

Tough year ahead

General Information



| | |
|---------------------------|---|
| GDP | USD82.3bn (World ranking 66, World Bank 2015) |
| Population | 20.9mn (World ranking 56, World Bank 2015) |
| Form of state | Republic |
| Head of government | Maithripala Sirisena |
| Next elections | 2020, Presidential |



Strengths

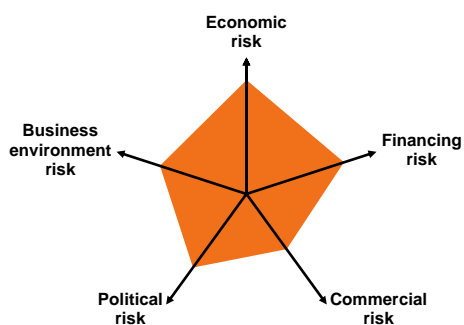
- Strong economic growth, despite the currency crisis of 2000/2001 and global downturn in 2009
- Increased tourism revenues and workers' remittances
- Economic policies are broadly supportive of business and economic growth
- Growing tourism sector

Weaknesses

- Ethnic tensions remain a threat to stability and growth prospects
- Fractured nature of the political system, with generally weak coalition governments
- Vulnerability of export base (45% textiles and clothing)
- Large fiscal deficits and high public debt

Country Rating

C3



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

| Exports | Rank | Imports |
|----------------|-------|-------------------------|
| United States | 27% 1 | 23% India |
| United Kingdom | 10% 2 | 20% China |
| India | 7% 3 | 7% Japan |
| Germany | 5% 4 | 6% United Arab Emirates |
| Italy | 4% 5 | 5% Singapore |

By product (% of total)

| Exports | Rank | Imports |
|---|-------|--------------------------------------|
| Articles of apparel, clothing accessories | 46% 1 | 12% Petroleum and related materials |
| Coffee, tea, cocoa, spices | 16% 2 | 12% Road vehicles |
| Rubber manufactures | 6% 3 | 12% Textile yarn |
| Vegetables and fruits | 3% 4 | 4% Non metallic mineral manufactures |
| Non metallic mineral manufactures | 3% 5 | 4% Iron and steel |

Source: UNCTAD

Economic Overview

Improving but still fragile

Economic growth slowed to +4.4% in 2016 (down from +4.8%). Real GDP growth decelerated in the first half of 2016 due to floods. In the second half, the economy showed signs of improvement and growth picked up as services and manufacturing improved.

In 2017, economic growth is set to stabilize around +4.4% before accelerating in 2018. Exports should recover gradually on the back of higher global demand and the competitive tourism industry. In the short-run, domestic demand expansion will be limited due to monetary tightening and continued fiscal consolidation.

Risks to the outlook are elevated and stem from domestic and external sources. On the domestic front, they are related to weather conditions (drought, e.g.), the capacity of the government to reduce debt sustainability risk and drive crucial economic reforms (SOE, e.g.).

Externally, cause for concern lies in potential shocks such as lower exports, since the country has a very weak external position. Moreover, the authorities are scrutinized by the IMF. In June 2016, the latter approved a 36-month Extended Fund Facility for around USD1.5bn to support the economy in its reform agenda.

Limited policy space

The central bank has announced that it will move from monetary targeting to a flexible inflation targeting framework. The aim for this is to keep inflation in a range of 4-6%. Against this backdrop, the authorities will likely maintain a restrictive monetary policy this year. Inflation rose above +6% in February 2017 and prolonged drought poses a significant risk of further deterioration. Moreover, the financial situation could become precarious due to the excessive growth of domestic credit (above +20% y/y in 2016) and downward pressures on the currency.

Public finances are weak. Public debt is more than 60% of GDP. Public deficit is elevated (more than 3% GDP). Going forward, a gradual improvement should be expected on the basis of higher revenues following the rise in Value-added Tax and reforms to improve revenue mobilization.

Weak external position

External fundamentals are very fragile. External debt accounts for 56% GDP. Foreign exchange reserves are at a low level and provide cover for around 3 months of imports. The current account is in deficit (-1.8% GDP).

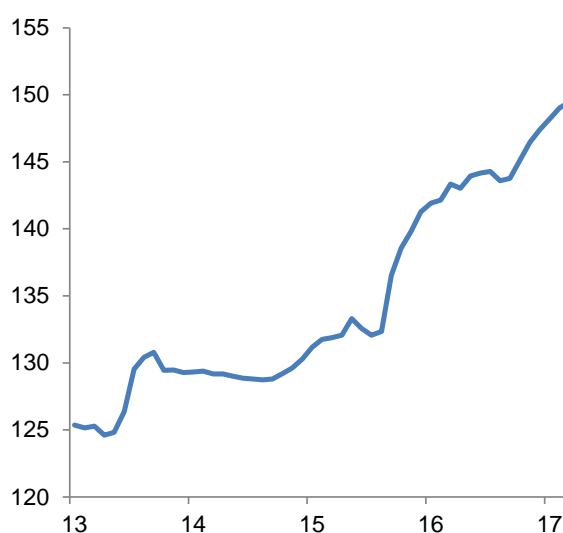
In the medium term, the situation is set to improve at a modest pace. An enhanced monetary policy framework and a more flexible currency would help mitigate external shocks and build up foreign exchange reserves. Progress on the reform agenda – with a focus on taxes through the Inland Revenue Act - would help reduce sustainability risk and boost foreign direct investment inflows.

Key economic forecasts

| | 2015 | 2016f | 2017f | 2018f |
|----------------------------|------|-------|-------|-------|
| GDP growth (% change) | 4.8 | 4.4 | 4.4 | 5.0 |
| Inflation (% year average) | 0.9 | 4.0 | 4.5 | 2.7 |
| Fiscal balance (% of GDP)* | -6.9 | -5.4 | -4.7 | -3.9 |
| Public debt (% of GDP) | 76.0 | 77.0 | 75.8 | 73.5 |
| Current account (% of GDP) | -2.4 | -1.8 | -2.2 | -2.5 |
| External debt (% of GDP) | 55.1 | 56.3 | 55.9 | 55.4 |

Sources: IHS, IMF, Euler Hermes

LKR/USD



Sources: IHS, Euler Hermes

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