SRI LANKA ECONOMICS - A NEW CHAPTER BEGINS

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Sri Lanka: A new chapter begins

- 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 & productivity to raise the country's potential GDP towards 7-7.5% per annum

In the spotlight: Shining!

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 should allow the country to harvest its great untapped potential (see HSBC's 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 the 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.

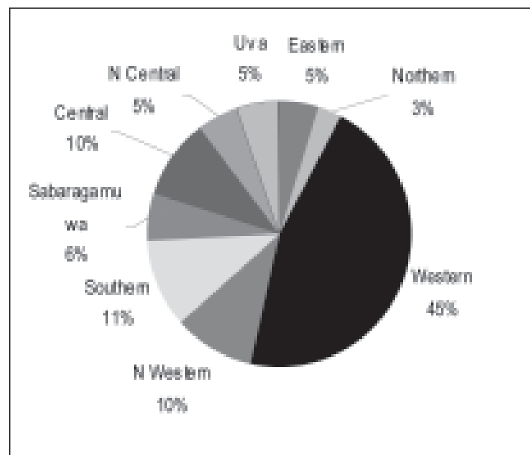
The growth outlook is more positive with massive reconstruction and rehabilitation work set to start, and the collapse in inflation and central bank policy easing helping as well. Overall then we look for economic momentum to pick up through the year with our average 2009 GDP growth forecast being 3.7% per annum. We estimate economic momentum will pick up even more in 2010 with growth averaging 7% per annum.

Peace dividends

Now that the war is over, the key questions are where has Sri Lanka been missing out on and where do the opportunities lie?

First, the end of the war means that the reclaimed regions in the North and East, which make up roughly one-third of Sri Lanka's coast line and its land mass, can be economically and socially integrated back to the country. Currently these regions contribute only 8% to national GDP (chart 1).

1. GDP by province (2008)



Source: Central Bank of Sri Lanka

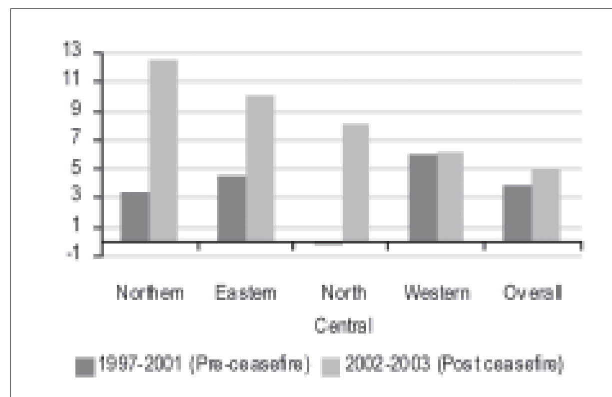
The economic structure of the North and the East is largely rural with proximity to beaches and the ocean. The latter suggests that there is huge scope to boost the fisheries industry, obviously along the coast-line but also inland water fishing along rivers and tanks' once de-mining is done. Tourism can get a big boost as well, especially in the East, where the beaches are very flat with comparisons often made with the Maldives.

The liberated areas, especially the North, have very fertile lands, though agricultural productivity over the years has been very poor on account of a consistent lack of investment. Clearly the potential here is very high as long as the government makes investment in building rural/agricultural infrastructure.

A key question is how much can the areas actually add to GDP. It's a difficult one to answer but we can look back to the period just after the cease-fire in 2002 to get a better handle on this.

Chart 2 draws from a World Bank study which shows that the economic performance of the North (up 9.2ppts) and East (up 5.5ppts) improved dramatically in the 2002-03 period. Given that the war has now ended the boost to growth should be much more substantial and more importantly sustainable.

