5 EXTERNAL SECTOR DEVELOPMENTS AND POLICIES

5.1 Overview

The external sector which performed well during the first half of the year, faced several challenges during the latter part due to adverse global developments and rapid growth in import demand. Globally, the intensified sovereign debt crisis in the Euro area, sluggish recovery in the global economy, and geopolitical uncertainties in some oil producing Middle Eastern and North African countries exerted pressure on oil prices and financial inflows. Domestically, the expanded aggregate demand resulted in a rapid growth in imports widening the trade deficit substantially, despite an impressive growth in exports. Exports grew by 22 per cent supported mainly by industrial exports, while imports grew by 51 per cent reflecting a sharp growth in intermediate goods led mainly by oil imports and investment goods for project related imports.

Inflows to the capital and financial account remained strong, though such inflows were insufficient to offset the high current account deficit. Inflows of private long-term investments including foreign direct investments (FDI) and inflows to the Government remained healthy. However, the higher current account deficit led the overall Balance of Payments (BOP) to record a deficit of US dollars 1.06 billion by end 2011.

The gross official reserves of the country reached a historically high level of US dollars 8.2 billion by mid-August 2011 and declined thereafter. Absorption of foreign exchange inflows, receipts to the Government including the proceeds of Sovereign bond issue, as well as receipts under the IMF Stand-by Arrangement (SBA) helped build-up the official reserves during the first eight months of the year. However, during the latter part of 2011, the widened trade deficit resulting from the sharp increase in import expenditure created a strong demand for foreign exchange in the domestic foreign exchange market. This necessitated the Central Bank to intervene by supplying foreign exchange to the market, thereby reducing the pressure in the domestic foreign exchange market. As a result, the gross official reserves which stood at a record high level in August declined to US dollars 6.0 billion by end 2011, equivalent to 3.5 months of imports.

The exchange rate policy in 2011 continued to focus on preventing undue fluctuations in the exchange rate and reducing pressure in the domestic foreign exchange market. With continued foreign currency inflows during the first eight months of the year and the Central Bank absorbing a bulk of such inflows, the rupee recorded a marginal appreciation against the US dollar up to August 2011. Thereafter, with the increasing demand pressure in the domestic foreign exchange

Chart 5.1 Balance of Payments

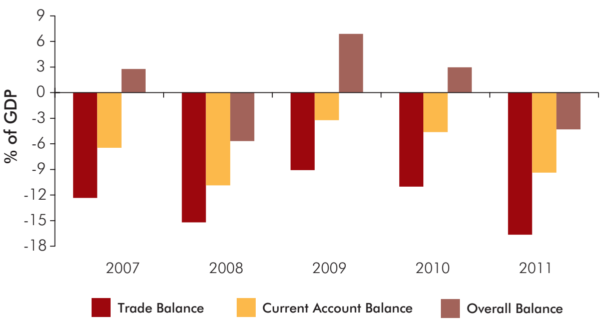
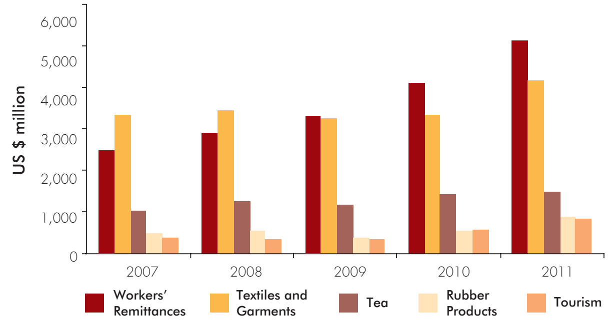


Chart 5.2 Major Sources of Foreign Exchange Earnings



market towards the latter part of the year, the Central Bank supplied foreign exchange to the market to ensure adequate foreign exchange liquidity and prevent any undue depreciation in the exchange rate. Further, along with the Government budget proposal to strengthen export competitiveness and curtail rising import expenditure, the rupee depreciated by 3 per cent in November 2011. Accordingly, by end 2011, the rupee depreciated by 2.59 per cent vis-a-vis the US dollar.

Several important policy measures were initiated recently to establish a conducive environment to further improve the external balances in 2012. More flexibility in the exchange rate was allowed since beginning of 2012, whereby Central Bank's intervention was limited only to finance part of the petroleum bill payment obligations. The other key policy measures include, relaxing exchange control regulations in order to facilitate enterprises to borrow directly from international financial markets, permitting commercial banks to raise Tier 2 capital from foreign sources, increasing repurchase and reverse repurchase rates by 50 basis points each and increasing domestic petroleum prices reflecting international oil prices. Further, the threshold for foreign investments in Treasury bills and bonds was raised from 10 per cent to 12.5 per cent of the outstanding stock of Government securities in December 2011. These policy measures are expected to generate necessary adjustments in the current account and the financial and capital account, thereby strengthening the external sector stability.

5.2 External Trade Policies and Institutional Support

External trade policies in 2011 mainly focused on broadening the export base, diversification of export markets, increasing domestic value addition and creating an enabling environment for trade to support the country's envisaged higher growth trajectory. Accordingly, the external trade policy framework aimed at achieving external sector competitiveness through harnessing inherent domestic skills and resources, infrastructure development, fostering technological innovations and facilitating private investment in high potential industries.

The four band duty structure, introduced on 1 June 2010, remained effective in 2011. Currently applicable duty rates of 0, 5, 15 and 30 per cent were simplified from the previously held five band duty structure of 0, 2.5, 6, 15 and 28 per cent. Under the present structure, most raw materials and machinery used for production of goods for exports were placed on the zero duty band or as duty free from the previous 2.5 per cent duty band. These measures were taken to boost domestic industrial production and encourage value added exports.

The budget 2011 introduced progressive measures to expand the export base by incentivising product innovation and value addition while facilitating imports to foreign exchange earning industries. A Cess on many unprocessed and semi processed exports, including raw rubber and minerals such as titanium and natural graphite was introduced to encourage value

Table 5.1 Balance of Payments Analytical Presentation (a)

Item	US$ million					Rs. million				
	2007	2008	2009	2010 (b)	2011 (c)	2007	2008	2009	2010 (b)	2011 (c)
Trade Balance	**-3,657**	**-5,981**	**-3,122**	**-4,825**	**-9,710**	**-404,703**	**-647,207**	**-358,707**	**-545,350**	**-1,073,900**
Exports	7,640	8,111	7,085	8,626	10,559	845,683	878,499	813,911	974,387	1,167,588
Imports	11,296	14,091	10,207	13,451	20,269	1,250,386	1,525,705	1,172,618	1,519,737	2,241,488
Services (net)	302	401	391	707	1,099	33,357	43,557	44,780	79,766	121,635
Receipts	1,775	2,004	1,892	2,474	3,084	196,249	217,180	217,378	279,634	340,977
Payments	1,472	1,603	1,501	1,768	1,985	162,892	173,623	172,598	199,868	219,342
Income (net)	-358	-972	-488	-617	-647	-39,054	-105,032	-55,814	-69,776	-72,046
Receipts	449	-32	116	323	467	50,213	-3,133	13,551	36,508	51,109
Payments	807	940	603	940	1,114	89,267	101,899	69,365	106,284	123,155
Goods, Services and Income (net)	**-3,712**	**-6,552**	**-3,219**	**-4,735**	**-9,258**	**-410,401**	**-708,681**	**-369,740**	**-535,360**	**-1,024,311**
Current Transfers (net)	**2,311**	**2,666**	**3,005**	**3,660**	**4,643**	**255,684**	**288,639**	**345,498**	**413,885**	**513,216**
Private Transfers (net)	2,214	2,565	2,927	3,608	4,583	245,006	277,711	336,578	407,967	506,630
Receipts	2,502	2,918	3,330	4,116	5,145	276,814	316,091	382,818	465,166	569,103
Payments	288	353	403	508	562	31,808	38,380	46,240	57,199	62,473
Official Transfers (net)	97	101	77	52	60	10,677	10,928	8,920	5,918	6,587
Current Account	**-1,402**	**-3,886**	**-214**	**-1,075**	**-4,615**	**-154,717**	**-420,042**	**-24,242**	**-121,475**	**-511,095**
Capital and Financial Account	**2,097**	**1,773**	**2,594**	**2,877**	**4,262**	**230,978**	**193,713**	**299,381**	**322,035**	**458,412**
Capital Account	**269**	**291**	**233**	**164**	**164**	**29,669**	**31,456**	**26,832**	**18,521**	**18,126**
Capital Transfers (net)	269	291	233	164	164	29,669	31,456	26,832	18,521	18,126
Receipts	278	303	247	182	185	30,735	32,774	28,465	20,599	20,382
Payments	10	12	14	19	20	1,066	1,319	1,633	2,078	2,256
Financial Account	**1,828**	**1,483**	**2,361**	**2,713**	**4,097**	**201,309**	**162,258**	**272,550**	**303,515**	**440,286**
Long-term:	1,251	1,016	1,304	2,379	3,292	140,054	109,174	149,772	268,228	362,419
Direct Investment	548	691	384	435	896	60,768	74,837	44,112	49,008	99,265
Foreign Direct Investment (net)	548	691	384	435	896	60,768	74,837	44,112	49,008	99,265
Private Long-term (net)	31	74	79	149	153	3,314	7,768	9,105	17,569	16,804
Inflows	199	265	390	580	364	22,033	28,693	44,795	65,934	40,187
Outflows	168	191	311	431	211	18,719	20,925	35,691	48,365	23,384
Government, Long-term (net)	672	252	840	1,796	2,244	75,971	26,568	96,555	201,650	246,350
Inflows	1,290	1,059	1,780	2,460	3,029	144,146	114,658	204,435	276,582	333,630
Outflows	618	807	940	665	785	68,175	88,090	107,880	74,932	87,280
Short-term:	577	466	1,058	334	805	61,256	53,084	122,777	35,287	77,867
Portfolio Investment (net)	101	60	-6	-230	-171	11,249	6,460	-785	-26,010	-18,979
Private Short-term (net)	20	594	228	-1,032	-228	1,868	63,987	26,108	-116,655	-25,226
Commercial Bank Assets (net)	-281	210	-435	249	183	-31,352	17,889	-51,298	33,343	14,724
Commercial Bank Liabilities (net)	364	-185	-98	815	788	38,746	-11,858	-8,836	84,356	81,555
Government Short-term (net)	372	-213	1,369	531	233	40,744	-23,395	157,588	60,252	25,794
Allocation of SDRs (d)	-	-	508	-	-	-	-	58,353	-	-
Valuation Adjustments	-	-	-	-	-	-	-	-	-	-
Errors and Omissions	-165	728	346	-881	-707	-16,259	80,534	40,082	-112,586	-53,167
Overall Balance (e)	**531**	**-1,385**	**2,725**	**921**	**-1,061**	**60,002**	**-145,795**	**315,221**	**87,974**	**-105,850**
Monetary Movements (e)	-531	1,385	-2,725	-921	1,061	-60,002	145,795	-315,221	-87,974	105,850
Annual Average Exchange Rate Rs./US$						**110.62**	**108.33**	**114.94**	**113.06**	**110.57**
Ratio to GDP in Percentages (f)										
Trade Account	-11.3	-14.7	-7.4	-9.7	-16.4	-11.3	-14.7	-7.4	-9.7	-16.4
Current Account	-4.3	-9.5	-0.5	-2.2	-7.8	-4.3	-9.5	-0.5	-2.2	-7.8
Current Account without Grants	-4.6	-9.8	-0.7	-2.3	-7.9	-4.6	-9.8	-0.7	-2.3	-7.9

(a) This presentation conforms as far as possible to the Balance of Payments Manual, 5th Edition (1993) of the International Monetary Fund (IMF). In addition, beginning 1994, Offshore Banking Units have been treated as a part of the domestic banking system.
(b) Revised
(c) Provisional
(d) General and special allocations of Special Drawings Rights (SDRs) by the IMF.
(e) US dollar values are converted into rupee values using period average exchange rates.
(f) Based on GDP at current market prices published by the Department of Census and Statistics.

Sources: Sri Lanka Customs
External Resources Department
Board of Investments of Sri Lanka
Department of Census and Statistics
Central Bank of Sri Lanka

Table 5.2 Average Import Duty Collection Rate (a)

percentage (%)

Item	2007	2008	2009	2010	2011 (b)
Consumer Goods	**12.4**	**12.6**	**19.4**	**12.6**	**11.0**
Food and Beverages	13.5	14.8	26.8	12.1	12.3
Rice	3.1	3.1	5.4	2.1	21.2
Flour	31.9	22.6	22.6	40.8	8.1
Sugar	23.9	32.8	26.5	4.0	5.0
Wheat and Meslin	6.3	6.7	32.2	12.4	12.2
Milk and Milk Products	7.7	2.0	29.2	6.4	1.2
Dried Fish	2.9	9.4	10.9	12.2	12.1
Other Fish Products	4.9	8.7	18.3	25.0	21.3
Other	20.8	24.2	27.2	19.6	21.0
Non-Food Consumer Goods	11.2	8.4	6.7	13.3	9.7
Motor Cars & Cycles	16.3	7.7	6.2	18.4	14.0
Radio Receivers - Television Sets	7.7	6.3	7.1	20.0	2.3
Rubber Tyres & Tubes	22.4	19.2	20.1	21.6	20.9
Pharmaceutical Products	0.4	0.4	0.4	0.3	0.2
Other	10.6	13.0	8.6	9.7	7.4
Intermediate Goods	**1.5**	**2.2**	**5.0**	**1.7**	**1.0**
Fertiliser	2.7	2.5	2.5	1.0	0.0
Crude Oil	0.0	0.0	0.0	0.0	0.0
Other Petroleum Products	1.6	4.7	19.0	3.2	1.1
Chemical Elements and Compounds	1.9	1.8	1.9	1.1	0.3
Dyeing, Tanning and Colouring	2.5	2.1	2.1	2.1	2.3
Paper and Paper Boards	2.2	2.0	2.1	1.8	1.4
Textiles	0.1	0.2	0.2	0.1	0.1
Other	3.3	2.9	4.9	3.2	2.0
Investment Goods	**4.8**	**5.3**	**4.4**	**4.8**	**3.9**
Building Materials	7.2	7.2	8.2	5.9	4.3
Transport Equipment	7.1	7.1	3.7	7.6	7.8
Machinery and Equipment	2.7	3.1	2.5	2.8	1.5
Other Investment Goods	4.2	3.9	3.3	4.0	2.8
Average Import Duty Collection Rate	**4.1**	**4.6**	**7.8**	**5.0**	**3.8**

(a) Actual import duty collection (including Special Commodity Levy wherever applicable) as a percentage of total imports (c.i.f. values).
(b) Provisional

Source: Sri Lanka Customs

addition, while finished goods were exempted from Cess. Import duty on machinery and equipment was reduced in order to enhance access to advanced technologies by domestic industries, enabling them to produce globally competitive products. Further, Cess on goods demanded by the tourism industry for expansions, refurbishments and upgraded services was reduced to facilitate efforts in making the tourism industry capable of handling 2.5 million tourists by 2016.

