Chapter 5

EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

5.1 Overview

Sri Lanka's external sector continued to expand in the midst of many challenges in an environment where sustained strong global growth was also experienced in 2006. The Balance of Payments (BOP) recorded a surplus for the second consecutive year. The Foreign Direct Investment (FDI) reached a record high level in 2006, surpassing the previously recorded highest level in 1997. Sri Lanka's exports continued to grow taking advantage of the higher growth in its major export destinations, increased access to several selected markets under preferential trading arrangements and continuous efforts by exporters to penetrate into new and high value niche markets. Amidst intense global competition, the apparel exports exceeded US dollars 3 billion mark in 2006, aided by increased access to the EU market under the GSP+ scheme and continuous demand from USA .The rapid growth in regional countries boosted exports of services, especially, transshipment cargo handling and tourism. Though tourist arrivals suffered a setback during the latter part of the year, the overall performance in terms of earnings during the year showed an improvement over the previous year. Worker remittances increased substantially for the second consecutive year. In the meantime, imports grew at an increased rate due to higher international oil prices, and imports of investment goods. The exceptionally high oil prices experienced during the year led to a deterioration in the terms of trade by 3.5 per cent. Reflecting these developments, the external official reserves improved, thereby strengthening the resilience of the external sector to external shocks. The rupee depreciated by around 5.2 per cent which was commensurate with the inflation difference between Sri Lanka and its major trading partners, reducing the pressure in the foreign exchange market. To attain the objectives of mitigating the impact of rising oil prices on the BOP, reducing volatility in the domestic foreign exchange market and protecting consumers from rising oil prices, the Central Bank took initiatives to encourage the Ceylon Petroleum Corporation (CPC) to enter into hedging arrangements in relation to their oil purchases.

5.2 External Sector Policies and Institutional Support

In 2006, international trade and finance continued to operate in a free and liberal economic environment underpinned by full current account convertibility, limited capital account restrictions and a freely floating exchange rate regime. In the midst of external and domestic shocks, the free-market economic policies, the healthy investment climate and improved payment system have enabled the country to achieve a higher growth in recent years. External trade policy is aimed at product diversification through enhancing competitiveness of domestic production and capturing new markets through mutually beneficial trade and investment treaties.

The capital account was further opened in 2006 by providing opportunities to foreign nationals to invest in rupee denominated government Treasury bonds. In addition to available concessional financing, the government requires more long-term foreign financing to implement major infrastructure projects, which are essential to promote regionally balanced growth. Therefore, it is necessary for Sri Lanka to establish its presence in the international capital markets to fill its foreign financing gap, while being conscious of external debt sustainability. In this regard, the government opened the rupee denominated Treasury bond market for foreign investors with effect from 01 November 2006, up to a maximum limit of 5 per cent of the total value of Treasury bonds outstanding at any given point of time. Accordingly, foreign investors including foreign country funds, mutual funds and regional funds approved by the Securities and Exchange Commission (SEC) of Sri Lanka, corporate bodies incorporated outside Sri Lanka and citizens of foreign states are now permitted to invest in rupee denominated Treasury bonds. In order to mitigate the risks arising from a sudden outflow of funds, the Central Bank has teken action to build a Special Fund, denominated in US Dollars, out of which any demand for foreign exchange for that purpose would be met.

The continuation of trade liberalisation policy yielded a lower average tariff rate of 4.2 per cent in 2006 compared to 4.3 per cent in 2005. The main trade policy instrument, the import tariff, comprised of a five-band tariff structure of 0, 2.5, 6, 15 and 28 per cent in 2006. Accordingly, the government continued to maintain duty on basic raw materials at the lowest tariff band and apply middle and upper rates to intermediate and finished goods. Several duty

Table 5.1 Balance of Payments Analytical Presentation (a)

Item	US dollars million					Rs.million				
	2002	2003	2004	2005	2006 (b)	2002	2003	2004	2005	2006 (b)
Trade Balance	-1,406	-1,539	-2,243	-2,516	-3,370	-134,706	-148,324	-227,171	-253,082	-350,037
Exports	4,699	5,133	5,757	6,347	6,883	449,855	495,426	583,967	638,276	716,579
Imports	6,106	6,672	8,000	8,863	10,253	584,561	643,750	811,138	891,359	1,066,615
Services, net	295	399	419	338	257	28,224	38,443	42,735	34,043	26,660
Receipts	1,268	1,411	1,527	1,540	1,625	121,340	136,123	154,746	154,877	168,802
Payments	974	1,012	1,108	1,202	1,368	93,115	97,680	112,011	120,833	142,142
Income,net	-252	-172	-204	-299	-388	-24,167	-16,535	-20,688	-30,049	-40,353
Receipts	75	170	157	35	311	7,201	16,385	15,813	3,629	32,457
Payments	328	341	360	335	700	31,368	32,920	36,501	33,678	72,810
Goods, Services and Income (net)	-1,364	-1,312	-2,028	-2,478	-3,502	-130,648	-126,416	-205,124	-249,088	-363,730
Private Transfers, net	1,097	1,205	1,350	1,736	2,068	104,980	116,350	136,672	174,542	215,102
Receipts	1,287	1,414	1,564	1,968	2,326	123,183	136,475	158,291	197,968	241,919
Payments	190	209	214	233	257	18,202	20,125	21,619	23,426	26,817
Official Transfers (net)	31	36	30	93	101	2,982	3,441	3,038	9,300	10,524
Current Account	-236	-71	-648	-650	-1,334	-22,686	-6,625	-65,414	-65,246	-138,104
Capital and Financial Account	444	722	631	1,224	1,807	40,639	69,723	60,539	123,866	190,751
Capital Account	65	74	64	250	291	6,219	7,146	4,974	25,108	30,289
Capital Transfers(net)	65	74	64	250	291	6,219	7,146	4,974	25,108	30,289
Receipts	71	81	71	257	299	6,782	7,768	5,643	25,863	31,169
Payments	6	6	7	7	8	563	622	669	755	879
Financial Account	379	648	567	974	1,517	34,420	62,577	55,565	98,757	160,462
Long-term:	326	722	680	798	906	28,911	69,721	69,805	80,391	95,074
Direct Investment	185	201	227	234	451	17,716	19,450	22,826	23,505	46,971
Foreign Direct Investment	181	171	217	234	451	17,281	16,557	21,948	23,505	46,971
Privatisation Proceeds	5	30	10	-	-	435	2,893	878	-	-
Private Long-term (net)	-21	-33	14	11	-35	-2,039	-3,201	2,270	1,054	-3,591
Inflows	115	101	169	197	139	11,007	9,738	17,503	19,739	14,465
Outflows	136	134	155	186	174	13,046	12,939	15,233	18,685	18,056
Government, Long-term (net)	162	554	439	553	491	13,233	53,472	44,709	55,832	51,694
Inflows	542	913	771	747	932	51,843	88,106	78,299	75,309	97,690
Outflows	380	359	331	194	441	38,610	34,634	33,590	19,477	45,996
Short-term:	53	-75	-112	176	610	5,509	-7,145	-14,240	18,366	65,387
Portfolio Investment	25	2	11	60	51	2,443	209	1,109	6,103	5,377
Private Short-term (net)	68	19	28	16	-30	6,548	1,877	2,514	1,640	-3,066
Commercial Bank Assets (net)	104	-94	-354	-223	297	6,893	-9,090	-45,367	-19,669	23,789
Commercial Bank Liabilities (net)	-145	-2	202	323	293	-10,375	-141	27,504	30,292	39,287
Government Short-term (net)	-	-	-	-	-	-	-	-	-	-
Valuation Adjustments	93	-	-	-	-	8,900	-	-	-	-
Errors and Omissions	38	-148	-189	-72	-270	9,197	-14,487	-2,599	-10,494	-15,426
Overall Balance (c)	338	502	-205	501	204	36,051	48,610	-7,474	48,125	37,221
Monetary Movements (c)	-338	-502	205	-501	-204	-36,051	-48,610	7,474	-48,125	-37,221
Annual Average Exchange Rate Rs/US$						95.66	96.52	101.19	100.50	103.96
Ratio to GDP in percentages										
Trade Account	-8.5	-8.4	-11.2	-10.7	-12.5	-8.5	-8.4	-11.2	-10.7	-12.5
Current Account	-1.4	-0.4	-3.2	-2.8	-4.9	-1.4	-0.4	-3.2	-2.8	-4.9
Current Account without Grants	-1.6	-0.6	-3.4	-3.2	-5.3	-1.6	-0.6	-3.4	-3.2	-5.3

(a) This presentation conforms as far as possible to the Balance of Payments Manual, 5th Edition (1993) of the International Monetary Fund. In addition, beginning 1994, Foreign Currency Banking Units (FCBUs) have been treated as a part of the domestic banking system.

(b) Provisional

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

Source: Central Bank of Sri Lanka

changes, particularly related to essential food items and non-essential consumer items were made in 2006. As prudential measures to deter imprudent lending for the import of non-essential items, while promoting stability of the financial system, several of these items were brought under a margin deposit of 50 per cent at the time of opening letters of credit and before releasing documents on Document against Acceptance (DA terms) in 2006. The other charges applicable to imports in 2006 were surcharge on customs duty (10% of customs duty), Value Added Tax (VAT), Port and Airport Development Levy (PAL), Social Responsibility Levy (SRL), Excise Duty (for alcohol, tobacco products and vehicles) and cess on non-essential consumer items.

Box 6

Economic Implications and Prerequisites for Further Opening of the Capital Account

Capital account opening is the process in which a country moves from a closed capital account regime, where capital may not move freely in and out of the country to an open capital account regime, where capital enters and leaves freely. Opening the capital account generally promotes economic growth, facilitates risk sharing through portfolio diversifications and results in efficiency gains. Several emerging market economies have relaxed and removed restrictions on capital transactions and liberalised domestic financial markets, given the need for investment needs arising from insufficient domestic savings. However, financial crises have also been reported in a number of countries after the opening of the capital account, not due to the weaknesses of the concept *per se*, but due to the prevalence of a weak banking and financial sector, lack of proper prudential regulations and poor supervision.

