Chapter 9

TRADE, BALANCE OF PAYMENTS AND TOURISM

9.1 Overall Developments

The external sector in 2003 gathered momentum from the recovery seen in 2002. International trade expanded. Receipts from services and worker remittances grew, reducing the current account deficit. Increased inflows through the financial and capital account more than offset the current account deficit bringing about a substantial surplus in the balance of payments (BOP) for the third consecutive year. Consequently, the foreign reserves of the country rose further to a comfortable level. The external competitiveness measured by the real effective exchange rate (REER), improved, as did the terms of trade. The external debt service ratio declined. As a whole, the foreign exchange market further expanded and deepened, although some volatility was experienced in this market towards the end of the year owing to uncertain political developments. All these developments would serve to strengthen the country's resilience to external shocks.

The external sector responded positively to favourable developments in both the global economy and the domestic economy. The global economy grew at a rate of 3.9 per cent, higher than the earlier expected growth rate of 3.2 per cent, while Sri Lanka's major export market, the US performed better, growing at 3.1 per cent. The impact of the war in Iraq was less severe than feared as it ended relatively quickly. However, oil prices increased in 2003, in contrast to the earlier expectations of a decline, following the Iraq war. The adverse impact of high oil prices was partly offset by favourable domestic weather conditions, which reduced the use of thermal power.

On the domestic front, the continuation of the ceasefire, improved macroeconomic management and accelerating economic reforms contributed to laying a strong foundation for future economic growth. This led to the approval of the Poverty Reduction and Growth Facility and the Extended Fund Facility (PRGF-EFF) by the IMF and enhanced assistance from the World Bank, ADB, Japan and other donors. These developments too had positive effects on the external sector. The PRGF-EFF facility made available IMF credit on more concessional terms and conditions than the assistance under the Stand-By Arrangement (SBA) that was completed in 2002. It was also considered an endorsement of the government's medium-term economic policies. This endorsement helped to obtain a larger amount of assistance from other donors as well. Donors pledged assistance of US dollars 4.5 billion during the period 2003-2006 at the donor conference held in Tokyo in June 2003.

The overall BOP recorded a surplus of US dollars 502 million in 2003, the highest such surplus since 1993. The major contributory factors for this very high surplus were a faster recovery in the tourism sector, continuous increase in port activities, higher worker remittances and increased utilisation of foreign aid by the government. In the sphere of trade, exports responded positively to favourable developments in the global economy and recorded a growth rate of 9 per cent in US dollar terms. The recovery in exports was broad based, with agricultural exports growing at 3 per cent and industrial exports at 10 per cent. Within industrial exports, garment exports recorded a 6.3 per cent growth, while other industrial exports recorded an impressive growth of 16.2 per cent, reflecting a move towards a beneficial diversification of Sri Lanka's industrial exports towards non-garment exports. Imports also grew at 9 per cent in US dollar terms during the year. Consumer goods imports grew by 12 per cent and investment goods by 13 per cent. The recovery in import of capital goods, particularly during the second half, is an indication of expanding investment activity in the economy creating a conducive environment for future economic growth.

The services account recorded a significant improvement during 2003 owing to a boost in tourist earnings and increased earnings from transportation services. The tourism industry benefited directly from the continuation of the cease-fire. A drop in outflows relating to rental payments for hired power due to a greater use of hydropower also contributed to this improvement. Meanwhile, the deficit in the income account contracted notably during the year owing to higher income generated from official reserves. Current transfers continued to record a steady growth of 9 per cent, due to increased worker remittances. The improvements in the services, income and transfer accounts offset the impact of a slightly larger trade deficit, resulting in the current account deficit contracting to US dollars 101 million (0.6 per cent of GDP) from US dollars 237 million (1.4 per cent of GDP) in 2002.

Meanwhile, capital inflows to the government through loans, grants and privatisation proceeds and the continuation of foreign direct investments (FDI) contributed to the improvement in the capital and financial account. The resultant overall surplus led to the building of official foreign reserves equivalent to 4.2 months of imports at end 2003, from 3.3 months of import cover at end 2002. The total gross external assets of the country, *i.e.*, official reserves plus foreign assets owned by commercial banks, were sufficient to finance 5.8

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				
	1999	2000	2001	2002	2003(b)	1999	2000	2001	2002	2003(b)
Trade Balance	-1,369	-1,798	-1,157	-1,406	-1,539	-96,702	-134,176	-102,592	-134,706	-148,324
Exports	4,610	5,522	4,817	4,699	5,133	325,170	420,114	430,372	449,855	495,426
Imports	5,979	7,320	5,974	6,106	6,672	421,873	554,290	532,964	584,561	643,750
Services, net (c)	147	38	204	295	396	10,342	2,907	14,692	28,224	38,152
Receipts	968	953	1,355	1,268	1,408	68,132	72,187	120,937	121,340	135,831
Payments	820	915	1,151	974	1,012	57,791	69,280	106,246	93,115	97,680
Income-net	-254	-305	-267	-253	-192	-17,831	-23,009	-23,842	-24,174	-18,540
Receipts	167	152	108	75	144	11,810	11,568	9,584	7,201	13,855
Payments	421	456	375	328	336	29,640	34,577	33,425	31,375	32,396
Goods, Services and Income (net)	-1,476	-2,064	-1,220	-1,364	-1,335	-104,191	-154,278	-111,742	-130,655	-128,713
Private Transfers, net	887	974	984	1,097	1,205	62,472	73,620	87,837	104,980	116,321
Receipts (d)	1,056	1,160	1,155	1,287	1,414	74,356	87,697	103,180	123,183	136,446
Payments	169	186	172	190	209	11,884	14,078	15,343	18,202	20,125
Official Transfers (net)	26	24	22	31	29	1,816	1,801	1,925	2,982	2,785
Current Account	-563	-1,066	-215	-237	-101	-39,903	-78,857	-21,980	-22,693	-9,608
Capital and Financial Account	373	443	562	444	702	30,473	31,827	49,077	40,634	67,851
Capital Account	80	50	198	65	61	5,650	3,795	17,766	6,219	5,927
Capital Transfers (net) (e)	80	50	198	65	61	5,650	3,795	17,766	6,219	5,927
Receipts	86	56	203	71	68	6,018	4,230	18,241	6,782	6,550
Payments	5	6	5	6	6	368	435	475	563	622
Financial Account	293	393	364	379	641	24,823	28,032	31,311	34,414	61,924
Long-term:	435	304	163	326	717	30,985	22,594	14,337	28,905	69,155
Direct Investment	177	176	172	185	201	12,449	13,319	15,271	17,716	19,450
Foreign Direct Investment	177	173	82	181	171	12,449	13,119	7,310	17,281	16,557
Privatisation Proceeds	-	3	90	5	30	-	200	7,961	435	2,893
Private Long-term (net)	196	82	-257	-21	-33	14,086	5,622	-22,918	-2,044	-3,215
Inflows (f)	361	298	44	115	102	25,727	22,134	4,016	11,007	9,855
Outflows (e)	165	216	301	136	136	11,641	16,512	26,934	13,052	13,070
Government, Long-term (net)	62	47	249	162	548	4,451	3,653	21,984	13,233	52,920
Inflows	381	355	575	542	908	26,896	26,965	51,193	51,843	87,554
Outflows	319	308	326	380	359	22,445	23,312	29,209	38,610	34,634
Short-term:	-142	88	201	53	-76	-6,162	5,438	16,974	5,509	-7,231
Portfolio Investment	-13	-45	-11	25	2	-886	-3,355	-1,025	2,443	209
Private Short-term (net)	-10	100	-42	68	18	-667	7,569	-3,798	6,548	1,790
Commercial Bank Assets (net)	-19	-141	183	104	-94	1,766	-18,736	2,867	6,893	-9,090
Commercial Bank Liabilities (net)	-101	174	71	-145	-2	-6,375	19,960	18,929	-10,375	-141
Government Short-term (net)	-	-	-	-	-	-	-	-	-	-
SDR Allocations	-	-	-	-	-	-	-	-	-	-
Valuation Adjustments	-	-	-	93		2,103	5,189	22,245	8,900	-
Errors and Omissions	-73	101	-127	38	-99	-6,857	10,902	-19,578	9,209	-9,634
Overall Balance (g)	-263	-522	220	339	502	-14,184	-30,939	29,765	36,051	48,610
Monetary Movements (g)	263	522	-220	-338	-502	14,184	30,939	-29,765	-36,051	-48,610
Exchange Rate Rs./US $	70.39	75.78	89.36	95.66	96.52					
Ratio to GDP in percentages										
Trade Account	-8.7	-10.8	-7.4	-8.5	-8.4					
Current Account	-3.6	-6.4	-1.4	-1.4	-0.6					
Current Account without Grants	-3.6	-6.6	-1.5	-1.6	-0.7					

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.

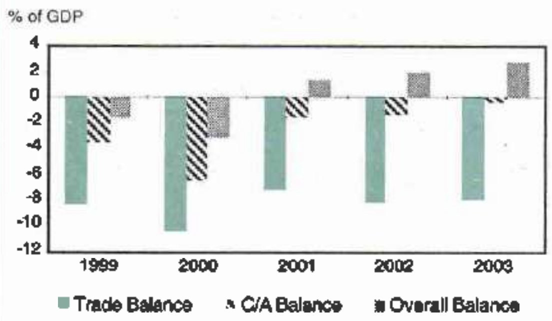
(d) Includes US dollars 85 mn. and US dollars 45 mn. received in 1999 and 2000 as compensation of US dollars 2,500 per person to 37,343 and 29,323 Sri Lankans, respectively, who lost employment in Kuwait due to the Gulf War in 1990. In addition, US dollars 27 mn was also received as second round payments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

(e) Includes US dollars 147.6 mn. in respect of a technical amortisation 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.

(f) 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.

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

Chart 9.1
Balance of Payments



months of imports at end 2003, in comparison to 4.9 months of imports at end 2002. The reserve build-up has reduced the country's external sector vulnerability and helped to stabilise the exchange rate.

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
2001	-12.8	-18.4	139.6	139.9	99.8	30.6	37.8
2002 (c)	-2.4	2.2	141.2	137.7	102.5	28.4	36.9
2003 (d)	9.2	9.2	150.2	136.3	110.2	27.7	36.0

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) Revised
(d) Provisional

The rupee depreciated marginally by 0.01 per cent against the US dollar in comparison to a depreciation of 3.7 per cent in 2002. However, due to the sharp depreciation of the US dollar in international foreign exchange markets against other major currencies, the rupee depreciated at a higher rate

Chart 9.2
External Trade

Chart 9.2.1
Trade Balance

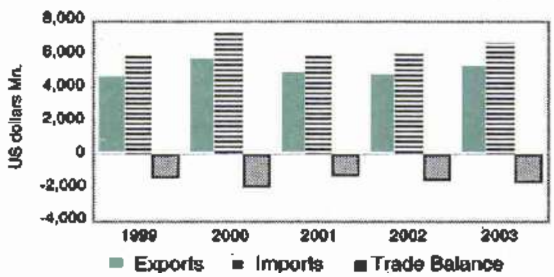


Chart 9.2.2
Export and Import Volume Indices
(1997 = 100)

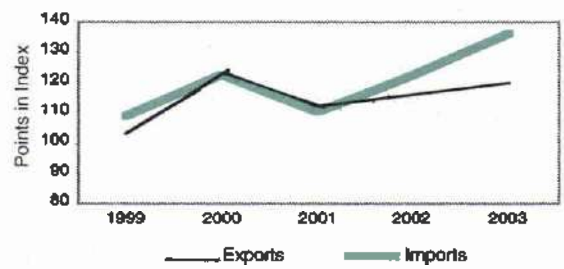


Chart 9.2.3
Unit Value Indices
(1997=100)

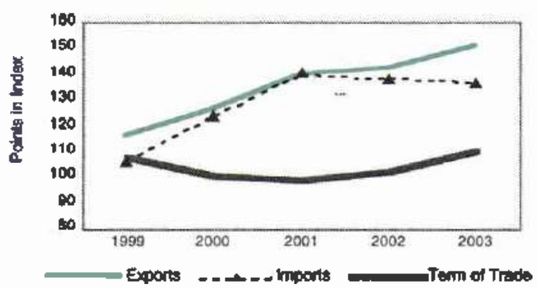
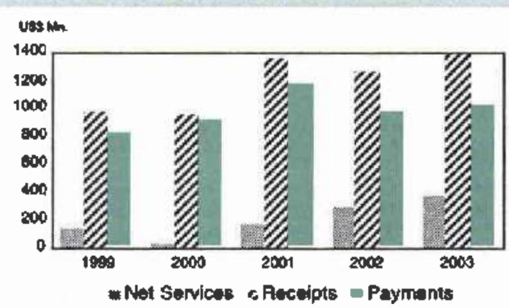


Chart 9.2.4
Trade in Services



against the euro, the pound sterling, yen and SDR. The larger depreciation against other currencies and the deceleration of domestic inflation improved Sri Lanka's external competitiveness measured in terms of two REER indices, namely, a 5-currency REER and a 24-currency REER, by 2.8 per cent and 3.4 per cent, respectively. Debt service ratios declined reflecting improved capacity of the country to service external debt due to higher foreign exchange earnings.

9.2 Exports

The export sector recovered in 2003, continuing the growth momentum that began in late 2002 after one and a half years of contraction experienced prior to that. Exports in US dollar terms increased by 9 per cent in 2003 in contrast to a decline of 2 per cent in 2002. Export earnings amounted to US dollars 5,133 million in 2003, compared with US dollars 4,699 million in 2002. Industrial exports, dominated by garment exports, made a significant contribution of 80 per cent to this improvement. Agricultural exports also contributed to this growth due to favourable tea and rubber prices. The global economic recovery strengthened the market for Sri Lankan products, particularly garments, machinery, mechanical and electrical equipment, rubber based products, diamonds, crustaceans and molluscs, fish products and plastics. Of the three major export categories, the value of agricultural exports in US dollars grew by 3 per cent and industrial exports increased by 10 per cent, while mineral exports declined by 7 per cent.

The unit value index of exports rose by 5.5 per cent, while the export volume index increased by 3.5 per cent. Export volume grew by 6.8 per cent and 10.2 per cent during the first and second quarters of 2003, respectively, but declined by 2.8 per cent during the third quarter and increased by 1.8 per cent during the fourth quarter of 2003. The slower growth performance during the second half was due to reduced growth in gems, petroleum products and a few other industrial products, which had grown substantially in the second half of 2002. Prices remained favourable throughout the year. The higher unit value partly reflects changes in product composition, which shifted to relatively more expensive and higher quality products. International prices of many industrial products exported by Sri Lanka remained at higher levels than in the previous year. The volume of industrial and agricultural exports increased by 3.1 per cent and 5.5 per cent, respectively, offsetting the impact of the decline in the volume of mineral exports (-2 per cent). With a decline in import prices by 1.8 per cent, the terms of trade improved by 7.4 per cent in 2003 compared with 4.6 per cent in 2002.

TABLE 9.3
Composition of Exports

Category	US dollars million					Rs. million				
	1999	2000	2001	2002	2003 (a)	1999	2000	2001	2002	2003 (a)
Agricultural exports	947	1,005	932	938	965	66,751	76,271	83,252	89,682	93,069
Tea	621	700	690	660	683	43,728	53,133	61,602	63,105	65,937
Rubber	33	29	24	27	39	2,305	2,179	2,129	2,552	3,718
Coconut	129	121	82	84	93	9,119	9,174	7,348	8,009	8,926
Kernel products	84	77	41	41	48	5,973	5,786	3,639	3,958	4,601
Other	45	45	42	42	45	3,146	3,386	3,709	4,051	4,325
Minor agricultural products	165	155	136	168	150	11,598	11,784	12,174	16,016	14,489
Industrial exports (b)	3,551	4,283	3,710	3,631	3,977	250,516	325,931	331,687	347,657	383,833
Food, beverages and tobacco	86	152	128	123	145	6,093	11,573	11,389	11,799	13,993
Textiles and garments	2,425	2,982	2,543	2,424	2,575	171,068	226,930	227,360	232,027	248,572
Petroleum products	74	98	68	73	65	5,210	7,414	6,053	7,003	6,299
Rubber products	161	196	172	182	231	11,350	14,924	15,417	15,441	22,299
Ceramic products	49	47	42	42	42	3,442	3,558	3,791	4,046	4,064
Leather, travel goods and footwear	201	176	150	84	58	14,140	13,391	13,400	8,045	5,583
Machinery and equipment	201	244	245	266	290	14,155	18,594	21,895	25,509	27,951
Diamonds and jewellery (c)	171	192	165	205	233	12,064	14,546	16,495	19,634	22,506
Other industrial exports	184	197	177	231	338	12,995	15,002	15,887	24,153	32,566
Mineral exports	64	97	86	90	84	4,540	7,352	7,666	8,628	8,069
Gems	61	93	82	86	79	4,326	7,091	7,276	8,173	7,601
Other mineral exports	3	3	4	5	5	214	262	390	455	468
Unclassified (d)	48	137	88	41	108	3,363	10,560	7,767	3,883	10,455
Total exports (b)	4,610	5,522	4,817	4,699	5,133	325,171	420,114	430,372	449,850	495,426

(a) Provisional
(b) Adjusted
(c) Diamond exports reported by the Sri Lanka Customs from 1999 onwards were adjusted for data obtained from the National Gem and Jewellery Authority.
(d) 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

Export Structure

Since liberalisation in 1977, the share of industrial exports expanded continuously and had become the major contributor to 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 2003. This ratio has remained above 75 per cent during the last 6 years. The share of other exports, including mineral exports, declined from 7 per cent in 1977 to 4 per cent in 2003. Textiles and garments, which have provided the largest contribution to industrial exports since 1986, contributed 65 per cent of industrial exports in 2003.

