Sri Lanka in Turmoil: No Chinese Debt Trap!

by Hussein Askary

July 24—On July 14, Sri Lanka's President, Gotabaya Rajapaksa, sent his resignation to the speaker of the parliament after fleeing to Singapore following massive protests demanding his and the government's resignations. The crisis started in earnest in May, when the Central Bank of Sri Lanka declared that the country was practically in default, unable to service its foreign debt. The depletion of foreign reserves left the country unable to purchase food, fuel and medicine from international markets. Ranil Wickremesinghe, Gotabaya's Prime Minister since April of this year, has now been elected as Sri Lanka's new President.

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Indebtedness to Western financial institutions drove Sri Lanka into crisis conditions. Shown, an anti-government protest in front of the Presidential Secretariat, Colombo, Sri Lanka, April 13, 2022.

As we explain in this article, the problems of Sri Lanka are long-term problems, but contrary to what has been propagated by Western think tanks and mass media, this crisis has nothing to do with Chinese loans for infrastructure projects in the country. Our investigation of official documents and statistics demonstrates that the actual cause was the indebtedness to Western financial institutions. It is legitimate to ask whether the government of Sri Lanka made a mistake beginning in 2009 by massively resorting to international credit markets to address its financial problems after the devastating and prolonged civil war was ended. But putting the blame on China is an absurdity.

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Sanctions imposed by the U.S., the UK, and the EU on Russia intensified the crisis by interfering with especially food and fertilizer imports. Here, Sri Lankans demand the resignation of President Rajapaksa and his government.

More recently, the sanctions policy imposed by the U.S., UK and EU on Russia augmented the crisis in Sri Lanka and around the world, driving the already high rate of inflation into hyper-inflation territory, especially in food and fuel. This was clearly expressed by new President Wickremesinghe during his participation in a panel on hunger and the food crisis, shown on India TV. He said there are as many as six million people facing malnutrition in Sri Lanka. Wickremesinghe took the gloves off, assigning Western responsibility for this through the West's sanctions policy, nominally focused on Russia:

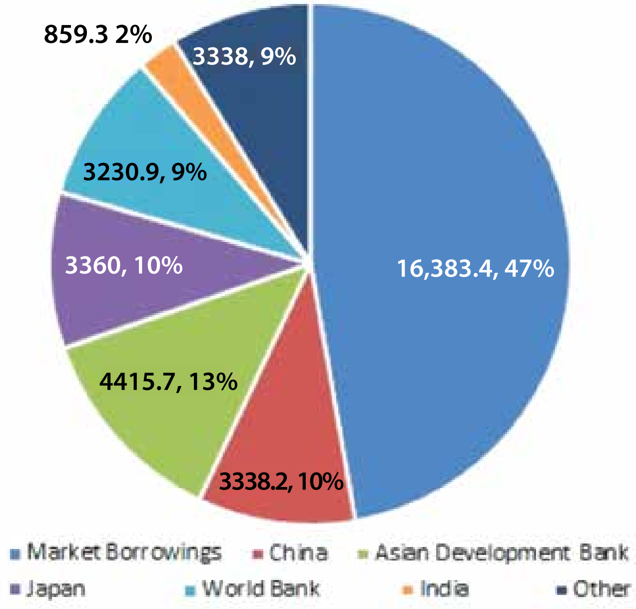
> Do you think sanctions will help? It will only drag the prices up.... Let us look at the sanctions that are being imposed and ask ourselves if this is necessary. The sanctions won't bring Russia to its knees, but it will bring the rest of the third world to its knees.

Of great concern now is that the International Monetary Fund and World Bank will attempt to "help" in dealing with the debt problem with their typical austerity policies, via "liberal reforms," ignoring the responsibility of a nation's government for the welfare of its people. Unfortunately, Wickremesinghe, according to experts in Sri Lanka reached by *EIR*, is in favor of such liberal reforms and will work closely with the IMF to impose "painful but necessary" changes, such as ending the free healthcare and free education offered by the government and removing the subsidies for fuel, electricity and food. This will lead to further unrest, while being portrayed as necessary "reforms" which will, of course, be backed by the West.

