RAM
HOLDINGS

REDEFINING EXCELLENCE
Celebrating 20 Years Of Leadership
1990 - 2010

ICASL-RAM Ratings (Lanka) CEO Breakfast Meeting

Sri Lanka's Economic Outlook 2011

Sustaining growth and rebuilding momentum

Dr Yeah Kim Leng, Chief Economist
Kristina Fong, Senior Economist
Jason Fong, Economist

November 18, 2010

RAM HOLDINGS
Economics Research

Outline

I. **Global economic update and implications**

II. **Sri Lanka's current performance and outlook for 2011-2012**

III. **Update of medium term GDP growth forecast**

IV. **Enhancing post-conflict business environment**

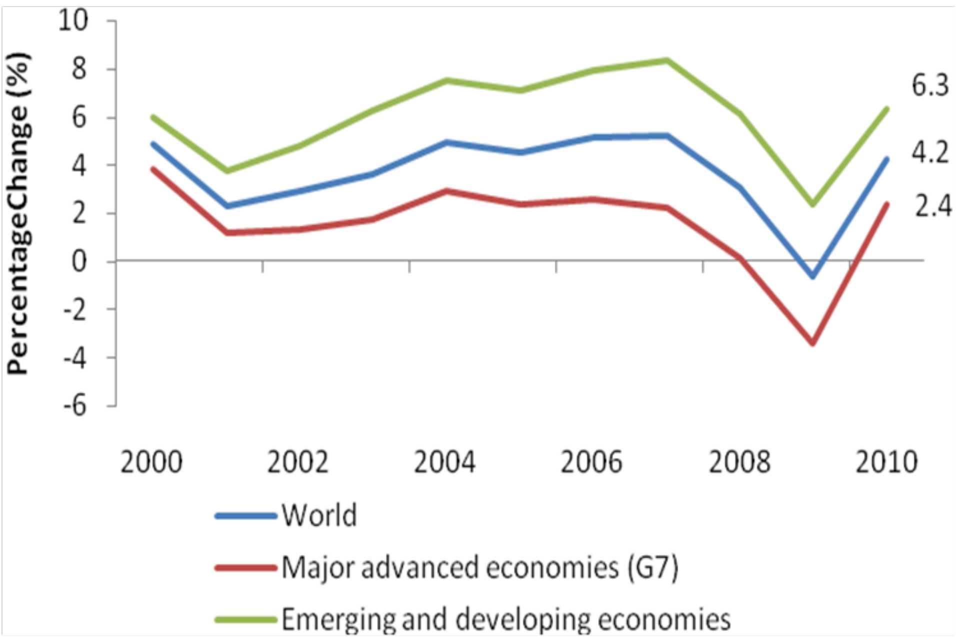
V. **Concluding remarks**

Strong rebound but global recovery remains fragile

Dual-speed global recovery with demand still below pre-crisis level

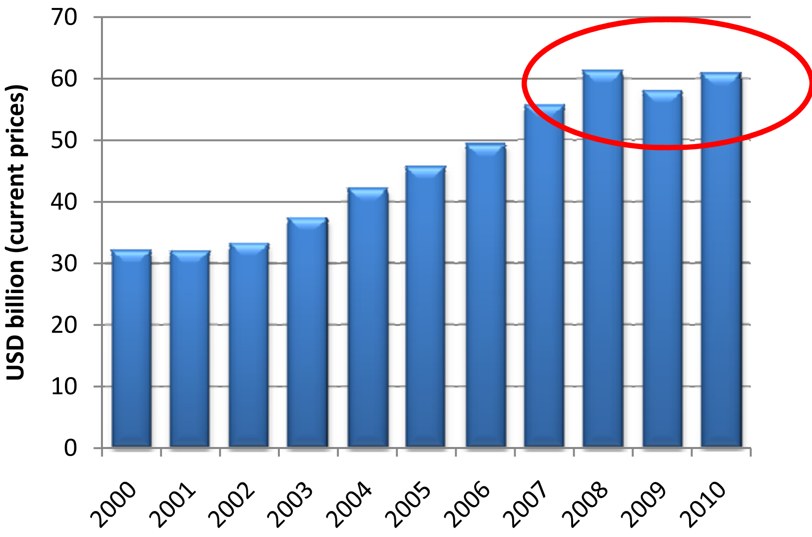
- Strong 1H2010 but weakening industrial output (PMIs) in the second half suggests global demand may take breather amidst continuing high unemployment in advanced economies.
- Weak domestic spending is exacerbated by uncertainty over sustainability of recovery in advanced economies caused by high fiscal deficits and debt levels coupled with weak credit growth as deleveraging and rebuilding balance sheet continues.

Dual-speed global recovery in 2010



Source: Bloomberg Consensus forecasts and RAM Economics

Global output yet to reach pre-crisis output level



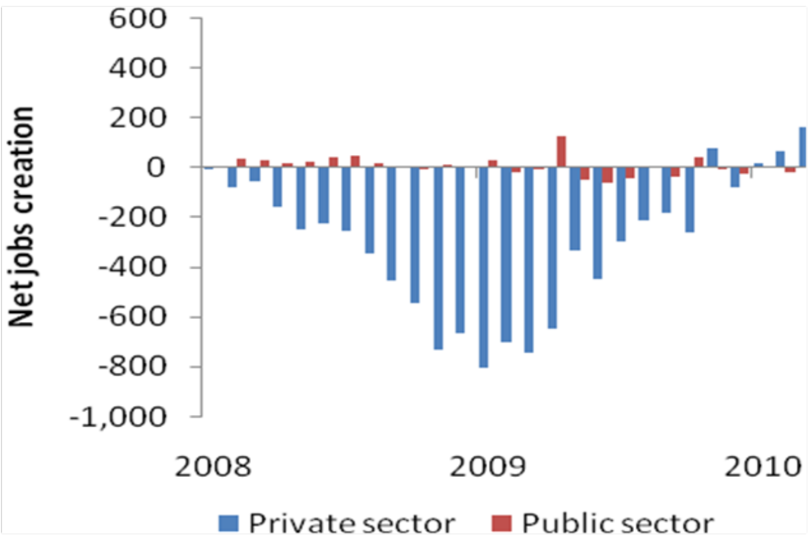
Source: IMF World Economic Outlook database October 2010

General weakness with pockets of strength

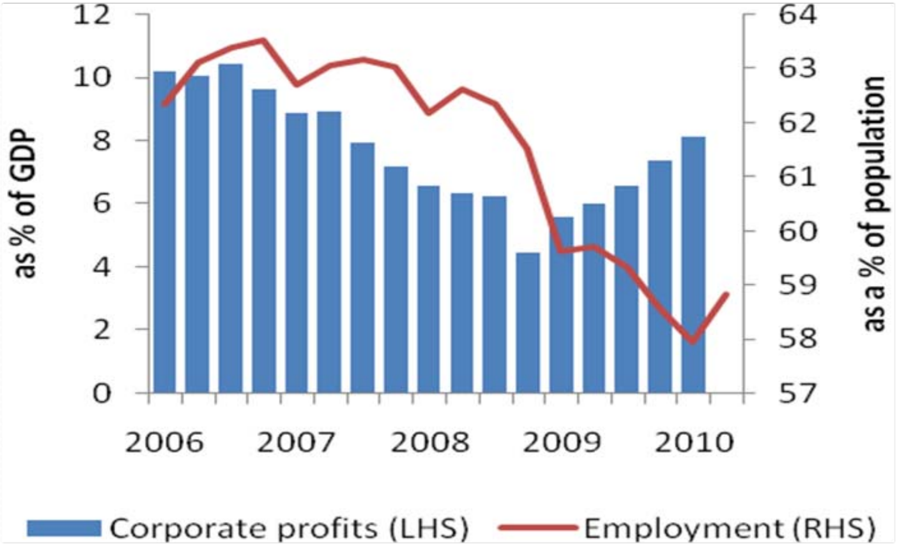
US recovery remains fragile as unemployment rate remains high at 9.6%

- A 'jobless' recovery as US unemployment rate persists at 9.6% while job creation remains weak.
- Government bailout, aggressive fiscal and monetary policy response and the resultant recovery have resulted in rising corporate profits but hiring remains weak.

