5

EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

5.1 Overview

Sri Lanka's external sector experienced heightened vulnerabilities in 2021 amidst persistently high debt service obligations and a weakened balance of payments (BOP) position along with lacklustre performance in the domestic foreign exchange market with continuous pressure on the external value of the currency. Although a rebound and a steady growth were observed in exports, a much higher import expenditure resulted in the trade deficit widening notably, weighing negatively on the external current account. The expansion in the trade deficit was driven by the significant increase in imports, even in the presence of selected import restrictions, which outpaced the growth of exports. The widening of the trade deficit was more pronounced in the latter part of 2021 and in early 2022 due to the combined effect of a sharp revival in imports due to the normalisation of economic activities as well as higher energy prices. The performance of the services sector remained subdued in both 2020 and 2021 despite the healthy growth in the computer services subsector, while the tourism sector only picked up towards the latter part of 2021. The deficit in the primary income account reduced marginally in 2021 compared to the previous year as interest and dividend payments were low during 2021. A slowdown in workers' remittances was observed during the second half of the year, resulting in a notable decline in the surplus of the secondary income account. Consequently, the current account deficit widened significantly to 4.0 per cent of the Gross Domestic Product (GDP) in 2021, compared to 1.5 per cent of GDP registered in 2020. The financial account also recorded a subdued performance as foreign investments in the form of foreign direct investment (FDI) remained subdued, while portfolio investments in the stock exchange and the government securities market also continued to witness net outflows. Adding pressure on external accounts, foreign inflows to the Government were limited to foreign project loans and grants as well as two foreign currency term financing facilities. The Central Bank received foreign exchange flows on account of the new Special Drawing Rights (SDR) allocation from the International Monetary Fund (IMF) and international swap arrangements with the

Bangladesh Bank and the People's Bank of China (PBOC) in 2021 and Reserve Bank of India (RBI) in early 2022. In view of mounting imbalances in the external sector due to lack of foreign exchange inflows, several measures were taken to improve foreign currency liquidity in the domestic foreign exchange market and to replenish international reserves. The Central Bank imposed mandatory conversion requirements on export proceeds and directed banks to sell a part of the converted export proceeds and workers' remittances to the Central Bank. The Central Bank and the Government also implemented several measures to induce workers' remittances during the year. At the same time, taking into consideration the dearth of foreign exchange liquidity in the market, the Central Bank provided financing support for the importation of essential goods, mainly fuel, LP gas and coal, as a national priority in 2021 and 2022. Although the exchange rate was broadly maintained at a stable level during 2021 and in early 2022 to support the recovery process of the economy, considering the emerging difficulties in the external front, the Central Bank allowed a measured adjustment in the exchange rate since early March 2022. However, the notable pressures witnessed in the domestic foreign exchange market caused a large overshooting. Consequently, the Sri Lanka rupee which depreciated by 7.0 per cent in 2021, depreciated significantly by 33.0 per cent by end March 2022. Having identified the need for implementing urgent measures to address the current external sector crisis, and to complement them with broader economic reforms aimed at resolving persistent and long standing issues in the economy, the Government and the Central Bank initiated further measures in early 2022, including the initiation of engagements with the IMF and to manage the country's external debt in a sustainable manner.

Table 5.1
Balance of Payments Analytical Presentation

Item	US$ million		Rs. million	
	2020 (a)	2021 (b)	2020 (a)	2021 (b)
Current Account (net)	-1,187	-3,343	-238,248	-672,960
Trade Balance	-6,008	-8,139	-1,115,988	-1,617,274
Exports	10,047	12,499	1,858,927	2,486,943
Imports	16,055	20,637	2,974,915	4,104,218
Services (net)	819	1,586	150,014	316,225
Receipts	3,035	2,475	559,615	493,320
Payments	2,216	889	409,601	177,095
Primary Income (net)	-2,205	-2,018	-423,063	-406,605
Receipts	198	116	36,766	22,769
Payments	2,404	2,134	459,829	429,374
Secondary Income (net)	6,207	5,228	1,150,789	1,034,694
Secondary Income: Credit	7,117	5,498	1,319,377	1,088,388
Workers' Remittances	7,104	5,491	1,317,007	1,087,188
Government Transfers	13	6	2,371	1,200
Secondary Income: Debit	910	270	168,589	53,694
Capital Account (net)	28	25	5,193	5,009
Capital Account: Credit	51	50	9,472	9,850
Capital Account: Debit	23	24	4,279	4,841
Current and Capital Account (net)	-1,159	-3,318	-233,056	-667,951
Financial Account (net)	-394	-4,029	-77,578	-962,044
Direct Investment: Assets	15	17	2,699	3,468
Direct Investment: Liabilities	434	598	80,592	118,973
Portfolio Investment: Assets	-	-	-	-
Portfolio Investment: Liabilities	-2,383	-906	-441,922	-181,568
Equity	-217	-236	-40,223	-46,914
Debt Securities	-2,166	-670	-401,700	-134,654
Financial Derivatives	-	-	-	-
Other Investment: Assets	-136	387	-27,446	77,454
Currency and Deposits	64	306	11,666	62,761
Trade Credit and Advances	-224	257	-41,647	51,199
Other Accounts Receivable	24	-176	2,535	-36,506
Other Investment: Liabilities	231	2,216	38,567	605,734
Currency and Deposits	-15	4,016	-3,519	810,195
Loans	174	-1,552	29,568	-309,188
Central Bank	-14	-57	-2,689	-11,377
Deposit-taking Corporations	75	-2,152	10,390	-429,506
General Government	169	664	31,961	132,662
Other Sectors	-56	-7	-10,093	-968
Trade Credit and Advances	185	-428	32,565	-87,756
Other Accounts Payable	-114	180	-20,046	34,713
Special Drawing Rights (SDRs)	-	787	-	157,771
Reserve Assets	-1,992	-2,526	-375,594	-499,826
Monetary Gold	-667	-212	-123,485	-42,734
Special Drawing Rights	-5	123	-825	24,635
Reserve Position in the IMF	-	-	-	-
Other Reserve Assets	-1,319	-2,437	-251,284	-481,726
Currency and Deposits	-177	1,536	-37,326	300,122
Securities	-1,143	-3,976	-214,172	-782,339
Net Errors and Omissions	765	-711	155,478	-294,093
Overall Balance (c)	-2,328	-3,967	-405,854	-745,312
As a Percentage of GDP				
Trade Balance	-7.4	-9.6		
Goods and Services	-6.4	-7.8		
Current Account	-1.5	-4.0		
Current and Capital Account	-1.4	-3.9		

(a) Revised
(b) Provisional
(c) Refer Table 5.12 for the derivation of overall balance

Source: Central Bank of Sri Lanka

Figure 5.1
Performance of the External Sector

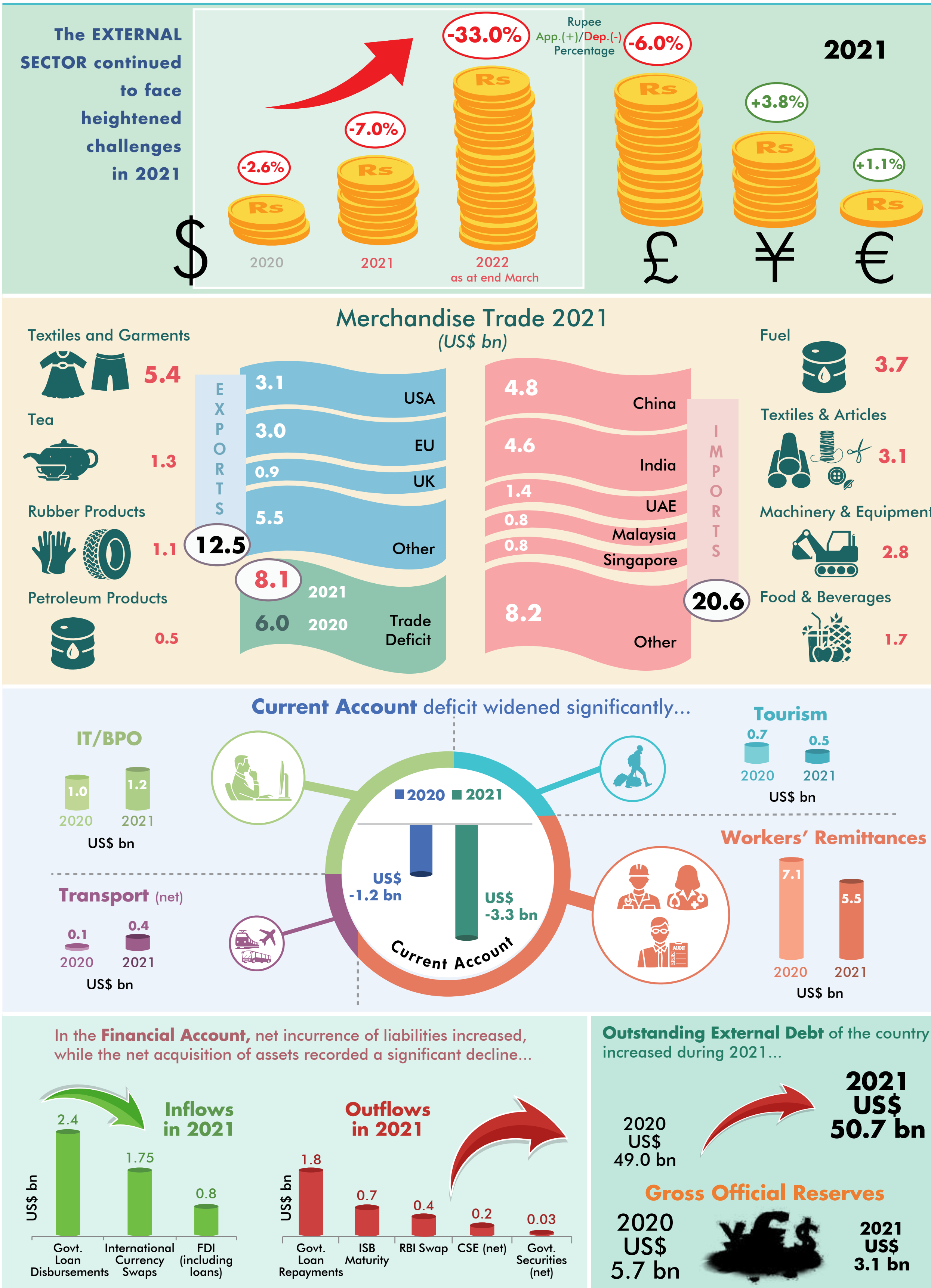

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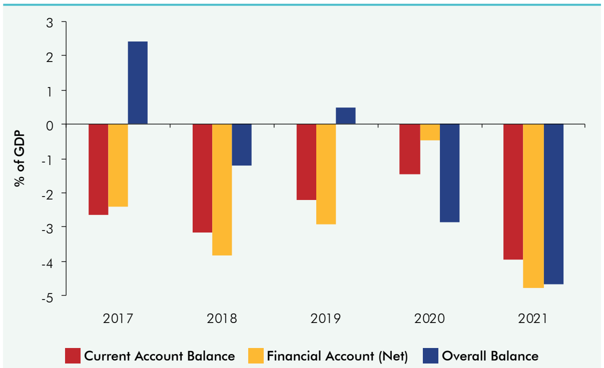
Figure 5.2
Balance of Payments



Source: Central Bank of Sri Lanka

5.2 Current Account Balance

Despite the increase in the services account balance and the decline in the primary income account deficit, the external current account deficit widened significantly in 2021 as a result of the widened trade deficit and the decline in the surplus in the secondary income account. Higher import expenditure compared to export earnings resulted in a widened trade deficit of around US dollars 8.1 billion in 2021 as opposed to the relatively lower trade deficit of US dollars 6.0 billion recorded in 2020. The surplus in the services account increased due to higher inflows observed on account of information technology led business process outsourcing (IT/BPO) related services and improvements in the transport sector. The tourism sector also showed signs of revival during the latter part of the year. The deficit in the primary income account contracted with the decline in dividend payments of Direct Investment Enterprises (DIEs) and coupon payments on account of government securities held by foreign investors despite the increase recorded in reinvested earnings of DIEs. In comparison to 2020, workers' remittances contracted notably during 2021, particularly during the latter half of the year, possibly due to a notable difference in exchange rate in the grey market compared to the official rate that prevailed at that time. As a result, the current account deficit widened to US dollars 3.3 billion in 2021, compared to US dollars 1.2 billion recorded in 2020. Reflecting the expansion in the current account deficit and a moderate expansion in the output, the current account deficit as a percentage of GDP stood at 4.0 per cent in 2021, compared to 1.5 per cent in 2020.

Table 5.2
Current and Capital Account

US$ million

Item	2020 (a)			2021 (b)		
	Credit	Debit	Net	Credit	Debit	Net
Goods and Services	13,083	18,271	-5,189	14,974	21,526	-6,552
Goods	10,047	16,055	-6,008	12,499	20,637	-8,139
General Merchandise	10,047	16,047	-5,999	12,499	20,636	-8,138
Non-monetary Gold	-	9	-9	-	1	-1
Services	3,035	2,216	819	2,475	889	1,586
Transport	1,174	1,059	114	608	256	352
Sea Transport	702	635	67	450	150	300
Freight	702	635	67	450	150	300
Air Transport	472	424	48	158	106	52
Passenger	394	354	40	108	89	19
Freight	78	71	7	50	17	33
Travel (c)	682	449	234	507	239	268
Construction	7	10	-3	10	11	-1
Insurance and Pension Services	39	82	-42	20	37	-17
Financial Services	96	220	-125	95	102	-7
Telecommunications and Computer Services	995	288	706	1,201	171	1,030
Telecommunications	24	32	-8	32	31	2
Computer Services	971	257	714	1,168	140	1,028
Other Business Services	16	37	-21	16	17	-1
Government Goods and Services n.i.e.	26	70	-44	19	57	-38
Primary Income	198	2,404	-2,205	116	2,134	-2,018
Compensation of Employees	36	132	-96	30	74	-43
Investment Income	162	2,271	-2,110	86	2,060	-1,975
Direct Investment	17	636	-619	16	647	-631
Dividends	14	445	-431	12	357	-345
Reinvested Earnings	3	191	-188	4	290	-286
Portfolio Investment	-	943	-943	-	818	-818
Equity	-	35	-35	-	26	-26
Interest	-	908	-908	-	793	-793
Short Term	-	2	-2	-	...	...
Long Term	-	905	-905	-	793	-793
Other Investment	56	693	-637	43	595	-552
Reserve Assets	89	-	89	27	-	27
Secondary Income	7,117	910	6,207	5,498	270	5,228
General Government	13	-	13	6	-	6
Workers' Remittances	7,104	910	6,194	5,491	270	5,221
Current Account	20,398	21,585	-1,187	20,587	23,930	-3,343
Capital Account	51	23	28	50	24	25
Capital Transfers	51	23	28	50	24	25
General Government	24	-	24	11	-	11
Corporations and Households	27	23	4	38	24	14
Current and Capital Account	20,449	21,608	-1,159	20,637	23,955	-3,318

(a) Revised
(b) Provisional
(c) Passenger services provided to non-residents are included in transport services.

Source: Central Bank of Sri Lanka

5.2.1 Merchandise Trade Account

Trade Balance

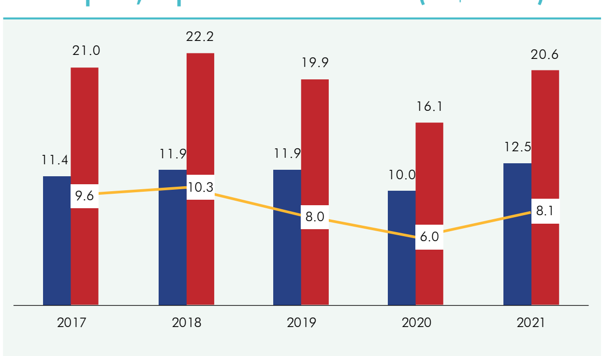
The deficit in the trade account that contracted during the last two years, widened notably in 2021 as the steady increase in exports was outpaced by the sharp increase in imports. The deficit in the trade account widened to US dollars 8,139 million in 2021 from US dollars 6,008 million in 2020. Contributing to the expansion in the trade deficit, imports increased notably, primarily driven by higher commodity prices, including prices of fuel, increased demand for imported items due to normalisation of economic activity, higher import expenditure on account of medical and pharmaceutical items such as vaccines, and the relaxation of some of the restrictions on importation of non-essential goods. As a percentage of GDP, the trade deficit widened to 9.6 per cent in 2021, compared to 7.4 per cent in 2020.

