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# RISKS TO WATCH

# SRI LANKA

Sri Lanka's President Mahinda Rajapaksa has started his second term of office and followed up his mid-November inauguration with a 2011 budget that carried a long promised and sweeping set of fiscal and tax reforms.

## FISCAL REFORM

Rajapaksa, who is also the finance minister, presented his 2011 budget on Nov. 22 and it came with a host of fiscal, financial and tax reforms urged by the private sector and the International Monetary Fund.

Sri Lanka also moved in the opposite direction to many of its Asian peers by easing foreign exchange controls. It previously had one of the strictest regimes, and therefore had worried less than others about a flood of hot money as a result of the U.S. Federal Reserve's second round of quantitative easing.

All the moves were designed to make Sri Lanka an easier investment destination for foreign and local companies, address government inefficiency and narrow a perennially big budget gap. The budget was notably light on revenue proposals.

While the private sector generally applauded the changes, Sri Lanka's 1.3 million public employees are less pleased with what they viewed as an insufficient wage hike, which Rajapaksa has been promising since he won office in 2005. They, and poor government follow-through, could put the changes at risk, and leave potential foreign investors still wary of Sri Lanka as a destination.

### What to watch:

- Concrete steps to make state-run entities revenue earners. Most of the deficit reduction plans hinge on turning around loss-making state ventures hampered by subsidy schemes, mismanagement and an infamously intractable corps of bureaucrats.
- Public sector pushback.
- Any hint of foreign direct investment picking up after surprisingly falling in 2010.

## PERCEPTIONS

Rajapaksa rushed a constitutional amendment through parliament, which his ruling alliance controls, that removed the last vestiges of any checks on a presidency that was already barely checked. It also removed the presidential two-term limit.

The fact that the president has put three brothers, two of whom were popularly elected, in crucial positions has predictably caused some grumbling that the Rajapaksa clan controls too much. They in fact have about 70 percent of the 2010 budget under the ministries they run.

That must be viewed in the context of South Asia's long history of producing and tolerating family political dynasties. There are some whispers of frustration from inside the president's coalition, which are unlikely to amount to much given Rajapaksa's skill at charming, co-opting or coercing opponents.



A supporter of the ruling party, United People's Freedom Alliance, holds a poster of parliament member, Dinesh Gunawardena, as she screams during a rally celebrating the closing of parliamentary polls in Colombo. REUTERS/Andrew Caballero-Reynolds

Those factors have led to continually negative international press for Sri Lanka and Rajapaksa's government, which has kept the defiant stance it adopted when fighting off intervention as it neared victory over the Tamil Tigers in a quarter-century war. It has hired influential U.S. and British public relations firms to polish its reputation, but martial and sometimes inconsistent messaging has at times undermined Sri Lanka's efforts to pitch itself as a prime investment destination.

### What to watch:

- A shift toward a more consistent message and tone from the government.
- Signs of new investment beyond the present, mostly bilateral deals, between the government and China and India.

## LABOUR, STUDENT UNREST

Rajapaksa finally delivered his promised pay hike for state employees in the budget but alongside that subjected about a fifth of civil servants to income taxes for the first time. So the raise is unlikely to quell dissatisfaction among state workers, who were already frustrated they had to wait through Rajapaksa's entire first five years in office. Already this year, university students have held strikes, which traditionally presage labour unrest. A handful of state workers have taken token actions. A recent flare-up at a university caused minor injuries and the government blamed the Marxist JVP party.

