



2009

# Sri Lanka Economic Outlook



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## A New Chapter for Sri Lanka

In May 2009, after a bitter 30-month long military campaign, the Sri Lankan Government succeeded in ending Asia's longest running domestic ethnic conflict with the elimination of the remnants of Liberation Tigers of Tamil Eelam (LTTE). This has been an abrupt, and for many observers surprising, turnaround. All previous administrations had failed to contain the LTTE despite 26 years of sporadic military efforts, several peace processes, over 80,000 casualties, and significant reduction in potential economic growth. The Government has been rewarded with huge popularity at home (even as they face approbation from a vocal Tamil diaspora abroad), and are likely to win an overwhelming mandate to govern in upcoming elections. Peace has returned to the 'paradise island' at last, and the Northern and Eastern parts of the country are now accessible. Rebuilding trust with the Tamil minority, and resolving the issue of internment camps in the North remains a political imperative, but one which the Government appears to be committed to. That President Rajapakse chose Tamil for his post victory parliamentary address spoke volumes about his political intent.

Obviously the economy is likely to be a major beneficiary as the widely expected 'peace' dividends flow. Reconstruction funds pledged by foreign donors; foreign direct investment (FDI), and expenditure reductions in defence (17% of the budget) are expected to reduce Sri Lanka's perennial budget deficit, currently 7.7% of GDP. But the largest impact is likely to be on growth overall and investment, not just reductions in expenditure. The drought of FDI caused by the war, coupled with an inadequate domestic savings rate, constrained the economy from realizing its growth potential – there has long been simply too little money around. We also expect a return of business and stock market confidence, and tourist arrivals, as the icing on the cake.

Our review of Sri Lanka's prior six years of economic performance uncovers all the hallmarks of the hidden gem that we have believed in, and invested in, for close to a decade - fast growth rates, structural balance, strong domestic consumption, and banking system soundness. We believe that the country has the potential for an extended period of supernormal 'Chindia' rates of growth of 8% plus, and offers a fundamentally attractive investment story. Peace will evolve to Prosperity.

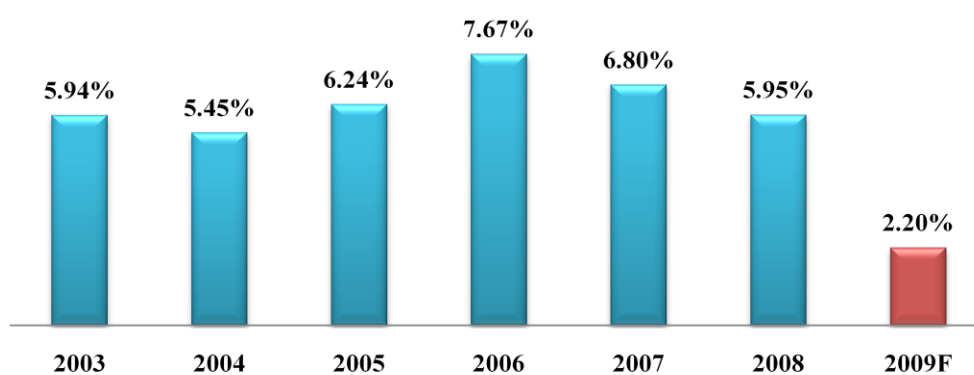
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## Economic Activity and Growth Rates

Sri Lanka, an island of 65,600 square kilometers off the southern tip of India, is an economy of 41 Bn. USD in nominal GDP, with a population of 20 million. GDP per capita just exceeds USD 2000. Despite the war and the inevitable reduction in foreign direct and domestic investment and business confidence, the economy has performed very well over the past 6 years, producing an average growth rate of 6.3% from 2003-2008.

