Chapter 5

EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

5.1 Overview

- **Sri Lanka's external sector, despite the several major challenges faced during 2005, achieved a substantial expansion in external trade and financial flows eventually leading to a surplus in the Balance of Payments (BOP). This was largely, buoyed by continuing global economic growth and the combined efforts of entrepreneurs and the government.** With sustained global economic growth, especially, growth in major export destination countries, there was continued demand for Sri Lanka's exports, primarily due to their high quality. The external sector successfully overcame the challenges posed by the termination of the Multi Fibre Arrangement (MFA), through prior measures taken by entrepreneurs in readiness for international competition. These private sector initiatives were facilitated by the efforts of the government to enhance market access through commercial diplomacy. Higher earnings and the partial pass-through of high oil prices to the domestic economy enabled the sector to contain the impact of escalating energy costs and maintain external competitiveness. Tourism slowed temporarily, but higher inflows under worker remittances, inflows in relation to tsunami related reconstruction by way of grants, debt moratoria and loans and grants to the government, offset the higher outflow on account of financing imports. These generated a balance of payment surplus in 2005, and improved the debt servicing capacity. External reserves improved to a comfortable level, further strengthening the country's resilience to external shocks. The rupee appreciated moderately against major currencies but it did not cause a significant impact on the external competitiveness.
- **Exports grew by 10.2 per cent and imports by 10.8 per cent in 2005, resulting in a widened trade deficit. The current account deficit widened only marginally, benefiting from a substantial increase in remittances.** Exports reached US dollars 6,347 million with supply improvements and an expansion in global demand. Export volume grew by 6.7 per cent and export prices increased by 3.3 per cent. Imports increased to US dollars 8,863 million, reflecting a volume growth of 2.7 per cent and a price increase of 7.8 per cent. The moderate volume growth in imports is a result of lower growth in consumer goods (0.9 per cent). There was a higher growth in intermediate goods (2.7 per cent) and investment goods (4.2 per cent). The volume of imports responded to the escalation in commodity prices, but continued economic expansion and higher export demand stimulated intermediate and investment goods imports. Overall growth in import prices exceeded the growth in export prices causing deterioration in the terms of trade by 4.2 per cent in 2005. The trade deficit increased to US dollars 2,516 million in 2005, while the current account deficit widened marginally by 0.3 per cent to US dollars 650 million.

Chart 5.1
External Trade

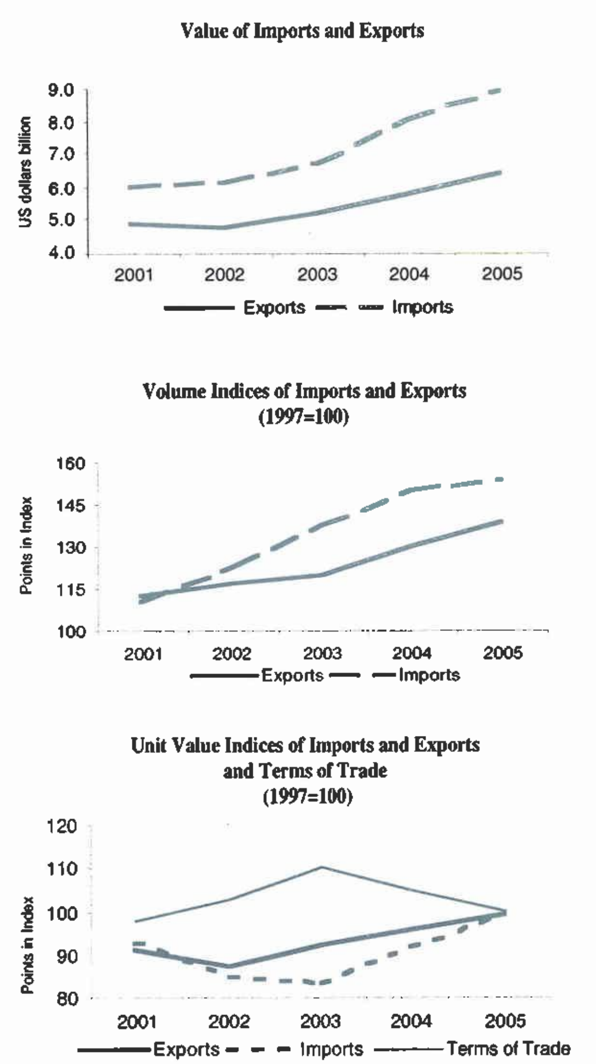


Table 5.1

Balance of Payments Analytical Presentation (a)

Item	US dollars million					Rs. million				
	2001	2002	2003	2004	2005 (b)	2001	2002	2003	2004	2005 (b)
Trade Balance	-1,157	-1,406	-1,539	-2,243	-2,516	-102,592	-134,706	-148,324	-227,171	-253,082
Exports	4,817	4,699	5,133	5,757	6,347	430,372	449,855	495,426	583,967	638,276
Imports	5,974	6,106	6,672	8,000	8,863	532,964	584,561	643,750	811,138	891,359
Services, (net) (c)	204	295	399	419	338	14,692	28,224	38,443	42,735	34,043
Receipts	1,355	1,268	1,411	1,527	1,540	120,937	121,340	136,123	154,746	154,877
Payments	1,151	974	1,012	1,108	1,202	106,246	93,115	97,680	112,011	120,833
Income (net)	-267	-252	-172	-204	-299	-23,842	-24,167	-16,535	-20,732	-30,049
Receipts	108	75	170	157	35	9,584	7,201	16,385	15,813	3,629
Payments	375	328	341	360	335	33,425	31,368	32,920	36,545	33,678
Goods, Services and Income (net)	-1,220	-1,364	-1,312	-2,028	-2,478	-111,742	-130,648	-126,416	-205,168	-249,088
Private Transfers (net)	984	1,097	1,205	1,350	1,736	87,837	104,980	116,350	136,672	174,542
Receipts	1,155	1,287	1,414	1,564	1,968	103,180	123,183	136,475	158,291	197,968
Payments	172	190	209	214	233	15,343	18,202	20,125	21,619	23,426
Official Transfers (net)	22	31	36	30	93	1,925	2,982	3,441	3,038	9,300
Current Account	-215	-236	-71	-648	-650	-21,980	-22,686	-6,625	-65,458	-65,246
Capital and Financial Account	562	444	722	631	1,224	49,077	40,639	69,723	61,588	123,866
Capital Account	198	65	74	64	250	17,766	6,219	7,146	6,573	25,108
Capital Transfers(net) (d)	198	65	74	64	250	17,766	6,219	7,146	6,573	25,108
Receipts	203	71	81	71	257	18,241	6,782	7,768	7,242	25,863
Payments	5	6	6	7	7	475	563	622	669	755
Financial Account	364	379	648	567	974	31,311	34,420	62,577	55,015	98,757
Long-term:	163	326	722	680	798	14,337	28,911	69,721	69,255	80,391
Direct Investment (net)	172	185	201	227	234	15,271	17,716	19,450	22,826	23,505
Foreign Direct Investment(net)	82	181	171	217	234	7,310	17,281	16,557	21,948	23,505
Privatisation Proceeds	90	5	30	10	0	7,961	435	2,893	878	-
Private Long-term (net)	-257	-21	-33	14	11	-22,918	-2,039	-3,201	1,720	1,054
Inflows	44	115	101	169	197	4,016	11,007	9,738	17,395	19,739
Outflows (d)	301	136	134	155	186	26,934	13,046	12,939	15,675	18,685
Government, Long-term (net)	249	162	554	439	553	21,984	13,233	53,472	44,709	55,832
Inflows	575	542	913	771	747	51,193	51,843	88,106	78,299	75,309
Outflows	326	380	359	331	194	29,209	38,610	34,634	33,590	19,477
Short-term:	201	53	-75	-112	176	16,974	5,509	-7,145	-14,240	18,366
Portfolio Investment (net)	-11	25	2	11	60	-1,025	2,443	209	1,109	6,103
Private Short-term (net)	-42	68	19	28	16	-3,798	6,548	1,877	2,514	1,640
Commercial Bank Assets (net)	183	104	-94	-354	-223	2,867	6,893	-9,090	-45,367	-19,669
Commercial Bank Liabilities (net)	71	-145	-2	202	323	18,929	-10,375	-141	27,504	30,292
Government Short-term (net)	-	-	-	-	-	-	-	-	-	-
SDR Allocations	-	-	-	-	-	-	-	-	-	-
Valuation Adjustments	-	93	-	-	-	22,245	8,900	-	-	-
Errors and Omissions	-127	38	-148	-189	-72	-19,578	9,197	-14,487	-3,604	-10,494
Overall Balance (e)	220	338	502	-205	501	29,765	36,051	48,610	-7,474	48,125
Monetary Movements (e)	-220	-338	-502	205	-501	-29,765	-36,051	-48,610	7,474	-48,125
Annual Average Exchange Rate Rs/US$						89.36	95.66	96.52	101.19	100.50
Ratio to GDP in percentages										
Trade Account	-7.4	-8.5	-8.4	-11.2	-10.7	-7.3	-8.5	-8.4	-11.2	-10.7
Current Account	-1.4	-1.4	-0.4	-3.2	-2.8	-1.6	-1.4	-0.4	-3.2	-2.8
Current Account without Grants	-1.5	-1.6	-0.6	-3.4	-3.2	-1.7	-1.6	-0.6	-3.4	-3.2

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.

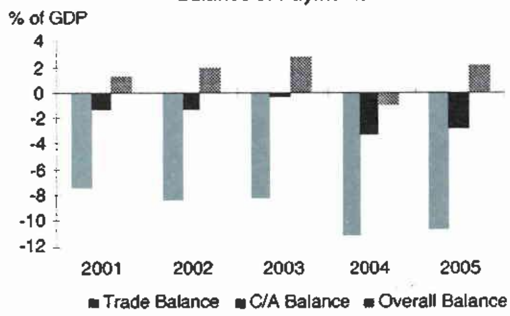
(b) Provisional

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

(d) Includes US dollars 147.6 million in respect of a technical amortization 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.

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

Chart 5.2
Balance of Payments



The sharp increase in remittances, which grew by 22.6 per cent to US dollars 1,918 million, helped contain the current account deficit in 2005. Net inflows to the Capital and Financial account increased by 94.0 per cent in 2005, resulting in an overall BOP surplus of US dollars 501 million. These enhanced the official external reserves to US dollars 2,735 million (3.7 months of imports) by end 2005. The exchange rate vis-a-vis the US dollar appreciated by 2.4 per cent. The total external debt outstanding of the country as a percentage of the GDP declined to 48.3 per cent. The debt service ratios improved further in 2005, owing to increased foreign earnings and the debt moratoria.

5.2 External Sector Policies and Institutional Support

- **International trade and finance continued to operate in a free and liberal economic environment in 2005. There was full current account convertibility, partial capital account convertibility and a freely floating exchange rate regime.** Being a small open economy, the continuously improving liberal economic environment and the greater freedom in trade, investment and payments have benefited Sri Lanka in maintaining its growth momentum and in strengthening the ability to face recurrent external shocks during the last three decades. Current account convertibility has been maintained as defined under the IMF Article VIII since 1994. However, to safeguard the country from large and volatile capital flows, limited capital account restrictions are still in place. The continuation of an independently floating exchange rate regime since 2001 has also served the economy well, particularly for the export sector to maintain its external competitiveness, through autonomous adjustments in the exchange rate broadly in line with changes in economic fundamentals of the country.
- **Sri Lanka continued to maintain a fairly liberal foreign investment regime.**The Foreign Direct Investment (FDI) regime is open except for four areas: money lending, pawn broking, retail trade with a capital of less than US dollars 1 million and coastal fishing. Inflows of FDI, which have remained at around US dollars 200 million per annum (1-2 per cent of GDP), increased to US dollars 272 million in 2005. Recognising the importance of FDI in accelerating economic growth, the government intends to attract more foreign investment in the future, by identifying potential investors and encouraging them through various incentives and strategic agreements such as the GSP+(Generalised System of Prefereneces) scheme and bilateral agreements.
- **The government attempts to diversify external funding sources as Sri Lanka's per capita income has moved up to the low middle-income level, thereby reducing the country's access to concessional funds.** The capital account is being opened up gradually to diversify sources of foreign inflows for both the government and the private sector. As an initial step, the government has issued Nation Building Bonds to raise resources from expatriate Sri Lankans and intends to grant permission for non-residents to invest in a certain percentage of government rupee securities. In addition, the government obtained sovereign ratings to facilitate borrowings from international capital markets.
- **External trade relations were further strengthened in 2005 with the expansion in multilateral, regional and bilateral trade arrangements.** Sri Lanka remained firmly committed to the multilateral trading system, being a founder member of the World Trade Organisation (WTO). Sri Lanka has made commitments to the WTO on trade in goods and also made commitments under the General Agreement on Trade in Services (GATS) on telecommunication, tourism and financial services. At the Sixth WTO Ministerial Meeting held in Hong Kong in December 2005, Sri Lanka contributed to the success of countries having similar interests, by designating a number of agricultural products as special products which would be exempt from further tariff cuts to support local farmers. Further, under the proposed 'new special safeguard mechanism', Sri Lanka is expected to maintain freedom to impose higher tariffs on certain agricultural products to protect its local farmers in the event of a surge of imports of these products. However, protection for agriculture has to be for a limited period of time, that is, until productivity enhancing measures are introduced to domestic agriculture. Continuing protection impacts negatively on Sri Lanka's export competitiveness and consumer welfare.
- **Sri Lanka made further progress in securing market access through regional trading arrangements in 2005.** At the regional summit in January 2004, Sri Lanka agreed to convert the South Asian Preferential Trading Agreement (SAPTA) into the South Asian Free Trade Area (SAFTA) with effect from 1 January 2006. In the past, there have been several attempts to establish SAFTA, but the lack of political will and disputes among members hindered its progress. As per the current agreement, SAFTA will be built upon four pillars: establishing

rules of origin criteria, accepting negative lists, agreeing on a mechanism for compensation of revenue loss for least developed countries (LDCs) and establishing technical assistance to needy countries. The first-phase of tariff reduction under SAFTA is to be implemented on 1 July 2006, and SAFTA will become fully operational with the intra-regional tariff of non-negative list items reaching 1-5 per cent by 2016. A further stride in regional agreements was Sri Lanka achieving substantial progress in finalising the draft Free Trade Agreement (FTA) of the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMST-EC). Sri Lanka continued to receive tariff concessions from member countries under the Global System of Trade Preferences (GSTP), which was established as a framework for the exchange of tariff preferences among developing countries.

