

RAM

ECONOMIC OUTLOOK SRI LANKA OVERVIEW

June 2007



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ECONOMIC OUTLOOK

JUNE 2008

Sri Lanka: Key Economic Challenges and Prospects for 2008 and 2009

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Coping with External Shocks and Internal Challenges

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I. GLOBAL ECONOMIC CONDITIONS AND REGIONAL PERSPECTIVES

A sharper turn for the worst in 2008 but most Asian economies likely to be resilient due to strong domestic demand and ample liquidity

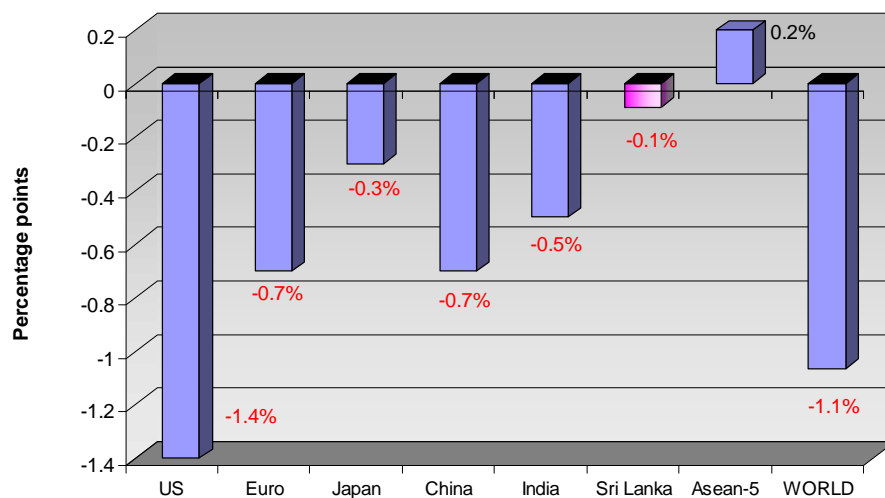
Most Asian economies expected to weather the effects of a slowdown in the advanced economies

Global economic and financial conditions in 2008 have turned more adverse – buffeted largely by the US sub-prime mortgage crisis and its accompanying financial market turmoil, global liquidity tightening and credit risk re-pricing.

Compounding the slowdown in the advanced economies, the further escalation in world crude oil and commodity prices and unanticipated natural disasters that had hit major food producing regions in 2008, are adding to the economic woes and challenges facing developing economies.

As reflected by the changes in the forecasts by the International Monetary Fund (IMF) highlighted in Figure 1, the US and European Union economies are likely to slow down more than expected. Most Asian economies however are bracing to absorb the global slowdown with some moderation in growth, the degree of which will vary with their exposure to the international markets and resilience of domestic demand.

Figure 1. Revision in IMF's Growth Forecasts for 2008
(IMF's October 2007 and April 2008 WEO Outlook)



Source: International Monetary Fund, *World Economic Outlook Database*, April 2008

Asian economies must find ways to deal with escalating oil prices prevailing in global markets

More ominous however is the ability of the Asian economies to adjust to the food and energy inflation shock as world crude oil price zoomed past the USD130 per barrel in May 2008. Exhibiting strong downward stickiness due to a combination of factors such as tight supply, threats of supply disruptions, robust demand from the fast-growing large emerging economies such as China and India, weakening dollar as well as market speculation by institutional investors¹, Asian economies will have to adjust to the high oil prices that will likely remain above USD100 a barrel for the rest of this year.

Inflation remains a lingering issue

The Asian economies including Sri Lanka are adjusting to the food and fuel shocks by cutting back on fuel subsidies to keep fiscal costs within manageable levels. Unavoidably, depending on the magnitude of the fuel subsidy cuts, inflation will be driven to decade-highs for most countries in the region.

The largely export-oriented Asian economies also have to contend with slowing export demand as the US economy weakens in the first half of 2008 and likely to remain so if it cannot avert a possible shallow recession in the second half especially if consumer spending continues to weaken amidst rising unemployment and housing foreclosures.

In this report, RAM Economics Research examines the ability of the Sri Lankan economy to absorb these shocks, taking cognizance of the macroeconomic imbalances and challenges that were evident following the country's commendable performance in 2007. It will then present the house views on the outlook for 2008 and 2009.

Sri Lanka's GDP growth during pre and post-Asian Financial Crisis periods has been commendable

Commendable growth achieved by Sri Lanka during pre and post-Asian Financial Crisis periods

The Sri Lankan economy achieved an average annual real growth of 4.9% during the post-Asian Financial Crisis (1999-2007), a shade slower compared to the 5.1% average for the same period before the 1998 Asian financial crisis. The growth performance is commendable given the numerous shocks to the economy such as the 2004 tsunami, resumption of armed conflict in 2006, and higher prices of crude oil and other commodities during this period.

From a regional perspective, the country's medium term growth is slightly below the average of 5.3% achieved by the selected South Asian countries as well as the overall average of 6.0% for emerging and developing economies.

¹ In a testimony to the US Senate Committee on Homeland Security on 20 May 2008, Michael W. Masters, the managing member and portfolio manager of Masters Capital Management LLC, stated that assets allocated to commodity index trading strategies have risen from US\$13 billion at the end of 2003 to US\$260 as of March 2008, and the

With the exception of Nepal, the other South Asian countries particularly India and Bangladesh chalked up more than a percentage point higher growth during the post-AFC period than in the same period before the 1998 crisis (Table 1).

Southeast Asian economies performed slightly better than South Asian countries

By contrast, the Southeast Asian countries grew more slowly during the post-AFC period, averaging 6.2% compared to 7.1% during the pre-AFC period. The countries most affected by the 1998 Asian financial crisis such as Indonesia, Malaysia and Thailand achieved slower growth by between 2 and 4 percentage points during the post-AFC period. Nonetheless, the Asean economies collectively grew by close to a percentage point higher than the average growth rate for South Asian countries, at 6.2% and 5.3% respectively.

Table 1. Comparative Growth Performance of Selected Asian Economies

| | Average annual growth in constant price (%) | | | |
|-----------------------|---|--------------------|-------------------|--------------------|
| | GDP | | Per capita income | |
| | Pre-AFC (1989-97) | Post-AFC (1999-07) | Pre-AFC (1989-97) | Post-AFC (1999-07) |
| South Asia | 4.9 | 5.3 | 2.8 | 3.8 |
| Bangladesh | 4.6 | 5.7 | 2.4 | 3.7 |
| India | 5.6 | 7.1 | 3.5 | 5.2 |
| Pakistan | 4.3 | 5.1 | 1.7 | 3.1 |
| Nepal | 5.1 | 3.7 | 2.5 | 3.2 |
| Sri Lanka | 5.1 | 4.9 | 3.9 | 3.7 |
| Southeast Asia | 7.1 | 6.2 | 4.5 | 4.5 |
| Cambodia | 5.4 | 9.8 | 0.9 | 7.8 |
| Indonesia | 7.0 | 4.6 | 5.4 | 3.5 |
| Laos | 6.9 | 6.7 | 4.2 | 4.3 |
| Malaysia | 9.2 | 5.6 | 6.3 | 3.4 |
| Philippines | 3.5 | 4.9 | 1.2 | 2.7 |
| Singapore | 8.9 | 6.1 | 5.4 | 4.2 |
| Thailand | 7.9 | 5.0 | 6.8 | 4.1 |
| Vietnam | 7.9 | 7.3 | 6.1 | 5.8 |

Source: International Monetary Fund, *World Economic Outlook Database*, April 2008

Sri Lanka GDP per capita highest in South Asia

Though dwarfed by India and Pakistan in terms of size of the economy as measured by the gross domestic product (GDP), Sri Lanka has the highest per capita income among the selected South Asian countries. Its per capita income based on purchasing power parity is 1.5 times that of India and 3.4 times that of Nepal (Table 2).

prices of the 25 commodities that compose these indices have risen by an average of 183% in those five years.

