Chapter 5

EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

5.1 Overview

Positive trends which Sri Lanka recorded relating to the country's Balance of Payments (BOP) during the previous three years continued into the first three quarters of 2008 amidst challenging domestic and external environments, but this was significantly reversed thereafter, in the wake of the financial and economic crises that pervaded the world. The economic fundamentals of the country, including external sector variables, had been improving steadily until the end of the third quarter of 2008. Most of the external sector indicators; exports, worker remittances, balance of payments, short-term investments and external reserves, performed well above the original projections. Exports were growing at around 10 per cent until September 2008, despite many challenges such as the economic slowdown of major trading partners, the rising oil prices and costs of production, the relatively stable exchange rate, the higher interest rates and the uncertainty about renewal of concessions under the GSP+ scheme. The import expenditure grew sharply on account of the unprecedentedly higher petroleum and commodity prices in the international markets and consequently, the trade deficit widened by 88.1 per cent by end September, 2008. The widened trade deficit was partly offset by the increased private remittances, which grew well above 20 per cent throughout the first nine months, thereby softening the impact of the wider trade deficit on the current account. Net foreign short-term inflows to the government and the private sector peaked at US dollars 1,004 million by end September, 2008 and helped generate a surplus in the capital and financial account.

This was more than sufficient to finance the higher current account deficit, generating a surplus of US dollars 173 million in the BOP by end September 2008.

As the year progressed, the entire external financial landscape changed, rapidly deteriorating the global economic growth prospects, which weakened the satisfactory external sector performance achieved by the country until the end of September 2008. The financial crisis triggered by the sub-prime mortgage lending in the United States, spilled over to other major markets, which in turn, resulted in a global financial turmoil that gradually seeped into the real sectors. The resulting slowdown in global growth, particularly in the advanced economies, led to a substantial decline in global demand for energy and other goods, which led the prices of petroleum and other commodities to plummet. The unexpectedly large swings in the international commodity prices have not only reduced the hefty import bill by a considerable amount, but have affected the demand for exports. The year ended with a trade deficit of US dollars 5,871 million, reflecting an increase of 60.6 per cent over 2007. The global financial turmoil and the resulting liquidity crunch and growing uncertainties significantly curtailed international trade and capital flows. It also led to a sudden withdrawal of a large part of investment in Treasury bills and bonds by foreign investors, the hasty claims on short-term credit facilities, an acute drying-up of commercial financing and severe valuation losses arising from a sharp depreciation of major international currencies against the US dollar. Accordingly, the setback experienced in the external sector in the last quarter exerted pressure on the country's balance of payments. The surplus in the balance of payments, which had reached a peak of US dollars 515 million by end July 2008, turned into a deficit of US dollars 1.2 billion by end 2008 and external official reserves excluding Asian Clearing Union (ACU) liabilities, declined by about 50 per cent to US dollars 1.75 billion from a record level of US dollars 3.56 billion in July 2008.

Chart 5.1 Balance of Payments

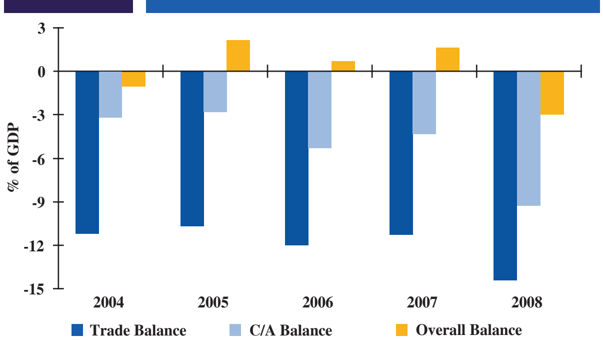
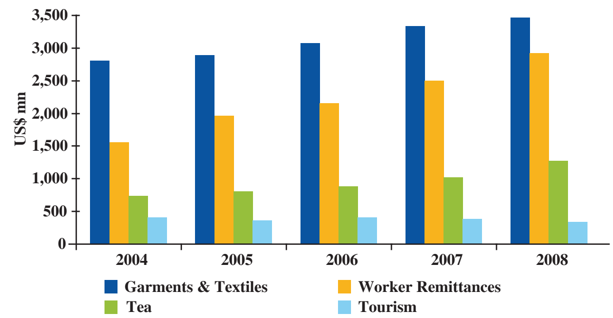


Chart 5.2 Major Sources of Foreign Exchange Earnings



The exchange rate policy in 2008 focused more on the stability amidst unprecedented high volatility in global currency markets, while allowing for some gradual depreciation towards the end of the year to maintain external competitiveness. The exchange rate appreciated during the first four months and depreciated thereafter, the volatility, however, was contained by the Central Bank's intervention in the domestic foreign exchange market. The capital account liberalisation was further promoted by permitting foreign investors to subscribe up to 10 per cent of the outstanding rupee denominated Treasury bills effective from May, 2008. Continuing with the declining trend observed in the past few years, the total external debt of the country as a percentage of GDP declined in 2008.

5.2 External Sector Policies and Institutional Support

The focus of government's external trade strategy continued to be centred on export diversification, in terms of products and markets. It strived to increase exports by promoting exports of high value added components, encouraging productivity enhancing activities and the use of

Table 5.1 **Balance of Payments Analytical Presentation (a)**

Item	US dollars million					Rs. million				
	2004	2005	2006	2007	2008(b)	2004	2005	2006	2007	2008(b)
Trade Balance	**-2,243**	**-2,516**	**-3,370**	**-3,656**	**-5,871**	**-227,171**	**-253,082**	**-350,037**	**-404,703**	**-635,359**
Exports	5,757	6,347	6,883	7,640	8,137	583,967	638,276	716,579	845,683	881,321
Imports	8,000	8,863	10,253	11,296	14,008	811,138	891,359	1,066,615	1,250,386	1,516,681
Services, net	419	338	257	302	402	42,735	34,043	26,660	33,357	43,680
Receipts	1,527	1,540	1,625	1,775	2,003	154,746	154,877	168,802	196,249	217,055
Payments	1,108	1,202	1,368	1,472	1,601	112,011	120,833	142,142	162,892	173,375
Income ,net	-204	-299	-389	-358	-972	-20,688	-30,049	-40,424	-39,054	-105,032
Receipts	157	35	311	449	-32	15,813	3,629	32,457	50,213	-3,133
Payments	360	335	700	807	940	36,501	33,678	72,881	89,267	101,899
Goods, Services and Income (net)	**-2,028**	**-2,478**	**-3,503**	**-3,712**	**-6,441**	**-205,124**	**-249,088**	**-363,801**	**-410,401**	**-696,712**
Private Transfers (net)	1,350	1,736	1,904	2,214	2,565	136,672	174,542	197,861	245,006	277,711
Receipts	1,564	1,968	2,161	2,502	2,918	158,291	197,968	224,678	276,814	316,091
Payments	214	233	257	288	353	21,619	23,426	26,817	31,808	38,380
Official Transfers (net)	30	93	101	97	101	3,038	9,300	10,524	10,677	10,928
Current Account	**-648**	**-650**	**-1,499**	**-1,401**	**-3,775**	**-65,414**	**-65,246**	**-155,416**	**-154,717**	**-408,073**
Capital and Financial Account	**631**	**1,224**	**1,808**	**2,097**	**1,773**	**60,539**	**123,866**	**190,768**	**230,978**	**193,713**
Capital Account	**64**	**250**	**291**	**269**	**291**	**4,974**	**25,108**	**30,292**	**29,669**	**31,456**
Capital Transfers (net)	64	250	291	269	291	4,974	25,108	30,292	29,669	31,456
Receipts	71	257	299	278	303	5,643	25,863	31,171	30,735	32,774
Payments	7	7	8	10	12	669	755	879	1,066	1,319
Financial Account	**567**	**974**	**1,517**	**1,828**	**1,483**	**55,565**	**98,757**	**160,477**	**201,309**	**162,258**
Long-term:	680	798	907	1,251	1,016	69,805	80,391	95,089	140,054	109,174
Direct Investment	227	234	451	548	691	22,826	23,505	46,985	60,768	74,837
Foreign Direct Investment	217	234	451	548	691	21,948	23,505	46,985	60,768	74,837
Privatisation Proceeds	10	-	-	-	-	878	-	-	-	-
Private Long-term (net)	14	11	-35	31	74	2,270	1,054	-3,590	3,314	7,768
Inflows	169	197	139	199	265	17,503	19,739	14,469	22,033	28,693
Outflows	155	186	174	168	191	15,233	18,685	18,058	18,719	20,925
Government, Long-term (net)	439	553	491	672	252	44,709	55,832	51,694	75,971	26,568
Inflows	771	747	932	1,290	1,059	78,299	75,309	97,690	144,146	114,658
Outflows	331	194	441	618	807	33,590	19,477	45,996	68,175	88,090
Short-term:	-112	176	610	577	466	-14,240	18,366	65,387	61,256	53,084
Portfolio Investment	11	60	51	101	60	1,109	6,103	5,377	11,249	6,460
Private Short-term (net)	28	16	-30	20	594	2,514	1,640	-3,066	1,868	63,987
Commercial Bank Assets (net)	-354	-223	297	-281	210	-45,367	-19,669	23,789	-31,352	17,889
Commercial Bank Liabilities (net)	202	323	293	364	-185	27,504	30,292	39,287	38,746	-11,858
Government Short-term (net)	-	-	-	372	-213	-	-	-	40,744	-23,395
Errors and Omissions	-189	-72	-105	-165	777	-2,599	-10,494	-1,830	-16,259	88,137
Overall Balance (c)	**-205**	**501**	**204**	**531**	**-1,225**	**-7,474**	**48,125**	**33,523**	**60,002**	**-126,223**
Monetary Movements (c)	205	-501	-204	-531	1,225	7,474	-48,125	-33,523	-60,002	126,223
Annual Average Exchange Rate Rs/US$						**101.19**	**100.50**	**103.96**	**110.62**	**108.33**
Ratio to GDP in percentages (d)										
Trade Account	-10.9	-10.3	-11.9	-11.3	-14.4	-10.9	-10.3	-11.9	-11.3	-14.4
Current Account	-3.1	-2.7	-5.3	-4.3	-9.3	-3.1	-2.7	-5.3	-4.3	-9.3
Current Account without Grants	-3.3	-3.0	-5.7	-4.6	-9.5	-3.3	-3.0	-5.6	-4.6	-9.5

Source: Central Bank of Sri Lanka

(a) This presentation conforms as far as possible to the Balance of Payments Manual, 5th Edition (1993) of the International Monetary Fund. In addition, beginning 1994, 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 period avarage exchange rates.
(d) Based on GDP at current market prices published by Department of Census and Statistics.

effective marketing strategies in an increasingly competitive international arena, and exploring new markets, thereby making trade a strong contributor to the overall economic performance of the country. However, slow progress in export diversification, the significant decline in global demand, the increasing number of bilateral and multilateral trade agreements and trading blocs and the need to adhere to international standards and regulations posed significant challenges to Sri Lanka's external trade.

Wide fluctuations in prices of essential consumer items in the world market necessitated temporary measures to reduce their impact on domestic prices. These included duty waivers on a few essential goods to contain inflationary pressures that persisted throughout the first half of the year. At the same time, in order to curtail pressures on the trade deficit to expand further, measures were taken to adjust tariffs and impose margin deposit requirements on certain imports that were deemed to be non-essential. With the sharp decline in commodity prices in global markets towards the end of 2008, most duty measures were removed or reversed in order to recoup government's tax revenue.

