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Belt and Road Initiative, Debt and Diplomacy:
Challenges and Opportunities for China-Sri Lanka Economic Relations

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DUSHNI WEERAKOON AND JANAKA WIJAYASIRI
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## Acronyms

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<th>Acronym</th>
<th>Description</th>
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<tbody>
<tr>
<td>AIIB</td>
<td>Asian Infrastructure Investment Bank</td>
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<tr>
<td>ASEAN</td>
<td>Association of Southeast Asian Nations</td>
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<tr>
<td>BRI</td>
<td>Belt and Road Initiative</td>
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<tr>
<td>BRICS</td>
<td>Brazil-Russia-India-China-South Africa</td>
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<td>CDB</td>
<td>China Development Bank</td>
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<td>CEPA</td>
<td>Comprehensive Economic Partnership</td>
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<tr>
<td>CIFIC</td>
<td>Colombo International Financial City</td>
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<tr>
<td>CMPH</td>
<td>China Merchant Ports Holdings</td>
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<tr>
<td>ECTA</td>
<td>Economic Cooperation and Technology Agreement</td>
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<td>ERD</td>
<td>Department of External Resources</td>
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<td>EXIM</td>
<td>Export-Import Bank of China</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>FTA</td>
<td>Free Trade Agreement</td>
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<td>FTFFs</td>
<td>Foreign Currency Term Financing Facilities</td>
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<tr>
<td>GOSL</td>
<td>Government of Sri Lanka</td>
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<td>GSP</td>
<td>Generalised System of Preferences</td>
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<td>IPS</td>
<td>Institute of Policy Studies of Sri Lanka</td>
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<tr>
<td>ISBs</td>
<td>International Sovereign Bonds</td>
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<tr>
<td>ISFTA</td>
<td>India-Sri Lanka Free Trade Agreement</td>
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<tr>
<td>LTTE</td>
<td>Liberation Tigers of Tamil Eelam</td>
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<tr>
<td>MCC</td>
<td>Millennium Challenge Corporation</td>
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<tr>
<td>MOU</td>
<td>Memorandum of Understanding</td>
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<tr>
<td>RBI</td>
<td>Reserve Bank of India</td>
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<tr>
<td>SAARC</td>
<td>South Asian Association for Regional Economic Cooperation</td>
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<td>SOEs</td>
<td>State Owned Enterprises</td>
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1. Introduction

While Sri Lanka’s political and economic relations with China have spanned decades, bilateral engagements took a new turn from 2006; the scale of engagement escalated rapidly as China began to emerge as a major source of development loans to Sri Lanka, alongside government efforts to tap international capital markets for foreign borrowing. As the country’s foreign debt began to grow - veering disproportionately towards costlier foreign borrowing as traditional sources of concessionary foreign borrowing shrank - Sri Lanka’s heavy reliance on China for large scale infrastructure project loans have come to the forefront of discussions related to the resultant hike in debt vulnerability. Indeed, in more recent times, these discussions have come to be viewed almost exclusively through the lens of a so-called ‘debt trap diplomacy’. In short, the argument made is that a rising foreign debt overhang in Sri Lanka owes its origins to low-return mega infrastructure projects funded generously by China, where an inability to service debt thereafter allows China to take ownership of these strategic assets. The most famous of such cited examples in the narrative is Sri Lanka’s China funded Hambantota seaport (New York Times, 2018).

“The issue of debt trap diplomacy has gained global attention in the face of China’s ambitious Belt and Road Initiative (BRI) - a trade and investment project - aimed at rebuilding the network of the Ancient Silk Route connecting China to Europe through both land and sea routes.”

The issue of debt trap diplomacy has gained global attention in the face of China’s ambitious Belt and Road Initiative (BRI) - a trade and investment project - aimed at rebuilding the network of the Ancient Silk Route connecting China to Europe through both land and sea routes. Given that the BRI spans 65 countries and about 60% of the world’s population, its geo-political implications were bound to generate widespread discussions and controversies.

For Sri Lanka - straddling vital shipping routes - the entry of China as a major political and economic presence in the country brings both opportunities and challenges. Despite long historical connections, bilateral relations began to grow to new heights post-2006 in the wake of Sri Lanka’s military attempts to defeat an armed separatist threat. A beleaguered country under pressure from the West and India to halt military advances increasingly looked to China for political and economic support. But, in the process, China’s growing influence has increasingly not only become a source of domestic political tug-of-war, but also a source of friction in Sri Lanka’s international relations with regional and global powers. Indeed, despite half-hearted attempts of a new government in Sri Lanka to lessen the country’s growing economic dependence on China in 2015, bilateral relations have continued to flourish with hardly any notable change.

China’s entry as a growing source of development lending to Sri Lanka post-2006 has, over time, coalesced into almost all areas of the economy. As economic relations grew exponentially, China emerged as Sri Lanka’s single largest bilateral source of development finance (overtaking Japan), Sri Lanka’s second largest source of imports (close to overtaking India), Sri Lanka’s second largest source of tourists (close on the heels of India) and, more recently, the largest source of foreign direct investment to Sri Lanka (FDI).
Alongside the above, as Chinese funded mega infrastructure projects spanning seaports, airports, energy, roads and highways, amongst others, have sprung up across Sri Lanka. China’s growing presence is generating renewed interest in how Sri Lanka's future economic engagement will plan out vis-à-vis the BRI.

This paper attempts to explore some of these issues in the context of national, regional and global geo-political shifts that are influencing Sri Lanka's economic and political ties with China. Section 2 provides a background to Sri Lanka’s historic economic and geo-strategic relations with China; Section 3 sets out the main elements of the BRI and Sri Lanka’s key related engagements with it; Section 4 addresses the contentious issue of China's role in Sri Lanka’s growing foreign debt overhang; Section 5 looks at more recent developments of broader economic engagements via the BRI, and; Section 6 concludes with some policy recommendations.
2. China-Sri Lanka Historic, Economic and Geo-strategic Relations

Sri Lanka-China relations are centuries old, and have been historically strengthened by shared religious and cultural values, in addition to trade and commerce. As a country geographically positioned at the centre of the Indian Ocean straddling major shipping routes, Sri Lanka has long been a part of China’s maritime trade route. Over the last decade, however, as bilateral economic relations grew exponentially amidst growing regional and global rivalries, Sri Lanka has had to increasingly walk a tightrope - seeking economic benefits from China while maintaining close relations with India and other partners such as the US and Japan.

2.1 From Cultural and Historical Ties to a Strategic Partnership in 2006

For many centuries, Sri Lanka had been at the centre of the historical Silk Road connecting Europe and China. Although the initial Silk routes were over land, following the fall of the Mongol Empire in the 14th Century, China shifted its approach to include a stronger emphasis on maritime trade (Seneviratne, 2016). Sri Lanka has been part of the maritime trade route of China since then. It has been noted that Sri Lanka was an emporium where traders from West and East exchanged wares and the discovery of many Roman coins in some parts of the country bear testimony to it.

In more modern times, the Rubber-Rice Pact between Sri Lanka and China signed in December 1952 marks a significant milestone in bilateral ties between the two nations. This was also one of the first agreements that China signed with a non-communist country. In fact, it was signed five years before China and Sri Lanka established formal diplomatic relations (Li, Li, 2017). Through this Pact, Sri Lanka guaranteed to import 270,000 metric tons of rice each year while China agreed to purchase 50,000 tons of rubber each year for a period of five years. The Pact was renewed every five years until 1982 and is considered to be one of the most useful trade agreements that Sri Lanka had negotiated in the past. It ensured that China offered 40 % more than the market price for rubber, while Sri Lanka provided rice for less than a third of its market value. It is also considered to be one of the most successful and durable South-South trade agreements in the world (Kelegama, 2014).

The Rubber-Rice Pact paved the way to establish formal diplomatic relations between China and Sri Lanka. The Pact was signed despite protests made by the US which threatened to invoke the Battle Act and withdraw aid from Sri Lanka. In fact, the US Vice President, Richard Nixon, visited Sri Lanka in November 1953 to dissuade the country from continuing to trade with China, arguing that Sri Lanka was selling strategic material to a communist country during the height of the Korean War. Nixon spent three days in Colombo and after discussions with Sri Lankan authorities, he was convinced that the Pact was signed mainly for economic reasons and not because of sympathies with communism (Watson, 2010).

In February 1957, formal diplomatic relations were established with China and thereafter in 1962, the two nations signed the first agreement on Economic and Technological Cooperation. The following year, a maritime agreement guaranteed that all commercial vessels engaged in cargo and passenger services between the two countries and a third country will be treated on the Most Favoured Nation (MFN) status.

