

ECONOMIC MONTHLY MAY'17

We've got "sunshine on a cloudy day"

The month of May came with several positive news for the Sri Lankan economy.

- Earlier in the month the government successfully completed a sovereign bond issue of USD 1.5bn with relatively favourable rates (at 6.2%). The issue attracted increased investor interest with over USD 1bn in demand. These inflows together with the syndicated loan of USD 450mn will help in repaying foreign borrowings, taking the pressure off on the country's foreign reserves heading into the second half of the year. As at end April, foreign reserves stood at USD 5bn, about USD 1bn lower compared to the start of the year.

- After much delay, the government came to a staff-level agreement with the IMF on the second review of the country's economic reform program outlined under the Extended Fund Facility (EFF) of the IMF. The delay in this agreement held back the disbursement of the third tranche of the IMF loan facility which was supposed to be provided in April this year. However, the review will only be completed with the approval of the IMF Executive Board in June. In the meantime, the government is expected to submit the new Inland Revenue Act to the Parliament. So the third tranche of the loan can only be expected sometime after June this year.

- Sri Lanka regained the GSP+ tariff benefits after 7 years. This is expected to significantly boost exports of the country. Exports declined in both 2015 and 2016, significantly adding to the expansion of the trade deficit. An improvement in exports with these tariff benefits will likely help relieve pressure on external balances.

But it's still not all clear skies

As we highlighted in our last report in April as well, there are still considerable weaknesses in the economy which makes it vulnerable, particularly to external shocks. With the political scandals surrounding the Trump administration in the US and geopolitical tensions in the Asian region, global analysts have raised concerns that it could lead to a sell-off in emerging market assets yet again. In such an event, Sri Lanka could also see outflows of foreign funds, which could put pressure on the external finances.

Last year, in the run up to and following the US presidential election, emerging markets saw significant foreign fund outflows. This was reflected in the Sri Lankan government securities market as well which saw about USD 800mn net outflows (about Rs. 120bn) of foreign investments from October 2016 up to end February 2017. Since then, the inflows seem to have stabilized and have recorded around USD 127mn net inflows (about Rs. 19bn) by the third week of May.

What does this mean for rates and the LKR?

The positive events bode well for our end-2017 view of rates and LKR. Our base case view sees a decline in interest rates and a possibility of a further limited depreciation in the LKR (against the USD) by the end of 2017.

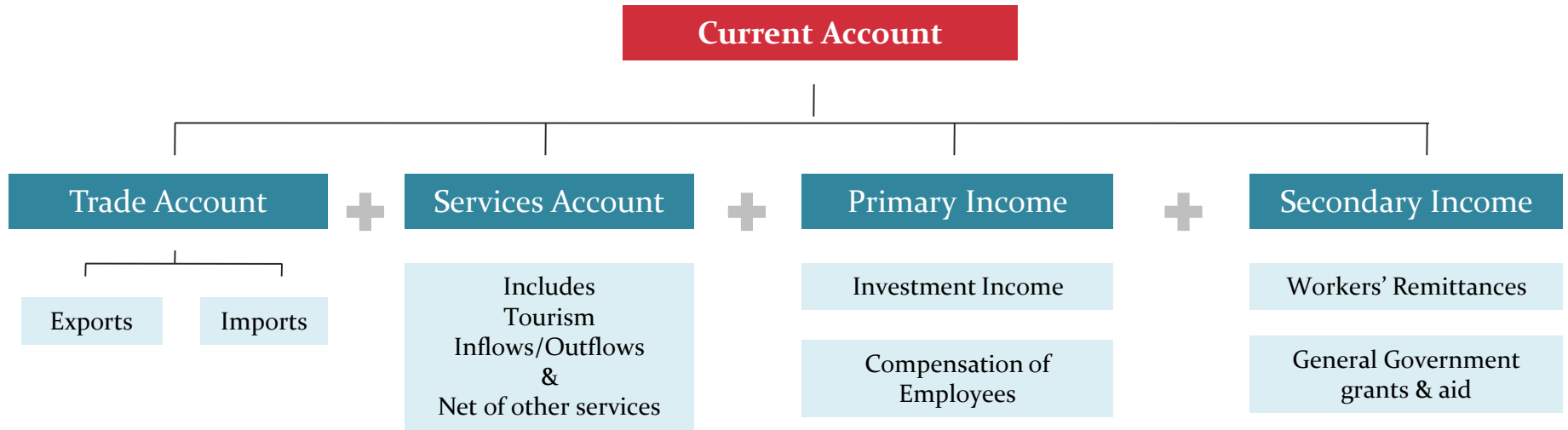
- Our base case of 45% probability expects the 12-month T-Bill rate to decline and end 2017 between 7.5% and 10.0%. (As at 19th May 2017 at 10.68%)
- Our base case for the LKR – again with a 45% probability – sees the currency depreciating a bit further, with an upper-bound limit of Rs. 158 against the USD; it is now above the lower-end of Rs. 148 of our base case view. (As at 19th May 2017 at Rs. 152.5 against the USD)

In the event of any foreign outflows driven by external instabilities, we could expect upward pressure on rates and depreciatory pressures on the LKR in the short term.

