Chapter 5

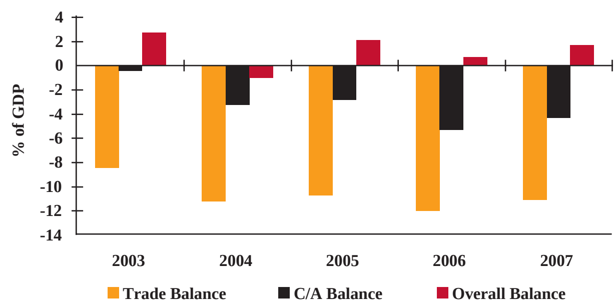
EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

5.1 Overview

The external sector continued to sustain its strong performance in 2007, largely supported by the favourable global economic environment during much of 2007. The Balance of Payments (BOP) recorded a surplus for the third consecutive year. Exports continued to grow amid intense global competition. In particular, exports to the EU grew substantially benefiting from increased access to EU markets under the GSP+ scheme. Following the high performance of apparel exports, which have exceeded US dollars 3 billion since 2006, tea exports exceeded the US dollars 1 billion mark in 2007. Imports also increased reflecting the higher demand for investment and intermediate goods and the sharp increase in international commodity prices including that of crude oil. The higher international prices of several essential imported goods as compared to those of Sri Lanka's exports led to a deterioration in the country's terms of trade by 1.0 per cent. The trade deficit too widened further, which was largely offset by increased private remittances. Earnings from the export of services such as transportation, Information Technology (IT) and IT enabled services continued to increase, while there was a decline in the earnings from tourism. Tourist arrivals declined sharply during the first half of the year, but recovered substantially during the latter part of the year. The services account surplus together with the increase in worker remittances helped contain the current account deficit, which improved as a percentage of GDP in 2007. The surplus in the capital and financial account was more than sufficient to offset the deficit in the current account, leading to an overall surplus in the BOP. Consequently, the external official reserves of the country improved to a comfortable level, which is sufficient to finance more than 3 months of imports.

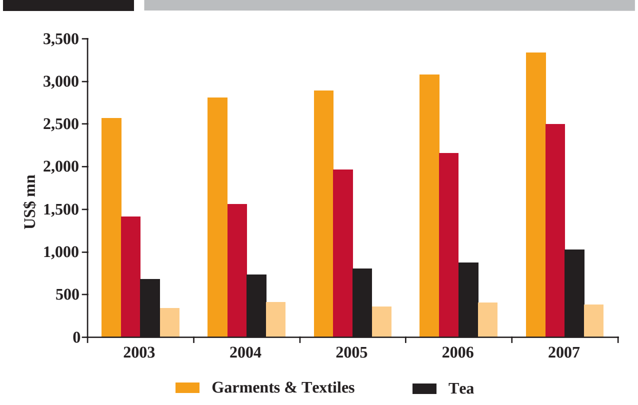
The government successfully launched its debut international bond issue, which was oversubscribed by over three times, reflecting international investor confidence in the Sri Lankan economy. With this international bond issue and

Chart 5.1 Balance of Payments



foreign investors' subscriptions to rupee denominated Treasury bonds, foreign capital inflows to the government reached a record high in 2007. The realised Foreign Direct Investment (FDI) also increased substantially during 2007 surpassing the previous highest level recorded in 2006. The rupee, which depreciated at a relatively higher rate against the US dollar during the first three quarters of the year, appreciated in the last quarter with the inflow of the proceeds from the debut sovereign bond issue and recorded a marginal depreciation of 0.93 per cent by end 2007 and stabilised thereafter. A further liberalisation of the capital account in 2007 in the form of permitting foreign investors to subscribe up to 10 per cent of the outstanding rupee denominated Treasury bonds also contributed to the appreciation of the rupee with increased foreign fund inflows to the country. The recent stabilisation of the Sri Lanka rupee underlines the need for export and import competing sectors to focus more on productivity improvements in order to maintain external competitiveness. Meanwhile, the total external debt of the country as a percentage of GDP increased marginally in 2007, mainly due to Sri Lanka's debut international sovereign bond issue and foreign subscriptions to Treasury bonds.

Chart 5.2 Major Sources of Foreign Exchange Earnings



5.2 External Sector Policies and Institutional Support

The external sector continued to operate in a free and liberal economic environment with special emphasis on the expansion of trade in goods and services through harmonious development of economic relations with major trading partners. Current account convertibility, the floating exchange rate regime and the further liberalised capital account helped improve the external sector. The government's policy on exports envisaged higher earnings through increased value addition and equitable regional economic development to ensure that benefits thus generated would reach the grass roots.

The depth of openness continued to remain high as reflected in the low average tariff rate of 4.1 per cent in 2007. This compares well with Sri Lanka's average bound tariff level of 37.8 per cent.In accordance with the legal commitments made to the WTO by Sri Lanka, the relevent tariff rates are maintained below the bound tariff levels.Tariffs remain the main trade policy instrument. The five-band tariff structure of 0, 2.5, 6, 15 and 28 per cent, which was introduced in 2004 continued to prevail in 2007. Preferential tariffs were offered on imports under bilateral and regional trade agreements. These developments promoted market access, transparency and predictability in the external trading environment. However, duty rates on consumer goods were subject to frequent changes in 2007 in order to provide relief to consumers particularly in the festive seasons and shield domestic producers from a surge in imports. The other charges applicable to imports in 2007 were a surcharge on customs duty (10 per cent of customs duty), VAT, Port and Airport Development Levy (PAL), Social Responsibility Levy (SRL), Excise Duty (on alcohol, tobacco products and vehicles) and a cess on non-essential consumer items. Meanwhile, single specific customs duty rates were introduced on ten selected food items, instead of the surcharge on imports, the VAT, the SRL, a cess and other charges applicable at the customs.

Sri Lanka is firmly engaged in the bilateral and regional trading agreements, while upholding multilateral initiatives in WTO fora as the long term strategy to strengthen the country's position in the global trading system. The integration of the domestic economy with those of the trading partners as envisaged by entering into trading arrangements led not only to straightforward economic gains as specifically stated in the agreements, but also to a multiple of spin-off benefits beyond those envisaged in such agreements. With a view to strengthening the traditional ties and developing Sri Lanka as the South Asian trading hub, the country, as an active member of the South Asia Free Trade Agreement (SAFTA), the

Table 5.1 Balance of Payments Analytical Presentation (a)

Item	US dollars million					Rs. million				
	2003	2004	2005	2006	2007 (b)	2003	2004	2005	2006	2007(b)
Trade Balance	-1,539	-2,243	-2,516	-3,370	-3,560	-148,324	-227,171	-253,082	-350,037	-394,327
Exports	5,133	5,757	6,347	6,883	7,740	495,426	583,967	638,276	716,579	856,808
Imports	6,672	8,000	8,863	10,253	11,301	643,750	811,138	891,359	1,066,615	1,251,135
Services, net	399	419	338	257	239	38,443	42,735	34,043	26,660	26,301
Receipts	1,411	1,527	1,540	1,625	1,711	136,123	154,746	154,877	168,802	189,266
Payments	1,012	1,108	1,202	1,368	1,473	97,680	112,011	120,833	142,142	162,965
Income ,net	-172	-204	-299	-389	-358	-16,535	-20,688	-30,049	-40,424	-39,041
Receipts	170	157	35	311	449	16,385	15,813	3,629	32,457	50,213
Payments	341	360	335	700	807	32,920	36,501	33,678	72,881	89,254
Goods, Services and Income (net)	-1,312	-2,028	-2,478	-3,503	-3,679	-126,416	-205,124	-249,088	-363,801	-407,067
Private Transfers, net	1,205	1,350	1,736	1,904	2,214	116,350	136,672	174,542	197,861	245,006
Receipts	1,414	1,564	1,968	2,161	2,502	136,475	158,291	197,968	224,678	276,814
Payments	209	214	233	257	288	20,125	21,619	23,426	26,817	31,808
Official Transfers (net)	36	30	93	101	97	3,441	3,038	9,300	10,524	10,677
Current Account	-71	-648	-650	-1,499	-1,369	-6,625	-65,414	-65,246	-155,416	-151,383
Capital and Financial Account	722	631	1,224	1,808	2,097	69,723	60,539	123,866	190,768	230,978
Capital Account	74	64	250	291	269	7,146	4,974	25,108	30,292	29,669
Capital Transfers(net)	74	64	250	291	269	7,146	4,974	25,108	30,292	29,669
Receipts	81	71	257	299	278	7,768	5,643	25,863	31,171	30,735
Payments	6	7	7	8	10	622	669	755	879	1,066
Financial Account	648	567	974	1,517	1,828	62,577	55,565	98,757	160,477	201,309
Long-term:	722	680	798	907	1,251	69,721	69,805	80,391	95,089	140,054
Direct Investment	201	227	234	451	548	19,450	22,826	23,505	46,985	60,768
Foreign Direct Investment	171	217	234	451	548	16,557	21,948	23,505	46,985	60,768
Privatisation Proceeds	30	10	-	-	-	2,893	878	-	-	-
Private Long-term (net)	-33	14	11	-35	31	-3,201	2,270	1,054	-3,590	3,314
Inflows	101	169	197	139	199	9,738	17,503	19,739	14,469	22,033
Outflows	134	155	186	174	168	12,939	15,233	18,685	18,058	18,719
Government, Long-term (net)	554	439	553	491	672	53,472	44,709	55,832	51,694	75,971
Inflows	913	771	747	932	1,290	88,106	78,299	75,309	97,690	144,146
Outflows	359	331	194	441	618	34,634	33,590	19,477	45,996	68,175
Short-term:	-75	-112	176	610	577	-7,145	-14,240	18,366	65,387	61,256
Portfolio Investment	2	11	60	51	101	209	1,109	6,103	5,377	11,249
Private Short-term (net)	19	28	16	-30	20	1,877	2,514	1,640	-3,066	1,868
Commercial Bank Assets (net)	-94	-354	-223	297	-281	-9,090	-45,367	-19,669	23,789	-31,352
Commercial Bank Liabilities (net)	-2	202	323	293	364	-141	27,504	30,292	39,287	38,746
Government Short-term (net)	-	-	-	-	372	-	-	-	-	40,744
Valuation Adjustments	-	-	-	-	-	-	-	-	-	-
Errors and Omissions	-148	-189	-72	-105	-198	-14,487	-2,599	-10,494	-1,830	-19,593
Overall Balance (c)	502	-205	501	204	531	48,610	-7,474	48,125	33,523	60,002
Monetary Movements (c)	-502	205	-501	-204	-531	-48,610	7,474	-48,125	-33,523	-60,002
Annual Average Exchange Rate Rs/US$						96.52	101.19	100.50	103.96	110.62
Ratio to GDP in percentages (d)										
Trade Account	-8.1	-10.9	-10.3	-11.9	-11.0	-8.1	-10.9	-10.3	-11.9	-11.0
Current Account	-0.4	-3.1	-2.7	-5.3	-4.2	-0.4	-3.1	-2.7	-5.3	-4.2
Current Account without Grants	-0.6	-3.3	-3.0	-5.7	-4.5	-0.6	-3.3	-3.0	-5.7	-4.5

(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, Offshore Banking Units (OBUs) have been treated as a part of the domestic banking system.
(b) Provisional.
(c) US dollar values are converted into rupee values using end period exchange rates.
(d) Based on GDP at current market prices published by Department of Census and Statistics.

Source: Central Bank of Sri Lanka.