## RISK DATA

<b>Sovereign foreign currency:</b>	
S&P	B (positive)
Fitch	B+ (stable)
<b>World Governance Indicators:</b>	
Voice & Accountability	32.2
Political Stability	11.8
Govt Effectiveness	49.0
Regulatory Quality	43.3
Rule of Law	53.3
Control of Corruption	44.8
<b>IHS Global Insight</b>	
Country risk	3.12
Sovereign	B+ (stable)
<b>Economist Intelligence Unit</b>	
Sovereign risk	B
Political risk	B
Country risk	B

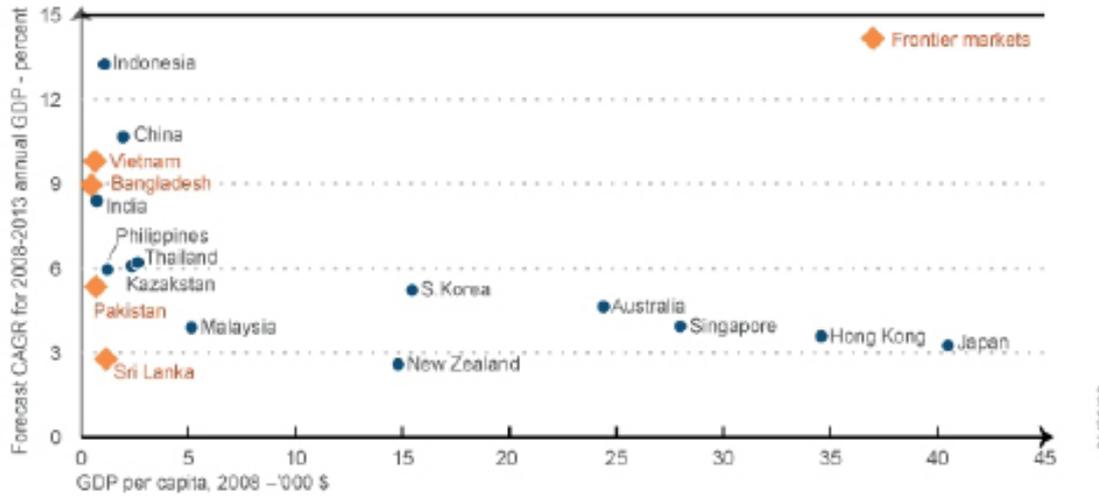
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# Emerging Asia's growth potential

Vietnam and Bangladesh are frontier markets where high growth is seen



Source: CLSA, World Bank, IMF



## KEY DATES

- December 14, 2010**  
Central bank monetary policy committee meeting
- February 19, 2011**  
ICC Cricket World Cup

## RISK DATA

<b>JLT Group</b>	
Strikes, riots & civil unrest	6
Terrorism	5
War & civil war	5
Economic risk	7
Currency risk	7
Sovereign risk	7
Expropriation	5
Contract repudiation risk	7
Legal & regulatory risk	6
<b>Coface</b>	
Country rating	C
Business climate	B
<b>Transparency International</b>	
Corruption Perceptions Index Score	3.1
Rank (of 180)	97
<b>World Bank Doing Business</b>	
Rank (of 183)	105
<b>WEF Global Competitiveness</b>	
Score	4.25
Rank (of 133)	62
<b>Reporters Sans Frontières</b>	
World Press Freedom Index Score	62.50
Rank (of 175)	158

### What to watch:

- Any overt attempt by the JVP, a party that set off 1971 and 1988-89 insurrections that led to more than 100,000 deaths, to channel dissatisfaction into public support.
- The intensity of the first post-budget labour action
- Whether trade unions drop their support for Rajapaksa and drift back toward the now-rudderless opposition. Union members in Sri Lanka have traditionally been quick to lose fealty to leaders they view as doing too little for them.

### FOOD AND FUEL PRICES

Although it is a global issue, the rising cost of food has joined the list of ordinary Sri Lankans' complaints. Even during the presidential campaign late last year, Rajapaksa supporters complained about the rising cost of living despite official figures that show inflation slowing and that its per capita income has entered middle-income territory. In the past, opposition parties have been able to rally public support around the food price issue, but their attempt in the last election season fell flat. Nonetheless, it is something the Rajapaksa government will have to monitor.

### What to watch:

- If the opposition gains any traction with the issue
- Public reaction to the inevitable rise of fuel and electricity prices, as the government begins to remove subsidies to the state petroleum and power companies.