In recognition of the importance of geographical and technological connectivity in promoting trade and commerce to achieve inclusive growth, imports of investment goods for infrastructure development projects were exempted from certain taxes. Accordingly, effective 1 January 2011, imports for infrastructure development projects funded through foreign loans or donations directly to Ministries, approved by the Minister of Finance and Planning were exempted from Nation Building Tax (NBT), Value Added Tax (VAT) and Customs duty. Further, importation of bitumen and certain categories of transport equipment were exempted from NBT, while exempting high-tech equipment in the telecommunication industry from VAT. These policies led to a rapid rise in importation of infrastructure related investment and intermediate goods in 2011.

Several measures were introduced to stabilise domestic prices of certain food items. Special Commodity Levy (SCL) was used as the main instrument to manage imports in order to protect domestic suppliers and was imposed on the importation of several food items, especially at times of high domestic supply. Cess on importation of certain food items such as dried vegetables and dried fruits were increased while introducing Cess on importation of wheat flour and thriposha.

Concerted efforts were made to improve support services for external trade by strengthening the institutional framework. Institutions engaged in external trade facilitation focused on improving their services towards supporting the country's external trade policies and creating an environment conducive for entrepreneurs and exporters. To expedite the documentation process, Sri Lanka Customs took initiatives to implement online custom declarations. The system facilitates electronic submission of custom declarations and online payments by exporters and importers with real-time information updating at the host port, Customs and the facilitating bank. In order to streamline procedures and to enhance operational efficiency, the Export Development Board (EDB) set up 20 Advisory Committees comprising both private and public sector representatives to cover key product sectors. The EDB targeted seven priority product sectors as high potential earners that would facilitate reaching the export target of US dollars 15 billion by 2015. These sectors are apparel, tea, rubber based products, gems, diamonds and jewellery, ICT / BPO / KPO, food and beverages, spices and allied products. Agro export businesses were further promoted through targeted grower and supply chain development programmes which enabled to increase exports of minor agricultural products over the years with prospects for further growth in the future. In a bid to integrate and position Sri Lanka's high quality, unique products under one brand name, Sri Lanka cinnamon was launched as 'Ceylon cinnamon' in line with 'Ceylon tea' and ' Ceylon Sapphire'. This was initiated to market Ceylon cinnamon globally as a high value commodity. Meanwhile, rising geopolitical tensions and financial market uncertainties in key export destinations resulted in an increase in insurance covers for export credits by the Sri Lanka Export Credit Insurance Corporation (SLECIC). The highest growth in export credit insurance was recorded from the Middle East followed by the EU.

With the continued uncertainty in the world economy, there has been an increasing trend towards negotiated trading arrangements. Sri Lanka, as an open economy, endeavoured to strengthen its trade ties with trading partners at the bilateral, regional and multilateral levels amidst drawbacks and delays that have been common in the world trade negotiating arena. The Doha Development Round (DDR) of the World Trade Organization (WTO), which was the main multilateral level trade negotiation, could not reach a formal agreement despite the members' commitment to conclude negotiations by 2011. At the eighth Ministerial Conference of the WTO held in December 2011, Sri Lanka flagged its concerns with respect to the delay in the completion of the Doha Round as it has critical interests in the area of agriculture and non-agricultural market access (NAMA). The Global System of Trade Preferences (GSTP) which promotes South-South trade under the aegis of the United Nations Conference on

Table 5.3 Trade Indices (a)

2010=100

Category	Value Index			Volume Index			Unit Price index		
	2010	2011 (b)	Growth (%)	2010	2011 (b)	Growth (%)	2010	2011 (b)	Growth (%)
EXPORTS									
Agricultural Exports	100.0	109.7	9.7	100.0	97.5	-2.5	100.0	112.5	12.5
Tea	100.0	103.5	3.5	100.0	98.2	-1.8	100.0	105.4	5.4
Rubber	100.0	119.2	19.2	100.0	83.1	-16.9	100.0	143.5	43.5
Coconut	100.0	160.6	60.6	100.0	116.3	16.3	100.0	138.1	38.1
Minor Agricultural Products	100.0	124.2	24.2	100.0	144.2	44.2	100.0	86.1	-13.9
Industrial Exports	100.0	131.2	31.2	100.0	118.5	18.5	100.0	110.7	10.7
Textiles and Garments	100.0	125.0	25.0	100.0	113.5	13.5	100.0	110.1	10.1
Petroleum Products	100.0	210.0	110.0	100.0	134.8	34.8	100.0	155.8	55.8
Rubber Based Products	100.0	159.0	59.0	100.0	117.0	17.0	100.0	135.9	35.9
Mineral Exports	100.0	135.7	35.7	100.0	110.0	10.0	100.0	123.3	23.3
Total Exports	100.0	122.5	22.5	100.0	110.4	10.4	100.0	110.9	10.9
IMPORTS									
Consumer Goods	100.0	147.7	47.7	100.0	125.6	25.6	100.0	117.6	17.6
Food and Beverages	100.0	118.4	18.4	100.0	108.5	8.5	100.0	109.1	9.1
Other Consumer Goods	100.0	181.2	81.2	100.0	145.2	45.2	100.0	124.8	24.8
Intermediate Goods	100.0	152.5	52.5	100.0	123.3	23.3	100.0	123.7	23.7
Fertiliser	100.0	169.5	69.5	100.0	122.9	22.9	100.0	137.9	37.9
Petroleum Products	100.0	157.7	57.7	100.0	121.1	21.1	100.0	130.2	30.2
Chemicals	100.0	135.0	35.0	100.0	115.8	15.8	100.0	116.6	16.6
Wheat and Maize	100.0	161.8	61.8	100.0	117.9	17.9	100.0	137.2	37.2
Textiles	100.0	128.3	28.3	100.0	111.7	11.7	100.0	114.8	14.8
Plastics	100.0	123.7	23.7	100.0	110.8	10.8	100.0	111.7	11.7
Diamonds	100.0	284.9	184.9	100.0	200.4	100.4	100.0	142.2	42.2
Investment Goods	100.0	155.6	55.6	100.0	128.2	28.2	100.0	121.3	21.3
Building Materials	100.0	131.0	31.0	100.0	121.2	21.2	100.0	108.0	8.0
Transport Equipment	100.0	179.7	79.7	100.0	144.4	44.4	100.0	124.4	24.4
Machinery and Equipment	100.0	160.1	60.1	100.0	125.4	25.4	100.0	127.7	27.7
Other Investment Goods	100.0	120.6	20.6	100.0	118.9	18.9	100.0	101.4	1.4
Total Imports	100.0	151.2	51.2	100.0	123.5	23.5	100.0	122.4	22.4
Terms of Trade							100.0	90.7	-9.3

(a) In terms of US dollars and trade indices were calculated with a wide coverage and 2010 as the base year.
(b) Provisional

Sources: Sri Lanka Customs
Central Bank of Sri Lanka

Trade and Development (UNCTAD) reaped only marginal benefits to Sri Lanka. Sri Lanka exported only US dollars 10.6 million worth of goods in 2011 under GSTP, which highlights the need to improve utilisation of facilities under the agreement.

As an initiative to widen the scope of the Asia-Pacific Trade Agreement (APTA), Sri Lanka ratified framework agreements on trade facilitation and investment and signed a framework agreement on services. As APTA provides market access to large markets such as China and Korea, Sri Lanka supported the full implementation of granting 40 per cent margin of preference (MOP) on 40 per cent of the tariff lines. Sri Lanka is treated as a least developed country (LDC) in APTA and therefore, exempted from the above commitments. In 2011, members continued their negotiations on further streamlining the negative list. Despite the wide scope of APTA, only limited goods such as tea and coir form the bulk of the exports under the agreement.

Sri Lanka continued its efforts to strengthen trade ties at both multilateral and bilateral levels in the South Asian region. With the objective of further accelerating regional trade, the South Asian Free Trade Area (SAFTA) had already offered to reduce 20 per cent of the tariff lines from their sensitive lists and this will be implemented from the beginning of 2012. Further, members are expected to progressively reduce tariffs to 0 per cent from 5 per cent by 2016. However, trade under SAFTA and South Asian Preferential Trade Agreement (SAPTA) have been low as Sri Lanka's trade with its main regional trading partners, India and Pakistan, is under bilateral agreements. The SAARC Agreement on Trade in Services (SATIS) which was signed in April 2010 is already ratified by all members except Afghanistan and Bhutan. Members commenced negotiations on their Schedules of Commitments in March 2011 and are expected to finalise and adopt them by June 2012. In the bilateral front, Sri Lanka's exports to India increased by 9.5 per cent in 2011 while imports from India increased by 72.4 per cent. Despite the clear disparity in value, Sri Lanka benefited from the ISFTA as bulk of exports to India fall under the ISFTA, while the greater share of imports falls outside the agreement. Subsequent to the stalemate witnessed in the Comprehensive Economic Partnership Agreement (CEPA) since 2008, the Cabinet of Ministers appointed an Inter-Agency Committee (IAC) in February 2011 for the purpose of revising the draft text of the proposed agreement. After the meetings with domestic stakeholders, the IAC finalised the revision of the draft text except the chapter on investment. Exports to Pakistan showed a significant improvement since the Pakistan-Sri Lanka Free Trade Agreement (PSFTA) was implemented in 2005. In 2011, exports grew by 25 per cent, reflecting Pakistan's status as a growing trading partner of Sri Lanka.

5.3 Trade in Goods, Trade Balance and Terms of Trade

Export Performance

Exports which rebounded in 2010, strengthened further during 2011 despite a fragile recovery in the world economy. Earnings from exports exceeded the US dollars 10 billion mark and reached US dollars 10,559 million, an increase of 22.4 per cent in 2011 over the previous year. The export growth in 2011 is commendable and highlighted the resilience of exports as it was achieved amidst slow and uncertain economic recovery in Sri Lanka's traditional markets, particularly, USA, EU, and the Middle East. The expansion in domestic economic activities and the favourable investment climate with low interest rates and improved infrastructure contributed to the growth in exports. The largest contribution to the growth in export earnings amounting to US dollars 1,896 million came from industrial exports followed by agricultural exports (US dollars 221 million).

Industrial exports increased by 31.1 per cent to US dollars 7,992 million in 2011. Major contribution to this growth came from exports of textiles and garments, rubber products and petroleum products. Further, earnings from exports of food, beverages and tobacco, gems, diamonds and jewellery, transport equipment and machinery and mechanical appliances made a significant contribution to export earnings.

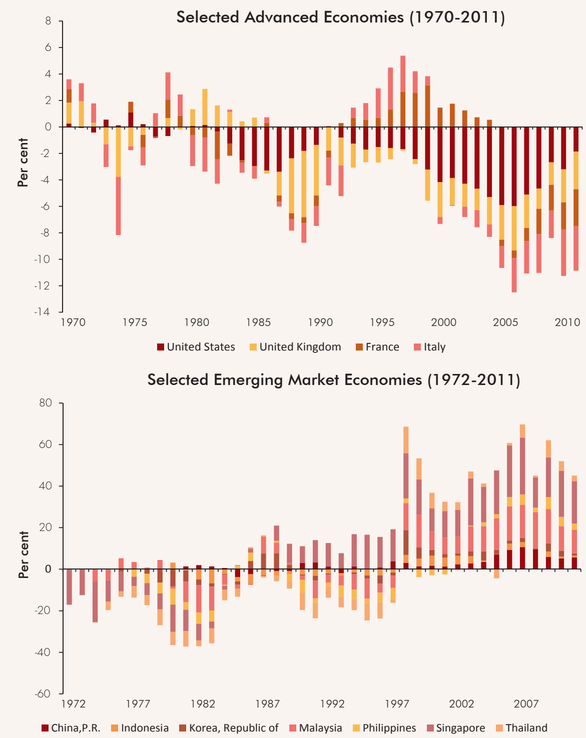
BOX 10

Global Imbalances

The notion of global imbalances comes to the forefront of policy discussions from time to time, particularly in times of economic turmoil, when there are efforts to search for 'causes' of economic strain. Some trends and structural changes that may have not been 'noticed' in economic good times may suddenly appear significant in times of turmoil. Some macroeconomic trends which were considered 'benign' for some countries in certain times may look 'threatening' for them under different circumstances. If such 'trends' are deemed to be unfavourable for those countries, there has been a tendency to term them as 'imbalances'. This use of terminology is interesting in the global policy discussions, particularly, in the 'north-south' dialogue, because to define an outcome as 'unfavouarble' may seem to depend on 'who gains and who suffers' (Cabraal, 2012).