- **Bilateral negotiations between Sri Lanka and the European Union (EU) yielded a breakthrough in 2005, but further negotiations are required to reap fuller benefits.** The existing Generalised System of Preferences (GSP) Scheme was replaced by a three-tiered scheme consisting of: the GSP+, the General Scheme and the Everything But Arms Scheme. Although Sri Lanka was able to qualify for zero duty concessions under the GSP+ scheme since 1 July 2005, the new GSP scheme as a whole, with the General Scheme and Everything But Arms Scheme, became operational later on 1 January 2006. Sri Lanka was the first country to receive tariff preferences under the GSP+ scheme, which was introduced to support countries with special development needs and meet the objective criteria for sustainable development and good governance. The GSP+ offered tariff preferences including duty free access for 7,200 products including a few major items imported from Sri Lanka such as textiles and garments, tobacco, gloves, porcelain products and activated carbon. However, the utilisation of this facility has been lower than anticipated, particularly in the apparel industry, due to the stringent rules of origin criterion, which requires a country to contribute at least 50 per cent of the value addition to be qualified for the benefits. The low domestic raw material base does not permit the apparel sector to achieve over 50 percent domestic value addition. Hence, Sri Lanka is actively negotiating with the EU to bring down the value addition component to 35 per cent to reap the benefits under the GSP+ scheme.

- **Negotiations on the Comprehensive Economic Partnership Agreement (CEPA) between Sri Lanka and India continued in 2005.** The CEPA is intended to widen the existing Indo-Sri Lanka Free Trade Agreement (ISLFTA) by further deepening concessions on trade in goods and services, promoting investment flows and enhancing economic cooperation in the areas of transportation, infrastructure, education, tourism and information and communication technology. Sri Lanka and India held several rounds of technical level negotiations to draw up a framework and a road map for effective implementation of CEPA.

- **The bilateral agreement signed by Sri Lanka and Pakistan on trade became operational from June 2005.** Sri Lanka has received concessions for a large number of items including tea, betel leaves, apparel and ceramic products, while Pakistan has also received concessions for her important exports such as Basmati rice and potatoes. A salient feature of this agreement is the flexibility in meeting the rules of origin criterion where product transformation is required only up to the six-digit level of the HS (Harmonised Commodity Description and Coding System) tariff headings, compared with the requirement of a four-digit level under the ISLFTA. This will help Sri Lanka to attract foreign investment and promote domestic industries to manufacture products for the Pakistan market with greater ease. Under the agreement, Sri Lanka will phase out tariff on goods over a period of five years while Pakistan will do so in three years, except for those products in the negative lists.

- **Several other bilateral trade discussions took place in 2005.** Sri Lanka and Thailand agreed to sign a Preferential Trading Agreement (PTA). The improvement of Sri Lanka's prospects for trade and economic relations with the USA was especially important in the wake of the elimination of quota for textiles and clothing. Therefore the dialogue with the US authorities on the initiation of a Free Trade Agreement (FTA) between Sri Lanka and the USA was continued. The negotiations under the Trade and Investment Framework Agreement (TIFA) between Sri Lanka and the USA have become an important mechanism in pursuing the prospects of the FTA and resolving the trade and economic issues successfully. The framework agreement between Sri Lanka and Iran was signed in November 2004 and the negotiations on the concession lists were finalised in Colombo in September 2005. The process of completing domestic legal procedures by both countries in order to give effect to the agreement is in progress. Once both countries notify each other of the completion of this process, the agreement is expected to come into force.

- **To expand market access, the government continued to provide a wide spectrum of facilities to exporters.** The Board of Investment (BOI), the main foreign investment promotion institution of the government, supported exporters with tax holidays and duty exemptions on the import of raw materials and investment goods. The Sri Lanka Export Development Board (SLEDB) continued to provide support through marketing, financing and e-business opportunities. SLEDB continued to help in resolving problems faced by exporters at the Export and Enterprise Development Forum, bringing together both government officials and entrepreneurs. SLEDB has also worked closely with relevant ministries and other

Box 9

Comprehensive Economic Partnership Agreement between India and Sri Lanka

The Indo - Sri Lanka Free Trade Agreement (ISLFTA), signed in 1998 and entered into force in 2000 formed the groundwork for the proposed Comprehensive Economic Partnership Agreement (CEPA). The CEPA was designed with the intention of enhancing and diversifying the existing bilateral cooperation, mostly limited to trade in goods, by adding the complementary dimensions of services, investment and economic cooperation. The CEPA will also be a model for similar agreements in the future and the first step toward moving in to deeper economic integration in the region.

With the implementation of the ISLFTA, India emerged as the largest supplier of Sri Lanka's imports since 2001 with a share of 21 per cent of total imports being sourced by India in 2005. Exports to India, as a percentage of total exports, have expanded from 1.0 per cent in 2000 to 8.9 per cent in 2005. Realising the potential benefits of greater economic integration, the Governments of the two countries, led by the then Prime Ministers, appointed a Joint Study Group (JSG) in 2003 to asses the status of the bilateral relations and make recommendation on how to navigate the two economies toward greater cooperation by entering into in to a partnership agreement. The findings of the JSG include improvements in the existing ISLFTA binding commitments in identified sectors in services, facilitating investment flows and improved cooperation in the field of education, medicine and health, transportation, agriculture and oceanic resource exploration.

Discussions on the agreement commenced in 2004 with the Commerce Secretary level meetings. At these, the fundamental principles for negotiations were agreed upon, with prominence being given to the two factors: paying due consideration to the asymmetries of the two economies, and progressive and sequential liberalisation of the services sector.

Consequent on the Secretary level meetings, the two countries have appointed a Trade Negotiating Committee (TNC), which, along with the respective working groups/ subgroups, under the leadership of the Commerce Secretaries, would pursue sector specific negotiations. The two sides have now held six rounds of technical level discussions as at end January 2006 achieving substantial progress in all sub sectors with the parties agreeing to resolve the few remaining outstanding issues.

Commitments made in respect of trade in goods would be aimed at reducing the size of the negative lists of the current ISLFTA, relaxation of the rules of origin criteria, elimination of non-tariff barriers and concluding mutual recognition of product standards and memoranda of understanding on consumer protection and legal metrology.

The bilateral negotiations in the services sector are progressing in accordance with the General Agreement on Trade in Services (GATS) negotiating framework and its positive list approach, progressive liberalisation and sequencing of liberalisation framework. The two countries also discussed the issues of movement of natural persons, Mutual Recognition Agreements (MRA) in professional services and supply of services under Mode 3 and Mode 4.[1] Services under consideration for initial listing comprise information and communication technology, tourism and leisure industry, construction and engineering, health, transport and logistic services. Financial services, which focus on banking, insurance and securities related services are covered separately under a subgroup falling within the scope of the services sector. The intended liberalization in financial services will be mostly in relation to Mode 3, with deeper concessions granted through the national treatment. Any measures under Mode 1 will pose significant difficulties and thus will be considered along with developments in national policies on capital account liberalisation.

India has been gaining importance as a major investor in Sri Lanka, with trade led investment increasing substantially since the implementation of the FTA. Today a significant share of Indian investment in the SAARC region is invested in Sri Lanka and with a total investment of over US dollars 181 million,India has become the seventh largest foreign investor in Sri Lanka by 2005. Noting the strategic importance of the two countries, the negotiations on investment aim to promote and protect bilateral investment and predict the investment climate in the two economies to enhance and encourage future investment flow. In addition, the subgroup on the avoidance of double taxation and fiscal evasion is working on a stand alone agreement, which, under the broader realm of CEPA, will promote and facilitate more economic activities between the two countries. It is anticipated that these measures would boost investor confidence while augmenting the quality and quantity of investment flowing into Sri Lanka.

In the context of economic cooperation, Sri Lanka has earmarked education, health, rail transport, non-conventional power generation and intellectual property rights development as priority sectors where India may extend support. Sector specific project proposals for assistance are being formulated in consultation with stakeholders.

Defining transparent Rules of Origin (ROO) criteria applicable under the CEPA is equally important as lowering tariff. ROO criteria ensure that a good or a service being traded under preferential tariff contains sufficient inputs from the source country. In the case of trade in goods, determination of ROO is straight forward. If the product incorporates inputs sourced from other countries, a minimum value addition as specified in ROO criteria has to be completed by the member country. However, under the CEPA, which incorporates services, investment and economic cooperation defining transparent and simple ROO criteria will be equally important and crucial for both countries to avoid future potential trade conflicts.

Source: Department of Commerce
Board of Investment of Sri Lanka

1 A service can be traded in four different modes. Mode 1 - Cross-Border Trade, Mode 2 - Consumption Abroad: when a service recipient travels to a foreign country to receive the service, Mode 3 - Commercial Presence: when commercial establishments are set up to produce and sell services and Mode 4 - Presence of Natural Persons: when individuals travel to foreign countries to sell services.

stakeholders to implement some recommendations made in the "National Export Strategy: 2004-2008". The Sri Lanka Export Credit Insurance Corporation (SLECIC) continued to assist exporters through export credit insurance and credit guarantees in 2005. The Sri Lanka Standards Institution (SLSI) continued to supply the guarantee of quality for exports against the relevant Sri Lanka standards, in addition to serving as the national enquiry point on standards, technical regulations and conformity assessment procedures in evaluating WTO related Technical Barriers to Trade (TBT).

- **The trade and tariff cluster and the export cluster under the National Council for Economic Development (NCED) reviewed trade policies and performance.** The trade and tariff cluster has recommended several measures including the reduction of the Value Added Tax (VAT) for local suppliers of intermediate goods, duty free concessions to acquire advanced technology, financial assistance for technology improvements, simplified VAT applications and a zero rate VAT structure for garment buying offices.

Table 5.2

Average Import Duty Collection Rate (a)

Item	2001	2002	2003	2004	2005(b)
Consumer goods	**13.3**	**13.3**	**13.5**	**10.4**	**10.4**
Food and beverages	15.3	14.4	14.2	8.5	9.6
Rice	21.2	32.9	29.1	4.9	10.6
Flour	13.3	12.3	11.5	7.2	3.8
Sugar	16.2	16.0	16.8	4.6	1.5
Wheat and meslin	0.0	0.0	0.0	0.1	1.1
Milk and milk products	15.3	11.9	12.2	7.9	10.2
Dried fish	2.0	7.9	10.8	5.9	5.9
Other fish products	6.3	6.8	7.9	10.0	9.8
Other food items	25.4	22.9	22.3	17.4	22.0
Non-food consumer goods	10.9	12.1	13.0	12.2	11.1
Motor cars & cycles	21.1	23.3	22.1	21.1	18.9
Radio receivers-television sets	8.3	8.6	8.9	9.4	13.6
Rubber tyres & tubes	29.6	27.9	26.0	25.8	26.2
Pharmaceutical products	0.6	0.6	0.6	0.6	0.5
Other non-food items	9.7	9.4	9.2	8.9	8.7
Intermediate goods	**1.7**	**1.6**	**1.5**	**1.9**	**1.9**
Fertiliser	-	0.4	2.6	3.1	2.7
Crude oil	....	0.0	0.0	0.0	0.0
Other petroleum products	0.9	0.8	0.8	0.9	0.9
Chemical elements and compounds	3.3	1.1	2.2	2.6	2.0
Dyeing , tanning and colouring	6.3	4.0	4.6	4.5	4.4
Paper and paper boards	6.7	5.2	5.4	6.0	6.0
Textiles & clothing	0.1	0.1	0.1	0.0	0.1
Other intermediate goods	4.2	4.3	3.3	4.3	4.5
Investment goods	**5.3**	**5.5**	**7.2**	**6.1**	**5.8**
Building materials	9.3	7.4	7.7	9.0	7.8
Transport equipment	10.3	11.0	12.9	11.9	9.7
Machinery and equipment	2.7	3.7	5.6	3.2	3.3
Other investment goods	4.2	3.8	4.6	5.0	5.3
Total	4.9	4.8	5.3	4.5	4.3

