

RAM

ECONOMIC OUTLOOK Sri Lanka

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NOVEMBER 2010

Sri Lanka's Economic Outlook 2011

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Sustaining Growth and Rebuilding Momentum

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HIGHLIGHTS

Dual-speed recovery of global economy

- ◆ As recovery momentum picks up globally after the downturn in 2008/09, a substantial proportion of worldwide growth over the next 3-5 years is expected to be derived from large emerging markets – driven by their inherent domestic demand (given their large populations) and high growth rates (averaging 8%-10% over the next 5 years).
- ◆ Developing countries stand to leverage on this shift in growth through the restructuring of production, such that it will be complementary to the demand and output generated by these nations, rather than to be in direct competition against them. Moreover, there will be a need to strengthen domestic demand as growth in the industrialised economies remains weak.

Sri Lanka enjoying strong rebound since 2Q 2009

- ◆ The Sri Lankan economy has pulled out of the slowdown on the back of the improving global economic environment, exhibiting continuous robust expansion in the first 2 quarters of 2010. Overall GDP growth for 2010 is anticipated to reach 6.8%.
- ◆ Industry and services growth has contributed significantly to overall GDP strength, adding 1.9 and 4.0 percentage points respectively.

Improved outlook for 2011 and 2012

- ◆ The economy is projected to expand 6.5% in 2011, followed by 6.3% in 2012. This will be driven by domestic final demand as net trade contribution to GDP remains in negative territory. Buoyant consumer and investor sentiments will contribute to the robust domestic demand while rising investments, especially from the foreign and domestic private sectors, provide upside to our growth forecasts.
- ◆ The services sector will benefit from the healthy domestic demand; it is expected to be able to sustain a growth of 7% in 2011 and 2012. Underpinned by the sizeable manufacturing sub-sector, the industry segment is projected to expand 6.4% per annum over the next 2 years.
- ◆ The services sector is expected to lead growth for the rest of 2010, expanding at an estimated 6.8% for the full year. It is projected to advance 7.0% in 2011, followed by 6.9% in 2012.
- ◆ Meanwhile, the industry sector is expected to perform substantially better on the back of a healthier export market and rising domestic demand. This sub-sector is projected to expand 6.5% in 2010, and 6.4% in both 2011 and 2012.
- ◆ On the demand side, the surge in both public and private investment activities is expected to continue following an estimated 5.5% rise in 2010.

The crowding-in of private investment in tandem with the rise in public expenditure on post-conflict rebuilding projects is envisaged to contribute to the country's increasing gross fixed capital formation which is projected to expand by 6.5% in 2011 and 7.0% in 2012.

- Exports and imports of goods and services are anticipated to accelerate on the back of strengthening external demand and the generally higher level of domestic industrial activities. Export growth is projected to come in at 4.9% in 2010, before rising to 5.5% in 2011. Growth is expected to be maintained at 5.5% the following year.

Benign price pressures in 2010, with capital inflows driving up currency value

- Interest rates have remained accommodative for economic growth in 2010, as inflationary pressures have been minimised and downside risks to growth have become more prevalent. This has led to a cut in repo rates in the second half of 2010.
- Inflation is expected to come in at 5.8% for 2010, before advancing to 6.7% in 2011. This acceleration is likely to be fuelled by external factors, with some mitigating domestically originated downward pressures on the back of stronger economic performance.
- While inflation is expected to remain relatively benign in 2011, we anticipate upward adjustments of 50-75 bps to the repo rate. This is largely due to the expected increase in foreign investment next year, which may have to be monitored to keep price pressures in check.
- The continued increase in capital inflows in 2011 will be largely driven by the relaxation of capital controls, with a view to allowing more foreign funds in to finance infrastructure projects associated with the post-war reconstruction, and easing liquidity levels in the advanced economies.
- This ongoing appreciation of the real effective exchange rate has generally reduced export competitiveness, and may have caused a widening of the trade deficit this year. However, we expect the Sri Lankan currency to appreciate moderately against most major currencies in 2011.

Average long-term growth projection revised upwards

- An improving macroeconomic environment, coupled with fiscal and other structural reforms to energise the private sector and harness market forces to raise economic efficiency and productivity, will lay the foundation for the country's transition from low-middle-income to middle-income status.
- Our average annual GDP growth forecast for the 2011-2015 period has been revised upwards from 5.5% to 6.2%; the projection for 2016-2020 has been raised a notch, from 6.0% to 6.1%.
- The revisions are underpinned by several key factors: (a) a quicker-than-expected reduction in the country's macroeconomic imbalances; (b) the

global financial crisis' less severe impact on the domestic economy; (c) the quick - albeit fragile - global recovery; and (d) rising confidence in the post-conflict economic rebound.

Key risks and challenges

- ◆ In 2009, Sri Lanka reported the largest fiscal deficit and highest level of public debt among emerging Asia-Pacific economies. Moreover, the current-account deficit of 3.7% has weighed against investor sentiments.
- ◆ Sri Lankan public finances are expected to remain structurally weak over the medium term, as the development of a post-war economy amid a hefty debt and fiscal deficit can be extremely challenging, both in terms of time and money. We therefore expect the overall fiscal deficit to only narrow slightly to 7.5% in 2011, in the absence of additional external aid.
- ◆ Besides the much-needed restructuring of fiscal finances, there is also a pressing need for economic reform and kick-starting a full-scale recovery of investment activities (especially in the private sector), which will provide the foundation for economic growth.
- ◆ In the past, political uncertainty had been the crux of lacklustre investment activity. Moreover, investment within the economy had been largely driven by the public sector. There is a need to encourage more investment in the private sector, for the economy to truly surge ahead and rebuild.
- ◆ Administrative bottlenecks remain one of Sri Lanka's main impediments against facilitating a more vibrant business environment. Reforms in this area would greatly boost and facilitate a higher level of private investments.
- ◆ An improving macroeconomic environment, coupled with fiscal and other structural reforms to energise the private sector and harness market forces to raise economic efficiency and productivity, will set the tone for the country's transition from low-middle-income to middle-income status.

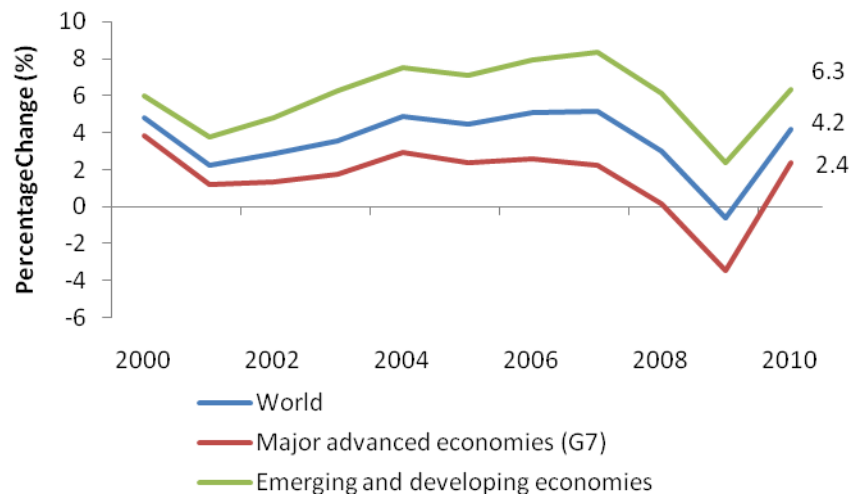
I. GLOBAL ECONOMIC RECOVERY: New challenges for developed economies

A. Global economic prospects

World demand yet to revisit pre-crisis levels

After a tumultuous year, external demand is recovering, albeit at a lacklustre pace. Demand conditions worldwide have yet to revert to pre-crisis levels due to the lingering, broad-based effects of the global financial crisis. Despite this, there has been a distinct difference in the speed of recovery as growth in the developing economies has vastly outpaced that of the developed countries (Figure 1).

Figure 1: Global growth of the major economic blocs, and projections for 2010



Source: International Monetary Fund and RAM Economics

Domestic demand in the advanced economies has been constrained by severely weakened labour markets, as cumulative job losses from the crisis are still at significantly high levels. Despite this, it is important to note that the recovery of the advanced economies will continue, albeit slower than initially anticipated, as recovery momentum still depends on the build-up of both investor and consumer confidence.

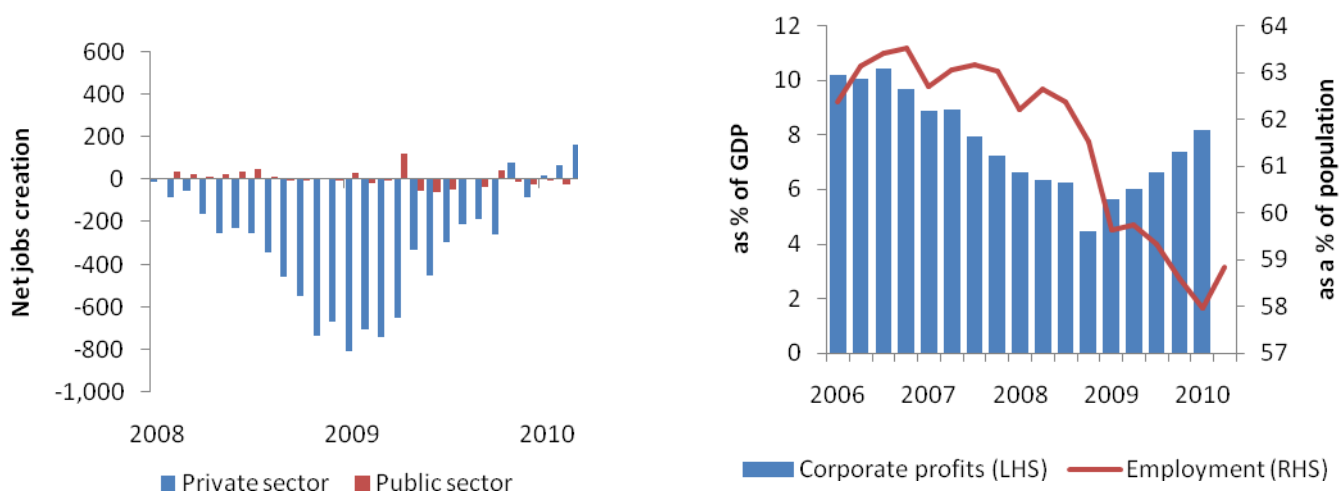
Advanced economies' demand conditions – weak with pockets of strength

The United States ("US"), which had lost as many as 8.5 million jobs in the private sector during the slump, has only recovered 0.7 million jobs in recent months. To make matters worse, there are expectations of more job losses

from the public sector in the coming months, as a weakened economy and high debt levels constrain government expenditure.

Furthermore, the ongoing housing slump has continued exerting a tremendous toll on American consumers' wealth as credit conditions - with regard to this specific sector - remain tight. While American corporate profits have indeed been recovering, employment in general continues to decline. This phenomenon is the result of the previous year's crisis, which has prompted companies to hoard cash as banks tighten credit in a bid to rejuvenate their (the banks') balance sheets.

