Central Bank of Sri Lanka

News Survey

Volume 35 Number 1 Jan-Mar 2015

IN THIS ISSUE

04100077
ISSN 1391 3589

Price per copy: Rs. 60.00 /
Annual subscription (Inclusive of postage): Rs. 420.00

Regional Development in the context of Economic Growth in Sri Lanka*

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As per the current medium term plans, Sri Lanka's economic growth is expected to be around 8% p.a. In order to achieve this high rate of economic growth, a positive contribution has to come from the regions. At present, Sri Lanka is more or less self-sufficient in agricultural products. What is now required for the agriculture sector is to promote better quality products aiming at external markets in view of the available limited domestic market. Therefore, technological applications, process improvements, proper planning for crops and exploring market channels specially focusing the external market are the current requirements for the agriculture sector. For the industrial sector what is required is a positive contribution from new industries. In this regard, there is a variety of products that Sri Lanka can consider producing as substitutes for imports as well as to cater to international markets. Promoting new industries is a must towards achieving sustainable economic growth as there is a potential in this sector to contribute to high economic growth. In the services sector too, new ventures for value addition have to be explored and promoted, deviating from traditional services. Services from banking, tourism, telecommunication, trade, skill development, technological advice are some of the areas that can be promoted in the services sector.

The sector-wise sectoral contribution to economic growth has changed dramatically during post liberalization period since 1977. Table 1 gives the province-wise percentage contribution from three sectors in the recent past.

Accordingly, the contribution of agriculture has declined towards 2012[1] while that from industrial and services sectors have expanded proving that there is a greater development in industries and services in the regions. In all provinces, the percentage contribution from the agricultural sector has declined. In order to achieve a high economic growth, there is no argument about the requirement of paying a greater attention to rural sector development. These developments may be from agriculture, industry or services. In the recent past, infrastructure developments such as roads and highways, communication, housing, city developments and beautification, ports and harbours, education including universities and schools, and construction with the initiation of both government and private sector have contributed to promote regional economic growth in the country. Table 2 gives some statistics on provincial contribution to economic growth.

Accordingly, there is a change in the contribution to GDP by provinces. Although it is not possible to achieve 100

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[1] This does not mean that the agriculture sector has not grown. The other sectors have grown faster.

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* The author wishes to thank Dr. C Amarasekera, Deputy Director of the Economic Research Department of the Central Bank for his valuable comments on the first draft.

Table 1
Province-wise Sectoral Contribution to GDP

(percentage)

Year		Island	Western	Central	Southern	Northern	Eastern	North Western	North Central	Uva	Sabaragamuwa
1996	Agriculture	22.4	5.7	34.0	36.4	20.1	34.3	34.3	47.4	53.4	26.3
	Industry	26.4	32.5	18.2	16.5	9.2	24.5	28.2	10.1	9.9	37.0
	Services	51.2	61.8	47.8	47.1	70.7	41.3	37.5	42.4	36.7	36.7
	Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
2012	Agriculture	11.0	2.9	15.8	13.1	19.6	19.0	14.5	20.7	27.5	18.2
	Industry	31.5	35.1	29.0	33.7	23.6	29.2	30.1	24.9	23.5	26.9
	Services	57.5	62.1	55.2	53.3	56.9	51.7	55.3	54.4	49.0	54.9
	Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Central Bank of Sri Lanka

* Provincial data are available only from 1996.

Table 2
Provincial Contribution to Economic Growth

(percentage)

Year	Province								
	Western	Central	Southern	Northern	Eastern	North Western	North Central	Uva	Sabaragamuwa
1996	43.7	10.0	9.0	2.4	4.8	11.3	4.6	5.1	9.0
2000	49.6	9.4	9.4	2.2	4.5	10.4	3.9	3.9	6.7
2012	43.4	9.8	11.5	4.0	6.3	9.6	4.7	4.5	6.1

Source: Central Bank of Sri Lanka

per cent equality among the provincial contribution to GDP, developments in the regions have contributed to reduce disparity among provinces. Governments, which came to power especially after liberalization policies were implemented, have attempted to reduce regional disparity by implementing various development projects/schemes. Government subsidies and price ceilings for products, regional infrastructure developments and improving quality of government services have positively contributed to reduce regional disparities. In the recent past, many programmes such as subsidised credit schemes, rural credit schemes, micro financing projects, Janasaviya and Samurdhi and establishment of different funds and sales centres for products from the regions are some to be named as factors that contributed to regional development thereby to reduce regional disparities. The proportional contribution to economic growth in the Western province, which is the concentrated province for major economic activities, has declined while that of many other provinces has increased in 2012 compared to year 2000, showing the effect of regional development programmes.

Contribution of banking and finance sector has also been helpful in reducing regional disparities. Activities such as establishing new banks and expanding their branch networks around the country, establishing new institutions such as Regional offices of the Central Bank, Regional Rural Development Banks, merchant banking are some of the institutional developments undertaken in the banking sector both by the government and the private sector which contributed to promote activities in the regions. Extending bank branches with user friendly facilities in the regions have contributed enormously to reduce disparities among the regions. Table 3 gives some statistics in regard to bank branches in the regions in 2012 with a comparison to year 2000 and 1996.

Because of the bank branch expansion, new deposit and creditor schemes, payments and transfer mechanisms, settlement systems, new markets have emerged in the country. The application of computer and mobile phone based systems has contributed enormously to reduce regional disparities among communities who use banking and finance services for their activities. As shown in Table 3,

Table 3

Province-wise Bank Branches & Banking Density Index

Year	All Island	Province								
		Western	Central	Southern	Northern	Eastern	North Western	North Central	Uva	Sabaragamuwa
	No. of Branches									
1996	1253	454	144	150	48	65	115	92	84	101
2000	2872	930	354	401	68	101	391	160	192	295
2012	3349	1194	363	383	221	254	301	195	180	258
	Banking Density Index*									
1996	6.83	9.62	6.21	6.26	3.45	4.86	5.31	8.19	7.36	5.70
2000	14.83	18.75	14.12	16.04	4.65	7.07	17.34	13.62	15.66	15.92
2012	16.47	20.45	14.13	15.49	20.80	16.30	12.65	15.43	14.22	13.40

Source: Central Bank of Sri Lanka

** Bank Branches per 100,000 people*

number of bank branches has increased and so has Banking Density Index.

At the same time, policies relating to rural banking and rural credit have helped introducing new schemes in the regions which contributed to reduce disparities among the provinces. Because of the finance sector developments, informal sector activities in the regions have declined substantially over time. For instance, the loans obtained from institutional sector have increased enormously while at the same time higher amount of loans obtaining at a low interest rate from this sector. Table 4 indicates the developments in the informal sector activities relating to finance over time.

Institutional and policy changes of the financial sector have also helped to increase the presence of the organized sector financial activities in the remote areas. In the history of the Central Bank policies, the appointment of Credit Advisory Board, opening of six Regional Offices of the Central Bank in provinces, establishment of the medium term credit fund, proactive interest rate and credit promotion policies for lending institutions, and awareness programmes have been some of the possible action by the Central Bank that helped promoting the presence of the organized sector activities in the rural sector. Financial institutions, i.e., banks, have acted proactively to Central Bank policies specially in the areas of expanding establishment of bank branches in the rural areas[2], providing facilities such as placing automated teller machines, granting loans and credit to needy sectors at attractive terms and conditions, engaging in promotional activities in creating awareness among the public have positively contributed to increase the activities of organized market in the interior, specially in the rural sector of the country.

At present, usage of state-of-the-art technology in the payment and settlement systems have contributed to reduce disparities in the payment systems of the regions. Teller machines, card payment systems, phone banking and tele-banking have helped narrowing down the differences in the mode of payment and settlement practices in the regions as compared to rudimentary systems available in the past, while promoting a deeper financial sector in the rural economy. In the past, servicing hours of commercial banks for transactions during a day were limited. However, presently there are banks which function around the clock for business. Usage of computers has created easy mechanisms for both financial institutions and customers. These have promoted value addition activities in the regions and reduced disparities among the regions.

At present, there are many schemes introduced by the government attempting to promote regional activities. Micro financing projects, credit schemes based on the directions of the regulators and initiatives of commercial banks and skill development programmes for the stakeholders and the general public are some of the ongoing schemes which are helpful to reduce regional imbalances through developing innovative activities. There is enormous capacity and opportunities available in the regions which can contribute to a high economic growth. Developing industries and services is essential in this regard, and to increase the value addition to overall economy, further regional developments are essential.

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2. As per the Central Bank's policy, commercial banks have to open two branches outside Western Province whenever they open a new branch in Western Province effective from 2008.

