

## Chapter 5

# EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

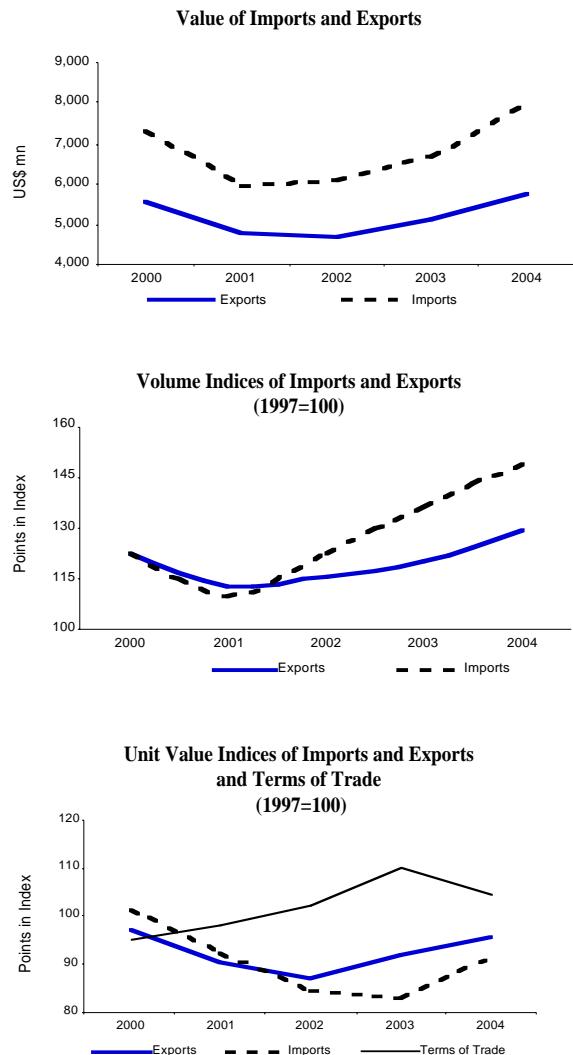
### 5.1 Overview

In 2004, Sri Lanka's external sector benefited from the increased global economic growth and the expansion in international trade. However, the country had to face a few challenges that were posed by way of unexpected external shocks. External trade expanded considerably with an increase in both exports and imports. Export earnings in US dollar terms increased by 12 per cent, reflecting the volume growth of 8 per cent and unit price increase of 4 per cent, to US dollars 5,757 million, outperforming the 9 per cent growth recorded in 2003. This rate of growth was the highest annual growth since 2000, benefiting from the higher global demand and improved export competitiveness. In the meantime, imports grew by 20 per cent, led by increases in both volume (9 per cent) and prices (10 per cent), to US dollars 8,000 million, compared with the 9 per cent growth in 2003. The resultant terms of trade recorded a deterioration of 5.2 per cent in 2004 mainly due to the sharp increase in import prices of intermediate and investment goods. The drought in 2004 necessitated higher imports of crude oil and food items, while the international oil prices reached historically high levels and sharply increased the petroleum import bill. Consequently, the trade deficit widened to US dollars 2,243 million, which was partly financed with remittances and net earnings in the services account, thereby containing the current account deficit to US dollars 648 million.

The higher global economic growth and the peaceful environment that prevailed in Sri Lanka in view of the ceasefire, helped the earnings from tourism to continue its growth momentum, which in turn, contributed to a surplus in the services account. Worker remittances grew at a healthy rate of 11 per cent in 2004, retaining its position as the largest net inflow to the country. However, the surpluses in the services and transfer accounts were not sufficient to fully offset the widened deficits in the trade and income accounts, worsening the current account balance. This situation was further aggravated by the lower net inflows to the capital and financial account mainly due to the decline in foreign aid disbursements to the government. A notable development in financial inflows during 2004 was the significant increase in capital flows to the private sector by way of foreign direct investments, loan capital and portfolio investments, reflecting improvements in foreign investors' confidence. However, net inflows in the capital and financial accounts were not sufficient to offset the current account deficit, and hence the overall balance of payments (BOP) recorded a deficit, reversing the trend of surpluses

recorded in the previous three consecutive years. This led to a decline in external official reserves and increased the pressure on the exchange rate. In this adverse environment, the continuation with the independently floating exchange rate regime, pursued by Sri Lanka since 2001, helped to mitigate the impact of the external shocks, and helped the country to

Chart 5.1  
External Trade



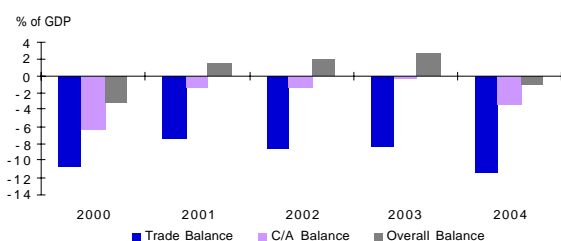
**Table 5.1**  
**Balance of Payments Analytical Presentation**  
**(Incorporating FCBUs of Commercial Banks as Part of the Domestic Banking System) (a)**

Item	US dollars million					Rs. million				
	2000	2001	2002	2003	2004 (b)	2000	2001	2002	2003	2004 (b)
Trade Balance	-1,798	-1,157	-1,406	-1,539	-2,243	-134,176	-102,592	-134,706	-148,324	-227,171
Exports	5,522	4,817	4,699	5,133	5,757	420,114	430,372	449,855	495,426	583,967
Imports	7,320	5,974	6,106	6,672	8,000	554,290	532,964	584,561	643,750	811,138
Services, net (c)	38	204	295	399	419	2,907	14,692	28,224	38,443	42,735
Receipts	953	1,355	1,268	1,411	1,527	72,187	120,937	121,340	136,123	154,746
Payments	915	1,151	974	1,012	1,108	69,280	106,246	93,115	97,680	112,011
Income, net	-305	-267	-252	-172	-204	-23,009	-23,842	-24,167	-16,535	-20,688
Receipts	152	108	75	170	157	11,568	9,584	7,201	16,385	15,813
Payments	456	375	328	341	360	34,577	33,425	31,368	32,920	36,501
<b>Goods, Services and Income (net)</b>	<b>-2,064</b>	<b>-1,220</b>	<b>-1,364</b>	<b>-1,312</b>	<b>-2,028</b>	<b>-154,278</b>	<b>-111,742</b>	<b>-130,648</b>	<b>-126,416</b>	<b>-205,124</b>
Private Transfers, net	974	984	1,097	1,205	1,350	73,620	87,837	104,980	116,350	136,672
Receipts (d)	1,160	1,155	1,287	1,414	1,564	87,697	103,180	123,183	136,475	158,291
Payments	186	172	190	209	214	14,078	15,343	18,202	20,125	21,619
Official Transfers (net)	24	22	31	36	30	1,801	1,925	2,982	3,441	3,038
<b>Current Account</b>	<b>-1,066</b>	<b>-215</b>	<b>-236</b>	<b>-71</b>	<b>-648</b>	<b>-78,857</b>	<b>-21,980</b>	<b>-22,686</b>	<b>-6,625</b>	<b>-65,414</b>
<b>Capital and Financial Account</b>	<b>443</b>	<b>562</b>	<b>444</b>	<b>722</b>	<b>636</b>	<b>31,827</b>	<b>49,077</b>	<b>40,639</b>	<b>69,723</b>	<b>62,138</b>
Capital Account	50	198	65	74	64	3,795	17,766	6,219	7,146	6,573
Capital Transfers (net) (e)	50	198	65	74	64	3,795	17,766	6,219	7,146	6,573
Receipts	56	203	71	81	71	4,230	18,241	6,782	7,768	7,242
Payments	6	5	6	6	7	435	475	563	622	669
Financial Account	393	364	379	648	572	28,032	31,311	34,420	62,577	55,565
Long-term:	304	163	326	722	684	22,594	14,337	28,911	69,721	69,805
Direct Investment	176	172	185	201	227	13,319	15,271	17,716	19,450	22,826
Foreign Direct										
Investment	173	82	181	171	217	13,119	7,310	17,281	16,557	21,948
Privatisation Proceeds	3	90	5	30	10	200	7,961	435	2,893	878
Private Long-term (net)	82	-257	-21	-33	18	5,622	-22,918	-2,039	-3,201	2,270
Inflows (f)	298	44	115	101	169	22,134	4,016	11,007	9,738	17,503
Outflows (e)	216	301	136	134	151	16,512	26,934	13,046	12,939	15,233
Government, Long-term (net)	47	249	162	554	439	3,653	21,984	13,233	53,472	44,709
Inflows	355	575	542	913	771	26,965	51,193	51,843	88,106	78,299
Outflows	308	326	380	359	331	23,312	29,209	38,610	34,634	33,590
Short-term:	88	201	53	-75	-112	5,438	16,974	5,509	-7,145	-14,240
Portfolio Investment	-45	-11	25	2	11	-3,355	-1,025	2,443	209	1,109
Private Short-term (net)	100	-42	68	19	28	7,569	-3,798	6,548	1,877	2,514
Commercial Bank Assets (net)	-141	183	104	-94	-354	-18,736	2,867	6,893	-9,090	-45,367
Commercial Bank Liabilities (net)	174	71	-145	-2	202	19,960	18,929	-10,375	-141	27,504
Government Short-term (net)	-	-	-	-	-	-	-	-	-	-
SDR Allocations	-	-	-	-	-	-	-	-	-	-
Valuation Adjustments	-	-	93	-	-	5,189	22,245	8,900	-	-
Errors and Omissions	101	-127	38	-148	-193	10,902	-19,578	9,197	-14,487	-4,198
<b>Overall Balance (g)</b>	<b>-522</b>	<b>220</b>	<b>338</b>	<b>502</b>	<b>-205</b>	<b>-30,939</b>	<b>29,765</b>	<b>36,051</b>	<b>48,610</b>	<b>-7,474</b>
Monetary Movements (g)	522	-220	-338	-502	205	30,939	-29,765	-36,051	-48,610	7,474
Exchange Rate Rs/US\$						75.78	89.36	95.66	96.52	101.19
Ratio to GDP in percentages										
Trade Account	-10.8	-7.4	-8.5	-8.4	-11.4	-10.7	-7.3	-8.5	-8.4	-11.4
Current Account	-6.4	-1.4	-1.4	-0.4	-3.3	-6.3	-1.6	-1.4	-0.4	-3.3
Current Account without Grants	-6.6	-1.5	-1.6	-0.6	-3.4	-6.4	-1.7	-1.6	-0.6	-3.4

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  
(c) Services receipts in 2001 include US dollars 382.4 million received by Sri Lankan Airlines as insurance claims for the aircraft destroyed by the attack on the airport in July 2001, while Services payments in 2001 include US dollars 292.8 million paid to the lessors of the aircraft. The net receipt of these insurance claims was US dollars 89.6 million.  
(d) Includes US dollars 45 million received in 2000 as compensation of US dollars 2,500 per person to 29,323 Sri Lankans, who lost employment in Kuwait due to the Gulf War in 1990.  
(e) Includes US dollars 147.6 million in respect of a technical amortization under private capital outflows and a corresponding adjustment under capital transfer receipt in 2001 for the remaining capital of the aircraft destroyed by the attack on the airport in July 2001.  
(f) Includes adjustment to capital inflows in 2000 on account of the import of aircraft for which advance payments had been made in previous years.  
(g) All transactions in the Monetary Sector are converted at the end of year exchange rates.

