Rethinking the External Debt Issue of Sri Lanka: Causes and Implications

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Sri Lanka is a small but important country on the 21st Century Maritime Silk Road. Ever since the end of civil war in 2009, the Sri Lankan economy has achieved remarkable growth. However, the debt problem, especially the external debt issue, keeps on perplexing this "Pearl of the Indian Ocean". Chinese investment in Sri Lanka is regarded by some as the root cause of this problem. To some extent, this issue has cast negative influence on the Sino-Sri Lankan relations. Therefore, it is vitally important to identify and analyze the real sources of Sri Lanka's external borrowings. Moreover, assessing the implications of this issue on China-Sri Lanka relations is conducive to strengthening bilateral friendship and deepening the economic ties, thus facilitating the advance of the Belt and Road Initiative.

Situation of Sri Lanka's External Debt

According to definition by the International Monetary Fund (IMF), a country's external debt refers to "the outstanding amount of those actual current, and not contingent, liabilities that require payment(s) of principal and/or interest by the debtor at some point(s) in the future and that are owed to nonresidents by residents of an economy."[1] The volume and structure

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1 IMF, *External Debt Statistics: Guide for Compilers and Users*, 2014, p.5.

of a country's external debt are important indicators of its macroeconomic situation, especially concerning the external risks to the economy. After 2009, Sri Lanka entered an era of robust economic growth. However, its external debt problem has become more prominent since then.

Rapid rise of external debt volume

According to data provided by the Central Bank of Sri Lanka (CBSL), the volume of Sri Lanka's external debt rose from $20.91 billion in 2009 to $51.82 billion in 2017, more than doubling its size in less than 10 years.[2] This growth rate is much higher than that of Sri Lanka's GDP in the corresponding period.[3] The nine years' time also marks another peak period in Sri Lanka's history of external borrowing, second only to the years from 1978 to 1995 when the growth rate of external debt reached 13%.[4]

Heavy economic reliance on external debt

There are three main indicators to evaluate a country's external debt status, namely the liability ratio, debt servicing ratio and foreign debt ratio. The liability ratio is the ratio of a country's total external debt to its GDP, which indicates the dependency of a country's economic development on external debt. The generally accepted safe level for this debt-to-GDP ratio is 25%.[5] Sri Lanka's liability ratio, however, has been higher than 50% most of the time since 2009 (as shown in Figure 1), even higher than the average level of 26% among developing countries.[6]

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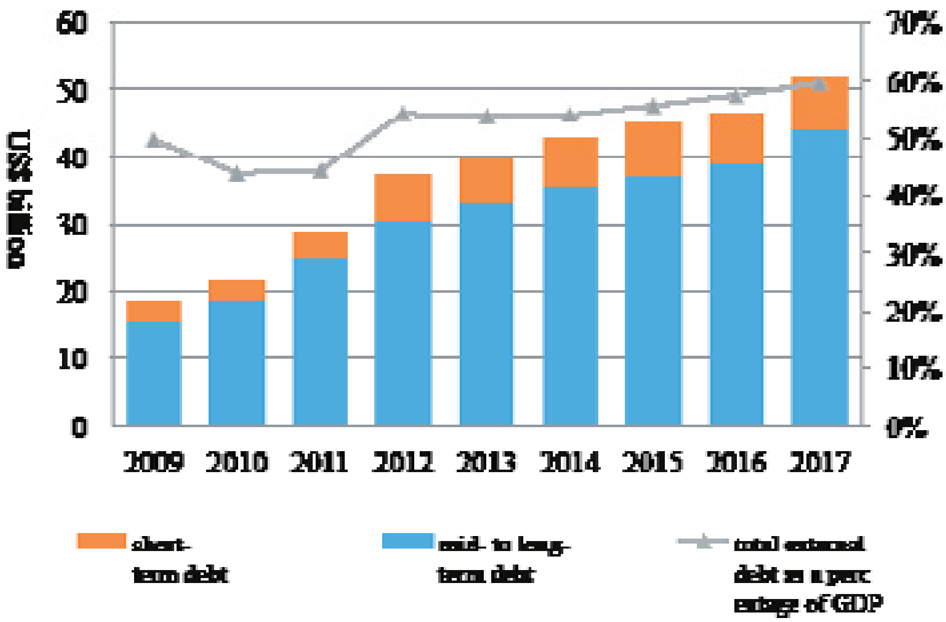
2 "Annual Reports," Central Bank of Sri Lanka, https://www.cbsl.gov.lk/en/publications/economic-and-financial-reports/annual-reports.

3 According to CBSL data, the annual GDP growth rates of Sri Lanka from 2009 to 2017 are 4.8%, 8.0%, 8.4%, 9.1%, 3.4%, 5.0%, 4.8%, and 4.4%.

4 Palitha Pathberiya and Albert Wijeweera, "An Overview of the External Debt Situation in Sri Lanka," *UNEAC Asia Papers*, No.9, 2005.

5 Chen Hong, *Public Finance*, 6th edition, China Renmin University Press, 2008, pp.455-456.

6 Bidisha Das, "Are South Asian Countries Sinking into a Debt Trap?" The World Bank, November 16, 2017, https://blogs.worldbank.org/opendata/are-south-asian-countries-sinking-debt-trap.



Source: Annual reports of Central Bank of Sri Lanka (CBSL)

Figure 1 Liability Ratio and Structure of Sri Lanka's External Debt

The debt servicing ratio refers to the percentage of debt service payments (principal and interest) to export earnings. A country's international finances are healthier when this ratio is low. A healthy ratio is between 0 and 20%. It is believed that once this ratio exceeds 20%, the country is faced with an external debt crisis. Sri Lanka's debt servicing ratio has exceeded this level since 2013. In 2017, the figure was 23.85%, a bit lower than that in 2015 and 2016, yet still signifying a high risk of serving its massive external debt.