Another milestone in Sri Lanka-China relations was the initiation of high-level state visits. Some notable visits included those of Premier Chou En Lai to Sri Lanka in 1957 and 1964, and that of Sri

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1 This section draws on Wijayasiri and Senaratne (2018).
Lanka’s then Prime Minister, Sirimavo Bandaranaike, to China in 1972. This resulted in a gradual increase in Chinese bilateral aid packages, along with the initiation of the construction of the Bandaranaike Memorial International Conference Hall (BMICH).

A Sri Lanka-China Society was formed in 1981 with the aim to strengthen friendly relations. Additionally, the Sino-Lanka Joint Trade Committee and the Sino-Lanka Economic and Trade Co-operation Committee were established in 1982 and 1984, respectively. These were then amalgamated in 1991 to form the Sino-Lanka Joint Commission for Economic and Trade Cooperation. In addition, the Sri Lanka-China Business Cooperation Council was formed in 1994, adding to the growing attempts to strengthen economic relations between the two nations.

China-Sri Lanka relations in this period were reflective of China’s broader engagements in three key areas: fostering South-South solidarity; strengthening the Non-Aligned Movement (NAM); and manoeuvring politically and diplomatically viz. the nationalist government in Taiwan. As China’s industrial growth accelerated and the Cold War tensions diminished, commercial motivations strengthened with the desire to secure access to natural resources. Thus, as China’s role in the global arena expanded, so did its approach and motives for providing financial aid and assistance to developing economies across Africa, Asia and Latin America (Institute of Policy Studies of Sri Lanka [IPS], 2014).

With these changes, China’s relations with Sri Lanka too began to undergo swift changes. Bilateral political and economic relations took on a new urgency during the Sri Lankan government’s war effort of 2006-2009 against an armed separatist campaign waged by the Liberation Tigers of Tamil Eelam (LTTE) for over thirty years. Whilst the LTTE was successfully defeated by government forces in May 2009, in the preceding three years, China emerged as Sri Lanka’s key political and economic ally in the face of growing international opposition to the military efforts. During the height of the war, China stepped in to provide arms and equipment when India was reluctant to do so owing to its own domestic political compulsions. It has been aptly noted that “without the Chinese backing, the government would have had neither the money nor the will to ignore world opinion in its offensive against the LTTE towards the end of the war” (Kingsbury, 2012, p.151). Indeed, not only did China provide Sri Lanka with much needed military hardware to fight the war, but it also gave Sri Lanka political cover over allegations of human rights violations in the final stages of the war levelled by the Western bloc.

Flourishing relations between China and Sri Lanka during this era resulted in many agreements and saw closer relations due to Sri Lanka’s increasingly pro-China stance. For example, during a state visit to China in 2007 by Sri Lanka’s President Rajapaksa on the occasion of the Golden Jubilee celebrations of diplomatic relations, eight bilateral agreements and Memorandums of Understanding (MOUs) were signed with China. These included agreements on economic and technical cooperation, the establishment of a Friendship City Relationship between Guangzhou and Hambantota, investment...
promotion cooperation, cooperation in the film industry, academic exchanges, etc. One of the key outcomes was the commencement of the Hambantota port in 2007 as one of the first mega infrastructure projects built with Chinese funding. Post-2009, as political relations turned more and more to incorporate economic relations, Sri Lanka and China signed a Strategic Cooperative Partnership (SCP) agreement in May 2013; under this, a whole range of issues were covered including trade, investment, and financial assistance. As a key follow up, China and Sri Lanka entered into formal negotiations on a Free Trade Agreement (FTA) in 2014. In the same year, Sri Lanka gave the go-ahead to China on a controversial Colombo Port City project that sought to reclaim land in close proximity to the country’s main commercial Colombo port. Under the agreement, China was to be given a freehold title to a share of the reclaimed land. Sri Lanka also became one of the first countries to openly support the BRI proposal floated by China in 2013.

Sri Lanka’s growing economic and political links with China was not without its own set of challenges. The country’s geo-strategic position in the Indian Ocean meant that a perceived ‘tilt’ to China inevitably put a spotlight on regional and global rivalries being played out in the Indian Ocean. Of most concern, and most challenging for Sri Lanka, was to balance its historic close dependence on India viz. strengthened links with China.

2.2 Regional and Global Rivalries in the Indian Ocean and Sri Lanka’s Balancing Act

India is Sri Lanka’s closest neighbour and shares deep historical, cultural and religious ties, with both countries have been subject to British colonial rule. Bilateral relations in the post-independence period are described as “friendly and cordial with their expected ups and downs, closeness and distance, suspicion and cooperation as happens between immediate neighbours” (Gooneratne, 2000, p.22). However, bilateral relations have often been tense. The outbreak of Sri Lanka’s separatist conflict strained relations, particularly in the 1980s, as perceptions of Indian interference grew. For instance, it has been argued that bilateral relations became unusually strained due to “brazen Indian political and military intervention to settle the Tamil question in the island” (Balachandran, 2016, para 1). The history of Indian intervention in Sri Lanka - both covert and overt - ranged from encouraging, funding and training of the LTTE, sending an Indian Peace Keeping Force (IPKF) to disarm the LTTE, and the 1987 Indo-Sri Lanka Accord which proposed a political solution to Sri Lanka’s conflict by establishing a provincial council system and devolution of power. All of these interventions became a source of nationalist anger and resentment in Sri Lanka that has left lingering suspicions about Indian intentions. To a large degree, these interactions have left a section of Sri Lankan population with perception of undue domination by its neighbouring ‘big brother’.

Over time, there was a gradual improvement in bilateral relations, supported by growing economic links through the South Asian Association for Regional Economic Cooperation (SAARC) that culminated in both countries linking a bilateral free trade agreement in 1998. There was tacit support from India for the many rounds of ‘peace talks’ conducted in relation to Sri Lanka’s separatist conflict in the second half of the 1990s and early 2000s; during the war years of 2006-2009, India refrained from interference unlike previously. However, the relationship also drifted during this period in view of India’s reticence to provide any material support to Sri Lanka on the war front (Harjini, 2013). In this context, weapons and ammunition supplies to Sri Lanka were provided by China, Russia and Pakistan as supplies of arms, ammunition and equipment dried.

“China’s growing influence in post-war Sri Lanka fed into a new source of tension in relations between India and Sri Lanka. India’s concerns are easily understood.”
up from traditional Western country sources as well.

Post-war, India made significant contributions towards reconstruction and resettlement in Sri Lanka's former war-affected regions - providing funding to rebuild the Pallai-Kankesanthurai railway line, to rehabilitate the Kankesanthurai harbour, build houses, donate bicycles to internally displaced persons (IDPs), etc. This was in line with India's traditional direction of its development assistance towards its immediate neighbours whose stability was important to India. At the same time, however, China's growing influence in post-war Sri Lanka fed into a new source of tension in relations between India and Sri Lanka. India's concerns are easily understood. China's rise has important and far-reaching ramifications for India (Raghavan, 2012). It is the one major power that impacts directly on India's geopolitical space. The prospect of having another power in India's immediate neighbourhood, especially the growing profile of China in South Asia, is undoubtedly of some concern.

Despite the obvious bilateral rivalries, this does not mean that China-India relations have suffered. Rather, they are also forging strong economic ties as they build their economic and military power, and exercise their diplomatic clout in institutions of global governance (Ayres, 2018). Both have pressed for greater representation and roles in global institutions such as at the UN Security Council and in Bretton Woods institutions. Also New Delhi and Beijing have been working together to develop alternative institutions and groupings of governance not dominated by the West - this includes groupings such as Brazil-Russia-India-China-South Africa (BRICS), and the BRICS Bank renamed as the New Development Bank (NDB), and Asian Infrastructure Investment Bank (AIIB). Nonetheless, regional rivalries alongside broader global alignments continue to play out, particularly in vital areas such as the Indian Ocean. As argued by Basu (2017), "long accustomed to perceiving the Indian Ocean as its own sphere of influence, India has been rattled at China's growing presence in the region" (Basu, 2017, para 7). Those countries, such as Sri Lanka, caught in the middle, therefore, have to be continually cognisant of the need to balance their relations and interests in the region and beyond.²

Beyond India's immediate geographic concerns are those of the US as it plays out its own strategic regional and global rivalries with China. Sri Lanka's internationally beleaguered government, under continued pressure from the US and EU to address charges of war crimes, was to find itself on a collision course with the Western bloc, and increasingly with India in regards to post-war power-sharing arrangements. Against this backdrop, both the US and EU imposed soft economic sanctions by way of cutbacks in aid budgets and withdrawal of trade concessions, respectively. For instance, a US Congressional Committee voted in 2011 to ban aid to Sri Lanka while preferential tariff concessions extended to Sri Lanka in 2005 under the EU Generalised System of Preferences (GSP) plus were withdrawn in 2009.