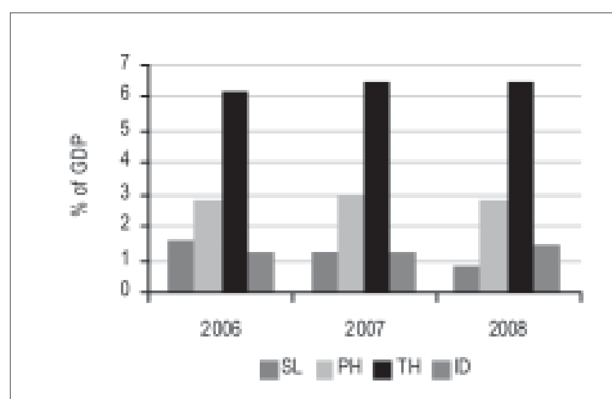
2. Cease fire growth boost was roughly 1.1ppt



Source: World Bank

In terms of the sectors, **tourism** is obviously one of the main sectors that has been impacted by the war, with revenues being disappointing. In 2008 Sri Lanka received a paltry USD 320mn in tourism-related revenues, much lower than other destinations such as Indonesia (USD 7.4bn), Thailand (USD 17.6bn) and the Philippines (USD 4.4bn), see chart 3.

3. Tourism revenues: Sri Lanka lagging



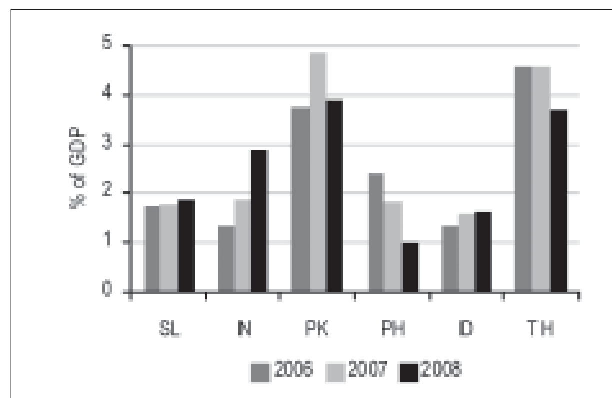
Source: CEIC, HSBC

Since the war has ended there has been some rise in the tourist inflows and we believe that the potential is immense given that Sri Lanka has some of the best beaches in this part of the world, particularly in the eastern part of the country and also tea gardens, wildlife, Buddhist heritage sites etc. But for the country to be able to fully exploit these resources it needs to improve not only the security situation but infrastructure as well.

Currently there are some 2mn Sri Lankan's who live off-shore and even if 10% plan to visit the country that should see 200k tourists coming in. Note; the government is promoting Sri Lanka as an environmentally friendly place to visit.

Sri Lanka also has not been able to attract much **foreign direct investment** (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 an average received just USD550m in investment, roughly equivalent to around 2% of GDP (chart 4), compared with Pakistan's inflows of nearly USD6bn per year and India's bumper USD 31bn inflow last year. Note the tourism sector is very attractive for FDI similar to what we have seen in the case of Vietnam.

4. Gross FDI inflows



Source: CEIC, HSBC

The other sector that has great potential is **knowledge based outsourcing**; mainly finance and accounting off-shoring given that the country has the 2nd largest pool of UK qualified accounting professionals in the world. The country can also export software and IT enabled services given the availability of qualified engineers and liberalisation of the international communications gateway back in 2003.

According to the AT Kearney Global Services Location Index (GSLI), which ranks the top 50 outsourcing destinations globally, Sri Lanka ranked 16th in the 2009 edition (done before the end

of the war) compared with 29th in 2007 – the upgrade largely reflecting its comparative lower costs. The other key advantages of Sri Lanka being its proximity to India and the government's continued support and commitment to the industry.

5. AT Kearney Global Services Location Index (GSLI)

	2009	2007
India	1	1
China	2	2
Malaysia	3	3
Thailand	4	4
Indonesia	5	6
Egypt	6	13
Philippines	7	8
Vietnam	10	19
Mexico	11	10
Brazil	12	5
US	14	21
Sri Lanka	16	29
Romania	19	33
Pakistan	20	30
Mauritius	25	25
Russia	33	37
Singapore	35	11
Poland	38	18
Ukraine	42	47
Ireland	48	50
Portugal	50	46