FIGURE 1

Debt Stock by Lender

(US$, millions)



Source: Sri Lanka Dept. of External Resources

Whence comes Sri Lanka's debt trap? It's not from China, whose loans are only 10% of the total. (The segments are identified clockwise in the key, starting from Market Borrowings on the right.)

The Fake Narrative of a Chinese 'Debt-Trap'

The Western (and some Indian) mainstream media, think tanks, and research centers, and even many government officials, have declared the Sri Lankan Hambantota Port development the main example of "China's debt trap diplomacy." Two American "researchers" with a background not in economics or finance, but in security matters, were commissioned in May 2018 by the U.S. State Department to write a report, "Debtbook Diplomacy: China's Strategic Leveraging of its Newfound Economic Influence and the Consequences for U.S. Foreign Policy," which stated that they would make Hambantota Port the "template" for this false narrative.

The best-documented debunking of the debt-trap myth regarding Hambantota Port is the June 2000 China-Africa Research Initiative's working paper, "Debt Relief with Chinese Characteristics," by Dr. Deborah Brautigam and associates at the School of Advanced International Studies at Johns Hopkins University, reviewing thousands of pages of official documents and interviews with officials and experts. The irony is that Brautigam's study demonstrated clearly that China's deal with Sri Lanka was a bail-out and debt *relief* measure which, in fact, saved the day for Sri Lanka's finances in 2017.

As our own research and interviews with experts will show here, the entire story of China

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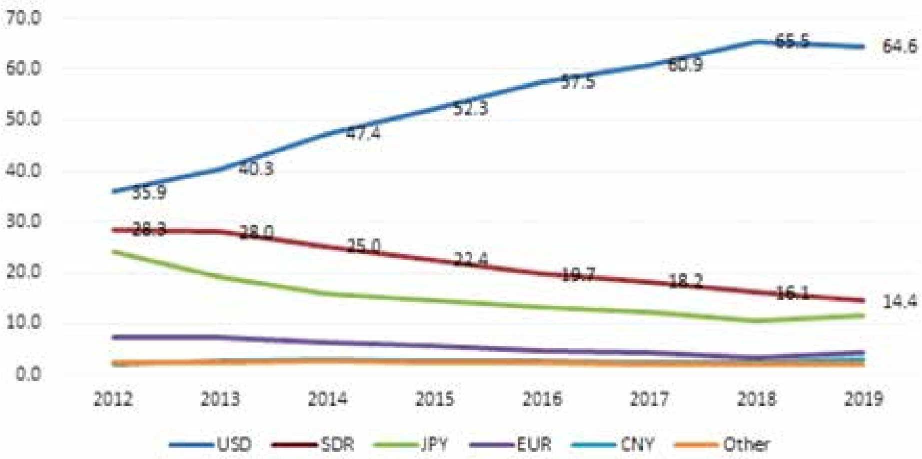
China is Sri Lanka's largest foreign direct investor, especially in infrastructure, such as Hambantota Port, where these two cargo ships are shown docked.

FIGURE 2

Changes in Debt Stock by Currency

(US $, million)



Source: Sri Lanka Dept. of External Resources

Sri Lanka's debt denominated in U.S. dollars (in blue) rose significantly in the 2012-2019 period, while debt in China's renminbi (CNY) mostly grew late in the period. It is shown here in blue-green, scarcely visible at the bottom between the orange and the purple, until 2018.

being the source of Sri Lanka's debt is fake, through and through.

Who Owns Sri Lanka's External Debt?

Two essential facts are ignored when the media in the West deal with the external debt of Sri Lanka: the composition of the debt, and the real causes of the debt crisis. China's share of the external public debt of Sri Lanka is only 10%. Western financial institutions (including the private credit markets) and their ally, Japan, hold the lion's share of the debt.