Chart 5.2  
Balance of Payments



maintain its external competitiveness. Meanwhile, the country's total external debt as a percentage of GDP declined marginally, reflecting the lower net loan capital inflows during the year. On a positive note, the debt service ratios remained at low and manageable levels.

## 5.2 External Sector Policies and Institutional Support

In 2004, international trade continued to operate in a free and liberal environment, as per undertakings given by Sri Lanka when it accepted the IMF Article VIII status in 1994. Being a small open economy, the continuously improving liberal economic environment and the greater freedom, which the country has promoted in trade, investment and payments have benefited Sri Lanka immensely in maintaining its growth momentum in the midst of external shocks and adverse environments during the last three decades. However, to safeguard the country from large and volatile capital flows, limited capital account restrictions are still in place.

The maintenance of an independently floating exchange rate regime since 2001 has served the economy well, particularly the export sector, which grew continuously except in a few selected years when it faced disturbances. It has helped the country to maintain its external competitiveness, through autonomous variations in currency movements broadly in line with Sri Lanka's economic fundamentals vis-a-vis the rest of the world.

The external trading environment was strengthened by entering into several multilateral and bilateral arrangements and negotiations in 2004. Sri Lanka negotiated in the World Trade Organization (WTO) fora, to bring a settlement to the unequal tariff being imposed on Sri Lanka as against tariff imposed on other competitors by major countries such as the USA, EU countries, Australia and Japan. The lacklustre performance at WTO negotiations in the aftermath of the collapse of the Cancun Ministerial Meeting was reversed with the adoption by the WTO General Council a framework to take negotiations under the Doha Development Agenda forward, in the areas of Agriculture, Non Agricultural Market Access (NAMA) and Development Issues. Sri Lanka stands to benefit

from this development through greater access to both agriculture and non-agriculture markets in developed countries. In 2004, the WTO concluded the second Trade Policy Review of Sri Lanka. In the review, while being critical of some of the developments since 1995, WTO members were mostly positive about Sri Lanka's policy directions.

At the Eleventh Session of the United Nations Conference on Trade and Development (UNCTAD XI) held in 2004, Sri Lanka participated in discussions on debt relief and debt sustainability, specific needs of small vulnerable and net food importing economies, market access through the movement of natural persons, issues relating to Sri Lanka on Trade Related Intellectual Property Rights (TRIPS), benefits under the Global System of Trade Preferences (GSTP) and technical assistance on capacity building.

Sri Lanka is actively pursuing the receipt of greater benefits under the Generalised System of Preferences (GSP) from participating developed countries, through a change in the Rules of Origin (ROO) criteria on a cumulative basis considering entire South Asian Association for Regional Cooperation (SAARC) countries. In view of the recent tsunami disaster, EU is considering granting Sri Lanka special concessions under the GSP. In addition to this, Sri Lanka had already received special incentives from the EU in view of Sri Lanka's sound labour practices.

On the regional front, SAARC leaders agreed to establish the South Asian Preferential Trade Agreement (SAFTA) with effect from 1 January 2006. Under the SAFTA, serious attempts will be made to reducing tariffs and remove Non Tariff and Para Tariff Barriers to promote intra-regional trade, and investment. Members of the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMST-EC) formerly known as Bangladesh, India, Myanmar, Sri Lanka and Thailand Economic Cooperation, signed a framework agreement to set up a Free Trade Agreement (FTA) in February 2004. The first BIMST-EC Summit attended by the Heads of State was held in July 2004, in Thailand. The summit focused on a wide range of issues such as transnational crime and terrorism, combating and controlling disease, poverty alleviation, promotion of tourism, energy, fisheries and indigenous medicine and knowledge.

There were several accomplishments in bilateral trade relations in 2004. Sri Lanka and India agreed to convert the Indo-Sri Lanka Free Trade Agreement (ISLFTA) into a Comprehensive Economic Partnership Agreement (CEPA) incorporating trade in services and investment. The Pakistan-Sri Lanka Free Trade Agreement (PSLFTA) was signed in February 2005. Under the PSLFTA, Sri Lanka will receive duty free access for 206 items. In addition, Sri Lanka will receive duty free access for tea to Pakistan, on a quota basis. Pakistan was an important market for Sri Lankan tea in the 1970s and gradually lost its share to Kenya. The agreement will pave the way for regaining some of the lost market share.

At the seventh session of the Joint Commission for Economic Cooperation between Sri Lanka and Iran held in January 2004, two countries agreed to establish a Preferential Trading Agreement. Discussions were held on the elimination of the textile quota at the 16<sup>th</sup> session of European Commission (EC) - Sri Lanka Joint Commission held in October 2004. At the third round of negotiations under the Bangkok Agreement, Sri Lanka received preferential treatment with respect to several export items. A few rounds of discussions were held in 2004 to establish a Comprehensive Economic Partnership Agreement between Sri Lanka and Singapore (CEPASS) in 2004.

In addition to paving the way for increased market access through multilateral and bilateral negotiations, the government has been providing a wide spectrum of support to exporters. In 2004, special incentive schemes were made available for

exporters registered with the Board of Investment (BOI) of Sri Lanka, subject to minimum investment requirements. These incentive schemes include tax holidays, concessionary taxes and import duty exemptions on capital goods and raw material. The Sri Lanka Exports Development Board (SLEDB), continued to bring together the government and entrepreneurs in resolving problems on trade and investment at the Exporters' Forum, in addition to providing support on marketing, financing and online access to international data bases. The SLEDB formulated the National Export Strategy (NES) covering the period 2004-2008, with inputs from both the private and state sectors. The Sri Lanka Export Credit Insurance Corporation (SLECIC) continued to assist exporters through export credit insurance and guarantees. The Sri Lanka Standards Institution (SLSI) supplied the guarantee of quality for export items against the relevant Sri Lanka standards. The trade and tariff cluster and the export cluster of the National Council for Economic Development (NCED) continued to review the trade related issues and made relevant recommendations in 2004 to promote external trade. Several more incentives were proposed by the Budget 2005, which focussed on increasing value addition by exporters. Those include VAT reduction for local suppliers of intermediate goods, duty free concessions to acquire advanced technology, financial assistance for technology improvement, simplified VAT applications and a zero rate VAT structure for garment buying offices.

A few export items were subject to a cess, which generates funds for research and development of respective industries. In addition to the continuing cess on tea and coconut exports, a cess on cinnamon exports was introduced and the cess on rubber exports was reintroduced in 2004. The import tariff structure underwent several changes in 2004 with the multiple objectives of enhancing Sri Lanka's competitiveness, raising fiscal revenue, simplifying the tariff structure, and lowering the cost of living. However, it has proven difficult to meet all the objectives at the same time. For example, on January 1, 2004, tariff bands were changed from 2.5, 5, 10, 15, 20 and 25 per cent respectively to 3, 6, 12, 16, 20 and 27.5 per cent to raise revenue, but it would have raised the cost of production too. At the same time, duty waivers have been granted on imports of wheat grain, crude oil, refined petroleum products, printed books, gem and gold, textile, paddy and vegetable seeds and pharmaceuticals. These waivers were followed by a further set of full and partial duty waivers granted on February 1, 2004 on dhal and reduced duty on potatoes, big onions, chillies and milk powder, to contain domestic price escalations. In the remainder of the year, duty waivers were granted on sugar and rice to provide further relief to the public, but duty was re-imposed on big onions and brown sugar (see Box 4).

The the maximum age of used motor vehicles eligible to be imported was extended by six more months to three and a half years from the beginning of 2004, to reduce the import cost of motor vehicles. Meanwhile to discourage excessive

**Table 5.2**  
**Average Import Duty Collection Rate (a)**

Item	2000	2001(b)	2002(b)	2003(c)	2004(d)
<b>Consumer goods</b>	<b>11.5</b>	<b>13.3</b>	<b>13.3</b>	<b>13.5</b>	<b>10.4</b>
Food and drink	11.7	15.3	14.4	14.2	8.5
Rice	30.0	21.2	32.9	29.1	4.9
Flour	6.2	13.3	12.3	11.5	7.2
Sugar	15.9	16.2	16.0	16.8	4.6
Wheat and meslin	0.0	0.0	0.0	0.0	0.1
Milk and milk products	10.6	15.3	11.9	12.2	7.9
Dried fish	1.3	2.0	7.9	10.8	5.9
Other fish products	5.1	6.3	6.8	7.9	10.0
Other food items	18.7	25.4	22.9	22.3	17.4
Non-food consumer goods	11.3	10.9	12.1	13.0	12.2
Motor cars & cycles	16.6	21.1	23.3	22.1	21.1
Radio receivers- television sets	6.8	8.3	8.6	8.9	9.4
Rubber tyres & tubes	23.5	29.6	27.9	26.0	25.8
Medicinal & pharmaceutical products	0.5	0.6	0.6	0.6	0.6
Other non-food items	11.1	9.7	9.4	9.2	8.9
<b>Intermediate goods</b>	<b>2.9</b>	<b>1.7</b>	<b>1.6</b>	<b>1.5</b>	<b>1.9</b>
Fertiliser	-	-	0.4	2.6	3.1
Crude oil	7.4	...	0.0	0.0	0.0
Other petroleum products	5.3	0.9	0.8	0.8	0.9
Chemical elements and compounds	3.2	3.3	1.1	2.2	2.6
Dyeing , tanning and colouring	5.2	6.3	4.0	4.6	4.5
Paper and paper boards	5.0	6.7	5.2	5.4	6.0
Textiles & clothing	0.1	0.1	0.1	0.1	0.0
Other intermediate goods	3.5	4.2	4.3	3.3	4.3
<b>Investment goods</b>	<b>4.0</b>	<b>5.3</b>	<b>5.5</b>	<b>7.2</b>	<b>6.1</b>
Building materials	7.5	9.3	7.4	7.7	9.0
Transport equipment	7.4	10.3	11.0	12.9	11.9
Machinery and equipment	1.8	2.7	3.7	5.6	3.2
Other investment goods	3.2	4.2	3.8	4.6	5.0
<b>Total</b>	<b>4.5</b>	<b>4.9</b>	<b>4.8</b>	<b>5.3</b>	<b>4.5</b>

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

- (a) Actual import duty collection as a percentage of total import value (c. i. f).  
 (b) This includes the impact of 40 per cent surcharge imposed on selected imports on 21 February 2001 and the 20 per cent surcharge on 1 April 2002  
 (c) This includes the impact of 20 per cent surcharge imposed on selected imports on 01 January 2003.  
 (d) Provisional

importation of high value and fuel inefficient motor vehicles, excise duty was increased on October 15, 2004 to economise on fuel consumption in the wake of rising oil prices. This measure was further strengthened by subjecting these imports to a 100 per cent deposit margin requirement. Finally, on November 19, 2004, the six tariff band structure was reduced in Budget 2005 to a four band structure comprising 2.5, 6, 15 and 28 per cent, with effect from the beginning of 2005. To guide Sri Lanka's tariff formulation, the Presidential Tariff Commission was reformulated as a cluster in the NCED in 2004. The ultimate outcome of various tariff waivers and tariff reductions was the decline in the average tariff on imports, reflecting the prevalence of a more liberal trade regime in 2004. The average tariff declined from 5.3 to 4.5 per cent in 2004.

