Frontier Research

ECONOMIC QUARTERLY JANUARY '17

Views Updated

Photo Credits: Udeshi Gurusinghe - https://www.instagram.com/esposito13/

Executive Summary

Following the second rate hike in July, the Central Bank of Sri Lanka (CBSL) maintained policy rates over the latter part of 2016. Credit growth to the private sector decelerated considerably on effects of the monetary tightening measures, moderating to 22.0% YOY in October from 28.5% YOY growth seen in July. However, on an absolute basis, credit growth continued to remain at higher levels. Following its first review of the EFF (Extended Fund Facility) arrangement, the IMF noted that Sri Lanka's performance under the program has been 'broadly satisfactory' and expressed that the economy and financial markets have shown signs of stabilizing with implementation of the authorities' reform program, particularly following the reinstatement of the tax revisions in November. However, it highlighted the 'urgent' need for 'steadfast' implementation of fiscal and structural reforms in order to keep the program on track through 2017. The Fund also pointed out that currently it does not recommend further monetary tightening, given subsiding inflation and the rise in interest rates following the two rate hikes this year.

Global markets were affected by the impact of the surprise Trump victory in the November US Presidential Elections, amidst the uncertainty in Europe created by the Brexit referendum. The quarter came to an end with the US Federal Reserve hiking interest rates for the first time in a year, accelerating post-Trump outflows from emerging markets. Meanwhile, the European Central Bank extended its bond purchasing program (quantitative easing) by 9 months, but reduced the amount of bonds purchased each month. The quarter ended with analysts seeing a commodity rally, following the November 30th OPEC agreement for an oil production cut. The recovery is helping emerging markets rebound from the volatility of the last two months.

The trend in outflows from emerging markets spilled over to Sri Lanka as well in the last quarter of 2016, with total foreign holdings in government securities reducing by Rs. 54.3bn since end September, offsetting the inflows seen following the Brexit outcome. Gross official reserves also fell "below comfortable levels" in the last quarter as noted by the IMF. On this note, the IMF report stated that the government had requested and was granted a reduction in the Net International Reserves (NIR) target for September and December 2016.

Round up of our updated end 2017 views on rates and LKR

Taking into account both recent local and global developments we have updated our views for end 2017 rates and LKR.

Here are the key points you should know;

- Our revised base case view on rates and LKR for end-2017 remains largely unchanged from our September update; a decline in interest rates and 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%. (Mid-point of 8.8% by end 2017)
    - Our base case for the LKR – again with a 45% probability – sees the currency depreciating a bit further, ending 2017 between Rs. 148 and Rs. 158 against the USD. (Mid-point of Rs. 153 against the USD by end 2017)
- Key assumption of the view is an improvement in the fiscal situation next year particularly given the IMF presence and the promising (**if implemented well**) fiscal measures introduced in the Budget 2017.
    - Our fiscal forecast for 2017 projects the overall budget deficit to be at 5.0% of GDP, slightly higher than the 4.6% of GDP expected by the government. However, this is lower than the deficits we have seen in recent years. We feel the government may be a bit too ambitious in its revenue projections and as such have revised down our revenue forecasts to reflect a lower YOY growth (16% YOY as oppose to government's projection of 27%). Nevertheless, overall fiscal conditions are likely to see an improvement compared to what we have seen in the last couple of years. (Focus 1 looks at our 2017 fiscal forecasts in detail)

Executive Summary

- However, we stress of the possible black-swan type risks the external environment could bring next year given the drastic changes in the US political trajectory under a Trump presidency.
    - More than the politics itself, the key in understanding the possible risks is how markets will react to this uncertainty. While these policies may take time to materialize, views around them by market participants (irrespective of whether the policies are actually good or bad or are even actually implemented) could cause adverse reactions in markets, which may open doors to a range of negative black-swan type risks in 2017.
    - To account for these risks and their implications on our rates and LKR, we have introduced a high-risk alternative scenario (Trumped-up - 10% probability) to our end-2017 views.
    - In this scenario we expect the 12-month T-Bill rate to increase considerably, ending 2017 between 14% and 20% (mid-point of 17% by end 2017) and the LKR to depreciate significantly to end the year between Rs. 170 and Rs. 200 against the USD (mid-point of Rs. 185 against the USD by end 2017).
- We also acknowledge that these changes could bring about positive implications for rates and LKR. Such impacts are accounted for in our positive alternative scenario (Trumped-down – 5% probability) where we see a further decline in rates and/or an appreciation in the LKR by the end of 2017.
- While our base case remains positive, we stress that clients should be very mindful of outlier risks. Even though these events are of lesser probability than the base case scenario, clients should be prepared for a quick change in outlook to an adverse scenario, as they are related to global factors that could rapidly change. I.e. be prepared well in advance for these risks, and **be vigilant.**

You can find our end-2017 views in detail in pages 34-36.

Back

Focus 1: Fiscal Forecasts 2016 & 2017

By Ashini Samarasinghe

As outlined in the Budget 2017, the government projects a 4.6% (of GDP) budget deficit next year. In achieving this target, the government has presented a few promising revenue measures which includes revisions to tax structures as well as increasing tax administrative efficiencies.

This focus will have a look at our key fiscal forecasts for 2017.

- Our fiscal forecast for 2017 projects the overall budget deficit to be at 5.0% of GDP, slightly higher than the 4.6% of GDP expected by the government. However, this is lower than the deficits we have seen in recent years. [See page 10]

- We feel the government may be a bit too ambitious in its revenue projections for next year expecting it to grow by 27% YOY. As such our projections have revised down the revenue forecast to reflect a lower YOY growth of 16%. [See page 07]

- The government expects public investments to be at 5.2% of GDP in 2017. This is significantly lower than the 7.0% of GDP initially estimated for 2016, but slightly higher than the revised 2016 estimate of 4.1% of GDP. Given the past trend of public investments being cut down to close in on the overall budget deficit target, our forecasts see public investments lower than the government's projection, and as such expect it to be at 4.1% of GDP in 2017. [See page 09]

- In terms of financing the budget, the government remains optimistic on attracting foreign financing in 2017, projecting about 44% of the deficit to be financed through foreign sources (Project and Program Loans, Commercial Borrowing – e.g. dollar bonds). However, given the rising rate environment globally and possible risks ahead for emerging markets given recent developments in the US political landscape we feel it will be difficult to obtain foreign financing next year. As such, we feel the government may have to rely more on domestic financing sources in 2017. [See page 11]

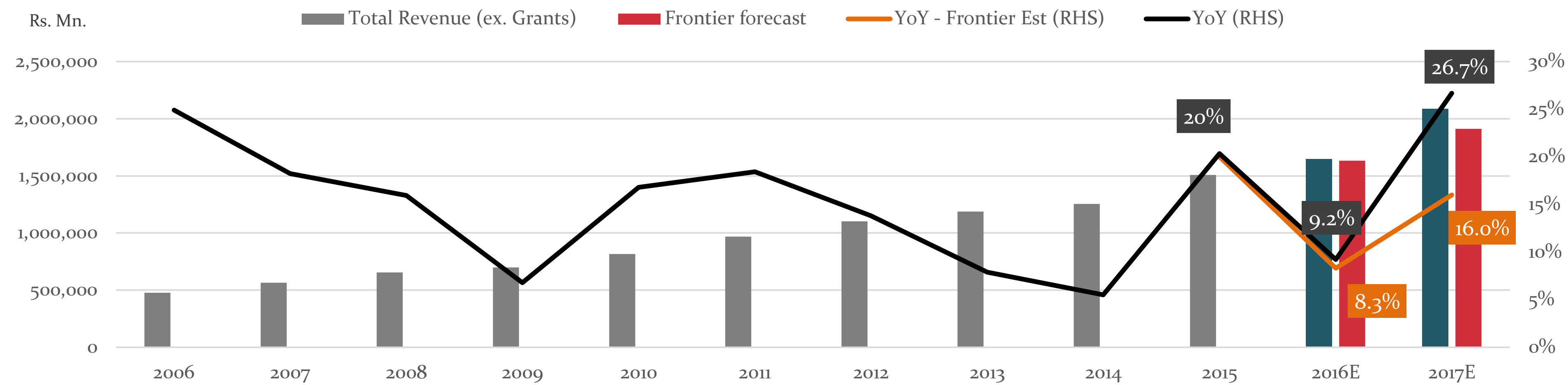
You can find detailed charts of these forecasts in the subsequent pages.

Key Fiscal Forecasts

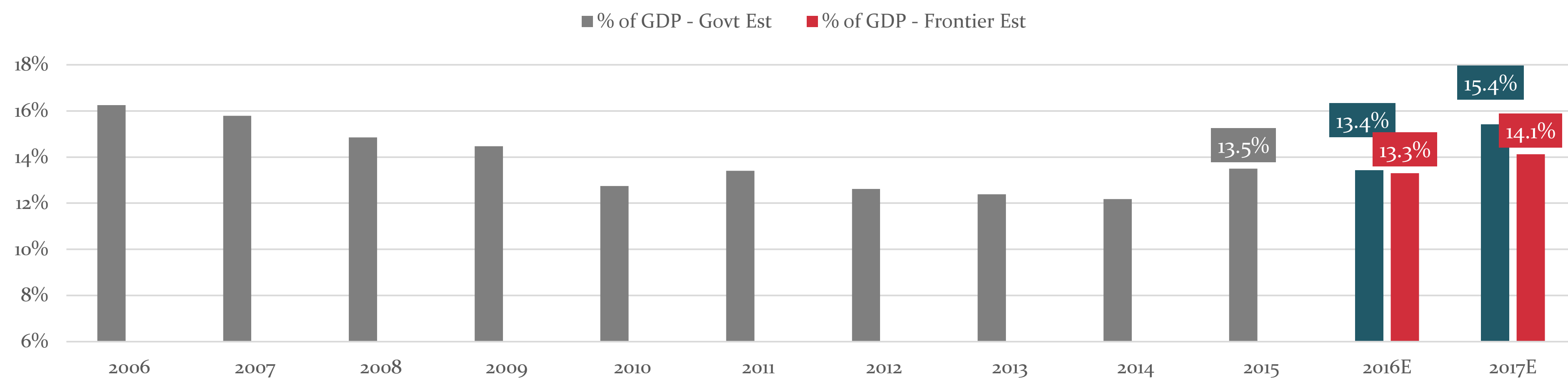
% of GDP	2016		2017	
	Government	Frontier	Government	Frontier
Total Revenue (Excl. Grants)	13.4%	13.3%	15.4%	14.1%
Tax Revenue	11.7%	11.5%	13.5%	12.4%
Non Tax Revenue	1.2%	1.2%	1.4%	1.2%
Recurrent Expenditure	15.0%	15.3%	15.0%	15.2%
Public Investment	4.1%	3.9%	5.2%	4.1%
Revenue Surplus/(Deficit)	(1.6%)	(2.0%)	0.5%	(1.1%)
Budget Surplus/(Deficit)	**(5.5%)**	**(5.7%)**	**(4.6%)**	**(5.0%)**
Foreign Financing	3.2%	2.9%	2.0%	1.5%
Domestic Financing	2.2%	2.8%	2.6%	3.5%

Back

Total Revenue (Excl. Grants)



