A JKSB Research Publication

Economic Update

- Through the years of war, the Sri Lankan economy has been described as resilient. Indeed, a CAGR of 6.42% during the last five years, that's during the height of war, proves it. **The war is over**. 28 years of wishful thinking is now, reality. Its early days yet, but our preliminary analysis is encouraging, global doom notwithstanding.

- The immediate focus will be on reconstruction of the North and East, home to approximately 13.5% of the population and some of the country's most fertile agricultural and fishing grounds and mineral deposits. The "*Nagenahira Navodaya*" program of the GoSL for the rebuilding of the Eastern Province alone requires an estimated 197b LKR. The Northern Province requirements are still sketchy, but the region saw the heaviest of the fighting. On our estimates, the base case rebuilding of the two provinces is the equivalent of 4% of nominal GDP per year for over the next 2-3 years. Several large scale infrastructure projects are on the pipeline with funding commitments in place from foreign sources. We upgrade our GDP estimates for CY09 to 4.3% from 2.5%. CY10 stands at 8.6%.

- Inflation has, as anticipated, dropped sharply, pulled down by falling costs. The CCPI on a point to point basis has fallen for ten straight months from a high of 28.2% in June 2008 to 2.9% in April 09. Interest rates have started its descent after a lag. The benchmark 364 day Treasury bill has shed over 500bps YTD to stand at 13.4%.

- Revenue shortfalls saw the Budget deficit come in at 7.7% GDP in CY08. Revenues are likely to remain under pressure in CY09. In the past, the Government has had the flexibility of adjusting its capex budget to prevent wide deficits. With rebuilding requirements, that flexibility reduces, leading to a 9.4% deficit for CY09 on our estimates. Longer term revenues should however have an easier path once the post war economy revs up.

- The trade deficit has narrowed by 54% for the first 3 months of the year as imports have fallen sharper and exports lesser than feared. Whilst the rebuilding drive should pep up imports hereafter, the CY09 deficit is still expected to come in 39% below CY08. Capital outflows during the height of the global financial crisis saw the BOP turn a negative US$1225m after a three year positive trend. Reserves have dropped to approximately 1.3x of average 12 month trailing imports, which however includes the period of the country's largest ever import bills. Whilst initial jitters sent the rupee on a 6.25% depreciation against the greenback in April, short term aid flows and loan arrangements with India have seen it stabilize since, with an overall 1.8% depreciation against the greenback YTD. Negotiations are underway with the IMF for a standby structural loan of US$1.9b. If aid flows to the affected areas, shorter term worries can be negated, as evidenced in May.

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June 2009

GDP Growth

After 28 years, the country is rid of war. So, what's in store now?

- For starters, lets keep in mind, that even during the period of war, the economy grew at an average 4.8%. Over the last 5 years the economy ticked over at an average 6.42% growth, through a combination of domestic and external drivers.
- Looking at the short term, the dampener is that globally, times are bleak. We do not presume nor claim expertise in global economics and will take the assumption that things have bottomed out, but a recovery, if any, will take place only in CY2010. But, we will not bank on it. So we look inwards, and see what's on the table without the shackles of war.
- The East was cleared in CY2007. Plans were drawn up for its reconstruction under the government's "*Nagenahira Navodhaya*" program. Now that war is history, this can be implemented in full. The action plan for the reconstruction of the North is to be presented by the GoSL in the near future. Information is sketchy at best so here we will make do with base assumptions.
- The total investment for the strategies of the "*Nagenahira Navodaya*" is estimated at LKR 197b inclusive of:
  - Reconstruction of approximately 120,000 houses
  - Increasing access to electricity in the province from 58% to 70% by 2010
  - Rehabilitation where required of the network of 857km of national highways, 1099km of rural roads and 8450 kms of feeder roads.
- A base case assumption of half that estimate spread over the next two years, equates to 2.2% of nominal GDP per year. The North suffered much more. Approximately 250,000 people are displaced as opposed to an estimate of 105,000 IDP's in the East. Even at a minimum assumption of an equivalent cost of rebuilding as to the East, this would add in another 2.2% to nominal GDP from 2010.
- The Eastern province also is home to some of the most fertile agricultural and fishing grounds in the country, which gradually can be re-cultivated and harvested, without the severe restrictions in place during the war. The two provinces also house the country's silica, limestone and copper deposits.
- The total population in the two provinces is estimated at 2.7m or approximately 13.5% of the total population of the country. The scope for internal trade from a low base is significant. Fixed line penetration is approximately 1% in the Northern Province offering potential for the telecommunications sector. Keeping in mind that a significant portion of the households in the Northern Province have family members overseas, the speed of personal recovery and re-building will be considerably fast. The scope for the Banking Sector in the region is underlined by the approval for the opening of 67 new bank