Huge job losses during financial crisis, raising US unemployment rate to 9.6%



Corporate profits trending up while employment decline reversed in 1H2010

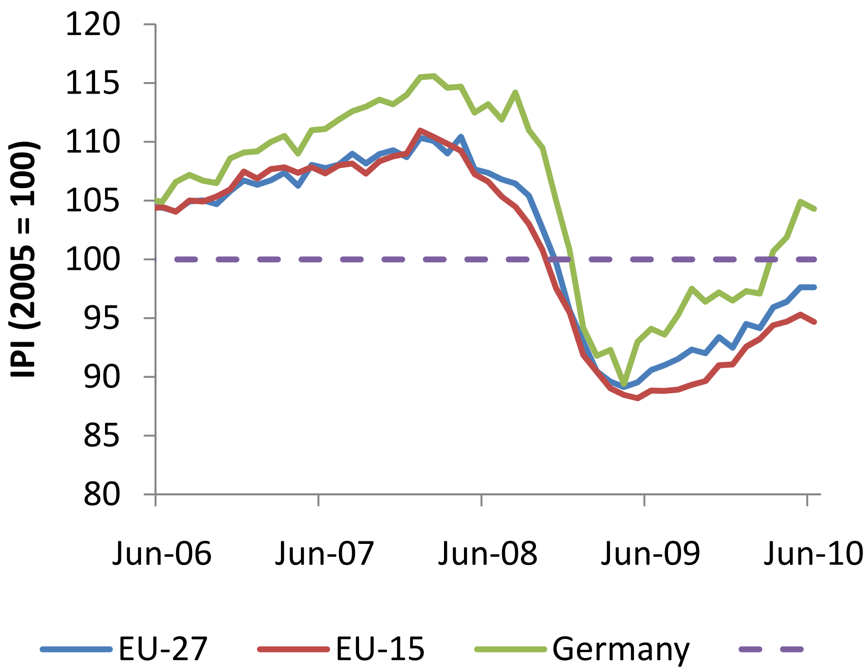


General weakness with pockets of strength (cont'd)

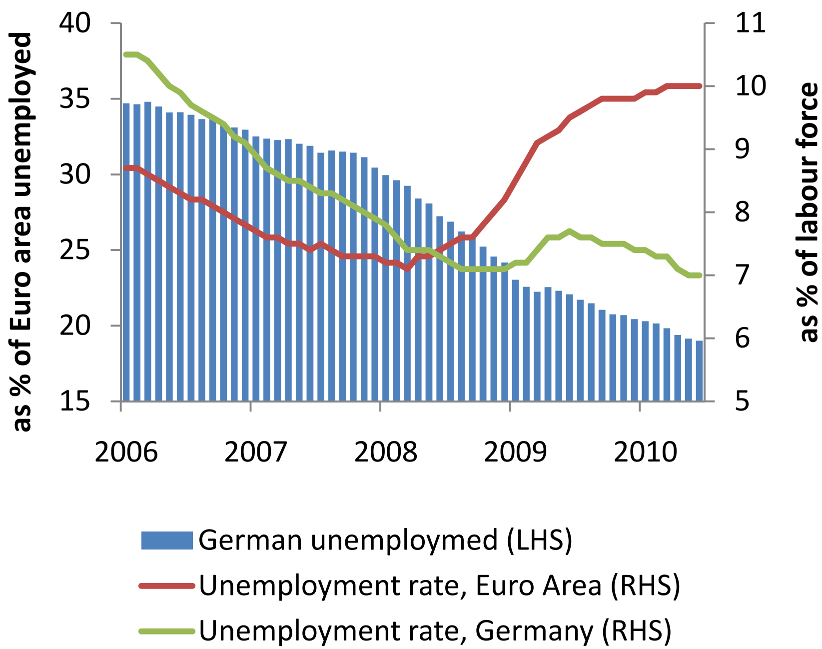
In Europe, Germany is leading the recovery

- Exports driving faster recovery in Germany as unemployment shows steady decline.
- More labour-friendly measures taken by firms during economic downturn and higher labour productivity resulting in a faster pace of recovery of the German economy.

Industrial output growth diverging as Germany speeds ahead



Germany's unemployment rate eases to 7% as against 10% for Euro area

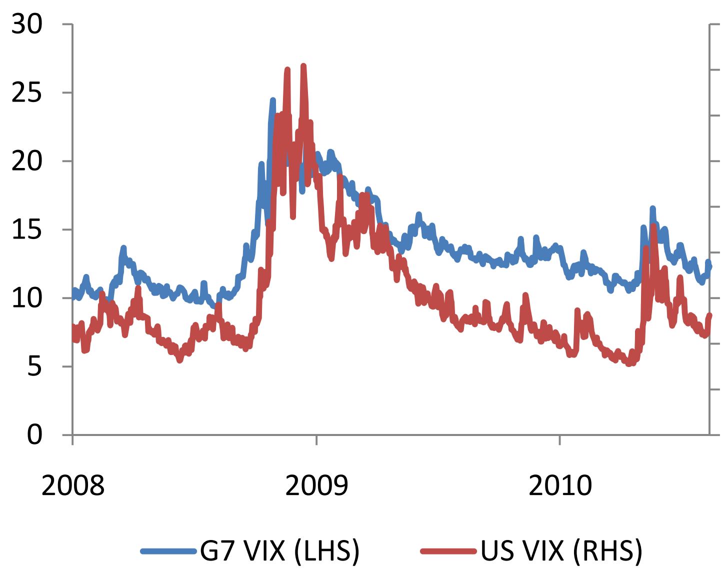


Global financial conditions have stabilised

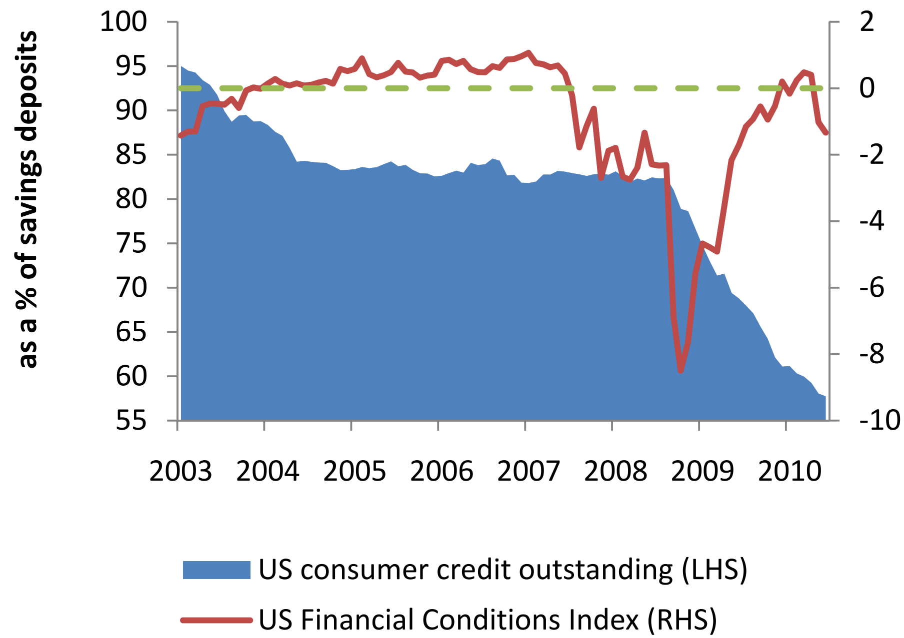
Global financial conditions less volatile but remain vulnerable to shocks

- Market volatility has eased considerably since its high during the Lehman collapse in Sep 2008 but it has increased in recent months due to double dip concernsm amidst austerity drive in Europe and market focus on sovereign credit quality problems in several European economies.
- Despite low interest rate and quantitative easing, credit lending remains weak in the US, constraining the consumer-led recovery.