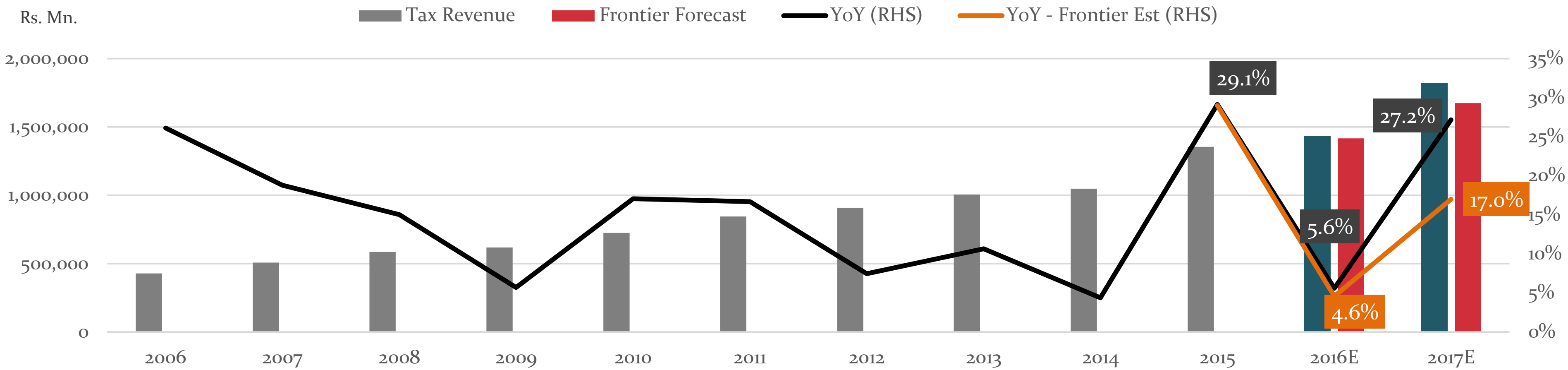
As a % of GDP



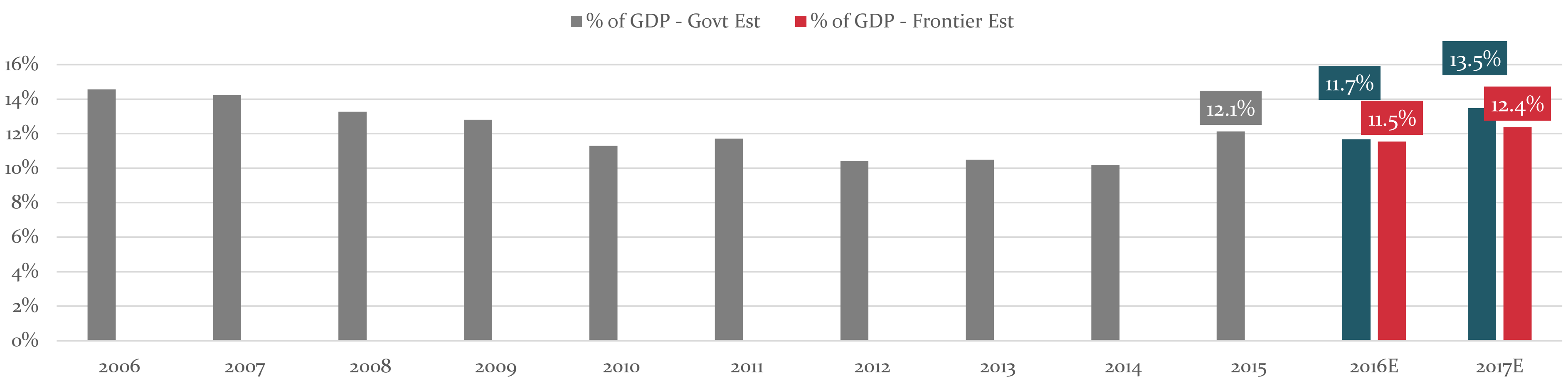
% GDP figures from 2010 onwards are based on revised GDP data (2010 Base)

Back

Tax Revenue

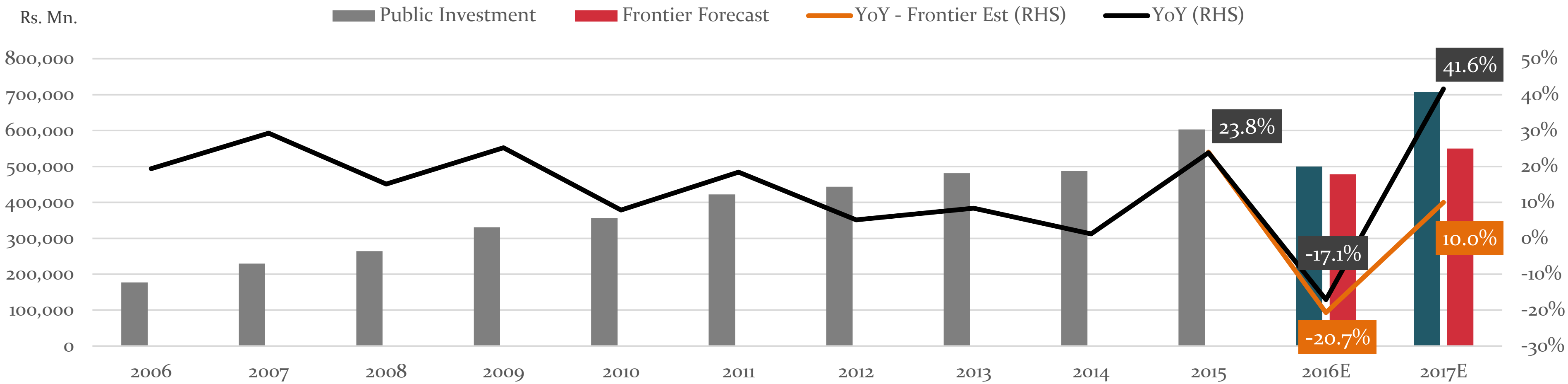


As a % of GDP

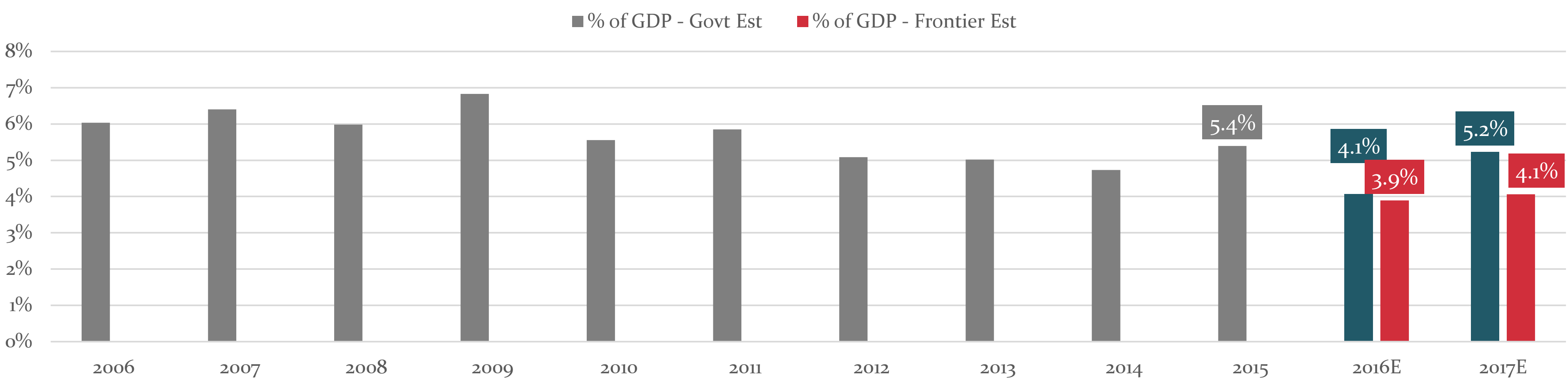


% GDP figures from 2010 onwards are based on revised GDP data (2010 Base)

Public Investment

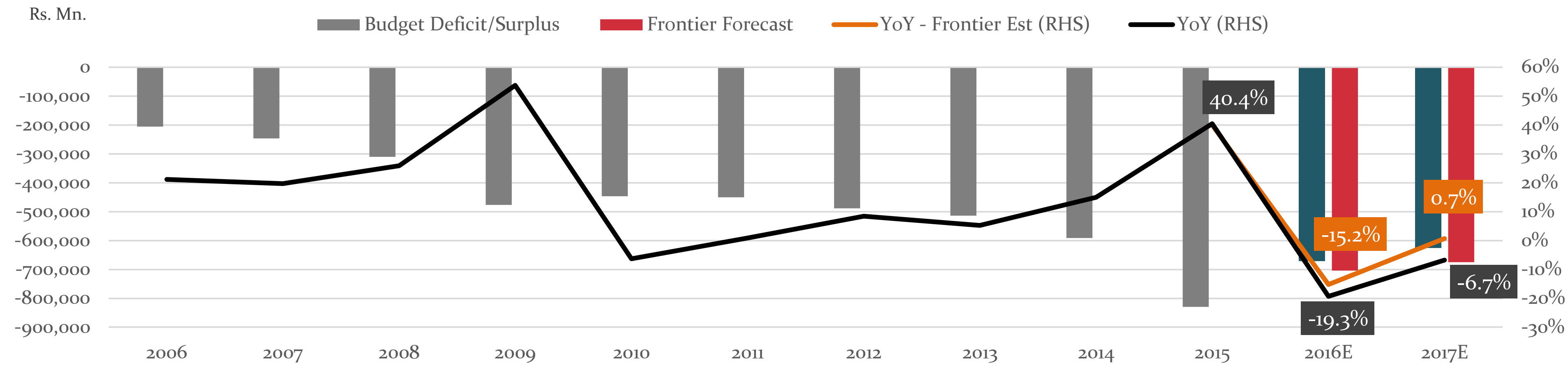


As a % of GDP

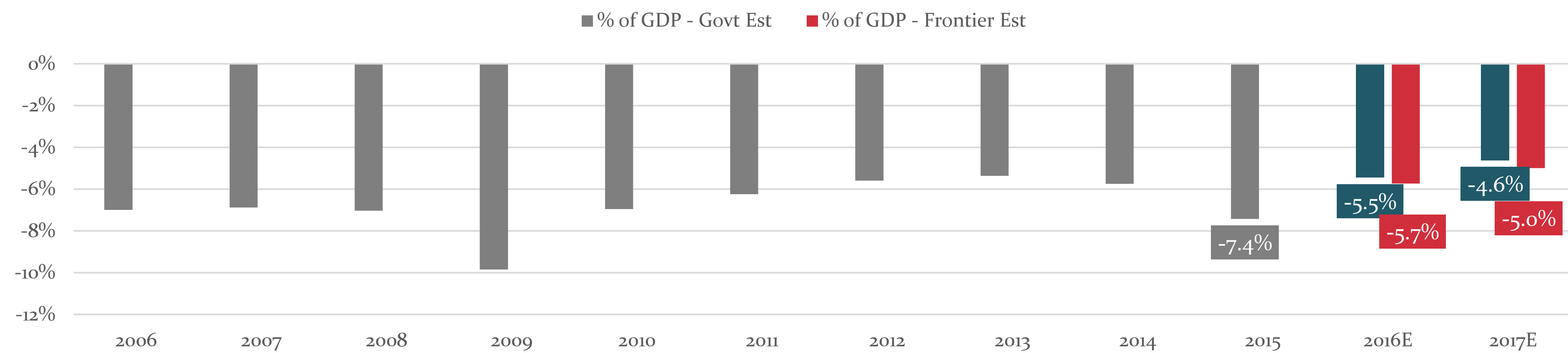


% GDP figures from 2010 onwards are based on revised GDP data (2010 Base)