Sri Lanka permitted the movement of capital inflows and outflows selectively in 1978. Inward FDI and portfolio investments were freely permitted, subject to existing regulations to attract foreign direct investments needed for export-oriented industrialisation, financing the widening savings-investment gap and helping domestic companies to expand their production capacity with low cost funds from foreign lenders. At the same time, as a risk mitigation mechanism, outward investments and foreign borrowings by Sri Lankans were permitted only on a case-by-case basis depending on the merits of each case. Benefiting from these policy changes, gross FDI inflows increased to US dollars 49 million in 1979. This trend continued thereafter, eventually reaching US dollars 604 million in 2006. Consequently, the country's industrial base and export base have diversified and expanded over the years, and at present all enterprises approved by the Board of Investment (BOI) account for about 73 per cent of total exports of the country and for 89 per cent of total industrial exports. Nearly 400,000 people are directly employed in BOI approved enterprises and a large number of people are indirectly employed in related sectors. The portfolio investment inflows also have been increasing gradually, which reached a record level of US dollars 354 million in 2006. Along with these favourable developments, other trade related services such as port services, and financial services also expanded substantially.

Further opening up the capital account has been suggested as being a means to facilitate economic growth further through promoting higher investment by minimising cost of equity capital and debt and improving the efficiency of the financial system through greater competition and to provide opportunities for Sri Lankan investors to expand their operations both locally and abroad. It is also claimed that this situation has been further intensified with Sri Lanka graduating to now being a country with a middle-income country status and imposition of limitations on concessional financing available to the country. Meanwhile, some of the domestic private sector enterprises with overseas investments have demonstrated the capability of local entrepreneurs to compete successfully in international markets. As financing needs of the government has exceeded official external financing over the years, it has become necessary for the government to resort to syndicated loans and external commercial borrowings on a modest scale. Even

Box 6 (Contd.)

Economic Implications and Prerequisites for Further Opening of the Capital Account

some of the private sector enterprises currently resort to foreign borrowings, as it is cheaper to borrow abroad. Some of these companies have already demonstrated their ability to raise capital from international markets through international bond issues and loans. These developments indicate the potential for other viable companies to mobilise funds at relatively low cost from international markets.

Recent measures in opening the capital account

In 2006, towards further opening of the capital account, the government permitted foreign country funds, regional funds or mutual funds approved by the Securities and Exchange Commission of Sri Lanka, corporate bodies incorporated outside Sri Lanka and citizens of foreign countries to purchase and hold up to 5 per cent of the total outstanding value of Rupee Denominated Treasury Bonds at any given point of time. During the year, the government also issued foreign currency denominated Nation Building Bonds for non-resident Sri Lankans and Sri Lankan professionals living in Sri Lanka or abroad who earn income in foreign currency. These measures are expected to benefit the economy in several ways. The government's borrowing cost may reduce through competitive bidding from both foreign and domestic investors. In addition, a country may receive foreign exchange through bond issues, which would increase official reserves of the country, further strengthening the country's resilience to external shocks. However, these inflows should be prudentially invested and managed to effectively overcome any unforeseen events, which may lead to sudden capital outflows. These measures may also facilitate the country's efforts to mobilise funds in the international capital markets by increasing foreign investors' appetite for investment in Sri Lankan debt instruments. Table B 6.1 compares the present position of selected capital account restrictions in Sri Lanka and India.

Potential areas for future opening

Though inward foreign direct investments are freely permitted, foreign investment is not permitted in certain businesses such as money lending, pawn broking, coastal fishing and retail trade with a capital of less than US dollars 1 million. In some cases, there are restrictions on foreign ownership (permitted only up to 40 per cent of issued share capital) in certain businesses.[1] There are a few other areas, which strictly require the approval of the relevant line ministries due to security and environmental concerns.[2] While these limitations may continue, potential areas for further relaxation may include outward foreign direct investments, listing of shares in foreign share markets and foreign borrowings by companies incorporated in Sri Lanka, foreign investment by long-term funds, listing the shares of companies incorporated outside Sri Lanka in the Colombo Stock Exchange and permission for non-residents to subscribe to debt instruments of local companies. The relevant authorities may examine these potential areas further and respond appropriately in time to come.

Prerequisites for further capital account opening

At the same time, considering the dangers of greater capital flows including the impact on the domestic financial system, exchange rate volatility, competitiveness and complication of macroeconomic management, it is essential to carefully consider some basic preconditions before moving towards such policies. These would include the convergence of domestic interest rates towards global interest rates to narrow the interest rate differentials, which will lower speculative capital flows, and encourage long-term capital flows. Therefore, it is necessary to maintain a low and stable inflation in the country. Sound and proper regulatory framework with effective enforcement mechanism and enhanced risk management practices should also be put in place prior to opening further to avoid future financial crisis. It is also necessary to prepare a clear roadmap for sequencing the process based on a careful examination of the effectiveness of the prevailing regulatory framework, the macroeconomic conditions in the country and health of corporate, banking and other financial institutions.

[1] Such businesses include (i) production of goods where Sri Lanka's exports are subject to internationally determined quota restrictions, (ii) growing and primary processing of tea, rubber, coconut, cocoa, rice, sugar and spices, (iii) mining and primary processing of non-renewable national resources, (iv) timber based industries using local timber, (v) fishing (deep sea fishing), (vi) mass communications, (vii) education, (viii) freight forwarding, (ix) travel agencies and (x) shipping agencies.

[2] These include areas such as (i) air transportation, (ii) coastal shipping, (iii) industrial undertakings in the Second Schedule of the Industrial Promotion Act, No. 46 of 1990 (any industry manufacturing arms, ammunitions, explosives, military vehicles and equipment, aircraft and other military hardware; any industry manufacturing poisons, narcotics, alcohols, dangerous drugs and toxic, hazardous or carcinogenic materials; and any industry producing currency, coins or security documents, (iv) large scale mechanized mining of gems and (v) lotteries.

Box 6 (Contd.)

Economic Implications and Prerequisites for Further Opening of the Capital Account

TABLE B - 6.1
Present Capital Account Restrictions in Sri Lanka & India

Item		Sri Lanka	India
1. Foreign Direct Investment (FDI)	Abroad	Permitted on a case -by -case basis	Companies/registered partnerships firms are permitted to invest up to 200 per cent of their net worth in business activities overseas.
	Domestic	Most areas are opened up to 100 per cent except for a few areas (see footnotes 1&2)	Under automatic route investment is permitted in sectors up to the sectoral caps except in certain sectors, where investment is prohibited.
2. Foreign Investment in Shares	Abroad	Not permitted	Approved Indian investors including mutual funds are permitted to invest abroad within an aggregate ceiling of US $ 3 billion. Individuals are allowed to purchase shares up to US$ 50,000 per financial year without RBI approval.
	Domestic	Non-residents may invest up to 100 per cent of equity subject to certain exclusions and limitations	Foreign institutional investors registered with Securities and Exchange Board of India and Non-resident Indians are permitted to purchase shares under the Portfolio Investment Scheme up to the approved limit.
3. Investment in Government Securities	Abroad	Not permitted	Approved Indian investors including mutual funds are permitted to invest abroad within an aggregate ceiling of US $ 3 billion.
	Domestic	Foreign funds approved by Securities and Exchange Commission of Sri Lanka are permitted to purchase up to 5 per cent of total outstanding rupee denominated Treasury bonds. Non-residents are also permitted to invest in Sri Lanka Development Bonds (SLDBs)	Foreign funds are permitted to invest up to an aggregate of US2.6 billion worth of government securities and Treasury bills. This limit will be increased to US 3.2 billion in March 2007.
4. External Commercial Borrowings (ECB)		ECB is permitted on a case-by-case basis	Companies can avail up to US$750 million ECB per annum.
5. Financial Capital Transfers- by Individuals		Not permitted	Individuals are permitted to remit freely up to US$ 50,000 per financial year for current/capital account transactions.

Table 5.2 Average Import Duty Collection Rate (a)

Item	2002	2003	2004	2005	2006(b)
Consumer goods	13.1	13.5	10.4	10.4	11.2
Food and beverages	14.1	14.2	8.5	9.6	10.7
Rice	32.9	29.3	4.9	10.6	23.4
Flour	12.3	11.5	7.2	3.8	33.7
Sugar	14.4	16.8	4.6	1.5	1.9
Wheat and meslin	0.0	0.0	0.1	1.1	5.6
Milk and milk products	11.9	12.2	7.9	10.2	9.6
Dried fish	7.9	10.8	5.9	5.9	5.0
Other fish products	6.8	7.9	10.0	9.8	7.8
Other	22.9	22.3	17.4	22.0	24.2
Non-food consumer goods	12.1	13.0	12.2	11.1	11.7
Motor cars & cycles	23.3	22.1	21.1	18.9	18.3
Radio receivers- television sets	8.6	8.9	9.4	13.6	7.1
Rubber tyres & tubes	27.9	26.0	25.8	26.2	19.2
Pharmaceutical products	0.6	0.6	0.6	0.5	0.3
Other	9.4	9.2	8.9	8.7	10.3
Intermediate goods	1.6	1.5	1.9	1.9	1.4
Fertiliser	0.4	2.6	3.1	2.7	2.5
Crude oil	0.0	0.0	0.0	0.0	0.0
Other petroleum products	0.8	0.8	0.9	0.9	1.3
Chemical elements and compounds	1.1	2.2	2.6	2.0	1.8
Dyeing , tanning and colouring	4.0	4.6	4.5	4.4	2.6
Paper and paper boards	5.2	5.4	6.0	6.0	2.4
Textiles	0.1	0.1	0.0	0.1	0.1
Other intermediate goods	4.3	3.3	4.3	4.5	3.3
Investment goods	5.5	7.2	6.1	5.8	5.2
Building materials	7.4	7.7	9.0	7.8	9.2
Transport equipment	11.0	12.9	11.9	9.7	7.0
Machinery and equipment	3.7	5.6	3.2	3.3	3.2
Other investment goods	3.8	4.6	5.0	5.3	3.4
Total	4.8	5.3	4.5	4.3	4.2

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

Sources : Sri Lanka Customs
Ceylon Petroleum Corporation
Prima Ceylon Limited

Being a small economy with limited domestic demand, Sri Lanka does not have a choice but to adopt external trade relations and policies aimed at enhancing the integration of domestic economy with global markets. It would help the country to reap benefits of ever increasing global demand, technological developments, and the transfer of skills and knowledge. Sri Lanka remains firmly committed to the multilateral trading system and continued to participate actively in free trade negotiations initiated by the World Trade Organisation (WTO).