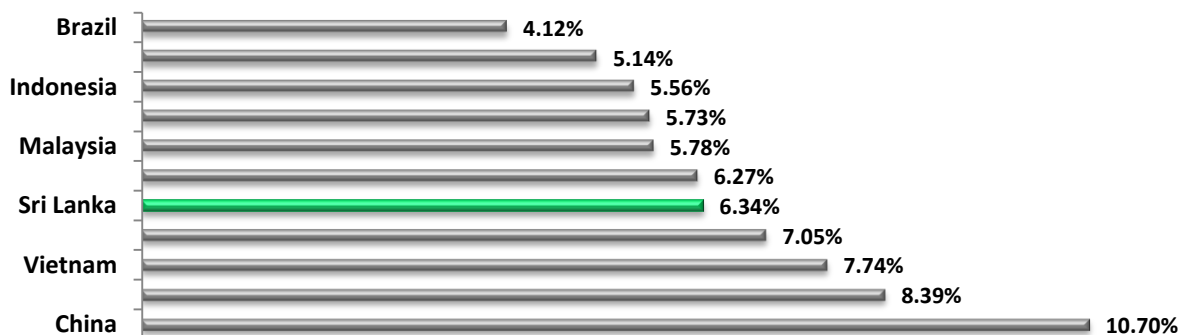
### GDP growth rate



Source: International Monetary Fund

This performance has been largely unrecognized by foreign investors, who have focused on geopolitical risks rather than fundamental economic performance. Comparatively, Sri Lankan growth rates have exceeded all Asean countries popular with foreign investors (Singapore, Indonesia, Thailand, Malaysia). Sri Lankan growth has been exceeded only by Russia, Vietnam, India and China. Structurally, the quality of this growth has only been exceeded by India and Vietnam, and not reliant on oil and gas (Russia) or overly reliant on G3 economy exports (China).

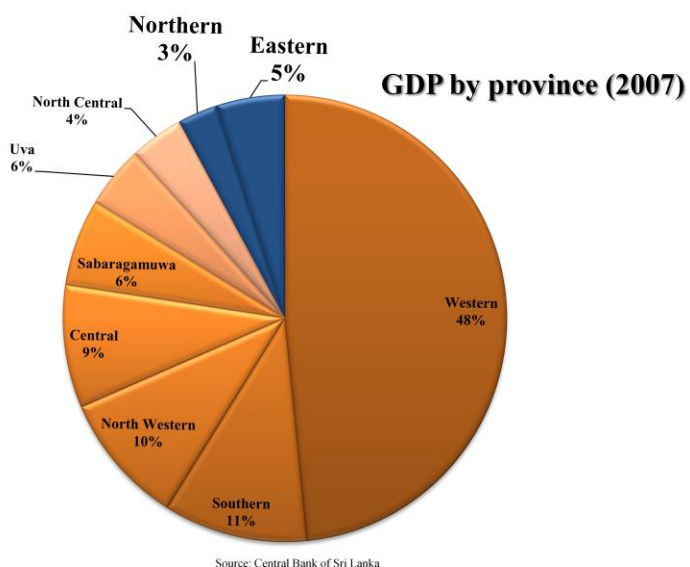
### Average GDP Growth Rates, 2003-2008, constant prices



Source: International Monetary Fund

## Provincial GDP breakdown

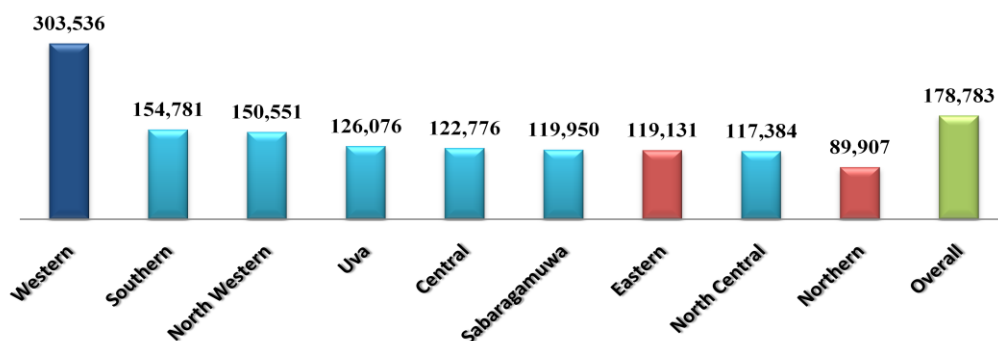
This level of growth has been achieved despite the economy effectively only running on one provincial engine—that of the western province, home to the political and business capital Colombo. A provincial breakdown of the GDP contribution reveals that the Northern and Eastern territories collectively contributed only 8% of the economy in 2007, with the Western province contributing to 48% of the economy's growth. This is an unusually concentrated economy even by Asian standards, revealing an effective containment of the war, and the constraints on economic activity that results, to the Northern and Eastern provinces



Although this pattern of excessive concentration of economic activity in the metropolitan centre is common in Asia (Bangkok relative to the Thai economy or Manila relative to the Philippines for example), the war did remove most of the eastern and northern provinces entirely, as well as restrain investment in other provinces closer to these LTTE controlled areas. A recovery boost to these neglected provinces, and a corresponding increase in overall country growth rates, is therefore to be expected. This alone could contribute 1 to 1.5% of additional GDP growth in our view.