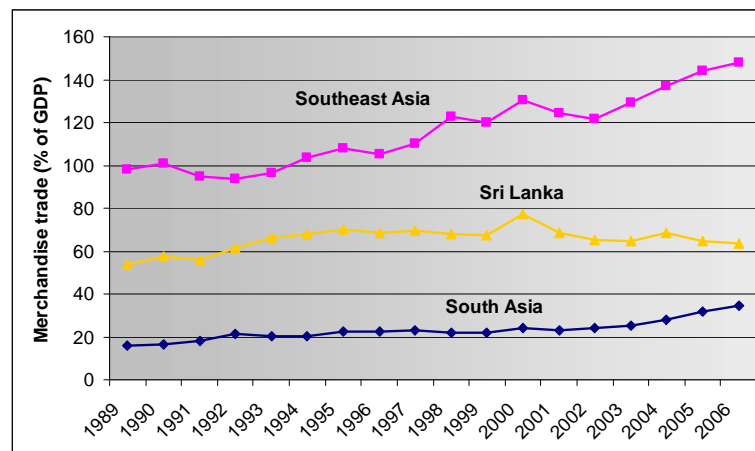
Table 2. Size of Economy and Per Capita Income as at end 2007

| | GDP size (current PPP dollar in bn) | Per capita GDP (current PPP dollar) |
|-----------------------|--|--|
| South Asia | 3,715.8 | 2,502.0 |
| Bangladesh | 206.7 | 1,300 |
| India | 2,988.9 | 2,659 |
| Pakistan | 410.0 | 2,592 |
| Nepal | 29.0 | 1,207 |
| Sri Lanka | 81.3 | 4,079 |
| Southeast Asia | 2,502.2 | 4,841.0 |
| Cambodia | 25.9 | 1,806 |
| Indonesia | 837.8 | 3,725 |
| Laos | 12.6 | 2,060 |
| Malaysia | 357.4 | 13,315 |
| Philippines | 299.6 | 3,378 |
| Singapore | 228.1 | 49,714 |
| Thailand | 519.4 | 7,900 |
| Vietnam | 221.4 | 2,587 |

Source: International Monetary Fund, *World Economic Outlook Database*, April 2008

Southeast Asian economies are highly dependent on trade

In explaining the higher growth performance and greater prosperity of the Southeast Asian countries, much attention has been focused on their higher savings and investment rates. Another inescapable characteristic is that these economies are also more integrated with the global economy as reflected by their dependence on trade (Figure 2). It is noted that Sri Lanka's merchandise trade to GDP ratio is higher than the average for the South Asian region but it has been inching downwards since 2000.

Figure 2. Merchandise trade to GDP (%)

Source: World Bank, *World Development Indicators*, April 2008

Current account deficits have widened for a number of Asian economies but their sustainability varies

Sri Lanka's current account deficit reached 4.6% of GDP in 2007

With the exception of Bangladesh, the current account in the balance of payments of most South Asian economies have deteriorated in 2007 compared with the 5-year average annual trend (Table 3). Sri Lanka's current account deficit rose to 4.6% of GDP in 2007 compared with its 5-year trend of 3.2% which is the highest among the South Indian economies.

By contrast, 5 of the 8 selected Southeast Asian countries recorded higher current account surpluses in 2007 than their respective 5-year trend levels. Of the 3 deficit countries, Laos and Vietnam's current account deteriorated sharply to 23.1% and 9.6% of GDP respectively in 2007 with the latter country grappling with a deepening economic crisis in June 2008.

State of current account balance attributable to low savings level

Sri Lanka's current account is reflective of its low level of savings relative to investment while Vietnam's deficit resulted from high investment that exceeded 35% of GDP.

Table 3. Current Account Balance of the Selected Asian Economies

| | Last 5 years' average (2003-07) | | 2007 | |
|-----------------------------------|------------------------------------|-------------|--------------|-------------|
| | USD bn | % of GDP | USD bn | % of GDP |
| South Asia¹ | -7.98 | -0.4 | -27.4 | -2.0 |
| Bangladesh | 0.22 | 0.3 | 0.33 | 0.5 |
| India | -5.98 | -0.5 | -19.35 | -1.8 |
| Pakistan | -1.56 | -0.7 | -7.11 | -4.9 |
| Nepal | 0.15 | 1.9 | 0.06 | 0.6 |
| Sri Lanka | -0.82 | -3.2 | -1.37 | -4.6 |
| Southeast Asia¹ | 56.11 | 2.4 | 89.76 | 17.7 |
| Cambodia | -0.15 | -2.6 | -0.08 | -0.9 |
| Indonesia | 6.36 | 1.9 | 11.01 | 2.5 |
| Laos | -0.49 | -15.4 | -0.93 | -23.1 |
| Malaysia | 19.89 | 13.7 | 26.05 | 14.0 |
| Philippines | 3.12 | 2.6 | 6.35 | 4.4 |
| Singapore | 26.20 | 20.9 | 39.16 | 24.3 |
| Thailand | 3.40 | 1.6 | 14.92 | 6.1 |
| Vietnam | -2.22 | -3.9 | -6.72 | -9.6 |

¹ Weighted average

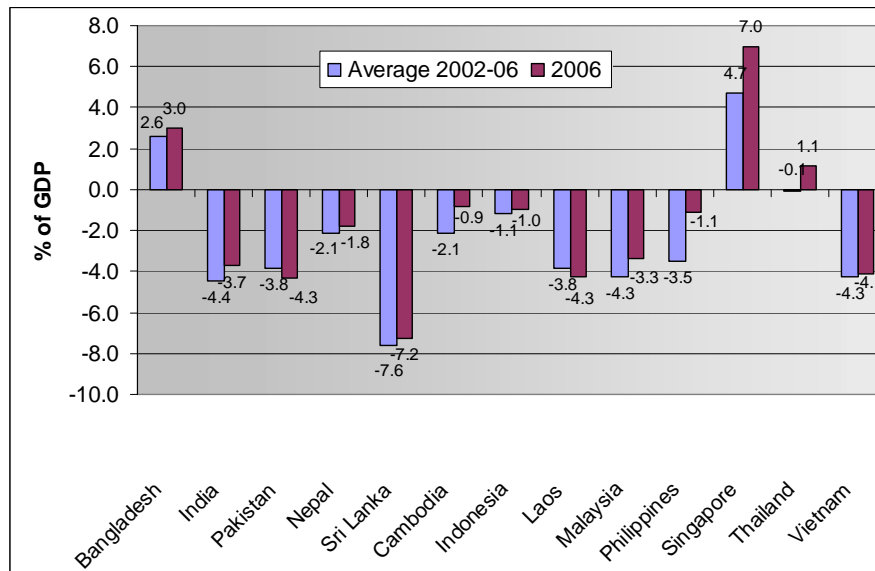
Source: International Monetary Fund, *World Economic Outlook Database*, April 2008

Most governments in South and Southeast Asian countries running fiscal deficits

Sri Lanka's fiscal deficit highest in the Southeast and South Asian region

Except for Singapore and Thailand, the other 11 selected South and Southeast Asian countries have been running fiscal deficits for extended periods especially after the 1998 Asian financial crisis. In particular, Sri Lanka's fiscal deficit continues to be the highest in the region although it recorded a slight improvement in 2007 (Figure 3).

Figure 3. Fiscal deficits of the selected South and Southeast Asian countries



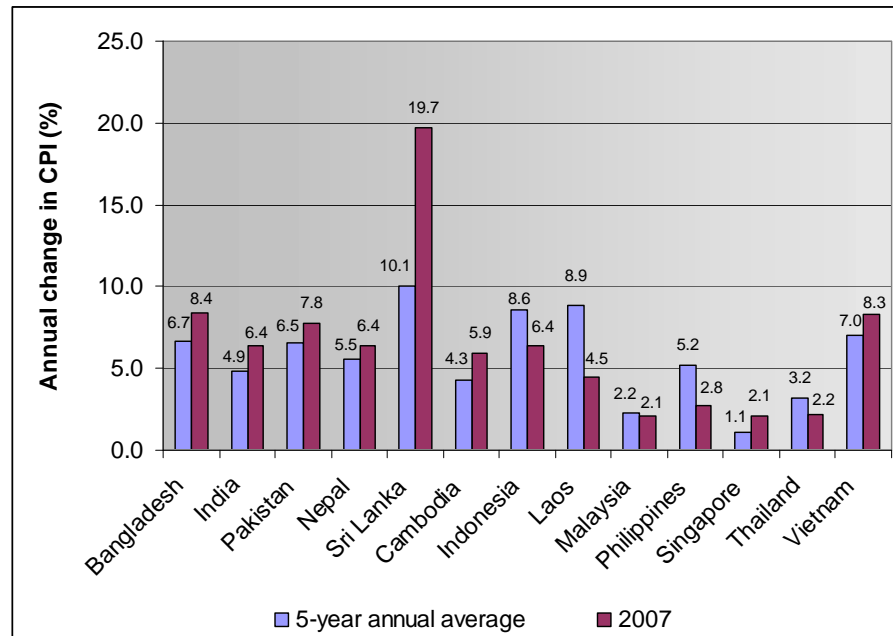
Source: World Bank, *World Development Indicators* April 2008

Except for several Southeast Asian countries, CPI inflation rose above trend for most countries in 2007 with Sri Lanka being the worst hit

Sri Lanka hard hit by inflation

Inflation as measured by the Consumer Price Index (CPI) rose in all the selected South Asian countries as the already high world prices of fuel and commodities further surged in the first half of 2008. Sri Lanka was the hardest hit in 2007 as it lifted its fuel subsidy earlier than most of the other Asian economies (Figure 4).