However, it should be noted that maintaining a low and predictable tariff structure would promote investor confidence and increase resource allocation efficiency, enabling Sri Lanka to reach a high long term economic growth path.

### 5.3 Trade in Goods and Trade Balance

External trade expanded further in 2004, with increases in both exports and imports. Export earnings grew by 12 per cent to US dollars 5,757 million compared to the 9 per cent growth recorded in 2003, reaching the highest performance since 2000. Imports grew by 20 per cent to US dollars 8,000 million, recording a sharp increase over the 9 per cent growth in 2003. This has led to a widening of the trade balance by US dollars 704 million to US dollars 2,243 million.

Table 5.3  
Trade Indices (a)

1997=100

Category	2003			2004 (b)			Growth Rate (b)		
	Value Index	Volume Index	Unit Price Index)	Value Index	Volume Index	Unit Price Index	Value Index	Volume Index	Unit Price Index
<b>EXPORTS</b>									
<b>Agricultural exports</b>	<b>90.8</b>	<b>109.6</b>	<b>82.9</b>	<b>100.3</b>	<b>112.9</b>	<b>88.8</b>	<b>10.4</b>	<b>3.1</b>	<b>7.1</b>
Tea	94.8	112.0	84.6	102.5	113.8	90.1	8.1	1.6	6.4
Rubber	49.0	58.1	84.3	65.3	65.6	99.5	33.3	12.8	18.1
Coconut	78.8	96.5	81.6	96.1	112.8	85.2	22.1	16.9	4.5
Other agricultural products	103.5	135.9	76.2	111.7	134.6	83.0	7.9	-1.0	9.0
<b>Industrial exports</b>	<b>115.5</b>	<b>124.1</b>	<b>93.1</b>	<b>130.9</b>	<b>135.4</b>	<b>96.7</b>	<b>13.3</b>	<b>9.1</b>	<b>3.8</b>
Textiles and garments	113.0	118.5	95.4	123.2	127.7	96.5	9.1	7.8	1.2
Petroleum products	67.0	45.8	146.4	102.3	59.4	172.1	52.6	29.8	17.6
Other industrial exports	125.3	143.2	87.5	149.8	158.9	94.3	19.6	11.0	7.8
<b>Mineral exports</b>	<b>93.6</b>	<b>91.5</b>	<b>102.4</b>	<b>134.2</b>	<b>96.1</b>	<b>139.7</b>	<b>43.4</b>	<b>5.1</b>	<b>36.5</b>
Gems	94.9	92.9	102.1	130.7	96.2	135.8	37.7	3.5	33.0
Other mineral exports	76.8	72.2	106.4	181.5	94.5	192.1	136.3	30.9	80.5
Total Exports	110.4	120.1	92.0	123.9	129.4	95.7	12.2	7.8	4.0
<b>IMPORTS</b>									
<b>Consumer goods</b>	<b>124.0</b>	<b>152.4</b>	<b>81.4</b>	<b>132.9</b>	<b>158.4</b>	<b>83.9</b>	<b>7.2</b>	<b>3.9</b>	<b>3.2</b>
Food and drink	87.9	105.4	83.4	92.8	102.5	90.6	5.6	-2.7	8.6
Other consumer goods	176.4	220.7	79.9	191.1	239.5	79.8	8.3	8.5	-0.2
<b>Intermediate goods</b>	<b>121.9</b>	<b>127.3</b>	<b>95.8</b>	<b>149.2</b>	<b>135.7</b>	<b>110.0</b>	<b>22.4</b>	<b>6.6</b>	<b>14.8</b>
Fertiliser	132.0	131.6	100.3	160.7	130.4	123.2	21.7	-0.9	22.8
Crude Oil	163.4	110.0	148.6	229.2	121.3	189.0	40.2	10.3	27.2
Other Petroleum	147.4	102.5	143.8	219.3	110.3	198.9	48.8	7.6	38.3
Chemical Elements and Compounds	124.7	143.4	86.9	151.4	150.6	100.5	21.4	5.0	15.6
Wheat and Meslin	99.5	116.3	85.6	132.9	125.8	105.6	33.5	8.2	23.4
Textiles (Including Clothing)	99.0	114.2	86.7	109.2	125.0	87.4	10.3	9.4	0.8
Plastics	130.0	156.0	83.3	166.2	159.0	104.5	27.9	1.9	25.5
Diamonds	163.3	139.9	116.7	163.6	125.7	130.1	0.2	-10.1	11.5
Other	129.0	167.1	77.2	156.0	174.4	89.4	20.9	4.4	15.8
<b>Investment goods</b>	<b>99.6</b>	<b>145.9</b>	<b>68.2</b>	<b>125.9</b>	<b>172.8</b>	<b>72.9</b>	<b>26.5</b>	<b>18.4</b>	<b>6.8</b>
Building materials	120.8	145.0	83.3	147.9	169.0	87.5	22.4	16.5	5.1
Transport equipment	99.0	82.1	120.6	123.3	93.7	131.6	24.6	14.2	9.1
Machinery and equipment	93.9	173.1	54.2	115.3	205.5	56.1	22.9	18.7	3.5
Other investment goods	85.5	80.7	105.8	149.5	106.2	140.8	74.9	31.5	33.0
Total Imports	113.7	136.5	83.3	136.0	148.8	91.4	19.9	9.0	9.7
Terms of Trade			110.4			104.7			-5.2

(a) In terms of US dollars

(b) Provisional

Sources : Sri Lanka Customs

Central Bank of Sri Lanka

In 2004, the unit value index of exports rose by 4.0 per cent benefiting mainly from increasing demand for tea, rubber and gems in the international markets. However, a sharp increase in the import price index reflecting price increases in petroleum, building materials, fertilizer, wheat, sugar and milk products resulted in a deterioration in the terms of trade by 5.2 per cent. Furthermore, the narrow export base and excessive dependence on a few markets remain sources of significant risks in export performance in Sri Lanka.

### Export Performance

Industrial exports preponderate in export earnings with a high share of 78 per cent, while agricultural exports account only for 19 per cent. Hence, the contribution to the growth in exports in 2004 was mostly from the industrial sector, which contributed 85 per cent. The comparative figure for agricultural exports was 16 per cent.

Agricultural exports grew by 10 per cent in 2004 reflecting the higher performance of the three major crops, viz. tea, rubber and coconut. Tea was benefited by higher prices, while coconut registered a relatively higher volume growth in 2004. Rubber exports benefited both in terms of volume and prices. Tea prices increased by 7 per cent to US dollar 2.46 per kg in 2004 mainly due to an increased demand for low grown tea from the Middle East, Russia and other former Soviet Block

countries. Russia continued to be the largest buyer of Sri Lankan tea with a share of 19 per cent of the total tea exports in 2004 followed by United Arab Emirates and Turkey. The moderate growth in tea production led to a moderate increase in the volume of tea exports by 1 per cent. This led Kenya to overtake Sri Lanka as the largest exporter of tea, supported by a large production increase in that country. The share of value added tea exports, packeted tea and green tea exports decreased with a lower demand. Export earnings from coconut increased by 22 per cent in 2004 with higher exports of desiccated coconut and coir fibre products, which benefited from the increased demand from the Middle East, Germany and China. A special tax was imposed from January 2005 on imported edible oil to support the coconut industry. The export of rubber grew by 33 per cent in 2004, having benefited from the continuous increases in prices since July 2002. The demand for local consumption by the manufacturing sector reduced the volume of rubber available for exports thereby affecting earnings from exports of rubber as a primary product. To meet the local demand for rubber as an industrial input, 14,256 metric tons of natural rubber were imported in 2004.

Minor agricultural exports increased by 8 per cent in 2004 in sharp contrast to the 10 per cent decline in 2003. The growth was mainly supported by higher exports of cloves, vegetables, cinnamon and unmanufactured tobacco. This sector benefited

Table 5.4  
Composition of Exports

US Dollars million

Category	2003		2004(a)		Change in Value (a)	Growth rate (a)	Contribution to Growth (a)
	Value	Share	Value	Share			
<b>Agricultural exports</b>	<b>965</b>	<b>19</b>	<b>1,065</b>	<b>19</b>	<b>100</b>	<b>10.4</b>	<b>16.0</b>
Tea	683	13	739	13	56	8.2	8.9
Rubber	39	1	51	1	12	30.8	1.9
Coconut	93	2	113	2	20	21.5	3.2
Kernel products	48	1	59	1	11	22.9	1.8
Other	45	1	54	1	9	20.0	1.4
Minor agricultural products	150	3	162	3	12	8.0	1.9
<b>Industrial exports</b>	<b>3,977</b>	<b>77</b>	<b>4,506</b>	<b>78</b>	<b>529</b>	<b>13.3</b>	<b>84.8</b>
Food, beverages and tobacco	145	3	175	3	30	20.7	4.8
Textiles and garments	2,575	50	2,809	49	234	9.1	37.5
Petroleum products	65	1	100	1	35	53.8	5.6
Rubber products	231	5	283	5	52	22.5	8.3
Ceramic products	42	1	47	1	5	11.9	0.8
Leather, travel goods and footwear	58	1	43	0	-15	-25.9	-2.4
Machinery and equipment	290	6	386	7	96	33.1	15.4
Diamond and jewellery (b)	233	5	265	5	33	13.7	5.1
Other industrial exports	337	7	398	7	61	18.1	9.6
<b>Mineral exports</b>	<b>84</b>	<b>2</b>	<b>120</b>	<b>2</b>	<b>36</b>	<b>42.9</b>	<b>5.8</b>
Gems	79	2	109	2	30	38.0	4.8
Other mineral exports	5	0	11	0	6	120.0	1.0
<b>Unclassified (c)</b>	<b>108</b>	<b>2</b>	<b>66</b>	<b>1</b>	<b>-42</b>	<b>-38.9</b>	<b>-6.7</b>
<b>Total exports (d)</b>	<b>5,133</b>	<b>100</b>	<b>5,757</b>	<b>100</b>	<b>624</b>	<b>12.2</b>	<b>100.0</b>
Annual average exchange rate	96.52		101.19				

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

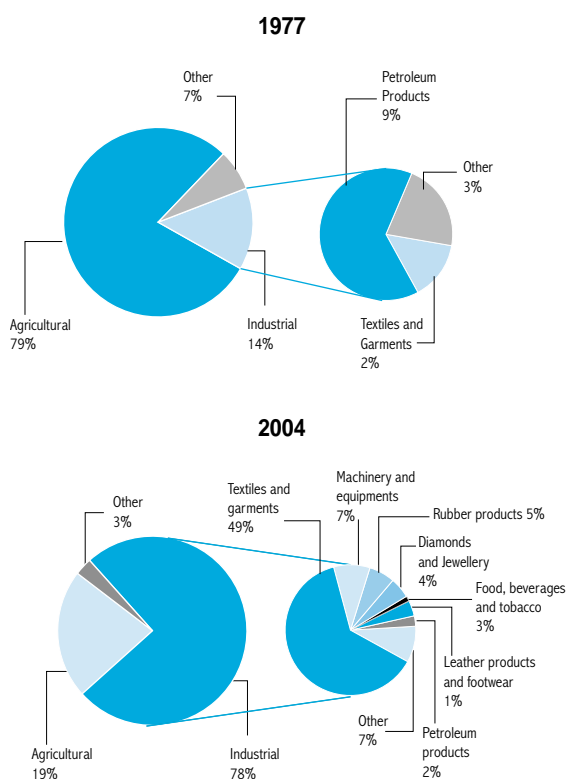
(a) Provisional

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

(c) Includes re-exports

(d) Adjusted

Chart 5.3  
Share of Exports by Major Categories



from duty free access to the Indian market under the ISLFTA and the strong demand from the Middle East countries for vegetables. Export earnings from dried and fresh fruits, betel leaves and essential oils increased, while earnings from coffee, pepper, nutmeg and mace and cardomom declined in 2004.