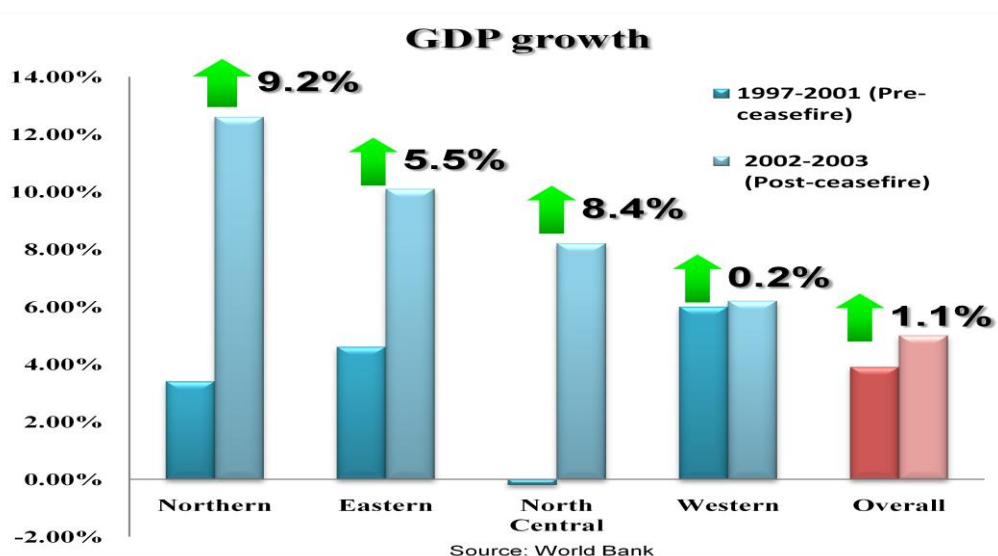
It is not just economics. The battered Northern and eastern provinces have been left behind so much that they have a per capita income less than one third of the rich Western province. The North remains below the critical 1000 USD mark of absolute poverty. We believe that the political accommodations necessary to secure the new found peace will also require a new, 'economic war' to be won in the North and the East. Peace demands prosperity much as prosperity demands peace. If the Tamil population in these areas are rapidly re-assimilated into the greater economic growth pattern of the country, and experience the benefits of new goods and services, infrastructure, and jobs, the 'struggle' will rapidly recede in importance.

### GDP per capita (2007)



Source: Central Bank of Sri Lanka

To test the reality of our 1-1.5% neglected province boost to overall growth hypothesis. We looked back at the growth of the country during the Ceasefire Agreement (CFA) in the 2002-2003 period.



Source: World Bank

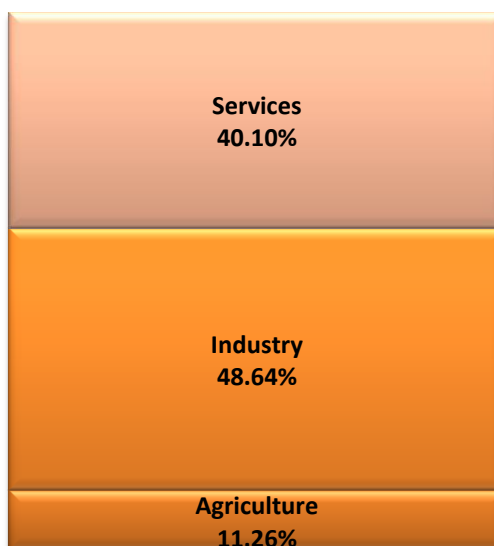
Sri Lankan GDP growth improved immediately during the CFA, especially for the war torn provinces where the North experienced an annualized growth boost of 9.2% relative to the pre-ceasefire period. The overall economic growth rate improved by 1.1%, an indication of how even a limited ceasefire restores economic activity, and can bring about 'peace dividends'.

