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## Sri Lanka and great-power competition in the Indo-Pacific: a Belt and Road failure?

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### Theme

This paper looks at the situation in Sri Lanka and the impact of the new Chinese Belt and Road Initiative. It further analyses the effects of great-power competition on Sri Lanka and the other countries in the Indo-Pacific region.

### Summary

Over the past decade Sri Lanka has become an object of interest to great powers such as China, India, Japan and the US, essentially due to its unique Indo-Pacific location. Of the great powers, China has been the one to most increase its presence there, as the island-state is very important to its Belt and Road Initiative. This paper analyses China's involvement in Sri Lanka in order to identify why it has become a key economic and strategic partner. It also identifies areas of improvement in its relationship with local governmental and civil society actors.

### Analysis

Sri Lanka has not attracted this much attention from the international press since the civil war between the government in Colombo and the Tamil Tigers ended in 2009.<sup>1</sup> The renewed attention is due to the fact that the island has become the epicentre of great power competition in the Indo-Pacific region. China's growing and significant presence in the country has attracted special attention, as it offers a valuable insight into the effects of its *Belt and Road Initiative*. Most of the literature on the topic has not focused sufficiently on the local players, presenting them as mere pawns in the hands of China and other great powers. This paper will attempt to make up for these shortcomings by looking at how the priorities of the Sri Lankan government explain the nature of foreign involvement in the country.

### China is an attractive partner for Sri Lanka

China has granted Sri Lanka US\$10,000 million worth of loans, making it the third largest recipient of Chinese funds of the Belt and Road Initiative countries after Pakistan and Russia. Both the substantial increase in the amount of *debt owed to China by Sri Lanka* and the leasing of Hambantota port to a Chinese-led consortium have sparked a heated debate on the effects of Chinese financial involvement in Silk-Road countries. Opponents

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<sup>1</sup> The author would like to express his gratitude to Virginia Crespi de Valldaura for her valuable help in preparing this paper.

have seen this financial involvement as a Chinese attempt to increase its political and military influence in the area through its so-called '**debt-trap diplomacy**'. Although this point of view has been defended by many international news outlets and think tanks,<sup>2</sup> and even by the US Vice-President Mike Pence, it lacks a solid foundation.

According to the Central Bank of Sri Lanka,<sup>3</sup> 14% of the US\$55,000 million Sri Lanka owes in foreign debt are owed to the ADB, while 12% are owed to Japan, 11% to the World Bank and 10.6% to China. The country will have to pay back US\$17,000 million worth of debt between 2019 and 2022, mainly to commercial banks and to traditional multilateral donors. Its currency reserves of US\$9.100 million seem insufficient to meet the payments in the medium term, especially given that the country's balance of payments in the last four years has barely reached a surplus of US\$150 million. Furthermore, Sri Lankan public debt stands at 77% of its GDP, making it **the most indebted** among other neighbouring countries such as India, Malaysia, Pakistan and Thailand. This all suggests that Sri Lanka has a debt problem that extends beyond its commitments to China. Indeed, China's latest loan to Sri Lanka is intended to service some of the debt owed to other creditors.<sup>4</sup>

This is not to say that there have not been important changes in the ownership of Sri Lankan debt since the civil war ended in 2009. Sri Lanka received a substantial amount of development aid from the West during the Cold War, yet this was no longer the case in the last decade. Three main factors eroded the weight of multilateral development banks and Western powers as creditors during the period: the international financial crisis, Sri Lanka's transition from a low-income to a lower-middle income country<sup>5</sup> and the distancing of Western powers from the government of Mahinda Rajapaksa. In this context, the Sri Lankan state was forced to rely much more heavily for funding on international financial markets and on Beijing. The latter offered larger sums than the Western powers were willing to provide and at more favourable conditions than those proposed by commercial banks.