Table 5.2 Average Import Duty Collection Rate (a)

Item	2003	2004	2005	2006	2007(b)
Consumer goods	13.5	10.4	10.4	11.2	12.4
Food and beverages	14.2	8.5	9.6	10.7	13.5
Rice	29.3	4.9	10.6	23.4	3.1
Flour	11.5	7.2	3.8	33.7	31.9
Sugar	16.8	4.6	1.5	1.9	23.9
Wheat and meslin	0.0	0.1	1.1	5.6	6.3
Milk and milk products	12.2	7.9	10.2	9.6	7.7
Dried fish	10.8	5.9	5.9	5.0	2.9
Other fish products	7.9	10.0	9.8	7.8	4.9
Other	22.3	17.4	22.0	24.2	20.8
Non-food consumer goods	13.0	12.2	11.1	11.7	11.2
Motor cars & cycles	22.1	21.1	18.9	18.3	16.3
Radio receivers- television sets	8.9	9.4	13.6	7.1	7.7
Rubber tyres & tubes	26.0	25.8	26.2	19.2	22.4
Pharmaceutical products	0.6	0.6	0.5	0.3	0.4
Other	9.2	8.9	8.7	10.3	10.6
Intermediate goods	1.5	1.9	2.1	1.5	1.5
Fertiliser	2.6	3.1	2.7	2.5	2.7
Crude oil	0.0	0.0	0.0	0.0	0.0
Other petroleum products	0.8	0.9	1.9	2.3	1.6
Chemical elements and compounds	2.2	2.6	2.0	1.8	1.9
Dyeing , tanning and colouring	4.6	4.5	4.4	2.6	2.5
Paper and paper boards	5.4	6.0	6.0	2.4	2.2
Textiles	0.1	0.0	0.1	0.1	0.1
Other intermediate goods	3.3	4.3	4.5	3.3	3.3
Investment goods	7.2	6.1	5.8	5.2	4.8
Building materials	7.7	9.0	7.8	9.2	7.2
Transport equipment	12.9	11.9	9.7	7.0	7.1
Machinery and equipment	5.6	3.2	3.3	3.2	2.7
Other investment goods	4.6	5.0	5.3	3.4	4.2
Average Tariff	5.3	4.5	4.6	4.3	4.1

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

Sources : Sri Lanka Customs
Ceylon Petroleum Corporation
Prima Ceylon Limited

Asia-Pacific Trade Arrangement (APTA), the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMST-EC) and the Indian Ocean Rim Association for Regional Cooperation (IORARC), consistently supported further regional integration.

As per the road map of the Indo-Sri Lanka Free Trade Agreement (ISLFTA), following sequential liberalization, the extent of insulation for non-sensitive products has been gradually removed. Except for sensitive products, all other items from India will enter Sri Lankan markets duty free from the end of March 2008. Although Sri Lanka has been accorded such concessions far back in 2003, Sri Lanka still depends heavily on a few export items and lags in export diversification. Thus, stern efforts need to be taken by the exporters to exploit the benefits availed to them by this agreement, as India is a country with a rapidly growing economy. Negotiation under the Comprehensive Economic Partnership Agreement (CEPA) with India helped resolve some existing barriers to trade. One pillar of CEPA negotiations was for an expansion of trade in goods between the two countries. India agreed to remove port restrictions that limited imports of tea to come in only through two Indian ports, namely, Calcutta and Cochin. The removal will enable Sri Lankan exporters to utilise the Tariff Rate Quota (TRQ) of 12.5 million kg of tea under ISLFTA. India also agreed to provide a TRQ of 3 million pieces of garments without any condition on sourcing of fabrics and port restrictions, for which procedures for operationalisation has been completed.

Since the implementation of the Pakistan-Sri Lanka Free Trade Agreement (PSLFTA) in 2005, Sri Lanka's exports to Pakistan have increased by 27 per cent by 2007. By 2007 Sri Lanka's exports have been accorded 67 per cent tariff reduction whereas Pakistan has received 40 per cent tariff reduction for goods exported to Sri Lanka. The balance of trade continued to be in favour of Pakistan, as Sri Lanka's exports had not increased as expected. Although Sri Lanka's major export items such as apparel and tea are on the negative list, tariff rate quotas (TRQs) and higher margins of tariff preferences are available on these items. However, the performance of Sri Lanka's exports under the PSLFTA has been poor, mainly due to the low utilization of TRQs. Pakistan has granted TRQs for 10,000 metric tons of tea per annum at a zero rate of duty, 1,200 metric tons of betel leaves per annum at a preferential margin of 35 per cent and 3 million pieces of garments at a zero rate of duty. Both countries have agreed to expand the scope of the current agreement into a Comprehensive Economic Partnership Agreement (CEPA) by incorporating services, investment and customs cooperation, which would help both countries realise their trade and investment potential and further deepen bi-lateral relations.

Sri Lanka was able to create trade opportunities in the EU market due to increased market access under the Generalised System of Preferences (GSP+) scheme. With regard to apparel, benefits under the GSP+ scheme were instrumental in meeting the challenges in the international market and helped transform the industry from a contract manufacturer to a fully integrated service provider. As per the objectives of the GSP+ scheme, which promotes rapid industrialisation by developing backward integration and creating new industries, noticeable developments have taken place across many industries. In addition to the establishment of large scale knitted factories and ancillary product manufacturing units, the major exporters of apparel have continued to focus on capacity building of the apparel industry. By increasing their commitment to ethical and sustainable practices through maintaining a balance between profit and socio and environmental factors, major apparel exporters strove to become total solution providers to world class companies producing branded clothing.

Box 12 — Preferential Trade Access and its Implications

Preferential Trading Arrangements which lead to Free Trade Agreements (FTAs) are either bilateral, involving only two countries or multilateral, involving more than two countries but not the whole world. They usually intend to lower trade barriers among participating countries and, as a consequence, increase the degree of economic integration among the member countries. Typically, these trade agreements increase access to each member country's markets by reducing tariff for member countries in a mutually beneficial manner. FTAs create a level playing field in international trade among the members and encourage member governments to adopt open and transparent procedures for the benefit of all members equally. An FTA creates a win-win situation in an environment of mutually beneficial rule based system which does not deal only with trade but also with foreign direct investment, government procurement, etc. The straightforward economic gains and other spin-off benefits to be realised from the FTAs would expand across all sectors of the member countries.

A scheme like the Generalised System of Preferences (GSP+) which has immensely benefited exports originating from Sri Lanka is a non-reciprocal unilateral instrument of trade development offering preferential market access. Under GSP+ preferential access to EU countries, a concession was offered to countries like Sri Lanka in return for ratification and implementation of 27 international conventions on good governance, human rights, environment and labour standards. Unlike the other trade agreements, a non-reciprocal agreement does not provide direct benefits to the importing country, and in the case of GSP+, the EU, which includes 27 European countries. The GSP+ scheme is reviewed by the EU every three years and the current scheme is therefore to be reviewed in the second half of 2008. The continuation of non-reciprocal concessions beyond the initially offered period depends not only on the successful implementation and ratification of all the conventions, but also on socio-political and trade policies of the EU countries and, hence, there always exists a risk on the continuation of preferential concessions.

The economic gains that are realised from FTAs and the GSP+ scheme are short-term in nature. Non-reciprocal trade agreements may be terminated at any time by withdrawing preferential market access to exports from the beneficiary country. The gains from the other FTAs also may gradually diminish over time. The establishment of successful FTAs creates incentives for non-member countries either to seek membership of the existing FTAs or establish new FTAs. Therefore, more and more economies would seek FTAs particularly with large trading partners, and, hence, preferences in the existing FTAs would gradually be eroded.

Meanwhile, excessive reliance on short-term benefits from FTAs and the GSP+ scheme may have resulted in a mis-allocation of productive resources. The total resource allocations will therefore, be unproductive in the event of an erosion of preferences or a withdrawal of tariff and duty concessions already granted.

Therefore, advance strategic preparation by market players has become increasingly important to maintain the competitiveness and sustainability of the expansion into the overseas markets, while consolidating the gains in external markets availed by the short-term concessions of FTAs. The experience gained through the participation in the preferential trade agreements could be used to become globally competitive entities, through long term strategies, focusing on impending competitive markets without continuously depending on FTAs and non-reciprocal agreements like the GSP+ scheme.

The future of a country's foreign trade will always depend on its comparative advantage and, as focused in recent times, competitive advantages. In a modern world where Information and Communication Technology (ICT) has become of paramount importance, competitive advantage has now become a main determinant of foreign trade expansion. This requires local industries to raise productivity and efficiency in production so as to successfully compete with the rival producers in other parts of the world.

Bilateral relations between Iran and Sri Lanka made greater strides in 2007. The two countries stressed their determination to further promote mutual cooperation in economic, trade, cultural, scientific and technological fields. The recent negotiations resulted in the signing of several Memoranda of Understanding in relation to the Uma Oya Multipurpose Development Project, the Expansion of the Sapugaskanda Oil Refinery, Cooperation in Maritime Shipping, an agreement on Customs Cooperation and providing no interest credit terms (four months) for petroleum purchases. It was also agreed to promote tourism between the two countries.

Being a small country with limited domestic demand, the consequential low scale of production results in a higher cost of production relative to that of Sri Lanka's competitors. Therefore, as in the case of tea, the exporters need to pursue strategies to differentiate their products in terms of quality to gain an edge in international markets. Such differentiation, which requires value addition, would drive the process to create Sri Lankan brands and vice versa. Although supply chain issues drove prices up in 2007, Sri Lanka's tea was able to secure a premium price in the international market. However, to facilitate sustaining a better position in the international market, tea as well as other products require to be validated and certified for conformity of the different international standards. In its endeavour to carve out a niche position in the international market, the apparel industry has strategically launched the "garments without guilt"

Table 5.3 **Trade Indices (a)**

1997=100

Category	2006			2007(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	121.7	122.3	99.5	141.9	125.9	112.7	16.6	2.9	13.3
Tea 122.2	124.0	98.6	142.2	122.1	116.5	16.3	-1.5	18.2	
Rubber	118.4	77.0	153.8	139.0	85.8	162.1	17.5	11.5	5.4
Coconut	105.3	112.4	93.7	120.0	124.1	96.7	14.0	10.4	3.2
Other agricultural products	134.2	146.8	91.4	159.7	167.9	95.1	19.0	14.4	4.1
Industrial exports	156.1	150.3	104.0	172.0	163.0	105.5	10.0	8.4	1.4
Textiles and garments	135.2	141.2	95.7	146.6	150.8	97.2	8.5	6.8	1.6
Petroleum products	193.5	64.9	298.3	173.5	57.5	301.7	-10.4	-11.4	1.1
Other industrial exports	199.9	177.6	111.7	226.0	198.6	113.8	13.0	11.8	1.9
Mineral exports	134.2	120.7	126.5	144.6	132.7	109.0	7.7	10.0	-13.9
Gems	124.3	119.9	120.2	128.6	126.3	101.8	3.5	5.3	-15.3
Other mineral Exports	264.8	130.3	203.2	354.3	216.6	163.6	33.8	66.2	-19.5
Total Exports	148.1	143.3	103.3	166.5	153.8	108.3	12.5	7.3	4.8
IMPORTS									
Consumer goods	164.4	175.9	93.5	163.1	167.2	97.6	-0.8	-4.9	4.4
Food and beverages	118.0	108.7	108.5	129.4	116.8	110.8	9.7	7.5	2.1
Other consumer goods	231.8	273.5	84.8	212.1	240.4	88.2	-8.5	-12.1	4.1
Intermediate goods	190.4	146.2	130.2	208.5	147.5	141.4	9.5	0.8	8.6
Fertiliser	247.1	162.1	152.5	290.0	145.8	199.0	17.3	-10.1	30.5
Crude Oil	389.7	118.7	328.4	388.1	106.7	363.7	-0.4	-10.1	10.7
Other Petroleum	378.0	143.5	263.5	534.5	187.4	285.2	41.4	30.6	8.3
Chemical Elements and Compounds	191.8	144.2	133.0	206.9	154.4	134.0	7.9	7.1	0.7
Wheat and Meslin	144.1	152.1	94.8	169.8	120.6	140.7	17.8	-20.7	48.5
Textiles (Including Clothing)	111.5	133.7	83.4	117.7	138.7	84.8	5.6	3.7	1.7
Plastics	225.4	172.3	130.8	249.9	184.5	135.4	10.8	7.1	3.5
Diamonds	193.2	116.6	165.8	172.6	103.4	167.0	-10.7	-11.3	0.7
Other	205.0	202.7	101.1	197.4	195.9	100.8	-3.7	-3.3	-0.4
Investment goods	169.3	195.0	86.8	202.5	227.6	89.0	19.6	16.7	2.5
Building materials	201.0	197.3	101.9	287.2	259.9	110.5	42.8	31.7	8.5
Transport equipments	175.2	101.3	173.0	175.2	100.9	173.6	0.0	-0.3	0.3
Machinery and equipments	143.3	230.3	62.2	167.7	259.6	64.6	17.0	12.7	3.8
Other investment goods	261.8	123.4	212.3	285.2	166.6	171.2	8.9	35.0	-19.3
Total Imports	174.8	163.4	107.0	192.7	170.1	113.3	10.2	4.1	5.9
Terms of Trade			96.6			95.6			-1.0