According to a press release by the Sri Lankan Department of Foreign Resources, the composition of the foreign debt of Sri Lanka in April 2021 was as follows:

TABLE 1

Composition of Foreign Debt

International capital markets borrowing	$16.4 billion	(47%)
Asian Development Bank	$4.4 billion	(13%)
China	$3.4 billion	(10%)
Japan	$3.4 billion	(10%)
World Bank	$3.2 billion	(9%)
Others	$3.0 billion	(9%)
India	$0.859 billion	(2%)

The major donors of the Asian Development Bank are Japan and the U.S.

Thus, a simple look at the facts, usually ignored or concealed in the West, shows that the real culprits are from the same Western countries where the "China debt-trap" narrative was concocted.

Inflation

Reflecting the global crisis, inflation in Sri Lanka, as measured by the year-on-year change in the Colombo Consumer Price Index (CCPI), increased to 39.1% in May 2022 from 29.8% in April 2022. This increase in inflation was driven by the monthly increases of both food and non-food categories, such as petroleum products and fertilizers. Subsequently, food inflation increased to 57.4% in May 2022 from 46.6% in April 2022, while non-food inflation increased to 30.6% in May 2022 from 22.0% in April 2022.

Prices of items in the non-food category recorded increases mainly due to price increases in transport (petrol, diesel, and bus fare), housing, water, electricity, gas, and other fuel (LP gas, and materials for maintenance/reconstruction). Further, within the food category, increases were observed in prices of vegetables, fresh fish, rice, bread, dried fish, and dhal during the month.

Foreign Currency Reserves

Gross official reserves declined by $2.5 billion during the year through June due to sizeable foreign debt service payments of the Government, honoring of maturing liabilities of the Central Bank, as well as the significant supply of foreign exchange by the Central Bank to facilitate imports of essential items including fuel, LP gas, coal, medicine, and essential food items, particularly during the latter part of 2021.

Decline in Value of Local Currency

While the Sri Lankan rupee has been in steady decline for several years (Rs to US$: 181 in December 2019, 186 in December 2020, 200 in December 2021) it suddenly dipped to a historical low level of 360 rupees to the U.S. dollar in early March 2022. This was

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Expensive borrowing from Western financial investors such as BlackRock, constitute the greatest part of Sri Lanka's external debt. Shown, BlackRock's headquarters in Midtown Manhattan, New York City.

triggered by the global crisis and the imminent default on payment of $78 million in matured foreign bonds in April. A 30-day grace period expired, and on May 18, the Central Bank of Sri Lanka declared the country was in a preemptive default status.

Political unrest followed as the government failed to provide fuel and imported food—the prices for which have dramatically increased, while the government's ability to provide foreign currency to support continued imports dried up.

Causes of the Debt Crisis

What are the actual causes of Sri Lanka's debt crisis? They are:

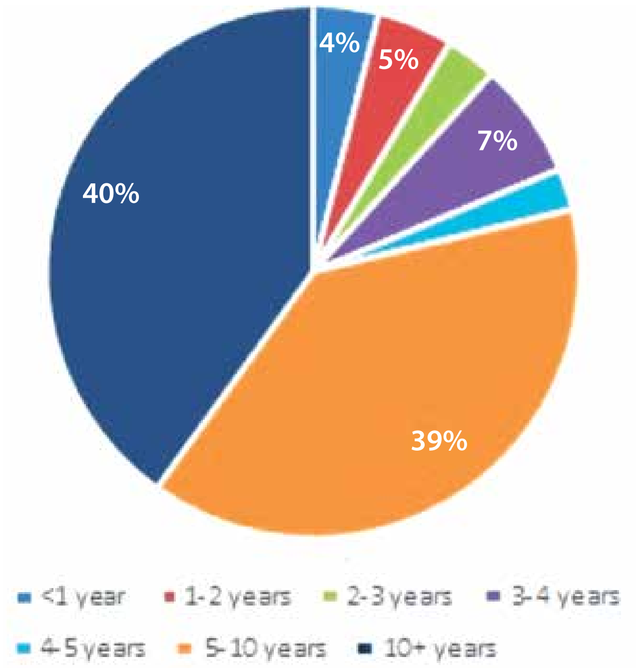
Borrowing in international capital markets. After a devastating civil war ending in 2009, the government resorted to expensive borrowing from international bond markets for the reconstruction process. These sovereign loans, mostly from Western financial investors such as the American and British giants BlackRock and Ashmore, constitute the greatest part of the external debt of the country (47%). It was the scramble to repay some of this debt, which matured in 2017, that pushed the Sri Lankan government to offer the Hambantota Port for leasing. China accepted the offer in return for $790 million that was used to repay the debt to the international markets, not to China.

