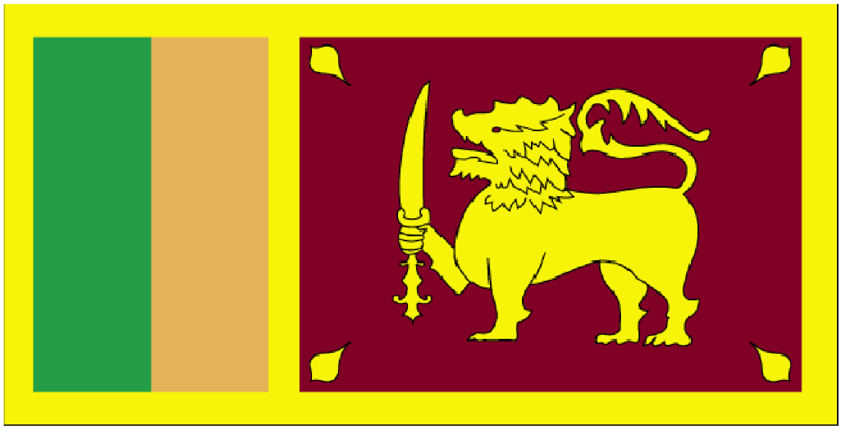
Country report

SRI LANKA



Summary

The end of the civil war has boosted long-term economic prospects for Sri Lanka. The economy is expected to grow over 6% in 2010. However, the humanitarian situation remains poor since the government has failed to address the grievances of the Tamil minority. This failure has led to deteriorated international relations, as the EU removed special tariff concessions for Sri Lanka, which are likely to hurt exports. The political scene is more stable after the landslide victory of President Rajapakse. However, there are fears he will continue to tighten his grip on power. Public finances remain weak despite an IMF loan. The external position has improved after a balance of payments crisis was averted end-2008 but remains precarious.

Things to watch:

- The humanitarian situation
- Fiscal consolidation efforts
- President Rajapakse's efforts to concentrate power

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Sri Lanka

National facts	
Type of government	Republic
Capital	Colombo
Surface area (thousand sq km)	66
Population (millions)	21.3
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		2009
Economic size	*bn USD*	*% world total*
Nominal GDP	42	0.07
Nominal GDP at PPP	97	0.14
Export value of goods and services	9	0.06
IMF quotum (in mln SDR)	413	0.19
Economic structure	*2009*	*5-year av.*
Real GDP growth	3.5	6.4
Agriculture (% of GDP)	13	12
Industry (% of GDP)	30	30
Services (% of GDP)	58	58
Standards of living	*USD*	*% world av.*
Nominal GDP per head	2075	23
Nominal GDP per head at PPP	4772	43
Real GDP per head	1521	20

Social and governance indicators	rank / total
Human Development Index (rank)	102 / 182
Ease of doing business (rank)	105 / 183
Economic freedom index (rank)	120 / 179
Corruption perceptions index (rank)	97 / 180
Press freedom index (rank)	162 / 175
Gini index (income distribution)	41.1
Population below $1 per day (PPP)	0.14

Foreign trade			2009
Main export partners (%)		*Main import partners (%)*	
US	20	India	21
UK	13	China	14
India	5	Singapore	7
Germany	5	Iran	6
Main export products (%)			
Textiles & garments			48
Tea			17
Diamonds & gems			5
Petroleum products			2
Main import products (%)			
Mineral products			21
Machinery & transport equipment			17
Textiles			14
Base metals			7
Openness of the economy			
Export value of G&S (% of GDP)			21
Import value of G&S (% of GDP)			30
Inward FDI (% of GDP)			1.1

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

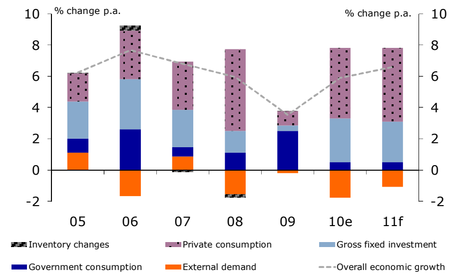
Economic structure and growth

The Democrat Socialist Republic of Sri Lanka is an island situated in the Indian Sea just southeast 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 the name was changed to Sri Lanka in 1972. Last year, a long-standing civil war with the Tamil minority, which had ravaged the country, finally came to an end.