## Economic Structure

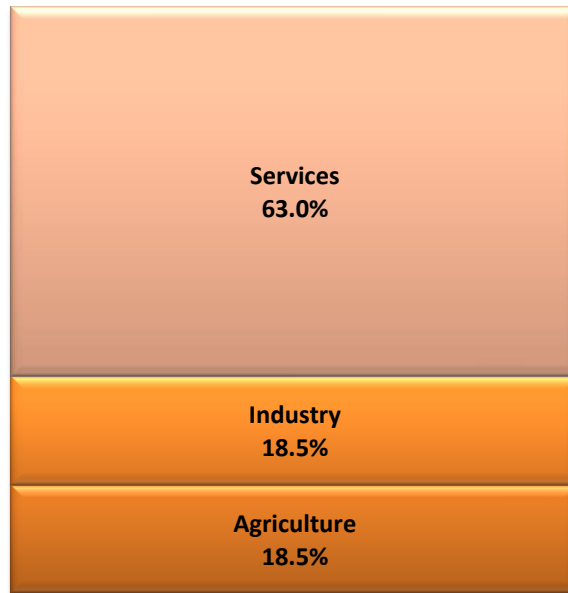
As with growth, Sri Lanka is a hidden 'Cinderella', with the structural advantages of much larger, industrializing and consumption based economies such as India and China. Primary industry, notable Agriculture, contribute only 12% of output, making Sri Lanka less dependent on the monsoon rains variables that so affect India's 18% agricultural base. Vietnam, another frontier, high growth market, remains dependent on agriculture for 22% of its GDP by comparison. What agriculture the country does produce is largely for domestic consumption, providing only 12% of exports.

Industry, at 28%, exceeds the Indian level. The GDP contribution of the services sector for Sri Lanka is slightly below that of India's and substantially above China's.

