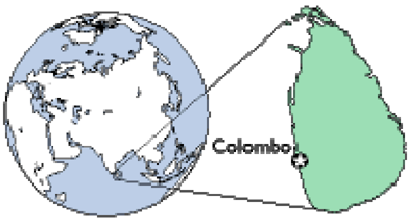
COUNTRY REVIEW

Sri Lanka



15 November 2010

ANALYST: Andrew Atkinson

EULER HERMES COUNTRY RISK GRADE: C

Country Risk Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest risk.

Strengths

- The 25-year civil war appears to have drawn to a close and, although this does not necessarily signify that periodic violence will not continue, there is a prospect of greater freedom of movement of people and goods and therefore of economic development
- Sound economic growth, despite the currency crisis of 2000/2001 and global downturn in 2009
- Tourism revenues and workers' remittances provide hard currency inflows
- Economic policies are broadly supportive of business and economic growth

Weaknesses

- Although the risk of ethnic conflict is much reduced, it remains a threat to stability and growth prospects
- Fractured nature of the political system, with generally weak coalition governments
- Vulnerability of export base (textiles and clothing) following expiry of the Multi-Fibre Arrangement
- Relatively strong inflationary pressures
- Large fiscal deficits and high public debt
- Banking system weaknesses

Key Risks

- With their positions entrenched following the end of the civil war and recent electoral successes, political leaders may reject the opportunity to promote social and ethnic cohesion and they may embark on uncontrolled spending in the post-war period. These factors could combine to heighten already large fiscal and current account deficits at the same time as donors and the IFIs (relations have a chequered record) become more reluctant to be perceived as supporting the regime.

Country Risk Assessment

Ratings	Sri Lanka Latest	Sri Lanka Previous	Median Grade C	Median Grade B	Peers India	Peers Angola
Systemic Political Risk:	**P3+**	**P3+**	**P3+**	**P2-**	**P2-**	**P3-**
Systemic Economic Risk:	**E5**	**E5**	**E5**	**E4**	**E4**	**E5**
ME rating:	ME5	ME5	ME5	ME4	ME4	ME4
Structure	*5.7*	*5.0*	*5.9*	*4.7*	*4.0*	*5.7*
Policy	*5.6*	*6.0*	*5.2*	*4.5*	*5.2*	*5.2*
Solvency	*4.5*	*3.5*	*3.0*	*2.3*	*1.9*	*2.0*
External Liquidity	*2.2*	*5.8*	*4.3*	*3.3*	*3.6*	*2.8*
SBE rating:	SBE4	SBE3	SBE4	SBE3	SBE4	SBE5
COUNTRY GRADE:	**C**	**C**	**C**	**B**	**B**	**C**

Nomenclature:
Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).
Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).
ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).
The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).
SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).
Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Country Risk Unit

ECONOMIC STRUCTURE

Country Profile	
Capital city:	Colombo
Population:	20.24 mn (2009)
GDP:	USD 41977 mn (2009)
Currency:	Rupee (LKR)
Form of state:	Republic
Head of government:	President Mahinda Rajapakse
Next elections:	Parliamentary by April 2016, presidential by November 2015

Major Industries (% of GDP at market prices, 2009)	
Agriculture	10.1%
Industry	29.8%
Services	60.1%

Global Assumptions	2010f	2011f
World GDP growth (% yr/yr)	3.8	2.9
World trade growth (% yr/yr)	12.6	8.2
Oil prices: Brent (USD/b)	80.0	80.0

Main Exports (% of total, 2009)	
Clothing & textiles	61.7%
Tea	22.3%
Rubber-based products	7.2%

Main Imports (% of total, 2009)	
Petroleum	21.2%
Textiles	14.1%
Machinery	9.9%

Lead Export Markets (% of total exports, 2008)	
US	21.3%
UK	11.7%
India	6.6%
Germany	5.0%

Lead Import Markets (% of total imports, 2008)	
India	21.1%
China	11.1%
Singapore	8.5%
Iran	7.8%