For more details on assumptions and alternative scenarios for LKR and rates please [click here](#). (Please note that the attached report no longer contains details of our views, you can find them through the link mentioned above).

In the discussion of external sector performance by the media, the most cited words include imports, exports, trade deficit, tourism, remittances and balance of payment. The general perception is that the trade deficit is usually off-set by tourism earnings and remittances in the Current Account. In this focus, we illustrate the components of the Current Account and highlight a few key points that are often ignored in the media.

- The Balance of Payment (BoP) consists of the three main accounts; Current Account, Capital Account and Financial Account. The Current Account comprises of the more commonly talked about Trade Account, tourism earnings and remittances, along with a few other categories that are less known. [See [page 05](#)]
- Trade account primarily includes imports and exports of goods.
- Services account consists of net earnings on Tourism, Transport, Telecommunication, Financial services and several other services offered and received internationally. [See [page 08](#)]
 - Services account, which includes Tourism, comprises of both inflows and outflows. However, what is often highlighted in the media is the inflows of Tourism, neglecting the outflows of the industry which took away nearly half its inflows over the recent years.
 - Services account is generally in surplus mainly owing to net inflows from Tourism. However, it is also contributed by net inflows of other services such as Transport and Telecommunication as well.
- Primary Income account includes profit and interest receipts and payments made for international investments (equity and debt) during the year. This account is generally in deficit due to large payments of profits, dividends and interest for foreign investments made within Sri Lanka. [See [page 09](#)]
- Secondary Income account mainly comprises of inflows and outflows of Workers' Remittances. The outflows of remittances are a rather negligible amount. Accordingly, this account is usually in surplus. [See [page 10](#)]



Composition of the Current Account – 2016

| USD Mn | 2016: visible the numbers published in the monthly External Sector Report | 2016 official figures published at the end of the year by the CBSL |
|---|--|---|
| Trade Deficit | -9,090 | -9,090 |
| Services Account – Receipts | 3,518 | 7,138 |
| Service Account – Payments | | -4,259 |
| Primary Income – Net | | -2,184 |
| Secondary Income – Worker’s Remittances | 7,242 | 7,260 |
| Secondary Income – Payments | | -807 |
| Current Account Balance | 1,670 | -1,942 |
| Not visible till end of year | -3,612 | |

2016: visible

The CBSL’s monthly External Sector Report, simply provides the highlights of the events of that month (these are the numbers which generally get highlighted in the media).