Table 4

Trends in Informal Sector Finance*

Source of Finance	Year		
	1963	1986/87	2003/04
(a) Institutional;	14.3	39.8	66.1
of which, Commercial Banks	7.8	23.4	35.9
(b) Non-Institutional;	85.7	60.2	38.9
of which, Money Lenders	22.5	18.7	8.2
Friends/Relatives	39.0	35.7	29.0
Others	24.2	5.8	1.8

Source: Consumer Finances and Socio-economic Surveys, CBSL

** Data for current years are not available for comparison.*

Government assistance for further developing education in the country, especially in the remote areas, have given a helping hand for the people living in those areas to improve their value addition. Development programmes for schools have been undertaken under different government projects to transform the school education system to be more productive. Establishment of science and computer laboratories in schools workshops and awareness programmes for upliftment of teacher training, assistance to students who have received outstanding results at national level exams, and scholarship programmes have been helpful for students. These activities have helped reducing the number of students who are not attending school and therefore improving the literacy levels in the regions. Number of universities in the country have increased to 17 at present compared to 7 in 1980s. In addition, establishment of private universities has been encouraged and as a result the country has many private universities with an enormous demand from those who cannot enter into public universities. These universities offer a wide range of disciplines of studies which can be selected by the students based on their choices. There is a substantial demand from the private sector establishments in both domestic and international markets for those who pass out from the private universities. Private universities offer a variety of areas for the students to acquire educational qualifications based on links with popular international universities. Both government and private universities have provided educational facilities in the regions which have contributed to expand related economic activities inside the country. These have helped promoting value additions from provinces outside the Western Province where there was a prominence for studies, for which there was a greater demand in the past.

At present, there is a variety of government subsidy schemes which help to develop regional agricultural and semi industrial based activities. Floor prices for products such as paddy, potatoes and onions, subsidy schemes for fertilizer and seeds, credit schemes for agriculture and SME sector have enormously contributed to uplift the face of economic activities in the regions. Land areas under cultivation and number of people engaged in the economic activities have increased due to the facilities provided. Industries such as textile and garments are doing well and there is a substantial value addition for the products while creating employment opportunities, especially for youths in the villages. These have helped to reduce regional disparities in value additions.

The conclusion of the internal conflict, which prevailed for nearly three decades and resulted in a substantial setback to economic activities, has provided a conducive environment for expansion in economic and social activities in the regions. Further, new avenues are opened for confident building of the industrialists. Interior constructions relating to roads, houses, irrigation schemes etc. have provided value additions to GDP. Services sector including transport, trade, banking and finance, and tourism has been able to rise up due to peaceful environment in the country which gives some awakening to regional economic activities. These have also helped mitigating regional disparities. There are a number of indicators to measure the results of interior developments. Annexure lists out some indicators to show the results of innovations in the regions for the most current period (2009/10) compared with those available for an earlier period (2006/07). Accordingly, all indicators have shown that there is a clear upliftment in the life styles of the people in 2009/10 when compared to

2006/07. Building permanent houses, safe drinking water supply, making available household equipment such as television, telephones, motor cars and vans, refrigerators, personal computers have recorded increases in almost all regions. Income has grown as shown by the per capita income while reducing the income disparity as shown by favourable improvements in the income disparity index, the Gini coefficient, for households. As a result of these developments there is an improvement in the prosperity as shown by the increased level of prosperity index. Poverty has declined over time in almost all provinces when compared to that of the Western province. This has led to reduce the income disparity in the provinces thus reducing poverty.

However, it is to be noted that benefits in the Western Province as measured by all these indices are still higher showing that the Western Province has a higher prosperity with a higher income. For instance, per capita income in the Western Province in 2012 was Rs.563,920 while that of other provinces were lower. Table 5 gives difference between average per capita income of the country and those of other provinces separately. Accordingly, other than Western Province, all other provinces have recorded a low per capita income compared to the average per capita income of the country. However, except for the provinces of Central, North Western, Uva and Sabaragamuwa, the said difference for other provinces has narrowed down in 2012 compared to 1996, showing an improvement in economic activities in those provinces.

Table 5

Change in the Per Capita Income of the Provinces Compared with Per Capita Income of the Country – 1996, 2012 (Rs.)

Year	Per capita income of the country	Difference Between the Per Capita Income of the Province and that of the Country								
		Western	Central	Southern	Northern	Eastern	North Western	North Central	Uva	Sabaragamuwa
1996	37,955	26,573	(7,770)	(11,853)	(25,805)	(12,766)	(1,428)	(9,696)	(7,065)	(2,543)
(%)		70.01	(20.47)	(31.22)	(67.98)	(33.63)	(3.76)	(25.54)	(18.61)	(6.70)
2012	372,814	191,106	(83,250)	(19,902)	(85,350)	(68,771)	(66,040)	(92,345)	(101,564)	(131,063)
(%)		51.26	(22.33)	(5.33)	(22.89)	(18.44)	(17.71)	(24.76)	(27.24)	(35.15)

Source: Author's computation based on the data from the Central Bank of Sri Lanka

Existing government institutional network can be used for further promoting economic activities in the regions. At present, there are many government Ministries and institutions functioning in the country from which a substantial support could be obtained for attempts in regional developments. This institutional framework may provide a comprehensive supportive mechanism to promote production processes in the regions which leads to minimize disparities among regions.

The initiatives to promote Small and Medium Enterprises and micro financing sector are other areas which can be utilised for enhancing economic growth in the regions. Creating awareness and provisioning finance to initiate different types of industries are some areas of helps that can be obtained from these schemes to improve economic activities. Presently available loan schemes implemented by the Central Bank, particularly aiming at regional agricultural and industrial promotion in the regions, can be considered as contributory schemes for regional growth. Under these schemes, the Central Bank has provided substantial amount of funds for the entrepreneurs in the regions. Second Perennial Crops Development Project, Viskam Credit Line for Development of Commercialised Agribusiness, Resumption of Economic Activities in the Eastern Province Loan Scheme, The Prosperity Loan Scheme, Provincial Development Credit Scheme, Post Tsunami Coastal Rehabilitation and Resource Management Programme, Small Farmers and Landless Credit Project, Poverty Alleviation Microfinance Projects, Dry Zone Livelihood Support and Partnership Programme, Small Holder Plantation Entrepreneurship Development Programme, National Agribusiness Development Programme, Repair of Damaged Houses in the North and East were some of the supportive schemes operated by the Central Bank during 2013 in order to promote regional development in the country. Other than these, commercial banks have also started different types of loan schemes by their own to promote agricultural and industrial activities in the regions. Under these supportive schemes a variety of skill development and awareness programmes such as workshops, best practices in agriculture and financial literacy, have been conducted in the regions other than provision of finance to projects. Some of these programmes (such as PAMP projects) have covered a substantial area like 14 districts out of a total of 25 in the island. Small industries, agriculture and livestock, trade, services and fisheries are some of the purposes for which these schemes have funded. Table 6 gives information about the performance of loan schemes implemented by the Central Bank during

Table 6
Performances of the Supportive Schemes Implemented by the Central Bank

Program	**Year**				
	2009	**2010**	**2011**	**2012**	**2013**
1. Agriculture and Animal Husbandry					
2nd Perennial Crops Development Project - RF (2006 - 2014), Tea Development Proect - RF (2006 - 2018), New Comprehensive Rural Credit Scheme (Continuous Program), Agro-Livestock Development Project, Krushi Navodaya Scheme, "Viskam" Credit Line for Development of Commercial Agri-business, Commercial Scale Dairy Development Loan Scheme (CSDDLS)	**No. of Loans**				
	72,603	76,201	102,858	116,064	96,751
	Loan Amount (Rs. mn)				
	4,263.2	4,125.2	7,575.5	10,543.8	8,437.9
2. Small and Medium Enterprise Sector					
Matale Regional Economic Advancement Project - RF (MREAP - RF)(2007 2009),Sabaragamuwa Province Integrated Rural Development Project - RF (SPIRDP - RF) (2007 - 2010), Sabaragamuwa Province Integrated Rural Development Project - Phase II (SPIRDP - Phase II), Post Tsunami Line of Credit - EIB Contract B Loan Scheme (2006 - 2014), Susahana Loan Scheme - Phase II, Construction Sector Development Project (2007 - 2012), Awakening North Loan Scheme, Awakening Nort Loan Scheme Phase I, Awakening Nort Loan Scheme Phase II, Resumption of Economic Activities in the Eastern Province - Phase I, Resumption of Economic Activities in the Eastern Province - Phase II, Resumption of Economic Activities in the Eastern Province - Phase III, Saubagya Loan Scheme (Prosperity Loan scheme), Self-Employment Initiative Loan Scheme, Post Tsunami Coastal Rehabilitation & Resource Management Program (PTCRRMP), Provincial Development Credit Scheme	**No. of Loans**				
	1,758	18,572	11,724	19,535	25,505
	Loan Amount (Rs. mn)				
	1,248.1	3,686.6	3,386.4	4,419.7	6,202.0
3. Microfinance Sector					
Dry Zone Livelihood Support and Partnership Program (2006-2012), Dry Zone Livelihood Support and Partnership Program - RF (2013-2015), Smallholder Plantation Entrepreneurship Development Program (SPEnDP) (2006 - 2012), Small Farmers and Landless Credit Project - Revolving Fund (1997 - 2017), Poverty Alleviation Microfinance Project RF (PAMP - RF) (2007 - 2027), Poverty Alleviation Microfinance Project II (PAMP II) (2009 - 2015), Poverty Alleviation Microfinance Project II - RF (PAMP II - RF) (2013 - 2018), National Agri-Business Development Program (NADeP)	**No. of Loans**				
	23,215	26,607	31,463	27,250	42,724
	Loan Amount (Rs. mn)				
	885	1,057	1,419	1,360	2,545
all Programmes	**Total No. of Loans**				
	97,576	121,380	146,045	162,849	164,980
	Total Loan Amount (Rs. mn)				
	2,133	4,743	4,806	5,780	8,747

Source: Regional Development Department's Database, Central Bank of Sri Lanka recent five years. Accordingly, number of entrepreneurs borrowed and amount disbursed by the Central Bank for them have increased towards 2013 compared with the initial year 2009 indicated in the Table.