Sri Lanka made progress in furthering its regional and bilateral trading arrangements in 2006. In the regional front, the first phase of trade liberalisation under SAFTA was introduced in July, 2006. After the accession of China in 2001, the six member Asia-Pacific Trade Agreement (APTA), formerly known as Bangkok Agreement, initiated a process to revitalise the agreement. The tariff concessions offered under bilateral trade agreements by way of tariff eliminations and tariff reductions helped withstand the strong international competition and maintain the growth momentum in the external sector in the post Multi-Fibre Arrangement (MFA) era. As per the second phase of tariff liberalisation under the Indo-Sri Lanka Free Trade Agreement (ISLFTA), Sri Lanka has been subject to zero duty on all goods from Sri Lanka, except for the items in the negative list since March, 2003. However, Sri Lanka's exports to India were largely concentrated on a few items. Sri Lanka also reduced its tariff by 70 per cent in 2006 for all goods from India except for the items in the negative list. Two way trade between Sri Lanka and India increased by 11 per cent to US dollars 2.7 billion in 2006. Two rounds of technical level negotiations under the Comprehensive Economic Partnership Agreement (CEPA) were held in 2006. These negotiations were on trade in goods and services, trade in financial services, air services, investment, treatment of double taxation and economic cooperation. Both countries stressed the need to conclude the ongoing negotiation towards its fast implementation before the end 2007 in a mutually beneficial manner. Under the Pakistan-Sri Lanka Free Trade Agreement, a 67 per cent tariff reduction was also received on Sri Lankan exports to Pakistan in 2006. Exports to Pakistan increased significantly by 46 per cent reflecting higher performance in categories such as fruits, tea, rubber, coconut and wood products.

Tariff concessions granted under the GSP+ (Generalised System of Preferences) scheme helped to diversify exports and markets in the European Union (EU) region. Despite intense competition, apparel exports to the EU increased by 17.3 per cent mainly on account of the GSP+ tariff concessions. However, due to rigid and complex rules of origin (ROO) criteria, Sri Lanka's utilisation rate of concessions of apparel was low in 2006. At the request of the Government, the European Commission set up a study team to carry out an impact assessment on the change of ROO under the GSP+ scheme. The current GSP+ scheme is scheduled to be reviewed by the EU in December, 2008.

The government continued to support the exporters using a wide spectrum of arrangements. Major institutions involved in this exercise were the Board of Investment (BOI), Sri Lanka Export Development Board (SLEDB), Sri Lanka Export Credit Insurance Corporation (SLECIC) and Sri Lanka Standards Institution (SLSI). The Bureau of Indian Standards (BIS) and SLSI entered into a bilateral cooperation agreement in August, 2006 to facilitate trade between the two countries through standardisation, quality control and certification of products.

A number of initiatives have been taken by the government aimed at increasing the competitiveness of the textiles and apparel sector to enable it to withstand the emerging pressure. These include the reduction of the VAT for local suppliers of intermediate goods, duty free concessions to acquire advanced technology, financial assistance for technology improvements, simplified VAT applications, a zero rate VAT structure for garment buying offices, establishment of the College of Textiles and Clothing and reopening of defunct textiles units to facilitate vertical integration of the garment industry. Given the strong competition in the international market, renewed interest of major exporters to invest heavily in the defunct units augurs well for the industry's future and is indicative of a broader sense of growing confidence. Apparel industry has geared up to making a major breakthrough in the international market with the launch of their new campaign titled "Garments without Guilt". The industry increased its focus on being an ethical supplier of garments empowering women whilst refraining from employing child labour. The purpose of this campaign is to prepare the industry to meet the international competition when various restrictions placed by the USA and the EU on Chinese garment exports are removed in 2008.

5.3 Trade in Goods, Trade Balance and Terms of Trade

Export Performance

The growth in exports continued in 2006 benefiting from improvements in the quality of exports, economic prosperity of export destination countries, enhanced market access through further integration of the domestic economy with the world economy and commercial diplomacy and various initiatives by the government and major exporters. Export earnings increased by 8.4 per cent to US dollars 6,883 million

Table 5.3 **Trade Indices (a)**

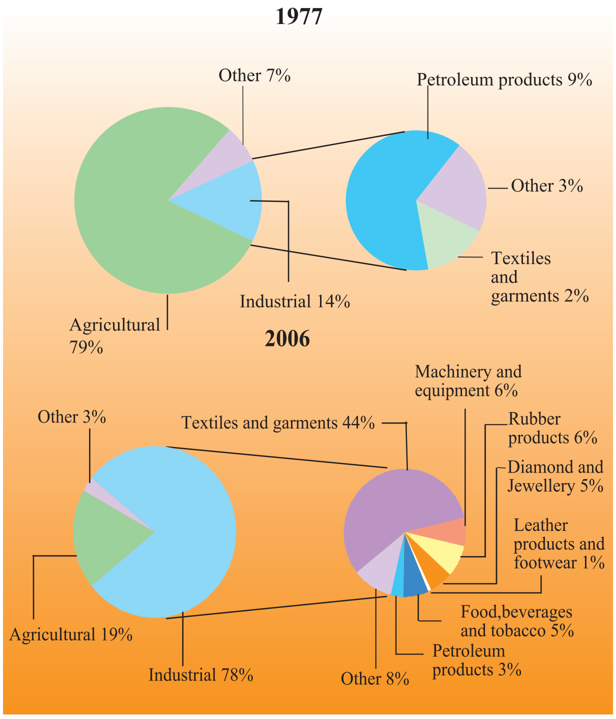
1997=100

Category	2005			2006 (b)			Growth Rate (b)		
	Value Index	Volume Index	Unit Price Index	Value Index	Volume Index	Unit Price Index	Value Index	Volume Index	Unit Price Index
EXPORTS									
Agricultural exports	108.6	116.1	93.5	121.7	122.6	99.3	12.1	5.6	6.2
Tea	112.4	117.3	95.8	122.2	124.0	98.6	8.7	5.7	2.9
Rubber	59.7	53.9	110.7	118.4	77.0	153.8	98.2	42.8	38.9
Coconut	96.3	102.3	94.1	105.3	112.4	93.7	9.3	9.8	-0.4
Other agricultural products	126.5	155.6	81.3	134.2	148.7	90.2	6.1	-4.4	11.0
Industrial exports	143.7	145.4	98.9	156.1	150.7	103.6	8.6	3.7	4.7
Textiles and garments	127.0	134.4	94.5	135.2	141.2	95.7	6.4	5.1	1.3
Petroleum products	134.5	54.4	247.4	192.2	69.3	277.3	42.9	27.4	12.1
Other industrial exports	180.3	177.1	101.8	197.6	178.5	110.7	9.6	0.8	8.7
Mineral exports	160.4	115.5	138.8	152.4	120.7	126.3	-5.0	4.5	-9.0
Gems	144.9	115.7	125.3	143.9	119.9	120.0	-0.7	3.6	-4.2
Other mineral Exports	365.0	144.1	319.8	264.8	130.3	203.2	-27.5	-9.6	-36.5
Total Exports	136.6	138.0	98.9	148.1	143.6	103.1	8.4	4.1	4.2
IMPORTS									
Consumer goods	138.6	159.8	86.7	164.4	175.9	93.5	18.6	10.1	7.8
Food and beverages	95.2	101.3	94.0	118.0	108.7	108.5	23.9	7.3	15.5
Other consumer goods	201.7	244.9	82.4	231.8	273.5	84.8	14.9	11.7	2.9
Intermediate goods	168.7	139.3	121.1	191.6	146.2	131.0	13.5	5.0	8.2
Fertiliser	203.3	135.7	149.8	247.1	162.1	152.5	21.6	19.4	1.8
Crude Oil	292.7	110.7	264.4	389.4	118.6	328.3	33.0	7.1	24.2
Other Petroleum	320.4	132.5	241.8	378.0	143.5	263.5	18.0	8.3	9.0
Chemical Elements and Compounds	182.8	143.2	127.6	191.8	144.2	133.0	4.9	0.7	4.2
Wheat and Meslin	102.6	109.5	93.7	144.1	152.1	94.8	40.5	38.9	1.1
Textiles (Including Clothing)	110.4	131.8	83.8	111.5	133.7	83.4	1.0	1.5	-0.5
Plastics	201.7	176.3	114.4	225.4	172.3	130.8	11.8	-2.3	14.3
Diamonds	192.5	139.4	138.1	193.2	116.6	165.8	0.4	-16.4	20.0
Other	183.4	181.6	101.0	212.6	202.7	104.9	15.9	11.6	3.9
Investment goods	141.0	180.0	78.3	169.3	195.9	86.4	20.1	8.8	10.4
Building materials	186.6	190.9	97.8	201.0	197.3	101.9	7.7	3.4	4.2
Transport equipment	156.3	104.8	149.2	179.5	102.0	175.9	14.9	-2.6	17.9
Machinery and equipment	115.7	204.4	56.6	144.7	231.3	62.5	25.0	13.2	10.5
Other investment goods	171.8	127.6	134.6	243.3	126.0	193.1	41.6	-1.2	43.4
Total Imports	151.1	152.8	98.9	174.8	163.6	106.9	15.7	7.1	8.0
Terms of Trade			100.0			96.5			–3.5

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

Sources : Sri Lanka Customs
Central Bank of Sri Lanka

Chart 5.3 **Share of Exports by Major Categories**



in 2006, which was the combined outcome of improved prices and volumes.

