Economic Research
JPMorgan Chase Bank, Singapore
May 29, 2003

JPMorgan

Sri Lanka

A New Tiger in the Making

- **Sri Lanka is rapidly moving to set its house in order.** The latest peace initiative launched last year by Prime Minister Ranil Wickremasinghe continues to yield tangible results. Undoubtedly, the complex nature of the ongoing negotiations will result in occasional setbacks, as highlighted by the current impasse in talks between the government and the Liberation Tigers of Tamil Eelam (LTTE). Also, several thorny issues, such as power-sharing, still have to be addressed. However, we remain positive that both sides are genuinely interested in capitalizing on what is clearly the first credible chance at peace in over two decades.

- **Investors should take note as Sri Lanka attempts to transform itself into a new Asian tiger.** Estimates suggest that the civil war lowered annual economic growth by 2-3 percentage points. Looking ahead, the prospects for peace should allow Sri Lanka to unlock its potential by capitalizing on its high literacy rate, low-cost structure, strategic location on container shipping routes, tourism potential, and proximity to a more vibrant India, the third-largest Asian economy. Indeed, the economy could chalk up annual growth rates of around 7% later in the decade, ranking it among the fastest-growing economies.

- **The healing process for the war-torn economy has already begun, with the initial benefits of the peace dividend beginning to come through.** Consumer and investor confidence are heading north, risk and defense expenditure are declining, and interest in industries and asset markets by overseas investors is on the rise. Structural shifts in the economy are also currently under way, though their benefits will be dictated by the pace and nature of reforms.

- **The new 3-year IMF program signals a ramping up of official support.** In April, Sri Lanka initiated a PRGF and EFF with the IMF that run until 2006; combined, these facilities total US$567 million. Support from other official sources, both bilateral and multilateral is also set to rise. The program focuses on fiscal consolidation and reducing the state's role in the economy, and will be very useful for investors in terms of tracking reform progress.

Contents

Giving peace a chance	3
Political overview	4
Key events in the conflict	5
Economic overview	6
Economic outlook	8
Key economic forecasts	12
Medium-term fiscal dynamics	13

David G. Fernandez
(65) 6882-2461
david.g.fernandez@jpmorgan.com

Rajeev Malik
(65) 6882-2375
rajeev.malik@jpmorgan.com

www.morganmarkets.com

JPMorgan Chase Bank
David G. Fernandez (65) 6882-2461
david.g.fernandez@jpmorgan.com
Rajeev Malik (65) 6882-2375
rajeev.malik@jpmorgan.com

Table 1. Basic facts on Sri Lanka

Long name	Democratic Socialist Republic of Sri Lanka
Location	435 km North to South, 240 km West to East
Total area	65,610 sq km
Climate	Tropical
Natural resources	Limestone, graphite, phosphates, gems
Population	19.0 million
Ethnic groups	Sinhalese (74%), Tamils (18%), Moors (7%), Burgher, Malay, and Vedda (1%)
Religions	Buddhist (70%), Hindu (15%), Christian (8%), Muslim (7%)
Political parties	Governing coalition—United National Front—comprising United National Party, Tamil National Alliance, Sri Lanka Muslim Congress, Ceylon Workers' Congress
Capital	Colombo
Main cities	Colombo (2.2 million), Gampaha (2.1 million), Kurunegala (1.5 million), Kandy (1.3 million)
Nominal GDP	US$16.6 billion (2002)
GDP per capita	US$871
Life expectancy	70 years (male), 76 years (female)
Literacy rate	91.8
Agriculture products	Paddy, tea, rubber, coconut
Industries	Textile and wearing apparel, chemical and petroleum products, plastics, leather products
Key exports	Textiles & garments (53%), tea (14.3%), rubber & rubber products (4%), diamonds & jewellery (3.8%), leather and footwear 3.1%), coconut products (1.7%)
Key export destinations	US (40%), UK (11.9%), Middle East (9%), Germany (4.1%)
Currency	Rupee (SLRs); managed float within a ±0.25% daily band
Exchange rate	SLR97.35/US$ (as of May 28, 2003)

JPMorgan Chase Bank
David G. Fernandez (65) 6882-2461
david.g.fernandez@jpmorgan.com
Rajeev Malik (65) 6882-2375
rajeev.malik@jpmorgan.com

Giving peace a chance

A civil war commenced in the North and the East of the country in 1983 between organized ethnic Tamil armed groups and the majority Sinhalese government. Feeling increasingly marginalized following official moves to reverse their influence, some Tamils organized armed groups to fight the government, and the Liberation Tigers of Tamil Eelam (LTTE) emerged as the most potent group. More than 60,000 lives have been lost, and the economic growth has suffered significantly owing to the hit to investment spending, investor confidence and tourism. Sharply higher defense expenditure and revenue shortfall put pressure on government finances, and the budget deficit ballooned to peak around 10% of GDP in 2000. Official estimates suggest that the war lowered GDP growth by around 2-3 percentage points a year.

Two previous attempts at a ceasefire in 1989 and 1994 failed, but things began looking up following the September 11, 2001, World Trade Center attacks in the United States and the election of a new government in Sri Lanka later in that year.

Opposition leader Ranil Wickremasinghe fought the election with a bold promise to end the civil war through peaceful negotiation, and a war-weary electorate responded favorably. Subsequently, Prime Minister Wickremasinghe's government made a renewed effort to bring about peace, and the LTTE declared a unilateral ceasefire in late December. A Permanent Ceasefire Agreement was signed in February 22, 2002.

Peace holds; healing from 20-year conflict begins

Formal peace talks between the Sri Lanka government and the LTTE began on September 16, 2002, in Thailand. Subsequent sessions have taken place on a more or less monthly basis in Asia and Europe and have helped further solidify the peace process.

A significant achievement for the ruling government was the agreement reached in early 2002, as a result of which both sides accepted a federal model as an alternative to the separate Tamil state that the Tigers had been fighting for. Details about the degree of autonomy have yet to be worked out and negotiations are likely to be challenging.

