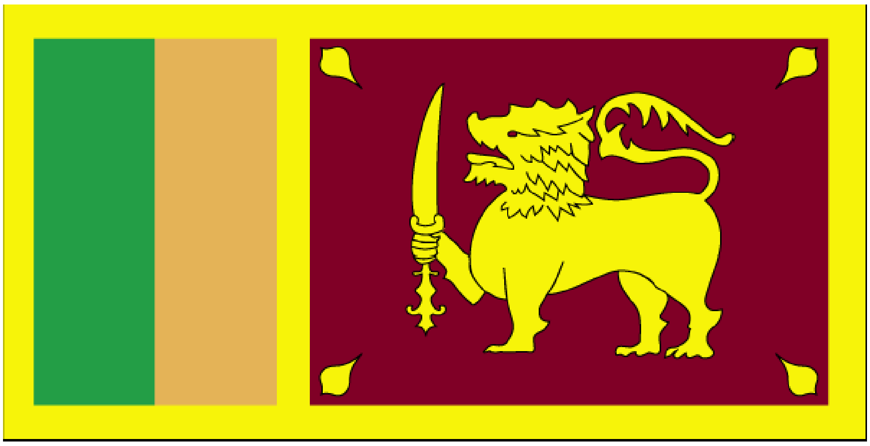
Rabobank

Country report **SRI LANKA**



Summary

The Sri Lankan economy faces twin challenges of fundamental fiscal weakness and deteriorating external liquidity. On a more positive note, the country is freed from the shackles of a three decade-long civil war, which has majorly boosted its economic prospects. But at the same time, the country's export and tourism sectors are being challenged amid weak global demand conditions. Furthermore, there is a current obligation to adhere to fiscal norms in order to attract international funding. It remains to be seen if the current pace of fiscal consolidation would continue in the future. The ruling coalition is firmly in power, which bodes well for political stability, but nurtures highly authoritarian tendencies. This may adversely affect the business and social environment. Overall, the socio-political situation seems to be the largest risk for Sri Lanka.

Things to watch:

- Authoritarian tendencies of the government
- Continued upward inflationary pressures
- Weak external liquidity
- Continuity of fiscal consolidation efforts

Author: **Preethika Kannan**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
P.Kannan@rn.rabobank.nl

Sri Lanka

National facts		
Type of government	Republic	
Capital	Colombo	
Surface area (thousand sq km)	66	
Population (millions)	21.5	
Main languages	Sinhala (74%)	
	Tamil (18%)	
Main religions	Buddhist (69%)	
	Muslim (8%)	
	Hindu (7%)	
Head of State (president)	Mahinda Rajapakse	
Head of Government	Mahinda Rajapakse	
Monetary unit	Rupee (LKR)	

Economy		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	59	0.09
Nominal GDP at PPP	117	0.15
Export value of goods and services	14	0.06
IMF quotum (in m SDR)	413	0.19
Economic structure	*2011*	*5-year av.*
Real GDP growth	8.3	6.4
Agriculture (% of GDP)	12	12
Industry (% of GDP)	30	30
Services (% of GDP)	58	58
Standards of living	*USD*	*% world av.*
Nominal GDP per head	2887	27
Nominal GDP per head at PPP	5660	46
Real GDP per head	1747	21

Social and governance indicators	rank / total
Human Development Index (rank)	97/187
Ease of doing business (rank)	89/132
Economic freedom index (rank)	97/179
Corruption perceptions index (rank)	86/183
Press freedom index (rank)	163/178
Gini index (income distribution)	40.3
Population below $1.25 per day (PPP)	0.07

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
USA	20	India	27
UK	9	China	16
Italy	5	Singapore	7
Germany	5	Iran	6
Main export products (%)			
Textiles			40
Tea			14
Petroleu			5
Diamonds & gems			5
Main import products (%)			
Mineral products			21
Machinery & transport equipment			22
Cotton yarn and textiles			14
Base metals			8
Openness of the economy			
Export value of G&S (% of GDP)			23
Import value of G&S (% of GDP)			37
Inward FDI (% of GDP)			1.7

Economic structure and growth

The Democrat Socialist Republic of Sri Lanka is an island situated in the Indian Sea, just south-east of the Indian coast. After being controlled by the Portuguese in the 16th century and by the Dutch in the 17th century, the island became a British colony in 1802. Under British rule, the country was known as Ceylon, but after gaining independence in 1972 the name was changed to Sri Lanka. After independence, the country was plagued by a 26-year civil war with the Tamil minority, which ravaged the country and finally came to an end in 2009. The end of the civil war has boosted the economic prospects for Sri Lanka, as a vast amount of arable land is available in the ravaged Northern and Eastern parts of the island, which can now be properly cultivated.

