Chinese Role in the Sri Lankan Financial Crisis and India's Reaction

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Abstract

In the post-Covid-19 scenario, the economies of many countries suffered. Some managed to recover their economy; for example, the Indian economy recovered in a K-shaped phase. However, it was difficult for Sri Lanka to manage its foreign exchange reserves. Its financial condition became so poor that it led to a catastrophe in its political arena. The following article is to demystify Sri Lanka's financial crisis. In order to do so, some questions have been analysed; a) How did Sri Lanka end up in a financial crisis and what is China's role in it? b) What is Chinese reaction to the crisis? and c) Being an immediate neighbor, how has India behaved in regard to the crisis? The article concludes by elucidating India's financial aid to Sri Lanka with an overall analysis and conclusion.

Introduction

Sri Lanka became independent in 1948. It procured its first loans from multilateral financial institutions in the mid-1960s. After that period, its external debt problem only grew. There were many mega projects such as the Mahaweli Development program to increase arable land and others, financed through loans from bilateral partners and multilateral institutions like the World Bank.

In 1977, Sri Lanka abruptly changed its economic ideology and policy, embracing an 'open economy'. A 'big bang' liberalisation

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of price controls, exchange controls, and subsidies led to a period of high inflation and the manufacturing sector's decline. By the early 1980s, the contribution of manufacturing to GDP declined and plateaued. The country adopted an International Monetary Fund (IMF)-recommended program of privatisation in the late 1980s.

In the absence of a national development banking system, a depreciating currency, and an ongoing Civil War brought financial crisis in the island. Sri Lanka was keen to join the path of development. It sought help from the IMF. As per IMF policy, Structural Adjustment Programme or SAP countries could not continue with the welfare programme for a very long period if they followed the neo-liberal economic policy. The putting off IMF's welfare programme forced the country to depend more on concessional bilateral and multilateral lenders. This process essentially paved the way for an external 'debt trap'.[1] However, Sri Lanka resorted to funding its widening trade deficit from the IMF.

According to the Ministry of Finance and Planning of Sri Lanka, in 2005, 50 per cent of Sri Lanka's total external debt was owed to the World Bank and Asian Development Bank alone, while another 29 per cent was owed to Japan, the leading bilateral lender at the time.[2]

In 2009, in the aftermath of the civil war, the government began tapping into China's rapidly increasing development finance. Between 2009 and 2018, Sri Lanka borrowed around USD 7.8 billion to develop transport and energy infrastructure - about 9.3 per cent of its 2019 GDP.[3] As per the Central Bank of Sri Lanka[4], repeated attempts at IMF reforms have failed to solve the underlying problems in Sri Lanka's economy. In 2018 alone, the country spent USD 1.8 billion on currency interventions defending the rupee due to excessive imports.

Chinese Involvement

It was a Canadian-based firm that studied about the relevance of Hambantota Port.[5] Its study highlighted that the Colombo Port was in the middle of the town, while Hambantota had a hinterland, meaning it offered tremendous potential for expansion and development.[6] However, the Canadian firm could not get the project due to the changes in Sri Lankan domestic politics.[7] The project was offered to the U.S., but it denied the project. It was also offered to India, but India also refused because it lacked funding for big and ambitious projects. China saw the relevance of this port, and its construction firm, the China Harbor Group, lobbied hard for the project. China Exim bank agreed to fund it, and the China Harbor won the contract.[8]

In 2007, when Sri Lanka was in the mid of civil war, China Exim-bank offered USD 307 million, a 15-year commercial loan with a four-year grace period, offering Sri Lanka a choice between a 6.3 per cent fixed interest rate or one that would rise or fall depending on LIBOR[9], a floating rate. Colombo chose the former, conscious that global interest rates were trending higher during the negotiations. Phase I of the port project was completed on schedule within three years.