Budget Deficit/Surplus



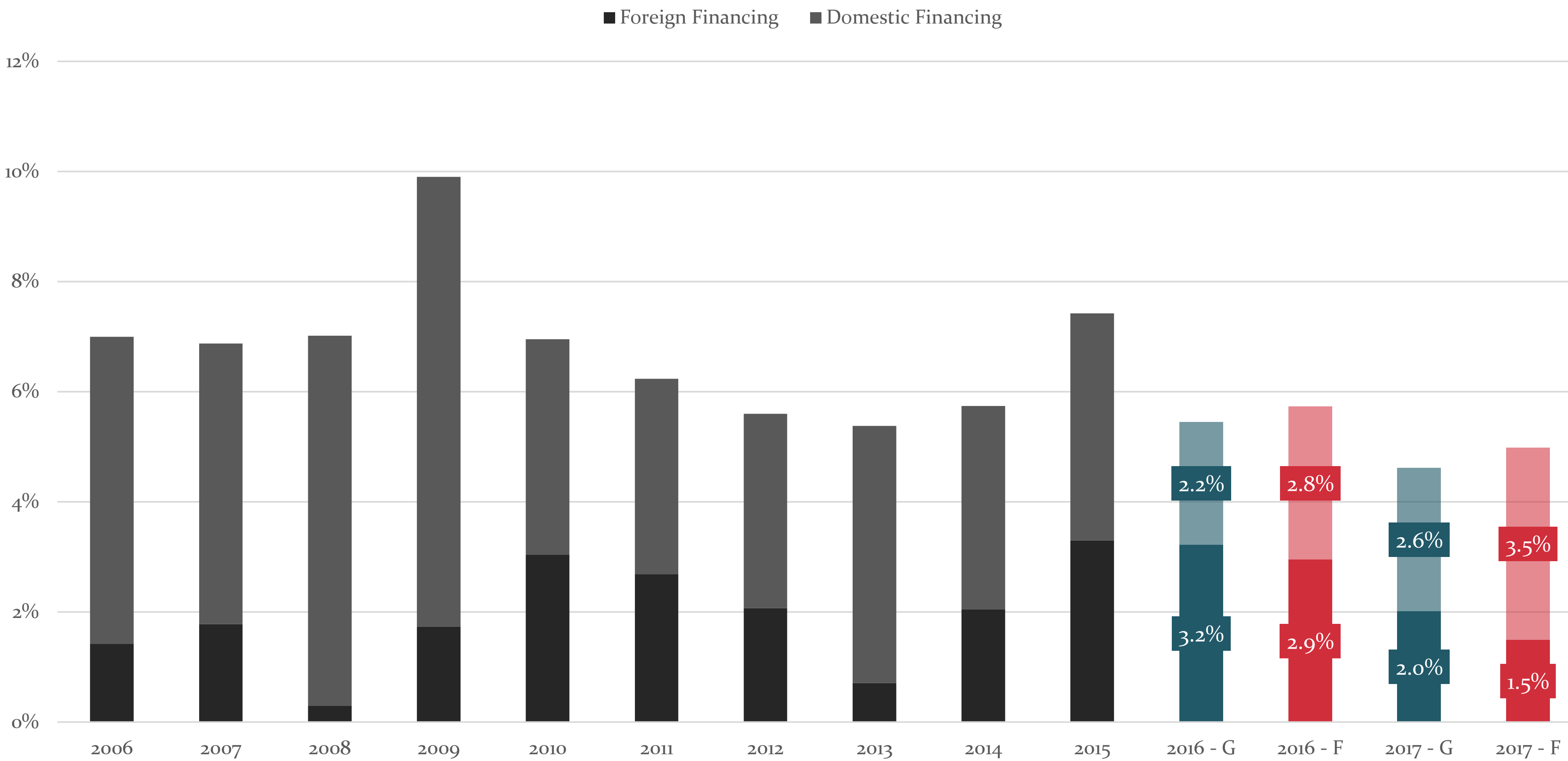
As a % of GDP



% GDP figures from 2010 onwards are based on revised GDP data (2010 Base)

Foreign and Domestic Financing % of GDP

Back



% GDP figures from 2010 onwards are based on revised GDP data (2010 Base)

By Thilina Panduwawala

2016 was a year that saw a number of 'shock' events commanding market sentiment. In this focus we are looking at how global markets performed over the year. We focused on four different market indicators for our review:

- S&P 500 equity benchmark
- MSCI Emerging Markets Currency Index
- Brent crude oil prices
- Gold prices

Overall, all four indicators have seen bouts of volatility throughout 2016 but have recorded gains over the year, recovering from lows seen in early 2016. These lows were the result of two factors that affected markets:

- Reduction in oil prices since 2014
- US Federal Reserve rate hike announced on December 17th of 2015.

Plight of Oil & a resurgent OPEC

Brent Crude oil prices hit its lowest since 2003 on January 20th, as the market was burdened by a supply glut. The low prices caused budget deficits to widen in oil producing countries, forcing the OPEC to attempt joint action to limit output for the first time since 2008. Oil prices rallied in Feb-Mar as the OPEC attempted to reach consensus on production limitations, which saw support from non-OPEC Russia as well. But the first attempt failed in April as Iran refused to limit its output below its pre-sanction levels.

The second attempt was successful, resulting in an initial agreement in September and a more detailed one in November. Prices have rallied to well over US$50 in their aftermath, but analysts continue to doubt the OPEC's ability to implement its promises.

By Thilina Panduwawala

US Federal Reserve Interest Rates

The US Federal Reserve (Fed) hiked interest rates in December 2015 for the first time since 2006. Despite expectations of a number of hikes in 2016, the economic slowdown caused the Fed and other central banks, to continue the 'lower for longer' monetary policy to sustain growth. This prompted a recovery in global stocks and return of inflows to emerging markets. The Fed kept postponing the expected hikes through the year, amidst the Brexit uncertainty and then the US elections. However, with US economic data being favorable, the Fed raised rates in their December meeting. This was largely priced in with the expectation for two more hikes in 2017. However, the initial forecasts from the Fed now shows a median expectation for three more hikes in 2017.

Brexit Surprise

'Remain' was the obvious choice of markets. But voters delivered a shocking 'Exit' for the UK from the EU. Global stocks lost a record US$3 trillion. Market volatility spiked. The future of the EU was questioned & Britain was assumed to be heading to recession. However, UK is expected to take till March 2017 to trigger the two year process of leaving the EU and there has been much uncertainty about the process, including an ongoing legal proceeding. Most markets, especially emerging markets, saw major gains after the initial uncertainty led to a realization that in reality it has not been so 'doom & gloom'; at least for now.

Trump trumps

Polls were proven wrong yet again as Donald Trump swept into the Oval office on Nov 8th. After an initial shock reaction, US stock markets began a rally that has continued into December with the S&P 500, Dow Jones & NASDAQ reaching record highs. This was grounded on the fiscal stimulus & tax cuts promised by President-elect Trump. These policies are expected to force the Fed to increase the pace of its rate hikes to keep inflation under control. In addition, the dollar strengthened significantly and US Treasury yields jumped to record highs amidst a global bond selloff.

By Thilina Panduwawala

Emerging Markets trumped or Trump-ed?

The MSCI Emerging Markets Currency Index has seen a year-to-date gain of 3.5% against the US dollar, recovering from the post-Fed hike lows in early 2016. But the gains have been trimmed significantly by the surprise election of Donald Trump to the US Presidency. His protectionist policies and aggressive stance towards China, coupled with the expectations and subsequent announcement of a December 2016 Fed rate hike, have not been good news for emerging market capital flows. November alone saw US$24bn in outflows, according to the International Institute of Finance. Along with the strengthening dollar, this has meant significant depreciation of EM currencies. While some analysts predict a 'dollar crisis' in the making for EMs, others point to political uncertainty in developed markets and improving EM fundamentals as bright spots for these countries.

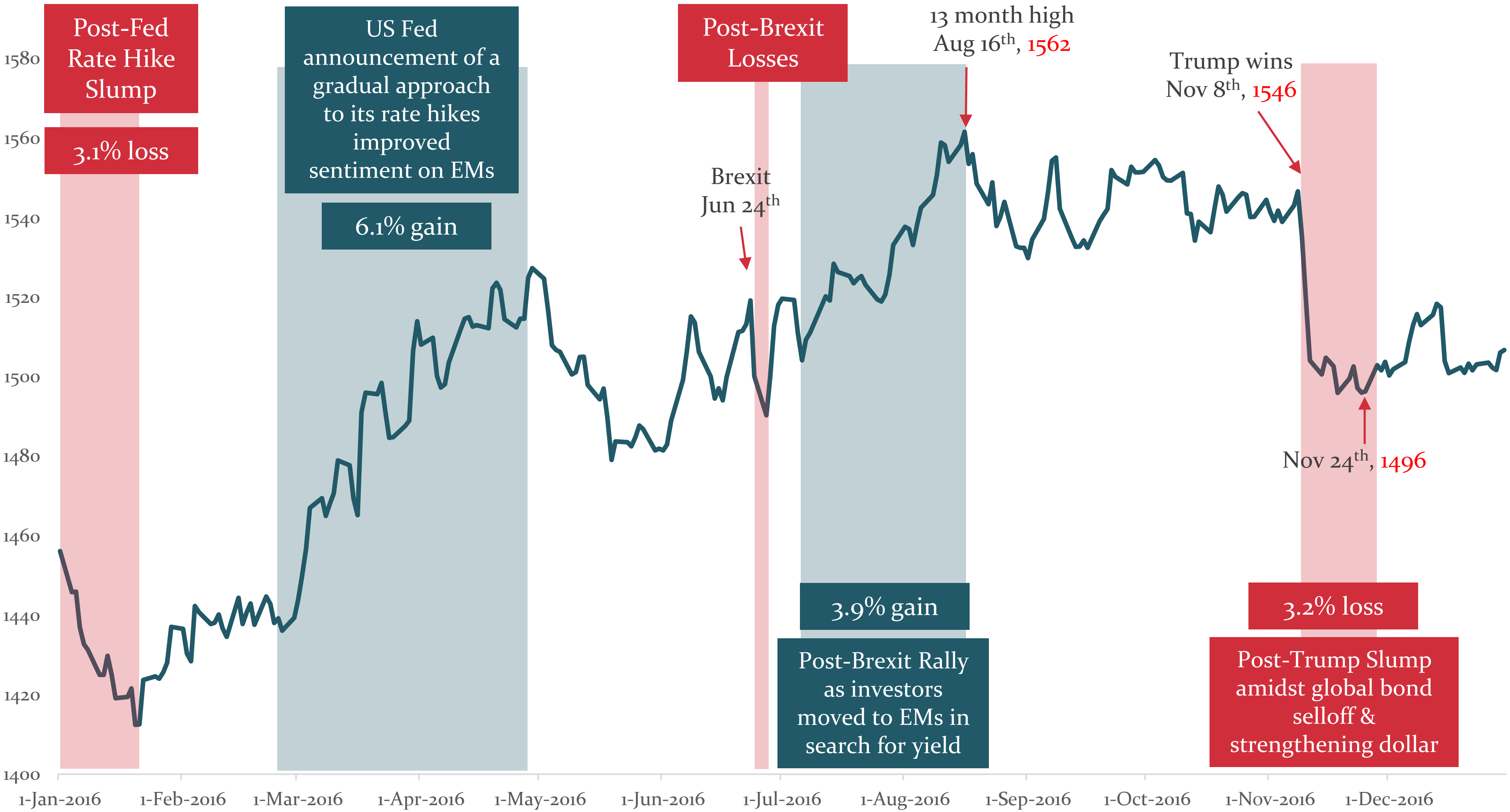
Gold not so golden?

The 'shock' events, market volatility and slow global economic growth had some analysts predicting gold prices reaching highs of US$1500 in 2016. But such predictions have been let down, especially so following the election of Donald Trump. Prices did reach a near three year high following a post-Brexit rally fueled by market volatility and prices are up by over 8.6% for the year, but a number of factors, including the strengthened US dollar and the cash crunch in India, have caused prices to experience a slump in November.

