

China-India Brief

A publication of the Centre on Asia and Globalisation



Image Credit: Wikimedia Commons: AntanO

Guest Column

Tightrope Balancing amidst an Economic Crisis: Lessons Learnt from Sri Lanka

By Shakthi V. De Silva

Sri Lanka's suspension of foreign debt repayments in April 2022 presaged a tumultuous political upheaval. Over the next few months, protestors besieged the presidential palace and set fire to the prime minister's home. By July, then President Gotabaya was forced to flee to the Maldives—and subsequently to Singapore and Thailand—while Ranil Wickremesinghe was sworn in as the eighth executive president of Sri Lanka. The island's economy shrank by 7.8 percent that year as rolling power cuts and inadequate fuel distribution hampered

 Lee Kuan Yew
School of Public Policy

 CENTRE ON ASIA
AND GLOBALISATION

The *China-India Brief* is a bi-monthly digest focusing on the relationship between Asia's two biggest powers. The Brief provides readers with a key summary of current news articles, reports, analyses, commentaries, and journal articles published in English on the China-India relationship. It features a Guest Column weighing in on key current issues in China-India relations.

Centre on Asia and Globalisation

cag@nus.edu.sg

469A Bukit Timah Road, Tower Block 10,

Singapore 259770

<https://lkyspp.nus.edu.sg/cag>

cont'd p2

daily life. Many believe that Sri Lanka hit its nadir and would take several years, if not a decade, to rise back up. A political and economic crisis of this nature does, however, carry a silver lining. If foreign relations with major powers are managed effectively, nations, even as battered as Sri Lanka, can make a faster than expected recovery. Before we delve into how this can be accomplished, let's sketch out the immediate outcomes of this politico-economic crisis.

World Bank reports **indicate** that Sri Lanka's poverty level doubled from 13.1 percent in 2021 to 25.6 percent in 2022, corresponding to roughly 2.7 million citizens falling into poverty in just one year. Since the hard default, Sri Lanka has undertaken a series of reforms to increase tax revenue and sought financial assistance from the International Monetary Fund (IMF) by way of an Extended Fund Facility arrangement. Political and social stability however remains tense as protests continue to sprout sporadically throughout the country demanding the removal of the new tax regime, provision of a living cost allowance and the reduction of electricity tariffs. According to the Central Bank, Sri Lanka's economy will continue to shrink by 3 percent this year.

Against this backdrop, conditions seem ideal for India and China to draw Sri Lanka closer into their respective orbits. After all, the two Asian giants have been in competition to woo the small South Asian island-state for several decades.

India has, since independence, branded Sri Lanka as an **“unsinkable aircraft carrier 14 miles off India's coast.”** The island's geographic proximity to South India coupled with its strategic position astride the main sea lanes of the Indian Ocean necessitate New Delhi to be keenly aware of developments in Sri Lanka. Since the end of the Sri Lankan Civil War in 2009, New Delhi has adopted a two-pronged strategy, focusing on the provision of humanitarian and economic assistance to the Tamils in the north and east of Sri Lanka and concomitantly rebuilding strained relations with Colombo by supporting major infrastructure projects across the country. The latter policy was rejuvenated with the arrival of Narendra Modi who actively sought stronger relations with regional states through the Neighbourhood First Policy.

India is one of the main sources of **tourist arrivals** to Sri Lanka. It is the island's largest trading partner, followed closely by the US and China, contributing **41 percent** of Sri Lanka's total trade in 2022, and is also Sri Lanka's **largest source of imports** followed by China. Both China and India played a significant role in Sri Lanka's recovery after its default in April 2022. New Delhi provided credit lines enabling the island to acquire essential medicine and other necessary goods, while Beijing offered it a **two-year debt moratorium.**



Akin to India, China has similarly been developing stronger relations with Sri Lanka. Less than a decade after its independence, Sri Lanka signed a trade agreement with China and followed this soon after with the establishment of diplomatic ties. Sino-Sri Lankan relations reached new heights with the inauguration of President Xi Jinping. Under his administration, there were frequent high-level visits between the two nations and several cooperation agreements were signed. By 2012, China became the island's **largest provider of development aid** surpassing traditional donors such as the Asia Development Bank, and the World Bank. A year later, it became Sri Lanka's **biggest source of foreign direct investment**.

Many **Indian** and **Western** scholars have erroneously labelled Sri Lanka's decision to lease the Hambantota Port as reflective of

Beijing's 'debt trap strategy.' **Studies** indicate that instead of being coerced to lease the port, it was Sri Lanka's decision to lease the port to China for ninety-nine years in return for a USD 1.12 billion investment which was used to pay off its debt to other international stakeholders. Additionally, a quick scan of Sri Lanka's **external debt** (as of March 2023) shows that the majority of the commercial loans actually consist of International Sovereign Bonds (35 percent) rather than bilateral debt (31 percent). And though China is indeed the largest creditor among non-Paris Club countries, it accounts for just 13 percent of Sri Lanka's total external debt. Thus, to claim that Sri Lanka's decision to lease the Hambantota Port or that Sri Lanka's extant debt to China is reflective of a 'Chinese debt trap' fails to recognise Sri Lanka's **agency and reasoning** behind both decisions.