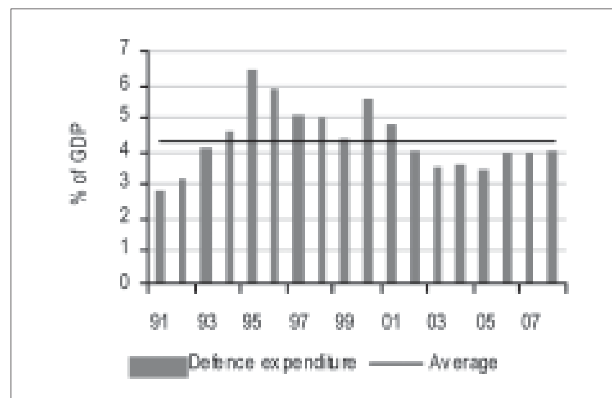
Source: AT Kearney

We also believe that the **agricultural sector** has the potential to develop further, especially moving towards more value added products. For example the Sri Lanka Tea Board is promoting the production of instant tea and ready to drink green tea beverages as Sri Lankan green tea has higher amounts of polyphenols compared with Chinese or Japanese green tea. Overall we believe that investment in branding is the key issue going forward. Here Dilmah tea is an excellent example. There also exists opportunities for investment in tea, rubber and the fisheries sector. Already some private equity funds are looking into these.

The end of the war not only opens opportunities in the various parts of the economy, some of which are discussed above, but also allows the re-orientation of massive resources away from the war and towards public investment. In chart 6 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.

6. Defence expenditure set to slow

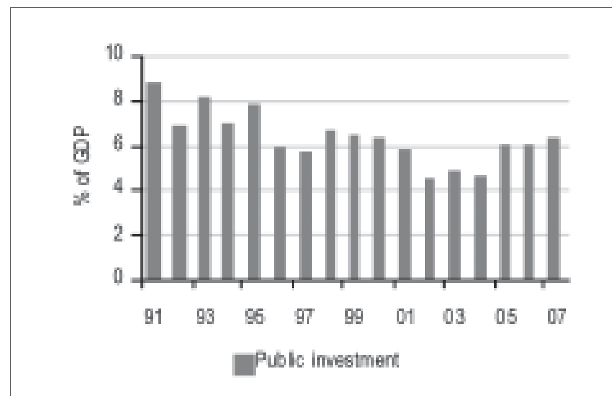


Source: CEIC, HSBC

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 as the security situation improves. Already we have seen some savings on account of lower artillery replacement needs.

As the capital is freed up from military expenditure, the government should be able to divert more to boost investment in the economy (chart 7) 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.

7. Public investment: scope for improvement



Source: CEIC, HSBC

In embarking upon this new chapter the country faces a number of challenges. In table 8 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.

8. 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

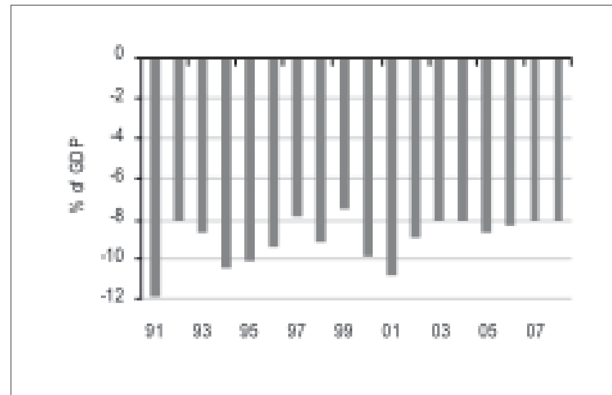
Source: World Economic Forum Competitiveness Report 2008-09

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 9), 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.

