John Keells Stock Brokers (Pvt) Ltd.
A JKSB Research Publication
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GDP Growth

The economy gained momentum with preliminary government statistics indicating a 6% growth for the final quarter of CY09, leading to a 3.5% growth for the full year. This is marginally short of our initial expectations of a 3.8% growth as the Yala harvest sharply dipped on account of drought. Whilst a brief lull was expected and experienced during the run up to the presidential elections and the coming parliamentary elections, we expect the economy to gain traction thereafter, predominantly from the domestic sectors.

The resettlement of the IDP's have picked up momentum and the opening of the A9 is viewed as a key accelerator of inter province activity. As outlined in our August 2009 Strategy, the base case requirements for the rebuilding of the two affected provinces equates to almost 4.4% GDP over the medium term. The reconstruction of the provinces and their integration with the mainstream economy has significant upside potential not only to the North and East but to the entire breadth of the country's economy.

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The government plans of re-irrigating and cultivating over 150,000 acres of land in the North and East and the re harvesting of the fertile fishing grounds in the North and East should prop up Agriculture. A turnaround in tea volumes will further bolster the sector.

Similarly, the services sector should pick both as a result of the expansion of activities into the hitherto alienated areas as well as the pick up in consumer purchasing power amidst stable prices. Banking penetration in the North and East of the country has significantly increased with most banks setting up new branches or adding to their existing branch networks in these areas within a few months of the end of the war. Potential for aggressive loan disbursement and sound deposit growth in these areas is already evident. Credit growth which was flat for much of the last 18 months have started to turn positive over the last month while NPL ratios in some banks that peaked in July have begun to decline on increased recoveries. We expect the sector to record asset growth of 12% - 15% in FY10.

Similarly, fixed line penetration in the North is estimated at just 1% with Mobile in the East at 20% as opposed to the ex-north-east penetration of 17% for fixed line and 58% for mobile, signifying strong upside potential for the telecommunications sector.

Whilst the lingering external worries can drag the momentum, we nevertheless expect the economy to pick up with a growth of 7.9% in CY10, sustainable through the medium term.

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	6.1	8.8
Mining & Quarrying	0.7	3.0	5.6	7.9	14.1	8.0	19.2	12.8	5.0	5.0
Manufacturing	-4.0	1.1	4.2	5.1	6.0	5.3	2.4	4.9	3.3	5.0
Construction	2.5	1.0	5.5	6.6	8.9	8.0	9.0	7.8	8.5	10.0
Services	-0.6	6.0	7.9	7.6	6.8	8.7	7.6	5.3	2.0	8.6
GDP Growth	**-1.4**	**4.0**	**6.0**	**5.3**	**6.0**	**7.4**	**6.8**	**6.0**	**3.5**	**7.9**

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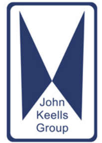


Fiscal Deficit

According to preliminary government estimates, the fiscal deficit veered sharply away from the approved estimates of under 7% GDP to an estimated 10.3% GDP, falling deeper than even our estimates of a 9.5% deficit.

We suspected that the approved revenue estimates of 16.5% GDP was optimistic, given the slow down in the economy in the 1st Half of the year, as well as a sharp reduction in imports, both as a reduction in the import prices of key commodities as well as the deterrent effect of penal duties on consumer good imports enacted during the first half of the year to protect the LKR. Combined with sluggish corporate earnings during the first 9 months of the year, revenue collections reduced to approximately 14.5% GDP from 14.9% in CY08. Similarly, the high interest costs at the beginning of the year as well as higher borrowing requirements in view of the larger deficit drove up domestic borrowing costs, increasing expenditure to 18.1% GDP against 17% in 2008.

The government's target of pruning down the deficit to 5% GDP by 2011 as spelt out in the MEFP attached to the LOI signed for the IMF Stand-by facility though admittedly steep, is nothing new, as the government has, repeatedly in the past attempted to stem the declining revenue trend. Practical implementation however is, and will be, a difficult proposition especially under current circumstances and the government's persistence in curbing alcohol and tobacco sales, all key revenue contributors.