Thus, China became an attractive new source of funding, especially to a government that wanted to prove to its population that it could boost the country's socioeconomic development in the aftermath of the civil war. To this end, President Rajapaksa adopted an economic programme that was fully in line with Beijing's vision, focusing on the construction of adequate infrastructure as a first step to attracting foreign investment and fostering local socioeconomic development.

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<sup>2</sup> See, for instance, Jonathan E. Hillman (2018), 'Game of loans: how China bought Hambantota', CSIS Briefs, Center for Strategic & International Studies, 2/IV/2018, <https://www.csis.org/analysis/game-loans-how-china-bought-hambantota>; and Harsh V. Pant (2017), 'China's debt trap diplomacy', Observer Research Foundation, 3/VIII/2017, <https://www.orfonline.org/research/chinas-debt-trap-diplomacy/>.

<sup>3</sup> Central Bank of Sri Lanka (2018), 'Annual Report 2017: Statistical Appendix', Table 115, 17/IV/2018, [https://www.cbsl.gov.lk/sites/default/files/cbslweb\\_documents/publications/annual\\_report/2017/en/14\\_Appendix.pdf](https://www.cbsl.gov.lk/sites/default/files/cbslweb_documents/publications/annual_report/2017/en/14_Appendix.pdf).

<sup>4</sup> Shihar Aneez (2018), 'Sri Lanka accepts \$1 billion, eight year syndicated loan from China Development Bank', Reuters, 25/V/2018, <https://in.reuters.com/article/sri-lanka-china-loan/sri-lanka-accepts-1-billion-eight-year-syndicated-loan-from-china-development-bank-idINKCN1IQ2FT>.

<sup>5</sup> This greatly affects its possibilities for attracting funds from multilateral development banks.

In order to implement the programme, Rajapaksa needed both the external funding and the technical expertise required to build infrastructures in critical areas such as transport, energy and telecommunications. Since Western countries and companies had lost interest in Sri Lanka, China was in a unique position to fulfil the role. The example of China Merchants Port Holdings is a perfect illustration. As a state-owned Chinese company, it had access to cheaper funding than that available to Western private companies. Thus, it was freer to become involved in longer-term projects than its market-driven opponents.

In 2011 there was a public tender to grant construction and management rights for the container terminal of the **Port of Colombo** for a period of 35 years. The only offer came from a Chinese-Sri Lankan consortium consisting of China Merchants and Aitken Spence. China Merchants initially controlled 55% of the consortium, while Aitken Spence controlled 30% and Sri Lanka Ports Authority the remaining 15%. The following year, China Merchants bought out Aitken Spence's share, meaning it now controlled 85% of the partnership. The venture increased the Port of Colombo's capacity in record time thanks to the rapid construction of the terminal (which took only 28 months) and the introduction of new management techniques. Since then, the Port of Colombo has risen in every international ranking and the number of TEUs it handles per year has increased from 2.3 million in 2011 to 2.5 million in 2015 and 6.2 million in 2017. This makes it the world's 23<sup>rd</sup> largest port in terms of volume of cargo handled, and the largest in South Asia.

This outstanding performance encouraged current President Maithripala Sirisena –who had originally been much more reluctant than his predecessor to strengthen ties with Beijing– to suggest that China should implement similar management methods at the **Port of Hambantota**.<sup>6</sup> The result was a 99-year lease agreement that came into force in December 2017. The agreement specified the creation of two public-private partnerships between China Merchants and the Sri Lanka Ports Authority, which would manage the Port's administrative and commercial operations. In exchange for its participation, China Merchants agreed to pay US\$1.120 million and to invest a further US\$400-600 million in expanding the port. China Merchants currently owns a 70% share of the partnerships, but in a decade's time its share will start to be gradually reduced until the two parties own 50% each.

Since it opened in November 2010, the port has been notable for its lack of activity, yet there are signs that this is beginning to change. While only 183 boats entered the port in the whole of 2017, 2018 has seen 132 boats enter in only the first quarter. The port has a perfect location on the route between the Malacca Straits and the Suez Canal, which joins Asia to Europe. It will help ease the pressure on the Port of Colombo and provide services to the 36,000 boats that complete the route each year, since they currently have to veer significantly off-route to refuel and carry out other necessary activities.