Market volatility has normalised but remains vulnerable to shock (eg. Greek sovereign debt)



US financial conditions are near normal but consumer credit has declined sharply

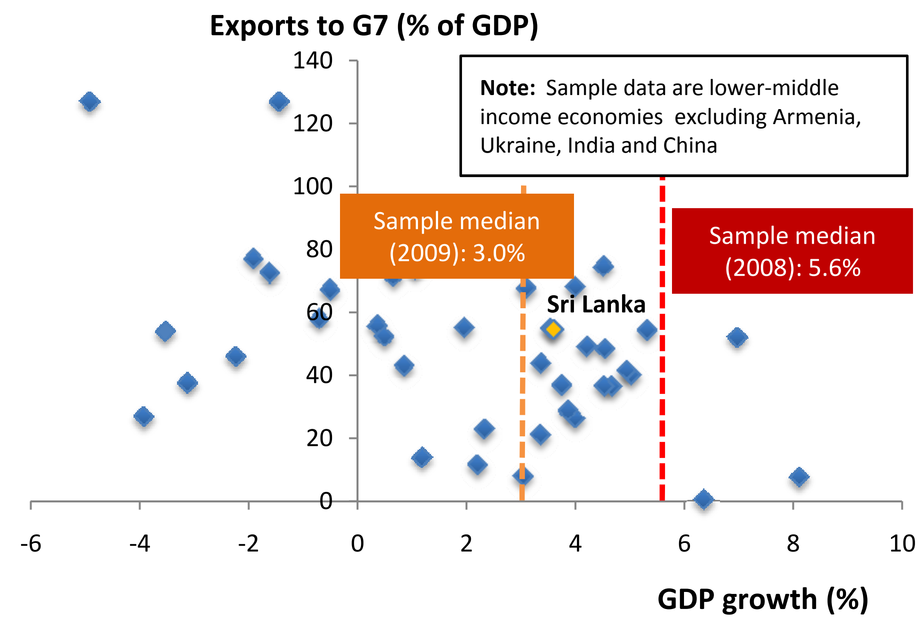


Implications for emerging economies

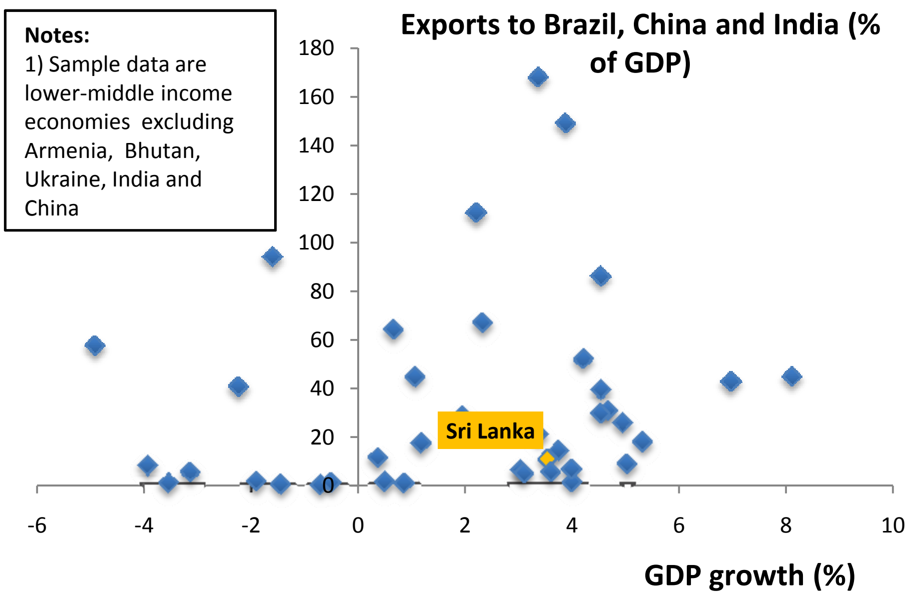
1. Shift in global demand to fast growing, large emerging economies

- 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).
- Other developing countries can 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.

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

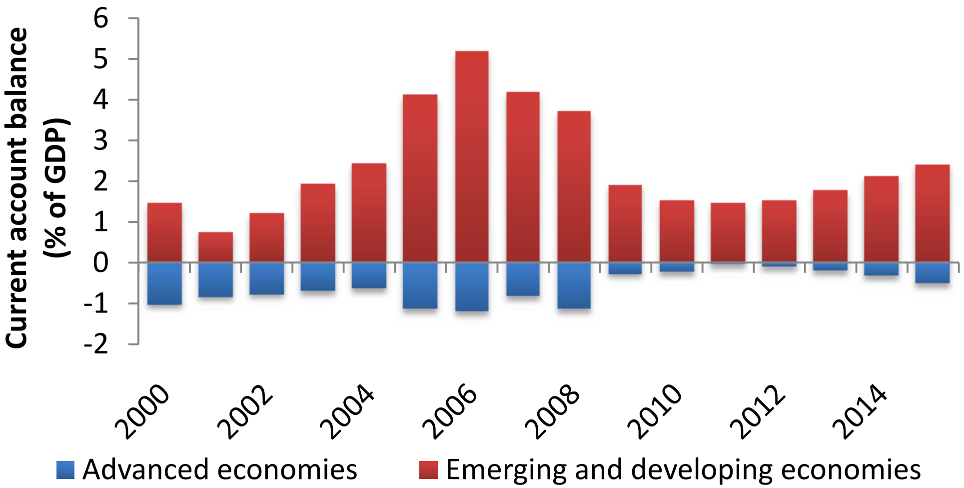


Lower-middle-income economies' growth and exports to large emerging markets in 2009

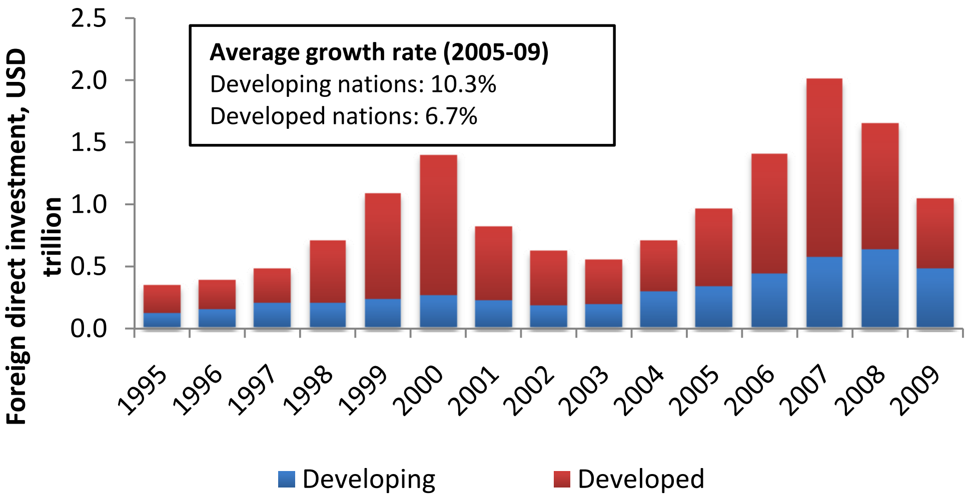


Implications for emerging economies (cont'd)

High current account surplus in emerging and developing economies



FDI flows to developing versus developed economies



2. Re-balancing of aggregate final demand to domestic rather than export

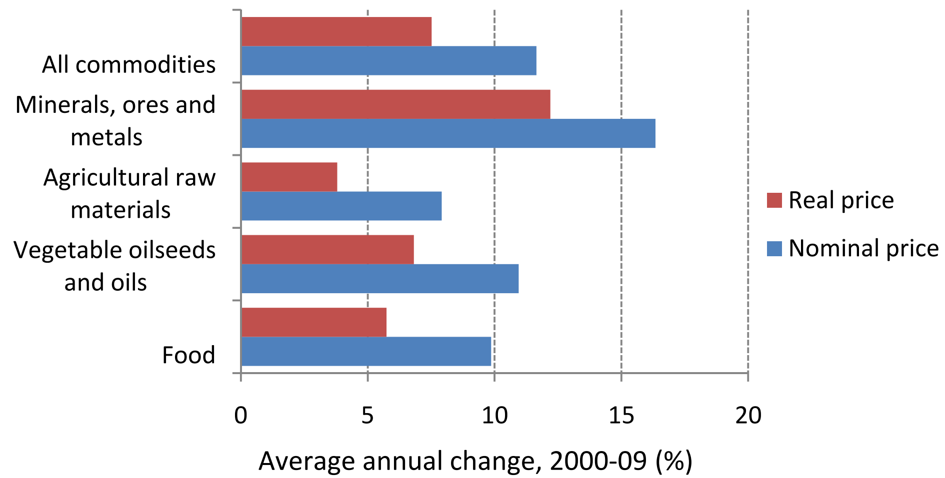
- Domestic demand in the developing world has to be accelerated to rebalance growth and absorb the demand resulting from weak growth in the advanced economies.