The composition of exports remained almost unchanged in 2006 compared to the previous year. Industrial exports grew by 8.8 per cent in 2006. Despite the intense global competition, apparel exports grew by 6.4 per cent in 2006. Although apparel exports to the USA declined marginally, exports to the EU including apparel increased significantly by 18.4 per cent partly capitalising the concessions offered by the GSP+ scheme. The growth in the EU was reflected in the expansion of market share in the UK, Italy, Germany, France and the Netherlands. Although the exports of rubber based products increased in 2006, the sector was affected by high and aggressive fluctuations in the prices of raw materials. Food and beverage exports, which increased remarkably in 2005, were affected by the reduction in exports of vanaspathi to India in 2006. Agricultural exports were largely led by higher performance of tea and rubber in 2006**.** With a record-setting performance, tea exports benefited from supply shortages in the international markets due to the drought in Kenya and a greater demand from the CIS and the Middle East countries. However, the value added tea exports declined in 2006, mainly due to lower exports to Jordan, Iraq and

Table 5.4 **Composition of Exports**

Category	2005		2006 (a)		Change in Value(a) US dollars million	Growth rate(a) %	Contribution to growth (a) %
	Value US dollars million	Share %	Value US dollars million	Share %			
Agricultural exports	1,153.8	18.2	1,292.7	18.8	138.9	12.0	25.8
Tea	810.2	12.8	881.2	12.8	71.0	8.8	13.2
Rubber	46.9	0.7	93.1	1.4	46.2	98.5	8.6
Coconut	113.3	1.8	123.8	1.8	10.5	9.3	1.9
Kernel products	48.8	0.8	52.8	0.8	4.0	8.2	0.7
Other	64.5	1.0	71.0	1.0	6.5	10.1	1.2
Other agricultural products	183.4	2.9	194.6	2.8	11.2	6.1	2.1
Industrial exports	4,948.4	78.0	5,383.4	78.3	435.0	8.8	81.2
Food, beverages and tobacco	318.2	5.0	363.9	5.3	45.7	14.4	8.5
Textiles and garments	2,894.5	45.6	3,080.3	44.8	185.8	6.4	34.7
Petroleum products	130.9	2.1	187.2	2.7	56.3	43.0	10.5
Rubber products	394.4	6.2	427.5	6.2	33.1	8.4	6.2
Ceramic products	47.1	0.7	47.4	0.7	0.3	0.6	0.1
Leather, travel goods and footwear	43.8	0.7	40.6	0.6	-3.2	-7.3	-0.6
Machinery and equipment	329.9	5.2	394.3	5.7	64.4	19.5	12.0
Diamond and jewellery	277.9	4.4	327.0	4.8	49.1	17.7	9.2
Other industrial exports	511.7	8.1	515.2	7.5	3.5	0.7	0.7
Mineral exports	143.3	2.2	136.2	1.9	-7.1	-5.0	-1.3
Gems	120.3	1.8	119.5	1.7	-0.8	-0.7	-0.1
Other mineral exports	23.0	0.4	16.7	0.2	-6.3	-27.4	-1.2
Unclassified (b)	101.2	1.6	70.4	1.0	-30.8	-30.4	-5.7
Total exports (c)	6,346.7	100.0	6,882.7	100.0	536.0	8.4	100.0
Annual average exchange rate	100.50		103.96				

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

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

Libya. Rubber exports too increased in 2006 reflecting increases in both prices and volumes. The price of rubber rose to historically high levels in 2006 on account of escalating oil prices. However, the price of natural rubber was highly volatile in the international markets during 2006, responding to oil prices, weather patterns, actions of hedge funds, demand from major buyers, global production and inventories. Other agricultural exports increased reflecting higher exports of fruits, pepper, cinnamon and unmanufactured tobacco. The external demand for these products was stimulated by the duty free access to the Indian market under the ISLFTA and the growing demand from the Middle Eastern countries.

Import Performance

Imports grew by 15.7 per cent to US dollars 10,253 million in 2006, reflecting both increased demand and higher import prices. The expansion of manufacturing and processing activities, ever expanding demand for consumer durables, and the relatively low interest rate regime contributed to raise import demand for all three categories, viz., intermediate, investment and consumer goods, in 2006.

Intermediate goods imports, which is dominated by petroleum products, grew by 12.1 per cent in 2006. A sharp increase in the intermediate goods imports during the first three quarters was led mainly by higher expenditure on petroleum imports. During this period, the average price of crude oil increased by 32.8 per cent. However, as a result of the slowdown of international oil prices, intermediate goods imports increased only by 4.3 per cent in the fourth quarter of 2006. Petroleum imports accounting for

Chart 5.4 **Share of Imports by Major Categories**

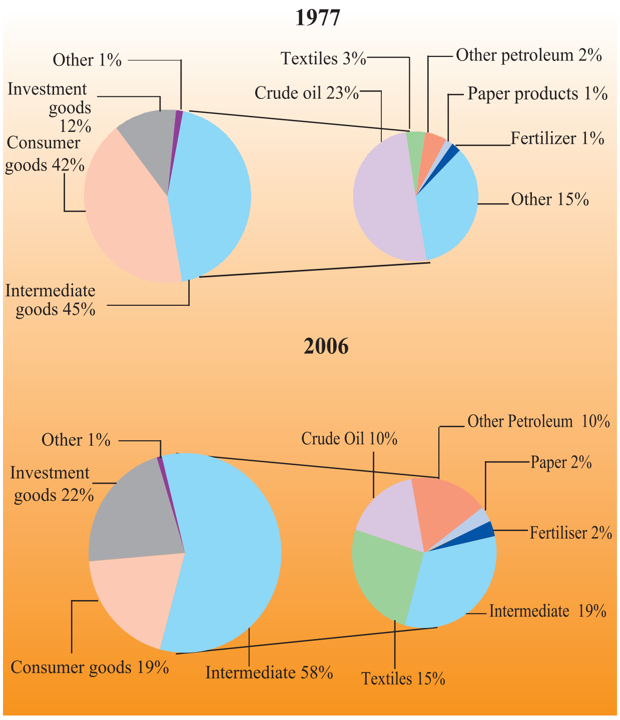


Table 5.5 **Composition of Imports**

	2005 Value US dollars million	2005 Share %	2006 (a) Value US dollars million	2006 (a) Share %	Change in Value(a) US dollars million	Growth rate(a) %	Contribution to growth (a) %
Consumer goods	1,643.9	18.5	1,980.2	19.3	336.3	20.5	24.2
Food and beverages	752.6	8.5	956.0	9.3	203.4	27.0	14.6
Rice	15.6	0.2	5.5	0.1	-10.1	-64.7	-0.7
Sugar	132.3	1.5	223.7	2.2	91.4	69.1	6.5
Wheat	141.4	1.6	198.6	1.9	57.2	40.5	4.1
Other	463.3	5.2	528.2	5.2	64.9	14.0	4.7
Other consumer goods	891.3	10.1	1,024.2	10.0	132.9	14.9	9.6
Intermediate goods	5,317.1	60.0	5,961.7	58.1	644.6	12.1	46.4
Petroleum	1,655.2	18.7	2,069.6	20.2	414.3	25.0	29.8
Fertiliser	135.0	1.5	164.1	1.6	29.1	21.6	2.1
Chemicals	248.6	2.8	260.8	2.5	12.2	4.9	0.9
Textiles	1,531.0	17.3	1,546.2	15.1	15.2	1.0	1.1
Other intermediate goods	1,747.3	19.7	1,921.0	18.7	173.7	9.9	12.5
Investment goods	1,869.6	21.1	2,245.7	21.9	376.1	20.1	27.1
Machinery and equipment	860.4	9.7	1,075.4	10.5	215.0	25.0	15.5
Transport equipment	325.3	3.7	373.6	3.6	48.3	14.8	3.5
Building materials	507.0	5.7	546.2	5.3	39.2	7.7	2.8
Other investment goods	176.9	2.0	250.5	2.4	73.6	41.6	5.3
Unclassified imports	32.6	0.4	65.4	0.6	32.8	100.7	2.3
Total imports (b)	8,863.2	100.0	10,253.0	100.0	1,389.8	15.7	100.0
Annual average exchange rate	100.50		103.96				

(a) Provisional
(b) Adjusted

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

20.0 per cent of the overall imports, increased by 25.0 per cent to US dollars 2,070 million in 2006 from US dollars 1,655 million in 2005. Meanwhile, the non-oil intermediate goods increased by 6.3 per cent, reflecting the expansion of the industrial sector. The growth in textiles, chemical products, diamond, jewellery, paper and rubber based industries has also contributed to high imports of intermediate goods in 2006.

Amongst the non oil imports, investment goods exhibited the fastest growth in 2006. Investment goods imports, which has been continuously expanding in recent years, grew by 20.1 per cent in 2006, outperforming the growth of 12.0 per cent recorded in 2005. The broad-based growth of investment goods across major sub-sectors, i.e., machinery and equipment, building material and transport equipment was underpinned by accelerated development projects launched by the government and investment projects undertaken by the private sector, especially in the fields of construction, telecommunication and information technology. Incentives offered by the government for acquiring advanced technology encouraged industries to modernise their production facilities in 2006.

In tandem with higher import prices and increased demand, consumer goods imports increased by 20.5 per cent in 2006. The expenditure on food and beverages increased, reflecting higher international prices of sugar, milk products and wheat. Wheat and sugar were the major contributors within this sub-sector accounting for almost 50 per cent. In the consumer durables sub-sector, the imports of motor vehicles for personal use, which showed a decline in 2005, increased significantly in 2006.