Focus 2: S&P 500 – 1 year performance [11.2% annual gain]

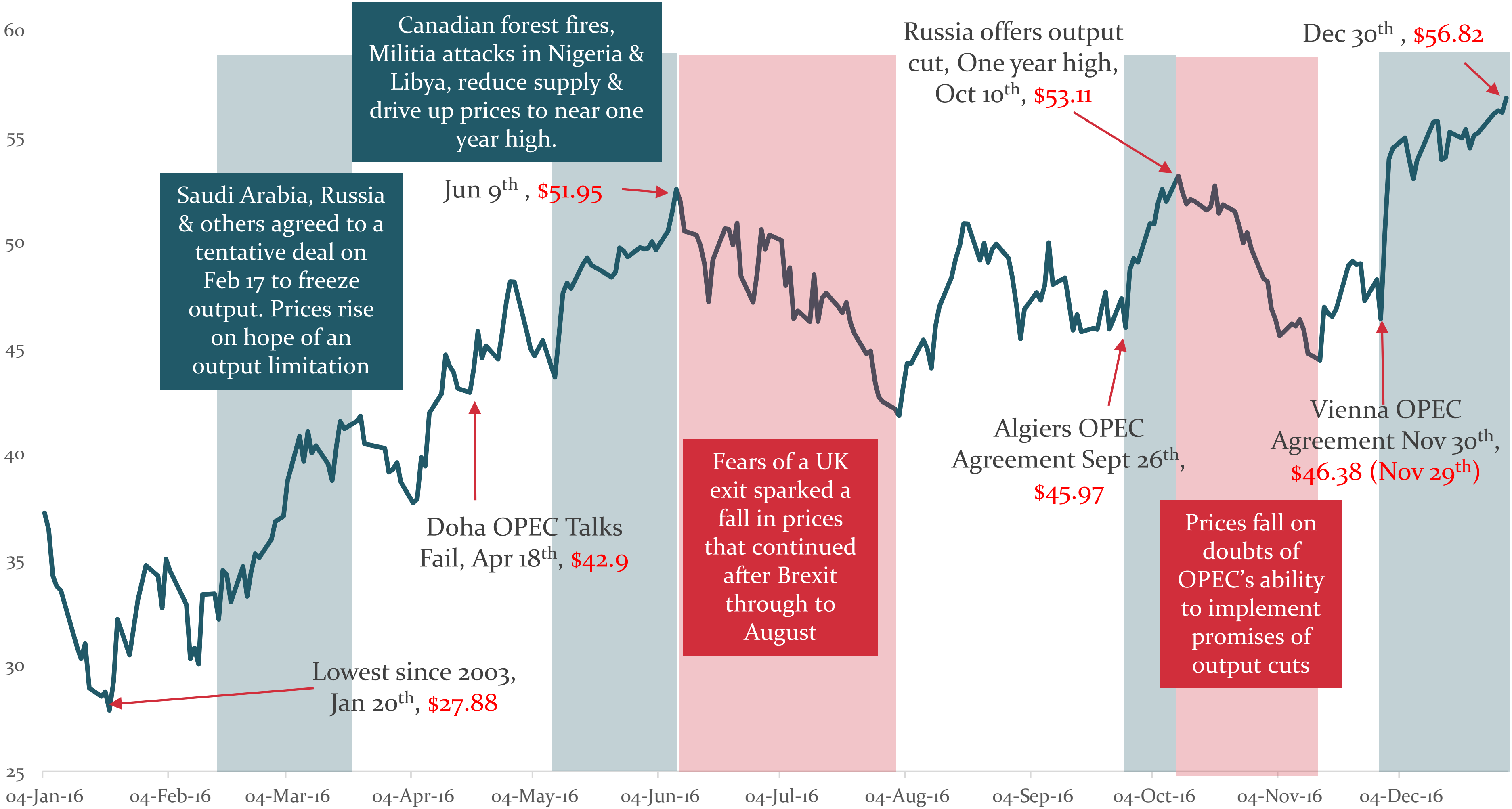
Source: Investing.com, Reuters

Focus 2: MSCI Emerging Market Currency Index – 1 year performance [3.5% annual gain]



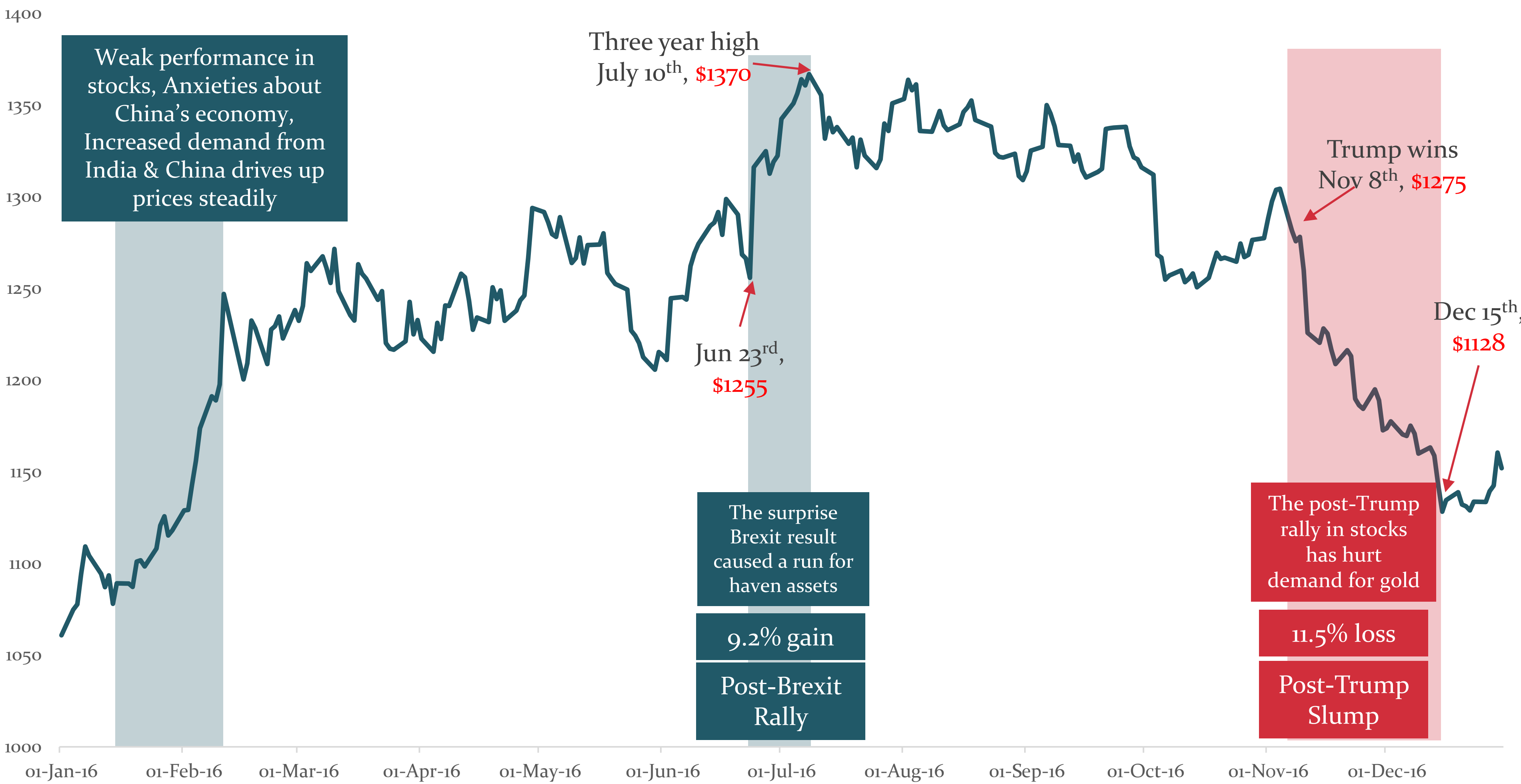
Source: MSCI, Bloomberg

Focus 2: Brent Crude Oil Prices – 1 year performance [52.7% annual gain]



Source: Investing.com, Bloomberg, Reuters, CNN

Focus 2: Spot Gold XAU/USD – 1 year performance [8.6% annual gain]



Source: Investing.com, Reuters, CNN

Quarterly Dashboard (YOY)

CCPI (2006/07 Base)	Sep-16	Dec-16
Headline Inflation	3.9%	4.1%
Core Inflation	4.2%	6.3%
NCPI (2013 Base)	**Sep-16**	**Nov-16**
Headline Inflation	4.7%	4.1%
Core Inflation	5.7%	6.8%

	Sep-16	Dec-16
Gross Official Reserves (US$ bn)	6.5	6.1
USD/LKR(end-month)	146.72	149.80

	Jun-16	Sep-16
Exports	-5.0%	5.7%
Imports	-0.2%	-2.5%
Trade Deficit	6.0%	-12.0%

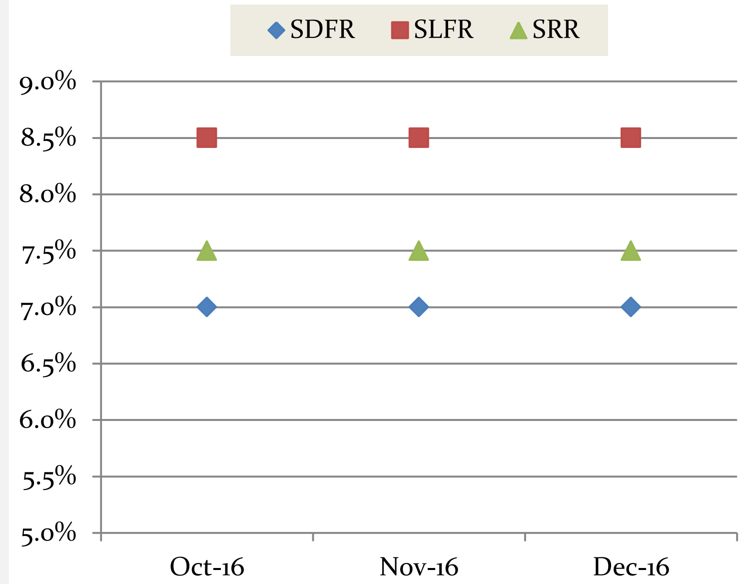
	Jul-16	Oct-16
Broad Money	17.8%	17.8%
Reserve Money	22.9%	23.0%
Private Sector Credit	28.5%	22.0%

Monetary Policy Statement

The Central Bank of Sri Lanka (CBSL) left key policy rates unchanged during the last quarter of 2016, highlighting the slowdown in credit growth following its second rate hike for the year implemented in July. However, while credit to the private sector decelerated on a YOY basis, the CBSL did acknowledge that in absolute terms credit growth still remained high.

The CBSL also noted reduced concerns on inflation despite the one-off effects anticipated from the re-implementation of the VAT and NBT revisions.

In its most recently presented CBSL Roadmap for 2017, the Governor stated that the Bank intended to "introduce several changes in the monetary policy formulation process" including a reduction in the number of Monetary Policy Committee (MPC) meetings to 8 per year from the current 12, so as to allow for more in-depth analysis on economic developments to be included in the policy formulation process.



Movements in Macro Economic Variables in the last quarter

Gross Domestic Product

Economic growth improved in the third quarter of 2016 (2010 base), growing by 4.1% YOY, compared to the 2.6% YOY growth seen in the second quarter. Growth was largely fuelled by expansion in the Services and Industrial sectors which recorded increases of 4.7% and 6.8% YOY respectively. Similar to previous quarters, growth in Financial services, Real estate activities and Construction contributed to the overall growth. Meanwhile, the Agrarian sector continued to record negative growth, down by 1.9% YOY in 3Q16 from a decline of 5.6% YOY in the previous quarter.