The economy is structured around the services sector which contributes 58% to GDP, followed by the industrial sector with 30% and the agricultural sector with 12%. Although the agricultural sector is relatively the smallest, it is very important as it employs over 30% of the labour force. The services sector, which is almost five times as large, employs 43% of the work force. The basic literacy level of the adult population is relatively high at 95%. But tertiary education levels are poor and current skill levels are not high enough to develop a more knowledge-based economy.

The most buoyant sectors are tea, fishery, light food processing, textiles & garments and tourism. The country's main export products are textiles & garments, accounting for more than half of total exports, followed by tea, diamonds and petroleum products. The US, UK, Italy, Germany and India are Sri Lanka's main export partners.

The economy is expected to expand by an average of 6% in 2012, which is down from 8.3% in 2011, due to a combination of tight monetary policy and subdued global demand. Still at 6%, growth is likely to remain relatively buoyant in 2012-13 due to strong growth in construction and agriculture, which are both still benefiting from a peace dividend following the end of the civil war. In 2013-16 economic expansion is forecast to average around 7% a year. Regional imbalances in wealth across the island should diminish slightly as investment in the war-affected provinces is ramped up. However, wealth will remain concentrated in the urban centers, and particularly in Colombo.

Sri Lanka's economy remains vulnerable to inclement weather, which can reduce agricultural output and affect hydropower plants. These plants account for almost half of the generating capacity. In 2011, when the rainfall was irregular and below average, hydropower generation dropped to less than 15% of total demand. The sensitivity to weather volatility is not expected to decline in the medium term.

In general Sri Lanka, many rural inhabitants have limited access to the official financial sector. However, the financial system is fundamentally overbanked, with 37 banks and 28 finance companies vying for a private-sector credit base of around 30% of GDP. Profit is low and asset quality is poor which is the result of a legacy of non-performing loans. The NPL ratio is high at 15%, with stocks of NPL's being larger in state-owned banks than in private banks.

Political and social situation

Sri Lanka is a parliamentary democracy, but the presidency is the main seat of power. In April 2010, President Mahinda Rajapakse's ruling coalition won a landslide victory in the parliamentary elections as a result of the immense popularity it gained after defeating the tamil insurgency and thus ending the civil war that had ravaged the country for over three decades. Since then, convincing victories in the local elections consolidated the power of the already strong administration. They have been able to push through a range of economic and constitutional reforms such as abolition of term limit for presidency and empowering the president to directly appoint members of the Supreme Court, Police force and electoral commission. The Rajapaksa government has focused on economic growth, implementing infrastructure projects and structural reforms that have boosted the GDP growth from 3.9% in 2009 to 8.3% in 2011.

Sri Lanka's main opposition parties are fragmented and lack the ability to mount a credible challenge to the ruling coalition. While the concentration of power bodes well for political stability, there are concerns about the government's authoritarian tendencies that could affect Sri Lanka's overall business environment. While the next presidential election is due only in 2015, there is a small possibility that the administration could call for a snap general election in an attempt to consolidate its grip on power by seeking a renewed mandate.

The president runs a highly personalised administration in which power is concentrated within a close group of his relatives and associates. Critics of this inner circle are met with an aggressive response, and many journalists have been physically attacked. The government has also been accused of stifling press freedom. Sri Lanka remains one of the worst places in the world in terms of press freedom. In Press Freedom Index 2011-12: the island was ranked 163 out of 179 countries worldwide.