Industrial Exports

Earnings from industrial exports increased by 10 per cent in 2003 compared to a decline of 2 per cent in 2002. Textiles and garments contributed 50 per cent to the total export earnings in 2003. The other major categories were machinery, mechanical and electrical equipment (6 per cent), diamonds and jewellery and rubber based products (4.5 per cent) each, food, beverages and tobacco (3 per cent), leather products and footwear and petroleum products (1 per cent each) and miscellaneous items totalling 7 per cent.

The major contribution to the increase in industrial exports came from higher exports of textiles and garments, in response to increased demand from industrial countries. Earnings from textile and garment exports increased by 6.3 per cent to US dollars 2,576 million in 2003, continuing the increasing trend since October 2002. The volume and unit price of textiles and garment exports increased by 3 per cent each during 2003.

USA and the European Union (EU) continued to be major export destinations for Sri Lanka's textiles and garment exports accounting for 93 per cent of all garment exports in 2003. Garment exports to USA and the EU increased by 4 per cent and 12 per cent, respectively, as demand rose in these two economies. Although EU had removed quota restrictions on textiles and garments imported from Sri Lanka from 1 January 2001, Sri Lanka was not able to achieve the expected gains in 2001 and 2002, as markets were depressed in the EU. However, in 2003, Sri Lanka was able to benefit from quota free access to EU markets by supplying high quality and high value garments. As garments were also among products that received additional benefits under the Special Incentive Arrangement (SIA) of EU under the Generalised System of Preference (GSP) effective from 1 February 2004, this upward trend is expected to continue in 2004. Exports to Canada, which were under quota restrictions, increased by 2 per cent in 2003. The relative share of garment exports to other quota free countries increased from 4 per cent in 2002 to 5 per cent in 2003. Including the EU, the share of garments exported to non quota countries increased from 35 per cent in 2002 to 37 per cent in 2003, reflecting continued reduction in dependence on quota, albeit at a slower rate.

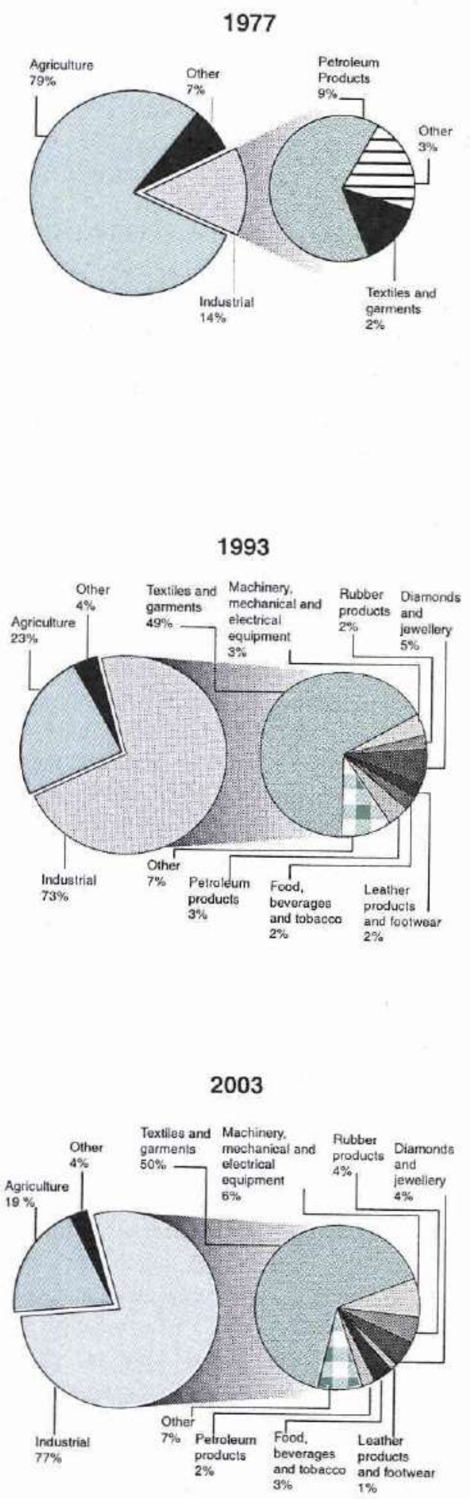
Of the subcategories in the textiles and garment sector, garment exports increased by 7 per cent, while textile exports increased by 4 per cent. Export of yarn and other made up articles declined by 10 per cent and 8 per cent, respectively. In 2003, more than 94 per cent of textile and garment exports came from BOI enterprises. Export earnings of BOI enterprises increased by 8 cent compared to a decrease of 3 per cent in 2002. Exports by non-BOI enterprises, which are mainly by small scale exporters, declined further by 16 per cent in 2003 compared to an 18 per cent decline in 2002, demonstrating the difficulties of competing in a market where cost and quality factors determined sales. Net foreign exchange earnings from the textile and garment sector increased by 9 per cent in 2003. As prices of textile imports remained at the previous year's level this increase reflects a move towards higher value added products in the garment industry, which was anticipated.

Industrial exports, excluding textiles and garments, grew by 16.2 per cent in 2003, compared to 3 per cent in 2002. Among these, exports of machinery and mechanical and electrical equipment increased by 9 per cent. Earnings from rubber based product exports increased by 27 per cent, compared to 6 per cent in 2002. The growth was mainly in export of tyres and gloves. Tyres, *i.e.* re-treaded, new pneumatic, solid and cushion, accounted for 52 per cent of total rubber based product exports and increased by 42 per cent in 2003. Industrial and surgical gloves accounted for 31 per cent of rubber based product exports and grew by 18 per cent. Other major rubber based product exports that increased during the year included apparel and clothing accessories, floor coverings and mats, pharmaceutical products, plates, sheets and strips and inner tubes.

The export of diamonds and jewellery increased by 14 per cent in 2003, compared to an increase of 11 per cent in 2002. Diamond exports increased by 13 per cent in 2003 responding to high demand from major trading centres such as Belgium, Israel, Vietnam, USA and Japan. The jewellery market, which suffered due to the sluggish economic situation in Japan, USA and the European markets in 2002, recovered steadily and grew by 26 per cent in 2003. During the year, jewellery producers benefited from the exemption from VAT granted to raw materials such as gold, silver, diamonds, pearls and gem imports after August 2002. The demand for diamonds and gems in the local market too remained high due to the growth in the tourist industry. Germany was the largest buyer of jewellery from Sri Lanka (20 per cent) followed by UAE, Japan, Switzerland, Singapore and UK.

Export earnings from food, beverages and tobacco increased by 18 per cent in 2003 compared to the decline of 4 per cent in 2002. This was attributable to higher earnings from crustaceans and molluscs, and fresh and frozen fish, which increased by 20 per cent and 18 per cent, respectively. However, prices of these products in international markets were lower than in the previous year. The low returns on shrimp exports has acted as a disincentive to the expansion of farming.

Chart 9.3
Share of Exports by Major Categories



The Ministry of Fisheries and Ocean Resources has been closely monitoring the quality and standards of farms against a set of required quality and standards determined under the Fisheries and Aquatic Resources Act as a precautionary measure to control diseases. Legal action was initiated against farms that had violated these regulations. Demand for these products in USA, Japan and France and some Asian countries including Singapore, Hong Kong, South Korea and Thailand remained high.

The European Council approved eight fish processing plants in 2003 to export fish products to EU countries. The construction of a fish canning and smoking factory at the Mutuwal Fishery Harbour commenced in December 2003. This project targets both export and local markets and is expected to commence production in August 2004. Among other food exports, fruit and vegetable juices, manufactured tobacco, coconut milk powder, coconut cream, malted milk, sweet biscuits and mineral water exports increased in 2003.

Earnings from the export of petroleum products declined by 11 per cent as naptha produced by the Ceylon Petroleum Corporation was fully utilised domestically by the combined cycle power plant for power generation. However, the export value of bunkering and aviation fuel increased by 9 per cent with improvements in port and aviation services and higher unit prices. Export earnings from all other major categories including, plastics, ceramic products, chemical products, footwear and other leather products, articles of wood, toys, articles of copper, quartz, coconut by products etc., increased during the year.

Agricultural Exports

The three plantation crops contributed 84 per cent to agricultural exports in 2003 – tea 71 per cent, coconut 9 per cent and rubber 4 per cent. Other agricultural exports, which are dominated by cinnamon, cloves and un-manufactured tobacco, contributed the remaining 16 per cent. Export earnings from agricultural products increased by 3 per cent, largely due to the increase in plantation crop exports.

Plantation Crops

Earnings from tea, amounting to US dollars 683 million, increased by 4 per cent in 2003. Tea exports suffered due to the Iraq war, but recovered in May and June due to large volumes of tea being exported to Middle Eastern countries following the end of the war. This recovery continued, resulting in an 11 per cent growth during the latter half of 2003. However, the annual increase was marginal. Tea export prices, which were lower than in 2002 until May 2003, recovered gradually thereafter, resulting in an average price of US dollars 2.29 per kg in 2003 as against US dollars 2.26 per kg in 2002.

Of total tea exports, 59 per cent were in bulk form, and 33 per cent in packed form. The remaining 8 per cent was in tea bags and higher value added forms such as domestic tea blended with foreign teas and instant and green teas. Russia continued to be the single largest buyer with a share of 19 per cent in 2003. The Russian government raised the minimum import duty on value added black/green tea from euro 0.40 to euro 0.80 per kg with effect from 11 March 2003. Simultaneously, they raised the minimum declared value of tea sharply by 100 -200 per cent. Tea exports to Russia in bulk form, which is not subject to tariff revision, increased by 397 metric tons to 32,762 metric tons in 2003. Teas in value added forms too increased by 1,947 metric tons to 25,344 metric tons accounting for 44 per cent of total tea exports to Russia. With this tariff revision, Sri Lanka will find it difficult to compete with Russia's local value added tea producers. However, Russia's effort to popularise value added tea may create a demand for bulk tea exports.

Syria overtook the United Arab Emirates (UAE) and became the second largest buyer of tea with a share of 10 per cent. This was partly because tea was channelled through Syria to Iraq and other Arab countries during the war period. UAE accounted for 9 per cent. Other major buyers were Libya (7 per cent), Turkey (6 per cent), Iran (5 per cent) Jordan and Saudi Arabia (4 per cent) each. As a group, Middle East countries bought 43 per cent of total tea exports, while CIS countries bought 25 per cent and EU bought 10 per cent in 2003.

Earnings from the three major coconut products, namely, desiccated coconut, copra and coconut oil, increased by 16 per cent in 2003 compared with an increase of 1 per cent in 2002. The increase was a result of significant increases in the export volumes of desiccated coconut and copra, which came from the increased coconut crop and lower domestic demand from the coconut oil industry. That demand was lower as edible oil imports increased after the special surcharge on import duties was removed in September 2002. The exported volumes of these products increased by 48 per cent and 32 per cent, respectively, while their prices declined by 22 per cent and 11 per cent, respectively. Coconut oil exports however, declined by 4 per cent in 2003. This is evidence of the adverse impact of ad hoc changes in tariff policy, which create distortions in the market. With the higher harvest of fresh nuts, coconut product exports, other than the three major products, too increased by 6 per cent in 2003. Export earnings from coir fibre mattresses and coir yarn grew significantly. A long-term clear tariff policy is critical to developing the coconut product export industry on a more sustainable basis.

Export earnings from rubber increased by 44 per cent to US dollars 39 million in 2003, which accounts for less than 1 per cent of total exports earnings. Rubber prices continued to increase since July 2002 following international market trends. The average rubber export price increased by 50 per cent in 2003 over 2002. The volume of exports declined by 1.4 million kg to 35.3 million kg in 2003. Lower export volumes were due to high local consumption in industry. Rubber production increased from 90.5 million kg in 2002 to 92 million kg in 2003, while local consumption of rubber increased from 54 million kg to 56 million kg in 2003, as the rubber based manufacturing sub-sector expanded during 2003. To meet the input requirements of the local industrial sector, 9.2 metric tons of natural rubber were imported in 2003 compared with 4.9 metric tons in 2002.

Other Agricultural Exports

Export earnings from other agricultural exports, known as minor agricultural exports, declined by 10 per cent to US dollars 150 million in 2003 from US dollars 168 million in 2002. Three major crops in this category, *viz.*, cinnamon, unmanufactured tobacco and pepper, accounted for 63 per cent of total other agricultural product exports in 2003. Earnings from cinnamon exports increased marginally. Despite price increases, exports of unmanufactured tobacco declined due to increased demand in the local industry. The quantity of pepper exported declined by 2 per cent, while pepper prices declined by 15 per cent because of increased global production. Furthermore, Indian pepper producers lobbied against pepper imports from Sri Lanka as Sri Lanka has enjoyed a 100 per cent tariff concession under the Indo-Sri Lanka Free Trade Agreement (ISLFTA) since March 2003. This protest may have negative impacts on Sri Lanka's exports, depending on the outcome of lobbying. Earnings from cloves, which became a significant commodity among other agricultural products in 2002, declined by 79 per cent (US dollars 23 million) in 2003. Both prices and the volume of clove imports to India from Sri Lanka declined since the quality fell below expected levels. Demand for nutmeg and mace remained steady throughout the year. Cardamom prices declined, but export volumes increased substantially to satisfy demand from India. All these spices received duty free access to the Indian market after March 2003. Increased prices for exports of vegetables resulted in a higher export value, despite lower quantities. Export earnings from dry and fresh fruits, betel leaves and coffee increased, while earnings from essential oils, arecanuts, cashew nuts and cocoa products declined in 2003.

Mineral Products

Earnings from mineral exports declined by 7 per cent in 2003 mainly due to a decline in gem exports, which account for 94 per cent of mineral exports. Gem exports were affected by unresolved issues in the gemstone trade, especially the controversy over artificial quality improvements to sapphires in Thailand. Buyers had questioned whether Sri Lanka too used chemicals in the heat treatment process and this caused an adverse impact on the gem trade during the early part of the year. However, this problem was resolved in favour of Sri Lanka. Sri Lankan heat treated gemstones regained the market towards the end of 2003. The high standards maintained by Sri Lanka will improve Sri Lanka's competitiveness over Thailand in heat treated gemstones.

Sri Lanka continued to be the largest supplier of top quality large blue sapphires of natural colour to the world market and the prices of these products were stable during the year. The demand for calibrated blue, pink and yellow sapphires in the European and US markets remained stable throughout the year. USA continued to be the largest buyer of Sri Lankan gems in 2003. Italy, Switzerland, UK, Germany and France were among the major buyers in the European market. Hong Kong maintained its position as the centre for fine gems and jewellery in the Asia-Pacific region. Japan and Thailand continued to be major markets for Sri Lankan gems in this region. Gem sales were higher in the local market with the revival of the tourist industry since the latter part of 2002. On the supply side, floods and earth slips in May and June 2003 adversely affected gem mining, but supply recovered gradually thereafter. The National Gem and Jewellery Authority completed scientific surveys and auctioned new lands for mining in Balangoda, Wellawaya and Matara, which increased the supply of raw gems towards the end of 2003. Earnings from other mineral exports grew by 2 per cent, reflecting higher earnings from ilmenite exports.

9.3 Imports

Imports grew by 9 per cent to US dollars 6,672 million in 2003 compared to 2 per cent in 2002 reflecting the economic recovery and the reduction of the import surcharge from 40 per cent to 20 per cent. Demand for intermediate goods increased due to the recovery in exports and domestic market oriented industrial activity, while demand for investment and non-food consumer goods increased reflecting improved investor and consumer confidence. Food imports increased only marginally, as lower imports of rice, wheat and sugar, offset the increases in milk food and other food items. The import volume index increased by 11 per cent, while the unit price index declined by 2 per cent in 2003, high petroleum prices notwithstanding.

Import Structure

There has been a gradual shift from consumer goods to intermediate and investment goods imports since economic liberalisation in 1977. Expansion in the industrial sector required higher imports of intermediate goods, while infrastructure development and construction activities, expansion in transport sectors and increased use of advanced technology increased imports of investment goods. Further, an increase in the domestic supply of rice and other food items reduced the need for food imports. When compared with 2002, the relative importance of intermediate and investment goods increased marginally from 76 per cent to 77 per cent, while consumer goods remained at 22 per cent. The share of other imports (including defence related imports) decreased from 2 per cent to 1 per cent in 2003.

TABLE 9.4
End-Use Classifiction of Imports

Category	US dollars million					Rs. million				
	1999	2000	2001	2002	2003(a)	1999	2000	2001	2002	2003 (a)
Consumer goods	1,242	1,388	1,235	1,319	1,481	87,505	105,403	110,059	126,181	142,911
Food and drink	661	693	654	696	701	46,562	52,584	58,466	66,540	67,713
Rice	46	4	11	18	8	3,290	288	969	1,732	819
Sugar	106	141	115	132	116	7,448	10,777	10,289	12,634	11,196
Wheat	111	127	110	130	137	7,792	9,625	9,783	12,427	13,255
Other	398	421	419	415	440	28,032	31,894	37,425	39,746	42,443
Other consumer goods	581	696	581	623	779	40,943	52,619	51,593	59,641	75,198
Intermediate goods	3,057	3,789	3,321	3,492	3,811	215,658	287,196	296,522	334,357	367,676
Petroleum	500	901	731	789	838	35,344	68,381	65,190	75,627	80,807
Fertiliser	66	80	67	76	88	4,690	6,059	6,047	7,259	8,457
Chemicals	136	147	142	155	170	9,590	11,152	12,647	14,792	16,363
Textiles and clothing	1,320	1,471	1,320	1,321	1,372	93,105	111,386	117,993	126,438	132,415
Other intermediate goods (b)	1,035	1,190	1,061	1,151	1,344	72,929	90,218	94,644	110,241	129,634
Investment goods	1,565	1,737	1,081	1,170	1,320	110,599	130,889	96,185	112,046	127,363
Machinery and equipment	678	787	610	640	698	47,736	59,538	54,287	61,296	67,330
Transport equipment (c)	523	529	129	151	206	37,191	39,489	11,469	14,449	19,869
Building materials	260	305	249	272	328	18,296	23,087	22,145	26,013	31,677
Other investment goods	105	116	93	108	88	7,376	8,776	8,285	10,288	8,487
Unclassified imports	115	406	337	125	60	8,126	30,802	30,198	11,907	5,799
Total imports (d)	5,980	7,320	5,974	6,105	6,672	421,888	554,290	532,964	584,491	643,749

(a) Provisional
(b) Diamond imports reported by the Sri Lanka Customs in 1999 and 2000 were adjusted for data obtained from major importers.
(c) Includes the value of 3 aircraft each imported by SriLankan Airlines in 1999 and 2000.
(d) Adjusted

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

Consumer Goods

The import of consumer goods increased by 12 per cent in 2003 though food and drink imports increased by 1 per cent over 2002. This marginal growth was largely attributable to high imports in December 2003 (40 per cent increase over December 2002), partly reflecting the impact of anticipated upward revisions of tariffs and Value Added Tax (VAT) in Budget 2004. Slower growth in food imports was attributed to declines in rice, wheat and sugar imports, which offset the impact of higher imports of milk products and other food items.