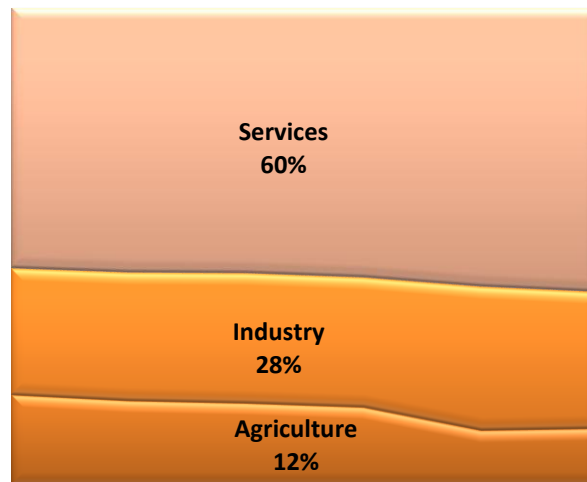
## China GDP breakdown



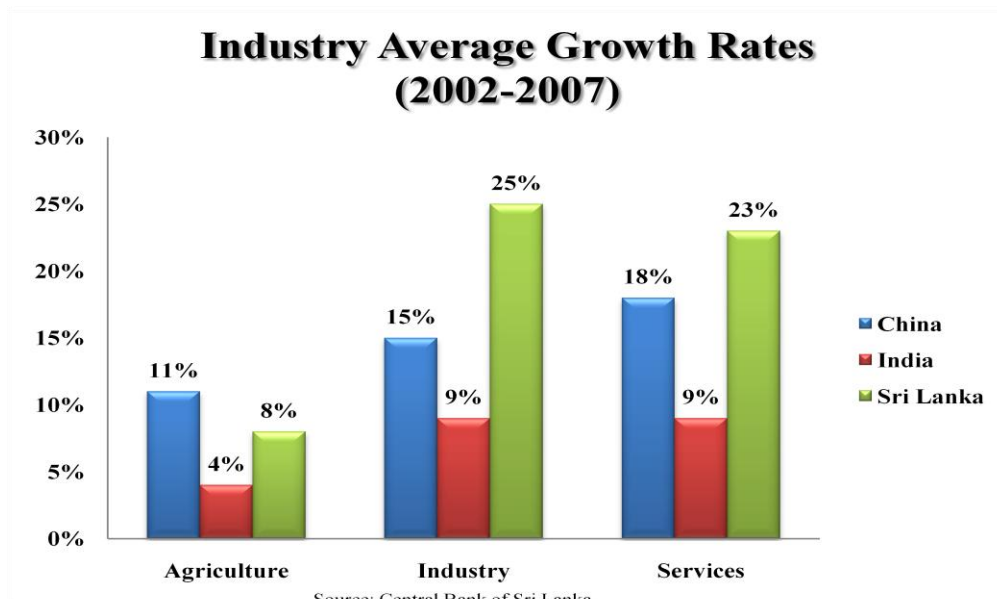
## India GDP Breakdown



## Sri Lanka GDP Breakdown

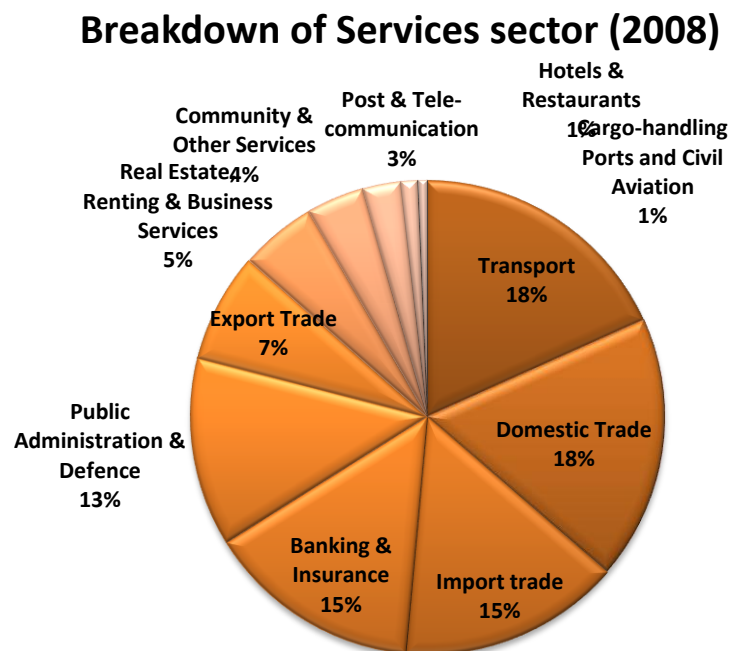


Sources: Annual Reports of respective countries

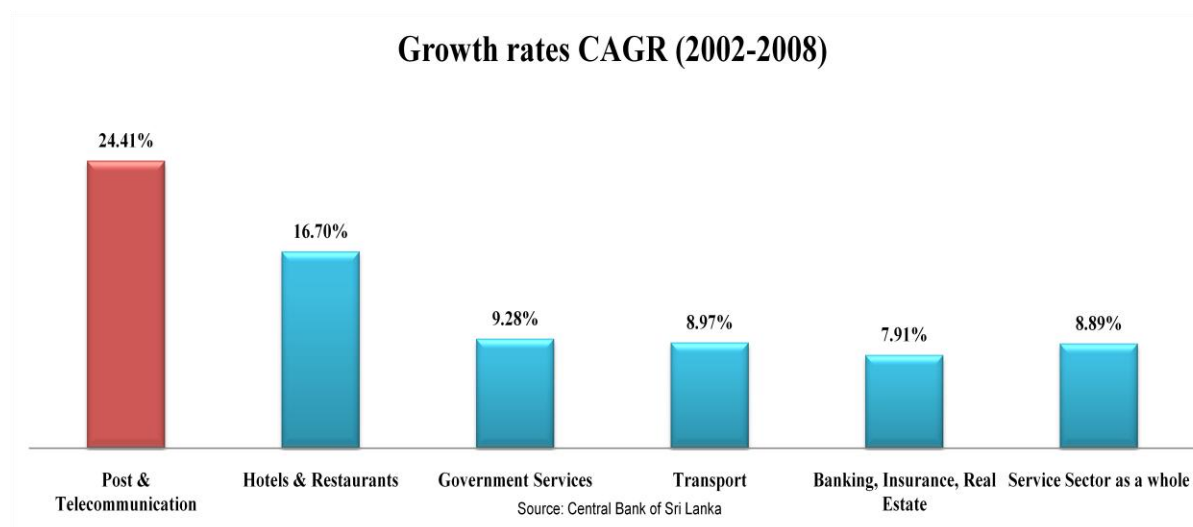


Strong recent growth in the Industry and Services sectors has driven the reduced dependence on Agriculture. Again, Sri Lanka has achieved higher growth rates in the Industry and Services sector than China and India, albeit of a lower base, with annualized rates of 25% and 23% for the Industry and Services sector.