9. Budget deficits remain large



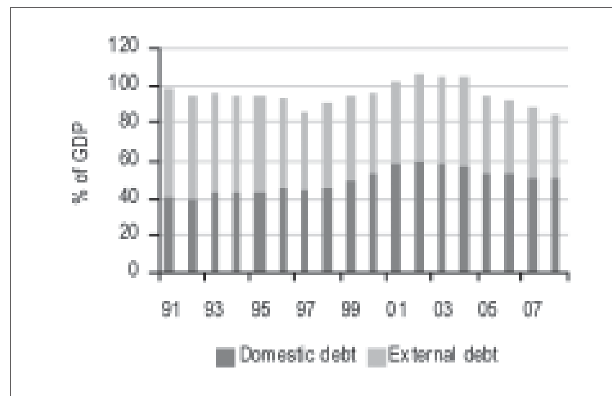
Source: CEIC, HSBC

According to the government's latest MTMFF (2008-11), the aim is to bring down the budget deficit to 5% of GDP by 2011, something which was originally meant to have been achieved in 2006. However, this time around the government is addressing the issue with renewed impetus – having already taken a number of measures to demonstrate its commitment such as introducing a nation building tax and raising excise duties on liquor, cigarettes and other consumer items etc. The fact that the war is over and the 5% target is also an important part of the IMF's 20-month USD 2.6bn stand by facility, we think greater strides should be made in the right direction.

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, but initially some part would have to come from the government. Note that Sri Lanka achieved middle-income status (GDP per capita above USD1000) in 2004, however it has continued to receive a fair bit of concessional financing first on account of the tsunami and should continue to do so now given its post-conflict status.

Consistently large budget deficits have resulted in Sri Lanka having one of 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 10). 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 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.

10. Public debt to GDP ratio has improved



Source: CEIC, HSBC

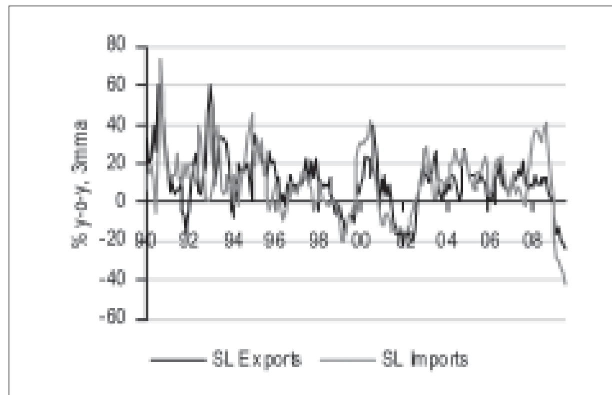
The other point worth highlighting is that in recent times the government has increased the use of foreign-currency financing to reduce domestic crowding-out. According to the IMF's 2008 Article IV consultation the total stock of public commercial dollar debt was USD 3.5bn (8.3% of GDP) at the end of 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 rest of 2009 we thought it useful to highlight the trajectory of the main components:

- **Exports** have contracted by an average 18% y-o-y in first half of the year but with **imports** falling by double that pace, the trade deficit narrowed to USD 1.3bn versus a shortfall of USD 3.1bn in the same period last year. Going forward the outlook of exports should improve, consistent with some stabilisation in US and Europe (60% of exports). Imports are also expected to turn up given movements in food and oil prices. Overall, however, we think the trade deficit for 2009 will be just over USD 4bn compared with nearly USD 6bn last year.

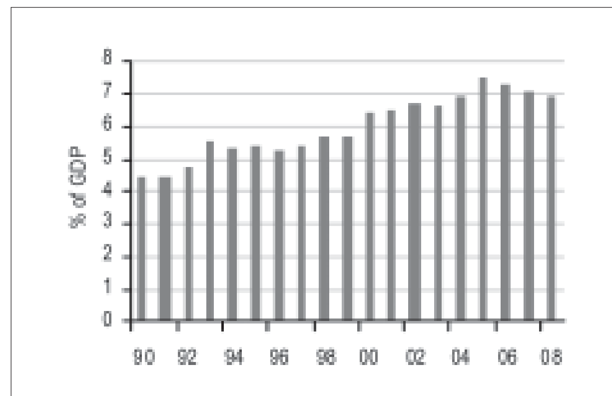
11. Exports and imports have collapsed



Source: CEIC, HSBC

- A key source of financing is **remittances** from offshore Sri Lankans (chart 12), with the country receiving USD2.6bn last year. Remittances have started 2009 on a relatively good footing, with inflows being USD 1.6bn in the first six months, up 5.4% compared with the same period last year. We ourselves have been much more conservative in the remittance outlook this year given rising layoffs across the globe; however the impetus to send more money home now that the war is over should not be underestimated.