The information available at present is not sufficient to carry out a comprehensive evaluation of the effectiveness of these schemes. No. of loans and amount of money granted have increased over the period showing increased involvement of credit schemes for development in the grass root level activities. Some available macro-economic indicators can be used to gauge the results of these activities in reducing regional disparities. For instance, the contribution from the western province in the GDP has declined as a result of higher contributions from some interior provinces. The decline in overall poverty (as shown by poverty head count index) and decline in income disparity (as shown by low Gini coefficient in 2009/10 compared to that of 2006/07) are some of the other indicators that can be used to gauge the successfulness of the attempts made by authorities to improve regional development in the recent times. Usage of modern facilities such as televisions, phones, motor vehicles, refrigerators, and computers etc. have increased during the recent times. After all, as a result of these improvements the values of the 'Prosperity Index' computed by the CBSL have recorded high values in 2011 as compared to 2004, despite giving a higher prosperity index (76.1) for the Western Province (details are given in the Annexure).

Although these are some of the positive achievements, a substantial effort is required to further promote interior

Annexure

Indicators of Regional Development by Province

Indicator	Year	All Island	Western	Central	Southern	Northern	Eastern	North Western	North Central	Uva	Sabara-gamuwa
Permanent Houses (wall type)											
	2006/07	88.9	92.3	85.0	90.0	-	84.8	85.7	88.1	90.5	88.1
	2009/10	91.7	94.2	91.1	92.8	89.1	90.4	89.0	92.1	93.4	88.0
Safe drinking water supply											
	2006/07	84.8	94.3	70.6	84.4	-	92.2	90.5	86.4	81.4	67.2
	2009/10	87.7	95.7	81.2	86.2	96.2	96.0	91.4	91.7	69.9	70.4
No toilet facilities											
	2006/07	3.6	1.8	5.3	1.9	-	13.9	5.6	3.2	2.5	2.4
	2009/10	2.5	0.4	2.5	1.5	18.1	8.9	3.3	1.2	1.2	0.9
Availability of Household Equipment											
Television	2006/07	77.3	87.2	76.0	74.7	n.a	60.2	74.4	72.7	70.2	73.3
	2009/10	80.0	88.4	81.7	79.8	54.3	63.2	78.5	79.2	78.0	77.5
Telephone	2006/07	14.8	26.2	12.1	11.7	-	9.3	10.2	9.0	5.5	8.2
	2009/10	77.1	86.0	76.2	76.6	65.2	63.5	75.1	78.2	71.7	72.0
Motor car/van	2006/07	6.0	10.4	4.5	4.1	-	1.3	4.3	3.2	2.7	3.8
	2009/10	25.8	10.3	5.0	3.4	0.9	0.9	5.5	3.5	2.8	3.7
Refrigerators	2006/07	35.1	55.2	28.1	31.8	-	19.6	28.7	26.4	15.5	23.9
	2009/10	39.6	60.0	34.1	38.0	16.2	22.2	36.0	32.5	21.8	30.4
Personal Computers	2006/07	7.0	13.5	6.4	4.5	-	2.3	3.9	3.4	3.3	2.8
	2009/10	12.5	21.2	11.7	10.2	6.5	5.9	9.8	8.5	5.8	8.4
Poverty Head Count Index (percentage)											
	1990/91	26.1	19.1	30.7	30.2	n.a	n.a	25.8	24.5	31.9	31.0
	2006/07	15.2	8.2	22.3	13.8	-	10.8	14.6	14.2	27.0	24.2
	2009/10	8.9	4.2	9.7	9.8	12.8	14.8	11.3	5.7	13.7	10.6
Provincial Per Capita GDP (Rs.)											
	1996	37,955	64,528	30,185	26,102	12,150	25,189	36,527	28,259	30,890	35,412
	2012	372,814	563,920	289,564	352,912	287,464	304,043	306,774	280,469	271,250	241,751
Gini Coefficient (households)											
	2006/07	0.49	0.49	0.48	0.44	-	0.44	0.48	0.44	0.48	0.48
	2009/10	0.49	0.47	0.48	0.42	n.a	0.42	0.54	0.44	0.47	0.53
Prosperity Index											
	2004	46.6	61.1	45.8	44.9	42.5	41.2	43.8	40.6	42.4	42.7
	2011	60.6	76.1	58.3	60.0	55.6	54.6	57.1	54.9	54.5	55.8

Sources: Central Bank of Sri Lanka

Household Income & Expenditure Survey Reports, Dept. of Census & Statistics economic growth and to reduce regional disparities. The lessons from countries such as Japan, China and Korea can be used to promote our own economic growth leading to a high income level of the entire nation. In these countries economic reforms with dedicated political leadership have helped accelerating the economic growth.[3]

The existing institutional setup, positive attitudes of the government and available peace and the political stability are some of the positive factors that can be used in the attempts of reaching higher level of income for the people in the country. In the attempts in achieving a country with higher middle income level as per the World Bank classifications, there is no argument about the necessity of regional development. The policies and attitudes of the people have to be changed positively in achieving these expectations.

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[3] For details see the article titled "Lessons from China for our Prosperity" published by the author in News Survey, Jan. March 2014, Central Bank of Sri Lanka.

Liberalization of Capital Account in Sri Lanka:

Key measures and their impacts to the Sri Lankan economy

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1. Introduction

Exchange controls are the restrictions imposed by governments on the movement of currency across countries and are conventionally maintained by different economies citing different benefits such as conservation of foreign reserves, stabilisation of exchange rates, avoiding capital flight, correcting disequilibrium in balance of payments and maintaining over-valuation of home currency, though some of those are subject to heavy criticism by various stakeholders of the economy as they involve lots of costs; distort investor confidence, lead to over valuation of local currency, disturb necessary foreign capital inflows that fill the domestic savings gap. Therefore, the level of exchange controls and the liberalization of them are a trade-off between costs and benefits, and frequently described by exchange control policy which is an integral part of the overall macroeconomic policy framework of a country. Even in Sri Lanka, the exchange control policy was flexible enough to respond to the changes in overall macroeconomic policy frameworks adopted by different political regimes in power. Sri Lanka adopted a fairly liberal exchange control policy until the 1950s followed by a gradual tightening which reached its peak in the 1970s. However, with the adoption of open market economic policies in 1977, the controls have been relaxed gradually with a view to attract foreign capital, expedite economic growth, generate more employment opportunities and to promote economic welfare and wellbeing among the general public. The aim of this article is to discuss key policy measures implemented to liberalize the capital account in Sri Lanka, and the impact of such liberalization on the Sri Lankan economy.

2. Foreign Exchange, international transactions and the role of Exchange Control Function

Though the terms ‘foreign exchange’ and ‘foreign currency’ are frequently used as synonyms, in terms of the Exchange Control Act[1](ECA), ‘foreign exchange’ is the broader term that includes *foreign currency and all deposits, credits and balances payable in any foreign currency and any such drafts, travellers’ cheques, letters of credit and bills of exchange as are expressed or drawn in Sri Lanka currency but payable in any foreign currency,* while ‘foreign currency’ means *any currency other than Sri Lanka currency and including any currency payable by a foreign government or institution to a person in, or resident in, Sri Lanka in respect of his pension or other gratuities due to him*.

Inception of foreign currency is believed to have happened soon after the inception of foreign trade despite ‘barter system’[2] which prevailed in the early days. Ancient Chinese and Roman coins found in many parts of the world are classic examples of historical usage of foreign currencies. Since Sri

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[1] Exchange Control Act., No. 24 of 1953, as amended.

[2] Barter is a system of exchange by which goods or services are directly exchanged for other goods or services without using a medium of exchange such as money.

Lanka was one of the popular locations in the 'Maritime Silk Route' and linked the eastern and western parts of the world, it is believed that the usage of foreign currencies in Sri Lanka started at the same period. Currencies used by trade partners were widely accepted as trading currency in most instances and there was no evidence of separate mechanism or intervention similar to exchange controls other than collecting taxes from foreign traders. Therefore, the levels of encouragements or discouragement by governments on trade in respect of particular items or with particular parties (nations) were through tax systems where higher taxes made transactions more expensive and discouraging.

Though international transactions began with marketed products by travelling from one country to another thousands of years ago, in today's globalized world, it has evolved from basic trade of goods to extremely complex transactions that exchanging almost everything is now possible irrespective of its form of existence, globally within seconds. Therefore, many systems and mechanisms have been evolved to deal with complexity and to minimize adverse consequences of them. Exchange controls are also one such mechanism though its application and intensity may vary due to many factors.

Exchange control function regulates cross border foreign exchange flows; primarily payments and receipts between persons resident in the country and persons resident outside the country which frequently involve conversion of local currency into foreign currency (*vice versa*). Perhaps, meaning of 'exchange control' may be extended to cover all foreign exchange transactions effected within the country[3] irrespective whether of any conversion is involved or not. Exchange control regulations emerged as a widely accepted mechanism to preserve foreign exchange reserves by controlling outflows during World War II and relevant legal enactments emerged in 1940s. Though the behaviour of market forces are always preferred to occur through macroeconomic principles than regulations, many economies in the world learnt many lessons from economic turbulences in the recent past i.e. Asian crisis (1997-98) and global financial crisis (2007-2010) particularly so that the importance of prudential regulations and surveillance systems to ensure market discipline and stability, was understood as respective governments have inseparable responsibility in promoting the well-being of its citizens.

