food items	9.4	10.1	9.1	11.1	9.7
Intermediate goods	5.9	4.7	4.1	2.9	1.7
Fertiliser	0.1	-	-	-	-
Crude oil	21.7	25.8	15.8	7.4	...
Other petroleum products	18.7	16.7	16.1	5.3	0.9
Chemical elements and compounds	7.6	5.8	3.6	3.2	3.3
Dyeing, tanning and colouring	7.1	7.5	5.3	5.2	6.3
Paper and paper boards	6.0	6.0	5.7	5.0	6.7
Textiles & clothing	0.8	0.1	0.1	0.1	0.1
Other intermediate goods	5.2	4.8	4.1	3.5	4.2
Investment goods	7.0	6.0	4.4	4.0	5.3
Building materials	9.1	9.3	7.8	7.5	9.3
Transport equipment	17.3	11.8	7.4	7.4	10.3
Machinery and equipment	3.4	3.0	2.2	1.8	2.7
Other investment goods	6.3	4.4	3.4	3.2	4.2
Total	7.7	7.4	7.0	4.5	4.9

(a) Actual import duty collection as a percentage of total adjusted import value (c.i.f.).

(b) This includes the impact of 40 per cent surcharge imposed on selected imports on 21 February 2001.

(c) Provisional

Sources: Sri Lanka Customs
Co-operative Wholesale Establishment
Ceylon Petroleum Corporation
Prima Ceylon Ltd.

The surcharge of 25 per cent on edible oils, which was imposed on 17 July 2000, continued till 11 January 2001. This was changed to a specific surcharge of Rs. 20 per kg for the period 12 January - 31 December 2001. The duty rate of 35 per cent and the surcharge of 35 per cent on potato imports were replaced with a specific duty rate of Rs. 20 per kg from 8 December 2000.

The grant of duty waivers on imports has been limited to a very few essential items. Duty payable on imports of crude oil and refined products (petrol, kerosene, diesel, fuel oil and aviation fuel) was waived till 30 June 2001 and then extended till 31 December 2001 in view of the high cost of petroleum products. A partial duty waiver on the importation of motor vehicles granted to parliamentarians, provincial and local government servants and public servants since 22 February 1999 was withdrawn with effect from 8 March 2001 in order to contain loss of revenue. A full duty waiver of 35 per cent was granted to rice importers for the period 22 November to 10 December 2001 due to the poor domestic harvest. This facility was thereafter reduced by 50 per cent to 17.5 per cent and extended till 31 December 2001. A duty waiver would not have been necessary, had the decision to import rice been taken at an appropriate time when it was realised that the rice harvest was inadequate to meet domestic demand.

To reciprocate the facility granted by EU to export textiles and garments without quota restriction to EU countries, import duty on carpets and other textile floor coverings was reduced from 25 per cent to 10 per cent with effect from 11 January 2001. A few rates were revised by introducing or removing National Sub-Headings of HS codes. The concessions granted under the Indo Lanka Free Trade Agreement (ILFTA) were expanded unilaterally honouring the conditions in the Agreement.

Taking the many factors that adversely affected the economy in 2001 into account, government announced a relief package on 5 October 2001. Consequently, the import duty of 25 per cent on bagged cement and bulk cement was reduced to 15 per cent and 10 per cent, respectively, on 12 October 2001. Import duty on essential raw materials such as polyethylene, iron, carbon, asbestos, dye used in the textiles industry, craft paper and paper boards, yeast, chemical products etc. was removed on 20 October 2001 to reduce the cost of raw materials. Most of these items were under the duty rate of 5 per cent before the revision. This will fall in line with the objective of consolidating the tariff structure into a two-band structure by eliminating the concessionary rate of 5 per cent applied on industrial raw material and machinery as announced in the Budget 2000.

Despite these tariff reductions the average import duty, i.e. the ratio of import duty collection to total adjusted imports, increased from 4.5 per cent in 2000 to 4.9 per cent in 2001, reflecting the impact of the 40 per cent surcharge on selected imports. The average import duty rate without the impact of 40 per cent surcharge was 3.9 per cent. The share of dutiable imports in total imports declined from 29 per cent in 2000 to 25 per cent in 2001 reflecting the decline in imports of dutiable items due to high duty payable after the surcharge.

Dutiable imports within the consumer goods category increased marginally from 56 per cent in 2000 to 56.5 per cent in 2001. The average import duty rate on both food and drink and non-food consumer goods categories increased significantly in 2001. These increases were due to the imposition of the surcharge on selected consumer goods and the impact of the removal of duty concession granted on motor vehicles. When adjustments are made for the 40 per cent surcharge, the average duty rate on consumer goods was around 11 per cent.

In the intermediate goods category, dutiable imports declined from 19 per cent to 12 per cent, while in the investment goods category, dutiable imports declined from 40 per cent to 39 per cent in 2001. Despite the impact of the 40 per cent surcharge, the average duty rate on intermediate goods declined to 1.7 per cent due to the impact of the duty waivers granted on petroleum products and duty concessions on some raw materials granted since October 2001. The average duty rate on investment goods increased due to the surcharge on imports. However, when adjustments are made for the surcharge, the average duty rate would be as low as 4 per cent in 2001.

Textiles and Garment Quota Allocation

Allocation of textiles and garment quota under the quota system began in 1978 at the Ministry of Textile Industries. After 1 July 1992, the administration of the quota system became the responsibility of the Textile Quota Board (TQB) currently under the Ministry of Enterprise Development, Industrial Policy and Investment Promotion. However, the Uruguay Round Agreement on Textile and Clothing (Multi-Fibre Arrangement (MFA)) of 1994 envisaged the phased elimination of textile quota over a ten year transition period. The process was to be implemented in four phases, starting on 1 January 1995. The first two phases of integration of quota categories were implemented in 1996 and 1998. The third phase of integration became effective on 1 January 2002.

EU removed all quota restrictions on textiles and garment exports to the EU countries on 1 January 2001. However, exporters to EU have to obtain export visas from BOI or the Textile Division of the Ministry of Enterprise Development, Industrial Policy and Investment Promotion for the purpose of monitoring exports while ensuring that the export items are produced in Sri Lanka.