12. Remittance inflows remain strong

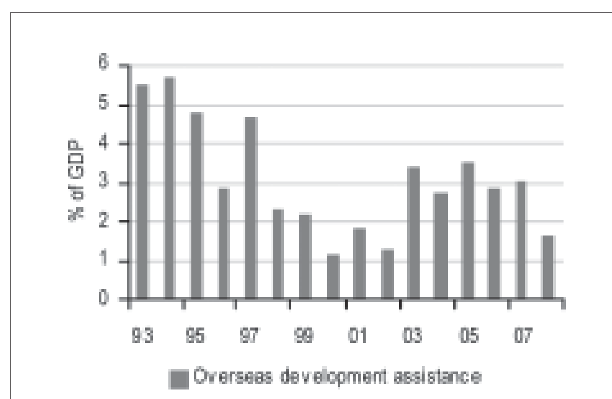


Source: CEIC, HSBC

- 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 conflict.

13. Overseas development assistance



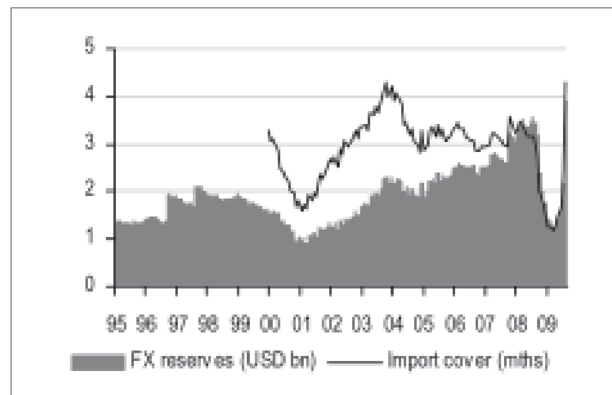
Source: CEIC, HSBC

- **Portfolio inflows** have increased significantly, especially to the bond market, since the end of the war. This has been applying upward pressure to the Sri Lankan rupee, but little has been passed through given the central bank's aggressive internvention by USD purchases.

- Sri Lanka received the much talked about **IMF stand-by facility** of USD 2.6bn, more than the initially stated figure of USD 1.9bn. This has provided immediate support to the country's FX reserves and more importantly to off-shore investor sentiment.

- 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** reaching a record USD 3.9bn at the beginning of September which is equivalent to over 4-months of imports based on 12-month average of imports of USD1bn.

14. FX reserves have risen sharply

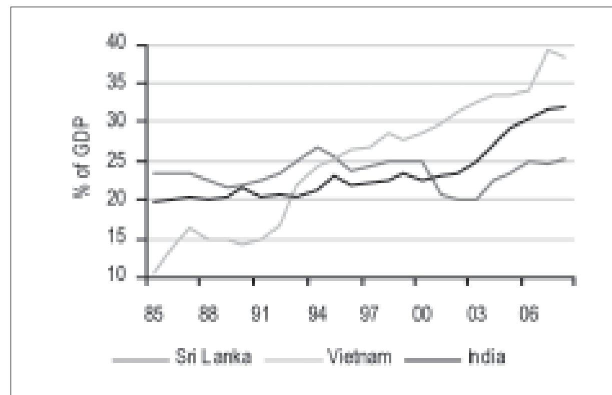


Source: CEIC, HSBC, CBSL

Long-term 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 the liberated areas start contributing to the economy and greater investment boosts productive potential.

15. Raising the investment share of GDP is key



Source: CEIC, HSBC

In chart 15 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 domestic capital is invested at home.

Looking at the labour side of the equation, currently around 42% of the population is under the age of 25yrs. Based on United Nations population projections the share of working age population in the total population will remain at roughly 60% in 2030, which is comparable to that of China or Vietnam. But with roughly 20% of the population being more than 60-years of age by then, the fiscal burden will no doubt increase. This is something which the government needs to plan for overtime.

The country has also made strides in boosting productivity with it growing by roughly 5% over the last five years compared with an average of 3% since 1991. This however is still below that in Vietnam (6%) or in China (10%) so scope for improvement remains. Assuming rising productivity and a higher capital base we think the country can see its potential GDP rise to 7-7.5% over the coming period.