

# The Debt-Trap Diplomacy Revisited: A Case Study on Sri Lanka's Hambantota Port

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## Abstract

There is a strong case to reconsider the “debt-trap diplomacy” of China. The narrative that holds “Chinese loans are responsible for the debt-crises plaguing under developed and developing countries” (The Maritime Executive, 2019) needs a critical reexamination and, perhaps, a rethink in our geostrategic and geopolitical calculations. This paper is a case study on Sri Lanka's Hambantota port, an asset handed over to China on lease for 99 years in the year 2017, which the dominant narrative claims to be a significant foreign policy debacle engineered by the Chinese. An inquiry into the crisis, however, traces its development back to the country's fiscal management and macroeconomic realities that, the study argues, impelled Sri Lanka to take the tough call it did. Sri-Lanka is beset by twin deficits, among other macro-economic challenges, forcing its authorities to embark on external financing to meet fiscal expenditures, especially for the infrastructure projects. While the bulk of external capital comes from traditional creditors such as IMF and World Bank, the loan for the Hambantota project was sanctioned by China. Assessments from experts ruled out the economic potentiality of the project, owing to its commercial non-viability and logistical challenges. This decidedly prompted authorities to discontinue the project and the immediate consequence of which was difficulty in

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revenue generation, translating into substantial constraints on the fiscal front resulting from the country's soaring debt-servicing cost. Faced with a series of international sovereign debt-payment obligations lined up in the years 2020 and 2021, Sri Lanka finally gave up its non-productive asset in exchange for some extra foreign exchange reserves to meet the debt obligations lined up in the years ahead. Out of some 3000 infrastructure projects where China has invested in, the Hambantota port was the only one used as a textbook example for "the Debt-trap diplomacy." However, drawing from objective analyses and empirical studies this case study finds no evidence for "Debt-trap diplomacy."

**Keywords:** Diplomacy, debt, Chinese loans, fiscal policy, and macro-prudential analysis.

## 1. Introduction

China is rapidly increasing its economic expansion and geopolitical (over) outreach over the last decade. Through various forms of economic diplomacy and geostrategic positioning, China has enlarged its trade and investment footprints across the board. However, its growing engagement with smaller nations of the South-Asian region has drawn attention from policymakers, academics, and in particular, strategists concerned with China's ascension and its implication for the existing global order. Of late, there have been growing concerns among the strategic community including India's, that Chinese ties with countries such as Bangladesh, Pakistan, and Sri Lanka could potentially result in the "String of pearls," a theory that Chinese military bases would encircle India and expand its overseas presence.

A more in-depth analysis of Chinese engagement with smaller countries in South Asia suggests that the dynamics of these relationships are much more complicated. For one, each of these countries is at different stages of engagement, and everyone is learning from each other's experiences. Each one of them retains agency in their relationship with China, India, and the United States (hereon USA), in so far as domestic factors heavily influence foreign policy in these countries. Also, according to reports, these

countries' military ties with China pales in comparison with their ties with India, and even the USA. However, amidst all these growing concerns, emerges a dominant geopolitical narrative called the Debt-trap diplomacy. The narrative suggests the following; the recent Chinese heavy lending under the ongoing BRI (Belt and Road initiative) could entrap participating countries by encumbering them with heavy debts that countries as a response measure cede their sovereign rights to China in return for the use of their territory's infrastructure. "Debt-trap diplomacy," broadly defined, is where a creditor country intentionally lends excessive credit to a smaller debtor country, intending to extract economic or political concessions when the smaller country cannot service the loan (Doherty, 2019). This narrative stemmed from the recent spree of exuberant Chinese largesse in infrastructural investment in the continents of Asia and Africa. According to analysts, such investments are often associated with severe consequences for recipient countries, one of which is debt-crisis. Out of more than 3,000 projects of various kinds financed by Chinese banks, Hambantota is the only one that has ever been used as evidence for "debt-trap diplomacy" (Brautigam, 2019). According to this case study, there is very little evidence to support such a claim. In fact, a deeper analysis of the crisis points to possible causes emanating from within than from without.