Export and Import Performance, Terms of Trade and Direction of Trade

Export Performance

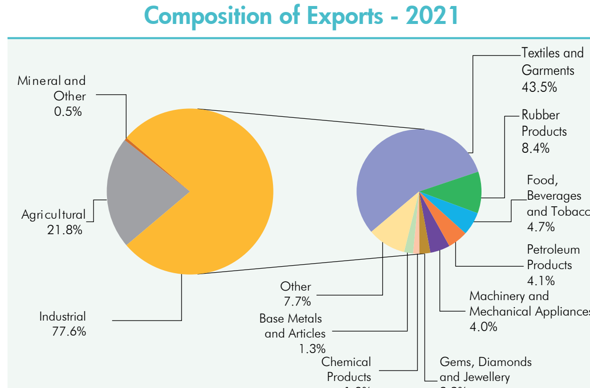
Earnings from merchandise exports reached US dollars 12,499 million in 2021, recording the highest level of export earnings for a year, exceeding the previously highest export earnings of US dollars 11,940 million that was recorded in 2019. Accordingly, export earnings grew by 24.4 per cent compared to US dollars 10,047 million recorded during 2020. Indicating the strong export performance, earnings from exports continued to exceed US dollars 1.0 billion consecutively every month from June 2021. Further, the highest ever monthly export value of US dollars 1,211 million was recorded in November 2021. The increase in export earnings during 2021 resulted from the broad-based increase in earnings from most export categories. Special policy attention received from the Government, the Central Bank, and other relevant authorities, particularly through the setting up of new follow up mechanisms and granting incentives towards export-oriented industries and industries affected by the pandemic, recovery of domestic production due to the rapid vaccination rollout, and the gradual revival of both demand and supply market chains with the normalisation of global markets were the main drivers of higher export earnings. As evident from the movements in the export volume and unit value indices, the increase in export volumes significantly contributed to the increase in export earnings. As a percentage of GDP, export earnings increased to 14.8 per cent in 2021 from 12.4 per cent recorded in 2020.

Figure 5.3
Exports, Imports and Trade Deficit (US$ billion)



Sources: Sri Lanka Customs
Central Bank of Sri Lanka

Figure 5.4
Composition of Exports - 2021



Sources: Sri Lanka Customs
Central Bank of Sri Lanka

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Table 5.3
Composition of Exports

Category	2020		2021 (a)		Change in Value US$ million	Y-o-Y Change %	Contribution to Change %
	Value US$ million	Share %	Value US$ million	Share %			
Agricultural Exports	**2,336.2**	**23.3**	**2,729.5**	**21.8**	**393.3**	**16.8**	**16.0**
Tea	1,240.9	12.4	1,324.4	10.6	83.4	6.7	3.4
Spices	333.5	3.3	454.8	3.6	121.3	36.4	4.9
Coconut	345.2	3.4	425.2	3.4	80.1	23.2	3.3
Seafood	189.8	1.9	274.1	2.2	84.3	44.4	3.4
Minor Agricultural Products	134.7	1.3	148.8	1.2	14.1	10.5	0.6
Rubber	30.1	0.3	42.2	0.3	12.1	40.1	0.5
Unmanufactured Tobacco	25.5	0.3	31.6	0.3	6.1	23.9	0.2
Vegetables	36.6	0.4	28.5	0.2	-8.0	-22.0	-0.3
Industrial Exports	**7,672.0**	**76.4**	**9,702.0**	**77.6**	**2,030.0**	**26.5**	**82.8**
Textiles and Garments	4,423.1	44.0	5,435.1	43.5	1,012.1	22.9	41.3
Rubber Products	786.1	7.8	1,050.4	8.4	264.4	33.6	10.8
Food, Beverages and Tobacco	464.0	4.6	586.9	4.7	122.8	26.5	5.0
Petroleum Products	373.6	3.7	506.4	4.1	132.8	35.6	5.4
Machinery and Mechanical Appliances	337.5	3.4	500.9	4.0	163.4	48.4	6.7
Gems, Diamonds and Jewellery	181.5	1.8	276.7	2.2	95.2	52.5	3.9
Chemical Products	172.7	1.7	223.2	1.8	50.5	29.2	2.1
Base Metals and Articles	110.9	1.1	156.4	1.3	45.5	41.1	1.9
Animal Fodder	102.9	1.0	149.4	1.2	46.5	45.2	1.9
Transport Equipment	71.4	0.7	148.2	1.2	76.8	107.5	3.1
Other Industrial Exports	648.4	6.5	668.5	5.3	20.1	3.1	0.8
Mineral Exports	**25.1**	**0.2**	**44.5**	**0.4**	**19.4**	**77.3**	**0.8**
Unclassified Exports	**14.1**	**0.1**	**22.6**	**0.2**	**8.5**	**60.1**	**0.3**
Total Exports (b) (c)	**10,047.4**	**100.0**	**12,498.6**	**100.0**	**2,451.2**	**24.4**	**100.0**
Annual Average Exchange Rate (d)	**185.52**		**198.88**				

(a) Provisional
(b) Excludes re-exports
(c) Adjusted for lags and other factors of recording
(d) Rupee/US dollar exchange rate

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

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Earnings from industrial exports increased by 26.5 per cent to US dollars 9,702 million in 2021 compared to 2020, accounting approximately 78 per cent of the total exports. While the growth within the industrial exports category was broad-based, earnings from textiles and garments exports recorded a growth of 22.9 per cent reaching US dollars 5,435 million during 2021 and contributing more than 40 per cent of the increase in the total exports. Increases in earnings from all major export destinations of garments led to this increase. Exports of rubber products, led by solid tyres and household rubber gloves, supported the rubber product sector to record an improved performance while becoming the third most prominent export sector of Sri Lanka, which exceeded US dollars 1 billion after garments and tea. Earnings from petroleum exports increased, led by bunkering and aviation fuel exports, due to the increase in average export prices despite the low volume of supply. The increase in the food, beverages and tobacco category was mainly driven by value added coconut products, animal or vegetable fats and oils, and crustaceans preparations (mainly crabs). However, reflecting the weakened demand for Personal Protective Equipment (PPE) exported by Sri Lanka, earnings from made up textile articles (mainly facemasks) and plastic clothing articles categorised under plastics and articles thereof declined considerably during 2021.

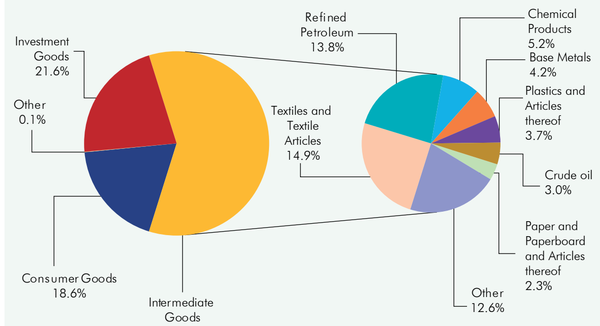
With the improved performance of most of the subcategories, agricultural exports recorded a growth of 16.8 per cent in 2021 compared to 2020. Higher earnings from spices, tea, seafood and coconut products mainly contributed to this increase, while export earnings from vegetables declined. Offsetting the decline in average export prices, the increase in export volume of 7.7 per cent led to the increase in earnings from tea exports in 2021. The higher earnings recorded by natural rubber, spices (mainly cinnamon and nutmeg) and unmanufactured tobacco products were driven by higher export prices, whereas both higher prices and volumes led to the increase in earnings from seafood, pepper and coconut (both kernel and non-kernel products). Earnings from minor agricultural products increased due to higher export volumes of fruits, cereals and essential oil exports. However, the lower export volumes led to the weak performance of vegetable exports, despite higher prices.

Earnings from mineral exports, which account for less than 1 per cent of total exports, improved by 77.3 per cent in 2021 compared to the previous year. Titanium ores categorised under ores, slag and ash primarily contributed to this increase, while increases in natural graphite and quartz led to the increase in earnings from earths and stones and precious metals.

Import Performance

Amidst the continuation of certain import restrictions, mainly on personal vehicle imports, expenditure on imports increased considerably by 28.5 per cent to US dollars 20,637 million in 2021 compared to 2020. The increasing demand for inputs with the resumption of domestic economic activities, elevated price levels in global commodity markets, including fuel prices, higher reliance on refined petroleum due to intermittent

Figure 5.5
Composition of Imports - 2021



Sources: Sri Lanka Customs
Central Bank of Sri Lanka

closures of the refinery, higher expenditure on account of medical and pharmaceutical items such as vaccines, and the relaxation of some import restrictions mainly accounted for the increase in imports despite extremely low imports of personal motor vehicles. Import growth was broad-based as observed in the increases in almost all major categories of imports. As observed by movements in import volume and unit value indices, in general, import expenditure was influenced by both volume and price increases, despite the effect of volume and price changes varying across major categories of imports. As a per cent of GDP, import expenditure increased to 24.4 per cent in 2021, compared to 19.8 per cent in 2020.

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Accounting for more than half of total import expenditure, expenditure on intermediate goods contributed largely to the increase in imports during 2021. Expenditure on intermediate goods imports increased by 35.6 per cent to US dollars 12,309 million during the year. During 2021, as the largest expenditure item of the country's import bill, fuel imports, on account of crude oil, refined petroleum (including LP gas), and coal, increased to US dollars 3,743 million compared to US dollars 2,543 million in 2020. Notable increases in average prices of all three subcategories, as well as the increased import volumes of refined petroleum, caused the fuel bill to rise, offsetting the effect of low volumes of crude oil and coal imports. Import expenditure on textiles and textile articles, the second largest import item, surpassed the US dollars 3 billion mark for the first time. This was led by the increase in expenditure on fabrics and yarn, which were utilised to meet the higher demand for Sri Lankan garments from major export destinations such as countries in the EU, the UK and the USA. Imports of chemical products (mainly carbon) surpassed US dollars 1 billion for the first time, while other import categories including base metals (mainly iron and steel), plastics and articles in primary form, and natural and synthetic rubber recorded high growth rates during the year. However, the ban that prevailed during most parts of 2021 on importing chemical fertiliser led to lower expenditure on fertiliser (mainly urea), while unmanufactured tobacco and mineral products such as cement clinkers recorded lower expenditure values in 2021 compared to 2020.

Expenditure on investment goods, which accounted for around 22 per cent of total import expenditure, increased by 25.2 per cent to US dollars 4,463 million in 2021. Expenditure on all import items categorised under machinery and equipment increased in 2021 compared to 2020, except for the machinery and equipment parts, while office machines (mainly computers),

Table 5.4
Composition of Imports

Category	2020 Value US$ million	2020 Share %	2021 (a) Value US$ million	2021 (a) Share %	Change in Value US$ million	Y-o-Y Change %	Contribution to Change %
Consumer Goods	**3,401.7**	**21.2**	**3,848.7**	**18.6**	**447.0**	**13.1**	**9.8**
Food and Beverages	1,554.4	9.7	1,666.5	8.1	112.1	7.2	2.4
Rice	10.5	0.1	73.0	0.4	62.5	595.3	1.4
Sugar and Confectionery	277.1	1.7	288.8	1.4	11.7	4.2	0.3
Dairy products	333.8	2.1	317.7	1.5	-16.1	-4.8	-0.4
Lentils	96.9	0.6	143.0	0.7	46.1	47.5	1.0
Other	836.0	5.2	843.9	4.1	7.9	0.9	0.2
Non-Food Consumer Goods	1,847.3	11.5	2,182.2	10.6	334.9	18.1	7.3
Medical and Pharmaceuticals	595.5	3.7	882.5	4.3	287.0	48.2	6.3
Telecommunication Devices	268.4	1.7	382.9	1.9	114.5	42.6	2.5
Home Appliances	174.2	1.1	257.1	1.2	82.9	47.6	1.8
Clothing and Accessories	200.7	1.2	221.3	1.1	20.7	10.3	0.5
Other	608.5	3.8	438.4	2.1	-170.0	-27.9	-3.7
Intermediate Goods	**9,076.5**	**56.5**	**12,308.9**	**59.6**	**3,232.4**	**35.6**	**70.5**
Fuel	2,542.6	15.8	3,742.9	18.1	1,200.3	47.2	26.2
Textiles and Textile Articles	2,335.1	14.5	3,066.9	14.9	731.9	31.3	16.0
Chemical Products	831.5	5.2	1,074.4	5.2	242.9	29.2	5.3
Base metals	460.3	2.9	866.4	4.2	406.1	88.2	8.9
Plastics and articles thereof	540.2	3.4	765.7	3.7	225.6	41.8	4.9
Paper and paperboard and articles thereof	383.1	2.4	468.9	2.3	85.8	22.4	1.9
Wheat and maize	384.4	2.4	418.3	2.0	33.8	8.8	0.7
Other Intermediate Goods	1,599.4	10.0	1,905.4	9.2	306.0	19.1	6.7
Investment Goods	**3,563.2**	**22.2**	**4,462.7**	**21.6**	**899.5**	**25.2**	**19.6**
Machinery and Equipment	2,176.1	13.6	2,809.5	13.6	633.4	29.1	13.8
Building Materials	1,035.6	6.5	1,248.9	6.1	213.2	20.6	4.7
Transport Equipment	348.3	2.2	398.5	1.9	50.2	14.4	1.1
Other Investment Goods	3.2	0.02	5.8	0.03	2.6	81.4	0.1
Unclassified Imports	**14.0**	**0.1**	**17.1**	**0.1**	**3.1**	**22.2**	**0.1**
Total Imports (b)(c)	**16,055.4**	**100.0**	**20,637.4**	**100.0**	**4,582.0**	**28.5**	**100.0**
Annual Average Exchange Rate (d)	**185.52**		**198.88**				

(a) Provisional
(b) Excludes re-imports
(c) Adjusted for lags and other factors of recording
(d) Rupee/US dollar exchange rate

Sources: Ceylon Petroleum Corporation
Lanka IOC PLC
Sri Lanka Customs
Central Bank of Sri Lanka

Table 5.5
Volume of Major Imports

MT '000

Item	2017	2018	2019	2020	2021 (a)
Refined Petroleum (b)	4,895	4,959	4,740	4,028	4,553
1st Quarter	1,275	1,382	1,199	1,249	1,378
2nd Quarter	1,123	1,207	1,206	678	1,008
3rd Quarter	1,336	1,317	1,211	1,123	865
4th Quarter	1,161	1,054	1,124	978	1,302
Wheat	1,250	1,297	1,159	1,404	1,307
1st Quarter	291	412	164	272	323
2nd Quarter	334	329	318	285	288
3rd Quarter	359	285	292	498	335
4th Quarter	265	271	385	348	360
Crude Oil (b)	1,591	1,674	1,842	1,667	1,182
1st Quarter	282	283	461	464	274
2nd Quarter	376	459	460	265	368
3rd Quarter	464	461	461	568	362
4th Quarter	469	471	460	370	178
Sugar	498	645	556	683	582
1st Quarter	108	205	140	193	293
2nd Quarter	158	166	153	108	140
3rd Quarter	101	119	100	209	14
4th Quarter	132	154	164	172	136
Fertiliser	399	861	707	952	412
1st Quarter	78	256	148	88	114
2nd Quarter	73	154	142	294	182
3rd Quarter	129	225	238	126	17
4th Quarter	119	226	179	444	98
Rice	748	249	24	16	147
1st Quarter	259	203	8	8	3
2nd Quarter	79	37	3	2	4
3rd Quarter	160	2	5	2	3
4th Quarter	250	7	8	4	137

(a) Provisional
(b) Adjusted

Sources: Ceylon Petroleum Corporation
Lanka IOC PLC
Sri Lanka Customs
Central Bank of Sri Lanka

telecommunication devices (mainly transmission apparatus) and medical and laboratory equipment contributed the most to this increase. Imports of building material and transport equipment (including commercial use vehicles) also increased despite the continuation of some import restriction measures throughout 2021. The increase in the building material category was driven by iron and steel imports amidst the lower expenditure on cement, while expenditure on agricultural tractors, lorries and railway equipment led to the increase in transport equipment imports.

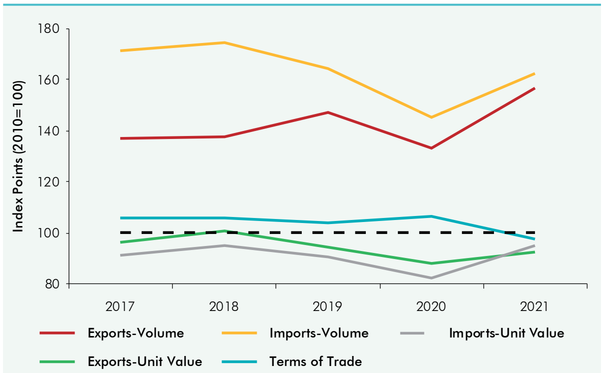
Expenditure on non-food consumer goods increased by 18.1 per cent to US dollars 2,182 million in 2021 compared to US dollars 1,847 million in 2020. The largest contribution to this increase was from medical and pharmaceuticals, particularly the vaccines imported under the COVID-19 vaccination programme. Mobile telephones, rubber tyres and televisions were among the other categories that contributed to the notable increase in the imports of non-food consumer goods. However, with the continuation of restrictions imposed by the Government and the Central Bank since March 2020, the importation of vehicles for personal use was at a very low level during 2021 compared to 2019 and 2020.

Expenditure on food and beverages imports increased by 7.2 per cent in 2021 compared to 2020. Higher imports of coconut oil led the oils and fats category to record the largest increase in the food and beverages category, while the importation of rice, mainly towards the end of the year (about US dollars 63 million during the last two months of 2021), caused the cereals and milling industry products category to record a considerable increase during 2021 compared to 2020. Dhal, sugar and fresh fruits were the other major food items that recorded an increased import expenditure in 2021. However, expenditure related to seafood, beverages and dairy products declined during 2021 driven by low import expenditure on canned fish and sprats, alcoholic beverages and milk powder, respectively. The rise in unit values largely contributed to the significant increase in import expenditure.