3. Resurgence of capital flows to emerging markets

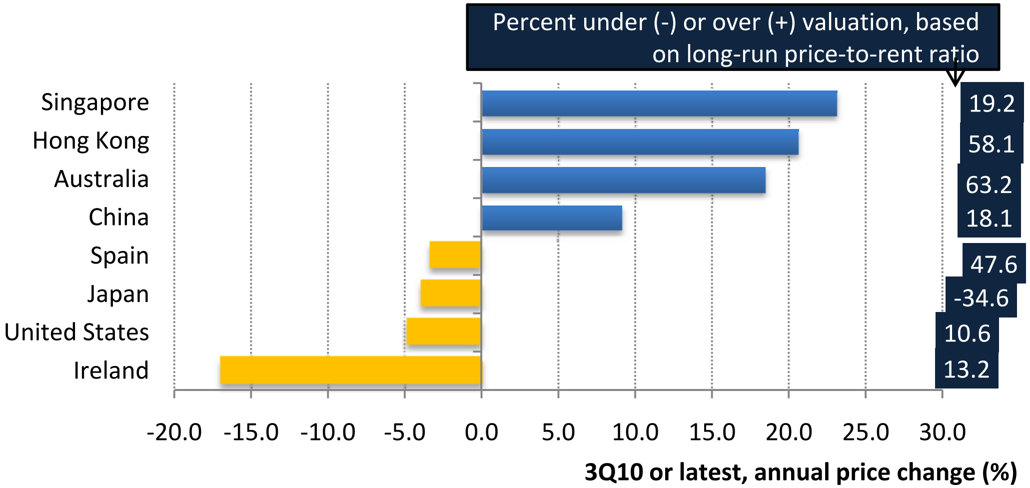
- Better growth prospects will drive higher FDI flows to emerging economies.

Implications for emerging economies (end)

Pick-up in commodity prices



The Economist's house-price indicators



4. Flow of funds to commodity markets

- Concern over commodity price bubbles resulting from surge in global liquidity

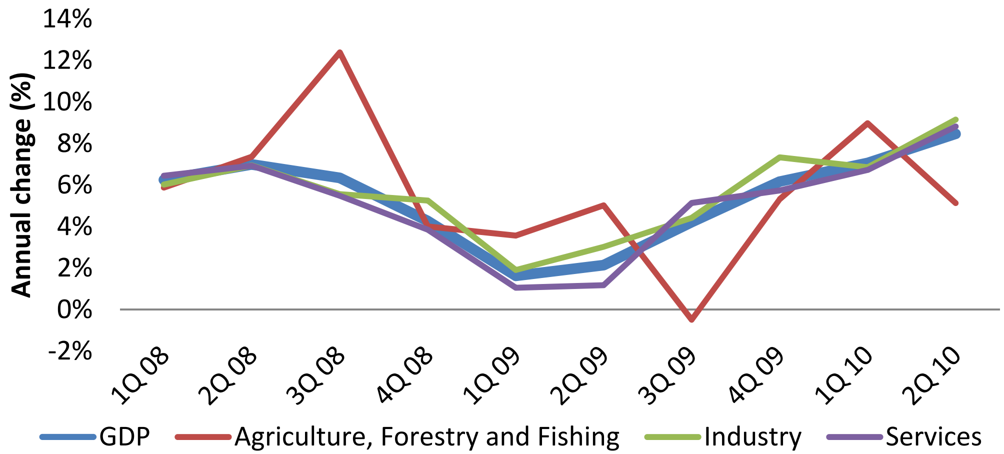
5. Excess liquidity and 'hot money' flows to emerging markets

- Increased risk of property and other asset bubbles.

II. Sri Lanka’s current performance and outlook for 2011-2012

Economy poised for strong rebound

Strong first half performance



	Quarterly change (% yoy)				
	GDP	*Agriculture*	*Industry*	*of which Manufacturing*	*Services*
1Q2009	**1.6**	3.6	1.9	2.7	1.0
2Q2009	**2.1**	5.0	3.0	1.1	1.2
3Q2009	**4.2**	-0.5	4.4	3.2	5.1
4Q2009	**6.2**	5.3	7.3	6.0	5.7
1Q2010	**7.1**	9.0	6.9	5.8	6.7
2Q2010	**8.5**	5.1	9.2	8.9	8.8
3Q2010f	**6.6**	4.0	7.0	6.5	7.0
4Q2010f	**5.3**	4.0	6.5	6.0	6.0

Strong first half performance

- 1Q GDP 7.1% and 2Q 8.5%
- Recovery in exports and domestic demand.
- Low base effects.
- Inventory re-building

Growth for 2010 estimated at 6.8%

- The services sector is expected to lead growth for the rest of 2010, expanding at an estimated 6.8% for the full year.
- Industry, led by manufacturing, is projected to expand by 6.5% in 2010.

Above trend growth expected in 2011 and 2012

Real GDP growth by sectors of production

	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
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

f – forecast by RAM Economics

Real GDP growth in 2011 projected at 6.5%, and marginally lower at 6.3% in 2012

- The services sector is projected to grow by 7.0% in 2011 and 6.9% in 2012, while industry, led by manufacturing, is projected to expand by 6.4% in 2011 and 2012.

Key factors underpinning growth:

- Post conflict infrastructure and reconstruction spending.
- Modest growth in advanced economies but strong growth in India and China.
- Crowding-in of private investment especially FDI due to rising investor confidence and upward of growth outlook upwards.

Above trend growth expected in 2011 and 2012

GDP growth of 6.5% expected in 2011 followed by 6.3% 2012 :

- Above average growth of 6.0% this decade (excluding 2001 recession and 2009 slowdown) and 5.5% in the 1980s and 1990s.
- Broadening consumption base as employment level rises.
- More upbeat consumer sentiments bolstered by post-conflict investor confidence and re-building momentum.
- Domestic demand, including public spending, seen to sustain growth momentum at 6.3% in 2012, despite weak global economy..

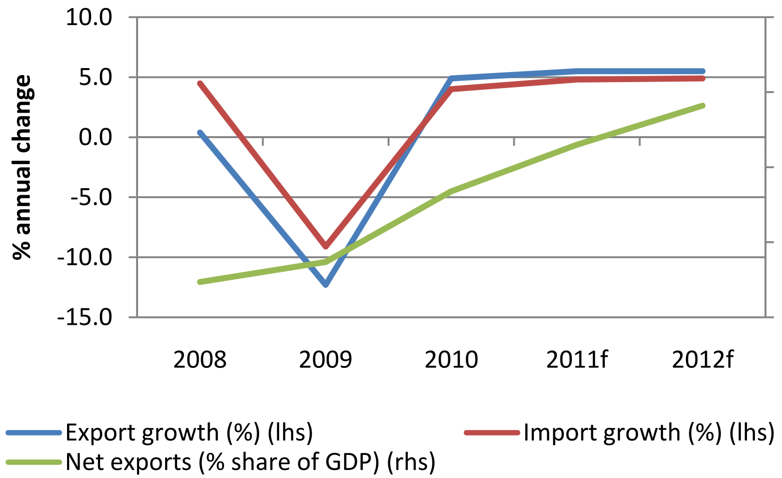
Real GDP growth by expenditure components

	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

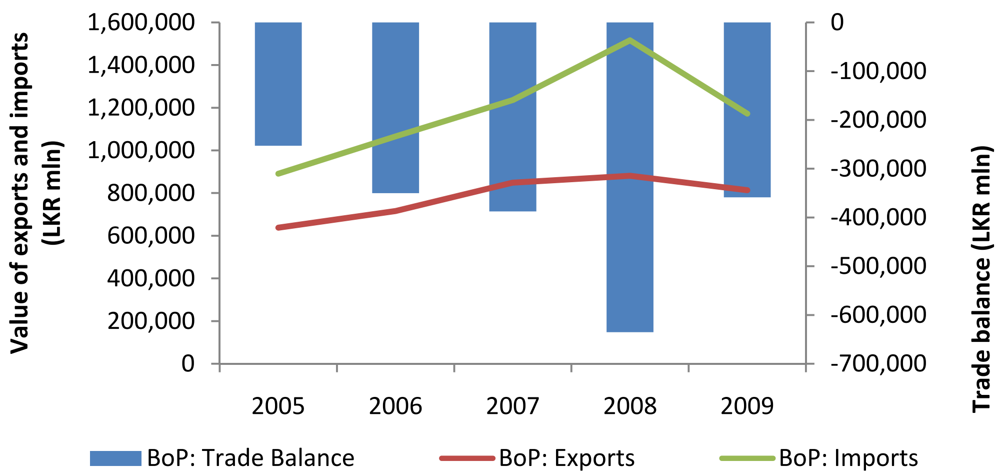
f – forecast by RAM Economics

External sector performance and prospects

Net export expected to narrow but remain sizeable



Merchandise trade deficit



Continuing negative net export contribution to GDP:

- Real export growth projected to normalize to 5.5% in 2011 and 2012 while import growth steadies to 4.8% in 2011 and 4.9% in 2012
- Negative net export expected to narrow to 8.3% in 2011 and 8.1% in 2012.

