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REPORT

From: General Secretariat of the Council
To: Asia-Oceania Working Party

Subject: Member States and EU Heads of Mission report: Sri Lanka - 17 June 2022

Delegations will find attached the report on the above.

Member States and EU Heads of Mission report: Sri Lanka - 17/06/2022

Introduction

On 19th May 2022, COASI tasked Heads of Mission (HoMs) in Colombo with a report to contribute to the discussion on the next steps in EU-Sri Lanka relations. This was triggered by the governance and economic crises in Sri Lanka, which led to widespread violence on 9th May 2022. These are analysed below, indicating that if not tackled swiftly, the country will further erase the socio-economic gains it has made since the end of the civil war.

The main changes since the 9th May are in the economic sphere, with measures aimed at rationalisation of resources and an attempt to prevent a humanitarian emergency. The momentum for political reforms has so far only been partly seized – the 21st Amendment to the constitution (aiming at reducing the power of the current “Executive Presidency”) is supposed to be discussed in Parliament soon. However, the main goal of the protesters, i.e. the resignation of the President, has not been achieved so far, carrying the risk of further discontent and violence, and a call for more order, possibly through an increase of Army presence in the State.

Another scenario is that swift progress in talks with the IMF and debt restructuring (including China), combined with sustained support by India, brings calm and relief. This would allow economic activities to re-start and pave the way for a more orderly transition at the next elections. Yet, India is slowing down its support, possibly reflecting some scepticism regarding current developments.

Be that as it may, what is happening in Sri Lanka has interesting lessons for assessing the success of China’s belt and road initiative and India’s role in South Asia. It is also of importance for how the International Financial Institutions will tackle the impact of global credit tightening on emerging markets/middle-income countries: default and debt restructuring with China are likely to be discussed more intensively in the months to come.

1. Protest dynamics and 9th May incidents

Protests focused on the ousting of President Rajapaksa began on 31 March, when after 13-hour power cuts, demonstrators clashed with the police on their way to the President’s private home. A state of emergency and a ban on social networks was immediately enacted and then lifted a couple of days later. This ignited a wider movement, more focused on human rights and led by the youth, who set up camp at the gates of the Presidential Secretariat, and of the residence of the Prime Minister (“Temple Trees”). Spontaneous protests, more linked to shortages in cooking gas, diesel, petrol and to continuous power cuts, erupted in other parts of the country. While these were overall peaceful, there were incidents and one person was killed by the police when threatening to set fire to a petrol truck.

The death toll grew bigger on 9th May, when then-Prime Minister Mahinda Rajapaksa addressed more than 2,000 Sri Lanka Podujana Peramuna (SLPP) members, who then went out to attack anti-government protestors. The police intervened too late, after the assault had left a trail of destruction. One hour later, the tide turned and many

more anti-Government protestors turned up and attacked the initial attackers. During the night, a curfew notwithstanding, groups were at city intersections to identify remaining buses and search for any government politicians. Even though the PM finally handed in his resignation, more than 2,000 incidents were reported with more than 60 properties belonging to MPs attacked, some of them looted or burnt down. Media reported that at least nine people were killed, including one Member of Parliament.

Most observers assess that this wave of violence was ignited by Mahinda Rajapaksa's supporters, that the State's security establishment was aware of the risk but did not anticipate it well enough, and that the reaction, mainly by forces related to Marxist movements, was planned, targeted and on a wider scale than the one initiated by the Rajapaksa's supporters.

Since then, the social protest movement has continued but has rejected offers to sit in parliamentary committees, or to negotiate with political leaders. Some members of the movement, however, sent the list of demands to the Parliament and are using social networks intensively to develop the legitimacy of its action. These requests are more centred on the governance crisis and demanding that all Rajapaksa and their 'cartel' system can no longer permeate Sri Lankan politics. In this context the new Prime Minister Ranil Wickremasinghe is perceived as being part of the 'system'. Some consider he threw a lifeline to the Rajapaksas, while others commended him for filling a dangerous political void.