Terms of Trade

The terms of trade, which is the ratio of export prices to import prices, deteriorated for Sri Lanka in 2021. The export price index increased by 5.4 per cent to 92.4 index points, while the import price index increased by a higher rate of 15.2 per cent to 94.9 index points. The increases in the price indices of all major categories of exports contributed to the increase in export prices while higher prices of the

Figure 5.6
Terms of Trade and Trade Indices



Source: Central Bank of Sri Lanka

importation of intermediate goods and consumer goods mainly accounted for the increase in the overall import price index. As such, the terms of trade deteriorated by 8.6 per cent to 97.4 index points in 2021 indicating that the amount of imports can be purchased from a unit of exports has declined, as the import price index increased at a higher pace than the export price index.

The expansion in trade volumes contributed significantly to the increase in both export earnings and import expenditure during 2021. The export volume indices for all three main categories of exports improved, while the import volume indices for intermediate and investment goods increased during the year. However, the import volume index for consumer goods marginally decreased in 2021.

Table 5.6
Trade Indices (a)

2010 = 100

Category	Value Index			Volume Index			Unit Value Index		
	2020	2021 (b)	Y-o-Y Change %	2020	2021 (b)	Y-o-Y Change %	2020	2021 (b)	Y-o-Y Change %
EXPORTS									
Agricultural Exports	101.3	118.4	16.8	90.5	101.1	11.7	112.0	117.1	4.6
Tea	86.2	92.0	6.7	80.7	87.2	8.0	106.8	105.5	-1.2
Rubber	17.4	24.3	40.1	29.4	29.3	-0.5	59.1	83.2	40.8
Coconut	208.4	256.7	23.2	168.0	188.1	11.9	124.0	136.5	10.1
Spices	161.0	219.5	36.4	114.5	146.9	28.3	140.6	149.4	6.3
Minor Agricultural Products	188.6	208.3	10.5	173.1	188.4	8.8	108.9	110.6	1.5
Industrial Exports	125.9	159.3	26.5	153.5	183.2	19.3	82.1	86.9	6.0
Textiles and Garments	131.9	162.1	22.9	111.5	140.6	26.1	118.3	115.3	-2.5
Petroleum Products	141.9	192.4	35.6	238.5	282.8	18.6	59.5	68.0	14.3
Rubber Products	141.2	188.7	33.6	100.0	112.6	12.7	141.3	167.6	18.6
Mineral Exports	103.6	183.7	77.3	68.6	111.4	62.6	151.2	164.8	9.1
Total Exports	116.5	145.0	24.4	132.9	156.9	18.0	87.7	92.4	5.4
IMPORTS									
Consumer Goods	137.5	155.5	13.1	128.0	127.8	-0.2	107.4	121.7	13.3
Food and Beverages	117.5	126.0	7.2	127.4	125.5	-1.5	92.2	100.4	8.8
Non-Food Consumer Goods	160.4	189.5	18.1	128.7	130.4	1.3	124.7	145.3	16.6
Intermediate Goods	112.8	152.9	35.6	140.2	152.0	8.5	80.5	100.6	25.0
Fuel	83.6	123.1	47.2	133.1	134.2	0.8	62.8	91.7	46.1
Fertiliser	107.8	65.9	-38.9	160.2	74.5	-53.5	67.3	88.4	31.4
Chemical Products	159.9	206.6	29.2	157.9	177.3	12.2	101.3	116.6	15.1
Wheat and Maize	144.8	157.6	8.8	138.9	134.2	-3.3	104.3	117.4	12.6
Textiles and Textile Articles	129.1	169.5	31.3	126.8	153.9	21.4	101.8	110.2	8.2
Plastics and Articles thereof	127.7	181.0	41.8	148.9	169.5	13.8	85.8	106.8	24.6
Diamonds, Precious Stones and Metals	31.0	38.0	22.5	36.5	41.9	14.7	85.1	90.9	6.8
Investment Goods	129.3	162.0	25.2	183.4	230.6	25.7	70.5	70.3	-0.4
Building Materials	126.0	152.0	20.6	147.7	154.5	4.7	85.4	98.3	15.2
Transport Equipment	58.8	67.3	14.4	50.4	46.7	-7.5	116.6	144.1	23.6
Machinery and Equipment	162.7	210.1	29.1	264.5	359.0	35.7	61.5	58.5	-4.9
Other Investment Goods	96.2	174.5	81.4	112.9	142.6	26.4	85.2	122.3	43.5
Total Imports	119.7	153.9	28.5	145.5	162.2	11.5	82.3	94.9	15.2
Terms of Trade							106.5	97.4	-8.6

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

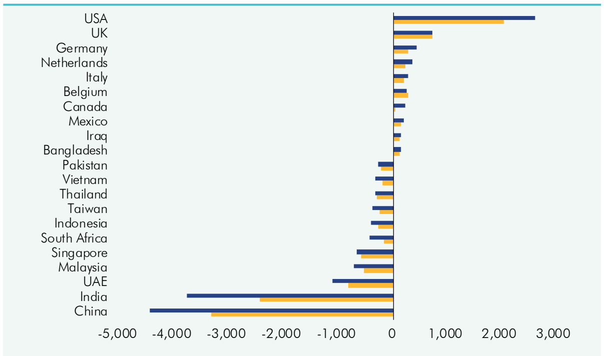
Source: Central Bank of Sri Lanka

Direction of Trade

Sri Lanka continued to have similar major trading partners in 2021 compared to the previous year. In value terms, India regained its position as the main trading partner of Sri Lanka in 2021, followed by China and the USA, all of which together contributed to around 42 per cent of total trade (both exports and imports) of Sri Lanka. Total trade with India and China exceeded US dollars 5 billion each, while trade with the USA exceeded US dollars 3.5 billion. The UAE, the UK and Germany were the other major trading partners, accounting for more than US dollars 1 billion each in 2021. As per the country wise trade balances in 2021, notable trade surpluses were recorded with Western countries such as the USA, the UK, Germany, Netherlands, Italy and Belgium, while significant trade deficits were recorded with Asian countries such as China, India, the UAE, Malaysia, and Singapore.

The USA and European countries remained the major destinations for Sri Lankan exports in 2021. The USA continued to be the single largest buyer of Sri Lankan exports with more than US dollars 3 billion worth of exports, which accounted for 24.9 per cent of total exports, followed by the UK (7.5 per cent), India (6.6 per cent), Germany (6.1 per cent) and Italy (4.6 per cent). In line with increased exports, earnings from most destinations, including the top ten export destinations of Sri Lanka, increased during 2021. Garments, rubber products, machinery and mechanical appliances, and food, beverages and tobacco were major products exported to the USA. The USA continued to be the single largest garment export destination for Sri Lanka with a share of 42 per cent of total garment exports in 2021. Exports to the UK were denominated by garments, rubber products, made up textile articles, food, beverages and tobacco, machinery and mechanical appliance and seafood. Exports to India included spices, animal fodder, textiles, food, beverages and tobacco, wood and paper products and minor agricultural products. The EU as a region accounted for about 24 per cent of total exports in 2021, including about 30 per cent of total garment exports. Rubber products, food, beverages and tobacco, tea, seafood, machinery and mechanical appliances and coconut kernel products were among the other major items exported to the EU. In 2021, the Middle East and the Commonwealth of Independent States (CIS) led by Russia were the main export destinations for tea, jointly contributing to about 58 per cent of tea exports by Sri Lanka.

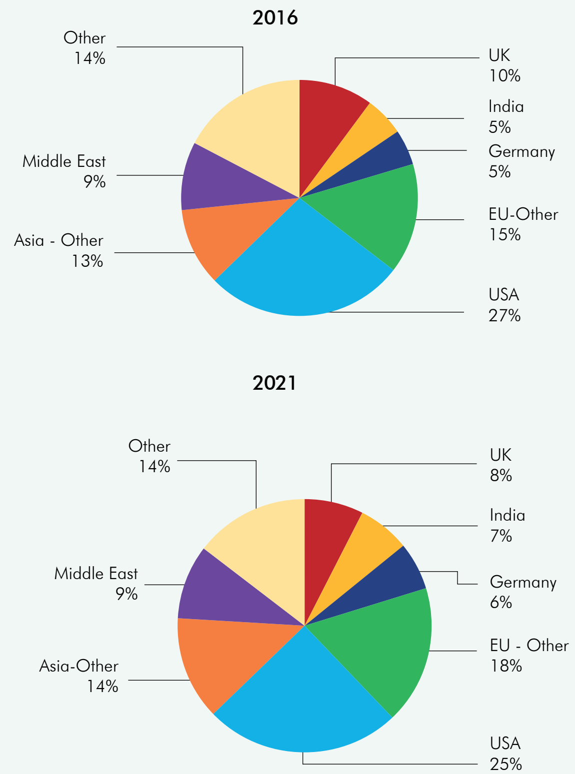
Figure 5.7
Countrywise Trade Balances (US$ million)



Source: Central Bank of Sri Lanka

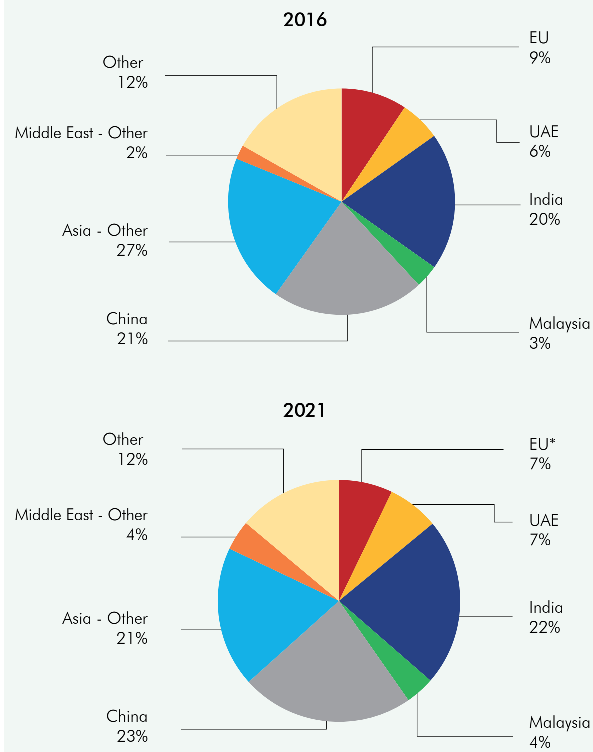
Asian countries continued to be the major source of Sri Lankan imports in 2021. China continued to be the largest source of imports for the third consecutive year, recording more than US dollars 4.7 billion of imports in 2021, with a share of about 23 per cent of total imports. Import expenditure from China increased by 33 per cent, mainly due to higher imports of machinery and equipment, textiles and textile articles, building material, and medical and pharmaceuticals. India and the UAE followed suit as the second and the third largest import sourcing countries in 2021, accounting for shares of about 22.4 per cent and

Figure 5.8
Exports by Destination



Source: Sri Lanka Customs

Figure 5.9
Imports by Origin



* Excluding the UK

Source: Sri Lanka Customs

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6.8 per cent, respectively. Expenditure on import items from India increased by 50 per cent, due to petroleum products, textiles and textile articles, base metals, and wheat. Major imports from the UAE were petroleum products, base metals and building materials, which contributed to around 86 per cent of total imports from the UAE. As an import source, Malaysia gained the fourth position in 2021 due to increases in major import items such as petroleum products, food preparations, machinery and equipment, chemical products, and oils and fats. The major imports from Singapore in 2021 consisted of petroleum products, chemical products and machinery and equipment. As an import source, Japan was positioned at the tenth position in 2021 compared to the sixth position in 2020, mainly due to restrictions on vehicle imports during the year.

External Trade Policies, Developments and Institutional Support

The revival of the merchandise trade sector in 2021 was supported by the policy support and the efforts of all the stakeholders of the sector amidst the devastating impact of the pandemic. The policy stimuli from the Government and the Central Bank, together with improving global economic conditions helped the export sector rebound beyond pre-pandemic levels. The Government's efforts to support domestic producers by developing import substitutes to several agricultural and industrial products while conducting aggressive export promotion and maintaining low taxes continued throughout the year. At the beginning of 2021, the Presidential Task Force on Economic Revival and Poverty

Alleviation focused its attention on encouraging export earnings and other non-debt inflows of foreign exchange through combined efforts with relevant stakeholders to align their activities in a streamlined and targeted manner. Accordingly, several subcommittees coordinated by the Central Bank were initiated for each major sector such as merchandise trade (textiles and garments, gem and jewellery, rubber products, tea, coconut products, fisheries, spices and minor agricultural export crops), tourism earnings, workers' remittances and foreign investments. These subcommittees attempted to achieve assigned targets while engaging with relevant stakeholders to overcome immediate issues and bottlenecks that hinder the progress of each sector. At the same time, the Ministry of Trade initiated formulating a National Trade Policy to strengthen policy guidance on trade. Meanwhile, the World Trade Organization (WTO) estimates that the growth of world merchandise trade volume rebounded by 9.8 per cent in 2021 (from a contraction of 5.0 per cent in 2020) moderating to 3.0 per cent in 2022 while authorities would need to focus on securing the export share in international markets through appropriate policies and support.

Several import restrictive measures were relaxed during 2021. Import controls adopted by the Government during the first half of 2020 due to external sector pressures were gradually lifted during 2021. A series of Extraordinary Gazettes were issued in this regard by the Department of Imports and Exports Control setting out directions on import controls during 2020 and 2021, under the guidance of the Tariff Determination Committee appointed by His Excellency the President. These restrictions were imposed temporarily, in order to preserve foreign exchange, primarily on selected non-essential and non-urgent import items with a minimum expected impact on domestic industries and consumers. However, since June 2021, these import restrictions were significantly reduced, although the Central Bank imposed a 100 per cent cash margin deposit requirement against the importation of selected non-essential/non-urgent goods made under letters of credit and documents against acceptance terms with Licensed Commercial Banks and National Savings Bank for a brief period during September 2021. In addition, the importation of inorganic fertiliser was restricted in May 2021 in line with the Government's policy move to transit to organic agriculture. However, these measures were also relaxed by November 2021. Considering the continuous pressure on the external sector, the Government imposed several restrictions on selected non-urgent and non-essential consumer items during March 2022 such as import licenses requirements, while increasing import duties.

Several measures were undertaken to improve the institutional support to the external sector during 2021 aiming to support the recovery of the sector from the impact of the pandemic. The Export Development Board (EDB) continued with the implementation of the National Export Strategy (NES) 2018-2022, while recommencing the promotional activities. The NES Action Plan was continuously implemented in the areas of market development, product and supply chain development and capacity building. While continuing web based promotional activities, the EDB recommenced participation in physical trade fairs, business-to-business promotion programmes, and brand promotion campaigns, which were mostly limited to the virtual mode during 2020. Trade chambers also contributed towards export promotion, helping to link-up the public and private sector stakeholders in policymaking and grievance handling. The Sri Lanka Standards Institution (SLSI) continued the process of formulation and upgrading of national standards, which helped local manufacturers compete with foreign products. Accordingly, to improve national standards to be in line with international standards, the SLSI revised 128 standards out of 327 published standards by end 2021. Amidst the challenging market environment, the Sri Lanka Export Credit Insurance Corporation (SLECIC) reported about Rs.48.7 billion worth of insured businesses recording an increase of Rs.11.6 billion over the previous year. The modernisation programme for Sri Lanka Customs (SLC) continued under ten subcommittees that analysed operational and management processes and provided recommendations on required reforms. Meanwhile, a Presidential Commission of Inquiry was appointed in February 2021 to investigate and report on matters related to the SLC with a view to improving processes and preventing revenue leakages. The SLC streamlined its activities further, in relation to the implementation of the Trade Facilitation Agreement (TFA) of the WTO.

Sri Lanka's exports under trade agreements improved in 2021 in line with the increase in overall earnings from exports. During the period under review, trade with the main trading partners, namely, the EU and the USA under Generalized System of Preferences (GSP) schemes, paved the way for increased market opportunities. Sri Lanka is expected to benefit from the current EU GSP+ scheme until its validity period ends in 2023 as established following Sri Lanka's reclassification as a lower middle income country in July 2020.

