Economics

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Sri Lanka Macro View

Trip Notes – A Mixed Picture

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- **External accounts remain under near-term pressure – LKR may still weaken**. The big driver of the deterioration in FX reserves./BOP since August are: 1) significant CA deficit widening, by a larger-than-expected 6.7% of GDP in 2011, on the back of a combination of oil/gold prices, strong growth and unsterilized FX intervention fuelling credit growth; 2) global de-risking last year exposing the country's vulnerability to portfolio positioning; 3) pegging the LKR for too long, which resulted in a sharp drop in FX reserves that posed another negative feedback loop on portfolio flows.

- **But the government is now taking corrective action.** The government has shifted towards more FX flexibility, hiked the policy rate by 50bps, announced tighter credit growth targets, imposed import levies and, more recently, made bold adjustments to fuel/electricity prices, aimed at narrowing the CA gap. These are positive steps, but the impact may take time.

- **Unfortunately, the policy approach to closing interim external gap also relies on external commercial borrowings.** One factor that has likely exacerbated Sri Lanka's external bond underperformance is the government's support for external commercial borrowings (e.g. by banks) to help support portfolio inflows.

- **Key thing to watch: will the IMF disburse funds?** On the positive front, the IMF seems very pleased with the recent policy steps of the government. We think they could qualify to receive the long-delayed $850mn of undisbursed standby loans. While some officials have made public pronouncements they wouldn't tap the IMF, we think it's possible (some people we met believe it's probable) and makes sense for them to do so.

- **Monetary policy outlook.** Despite painful fuel/electricity price hikes, the timing of implementation is a good one (bottom of the headline inflation; peak harvest season) and see low risk of 'overheating'. We expect CBSL to stay on hold for now, but monetary policy will be determined more by external liquidity pressures. If FX reserves fall too close to US$5bn (3 months of imports), more tightening may be pursued.

- **Market Outlook – We would be buyers on dips of Sri Lanka dollar bonds;** March-April may be the better timetable to scale in the run-up to new issuance and potentially more capitulation. Last Dec, we expected Sri Lanka dollar bonds to underperform Vietnam, but now that it is trading over 500+bps (z-spreads) and 125-150bps wider than Vietnam (mid), we think investors should look to scale in, possibly more in March-April when the next IMF staff mission visits and we may be closer to new issuance. On the Treasury bills/bonds, we think it may still be too early—LKR may still be under pressure in the near term, inflation pressures will escalate on recent fuel/electricity price adjustments, and seasonal liquidity tightness during New Year-festival around April could provide better entry points.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Trip Notes – A Mixed Picture

Growth is expected to slow in 2012

There is a growing recognition even within the CBSL that growth could slow from the earlier target of 8% to 7.0-7.5% as efforts to tighten monetary/credit growth are implemented, alongside a sharp rise in fuel/electricity prices and challenging global growth backdrop. A number of pundits surmise that the government's big infrastructure investment push in the last few years is yielding disappointing returns especially in terms of FDI pick-up, and may be a reflection of inadequate planning and lack of a clear strategy. Thus, some people we met believe FDI will not pick up significantly from last year's lackluster $1bn (1.7% of GDP), and fall short of the government's $2bn forecast for 2012.[1]

BoP and FX Outlook – near-term pressures may persist

A big source of investor concern is the significant shift in the BoP and FX reserve trends since August last year, resulting in a sharp erosion of FX Reserves ($5.9bn as of Dec 2011 vs. a peak of $8.1bn in Aug 2011). There were likely three big drivers for this: First, rise in oil and gold prices, and liquidity creation from unsterilized FX intervention following the surge in portfolio inflows fueled strong import-related credit growth and a rapid deterioration in the current account deficit; Second, the shift in global risk sentiment from the escalating Eurozone crisis prompted an unwind of portfolio positions, and therefore, exposing the country's external vulnerability. Third, instead of letting the currency adjust to the more adverse shift in external flows, CBSL intervened for too long to peg the USD- LKR, resulting in eroding FX competitiveness and a sharp drop in FX Reserves. This led to another round of negative feedback loop on portfolio flows as people holding LKR-denominated assets either unwound positions or just started hedging their FX exposure.