This movement is also a strong nation building exercise, whose significance thirteen years after the end of the civil war cannot be underestimated. It is the first time that there are joint Tamil-Sinhalese-Muslim-Christian commemorations of the deaths that resulted from the 26 year-long conflict. It is the first time that Tamil and Sinhalese can relay joint requests to change the oppressive nature of the security apparatus.

While the youth social movement has the sympathy of a good part of society, the poorest sections of the population will find addressing the growing shortages more important than the individual freedoms and changes in the political culture. The potential of a humanitarian crisis is therefore likely to lead to stronger and different protests, as current economic prospects are dire.

2. A COVID-induced economic crisis aggravated by mismanagement

Like other countries in South Asia, Sri Lanka's economic development has been hampered by a large state sector, protectionist tendencies, and low foreign direct investment. Unlike some countries in South Asia, Sri Lanka has over the years combined heavy international borrowing – most recently from China, excessive spending on largely uneconomical infrastructure projects, over-reliance on remittances and tourism without serious efforts to increase government revenues and achieving fiscal consolidation. This was not on a sustainable trajectory, but it could be managed through increased exports, and continuous growth in remittances and tourism forex.

Remittances and tourism revenues were impacted greatly by the Constitutional crisis in 2018, the Easter Bomb attacks in 2019 and the COVID-19 fall-out in 2020 and 2021.

This caused ratings' downgrades, increased costs of debt servicing and additional pressure on the exchange rate of the Sri Lanka Rupee (LKR).

In the face of such a negative outlook, most experts and Western diplomats recommended to the Government formed by President Rajapaksa to increase taxes and the interest rate, to rein in public expenditures (including through a re-structuring of the army), to improve productivity (including in the agricultural sector), to refrain from issuing additional sovereign bonds, to have a more flexible approach to the LKR exchange rate and to seek IMF assistance and support.

Instead, the Government cut taxes significantly, expanded public expenditures, decreased productivity incentives in particular by banning chemical fertilisers overnight, proceeded with increasingly exorbitant sovereign bonds, increased its monetary base (by printing money extensively), burned almost all its meagre reserves in defending the exchange rate, and refused to seek IMF assistance until very recently. This populist guide to economics has now resulted in default, in about 50% devaluation of the LKR to the EUR in the last 2 years, in a current inflation rate of 39% (57% for food, likely to continue raising), in long power cuts and in massive shortages of diesel, petrol, cooking gas, medicines.

3. Debt restructuring: Sri Lanka is the canary in the coal mine

Even though this debacle is partly self-inflicted, some key elements are likely to be found in other countries as well. In this context, Sri Lanka is the canary in the coal mine: there may be an epidemic of emerging market defaults, as several lower middle-income countries have to deal with a massive triple blow. First, spiralling oil and grain prices have put importing economies under pressure. Second, monetary tightening in the Western world is moving rates upwards, making some developing economies' debt difficult to manage. Third, the Chinese Belt and Road initiative has burdened certain countries with unsustainable debt. While Chinese loans (State and banks) represent less than 20% of the total Sri Lankan debt, they are likely to have high interest rates and less favourable repayment conditions - for projects that have often failed to generate returns.

In terms of sequencing, Sri Lanka needs to have a staff level agreement with the IMF (measures to be taken by the Government to be on a better economic path), to negotiate a debt restructuring with all the creditors and then go to the IMF board to have access to IMF financing.

The most interesting and difficult stage will be the debt re-structuring. Sri Lanka's advisors (Lazard Frères and Clifford Chance) will not only concentrate on the old Paris and London clubs of lenders, but will have to deal with China and a range of private investors. While the common framework agreed by the G20 in November 2020 could be used, past experience has shown that there is not always a strong will to do so. Private investors will be reluctant to negotiate until there is a semblance of political stability, convincing reforms, transparency regarding all creditors (including China) and robust legal rights and enforcement protections. Indeed, many holders of Sri Lankan sovereign bonds fear that Chinese lenders would be senior creditors, and therefore prioritised for repayment.

In the meantime, discussions on a staff level agreement are moving forward fast as Sri Lanka has already taken a number of measures (free-floating exchange rate, increase in interest rate, taxes and levies, flexible exchange rate, decreasing subsidies) and is willing to take more painful steps towards fiscal discipline. This,

however, is hitting the poorest segments of the population hard and is aggravating the scarcity of many essential goods.