Table 5.6 **Volume of Major Imports (a)**

'000 mt

Item	2002	2003	2004	2005 (b)	2006 (c)
Rice	95	35	222	52	12
1st Quarter	51	22	9	43	3
2nd Quarter	9	9	9	4	2
3rd Quarter	10	2	4	2	3
4th Quarter	25	2	200	3	4
Wheat	993	919	993	864	1,200
1st Quarter	309	262	257	272	287
2nd Quarter	215	232	218	191	321
3rd Quarter	221	217	189	174	331
4th Quarter	248	208	329	227	261
Sugar	554	509	438	418	525
1st Quarter	146	151	98	49	112
2nd Quarter	141	135	173	167	137
3rd Quarter	110	104	71	94	127
4th Quarter	157	119	96	108	149
Petroleum (Crude oil)	2,300	1,995	2,200	2,008	2,151
1st Quarter	539	382	586	586	592
2nd Quarter	513	466	464	581	535
3rd Quarter	593	500	634	246	582
4th Quarter	655	647	516	595	442
Refined Petroleum	1,348	1,168	1,645	1,823	1,763
1st Quarter	276	340	460	314	402
2nd Quarter	426	239	380	396	468
3rd Quarter	266	317	341	711	334
4th Quarter	380	272	464	402	559
Fertiliser	537	514	510	529	633
1st Quarter	103	124	54	168	165
2nd Quarter	163	166	164	111	203
3rd Quarter	138	49	76	142	119
4th Quarter	133	175	216	107	146

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

Sources: Sri Lanka Customs
Ceylon Petroleum Corporation
Prima Ceylon Limited

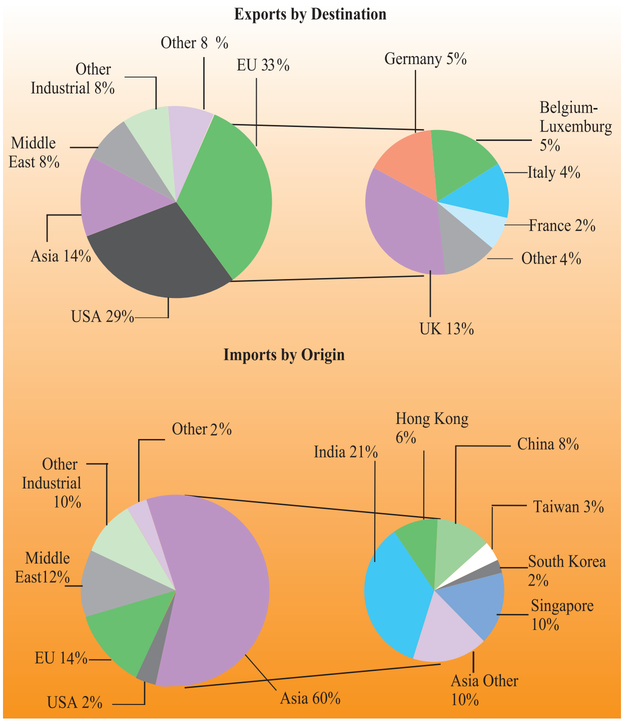
The trade deficit widened further in 2006 reflecting faster pace of imports over exports. The trade deficit widened to US dollars 3,370 million (12.5 per cent of GDP) compared to US dollars 2,516 million in 2005 (10.7 per cent of GDP).

Higher growth in import prices over the export prices resulted in a deterioration of the terms of trade in 2006. Fuelled by the surge in world oil prices, exports of rubber and petroleum products, including bunker and aviation fuel, increased with a marked rise in prices during 2006. A substantial shortfall in Kenyan tea production and continuous improvements in the quality of Ceylon tea led tea prices to rise above the global average price. Thus, despite the marginal increase in prices of garments and textile exports in the face of intense competition following the termination of the MFA in 2005, the rise in the average prices of tea, rubber and petroleum products helped increase the overall export prices by 4.2 per cent during 2006. The volume of exports grew by 4.1 per cent in 2006. The high oil prices that prevailed during the year increased the prices of fertilizer, chemical compounds and sugar. The international sugar prices soared as a significant share of the sugar cane crop was diverted for the production of the bio-fuel, ethanol which became a popular substitute for gasoline. Short wheat crops around the world combined with strong demand for wheat and shrunk stocks caused prices to soar to the highest levels in a decade. These developments led import prices to grow by 8.0 per cent, whilst the volume of imports increased by 7.1 percent. Although, the terms of trade deteriorated by 3.5 per cent during 2006, it was lower than the 4.2 per cent deterioration recorded in 2005.

Direction of Trade

Western countries continued to be the major export destinations, while Asian countries were the major import suppliers. The USA remained Sri Lanka's largest export destination, although its share had declined marginally from 31 per cent in 2005 to 29 per cent in 2006. Exports to the USA increased only marginally by 0.9 per cent reflecting a slow growth of apparel exports on account of intense regional competition. The UK remained the second largest destination for Sri Lanka's exports with a share of 12.8 per cent. Exports to the UK rose significantly, capitalising on tariff concession received by Sri Lanka under the GSP+ scheme. India remained the third largest export destination. However, the share of exports to the Indian market declined to 7 per cent in 2006 from 9 per cent in 2005, mainly due to lower exports of vanaspathi. Belgium, Germany, Italy, Russia, United Arab Emirates, France and

Chart 5.5 **Direction of Trade - 2006**



Japan were the other major destinations for Sri Lanka's exports.

Asia as a region, continued to be the major origin of imports with a larger contribution from India in 2006. The market share of Asian countries remained unchanged at 60 per cent in 2006. India with a share of 21 per cent was the largest source of imports, followed by Singapore (10 per cent), China (8 per cent), Iran (7 per cent) and Hong Kong (6 per cent).

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

Trade in Transportation Services

Net earnings from transportation services, which consist of freight charges, port related activities and passenger fares, increased by 3.6 per cent to US dollars 211 million in 2006. Inflows from transportation services increased by 11.5 per cent mainly led by a substantial increase in port related activities, resulting from a higher volume of transshipment cargo handling, and increased earnings from passenger fares due to the expansion of flying destinations by the national carrier as well as the increase in flight frequency. Transshipment cargo handling grew by 37 per cent reflecting India's expanding international trade in tandem with higher economic growth. Several port development projects identified in the Government's Ten Year Horizon Development Framework 2006-2016, especially the construction of the Colombo South Harbour,

Table 5.7 **Net Services, Income and Transfers (a)**

Item	US dollars million 2005	US dollars million 2006 (b)	Rs. million 2005	Rs. million 2006 (b)
1. Transportation	204	211	20,452	21,885
2. Travel	115	37	11,553	3,836
3. Telecommnication Services	25	19	2,503	1,959
4. Computer and Information Services	82	98	8,371	10,188
5. Construction Services	24	24	2,396	2,456
6. Insurance Services	39	20	3,890	2,081
7. Other Business Services	-134	-138	-13,513	-14,297
8. Government Expenditure n.i.e.	-16	-14	-1,607	-1,448
Total Services	338	257	34,043	26,660
1. Compensation of Employees	-9	-11	-940	-1,138
2. Direct Investment	-112	-360	-11,245	-37,413
3. Interest and Other Charges	-178	-18	-17,864	-1,802
Total Income	-299	-388	-30,049	-40,353
1. Private	1,736	2,068	174,542	215,102
2. General Government	93	101	9,300	10,524
Total Current Transfers	1,828	2,169	183,842	225,626

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

Source: Central Bank of Sri Lanka

would increase future earning prospects and competitiveness of the Colombo Port. Meanwhile, outflows on account of transportation also increased at a higher rate of 14.9 per cent, in line with a higher growth in imports and an increase in Sri Lankans travelling abroad for leisure, employment, education and healthcare purposes.

Travel and Tourism

Tourist arrivals increased by 1.9 per cent to 559,603 in 2006 over the 549,308 arrivals in 2005. Reversing the set-back experienced in 2005 due to the tsunami devastation, the number of tourist arrivals recovered gradually during the first half of 2006 recording a growth of 17 per cent. However, during the latter part of the year, the situation changed gradually in the wake of the travel advisories issued

Chart 5.6 **Monthly Tourist Arrivals**

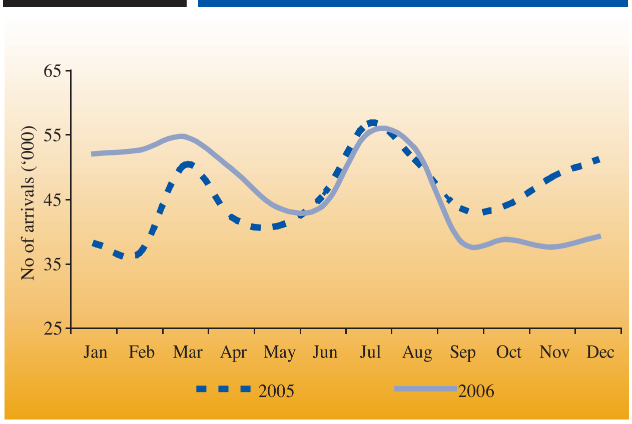


Table 5.8 **Tourism Performance**

Item	2002	2003	2004 (a)	2005 (a)	2006 (b)	Growth Rate 2005 (a)	Growth Rate 2006 (b)
Tourist arrivals	393,171	500,642	566,202	549,308	559,603	13.1	1.9
Tourist guest nights ('000)	3,989	5,093	5,742	4,754	5,793	12.7	21.9
Room occupancy rate (%)	43.1	53.2	59.3	45.4	47.8	11.5	5.3
Gross tourist receipts (Rs. million)	24,202	32,810	42,059	36,377	42,586	28.2	17.1
Per capita tourist receipts (Rs.)	61,556	65,536	74,283	66,223	76,100	13.3	14.9
Total employment (no.)	93,170	112,226	129,038	125,004	133,558	15.0	6.8
Direct	38,821	46,761	53,766	52,085	55,649	15.0	6.8
Indirect	54,349	65,465	75,272	72,919	77,909	15.0	6.8

(a) Revised
(b) Provisional

Sources: Central Bank of Sri Lanka
Sri Lanka Tourist Board

by some Western countries including Italy, Germany, France and Australia, which discouraged travel to Sri Lanka. In response the government had several meetings with the relavant ambassadors and engaged in marketing campaigns in those countries to promote Sri Lanka as a safe destination. In spite of negative travel advisories gross earnings from tourism increased at a high rate of 24.7 per cent to US dollars 410.3 million in 2006, mainly due to higher room charges and increased occupancy rates compared with those in 2005. Western Europe, accounting for a market share of 40.8 per cent continued to be the largest tourist-generating region, while South Asia remains the second largest destination with a market share of 30.2 per cent. However, as a single country, India continued to be the largest tourist generating market to Sri Lanka for the second consecutive year.

Trade in Telecommunication and Information Technology Services

Earnings from telecommunication services increased by around 55 percent to US dollars 68 million in 2006. However, the increased competition among the telecommunication companies since the liberalisation of the international telecommunication gateway in 2003, has driven down the international call charges encouraging Sri Lankans to originate international calls from Sri Lanka. As a result, outflows on account of telecommunication services continued to grow since 2003. Consequently, the net earnings from telecommunications decreased by 24.5 per cent to US dollars 19 million in 2006.

Exports of Software and Information Technology (IT) enabled services such as IT related Business Process Outsourcing (BPOs), continued to grow in 2006, supported by further improvements in IT related infrastructure facilities. Net earnings from software and IT enabled services exports increased by around 19 per cent to US dollars 98 million in 2006. Sri Lanka possesses a comparative advantage in promoting the export of such services due to higher literacy rates. Sri Lanka has the capacity to produce highly qualified accountants, engineers, lawyers, IT experts and other professionals and has a relatively better IT infrastructure. In addition, Sri Lanka has a sound legal framework for IT development and e-commerce that protects copyrights and intellectual property rights. These positive factors could be favourably used for the promotion of IT related investments in Sri Lanka.