The largest food item, wheat grain imports, declined to 918,700 metric tons in 2003 compared to 993,200 metric tons in 2002. Wheat imports in 2002 were unusually high as this included delayed wheat shipments from 2001 and wheat imported for building up domestic stocks. Sri Lanka imported more than 80 per cent of its total wheat requirement from India in 2003. This share was 57 per cent in 2002. The Indian export credit line of US dollar 31 million made available to Sri Lanka for wheat imports was the major reason for this change. Sri Lanka had already used US dollars 7.4 million in 2003. Wheat flour imports declined from 11,325 metric tons in 2002 to 9,705 million in 2003.

Rice imports declined from 95,100 metric tons in 2002 to 34,580 metric tons in 2003, due to the record domestic paddy production in 2003. Despite lower import prices, sugar imports declined by 44,600 metric tons to 509,300 metric tons in 2003. Despite higher prices, imports of milk products increased by 3 per cent in volume terms. Fish imports increased marginally, utilising the duty free facility granted in September 2002. Despite higher import duties, imports of big onions, potatoes, chillies, garlic and fruit increased to satisfy higher demand as well as to compensate for lower domestic production than in 2002.

Imports of all major categories of consumer durables increased significantly, reflecting the impact of increased consumer confidence and income. Imports of motor cars and motor cycles increased by 67 per cent in 2003, while the import of rubber tyres and tubes rose by 10 per cent. Imports of radio receivers and television sets increased by 18 per cent, while medical and pharmaceutical imports increased marginally. Other consumer durable imports, which increased in 2003, were ceramic and glass tableware, electrical kitchenware, clothing, footwear, toys and skin care products.

Intermediate Goods

Intermediate goods imports increased by 9 per cent in value terms in 2003. Textile imports, the largest item, accounted for 36 per cent of intermediate goods imports in 2003. The volume of textile imports increased by 4 per cent reflecting higher derived demand from garment exports. The expenditure on textile imports increased by 4 per cent, entirely due to higher volume.

The second largest item, crude oil and refined petroleum products, accounted for 22 per cent of total intermediate goods and rose by 6 per cent in 2003. The volume of crude oil imports declined from 16.8 million barrels in 2002 to 14.7 million barrels in 2003. The average price of crude oil increased by 17 per cent from US dollars 25.13 per barrel in 2002 to US dollars 29.46 per barrel. The value of refined petroleum product imports increased by 11 per cent due to increased prices (18 per cent) although the quantity imported was less than in 2002. The lower volume of petroleum imports was due to reduced demand for thermal power generation with increased hydropower generation.

The value of diamond imports, the third largest intermediate import item, increased by 22 per cent, reflecting the improvement in exports. Expenditure on fertiliser imports increased by 16 per cent entirely due to high prices as the quantity declined by 4 per cent. Although the fertiliser subsidy scheme was continued, increased domestic prices may have reduced the demand for fertiliser in 2003. Other intermediate goods imports increased by 15 per cent, mainly due to higher imports of inputs for paper, chemicals, garments, jewellery, bakery and rubber based manufacturing industries.

Investment Goods

Imports of investment goods increased by 13 per cent in 2003. The import of transport equipment rose by 37 per cent, with high volumes of imports of parts and accessories for lorries,

TABLE 9.5

Volume of Major Imports (a)

'000 mt

Item	1999	2000	2001	2002	2003(b)
Rice	214	15	52	95	35
1st Quarter	24	7	3	51	22
2nd Quarter	12	7	7	9	9
3rd Quarter	31	...	2	10	2
4th Quarter	146	1	40	25	2
Wheat	859	922	760	993	919
1st Quarter	207	266	231	309	262
2nd Quarter	263	210	229	215	232
3rd Quarter	189	247	177	221	216
4th Quarter	200	199	123	248	208
Sugar	479	562	420	554	509
1st Quarter	152	128	100	146	151
2nd Quarter	64	185	127	141	135
3rd Quarter	138	85	109	110	104
4th Quarter	125	164	84	157	120
Petroleum (Crude oil)	1,832	2,347	1,954	2,300	1,995
1st Quarter	244	608	237	539	382
2nd Quarter	503	583	539	513	466
3rd Quarter	548	613	624	593	500
4th Quarter	537	543	554	655	647
Fertiliser	539	559	460	537	514
1st Quarter	97	149	66	103	124
2nd Quarter	158	102	183	163	166
3rd Quarter	129	174	83	138	49
4th Quarter	155	134	128	133	175

(a) Adjusted
(b) Provisional

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

railway or train, trucks and buses. Machinery and equipment imports increased by 9 per cent with higher imports of sewing machines and parts and accessories and portable digital automatic data processing machines, parts for concrete block making machines, electricity generators and television sets. The import of building materials increased by 21 per cent with the recovery in the construction sector.

Direction of Trade

Industrialised countries are the main destination for Sri Lankan exports following the economic liberalisation in 1977. However, the share of these countries has been declining gradually from 76 per cent in 1995 to 70 per cent in 2003. Similarly, as origin of imports, the share of industrial countries declined from 37 to 31 per cent during the same period. Trade with Asian countries expanded. The share of developing countries as export destinations increased from 22 per cent in 1995 to 25 per cent in 2003. The share of Eastern European countries increased from 2 per cent to 4 per cent. The share of developing countries as the origin of Sri Lanka's imports, increased from 64 per cent in 1995 to 68 per cent in 2003.

Chart 9.4
Direction of Trade

Chart 9.4.1
Exports by Destination

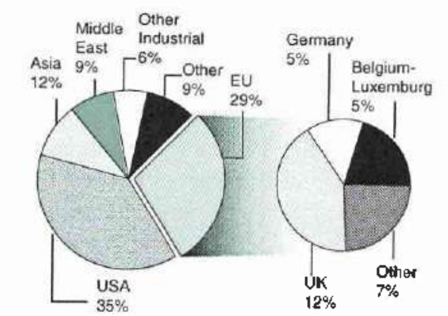
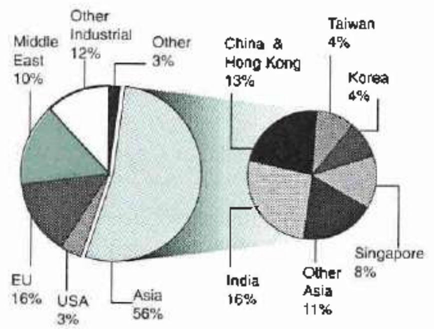


Chart 9.4.2
Imports by Origin



USA has been the single largest buyer of Sri Lanka's exports since 1979. However, its market share declined from a peak of 41 per cent in 2001 to 38 per cent in 2002 and 35 per cent in 2003. Textile and garment exports accounted for 83 per cent of total exports to USA in 2003. The market share of UK, the second largest buyer, remained unchanged at 13 per cent. Shares of garments and tea in exports to UK accounted for 77 per cent and 2 per cent, respectively. The Indo-Sri Lanka Free Trade Agreement (ISLFTA) helped increase trade with India. In 2003, the third year after the commencement of the Agreement, India bought 5 per cent of Sri Lanka's total exports. Exports to Germany, Belgium and Luxembourg accounted for 5 per cent each and to Japan for 3 per cent. Major exports to Germany were garments and tea, while diamonds and garments were the main exports to Belgium and Luxembourg. Other major items exported to Western countries were precious stones, gloves, tyres, coconut by-products, prawns and fish products and statuettes and ornamental articles. Japan remained one of Sri Lanka's major markets for frozen shrimp, machinery parts and accessories, tea, fish products and precious stones. Western industrial countries as a group continued to be Sri Lanka's largest export trading partner in 2003.

Once again, India was the largest source of imports (16 per cent), followed by China and Hong Kong (13 per cent), Singapore (8 per cent) and Japan (7 per cent). Imports from India increased by 26 per cent in 2003. Petroleum products, wheat, cotton yarn and fabrics, food products including sugar, onions, chillies, lentils, edible products *etc.*, iron and steel, vehicles, pharmaceutical products and machinery were the major items imported from India. Imports from China and Hong Kong increased by 18 per cent, while those from Singapore increased by 21 per cent. Fabric and accessories for the garment industry were the major items imported from China and Hong Kong. Petroleum products, sewing machines, telephone equipment and data processing machines and parts were among the major items imported from Singapore. Imports from Japan increased by 26 per cent due to an increase in motor vehicle imports. Other significant sources of imports were the Republic of Korea, Taiwan, Malaysia and UK (4 per cent each) and USA and UAE (3 per cent each). Accordingly, Asian countries, as a group, continued to be the major origin of imports. Their market share increased from 53 per cent in 2002 to 56 per cent in 2003. Imports from Asian countries increased by 15 per cent, mainly as a result of higher imports from India.

Countries in the South Asian Association for Regional Co-operation (SAARC) accounted for 7 per cent of the total exports and 18 per cent of total imports in 2003, an increase over the respective shares of 6 per cent and 16 per cent in 2002. In the SAARC region, India was Sri Lanka's largest export destination (5 per cent of total exports) and the largest source of imports and its share has been increasing at a faster rate since the implementation of the free trade agreement between the two countries. Sri Lanka's trade with Pakistan increased significantly over the previous year, though still small in absolute terms (1 per cent of total exports and imports each). EU accounted for 30 per cent of total exports and 16 per cent of total imports in 2003. Exports to CIS countries accounted for 4 per cent of Sri Lanka's exports with higher tea exports to Russia.

9.4 Services and Income

The services account registered a higher surplus for the third consecutive year, registering a net inflow of US dollars 396 million, a 34 per cent increase over the previous year. The improvement in the services account was mainly brought about by higher receipts from travel and transportation services.

Earnings from travel have two components; namely, earnings from tourism and receipts from non-resident Sri Lankans visiting Sri Lanka. The boom in tourist arrivals resulted in tourist earnings rising by 30 per cent to US dollars 324 million in 2003. Receipts from non-resident Sri Lankans visiting Sri Lanka have been estimated at US dollars 100 million during the year. Even though this inflow is expected to level off over the years, permanent peace could make this a regular inflow of foreign exchange as non-resident Sri Lankans are likely to visit the country more frequently.

Net transportation services, which include passenger fares, freight services and port related earnings, increased by 10 per cent to US dollars 201 million owing mainly to higher tourist arrivals. Although activities relating to transshipment cargo handling increased during the year, foreign receipts increased only marginally due to more competitive prices offered for services at the Colombo port.

The IT sector recovered in 2003 from the setback in 2002. The slowdown in the world economy in 2001 and 2002 caused a major decline in overall IT spending the world over as large global enterprises reduced purchases of IT products and services, causing many IT solution suppliers worldwide to suffer losses and decreases in overall growth. Sri Lanka's computer and information services sector, which was also affected by these global trends, had a significant recovery in 2003. IT exports increased by 60 per cent to US dollars 80 million in 2003 from US dollars 50 million in 2002. With the earnings per employee being significantly higher than those of other major foreign exchange earners, this is an area in which Sri Lanka has a considerable potential not only in terms of earning foreign exchange, but also in attracting foreign direct investments as well as generating employment opportunities. The government could support this sector by adopting the required regulatory environment, upgrading and modernising infrastructure and assisting human resource development, in terms of quantity as well as quality.

Net receipts from the telecommunications services declined by 26 per cent to US dollars 45 million during the year. With the liberalisation of the international gateway under the new National Communications Policy, about 30 companies applied for new licences for using and providing services to customers. The high competition has led to a significant fall in the domestic price of international calling charges raising the number of Sri Lankans calling the rest of the world. Meanwhile, the deficit from other business services declined by 13 per cent to US dollars 117 million, owing to lower outflows on account of hired power-rental payments, as the use of thermal power was replaced with hydropower to some extent during 2003 due to favourable domestic weather conditions.

TABLE 9.6

Net Services, Income and Transfers (a)

Item	US dollars million		Rs. million	
	2002	2003(b)	2002	2003(b)
Transportation	183	201	17,535	19,392
Travel	100	145	9,629	13,940
Telecommnication services	61	45	5,795	4,380
Computer and information services	50	80	4,783	7,701
Construction services	27	34	2,534	3,329
Insurance services	18	19	1,710	1,827
Other business services	-134	-117	-12,773	-11,292
Government expenditure n.i.e.	-10	-11	-989	-1,126
Total services	**295**	**396**	**28,224**	**38,152**
Compensation of employees	-4	-5	-425	-530
Direct investment	-96	-89	-9,154	-8,612
Interest and other charges	-152	-98	-14,595	-9,398
Total income	**-253**	**-192**	**-24,174**	**-18,540**
Private	1,097	1,205	104,980	116,32
General government	31	29	2,982	2,785
Total current transfers	**1,128**	**1,234**	**107,962**	**119,106**

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

The deficit in the income account contracted significantly during the year, mainly due to a significant increase in income from the country's international reserves, and helped to reduce the current account deficit. Both gross official reserves and international reserves of commercial banks increased for the third consecutive year, while global interest rates remained at almost the same level as in 2002. As a result, interest income on international reserves increased during the year. In addition, efficient management of official reserves by the Central Bank and movements in cross currency exchange rates and prices of foreign securities held by the Central Bank had a favourable effect on foreign exchange trading profits and foreign securities trading profits. Income generated from official reserves increased to US dollars 110 million from US dollars 41 million in 2002. This was sufficient to meet over 75 per cent of the interest payments on government external debt. Outflows to the income account, which comprised interest payments on external debt of the country and profits and dividends to non-residents on foreign investments, increased by 2 per cent to US dollars 336 million in 2003.

9.5 Current Transfers

Net inflows to the transfers account continued to contribute in increasing volumes to offset the trade deficit. In 2003, the surplus in the transfers account amounted to 91 per cent of the trade deficit. This ratio was below 50 per cent prior to 1996 and below 70 per cent prior to 2000, except for 1998 when the trade deficit was exceptionally low.

Total net current transfers, comprising net private transfers and net official transfers, increased by 9 per cent to US dollars 1,234 million. Net private transfers, which account for over 98 per cent of total net transfers, were the main source of the improvement. Sri Lankan migrant workers remitted US dollars 1,414 million in 2003, an increase of 10 per cent over the previous year.

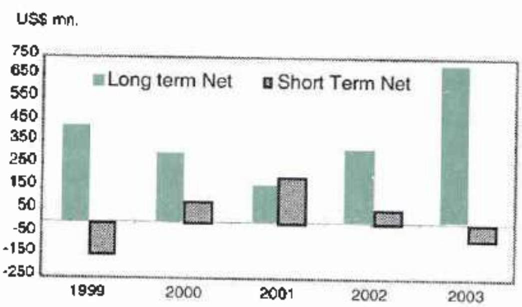
The improvement in 2003 is partly due to an increase in the number of Sri Lankans migrating for foreign employment. Annual migrants increased by 3 per cent, to 208,801 in 2003. The Iraq war appears to have had little adverse impact on foreign employment in the Middle East, as it ended earlier than expected. Due to the uncertainties that prevailed in the Middle East region prior to the war, workers are believed to have remitted more of their savings in advance as a precautionary measure. This is reflected in higher remittances during the first few months of 2003. The ongoing peace process would also have led to more funds being channelled through the formal banking sector, particularly in the North and East, where commercial banks were more active than in the past. It has been reported that branches of commercial banks in the North and East have been receiving increasing amounts of remittances during the year.

Worker remittances from the West Asian region accounted for 57 per cent of total private transfer receipts. The share of earnings from the West Asian region has been decreasing from 2002, with the increase in employment in Europe, even though the number of migrant workers to the West Asian region increased. Eighteen per cent of total transfer receipts came from countries in the European Union. This share has gradually increased over the last four years, perhaps also reflecting the increasing number of migrants. North America, other European countries and the Far East continued to account for about 6 per cent, 8 per cent and 5 per cent of worker remittances, respectively.

9.6 Capital Movements

Net inflows to the capital and financial account improved during the year, mainly due to larger capital inflows to the government. The signing of the PRGF-EFF Agreement with the IMF helped the government to receive larger capital inflows during the year. Although the IMF credit is not available to the government budget, but is meant for supporting the BOP, the Agreement served as a catalyst for other receipts. Other donor assistance, particularly new commitments from the World Bank, ADB and Japan, are linked to the progress in the implementation of economic reforms in the PRGF-EFF, as each donor country's assistance strategy was based on the Poverty Reduction Strategy Paper (PRSP) associated with the PRGF-EFF. The donor conference held in Tokyo, in June 2003, endorsed the policies in the PRSP, and pledged assistance amounting to US dollars 4.5 billion for the period 2003-2006. A portion of this new commitment was disbursed during 2003. A large part of the Tokyo commitment is available for the implementation of economic reforms and for the development of infrastructure facilities for the whole country. A significant part of assistance is committed to rehabilitation and reconstruction of the North and East. Therefore, reaping the full benefit of the donors' pledges would critically depend on the progress in the implementation of economic reforms, as well as progress in the peace process.