Trade deficit projected to widen slightly in 2010 and 2011:

- Rise in imports expected to widen trade deficit to an estimated USD5.6 bn in 2010 to USD6.9 bn in 2011.

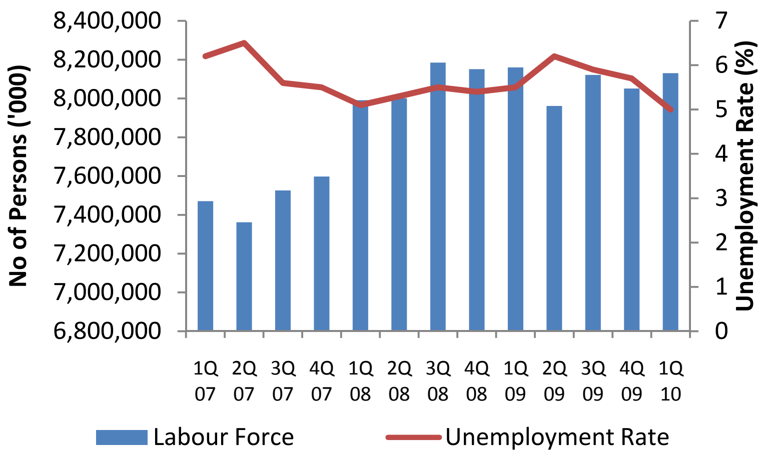
f – forecast by RAM Economics

Employment and wage trends – *turning favorable*

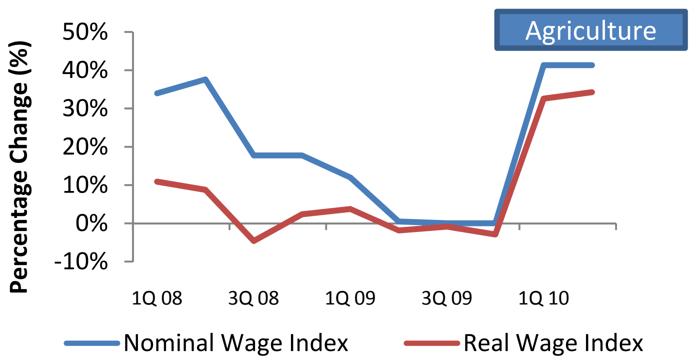
Increasing absorption of labor key to higher growth:

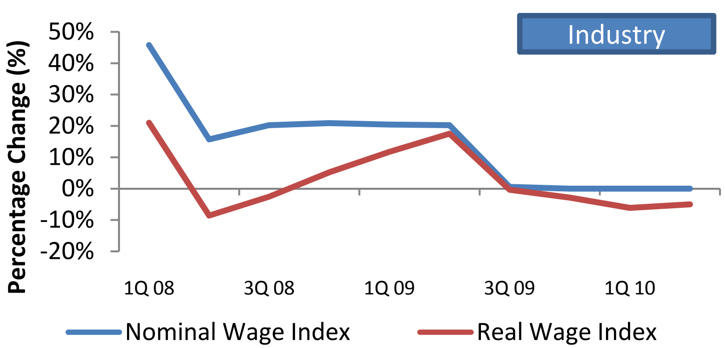
- Release of surplus labor will raise employment level but dampens wage rates if labor demand is not strong.

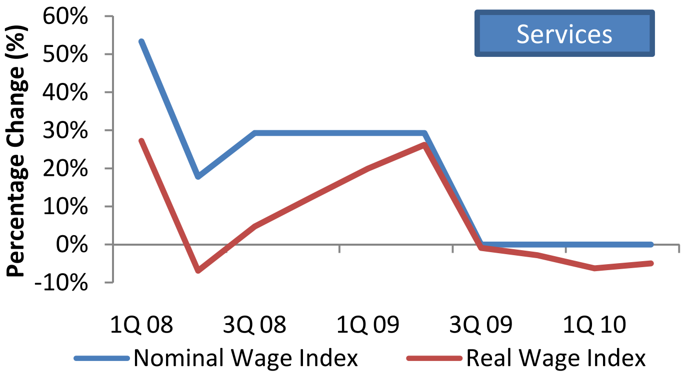
Labor force and unemployment trends



Wage trends







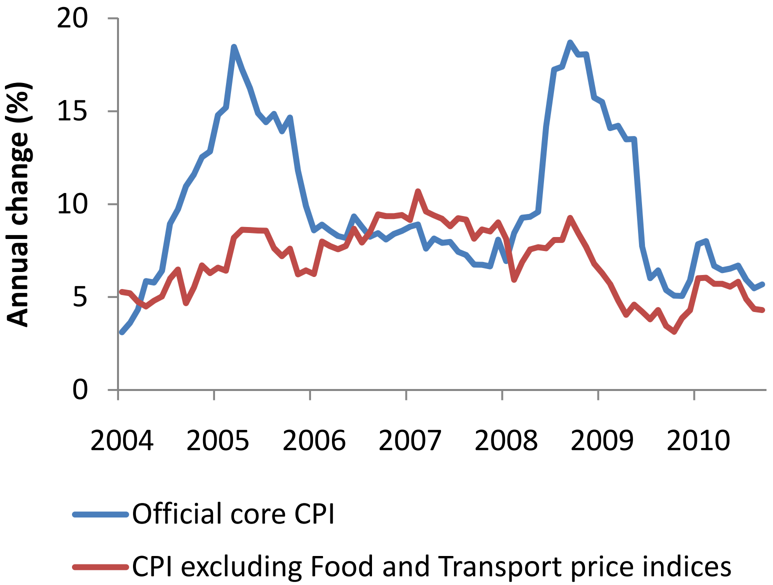
f – forecast by RAM Economics

Inflation trends – relatively tame in 2010

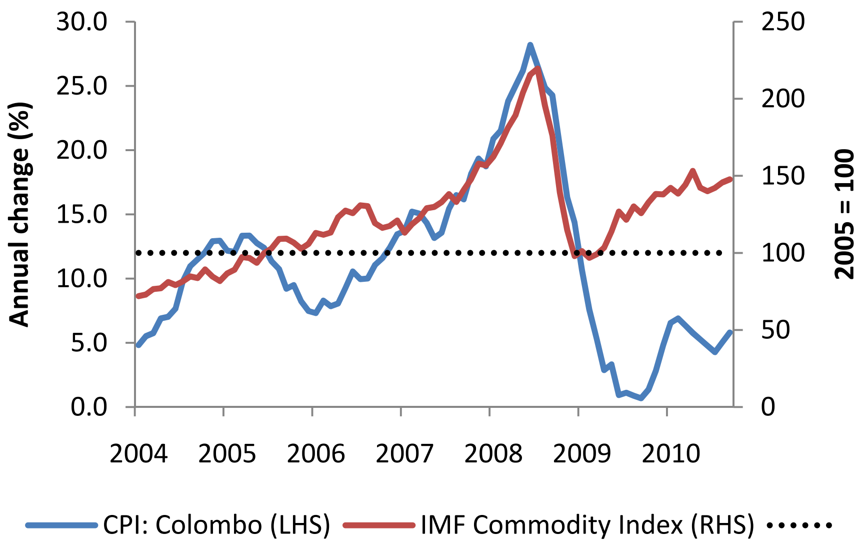
Inflation threat has receded but vigilance needed in 2011 as commodity prices rise:

- Inflationary pressures relatively tame in 2010, but non-core inflation – food and energy prices – remains volatile
- Non-core inflation largely caused by external price shocks – firming commodity prices as global demand recovers.
- CPI inflation expected to rise to 6.7% in 2011 and 7.0% in 2012.