4. Humanitarian needs and priorities

Successive Sri Lankan Governments have subsidised essential items like petrol, electricity, fertilizers and medicines, no longer possible because of forex scarcity, inflation and devaluation. This predicament comes with the backdrop of a looming food crisis: due to the sudden (and in the end temporary) ban on imports of chemical fertilisers and pesticides last year, Sri Lanka's agricultural output this year has fallen dramatically with harvest yields expected to be as low as 50% compared to last year.

The key question therefore remains unanswered: how will Sri Lanka be able to import its most essential food (including seeds and fertilisers) and energy items, until an IMF staff level agreement and debt restructuring could open up new funding sources? In this context, the UN took the initiative to present on 9th June a Humanitarian Needs and Priorities Plan (HNP) for the four months to come. The amount requested, USD 47.2 Mio, is limited as it is rather targeted on 1) food and nutrition security – USD 34.5 Mio, 2) Health: (distribution of vital medicines and supplies – USD 8 Mio), and 3) education and protection in particular for gender-based Violence (GBV) and children, as well as addressing mental health – USD 4.7 Mio. Limited data and unclear targeting will need to be addressed to ensure the most vulnerable people are reached, while coordination will be essential.

Humanitarian assistance to address food insecurity is not often associated with a middle-income country, but it may become a more recurrent feature in the above described context. The UN and donors may need to consider new ways to provide assistance as usual modalities of aid delivery, such as cash assistance, would in the case of Sri Lanka bear inflationary risks or at least one may need to consider a mix of cash and supplies such as for instance seeds and fertilisers.

The US, Canada and New Zealand have indicated bilaterally that they would respond to the UN call for funding, and Australia pledged AUD 9 Million (6 M €) by redeployment of former programs. The EU activated some months ago the civil protection mechanism to provide medicines to Sri Lanka and provided limited humanitarian relief through the IFRC/Sri Lanka Red Cross. Currently, the possibility to activate EU's Foreign Policy Instrument (FPI) is being discussed. Yet, the most crucial and interconnected factors for Sri Lanka's way out of the crisis will be the substantial assistance from India, the possibility for China to quickly agree to debt restructuring and some political stability that could eventually pave the way for deep and orderly change.

5. Governance: cosmetic or orderly changes ?

After the 9 May events, the President tried to form a new unity government with the Leader of the Opposition, who initially refused on the grounds that he could not be a Prime Minister under a discredited President. He then offered to serve if a calendar for the resignation of the President was offered, but in the meantime, the President had offered the position to Ranil Wickremasinghe. The latter has been sworn in as

Prime Minister five times before (three of them for the 2015-2019 mandate), often with fraught relations with the President in place.

His appointment has divided people. Some, including a majority of MPs, will focus on his experience as a relatively knowledgeable economic steward of the State and a valid interlocutor for the international community. Others, including a major part of the population and in the opposition perceive him as associated with the Rajapaksas as he did not manage to have them condemned for corruption the last times he was PM (2015-2019). This perception is not improved by the fact that he is a one-seat party, and that therefore he filled the main Cabinet positions with MPs from the Presidential majority SLPP but also with two SJB MP who “crossed-over” to take responsibility as Minister. As largest opposition party, the SJB decided against joining the Government.

The current government set-up obviously falls short of the changes demanded by the protest movement, which feels aggravated by President Rajapaksa’s recent confirmation to media that he intends to serve the remaining of his constitutional term i.e. till November 2024.

Some MPs from the SLPP are looking at their chances to defend their seat at the next Parliamentary elections, which could happen as early as February 2023 according to the Constitution (if the President dissolves Parliament). They have therefore pushed Basil Rajapaksa, who as former Minister of Finance and architect of the SLPP has a special responsibility in the current state of affairs, to relinquish his MP seat to the benefit of one of the wealthiest Sri Lankan, Dhammika Perera, who could take a major economic portfolio in the Government despite possible conflict of interest. The MPs are also likely to agree to a new Amendment to the Constitution (the 21st in 42 years), which would limit some of the Presidential powers, in particular those affecting appointments in the judiciary and other organs for which independence is needed. The Amendment could also ban dual citizens from entering politics, thus bringing an end to Basil Rajapaksa’s electoral aspirations (Sri Lankan and US citizen).