In Sri Lanka, the exchange control function was formally established under the Central Bank of Sri Lanka in terms of the Exchange Control Act., No. 24 of 1953 (ECA), and a series of general permissions have been granted by way of operating instructions, directions, rules and regulations issued thereunder by the Minister of Finance or the Controller of Exchange who is expected to function under the direction of the Governor of the Central Bank of Sri Lanka, and exercise powers by himself or on his behalf by any other officer designated as an assistant to him, as empowered in ECA. However, there is evidence to prove that exchange control function was in operation for many years before the enactment of the ECA.

During the period that Sri Lanka adopted a fixed exchange rate regime, exchange control was a necessity as it helps to forgo 'free capital mobility' under an impossible trinity that chose to keep 'monetary independence' and 'fixed exchange rate'. However, with migration of fixed exchange rate system towards flexible exchange rate regime, the importance of exchange controls that restrict free capital mobility was gradually diminished. Therefore, exchange control liberalizations were initiated, sequencing from fully liberalization current account transactions and are now in the process of gradual liberalization of capital account transactions. Monitoring, supervision and surveillance are integral parts of any exchange control liberalization process.

2.1 Liberalization of Current Account

Relaxation of exchange controls on current international transactions which includes payments or receipts involving trade in goods and services, factor and remittances for family living expenses, were gradually implemented (after 1977) throughout the 1980s and completed with the Sri Lanka's acceptance of the obligations under Article VIII of the Articles of Agreement of the International Monetary Fund (IMF) in early 1994. Accordingly restrictions on current international transactions have been removed since 18th March, 1994 and Licensed Commercial Banks who are authorized dealers[4] in foreign exchange have been granted permission[5]to release foreign exchange without restrictions[6] for all current transactions exercising their judgment and discretion after satisfying themselves with the bona-fide of such requests.

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[3] between persons resident in the country

[4] Appointed in terms of the section 4 of the ECA

[5] In terms of the section 7of the ECA that restricts persons in Sri Lanka make any payment to a person resident outside Sri Lanka, except with the permission of the Central Bank of Sri Lanka.

[6] subject to trade policy of the government

The requirement for repatriation and surrendering export proceeds to an authorized dealer in Sri Lanka were also removed[1].

Upon removal of restrictions on non-capital transactions (liberalization of the current account), relaxation of exchange control regulations on capital account transactions was commenced.

3. What is capital account, key liberalization measures and their economic benefits in Sri Lanka?

3.1 What is Capital Account?

Capital account in a country's balance of payments represents variety of financial flows involving the acquisition (or disposal) of assets in one country by residents of another. Liberalization of capital account transactions means the removal or easing of restrictions on capital mobility into and out of a country. In the late 1980s developing countries all over the world began easing restrictions on capital flows. Economic theories suggest that unfettered international capital flows can foster a more efficient allocation of resources, provide opportunities for risk diversification, and help promote financial development. In recognition of these potential benefits, governments of industrial countries have undertaken widespread capital account liberalization over the past quarter-century. Many attribute efficiency gains, increased diversification opportunities, and financial development in these countries to opening up of capital markets.

Primarily, foreign capital flows can be categorized as debt and non-debt creating capital flows. Debt can be denominated in foreign currencies as well as local currency, and flowing into (or out of) a government, corporate and banking sectors as well as individuals. Non-debt creating funds usually consist of foreign direct investments (FDI)[2], portfolio investments[3] and grants.

The reduced importance of bank lending and greater importance of FDI in the more recent period is widespread across regions. However, one should note that FDI has been relatively larger in Asian countries than in other regions. Generally, it is argued that FDI is the most desirable form of foreign capital as it brings along positive externalities, such as management expertise, technology and increased access to foreign markets. Moreover, it is a widely accepted fact that portfolio investment flows have greater volatility as they are less costly to reverse (than FDI) and are continuously allocating and reallocating them to optimize the return. It is also argued that FDI has lower sensitivity to international interest rates and is driven by considerations of long-term profitability.

3.2 Liberalizations of Capital Account

Benefits and risks of capital account liberalization have been the subject of many studies and widely discussed in the past few decades. Evidence has shown that easing restrictions on capital flows help emerging economies to foster sustainable growth as capital inflows provide additional financial resources for productive activities and facilitate the transfer of technological and managerial know-how. On the other hand, volatility of capital flows poses major risks to monetary and financial stability, as most of the capital flows contain significant pro-cyclical elements that lead to lending/investing in good times but tend to pull back in bad times, amplifying the turbulence, especially if capital account liberalization is implemented under unfavourable circumstances without policy support. Countries that have managed to overcome negative externalities arising from capital account liberalization, particularly excessive inflows, have not relied on a single policy measure, but a carefully selected and well-coordinated set of policies. The appropriate policy combination depends on variety a of factors, such as the causes behind the inflows, the availability and flexibility of instruments, the nature of domestic financial markets, and the macroeconomic and policy environment in the recipient country.

At present, the capital account of Sri Lanka is partially liberalized, and the liberalization of capital account was commenced in 1990s after fully liberalization of current account. All though the pace was slow at the beginning, steps have been taken to expedite the process in the recent years. Sri Lanka has also followed the widely accepted "sequencing"

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[1] In terms of the Section 22(4)of the ECA that requires exporters to repatriate export proceeds within 6 months period, and the requirement of surrendering export proceeds to an authorized dealers in terms of the Section 6(2)(a).

[2] Foreign Direct Investment (FDI) refers to an investment made to acquire lasting or long-term interest in enterprises operating outside the economy of the investor (IMF). Usually it represents acquisition of at least 10 % of the voting shares of the enterprise.

[3] Portfolio Investments represent purchases of securities (stocks and bonds) with the expectation of optimize return on it and do not involve in management.

in capital account liberalization process which is a gradual approach;

- Inflows Vs Outflows (relax restrictions on inflows before the outflows)
- Long-term Vs Short-term (allow short-term capital flows at a later stage)
- Institutions Vs Individuals (priority be given to the institutional sector)

Capital account liberalization measures introduced in Sri Lanka and its impact on Sri Lankan economy would be discussed in this article under the following categories;

a) Investments in Sri Lanka by persons resident outside Sri Lanka

b) Investment abroad by persons resident in Sri Lanka

c) Borrowing by persons resident in Sri Lanka from external sources

3.3 Investments in Sri Lanka by persons resident outside Sri Lanka

3.3.1 Investments in Shares

Prior to 1990, it was necessary to obtain approval from the Government of Sri Lanka (GOSL) or any legal or administrative authority constituted or appointed by GOSL to issue and transfer shares in a company incorporated in Sri Lanka to persons resident outside Sri Lanka. However, general permission has been granted on 25th October 1990, for the purposes of sections 10, 11, 15 of the ECA, to issue or transfer shares in a listed public company up to 40% of its issued capital to a resident outside Sri Lanka subject to certain conditions. Share Investment External Rupee Account (SIERA) was introduced as a facilitating and monitoring mechanism where all inflows and outflows in respect of share investments shall be routed through such SIERA. On 29th June 1992, being a further relaxation measure, permission has been granted to issue and transfer of shares up to 100% of issued capital in a company incorporated in Sri Lanka (irrespective of listed or non-listed companies) to persons resident outside Sri Lanka, subject to certain exclusions and limitations which were further relaxed in March 1993.

The prevailing permission, applicable for issuance and transfer shares to persons resident outside Sri Lanka, was published in the Gazette (extraordinary) No. 1232/14 dated 19th April 2002[4]. In terms of the said permission, persons resident outside Sri Lanka are allowed to invest in shares of a company incorporated in Sri Lanka up to 100% of its issued share capital subject to exclusions and limitations.

The above permission shall not apply (areas not allowed for foreign equity investments) in respect of shares of a company proposing on or carrying on any of the business relating to money lending[5], pawn broking, retail trade[6], coastal fishing and provision of security services[7]. Further, in respect of shares in a company carrying on or proposing to carry on any of the businesses relating to production of goods where Sri Lanka's exports are subject to internationally determined quota restrictions, growing and primary processing of tea, rubber, coconut, cocoa, rice, sugar and spices, mining and primary processing of non-renewable national resources, timber based industries using local timber, deep sea fishing, mass communication, education, freight forwarding, travel agencies and shipping agencies are permitted only up to 40% of the issued capital of such company.

These general permissions helped to position Sri Lanka as an investor friendly nation despite unfavorable security situation prevailed last two decades and attract much needed foreign direct Investments (FDI) that enriched us with technological and managerial know-how, as well as global market access. Such FDIs greatly contributed to reduce unemployment rate from at present levels.

3.3.2 Investments in Government Securities

Sri Lanka Development Bonds (SLDBs)

SLDB is a foreign currency denominated debt instrument issued by the Government of Sri Lanka (GOSL). In 2004, by opening government securities market to eligible foreign

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[4] amended by No. 1248/19 dated 08th August 2002 and No. 1685/2 dated 21st December 2010

[5] except other than the business of providing of credits to investors to purchase securities of a listed company by a company registered as a margin provider

[6] with a capital of less than one million US Dollars

[7] including security management, assessment and consulting to individuals or private organizations

investors[1] permission has been granted[2] for the purpose of purchasing and marketing SLDBs to acquire, hold or transfer SLDBs.