The bond market is a brutal, profit-seeking force which has a secondary market in which investors sell the sovereign debt of troubled countries to so-called "vulture funds," who buy the debt from investors at a huge discount, to later demand full payment from the debtor nations. They do not renegotiate, reschedule, nor cancel their debt. Payments must be made on time; otherwise the country will be shut off from lending sources while rating agencies downgrade their credit ratings. What is worse is that the vulture funds sue sovereign debtors in British and American courts, where, under the threat of seizing the assets of those nations abroad, the courts usually judge in favor of the vulture funds.

FIGURE 3

Maturity Structure of the Debt Stock

(by major currencies, US $, million)



Source: Sri Lanka Dept. of External Resources

Sixty percent of Sri Lanka's debt comes due within a ten-year period or less, some of it much less.

The trade deficit. As in the case of Pakistan, Sri Lanka has a major dependency on imports of oil and gas and their refined products for transport and power generation. In recent years global prices for those commodities have increased, but in 2021-2022 the prices skyrocketed. These items, in addition to fertilizer, constitute the largest part of the imports of the country. In 2020, total exports were $10 billion while imports stood at $16 billion (a $6 billion deficit). In 2021, the deficit increased to $8 billion ($12 billion exports and $20 billion imports). Consequently, the current account deficit widened significantly to 4.0% of the Gross Domestic Product (GDP) in 2021, compared to 1.5% of GDP registered in 2020.

Sri Lanka's main export items are textiles and garments (accounted for $5.4 billion in 2021), tea ($1.3 billion), and rubber products ($1.1). Imports include fuel ($3.7 billion in 2021) and textile materials. Sri Lanka does not produce the raw materials nor the machinery ($3.1 billion) to make its main exports; it also must import equipment ($2.8 billion) and food and beverages ($1.7 billion).

Chemical fertilizers constitute another important import item, but in 2021 the government issued a ban on chemical fertilizer imports in order to promote organic agriculture. The catastrophic result was that food production dropped by 20%. The ban was relaxed later in the year.

While Sri Lanka's exports are relatively stable or stagnant in value, import prices have increased dramatically in the past two years.

Collapse of Tourism

Due both to terrorism and the COVID-19 pandemic, tourism to Sri Lanka has virtually collapsed. According to the Sri Lankan Tourism Authority, earnings from tourism had been the major contributor to the surplus in the services account for many years, as well as a major source of foreign exchange and employment.

In April 2019, on Easter Sunday, Islamic State terrorists launched simultaneous suicide bombings on a church and a hotel in Sri Lanka's capital, Colombo, killing a large number of locals and foreign tourists. A second disaster struck with the 2020 outbreak of the COVID-19 pandemic. The number of tourists visiting the country fell to a trickle.

A look at the numbers gives a clear picture:

TABLE 2

Foreign Tourist Entries and Income Generated

2017. 2,116,407 tourists.
Income generated: $3.9 billion.
Employment generated: 156,369 direct jobs (and 202,846 indirect jobs).

2018. 2,333,796 tourists.
Income generated: $4.4 billion.
Employment generated: 169,000 direct jobs (219,484 indirect jobs).

2019. 1,913,702 tourists.
Income generated: $3.6 billion.

2020. 507,704 tourists.
Income generated: $682 million.

2021. 194,495 tourists.
Income generated: $507 million.

The government supported the industry to compensate for the losses and avoid social and political unrest. The result was an increase in government borrowing both internally and externally. The tourism sector accounts for the largest share of the labor force of Sri Lanka, with 8 million workers out of a total population of 22 million.