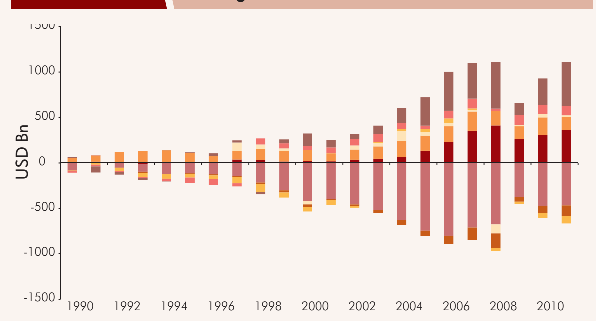
The notion of current 'global imbalances' is generally referred to large current account deficits of some developed economies and resulting large surpluses of some emerging market and developing economies.[1] In this context, the term 'imbalance' suggests a situation that is not very favourable. In fact, the phenomenon of current account surpluses in some countries and current account deficits in others is nothing new in global economy. However, the emerging issue seems to be that historically surplus economies have now turned into deficit economies and vice versa. Chart B 10.1 clearly depicts this reversal of current account balances in some advanced and emerging market economies since 1970. As the Chart shows, until around 1996, emerging market and Asian economies have been experiencing current account deficits, which have turned into surpluses quite dramatically since about 1997. Meanwhile, the reverse has occurred in advanced economies. It would be interesting to examine what led to this change. In the aftermath of the Asian financial crisis in 1997, most Asian economies started to accumulate larger international reserves to cover short-term debts. From the perspective of advanced economies, it is generally the case that they have been experiencing larger trade imbalances, with imports exceeding the exports by a wide margin, thereby running larger saving/investment imbalances. Consequently, the emerging market economies with larger current account

Chart B 10.1 Current Account Balance/GDP



Source: World Economic Outlook Database, International Monetary Fund, Sep 2011

Chart B 10.2 Current Account Balances of Key Economic Regions and Some Selected Countries



Source: World Economic Outlook Database, International Monetary Fund, Sep 2011

surpluses exported capital to advanced economies. For instance, the size of the current account surpluses of Asian economies (mainly the People's Republic of China and Japan) and oil exporting economies seem to be almost the mirror image of the current account deficits in advanced economies (Chart B 10.2).

These developments in international financial flows naturally led to significant 'international' reserve accumulation in emerging market and developing economies, and the external stability that these large

[1] Bracke et al., (2008) define global financial imbalances as "external positions of systemically important economies that reflect distortions or entail risks for global economy". As described by them, global imbalances are driven by structural and cyclical factors, which are often highly interdependent. The structural determinants relate to imperfections in the financial markets due to incomplete process of financial globalization, where the imperfections in the financial markets of fast-growing emerging market economies drive off their capital to advanced economies. Cyclical factors or the macroeconomic policy-induced factors may relate to savings/investment imbalances in the private and public sectors.

reserves portrayed, encouraged further capital flows into these economies. Meanwhile, the external debt stock of emerging market and developing economies also increased substantially (albeit as a percentage of GDP, there is a significant consolidation in recent years). However, quite paradoxically, despite larger reserve levels in emerging market and Asian economies, substantial interest rate differentials exist between emerging capital-providing nations (where interest rates are higher) and advanced capital-receiving nations (where interest rates are lower). Such interest rate differentials lead to surplus emerging economies earning less on investment in advanced economies, while paying higher interest on their foreign debt, raised from advanced economies. This phenomenon may also be referred to as 'round-tripping' of surpluses of emerging economies (Cabraal, 2012). Perhaps spurred by these imperfections in the global financial system, the 'imbalances' have continued to grow rather than to be curtailed them.

Considering as to who gains and who loses, it is unlikely that this issue of 'imbalances' would have been even highlighted if not for the recent global financial crisis. Some suggest that it is timely to respond to this situation in a planned and collective manner. Specifically, the surplus countries could intensify regional cooperation and coordination by means of reserve-pooling, swap and credit lines, for example, the Chiang-Mai Initiative Multilateralization (CMIM), where some South-Eastern and East-Asian nations pool a portion of their international reserves in order to create a regional liquidity support facility (SEACEN, 2012). Such measures to address the systemic distortions in the global financial system would help reduce the severity of global imbalances. A resilient financial system at national level will be the key to ensure regional and global financial stability, while strengthening of economic surveillance will need to take place beyond traditional boundaries. 'Global imbalances' have continued through many economic crises over the course of the world economic history, however, an orderly unwinding of these imbalances is hard to come by, unless a coordinated effort is made by surplus and deficit economies committing themselves to addressing domestic as well as systemic distortions through appropriate structural reforms.[2]

References

1. Bracke, T., Bussiere, M., Fidora, M. and Straub, R. (2008): 'A Framework for assessing global imbalances' European Central Bank Occasional Paper Series No.78.
2. Cabraal, A.N. (2012): 'Global imbalances: Implications for SEACEN economies and moving Asia forward as a region', keynote address at the 10th SEACEN Executive Committee Meeting, Colombo, Sri Lanka.
3. IMF (2011): World Economic Outlook, International Monetary Fund.
4. SEACEN (2012): 'Global imbalances: Implications for SEACEN economies and moving Asia forward as a region', The South East Asian Central Banks (SEACEN) Centre.

[2] From the view point of larger current account deficit economies, a rebalancing may be needed from public to private demand, in order to ensure fiscal sustainability, while encouraging private savings (IMF, 2011). The rebalancing strategies should target at creating policy space to support sustainable economic recovery and creating employment. Meanwhile, for surplus economies, the rebalancing has to happen from external to domestic demand, in order to improve their resilience to shocks originating in advanced economies, while ensuring sustainable economic growth.

Earnings from textile and garment exports, which accounted for 39.7 per cent of total exports, increased by 24.9 per cent to US dollars 4,191 million in 2011, surpassing the US dollars 4 billion target set by the apparel industry. Quality of Sri Lankan garments as well as rising cost of production in competitor countries mainly due to wage pressures, have helped sustain a strong demand for exports of textiles and garments of Sri Lanka. Apparel exports to USA increased by 21.5 per cent, while those to EU increased by 25.1 per cent during the year. Market diversification and increased value addition also helped in increasing apparel export earnings in 2011. To further enhance local value addition, several measures were taken in the budget 2012, such as, exempting all taxes imposed on the importation of yarn and exempting VAT and Customs duty on equipment required to modernise the apparel industry.

Earnings from industrial exports such as rubber products, petroleum products, transport equipment, machinery and mechanical appliances, gems, diamonds and jewellery and food, beverages and tobacco increased in 2011. Earnings from rubber product exports increased by 58.7 per cent to US dollars 885 million in 2011, mainly due to an increase in prices. Domestic manufacturers of solid rubber tyres and rubber gloves for exports, in particular, were encouraged by high rubber prices, while more opportunities for value addition were also used resulting an increase in export earnings. Earnings from exports of petroleum products increased, reflecting an increase in prices and bunkering volumes. Bunkering activities are expected to increase further with expanding port operations in Colombo and Hambantota. Transport equipment, such as bicycles and boats, and mechanical appliances, such as insulated cables and transformers, also recorded an increase during the year. Benefiting by tariff concessions provided for gems, diamonds and jewellery industry and facilitation for sourcing materials for value addition, export of gems, diamonds and jewellery increased by 29.9 per cent to US dollars 532 million in 2011, where gem exports grew by 35.6 per cent and diamond exports grew by 28.9 per cent. Earnings from food, beverages and tobacco exports increased by 42.4 per cent to US dollars 348 million, mainly due to the increase of milling industry products, which comprised of wheat, rice, manioc and potato milled for flour, vegetables, and fruits preparations.

Earnings from agricultural exports, which accounted for 23.9 per cent of total exports, increased by 9.6 per cent to US dollars 2,528 million. Earnings from traditional agricultural crops increased due to higher prices that prevailed in the international market during the first half of 2011. Among agricultural exports, tea accounted for 14.1 per cent of total export earnings in 2011 followed by coconut (2.5 per cent), spices (2.2 per cent) and rubber (2 per cent).

Tea exports continued to be the major agricultural export, contributing 59 per cent to the total agricultural exports. Earnings from tea exports increased by 3.5 per cent to US dollars 1,491 million despite the slowdown in exports to traditional destinations in the Middle East during the second half of 2011. The average export price of tea rose by 5.1 per cent to US dollars 4.62 per kg during 2011, due to increased preference of tea importing countries for high quality 'Ceylon tea' and global demand for orthodox tea, which accounted for nearly 90 per cent of tea produced in Sri Lanka. Due to geopolitical tensions in some of the major markets in the Middle East, export volume of tea declined marginally by 1.5 per cent to 323 million kg in 2011. The extension of the fertiliser subsidy to cover plantations introduced in mid 2011 would help increase production of tea and thereby increase export volumes in the near future. The Cess levy of Rs. 10 per kg introduced in the budget for 2011 on bulk tea exports appears to be partly instrumental in increasing the export of value added tea, as reflected by a 6.9 per cent decline in the quantity of bulk tea exports in 2011. The share of value added tea exports out of total tea exports increased from 59.5 per cent in 2010 to 63.9 per cent in 2011.

Earnings from export of rubber and coconut increased mainly due to an increase in prices. Earnings from rubber exports increased by 19.1 per cent to US dollars 206 million in 2011 despite a decline in export volumes. A short supply of natural rubber in the world market resulting from unfavourable weather conditions in major rubber producing countries coupled with high oil prices contributed to higher prices at the Colombo auction, particularly in the first half of 2011. The average export price of rubber rose by 45 per cent to US dollars 4.84 per kg in 2011. Despite higher export prices, export volumes of rubber declined by 17.9 per cent in 2011, due to increased domestic demand by rubber manufacturing industries and the Cess on raw rubber exports. Meanwhile, earnings from export of coconut products increased by 60.4 per cent to US dollars 266 million in 2011, largely due to higher earnings from desiccated coconut exports. The sharp increase in desiccated coconut exports was driven by higher volumes and favourable

Chart 5.3 Export Performance

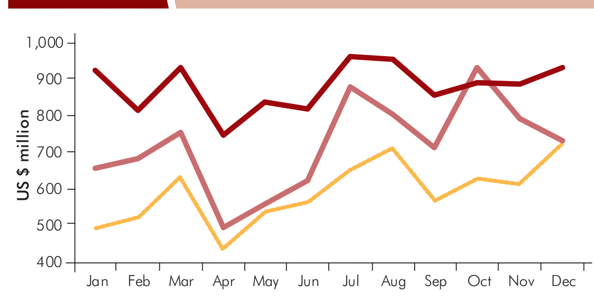


Table 5.4 Composition of Exports (a)

Category	2010 (b) Value US$ million	2010 (b) Share %	2011 (c) Value US$ million	2011 (c) Share %	Change in Value (c) US$ million	Growth Rate (c) %	Contribution to Growth (c) %
Agricultural Exports	**2,306.4**	**26.7**	**2,527.8**	**23.9**	**221.4**	**9.6**	**11.5**
Tea	1,440.6	16.7	1,490.9	14.1	50.3	3.5	2.6
Rubber	173.2	2.0	206.4	2.0	33.1	19.1	1.7
Coconut	165.8	1.9	266.0	2.5	100.1	60.4	5.2
Spices	207.3	2.4	235.2	2.2	27.9	13.5	1.4
Vegetables	23.4	0.3	16.9	0.2	-6.5	-27.6	-0.3
Unmanufactured Tobacco	32.2	0.4	38.4	0.4	6.2	19.2	0.3
Minor Agricultural Products	71.6	0.8	88.7	0.8	17.1	23.8	0.9
Seafood	192.2	2.2	185.3	1.8	-6.9	-3.6	-0.4
Industrial Exports	**6,096.1**	**70.7**	**7,991.7**	**75.7**	**1,895.6**	**31.1**	**98.1**
Textiles and Garments	3,356.0	38.9	4,191.2	39.7	835.2	24.9	43.2
Rubber Products	557.6	6.5	884.8	8.4	327.3	58.7	16.9
Petroleum Products	263.4	3.1	552.7	5.2	289.3	109.9	15.0
Gems, Diamonds and Jewellery	409.0	4.7	531.5	5.0	122.5	29.9	6.3
Food, Beverages and Tobacco	244.6	2.8	348.2	3.3	103.6	42.4	5.4
Machinery and Mechanical Appliances	258.8	3.0	312.2	3.0	53.4	20.6	2.8
Printing Industry Products	246.1	2.9	235.1	2.2	-11.1	-4.5	-0.6
Transport Equipment	143.9	1.7	225.0	2.1	81.2	56.4	4.2
Leather, Travel Goods and Footwear	60.2	0.7	65.1	0.6	4.9	8.2	0.3
Ceramic Products	39.9	0.5	38.3	0.4	-1.6	-4.1	-0.1
Other Industrial Exports	516.6	6.0	607.5	5.8	90.9	17.6	4.7
Mineral Exports	**24.2**	**0.3**	**32.9**	**0.3**	**8.6**	**35.7**	**0.4**
Unclassified	**199.2**	**2.3**	**6.5**	**0.1**	**-192.7**	**-96.7**	**-10.0**
Total Exports (d)(e)	**8,625.8**	**100.0**	**10,558.8**	**100.0**	**1,933.0**	**22.4**	**100.0**
Annual Average Exchange Rate (f)	**113.06**		**110.57**				

(a) Categories are reclassified based on National Import Tariff Guide - 2010
(b) Revised
(c) Provisional
(d) Adjusted
(e) Excludes re-exports
(f) 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

prices fetched at auctions. Export of fresh coconuts declined both in value and volume terms by 46.4 per cent and 60.5 per cent, respectively, in 2011 due to increased domestic demand.

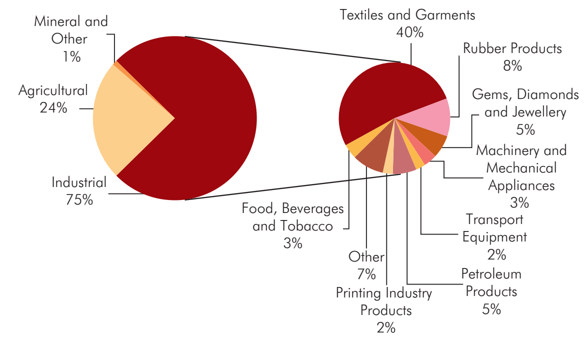
Earnings from spices and minor agricultural products grew with favourable prices in the international market. Earnings from spices led by cinnamon and nutmeg increased by 13.5 per cent to US dollars 235 million in 2011. Cinnamon exports grew by 31.4 per cent to US dollars 129 million largely due to an increase in prices by 30.8 per cent to US dollars 9.38 per kg in 2011. Earnings from pepper and cloves declined due to a decrease in export volumes although prices remained high. Minor agricultural products including fruits, edible nuts, cereals, flowers and foliage and cocoa recorded higher export earnings. Earnings from unmanufactured tobacco increased by 19.2 per cent to US dollars 38 million in 2011.