The growth of the industrial exports by 13 per cent was led predominantly by the strong performance attained by textiles and garments, machinery and equipment and rubber based products. This was supported by increased market access that was afforded to these sectors through trade negotiations. Textiles and garment exports, which accounted for 49 per cent of the total exports and 62 per cent of industrial exports grew by 9 per cent in 2004, in spite of the strict competition which Sri Lanka began to face in the wake of the phasing out of the MFA. The volume of apparel exports in 2004 grew by 8 per cent, while export prices increased by 1 per cent. The apparel industry was able to minimise the potential risks arising from the heavy concentration in the US market by expanding its market share in the EU. Garment exports to the EU market benefited from the special incentive arrangement with the EU under the GSP scheme since February 2004. Other industrial sub sectors, except leather, travel goods and footwear, continued to grow in 2004. The jewellery sector, which suffered a setback in 2002 recovered steadily responding to the

high demand from major trading centres such as Belgium, Israel, Vietnam, USA and Japan. Jewellery producers were benefited by the exemption of VAT on the import of raw materials such as gold, silver, diamonds, pearls and gems.

Earnings from mineral exports increased by 43 per cent in 2004 in contrast to a decline in 2003 mainly due to the higher exports of gems, which accounted for 90 per cent of the mineral exports. Gem exports that had been adversely affected by unresolved issues in the gemstone trade in 2003, regained the market, posting a robust growth of 38 per cent in 2004. Sri Lanka continued to be the largest supplier of high quality sapphires to the world market. USA continued to be the largest buyer of Sri Lankan gems in 2004 followed by Japan and Thailand. It is noteworthy that there is scope for increasing earnings from jewellery exports, if the country could go for innovative designs, supported by modern skills and sufficient raw materials in the form of cut and polished gem stones.

### Import Performance

Imports grew by 20 per cent to US dollars 8,000 million in 2004, as against the 9 per cent growth in 2003, reflecting the impact of the economic expansion, the prolonged drought, the

Chart 5.4  
Share of Imports by Major Categories

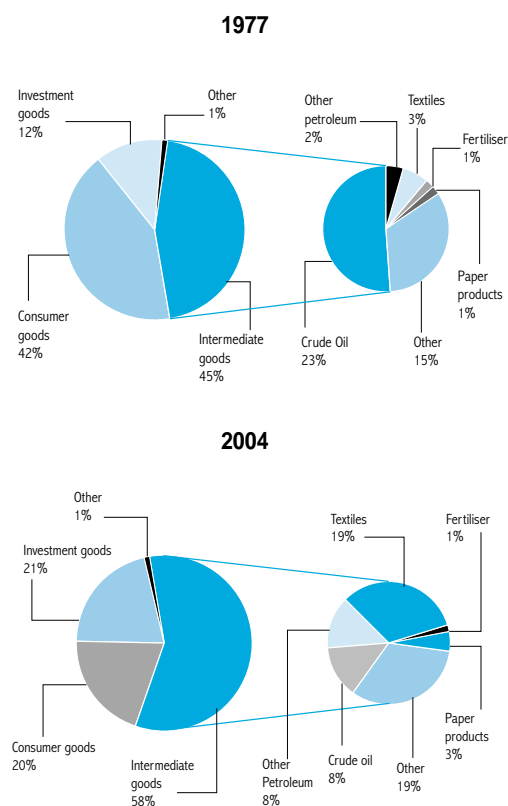


Table 5.5  
End-Use Classification of Imports

US Dollars million

Category	2003		2004(a)		Change in Value (a)	Growth rate (a)	Contribution to Growth (a)
	Value	Share	Value	Share			
<b>Consumer goods</b>	<b>1,481</b>	<b>22</b>	<b>1,623</b>	<b>20</b>	<b>142</b>	<b>9.6</b>	<b>10.7</b>
Food and drink	701	11	779	9	78	11.1	5.8
Rice	8	0	59	1	51	638.0	3.8
Sugar	116	2	110	1	-6	-6.0	-0.5
Wheat	137	2	183	2	46	34.0	3.5
Other	440	7	427	5	-13	-2.9	-1.0
Other consumer goods	780	11	844	11	64	8.3	4.9
<b>Intermediate goods</b>	<b>3,811</b>	<b>57</b>	<b>4,645</b>	<b>58</b>	<b>834</b>	<b>21.9</b>	<b>62.8</b>
Petroleum	838	13	1,209	15	371	44.3	28.0
Fertiliser	88	1	107	1	19	21.6	1.5
Chemicals	170	3	206	3	36	21.2	2.7
Textiles and clothing	1,372	21	1,514	19	142	10.3	10.7
Other intermediate goods	1,343	19	1,609	20	266	19.8	20.0
<b>Investment goods</b>	<b>1,320</b>	<b>20</b>	<b>1,670</b>	<b>21</b>	<b>350</b>	<b>27.0</b>	<b>26.3</b>
Machinery and equipment	698	11	857	11	159	22.8	12.0
Transport equipment	206	3	257	3	51	24.8	3.8
Building materials	328	5	402	5	74	23.0	5.5
Other investment goods	88	1	154	2	66	75.1	5.0
<b>Unclassified imports</b>	<b>60</b>	<b>1</b>	<b>61</b>	<b>1</b>	<b>1</b>	<b>1.7</b>	<b>0.1</b>
Total imports (b)	6,672	100	8,000	100	1,327	19.9	100.0
Annual Average Exchange Rate	96.52		101.19				

(a) Provisional  
(b) Adjusted

Sources : Sri Lanka Customs  
Co-operative Wholesale Establishment  
Ceylon Petroleum corporation  
Major importers of diamonds  
Central Bank of Sri Lanka  
Prima Ceylon Limied

escalation of oil prices and the relatively low interest rate regime. The economic expansion resulted in an increase in the imports of investment and intermediate goods, while the drought conditions led to an escalation of the imports of food items and petroleum products.

Over the years, since the economic liberalisation in 1977, there has been a gradual change in the composition of imports, with consumer goods declining and intermediate and investment goods increasing. In 2004, the share of consumer goods further declined to 20 per cent, while the share of intermediate and investment imports increased to 58 and 21 per cent, respectively.

The expenditure on consumer goods increased by 10 per cent to US dollars 1,623 million in 2004. Rice imports were increased to keep the market supplied with this staple food item in the wake of low domestic production and in response to the removal of the duty of Rs. 9 per kg on rice imports since September, 2004. Imports of all major categories of consumer durables increased except the imports of motor vehicles, which recorded a marginal decline. The imports of motor vehicles increased by 12 per cent in the first three quarters of 2004 compared with the corresponding period in 2003. However, as a result of the increase in excise taxes and the introduction of a minimum cash margin of 100 per cent to cover the Letters of Credit with effect from October 22, 2004, the imports of motor

vehicles for private use declined sharply in the last quarter of 2004.

Intermediate goods imports, consisting mostly of textiles and petroleum, grew by 22 per cent. The average price of crude oil increased from US dollars 29.46 per barrel in 2003 to US dollars 37.48 per barrel in 2004 leading to the higher growth in the value of imports. The import volume of crude oil is limited by the refinery capacity. Hence, to meet the increased demand for petroleum products, more refined products were imported. The sharp increase in the export of textiles and garments required higher imports of raw materials. Other intermediate goods imports such as paper, chemicals, jewellery, bakery and rubber based manufacturing industries, increased by 15 per cent.

Investment goods imports, notably, building materials, transport equipment and machinery and equipment increased by 27 per cent in 2004, having benefited from the economic expansion and the low interest rate regime. The largest item in investment goods, machinery and equipment, which accounts for more than a half of the import category and consists of power generators, transmission apparatus, data processing machines, telecommunication equipments and sewing machines etc. increased by 23 per cent in 2004. The growing telecommunications sector stimulated demand for the import of modern telecommunication equipment and transmission

Table 5.6  
Volume of Major Imports (a)

Item	2000	2001	2002	2003	2004(b)
<b>Rice</b>	<b>15</b>	<b>52</b>	<b>95</b>	<b>35</b>	<b>222</b>
1st Quarter	7	3	51	22	9
2nd Quarter	7	7	9	9	9
3rd Quarter	...	2	10	2	4
4th Quarter	1	40	25	2	200
<b>Wheat</b>	<b>922</b>	<b>760</b>	<b>993</b>	<b>919</b>	<b>993</b>
1st Quarter	266	231	309	262	257
2nd Quarter	210	229	215	232	218
3rd Quarter	247	177	221	217	189
4th Quarter	199	123	248	208	329
<b>Sugar</b>	<b>562</b>	<b>420</b>	<b>554</b>	<b>509</b>	<b>438</b>
1st Quarter	128	100	146	151	98
2nd Quarter	185	127	141	135	173
3rd Quarter	85	109	110	104	71
4th Quarter	164	84	157	119	96
<b>Petroleum (Crude oil)</b>	<b>2,347</b>	<b>1,954</b>	<b>2,300</b>	<b>1,995</b>	<b>2,200</b>
1st Quarter	608	237	539	382	586
2nd Quarter	583	539	513	466	464
3rd Quarter	613	624	593	500	634
4th Quarter	543	554	655	647	516
<b>Refined Petroleum</b>	<b>1,257</b>	<b>1,420</b>	<b>1,348</b>	<b>1,168</b>	<b>1,259</b>
1st Quarter	327	537	276	340	399
2nd Quarter	293	419	426	239	323
3rd Quarter	321	224	266	317	275
4th Quarter	316	240	380	272	262
<b>Textiles and Clothing</b>	<b>239</b>	<b>234</b>	<b>244</b>	<b>253</b>	<b>257</b>
1st Quarter	61	60	57	61	58
2nd Quarter	63	63	65	65	66
3rd Quarter	57	52	61	58	66
4th Quarter	58	59	61	68	66
<b>Fertiliser</b>	<b>559</b>	<b>460</b>	<b>537</b>	<b>514</b>	<b>510</b>
1st Quarter	149	66	103	124	54
2nd Quarter	102	183	163	166	164
3rd Quarter	174	83	138	49	76
4th Quarter	134	128	133	175	216