Basic indicators

Selected economic indicators	2007	2008	2009	2010f	2011f
Nominal GDP (USD mn)	32,350	40,714	41,977	47,577	53,680
Population (mn)	19.88	20.06	20.24	20.40	20.60
GDP per capita (USD)	1,627	2,030	2,074	2,332	2,606
Real GDP growth (% yr/yr)	6.8	5.9	3.6	6.5	7.0
Inflation (%, ave)	15.8	22.5	3.5	6.0	9.0
Fiscal balance (excluding grants, % of GDP)	-8.4	-6.8	-10.4	-7.4	-5.6
Current account balance (% of GDP)	-4.6	-9.8	-0.7	-3.7	-3.4
External debt/GDP (%)	43.3	37.2	41.5	37.8	35.4
External debt/Exports of goods & services (%)	142.1	146.6	191.2	168.2	154.5
Debt-service ratio (%)	5.4	9.7	11.0	11.2	8.9
Foreign exchange reserves (USD mn)	3,297	2,393	4,521	4,900	5,200
Import cover (months)	2.9	1.7	4.6	4.0	3.7
Exchange rate assumption, LKR:USD (av)	110.6	108.3	114.9	113.5	115.5
f: CRU central forecast					

Sources: Central Bank, IMF, World Bank, Euler Hermes Country Risk Unit

Political Stability

Domestic political dynamics changed fundamentally with the military defeat of the Tamil separatist Liberation Tigers of Tamil Eelam (LTTE or Tamil Tigers) in May 2009. Ethnic fissures between the Sinhalese majority and Tamils (12% of the population) will not be resolved quickly but, with relative peace after a 25-year civil war, there is now potential for rebuilding civil society, improving infrastructure nationwide and generating even stronger economic growth.

Presidential elections in January 2010 were expected to be close but Mahinda Rajapaksa had the advantages of incumbency and had gained popularity following defeat of the Tamil Tigers. However, his key challenger, former head of the armed forces General Sarath Fonseka, similarly claimed such an electoral boost. In the event, Rajapaksa won comfortably, allowing continuity in overall policy direction. In April 2010, parliamentary elections provided the ruling United People's Freedom Alliance (UPFA) with a large majority, with further evidence that post-war euphoria influenced voting behaviour. In September 2010, parliament ratified constitutional amendments that will permit Rajapakse to seek a third term, even though his current one does not expire until November 2015. Recent changes increase **concerns relating to unchecked powers of the executive. Rajapakse, his brothers and wider family an**d the **UPFA already control the key levers of power (including security, judiciary and bureaucracy).** In the ST, this suggests a period of policy continuity and stability but such concentration of power does not augur well for the LT. Moreover, a degree of complacency may become evident in government affairs now that peace has returned and the grievances of the Tamil minority—located principally in the north and east of the island—may be left unresolved, thereby providing scope for ethnic problems to resurface in the longer term.

Although the UPFA currently has a strong hold on power—currently holding a two-thirds majority in parliament—the country has a **history of fractious party politics, with structures and allegiances fluid, reflecting personal, family and regional rivalries**. As a result, recent governments tended to be formed through temporary alliances and coalitions, with little prospect of providing overall stability or continuity of policies. Such trends may be reasserted in coming years.

Regional policy remains focused on India's hegemony in the sub-continent. The region's economic giant distanced itself from direct involvement in the Tamil conflict. However, India was swift to offer assistance following the December 2004 tsunami and **economic relations are close, with trade ties improving** following meetings of country members of the South Asian Association for Regional Cooperation (SAARC). Moreover, there has been tentative progress towards a preferential trade agreement under the auspices of the Indian Ocean Rim Association for Regional Co-operation (IOR-ARC). In wider international relations, Norway had been closely involved in attempts to broker a peace process and Japan remains the leading bilateral donor. In recent years, **China has been extending its interest in Sri Lanka—partly through seeking port facilities in the Indian Ocean—and this has led to concerns in New Delhi that its area of influence is being encroached.** Relations with multilateral agencies—particularly the IMF, World Bank and Asian Development Bank—which tended to be disrupted by domestic political developments and Tamil rebel activity—remain uneasy. **The EU suspended GSP Plus trade privileges in August 2009 because of perceptions of human rights' abuses** and the international community will require evidence that other liberties will not now be curtailed before considering restoration of full trade, aid and financial relations.