Figure 4. Average 5-year and 2007 CPI of Selected Asian Countries



Source: World Bank, World Development Indicators April 2008

II. CURRENT STATUS OF THE SRI LANKAN ECONOMY

Domestic demand remains robust despite price shocks and slower exports

Strong growth of 6.8% registered in 2007

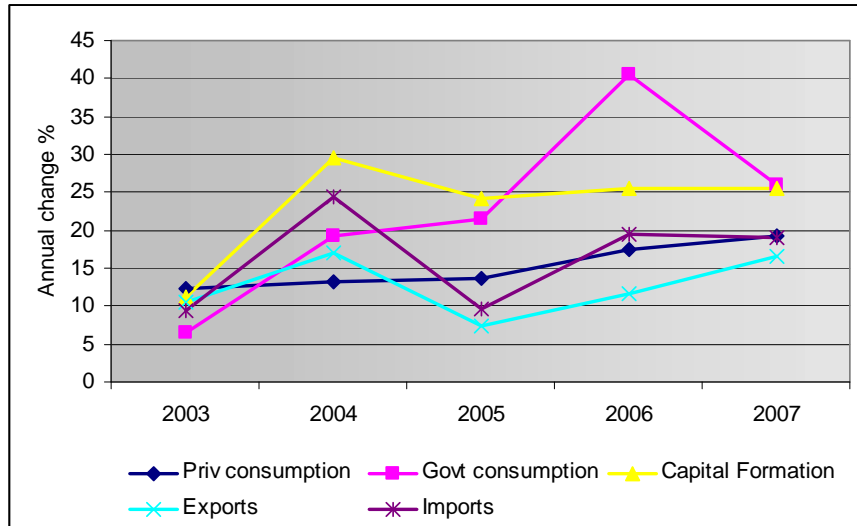
In 2007 Sri Lanka's economy expanded more moderately at 6.8% compared to 7.7% in the previous year. Growth was supported by strong domestic demand fueled by higher public sector spending in military and post-tsunami construction, negative real interest rates, strong remittances and robust credit expansion.

Private consumption records double digit growth

Supported by higher remittances, wage increases and a rise in employment as well as facilitated by strong credit expansion, private consumption grew strongly by 19.2% to account for 66.4% of GDP in nominal terms in 2007 (Figure 5).

Figure 5: Sri Lanka's GDP Growth Driven Largely by Domestic Demand

(current prices)

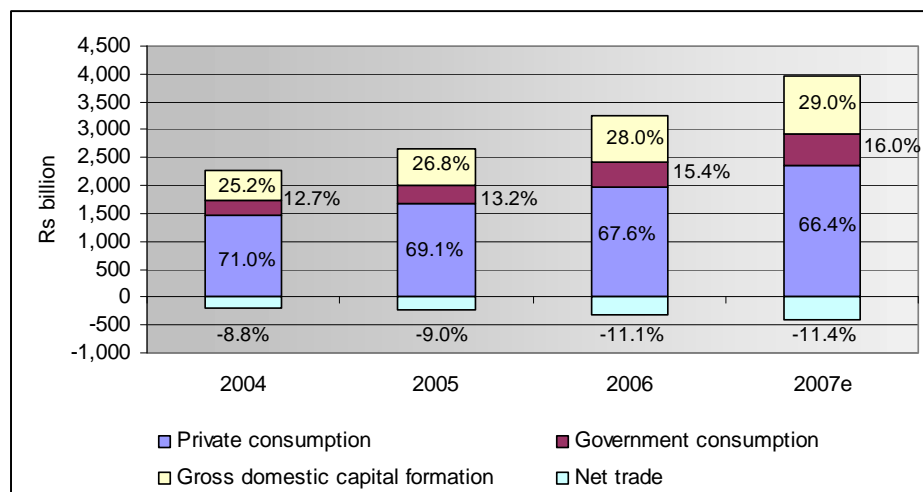


Source: Central Bank of Sri Lanka, *Selected Economic Indicators March 2008*

Strong domestic demand driven by strong government spending and private investment

Domestic demand continues to be driven largely by private consumption with rising contribution from government spending and private investment (Figure 6). Government spending has risen strongly due to higher wage bills, expansion of the civil service and increased allocation to contain the escalation in armed conflict following the end of the ceasefire with the Liberation Tigers of Tamil Eelam (LTTE) in 2006.

Figure 6. Trends in Sri Lanka's GDP by Expenditure



Source: Central Bank of Sri Lanka, *Selected Economic Indicators March 2008*

The capital investment was largely channeled into construction, with more than 80% of the total financed by the private sector (Table 4).

Table 4. Composition of Gross Fixed Capital Formation

(% of total)

| | 2003 | 2004 | 2005 | 2006 | 2007 |
|--|-------------|-------------|-------------|-------------|-------------|
| Construction | 54.0 | 55.6 | 57.5 | 57.4 | 60.8 |
| <i>Residential Buildings</i> | 20.2 | 21.9 | 22.5 | 22.5 | 23.0 |
| <i>Non-residential Buildings</i> | 10.1 | 10.8 | 11.2 | 11.4 | 21.0 |
| <i>Other</i> | 23.7 | 22.9 | 23.9 | 23.4 | 16.7 |
| Machinery and Equipment | 42.3 | 41.7 | 40.1 | 39.9 | 36.2 |
| <i>Transport Equipment</i> | 11.8 | 10.4 | 8.5 | 7.2 | 6.2 |
| <i>Other</i> | 30.5 | 31.4 | 31.5 | 32.6 | 29.9 |
| Land Improvement & Plantation Development | 3.8 | 2.7 | 2.4 | 2.7 | 3.1 |
| Source of Expenditure on GFCF | | | | | |
| Private | 87.3 | 89.2 | 83.5 | 85.5 | 80.7 |
| Public | 12.7 | 10.8 | 16.5 | 14.5 | 19.3 |

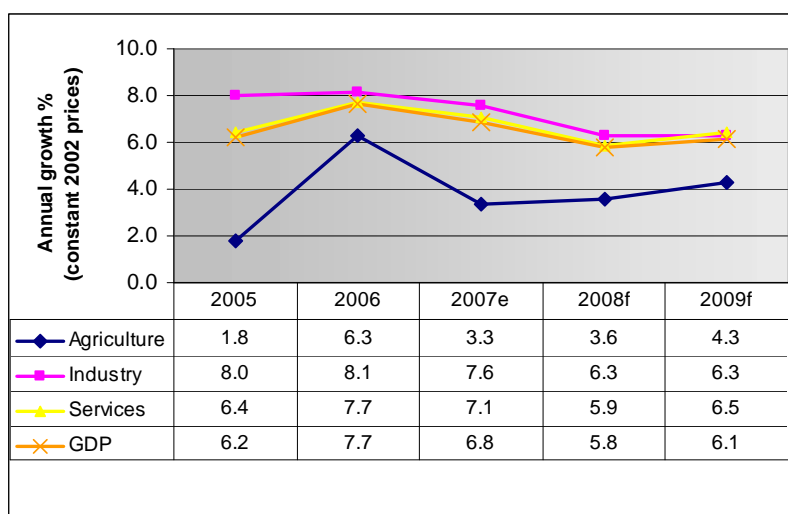
Source: Sri Lanka Department of Census and Statistics

Growth moderated in all industrial sectors with agriculture exhibiting more pronounced slowdown

Adverse weather conditions and supply disruptions slowed growth in agriculture sector

The agriculture sector has been characterized by more volatile growth than the other economic sectors. Its slower growth of 3.3% in 2007, after spiking to 6.3% in the previous year, is explained by lower production of key crops such as tea and rice due to adverse weather conditions and supply disruptions (Figure 7). Nonetheless, agricultural activities have benefited from the run-up in world food and non-food commodity prices.

Figure 7. GDP Performance by Major Industrial Sectors



Source: Sri Lanka Department of Census and Statistics; f - forecast by RAM Economics

The industry sector has been experiencing steady growth averaging 7.0% annually over for the past five years. It is supported mainly by robust growth in mining and quarrying, and manufacturing activities. The main contributors to manufacturing growth are textiles and apparel, and food products.

Services sector accounted for 60% of GDP growth over the past 5 years

The services sector is the largest contributor to economy, accounting for 60% of GDP for the past 5 years. The financial services, telecommunications and other business sectors such as real estate services have greatly contributed to this growth; however tourist-related sub-sectors like restaurants and hotels have experienced lackluster performance due to heightened security fears.

Trade deficit and external balance propped up by strong remittance

Net trade remains in negative territory

Reflecting the robust domestic demand, nominal imports expanded by 19.0% while export growth picked up to 16.7% from 11.6% in the previous year. Consequently, net trade remained negative with a slight deterioration -11.4% in 2007 from -11.1% in the previous year.

Increased exports to EU, assisted by the GSP+ agreement

External trade activities have been supported by trade agreements such as the Generalised System of Preferences Plus ("GSP+") endorsed by the European Commission which is a unilateral accord due for renewal at the end of 2008. This agreement has enabled a higher amount of exports to flow into EU markets, on the back of a softening US economy; still, only about 0.7% of total exports flow to the EU markets.