Inflation

Headline inflation remained largely stable during the fourth quarter of 2016 with a slight dip seen in November owing to base effects. Inflation edged up in October, reversing the downward trend seen in the previous four months. On a YOY basis, it grew to 4.2%, while rising 0.6% over the month. The increase was largely due to higher prices in the Food & Beverage (F&B)category, while the Non-Food category recorded no growth during the month. In November, inflation dipped to 3.4% YOY due to base effects of higher inflation during the same period in 2015. This was despite reporting 0.6% growth over the month, primarily contributed by the Non-Food category due to impacts from the reinstatement of tax revisions. Communication and Health sub-categories saw the largest increments, recording growth of 10.6% and 3.1% MOM respectively. Core inflation climbed to 5.2% YOY in November from 4.2% growth in the previous month. Headline inflation accelerated once again to 4.1% YOY in December, rising by 1.0% over the month. Drought conditions hampering food supplies coupled with lower output in the off season saw rice and vegetable prices soar, causing F&B inflation to see a significant monthly growth of 1.7% in December. Non-Food inflation, on the other hand, recorded a more moderate growth of 0.4% over the month. Core inflation further escalated to 6.3% YOY in December, while growing by 1.1% on MOM basis, indicative of underlying inflationary pressures

Foreign Exchange

During the quarter, the LKR depreciated by 2.1% against the USD, to stand at Rs. 149.8 against the US dollar as at end December 2016. The weakness was mainly attributable to further debt outflows and sustained import pressures during the quarter. These impacts were exacerbated, compared to the last quarter, due to the risk off sentiment affecting investors following the surprise win by Donald Trump at the US Presidential Election in November. Over the year 2016, the LKR recorded a depreciation of 4.0% against the US dollar. The LKR continued to strengthen against the sterling pound in the fourth quarter, appreciating 13.8% during the year.

Macro Economic Variables Movements in the last quarter

External Sector

Export earnings improved slightly in the third quarter of 2016, reporting its first positive YOY growth in 18 months in August. However, on a cumulative basis, for the nine months to September 2016, export revenues contracted by 3.0% YOY. Declines in all major categories supported the overall contraction. Agricultural exports were weighed down by declines in Tea and Spice exports, while earnings from Rubber exports recorded an increase during the period. Exports of Transport Equipment halved in the first nine months of 2016 compared to the same period in the previous year, resulting in a 1.8% decline in Industrial exports during the period. This was despite an improvement in Textiles and Garments exports due to higher exports to both non-traditional and traditional markets. Expenditure on imports contracted by a marginal 1.7% YOY during the first nine months of 2016, owing to significantly lower vehicle and fuel imports. Imports of Investment goods however continued to show strong growth, rising by 8.5% YOY during the nine months, driven by higher expenditure on Machinery and Equipment and Building materials. Overall, the cumulative trade deficit for the first nine months of 2016 amounted to US$ 6.2bn, unchanged from the levels seen during the same period in 2015.

Reserves

Gross official reserves remained at low levels during the last quarter of 2016, dipping to US$ 6.1bn by end-October from US$ 6.5bn at the end of the previous month. In November, it declined by a further US$416mn to stand at US$5.6bn by the end of the month. It recovered slightly once again in December to end the year at US$6.1bn. However this is US$1.2bn lower than the levels seen at the end of 2015. In terms of months of imports, it is approximately equal to 3.9 months.

Global Developments in the last quarter

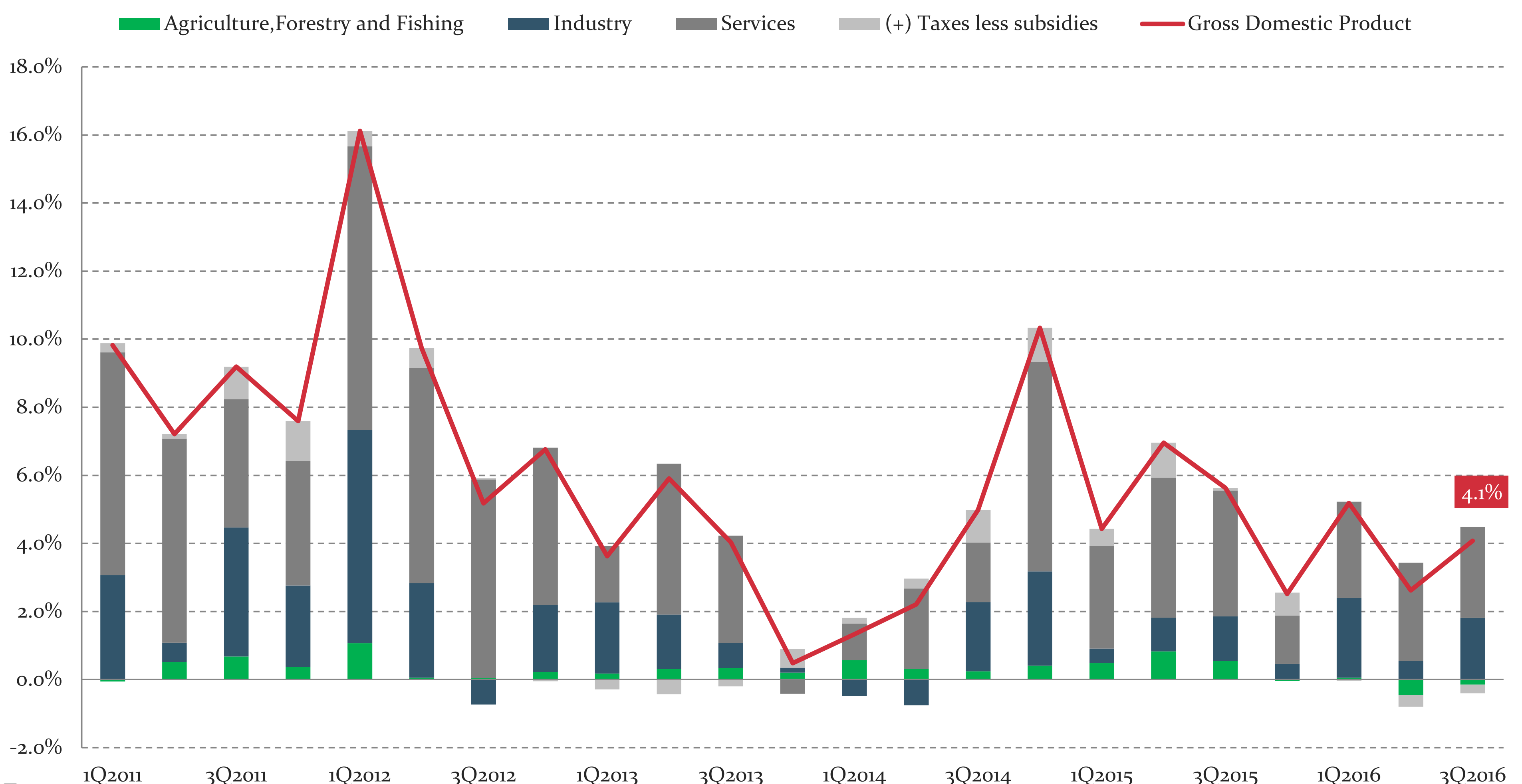
Global markets moved from the post-Brexit uncertainty of the third quarter, to uncertainty over the US presidential election in the final quarter. The uncertainty was heightened when Donald Trump emerged President-elect, but US stock indices rallied to record highs instead of crashing. The quarter was characterized by the markets reacting to expectations of Trump's stimulus package delivering inflation – termed 'Trumpflation' – and trying to figure out what his policy direction might be. Inflationary prospects sparked a global debt selloff that caused record high US Treasury yields and significant outflows from emerging markets. The US dollar also rallied, reaching a 14 year high at one point. This led to weakening of other currencies, including the Euro and Emerging Market (EM) currencies. Adding to EM woes was the first US Federal Reserve rate hike in a year in December and prospects of three more hikes in 2017, up from the two expected earlier. In Europe, the Pound struggled in the face of Prime Minister May's apparent policy towards exiting the EU single Market, in order to gain autonomy over immigration and border control. Adding to this is an upcoming UK Supreme Court ruling on whether the PM or the Parliament has power to invoke Brexit.

Despite the negative sentiment seen towards the end of the year, many EM assets, including equities and debt, recorded their first year of positive returns since 2012. The gains were mostly driven by a rebound in commodity prices. However, they recorded the lowest foreign fund inflows since 2008 particularly owing to concerns around rising US interest rates. India managed to stay in the headlines through PM Modi's surprise demonetization of Rs.500 and Rs.1000 notes in early November. The intention was to clampdown on corruption and to increase the tax base, but it also caused a liquidity crunch that is expected to slow down growth and corporate earnings.

Brent crude : Oil prices rallied significantly in this quarter, ending in the mid $50s range, following the November 30th agreement among OPEC and non-OPEC producers to limit output. The agreement promises to cut output by over a million barrels per day and was made possible only due to compromises made with Iran, Libya and others. Iran has been allowed to continue raising output to pre-sanction levels, forcing Saudi Arabia to carryout most of the cuts. However, analysts have raised doubts on the impact on the global supply glut amidst record output and possibility of US shale output increasing along with the rally in price.

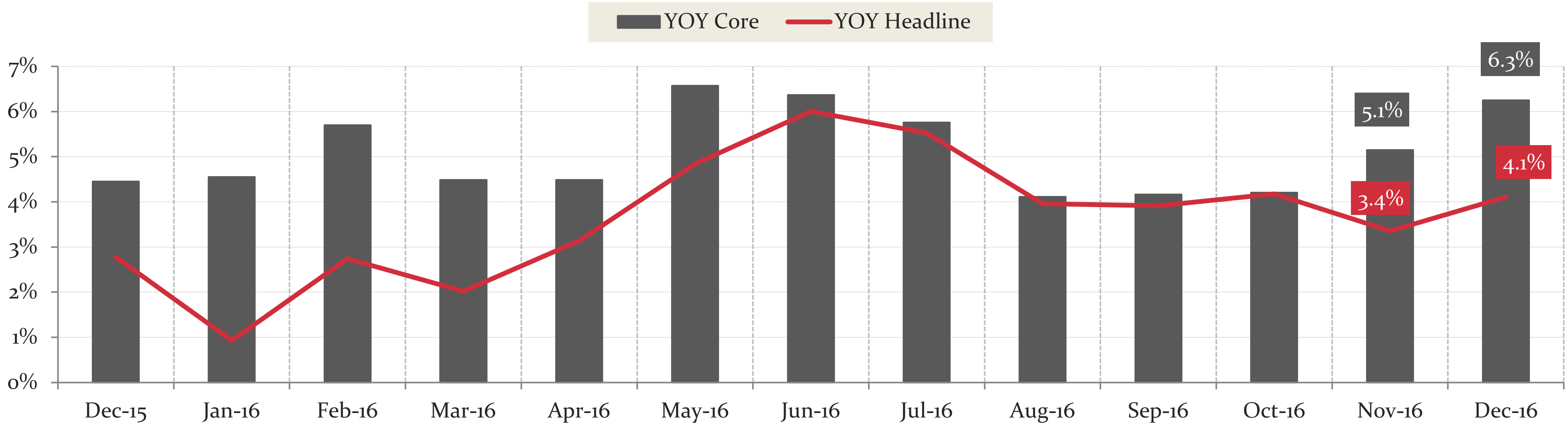
Gold : Gold prices were expected to perform much better than what reality played out to be, with prices actually reducing following Trump's victory, despite the uncertainty. The year ended with prices in the $1,100s, down from the $1,200s in the 3rd quarter.