Core CPI stabilising



Colombo CPI and IMF Commodity Index



Source: Bloomberg

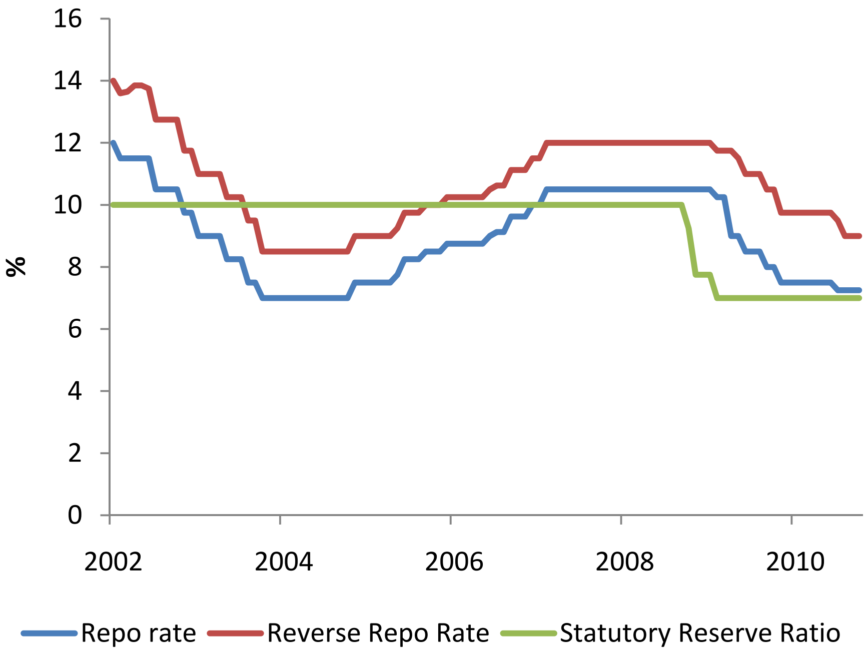
RAM HOLDINGS
Economics Research

Monetary policy – *focus on growth as inflation eases*

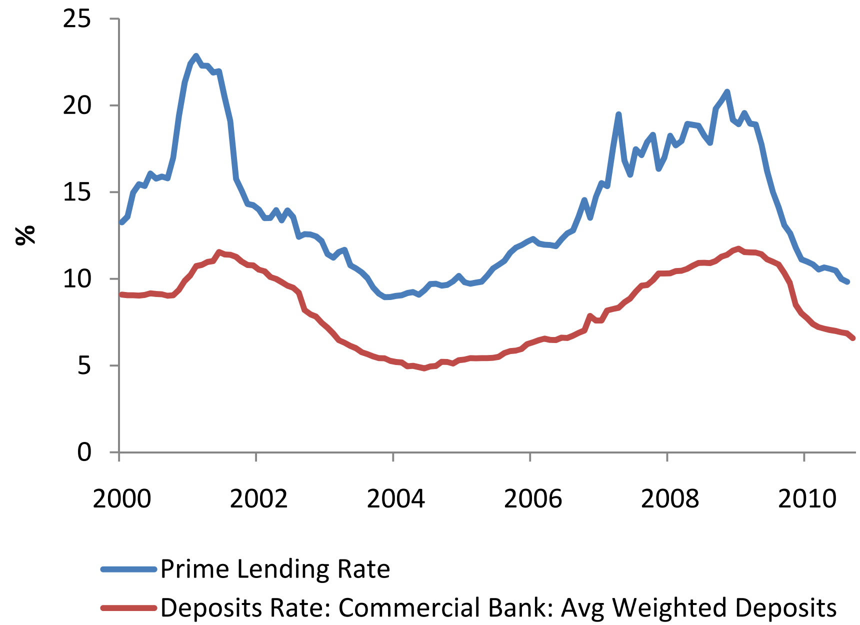
Appropriate monetary policy response:

- Key interest rates lowered to stimulate domestic growth as inflation eases
- Weaker growth in external economy raises risk to growth.

Policy rates growth-accommodating but a slight increase of 50 to 75 bps expected next year