For a conflict-torn country struggling to generate tax revenue, the loan terms seemed reasonable. That same year, Sri Lanka also issued its first international bond with an interest rate of 8.25 per cent.[10] Both decisions would come back to haunt Sri Lanka. After the civil war, the government embarked on a debt-financed push to build and improve the country's infrastructure. Annual economic growth rates climbed to 6 per cent, but Sri Lanka's debt burden also soared.

In Hambantota, instead of waiting for Phase I of the port to generate revenue as the Ramboll team had recommended, the Prime Minister Mahinda Rajapaksa pushed ahead with Phase II, transforming Hambantota into a container port. In 2012, Sri Lanka borrowed another USD 757 million from China Exim bank, at a reduced, post-financial-crisis interest rate of 2 per cent. Rajapaksa took the liberty of naming the port after himself. By 2014, Hambantota was losing money. Realising that they needed more experienced operators, the Sri Lanka Ports Authority (SLPA) signed an agreement with China Harbor and China Merchants Group to have them jointly develop and operate the new port for 35 years. China Merchants was already using a new terminal in the harbour in Colombo, and China Harbor invested USD 1.4 billion in Colombo Port City, a lucrative real-estate project involving land reclamation. But while the lawyers drew up the contracts, political upheaval was taking shape.

Mahinda Rajapaksa called a surprise election in January 2015, in which former Health Minister Maithripala Sirisena contested and won the election. However, the economic challenges of the Rajapaksa government were piled up via international sovereign bonds, which comprised 40 per cent of the country's external debt. When Sirisena took office, Sri Lanka owed more than Japan[11], World Bank, Asian Development bank than to China. Of the 5.4 billion USD in debt service, Sri Lanka only paid 5 per cent because of Hambantota.[12] Colombo arranged a bailout[13] from the IMF and decided to raise the much-needed dollars by leasing out the underperforming Hambantota Port to an experienced company. There was not an open tender, and the only two bids came from China Merchants and China Harbor; Sri Lanka chose China Merchants, making it the majority shareholder with a 99-year lease, and used the USD 1.12 billion cash infusion to bolster its foreign reserves, not to pay off China's Exim bank.[14]

Sri Lankan Perspective towards China

Sri Lankan perspective towards China was positive because of the following reasons:

- According to the Ministry of Finance and Planning (2013), Sri Lankan policymakers viewed Chinese contractors favourably due to their excellent balance of speed, efficiency, and product quality.
- Additionally, they finished projects ahead of time while engaging in extensive CSR activities benefiting local constituents.
- For Sri Lanka, China was the only available lending source for long-term project financing and equity investments, especially at the height of the 2008 global financial crisis.[15]

China contributed to infrastructure development in Sri Lanka through direct investment and official loans.[16] Infrastructure-related FDI from China averaged about USD 200 million annually over 2013–17 (¼ per cent of GDP), while outstanding bilateral loans from China to Sri Lanka's public sector, including SOEs, were estimated at USD 4.6 billion end-2016 (5.8 per cent of GDP)".[17]

After analysing the Sri Lankan perspective towards China, it is imperative to underline the Chinese perspective towards the debt crisis in Sri Lanka.

China's reaction towards Sri Lanka

In China, the reaction has been mainly that of anger and resentment.