Economic Stability

The economy is classified by the World Bank as lower-middle income, with GDP per capita now around USD2,500. Per capita incomes increased by an annual average 3.9% between 2000 and 2009. The economy is dominated by **services, which account for approximately 60% of overall GDP**, although the clothing sub-sector provides a developing export trade in manufactured goods. The expiry of the Multi-Fibre Arrangement (MFA) at the end of 2004 was expected to affect adversely the textile and clothing sectors, particularly as it was anticipated that large producers such as China and India would be more competitive than Sri Lanka in world markets. In practice, export growth of the sector slowed but the end of the MFA did not result in multiple bankruptcies and closures. The clothing and textile sector has proved to be resilient (aided by some concessional access to traditional markets and by an emphasis on niche sectors in higher quality garments). **Agriculture still accounts for around 10% of GDP** and it remains significant in terms of employment within the labour force. In addition, it contributes to the development of the manufacturing sector through agro-processing activities.

The **economy, with principal exports of clothing and textiles (over 60% of the total) and tea (22%), should expand by around 6.5% this year and 7% in 2011**, after only 3.6% in 2009. Significantly, rates of economic growth remained relatively high even when the conflict with the Tamil Tigers was at its most intense, with annual real GDP growth averaging 6.5% in 2005-08. Nevertheless, many aid pledges—and therefore assistance to promote economic development—are tied to improvements in human rights (the UK suspended debt relief in May 2007) as well as resolution of the Tamil conflict and only the latter is perceived as having made meaningful progress.

A **structural weakness in the economy is the tendency to register large fiscal deficits**. Excluding grants and proceeds from privatisation, the annual fiscal **deficit since 2002 has averaged over 7% of GDP and was over 10% in 2009**, partly reflecting heightened defence and military expenditure. However, part of the fiscal problem has been the short-term nature of governments and the need to balance conflicting fiscal priorities of coalition partners and the current consolidation of political power may ease some such pressures. **We forecast that the deficit will improve in 2010 and 2011, although remaining 5.6% of GDP in the latter year**. However, delays in the reform process and lack of commitment in the administration of revenue services create further fiscal concerns and reconstruction costs following natural disasters (as with the tsunami at end-2004) can add to the fiscal deficit/GDP ratio, although international donations offset a large proportion of such expenditure. **Fiscal imbalances have been a significant contributory factor to the country's fragile relationship with the IMF and the Fund's decision to delay releases from some facilities.** Public debt will remain high at around 80-90% of GDP. Servicing that debt will be a key constraint on the government's economic management but may ensure that the government attempts to appease the wider donor community so that it can access grants and aid.

Petroleum shipments account for over 20% of the annual import bill and result in inflationary pressures, particularly in times of high international oil prices. (In 2008 benchmark Brent oil prices peaked at USD146/barrel and are currently over USD80/b, compared with an average of USD63/b in 2009). Inflationary pressures also arise from uncertain weather-related shortages in domestic food supply and high domestic consumption. Overall, **inflationary pressures are likely to rise in 2011 (CPI average 9%),** reflecting looser credit control and higher prices for imported commodities (including, but not exclusively, oil). There is also a risk that the government will indulge in populist spending in the post-war period. Strong remittance inflows, concessional lending and positive interest rate differentials will provide support for the rupee in the short term but any real appreciation will result in a loss of export competitiveness and generate underlying pressures for long-term depreciation.

