HSBC Global Research

Sri Lanka Economics

A new chapter begins

- **The civil war is finally over, boosting confidence and leading to a rush to invest in Sri Lanka**
- **We think there are great untapped opportunities, however many challenges remain**
- **The end of the war has brightened the country's growth prospects; we look for GDP to average 4% this year (up from 3.2%), accelerating to 6% in 2010**

After 26 years of civil conflict the Government of Sri Lanka has succeeded in militarily defeating the Liberation Tigers of Tamil Elam (LTTE). The local equity market celebrated the development by rallying more than 6% intra-day.

The end of the war marks the beginning of a new chapter in Sri Lankan history and would allow the country to harvest its great untapped potential (see our detailed country report *Sri Lanka: Fighting the odds*, January 2008). However in order to move towards that target the government needs to create the right post-conflict environment by not only ensuring security, law and order and protection for the broader civilian population but most importantly a political solution to the ethnic problem. In this regard President's commitment to finding a "home grown" political solution and assurance of equal rights to all communities is positive.

Sri Lanka now finds itself in the spotlight and for the first time in years for something very positive. In our mind, the country has great potential to develop tourism and business process outsourcing, not to mention attract foreign direct investment into its manufacturing sector. Some concerns however remain about the country's twin deficits and we address them in detail here.

The growth outlook is more positive with massive reconstruction and rehabilitation work set to start, and the collapse in inflation and central bank policy easing helping as well. Overall then we look for economic momentum to pick up through the course of the year with GDP printing nearly 6% by 4Q. Our year-average growth stands at 4% and we estimate economic momentum will pick up even more in 2010 with growth averaging 6%.

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In the spotlight: Shining!

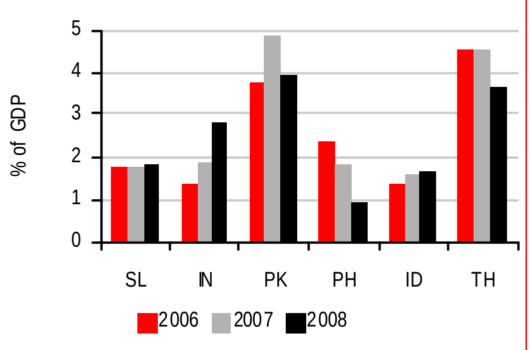
- Tourism, BPO and manufacturing are key sectors ripe for FDI
- At the same time public investment should get a boost as military spending is cut back
- Overall, we expect a rising investment share of GDP to raise the country's potential GDP towards 7-7.5%

Peace dividends

Now that the war is over, the key questions are where has Sri Lanka been missing out and where do the opportunities lie[1]. Our thoughts follow:

- For one, the country has not been able to attract much **FDI** on account of the war, despite a highly literate and easily trainable workforce and under-developed industrial base. Over the last three years Sri Lanka has on average received just USD550m in investment, roughly equivalent to around 2% of GDP (chart 1), compared with Pakistan's inflows of nearly USD6bn per year and the tremendous improvements seen in India .

1. Gross FDI inflows

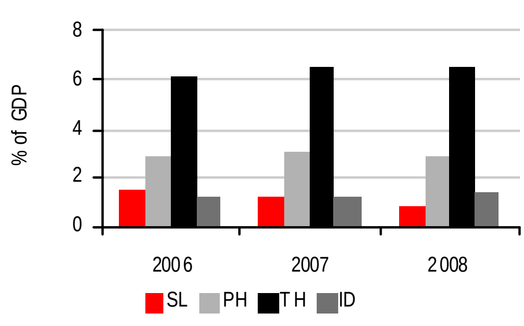


Source: CEIC, HSBC

- **Tourism revenues** have also been disappointing; despite having some of the best beaches in the region, tea gardens and Buddhist heritage sites. In 2008 Sri Lanka received only USD342m in tourism-related revenues, much lower than other destinations such as Indonesia, Thailand and the Philippines (chart 2). The war has kept visitors away; however we believe that if the security situation improves then the stage would be set for a substantial increase in inflows. The government is promoting Sri Lanka as an environmentally friendly place to visit. Note the sector remains attractive for FDI similar to what we have seen in Vietnam.