More recently, the thorny issue of the military's High Security Zones (HSZs) in Jaffna threatened to derail the peace talks at the fourth round in January 2003. The HSZs were set up after the government captured Jaffna from the LTTE, and have been used by the army. The bone of contention is that, in light of the ceasefire and peace initiatives, the rebels have been putting pressure on the military to leave these areas in order to make place for returning residents. The military, worried by the shift in the balance of forces if it moves out, has been resisting the move. A compromise is probable as the government is likely to separate the issue of the Tigers disarming from that of the army moving out of the HSZs.

Negotiations have not been smooth sailing

Apart from the typical setbacks likely in negotiating such a challenging peace plan, the process now also faces occassional criticism by President Kumaratunga, who is also the leader of the People's Alliance, the main opposition party, and commander-in-chief of the armed forces. Earlier this year, she stated publicly that she would not refrain from using her executive power to dismiss Prime Minister Wickremasinghe if national security is compromised, broadly referring to the several concessions offered by the prime minister to the rebels. Note that the president is allowed to dissolve parliament 12 months after the most recent election (which took place in December 2001).

At the same time, the Sri Lanka Muslim Congress (SLMC), whose support allows the government to have a majority in parliament, has been critical of the prime minister's concessions to the Tamil population. These dynamics make the ruling government vulnerable and threaten the peace negotiations.

In late April 2003, Dr. Anton Balasingham, political advisor to and chief negotiator for the LTTE, sent a letter to the prime minister indicating that the LTTE leadership has decided to suspend its participation in the negotiations for the time being. This is a major setback, and envoys of various countries are trying to reach a compromise to ensure the LTTE's presence at the Tokyo Conference in early June, the goal of which is to obtain international assistance for Sri Lanka.

JPMorgan Chase Bank
David G. Fernandez (65) 6882-2461
david.g.fernandez@jpmorgan.com
Rajeev Malik (65) 6882-2375
rajeev.malik@jpmorgan.com

Political overview

The United National Party (UNP) and the Sri Lanka Freedom Party (SLFP) have dominated local politics since independence in 1948. The UNP ruled from 1948-56, but an important transition came about in 1956, when SWRD Bandaranaike led the SLFP to victory on a "Sinhala only" policy. With the exception of a short period in 1960, the SLFP ruled from 1956-65. After the assassination of SWRD Bandaranaike in 1959, his widow, Sirimavo, took over, becoming the world's first woman prime minister.

Dudley Senanayake of the UNP returned to power in 1965, followed by Sirimavo Bandaranaike in 1970. Her government sanctioned new university admissions regulations that discriminated against Tamils. A new constitution was introduced in 1972, changing the country's name from Ceylon to Sri Lanka, and made the protection of Buddhism a constitutional principle. Overall, the new constitution weakened the role of the president, who was now to be appointed by the prime minister. The Bandaranaike government pursued a somewhat socialist agenda.

JR Jayewardene led the UNP to power in 1977 and a new constitution was introduced a year later, with a stronger presidency based on the system of the French Fifth Republic. He was elected president by parliament in 1978 and by national elections in 1982. A 1982 referendum also extended the life of the parliament by another six years. Jayewardene ended many of the excesses of the Bandaranaike government but failed to fully confront the causes of communal tension and problems.

Table 2. Key political and economic appointments in Sri Lanka

Post	Appointment holder
President	Chandrika Bandaranaike Kumaratunga
Prime Minister	Ranil Wickremasinghe
Finance Minister	K N Choksy
Defense Minister	Tilak Marapone
Interior Minister	John Amaratunga
Power & energy	Karu Jayasuriya
Industrial policy & investment promotion	G L Pieris
Agriculture & livestock	S B Dissanayake
Foreign affairs	Tyronne Fernando
Justice, law refrom & national integration	W J M Lokubandara
Port development & shipping	Rauf Hakeem
Fisheries & ocean resources	Mahinda Wijesekara
Mass communication	Imtiaz Bakeer Markar
Economic reform, science & technology	Milinda Moragoda
Commerce & consumer affairs	Ravi Karunanayake
Central Bank Governor	Amarananda Jayewardena

The 1982 election was boycotted by the Tamil United Liberation Front (TULF) and its 16 members were expelled for refusing to swear a loyalty oath. Rioting on an unprecedented scale broke out in 1983, leading to a breakdown of order. Just ahead of the 1988 elections, Jayewardene announced that he would not run for president.

Ranasinghe Premadasa of the UNP defeated Mrs. Bandaranaike of the SLFP in the 1988 presidential elections and the UNP won an absolute majority in the 1989 parliamentary elections. Premadasa was assassinated on May 1, 1993 and was replaced as president by then prime minister Dingiri Banda Wijetunga, who appointed Ranil Wickremasinghe as prime minister.

The SLFP returned to power in coalition in 1994. The coalition, the People's Alliance (PA), won a plurality in the August 1994 parliamentary elections. Chandrika Bandaranaike Kumaratunga, daughter of Sirimavo Bandaranaike and widow of the assassinated film-star-turned-politician Vijaya Kumaratunga, became prime minister. After its victory in the March 1997 local government elections, the PA government pushed forward with a new military campaign, but tensions were emerging within the government coalition and in relations with the opposition UNP.

Kumaratunga won a second term as president in December 1999, but her People's Alliance was defeated in the December 2001 parliamentary election by the reform-minded opposition leader Ranil Wickremasinghe of the UNP, who fought the election with a bold promise to end the civil war through peaceful negotiation.

The UNP won 45.6% of the vote, enough to garner 109 of the 225 seats in parliament. Also, the UNP strengthened its position owing to support from the Tamil National Alliance and the Sri Lanka Muslim Congress. These three are the main parties in the ruling UNF coalition government.