- There has been large-scale condemnation on the Chinese internet of what is being called Sri Lanka's victim card.[18] There are accusations that the island nation 'took advantage' of China, and used it as an ATM,[19] and is now 'publicly embarrassing China'. The words used for Sri Lanka and its political class are far from flattering, including 'white-eyed wolf' behaviour[20] of Sri Lanka.
- China got further disappointed as Sri Lanka decided to suspend foreign debt payments in April, defaulted on its debts in May, declared bankruptcy in July, and went to the IMF for assistance.
- China says Sri Lanka's decisions are detrimental to Chinese interests as they will cause severe economic losses to China. China had wanted Sri Lanka to keep repaying its debts. At the same time, China helped it to secure better deals at the international financial institutions, which in a way, would have also ensured that the money continued to make its way back into the Chinese coffers.
- The Chinese side has positioned Sri Lanka as an 'economy enemy' of China,[21] forcing it (China) to offer debt relief to Sri Lanka, under unfavourable IMF conditionality.
- China has been opposing the IMF's condition of debt haircut (which requires all the creditors to forgive an equal amount of debt voluntarily) because it will be a more significant loss for a creditor of new debts like China. In contrast, most of Sri Lanka's existing debt is 'old debt'. China, therefore, must not allow itself to be a scapegoat but instead make active efforts to scuttle Sri Lanka's bid to obtain IMF assistance.[22]
- What further irked the Chinese side was that Sri Lankan leaders, including ex-President Gotabaya Rajapaksa, Sri Lankan ambassador to China, Palitha Kohona, among others, publicly raised concern over the lack of China's interest in helping Sri Lanka. They argued that this has further strengthened the Western/Indian discourse of Chinese

culpability in Sri Lanka's debt crisis, and the economic crisis faced by several other developing countries, and built-up of international pressure on China to align its stance with the Paris Club and re-consider its position on the 'Common Framework for Debt Treatment'.[23]

Sri Lanka's Importance to India

India places a lot of significance on Sri Lanka as an island nation, strategically placed in the Indian Ocean. About 70 percent of the oil consumed in India is imported through the ports of the Indian Ocean. Due to China's influence, India has stepped up its efforts in Sri Lanka and the IOR region. India is participating in forums like the Indian Ocean Rim Association for Regional Cooperation (IOR-ARC) and the Indian Ocean Naval symposium. India has also been increasing its presence by becoming a significant foreign investor in local infrastructure development and mining projects, particularly around the coast of the Indian Ocean.[24]

India was Sri Lanka's second-largest trading partner in 2020 as trade accounted for nearly USD 3.6 billion in bilateral product trade. The Bank of India estimated that from 2005 to 2019, FDI from India totalled roughly USD 1.7 billion.[25] Sri Lankan businesses are also expanding in India. Bilateral Free Trade Agreements, Double Taxation Avoidance Agreements, and Investment Protection and Promotion Agreements are just a few of the bilateral agreements that offer a solid legal basis for growing economic ties. Additionally, there are bilateral MoUs and deals on air services, agriculture, small development projects, and financial project cooperation.

Indian Aid to Sri Lanka

After the financial crisis began, India's economic engagement has provided bilateral assistance to Sri Lanka that can be broadly categorised into two groups: one is assistance to meet immediate needs, and the second is aid to resurrect the sectors that were negatively impacted by the pandemic and the forex reserves downturn.[26]

The Government of India has provided a package of food, health, and energy security, as well as foreign reserves, support totalling more than USD 3.5 billion to meet the immediate needs. This package also included a USD 1 billion concessional loan to the Government of Sri Lanka, in the background of Sri Lanka's financial crisis of 2022.[27] A Line of Credit (LOC) of USD 500 million was used to finance the purchase of petroleum products such as aviation fuel, diesel, and gasoline in February 2022. A Memorandum of Understanding was signed in March 2022 to establish the Trincomalee Power Company in eastern Sri Lanka. The USD 500 million renewable energy project in Sri Lanka's north was awarded to Indian energy and port billionaire Gautam Adani. Adani had already won the USD 700 million contract to construct the West Container Terminal in the Colombo port.[28]

Indian Oil Corporation supplied a consignment of 40,000 MT of fuel outside the LOC facility. Sri Lanka requested an additional USD 500 LOC from India to purchase electricity. India extended a currency swap facility of USD 400 million under the South Asia Association of Regional Centre (SAARC). Currency Swap Framework 2019-22 and a deferral of dues of approximately USD 1 billion until March 2022, to be paid by the CBSL to the Reserve Bank of India under the Asian Clearing Union, to support the declining foreign reserves.[29]

Additionally, in response to the urgent need for medications, India donated a shipment of pharmaceuticals and medical supplies to many hospitals in Sri Lanka. Further, kerosene has been provided for Sri Lankan fishermen use. The Tamil Nadu government has also promised to provide USD 16 million in humanitarian aid, including 40,000 MT of rice, 500 MT of milk powder, and medications for Sri Lanka. The Government of India also agreed to provide a USD 55 million credit line at the request of the Government of Sri Lanka for the purchase of 65000 MT of urea fertiliser for the Yala season's planting.[30]

How have Indian Bureaucrats and Academicians reacted to the Crisis?