(a) Adjusted  
(b) Provisional

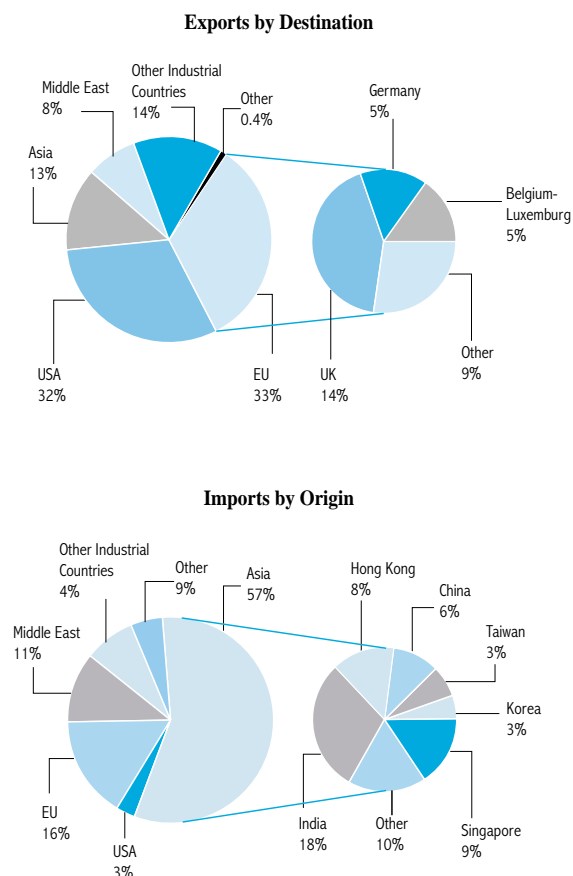
Sources : Sri Lanka Customs  
Co-operative Wholesale Establishment  
Ceylon Petroleum Corporation  
Prima Ceylon Limited

apparatus. The growth in building materials was partly attributed to an increase in the imports of items related to a larger number of BOI projects in property development, refurbishment, expansion or upgrading of hotels with the boom in the tourist arrivals and the expansion in housing construction.

### Direction of Trade

The direction of trade remained mostly unchanged in 2004. Industrialised countries dominated by the USA and the EU continued to be the major destinations for Sri Lanka's exports. The USA has been the single largest buyer of Sri Lanka's exports since 1979 and continued to be an important market for Sri Lanka's textiles and garments with a share of 58 per cent. However, the share of exports to the USA has declined from 35 per cent in 2003 to 32 per cent in 2004 mainly due to the expansion of trade with other countries. The reduction of the export share of the USA is also attributed to the somewhat

Chart 5.5  
Direction of Trade



higher duties, preferential treatment given to many other developing countries and increased competition from other textile exporting countries. The duty range applicable to Sri Lankan products in the USA stood between 0 per cent and 28 per cent. Thus, Sri Lanka continued to negotiate with the USA to convert the Trade and Investment Framework Agreement (TIFA) into a Free Trade Agreement.

UK is the second largest destination for Sri Lanka's exports with a share of 14 per cent of total exports. The largest export item to the UK, textile and garments, accounted for 23 per cent of the total textiles and garment exports. The UK was a major market for tea and rubber based products too.

Trade with India sharply increased in 2004, benefiting from the concessions offered under ISLFTA. Since the signing of the ISLFTA in 2000, the share of exports to India has been increasing. In 2004, it amounted to 7 per cent, an increase from 5 per cent recorded in 2003. Some of the major exports to India were refined copper, electric conductors, waste and scrap of alloy steel, cloves, desiccated coconut and cored wire.

Other major destinations for Sri Lanka's exports were Germany, Belgium-Luxembourg, Japan, Italy, Russia and the UAE. The main exports to Germany were garments, tea, solid tyres, gloves and coconut fibre products. Diamonds and garments were the main exports to Belgium-Luxembourg. Other major items exported to Western countries were precious stones, gloves, tyres, coconut by-products, prawns and fish products and figurines and ornamental articles. Meanwhile, exports to Japan decreased as a result of the low exports of frozen shrimp. The output of the shrimp farming industry continued to decline due to bacterial diseases and inefficient management.

Asian countries, as a group, continued to be the major origin of imports. Their market share increased from 53 per cent in 2002 to 56 per cent in 2003 and 57 per cent in 2004 as imports from these countries increased by 21 per cent in 2004. Countries in the South Asian Association for Regional Co-operation (SAARC) accounted for 9 per cent of the total exports and 20 per cent of the total imports in 2004. The EU accounted for 15 per cent of the total imports in 2004.

India was the largest source of imports (18 per cent), followed by China including Hong Kong (14 per cent), Singapore (9 per cent) and Iran (5 per cent). Imports from India increased by 34 per cent in 2004, with main imports being pharmaceutical products, wheat, rice, transport vehicles, and cotton yarn. The trade deficit with India has also increased from US dollars 828 million in 2003 to US dollars 1,048 million in 2004. Sri Lanka's trade with Pakistan also increased significantly over the previous year, though still insignificant in value, that is 1 per cent each in both total exports and total imports.

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

The main items in trade in services have traditionally been transportation, travel and other business services. In recent years, however, the other business services category was further disaggregated into information technology, telecommunication, construction and insurance services as they

Table 5.7  
Net Services, Income and Transfers (a)

Item	US dollars million		Rs. million	
	2003	2004 (b)	2003	2004(b)
1. Transportation	201	209	19,423	21,201
2. Travel	162	217	15,628	22,232
3. Telecommunication Services	45	33	4,380	3,304
4. Computer and Information Services	65	72	6,274	7,286
5. Construction Services	34	20	3,329	2,012
6. Insurance Services	19	20	1,827	2,024
7. Other Business Services	-117	-137	-11,292	-13,798
8. Government Expenditure n.i.e.	-11	-15	-1,126	-1,527
Total Services	399	419	38 443	42,735
1. Compensation of Employees	-5	-6	-530	-601
2. Direct Investment	-89	-92	-8,612	-9,303
3. Interest and Other Charges	-77	-106	-7,393	-10,784
Total Income	-172	-204	-16,535	-20,688
1. Private	1,205	1,350	116,350	136,672
2. General Government	36	30	3,441	3,038
Total Current Transfers	1,241	1,380	119,790	139,710

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

emerged as important sectors. The surplus in the services account increased by about 5 per cent to US dollars 419 million in 2004.

#### Trade in Transportation Services

Inflows from transportation services, consisting of passenger fares, freight charges and port related earnings, increased by about 11 per cent in 2004, on account of the increased passenger fares, resulting from the record number of tourist arrivals and increased port related activities, led by transshipment cargo. Outflows of transportation services increased by about 15 per cent reflecting the surge in imports, exceeding the growth in exports and an increasing number of Sri Lankans travelling abroad. Reflecting these developments, the net earnings from transportation services increased by about 4 per cent to US dollars 209 million during 2004.

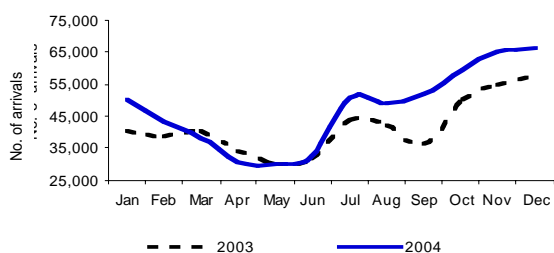
Table 5.8  
Tourism Statistics: 2000-2004

Item	2000	2001	2002	2003(a)	2004 (b)	Percentage Change	
						2003(a)	2004(b)
Tourist arrivals	400,414	336,794	393,171	500,642	566,202	27.3	13.1
Tourist guest nights ('000)	4,056	3,342	3,989	5,093	5,742	27.7	12.8
Room occupancy rate (%)	52.3	42.1	43.1	53.2	59.3	23.4	11.5
Gross tourist receipts (Rs.mn)	19,162	18,863	24,202	32,810	41,790	35.6	27.3
Per capita tourist receipts (Rs.)	47,855	56,008	61,556	65,536	73,808	6.5	13.3
Total employment (no.)	91,063	80,904	93,170	112,226	129,038	20.5	15.0
Direct	37,943	33,710	38,821	46,761	53,766	20.5	15.0
Indirect	53,120	47,194	54,349	65,465	75,272	20.5	15.0

(a) Revised  
(b) Provisional

Sources: Sri Lanka Tourist Board  
Central Bank of Sri Lanka

Chart 5.6  
Monthly Tourist Arrivals



### Travel and Tourism

Sri Lanka's tourism industry recorded the highest ever arrivals of about 566,200 tourists in 2004. Gross earnings from tourism increased from US dollars 340 million in 2003 to US dollars 413 million in 2004. The total earnings, including earnings from visiting non-resident Sri Lankans, increased by about 10 per cent to US dollars 513 million. The gross expenditure on travel also increased by about 6 per cent to US dollars 296 million in 2004 as a result of more Sri Lankans choosing to travel abroad.

Western Europe, which accounted for 50 per cent of the total arrivals in 2004, continued to be the largest tourist-generating region for Sri Lanka, recording an increase of 13 per cent in 2004. Arrivals from Asia, led by India, increased by 12 per cent, accounting for 35 per cent of the total arrivals in 2004. Arrivals from Australia, North America, The Middle East and Eastern Europe too recorded significant increases in 2004.

One third of the embarkation levy and the one per cent levy on the turnover of tourist establishments are being channelled to the Sri Lanka Tourist Board (SLTB) for promotional activities and human resources development. Collections from the embarkation levy and the one per cent levy on the turnover of tourist establishments in 2004 amounted to Rs.439 million and Rs.301 million respectively. The SLTB along with the Ministry of Tourism unveiled a special promotional campaign known as 'Bounce Back Sri Lanka' to rebuild the county's image as a popular tourist destination.

### Trade in Telecommunication and Information Technology Services

Net earnings from telecommunications services, which have been on a declining trend since the liberalisation of the international gateway in April 2003, declined further by 27 per cent to US dollars 33 million in 2004 due to an increasing number of international calls generating from Sri Lanka. As a result of the increased competition, the cost of international calls generating from Sri Lanka became lower than the cost of calls generated from abroad. This is an usual trend at the beginning of the liberalization process but not a concern, since the availability of better communication facilities would

improve productivity in other sectors of the economy. Other possible reasons for the decline could be the increased use of the Internet, facsimile and e-mail for communication.

Meanwhile, net earnings from IT exports increased by 11 per cent to US dollars 72 million in 2004. However, these incipient foreign exchange earnings foretell the enormous potential, which Sri Lanka has in this area for future exploitation. In this connection, the continuation of skills development, further expansion in telecommunication infrastructure to ensure reliable connectivity and speedy transmission are crucial factors for future development of IT exports.

### Inflows and Outflows of Income

The rise in global interest rates coupled with a prudent management of official reserves by the Central Bank caused the interest income and trading profits from investing official reserves to increase by 16 per cent, although the level of official reserves recorded a significant decline in 2004. The gains from exchange valuation adjustments declined marginally in 2004, due to the lower depreciation of the US dollar against other major currencies, compared with the sharper depreciation experienced in 2003. The gross income earned from total external reserves increased considerably as the rise in income from official reserves was supplemented by a rise in income from reserves held by commercial banks. The outflow of income increased by 6 per cent in 2004 due to the increase in profits and dividends repatriated to foreign investors and share holders as well as higher interest payments made on external debt. Consequently, the income account deficit widened by 19 per cent to US dollars 204 million in 2004 as the absolute size of the outflows were considerably higher than the inflows.