The running of a high deficit over the medium term however for once does not cause for alarm as a bulk will be through increased capital spending and the rebuilding of the war torn provinces, all which will have significant economic paybacks in the medium term.

The current income tax regime is not benign by any stretch of the imagination. The challenge to the authorities will be in broadening its collection base so that the tax revenues mirror the economic growth of the country. The immediate growth is likely to come from the Construction, Tourism, Agricultural, Retail and Banking Sectors. Whilst the formal sectors will anyway contribute to revenue along existing tax collection routes, roping in the predominantly rural informal agricultural sector and the retail sectors will be a practical and political problem.

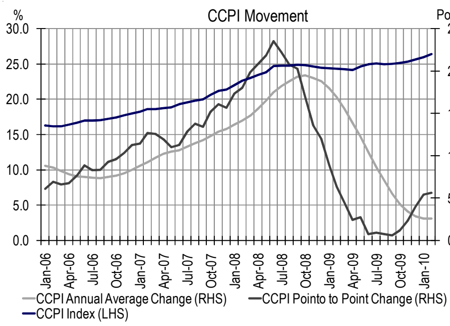
Increasing corporate revenue and a pick up in imports should help the government revenue efforts in CY10. Encouragingly, with the worry on reserves receding, the government has been signaling its willingness to reduce penal import duties in order to stimulate growth, which can have immediate positive elasticity on imports and hence revenues as well.

It should be appreciated that despite the conflict, the government has been successful in curtailing expenditure, with a bulk of the overruns in CY09 coming in on the borrowing costs. With the end of the conflict and the sharp reduction in interest costs, current expenditure curtailment should be a much more feasible way of attempting the 5% deficit hurdle. The government deferred the 2010 budget scheduled for November 2009, having instead a Vote on Accounts, with the 2010 budget likely to be presented on after the general elections scheduled for April 2010.

The running of a high deficit over the medium term though running contrary to the IMF MEFP however for once does not cause us alarm as a bulk will be through increased capital spending and the rebuilding of the war torn provinces, all which will have significant economic paybacks in the medium term. The postponing of the budget does seem to suggest that the government cognizant of the necessity of capex, may be looking towards the implementation of current expenditure management. Therefore, despite a likelihood of a continued high single digit deficit outlook, the change in the combination of contributing factors from current expenditure to capex is in reality, a positive.

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%	14.5%
Tax revenue	14.8%	14.0%	12.7%	13.5%	13.9%	14.6%	14.2%	13.3%	12.8%
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%	24.7%
Current expenditure	21.6%	20.9%	18.4%	18.6%	18.1%	18.6%	17.4%	17.0%	18.1%
Current account deficit	-4.9%	-4.4%	-3.2%	-3.7%	-2.6%	-2.4%	-1.6%	-2.2%	-3.7%
Budget deficit	**-10.8%**	**-8.9%**	**-7.7%**	**-7.9%**	**-8.4%**	**-8.0%**	**-7.8%**	**-7.7%**	**-10.3%**

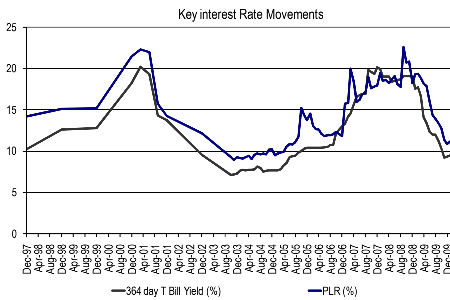
Inflation



The CCPI bottomed off from September 2009 with upward pressure coming from the increase in administered price in fuel and an increase in food prices on account of a shortfall in the Yala harvest as well as an increase in the health and education basket.

The harvest variance effects on price trends are likely to be short term. The more sustained effects will come predominantly through global commodity prices, on which Sri Lanka is highly dependent. With crude prices nosing up, the government may be forced to re-adjust administered pump prices which were reduced in the run up to the presidential elections especially in light of the high fiscal deficit concerns, leading to a relatively sharper rise in price levels in CY10. The cushion however can be lower food prices once increased cultivation of the North and East flows through. We expect the CCPI to register an average 12% increase in CY10.