Table 5.7
Exports under Preferential Trade Agreements of Sri Lanka

Preferential Agreement	2020 Value (US$ million)	2021 (a) Value (US$ million)	2021 (a) Growth (%)	2021 (a) Share (%)	Major Export Products (Ordered by size of export)
Generalised System of Preferences (GSP)	3,671.8	4,312.7	17.5	80.8	Garments, Rubber products, Tea, Food beverages & tobacco, Seafood, Machinery and mechanical appliances
o/w EU (including GSP+) (b)	1,907.0	2,402.1	26.0	45.0	Garments, Rubber products, Tea, Food beverages & tobacco, Seafood, Machinery and mechanical appliances
UK	690.9	680.7	-1.5	12.8	Garments, Rubber products, Machinery and mechanical appliances, Food beverages & tobacco, Seafood, Transport equipment
USA (c)	585.7	677.8	15.7	12.7	Garments, Rubber products, Food beverages & tobacco, Chemical products, Spices
Russian Federation (d)	142.2	132.9	-6.5	2.5	Tea, Rubber products, Coconut non-kernel products, Garments, Chemical products
Australia	79.2	103.5	30.7	1.9	Garments, Rubber products, Food beverages & tobacco, Tea, Coconut kernel products
Canada	61.0	87.9	44.0	1.6	Rubber products, Garments, Coconut kernel products, Food beverages & tobacco, Seafood
Japan	71.0	87.6	23.4	1.6	Tea, Chemical products, Coconut non-kernel products, Food beverages & tobacco, Seafood
Turkey	80.3	74.1	-7.7	1.4	Tea, Rubber products, Chemical products, Garments, Coconut non-kernel products
Other GSP	54.6	66.1	21.1	1.2	
Indo-Sri Lanka Free Trade Agreement (ISFTA) Implemented in 2000	358.4	525.8	46.7	9.9	Animal fodder, Food beverages & tobacco, Spices, Minor agricultural exports, Wood and paper products
Asia-Pacific Trade Agreement (APTA) Implemented in 1975 (e)	204.7	238.6	16.6	4.5	Garments, Tea, Coconut non-kernel products, Chemical products, Rubber products
Global System of Trade Preferences (GSTP) Implemented in 1989	89.5	91.8	2.5	1.7	Spices, Base metals and articles, Coconut kernel / non-kernel products, Animal fodder, Rubber products
Pakistan-Sri Lanka Free Trade Agreement (PSFTA) Implemented in 2005	53.0	62.3	17.6	1.2	Minor agricultural exports, Coconut kernel / non-kernel products, Natural rubber, Machinery and mechanical appliances
South Asian Free Trade Area (SAFTA) Implemented in 2006	42.2	101.6	140.6	1.9	Spices, Coconut kernel / non-kernel products, Base metals and articles, Textiles, Tea
SAARC Preferential Trading Arrangement (SAPTA) Implemented in 1995	0.8	1.4	83.6	0.03	Rubber products, Chemical products, Tea, Food beverages & tobacco, Textiles
Total Exports under Preferential Agreements	**4,420.4**	**5,334.3**	**20.7**	**100.0**	
As a Share of Sri Lanka's Total Exports	**44.0**	**42.7**			

(a) Provisional
(b) The EU-GSP provides preferential access for 66 per cent of the tariff lines on imported goods to the EU, while the EU-GSP+ provides zero duty access to the same tariff lines on imported goods to the EU. Excludes the UK.
(c) Shows GSP eligible exports since the US-GSP expired on 31.12.2020 and it is expected to re-authorised with retroactive basis.
(d) Includes Russia, Belarus and Kazakhstan
(e) Earlier known as the Bangkok Agreement (1975)

Sources: Department of Commerce
Sri Lanka Customs

The US GSP scheme expired on 31 December 2020 and is expected to be reauthorised on a retroactive basis as per the general practice of the US Government. The UK's Global Tariffs (UKGT), which is a different tariff system from that of the EU, came into effect on 01 January 2021 and Sri Lanka as an EU GSP+ beneficiary, continued to enjoy the same duty free access to the UK. However, the UK is expected to implement a new GSP scheme from 2022 onwards and the Department of Commerce of Sri Lanka has provided the required inputs to the relevant authorities in the UK. The GSP scheme offered by Japan, which expired on 31 March 2021, was extended for a period of 10 years until 2031. In addition, Sri Lanka continued to benefit from GSP schemes offered by several other countries, such as the Russian Federation, Turkey, Australia, Canada, Switzerland, Norway and New Zealand, although their contribution to exports remained relatively low. Under bilateral Free Trade Agreements (FTAs), the Indo-Sri Lanka Free Trade Agreement (ISFTA) and the Pakistan Sri Lanka Free Trade Agreement (PSFTA) continued to benefit Sri Lanka, contributing to an increase in exports under FTAs in 2021. Exports through FTAs with India and Pakistan remained high around 65 per cent of total exports to these countries in 2021. Meanwhile, the share of imports under the ISFTA and the PSFTA was below 5 per cent (US dollars 209 million) and 3 per cent (US dollars 12 million), respectively, of total imports from India and Pakistan. Under regional trade agreements, exports under the Asia Pacific Trade Agreement (APTA) (due to higher exports to China, South Korea and Bangladesh) and Global System of Trade Preferences (GSTP) (due to higher cinnamon exports to Mexico) improved during 2021. Mongolia joined as the seventh member of the APTA in September 2020, and other Participating States, including Sri Lanka, exchanged tariff concessions reciprocally with Mongolia with effect from 01 January 2021. Exports under the SAARC Preferential Trading Arrangement (SAPTA) continued to remain at low levels while exports under the South Asian Free Trade Area (SAFTA) improved during 2021. Sri Lanka's multilateral trade engagement with the WTO continued in 2021. Work is underway to negotiate and enter into preferential trade agreements with trade partners with future potential, such as China, Japan, Indonesia and Bangladesh, and the review process of the Singapore-Sri Lanka FTA continued during 2021. Meanwhile, Sri Lanka could also seek the possibility of joining other regional trade agreements such as the Regional Comprehensive Economic Partnership (RCEP) to expand and diversify the export market.

5.2.2 Services Account

The surplus in the services account recorded a notable increase in 2021 compared to the previous year, but remained lower than the pre-pandemic and pre-Easter Sunday attacks levels. This was mainly due to the healthy growth in earnings from computer services, gradual improvement in earnings from tourism and improvements in freight related to sea and air transport services. As a result, the surplus in the services account amounted to US dollars 1.6 billion in 2021 compared to US dollars 0.8 billion in 2020.

5

Travel and Tourism

The tourism industry, which was severely affected by the COVID-19 pandemic, witnessed a steady recovery in the latter part of 2021 aided by effective measures taken by relevant authorities along with the improved global perception of Sri Lanka as a safe travel destination. Since the reopening to foreign travellers in January 2021, Sri Lanka saw a steady increase in international travellers, despite intermittent lockdowns. This enabled the tourism sector to implement and improve its health and safety protocols, which have proven to be effective. Following the temporary restrictions in April 2021, due to the emergence of the third wave of the pandemic, Sri Lanka was reopened in June 2021 for fully vaccinated travellers with quarantine free entry. As a result of these measures along with the successful domestic vaccination rollout, international tourist arrivals started to pick up steadily from September 2021 to peak in December 2021 with 89,506 arrivals. In support of the recovery of the tourism sector, authorities implemented several measures such as revising codes of conduct, which specified health and safety regulations for all tourist enterprises and tourist services and upgrading the health and safety guidelines. The tourism sector was also provided with extended moratorium on its debt payable to the financial sector until such time they are able to recover from the set-backs they experienced since 2019. Tourist arrivals declined by 61.7 per cent to 194,495 in 2021 compared to 507,704 in 2020, of which 507,311 arrivals were recorded during the first three months of 2020. The steady increase in tourist arrivals continued

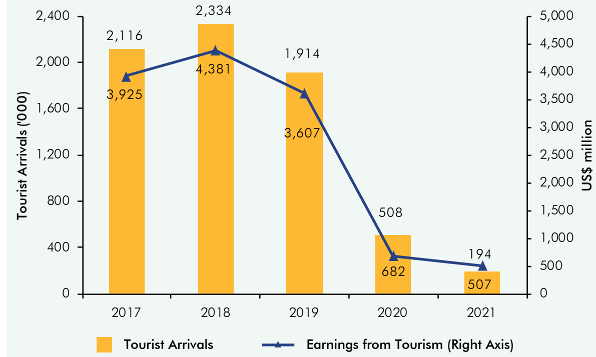
Table 5.8
Performance of Tourism Sector

	2017	2018	2019	2020	2021(a)	Y-o-Y (%) 2021
Tourist Arrivals (No.)	2,116,407	2,333,796	1,913,702	507,704	194,495	-61.7
Arrivals by Purpose of Visit						
Pleasure	1,744,149	1,979,819	1,592,212	444,328	157,766	-64.5
Business	70,683	71,255	70,068	13,946	3,956	-71.6
Other	301,575	282,722	251,422	49,430	32,773	-33.7
Tourist Guest Nights ('000)	23,068	25,205	19,902	4,315	2,937	-31.9
Room Occupancy Rate (%)	73.3	72.8	57.1	15.0	18.6	24.3
Gross Tourist Receipts (Rs. million)	598,143	711,961	646,362	124,189	101,903	-17.9
Per Capita Tourist Receipts (Rs.)	282,622	305,066	337,755	244,609	523,936	114.2
Total Employment (No.) (b)	359,215	388,487	402,607	347,751	357,927	2.9
Direct Employment	156,369	169,003	173,592	175,990	177,476	0.8
Indirect Employment	202,846	219,484	229,015	171,761	180,451	5.1

(a) Provisional
(b) Estimates

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

Figure 5.10
Tourist Arrivals and Earnings from Tourism



Source: Sri Lanka Tourism Development Authority

during early 2022 despite the disruptions to global tourism caused by geo-political tensions.

Europe was the dominant region for tourist arrivals, while India continued to be the dominant single country for tourist arrivals. About 93,496 arrivals were recorded from Europe, accounting for 48 per cent of total tourist arrivals. The Asia Pacific region recorded the second highest arrivals in 2021 with 83,926 tourists, accounting for 43.2 per cent of total tourist arrivals, despite the very low number of travellers from China. In terms of tourist arrivals by individual countries, India maintained its lead with 56,268 arrivals during 2021 followed by Russia, the UK, Germany, and Pakistan. In late August 2021, Sri Lanka resumed its tourism campaign in India, opening its borders to fully vaccinated travellers. Russia surpassed the UK as the second largest tourist destination in 2021 due to tourism promotion programmes carried out targeting charter flights from Russia, suggesting that enhanced connectivity through regular routes and seasonal charter flight operations could be promoted as a means to attract tourists from both traditional and non-traditional markets. In 2021, the top five tourist source destinations accounted for 56.4 per cent of total tourist arrivals in Sri Lanka.

While there was an increase in both average spending per tourist and the duration of stay, earnings from tourism was moderate in 2021 compared to the previous year as a result of reduced tourist arrivals. As per the revised estimates on tourist spending and duration of stay for 2021 by the Sri Lanka Tourism Development Authority (SLTDA), the average spending per tourist in 2021 rose to US dollars 172.6 per day from US dollars 158.1 per day in 2020. Further, the average duration of stay by a tourist was estimated to be at 15.1 days in 2021, in comparison to 8.5 days in 2020, reflecting the impact of quarantine due to COVID-19 restrictions. Earnings from tourism decreased by 25.7 per cent to US dollars 507 million in 2021, in comparison to US dollars 682 million in 2020. Meanwhile, limited outflows related to travel were also recorded in 2021 compared to 2020.

Investment in the tourism sector expanded further in 2021, indicating the continuous confidence of investors in Sri Lanka's tourism potential. The Investor Relations Unit (IRU) of the SLTDA received 45 new investment projects related to the tourism sector amounting to US dollars 134 million in 2021, with a collective capacity of 1,328 rooms. Meanwhile, IRU granted approvals for 30 tourism related projects during 2021 amounting to US dollars 104 million, with a collective capacity of 922 rooms. In addition, 87 hotel projects with 6,265 rooms are currently under construction at various levels. Accordingly, graded establishments amounting to 480 with a total capacity of 25,958 rooms and supplementary establishments, including boutique villas, bungalows, guest houses, heritage bungalows, heritage homes, home stay units, rented apartments and rented homes amounting to 3,177 with a total capacity of 21,379 rooms were in operation in 2021.

The Government and the private sector jointly implemented several policy initiatives and various promotional programmes to attract tourists in 2021. The debt moratoria in relation to the tourism sector granted by Licensed Banks, Licensed Finance Companies and Specialised Leasing Companies at the request of the Central Bank in response to the COVID-19 pandemic, was in place until 31 March 2021, and further extended until 01 October 2021. However, in view of the lasting adverse effects of the pandemic on the industry, the Central Bank extended the debt moratoria again for another nine months ending in July 2022. In line with this extension, moratoria on lease rentals of business and private sector vehicles providing passenger transport services to the tourism sector were also extended. Furthermore, the Saubagya COVID-19 Renaissance Facility implemented by the Central Bank to provide loans at concessionary interest rates to individuals and businesses in the tourism sector, was extended several times, until 30 June 2022 on a case by case basis. In addition, several measures were taken by the tourism authorities to reduce the burden faced by stakeholders of the industry, such as extending the validity period of licenses of all tourism establishments registered with the SLTDA and extending the validity of tourist guide licenses until 31 December 2021. The SLTDA, in collaboration with the Sri Lanka Institute of Tourism and Hotel Management (SLITHM) introduced an e-learning platform for continuous professional development to all registered guides to improve their knowledge and skills. Further, the SLTDA launched a membership drive to encourage informal sector tourism operators to register with the SLTDA. All informal tourism businesses, including tourist hotels, guest houses, homestays, bungalows, travel agencies, tourist-friendly eating places, restaurants, and spa and wellness centres are allowed to register through a provisional registration

BOX 5
The Role of Tourism during Post-Pandemic Recovery in Sri Lanka

Introduction

Tourism is defined as "a social, cultural and economic phenomenon which entails the movement of people to countries or places outside their usual environment for personal or business/professional purposes" by the United Nations World Tourism Organisation (UNWTO). International Tourism (hereinafter referred to as "Tourism") is basically exportation of services. Tourism earnings and expenditure are recorded as "Travel" under "Services" in the Goods and Services Account of the Balance of Payment (Balance of Payment and International Investment Position Manual - BPM 6 of the International Monetary Fund). Tourism remains an important source of net foreign currency earnings for a country, as the foreign currency outflows on account of inputs are minimal. In addition to earning foreign currency, the tourism industry also contributes to economic growth, employment, and reduction in regional income disparity. Sri Lanka's strategic location, attractive natural endowments, cultural diversity, and rich history, together with the peaceful, clean, safe and foreigner-friendly environment, provide the basis for this industry to flourish. Therefore, development of the tourism industry will be a key economic priority, particularly in the post-pandemic economic recovery period, to mitigate external sector imbalances in the country.

Significance of Earnings from Tourism for the Economy at Present

Tourism remained the third largest source of foreign currency earnings between 2014 and 2019 and contributed to about 14 per cent of total foreign currency earnings during this period. Although export earnings, which is the largest source of foreign currency earnings, grew from US dollars 8,626 million in 2010 to US dollars 12,499 million in 2021, generation of earnings through such exports needed a considerable amount of import expenditure on account of inputs. However, tourism as a single industry has been able to generate substantial earnings with a relatively low reliance on imports of inputs. For instance, in the peak year of tourism in Sri Lanka, i.e., 2018, earnings from tourism, estimated at US dollars 4,381 million, outnumbered net export earnings of the apparel industry, that is, export earnings net of import expenditure on textiles (US dollars 2,459 million), and export earnings by other key industries such as tea (US dollars 1,428 million) and rubber products (US dollars 875 million). Meanwhile, workers' remittances, which have been the second largest source of foreign currency earnings, brought an average of US dollars 7,023 million per annum between 2014 and 2019 despite falling to US dollars 5,491 million in 2021. Therefore, tourism is an important source of foreign currency earnings to Sri Lanka and has a key role to play in maintaining the country's resilience to external sector pressures.

Potential of the Tourism Industry

The global tourism industry recorded a steady growth in the recent decades despite setbacks suffered from time to time due to occurrences such as the global financial crisis and outbreaks of epidemics. Tourist arrivals reached 1,468 million by 2019 according to UNWTO. Sri Lanka too saw a continuous increase in tourism arrivals in the past until 2018, with a substantial increase from 2010 when the civil war ended. In fact, in 2018, Sri Lanka was named the top destination for the year 2019 by the acclaimed tourism information provider "Lonely Planet." However, unfortunately, tourism arrivals in 2019 saw a set back because of the terrorist attacks on Easter Sunday in April 2019, though global tourist arrivals reached the record highest in that year. Despite this setback, tourist arrivals and earnings showed a recovery by end of 2019 and early 2020, before starting to decline again because of the COVID-19 pandemic. Meanwhile the global tourism industry is expected to record a slow recovery in the forthcoming years. According to a survey conducted by UNWTO in January 2022 among its panel of tourism experts, 63 per cent of respondents expected that international tourist arrivals in their countries will not recover to the 2019 level until 2024, while 79 per cent of the respondents believed that arrivals in the Asia Pacific region will not recover to 2019 levels until 2024. However, UNWTO, World Travel and Tourism Council (WTTC) and market analysts have shown that there is substantial pent-up savings and a yearning to travel among potential travellers, while tourism characteristics have fundamentally changed because of the pandemic. Therefore, there is a potential for Sri Lanka to attract a substantial number of tourists and/or generate substantial foreign currency earnings from tourism even in 2022 and 2023, if appropriate strategies are implemented efficiently and effectively.

Pandemic and Tourism Response in the Era of "New Normal"

Recognising the importance of supporting the tourism industry, the Government and the Central Bank provided a multitude of relief measures during the COVID-19 pandemic, such as debt moratoria, concessionary loan schemes, waivers on fees, relief on electricity bills, one-off grants and tax relief measures. Meanwhile, rules were issued by the Monetary Board of the Central Bank of Sri Lanka in January 2022 requiring hotel service providers to accept payments from non-residents only in foreign currency, which will ensure the inflow of foreign currency to the country on account of tourism. This also allows the tourism sector to strengthen its earnings in foreign currency without major capital investments, as the sector has made heavy investments in local and foreign currency. Meanwhile, some small-scale hotels kept afloat by renting hotels as quarantine centres when the industry as a whole suffered a significant setback due to the COVID-19 pandemic.