Sources: Sri Lanka Customs
Ceylon Petroleum Corporation
Prima Ceylon Limited

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

- **The tariff structure was further rationalised in 2005 but several competing objectives had to be considered.** Although the liberalisation of trade by removing tariff generates economic benefits, other aspects of tariff, such as fiscal revenue, raising protection for domestic producers and provision of industry specific incentives interfere with the attempts at trade liberalisation. The six band tariff structure of 3 per cent, 6 per cent, 12 per cent, 16 per cent, 20 per cent and 27.5 per cent in the previous year was replaced with the five band tariff structure of 0 per cent, 2.5 per cent, 6 per cent, 15 per cent and 28 per cent in 2005. The duty on basic raw materials was kept at the lowest tariff level while intermediate goods were placed at the intermediate tariff. Finished products were placed at the highest tariff. All categories of imported paper were brought into the zero tariff band to reduce the cost of printing. Certain items such as palm oil, electrical fans and electrical parts were placed at higher tariff to protect domestic producers. To protect farmers, duty waivers on rice, wheat grain and wheat flour were withdrawn in 2005. Duty concessions were granted for the importation of new machinery for advanced technology applications. A surcharge of 10 per cent was continued on all imported goods except for food items such as milk and cream, potatoes, lentils, rice, sugar, infants' food, etc. and items such as cement, paper and paperboards and three wheelers. As a measure of relief to three-wheeler operators, import duty on tyres used for three wheelers was reduced from 28 per cent to 15 per cent. As a revenue measure, the Port and Airport Development Levy (PAL) was increased from 1 per cent to 1.5 per cent. However, the PAL applicable to exports was reduced to 0.25 per cent as an incentive for exporters. The Excise Tax which had been confined to cigarettes, petroleum products, aerated water and motor vehicles, was extended to some consumer durables such as air-conditioners, refrigerators, washing machines, televisions, tv-antennae and electrical items. A Withholding Tax of Rs.5,000 on each motor vehicle, imported or newly registered other than three wheelers, lorries and public transport buses was imposed in 2005. Further, with a view of discouraging substandard vehicles from being imported to Sri Lanka, an import inspection certification system was put in place in 2005. To facilitate education in music, import duty on musical instruments was also reduced from 28 per cent to 15 per cent in 2005. The net outcome of tariff changes during the year was the decline of average tariff on imports from 4.5 per cent in 2004 to 4.3 per cent in 2005. A few items were subjected to a cess with the objectives of generating funds for research and development of the respective industries and ensuring sufficient availability of raw materials for local industries. In addition to the prevailing cess on tea, coconut and rubber exports, a cess on the export of cinnamon was introduced in 2005.

- **The Budget 2006 proposed to secure foreign employment of about 150,000 in 2006.** As the workers' remittances remain one of the major sources of foreign resources to the country, the budget proposed to explore the possibility of entering into more bilateral agreements with countries and to develop special training programmes in areas such as nursing, shipping and information technology. As an incentive for returnees from foreign employment to start- up self-employment projects, the government has proposed a special duty free allowance of up to US dollars 5,000 on the basis of the period of stay abroad, for those returning after at least two years of continuous foreign employment. They will be entitled to utilise this allowance within 6 months from the date of their return.

5.3 Trade in Goods and Trade Balance

- **External trade recorded a healthy growth in 2005 benefiting from continued growth in the world economy, further integration of the domestic economy with the world economy, a conducive domestic policy framework and increased domestic economic activity.** Export earnings grew by 10.2 per cent to US dollars 6,347 million in 2005 over and above the 12.2 per cent growth recorded in 2004. Expenditure on imports grew by 10.8 per cent to US dollars 8,863 million in 2005 compared with the 19.9 per cent growth in 2004. This has resulted in widening of the trade deficit by US dollars 274 million to US dollars 2,516 million.

- **Prices of exports grew by 3.3 per cent and the volume of exports by 6.7 per cent in 2005, but import prices grew by 7.8 per cent and the volume of imports by 2.7 per cent.** The terms of trade therefore deteriorated by 4.2 per cent. The export price of tea increased due to improvements in quality and demand from major buyers. The price of coconut was mainly driven by higher demand for desiccated coconut, copra and coconut oil from Pakistan and Middle Eastern countries.

Table 5.3

Trade Indices (a)

1997=100

Category	2004			2005 (b)			Growth Rate (b)		
	Value Index	Volume Index	Unit Price Index)	Value Index	Volume Index	Unit Price Index	Value Index	Volume Index	Unit Price Index
EXPORTS									
Agricultural exports	**100.3**	**112.9**	**88.8**	**108.6**	**116.1**	**93.5**	**8.3**	**2.9**	**5.3**
Tea	102.5	113.8	90.1	112.4	117.3	95.8	9.7	3.1	6.4
Rubber	65.3	65.6	99.5	59.7	53.9	110.7	-8.6	-17.8	11.2
Coconut	96.1	112.8	85.2	96.3	102.3	94.1	0.2	-9.3	10.5
Other agricultural products	111.7	134.6	83.0	126.5	155.6	81.3	13.3	15.6	-2.0
Industrial exports	**130.9**	**135.4**	**96.7**	**143.7**	**145.4**	**98.9**	**9.8**	**7.4**	**2.3**
Textiles and garments	123.2	127.7	96.5	127.0	134.4	94.5	3.0	5.3	-2.1
Petroleum products	102.3	59.4	172.1	134.5	54.4	247.4	31.5	-8.5	43.7
Other industrial exports	149.8	158.9	94.3	180.3	177.1	101.8	20.3	11.5	8.0
Mineral exports	**134.2**	**96.1**	**139.7**	**160.4**	**115.5**	**138.8**	**19.5**	**20.3**	**-0.6**
Gems	130.7	96.2	135.8	144.9	115.7	125.3	10.9	20.2	-7.8
Other mineral exports	181.5	94.5	192.1	365.0	114.1	319.8	101.1	20.8	66.5
Total Exports	**123.9**	**129.4**	**95.7**	**136.5**	**138.0**	**98.9**	**10.2**	**6.7**	**3.3**
IMPORTS									
Consumer goods	**132.9**	**158.4**	**83.9**	**138.6**	**159.8**	**86.7**	**4.3**	**0.9**	**3.4**
Food and beverages	92.8	102.5	90.6	95.2	101.3	94.0	2.5	-1.2	3.8
Other consumer goods	191.1	239.5	79.8	201.7	244.9	82.4	5.6	2.3	3.2
Intermediate goods	**149.2**	**135.7**	**110.0**	**168.7**	**139.3**	**121.1**	**13.1**	**2.7**	**10.1**
Fertiliser	160.7	130.4	123.2	203.3	135.7	149.8	26.5	4.1	21.6
Crude oil	229.2	121.3	189.0	292.7	110.7	264.4	27.7	-8.7	39.9
Other petroleum	219.3	110.3	198.9	320.4	132.5	241.8	46.1	20.1	21.6
Chemical elements and compounds	151.4	150.6	100.5	182.8	143.2	127.6	20.7	-4.9	27.0
Wheat and meslin	132.9	125.8	105.6	102.6	109.5	93.7	-22.8	-13.0	-11.2
Textiles (including clothing)	109.2	125.0	87.4	110.4	131.8	83.8	1.1	5.5	-4.1
Plastics	166.2	159.0	104.5	201.7	176.3	114.4	21.4	10.9	9.5
Diamonds	163.6	125.7	130.1	192.5	139.4	138.1	17.6	10.8	6.1
Other	156.0	174.4	89.4	183.4	181.6	101.0	17.6	4.1	12.9
Investment goods	**125.9**	**172.8**	**72.9**	**141.0**	**180.0**	**78.3**	**12.0**	**4.2**	**7.5**
Building materials	147.9	169.0	87.5	186.6	190.9	97.8	26.1	12.9	11.7
Transport equipment	123.3	93.7	131.6	156.3	104.8	149.2	26.8	11.8	13.4
Machinery and equipment	115.3	205.5	56.1	115.7	204.4	56.6	0.3	-0.6	0.9
Other investment goods	149.5	106.2	140.8	171.8	127.6	134.6	14.9	20.2	-4.4
Total Imports	**136.4**	**148.8**	**91.7**	**151.1**	**152.8**	**98.9**	**10.8**	**2.7**	**7.8**
Terms of Trade			104.4			100.0			-4.2

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

Sources : Sri Lanka Customs
Central Bank of Sri Lanka

Prices of natural rubber increased commensurate with the increase in artificial rubber prices as a result of soaring international petroleum prices. The price increases of these products were sufficient to offset the impact of the reduction of prices in textiles and garments resulting from the intense competition following the termination of the MFA in 2005. Prices of imports increased reflecting the higher prices of petroleum, fertiliser, chemical compounds, building materials, transport equipment and consumer goods.

Export Performance

- **The composition of exports demonstrated the continuing dominance of industrial exports followed by agricultural and mineral exports.** Industrial exports continued to drive export growth in 2005 with a dominant share of 78 per cent and contributing 75 per cent to the overall export growth. Agricultural exports accounted for 18 per cent of the total exports and contributed 15 per cent to the growth of exports, followed by mineral and other exports accounting for 4 per cent of exports, contributing 10 per cent to the growth in 2005.
- **Industrial exports grew by 9.8 per cent in 2005.** The growth was underpinned by the high performance of rubber-based products, textiles and garments and food and beverages. Textiles and garments exports, which accounted for 46 per cent of total exports, grew by 3.0 per cent, reflecting the higher volume of exports. The volume index for textiles and garments increased by 5.3 per cent while unit value index declined by 2.1 per cent. Textiles and garment exports to the USA, the largest buyer, grew by 6.1 per cent. The restriction imposed by the USA on apparel imports from China and growing demand for core apparel categories exported by Sri Lanka helped in increasing Sri Lanka's market share in the USA. Textiles and garments exports to the EU, the second largest destination, increased only marginally in 2005 since the expected benefits under the GSP+ scheme did not materialise due to issues relating to rules of origin. Negotiations are underway with the EU authorities to resolve these issues, which will enhance apparel exports to the EU in the future. Exports of rubber tyres, tubes and medical gloves grew significantly in 2005 due to the strong demand from the USA and the EU. Gems, jewellery and diamond exports registered healthy growth rates in 2005 with growing global demand. The gem and jewellery industry benefited from the VAT exemptions on imports as well as trading of gems, diamonds and precious metals with effect from 1 August 2005.

Table 5.4

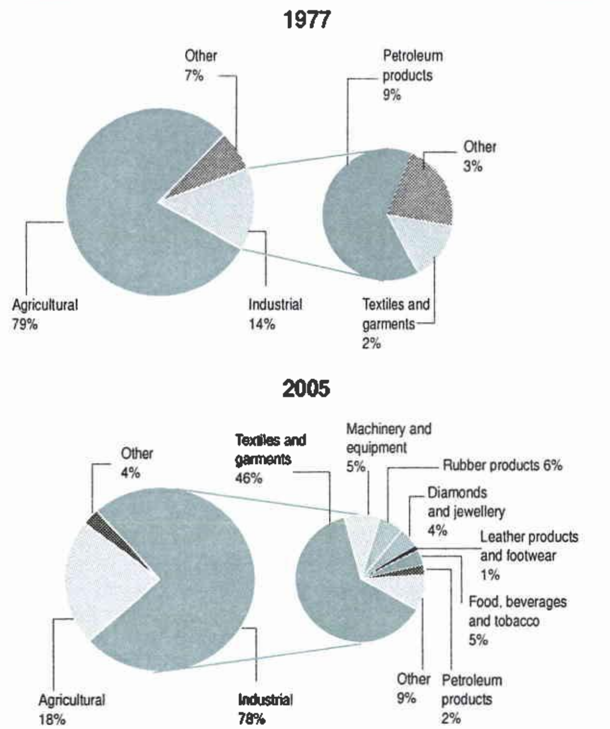
Composition of Exports

Category	2004		2005(a)		Change in value (a) US dollars million	Growth rate (a) %	Contribution to growth (a) %
	Value US dollars million	Share %	Value US dollars million	Share %			
Agricultural exports	**1,065.2**	**18.5**	**1,153.8**	**18.2**	**88.6**	**8.3**	**15.0**
Tea	738.9	12.8	810.2	12.8	71.3	9.6	12.1
Rubber	51.3	0.9	46.9	0.7	-4.4	-8.6	-0.7
Coconut	113.1	2.0	113.3	1.8	0.2	0.2	0.0
Kernel products	58.6	1.0	48.8	0.8	-9.8	-16.7	-1.7
Other	54.5	0.9	64.5	1.0	10.0	18.3	1.7
Other agricultural products	161.9	2.8	183.4	2.9	21.5	13.3	3.6
Industrial exports	**4,506.1**	**78.3**	**4,948.4**	**78.0**	**442.3**	**9.8**	**75.0**
Food, beverages and tobacco	175.1	3.0	318.2	5.0	143.1	81.7	24.3
Textiles and garments	2,808.9	48.8	2,894.6	45.6	85.7	3.1	14.5
Petroleum products	99.6	1.7	130.9	2.1	31.3	31.4	5.3
Rubber products	282.9	4.9	394.4	6.2	111.5	39.4	18.9
Ceramic products	46.8	0.8	47.1	0.7	0.3	0.6	0.1
Leather, travel goods and footwear	42.6	0.7	43.8	0.7	1.2	2.8	0.2
Machinery and equipment	385.7	6.7	329.9	5.2	-55.8	-14.5	-9.5
Diamond and jewellery	265.3	4.6	277.9	4.4	12.6	4.7	2.1
Other industrial exports	399.2	6.9	511.7	8.1	112.5	28.2	19.1
Mineral exports	**120.0**	**2.1**	**143.3**	**2.3**	**23.3**	**19.4**	**4.0**
Gems	108.5	1.9	120.3	1.9	11.8	10.9	2.0
Other mineral exports	11.5	0.2	23.0	0.4	11.5	100.0	2.0
Unclassified (b)	**66.0**	**1.1**	**101.2**	**1.6**	**35.2**	**53.3**	**6.0**
Total exports (c)	**5,757.2**	**100.0**	**6,346.7**	**100.0**	589.4	10.2	100.0
Annual average exchange rate	101.19		100.50				