Table 5.2 Average Import Duty Collection Rate (a)

Item	2004	2005	2006	2007	2008(b)
Consumer Goods	**10.4**	**10.4**	**11.2**	**12.4**	**6.7**
Food and Beverages	8.5	9.6	10.7	13.5	6.8
Rice	4.9	10.6	23.4	3.1	4.2
Flour	7.2	3.8	33.7	31.9	24.3
Sugar	4.6	1.5	1.9	23.9	2.5
Wheat and Meslin	0.1	1.1	5.6	6.3	6.3
Milk and Milk Products	7.9	10.2	9.6	7.7	1.4
Dried Fish	5.9	5.9	5.0	2.9	2.9
Other Fish Products	10.0	9.8	7.8	4.9	1.4
Other	17.4	22.0	24.2	20.8	14.0
Non-Food Consumer Goods	12.2	11.1	11.7	11.2	6.5
Motor Cars & Cycles	21.1	18.9	18.3	16.3	4.6
Radio Receivers - Television Sets	9.4	13.6	7.1	7.7	6.0
Rubber Tyres & Tubes	25.8	26.2	19.2	22.4	21.5
Pharmaceutical Products	0.6	0.5	0.3	0.4	0.4
Other	8.9	8.7	10.3	10.6	10.5
Intermediate Goods	**1.9**	**2.1**	**1.5**	**1.5**	**2.1**
Fertiliser	3.1	2.7	2.5	2.7	2.7
Crude Oil	0.0	0.0	0.0	0.0	0.0
Other Petroleum Products	0.9	1.9	2.3	1.6	4.4
Chemical Elements and Compounds	2.6	2.0	1.8	1.9	1.8
Dyeing, Tanning and Colouring	4.5	4.4	2.6	2.5	2.4
Paper and Paper Boards	6.0	6.0	2.4	2.2	1.7
Textiles	0.0	0.1	0.1	0.1	0.1
Other Intermediate Goods	4.3	4.5	3.3	3.3	3.2
Investment Goods	**6.1**	**5.8**	**5.2**	**4.8**	**5.2**
Building Materials	9.0	7.8	9.2	7.2	6.6
Transport Equipment	11.9	9.7	7.0	7.1	12.0
Machinery and Equipment	3.2	3.3	3.2	2.7	2.4
Other Investment Goods	5.0	5.3	3.4	4.2	4.3
Average Tariff	**4.5**	**4.6**	**4.3**	**4.1**	**3.8**

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

Source : Sri Lanka Customs

The five-band tariff structure of 0, 2.5, 6, 15 and 28 per cent, introduced in 2004, remained as the main trade policy instrument. The surcharge on customs duty was increased to 15 per cent from 10 per cent in 2008. Meanwhile, in order to contain the rise in the prices of essential food items, the customs duty, Value AddedTax (VAT), Port and Airport Development Levy (PAL), Social Responsibility Levy (SRL) and other charges applicable at the customs point for eleven selected essential food items, were replaced by a lower, single Special Commodity Levy. The average tariff rate, calculated based on total imports and customs duties decreased to 3.8 per cent in 2008 from 4.1 per cent in 2007, largely due to duty reductions granted on essential food items and duty waivers to public servants to import personal motor vehicles. However, there were other charges applicable to imports: a surcharge on customs duty, VAT, PAL, SRL, Excise Duty (on alcohol, tobacco products and vehicles) and cess on non-essential consumer items. Preferential tariffs offered on imports under bilateral and regional trade agreements continued to promote transparency and predictability in the external trading environment.

Sri Lanka continued to strive to enhance market access at the bilateral, regional and multilateral levels. At the multilateral level, the Doha Round of negotiations which has been the central mandate of the World Trade Organization (WTO) negotiations since 2001, completed its eighth year without a successful conclusion. Market access negotiations under Agriculture and Non-Agriculture were foused on implementing an ambitious tariff reduction mechanism. With regard to Agriculture, Sri Lanka had to maintain a balance as a net food importing developing country and as a nation to support the vulnerable domestic agricultural sector. Under Non-Agriculture Market Access (NAMA), Sri

Lanka is concerned about its own tariff reductions as well as meaningful tariff reductions in key export markets. Negotiations under own tariff reductions were concluded with Sri Lanka committing to bind 80 per cent of its tariff lines at an average of 30 per cent. Accordingly, Sri Lanka retains sufficient policy space by excluding 20 per cent of its tariff lines from tariff reduction. The negotiations on trade rules, services, trade related intellectual property rights (TRIPS), trade facilitation, geographic indications, etc. also continued during 2008. The growing fears about protectionism amid the global economic downturn are expected to enhance the commitment of the members for an early and successful conclusion of the WTO negotiations.

The recent growth in Sri Lanka's exports to the European Union was supported by the utilisation of concessions granted under the Generalised System of Preferences (GSP+) scheme, which provides duty free market access to Sri Lankan exporters. The impact of the scheme is reflected in the expansion of the country's market share, particularly in the UK, Italy and Belgium-Luxembourg as well as the product diversification in exports to the EU. The current GSP+ scheme lapsed at the end of 2008 and was renewed with some changes for a period of three years from 2009. Although Sri Lanka is included in the renewed scheme to receive preferential access for its exports to the EU, its eligibility is currently under review, to assess the degree of effective implementation of certain international conventions.

Sri Lanka's final tariff liberalisation commitment under the Indo-Sri Lanka Free Trade Agreement (ISLFTA) came into effect since November 2008 by deepening tariff preferences from 70 per cent to 100 per cent for 2,700 products. With this completion of the commitment, ISLFTA which came into effect from March, 2000 is now fully in force. Exports to India declined in 2008 mainly due to lower exports of copper, aluminium and related products. However, this does not undermine the vast potential in trade between the two countries, particularly at times when other major markets are affected by crisis.

The two nations are forging ahead with the negotiations for further liberalisation under the Comprehensive Economic Partnership Agreement (CEPA). The CEPA is expected to take the ISLFTA one stride further, towards the greater economic integration between the two countries by reducing the respective negative lists further and incorporating trade in services. Although, both countries concluded the discussions on the CEPA Framework Agreement, the finalisation process was delayed in view of the stressing need for further consultations with all stakeholders to accommodate their views.

A similar comprehensive economic partnership agreement with Pakistan is being negotiated with a view to further expanding existing trade opportunities for both goods and services under the Paskistan-Sri Lanka Free Trade Agreement (PSLFTA) implemented in June 2005. Two rounds of negotiations have already been concluded on the CEPA with Pakistan. Some issues pertaining to tariff concessions on auto sector products, crude coconut oil and bottle cooling machines were settled in June 2008. A substantial improvement in bilateral trade is recorded after the implementation of the PSLFTA, with the value of exports from Sri Lanka growing at 81 per cent while imports from Pakistan registering an increase of 78 per cent, by 2008 compared with the respective pre-agreement values. The fourth tariff reduction commitment of Sri Lanka in deepening its margin of preferences from 40 per cent to 60 per cent was implemented in November 2008. Once Pakistan implements its final tariff reduction commitment, 4,500 Sri Lankan products will enjoy duty free access to Pakistan.

The Trade Investment Framework Agreement (TIFA) with USA provides a useful institutional arrangement for promoting closer co-operation between the two countries. It provides regular high level contacts among the trade officials where one could identify and address any barriers to trade between the two countries. A Ministerial level Annual Consultative Meeting was held in Washington in May 2008 and Sri Lanka primarily aimed at securing enhanced market access for its exports to USA, in particular apparel, and pursuing US cooperation in areas such as intellectual property rights.

With a view to strengthening the traditional trade ties with its neighbours, Sri Lanka, as an active member, consistently supported regional trade negotiations. These included the South Asia Free Trade Agreement (SAFTA), the 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 (IOR-ARC) to ensure trade integration among the member countries is meaningful. Sri Lanka is also in the process of negotiating for enhanced trade and economic co-operation with Iran and China.

Measures taken by the Government and other institutions as enunciated in the Ten Year Horizon Development Framework of the Government have had an impact on the country's trade patterns. Implementation of large scale projects on ports development, power plants, irrigation projects and water resources schemes, rural electrification schemes and fertiliser subsidy programmes raised the volume of imports of investment and intermediate goods while some other initiatives to promote domestic production amidst wide fluctuations in prices of essential consumer goods, curtailed the volume of consumer goods imports by a certain

Table 5.3 **Trade Indices (a)**

1997=100

Category	2007(b)			2008(c)			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	**141.9**	**125.9**	**112.7**	**174.6**	**130.3**	**134.0**	**23.1**	**3.5**	**18.9**
Tea	142.2	122.1	116.5	176.4	125.4	140.7	24.0	2.7	20.8
Rubber	139.0	85.8	162.1	159.0	80.7	196.9	14.4	-5.9	21.5
Coconut	120.0	124.1	96.7	145.4	123.0	118.2	21.1	-0.9	22.2
Other Agricultural Products	159.7	167.9	95.1	198.1	187.8	105.5	24.1	11.9	10.9
Industrial Exports	**173.3**	**163.0**	**106.4**	**178.9**	**162.3**	**110.2**	**3.2**	**-0.4**	**3.6**
Textiles and Garments	146.5	150.8	97.2	152.2	154.6	98.4	3.9	2.5	1.3
Petroleum Products	173.5	57.5	301.7	261.7	62.9	416.1	50.9	9.4	37.9
Other Industrial Exports	230.6	198.6	116.1	228.4	187.9	121.6	-0.9	-5.4	4.7
Mineral Exports	**143.1**	**135.0**	**106.0**	**137.0**	**134.2**	**102.1**	**-4.2**	**-0.6**	**-3.7**
Gems	127.0	126.3	100.6	121.7	124.3	97.9	-4.2	-1.6	-2.7
Other Mineral Exports	354.3	249.5	142.0	338.6	264.3	128.1	-4.4	5.9	-9.8
Total Exports	**164.4**	**153.8**	**106.8**	**175.1**	**154.4**	**113.4**	**6.5**	**0.3**	**6.1**
IMPORTS									
Consumer Goods	**163.1**	**167.2**	**97.6**	**200.6**	**195.3**	**102.7**	**23.0**	**16.8**	**5.3**
Food and Beverages	129.4	116.8	110.8	176.0	157.2	111.9	36.0	34.6	1.0
Other Consumer Goods	212.1	240.4	88.2	236.3	250.6	94.3	11.4	4.2	6.9
Intermediate Goods	**208.7**	**147.5**	**141.5**	**269.4**	**154.2**	**174.7**	**29.1**	**4.6**	**23.4**
Fertiliser	290.0	145.8	199.0	868.6	197.8	439.2	199.5	35.7	120.8
Crude Oil	388.1	106.8	363.5	500.9	102.3	489.7	29.1	-4.2	34.7
Other Petroleum	535.9	187.4	286.0	742.7	202.3	367.2	38.6	7.9	28.4
Chemical Elements and Compounds	206.9	154.4	134.0	265.5	181.3	146.5	28.3	17.4	9.3
Wheat and Meslin	169.8	120.6	140.7	272.5	116.4	234.0	60.5	-3.5	66.3
Textiles (Including Clothing)	117.7	138.7	84.8	122.7	143.6	85.4	4.3	3.5	0.7
Plastics	249.9	184.5	135.4	257.0	180.3	142.5	2.8	-2.3	5.2
Diamonds	172.6	103.4	167.0	287.4	128.2	224.2	66.5	24.0	34.3
Other	197.4	195.9	100.8	216.5	196.3	110.3	9.6	0.2	9.4
Investment Goods	**202.5**	**225.3**	**89.9**	**224.6**	**217.9**	**103.1**	**10.9**	**-3.3**	**14.7**
Building Materials	287.2	259.9	110.5	342.8	260.1	131.8	19.4	0.1	19.3
Transport Equipment	175.2	99.5	176.0	195.5	99.2	197.0	11.6	-0.3	12.0
Machinery and Equipment	167.7	257.3	65.2	175.9	244.6	71.9	4.9	-4.9	10.3
Other Investment Goods	285.2	157.4	181.2	323.4	154.3	209.6	13.4	-1.9	15.6
Total Imports	**192.6**	**169.5**	**113.6**	**238.8**	**177.1**	**134.9**	**24.0**	**4.4**	**18.7**
Terms of Trade			94.0			84.1			-10.6

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

Sources : Sri Lanka Customs
Central Bank of Sri Lanka

extent. An array of export development programmes were carried out by the Export Development Board (EDB) in 2008. Providing high quality value added agro products to the export market, and establishing export zones with the involvement of farmers in rural villages, so that the dividends generated from exports could be distributed among a wider section of the people, has been among the key initiatives taken by the EDB. The EDB, with the participation of the Sri Lanka Standards Institution (SLSI), has also initiated measures to formulate a Sri Lanka Standard for Organic Agriculture Production and Processing with the objective of supporting exporters of agricultural products to obtain international standards. The SLSI was also actively involved in the work related to the establishment of the South Asian Regional Standards Organisation to promote and undertake harmonisation of national standards of the SAARC countries with a view to removing the technical barriers to trade and facilitating the flow of goods and services in the region.