Import Performance

Expenditure on imports increased by 50.7 per cent to US dollars 20,269 million in 2011 compared to US dollars 13,451 million in 2010. Higher demand for all major categories of imports; consumer, intermediate and investment goods, as well as higher international commodity prices contributed to the surge in import expenditure. Import of intermediate goods accounted for 60.6 per cent of total imports while investment goods accounted for 21.2 per cent of total imports. Consumer goods imports accounted for 18 per cent to the total import expenditure.

Expenditure on import of intermediate goods increased by 52.4 per cent to US dollars 12,275 million in 2011, led by higher petroleum and textile imports which increased by 57.7 per cent and 28.1 per cent, respectively, accounting for a combined contribution of 35.1 per cent to

Chart 5.4 Exports by Commodities



the total import expenditure. The average import price of crude oil increased by 36.6 per cent to US dollars 108.59 per barrel during the year, compared to US dollars 79.52 per barrel during 2010, mainly due to increased demand from emerging market economies and political uncertainties which prevailed in oil exporting countries in North Africa and the Middle East. The volume of petroleum imports, crude oil and refined petroleum products, also increased in 2011, driven by higher demand for expanding economic activities and increased thermal power generation. As a result, expenditure on petroleum imports amounted to US dollars 4,795 million in 2011 compared to US dollars 3,041 million in 2010. The expenditure on textile imports amounted to US dollars 2,321 million in 2011, reflecting both the increased demand for apparel exports and higher prices of textiles, particularly prevailed in the first half of 2011.On net terms, exports of textiles and garments amounted to US dollars 1,871 million in 2011. The expenditure on fertiliser imports increased by 69.5 per cent to US dollars 407 million in 2011, led by higher prices that prevailed in the international market and increased volume of imports as the fertiliser subsidy was extended to cover all crops, effective from May 2011. Expenditure on wheat and maize imports also increased by 62 per cent to US dollars 429 million. Import of other categories of intermediate goods, such as chemicals, diamonds and precious metals also increased during the period. Meanwhile, import of gold, which is the main sub-category within the import of diamonds, precious stones and metals, increased by over six fold to US dollars 604 million in 2011 partly due to the removal of import duty on gold in 2010.

Import of investment goods recorded a significant increase of 55.4 per cent in 2011 to US dollars 4,286 million led by increase in transport equipment, machinery as well as building materials. Increase in investment goods imports was attributed mainly to the large scale infrastructure development projects of the government funded by foreign inflows, which increased substantially during the year. Machinery and equipment which comprise engineering equipment, electronic equipment, telecommunication devices, office machinery, medical and laboratory equipment and machinery for the textile industry increased by 59.9 per cent to US dollars 2,141 million. Expenditure on imports of transport equipment which comprise vehicles for transport of passenger and goods, heavy-duty vehicles, small scale ships and boats grew by 79.5 per cent to US dollars 1,065 million. Expenditure on import of building materials which comprise mainly cement, iron and steel, aluminum articles and mineral products increased by 30.9 per cent to US dollars 1,076 million in 2011 reflecting an expansion in construction activities in the country.

Expenditure on import of consumer goods increased by 47.5 per cent to US dollars 3,654 million in 2011. Non-food consumer goods contributed 57.1 per cent to the total of consumer goods imports. The main contributor to increase the imports of non-food consumer goods was personal motor vehicles, motor cycles and trishaws, which increased by 93.6 per cent to US dollars 881

Chart 5.5 Import Performance

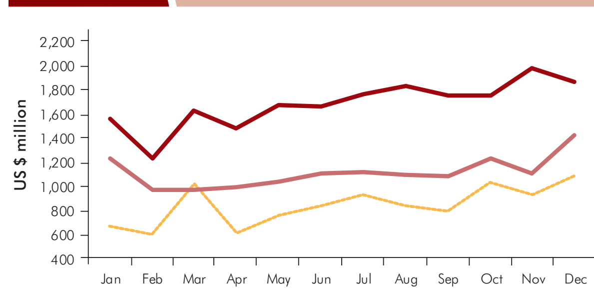


Table 5.5 Composition of Imports (a)

Category	2010 (b) Value US$ million	2010 (b) Share %	2011 (c) Value US$ million	2011 (c) Share %	Change in Value (c) US$ million	Growth Rate (c) %	Contribution to Growth (c) %
Consumer Goods	2,476.3	18.4	3,653.6	18.0	1,177.3	47.5	17.3
Food and Beverages	1,321.6	9.8	1,566.9	7.7	245.3	18.6	3.6
Rice	59.0	0.4	18.4	0.1	-40.6	-68.8	-0.6
Sugar and Sugar Confectionery	364.5	2.7	427.6	2.1	63.2	17.3	0.9
Dairy Products	258.6	1.9	345.2	1.7	86.6	33.5	1.3
Lentils	128.8	1.0	116.9	0.6	-11.9	-9.2	-0.2
Other	510.8	3.8	658.8	3.3	148.0	29.0	2.2
Other Consumer Goods	1,154.8	8.6	2,086.7	10.3	932.0	80.7	13.7
Vehicles	455.1	3.4	881.0	4.3	425.9	93.6	6.2
Medical and Pharmaceuticals	216.9	1.6	348.2	1.7	131.3	60.5	1.9
Home Appliances	93.2	0.7	227.9	1.1	134.7	144.4	2.0
Clothing and Accessories	91.7	0.7	141.8	0.7	50.1	54.6	0.7
Other	297.9	2.2	487.9	2.4	190.1	63.8	2.8
Intermediate Goods	8,054.4	59.9	12,275.3	60.6	4,220.9	52.4	61.9
Petroleum Products	3,040.8	22.6	4,794.9	23.7	1,754.1	57.7	25.7
Textiles	1,811.9	13.5	2,320.7	11.4	508.7	28.1	7.5
Diamonds and Precious Metals	378.1	2.8	1,075.7	5.3	697.7	184.5	10.2
Chemical Products	520.3	3.9	702.0	3.5	181.7	34.9	2.7
Wheat and Maize	265.1	2.0	429.4	2.1	164.3	62.0	2.4
Fertiliser	240.3	1.8	407.2	2.0	166.9	69.5	2.4
Other Intermediate Goods	1,797.8	13.4	2,545.3	12.6	747.6	41.6	11.0
Investment Goods	2,757.9	20.5	4,286.1	21.1	1,528.2	55.4	22.4
Building Materials	822.1	6.1	1,076.1	5.3	254.0	30.9	3.7
Transport Equipment	593.2	4.4	1,064.6	5.3	471.4	79.5	6.9
Machinery and Equipment	1,339.3	10.0	2,141.4	10.6	802.1	59.9	11.8
Other Investment Goods	3.3	0.0	4.0	0.0	0.7	20.7	0.0
Unclassified Imports	162.3	1.2	53.9	0.3	-108.5	-66.8	-1.6
Total Imports (d)(e)	13,450.9	100.0	20,268.8	100.0	6,817.9	50.7	100.0
Annual Average Exchange Rate (f)	113.06		110.57				

(a) Categories are reclassified based on National Import Tariff Guide - 2010
(b) Revised
(c) Provisional
(d) Adjusted
(e) Excludes re-imports
(f) Rupee/US dollar exchange rate

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

million, during the year. Increase in motor vehicle imports was influenced by the reduction in import duties and supported by relatively easy access to credit at competitive rates and increased real income levels. Medical and pharmaceutical product imports also increased by 60.6 per cent to US dollars 348 million in 2011. The expenditure on food and beverages imports increased by 18.6 per cent in 2011 to US dollars 1,567 million, mainly due to increased international prices of major consumer food varieties. Expenditure on sugar and confectionery goods imports increased by 17.3 per cent to US dollars 428 million partly driven by increase in sugar import price by 6.2 per cent due to global supply constraints in 2011. Import of dairy products, including milk powder, increased by 33.5 per cent to US dollars 345 million also due to higher international prices.

Trade Balance

The trade deficit in 2011 widened substantially reflecting the increase in import expenditure by 50.7 per cent outpacing the 22.4 per cent growth in exports earnings. Accordingly, the trade deficit increased by 101.2 per cent to US dollars 9,710 million in 2011 from US dollars 4,825 million in 2010. As a percentage of GDP, the trade

Chart 5.6 Imports by Commodities

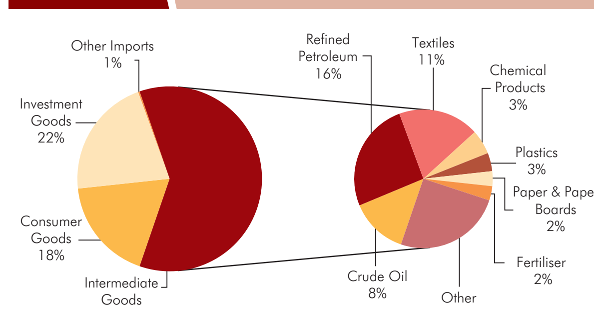


Table 5.6 Volume of Major Imports (a)

'000 mt

Item	2007	2008	2009	2010 (b)	2011 (c)
Rice	88	84	52	126	28
1st Quarter	4	41	3	121	8
2nd Quarter	7	28	3	2	2
3rd Quarter	3	12	2	2	9
4th Quarter	74	3	44	1	9
Wheat (d)	952	919	1,026	1,052	1,242
1st Quarter	204	272	288	352	322
2nd Quarter	388	312	229	171	455
3rd Quarter	274	153	220	292	254
4th Quarter	87	182	289	236	211
Sugar	478	571	466	548	606
1st Quarter	111	163	123	145	163
2nd Quarter	137	130	110	145	170
3rd Quarter	117	164	142	154	124
4th Quarter	113	114	92	104	149
Petroleum (Crude Oil) (d)	1,968	1,853	2,066	1,819	2,070
1st Quarter	272	229	559	332	557
2nd Quarter	556	525	417	541	555
3rd Quarter	589	544	416	541	410
4th Quarter	550	555	673	405	547
Refined Petroleum (d)	2,411	2,476	2,264	2,991	4,283
1st Quarter	621	807	433	814	887
2nd Quarter	682	603	639	931	1,133
3rd Quarter	521	504	579	541	1,038
4th Quarter	588	563	614	706	1,224
Fertiliser	569	773	462	649	801
1st Quarter	62	125	46	88	131
2nd Quarter	171	223	83	238	207
3rd Quarter	132	216	110	165	266
4th Quarter	205	208	223	158	197

(a) Categories are reclassified based on National Import Tariff Guide - 2010
(b) Revised
(c) Provisional
(d) Adjusted

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

deficit increased to 16.4 per cent in 2011 from 9.7 per cent in 2010.

Terms of Trade

The terms of trade deteriorated by 9.3 per cent in 2011 due to an increase in prices of imports at a higher rate than that of exports. The exports price index grew by 10.9 per cent in 2011 reflecting higher prices prevailed in the first half of 2011 for agricultural commodities and higher earnings of industrial products partly owing to quality improvements. The average export price index of coconut products and rubber increased by 38.1 per cent and 43.5 per cent, respectively, while the average tea export price index increased marginally by 5.4 per cent in 2011. The industrial export price index also increased by 10.7 per cent in 2011, mainly due to 55.8 per cent increase in petroleum products and 35.9 per cent increase in rubber based products exports.

Import price index increased by 22.4 per cent in 2011 reflecting an increase in price of all major import categories. Import prices of the food and non-food category increased by 9.1 per cent and 24.8 per cent respectively, leading to an increase in the consumer good price index by 17.6 per cent. Average prices of intermediate goods increased by 23.7 per cent mainly due to 37.9 per cent increase on fertiliser and 30.2 per cent increase in petroleum products. Import prices of investment goods also increased by 21.3 per cent in 2011, mainly led by machinery and equipment and transport equipment categories.

Direction of Trade

India remained the major trading partner in 2011 followed by Singapore and USA. The other countries that had trade over US dollars 1 billion in 2011 include China, Iran, UK and Japan. USA and UK remained the largest export destinations, while India and Singapore followed by China remained the foremost import origins in 2011. India contributed to over 16 per cent of Sri Lanka's external trade in 2011.

USA accounted for 20.3 per cent of Sri Lanka's exports, followed by UK (10.5 per cent) and EU (23.3 per cent, excluding UK). Garments continued to account for the bulk of exports to these markets. Among EU member countries, Italy (5.8 per cent), Belgium (5.4 per cent) and Germany (4.8 per cent) remained the leading export destinations in 2011. Almost 79 per cent of Sri Lanka's processed diamonds were exported to Belgium in

Chart 5.7 Terms of Trade and Trade Indices

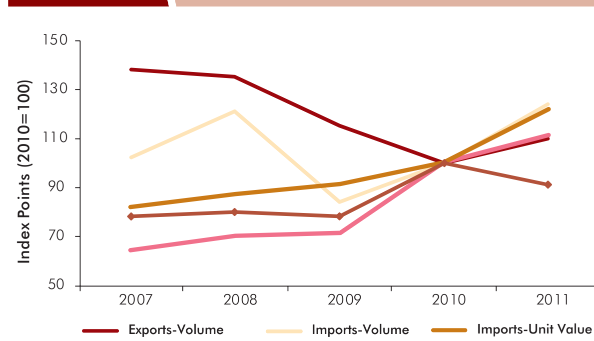


Chart 5.8 Exports by Destinations

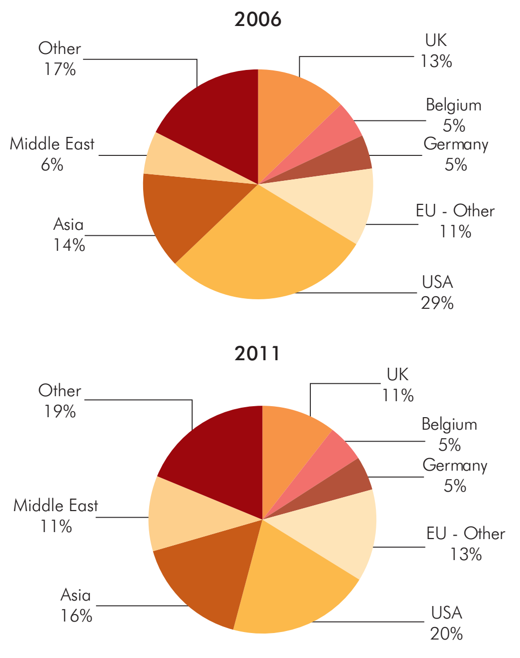
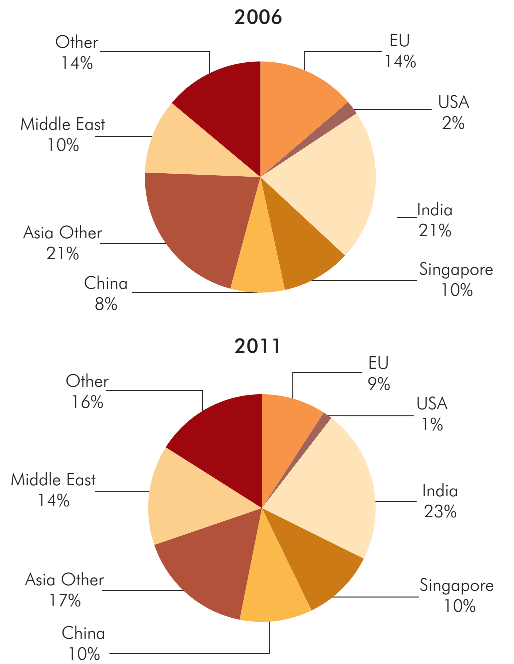


Chart 5.9 Imports by Origin



2011. Exports to India accounted for about 4.9 per cent of Sri Lanka's total exports, increased by 9.5 per cent in 2011 and comprised of machinery and equipment, animal fodder, spices and garments. Russia continued to be the major destination for tea exports accounting for nearly 17 per cent of total tea exports in 2011. Singapore emerged as an important export destination in 2011 by accounting for nearly 3.9 per cent of Sri Lanka's exports.