Treasury bonds and treasury bills

In 2006, Treasury bond market has been opened for foreign investors up to 5% of the outstanding Treasury bond stock at any given point of time subject to minimum holding period of 2 years for maturity and 1 year for sale at secondary market[3]. However, requirement for the minimum holding period was removed in January 2007 while the 5% celling has been increased up to 10% in December 2007[4]. Treasury bill market also has been opened for foreign investors up to 10% of the outstanding Treasury bill stock in 2008[5]. With a view to further encourage foreign worker remittances into Sri Lanka, both Treasury bill and Treasury bond market have been opened for Sri Lankan diaspora and migrant workforce up to 10% of the outstanding Treasury bill/bond stock in 2009[6].The threshold for foreign investments in Treasury bills and Treasury bonds was raised from 10% of the outstanding Treasury bill and Treasury bond stock to 12.5% in 2011[7].

These permissions have encouraged public investments (through government's borrowing programs) without excessively rely on local market and minimizing crowding out effect on the private investments, by diversifying the investor base of the government securities market. Foreign inflows through opening up of the government securities markets contributed to maintain healthy the Balance of Payment position as well.

3.3.3 Deposit Accounts: Investments in Special Foreign Investment Deposit Accounts (SFIDA)

Section 7 of the ECA prohibits persons resident in Sri Lanka to place or hold any sum to the credit of any person resident outside Sri Lanka. Therefore, a general permission has been granted to authorized dealers to accept investments in deposits at Domestic Banking Unit (DBU) from persons resident outside Sri Lanka in 20088. Accordingly, Citizens of foreign states, Sri Lankan citizens resident outside Sri Lanka, corporate bodies incorporated outside Sri Lanka and foreign institutional investors such as country funds, mutual funds and regional funds have been permitted to invest in deposit accounts called Special Foreign Investment Deposit Account (SFIDA) at any authorized dealer. These accounts may be opened in Sri Lanka rupees or in any designated foreign currency and may be held jointly with two or more eligible investors. Requirement of maintaining a minimum deposit of USD 10,000/- or equivalent in any other designated foreign currency or Sri Lankan rupees which was introduced at the inception of SFIDA has been withdrawn in May 20149.

3.3.4 Debentures (listed or non-listed)

Initially in 2010, permission has been granted with regard to issue and transfer of rupee denominated debentures in a company incorporated in Sri Lanka, to foreign institutional investors and persons resident outside Sri Lanka, subject to condition that such debentures shall be listed in Colombo Stock Exchange. Subsequently in 2014, a fresh permission has been granted[10] permitting foreign investment in listed debentures as well as in non-listed debentures, and citizens of foreign states were permitted to invest in listed/non-listed debentures irrespective of their residential status.

3.3.5 Investments in units in unit trusts

Investing in units in unit trusts is a popular mode of investment amongst the small investors who wish to bear a minimal risk of investment. In terms of provisions of section 10 of the ECA, permission of the Central Bank of Sri Lanka (CBSL) is required for the residents to issue securities inclusive of units in unit trusts to residents outside Sri Lanka. Therefore, in 2013, a general permission has been granted to foreign investors to invest in units in unit trusts in Sri Lanka[11].

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[1] Citizens of foreign states, Companies or firms established outside Sri Lanka, Citizens of Sri Lanka who are permanently living outside Sri Lanka, Citizens of Sri Lanka who have proceeded outside Sri Lanka to take up employment or to set up a business or engage in a profession, Primary Dealers appointed by the Central Bank of Sri Lanka and Companies registered to carry on insurance business in Sri Lanka.

[2] in terms of the operating instructions Ref.06/04/03/2004 dated 16th July 2004 issued to authorized dealers

[3] in terms of Gazette (extraordinary) No. 1469/25 dated 01st November 2006 and the Operating Instructions Ref. 06/04/07/2006 dated 01st November 2006.

[4] in terms of Operating Instructions Ref. 06/04/10/2007 dated 06th December 2007.

[5] in terms of the Directions issued to authorized dealers Ref. 06/04/02/2008 dated 06thMay 2008.

[6] in terms of the Directions to authorized dealers Ref. 06/04/01/2009 dated 07th January 2009.

[7] in terms of the Directions to authorized dealers Ref. 06/04/09/2011 dated 06th December 2011.

[8] In terms of the Directions to authorized dealers Ref. 06/04/05/2008 dated 02nd June 2008.

[9] in terms of the Directions to authorized dealers Ref. 06/04/02/2014 dated 28th May 2014.

[10] in terms of Gazette (extraordinary) No. 1864/39 dated 28th May 2014.

[11] in terms of the Gazette (extraordinary) No. 1795/39 dated 31st January 2013.

3.4 Foreign Loans /Borrowings

3.4.1 Borrowings from abroad by companies incorporated in Sri Lanka

Sections 5 and 7 of the ECA restrict resident Sri Lankans and companies incorporated in Sri Lanka to borrow from foreign sources and repay such loans. Therefore, the prior approval of the Controller of Exchange was required to borrow from foreign sources by companies incorporated in Sri Lanka.

External Commercial Borrowing Scheme

A general permission has been granted[12] for a company incorporated in Sri Lanka to borrow from a person resident outside Sri Lanka, under the External Commercial Borrowing Scheme (ECBS) effective from 01st January 2013 to 31st December 2015 and the maximum amount that can be borrowed (under ECBS) by a company shall be USD 30mn or its equivalent value in any other foreign currency provided however that the maximum amount of borrowing per company per each calendar year shall be USD 10 mn or its equivalent value in any other foreign currency. This facility has been created alternative avenues to meet financing needs of such entities at a relatively low cost in order to maintain expected high growth momentum of Sri Lanka.

3.4.2 Borrowings by Sri Lankan students from foreign financial institutions

In terms of prevailing exchange control regulations, Sri Lankans who have proceeded outside Sri Lanka for educational purposes are considered as residents in Sri Lanka[13]. Therefore, they are required to obtain permission from the CE to borrow from foreign sources when they are studying abroad[14]. Therefore, general permission has been granted[15] in 2011 for Sri Lankan students who are studying abroad to borrow from foreign institutions and to repay such loans by remitting funds from Sri Lanka through authorized dealers. The main objective was to encourage and facilitate Sri Lankan students to acquire world class education, knowledge and skills, even utilizing funds borrowed from foreign financial institutions, serve to the motherland. This will be a great relief for the parents who are struggling to finance for the education of their children.

Therefore, measures that were taken towards liberalization of capital account in Sri Lanka, by way of permissions for foreign investments in Sri Lanka, through various instruments such as government securities, shares, bank deposits, units in unit trusts and debentures, have already delivered significant benefits to the society, directly as well as indirectly, by narrowing down the savings-investment gap and provide alternative sources for raising funds that support the development activities in cost effective ways, achieving low level of unemployment and poverty, healthy overall position of BOP, improved macroeconomic conditions reflected in lower level of inflation and interest rates, relatively high growth rate etc.

3.5 Investments outside Sri Lanka by persons resident in Sri Lanka

In terms of provisions of section 17(2) of the ECA, persons in or resident in Sri Lanka are not permitted to acquire, hold or transfer any security[16] outside Sri Lanka. However, as a further

Table 1: Limits applicable for investment outside Sri Lanka

	Category	**Amount (USD)***
1	A company listed at the Colombo Stock Exchange	500,000 per annum
2	A company not listed at the Colombo Stock Exchange	100,000 per annum
3	A partnership registered in Sri Lanka	100,000
4	An individual resident in Sri Lanka	100,000
5	An individual employee of a branch in Sri Lanka or subsidiary of a company incorporated outside Sri Lanka to acquire shares of such company under an Employee Share Option Scheme.	100,000

* in USD or an equivalent amount in any other designated foreign currency

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[12] in terms of the Gazette (extraordinary) No. 1791/15 dated 01st January 2013.

[13] in terms of the Ceylon Government Gazette No. 15,007 of 21st April 1972.

[14] in terms of Section 5 of ECA.

[15] in terms of the Gazette (extraordinary) No. 1719/23 of 18th August 2011.

[16] Means shares, stocks, bonds, capital in any partnership, notes (other than promissory notes), debentures, debenture stocks, units in unit trusts etc.

measure of liberalizing capital accounts, in 2011, permission has been granted for companies incorporated in Sri Lanka[1], partnerships registered in Sri Lanka and individuals resident in Sri Lanka to invest in shares of companies incorporated outside Sri Lanka and sovereign bonds issued by foreign governments and governmental organizations subject to limitations specified in the Table 1[2]:

One of the primary benefits of allowing investments outside Sri Lanka by residents/resident companies is that it allows money to go in to business opportunities which has the best prospects for growth anywhere in the world. That helps investors aggressively seek the best return for their investments while diversifying the risk. That also promotes commercial presence for the companies which already entered to foreign markets enabling them to grow fast and to grab benefits from the favorable tax regimes in the host countries. Sri Lanka expected to be benefited by returns of such investment.

