



# ECONOMICS COMMENTARY

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## Global Downturn: Whither Sri Lanka?

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### ***Recovering domestic economy snagged by global slowdown***

The South Asian economies have had to face several supply-side shocks, foremost among which have been rocketing food and oil prices. Like its regional neighbours, Sri Lanka has also not been spared these ravages. Just as the domestic economy had been on the verge of recovering from the global oil and food shocks, the American sub-prime crisis had morphed into a global recession, the likes of which has not been encountered in the post-World War 2 era.

Amid this scenario, the country has suffered an estimated 10% income loss in terms of trade shocks arising from the surge in world commodity prices (refer to chart). According to the World Bank report entitled *Global Financial Crisis: Implications for South Asia*, Sri Lanka's staple food prices had spiked 83% and has exerted a bigger impact on inflation than fuel. However, staple food prices have since moderated due to increased production. Furthermore, the price of oil has more than halved from its high of USD150 per barrel a few months ago. These factors, together with the Central Bank's tight monetary policy, have somewhat eased inflationary pressures.

The rate of inflation, as measured by the year-on-year change in the Colombo Consumer's Price Index (base = 2002), came up to 20.2% in October, having progressively declined from its peak of 28.2% in June 2008. Hence, the declining prices of oil and food have afforded some respite. Even so, the unravelling global financial

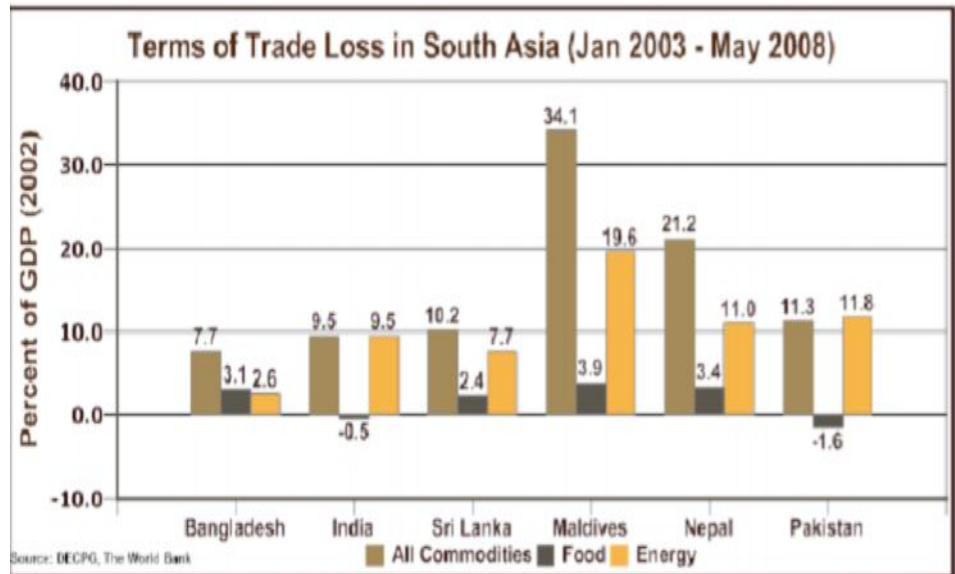
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turmoil poses significant downside risks, not only to Sri Lanka, but also to other South Asian countries and the world at large.



### **Risk Transmission**

#### ***Indirect repercussions of worldwide slowdown***

Technically, these risks can permeate not just from the financial sector, but also from the real sector. The financial sector can be affected in terms of volume and foreign capital flows. Meanwhile, the real sector can be distressed by the adverse effects of a global slowdown on exports, probable declines in remittances and further slowing of private investment due to higher interest rates and weaker export demand. All said, the effects of these will be varied; larger entities are envisaged to be able to better weather the impending storm compared to their smaller counterparts.

### **Financial Sector**

#### ***Financial sector largely immune from direct impact, but not from ripple effects***

In the Sri Lankan context, capital controls have largely insulated the country from the global turmoil. Even though the stock market and the country's foreign reserves have been affected, the financial and banking sector has remained intact as domestic banks have minimum exposure to foreign investments and assets. In addition, the local branches of foreign banks are protected by the controls imposed by the Sri Lankan Central Bank, reinforced by the regulator's close monitoring. The banking sector, nevertheless, could be affected by the looming threat of reduced exports and the

resultant fallout. However, the immediate concerns for the domestic financial sector are high inflation and lofty interest rates, which in turn are likely to affect asset quality, financial performance, liquidity and capitalisation. While commercial banks will not be entirely immune, the greatest impact from these adverse developments will be felt by leasing and finance companies.