The end of the civil war should boost economic prospects in the long run, but last year the economy expanded by only 3.9%, markedly lower than the average of 6.2% recorded from 2004-2008. In 2009, the economy was hit by the global financial crisis, mostly via lower exports, tourism, foreign investment and a liquidity crunch. The economy is structured around the services sector, which constitutes 58% of GDP. This is followed by the industrial sector with 30% and by the agricultural sector with 13%. Although the agricultural sector is the smallest, it is very important as it employs 34.7% of the labour force, whereas the services industry, which is almost four times as large, employs only marginally more people with 39.2% of the labour force. The most buoyant sectors are food processing, textiles and apparel, port construction, food and beverages, insurance and banking, and telecommunications.

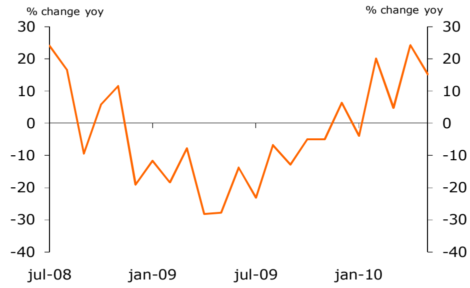
The country's largest export products are textiles and garments, about half of the total exports. Other important export products are tea, diamonds and gems. The US, the larger Eurozone countries of UK and Germany, and India are Sri Lanka's main export partners. Last year, exports

Chart 1: Growth performance



Source: EIU

Chart 2: Exports



Source: Bloomberg

had fallen by an average 12.9% yoy as demand for its exports products waned with the US and Eurozone falling into a recession. This year, the outlook is favourable as exports have risen three months in a row since February. In May, exports grew 15.1% yoy, but these figures are still only a modest improvement from the steep declines last year. Downside risks are high, especially when the economic recovery in the US stalls since it is Sri Lanka's largest export destination. Also, the recent withdrawals of preferential trade benefits of the EU on human rights grounds could hurt further export growth.

Going forward, the growth outlook is more positive than in 2009. Private consumption and gross fixed investment had traditionally boosted economic growth, but faltered last year and government expenditures had to carry the torch. This year, private consumption is well on track and gross fixed investments are back. Public and private investments have increased mostly for reconstruction purposes. While overall foreign investment has decreased this year, investments from India and China did increase. Especially in strategically important infrastructure projects such as a large coal fired power station, roads and railways in the north and airports and seaports in the south. These investments will further diversify and enhance the structure of the economy in the longer term. Long term growth prospects are favourable for Sri Lanka, considering it has already been growing over 6% in the past five years under the burden of a civil war and in the wake of the devastating tsunami in 2004. We estimate the economy to grow around 6% yoy in 2010.

Sri Lanka's banking sector is moderately healthy. It has no direct exposure to US subprime securities but one bank almost collapsed last year due to the global liquidity crunch. The non-performing loan ratio was estimated at 9% at end-2009. This is rather high but the average capital adequacy ratio of 13% seems adequate.