Chart 9.5
Capital Flows



Total long-term loan capital received by the government increased by 68 per cent to US dollars 908 million during the year. This was a significant improvement in the utilisation of available foreign assistance compared to US dollar 542 million disbursed in 2002. The utilisation rate has increased to 21 per cent in 2003 from 15 per cent in 2002 and around 13 per cent in both 2000 and 2001[1]. The improvement was mainly due to a larger amount of programme financing being available for budgetary purposes. Total disbursements under programme financing amounted to US dollars 244 million during the year. The raising of a commercial loan of US dollars 100 million from the international capital market also helped to increase disbursements in 2003. Total project financing amounted to

1. The utilisation ratio is defined as total disbursements during the year as a percentage of the total of committed undisbursed balance at end of the previous year and new commitments during the year.

US dollars 556 million, a 17 per cent increase over 2002. The World Bank released a new programme loan of US dollars 127.5 million under the Poverty Reduction Support Credit (PRSC) to support the government budget in implementing economic reforms. In addition, the World Bank continued to provide assistance to develop sectors such as health and education under previous commitments. The Asian Development Bank also provided programme financing of around US dollars 65 million to the budget and project financing of around US dollars 150 million relating to infrastructure development and rural financing during the year. Japan's assistance exceeded US dollars 230 million. The 36th Loan Package signed between the Japanese government and the Sri Lankan government in March 2003 committed another US dollars 280 million to implement five projects. A part of this commitment was utilised during 2003.

However, the uncertainty that prevailed towards the end of the year slowed down foreign assistance. For example, the disbursement of the second tranche of the PRGF-EFF, expected within the year was postponed. Other donors also adopted a 'wait and see' approach in finalising their donor assistance programme for 2004 as a larger part of assistance would depend on the success of the PRGF-EFF arrangement with the IMF.

The committee appointed by the government to speed up foreign aid utilisation took several measures that helped improve disbursements for project financing and shortened the time taken to finalise loan agreements. However, more needs to be done to speed up the process of project implementation. The government announced at the Donors' Conference in Tokyo that it would establish an institutional framework to increase the capacity to utilise foreign aid at a faster rate. Major donors have also pledged to provide assistance to develop the necessary institutional framework.

Higher utilisation of foreign assistance received on concessional terms and conditions would also reduce the need to obtain less concessional loans such as export credits and commercial borrowings. In particular, although some available export credit appears to be more concessional than commercial borrowings in terms of interest rates and maturity, the actual cost of these credits could sometimes even be higher than commercial credits, as such credit can be used only to import specific items produced in the donor country.

Principal repayments on the government's medium-term loans declined to US dollars 359 million, from US dollars 380 million in 2002. The decrease in repayments was mainly due to the lower repayment of defence related credit, which amounted to US dollars 92 million in 2003 compared to US dollars 144 million in 2002. As a result of higher disbursements and lower repayments of foreign loans, the net disbursements to the government increased to US dollars 548 million from US dollars 162 million in 2002, making a significant contribution to the overall surplus in 2003.

In contrast, inflows of loan capital to the private sector decreased to US dollars 102 million in 2003 from US dollars 115 million in 2002. Only a few private sector companies engaged in new foreign borrowing during the year. The larger part of disbursements related to existing commitments and medium-term external credit obtained by BOI companies for trade and investment related purposes. The lower external private borrowings partly reflected the lower domestic interest rates, which reduced the advantage of foreign borrowing. It may also have reflected a continuation of the private sector's 'wait and see' approach in making medium and long-term investments. It also reflected some difficulties faced by the Sri Lankan private sector in raising foreign capital. In the past, a larger amount of private sector foreign borrowings came under government guarantees to entities partly or fully owned by the government, such as Air Lanka and Sri Lanka Telecom. With the privatisation of these companies, the government has moved gradually away from providing guarantees for foreign loans by the private sector.

The government has initiated measures to facilitate the private sector to obtain foreign loans. First, the government is negotiating with international rating agencies to obtain a sovereign rating for the country. A sovereign rating, together with the already available domestic ratings, would help international investors to assess the creditworthiness and establish risk premia for local firms more easily. Secondly, the government has tabled a new Foreign Exchange Management Act in Parliament, which would simplify the existing procedure for foreign borrowings by the private sector and further

TABLE 9.7

Major Projects Financed by Foreign Lending during 2003

Donor	Project	Amount Disbursed US dollars mn
Asian Development Bank		211.0
Of which	Private Sector Development Subprogramme I	53.4
	SME SPD Credit Assistant Project	18.3
	Southern Transport Development Project	14.7
	Urban Dev. & Low-Income Housing Programme	14.4
	3rd Water Supply & Sanitation Project	13.2
	Road Network Improvement Project	11.7
	SME-Sector Development Programme	11.1
	Secondary Education Modernisation Project	11.0
International Development Association		202.0
Of which	Poverty Reduction Support Credit	127.9
	Private Sector Infrastructure Dev. Project	15.8
	Mahaweli Restructuring & Rehab. Project	14.5
	Second General Education Project	8.4
	Sri Lanka Central Bank Modernisation Project	7.0
Japan		234.0
Of which	Power Sector Restructuring Programme	31.3
	Kukule Ganga Hydroelectric Power Project	29.3
	Small Scale Infr. Rehab. & Upgrading Project	28.4
	Electricity Transmission & Substation Dev. Project	14.7
	Kelanitissa Combined Cycle Power Plant Project	12.7
	Towns North of Colombo Water Supply Project	10.6
	Port of Colombo North Pier Dev. Project II	10.4
	Bandaranaike International Airport Dev. Project	10.1
	Baseline Road Project	8.4

liberalise the restrictions on medium and long-term borrowings by the private sector. The implementation of these two measures would enhance the private sector's ability to raise capital from international markets on the merits of their own balance sheets. However, progress in the peace process and removal of political uncertainty are two crucial factors, which would encourage the private sector to make medium and long-term investments. In addition, the International Finance Corporation (IFS), the commercial lending arm of the World Bank, has increased its activities with the private sector.

Foreign Direct Investment

Inflows of foreign direct investment including privatisation proceeds increased to US dollars 229 million in 2003 from US dollars 197 million in 2002 mainly due to larger privatisation proceeds of US dollars 30 million in 2003[1]. The realised inward investment flowed mainly to sectors such as power and energy, port related developments, telecommunications and manufacturing. However, net FDI inflows were marginally lower in 2003 owing to a larger outflow of US dollars 27 million compared to the outflow of US dollars 11 million in 2002. The larger outflow was mainly due to the acquisition of a commercial bank in Bangladesh by a Sri Lankan commercial bank which invested US dollars 20 million for the acquisition.

FDI inflows in the medium term depend largely on the number of agreements signed between the BOI and foreign investors. With the progress in the peace process, the number of new agreements signed increased, as did the number of inquiries and projects under negotiation. The estimated foreign direct investment from new agreements signed during 2003 is about US dollars 430 million in comparison to the corresponding figure of US dollars 160 million in 2002. This development indicates that the implementation of these new projects should bring significantly larger FDI inflows in the next few years. However, with the political uncertainty in the latter part of the year, activity slowed down and a few large projects under negotiation have been postponed.

Privatisation proceeds from foreign sources were lower than expected during 2003 mainly due to the purchase of the Sri Lanka Insurance Corporation (SLIC) by a local entity, and delays in the receipt of the proceeds from the sale of 100 petrol stations and a common user facilities of Ceylon Petroleum Corporation. The receipt of US dollars 30 million on account of privatisation proceeds in 2003 related to the liberalisation of the domestic petroleum sector under which the Indian Oil Corporation entered the domestic market as second player in the petroleum sector.

1. FDI inflows exclude foreign loans obtained by BOI companies from sources other than their parent companies. According to the latest Balance of Payments Manual published by the IMF, these loan capital inflows are reported under private long-term loan inflows.

Short-Term Capital

Portfolio investment recorded a marginal net inflow of US dollars 2 million in 2003 compared to the inflow of US dollars 25 million in 2002. The lower net inflow recorded was mainly due to a large outflow of around US dollars 40 million, resulting from the strategic purchase of the controlling interest of a large hotel company by a local blue chip company from its foreign investors. Other than for this transaction, net inflows to the Colombo Stock Exchange were positive throughout the year, reflecting an improvement in foreign investor confidence. Total purchases by foreigners amounted to US dollars 145 million, while total sales were US dollars 143 million. The increase in the total volume of transactions by foreigners to US dollars 288 million in 2003 from US dollars 140 million in 2002 reflects improved foreign investor interest in the share market. Private short-term credit, comprising short-term export and import related credit, recorded a lower net inflow of US dollars 18 million.

Net foreign assets of commercial banks improved by US dollars 96 million in 2003, from US dollars 40 million in 2002, despite the Central Bank's purchase of US dollars 375 million from commercial banks during the year. This improvement was mainly due to the repayment of US dollars 158.5 million of Sri Lanka Development Bonds (SLDBs), held by commercial banks. SLDBs are treated as domestic assets, and their repayment by the government, and consequent investment in foreign assets by commercial banks, improved the NFA of commercial banks in the last two months of the year. The expectation of a higher depreciation of the rupee during the latter part of the year also encouraged commercial banks to continue to hold onto assets in foreign currency. Meanwhile, gross external liabilities of commercial banks remained almost unchanged during the year.

9.7 External Assets

Reflecting the net results of above mentioned developments, the BOP recorded an overall surplus of US dollars 502 million in 2003. This was the third consecutive year that the BOP recorded a surplus, and was the second highest surplus ever recorded. The highest surplus (US dollars 661 million) was registered in 1993.

Chart 9.6
Quarterly External Assets

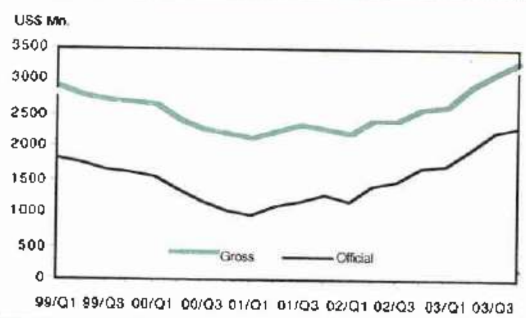


TABLE 9.8

External Assets of Sri Lanka (a)

Ownership	US dollars million(b) 1999	2000	2001	2002	2003	Rupees million(b) 1999	2000	2001	2002	2003
1. Government	20	22	78	46	55	1,441	1,767	7,302	4,424	5,320
2. Government agencies	-	-	-	-	-	-	-	-	-	-
3. Central bank	1,619	1,026	1,260	1,654	2,274	116,571	81,819	117,365	160,018	219,984
4. Total official assets	1,639	1,049	1,338	1,700	2,329	118,013	83,585	124,668	164,442	225,304
5.Commercial banks	942	1,083	900	795	889	67,946	86,682	83,815	76,921	86,011
6. Total external assets	2,582	2,131	2,238	2,495	3,218	185,958	170,268	208,482	241,364	311,315
7. Gross official assets in months of										
7.1 Merchandise imports	3.3	1.7	2.7	3.3	4.2					
7.2 Import of goods and services	2.9	1.5	2.3	2.9	3.6					
8. Total assets in months of										
8.1 Merchandise imports	5.2	3.5	4.5	4.9	5.8					
8.2 Import of goods and services	4.6	3.1	3.8	4.2	5.0					

Source: Central Bank of Sri Lanka

(a) Reserves from 2002 are calculated at market value.

(b) 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	1999	2000	2001	2002	2003
Rs. per US dollar	72.12	82.65	93.16	96.73	96.74

The surplus in the BOP led to a build up of the country's net official reserves. The Central Bank's purchases of foreign exchange from commercial banks, which amounted to US dollars 375 million on a net basis during the year, helped boost the reserves. The absorption of excess foreign exchange liquidity by the Bank also helped to stabilise the exchange rate, particularly during the third quarter. Cash disbursements of concessional loans and commercial borrowing by the government amounted to US dollars 532 million. These receipts served to help the servicing of a large part of foreign public debt and SLDBs. In addition, the management of the international reserves portfolio by the Central Bank also added around another US dollars 110 million in terms of interest income, trading profits and valuation gains.

9.8 Foreign Exchange Market Developments

In international foreign exchange markets, the US dollar continued to weaken against other major currencies for the second consecutive year. Despite the recent recovery in the US economy, concerns about the escalating twin deficits in the US, namely, the current account and fiscal deficits, weakened the US dollar against other major currencies. The United States appeared to have been moving away from a strong dollar policy, while the Bank of Japan reduced intervention to weaken the yen. All these developments contributed to the depreciation of the US dollar against the Japanese yen (10.8 per cent), the sterling pound (11.0 per cent) and the euro (19.9 per cent) in

TABLE 9.9

Exchange Rate Movements

Currency	In Rupees per unit of Foreign Currency: End of Year Rates 2001(b)	2002	2003	Annual Average 2001(b)	2002	2003	Percentage Change Over Previous Year (a): Point to Point 2002	2003	Annual Average 2002	2003
Euro	82.27	101.38	121.60	79.99	90.43	109.16	-18.8	-16.6	-11.5	-17.2
Indian rupee	1.93	2.01	2.12	1.89	1.97	2.07	-4.3	-5.4	-4.1	-4.8
Japanese yen	0.71	0.82	0.90	0.74	0.76	0.83	-13.1	-9.7	-2.6	-8.4
Pound sterling	135.06	155.12	172.20	128.66	143.74	157.71	-12.9	-9.9	-10.5	-8.9
US dollar	93.16	96.73	96.74	89.36	95.66	96.52	-3.7	0.0	-6.6	-0.9
SDR	116.97	130.99	143.75	113.75	123.93	135.23	-10.7	-8.9	-8.2	-8.4

Effective Exchange Rate Indices (c)	Monthly Index Dec. 2001	Dec. 2002	Dec. 2003	Annual Average 2001	2002	2003	Percentage Change Over Previous Year: Point to Point 2002	2003	Annual Average 2002	2003
NEER (1999 = 100)	82.65	76.07	71.58	85.10	78.87	73.85	-8.0	-5.9	-7.3	-6.4
REER (1999 = 100)	99.60	100.08	96.69	99.19	99.33	97.24	0.5	-3.4	0.1	-2.1

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.

(b) With effect from 23 January 2001, the Central Bank refrained from announcing these rates and allowed market forces to determine the exchange rate.

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

Chart 9.7
Exchange Rate Movement - 2003

Chart 9.7.1
Exchange Rate 2003- Rs./US$

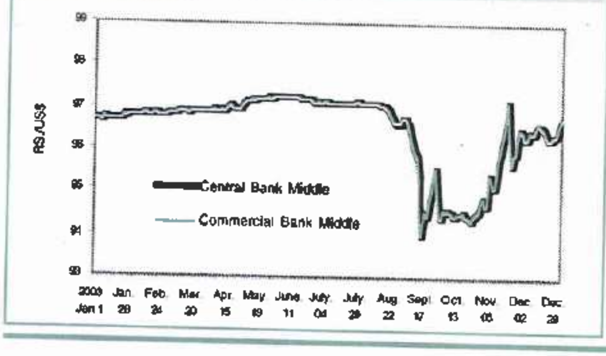
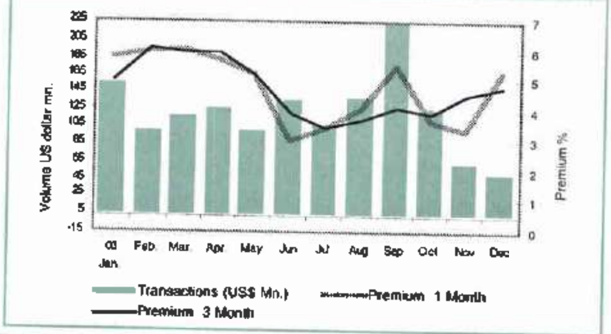


Chart 9.7.2
Inter Bank Forward Transactions-2003



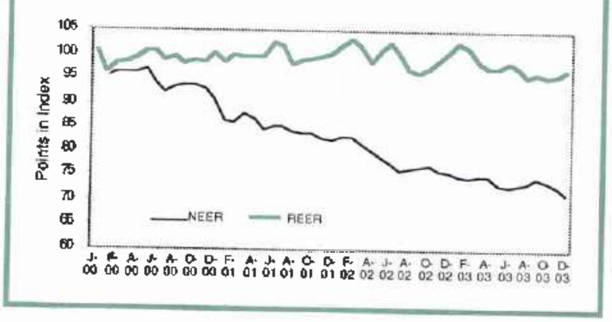
2003. This followed the depreciation of the US dollar by 10.9 per cent, 10.6 per cent and 18.7 per cent, respectively, against these currencies during the pervious year.

Most currencies in emerging market economies in Asia also appreciated against the US dollar, although at a relatively lower rate than major currencies. This was a result of heavy intervention by central banks in Asia to build up official reserves at a rapid rate, and perhaps to avoid significant appreciation of their currencies. This reserve build-up also partly helped the gradual correction of the US dollar as a large part of these official reserves were invested in US securities. The Indian rupee, the Singapore dollar, the Indonesian rupiah, the Taiwan dollar, and the Thailand baht appreciated against the US dollar by 5.1 per cent, 1.9 per cent, 6.1 per cent, 2.0 per cent and 9.2 per cent, respectively, during the year, while the Korean won and the Philippine peso depreciated by 0.7 and 4.3 per cent, respectively. Meanwhile China, Malaysia and Hong Kong continued to peg their currencies to the US dollar despite pressure for greater flexibility in their exchange rate regimes.