JPMorgan Chase Bank
David G. Fernandez (65) 6882-2461
david.g.fernandez@jpmorgan.com
Rajeev Malik (65) 6882-2375
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Key events in the conflict

1948	Sri Lanka (then Ceylon) gains independence
1956	Ethnic and linguistic tensions
1972	Tamil Tiger leader Prabhakaran forms Tamil New Tigers, later to become the LTTE
1975	Alfred Duriappah, a prominent Tamil politician and Mayor of Jaffna, is assassinated
1976	Prabhakaran formally creates the LTTE; Tamil leaders call for the creation of a Tamil nation, Tamil Eelam, in northeast Sri Lanka
1978	Sri Lanka's second constitution recognizes Tamil as a national language
1979	Government approves Prevention of Terrorism Act
1983	Two days of worst-ever ethnic riots
1984	India begins arming and training guerillas from major Tamil militant groups
1985	1st peace talks held in Bhutan
1987	2nd attempt at peace talks; India and Sri Lanka sign a peace accord; Indian Peace keeping Forces (IPKF) deployed
1988	Ranasinghe Premadasa elected president; wants Indian forces to pull out
1990	3rd attempt at peace; government asks IPKF to leave in order to appease the LTTE
1991	Indian Prime Minister Rajiv Gandhi blown up by an LTTE suicide bomber while campaigning in South India
1993	Premadasa killed by an LTTE suicide bomber
1994	Chandrika Kumaratunga's new government undertakes 4th attempt at peace
1995	Clashes between government forces and the LTTE kill thousands
1998	An LTTE suicide bomber attacks Sri Lanka's holiest Buddhist shrine
1999	A suicide bomber attacks Kumaratunga at an election rally
2000	Norway offers to play role of an intermediary
2001	**July**: The LTTE launch a massive attack on Colombo's international airport and the adjoining air force base
	December: Ranil Wickremasinghe becomes prime minister; a ceasefire is declared
2002	**September**: Government lifts ban on the LTTE; 5th attempt at peace, but 1st round following the ceasefire in 2001; talks held in Sattahip naval base in Thailand; subsequent rounds held in the following months
	October-December: 2nd and 3rd rounds of peace talks, also in Thailand
	December: Donors' meeting held in Norway
2003	**February**: 4th round of peace talks held in Berlin
	March: 5th round of peace talks held in Tokyo
	April 14: US hosts a meeting of donor countries and organizations; the LTTE remains on Washington's banned list of terrorist organizations
	April 21: Tigers suspend participation in peace talks; the LTTE also announces that it is not likely to attend a donors' meeting that Japan is hosting in June
	May: Norwegian mediators brief senior government officials after talks with Tigers aimed at kickstarting stalled negotiations

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david.g.fernandez@jpmorgan.com
Rajeev Malik (65) 6882-2375
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Economic overview

Despite the pervasive negative effects of the civil war on economic activity, the fact that Sri Lanka has managed an average GDP growth rate of 4.3% since 1983 is a testament to the economy's resilience. Over time, agriculture has decreased in importance for the overall economy and in its place the services sector has risen. Nevertheless, we would emphasize that manufacturing, which is dominated the private sector, is typically the driver of overall growth.

Within industry, production is concentrated in a few sectors and is heavily export-oriented. The key sectors are textiles, clothing, and food and beverage, which together account for over two-thirds of production. Privately-owned, export-oriented entities account for close to 90% of total manufacturing production, supported by incentives available to export industries (tax breaks, holidays, and duty-free imports of raw materials and capital goods).

Services continues to grow as a share of GDP, but the sector's development has been uneven and structural problems there raise concerns. Banking dominates the financial sector, accounting for about 60% of the sector's assets. The debt market is underdeveloped with access to long-term funding limited largely to the development banks. As a result, Sri Lanka has high intermediation costs. Within the banking sector, the state plays a major role through its ownership of the Bank of Ceylon and People's Bank, the country's two largest commercial banks, accounting for 50% of the sector.

These two state banks are being restructured and further reforms are in the pipeline, although privatization in the short term has been ruled out. On a more constructive note, despite difficulties last year, the two state-owned insurance corporations were successfully sold this year. Finally, reforms to give the central bank (CBSL) more autonomy are under way.

Table 3: Sectoral shares in GDP

%	1980	1990	2002
Agriculture	27.6	26.3	19.6
Industry	29.6	26.0	26.6
Services	42.8	47.7	53.8

A potentially important catalyst to further service sector development is tourism. Sri Lanka's tourist industry has the potential to become a major source of economic growth and hard currency, but the civil war has retarded its development. Indeed, in 2001 – the year that the Tamil Tigers blew up the fleet of Sri Lankan Airlines on the tarmac of the international airport – visitor arrivals slumped to below 350,000 and generated a mere US$211 million in revenues. Both arrivals and revenues in 2001 hit their lowest levels since 1996. Despite these woes, currently around 100,000 people are directly or indirectly employed in the tourist sector, making it the country's third-largest employer.

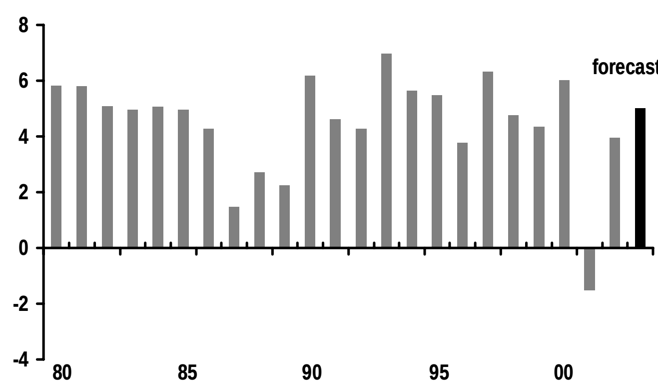
Finally, agriculture's importance in the economy has declined over the years, now representing about 20% of GDP although still employing over one-third of the labor force. The sector's main exports are tea, rubber, and coconuts. Indeed, Sri Lanka is the world's largest tea exporter with revenues over US$700 million annually and is the second-largest exporter of coconuts (behind the Philippines).

State dominance continues

The state dominates key aspects of the economy, owning all utilities, 90% of the land, and large parts of the financial sector. Sri Lanka has the highest ratio of public employees in Asia, employing 12% of the labor force versus 8% in Pakistan and around 5% in India. Not sur-

Sri Lanka: real GDP growth

%oya



JPMorgan Chase Bank
David G. Fernandez (65) 6882-2461
david.g.fernandez@jpmorgan.com
Rajeev Malik (65) 6882-2375
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prisingly then, expenditure on personnel services consumes around 10% of GDP.