The early cracks in Sri Lanka's strained post-war relations with Western powers and India continued to widen progressively. A US resolution against Sri Lanka at the United Nations Human Rights Council (UNHRC) calling for an accountable judicial mechanism to probe 'war crimes' received the backing of India in 2012 and 2013, spurred by its own politics in the Southern states. It was the first occasion on which India had voted for a country-specific charge at a multilateral forum. Thus, the divisions of the various players became more marked as the rivalries intensified.

Predictably, there was a pushback by both domestic and external parties to counter China's growing dominance in Sri Lanka. In the run up to Sri Lanka's crucial presidential elections in January 2015, the then opposition political candidates pledged to review the terms and conditions under which development finance was obtained from China for mega infrastructure projects; more specifically, they pledged to halt an ambitious Colombo Port City project which offered China a freehold lease on reclaimed land next to the vital Colombo port.

² In 2014, New Delhi lodged its concerns with Colombo over the docking of Chinese submarines at the Colombo port.
There are also other, albeit less contentious, concerns driving efforts to neutralise China’s growing influence. These include the export of its model of state-led development that echoed the nationalist-populist, state-centred economic policies pursued during 2006-2014. Many of the contracts for large infrastructure projects were conducted on the basis of government-to-government negotiations, edging out wider participation, both the domestic private sector as well as other potential foreign investors.

As the political and economic influence of Sri Lanka’s traditional developments partners waned, the idea of a regime change was understood to have received the tacit approval and backing of countries such as the US and India as well. In the immediate aftermath of an unexpected electoral defeat for the incumbent government, the message of the new incoming government was clear; Sri Lanka intended to rebalance its foreign relations, lessen its economic and political dependence on China, while repairing those same relationships with the US, EU and India. Immediately after assuming office in January 2015, the government did indeed suspend the Colombo Port City project and impose a temporary halt to many other on-going Chinese funded infrastructure projects. However, in a short time as six months, Sri Lanka’s new policy towards China began to undergo a rapid U-turn amidst rising domestic economic compulsions, and most projects were given the go-ahead once more.

“Despite China's continued and growing presence post-2015 too, there was a notable improvement in Sri Lanka’s relations with the Western bloc and India as expected. This manifested in the form of short term swap arrangements offered by the Reserve Bank of India (RBI), selection of Sri Lanka to benefit from the MCC and the reinstatement of GSP plus facilities to Sri Lanka by the EU in 2017, etc.”

The reality was that there was no compensatory economic assistance from the Western bloc and India to offset readily available development assistance from China. While promises were held out - e.g., the reinstatement of GSP plus preferential access to the EU market and qualifying for grant funding under the US Millennium Challenge Corporation (MCC) compact, tied-in conditions were also attached to receive such assistance. The GSP plus reapplications involved substantive commitments on the part of Sri Lanka to address perceived gaps in laws and regulations pertaining to areas such as human rights, whilst the MCC encouraged the adoption of market-efficiency enhancing economic reforms. As these negotiations dragged on, Sri Lanka made overtures to China once again to renew on-going projects and as well as seeking commitments on fresh loans.

However, despite China's continued and growing presence post-2015 too, there was a notable improvement in Sri Lanka’s relations with the Western bloc and India as expected. This manifested in the form of short term swap arrangements offered by the Reserve Bank of India (RBI) to the tune of USD 1.5 billion to help ease Balance of Payments pressures faced by Sri Lanka in 2015, the selection of Sri Lanka to benefit from the MCC in 2016 and the reinstatement of GSP plus facilities to Sri Lanka by the EU in 2017, etc.

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3 This exceeded the USD 400 million made available to any SAARC country by the RBI under its SAARC swap facility.
India-Sri Lanka relations in particular improved “due to the evolution of new thinking in New Delhi and the change of regime in Colombo brought about by the Presidential and Parliamentary elections of 2015, the two countries appear to have broken away from the past and moved towards mutual understanding” (Balachandran, 2016, para 1). In the wake of the controversial 70 % debt-to-equity swap offered to China in the Hambantota port, some observers believe that India is deliberately enhancing its engagement with Sri Lanka (Outlook India, 2017). India has pressed for similar treatment to take over the running and management of the adjoining Mattala International Airport built with Chinese funds. This is despite its performance being below expectations and earning itself the dubious title of the ‘world's emptiest airport’. In addition, India is making a concerted effort to compete against China in other mega projects of interest to both nations, involving investments in container terminals at the Colombo port and LNG gas power projects in Sri Lanka's Eastern province. It is important to note that both Indian and Chinese attempts to engage more closely with Sri Lanka have met with domestic resistance, including criticism against ‘selling off strategic assets’ to China and India.

These growing regional power rivalries have seen India allying itself more closely with the US, Japan and Australia - the Indo-Pacific Alliance or ‘quad’ - to counter China’s growing influence in the Indian Ocean. Recent antagonistic developments such as the trade war where the US and China have imposed punitive tit-for-tat tariffs on each other’s exports, raising the spectre of these rivalries hardening into a ‘new cold war’. In the future, confrontations over economic matters - including sanctions imposed on some Chinese companies recently - are more likely to be overshadowed by rivalries over strategic control in disputed areas such as the South China Sea, and competing interests over financial security. The establishment of AIIB, BRICS New Development Bank, etc. can be viewed as the initial steps against the hegemony of the US dollar in the global economy by China and its close allies such as Russia and Iran.

Any escalation of rivalries in these expanding spheres can convert strategic locations in the BRI to ‘frontiers’ of a new cold war. Sri Lanka’s geographic location clearly makes it such a hot spot, which requires the country to acquire considerable geo-strategic analytical and diplomatic skills to navigate both the opportunities and challenges.
3. Positioning Sri Lanka in the BRI

From 2013, the launch of a revived Silk Road - ‘One Belt, One Road (OBOR)’, or the BRI - has been the linchpin around China’s efforts to underwrite infrastructure investment in countries along the route. For China, the BRI contains vital sea lanes in the Indian Ocean along which a large share of its imports and exports pass. Here, Sri Lanka’s post-war focus on rapid infrastructure development was also closely aligned with China’s own long-term priorities in the region, providing the basis for mutually supportive economic initiatives tied into the BRI.

3.1 The Framework of the BRI

The USD 4 trillion BRI is considered to be China’s most ambitious foreign trade and investment project to date. The project was initially named as OBOR. Later it was renamed as the BRI as the term ‘one’ in OBOR implies only a single network, while BRI would better reflect the project’s numerous networks of clusters. In October 2017, BRI was written into the Communist Party’s constitution at the 19th National Congress of the Communist Party of China (CPC), a sign of the project’s policy significance for China and its current leadership.

The BRI is China’s attempt at rebuilding the network of the Ancient Silk Route, which was a trade route connecting China to Europe through both land and sea routes. China’s President, Xi Jinping, unveiled the project in late 2013 during a visit to Astana, Kazakhstan and Southeast Asia. The BRI focusses on improving connectivity and cooperation among Asian countries, Africa, China and Europe (Figure 1). The emphasis is on enhancing land as

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4 This section draws on Wijayasiri and Senaratne (2018).
well as maritime routes through a network of roads, rail lines and seaports. This is mainly carried out through large scale infrastructure projects to improve ports and trade transport. The project spans over 65 countries and about 60% of the world’s population (Djankov and Miner, 2016). The funding for the project comes through the AIIB and Silk Road Fund, which is a USD 40 billion development fund created for the initiative.

One arm of the BRI, ‘Silk Road Economic Belt’ (the Belt) extends overland from China to Europe through Central Asia, and the other, ‘21st Century Maritime Silk Road’ (the Road), links China to Southeast Asia, the Middle East, East Africa and Europe along the Mediterranean, the Indian, Atlantic and Pacific Oceans connecting over 20 countries.

The initiative was motivated by concerns in regard to the slowdown of the Chinese economy as it transitioned from an investment-led growth model to a consumer demand growth model. With China experiencing overcapacity in sectors across the country, seeking market access abroad was seen as a method to address this problem at home. Also, the initiative aims to allow Chinese enterprises to access opportunities to undertake various projects and commerce in the BRI countries, assisting them to be globally competitive and become global brands through joint ventures, technology transfers and public-private partnerships (PPPs). The BRI is considered to be an open and inclusive initiative allowing every country to take part in its development.