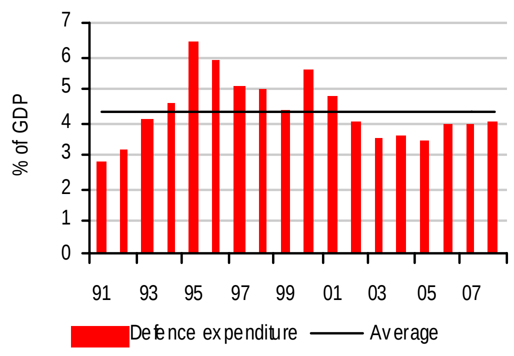
[1] For investment opportunities in the bond market see *Sri Lanka Local Rates: Searching for a peace dividend*, 19 May.

2. Tourism revenues: Sri Lanka lagging



Source: CEIC, HSBC

3. Defence expenditure set to slow



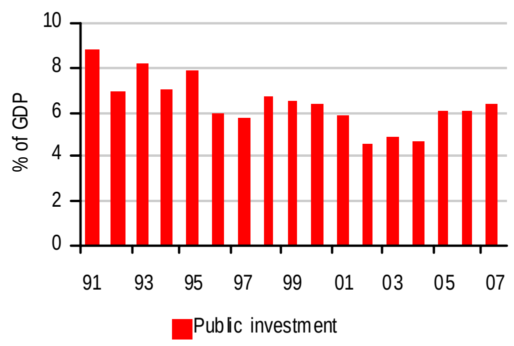
Source: CEIC, HSBC

- The other sector that has great potential is **exports of software** and IT enabled services such as IT-related **business process outsourcing (BPO)**. This reflects the availability of qualified engineers, high literacy rates, good English language skills, and liberalisation of the international communications gateway back in 2003. Here we think Sri Lanka can learn from the experience of India and if it wants to develop this industry then labour costs would need to be highly competitive.

- Over the last 26 years **massive resources** have been diverted to meet the needs of the military. In chart 3 we have shown **defence expenditure** as a percentage of GDP going back to 1991 – on average the country has spent more than 4% of GDP every year on equipment/artillery purchases and salaries of military staff. As a means of comparison Pakistan has been spending roughly 3% of GDP since 2000. No doubt both countries needed this expenditure but this does emphasise the high financial cost of war not to mention the loss of life and high quality labour on account of emigration. Over time we think there is scope to cut back on military expenditure, however in the near term security concerns and counter-insurgency measures would probably remain.

- Additionally as capital is freed up from military expenditure, the government should be able to divert more to boost investment in the economy (chart 4) to ease infrastructure bottlenecks and also to aid reconstruction efforts. Note public investment levels in Sri Lanka have been high for a country in civil war for so long; at 6% it is roughly similar to the level in India but behind Vietnam (10%), suggesting scope for further improvement.

4. Public investment: scope for improvement



Source: CEIC, HSBC

In embarking upon this new chapter the country faces a number of challenges. In table 5 we have shown the most problematic factors for doing business in Sri Lanka according to the World Economic Forum's executive opinion survey for 2008-09. In addition investors have concerns about the country's high budget deficit and external funding constraints – we look at each of these in detail below.

5. The most problematic factors for doing business in Sri Lanka

Inflation	20.0
Corruption	11.5
Tax rates	10.4
Tax regulations	9.9
Policy instability	7.8
Access to financing	7.3
Inefficient government bureaucracy	6.4
Government instability/coups	6.3
Inadequate supply of infrastructure	5.7
Poor work ethic in national labour force	4.0