The foreign debt ratio is the percentage of a country's outstanding external debt to its export earnings. Similar to the liability ratio, there is a recognized safe margin, which is 100%. When a country's foreign debt ratio is higher than 100%, it is probably already shouldering a tremendously heavy burden to pay back its external debt. It is most worrying that this ratio of Sri Lanka has been higher than 200% since 2009. In 2017, the figure even reached 271% (see Table 1).

Table 1 Debt Servicing Ratio & Foreign Debt Ratio of Sri Lanka (2009-2017)

Year	Debt Servicing Ratio	Foreign Debt Ratio
2009	22.4%	233%
2010	16.7%	223.7%
2011	12.7%	211.5%
2012	19.7%	273.3%
2013	26.8%	264.6%
2014	20.8%	256.4%
2015	27.3%	264.6%
2016	25.0%	267%
2017	23.85%	271%

Source: Annual reports of Central Bank of Sri Lanka (CBSL)

Surging cost of external borrowing

The main foreign sources from which Sri Lanka borrows its capital include foreign sovereign governments, of which China and Japan are the two leading creditors; international and regional multilateral financial institutions, such as the IMF, the Asian Development Bank (ADB); and the international financial market, where sovereign bonds are issued by the Sri Lankan government. Sovereign bonds are issued with the endorsement of the state's sovereignty and credibility and raise money with the interest level defined by the international financial market, making the cost much higher than the former two sources. The share of non-concessional loans in Sri Lanka's foreign debt portfolio has risen sharply from 2% in 2003[7] to 54.8%

7 "An analysis of Sri Lanka's External Debt and Its Risks," Economic and Commercial Counsellor's Office, Chinese Embassy in Sri Lanka, April 29, 2005, http://lk.mofcom.gov.cn/article/ztdy/200504/20050400083596.shtml

in 2017,[8] indicating the economy has started to borrow more money from the international financial market and consequently the cost of its foreign debt is rising fast.

On the other hand, although Sri Lanka owes massive debt to external sources, the term structure of its external debt in 2017 is relatively healthy, as long-term debt accounts for 85.2% of its total external debt, while short-term debt only accounts for 14.8% (as seen in Figure 1). This short-term debt percentage is lower than 25%, which is the internationally acknowledged warning line. Therefore, although the repayment burden is quite heavy, the short-term pressure of Sri Lanka's external debt seems manageable in 2017.

Causes of Sri Lanka's External Debt Problem

Once a prosperous plantation economy, the economic situation of Sri Lanka used to be better than its neighbors across South Asia. However, half a century later the country seems to be lagging behind. Why does today's Sri Lanka fall in such a situation and have to bear a heavy burden of external debt? To answer this question, we need to trace back the economic fundamentals, including Sri Lanka's high financial demand for infrastructure construction, its weak position in global trade, its large non-productive spending which lasted as long as 26 years throughout the civil war, and its growth model featuring high reliance on debt finance.

Huge demand for investment in economic recovery

Ever since the end of civil war in 2009, economic reconstruction has become the core mission of the Sri Lankan government. Then President

8 "Annual Report 2017," Central Bank of Sri Lanka, p.214, https://www.cbsl.gov.lk/en/publications/economic-and-financial-reports/annual-reports/annual-report-2017.

Mahinda Rajapaksa presented the "Mahinda Chintana - Vision for the Future," a grand blueprint for Sri Lanka's development. "The objective of our next massive leap forward is to transform Sri Lanka into a strategically important economic center of the world," he said, "Using our strategic geographic location effectively, I will develop our motherland as a naval, aviation, commercial, energy and knowledge hub, serving as a key link between the East and the West."[9] In order to achieve this grand objective, the Rajapaksa government put infrastructure construction including ports, airports, roads, electricity, telecommunications and irrigation facilities as the national priority. During Rajapaksa's tenure in office, Sri Lanka embarked on a series of ambitious projects, including the expansion of the Colombo port, the Hambantota port, the expansion of Bandaranaike airport and the Norochcholai power plant. To provide sufficient funds for these large-scale projects, the Rajapaksa administration expanded borrowing from external sources.

While the current President Maithripala Sirisena has been criticizing his predecessor's heavy commercial borrowing and large-scale government spending on infrastructure since coming to power in 2015, he also acknowledged that "inadequate physical infrastructure services are a significant drag on growth" in his government's development blueprint "Vision 2025: A Country Enriched," and expressed his determination to make Sri Lanka "the hub of the Indian Ocean." Key infrastructure projects listed in the vision include investments on road infrastructure, Western Megapolis Development, industrial zones (Charlie Mount, Matara, Kalutara, Seethawaka, Hambantota, and Trincomalee), the Kerawalapitiya LNG project, and the Floating Terminal.[10]

Although infrastructure construction plays a critical role in promoting

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9 "Mahinda Chintana: Vision for the Future," Sri Lankan Ministry of Finance and Planning, 2010.
10 "Vision 2015: A Country Enriched," Government of Sri Lanka, September 2017, http://www.treasury.gov.lk/documents/10181/66400/Vision_2025_English.pdf/8d93e8db-2c3a-4e15-9ab2-fc619817e6fd.

Sri Lanka's economic growth, the lack of private investment is a serious problem, as infrastructure building needs enormous financial support but it takes a long time for the projects to generate profits. What's more, infrastructure bears some characteristics of public goods, meaning it usually creates more social welfare for the public than economic benefits for certain investors. It is inevitable that private investors (including foreign direct investment) are reluctant, and often even refuse to participate in infrastructure projects. Therefore, most infrastructure projects rely on public funding. Nevertheless, given limited public resources in Sri Lanka and the depletion of foreign exchange reserves because of the civil war, there is no possibility that Sri Lanka could afford these expensive infrastructure projects by itself. Under these circumstances, foreign borrowing becomes the only option. In addition, since infrastructure construction usually takes a long time to finish, the projects can hardly be economically effective in the short term; starting many infrastructure projects simultaneously could easily lead to a shortage of funds and an accumulation of external debt.