The US dollar/Sri Lankan rupee exchange rate was also stable during most of the year. The rupee depreciated at a decelerating rate during the first half of the year and started to appreciate until November with some sharp appreciation during the month of September. At one stage, the US dollar/rupee rate had appreciated by 2.8 per cent to Rs.94.02 per US dollar. The Central Bank's purchases of foreign exchange in the market to build reserves helped to smoothen fluctuations and to contain the appreciation. The political uncertainty in November reversed the appreciating trend and led to higher volatility in the exchange rate during the last two months of the year. As a result of these developments, the rupee US dollar rate at end 2003 was almost at the same level as at the beginning of the year. For the year as a whole, the rupee depreciated only by 0.01 per cent against the US dollar, to Rs.96.74 per US dollar, in comparison to depreciations of 3.7 per cent and 11.3 per cent in 2002 and 2001, respectively. In addition to the weakening of the US dollar, the stability of the rupee in 2003 reflected improved economic fundamentals, larger capital inflows to the government from donors, growing portfolio investments by foreigners and higher tourist earnings and worker remittances.

However, the cross exchange rate effects between the US dollar and other major currencies resulted in a larger depreciation of the rupee against other currencies during the year. The rupee depreciated against the Japanese yen (9.7 per cent), the sterling pound (9.9 per cent), the euro (16.6 per cent) and the Indian rupee (5.1 per cent) in 2003. The rupee depreciated by 8.5 per cent against the SDR.

Chart 9.8
Effective Exchange Rate Indices
(1999=100)



Nominal and Real Effective Exchange Rates

Despite only a marginal depreciation in the nominal rupee dollar exchange rate, the nominal effective exchange rate (NEER) of the Sri Lanka rupee based on a 5-currency basket of the US dollar, Japanese yen, sterling pound, euro and the Indian rupee, depreciated by 5.0 per cent from end 2002 to end 2003 reflecting the sharp depreciation of the rupee against other major currencies. The 24-currency NEER computed against a basket of 24 currencies including both

Box 16

Real Effective Exchange Rate (REER)

Exchange Rates

An exchange rate can be expressed either in terms of the national currency value of a unit of foreign currency (price quotation system) or foreign currency value of a unit of the national currency (volume quotation system). While it is customary to express the exchange rate in the former, the latter is a more appropriate indicator to assess the extent of appreciation and depreciation of the national currency[1]. For example, the annual average exchange rate of the rupee against the US dollar moved from Rs. 95.66 in 2002 to Rs.96.52 in 2003, and hence the US dollar value of the rupee dropped from 1.05 US cents to 1.04 US cents per rupee during this period. Accordingly, the average nominal exchange rate (NER) of the rupee against the US dollar depreciated by 1 per cent in 2003, in nominal terms.

Two other widely used indicators to measure exchange rate changes are the Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER). The NEER is a weighted average of major bilateral nominal exchange rates, with weights based on the trade shares reflecting the relative importance of each currency in the effective exchange rate basket.[2] The REER is obtained by adjusting the NEER for inflation differentials with the countries whose currencies are included in the basket. As the inflation rate in each country is assumed to broadly indicate the trends in domestic costs of production, the REER is expected to reflect foreign competitiveness of domestic products.

However, one cannot solely rely on the REER indicator to gauge the variations in competitiveness, as it does not adequately capture the impact of a host of other factors such as the changes in macro-economic policies, changes in the trade and exchange system including the changes in the regulatory and institutional environment and productivity changes. In addition, there could be data deficiencies, particularly in the price indicators.

Nevertheless effective exchange rate indicators are widely used to assess competitiveness. The main focus of the NEER and the REER is on the trade balance, particularly the exchange rate induced changes in trade flows. A trend appreciation of the real effective exchange rate is considered unfavourable for the growth of export and import competing industries.

Publication of Indices

The Central Bank has, for many years, computed several NEER and REER indices for its own internal policy purposes, the details of which were not made available to the public, in the past. As Sri Lanka has moved to an independently floating exchange rate regime, and consequently, bilateral exchange rates being determined by the market, it is felt the publishing these indices would provide useful information to the market.

Rather than concentrating on the movements of the exchange rate against one foreign currency only, this would enable market participants to track the movement of the Sri Lanka rupee against an average basket of currencies. In particular, the movements in the REER, which takes into account both the effect of cross currency movements and the difference in inflation rates, would provide some information on the Sri Lanka's international competitiveness.

In addition to providing the NEER and REER indices, the computational methods, the currencies in the basket and the trade weights used in the computations are also published. This would enable interested parties to carry out their own analyses. The indices will be updated on a monthly basis in the future.

Calculation, Sources and Methodology

The NEER and REER based on trade composition with 24 trading partner countries are computed on a regular basis by the Central Bank.

NEER

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

$$\text{NEER} = \prod_{i=1}^{24} (e / e_i)^{w_i}$$

where
- e : Exchange rate of the Sri Lankan rupee against the US dollar (US dollars per rupee in index form)
- e_i : Exchange rates of currency i against the US dollar (US dollars per currency i in index form)
- w_i : Weights attached to the country/ currency i in the index

1. The British use the 'volume quotation system' where the exchange rate for the sterling pound is generally expressed in terms of foreign currency per sterling pound.

2. The notion of Nominal Effective Exchange Rate was developed by Hirsch and Higgins (1970) and later extended by others.

Box 16 (contd.)

Weighting Scheme

The weights are constructed on the basis of Sri Lanka's bilateral trade with each of the 24 countries. The proportion of each country's bilateral trade to Sri Lanka's total trade is then normalised to arrive at the following weights:

Trading Composition
(1999 = 100)
(per cent)

Country	Weight
United States	24.5
United Kingdom	10.62
Japan	8.95
India	6.99
Hong Kong	6.97
Singapore	6.17
Korea	5.22
Taiwan	4.48
Germany	4.35
Belgium	3.51
Thailand	2.44
Netherlands	2.40
France	2.24
Indonesia	2.20
Malaysia	2.18
China	2.05
Italy	1.75
Canada	1.00
Sweden	0.74
South Africa	0.55
Denmark	0.34
Bangladesh	0.20
Philippines	0.12
Kenya	0.03
	100.00

The selection of the countries in the basket is based on bilateral trade shares and the importance in terms of competitiveness of those countries exports with Sri Lankan exports in international markets. For example, even though Kenya's bilateral trade share with Sri Lanka is not within the largest 24 trade shares, Kenya has been included in the basket as it is a major competitor of Sri Lankan tea in the international markets.

REER

REER is the inflation adjusted NEER.

$$\text{REER} = \prod_{i=1}^{24} [(e/e_i)(P/P_i)]^{w_i}$$

where P : Consumer Price Index (CPI) of Sri Lanka

P_i : CPI of country i

CPI are updated on a monthly basis. However, the time lag with which the CPI data is available varies from country to country. Therefore, the REER index based on actual data is published with a six week time lag.

The exchange rates have been defined in terms of indices so that the appreciation / depreciation of the rupee relative to other currencies is directly reflected by a rise / fall in the REER index value.

In order to ensure up to date information, the base year 1999 has been set and the index begins from January 2000. Data on the 24 currency REER index is available in Table 9.9 and Appendix Table 111.

trading partners and competitor countries depreciated by 5.9 per cent during the same period. Meanwhile, the REER against the 5-currency basket depreciated by 2.8 per cent, while against the 24-currency basket, it depreciated by 3.4 per cent during the same period. This indicates that the Sri Lanka's external competitiveness, in terms of the REER indices, has improved further.

Domestic Foreign Exchange Market

The domestic foreign exchange market continued to expand and deepen in 2003, both in terms of volume of transactions and in terms of the duration of forward transactions. The total volume of forward market transactions rose by 48 per cent to US dollars 1,401 million during the year, and was about 38 per cent of the total transactions in the interbank market during the year. The average monthly volume of forward transactions increased to US dollars 117 million in 2003, compared to US dollars 79 million in 2002. An increase in forward transactions with longer maturity periods was also evident, indicating improved market confidence. Forward premia were below interest rate differentials throughout the year except for a few days when the rate was highly volatile.

Activities in the forward market indicate the growth in the foreign exchange market. In 2003, activities grew considerably, particularly during the first 10 months of the year, when the exchange rate was relatively stable and even appreciating against the US dollar. Forward transactions have become a popular instrument among Sri Lankan exporters to hedge against foreign exchange risk. When there was an appreciating trend in the rupee, exporters started selling their export proceeds in the forward market, as evidenced by the increase in volume during the period of appreciation. This also led to a drop in the forward premia to around 4 per cent, well below the interest rate differential of around 7 per cent between the rupee and the US dollar. However, when there was an expectation of depreciation at a higher rate during the last two months of the year, volumes of forward transactions dropped significantly. This was partly due to the fact that Sri Lankan importers are less used to hedging foreign exchange risk, and entering into forward transactions than exporters. With the expectation of a higher depreciation, importers tend to increase the demand for foreign exchange in the spot market rather than entering into forward agreements. This not only exerts further pressure on the exchange rate to depreciate, but also increases the cost of imports as importers need rupee funds in advance to purchase foreign exchange from the spot market. Hence, there appears to be a need to encourage importers to use forward instruments, which would both reduce the volatility in the foreign exchange market and reduce import costs. The higher volatility in the exchange rate during the latter part of the year in response to political uncertainty highlights the fact that the domestic foreign exchange market needs to be further deepened to minimise excess volatility.

9.9 External Debt

As a percentage of GDP, the total external debt of the country increased to 58.4 per cent in 2003 from 56.3 per cent in 2002. However, in US dollar terms, the total external debt of the country increased by 14 per cent to US dollars 10,644 million at end 2003. The increase in government debt, including IMF liabilities, by US dollars 1,293 million (15 per cent) to US dollars 10,025 million contributed to the increase in total external debt. It has been estimated that more than 50 per cent of the increase in total external debt in US dollars is due to the sharp depreciation of the US dollar against major currencies, as approximately 43 per cent and 31 per cent of the debt are denominated in SDR and yen, respectively. Medium and long-term debt, accounting for 94 per cent of the total external debt, mainly consisted of concessional debt of the government (85 per cent). The balance non-concessional stock largely represented medium and long-term private sector debt as the government's non-concessional stock is relatively small. In US dollar terms, the government's non-concessional debt stock remained almost unchanged at US dollars 219 million due to the repayment of outstanding defence credit of US dollars 90 million and the receipt of US dollars 100 million through a commercial loan raised from international financial markets. There is a continuing need to limit non-concessional external debt to maintain the external debt sustainability of the country. Higher utilisation of loans received on concessional terms could meet the financing needs of the government at a lower cost in a more sustainable manner.

Meanwhile, the total private sector debt, including short-term debt, declined by 2 per cent to US dollars 1,553 million during the year. Government guaranteed external debt to public corporations and private sector declined by 13 per cent to US dollars 599 million, as government refrained from providing guarantees to the private sector. Private sector external debt without government guarantees increased to US dollars 335 million in 2003, consisting largely of medium-term trade credit.

Short-term external debt increased to US dollars 619 million (5 per cent of GDP) from US dollars 601 million in

Chart 9.9
External Debt

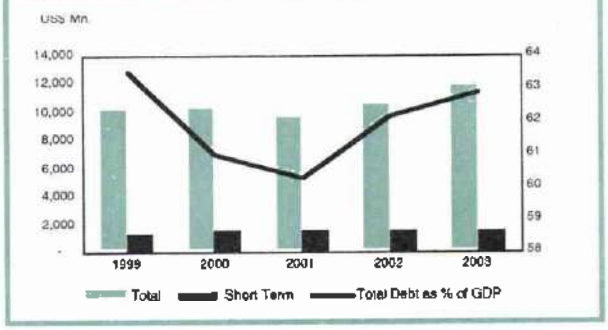


TABLE 9.10
Outstanding External Debt and Banking Sector External Liabilities

Item	US dollars million					Rupees million				
	1999	2000	2001	2002	2003(a)	1999	2000	2001	2002	2003(a)
1. Medium and long-term debt	**8,613**	**8,456**	**7,839**	**8,732**	**10,025**	**620,274**	**676,045**	**730,245**	**844,703**	**959,811**
1.1 Government	7,125	6,989	6,808	7,464	8,723	513,785	559,544	634,255	721,956	843,882
1.2 Public corporations and private sector with government guarantee	944	1,028	572	689	599	68,105	82,302	53,324	66,663	57,952
1.3 Public corporations and private sector without government guarantee	286	278	249	292	335	20,618	22,257	23,203	28,297	32,425
1.4 IMF drawings	258	161	209	287	368	17,766	11,943	19,463	27,787	35,552
2. Short-term debt	**475**	**575**	**533**	**601**	**619**	**34,240**	**46,034**	**49,648**	**58,116**	**59,848**
2.1 Government	-	-	-	-	-	-	-	-	-	-
2.2 Other (CPC and other trade credit) (b)	475	575	533	601	619	34,240	46,034	49,648	58,116	59,848
3. Banking sector external liabilities (c)	**885**	**1,076**	**1,119**	**1,001**	**1,046**	**63,838**	**86,132**	**104,201**	**96,807**	**101,149**
3.1 Central Bank	...	...	2	1	-	7	33	172	123	32
3.2 Commercial Bank	765	938	1,009	865	863	55,142	75,101	94,030	83,655	83,514
3.3 ACU liabilities	121	137	107	135	182	8,689	10,998	9,999	13,029	17,604
4. Total external debt (1+2)	**9,088**	**9,031**	**8,372**	**9,333**	**10,644**	**654,514**	**722,079**	**779,893**	**902,818**	**1,029,659**
5. Total external debt and liabilities (1+2+3)	**9,973**	**10,106**	**9,490**	**10,334**	**11,689**	**718,352**	**808,211**	**884,095**	**999,629**	**1,130,808**
MEMORANDUM ITEMS										
Medium and long-term debt										
Project loans	5,517	5,346	5,374	4,358	6,961	397,882	427,965	480,237	421,637	673,432
Non-project loans	1,612	1,426	1,154	3,048	1,726	116,247	114,174	103,163	294,880	167,007
Suppliers' credits	182	338	316	100	216	13,146	27,074	29,411	9,718	20,921
IMF drawings	258	161	209	287	368	17,766	11,943	19,463	27,787	35,552
Other loans (d)	1,043	1,185	786	939	754	75,233	94,890	97,971	90,680	72,899
Short-term debt and banking Sector liabilities	1,360	1,650	1,651	1,602	1,664	98,078	132,166	153,850	154,923	160,997
As a percentage of GDP										
Total external debt	57.8	54.5	53.2	56.3	58.4	59.2	57.5	55.4	57.0	58.5
Total banking sector external liabilities	5.6	6.5	7.1	6.0	5.7	5.8	6.9	7.4	6.1	5.7
Total external debt and liabilities	63.5	61.0	60.3	62.4	64.1	65.0	64.4	62.8	63.1	64.2
Short-term debt	3.0	3.5	3.4	3.6	3.4	3.1	3.7	3.5	3.7	3.4
Short-term debt and banking Sector external liabilities	8.7	10.0	10.5	9.7	9.1	8.9	10.5	10.9	9.8	9.1
As a percentage of total debt and liabilities										
Short-term debt	4.8	5.7	5.6	5.8	5.3	4.8	5.7	5.6	5.8	5.3
Short-term liabilities	8.9	10.6	11.8	9.7	8.9	8.9	10.7	11.8	9.7	8.9
Short-term debt as a percentage of official reserves	29.0	54.8	39.8	35.3	26.6	29.0	55.1	39.8	35.3	26.6

(a) Provisional
(b) Includes acceptance credits of Ceylon Petroleum Corporation and other trade credit.
(c) ACU debits and foreign liabilities of commercial banks including those of FCBUs.
(d) Includes long term loans of public corporations and private sector institutions.

Sources: Central Bank of Sri Lanka
External Resources Department

2002. Short-term debt consists only of trade related credit. Liabilities to the IMF increased by US dollars 80 million during the year on account of disbursements related to PRGF-EFF programme. Meanwhile, banking sector external liabilities increased by US dollars 45 million to US dollars 1,046 million, mainly due to a larger stock of ACU liabilities at the end 2003.

As a result of the above developments, total external debt and other liabilities, which includes banking sector external liabilities too increased to 64.1 per cent of GDP in 2003 from 62.4 per cent in 2002. However, in US dollar terms, the stock increased by 13 per cent to US dollars 11,689 million.

9.10 Debt Service Payments

Debt service ratios, which compare total debt service payments against foreign exchange earnings of the country, reflect that the country's capacity to service external debt has improved further in 2003. These ratios indicate that the country has continued to improve the affordability of servicing external debt due to higher foreign exchange earnings and lower debt service payments in US dollar terms. Debt service payments as a percentage of receipt from merchandise exports and services, declined to 11.6 per cent in 2003 from 13.2 per cent in 2002. As a percentage of receipt from goods, services, income and private transfers, debt service payments decreased to 10.8 per cent in 2003 from 9.3 per cent in 2002. The declining trend in debt service ratios is an indication of both an improvement in the country's external sector vulnerability and the sustainability of external debt.

Total debt service payments, which include both amortisation and interest payments on all external debt, decreased by 4 per cent to US dollars 757 million during 2003. However, amortisation payments, which account for 70 per cent of total debt service payments, decreased by 8 per cent to US dollars 527 million, mainly due to lower repayments of government's defence related credit. The increase in interest payments by 6 per cent to US dollars 229 million is mainly due to two reasons. First, although global interest rates remained almost at the same levels, large disbursements of government medium and long-term loans increased the debt stock and thereby interest payments thereon. A higher debt stock does not necessarily increase amortisation payments in the short-term as most of the government's external loans carry a grace period for repayments of principal, but increases interest payments. Secondly, the sharp depreciation of the US dollar during the year increased debt service payments measured in US dollars terms.