Figure 2: US employment situation and corporates' profit performance



Source: US Bureau of Labour Statistics and Bureau of Economic Analysis

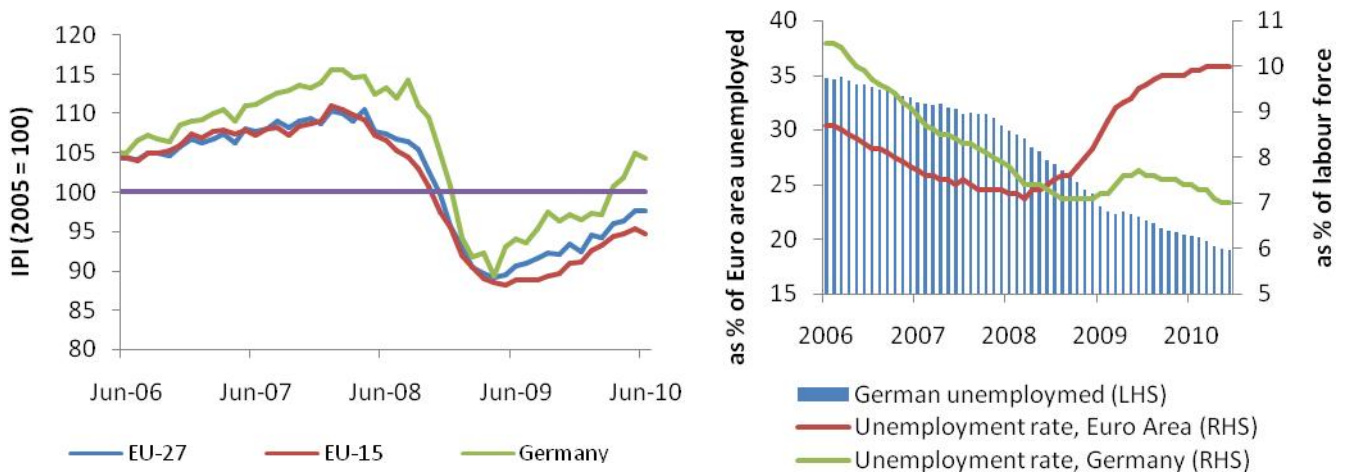
Nonetheless, a prolonged sluggishness in the US labour market is not inevitable as corporations are likely to start hiring again once banks ease up on credit conditions as debt fears in Europe begin to subside. The US Federal Reserve's recent action of increasing domestic liquidity through further quantitative easing and maintaining low interest rates are expected to encourage firms to generate employment. Moreover, the recently signed laws in the US – the emergency USD26 billion jobs bill and the Manufacturing Enhancement Act – will likewise act to prop up employment in the short term.

As a result of the expected slow - but recovering - private-sector job creation and stop-gap interventionist policies in employment, any improvement in American consumer demand will remain a long-drawn-out process. It is therefore very unlikely that the world's largest economy will be able to revisit its pre-crisis employment conditions in the short term.

In Europe, export-oriented Germany has been enjoying a speedier recovery than its immediate neighbours. Germany's higher level of labour productivity and larger exposure to the international markets – in terms of merchandise trade – have inevitably resulted in a faster pace of recovery for its industrial sector. Additionally, the *Kurzarbeit* programme – a scheme subsidising

companies that retain workers – had allowed Germany to maintain a relatively healthy labour market and domestic consumer demand throughout the recent global financial crisis.

Figure 3: Comparison of industrial production index (or IPI) and labour-market conditions in Germany vs the European Union



Source: Eurostat and CEIC

However, demand from the advanced economies – particularly the US and Europe – is expected to stay weak through the rest of this year, especially if there are further shocks to global demand or financial flows. The feeble demand is likely to persist as structural issues take time to be remedied while private-sector confidence builds up gradually.

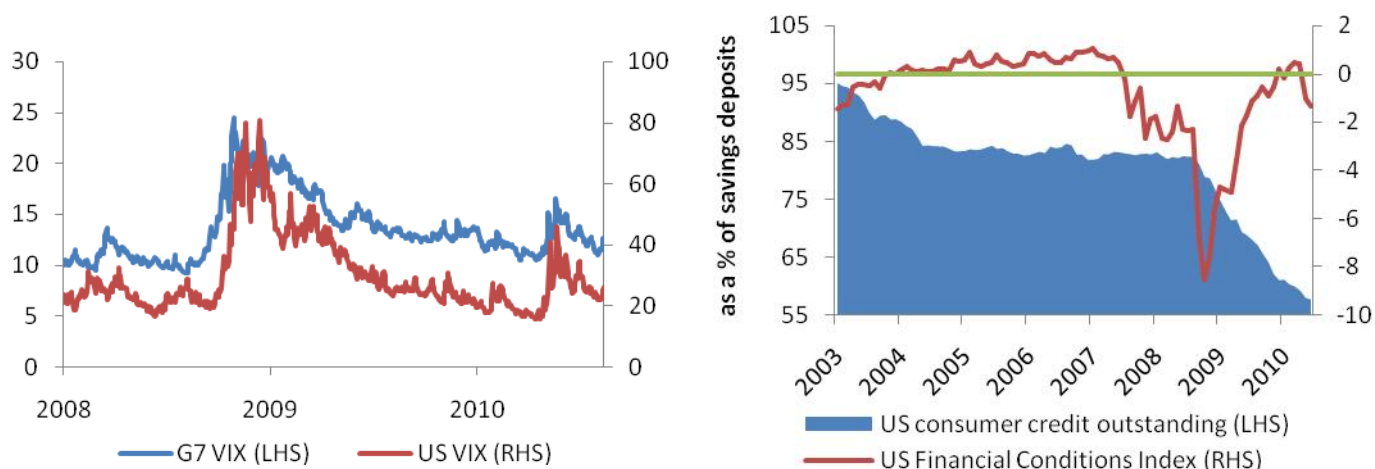
Global financial conditions – stabilisation and recovery

Global financial conditions – particularly in the US – are still somewhat volatile, as measured by the Volatility Index¹ (“VIX”) for composite US and G7² equities shown below. The increased volatility in recent months can be attributed to fears of yet another contraction in global output as advanced economies have pledged several fiscal austerity measures to combat their excessive debts, and as China fights to contain its accelerating inflation.

¹ VIX shows the expected change in prices in the following month (regardless of upside and downside changes).

² G7 refers to the US, UK, Japan, Germany, France, Italy and Canada.

Figure 4: US and G7 financial conditions indicators



Source: Bloomberg and CEIC

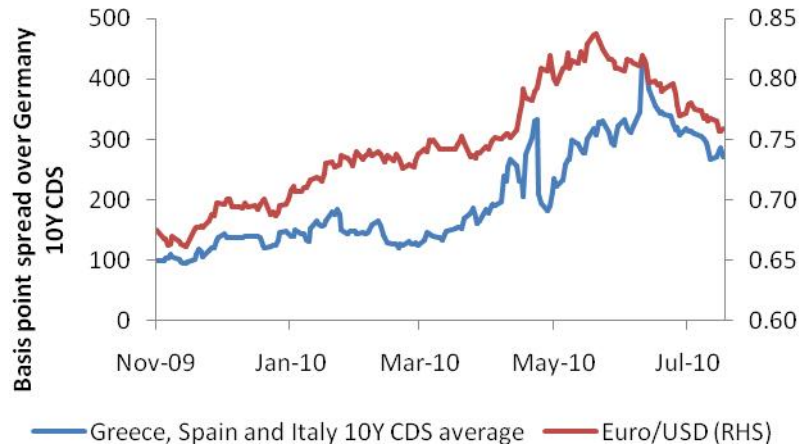
Indeed, financial conditions³ in the US have worsened because this increased pessimism has translated into higher interest payments and tighter lending standards as the credit-risk premium increases (refer to Figure 4, right panel). This has led to a further contraction in bank lending while lower consumer wealth levels have reduced credit creation within the economy. While this has considerably subdued demand, it indicates that American households have rebalanced their consumption behaviour and, as such, contribute to the sustainability of the US banking sector’s recovery.

In Europe, banks’ substantial exposure to fiscally unstable government debt (the sovereign debts of some of these countries are estimated to reach 150% of their GDP by the end of this year) has caused significant financial turmoil within the region since late 2009. This ongoing saga is best represented by the highly indebted countries’ credit-default swap⁴ spreads against Germany and the performance of the region’s currency (the euro) through the year.

³ Financial conditions are measured by Bloomberg’s Financial Conditions Index, which is a composite of different US markets (equities, bonds and money); the index represents the number of deviations the current market conditions move above or below the market average.

⁴ Credit-default swaps are used as a proxy to measure investors’ perspective of a security’s default potential.

Figure 5: Selected European credit-default swap spreads (average) and the performance of the euro



Source: Bloomberg and CEIC

Measures that have been implemented of late have prevented the total collapse of financial confidence in the European Union (“EU”). This includes the announcement of the joint EU-International Monetary Fund €750 billion European Financial Stability Mechanism, designed to provide short-term liquidity for the region’s sovereign debt and the release of favourable region-wide bank stress-test results, where only 7 out of the 91 tested banks had failed amid a scenario of adverse sovereign shocks. Furthermore, many of the high-deficit nations such as Greece, Italy and Spain have pledged to stabilise their public finances over the short term, to calm their highly volatile financial markets.

Despite several months of demand growth, international financial conditions are still volatile due to the unwinding of the sizeable bail-out fund, quantitative easing by the crisis-hit advanced economies and the implementation of fiscal austerity measures in most developed economies.

B. Implications for emerging economies

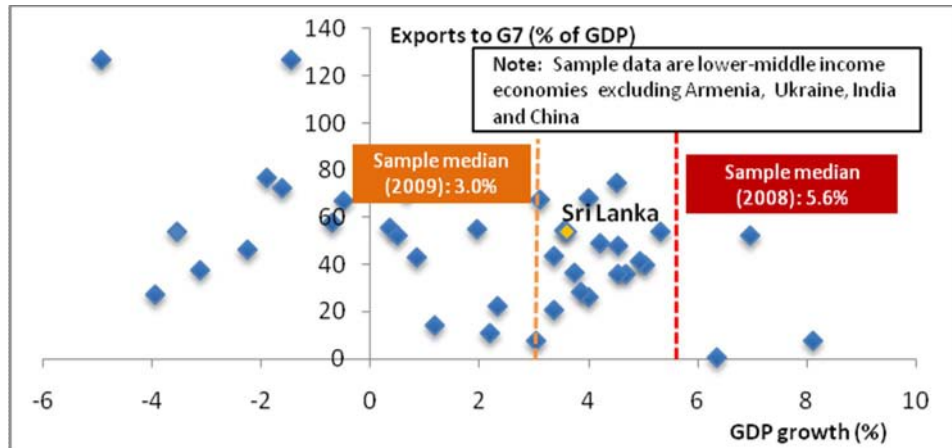
Shift in demand to fast-growing emerging economies

As noted in the earlier section, the pronounced slowdown in the advanced economies during the severe global downturn in 2008/09 is now prolonging worldwide recovery. With demand conditions extensively weakened in the developed world, however, production structures and trade flows will have to be adjusted amid the new global economic landscape.

A case in point is the adverse impact the global contraction has had on emerging markets (Figure 6). Similar to the rest of the world, the lower-middle-income economies had experienced a deceleration in growth,

particularly countries that which had a significant dependence on the overall demand environment of advanced economies.

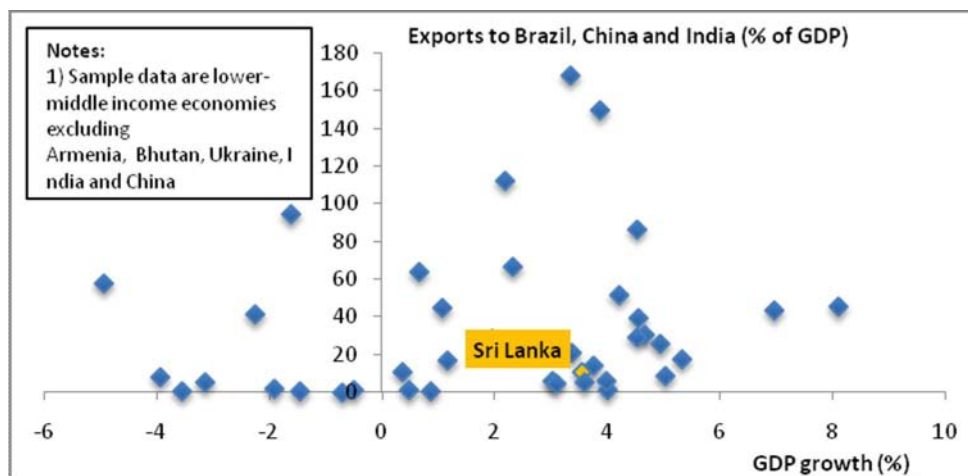
Figure 6: Lower-middle-income economies' growth and exports to the G7 in 2009



Source: World Bank, International Monetary Fund and RAM Economics

More importantly, countries that already had strong trade ties with large emerging markets (i.e. Brazil, China and India) or that had been able to shift their trade patterns accordingly had managed to sustain their growth during the global downturn. A few outliers – Armenia and Ukraine, for example – within this data set indicate that trade flows to these large emerging economies are insufficient to offset any structural weakness these countries may have in their financial sectors – particularly those with extensive capital exposures to the developed world.