Sri Lanka remains important for Beijing, therefore, not only because it serves as a vital node in its Maritime Silk Road and its deep economic engagement but also because the optics of disengaging with Sri Lanka after purportedly ‘entrapping it in a debt trap’ would undoubtedly damage Beijing’s image in the international community. Moreover, some **observers** have suggested that Hambantota Port would be the most likely location for the establishment of China’s second overseas military base following Djibouti, further underscoring Sri Lanka’s significance to Beijing. If such a base is established however, it would unequivocally alarm India given the island’s proximity to it and, as a result, New Delhi has remained very watchful of developments concerning Sino-Sri Lankan relations.

Indeed, when news emerged in late July 2022 that a Chinese research vessel, the **Yuan Wang 5**, was approaching to dock at Hambantota port, India protested to Sri Lanka, citing security concerns. Occurring just days into the new Wickremesinghe administration, the vessel had already been granted approval to dock by the previous government. Moreover, as mentioned, a majority stake in Hambantota port was leased to a Chinese state-owned entity—China Merchants Port Holdings Company Limited (CM Port)—making it difficult for the new government to refuse entry to the vessel. In order to avoid slighting either of its neighbours, Colombo sought a compromise, allowing the vessel to dock at

Hambantota provided that it kept its Automatic Identification System (AIS) switched on within Sri Lanka’s Exclusive Economic Zone (EEZ) and that it did not conduct any research/surveys while in Sri Lankan waters. This was to become the first indication of Sri Lanka’s **tightrope balancing** after the political turmoil. Even though the process to reach the decision appeared haphazard, a potential diplomatic storm was avoided by appeasing both India and China without harming Sri Lankan national interests.

Despite this bumpy start, the new administration continued to seek deeper relations with New Delhi and Beijing, promoting regular high-level exchanges and engagement with both. As a consequence, generous donations and grants poured in from China and India. As Sri Lanka reeled from high food price inflation, China donated **1,000 metric tons of rice** in June 2022, and **10.6 million litres of diesel** in November 2022. By January 2023, China had **gifted** approximately USD 14 million worth of school uniform material and USD 5.5 million of essential medicine and medical supplies to the Sri Lankan government.

India, in addition to similar **donations** of medical equipment and food supplies, **notified** the IMF in January 2023 that it would provide financing assurances to support Sri Lanka’s debt restructuring efforts. The move earned a wave of **goodwill and gratitude** from Sri Lankans, as India was the first major bilateral creditor to

step forward and provide such assurances, while others, including the Paris Club and particularly China, were still considering.

Realising the importance of replicating India's actions, China belatedly **announced** in March 2023 that it would also provide financing assurances to Sri Lanka. What is notable during this period is that Colombo opted to avoid pressuring Beijing into making a decision, and instead, granted it considerable time to recognise the importance of supporting the IMF's restructuring program for the island. Had Sri Lanka criticised Beijing's indecision alongside Washington and other Western allies, it would have further alienated Beijing, hardening the latter's posture towards Sri Lanka.

Similarly, when the Chinese Ambassador to Sri Lanka, Qi Zhenhong, very publicly **lamented** Sri Lanka's decision to seek assistance from the IMF (rather than China) in April 2022, Colombo chose not to respond in a similar public manner that would have escalated the situation. Instead, according to some government officials I've interviewed, Colombo engaged in backdoor diplomacy to placate Beijing and convince it to support its efforts to resolve its outstanding debt problems.

Sri Lanka's act of tightrope balancing carries important lessons for other economically unstable Asian and African

nations. Leveraging on the interests that the competing regional great powers—China and India—had on the island, Colombo welcomed engagement with both, ensuring that the two effectively competed against one another to woo Sri Lanka with concessions and gifts. Thus, if managed astutely, small nations can galvanise aspiring regional hegemony to help them rebuild their **economy**. This however, has to be done whilst ensuring the country's sovereignty and national interests are protected. More often than not, when small nations such as Sri Lanka engage New Delhi, Washington, or Beijing, they are at risk of falling within the orbit of one of the great powers—thereby limiting opportunities to maximise assistance from all parties—unless they are able to effectively play the great powers off one another.

Shakthi De Silva is a Non-Resident Vasey Fellow at Pacific Forum International (2023-24) and a Visiting Lecturer at the Royal Institute of Colombo where he teaches courses on International Relations. He previously served as a Lecturer at the University of Colombo (Sri Lanka) and as a Researcher for think tanks in the Sri Lankan Defence Ministry and Ministry of Foreign Affairs. His publications have featured in *Journal of the Indian Ocean Region*, *Journal on Defence & Policy Analysis* and *South Asian Survey*. He tweets at [@shakthi721994](https://twitter.com/shakthi721994).