TABLE 9.11
External Debt Service Payments

Item	US dollars million					Rs. million				
	1999	2000	2001	2002	2003(a)	1999	2000	2001	2002	2003(a)
1. Debt service payments	846	953	813	788	757	59,321	74,554	72,584	74,717	72,732
1.1 Amortisation	550	621	558	572	527	48,472	49,410	49,883	54,011	50,633
To IMF	100	97	78	56	32	6,813	9,700	6,966	4,647	2,869
To others	451	524	480	516	495	31,658	39,711	42,918	49,364	47,764
1.2 Interest payments	296	332	254	216	229	20,850	25,144	22,701	20,705	22,099
To IMF	5	5	5	4	4	376	410	348	398	414
To others	291	326	250	212	225	20,474	24,734	22,353	20,307	21,685
2. Earnings from merchandise exports and services	5,578	6,476	6,172	5,967	6,541	393,303	492,301	551,309	571,195	631,257
3. Receipts from merchandise exports, services, income and private transfers	6,801	7,787	7,436	7,330	8,099	479,469	591,567	664,073	701,579	781,558
4. Debt service ratio (b)										
4.1 As a percentage of 2 above										
Overall ratio	15.2	14.7	13.2	13.2	11.6	15.1	15.1	13.2	13.1	11.5
Excluding IMF transactions	13.3	13.1	11.8	12.2	11.0	13.3	13.1	11.8	12.2	11.0
4.2 As a percentage of 3 above										
Overall ratio	12.4	12.2	10.9	10.8	9.3	12.4	12.6	10.9	10.6	9.3
Excluding IMF Transactions	10.9	10.9	9.8	9.9	8.9	10.9	10.9	9.8	9.9	8.9
5. Government debt service payments										
5.1 Government debt service payments (c)	449.0	437.0	449.8	521.9	502.0	31,612.9	33,099.6	40,190.0	49,927.6	48,452.1
5.2 As a percentage of 1 above	53.1	45.9	55.3	66.2	66.3	53.3	44.4	55.4	66.8	66.6

Source: Central Bank of Sri Lanka

(a) Provisional.
(b) Debt service ratios calculated in rupee values and US dollar values differ due to variations in exchange rates during the year.
(c) Excludes IMF transactions.

9.11 External Trade Environment and Policy

The external trade and tariff policy under the market oriented policy framework has been aimed at achieving a liberal, competitive less protective tariff regime characterised by a low and simplified tariff structure. However, the policy direction was interrupted with the introduction of a number of tariff bands in November 2002 replacing the two-band tariff system of 10 and 25 per cent, which had been in effect since February 2000. A large number of duty free items (1,663 items) were brought under a new band of 2 per cent, while another 59 items were brought under a 20 per cent band. Some selected machinery and equipment (820 items) were maintained under the 5 per cent rate of tariff while 1,260 items were maintained at 25 per cent. A few items such as beer and tobacco are at a higher rate of 75, while some cigarettes are under a rate of 100 per cent. Meanwhile, 31 items including some varieties of tobacco and footwear are subject to either ad valorem or specific duties, whichever is higher. Another 46 items including major agricultural products, are still subject to specific duties. The permanent Tariff Advisory Council, which was set-up in 2002 to examine and correct anomalies and distortions in the tariff structure, and to address representations, made by importers and industrialists, continued its work in 2003.

Tariffs and Taxes on External Trade

Except for revisions made to import duty on a few selected items, no major change was made to the tariff structure in 2003. Minor changes were made to the tariff structure four times during the year. The import surcharge of 20 per cent was extended until 31 December 2003. Imports of onions and chillies were added to the list of exemptions applicable to import duty surcharge. Distortions by way of duty waivers, exemptions and introduction of surcharges were maintained at a minimum level in line with the present policy direction.

The specific duty on rice was raised from Rs.5 per kg to Rs.7 per kg on 05 March 2003 and then increased to Rs.9 per kg on 21 August 2003. Specific duty on bicycles and tricycles was increased from Rs.500 per unit to Rs.750 per unit on 05 March 2003. Duty rates on a few selected items such as fruits, perfumes, beauty or makeup preparations, selected plastic items, hides and leather products, plywood and other panels, carpets, parts and accessories for vehicles and some machinery and equipment were revised from 21 August 2003.

With effect from 4 September 2003, the 2 per cent tariff band was revised upwards to 2.5 per cent, while the specific duty of Rs.6 per kg on big onions, preserved and dried onions and Rs.3.50 per kg on sugar were raised to Rs.8 per kg and Rs.3.75 per kg, respectively. The import duty on liquor was revised upward from 9 September 2003.

The revenue forgone due to duty waivers on import was limited to Rs.163 million in 2003 as against Rs.9,034 million in 2002. The removal of duty waivers granted on petroleum and some food products in 2003 was the major cause of the lower revenue loss. Duty waivers were granted only on donations to charitable institutions, religious institutions, diplomatic missions and goods imported for development projects in terms of the agreement signed by the government with donor agencies.

With the full year effect of the upward revisions made to the tariff structure in March and November 2002, the average import duty, i.e., the ratio of import duty collection to total adjusted imports, increased from 4.8 per cent in 2002 to 5.3 per cent in 2003. The average import duty rate, without the impact of the 20 per cent surcharge was 4.6 per cent as against 4.1 per cent in 2002. The increase in the average duty rate was mainly

TABLE 9.12

Average Import Duty Collection Rate (a)

Item	1999	2000	2001(b)	2002(b)	2003(c)(d)
Consumer goods	12.8	11.5	13.3	13.3	13.5
Food and drink	13.6	11.7	15.3	14.4	14.2
Rice	16.4	30.0	21.2	32.9	29.3
Flour	-	6.2	13.3	12.3	11.5
Sugar	21.3	15.9	16.2	16.0	16.8
Wheat and meslin	0.3	0.0	0.0	0.0	0.0
Milk and milk products	11.6	10.6	15.3	11.9	12.2
Dried fish	1.2	1.3	2.0	7.9	10.8
Other fish products	4.8	5.1	6.3	6.8	7.9
Other food items	19.9	18.7	25.4	22.9	22.3
Non-food consumer goods	12.0	11.3	10.9	12.1	13.0
Motor cars & cycles	20.1	16.6	21.1	23.3	22.1
Radio receivers/ television sets	11.9	6.8	8.3	8.6	8.9
Rubber tyres & tubes	28.4	23.5	29.6	27.9	26.0
Medicinal & pharmaceutical products	0.6	0.5	0.6	0.6	0.6
Other non-food items	9.1	11.1	9.7	9.4	9.2
Intermediate goods	4.1	2.9	1.7	1.6	1.5
Fertiliser	-	-	-	0.4	2.6
Crude oil	15.8	7.4	...	0.0	0.0
Other petroleum products	16.1	5.3	0.9	0.8	0.8
Chemical elements and compounds	3.6	3.2	3.3	1.1	2.2
Dyeing, tanning and colouring	5.3	5.2	6.3	4.0	4.6
Paper and paper boards	5.7	5.0	6.7	5.2	5.4
Textiles & clothing	0.1	0.1	0.1	0.1	0.1
Other intermediate goods	4.1	3.5	4.2	4.3	3.3
Investment goods	4.4	4.0	5.3	5.5	7.2
Building materials	7.8	7.5	9.3	7.4	7.7
Transport equipment	7.4	7.4	10.3	11.0	12.9
Machinery and equipment	2.2	1.8	2.7	3.7	5.6
Other investment goods	3.4	3.2	4.2	3.8	4.6
Total	7.0	4.5	4.9	4.8	5.3

(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 and the 20 per cent surchage from 01 April 2002.

(c) This includes the impact of 20 per cent surcharge imposed on selected imports on 01 January 2003.

(d) Provisional

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

due to the impact of replacing items under the zero band by a 2 per cent tariff in November 2002 and revisions made thereafter. Consequently, the share of dutiable imports in total imports increased from 28 per cent in 2002 to 37 per cent in 2003, expanding the tariff base.

Dutiable imports within the consumer goods category increased from 61 per cent in 2002 to 67 per cent due to the imposition of duty on previously some duty free items. The average import duty rate on food and drink increased marginally as high specific duties were effective on major food items to protect local producers. The average import duty rate on non-food consumer goods categories increased to 13 per cent in 2003 from 12 per cent in 2002.

In the intermediate goods category, the share of dutiable imports increased from 10 per cent to 18 per cent, while in the investment goods category, the share increased from 45 per cent to 62 per cent in 2003. However, the average duty rate on intermediate goods remained at the 2002 level as a large part of the intermediate imports are still duty free. The average duty rate on investment goods increased from 5.5 per cent to 7.2 per cent as a large share of investment goods are now under the tax net and liable for both import duty and surcharge. This also reflects the impact of expensive transport equipment imported during the year.

Import and Export Controls

In 2003 several amendments were made to the Imports and Exports (Control) Act, No.1 of 1969 (as amended by Act, No.48 of 1985 and Act, No.28 of 1987) with numerous objectives. In order to minimise administrative delays and simplify procedures, the involvement of the Controller of Exchange was removed from the import of goods with a value exceeding US dollars 1,000 as a gift or without any foreign exchange payment requirement, in February 2003. Similarly, the Ministry of Defence was exempted from the requirement of obtaining import control licences for importations done in respect of state security services in March 2003. Giving more flexibility to importers to finalise their transactions, the time period given to importers between the date of advance payment and goods receipt was increased from 30 days to 90 days in December 2003.

To avoid illegal transactions in the diamond trade, all imports of rough diamonds are required to be certified as having been handled in accordance with the provisions of the Kimberley Process Certificate Scheme, which certifies the authenticity of such trading activity since June 2003. All exports of rough diamonds should also be accompanied by a certificate issued by the National Gems and Jewellery Authority to ensure that the consignment was processed using diamonds imported in accordance with the provisions of this scheme.

To protect the environment, a licence fee was imposed on the c.i.f. value of imports when import licences are issued for used vehicle seats (20 per cent), used furniture and cut portions of motor vehicles (50 per cent each), used refrigerators, deep freezers and air conditioners for personal use (5 per cent each) and in commercial quantity (10 per cent each) in August 2003. Furthermore, special purpose vehicles and agricultural and construction machinery older than 10 years were brought under a licensing requirement from October 2003. Some machinery parts were removed from the licensing requirement in June 2003 to further liberalise such imports. With these amendments, the total number of items under import controls at 6 digit level of Harmonised System of Codes (HS Code) increased by 63 items to 376 items by end 2003.

About 30 categories of exports, *i.e.*, wood and articles of wood (ebony), ivory and ivory products and passenger motor vehicles (first registered in Sri Lanka prior to 1945) and several mineral products such as waste and scrap of copper, nickel, aluminium, lead, zinc, tin, tungstern, molybdenum, tantalum and magnesium, continued to remain under licence with the objectives of environmental protection and preservation of antiques. Except quartz, iron and non-alloy and steel products, the entire export sector has continued to be free from all export and ad valorem sales taxes since end 1992. However, export cesses are applied on tea, coconut and coconut products, cashew nuts in shells, raw hides and non-ferrous scrap metal. A nominal fee or royalty is levied on conch shells, coral chanks, elephants and tuskers.

The number of items on the list of exemptions has remained unchanged at 22 since 6 November 2002. The Director General of Customs has to be satisfied that those goods are imported for the purpose approved under the respective categories and that approval has been obtained from the Secretary to the Treasury. The list of concessions consisting of 13 items with a concessionary duty rate of 2 per cent and 2 items with 50 per cent of normal duty remained unchanged since 6 November 2002. However, the concessionary rate of 2 per cent was increased to 2.5 per cent on 4 September 2003.

A Ports and Airports Development Levy (PAL) of 1 per cent of the c.i.f. value of imports was introduced with effect from 1 May 2002. Imports for processing and re-export subject to PAL at 0.75 per cent of the c.i.f. value of imports, was reduced to 0.5 per cent from 1 January 2003.

The Agreement on Customs Valuation was implemented in Sri Lanka in January 2003[1]. The Agreement aims at a fair, uniform and neutral system for the valuation of goods, which conforms to commercial realities and it will replace any arbitrary or fictitious customs valuation procedures.

Textile and Garment Quota Allocation

During 2003, the Textile Quota Board (TQB) changed its quota allocation, surrendering and transferring procedures to make the system more flexible, cost effective and less tedious in documentation. The TQB has introduced a new quota transfer

1. Officially called as the Agreement on Implementation of Article VII of GATT 1994.

procedure to make this transaction more effective and useful for exporters. Under the new procedure the transferred quota will be combined with the main quota of the transferee and could be utilised throughout the quota year along with any other quota available to the transferee. This will increase the flexibility of utilising transferred quota, which had to be exported in bulk under the previous system. The surrender scheme of quota too was revised by providing an opportunity to quota holders who surrendered excess quotas before October in the particular year to obtain 100 per cent credit for surrendered quota. Under the earlier system, credit (in terms of quota) for surrendered quota varied according to the time of surrendering unutilised quota and quota holders who surrendered quota after August were not eligible for any such credit. Furthermore, TQB reserved quota for distribution among any previously sick factories, which are revived. Since January 2003, the requirement to register the sub contracts with TQB has been removed.

Approximately 30 quota categories were open to export to USA and 10 categories to Canada in 2003. Basic quota availability to USA and Canada increased by 9 per cent and 13 per cent, respectively. Accordingly, overall quota availability to those countries increased by 9 per cent in 2003.

The overall quota utilisation rate in 2003 declined to 65 per cent, compared to 70 per cent in 2002. However, the volume of exports under quota increased by 2 per cent during the year. The utilisation of quota varied widely across different product categories and countries. The utilisation of the US quota dropped from 71 per cent in 2002 to 67 per cent in 2003, despite the higher demand from USA for Sri Lankan garments. The under-utilisation was partly due to insufficient demand for particular items, preference of local producers to use their capacity to produce high value added garments under other quota categories or to produce non-quota garments. This was evident in the increased exports of non-quota garment categories and full utilisation of some popular categories. Utilisation ratios for certain popular categories like dresses, trousers, underwear, knit shirts and blouses remained above 90 per cent.

As in previous years, the utilisation rate of quota submitted by Canada was lower than that by USA. The overall utilisation rate of Canadian quota declined marginally from 33 per cent in 2002 to 32 per cent in 2003. The only category that was utilised over 90 per cent was trousers, overalls and shorts.

Incentives to Exporters

In 2003, government initiated several incentive schemes for exporters, which were proposed in the Budget 2003, while continuing with the existing incentives in the form of tax exemptions, duty free imports of raw materials and duty and tax concessions. These existing schemes include bonded warehouse facilities for imported capital and intermediate goods, and the refund of duties and other fiscal levies on imported inputs used in the manufacture of exports. Tax holidays are also available to export trading houses exceeding an annual turnover of US dollar 25 million for 5 years while trading houses with turnover exceeding a minimum level of US dollars 5 million are eligible for concessionary rates of 5-10 per cent. Other, sector-specific tax incentives, are also available, including a tax holiday of 5-10 years for large scale infrastructure and agricultural undertakings, 3 year concessionary tax holidays for IT and IT enabling services *etc.* subject to minimum investment requirements. As proposed by Budget 2003, industries with investment of Rs.15 million and engaged in manufacturing and exporting more than 80 per cent of their products, including non traditional exports, were granted tax holidays of 3 years for those in the Western Province (Region I) and 5 years for other provinces (Region II).

Direct financial assistance is limited to small scale and selected industries. The Sri Lanka Export Development Board (SLEDB) provided financial assistance to exporters on a cost sharing basis for their own initiatives to promote Sri Lankan products in overseas markets. A scheme was introduced to help handloom exporters to modernise, improve productivity and become competitive in the international market. A rebate scheme for exporters of frozen chicken, meat and eggs was also introduced in 2003. The estimated cost of these programmes was around Rs.30 million for 2003.

Institutional Support to Exporters

Several institutions continued to support exporters in a variety of ways, *e.g.*, product development, market access, marketing, insurance facilitation and credit. They extended their support with a range of products to cater to different steps in the export process. The SLEDB continues to improve production activities in Export Processing Companies (EPCs), which bring together the private sector (export trading houses), the state sector and village producers of exportable products. Under this programme, 9 projects involving nearly 5,700 producers are in progress.

As proposed in Budget 2003, the Tea Association of Sri Lanka was formed with private sector participation to take over regulatory activities of the tea industry thus far carried out by the government. A main objective of the Association was the development of 'Ceylon Standards' for tea so as to differentiate Sri Lankan tea from other teas. With the objective of developing the image of Sri Lanka as the foremost production centre for sapphires, Ceylon Sapphire Council Ltd. (CSCL) was formed in 2003. CSCL entered into an alliance with a world renowned jewellery designer to promote 'Ceylon Sapphire Brand Strategy' targetting the high end of the market. The SLEDB made arrangements for 333 exporters to participate in 54 trade fairs worldwide and seven inward and outward missions were organised during the year.

To promote marketing, SLEDB inaugurated the Sri Lanka centre in Chennai, India in 2003, with the objective of acquiring benefits arising from enhanced concessions available under the Indo Sri Lanka Free Trade Agreement. The centre is expected to promote a selected range of products targeting the middle and upper segments of the Indian market to further promote marketing and investment. In 2003, BOI has successfully undertaken several incentive programmes. They led high level outward investment promotion missions to China, Malaysia, Germany, France, India, Japan, Thailand and Bahrain. A number of high level inward business delegations from India, Thailand, China, Singapore and the UK also visited Sri Lanka.

Several measures were taken by SLEDB to combat the threat posed by the ending of the MFA in 2004 and in projecting Sri Lanka's image in the apparel sector. Training and production balancing programmes were organised. Two market promotion programmes in USA and EU were carried out targetting reputed buyers of branded products.

Insurance facilities to exporters were promoted by SLECIC. SLECIC also provided a wide range of other facilities to exporters covering guarantees to banks and other financial institutions, guarantees to overseas buyers, refinance to lending institutions for loans granted for expanding exports. SLECIC has taken steps to minimise its risk exposure by way of reinsurance from a reputed firm to cover its liabilities. This has enhanced its risk taking capacity. It will also enable expanding its scope and coverage to wider areas of business activities. Despite the expansion of activities in its traditional areas of businesses, SLECIC offered new schemes to provide services to financing institutions. Its scope of business too has widened to cover new areas such as issuing status reports of foreign buyers, direct finance facilities at the post shipment stage and provision of guaranties to financial institutions that offer pre-departure loans to repatriate workers.