branches in the Northern Province within the first 3 weeks of the end of the war as opposed to 136 branches being opened during the entire CY2008.

- We also believe that some of the best beaches in the country are found in the eastern province where investment can stream, once confidence returns.
- In addition, several large scale infrastructure projects are on the pipeline, with foreign funding commitments.

Infrastructure Projects

Ongoing	Proposed
Roadways	
Colombo - Matara Expressway - 128 km Estimated Cost US$585m, funded 70% by the ADB & JBIC and 30% by the GoSL Approx 50% completed. Scheduled for completion by 2011 **Flyovers** Target of 17 flyovers in Colombo & Suburbs 2 already Completed **Colombo - Katunayake Expressway - 25km** Estimated Cost US$235m, funded by the EXIM Bank of China and the GoSL Expected to be completed in 2012	**Katunayake - Anuradhapura Highway** Estimated Cost US$40m, funded 80% by the Government of Korea and 20% by the GoSL
Power Projects	
Kerawalapitiya Power Plant - 300MW Combined Cycle Estimated Cost US$300m, funded 97% by West Coast Power Ltd and 3% by the GoSL Part Commissioned **Upper Kotmale Hydro Power Plant - 150 MW Hydro** Estimated Cost US$332m, funded 70% by the ADB & JBIC and 15% by the GoSL Expected to be completed in 2011 **Norochcholai Coal Power Plant - First Stage 300MW** Estimated Cost US$450m, funded 97% by EXIM Bank of China and 3% by the GoSL Expected to be completed in 2011	**Coal Power Plant - Trincomalee - 500MW** Estimated Cost US$520m, funded jointly by the GoSL and India Expected to be completed in 2012
Sea Ports	
Hambantota Port Development Estimated Cost US$370m, funded 80% by EXIM Bank of China and 20% by the GoSL Expected to be completed in 2011 **Galle Port Development** Estimated Cost US$146m, funded 80% by JBIC and 20% by the GoSL	**Colombo Port Expansion** Estimated Cost US$750m, to be funded 38.5% each by ADB and selected Private Investors and 23% by the GoSL Construction of breakwater has commenced. **Oluveli Port Devleopment** Estimated Cost US$53m, funded 80% by Denmark and 20% by the GoSL
Other	
	Jaffna Water Supply Scheme Estimated Cost US$100m, funded by ADB (80%) and the GoSL Expected to be completed in 2012 **Moragahakande & Kalu Ganga Development** Estimated Cost US$425m, funded by the GoSL, JBIC and the Government of Kuwait

- We increase our GDP estimates for CY09 from 2.5% to 4.3%, driven primarily by the reconstruction activity and a pick up in agriculture, despite shortfalls in tea production. The medium term outlook thereafter should average 8-10%, externalities notwithstanding. The real strides in the two provinces will be seen only when reconstruction starts in earnest in CY2010 and the effects of the strides in the two provinces roll over to jack up confidence and hence economic activity elsewhere in the island.