Figure 7: Lower-middle-income economies' growth and exports to large emerging markets in 2009



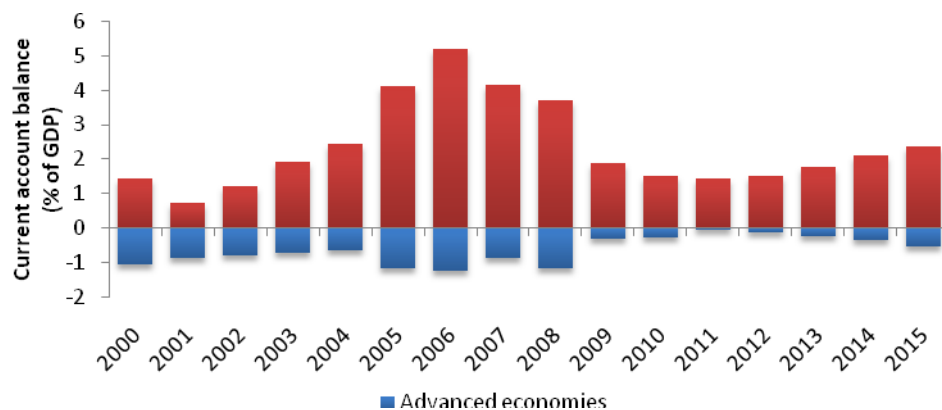
Source: World Bank, International Monetary Fund and RAM Economics

A substantial proportion of global growth over the next 3-5 years will be derived from large emerging markets, due to their inherent domestic demand (arising from their large populations) and high growth rates (averaging 8%-10% over the next 5 years). The developing world outside this specific group of countries can be expected to leverage on the shift in growth poles by restructuring production such that it will be complementary to the demand and output generated by these countries, rather than to be in direct competition against them.

Rebalancing developing economies' domestic demand

A weakening of economic conditions in the developed world also signals that domestic demand in the developing world has to be accelerated to rebalance growth. The developing world is unable to depend entirely on the advanced economies' demand over the short term to absorb any domestic production surpluses, as shown by the stabilising global current-account balances in Figure 8.

Figure 8: Selected aggregate current-account balances (2000-2015)



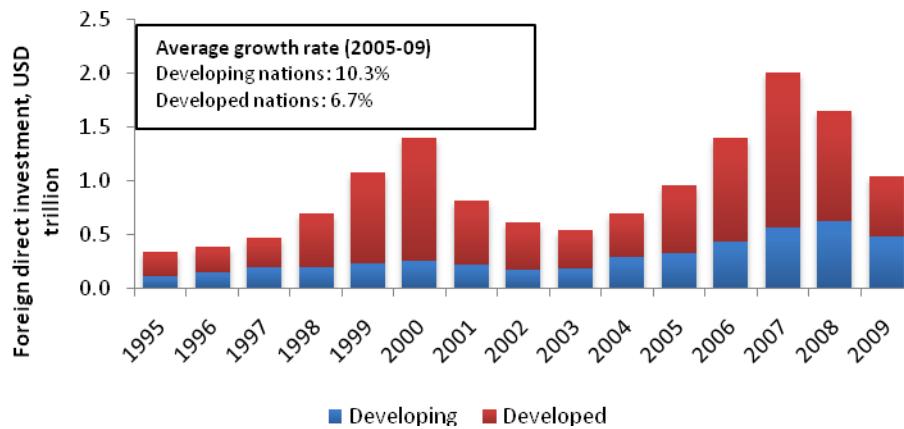
Source: International Monetary Fund and RAM Economics

It is unlikely that the world will see such huge imbalances in the near term, as the overall labour-market situation in the US is still fairly weak and the financial system has yet to fully recover from its paralysis since 2008.

Resurgence of capital flows to emerging markets

By extension of their weakening demand, the advanced economies' recessions had clouded investment prospects for the developed world. In the 5 years since 2009, foreign direct investments have been flowing more rapidly to the developing world than the higher-income economies (Figure 9).

Figure 9: Global flow of foreign direct investments



Source: United Nations Conference on Trade and Development and RAM Economics

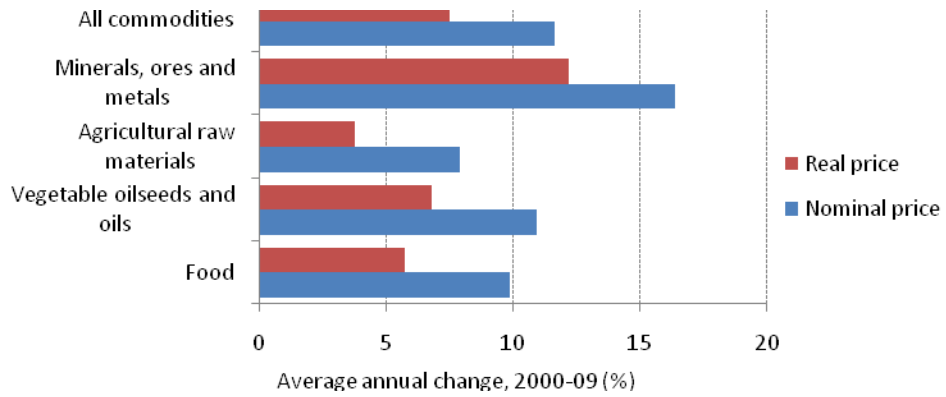
As a result of differing growth prospects across the hemisphere, investment flows are more likely to be channelled to developing economies in the coming years. This may exert some upward pressure on inflation in emerging markets, depending on the degree of capital controls imposed by each nation.

Flow of funds to commodity markets and impact on prices

The recent “quantitative easing” operations by the US Federal Reserve, with the intention of increasing liquidity in the American financial system to boost the real economy, may cause funds to be parked in commodities as well as high-yield economies’ (i.e. emerging markets) debt and asset markets. This phenomenon has happened before, i.e. earlier in the decade, when a prolonged period of relatively relaxed interest rates had caused the housing bubble in the world’s largest economy and then gone on to become one of the primary causes of the recent global recession.

Notably, commodity prices have been pushed up rather substantially throughout the decade, as other forms of assets had become relatively more risky after the revelation of their long-term financial fragility (Figure 10).

Figure 10: Global commodity price indices

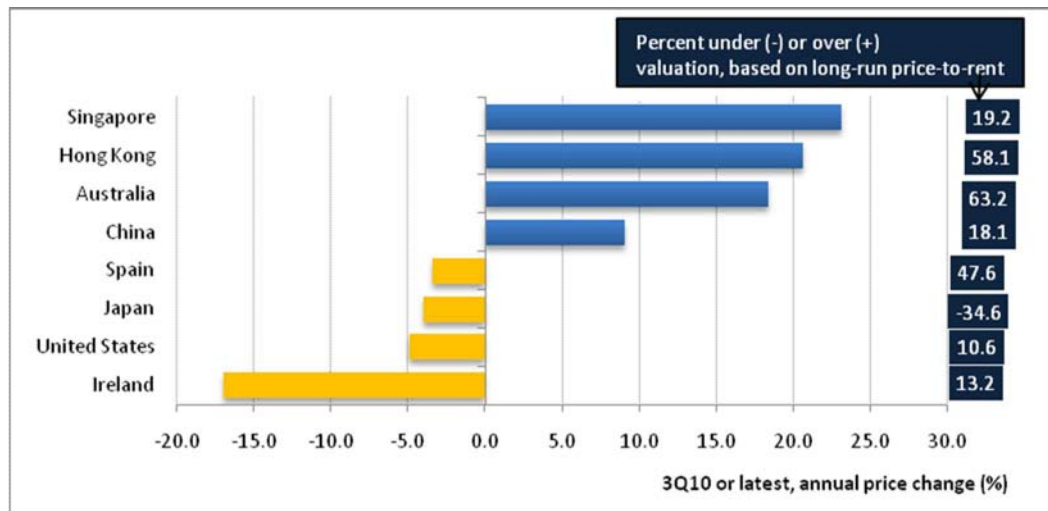


Source: United Nations Conference on Trade and Development and RAM Economics

This had, of course, led to the commodity price bubble that had been the prelude to the debilitating slump in 2008. The bursting of the commodity bubble had significantly displaced global consumption and production patterns at the onset of recession. As such, it is now one of the factors constraining global recovery.

Excess liquidity in the advanced nations may also affect emerging markets through various asset classes. For example, property that is usually a mainstay in most investment portfolios had experienced a tremendous shift – from advanced economies to emerging markets – during the recession (Figure 11).

Figure 11: The Economist's house-price indicators (as of 21 October 2010)



Source: The Economist

II. SRI LANKA'S SHORT- AND MEDIUM-TERM OUTLOOK

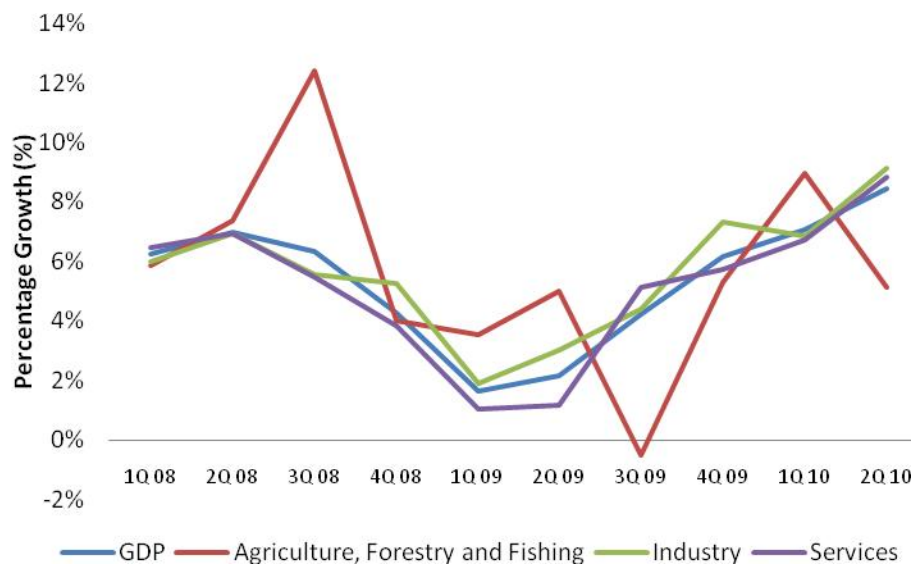
A. Current performance and outlook for 2011 and 2012

Strong rebound since 2Q 2009

Sri Lanka had averted a recession despite the global downturn in 2008/09, albeit with a more moderate pace of growth (3.5%) in 2009 - slightly above our projection of 3.2%.

The Sri Lankan economy had pulled out of the slowdown on the back of the improving global economic environment, exhibiting continuous robust expansion in the first 2 quarters of 2010. Industry and services growth has contributed significantly to overall GDP strength whilst the resource-based sector remained volatile due to seasonality. Overall GDP growth for 2010 is anticipated to reach 6.8%.

Figure 12: Economic performance of major industry sectors



Source: Department of Census and Statistics, Sri Lanka

The commendable pick-up in economic growth can also be attributed to the post-war business environment, with more upbeat consumer and investor sentiment as a whole. This is seen to have given industry players the confidence to ramp up activities, which has also been timely in the wake of the economic rebound of the nation's major trading partners and the Asian region as a whole.

The industrial sector has remained resilient, with the recovery in the export of textiles and apparel as well as a marked improvement in the services sector.

On the other hand, agricultural activities, which had suffered the most during the downturn, have been bolstered by the strong prices of commodities.

Looking ahead, growth through the rest of 2010 is anticipated to be mainly supported by the strengthening of domestic demand, further boosting the services sector. In particular, there has been a significant increase in tourism, which has contributed positively to the growth of the hotels and restaurants sub-sectors.