Mistrust of government is considerable due to widespread public-sector corruption. Many political institutions lack transparency and independence. State expropriation of private sector assets in 2011 – a new bill allowed land to be expropriated when the land is not put to right use - has raised concerns. The judicial system is weak and vulnerable to political interference. The commercial court system is subject to extensive delays that often lead investors to pursue out-of-court settlements. A fairly reliable registration system exists for recording private property, including land and buildings, but fraud and forged documents are problems. In the past two years the Colombo Stock Exchange (CSE) has seen a series of major scandals, which have threatened the integrity of the bourse and increased uncertainty towards trading in the CSE.

On the social front, the rising cost of living has led to a growing, if muted, domestic discontent. Moreover, Mr. Rajapaksa's government is coming under increasing international pressure over alleged human rights abuses and its failure to take steps towards reconciliation with ethnic and religious minorities following the ending of the civil war. While the war has ended, the core issues and demands of the tamil population in Sri Lanka, such as greater opportunities for social integration and development, remain unaddressed.

Sri Lanka's increasing reliance on developing financing and trade credit from India and China has reduced the political leverage of Western donor countries, which tend to link aid and credit with human rights matters. We see increased relations with countries such as China, Russia, Iran and Myanmar that have supported the Sri Lankan Government in its fight against the LTTE.

Economic policy

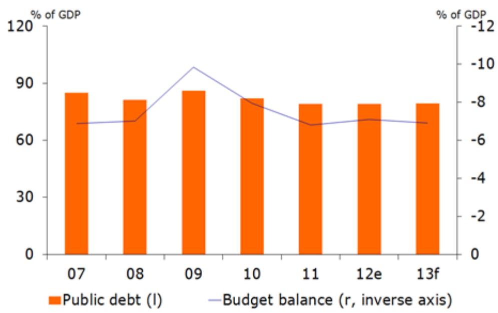
The Sri Lankan economy faces twin challenges of fundamental fiscal weakness and deteriorating external liquidity. The fiscal situation suffers from a high public debt and interest burden, while the weak external liquidity is exacerbated by moderately high and increasing external debt.

The large trade deficit, the low level of foreign exchange (FX) reserves and the recent rise in inflation are Sri Lanka's main concerns at the moment, next to the weak fiscal situation. The budget deficit is narrowing and decreased from a whopping 9.9% of GDP in 2009 to 6.8% of GDP in 2011. Unfortunately, this is mostly attributable to the IMF-required austerity measures and not to Sri Lanka's own fiscal discipline. The IMF extended a USD2.6bn loan in 2009 to Sri Lanka which immensely helped in arresting a then-imminent balance of payments crisis. Going forward, the budget deficit will only be reduced on a more structural level if the government finds a way to increase revenues and curtail spending. The government has introduced several measures to broaden the tax base, improve tax administration, rationalize import duties and to avoid tax evasion. Indirect taxes are the main source of tax revenue, but direct tax revenue is likely to rise as the tax net is widened. While public debt is moderating, it still remains at over 79% of GDP (end 2011), a little less than half of which is external public debt, with the rest being domestic. About one-fifth of domestic public debt comprises short-term treasury bills, the remainder includes medium- and long-term bonds and loans. Interest costs are higher than budgeted owing to exchange-rate depreciation and higher domestic interest rates due to tighter monetary conditions.

Inflation, having reached a high of 9% in August 2012, is likely to remain high in the coming months following fuel price hikes at the start of the year, rapid credit growth and adverse weather conditions, which have pushed up domestic food prices. Food prices carry a weight of 41% in the consumer price index. Furthermore, the broad money supply grew at a phenomenal rate of 37.4% in 2011, which added fuel to fire. To curtail the excessive credit growth that occurred in 2011 and early 2012, the central bank (CBSL) raised interest rates twice in early 2012. Since then monetary policy has been left unchanged. The bank will continue to come under pressure from the government to keep interest rates low in order to boost economic growth. Unless inflation rises above the current levels, which the IMF and government are still comfortable with, the CBSL is likely to maintain its bias towards supporting growth this year. Loose local credit conditions and the depreciation of the currency will cause inflationary pressures to remain elevated in 2012.

