

**ASIA WEEKLY:**  
**Postcard from Sri Lanka—Winds of Change**



**For the Week Ended  
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As Sri Lanka puts an end to a civil war that has claimed more than 70,000 lives over three decades, it seems poised to enter a new era of peace and economic growth.

To be sure, Sri Lanka's long war has left it in bad shape. The country's defense spending has been hefty and foreign tourism has suffered due to the violence. Sri Lanka has only a modest savings rate of 26%, and without many other options, it has been forced to provide substantial tax incentives to foreign investors and to sectors that earn foreign exchange. However, investors still seemed worried about the safety of doing business in Sri Lanka, despite all its efforts. Consequently, the country attracted only limited Foreign Direct Investments (FDI) until it opened its telecom sector to foreigners recently. Another problem facing Sri Lanka is its inefficient tax collection—its tax base is as low as 3% of the population—which has led to fiscal deficits in the double digits. High government debt has also contributed to long periods of double-digit inflation.

However, during my visit here this week, I observed a sense of renewed optimism and security among people with hopes for stability and positive change.

The end of Sri Lanka's civil war with the rebel group Tamil Tigers in May of this year has created opportunities to develop the northeastern parts of the country—the region of the ethnic Tamil minority. Global perception of the island nation seems to be changing, judging by a recent surge in its stock market and inflows of foreign tourists. Hotels have reached record occupancy levels and senior officials at leading banks that I met with confirmed their renewed interest in lending to the hospitality sector, which was considered financially risky until now. My own hotel in Colombo was buzzing with attendees of two different business conferences.

While meeting with a policy think tank in Colombo, I learned that Sri Lanka actually initiated privatization and globalization reforms as early as the 1970s and has a good track record as one of South Asia's most open business environments. Its annual per capita income of US\$2,000 is much higher than its South Asian peers. The country has also made significant investments over time in health and education, and as a result, unemployment is low, and much of its labor force is skilled and can speak English. That said, the island's prosperity hinges largely on vibrancy in the global economy, with its total external trade remaining as high as three-quarters of GDP. While it exports tea, rubber and high-end garments to the world, Sri Lanka continues to depend on imports of oil, wheat, milk and sugar to meet its basic needs, resulting in a trade deficit. The resulting deficit has led Sri Lanka's currency, the rupee, to depreciate and has caused inflation in essential commodities.

On the political front, the current president has decided to capitalize on his party's current popularity and called for an early election. Observers are hopeful for a good stretch of political stability. While the new government should certainly attempt to help displaced Tamil minorities and integrate them into society, it should also take substantive steps to improve labor productivity, correct taxation anomalies and streamline the government machinery, which now employs about 20% of the labor force. Development of these areas could help Sri Lanka overcome its war-torn past and continue to prosper.

Sunil Asnani

Research Analyst

Matthews International Capital Management, LLC

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