5.3 Trade in Goods, Trade Balance and Terms of Trade

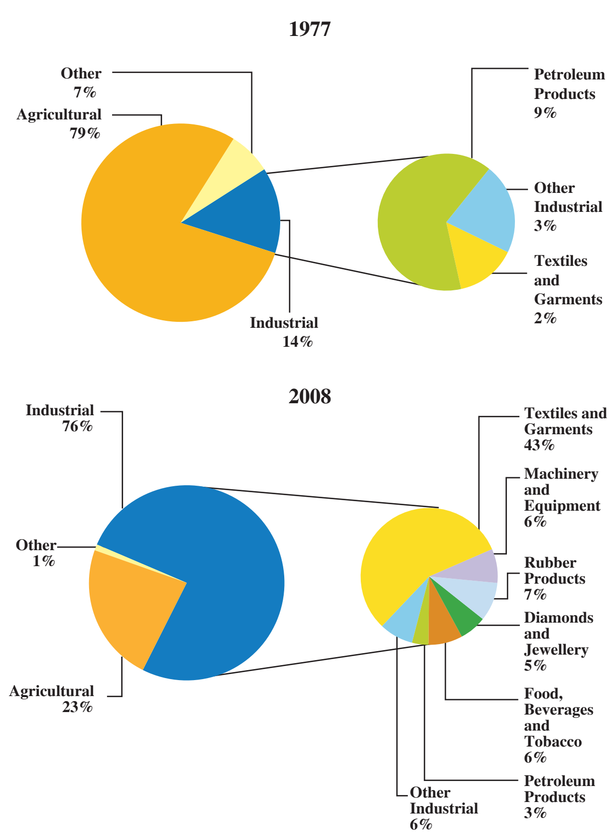
Export Performance

Earnings from exports grew by 6.5 per cent to US dollars 8,137 million in 2008 from US dollars 7,640 million in 2007. Exports, which recorded a healthier growth of 12.7 per cent during the first eight months of the year, suffered as a result of the contraction in global demand towards the end of the year, leading to a decline in growth to 6.5 per cent by the end of the year. The agricultural exports, which grew by 23.1 per cent to US dollars 1,855 million in 2008, provided the major impetus to growth during the year. Agricultural exports contributed to nearly 70 per cent of this, which is largely due to the attractive prices in the international market.

Agricultural exports were led by the tea sector recording earnings of US dollars 1,271 million in 2008, mainly due to higher prices of tea. Sri Lanka's tea prices reached record levels during the first nine months of 2008, in the wake of rising demand from the United Arab Emirates (UAE) and the other Middle Eastern countries, amidst uncertainties of production in Kenya. The Middle Eastern nations and the CIS countries, which constituted the largest market for Sri Lanka's tea exports, accounted for about 46 per cent and 23 per cent, respectively, of the total tea exports in 2008.

Tea prices at the Colombo Auction decreased since the third week of the September onwards, following intensification of the global financial turmoil. The situation was aggravated by the "wait and see" attitude taken by the buyers in anticipation of further price reductions. The high prices that prevailed during the first three quarters also compelled producers to supply lower quality tea to the auctions with a view to increasing quantity, resulting in a deterioration of the quality of the tea sold at the auction. The tea prices continued to plunge further to a level that the manufacturers and the green leaf suppliers could not even recover their costs and some stocks remained unsold at the auction. The government had to intervene in the market to stabilize the prices, by purchasing

Chart 5.3 Exports by Commodities



the unsold tea through the Sri Lanka Tea Board (SLTB), which was re-sold in subsequent auctions in January 2009 when prices improved. Although the prices at the Colombo Auction deteriorated further towards the end of the year, they remained above those of other major Auction centres around the world. In order to ensure that the high quality associated with Ceylon Tea is maintained, the SLTB took measures to ensure that standards set out by them were adhered to by the green leaf suppliers as well as the tea manufacturers.

Minor agricultural products, which generated US dollars 287 million in 2008, are increasingly becoming an important source of export earnings for the country. Within the minor agricultural products, exports of fruits, vegetables and certain spices, such as cloves, recorded impressive growth in the first part of 2008 reflecting both price and quantity increases. Cinnamon and betel leaves, on the other hand, increased mainly due to the higher prices that prevailed in the international markets.

At US dollars 6,159 million, exports of industrial products recorded a modest growth of 3.2 per cent in 2008, partly due to the sluggish demand for apparel in the USA. This is attributed mainly to the heightened competition among several developing nations, the relatively higher cost of production, and the sharp depreciation of the euro and the UK pound against the US dollar, which have reduced the competitiveness of Sri Lanka's exports to some extent. Industrial exports which grew by 4.8 per cent during the first three quarters declined by 1.3 per cent in the last quarter due to the lacklustre global demand as the crisis in the U.S. took on global proportions.

The apparel exports grew by a lower rate of 3.9 per cent to US dollars 3,469 million in 2008 compared to the growth rates of around 6 - 8 per cent achieved in the recent past. Nevertheless, the USA continued to be the largest single market for Sri Lanka's exports, accounting for nearly 45 per cent of the garment exports. However, Sri Lanka's share of apparel imports by the USA, declined in 2008.

Table 5.4 Composition of Exports

Category	2007(a) Value US dollars million	2007(a) Share %	2008(b) Value US dollars million	2008(b) Share %	Change in Value(b) US dollars million	Growth rate(b) %	Contribution to growth(b) %
Agricultural Exports	**1,507.2**	**19.7**	**1,854.8**	**22.8**	**347.6**	**23.1**	**70.0**
Tea	1,025.2	13.4	1,271.5	15.6	246.3	24.0	49.6
Rubber	109.4	1.4	125.1	1.5	15.7	14.4	3.2
Coconut	141.2	1.8	171.0	2.1	29.8	21.1	6.0
Kernel Products	60.3	0.8	82.4	1.0	22.0	36.6	4.4
Other	80.9	1.1	88.7	1.1	7.8	9.6	1.6
Other Agricultural Products	231.5	3.0	287.3	3.5	55.7	24.1	11.2
Industrial Exports	**5,967.3**	**78.1**	**6,159.5**	**75.7**	**192.2**	**3.2**	**38.7**
Food, Beverages and Tobacco	513.5	6.7	458.3	5.6	-55.1	-10.7	-11.1
Textiles and Garments	3,339.6	43.7	3,468.7	42.6	129.1	3.9	26.0
Petroleum Products	168.9	2.2	254.8	3.1	85.9	50.9	17.3
Rubber Products	482.5	6.3	541.9	6.7	59.4	12.3	12.0
Ceramic Products	47.1	0.6	49.0	0.6	2.0	4.2	0.4
Leather, Travel Goods and Footwear	22.9	0.3	16.7	0.2	-6.3	-27.3	-1.3
Machinery and Equipment	542.2	7.1	461.0	5.7	-81.2	-15.0	-16.4
Diamond and Jewellery	367.2	4.8	436.1	5.4	68.8	18.7	13.9
Other Industrial Exports	483.6	6.3	473.1	5.8	-10.5	-2.2	-2.1
Mineral Exports	**127.8**	**1.7**	**122.4**	**1.5**	**-5.4**	**-4.2**	**-1.1**
Gems	105.5	1.4	101.0	1.2	-4.4	-4.2	-0.9
Other Mineral Exports	22.4	0.3	21.4	0.3	-1.0	-4.4	-0.2
Unclassified	**37.6**	**0.5**	**0.0**	**0.0**	**-37.6**	**-100.0**	**-7.6**
Total Exports(c)(d)	**7,640.0**	**100.0**	**8,136.7**	**100.0**	**496.7**	**6.5**	**100.0**
Annual Average Exchange Rate	110.6232		108.3338				

(a) Revised
(b) Provisional
(c) Excludes re-exports
(d) Adjusted

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

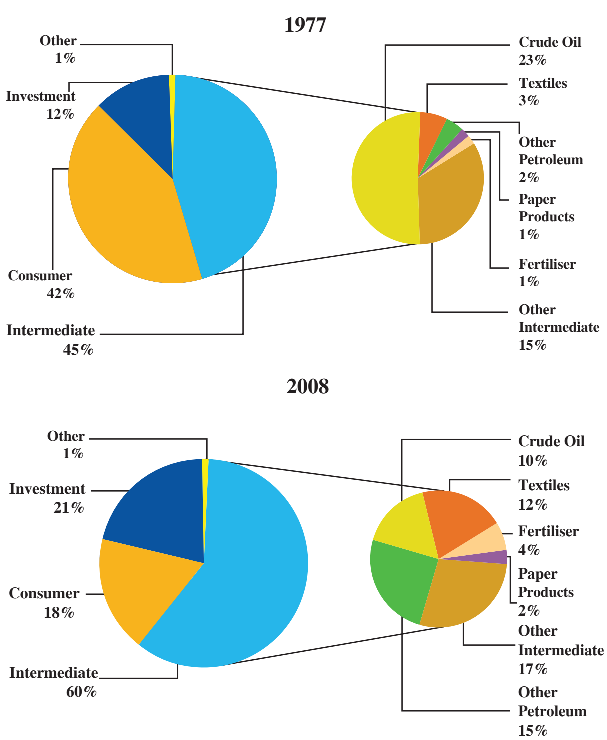
The declining growth of the US market in recent years was offset to a certain extent by the sharp expansion in exports to the EU, the largest market for Sri Lanka's exports of apparel. The growth in exports to the EU was supported by the GSP+ scheme, which provides duty free market access to Sri Lankan exporters. Amongst the members of the EU, the United Kingdom was the largest market for Sri Lanka, followed by Italy and Germany. Some manufacturers were affected by the uncertainty that prevailed towards the middle of the year regarding the future of the GSP+ scheme.

Earnings from most other categories of industrial exports such as petroleum products, rubber products and processed diamonds grew during the year 2008. With respect to the bunkering business, measures would have to be taken to increase the competitiveness and the efficiency of the service to consolidate its position in the South Asian region as the foremost ancillary service provider. Despite the progress made in the beginning of the year, the country's exports of solid tyres and other products made from natural rubber were affected towards the latter part of the year by the cutbacks in production by large manufacturers, particulary the major automakers of the US and Japan. Despite the shortfall in demand for coloured gems for the jewellery industry, the demand for diamonds has shown an increase of 20.2 per cent in 2008. Although diamonds are not available in Sri Lanka, the country has established itself as a leading diamond processing centre with US dollars 418.7 million in export earnings, with about 6-8 per cent value addition. Sri Lanka has acquired a reputation for the high quality of diamond cutting in Antwerp where the most prestigious of diamond retailers reside. The Budget 2008 promoted the value addition to the gem industry by granting tax exemptions, allowing exporters to credit 50 per cent of foreign exchange earnings to foreign currency accounts for the importation of raw materials and charging a lower income tax of 2.5 per cent in place of the prevailing income tax.