## **2. Hambantota port**

The Hambantota port was a billion dollar project envisaged by the Sri Lankan government expected to have delivered, among other things, commercial benefits and logistical feasibility. The main objective of this project was to increase ship-traffic along the east-west shipping route located just ten nautical miles south of Hambantota, which would be achieved by easing pressure on the Colombo port, one of ' 'Asia's most important container terminals. The project commenced in 2008 under the administration of President Mahinda Rajapaksa. Having now renamed "the Magampura Mahinda Rajapaksa Port," the first phase of the project was declared open in November 2010. Construction of the first phase cost USD 361 million, out of which 85% was loaned by the EXIM Bank of China at a 6.3% interest rate. According to

assessments from leading consultancy firms, Hambantota was not particularly an economically viable proposition. Situated in a fairly remote location, there are virtually no industrial hubs near Hambantota. This would make it difficult to generate income as prospects of commercial activity in and around the port are low, and therefore, potentially no natural customer to its doorstep, claim experts. The construction came to a halt in 2010 owing to political instability and, for the most part, the undeniable revelation that the port made not much logistic or economic sense. It was a case of political expediency overriding commercial feasibility. No sooner than the new government came to power, decisions were underway to divest the non-productive asset. Struggling to service the debt, Sri-Lanka, in 2017, according to mainstream media reporting, negotiated a “debt-to-equity swap agreement” with China Merchant Port Holdings Limited (CM Port) and leased Hambantota port for 99 years.

There are considerably three motivations behind the high-profile Hambantota project. To start with, Hambantota had long been considered a potential port location because of its proximity to sea lanes, thereby making it convenient for refueling. Secondly, the need to rebuild Hambantota after it had been devastated by the Indian Ocean Tsunami in 2004. Yet despite these pragmatic concerns for the project, one important driver for the effort was Sri Lanka’s domestic stability and security (Samaranayake, 2019). Situated in an arid zone and salt-producing region of the southern part of the island, Hambantota’s underdevelopment was believed to be a source of conflict and discontent during the Janatha Vimukthi Peramuna (People’s Liberation Front, or JVP) insurgency in the 1980s. Even a minister from the opposition opined that the project “will usher economic transformation in the country, especially in the Southern and Uva provinces.” (Samaranayake, 2019)

Despite being a subject of much criticism from experts for its poor implementation, the Sri Lankan leaders nonetheless sought to invest in the Hambantota project in light of the country’s experience with natural disaster, insurgency, and an overarching post-conflict ambition to position Hambantota as a regional and

global trade hub within Asia and to East Africa (Marithyas, Perera & Yehiya, 2016).

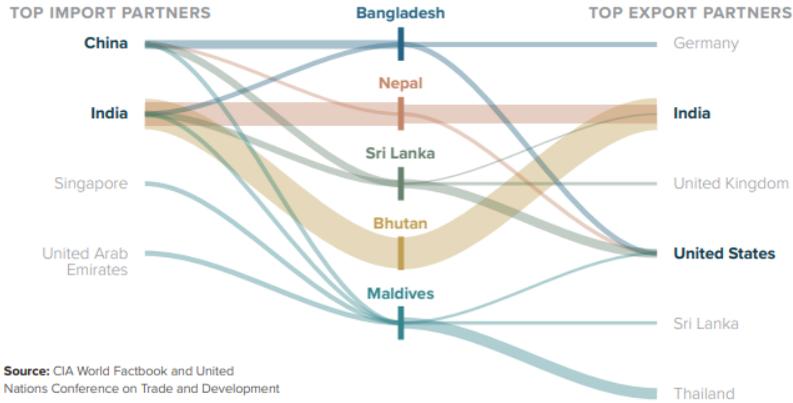
### **3. Diagnosis of the crisis**

Although what transpired in December 2017 between the two authorities viz. Sri Lanka and China resulted in major foreign policy failure, a more in-depth analysis of the event, questions the veracity of such claims to have even qualified as a crisis in the first place. Unpacking the macro-economic reality of the Island nation throws light into the crisis with critical insights that challenge the dominant narrative “Debt-Diplomacy.”