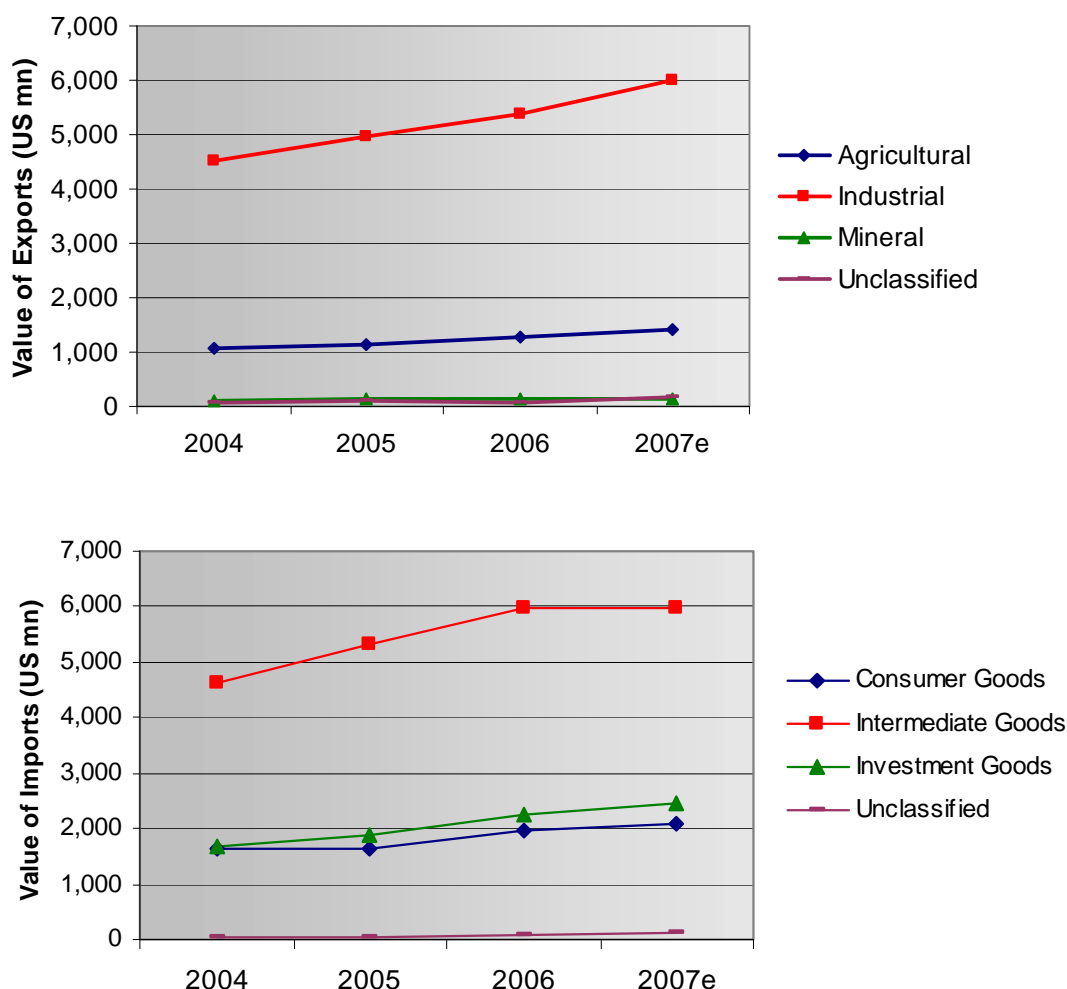
The agreement is expected to be renewed at its next evaluation, however, after this, it will only continue for another three years until 2011; thus, there is immense pressure on producers who currently benefit from this agreement to concentrate on improving productivity and being competitive in export markets on their own accord.

Textiles and apparel remain a strong contributor to export growth

Textiles and apparel remain the largest component of exports (around 45%) with industrial products, in general, exhibiting robust growth that underpinned the strong trade performance in recent years.

The composition of exports and imports by function are shown in Figure 8. Industrial products accounted for 78% of total exports in 2007. Imports on the other hand are dominated by intermediate goods with 56% share of the total. Capital goods and intermediates jointly made up close to 80% of total imports, suggesting that much of the trade deficit is driven by investment and export demand.

Figure 8. Trends and Composition of Exports and Imports



Source: Central Bank of Sri Lanka; e-estimates by RAM Economics Research

Income remittances help to improve the balance of payments position

The inflow of foreign income remittances has partially offset the goods and services trade deficit. Besides improving the country's balance of payments position, the remittances have helped to raise the income and purchasing power especially amongst the rural population. The remittances, which jumped 54.7% in 2007, are expected to grow further (Table 5).

The current account deficit narrowed to 4.3% of GDP in 2007 (World Bank's figure is 4.6%) from 5.3% in the previous year. A further narrowing in the deficit is expected in 2008 in line with the expected moderation in economic growth and currency depreciation, but the recent spike in the international prices of crude oil and food commodities will have the undesired effect of increasing the country's import bill.

Table 5. Current Account Transaction Changes in 2007(p)

| | Annual change % | % GDP |
|--|--------------------------------|--------------|
| Exports of goods and services | 18.1 | 29.5 |
| <i>Merchandise</i> | 19.6 | 24.2 |
| <i>Other</i> | 12.1 | 5.3 |
| Factor income from rest of the world | 54.7 | 1.4 |
| Current transfers from rest of the world | 23.2 | 7.8 |
| Current receipts from the rest of the world | 20.2 | 38.7 |
| Imports of goods and services | 17 | 39.9 |
| <i>Merchandise</i> | 17.3 | 35.3 |
| <i>Other</i> | 14.6 | 4.6 |
| Factor income paid to rest of the world | 22.1 | 2.5 |
| Current transfers to rest of the world | 18.6 | 0.9 |
| Current payments to rest of the world | 17.3 | 43.3 |
| Current account surplus(+)/ deficit(-) | -2.5 | -4.3 |

Source: Sri Lanka Department of Census and Statistics; p-provisional estimate by SLDCS

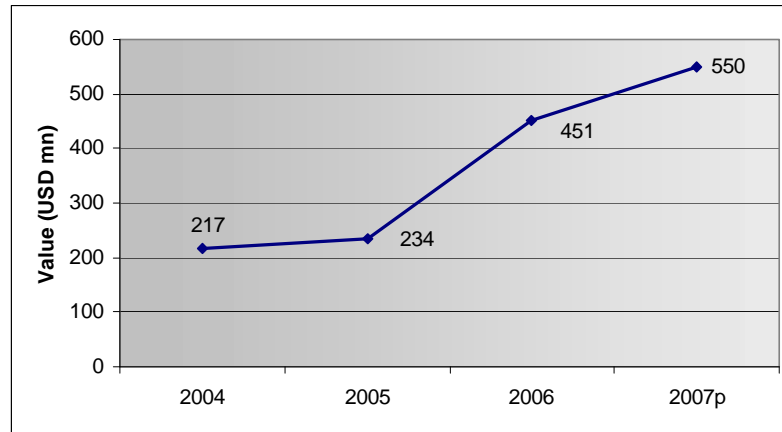
On the other hand, the latest trends in import composition indicate that more development projects are being expedited and private investment activities are more rampant especially in heavy industries such as construction and telecommunications.

FDI inflow on an increasing trend

Foreign direct investment (FDI) has been on a steady rise and has even picked up in momentum recently (Figure 9). The FDI inflow for 2007 has been projected at USD550 million. It comprised mainly equity capital by foreign entities, followed by re-investment of retained earnings.

The main recipient sectors are the telecommunications, business process outsourcing and hospitality industries, contributing to the large foreign presence in the country's services-oriented industries. Despite the encouraging upward trend, the country's inward FDI still remained low compared to its regional peers.

Figure 9. Foreign Direct Investment Inflows



Source: Central Bank of Sri Lanka; p-projected by CBSL

Given the favorable international receipts and capital and financial inflows, the overall balance of payments (BOP) is expected to continue its surplus run which started in 2005.

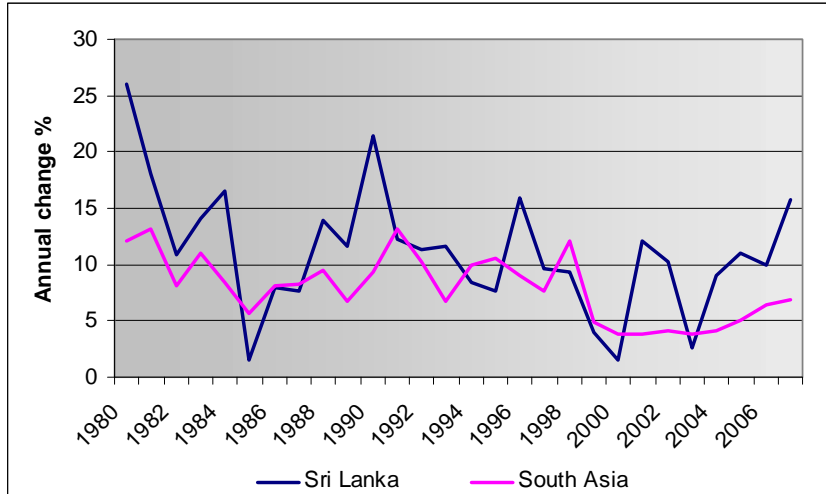
Sri Lankan rupee seen depreciating against various currencies

The Sri Lankan Rupee has depreciated against the major currencies such as the US dollar, Sterling pound and the Japanese yen as well as against other Asian currencies. This downward pressure on the currency is expected to persist in the short term due to strong domestic inflationary pressures and continuing current account deficit.

Inflation higher and more volatile than regional peers

Inflation in Sri Lanka has traditionally been higher and more volatile compared to its South Asian peers. Between 1980 and 2007, the country's annual inflation increased at an average of 11.2% with a standard deviation of 5.6%, substantially higher than the corresponding figures for the South Asian regional at 8.0% and 2.9% respectively.

