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Sri Lanka Business Forecast Report Q2 2014

https://marketpublishers.com/r/SE4D276FC7EEN.html
Date: February 2014
Pages: 41
Price: US$ 1,195.00 (Single User License)
ID: SE4D276FC7EEN

Abstracts

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Core Views

Although the US is pressing for a UN inquiry into war crimes in Sri Lanka that allegedly occurred during the final stages of the country's civil war, the island state will continue to receive strong political and economic support from China, its strategic partner. Even if a UN resolution is passed, President Mahinda Rajapaksa's government will remain strong, and the current economic growth momentum will not be derailed.

We are forecasting a healthy real GDP growth rate of 6.8% year-onyear (y-o-y) in 2014, as we expect public investment in infrastructure development to continue supporting growth and the gradual recovery in the US and European markets to bode well for goods exports. In addition to a potential bottoming out of private sector credit, the recent rise in public sector credit could have inflationary consequences over the coming months. Economic growth continues to be on a sound footing, and the Central Bank of Sri Lanka will remain cautious of further rate cuts and will likely keep rates steady for a prolonged period. We are forecasting the reverse repo rate to end the year at its current level of 8.00%. We expect the Sri Lankan rupee to remain fairly stable against the US dollar over the course of 2014, as the recent improvement seen in the external sector will lend support to the currency.

Even though the Sri Lankan government remains committed to consolidating its fiscal account, the pace of consolidation will be slow due to the marginal impact of ongoing tax reforms and the downward rigidity in government expenditures. As such, the fiscal deficit as a share of GDP will likely stay elevated over the course of the next few years, and we are forecasting it to come in at 5.8% in 2014 before falling marginally to 5.7% in 2015. **Major Forecast Changes** We have recently upgraded our 2014 current account

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forecast to -5.0% of GDP, from -5.4% previously.

Key Risks To Outlook

Upside Risks To Current Account Deficit: Risks include the potential for adverse global commodity price movements (especially that of oil prices) and a flare-up in sovereign risk in the European Union. Risk To Rupee Outlook: Sri Lanka's current account deficit continues to be largely financed by government borrowing from abroad, as its foreign direct investment is inadequate to finance the large deficits. This is unsustainable in the long run and is bearish for the currency, as the government is already burdened by high external debt.

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Even though the Sri Lankan government remains committed to consolidating its fiscal account, the pace of consolidation will be slow owing to the marginal impact of ongoing tax reforms and the downward rigidity in government expenditures. As such, the fiscal deficit as a share of GDP will likely stay elevated over the course of the next few years; we forecast it to come in at 5.8% in 2014 before falling marginally to 5.7% in 2015.

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While we have a long-term bearish outlook on the Sri Lankan rupee, we expect the currency to remain fairly s Table against the US dollar over the course of 2014, as the recent improvement seen in the external sector will lend support to the currency. A heavy reliance on financial account inflows poses a risk despite the healthy build-up in foreign reserves.

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