***Leasing and finance companies grappling with domestic concerns***

Registered finance companies (“RFC”) and leasing firms are likely to be indirectly affected by the global crisis rather than directly; the sectors they cater to are likely to be caught by the global turbulence. At present, these 2 sectors are ravaged by domestic macroeconomic concerns, as mentioned earlier. Having said that, these segments have performed relatively well despite several challenges, particularly high inflation. The resilience of the overall sector is attributable to the fact that larger firms have established deposit franchises and financial flexibility. In addition, these RFCs have been tightening their monitoring processes and collections. RAM Ratings believes that these efforts have given the larger players an edge over their smaller peers - as already reflected in our rating actions. RFCs that carry ratings below BBB- are particularly vulnerable and have experienced downward rating actions. For instance, approximately 55% of RAM Ratings’ universe of non-investment-grade RFCs has faced negative rating actions; the mildest of these has been a negative rating outlook while the harshest has been a 1-notch downgrade with a negative outlook. The unfolding global crisis will affect these industries as their loan portfolios will be either directly or indirectly hit by the downturn in the export sector and its ripple effects across the economy.

***Reinsurance premiums and commissions may be tight***

The effects of the credit upheaval and global slowdown will have a medium-term impact on the domestic insurance sector; the global reinsurance capacity is likely to have shrunk pursuant to the worldwide crisis. Even though these effects are unlikely to be severe, the contraction in reinsurance capacity is likely to push up reinsurance costs. Given that reinsurers retro-cede globally, the American and European turmoil will have impinged upon reinsurers around the world. RAM Ratings notes that local insurers generally arrange their reinsurance programmes through reinsurance brokers, which in turn spread the risks among various reinsurers. Therefore, while counterparty risk is envisaged to remain largely unchanged, reinsurance premiums are likely to increase.

## **Exchange Rate**

### ***Exchange rate and Sri Lanka's competitiveness***

A key determinant of Sri Lanka's export competitiveness is the local currency's exchange rate. RAM Ratings believes that the proposed USD700 billion financial rescue plan sanctioned by the United States' ("US") Federal Reserve will undoubtedly increase inflationary pressures in the US, and that the US dollar is likely to weaken against other major currencies over the medium to longer term. Thus if the rupee's exchange rate is artificially maintained, our exports could become expensive.

## **Export Sector**

### ***Garments seen as most vulnerable segment***

Sri Lanka has an export-dependent economy; the garment industry takes up approximately 43% of the nation's total exports, and is the most vulnerable in the face of the global downturn. As more than 95% of these exports are to the European Union and the US, any slackening in demand for garments could have a material impact on the industry. Although the government has proposed a LKR 21 billion bailout package for this industry, it could also widen the budget deficit, thereby increasing the government's cost of borrowing and exerting further inflationary pressure.

### ***Tea sector will be affected, but may recover sooner***

The nation's second-largest export category is tea. Although this sector has been enjoying an uptrend in prices, there has been a sharp fall in commodity prices and demand of late; tea small-holders have already felt the brunt of this unfavorable turn of events. However, this slump in demand is likely to ease over the medium term, with the price of tea recovering to historical levels. Hence, the less robust global demand for tea is only expected to be a short-term phenomenon. RAM Ratings notes that the bulk of Sri Lanka's exports (44%) is purchased by Middle Eastern countries, followed by the Commonwealth of Independent States ("CIS"). On this note, countries in the CIS have been more adversely affected than those in the oil-rich emirate region.

### ***Domino effects of waning exports***

The contraction in demand for exports will have a knock-on effect on employment, especially for the more vulnerable segments of society. This unemployment, coupled with inflation, may strain the economy even further.

***Foreign remittances may be influenced***

Apart from the export sector, foreign remittances may also be affected. Foreign remittances not only provided a cushion for the country's balance of payments; more importantly, it is a chief source of income and a safety net for a large number of poor households. We note that most remittances originate from low- or semi-skilled workers working in oil-rich countries. These earnings are generally secure as these countries have amassed sufficient reserves and income from the oil-price boom. Nevertheless, remittances from the OECD and central European countries are more at risk. Moreover, foreign investments are also likely to be affected by the global slowdown in demand.

***Tourism industry to stay in doldrums***

The local tourism sector, meanwhile, has been hard hit by foreign travel advisories in the last few years. The global financial turbulence will further depress the tourism industry, Sri Lanka in particular and the world in general.

**Summary**

Overall, Sri Lanka's exports will be affected and this will have a domino effect on other sections of the economy. In such challenging times, investors' risk tolerance will contract, with a corresponding predilection for liquidity. As such, they are likely to prefer investing in highly rated and short-term assets. Given the dampening demand, both local and overseas, private-sector companies are likely to consolidate and trim excess fat. Amid such significant downside risks, however, the severity and depth of the slump will also depend much on the government's response.

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