India continued to be the largest source of imports in 2011 and accounted for nearly 21.9 per cent of imports in 2011. Total imports from India amounted to US dollars 4,431 million in 2011. Main imports from India were refined petroleum products, motorcycles and auto-trishaws. Singapore and China followed as the second and third largest import origins, accounting for 10.5 per cent and 10.3 per cent of total imports, respectively. Main imports from Singapore comprised fertiliser and petroleum products, while the major imports from China were machinery and cotton. Iran and Japan remained the fourth and fifth largest source of imports, respectively. Imports from Iran and Japan comprised mainly crude oil and motor vehicles, respectively.

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

Trade in Services

The surplus in the services account of the BOP increased substantially by 55 per cent in 2011. The services account which consists mainly of transportation, travel, communication, computer and information services registered a surplus of US dollars 1,099 million during 2011, compared to the surplus of US dollars 707 million recorded in 2010, with a higher contribution from transportation and travel sub sectors.

Transportation Services

Transportation services, the largest category within the services sector, primarily led the growth in the services account. In spite of the slowdown in global economic activities, the gross inflows on account of transportation services consisting of passenger fares, freight charges and port and air port related activities reported a substantial growth of 20 per cent to US dollars 1,392 million during 2011. Meanwhile, outflows on account of transport services also increased by 17 per cent to US dollars 953 million in 2011, reflecting the higher growth of imports and the increase in Sri Lankans travelling abroad for leisure, employment, education and health care services.

Gross inflows on account of passenger fares increased by 26 per cent to US dollars 591 million in 2011. This was mainly due to the increase in the number of passengers travelling with SriLankan Airlines with its expansion of flying destinations, flying hours and flying frequency and increase in air fares mainly led by the fuel surcharge. Meanwhile, outflows on account of passenger fares also increased by 13 per cent to US dollars 425 million in 2011. SriLankan Airlines which purchased 5 new aircrafts in 2011, expects to add 2 more aircrafts in 2012 and expand its current fleet of 19, to 28 by 2016. With the planned acquisition of new aircrafts, increased tourist arrivals, expansion of airport capacity, expansion of flight destinations and increase in frequency of flights by the national carrier, inflows on account of passenger fares are expected to increase further in coming years.

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

Item	US$ million		Rs. million	
	2010 (b)	2011 (c)	2010 (b)	2011 (c)
1. Transportation Services	345	439	38,968	48,521
2. Travel	123	329	13,778	36,518
3. Communication Services	27	29	3,106	3,173
4. Computer and Information Services	265	355	29,962	39,251
5. Construction Services	36	36	4,037	4,012
6. Insurance Services	31	35	3,481	3,895
7. Other Business Services	-102	-108	-11,591	-11,854
8. Government Expenditure n.i.e.	-17	-17	-1,976	-1,882
Total Net Services	707	1,099	79,766	121,635
1. Compensation of Employees	-11	-11	-1,235	-1,224
2. Direct Investment	-294	-375	-33,176	-41,580
3. Interest and Other Charges	-312	-261	-35,366	-29,242
Total Net Income	-617	-647	-69,776	-72,046
1. Private	3,608	4,583	407,967	506,630
2. General Government	52	60	5,918	6,587
Total Net Current Transfers	3,660	4,643	413,885	513,216

Source: Central Bank of Sri Lanka

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

Gross inflows on account of freight, port and airport related services increased by 15 per cent to US dollars 800 million during 2011. Port related activities expanded as a result of higher number of vessel arrivals and increased volume of cargo and container handling. Port related activities are expected to grow rapidly in the period ahead with the recovery in global trade, greater usage of Hambantota port and other ports, launching of a port related online payment facility, establishment of a well-secured cargo warehousing and handling facility and construction of a state-of-the-art cargo village in Peliyagoda.

Travel and Tourism

Post-conflict growth momentum in the tourism sector continued to improve in 2011. The highest ever tourist arrivals of 855,975, an increase of 30.8 per cent compared to 2010, was recorded in 2011. Largest number of arrivals were from India (171,374) followed by UK (106,082), Germany (55,882), France (48,695), Maldives (44,018) and Australia (41,728). Tourist arrivals from the Middle East also increased by 53.2 per cent in 2011. Over 77 per cent of tourists arrived in Sri Lanka for holiday purposes, while 8 per cent of tourists arrived for business purposes in 2011 and others visited friends and relatives, conventions and meetings, and for religious and cultural purposes.

Earnings from tourism continued to grow significantly. In 2011, earnings from tourism registered an increase of 44.2 per cent compared to the previous year to record US dollars 830 million. The average spending by a tourist per night increased from US dollars 88 in 2010 to US dollars 97 in 2011, due to enhanced facilities and increased arrival of high end tourists.

A comprehensive National Tourism Strategy was launched in 2011, targeting all aspects of tourism sector development up to 2016. Government made a concerted effort together with the industry towards sustaining the revival and boom in the tourism industry. Objectives of the strategy are positioning Sri Lanka as one of the most sought after tourist destinations, including promoting tourism to reach 2.5 million tourist arrivals with annual foreign exchange earnings of US dollars 2.75 billion by 2016 while increasing direct and indirect employment to 500,000. Meanwhile, the one-stop unit which was established at the Sri Lanka Tourism Development Authority (SLTDA) to facilitate investments, processed more than 210 investment applications in 2011 to build 9,192 rooms. The homestay programme launched to provide more interactive facilities for tourists, added 143 units in 2011 and will further increase the number of units to 500 by 2012 including hotels, boutique hotels, boutique villas, home stay units, guest houses and heritage homes.

Visit Sri Lanka 2011 programme helped to attract tourists from new markets. Increased arrivals from countries such as China, Russia, Japan and Middle East were seen in 2011. In 2011, all key attractions were placed under 8 unique themes, namely, Heritage, Festive, Scenic, Essence, Thrills, Bliss, Pristine and Wild. MICE Tourism, which included Meetings, Incentive Travel, Conferences and Exhibitions, also showed a healthy growth by contributing around 12 per cent in 2011. New locations for product development extended from Kalpitiya, Passikudah, Dedduwa, Kuchchiveli to Vakarai, Yala, Hambantota, Silawatura and Jaffna. To meet the challenges of a fast growing tourism industry, more opportunities for training and development were initiated. Student intake for training in the hospitality industry was increased by 72 per cent in 2011, to meet the skills shortage in the market. SLTDA embarked on refurbishing its holiday resorts and guest houses. A new Tourism Act was drafted in 2011, to amalgamate the present four institutions with two institutions, viz Sri Lanka Tourism Authority and Sri Lanka Institute of Tourism and Hotel Management.

Tourism sector related infrastructure and services were further expanded in 2011. Several international hotel chains such as Shangri-La, Sheraton, Hyatt and Sun City are to enter into the tourism industry shortly. Eleven new airlines, Gulf Air, China Eastern, Aerosvit Airlines, Oman Air, Finnair, Hainan Airlines, Flydubai, Nova Airways, Pakistan International Airlines, Spicejet and Aeroflot registered to fly to Sri Lanka during the last two years. SriLankan Airlines also expanded its routes and frequency to cater to the increasing demand from emerging market economies and traditional tourist markets in Europe. SriLankan Air Taxis started operations covering 14 popular domestic tourist destinations in 2011 to attract and facilitate tourism.

Communication Services

Communication services continued to expand in 2011. Gross foreign inflows on account of communication services increased by 2.4 per cent to US dollars 85 million. Increase in earnings on International Direct Dialing (IDD) for voice calls mainly contributed to this growth.

Table 5.8 Tourism Performance

Item	2007	2008	2009	2010	2011 (a)	Growth Rate (%)	
						2010	2011 (a)
Tourist Arrivals (No.)	494,008	438,475	447,890	654,476	855,975	46.1	30.8
Pleasure	331,238	321,079	358,188	516,538	663,343	44.2	28.4
Business	52,116	37,261	38,473	83,270	68,097	116.4	-18.2
Other	110,654	80,135	51,229	54,668	124,535	6.7	127.8
Tourist Guest Nights ('000)	4,940	4,166	4,076	6,548	8,559	60.7	30.7
Room Occupancy Rate (%)	46.2	43.9	48.4	70.2	77.1	44.8	10.0
Gross Tourist Receipts (Rs. million)	42,571	37,094	40,133	65,018	91,926	62.0	41.4
Per Capita Tourist Receipts (Rs.)	86,175	84,598	89,605	99,344	107,393	10.9	8.1
Total Employment (No.)	145,238	123,134	124,970	132,055	138,685	5.7	5.0
Direct	60,516	51,306	52,071	55,023	57,786	5.7	5.0
Indirect	84,722	71,828	72,899	77,032	80,899	5.7	5.0

(a) Provisional

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

In the face of competition among the existing service providers and from new entrants to the market, the reduction in international call charges by both mobile and fixed line telecommunication operators encouraged IDD usage. However, with increased utilisation of e-mail, broad-band internet, satellite and cable TV and outgoing IDD, outflows on account of telecommunication increased at a parallel rate. To develop Sri Lanka as a Regional Hub for Asian telecommunication networks, the Telecommunication Regulatory Commission of Sri Lanka (TRCSL) has formulated plans to acquire fourth Generation (4G) telecommunication technology, which will enable and facilitate the country to harness its full potential and to grasp the opportunities for further expansion in communication services. With continuous technological innovation, it is expected that this sector will expand further in 2012 and beyond.

Computer and Information Services

Computer and information technology (IT) services sub-sector showed a remarkable growth in 2011. Gross inflows on account of the computer and information sub-sector increased by 34 per cent to US dollars 355 million during 2011. Identifying the potential of the Business Process Outsourcing (BPO) industry, the Government has taken several initiatives to fast track the development of this sector by providing fiscal and other incentives and concessions. *The AT Kearney Global Services Location Index (GSLI) - 2011* has ranked Sri Lanka among the top 25 in its index identifying the leading outsourcing destinations globally, and Colombo was ranked among the top 10 emerging outsourcing cities by *Global Services* magazine. *Lanka BPO Academy*, a recognised BPO training provider, which was set up in late 2010 plans to train more students and BPO professionals, which would facilitate the expansion of the BPO industry in Sri Lanka. Meanwhile, inflows on account of Knowledge Process Outsourcing (KPO), which is classified under 'other business services' also increased in 2011. Despite the limited size of the workforce in relation to other large outsourcing players such as India, Sri Lanka possesses highly skilled professionals in the fields of IT, finance and accounting. Professional expertise coupled with the location advantage in terms of time-differences is expected to place Sri Lanka as a preferred and an attractive outsourcing destination for KPO services.

Inflows and Outflows of Income

The income account recorded a deficit of US dollars 647 million during 2011 compared to the deficit of US dollars 617 million in 2010. Gross inflows to the income account increased significantly by around 45 per cent to US dollars 467 million, mainly due to the interest income from investment of official international reserves and profits earned on trading foreign currency and securities. In addition, higher depreciation of the US dollar against other major currencies such as the Euro and the Pound sterling in 2011, resulted in a significant gain in values of the official reserves denominated in those currencies when valued on the mark-to-market basis in US dollar terms. Meanwhile, outflows in the income account also increased by around 18 per cent to US dollars 1,114 million as a result of an increase in interest payments on foreign loans obtained by the Government. Of the interest payments on foreign loans of US dollars 709 million, interest paid on long and medium-term loans accounted for about 57 per cent. Meanwhile, outflows on account of FDIs increased by 27 per cent to US dollars 385 million, mainly due to the repatriation of profits and dividends by foreign enterprises established in Sri Lanka. However, a considerable portion of profits and dividends has been reinvested facilitating the expansion of existing operations during 2011.

Current Transfers

The net current transfers in 2011 increased significantly to US dollars 4,643 million from US dollars 3,660 million in 2010. Workers' remittances, which constitute a greater share of current transfers, continued to be the foremost foreign exchange earner in 2011, increasing notably by 25 per cent to US dollars 5,145 million, compared to US dollars 4,116 million in 2010. Repatriation of savings by migrant workers owing to uncertainty in the Middle Eastern countries, increase in average wages of workers, increased migration to high wage paying countries such as Korea, Malaysia and Singapore and increased labour migration of the professional category were the main factors which contributed to the inflows of workers' remittances in 2011. Also, entering into collective agreements on labour migration with several countries by the relevant authorities and expansion of the availability of formal channels including the increased number of bank branches and service offices in the Northern and Eastern provinces to remit funds to Sri Lanka helped to increase remittances during the year. Meanwhile, the number of migrant workers leaving for foreign employment increased by 6.4 per cent to 262,960 in 2011. To attract migrant workers' remittances, the Government in the 2012 budget provided a tax exemption for five years for migrants' investments on capital goods to commence new businesses.