The BRI has five key objectives, namely policy coordination, connectivity, unimpeded trade, financial integration, and people-to-people bonds. It expects to achieve policy coordination through intergovernmental cooperation on macroeconomic policies and increased connectivity by developing trade infrastructure as well as through trade and investment cooperation. Financial integration is expected to be achieved through joint efforts to establish the AIIB, BRICS New Development Bank, and signing of MOUs on cooperation in bilateral financial regulation to establish an efficient regulation coordination mechanism in the region. The objective of developing people-to-people bonds is expected to be achieved through cultural and academic exchanges and tourism, among others.

Southeast Asia and South Asia are expected to be key beneficiaries of the BRI (Deloitte, 2018). For the former, it is partly due to the proximity to China and a higher state of development, and partly due to the demand for better infrastructure. For the latter, the size of the population and vast market potential are noteworthy. Amongst the other beneficiaries include Europe, Russia and Central Asia and Africa. To date, infrastructure has attracted more funding than other sectors although it also encompasses investments in manufacturing and trade, as well as softer investments in tourism and culture. The BRI initiative has also extended to the Americas (North and South) as Chinese investments in Latin America continue to rise. In little over a decade, China has jumped from being one of Latin America’s smallest trading and investment partners to being one of its largest.

One of the primary challenges the initiative has faced includes obtaining the support and cooperation of other emerging economies, mainly India. Western powers also remain sceptical of the initiative and view it as China’s means of increasing its geopolitical power and influence. Despite this, it has received a high level of cooperation from many nations including those in South Asia (Bangladesh, the Maldives, Nepal, Pakistan and Sri Lanka) and Southeast Asia.

Since its launch, the BRI project in the past four years has grown in size in terms of investment and the number of countries involved. In May 2017, the Belt and Road Forum for International Co-operation was held in Beijing. It was attended by heads of states of 29 governments, representatives from 130 countries and representatives of more than 70 international organisations. This event was the highest-level meeting of its kind since the BRI was proposed in 2013.

### 3.2 China’s Projects in Sri Lanka in Support of the BRI

Sri Lanka has been an important stop on the Maritime Silk Road since ancient times. It lies along one of the world’s busiest trade routes, connecting Asia with Europe, and plays a key part in China’s BRI.

Sri Lanka’s focus on public investment in infrastructure
post-2006 is closely aligned with China’s BRI initiatives. China’s loan commitments to Sri Lanka have seen infrastructure investments in energy, highways, seaports and airports. Some of the significant large scale projects include those such as the Puttalam Coal Power project, Hambantota Port Development project, Outer Circular Highway Project - Phase 3, Extension of Southern Expressway (Matara to Hambantota) Project, and Section 1 of the Central Expressway Project.

In total, Sri Lanka had obtained USD 9.2 billion of development loans from China by end 2017, with the bulk (USD 7.2 billion) raised from the Export-Import (EXIM) Bank of China and the China Development Bank (CDB) accounting for another USD 1.9 billion (Department of External Resources [ERD], 2018). A breakdown of these loans in by sector as shown in Figure 2 indicates that much of the focus has been on the roads and transportation sector (49%), followed by power and energy (18%), ports and shipping (15%) and irrigation and water (14%).

Of the vast portfolio of Chinese funded projects, only a few 'strategic' infrastructure projects have drawn heavy global interest (Thorne and Spevak, 2017). The most contentious is the Hambantota port located at the southern tip of Sri Lanka, initiated in 2007 at a total estimated cost of USD 1.4 billion. It is situated along strategically vital shipping routes linking East Asia to the Middle East and Europe, and is regarded in some quarters as a part of China's 'string of pearls' - a network of port facilities developed by China along the Indian Ocean between the Chinese mainland and Port Sudan. Some have likened these maritime initiatives to a military strategy which would grant convenient access to China’s navy in the region, but China has continually refuted this idea.

Questions over the long term commercial viability of the Hambantota port had dogged it since the start. It has not helped that an adjoining international airport - Mattala International Airport - also built with Chinese funding, has also underperformed in the operational stage. Indeed, the fact of both being located in the hometown of Sri Lanka's then-President has given risen to allegations that these have been political vanity projects with little/marginal commercial use.

In addition to the Hambantota port, the launch in 2014 of the 'Colombo Port City' project - a reclamation of a large tract of land adjacent to Sri Lanka's primary seaport of Colombo - appeared to reaffirm China's unshakeable presence in Sri Lanka. All costs of land

**“Of the vast portfolio of Chinese funded projects, only a few 'strategic' infrastructure projects have drawn heavy global interest. The most contentious is the Hambantota port located at the southern tip of Sri Lanka.”**
reclamation estimated at USD 1.4 billion is borne by China; thus, it was not undertaken on the basis of a loan advance, but rather as Chinese FDI into Sri Lanka. In return, Sri Lanka undertook to vest a share of the reclaimed land with China on a freehold basis. The project drew much criticism, including long term environmental concerns, and was suspended immediately following Sri Lanka’s change of government in 2015. A year later, it was allowed to resume once again with the only major change being the revision of a freehold title to a 99-year lease for the land vested with China.

Some of these projects have drawn widespread criticism for insufficient attention to commercial viability and potentially adverse environmental impacts. For instance, while the Environmental Impact Assessment (EIA) of the Colombo Port City project showed that there is a negligible impact from the construction, some have raised concerns around negative impacts due to the mining required for landfill and for marine life due to the reclamation of land for the project (Sivaram, 2017).

Aside from the downside effects of loans not tied to protocols and conditions on environment, displacement, etc., that typically govern loan disbursements from multilateral lending agencies such as the World Bank and Asian Development Bank (ADB), the absence of transparency and accountability mechanisms have also led to allegations of corruption being associated with lending from China. This has often manifested in perceptions of elevated costs of large projects or kickbacks received for project approval.

The potential pitfalls are compounded by the fact that most contracts are negotiated bilaterally, without formal competitive bidding processes where Chinese companies are selected as the project contractor. This is often a distinctive feature of China’s model - i.e., the engagement of Chinese domestic state-owned enterprises (SOEs) and tied assistance in the form of subsidies to Chinese firms, to expand overseas. As a result, in project procurement, priority is most often given to equipment, materials, technology or services from China. The establishment of Chinese firms in loan recipient countries can be another facet of the model, further limiting spillover benefits to borrowing economies. Thus, employment or skills transfer spillovers also tend to be low. In the case of Sri Lanka for instance, it was estimated that some of the mega projects employed approximately 26,000 Chinese semi-skilled and unskilled workers (Kelegama, 2014).

As noted earlier, despite attempts by Sri Lanka’s new government in 2015 to push back against large scale Chinese funded projects, China’s economic involvement has been growing steadily since as well. Indeed, it could be argued that China has been permitted to take an even firmer foothold in Sri Lanka, post-2015. The most contentious is the conclusion of the debt-to-equity swap on the Hambantota port in 2017. Additionally, an Economic Processing Zone (EPZ) next to the port is also earmarked to attract Chinese investors. The controversial Colombo Port City project - renamed the Colombo International Financial City (CIFC) - was also seamlessly absorbed into an ambitious USD 45 billion Western Megapolis Development project. With the completion of land reclamation by 2019, USD 15 billion is expected to flow in to transform the CIFC for business, training and leisure investments.

These mega infrastructure projects - seemingly concluded by following China’s partiality to a policy of non-interference in national economic strategies - have raised concerns over doubtful project selections, poor financial returns, and ultimately, the ability of the recipient country to repay its loan obligations. Thus, in Sri Lanka, like elsewhere where China has invested heavily in large infrastructure projects, there has been much criticism that China’s economic presence has been overwhelmingly associated with debt accumulation with limited spillover benefits for the domestic economy.
Over the last decade, there have been manifest changes in both the demand for, and supply of development assistance. On the supply side, the adoption of unconventional monetary policy in advanced economies as a response to the global financial crisis opened up opportunities for developing and emerging economies to issue sovereign bonds in foreign currency denominated debt and attract investors in search of higher yields. In the midst of these developments, new non-traditional sources of development finance such as China - flush with the world’s biggest foreign-exchange reserves - began to make their presence felt. Such funds helped to finance an ambitious post-war public investment push for infrastructure development in Sri Lanka. However, a decade on, the resilience of the Sri Lankan economy is being tested with a sharp spike in external debt settlements. With debt-to-equity swap arrangements in key China funded infrastructure projects, it has also raised the issue as to whether Sri Lanka has got entangled in a Chinese debt trap via ‘debt diplomacy’.