The government has taken corrective steps but it may take time for these to substantially reduce external funding gap. However, in the last month, the government has taken more decisive corrective steps to reduce the pressure on FX reserves: First, it has now formally shifted its FX policy from targeting a "price" (i.e. a specific USD-LKR spot), and instead will now only intervene based on "quantity" determined by dollar needs to fund oil imports. Second, it surprised the market with a 50bps hike and imposed a specific credit growth target for banks of 18% if locally funded (23% if 5% of funds are raised abroad, which is a significant slowdown from the current pace of 33.5%; Third, it has imposed/hiked a number of special commodity levies on food/agri products (e.g. revising levies on sugar, pulses, garlic, oil, and fish early this year); and last, and probably the most politically difficult, was to announce a wide range of price hikes, namely a 37% hike in diesel prices, 50% hike in kerosene prices, 9% hike in petrol prices and an electricity tariff hike ranging from 20%-40%, effective in March. These price hikes help encourage energy efficiency and curb related imports as well as act as a tax on consumers to the extent demand for these goods are inelastic, crowding out non-energy imports (over the last year there has been a significant increase in imports of gold/motor vehicles).

Where do we go from here? While the government hopes these tightening/FX policies could help curb the Current Account deficit from 6.7% of GDP in 2011 (a substantially wider figure than we earlier estimated) to~5% of GDP, this may not happen quickly enough to close to external funding gap given inadequate FDI and official loans. Thus, weakening pressure on LKR could still persist in the near term.

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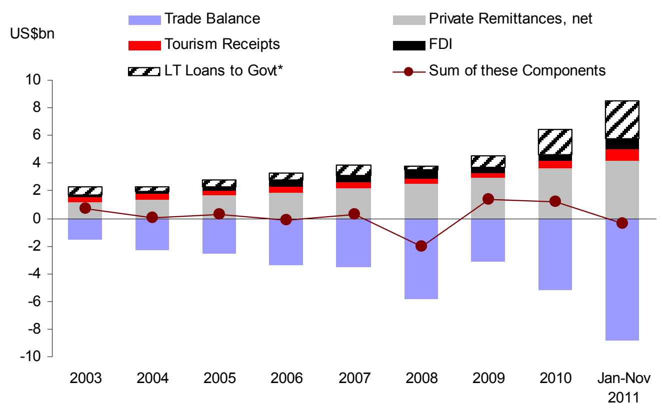
[1] CBSL told us FDI reached $1bn in 2011, but as of November 2011, the latest external accounts report still have FDI in Jan-Nov 2011 pegged at $679.3mn.

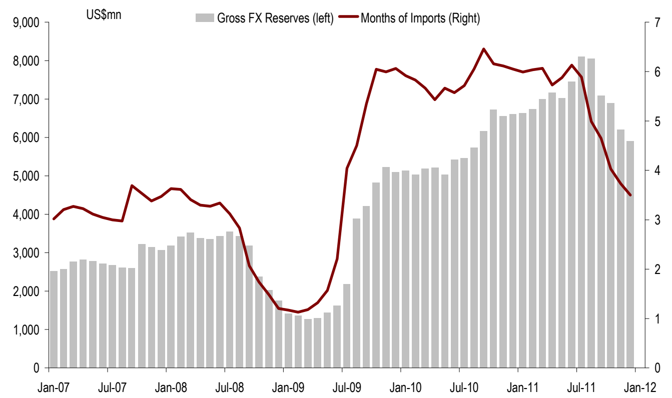
The government's policy approach to close the external gap appears to rely on overseas borrowings, giving the green light for a number of Sri Lankan banks (including Bank of Ceylon) to issue both senior and Tier 2 sub-debt while also liberalizing restrictions on corporates to borrow as well. While this could bring in meaningful portfolio inflows, there are two related drawbacks: 1) some of these deals will take time and won't materialize immediately. We expect state-owned Bank of Ceylon will be the first to issue in April; 2) If these borrowers come to the market at a time that the balance of payments and LKR is still under pressure and foreign borrowing is seen a necessary to buffer FX reserves, then investors will demand a higher concession from the borrowers. We think this partly explains why Sri Lanka dollar bonds have underperformed significantly in the last few months.