Sri Lanka’s economy experiences a set of complicated policy challenges on the structural front. The country is beset by overstretched fiscal positions and persistent trade deficits, famously characterized as twin deficits. The former signals that a country’s national expenditure far exceeds its ability to generate revenue, and the latter suggests a severe lack in the production of tradable goods and services. Such economies can be buffeted by high levels of debt, heavy dependence on foreign capital inflows, a steady depreciation of its currency, and high-interest rate.

According to studies by a leading policy expert, in the years between 2006 and 2014, Sri Lanka’s economic growth and development became heavily reliant on a public investment led infrastructure drive (Weerakoon & Kumar, 2019). The lack of domestic wherewithal and capital to support the massive infrastructure projects left the country with a tightened fiscal space to meet the public spending objectives. Understandably, this had prompted authorities to embark on external sources for development finance. And among many other creditors, China’s recent heavy lending and aggressive involvement in the country’s development process has drawn much attention from the world. By 2005, China had topped the list of development assistance providers to Sri Lanka, and overtaking Japan in 2010 in development disbursements. Economic ties between the two countries increased under the leadership of President Mahinda Rajapaksa (2005-2015), which grew even more during the incumbent President Maithripalala Sirisena.

China is the largest source of imports for Bangladesh and Sri Lanka, the second largest for Nepal, and the third largest for Maldives, but it is notably not a top market for the SSA countries' exports. Lines are proportional to the percentage of imports (exports) from (to) the trade partner.



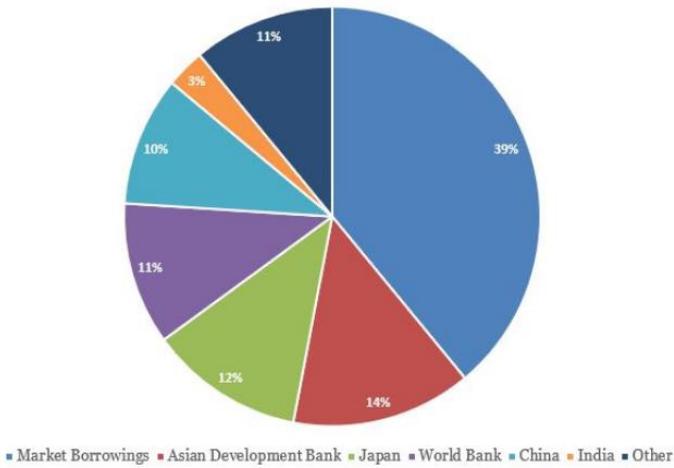
When it comes to trade, China is the second-largest importer after India. On the export front, China is Sri Lanka’s sixth-largest destination, while the United States tops the list. More important for the economy is FDI inflows that boost foreign reserves, which allows the country to repay its loans, mostly US dollars denominated. Major sources of FDI for Sri Lanka are India, Netherlands, Singapore, and China. Apart from FDI, China is also the largest provider of loans to Sri Lanka for infrastructure projects, which accounted for 21.5 percent, followed by other bilateral and multilateral sources such as Japan, the World Bank, and the Asian Development Bank (ADB) respectively. However, when assessing China’s significant role in this development space, it is crucial to put into context Sri Lanka’s debt specific to China as compared to the overall debt.