Decline of remittances. Over the past two decades, annual remittances from Sri Lankan nationals abroad have represented nearly one fourth of the total credits to the external current account, on average, while in 2020 they rose to over one third (35%). But the COVID-19 pandemic affected globally the service sector, in which Sri Lankan foreign workers are generally employed. Remittances declined from $7 billion in 2020 to $5 billion in 2021.

The government of Sri Lanka has been plagued by persistent fiscal deficits for decades, compelling the government to continually borrow from both domestic and foreign markets, accumulating public debt. As a result, a large fraction of government revenue and foreign currency inflows to the country are required to be channeled into debt service payments, permitting little leeway for productive investments.

Increasing the productivity of the Sri Lankan economy holds the key to the solution. But this requires large investments in infrastructure, industrialization, and the modernization of the agricultural sector. Finding alternatives for the very expensive imports of petroleum products is another very important element of the required solution.

China's Role and the BRI

China does not have a magic wand to wave and thereby change the conditions of nations. That China managed to eliminate extreme poverty internally, and build the world's most productive economy, was the result of hard work and massive investments in infrastructure and the labor force through education. China's role in Sri Lanka is positive because it focusses on developing the productive aspects of the economy, such as modernizing the infrastructure. As we demonstrated, contrary to the debt-trap narrative, China is not Sri Lanka's largest creditor, but it is the largest foreign direct investor. Sri Lanka will play a key role in the Maritime Silk Road of the 21st Century. China's investments in Sri Lanka are long-term projects that gradually increase the productivity of the economy. But they do not represent a quick fix.

ILO/M. Crozet

Sri Lanka's main export items are textiles and garments. Here, women workers turn out garments for export at a Unichela factory in Sri Lanka, Jan. 18, 2005.

In a July 18 interview with China's *Global Times*, Sri Lanka's Ambassador to China, Palitha Kohona, said he is confident:

> Whatever government is in power will maintain excellent relations with China.... China is the major trading partner and investor of Sri Lanka, we have a strategic partnership between the two countries; whoever takes over the government after an election will maintain the confidence of the Chinese government as well as the good will of the Chinese people. BRI [Belt and Road Initiative] investments are critical in the Sri Lankan economy after the situation stabilizes. It not only brought foreign exchange, but also generated employment.

China's Foreign Ministry spokesperson, Wang Wenbin, said at a press briefing July 15 that Chinese financial institutions have actively approached and negotiated with Sri Lanka after the country stopped debt repayment:

> China is ready to work with relevant countries and international financial institutions to continue to play a positive role in supporting Sri Lanka's response to current difficulties and efforts to ease debt burdens and realize sustainable development.

Wang added that as a friend and neighbor, China has been providing assistance for Sri Lanka's socio-economic development to the best of its capacity.

Recently, China has announced a total of $74 million emergency humanitarian aid to Sri Lanka including two batches of emergency humanitarian grain aid—2,000 tons of rice. But the shortages in Sri Lanka are immense: cooking oil, fertilizer, medicine, and even food stocks—which combine to pose a huge challenge to Sri Lankans' immediate, basic household cooking, transportation, and medical needs, as well as their preparation for the upcoming cultivation season.

Another matter of concern is that the U.S. and Britain will seize upon this situation to promote a geopolitical agenda. A source in Sri Lanka told *EIR* that the new U.S. Ambassador to Sri Lanka, Julie J. Chung, has experience in "soft-power" manipulation—coordinating military-civilian efforts in conflict zones, including in Iraq and Ibero-America. In late April she organized a major conference titled, "A Shared Vision for the Indo-Pacific," to discuss with Sri Lankan military and strategic experts the Biden Administration's anti-China strategy for the Indo-Pacific region.

The last thing Sri Lanka needs is to get entangled in British geopolitical traps. Its ability thus far to have a balanced stance between East and West has served the country well in avoiding renewed conflicts. What is needed is to establish a new economic policy based on the physical-economic enhancement of the nation's productivity and potential.

Rather than pushing the thoroughly debunked debt-trap narrative against China, the U.S. and Europe should join hands with China and the Belt and Road Initiative to assist in rapidly raising the productive capabilities of Sri Lanka and other nations, through investments and long-term, low-interest credits for infrastructure projects, industries, and modern agricultural production.