Receipts from tourism and (particularly) workers' remittances tend partly to offset annual deficits in the visible trade balance but the current account deficit was equivalent to just below 10% of GDP in 2007. **We forecast that the current account deficit will moderate to below 4% this year and below 3.5% in 2011**. Nevertheless, financing external deficits and providing rupee support (in need) will limit further accumulation of FX reserves (currently around USD5bn, double that recorded at end-2008), which provide import cover of 3.5-4 months. External debt is equivalent to around 35% of GDP and 150% of export receipts. However, the debt stock is largely owed to donors at concessional rates and, accordingly, the debt service ratio at around 8-11% is relatively comfortable, although financial resources would be more productively employed elsewhere.

Structural Business Environment

The **business environment is well below average of the countries we assess**, with some structural impediments (including relatively poor infrastructure and irregular power supplies) to growth, although policies have improved and the official stance is generally positive towards foreign investment. The Heritage Foundation's 2010 Index of Economic Freedom (IEF) rates the country as "mostly unfree" and ranks it 120 out of 179 countries surveyed, above Yemen, Malawi and Côte d'Ivoire but below Gabon, Pakistan and Senegal. The IEF notes that business formation is relatively easy and streamlined. However, non-tariff barriers remain high, corruption can add to the costs of trade and court enforcements of property rights remain vulnerable to political influence. The World Bank's Doing Business 2011 report ranks Sri Lanka 102 out of 183 countries in terms of overall ease of doing business. It indicates that enforcing contracts involves less bureaucracy and cost than the regional average but can take longer before recovery is achieved in terms of a payment dispute. The recovery rate because of insolvency is significantly higher than the regional average and less expensive and less time consuming. Transparency International's 2010 Corruption Perceptions Index ranks Sri Lanka 91= (with Bosnia & Herzegovina, Gambia and Guatemala out of 178, above Burkina Faso, Egypt and Mexico but below India, Jamaica and Liberia.

The **financial system is subject to government influence**, including through the allocation of credit. Although foreign equity limitations in commercial banks have been lifted to 100%, the IMF indicates that the financial sector and its supervision and regulatory enforcement remain generally weak. It is reported that non-performing loans remain extensive, particularly within the public sector, with two state-owned banks accounting for around 40% of sector assets. **Although the regulatory background is largely consistent with international standards, in practice, financial supervision and enforcement are insufficient and the central bank is not independent.**

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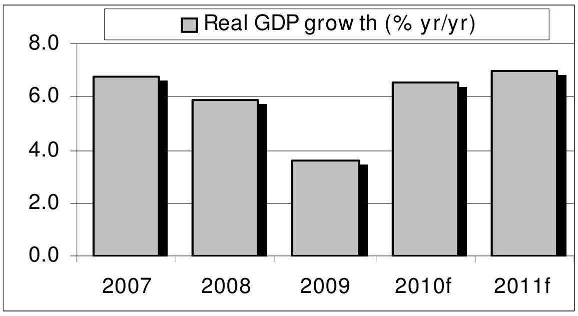
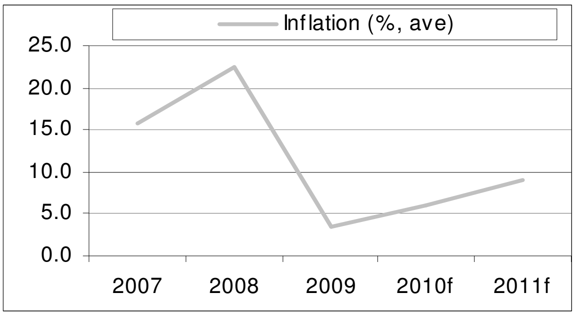
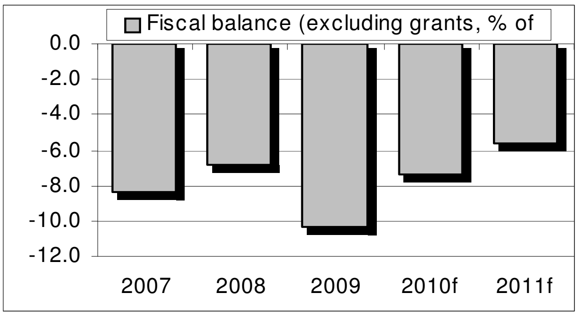
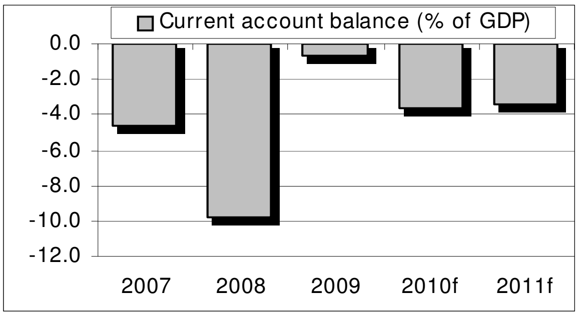
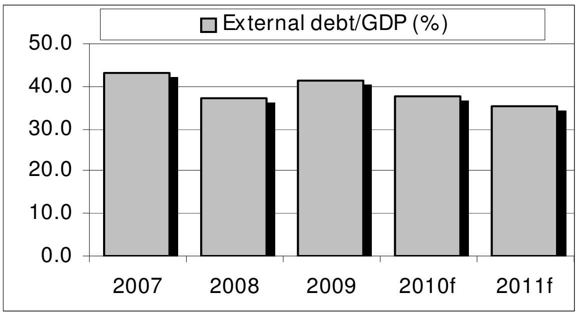
Charts