With the objective of preventing the forgery of export visas and Certificates of Origin, the TQB introduced an Electronic Data Exchange System in co-ordination with the European Commission on 1 September 2001. When the export visas are issued to the exporters, the TQB transmits all relevant information to the European Commission in Brussels through the Electronic Data Exchange System. This system enables the European Commission to monitor the country of origin, product category and other relevant information instantaneously and prevent importation of misclassified or products not produced in Sri Lanka to EU countries. As Sri Lanka has access to the EU market without quota restrictions, forgeries of this nature are quite possible.

Approximately 33 quota categories were open to export to USA and 15 categories to Canada in 2001. Basic quota availability to USA and Canada rose by 7 per cent and 10 per cent, respectively. Accordingly, overall quota allocation to those two countries increased by 7 per cent in 2001. Overall quota allocation in 2001 showed a decline of 8 per cent due to absence of the EU quota, which is considered as a favourable development in view of the phased elimination of quota under MFA. This will avoid the risk of removing a large number of quota at the last stage of the phasing out process in 2005.

The overall quota utilisation rate in 2001 declined to 72 per cent, compared to 79 per cent in 2001 as a result of weak export demand. The utilisation of quota varied widely across different product categories and countries. The utilisation of the US quota dropped significantly from 84 per cent in 2000 to 73 per cent in 2001 reflecting the lower demand from slower economic growth in the USA. The under utilisation was partly due to insufficient demand for particular items and partly due to preferences of local producers to use capacity to produce high value added garments under other quota categories or to produce non-quota garments. This was evident by the increased export of non-quota garment categories and the full utilisation of some popular categories. Quota allocated for certain popular categories to USA such as lady's dresses, shirts and blouses, skirts, trousers, dressing gowns, night wear, underwear, sweaters, men's and boys' shirts were fully utilised.

As in previous years, the utilisation rate of quota on export to Canada was lower than to USA. The overall utilisation rate of Canadian quota declined from 43 per cent in 2000 to 42 per cent in 2001. Men's and women's trousers, overalls and men's shorts and breeches, winter outerwear, blouses and babies garments to Canada were among the categories, where utilisation rates were significantly higher. Total exports earnings from USA on account of textiles and garment exports declined by 11 per cent in 2001. However, earnings from textiles and garment exports to Canada increased by 1 per cent, despite a lower rate of quota utilisation, indicating a move towards non-quota markets. Export earnings from non-quota countries declined by 20 per cent in 2001.

The Electronic Visa Information System (ELVIS) which was initiated in December 1999 to transmit key statistics on exports of textiles and garments directly to the US Customs through electronic media continued to operate successfully in 2001.

Incentives to Exporters

With a view to enhancing the competitiveness and profitability of the export sector, the government implemented various incentives proposed in the 2001 Budget targeting exporters as well as other industrialists. The handloom, power-loom and handicraft industries were granted a series of incentives ranging from a three year tax holiday for exports of handicrafts, special credit scheme to support capital requirements, financial assistance to modernise factories and incentives for marketing and product development.

Tax concessions such as an exemption from NSL and GST, as well as a 5 year tax holiday on profits from exports, were offered in the 2001 Budget for export of information technology related services. The present tax holiday of 5 years enjoyed by export oriented software development firms was extended to these software related services as well. Turnover arising from carrying on the business of a port operator, including a port container terminal operator, in any port in Sri Lanka and services provided by airline agents in relation to exports, import of aircraft and ships to be used in international transportation of goods and passengers and import of aviation fuels, was exempted from NSL.

The government also took action to establish a Fishery Resources Development Fund to assist prawn farming, inland fisheries and other fishery related activities. The fund was to be created from a cess on export of prawns. This will assist the industry to safeguard itself from epidemics and ensure a continuous supply for export.

Institutional Support to Exporters

The Ministry of Enterprise Development, Industrial Policy and Investment Promotion, export development organisations, such as the Export Development Board (EDB) and the Sri Lanka Export Credit Insurance Corporation (SLECIC) and other related ministries and government institutions continued to support exporters throughout the year. The Ministry of Plantation Industries provided support for the development of traditional exports and EDB played the major role in the development and promotion of non- traditional exports. SLECIC provided credit insurance and guarantee services. Other relevant institutions, especially the Ministry of Foreign Affairs and the Ministry of Commerce and Consumer Affairs, continued to educate exporters on facilities available through bilateral, regional and multilateral organisations and were instrumental in establishing contacts between Sri Lankan entrepreneurs and foreign counterparts. Private sector institutions such as Chambers of Commerce, played an active role in promoting exports.

The objectives of SLECIC are to issue insurance policies to exporters and guarantees to banks and financial institutions for the development of Sri Lanka's exports. In 2001, the number of policies and guarantees in force was 205 compared to 296 in force at end December 2000. These included whole turnover export payments insurance policies, specific policies, small scale insurance policies, policies covering entrepot trade, computer software and special schemes for exports to Iraq. There were 49 new insurance policies issued in 2001 amounting to Rs.500 million as against 35 policies in 2000. New guarantees in force at end 2001 amounted to 1,672 to the value Rs.2,485 million. A few insurance policies were in place for new and small scale exporters enabling them to compete in international markets with confidence. A special insurance cover for tea exports to Iraq, which was launched by SLECIC in 2000, provided four insurance policies to the value of Rs. 150 million in 2001.

EDB assisted exporters to participate in international trade fairs to retain or expand market share in the conventional markets such as Europe, USA, Canada and Japan. EDB has identified South Africa, Poland, CIS countries, the Nordic region, SAARC region, ASEAN and Korea as new markets to be developed. Seminars were conducted for potential exporters to gain knowledge of these markets, trade promotion missions were sent to these countries and trade delegations from China and Malaysia visited Sri Lanka. The trade promotion office of EDB in Male commenced a pilot project in order to create a demand for Sri Lankan products in the Maldives. The Maldives was the second largest export destination for Sri Lanka's products among the SAARC region. Regional e-commerce centres have been established in Galle, Matara, Hambantota, Kandy and Kurunegala to assist small and medium scale exporters to find and communicate with business partners, finalise contracts and sell their products to international customers via the Internet. EDB continued to provide advice and assistance to exporters to resolve various operational problems relating to sea and airfreight and entrepot trade. Awareness programmes and seminars were conducted on e-commerce, import/export procedures, export packaging and on quality circles. EDB has channelled its resources to provide multi-faceted services to the export sector ranging from computerised database facilities, bulletin board service, advisory services and library facilities.