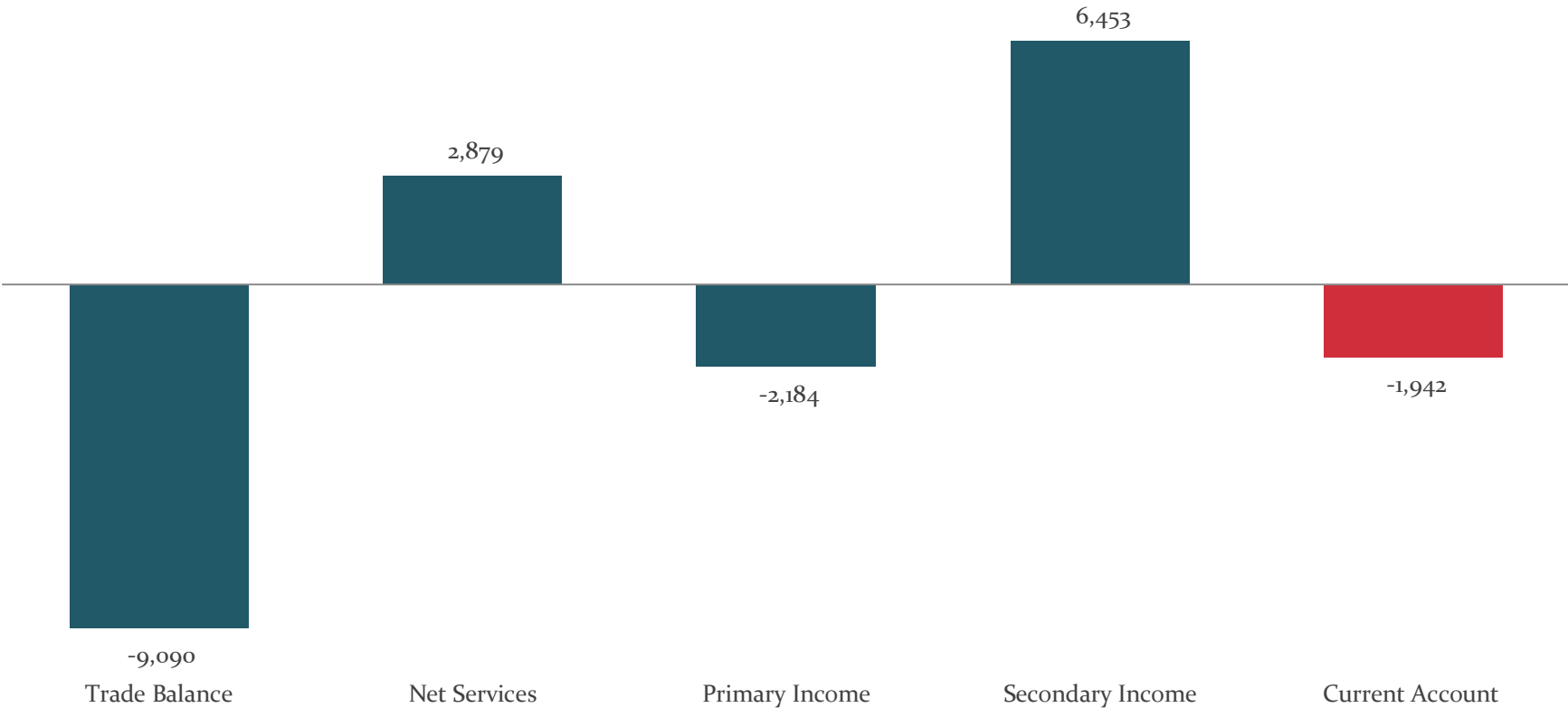
Accordingly, such figures may not give a true depiction of the state of the Current Account. In fact, based on last year’s external sector performance the monthly updates have reported on activities that are worth only about US\$ 1.7bn, while the movement of another US\$3.6bn remained unnoticed.

2016

The detailed report on last year’s external sector performance is published by the Central Bank in its Annual Report 2016, where the Current Account deficit reported is larger than what it may seem based on statistics in the monthly report.