Current Account Balance

The current account deficit increased substantially to US dollars 4,615 million in 2011 from US dollars 1,075 million in 2010 on account of the significantly high trade deficit. In terms of GDP, the current account deficit increased to 7.8 per cent of GDP in 2011 from 2.2 per cent of GDP in 2010. The deficit was mainly due to the widening trade deficit on account of increased import expenditure, particularly, oil and investment goods. However, about two-thirds of the deficit in the trade account was offset by higher inflows of workers' remittances and the surplus in the services account. Since the high current account deficit is a reflection of the high savings-investment gap of the country, it is important that the expansion in aggregate demand is curtailed through appropriate policies both monetary and fiscal, to bring it down to a level consistent with sustainable net capital inflows.

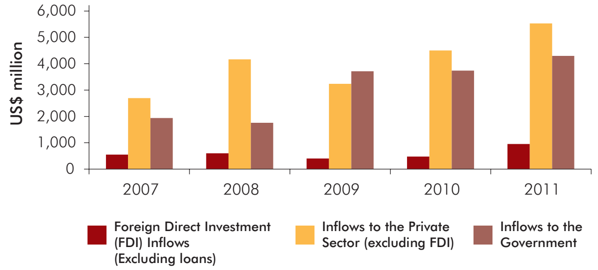
5.5 Capital and Financial Flows and Balance of Payments

Foreign Direct Investment

Reflecting positive investor confidence, Sri Lanka recorded the highest ever gross inflows of FDI in 2011. FDI, including loans, increased to US dollars 1,066 million in 2011 compared to US dollars 516 million in 2010. During the year, US dollars 110 million of loans were received by the Board of Investment (BOI) approved companies, compared to US dollars 39 million in 2010. Initiatives taken to streamline the approval process by establishing the 'one-stop-unit' concept and expedite development of prime infrastructure facilities resulted in higher FDI inflows of around US dollars 390 million during the last quarter of the year, compared to the average per quarter receipts of around US dollars 225 million during the first three quarters of the year. Positive investor sentiment was further buoyed by improvements in the country's rankings in global competitiveness and ease of doing business indices, as published in *Global Competitiveness Report 2011-2012* and *Doing Business in a More Transparent World-2012*, reports released by the World Economic Forum and World Bank, respectively.

A noticeable change was observed in sector-wise composition of FDI inflows. Hotels and restaurant sector (20 per cent share) attracted most FDI inflows in 2011, followed by the Telecommunication sector (18 per cent share), which used to be the dominant sector in recent years. Inflows to Hotels and restaurant sector were brought in by several prominent international hotel companies intending to cash in on the post-war tourism boom. A major investment share

Chart 5.10 Inflows to the Capital and Financial Account



was received from a leading hotel chain with an investment of around US dollars 130 million for constructing two luxury hotels in Colombo and Hambantota. Meanwhile, the FDI inflows in 2011 consisted of equity capital of US dollars 33 million, loans and advances of US dollars 513 million by shareholders, intra-company borrowing of US dollars 192 million, foreign loans of US dollars 110 million and reinvestment of retained earnings of US dollars 218 million by existing companies.

FDI outflows increased to US dollars 60 million in 2011 from US dollars 43 million in 2010, partly due to exchange control relaxations on foreign investments abroad. Accordingly, the net FDI inflows during 2011 increased to US dollars 896 million from US dollars 435 million recorded in 2010. The investment commitment of contracted projects along with the number of projects contracted increased during 2011 compared to 2010, indicating prospects for realisation of new FDI in coming years.

Medium and Long-term Capital to the Government

Reflecting fast implementation of major ongoing infrastructure projects, loan inflows to the Government increased significantly. Medium and long-term loan inflows to the Government excluding the proceeds of the Sovereign bond of US dollars 1 billion, amounted to US dollars 2,029 million during 2011, compared to US dollars 1,460 million in 2010. In July 2011, Sri Lanka's fourth international Sovereign bond to the value of US dollars 1 billion was successfully issued, with an oversubscription of 7.5 times. Meanwhile, the foreign funds utilisation[1] rate increased significantly in 2011 to 38.2 per cent from 24.8 per cent in 2010. Foreign loan inflows were mostly directed towards continuation of infrastructure projects such as Colombo Port Expansion Project, Rehabilitation and Improvement of Priority Roads Project, Upper Kotmale Hydro Power Project, Greater Colombo Transport Development Project and Southern Highway Construction Project.

[1] The foreign funds utilisation rate was computed as the ratio of disbursements during 2011 to the committed undisbursed balance as at end June 2011.

Table 5.9 Major Projects Financed with Foreign Borrowings during 2011

Lender and Project	Amount Disbursed US$ million
Asian Development Bank	**262.5**
of which; Colombo Port Expansion Project	75.0
National Highways Sector Project	41.3
Eastern and North Central Provincial Road Project	20.2
Northern Road Connectivity Project	19.9
Australian and New Zealand Investment Bank	**35.7**
of which; Integrated water Supply Scheme for the Unserved Areas of Ampara District (III)	35.7
Calyon Credit Agricole CIB	**18.5**
of which; Rehabilitation of Wimalasurendra and New Laxapana Power Stations	18.5
China Development Bank Corporation	**75.4**
of which; Rehabilitation and Improvement of Priority Road Project	75.4
Export Development Bank of Iran	**17.1**
of which; Implementation of Rural Electrification project (VIII)	17.1
Export-Import Bank of China	**333.5**
of which; Puttalam Coal Power Project (II)	63.6
Mattala Hambantota International Airport Project	51.7
Supply of two Nos. MA 60 Aircrafts Project	39.7
Northern Road Rehabilitation Project	68.1
Colombo - Katunayake Expressway (CKE) Section A1, A2, A4	41.7
Bunkering Facility & Tank Farm Project at Hambantota	28.2
Government of India	**201.2**
of which; Railway Line Omanthai-pallai, Madhu-Tallaimannar & Medawachchiya	121.5
Upgrading of Railway Line Colombo Matara (I and II)	51.2
India Dollar Credit Line Agreement	28.6
Government of Japan	**346.4**
of which; Upper Kotmale Hydro Power Project	77.9
Southern Highway Construction Project (II)	64.5
Greater Colombo Transport Development Project	43.5
Emergency Natural Disaster Rehabilitation Project	42.4
Water Sector Development Project	29.0
Government of the Republic of Korea	**26.6**
of which; Improvement of Padeniya - Anuradhapura Road Project	23.4
International Development Association	**195.7**
of which; Small and Medium Enterprise Development Facility Project	28.8
North East Local Services Improvement Project	19.0
Second Community Development and Livelihood Improvement Project	18.2
Additional Financing for North-East Housing Reconstruction Project	17.2
Second North-East Irrigated Agriculture Project	16.7
Renewable Energy for Rural Economic Development	15.9
Emergency Northern Recovery Project	15.5
Nordea Bank Denmark A/S	**38.6**
of which; Kelani Right Bank Water Treatment Plant	22.8

Source: External Resources Department

Short-term Capital to the Government

Short-term net foreign inflows on account of investments in Treasury bills and bonds in 2011 amounted to US dollars 233 million compared to US dollars 531 million in 2010. Reflecting the growing uncertainties in advanced economies and diversification of investments to emerging economies, foreign investors showed a continued interest in investing in Sri Lanka's government securities. Accordingly, by end November 2011, outstanding value of foreign holdings of government securities as a percentage of total outstanding value of government securities reached the threshold level of 10 per cent. Subsequently, in view of the increased demand, as well as the need to support the growth momentum of the economy, the Central Bank on 6 December 2011 raised the threshold for foreign investments in Treasury bills and bonds from 10 per cent to 12.5 per cent.

Long-term Capital to the Private Sector

Private sector long-term loan inflows amounted to US dollars 364 million in 2011, compared to US dollars 580 million recorded in 2010. The higher inflows in 2010 was due to the one-off receipt of US dollars 451 million from the Exim Bank of China to Lanka Coal Company Limited (LCCL) for the Puttalam Coal Power Project. Inflows in 2011 includes receipt of US dollars 65 million from the Exim Bank of China to LCCL for the Puttalam Coal Power Project and US dollars 54 million to Airport and Aviation Services (Sri Lanka) Limited for Mattala International Airport Project. In line with higher FDI inflows in 2011, foreign loan inflows to the BOI approved companies increased to US dollars 110 million compared to US dollars 39 million in 2010. Foreign borrowings by the private sector in 2011 were mainly for investment in hotels, telecommunication and power and energy sectors. Meanwhile, gradual relaxation of exchange control regulations effected by the Central Bank, facilitated foreign exchange transactions and business activities, enabling corporates to borrow from foreign lending sources. This has resulted in 23 private companies obtaining approval for raising foreign loans, amounting to US dollars 205 million during 2011.

Short-term Capital to the Private Sector and Public Corporations

Private short-term capital inflows increased substantially during 2011. Private short-term capital inflows consist of portfolio investments, trade credits and changes in assets and liabilities of commercial banks. Private short-term capital reversed to a net inflow of US dollars 572 million in 2011 compared to a net outflow of US dollars 198 million in 2010. This was mainly driven by the increase in net foreign liabilities of commercial banks and large oil import credits received by the Ceylon Petroleum Corporation (CPC) during 2011. The CPC received trade credits of US dollars 2,674 million including US dollars 1,455 million of Iranian line of credit for oil imports in 2011, compared to US dollars 1,490 million of total trade credits received in 2010. Further, US dollars 1,369 million of Iranian credits were settled during 2011.

Gross foreign inflows to the Colombo Stock Exchange (CSE) during 2011 decreased to US dollars 452 million, compared to US dollars 819 million in 2010, while net outflows recorded in 2011 was US dollars 171 million, compared to net outflows of US dollars 230 million in 2010. The decline in gross inflows could partly be due to diversification of investments with investors' preference for safe investment opportunities such as commodities, particularly gold, and fixed income bearing government securities amidst growing global debt crisis.

Net foreign liabilities of commercial banks increased by US dollars 971 million to US dollars 2,125 million in 2011. Foreign assets of commercial banks decreased by US dollars 183 million in 2011 compared to US dollars 249 million in 2010. Meanwhile, foreign liabilities of commercial banks increased by US dollars 788 million during 2011, compared to US dollars 815 million in 2010, resulting in net foreign liabilities of commercial banks increasing by US dollars 971 million in 2011. Increase in net foreign liabilities of commercial banks were mainly due to, conversion of foreign assets and increasing foreign liabilities, to generate foreign exchange to finance domestic foreign currency lending to CPC by around US dollars 620 million, and to other private sector enterprises, as well as, to finance investment in Sri Lanka Development Bonds by commercial banks.

Balance of Payments

BOP, which recorded a substantially high surplus in August, turned into a deficit by end 2011, mainly due to adverse global developments and increased domestic demand, in the last quarter of the year. By mid-August 2011, the BOP recorded a healthy surplus of US dollars 1.2 billion supported by inflows to the services account, workers' remittances and other financial flows to the Government and the private sector. However, with accelerated economic activity in the country, substantially high demand for intermediate and investment goods and high international oil prices led the trade deficit to expand significantly in the latter part of the year, resulting in a relatively high current account deficit in 2011. Although, the surplus in the capital and financial account increased significantly in 2011 compared to 2010, the high current account deficit surpassed the surplus in the capital and financial account resulting in a deficit of US dollars 1,061 million in the BOP by end 2011.

International Reserves

Gross official reserves, comprising of international reserves owned by the Central Bank and the Government (excluding Asian Clearing Union (ACU) balances) amounted to US dollars 5,958 million by end 2011, compared to US dollars 6,610 million by end 2010. The reserve position by year end was equivalent to 3.5 months of imports compared to 5.9 months of imports recorded by end 2010. Due to the Central Bank's move in absorbing excess foreign exchange from the market, receipts of Sovereign bond proceeds and the receipts under IMF SBA, the gross official reserves of the country reached a record high level of US dollars 8.2 billion by mid-August 2011. However, during the second half of 2011, the widened trade deficit necessitated the Central Bank to supply foreign exchange to meet a part of such increased demand, despite increased receipts on account of workers' remittances, tourism and inflows to capital and financial account. As a result, the gross official reserves declined to US dollars 6 billion by end 2011.

Under the IMF-SBA facility, a total of SDR 1.65 billion (approximately US dollars 2.56 billion) was approved in July 2009. Accordingly, by end 2010, four reviews were completed and a total of US dollars 1.3 billion (SDR 827 million) was received on account of the SBA facility (see Central Bank of Sri Lanka – Annual Report 2010- Box 11). The fifth and sixth reviews were completed in February and April 2011, respectively, and a total of US dollars 436 million was received as the sixth and seventh tranches (SDR 137.8 million each). Further, based on the successful performance under the IMF – SBA programme, the IMF Executive Board in

Table 5.10 International Reserves of Sri Lanka (a)

Ownership	US$ million (b)					Rs. million				
	2007	2008	2009	2010	2011 (c)	2007	2008	2009	2010	2011(c)
1. Government	99	101	113	88	615	10,768	11,411	12,920	9,747	70,088
2. Central Bank	3,409	2,301	5,244	7,109	6,133	370,640	260,297	599,880	788,722	698,528
3. Total Official Reserves (1+2)	3,508	2,402	5,357	7,196	6,748	381,408	271,708	612,799	798,469	768,616
4. Commercial Banks	1,448	1,238	1,673	1,424	1,241	157,454	140,075	191,373	158,031	141,394
5. Total International Reserves (3+4)	4,956	3,640	7,030	8,621	7,989	538,862	411,783	804,173	956,500	910,010
6. Gross Official Reserves in Months of										
6.1 Import of Goods	3.7	2.0	6.3	6.4	4.0					
6.2 Import of Goods and Services	3.3	1.8	5.5	5.7	3.6					
7.Total Reserves in Months of										
7.1 Import of Goods	5.3	3.1	8.3	7.7	4.7					
7.2 Import of Goods and Services	4.7	2.8	7.2	6.8	4.3					

(a) Calculated at market value and includes Asian Clearing Union (ACU) balances.
(b) Converted at the following year end rates, except for certain items in the International Reserves of the Central Bank of Sri Lanka which were converted at the representative rate agreed with the International Monetary Fund.