4.1 Tapping China for Loans in the New Development Finance Landscape

In the run up to the global financial crisis of 2007/2008, international capital markets had begun to witness the entry of first-time international bond issuers from emerging economies. After a brief hiatus, when investors retreated from risky assets at the onset of the financial crisis, debut euro bond issuances - a bond in a currency other than that of the country issuing it - resumed once again. A slew of factors on both the demand and supply side prompted the renewed interest in bond issuances by emerging economies.

On the demand side, the central banks of much of the advanced economies including those of the UK, Japan, US and EU adopted unconventional monetary policy initiatives in the immediate aftermath of the global financial crisis. This involved the practice of quantitative easing (QE) - i.e., expanding their balance-sheets by creating new money in order to buy assets - which saw the injection of ample liquidity into markets, accompanied by a sharp fall in interest rates. The climate of low returns on investments and weak output growth in much of the developed world prompted investors to seek higher yields elsewhere. The appeal of expanding emerging economies was not confined to Asia alone. There was interest in diverse countries with a geographic spread across Asia, Africa, Latin America, Europe and the Middle East.

“A rapid increase in development assistance from China to African, South American and Asian economies in sectors such as transport and energy were driven by a desire to secure natural resources as well as extend its geo-political and economic influence.”

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5 This section draws on Weerakoon (2017a).
On the supply side, the prospect of graduating from low income to middle income status for many emerging economies galvanised a search for funding other than traditional concessionary soft-window development finance. For the most part, the quantum of finance necessary for investments in infrastructure was a critical factor in nudging these countries towards international capital markets (Guscina et al., 2014). With underdeveloped domestic capital markets, many resorted to international capital market borrowing to bridge a rising financing gap. Indeed, in the face of ample global liquidity and favourable interest rates, international capital market borrowing was also cheaper for some emerging economies, albeit with additional risks arising from currency mismatches.

A second equally important development was the emergence of a new non-traditional source of development finance such as China, flush with the world’s biggest foreign-exchange reserves. A rapid increase in development assistance from China to African, South American and Asian economies in sectors such as transport and energy were driven by a desire to secure natural resources as well as extend its geo-political and economic influence. Whilst a paucity of reliable data has generated mixed evidence on the scale of investments and lending by China, that there was rapid growth in such finance is not disputed.

Some studies suggest that China has emerged as Africa's most important economic partner, with a significant presence in the top four across five measures of economic connection adopted by the study - i.e., trade, investment stock, investment growth, infrastructure financing and aid (Yuan Sun et al., 2017).

Conversely, there are others who argue that China’s investments and leading to Africa may be overestimated (Dollar, 2017). The sums quoted are said to add up to pledges only, rather than actual flows, leading to a substantive over-estimation of China’s economic presence. In fact, some studies suggest that only half of announced Chinese loans to Africa have actually materialised in reality (Brautigam and Hwang, 2016).

Despite disagreements on the actual numbers, China’s development assistance in overlooked areas like infrastructure, and its efforts to fund new multilateral lending agencies have changed the international development finance architecture. As complementary to the growing demand for resources for infrastructure projects, Chinese funding saw the establishment of the BRICS Development Bank in 2014 based in Shanghai, with financial contributions from Brazil, Russia, India and South Africa, and the AIIB also in 2014. The 70 strong membership of the AIIB includes every G7 country except Japan and the US.

The attractions of these new funding sources - bilateral loans from China and/or tapping international capital markets for hard currency - to governments are clear in that these sources have the advantage of volume, ownership, alignment and speed of project delivery (Greenhill et al., 2013). Such funds have the benefit of being free of conditions and lengthy processes that typically govern multilateral funding. Thus, governments can access larger volumes more quickly, and disburse according to their presumed needs at will in view of the fact that lenders also tend to follow a policy of non-interference in national economic strategies. Unlike when seeking loans from multilateral lending agencies, there can be distinct attractions to governments when they do not face tough questions on the fundamentals of their economic strategy.

But, there are high risks. There is ample scope for avoidance of rational analysis of investment choices when financing is available to governments without any questions or conditions. Where institutions are weak, the quality of public investment - i.e., its effectiveness and efficiency - is also likely to be compromised. These institutional factors include elements such as the quality of project selection, management and evaluation, and of the regulatory and operational frameworks (Ghazanchyan et al., 2017). As a result, the potential commercial viability of infrastructure projects to generate returns is bound to be weak. Indeed, there is some evidence to suggest that infrastructure projects implemented in partnership with multilateral agencies perform relatively better than those efforts managed solely by governments (ADB, 2016).

Under these conditions, the risks are heightened when mega infrastructure projects are involved. For many developing country governments, the lure of
“New and complex financing landscape can hold significant risks for countries burdened by inadequate institutional and bureaucratic structures to manage these flows strategically. If returns on big infrastructure investments fail to live up to expectations, the risks of over exposure on foreign currency denominated debt is high.”

Clearly, however, geopolitical interests are also at stake when China’s expanding involvement is analysed and interpreted. It has spawned a growing clutch of reports on China’s so-called ‘debt diplomacy’ arguing that countries are being entrapped in debt and forced to concede political and economic rights to China in return (Parker and Chefitz, 2018). Sri Lanka’s debt-to-equity swap on Hambantota port that gave China a critical 70% stake is most often held up as the example of debt diplomacy in practice. Clearly, Sri Lanka is struggling to manage a bunching up of foreign debt settlements, but whether or not it is a debt trap of China’s making is open to debate.

4.2 Sri Lanka’s Growing Debt Overhang: Is it a China Debt Trap?

The issue of a high and growing debt overhang in Sri Lanka’s post-war economic development strategy is an area garnering growing policy and research attention (Weerakoon, 2017a). Sri Lanka’s initial foray into international capital markets in 2007 came hard on the heels of obtaining its first sovereign credit rating a year earlier. Against the backdrop of a heightened military effort, the government sought to build up its dwindling foreign exchange reserves through a debut issue of a five-year USD 500 million International Sovereign Bonds (ISBs). In fact, it drew significant political opposition at the time, including threats that an incoming new government will not honour the settlements. Despite such initial misgivings, Sri Lanka has since
become a regular issuer of ISBs, returning time and time again to international markets on a total of 12 occasions since 2007. In fact, Sri Lanka went for its largest offshore USD 2.5 billion issue in 2018 (Table 1). In total, outstanding ISBs amounted to 12 % of GDP by 2017.

In addition to ISBs, Sri Lanka also raised foreign capital from time to time through syndicated loans [(or foreign currency term financing facilities (FTFFs)] - i.e., credits granted by a group of banks to a borrower. The FTFFs often offer lower rates to a borrower with shorter maturities than a bond issuance. This is because the monitoring process involved poses a credible threat to borrowers of loans being cancelled at a relatively low cost to the banks. Thus, banks can limit their risks on FTFFs relative to the issuance of bonds. Also, ISBs have longer maturities with bondholders able to exert only limited influence over the issuer since bonds cannot be reversed before they mature.

Sri Lanka also tapped additional sources of foreign capital via government gilt-edged securities from 2006 onwards. In 2006, a threshold limit of 5 % of Treasury bonds outstanding to foreign investors was introduced. The limit was opened up further to 10 % in 2007. In 2008, the Treasury bill market was also opened to foreign investors with a threshold limit of 10 %. Foreign investor limit on outstanding Treasury bills and bonds stock was increased further to 12.5 % in 2011. This was subsequently reduced to 10 % in 2016 and cut further to 5 % in 2019.

Finally, from relying primarily on traditional sources of development finance such as multilateral financial institutions (MFIs) and Japan, Sri Lanka began to lean towards long-term loans from emerging lenders, with the primary source being China. During the period 2006-2014, long-term loan commitments from China to the government of Sri Lanka (GOSL) approximated to just under USD 8 billion. There was a brief hiatus in 2015 as Sri Lanka’s newly elected government suspended on-going Chinese funded projects, but loan commitments resumed once again in 2016. In total, USD 9.2 billion of development loans had been obtained from China by end of 2017 (ERD, 2018). In 2018, Sri Lanka marked a further milestone, departing from its past practices of obtaining only long-term development loans from China to tap the CDB for commercial loans in the form of a USD 1 billion FTFF. In 2019, China granted the single largest project loan to Sri Lanka of USD 990 million for the construction of an expressway.