Composition of the Current Account – 2016

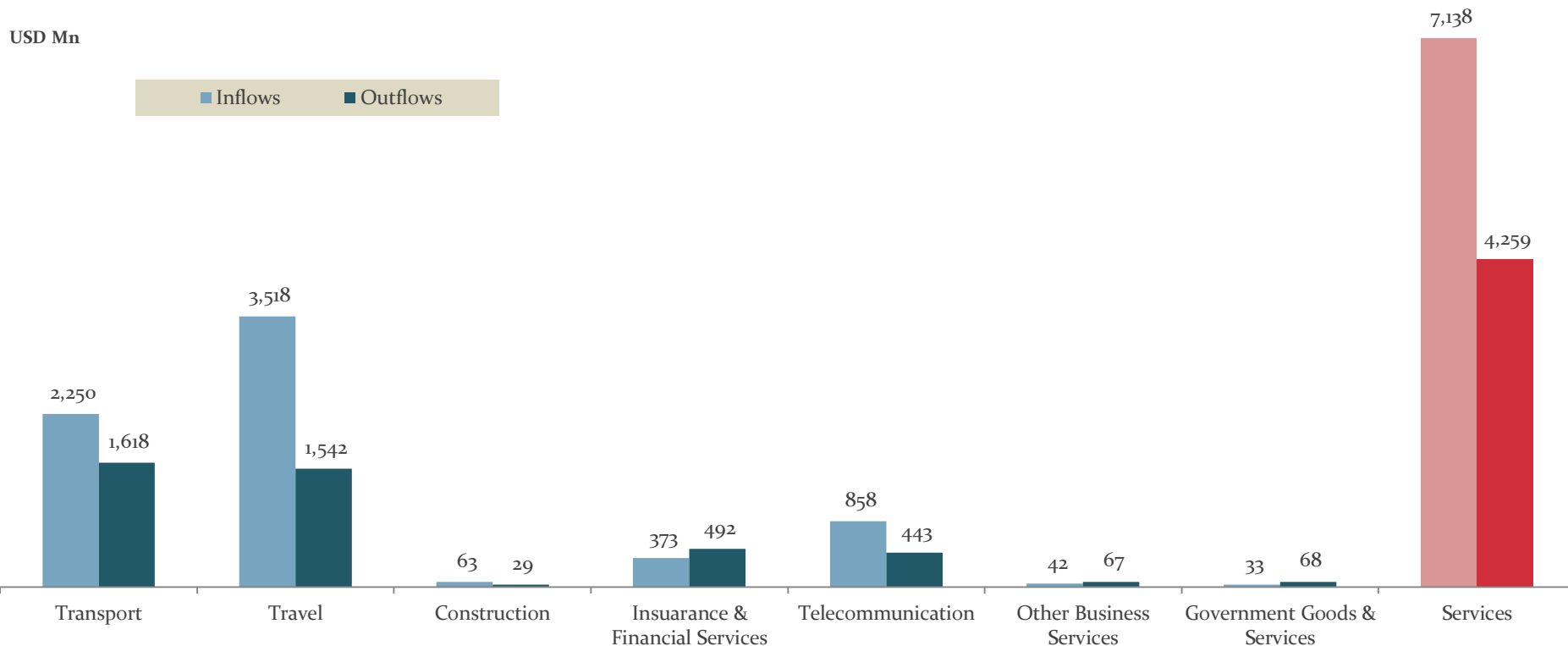
USD Mn



$$\text{Trade Balance} + \text{Net Services} + \text{Primary Income} + \text{Secondary Income} = \text{Current Account Balance}$$

Composition of the Services Account – 2016

Aside from Tourism (Travel), Services Account comprises of several other components, including Transport and Telecommunication services – some of which account for substantial amounts of net inflows but are rarely noted. Another point seldom talked of is the significant outflows of Tourism sector, which takes away up to about half of its inflows, which are constantly highlighted in the media.

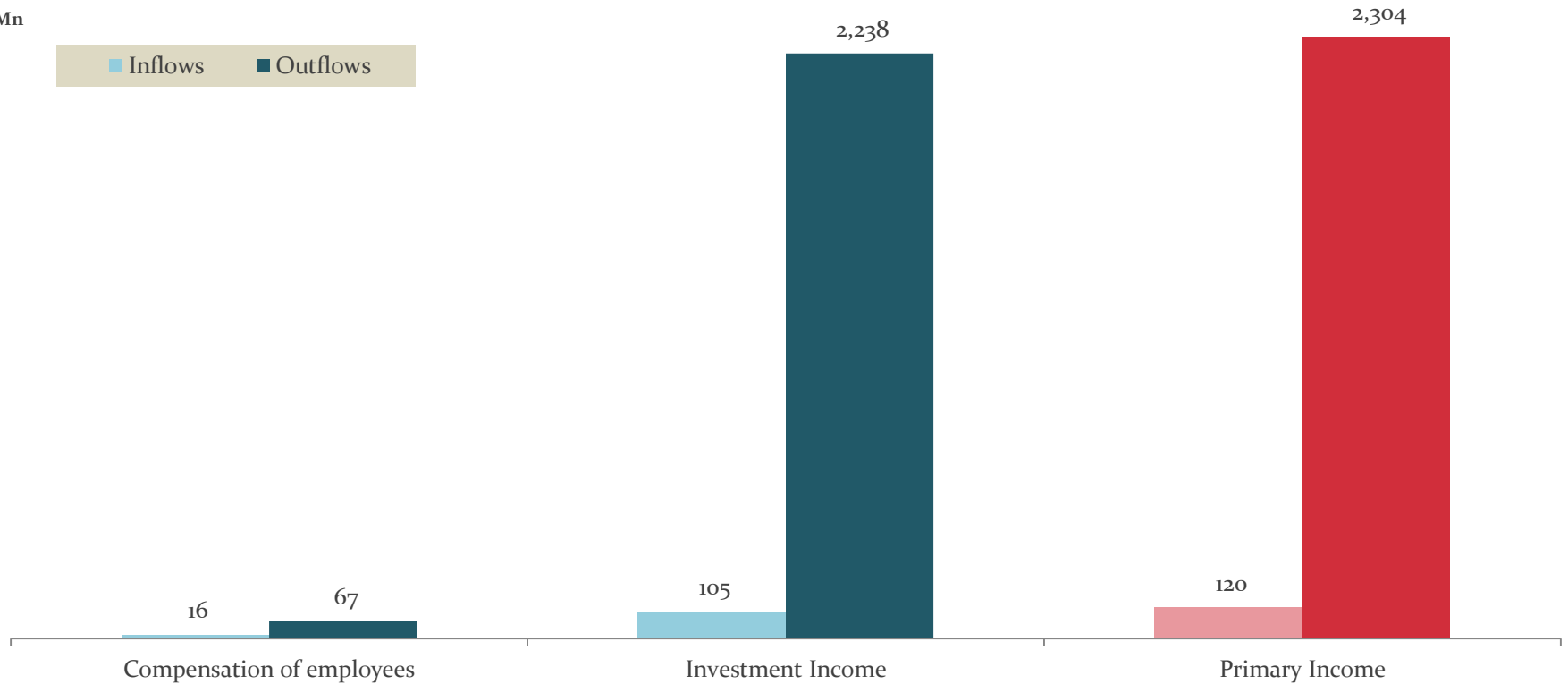


Composition of Primary Income – 2016

Primary Income account includes profit & interest receipts and payments made for international investments (equity and debt) during the year. This account is generally in deficit due to significant payments of profits, dividends and interest made to foreign investors.