Figure 1. Major Components of External Flows



Source: CBSL, and CEIC Data Company Ltd., and CIRA
Note: *Data on Financial Account: Long-Term flow to Central Government is only available up to June 2011. We interpolate the Jan-Nov 2011 figure the full yr $3bn figure given to us by CBSL, and interpolate the 11-month figure.

Figure 2. Gross FX Reserves vs. Months of Import Cover



Source: CBSL, and CEIC Data Company Ltd.

Watch the IMF – will it or won't it?

The IMF seems very pleased with the recent policy steps the government is taking, and thus, we think that the Sri Lanka government would qualify to have the remaining long-delayed $850mn in IMF tranches disbursed. While the government has made public headlines saying it wouldn't tap it, we think it makes sense for it to do so: we view the borrowing cost of 3.3% for the remaining tranches is still much cheaper than for the government to borrow in commercial terms and, more importantly, the signaling factor for investor confidence of a resumption of IMF loans would also be very valuable. The IMF Staff Mission is planning to visit in March-April and it will be important to watch headline events that could arise about the remaining loans. A positive pronouncement about resumption of IMF loans could be a trigger for renewed confidence in the rupee's pending stability.

Inflation and Monetary Policy – Pause for now

Inflation has decelerated but is expected to reverse course on recent sharp price hikes. Inflation has decelerated sharply on two drivers: the powerful base effect and very good harvest which is further driving down food, which in turn accounts 41% of the CPI basket. Thus, CBSL forecasts inflation forecast to decelerate further from 3.8% in Jan to possibly a sub 3% reading in Feb. The key risk is the impact of the fuel/electricity hikes. While clearly a good step from a fiscal/external front, we could see a sharp impact on inflation. CBSL estimates the

first round effect of the recent price hikes is about +0.5ppts but this figure is likely understated, given the second round effects which is not yet calculated in the estimate. The one good thing from this price hike (which we think Indonesia could learn from) is that it is implementing it during both the bottom of inflation cycle, and during the peak harvest season in Feb-March (with a good harvest backing modest food inflation) and, thus, it has a reasonable chance of absorbing the inflation spike while hopefully anchoring inflation expectations. CBSL forecasts inflation this year would average about 7.0% this year.

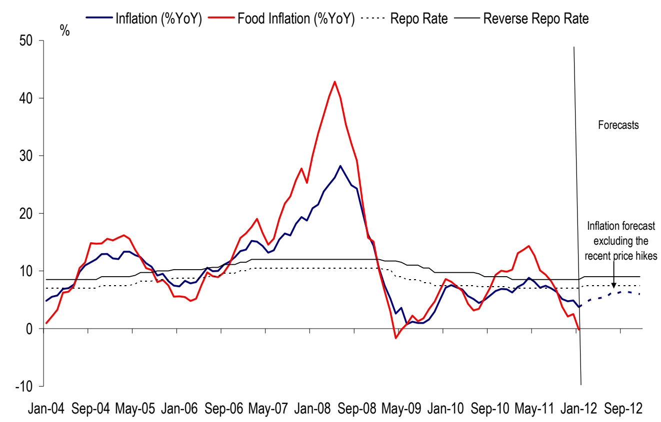
We think monetary policy will be determined by the extent to which external pressures persist from here, rather than a real concern about escalating inflation risks. Despite strong credit growth and pending price hikes, Sri Lanka's economy seems to show limited signs of overheating risk-- labor slack limits wage pressures, and investment-driven growth in recent years adds to potential output, easing pressure on the output gap. This, coupled with adequate monetary transmission from the recent hike, as well as a more flexible LKR thus reduce the likelihood of the CBSL hiking rates further from here. However, if external shocks continue to put significant pressure on LKR and reserves fall too close to CBSL's comfort threshold, which it says is about $5bn (three months of imports), this could lead to further monetary tightening. Notwithstanding a more flexible FX policy, we think CBSL's tolerance for FX volatility has limits, given the country's significant external debt.