Former High Commissioner to Sri Lanka and former Ambassador to China Ashok K. Kantha stated that India had long-standing concerns about Chinese projects and was sceptical of Indian enterprises participating in such projects. According to him, the new Colombo City project is a part of a broader pattern of Chinese intrusions into a range of island nations. In addition, the Hambantota project had previously incurred losses of USD 300 million by the end of 2016. The government was forced to approve a contract turning the port to China in July 2017.

- Ambassador Kantha said, like the Hambantota port, the Colombo City port project was also being funded by the China Harbour Engineering Company (CHEC). He emphasised that CHEC was a division of China Communications Construction Company, a Chinese government-run infrastructure company in charge of President Xi's Belt and Road Initiative. Previous projects were accused of breaking environmental laws. He did not see how the Colombo City project would economically benefit Sri Lanka.[31]

- Professor P. Sahadevan said that the Hambantota and Colombo City project (CCP) differed. The Hambantota project was to bring in revenues through the docking of ships, but it did not make money, and hence the project did not work out. He added that the CCP was, however, a commercial venture. This meant that the project's multi-functional design was done solely to generate revenue from its residential, commercial, and other assets. He said that the project enamoured Sri Lankans and thought they could make the money they had lost in earlier projects.[32]

Analysis

The Chinese role in Sri Lanka's financial crisis could be understood through the port project of Hambantota. However, some analysts believe that China is not responsible as it offered a choice to Sri Lanka to restructure the loan. However, the situation in Sri Lanka was so pathetic that it could not go back to restructuring loans because of the Covid-19 crisis.

There are two aspects which points out that China is responsible for Sri Lankan crisis. Firstly, Sri Lanka had the Hambantota port in 2017. There was no Covid-19 crisis at the time, and Sri Lanka loan was supposed to restructure the loan. Secondly, if the loan interest rates are compared to the Japanese interest rate, it is lower than the Chinese interest rate. This aspect reflects that China was aware of the economic history of Sri Lanka, and it still offered loans at the market floating rate and 6.3 per cent fixed interest rate. The US had declined the project because of Sri Lanka's financial situation.

Conclusion

After Sri Lanka became independent, it chose the path of rapid development. It knocked on the door of the IMF, World Bank other financial institutions. However, the long-stretched civil war, change in central authority and its policies also impacted the economic decisions of Sri Lanka. The country then depended on China for financial assistance and development projects, and we saw the hasty decisions Sri Lanka took adversely affected its economy.

In China, the dominant perspective about investing in Sri Lanka was based on cooperation and a win-win situation for both countries. However, there was a change in the status, and things did not go as expected. China's onerous terms and feeble revenues have pushed Sri Lanka to debt, and now the Hambantota port remains under lease to a Chinese firm.

Therefore, Sri Lanka should look more in the direction of India. Sri Lanka and India have had mostly peaceful political and economic relations except for contentious issues like the Tamil conflict, the fishermen issue and maritime boundary disputes. As far as the crisis is concerned, India might not have huge funds for building infrastructure in Sri Lanka, but India has not denied aid to the country. Current Prime Minister Ranil Wickremesinghe recently called India a 'breath of life' in hard times, even calling India its closest neighbour.[33] Sri Lanka has faced immense backlash. However, the government's present decisions would decide the country's future, but Sri Lanka would have to be extremely careful in its decision-making in order to overcome the trap of debt diplomacy.

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