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<sup>6</sup> Sirisena is a staunch defender of the private sector whereas Rajapaksa was much more in favor of strengthening state-owned companies.

Another advantage of Chinese investment is the speed with which companies manage and implement projects. The Port of Hambantota is again a good example. Rajapaksa's government presented the project to the Chinese in 2006, the agreement was signed in 2007, construction work started in 2008 and the port was opened in October 2010. Indeed, the Sri Lanka Ports Authority cites expeditiousness as the official reason why it chose to grant the project to China.<sup>7</sup> Chinese promptness certainly contrasts with the long and complex negotiation and implementation processes that characterise agreements with the traditional great powers. The example of Sri Lanka's funding agreement with the Japan International Cooperation Agency to build Colombo's light rail is an apt illustration. After more than three years of field studies, it is expected that the agreement will finally be signed at the end of 2018, while construction will not begin until 2020 and it will not enter into operation until 2024.

Indeed, it is significant that both of the Presidents that have ruled Sri Lanka since the end of the war have seen their key projects materialise thanks to Chinese capital. The Exim Bank of China financed 85% of the construction of the Port of Hambantota, developed during the Rajapaksa presidency. The state-owned China Communication Construction Company is investing US\$1.400 million on the construction of **Colombo International Financial Centre**, which has finally been approved by President Sirisena. This latest project is particularly significant, as Sirisena had originally been critical of his predecessor's close ties to Beijing, to the extent that he initially suspended the project for a year. It also shows that China is not only a key lender to Sri Lanka but is also emerging as a key investor.

### The Chinese modus operandi China in Sri Lanka

All Sri Lankan Ministries are obliged to present all projects that require international funding to the Ministry of Finance.<sup>8</sup> Guided by the President, the Ministry of Finance then chooses what projects to promote and who is to fund them, an important point as the Ministry sometimes selects the funding based on a competitive tender while on other occasions it directly selects a specific government or institution. The latter practice does not exclusively benefit China since other traditional donors can be included as well.

The procedure used to prioritise projects is different for loans and for investments. For projects that require a loan, Chinese lenders usually accept the viability studies and risk analyses provided by local authorities at face value. Thus, many of the due diligence issues attributed to China when selecting and managing their projects can in fact be traced back to the priorities of local authorities. President Rajapaksa, for instance, is originally from the south of the island and was interested in developing an area where resentment towards the Colombo elites and the large amount of development aid they have received is strong. He therefore took out Chinese loans to rapidly develop ambitious infrastructure projects such as the Mattala Rajapaksa International Airport, the Port of

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<sup>7</sup> Sri Lanka Ports Authority (2010), 'Hambantota harbour dream come true', 25/VIII/2010, [http://portcom.slpa.lk/news\\_events\\_220.asp](http://portcom.slpa.lk/news_events_220.asp).

<sup>8</sup> Many Sri Lankan Ministers are members of Parliament representing local constituencies, meaning they tend to propose projects that benefit their own voters.

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Hambantota and the MRCI Stadium at Hambantota. All of these have so far been underutilised and the level of investment they required seems hard to justify. Nevertheless, it is too early to draw conclusions on some of the projects, as the government is currently planning a programme to develop the entire region through the infrastructures' reactivation, the expansion of the road network and the creation of a large-scale industrial park.<sup>9</sup>

When considering an investment, however, Chinese players draw up their own viability analyses. While the Chinese Embassy lobbies for and coordinates Chinese projects in the country, it is the banks and companies themselves who make use of their solid presence on the ground to launch the initiatives.<sup>10</sup> They write up their own project status and project evaluation reports, although only for internal use. After all, they do not feel obliged to keep their citizens or the international community informed and believe it is the local government's obligation to keep its own people informed.