GDP Growth (%) Sector	2001	2002	2003	2004	2005	2006	2007	2008	2009E	2010E
Agriculture	-3.0	2.5	1.6	-0.9	1.9	4.7	3.3	7.5	7.7	8.9
Mining & Quarrying	0.7	3.0	5.6	7.9	14.1	8.0	19.2	12.8	5.0	6.0
Manufacturing	-4.0	1.1	4.2	5.1	6.0	5.3	2.4	4.9	3.8	4.6
Construction	2.5	1.0	5.5	6.6	8.9	8.0	9.0	7.8	8.5	15.0
Services	-0.6	6.0	7.9	7.6	6.8	8.7	7.6	5.3	2.9	8.8
GDP Growth	**-1.4**	**4.0**	**6.0**	**5.3**	**6.0**	**7.4**	**6.8**	**6.0**	**4.3**	**8.6**

Fiscal Deficit

- Government revenues came under pressure in the final quarter of CY08, pruning down nominal growth to 15% for the year, which as a percentage of GDP, slipped from 15.8% in CY07 to 14.9% GDP in CY08. Despite the escalation of the war, recurrent expenditure was kept in check, coming in just 4% above the budget for the year. Drying up foreign funding and decelerating domestic revenue collection kept capital expenditure at 6% GDP, with the deficit for the year at 7.7% GDP, just under our estimates of 7.8%. In the face of difficulties in obtaining foreign funding in the wake of the ongoing global problems, the reliance on domestic market borrowings increased from LKR 127b in 2007 to LKR 309b in CY08.

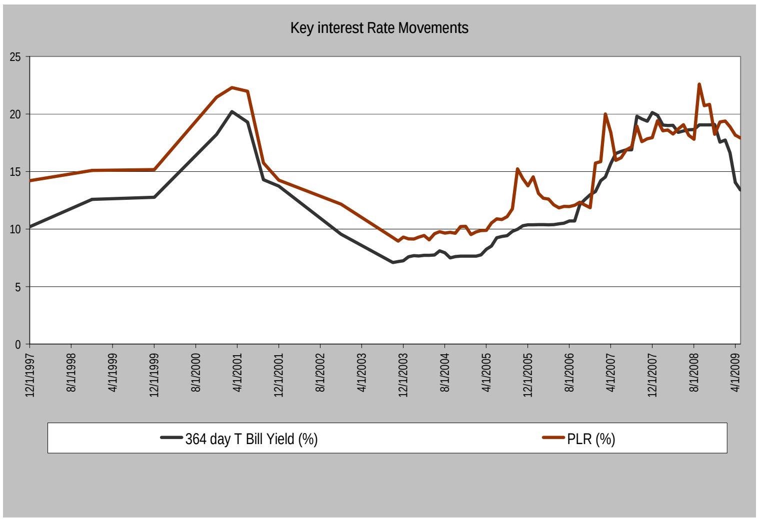
- The approved estimates for CY09 points to a revenue base of 16.4% GDP and a deficit of 6.5% with current expenditure budgeted at 15.8% GDP and capital investment at 7.1% GDP. The slowdown in the economy in the first half makes a targeted nominal revenue growth of 30% a stiff target. In the past shortfalls in revenue collections have been shored up at the expense of capital spending, which in the face of the large scale reconstruction effort envisaged, make difficult to prune down. Our revenue estimates stand at 14.8% GDP with the increased capital spending requirements pushing the deficit to 9.4% GDP in CY09.

Government Finance (% of GDP)	2001	2002	2003	2004	2005	2006	2007	2008	2009E
Revenue	16.7%	16.5%	15.2%	14.9%	15.5%	16.3%	15.8%	14.9%	15.1%
Tax revenue	14.8%	14.0%	12.7%	13.5%	13.9%	14.6%	14.2%	13.3%	13.4%
Non tax revenue	1.9%	2.5%	2.5%	1.4%	1.6%	1.7%	1.7%	1.6%	1.7%
Total expenditure	27.5%	25.4%	22.9%	22.8%	23.8%	24.3%	23.5%	22.7%	24.5%
Current expenditure	21.6%	20.9%	18.4%	18.6%	18.1%	18.6%	17.4%	17.0%	17.0%
Current Account deficit	-4.9%	-4.4%	-3.2%	-3.7%	-2.6%	-2.4%	-1.6%	-2.2%	-1.8%
Budget deficit	-10.8%	-8.9%	-7.7%	-7.9%	-8.4%	-8.0%	-7.8%	-7.7%	-9.4%

Interest Rates

- The continuous fall in price levels is building up confidence in the sustainability of benign inflation and the logic of maintaining high rates to attract foreign investment into the short term bond market window have disappeared with the global crisis. The benchmark 364 Treasury Bill rate have progressively come off despite high government borrowing, climbing down from 19.08% as at end CY08 to 13.40% as at end May CY09. The short term reliance on market borrowings by the government will however prevent a steeper fall in line with inflation.