Import Performance

Expenditure on imports grew by 24.0 per cent to US dollars 14,008 million compared to US dollars 11,296 million in 2007. The sharp increases in international commodity prices led imports to grow by 33.7 per cent during the first three quarters of 2008. Imports decelerated significantly thereafter with the changes in global economic conditions. The soaring commodity prices had an unfavourable impact on import expenditure until September 2008, when all major categories of imports grew very rapidly. Prices of most commodities, including petroleum, exhibited a series of historical highs during this period. The largest contribution to this growth came from intermediate goods, primarily due to the higher expenditures incurred on petroleum imports, whose share as a percentage of total imports had increased from 22 per cent in 2007 to 24 per cent in 2008. However, towards the end of year, the global economic crisis led to a substantial decline in global demand for petroleum and other commodities, which caused prices to plummet. The unexpected decline in prices led to a significant decline in import expenditure in the last quarter.

Chart 5.4 Imports by Commodities



5 EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

Table 5.5 **Composition of Imports**

Category	2007(a) Value US dollars million	2007(a) Share %	2008(b) Value US dollars million	2008(b) Share %	Change in Value (b) US dollars million	Growth rate(b) %	Contribution to growth(b) %
Consumer Goods	**2,001.8**	**17.7**	**2,549.2**	**18.2**	**547.4**	**27.3**	**20.2**
Food and Beverages	1,064.8	9.4	1,505.0	10.7	440.3	41.3	16.2
Rice	38.7	0.3	43.8	0.3	5.1	13.0	0.2
Sugar	154.1	1.4	206.2	1.5	52.1	33.8	1.9
Wheat	233.9	2.1	375.5	2.7	141.6	60.5	5.2
Other	638.0	5.6	879.5	6.3	241.6	37.9	8.9
Other Consumer Goods	937.1	8.3	1,044.2	7.5	107.1	11.4	4.0
Intermediate Goods	**6,517.3**	**57.7**	**8,340.6**	**59.5**	**1,823.3**	**28.0**	**67.2**
Petroleum	2,500.7	22.1	3,368.2	24.0	867.5	34.7	32.0
Fertiliser	192.5	1.7	576.6	4.1	384.1	199.5	14.2
Chemicals	281.4	2.5	361.1	2.6	79.7	28.3	2.9
Textiles and Clothing	1,632.2	14.4	1,701.9	12.1	69.7	4.3	2.6
Other Intermediate Goods	1,910.5	16.9	2,332.8	16.7	422.3	22.1	15.6
Investment Goods	**2,685.2**	**23.8**	**2,978.8**	**21.3**	**293.7**	**10.9**	**10.8**
Machinery and Equipment	1,246.7	11.0	1,307.7	9.3	60.9	4.9	2.2
Transport Equipment	364.5	3.2	406.7	2.9	42.2	11.6	1.6
Building Materials	780.3	6.9	931.6	6.7	151.3	19.4	5.6
Other Investment Goods	293.6	2.6	332.9	2.4	39.3	13.4	1.4
Unclassified Imports	**92.2**	**0.8**	**139.4**	**1.0**	**47.2**	**51.1**	**1.7**
Total Imports(c)	**11,296.5**	**100.0**	**14,008.0**	**100.0**	**2,711.5**	**24.0**	**100.0**
Annual Average Exchange Rate	110.6232		108.3338				

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

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

Petroleum imports, which grew by 61.4 per cent during the first three quarters, declined by 25.6 per cent in the fourth quarter due to the significant price swing in the international market. The resulting reduction in expenditure on petroleum and other imports led growth in imports to decelerate very rapidly, to record a flat rate in the last quarter.

Import expenditure incurred on intermediate goods increased by 28.0 per cent to US dollars 8,341 million, contributing about 67 per cent towards the import growth in 2008. Apart from petroleum, a noteworthy increase in expenditure on fertiliser imports was recorded in 2008, led by the higher prices that prevaliled in the international markets and the increased volumes generated by the fertiliser subsidy. Over 50 per cent of imported fertilisers comprised of Urea in 2008, which is used extensively by the paddy farmers in Sri Lanka. The favourable trends in agricultural prices have prompted farmers to cultivate marginal lands, adding pressure on the fertiliser requirement. Imports of textiles and clothing, of US dollars 1,702 million in 2008, depicted a modest increase of 4.3 per cent over that of 2007, reflecting the slow growth of apparel exports.

Expenditure on consumer goods imports increased by 27.3 percent to US dollats 2,549 million in 2008. Within the consumer goods category, expenditure on food and drinks, increased significantly reflecting the high prices of wheat, milk, sugar and rice that prevailed before the commodity price bubble burst. Wheat import volumes declined marginally by 3.5 per cent in 2008. Import expenditure on motor vehicles recorded a higher growth of 16.2 per cent in 2008, which was attributed to the issuance of duty free vehicle import permits to public servants since 2007, which was subsequently withdrawn in April 2008.

The continued growth in the investment goods category, which recorded a growth of 10.9 per cent to US dollars 2,979 million in 2008, was led by increases in building materials. This could be attributed to the numerous large-scale infrastructure development projects undertaken across the country. Favourable developments in the foreign aid utilisation rate, better utilisation of foreign

Table 5.6 Volume of Major Imports (a)

'000 mt

Item	2004	2005	2006	2007(b)	2008(c)
Rice	**222**	**52**	**12**	**88**	**84**
1st Quarter	9	43	3	4	41
2nd Quarter	9	4	2	7	28
3rd Quarter	4	2	3	3	12
4th Quarter	200	3	4	74	3
Wheat	**993**	**864**	**1,200**	**952**	**919**
1st Quarter	257	272	287	204	272
2nd Quarter	218	191	321	388	312
3rd Quarter	189	174	331	274	153
4th Quarter	329	227	261	87	182
Sugar	**438**	**418**	**525**	**481**	**575**
1st Quarter	98	49	112	112	163
2nd Quarter	173	167	137	138	131
3rd Quarter	71	94	127	118	167
4th Quarter	96	108	149	113	114
Petroleum (Crude Oil)	**2,200**	**2,008**	**2,151**	**1,938**	**1,853**
1st Quarter	586	586	592	272	229
2nd Quarter	464	581	535	557	525
3rd Quarter	634	246	582	559	544
4th Quarter	516	595	442	550	555
Refined Petroleum	**1,645**	**1,823**	**2,302**	**2,314**	**2,386**
1st Quarter	460	314	540	597	778
2nd Quarter	380	396	587	646	583
3rd Quarter	341	711	479	517	465
4th Quarter	464	402	696	554	560
Fertiliser	**510**	**529**	**633**	**569**	**773**
1st Quarter	54	168	166	62	125
2nd Quarter	164	111	203	171	223
3rd Quarter	76	142	119	131	216
4th Quarter	216	107	146	205	209

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

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

aid, increase in aid commitments also contributed to this outcome. However, towards the end of the year, the drop in external financing resulting from the ongoing credit crisis affected some infrastructure spending already earmarked by the government and the private sector. The lower international prices of capital goods in the latter part of the year, emanating from slowing down the pace of construction work in emerging markets such as China and India, and recessions in the developed countries are expected to continue for the greater part of 2009.

Trade Balance

The higher growth of expenditure on imports in 2008 relative to the modest growth in exports contributed to the substantial expansion in the trade deficit in 2008. The overall trade deficit widened by 60.6 per cent to US dollars 5,871 million in 2008 from US dollars 3,656 million in 2007.

Terms of Trade

Despite the favourable prices fetched by agricultural exports, the rise in international commodity prices, particularly petroleum, led the terms of trade to deteriorate significantly by 10.6 per cent in 2008.

The prices of exports grew by 6.1 per cent in 2008. The monthly average price of tea exported from Sri Lanka continued to rise and reached the highest ever recorded level of US dollars 4.28 per kilogram in September, 2008. However from end September, they took on a declining trend as the emergence of recession ended the price boom. The lower demand for Ceylon Tea emanated mainly from the income effects of the unexpected decline in oil prices on the major oil exporting countries, which are the main buyers of Ceylon Tea. Demand from the rest of the world was affected by the global recession, which aggravated the situation. The average price of tea exported from Sri Lanka fetched US dollars 3.98 per kilogram in 2008, compared to the average price of US dollars 3.29 per kilogram obtained in 2007. As with tea, natural rubber exports drew attractive prices during the first eight months of 2008. The highest export price of US dollars 3.24 per kilogram was recorded in July 2008 after which it was on a declining trend. The average export price of rubber, stood at US dollars 2.57 per kilogram in 2008, compared to the average price of US dollars 2.12 per kilogram in 2007. This remarkable increase reflects increasing crude oil prices which raised the cost of producing synthetic rubber and the strong demand for tyre production, especially from China,

Chart 5.5 Terms of Trade and Trade Indices

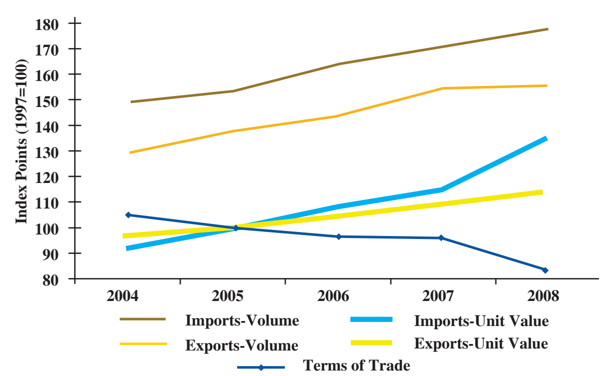
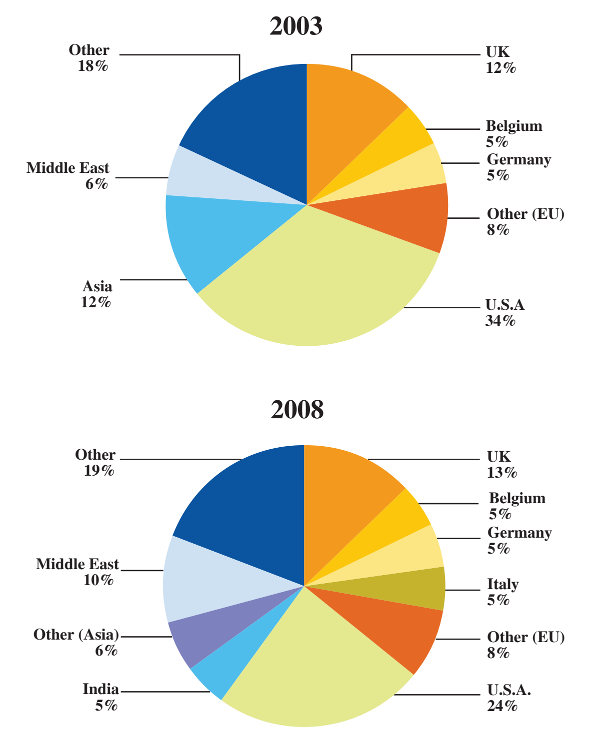


Chart 5.6 Exports by Destination



the world largest rubber consumer and tyre exporter. However, the decline in price of oil later on in the year was reflected in lower synthetic rubber prices. The export prices of coconut and other agricultural products such as cinnamon, pepper, cloves and tobacco, also increased in 2008.