The handloom and handicraft industries are priority sectors chosen by the EDB for development. EDB provides assistance for product development, quality upgrading and attaining quality standards while also providing market intelligence and advice. An incentive of 20 per cent of the f.o.b. value was also paid to handloom exporters. EDB with the Ministry of Enterprise Development, Industrial Policy and Investment Promotion and its agencies, implemented several market development programmes, liaising closely with the Apparel Associations. It also provided market development and supply development assistance such as provision of market infrastructure facilities, establishment of links for design development, greater liaison with Department of Commerce offices in overseas Missions and organisation of country pavilions at recognised international fairs and skills development programmes.

During 2001, the Chambers of Commerce held seminars and discussions on important issues in order to improve their understanding and identify alternative solutions while building up consensus among different interested parties. Chambers also participated in meetings organised by government officials enhancing their contribution to policy dialogue and facilitating settlement of issues faced by industrialists.

Freight Rates

During 2001, the overall average freight rate increased, particularly during the second half of the year. Despite the global trend of bringing down the basic freight rates, the average freight rates that shippers have to pay at Sri Lanka's ports increased due to upward revisions of existing charges and new charges imposed by the shipping lines. Among the existing charges, the terminal handling charge was increased by 33 per cent (from US dollar 86 to US dollars 115 per 20 foot container and US dollars 138 to US dollars 184 per 40 foot container) on 1 May 2001 to meet increasing operational cost. The bunkering adjustment charge was increased by 50 per cent (for USA, from US dollars 70 to US dollars 105 per 20 foot container and for UK, from US dollars 50 to US dollars 75 per 20 foot container) during the year. Adding an additional burden, a war risk surcharge came into effect after the attack at the Katunayake International Airport. War risk surcharges of US dollar 350 and US dollar 700 were levied for 20 foot and 40 foot containers, respectively, with effect from the first week of August 2001. Following the September attacks in USA, a war risk surcharge of US dollars 150 per 20 foot container and US dollars 300 per 40 foot container was levied on all West-bound cargo. In addition, a levy of US dollars 10 per container as a Suez Emergency Surcharge was also levied on those ships transiting through the Suez from 1 October 2001. However, with the favourable developments in the international and local political atmosphere, the war risk surcharge was reduced to US dollars 100 and US dollars 200, respectively, in December 2001. These war risk surcharges were further reduced in early 2002 and complete removal is expected during the first half of 2002 with the improving security situation. A change in basic freight rates was evident only in the UK/ Continent region in 2001.

With the combined effect of all those factors, the average freight rate for all major destinations increased moderately by about 5 per cent in 2001. A commodity wise classification showed increases in freight rates for all major commodities in 2001.

A noteworthy feature in the world shipping industry in the recent past has been the expansion of consortia, which resulted in economies of sale, bringing down their freight rates. The strong shipping lines within the consortia were able to survive with lower freight rates but certain lines in the Far East were unable to survive in this competitive environment. The size of the ships too increased gradually to almost 6,000 to 8,000 twenty foot containers, where the capital investments were very high. As these shipping lines had to be competitive to find sufficient cargo to operate at full capacity, there was a tendency to bring down the freight rates. The international freight rates have not stabilised due to various ancillary charges imposed by shipping lines to recoup the earnings forgone due to lower charges. However, freight rates are expected to stabilise at a lower level when most strong shipping lines join up in mega consortia in the long run.

9.12 Trade Relations, Trading and Clearing Arrangements

Sri Lanka took several steps to strengthen regional, bilateral and multilateral relations in 2001. Sri Lanka implemented commitments under phase two of the Indo-Lanka Free Trade Agreement (ILFTA) unilaterally in March 2001. EU has granted quota free access to imports of textiles and garment from Sri Lanka to the EU market on 1 January 2001. In response, Sri Lanka reduced the tariff on carpets and floor coverings from 25 per cent to 10 per cent on 12 January 2001 in line with the agreement with the EU.

Sri Lanka received a proposal from Pakistan to enter into a Free Trade Agreement with Pakistan. The draft proposal prepared by the Pakistan authorities was similar to provisions in the ILFTA with some variations in phasing procedures for tariff concessions, rules of origin and elimination of non-tariff barriers. The Cabinet granted approval to take steps necessary to initiate negotiations with Pakistan to conclude a Free Trade Agreement. A technical committee was set up to prepare the ground work for the negotiation with Pakistan. Preliminary work on the request

Box 13

Indo Lanka Free Trade Agreement- An Evaluation of Trade and Investment Performance

The Indo-Lanka Free Trade Agreement (ILFTA) was signed on 28 December 1998 by the President of Sri Lanka and Prime Minister of India and became effective in 2000. Sri Lanka implemented tariff concessions on February 2000 and India in March 2000. Tea and garment exports, which are subject to quota limits under the Agreement, commenced in April 2000 under tariff concessions.

The two countries removed tariffs entirely on some goods immediately, while partial concessions were granted on selected goods[1]. The removal of all tariffs on the latter category of products will take place gradually over a period of time. However, the agreement excludes some goods from receiving any tariff concessions due to concerns such as potential threat to important domestic industries and national security.

India is an important trading partner of Sri Lanka. In 2001, India ranked first in respect of Sri Lanka's imports and eleventh in respects of its exports, indicating Sri Lanka's enormous export potential to that country. Sri Lanka's total exports to India increased by 24 per cent while total imports from India increased marginally (0.2 per cent) in 2001. Exports to India under the ILFTA amounted to US dollars 16.2 million, which was 23 per cent of the total exports to India in 2001 (Table 1). Exports under the ILFTA increased by 88 per cent in 2001. Among exports, waste paper, dual online memory modules, ice cream machines, multi-wall paper sacks, meat products etc. entered duty free. Tea, polished marble slabs, porcelain table wear, copper scrap, pine resin, heavy melting scrap etc. received a 50 per cent tariff concession.