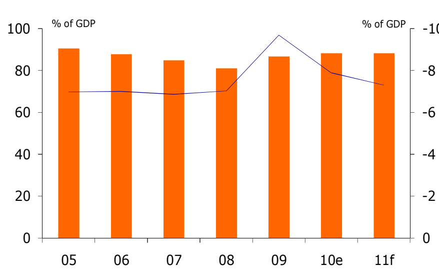
Political and social situation

While Sri Lanka is a democracy, the country is increasingly being ruled in an authoritarian manner by president Rajapakse. His United People's Freedom Alliance (UPFA), won a resounding mandate of 144 seats in the 225-member parliament last April, only six seats short of a two-thirds majority. With only six votes of outside support needed, it can be expected any reforms are quickly pushed through. While the decisive mandate bodes well for political stability, Rajapakse is going too far to tighten his grip on power. Between the January presidential elections and April parliamentary elections, he cracked down on the main opposition party led by former army general Fonseka. He was also Rajapakse's main contender in the presidential elections and stood a good chance of winning. His popularity was significant after he led the Sri Lankan army to victory over the Tamils. However, Rajapakse also claimed responsibility for the victory and had seen Fonseka as a threat even after winning the presidential mandate. Fonseka remained influential in the military as well as in politics with a loyal following. Fearing a coup, Rajapakse raided Fonseka's party office and removed powerful military officials loyal to Fonseka from their positions. As expected, Rajapakse quickly sought to make constitutional amendments which would allow him to run for a third term in office. The amendment has been approved by parliament. Rajapakse is now able to run for an unlimited number of terms. He also has the power to appoint top judges and commissioners for elections, unhindered by any legal veto. Power was already highly concentrated with the president, as he also acts as chief of state, defence and finance minister. Before this amendment was approved, Rajapakse agreed with the opposition leader to weaken the presidency, which was a big surprise. In effect, constitutional changes would be made to create the position of an executive prime minister, who would be accountable to the parliament. We suspected Rajapakse's only motivation to agree with this amendment was to ease international tension and buy time to pursue his agenda of gaining more power. If Rajapakse continues this way, it seems he will go for a full dictatorship, a very bad development. International tension has risen since the government received overwhelming criticism regarding the dismal humanitarian situation of the Tamil minority. The government has not addressed any of the Tamil grievances and has not made due on a political solution promised to the Tamils one year ago. The government actually claims to fear a re-emergence of the Tamil rebels, even as it seems clear their defeat last year has effectively neutralized any conventional warfare capabilities. While no terrorist attacks were recorded last year, the government states the Tamils still have weapons and has kept the emergency rule in place, which seems exaggerated. There have only been modest moves to address the core causes of the conflict by the government. These include the holding of local elections in two northern districts in August 2009 and the integration of Tamils into the country's police force in September 2009. Also most internally displaced people were freed by the end of last year. However, much remains to be done to fully include the Tamil minority in the Sri Lankan society. The low voter turnout in Tamil-majority areas in the January 2010 presidential election as well as the April parliamentary election indicates continued disillusionment of Tamils vis-à-vis the government. The international community agrees that the Tamil grievances have not been properly addressed, as the EU has withdrawn several tariff concessions, after Sri Lanka rejected EU demands for written evidence on improvements of the humanitarian situation. International relations have worsened further after the government heavily resisted an independent international war crimes investigation to be conducted by the UN. It stated an internal investigation would be sufficient and actually denied visas for UN staff members, preventing them to leave the UN offices in Colombo.

Economic policy

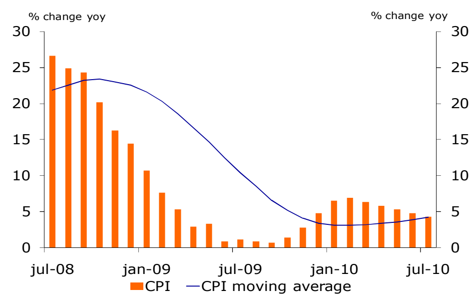
The fiscal position of Sri Lanka is very weak, as the government continuously runs large budget deficits and the public debt is very high. Public debt stands at 88.5% of GDP in 2010. In the past five years, the budget deficit averaged a large 7.5% of GDP. This year, it is expected to record 7.9% of GDP, a slight improvement from the whopping 9.7% of GDP budget deficit in 2009. The