### Current Transfers

Net inflows to the transfers account continued to be the major source of financing the widening trade deficit. Worker remittances increased by 11 per cent to US dollars 1,564 million in 2004, partly due to an increase in the number of Sri Lankans working abroad. The number of annual migrants for employment increased by 2 per cent to 213,114 in 2004.

Worker remittances from the Middle East region accounted for 55 per cent of total private transfers. Despite a rise in the number of workers, the relative share of earnings from the Middle East region has been declining gradually from 2000, due to a rise in employment in Europe that paid relatively better remunerations. The West Asian countries continue to recruit more unskilled workers, especially housemaids. During 2004, about 18 per cent of the total transfer receipts came from countries in the European Union, which recorded a continuous growth in the last 5 years. The other significant contributors were other European countries, North America, and the Far East that accounted for about 8 per cent, 7 per cent and 5 per cent of the total remittances, respectively.

Worker remittances have become the single largest inflow of foreign exchange after exports and play an important role in offsetting the impact of the trade deficit on the current account. It has been reported that a significant amount of worker remittances are still coming into the country through informal channels. The availability of money transfer facilities in bank branches in rural areas and the rationalisation of applicable charges would facilitate the remittance of money through formal channels. Towards this end, the National Savings Bank (NSB) was permitted to open accounts and mobilize remittances from Sri Lankans working abroad. In addition, the government proposed, in the Budget 2005, to introduce several incentives such as housing loan facilities for workers who are remitting money through state banks.

The official current transfers such as food and commodity aid, cash grants, and technical assistance grants decreased by 17 per cent to US dollars 30 million in 2004 in line with low foreign aid inflows.

## 5.5 Capital and Financial Accounts, and Balance of Payments

### Capital and Financial Accounts

The combined surplus in the capital and financial accounts finances the current account deficit. The excess or deficit of capital and financial accounts, after financing the current account deficit is reflected as a BOP surplus or a deficit, respectively. The capital account, which records grants in capital nature, mostly to the government from donors, decreased by 14 per cent to US dollars 64 million. The financial account recorded a surplus of US dollars 572 million in 2004 compared to the surplus of US dollars 648 million recorded in 2003. The decline in the surplus of the capital and financial account was mainly due to lower official inflows by way of loans and grants. This decline was partly offset by higher private capital inflows by way of foreign direct investment (FDI), loans and portfolio inflows.

### Foreign Direct Investment

FDI inflows to Sri Lanka including privatisation proceeds increased by 2 per cent to US dollars 233 million in 2004,

recording the highest annual flows received by the country since 1997. This was due to the implementation of a large number of BOI agreements that were contracted earlier. However, the approvals and commitments of FDI declined during 2004, partly due to political uncertainty in the aftermath of elections and partly due to the more careful screening of FDI applications to ensure the quality and the reliability of investments. This lower amount of approved FDI is not likely to reduce the actual FDI inflows in the future, as the selected projects are more likely to be implemented. The services sector recorded the highest percentage of FDI inflows (47.7 per cent), indicating a continuing trend of a shift towards service-based industries from manufacturing, in line with the emerging global patterns. The outflow of FDI remained low at US dollars 6 million during the year, because they were permitted only on a case-by-case basis.

### Privatisation Proceeds

Foreign inflows of privatisation proceeds decreased from US dollars 30 million in 2003 to US dollars 10 million in 2004, this being the balance due from Lanka IOC. Though there were expectations of high privatisation proceeds from foreign sources in 2004, much of the expected funds were not realised due to the delays in the divestiture of a part of the CPC assets, and several other public sector enterprises.

### Loan Capital to the Government

The total long-term inflows to the government decreased by 16 per cent to US dollars 771 million in 2004, while the outflows declined by US dollars 28 million to US dollars 331 million. The significant decline of program loans to US dollars 30 million in 2004 from US dollars 226 million in 2003 was largely due to delays in the implementation of structural reforms. The disbursement of project loans increased by 4 per cent to US dollars 591 million in 2004 from US dollars 569 million in 2003 primarily due to the faster implementation of projects towards the latter part of the year.

Of the total loan receipts, 93 per cent were received on concessional terms and the balance 7 per cent on commercial terms and conditions. The multilateral lending agencies provided the bulk of the foreign loans in 2004. ADB and International Development Association (IDA) continued to be the major multilateral lending agencies providing around US dollars 185 million and US dollars 68 million, respectively. Bilateral assistance amounted to US dollars 347 million, of which US dollars 271 million was received from Japan and US dollars 25 million from Germany. The financial assistance from Japan accounted for about 38 per cent of total concessional loans, while ADB and IDA accounted for 26 per cent and 10 per cent, respectively.

The shortfall in external financing on concessional terms and conditions were partly offset by new issues and rollovers of foreign currency denominated loans on commercial terms and conditions. These loans would provide only a temporary relief to the shortfall that would not be a substitute for medium

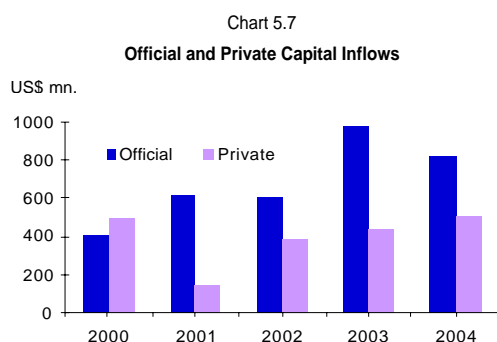


Table 5.9

**Major Projects Financing by Foreign Lending during 2004**

Donor	Project	Amount Disbursed US dollars mn.
<b>Asian Development Bank</b>		<b>184.8</b>
Of which:	Third Road Improvement Project	26.2
	Plantation Reform Project	17.7
	Fiscal Management Reform Program	15.6
	NCP Rural Development Project	15.0
	Rural Finance Sector Development Program	14.9
	Upper Watershed Management Project	14.7
	3rd Water supply & sanitation Sector	11.7
	Southern Provincial Road Improvement Project.	11.5
<b>International Development Association</b>		<b>67.8</b>
Of which:	Teacher Education & Teacher Deployment	14.0
	Private Sector Infrastructure Dev. Project	11.9
	Environmental Action 1 Project	10.5
	Second General Education Project	7.4
<b>Japan</b>		<b>270.9</b>
Of which:	Small-Scale Infrastructure Rehabilitation (SIRUP II)	60.4
	Small & Micro Enterprise Promotion (SMILE III)	30.8
	Kukule Ganga Hydroelectric Power Project	24.1
	Small Scale Infrastructure Rehabilitation and Upgrading	18.4
	Bandaranayake International Airport Development Project	16.7
	Kalu Ganga Water Supply Project for Greater Colombo	15.3

Sources: Central Bank of Sri Lanka  
External Resources Dept.

and long term external financing on highly concessional terms and conditions. From the external sector's point of view, these dollar denominated loans would not bring additional capital flows into the country, as mostly resident commercial banks are investing in the SLDBs in the form of FCBU loans to the government. It would only be a compositional shift of commercial banks' foreign reserves to official foreign reserves. From the point of view of public debt, these loans would increase debt service burden due to higher cost and low maturity. Therefore, attempts at a higher utilisation of available foreign assistance on concessional terms and conditions should form the top-most strategy of external financing.

The foreign aid utilisation rate declined in 2004 by 6 percentage points from 24 per cent in 2003 to 18 per cent in 2004. The uncertain political environment that prevailed during the early part of 2004 and the delays in project implementation due to institutional weaknesses, inflexible procedures and administrative difficulties have contributed to this low utilisation of foreign aid. Though the committee appointed by the government to accelerate the utilisation of funds implemented several measures to overcome such problems, the overall aid utilisation ratios indicate that there are still gaps to be filled to reach optimal levels. Donor assistance to government comes with an array of concessions. Hence, it is very important that such funds are effectively and timely utilised, as the cost of funds from this source is very much lower than the alternative commercial sources.

The slight improvement in foreign aid utilisation ratios in 2003 was partly due to the temporary institutional set-up, which focused on faster implementation of foreign funded projects. Establishing a permanent institutional set up with proper

authority to streamline the implementation process would improve the utilisation of available donor assistance on concessional terms and conditions. The government has already created such an institutional framework in the form of the Taskforce for Rebuilding the Nation (TAFREN), for accelerating the use of donor assistance pledged for post tsunami reconstruction.

### Loan Capital to the Private Sector

Long-term capital inflows to the private sector and public corporations increased sharply to US dollars 169 million in 2004 from US dollars 101 million in 2003. The main contribution to this increase came from the successful US dollars 100 million-bond issue by the Sri Lanka Telecom (SLT), which was oversubscribed by several folds by foreign investors. This is the first-ever international bond issue by a Sri Lankan company in the international markets and would encourage other Sri Lankan companies to secure capital in such markets in the future. Through this bond issue, the company managed to mobilise funds at a relatively low rate without any government guarantee. For this purpose, the SLT had to obtain international rating independently as sovereign ratings are not available for the country. Hence, the availability of sovereign ratings would facilitate the private sector to mobilise medium and long-term funds in the international markets on better terms and conditions. Apart from the funds raised by the SLT, only a few private sector companies engaged in new foreign borrowings during 2004, as the domestic lending rates were attractive.

In the past, foreign loans to the private sector were largely arranged through government intervention by way of providing guarantees or on-lending by the government using donor funds. This was partly due to the state ownership of a large number of public corporations. With the privatisation of these corporations and rising public debt, the government has gradually moved away from intervening to mobilise medium and long-term credit to the private sector. However, the country still needs to attract medium and long-term loan capital from foreign sources at competitive rates to promote private sector investment, as domestic resources are not sufficient to maintain investment at the desirable level for achieving higher rates of economic growth. The government could play the role of facilitator to help private sector to raise external borrowings by obtaining sovereign ratings for Sri Lanka. In this connection, the recent decision under the NCED framework for obtaining sovereign ratings for Sri Lanka is a move in the right direction.

### Short-term Capital

Portfolio investments recorded a net inflow of US dollars 11 million in 2004 compared to a marginal inflow of US dollars 2 million in 2003. The Colombo bourse performed exceptionally well during the year compared to other stock exchanges in the region, indicating an improvement in investors' confidence. The appetite for shares of blue chip companies, together with potential for higher economic growth induced foreign investors to invest in Sri Lankan equities

during the year. Meanwhile, private short-term credit, comprising short-term export and import related suppliers' credit, recorded a higher net inflow of US dollars 28 million with the expansion in external trade, compared to the net inflow of US dollars 19 million recorded in 2003.