In total, over the period 2007-2018, Sri Lanka raised USD 15.3 billion by way of ISB issues and

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**Figure 3**

**Foreign Borrowing and External Public Debt**

3a. Foreign Borrowing

3b. Concessional vs Non-concessional

Notes: Includes only central government borrowing.

Source: Estimated from data available from ERD, Performance Report, Colombo: Ministry of Finance (various years); and CBSL, Annual Report, Colombo: Central Bank of Sri Lanka (various years).
FTFFs while tapping China for a total USD 9.2 billion as development loans, and additional large amounts as foreign investments in gilt-edged government securities (Figure 3a). Sri Lanka’s shift to these new and relatively more costly forms of foreign borrowing saw its outstanding debt stock undergo a swift change. Non-concessionary forms of borrowing which accounted for less than 7% of total foreign debt had spiralled to over 50% by 2012, accompanied by a rising foreign debt service ratio (Figure 3b).

The growing exposure to foreign debt vulnerability is easily explained. On the heels of an ambitious public infrastructure investment push, Sri Lanka’s GDP growth shot up to over 8% per annum during 2010-2012 (Table 1). But the boom was to prove short-lived, leaving in its wake an economy that had grown to rely excessively on the non-tradeable sector for growth, without commensurate growth in export earnings to relieve a growing foreign debt burden (Weerakoon, 2017b).

As the country’s foreign debt exposure grew, so too did criticism of China’s role in facilitating the debt-driven infrastructure push, articulated by opponents of the government of the day, both in Sri Lanka and outside. The argument that China is responsible for Sri Lanka’s growing foreign debt overhang and debt servicing difficulties came to reflect ‘fact’ with the decision by the GOSL to enter into a debt-for-equity swap with regards to the Hambantota port in 2017. It came to be interpreted as a forced sale by Sri Lanka to China and a warning to other borrowing nations of the perils of Chinese debt entrapment (Smith, 2019).

The facts of the Hambantota port loan lay bare some of the fallacies. Of the total USD 1.3 billion estimate for Phase 1 and Phase 2 of the project, funding for the former (USD 307 million) was obtained in 2007 at a fixed rate of 6.3% with a four-year moratorium. Clearly, Sri Lanka was placed disadvantageously in regards to the initial loan conditions, when globally, rates declined rapidly following the global financial crisis of 2008. However, it should also be borne in mind that Sri Lanka’s debut five-year ISB offer in October 2007 was issued at 8.25%. Moreover, what is often overlooked is that the rest of the loan (USD 1 billion) was obtained on concessional terms of 2% from the Exim Bank of China.

The Hambantota port became operational in 2010, but its commercial performance was below expectations. Nonetheless, while the port itself failed to generate revenues to cover the loan repayments, there is no
evidence to suggest that Sri Lanka was unable to service its debt obligations to China. Rather, the government was understandably reluctant to make additional investments needed to make the port commercially viable, and instead saw it as an opportunity to hand over responsibilities to develop, manage and operate the port to Chinese authorities themselves. Importantly, the transaction also had the added advantage of bringing in non-debt capital inflows as a PPP deal at a time when Sri Lanka was struggling to raise FDI inflows.

As a result, China Merchant Ports Holdings (CMPH) obtained a 70% equity stake in the port on a 99-year lease for a sum of USD 1.1 billion in 2017 to develop, manage and operate Hambantota port valued at USD 1.4 billion. CMPH used USD 974 million to acquire 85% shares in the Hambantota International Port Group (HIPG) - the company which was granted the 99-year lease term - with USD 146 million to be used for the future development of the port. Additionally, China also expressed its commitment to develop an adjacent economic zone. Also, investments of USD 400-600 million is being considered to develop Phase 3 of the Hambantota port with a completion date of 2021. Sri Lanka received USD 292 million in December 2017, USD 97 million in January 2018 and USD 584 in June 2018 as the third and final tranche of the deal.

The nature of the 'debt-to-equity' swap also remains unclear. A debt-to-equity swap is an arrangement whereby the debts of a company are exchanged for stock or equity. Technically, the transfer of Hambantota port shares to CMPH qualifies as a debt-to-equity swap, and the GOSL has been at pains to recognize it as such. However, Chinese authorities maintain that the Hambantota port loans are separate to the lease agreement and no swap of equity for debt has taken place. This would imply that the loan is merely transferred from the books of the Sri Lanka Ports Authority (SLPA) to that of the Treasury. Indeed, fiscal accounts for 2018 do not indicate an inflow from the Hambantota port as proceeds from divestiture of a SOE. It remains to be seen whether Sri Lanka will continue to service the port loan or recognize the injection of funds as FDI.

The fact that Sri Lanka’s growing foreign debt overhang made a quick injection of non-debt flows in the form of the Hambantota port sale attractive to Sri Lanka’s government of the day can hardly be interpreted as a forced sale because Sri Lanka was unable to service its Hambantota port loans from China. The total amount that has to be paid for the Hambantota port is around USD 1.7 billion by 2036, as both capital and interest. The GOSL had settled Phase I

Figure 4
China’s Debt Share
“Available debt statistics do not support the argument that Sri Lanka is also overburdened and overwhelmed by its debt to China. In 2018, loans from China accounted for just over 9% of Sri Lanka’s overall foreign debt, having held a share of 0.5% of total debt in 2006.”

Even more tellingly, of the total loans of USD 9.2 billion obtained from China by end 2017, 61% was offered to Sri Lanka on concessionary terms (ERD, 2018). Concessional terms on Chinese loans are typically fixed rates at 2%, with other fees of 0.5% and maturity periods typically of 15-20 years (ERD, 2018). Certainly, the terms compare less favourably to Sri Lanka’s other major bilateral donors, most specifically Japan, but in comparison to raising ISBs or FTFFs, tapping China can be more price advantageous, with possibly more flexibility on loan rescheduling if required.

The 40% of loans from China that had been obtained on commercial terms (accounting for USD 3.6 billion) pale in significance next to the USD 15.3 billion from ISBs and FTFFs taken during the same period. China’s share of these non-concessionary borrowing amounts to only 20% of Sri Lanka’s large and rising non-concessional share of foreign debt which stood at 55% of total foreign debt in 2018. Thus, the vast bulk (80%) of the country’s high-cost foreign borrowing is made up of ISBs, FTFFs, and foreign holdings of Treasury bills and bonds. This shift in composition has been the main driver of Sri Lanka’s rising debt service ratio, where Chinese development loans have played a very secondary role.

The choice open to Sri Lanka between accessing development loans from China or raising ISBs is not on pricing; these are two very different forms of finance available to emerging economies today. Chinese development loans come with an added element of managerial expertise - to manage and build infrastructure projects - more commonly associated with FDI. On the other hand, ISBs have shorter maturities and would have been far more costly.

Thus, Chinese loans are clearly not the primary cause of Sri Lanka’s debt imbroglio. But, it can be argued that they have contributed to, and possibly aggravated, the problem. As discussed previously, loans from China are attractive to governments for multiple reasons, but they also carry heavier risks in weak institutional settings. With much of Chinese development loans plugged into infrastructure projects with relatively low financial returns over the long term, Sri Lanka turned to ISBs for reserves accumulation and debt servicing. As a result, the returns on ISBs/FTFFs are likely to be considerably lower than their borrowing costs, adding to Sri Lanka’s growing debt exposure.

Despite much criticism of debt-financed growth during 2006-2014, Sri Lanka’s debt intake appears to have accelerated in the post-2015 era. As the government sought to redress what it considered a close tilt to China, and some Chinese funded projects were halted, loan inflows on average have fallen considerably. These inflows, however, have been replaced by far greater volumes of costly commercial borrowing from ISBs/FTFFs (Figure 5).

While the average volume of funds from China dropped to USD 635 million per annum during 2015-2018 from its peak of USD 1,160 million during 2010-2014, Sri Lanka’s capital market borrowing...
rose from an average of USD 900 million per annum to USD 2,340 over the same period. The reliance on ISBs/FTFFs was also dictated by a gradual drawdown of foreign investments in Sri Lanka’s gilt-edged securities. Going by these more recent trends, the cost of foreign debt servicing is set to rise even further in the coming years.