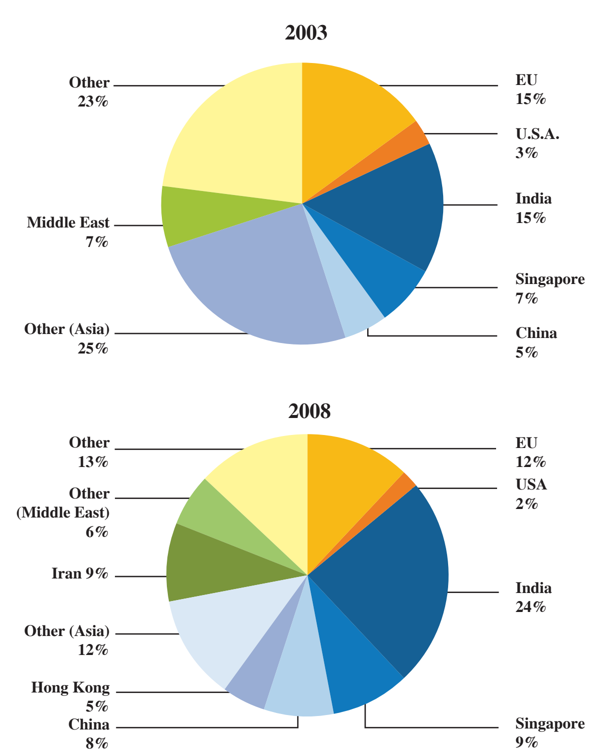
The prices of imports grew by 18.7 per cent in 2008. Driven by strong US consumption and soaring demand from China, India and other emerging economics, which have been the mainstay of recent global growth, commodity prices reached their higest levels in decades by 2008, as supply could not keep up with demand. The sharp increase in crude oil prices spilled over into other primary commodities, including food and metals, the prices of which continued to rise sharply until mid 2008. Import price of crude oil increased significantly in line with the world market until July, 2008 to record the highest average import price of US dollars 134.34 per barrel and then declined sharply to US dollars 46.27 per barrel by December, 2008. The average import price of wheat was almost US $ 454.59 per metric ton in October, 2008, recording the highest level since the mid 1970s. Sugar prices too have increased in the international market in 2008 compared to last year. Sugar production declined in 2008 as grain production displaced sugar in several countries. However, towards the end of 2008, prices suddenly collapsed in the face of a global financial crisis and economic downturn, delivering what many refer to as the most significant commodity price swing of the century.

Direction of Trade

The Western countries continued to be the main destination for Sri Lankan exports in 2008 while the Asian countries dominated Sri Lanka's imports. While the USA and the UK remained the largest export destination countries, Singapore, Iran and China followed India as the foremost import-originating countries.

Among the major export destinations, the USA, the most important market for Sri Lanka, accounted for 23 per cent of exports. Exports to the USA declined by 5.1 per cent mainly due to the reduction in apparel exports. Apparel exports to the USA declined by 5.4 per cent in 2008. Exports to the European Union increased by 12.5 per cent in 2008. Within the European Union, exports to

Chart 5.7 Imports by Origin



the UK, which is also Sri Lanka's second largest export destination, increased significantly by 7.1 per cent in 2008 while exports to Italy and Beligium-Luxembourg increased by 12.7 per cent and 6.3 per cent respectively. Exports to most countries in the euro region increased due to the tariff concessions given under the GSP+ scheme. India, which was the third largest export destination in 2007, moved down to the fifth position in 2008 in view of a 18.8 per cent decline in exports to India. Exports to India consisted mainly of vegetable fats, spices, rubber products and gems.

However, in terms of imports, India continued to be the largest source of imports, as imports from India grew by 31.9 per cent in 2008, accounting for nearly 25 per cent of Sri Lanka's imports in 2008 compared to 23 per cent share of imports in 2007. Driven by higher imports, total trade with India exceeded US dollars 3.9 billion in 2008 highlighting the unique position India holds as the major trading partner country. The main imports from India included refined petroleum products, sugar, motorcycles and auto-trishaws, copper wires, etc. Singapore and Iran followed as the second and third largest import source countries, reflecting growth rates of 11.1 per cent and 41.5 per cent, respectively in 2008. They account for 8.9 per cent and 8.5 per cent of total imports. Main imports from Singapore comprised of fertiliser, petroleum products and unwrought gold. The major import from Iran consisted of crude oil. China and Hong Kong also remain significant import source countries for Sri Lanka, holding shares of 7.8 per cent and 5.0 per cent of imports, respectively.

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

Trade in Services

The surplus in trade in services widened significantly to US dollars 402 million in 2008 from US dollars 302 million in 2007. Transportation, telecommunication, computer and information technology services, construction and insurance services recorded surpluses in 2008. This improvement was partially offset by increase in deficits in other business services and travel.

Table 5.7 Net Services, Income and Transfers (a)

Item	US dollars million 2007	US dollars million 2008(b)	Rs. million 2007	Rs. million 2008(b)
1. Transportation	241	299	26,728	32,458
2. Travel	-8	-86	-851	-9,297
3. Telecommunication Services	18	26	1,984	2,756
4. Computer and Information Services	175	230	19,359	24,917
5. Construction Services	27	35	3,015	3,774
6. Insurance Services	15	22	1,681	2,337
7. Other Business Services	-153	-109	-17,029	-11,757
8. Government Expenditure n.i.e.	-14	-14	-1,531	-1,508
Total Services	**302**	**402**	**33,357**	**43,680**
1. Compensation of Employees	-11	-14	-1,240	-1,483
2. Direct Investment	-346	-464	-38,287	-50,256
3 Interest and Other Charges	-1	-495	472	-53,293
Total Income	**-358**	**-972**	**-39,054**	**-105,032**
1. Private	2,214	2,565	245,006	277,711
2. General Government	97	101	10,677	10,928
Total Current Transfers	**2,311**	**2,666**	**255,684**	**288,639**

Source: Central Bank of Sri Lanka

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

Transportation Services

Transportation services, the largest category within the service sector, primarily led growth in the service sector. In spite of the slowdown in the global economic activities, the gross inflows on account of transportation services consisting of passenger fares, freight charges and other port related activities reported a remarkable growth of 22 per cent during the first nine months. However, this growth deteriorated in the last quarter mainly due to reduction of passenger traffic, passenger fares, cargo transportation and freight charges reflecting the rapid decline in global trade and broadening impact of the economic slowdown. The slowdown in the last quarter contained the inflows on account of transportation services to US dollars 999 million limiting the annual growth to 19.3 per cent in 2008. Meanwhile, outflows on account of transportation also increased at a rate of 17.3 per cent, in line with the higher passenger and freight charges that prevailed in the international markets during the most part of the year.

Gross inflows from passenger fares increased mainly due to the increase in air fares led by the fuel surcharges. However, towards the latter part of the year, the earnings on passenger fares declined due to the contraction in the business travel along with reduction in travel for meetings and conventions due to the global economic slowdown. As remedial measures, the aviation industry is considering to enter into new product lines such as cargo, catering, ground handling, engineering services and training aircraft engineers to boost the slumped airline industry. Further, the operation of the newly built cargo handling terminal at the Bandaranaike International Airport by SriLankan AirLines will boost the cargo handling capacity, focusing on the growing Indian market.

Gross inflows on account of port-related activities increased as a result of increased transshipment attributable to the growing Indian economy and the improved service delivery at the Port of Colombo. The transshipment handling has recorded a growth of around 11.5 per cent during 2008. In order to sustain the growth in port-related activities and to successfully meet the future challenges from the competing ports in the region, Sri Lanka Ports Authority has improved its operations and has enhanced its productivity.

Travel and Tourism

The tourism industry remained sluggish during 2008 and the cumulative tourist arrivals declined by 11.2 per cent to 438,475 in 2008 compared to 494,008 arrivals in 2007. At the beginning of the year, arrivals were mainly affected by the travel advisories issued by some major tourist generating countries and as the year progressed, these factors were combined with the global recession that resulted from financial market turmoil. Decreases in arrivals were recorded in respect of key markets of South Asia and Western Europe as well as other markets such as East Asia, North America and Australia during 2008. Increases in arrivals were recorded from the Middle East and Eastern Europe. Earnings from tourism declined to US dollars 342 million in 2008 from US dollars 385 million in 2007. In terms of purpose of visit, of the 438,475 tourist arrivals in 2008, majority of them (73.2 per cent) visited the country for holiday purposes, while 8.5 per cent came for business purposes. While 8.3 per cent indicated they were visiting friends and relatives, 2.6 per cent visited for religious and cultural purposes, and 1.3 per cent had come for conventions and meetings.

Amidst many challenges, the Sri Lanka Tourism Development Authority has taken several measures to promote tourism. The Marketing Strategy and Activity Plan for 2008-2010 was presented focusing on four key markets; India, UK, Russia and the Middle East, that have shown a growth potential. Several steps have been taken to revitalise the tourism industry in the Eastern Province. The government also offered a stimulus package in January 2009 to help revive the ailing tourism industry, which included rescheduling of loans, waiving off the fuel surcharge and the Economic Service Charge (ESC). The rapid slowdown of international tourism growth since mid-2008, may continue into 2009 reflecting the impact of the deterioration of the global economic situation. However, with the imminent end of the war against

Table 5.8 Tourism Performance

Item	2004	2005	2006	2007(a)	2008(b)	Growth rate % 2007(a)	Growth rate % 2008(b)
Tourist Arrivals	566,202	549,308	559,603	494,008	438,475	-11.7	-11.2
Tourist Guest Nights ('000)	5,742	4,754	5,793	4,940	4,165	-14.7	-15.7
Room Occupancy Rate (%)	59.3	45.4	47.8	46.2	43.9	-3.3	-5.0
Gross Tourist Receipts (Rs. million)	42,059	36,377	42,586	42,571	37,094	0.0	-12.9
Per Capita Tourist Receipts (Rs.)	74,283	66,223	76,100	86,175	84,598	13.2	-1.8
Total Employment (no.)	129,038	125,004	133,558	145,239	124,456	8.7	-14.3
Direct	53,766	52,085	55,649	60,516	51,857	8.7	-14.3
Indirect	75,272	72,919	77,909	84,723	72,599	8.7	-14.3

(a) Revised
(b) Provisional

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

terrorism after more than two decades, the tourism sector is expected to emerge as one of the thrust sectors of the economy in the medium-term.

Telecommunication and Information Technology Services

The net earnings from telecommunication services increased by around 42 per cent in 2008. However, with the increased utilisation of email, broad band internet, satellite TV and International Direct Dialling (IDD), outflows on account of telecommunication services have continued to grow albeit at a slower pace. In the face of intense competition from new entrants to the market, the reduction in international call charges by both mobile and fixed line telecommunication operators facilitated the growth of IDD usage.

Sri Lanka is emerging as a favourite offshore outsourcing destination for specialised services such as software development, Information Technology Enabled Services (ITES) including Business Process Outsourcing (BPO) and Knowledge Process Outsourcing (KPO) and other Information Technology (IT) related services. This sector has grown remarkably by around 31 per cent to US dollars 230 million in 2008 from US dollars 175 million in 2007. Although, the top markets for Sri Lanka's software and ITES exports are Europe and North America, the potential exists to expand the market share in the African and Middle Eastern regions. Competitive operational costs, enhanced IT infrastructure facilities, availability of skilled workforce, price competitiveness due to concessions on service tax and the delivery of quality service facilitated the sustenance of the industry growth trend amidst the global financial turmoil. During 2008, several initiatives were taken to create a more conducive environment for IT and ITES sectors by further improving the IT infrastructure along with creating dedicated IT zones and appointing a Presidential Task Force on IT and English under the Ministry of Enterprise Development and Investment Promotion. The established IT Service Parks expanded its landscape through assisting and facilitating start-up companies by providing them with 'incubation centres', which have all the necessary infrastructure facilities required to start IT or ITES operations, other than providing IT facilities for software development companies. Specialised training in the areas of KPO in both accountancy and law can be utilised to enhance the quality of ITES providers who are already equipped with well qualified professionals to exploit industry opportunities emerging with the official declaration of the year 2009 as "The year of Information and Communication Technology and English".

However, this sector is likely to experience a slowdown in the coming years due to the economic slowdown in the top markets, namely, United States and Europe. The significantly increasing lay-offs in these markets over the last few months and the protectionist measures that may be taken by the US Government to protect local production rather than off-shore outsourcing may however hinder the demand for ITES in Sri Lanka.