In February 2012, the Central bank moved towards limited foreign exchange market intervention in order to arrest the continuous and steep decline in its FX reserves which could have led to a repetition of the balance of payments crisis situation as in 2009. Pressure from the IMF hastened the decision. In the future, the central bank will intervene only to smooth out excess volatility of the local currency. This move has resulted in a steep depreciation of the Sri Lankan Rupee against the US Dollar.

Figure 1: Fiscal situation



Source: EIU

Figure 2: Rupee volatility

Source: Ecowin

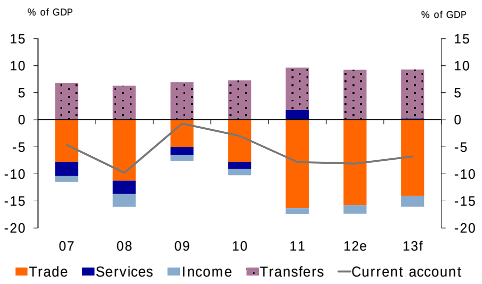
Balance of Payments

Sri Lanka's current account has posted continuous deficits in previous years and this year is no exception. The current account deficit widened to a whopping 7.8% of GDP in 2011 from 3% of GDP in 2010, the main culprit being the trade deficit, which was at a historical high of 16.3% of GDP in 2011. Both imports and exports recently contracted year-on-year in response to falling prices and weakening demand conditions—imports of consumption goods in particular have fallen, while investment goods imports continue to grow. More than half of all imports are for investment purposes. The Sri Lanka rupee has been allowed to float freely since February 2012, and the following steep depreciation of the currency should damp down growth in merchandise imports in 2012 (although import prices will rise as a result of the currency's depreciation, this should be outweighed by the fall in volumes). The government has also imposed higher tariffs on certain imports, such as cars, which has worked to dampen demand. The transfer and services balances posted surpluses of 1.9% and 7.8% of GDP in 2011, respectively, while the income balance had a 1% of GDP deficit in 2011. Going forward, the current account deficit is projected to narrow to less than 7% of GDP in 2012.

It would be worthwhile to mention that remittances are the biggest single source of foreign exchange for Sri Lanka. Over 1.5 million Sri Lankans are employed abroad, mainly as labourers or housemaids in Gulf states. The decrease in remittances would create serious repercussions in the Sri Lankan economy, as one quarter of the entire population are dependent on this income, but so far remittances have been remarkably resilient.

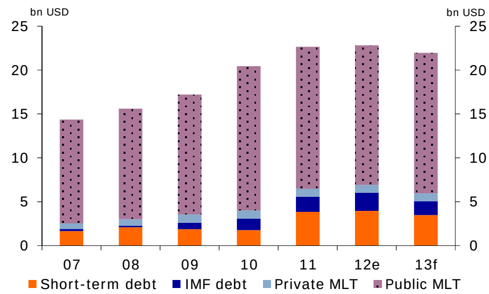
While the IMF aid helped Sri Lanka in avoiding a major balance of payments crisis in 2009, Sri Lanka will continue to remain dependent on inflows of foreign investment from countries such as China, India, Myanmar and Japan, as well as debt financing to fund its external needs. About half of the 2012 external financing needs stem from the current account deficit, the other half from the repayment and interest payments on loans.

Figure 3: Current account balance



Source: EIU

Figure 4: External debt



Source: EIU

External position

While Sri Lanka's external position has improved compared to the dramatic situation of early 2009, it is still rather weak. The central bank's external reserves, which were falling sharply towards the end of 2011, have stabilized with gross international reserves at USD 5.8bn (2.9 months of imports) at end-June, which is still below acceptable levels. The FX-reserves debt service cover is expected to fall from 182% in 2011 to 111% in 2012, which is worrying as well.

Foreign debt fell to 38% of GDP in 2011 and is expected to further fall to a moderate 33% of GDP in 2013. Of the total foreign debt, less than a fifth is short-term debt, which is favorable. Of the remaining medium-to-long term debt, over 70% is owned by the public sector. Sri Lanka's bond yields have trended downward in recent years as the international investor community looked favorably to Sri Lanka as the country has taken steps to address its fiscal deficit. The first international bond issuance in 2007 was priced at 8.25% a year and a subsequent 2009 issue at 7.4%. Amid an environment of increasing risk aversion, the level of interest in the bond issuance and the lower yields achieved mark a positive development. This is good news as Sri Lanka relies on debt financing to cover the current account deficit.