Thus, geopolitical shifts and rivalries have played a major role in pushing forward the idea that Chinese development loans have been at the centre of Sri Lanka’s struggles in managing a growing debt burden, irrespective of what available data suggest. It is true that China has made swift inroads within a decade to account for over 9% of Sri Lanka’s overall debt from holding just 0.5% in 2006. In that time, Japan’s share fell from 28% to just 11%, while India’s share grew modestly from 1 to 3%. However, if only government-to-government bilateral loans are considered, both China and India account for an equal share of 14%, with Japan still holding the bulk share of 50%.

For traditional donors like Japan, the emergence of new donors like China are viewed as posing risks to recipient countries in the form of debt accumulation, postponement of governance reforms, and overambitious capital projects due to the absence of careful investment appraisals (Sato, 2010). However, advanced economies including Japan, are no longer offering large volumes of official development assistance (ODA); other emerging sources like India do not have the same resources to match China. It is therefore apparent that for many low middle income and emerging economies like Sri Lanka, the options available to raise large volumes of funds from elsewhere are very limited.

Indeed, Sri Lanka is a test case of a country that did a sharp U-turn despite initial efforts by an incoming new government to break out of a loan dependency on China. It is revealing that Sri Lanka has become even more reliant on China since then, not only for project loan financing, but also as a source of capital market borrowing. In fact, China’s share of Sri Lanka’s overall debt rose from 7.5% in 2014 to 9.2% in 2017 during a period when ‘rebalancing’ economic relations with India and the West was the official position.

As countries like Sri Lanka gear up to engage with the BRI, existing economic ties are likely to expand further. In this climate, lessons learnt from past experiences will be critical to manage debt accumulation risks and ensure that much broader economic benefits prevail.

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Notes: Includes USD 1 billion FTFF from CDB under borrowings from China in 2018.

Source: Estimated from data available from ERD, Performance Report, Colombo: Ministry of Finance (various years); and CBSL, Annual Report, Colombo: Central Bank of Sri Lanka (various years).

This excludes commercial loans borrowed from the EXIM Bank of China.
5. Leveraging the BRI for Long-term Gains

The true scope of China's BRI has remained shrouded in ambiguities. Many of the large infrastructure projects predated the 2013 BRI initiative by a considerable number of years. These have subsequently been drawn into BRI connectivity initiatives intended to deliver, amongst others, significant trade benefits to China.

To counter criticism that China's engagement with developing and emerging economies are disproportionately mired in debt intake by participating economies, the potential long-term gains to be had from active involvement in the BRI has been a strong inducement. Indeed, infrastructure gaps are often the single biggest constraint faced by many of the developing economies in the BRI in attempting to strengthen trade and investment prospects. As such, it is often argued that China's involvement in infrastructure development is a necessary precursor to broader economic engagement beyond debt and towards FDI and trade, amongst others.

5.1 FDI, Tourism and Connectivity
Historically, Sri Lanka's record for attracting inflows of FDI has been relatively weak. For the most part, inflows have averaged around 1% of GDP, well below the comparator performance of its peer group. Whilst much of this was blamed on Sri Lanka's three-decade-long conflict that dissuaded investors, the country's post-war performance in attracting FDI has been no better (see Table 1). Any inflows that did come in veered towards infrastructure and related investments in real estate with limited productivity enhancing inflows to manufacturing and services (Figure 6).

The dominance of FDI into infrastructure is to be expected given Sri Lanka's post-war reliance on investments in infrastructure for growth. This trend began to heighten with the entry of China as a growing source of FDI for Sri Lanka from 2014.

FDI inflows from China were almost non-existent until then, despite the growing inflows of development loans from 2006 onwards (Figure 7a). However, by 2017, China had become one of the key sources of FDI to Sri Lanka, accounting for about 0.5% of GDP. This doubled to

Figure 6
FDI by Sector into BOI Enterprises

<table>
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<tr>
<th>Year</th>
<th>Infrastructure</th>
<th>Manufacturing</th>
<th>Services</th>
<th>Agriculture</th>
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Source: Estimated from data available from CBSL, Annual Report, Colombo: Central Bank of Sri Lanka (various years).
1 % of GDP in 2018 with the capital infusion to the GOSL related to the payments on the Hambantota port lease.

Thus, from almost negligible inflows, China's share of total inflows has grown steadily to about one-third of total inflows over a span of five years (Figure 7b). As previously noted, figures for 2018 are distorted by the Hambantota port-related inflows recognised as FDI by Sri Lanka. In contrast, India has been a steady source of FDI to Sri Lanka since the late 1990s; India's share of FDI has been steadily increasing over time, emerging as one of the top five sources of FDI to Sri Lanka, but it still remained at 13 % in 2017.

China's breakthrough from being a source almost entirely of 'debt-creating inflows' to generating some non-debt creating inflows began in earnest with the launch of the Colombo Port City project in 2014, hailed as Sri Lanka's largest FDI project at the time. Despite the higher volumes of FDI from China, there are concerns that these are being channelled to less desirable non-tradable sectors such as real estate, mixed development projects and infrastructure. Indeed, the sectoral breakdown of overall FDI inflows mirrors the rise of China as a growing source of FDI for Sri Lanka. Aside from infrastructure, Chinese FDI into productivity-enhancing manufacturing and services sector activities remains limited.

But there is potential scope for a shift to more productive FDI inflows in the longer-term. The entry of Bank of China - the fourth largest commercial bank in the world - to Sri Lanka in 2018 is one such step. With around 60 Chinese SOEs estimated to be present in Sri Lanka - with approximately 26 of these establishing their South Asian

By 2017, China had become one of the key sources of FDI to Sri Lanka, accounting for about 0.5 % of GDP. This doubled to 1 % of GDP in 2018.
If gains are to be reaped from the BRI, and debt generation managed more effectively, much more needs to be done to address weaknesses in Sri Lanka's FDI regime.

Greater connectivity between China and Sri Lanka are helping to cement not only business links but also other people-to-people exchanges in areas such as tourism which has recorded a significantly higher number of Chinese tourists visiting Sri Lanka. In more recent times, India has been the leading source market for tourism to Sri Lanka, but China is beginning to catch up. From a near non-existent base, the numbers of Chinese tourists visiting Sri Lanka has grown exponentially to account for about 13% of all arrivals in 2016 compared to India's larger share of about 18%. This increase in Chinese tourist arrivals to Sri Lanka has been facilitated by increased air connectivity between Colombo and opening up of a number of destinations in China, operated by airlines of both countries.

However, Sri Lanka is not a top travel destination for Chinese tourists when compared to other countries. In fact, the share of Chinese tourists in Sri Lanka has been shrinking marginally since 2016. Southeast Asia, Japan and South Korea are the most popular destinations for Chinese tourists. Thus, there remains considerable room for Sri Lanka to take steps

**Figure 8**
Tourist Arrivals: China and India

Source: Estimated from data available from CBSL, Annual Report, Colombo: Central Bank of Sri Lanka (various years).
to increase tourism from China, but it will require focused efforts to draw Chinese tourists away from closer, and often times cheaper, alternatives in countries such as Thailand and Vietnam that attracted 10 million and 4 million Chinese tourists, respectively, in 2017.

5.2 Trade and Bilateral Agreements

Bilateral trade between China and Sri Lanka, particularly imports by Sri Lanka, has grown significantly over the last decade by six-fold between 2006 and 2017 from USD 800 million in 2006 to USD 4.4 billion by 2018, making China one of the top two trade partners of Sri Lanka. Much of the increase in trade was the result of a surge in Chinese imports compared to exports to China from Sri Lanka. Thus, the growth in bilateral trade has been lopsided, with Sri Lanka recording a growing trade deficit vis-a-vis China over the years.

Figure 9
Trade with China: Exports and Imports

Source: Estimated from data available from CBSL, Annual Report, Colombo: Central Bank of Sri Lanka (various years).
By contrast, as an export market, China is disappointingly insignificant, despite its market share rising from 0.4% of total exports in 2006 to nearly 3% by 2015. Sri Lanka’s main export products to China are apparel, tea, rubber, coconut and spices but there is a lack of brand awareness of Sri Lankan exports in the Chinese market amidst significant competition. In 2018, China’s share of exports had dropped to only 2% of Sri Lanka’s total exports, indicating a lack of momentum in penetrating the large Chinese market.

Sri Lanka’s limited breakthroughs in penetrating the Chinese market over the last decade is in contrast to greater strides made in entering the Indian market, thanks in part to the early successes of the India-Sri Lanka Free Trade Agreement (ISFTA). Despite a drop in market share following its early successes, Sri Lanka has managed to grow its share of exports to India, standing at more than thrice that of China in 2018, at 6.5%.