USD Mn

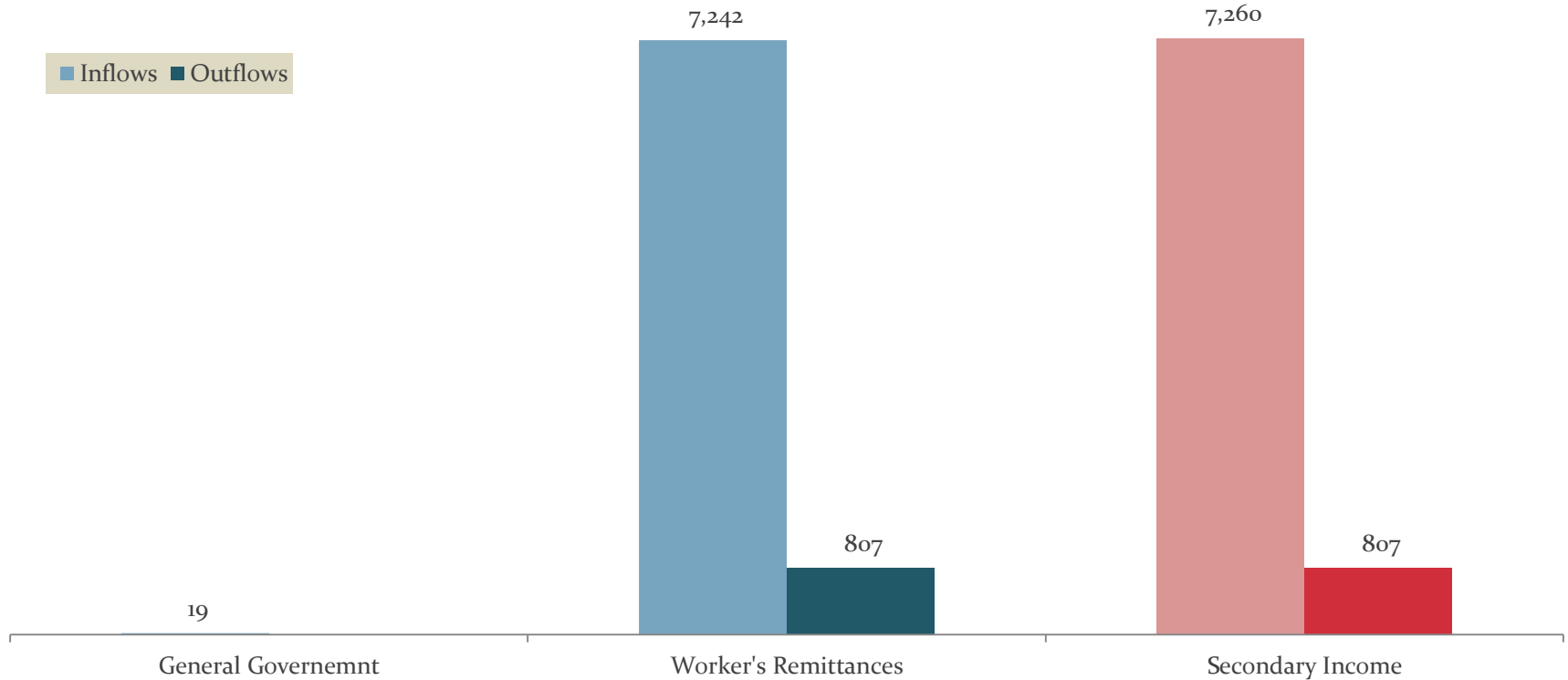
Inflows Outflows



Composition of Secondary Income – 2016

Secondary Income account mainly comprises of inflows and outflows of Workers' Remittances. The outflows of remittances are a rather negligible amount. Accordingly, this account is usually in surplus.