Figure 10. Inflation trends in Sri Lanka versus South Asian's Average

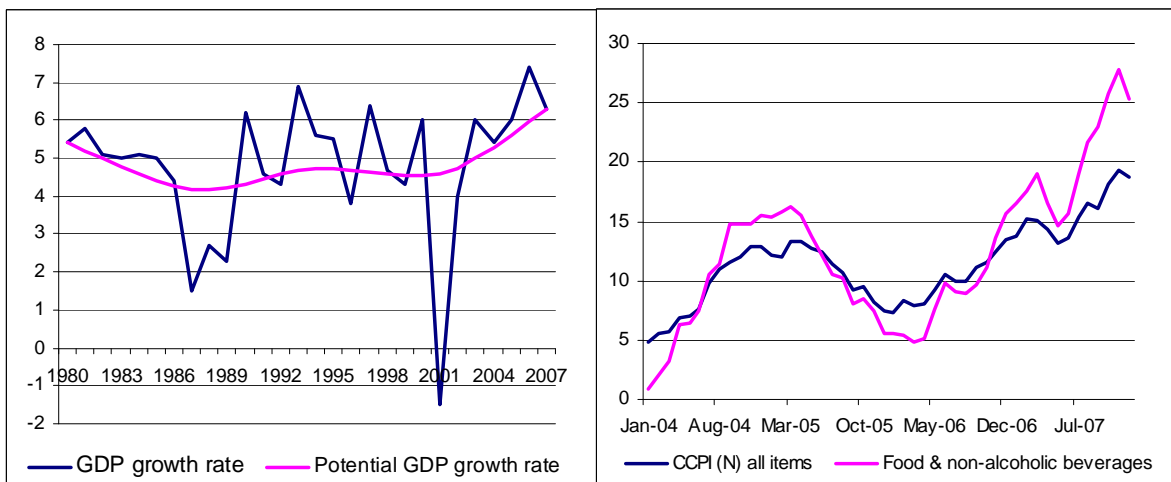


Source: IMF, Central Bank of Sri Lanka

Inflationary pressures stemming mainly from robust domestic demand and world oil and food price shocks

At 15.8% in 2007, Sri Lanka's current inflation is above its 5-year (medium-term) average of 9.7%. This suggests that the country is growing above its potential, facing supply-side price pressures, or both. Figure 11 provides some insights on the former hypothesis. Sri Lanka's GDP growth rate has been consistently above or near its growth potential² since 2001, implying the presence of inflationary pressure from robust domestic demand. However, in 2007 the Sri Lankan economy converged to its estimated potential growth rate of 6.3% while inflation continued increasing.

Figure 11. GDP Growth and CPI Price Trends



Source: IMF, Central Bank of Sri Lanka, RAM Economics Research

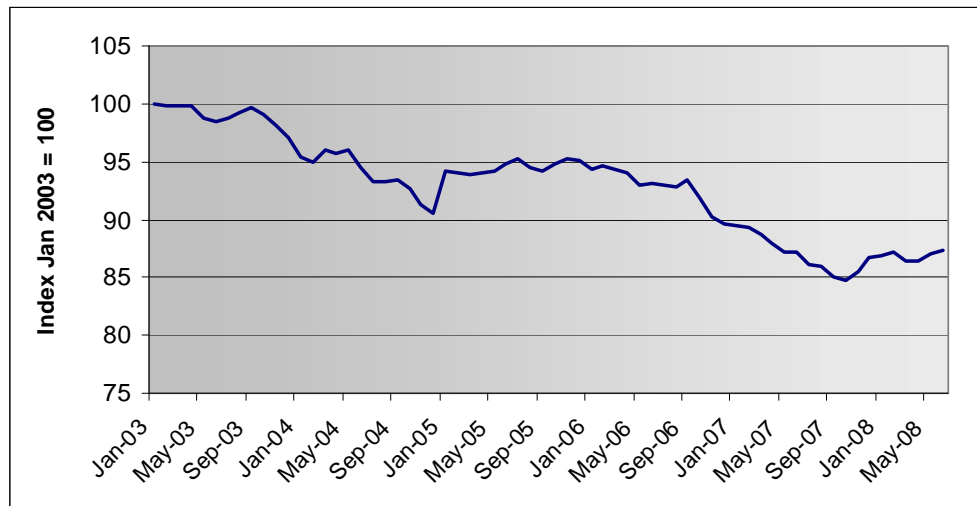
² GDP growth potential is approximated using the Hodrick-Prescott filter.

High global food prices and weakening Rupee fueling imported inflation

Imported inflation caused by high global food and oil prices and depreciating currency

There is also evidence that this bout of inflation has been imported, specifically from high global food prices and the depreciating Sri Lankan Rupee. Comprising 46.7% of the CCPI (N) basket, the food & non-alcoholic beverages component outpaced overall inflation in 2007, rising by 20.2% compared to 15.8% for all items. Furthermore, the transmission effects from high global food prices to domestic inflation have been exacerbated by the depreciating Sri Lankan Rupee. In 2006 and 2007, its currency depreciated at by 5.0% and 3.2% respectively, higher than the 5-year average of 3.1% (Figure 12).

Figure 12. Sri Lanka Rupees' Nominal Effective Exchange Rate



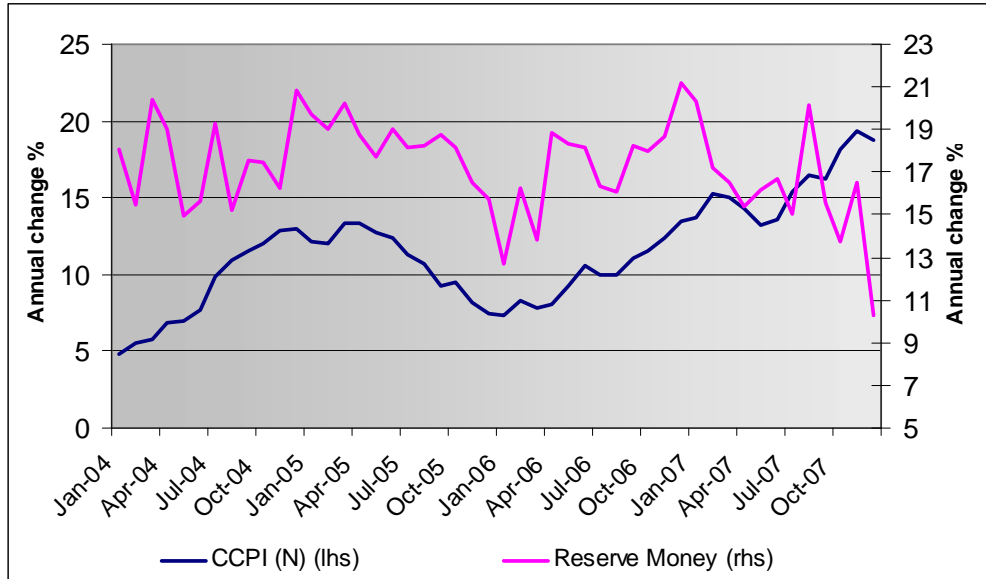
Source: RAM Economics Research

Reserve money targeting policy effective in curbing demand-side inflation

More efforts needed to tackle supply-side inflation by increasing supply and production efficiency

To achieve its mandate of economic and price stability, the Central Bank of Sri Lanka uses both repo and reverse repo rates and sets targets for reserve money growth. With respect to price stability, this strategy has proven successful in controlling inflation on the demand-side. We note that between 2004 and 2006, reserve money growth was approximately 5%-7% higher than inflation with a correlation of 45% (monthly growth data). This figure, however, reversed in 2007 to -47% when supply driven food inflation started driving overall inflation trends, suggesting that efforts to contain supply-side inflation has been ineffective (Figure 13).

Figure 13. Inflation and reserve money



Source: Central Bank of Sri Lanka

III. SRI LANKA'S ECONOMIC OUTLOOK FOR 2008 AND 2009

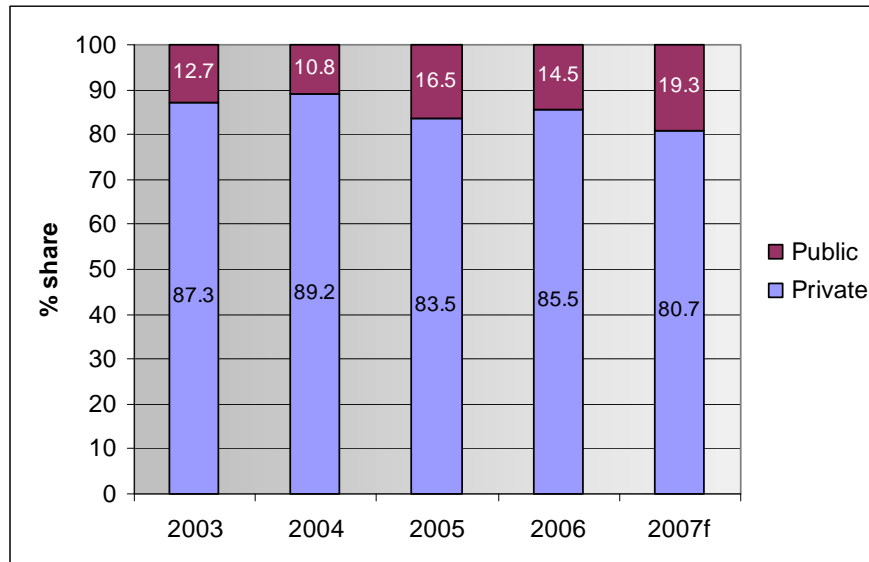
The economy is projected to grow at a moderate pace of 5.8% in 2008 and 6.1% in 2009

Private sector investment activity to drive domestic demand expansion

Besides the slowdown in the global economy, Sri Lanka's domestic demand expansion is expected to moderate as a result of monetary tightening and high inflation. Private sector investments, which form the bulk of investment activity in Sri Lanka, are expected to pick up in the short term, and at a higher growth rate than public investment activity (Figure 14). There has been a significant rise in investment in the construction sector with much of the growth over the past few years driven by post-tsunami rebuilding and public sector investment that consists of infrastructure projects earmarked under the '10 year Development Plan'.