Inflows and Outflows of Income

A significant increase in income from investment of official external reserves of the country helped to contain the widening deficit in the income account in 2006. The interest income from investment of official reserves increased by 6 per cent to US dollars 73 million in 2006, mainly due to the rising global interest rates and a further accumulation of official reserves. In addition, the depreciation of the US dollar against other major currencies in 2006, as against the appreciation in 2005, resulted in a significant gain in the values of the external reserves valued on the basis of marked to market in US dollar terms. Meanwhile, interest payments on external debt increased substantially during the year due to a higher debt accumulation in the past and expiration of the debt moratorium in 2005. Repatriation of profits and dividends by foreign investors, which includes reinvestment of retained earnings by those investors for the expansion of existing operations, also increased substantially.

Current Transfers

Inflows to the current transfers account increased by 18.6 per cent in 2006 led mainly by increased worker remittances, which grew at a higher rate for the second consecutive year, following the tsunami devastation in 2004. Worker remittances increased significantly by 21.2 per cent to US dollars 2,326 million, despite the number of migrants leaving for foreign employment declining by 14.4 per cent to 201,143 in 2006. This increase was attributable mainly to the increase in the average wages of

Box 7

Need for Enhancing Remittances from Migrant Sri Lankan Workers

Worker remittances have become a major source of foreign inflows to the country. Remittances began to grow at a higher rate during 2005 and 2006 due to high oil income in oil producing countries coupled with the impact from the aftermath of the Tsunami devastation. These increased inflows helped to finance around 70 per cent of trade deficits in 2005 and 2006 and to contain current account deficits. In view of the economic importance of worker remittances (see Box 10 in CBSL, Annual Report 2005) the Central Bank took several new initiatives during 2006 to enhance remittances further.

Measures to Enhance Worker Remittances

Several measures were initiated in 2006 jointly by the Central Bank, commercial banks, Association of Licensed Foreign Employment Agencies (ALFEA) and Sri Lanka Bureau of Foreign Employment (SLBFE) to identify problems faced by the migrant workers in remitting money and problems faced by banks in mobilising remittances. A major problem faced by migrant workers was the lack of awareness on benefits provided by commercial banks. Thus, with the Central Bank advice, SLBFE and foreign employment agencies began to educate both Sri Lankan migrants in labour hiring countries, their beneficiaries in Sri Lanka as well as would be migrants on facilities offered by commercial banks and benefits available to them. Meanwhile, recognising the economic importance of worker remittances, the government appointed a High-Level Committee to study issues and recommend appropriate policies and mechanisms to encourage migrant workers to use formal channels for remittances.

The need for various other measures was also felt strongly. These include language training, training on handling of electronic household items, diversifying employment markets, arrangements for long-term employment contracts and direct government involvement in securing foreign employment for Sri Lankans. Efforts should also be directed towards encouraging labour hiring countries in East Asia and the Middle East to increase average wages of the migrants. In addition, creating awareness on availability of duty free allowances to purchase goods from duty free shops in Sri Lanka, extension of the duration of duty free allowance were also felt necessary to enhance remittances by migrant workers. Linking incentives such as duty free allowances, housing loans and loan facilities to commence self-employment projects on return to the country, etc. to the amount remitted would further encourage remittances through the banking channels. Provision of pre-departure loan facilities to potential migrants with agreements to remit money through the particular banks would also encourage remittances through banking channels. Meanwhile, the foreign employment agencies should be incentivised by way of recognition of their contribution.

Difficulties faced by commercial banks such as visas for operating in host countries need to be resolved. This is vital since the efforts of commercial banks in channelling remittances through official means not only enhances remittances flows to the country, but also prevent those funds being utilised for illegal activities including terrorist financing. To further enhance this process, domestic banks could also use the widespread postal network and mobile telephone technology to deliver the remittances fast, while sharing their payment infrastructures for better delivery of services to the beneficiaries. Since the remittances are directly linked to income of migrant workers, there should be a gradual increase in the skill levels of migrants leaving Sri Lanka.

migrants in the oil producing Middle Eastern region, increased migration to high wage countries such as Korea, Malaysia and Singapore, etc., and the popularisation of the electronic fund transfer system by Sri Lankan banks among Sri Lankan migrants. New initiatives taken by the Central Bank with the active collaboration of state banks, Sri Lanka Bureau of Foreign Employment (SLBFE) and the Association of Licensed Foreign Employment Agencies (ALFEA) are likely to enhance worker remittances further in the future. The enhanced worker remittances financed about 69 per cent of the trade deficit in 2006.

Current Account Balance

The current account deficit widened substantially to US dollars 1,334 million in 2006 from US dollars 651 million in 2005. In terms of GDP, it increased to 4.9 per cent of GDP in 2006 from 2.8 per cent of GDP in 2005. The widening current account deficit reflects the widening savings-investment gap of the country, highlighting the need for attracting foreign capital to meet the necessary investment expenditure, which is required to achieve an economic growth rate of 7-8 per cent.

5.5 Capital and Financial Flows, and Balance of Payments

Foreign Direct Investment (FDI)

In 2006, the country received the highest-ever FDI inflows, surpassing the previous highest level recorded in 1997. The total FDI inflows reached the highest-ever level of US dollars 604 million in 2006, surpassing the previous record level of US dollars 450 million in 1997, which included privatisation proceeds of around US dollars 301 million. The increased investment flows could be attributable to the substantial increase in reinvestment of retained earnings by the existing BOI companies, especially those in the services sector, and new initiatives by the BOI to attract higher investments including the setting up of 300 factories in less developed regions under its Nipayum Centre programme. The FDI inflows consist of equity capital of US dollars 81 million, loans and advances of US dollars 75 million by the shareholders, foreign loans of US dollars 124 million and the reinvestment of retained earnings of US dollars 324 million by the existing companies. The acceleration of the basic infrastructure development in the form of roads, highways and power supply, etc., while maintaining an enabling business environment that ensure property rights, sound and fast dispute settlement and a greater labour mobility, would help achieve even higher levels of FDI. Meanwhile, FDI outflows decreased to US dollars 30 million in 2006 from US dollars 38 million in 2005 as only a few selected local companies invested abroad during the year.

Foreign Capital to the Government

The government was able to mobilise a record US dollars 1.2 billion worth of grants and loans during 2006. Of the total loan receipts in 2006, 75 per cent was received on concessional terms and the balance 25 per cent on commercial terms and conditions. The total grants,

Table 5.9 Major Projects Financed by Foreign Lending during 2006

Lender		Project	Amount Disbursed US dollars million
Asian Development Bank			174.9
	of which;	Southern Transport Development Project	23.4
		Rural Finance Sector Development Programme	19.7
		Road Sector Development Project	19.0
		Strengthening of the Fiscal Management Institutions Project	15.5
		Road Network Improvement Project	13.7
International Development Association			100.2
	of which;	Tsunami Emergency Recovery Project Phase II	24.6
		Renewable Energy for Rural Economic Development Project	19.3
		North East Housing Reconstruction Project	16.3
		Road Sector Assistance Project	13.6
Government of Japan			262.5
	of which;	Bandaranayake International Airport Development Project	44.7
		Sri Lanka Tsunami Affected Area Recovery and Take off (STAART) Project	27.3
		Southern Highway Construction Project	25.8
		Small & Micro Industries Leader & Enterpreneur Promotion (SMI LE iii)	24.7
		Small Scale Infrastructure Rehabilitation & Upgrading	22.9
		Kalu Ganga Water Supply Project for Greater Colombo	16.9
		Greater Kandy Water Supply Project	15.9
		Small Scale Infrastructure Rehabilitation & Upgrading (SIRUP ii)	15.7
Government of Federal Republic of Germany			55.2
	of which;	DFCC IV Private Sector Development	17.9
		Sapugaskanda Diesel Power Plant Project- First Extention	16.4
		NDB V Private Sector Promotion Programme	10.1
Citicorp Investment Bank(S) Limited			100.0
		Syndicated Loan	100.0
Hongkong & Shanghai Banking Corparation Limited			50.0
		Syndicated Loan	50.0

Sources: Central Bank of Sri Lanka External Resources Dept.

consisting of both the current and capital nature, increased to US dollars 287 million in 2006 from US dollars 236 million in 2005, due to more funds being received for tsunami reconstruction activities. Meanwhile, the total long-term loan inflows increased to US dollars 932 million in 2006. During 2006, the government mobilised US dollars 150 million syndicated loans from the international markets. Concessional loan inflows also increased by around 11 per cent to US dollars 703 million. The programme loan inflows increased to US dollars 52 million in 2006 and consisted of loans for the fiscal management reform programme, the rural financial sector development programme and the Sapugaskande power plant programme. However, the government was not able to utilise fully the available programme financing, as the proposed improvements in the Ceylon Electricity Board (CEB) were not implemented during the year. The disbursement of project loans increased by around 6.5 per cent to US dollars 651 million in 2006 due to the reconstruction of infrastructure damaged by the tsunami and the implementation of several other infrastructure projects. The foreign aid utilization rate increased in 2006 to 21.2 per cent from the 17.0 per cent recorded in 2005[1]. Meanwhile, loan repayments by the government increased significantly by 127.4 per cent to US dollars 441 million, with the recommencement of debt repayment in 2006 with the end of the debt moratorium in 2005 and the increase in defence loan repayments.

External and domestic commercial foreign currency borrowings increased significantly in 2006. Although, these foreign currency commercial loans have been relatively cheaper compared to rupee borrowings, the sharp rise in commercial debt stock would increase the debt stock's exposure to exchange rate risks. Since all these foreign currency loans were on commercial rates with relatively shorter maturities compared with concessional external loans, it is prudent that these funds are invested in highly productive projects so that servicing these commercial debts would not threaten government's fiscal and debt sustainability. In this context, the government should actively consider promoting Public- Private Partnerships (PPPs) as a viable alternative financing mechanism for developing much needed major infrastructure facilities. Several developed and developing countries have increasingly formed PPPs in infrastructure development, as a mechanism for financing of long-term infrastructure development, diversifying risks associated with long-term projects and to harness the efficiency and managerial capability of the private sector. It is also important to be mindful of the hidden cost of some export credit facilities offered by the bilateral lenders, as the actual costs of such loan facilities are much higher than the apparent low rates of interest offered by them. This is because, very often, under such facilities, a major portion of loan proceeds are to be utilised to procure goods and services from specified organisation or lending countries, which prevents the borrowing country from reaping benefits through a competitive international bidding process. In some cases, these facilities also carry hidden charges in the form of unnecessary technical assistance programmes, insurance premia, management fees and other charges.