Poverty high; worse in war-affected areas

The 2002 Household Survey showed that the poverty rate in Sri Lanka has risen to 28% from about 20% in the early 1990s. Poverty rates vary across the country and, not surprisingly, are worse in the areas worst affected by the civil war. In the Western Province, the poverty rate is 23%; and while the formal survey does not cover the conflict areas, anecdotal evidence points to rates in the 50% neighborhood. These different poverty rates are echoed in different economic growth rates, with the Western Province growing at a pace of over 7% in the 1990s while the provinces with the highest poverty incidence grew less than 2%. Social welfare programs, which will be a key part of addressing Sri Lanka's high poverty rate, have had a political element to their application; the new Welfare Reform Act sets objective criteria, using means testing, for the application of these programs.

IFI involvement steps up

In the past, the civil war hampered the building of Sri Lanka's relationship with the International Financial Institutions. Now, those relationships are quickly deepening. Following up on the successful Stand-By Arrangement with the IMF that ran from April 2001 to September 2003, Sri Lanka recently entered into a three-year, joint Poverty Reduction and Growth Facility (PRGF) and Extended Fund Facility (EFF) arrangement. Under the PRGF, US$369 million is available, and together with the US$198 million available under the EFF, the total size of the facility is US$567 million. The focus of the IMF program is twofold: (1) fiscal consolidation to reduce public debt; (2) structural reforms to reduce the role of the public sector.

The World Bank also is stepping up its activities in Sri Lanka, supporting the government economic program – the key target of which is to half the number of poor people by 2015. To date, the Bank has committed US$2.7 billion in loans, credits, and grants to support 98 different projects, while Asian Development Bank loans total US$2.6 billion. The base case for the World Bank lending program through 2006 consists of about four projects per year for a total of US$800 million.

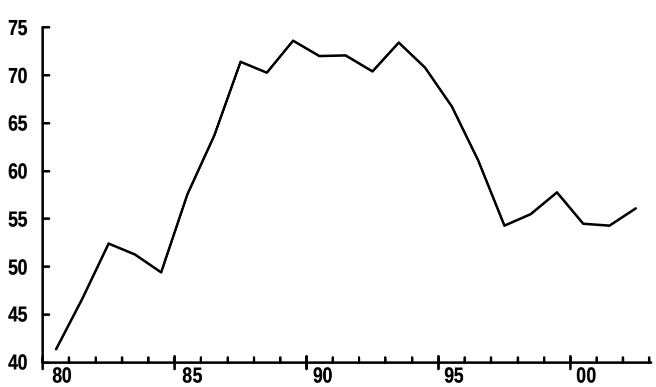
External debt

Sri Lanka's external debt at end-2002 stood at US$9.3 billion or 54% of GDP. Medium- and long-term debts directly owed by the government make up 80% (US$7.4 billion) of the total stock of external debt consists of medium- and long-term government debt, mostly in the form of project loans. Short-term external debt, consisting basically of private trade credits, are very small at about US$0.6 billion or 3.6% of GDP.

The government's debt service payments in 2002 were around US$500 million, compared to total external debt service payments of around US$800 million. Total debt service in 2002 was 12.2% of total exports of goods and services.

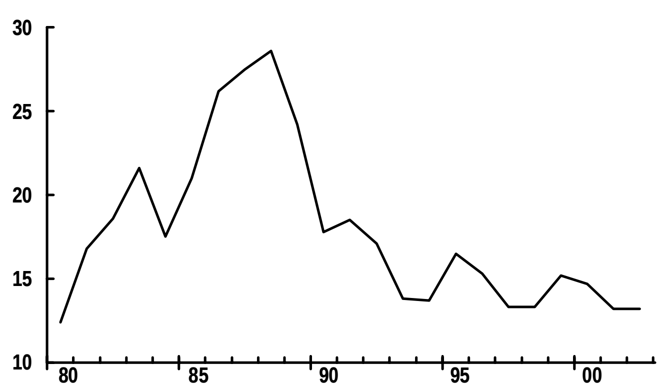
Sri Lanka: external debt

% of GDP



Sri Lanka: debt service ratio

% of exports and services



JPMorgan Chase Bank
David G. Fernandez (65) 6882-2461
david.g.fernandez@jpmorgan.com
Rajeev Malik (65) 6882-2375
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Economic outlook

Real GDP grew 5.9%oya in 02Q3, though growth is inflated by previous year's low base, owing to a sharp contraction of 3.9%oya. High-frequency data for the fourth quarter hints that the economy expanded 6.2%, bringing the full-year growth to 4%. Although below the historical average of around 5%, the outturn is nevertheless respectable and suggests a decent recovery following a series of shocks – drought, attack on Colombo airport and global slowdown – in the previous year. Undoubtedly, the ceasefire between the government and the LTTE was a major boost to confidence as it lowered risk aversion.

Tourism and shipping industries have been positively impacted thanks to the ongoing peace talks, which have eased security concerns and boosted domestic and external trade activity. Additionally, a pick-up in investment spending will be slower, but eventually come through as lower interest rates, higher consumer and business confidence boost demand prospects. However, recovery in exports has been unimpressive, though this too should rebound later this year, in line with the recovery in global demand.

The ongoing recovery is forecast to strengthen this year, and the IMF projects GDP growth of 5.5%, below the medium-term potential of 6.5%. Growth will likely be powered by a rebound in domestic demand, including resumption of delayed public investment, and by a more normal weather pattern. Additionally, rebuilding efforts will likely boost construction activity, while further normalization of intra-country travel, especially between northeast and the rest of the country will boost service activities.

Industrial recovery has been less striking due to continuing power shortages which hit manufacturing production, and low water level in reservoirs, which affected output of utilities. Importantly, electricity supply should improve with the commissioning of an additional 165 megawatts of capacity in 03H1. To be sure, economic recovery should become more broad-based, and further strengthen in 2004, barring political or external economic shocks.

Stability arising from the current peace process is critical to ensuring continued upturn in economic activity. In fact, if the economy can achieve its medium-term growth potential of around 6.5% per annum, it would be ranked among the fastest-growing economies in Emerging Asia.