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

Sources : Sri Lanka Customs
Central Bank of Sri Lanka

campaign on the basis of ethical manufacturing standards, which support rural employment and empowering women and prohibit child labour. Historically, Sri Lanka's strengths lay with its quality products such as genuine cinnamon, Ceylon sapphire, Ceylon tea, high quality copra and ceramic products. These industries were further supported in recent years by the infusion of technology and product development. Trade agreements have availed opportunities to exporters to export items duty free or at preferential tariff rates. However, it may be noted that the trading partners pursue trade arrangements with other countries too, giving tariff preferences, while also lowering the bound tariff levels in relation to WTO commitments. Therefore, it is imperative to expand markets and products in these preferential markets and consolidate the position through quality products before benefits and preferences erode.

The government has continued to facilitate trade through various forms of support. The BOI continued to function as the central facilitation point for investors. A large number of export processing zones with business-friendly regulations and attractive incentives such as full tax holidays (3 to 15 years), concessionary tax rates (after tax holidays), exemptions from exchange controls, duty free concessions for imports of capital goods and raw material and allowing repatriation of capital/dividends resulted in the BOI approved industries accounting for more than 65 per cent of total exports in recent years. Other major institutions involved in facilitating external trade were the Sri Lanka Export Development Board, the Sri Lanka Export Credit Insurance Corporation and the Sri Lanka Standards Institution.

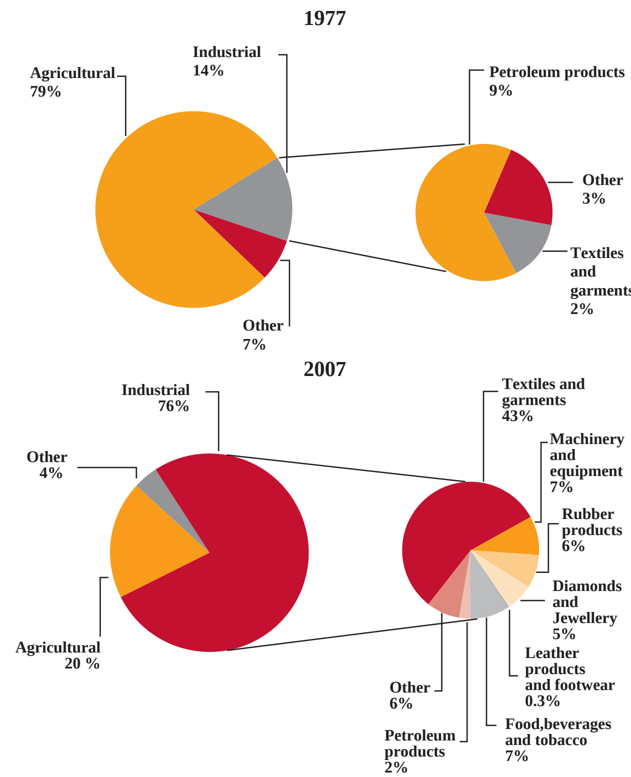
5.3 Trade in Goods, Trade Balance and Terms of Trade

Export Performance

Earnings from exports increased further in 2007, with increases in volumes as well as prices in respect of some key categories of exports. Initiatives taken by exporters to meet intensifying competition in international markets, trading arrangements between Sri Lanka and her key trading partners as well as the favourable performance of export destination countries in terms of economic growth, through much of 2007, helped raise earnings from industrial exports. Meanwhile, the unprecedented rise in petroleum prices in international markets indirectly had a favourable impact on Sri Lanka's key agricultural commodity exports, by raising demand for such exports. Consequently, export earnings in 2007 totalled US dollars 7,740 million, which is an impressive increase of 12.5 per cent, year-on-year, compared to the previous year.

Industrial exports expanded by 10.0 per cent in 2007, largely supported by a marked increase in the earnings from exports of garments and textiles.

Chart 5.3 Exports by Commodities



Exports of garments and textiles continue to be the largest source of foreign exchange earnings for Sri Lanka. Much of the increase in exports of garments and textiles could be attributed to the concessions received by Sri Lanka in respect of its exports to countries in the European Union under the Generalised System of Preferences (GSP+) scheme. The share of garments exported to the European Union further increased to 45 per cent in 2007, from 40 per cent and 36 per cent in 2006 and 2005, respectively. Nevertheless, the USA continued to be the largest single market for Sri Lanka's garment exports, accounting for nearly 50 per cent of the garment exports. Amongst the members of the European Union, the United Kingdom was the largest market for Sri Lanka's garment exports, accounting for 25 per cent of the total garment exports in 2007, followed by Italy and Germany, which accounted for 9 per cent and 5 per cent, respectively. These statistics highlight the very high degree of concentration of markets for garment exports and hence the sensitivity of the country's export performance to developments in a few industrialised countries. With respect to other sub-categories of industrial exports, food, beverages and tobacco, rubber products, diamonds and jewellery, and machinery and equipment were amongst those which recorded significant growth.

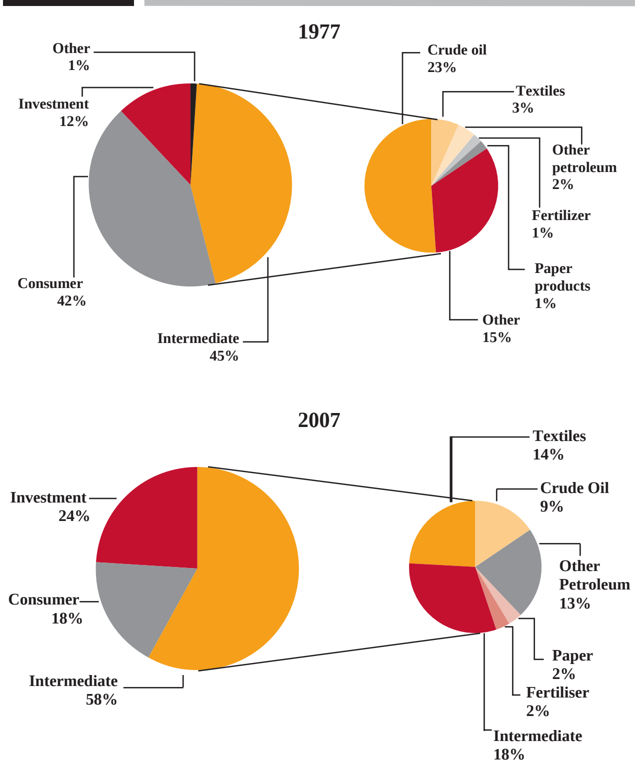
Table 5.4 **Composition of Exports**

Category	2006 Value US dollars million	2006 Share %	2007(a) Value US dollars million	2007(a) Share %	Change in Value(a) US dollars million	Growth rate(a) %	Contribution to growth(a) %
Agricultural exports	1,292.7	18.8	1,507.2	19.5	214.5	16.6	25.0
Tea	881.2	12.8	1,025.2	13.2	143.9	16.3	16.8
Rubber	93.1	1.4	109.4	1.4	16.3	17.5	1.9
Coconut	123.9	1.8	141.2	1.8	17.3	14.0	2.0
Kernel products	52.8	0.8	60.3	0.8	7.5	14.1	0.9
Other	71.0	1.0	80.9	1.0	9.9	13.9	1.1
Other agricultural products	194.6	2.8	231.5	3.0	37.0	19.0	4.3
Industrial exports	5,401.1	78.5	5,920.5	76.5	519.3	9.6	60.5
Food, beverages and tobacco	363.9	5.3	513.5	6.6	149.6	41.1	17.4
Textiles and garments	3,080.4	44.8	3,341.7	43.2	261.3	8.5	30.5
Petroleum products	188.4	2.7	168.9	2.2	-19.5	-10.4	-2.3
Rubber products	427.5	6.2	481.5	6.2	54.0	12.6	6.3
Ceramic products	47.4	0.7	47.1	0.6	-0.3	-0.7	0.0
Leather, travel goods and footwear	40.6	0.6	23.9	0.3	-16.7	-41.2	-2.0
Machinery and equipment	394.3	5.7	542.2	7.0	147.9	37.5	17.2
Diamonds and jewellery	327.0	4.8	368.0	4.8	41.0	12.5	4.8
Other industrial exports	531.7	7.7	433.9	5.6	-97.8	-18.4	-11.4
Mineral exports	119.9	1.7	129.2	1.7	9.2	7.7	1.1
Gems	103.2	1.5	106.8	1.4	3.6	3.5	0.4
Other mineral exports	16.7	0.2	22.4	0.3	5.6	33.8	0.7
Unclassified (b)	68.9	1.0	183.6	2.4	114.6	166.2	13.4
Total exports (c)	6,882.7	100.0	7,740.5	100.0	857.7	12.5	100.0
Annual average exchange rate	103.96		110.62				

(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 5.4 **Imports by Commodities**



The year 2007 was another favourable year for tea, the largest source of export earnings among agricultural commodities. For the first time in the history of tea exports in Sri Lanka, earnings crossed the US dollars 1 billion benchmark in 2007. It has taken nearly 17 years for tea exports to double its earnings. Although shocks such as labour union action directed at wage increases and delayed application of fertilizer due to drought and a sharp rise in the prices of fertilizer resulted in a drop in production, strong demand particularly for low grown tea from Middle Eastern and CIS countries, pushed the average price of tea exported from Sri Lanka further up. The Middle East and CIS countries, which constituted the largest markets for Sri Lanka's tea exports, accounted for about 24 per cent and 50 per cent, respectively, of the total tea exports in 2007. Their strong demand for the unique features of Ceylon tea is partly attributed to their rising incomes in line with rising oil prices. Increasing unionised action in the tea sector meanwhile remains an issue of concern, given that it can affect the long-run viability of companies producing tea as well as the competitiveness of tea exported from Sri Lanka in international markets. With respect to exports of other agricultural commodities, rubber exports further increased in 2007, responding to the rising trend in international prices of natural rubber, which in turn was a consequence of the increase in the price of synthetic rubber following the increase in petroleum prices. The export price of coconuts also increased in 2007, which could be attributed to the use of coconut oil for the production of bio-fuel internationally. However, the export of coconuts and coconut products was prohibited by law towards the end of 2007 as the domestic price of coconuts rose considerably. This contributed to a decline in exports of coconuts in 2007.