### The Services Sector



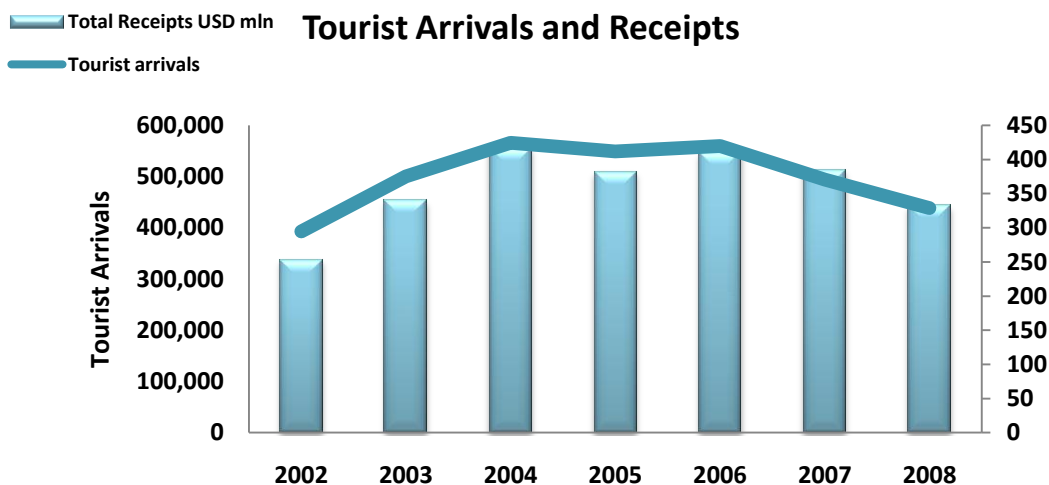
The GDP contribution breakdown of the Services sector in Sri Lanka shows a well developed, diversified services economy driven by domestic consumption, whose largest contributors, Transport and Domestic Trade, contribute no more than 18% of sector's overall GDP. Overall, trade and retail dominate, the expected pattern in a mature economy. Transport is close behind, for a nation that does appear to be continually moving around the island. Financial services account for 15% of services, or 9% of the overall economy, a healthy level. Telecommunications and real estate activities, and hotels and restaurant show room for growth in contribution. All of these are sectors that demand a certain level of disposable income, and tend to pick up above a GDP per capita of 3000 plus, at which point consumers have covered their basic needs and can afford greater discretionary services. As a result, these sectors are concentrated in the Western province. However, what they lack in GDP scale they make up for in growth rates.



Telecommunications, essentially mobile, is one of the fastest growth sectors in the economy as mobile penetration rates continue to expand. In common with many emerging Asian economies, working class consumers from farmers to three wheel 'Bajaj' drivers have skipped landlines and moved straight to pre paid mobile telephony. This segment continues to offer opportunities, and has attracted considerable foreign direct investment from both Malaysia and Indian operators.

The limited absolute GDP contribution of the hotel and restaurants services segment (merely 1% services) reflects the devastating impact the war had on the tourism industry. Tourism receipts grew at a CAGR of 8.73% during 2002-2007, but off a very low base as arrivals struggled to ever exceed a paltry 500,000 visitors per annum. Given the phenomenal potential for tourism the country offers, with a huge wealth of attractions from beaches and spa hotels to

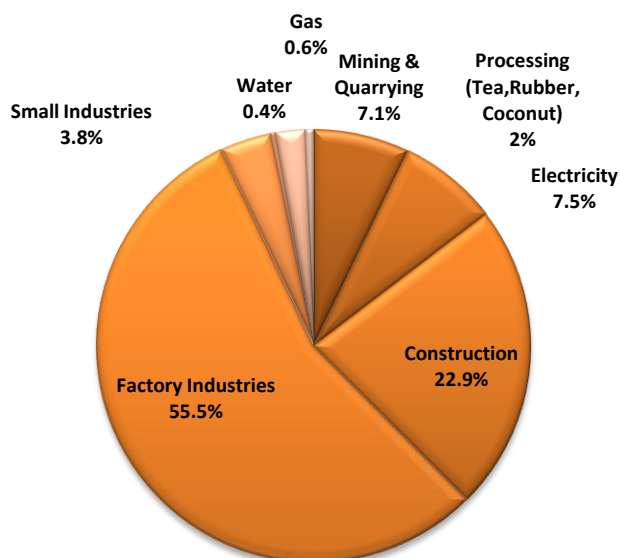
ancient cities, temples and wildlife gameparks, this remains a major challenge. By comparison, Thailand gets 15 million visitors annually, and Singapore, with few natural attractions to offer, gets 10 million.