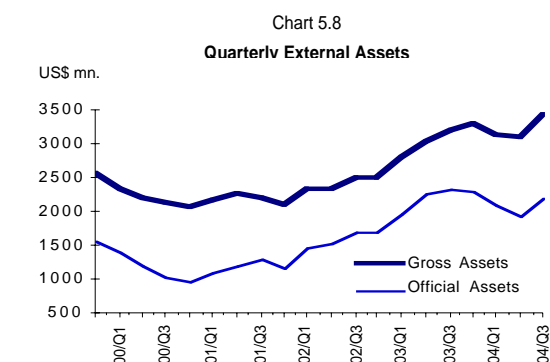
Despite commercial banks converting some of their foreign assets to foreign currency denominated domestic assets (SLDBs and FCBU loans), net foreign assets of commercial banks increased by US dollars 152 million in 2004 compared to an increase of US dollars 95 million recorded in the previous year. Foreign assets of commercial banks increased mainly due to a sharp rise in private remittances to NRFC accounts, receipt of the balance of privatisation proceeds from the sale of CPC assets to Lanka IOC, international bond issue by the SLT and foreign borrowings by commercial banks and few other private sector enterprises. External liabilities of commercial banks increased mainly due to a substantial increase in foreign currency deposits. A relatively higher depreciation of the rupee during the second and third quarters and expectations of a further depreciation during the fourth quarter of 2004 also encouraged commercial banks to accumulate and hold onto more assets in foreign currencies than in the previous year.

### Balance of Payments and External Reserves

Since the net inflows to the capital and financial account were not sufficient to finance the widened current account deficit, the overall balance of payments recorded a deficit of US dollars 205 million in 2004 compared to the surplus of US dollars 502 million recorded in 2003. This deficit exerted pressure on both, the exchange rate and official reserves, during 2004.

### External Reserves

Gross official reserves of the country, which had been increasing since 2001, reflecting surpluses recorded in the BOP in the last three consecutive years, declined in 2004. Increases



in the international commodity prices, including the historically high oil prices, and the increased volume of imports of both intermediate and investments goods, substantially increased the import expenditure during the year, exerting pressure on the external reserves and the exchange rates. This, coupled with the delays in disbursement of donor assistance to government, led to an excessive volatility in the exchange rate market during the second and third quarters requiring the Central Bank's intervention in the forex market to contain the excessive volatility, which in turn led to a loss of reserves. However, the deterioration in official reserves was contained to some extent by the new issues and rollovers of foreign currency loans, the receipt of financial assistance from ADB and Japan, and a foreign currency loan repayment to government by the SLT during the fourth quarter. Reflecting these developments, the gross official reserves declined to US dollars 2,196 million by end December 2004, from US dollars 2,329 million in 2003.

The decline in official reserves increased the country's vulnerability to external shocks measured in terms of basic indicators. The import coverage of gross official reserves

Table 5.10

External Assets of Sri Lanka (a)

Ownership	US dollars million (b)					Rs. million				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
1. Government	22	78	46	55	95	1,767	7,302	4,424	5,320	9,897
2. Government Agencies	-	-	-	-	-	-	-	-	-	-
3. Central Bank	1,026	1,260	1,654	2,274	2,101	81,819	117,365	160,018	219,984	219,795
4. Total Official Assets	1,049	1,338	1,700	2,329	2,196	83,585	124,668	164,442	225,304	229,693
5. Commercial Banks	1,083	900	795	889	1,243	86,682	83,815	76,921	86,011	129,987
6. Total External Assets	2,131	2,238	2,495	3,218	3,438	170,268	208,482	241,364	311,315	359,680
7. Gross Official Assets in Months of										
7.1 Merchandise Imports	1.7	2.7	3.3	4.2	3.3					
7.2 Import of Goods and Services	1.5	2.3	2.9	3.6	2.9					
8. Total Assets in Months of										
8.1 Merchandise Imports	3.5	4.5	4.9	5.8	5.2					
8.2 Import of Goods and Services	3.1	3.8	4.2	5.0	4.5					

Source: Central Bank of Sri Lanka

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

(b) Converted at the following end year rates, except for certain items in the International Reserve of the Central Bank which were converted at the representative rate agreed with the IMF.

Year	2000	2001	2002	2003	2004
Rs. per US Dollar	80.06	93.16	96.73	96.74	104.61

declined to 3.3 months of imports by end 2004 from 4.2 months of imports at end 2003. Similarly, the level of official reserves at end 2004 was sufficient to meet only 79 per cent of all short term external liabilities of the country compared to 102 per cent at end 2003. This ratio would decline further to 74 per cent at end 2004 if foreign currency denominated domestic liabilities maturing within a year were also included in the short-term external liabilities. The latter is a more appropriate measure of the adequacy of gross official reserves from a vulnerability point of view, as domestic foreign currency debt of the government are serviced out of official reserves.

Despite the decline in official reserves, the total external reserves of the country increased by US dollars 220 million to US dollars 3,438 million at the end of 2004 from US dollars 3,218 million in 2003, mainly due to the build up of external assets of commercial banks.

## 5.6 External Debt and Debt Service

### External Debt

Sri Lanka's total external debt as a percentage of GDP decreased to 57.8 per cent in 2004 from 58.4 per cent in 2003. However, in absolute terms, the total external debt increased by 7 per cent to US dollars 11,346 million as at the end of 2004. As a wider aggregate, the total external debt and banking sector external liabilities increased by about 9 per cent to US dollars 12,775 million. The increase was reflected in increases in both concessional government debt and banking sector external liabilities. More than 40 per cent of the increase in external debt in US dollars is due to the depreciation of the US dollar against major currencies, as approximately 42 per cent and 31 per cent of debt are denominated in SDR and Yen, respectively.

Medium and long-term debt, accounted for about 94 per cent of the total debt stock in 2004, of which 84 per cent consisted of concessional debt of the government, with the remaining 16 per cent representing the non-concessional debt. The non-concessional debt consisted of mostly medium and long-term private sector debt, as the Government non-concessional debt stock is relatively small. In US dollar terms, the government non-concessional debt stock increased by 7 per cent to US dollars 232 million by end 2004. Higher and efficient utilisation of loans on concessional terms and limiting

non-concessional debt are crucial factors for Sri Lanka to maintain a sustainable level of external debt.

Total private sector short-term debt increased by about 4 per cent to US dollars 647 million during 2004 from US dollars 620 million. The stock of government guaranteed external debt of public corporations and private sector declined by 16 per cent to US dollars 507 million, as the government was cautious in providing such guarantees in line with its policy of reducing contingent liabilities. The decline was entirely due to the amortisation of debt owed by Sri Lanka Airlines and Sri Lanka Telecom during the year amounting to US dollars 73 million. Private sector external debt without government guarantees increased significantly by about 23 per cent to US dollars 411 million in 2004 due to a successful international bond issue by the SLT amounting to US dollars 100 million.

Short-term external debt stock of the country, which consists of trade credit, increased by about 4 per cent to US dollars 647 million. The share of short-term debt in the total debt stock decreased marginally to 5.7 per cent. Liabilities to the IMF decreased by US dollars 110 million during the year due to the repayment of outstanding loans under the Stand By Arrangement (SBA) programme. Meanwhile, external liabilities of the banking sector increased by US dollars 383 million to US dollars 1,429 million by end 2004 mainly due to a temporary stock of ACU liabilities and an increase in commercial bank liabilities.

Reflecting the above-mentioned developments, the total external debt and other liabilities including banking sector liabilities increased marginally to 65 per cent of GDP in 2004 from 64.1 per cent of GDP in 2003. However, as already commented upon, in US dollar terms, the debt stock increased by 9 per cent to US dollars 12,775 million.

### Foreign Debt Service Payments

Total debt service payments consisting of both amortisation of medium and long-term foreign debt and interest payments on all foreign debt increased by 10 per cent to US dollars 839 million in 2004. The total amortisation payments, which account for about 70 per cent of debt service payments, increased by 12 per cent to US dollars 590 million in 2004 mainly due to an increase in repayments to the IMF on account of the outstanding facilities under Stand-by Arrangements (SBA). During the year, capital repayments to the IMF increased to US dollars 107 million from US dollars 32 million in 2003. However, amortisation payments of government debt decreased by 8 per cent to US dollars 331 million mainly due to declining defence loan repayments. The interest payments increased by about 6 per cent to US dollars 249 million in 2004, reflecting increases in both the government's external debt stock and global interest rates. Furthermore, due to the weakening of the US dollar in the international markets, repayments on debt denominated in Japanese yen and SDR increased by 19 per cent and 16 per cent, respectively.

The country's capacity to service the external debt, as measured by the debt service ratio, deteriorated marginally in

Chart 5.9  
External Debt

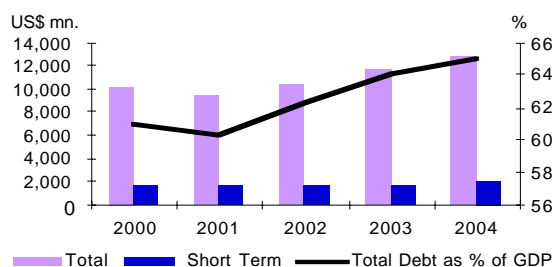


Table 5.11

## Outstanding External Debt and Banking Sector External Liabilities

Item	US dollars million					Rs. million				
	2000	2001	2002	2003	2004(a)	2000	2001	2002	2003	2004(a)
1. Medium and Long-term Debt	8,456	7,839	8,732	10,027	10,698	676,045	730,245	844,709	970,004	1,119,090
1.1 Government	6,989	6,808	7,464	8,723	9,523	559,544	634,255	721,956	843,882	996,138
1.2 Public Corporations and Private Sector with Government Guarantee	1,028	572	689	602	507	82,302	53,324	66,663	58,251	52,986
1.3 Public Corporations and Private Sector without Government Guarantee	278	249	293	334	411	22,257	23,203	28,303	32,319	42,944
1.4 IMF Drawings	161	209	287	368	258	11,943	19,463	27,787	35,552	27,023
2. Short-term Debt	575	533	601	620	647	46,034	49,648	58,116	59,935	67,726
2.1 Government	-	-	-	-	-	-	-	-	-	-
2.2 Other (b)	575	533	601	620	647	46,034	49,648	58,116	59,935	67,726
3. Banking Sector External Liabilities (c)	1,076	1,119	1,001	1,046	1,429	86,132	104,201	96,807	101,149	149,492
3.1 Central Bank	...	2	1	-	1	33	172	123	32	128
3.2 Commercial Bank	938	1,009	865	863	1,066	75,101	94,030	83,655	83,514	111,464
3.3 ACU Liabilities	137	107	135	182	362	10,998	9,999	13,029	17,604	37,899
4. Total External Debt (1+2)	9,031	8,372	9,333	10,647	11,346	722,079	779,893	902,825	1,029,939	1,186,816
5. Total External Debt and Liabilities (1+2+3)	10,106	9,490	10,334	11,692	12,775	808,211	884,095	999,632	1,131,088	1,336,308
MEMORANDUM ITEMS										
Medium and Long-term Debt										
(1) Project Loans	5,346	5,374	4,358	6,961	7,702	427,965	480,237	421,637	673,432	805,646
(2) Non-Project Loans	1,426	1,154	3,048	1,726	1,763	114,174	103,163	294,880	167,007	184,467
(3) Suppliers' Credits	338	316	100	216	232	27,074	29,411	9,718	20,921	24,259
(4) IMF Drawings	161	209	287	368	258	11,943	19,463	27,787	35,552	27,023
(5) Other Loans (d)	1,185	786	939	756	743	94,890	97,971	90,686	73,092	77,696
Short-term Debt and Banking Sector Liabilities	1,650	1,651	1,602	1,665	2,077	132,166	153,850	154,923	161,084	217,217
As a percentage of GDP										
Total External Debt	54.5	53.2	56.3	58.4	57.8	57.5	55.4	57.0	58.5	59.7
Total Banking Sector External Liabilities	6.5	7.1	6.0	5.7	7.3	6.9	7.4	6.1	5.7	7.5
Total External Debt and Liabilities	61.0	60.3	62.4	64.1	65.0	64.4	62.8	63.1	64.3	67.2
Short-term Debt	3.5	3.4	3.6	3.4	3.3	3.7	3.5	3.7	3.4	3.4
Short-term Debt and Banking Sector External Liabilities	10.0	10.5	9.7	9.1	10.6	10.5	10.9	9.8	9.2	10.9
As a percentage of Total Debt and Liabilities										
Short-term Debt	5.7	5.6	5.8	5.3	5.1	5.7	5.6	5.8	5.3	5.1
Short-term liabilities	10.6	11.8	9.7	8.9	11.2	10.7	11.8	9.7	8.9	11.2
Short-term Debt as a percentage of Official Reserves	54.8	39.8	35.3	26.6	29.5	55.1	39.8	35.3	26.6	29.5

(a) Provisional

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

(c) ACU debits and foreign liabilities of commercial bank including those of FCUBs

(d) Includes long term loans of public corporations and private sector institutions.