Loan Capital to the Private Sector

Long-term loan inflows to the private sector and public corporations decreased in 2006. Availability of credit at relatively low interest rates in the domestic market and higher international market rates may have discouraged foreign borrowings by the private sector during the first half of 2006. Restraints by the government in guaranteeing foreign loans to public corporations and private sector institutions may also have contributed to this low level of disbursements. Further, it is reported that some investors may not be making medium and long-term investments due to concerns arising out of prevailing security situation and have adopted a 'wait and see' attitude, which may have, to some extent, reduced the demand for foreign financing in 2006. At the same time, there are many investors who have realised that, currently, most assets in the country are available at a discounted price due to the prevailing security situation, and that such assets are likely to command higher prices in the future with the expected rapid improvement in infrastructure facilities and upgrading of existing assets. In that background, several investors believe that they could make use of the current situation to expand their investment now to generate substantial gains in the future.

Short-Term Capital

Total net short-term private capital inflows reached US dollars 610 million in 2006, compared to US dollars 176 million recorded in 2005 due to a substantial increase in investment in Sri Lanka Development Bonds (SLDBs) and in domestic foreign currency lending by commercial banks. Both inflows and outflows on account

Table 5.10 External Assets of Sri Lanka (a)

Ownership	US dollars million (b)					Rs. million				
	2002	2003	2004	2005	2006	2002	2003	2004	2005	2006
1. Government	46	55	95	131	128	4,424	5,320	9,897	13,417	13,789
2. Government Agencies	-	-	-	-	-	-	-	-	-	-
3. Central Bank	1,654	2,274	2,101	2,604	2,709	160,018	219,984	219,795	265,873	291,747
4. Total Official Assets	1,700	2,329	2,196	2,735	2,837	164,442	225,304	229,693	279,290	305,536
5. Commercial Banks	795	889	1,243	1,466	1,169	76,921	86,011	129,987	149,656	125,867
6. Total External Assets	2,495	3,218	3,438	4,201	4,005	241,364	311,315	359,680	428,946	431,403
7 Gross Official Assets in Months of										
7.1 Merchandise Imports	3.3	4.2	3.3	3.7	3.3					
7 2 Import of Goods and Services	2.9	3.6	2.9	3.3	2.9					
8 Total Assets in Months of										
8.1 Merchandise Imports	4.9	5.8	5.2	5.7	4.7					
8 2 Import of Goods and Services	4.2	5.0	4.5	5.0	4.1					

(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	2002	2003	2004	2005	2006
Rs. per US dollar	96.75	96.74	104.61	102.12	107.71

Source: Central Bank of Sri Lanka

of portfolio investments increased during the year, resulting in low net inflows of US dollars 51 million in 2006. The Colombo Stock Exchange (CSE) continues to remain one of the best performing share markets in Asia attracting a gross inflow of US dollars 355 million in 2006, compared to US dollars 276 million in 2005. Net foreign assets of commercial banks decreased significantly in 2006 due to the combined effect of increased foreign currency lending to the government and higher foreign currency liabilities due to new foreign loans raised by commercial banks.

Balance of Payments and External Reserves

As net inflows to the capital and financial account were more than sufficient to offset the widened current account deficit, the BOP recorded a surplus of US dollars 204 million in 2006.

External Reserves

The BOP surplus strengthened the gross official reserves for the second consecutive year. The gross official reserves, excluding ACU receipts, increased, in spite

Table 5.11 **Outstanding External Debt and Banking Sector External Liabiliites**

Item	US dollars million					Rs. million				
	2002	2003	2004	2005	2006 (a)	2002	2003	2004	2005	2006 (a)
1. Medium and Long-term Debt	8,732	10,116	10,699	10,690	11,601	844,709	978,556	1,119,155	1,091,644	1,249,518
1.1 Government	7,464	8,812	9,523	9,354	10,502	721,956	852,433	996,203	955,207	1,131,074
1.2 Public Corporations and Private Sector with Government Guarantee	689	602	507	567	461	66,663	58,251	52,986	57,912	49,662
1.3 Public Corporations and Private Sector without Government Guarantee	293	334	411	388	394	28,303	32,319	42,944	39,588	42,465
1.4 IMF Drawings	287	368	258	381	244	27,787	35,552	27,023	38,937	26,316
2. Short-term Debt	601	620	647	664	634	58,116	59,935	67,726	67,759	68,286
2.1 Government	-	-	-	-	-	-	-	-	-	-
2.2 Other(CPC and other trade credit) (b)	601	620	647	664	634	58,116	59,935	67,726	67,759	68,286
3. Banking Sector External Liabilities (c)	1,001	1,046	1,429	1,666	1,994	96,807	101,149	149,492	170,170	214,802
3.1 Central Bank	1	-	1	1	3	123	32	128	131	284
3.2 Commercial Bank	865	863	1,066	1,388	1,681	83,655	83,514	111,464	141,753	181,040
3.3 ACU Liabilities	135	182	362	277	311	13,029	17,604	37,899	28,286	33,478
4. Total External Debt (1+2)	9,333	10,735	11,346	11,354	12,235	902,825	1,038,491	1,186,881	1,159,403	1,317,804
5. Total External Debt and Liabilities (1+2+3)	10,334	11,781	12,775	13,020	14,230	999,632	1,139,640	1,336,373	1,329,573	1,532,605
MEMORANDUM ITEMS										
Medium and Long-term Debt										
(1) Project Loans	4,358	6,961	7,702	7,416	8,071	421,637	673,432	805,646	757,262	869,336
(2) Non-Project Loans	3,048	1,726	1,763	1,655	1,855	294,880	167,007	184,467	169,038	199,770
(3) Suppliers' Credits	100	218	240	283	459	9,718	21,048	25,123	28,907	49,458
(4) IMF Drawings	287	368	258	381	244	27,787	35,552	27,023	38,937	26,316
(5) Other Loans (d)	939	843	735	955	972	90,686	81,516	76,896	97,500	104,638
Short-term Debt and Banking Sector Liabilities	1,602	1,665	2,077	2,330	2,628	154,923	161,084	217,217	237,929	283,088
As a percentage of GDP										
Total External Debt	56.3	58.9	56.6	48.2	45.4	57.0	59.0	58.5	49.0	47.0
Total Banking Sector External Liabilities	6.0	5.7	7.1	7.1	7.4	6.1	5.7	7.4	7.2	7.7
Total External Debt and Liabilities	62.4	64.6	63.7	55.3	52.8	63.1	64.7	65.9	56.2	54.7
Short-term Debt	3.6	3.4	3.2	2.8	2.4	3.7	3.4	3.3	2.9	2.4
Short-term Debt and Banking Sector External Liabilities	9.7	9.1	10.4	9.9	9.7	9.8	9.2	10.7	10.1	10.1
As a percentage of Total Debt and Liabilities										
Short-term Debt	5.8	5.3	5.1	5.1	4.5	5.8	5.3	5.1	5.1	4 .5
Short-term liabilities	9.7	8.9	11.2	12.8	14.0	9.7	8.9	11.2	12.8	14.0
Short-term Debt as a percentage of Official Reserves	35.3	26.6	29.5	24.3	22.4	35.3	26.6	29.5	24.3	24 .4

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

Sources: Central Bank of Sri Lanka
External Resources Dept.

of a higher debt repayment to the IMF. However, in terms of import coverage, reserves declined to 3 months of imports in 2006 from 3.3 months of imports in 2005, mainly due to the higher oil imports expenditure in 2006. Meanwhile, the reserve adequacy, as measured by the ratio of gross official reserves to short term debt and liabilities, improved to 92 per cent in 2006 from 84 per cent in 2005. Notwithstanding such improvement, the total external reserves of the country, excluding ACU receipts, decreased, mainly due to the utilisation of commercial banks' foreign assets to meet the excess demand for import financing.

5.6 External Debt and Debt Service

External Debt

The total external debt of the country, as a percentage of GDP, continued to decline in 2006, reflecting further improvements in the country's debt sustainability, primarily due to a higher output growth. Accordingly, as a percentage of GDP, the total external debt decreased to 45.4 per cent in 2006 from 48.2 per cent in 2005. In US dollar terms, the total external debt increased by around 7.8 per cent to US dollars 12,235 million in 2006, owing to increased loan disbursements to the government and weakening of the US dollar against major currencies. Of the total outstanding external debt, around 42 per cent of the loans were denominated in SDR and around 30 per cent in Japanese yen. Meanwhile, the total external debt and liabilities, which consist of ACU liabilities and commercial banks' liabilities, also decreased to 52.8 per cent of GDP. The banking sector's external liabilities increased significantly by around 20 per cent to US dollars 1,994 million by end 2006 as some commercial banks raised foreign loans.