Sri Lanka

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	6.8	6.0	3.5	8.0	8.3	6.0	6.8
Consumer prices (average % change pa)	15.8	22.6	3.4	5.9	7.0	6.9	5.5
Current account balance (% of GDP)	-4.6	-9.8	-0.7	-3.0	-7.8	-8.1	-6.8
Total foreign exchange reserves (mln USD)	3380	2469	4616	6710	7000	6600	7340
Economic growth							
GDP (% real change pa)	6.8	6.0	3.5	8.0	8.3	6.0	6.8
Gross fixed investment (% real change pa)	9.1	5.3	1.3	9.2	14.6	8.7	11.0
Private consumption (real % change pa)	4.5	7.6	0.8	10.1	15.0	5.5	6.0
Government consumption (% real change pa)	4.7	9.5	19.1	-3.7	1.9	5.4	6.2
Exports of G&S (% real change pa)	7.3	0.4	-12.3	8.8	11.0	0.4	6.2
Imports of G&S (% real change pa)	3.7	4.0	-9.6	12.6	20.0	2.4	7.5
Economic policy							
Budget balance (% of GDP)	-6.9	-7.0	-9.9	-8.0	-6.8	-7.1	-6.9
Public debt (% of GDP)	85	81	86	82	79	79	79
Money market interest rate (%)	30.9	21.2	11.7	9.0	8.2	9.4	8.5
M2 growth (% change pa)	16	-8	20	18	21	12	16
Consumer prices (average % change pa)	15.8	22.6	3.4	5.9	7.0	6.9	5.5
Exchange rate LCU to USD (average)	110.6	108.3	114.9	113.1	110.6	127.3	126.7
Recorded unemployment (%)	6.0	5.2	5.7	5.8	5.4	5.1	5.0
Balance of payments (mln USD)							
Current account balance	-1498	-3986	-291	-1472	-4638	-4740	-4490
Trade balance	-2527	-4571	-2101	-3854	-9728	-9250	-9350
Export value of goods	7640	8111	7085	8307	10538	10510	11380
Import value of goods	10167	12682	9186	12161	20266	19760	20730
Services balance	-827	-1008	-630	-653	1099	20	170
Income balance	-358	-972	-487	-573	-647	-920	-1320
Transfer balance	2214	2565	2927	3608	4638	5410	6000
Net direct investment flows	548	690	384	435	971	920	1000
Net portfolio investment flows	-4	314	335	877	1300	1000	1050
Net debt flows	1946	812	1559	2869	4802	3200	2090
Other capital flows (negative is flight)	-320	1222	810	-870	-1732	-880	1100
Change in international reserves	672	-948	2797	1839	703	-500	750
External position (mln USD)							
Total foreign debt	14369	15615	17213	20452	22661	22820	21960
Short-term debt	1644	2100	1873	1773	3831	3960	3480
Total debt service due, incl. short-term debt	1712	2900	3612	3427	3840	5930	6530
Total foreign exchange reserves	3380	2469	4616	6710	7000	6600	7340
International investment position	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total liabilities	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-7.8	-11.2	-5.0	-7.8	-16.4	-15.8	-14.1
Current account balance (% of GDP)	-4.6	-9.8	-0.7	-3.0	-7.8	-8.1	-6.8
Inward FDI (% of GDP)	1.9	1.8	1.0	1.0	1.7	1.6	1.6
Foreign debt (% of GDP)	44	38	41	41	38	39	33
Foreign debt (% of XGSIT)	116	118	138	134	117	110	96
International investment position (% of GDP)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	14	22	29	23	20	29	29
Interest service ratio incl. arrears (% of XGSIT)	2	3	3	5	3	2	2
FX-reserves import cover (months)	3.2	1.9	4.7	5.3	3.8	3.4	3.6
FX-reserves debt service cover (%)	197	85	128	196	182	111	112
Liquidity ratio	113	86	117	121	102	93	96

Source: EIU