Chart 3: Public finances



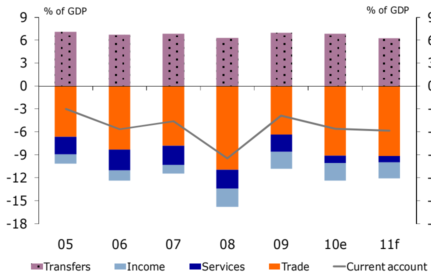
Source: EIU

Chart 4: Inflation



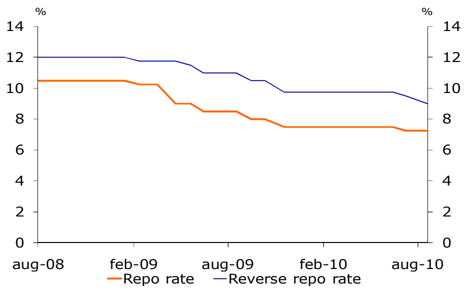
Source: Bloomberg

Chart 5: Current account balance



Source: EIU

Chart 6: Policy rates



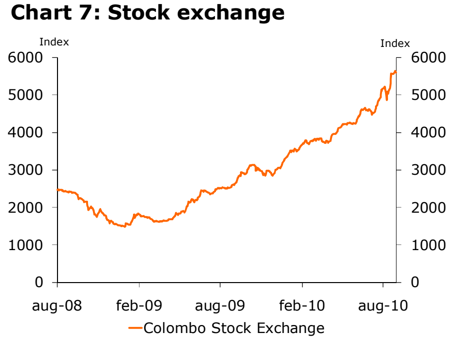
Source: Bloomberg

constraints to structural improvements have always been a very narrow revenue base (estimated at 10-15% of GDP) and high and rigid expenditures. The largest weaknesses are the very large bureaucracy, as half of total revenues go towards public sector wages, making expenditures very inflexible. The government already promised another wage hike in 2011. Extensive social spending and transfers to loss-making state owned firms further add to the inflexible nature of government expenditures. And finally, the government's strategy to drive growth through fiscal stimuli certainly does not help to any fiscal consolidation.

In the 2010 budget, presented last August, the budget deficit is to be restricted to 8% of GDP in 2010. While total revenues are expected to be USD 7.4bn, total expenditures are estimated at USD 11.5bn. Interesting is that the government does not curtail defence spending, given the end of the civil war. USD 1.64bn is allocated to defence spending , only slightly down from USD 1.65bn in 2009. The 8% of GDP target misses the IMF target of 7% of GDP, which was already to be expected. Sri Lanka has had difficulties with the IMF in the past and lapsed on a loan agreement in 2001. This year, the IMF delayed the third tranche of the a USD 2.6bn loan as Sri Lanka's consolidation efforts were unsatisfactory. While the IMF later did disburse the tranche as the government promised to step up its efforts, we remain very cautious.

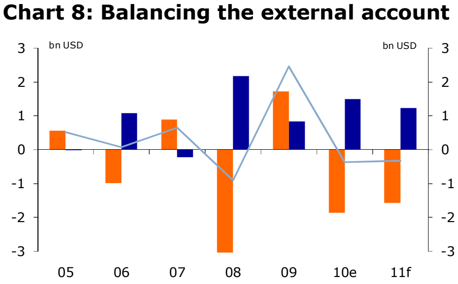
After a period of monetary tightening, the central bank of Sri Lanka (CBSL) shifted to a looser policy stance last August. In a surprise move, it cut the reverse repo rate by 50bps to 9.0%, while leaving the repo rate on hold at 7.25%. Room for monetary loosening exists as inflation has fallen in the course of the year. The annual gain in consumer prices has slowed from 6.9% in February to 4.3% in July. This is exceptionally low for Sri Lanka, as it is markedly under the average inflation rate of 12% in 2004-2009. The lower inflation rate is a consequence of the end of the civil war, which has opened up the North and the East of the country. These areas are dominated by agriculture, and therefore crop production has increased rapidly and has reduced the cost of food products. As food comprises 50% of the basket of goods in the consumer price index, inflation