Import Performance

Expenditure on imports recorded relatively modest increases during much of the year 2007 mainly as a result of subdued increases in expenditure on consumer goods imports. However, by end 2007, expenditure on imports recorded an increase of 10.2 per cent, year-on-year, due to significant increases in expenditure on imports of investment goods and more notably, petroleum. Imports of petroleum contributed 40 per cent to the year-on-year increase in expenditure on imports in 2007, as a result of international petroleum prices rising to unprecedented levels towards the end of 2007. The monthly average imported price of crude oil increased from US dollars 59.85 a barrel in December 2006 to above US dollars 90 a barrel in December 2007. Fertiliser, textiles and clothing and chemicals were among the other intermediate goods, in respect of which import expenditure increased in 2007.

A positive development in respect of Sri Lanka's imports in 2007 was the 19.6 per cent growth in the cumulative expenditure on investment goods, which augurs well for future economic activity. The expansion of expenditure on imports of investment goods was underpinned by the accelerated development projects launched by the government and projects undertaken by the private sector, especially in the construction, telecommunication and information technology sectors. The expansion of expenditure on investment goods imports is expected to remain strong and will be a decisive factor in the outcome in the performance of imports in coming years.

The growth of expenditure on consumer goods in 2007 occurred mainly in respect of the food and beverages category. Representing as much as 50 per cent of the expenditure on consumer goods imports, expenditure on food and beverages increased by 11.4 per cent, mainly as a result of higher international prices of several key categories of food in 2007. Higher prices in the international commodity markets were driven by weather related set-backs, poor harvests and stocks in major producing countries and rising standards of living in many emerging countries. As the volume of imports declined, the growth of expenditure on wheat was entirely driven by higher prices. Meanwhile, a sharp increase was recorded in relation to imports of rice in 2007. This was a result

Table 5.5 **Composition of Imports**

Category	2006 Value US dollars million	2006 Share %	2007(a) Value US dollars million	2007(a) Share %	Change in Value (a) US dollars million	Growth rate(a) %	Contribution to growth(a) %
Consumer goods	1,980.2	19.3	2,001.8	17.7	21.6	1.1	2.1
Food and beverages	956.0	9.3	1,064.8	9.4	108.8	11.4	10.4
Rice	5.5	0.1	38.7	0.3	33.2	599.9	3.2
Sugar	223.7	2.2	154.1	1.4	-69.6	-31.1	-6.6
Wheat	198.6	1.9	233.9	2.1	35.3	17.8	3.4
Other	528.2	5.2	638.0	5.6	109.8	-12.4	10.5
Other consumer goods	1,024.2	10.0	937.1	8.3	-87.1	-8.5	-8.3
Intermediate goods	5,962.4	58.1	6,513.4	57.6	551.0	9.2	52.6
Petroleum	2,070.3	20.2	2,496.8	22.1	426.4	20.6	40.7
Fertiliser	164.1	1.6	192.5	1.7	28.5	17.3	2.7
Chemicals	260.8	2.5	281.4	2.5	20.6	7.9	2.0
Garments and Textiles	1,546.2	15.1	1,632.2	14.4	86.0	5.6	8.2
Other intermediate goods	1,921.0	18.7	1,910.5	16.9	-10.5	-0.5	-1.0
Investment goods	2,245.7	21.9	2,685.2	23.8	439.5	19.6	42.0
Machinery and equipment	1,065.4	10.5	1,246.7	11.0	181.3	17.0	17.3
Transport equipment	364.5	3.6	364.5	3.2	0.0	0.0	0.0
Building materials	546.2	5.3	780.3	6.9	234.1	42.9	22.4
Other investment goods	269.6	2.4	293.6	2.6	24.1	8.9	2.3
Unclassified imports	65.4	0.6	100.2	0.9	34.8	53.2	3.3
Total imports (b)	10,253.7	100.0	11,300.5	100	1,046.8	10.2	100.0
Annual average exchange rate	103.96		110.62				

(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	2003	2004	2005	2006(b)	2007(c)
Rice	35	222	52	12	88
1st Quarter	22	9	43	3	4
2nd Quarter	9	9	4	2	7
3rd Quarter	2	4	2	3	3
4th Quarter	2	200	3	4	74
Wheat	919	993	864	1,200	952
1st Quarter	262	257	272	287	204
2nd Quarter	232	218	191	321	388
3rd Quarter	217	189	174	331	274
4th Quarter	208	329	227	261	87
Sugar	509	438	418	525	481
1st Quarter	151	98	49	112	112
2nd Quarter	135	173	167	137	138
3rd Quarter	104	71	94	127	118
4th Quarter	119	96	108	149	113
Petroleum (Crude oil)	1,995	2,200	2,008	2,151	1,938
1st Quarter	382	586	586	592	272
2nd Quarter	466	464	581	535	557
3rd Quarter	500	634	246	582	559
4th Quarter	647	516	595	442	550
Refined Petroleum	1,168	1,645	1,823	1,763	2,297
1st Quarter	340	460	314	402	489
2nd Quarter	239	380	396	468	527
3rd Quarter	317	341	711	334	736
4th Quarter	272	464	402	559	545
Fertiliser	514	510	529	633	569
1st Quarter	124	54	168	166	62
2nd Quarter	166	164	111	203	171
3rd Quarter	49	76	142	119	132
4th Quarter	175	216	107	146	205

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

Sources: Sri Lanka Customs
Ceylon Petroleum Corporation
Prima Ceylon Limited

of a duty waiver being granted in respect of rice imports from mid-October to end-December 2007, as a temporary measure to curb the escalating rice prices in the domestic market. With respect to imports of consumer durable items, a decline was recorded in the expenditure on motor cars and cycles, which could be attributed to the higher effective rates of tariffs applicable to imports of motor vehicles in 2007.

The higher growth of exports compared to the growth of imports helped contain the expansion of the trade deficit in 2007. The trade deficit widened modestly by 5.6 per cent in 2007 compared to the 34.0 per cent expansion in 2006. The overall trade deficit widened to US dollars 3,560 million in 2007 from US dollars 3,371 million in 2006.

The terms of trade in 2007 posted yet another year of deterioration. Nevertheless, the favourable prices for agricultural products cushioned the adverse impact of such deterioration. The surge in oil prices coupled with supply tightness in the world food market indirectly had a favourable impact on Sri Lanka's key agricultural products. The monthly average price of tea exported from Sri Lanka rose to the highest ever recorded level of US dollars 3.78 per kilogram in December 2007. The average price of tea exported from Sri Lanka in 2007 was US dollars 3.28 per kilogram, compared to an average price of US dollars 2.69 per kilogram in 2006. Similarly, the average export price of rubber, which was US dollars 2.13 per kilogram in 2007, compared to the average price of US dollars 1.99 per kilogram in 2006, further increased towards the end of 2007. This was driven partly by the historical high oil prices and short term supply concerns. Given the pressure exerted by the rise in exports from China and other countries, prices of apparel remained subdued in 2007 and there seemed to be little prospect of any favourable increase in the near term. The export prices of coconut and other agricultural products such as cinnamon, pepper, cloves and tobacco also increased in 2007. With respect to imports, prices of cereals increased significantly in international markets during 2007 mainly due to drought related supply shortages in producer countries such as Australia. International prices of dairy products also increased consequently mainly as a result of higher animal feed costs, strong import demand from developing countries and supply tightness. Prices of both wheat and milk products reached unprecedented high levels in 2007. Likewise, prices of rice have also risen reflecting the tightening of market conditions in key exporting countries. In contrast to the developments discussed above, in 2007, international prices of sugar, which declined somewhat in the last quarter of 2006 following a gradual but notable increase since early 2004, were driven down further by surpluses in production.

As the Food and Agriculture Organisation (FAO) points out, while weather related factors, which have impacted on cereal and dairy product prices are only of significance in the short to medium-term, there are other factors that have contributed to these price increases, which are of significance in the long-term. Amongst these factors is the increasing use of cereals such as corn and maize as well as sugar and edible

Chart 5.5 Terms of Trade and the Export and Import Indices: Volume and Unit Value

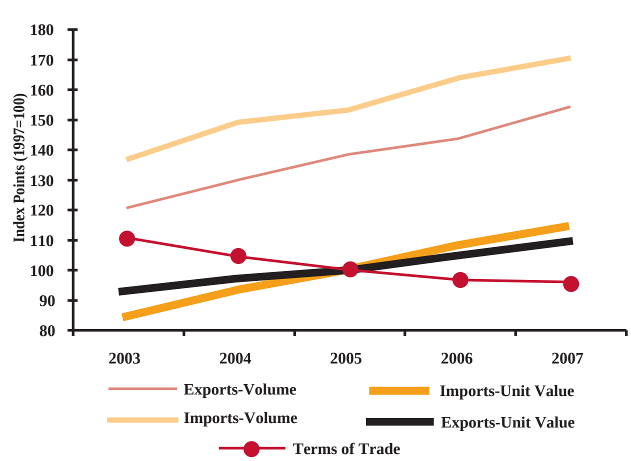
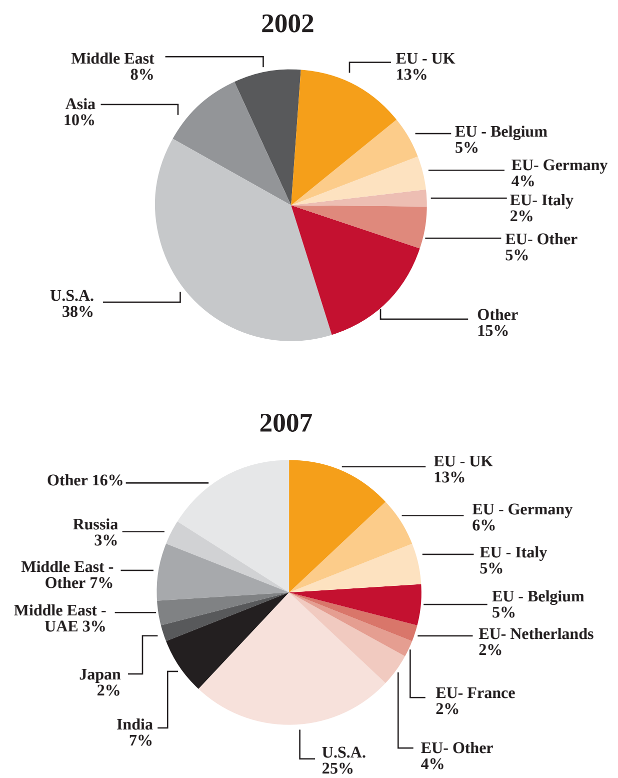


Chart 5.6 Exports by Destination



oils for bio-fuel production. Another important factor in relation to international food prices is the increasing demand for consumption by developing and emerging economies.

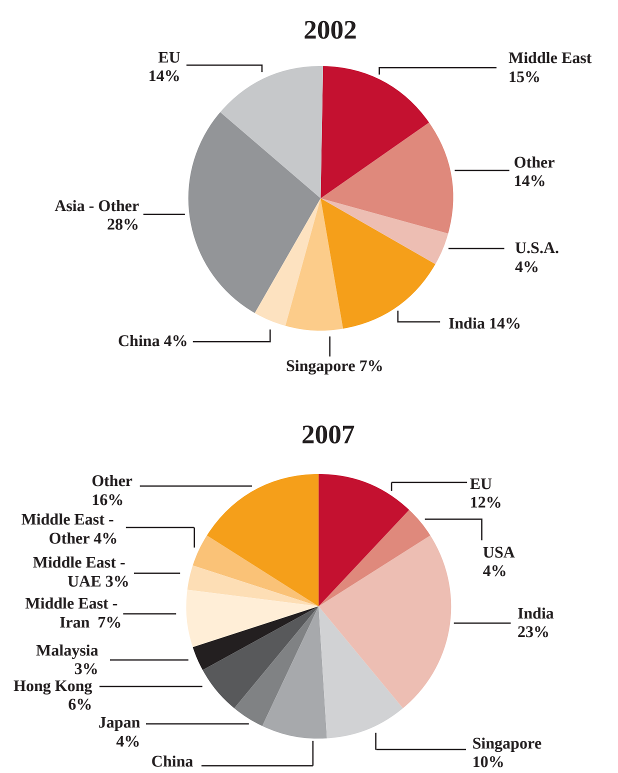
As a result of the developments discussed above, prices of exports grew by 4.2 per cent while import prices grew by 8.0 per cent in 2007. The terms of trade deteriorated marginally by 1.0 per cent in 2007, reflecting the higher growth in the unit value index of imports relative to the growth in the unit value index of exports.