Figure 3. IMF Standby Loan – Disbursement Schedule

	In SDR	In USD*	Status
Jul-09	206.7	320.8	Disbursed
Nov-09	206.7	330.7	Disbursed
Jul-10	206.7	310.8	Disbursed
Sep-10	275.6	420.8	Disbursed
Feb-11	137.8	214.0	Disbursed
Apr-11	137.8	220.3	Disbursed
Aug-11	137.8	212.7	Not disbursed
Nov-11	137.8	212.7	Not disbursed
Feb-12	137.8	212.7	Not disbursed
Apr-12	137.8	212.7	Not disbursed
Total	**1722.5**	**2668.2**	

Source: IMF, Bloomberg
Note: We use average SDR spot rate for the month in which the loans were disbursed, but for the undisbursed tranches, we use the latest spot rate

Figure 4. We expect rates to remain on hold in 2012



Source: CEIC Data Company Ltd., and CIRA

Fiscal Policy – No major policy reforms

Fiscal performance in 2011 had a mild fiscal slippage (7.0% of GDP vs 6.8% revised target) and was a reflection of implementation of various measures to broaden and simplify the tax base (largely taken in the 2011 Budget, when corporate/income tax rates were rationalized and some VAT reforms were introduced). Unfortunately, this has also resulted in a decline in tax-to-GDP ratio from 12.9% of GDP in 2010 to 12.7% of GDP. We think the 13.3% tax-to-GDP target this year looks ambitious, especially now that the growth forecast may be scaled down, but the Finance Ministry appears to be approaching a wait-and -see attitude. A few new measures, like increasing the commodity levy on sugar exports and raising import duties on fuel should be net positives for tax coffers. On the expenditure side, recurrent and interest expenditures have come down in recent

years, giving it room to target public investment spending at about 6% of GDP, which it hopes to maintain in the next 5-6 years. However, CBSL believes that if the deficit were under pressure to breach the target, this is an area in the budget that could see some cuts. In line with expectations, we are unlikely to see any major reduction in defense spending (~3-3.5% of GDP) given that nearly 80% of defense expenditure is recurrent in nature. Also key to watch is the Debt/GDP ratio, which would likely edge up due to LKR depreciation.

SOE Losses–could we see more reforms?

The recent price hikes in fuel and electricity are meant to improve the cost recovery of the Ceylon Petroleum Corporation (CPC) and Ceylon Electricity Board (CEB), the two biggest sources of SOE losses, helping to recover LKR75bn and LKR30bn, respectively. Given tighter budget constraints by the government, one observer we met noted that despite strong public pronouncements of "no privatization", he thinks the recent IPO of People's Leasing Company, a 100%-owned subsidiary of state-owned People's Bank, is an important test-case for what could be the future policy approach to addressing SOE inefficiencies –start divesting stakes to raise capital. State-owned Sri Lanka Airlines, for example, is also reported selling its catering company. Following the PPP model could thus be a viable option. While reforming CPC and CEB will likely be very difficult, the adjustment in fuel/electricity prices could raise public support for efficiency enhancing reforms, and one observer believes a study has already been conducted about possibly breaking up CPC/CEB, for example.