USD Mn



Dashboard

| | Month-on-Month | | Year-on-Year | |
|----------------------------|----------------|-------|--------------|-------|
| Inflation | Mar | Apr | Mar | Apr |
| Headline Inflation (CCPI)* | -0.2% | 0.5% | 7.3% | 6.9% |
| Core Inflation (CCPI)* | 0.2% | 0.1% | 7.3% | 6.8% |
| Headline Inflation (NCPI) | -0.3% | 1.3% | 8.6% | 8.4% |
| Core Inflation (NCPI) | 0.2% | 0.2% | 7.0% | 5.9% |
| Monetary Aggregates | Feb | Mar | Feb | Mar |
| Broad Money (M2B) | 1.7% | 2.3% | 18.0% | 20.0% |
| Credit to Public Corp. | 3.2% | 3.5% | 1.6% | 7.5% |
| Credit to Private Sector | 1.7% | 1.9% | 21.0% | 20.4% |
| External Sector | Dec | Jan | Dec | Jan |
| Exports | 6.1% | 0.7% | 4.7% | -3.8% |
| Imports | 4.8% | -1.0% | 10.4% | 13.2% |
| Trade Deficit | 3.8% | -2.4% | 16.1% | 35.2% |

- The monthly increase in CCPI Headline inflation was led by higher Food inflation and heightened demand conditions during the festive season. Food & Beverage (F&B) inflation saw a 1.7% rise during April, from a decline of 0.7% recorded in the previous month. Nevertheless YOY inflation fell from its record highs seen in the previous month.

- Private sector credit saw an absolute growth of Rs. 82.0bn in March – higher than Rs. 70.9bn recorded in February.
- Net credit to government grew 13.3% YOY, in March reporting a Rs. 22.4bn absolute rise over the month.

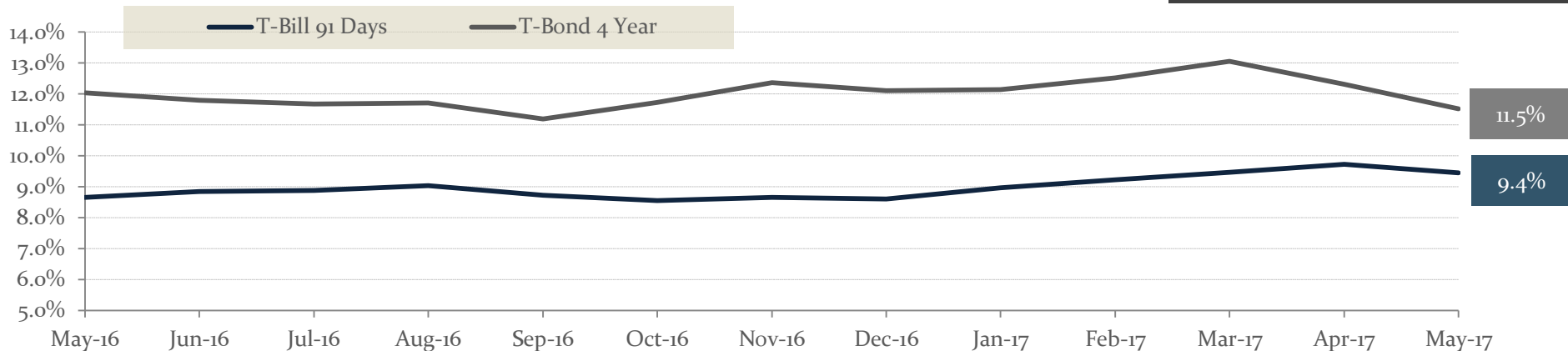
- Exports – The poor performance was owing to contraction in industrial exports, despite the growth in agricultural exports.

- Imports – Continued to record double digit growth for the fourth consecutive month, largely driven by intermediate and consumer goods imports. Investment goods reversed from its upward trend seen since January 2016.

- Trade Deficit - US\$ 934mn by end January; a 35.2% increase from the levels recorded in January 2016.