Year	2007	2008	2009	2010	2011
Rs. per US dollar (year end)	108.72	113.14	114.38	110.95	113.90

(c) Provisional

Source: Central Bank of Sri Lanka

BOX 11 Gold as a Reserve Asset

Introduction

Gold is one of the most precious metals in the world and it is a highly valuable metal for coinage and jewellery long before recorded history. Gold standards have been the most common basis for conduct of monetary policies since the last century. With mounting global economic worries, prices of gold have reached record-breaking levels due to its value as a safe haven asset, inflation hedge, investment and source of high quality collateral.

With the crash of financial markets in 2007, businesses and investors lost faith in foreign exchange, equity and property markets. The impact of the Euro zone and US debt crises resulted in a drastic increase in demand for gold as a safe haven asset. Inflationary pressures and enhanced investment in gold by global central banks have also boosted demand for gold.

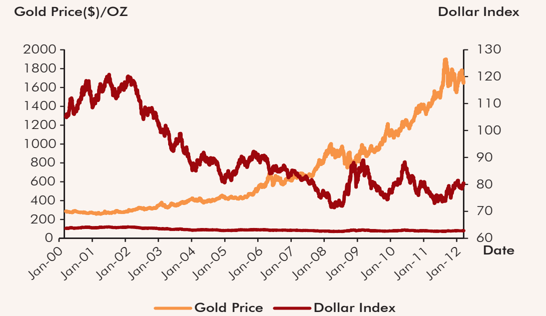
Role of Gold in Central Bank Reserve Management

According to the World Gold Council, despite being a commodity, gold is the third largest reserve asset held by central banks – exceeded only by USD and EUR denominated assets. This is mainly due to the fact that the value of the foreign reserves of a country must be preserved, as far as possible, even during times of turbulence.

Gold also meets the main objectives of reserve management, which includes low risk, high liquidity and positive returns due to the following reasons.

- The investment guidelines of most central banks are limited to investment in a few key asset classes such as deposits with investment grade institutions, high quality sovereign debt and quasi-sovereign bonds and Special Drawing Rights (SDR). However, the recent crises have highlighted the fact that even sovereign debt is not devoid of credit risk, as credit quality of many sovereign assets have deteriorated sharply. In this environment, gold will be the most eligible reserve asset for every central bank in the world, as it doesn't bear credit risk or counter-party risk.
- Historically, gold has a positive correlation with inflation. Hence by investing in gold central banks can mitigate the inflationary risks faced by the investment portfolios of banks during periods of high inflation. Further, gold holdings will improve public confidence in a currency or central bank especially at a time of crisis.
- Most central banks hold their reserves in US dollar-denominated assets. Gold has a negative relationship with the US dollar due to its function as an alternative store of value. Hence by diversifying into gold, reserve managers can overcome the risks arising from dollar depreciation.

Chart B 11.1 Movement of Dollar Index and Gold Price 2000-2011



Source: Bloomberg Financial Data

- The gold market remained liquid throughout the financial crisis even with liquidity issues in other markets. Gold liquidity is supported by its diverse range of buyers and sellers who have differing trading motives and who react differently to price movements. Unlike financial assets, source of demand for gold is not dependent only for the investment purpose. Further, the supply of gold is also diversified, making it difficult for a few market players to manipulate the market.
- Historically, gold has a safe-haven demand during times of financial market turmoils. This is owing to gold not having any credit risks and because its value cannot be depreciated by the policies that are often put in place to remedy financial crises. Also, a new financial use of gold has been created during the period of crisis where central counter-party clearing houses have started to accept gold as a collateral.

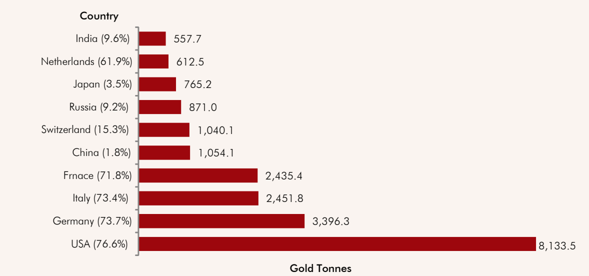
Central banks of both advanced and emerging economies became net buyers of gold for the first time in 2010 since 1988 as the economic crises unfolded in the western world.

Main gold holding nations

As at the end of December 2011, 76.6 per cent of USA's foreign reserves are in the form of gold which is the highest in any country in the world. Germany, Italy, France and the Netherlands hold more than 60 per cent of their foreign reserves in gold.

In the case of the Asian region, China led the way to enhance its gold reserves by increasing its gold holdings from 600 tonnes to 1,054 tonnes. Other Emerging Market Economies that increased gold holdings during the past few years include Thailand, Sri Lanka, Korea and India.

Chart B 11.2 Major Gold Holding Nations as at December 2011



** Percentage of Gold in the foreign reserve is indicated next to the country's name

Source: IMF

Gold Reserves in Sri Lanka

The Central Bank commenced trading activities in gold in early 1990s. Central Bank engages in buying and selling of gold in the international market with the view of optimizing reserve management objectives and it gradually accumulated its gold holdings.

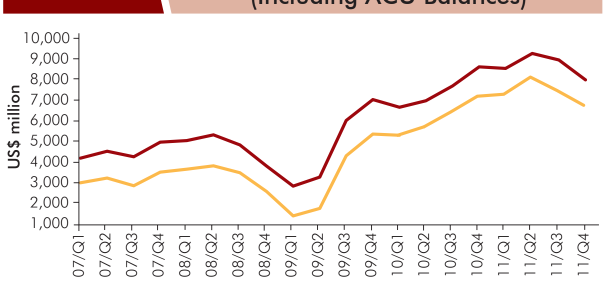
In 1990s, prior to the deregulation of gold imports, Central Bank imported physical quantities of retail items of gold (i.e., bars and coins) on consignment basis for the purpose of reselling to retail local customers. In 1996 this function was entrusted to commercial banks. After handing over of the retail function to the commercial banks, Central Bank has not made any sale of gold in the local market, nor has it imported any gold for retail sale.

The recent major gold purchase by Central Bank was in 2009 with the purchasing of 10 tonnes of gold from IMF. Central Bank continues to maintain an adequate level of gold in its foreign reserves.

April 2011 decided to re-structure the reviews and disbursements from quarterly to semi-annual basis and the remaining four tranches were combined into two, by doubling the former tranche value. The seventh review is expected to be completed on 2 April, 2012 and US dollars 427 million (SDR 275.6 million) is expected to be received as the eighth tranche. The eighth and final review of the SBA programme is scheduled to be completed in July 2012 and the final tranche to be released subsequently, concluding the programme.

The total international reserves, which consist of gross official reserves (excluding ACU balances) and commercial banks' foreign assets amounted to US dollars 7,199 million by end 2011, compared to US dollars 8,034 million by end 2010. The decrease in total international reserves by US dollars 836 million was due to the decline in gross official reserves by 653 million and a decline in commercial banks' foreign reserves by US dollars 183 million. The reserve adequacy, as measured by the ratio of gross official reserves to short-term external debt (one year or less maturity), decreased to 71 per cent by end 2011, from 96.5 per cent recorded at end 2010 reflecting both the drop in reserves and increase in short-term debt. The increase in short-term debt is mainly driven by the increase in commercial banks' liabilities as well as due to the repayment of Sovereign bond of US dollars 500 million (issued in 2005) which is falling due for settlement in 2012.

Chart 5.11 Quarterly International Reserves (Including ACU Balances)



Based on an increasingly evident peace dividend as reflected by greater macroeconomic and financial stability, improving external payments position and fiscal consolidation, the international rating agencies upgraded Sri Lanka's ratings in early 2011. Fitch Ratings upgraded Sri Lanka's Long-term Foreign and Local Currency Issuer Default Ratings (IDRs) to 'BB-' from 'B+', while the outlook on these ratings remained 'Stable'. Further, Fitch upgraded the Country Ceiling to 'BB-' from 'B+' and affirmed the Short-term Foreign-Currency IDR at 'B'. Meanwhile, Moody's Investors Services upgraded the outlook of Sri Lanka's B1 foreign currency sovereign rating from 'Stable' to 'Positive', and S&P upgraded the outlook of Sri Lanka's 'B+' foreign currency sovereign rating from 'Stable' to 'Positive'.

Several measures were initiated by the Central Bank to attract more foreign inflows to the country. Local enterprises were encouraged to borrow directly from international financial markets by relaxing exchange control regulations, while commercial banks were permitted to raise foreign funds to increase their Tier 2 capital. Further, foreign inflows to the government securities market were encouraged by raising the threshold for foreign investments from 10 per cent to 12.5 per cent of outstanding Treasury bills and bonds stock in December 2011. Also, the Central Bank in coordination with relevant institutions will closely monitor foreign exchange inflows to the country in order to ensure that anticipated inflows are received.

5.6 External Debt and Debt Service

External Debt

The total external debt of the country as a percentage of GDP decreased to 41.3 per cent in 2011 from 43.3 per cent in 2010. In US dollar terms, total external debt increased by 14.1 per cent to US dollars 24.5 billion in 2011 from US dollars 21.4 billion in 2010, mainly owing to an increase in medium and long-term debt. Of the medium to long-term debt, the government debt accounted for about 85 per cent. The higher level of disbursements to the Government, including US

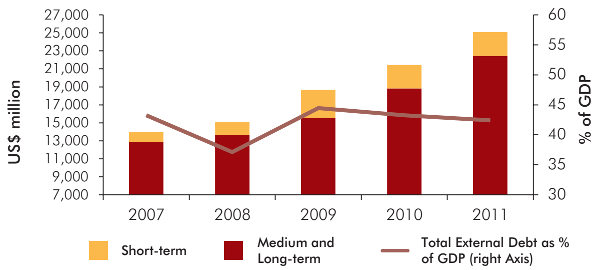
Table 5.11 Outstanding External Debt and Banking Sector External Liabilities

Item	US$ million					Rs. million				
	2007	2008	2009	2010	2011 (a)	2007	2008	2009	2010	2011 (a)
1. Medium and Long-term Debt	**12,879**	**13,646**	**15,564**	**18,823**	**21,882**	**1,400,883**	**1,543,952**	**1,780,313**	**2,088,449**	**2,492,391**
1.1 Government	11,744	12,593	13,769	16,076	18,508	1,276,846	1,424,729	1,574,933	1,783,728	2,108,084
1.2 Public Corporations and Private Sector with Government Guarantee	345	251	110	517	646	37,501	28,429	12,608	57,398	73,581
1.3 Public Corporations and Private Sector without Government Guarantee	539	634	967	919	1,010	58,553	71,715	110,570	101,913	115,033
1.4 IMF Drawings (b)	251	169	719	1,311	1,718	27,933	19,079	82,201	145,410	195,693
2. Short-term Debt	**1,111**	**1,460**	**3,098**	**2,615**	**2,584**	**120,748**	**165,207**	**354,341**	**290,149**	**294,311**
2.1 Government (c)	457	212	1,622	2,171	2,367	49,641	24,006	185,534	240,855	269,654
2.2 Other (d)	654	1,248	1,476	444	216	71,107	141,201	168,808	49,294	24,657
3. Banking Sector External Liabilities	**2,493**	**2,669**	**2,251**	**3,393**	**4,385**	**271,063**	**301,950**	**257,575**	**376,418**	**499,506**
3.1 Central Bank (e)	2	1	227	228	229	219	64	26,042	25,322	26,047
3.2 Commercial Banks (f)	2,046	1,861	1,763	2,578	3,366	222,389	210,531	201,696	286,052	383,427
3.3 Asian Clearing Union (ACU) Liabilities	446	808	261	586	790	48,454	91,355	29,837	65,044	90,032
4. Total External Debt (1+2)	**13,989**	**15,107**	**18,662**	**21,438**	**24,466**	**1,521,581**	**1,709,159**	**2,134,654**	**2,378,598**	**2,786,701**
5. Total External Debt and Liabilities (1+2+3)	**16,483**	**17,775**	**20,913**	**24,830**	**28,851**	**1,792,643**	**2,011,109**	**2,392,229**	**2,755,015**	**3,286,208**
MEMORANDUM ITEMS										
Medium and Long-term Debt										
Project Loans	10,002	11,148	11,914	13,174	14,482	1,087,359	1,261,304	1,362,806	1,461,729	1,649,492
Non-Project Loans	1,064	740	708	1,516	1,860	115,697	83,703	81,025	168,151	211,847
Suppliers' Credits	679	705	1,146	1,838	2,683	73,790	79,722	131,103	203,888	305,631
IMF Drawings (b)	251	169	719	1,311	1,718	27,933	19,079	82,201	145,410	195,693
Other Loans (g)	884	885	1,077	985	1,139	96,054	100,145	123,178	109,271	129,727
Short-term Debt and Banking Sector External Liabilities	**3,604**	**4,129**	**5,349**	**6,008**	**6,969**	**391,811**	**467,157**	**611,916**	**666,566**	**793,817**
As a Percentage of GDP (h)										
Total External Debt	43.2	37.1	44.4	43.3	41.3	42.4	38.8	44.1	42.4	42.6
Total Banking Sector External Liabilities	7.7	6.6	5.4	6.8	7.4	7.6	6.8	5.3	6.7	7.6
Total External Debt and Liabilities	51.0	43.7	49.7	50.1	48.8	50.1	45.6	49.5	49.2	50.2
Short-term Debt	3.4	3.6	7.4	5.3	4.4	3.4	3.7	7.3	5.2	4.5
Short-term Debt and Banking Sector External Liabilities	11.1	10.1	12.7	12.1	11.8	10.9	10.6	12.7	11.9	12.1
As a Percentage of Total Debt and Liabilities										
Short-term Debt	6.7	8.2	14.8	10.5	9.0	6.7	8.2	14.8	10.5	9.0
Short-term Liabilities	15.1	15.0	10.8	13.7	15.2	15.1	15.0	10.8	13.7	15.2
Short-term Debt as a Percentage of Official Reserves	**31.7**	**60.8**	**57.8**	**36.3**	**38.3**	**31.7**	**60.8**	**57.8**	**36.3**	**38.3**

(a) Provisional
(b) Includes drawings under the International Monetary Fund (IMF) Stand-by Arrangement facility of 2009.
(c) Includes outstanding Treasury bills and Bonds issued to non-residents.
(d) Includes Iranian line of credit of the Ceylon Petroleum Corporation and other trade credits.
(e) Includes currency Swaps of US dollars 200 mn from 2009.
(f) Foreign liabilities of commercial banks including those of Offshore Banking Units.
(g) Includes long-term loans of public corporations and private sector institutions.
(h) Based on GDP at current market prices published by the Department of Census and Statistics.