Inflows and Outflows of Income

The deficit in the income account widened to around US dollars 972 million during 2008 compared to the deficit of US dollars 358 million in 2007. The interest income from investment of official reserves decreased by around 9 per cent to US dollars 96 million in 2008, mainly due to the lower global interest rates and gradual diminution of official reserves during 2008. In addition, the higher appreciation of the US dollar against major currencies such as Euro and Sterling pound in 2008 and the decline in market value of securities resulted in valuation losses in the external reserves valued on the basis of mark-to-market in US dollar terms. Similarly, earnings from the foreign financial assets of the private sector including commercial banks decreased due to the lower global interest rates that prevailed in 2008. Meanwhile, outflows in the income account increased by around 17 per cent to US dollars 940 million mainly due to the substantial increase in repatriation of profits and dividends of the foreign direct investment enterprises by foreign investors by around 35 per cent to US dollars 470 million. However, the repatriation of profits and dividends includes offsetting entry for reinvestment of retained earnings by those investors for the expansion of existing operations of the foreign direct investment enterprises.

Current Transfers

Workers' remittances grew at a higher rate of 16.7 per cent reaching US dollars 2,918 million in 2008. This increase was attributed mainly to the increase in the number of migrant workers leaving for foreign employment which increased by 16 per cent in 2008, the increase in the average wages of migrants in the Middle Eastern region due to the rise in income level of oil producing countries and the increased migration to high wage countries such as Korea, Malaysia and Singapore. Further, the deployment of Sri Lankan troops as UN Peacekeepers too have contributed to the boost in inward remittances. The new measures initiated by the commercial banks under the guidance of the Central Bank to mobilise more remittances through creation of awareness among migrants 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 increase the remittances through formal channels in 2008.

Due to the prevailing global recession, there is a possibility that some of the high-wage earning Sri Lankan migrant workers will be made redundant. However, over 68 per cent of the Sri Lankan migrant workers are engaged as unskilled workers, while 24 per cent and 8 per cent of the workers are engaged in skilled and semi-skilled, and professional jobs respectively. Further, over 85 per cent of Sri Lankan migrant workers are spread over the Middle Eastern countries while only a small percentage serve in European and other Western countries which are in recession. Since only an insignificant proportion is employed in the recession-affected countries while the majority is engaged in low wage earning occupations, a relatively steady inflow of workers' remittances can be expected in 2009.

Current Account Balance

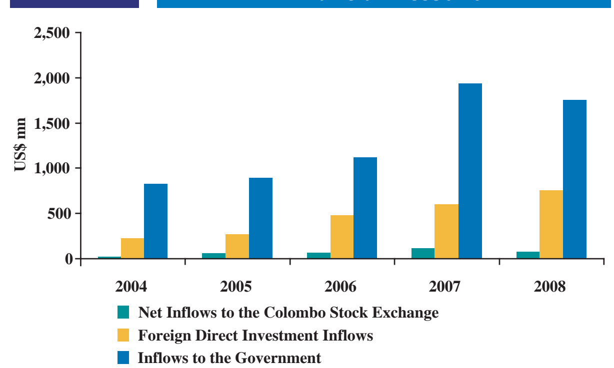
The current account deficit more than doubled to US dollars 3,775 million in 2008 from US dollars 1,401 million in 2007 due to increased trade deficit led by unprecedentedly high import expenditure. In terms of GDP, the current account deficit deteriorated to 9.3 per cent of GDP in 2008 from 4.3 per cent of GDP in 2007. The historically high petroleum and commodity prices that prevailed during the first half of the year resulted in the trade balance to record a deficit of US dollars 5,871 million by end 2008. However, the robust workers' remittances and worthy performance of the services sector helped contain the widening current account deficit. The high current account deficit reflects the high savings-investment gap of the country. Non-availability of adequate national savings for productive long-term investments suggests the need for substantial foreign capital, to achieve a consistently high rate of growth in the coming years.

5.5 Capital and Financial Flows and Balance of Payments

Foreign Direct Investment (FDI)

FDI inflows reached the highest recorded level in 2008 mainly due to increased reinvestment of retained earnings. The increase in reinvestment of retained earnings as a strategic choice shows the confidence of the existing investors in the future economic prospects of the country with the current improvement in the security situation. In the midst of the global financial crisis many countries encountered difficulties in attracting new FDI. Hence, the increase in reinvestment of retained earnings amidst the global economic crisis situation particularly shows heightened confidence about the prospects of the Sri Lankan economy. As a result, the gross FDI inflows including the foreign loans obtained by the BOI approved companies reached a record level of US dollars 889 million in 2008

Chart 5.8 Major Inflows to the Capital & Financial Account



compared to US dollars 734 million in 2007. FDI inflows in 2008 consisted of equity capital of US dollars 131 million, loans and advances of US dollars 110 million by the shareholders, intra-company borrowings of US dollars 101 million, foreign loans of US dollars 137 million and the reinvestment of retained earnings of US dollars 410 million by the existing companies. Meanwhile, FDI outflows increased to US dollars 62 million in 2008 from US dollars 55 million in 2007 as a few local companies also invested abroad, during the year.

Foreign investment commitments approved by BOI increased during 2008 despite the modest decline in the number of projects approved. Most of the projects approved were large scale projects engaged in telecommunication and manufacturing sectors. The highest FDI inflows were from Malaysia, amounting to US dollars 150 million, followed by India amounting to US dollars 126 million.

The long-term nature of the FDI flows reflects the importance of FDI over the other short-term financial flows of a speculative nature. In contrast to FDI, short-term financial flows are volatile and subject to the risk of sudden withdrawal especially during a crisis situation. Therefore, it is imperative that a more conducive environment for investment is created by providing required infrastructure facilities, establishment of property rights, faster allocation of lands for new investments, transparent licensing procedures, a fast dispute settlement system and greater labour mobility to attract a higher level of FDI.

Foreign Capital to the Government

Medium and Long-Term

Foreign inflows to the government consisting of both loans and grants decreased in 2008, mainly due to the lack of counterpart funds available for externally funded projects due to the global financial crisis. Though some commercial loans did not materialise as a result of the intensifying global financial crisis towards the end of the year, the government was able to mobilise US dollars 1.4 billion worth of loans and grants during 2008 as compared to US dollars 1.6 billion in 2007 which included the sovereign bond proceeds of US dollars 500 million. During the year, the total of long and medium term loan inflows to the government amounted to US dollars 1,059 million compared to US dollars 1,290 million in 2007. Of the total loan receipts in 2008, 604 million (57 per cent) was received on concessional terms while US dollars 455 million (43 per cent) was received on non-concessional or commercial terms.

Table 5.9 Major Projects Financed with Foreign Borrowings in 2008

Lender and Project	Amount Disbursed US dollars million
Asian Development Bank	**247.0**
of which; Colombo Port Expansion Project	42.9
Power Sector Development Project	21.4
Southern Transport Development Project - Supplementary	19.2
Secondary Towns & Rural Community Water/Sanitation Supplementary 1	16.7
Secondary Towns & Rural Community Water/Sanitation	15.3
Fiscal Management Programme	15.0
Southern Transport Development Project - Supplementary	11.9
National Highways Sector Project	11.0
Bank Austria Creditanstalt AG	**27.7**
of which; Enhancement & Strengthening of the Road Infrastructure by Construction of Five Bridges	9.7
Danske Bank A/S	**14.1**
of which; Towns South of Kandy Water Supply Project	14.1
European Investment Bank	**28.7**
of which; DFCC Global Loan II	15.1
Government of France	**20.8**
of which; Trincomalee Intergrated Infrastructure Project [TIIP]	10.7
Government of Japan	**262.9**
of which; Southern Highway Construction Project	60.7
Upper Kotmale Hydro Power Project	57.0
Provincial Road Improvement Project	17.6
Walawe Left Bank Irrigation & Extension Project II	16.9
Power Sector Restructuring Project (Kerawalapitiya)	16.1
Environmentally Friendly Solution Fund II	12.1
Lunawa Environment Improvement & Community Development Project.	11.8
Pro-Poor Rural Development Project	11.4
Colombo City Electricity District Devlopment Project	10.7
Kalu Ganga Water Supply Project for Greater Colombo.	10.2
Government of The People's Republic of China	**40.4**
of which; Preferential Buyers' Credit	23.2
Supply of 15 Nos. Diesel Multiple Units	10.6
HSBC Bank PLC (UK)	**32.4**
of which; Regional Bridge Project HSBC Bank Plc UK	23.4
HSBC Limited (Hong Kong)	**26.3**
of which; Regional Bridge Project HSBC Bank Hongkong	26.3
International Development Association	**95.3**
of which; Road Sector Assistance Project	45.2
North East Housing Reconstruction Project	20.2
Kingdom of Spain	**20.1**
of which; Design Supply & Setting up of two water treatment plants at Galle & Negambo	13.5
Nordea Bank Denmark A/S	**28.6**
of which; Oluvil Port Development Project	15.8
Kelani Right Bank Water Treatment Plant	12.8

Sources: Central Bank of Sri Lanka
External Resources Department

The concessional loan inflows were mostly directed towards the implementation of infrastructure projects such as expansion of the Colombo Port, construction of Southern Expressway and new Hambantota Port etc. Despite the faster implementation of major projects, the foreign aid utilisation rate[1] decreased marginally in 2008 to 20.5 per cent from 20.6 per cent in 2007, due to an increase in new aid commitments for new projects during the year. Meanwhile, long-term loan repayments by the government increased by 30.6 per cent to US dollars 807 million in 2008 mainly due to the repayment of goverment's commercial borrowings and the debts deferred in 2005 by Paris Club members, which need to be settled in seven instalments commencing from 2006. The total grants, consisting both of a current and capital nature, increased to US dollars 289 million in 2008 from US dollars 277 million in 2007. The government continued to receive a substantial amount of grants for the reconstruction of infrastructure damaged by the tsunami during 2008 as well.

Short-Term

Short-term net inflow on account of the government Treasury bills and bonds by foreigners reached its peak level of US dollars 185 million by end September 2008. However, with the intensification of the global financial crisis, the inflows recorded till end September 2008, suddenly reversed and by end 2008 turned into a net outflow of US dollars 213 million, due to the withdrawals by investors. Short-term net outflows on account of the government Treasury bonds by foreigners amounted to US dollar 264 million in 2008 compared to the net inflows of US dollars 372 million recorded in 2007. As part of further liberalisation of the capital account, the government permitted foreigners to invest up to a maximum of 10 per cent of the value of outstanding Treasury bills effective from May 2008. As a result of the liberalisation of Treasury bills market, government received a net inflow of US dollars 51 million on account of Treasury bills during 2008. However, investments in Treasury bills and bonds which are classified as short-term capital are much susceptible to volatile global financial outlook, and the intensification of financial crisis in September 2008 fuelled the rapid liquidation and repatriation of investment in Treasury bills and bonds. A total of US dollars 430 million of investments in Treasury bills and bonds were withdrawn during the period October to December 2008. In order to meet sudden foreign exchange requirement arising from liquidation of these investments and to create confidence among the investors, the Central Bank utilised the Sinking Fund that was created for such a purpose to facilitate the withdrawal of funds by foreign investors, without exerting an undue pressure on the domestic foreign exchange market.

[1] The foreign aid utilization rate is measured as the ratio of disbursement during 2008 to committed undisbursed balance as at end June 2008.

Foreign Capital to the Private Sector and Public Corporations

Long-Term

Long-term loan inflows to the private sector increased by 33.2 per cent to US dollars 265 million in 2008. Several private sector enterprises including a few BOI enterprises, particularly in power and energy, telecommunications and finance sectors obtained foreign loans to finance the expansion of their businesses as the domestic interest rates were relatively high in 2008.

Short-Term

The total net short-term capital inflows which consist of portfolio investments, private short-term credits and changes in commercial bank assets and liabilities, increased substantially to US dollars 679 million in 2008, compared to US dollars 205 million recorded in 2007, largely due to the extension of the Iranian line of credit to the Ceylon Petroleum Corporation (CPC) for petroleum imports. During 2008, CPC received net trade credits of US dollars 601 million including US dollars 381 million of Iranian line of credit.