(a) Provisional
(b) Includes re-exports
(c) Adjusted

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

Chart 5.3
Share of Exports by Major Categories



- **Agricultural exports grew by 8.3 per cent in 2005, reflecting the volume growth of 2.9 per cent and a price increase of 5.3 per cent.** The growth was primarily driven by the strong performance of tea. Tea exports reached a record 309 million kg and fetched higher prices. Russia continued to be the largest buyer of Sri Lankan tea with a share of 19 per cent in 2005 followed by the United Arab Emirates and Syria. Other key markets were Iran, Turkey, Jordan and Saudi Arabia. Export earnings from coconut increased only marginally by 0.2 per cent in 2005 as a result of the low coconut harvest. Exports of natural rubber declined by 8.6 per cent in 2005 due to the high domestic consumption of natural rubber by rubber based industries. The international prices of natural rubber continued to increase and are expected to remain high in the foreseeable future as a result of the high prices of petroleum and synthetic rubber. Minor agricultural exports increased by 13.2 per cent in 2005. There were higher exports of vegetables, cinnamon, pepper and cloves. External demand for these products was stimulated by the duty free access to the Indian market under the ISLFTA and the growing demand from Middle Eastern countries.

- **The new safety standard of the EU remains a concern for tea exports.** Hazard Analysis and Critical Control Point (HACCP) imposed by the EU with effect from January 2006, requires that all tea factories should adhere to these food safety standards throughout the food production process to access the EU market. The Sri Lanka Tea Board has initiated several measures to help tea factories in Sri Lanka to obtain food safety standards imposed by the tea importing countries. However, the EU has given a grace period of six months up to June 2006 for countries to comply with these standards. Some tea manufacturing and exporting companies in Sri Lanka have already obtained these standards and several other companies are expected to comply with HACCP by end July 2006. Remaining companies should also be encouraged to obtain these standards.

- **Earnings from mineral exports increased by 19.5 per cent in 2005, reflecting the higher exports of gems, which accounted for 84 per cent of mineral exports.** Sri Lanka continued to be the largest supplier of high quality sapphires to the world market. Several initiatives were taken by the government to promote the unique features of sapphires exported by Sri Lanka under the brand name of "Ceylon Sapphire". The USA continued to be the largest buyer of Sri Lankan gems in 2005 followed by Thailand and Switzerland.

Import Performance

- **Imports grew by 10.8 per cent to US dollars 8,863 million in 2005, reflecting both increased demand and higher**

Chart 5.4
Share of Imports by Major Categories

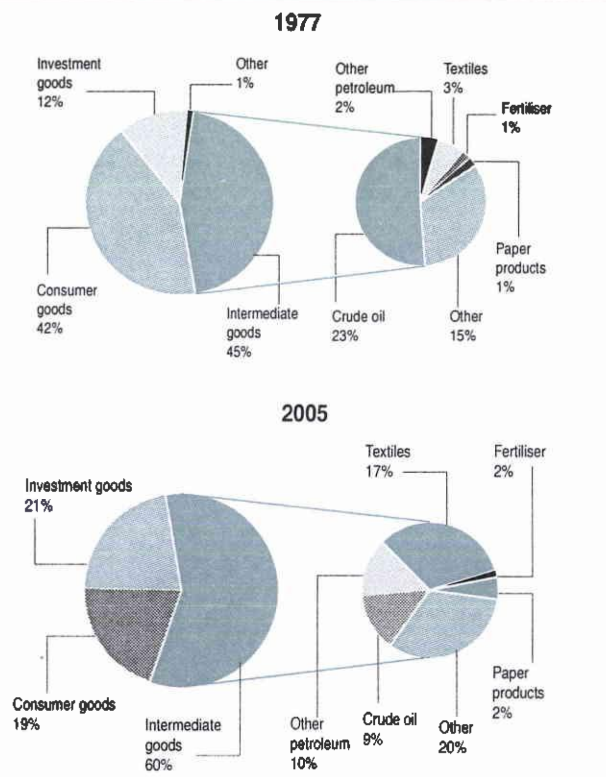


Table 5.5
Composition of Imports

Category	2004 Value US dollars million	2004 Share %	2005(a) Value US dollars million	2005(a) Share %	Change in value (a) US dollars million	Growth rate (a) %	Contribution to growth (a) %
Consumer goods	**1,623.5**	**20.3**	**1,643.9**	**18.5**	**20.5**	**1.3**	**2.4**
Food and beverages	779.1	9.7	752.6	8.5	-26.5	-3.4	-3.1
Rice	59.4	0.7	15.6	0.2	-43.8	-73.8	-5.1
Sugar	111.4	1.4	132.3	1.5	20.8	18.7	2.4
Wheat	183.1	2.3	141.4	1.6	-41.7	-22.8	-4.8
Other	425.2	5.3	463.3	5.2	38.2	9.0	4.4
Other consumer goods	844.4	10.6	891.4	10.1	46.9	5.6	5.4
Intermediate goods	**4,645.4**	**58.1**	**5,317.1**	**60.0**	**671.8**	**14.5**	**77.8**
Petroleum	1,209.3	15.1	1,655.3	18.7	445.9	36.9	51.6
Fertiliser	106.7	1.3	135.0	1.5	28.3	26.5	3.3
Chemicals	205.9	2.6	248.6	2.8	42.7	20.7	4.9
Textiles and clothing	1,514.1	18.9	1,531.0	17.3	16.9	1.1	2.0
Other intermediate goods	1,609.4	20.1	1,747.3	19.7	137.9	8.6	16.0
Investment goods	**1,669.9**	**20.9**	**1,869.6**	**21.1**	**199.7**	**12.0**	**23.1**
Machinery and equipment	857.4	10.7	860.4	9.7	3.0	0.3	0.3
Transport equipment	256.6	3.2	325.3	3.7	68.7	26.8	8.0
Building materials	402.0	5.0	507.0	5.7	105.0	26.1	12.2
Other investment goods	153.9	1.9	176.9	2.0	23.0	14.9	2.7
Unclassified imports	**61.1**	**0.8**	**32.6**	**0.4**	**-28.5**	**-46.7**	**-3.3**
Total imports (b)	7,999.8	100.0	8,863.2	100.0	863.4	10.8	100.0
Annual average exchange rate	101.19		100.50				

(a) Provisional
(b) Adjusted

Sources : Sri Lanka Customs
Ceylon Petroleum Corporation
Central Bank of Sri Lanka
Prima Ceylon Limited

Table 5.6
Volume of Major Imports (a)

'000 mt

Item	2001	2002	2003	2004(b)	2005(c)
Rice	**52**	**95**	**35**	**222**	**52**
1st Quarter	3	51	22	9	43
2nd Quarter	7	9	9	9	4
3rd Quarter	2	10	2	4	2
4th Quarter	40	25	2	200	3
Wheat	**760**	**993**	**919**	**993**	**864**
1st Quarter	231	309	262	257	272
2nd Quarter	229	215	232	218	191
3rd Quarter	177	221	217	189	174
4th Quarter	123	248	208	329	227
Sugar	**420**	**554**	**509**	**438**	**418**
1st Quarter	100	146	151	98	49
2nd Quarter	127	141	135	173	167
3rd Quarter	109	110	104	71	94
4th Quarter	84	157	119	96	108
Petroleum (Crude oil)	**1954**	**2300**	**1995**	**2200**	**2008**
1st Quarter	237	539	382	586	586
2nd Quarter	539	513	466	464	581
3rd Quarter	624	593	500	634	246
4th Quarter	554	655	647	516	595
Refined Petroleum	**1420**	**1348**	**1168**	**1645**	**1823**
1st Quarter	537	276	340	460	314
2nd Quarter	419	426	239	380	396
3rd Quarter	224	266	317	341	711
4th Quarter	240	380	272	464	402
Textiles and Clothing	**234**	**244**	**253**	**257**	**266**
1st Quarter	60	57	61	58	56
2nd Quarter	63	65	65	66	68
3rd Quarter	52	61	58	66	73
4th Quarter	59	61	68	66	70
Fertiliser	**460**	**537**	**514**	**510**	**529**
1st Quarter	66	103	124	54	168
2nd Quarter	183	163	166	164	111
3rd Quarter	83	138	49	76	142
4th Quarter	128	133	175	216	107

(a) Adjusted
(b) Revised
(c) Provisional

Sources : Sri Lanka Customs
Ceylon Petroleum Corporation
Prima Ceylon Limited

import prices. The expansion of economic activities in the country, post tsunami reconstruction activities, appreciation of exchange rates and the low interest rate regime raised import demand for all three categories, viz, intermediate, investment and consumer goods.

- **Intermediate goods imports, mainly petroleum products and fabrics, grew by 14.5 per cent in 2005.** Expenditure on petroleum imports, which accounted for 19 per cent of the overall imports, increased by 36.9 per cent to US dollars 1,655 million in 2005, primarily due to the escalation of crude oil prices by 39.8 per cent in 2005. The price of a crude oil barrel, which was US dollars 29.46 in 2003 increased to US dollars 37.48 in 2004 and further to US dollars 52.39 in 2005. Although the import volume of crude oil declined by 8.7 per cent, mainly due to the temporary shut down of the petroleum refinery for routine biannual maintenance work in 2005, the import volume of refined petroleum products increased by 10.8 per cent in 2005. Overall imports excluding petroleum increased only by 6 per cent in 2005 compared to the growth of 16.4 per cent recorded in 2004. The imports of intermediate goods to be used for chemical products, diamond, jewellery, paper and rubber based industries also increased in 2005.

- **Investment goods imports, which registered a continuous expansion in recent years, grew further by 12 per cent in 2005, reflecting investor confidence, particularly in the second half of 2005.** The growth in investment goods was driven mainly by higher imports of building material and transport equipment. Import demand for cement, iron and aluminium materials, asbestos, wood sawn and timber and electrical apparatus increased due to post tsunami construction activities, state infrastructure development activities and the construction of commercial and residential buildings.

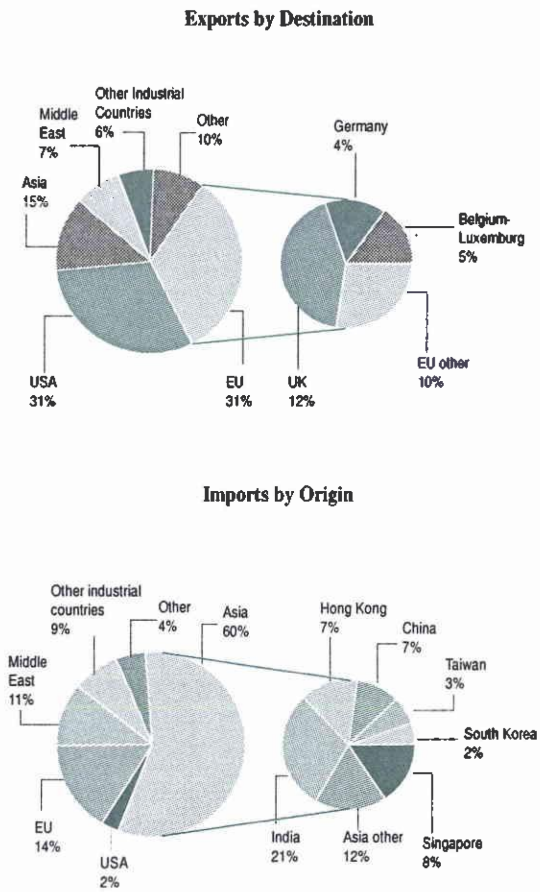
- **Continuing the trend that prevailed in 2004, the share of consumer goods imports declined further** to 19 per cent in 2005 from 20 per cent in the previous year while the share of intermediate and investment goods increased to 60 per cent and 21 per cent respectively in 2005, owing to growing investment and production activities in the country. The expenditure on consumer goods increased only by 1.3 per cent to US dollars 1,644 million in 2005 compared to the 10 per cent growth in the previous year. The record high paddy harvest led to containing rice imports in 2005. The imports of motor vehicles for personal use continued to decline in 2005 on account of the increase in excise duties imposed on imports of used vehicles and the introduction of a minimum cash margin of 100 per cent to cover the Letters of Credit in 2004.