Yet, these measures seem to be mainly cosmetic. The 21A has been drafted by the Minister of Justice, Mr. Rajapakse, without much consultation, and it was then further diluted. This is why most of the population is convinced that the vast majority of Sri Lanka’s political class is playing for time, appeasing the street while keeping their patronage politics tradition. This makes for a volatile environment as the looming food crisis may bring a different kind of protests. As seen on 9th May, people will be ready to use violence: the civilian rule prevailed on that occasion, but the future depends very much on the support that India will extend and how China will approach the debt restructuring exercise.

6. India and China

[REDACTED]

[REDACTED]

7. The EU's role

The current adversity does not do justice to Sri Lanka's achievements as a resilient and successful democracy in South Asia. Despite a complex history of violence, the country has managed to build institutions, to generate historic economic growth while ensuring the highest development index in South Asia. If only for that, and notwithstanding its geostrategic importance for the Indo-Pacific strategy, supporting Sri Lanka coincides with EU interests and values.

At the same time, in recent years, Sri Lanka has not always been particularly receptive to the EU's calls for cooperation. Colombo withdrew from the co-sponsorship of the UN Human Rights Council Resolution, did not advance reconciliation and accountability, and the only timid reforms were adopted in fear of losing preferential market access. Moreover, Sri Lanka banned imports of products that originated mainly in Europe (cars, high-end equipment, fine food) and did not engage in the WTO. More recently, it abstained to vote against Russia's invasion in international fora, and even helped a plane owned by a European company but nationalised illegally by Russia to fly back to Moscow, against ICAO general instructions.

The above could lead to a reflection to calibrate people-centric activities, focusing more on the basic needs of the population than on the current political dispensation. In terms of public messages, the Member States resident in Colombo and the EU have been united in calling for restraint from all parties. Some level of stability is essential to achieve some form of economic recovery, without which it is hard to see how the country could avoid further chaos. So far, looting and 'security tolls' on roads have

been avoided, but one could imagine that without swift progress, Sri Lanka risks to slide into further trouble.

At this juncture, it seems that the political class is missing the window of opportunity to address the needed systemic changes. This means that EU actions such as ongoing support for reconciliation, social cohesion and justice reforms become even more relevant. So does the support to civil society organisations.

Looking forward, the EU and its Member States could become partners in supporting needed reforms, while addressing the most urgent grievances of vulnerable parts of the population. Immediate and prospective EU engagement could follow the following parameters:

a) **Political engagement:** to continue political dialogue and outreach to all parts of the political spectrum and civil society, with the aim to encourage constructive and non-violent engagement.

b) **Economic and financial support:** to consider some flexibility in the criteria to provide EU's Macro-financial assistance designed for partner countries experiencing a balance of payments crisis. It could take the form of medium/long-term loans or grants, once Sri Lanka would benefit from a disbursing International Monetary Fund programme.

c) **Cooperation:** to realign certain activities so that delivery is adapted to urgent needs and priorities. To focus existing and planned cooperation on necessary reforms and programmes including on public finance, social protection and green recovery. To encourage flexibility in funding redeployment.

d) **Humanitarian:** monitor closely the situation, and be ready to provide support to the most vulnerable (under ECHO emergency funding), in particular in the field of food security, health and protection.

e) **Trade:** support continued compliance of Sri Lanka with GSP+ commitments to ensure continued access to the European market for its vital export industries.

e) **Human rights:** agree on a common line for the September session of the Human Rights Council, based on continued scrutiny, request for stronger engagement of Sri Lanka and focus on actual measures to deal with reconciliation.

The EU needs to strike the right balance between the specificity of this geo-strategic island, in line with the EU's strategy for cooperation in the Indo-Pacific, and the lessons that it carries for those countries whose stability is being hit by inflationary pressure, credit tightening and unsustainable debt, partly owned by China.