WTTC has highlighted several new features of the "new normal" or the current trends in global tourism, which should be adapted to (Trending in Travel – Emerging Consumer Trends in Travel & Tourism in 2021 and beyond, November 2021). For example, travellers are skeptic of booking well in advance owing to the sudden changes in restrictions imposed by countries and risks from testing positive for COVID-19. Further, travellers prefer accommodation and transport options that allow sudden cancellations without a penalty. Secondly, due to the normalisation of remote working through the pandemic, concepts such as "digital nomads" and "staycations" have become popular, and travellers seek long duration visa, long duration discounts at places of accommodation, fast internet, and other work-related facilities. International tourism organisations further note that the length of stay and spending on a trip increased in 2021. Thirdly, the profile of travellers has changed with more younger travellers (in their 20s to 40s) opting to travel, rather than older persons or families with small children due to health concerns. Therefore, the tourism industry and the country as a whole should be able to accommodate the needs and preferences of such tourists. This age group values adventure and individualism and they use mobile phones and digital services to plan and book their trips and rely on social media, blogs and online reviews of other travellers. Fourthly, appreciation of the value of mental health and personal wellness has increased notably in the recent past and consumer interest in achieving these needs through travelling has also increased. There is also an interest for "philantourism" where tourists can get involved in philanthropical activities and "ecotourism" to gain knowledge about ecological centres around the world. Fifth, the tendency to go on secondary trips, exploring lesser-known attractions near places of main tourism interests and rural tourism has also increased.

Sri Lankan Tourism: The Way Forward

The Ministry of Tourism and institutions under its purview together with the private sector keep strategising and implementing a plethora of measures to develop tourism infrastructure in the country and promote Sri Lanka in target markets. The tourism strategic action plan 2022-2025 developed by the Sri Lanka Tourism Development Authority (SLTDA) provides effective guidance for implementation of actions to upgrade the sector and resolve issues. A comprehensive tourism policy has also been drafted by the Ministry of Tourism and the Cabinet approval is awaited. However, there are certain aspects that require emphasis in policy development and implementation of strategies:

(i) Exploring new drivers of tourism

Sri Lanka has the potential to expand and enhance services in new areas of tourism such as wellness tourism, educational tourism and philanthropical tourism. In the sphere of wellness tourism, opportunities targeted at providing facilities to improve physical and mental well-being, such as peaceful and relaxing stays, retreats, meditation, yoga and Ayurvedic treatments could be expanded. Under educational tourism, short-term or long-term educational programmes in the areas such as English and South Asian culture and civilisation can be offered at existing or new educational institutions. It is common for East Asians to undertake English Language programmes abroad after graduating from school and such programmes can be offered in Sri Lanka. Exchange programmes and home-stay programmes for foreign students can be encouraged as well. Philanthropical tourism can provide opportunities for foreigners to engage in philanthropical activities such as charity work and agricultural work in the country.

(ii) Greater importance of preserving and protecting the natural environment and pollution reduction.

There is a strong and growing interest towards conservation of nature and eco-friendliness among world travellers as given in various UNWTO and WTTC publications as well as communications from the Sri Lankan hotel sector. Sri Lankan authorities have a greater role in ensuring that construction of places of tourist accommodation does not destroy nature or scenic views for others (such as hotels at the edge of beaches) and does not result in encroachment of forests and other protected areas hidden from the public eye. Further, noise pollution near attractions and places of accommodation should be managed. Supervising practices that tourism service providers are engaged in are environmentally friendly (for example, whale watching tours disturbing whales) is also important. Also, the recently enacted Animal Welfare Act should be made of use to reduce the negative publicity that was created due to the treatment of elephants and wild animals, leopards in particular.

(iii) Focus on the individual tourist's journey

SLTDA conducts a survey among departing tourists mostly on a yearly basis. In the 2018-2019 survey report, it is stated that only 17 per cent of tourists used package-tours showing that tourists plan their own trips to a great extent. Further, 60 per cent of surveyed tourists had obtained travel information from friends and relatives and 30 per cent from online sources, highlighting the importance of personal recommendations and personal online reviews. These findings underscore the importance of satisfying each individual tourist and the impact individuals can make on publicity. Further, the general satisfaction level is moderate, since only 60 per cent of the tourists stated that their stay was "excellent" and only 36 per cent of the tourists stated that they want to visit Sri Lanka again. Even the seemingly minute inconveniences to tourists can destroy their entire experience and ignite negative publicity affecting the whole tourism industry.

(iv) Greater use of digital technology

There is scope to enhance the use of digital technologies to improve tourist experience and transition from high-density to socially-distanced tourism. Although some steps have been taken in this direction such as the SLTDA website and the tourism mobile app (being developed), enhanced measures to use digital technology are necessary, expeditiously. UNWTO and the Asian Development Bank (ADB) in "COVID-19 and the future of tourism in the Asia and Pacific" (March 2022) also point out the expanding role of digital technology in tourism.

In Sri Lanka, tourism is concentrated in the Western, Southern, and Central Provinces and the Sigiriya region. Crowding in National Parks have gathered considerable negative publicity lately. Meanwhile, even the ancient cities of Anuradhapura and Polonnaruwa do not attract a significant number of tourists (Table 86 of the Statistical Appendix). Other areas of the country provide ideal locations to conduct wellness, rural, philanthropical, adventure tourism etc. and tourists should be directed to attractions in these areas. Meanwhile, tourists are compelled to go through inconveniences such as buying tickets at individual tourism sites and not having updated information online about events (such as "Peraharas" and festivals, even the small-scale ones), public transport, security services, dress code at religious sites, prohibited items in national parks, etc. Therefore, incorporation of such information and the facility to purchase customised ticket bundles as per individual preference to the mobile app being developed or to a website dedicated to tourists will be highly beneficial. Digital technologies can also be used to provide touchless service delivery methods, QR Code based contactless payment options and to store and share health and safety information.

(v) Improving information to exploit the potential of tourism for better policy making

Appropriate policy decision making rests on a sound information network. Given the intense competition among countries to attract tourists and the evolving nature of tourist characteristics, use of a strong information network for policy decisions is pivotal. The "Tourism Satellite Accounting" initiative that the Department of Census and Statistics is implementing with the support of UNWTO will enable better estimation of the economic contribution of tourism to National Accounts. Hence, its implementation needs to be fast tracked. In addition, high frequency data on a multitude of other aspects is necessary, such as characteristics of persons arriving under tourist visas, how much they are spending and for what and where, satisfaction level, employment in tourism, number and types of direct and indirect tourism service providers and various spatial information. The need for national tourism authorities to enhance their market research capabilities to improve the customer journey, trigger innovation and offer insights to the private sector has been highlighted in multi-country studies conducted during the pandemic by the International Monetary Fund as well. (Tourism in the Post-Pandemic World: Economic Challenges and Opportunities for Asia-Pacific and the Western Hemisphere, International Monetary Fund, 2021).

(vi) Improving risk management capabilities of the tourism sector

Since tourism is inherently an industry that is highly susceptible to geo-political events and is seasonal, the sector should enhance its own risk management capabilities rather than relying solely on concessions such as debt moratoria and fiscal handouts. Debt moratoria reduce incomes of banks, affect their liquidity, and increase risks. An adverse outcome on the banking sector can have ripple effects on the entire economy.

(vii) Reducing informal sub-sector within the sector

The tourism sector in Sri Lanka is characterised by a large number of Micro, Small and Medium scale enterprises (MSMEs), carrying out their businesses informally. However, encouraging such enterprises to register with authorities will help to ensure that strategies the Government is implementing are streamlined and relief measures, if needed, are provided equitably to all participants. Also, high informality in an industry constrains information collection for policy decision-making purposes, delivery of Government services and regulation for quality standards. Registration of businesses will improve access to finance and tax collection as well.

(viii) Encourage diversity among tourists

Facilities should be aimed at satisfying diverse types of travellers in terms of their interest, country of origin and spending capacity, rather than targeting high net worth individuals only. This will help to reduce reliance on travellers with specific characteristics or from a single country/region. In fact, all types of travellers contribute towards positive marketing of Sri Lanka. Catering to tourists of different spending capacities will enable local entities with different investment capabilities to function in the industry as well.

(ix) Reducing over-reliance on tourism

The International Monetary Fund (IMF), in "Tourism in the Post-Pandemic World - Economic Challenges and Opportunities for Asia-Pacific and the Western Hemisphere" (2021), notes that countries that are dependent on tourism are in fact small in size, have inadequate foreign exchange revenue and buffers, limited fiscal space and other macroeconomic vulnerabilities. Incidentally, over-reliance on tourism is a feature of countries that have been less successful in other exports and are suffering from such features. Such tourism-dependent countries have a relatively low level of export complexity that affects their options for new product development. Development of new products requires the expansion of the productive knowledge and capacities. Tourism is not an industry that enhances the technological capacity of a country and is highly vulnerable to external shocks. In the aforementioned publication, the IMF shows the prudence of tourism-dependent countries (which includes Sri Lanka) to nurture other goods and services export sectors using new digital economy tools or focus on overall export development. As suggested in this report, in the medium-term, Sri Lanka should re-think its tourism model and undertake necessary structural reforms.

Conclusion

It is expected that the tourism sector will provide an impetus for post-pandemic recovery of the Sri Lankan economy despite the impact of geo-political tensions and the challenging domestic socio-political environment. Concerted efforts by the Government and the private sector to create, and not just adapt to, a new normal would be necessary. In this endeavour, travel advisories issued by some governments based on the recent economic situation of Sri Lanka have to be countered by Sri Lankan authorities through better engagement. The recovery in the industry will depend on how well it will cater to the needs of the modern traveller, preparedness to possible supply and energy shortages, and sound management of finances in post-moratorium stages. From a marketing perspective, there is further potential for attracting tourists for diversified interests such as meditation and younger groups for medical and historical research. Both SLTDA and private tour operators need to encourage these specific groups of tourists to visit Sri Lanka offering attractive packages compared to peers in the region. With the waning of the pandemic, it is expected that the tourism sector could play a significant role in the economic revival of Sri Lanka.

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process. Meanwhile, several strategic efforts were taken to promote the country to attract a worldwide audience, focusing on novel areas. In this regard, the Sri Lanka Tourism Promotion Bureau (SLTPB) launched a five-year global communication campaign in March 2021 and initiated the promotion of film tourism for Indian cinema in October 2021. Moreover, the World Expo 2020, which was held from 1 October 2021 until 31 March 2022 in Dubai, provided an opportunity for Sri Lanka to promote trade, investment, and tourism. In 2021, several new themes were added to Sri Lanka tourism for the first time, such as the digital nomads initiative and the digital program 'Go on a Couch Safari' that livestreamed wildlife in Sri Lanka to enhance online engagement. Aggressive tourism promotions led Sri Lanka to achieve several accolades from world renowned tourism organisations as one of the best destinations to travel during 2021 by Condé Nast, Travel and Leisure magazine, CNN travel, etc. and it ranked as a top destination for wellness tourism and ranked second in Women Solo Travel Index.

Transport, Telecommunications, Computer and Information Services and Other Services

The IT/BPO sector performed well during 2021 surpassing the US dollar 1 billion mark. Freight transport services recorded a positive growth in 2021 after significant disruptions to sea freight transport services in 2020 due to the pandemic. Although ship traffic to the country's ports declined marginally in 2021, there was a notable increase in total container handling including domestic container handling, transshipments and restowing operations. Total cargo handled in terms of cargo loaded and cargo discharged also increased during the year. This was coupled with higher global cargo handling rates, resulting in higher freight related charges for both imports and exports of the country. Meanwhile, there was a notable reduction in earnings from air passenger services due to the decline in tourist arrivals with the pandemic. Passenger services outflows also reduced as a result of constrained travel opportunities for Sri Lankans to travel in non-resident airlines owing to the pandemic. Other services subsectors, including financial services, construction services, government services and other business services recorded modest net outflows in 2021. Accordingly, the surplus in the services account increased to US dollars 1.6 billion in 2021, compared to US dollars 0.8 billion in 2020. However, the surplus levels in the services account in 2020 and 2021 were significantly low compared to pre-Easter Sunday attacks level, mainly due to lower earnings from tourism.

5.2.3 Primary Income

The primary income account deficit recorded a contraction in 2021, as a result of the reduced interest payments on foreign loans, coupon payments on account of investments in government securities and dividend payments of DIEs, despite an increase in reinvested earnings of DIEs. Interest payments on foreign loans of the Government, private sector and the state owned business enterprises (SOBEs) declined during the year, while interest payments by deposit taking corporations to non-residents recorded a modest increase during the year. A decline in interest payments of foreign loans of the Government was observed, with the Government gradually moving to low cost concessional funding, while some short term commercial loans were gradually being paid off. Further, there was a significant decline in coupon payments of international sovereign bonds (ISBs) to non-residents due to the change in a part of the ownership of ISBs from non-residents to residents as well as due to the maturity of ISBs in 2020 and 2021, with no new issuances. However, an increase in reinvested earnings was observed in 2021 compared to 2020. Meanwhile, inflows to the primary income account declined, primarily due to the decrease in investment income on account of international reserves in 2021. With these developments, the deficit in the primary income account is estimated to be US dollars 2.0 billion in 2021, compared to US dollars 2.2 billion in 2020.

5.2.4 Secondary Income

The secondary income account weakened as a result of the moderation in workers' remittances in 2021. Workers' remittances, which recorded a healthy growth in the first five months of 2021 recorded a gradual decline from June 2021 onwards. This resulted in a decline of workers' remittances of 22.7 per cent in 2021 compared to a growth of 5.8 per cent recorded in 2020. The decline could primarily be attributed to the reduction in remittances received through official channels due to the notable difference in the exchange rate which prevailed in the grey market compared to the official rate. With these developments, net inflows to the secondary income account decreased to US dollars 5.2 billion in 2021 compared to US dollars 6.2 billion in 2020. A notable recovery in remittances is expected in 2022 with the sharp depreciation in the exchange rate since March 2022, together with the increasing number of migrant workers leaving for foreign employment. In order to facilitate workers' remittances through the banking sector, the Central Bank established a new department named the 'Foreign Remittances Facilitation Department' while also introducing a number of incentive schemes for workers remitting money through the banking sector. Further, a mobile application to facilitate the convenient transfer of remittances named 'Lanka Remit' was launched by LankaClear with the participation of most Licensed Commercial Banks (LCBs). A temporary monetary incentive above the official exchange rate was provided for remittances converted into rupees while several other incentive schemes are in the pipeline to be introduced to promote workers' remittances focusing on improved welfare of migrant workers and their families.

5.3 Capital Account Balance

Net inflows to the capital account remained broadly unchanged in 2021. Capital transfers to the Government reduced, while those to the private sector recorded an increase in 2021, compared to the previous year. Consequently, the capital account recorded a surplus of US dollars 25 million in 2021 compared to a surplus of US dollars 28 million recorded in 2020.

BOX 6

The Impact of Informal Money Transfers on Financial Markets and the Economy

Introduction

Efficient and safe movement of funds within a country and across the borders is an important component of the financial system of a country. This is more important for cross border transfers where foreign exchange is involved. Usually, a vast majority of these transactions occur through formal channels. However, in any economy, in varying sizes, there exist informal money transfer channels mainly for cross border transactions. The extent of informal channels and the use of formal channels by money remitters depends on the characteristics of a particular economy and financial market and the legitimacy of such transactions. Formal channels consist of the services provided by licensed and regulated entities such as financial institutions. Informal channels consist of participants of the unregulated markets such as Hawala, Hundi or Undiyal (in South Asia), Fei Qian or Chit (in South East Asia) and Black-market Peso (in European countries) service providers who have not been licensed to perform money remittance services in several countries. However, at present, certain countries with informal money transfer channels such as Germany, United Kingdom and United States of America pursue regulatory approaches in registration and licensing such service providers along with imposing anti-money laundering requirements. Hawala channels have been continuously used in moving the value of money from one place to another, without the physical movement of funds, since ancient times, when there were no formal banking channels. However, such informal channels still exist today, even though banking transactions have been made ultra-easy, as convenient as effecting by using a mobile app. These informal remitting services are used for legitimate as well as illegitimate purposes by various individuals, groups and entities. Such services are heavily exploited for criminal activities, even including laundering of money and financing of terrorism. For instance, Hawala channels were used to finance the activities that led to the deadly terrorist attack on the US World Trade Centre in 2001. Some favourable characteristics such as low cost of transactions, easy access, less paperwork, and quick transfers make these channels popular among remitters. However, being an informal business with the involvement of possible criminal activities, the possibility of losing money makes them a risky channel. Most importantly, these channels are highly vulnerable to misuse by money launderers and terrorist financiers. These types of informal and illegitimate payment channels could be detrimental to the smooth functioning of financial systems and economic activity of a country, as they move economic resources from the formal sector to the informal sector of an economy. This article intends to shed light on the adverse impacts of informal money remittance channels on financial systems and the economy of a country. Since all these informal remittance channels have more or less the same characteristics, the article will focus on the mainly used channel in Sri Lanka, namely Hawala, and refer to it as Hawala channels or informal channels alternatively.