- The PLR has been less responsive as banks have shied away from aggressive lending amidst fears of the global downturn triggered NPLs. With improvements in domestic sentiment, banks are likely to ease off on lending restrictions leaving the PLR room to ease off by approximately 200-300bps. However, a faster reduction will come through only when the global front clears.

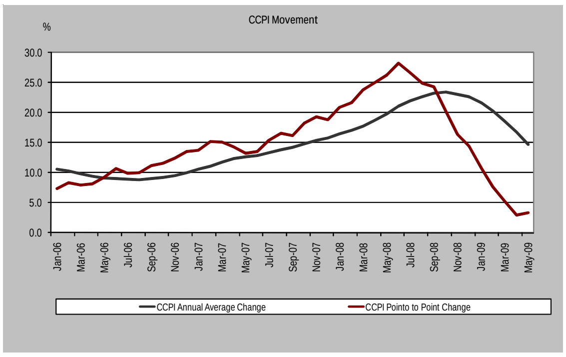


Inflation

- Price levels reduced for 7 consecutive months under the combined effects of downward price revisions of petroleum and gas as well as supply generated price reductions in food products, before adjusting marginally up by 2% in May. The CCPI on a point to point basis decelerated for ten consecutive months from the high of 28.2% in June 2008 to read 2.9% in April 2009 before adjusting upwards mildly by 3.3% in May CY09.

- The end of the war may not necessarily be good for price levels in the short term, as the additional demand will kick in ahead of any productivity gains in the region. Longer term however, the agricultural potential of the two provinces point out to a more stable supply base.

- Oil prices have moved beyond the US$60 mark by early June. However, given the cushion provided by high taxation on petroleum products, a significant upward revision to administered prices may not materialze. The same however may not hold true for LPG with indications of upward revisions already



in evidence. The sharp fall in the CCPI on a point to point basis is likely to have bottomed out in May and we see a gradual pick up in the second half of CY09. The tension of a steeper rise on imported inflation through currency depreciation seems to have waned with the potential aid inflows. This may change however, if aid does not come in.

- The change in the CCPI on an annual average basis has been less speedy, given high base effects in CY08. However, we see a sharper fall towards the 2H CY09 on the math of base effects. We expect the CCPI annual average change to read approximately 6% by end CY09 with an average of 8% thereafter in CY10.

External Trade

Exports

- Exports grew by 6.5% in CY08, with a healthy 12.5% growth in the first 8 months of the year retarded by the global downturn. However, its negative impact up todate, has been less than feared. Overall, exports have slipped by 12.6% for the first three months of the year, with the main sufferers being agricultural exports. The country's key apparel exports however have bucked the trend, growing by 6% during the period, with orders to the EU growing by over 18%, during arguably, the worst of the crisis period. This phenomena which was also mirrored by Bangladesh, can be to an extent explained by the shift in orders from more expensive producing countries.

- Tea prices are likely to remain under CY08 record levels keeping agricultural export revenues in CY09 22% below the previous year. However, even allowing for a possible reduction in textile exports in the second half of the year, total exports should be approximately only 11% below last year, as against our earlier gloomier outlook of an 18% decline.

- Agricultural exports are likely to recover in CY10 led by Tea and output growth in non traditional exports as the North and East cultivation swing in. On the assumption of the global economies bottoming out by end CY09, we expect the exports drop to bottom out and recover by 12% in CY10, but in absolute terms, still remain under CY08 booked revenues.

Imports

- Imports hiked by 24% in CY08, driven mainly by petroleum prices. The subsequent fall in oil prices combined with restrictive import procedures for certain categories of consumer goods and lower demand have driven down the import bill by over 30% during the first three months of CY09. Whilst oil prices show signs of recovery, it should nevertheless average below last year record highs. The end of the war and the subsequent rebuilding of the affected areas will give rise to increased building material and heavy transport equipment in the latter half of the year. Together with increased fertilizer imports coming in the wake of more agricultural lands in the north and east being cultivated, we expect the weakness to be whittled away to a negative 23% for the full year.