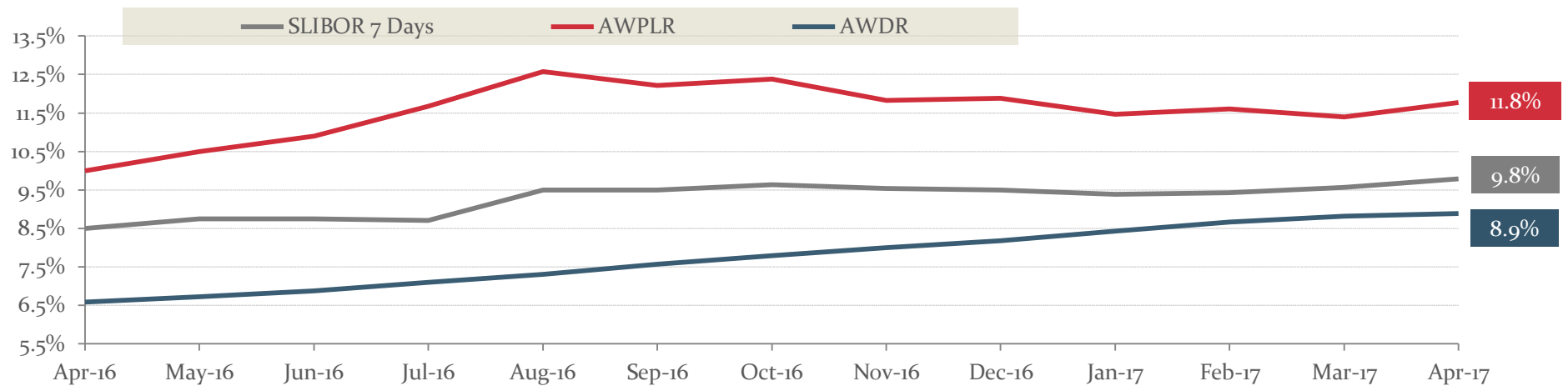
Government Security Rates

SDFR(formerly Repo) 7.25%
 SLFR(formerly Reverse Repo) 8.75%
 SRR 7.5%



*T-Bond 4-year rates are from www.investing.com as at 19th May'17

Key Interest Rates- Average for the month

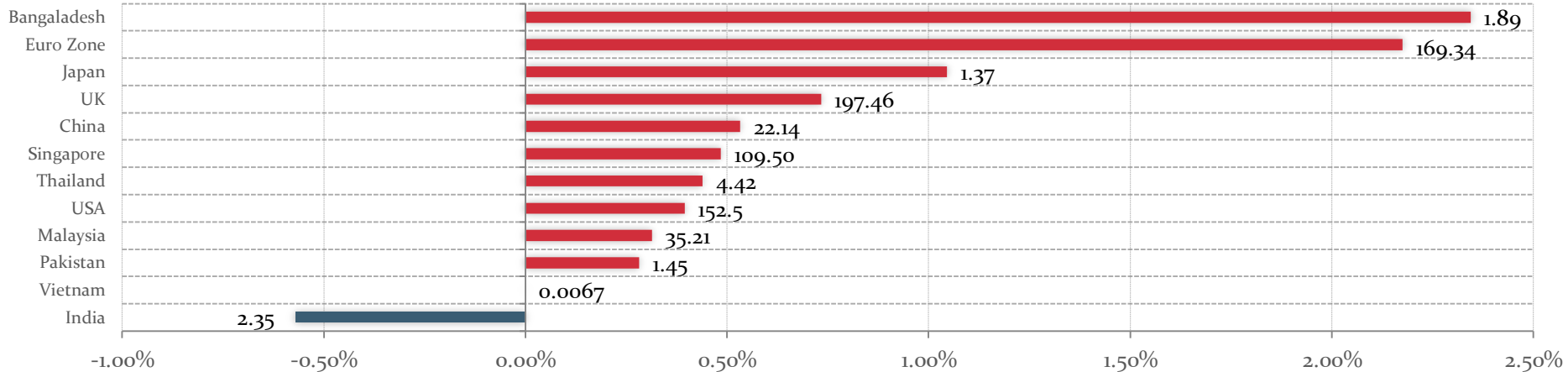


Currency Movements- against the LKR (as at 19th May 2017)

Depreciation against LKR

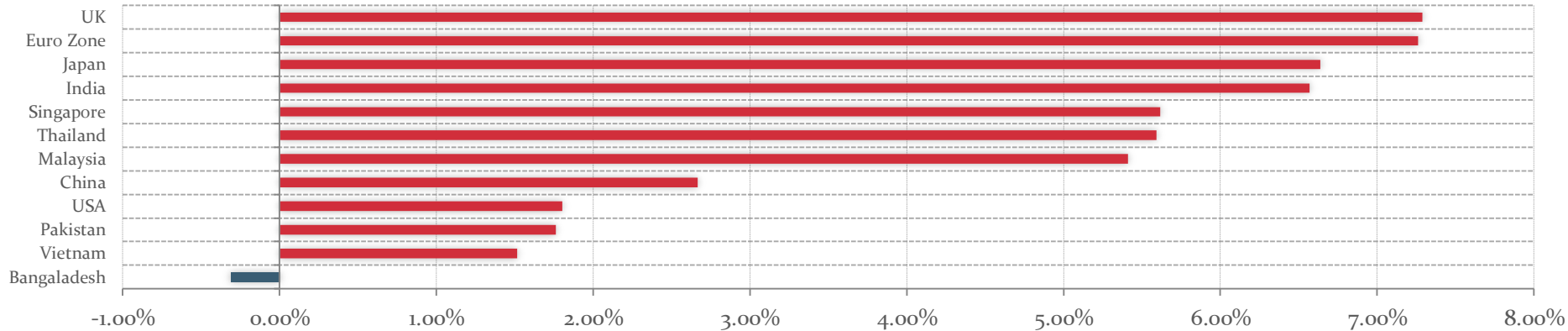
Appreciation against LKR

MTD (Month-To-Date)