Introduction to Hawala Transactions

These remitting channels work as network arrangements and can be sometimes found within a particular community in the society. In these arrangements, the value transfers are facilitated by agents belonging to these networks who are located all over the world. In the Hawala channels, the Hawala agents or dealers (also known as Hawala Dars) live in different countries and settlements of transactions occur completely based on trust. An agent in one country collects money from people who need to send money to another country and the agent in that particular country settles those amounts to the intended recipients in the currency they desire. Accordingly, there is no physical cash movement across the borders, no financial institutions are involved in cross border transactions, and no transactions are properly recorded under these channels. However, financial institutions may be involved in the event domestic fund transfers are required.

Users of Hawala Channels

Hawala is used for both legitimate as well as illegitimate purposes by different economic agents. These include, a) foreign workers remitting money for families in their native countries, b) traders paying funds for goods imported and receiving funds for goods exported, c) parents transferring funds for their children's foreign education, d) people who live in areas with less developed banking channels that provide remittance services, e) migrants without proper visa remitting funds and, f) illegitimate users such as money launderers and terrorist financiers.

Main Features of Hawala Channels

Hawala and informal channels have special features, which make these remitting channels attractive for users. Some of those features are as follows. ***Accessibility***: informal channels have subtly penetrated every corner of the world and made their way into most economic activities including remote areas where formal banking facilities are limited or not available. ***Affordability***: charges associated with fund remittances through formal banking channels are expensive when compared to the commissions involved in Hawala. Also, usually, the exchange rate offered by Hawala agents is more attractive than that of authorised dealers in foreign exchange. ***Speed:*** there are no cross border movements of currency in these informal channels and the amount equivalent to the foreign currency value is locally settled either by depositing funds to an account of the recipient or by settling in cash. In some instances, the recipients receive the money within a couple of hours and some have the option to receive money to their doorstep upon revealing the password to the respective Hawala agent. **Convenience:** these informal arrangements are

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convenient from the remitter's perspective as in countries where there are many expatriate Sri Lankan workers, such as Kuwait, South Korea and the Maldives, these agents possess mechanisms to collect salaries from the workers at the work premises itself, for the purpose of sending it to their families. ***Possible anonymity:*** this is the most appealing feature of Hawala. No paper or documentary proof is required for these arrangements. Hence, it is an indirect invitation for people who need to maintain secrecy in their transactions. Further, the legitimacy of the source of funds is not questioned by service providers since these agents are not subject to any regulatory supervision. In general, the more exchange and monetary restrictions and controls, the higher would be Hawala and Undial activities as customers in the formal sector also tend to patronize these services.

Money Laundering and Terrorist Financing Through Hawala Channels

Informal money remitting channels provide a convenient platform for illegal money transfers through money laundering and terrorist financing activities. *Money laundering* is simply the conversion of money generated from illicit crimes into legally accepted money. The process of money laundering involves the following three steps. The first step is the *placement* where proceeds of the illicit crime are placed in the financial channel, i.e., in bank accounts. The second step is *layering*, which involves a series of transactions involved to conceal the origin of the proceeds of the illicit crime. The final step is *integration* where proceeds of the illicit crime are absorbed into the economy. *Terrorist financing* is the act of funding terrorist activities and/or organisations. The source of financing terrorism can be legal or illegal. Continuous inflows to backup terrorist activities are a must to continue the agendas of terrorist groups. Hence, different avenues are misused by terrorists for their funding needs.

There are several ways in which Hawala channels support money laundering and terrorist financing. The absence of a regulatory framework to control and identify any drawbacks and negative consequences of these channels is one of the key factors making them vulnerable to money laundering and terrorist financing. The absence of proper record retention procedures by these agents is another supportive factor. Compared to the banking sector, the lack of attention to the source and use of funds during these transactions also encourage money launderers and terrorist financiers. The difficulty to initiate legal proceedings is another notable feature.

Risks of Using Informal Channels

Many innocent people get caught in law enforcement investigations as a result of their choice to use Hawala channels to transfer funds arising from otherwise lawful and legitimate transactions. Hawala does not often utilise any sort of negotiable instrument or wire transfer. Instead, transfers of money take place based on communications between members of Hawala dealers. Hence, there is no way to prove the transaction and there is a high possibility of losing all the hard earned money that needs to be transferred. Sometimes Hawala dealers are directly or indirectly involved in criminal activities such as fraud and drug trafficking to balance books. Hence, there is a high possibility of law enforcement agencies investigating Hawala dealers. In such an instance, people who innocently or unknowingly use Hawala channels may also be inquired by authorities.

Impact of Hawala on Financial Markets, the Economy and the Country

Informal cross border transactions could have negative impacts on financial markets, the economy and the national security of a country. Following are some of the main areas that could have an impact by having sizeable informal cross border channels:

Lower Tax Income

Hawala channels allow individuals or entities to transfer money through informal channels, thus facilitating tax evasion. The government incurs losses from direct taxes in the form of income, taxes as well as indirect taxes related to such transactions. Since the transactions carried out through Hawala channels are not being recorded, and due to the unavailability of such information to the local tax authorities, the income of the parties involved in the transactions along with the income of Hawala agents are excluded from the tax income of a country. Further, indirect taxes relating to transactions carried out through formal systems, such as registration fees and other service taxes are avoided, thereby negatively affecting government income. Hawala transactions are also used by importers and exporters of a country for the purpose of avoiding taxation on goods. For example, an importer could request the overseas exporter to underquote the invoices thereby reducing the tax to be paid to the government by the importer. The difference between the actual cost and the invoiced cost could then be settled through Hawala channels, which would be unnoticed by the tax authorities.

Impact on Balance of Payments (BOP) and Foreign Reserves of a Country

Workers' remittances have become a significant component in foreign inflows and the balance of payments in emerging economies like Sri Lanka. When workers remit foreign earnings through informal channels such as Hawala, such earnings are not reflected in the calculation of BOP. This is relevant to several other components reported in BOP, such as merchandise trade. Accordingly, BOP statistics will not reflect the true position of the external sector of a country. Further, since foreign reserves of a country are accumulated through the transfer of funds via formal channels, Hawala transfers will not help in building up foreign reserves of a country, in fact, it could deplete reserves due to the possible switch between formal and informal channels.

Impact on Money Supply

The direct effect on broad money of an economy is almost zero for Hawala transactions as there is no physical movement of cash. However, the composition of broad money of the recipient country can be affected by Hawala transactions due to the cash centric nature of the transactions as there could be a decline in bank deposit accounts (savings and time deposits) in favor of cash transactions. The negative impact of Hawala channels on the banking sector and the development of a cash economy which could create instability of demand for money would limit financial intermediation and affect monetary transmission mechanisms causing inefficiency in monetary policy.

Impact on Financial Intermediation

The leakage of money from the banking system could constrain the availability of banking resources. It could also cause an increase in market interest rates when banks attempt to attract deposits by offering higher interest rates. Further, the essential functions of financial intermediation are threatened by alternative informal money transfer channels. Banks may also lose their market share due to an increase in the Hawala network.

Impact on National Security

The existence of informal channels is a challenge for national security agencies since several large terrorist attacks in the world have been partially funded by such channels. Hawala is a form of underground banking method, which is considered a threat to the effectiveness of the fight against terrorist financing since certain sources of terrorist financing are channeled through informal mechanisms. Accordingly, every effort should be made to stop expanding these channels and to stop terrorists using Hawala channels.

Sri Lanka and Hawala Channels

The Growth of Informal Money Transfer Channels

It has been observed that workers' remittances in Sri Lanka fell notably in 2021 mainly due to fewer worker departures for foreign countries during the pandemic and the expansion of Hawala channels due to large exchange rate differentials between the formal market and the grey market. Migrant workers have been incentivised to switch to Hawala channels by the premium paid on the foreign exchange conversion rate by Hawala agents. The drastic drop in workers' remittances in 2021 negatively affected the BOP position in Sri Lanka. It has been reported that Sri Lankan importers too use Hawala channels to pay their import bills because of the shortage of foreign currency supply in formal channels arising from exchange rate differentials even though the use of Hawala channels to obtain foreign currency is expensive. Overall, the popularity of Hawala channels in recent times has deprived the country from receiving crucial flows of foreign currency through formal channels, thus dampening the supply of foreign exchange, and shrinking foreign currency reserves creating BOP concerns. Thus, the expansion of Hawala channels poses a significant threat to the BOP position in Sri Lanka. However, if formal channels can continuously maintain a competitive exchange rate based on market demand and supply, the demand for informal remittance channels is expected to be contained, as the exchange rate differential is expected to reduce substantially.

Recent Actions Taken against the Hawala Channels

Efforts to contain the expansion of Hawala channels in the island were strengthened in 2021, in view of the severe threats they pose to the economy, as discussed earlier. Public awareness sessions, including newspaper advertisements and articles, to increase the level of understanding of the public on the risk of Hawala type transactions, were conducted. Funds of accounts involved in such transactions were seized until investigations into their possible connections with unlawful activities are concluded. Further, financial incentives such as offering extra rupees to encourage foreign workers to remit their earnings through formal channels such as banks and other financial institutions were introduced. Moreover, other incentives such as retirement benefits and loan facilities for foreign remitters were also proposed with a view to promoting formal remittance channels and discouraging the use of informal channels.

Way Forward

The existence of Hawala channels poses a great risk to the global economy and the threat of vast expansion of these channels has been addressed by different countries by employing varied tactics. In India, Hawala transactions are restricted by prohibiting the making of any payment to any person outside India without conditional approval from the Reserve Bank of India (RBI). In addition, the RBI has implemented actions to enhance the quality of formal financial services such as establishing branches of commercial banks in rural areas to access the formal financial sector and permitted the non-bank financial sector to access Money Transfer Service Schemes to contain the impact of Hawala channels. Subsequently, the Indian Government enacted The *Financial Exchange Management Act* in the 1970s. Pakistan took steps towards the transformation of money changers to foreign exchange companies in which they were given a two year period to register and comply. The publication made by the Financial Action Task Force titled *The Role of Hawala and other Similar Service Providers in ML/TF* in 2013, clearly explains strategies to identify unregulated Hawala and other similar service providers and possible avenues to create incentives to formalise their business. At present, authorities plan to pursue steps to implement an appropriate legal framework to monitor and legalise Hawala channels in Sri Lanka.

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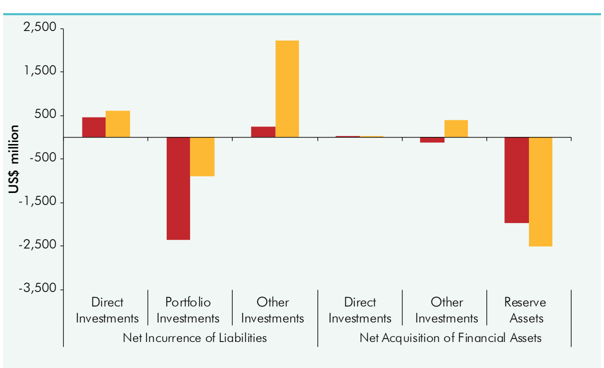
5.4 Financial Account

In the financial account of the BOP, the net incurrence of liabilities increased while the net acquisition of assets recorded a significant reduction during 2021. The net incurrence of liabilities recorded an increase of US dollars 1.9 billion in 2021 compared to a reduction of US dollars 1.7 billion in 2020. Reflecting the continued uncertainty driven by the COVID-19 pandemic as well as domestic circumstances, FDIs including foreign loans to DIEs remained modest in 2021, similar to the previous year. As a result, FDIs, including foreign loans to DIEs, amounted to US dollars 784 million in 2021, in comparison to US dollars 670 million in 2020. Further, FDIs, excluding foreign loans to DIEs, amounted to US dollars 598 million in 2021, in comparison to US dollars 434 million recorded in 2020. On a sector wise basis, major FDIs were received by projects related to telecommunications, property development, textiles and hotels sectors, while such FDIs were primarily received by already established DIEs. Despite the moderation in FDIs in 2021, going forward, FDIs are anticipated to materialise particularly to the Colombo Port City and the Hambantota port project. Further, efforts are also underway to monetise underutilised assets under the Urban Development Authority, which will also contribute to the FDI flows to the country.

Figure 5.11
Financial Account



Source: Central Bank of Sri Lanka

The main financial inflows to the Government during 2021 included the receipt of two foreign currency term financing facilities from the China Development Bank (CDB) in April and September 2021 totalling around US dollars 810 million. In addition, investments in the form of debt securities,

Table 5.9.A
Financial Account

US$ million

Item	2020 (a) Net Acquisition of Financial Assets	2020 (a) Net Incurrence of Liabilities	2021 (b) Net Acquisition of Financial Assets	2021 (b) Net Incurrence of Liabilities
Financial Account	-2,113	-1,718	-2,122	1,907
Direct Investment	15	434	17	598
Equity and Investment Fund Shares	10	211	13	317
Equity other than Reinvestment of Earnings	7	20	9	27
Direct Investor in Direct Investment Enterprise	7	20	9	27
Reinvestment of Earnings	3	191	4	290
Debt Instruments	4	223	5	281
Direct Investor in Direct Investment Enterprise	4	223	5	281
Portfolio Investment	-	-2,383	-	-906
Equity and Investment Fund Shares	-	-217	-	-236
Debt Securities	-	-2,166	-	-670
General Government	-	-2,166	-	-670
Short Term (Treasury Bills)	-	-122	-	-2
Long Term	-	-2,044	-	-668
Treasury Bonds	-	-431	-	-25
Sri Lanka Development Bonds	-	22	-	-2
Sovereign Bonds	-	-1,635	-	-640
Issuances	-	-	-	-
Maturities	-	-859	-	-700
Secondary Market Transactions	-	-776	-	60
Financial Derivatives	-	-	-	-
Other Investment	-136	231	387	2,216
Currency and Deposits	64	-15	306	4,016
Central Bank	-	400	-	1,375
Short Term	-	...	-	1
Long Term	-	400	-	1,374
Deposit-taking Corporations	64	-415	306	2,641
Short Term	259	-415	256	2,641
Long Term	-194	-	50	-

Continued on page - 167

Memorandum Items	2020 (a)	2021 (b)
Foreign Direct Investment (FDI)		
Equity	20	27
Reinvestment of Earnings	191	290
Intercompany Loans	223	281
Total FDI (1)	434	598
Loans to BOI Companies (2)	236	187
Total FDI, Including Loans to BOI Companies (1 + 2)(c)	670	784
Total Net Inflows to the CSE	-225	-238
Direct Investment	-8	-2
Portfolio Investment	-217	-236
Net Foreign Investments in Rupee Denominated Government Securities (Treasury Bills and Bonds)	-553	-27
Foreign Purchases	120	17
Foreign Sales	673	44

(a) Revised
(b) Provisional
(c) Any difference with the estimates of BOI is due to differences in coverage and compilation methodologies.

Source: Central Bank of Sri Lanka

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which mainly consist of foreign investments in ISBs and rupee denominated government securities, recorded a net outflow of US dollars 670 million in 2021. This was due to the net impact of the maturity of an ISB of US dollars 1.0 billion in July 2021, of which, US dollars 700 million was owed to non-residents, net sales of foreign investment in the rupee denominated government securities market and net purchases related to Sri Lanka's ISBs made by non-residents from the secondary market during the year. The Central Bank received a quantum of inflows, including the receipt of the SDR allocation from the IMF in August 2021 (around US dollars 787 million), and the proceeds from the bilateral currency swap facility with the Bangladesh Bank in August and September 2021 (US dollars 200 million). Further, the Central Bank entered into a bilateral swap facility equivalent to approximately US dollars 1.5 billion with the PBOC in March 2021, which was activated in December 2021. Further, during the year, the Central Bank settled a swap facility with the RBI amounting to US dollars 400 million that was obtained in 2020. Meanwhile, financial inflows to the private sector remained modest in 2021. As such, portfolio investments in the form of equity, which consist of foreign residents' investments in the Colombo Stock Exchange (CSE), other than direct investment transactions, recorded a net outflow of US dollars 236 million in 2021, compared to a net outflow of US dollars 217 million in 2020. Further, foreign loan inflows to the private sector and SOBEs also recorded a modest net outflow in 2021. Meanwhile, in terms of foreign inflows to the banking sector, currency and deposits recorded a significant net increase, while there was notable net settlements of short term foreign loan liabilities of the banking sector. The net incurrence of liabilities of trade credit and advances declined, primarily due to net settlements of oil bills by the Ceylon Petroleum Corporation as a result of lower demand for fuel during the pandemic periods. Further, other accounts payable, mainly consisting of Asian Clearing Union (ACU) liabilities managed by the Central Bank, recorded a net increase in 2021.