Of the total medium and long-term debt, the government debt accounts for as much as 90 per cent, with the remaining 10 per cent representing borrowings of both, the private and public corporations and debt obligations

Table 5.12 External Debt Service Payments

Item	US dollars million					Rs. million				
	2002	2003	2004	2005	2006 (a)	2002	2003	2004	2005	2006 (a)
1. Debt Service Payments	788	761	843	623	1,079	74,704	73,125	85,318	62,577	112,599
1.1 Amortization	572	526	594	419	759	54,006	50,502	59,990	42,075	79,227
(i) To IMF	56	32	107	39	144	4,647	2,869	10,718	3,902	15,276
(ii) To Others	516	493	487	380	615	49,359	47,632	49,272	38,173	63,951
1.2 Interest Payments	216	235	249	204	321	20,698	22,623	25,328	20,502	33,372
(i) To IMF	4	4	10	10	14	398	414	988	973	1,452
(ii) To Others	212	230	240	194	307	20,300	22,209	24,340	19,530	31,920
2. Earnings From Merchandise Exports and Services	5,967	6,544	7,284	7,887	8,508	571,195	631,549	738,714	793,153	885,380
3. Receipts From Merchandise Exports, Services, Income and Private Transfers	7,330	8,127	9,004	9,891	11,144	701,579	784,408	912,817	994,751	1,159,756
4. Debt Service Ratio (b)										
4.1 As a percentage of 2 above										
(i) Overall Ratio	13.2	11.6	11.6	7.9	12.7	13.1	11.6	11.5	7.9	12.7
(ii) Excluding IMF Transactions	12.2	11.1	10.0	7.3	10.8	12.2	11.1	10.0	7.3	10.8
4.2 As a percentage of 3 above										
(i) Overall Ratio	10.8	9.4	9.4	6.3	9.7	10.6	9.3	9.3	6.3	9.7
(ii) Excluding IMF Transactions	9.9	8.9	8.1	5.8	8.3	9.9	8.9	8.1	5.8	8.3
5. Government Debt Service Payments										
5.1 Government Debt Service Payments (c)	522	502	484	268	610	49,928	48,452	48,952	26,927	63,369
5.2 As a percentage of 1 above	66.2	66.0	57.4	43.0	56.5	66.8	66.3	57.4	43.0	56.3

(a) Provisional
(b) Debt service ratios calculated in rupee values and US dollar values differ due to variations in exchange rates during the year.
(c) Excludes IMF transactions

Source: Central Bank of Sri Lanka

to the IMF. This reflects the government's continuous dominance in attracting foreign loan capital into the country and the limitations of the private sector in raising external debt. The financially sound private sector enterprises need to be encouraged to raise medium and long-term external capital for their investments. This would release domestic financial resources to private sector enterprises that are not capable of raising external debt. Of the government's external debt stock, concessional debt accounts for 96 per cent.

External Debt Service Payments

Debt service ratios reverted to pre-tsunami levels following the one-off reduction in debt servicing in 2005 due to the benefits of the debt moratorium. The total debt service payments, which consist of both amortisation and interest payments on all foreign debt, increased significantly by around 73.2 per cent to US dollars 1,079 million in 2006. The expiration of the debt moratorium offered by members of the Paris Club, G-8 countries and multilateral lending institutions in 2005 and the resumption of scheduled debt repayments in 2006, the increase in defence loan repayments, increased debt servicing costs of government's commercial borrowings, and the depreciation of the US dollar against the SDR had contributed to the increase in Sri Lanka's external debt service payments in US dollar terms, during 2006. However, debt service ratios, which measure the country's capacity to service its external debt still remains at comfortable levels despite a relatively high external debt stock, mainly due to the large stock of concessional debt with long repayment periods.

5.7 Exchange Rate Regime and Exchange Rate Movements

Sri Lanka continued to follow an independently floating exchange rate regime during 2006, allowing market forces to determine the exchange rate with limited intervention by the Central Bank to mitigate excessive volatility in the market. This regime has served well for Sri Lanka since its adoption in 2001. The rupee, which appreciated during 2005 against major international currencies in the wake of the massive aid pledges by the international donors and the higher tsunami related foreign inflows, reverted to its usual depreciating trend during 2006. The rupee depreciated at a moderate rate against the US dollar (5.2 per cent), Japanese yen (4.3 per cent) and Indian rupee, (7.2 per cent), while it depreciated at a higher rate against the sterling pound (16.7 per cent) and euro (14.6 per cent), mainly due to the weakening of the US dollar against these currencies during 2006.

A larger current account deficit, caused by substantially higher imports and the relatively higher domestic inflation that prevailed in Sri Lanka compared to those of its trading partners and competitor countries, exerted pressure on the exchange rate to depreciate. However, increased worker remittances, unprecedented FDI inflows and higher foreign inflows to the government, including commercial borrowings, resulted in an overall balance of payments surplus in 2006 and improved market confidence, thus negating the tendency for excessive depreciation of the rupee towards the end of 2006.

Nominal and Real Effective Exchange Rates

During 2006, the Nominal Effective Exchange Rate depreciated, reversing the appreciating trend seen in 2005, while the Real Effective Exchange Rate continued with the same trend. Reflecting the higher nominal depreciation of the Sri Lanka rupee against the major currencies, the nominal effective exchange rate (NEER) of the Sri Lanka rupee, based on both, the 5 currency and the 24 currency baskets, depreciated during 2006. Meanwhile, the real effective exchange rate (REER), which takes into account the inflation differentials amongst countries in addition to the variations in exchange rates, appreciated during 2006, indicating a deterioration in the competitiveness of Sri Lanka's exports. This could be attributed to the

Chart 5.10 Exchange Rate Movements

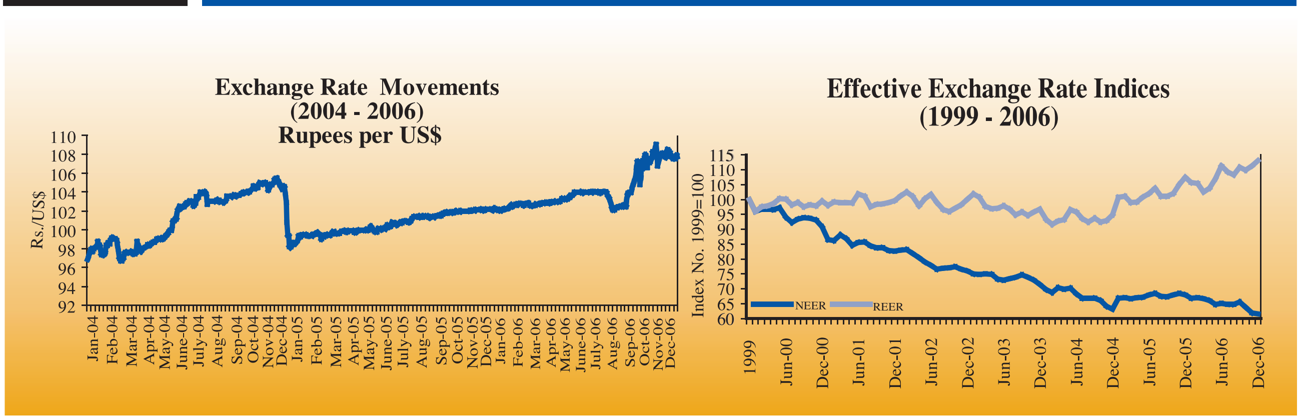


Table 5.13 Exchange Rate Movements

Currency	In Rupees per unit of Foreign Currency: End of Year Rates 2004	2005	2006	Annual Average 2004	2005	2006	Percentage Change Over Previous Year (a): Point to Point 2005	2006	Annual Average 2005	2006
Euro	142.32	120.96	141.58	125.79	125.10	130.63	17.66	-14.56	0.55	-4.24
Indian Rupee	2.40	2.27	2.44	2.23	2.28	2.30	5.67	-7.19	-2.22	-0.86
Japanese Yen	1.02	0.87	0.91	0.94	0.91	0.89	17.53	-4.30	2.33	2.26
Pound Sterling	201.37	175.94	211.29	185.35	182.87	191.53	14.45	-16.73	1.35	-4.52
US Dollar	104.60	102.12	107.71	101.19	100.50	103.96	2.43	-5.19	0.69	-3.33
SDR	161.60	145.95	162.03	149.88	148.45	153.00	10.72	-9.92	0.96	-2.97
Effective Exchange Rate Indices (b)	**Monthly Index: Dec. 2004**	**Dec.2005**	**Dec.2006**	**Annual Average: 2004**	**2005**	**2006**	**Percentage Change Over Previous Year (a): Point to Point 2005**	**2006**	**Annual Average 2005**	**2006**
NEER (1999=100)	63.18	68.07	61.61	67.63	67.55	64.93	7.74	-9.49	-0.12	-3.88
REER (1999=100)	94.93	107.41	112.87	93.61	101.96	108.19	13.15	5.08	8.92	6.11

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

Source: Central Bank of Sri Lanka

(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 each of the currency baskets. The REER is computed by adjusting the NEER for inflation differentials with the countries whose currencies are included in each basket. A minus sign indicates depreciation.

relatively higher domestic inflation compared to those of the trading partner and competitor countries.

Developments in the Domestic Foreign Exchange Market

The level of activity in the inter-bank foreign exchange market increased substantially during 2006 reflecting higher international trade and remittances flows. Several measures introduced by the Central Bank in consultation with the players in the foreign exchange market also contributed for further expansion in the foreign exchange market. During the year, the Central Bank permitted commercial banks to offer rupee based cross currency options to domestic corporate clients to expand the activities in the foreign exchange market. The customer market, which consists of foreign exchange sales and purchases to and from customers by commercial banks, also recorded an increase in the level of activity. The total volume of transactions in the customer market recorded the highest level since the floating of the rupee and reflected an 11 per cent increase over 2005. However, forward transactions in the customer market still remain negligible, which indicates the need for more public awareness on the use of available instruments to hedge the exchange rate risk.

The Central Bank took the initiative to facilitate the CPC entering into hedging arrangements for oil imports to mitigate the impact of rising oil prices on the BOP and to reduce volatility in the foreign exchange market. As the oil prices reached a record high level in 2006, expenditure on oil imports increased by US dollars 415 million to US dollars 2,070 million. This created excessive volatility in the market, whilst increasing the trade deficit. Had the CPC entered into a hedging mechanisms prior to 2006 the country could have saved substantial foreign exchange reducing the trade deficit and excessive volatility in the foreign exchange market. Hence, the Central Bank decided to encourage CPC to enter into hedging arrangements as soon as possible, and the CPC has now done so in early 2007. The introduction of hedging instruments would also further develop the domestic foreign exchange market.

As in the past, the Central Bank intervened in the foreign exchange market throughout 2006, to smoothen out the excess volatility in the foreign exchange market and to build up its foreign reserves. It absorbed a total of US dollars 307 million from the inter-bank market and supplied US dollars 791 million during 2006, resulting in a net supply of US dollars 484 million during 2006, which is lower than the net supply of US dollars 515 million in 2004. Net supply was at a low level in 2005 due to large tsunami related inflows received in 2005 When the oil prices were unusually high, the Central Bank had to supply foreign exchange to the market to ensure stability in the domestic foreign exchange market, particularly during the second and third quarters of 2006.

Chart 5.11 Inter- Bank Forward Transactions (2003- 2006)