Large trade deficit and high non-productive cost of war

The Sri Lankan government started to reform its economic policy from 1977, allowing more exports and loosening its strict control over imports. As a result, the exports of Sri Lanka grew, but not as fast as its quickly expanding imports. The commodity trade deficit increased rapidly. In 1983 when the civil war broke out, the trade deficit of Sri Lanka grew from Rs. 1.48 billion to Rs. 16.9 billion, increasing more than 10 times within five years.[11]

After the civil war erupted, the Sri Lankan government spent large amounts of monetary resources in purchasing weapons and equipment as well as strengthening logistics. The increase in military spending was

11 Li Lisha, "Analysis of Sri Lanka's External Debt," *South Asian Studies*, 1985, p.40.

astonishingly rapid: before 1983, Sri Lanka spent just $10 million on military affairs, accounting for less than 0.8% of the country's GDP; in 1994, this ratio rose sharply to 3.4%.[12] According to data from *Jane's Defence Weekly*, in 2008, the military spending of Sri Lanka was $1.46 billion, accounting for 5% of the country's annual GDP and 11% of the government budget.[13] Unable to bear this large expenditure, the Sri Lankan government was forced to borrow money from foreign sources. In 1978, its external debt already accounted for 40% of its GDP of that year. As a result of continuous large amounts of external borrowing, the external debt-to-GDP ratio reached a peak of 73.6% in 1989.[14]

Different from infrastructure construction, weapons purchasing is fundamentally a consumption activity. In other words, this pure spending activity had no economic production function but only constituted a debt burden for Sri Lanka. Also, the long-lasting civil war caused tremendous damage to Sri Lanka's infrastructure, severely weakened its tax basis and dragged the economy into a devastated situation. The frequent conflicts also deteriorated Sri Lanka's investment environment, leading to substantial reduction of foreign direct investment (FDI) inflows.

While the spending kept rising, Sri Lanka's foreign income did not increase correspondingly. After the end of civil war, the Sri Lankan commodity trade deficit continued to grow: from 2009 to 2017, its exports increased from $7.08 billion to $11.36 billion, while imports rose from $10.2 billion to $20.98 billion,[15] leading to the trade deficit expanding from $3.12 billion to $9.62 billion. The problem of low inflows and high outflows

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12 Nadir A.L. Mohammed, "Civil Wars and Military Expenditures: A Note," World Bank, 1999, p.11, http://siteresources.worldbank.org/DEC/Resources/civilwars_and_military_expenditures_anote.pdf.

13 Peng Lingxia, "Military Spending of Sri Lanka Increases by 20%," October 16, 2007, http://www.dsti.net/Information/News/44860.

14 Palitha Pathberiya and Albert Wijeweera, "An Overview of the External Debt Situation in Sri Lanka," p.7.

15 Annuals Reports 2010 and 2017, Central Bank of Sri Lanka.

remains the same, if not getting worse.

The depreciation of the Sri Lankan currency has been another factor in its growing debt burden. In 2009, the exchange rate between the US dollar and the Sri Lankan rupee was 1:115; in 2017, the rate became 1:152.5, marking a 24.6% depreciation of the Sri Lankan currency. The depreciation has magnified the amount that Sri Lanka needs to pay back in Sri Lankan rupee terms, since most of its external debt is denominated in the US dollar. On the other hand, a stronger dollar would raise the interest rate in the international market and therefore make it even more expensive to borrow abroad. If seen from a global perspective, developed economies such as the United States have now entered a period of recovery and are exhibiting improved economic performance, while the risks of emerging economies are growing. Accordingly, in order to hedge against these risks, more international investors tend to reinvest their capital into developed markets. This capital outflow has decreased the monetary reserves that Sri Lanka needs for economic reconstruction, and necessitates the option of borrowing from external sources.

Meanwhile, Sri Lanka's foreign exchange reserves have grown much slower than its external debt, which severely restricts its ability to repay debt. From 2009 to 2017, the foreign exchange reserves of Sri Lanka were between $5 billion to $8 billion. In 2017, the figure rebounded to $7.96 billion, which could only satisfy the country's import needs for 4.6 months.[16] During the same period, the foreign exchange reserves to debt ratio kept tailing off and has decreased from 25.6% in 2009 to 12.9% in 2016 (see Table 2). Although this ratio in 2017 increased again to 15.4%, it still indicates that Sri Lanka does not own enough foreign reserves to cover the payment of its external debt.

16 "Annual Report 2017," Central Bank of Sri Lanka, p.175.

Table 2 Foreign Exchange Reserves to Debt Ratio of Sri Lanka (2009-2017)

Year	Foreign Exchange Reserves (US$ billion)	External Debt (US$ billion)	Foreign Reserve to External Debt Ratio (%)
2009	5.357	20.913	25.6%
2010	7.196	24.830	29.0%
2011	6.748	28.851	23.4%
2012	7.106	37.098	19.2%
2013	7.495	39.905	18.8%
2014	8.208	42.914	19.1%
2015	7.304	44.839	16.3%
2016	6.019	46.586	12.9%
2017	7.959	51.824	15.4%

Source: Annual reports of Central Bank of Sri Lanka (CBSL)