Large-scale infrastructure projects form the bulk of public investment as the government remains committed to improving the country's infrastructure and concomitantly raising the investment level.

Figure 14. Share of Public and Private Sector in Gross Fixed Capital Formation



Source: Sri Lanka Department of Census and Statistics; f-forecast by SLDCS

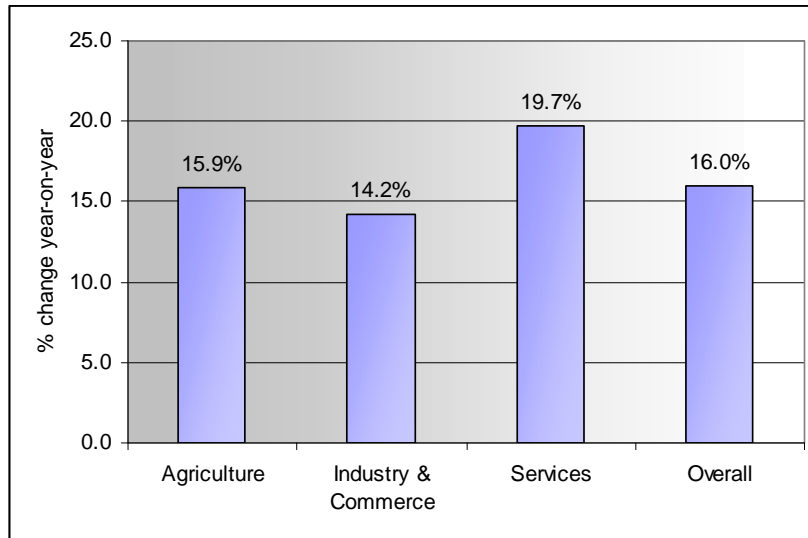
Public Private Partnerships to push infrastructure projects forward

More recently, there has been a push for more Public-Private Partnerships (PPPs) to attract greater private participation in infrastructure and development projects which will help to ease the burden on government finances.

Real wage growth a key aspect to robust private consumption

Private consumption, which accounts for more than 60% of GDP, is expected to moderate in the face of tighter credit conditions and higher interest rates. Despite high inflation, consumer spending remains supported by strong wage growth and remittances from abroad. Reflecting the ability to cope with rising prices, real wage growth in the first quarter of 2008 rose by 16% compared to the same quarter last year (Figure 15). A wage-price inflation spiral remains a risk, though it has receded with monetary tightening.

Figure 15. Wage growth in 1Q2008

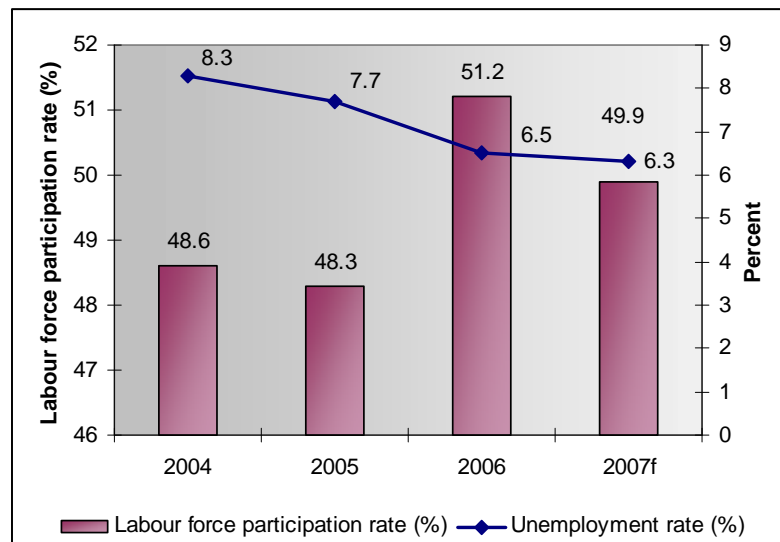


Source: Central Bank of Sri Lanka, *Selected Economic Indicators March 2008*

Services sector employment on the increasing trend

The recent unemployment trends have closely reflected the changes in economic activity amongst the relative sectors (Figure 16). Employment in the agricultural sector fell mainly due to the reduction in paddy and tea production.

Figure 16. Labour market trends



Source: Central Bank of Sri Lanka; f - forecast by CBSL

Conversely, there has been a marginal increase in the employment in service sector industries. It is noted that the main cause for unemployment is the incidence of skills mismatch. On a positive note, however, unemployment has been on the declining trend since the start of the period monitored as shown

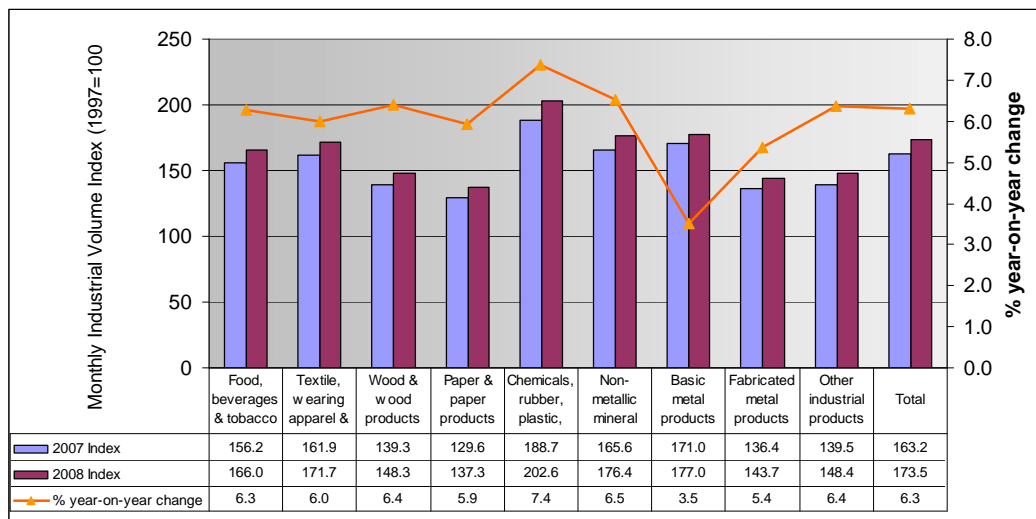
above. A stable and improving labor market will be a key determinant for consumer spending.

Modest industrial expansion in 1Q08 but slower growth in key sectors

Strong 1st quarter industrial output performance

The industrial production index shows an expansion of 6.3% in the first quarter of 2008, expanding about the same rate as the whole of last year. It suggests that domestic and export demand remains resilient. Nevertheless, key industries such as food and beverage and textiles and wearing apparel expanded more slowly by 0.3 to 1.0 percentage point, in line with the more moderate growth of the economy expected in 2008 (Figure 17).

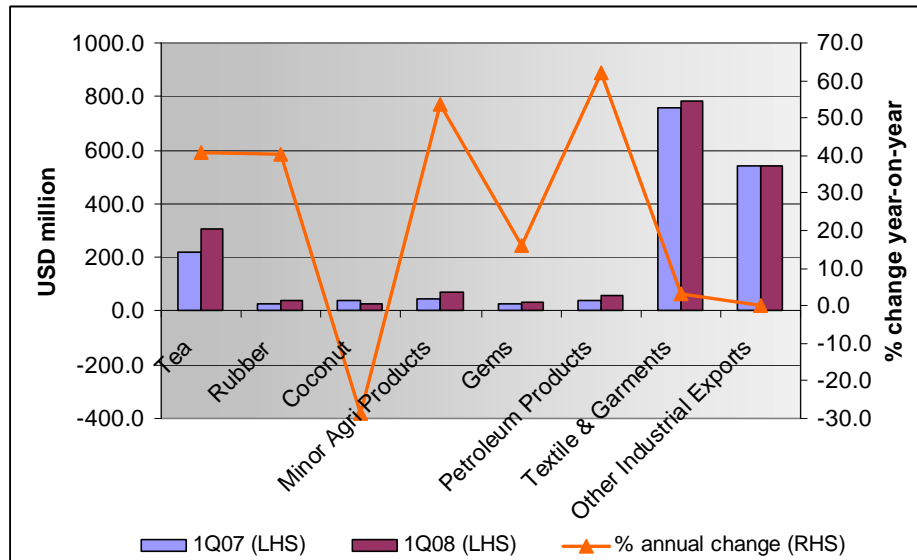
Figure 17. Growth Performance of Key Industries in First Quarter of 2008



Source: Central Bank of Sri Lanka, *Selected Economic Indicators March 2008*

Exports of resource-based products remained resilient

Export of the major agricultural and primary commodities remained strong with double-digit growth recorded in the first quarter of 2008. The strong exports attest to the resilient demand for resource-based products but the slower rise for the country's key exports, textiles and garments and other industrial products warrant closer monitoring (Figure 18).