Table 1: Quarterly GDP growth by industry

(constant 2002 prices)

	GDP	Quarterly change (% yoy)				% of GDP			
		<u>Agriculture</u>	<u>Industry</u>	<u>of which Manuf</u>	<u>Services</u>	<u>Agriculture</u>	<u>Industry</u>	<u>of which Manuf</u>	<u>Services</u>
1Q2009	1.6	3.6	1.9	2.7	1.0	13.6%	28.5%	17.7%	57.9%
2Q2009	2.1	5.0	3.0	1.1	1.2	12.3%	27.9%	16.9%	59.8%
3Q2009	4.2	-0.5	4.4	3.2	5.1	12.2%	28.3%	17.5%	59.5%
4Q2009	6.2	5.3	7.3	6.0	5.7	10.1%	29.8%	17.8%	60.1%
1Q2010	7.1	9.0	6.9	5.8	6.7	13.8%	28.4%	17.9%	57.8%
2Q2010	8.5	5.1	9.2	8.9	8.8	11.9%	28.1%	16.7%	60.0%

Source: Central Bank of Sri Lanka

The services sector is expected to lead growth for the rest of 2010, expanding at an estimated 6.8% for the full year. It is projected to advance 7.0% in 2011, followed by 6.9% in 2012 (Table 2).

Meanwhile, the industry sector (encompassing mining, manufacturing and construction activities) is expected to perform substantially better on the back of a healthier export market and rising domestic demand. This sub-sector is projected to expand 6.5% in 2010, and 6.4% in both 2011 and 2012.

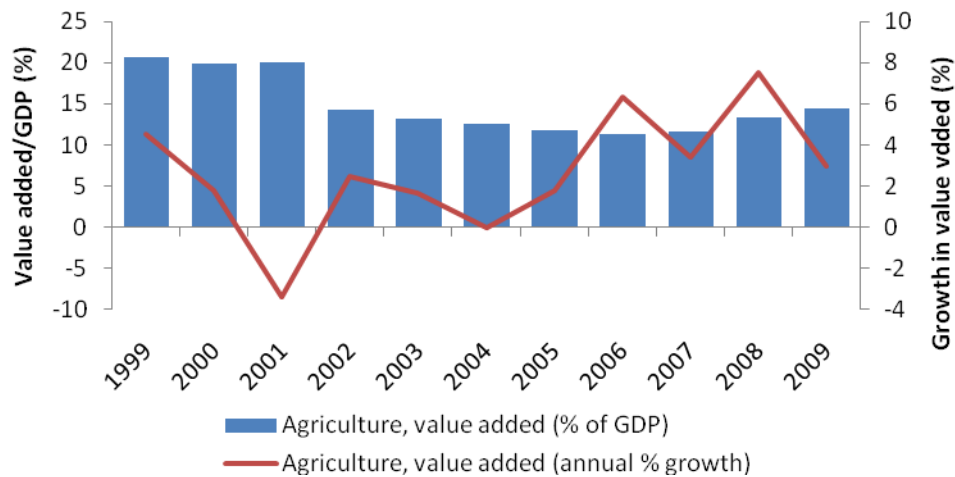
Table 2: GDP growth by industry origin

	GDP	Agriculture	Industry	Services
A. Annual change %				
2007	6.8	3.4	7.6	7.1
2008	6.0	7.5	5.9	5.6
2009	3.5	3.2	4.2	3.3
2010f	6.8	7.9	6.5	6.8
2011f	6.5	4.1	6.4	7.0
2012f	6.3	3.2	6.4	6.9

	GDP	Agriculture	Industry	Services
B. Contribution to GDP growth (% points)				
2007	6.8	0.4	2.1	4.2
2008	6.0	0.9	1.7	3.4
2009f	3.5	0.4	1.2	2.0
2010f	6.8	0.9	1.9	4.0
2011f	6.5	0.5	1.8	4.2
2012f	6.3	0.4	1.8	4.1
C. Share of GDP (%)				
2007	100.0	11.9	28.5	59.6
2008	100.0	12.1	28.4	59.5
2009f	100.0	12.0	28.6	59.3
2010f	100.0	12.2	28.5	59.3
2011f	100.0	11.9	28.5	59.6
2012f	100.0	11.5	28.5	59.9

The contribution of agricultural value-added to GDP had been exhibiting a long-term secular decline, before reversing the tide since 2006 (Figure 13).

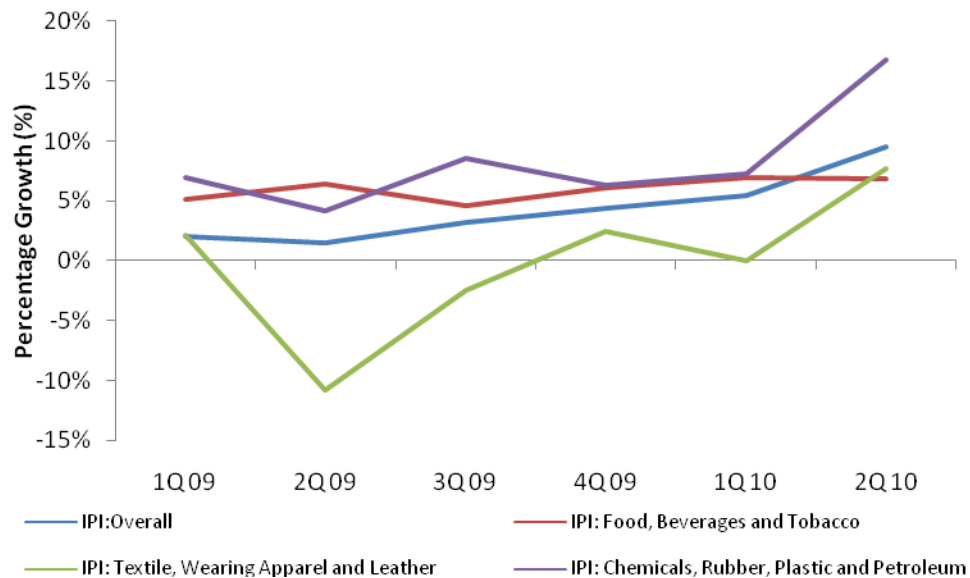
Figure 13: Performance of the agriculture sector



Source: World Bank and RAM Economics

On the industrial side, output has been trending upwards across the board. In particular, a rapid pick-up was observed at the start of 2010, with overall production increasing 9.5% year-on-year (“y-o-y”) in 2Q 2010. The textiles and apparel segment had been the only export-oriented industry to experience output contraction (of 10.9%) during the global recession, as it was the most exposed to external demand among all the industrial activities.

Figure 14: Output of export-oriented industry sectors



Source: Central Bank of Sri Lanka

The ramp-up of production activity in the first half of this year had been partly due to the low-base (y-o-y) effect; production is expected to normalise in 2H 2010. The “chemicals, rubber, plastics and petroleum products” segment was the best performer in 1H 2010, achieving a 16.8% expansion in output in 2Q 2010 that was driven by more robust rubber prices.

Greater consumer and investor confidence spurs domestic demand

Trends in domestic demand show that there is significant dependence on public-sector spending. An accelerated shift to private-sector-led growth is needed to raise the economy’s potential output, dynamism and international competitiveness.

It is encouraging to note that measures to promote such a shift are now easier to implement with the end of the civil war in 2009, as investor sentiment is expected to be bolstered by greater socio-economic and political stability. Interest rates are also expected to remain accommodative for the rest of 2010, especially when inflationary pressures are less of a concern to the monetary authorities while softening economic growth remains the chief concern.

Private consumption increased marginally in 2009. However, it is expected to strengthen in line with more upbeat consumer sentiment, as indicated by the uptick in consumption and retail lending.

Meanwhile, unemployment levels have been trending downwards since the end of the conflict (falling to 5.0% in 1Q 2010). On the other hand, the country’s labour force has grown, indicating a strengthening of the labour base (refer to employment and wage trends).

These trends are reflective of a broadening consumption base that lends confidence to businesses vis-à-vis investing, thus adding to the post-war recovery momentum. These factors will underpin the strong rise in private consumption, which is projected to expand 6.6% in 2010. The pace of consumption is expected to continue, coming in at 6.2% in 2011 and 6.0% in 2012 (Table 3).

Table 3: Trends in domestic and external demand

	2007	2008	2009	2010f	2011f	2012f
Private consumption	3.9	7.5	0.6	6.6	6.2	6.0
Public consumption	7.4	9.8	20.2	7.1	5.9	5.0
Private investment	5.4	3.9	-2.1	5.5	6.5	7.0
Public investment	27.6	11.1	14.5			
Exports	7.3	0.4	-12.3	4.9	5.5	5.5
Imports	3.7	4.0	-9.1	4.0	4.8	4.9
GDP	6.8	6.0	3.5	6.8	6.5	6.3

*Source: World Bank, April 2010
f = forecast by RAM Economics*

The surge in both public and private investment activities is expected to continue following an estimated 5.5% rise in 2010. The crowding-in of private investment in tandem with the rise in public expenditure on post-conflict rebuilding projects is expected to contribute to the country's increasing formation of gross fixed capital, which is projected to expand by 6.5% in 2011 and 7.0% in 2012.

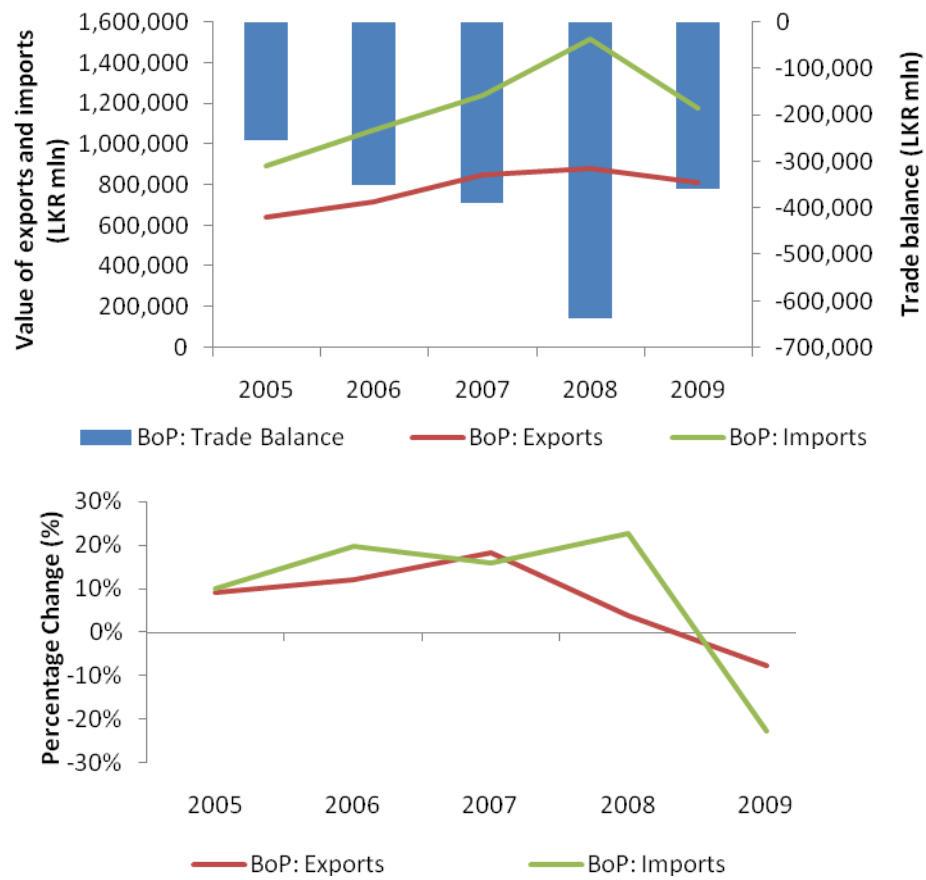
Exports and imports of goods and services are expected to accelerate on the back of strengthening external demand and the generally higher level of domestic industrial activity. Export growth is projected to come in at 4.9% in 2010, before rising to 5.5% in 2011. Growth is expected to be maintained at 5.5% in 2012.

Need for external demand to be bolstered further

Sri Lanka's level of trade plunged amid the global financial turmoil in 2009, with gross exports and imports contracting 12.3% and 9.1%, respectively (Figure 15). Imports, meanwhile, moderated from the spike in 2008, dampened by the reining in of trade credit. Despite the unfavourable external environment, the domestic economy avoided falling into recession, achieving an overall 3.5% GDP growth in 2009.