The disappointing performance of Sri Lanka's external sector, as indicated above, is fundamentally determined by its disadvantaged position in the global economic system. First, many industries in Sri Lanka are far from fully modernized. Its main exports are textiles and clothes, tea and rubber products, of which the value added is quite low. In comparison, the prices of consumption goods, intermediate commodities and capital goods that Sri Lanka imports are growing more quickly than that of its exports, which has led to the deterioration of Sri Lanka's terms of trade[17] and the decreased capability of its exports to make a profit and accumulate foreign exchange reserves. Second, the United States and Europe are Sri Lanka's main export markets. Since the 2008 global financial crisis, the demand from these

17 Terms of trade refers to the relative price of imports in terms of exports and is defined as the ratio of export prices to import prices. It can be interpreted as the amount of import goods an economy can purchase per unit of export goods. See M. Obstfeld and K. Rogoff, *Foundations of International Macroeconomics*, Cambridge, MA: MIT Press, 1996, p.199.

markets has not been as robust as before. For this reason, the growth rate of Sri Lanka's exports has been slow. Most importantly, because of the long-lasting civil war, Sri Lanka has missed the period of East Asian economies' burgeoning growth in the second half of the 20th century, and failed to integrate itself into the flourishing East Asian production and trade network. Faced with the globalization trend at the end of the 20th century, Sri Lanka did not grasp the opportunity and fully utilize its geographical advantage to forge itself into the trade hub of the Indian Ocean and the point of connection between the West and the East.

Dependence on debt-driven growth pattern

Since the mid-20th century, many developing countries have sought external financing sources to support their domestic economic needs. Later this model became a globally popular formula. The money borrowed from external sources, on one hand, could pay for trade deficits and ease the shortage of financial resources faced by these developing countries, and could be used to establish productive enterprises and infrastructure to produce development momentum. On the other hand, external debt is different from internal debt in that it does not involve the redistribution of the society's existent wealth; instead, it means an increase of disposable capital and stimulates national economy in the short term. This quality of external borrowing is widely welcomed by newly-born developing countries whose economic development requires financial input.

Sri Lanka chose a similar path. In 1954, the Sri Lankan government borrowed its first external debt (Rs. 0.13 billion) from the World Bank and other international financial organizations to balance its trade deficit. By 1976, Sri Lanka's external debt had grown to Rs. 4.97 billion. After J. R. Jayewardene came to power in 1977, he expanded the scale of external borrowing. As a result, Sri Lanka's external debt reached Rs. 46.03 billion in 1983.[18] When the civil war broke out later, the Sri Lankan government was forced to keep on borrowing. The decreased trade and shrinking income as a result of the war made Sri Lanka incapable of paying back its external debt and it started to use the newly borrowed money to pay off the old debt. Once this "vicious circle" formed, it became self-reinforcing and gradually Sri Lanka has become mired in a cycle of continuous borrowing.

Nature of the external debt issue

The external debt problem of Sri Lanka, as shown above, is deeply rooted in the country's history and is mainly caused by structural constraints of its economy. Essentially, this problem is an issue of development; it is about the development path Sri Lanka has chosen to achieve high-speed growth after missing earlier historical opportunities. After the civil war, President Rajapaksa adopted the investment-driven growth strategy, making infrastructure projects top priority. This strategy serves two goals: one is to push Sri Lanka to integrate into the trade and logistics system of the Indian Ocean more quickly; the other target is to improve Sri Lanka's investment environment to attract more foreign investment. However, Sri Lanka itself cannot fully perform this strategy due to a severe shortage of capital. In this context, borrowing money from outside became the option for the Sri Lankan government.

If we look at where the borrowed money has been used by the Sri Lankan government, a clear divergence can be seen. Before 2009, the external borrowing was mainly used for two purposes, covering the trade deficit purchasing arms and military equipment. Instead of strengthening the country's productive capacities, both of these two subjects were fundamentally consumption costs and therefore not helpful in paying back the debt. In fact, the more money they consumed, the more reliant the Sri

18 Li Lisha, "Analysis of Sri Lanka's External Debt," p.39.

Lankan economy became on external debt. During this period, external debt acted as an "instant painkiller." After the civil war ended in 2009, the Sri Lankan government started to put the capital it borrowed into economic construction, infrastructure in particular. Productive investment thus started to increase, which is of vital importance for Sri Lanka to harvest continuous growth in the long run. The money borrowed abroad started to help the country get back on the normal track of development.

From the perspective of world history, whether a large-size debt default would happen actually does not depend solely on how much money a country has borrowed from outside, but is often determined by whether its government makes reasonable use of the money borrowed. "Reasonable" here has two meanings: one is reasonable purpose, indicating the money is used for expansion of economic productivity instead of one-off consumption, to ensure sustainability of capital; the other is reasonable management, referring to the careful arrangement of term structure, making sure the payment of debt is properly allocated over a period of years, in such a way that the government can make ends meet and avoid excessively concentrated debt-serving burden and even default crisis. The external debt crisis in several Latin American countries from the 1980s to 1990s was partly because these countries borrowed too much short-term external debt or issued too much floating rate bonds, and put them into projects requiring long time periods to yield economic returns. On the other hand, these countries had very limited income earning capacity from exports. When the international economic environment changed and interest rates dramatically rose, these countries were no longer able to service their debt and had no choice but to declare debt defaults, which led to severely downgraded ratings of their credit in the international capital market. By comparison, although Sri Lanka is shouldering a heavy volume of foreign debt, both the purpose and the term structure of its external debt is relatively reasonable; the government has not lost control of its external debt yet.

Implications for China-Sri Lanka Relations

China and Sri Lanka, as old friends, enjoy a robust and cooperative relationship. However, there have been increasing concerns and misunderstandings about Chinese investment in Sri Lanka. The external debt issue in particular is casting shadow on the friendship.