Table 5.9.B
Financial Account

US$ million

Item	2020 (a) Net Acquisition of Financial Assets	2020 (a) Net Incurrence of Liabilities	2021 (b) Net Acquisition of Financial Assets	2021 (b) Net Incurrence of Liabilities
Other Investment (Continued from page - 166)				
Loans	-	174	-	-1,552
Central Bank	-	-14	-	-57
Credit and Loans with the IMF	-	-14	-	-57
Extended Fund Facility	-	-14	-	-57
Deposit-taking Corporations	-	75	-	-2,152
Short Term	-	403	-	-2,169
Long Term	-	-328	-	17
General Government	-	169	-	664
Long Term	-	169	-	664
Other Sectors (c)	-	-56	-	-7
Long Term	-	-56	-	-7
Trade Credit and Advances	-224	185	257	-428
Deposit-taking Corporations	9	-	-3	-
Short Term	9	-	-3	-
Other Sectors (d)	-233	185	260	-428
Short Term	-233	185	260	-428
Other Accounts Receivable/Payable	24	-114	-176	180
Central Bank	-	-114	-	180
Short Term (e)	-	-114	-	180
Deposit-taking Corporations	24	-	-176	-
Short Term	24	-	-176	-
Special Drawing Rights	-	-	-	787
Reserve Assets	**-1,992**		**-2,526**	
Monetary Gold	-667		-212	
Special Drawing Rights	-5		123	
Reserve Position in the IMF	-		-	
Other Reserve Assets	-1,319		-2,437	
Currency and Deposits	-177		1,536	
Claims on Monetary Authorities	-1,092		1,055	
Claims on Other Entities	914		481	
Securities	-1,143		-3,976	
Debt Securities	-1,143		-3,976	
Long Term	-1,143		-3,976	
Other Claims	1		3	
Financial Account (net)	**-394**		**-4,029**	
Memorandum Items				
Long Term Loans to the Government (net)	169		664	
Inflows (Disbursements)	1,882		2,418	
Project Loans	1,382		1,608	
Foreign Currency Term Financing Facilities	500		810	
Repayments	1,713		1,754	

(a) Revised
(b) Provisional
(c) Includes State Owned Business Enterprises (SOBEs) and private sector companies
(d) Includes trade credits received by the Ceylon Petroleum Corporation (CPC) and other private companies
(e) Net transactions of Asian Clearing Union (ACU) liabilities

Source: Central Bank of Sri Lanka

Net acquisition of financial assets recorded a significant reduction, reflecting the decline in gross official reserves in 2021. Net acquisition of financial assets declined by US dollars 2.1 billion in

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2021, mainly due to the reduction in foreign assets of the Central Bank. Gross official reserves declined by US dollars 2.5 billion during the year due to sizeable foreign debt service payments of the Government, honouring of maturing liabilities of the Central Bank as well as the significant supply of foreign exchange by the Central Bank to facilitate imports of essential items including fuel, LP gas, coal, medicine and essential food items, particularly during the latter part of 2021. However, net acquisition of assets in the form of currency and deposits of deposit taking corporations and the net acquisition of assets on trade credit and advances, which represents trade credit and advances given by Sri Lankan exporters to their overseas trading partners, increased during the year while other accounts receivable of LCBs recorded a net decrease during the year.

Table 5.10
Major Projects Financed with Foreign Borrowings during 2021

Lender and Project	Amount Disbursed US$ million
Government Projects - Total	**1,608**
of which;	
Asian Development Bank	**613**
of which;	
Integrated Road Investment Programme	221
Secondary Education Sector Improvement Programme	52
Mahaweli Water Security Investment Programme	42
International Development Association	**294**
of which;	
Climate Resilience Improvement Management	36
Strategic Cities Development Project	28
Government of Japan	**135**
of which;	
New Bridge Construction Project over the Kelani River	51
National Transmission and Distribution Network Development and Efficiency Improvement Project	34
International Bank for Reconstruction & Development	**131**
of which;	
COVID-19 Emergency Response & Health Systems Preparedness Project	54
Primary Health Care System Strengthening Project	42
Export-Import Bank of China	**126**
of which;	
Kandy North Pathadumbara Integrated Water Supply Project	54
Construction of Extension of Southern Expressway	36
Widening and Improvement of Roads and Reconstruction of Bridges in Central and Uva Provinces	34
Export Import Bank of India	**81**
of which;	
Dollar Credit Line for the Development of Railway Sector	80
Agence Francaise De Development	**27**
of which;	
Implementation of Ambatale Water Supply Project	10
Asian Infrastructure Investment Bank	**22**
of which;	
Support to Colombo Urban Regeneration Projects	19
Co-op Centrale Raiffeisen-Boerenleenbank	**22**
of which;	
Development of General Hospital Kaluthara	13

Source: Ministry of Finance

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5.5 Overall Balance

The overall balance of the BOP, which represents the change in net international reserves, continued to record a significant deficit in 2021. Gross official reserves declined notably in 2021, due to the continued moderation of inflows to the financial account, substantial external debt service payments and net sales to the domestic foreign exchange market by the Central Bank during the year. Consequently, net international reserves recorded a deficit by end 2021, resulting in the overall balance also recording a deficit of around US dollars 4.0 billion in 2021, compared to a deficit of US dollars 2.3 billion in 2020.

5.6 International Investment Position

In terms of the International Investment Position (IIP), Sri Lanka's external liability position increased, while the external asset position declined by end 2021 from end 2020. Accordingly, the country's external liability position increased to US dollars 64.5 billion at end 2021 from US dollars 58.6 billion at end 2020, while the country's external asset position declined to US dollars 8.8 billion at end 2021 from US dollars 10.9 billion reported at end 2020. Consequently, the net liability position of the IIP increased to US dollars 55.7 billion at end 2021 from US dollars 47.7 billion at end 2020.

Sri Lanka's external asset position with non-residents recorded a significant decline during 2021. The stock position of external assets decreased primarily due to the decline in gross official reserves from US dollars 5.7 billion as at end 2020 to US dollars 3.1 billion at end 2021.[1] Meanwhile, the direct investment asset position that represents direct investments abroad by Sri Lankan residents increased marginally during the year. The asset position of deposit taking corporations in the form of currency and deposits increased, while other accounts receivable recorded a decrease. Meanwhile, the outstanding asset position of trade credit and advances given to non-residents by the private sector increased by end 2021 from the position observed at end 2020.

Sri Lanka's total liability position to non-residents, as reflected in the IIP, also increased significantly by end 2021. This is mainly due to the increase in direct investment liabilities, increase in currency and deposit liabilities of the Central Bank and deposit taking corporations as well as the increase in liabilities resulting from the SDR allocation. The liability position of outstanding direct investments in the form of equity increased by about US dollars 4.0 billion due to substantial valuation gains in a few major equity positions of non-resident companies listed in the CSE. These equity gains were prominent in some companies in particular, as the equity position increased substantially from the beginning of the year, resulting in significant valuation gains for these non-resident investors by the end of 2021. Further, the Central Bank's currency and deposits liability position increased by end 2021, as a combined effect of entering into new bilateral currency swap arrangements with PBOC amounting to CNY 10 billion (equivalent to around US dollars 1.5 billion) and the Bangladesh Bank (US dollars 200 million) and the settlement of the SAARCFINANCE swap facility with the RBI (US dollars 400 million) during the year. Meanwhile, the currency and deposits liability position of the deposit taking corporations also increased by end 2021. Further, the SDR liability position also increased

[1] Section 5.6.1 provides a detailed analysis on the reserve asset position.

Table 5.11
International Investment Position

US$ million
(End period position)

Item	2020 (a)		2021 (b)	
	Assets	Liabilities	Assets	Liabilities
Direct Investment (c)	1,509	13,655	1,522	17,891
Equity and Investment Fund Shares	1,473	8,665	1,482	12,626
Debt Instruments	36	4,990	40	5,264
Portfolio Investment	...	8,579	...	7,508
Equity and Investment Fund Shares		867		1,148
Other Sectors		867		1,148
Debt Securities (d)	...	7,712	...	6,360
Deposit-taking Corporations	...		...	
Short Term	...		...	
General Government		7,616		6,266
Short Term		4		1
Long Term		7,613		6,265
Other Sectors		96		94
Long Term		96		94
Financial Derivatives	-	-	-	-
Other Investment	3,710	36,340	4,096	39,100
Currency and Deposits	835	1,734	1,142	5,749
Central Bank		400		1,775
Short Term		...		1
Long Term		400		1,774
Deposit-taking Corporations	835	1,333	1,142	3,974
Short Term	622	1,333	878	3,974
Long Term	214		264	
Loans		31,353		29,585
Central Bank		1,378		1,265
Credit and Loans with the IMF		1,378		1,265
Deposit-taking Corporations		5,324		3,172
Short Term		4,174		2,005
Long Term		1,150		1,167
General Government		20,570		21,077
Long Term		20,570		21,077
Other Sectors (e)		4,081		4,071
Long Term		4,081		4,071
Trade Credit and Advances	954	2,341	1,211	1,913
Deposit-taking Corporations	101		98	
Short Term	101		98	
Other Sectors (f)	853	2,341	1,113	1,913
Short Term	853	2,341	1,113	1,913
Other Accounts Receivable/Payable	1,920	343	1,744	523
Central Bank (g)		343		523
Short Term		343		523
Deposit-taking Corporations	1,920		1,744	
Short Term	1,920		1,744	
Special Drawing Rights (SDRs)		570		1,330
Reserve Assets	5,664		3,139	
Monetary Gold	409		175	
Special Drawing Rights	3		124	
Reserve Position in the IMF	69		67	
Other Reserve Assets	5,184		2,773	
Currency and Deposits	2,210		2,729	
Claims on Monetary Authorities	861		899	
Claims on Other Entities	1,350		1,830	
Securities	2,974		44	
Debt Securities	2,974		44	
Total Assets / Liabilities	10,883	58,574	8,758	64,498
Net International Investment Position		-47,691		-55,740
Memorandum Items				
IIP- Maturity-wise Breakdown	10,883	58,574	8,758	64,498
Short Term	6,184	9,062	6,804	9,564
Long Term	4,699	49,512	1,954	54,934

(a) Revised
(b) Provisional
(c) Includes direct investment position of BOI, CSE and other private companies
(d) Foreign currency debt issuances are based on market value while domestic currency issuances are based on book value.
(e) Includes loans outstanding position of project loans obtained by SOBEs.
(f) Includes outstanding trade credit position of Ceylon Petroleum Corporation and private sector companies.
(g) Outstanding position of ACU liabilities managed by the Central Bank

Source: Central Bank of Sri Lanka

by end 2021 with the new allocation of SDR by the IMF of around US dollars 787 million during the year. However, the portfolio investment liability position declined by end 2021 compared to that of end 2020, mainly with the repayment of the maturing ISB during the year and the decline in market prices of outstanding Government ISBs. The foreign loan liability position of the IIP also declined by end 2021, mainly contributed by the reduction in foreign loan liabilities of the Central Bank and deposit taking corporations. Nevertheless, the foreign loan liability position of the Government recorded an increase mainly in view of the two foreign currency term financing facilities obtained during the year. Further, outstanding trade credits received by Sri Lankan importers decreased, while the outstanding position of other accounts payable increased, with an increase in ACU related liabilities of the Central Bank during 2021.

5.6.1 Reserve Asset Position

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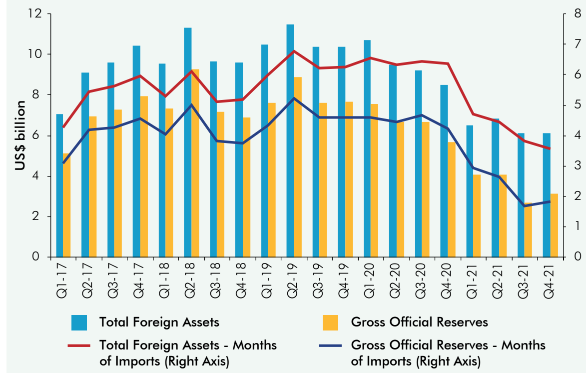
Gross official reserves (GOR) declined to US dollars 3.1 billion by end 2021 compared to US dollars 5.7 billion recorded at end 2020. The decline in GOR was a combined result of significant foreign currency debt service payments and the Central Bank intervention in the domestic foreign exchange market, in view of moderate foreign exchange inflows during the year. Major inflows that helped replenish GOR during the year included two foreign currency term financing facilities of around US dollars 810 million from the CDB, SDR allocation of approximately US dollars 787 million by the IMF and bilateral currency swap facilities with the PBOC of around US dollars 1.5 billion (CNY 10 billion) and with the Bangladesh Bank of US dollars 200 million. However, the substantial foreign currency debt service payments, including the repayment of maturing ISB (US dollars 1.0 billion), principal and interest payments related to foreign project

Figure 5.12
Quarterly Gross Official Reserves and Total Foreign Assets



Source: Central Bank of Sri Lanka

loans and foreign currency term financing facilities (US dollars 2.2 billion), capital and interest payments for Sri Lanka Development Bonds (SLDBs) and the loans from Offshore Banking Units (OBUs) (US dollars 2.3 billion), and the Central Bank's intervention in the domestic foreign exchange market by way of supplying foreign exchange to finance essential import bills, mainly contributed to the decline in the GOR level during the year. The end year GOR level was equivalent

Table 5.12
Gross Official Reserves, Total Foreign Assets and Overall Balance

US$ million (End period position)

Item	2017	2018	2019	2020	2021 (a)
1. Government Foreign Assets	488	817	386	155	177
2. Central Bank Foreign Assets	7,470	6,102	7,256	5,510	2,962
3. Gross Official Reserves (1+2)	**7,959**	**6,919**	**7,642**	**5,664**	**3,139**
4. Foreign Assets of Deposit-taking Corporations	2,478	2,664	2,760	2,856	2,983
5. Total Foreign Assets (3+4) (b)	**10,436**	**9,583**	**10,402**	**8,521**	**6,122**
6. Reserve Related Liabilities (c)	1,361	1,425	1,771	2,121	3,562
7. Net International Reserves (NIR) (3-6)	**6,597**	**5,495**	**5,871**	**3,543**	**-423**
8. Overall Balance (d)	**2,068**	**-1,103**	**377**	**-2,328**	**-3,967**
9. Gross Official Reserves in Months of:					
9.1 Import of Goods	4.6	3.7	4.6	4.2	1.8
9.2 Import of Goods and Services	3.8	3.1	3.7	3.7	1.8
10. Total Foreign Assets in Months of:					
10.1 Import of Goods	6.0	5.2	6.3	6.4	3.6
10.2 Import of Goods and Services	4.9	4.3	5.1	5.6	3.4

(a) Provisional
(b) Excludes foreign assets in the form of 'Direct investment abroad' and 'Trade credit and advances granted'
(c) The total outstanding debt of the Central Bank, excluding outstanding Special Drawing Rights (SDRs)
(d) Change in NIR position during the period

Source: Central Bank of Sri Lanka

to 1.8 months of imports (4.2 months of imports in 2020) and 23 per cent of the country's short term debt and liabilities on remaining maturity basis (43 per cent in 2020). Meanwhile, total international reserves, which comprise both GOR and foreign assets of the banking sector, also declined towards end 2021 mainly due to the decline in official reserves, although holdings of foreign assets of deposit taking corporations recorded a moderate increase. Total foreign assets of the country were equivalent to 3.6 months of imports by end 2021 compared to 6.4 months of imports in 2020.