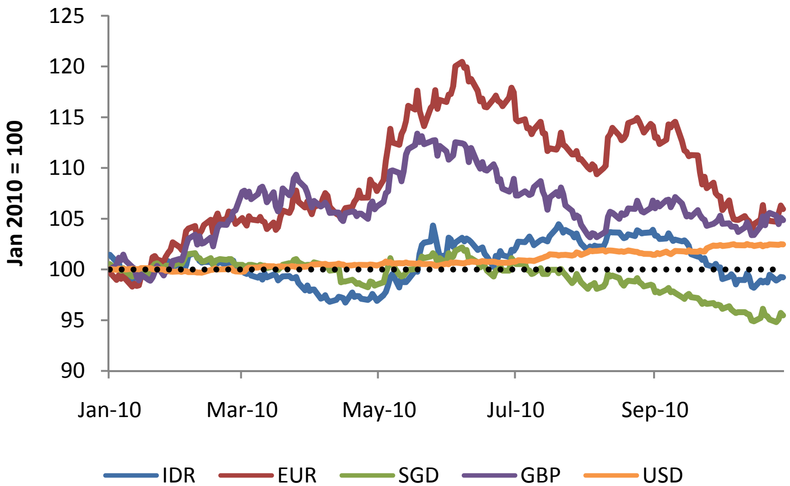


Narrowing interest margin as lending rates fall faster than deposit rates

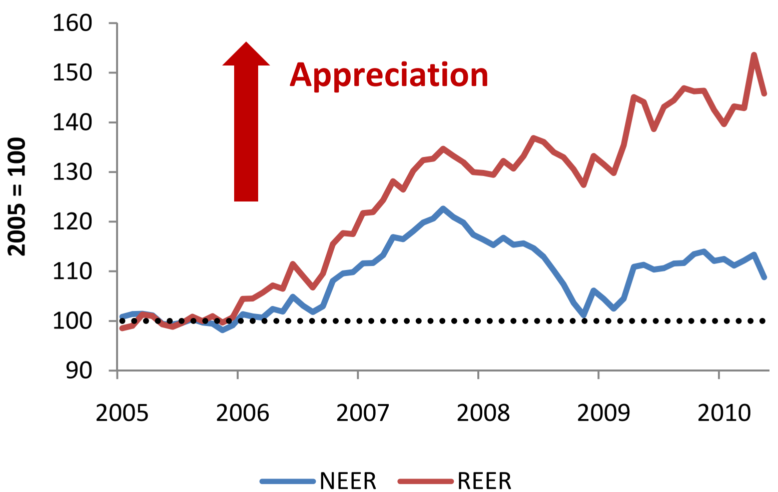


Exchange rate strengthening but remains volatile

LKR against selected currencies

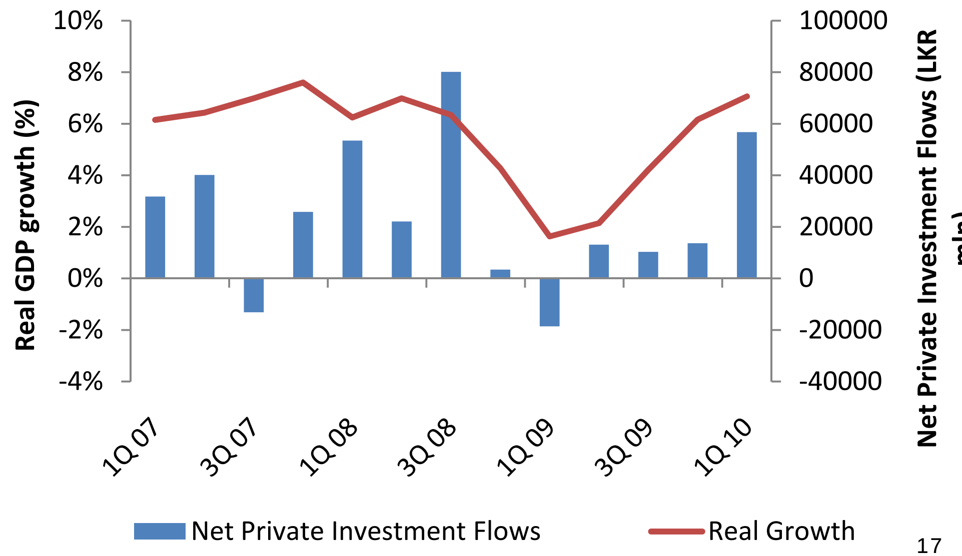


REER trending upwards



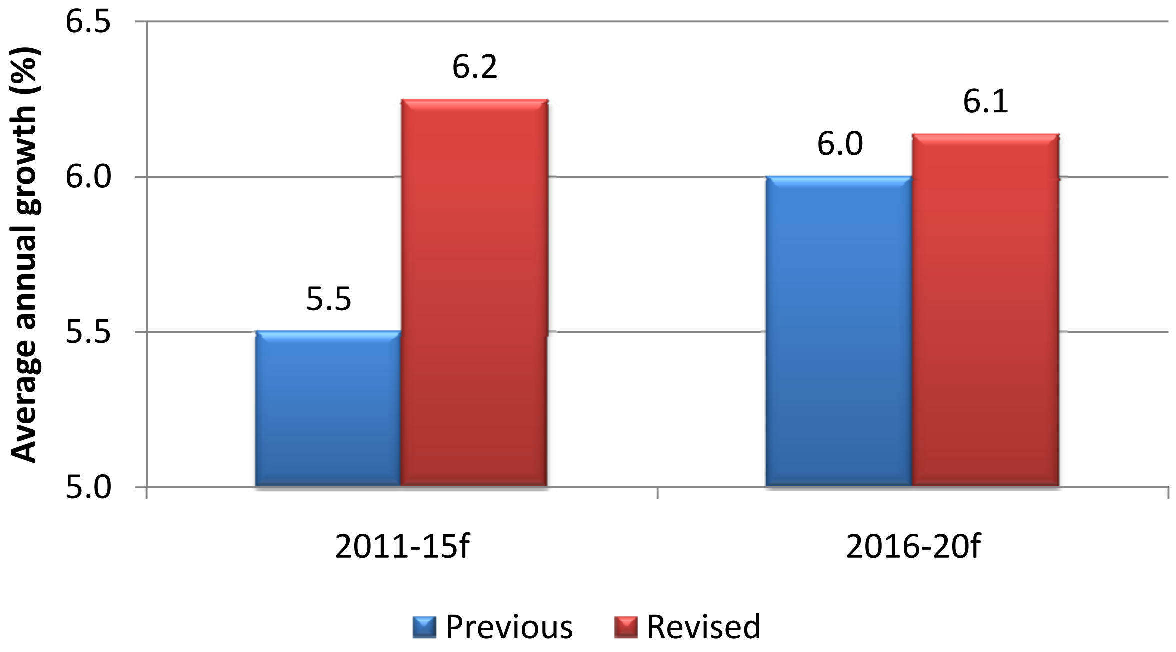
- Volatile movements against currencies of major trading partner
- Positive net investment inflows adding to exchange rate appreciation.
- Further strengthening capped by current account deficit.

Strengthening economic performance attracted foreign funds



Improved medium-to-long term growth prospects

Medium- to long-term average GDP growth rates revised upwards



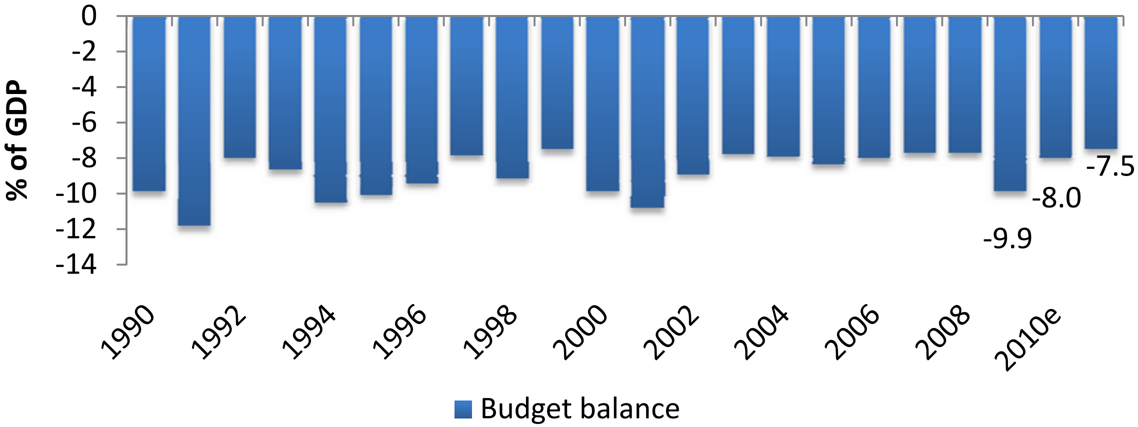
f – forecast by RAM Economics

Key factors underpinning upward revision:

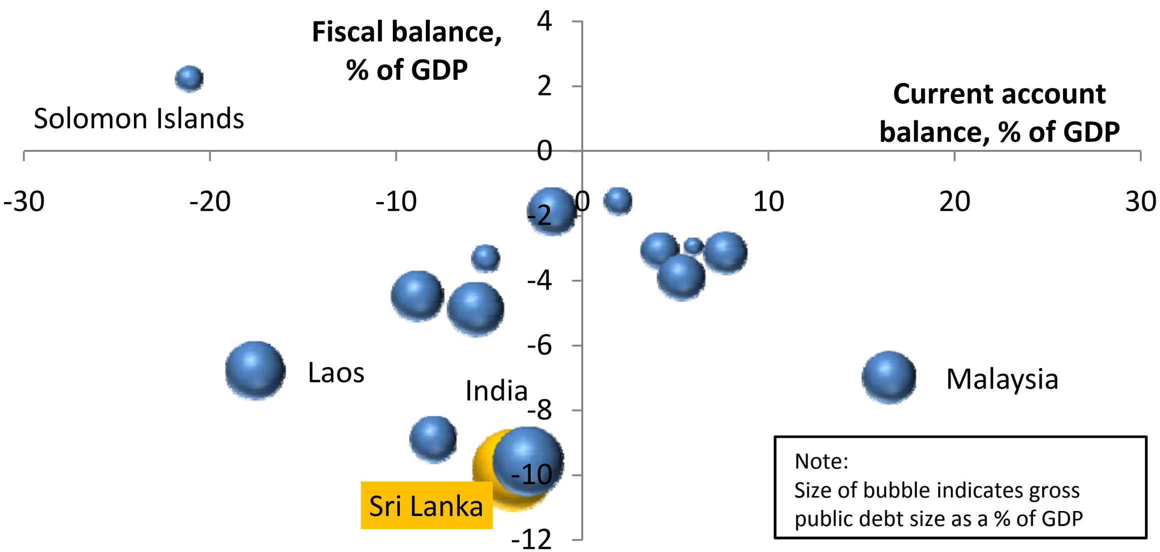
- Quicker-than-expected reduction in the country's macroeconomic imbalances,
- Less severe effect from the global financial crisis on the domestic economy
- Quick - albeit fragile - global recovery
- Rising confidence in the post-conflict economic rebound.

Fiscal sustainability and macroeconomic stability

Fiscal deficit remains at a high level



Comparison of fiscal sustainability across countries



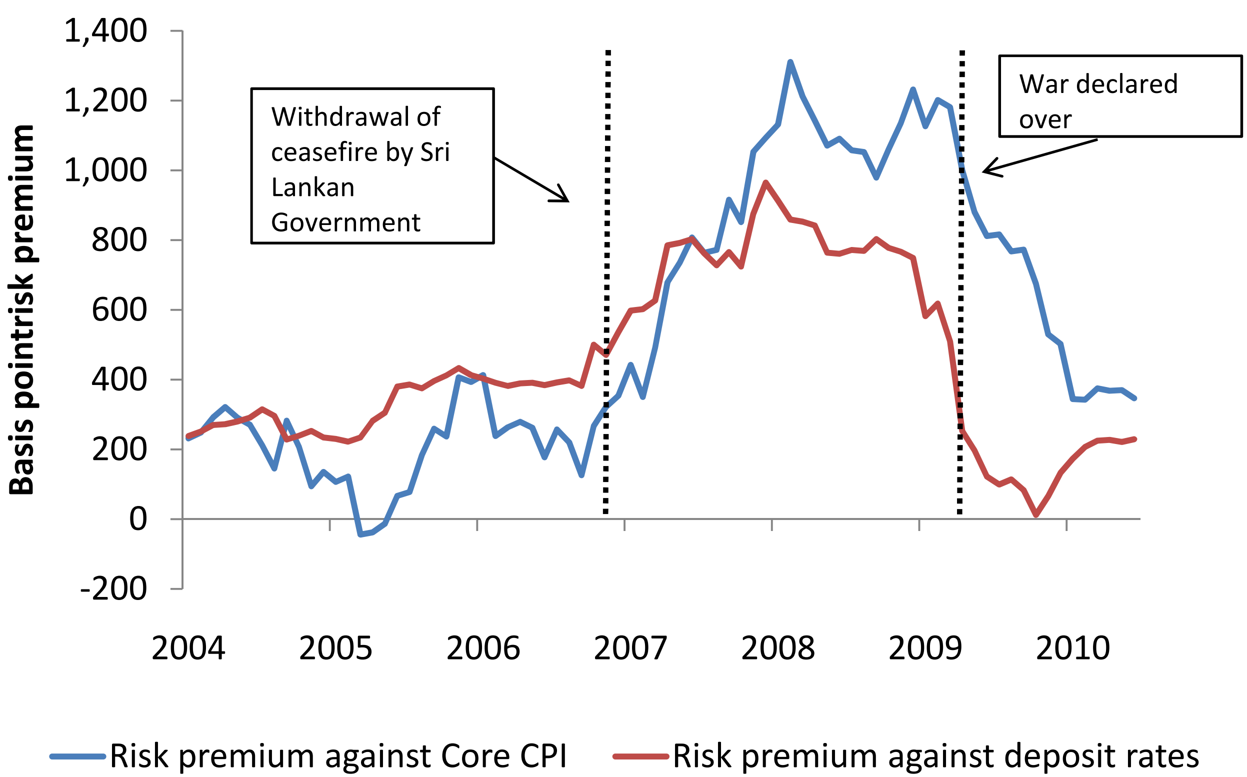
Note:
Size of bubble indicates gross public debt size as a % of GDP