Sources: External Resources Department
Central Bank of Sri Lanka

Chart 5.12 External Debt



dollars 1 billion Sovereign bond proceeds received in July 2011 resulted in government debt stock increasing by 15 per cent in 2011. Concessional loans to the Government from multinational institutions increased by 4 per cent to US dollars 5.48 billion in 2011. Meanwhile, concessional debt as a per cent of total government external debt decreased to 63 per cent by end 2011, from 71 per cent recorded by end 2010. In 2011, Short-term debt decreased marginally to US dollars 2.58 billion from US dollars 2.62 billion in 2010. This was mainly due to the drop in outstanding value of trade credits to the CPC, despite the marginal increase in outstanding stock of Treasury bills and bonds. Meanwhile, the ratio of short-term debt to total debt and liabilities declined to 9 per cent by end 2011.

On the currency composition of total external debt outstanding, the shares on SDR and US dollar denominated debt accounted for 28.4 per cent and 34.8 per cent, respectively, while 26.5 per cent was denominated in Japanese yen.

The banking sector external liabilities increased substantially by 29 per cent to US dollars 4.4 billion by end 2011. This was mainly due to the increase of commercial bank liabilities to US dollars 3.4 billion by end 2011, compared to US dollars 2.6 billion by end 2010, as a result of increased import credits by commercial banks to corporate borrowers, particularly to the CPC. Meanwhile, the ACU liabilities increased to US dollars 790 million by end 2011, from US dollars 586 million by end 2010, owing to deferred settlement by the year end. The total external debt and liabilities as a percentage of GDP declined marginally to 48.8 per cent by end 2011, from 50.1 per cent in 2010.

External Debt Service Payments

The total foreign debt service payments, consisting of amortisation and interest payments, declined in nominal terms to US

Table 5.12 External Debt Service Payments

Item	US$ million					Rs. million				
	2007	2008	2009	2010 (a)	2011 (b)	2007	2008	2009	2010 (a)	2011 (b)
1. Debt Service Payments	1,232	1,525	1,702	1,761	1,717	136,521	165,511	195,727	199,144	189,732
1.1 Amortization	791	1,075	1,346	1,142	1,008	87,731	116,702	154,713	129,100	111,392
(i) To IMF	5	77	95	46	11	789	8,582	10,941	5,238	1,238
(ii) To Others	786	998	1,251	1,095	996	86,942	108,120	143,772	123,862	110,154
1.2 Interest Payments	441	450	357	619	709	48,790	48,809	41,014	70,043	78,340
(i) To IMF	14	11	6	7	9	1,509	1,173	644	803	1,081
(ii) To Others	427	440	351	612	700	47,281	47,636	40,370	69,240	77,259
2. Earnings from Exports of Goods and Services	9,415	10,115	8,977	11,100	13,643	1,041,932	1,095,679	1,031,289	1,254,021	1,508,565
3. Receipts from Export of Goods, Services, Income and Private Transfers	12,365	13,001	12,423	15,539	19,254	1,368,959	1,408,637	1,427,658	1,755,695	2,128,776
4. Debt Service Ratio (c)										
4.1 As a Percentage of 2 above										
(i) Overall Ratio	13.1	15.1	19.0	15.9	12.6	13.1	15.1	19.0	15.9	12.6
(ii) Excluding IMF Transactions	12.9	14.2	17.8	15.4	12.4	12.9	14.2	17.9	15.4	12.4
4.2 As a percentage of 3 above										
(i) Overall Ratio	10.0	11.7	13.7	11.3	8.9	10.0	11.7	13.7	11.3	8.9
(ii) Excluding IMF Transactions	9.8	11.1	12.9	11.0	8.8	9.8	11.1	12.9	11.0	8.8
5. Government Debt Service Payments										
5.1 Government Debt Service Payments (d)	813	1,066	1,166	922	1,152	89,924	115,508	134,019	104,240	127,365
5.2 As a Percentage of 1 above	66.0	69.9	68.5	52.4	67.1	65.9	69.8	68.5	52.3	67.1

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

Sources: Central Bank of Sri Lanka

dollars 1,717 million in 2011 from US dollars 1,761 million in 2010. Further, as a percentage of exports of goods and services, total foreign debt service payments decreased to 12.6 per cent in 2011, compared to 15.9 per cent in 2010 and 19 per cent in 2009. The higher ratios in 2010 and 2009 could mainly be attributed to the settlement of syndicated loan of US dollars 25 million and US dollars 225 million, respectively, and the full settlement of debt moratorium, granted in 2005 in the aftermath of Tsunami disaster in 2004. Meanwhile, the significant increase in exports of goods and services in 2011 could have greatly contributed to lowering the debt service ratio.

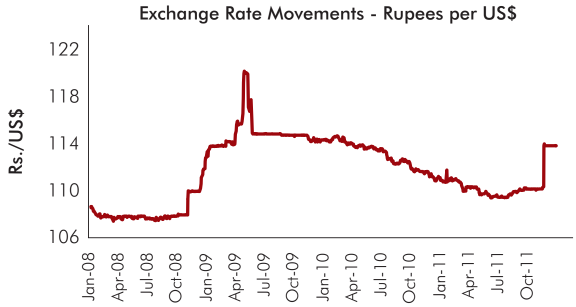
5.7 Exchange Rate Regime and Exchange Rate Movements

Exchange rate policy in 2011 focused on reducing pressure in the domestic foreign exchange market thereby avoiding undue fluctuations in exchange rate. The rupee appreciated by 1.23 per cent vis-a-vis the US dollar in the first half of 2011, supported by substantial receipts on account of remittances, tourism and inflows to the capital and financial account, while depreciating by 0.54 per cent during the third quarter of 2011 due to the demand pressure led by the sharp increase in import expenditure. Meanwhile, along with the Government budget proposal to strengthen export competitiveness and curtailing increasing import expenditure, the rupee was depreciated by 3 per cent in November 2011. Accordingly, by end 2011, the rupee depreciated against the US dollar by 2.59 per cent to Rs.113.90. Meanwhile, the annual average exchange rate against the US dollar in 2011 was Rs. 110.57 compared to Rs. 113.06 in 2010.

Reflecting cross currency behaviour, the rupee showed mixed movements against other major currencies during 2011. The rupee appreciated significantly against the Indian rupee (15.01 per cent) and moderately against the Euro (0.09 per cent) with the slowdown in activity of Euro Zone. Rupee depreciated against the Pound sterling (2.30 per cent) and the Japanese yen (7.21 per cent). The rupee depreciated against the SDR by 2.31 per cent during 2011 reflecting movements of major currencies such as Euro, Yen, and Pound sterling against the US dollar in international markets.

In February 2012, the Central Bank decided to allow more flexibility in the exchange rate and limit its intervention in the foreign exchange market. Hence the supply of foreign exchange will be limited to the extent needed to settle the major portion of petroleum import bills, and to absorb surplus foreign exchange liquidity that would flow into the market from various sources including the receipts of Tier-2 capital for commercial banks, inflows to equity and bond markets etc., that may otherwise lead to an undue appreciation of the rupee. The intention of this policy was to discourage imports while encouraging exports, enabling to reduce the trade deficit, as well as, the current account deficit.

Chart 5.13 Exchange Rate Movements



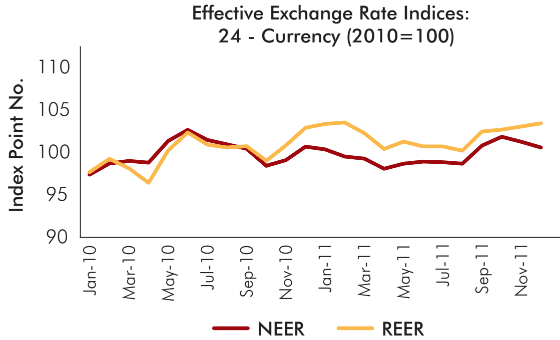


Table 5.13 Exchange Rate Movements

Currency	In Rupees per unit of Foreign Currency						Percentage Change over Previous Year (a)			
	End Year Rate			Annual Average Rate			End Year		Annual Average	
	2009	2010	2011	2009	2010	2011	2010	2011	2010	2011
Euro	163.72	147.56	147.42	160.21	150.10	153.86	10.95	0.09	6.73	-2.45
Indian rupee	2.46	2.48	2.15	2.39	2.49	2.39	-0.73	15.01	-3.91	4.27
Japanese yen	1.24	1.36	1.47	1.23	1.29	1.39	-8.80	-7.21	-4.54	-7.06
Pound sterling	181.75	171.41	175.45	179.87	174.81	177.23	6.03	-2.30	2.90	-1.37
US dollar	114.38	110.95	113.90	114.94	113.06	110.57	3.09	-2.59	1.66	2.26
SDR	178.67	170.84	174.87	177.22	172.50	174.54	4.58	-2.31	2.73	-1.17

Effective Exchange Rate Indices (b) (c) (2010=100)	End Year Index			Annual Average Index			Percentage Change over Previous Year			
							End Year Index		Annual Average Index	
	2009	2010	2011	2009	2010	2011	2010	2011	2010	2011
NEER - 24 currencies	98.12	100.49	101.43	99.85	100.00	99.83	2.42	0.93	0.15	-0.17
REER - 24 currencies (d)	97.48	102.73	103.90	97.65	100.00	102.07	5.38	1.14	2.40	2.07

(a) Changes computed on the basis of foreign currency equivalent of Sri Lanka rupees. A minus sign indicates depreciation.
(b) The Nominal Effective Exhange 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 the countries whose currencies are included in the basket. A minus sign indicates depreciation.
(c) The exchange rates have 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.
(d) CCPI was used for REER computation.

Source: Central Bank of Sri Lanka

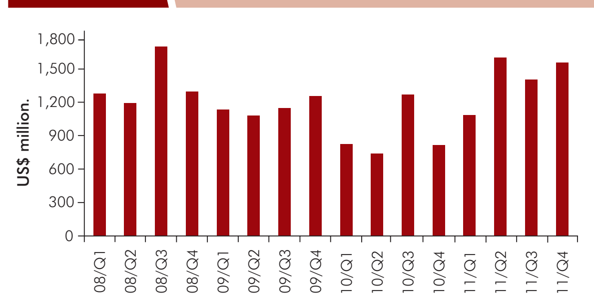
Nominal and Real Effective Exchange Rates

During 2011, both the Nominal Effective Exchange Rate (NEER) and the Real Effective Exchange Rate (REER) appreciated, following the trend observed in 2010. Reflecting a rapid pace of nominal appreciation of the Sri Lanka rupee against Indian rupee and Euro, the NEER of the Sri Lanka rupee, based on the 5-currency basket, (which includes the US dollar, Pound sterling, Euro, Japanese yen and Indian rupee) appreciated by 1.94 per cent, while the NEER based on the nominal exchange rates of 24 trading partners and competitors appreciated by 0.93 per cent. Higher nominal appreciation of the rupee and the relatively high domestic inflation as compared to that of trading partners and competitors, resulted in the REER based on both 5-currency and 24-currency baskets appreciating by 2.65 per cent and 1.14 per cent, respectively, during 2011.

Developments in the Domestic Foreign Exchange Market

Despite the setback in the global economic environment, the level of activity in the domestic inter-bank foreign exchange market expanded in 2011. With increased international trade, surge in workers' remittances and inflows to the services and financial accounts of the BOP and the relatively stable exchange rate, the total volume of spot transactions increased to US dollars 10,787 million in 2011 (66 per cent of total transactions) compared to US dollars 7,416 million recorded during 2010. Following the trend in the spot market, total volume of forward transactions also increased to US dollars 5,655 million in 2011 from US dollars 3,649 million in 2010. Forward bookings of foreign exchange increased during the latter part of 2011 due to demand pressure in the foreign exchange market emanated from increased imports. Accordingly, total inter-bank foreign exchange transaction volume

Chart 5.14 Quarterly Inter-Bank Forward Transaction Volumes



substantially increased to US dollars 16,442 million during 2011 from US dollars 11,064 million during 2010. In the face of continued demand for foreign exchange due to widened trade deficit as a result of increased imports of intermediate goods and investment goods, the Central Bank had to supply increased amount of foreign exchange towards the latter part of the year. Accordingly, during 2011, the Central Bank absorbed US dollars 343 million and supplied US dollars 3,183 million leading to a net supply of US dollars 2,840 million.

The forward premia for one-month, three-months and six-months remained slightly lower than interest rate differentials during a major part of the year. This indicated the market expectation of continued future inflows into the domestic foreign exchange market in the short-term. Higher interest rate differential resulting from lower international interest rates compared to domestic market interest rates and the relatively stable exchange rate supplemented in attracting foreign investments into the domestic Treasury bills and bonds market during the year. However, with forward premia for one-month exceeding the interest rate differential in the last few months of 2011, trends in market expectations reversed towards a depreciation of the exchange rate. Meanwhile, negative Net Open Positions (NOP) of commercial banks also showed a gradual decrease towards end of the year, indicating market expectation of a depreciation in the exchange rate in the short-term.

To address excess volatility in the exchange rate and speculative behavior in the domestic foreign exchange market, Central Bank took measures in March 2012 with regard to forward contracts and NOPs of commercial banks. Accordingly, commercial banks were directed to limit the period of forward contracts on foreign exchange transactions to a maximum of 90 days and current exposure limits on NOPs were revised downward.