China's role in Sri Lanka's external debt problem

It is a fact that China is playing some role in the external debt issue of Sri Lanka, but it is definitely not the primary cause of problem. To begin with, China did not become the main creditor of Sri Lanka until recent years. The present situation of Sri Lanka's external debt is more a result of historical accumulation. The biggest creditors of Sri Lanka used to be Japan, Europe, the United States, the IMF and other international financial institutions. China did not appear on the list until the beginning of this century. According to the data of CBSL, from 2019 to 2022, the debt service payment to China would only account for a small part in Sri Lanka's total external debt service; most of the service payment would go to commercial creditors and the Asian Development Bank, among others.[19] Second, China is in fact not the first country that the Sri Lankan government turned to for investment. For example, the Hambantota port project, as MP Namal Rajapaksa, the eldest son of former President Mahinda Rajapaksa, once put it, "was initially offered to India, but they did not get back."[20] It was later

19 M. K. Bhadrakumar, "Rethink on Sri Lanka's Rajapaksa Is Timely. Make Sri Lanka a Playfield of 'China-India plus One'," *Indian Punchline*, November 1, 2018, https://indianpunchline.com/rethink-on-sri-lankas-rajapaksa-is-timely-make-sri-lanka-a-playfield-of-china-india-plus-one.

20 "India Misread Our Ties with China: Namal Rajapaksa," *The Hindu*, February 7, 2017, https://www.thehindu.com/todays-paper/tp-international/India-misread-our-ties-with-China-Namal-Rajapaksa/article17244242.ece

that Sri Lanka turned to China for financial support. Last, different from IMF strict requirements for economic and financial reforms, there are no political conditions attached to Chinese investment, and China sticks to the principle of non-interference in others' internal affairs, leaving the Sri Lankan government to decide where to invest the capital. Investment from China has been mostly used for infrastructure construction, which is the priority of the Sri Lankan government and will do much good to Sri Lanka's long-term economic growth. China-Sri Lanka economic cooperation is based on the strategic cooperation partnership and long-lasting bilateral friendship between the two countries. Also, the specific terms of cooperation were negotiated by the two sides on the basis of equality, which is fundamentally different from the "creditor imperialism" that the West once pursued. In the 21th century, every sovereign country has the right and freedom to decide its own development path.

China has been one of Sri Lanka's main creditors in recent years. When President Rajapaksa assumed power in 2005, his government strived to eliminate the Liberation Tigers of Tamil Eelam. However, the efforts caused sharp criticism and trade sanctions on the country imposed by the United States and other countries. Only China chose to stand by Sri Lanka's side and provided large amounts of economic assistance. After 2009, this cooperation pattern continued. Apart from multilateral financial institutions and other commercial creditors, China has become the No.1 source of Sri Lanka's foreign investment, who provided $1.2 billion in loans in 2009; this amount was nearly three times the $0.42-billion credit that was offered by the Asian Development Bank.[21] According to data of Chinese Embassy in Sri Lanka, Sri Lanka' s debt to China till 2017 has grown to nearly $5.5 billion, accounting for 10.6% of its whole external debt volume ($51.82 billion). To conclude, China has already become

21 Joe Leahy, "Sri Lanka Builds on Chinese Support," *Financial Times*, May 24, 2010, http://www.ftchinese.com/story/001032737/en?archive.

one of the main investors as well as creditors in Sri Lanka.

Nevertheless, as the data shows, the percentage of the money Sri Lanka owes to China is not predominantly high in the country's total debt. China is just one of many creditors of Sri Lanka. Also, nearly 61.5% of the loans Sri Lanka borrowed from China are concessional loans. This ratio is much higher compared with the ratio of concessional loans in the whole external debt of Sri Lanka, which is 48.8%. In this sense, China's loans to Sri Lanka are not the cause of Sri Lanka's overwhelming debt; on the contrary, it somehow manages to help release the strain by offering more concessional loans than other creditors.

Debt anxiety toward Chinese investment

Now that China is not the primary cause of the external debt problem in Sri Lanka, why is there this impression that China has created the entire burden? This is more of the psychological feeling of debt anxiety, which could be observed in the suspension of the Colombo Port City project in 2015 after President Sirisena took office. The debt anxiety keeps on afflicting China-Sri Lanka relations.

The reasons for this debt anxiety are complicated, including the asymmetric structure between the two economies and the dominant position of Chinese enterprises in investment and projects with low participation from the Sri Lankan side. Also, the partisan hysteria in Sri Lankan politics contributes in nurturing unseasonable sentiments. Additionally, negative reports in some influential media that maliciously depict Chinese investment in Sri Lanka continuously fuel the emotional unrest.

First, the bilateral trade between the two economies is unbalanced, in which Sri Lanka is at an unfavorable position and seems more dependent on China. In 2017, the direct investment from China accounted for 35% of Sri Lanka's total FDI inflows. For Sri Lanka, China is the No.1 source of FDI inflows, the second largest source of imports (18.9% of its total imports) and the sixth biggest market for its exports. Sri Lanka's trade deficit with Mainland China reached $3.78 billion, accounting for 38.3% of its trade deficit with all trade partners. If its trade deficit with Hong Kong was added, the percentage would exceed 40%, making China the country with which Sri Lanka runs the largest trade deficit.[22] In comparison, Sri Lanka is China's 83rd largest trade partner, the 54th largest destination of exports and ranks 102nd in its source of imports. Although the asymmetric structure of China-Sri Lanka economic cooperation is determined by the strength of the two economies, some Sri Lankan scholars and politicians are still very sensitive to the imbalance, even wrongfully accusing China of being a "threat" to Sri Lanka.

Second, there are concerns about the operational mode of Chinese enterprises in Sri Lanka. For a long time, a pattern has been followed where projects are financed by China and contracted with Chinese state-owned enterprises. Many Chinese companies have adopted the Engineering Procurement Construction (EPC) procedures and undertaken most work from feasibility studies in the beginning to final construction. Besides, due to lack of local technical personnel, it is often the case that Chinese companies send their engineers to Sri Lanka to perform after-sales service. While this mode is convenient for Chinese companies to control schedule and budget, for Sri Lanka it creates a sense of loss and the feeling of being excluded.