Figure 18. Performance of Major Exports in 1st Quarter of 2008

Source: Central Bank of Sri Lanka, *Selected Economic Indicators March 2008*

GDP growth forecasts for 2008 and 2009 by industry origin

Agriculture to maintain moderate growth

The agriculture sector is expected to maintain moderate growth levels in the short term, projected at 3.6% in 2008 and 4.3% in 2009. Growth will be supported by buoyant exports of agricultural products such as tea, rubber and other related products. These sub-sectors managed to clock up robust growth in the 40-55% range during the January-March 2008 compared to the same period last year.

Nevertheless, agriculture remains on a moderately declining trend in terms of its relative share to GDP. The decline is consistent with the transformation of the economy from an agriculture-oriented structure into one that is driven by manufacturing and services where productivity and wage growth are much higher.

Risks for this sector stem from external conditions

Downside risks for this industry materialize in the form of external, structural conditions that raises uncertainty. As an ongoing struggle to fight high levels of inflation, India, one of Sri Lanka's main trading partners has cut import duties on crude palm oil. This leaves Sri Lanka without the tariff advantage that it used to have when the duties were still in place. Thus, companies will need to find other ways to raise their levels of competitiveness in world commodity markets.

Construction sector expected to remain resilient

Construction has seen a steady boom especially in the post-tsunami period when rebuilding activities took precedence in national agendas. Not only has residential construction been on the rise, the number of commercial building projects has expanded concurrently with this trend. If the rising trend seen from the housing approval index is anything to go by, construction growth should still be considerably resilient to the rising costs of building materials. Several widely anticipated projects under the government's 10 year plan, which was announced in 2006, are expected to be underway this year backed by public financing initiatives.

Manufacturing growth to ease slightly

Growth in the manufacturing sector is projected to ease slightly to 5.7% in 2008 and 5.4% in 2009. In the first quarter of 2008, private sector industrial production grew by 6.3%. Of the individual subsectors, the chemicals, rubber, plastic and petroleum products sub-sector, recorded the highest expansion at 7.4%.

Textiles and apparel sub-sector to re-position itself in the global market

Output of the apparel industry, one of Sri Lanka's key drivers of manufacturing growth, remained strong while exports recorded moderate expansion in the first quarter. However, growth in this high profile industry may take a backseat in the medium term due to the intensifying price competition. Sri Lankan apparel exporters are experiencing stiff competition from countries such as Vietnam and Bangladesh. A different strategic approach has been proposed for this industry which would help it stay competitive in the global market. The strategy entails the incorporation of eco-friendly production processes to attract the increasingly environmentally conscious European buyers.

Telecommunications sub-sector to face challenges from high inflationary pressures and tightening credit

The telecommunications sub-sector is one of the stronger industries in the services sector. Not only has it attracted large amounts of FDI over the years, the market for its services is growing. For the January-March (07-08) period, there was a record increase in the number of fixed lines (44.9%), cellular phones (48.2%) and internet subscribers (38.7%). However, given tight credit conditions and higher inflationary expectations, the consumer sector may not be as active as the available capacity for these services would project.

Not surprisingly, there has been a shift in the choice in the mode of passenger transport in view of the increasing fuel prices from motor cars to motor cycles.

Tourism sector performance not expected to improve

Sri Lankan tourism has not been picking up, with average occupancy rates for hotels running at an average of 46.5% for the past 3 years. This declining trend is expected to continue in the short term due to ongoing security concerns.

Table 6. Sri Lanka's Actual and Projected GDP Growth by Industrial Origin

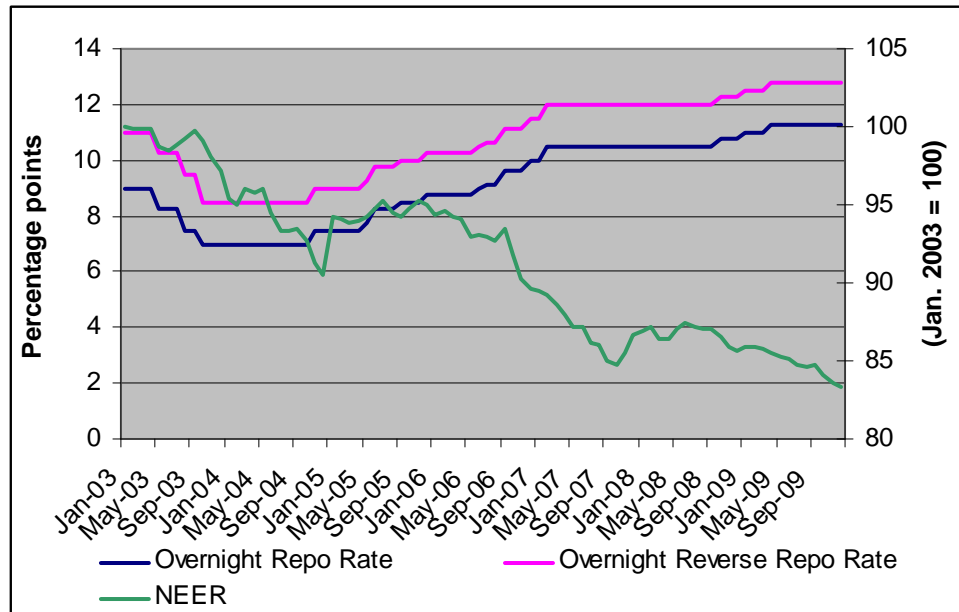
| | 2005 | 2006 | 2007e | 2008f | 2009f |
|-----------------------------------|------------|------------|------------|------------|------------|
| Agriculture | 1.8 | 6.3 | 3.3 | 3.6 | 4.3 |
| Agriculture, Livestock & Forestry | 6.9 | 3.4 | 2.0 | 2.5 | 3.0 |
| Fishing | -43.0 | 53.5 | 18.1 | 14.0 | 15.3 |
| Industry | 8.0 | 8.1 | 7.6 | 6.3 | 6.3 |
| Mining & Quarrying | 17.8 | 24.2 | 15.5 | 10.1 | 11.5 |
| Manufacturing | 6.2 | 5.5 | 6.2 | 5.7 | 5.4 |
| Electricity, Gas & Water | 14.0 | 14.8 | 6.1 | 5.5 | 6.0 |
| Construction | 9.0 | 9.2 | 10.1 | 7.0 | 7.1 |
| Services | 6.4 | 7.7 | 7.1 | 5.9 | 6.5 |
| Wholesale & Retail Trade | 6.4 | 7.1 | 6.4 | 5.1 | 5.5 |
| Hotels & Restaurants | -14.1 | 2.4 | -0.4 | -2.0 | 0.8 |
| Transport & Communication | 9.5 | 12.6 | 10.0 | 9.0 | 9.3 |
| Banking, Insurance & Real Estate | 7.0 | 8.5 | 8.6 | 5.0 | 7.3 |
| Ownership of Dwellings | 1.1 | 1.1 | 1.1 | 1.0 | 1.0 |
| Government Services | 5.4 | 5.0 | 5.8 | 6.1 | 5.7 |
| Private Services | 6.4 | 7.8 | 8.0 | 7.7 | 7.9 |
| Gross Domestic Product | 6.2 | 7.7 | 6.8 | 5.8 | 6.1 |

Source: Central Bank of Sri Lanka, Selected Economic Indicators March 2008; f – forecasts by RAM Economics Research

Interest and exchange rate expectations

Looking forward, we expect the Central Bank to tighten interest rates in the second half of 2008 by up to 75 basis points. This is premised on the need to further curb domestic demand and keep inflation at bay. In addition, we expect the recent depreciation trend of the Sri Lankan Rupee to continue, albeit at a slower pace compared to 2006 and 2007, by 1-3% on a trade weighted basis (Figure 19). These, together the central bank's current reserve money growth target of 15%, will maintain economic growth at a sustainable level as well as preventing a wage-price inflation spiral.

Figure 19. Forecasts of key interest rates and the Sri Lankan Rupee



Source: Central Bank of Sri Lanka, RAM Economics Research

IV. COPING WITH MACROECONOMIC IMBALANCES AND KEY CHALLENGES

Managing high inflation and capping food price pressures

High commodity prices remain the main cause of high inflation

High inflation remains a key worry, as reflected by the central bank’s moves to tighten policy rates (repo and reverse repo rates) and curbing reserve money growth.