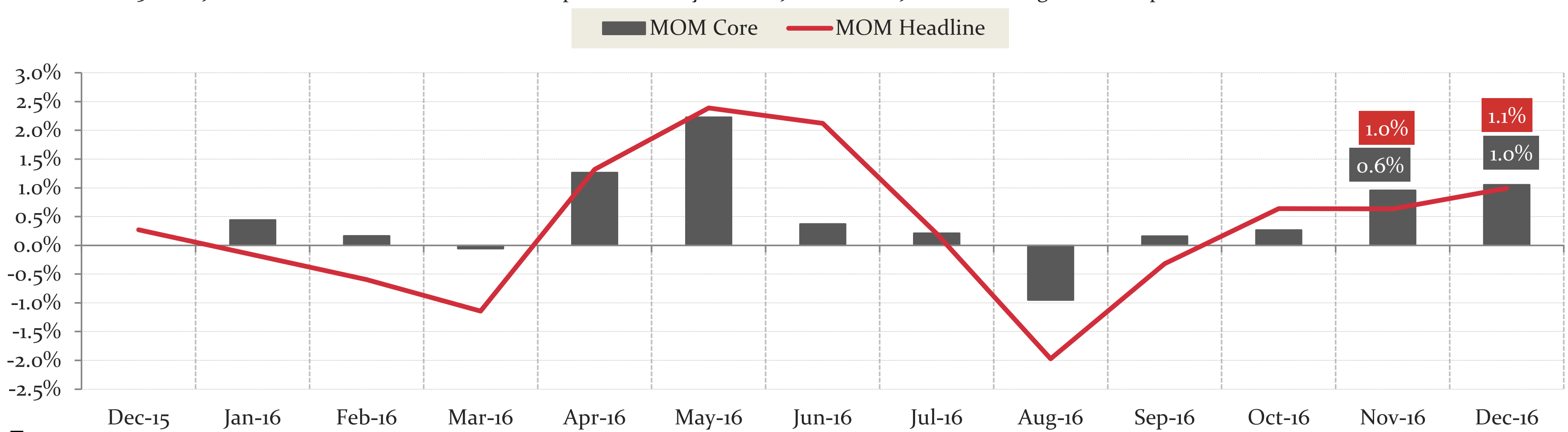
GDP growth - 3Q2016: 4.1% (2010 base)