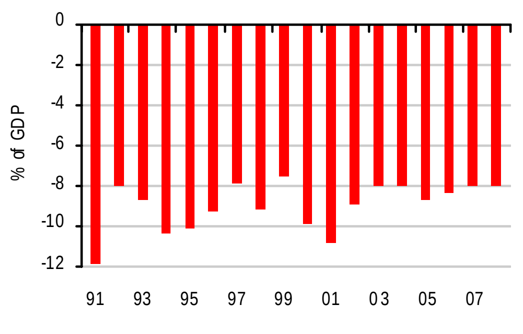
Source: World Economic Forum Competitiveness Report 2008-09

Fiscal constraints

The Sri Lankan authorities are well aware of the need for fiscal consolidation and debt reduction as laid out in the Fiscal Management Responsibility Act of 2003 and further enhanced by the current government's Medium-Term Macro Fiscal Framework (MTMFF) set out in 2006.

It is fair to say that some progress has been made in reducing the budget deficit (chart 6), however over the last two years the main aim of the government has been to end the war, so putting fiscal consolidation on the backburner. Now that the war is over there is hope that the government will renew its efforts to reign in the budget deficit. Much remains to be done in terms of rationalising the tax structure, broadening the tax base, cutting subsidies and most importantly reducing the government's high salary and interest bill.

6. Budget deficits remain large



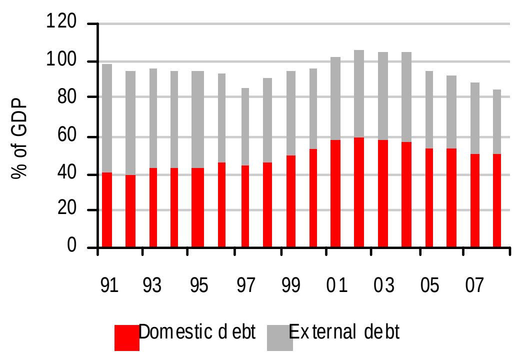
Source: CEIC, HSBC

According to the government's latest MTMFF (2008-11), the aim is to bring down the budget deficit to 5% by 2011, something which was originally meant to have been achieved in 2006, leaving us a little sceptical about the extent of fiscal consolidation the authorities will be able to achieve. However it is fair to say that military expenditure will reduce over time while at the same time government revenues will get some support as the renewal effort boosts growth.

But one has to bear in mind that the capital needs of the reconstruction and rehabilitation purposes will be immense. There is no doubt that Sri Lanka will receive a fair bit of overseas development assistance in these efforts. However given its middle-income status (GDP per capita above USD1000) since 2004, the extent of concessional financing that it can get will reduce.

Consistently large budget deficits have resulted in Sri Lanka having one the highest debt to GDP ratio in the region. The government has been able to reduce the ratio from more than 100% in 2004 to 85% at the end of 2008 (chart 7). However this is more a function of relatively higher growth in *nominal* GDP than growth in the outstanding level of debt. The only means of actually reducing the debt is fiscal consolidation where much progress is needed.

7. Public debt to GDP ratio has improved



Source: CEIC, HSBC

The other point worth highlighting is that in recent times the government has increased the use of foreign-currency financing to reduce domestic crowding-out. According to the IMF's 2008 Article IV consultation the total stock of public commercial dollar debt was USD 3.5bn (8.3% of GDP) at the end of 2008 up from USD 2.8bn at the end of 2007. However this can pose significant risks especially given the shorter tenors, large current account deficit and low levels of reserves. This takes us to the second issue that we want to talk about – the balance of payments.

Balance of payments

Sri Lanka saw a balance of payments deficit of USD1.3bn in 2008 (3.3% of GDP) on the back of a large trade deficit given the price spike in oil and food related commodities and rising offshore interest payments. In order to get a handle on what lies in store for 2009 we thought it useful to highlight the trajectory of the main components:

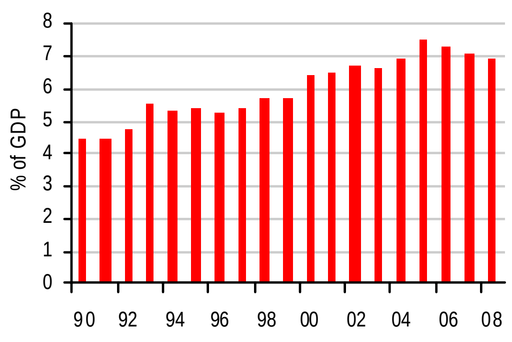
- **Exports** contracted by an average 13% y-o-y in 1Q but with **imports** falling by 27% y-o-y, the trade deficit narrowed to USD645m compared with a shortfall of USD1.4bn in the same period last year. Looking ahead we expect exports to remain weak given that nearly 60% of the shipments from the country are headed to the US and Europe combined. However we expect imports to decline by more aided by not only lower petroleum and food prices but also lower demand for export inputs and consumer goods (note imports of construction materials are set to increase). Overall we look for the **trade deficit** to narrow to around USD4.8bn from USD5.8bn last year.

8. Exports and imports have collapsed

Source: CEIC, HSBC

- A key source of financing is **remittances** from offshore Sri Lankans (chart 9), with the country receiving USD2.6bn last year. Remittances have started 2009 on a relatively good footing, with inflows being USD774m in 1Q, just 2% below levels seen in the same period last year. Looking ahead, inflows are going to feel the dampening impact of rising layoffs across the globe; however one should not underestimate the impetus to send more money home now that the war is over.

9. Remittance inflows remain strong

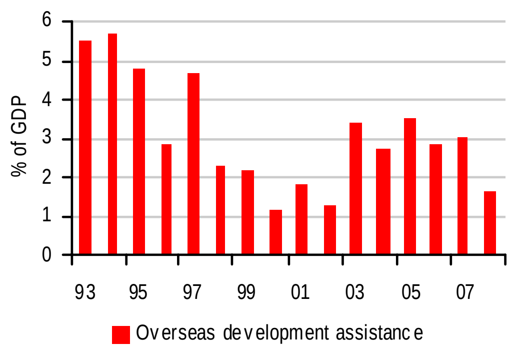


Source: CEIC, HSBC

- On the capital account side, **FDI flows** have averaged USD550m over the last few years. Given the current financial crisis FDI could be weaker this year. However going into 2010 we think there is substantial scope for pick-up as businesses look for investment opportunities in Sri Lanka, not to mention offshore Sri Lankans planning to come home.

- Sri Lanka has also been a key recipient of **overseas development assistance** (chart 10), averaging USD800m since 2005 and we believe that the pace of disbursement will pick up given large reconstruction and rehabilitation needs post the conflict.

10. Overseas development assistance



Source: CEIC, HSBC

- **Portfolio inflows** have increased significantly into the equity and bond market in response to the end of the war and as risk appetite globally has seen some improvement recently. This has seen the Sri Lankan rupee appreciate to 115 to the US dollar from 120 previously. Needless to say portfolio flows are extremely volatile and unreliable, as we saw last year.

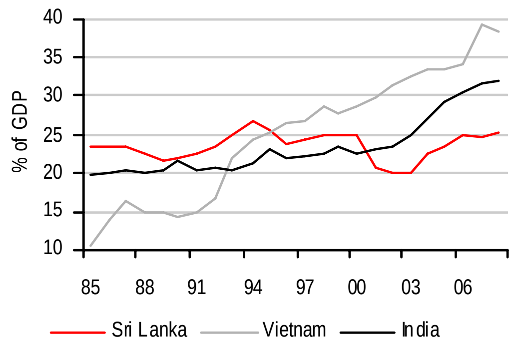
- The country also has a fair bit of **short-term debt** falling due in 2009 – according to S&P it is USD900m and according to IMF Article IV Consultation 2007 it is USD800m. This compares with **FX reserves** of USD1.4bn as of end March which is equivalent to 1.3 months worth of imports based on 12-month average of imports of USD1.1bn. Note however that FX numbers are probably dated now given the portfolio inflows discussed above and the central bank's indication that it has been building reserves rapidly now in order to keep the rupee competitive.

- As has been well publicised, Sri Lanka is in talks with the **IMF** for a **standby facility** worth USD1.9bn for balance of payments support. Although no final decision has been made, the central bank is confident that the facility will go through and we share its view.