Source: Sri Lanka Tourism Development Authority

### The Industrial Sector

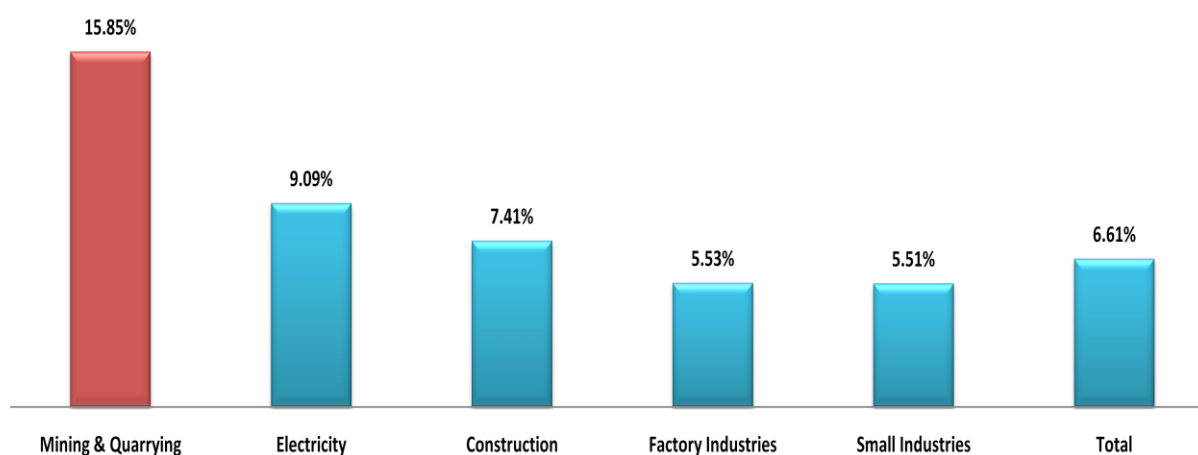
#### Breakdown of Industry sector (2008)



Source: Ministry of Finance and Planning

The Industry GDP breakdown tells a different story, with a marked focus on Factory Industries (essentially manufacturing and processing) and Construction, making up almost 80% of the total Industry sector GDP. Unfortunately the Sri Lankan Government statistics available at the time of writing did not permit a further analysis of the sub-segment breakdown, but the factory segment includes a relatively diversified portfolio of activities. These include apparels, the country's dominant export industry, rubber manufactured products including tires, and ceramics.