Direction of Trade

- **The direction of trade changed only marginally in 2005.** Western countries were the major export destinations and Asian countries were the major import suppliers. The USA remained Sri Lanka's largest export destination although its share has declined marginally from 32 per cent in 2004 to 31 per cent in 2005. The UK remained the second largest destination for Sri Lanka's exports. Although the total exports to the UK remained unchanged at US dollars 778 million in 2005, the share of exports declined from 14 per cent in 2004 to 12 per cent in 2005. Exports to India increased sharply by 44.4 per cent in 2005, benefiting from the ISLFTA. The share of exports to the Indian market increased to 9 per cent in 2005 from 7 per cent in 2004, reflecting the higher exports of refined copper, electric conductors, waste and scrap of alloy steel, cloves, desiccated coconut and vanaspathi. India is emerging as a significant trading partner since singing the ISLFTA in 2000. India has now become Sri Lanka's third largest export destination from being the 16th in 2000. Two way trade between Sri Lanka and India expanded further to reach US dollars 2.4 billion in 2005, compared with US dollars 1.8 billion in 2004.

- **Belgium- Luxembourg, Germany, Italy, United Arab Emirates, Russia and Japan were the other major destinations for Sri Lanka's exports.** The exports to Belgium-Luxembourg and Italy increased while exports to Germany and Japan decreased in 2005. The main exports to Germany were garments, tea, solid tyres, gloves and coconut fibre products. Diamonds and garments were the main exports to Belgium-Luxembourg. Other major items exported to the EU were precious stones, gloves, tyres, coconut by-products, prawns and fish products and statuettes and ornamental articles.

Chart 5.5
Direction of Trade



- **Asian countries, as a region, continued to be the major origin of imports recording a growth of 16 per cent in 2005.** The market share of Asian countries increased from 57 per cent in 2004 to 60 percent in 2005. India was the largest source of imports (21 per cent), followed by China including Hong Kong (14 per cent), Singapore (8 per cent) and Iran (6 per cent). Imports from India increased by 28 per cent in 2005, with major imports being refined petroleum products, pharmaceutical products, wheat, rice, transport vehicles and cotton yarn.

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

- **Transportation and travel services have been dominating trade in services, while information technology, including Business Process Outsourcing (BPO), telecommunication, construction and insurance services have been emerging as important sectors.** The surplus in the services account declined by about 19.3 per cent to US dollars 338 million in

2005, mainly due to the significant reduction in earnings from tourism and higher expenditure on transportation and travel.

Trade in Transportation Services

- **Inflows from transportation services, consisting of passenger fares, freight charges and port related earnings, increased by 7.9 per cent, mainly on account of increased port related activities, led by transhipment cargo in 2005.** Transhipment cargo handling increased by 10.9 per cent due to the expansion in international trade, especially as a result of the faster growth of India, which is a major destination for transhipment cargo from Sri Lanka. However, the construction of the Sethu Samudram canal and rapid development of several ports in India are likely to intensify competition for Sri Lanka's port related activities, unless Sri Lanka moves quickly to sustain the comparative advantages by accelerating proposed port development projects such as Colombo Southern Port Development project. Meanwhile, outflows in relation to transportation services increased by 13.3 per cent, reflecting the increasing number of Sri Lankans travelling abroad and increased payments on port related services. Due to these developments, net earnings from transportation services declined by 2.8 per cent to US dollars 204 million during 2005.

Travel and Tourism

- **Earnings from tourism faced a setback in 2005 due to the tsunami devastation.** Tourist arrivals declined by 3.0 per cent to about 549,000 in 2005 from the highest number of tourist arrivals of 566,000 recorded in 2004. Gross earnings from tourism declined at a higher rate of 20.3 per cent to US dollars 329 million in 2005, with a decline in room occupancy. The inflow of aid workers and tourists from India and Pakistan raised arrivals, but their occupancy in graded hotels was not significant. The total earnings, including earnings from visiting non-resident Sri Lankans, declined by 16.3 per cent to US dollars 429 million. The gross expenditure of Sri Lankans on travel increased by 6.2 per cent to US dollars 314 million in 2005 as a result of more Sri Lankans travelling abroad in 2005.

- **India emerged as Sri Lanka's single largest source of tourists in 2005, recording a 7.8 per cent growth.** Countries in Western Europe continued to be the major tourist-generating region, accounting for 41.4 per cent of the total arrivals in 2005, although their share has declined from 50.2 per cent in 2004. The tsunami devastation and the associated adverse publicity and increased hostilities in the north and the east of Sri Lanka during the latter part of the year resulted in tourist arrivals from this region declining by 20.1 per cent in 2005. Arrivals from North America recorded a significant increase in 2005 due to the large number of volunteers on tsunami relief, rehabilitation and reconstruction work. Asia, emerged as the second largest tourist generating destination, accounted for 40.7 per cent, recording a growth of 12.8 per cent. The Sri Lanka Tourist Board's plan to conduct a special international promotional campaign to attract more tourists with high spending capacity would help to increase foreign exchange earnings from tourism in 2006.

- **Sri Lanka's tourism potential has not yet been fully harnessed.** Compared with Singapore, which attracted around 9 million tourists in 2005, Sri Lanka attracted only 549,000 tourists in 2005. This is despite Sri Lanka's diverse attractions such as varied eco systems and heritage sites. As the private sector is the major player in this sector, its contribution to the formulation of a tourism policy and promotional activities in targeted foreign markets should be enhanced with a facilitative role by the government. In addition, promoting low-cost carriers would help increase tourist arrivals through increased air capacity and lower airfares.

Table 5.7

Net Services, Income and Transfers (a)

Item	US dollars million		Rs. million	
	2004	2005 (b)	2004	2005 (b)
1. Transportation	209	204	21,201	20,452
2. Travel	217	115	22,232	11,553
3. Telecommnication Services	33	25	3,304	2,503
4. Computer and Information Services	72	82	7,286	8,371
5. Construction Services	20	24	2,012	2,396
6. Insurance Services	20	39	2,024	3,890
7. Other Business Services	-137	-134	-13,798	-13,513
8. Government Expenditure n.i.e.	-15	-16	-1,527	-1,607
Total Services	419	338	42,735	34,043
1. Compensation of Employees	-6	-9	-601	-940
2. Direct Investment	-92	-112	-9,303	-11,245
3 Interest and Other Charges	-106	-178	-10,828	-17,864
Total Income	-204	-299	-20,732	-30,049
1. Private	1,350	1,736	136,672	174,542
2. General Government	30	93	3,038	9,300
Total Current Transfers	1,380	1,828	139,710	183,842

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

Chart 5.6

Monthly Tourist Arrivals

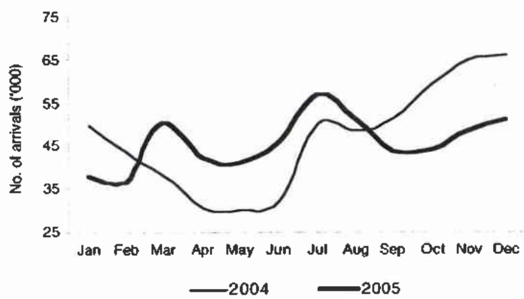


Table 5.8
Tourism Performance

Item	2001	2002	2003	2004(a)	2005(b)	Growth Rate	
						2004(a)	2005(b)
Tourist arrivals	336,794	393,171	500,642	566,202	549,308	13.1	-3.0
Tourist guest nights ('000)	3,342	3,989	5,093	5,742	4,400	12.7	-23.4
Room occupancy rate (%)	42.1	43.1	53.2	59.3	43.9	11.5	-26.0
Gross tourist receipts (Rs. million)	18,863	24,202	32,810	42,666	36,377	30.0	-14.7
Per capita tourist receipts (Rs.)	56,008	61,556	65,536	75,355	66,223	15.0	-12.1
Total employment (no.)	80,904	93,170	112,226	129,038	125,004	15.0	-3.1
Direct	33,710	38,821	46,761	53,766	52,085	15.0	-3.1
Indirect	47,194	54,349	65,465	75,272	72,919	15.0	-3.1

(a) Revised
(b) Provisional

Sources: Sri Lanka Tourist Board
Central Bank of Sri Lanka

Trade in Telecommunication and Information Technology Services

- **Net earnings from telecommunication services declined in 2005.** These earnings, which have been declining since the liberalisation of the international telecommunication gateway in April 2003, declined further by 24.2 per cent to US dollars 25 million in 2005, due to the increasing number of international calls generating from Sri Lanka. The decline in earnings was exacerbated by the increased usage of the Internet, facsimile and e-mail communication modes.
- **Net earnings from Information Technology (IT) exports increased by 13.9 per cent to US dollars 82 million in 2005, reflecting the rapid growth in IT exports including IT enabled services.** Continued development of skills and the further expansion of telecommunication infrastructure to ensure reliable connectivity and speedy transmission are necessary to promote the BPO industry, which is emerging as an important export of services.

Inflows and Outflows of Income

- **The deficit in the income account widened in 2005, despite the decline in interest payments on government external debt, which amounted to US dollars 76 million.** The interest income from investment of official external reserves increased by 15.4 per cent in 2005, largely due to an increase in the official external reserves of the country, which are managed by the Central Bank, and the rise in global interest rates during 2005. Meanwhile, a rise in the external reserves of commercial banks also resulted in a significant increase in interest income. However, the appreciation of the US dollar against other major currencies in 2005 as against the depreciation in 2004 caused a significant loss in the value of the external reserves valued on the basis of marked to market in US dollar terms. This loss reflects as a lower income in the income account. Repatriation of profits and dividends by foreign investors increased during the year due to higher earnings from their investments during 2005 and increased FDI inflows in the past. Consequent to these developments, the income account deficit widened by 46.6 per cent to US dollars 299 million in 2005 from US dollars 204 million in 2004.

Current Transfers

- **Net inflows to the current transfers account, the major source of financing the widening trade deficit, increased by 32.5 per cent to US dollars 1,828 million in 2005.** Private remittances, which include tsunami related current inflows of US dollars 50 million, increased significantly by 25.8 per cent to US dollars 1,968 million. Worker remittances, the second largest inflow to the current account rose by 22.6 per cent to US dollars 1,918 million during 2005. This was almost doubling of the historical growth rate. This high growth arose from Sri Lankans remitting large sums to family, friends and relatives in the aftermath of the tsunami disaster, the increase in the number of Sri Lankans taking up employment abroad during the year and the popularisation of electronic fund transfer systems among Sri Lankan migrants by several commercial banks. The number of annual migrants for employment abroad increased by 8.0 per cent to 230,206 in 2005.
- **Worker remittances, the single largest inflow of foreign exchange after exports, continued to play an important role in financing the widening trade deficit.** During 2005, worker remittances were sufficient to finance over 75 per cent of the trade deficit. Recognising the need for utilising the remittances for productive purposes and to attract more inflows to the country from migrant Sri Lankans, the government introduced 'Nation Building Bonds' as proposed in the Budget for 2006.
- **The Middle Eastern region continues to be the major employment-generating region for Sri Lankans.** Worker remittances from the Middle East region, which recruits mainly unskilled workers, accounted for 56.8 per cent of the total worker remittances in 2005. The European Union, which is emerging as a market for skilled labour, accounted for 18.5 per cent. During 2005, about 6.5 per cent of the total transfer receipts came from other European countries. The other significant contributors were North America and the Far East

Box 10

Economic Importance and Implications of Worker Remittances

Over the years, worker remittances have become a major source of foreign exchange inflows for developing countries. It has now become the second largest source of external financing available to many developing countries, after foreign direct investment (FDI) and amounts to more than twice the size of official aid.[1]

Over one million Sri Lankans have migrated for foreign employment, with the largest number migrating to Middle Eastern countries. Remittances have now overtaken foreign inflows to government and are a significant source of financing the widening trade deficit. However, in terms of foreign receipts exports earnings, especially from textile and garments remain a prime source, followed by remittances and earnings from export of services (Table B10.1).

Remittances ease foreign exchange constraints and pressure on the exchange rate, while improving the balance of payments (BOP). Remittances enhance a country's creditworthiness and its access to international capital markets. While capital flows tend to rise during the upturn of economic cycles and decline during the downturn, remittances tend to rise with the recipient country's economic downturn and vice versa. These remittances have become counter cyclical reducing the volatility in the external balance. Remittances are also less volatile than other sources of foreign exchange earnings for developing countries and have a more equitable income distributional impact.

Though remittances from migrants are useful, migration for employment is not without associated costs. The foremost cost is the social cost emanating from family breakdown, however, temporary. The brain drain and skills drain could also hurt economic growth. Some skills demanded by foreign countries could create scarcities in the labour exporting country.

Of the total migration, housemaids and unskilled labour together account for over 70 per cent of the total foreign employment migration and skilled migration accounts for around 20 per cent. Considering, the greater potential for increasing future remittance inflows by encouraging migration of highly capable professionals in the fields of accountancy, legal, engineering, architecture, information technology and software development, Sri Lanka's foreign employment policies could be re-oriented to encourage skill migration. Under the provisions of the General Agreement on Trade in Services (GATS), trade in services are now being gradually liberalised and there has been a growing recognition that Mode 4 or movement of natural persons is an important mode of delivering services. Since Sri Lanka produces highly qualified professionals in several fields, Sri Lanka posses a comparative advantage in their trade through Mode 4. Hence, the government could formulate a migration policy aimed at encouraging short-term migration of human capital, particularly in skilled categories.

Establishing partnerships between remittance service providers and existing postal and bank networks would help to expand capacity and improve efficiency in remittance services.