5.7 External Debt and Debt Servicing

5.7.1 External Debt

Sri Lanka's total external debt position increased in 2021, mainly with the increase in the external debt of the Central Bank and deposit taking corporations. The total external debt of the country increased to US dollars 50.7 billion at end 2021 from US dollars 49.0 billion by end 2020. Although the total outstanding foreign loans of the Government recorded an increase during the year, mainly with the receipt of two foreign currency term financing facilities obtained from the CDB, the external debt stock of the Government, valued at the market price, declined from US dollars 28.2 billion at end 2020 to US dollars 27.3 billion at end 2021. This was a result of the combined effect of the decline in market prices of Sri Lanka's outstanding ISBs and the repayment of an ISB that matured in July 2021. A key reason for the reduction of the outstanding government external debt in 2021 was due to lack of new borrowings from international markets, while repayment of some external debt obligations of the Government had to be met by utilising Central Bank's reserves. Meanwhile, the outstanding external debt of the Central Bank increased significantly by end 2021 in comparison

Table 5.13
Outstanding External Debt Position

US$ million
(End period position)

Item	2020(a)	2021(b)
General Government	28,187	27,344
Short Term	4	1
Debt Securities	4	1
Treasury Bills (c)	4	1
Long Term	28,183	27,343
Debt Securities	7,613	6,265
Treasury Bonds (c)	31	8
Sri Lanka Development Bonds (d)	27	24
International Sovereign Bonds (e)	7,555	6,233
Loans	20,570	21,077
Central Bank	2,690	4,892
Short Term	343	524
Currency and Deposits	...	1
Other Accounts Payable	343	523
Asian Clearing Union Liabilities	343	523
Long Term	2,348	4,368
Special Drawing Rights (SDRs) Allocation	570	1,330
Currency and Deposits	400	1,774
Loans	1,378	1,265
Credit and Loans with the IMF	1,378	1,265
Extended Fund Facility	1,378	1,265
Deposit-taking Corporations	6,657	7,146
Short Term	5,507	5,979
Currency and Deposits (f)	1,333	3,974
Commercial Banks	1,333	3,974
Loans	4,174	2,005
Commercial Banks	4,174	2,005
Long Term	1,150	1,167
Loans	1,150	1,167
Commercial Banks	1,109	1,084
Other Deposit-taking Corporations	41	83
Other Sectors (g)	6,517	6,078
Short Term	2,341	1,913
Trade Credit and Advances (h)	2,341	1,913
Long Term	4,176	4,165
Debt Securities (e)	96	94
Loans	4,081	4,071
Private Sector Corporations	2,315	2,425
State Owned Business Enterprises and Public Corporations	1,766	1,646
Direct Investment: Intercompany Lending (i)	4,990	5,264
Gross External Debt Position	49,041	50,724
As a Percentage of GDP		
Gross External Debt	60.5	60.0
Short Term Debt	10.1	10.0
Long Term Debt	50.4	50.0
As a Percentage of Gross External Debt		
Short Term Debt	16.7	16.6
Long Term Debt	83.3	83.4
Memorandum Items		
Non-Resident Holdings of Debt Securities - Sectorwise Breakdown at Face Value	12,058	11,400
General Government	11,883	11,225
Treasury Bills	4	1
Treasury Bonds	33	9
Sri Lanka Development Bonds	27	24
International Sovereign Bonds	11,820	11,191
Other Sectors	175	175
Face Value of Total Outstanding ISBs	14,050	13,050
Outstanding ISBs Held by Non Residents	11,820	11,191
Outstanding ISBs Held by Residents (excluded from External Debt Statistics from December 2019 onwards)	2,230	1,859

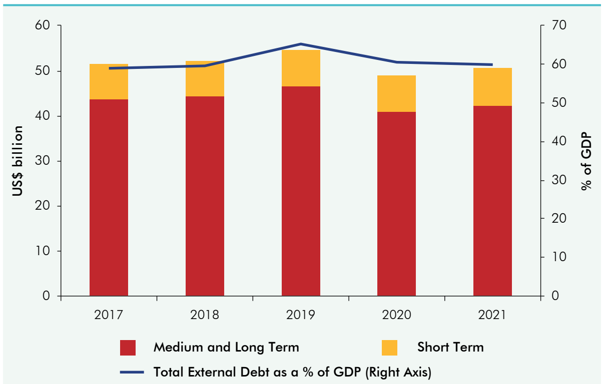
(a) Revised
(b) Provisional
(c) Based on book value
(d) Based on face value
(e) Based on market prices
(f) Includes deposits of non-resident foreign currency holders
(g) Includes private sector and State Owned Business Enterprises
(h) Includes trade credits outstanding of the Ceylon Petroleum Corporation and private sector companies
(i) Includes inter-company borrowings and shareholder advances of BOI registered companies

Source: Central Bank of Sri Lanka

to that of end 2020 due to the new bilateral currency swap arrangements with the Bangladesh Bank and the PBOC, although the international swap facility with the RBI obtained in 2020 was repaid during the year. The outstanding external debt of deposit taking corporations also increased owing to the significant increase in currency and deposits although the short term loans position declined markedly. Meanwhile, the outstanding external debt of the private sector corporations and SOBEs declined in 2021 with the reduction in outstanding trade credit received by the private sector and with the repayment of foreign loans of SOBEs, despite the increase in foreign loans obtained by the private sector corporations. Further, intercompany borrowing of DIEs recorded an increase during 2021, as a number of DIEs received intercompany loans and shareholder advances during the year.

The total outstanding external debt of the country as a percentage of GDP recorded a marginal decline during the year. The total outstanding external debt as a percentage of GDP stood at 60.0 per cent at end 2021, compared to 60.5 per cent reported at end 2020, reflecting the increase in nominal GDP during 2021 compared to 2020. The outstanding external debt position of the Government out of the total external debt position, declined to 53.9 per cent by end 2021 from 57.5 per cent recorded at end 2020. In terms of the debt maturity profile, debt with long term maturity declined marginally to 50.0 per cent of GDP by end 2021 compared to 50.4 per cent of GDP by end 2020.

Figure 5.13
External Debt



Source: Central Bank of Sri Lanka

5.7.2 Foreign Debt Service Payments

Despite the marginal increase in capital repayments, Sri Lanka's external debt service payments declined in 2021, compared to the previous year due to the reduction in interest payments. Capital repayments on external debt increased to US dollars 3.1 billion in 2021, compared to US dollars 3.0 billion recorded in 2020. Capital repayments in 2021 included the bilateral currency swap facility obtained from the RBI. Further, out of the US dollars 1 billion worth of ISBs that matured during 2021, US dollars 700 million were paid to non-residents upon maturity, while the remaining settlement was received by the residents. Capital repayments of foreign loans of the Government increased marginally during the year. Meanwhile, capital repayments of foreign loans by the private sector, SOBEs and deposit taking corporations declined considerably during the year, compared to the previous year. During the year, the Central Bank continued to repay the loan instalments related to the Extended Fund Facility obtained in 2016 from the IMF as a means of BOP support. Interest payments on external debt declined during the year to US dollars 1.4 billion, compared to US dollars 1.6 billion in 2020. This was mainly due to a decline in coupon payments of ISBs issued to non-residents, interest payments on foreign investments in the rupee denominated government securities market and interest payments on foreign loans of the Government during the year. Due to the combined effect of the increase in earnings from merchandise exports and services and the decline in external debt service payments in 2021

Table 5.14
External Debt Service Payments

US$ million

Item	2020 (a)	2021 (b)
1. Debt Service Payments	**4,604**	**4,498**
1.1 Amortisation	**3,004**	**3,111**
General Government	2,577	2,460
Project Loans	1,713	1,754
Debt Securities	864	706
Central Bank	14	457
IMF	14	57
International Swaps	-	400
Private Sector and Deposit-taking Corporations	412	193
Foreign Loans	412	193
1.2 Interest Payments	**1,601**	**1,388**
General Government	1,405	1,187
Project Loans	497	394
Debt Securities	908	793
Central Bank	19	15
IMF	18	15
International Swaps	2	1
Private Sector and Deposit-taking Corporations	167	175
Foreign Loans	167	175
Intercompany Debt of Direct Investment Enterprises	10	11
2. Earnings from Export of Goods and Services	**13,083**	**14,974**
3. Receipts from Export of Goods, Services, Income and Current Transfers	**20,398**	**20,587**
4. Debt Service Ratio		
4.1 As a Percentage of 2 above		
Overall Ratio	35.2	30.0
Excluding IMF Transactions	35.0	29.6
4.2 As a Percentage of 3 Above		
Overall Ratio	22.6	21.8
Excluding IMF Transactions	22.4	21.5
5. Government Debt Service Payments		
5.1 Government Debt Service Payments (c)	3,982	3,648
5.2 As a Percentage of 1 Above	86.5	81.1

(a) Revised
(b) Provisional
(c) Excludes transactions with the IMF

Source : Central Bank of Sri Lanka

compared to the previous year, total external debt service payments as a percentage of export of goods and services decreased to 30.0 per cent in 2021 from 35.2 per cent in 2020. The share of the Government's external debt service payments also declined to 81.1 per cent of the total external debt servicing in 2021 from 86.5 per cent in 2020.

5.8 Exchange Rate Movements

The Sri Lanka rupee was maintained broadly at stable levels during 2021 and in early 2022, before being allowed an adjustment in the exchange rate in early March 2022. The rupee exhibited some volatility exerting pressure to depreciate, particularly during the first four months of 2021 due to limited foreign currency liquidity in the domestic foreign exchange market. This was largely due to dried up foreign exchange inflows in the form of both debt and non debt flows amidst continued outflows to meet import bills and the debt servicing requirements of the Government. The Central Bank's intervention in the domestic foreign exchange market and the continued use of moral suasion helped stabilise the external value of the Sri Lanka rupee during the remainder of the year, and the first few months of 2022. Accordingly, with the engagement of the Central Bank, supported by the LCBs, the weighted average spot exchange rate in the interbank market remained broadly stable during the latter part of 2021 at around Rs. 200 - 203 per US dollar. As such, the annual depreciation of the rupee was limited to 7.0 per cent against the US dollar at end 2021, which helped mitigate the adverse consequences of excessive depreciation of the currency at the time the economy was on the verge of recovering from the devastating shock from the pandemic. The pressures observed in the domestic foreign exchange market could also be partly attributable to the inadequate conversion of foreign exchange earnings by foreign exchange earners. With the imposition of regulations on mandatory conversion requirements of export proceeds, the foreign exchange liquidity condition in the domestic market improved to a certain extent. Meanwhile, reflecting cross currency exchange rate movements, the Sri Lanka rupee appreciated against the Japanese yen (3.8 per cent) and the euro (1.1 per cent), and depreciated against the pound sterling (6.0 per cent) and the Indian rupee (5.5 per cent) during 2021. Furthermore, in the first two months of 2022, the Sri Lanka rupee remained broadly stable due to continued moral suasion. However, the pressures witnessed on the exchange rate amidst dried up

Table 5.15
Exchange Rate Movements

Currency	In Rupees per unit of Foreign Currency						Percentage Change over Previous Year (a)			
	End Year Rate			Annual Average Rate			End Year		Annual Average	
	2019	2020	2021	2019	2020	2021	2020	2021	2020	2021
Euro	203.67	229.42	226.86	200.14	212.07	235.10	-11.23	1.13	-5.62	-9.80
Indian Rupee	2.55	2.55	2.69	2.54	2.50	2.69	0.00	-5.45	1.46	-6.95
Japanese Yen	1.67	1.81	1.74	1.64	1.74	1.81	-7.54	3.82	-5.65	-3.96
Pound Sterling	238.46	254.35	270.60	228.20	238.22	273.51	-6.25	-6.00	-4.21	-12.90
US Dollar	181.63	186.41	200.43	178.78	185.52	198.88	-2.56	-7.00	-3.64	-6.72
Special Drawing Rights (SDR)	251.17	268.48	280.53	246.97	258.61	283.18	-6.45	-4.29	-4.50	-8.68
Effective Exchange Rate Indices (b) (c) (2017=100)	End Year Index			Annual Average Index			Percentage Change over Previous Year			
							End Year Index		Annual Average Index	
	2019	2020	2021	2019	2020	2021	2020	2021	2020	2021
NEER 24-currencies	86.74	83.12	79.65	88.17	85.93	78.64	-4.17	-4.18	-2.54	-8.48
REER 24-currencies	90.74	88.37	86.06	90.42	91.52	86.13	-2.61	-2.61	1.22	-5.90

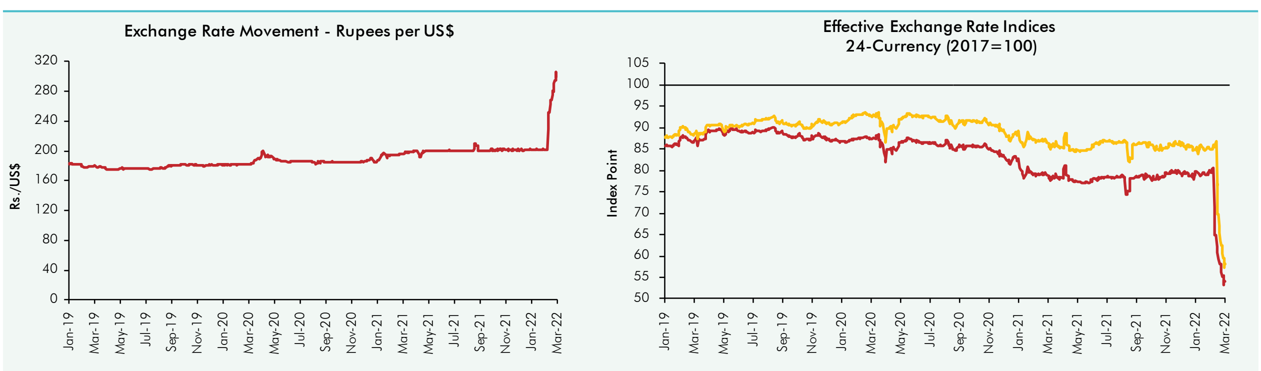
(a) Changes computed on the basis of foreign currency equivalent of Sri Lanka rupees. The sign (-) indicates depreciation of Sri Lanka rupee against each currency.
(b) The Nominal Effective Exchange Rate (NEER) is a weighted average of nominal exchange rates of 24 trading partner and competitor countries. Weights are based on the trade shares reflecting the relative importance of each currency in each of the currency baskets. The Real Effective Exchange Rate (REER) is computed by adjusting the NEER for inflation differentials with respect to each currency in the basket. A minus sign indicates depreciation. CCPI was used for REER computation.
(c) The exchange rate has been defined in terms of indices so that the appreciation/depreciation of the rupee relative to other currencies is directly reflected by a rise/fall in the values of the effective exchange rate indices, respectively.

Source: Central Bank of Sri Lanka

liquidity in the domestic foreign exchange market were amplified in 2021 and early 2022, warranting a measured adjustment that was allowed in the exchange rate in early March 2022. However, the outcome of the exchange rate flexibility that was thereafter allowed also in early March 2022, fell short of expectation due to large overshooting by market forces. Accordingly, the Sri Lanka rupee depreciated by 33.0 per cent against the US dollar by end March 2022. Such developments, along with the removal of other related regulatory restrictions and newly imposed import restrictions were expected to encourage more inflows of foreign exchange to the domestic foreign exchange market, particularly due to the net gain for exporters and remitters while discouraging non urgent imports and other outflows. Reflecting cross currency exchange rate movements, the Sri Lanka rupee depreciated against the euro (32.1 per cent), the Indian rupee (31.7 per cent), the pound sterling (31.1 per cent), and the Japanese yen (28.9 per cent) by end March 2022.

Other major currencies depreciated against the US dollar in 2021 in line with the broad-based strengthening of the US dollar due to multiple

Figure 5.14
Exchange Rate Movements



Source: Central Bank of Sri Lanka

factors including elevated upside volatility in energy prices, equity underperformance, policy rate hikes by the US Federal Reserve and liquidity concerns continuing to push investors seeking US dollar as a safe haven currency. Accordingly, by end 2021, the Japanese yen (10.4 per cent), the euro (8.0 per cent), the Indian rupee (1.6 per cent), and the pound sterling (1.1 per cent) depreciated against the US dollar. With the combined effect of the depreciation of the rupee against most major currencies, the Sri Lanka rupee depreciated against the SDR by 4.3 per cent and 32.1 per cent during 2021 and during 2022 until end March, respectively.

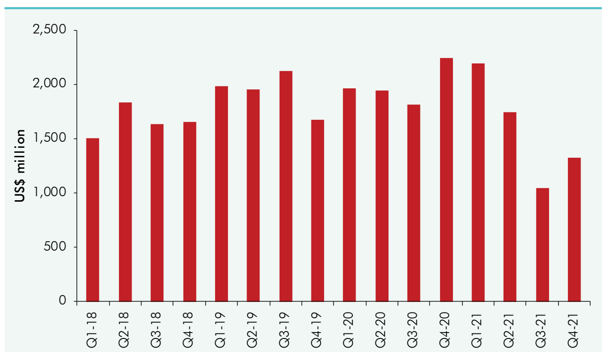
5.8.1 Nominal and Real Effective Exchange Rates

The 5-currency and the 24-currency Nominal Effective Exchange Rate (NEER) indices, which measure the movements of the Sri Lanka rupee against the basket of currencies, declined during the year. NEER indices declined, reflecting the nominal depreciation of the Sri Lanka rupee against selected major currencies together with the movements in cross currency exchange rates. Accordingly, the 5-currency and 24-currency NEER indices declined by 3.6 per cent and 4.2 per cent, respectively in 2021. The Real Effective Exchange Rate (REER) indices, which consider the variation in nominal exchange rates in the baskets of currencies, as well as the inflation differentials among countries, showed mixed performances. Accordingly, the 5-currency REER index increased by 6.9 per cent, while the 24-currency REER index declined by 2.6 per cent in 2021. However, the REER indices remained predominantly below the base year level (2017=100) in 2021, indicating the continued competitiveness of the Sri Lanka rupee. With the sharp depreciation of the exchange rate in March 2022, both NEER and REER indices declined substantially, reflecting the nominal depreciation of the Sri Lanka rupee against the US dollar and other major currencies considered in the basket. Accordingly, 5-currency NEER and REER indices declined by 31.9 per cent and 31.1 per cent, respectively, and 24-currency NEER and REER indices declined by 32.1 per cent and 35.1 per cent, respectively, by end March 2022.

5.8.2 Developments in the Domestic Foreign Exchange Market

The transaction volumes in the domestic foreign exchange market further declined in 2021. Accordingly, the volume of interbank foreign exchange transactions declined to US dollars 12,160 million in 2021, in comparison to US dollars 18,408 million in 2020. The total volume of spot exchange transactions declined significantly to US dollars 5,852 million (48.1 per cent of total transactions) in 2021, in comparison to US dollars 10,445 million in 2020. The total volume of forward transactions also decreased to US dollars 6,308 million in 2021 from US dollars 7,964 million in 2020. Meanwhile, the Central Bank intervened in the domestic foreign exchange market by way of supplying US dollars 747 million on a net basis in 2021. The net figure was the result of the supply of US dollars 1,253 million and the purchase of US dollars 506 million

Figure 5.15
Quarterly Inter-bank Forward Transaction Volumes



Source: Central Bank of Sri Lanka

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during the year. Moreover, the Central Bank continued to intervene in the domestic foreign exchange market during the first quarter of 2022 by supplying US dollars 265 million, on a net basis. The intervention of the Central Bank helped avoid large volatility in the exchange rate and supported the need for financing essential imports to ensure the avoidance of disruptions to the economy and people. However, the fixed exchange rate that prevailed during the latter part of 2021, is likely to have helped importers to frontload imports at cheaper costs, while exporters were reluctant to convert their export proceeds, impacting the domestic foreign exchange market negatively.