Direction of Trade

The degree of concentration of Sri Lanka's export markets further declined in 2007, but a few Western countries, which account for more than 50 per cent of Sri Lanka's exports, still comprise the largest markets. Amongst these are the USA (25 per cent), the UK (13 per cent), Germany (6 per cent) and Italy (5 per cent), which are key markets for garments and textiles and Belgium (5 per cent), the largest market for processed diamonds exported from Sri Lanka. Although the share of exports to the USA declined further due to intense competition in the apparel market, the USA continued to be the most important market for Sri Lanka's exports. India, which has become an increasingly important market for Sri Lanka's exports following the implementation of the Indo-Sri Lanka Free Trade Agreement in 2000, accounted for 7 per cent of Sri Lanka's exports by end 2007. Exports to India are dominated by exports of vegetable oil, namely, vanaspathi, which accounted for about 20 per cent of Sri Lanka's exports to India in 2007. Russia and the UAE, key markets for tea exports, accounted for around 3 per cent each of the total exports and Iran, another major market for tea, accounted for 1.5 per cent of the total exports in 2007. France, Japan and the Netherlands accounted for about 2 per cent, each, of Sri Lanka's exports in 2007 while other countries accounted for 1 per cent or less of the total exports.

India continued to be the largest source of imports into Sri Lanka in 2007, while Asian countries continued to dominate Sri Lanka's imports. India's share in Sri Lanka's total imports further increased to 23 per cent in 2007, with Sri Lanka importing refined petroleum as well as several consumer durable items such as motor vehicles and a large number of commodities such as sugar, rice, onions and cement. Other Asian countries from which Sri Lanka sourced its imports were Singapore (10 per cent), China (8 per cent), Iran (7 per cent), Hong Kong (6 per cent), Japan (4 per cent), the UAE (3 per cent) and Malaysia (3 per cent). The USA accounted for 4

Chart 5.7 Imports by Origin



per cent of Sri Lanka's imports in 2007. While the above mentioned countries accounted for about 68 per cent of the expenditure on imports in 2007, other countries from which Sri Lanka sourced its imports accounted for 2 per cent or less of the total expenditure on imports.

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

Trade in Transportation Services

Gross inflows on account of transportation services consisting of freight charges, port related activities and passenger fares increased by 11.9 per cent to US dollars 840 million in 2007. This was mainly led by a substantial increase in port related activities resulting from a higher volume of cargo handling and increased earnings from passenger fares due to the expansion of flying destinations, flying hours and flying frequency by the Sri Lankan Airlines and the operations of the newly set up national budget carrier, Mihin Lanka. The suspension of the regular operations by a few foreign airlines for a certain period during the year due to security concerns created additional opportunities for national carriers to fly more passengers. Earnings from port related activities increased with the growth in container handling at the Colombo port, especially with a substantial growth in transshipment container handling, which grew by 10.6 per cent. The growth in transshipment container handling could be attributed to the continuing high economic growth, India's expanding international trade and the improvement in service delivery at the Colombo port. To sustain the growth in port related activities and to successfully meet the future challenges from competing ports in the region, it is vital to implement the identified port development projects such as the Colombo South Harbour project, without further delay. Any delay in the implementation of projects would not only lead to cost escalation but may also shift business from the Colombo port to other competing ports in the region thereby retarding the future earnings potential of the port related services. Meanwhile, outflows on account of transportation increased at a rate of 10.6 per cent, in line with a higher growth in imports and an increase in Sri Lankans travelling abroad for leisure, employment, education and healthcare purposes. The competitive air travel packages offered by several airlines to several regional countries have largely contributed to the increase in the outbound travelling.

Travel and Tourism

The year 2007 saw a set-back in tourism, with tourist arrivals declining by 11.7 per cent to 494,008 in 2007 from 559,603 in 2006. Travel advisories issued by major tourist originating countries including the UK, Germany, Australia, Italy and France were a deterrent to the progress of the tourism industry.

Table 5.7 Net Services, Income and Transfers (a)

Item	US dollars million 2006	US dollars million 2007 (b)	Rs. million 2006	Rs. million 2007 (b)
1. Transportation	211	243	21,885	26,863
2. Travel	37	-8	3,836	-851
3. Telecommunication Services	19	18	1,959	1,984
4. Computer and Information Services	98	110	10,188	12,169
5. Construction Services	24	27	2,456	3,015
6. Insurance Services	20	15	2,081	1,681
7. Other Business Services	-138	-153	-14,297	-17,029
8. Government Expenditure n.i.e.	-14	-14	-1,448	-1,531
Total Services	257	239	26,660	26,301
1. Compensation of Employees	-11	-11	-1,138	-1,240
2. Direct Investment	-360	-346	-37,413	-38,287
3 Interest and Other Charges	-18	-1	-1,873	485
Total Income	-389	-358	-40,424	-39,041
1. Private	1,904	2,214	197,861	245,006
2. General Government	101	97	10,524	10,677
Total Current Transfers	2,004	2,311	208,385	255,684

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

Source: Central Bank of Sri Lanka

These advisories together with the uncertain security situation were reflected in the decline in arrivals from all the major markets except the UK, the Maldives and Russia. As a result, earnings from tourism declined to US dollars 385 million in 2007 from US dollars 410 million in 2006. Nevertheless, several initiatives were taken in 2007. By way of relief measures taken to support the industry, the government approved the postponement of the US Dollars 10 visa fee imposed by the Budget 2006, the temporary deferment of VAT payable on tourism operations, the suspension of penalty on delayed VAT payments and the moratoria on capital payments. The most noteworthy development in 2007 was the promulgation of the Tourism Act No. 38 of 2005 with effect from 1st October 2007. With the implementation of the Act, Sri Lanka Tourism Development Authority, Sri Lanka Tourism Promotion Bureau, Sri Lanka Convention Bureau and Sri Lanka Institute of Tourism and Hotel Management came into existence, boosting the role of the private sector. The new Tourism Act will hopefully generate a more effective public-private partnership in the management and the control of the tourism industry. As the private sector is the major player in this sector, its contribution to the formulation of tourism policy and promotional activities in targeted foreign markets as well as domestic initiatives, is likely to be enhanced with a facilitative role being played by the government. With respect to the purpose of visit, of the total tourist arrivals in 2007, 67 per cent arrived for holiday

Table 5.8 **Tourism Performance**

Item	2003	2004	2005	2006(a)	2007(b)	Growth rate 2006(a)	Growth rate 2007(b)
Tourist arrivals	500,642	566,202	549,308	559,603	494,008	1.9	-11.7
Tourist guest nights ('000)	5,093	5,742	4,754	5,793	4,940	21.9	-14.7
Room occupancy rate (%)	53.2	59.3	45.4	47.8	46.2	5.3	-3.3
Gross tourist receipts (Rs. million)	32,810	42,059	36,377	42,586	42,571	17.1	0.0
Per capita tourist receipts (Rs.)	65,536	74,283	66,223	76,100	86,175	14.9	13.2
Total employment (no.)	112,226	129,038	125,004	133,558	145,239	6.8	8.7
Direct	46,761	53,766	52,085	55,649	60,516	6.8	8.7
Indirect	65,465	75,272	72,919	77,909	84,723	6.8	8.7

(a) Revised
(b) Provisional

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

purposes, 11 per cent for business purposes, 8 per cent were visiting friends and relatives, 3 per cent visited for religious and cultural purposes while 2 per cent had come for conventions and meetings.

Trade in Telecommunication and Information Technology Services

The net earnings from telecommunications decreased by 4.3 per cent in 2007. However, the increased utilisation of internet and email services, the increase in International Direct Dialling (IDD) connected phone lines, and the cheaper international call charges offered by both mobile and fixed line telecommunications operators due to the increased competition since the liberalisation of the international telecommunication gateway in 2003, have encouraged Sri Lankans to use more international telecommunication services. As a result, outflows on account of telecommunication services have continued to grow since 2003.

The earnings from exports of software, Information Technology (IT) enabled services such as Business Process Outsourcing (BPO), Knowledge Process Outsourcing (KPO) and other IT related services increased further in 2007. Relatively better IT infrastructure facilities, the availability of a skilled workforce, price competitiveness and reliable and efficient service delivery helped sustain the growth in this industry. During 2007, Sri Lankan companies operating in the IT and Telecommunications industry have performed well in providing software solutions to overseas countries, especially in the Middle East and Eastern Africa. Sri Lanka possesses a comparative advantage in promoting the BPO and KPO due to availability of qualified professionals in fields such as accountancy and law. Further, Sri Lanka has the capacity to yield more benefits from BPO and KPO industries through specialisation and creating a more conducive environment for operating by further improving the IT infrastructure by creating a dedicated IT zone.

Inflows and Outflows of Income

Gross inflows to the income account increased significantly by around 44 per cent to US dollars 449 million, mainly due to the increased income from investment of official external reserves of the country, which helped contain the widening deficit in the income account in 2007. The interest income from investment of official reserves increased by 44 per cent to US dollars 105 million in 2007, mainly due to the higher global interest rates and further accumulation of official reserves during 2007. In addition, the higher depreciation of the US dollar against other major currencies such as the euro, the sterling pound and the Japanese yen in 2007, resulted in a significant gain in the values of the external reserves valued on the basis of marked to market in US dollar terms. Earnings from the foreign financial assets of the private sector including commercial banks also increased due to the higher global interest rates that prevailed in 2007. Meanwhile, outflows in the income account also increased by around 15 per cent to US dollars 807 million as a result of increased interest payments on external debt during the year due to higher debt accumulation in the past, and settlement of interest deferred under the Tsunami based debt moratorium in 2005. Repatriation of profits and dividends of the foreign direct investment enterprises by foreign investors, which includes offsetting entry for reinvestment of retained earnings by those investors for the expansion of existing operations of the foreign direct investment enterprises, also increased substantially.

Current Transfers

Worker remittances, which grew at a higher rate for the third consecutive year, reached US dollars 2,502 million in 2007. This increase was attributable mainly to the increase in the number of migrant workers leaving for foreign employment by 8 per cent to 217,306 in 2007, the increase in the average wages of migrants in the Middle Eastern region due to the rise in income level of oil producing countries such as Saudi Arabia, United Arab Emirates, Kuwait and Qatar, and increased migration to high wage countries such as Korea, Malaysia and Singapore. The new measures taken by commercial banks on the initiatives of the Central Bank to mobilise more remittances through creation of more awareness among migrant workers on the benefits of transferring money through banking channels and posting additional bank officers in several major labour hiring countries to mobilise remittances also helped to increase the remittances in 2007. The enhanced worker remittances are estimated to have financed about 70 per cent of the trade deficit in 2007.

Current Account Balance

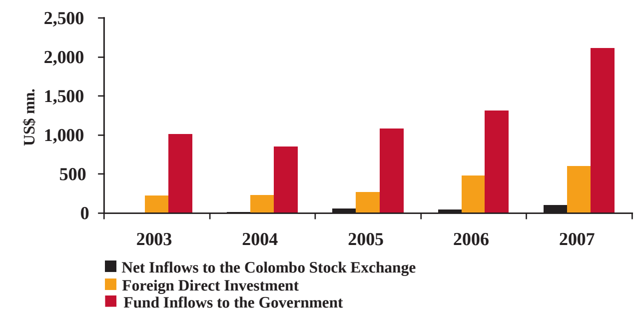
The current account deficit narrowed marginally to US dollars 1,369 million in 2007 from US dollars 1,499 million in 2006. In terms of GDP, it improved to 4.2 per cent of GDP in 2007 from 5.3 per cent of GDP in 2006. The increased worker remittances helped to contain the widening current account deficit and cushion the adverse impact of higher international commodity prices on the current account and exchange rates. The high current account deficit reflects the high savings-investment gap of the country, highlighting the need for attracting more foreign capital to meet the necessary investment expenditure, which is required to achieve an economic growth rate of 7-8 per cent.

