

China's Dilemmas in Bailing Out Debt-Ridden Sri Lanka

Ganeshan Wignaraja

To mark the 65th anniversary of bilateral diplomatic relations, Chinese Foreign Minister Wang Yi met with President Gotabaya Rajapaksa in Sri Lanka on 10 January 2022. The meeting occurred amidst the rapid global transmission of the Omicron virus, talk of Sri Lanka defaulting on its foreign debt repayments, and an economic slowdown in China. Whether China will bail out debt-ridden Sri Lanka or Sri Lanka should seek IMF assistance are pressing policy questions.

Sri Lanka had visible macroeconomic imbalances before the Covid-19 pandemic, as indicated by slowing growth, considerable fiscal and balance of payments deficits, and high external debt. The pandemic and strict containment measures caused an [unprecedented economic contraction](#) with negative growth of -3.6% in 2020. Subsequently, a half a million people in urban areas and the informal sector were added to the world's ['new poor.'](#) Despite the pandemic's toll, an economic revival during the first nine months of 2021 suggests 3-4% growth for the year. But growth in 2022 could be lower as the economy faces many downside risks like the spreading Omicron virus, worsening foreign debt, rising inflation, social tensions, and waning business confidence.

A steeply rising fiscal deficit meant that the external debt problem deteriorated during the pandemic. The government scrambled to implement measures to mitigate the contraction. At the same time, tax revenue fell to historic lows due to reduced activity in major commercial sectors, job losses, and previous income tax cuts. As a result, foreign debt levels totaled more than \$35 billion in April 2021. Moreover, Sri Lanka's foreign exchange reserves, which back the next five years of annual debt repayments of \$4-5 billion, are dangerously low. Furthermore, Sri Lanka has lost access to international bond markets as rating agencies, concerned about Sri Lanka's ability to service its debt, have downgraded its sovereign ratings to historic lows. The debt problem results from populist spending policies, the costs of a thirty-year civil conflict, a transition from grant aid to foreign commercial borrowing, and a notable currency depreciation.

China and Sri Lanka have enjoyed warm diplomatic ties since Sri Lanka first recognized China in 1950, supporting China's accession to the United Nations and signing a rubber-rice barter deal in 1952. More recently, China's global ascent has moved its diplomatic relations with Sri Lanka in a more commercial direction.

The Chinese debt trap remains controversial. Since the early 2000s, China has become a leading provider of commercial loans to Sri Lanka for infrastructure projects, including the Hambantota Port. There are claims that by accepting such loans, Sri Lanka is now stuck in a ['debt trap'](#). However, [the debt trap is not wholly Chinese](#). About half of Sri Lanka's foreign debt was owed to capital markets while [China accounted for about 10 percent](#) in April 2021. In January, during the high-level talks, Sri Lanka reportedly requested that China restructure its debt repayments and award it a \$1 billion concessionary credit facility for imports. Sri Lanka's request has created a dilemma for China. China does not want to lose Sri Lanka's friendship or the commercial opportunities accompanying it. However, China worries that unilaterally granting Sri Lanka moratoria or debt restructuring would create a new precedent in its lending practices. It does not want to end up in similar negotiations with other distressed developing countries that have received large amounts of

Dr. Ganeshan Wignaraja, a Non-Resident Senior Fellow at the Institute of South Asian Studies (ISAS) of the National University of Singapore and a Senior Research Associate at the Overseas Development Institute, explains that "Sri Lanka is now stuck in a 'debt trap'. However, the debt trap is not wholly Chinese."

Chinese loans. Moreover, an economic powerhouse like China may not want to be associated with a floundering economy. Thus, it is unclear whether China will agree to Sri Lanka's request.

The United States has also tried to assist Sri Lanka with mixed success. In April 2019, a [sizeable outright grant](#) of \$480 million over five years was offered to the government by the Millennium Challenge Corporation (MCC) compact for infrastructure development. However, indecision and delays by the government partly led the MCC Board to withdraw the offer in December 2020. Since the start of the pandemic, the United States has provided medical and humanitarian aid on a grant basis, most notably 3.4 million doses of the effective Pfizer vaccines for booster shots which are welcome in Sri Lanka.

The government has ruled out going to the IMF for assistance due to worries that the austerity policies the IMF demands, a floating exchange rate, higher taxes, public expenditure cuts, and the removal of subsidies for food or fuel, would be politically unpopular. But the advantages of IMF assistance—such as a low-interest loan to bail out Sri Lanka, the ability to borrow from international capital markets once again, and the benefit of IMF financial advice—seem to have been underplayed.

Instead, the government has opted for a raft of home-grown remedies, including an expansionary monetary policy, import restrictions, exchange controls, leasing of state land to investors, and a tourism and export push. Unfortunately, the limits of these policies are showing up in shortages of consumer goods and raw materials, rising inflation, a dollar shortage, capital flight, strikes, and falling business confidence. No one imagined that economic management was easy, but it is harder than usual during a pandemic-induced crisis.

Sri Lanka must undertake three urgent actions to address its economic woes:

- First, a national conference involving major political parties should be convened to forge a political consensus on the scale of the economic crisis and its policy implications.
- Second, a team of domestic experts should be tasked with developing a comprehensive structural reform program to stabilize, deregulate, and green the economy. Reforms should also strive to mitigate the hardship of the crisis on the citizens. To this end, drawing on [existing work by think tanks](#) can be helpful.
- Third, Sri Lanka should start talks with the IMF on a program of debt restructuring and financial assistance. There is a mounting risk that time is running out to deal with these challenges in an orderly manner. A disorderly default on foreign debt payments could hurt the economy for many years.

Rather than entertaining a bilateral approach to rescuing Sri Lanka, China can usefully add its powerful voice to calls for Sri Lanka to seek IMF assistance and channel technical assistance funds through the World Bank to support work on a structural reform program. The United States should continue medical and humanitarian aid to Sri Lanka, which directly benefits the population and expand support for private sector development and exports.

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