- Keeping oil at an average US$70 per barrel, intermediate imports can expand by 14% in CY10. With the rebuilding of the North and East pushing the need for investment good imports, total imports can push up by 14% in CY10.

Trade Deficit

- The sharp rise in the import bill pushed the trade deficit to US$ 5,871m in CY08. With the sharper fall in imports during the 1Q CY09, the deficit has shrunk by 54%. Whilst imports are likely to pick up during the latter half of the year on Investment Good imports mainly for the North and East reconstruction, the CY09 deficit is nevertheless likely to come in 39% under CY08 at approximately US$3,572m. The pick up in investments and consumer sentiment is likely to push the deficit up by 17.5% in CY10.

Summary of External Trade In US$ m	2001	2002	2003	2004	2005	2006	2007	2008	2009E	2010E
Agricultural Exports	932	939	965	1,065	1,153	1,299	1,507	1,854	1,450	1,860
Industrial Exports	3,710	3,630	3,977	4,506	4,948	5,381	5,966	6,159	5,722	6,141
Mineral Exports	90	90	84	120	144	137	128	122	75	85
Other	88	41	108	66	102	70	38	-	-	-
Total Exports	4,820	4,700	5,134	5,757	6,347	6,887	7,639	8,135	7,247	8,086
Consumer Good Imports	1,236	1,318	1,480	1,623	1,644	1,981	2,002	2,549	1,910	2,175
Intermediate Good Imports	3,321	3,492	3,812	4,645	5,317	5,965	6,515	8,338	5,895	6,705
Investment Good Imports	1,081	1,164	1,320	1,670	1,869	2,246	2,684	2,976	2,900	3,275
Other	337	125	60	61	33	65	100	139	80	90
Total Imports	5,975	6,099	6,672	7,999	8,863	10,257	11,301	14,002	10,785	12,245
Trade Balance	(1,155)	(1,399)	(1,538)	(2,242)	(2,516)	(3,370)	(3,662)	(5,867)	(3,537)	(4,159)

Current Account and Balance of Payments

- Net private remittances grew by 15.8% to US$2565m in CY08 and the services account widened by 33% to US$402m with increased net receipts from Transportation, Telecommunications, Computer and Information Services including BPO's. However, the Income Account deficit widened by over 170% to US$972m with higher repatriation of profits of foreign companies, lower income from foreign debt with falling global rates and write downs of investments on the appreciation of the US$ against the Euro and the Sterling. Combined with the high trade deficit, the CY08 current account deficit was pushed wider from US$1,401m to US$ 3,775m. The withdrawals from short term bonds in the height of the global crisis, a dearth of foreign commercial funding ended a three year positive run with a negative US$ 1.225m on the BOP.

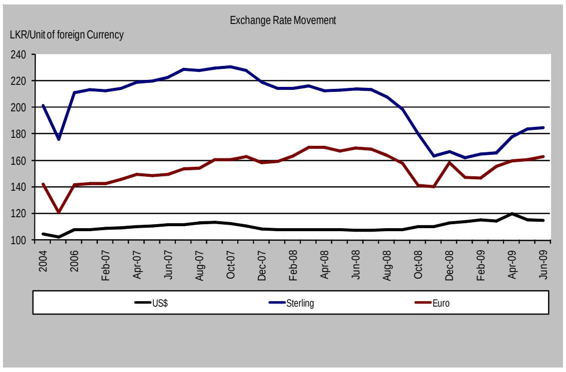
- Gross Official Reserves reduced to US$2561m with a marked fall in the latter half of the year, a gross equivalent of approximately 2.2 months of trailing 12 month average imports. Reserves have reduced further to US$ 1,373m by March CY09, equivalent to 1.3 months 12 months average imports.

- However, the pressure is likely to ease somewhat with the commencement of aid flows to the country after the cessation of the war. The immediate aid has been mostly emergency cash grants which have had a direct positive impact on reserves.