Inflation down and likely to fall further

Sri Lanka's food prices are the highest in South Asia, due to its inefficient domestic agricultural sector. Nevertheless, inflation is now down to 9-10%, and is expected to fall further to 7%. The IMF expects long-term inflation rate at around 4.5%.

Sri Lanka: stock market index

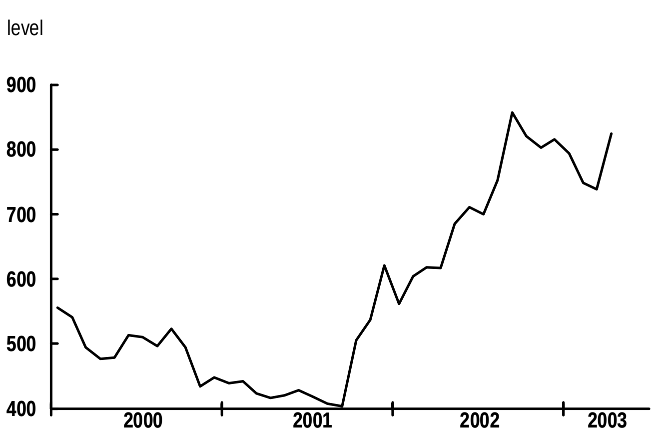

Table 4: Real GDP

%oya	2000	2001	2002	2003	2004
China	8.0	7.3	8.0	7.4	7.5
Hong Kong	10.2	0.6	2.3	1.0	3.4
India	4.0	5.4	4.3	5.4	6.2
Indonesia	4.9	3.4	3.7	3.0	3.5
Korea	9.3	3.1	6.3	3.5	6.7
Malaysia	8.3	0.4	4.2	3.0	5.0
Philippines	4.4	3.2	4.6	3.8	4.5
Singapore	9.4	-2.4	2.2	1.3	6.0
Sri Lanka	**6.0**	**-1.5**	**4.0**	**5.0**	**5.5**
Taiwan	5.9	-2.2	3.5	2.3	3.7
Thailand	4.6	1.9	5.2	4.2	5.4

JPMorgan Chase Bank
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david.g.fernandez@jpmorgan.com
Rajeev Malik (65) 6882-2375
rajeev.malik@jpmorgan.com

Inflation is forecast to edge down over the course of 2003, driven by higher agricultural supplies and greater stability in the exchange rate. Indeed, on a point-to-point basis, the Colombo District CPI (CDCPI) declined to 3% in April from 5.2% in January. The annual inflation rate has fallen to 5.1% from 6.5% in the same time period. More importantly, bid yields for government securities and foreign premiums for exchange rate signal that financial markets also expect inflation to continue falling.

On monetary policy, JPMorgan believes that interest rates will continue to decline owing to falling inflation and a stable exchange rate. Encouraged by the recent trends in economic activity and inflation, the central bank cut the repo rate to 8.25% in May from 9%.

Fiscal indicators gradually improving

The 2002 fiscal deficit narrowed to around 9% of GDP, though the outturn was slightly higher than the target of 8.5%. Expenditure was lower by around 0.5% of GDP, but revenue collection was unexpectedly lower by around 1% of GDP. Apart from cyclical factors, revenues were hit by a large number of exemptions granted when the GST was replaced with VAT and restructuring in payments from the state electricity company (CEB).

Total revenues account for around 16.5% of GDP, with tax revenues at 14%. Revenue performance remains poor, as reflected in deterioration in the tax/GDP ratio. The ratio has steadily declined from 19% in 1990. Total expenditure is substantially higher at 25.4%, with current expenditures making up over 80% of total expenditure (or about 21 % of GDP), and capital spending making up the balance. In particular, public investment has been declining, from slightly under 7% of GDP in the late 1990s to 4.6% last year.

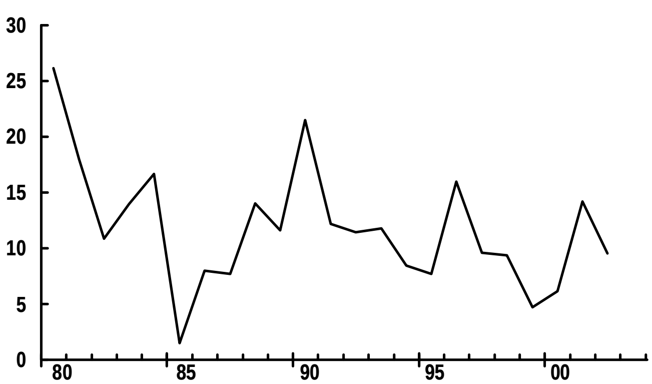
Efforts to contain spending are already paying dividend. Non-interest expenditure declined to 13.5% last year from almost 15% in 2001. However, interest expenditure remains high, and actually rose to 7.4% of GDP in 2002, resulting in a smaller-than-expected decline in the current expenditure/GDP ratio. Note that interest expenditure is around 11% of total expenditure and 17% of total revenue. Still, one encouraging trend in recent years is the rapid decline in the primary deficit, which has declined to 1.6% of GDP in 2002 from over 4% recently. The primary balance is forecast to post a smaller deficit of 0.2% in this year, but record a small surplus in 2003.

With such high budget deficits, the government is walking a tightrope in balancing its objectives of fiscal sustainability and continuing post-conflict spending initiatives. Sustainability is a challenge, as public debt is over 100% of GDP, and interest expense around 7.5% of GDP. The poverty-reduction strategy program (PRSP) envisages reduction in the fiscal deficit of around 1.25% of GDP per annum over the medium-term in order to keep sustainability on track.