### Growth Rates CAGR (2002-2008)



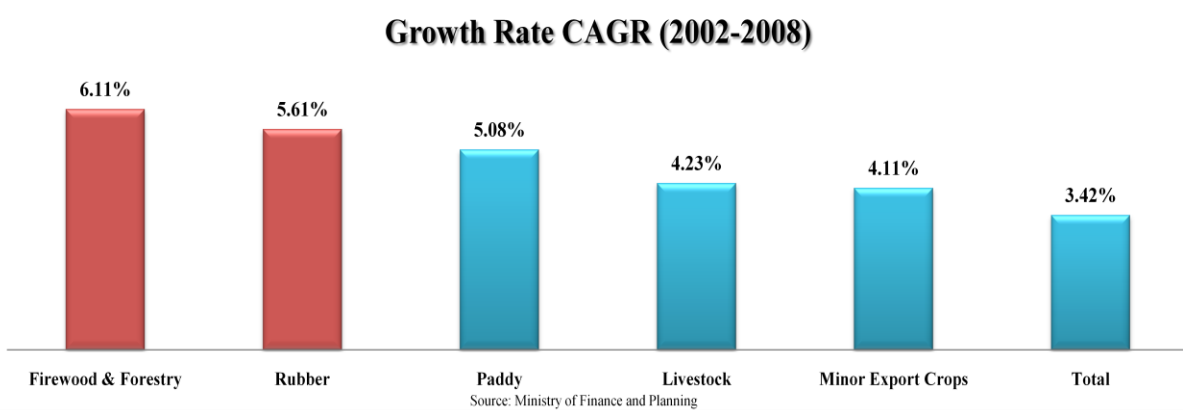
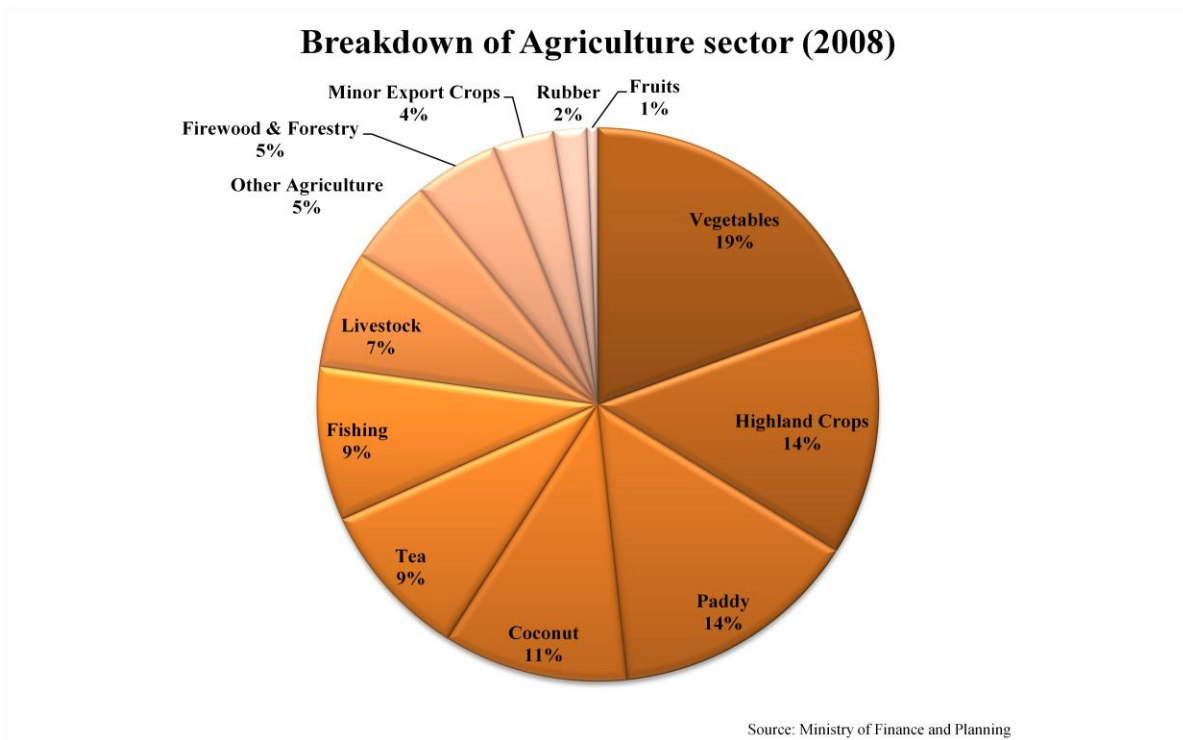
Source: Ministry of Finance and Planning

Growth rates have lagged in manufacturing recently, with evidence of a slowdown in the critical apparel export segment. Mining and Quarrying are growing fast, growth that can be attributed to exporting of gems and related products, but also reflect the growth of stone and finished stone products that are abundant in the country. This is a segment we believe may offer potential for foreign investors where better cutting and finishing technologies can be applied.

### The Agricultural Sector

The Agricultural sector is broadly diversified, a critical strength in a segment where over concentration in a particular crop or segment can be risky. Expectations of a large concentration in tea, the country's most famous export sector, are unfounded. In fact tea only accounts for 9% of agriculture, a mere 1.08% of overall GDP. Agriculture shows the domestic strengths of economy, with the top four largest contributors, Vegetables, Highland Crops,

Paddy and Coconut totaling 58% of Agricultural output all being largely for domestic consumption.



As befits an industrializing economy, growth rates in Agriculture are much lower than the 5-15% growth rates in manufacturing, and the 8-25% growth rates in services. Agriculture ranges from 3% plus to a little over 6%. Forestry and Rubber have led growth in the Agricultural sector. This is a reflection of the increasing interest in sustainable timber, and rubber plantations. Both segments are, we believe, attractive opportunities for foreign investment.

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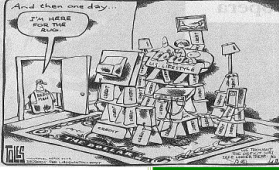


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