Nonetheless, the trade deficit worsened along with the decline in exports in 2009, although the slowdown in imports helped bring the deficit back down to around 2007 levels.

Figure 15: Trade balance



Source: Central Bank of Sri Lanka

Analyses of the composition of both agricultural and industrial exports show that there is a need for diversification (Figures 16 and 17). Moreover, the reliance on agricultural or commodity-based produce leaves export performance highly sensitive to changes in world prices, which can be quite volatile amid uncertain (and unfavourable) conditions. Moreover, Sri Lanka is subject to a great degree of competitive pressure from India (in particular) as a global supplier of these goods (i.e. tea and textiles).

Figure 16: Trends and composition of agricultural exports

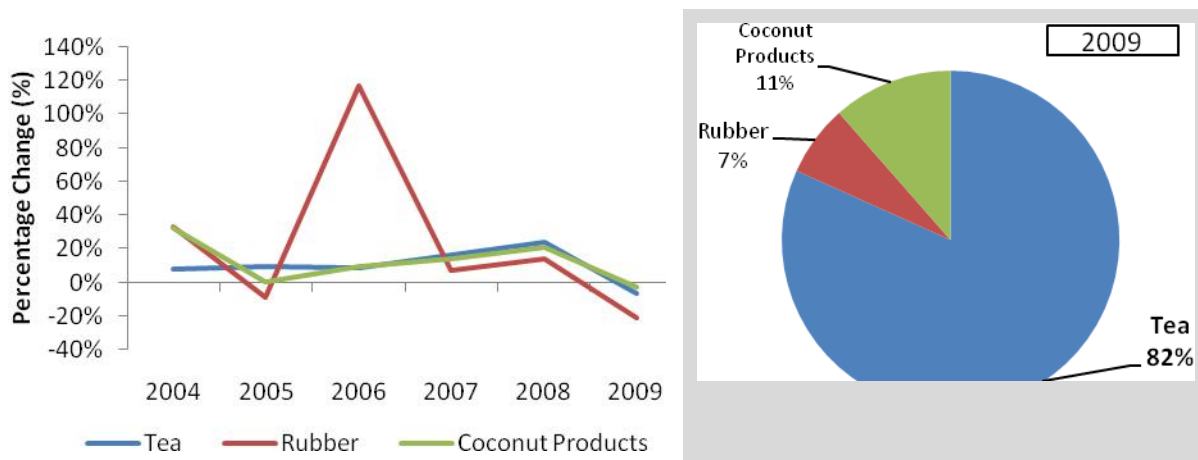
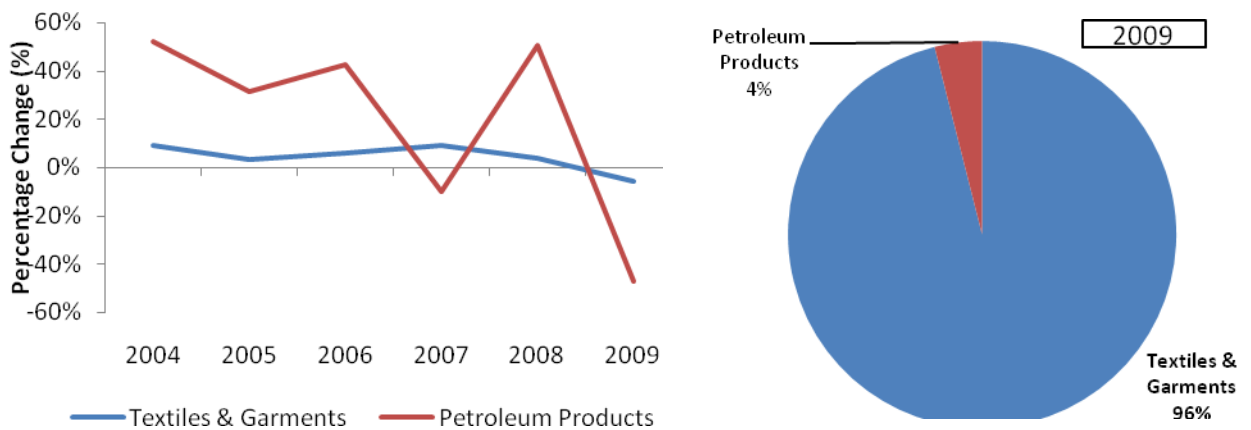


Figure 17: Trends and composition of industrial exports



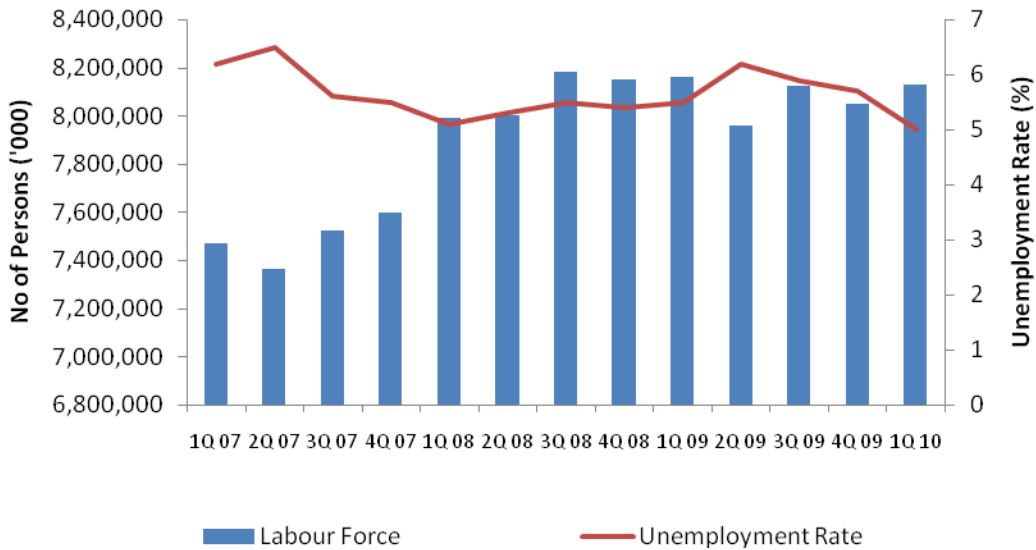
Source: Central Bank of Sri Lanka and RAM Economics

Employment and wage trends

Nominal and real wage rates have fallen subsequent to the end of the civil war as the economy has been experiencing a surge in labour supply. This has in turn exerted downward pressure on wages (Figure 18). Although nominal wages have remained relatively stable in 2010, the negative real wage rates in these 2 sectors imply that workers' nominal wages are being eroded by inflation.

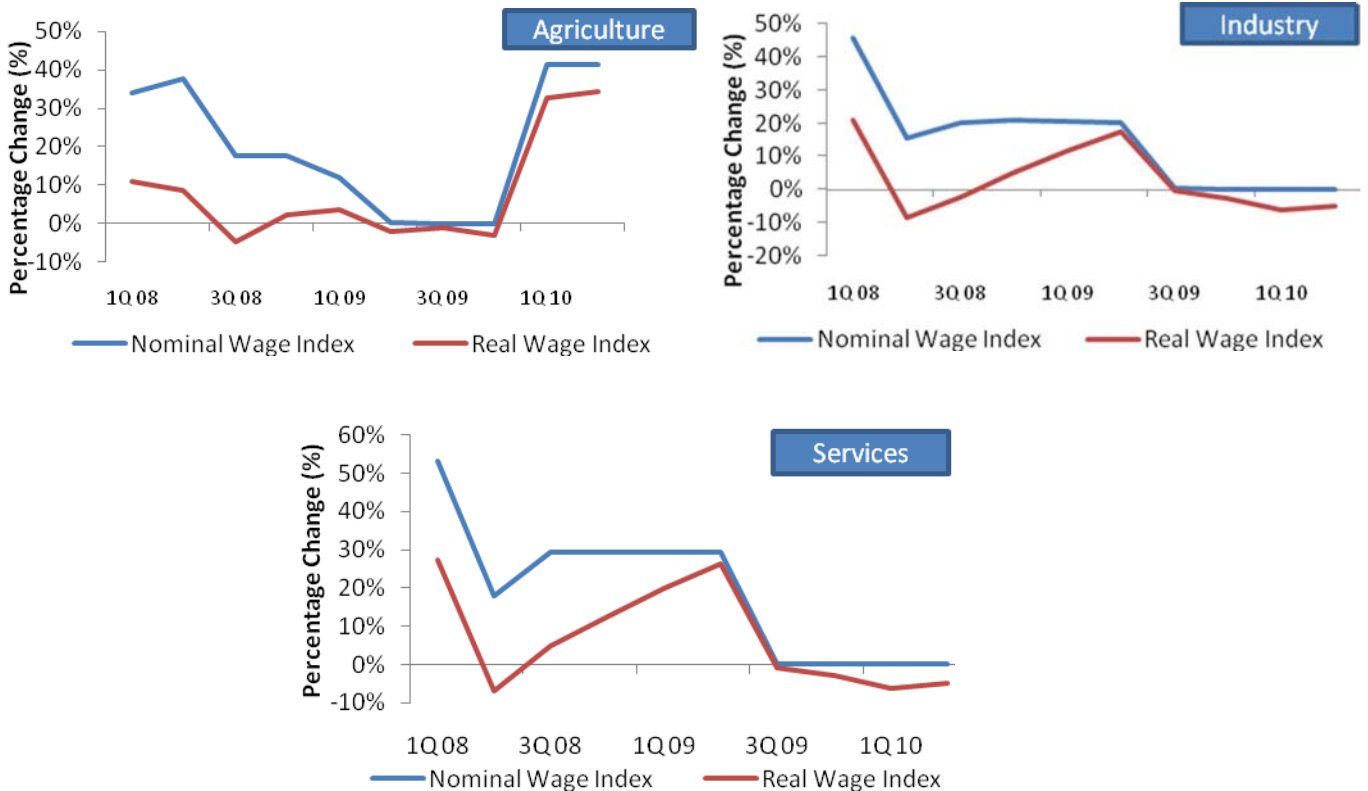
Agricultural wages on the other hand illustrate the contrary, both nominal and real wage rates rose along with the improvement in prices of commodities. However, rising labour costs indicate that Sri Lanka may also be losing some of its comparative advantage against its closest competitors in these sectors.

Figure 18: Trends in the labour force



Source: World Bank and Department of Census and Statistics, Sri Lanka

Figure 19: Nominal and real wage rates



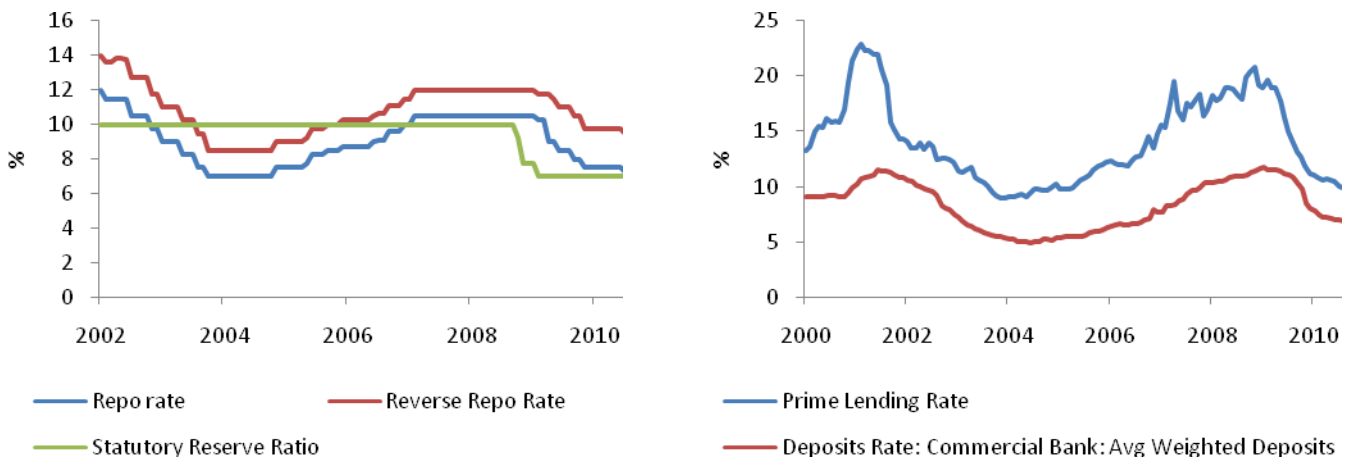
Source: World Bank

Monetary policy focused on growth as inflation takes a backseat

In the first 10 months of 2010, the Central Bank of Sri Lanka initiated 2 rounds of monetary-policy adjustments. The first featured a reduction in both key policy rates (i.e. the repurchase rate or “repo rate”, and the reverse repurchase rate) by 25 basis points (“bps”) in July. The second policy adjustment took place in July, when the reverse repo rate was reduced by a further 50 bps.