Source: Dept. of Census and Statistics

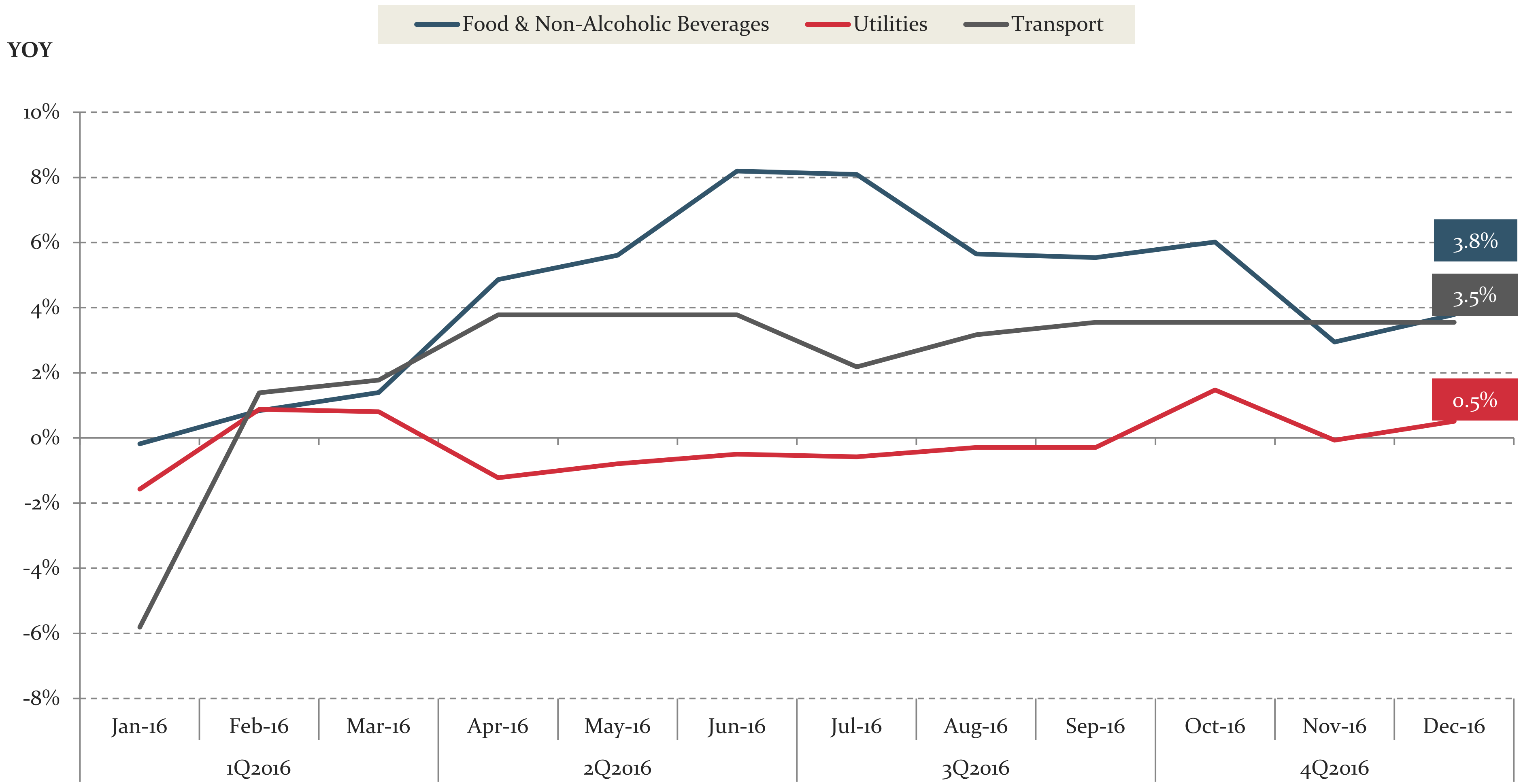
Inflation





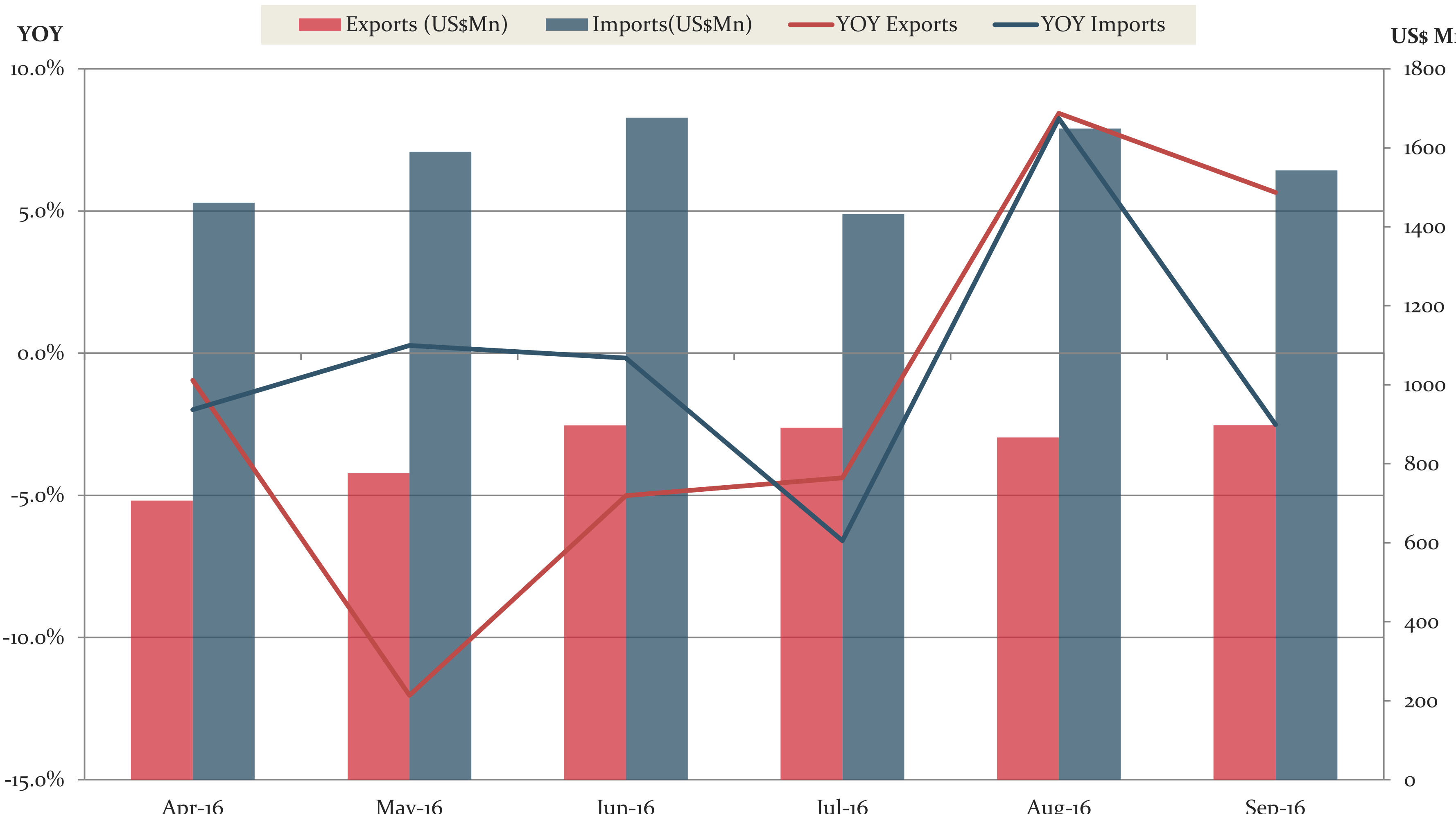
Source: Dept. of Census and Statistics

Inflation



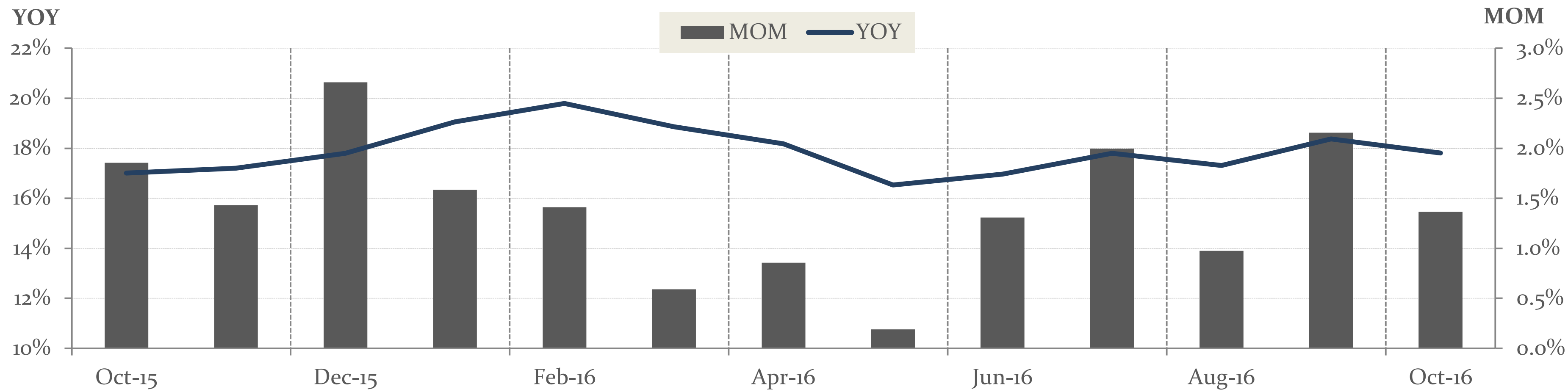
Source: Dept. of Census and Statistics

External Sector Performance

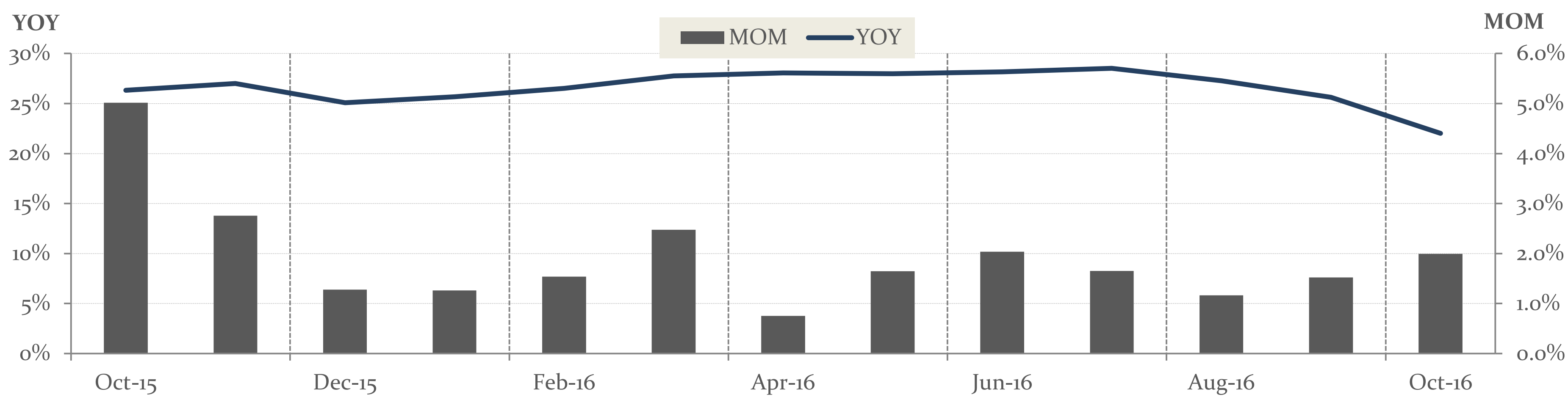


Source: CBSL

Broad Money Growth (M2b)



Private Sector Credit Growth

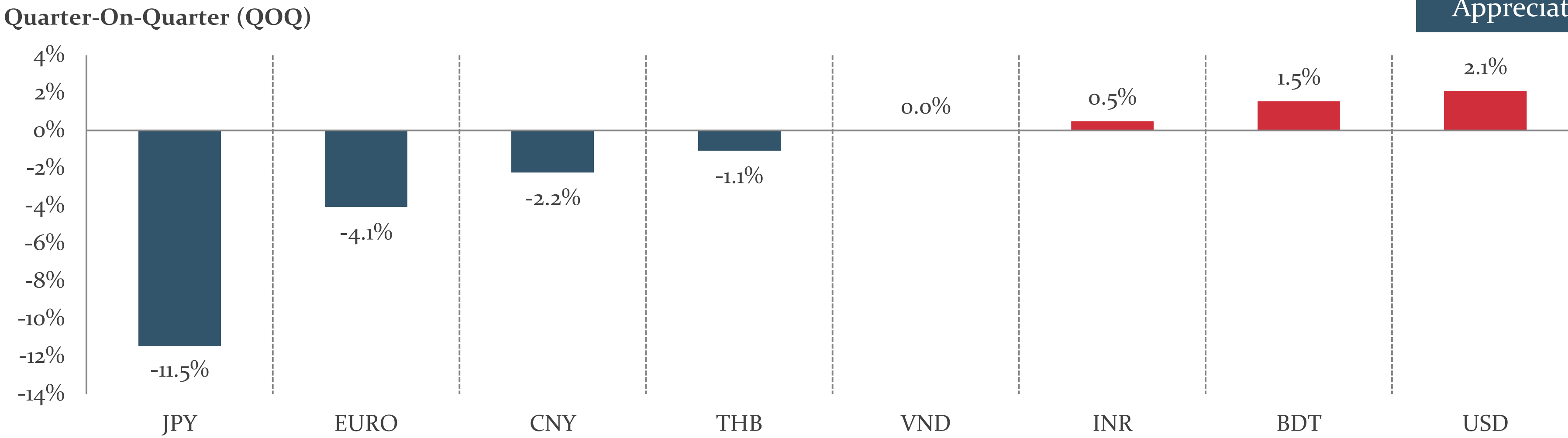


Source: CBSL

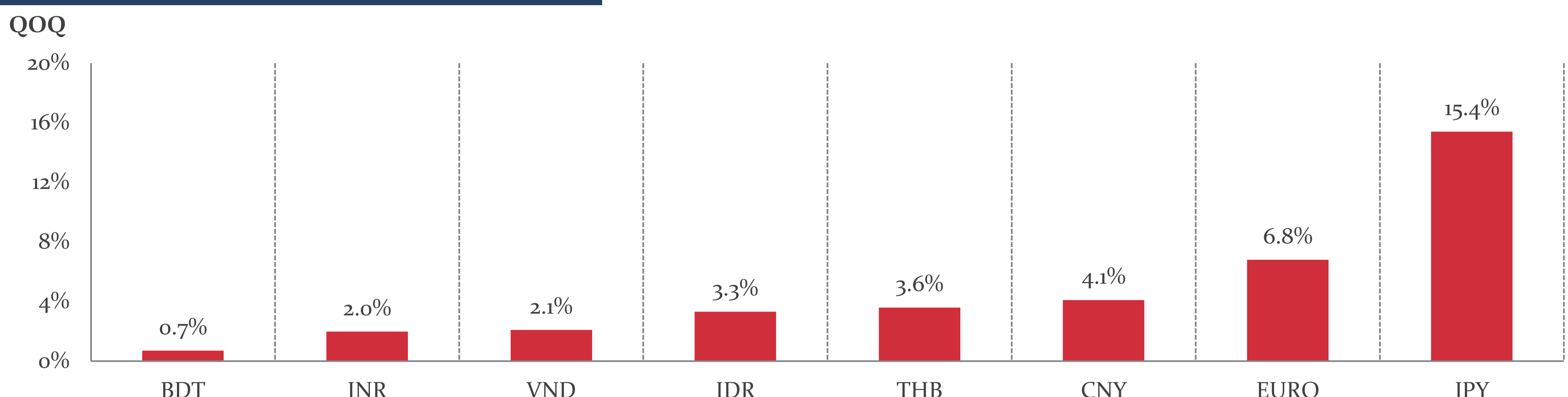
LKR Movements against Peer currencies (End-month exchange rates as at 30th Dec 2016)

Depreciation

Appreciation

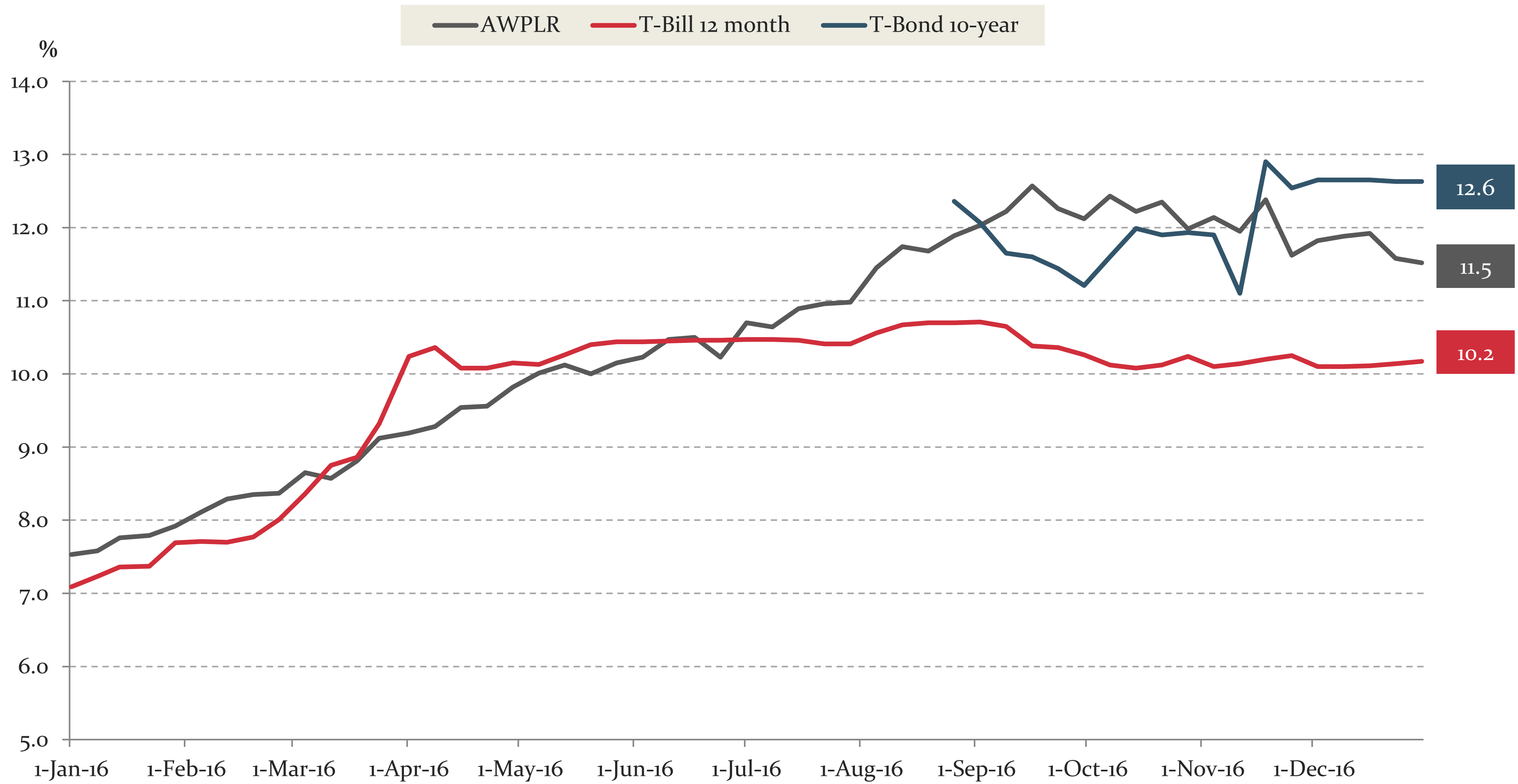


Peer currency Movements against USD



Source: CBSL, Bloomberg

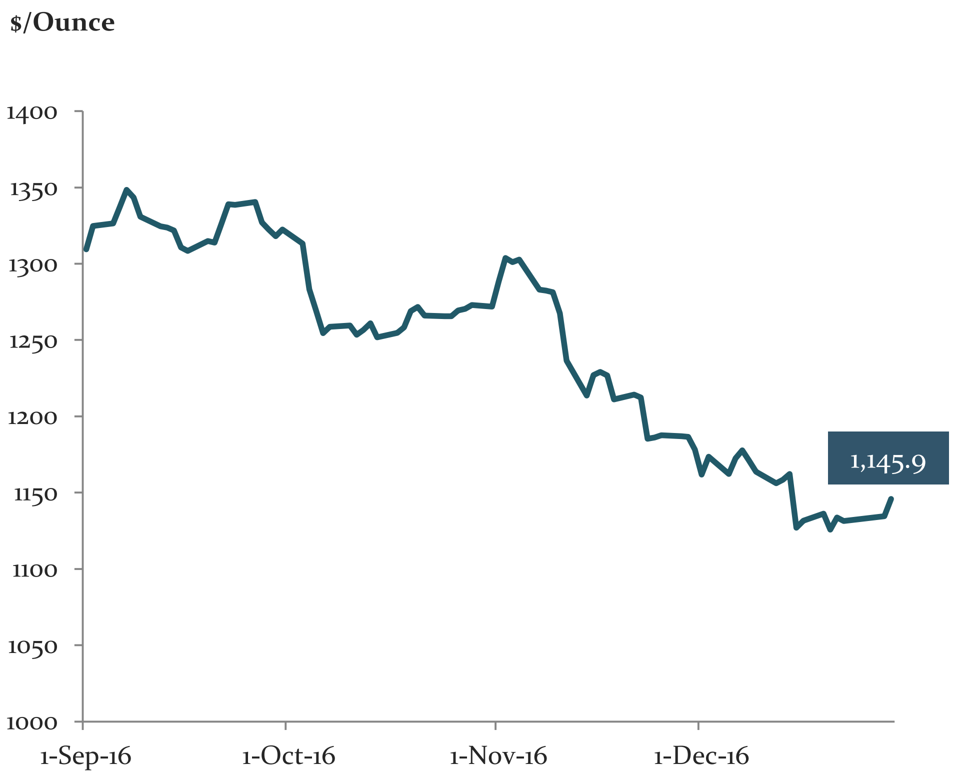
Interest Rates (As at End December 2016)