Concerning the pattern of funding, most projects invested by China are funded by the Export-Import Bank of China and China Development Bank, and engineering contracts are the usual way Chinese enterprises operate in Sri Lanka. As of June 2017, the amount of engineering contracts Chinese firms signed in Sri Lanka had accumulated to $18.6 billion, in which $13.5

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22 Li Yanfang, "Re-shaping China-Sri Lanka Economic Relations under Framework of 21st Century Maritime Silk Road," *South Asian Studies*, No.2, 2017, p.38.

billion worth of projects have already been finished.[23] Most of these contracts are concentrated in the field of infrastructure, especially ports, roads, electric power stations and other large-scale public facilities. It is reported that during the period from 2009 to 2015, 70% of Sri Lanka's infrastructure was financed by China and constructed by Chinese enterprises.[24]

There are many realistic reasons why many Chinese enterprises have adopted such an operational model. In these engineering contracts, the Chinese financing pattern ensures the money flows between Chinese financial institutions and Chinese enterprises. These enterprises are usually state-owned companies with affluent capital reserves and rich business experience. Therefore, they are more credit-worthy in the Chinese financial system and it is easy for them to acquire preferential facilities provided by Chinese financial institutions. In order to keep down costs and meet the deadlines, Chinese enterprises prefer to have control over the whole process from design to construction. Last, Chinese enterprises tend to employ Chinese workers, as employing Chinese staff could completely avoid differences in culture, language or lifestyle, and communication between employers and employees would be easy. Also, due to different knowledge systems of China and Sri Lanka, it is difficult for Chinese companies to find enough qualified Sri Lankan technicians. On the other hand, Chinese enterprises have only started to operate overseas lately, and they lack experience in dealing with foreign legal systems and labor unions. Under these circumstances, hiring Chinese workers has become a realistic and preferable option.

However, this mode of investment may lead to a sense of grievance among local people. Due to the fact that Chinese companies undertake

23 "Briefings of Bilateral Economic and Trade Cooperation between China and Sri Lanka," Department of Asian Affairs, Ministry of Commerce of China, http://yzs.mofcom.gov.cn/article/t/201709/20170902651439.shtml.

24 Debasish Roy Chowdhury, "Let Bygones Be Bygones, Colombo Urges Beijing, as Chinese Loans Take Their Toll," *South China Morning Post*, October 18,2015, https://www.scmp.com/business/global-economy/article/1869177/let-bygones-be-bygones-sri-lanka-urges-china.

most of the funding, designing and construction job, their operations in Sri Lanka seem quite exclusive. Also, as infrastructure construction, where Chinese investment is concentrated, usually takes a long time to complete, relevant projects do not create instant benefits; in the short term they do not produce substantial positive effects on local people's livelihood. Besides, hiring Chinese technicians and workers, though convenient and sometimes necessary for Chinese enterprises, does not make local people feel comfortable, as they believe they themselves are supposed to acquire these job opportunities. Finally, the land leasing issue and the ownership structure of certain enterprises would also bring about local people's complaints toward Chinese investment. If not handled properly or explained explicitly, the issues would precipitate many concerns about the fairness and reciprocity of China-Sri Lanka economic cooperation.

In addition, although China is the largest source of FDI in Sri Lanka, if compared with the $18.6-billion worth of engineering contracts, the amount of Chinese FDI flows to Sri Lanka ($1.12 billion) is quite slim. Engineering contracts are featured by nonrecurring one-time deal, while FDI would continuously contribute to local employment and tax revenues. This comparative shortage of direct investment may also lead to increasing discontent among local residents.

The investment model that many Chinese enterprises follow in Sri Lanka is determined by the comparative positions of the two countries and their different stages along the global production chain. For Sri Lanka, it is endowed with a strategic geographic position at the center of the Indian Ocean sea lanes, which, if made full use of, could be helpful in transforming this island country into a business, logistics and aviation hub of the Indian Ocean. To achieve this grand vision, accessible infrastructure and an advanced port industry are of primary importance. In a word, Sri Lanka has a great need for high-standard infrastructure. On the other hand, China is rich in production capacity, including the manufacturing capacity of iron and steel, cement and automobiles, machine tools, ships, electricity generation equipment and high-speed railways. Chinese products in these industries are of good quality and comparatively cheaper price. According to David Ricardo's classic theories of international trade, every participant in international trade benefits if they follow the principle of comparative advantage. In this sense, both Sri Lanka and China would benefit from bilateral trade and infrastructure cooperation.

However, the situation in other industries may not be so optimistic. Sri Lanka is an island country with limited population; both its domestic market and labor force are limited. These features have determined that Sri Lanka is not as attractive to labor-intensive enterprises as some ASEAN or African countries. More importantly, due to the long-lasting civil conflict, Sri Lanka has been staying out of the global production network and the East Asian trade chain. The level of trade connectivity and economic integration in Sri Lanka's neighborhood, namely the South Asian region, is one of the lowest around the world. The traditional regional organization, the South Asian Association for Regional Cooperation (SAARC), has failed in promoting regional economic integration. As a result, although Sri Lanka has signed free trade agreements with India and Pakistan, and is also a member of SAARC, the trade relations are still limited within bilateral fields and neither the regional market nor its supply chain can give Sri Lanka enough boosts to develop its industries, especially the manufacturing industry. Besides, without enough infrastructure, it is difficult to transport commodities from inland areas to ports for export. These factors explain why at this stage Chinese FDI is much lower than its engineering contract volume in Sri Lanka.