Reducing fiscal and current account vulnerability:

- Declining trend in 'twin deficits' – fiscal and current account, important to reduce risk premium and cost of borrowings/debt financing.
- Fiscal deficit projected to decline to -7.5% in 2011 from an estimated -8.0% in 2010.
- The current account deficit is projected at USD1.9 bn in 2010 and USD2.2 bn (4.2% of GDP) in 2011, easing to 4.0% of GDP in 2012.

Financial market stability – *lower borrowing costs*

Declining risk premium lowers funding cost

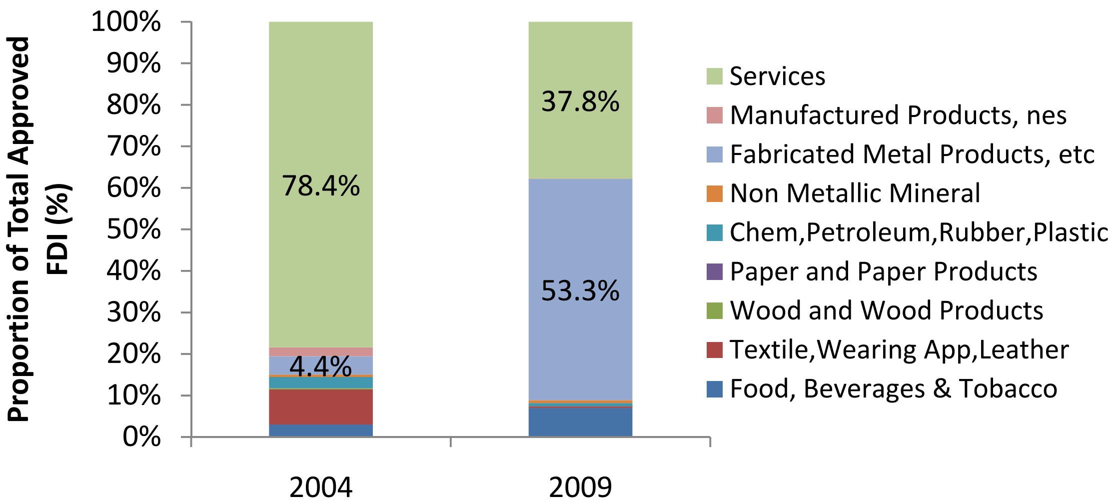


Benefits of improving macroeconomic stability:

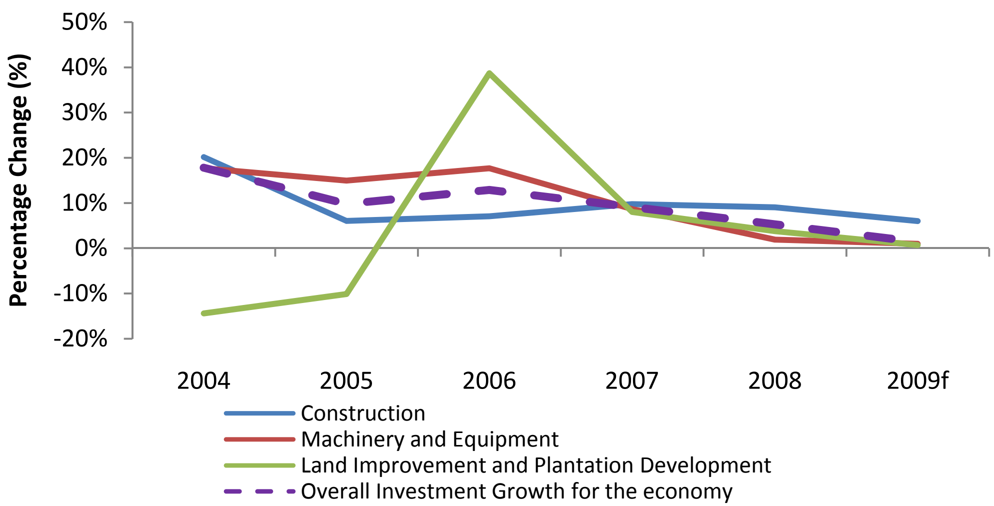
- Lower risk premia suggest increased investor confidence and lower funding cost for borrowers.

Leveraging on FDI

Changing composition of foreign direct investment



Growth rates of different types of investment



FDI in more diversified areas:

- Shift from financial services to fabricated metal products.
- Investment in infrastructures and facilities such as tax-free port zone and logistics hub will help to expand industrial capacity by attracting more diversified FDI in higher value manufacturing and service industries.
- Diversification from primary sector to secondary sector especially in industrial goods exports
- Deceleration in investment activities is a cause for concern.

Ease of doing business

Key strengths and weaknesses as found in World Bank's Ease of Doing Business 2011

Weaknesses:

- Dealing with construction permits
- Paying taxes
- Enforcing contracts
- Registering property

Strengths:

- Starting a business
- Protecting investors
- Trade across borders
- Closing a business
- Getting credit

Improvements in cross-country ranking can be accelerated to facilitate private sector activities:

- Compared to its performance in the 2010 survey, only 2 out of the 9 categories in 2011 survey had a better ranking (i.e. Starting a Business and Closing a Business).

IV. Enhancing post-conflict business environment

Ease of doing business (cont'd)

1. 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

2. Registering property

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

3. 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

4. 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

- Sri Lanka has more procedures involved in obtaining licences and permits to build a warehouse, compared to other South Asian.
- Number of procedures in property registration in Sri Lanka exceeds the regional average. Nonetheless, costs are still lower than those of its South Asian peers.
- 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).
- 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.

IV. Enhancing post-conflict business environment

Ease of doing business (end)

5. 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.

6. 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.

7. 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

- Administrative bottlenecks remain one of Sri Lanka's principal impediments against facilitating a more vibrant business environment.

Summary

- **Strong rebound from 2008/09 global financial crisis:** Sri Lanka's GDP growth in 2010 estimated at 6.8% or nearly twice the 3.5% achieved in the previous year.
- **Improved outlook for 2011 and 2012:** Economic prospects in 2011 and 2012 have improved considerably with GDP growth forecast at 6.5% and 6.3% respectively.
- **Medium-to-long term growth prospects revised upwards:** Average annual GDP growth raised to 6.2% from 5.5% for 2011-15 period while the earlier 6.0% forecast for 2016-20 has been raised marginally to 6.1% as the country's long term potential is increased
- **Key risks:** Risk to growth in post-conflict era has receded but several potential areas need monitoring:
  - *Prolonged weakness of the advanced economies*
  - *Accelerated inflation due to commodity price shocks*
  - *Slow pace of reforms*
  - *Investors' perception of increased fiscal weakness*
  - *Inability to diversify domestic production structure*

RAM

HOLDINGS

REDEFINING EXCELLENCE
Celebrating 20 Years Of Leadership
1990 - 2010

Thank you

RAM Economics Research
Level 19, The Gardens South Tower
Mid Valley City, Lingkaran Syed Putra
59200 Kuala Lumpur
Tel: (603) 7628 1101 / Fax: (603) 7620 8250
www.ram.com.my