The government is also in talks with India for an approximate US$200m facility as well as ongoing negotiations for a US$1.9b facility from the IMF. Whilst international politics seems to have delayed the IMF facility, the US$200m is likely to come through much faster.

- Over the medium term though numbers are still conjecture, aid flows for rehabilitation and reconstruction are should to step up, whilst longer term flows should materialize through increased direct investments. The Iranian oil facility is reportedly restructured allowing the country more breathing space in the short run. Therefore, should the aid flows materialize, the immediate concerns over the external reserves of the country should abate. On CY09 estimates, the March reported reserves provide a 1.5 month cover, which should edge up further with the inflows seen immediately after the cessation of the war in May.

Exchange Rate



- The sovereign bond issue in 2007 and the opening of short term debt windows for foreign investment yielded positive results in the pre crisis period. The LKR appreciated against the greenback, the Euro and the Sterling with the Central Bank absorbing forex during the period to maintain stability. However, the period of high inflation, capital flight from the short term debt instruments which were so successful in the early part of the year and fears over sharp reductions in reserves saw the currency depreciate in the final quarter of CY08 leading to a volatile period till mid May 2009. The LKR has depreciated 1.8% YTD against the US$ and 2% and 11% against the Euro and the Sterling respectively with a sharper 6.25% slide against the greenback by April being pulled back with the commencement of aid flows.

- With the potential for increased inflows over the short and medium term, the outlook for the currency is now more stable, with a tendency for appreciation, if and when the IMF facility is approved.

Summary of Economic Indicators	2001	2002	2003	2004	2005	2006	2007	2008	2009E	2010E
GDP										
GDP at current market Prices (Rs.b)	1,409.9	1,582.0	1,822.0	2,091.0	2,453.0	2,938.1	3,578.9	4,411	4,897.6	5,799.2
Per Capita GDP at current prices (US$)	841.0	869.9	982.7	1,061.5	1,241.3	1,420.6	1,662.7	1,959	2,070.4	2,346.4
GDP Growth (%)	(1.4)	4.0	6.0	5.4	6.0	7.4	6.8	6.0	4.3	8.6
Population										
Mid year Population (m)	18.7	19.0	19.2	19.4	19.6	19.8	20.0	20.2	20.4	20.6
Government Finance (% of GDP)										
Revenue	16.7	16.5	15.2	14.9	15.5	16.3	15.8	14.9	15.1	-
Expenditure	27.5	25.4	22.9	22.8	23.8	24.3	23.5	22.7	24.5	-
Current Account Deficit	(4.9)	(4.4)	(3.2)	(3.7)	(2.6)	(2.4)	(1.6)	(2.2)	(1.8)	-
Budget Deficit	(10.8)	(8.9)	(7.7)	(7.9)	(8.4)	(8.0)	(7.7)	(7.7)	(9.4)	-
Interest Rates & Inflation (%)										
AWDR (Year end)	10.8	8.0	5.3	5.3	6.2	7.6	10.3	11.6	7.0	7.0
AWPR	14.3	12.2	9.3	10.2	12.2	15.2	18.0	18.5	17.0	15.0
CCPI (Annual average)	14.2	9.5	6.3	7.6	11.6	13.7	17.5	22.6	6.0	8.0
External Trade (US $ m)										
Exports	4,820.0	4,699.0	5,133.0	5,757.0	6,347.3	6,887.0	7,740.0	8,135.0	7,247.4	8,086.5
Imports	5,980.0	6,106.0	6,672.0	7,999.0	8,863.1	10,257.3	11,300.5	14,002.0	10,784.7	12,245.3
Trade Balance	(1,160.0)	(1,407.0)	(1,539.0)	(2,242.0)	(2,515.8)	(3,370.3)	(3,560.5)	(5,867.0)	(3,537.3)	(4,158.9)
External Reserves (months of imports)	2.7	3.3	4.2	3.3	3.7	3.3	3.7	2.2	1.8	2.2
Year-end Exchange Rate (LKR/$)	93.2	96.7	96.7	104.6	102.1	107.7	108.7	113.1	116.0	120.0