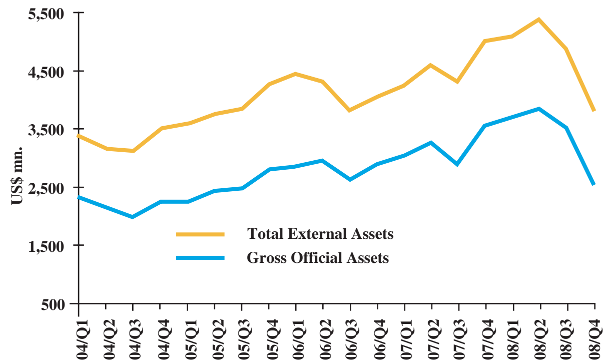
Despite a record level of gross inflow of US dollars 548 million received into the Colombo Stock Exchange (CSE), the net portfolio investment inflows declined to US dollars 60 million in 2008 as compared to US dollars 101 million in 2007. The companies in the automobile, banking and finance, insurance and telecom sectors attracted higher foreign investment. The outright sale of major shareholding of Associated Motorways PLC (AMW) and the selling of Nippon Telecommunication and Telegraphs Ltd.'s (NTT) stake in Sri Lanka Telecom Ltd. (SLT) and the minority shareholders' stake in SLT to the Global Telecommunications Holdings (GTH) attracted higher inflows to CSE. Gross outflows also increased to US dollars 488 million mainly due to the sale of NTT's stake in SLT.

Net foreign assets of commercial banks decreased by US dollars 210 million in 2008, mainly due to the conversion of foreign currency assets to domestic assets such as Sri Lanka Development Bonds (SLDB). Meanwhile, net liabilities of commercial banks decreased by US dollars 185 million in 2008 due to the decrease in foreign currency deposits both in Domestic Banking Units (DBUs) and Offshore Banking Units (OBUs).

Balance of Payments

BOP turned into a deficit in 2008, after recording surpluses continuously in the preceding three years. Due to the favourable external environment, BOP recorded a surplus during the first three quarters of 2008 and recorded a surplus of US dollars 515 million by end July 2008. However, the intensification of the global financial crisis in September 2008, adversely affected the satisfactory developments in the external sector. It led to the sudden withdrawal of investment in Treasury bills and bonds by foreign investors, the hasty claims on short-term credit facilities, the acute drying-up of commercial financing and severe valuation losses arising from the sharp depreciation of major international currencies against the US dollar. As a result, by end 2008, BOP turned into a deficit of US dollars 1,225 million.

Chart 5.9 Quarterly External Assets



External Reserves

During the greater part of the first nine months of 2008, the gross official reserves were maintained at a comfortable level equivalent to well over 3 months of imports. External official reserves excluding ACU liabilities rose to its highest

Table 5.10 External Assets of Sri Lanka (a)

Ownership	US dollars million (b)					Rs. million				
	2004	2005	2006	2007	2008 (c)	2004	2005	2006	2007	2008 (c)
1. Government	95	131	128	99	87	9,897	13,417	13,789	10,768	9,866
2. Government Agencies	-	-	-	-	-	-	-	-	-	-
3. Central Bank	2,101	2,604	2,709	3,409	2,474	219,795	265,873	291,747	370,640	279,870
4. Total Official Assets	2,196	2,735	2,837	3,508	2,561	229,693	279,290	305,536	381,408	289,736
5. Commercial Banks	1,243	1,466	1,169	1,448	1,238	129,987	149,656	125,867	157,454	140,075
6. Total External Assets	3,438	4,201	4,005	4,956	3,799	359,680	428,946	431,403	538,862	429,810
7. Gross Official Assets in Months of										
7.1 Merchandise Imports	3.3	3.7	3.3	3.7	2.2					
7.2 Import of Goods and Services	2.9	3.3	2.9	3.3	2.0					
8. Total Assets in Months of										
8.1 Merchandise Imports	5.2	5.7	4.7	5.3	3.3					
8.2 Import of Goods and Services	4.5	5.0	4.1	4.7	2.9					

(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 of Sri Lanka which were converted at the representative rate agreed with the IMF.

Year	2004	2005	2006	2007	2008
Rs. per US dollar (year end)	104.61	102.12	107.71	108.72	113.14

(c) Provisional

Source: Central Bank of Sri Lanka

ever level of US dollars 3,558 million in July 2008 which was the equivalent of 3.2 months of imports. Since then, reserves declined gradually as total outflows were higher than inflows with the intensification of the global financial crisis. By end 2008, the gross official reserves, with and without ACU payments, declined to US dollars 2,561 million and US dollars 1,753 million respectively. Accordingly, by end 2008, reserves with and without ACU were equivalent to 2.2 months and 1.5 months of imports respectively. The reserve adequacy as measured by the ratio of gross official reserves to short-term liabilities also declined to 45 per cent by end 2008 from 79 per cent at end 2007 mainly due to the reduction in reserves. The total external reserves of the country including ACU receipts also declined to US dollars 3,799 million.

The Central Bank took several measures to increase the reserve level of the country in 2009. The Central Bank has been in negotiation with three countries for currency SWAP arrangements. Under such arrangements the Central Bank has so far in 2009 received US dollars 200 million. In addition, several other steps have also been taken to boost the reserves. Promotion of investments in Treasury bills and bonds among the Sri Lankan Diaspora and the introduction of 20 per cent bonus interest on interest earned on NRFC and RFC accounts to encourage a higher level of inflows into those accounts were some of such initiatives.

Further, in response to an offer of the International Monetary Fund (IMF) to support Sri Lanka during the current global financial crisis, the government has sought a Stand-by Arrangement facility from IMF. Such support from IMF is for BOP purposes and the funds would be used to rebuild foreign reserves. It is expected that such support would enhance the assistance from other development partners as well as significantly improve international investors' confidence on Sri Lanka.

5.6 External Debt and Debt Service

External Debt

Continuing with the declining trend observed in the past few years, the total external debt consisting of medium and long-term, and short-term debt of the country declined to 37.1 per cent as a percentage of GDP in 2008 from 43.2 per cent in 2007. In US dollar terms, the total external debt increased by around 8 per cent to US dollars 15,107 million in 2008 basically driven by large short-term debt of CPC and other trade credits. Of the total external debt outstanding, 37.2 per cent was denominated in SDR, 31.1 per cent in Japanese Yen and 19.6 per cent in US dollars. The total external debt and liabilities, which consist of total external debt and banking sector external liabilities, decreased as a percentage of GDP in 2008 to 43.7 per cent from 51 per cent in 2007. The banking sector external liabilities as a percentage of GDP decreased to 6.6 per cent though in absolute terms it increased by 7.1 per cent to US dollars 2,669 million by end 2008, mainly due to the increase in ACU liabilities.

The government debt continued to account for a major share of external debt. From the total medium and long-term debt, the government debt accounted for 92 per cent, while the remaining share represented borrowings of the private sector and public corporations, and debt obligations to IMF. Out of the total government external debt, the concessional debt accounted for about 86 per cent. The elevation of the country to the lower middle income status has reduced the availability of concessional loans from multinational financial institutions, compelling the government to seek non-concessional loans to finance its development projects. However, the government maintained its non-concessional debt stock at a low risk level reducing the government's burden on debt.

Chart 5.10 External Debt

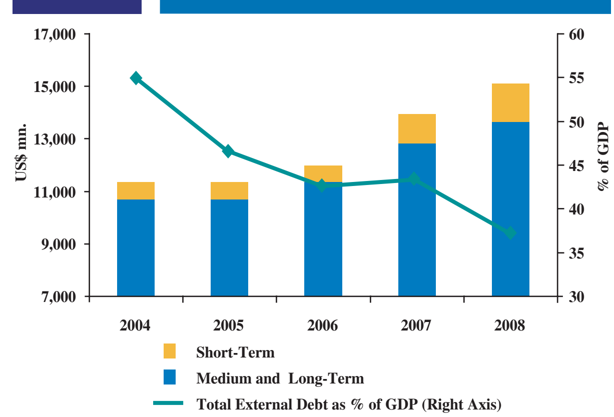


Table 5.11 Outstanding External Debt and Banking Sector External Liabilities

Item	US dollars million					Rs. million				
	2004	2005	2006	2007	2008(a)	2004	2005	2006	2007	2008(a)
1. Medium and Long-term Debt	**10,699**	**10,690**	**11,347**	**12,879**	**13,646**	**1,119,155**	**1,091,644**	**1,222,175**	**1,400,883**	**1,543,952**
1.1 Government	9,523	9,354	10,245	11,744	12,593	996,203	955,207	1,103,418	1,276,846	1.424.729
1.2 Public Corporations and Private Sector with Government Guarantee	507	567	465	345	251	52,986	57,912	50,065	37,501	28,429
1.3 Public Corporations and Private Sector without Government Guarantee	411	388	393	539	634	42,944	39,588	42,376	58,553	71,715
1.4 IMF Drawings	258	381	244	251	169	27,023	38,937	26,316	27,933	19,079
2. Short-term Debt	**647**	**664**	**634**	**1,111**	**1,460**	**67,726**	**67,759**	**68,286**	**120,748**	**165,207**
2.1 Government (b)	-	-	-	457	212	-	-	-	49,641	24,006
2.2 Other(CPC and other trade credit) (c)	647	664	634	654	1,248	67,726	67,759	68,286	71,107	141,201
3. Banking Sector External Liabilities (d)	**1,429**	**1,666**	**1,994**	**2,493**	**2,669**	**149,492**	**170,170**	**214,802**	**271,063**	**301,950**
3.1 Central Bank	1	1	3	2	1	128	131	284	219	64
3.2 Commercial Banks	1,066	1,388	1,681	2,046	1,861	111,464	141,753	181,040	222,389	210,531
3.3 ACU Liabilities	362	277	311	446	808	37,899	28,286	33,478	48,454	91,355
4. Total External Debt (1+2)	**11,346**	**11,354**	**11,981**	**13,989**	**15,107**	**1,186,881**	**1,159,403**	**1,290,461**	**1,521,581**	**1,709,159**
5. Total External Debt and Liabilities (1+2+3)	**12,775**	**13,020**	**13,976**	**16,483**	**17,775**	**1,336,373**	**1,329,573**	**1,505,263**	**1,792,643**	**2,011,109**
MEMORANDUM ITEMS										
Medium and Long-term Debt										
Project Loans	7,702	7,416	9,087	10,002	11,148	805,646	757,262	978,356	1,087,359	1,261,304
Non-Project Loans	1,763	1,655	867	1,064	740	184,467	169,038	93,331	115,697	83,703
Suppliers' Credits	240	283	435	679	705	25,123	28,907	46,877	73,790	79,722
IMF Drawings	258	381	244	251	169	27,023	38,937	26,316	27,933	19,079
Other Loans (e)	735	955	718	884	885	76,896	97,500	77,295	96,054	100,145
Short-term Debt and Banking Sector External Liabilities	**2,077**	**2,330**	**2,628**	**3,604**	**4,129**	**217,217**	**237,929**	**283,088**	**391,811**	**467,157**
As a percentage of GDP(f)										
Total External Debt	54.9	46.5	42.4	43.2	37.1	56.8	47.3	43.9	42.5	38.8
Total Banking Sector External Liabilities	6.9	6.8	7.1	7.7	6.6	7.1	6.9	7.3	7.6	6.8
Total External Debt and Liabilities	61.8	53.3	49.4	51.0	43.7	63.9	54.2	51.2	50.1	45.6
Short-term Debt	3.1	2.7	2.2	3.4	3.6	3.2	2.8	2.3	3.4	3.7
Short-term Debt and Banking Sector External Liabilities	10.0	9.5	9.3	11.1	10.1	10.4	9.7	9.6	10.9	10.6
As a percentage of Total Debt and Liabilities										
Short-term Debt	5.1	5.1	4.5	6.7	8.2	5.1	5.1	4.5	6.7	8.2
Short-term Liabilities	11.2	12.8	14.3	15.1	15.0	11.2	12.8	14.3	15.1	15.0
Short-term Debt as a percentage of Official Reserves	**29.5**	**24.3**	**22.4**	**31.7**	**41.6**	**29.5**	**24.3**	**24.4**	**31.7**	**43.3**

(a) Provisional
(b) Includes outstanding Treasury Bills and 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 Department

Foreign Debt Service Payments

Amortisations and interest payments which constitute the total foreign debt service payments increased to 15 per cent as a percentage of exports of goods and services in 2008 compared to 13.1 per cent in 2007. In US dollar terms, the debt service payments increased by 23.8 per cent in 2008. The continuation of scheduled debt repayments since 2006 after a one-off reduction due to the tsunami based debt moratorium in 2005 and the increasing debt servicing cost of the government's commercial borrowings in 2008 were the major reasons for the increase in the country's external debt service payments. The debt service ratios, which measure the country's capacity to service its external debt still remain at a comfortable level mainly due to the high share of concessional loans with longer repayment periods supported by continued growth in earnings from exports of goods and services.