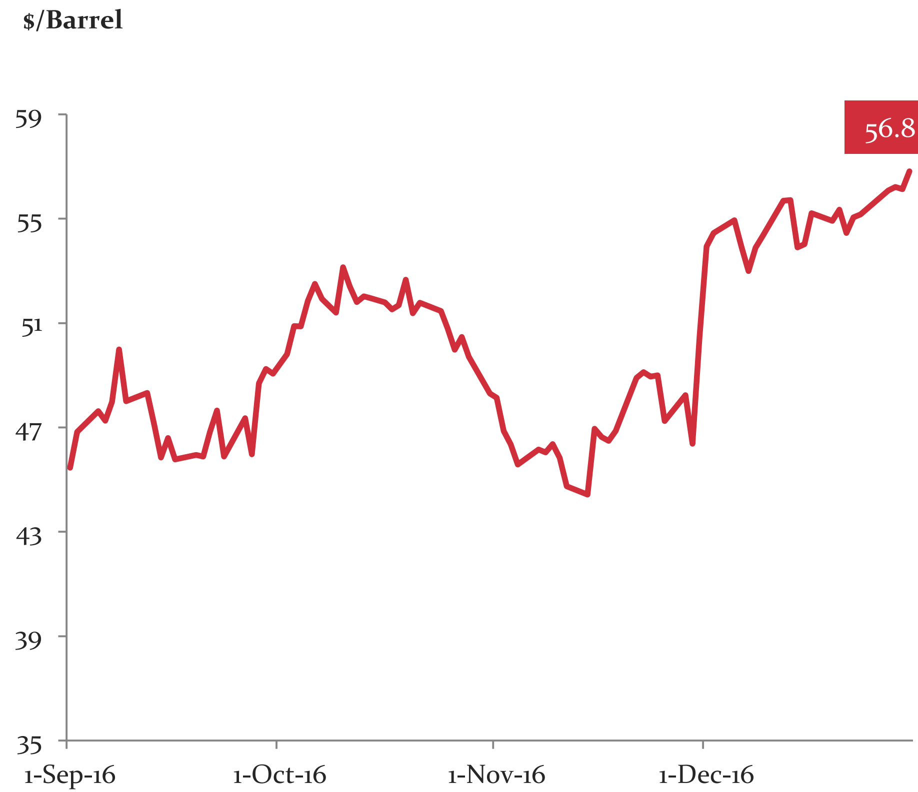
Source: CBSL, investing.com

Global commodity movements (As at End December 2016)

Gold



Brent crude

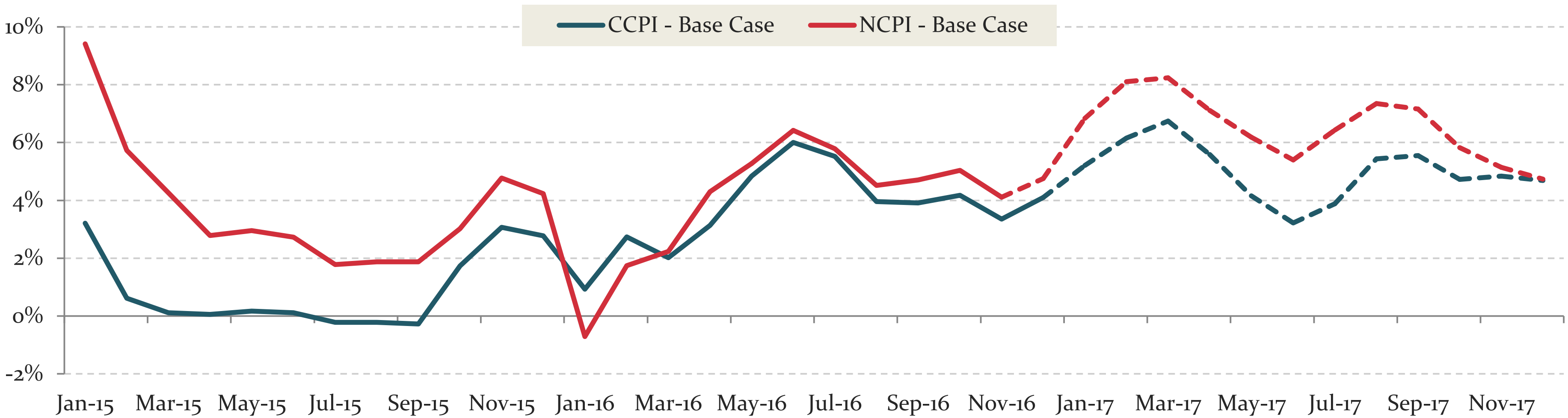


Source: Kitco, investing.com

Key Forecasts (*Updated forecast for 2016 fiscal deficit based on 2017 Budget)

Indicator	2009	2010	2011	2012	2013	2014	2015	2016F
GDP(% 2010 base)	-	-	8.4%	9.1%	3.4%	4.9%	4.8%	4.6%
Inflation (CCPI Annual Average)	-	6.2%	6.7%	7.6%	6.9%	3.3%	0.9%	5.0%
Fiscal Deficit (% of GDP)	-	7.0%	6.2%	5.6%	5.4%	5.7%	7.4%	5.7%*
Trade Deficit (USD 'Mn)	3,122	4,883	9,710	9,409	7,609	8,287	8,430	8,300
Current Account Deficit (USD 'Mn)	214	1,089	4,615	3,915	2,541	2,018	2,009	1,885

Inflation Outlook for 2017



Updated Views: End 2017

(16th November 2016)

Back

End 2017 Frontier Rates View - Benchmark: 12-month T. Bill

Currently in secondary market – 10.28% (as at 13th January 2017)

	Directional View: **End 2017**	Lower Bound **End 2017**	Upper Bound **End 2017**	**Mid Point (Avg.) End 2017**
BASE CASE 45% Probability	↓	7.5%	10.0%	**8.8%**
Continued Adjustment 30% Probability	↑	10.0%	14.0%	**12.0%**
Trumped-up 10% Probability	↑	14.0%	20.0%	**17.0%**
Trumped-down 5% Probability	↓	6.0%	7.5%	**6.8%**

** Remaining 10% incorporates other alternatives scenarios with different ranges for Rates

Back

End 2017 Frontier Rates View - Benchmark: 10-Year T. Bond

Currently in secondary market – 12.53%
(as at 13th January 2017)

	Directional View: **End 2017**	Lower Bound **End 2017**	Upper Bound **End 2017**	**Mid Point (Avg.) End 2017**
BASE CASE 45% Probability	↓	10.0%	12.0%	**11.0%**
Continued Adjustment 30% Probability	↑	12.0%	16.0%	**14.0%**
Trumped-up 10% Probability	↑	16.0%	22.0%	**19.0%**
Trumped-down 5% Probability	↓	8.0%	10.0%	**9.0%**

** Remaining 10% incorporates other alternatives scenarios with different ranges for Rates

Back

End 2017 Frontier LKR View against the USD - Benchmark: spot rate

Currently 150.00 per US dollar
(as at 13th January 2017)

	Directional View: **End 2017**	Lower Bound **End 2017**	Upper Bound **End 2017**	**Mid Point (Avg.) End 2017**
BASE CASE 45% Probability	↑	148	158	**153**
Continued Adjustment 30% Probability	↑	158	170	**164**
Trumped-up 10% Probability	↑	170	200	**185**
Trumped-down 5% Probability	↓	135	148	**142**

** Remaining 10% incorporates other alternatives scenarios with different ranges for LKR

End 2017 Frontier Rates & LKR View: The Framework

• Base case assumes an improvement in fiscal conditions next year given the promising fiscal measures introduced in the Budget 2017 **(if implemented well)** and with the IMF presence playing a role in encouraging key reforms and stabilizing fiscal situation. The base view also factors in that there will be no further monetary tightening.

While these assumptions – if materialized – could see an improvement in indicators the reason we are expecting a limited decline in rates and further depreciation in the LKR is to account for possible volatility caused by global uncertainties. Global headwinds such as rising interest rates trajectory with the US expected to tighten its monetary policy and the ensuing effects on emerging markets could play a key role in limiting the positive adjustment in these variables.

• Continued adjustment is a scenario where the fiscal situation does not improve and the CBSL does another rate hike. Also, takes into account possible worsening in global conditions as well. Pressure may also come from the bunching up of debt repayments or borrowing constraints due to a global shock.

• The Trumped-up scenario accounts for the possible black-swan type risks the external environment could bring next year given the drastic changes in the US political trajectory under a Trump presidency. More than the politics itself, the key in understanding the possible risks is how markets will react to this uncertainty. While these policies may take time to materialize, views around them by market participants (irrespective of whether the policies are actually good or bad or are even actually implemented) could cause adverse reactions in markets.

• The Trumped-down scenario accounts for the possibility that market sentiment around these changes in the global environment could turn positive. This scenario assumes a positive external backdrop along with further improvement in domestic economic conditions where there is a significant improvement in fiscal front with necessary fiscal reforms implemented well which would improve sentiment attracting FDIs and portfolio inflows. Also takes into account the sentiment around the success of Trade deals in the work, real estate projects etc. and possibly more than one rate cut.

Technical Notes

Upper Bound: Maximum value the variable is expected to reach at the end of the specified time period (end 2017)

Lower Bound: Minimum value the variable is expected to reach at the end of the specified time period (end 2017)

Mid Point: Expected average value of the variable. This is the average value we expect the variable to reach by the end of the specified time period (end 2017)

*** Probabilities in scenarios outlined total 90%. Remaining 10% incorporates other alternatives scenarios with different ranges for Rates and FX**

Economic Glossary

Reserve money: The currency issued by the Central Bank and commercial banks' deposits with the Central Bank (source: CBSL)

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

Net Foreign Assets: The sum of foreign assets held by monetary authorities and deposit money banks, less their foreign liabilities (Source:IMF)

Net Domestic Assets: are equal to net credit to government (NCG) plus claims on public corporations plus claims on private sector plus other items (net). (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 (2006/07=100) measures the general price level of consumer goods and services purchased in the Colombo urban areas. The consumer basket includes 373 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 fresh food, energy, transport, rice and coconuts from the basket. The core inflation basket represents 65% of the overall CCPI 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.