Politics – Stable enough to push through tough reforms

The Rajapaksa-led government remains popular and stable, and it is capitalizing on its popularity to push through tough reforms on the fuel/electricity hikes. We'll need to watch how its public support from the Sinhalese majority changes if growth slows and more painful reforms are taken but, for now, despite some protests, we don't see major political instability brewing. The opposition still looks very weak. One good thing noted by one of the political analysts we met is that, since Mahinda Rajapaksa (and his family) probably want to stay in power for the long haul, he has a vested interest in achieving sustainable growth rather than pursuing very short-run policies. While policy errors have been made over the last few years, the more volatile external funding environment may hopefully now push the government to take the necessary corrective steps to address them. However, on the negative side, it seems people we met believe reconciliation efforts with the Tamil minority appear weak at best.

Market outlook

Hard currency debt: In December, we noted that Sri Lanka dollar bonds *were likely to underperform Vietnam bonds* given that the former is far more vulnerable to portfolio flow volatility and deterioration in external accounts.[2] Back then, Sri Lanka was still trading about 50bps *through* Vietnam in z-spreads. However, we also didn't' anticipate the extent of Sri Lanka's underperformance, with dollar bonds now trading anywhere between *125-150bps wider* than Vietnam on z-spreads (mid-mid) following the significant under-performance last week.

[2] See *Asia Macro View - A Closer Look at Vulnerability to Financial Spillovers from Europe* (13-Dec-11).

While there are still risks, ***we think it may be worth scaling in gradually and doing a Sri Lanka-Vietnam switch***, in the coming months. *We would look for dip-buying opportunities, but these may come when we are closer to new issuance*. Despite the negative headline risks, there are a number of factors that make us believe that these problems are not insurmountable:

First, when we look at the sum of the current account and FDI and official loans last year, based on figures mentioned by officials (though it's not clear to us if these figures are gross or net figures), the overall reliance on portfolio flows don't look that large -- likely still below the $1bn range (though the problem is that we may have seen negative portfolio/ST outflows in the last few months that exacerbated this gap, and the extent of errors and omissions is unclear).

Second, after a number of policy errors, the government is now taking corrective action to stabilize external finances, including letting the LKR be more flexible, raising interest rates, announcing credit growth targets, imposing import levies and, more recently, jacking up fuel and electricity prices significantly. Thus, it is not being passive about the problem.

Third, President Mahinda Rajapaksa's government remains strong and stable with the President having strong constitutional powers, especially after the 18^{th} Amendment. This leads us to believe that Rajapaksa and his allies want to stay in power for the long haul. Thus, they should also have a vested interest in restoring macro stability and sustainable growth. Their stable government may also give them sufficient political capital to push through tough reforms.

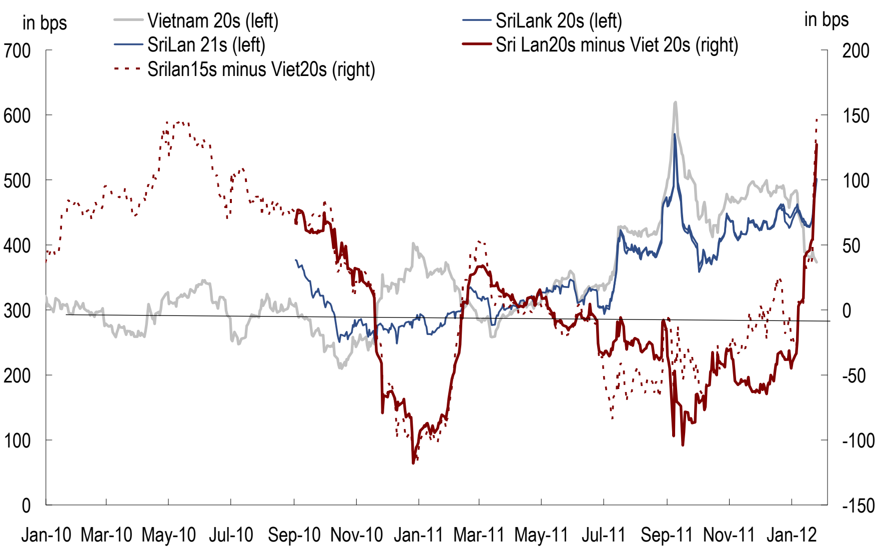
Last, in our meetings, the IMF seem happy with recent slew of policies (FX flexibility, credit growth curbs, levies and fuel/electricity hikes). We think the government could qualify for the disbursal of the remaining IMF tranches and, while no one has admitted it, whether it happens and when it may happen is unclear, we think it makes sense to tap it.