#### 4. Sri Lanka’s debt composition

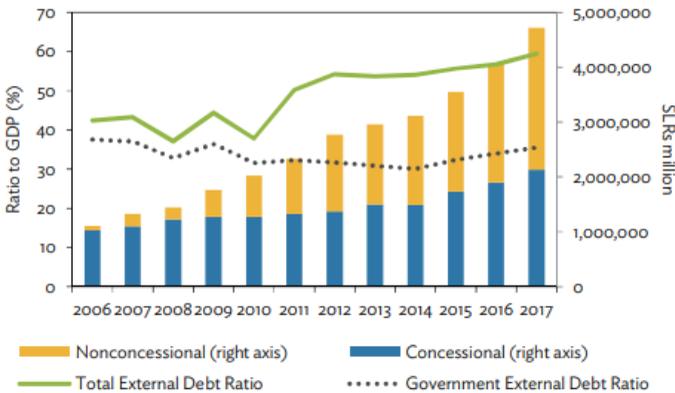
Sri Lanka’s debt-to-GDP ratio was 77.6 percent as of the year 2017. Out of this total debt, 42.1 percent was held domestically, whereas the remaining 35.5 percent comprises external borrowings. The former (42.1%) consists of mostly treasury bills and bonds and the latter consisted of bilateral and multilateral loans (20.6 % of GDP), international sovereign bonds and syndicated loans (15.4% of GDP), and the remaining are non-residents’ holdings of Treasury bills and bonds (1.1% of GDP) (Daily FT, 2019).

However, debt denominated in foreign-currency made up 50% of the total, while debt to bilateral and multilateral creditors accounted for 25 % of the total. According to reports, the country’s debt-to-GDP ratio remained above the median for emerging economies, which is 53%, not including major oil exporters.

**Sri Lanka’s Debt Stock by Lender**



8b: Government Foreign Debt Dynamics



GDP = gross domestic product, SLR = Sri Lanka rupee.  
 Note: Nonconcessional is the sum of "nonconcessional" and commercial borrowing by the central government.  
 Sources: Compiled using data from Central Bank of Sri Lanka (CBSL). Various years. *Annual Report*. Colombo; Ministry of Finance. Various years. *Annual Report*. Colombo.

As is evidenced by the above figure, the largest chunk of Sri Lanka's foreign debt was international sovereign bonds, which amounted to over 40 percent of the total foreign debt as of 2017. These borrowings were obtained from international capital markets at commercial rates since 2007. Given the nature of the debt, these borrowings put a heavy burden on external debt servicing, as these loans do not have a long payback period or even the option of paying back in installments. Once these international sovereign bonds reach a maturity period, they result in a significant increase in debt servicing costs, as the entire face value should be paid in full versus traditional concessionary loans that have an installment payment option.

## **5. Debt to China**

As of 2017, debt to China comprised over 10 percent of the total foreign debt, most of which was in the form of concessionary lending. According to government data estimates, China committed roughly 9.2 billion dollars from the year 2001 through 2017 (Samaranayake, 2019). Of this total commitment, 5.6 billion dollars (61 percent) was concessional financing, whereas 3.6 billion US dollars (39 percent) of it was obtained at commercial rates.

## **6. Loan for Hambantota port**

Under the leadership of Mahinda Rajapaksa, between 2007 and 2014, there were five loans obtained to construct the port. The total of these loans was to the tune of 1.263 billion US dollars. This comprises loans secured at commercial rates, as high as 6 percent, and the others in the form of concessionary lending. Out of the total loans, two loans, the combined worth of which was 357 million, were obtained at commercial rates. This indicates that 906 million US dollars consisting of the majority of the loans were borrowed on concessionary terms.

## 7. Findings and arguments

Sri Lanka has been considered to be an interesting case of a developing country because of its high level of social progress related to its per capita income level. The island nation was also held up as a model for the school of thought that emphasized basic needs fulfillment as a necessary step in a country's development trajectory (Weerakoon & Kumar, 2019). However, despite good human development outcomes, the country's economic performance has fallen short of expectations. The country's macroeconomic landscape has been characterized by fiscal dominance – soaring deficits and high public debt. The manifestation of which is a high degree of macroeconomic volatility, evidenced by frequent BOP (Balance of Payment) crises and instability. According to reports, the country has had 15 arrangements with the IMF (International Monetary Fund) in 52 years from 1965-2016. Lack of capacity in revenue generation and weaknesses in expenditure controls have contributed to high deficits and an enormous debt overhang. The increased expansionary measures adopted on the fiscal front has spilled over to the external sector, albeit via imprudent monetary and exchange rate policy responses, even as the country was witnessing an upsurge in non-concessional (dollar denominated) external debt. Given this macroeconomic reality, it only fits to situate the development challenges of the country in its proper context. As established, Sri Lanka's development model has been predominantly state-led as opposed to private sector driven. It is a development model of sorts that, more often than not, requires a massive fiscal expansion if not intervention.