Third, the topic of Chinese investment has been frequently manipulated in the domestic political brawl of Sri Lanka. The issue of external debt is, at present, one of the most salient issues in Sri Lankan public discussions.

Unfortunately, since Chinese investment is concentrated in infrastructure construction and has come to Sri Lanka with large amounts in a short period, it is most noticeable and could easily be used to attract public attention. Also, infrastructure building naturally involves issues such as financial terms, land acquisition and labor rights. In order to win public support, some politicians tend to speculate on these issues and label themselves as "representing people's interests" by opposing every decision made by the government, including cooperation with China. Chinese investment in Sri Lanka is fundamentally a business practice based on the two sides' consensus. However, this regular cooperative activity, though not flawless, is often misread with partisan bias, which would degrade the image of Chinese enterprises and is likely to nurture people's negative impressions toward Sino-Sri Lankan cooperation.

Last, negative international reports concerning this issue by some media could easily exert a self-reinforcing adverse effect. On one hand, countries like the United States and India are highly sensitive about Chinese investment in Sri Lanka. Some reports are not so objective and tend to neglect the benefits brought by China-led infrastructure projects, only exaggerating the flaws and shortcomings and even seeking to politicize economic issues, accusing China of deliberately trying to trap Sri Lanka in debt, and "dangling debt relief in exchange for its military's use of assets."[25] Such reports have strengthened some Sri Lankans' negative opinion toward Chinese investment. To make it worse, a self-reinforcing circle has been constructed since these misleading opinions are used as evidence to prove to the globe that the Sri Lankan public is holding grudge against China. In this sense, these reports could severely discredit Chinese investment and the Belt and Road Initiative.

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25 Maria Abi-Habib, "How China Got Sri Lanka to Cough Up a Port," *The New York Times*, June 25, 2018, https://www.nytimes.com/2018/06/25/world/asia/china-sri-lanka-port.html.

Influence of the external debt issue

Dating back to ancient times, the friendship between China and Sri Lanka enjoys strong historical basis. Religious and cultural interactions are frequent, and the two countries have become closer through long-time commercial and trade exchanges.

Political mutual understanding and economic win-win cooperation are the two most important pillars and anchors of Sino-Sri Lankan relations. These two elements have been bearing the strong bilateral relations since the establishment of diplomatic ties. In the 1950s, the two countries re-initiated this friendly relationship on the basis of the "Five Principles of Peaceful Coexistence," with both sides putting great emphasis on their sovereignty and independence, as well as the tradition of close coordination and being supportive of each other in regional affairs. Their early economic and trade cooperation was cemented in 1952 when they signed the Rubber-Rice Pact despite objections from Western countries, opening a window for the two traditional friends to support and communicate with each other again. On February 7, 1957, China and Sri Lanka established diplomatic ties and continued their deep-rooted friendship. The political mutual understanding and close economic cooperation were relatively rare under the circumstances of the Cold War. In that era, the foreign policies of most countries, whether political or economic ones, were basically and principally driven by ideology.

This special relationship has been much treasured by both sides. Sincere support of each other can be observed in every phase. During the Sri Lankan civil war, China stuck to its non-interference principle, and offered diplomatic support for the Sri Lankan government in the international arena. While Western countries imposed severe sanctions on Sri Lanka, China provided large amounts of economic assistance, which made the bilateral friendship even closer. The two countries have also worked together very closely on international multilateral occasions to support and help each other.[26] In 2013, China and Sri Lanka established a strategic cooperative partnership and since then have made new progress in pragmatic cooperation. The relationship is beneficial for both countries' fundamental and long-term interests and reflects the respect that each has for the other's development path.

Fluctuations of course are inevitable in any bilateral relations. In 2015, President Maithripala Sirisena's new government suspended the Colombo Port City project constructed by Chinese enterprises. However, after friendly consultation and coordination, the government decided to continue the development of the Colombo International Financial City to build an international financial and business district next to Colombo's main port, and China Communication and Construction Co. Ltd. dropped its claim for $143 million in compensation for delaying the project by almost one year. The project now continues, with the prospect of creating about 83,000 jobs and attracting more than $13 billion in FDI from outside investors including India, Singapore, Malaysia and China.[27]

China always cherishes and preserves the strong development momentum of bilateral relations. It is willing to maintain close high-level exchanges, strengthen friendly ties between political parties and governmental departments of the two sides and constantly consolidate and enhance political mutual trust. The Chinese government is also pushing for more people-to-people exchanges with the Sri Lankan people, promoting more Chinese tourists to visit Sri Lanka and experience its culture. The government also keeps encouraging Chinese companies to invest in Sri Lanka, not only to actively participate in projects like construction

26 "China-Sri Lanka Ties Going Strong at 60," Sri Lankan Department of Government Information, February 21, 2017, https://www.dgi.gov.lk/news/features/667-china-sri-lanka-ties-going-strong-at-60.
27 Shihar Aneez and Ranga Sirilal, "Sri Lanka to Allow Chinese Port City Project after Delay," *Reuters*, January 12, 2016, https://www.reuters.com/article/sri-lanka-china-portcity-idUSL3N14W42G20160112.

and management of ports, neighboring industrial zones and transport infrastructure, but also to explore the potential of investing in Sri Lankan manufacturing and agricultural processing industries, among others, in the hope of fostering new momentum of economic cooperation. Besides, China will fulfill its promises to assist Sri Lanka in carrying out livelihood projects such as a hospital for kidney patients, the outpatient building of the National Hospital and a water quality monitoring center. Today, many projects like these have become new landmarks for friendship between the two countries.[28]

The loans issue, if observed independently, is one facet of the comprehensive economic cooperation between Sri Lanka and China. The economic ties between the two countries are broader than this, and more resilient than what some believe them to be. Nevertheless, questions are always more attention arresting than achievements. Because of unbalanced structure of the two economies, it is easy for the relatively weak party to feel suspicious of the stronger party's motivations. Also, the imperfections in Chinese enterprises' operations mentioned above could be easily misinterpreted and manipulated. As a result, the debt issue between the two countries, especially the "debt anxiety" on the Sri Lankan part, could be magnified through political and social channels, with bigger influence beyond the traditional financial and economic arena. If it gets worse, this debt anxiety could even bury all the good merits of bilateral cooperation.