If realized, the deficit by 2006 is likely fall to slightly

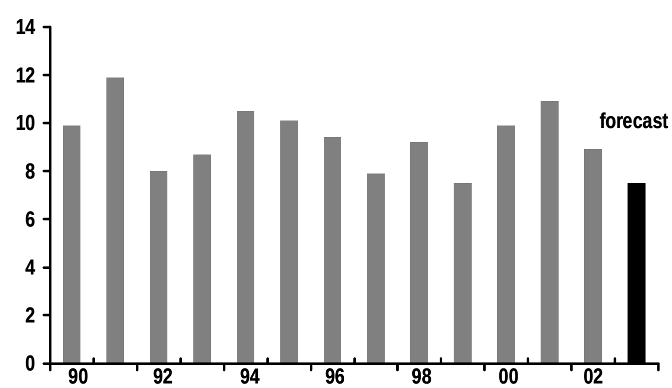
Sri Lanka: consumer prices

%oya



Sri Lanka: fiscal deficit

% of GDP



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david.g.fernandez@jpmorgan.com
Rajeev Malik (65) 6882-2375
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over 4% of GDP, the debt-to-GDP ratio to 84% of GDP, and interest payments to 5.5%. The primary balance could post a surplus of over 1% of GDP by 2006, if reforms remain on track. Needless to say, the objectives are challenging but not impossible to meet. The positive impact of the peace dividend in the form of higher economic growth, lower inflation and interest rates, decline in poverty, and foreign inflows could be substantial, but will take time to be fully realized.

The budget for 2003 proposed a budget deficit target of 7.5% of GDP. The coverage of the VAT was extended to cover the financial sector at 10%, and VAT exemptions lifted on some items. Extending the VAT coverage to include the wholesale and retail sectors has been postponed to January 2004 from July 2003. Expenditure is forecast to decline by 1% of GDP, despite a higher capital outlay.

One critical issue that will have a significant on the medium-term fiscal dynamics is the impact of devolution of power to the provinces. However, it is early days yet, and details of the exact nature and impact would partly depend on the power-sharing compromise reached between the government and the LTTE.

Current account and trade deficit

As would be expected for a country at this stage of development, Sri Lanka runs a merchandise trade deficit of around US$1-1.5 billion per year or about 7-10% of GDP. However, the current account deficit is lower than the trade deficit largely because of net private transfers which usually keep it capped at 2% of GDP.

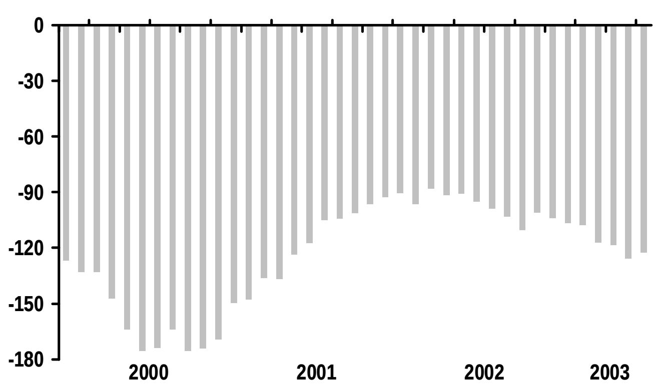
These transfers primarily consist of remittances from the 230,000 or so Sri Lankans working abroad, mostly elsewhere in Asia and in the Middle East. Gross private transfers amounted to nearly US$1.1 billion in 2001, and increased to around US$1.3 billion in 2002. These transfers from overseas workers are an important, stable source of balance of payments support. Indeed, they consistently rank as Sri Lanka's second leading hard currency earner after garments.

Going forward, JPMorgan expects that receipts from travel and transportation services will continue to rise, driving services generally to take a more prominent role in the invisibles account. In 2002, services registered a small surplus of US$271 million, with earnings from tourism rising to US$248 million. As peace deepens, these numbers should easily double.

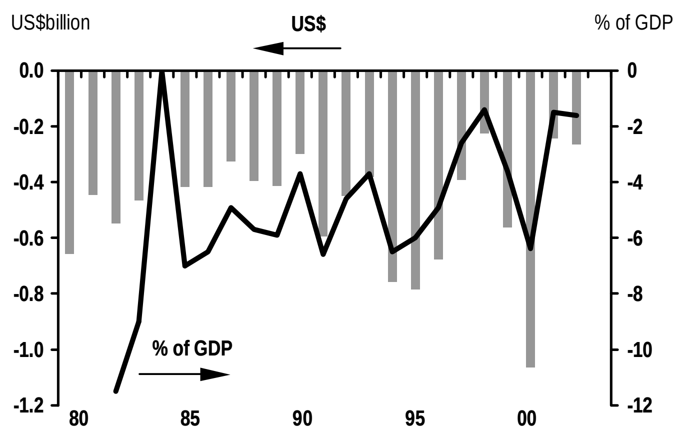
Regarding the trade deficit, it is important to note that the Sri Lanka government remains committed to free trade and the country has the most liberal trade environment in South Asia. Quantitative restrictions are very limited and in 2000 tariffs were rationalized into a two-tiered structure with a maximum rate of 25%. In 2002, the import surcharge was reduced to 20%. An exception to this liberal regime is for agriculture whose imports are

Sri Lanka: trade balance

US$million, 12mma



Sri Lanka: current account balance



JPMorgan Chase Bank
David G. Fernandez (65) 6882-2461
david.g.fernandez@jpmorgan.com
Rajeev Malik (65) 6882-2375
rajeev.malik@jpmorgan.com

subject to a higher tariff. The country's liberal trade regime has helped boost the export share of GDP to 35%, while imports are 50% of GDP. Garments and tea dominate merchandise exports, together accounting for over two-thirds of total exports. Garments themselves make up over half of export revenues. Imports are dominated by intermediate goods, especially of textiles and yarn, while import volumes of oil continue to rise.

Over the near term, JPMorgan expects that the trade deficit will widen due to increased import related to reconstruction efforts and to a still-dull external demand environment. Indeed, the trade deficit could approach 9% of GDP this year. However, the continued recovery in tourism and port activity, added to higher tansfers, will contain the widening of the current account deficit to around 3% of GDP.

Foreign exchange reserves slowly rising

International reserves rose to US$$1.7 billion at end-2002 from US$1.2 billion the previous year, a level sufficient to cover 3.3 months of imports. With the capping of the current account deficit mentioned above, JPMorgan expects that international reserves should double, rising above US$3 billion by 2006. Foreign direct investment started to climb from a very low level (US$82 million) in 2001 to almost US$250 million last year. In our view, the ongoing peace talks combined with the significant need to upgrade domestic infrastructure, should keep the capital account in healthy surplus going forward.