5.5 Capital and Financial Flows, and Balance of Payments

Foreign Direct Investment (FDI)

In 2007, the FDI inflows surpassed the previous peak level recorded in 2006 reflecting the continuous investor confidence on the Sri Lankan economy and the prevailing investor friendly investment regime in the country. The gross FDI inflows including the foreign loans obtained by the BOI approved companies reached a record level of US dollars 734 million in 2007 from US dollars 604 million in 2006, mainly due to a sharp increase in reinvestment of retained earnings by existing BOI companies, especially of those engaged in the services sector. The BOI's initiatives under the Nipayum Centre programme to promote investment in less developed regions has also contributed to the higher investment flows in 2007. The FDI inflows in 2007 consist of equity capital of US dollars 221 million, loans and advances of US dollars 96 million by the shareholders, intra-company

Chart 5.8 Major Inflows to the Financial Account



borrowings of US dollars 63 million, foreign loans of US dollars 131 million and the reinvestment of retained earnings of US dollars 223 million by the existing companies. Meanwhile, FDI outflows increased to US dollars 55 million in 2007 from US dollars 30 million in 2006 as several local companies were permitted to invest abroad during the year. To encourage more foreign investment in the country, it is necessary to develop basic infrastructure such as roads, highways and power supply to international standards and promote more Public-Private Partnership (PPPs) arrangements in major infrastructure projects that are currently undertaken solely by the government with borrowed funds. It is also necessary to create an enabling business environment that ensure property rights, faster allocation of lands for new investments, sound and fast dispute settlement and greater labour mobility to achieve higher levels of FDI.

Foreign Capital to the Government

Medium and Long Term

Foreign inflows to the government consisting of both loans and grants increased substantially in 2007 with the successful launch of the debut sovereign bond issue. The government successfully mobilised US dollars 500 million from the international capital markets with investors in all regions showing a keen interest in Sri Lanka's debut sovereign bonds amidst sub-prime issues adversely affecting international capital markets. As a result, the government was able to mobilise a record US dollars 1.6 billion worth of loans and grants during 2007 as compared to US dollars 1.2 billion in 2006. During the year, total long-term and medium-term loan inflows to the government including the sovereign bond proceeds increased to US dollars 1,290 million compared to US dollars 932 million in 2006. Of the total loan receipts in 2007, 51 per cent was received on concessional terms and the balance 49 per cent on commercial terms and conditions. This resulted in a drop in concessional loan inflows by around 6.2 per cent to US dollars 660 million. Though the proceeds of the bonds could be used for the acceleration of project implementation it would be

Table 5.9 Major Projects Financed with Foreign Borrowing during 2007

Lender	Project	Amount Disbursed US dollars million
Asian Development Bank		134.6
of which;	Sourthern Transport Development Project	19.1
	Road Network Improvement Project	16.2
	Power Sector Development Project	13.1
	Road Sector Development Project	12.2
	Secondary Towns and Rural Community Water/Sanitation	10.2
International Development Association		74.2
of which;	Road Sector Assistance Project	18.9
	North East Housing Reconstruction Project	17.9
	Renewable Energy for Rural Economic Development Project	9.8
Government of Japan		197.0
of which;	Southern Highway Construction Project	32.0
	Upper Kotmale Hydro Power Project	21.3
	Small and Micro Industries Leader and Entrepreneur Promotion (SMI LE iii)	19.5
	Sri Lanka Tsunami Affected Area Recovery and Take off (STAART) Project	15.3
	Pro-Poor Rural Development Project	15.0
	Walawe Left Bank Irrigation and Extension Project II	13.5
	Small-Scale Infrastructure Rehabilitation and Upgrading (SIRUP ii)	11.0
	Environmentally Friendly Solution Fund II	10.7
	Kalu Ganga Water Supply Project for Greater Colombo	10.3
	Provincial Road Improvement Project	9.8
Government of The People's Republic of China		175.4
of which;	Norachcholai Power Plant	142.8
	Supply of 100 Nos . Railway Passenger Carriages	12.5
European Investment Bank		42.9
	Post-Tsunami Line of Credit - Contract A	28.9
	DFCC Global Loan II	13.9
Government of Denmark		20.8
of which;	Colombo Sewerage Rehabilitation Project	11.4

Sources: Central Bank of Sri Lanka
External Resources Department

more advantageous to fund large infrastructure projects under the Public-Private Partnerships (PPPs) with foreign/local investment as debt flows increases the future debt burden of the government. The total grants, both of a current and capital nature, decreased to US dollars 277 million in 2007 from US dollars 287 million in 2006. During 2006, the government had received substantial amount of grants for the reconstruction of infrastructure damaged by the Tsunami in 2004. The foreign aid utilization rate decreased marginally in 2007 to 21.2 per cent from 22.5 per cent in 2006 despite the faster implementation of major projects that were funded by the development partners. This was largely due to substantial increase in new aid commitments received by the government for new projects during the year, which will be disbursed in the next few years. Meanwhile, loan repayments by the government increased by 40 per cent to US dollars 618 million in 2007 mainly due to the repayment of two installments of the debt deferred in 2005 as a result of the tsunami by Paris club members, which has to be settled in seven installments. The first such installment was made in 2006.

Short-Term

Short-term net inflows by way of subscriptions to the government Treasury bonds by foreigners amounted to US dollars 373 million in 2007. For the first time, the government permitted foreigners to invest up to a maximum of 5 per cent of the value of outstanding Treasury bonds effective from 1 November 2006 and the limit was further enhanced to up to 10 per cent in December 2007. Although these bonds have longer maturity periods, the inflows are classified as short-term capital as there is no any mandatory minimum holding requirements on these bonds and the investors are free to liquidate and repatriate their investment at any time. In order to mitigate volatility in the foreign exchange market arising from any sudden outflows of funds invested in Treasury bonds, the Central Bank has created a special reserve, in US dollars, and is committed to supply foreign exchange that may be demanded by the foreign bond holders to repatriate the proceeds of the bonds.

Loan Capital to the Private Sector and Public Corporations

Foreign loan inflows to the private sector and public corporations increased in 2007. Long-term loan inflows to the private sector and public corporations increased by 43 per cent to US dollars 199 million in 2007 mainly due to increased borrowing by the private sector, specially by the BOI enterprises. Several private sector enterprises, especially in tele-communications and finance sectors obtained foreign loans to finance the expansion of their businesses as the domestic interest rates were relatively high in 2007. There was no loan inflow to the public corporations during the year as the government has been cautious in guaranteeing foreign loans to public corporations. However, the government now encourages the private sector to raise capital from the international capital market for their investment needs. In this context, it is encouraging that the budget 2008 announced that the restrictions on external borrowings by the private sector will be reduced in 2008.

Short-Term Capital to Private Sector

Total net short-term capital inflows amounted to US dollars 206 million in 2007, compared to US dollars 610 million recorded in 2006, largely due to the lower domestic foreign currency borrowings by the government from the banking system. On a net basis, the government has borrowed US dollars 200 million from the banking system in 2007 as compared to US dollars 394 million in 2006. Meanwhile, the net portfolio investment inflows to the share market reached US dollars 101 million in 2007 as compared to US dollars 51 million in 2006. The Colombo Stock Exchange continues to remain one of the best performing markets in Asia, attracting a gross inflow of US dollars 423 million in 2007. Net foreign assets of commercial banks increased by US dollars 280 million in 2007 due to the investment of increased foreign currency deposits abroad. Meanwhile, net liabilities of commercial banks increased by US dollars 364 million in 2007 due to a few commercial banks resorting to overseas borrowings during the year and increase in foreign currency deposits.

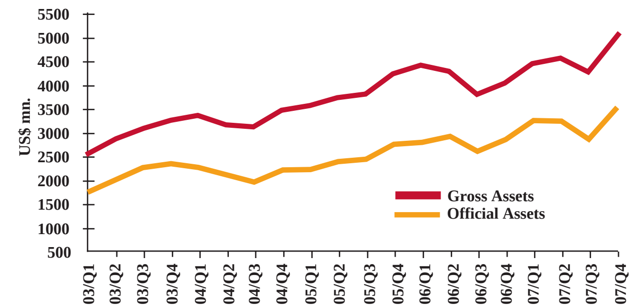
Balance of Payments and External Reserves

As net inflows to the capital and financial account were more than sufficient to offset the widened current account deficit, the BOP recorded a surplus for the third consecutive year. The BOP surplus amounted to US dollars 531 million in 2007, compared to the surplus of US dollars 204 million in 2006. The inflow of US dollars 500 million from the issuance of sovereign international bonds mainly contributed to this higher surplus.

External Reserves

The BOP surplus further strengthened the gross official reserves in 2007. The gross official reserves, excluding ACU receipts, increased to US dollars 3,063 million in 2007. Despite the higher import expenditure resulting from increased international prices of crude oil and essential commodities, reserves increased to 3.3 months of imports in 2007 compared to 3.0 months of imports in 2006. However, the reserve adequacy as measured by the ratio of gross official reserves to short term debt and liabilities declined to 77 per cent in 2007 from 82 per cent in 2006, mainly due to the significant increase in short term debt and liabilities. Meanwhile, the total external reserves of the country, excluding ACU receipts increased to US dollars 4,511 million from US dollars 3,694 million due to commercial banks building up their foreign assets with a substantial increase in foreign currency deposits.

Chart 5.9 Quarterly External Assets



5.6 External Debt and Debt Service

External Debt

The total external debt of the country as a percentage of GDP increased marginally in 2007 after declining for three consecutive years. As a percentage of GDP, the total external debt increased to 44.1 per cent in 2007 from 43.2 per cent in 2006. In US dollar terms, the total external debt increased by around 17 per cent to US dollars 14,252 million in 2007. The sharp increase in external debt, in US dollar terms, was partly attributed to the weakening of the US dollar against other major currencies. Of the total external debt outstanding, 38.6 per cent was denominated in SDR, 25.7 per cent in Japanese yen and 21.3 per cent

Table 5.10 External Assets of Sri Lanka (a)

Ownership	US dollars million (b)					Rs. million				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
1. Government	55	95	131	128	99	5,320	9,897	13,417	13,789	10,768
2. Government Agencies	-	-	-	-	-	-	-	-	-	-
3. Central Bank	2,274	2,101	2,604	2,709	3,409	219,984	219,795	265,873	291,747	370,640
4. Total Official Assets	2,329	2,196	2,735	2,837	3,508	225,304	229,693	279,290	305,536	381,408
5. Commercial Banks	889	1,243	1,466	1,169	1,448	86,011	129,987	149,656	125,867	157,454
6. Total External Assets	3,218	3,438	4,201	4,005	4,956	311,315	359,680	428,946	431,403	538,862
7 Gross Official Assets in Months of										
7.1 Merchandise Imports	4.2	3.3	3.7	3.3	3.7					
7.2 Import of Goods and Services	3.6	2.9	3.3	2.9	3.3					
8 Total Assets in Months of										
8.1 Merchandise Imports	5.8	5.2	5.7	4.7	5.3					
8.2 Import of Goods and Services	5.0	4.5	5.0	4.1	4.7					

(a) Calculated at market value and include Asian Clearing Union (ACU) receipts.
(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	2003	2004	2005	2006	2007
Rs. per US dollar (year end)	96.74	104.61	102.12	107.71	108.72