Chart 7: Stock exchange



Source: Bloomberg

Chart 8: Balancing the external account



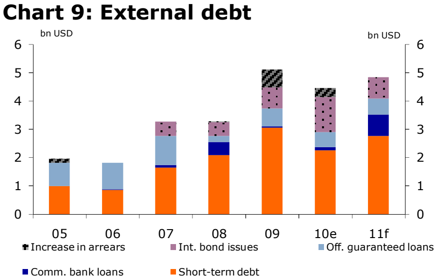
Source: EIU

slowed markedly. It is difficult to indicate whether further loosening will take place. Demand side inflationary pressures have not shown up yet leaving room for further rate cuts. However, private consumption and investment have been gaining pace and international food prices are expected to increase next year. As such the window for prolonged monetary loosening is limited.

Balance of Payments

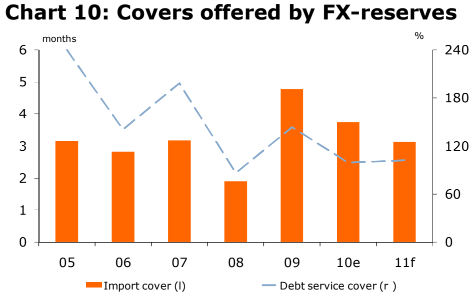
The current account has posted continuous deficits in previous years and this year will be no exception. The deficit is estimated at 5.6% of GDP in 2010, up from 3.9% of GDP in 2009.
The main culprit of the current account deficit is the trade balance, which is estimated to post a 9.1% of GDP deficit this year, up from a 6.3% of GDP deficit last year. The increase of the trade deficit is mainly attributable to higher global oil prices compared to last year and higher imports of machinery and transport equipment for the reconstruction of the Northern and Eastern provinces. Exports face a large downside risk now the EU has withdrawn the Generalized System of Preferences Plus (GSP+) status of Sri Lanka. The GSP+ status, which allows tariff-free access to EU markets, has been an important contributor to the success of the textiles and garments sector, which accounts for over half of total export earnings. Further adding to the current account deficit are the small deficits on the services and income balances, which are not estimated to change much this year. The largest pillar of support to the current account has been the transfer balance, which is estimated to decrease only slightly from a surplus of 7.0% of GDP in 2009 to 6.8% of GDP in 2010. The resilience of remittances in this respect has been surprising, given the fact that 90% of overseas Sri Lankan workers are employed in the Middle East, and the expected wave of lay-offs as the global crisis hit apparently did not occur.
FDI inflows have disappointed in the first half of the year, registering a decrease of 16.8% to USD 208m, nowhere near enough to cover the current account deficit. Uncertainty about the political situation was the main reason for the decline compared to last year, when FDI boomed on post-war optimism. Portfolio capital is also likely to fall compared to last year, when portfolio capital also boomed on post-war optimism. This led to a surge in the Sri Lankan stock exchange, which was with a annual gain of 125% one of the world's top performers in 2009. FX reserves stood at USD 4.9bn at the end of 2009 and are expected to fall to USD 4.5bn.

Chart 9: External debt



Source: EIU

Chart 10: Covers offered by FX-reserves



Source: EIU

External position

While the external position has improved from the dramatic situation of early 2009, it is still rather weak. Early 2009, a USD 2.6bn IMF loan averted a full blown balance of payments crisis. FX-reserves fell rapidly to cover imports by only 1.3 months. Now, FX-reserves cover imports by 3.7 months, which is a marked improvement but still not sound. Foreign debt has remained about the same compared to last year, at USD 17bn, equivalent to 36% of GDP. Of the total foreign debt, only a fraction is short-term debt (USD 2bn). Of the remaining USD 15bn medium to long-term debt, the public sector is the largest debtor. The debt service ratio has worsened to 99 in 2010 from 143 due to expensive loans issued by the government in the previous two years. Even so, global risk appetite seems sufficient to buy Sri Lankan government bonds. After successfully raising USD 500m in January, Sri Lanka plans to sell USD 1bn for a maturity of 10 years, which is very likely to succeed.