There is a need for close regulation and supervision of foreign employment agencies to avoid undue harassment faced by migrants. Existing economic partnership agreements could be renewed or new agreements could be reached aiming at increasing the migrant flows and strengthening safety measures.

Though remittances have been one of the prime sources of foreign financing, government should not rely on these inflows as a long-term source of foreign financing because expanding productive domestic job opportunities in the process of accelerating economic growth and increasing average income in the country may discourage migration for foreign employment. The alternative is the encouragement of FDI with a greater potential to bring in sophisticated technology, expand export markets, improve skills and increase productivity in the economy.

Table B10.1

Major Sources of Foreign Receipts and Significance of Workers' Remittances

(US dollars million)

	1980	1985	1990	1995	2000	2005 (a)
Export Earnings (Goods)	1,064.7	1,315.3	1,983.9	3,806.6	5,522.3	6,346.7
Textile & Garments	109.7	293.1	628.1	1,852.6	2,982.0	2,894.6
Tea	373.3	441.9	494.8	480.7	701.1	810.2
Rubber	156.7	97.8	76.9	111.5	28.7	46.9
Coconut	74.6	113.9	69.5	102.8	121.1	113.3
Other	350.4	368.6	714.6	1,259.0	1,689.4	2,481.7
Export Earnings (Services)	279.1	328.6	531.0	821.0	953.0	1,540.2
Transportation	40.5	63.5	95.3	336.0	406.0	673.4
Travel	49.0	82.2	127.8	226.0	252.0	429.1
Other	189.6	182.9	307.9	259.0	295.0	437.7
Worker Remittances	152.3	291.6	400.7	790.0	1,160.0	1,918.5
Foreign Direct Investment	42.9	24.4	34.0	27.5	175.1	272.2
Foreign Loans and Grants	307.0	516.6	526.3	847.0	422.0	972.0
Worker Remittances,as a % of						
Total current account inflows	9.3	13.8	12.9	20.6	14.9	19.4
Trade balance	15.4	40.0	57.0	52.5	64.5	76.2
Loans and grants	49.6	56.4	76.1	93.3	274.9	197.3
Total imports	7.4	14.3	14.9	14.9	15.8	21.6
GDP	3.8	4.9	5.0	6.1	7.0	8.1

(a) Provisional

Source: Central Bank Annual Reports

1 Global Economic Prospects: Economic Implications of Remittances and Migration (2006), World Bank.

Asian counties that accounted for 6.5 per cent and 4.5 per cent of the total remittances, respectively. As Sri Lanka continues to generate a professional workforce, the government could promote trade under Mode 4 of GATS by entering into bilateral agreements with countries, where there is demand for professional services in areas where Sri Lanka has a comparative advantage.

- **The official current transfers more than tripled from US dollars 30 million to US dollars 93 million in 2005.** The government received substantial transfers both in kind such as food, medicine, temporary shelter etc. and cash as immediate relief measures from both multilateral and bilateral donors in the aftermath of the tsunami destruction to assist tsunami victims.

Current Account Balance

- **The current account deficit decreased to 2.8 per cent of GDP in 2005 from 3.2 per cent of GDP in 2004.** However, in US dollar terms, it widened marginally by 0.3 per cent to US dollars 650 million in 2005. A sharp increase in the current transfer receipts, especially worker remittances, helped offset the trade deficit and contain the current account deficit.

5.5 Capital and Financial Accounts, and Balance of Payments

Capital and Financial accounts

- **Net inflows to the capital and financial account improved during 2005.** This was largely due to higher capital transfers, especially tsunami related inflows to the government, higher net portfolio inflows, increased loan inflows to the private sector and commercial banks converting their foreign assets to domestic assets and low repayment of government debt due to the debt moratorium. However, loan inflows to the government were lower in 2005 than in 2004. The capital account, which records grants of a capital nature, mostly to the government from donors, increased to US dollars 250 million in 2005, compared to US dollars 64 million in 2004. This was mainly due to the tsunami related capital inflows received from foreign donors. Meanwhile, the financial account recorded a surplus of US dollars 974 million in 2005, compared to the surplus of US dollars 567 million recorded in 2004. Consequently, the overall surplus in the capital and financial account was more than enough to offset the deficit in the current account.

Foreign Direct Investment (FDI)

- **Both FDI inflows and outflows increased in 2005.** The gross FDI inflows reached a record level of US dollar 272 million in 2005 from US dollars 223 million in 2004. This was mainly due to a sharp increase in the reinvestment of retained earnings by a company in the services sector. Of this, a major portion of around US dollars 151 million was received by 69 projects in the services and infrastructure sectors, followed by 36 projects in textile and apparel sub-sectors amounting to US dollars 47 million. The continuation of new foreign investment inflows to the apparel sector is an indication of foreign investors' confidence in the sustainability of the apparel industry in Sri Lanka despite higher global competition. The FDI outflows increased to US dollars 38 million in 2005 from US dollars 6 million in 2004, as a few local companies were permitted to invest abroad during the year. As a result of this outflow, net

Chart 5.7

Official and Private Capital Inflows

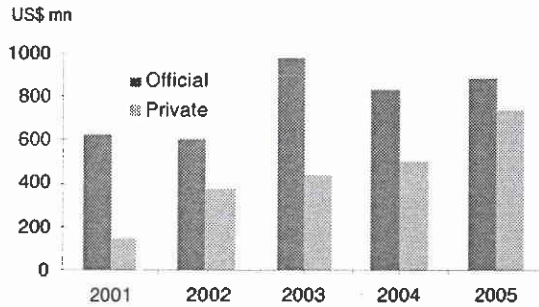


Table 5.9

Major Projects Financed by Foreign Lending during 2005

Donor	Project	Amount Disbursed US dollars mn.
Asian Development Bank		**198.1**
of which:	Financial Markets for Private Sector Development Project	19.8
	Road Network Improvement Project	16.7
	Road Sector Development Project	15.0
	3rd Water Supply & Sanitation Sector Project	14.0
	Secondary Education Modernisation Project	13.4
	Coastal Resource Management Project	12.9
	Power Sector Development Project	12.8
	SME SDP Credit Assistance Project	11.7
	Southern Transport Development Project	11.4
	Conflict Affected Areas RehabilitationProject	11.0
International Development Association		**113.1**
of which:	Renewable Energy for Rural Economic Development Project	22.6
	North East Housing Reconstruction Project	16.8
	Tsunami Emergency Recovery Project Phase II	14.2
	Relevancy & Quality-Undergraduate Education Project	12.3
	E-Sri Lanka Development Project	10.3
Government of Japan		**198.5**
of which:	Sri Lanka Tsunami Affected Area Recovery and Take off (STAART) Project	39.3
	Bandaranayake International Airport Development Project	35.3
	Small-Scale Infrastructure Rehabilitation & Upgrading (SIRUP ii) Project	21.0
	Kalu Ganga Water Supply Project for Grater Colombo	18.1
	Small Scale Infrastructure Rehabilitation & Upgrading Project	13.5
	Walawe Left Bank Irrigation & Extension Project (II)	10.0
Citicorp Investment Bank(s) Limited		**100.0**
	Facility Agreement	100.0
European Investment Bank		**17.9**
	DFCC Credit Line On-Lend to Private Sector	17.9

Sources: Central Bank of Sri Lanka
External Resources Dept.

FDI inflows increased by only US dollars 234 million from US dollars 217 million in 2004. During 2005, the number of projects approved by the BOI under Section 17 of the BOI Act decreased to 223 investment projects with a foreign investment commitment of US dollars 276 million, compared to 296 projects approved with a foreign investment commitment of US dollars 689 million in 2004. This decline in the number of approved projects was mainly due to the strict screening of FDI applications to ensure viability and acceptable quality of the projects. The number of projects contracted also declined from 228 projects with a foreign investment commitment of US dollars 361 million in 2004 to 167 projects with a foreign investment commitment of US dollars 322 million in 2005. The strict screening procedure is however expected to result in the realisation of a relatively larger share of contracted projects in the future. The BOI announced new incentives for investments in less developed regions to promote regionally balanced growth as stated in the government's policy agenda. Initially 300 factories under the Nipeyum Centres programme will receive these incentives.

Loan Capital to the Government

- **The total long term loan inflows to the government decreased by 3.1 per cent to US dollars 747 million in 2005 from US dollars 771 million in 2004.** The government received US dollars 93 million for tsunami reconstruction projects and obtained a syndicated foreign loan of US dollars 100 million. If tsunami related inflows and the syndicated loan were excluded, the loan inflows to the government would have decreased substantially by 28.1 per cent to US dollars 554 million. Meanwhile, loan repayment by the government decreased to US dollar 194 million, from US dollar 331 million in 2004, due to the benefit of the debt moratorium up to US dollars 188 million offered by the members of the Paris Club in 2005. The programme loan inflows were around US dollars 20 million in 2005. This was much lower than the projected inflows of US dollars 119 million for 2005 and also lower than the inflows of US dollars 30 million received in 2004. This decrease was due to delays in the implementation of reforms linked to disbursements. The shortfall in programme financing was met with the syndicated loan of US dollars 100 million. The disbursement of project loans also decreased by 10.0 per cent to US dollars 620 million in 2005 from US dollars 689 million in 2004, despite the receipt of US dollars 93 million project loans for tsunami reconstruction projects. If tsunami related loans were excluded, project loan disbursements would have decreased by 23.5 per cent to US dollars 527 million. Major foreign funded projects in 2005 were in the areas of road development, education, power, water supply and irrigation, SME development, airport development and rehabilitation of tsunami and conflict affected infrastructure facilities. It appears that despite several measures introduced by successive governments to accelerate the implementation of foreign funded projects, the poor progress in foreign loan disbursements indicates that bottlenecks in the implementation process continue. The foreign aid utilisation rate declined further in 2005 by 2 percentage points to 16.5 per cent.
- **Of the total loan receipts, 84.4 per cent was received on concessional terms and the balance was on commercial terms and conditions, compared to 92.7 per cent received on concessional terms in 2004.** As in the past, multilateral lending institutions provided the bulk of foreign loans in 2005. Asian Development Bank (ADB) and International Development Association (IDA) continued to be the major multilateral lending agencies providing around US dollars 198 million and US dollars 113 million, respectively. Bilateral assistance amounted to US dollars 271 million, of which US dollars 199 million was from Japan and US dollars 24 million was from Germany. Financial assistance from Japan accounted for 31.5 per cent of total concessional loans, while ADB and IDA accounted for 31.3 per cent and 17.9 per cent, respectively. During 2004, they accounted for 37.7 per cent, 25.8 per cent and 9.5 per cent, respectively.
- **The shortfall in concessional external financing was financed through non-concessional external and domestic foreign currency borrowings.** During the year, the government settled foreign currency denominated loans of US dollars 170 million from domestic banks (FCBU loans), while mobilising loans amounting to US dollars 585 million from FCBUs by way of new issues and rollovers, resulting in net domestic foreign currency borrowings of US dollars 415 million in 2005. In addition, the government mobilised a syndicated loan of US dollars 100 million in international markets to fill the remaining financing gap. Both the domestic foreign currency loans and syndicated loans were mobilised at market interest rates. Filling the shortfalls in medium and long term concessinal loans with foreign currency denominated commercial loans would have adverse implications for debt sustainability as the debt service tends to rise while debt stock becomes increasingly exposed to global interest rate fluctuations.

Loan Capital to the Private Sector

- **Long term capital inflows to the private sector and public corporations increased by around 16.6 per cent to US dollars 197 million in 2005 from US dollars 169 million in 2004.** The major contribution to this increase came from a bilateral loan of US dollars 144 million obtained by the Ceylon Petroleum Corporation (CPC) under the Indian Line of Credit to finance oil imports from India. This loan was negotiated by the government to mitigate the adverse impact of the increasing oil import bill on the country's BOP.

Short term Capital Inflows and Outflows

- **Short term capital recorded a net inflow of US dollars 176 million in 2005, compared to the net outflow of US dollars 112 million in 2004.** The net portfolio investment inflows through the equity market recorded an increase. This was owing to the strong performance of listed companies and the enabling economic environment. California Public Employees' Retirement System, the largest public pension fund in the USA, included Sri Lanka in its emerging markets investment eligibility list in 2005. Two initial public offers by service sector companies further boosted foreign investment in Sri Lankan stocks in 2005. Portfolio investment recorded a net inflow of US dollars 60 million in 2005, compared to US dollars 11 million in 2004 and the Colombo Stock Exchange emerged as one of the best performing markets in 2005. Private short term credit comprising short term export and import related suppliers' credit, recorded a net inflow of US dollars 16 million, compared to a net inflow of US dollars 28 million in 2004 due to low import growth in 2005 and the availability of the long term Indian Line of Credit for the importation of refined petroleum products from India.
- **Net foreign assets of commercial banks decreased by US dollars 100 million in 2005, compared to an increase of US dollars 151 million in 2004.** Foreign assets of commercial banks increased by US dollars 223 million in 2005 despite a net FCBU lending of US dollars 415 million to the government. However, the foreign liabilities of the commercial banks increased by US dollars 323 million in 2005 resulting in a decrease of net foreign assets by US dollars 100 million. The increase in foreign assets reflects the higher investments abroad by commercial banks. The increase in foreign liabilities of commercial banks reflects mainly the syndicated loan of US dollars 130 million raised by a commercial bank.