The most significant feature of Sri Lanka's impressive growth story averaging 7.5 percent annually after 2010 is the weak contribution of the net trade in an economy driven by private consumption and public investment. Since 2006, the country's development programs heavily relied on massive infrastructure drive, with a huge leap of public investment from a modest 4 percent of GDP to 6 percent of GDP. With the war coming close in 2010, infrastructure projects were rolled out more aggressively. Not surprisingly, this infrastructure-led economic growth is reflected in the breakdown of GDP growth. The service sector also expanded during this

period, driven by transport and communication, and retail trade. Indeed, the government saw infrastructure as a means to unlock growth. Many of the mega infrastructure projects like roads and over-bridges, offering better connectivity, did meet the growing demand for more and more public goods. However, these large scale investments on infrastructure projects, including other investments such as port and airport that empowered the Sri Lankan economy, could not be afforded without one; external capital and the other private investment, which had been stagnant, in the economy. The lack of in-house finance to accommodate the public-funded infrastructure expansion made exploiting external sources of development finance an alternative, if not the only alternative.

While the country embarked on external financing, there is also an interesting shift to commercial and international market borrowing from concessional loans, most of which were traditionally offered by multilateral institutions such as the World Bank, Asian Development Bank, and the like. Despite buffeted by chronic macroeconomic imbalances, Sri Lanka is, nonetheless, the wealthiest country, in terms of per capita income, in the South Asia region after the Maldives. Sri Lanka's rising per capita income has enabled it to have a transition to a lower middle-income country. While the nation prides itself on this development, it also effectively means Sri Lanka can no longer avail as much concessional assistance on development finance from multilateral creditors. According to the Department of External Resources, "In 2017, both ADB and the World Bank, the leading multilateral development partners of Sri Lanka, have officially announced the formal graduation of Sri Lanka from eligibility to access concessional resources from them". To adjust to this rather unwelcoming climate of obtaining finance for infrastructure projects, Sri Lanka sought development funds from international markets and international sovereign bonds, all of which are at commercial rates and shorter repayment schedules.

The Hambantota project is a case in point that highlights the challenges confronting nations transitioning into middle-income status. No longer able to avail concessional finance and the traditional creditors (World Bank and Asian Development Bank)

requiring a faster repayment schedule, the incumbent government, in 2017, leased the port in exchange for roughly 1 billion US dollars in forex reserves. According to a well-established narrative, the Hambantota deal was a “debt-equity swap” or the Chinese underwriting debt in return for control of the port. This widely held narrative may not hold much water because of the following. For starters, the government is still obliged to pay off the five loans sanctioned by the EXIM Bank of China to construct the port, and no amendments have been made pertaining to those loans. The loans were not defaulted on and the agreements thereof stand unchanged (Moramudalli, 2019). According to this line of reasoning, the lease cannot be considered a debt-equity swap – refers to a debt cancellation in return for the equity of an asset. As such, there was no cancellation of the debt.

However, the port did get leased to CM port (China Merchants Holdings Company Limited) for 99 years for 1.12 billion US dollars at 70 percent stake. Contrary to popular beliefs, this 1.12 billion dollar was not used to repay the loan for the Hambantota project. Instead, it was used, for the most part, to strengthen the country’s stock of foreign exchange reserves and to make some foreign debt repayment. Thus, it is reasonably accurate to say that the dollars received from the deal were largely used to cover the balance of payment issues – resulting from the surging debt servicing cost while growth on the export and the FDI inflows remained stagnant.

In retrospect, the Hambantota port deal cannot be interpreted as a debt-equity swap or the Chinese canceling debt in exchange for control of the port – although that seems to be a well-established narrative. The Sri Lankan government is still obliged to pay off five loans obtained from the EXIM Bank of China to construct the Hambantota Port, and the agreements pertaining to those loans have not been amended. The loans were not defaulted, and the agreements thereof, remain unchanged. In that sense, the port lease cannot be interpreted as a debt-equity swap, which refers to a cancellation of debt in exchange for the equity of an asset. In this case, there was no cancellation of the debt.