3.6 Fund Transfers by Migrants

Migration allowance was Rs. 750,000/- per individual and Rs. 1,000,000/- per family prior to 2008. Accordingly, funds in excess of the above should be credited to a non-resident blocked account (NRBA) in the name of the migrant and the interest earned on the same could be remitted. In 2008, the amount remittable as a migration allowance at the time of migration was increased up to USD 150,000/- per family (or per individual not accompanying a family)[3]. In addition to that, an amount of USD 20,000 could be remitted out of the Non Resident Blocked Account (NRBA) annually[4]. This has been further increased in 2013, to remit USD 150,000/- per individual[5] as a migration allowance at the time of migration while annual allowance of USD 20,000/- is also continued and considered individually. Further, proceeds from current transactions, provident fund and gratuity benefits can be repatriable in addition to the migration allowance. A dedicated non-resident blocked account named "Migrant Blocked Account (MBA)" has been assigned per migrant for the purpose of fund transfers. These eligible allowances can be either credited to a NRFC account opened in the name of the migrant or transferred to an account maintained by him/her abroad.

Liberalization of blocked accounts has created a good image for Sri Lanka foreign exchange control regime. When Sri Lankans who have migrated to foreign countries have money with them, they might expect to invest in Sri Lanka with the intention of earning more interest and the continuation of the relationship with the motherland. Several specific schemes for such investments have been introduced by Exchange Control Department from time to time. Further, their remittances to Sri Lanka are an important source of foreign exchange receipts. If their remittable funds are blocked indefinitely, they will be dissatisfied with the manner Sri Lanka treats them and, therefore, we cannot expect any patriotic behaviour from them. In the current trend of globalization and academic/professional performance of Sri Lankans, a considerable increase in migration of Sri Lankans and their support by way of remittances, investments and creation of employment opportunities to Sri Lankans could be expected.

4. Concluding Remarks

Liberalization of capital account is inevitable for countries that experiencing low domestic savings rate and wish to take advantage from inward investments. However, correct sequence, pace and timing are the key success factors while reasonably developed financial sector, sound macroeconomic fundamentals and enhanced toolkit for managing risks of large and volatile capital flows are prerequisites for meaningful liberalization.

Capital account liberalization process in Sri Lanka is quite consistent with the widely accepted sequencing and has expedited in post-conflict era where macroeconomic situation is improving at an accelerated rate. Unprecedented financial sector reforms including financial sector consolidation plan which aims much stronger financial institutions in the country are also being implemented. Range of instruments that are available for investment were further widened, i.e. shares, treasury bonds/bills, Sri Lanka Development Bonds, listed and unlisted debentures, unit trusts etc. However, one should not conclude that capital account liberalization supported by improved in the fundamentals or/and institutional reforms (pull factors) themselves brings more and more capital, by undermining the impact of "push factors" beyond control of the recipient.

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[1] other than companies limited by guarantee

[2] in terms of the Gazette (extraordinary) No. 1686/50 dated 01st January 2011.

[3] in terms of the Direction to authorized dealers ref. 06/04/08/2008 dated 02nd July 2008.

[4] in terms of the Direction to authorized dealers ref. 06/04/07/2008 dated 02nd July 2008.

[5] in terms of the Direction to authorized dealers ref. 06/04/15/2013 dated 12th June 2013.

In general, it is recommended to be vigilant on the sequence and the pace of capital account liberalization while managing macro-economic conditions and the financial sector healthiness. Implementation of liberalization measures shall be well planned followed by effective supervision and periodical review enables making adjustments whenever required, while optimizing flexibility and consistency in general. In particular, in the context where 100% foreign equity investments in to companies in Sri Lanka are allowed except few restricted areas and those areas should be periodically reviewed and rationalized. In case of debts, companies with sound track records and strong balance sheets should be encouraged to raising low cost debt from the international capital market particularly, as project financing, which are long term in nature. Therefore, the permitted level of foreign borrowings should be rationalized based on the balance sheet strength of such borrowers. However, short term foreign commercial borrowings should be strictly discouraged in the context that Sri Lanka experiencing low interest rate – excess liquidity regime. Financial disintermediation should also be avoided by preventing banking sector borrowings excessively from foreign sources.

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Middle Income Trap and Future of Sri Lankan Economy

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Introduction

In modern development discourse middle income trap is a prominent issue. Since some countries have been trapped within middle income level, economists try to address the above problem. Presently Sri Lanka also represents lower middle income stage. Since Sri Lanka is on a path of rapid economic growth after the terrorist issue, it is especially important for us to pay attention to the middle income trap. This article mainly focuses on the nature of middle income trap and what Sri Lanka can do to avoid it. Under that, defining middle income trap and identifying middle income countries according to the World Bank's (WB) countries classification system are explained in first part of the article. The second section discusses reasons as to why countries become stuck in the middle income trap by reviewing Thailand and Malaysian experiences with the middle income trap situation. In conclusion, this article proposes some steps for Sri Lanka to avoid the middle income trap.

Middle Income Trap

Some economists define middle income trap as a growth slowdown. This means that middle income stage too is a part of economic growth and development. If an economy stagnates in middle income level, it is known as a middle income trap. Middle income trap can be understood under following definition: "The middle -income trap is a development stage that characterizes countries that are squeezed between low-wage producers and highly skilled and fast-moving innovators. Cost advantages in manufactured exports that once drove growth start to decline in comparison with other lower-wage countries." (Aaron et al, 2013) This definition explains that a country's production structure and wages of labour cause it to stagnate within middle income status. For Ayiar at al, 2013 "Middle income trap is the phenomenon of hitherto rapidly growing economies stagnating at middle income level and failing to graduate into the ranks of high income countries" However, previous studies of growth slowdowns in fast-growing middle-income countries identify two modes of slowdowns: one is from low middle income to upper middle income and another is from upper middle income to high income. If a country remains in same income level for ten years, that can be identified as middle income trapped country. By summarizing above definitions middle income trap can be explained as a barrier to the growth of middle income economies. In this respect, it is important for us to understand how a country comes to be classified as a middle economy level country.

Country Classification System and Identifying Middle Income Countries

Various international organizations use various criteria to classify the development level of countries. For examples United Nation Development Programs (UNDP), International Monetary Fund (IMF) and World Bank (WB) use different methods to assess development of countries. From 1990 Human Development Index (HDI) is used by UNDP to classify development level of countries as follows: HDI gives values to countries from 0 to 1. In 1990 UNDP categorized countries into three development stages with an HDI below 0.5 being low human development countries, 0.5 to 0.8 being medium human development countries and above 0.8 being high human development countries. However, from 2009 it has been changed into four groups with further expanding of 0.8 to 0.9 high human developed countries and above 0.9 very high human developed countries.

IMF has used classification systems of other countries for their operational and analytical purposes. This classification has been changed from time to time as a result of their needs. However, the most important factor in this classification is how countries can be defined as middle income countries. In order to measure development, per capita income has been used by the World Bank. Earlier the World Bank provided financial assistance through the judgmental method. As a result of increasing the number of members of the World Bank, they have introduced a new country classification system to be used for their operational and analytical purposes. It is known as World Bank Atlas method. For further clarification see end note one.

By using this method World Bank calculates annual per capita income of all countries according to available data. Then as per the results of per capita income levels of countries they categorize economies by deciding on the income thresholds. These income thresholds are changed from time to time.
According to the above table following characteristics can be identified with regard to transition of income thresholds:

01. Low income threshold has increased from U.S. dollars 480 to 1035 between 1987 and 2012.

02. Over the period of 25 years lower middle income threshold has increased from U.S. dollars 481-1940 to 1036-4085.

03. Upper middle income threshold has increased from U.S. dollars 1941-6000 to 4086-12615.

04. High income threshold has increased from U.S. dollars >6000 to >12615.

05. Range of middle income has been rapidly expanding for above 25 years. For example in 1987 lower middle income range is U.S. dollars 481-1940 and upper middle income range is U.S. dollars 1941-6000. However in 2012 it has expanded U.S. dollars 1036-4085 and 4086-12615.

Further this data emphasizes that middle income range is the larger income threshold and highly fluctuated. Changing in world inflation, increasing world economic growth and increasing world income and expenditure cause to change definitions of income thresholds. As a result of that number of middle income countries has been changed. For further clarification per capita income and income categories of selected economies can be presented as follows:

Above income thresholds are calculated and countries have been divided into four income categories under the atlas method. If countries are in the middle income range, they are known as middle income countries.

This table illustrates that in 1987, 73 out of 163 countries were in the middle income threshold. However, in 2012 it was about 103 out of 215 countries. It shows an increase in the number of middle income countries. If countries stagnate in the middle income threshold for more than ten years continuously, it is then known as the middle income trap. For example according to the World Bank database, Malaysia and Thailand can be identified as countries in the middle income trap. Malaysia has been stagnant in the upper middle income range from 1992 to 2012. Thailand has been stagnant in the lower middle income stage for a long period and from 2009 it transcended to upper middle income level.

Why countries get stuck in the middle income trap

Economies of many countries rapidly expand at low income level. However, some countries tend to get trapped in middle income status. Several factors have been the reasons for this situation. Thailand and Malaysia are the most classic examples for middle income trap economies in the South East Asian countries. Therefore, these two countries have been selected to develop this discussion. Accordingly, reasons for middle income trap of Thailand and Malaysia can be separately identified as follows.