In absolute terms, exports under the ILFTA in 2001 increased only marginally, there were signs of improvement in the last quarter. The improvement is evident from the addition of new exports such as rubber slippers, computer parts, marble slabs, ice cream machines, re-melted copper, re-melted lead, chemical products, re-fabricated building accessories, ring and clip files and pharmaceuticals, after the implementation of the ILFTA.

Exports of items under quota remained low[2]. Sri Lanka exported 457 metric tons of tea in 2000 out of a quota of 11,250 metric tons and 480 metric tons out of 15,000 metric tons in 2001 under ILFTA. These exports amounted to 0.16 per cent of Sri Lanka's total tea exports each year. More than 90 per cent of tea exported under the ILFTA was in bulk form. The balance consisted of green tea, black tea in packets, instant tea and a few samples of flavoured tea bags. Sri Lanka exported 467 metric tons of tea to India outside the ILFTA without any duty concessions in 2001.

Table - 1
Export Performance under ILFTA

US dollars Mn.

Product	2000	2001
Total exports from Sri Lanka	58.04	71.99
Exports from Sri Lanka under ILFTA	9.21	16.23
Paper and wastepaper	4.28	4.23
Scrap (steel/aluminium, lead)	1.65	0.27
Copper scrap	0.08	1.03
Tea	1.13	0.66
Memory modules	0.62	0.88
Heavy melt scrap	0.00	0.60
Furniture	0.00	0.57
Ice cream machines	0.26	0.90
Marble slabs and ceramic products	0.16	1.30
Pharmaceutical products	0.11	0.17
Pine resin	0.01	0.67
Multi-wall paper sacks	0.05	0.32
Re-melted wire bars	0.00	0.21
Re-melted lead ingots	0.00	0.39

Source: Department of Commerce

Garment exports under the ILFTA in 2000 was not very encouraging either. Garment exports were limited to a few samples in 2000. However, 69,265 shirts and 312,296 pairs of gloves were exported in 2001. The value of these exports was US dollars 0.2 million. Although there was an improvement in 2001 compared to 2000, the amount exported was very much lower than the quota of 8 million pieces of garments.

There are a number of factors that contributed to the low level of garment and tea exports. Entry points for tea and garment exports under the ILFTA were restricted to two ports. Rules of origin criteria prevented the export of blended tea and most garment items. Indian manufactured fabric was required to be used for 6 million of 8 million pieces of garments under quota. Specific duty was levied on sensitive categories of garment items. Promotional effort by Sri Lankan exporters was inadequate.

Total imports from India were at US dollars 601 million in 2001, marginally higher than the US dollars 600 million in 2000. Essential food items such as lentils, big onions, sugar and chillies, which are in the negative list, were among the top ten items imported during 2001. Imports of goods in the negative list increased by 13.7 per cent to US dollars 210 million in 2001. Imported goods, which did not come under Sri Lanka's negative list (*i.e.* imports for which tariff concessions were granted or subject to gradual phase out), amounted to US dollar 391 million, a decline of 5.6 per cent in 2001.

Box 13 (Contd.)

India too has not been able to increase exports under tariff concessions granted under the ILFTA.

The Board of Investment (BOI) approved 5 foreign investment projects in 2000 and another 6 projects in 2001 under the provisions of ILFTA. Total investment emanating from these projects amounted to US dollars 31.5 million. Out of these, four projects with total investment of US dollars 4.4 million, commenced in 2001 while for the other five projects, with investment of US dollars 25.3 million, contracts have been signed with the BOI.

Non-tariff barriers in India constitute the major constraint to Sri Lanka achieving maximum benefit from the current concessions. It is evident that India provides various hidden subsidies to small scale Indian producers, e.g. charging lower excise tax rates for different segments of local Indian producers. There are complaints about cumbersome and non-transparent inspection procedures on the part of Indian Customs authorities. Sri Lankan exporters complain that inadequate awareness of the contents of the ILFTA and procedures on the part of Indian Customs officials, non acceptance of the Certificates of Origin issued by Sri Lankan authorities to fulfil the rule of origin requirement and irregularities in the Customs valuation have become barriers to trade with India. However, ILFTA does not deal with non-tariff barriers. Lifting those barriers should be one of the major concerns at the forthcoming Joint Ministerial Committee meeting.

The Indian government has made a number of changes in trade policy in its Budget 2000. The basis for calculating the Special Excise Duty (SED) was changed from import value to maximum retail price (MRP). The three - band rates at 8 per cent, 16 per cent and 24 per cent of SED was unified to 16 per cent while introducing an additional levy of 4 per cent for all imports. In addition, India has increased tariff rates for a large number of items such as tea (from 15 per cent to 70 per cent), leather products (from 35 per cent to 90 per cent) and noodles (from 35 per cent to 100 per cent). These policy changes enhanced protection to Indian producers and reduced the advantageous position that Sri Lankan exporters expected under the ILFTA.[3]

A series of measures needs to be taken to enhance co-operation between the two countries to facilitate the implementation process of the ILFTA. Even though, the agreement does not deal with any para-tariff or non-tariff barriers, it provides for the Joint Committee to negotiate to even out any such barriers or to address them through tariffication. The first meeting of the Joint Committee established under the ILFTA is behind schedule due to various reasons including regional political developments, and difficulties in fixing a mutually convenient date. The delay in holding the Joint Ministerial Committee meeting has become a bottleneck to progress under the ILFTA. Sri Lanka has implemented the second stage unilaterally by reducing duty rates in March 2001. India has not implemented the second phase and is waiting for the first Joint Ministerial Committee meeting to take a decision[4].