Besides, the geopolitical game in the Indian Ocean region has become more complicated than before. The Indo-Pacific strategy of the United States, the "Free and Open Indo-Pacific" concept proposed by Japanese Prime Minister Shinzo Abe, and India's "Mandala system" and "Neighborhood

28 Yi Xianliang, "Deep-Rooted Friendship: 60th Anniversary of the Establishment of China-Sri Lanka Diplomatic Relations," Daily News, February 10, 2017, http://www.dailynews.lk/2017/02/10/features/107241/deep-rooted-friendship-60th-anniversary-establishment-china-sri-lanka.

First" policy, all focus on the important geopolitical and geo-economic status of the Indian Ocean. Under these circumstances, Sri Lanka has made some adjustments to its foreign policy to achieve a balance among these powers. As the smaller part in this game, it is reasonable for Sri Lanka to adopt such a balancing policy and improve its relations with all big powers, including China, India and the US. Sri Lanka may also feel insecure about its economic reliance on China and hence take a more prudent attitude toward its economic cooperation with China. On the other hand, the tremendous improvement of domestic and external environment has made it convenient for Sri Lanka to recalibrate its policies. With the end of the Sri Lankan civil conflict, Western countries lifted their sanctions, and countries including Japan, the US and India started to offer economic assistance and concessional loans to Sri Lanka. The geopolitical competition has elevated Sri Lanka's geographic position and made its strategic importance more evident both regionally and globally. Sri Lanka has become one of the key small states in the international community. As a result, China is no longer the only partner that Sri Lanka can turn to for economic cooperation. This is another important change in the dynamics of China-Sri Lanka relations.

Conclusion

With the end of the civil conflict in 2009, the Sri Lankan economy has embarked on a fast growth track. In company with this growth, its external debt has continued to increase and risks of this issue have been accumulating. To some extent, the external debt problem has become a matter that haunts the Sri Lankan economy.

As a close friend and a lasting partner, China has always supported Sri Lanka's development. During the past years, China has provided a large amount of investment for Sri Lanka's economic construction. However, the debt issue originating from the investment has become an overwhelming topic in Sino-Sri Lankan relations at present. As the Belt and Road Initiative progresses around the world, the debt issue between the two countries has also attracted much attention internationally.

The reasons why some Sri Lankans feel anxious about Chinese investment in their country are complicated. The asymmetric structure of China-Sri Lanka trade and investment, the comparatively inward-looking feature of the operational mode of Chinese enterprises, and negative reports in some media all contribute to this debt anxiety problem. This feeling essentially mirrors Sri Lanka's reflections and worries about its ingrained habit of debt-driven growth and its disadvantageous position in the global economic system. These reflections will continue for a long time and could exert far-reaching influence on Sri Lanka's domestic and foreign policies. As the external debt issue ferments, Sri Lanka is now recalibrating its China policy and trying to achieve a balance among great powers. Concerning economic cooperation, China is still Sri Lanka's most important cooperative partner. In the meantime, Sri Lanka is trying to diversify its partner choices by expanding cooperation with India, Japan and many international organizations. In the diplomatic arena, Sri Lanka is taking full advantage of its critical geopolitical position to achieve balance among these powers in order to realize the largest national interests and reduce its reliance on one specific power.

With all this in mind, China should stick to its firm support for Sri Lanka on one hand and make some changes in specific policies accordingly on the other hand. As Chinese President Xi Jinping pointed out when he met Sirisena in 2016, "China is ready to work with Sri Lanka to inherit and carry forward the China-Sri Lanka friendship carefully cultivated by generations of people."[29] China will continue to make efforts to push its traditional

29 "Xi Jinping Meets with President Maithripala Sirisena of Sri Lanka," Chinese Ministry of Foreign Affairs, October 17, 2016, https://www.fmprc.gov.cn/mfa_eng/zxxx_662805/t1406780.shtml.

friendship with Sri Lanka toward a new stage. In the meantime, China is set to promote the five major goals under the framework of the Belt and Road Initiative, namely policy coordination, facilities connectivity, unimpeded trade, financial integration and people-to-people bonds. It is happy to see Sri Lanka continue playing an active role in the Belt and Road Initiative.

Chinese enterprises should also make improvements in their specific investment and cooperation models. From a long-term perspective, what threatens a developing economy like Sri Lanka is not the size of its external debt, but whether it is able to transform foreign investment into its own economic capacity. In order to help relieve Sri Lanka's debt anxiety, and most importantly, to help the country acquire its own economic advantages, Chinese enterprises should explore more space for bilateral cooperation in industries such as manufacturing and tourism and assist Sri Lanka in developing its advantageous industries. A more open market for Sri Lankan commodities would also help mitigate its trade deficit stress. Besides, it is advisable for China to provide Sri Lanka with more public facilities such as hospitals and schools.

To conclude, Sri Lanka is an important partner of China. Right now, Sri Lanka is threatened by mounting risks concerning the external debt problem, which has complicated reasons. Although China is one of the main creditors for Sri Lanka, it is not the primary cause of problem. In the face of Sri Lanka's debt anxiety, China should continue to support its economic development. The practice of economic cooperation between the two countries could be a good example for the implementation of the Belt and Road Initiative, of which Sri Lanka is an important participant. Therefore, it is necessary for China to properly address Sri Lanka's concerns about the debt issue and push for better coordination of their development visions.