Growth prospects

With the end of the war the country's growth prospects have brightened, not only in the near term on account of the reconstruction and rehabilitation work but also longer term as greater investment boosts productive potential.

11. Raising the investment share of GDP is key



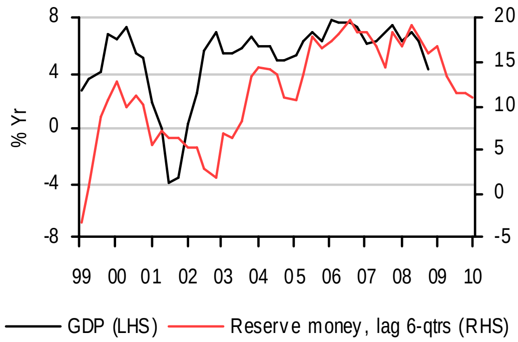
Source: CEIC, HSBC

In chart 11 we have shown the share of gross fixed capital formation in GDP. For Sri Lanka to have maintained this ratio between 20-25% has been an achievement but for it to really move into a high growth status like India or Vietnam, the country needs to see investment to GDP ratio in the range of 32-40%, which we think would be possible over the coming years as FDI inflows and public investment pick up whilst at the same time more of domestic capital is invested at home.

It is also worth highlighting that although productivity levels in the country have risen to around 4% or so they are still below that in Vietnam (6%) or in China (10%) so scope for improvement remains. Assuming rising productivity and higher capital base we think the country can see its potential GDP rise to 7-7.5%.

Having discussed more long-term growth issue we now want to discuss the country's near-term growth prospects. Looking back growth momentum slowed through 2008 with the economy expanding by only 0.1% q-o-q in seasonally adjusted terms or 4.2% y-o-y in 4Q08 given the dampening affect of the tight monetary policy maintained by the central bank (chart 12) and also weakness in external demand.

12. GDP lags reserve money growth

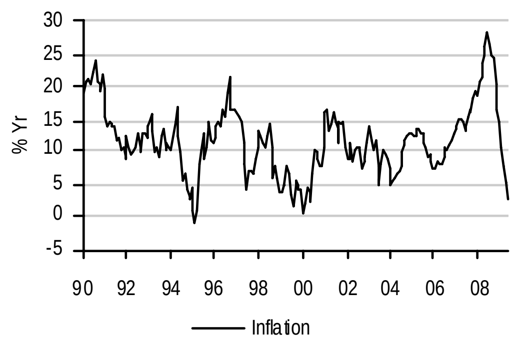


Source: CEIC, HSBC

These effects are expected to exert downward pressure 2009 as well; however the collapse in inflation (chart 13) is boosting real disposable incomes at home, thereby supporting consumption spending. Credit growth is also showing signs of picking up given easing market interest rates as the Central Bank of Sri Lanka loosened monetary policy aggressively.

The biggest boost to growth however will no doubt come from the positive spill over from the end of the war – reconstruction/rehabilitation work, increased investment and a rise in animal spirits at home.

13. Inflation: Sharp turnaround



Source: CEIC, HSBC

Overall then we believe that Sri Lanka is capable of clocking growth of around 4% in 2009 (revised up from our last published forecast of 3.2% in the *Asian Economics Quarterly*, 2Q 2009) with growth accelerating to an average of 6% in 2010.

14. Sri Lanka main forecasts

	2008	2009 (new)	2010 (new)	2009 (old)	2010 (old)
GDP y-o-y	6.0	4.0	6.0	3.2	5.0
Inflation y-o-y	22.7	2.6	10.4	4.3	9.4
Budget balance (% GDP)	-8.1	-7.9	-7.7	-8.0	-7.5
Public debt (% GDP)	85.1	82.0	78.0	82.1	77.8
Current account balance (% GDP)	-10.2	-6.7	-7.0	-7.1	-7.5
FDI (% GDP)	1.9	1.5	2.2	1.2	1.5

Source: CEIC, HSBC estimates

Disclosure appendix

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