The Joint Committee at its next meeting needs to consider several matters, (a) immediate tariff reductions by India under the second phase of implementation (b) decide that basic tariff rates are those that prevailed at the time of signing the agreement (similar to the case of tea) and (c) remove specific duties on imports to India. It is also important to explore the possibility of making imports of Sri Lankan garment to India gradually duty free as imports from Mexico and some Sub-Saharan countries under the North American Free Trade Agreement (NAFTA) and the African Growth and Opportunity Act (AGOA), respectively. Similarly, the source of fabric stipulation and restrictions on entry ports should be removed from the Agreement.[5] The active participation of two nodal chambers of the two countries should be encouraged, specially to undertake joint promotional activities, maintain a database and disseminate information and to provide market information to all stakeholders on a regular basis. In order to encourage business relations and to simplify procedures the two parties can introduce a simple and effective system to expedite the issue of business visa.

The early resolution of these issues would greatly facilitate the expansion of trade between the two countries. Such expansion would not only expedite Sri Lanka's economic recovery in 2002, but also improve future economic prospects, particularly given the projected slow recovery in industrial countries and the probable adverse impact from emerging trading blocks among other countries.

1. See Central Bank of Sri Lanka Annual Report - 1999, Box 6 - Indo-Lanka Free Trade Agreement for details of concessions granted in Phase 1 and proposed phasing out procedures of remaining duties.
2. Quota allocation of tea under the ILFTA was 11.25 mn.kgs. and 15 mn.kgs. in 2000 and 2001, respectively.
3. Only in the case of tea, Sri Lanka is till paying the 7.5 per cent, which is 50 per cent of the rate that prevailed when Sri Lanka and India signed the Agreement.
4. However, the Indian Government has reduced tariff rates on 2,799 tariff lines in the residual list of Sri Lanka's imports by 90 per cent in its Budget 2002/2003 effective on 1 March 2002. These items received 50 per cent tariff reduction under the first phase of the ILFTA.
5. Under SAPTA agreement, a large number of entry points (about 215) are available for Bangladesh to trade with India.

lists for tariff concessions, offering lists and negative lists has been completed.

Sri Lanka worked to expand trade relations with Brazil and the other Latin American countries through resident diplomatic missions in 2001. Sri Lanka approved the establishment of a resident diplomatic mission in Vietnam and expects to develop economic and business relations with Vietnam. Economic relations between China and Sri Lanka were further strengthened with the visit of the Chinese Prime Minister in May 2001. A steering committee was established under the Ministry of Foreign Affairs to identify opportunities and pursue the expansion of exports to China.

Regional economic co-operation was fostered further in 2001 with continuing discussions with the SAARC, Bangkok Agreement, and Bangladesh, India, Myanmar, Sri Lanka, Thailand-Economic Co-operation (BIMST-EC) and Indian Ocean Rim Association for Regional Co-operation (IOR-ARC).

A meeting of the SAARC Focal Point on Economic Co-operation was held in Kathmandu 21-22 October 2001. The progress of the trade negotiations under the South Asian Preferential Trading Arrangement (SAPTA) were reviewed at this meeting. Other issues reviewed at this meeting included drafting a regional agreement on protection of investment, avoiding double taxation, quality control measures and procedures for appointing consultants on Customs matters. In order to make arrangements for the fourth round of negotiations under SAPTA, the first meeting of the Inter-Government Group (IGG) was held in January 2002. It was decided to exchange request lists and information relating to trade and trade controlling measures of partner countries enabling the preparation of national schedules and a consolidated national schedule to be used in the fourth round of negotiations. The SAARC Focal Point on Economic Co-operation reiterated its strong commitment to the finalisation of the Comprehensive Treaty Regime for a South Asian Free Trade Area (SAFTA). The first working draft of the SAFTA treaty is expected to be studied and discussed by the Committee of Experts (COE).

The first meeting of the Inter-Governmental Group (IGG) formed by the Commerce Ministers of the BIMST-EC was held in New Delhi 5-6 February 2001, at which possible approaches towards Preferential Trading Arrangements leading to a Free Trade Area in the region were briefly deliberated. The third meeting of the BIMST-EC Trade and Economic Ministers was held in Yangoon on 15 February 2001. Based on the decision taken at this meeting a Group of Experts (GOE) was established to study and analyse the pros and cons of adopting a positive or negative list approach to recommend which approach BIMST-EC should adopt in achieving a free trade area. GOE is expected to submit the report to the Senior Trade and Economic Officials Meeting. The fourth meeting of the BIMST-EC Trade and Economic Ministers was held in Yangoon 19-21 December 2001. At this meeting Sri Lanka was designated as the lead country in the technology sector and the co-ordinating country in the sub-sectors of processed foods, gems and jewellery under the aegis of the trade and investment sector for the next three years. Further it was decided to upgrade the Ministerial Meeting of BIMST-EC to full ministerial level from the deputy ministerial level commencing from the next meeting which is scheduled to be held in Colombo in December 2002.

The third Ministerial Meeting of the Council of Ministers of IOR-ARC was held in Muscat, Oman in April 2001. Sri Lanka presented to the High Level Task Force of the IOR-ARC a position paper on funding the Secretariat and a study on the proposal of a Preferential Trading Arrangement leading to a Free Trade Agreement in the region. The second meeting of the High Level Task Force of IOR-ARC was held in Teheran, Iran. Sri Lanka hosted the working group meeting for the development of the IOR-ARC Compendium on Customs Procedures in February 2001. Sri Lanka undertook joint studies with India on the Relevance of Clearing and Payments Arrangements and Promoting Tourism and Institutional Mechanism for promoting Intra-Regional Trade in the IOR-ARC region. Under the Indian Ocean Rim Business Forum and the Indian Ocean Rim Academic Group, Sri Lanka and India have played an active role in the activities of IOR-ARC in order to achieve the objective of the Group.

Sri Lanka continued to receive tariff concessions from the participating developing countries of the Generalised System of Trade Preferences (GSTP). A Protocol for the accession of the Southern Common Market (MERCOSUR) to the Agreement on GSTP among developing countries was signed on 10 October 2001.

The seventeenth session of the Standing Committee of the Bangkok Agreement was held in Bangkok 25-31 October 2001. For the first time China participated as an official member at this meeting. China's accession to the agreement is expected to boost intra-regional trade among member countries. At this meeting member countries endorsed the proposal for the revitalisation of Bangkok Agreement. This move was considered useful since Bangkok Agreement has not contributed much to expand trade among its member countries during its 25 years of existence. It was decided to launch the third round trade negotiations under Bangkok Agreement at the meeting. Member countries agreed to the modalities and guidelines as well as to a specific timeframe for the conduct and completion of the third round.