These rate changes had been pre-emptive measures to ensure that economic activity would be able to maintain its recovery momentum when the Generalised System of Preferences Plus (or GSP+) was phased out in August. This had caused a fall in domestic interest rates in the second half of 2010 (Figure 20, right panel).

Figure 20: Key policy rates and interest-rate indicators in Sri Lanka



Source: Central Bank of Sri Lanka, International Monetary Fund and RAM Economics

While inflation is expected to remain relatively benign in 2011, we anticipate the repo rate to be lifted by some 50 to 75 bps. This is largely due to the expected increase in foreign investment next year, which may have to be monitored to keep price pressures in check.

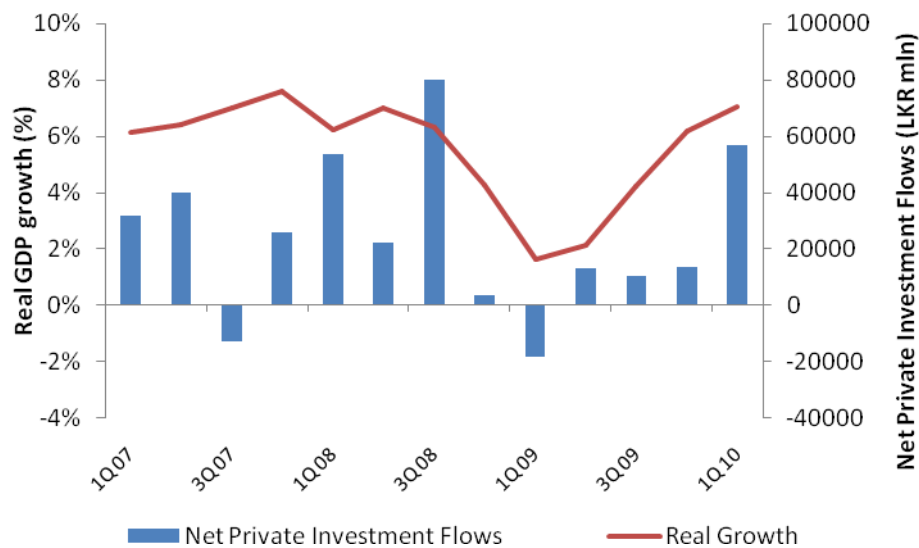
The anticipated increase in capital inflows in 2011 is largely attributable to the relaxation of capital controls, with a view to allowing more foreign funds to finance infrastructure projects associated with the post-war reconstruction, and easing liquidity levels in the advanced economies.

Moderately strong exchange-rate appreciation anchored by improving economic fundamentals and ebbing inflationary pressures

On the whole, the Sri Lankan rupee has been charting fairly volatile movements against its major trading partners in 2010 (Figure 22, left panel). This has been largely due to the unfolding of the European debt crisis, which had caused a significant amount of uncertainty among investors and spurred capital flight from that region in the middle of the year.

However, efforts – primarily in the form of the €750 billion European Stabilisation Fund, unveiled at the peak of the crisis – to prevent an outright confidence crisis in Europe have proved successful thus far, and have caused the exchange-rate level to normalise to some degree. Positive net investment flows have come about in tandem with the improving economic performance of the country. The considerable volume of foreign capital inflows in 2010 has been the main support for the strengthening local currency (Figure 21).

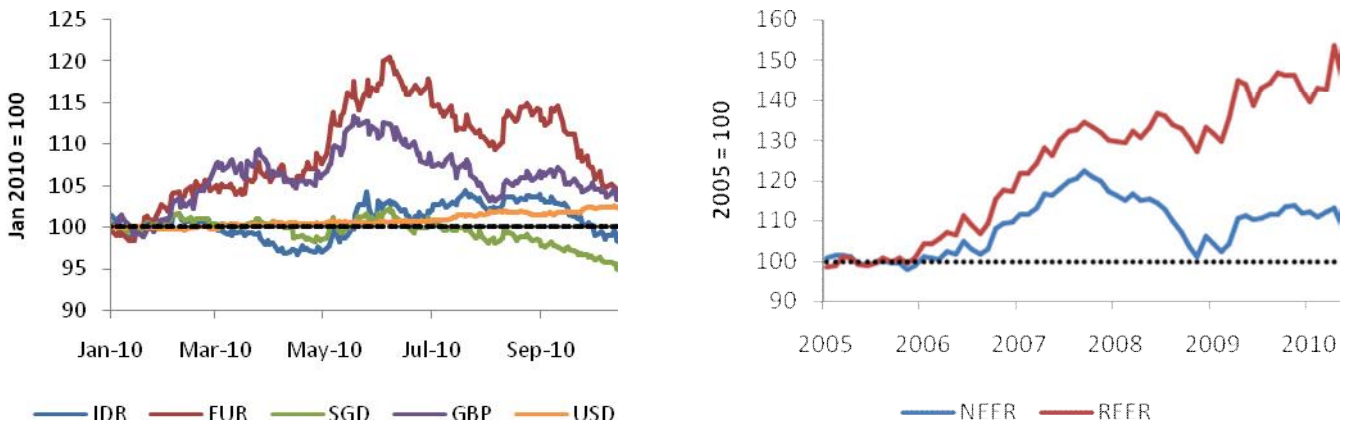
Figure 21: Strengthening economic performance attracted foreign funds



Source: Central Bank of Sri Lanka

From the perspective of an effective exchange rate, the normalisation of the Sri Lankan rupee's nominal value belies its high inflation-adjusted valuation (Figure 22, right panel). This is largely due to the significant inflation-rate differential between Sri Lanka and its major trading partners, as domestic inflation has increased faster than that in many advanced economies, where inflation has been damped down by the effects of the financial crisis. This ongoing appreciation of the real effective exchange rate has caused Sri Lanka's export competitiveness, as a whole, to fall and may have contributed to the widening of the trade deficit this year.

Figure 22: Sri Lanka's exchange-rate indicators⁵



Source: Central Bank of Sri Lanka, International Monetary Fund, Bloomberg and RAM Economics

A moderate appreciation of the Sri Lankan currency against most major currencies is expected in 2011. This comes on the back of an expected relaxation of capital controls to allow more capital inflow, with a view to assisting post-war reconstruction. However, Sri Lanka's persistent trade deficit will keep this overall appreciation in check throughout the year. As such, we project Sri Lanka's nominal effective exchange rate to shift up 3%-5% in 2011.

Inflation becoming less of a concern

Sri Lanka's domestic inflation rate generally follows international commodity price movements, as more than half of the index is attributed to volatile food and fuel prices (Figure 23, left panel). Following the end of the conflict in mid-2009 and because commodity prices have strengthened as the global recovery gains traction, inflation has been trending upwards.

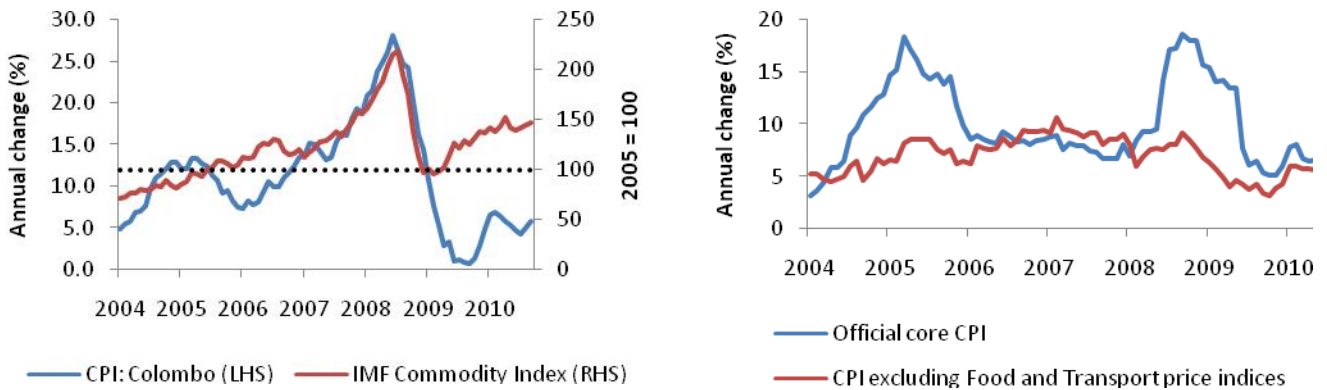
Upward price pressures have also been a result of tight food supply due to "occupied" agricultural land during the war. Additionally, import duties on various food items were reduced in November 2009, thus helping to moderate the upward pressure on prices.

However, inflationary pressures are still relatively tame in 2010 (compared to previous years), a result of the lacklustre economic recovery in the advanced economies that has prevented any sustained surge in commodity prices to pre-crisis levels.

Additionally, domestic surplus labour in the post-war environment has exerted downward pressure on wages and prices. This is reflected in the downward-trending core CPI statistics this year and the same price index after adjusting for the "food" and "transport" sub-indices (Figure 23, right panel).

⁵ IDR= Indian rupee; EUR= euro; SGD= Singaporean dollar; GBP= British pound; USD= US dollar; NEER = nominal effective exchange rate; REER = real effective exchange rate

Figure 23: Annual changes in Colombo Consumer Price Indices and the IMF Commodity Price Index



Source: Central Bank of Sri Lanka, International Monetary Fund and RAM Economics

Inflation is expected to come in at 5.8% in 2010, before and to accelerate to 6.7% in 2011. This acceleration is likely to be fuelled by external factors, with some mitigating domestically originated downward pressures on the back of stronger economic performance. With regard to external factors, we anticipate domestic capital controls to be relaxed in a bid to allow more foreign investment to assist in the post-war reconstruction and stimulate economic activity, particularly once the advanced economies increase the liquidity within their financial systems.

B. Medium- to long-term outlook

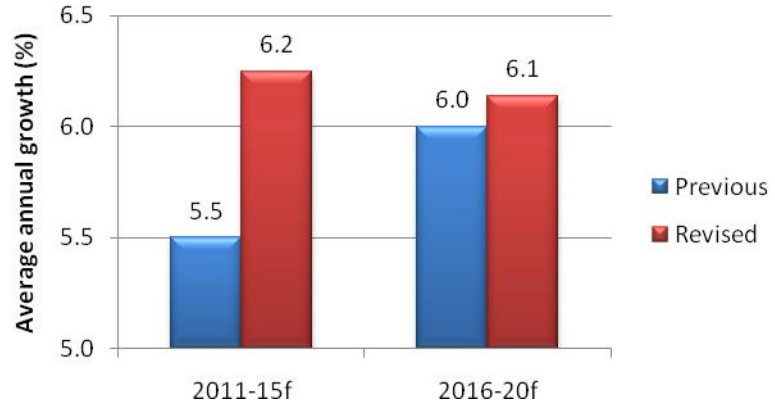
Average long-term growth revised upwards

Besides the quicker-than-expected reduction in the country's macroeconomic imbalances, key factors underpinning the upward revision in the nation's medium- to long-term average GDP growth include a less severe effect from the global financial crisis on the domestic economy, the quick - albeit fragile - global recovery, and rising confidence in the post-conflict economic rebound.

An improving macroeconomic environment, coupled with fiscal and other structural reforms to energise the private sector and harness market forces to raise economic efficiency and productivity, will set the tone for the country's transition from low-middle-income to middle-income status.