Source: Central Bank of Sri Lanka

Table 5.11 Outstanding External Debt and Banking Sector External Liabilities

Item	US dollars million					Rs. million				
	2003	2004	2005	2006	2007(a)	2003	2004	2005	2006	2007(a)
1. Medium and Long-term Debt	10,116	10,699	10,690	11,580	13,142	978,556	1,119,155	1,091,644	1,247,250	1,429,212
1.1 Government	8,812	9,523	9,354	10,478	12,005	852,433	996,203	955,207	1,128,493	1,305,225
1.2 Public Corporations and Private Sector with Government Guarantee	602	507	567	465	345	58,251	52,986	57,912	50,065	37,501
1.3 Public Corporations and Private Sector without Government Guarantee	334	411	388	393	539	32,319	42,944	39,588	42,376	58,553
1.4 IMF Drawings	368	258	381	244	253	35,552	27,023	38,937	26,316	27,933
2. Short-term Debt	620	647	664	634	1,111	59,935	67,726	67,759	68,286	120,748
2.1 Government (b)	-	-	-	-	457	-	-	-	-	49,641
2.2 Other(CPC and other trade credit) (c)	620	647	664	634	654	59,935	67,726	67,759	68,286	71,107
3. Banking Sector External Liabilities (d)	1,046	1,429	1,666	1,994	2,493	101,149	149,492	170,170	214,802	271,063
3.1 Central Bank	0	1	1	3	2	32	128	131	284	219
3.2 Commercial Banks	863	1,066	1,388	1,681	2,046	83,514	111,464	141,753	181,040	222,389
3.3 ACU Liabilities	182	362	277	311	446	17,604	37,899	28,286	33,478	48,454
4. Total External Debt (1+2)	10,735	11,346	11,354	12,214	14,252	1,038,491	1,186,881	1,159,403	1,315,536	1,549,960
5. Total External Debt and Liabilities (1+2+3)	11,781	12,775	13,020	14,209	16,745	1,139,640	1,336,373	1,329,573	1,530,338	1,821,023
MEMORANDUM ITEMS										
Medium and Long-term Debt										
(1) Project Loans	6,961	7,702	7,416	8,071	8,996	673,432	805,646	757,262	869,336	978,027
(2) Non-Project Loans	1,726	1,763	1,655	1,959	2,331	167,007	184,467	169,038	210,986	253,413
(3) Suppliers' Credits	218	240	283	355	679	21,048	25,123	28,907	38,242	73,785
(4) IMF Drawings	368	258	381	244	253	35,552	27,023	38,937	26,316	27,933
(5) Other Loans (e)	843	735	955	870	884	81,516	76,896	97,500	93,735	96,054
Short-term Debt and Banking Sector Liabilities	1,665	2,077	2,330	2,628	3,604	161,084	217,217	237,929	283,088	391,811
As a percentage of GDP (f)										
Total External Debt	56.9	54.9	46.5	43.2	44.1	57.0	56.8	47.3	44.8	43.3
Total Banking Sector External Liabilities	5.5	6.9	6.8	7.1	7.7	5.6	7.1	6.9	7.3	7.6
Total External Debt and Liabilities	62.4	61.8	53.3	50.3	51.8	62.5	63.9	54.2	52.1	50.9
Short-term Debt	3.3	3.1	2.7	2.2	3.4	3.3	3.2	2.8	2.3	3.4
Short-term Debt and Banking Sector External Liabilities	8.8	10.0	9.5	9.3	11.1	8.8	10.4	9.7	9.6	10.9
As a percentage of Total Debt and Liabilities										
Short-term Debt	5.3	5.1	5.1	4.5	6.6	5.3	5.1	5.1	4.5	6.6
Short-term liabilities	8.9	11.2	12.8	14.0	14.9	8.9	11.2	12.8	14.0	14.9
Short-term Debt as a percentage of Official Reserves	26.6	29.5	24.3	22.4	31.7	26.6	29.5	24.3	24.4	31.7

(a) Provisional
(b) Includes outstanding Treasury Bonds issued to non-residents.
(c) Includes acceptance credits of Ceylon Petroleum Corporation and other trade credits.
(d) ACU debits and foreign liabilities of commercial bank including those of OBUs
(e) Includes long term loans of public corporations and private sector institutions.
(f) Based on GDP at current market prices published by Department of Census and Statistics.

Sources: Central Bank of Sri Lanka. External Resources Dept.

in US dollars. Accordingly, the debt denominated in US dollars has increased in 2007 with the foreign investment in Treasury bonds and issuance of dollar denominated international bonds. The total external debt and liabilities, which consist of ACU liabilities and commercial banks' liabilities, also increased as a percent of GDP in 2007 to 51.8 per cent from 50.3 per cent in 2006. The banking sector's external liabilities increased significantly by over 25 per cent to US dollars 2,493 million by end 2007 as foreign liabilities of commercial banks increased during the year due to increases in foreign currency deposits as well as loans obtained by a few commercial banks abroad.

The government continues to account for the major share of external debt. Of the total medium and long-term debt, the government debt accounts for as much as 91 per cent, with the remaining 9 per cent representing borrowings of both the private sector and public corporations and debt obligations to the IMF. Of the government's external debt stock, concessional debt accounts for about 86 per cent. However, with

Chart 5.10 External Debt

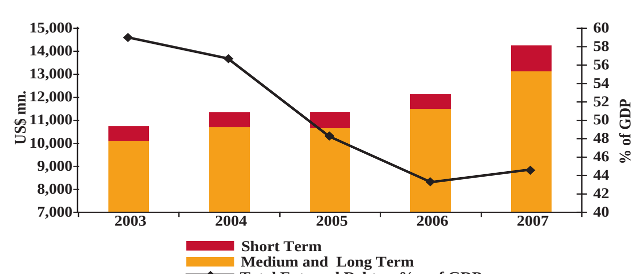


Table 5.12 **External Debt Service Payments**

Item	US dollars million					Rs. million				
	2003	2004	2005	2006	2007 (a)	2003	2004	2005	2006	2007 (a)
1. Debt Service Payments	761	843	623	1,080	1,232	73,125	85,318	62,577	112,670	136,508
1.1 Amortization	526	594	419	759	791	50,502	59,990	42,075	79,227	87,731
(i) To IMF	32	107	39	144	5	2,869	10,718	3,902	15,276	789
(ii) To Others	493	487	380	615	786	47,632	49,272	38,173	63,952	86,942
1.2 Interest Payments	235	249	204	321	441	22,623	25,328	20,502	33,443	48,777
(i) To IMF	4	10	10	14	14	414	988	973	1,452	1,509
(ii) To Others	230	240	194	307	427	22,209	24,340	19,530	31,991	47,268
2. Earnings From Merchandise Exports and Services	6,544	7,284	7,887	8,508	9,452	631,549	738,714	793,153	885,380	1,046,074
3. Receipts From Merchandise Exports, Services, Income and Private Transfers	8,127	9,004	9,891	10,980	12,403	784,408	912,817	994,751	1,142,515	1,373,101
4. Debt Service Ratio (b)										
4.1 As a percentage of 2 above										
(i) Overall Ratio	11.6	11.6	7.9	12.7	13.0	11.6	11.5	7.9	12.7	13.0
(ii) Excluding IMF Transactions	11.1	10.0	7.3	10.8	12.8	11.1	10.0	7.3	10.8	12.8
4.2 As a percentage of 3 above										
(i) Overall Ratio	9.4	9.4	6.3	9.8	9.9	9.3	9.3	6.3	9.9	9.9
(ii) Excluding IMF Transactions	8.9	8.1	5.8	8.4	9.8	8.9	8.1	5.8	8.4	9.8
5. Government Debt Service Payments										
5.1 Government Debt Service Payments (c)	502	484	268	442	467	48,452	48,952	26,927	45,996	51,694
5.2 As a percentage of 1 above	66.0	57.4	43.0	41.0	37.9	66.3	57.4	43.0	40.8	37.9

(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.

the country ascending to the middle income status, access to some of the concessional loan facilities from multilateral financial institutions is likely to wane in the medium-term. As a result, the government's non-concessional debt stock may increase in the medium-term. However, the government could maintain the non-concessional debt stock at a manageable level by encouraging both domestic and foreign investors to undertake major infrastructure projects, perhaps in partnership with the government. In this regard, it is necessary to encourage the private sector, especially the financially sound private sector enterprises to raise medium and long-term external loans from the international markets and multilateral financial institutions to finance such infrastructure projects and their own operations. This would release domestic financial resources to private sector enterprises that are not capable of raising external debt.

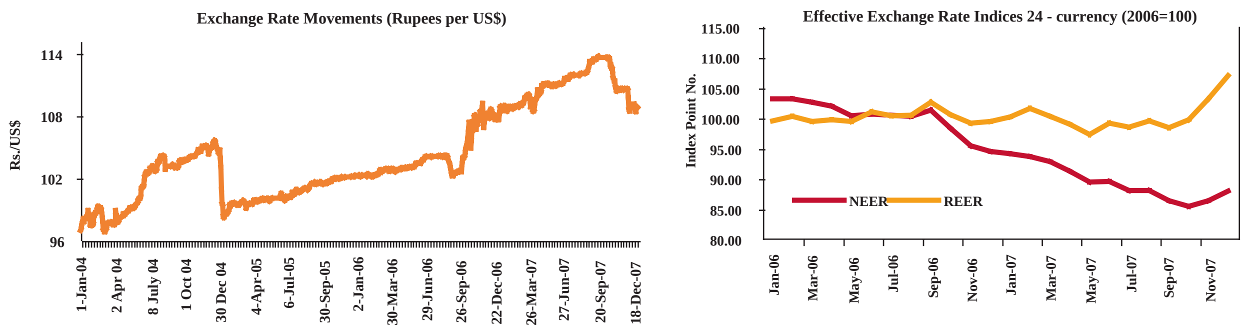
Foreign Debt Service Payments

The total debt service payments, consisting of both amortisation and interest payments on all foreign debt increased by 14.1 per cent in US dollar terms but remained around 13 per cent as a ratio of earnings from merchandise exports and services. The continuation of scheduled debt repayments since 2006 after a one-off reduction due to the Tsunami based debt moratorium in 2005, the increase in defence loan repayments, increasing debt servicing costs of government's commercial borrowings, and the weakening of the US dollar against major currencies had contributed to the increase in Sri Lanka's external debt service payments in US dollar terms, during 2007. The debt service ratios, which measure the country's capacity to service its external debt still remains at comfortable levels mainly due to the large stock of concessional debt of the government with long repayment periods and continuous growth in earnings from exports of goods and services.

5.7 Exchange Rate Regime and Exchange Rate Movements

Under the floating exchange rate regime, the Sri Lankan rupee no longer depreciates at a steady pace against major currencies, but responds to market forces of supply and demand in determining the exchange rate with limited intervention by the Central Bank to mitigate excessive volatility in the market. The rupee, which had been depreciating at a higher rate of around 5 per cent against the US dollar by October, reversed its depreciating trend with the inflow of proceeds from the international bond issue in October. The appreciating trend was further strengthened with the announcement of an increase in foreign ownership of Treasury bonds in December 2007 from up to 5 per cent to 10 per cent of the total outstanding Treasury bonds, and the weakening of the US dollar against major currencies. As a result, by end 2007 the depreciation of the rupee against the US dollar moderated to around 0.93 per cent as compared to a

Chart 5.11 **Exchange Rate Movements**



depreciation of around 5.2 per cent in 2006. The rupee depreciated moderately against the sterling pound (2.7 per cent) and the Japanese yen (5.6 per cent) while it depreciated at a higher rate against the Indian rupee (11.9 per cent) and the euro (10.9 per cent).