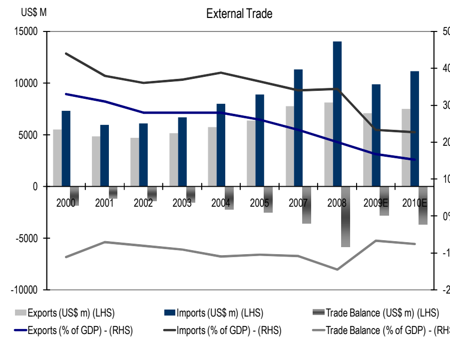
Interest Rates



Despite higher public sector borrowing, interest rates reduced sharply through CY09 before showing signs of leveling off by the end of the year. The 364 T-bill and the PLR shed 976bps and 740 bps respectively in CY09 to end at approximately 9.32% and 10.85%.

With prospects of sustained high public sector borrowings coupled with a pick up in private sector borrowings, there is likely to be upward pressure on rates with the PLR likely to settle in the range of 14-14.5% as outlined in our November review. The 364 day T-bill however may settle a mite lower than our earlier expectation of 13%.

Exports



Exports proved more resilient than our estimates, ending the year with a 12.7% decline, as opposed to our expectations of a decline of 17.5% yoy for CY09 with a pick up in Agricultural exports towards the tail end of the year, led by Tea and Rubber.

Tea should fully recover from the weather and trade union issues of CY09, supported by healthier prices. Agricultural exports should also benefit from rubber as well, as prices are likely to be healthy in CY10. The loss of GSP+ is likely to be muted in on overall volumes with the effect being rather felt by exporter's margins. Textile exports are dependent on the EU and US economies, and initial estimates point to a healthier year than the previous with US retail stats supporting a marginal recovery.

However, other industrial exports, especially the smaller ceramic and leather ware exporters may face difficulties due to the loss of GSP+ due to the squeeze on margins, with some dropping out eventually.

We expect exports to improve marginally by 6% in CY10 off the lower base of 2009.

Imports

Imports came in 4% under our estimates with a YoY drop of 30% with an across the board fall. The pick up in crude oil prices and increased demand for investment goods including machinery, building materials and transport equipment in the wake up of large scale infrastructure development and North –East re-development should see a spike in imports in CY10. In addition, the government is likely to ease punitive duty structures on imports which have suffocated consumer good imports and in consequence government revenues in CY09, leading to a pick up in consumer durable imports in the 2nd half of CY 2010 as well, leading to a 13% increase in the import bill for 2010.

Trade Deficit

The sharp fall in the import bill resulted in a 53% contraction in the trade deficit for CY09. However given our expectations of a sharper rise in imports for CY10, the trade deficit is likely to expand by 30% to US$ 3,666m in CY10.

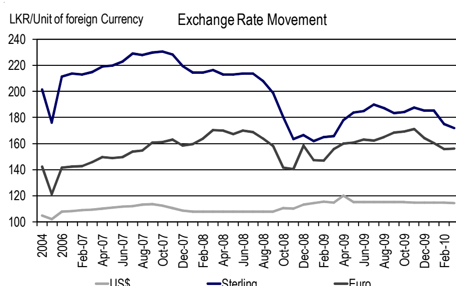
SUMMARY OF EXTERNAL TRADE
In US$ Mn

	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	1,690	1,895
Industrial Exports	3 ,710	3,630	3,977	4,506	4,948	5,381	5,966	6,159	5,305	5,500
Mineral Exports	90	90	84	120	144	137	128	122	90	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**	**7,085**	**7,480**
Consumer Good Imports	1,236	1,318	1,480	1,623	1 ,644	1,981	2,002	2,549	1,980	2,110
Intermediate Good Imports	3,321	3,492	3,812	4,645	5 ,317	5,965	6,515	8,338	5,651	6,271
Investment Good Imports	1,081	1,164	1,320	1,670	1,869	2,246	2,684	2,976	2,178	2,675
Other	3 37	125	60	61	3	3	65	100	80	90
Total Imports	**5,975**	**6,099**	**6,672**	**7,999**	**8 ,863**	**10,257**	**11,301**	**14,002**	**9,889**	**11,146**
Trade Balance	**(1,155)**	**(1,399)**	**(1,538)**	**(2,242)**	**(2,516)**	**(3,370)**	**(3,662)**	**(5,867)**	**(2,804)**	**(3,666)**