The eleventh Summit of the Group of 15 (G-15) was held in Jakarta in May 2001. The Summit focused on the potential for harnessing digital technology for development. The next summit of the G-15 is scheduled to be held in

Caracas, Venezuela in July 2002 where co-operation in the energy sector will be the theme.

The World Trade Organisation (WTO) Ministerial Conference was held 9-14 November 2001 in Doha, Qatar. Sri Lanka was among the 142 member countries participating at this Conference. Decisions taken by the WTO at this meeting to grant flexibility to developing countries to provide domestic support and protection on grounds of food security, livelihood concerns and rural development and extension granted under Article 27.4 of the WTO agreement on subsidies and countervailing measures allow Sri Lanka to continue with subsidies. Sri Lanka will also be a beneficiary from tariff reduction by developed countries on agricultural products and certain industrial products. This would create greater market access for developing countries for their agricultural products and industrial products such as garments and leather products. Sri Lanka will also benefit from the establishment of a work programme under the auspices of the General Councils of the WTO to examine specific problems of small and vulnerable economies. This group will make recommendations at the next Ministerial Conference to solve problems particular to small and vulnerable economies and this will help such economies to obtain tariff concessions from developed countries. The Doha declaration in respect of the WTO Agreement on Trade Related Intellectual Property Rights (TRIPS) would let Sri Lanka protect Sri Lankan products such as Ceylon tea of Sri Lankan origin under geographical indications. It would also allow countries to override patents in the interest of public health with enhanced scope to add tuberculosis, malaria and other epidemics in addition to the AIDS/HIV catastrophe. Under this, a WTO member could grant compulsory licences and allow parallel imports in respect of cheaper medicine.

Legislation is being drafted to provide for anti-dumping, subsidies and countervailing duties and safe-guard measures.

9.13 Internal Trade and Institutional Arrangements

Internal trade in Sri Lanka was adversely affected by the slowdown in domestic economic activity as well as the decline in external trade in 2001. As in recent years, internal trade was conducted in a relatively free market environment with minimum state intervention. Major controls and interventions were limited to trade regulations, while state intervention on price determination was limited to a few essential items. The state intervened mainly to ensure market competition, price stability and the availability of a few essential products, which are vulnerable to large seasonal fluctuations in supply or demand. Large fluctuations in prices or shortages in essential products, have harmful effects on both consumer and producer. Those interventions were carried through license issues, tariff changes and public sector trading institutions such as the Co-operative Wholesale Establishment (CWE), Lanka Salu Sala Limited and the State Pharmaceutical Corporation of Sri Lanka (SPCSL). The two regulatory bodies, the Department of Internal Trade (DIT) and Fair Trading Commission (FTC) continued to maintain price controls on pharmaceutical products and probe unfair trading practices.

The government continued with administered prices for petroleum products until the introduction of an automatic pricing formula in December 2001. The Ceylon Petroleum Corporation was the sole authority to import, refine and supply petroleum fuel, except lubricants and LP gas. The monopoly enjoyed by Shell Gas Lanka Ltd. expired on 8 December 2000 allowing other competitors to enter the market for gas. Laugfs Lanka Gas (Pvt) Ltd. entered the market in October 2001 as a competitor. LP gas prices in the domestic market have come down thanks to flat competition. The Food Commissioner's Department (FCD) acted as the sole authority in the purchase and distribution of wheat flour, milled by Prima Ceylon Ltd. till August 2001. Even though licensing requirements for wheat and wheat flour imports were removed and the private sector was allowed to import these without any restrictions from February 2000, the import of wheat grain was entirely handled by the CWE until September 2001. The import of wheat and the island-wide distribution of wheat flour were handed over to Prima Ceylon Limited in September 2001.

In order to ensure price stability and the availability of essential consumer goods, CWE continued to import major food items and purchase some locally produced goods. From February 2001, the Standing Cabinet Appointed Tender Board (SCATB) in the Ministry of Finance and Planning was appointed to take decisions on the procurement of rice, milk powder, dried fish, potatoes, onions and chillies on behalf of CWE. Subsequently, decisions regarding local purchases of imported food items, through local tenders, were also handled by the SCATB from 17 August 2001. Until 31 December 2001, purchasing and selling prices of these products were also decided upon by the SCATB.

The CWE imported certain products to compensate for shortages in local production, while reducing the importation of other products when the private sector imported quantities sufficient to meet the domestic demand. Further, it purchased local products when surpluses were available, while limiting such purchases in a time of shortage. The CWE intervened in the paddy market by purchasing 41,723 metric tons of paddy during the harvest seasons in 2001, while importing 15,750 metric tons of rice during a lean period. As the harvest of big onions increased only marginally in 2001, the CWE limited its domestic purchases of big onions to 1,551 metric tons (2,166 metric tons in 2000) while importing 4,184 metric tons (4 per cent of total imports) to meet increased demand. The CWE imported 1,037 metric tons of dried chillies (4 per cent of total imports) to meet the shortage in chillies (production declined from 19,834 metric tons to 17,410 metric tons) while limiting its local purchase of dried chillies to 16 metric tons (146 metric tons in 2000) reflecting its desire to ensure price stability, while ensuring the continuous supply of essential foods. The CWE's import share in total imports was relatively small in other major imported food items : lentils and sugar (12 per cent each) and dried fish products (1 per cent).

The CWE continued to distribute essential food items at reasonable prices through 157 retail shops and 41 wholesale shops, which include 5 new retail shops opened in 2001. However, the total turnover declined to Rs. 7,750 million, compared with Rs. 8,090 million in 2000. Turnover through the franchise shops was Rs. 357 million in 2001, compared to Rs 2,282 million (a decline of 84 per cent) in 2000. This was because franchise shops did not actively participate in trading activities. Out of 8,708 registered franchisees, only 1,230 purchased goods from CWE during 2001. No new franchise dealers were appointed in 2001.