* Indicative rate as at 19th May '17

YTD (Year-To-Date)

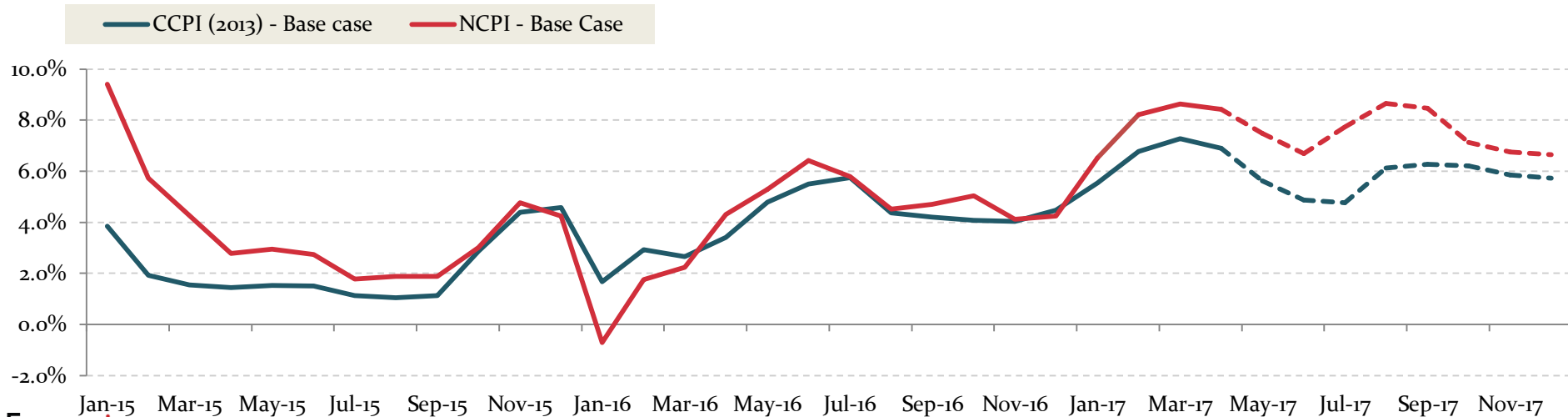


Key Forecasts

| Indicator | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 ^F |
|-----------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------------------|
| GDP(% 2010 base) | - | - | 8.4% | 9.1% | 3.4% | 4.9% | 4.8% | 4.4% | 4.5% |
| Inflation (CCPI Annual Average)* | - | - | - | - | - | - | 2.2% | 4.0% | 6.0% |
| Fiscal Deficit (% of GDP) | - | 7.0% | 6.2% | 5.5% | 5.4% | 5.7% | 7.6% | 5.4% | 5.0% |
| Trade Deficit (USD 'Mn) | 3,122 | 4,883 | 9,710 | 9,409 | 7,609 | 8,287 | 8,388 | 9,090 | 9,592 |
| Current Account Deficit (USD 'Mn) | 214 | 1,089 | 4,615 | 3,982 | 2,541 | 1,988 | 1,883 | 1,942 | 2,438 |

*CCPI inflation figures are based on the revised base of 2013

Inflation Outlook for 2017



M2b: The sum of currency held by the public and all deposits held by the public with commercial banks (Source:CBSL)

Gross Official Reserves: consist of monetary gold, SDR holdings, reserve position in the IMF and foreign exchange, which comprises holdings of foreign currency, deposits with foreign banks and investment in foreign securities. (Source: IMF)

CCPI: The Colombo Consumer Price Index (2013=100) measures the general price level of consumer goods and services purchased in the Colombo urban areas. The consumer basket includes 392 items which represent the typical urban households' consumption expenditure. (Source: DCS)

NCPI: The National Consumer Price Index (2013=100) is compiled using prices collected for all of the nine provinces. The national consumer basket includes 407 items which represent the consumption expenditure of all households in Sri Lanka. (Source: DCS)

Core inflation: Considered a more accurate gauge of underlying inflation and compiled by subtracting out what is considered volatile elements of the overall index. In Sri Lanka, the core inflation index is compiled by excluding volatile food, energy, transport from the basket. (Source:CBSL)

YOY: Year-on Year: percentage change expressed compared to a value of a previous year

MOM: Month-on-Month: percentage change of a variable compared to a value of a previous month.

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