In view of the long-term sustainability of the timber industry and environment protection, a Forest Stewardship Council Certification Scheme (FSC) was initiated by the SLEDB in 2003. FSC certification ensures that raw materials used for timber products are obtained from well managed forests.

Maintaining quality and standards is essential to be competitive in the international market. Sri Lanka Standards Institution (SLSI) issues quality certificates for agricultural products against the relevant Sri Lanka standards. Pre-export inspections for products like cashew, spices *etc.* were carried out on a voluntary basis. Nineteen fishery product processing establishments for export purposes were regularly inspected and monitored by SLSI. SLSI also provides advisory services for exporters on international standards and technical regulations.

In order to facilitate and advice on the expansion of existing enterprises and to resolve operational issues, an 'Investor Relation Unit' was set up at the BOI. SLEDB too continued to provide information and advisory services on international developments, benefits under various tax and tariff reductions and trade agreement *etc.* while they have successfully launched E-commerce services with a wide range of services to the business community.

The Exporters' Forum was expanded to include trade and investment issues. The Forum brings exporters, importers and investors together with relevant Ministers and relevant officials from government and other institutions to resolve their difficulties and problems through direct interaction.

Freight Rates

During 2003, the average freight rates for many destinations in respect of different commodities showed mixed changes. The basic freight rates to major destinations, *i.e.*, USA and European countries, showed increases despite the removal of the war risk surcharge. The general freight rates to UK, North Continent (Germany, France, Austria, Denmark and the Netherlands), Scandinavian, Baltic, Mediterranean Ports, USA, Canadian and Mexican ports increased during the year. The observed rates to UK, North Continent, Scandinavian, Baltic and Mediterranean ports fluctuated within a range of US dollars 525-750 per TEU (twenty foot equivalent unit). The general rates to the US East Coast region varied within US dollars 3,000 per TEU and US dollars 4,000 per FEU (forty foot equivalent unit) while to the US Pacific Coast (West Coast) the rates were around US dollars 2,000 per TEU and US dollars 2,775 per FEU. However rates varied within a wide range with respect to major exports. The average freight rates to USA for garments, tea, rubber, rubber gloves, terry towels and travel bags increased, whereas rates on solid rubber tyres and a few other items declined. The freight rates for tea to the Red Sea, Arabian Gulf and Japan decreased as the high war risk surcharge was removed by end of 2002. Freight rates to the North Continent increased for cotton yarn, rubber, rubber gloves, tea, brooms and brushes, while rates for garments, soft toys and solid rubber tyres decreased.

Freight rates were inclusive of one or more of surcharges, such as terminal handling charge, bunker adjustment factor, Suez Canal transit fee, export bill of lading fee and peak season surcharge. The Cargo Declaration Data Charge (CDDC) came in to effect subsequent to the security initiatives taken by the US government as a result of September 11. The US government introduced the US Customs 24 hour Advance Manifest Rule. In the event of non conformity with the rule, a penalty of US dollar 25 per bill is charged.

9.12 Trade Relations, Trading and Clearing Arrangements

Sri Lanka took several steps in 2003 to strengthen regional, bilateral and multilateral relations ensuring consistency with the World Trade Organisation (WTO).

In 2003, Sri Lanka made a series of new commitments to the WTO under the General Agreement on Trade in Services (GATS) on banking and insurance services, communications, tourism and travel related services. Those commitments portrayed the existing liberalisation stance of the country. A few amendments based on TRIPs were also introduced to Sri

Box 17

Developments in the World Trade Organisation

Since 1948, the General Agreement on Tariffs and Trade (GATT) had provided the rules for the international trading system. GATT reformed itself into the World Trade Organisation (WTO), a fully fledged international organisation, on 1 January 1995. A notable feature of the WTO is that there should be consensus among the membership of the WTO before any agreement is made operational.

The fundamental principles of the WTO are non-discrimination, reduced trade barriers, policy predictability, transparency, competitiveness and special treatment for less developed countries. Many believe that free trade as advocated by the WTO will benefit all countries, especially small countries which do not have a substantial domestic market. Hence, failure to agree on trade promoting liberalisation measures hurt all countries, and in particular small developing countries like Sri Lanka.

The Ministerial Conference is the WTO's highest decision-making body. The Ministerial Conference has to be held at least once every two years. Since the creation of WTO in 1995, there have been five Ministerial Conferences, Singapore (December 1996), Geneva (May 1998), Seattle (November-December 1999), Doha (November 2001) and Cancún (September 2003).

At the first Ministerial Conference in Singapore, a few issues were brought into discussion other than trade liberalisation. Those issues, known as 'Singapore Issues', are trade related investment issues, trade related competition policy, trade facilitation and transparency in government procurement.[1] At the second Conference held in Geneva, ministers underlined the crucial importance of the multilateral rule-based trading system, and reaffirmed the commitments and assessments made at Singapore.

The third Ministerial Conference held in Seattle ended without success, mainly as a result of the failure to agree on new issues and due to differences between the United States of America (USA) and the European Union (EU) on agricultural subsidies. The fourth Conference, in Doha, took place in the aftermath of the September 11 attack on the USA. The outcome, popularly known as the Doha Development Agenda (DDA), was to uphold the principles of the WTO and to commence negotiations on all issues reducing trade-distorting farm subsidies, slashing tariffs on farm goods, eliminating agricultural export subsidies, reducing tariffs on textiles and freeing up trade in services.

The draft declaration of the Cancún Ministerial Meeting covered key issues in areas such as agriculture, non-agricultural market access and Singapore Issues. On agriculture, there were clear differences between developed and developing countries and even among the developed countries. However, in order to move the negotiation forward, EU and USA agreed to narrow their differences. However, a group of 21 developing countries led by Brazil, India, Chile and South Africa (G-21), argued that neither the joint text of EC and USA nor the draft ministerial text had taken into account G-21's concerns on agriculture.[2] Therefore, the Ministers failed to reach consensus on the text on agriculture. Japan, Korea, EU and several other developed countries insisted on commencing negotiations on all Singapore Issues. The USA and EU supported commencing negotiations on the last two Singapore Issues, i.e., trade facilitation and transparency in government procurement. However, many developing countries rejected negotiations on any of the Singapore Issues. Finally, with failure to reach any agreement, the meeting came to an abrupt end.

Sri Lanka did not join the G-21 group of countries. However, Sri Lanka's negotiations were based on the protection of national interests especially in agriculture, non-agriculture market access, services and Singapore Issues.

The failure at Cancún is a serious blow to promoting global free trade, of which beneficiaries are mostly the developing countries. According to the World Bank, a successful completion of trade negotiations as per DDA could raise global income by more than US dollars 500 billion a year by 2015. Over 60 per cent of that gain would go to poor countries, helping to pull 144 million people out of poverty. Most of the gain would come through freer trade among themselves, while reduction in tariffs and other subsidies in developed countries also could help substantially.

Soon after the collapse of the meeting in Cancún many developing countries have begun negotiating for bilateral agreements with several developed countries. Such agreements, although having a strategic importance, undermine benefits of multilateral free trade, and divert trade away from other poor countries, causing an unfavourable imbalance in global resource allocation. Hence, it is the combined responsibility of the WTO and all of its 146 members to revert to the original principles of the WTO and bring back the negotiations to major issues without diluting their importance by bringing in other issues with unnecessary complications.

1. Ministerial declarations can be downloaded from the WTO website, www.wto.org
2. G-21 countries are Argentina, Bolivia, Brazil, Chile, China, Colombia, Costa Rica, Cuba, Ecuador, Egypt, Guatemala, India, Indonesia, Mexico, Nigeria, Pakistan, Paraguay, Peru, Philippines, South Africa, Thailand, and Venezuela.

Box 18

Second Trade Policy Review of Sri Lanka by the World Trade Organisation

Trade policy reviews at regular intervals are mandated in the agreements of the World Trade Organisation (WTO). In those reviews, trade and related policies of member countries are examined and evaluated at regular intervals *vis-à-vis* their commitments made to the WTO on the degree of trade liberalisation. For each review, two documents are prepared: a policy statement by the government of the member country under review and a detailed report written independently by the WTO Secretariat. These two documents are discussed by the Trade Policy Review Body of the WTO at a Plenary Session.

The frequency of each country's review varies according to its share of world trade. The four members with the largest share of world trade (currently, the European Community, the United States, Japan and Canada) are reviewed every two years, the next 16 largest countries every four years, and the rest every six years. Longer periods are fixed for least-developed country members. Sri Lanka, being a developing country, is reviewed once every six years. The first such review took place in 1995. The second was scheduled for 2001, but was completed in March 2004.

The following is a summary of the second trade policy review of Sri Lanka as completed in 2004.

1. The government has made considerable efforts to press ahead with the reconstruction and rehabilitation programme outlined in the policy document 'Regaining Sri Lanka'. Sri Lanka has made considerable progress in privatisation and deregulation.
2. Sri Lanka is committed to the primacy of the multilateral trading system, although it pursues regional and bilateral trade agreements in developing market access for its products.
3. Sri Lanka has introduced new intellectual property legislation, and will follow this up with effective implementation and enforcement.
4. Sri Lanka has simplified customs procedures, and in particular, has introduced computerised systems for customs clearance.
5. Sri Lanka has taken steps to reduce state involvement and eliminate foreign equity restrictions in financial services, and has made efforts to liberalise the telecommunications market.
6. Sri Lanka's heavy dependence on a few export markets and products, such as textiles and clothing, remains a serious concern.
7. There are indications that Sri Lanka's tariff regime has less predictability and transparency. Some such indications are the high level of applied Most Favoured Nation (MFN) tariffs, particularly for agricultural products; the low percentage of bound rates; the large gap between bound and applied rates; high tariff escalation and consequently high effective protection granted to some products; existence of other import charges (notably the surcharge and the Ports and Airports Development Levy), import restrictions on meat products, import prohibitions on genetically modified products, standards and contingency measures, licensing requirements for economic reasons and duty exemptions.
8. Government procurement procedures in Sri Lanka have demonstrated price preferences for locally manufactured products and local work contracts, while it suffers from opacity of tendering procedures. However, Sri Lanka is committed to reforming the procurement system.

The review mechanism provides an opportunity for a country to examine its own policies against WTO consistent policies. It also provides an excellent opportunity for a member country to scrutinise another member's trade regime and to bring to the notice of all WTO members any trade discouraging and discriminatory measures. This scrutiny can be done and favourable changes to the member country's trade regimes could be suggested by bringing together all forces of a country such as Permanent Representatives in Geneva, relevant government agencies, the private sector and their affiliated bodies. The existence of a calendar of reviews of WTO members helps a country in preparing for such scrutiny to help widen its access to markets in WTO member countries and to reap the full benefits of being a member of the multilateral trading arrangement.

Lanka's Draft Bill on Intellectual Property Rights, which was presented to Parliament in May 2003.

The second Trade Policy Review (TPR) by the WTO began in 2003 and was concluded in March 2004. TPR focused on Sri Lanka's major macroeconomic and trade policies, and commended Sri Lanka's liberalisation efforts, while being critical on few areas such as predictability and transparency, the high level of applied MFN tariffs, particularly for agricultural products, the low percentage of bound tariff rates, the large gap between bound and applied rates, high tariff escalation, high effective protection and other import charges.

Sri Lanka honoured the commitments under the Indo-Sri Lanka Free Trade Agreement (ISLFTA), which reached the third year of implementation, by granting further concessions on selected items from 05 March 2003. Under the ISLFTA, the Indian government made 2,799 tariff lines duty free for Sri Lanka from 18 March 2003. With this revision, 4,150 tariff lines (81 per cent of total tariff lines) in the Indian tariff schedule are free from duty for exports originating from Sri Lanka. India agreed to include three additional entry ports for garments shipped from Sri Lanka, while agreeing to provide both sea and airport access for entry points granted for tea and readymade garments in previous negotiations. Furthermore, India agreed to deepen the present tariff concessions on textiles. Arrangement will be made by India to issue visas for Sri Lankan businessmen without the requirement of a personal interview and based on letters issued by business chambers or the Government of Sri Lanka. Total imports from India increased by 26 per cent to US dollars 1,073 million in 2003, from US dollars 853 million in 2002.

The Joint Study Group (JSG) on the Comprehensive Economic Partnership Agreement between Sri Lanka and India (CEPA) was setup in April 2003 to make recommendation on how to take the two economies beyond trade towards greater integration. JSG has finalised the study in 2003 and recommended the entry into CEPA. JSG has further recommended that ISLFTA should be widened and deepened to improve market access through trade facilitation and removal of non-tariff barriers, include all service sectors and all modes of supply under the GATS framework, especially, the movement of business people and professionals, Mutual Recognition of Agreements (MRAs) on professional qualifications, special provisions for transport and logistics services, liberalisation of bilateral air services agreement to increase the number of flights and destinations, promote investment in each other's countries, and promote economic cooperation in infrastructure, education, tourism and information and communications technology.

The second meeting of the Joint Council of Trade and Investment Framework Agreement (TIFA) with the USA, which was signed in July 2002, was held in March 2003 in Washington D.C. USA. Both USA and Sri Lanka agreed to explore the possibility of organising outward and inward trade missions to promote trade relations. Other major issues discussed were participation in the US Container Security Initiative, the possibility of obtaining technical assistance and training for effective enforcement of the Intellectual Property Rights Legislation, capacity building and moving forward with the Doha Development Agenda (DDA) of the WTO. The DDA comprises issues relating to reducing trade-distorting farm subsidies, slashing tariffs on farm goods, eliminating agricultural-export subsidies, reducing tariffs on textiles and freeing up trade in services.

Discussions were in progress for economic and/or trade agreements with some other countries such as Bangladesh, China, Egypt, Malaysia, Pakistan, Thailand, Saudi Arabia and Singapore.

Regional economic co-operation was fostered further in 2003 with continuing discussions with the South Asian Association for Regional Co-operation (SAARC), Bangkok Agreement, Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Co-operation (BIMST-EC) and Indian Ocean Rim Association for Regional Co-operation (IOR-ARC).

The Heads of SAARC signed the SAFTA Agreement at the 12th SAARC Summit held in January 2004 in Islamabad. It is envisaged that the SAFTA Agreement will be operational by January 2006. No further round of SAPTA negotiations will be held in view of the finalisation of the SAFTA Agreement. In order to ensure timely implementation of the Agreement by 2006, the Committee of Experts appointed by the Council of Ministers has already commenced negotiations to finalise the important components of the agreement such as the sensitive list, technical assistance to less developed countries (LDCs) (Nepal, Bhutan, Maldives and Bangladesh), the mechanism for compensation of revenue loss for LDCs and finalisation of rules of origin.

The fourth BIMST-EC Trade/Economic Ministerial Meeting was held in March 2003 in Colombo. Economic cooperation under BIMST-EC was carried out in the fields of trade and investment, technology, transport and communications, energy, tourism and fisheries. Due to the wide scope of the trade and investment sector, it has been further divided into eight subsectors, namely, textiles and clothing, drugs and pharmaceutical, gems and jewellery, horticulture and floriculture, processed food, automobile industry and parts, rubber, tea and coffee, coconut and spices. Until end 2004, Sri Lanka would be the lead country of the technology sector and the chair country for the subsectors of processed foods and gems and jewellery. The first BIMST-EC Business Forum was held in Colombo on 1 December 2003. The delegates agreed to identify detailed activities under each subsector to the expedite the free trade agreement for the BIMST-EC region and to conduct another convention to facilitate implementation of initiatives. The Expert Group is working on drafting a framework agreement for a BIMST-EC free trade area and it is scheduled to be submitted to the BIMST-EC Summit in 2004.

The third round of negotiations under the Bangkok Agreement, which was aimed at offering a maximum 50 per cent margin of preference on existing tariffs in respect of agreed items, was concluded at the twenty first session of the Standing Committee of the Bangkok Agreement held in February 2004 in Thailand. Sri Lanka also exchanged offer lists with Bangladesh, China and South Korea. Both India and Sri Lanka have decided not to exchange concessions in view of the existing SLFTA between the two countries. Work on the amended version of the Bangkok Agreement, called the Asia-Pacific Trade Agreement, has progressed satisfactorily except for one outstanding issue with regard to domestic value addition criterion in respect of products not wholly produced or obtained.

Sri Lanka assumed the chairmanship of the Indian Ocean Rim Association for Regional Cooperation (IOR-ARC) for the period of 2003-2005 at the fourth IOR-ARC Council of Ministers held in Colombo in October 2003. At the council meeting, consensus was reached on the future direction of IOR-ARC with the adoption of the report by a high-level task force. The next IOR-ARC ministerial meeting is scheduled to be held in Sri Lanka in 2004. The major focus of IOR-ARC is on regional cooperation with special emphasis on economic, trade and investment. Ongoing regional cooperation projects of special interest to Sri Lanka include tourism promotion, fisheries and shipping.

Sri Lanka became a member of the Asia Co-operation Dialogue (ACD) at the second ministerial meeting held in Thailand in June 2003. As agreed at the first meeting of ACD members, the Asian Bond Fund was created on 2 June 2003. The aim of the Asian Bond Fund was to encourage the creation of an Asian Bond market, through concurrent development of both the demand and supply sides, so that Asian countries will both be issuing Asian bonds and investing in Asian bonds. The Asian Bond Fund is US dollar denominated and open for both US and European investments through the Bank for International Settlements. The first lot of Asian Bonds (ABF I) was launched in June 2003 with the participation of 11 member countries that have agreed to join the fund, with a starting capital of one billion US dollars.