Balance of Payments and External Reserves

- **The Balance of Payments (BOP) recorded a surplus in 2005.** Net inflows to the capital and financial account during the year were more than sufficient to finance the current account deficit. Consequently, the overall BOP recorded a surplus of US dollars 501 million in 2005 reversing the deficit of US dollars 205 million recorded in 2004.
- **Gross official reserves of the country, which declined in 2004 after recording increases for three consecutive years since 2001, rose again in 2005.** The improved reserve position enhanced the resilience of the country to external shocks. Gross official reserves increased to US dollars 2,735 million at end 2005 from US dollars 2,196 million at end 2004. The

Chart 5.8
Quarterly External Assets

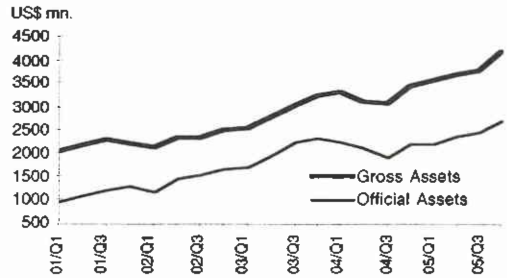


Table 5.10
External Assets of Sri Lanka (a)

Ownership						Rs. million				
	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
1. Government	78	46	55	95	131	7,302	4,424	5,320	9,897	13,417
2. Government Agencies	-	-	-	-	-	-	-	-	-	-
3. Central Bank	1,260	1,654	2,274	2,101	2,604	117,365	160,018	219,984	219,795	265,873
4. Total Official Assets	1,338	1,700	2,329	2,196	2,735	124,668	164,442	225,304	229,693	279,290
5. Commercial Banks	900	795	889	1,243	1,466	83,815	76,921	86,011	129,987	149,656
6. Total External Assets	2,238	2,495	3,218	3,438	4,201	208,482	241,364	311,315	359,680	428,946
7 Gross Official Assets in Months of										
7.1 Merchandise Imports	2.7	3.3	4.2	3.3	3.7					
7 2 Import of Goods and Services	2.3	2.9	3.6	2.9	3.3					
8 Total Assets in Months of										
8.1 Merchandise Imports	4.5	4.9	5.8	5.2	5.7					
8 2 Import of Goods and Services	3.8	4.2	5.0	4.5	5.0					

Source: Central Bank of Sri Lanka

(a) Reserves from 2002 are calculated on the basis of marked to market.
(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	2001	2002	2003	2004	2005
Rs. per US dollar (end year)	93.16	96.75	96.74	104.61	102.12

Box 11

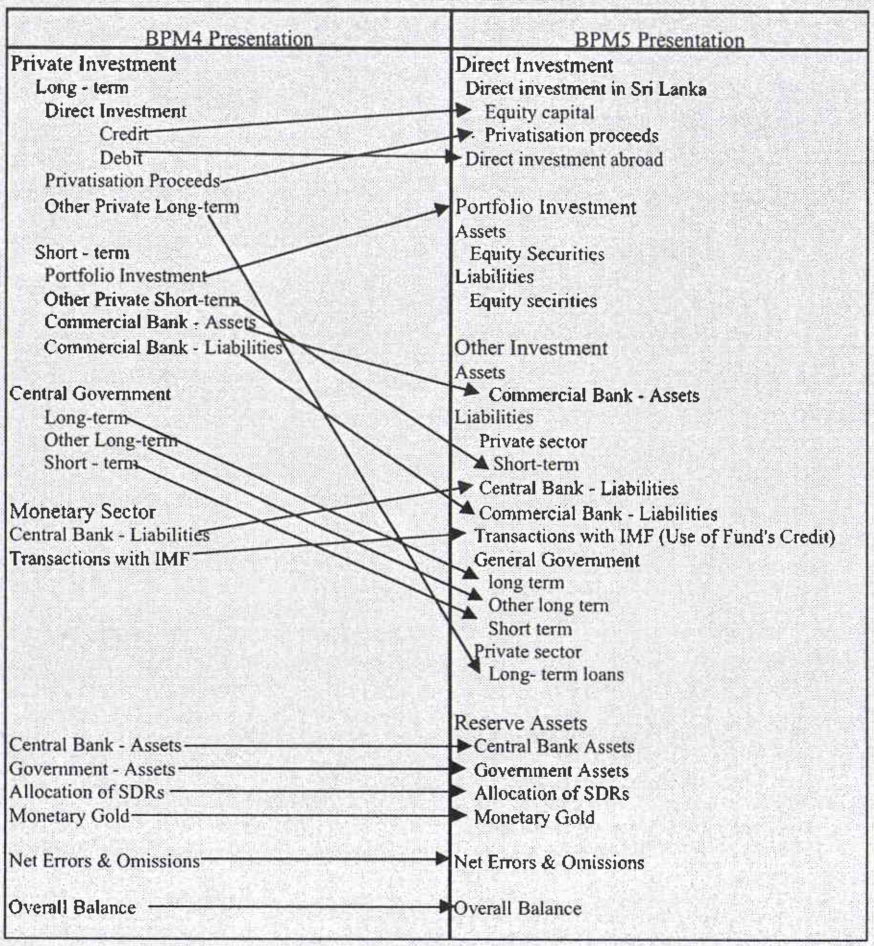
Re-classification of the Financial Account of the Balance of Payments Presentation

The compilation and presentation of the Balance of Payments (BOP) statistics are carried out according to international standards established by the International Monetary Fund (IMF) to facilitate economic analysis and cross country comparison. The standards are specified in the Balance of Payments Manual (BPM) published by the IMF. The 5th edition of the BOP Manual (BPM5) was published in 1993, after taking into consideration the rapid developments and sophistication of financial markets, changes in international trade in goods and growth in trade in services. In Sri Lanka, the trade, services, income and current transfer accounts have been mostly consistent with the BPM5 requirements, but the financial account has not been fully consistent in the previous years. Therefore, in 2005, the financial account has been upgraded to meet BPM5 specifications and is presented in Table 85A of the Annual Report.

The coverage of financial flows is significantly expanded and restructured in the BPM5, reflecting widespread alterations in the nature and composition of international financial transactions since the publication of the BPM4 in 1977. As such, under BPM5, financial account transactions are classified into four major categories, namely: direct investment, portfolio investment, other investment and reserve assets. Direct investment is further divided into direct investment in reporting country and direct investment abroad while portfolio investment and other investment are classified on an assets and liabilities basis. As per the BPM5, transactions related to reserve assets are recorded only on an assets basis.

Table B11.1

The Reallocation of Major Entries in the Financial Account from BPM4 Presentation to BPM5 Presentation



increase in reserves was brought about by the receipt of emergency assistance amounting to around US dollars 157 million from the IMF, US dollars 415 million net foreign currency loans mobilised from local commercial banks, a US dollars 100 million syndicated loan mobilised from the international market, a programme loan of US dollars 20 million from the ADB and the benefit of the debt moratoria offered by the members of the Paris Club and multilateral lending institutions and tsunami related inflows. The higher foreign exchange inflows to the country helped mitigate the impact of rising expenditure on imports. The import coverage of the gross official reserves improved to 3.7 months of imports by end 2005 from 3.3 months of imports at end 2004. The reserve adequacy as measured by the ratio of gross official reserves to short term debt and liabilities improved to 85.4 per cent in 2005 from 83.5 per cent in 2004. However, if foreign currency denominated domestic borrowings such as SLDBs and FCBU lending were included, the ratio would deteriorate to 71.6 per cent from 77.1 per cent, mainly due to a substantial amount of repayment of the FCBU loans falling due during 2006.

- **The total external reserves of the country increased to US dollars 4,200 million (5.7 months of imports) in 2005,** from US dollars 3,438 million (5.2 months of imports) by the end of 2004 solely due to an increase in official reserves.

5.6 External Debt and Debt Service

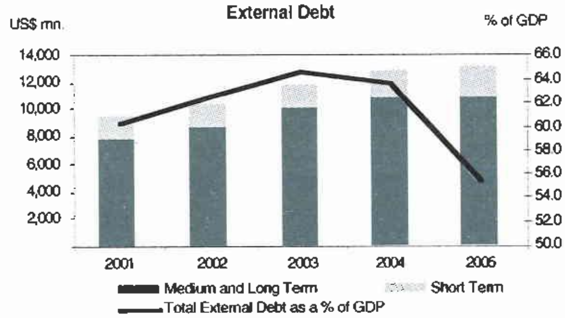
External Debt

- **The total external debt of the country, measured as a percentage of GDP, decreased during 2005 mainly due to the appreciation of the rupee against major currencies and the lower disbursement of loans from foreign lending institutions and bilateral donors in 2005.** As a per cent of GDP, total external debt decreased to 48.3 per cent in 2005 from 56.6 per cent in 2004. In US dollar terms, it increased marginally to US dollars 11,368 million in 2005 from US dollars 11,346 million in 2004. However, as a wider aggregate, the total external debt and liabilities increased by around 2.0 per cent to US dollars 13,034 million, reflecting an increase in commercial bank liabilities. Of the total external debt, around 30 per cent of the loans were denominated in Japanese yen and around 42 per cent in SDR, which depreciated by 12.8 per cent and 8.0 per cent, respectively, against the US dollar in 2005. This contributed to the decline in external debt. In addition, the debt written-off by Italy and China amounting to US dollars 9.2 million and US dollars 4.4 million, respectively, in 2005 to assist tsunami relief, rehabilitation and reconstruction also contributed to the decline in external debt.

- **Medium and long term debt of the country accounted for about 94 per cent of the total external debt stock in 2005.** As much as 87.5 per cent consisted of government debt, with the remaining 12.5 per cent representing private sector borrowings, public corporations' foreign debt and debt obligations to the IMF. Despite net positive borrowings, the government's concessional debt stock decreased by 3.1 per cent to US dollars 9,000 million in 2005 from US dollars 9,283 million in 2004 due to the appreciation of the US dollar against the SDR and the yen. Non- concessional debt of the government increased by 53.2 per cent to US dollars 368 million in 2005 due to the syndicated loan of US dollars 100 million raised at market interest rate. The liabilities to the IMF increased by 47.6 per cent to US dollars 381 million in 2005, from US dollars 258 million in 2004, due to the receipt of around US dollars 157 million as emergency assistance in the aftermath of the tsunami disaster.

Chart 5.9

External Debt



- **Medium and long term debt of the private sector and public corporations increased by 4.0 per cent to US dollars 955 million in 2005 from US dollars 918 million in 2004 mainly due to a loan raised by the CPC.** The external debt stock of the private sector and public corporations with a government guarantee increased by around 11.8 per cent to US dollars 567 million in 2005, from US dollars 507 million in 2004, mainly due to the utilisation of loan facilities amounting to US dollars 144 million by the CPC under the Indian Line of Credit. Though the government has been cautious in providing guarantees to public corporations and the private sector in pursuance of its policy of reducing contingent liabilities, the government guaranteed the loan of US dollars 144 million to CPC mainly to mitigate the adverse impact of the historically high oil prices on the country's BOP during 2005. However, long term loans to public corporations and the private sector institutions without a government guarantee decreased by 5.6 per cent to US dollars 388 million in 2005, from US dollars 411 million in 2004, as repayments of foreign loan by the private sector were higher than inflows.

- **The short term debt stock of the country, which consists of trade credit, increased by about 2.6 per cent to US dollars 664 million, due to the higher growth in imports compared**

to the growth of exports. The share of short term debt in the total debt stock increased by 5.8 per cent in 2005, from 5.7 per cent in 2004. Meanwhile, the banking sector's external liabilities increased by 16.6 per cent to US dollars 1,666 million by end 2005 mainly due to a sharp increase in the liabilities of commercial banks.

- **Reflecting the above developments, the total external debt and banking sector liabilities as a percentage of GDP, decreased to 55.4 per cent of GDP in 2005, from 63.7 per cent of GDP in 2004.** However, the total external debt and banking sector liabilities, in US dollar terms increased by 2.0 per cent to US dollars 13,034 million in 2005 from US dollars 12,775 million in 2004. This was largely due to the sharp increase in the external liabilities of the banking sector.

Foreign Debt Service Payments

- **The country's capacity to service the external debt improved significantly in 2005.** The debt service payments as a percentage of receipts from exports of goods and services improved to 7.9 per cent from 11.6 per cent in 2004. If repayments to the IMF were excluded, the debt service ratio would improve further to 7.3 per cent. An improvement in foreign exchange earnings from exports of goods and services, the moratorium on repayment of principal and interest on selected government loans and the decline in defence loan repayments contributed to this favourable development. If receipts from private remittances were also included, the ratio would improve substantially to 6.3 per cent.