The Lanka General Trading Company Ltd. distributes a wide range of products through a franchise dealer network to reach several segments of the population in addition to its own branch network. Some products were channelled through the sales promotion assistants of the company island wide. Both institutions played a role in ensuring fair competition. The co-operative societies also engaged in trading activities providing goods at reasonable prices through 617 wholesale and 7,839 retails outlets which operated under 311 cooperative societies. These societies made special contributions with respect to the distribution of dry rations amounting to Rs 4,699 million to 1.61 million Samurdhi beneficiaries in 2001.

The SPCSL continued to be the sole supplier of pharmaceutical products to government health care institutions and a major supplier to the market. The SPCSL supplied pharmaceuticals at prices fixed by the FTC. All private sector imports of pharmaceuticals remained under licensing and price controls. The SPCSL possesses an islandwide sales network through 36 distributors, 35 franchise Osu Sala outlets, 12 Rajya Osu Sala outlets and 10 authorised retailers. To ensure the quality of drugs a micro-laboratory was established in 2001. Sales promotion and public awareness programmes were conducted through electronic media, educational and clinical meetings and workshops. The SPCSL imported nearly 40 per cent of the pharmaceutical requirements of the country. The formula for determining retail prices remained unchanged.

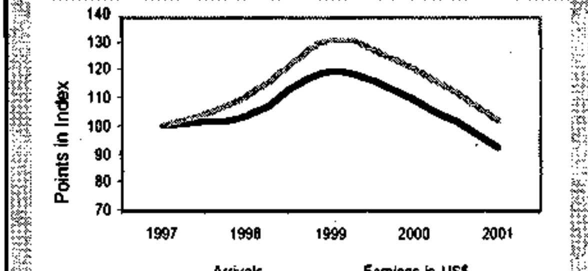
The DIT and the FTC were engaged in ensuring the orderly conduct of trade in a free market environment. These two institutions made efforts to increase consumer awareness of their rights by promoting the formation of consumer groups, taking measures to protect consumers, establishing fair trading practices, regulating internal trade and maintaining price controls when required. The FTC continued to maintain controls on prices of approximately 4,600 pharmaceutical items imported by 77 importers and produced by 7 local manufacturers. A regulatory system for pharmaceutical products requires adequate safeguards to ensure the quality of the products, while the gradual elimination of government control is necessary to improve the efficiency and reduce the excessive costs through competition.

The FTC was investigating five cases of anti-competitive practices and several consumer complaints under the provisions of the Fair Trading Commission Act. In 2001, DIT carried out 1,656 raids under the Consumer Protection Act of which 1,099 offenders were prosecuted. Under the Price Control Act, 26 raids were carried out and 10 offenders were prosecuted. Under the Fertiliser Regulation Act, 32 traders were charged for offences such as adulteration of fertiliser, nonconformity to standards and violation of regulations.

9.14 Tourism

The tourism sector suffered a major setback in July 2001. Tourist arrivals, which recovered significantly during the first half of 2001 (10.5 per cent increase), suffered severely from the attack at the Katunayake International Airport in July 2001. The tourism industry was further affected by several other factors such as the terrorist attacks in USA on September 11, the subsequent war on Afghanistan and political uncertainty followed by the announcement of a referendum and the general election. With a substantial decline (-44 per cent) in the second half of 2001, tourist arrivals declined by 15.9 per cent for the year as a whole. Total tourist arrivals in 2001 were 336,794 compared to 400,414 in 2000. Gross earnings from tourism declined

Chart 9.10
Tourism Statistics
(1997=100)



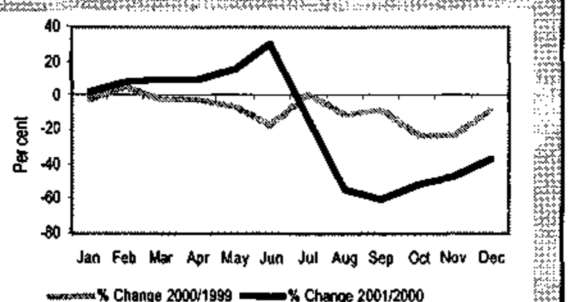
from US dollars 252 million in 2000 to US dollars 213 million in 2001.

SriLankan Airlines was not in a position to operate its normal schedules immediately, after several of its air planes were damaged in the attack on the airport. Rebuilding the confidence of foreign tour operators, foreign embassies and high commissions, foreign media and tourists became the major challenge facing the tourist industry.

The Ceylon Tourist Board (CTB) responded fast to formulate a crisis management plan in 2001. Under this plan major initiatives were taken to have foreign countries withdraw travel warnings and lower the insurance risk premium imposed by foreign airlines and shipping lines. The government introduced a relief package in 2001 to cover temporary difficulties faced by industrialists by way of rescheduling loans and interest payments. This included a moratorium on the repayment of capital and interest due for the period commencing 1 August 2001 up to 31 March 2002, capitalisation of loan repayment into a new loan or extending the repayment period or capitalisation of deferred interest. Loans were rescheduled on a case by case basis. As a result of efforts by the government and industrialists, most of the adverse travel advisories were withdrawn or modified and a slowdown in the rate of decline in monthly tourist arrivals was observed towards the end of 2001.

Tourist arrivals from almost all major regions declined during the latter half of 2001. Western Europe continued to be the major source of tourists to the country, accounting for 61 per cent of the arrivals but arrivals dropped by 22 per cent from the level in 2000. Arrivals from UK, the largest single source of arrivals from Western Europe, declined by 20 per cent while arrivals from other major sources such as Germany (-14 per cent), Italy (-28 per cent), France (-19 per cent), Switzerland (-27 per cent) and the Netherlands (-44 per cent) showed decreases. Norway is the only country in this region which recorded an increase (12 per cent) in tourist arrivals. Arrivals from Asia decreased by 2 per cent. Arrivals from East Asia decreased by 11 per cent, led by a decrease in arrivals from Japan

Chart 9.11
Change in Monthly Tourist Arrivals in 2000 and 2001



(-10 per cent) and Malaysia (-19 per cent). Arrivals from South Asia increased by 5 per cent with a 6 per cent increase in the arrivals from India. Tourist arrivals from Australasia and North America decreased by 28 per cent and 8 per cent, respectively, while arrivals from Eastern Europe increased by 3 per cent.