### Controversial aspects of China's economic presence

There can be no doubt that China is an attractive partner to the Sri Lankan government. However, its involvement in the country has also attracted controversy. China's undercutting of Sri Lankan sovereignty, as well as the lack of transparency of its operations and its lack of consideration for the environmental and social impact of its projects, have all been a source of criticism. Land leases to Chinese companies and Chinese-led consortiums in Hambantota and Colombo have been especially controversial, and have given rise to protests in these areas.

The controversies were such that they even led President Sirisena to suspend the development of Colombo's financial city so as to make some changes to the original project.<sup>11</sup> In the new agreement, China Communication Construction Company will no longer own whatever land it reclaims from the sea but will only enjoy a 99-year lease. The land, which had an undetermined status in the previous agreement, will now officially become a part of Colombo District and of the Sri Lankan state. Similarly, a detailed report on the project's environmental impact was carried out that listed 70 measures needed to mitigate any negative effects, where only 42 were outlined in the original agreement. In addition, the agreement forced China Communications Company to contribute LKR500 million to a compensation fund established by the Sri Lankan government for local fishermen. These alterations to the original project, which were motivated by a change of government, prove once again that local authorities and their priorities play a crucial role in the process of negotiating agreements with China.

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<sup>9</sup> 'Sri Lanka-China industrial zone office in Hambantota Port kicks off industrialisation of Ruhuna', *Daily FT*, 6/XI/2017, <http://www.ft.lk/business/Sri-Lanka-China-Industrial-Zone-Office-in-Hambantota-Port-kicks-off-industrialisation-of-Ruhuna/34-642838>.

<sup>10</sup> According to Sri Lanka's Ministry of National Coexistence there are around 110,000 Chinese citizens in the country. See Ministry of National Coexistence (2017), *People of Sri Lanka*, Selacine, Colombo, p. 215, [http://mncdol.gov.lk/web/images/downloads/publications/people\\_of\\_sri\\_lanka\\_book.pdf](http://mncdol.gov.lk/web/images/downloads/publications/people_of_sri_lanka_book.pdf).

<sup>11</sup> 'Sri Lanka's port city developer withdraws compensation claims', *Lanka Business Online*, 2/VIII/2016, <http://www.lankabusinessonline.com/sri-lankas-port-city-developer-withdraws-compensation-claims/>.

Sirisena's government is also more transparent than his predecessor's, as proved by the **Right to Information Act** that was introduced in February 2017. Despite this, Sri Lankan civil servants and politicians have a long habit of opacity. Their country has traditionally been an 'aid darling', a state accustomed to receiving aid despite its deficiencies in transparency and good governance. China has not exerted any pressure to improve transparency in the country either. The Chinese government considers that this is the local authorities' choice. Indeed, they themselves do not feel that they have to be accountable to Chinese citizens for whatever agreements they sign internationally, and so they do not feel compelled to make their content public.

Finally, there are frequent complaints that Chinese companies operating in Sri Lanka hire very few local workers and make investments that do not generate business opportunities for locals. Although the activities of Chinese companies in Sri Lanka create little local economic spill-overs, the presence of Chinese workers is not especially controversial, as the shortage of local construction workers frequently attracts foreign labour. Similarly, Chinese projects do not usually require the participation of other foreign companies, though they do occasionally bring one in if they need specific technical expertise or want to improve their own reputation. The latter point limits the incentives for the involvement of foreign governments in the development of the Belt and Road Initiative.

### The strategic dimension

The close ties that are developing between China and Sri Lanka are also the result of **geostrategic motivations**, as Sri Lanka has a privileged location on the Indian Ocean's maritime trade routes and is very close to India.