We would be look for further cues around March to April, when the next IMF staff mission may visit, to scale in more. One key risk is "timing" – bank and sovereign may come to the market with bond issuance in the coming months, and if external accounts don't stabilize before then, the market may demand larger concessions on borrowing costs if it is seen to be borrowing because it has to. It's not clear to us if any improvement on current account and/or possible IMF headline news will come before any pending new deals.

As an aside, when comparing Sri Lanka and Vietnam, both have similarly weak external liquidity/FX reserve ratios, but the former may still have better near-term growth prospects, with the help of a healthier banking system and less egregious track record of boom-bust monetary policy that has significant undermined Central Bank credibility. If growth is more robust, Sri Lanka's prospects for attracting more private capital flows could also be better. Both have current account deficit issues, but the nature of capital account vulnerability is different – Sri Lanka is more exposed to offshore private capital flows, Vietnam is vulnerable to various forms of domestic capital flight. Sri Lanka takes pride in the government's spotless debt default history while Vietnam (and state-owned Vinashin) does not. However, Vietnam's debt ratios, structure of the debt and interest burden is still more favorable than those of Sri Lanka, and thus it may be under less pressure to borrow offshore imminently, but resolution of its banking sector problems could raise future debt-funding pressures.

Overall, if Sri Lanka pursues corrective policies and potential IMF support (which is not a certainty) we think the ability of Sri Lanka to win back some confidence on private flows is still there. With a spread gap now at historical wides vs Vietnam, it may be worth scaling back in gradually, but we would wait for further clarity on external finances in the run-up to new issues which could offer better entry-levels.