Nominal and Real Effective Exchange Rates

During 2007, the Nominal Effective Exchange Rate (NEER) depreciated at a lower rate than in 2006 while the Real Effective Exchange Rate (REER) continued to appreciate. Reflecting a moderate nominal depreciation of the Sri Lanka rupee against most major currencies in currency baskets, the NEER of the Sri Lanka rupee, based on both, the 5 currency and the 24 currency baskets, depreciated at a lower rate as compared to a higher rate in 2006. Meanwhile, the REER, which takes into account the inflation differentials amongst countries in addition to the variations in nominal exchange rates, further appreciated during 2007, indicating a deterioration in the competitiveness of Sri Lanka's exports in terms of inflation differential. This could be attributed to the relatively higher domestic inflation compared to those of the trading partner and competitor countries and the lower nominal depreciation of the rupee in 2007.

Developments in the Domestic Foreign Exchange Market

Despite the higher growth in international trade, worker remittances and FDI, and foreign inflows on account of Treasury bonds, the level of activity in the inter-bank foreign exchange market declined in 2007. Market activity remained low during the first three quarters of the year largely due to the

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	
	2005	2006	2007	2005	2006	2007	2006	2007	2006	2007
Euro	120.96	141.58	160.27	125.10	130.63	151.63	-14.56	-11.66	-4.24	-13.85
Indian Rupee	2.27	2.44	2.77	2.28	2.30	2.69	-7.19	-11.83	-0.86	-14.42
Japanese Yen	0.87	0.91	0.97	0.91	0.89	0.94	-4.30	-6.83	2.26	-4.96
Pound Sterling	175.94	211.29	217.15	182.87	191.53	221.46	-16.73	-2.70	-4.52	-13.51
US Dollar	102.12	107.71	108.72	100.50	103.96	110.62	-5.19	-0.93	-3.33	-6.02
SDR	145.95	162.03	171.57	148.45	153.00	169.37	-9.92	-5.56	-2.97	-9.66
Effective Exchange Rate Indicies (b) & (c) (2006=100)	Monthly Index						Percentage Change Over Previous Year (a)			
							Point to Point		Annual Average	
	Dec. 2005	Dec. 2006	Dec. 2007	2005	2006	2007	2006	2007	2006	2007
NEER - 24 currencies	104.77	94.35	87.79	104.06	100.00	89.23	-9.95	-6.95	-3.86	-10.81
REER - 24 currencies	100.15	99.26	106.84	97.66	100.00	100.17	-0.89	7.64	2.40	0.17

(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 trade shares reflecting the relative importance of each currency in each of the currency baskets. 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.

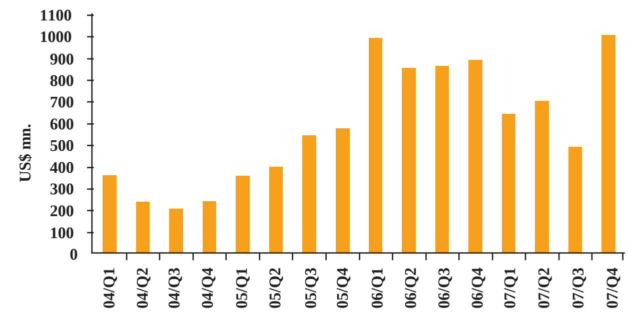
(c) CCPI(N) was used for REER computation.

Source: Central Bank of Sri Lanka.

expectations of a sharper depreciation of the rupee by foreign exchange earners and foreign exchange dealers. However, during the last quarter of 2007, the level of activity in the foreign exchange market picked up substantially with the successful completion of the debut international bond issue and the resultant reversal in the depreciating trend. Foreign exchange forward market transactions followed a declining trend with respect to the level of activity in the foreign exchange market during first three quarters and regained momentum in the fourth quarter of 2007.

The Central Bank participated in the domestic foreign exchange market throughout 2007, to smoothen out excessive volatility in the foreign exchange market and to build up official reserves. During the year, the Central Bank intervened on both sides of the market, which helped prevent erratic movements in the exchange rates. The Central Bank absorbed a total of US dollars 593 million from the inter-bank market and supplied US dollars 716 million during 2007, resulting in a net supply of US dollars 123 million in 2007 as compared to a net supply of US dollars 484 million in 2006. The impact of the appreciation of the currency needs to be mitigated through productivity improvements by export and import competing industries. Increasing commodity prices in international markets however, partly offsets the impact of the appreciation of the currency.

Chart 5.12 Quarterly Inter- Bank Forward Transactions



Foreign exchange market activities in derivative instruments gained momentum in 2007. Apart from the conservative buying and selling in the foreign exchange spot and forward markets, Sri Lanka rupee based foreign exchange options gained market preference in 2007. To hedge against the volatility in import prices of oil, the Ceylon Petroleum Corporation (CPC) commenced hedging a part of its oil purchases by entering into two hedging agreements to import diesel in February 2007 using the Zero Cost Collar mechanism and continued to hedge based on market developments there onwards. Through the hedging mechanism the CPC was able to save Rs. 209 million in 2007.

Box 13 — Tourism Industry: Realising its Potential

The tourism industry has emerged as one of the largest and fastest growing industries in the world. With increases in income and the liberalization of travel restrictions, people tend to move from country to country, generating new income and employment opportunities in the host countries. The year 2007 exceeded expectations for international tourism with arrivals reaching new record figures close to 900 million[1]. Tourism generates income through consumption of goods and services by tourists and creates opportunities for employment in service industries such as transportation, hotel accommodation and entertainment. In particular, tourism has become one of the leading ways for developing countries to increase their participation in the global economy.

Sri Lanka's tourism potential has not yet been fully exploited. Although Singapore lacks the richness of resources that Sri Lanka is endowed with, Singapore has attracted 10.5 million visitors in 2007[2]. In India, the tourism industry has seen a phenomenal growth between 2002 and 2007 and earnings from tourism have increased at the high rate of 33.8 per cent to US dollars 11,956 million in 2007[3]. In recent years, the Maldives has been successful in marketing natural assets such as unpolluted beaches on small coral islands, diving in blue waters abundant with tropical fish and glorious sunsets. Tourism now brings in about US dollars 450 million a year to the Maldives. Although tourism is the fourth largest foreign exchange earner of Sri Lanka, it still earns only around US dollars 400 million per year. Sri Lanka's rich cultural heritage, diverse landscape and a number of wildlife reserves present a wide range of opportunities for prospective tourists. But, the average expenditure per tourist per night (five star

[1] World Tourism Organization

[2] Tourist Board - Singapore

[3] Ministry of Tourism - India

Table B 13.1
Tourist Arrivals in selected Countries ('000)

Country	2006	2007(a)	Growth (%)
Singapore	9,751	10,493	7.6
India	4,447	4,977	11.9
Indonesia	4,871	5,505	13.0
Maldives	602	676	12.3
Sri Lanka	560	494	-11.7

(a) Provisional

Sources:
Tourist Board - Singapore
Ministry of Tourism - India
Ministry of Culture and Tourism – Indonesia
Tourism Promotion Board - Maldives

hotels) is around US dollars 100-150 in Sri Lanka, whereas that rate is around US dollars 600-800 in the Maldives and India. The Tourism industry has the potential to expand and develop by diversifying and promoting Sri Lanka in especially emerging market economies, such as India and China. India has been the top contributor in Sri Lanka's tourism earnings from 2005. The Middle East is also a potentially significant tourism generating market for Sri Lanka. Promoting Sri Lanka as a tourist destination in accordance with a well prepared strategic marketing plan targeting these markets will pay ample dividends in the medium to long run.

The above facts clearly indicate that Sri Lanka has a huge potential in this industry. Successive governments have recognized the potential and offered various incentives to promote the industry. In 2007, the government granted a range of concessions and incentives to promote tourism. In July 2007, the Ministry of Finance announced a temporary relief package for the Tourism Industry, which included postponing the implementation of the US dollars 10 visa fee imposed by the budget 2006 till the end of 2007, categorizing hotels and other classified entities within a 'lower tariff' category by the Ceylon Electricity Board, a moratorium on capital payments on loans provided to tsunami affected hotels, a temporary deferment of VAT payable on 'tourism operations' for a period of one year and the suspension of penalty on delayed VAT payments until end-March 2008.

A significant development in the industry in 2007 was the implementation of the Tourism Act No. 38 of 2005, which came into effect from 1st October 2007. With the promulgation of the new Tourism Act, the Sri Lanka Tourist Board Act No. 20 of 1966 that prevailed during the past 41 years was repealed. The resultant administrative decentralization enabled the creation of four statutory bodies, which are to work independently: Sri Lanka Tourism Development Authority, Sri Lanka Tourism Promotion Bureau, Sri Lanka Convention Bureau and the Sri Lanka Institute of Tourism and Hotel Management[4]. These new bodies will undertake development, planning, setting standards, marketing and promotion, as well as development of human resources in relation to tourism. The most laudable feature in the setting up of these administrative structures is that it avails equal opportunities to large, medium and small scale business operators to develop a healthy partnership with the government sector in all aspects of promoting tourism. It is expected that the new Tourism Act will lead to a more effective public-private partnership in the management and control of the tourism industry.

While recognising the fact that adverse publicity and security related issues have resulted in low tourist arrivals, there are several aspects of the industry, which are yet to receive sufficient attention and concerted efforts. Although "sun and beach tourism" remains the main attraction for most foreign visitors, alternative tourism such as eco , watersports and adventure , historical, ayurveda , cruise and golf tourism, which have great potential have been promoted only on a small scale. With the international growth of tourism, eco tourism has become increasingly popular. Sri Lanka is an ideal destination for eco tourism, given the many activities that tourists could engage in such as hiking, cycling, bird watching, photography and wildlife safaris. Further, given the scenic and varied landscape, adventure tourism also has potential in Sri Lanka. Today, in India, ayurveda tourism is fast becoming a new dimension in the health tourism niche market. Sri Lanka also has the potential to enhance its ayurveda tourism market and make it an integral part of our 'tourism profile'. "Sun and beach tourism", meanwhile, could be further expanded by developing unexploited beaches in the East and some of the other beaches of the country.

One of the biggest challenges that tourism is facing is retaining tour operator confidence in Sri Lanka and preventing

[4] Tourism Act No. 38 of 2005.

a diversion of traffic elsewhere from Sri Lanka. For this purpose, more aggressive marketing programmes and advertising campaigns need to be launched internationally. Active participation at global travel fairs will also help increase the confidence of tour operators and the world community in Sri Lanka. Meanwhile, steps should be taken to develop tourism infrastructure such as hotel and other accommodation facilities, banking facilities and transportation facilities up to international standards, in order to promote tourism. Tourism is sometimes associated with exploitation of human beings and it is imperative to take all possible steps to prevent such exploitation.

There is a belief that involving the private sector in tourism depends on incentives and subsidies given by the government. The role of the government has been one of facilitating, regulating and monitoring, planning, and integrating such planning in relation to tourism into the overall economic and social planning framework. Though Sri Lanka's tourism industry has to overcome many challenges, the industry should have the ability to develop without much government involvement. A good example in this respect has been provided by Sri Lanka's textile and garment industry, which developed on its own strength, meeting the market's requirements.

The newly liberated Eastern Province with its beautiful beaches, shallow seas and other natural endowments greatly enhances the country's potential in tourism. The private sector, perhaps with foreign collaboration, should be encouraged to tap this resource base early.

Sri Lanka has a long-standing reputation as a popular tourist destination in the world. If properly planned and managed, tourism can be highly profitable and could contribute to enhancing the quality of life of the local people with minimal negative social and environmental impacts. As part of the promotional drive, the industry should also attempt to manage perceptions and adverse publicity on Sri Lanka through its agents and contacts abroad. The industry has the potential to become a billion dollar industry soon, but that would happen only, if all stakeholders rise to the challenge.