External Reserves

Despite the external turmoil, net remittances grew 14% in CY09 to US$ 2,927m, approximately 4% over the years' trade deficit. Aid and inflows to government securities spiked and along with the initial disbursements of the IMF standby facility, raised official reserves to over US$ 5b by end January 2010. Excluding the IMF drawdown, reserves approximate 4.8 months of imports for CY10. With the upgrading of the country rating to B+ by Fitch, the access to foreign capital is likely to be easier and cheaper in the medium term, despite delays over the next disbursement of the IMF stand by agreement over concerns over budgetary over runs.

Exchange Rate



With the influx of foreign capital, the Central Bank has been absorbing excess foreign exchange, preventing a sharp appreciation of the currency. The LKR has depreciated by a marginal 1.3% in CY09 against the greenback whilst depreciating by a faster 3.5% and 11% against the Euro and Sterling respectively. The LKR has since appreciated 0.3% against the greenback and by a sharper 7% and 5% YTD against the Sterling and the Euro respectively amidst the concerns over the European economies.

Despite the delay in the third tranche of the IMF disbursement, the investment flows to the country are likely to be positive in the medium term. However, given the requirement to keep exporters to the EU from stress, especially in the light of the strengthening LKR against the Euro and the Sterling, the Central Bank may look to allow the currency to slide approximately 4-5% in CY10.

ECONOMIC INDICATORS

	2001	2002	2003	2004	2005	2006	2007	2008	2009E	2010E
GDP										
GDP at current market prices	1,410	1,582	1,822	2,091	2,453	2,938	3,579	4,411	4,857	5,872
Per Capita GDP at current prices (US$)	841	870	983	1,062	1,241	1,421	1,663	2,014	2,081	2,384
GDP Growth (%)	(1.4)	4.0	6.0	5.4	6.0	7.4	6.8	6.0	3.5	7.9
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	14.5	-
Expenditure	27.5	25.4	22.9	22.8	23.8	24.3	23.5	22.7	24.7	-
Current Account Deficit	(4.9)	(4.4)	(3.2)	(3.7)	(2.6)	(2.4)	(1.6)	(2.2)	(3.7)	-
Budget Deficit	(10.8)	(8.9)	(7.7)	(7.9)	(8.4)	(8.0)	(7.7)	(7.7)	(10.3)	-
Interest Rates & Inflation (%)										
AWDR (Year end)	10.8	8.0	5.3	5.3	6.2	7.6	10.3	11.6	8.0	9.0
AWPR	14.3	12.2	9.3	10.2	12.2	15.2	18.0	18.5	9.3	14.0
CCPI (Annual average)	14.2	9.5	6.3	7.6	11.6	13.7	17.5	22.6	3.4	12 .0
External Trade (US $ m)										
Exports	4,820	4,699	5,133	5,757	6,347	6,887	7,740	8,135	7,085	7,480
Imports	5,980	6,106	6,672	7,999	8,863	10,257	1,300	14,002	9,889	11,146
Trade Balance	(1,160)	1,407	1,539	2,242	2,515	3,370	(3,560)	(5,867)	(2,804)	(3,666)
External Reserves (months of imports)	2.7	3.3	4.2	3.3	3.7	3.3	3.7	2.2	4.7*	5*
Year-end Exchange Rate (LKR/$)	93.2	96.7	96.7	104.6	102.1	107.7	108.7	113.1	114.5	119.6

* *Excluding IMF Stand-By Facility Draw down*