Sri Lanka continued to receive tariff concessions from developing countries under the Global System of Trade Preferences (GSTP) and from the European Commission by participating in the Generalised System of Preferences (GSP). The European Commission has decided to grant additional benefits to Sri Lanka under GSP because of its remarkable progress towards compliance with the core labour standards as defined by the ILO. Sri Lanka would benefit from this arrangement with effect from 1 January 2004, which will remain effective till 31 December 2005.

The Asian Clearing Union (ACU) has performed well in 2003. The total value of transactions of Sri Lanka effected through the ACU mechanism increased by 29 per cent to US dollars 1,039 million in 2003, compared with 2002 due mainly to the increase of petroleum and wheat imports from India and petroleum from the Islamic Republic of Iran. The total receipts of funds in respect of exports from Sri Lanka to other ACU countries recorded an increase of 11.6 per cent in 2003. The rupee value of net settlements made under the ACU mechanism during the year 2003 amounted Rs.89.7 billion, recording an increase of 33 per cent over 2002. Legislation on anti-dumping, countervailing and safeguard measures that aimed at protecting the domestic industry from unfair trade practices, subsidised imports and import surges, was submitted for Cabinet approval in 2003. The proposed enactment on anti-dumping, countervailing and safeguard legislation in Sri Lanka constitutes legitimate WTO sanctioned multilateral trade remedies designed to promote and safeguard the domestic industry of the WTO member countries from unfair trading, causing or threatening to cause 'serious injury' to the domestic industry.

9.13 Internal Trade and Institutional Arrangements

Government presence in trading activities has diminished gradually over the last several years. Consequently, major controls and intervention were limited to trade regulations, while state intervention on price determination was limited to a few essential items. Benefitting from the economic recovery and the opening up of trade opportunities in the North and the East, internal trade further improved in 2003. The internal trade sector, which accounts for 10 per cent of GDP, grew by 4.2 per cent in 2003 compared with a 3.2 per cent growth in 2002. Meanwhile, government intervention in commercial activities was further curtailed in 2003 and was limited to the supply of essential items through a few state sector institutions.

Activities of the Co-operative Wholesale Establishment (CWE) were further rationalised in 2003, under its restructuring programme. CWE continued to engage in importing a few essential items, purchasing some domestic agricultural products and functioning as wholesale and retail trader. CWE purchased paddy (1,784 metric tons) and green gram (263 metric tons) locally in 2003. Steps were taken to sell 40 per cent shares of Sathosa Retail Ltd., to the private sector and improve the quality of services by upgrading its outlets to supermarkets.

Eliminating the monopoly enjoyed by the Ceylon Petroleum Corporation (CPC), the Indian Oil Company (IOC) entered the domestic market in March 2003. The importation of refined products and distribution activities were shared by CPC and IOC but importation of crude oil was solely handled by CPC. In 2003, CPC functioned as the major petroleum product supplier to the domestic market, accounting for about the 85 per cent of the market. CPC operates 948 filling stations throughout the island, of which 691 were owned by dealers and 257 owned by CPC. The formula based pricing system introduced by CPC in January 2002, continued in 2003.

The State Pharmaceuticals Corporation (SPC) is the sole supplier of pharmaceutical products to government health care institutions and a major supplier to the local market with 42 per cent of market share. SPC operates with an islandwide sales network of 48 distributors, 17 Rajya Osu Sala outlets, 37 franchise Osu Sala outlets, and 17 authorised retailers. STC General Trading Co. Ltd., mainly engaged in selling chemicals, tyres and motorcycles, underwent a structural change in 2002. Lanka Salu Sala Ltd., imports and distributes mainly textiles and garments through 24 sales outlets and mobile sales outlets. Distribution of free school uniform materials too operated through Salu Sala in 2003. Ceylon Fertiliser Co. Ltd. (CFC) is a major distributor of fertiliser islandwide with 26 per cent of market share. The company maintains 30 district fertiliser stores around the country to distribute quality fertiliser to the paddy, plantation and other agricultural sectors. With the benefits of the peace process, CFC was able to enter the fertiliser market in the Batticaloa District in the Eastern Province, and Kilinochchi in the Northern Province in 2003.

The co-operative societies engaged in both retail and wholesale trading activities during 2003. Despite the strong participation by the private sector, total turnover of the co-operative societies increased by 26 per cent to Rs.45.5 million as against Rs.36.2 million in 2002. The services were provided through 311 co-operative societies which operate 8,132 retails outlets of which 121 are new outlets. The societies were responsible for distributing dry rations to Samurdhi beneficiaries and displaced people, in addition to other business activities. In 2003, these distributed dry rations to flood affected people. These societies also purchased paddy, vegetables and milk from producers in rural areas.

While reducing the government's direct intervention in price control, steps were taken to facilitate market based price mechanisms to ensure fair prices to both producers and consumers. A pilot project under the Forward Sales Contract (FSC) System initiated by the Central Bank in 1999 was implemented during April 2002 to June 2003. Under the project, a number of awareness programmes have been held in all major agricultural areas of the country with a large participation. Under FSC, the farmers and the buyers are encouraged to enter into contracts on an agreed price and a quantity for a particular crop at the time of cultivation, thereby ensuring a fair price for the farmers' produce. In 2003, 38,007 FSCs were signed on a variety of crops such as maize, paddy, finger millet, soya bean, green gram, and other crops benefiting 42,374 farmers. The FSC system will minimise the fluctuations in prices realised by farmers.

The Consumer Affairs Authority (CAA) of Sri Lanka, the new regulatory arm of the Ministry of Commerce and Consumer Affairs, was established in March 2003, under the Consumer Affairs Authority Act, No. 9 of 2003. It was formed by merging the Fair Trading Commission and Department of Internal Trade. Protection of the consumer, promotion of effective competition and regulation of internal trade to ensure that consumers have adequate access to goods and services at competitive prices are the main objectives of the Authority. In 2003, five commodities were brought under the CAA Act. Accordingly, its approval is required for increases in the price of cement, LP gas, milk powder, mosquito coils and boxes of matches. In addition, a number of awareness programmes were conducted for students, the business community and teachers in several districts.

To promote marketing infrastructure 5 Dedicated Economic Centers (DEC) were established by end 2003. Another 7 DECs are under construction and 13 DECs are expected to commence in 2004. These centres will facilitate both farmers and consumers to realise a fair price for the commodities.

9.14 Tourism

With bright prospects for peace, Sri Lanka aims to establish a sustainable leisure industry and to extend benefits therefrom to people at large. The plan is to increase earnings by promoting arrival of high spending tourists. To do so, it is essential to develop infrastructure such as air travel, accommodation, marketing and human resources. Sri Lanka has entered into bilateral agreements with several countries to increase seating capacity in air travel. Accommodation capacity has been increased by promoting the construction of hotels and other types of accommodation. Training institutions have to be set up to develop human resources. However, bottlenecks persist in infrastructure facilities including roads, electricity and communications.

Chart 9.10
Monthly Tourist Arrivals

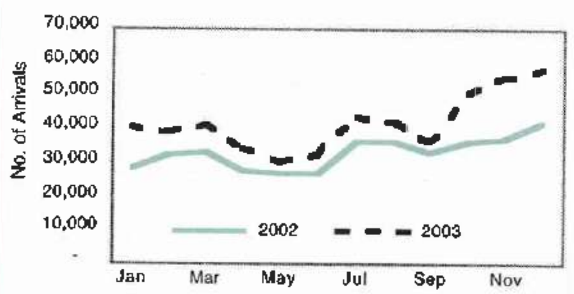


Chart 9.11
Tourist Arrivals and Earnings
(1997=100)

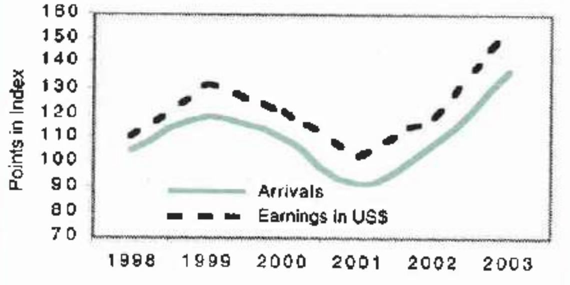


TABLE 9.13
Tourism Statistics

Item	2001	2002	2003(a)	Percentage Change	
				2002	2003
Tourist arrivals	336,794	393,171	500,642	16.7	27.3
Tourist guest nights ('000)	3,342	3,989	4,700	19.4	17.8
Room occupancy rate (%)	42.1	43.1	53.2	2.4	23.4
Gross tourist receipts (Rs.mn)	19,034	23,724	31,209	24.6	31.5
Per capita tourist receipts (Rs.)	56,515	60,340	62,338	6.8	3.3
Total employment (No.)	80,904	87,600	115,000	8.3	31.3
Direct	33,710	36,500	50,000	8.3	37.0
Indirect	47,194	51,100	65,000	8.3	27.2

(a) Provisional

Sources: Sri Lanka Tourist Board
Central Bank of Sri Lanka

In 2003, Sri Lanka was able to exceed its target of 500,000 tourists, reaching 500,642. This is the highest number of tourist arrivals in Sri Lanka so far. Tourist arrivals increased by 27.3 per cent in 2003. Benefits of the ceasefire and peace negotiations were felt strongly in the tourism sector. Recovery of the global economy, especially Western Europe, also contributed to higher arrivals. Gross earnings from the tourist industry increased by 39 per cent in 2003, from US dollars 248 million in 2002 to US dollars 324 million in 2003. The Sri Lanka Tourist Board (SLTB) expects to achieve a target of 650,000 tourists arrivals in 2004. This will exhaust existing room capacity and other infrastructure facilities, particularly during peak seasons. In December 2003, room occupancy rates increased to 77 per cent in the Colombo City, 64 per cent in the ancient cities and the southern coast. Insufficient flight frequency and seating capacity too became major constraints for the expansion in the tourist industry.

To increase accommodation, SLTB identified several locations to develop tourist resorts. Under the 'South West Coast Tourism and Community Infrastructure Development Project' funded by the Japan Bank for International Cooperation (JBIC) eight zones in the south west coast were selected to develop infrastructure facilities. Two thousand acres of marshy land with inland water bodies in the Dedduwa and Marawila area were identified to be developed as a major eco - tourism site. A BOI project aiming at converting old mansions and state bungalows for tourist accommodation is in place.

As there are seasonal variations in tourist arrivals, promotional campaigns have been carried out by the SLTB and private tour organisers to promote Asian tourists to utilise existing capacity during off-peak seasons. The main target markets are India, Pakistan, Bangladesh, Thailand, Malaysia and China. Sri Lanka was identified as an official destination by China in 2002 and the private sector responded positively by initiating promotional campaigns in 2003. This gives access to a large and fast growing market. Tourist arrivals from China increased from 4,338 in 2002 to 7,251 in 2003, a 67 per cent increase.

To ease the constraint of flying frequency, SriLankan Airlines increased the number of flight destinations and frequency. The Ministries of Tourism and Civil Aviation signed a bilateral agreement with the Maldives in May to promote tourism between the two countries. A similar joint agreement was signed with Pakistan in August 2003. Further, Sri Lanka negotiated arrangements with eight more countries, Oman, Singapore, Qatar, Egypt, Switzerland, UAE, France and Indonesia to provide bilateral air services. Several other airlines also increased flight frequencies.

SriLankan Airlines operates flights to 33 destinations in 21 countries. With the significant rise in tourist arrivals from India and Pakistan, SriLankan Airlines introduced additional flights to Cochin in May 2003 and Karachi in June 2003. Malaysian Airlines, and designated airlines from Qatar, Oman and UAE increased their weekly flight frequency, while Cyprus Airways, Aeroflot and Martin Air commenced flights to and from Sri Lanka in 2003. As a result, the number of scheduled passenger airlines increased from 20 in 2002 to 23 in 2003. The number of charter flights operated in 2003 was 7 against 4 in 2002. Air Monarch and Wim Airlines operated only during the peak period during the England cricket tour and Kandy Perahera, respectively. Furthermore, to meet the growing

TABLE 9.14
Tourist Arrivals - By Region

By Region	2002	2003(a)	Change 2003/2
Western Europe	200,295	255,169	27.4
of which:			
U.K.	67,533	93,278	38.1
Germany	55,170	58,908	6.8
France	19,989	28,585	43.0
Italy	12,177	15,654	28.6
Asia	143,064	177,351	24.0
of which :			
Hong Kong	3,759	3,075	-18.2
India	69,960	90,603	29.5
Japan	13,602	17,115	25.8
North America	19,866	25,110	26.4
Australasia	13,209	22,965	73.9
Eastern Europe	8,079	10,633	31.6
Other	8,658	9,414	8.7
Total	393,171	500,642	27.3

(a) Provisional

Sources: Sri Lanka Tourist Board
Central Bank of Sri Lanka

demand from India, negotiations were initiated to increase the number of flights between the two countries and to start a ferry service from Colombo to Tuticorin.

The majority of tourists (81 per cent) visited the country on vacation, while about 19 per cent came for other purposes, such as business, visiting friends and relatives, religious and cultural purposes *etc*. Out of the total arrivals, 78 per cent travelled in regular interregional flights, 19 per cent arrived in regular intraregional flights and 3 per cent by charter flights. SriLankan Airlines brought in 51 per cent of the tourists in 2003, compared with 52 per cent in 2002.

The Sri Lanka Tourist Board is expecting to establish a regional training centre to provide training and skills development programmes to satisfy both domestic and regional requirements. SLTB is to be restructured under the new Tourism Act by dividing it into three entities, a Tourism Development Council for planning and regulation of services, a Marketing Bureau to carry out overseas marketing and promotions and a Training Institute to train personnel.

New levies were introduced to generate funds for financing the three institutions proposed. The Airport Embarkation Levy was increased by US dollars 5 per person on 1 September 2003. With this revision, revenue from the embarkation levy increased by 53 per cent from Rs.393 million in 2002 to Rs.600 million in 2003. A levy of 1 per cent was imposed on the turnover of Sri Lanka Tourist Board approved establishments in September 2003.

In 2003, Western Europe continued to be the major source of tourists to the country, accounting for 51 per cent of the total arrivals, an increase of 27 per cent from 2002. Arrivals from Asia, led by India (30 per cent), increased by 24 per cent, accounting for 35 per cent of the total arrivals against 36 per cent in 2002. Arrivals from UK, the largest source of tourists to Sri Lanka, increased significantly in 2003, partly due to the visit of the England cricket team to Sri Lanka in December and the incentive packages provided by tour organisers, while tourist arrivals from India continued to increase in 2003. India became the second highest source of tourists, largely attributable to the promotional campaign launched by Sri Lankan Airlines in 2002. Tourist arrivals from North America, Eastern Europe, Australasia and the Middle East increased by 26 per cent, 32 percent, 74 per cent and 5 per cent, respectively, in 2003.

Foreign guest nights at tourist hotels increased by 15 per cent in 2003 compared to 10 per cent in 2002. The annual room occupancy rate increased to 53 per cent in 2003, against 43 per cent in 2002. The highest room occupancy rate was in the Colombo City (69 per cent) followed by ancient cities (54 per cent) and the east coast (51 per cent). Room occupancy rates were significantly higher during peak seasons, *i.e.*, July to August and October to December. The number of hotels in the graded accommodation sector increased from 222 in 2002 to 233 in 2003. The increase was distributed in six regions i.e. Greater Colombo (5), south coast (3), ancient cities (-1), east coast (2) and hill country (2).

Employment, both direct and indirect, in the sector increased in 2003. Direct employment is defined as employment in hotels and restaurants, travel agencies, tour operators, airlines, agencies providing recreational facilities and tourist shops. Domestic producers and suppliers of inputs and manufacturers and suppliers of handicrafts generate indirect employment.

Proving Sri Lanka's potential for developing new tourism products such as eco tourism and culture tourism, revenue from tourists visiting wildlife parks, botanical gardens, zoological gardens and the Cultural Triangle increased in 2003. To provide more opportunities for tourists to visit attractive places in the country, the Civil Aviation Authority (CAA) launched a programme to develop the domestic aviation sector with foreign direct investment. CAA is working with a consultancy team sponsored by the Danish government under the Danida Mixed Credit Scheme. There were three airlines, *i.e.*, Expo Aviation, Lion Air, Serendib and Express Ltd. engaged in domestic passenger transportation. They transported more than 100,000 passengers between Colombo and Jaffna in 2003.

The Sri Lanka Convention Bureau continued to promote MICE (meetings, incentive travels, conventions and exhibitions) tourism in 2003. Sri Lanka has become a popular destination for conferences and meetings, particularly, in the South Asia region. The majority of MICE traffic in 2003 was from India, Pakistan, Singapore and Malaysia. As India became the most important origin for MICE tourism, SriLankan Airlines increased the number of flights to India. Many international companies held their corporate meetings in Sri Lanka for groups ranging from 50 -350 people.

The Sri Lanka Tourist Board decided to implement the Tourism Satellite Account (TSA) system[1] in 2004 with technical assistance from the World Tourism Organisation (WTO). WTO introduced the Tourism Satellite Account in 1995 to develop a comprehensive and accurate database worldwide for the tourist industry. The Tourist Board will be responsible for implementing the TSA system and it will provide useful information for policy makers and industrialists.

Tourism was identified as one of the key areas for bilateral and regional co-operation in many fora in 2003. The International Tour Operators Meeting of BIMST-EC (Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Co-operation) was held in Sri Lanka in 2003. Major issues such as the promotion of tourist traffic to the BIMST-EC countries, and intra-regional Buddhist pilgrimage travel were discussed at this meeting. Tourism promotion and development is one of the special issues to be discussed at the next IOR-ARC Ministerial Meeting to be held in Sri Lanka in 2004. The Cabinet of Ministers approved a memorandum of understanding (MOU) for cooperation in tourism with Jordan.

1. The World Tourism Organisation (WTO) first introduced the Satellite Account System (TSA) in 1995 to develop a comprehensive and accurate database worldwide for the tourism industry. Countries who wish to enter into this system are expected to develop their tourism database according to the guidelines introduced by WTO.