The average annual GDP growth forecast for the 2011-2015 period has been revised upwards from 5.5% to 6.2%; the projection for 2016-2020 has been raised a notch, from 6.0% to 6.1% (Figure 24).

Figure 24: Upward revision in the projected medium- to long-term average GDP growth rates for Sri Lanka

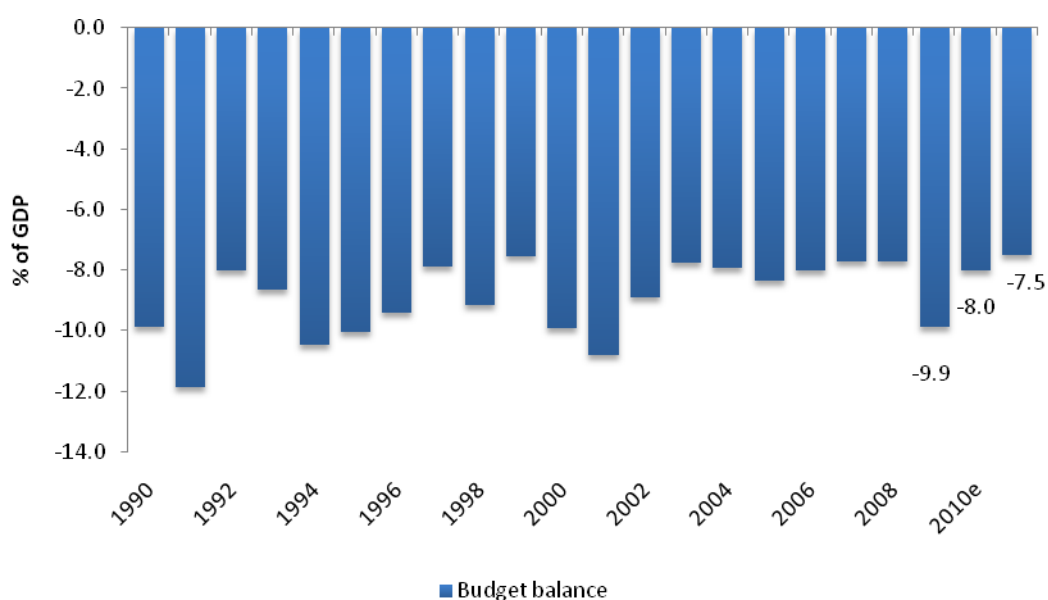


IV. POST-CONFLICT BUSINESS ENVIRONMENT – Main Challenges and Constraints against Growth

A. Fiscal consolidation without the downside to growth

The Department of Fiscal Policy of Sri Lanka estimates that the country's fiscal deficit will narrow to 8.0% in 2010, from the 8-year high of 9.9% in 2009 (Figure 25). This year, fiscal consolidation is expected to occur on the back of more revenue collection from taxes as the economy expands, particularly as the domestic labour market continues to strengthen after end of the civil war.

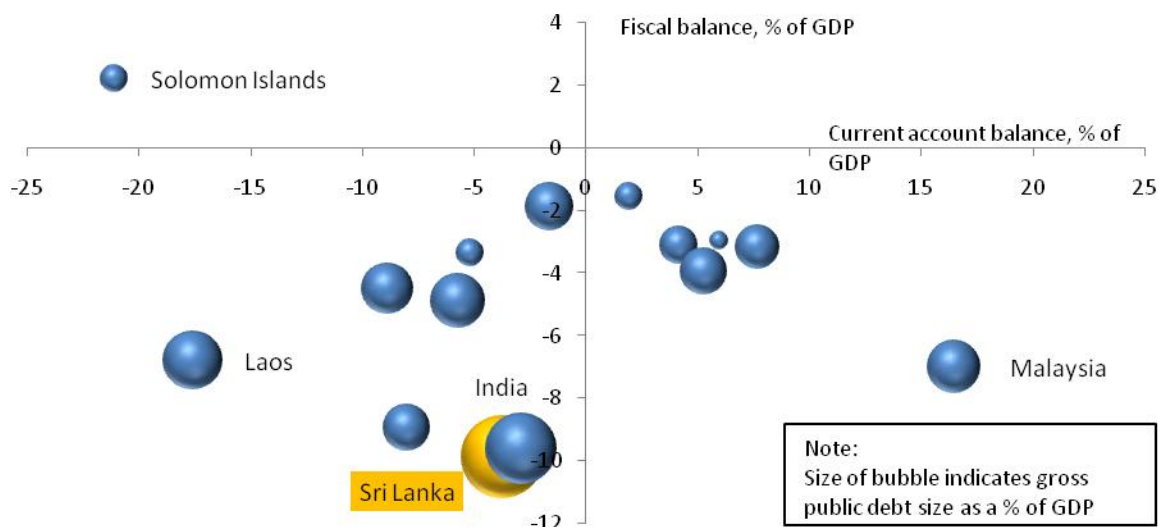
Figure 25: Sri Lanka's budget balance



Source: Central Bank of Sri Lanka and RAM Economics

In 2009, Sri Lanka reported the largest fiscal deficit and highest public debt level among emerging Asia-Pacific economies. Moreover, a current-account deficit of 3.7% has weighed against investor sentiments vis-a-vis the island nation (Figure 26). Consequently, an orderly restructuring of public-sector finances is required to reduce the cost of debt-financing while ensuring that the country's short-term development will not be jeopardized.

Figure 26: Comparison of Sri Lanka's fiscal-sustainability characteristics against those of emerging Asia-Pacific economies (2009)



Source: Bloomberg, International Monetary Fund and RAM Economics

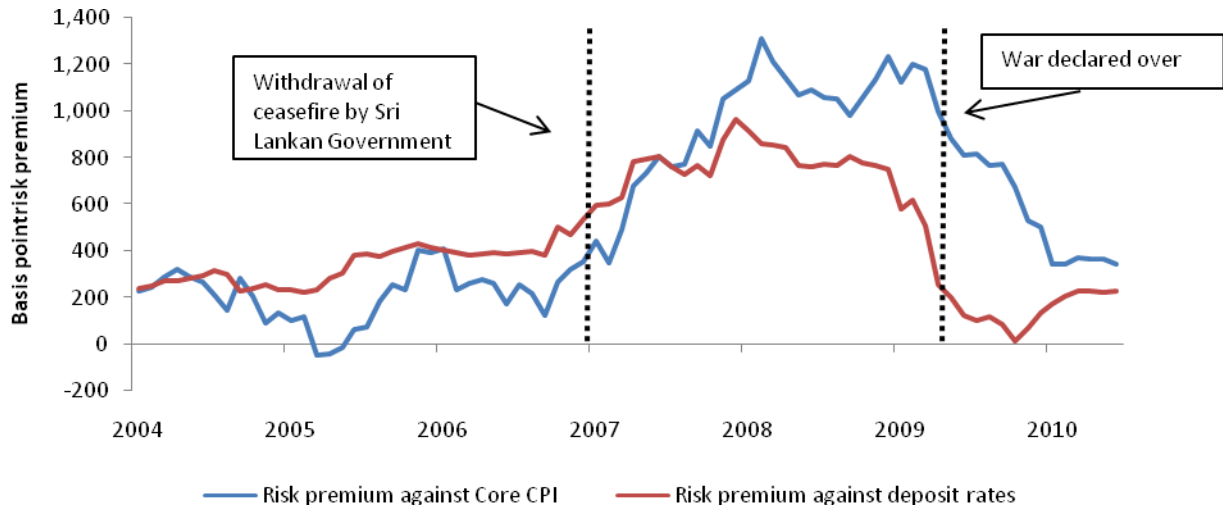
The real cost of public debt-financing (and as a gauge of investor sentiments) is calculated as the difference between government bond yields and the prevailing inflation rate or deposit rate.

For the purpose of this analysis, core CPI⁶ has been used as the yardstick, instead of the more popular inflation-indicating variant, because of the extreme volatility of commodity prices during that period. A larger risk premium indicates that the perceived risk in holding government securities has increased from the previous period.

Figure 27 illustrates the loss in investor confidence throughout the final phase of the civil war, particularly in late 2008 and early 2009, when the conflict had intensified. After the war was declared over in May 2009, the perceived risk of government bonds had fallen substantially, and has reverted back to pre-conflict levels.

⁶ Core CPI is defined as the CPI that is reweighted and recalculated to exclude the "food" and "transport" price sub-indices.

Figure 27: Different measures of Sri Lanka's 1-year risk premiums



Source: Bloomberg, International Monetary Fund and RAM Economics

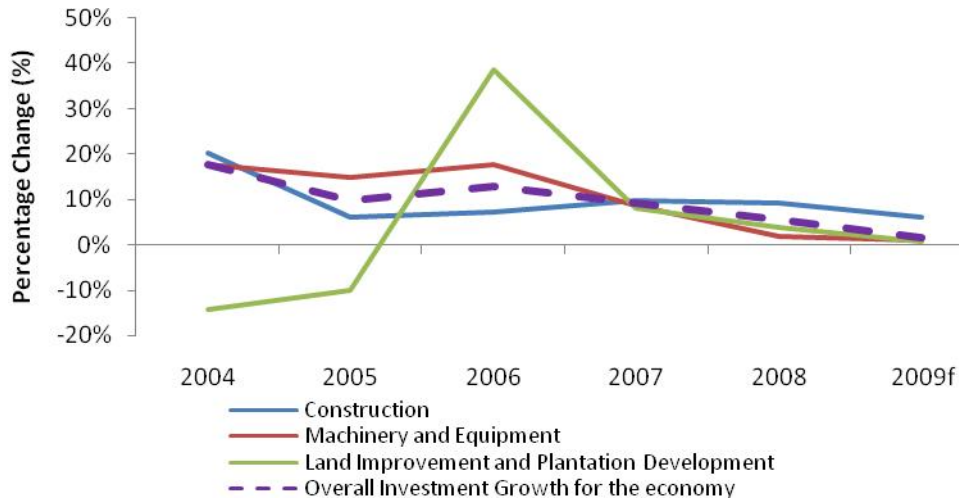
All said, Sri Lankan public finances are expected to remain structurally weak over the medium term, as the development of a post-war economy amid a high debt level and large deficit can be extremely challenging, both in terms of time and money. It is therefore expected that the overall fiscal deficit will only narrow marginally to 7.5% in 2011, in the absence of additional external aid.

B. Boosting private investment sets foundation for steady medium-term growth

As the country emerges from decades of civil unrest, the most pressing need for economic reform and kick-starting full-scale recovery is for investment activity (especially in the private sector) to be stimulated - to lay the foundation for economic growth.

In the past, political uncertainty has been the crux of lacklustre investment activity. Moreover, investment within the economy had been largely driven by the public sector. Nonetheless, there has been rapid moderation in these activities in the last few years, signalling a rather unfavourable trend in terms of the economy's long-term prospects and, thus, its ability to really surge ahead and rebuild.

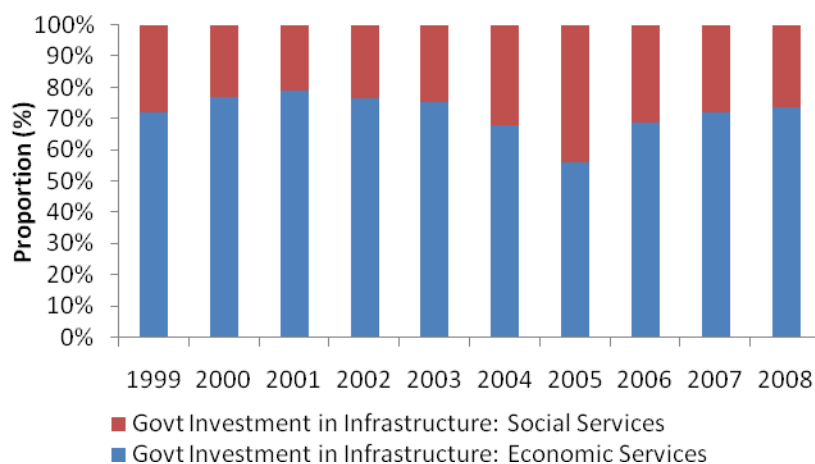
Figure 28: Rates of growth for different types of investment



Source: World Bank and Department of Census and Statistics, Sri Lanka
f = forecast by RAM Economics

The continuous deceleration in investment activities is most prominent in the machinery and equipment segment, pointing to less industrial upgrading and the sluggishness of this sector as a whole. Construction activities have held up better than the other investment areas; this sector is forecasted to have grown at a rate of 6% in 2009, as rebuilding efforts push through. However, the trends illustrated above indicate a big push for more productive private investment initiatives in order for the economy to achieve sustained growth.