The US, China, India and Japan are competing for **influence in the Indo-Pacific region**. This has led to frequent visits by high-level officials and civil servants to Sri Lanka seeking to address matters of security and defence. On 18 August 2018, for instance, Itsunori Odera became the first Japanese Minister of Defence to ever visit Sri Lanka. During the visit, Japan donated two patrol boats to the Sri Lankan government. This came only two weeks after China had announced that it would strengthen its defence ties with Colombo and donated a frigate to the Sri Lankan navy, and a week after the US State Department had announced a donation of US\$39 million to increase the navy's capabilities.

Like many other countries that are geographically close to India, Sri Lanka is taking advantage of China's increasing presence in South Asia to counterbalance New Delhi's influence. These offsetting tactics were particularly obvious under the Rajapaksa government. Sirisena's current government is more focused on diversifying its foreign alliances to avoid excessive dependence on a single country. However, this does not mean that Sri Lanka is hostile towards New Delhi. In fact, the Sri Lankan authorities have claimed that they have India's strategic interests in mind in their day-to-day management of Hambantota Port and refused to allow a Chinese submarine to dock in the Port of Colombo in May 2017. They have also asked the Indian government to become involved in many important projects. These include the management of Mattala airport, the

development of both the Port of Colombo's Eastern Terminal and of Trincomalee Port, and the construction of the country's first liquefied natural gas plant.

Many of these projects are the result of joint efforts between Japan and India. The two countries and the US are launching common initiatives in the region that compete with the Belt and Road Initiative, such as the *Free and Open Indo-Pacific Strategy*. The Sri Lankan government wants both India and Japan to build infrastructures that help develop the disadvantaged north and eastern regions of the country, just as China did in the south. President Sirisena is also strengthening defence ties with Tokyo, as illustrated by Minister Itsunory Odera's visit and that of the *Akebono*, a Japanese destroyer, to Hambantota Port this year.

It is becoming increasingly obvious that the US and Japan have very different conceptions of the *Free and Open Indo-Pacific Strategy*. Washington's approach is confrontational towards China and is focused on preserving the traditional balance of power in the region. This is favourable to India and its role in South Asia. Japan, on the other hand, has a more ambivalent relationship with Beijing and interprets the Strategy in a more inclusive way, believing it should be open to any other law-abiding state, and that could apply to China. In this regard, Japan is becoming more amenable to the Belt and Road Initiative as long as it remains transparent and sustainable and respects International Law. These developments are playing out on Sri Lankan soil, where the Japanese and Chinese Embassies host bilateral meetings to coordinate their involvement in local projects. Similarly, Japan has proposed some joint ventures with Chinese companies in West Africa. This **collaborative approach** embeds itself within a wider process of *détente* that was initiated by the two countries last spring, reached a new level last October with a state visit to China by Prime Minister Shinzo Abe and is expected to reach its culmination next year when Xi might reciprocate.

The EU and South Korea, for their part, share a common stance on Sri Lanka. Neither of them have significant strategic interests in the country that go beyond ensuring freedom of navigation in the area, nor do they particularly favour one of the regional integration schemes at the expense of another. Their shared priorities in the country consist of contributing to its socioeconomic development and seeking out business opportunities for their companies.

## Conclusion

The Indo-Pacific region has emerged as an epicentre of competition between the great powers, especially China, the US, Japan and India. Sri Lanka has become very important to these countries due to its strategic location in the region. To the concern of the other great powers, China has spectacularly increased its presence over the island-state during the past 10 years. This is due to the mutually beneficial relationship that has developed between the two countries: Sri Lanka is key to China's Belt and Road Initiative while China has proved to be a very attractive economic partner to the Sri Lankan government. Not only has it financed and developed projects at great speed but it has also willingly participated in local strategic initiatives. Nevertheless, there is room for improvement in China's relationship with Sri Lanka. Its projects have lacked transparency and sometimes have failed to take into account financial, environmental

and social sustainability concerns. This has been a source of controversy and has resulted in certain key initiatives having to be renegotiated. China will have to become more sensitive to local expectations if it wishes to consolidate its position as a fundamental partner to the Sri Lankan government and increase the appeal of the Belt and Road Initiative to other states.