Real GDP grow th (% yr/yr)
8.0
6.0
4.0
2.0
0.0
2007
2008
2009
2010f
2011f

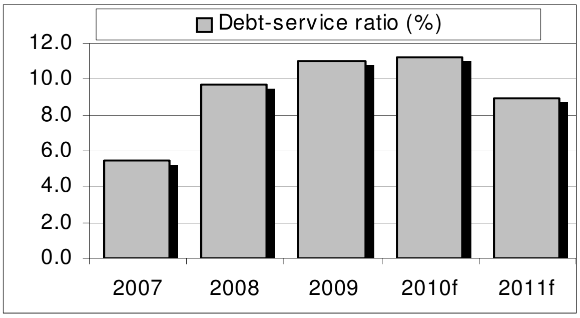

Inflation (%, ave)
25.0
20.0
15.0
10.0
5.0
0.0
2007
2008
2009
2010f
2011f

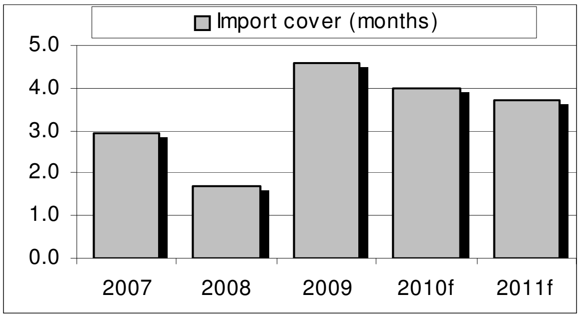

Fiscal balance (excluding grants, % of
0.0
-2.0
-4.0
-6.0
-8.0
-10.0
-12.0
2007
2008
2009
2010f
2011f


Current account balance (% of GDP)
0.0
-2.0
-4.0
-6.0
-8.0
-10.0
-12.0
2007
2008
2009
2010f
2011f


External debt/GDP (%)
50.0
40.0
30.0
20.0
10.0
0.0
2007
2008
2009
2010f
2011f


External debt/Exports of goods & services (%)
250.0
200.0
150.0
100.0
50.0
0.0
2007
2008
2009
2010f
2011f


Debt-service ratio (%)
12.0
10.0
8.0
6.0
4.0
2.0
0.0
2007
2008
2009
2010f
2011f


Import cover (months)
5.0
4.0
3.0
2.0
1.0
0.0
2007
2008
2009
2010f
2011f