Government has adopted tight monetary policy

We expect that these policies, along with high energy costs, elevated commodity prices and the weaker Rupee will contribute to further slow down domestic demand and inflation in 2008 and 2009.

Containing twin deficits

Fiscal deficit to remain a key challenge for policy makers

Besides the persistent inflation threat, the twin fiscal and trade (current account) deficits require close monitoring.

The increase in government spending has been attributed to increases in wages and salaries, pension payments, interest servicing payments and also spending on national security. Revenue collection which grew by 18.3% in 2007 fell short of the projected level due mainly due to tax concessions on imported essential goods that were introduced to help manage the higher cost of living. However, the growth in tax receipts was supported by a significant increase in income tax collection attributed to better administration of collection processes.

The budget deficit in 2007 came in at 7.2% of GDP, which was slightly lower than the 8.1% recorded in 2006 (Table 7). It is expected to hover around the 7.0% level in the near term. The expected improvement however may be derailed by higher public spending especially if welfare and other distributive programmes are needed to enable the low income groups to cope with rising food and fuel prices.

Table 7. Fiscal Balance and Sources of Financing

(% of GDP)

| | 2004 | 2005 | 2006 | 2007 |
|---|------|------|------|------|
| Total revenue | 14.9 | 15.6 | 16.3 | 17.1 |
| <i>Tax revenue</i> | 13.5 | 13.8 | 14.6 | 15.3 |
| <i>Non-tax revenue</i> | 1.4 | 18.0 | 1.7 | 1.8 |
| Total expenditure and lending (less repayments) | 22.9 | 24 | 24.4 | 24.3 |
| Fiscal balance (Revenue - Expenditure) | -8.0 | -8.4 | -8.1 | -7.2 |
| Financed by | | | | |
| Domestic sources | 5.6 | 5.1 | 5.6 | 3.0 |
| Foreign sources | 2.2 | 3.3 | 2.5 | 4.2 |

Source: Sri Lanka Department of Census and Statistics

Foreign financing becoming more widespread

In order to help keep domestic interest rates from significantly rising further, the Sri Lankan government also sought to finance more of its expenditure through foreign financing. Total net domestic financing totaled Rs128 billion in 2007, whereas foreign financing came in at Rs131 billion. The government's budgeted value of foreign financing as a percentage of total financing value is around 53% for 2008, which is close to the same proportion in 2007. Thus, the trend of foreign financing is expected to continue in the near term.

Maiden sovereign bond issue in 2007 oversubscribed by 3 times

Another significant development for the Sri Lankan economy in 2007 was the maiden issue of its sovereign bonds totaling USD500 million. This bond issue was the first of its kind in Sri Lanka and was oversubscribed by three times, with a yield of 8.25%. The implication of this high bond yield to the domestic private sector is that it can be now used as a point of reference for pricing foreign borrowing, thereby providing an alternative source of private financing.

Bond issue successful in boosting foreign currency reserves and lowering government debt

The sovereign bond issue has enabled the government to retire a significant amount of domestic debt held with the central bank, which in turn assisted in controlling the growing money supply. The bond issue has also boosted foreign currency reserves as the issue was taken up by well-developed markets like the US, Europe and Middle East which made up 40% and 30% of the subscription composition respectively. These foreign funds, thus raised, are directed at the financing requirements of major infrastructure projects and as a means of bridging finance for their implementation.

Short-term debt on the increase

The resultant effect is an increase, total outstanding government debt saw higher growth in the component of foreign debt and this was mainly attributed to the weakening of the Sri Lankan rupee against the USD and other major currencies. In terms of the composition of domestic debt, there has been an increase in short-term debt compared to medium to long term domestic debt.

Sovereign issue only a short term measure to remedy fiscal deficit

Debt sustainability is also of great concern. The sovereign debt issue may have helped the balance of payments and also helped pay down some of the government debt, however, this is only a short term measure and the government may need to make another similar issue soon or take out a syndicated loan. The growing loan interest payments are also of some concern for overall government finances especially at the prevailing higher international interest rates and they can ill afford another round of open market operations which could cause inflation to spiral out of control. Furthermore, with expenditure on security not expected to ease in the short term, the fiscal deficit will likely to persist longer.

The current account is expected to face increased pressures from higher imports stemming from strong consumer goods import as well as higher oil and food import bills. Further pressures could arise from the implementation of mega infrastructure projects that require substantial capital imports.

Striving for a solution to mounting oil import bill

High oil prices remain a key dilemma in controlling inflationary pressures

The Sri Lankan government abolished its regime of providing retail fuel subsidies in 2006. It saved the government an amount equivalent to an average of 0.7% of GDP annually. However, with the escalating global oil prices plaguing economies all over the world, for a developing nation facing these high commodity costs, it is difficult to prevent prices (for both producers and consumers) from spiraling out of control. At present, the country is experiencing high inflation levels, with the official rate breaching the 20% mark.

Sri Lankan economy extremely vulnerable to escalating oil prices

Currently, Sri Lanka imports 100% of its oil and this has rendered the country extremely vulnerable to the escalation in world oil prices. In the period of January to March of 2007 and 2008, crude oil imports actually fell by 15.8% in terms of quantity and conversely, an increase was observed for other petroleum products such as diesel and natural gas. However, even with the reduction in demand, the spike in world oil prices has nullified the gains from the country's exports and widened its trade deficit to USD 2 billion in the first 4 months of 2008,

Alternative energy generation not in widespread use

Although efforts to develop new methods of power generation have been underway (such as thermal, wind and hydro power), recent data shows that these methods are still not widely in use. For wind and hydro power in particular, power generated from these processes actually fell 21.1% and 18.8% respectively in the January-March period between 2007 and 2008. However, oil reserves were discovered in the northwestern region of Sri Lanka in 2007 and the government is aggressively promoting oil exploration contracts with countries such as Japan and India which would help ease the burden of these high global oil prices.

Reversing brain drain and tapping local talents

Brain drain a very serious impediment to long term growth potential

In some respect, the huge remittances that are propping up the positive balance of payments position is beneficial for the economy, however, a less myopic reality would be that the increase in Sri Lankan workers finding work elsewhere exhibits the very real issue of a 'brain drain'. Businesses, especially in the services sector, are finding it difficult to find suitable employees that have the right skill set for the job. Moreover, the pace of out-migration is observed to be increasing that could constrain the country's long-term growth potential.

Reducing political risks

Policy reversal has also contributed to development challenges

Although the country has an established parliamentary democracy system, the changes in government leadership over the years have been accompanied by reversal in economic policies and reforms. An example is the privatisation drive of the United National Front led by the United National Party during its 2002-2004 term, as opposed to the aims of the current ruling government known as the Peoples' Alliance led by the Sri Lanka Freedom Party, which has stopped the bulk of the privatisation projects. The ruling party advocates that strategic enterprises such as state-owned banks and utilities should be held under state control and that investment should be directed to disadvantaged areas as a way to alleviate poverty. These principles have been promoted in President Rajapaksa's 2005 election manifesto, 'Mahinda Chintana', which is frequently referred to for the formulation of policies.

Escalation in the armed conflict will divert resources away from development

Arguably the main concern for the Sri Lankan economy is the continuing conflict and instability caused by armed conflict with the Tamil Tigers. Not only is social unrest and citizen welfare of grave concern, the violence has also deterred much needed foreign investment and the improvement of infrastructure to foster economic growth. An escalation of the fighting will have serious ripple effects on the rest of the economy as more resources will be diverted toward national security and defence. The continuing civil conflict is a concern, not only on a humanitarian front, but also in terms of its impact on the long-term resilience of the economy to withstand external economic shocks and intensifying international competition for trade and investment.

IV. CONCLUSION

Near and medium term growth prospects, while turning unfavourable with the escalation in the armed conflict, will improve considerably once its containment is in sight

Growth will moderate in the immediate term

The main consensus on the short term outlook for Sri Lanka is that growth will slow in the immediate term and thus not reach the robust levels exhibited in prior years (as high as 7.3% in 2006) due to the escalating structural problems in the economy and the required tightening of monetary and fiscal policies to manage the world food and energy price shocks. The main risk to our growth expectations forecast is an escalation in the armed conflict that will not only drain the fiscal resources at the expense of development but also curtail investment and business activities particularly the inflow of foreign direct investment. The harnessing of foreign capital is important for the country to overcome the persistent domestic financing constraints as well as accelerate the country's industrial upgrading.

Although the civil unrest has historically been a primary weakness for the development of the economy - from supply disruptions to uncertainty and security concerns perceived by potential investors, ensuring consistency in economic policies and development aims is also important in harnessing the potential of foreign investment.

High value manufacturing and services activities imperative to maintaining high growth

Nonetheless, Sri Lanka has maintained its strength in the terms of industrial exports which form the integral part of export receipts and GDP growth in general. Trade agreements such as the GSP+ (a unilateral trade agreement) and other regional free trade agreements are central to maintaining this trend. There is also the need to reduce the current account deficit to a more sustainable level and increase the competitiveness of the country's exports especially the garment industry. While the garment industry has been the backbone of the country's manufacturing exports, the diversification of the sources of growth particularly the promotion of high value manufacturing and service industries is important to keep up with the rapid pace of growth and development seen in other Asian economies.

June 20, 2008