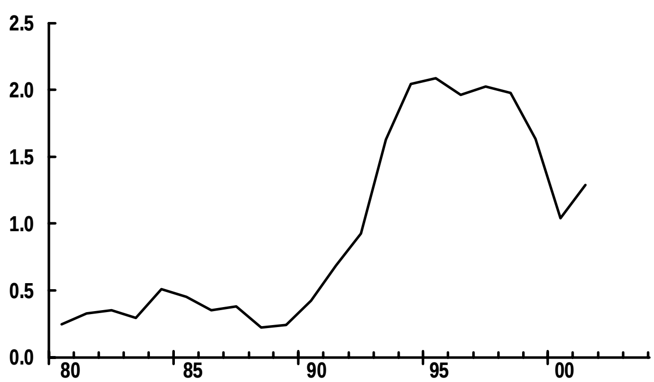
Rupee appears fairly valued

The rupee was floated in January 2001 in the wake of a drop in international reserves. After an initial sharp depreciation, the currency has stabilized, depreciating 3.7% against the US dollar during 2002. It appears fairly valued on real effective exchange rate (REER) basis.

Further, positive structural changes in the economy, renewed capital inflows, and declining rigidities in domestic inflation suggest a fall in the differential between local and foreign inflation rates, suggesting a slower pace of depreciation of the nominal exchange rate.

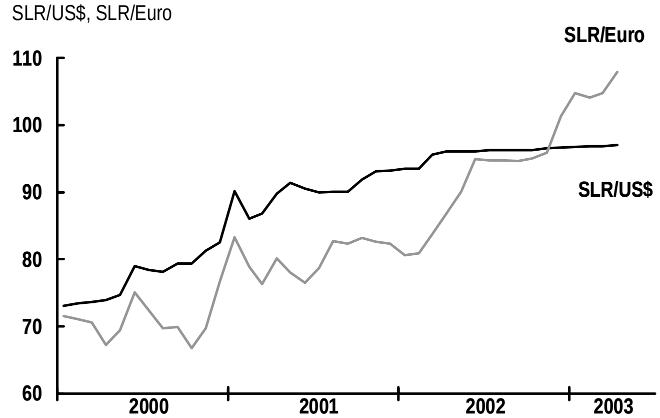
Sri Lankan: foreign reserves excluding gold

US$billion



Sri Lanka: exchange rates

SLR/US$, SLR/Euro



JPMorgan Chase Bank
David G. Fernandez (65) 6882-2461
david.g.fernandez@jpmorgan.com
Rajeev Malik (65) 6882-2375
rajeev.malik@jpmorgan.com

Table 5: Key macroeconomic data on Sri Lanka

	95	96	97	98	99	00	01	02e	03f
Domestic economic structure and performance									
Real GDP (%)	5.5	3.8	6.3	4.7	4.3	6.0	-1.5	4.0	5.0
GDP contribution (% point)									
- agriculture	0.8	-1.1	0.7	0.5	1.0	0.4	-0.7	0.5	0.3
- industry	1.9	1.4	2.0	1.6	1.3	2.1	-0.6	0.3	1.3
- services	2.5	3.0	3.6	2.6	2.1	3.6	-0.3	3.1	3.5
Nominal GDP (US$ billion)	13.0	13.9	15.1	15.8	15.6	16.3	15.6	16.6	18.2
GDP per capita (US$)	718	758	813	841	820	884	833	871	945
Employment (million)	5.4	5.5	6.2	6.0	6.1	6.3	6.2	6.3	n.a.
Share of total (%) - Public	24.4	21.0	17.3	18.0	18.4	18.3	18.8	17.3	n.a.
- Private	75.6	79.0	72.6	82.6	81.6	81.7	81.2	82.7	n.a.
Saving-investment balance (% of GDP)									
Gross national saving	19.5	19.0	21.5	23.4	23.5	21.4	20.1	20.1	n.a.
Gross national investment	25.7	24.2	24.4	25.1	27.3	28.0	22.2	22.5	n.a.
Inflation (Colombo CPI, %YOY, average-period)	7.7	15.9	9.6	9.4	4.7	6.2	14.2	9.6	8.9
Monetary indicators									
M2 (%YOY, end-period)	19.2	10.8	13.9	9.7	13.3	13.0	11.4	13.2	14.0
Net external banking assets (SLR billion)	66.5	61.9	89.3	93.7	83.9	59.4	80.0	101.7	n.a.
Prime lending rate (% pa)	18.1	18.3	14.7	15.0	14.7	16.2	19.3	13.2	n.a.
Nominal effective exchange rate (1990=100)									
Real effective exchange rate (1990=100)									
Exchange rate (SLR per US$, end-period)	51.3	55.3	59.0	67.8	72.1	80.1	93.2	96.7	100.0
Government balance									
Fiscal balance (% of GDP)	-10.1	-9.4	-7.9	-9.2	-7.5	-9.9	-10.9	-8.9	-7.5
Total revenue (SLR billion)	136.3	146.3	165.0	175.0	195.9	211.3	234.3	261.3	303.9
Grants (SLR trillion)	9.0	7.7	7.3	7.2	6.8	5.1	5.5	7.1	9.0
Total expenditure and net lending (SLR billion)	203.5	218.7	235.1	268.2	279.2	335.8	383.7	402.4	438.4
External balance of payments									
Current account balance (US$ million)	-787	-677	-393	-226	-563	-1066	-244	-264	-648
Trade balance (US$ million)	-1505	-1344	-1225	-1092	-1369	-1798	-1158	-1407	-1756
Capital & financial account balance (US$ million)	699	459	602	413	373	443	562	506	611
Gross foreign direct investment (US$ million)	53	120	430	193	177	176	172	235	350
Errors & omissions (US$ million)	140	150	-46	-150	-73	101	-98	96	0
Overall balance (US$ million)	52	-68	163	37	-263	-522	220	338	-37
FX reserves (US$ billion)	2.1	1.9	2.0	2.0	1.6	1.0	1.2	1.6	1.9
Imports cover (no of months)	4.1	3.8	4.1	4.0	3.1	1.5	2.0	2.4	2.7
External debt									
Foreign convertible currency debt (US$ billion)	8.7	8.5	8.2	8.7	9.1	9.0	8.5	9.3	-
Medium- and long-term (US$ billion)	8.2	8.0	7.7	8.3	8.6	8.5	8.0	8.7	-
Public (US$ billion)	8.2	8.0	7.7	8.3	8.6	8.5	8.0	8.7	-
Private (US$ billion)	-	-	-	-	-	-	-	-	-
Short-term (US$ billion)	0.5	0.5	0.5	0.5	0.5	0.6	0.5	0.6	-
Public (US$ billion)	-	-	-	-	-	-	-	-	-
Private (US$ billion)	0.5	0.5	0.5	0.5	0.5	0.6	0.5	0.6	-
External debt service (US$ billion)	0.8	0.7	0.7	0.8	0.8	1.0	0.8	0.8	-
Principal (US$ billion)	0.5	0.4	0.4	0.5	0.6	0.6	0.6	0.6	-
Interest (US$ billion)	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.2	-
External debt service ratio (% of exports)	16.5	15.3	13.3	13.3	15.2	14.7	13.2	13.2	-