Table 5.12 External Debt Service Payments

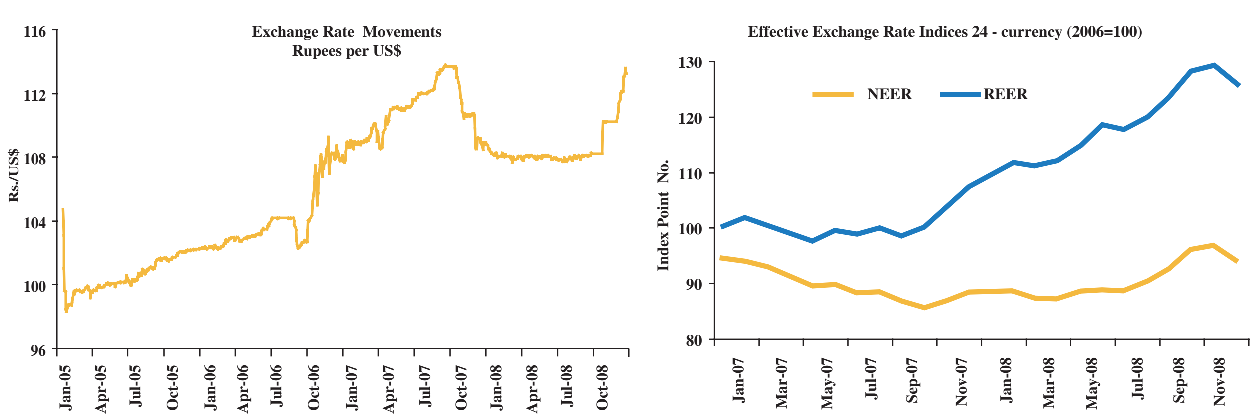
Item	US dollars million					Rs. million				
	2004	2005	2006	2007	2008 (a)	2004	2005	2006	2007	2008 (a)
1. Debt Service Payments	843	623	1,080	1,232	1,525	85,318	62,577	112,670	136,521	165,511
1.1 Amortization	594	419	759	791	1,075	59,990	42,075	79,227	87,731	116,702
(i) To IMF	107	39	144	5	998	10,718	3,902	15,276	789	8,582
(ii) To Others	487	380	615	786	998	49,272	38,173	63,952	86,942	108,120
1.2 Interest Payments	249	204	321	441	450	25,328	20,502	33,443	48,790	48,809
(i) To IMF	10	10	14	14	11	988	973	1,452	1,509	1,173
(ii) To Others	240	194	307	427	440	24,340	19,530	31,991	47,281	47,636
2. Earnings From Merchandise Exports and Services	7,284	7,887	8,508	9,415	10,140	738,714	793,153	885,380	1,041,932	1,098,376
3. Receipts From Merchandise Exports, Services, Income and Private Transfers	9,004	9,891	10,980	12,365	13,026	912,817	994,751	1,142,515	1,368,959	1,411,335
4. Debt Service Ratio (b)										
4.1 As a percentage of 2 above										
(i) Overall Ratio	11.6	7.9	12.7	13.1	15.0	11.5	7.9	12.7	13.1	15.1
(ii) Excluding IMF Transactions	10.0	7.3	10.8	12.9	14.2	10.0	7.3	10.8	12.9	14.2
4.2 As a percentage of 3 above										
(i) Overall Ratio	9.4	6.3	9.8	10.0	11.7	9.3	6.3	9.9	10.0	11.7
(ii) Excluding IMF Transactions	8.1	5.8	8.4	9.8	11.0	8.1	5.8	8.4	9.8	11.0
5. Government Debt Service Payments										
5.1 Government Debt Service Payments (c)	484	268	610	813	1066	48,952	26,927	63,368	89,924	115,508
5.2 As a percentage of 1 above	57.4	43.0	56.4	66.0	69.9	57.4	43.0	56.2	65.9	69.8

(a) Provisional
Source: Central Bank of Sri Lanka
(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.

5.7 Exchange Rate Regime and Exchange Rate Movements

The Central Bank's exchange rate policy in 2008 mainly focused on stability amidst unprecedented high volatility in the global currency markets, while allowing gradual depreciation to maintain external competitiveness. With the successful completion of Sri Lanka's debut international sovereign bond issue in October 2007, the rupee gradually appreciated against the US dollar till early 2008. It appreciated from Rs. 114 per US dollar in October 2007 to Rs. 107 per US dollar in March 2008. The rupee further strengthened with the announcement of an increase in foreign investment in Treasury bonds in December 2007 from 5 per cent to 10 per cent of the total outstanding Treasury bonds, and the weakening of the US dollar against major currencies during the first half of 2008. Further, with the opening of the Treasury bills market to foreign

Chart 5.11 Exchange Rate Movements



investors in May 2008 allowing them to invest up to 10 per cent of the outstanding Treasury bills, there was a continued pressure for the rupee to appreciate.

To mitigate excessive volatility in the foreign exchange market and to ensure that the competitiveness of the export sector is unaffected by an undue appreciation of the rupee, the Central Bank regularly absorbed foreign exchange from the domestic foreign exchange market, thereby strengthening its reserve position. Accordingly, the Central Bank's intervention in the market helped stabilize the exchange rate around Rs. 108 per US dollar level and by end October, the Central Bank had absorbed US dollars 622 million from the domestic foreign exchange market. With the intensification of the financial crisis, heavy outflows of foreign exchange due to the repatriation of short- term investments in Treasury bills and bonds and payments of high valued petroleum bills exerted heavy pressure on the exchange rate to depreciate in the last quarter of 2008. Besides, by end October 2008, considering the sharp decline in export prices, risks of lower export demand and the sharp appreciation of the US dollar against most major international currencies, the Central Bank allowed greater flexibility in the exchange rate, but excessive volatility was prevented through careful intervention. Accordingly, the Central Bank supplied US dollars 1,014 million to the foreign exchange market during the last quarter of 2008. On that basis, the total supply of foreign exchange by the Central Bank during 2008 amounted to US dollars 1,532 million.

As a result, by end 2008 the depreciation of the rupee against the US dollar was around 3.91 per cent as compared to a depreciation of around 0.93 per cent in 2007. At the same time, the rupee appreciated significantly against the Sterling pound (32.99 per cent), Indian rupee (17.54 per cent) and moderately against the Euro (0.51 per cent), while it depreciated against the Japanese Yen (22.44 per cent).

Nominal and Real Effective Exchange Rates

During 2008, both the Nominal Effective Exchange Rate (NEER) and the Real Effective Exchange Rate (REER) continued to appreciate at a faster rate than in 2007. Reflecting a nominal appreciation of the Sri Lanka rupee against most of the major currencies in the currency baskets, NEER of the Sri Lanka rupee, based on both the 5 currency

Table 5.13 Exchange Rate Movements

Currency	In Rupees per unit of Foreign Currency: End Year Rate			Annual Average Rate			Percentage Change Over Previous Year (a): End Year		Annual Average	
	2006	2007	2008	2006	2007	2008	2007	2008	2007	2008
Euro	141.58	160.27	159.45	130.63	151.63	159.32	-11.66	0.51	-13.85	-4.82
Indian Rupee	2.44	2.77	2.36	2.30	2.69	2.52	-11.83	17.54	-14.42	6.73
Japanese Yen	0.91	0.97	1.25	0.89	0.94	1.05	-6.83	-22.44	-4.96	-10.51
Pound Sterling	211.29	217.15	163.28	191.53	221.46	200.73	-2.70	32.99	-13.51	10.33
US Dollar	107.71	108.72	113.14	103.96	110.62	108.33	-0.93	-3.91	-6.02	2.11
SDR	162.03	171.57	174.27	153.00	169.37	171.24	-5.56	-1.55	-9.66	-1.10

Effective Exchange Rate Indices (b)(c) (2006=100)	Monthly Index			Annual Average			Percentage Change Over Previous Year (a): Monthly Index		Annual Average	
	Dec. 2006	Dec. 2007	Dec. 2008	2006	2007	2008	2007	2008	2007	2008
NEER - 24 currencies	94.35	87.79	93.71	100.00	89.23	90.20	-6.95	6.74	-10.77	1.09
REER - 24 currencies	99.26	105.65	125.47	100.00	100.07	118.08	6.43	18.77	0.07	18.00

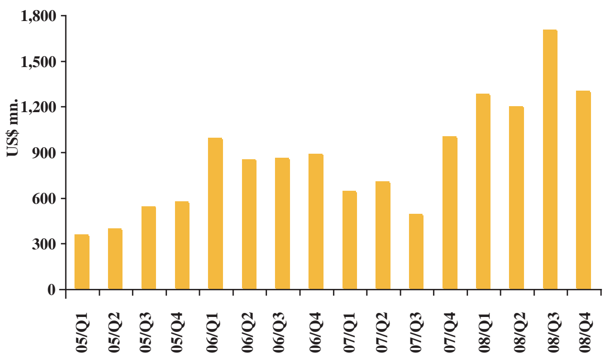
(a) Changes computed on the basis of foreign currency equivalent of Sri Lanka rupees. A minus sign indicates depreciation.

(b) NEER is the 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 was used for REER computation.

Source: Central Bank of Sri Lanka

Chart 5.12 Quarterly Inter-Bank Forward Transaction Volumes



and the 24 currency baskets, appreciated during 2008 when compared to the depreciation observed during 2007. Meanwhile, REER which takes into account the inflation differentials amongst countries in addition to the variations in nominal exchange rates, appreciated significantly during 2008.

Developments in the Domestic Foreign Exchange Market

The level of activity in the inter-bank foreign exchange market increased in 2008 led by transactions in Treasury bonds and bills, higher international trade, worker remittances and FDI. The higher interest rate differential resulted from lower international interest rates compared to domestic market interest rates and the relatively stable exchange rate supplemented in attracting foreign investments into the domestic Treasury bills and bonds markets in early part of the year. However, towards the latter part of the year, sudden liquidation of short-term investments with the intensification of the financial crisis and expectation of further depreciation of the rupee prompted the Central Bank to adapt precautionary and prudential measures to prevent speculative movements in the exchange rate and ensure stabilisation in the foreign exchange market. These measures contained the level of activity in the domestic foreign exchange market to a certain extent.

During the year, the Central Bank intervened in both sides of the market, which helped prevent erratic and undue movements in the exchange rates. The Central Bank absorbed a total of US dollars 656 million from the inter-bank market and supplied US dollars 1,532 million during 2008, resulting in a net supply of US dollars 876 million in 2008 as compared to a net supply of US dollars 123 million in 2007.