Table 01

Income Thresholds Transition U.S. dollars

Years	Low income	Lower middle income	Upper middle income	High income
1987	<= 480	481-1,940	1,941-6,000	> 6,000
1992	<= 675	676-2,695	2,696-8,355	> 8,355
1997	<= 785	786-3,125	3,126- 9,655	> 9,655
2002	<= 735	736-2,935	2,936-9,075	> 9,075
2007	<= 935	936-3,705	3,706-11,455	> 11,455
2012	<= 1,035	1,036-4,085	4,086-12,615	> 12,615

Source: World Bank database

Table 02

Per Capita Income (in US dollars) and Income Categories of Selected Economies in 2012

High Income		Upper Middle Income		Lower Middle Income		Low Income	
Country	Per Capita Income $	Country	Per Capita Income $	Country	Per Capita Income $	Country	Per Capita Income $
United State	51,755	China	6,093	India	1,503	Liberia	414
United Kingdom	38,694	Malaysia	10,432	Indonesia	3,551	Malawi	267
Japan	46,548	Brazil	11,320	Pakistan	1,255	Nepal	699
Singapore	54,007	Thailand	5,480	Sri Lanka	2,922	Ethiopia	467
Korea, Rep.	24,454	Colombia	7,763	Congo, Rep	3,154	Mali	696

Source: World Bank data base

Reasons for middle income trap of Thailand

1. Labour shortage

   Thailand has had both a skilled and unskilled labour shortage for many years. On the other hand labour cost of Thailand is cheap and relatively close to foreign countries. Therefore foreign workers are also not a solution for the above problem of Thailand.

2. Education system of Thailand

   Thailand education system has failed to provide sufficient number of graduates for their labour market. Information technology, communication skills and leadership skills are at a low level in Thailand's labour force. This situation influences the decisions of investors. Highly educated workers are needed to create innovative products. Therefore, the weakness of the education system directly influences growth slowdown in Thailand.

3. Low level of expenditure on research and development (R & D)

   Thailand investment on research and development to the GDP is at around 2%. As a result, development of Thailand's industrial sector is too slow. Revenue of high income countries depend on innovative production. They invest large amounts of money in GDP for the research and development. Low investments of Thailand in the above field contribute towards the middle income trap.

Table 03

Transition of Number of Countries in Various Income Thresholds 1987 - 2012

Year	1987	1992	1997	2002	2007	2012
Low income (L)	49	55	61	64	49	36
Lower middle income (LM)	46	70	58	53	54	48
Upper middle income (UM)	27	36	35	33	40	55
Middle Income (LM)+(UM)	73	106	93	86	94	103
High income (H)	41	39	50	56	65	76

Source: World Bank data base and author's calculation

In addition to above reasons, the following factors also have caused the middle income trap in Thailand. Still existing monopolistic powers of government on a large number of enterprises, macro-economic instability, weaknesses of fiscal structure and tax collection system and lack of financial resources can be identified as applicable reasons for Thailand's middle income trap. (Jitsuchon, 2012)

Why Malaysia is trapped in the middle income category

In recent history Malaysian economic growth rate has been systematically declining.

This table illustrates the slowdown of Malaysia's economic growth. This situation could have contributed towards Malaysia falling into middle income trap. Now it is vital to understand what could cause this growth slowdown. Declining of investment level is the main reason for the above situation as shown in the following table:
As above table illustrates we can identify a decrease of public and private sector investments; low level of investment cause the slowdown in growth. Also, on the other hand it helps to keep Malaysia in the middle income trap. Several factors caused to decline all investment of Malaysia such as declining profit of firms, Asian financial crisis and changing perceptions of investors. Malaysia is in middle income category for a long period. In addition to declining investment, the following factors have caused this situation (Wing They Woo, 2011).

Table 04

Average GDP Growth Rate of Malaysia in Various Years

Years	**1987-1997**	**2001-2005**	**2006-2010**
Average GDP growth rate	9.4%	4.5%	4.2%

Source: 8 and 9 Malaysia actual plans

1. High input costs from state-created monopolies

   Government has a monopolistic power related to various business activities such as business licenses and tenders for cronies, for example toll roads. On the other hand high tax rate, poor infrastructure also causes Malaysia to remain stagnant in middle income category (Wing They Woo, 2011).

2. Weakness of higher education sector

   Most of Malaysian graduates do not have sufficient amount of employment opportunities because of their low level of international language skills.

3. Religion based terrorism

   For example many church burning cases are reported from Malaysia in connection with conversion of children into Islam. These religious disparities also cause a growth slowdown in Malaysia.

4. Capricious legal system

   Corruption of police causes increase of street crimes in Malaysia. This is also an obstacle to development activities.

Table 05

Composition of Investment by Ownership in Malaysia

(Actual Value of Category as % of GDP)

Years	**1990**	**1995**	**2000**	**2005**	**2010**
Total investment	33.9	45.7	25.6	20.0	20.2
Private investment	21.9	32.7	12.8	8.9	9.5
Public investment	12.0	13.0	12.7	11.2	10.7

Source: 7,8, 9 and 10 Malaysia plans (MP) and 9 Midterm review (MTR)

However, after 2009 there is an upward movement of Malaysian economy. For example GDP growth rate of Malaysia increased to 7.4 percent in 2010 while the current growth rate stood at 4.7 per cent in 2013.

As two special cases Thailand and Malaysia experiences are important to identify reasons for arising middle income trap. However, following conditions of developing countries also can cause them to stagnate in middle income stage.

Weakens of Asian capital market development are also another factor to growth slowdown in asian countries. for Srinivasa Madhur 2008 following factors have caused to this situation: capital markets of asian countries are very small, transactions cost are high, Narrow investers basis and lack of institutional investers, Weak risk management practices and inadequate information disclosure.

Most middle income countries depend on traditional industries, which are less productive. In addition to that, such kind of production cannot compete with the contemporary business world. Developing countries always face various problems with regard to capital and technical knowledge. Therefore, it is difficult to convert a traditional production sector into an innovative production sector. This means, they tend to produce low value added output. On the other hand the services sector of these countries is not global and tradable, and is mainly based on domestic demand. For example in Malaysia, the services sector has provided over 42 percent amount of contribution to the GDP. But most of these activities are in traditional services. (Aaron et al, 2013) Agriculture sector is also based on labour intensive activities. Considerable amount of workers are employed in agriculture sector. This could be a reason for lack of labour available for the industry sector. Export structures of developing countries are not rapidly changing. So it is difficult to trade with other industrial economies. When globalizing, most of countries have opened up their economy to others. With that situation, competitiveness is very high among new industrial economies. Therefore traditional export structures limit countries within middle income level. When analyzing Asian economies; though Asia held technological superiority a thousand years ago, greater cultural rigidity diminished the ability to adapt to a new technological paradigm, delaying Asia's industrialization in the first half of the 20th century (Quamrul and Galor, 2007). Not only rigid cultural background but also lack of infrastructures facilities, education level of labour force, lack of technical knowledge also can be a cause of slow transformation of Asian economies. Large number of areas in some middle income countries is not yet urbanized. Under infrastructure facilities transport and communication are most important factors to create a sound business environment. Without developing above two main sectors it is not easy to market goods and services in the modern commercial world. Therefore, governments of developing countries have to spend more money to enhance infrastructure facilities. As a result of that government debt as well as expenses is increased in these countries. These governments have to finance their capital requirements by borrowing from external parties. Because of this it poses an external financial risk that can influence the internal financial system. Above factors can contribute to countries to stagnate within middle income status.

Sri Lanka had an inconstant socio economic background from 2000 to 2009, with the terrorist issue, 2004 tsunami situation, rapidly changing governments and development policies. Government has started to rebuild destroyed buildings, roads and other infrastructure. At the same time Sri Lanka has a stable socio economic background. As a result of that Sri Lanka has achieved 7.3 per cent economic growth in 2013. According to above positive impact it can be suggested this as the best occasion for implementing economic activities to avoid middle income trap. Former Indian governor Dr. Duvvuri Subbarao has proposed his own ten point strategies to avoid middle income trap at the **25th Anniversary Convention of the Association of Professional Bankers (APB) Sri Lanka. His suggestions for countries to avoid middle income trap can be listed as follows;**

1. Strengthen infrastructure
2. Skill empowerment
3. Improvement of higher education and focus on applied research
4. Create an environment for structural transformation to take place
5. Regulate, but do so efficiently
6. Manage financial sector development
7. Manage public finances responsibly
8. Manage globalization intelligently
9. Provide good governance
10. Don't make banking boring

This article elaborates only some suggestions of above and other additional few steps government has already taken.

In addition to all of these factors, the government of Sri Lanka has implemented a five hubs strategy to achieve development goals. They are: knowledge, commercial, naval, aviation and energy. Therefore, it is important to talk about impacts of five hubs strategy in moving toward the upper middle income economy, and how these hubs can be used to avoid the country from falling into the middle income trap:

Improvement of knowledge based development

Following suggestions can be given to develop country as a knowledge hub.

- **Reform higher education**

Syllabuses of subjects should be formed as needs of contemporary business world. It means, subjects should be a combination of theory and practical education. Especially large numbers of arts degrees are based on theories and they are conducted in local languages. As a result of that, it is difficult for these graduates to enter into the international job market. Therefore increasing university student enrolment, enhancing international language skills and conducting internship programs for graduates can be suggested as solutions for the above problems.