Rabobank

Sri Lanka

Selection of economic indicators	2005	2006	2007	2008	2009	2010e	2011f
Key country risk indicators							
GDP (% real change pa)	6.2	7.7	6.8	6.0	3.5	5.9	6.6
Consumer prices (average % change pa)	11.6	10.0	15.8	22.6	3.4	5.3	6.1
Current account balance (% of GDP)	-3.0	-5.7	-4.6	-9.5	-3.9	-5.6	-5.9
Total foreign exchange reserves (mln USD)	2650	2726	3380	2469	4930	4560	4230
Economic growth							
GDP (% real change pa)	6.2	7.7	6.8	6.0	3.5	5.9	6.6
Gross fixed investment (% real change pa)	9.8	12.9	9.1	5.3	1.3	10.6	9.6
Private consumption (real % change pa)	2.4	4.4	4.5	7.6	1.3	6.7	6.9
Government consumption (% real change pa)	9.1	25.0	4.7	9.5	20.1	3.3	3.3
Exports of G&S (% real change pa)	6.6	3.8	7.3	0.4	-12.3	3.0	8.5
Imports of G&S (% real change pa)	2.7	6.9	3.7	4.0	-9.1	7.2	9.1
Economic policy							
Budget balance (% of GDP)	-7.0	-7.0	-6.9	-7.0	-9.7	-7.9	-7.3
Public debt (% of GDP)	91	88	85	81	87	89	89
Money market interest rate (%)	10.2	12.9	30.9	21.2	10.0	9.6	9.1
M2 growth (% change pa)	19	18	17	8	20	19	12
Consumer prices (average % change pa)	11.6	10.0	15.8	22.6	3.4	5.3	6.1
Exchange rate LCU to USD (average)	100.5	103.9	110.6	108.3	114.9	112.9	113.3
Recorded unemployment (%)	7.7	6.5	6.0	5.2	5.7	5.5	5.3
Balance of payments (mln USD)							
Current account balance	-743	-1599	-1498	-3876	-1630	-2670	-3150
Trade balance	-1630	-2345	-2527	-4470	-2657	-4350	-4940
Export value of goods	6347	6883	7640	8137	6869	7360	8130
Import value of goods	7977	9228	10167	12607	9527	11700	13070
Services balance	-549	-769	-827	-999	-971	-460	-410
Income balance	-299	-388	-358	-972	-930	-1110	-1140
Transfer balance	1735	1903	2214	2565	2928	3250	3350
Net direct investment flows	234	451	548	690	442	590	620
Net portfolio investment flows	60	51	4	-662	871	-50	-130
Net debt flows	1007	116	1839	728	2038	250	1080
Other capital flows (negative is flight)	-27	1082	-221	2172	838	1490	1220
Change in international reserves	531	101	672	-948	2559	-390	-360
External position (mln USD)							
Total foreign debt	11262	11641	14003	15154	17196	17060	18220
Short-term debt	992	855	1632	2087	3049	2260	2760
Total debt service due, incl. short-term debt	1104	1943	1707	2864	3444	4590	4140
Total foreign exchange reserves	2650	2726	3380	2469	4930	4560	4230
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-6.7	-8.3	-7.8	-11.0	-6.3	-9.1	-9.2
Current account balance (% of GDP)	-3.0	-5.7	-4.6	-9.5	-3.9	-5.6	-5.9
Inward FDI (% of GDP)	1.1	1.7	1.9	1.8	1.1	1.3	1.2
Foreign debt (% of GDP)	46	41	43	37	41	36	34
Foreign debt (% of XGSIT)	113	106	113	114	140	124	120
International investment position (% of GDP)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt service ratio (% of XGSIT)	11	18	14	22	28	33	27
Interest service ratio incl. arrears (% of XGSIT)	1	2	2	3	3	3	3
FX-reserves import cover (months)	3.2	2.8	3.2	1.9	4.8	3.7	3.1
FX-reserves debt service cover (%)	240	140	198	86	143	99	102
Liquidity ratio	121	104	112	86	111	96	94

Source: EIU