The majority of tourists visited the country for vacation, while about 11 per cent came for other purposes. The other purposes were mainly business, visiting friends and relatives and religious and cultural purposes. Out of the total arrivals, 78 per cent travelled in regular inter-regional flights, 19 per cent arrived in regular intra-regional flights and 3 per cent in charter flights. SriLankan Airlines brought in 55 per cent of the tourists in 2001, compared with 51 per cent in 2000. This improvement was a reflection of the better performance in the first half of year with the addition of six new aircraft to the fleet in 1999 and 2000. The introduction of two new direct flights to Australia and Sweden in November 2000 by SriLankan Airlines too helped to increase arrivals from these two sources. During the first half of 2001, tourists travelling by SriLankan Airlines increased by 25 per cent. The number of tourists travelling by SriLankan Airlines declined by 41 per cent during the latter half of 2001 recording a negative growth of 9 per cent for the year as a whole. However, its relative importance increased due to fewer operations of other airlines after the attack on the Airport in July. The share of charter flights declined from 7 per cent in 2000 to 3 per cent in 2001.

Confirming Sri Lanka's potential for developing new tourism products such as eco-tourism and culture tourism, revenue from tourists visiting wild life parks, botanical gardens, zoological gardens and the Cultural Triangle continued to increase during the first half of 2001. However following the setback in the industry, earnings from these sources declined during the latter half of the year. The Sri Lanka Convention Bureau continued to promote meetings, incentive travel, conventions and exhibitions (MICE) tourism in 2001. MICE is considered as one of the more lucrative niches of tourism in the world. The Bureau sponsored 78 conference, 7 exhibitions and 5 incentive groups in 2001. Tourists visiting the country under the MICE category were estimated as 1,796 in 2001. The Bureau participated in several international campaigns, promoting Sri Lanka as a destination for MICE tourism in Asia. As a part of the promotional programme, the Colombo City Tourist Hotel Association and the Sri Lanka Association of Professional Conference/Event Organisers signed an agreement to maintain minimum room rates for conferences and meetings.

Following the difficulties faced by the industry, foreign guest nights at tourist hotels declined by 23 per cent in 2001. Foreign guest nights in all regions except the East

TABLE 9.12
Tourism Statistics 1999 – 2001

Item	1999	2000 (a)	2001 (b)	Percentage Change	
				2000	2001
1. Tourist arrivals	436,440	400,414	336,794	-8.3	-15.9
2. Tourist guest nights ('000)	4,479	4,056	3,435	-9.4	-15.3
3. Room occupancy rate (%)	57.6	52.3	42.1	-9.2	-19.5
4. Gross tourist receipts (Rs.mn.)	19,288	19,095	19,034	-1.0	-0.3
5. Per capita tourist receipts (Rs.)	44,194	47,688	56,515	7.9	18.5
6. Total employment (No.)	87,744	91,063	85,063	3.8	-6.6
Direct	36,560	37,943	35,443	3.8	-6.6
Indirect	51,184	53,120	49,620	3.8	-6.6

(a) Revised
(b) Provisional

Sources: Ceylon Tourist Board
Central Bank of Sri Lanka

Coast, declined substantially. Even though small in number, foreign guest nights in the East Coast increased by 24 per cent. Compensating for the negative impact of lower foreign guest nights on the hotel industry, to some extent, local guest nights increased by 8 per cent with substantial improvements in the Colombo City and hill country. Special low rates and promotional packages introduced by the hotel industry to overcome short-term difficulties helped that increase. The increase in the number of local guests helped the hotel industry to survive during the crisis period.

The room occupancy rate declined to 42 per cent, compared with 52 per cent in 2000. Room occupancy rates in all regions decreased with substantial declines in the South Coast, Greater Colombo and ancient cities. The number of hotel units in the graded accommodation sector increased from 207 to 209 in all regions; South Coast (83 to 85) and Hill Country (14 to 16). However, the number of active hotels in the City of Colombo (23 to 22) and Greater Colombo (40 to 39) declined, while it remained unchanged in the East Coast (4) and Ancient Cities (43). With the increased number of hotel units, room capacity grew from 13,311 to 13,408 in 2001. According to the star-classification of hotels, graded hotels increased from 72 in 2000 to 73 in 2001.

The average duration of stay (ADS) of tourists in the country decreased from 10.1 days in 2000 to 9.9 days in 2001. The slight decrease in the ADS was mainly due to the decrease in the ADS from the Western Europe (11.3 days to 11 days), Middle East (9.5 days to 8 days), Africa (10.1 days to 9.6 days) and the Caribbean (11.3 days to 11 days). The average stay of tourists from the Netherlands was high (12.7 days), followed by tourists from Austria (12.5 days), Denmark (12.4 days) and Germany (12 days) compared to those from India (7.4 days), Pakistan (8.1 days) and Japan (8.7 days).

Both direct employment and indirect employment in the sector declined significantly in 2001. Direct employment is considered as employment in hotels and restaurants, travel agencies, tour operators, airlines agencies providing recreational facilities, tourist shops and the Ceylon Tourist Board. Domestic producers and suppliers of inputs, manufacturers and suppliers of handicrafts generate indirect employment.

Tourism has been considered as one of the key areas for bilateral and regional co-operation in many fora recently. Sri Lanka served as the lead country in tourism in the BIMST-EC since 1998. At the fourth Ministerial meeting of the BIMST-EC held in Yangoon, Myanmar in December 2001, Sri Lanka relinquished its lead role in tourism to accept the lead role in the technology sector. However, an action plan prepared by BIMST-EC for the tourism sector is in place. Under the activities of the Indian Ocean Rim Academic Group, Sri Lanka has undertaken a joint study with India for promoting tourism in IOR-ARC. The Ministry of Foreign Affairs through diplomatic mission in Beijing and the Chinese Embassy in Colombo has been actively pursuing the designation of Sri Lanka by China as an official tourist destination, to facilitate the visit of Chinese tourists to Sri Lanka.