Sources: Central Bank of Sri Lanka External Resources Dept.

2004 compared to an improvement in 2003, despite an improvement in foreign exchange earnings, mainly due to a substantial increase in repayments to the IMF during the year. When repayments to the IMF are excluded, the ratio remained almost at the same level as in 2003. However, these ratios are not considered excessively burdensome by international standards, as concessionary debt accounts for the major share of total government debt.

## 5.7 Exchange Rate Regime and Exchange Rate Movements

In November 2003, the exchange rate with respect to the US dollar began a reversal of its appreciating trend experienced

earlier in the year. During the last two months of 2003, it suffered from high volatility due to both global and domestic shocks. A salient feature in 2004 was a further continuation of this depreciating trend throughout the year. With the pressure exerted by the BOP deficit on the exchange rate, it reached Rs.105.47 per US dollar, on 17 December 2004, the highest rate in the interbank market. However, in the aftermath of the tsunami disaster, the market reacted with an anticipation of large foreign aid inflows to the country, and the exchange rate responded by appreciating to Rs.104.61 per US dollar by 31 December 2004. For the year as whole, the rupee depreciated by 7.5 per cent against the US dollar compared to a marginal depreciation of 0.01 per cent in 2003.

Table 5.12

## External Debt Service Payments

Item	US dollars million					Rs. million				
	2000	2001	2002	2003	2004 (a)	2000	2001	2002	2003	2004 (a)
1. Debt Service Payments	953	813	788	761	839	74,554	72,584	74,704	73,125	84,845
1.1 Amortisation	621	558	572	526	590	49,410	49,883	54,006	50,502	59,561
(i) To IMF	97	78	56	32	107	9,700	6,966	4,647	2,869	10,718
(ii) To Others	524	480	516	493	483	39,711	42,918	49,359	47,632	48,843
1.2 Interest Payments	332	254	216	235	249	25,144	22,701	20,698	22,623	25,284
(i) To IMF	5	4	4	4	10	410	348	398	414	988
(ii) To Others	326	251	212	230	240	24,734	22,353	20,300	22,209	24,297
2. Earnings From Merchandise Exports and Services	6,476	6,172	5,967	6,544	7,284	492,301	551,309	571,195	631,549	738,714
3. Receipts From Merchandise Exports, Services, Income and Private Transfers	7,787	7,436	7,330	8,127	9,004	591,567	664,073	701,579	784,408	912,818
4. Debt Service Ratio (b)										
4.1 As a percentage of 2 above										
(i) Overall Ratio	14.7	13.2	13.2	11.6	11.5	15.1	13.2	13.1	11.6	11.5
(ii) Excluding IMF Transactions	13.1	11.8	12.2	11.1	9.9	13.1	11.8	12.2	11.1	9.9
4.2 As a percentage of 3 above										
(i) Overall Ratio	12.2	10.9	10.8	9.4	9.3	12.6	10.9	10.6	9.3	9.3
(ii) Excluding IMF Transactions	10.9	9.8	9.9	8.9	8.0	10.9	9.8	9.9	8.9	8.0
5. Government Debt Service Payments										
5.1 Government Debt Service Payments (c)	437	450	522	502	484	33,100	40,190	49,928	48,452	48,952
5.2 As a percentage of 1 above	45.9	55.3	66.2	66.0	57.7	44.4	55.4	66.8	66.3	57.7

Source: Central Bank of Sri Lanka

(a) Provisional

(b) Debt service ratios calculated in rupee values and US dollar values differ due to variations in exchange rates during the year.

(c) Excludes IMF transactions

Sri Lankan rupee depreciated at relatively higher rates against the other major currencies. It depreciated considerably against the euro (14.6 per cent), the sterling pound (14.5 per cent), the Indian rupee (11.5 per cent), the Japanese yen (11.2 per cent) and SDR (11 per cent) reflecting changes in the cross-currency rates against the US dollar in the international markets.

## Nominal and Real Effective Exchange Rates

Resulting from the relatively high depreciation of the rupee against major currencies, the nominal effective exchange rate (NEER) of the Sri Lanka rupee based on a 5 currency basket, (which include the US dollar, Japanese yen, sterling pound, Indian rupee and euro) depreciated by 10.3 per cent, while the NEER based on the nominal exchange rates of 24 trading

Table 5.13

## Exchange Rate Movements

Currency	In Rupees per unit of Foreign Currency						Percentage Change Over Previous Year (a)			
	End of Year Rates			Annual Average			Point to Point		Annual Average	
	2002	2003	2004	2002	2003	2004	2003	2004	2003	2004
Euro	101.38	121.60	142.32	90.43	109.16	125.79	-16.6	-14.6	-17.2	-13.2
Indian Rupee	2.01	2.12	2.40	1.97	2.07	2.23	-5.1	-11.5	-4.9	-7.2
Japanese Yen	0.82	0.90	1.02	0.77	0.83	0.94	-9.7	-11.2	-7.6	-10.9
Pound Sterling	155.13	172.20	201.37	143.74	157.71	185.35	-9.9	-14.5	-8.9	-14.9
US Dollar	96.73	96.74	104.61	95.66	96.52	101.19	0.0	-7.5	-0.9	-4.6
SDR	130.99	143.75	161.60	123.93	135.23	149.88	-8.9	-11.0	-8.4	-9.8
Effective Exchange Rate Indices (b)	Monthly Index			Annual Average			Percentage Change Over Previous Year			
							Point to Point		Annual Average	
	Dec. 2002	Dec. 2003	Dec. 2004	2002	2003	2004	2003	2004	2003	2004
NEER (1999 = 100)	76.07	71.58	63.18	78.87	73.84	67.63	-5.90	-11.74	-6.38	-8.41
REER (1999 = 100)	100.08	96.75	94.84	99.33	97.25	93.61	-3.33	-1.97	-2.09	-3.74

Source: Central Bank of Sri Lanka

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

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

Chart 5.10  
Exchange Rate Movements

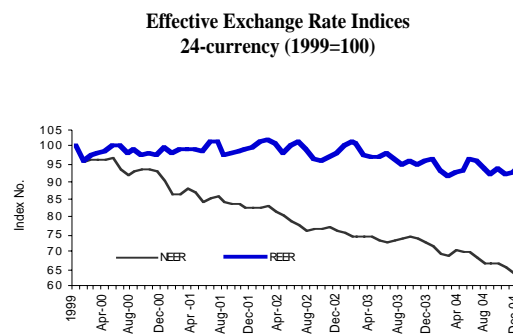
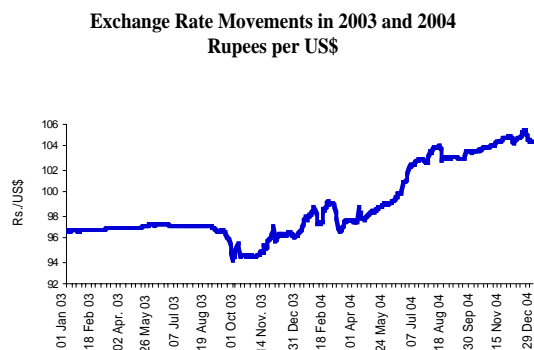
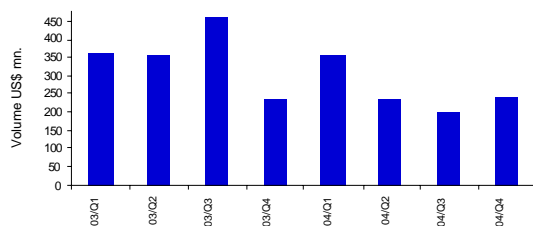


Chart 5.11  
Inter Bank Forward Transactions in 2003 and 2004



partners and competitors depreciated at a higher rate of 11.0 per cent during the year. However, when adjusted for the inflation differential, the real effective exchange rate (REER) depreciated marginally by 1.0 per cent and 1.1 per cent, with respect to the 5 currency and 24 currency baskets, indicating only a marginal improvement in the competitiveness of Sri Lanka's exports. Hence, by and large, the exchange rate of Sri Lanka has remained stable in real terms in 2004.

### Developments in the Domestic Foreign Exchange Market

The developments in the external sector during the year had a mixed impact on the domestic foreign exchange market activities during 2004. The uncertainty that prevailed during the year had a dampening impact on the forward market activities, while increasing transactions in the inter-bank spot market. The inter-bank foreign exchange volume including the forward

market volume increased substantially to US dollars 4,330 million in 2004 from US dollars 3,649 million in 2003, due to the large volume of trade in the spot market. The forward volume in the foreign exchange market, however, decreased to US dollars 1,026 million (23 per cent of total transactions) from US dollars 1,442 million (38 per cent of total transactions) recorded in 2003.

The forward market, which was active at the beginning of 2004 with a total of US dollars 355 million in transactions during the first quarter of the year, gradually declined during the year to record US dollars 233 million and US dollars 201 million in the second and third quarters before rising again to US dollars 232 million in the final quarter. Movements of both the volume and the premium of forward transactions reflected the levels of uncertainty that prevailed during the year. The average annualised forward premium increased to 7.86 per cent and 8.33 per cent for the 1 month and 3 month categories of forward transactions by the end of the year, in excess of the interest rate differentials that prevailed at 4.8 per cent for the two categories. The forward premia have been higher than the interest rate differentials throughout most of the year, indicating market expectations of faster depreciation of the currency or higher interest rates.

As in 2003, the Central Bank continued to intervene in the foreign exchange market to mitigate the excessive volatility in the foreign exchange market. In contrast to heavy purchases in 2003 to build up the official reserves, sale of foreign exchange dominated in 2004 as the Central Bank intervened to meet the increasing demand for foreign exchange in the market. Accordingly, the Central Bank sold US dollars 541.7 million and purchased US dollars 27 million in 2004, resulting in a net sale of US dollars 514.7 million.