The Hambantota port is now a PPP (Public Private Partnership) undertaking, out of which 70 percent of the stake is leased to CM port, and the remaining 30 percent stake remains with the Sri

Lanka Ports Authority (SxLPA). The CM Port and the SLPA jointly handle the commercial operation of the ports, while the government of Sri Lanka still owns its ownership. As per the lease agreement, the port was valued at 1.4 billion US dollars, and CM Port invested 1.12 billion dollars.

A common interpretation of the Hambantota leasing is, Sri Lanka unconditionally handed it over to China after it was unable to pay off the loan. This cannot be further from the truth, because by the time the government entered into the lease agreement, the debt servicing cost of the loans taken for the project amounted to only a small portion of the total cost of debt servicing. To add specificity, the loan installments, including the interest rounded up to less than 5 percent of the country's total foreign debt repayments. An actual cause for concern pertinent to foreign debt servicing cost was the maturity of international sovereign bonds, to the tune of more than 40 percent of the total debt servicing payments in 2019.

## **8. Conclusion**

Out of more than 3,000 projects of numerous kinds financed by China, Hambantota is the only example ever used as evidence for "debt-trap diplomacy" According to Centre for Global development estimates, Sri Lanka's debt to China stands at 3.85 billion. To put that into context, Sri Lanka's debt to China is 5.5 percent of the country's total debt. One interpretation is 94.5 percent of Sri Lanka's debt is not owed to China. Narrowing the scope further to external debt, which amounted to 32.5 billion, the proportion of debt owed to China rises to 12 percent. On the other front, the country's export-to-GDP ratio, which includes goods and services exports had come down to 39 percent from 21 percent in the years 2000 and 2017, respectively. This raised serious concerns about external debt sustainability. In the meantime, a major indicator of external debt sustainability, the foreign debt servicing ratio, reached an alarming peak of 28 percent in the year 2015. This ratio was well under management, standing at only 10.6 percent in 2007, which had now soared to an alarming rate of 22.5 percent at the end of the year 2017. Except for a slight correction to 19.7 percent in 2016, the external debt servicing-to-exports ratio remained above 20 percent since 2017. These circumstances forced

the country to increase its stock reserves of dollar currency, despite the uncertain macroeconomic environment for emerging economies on the back of the pending maturity of international sovereign bonds to the tune of 5 billion dollars due for payments in 2019-2022. One of the options for achieving this immediate objective was to lease Hambantota port, an investment that was not generating sufficient returns. To that end, the study finds very little evidence to support the debt-trap diplomacy, at least not in the case of the Hambantota port. The famous Hambantota port deal is, not in the least, an issue of Chinese debt. Instead, Sri Lanka has much more significant macroeconomic challenges that go well beyond China. The Hambantota ordeal is symptomatic of the external sector crisis Sri Lanka is facing. The crisis stemmed from the reduction of exports, persistent twin deficits (trade deficit and budget deficit), and the middle income trap. Clearly, there are more pressing structural issues confronting Sri Lanka, issues that seemingly pose significant political challenges. Therefore, this study does not find any causal relationship between Chinese loans and Sri Lanka's debt problem. Hence, Sri Lanka's debt problem is not "made in China." In conclusion, one may find more utility in having questions and propositions that are constantly deliberated and debated, than one would, in readily accepting 'narratives' that are dare not questioned and challenged.

## **9. Policy Implication**

Sri Lanka's response to the Hambantota circumstance is instructive for other nations, especially the small South Asian countries. Although the "debt-trap" perspective of Sri Lanka's experience is often deliberated, discussions regarding low-income countries transition to middle-income status, referred to as the middle-income trap, are not forthcoming. Developing nations, operating in these circumstances, face hurdles in achieving further levels of growth. Macro-prudential measures and efficient public finance management, among other things, are the need of the hour, should the country embark on graduating to middle-income status.

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