- **Improvement in Research and Development**

If global market demand is high for innovative products, under this circumstance technical knowledge is most important to produce new goods. Therefore, facilitation should be improved to conduct research and development activities. Establishing new research centers, introducing courses for students and conducting experimental research programs can be suggested to avoid middle income trap.

Infrastructure Development

When we consider about the future of the Sri Lanka, economic infrastructure development is an important factor to avoid middle income trap. Therefore, naval and aviation hubs concept is being implemented by government to promote infrastructure facilities. Presently government has started to implement several ports development projects under naval and maritime hub concept. Under these, ports development projects, new Colombo South Port and Hambanthota port development projects are most important to successful development of shipping industry. In addition to that Galle Tourism Port, Kankasanthure, Oluvil and Trincomalee ports are being developed. These ports will help to promote tourism trade and transport activities. On the other hand government tries to build country as aviation hub. Under that building of new Maththala airport and modernizing of Katunayaka airport are implemented. Mainly above navel and aviation sectors development will help to promote infrastructure facilities in Sri Lanka. It is very important to establish country as a trade center.

Development of Trade Activities

Commercial hub concept is vital to improve trade activities and build country as a key trade center. According to that new market places and modern shops should be established to increase trade activities. On the other hand necessary changes should be made in export sector to get the maximum from trade activities. This means, our export structure based on traditional industries. Therefore, government should encourage exporting high technical productions to develop country as a commercial hub. In addition to that presently over 60% of total export was exported to USA and European Union countries. Therefore, export market should be expanded further to achieve high economic growth. On the other hand expenditure on oil import is very high. Energy hub concept will help to minimize this cost. In addition to above highlighted suggestions five hubs concept is vital to reach to high income level. Geographical location of Sri Lanka can be used to develop our country as aviation and naval hubs. Tourism sector should be promoted through opening Sri Lankan national historical heritages and beautiful places to the world. As we all know, infrastructure facilities such as communications, transportations, roads and rail network should be developed further to achieve above targets.

Manage Agriculture Sector

One third of workers from labour force are working in agriculture sector. However, according to Central Bank Annual Report – 2012, the contribution of agriculture sector to the GDP is only 11.1%. This situation highlights two main problems. One is about productivity of agriculture sector and other one is productivity of respective labour force. This article will talk about management of labour force later. Here problems related to productivity of agriculture sector are only considered. There are two solutions that can be proposed to increase productivity of agriculture sector. Industrialization of agriculture sector is one solution for increasing its productivity. Under this, labour force participation should be minimized and new technical equipment should be introduced for the purpose of increasing productivity in this field. Through this, labour can be saved and productivity can be raised. On the other hand traditional agriculture should be transformed into commercial agriculture. It means that all lands should be controlled under collective organizations. Farmers should work as a group and profits should be shared according to their contribution. This may help to reduce cost and increase production efficiency. Under this organizations structure formal methods can be used to selling and distribution, and wastage can be managed. In addition to that this is a solution for some problems of farmers such as managing unbearable losses because of adverse weather conditions. As a result of above factors commercial and industrial agriculture can be proposed to solve problems related to agriculture sector.

Increasing Productivity of Labour Force

If industrial agriculture can be improved, it will help to reduce labour force participation in agriculture sector. Through this process remaining labour force can be used to increase productivity of industrial and services sectors. On the other hand new trained labour force may be developed through improving higher education opportunities. By executing above suggestions skilled labour force may be provided to international labour market. As a result it will help to increase contribution of remittance income to the GDP.

Manage Globalization Intelligently

There are positive and negative impacts of globalization for every country. Countries can open their economy to the world. Earning through exports and importing goods from international market are positive impacts of globalization. However, external shocks can influence the internal economy as well. Therefore, globalization should be managed intelligently to avoid middle income trap.

Summary

Middle income trap is a problem relating to the economic development and it is directly related to the annual per capita incomes of countries. After the ethnic conflict that Sri Lanka has been suffering for nearly 3 decades, per capita GDP increased rapidly where it exceeded US dollars 3,200 in 2013. Currently Sri Lanka has stable macro-economic conditions such as inflation, maintained at mid-single digit, unemployment rate at 4.2 per cent etc. On the other hand, there are huge developments in roads, ports and other infrastructure facilities during the last couple of years. As a result, the rank of Sri Lanka in human development index has further increased to 73 in 2013. However, economic structure has not changed in order to comply with contemporary development needs. In the basic development stage, most middle income trap countries including Thailand and Malaysia developed rapidly. They have been trapped in middle income level due to the slow pace of changes of economic structure. It affected their labour and capital market developments equally. Therefore, it is important for us too, to formulate and implement necessary structural changes to achieve economic development and avoid middle income trap. Education and human capital are another two important aspects that need to be developed through investments in order to cater to the problem of middle income tarp. In this move, focusing on transformation of production structure from traditional to innovative line is essential. On the other hand, necessary legal reforms to be introduced to facilitate more local and foreign investments in the industrial sector. In addition, the export market should be diversified further. In order enjoy maximum peace dividend, the social development in Sri Lanka is to be improved further while establishing the social and cultural stability. However it should be emphasized that development is a collective process and therefore, all parties should be stakeholders of this process

Monthly Bulletin - Septhember 2014 CBSL

PRICES AND WAGES

Colombo Consumers' Price Index (CCPI)[a]

TABLE 14

Base 2006/07 = 100

Period (b)			Commodities and Weights									
		All Items	Food and Non-Alcoholic Beverages	Clothing and Footwear	Housing, Water, Electricity, Gas and Other Fuels	Furnishing, H/H Equipment and Routine Maintenance of the House	Health	Transport	Communication	Recreation and Culture	Education	Miscellaneous Goods and Services
Weights		(100%)	(41.0%)	(3.1%)	(23.7%)	(3.6%)	(3.2%)	(12.3%)	(4.8%)	(1.5%)	(3.9%)	(2.9%)
2011	Average	151.5	172.7	147.6	124.4	133.8	240.3	149.6	90.3	139.0	140.6	131.1
2012	"	162.9	180.9	162.1	136.4	142.7	247.5	181.9	90.3	144.6	141.2	136.5
2013	"	174.2	195.2	170.8	151.0	148.5	251.7	190.2	90.3	150.4	142.6	142.2
2012	3rd Quarter	166.0	186.1	163.6	137.8	144.0	249.9	185.3	90.3	144.6	141.2	137.1
	4th Quarter	166.9	186.6	167.1	139.2	146.3	250.5	186.2	90.3	146.2	141.9	138.9
2013	1st Quarter	170.5	193.2	170.6	140.5	147.7	251.1	188.8	90.3	146.2	141.9	140.4
	2nd Quarter	173.5	193.6	171.3	151.3	148.5	251.4	189.7	90.3	149.9	142.3	142.3
	3rd Quarter	176.3	197.0	170.9	156.0	148.9	251.9	190.7	90.3	152.2	142.9	142.9
	4th Quarter	176.4	196.8	170.3	156.1	148.9	252.3	191.8	90.3	153.4	143.2	143.3
2014	1st Quarter	177.7	195.4	170.7	156.2	150.8	272.6	199.4	93.8	153.5	143.2	144.7
	2nd Quarter	179.8	200.3	171.0	156.1	151.2	273.0	199.5	93.8	153.6	143.3	146.2
2013	August	176.2	196.8	171.1	156.0	148.8	251.8	190.6	90.3	151.7	143.2	143.0
	September	175.8	195.9	170.6	156.1	148.9	252.2	190.8	90.3	153.2	143.2	143.1
	October	176.1	196.5	170.3	156.1	148.8	252.2	190.8	90.3	153.2	143.2	143.2
	November	176.5	197.0	170.3	156.1	148.9	252.3	191.8	90.3	153.5	143.2	143.3
	December	176.5	196.8	170.4	156.2	148.9	252.3	192.9	90.3	153.5	143.2	143.5
2014	January	177.5	195.1	170.6	156.3	150.0	272.4	199.3	93.8	153.5	143.2	143.8
	February	177.8	195.5	170.7	156.2	151.2	272.6	199.5	93.8	153.5	143.2	144.6
	March	177.9	195.7	170.8	156.2	151.2	272.8	199.5	93.8	153.6	143.3	145.7
	April	178.4	197.1	170.9	156.2	151.2	273.0	199.5	93.8	153.6	143.3	146.0
	May	179.5	199.6	171.0	156.0	151.2	273.0	199.5	93.8	153.6	143.3	146.0
	June	181.4	204.3	171.2	156.1	151.2	273.0	199.5	93.8	153.6	143.3	146.5
	July	183.2	208.6	171.2	156.0	151.2	273.0	199.5	93.8	153.6	143.3	146.7
	August	182.3	206.2	171.7	156.0	151.2	273.0	199.5	94.0	153.9	143.3	148.1

Source : Department of Census and Statistics

(a) The index was based on Household Income and Expenditure Survey conducted in 2006/07.
The weights are based on the consumption pattern of the urban households within the Colombo district.
The total basket value (at 2006/07 prices) was Rs. 27,972.11

(b) Annual and quarterly figures are averages of monthly figures.

Published by the Central Bank of Sri Lanka, Janadhipathi Mawatha, Colombo 1, Sri Lanka
Printed at the Central Bank Printing Press, 58, Sri Jayewardenepura Mawatha, Rajagiriya, Kotte, Sri Lanka