Figure 29: Components of public spending



Source: Central Bank of Sri Lanka

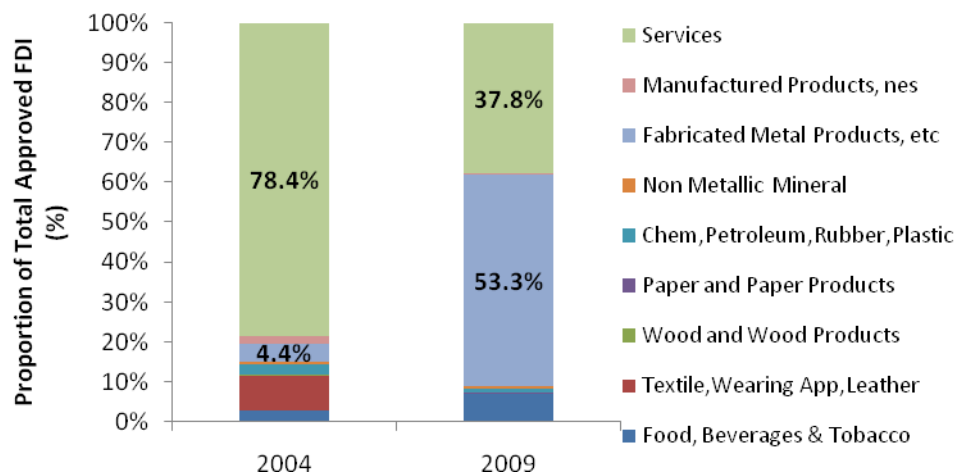
Furthermore, the USD500 million of USD-denominated sovereign bonds issued

in 2010 for the development of infrastructure and utilities shows the government's strong commitment to post-war reconstruction.

Moreover, strategic partnerships and investments by foreign counterparts are also helping towards this cause. The USD550 million tax-free port zone in Hambantota is a promising new development. This aims to serve as the premier logistics hub for the country, boosting both trade and investment activity in the country.

Despite the unrest the country has faced in the past, foreign direct investment ("FDI") has been forthcoming. Furthermore, there has been an interesting change in the relative composition of FDI over the 5-year horizon in our analysis. In 2004, about 78.4% of total approved investments were directed to the services sector, mainly consisting of investments related to the financial segment. By 2009, FDI had become more diversified; although there were still investments in the services sector, the industry that received the most FDI was fabricated metal products (Figure 30).

Figure 30: Changes in FDI composition



Source: Central Bank of Sri Lanka

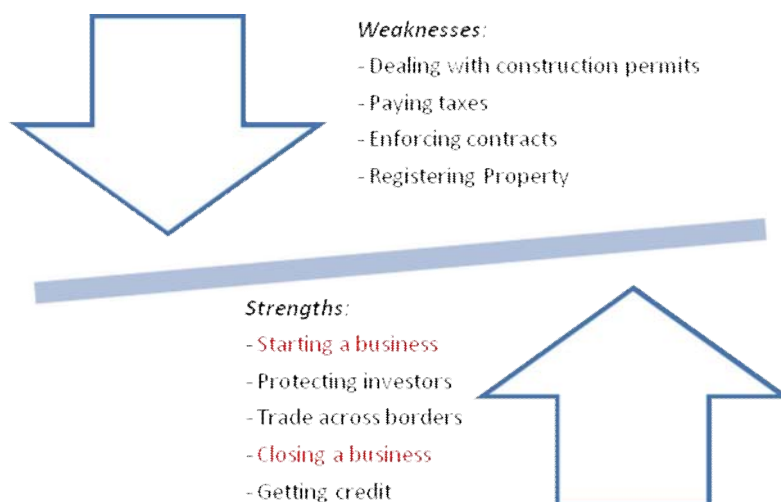
The data indicates a ramping up of capacity expansion vis-à-vis domestic industrial capability and diversification away from the primary sector. In particular, this is a sign of capacity build-up to enhance exports of industrial goods, rather than relying on commodities or the traditional manufacturing industry (textiles and apparel), where Sri Lanka faces stiff competition.

Ease of doing business

In the World Bank's *Ease of Doing Business* survey for 2011, Sri Lanka ranks 102nd in its composite score out of the 183 countries surveyed. This marks neither improvement nor deterioration in its position (Figure 31). However,

the relative strengths and weaknesses in its overall business environment become apparent when the detailed scoring is examined.

Figure 31: Sri Lanka’s business environment



Compared to its performance in the 2010 survey, only 2 out of the 9 categories had a better ranking (i.e. *Starting a Business* and *Closing a Business*, as denoted in red above). On the other hand, its ranking vis-à-vis the remaining indicators have deteriorated.

The main impediments to carrying out investment activities are described in greater detail in Table 4. They provide a useful gauge for policymakers when prioritising areas that need improvement, in order to stimulate business and investment activities.

Table 4: Areas for improvement

I. Dealing with construction permits

Measure	Sri Lanka	South Asia	OECD
Procedures (number)	22.0	18.4	15.8
Time (days)	214.0	241.0	166.3
Cost (% of income per capita)	1335.2	2039.2	62.1

Sri Lanka has more procedures involved in obtaining licences and permits to build a warehouse, compared to other South Asian and Organization of Economic Cooperation and Development (OECD) countries. Notably, costs are relatively lower as compared to South Asia but much higher than in the OECD countries, mainly attributable to the difference in the stage of economic development.

II. Registering property

Measure	Sri Lanka	South Asia	OECD
Procedures (No.)	8.0	6.3	4.8
Time (Days)	83.0	99.8	32.7
Cost (% of income per capita)	5.1	6.9	4.4

With regard to registering property, the number of procedures in Sri Lanka exceeds the regional average and those of the industrialised countries. Nonetheless, costs are still lower than those of its South Asian peers.

III. Obtaining credit

Measure	Sri Lanka	South Asia	OECD
Strength of legal rights	4.0	5.4	6.9
Depth of credit information	5.0	2.1	4.7
Public registry coverage (% of adults)	0.0	0.8	8.0
Private bureau coverage (% of adults)	18.6	3.8	61.0

There is much scope to further strengthen the country's financial infrastructure, in terms of the collection and dissemination of credit information (for both individuals and firms). Although Sri Lanka has a better ranking than its South Asian peers on average, there is a need to emphasise the exercise of the legal rights of both borrowers and lenders, to facilitate more financing activity.

IV. Protecting investors

Measure	Sri Lanka	South Asia	OECD
Extent of disclosure	4.0	4.4	6.0
Extent of director liability	5.0	4.4	5.2
Ease of shareholder suits	7.0	6.3	6.8
Strength of investor protection	5.3	5.0	6.0

There is a need to increase the level of transparency and accountability concerning transactions in the country, to encourage a higher level of economic activity.

V. Paying taxes

Measure	Sri Lanka	South Asia	OECD
Payments (no. per year)	62.0	31.1	14.2
Time (hours per year)	256.0	282.9	199.3
Profit tax (%)	27.4	17.8	16.8
Labour tax and contributions (%)	16.9	7.8	23.3
Other taxes (%)	20.3	14.2	3.0
Total tax rate (% profit)	64.7	39.9	43.0

Tax administration could be streamlined and revised to boost the efficiency of the overall system, which would in turn encourage more business activities and act as a “pull” factor for foreign investors.

VI. *Trading across borders*

Measure	Sri Lanka	South Asia	OECD
Documents to export (number)	8.0	8.5	4.4
Time to export (days)	21.0	32.3	10.9
Cost to export (USD per container)	715.0	1511.6	1058.7
Documents to import (number)	6.0	9.0	4.9
Time to import (days)	19.0	32.5	11.4
Cost to import (USD per container)	745.0	1744.5	1106.3

Administrative impediments to export activity act as a significant constraint against the volume of goods exported, although costs for both export and import activities remain quite competitive.

VII. *Enforcing contracts*

Measure	Sri Lanka	South Asia	OECD
Procedures (No.)	40.0	43.5	31.2
Time (Days)	1318.0	1052.9	517.5
Cost (% of claim)	22.8	27.2	19.2

The main issue here is the time it takes for an administrative action to be taken. Administrative bottlenecks remain one of Sri Lanka’s principal impediments against facilitating a more vibrant business environment.

IV. SUMMARY AND CONCLUDING OBSERVATIONS

Favourable short-term growth prospects

Having weathered the 2008/09 global downturn successfully, Sri Lanka's economy is poised for a strong rebound in 2010, with its estimated GDP growth approaching 7%.

The economy is projected to expand 6.5% in 2011, followed by 6.3% in 2012. The moderately strong growth will be driven by domestic final demand as net trade contribution to GDP remains in negative territory. Buoyant consumer and investor sentiments will contribute to the robust domestic demand while rising investment activity, especially from the foreign and domestic private sectors, will provide upside to our growth forecast.

The services sector will benefit from the healthy domestic demand; this segment is expected to sustain a 7% growth in both 2011 and 2012. Underpinned by the sizeable manufacturing sub-sector, the industry sector is projected to expand 6.4% per annum over the next 2 years.

Medium-to-long-term growth forecasts revised upwards

Our medium-to-long-term GDP growth forecast for Sri Lanka has been revised upwards from 5.5% to 6.2% per annum for the 2011-2015 period. Our projection for 2016-2020 has also been raised a notch, from 6.0% to 6.1%. The revisions are underpinned by several key factors: (a) a quicker-than-expected reduction in the country's macroeconomic imbalances; (b) the global financial crisis' less severe impact on the domestic economy; (c) the quick - albeit fragile - global recovery; and (d) rising confidence in the post-conflict economic rebound.

An improving macroeconomic environment, coupled with fiscal and other structural reforms to energise the private sector and harness market forces to raise economic efficiency and productivity, will set the tone for the country's transition from low-middle-income to middle-income status.

Key challenges and risks

The country's near-term challenges include striking a judicious balance between the need for fiscal consolidation, to rein in the deficit without derailing the momentum of post-conflict rebuilding and growth. At the same time, structural reforms are needed to enhance administrative efficiency and crowd in private investment, by building on the prevailing positive sentiments.

The key risks in the projected growth scenario for Sri Lanka include the

following:

- *Prolonged weakness of the advanced economies:* Weak demand from the advanced economies will dampen the growth of Sri Lanka's export-oriented industries. Additionally, the threat of trade and currency wars has increased recently. Protectionist policies and competitive currency devaluations could hinder global trade and investment flows.
- *Accelerated inflation due to commodity price shocks:* The recent second round of quantitative easing in the US, as well as continuing lax monetary conditions in developed economies amid near-zero or low interest rates, could unleash surplus liquidity in the global commodity markets, thereby causing another possible surge in commodity prices.
- *Slow pace of reforms:* The reforms needed to sustain investor confidence and private investment flows, especially FDI, into the country is crucial for the economy to achieve the projected growth. Further liberalisation and deepening of the financial markets, more efficient mobilisation of domestic savings as well as remittances from abroad to support productive investment, not to mention enhancing the ease of doing business, are key requirements for the achievement of a greater growth trajectory.
- *Investors' perception of increased fiscal weakness:* Sustaining the post-war economic growth would require substantial infrastructure work, and access to international financial markets would be a key pre-requisite in this regard. Insufficient measures to consolidate public-sector spending (particularly with regard to defense spending) will dampen investors' confidence and would be detrimental to medium-term economic growth.
- *Inability to diversify domestic production structure:* Currently, Sri Lanka's production structure competes directly against output from large emerging markets (China and India) and other cost-competitive economies. To sustain longer-term growth, a structural change is required to reorient domestic production in such a way that it complements the region's production structure.

11 November 2010

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