Figure 5. Comparing Historical z-spread Performance – Sri Lanka vs. Vietnam



Source: Bloomberg, and CIRA

Figure 6. Sri Lanka and Vietnam – Comparing Macro/Sovereign Credit Metrics

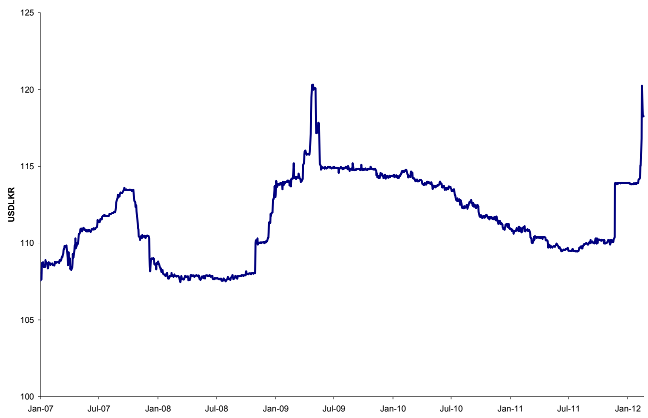
	Sri Lanka					Vietnam				
	2008	2009	2010	2011	2012F	2008	2009	2010	2011	2012F
Real GDP, % yoy	5.9	3.5	8.0	8.0	7.8	6.3	5.3	6.8	5.9	6.0
GDP per capita, US$	2,003	2,048	2,387	2,775	3,023	1,044	1,054	1,128	1,286	1,416
CPI, % avg	22.6	3.4	6.0	6.8	6.0	23.2	7.0	9.2	18.6	10.4
Credit Growth to private sector (% YoY)	7.0	-5.8	24.9	33.0	18.0	19.7	37.8	28.0	13.0	15.0
Policy Interest rate, % eop	10.5	7.5	7.3	7.0	6.0	9.5	8.0	9.0	15.0	12.0
Long term yield, % eop	19.1	9.3	7.6	7.5	8.5	10.0	11.7	11.5	13.0	12.0
lc/US$, avg	108.3	114.9	113.1	110.6	115.4	16,496	18,048	19,338	20,899	21,841
Current account, % of GDP	-9.5	-0.5	-2.9	-4.4	-4.8	-11.9	-7.8	-4.0	-3.7	-3.7
Net FDI, % of GDP	1.7	0.9	0.9	1.5	1.4	10.3	7.5	7.2	6.2	5.7
International reserves, US$ bn	1.8	5.1	6.6	6.0	6.7	23.9	16.4	12.5	15.3	19.2
% of ST Debt by Remaining Maturity	0.6	1.2	1.7	1.7	1.9	3.1	2.1	1.4	1.8	2.1
External debt % of GDP	43.6	49.8	50.1	48.0	51.4	31.5	42.2	44.7	43.3	41.5
External debt % of Exports	219.1	295.2	298.9	269.7	294.3	40.7	61.7	61.9	59.2	54.2
General Public debt % of GDP	81.4	86.2	81.9	82.0	83.0	42.9	51.2	56.7	57.3	57.8
of which Domestic	48.5	49.8	45.8	44.0	43.0	12.9	20.0	11.0	11.1	11.2
Consolidated government balance (% of GDP)	-7.0	-9.9	-8.0	-7.0	-6.4	-4.7	-8.9	-7.9	-5.0	-4.8
Gen. Gov. Int. Pymt/Gen. Gov. Revenue	31.0	42.6	42.2	35.3	34.5	5.3	4.1	5.5	5.3	4.9

Source: CIRA, Moody's

Local currency debt. The rupee has depreciated about 7.3% since August (mostly since mid-November), peaking above 120 per USD, underperforming all other Asian currencies, and we think already prices in the sharp current account/trade deterioration and portfolio volatility. However, despite recent moves to curb the CA deficit, we see the impact will take time and believe we could still see some further rupee pressure from here, with a key risk being what happens to oil

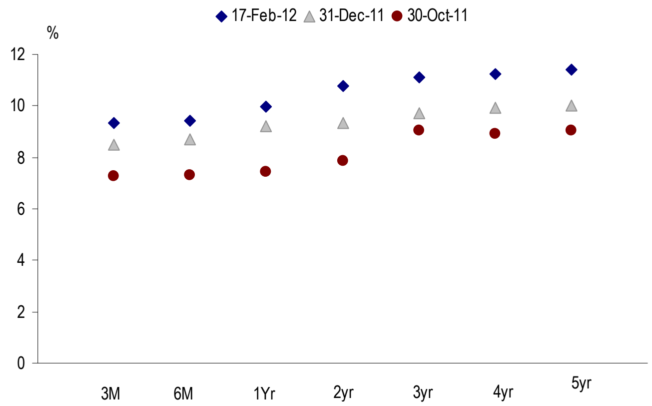
prices, further portfolio positions in LKR-denominated bonds and bills –we estimate there is about $2.15bn in offshore positions in LKR Treasury bills and bonds (the 12.5% quota on T-bonds not being utilized). However, we think a significant amount of T-bill exposure (about $650mn) is likely FX-hedged (3- and 6-M LKR T-bills provide roughly a 300bps spread on an FX hedged basis), and thus, the key thing to watch is what happens to the remaining roughly $1.5bn or so of LKR Treasury bond positions. Overall, we think it's probably still too early to dip into LKR-denominated bonds – yields are still historically low as we expect near-term rupee pressure could still persist and offshore positioning could create some volatility. Moreover, we would wait for seasonal tightness in during the April New Year festival for dip-buying opportunities.

Figure 7. Historical LKR spot



Source: Bloomberg

Figure 8. LKR Treasury bill/bond curve



Source: Bloomberg

Appendix A-1

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