Sources: Central Bank of Sri Lanka, IMF, CEIC, JPMorgan

JPMorgan Chase Bank
David G. Fernandez (65) 6882-2461
david.g.fernandez@jpmorgan.com
Rajeev Malik (65) 6882-2375
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Table 6: Sri Lanka: Central government debt sustainability framework, 2002-2007

(in percent of GDP, unless otherwise indicated)

		Projection				
	2002	2003	2004	2005	2006	2007
			I. Baseline Medium-Term Projections			
Central government debt 1/	104	99	94	89	84	78
of which: foreign-currency denominated	53	50	47	45	42	38
Change in central government debt	0.2	-4.7	-5.0	-5.4	-5.2	-5.8
Identified debt creating flows (4+7+12)	0.1	-3.9	-4.2	-4.7	-4.6	-5.6
Primary deficit	1.4	0.3	-0.3	-0.8	-1.2	-1.8
Revenue and grants	16.5	16.9	17.9	18.7	19.1	19.1
Primary (noninterest) expenditure	18.0	17.1	17.6	17.8	18.0	17.4
Automatic debt dynamics 2/	-0.9	-3.0	-3.7	-3.7	-3.3	-3.6
Contribution from interest rate/growth differential 3/	-4.3	-5.4	-5.6	-5.1	-4.3	-4.1
of which: contribution from real interest rate	-1.3	-0.4	0.1	0.6	1.2	1.2
of which: contribution from real GDP rate	3.0	5.0	5.7	-5.7	-5.5	-5.2
Contribution from exchange rate depreciation 4/	3.3	2.4	1.9	1.4	1.0	0.4
Other identified debt-creating flows	-0.4	-1.1	-0.2	-0.2	-0.2	-0.2
Privatization receipts (negative)	-0.4	-1.1	-0.2	-0.2	-0.2	-0.2
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalisation)	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3)	0.1	-0.7	-0.8	-0.7	-0.6	-0.2
Central government debt in percent of revenues 1/	627	587	527	476	437	407
Gross financing 5/	37	36	38	40	41	40
in billions of U.S. dollars	6	6	7	8	9	10
Key macroeconomic and fiscal assumption						
Real GDP growth (in percent)	3.2	5.5	6.5	6.8	7.0	7.0
Average nominal interest rate on public debt (in percent) 6/	8.1	8.0	7.6	7.1	6.9	6.4
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.1	0.0	0.6	1.1	1.9	1.9
Nominal appreciation (increase in US dollar value of local currency, in percent)	-6.2	-4.7	-3.9	-3.0	-2.3	-1.1
Inflation rate (GDP deflator, in percent)	9.2	8.0	7.0	6.0	5.0	4.5
Growth of real primary spending (deflated by GDP deflator, in percent)	-10.1	0.8	9.0	8.5	7.8	3.4
			II. Stress Tests			
Permanent shocks:						
Real GDP growth, real interest rate, and primary balance are at:						
1. 10 year historical averages in 2003-2007	104	100	97	94	90	87
2. 3 year historical averages in 2003-2007	104	106	108	111	112	114
3. Real interest rate is at 10 year historical average plus two standard deviations in 2003-2007	104	101	97	93	88	82
Temporary shocks in 2003 and 2004:						
4. Real interest rate is at historical average plus two standard deviations in 2003 and 2004	104	101	97	92	87	81
5. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004	104	105	106	100	94	88
6. Primary balance is at historical average minus two standard deviations in 2003 and 2004	104	104	104	98	92	86
7. Combination of 3-5 using one standard deviation shocks	104	106	108	101	94	86
8. One time 30 percent real depreciation in 2003 7/	104	127	121	114	108	101
9. 10 percent of GDP increase in other debt-creating flows in 2003	104	109	104	98	92	86
10. Impact on debt -to-GDP ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-4	104	100	97	92	84	81
10a. Impact on debt-to-revenue ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003	627	637	619	493	453	422
11. No new foreign concessional finding, with the gap financial domestically	104	99	94	89	84	79
12. Iraq war oil price shock	104	104	99	93	88	82

Historical statistics for key variables	Past 10 years		Past 3 years
	Historical Average	Standard Deviation	Historical Average
Primary deficit	2.1	1.3	2.9
Real GDP growth (in percent)	4.6	2.4	3.0
Nominal interest rate (in percent)	7.3	0.4	7.1
Real interest rate (in percent)	-1.9	2	-1.1
Inflation rate (GDP deflator, in percent)	9.2	2.3	8.1
Revenue to GDP ratio	19.5	1.9	17.5

1/ Indicate coverage of public sector, e.g. general government or nonfinancial public sector. Also whether net or gross debt is used

2/ Derived as [(r-p(1+g)-g+ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r=interest rate; p=growth of GDP deflator, g=real GDP growth rate:
a= - share of foreign-currency denominated debt; and e=nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar)

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r -p (1+g) and the real growth contribution as -g

4/ The exchange rate contribution is derived from the denominator in footnaote 2/ as ae(1+r).

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator)

Source: IMF

JPMorgan Chase Bank
David G. Fernandez (65) 6882-2461
david.g.fernandez@jpmorgan.com
Rajeev Malik (65) 6882-2375
rajeev.malik@jpmorgan.com