



## Media Release

### **More moderate growth but resilient against decelerating global economy and rising fuel/food prices**

RAM Ratings (Lanka) Limited ("RAM Ratings") held a media conference today, in conjunction with the release of a report entitled *Economic Outlook on Sri Lanka: Key Economic Challenges and Prospects for 2008 and 2009* by its Malaysian parent, RAM Holdings Berhad ("RAM"). RAM highlighted that the marked deterioration in global economic conditions in 1H 2008 had been triggered by the decelerating American and European economies, affected by the sub-prime credit meltdown, tightening liquidity and correcting housing market. Notably, the effects on developing economies, including Sri Lanka, have been compounded by unprecedented price shocks vis-à-vis food, commodities and oil.

Some Asian economies such as India, China, Malaysia and Indonesia are adjusting to these shocks by slashing fuel subsidies to reduce fiscal costs. Sri Lanka, on the other hand, has been mitigating its hefty subsidy cost through a price pass-through mechanism since 2005. Nonetheless, more expensive fuel and food imports (such as wheat and milk powder) will have negative effects on the country's balance of payments and economic growth.

RAM's Group Chief Economist, Dr Yeah Kim Leng, said, *"Despite these adverse developments, Sri Lanka's GDP growth is expected to only moderate to 5.8% in 2008, thereafter improving slightly to 6.1% in 2009. This would be in tandem with the anticipated easing in world food and energy prices, as supply increases and demand cools amid skyrocketing prices as well as greater awareness and coordination among countries in tackling excessive speculation in the international commodity markets."*

The country's Industrial Production Index went up 6.3% in 1Q 2008, about the same rate as for the entire 2007. This suggests that domestic and export demand is still resilient. Key industries such as food and beverage and textiles and apparel, however, expanded more slowly - by 0.3 to 1.0 percentage points - in line with more moderate economic growth in 2008.

Exports of major agricultural and primary commodities remained strong in 1Q 2008, with double-digit growth underpinned by resilient demand for resource-based products. The agricultural sector is envisaged to expand 3.6% in 2008, and 4.3% in 2009. This will be supported by buoyant exports of tea, rubber and other related products, all of which charted fairly robust growth (40%-55%) in 1Q 2008.

Meanwhile, the construction industry (both residential and commercial) has been booming, especially amid post-tsunami rebuilding efforts. Looking ahead, construction growth should remain resilient against more costly building materials, driven by several widely anticipated projects (announced in 2006) under the government's 10-year plan; these are expected to be funded by public financing initiatives, which will lend further support to the construction sector.

The manufacturing sector's pace is projected to ease slightly to 5.7% in 2008 and 5.4% in 2009. The output of the apparel industry, i.e. one of the key drivers of Sri Lanka's manufacturing sector, remained strong in 1Q 2008, with a moderate rise in exports. Nonetheless, this high-profile industry's growth may cool down in the medium term due to intensifying price competition from countries such as Vietnam and Bangladesh. A different strategic approach has been proposed for this segment, with the incorporation of eco-friendly production processes to attract increasingly environmentally conscious European buyers.

Elsewhere, telecommunication is one of the stronger sub-sectors within the broader services industry, having grown rapidly while attracting large amounts of foreign direct investment ("FDI") over the years. On the other hand, the consumer industry may not be as active as anticipated given tight credit conditions and expectations of mounting inflation. In the meantime, Sri Lankan tourism has also been subdued, with hotels reporting average occupancy rates of 46.5% for the past 3 years. This trend is expected to continue in the short term due to ongoing security concerns.

In the meantime, RAM's Group Chief Economist expects the Central Bank to tighten interest rates by up to 75 basis points in 2H 2008, premised on the need to further curb domestic demand and keep inflation at bay. He added, "*We also expect the Sri Lankan rupee to continue depreciating by 1%-3% on a trade-weighted basis this year, albeit at a slower pace compared to 2006 and 2007. This, together with the Central Bank's current growth target of 15% for reserves, should sustain economic growth and stave off a wage-price inflation spiral.*"



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On the whole, the consensus short-term outlook for Sri Lanka is that growth will slow in the immediate term due to the persistent structural problems in the economy and the required tightening of monetary and fiscal policies to manage the world food and energy price shocks. The main risk to our growth forecast is an escalation in armed conflict, which would not only drain fiscal resources but also curtail investment and business activities, particularly FDI inflow.

Promoting private-sector development and projects as well as its participation in infrastructure financing, together with the harnessing of foreign capital, is important to Sri Lanka vis-à-vis overcoming its domestic financing constraints and accelerating industrial upgrading. Although civil unrest has historically been a primary weakness for the development of the local economy - from supply disruptions to perceived uncertainties and security concerns by potential investors - ensuring consistency in economic policies and development is also important to facilitate private-sector-led growth and "crowd in" foreign investment.

At the same time, Sri Lanka also needs to increase its export competitiveness, especially in garments. While the garment industry has been the pillar of the country's manufacturing exports, diversifying growth sources is also vital towards keeping pace with fast-growing Asian economies, as well as deriving synergistic benefits from Asia's dynamic overall economic activities.

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