Table 5.11

Outstanding External Debt and Banking Sector External Liabiliites

Item	US dollars million					Rs. million				
	2001	2002	2003	2004	2005(a)	2001	2002	2003	2004	2005(a)
1. Medium and Long-term Debt	7,839	8,732	10,116	10,699	10,704	730,245	844,709	978,556	1,119,155	1,093,057
1.1 Government	6,808	7,464	8,812	9,523	9,368	634,255	721,956	852,433	996,203	956,620
1.2 Public Corporations and Private Sector with Government Guarantee	572	689	602	507	567	53,324	66,663	58,251	52,986	57,912
1.3 Public Corporations and Private Sector without Government Guarantee	249	293	334	411	388	23,203	28,303	32,319	42,944	39,588
1.4 IMF Drawings	209	287	368	258	381	19,463	27,787	35,552	27,023	38,937
2. Short-term Debt	533	601	620	647	664	49,648	58,116	59,935	67,726	67,759
2.1 Government	-	-	-	-	-	-	-	-	-	-
2.2 Other(CPC and other trade credit) (b)	533	601	620	647	664	49,648	58,116	59,935	67,726	67,759
3. Banking Sector External Liabilities (c)	1,119	1,001	1,046	1,429	1,666	104,201	96,807	101,149	149,492	170,170
3.1 Central Bank	2	1	0	1	1	172	123	32	128	131
3.2 Commercial Bank	1,009	865	863	1,066	1,388	94,030	83,655	83,514	111,464	141,753
3.3 ACU Liabilities	107	135	182	362	277	9,999	13,029	17,604	37,899	28,286
4. Total External Debt (1+2)	8,372	9,333	10,735	11,346	11,368	779,893	902,825	1,038,491	1,186,881	1,160,816
5. Total External Debt and Liabilities (1+2+3)	9,490	10,334	11,781	12,775	13,034	884,095	999,632	1,139,640	1,336,373	1,330,986
MEMORANDUM ITEMS										
Medium and Long-term Debt										
(1) Project Loans	5,374	4,358	6,961	7,702	7,527	480,237	421,637	673,432	805,646	768,643
(2) Non-Project Loans	1,154	3,048	1,726	1,763	1,614	103,163	294,880	167,007	184,467	164,857
(3) Suppliers' Credits	316	100	218	240	368	29,411	9,718	21,048	25,123	37,591
(4) IMF Drawings	209	287	368	258	381	19,463	27,787	35,552	27,023	38,937
(5) Other Loans (d)	786	939	843	735	813	97,971	90,686	81,516	76,896	83,029
Short-term Debt and Banking Sector Liabilities	1,651	1,602	1,665	2,077	2,330	153,850	154,923	161,084	217,217	237,929
As a percentage of GDP										
Total External Debt	53.2	56.3	58.9	56.6	48.3	55.4	57.0	59.0	58.5	49.1
Total Banking Sector External Liabilities	7.1	6.0	5.7	7.1	7.1	7.4	6.1	5.7	7.4	7.2
Total External Debt and Liabilities	60.3	62.4	64.6	63.7	55.4	62.8	63.1	64.7	65.9	56.3
Short-term Debt	3.4	3.6	3.4	3.2	2.8	3.5	3.7	3.4	3.3	2.9
Short-term Debt and Banking Sector External Liabilities	10.5	9.7	9.1	10.4	9.9	10.9	9.8	9.2	10.7	10.1
As a percentage of Total Debt and Liabilities										
Short-term Debt	5.6	5.8	5.3	5.1	5.1	5.6	5.8	5.3	5.1	5.1
Short-term liabilities	11.8	9.7	8.9	11.2	12.8	11.8	9.7	8.9	11.2	12.8
Short-term Debt as a percentage of Official Reserves	39.8	35.3	26.6	29.5	24.3	39.8	35.3	26.6	29.5	24.3

(a) Provisional
(b) Includes acceptance credits of Ceylon Petroleum Corporation and other trade credits.
(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 Dept.

Table 5.12

External Debt Service Payments

Item	US dollars million					Rs. million				
	2001	2002	2003	2004	2005 (a)	2001	2002	2003	2004	2005 (a)
1. Debt Service Payments	813	788	761	843	623	72,584	74,704	73,125	85,318	62,577
1.1 Amortization	558	572	526	594	419	49,883	54,006	50,502	59,990	42,075
(i) To IMF	78	56	32	107	39	6,966	4,647	2,869	10,718	3,902
(ii) To Others	480	516	493	487	380	42,918	49,359	47,632	49,272	38,173
1.2 Interest Payments	254	216	235	249	204	22,701	20,698	22,623	25,328	20,502
(i) To IMF	4	4	4	10	10	348	398	414	988	973
(ii) To Others	251	212	230	240	194	22,353	20,300	22,209	24,340	19,530
2. Earnings From Merchandise Exports and Services	6,172	5,967	6,544	7,284	7,887	551,309	571,195	631,549	738,714	793,153
3. Receipts From Merchandise Exports, Services, Income and Private Transfers	7,436	7,330	8,127	9,004	9,891	664,073	701,579	784,408	912,817	994,751
4. Debt Service Ratio (b)										
4.1 As a percentage of 2 above										
(i) Overall Ratio	13.2	13.2	11.6	11.6	7.9	13.2	13.1	11.6	11.5	7.9
(ii) Excluding IMF Transactions	11.8	12.2	11.1	10.0	7.3	11.8	12.2	11.1	10.0	7.3
4.2 As a percentage of 3 above										
(i) Overall Ratio	10.9	10.8	9.4	9.4	6.3	10.9	10.6	9.3	9.3	6.3
(ii) Excluding IMF Transactions	9.8	9.9	8.9	8.1	5.8	9.8	9.9	8.9	8.1	5.8
5. Government Debt Service Payments										
5.1 Government Debt Service Payments(c)	450	522	502	484	268	40,190	49,928	48,452	48,952	26,927
5.2 As a percentage of 1 above	55.3	66.2	66.0	57.4	43.0	55.4	66.8	66.3	57.4	43.0

(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

Source: Central Bank of Sri Lanka

- **Total debt service payments, which consist of both amortisation and interest payments on all foreign debt, decreased by 26.1 per cent to US dollar 623 million in 2005.** The debt moratoria offered by members of the Paris Club, G-8 countries and multilateral lending institutions, the decline in defence loan repayments and the appreciation of the US dollar against the yen and the SDR had a beneficial impact on Sri Lanka's external debt service payments in 2005. The total amortisation payments, which accounted for 67 per cent of total debt service payments, decreased by 29.5 per cent to US dollars 419 million, while the interest payments decreased by 18.1 per cent to US dollars 204 million. The amortisation payments in respect of government debt decreased by 44.6 per cent to US dollars 268 million in 2005. During 2005, amortisation payments to the IMF decreased by 63.6 per cent to US dollars 39 million due to the settlement of a significant amount of IMF loans in 2004 and the deferment of loan repayments granted by the IMF by way of tsunami related assistance. The appreciation of the US dollar in international markets resulted in decreases of 12.8 per cent and 8.0 per cent, respectively, in the repayments of debt denominated in Japanese yen and SDR.

5.7 Exchange Rate Regime and Exchange Rate Movements

- **The independently floating exchange rate regime served well in 2005.** The depreciating trend in the exchange rate, throughout 2004, reversed, following the tsunami disaster. The exchange rate appreciated to Rs.104.61 per US dollar on 31 December 2004 from Rs.105.47 per US dollar on 17 December 2004. It appreciated further to Rs.98.11 per US dollar by 12 January 2005 and depreciated slowly thereafter. For the year as a whole, the rupee appreciated by 2.4 per cent to Rs.102.12 per US dollar. Substantial foreign aid pledged by the bilateral and multilateral donors in the aftermath of the tsunami and the anticipation of further inflows including remittances led to market confidence. The improved overall BOP surplus strengthened the exchange rate stability.

- **The Sri Lanka rupee appreciated at a relatively higher rate against other major currencies during 2005 as the US dollar appreciated against them.** Reflecting the movements of other major currencies against the US dollar in international markets, the rupee appreciated significantly against the euro (17.7 per cent), the sterling pound (14.5 per cent), the Indian rupee (5.7 per cent), the Japanese yen (17.5 per cent) and the SDR (11.3 per cent).

Nominal and Real Effective Exchange Rates

- **Both Nominal and Real Effective Exchange Rates appreciated during 2005 reversing the depreciating trend.** Resulting from the relatively higher appreciation of the Sri Lanka rupee against major currencies, the nominal effective exchange rate (NEER) of the Sri Lanka rupee based on the 5 currency basket, (which includes the US dollar, the Japanese yen, the sterling pound, the Indian rupee and the euro) appreciated as much as by 8.5 per cent, while the NEER based on the nominal exchange rates of 24 trading partners and

Table 5.13

Exchange Rate Movements

Currency	In Rupees per unit of Foreign Currency						Percentage Change Over Previous Year (a)			
	End of Year Rates			Annual Average			Point to Point		Annual Average	
	2003	2004	2005	2003	2004	2005	2004	2005	2004	2005
Euro	121.60	142.32	120.96	109.16	125.79	125.10	-14.56	17.66	-13.22	0.55
Indian rupee	2.12	2.40	2.27	2.07	2.23	2.28	-11.46	5.67	-7.18	-2.22
Japanese yen	0.90	1.02	0.87	0.83	0.94	0.91	-11.15	17.53	-10.90	2.33
Pound sterling	172.20	201.37	175.94	157.71	185.35	182.87	-14.49	14.45	-14.91	1.35
US dollar	96.74	104.60	102.12	96.52	101.19	100.50	-7.52	2.44	-4.61	0.69
SDR	143.75	161.60	145.95	135.23	149.88	148.45	-11.05	11.30	-9.78	0.96

Effective Exchange Rate Indices (b)	Monthly Index			Annual Average			Percentage Change Over Previous Year			
							Point to Point		Annual Average	
	Dec. 2003	Dec. 2004	Dec. 2005	2003	2004	2005	2004	2005	2004	2005
NEER (1999 = 100)	71.58	63.18	68.07	73.84	67.63	67.55	-11.74	7.74	-8.41	-0.12
REER (1999 = 100)	96.75	94.93	106.99	97.25	93.61	101.92	-1.88	12.70	-3.74	8.88

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) 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.

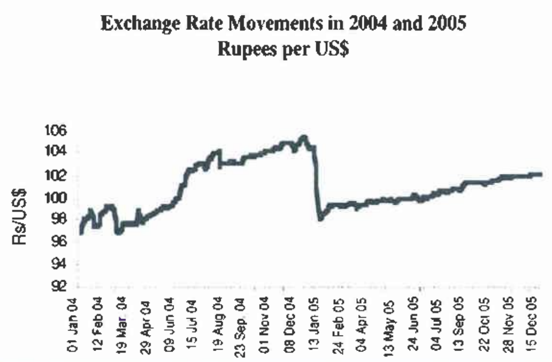
competitors appreciated by 7.7 per cent during 2005, compared to a depreciation of around 11.0 per cent in 2004. The higher nominal appreciation of the Sri Lanka rupee and the relatively higher domestic inflation as compared to that of trading partners and competitors resulted in the Real Effective Exchange Rate (REER) with respect to the 5 currency basket appreciating significantly by 13.1 per cent, in 2005. This reversed the depreciating trend in the REER seen since 2002. The REER depreciated by 0.1 per cent in 2002, 2.8 per cent in 2003 and 0.7 per cent in 2004. Meanwhile, the 24-currency REER, which depreciated by 3.4 per and 1.1 per cent, respectively in 2003 and 2004, appreciated by 12.7 per cent in 2005. The deterioration of the external competitiveness of Sri Lanka through exchange rate movements during 2005 was partly offset by productivity improvements particularly in the apparel sector.

Developments in the Domestic Foreign Exchange Market

- **The domestic foreign exchange market broadened and deepened with the expansion in trade and the stability in the exchange rate.** The combined volume of forward market activities and inter-bank spot market activities increased significantly to US dollars 7,807 million in 2005 from US dollars 4,330 in 2004. The volume of the spot market increased to US dollars 5,949 million, from US dollars 3,304 million

Chart 5.10

Exchange Rate Movements



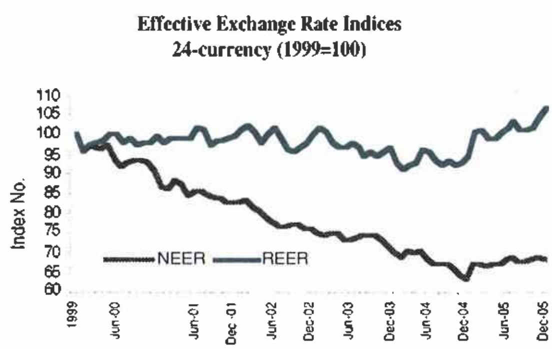
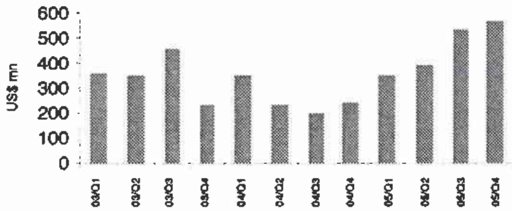


Chart 5.11
Quarterly Inter Bank Forward Transactions (2003 - 2005)



recorded in 2004, while the forward volume increased to US dollars 1,858 million (23.8 per cent of total transactions) from US dollars 1,026 million (23.7 per cent of total transactions) recorded in 2004. The annualised forward premium, as a percentage of the spot rate, decreased at the beginning of the year due to market expectations of an appreciation of the Sri Lanka rupee. Thereafter, it increased gradually reflecting the gradual depreciation of the rupee and higher domestic interest rates.

- **During 2005, the Central Bank intervened on both sides of the foreign exchange market to contain excess volatality,** selling US dollars 464 million and buying US dollars 290 million, resulting in lower net sales of US dollars of 174 million, compared to net sales of US dollars 515 million in 2004.