At the crux of opposition by Sri Lanka’s domestic industrialists to greater economic integration with large neighbours like India and China is the threat of high import competition. Indeed, their fears are heightened in view of the significant gains made by both countries as sources of imports into Sri Lanka. China, in particular, has made notable inroads, surpassing India to become the largest source of imports to Sri Lanka in 2016, before being edged out once again in 2017.

Sri Lanka’s trade deficit with China has grown persistently over the last decade from USD 750 million in 2006 to USD 3.9 billion by 2018; it has come to account for nearly 40% of the country’s overall trade deficit, nearly doubling from a 22% share in 2006 (Figure 10a). By contrast, some gains have been made in redressing Sri Lanka’s trade deficit with India - dropping from accounting for 50% of the overall deficit in 2006 to about 35% by 2018 (Figure 10b). Thus, Sri Lanka’s two large economic giants now account in equal measure for the country’s trade deficit.

The overall direction of trade flows and the sheer scale of imbalances - to be expected given the relative sizes of the economies concerned - have stymied efforts to push through liberalisation measures aimed at greater integration of the Sri Lankan economy with both India and China through trade agreements.

Sri Lanka’s first bilateral free trade agreement - and indeed that of India’s as well - was the (ISFTA) which has been in force since 2000. Under the ISFTA, Sri Lanka received considerable flexibility in terms of the size of its negative list of protected.

Figure 10
Sri Lanka's Trade Deficit with China and India

Source: Estimated from data available from CBSL, Annual Report, Colombo: Central Bank of Sri Lanka (various years).
With bilateral FTAs with China and India, in addition to select Southeast Asian economies, Sri Lanka will be better positioned to approach the ASEAN for a dialogue partnership, with the aim eventually of linking itself to the China-led Regional Comprehensive Economic Partnership (RCEP) process taking shaping in the Asian neighbourhood.

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As negotiations on bilateral FTAs with India and China dragged on, Sri Lanka hastened on to sign an FTA with Singapore in 2018. The Singapore-Sri Lanka Free Trade Agreement (SSFTA) is far more comprehensive in scope and extent of liberalisation in goods, services and investment than envisaged in either the India or China FTAs, but managed to be concluded in view of the lower threat perception posed by the city-State to key domestic interests. In addition, Sri Lanka is
also considering more bilateral FTAs with other Southeast Asian economies such as Thailand, Malaysia and Indonesia as a part of its renewed interests in closer cooperation with the ASEAN. With bilateral FTAs with China and India, in addition to select Southeast Asian economies, Sri Lanka will be better positioned to approach the ASEAN for a dialogue partnership, with the aim eventually of linking itself to the China-led Regional Comprehensive Economic Partnership (RCEP) process taking shaping in the Asian neighbourhood.

Post-2015, Sri Lanka’s new government put in considerable efforts to regain preferential access to the EU market under the GSP plus scheme that was withdrawn in 2009. Whilst GSP plus preferences were reinstated in 2017, in the more medium-term, the country will lose eligibility for this facility as it gains upper middle income status. In this context, alternative options that allow Sri Lanka to focus on large and dynamic Asian markets such as India, China, and ASEAN countries such as Singapore, Malaysia, Thailand, and Indonesia - extending to Korea and Japan as well - make sense from a broader economic perspective. Thus, closer links with China - along with India - will remain pivotal to Sri Lanka’s larger Asian integration ambitions.
6. Conclusion and Recommendations

For countries engaging with the BRI, the benefits are expected to stretch beyond loan financed infrastructure development by facilitating trade with new markets. In Sri Lanka too, emerging evidence suggests that economic relations with China are broadening to include a shift towards more FDI and trade flows. However, FDI inflows are still narrowly concentrated in less productive areas of infrastructure and mixed development projects, while bilateral trade flows are also overwhelming moving in favour of China. Under such circumstances, where positive economy-wide multiplier effects are rather limited, it is perhaps not entirely surprising that Sri Lanka’s rapid economic and political transformation of relations with China has been overshadowed by allegations of debt entrapment.

Growing anxieties about debt implications of engaging with China’s ambitious BRI have been fed by referencing Sri Lanka’s agreement to hand over majority control of the strategically-located Hambantota port on a debt-to-equity swap to China on a 99-year lease. But, as the most recently available data suggest, Chinese loans are not at the core of Sri Lanka’s struggles with a high cost, and high-risk foreign debt portfolio. China’s model of loan dispensation - a policy of not questioning national economic policies and priorities - certainly contribute to poor project selection and related weak revenue flows that exacerbate debt build up, but not to the extent implied by regional and global interpretations of China’s so-called debt entrapment.

A key lesson is that governments must be more accountable and transparent in sharing information on the proposed projects, not only on the terms and conditions of loan disbursements, but also on ensuring protocols on environment protection, as to economic feasibility assessments, population displacement, etc., are met. In the absence of transparency and accountability mechanisms, perceptions of costly Chinese loans bankrolling political prestige projects or contributing to an environment that facilitates corruption will persist. At the national level, safeguards on project appraisal and selection, and strong national debt management practices are essential to safely navigate the new financing landscape. At the global level, channelling more of the growing volume of bilateral loans through entities such as the AIIB will provide stronger institutional arrangements for both, the lenders and borrowers.

Thus, Sri Lanka’s experience also holds some important lessons for China as it pursues its aims to implement BRI projects. The BRI partner economies will be more persuasively convinced of ‘win-win’ outcomes if debt accumulation is balanced with more visible economic gains for local economies on other fronts from engagements with China. Aside from a temporary boost to output, revenue boosting or productivity enhancing economic returns on mega infrastructure projects are likely to accrue only in the long-term. In the interim, as debt burdens rise, gains in export earnings linked FDI inflows are critical for small economies such as Sri Lanka to lower risks of debt vulnerability.

Up to the present, such mutually beneficial gains on broader indicators have failed to materialise in Sri Lanka’s intensified economic engagement with China over the last decade. Growth in trade flows has been disappointingly weak for Sri Lanka, while imports from China have surged. There has been little or no related FDI into manufacturing that supports Sri Lanka’s aspirations to link up to global supply networks. On-going negotiations on the bilateral FTA are also dragging on with Sri Lanka’s understandable reluctance to commit to tariff elimination on 90 % of tariff lines as requested by China in light of the rapid inroads made by the latter into the domestic market. By contrast, India’s negotiating stance has been more open to the recognition of ‘asymmetric’ treatment owing to the vastly imbalanced sizes of the two respective economies.

Building local support for engagements with the BRI is crucial for its long term sustainability. In countries such as Sri Lanka, the initial response to China’s growing presence, including large numbers of Chinese workers, tourists, etc., has not generated any adverse
push-back from local communities. For the most part, visible infrastructure improvements in the form of better connectivity via expressways, amongst others, has helped to generate a favourable response. However, as the narrative of 'China' becomes almost synonymous with 'debt' amongst the population at large, other concerns such as rising Chinese imports or Chinese workers will inevitably be pushed to the forefront as well. Such concerns are beginning to find a voice in the form of public protests against the acquisition of land for an industrial zone in Hambantota, opening up of Chinese retail shops in direct competition with domestic businesses or the entry of Chinese tour guides in the leisure sector.

In turn, if economic relations are also perceived to be one-sided, the chances of disgruntlement spilling over into matters of autonomy and sovereignty are higher. With a significant portion of investment and funding in the BRI coming from Chinese public entities, including large swathes of FDI from Chinese SOEs, there is concern that a growing debt burden can lead to weaker negotiating strength and loss of sovereignty. Such developments will also intensify existing regional and global power rivalries. Safely navigating these can prove to be especially challenging for small economies such as Sri Lanka, unless it develops a long term economic and geo-strategic vision for the country when inviting foreign government participation in key infrastructure projects.

For Sri Lanka, balancing relations between the two giant neighbours, namely India and China, has been an arduous task. With India yet to sign on to the BRI, the future can become even more challenging despite the fact that both countries are quietly cementing their bilateral economic relations with rapidly expanding trade and FDI flows. Given that India considers South Asia to be its own backyard, China needs to draw in its regional power rival into the BRI process to ensure lessening of tensions for the smaller economies of South Asia and for the region as a whole.

An overriding reality for emerging Asian economies such as Sri Lanka is that they have much to gain from engagement in the BRI process, as part of a larger 'Asian pivot' strategy to take advantage of expanding trade and capital flows. This calls for China-Sri Lanka relations to be managed prudently without allowing it to be hijacked for political and geo-strategic reasons. It also requires a serious re-think on ways and means of building a meaningful partnership that is mutually beneficial to both parties.
References


