

To what extent does China's debt trap diplomacy affect the Sri Lankan Economy?

Author: Yashita R. Pujari

Affiliation: Allegheny College Meadville PA

E-mail: Pujari.yashita@gmail.com

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ABSTRACT

The purpose of this paper is to determine the extent to which China's debt trap diplomacy has affected the economy of Sri Lanka and to also understand whether there were other factors that played a role in the downfall of the Sri Lankan economy. In order to do so, I've collected data from the world bank in terms of the Sri Lankan GDP per capita, inflation and their imports & exports along with a couple of published articles. I believe that an analysis of this data will assist me in my process and conclusion.

Keywords: Debt trap, GDP, Inflation, GDP deflator, Covid-19, Russia-Ukraine

1. INTRODUCTION

As a citizen of India, Sri Lanka happens to be a neighbouring country. And as someone who has a personal friend from this place living here in India as she could not return to her home country due to its economical condition, I decided that I want to learn more in search of answers for the current Sri Lankan situation. I intend to narrow down the different reasons that might have caused the downfall while trying to study the intensity of China's debt trap diplomacy as it is quite unclear at the given moment.

2. BACKGROUND INFORMATION

A 'debt trap' refers to a scenario that occurs when one is required to take new loans in order to repay the old existing loans. This creates a cycle of increasing debt, as the principal amount keeps compounding and the interest rate also simultaneously heightens. There is a possibility for a debt trap when loans aren't repaid fully or in time. In this case, in order to allegedly obtain political or economic concessions from the debtor nation when it is unable to pay back its debt commitments, one creditor country allegedly extends excessive credit to another debtor country on purpose.

3. CHINA'S DEBT TRAP DIPLOMACY

In the field of global financing for development, China has emerged as a worldwide leader and is today the largest government creditor in the world. It would be exaggerated to refer to Chinese investments in emerging nations as neocolonialist policy instruments with a strategic aim. But even a disinterested observer might not give the Asian powerhouse clean bill of health. When nations accept investments from China, they are required to support China in international forums and refrain from criticising it on geopolitical problems like Taiwan or the state-sponsored atrocities in Uyghur. Furthermore, there are credible charges that Chinese companies are adopting deceptive tactics to secure contracts abroad.

Unquestionably, China has gained political power during the past 20 years. Beijing is now more explicit than ever about its desire to become a global powerhouse. There will undoubtedly be tremors in the world order as a result of the political aspirations of a militarily advanced nation supported by a 19 trillion USD economy. Additionally, China has an advantage over the G7 in the quest for market supremacy in renewable energy because of its near monopoly in rare earth metals.

With its current power, China is willing to lend, rather than first assessing a borrower country's creditworthiness and if fresh loans may subject it to a burdensome debt problem. China's own leverage increases in proportion to how much debt the borrower is carrying. The likelihood that China may demand a higher interest rate for lending money increases with the borrower's financial position. Chinese loan agreements frequently contain clauses relating to a security interest, such as lender-controlled income accounts. Using collateral, it

attempts to guarantee loan repayment with income from, say, commodities exports.

According to the report, a commercially assertive China restricts the borrowing state's crisis management alternatives while boosting its own role through a variety of contract conditions.

China is the sole recipient of a large portion of the crushing debt in many fragile nations. China's share of the public debt of deeply indebted developing nations increased from 6.2 percent to 11.6 percent between 2013 and 2016, according to a report by the International Monetary Fund (IMF) as China wants to grow its own economy, acquire strategic assets, and use its access to markets to gain political and strategic sway over recipient countries.

The dangers of Chinese lending to recipients, many of which are already susceptible to or experiencing financial or fiscal crises, are obscured by the lack of transparency in the Chinese lending system. Since 2014, every contract has included a broad secrecy clause obliging the borrowing nation to keep the specifics of the loan and even its existence a secret. It is noted that such China-enforced opacity violates the idea that public debt should be transparent and not kept from taxpayers so that governments may be held responsible.

4. RELATION BETWEEN CHINA AND SRI LANKA

In concern with Sri Lanka, due to its inability to take more action to restructure its debts in conversation with the IMF, China's debt trap diplomacy has grown to be a significant factor in the island nation's extraordinary economic catastrophe.

The devastating effects of the pandemic destroyed Sri Lanka's crucial tourism industry, and the Russian invasion of Ukraine disrupted global supply chains and accelerated the inflationary spiral that plunged Sri Lanka's economy into an abyss. As a result, Sri Lanka has become a cautionary tale of bad governance and misfortune.

When it became clear that Sri Lanka would be unable to pay back the expenditures of building the Hambantota port in the south of the nation, the country was compelled to provide a 99-year lease to a joint venture between China and Sri Lanka. This was viewed by many as a prime instance of Chinese debt-trap diplomacy. As a result of this procedure, the lending nation, also known as the predatory

nation or China in this case, had the chance to exploit the circumstance by prolonging the debt maturity date in order to exert control over the nation of the loan recipient.

Beginning in the middle of the 2000s, the Rajapaksa administrations developed close ties

with China, which resulted in China implementing various infrastructure projects. China gave Sri Lanka loans and help totaling \$50 million between 1971 and 2012, 94% of which came after Mahinda Rajapaksa was elected president in 2005. Only 2% of this sum was in the form of grants; the remainder was in the form of low-interest loans. The Mattala Rajapaksa International Airport and Colombo South Container Terminal were both finished in 2013, while construction on the Hambantota Port started in 2007. But even when the pro-China Rajapaksa administration was overthrown in 2015, the new administration, which promised a more impartial approach to regional diplomacy, continued to issue ISBs. In actuality, the sum rose from January 2015 to November 2019 when that administration was in office. As a result, Sri Lanka's external debt payback commitments for the 2019–21 period were nearly \$4 billion, of which about half was due to ISB repayments. The government was aware that paying back its foreign debt would be difficult because the repayment schedule was set in stone.

Early in 2021, the idea of obtaining a loan from the International Monetary Fund was suggested. The governor of the central bank at the time, however, rejected this choice, perhaps as a result of the tight conditions attached to IMF loans. The public would undoubtedly have been under a heavy strain to implement the IMF's demands. As an alternative, the government placed a higher priority on preserving Sri Lanka's credibility in global markets by continuing with on-time payments of ISB and other obligations. The government's worries about its financial image and conditionalities, however, were quickly rendered irrelevant when the Sri Lankan economy began to rapidly deteriorate.

Further in this paper, the extent to which China's debt trap diplomacy has affected the Sri Lankan economy will be discussed in terms of the country's GDP per capita, inflation rates as well as the exports

and imports by analysing the last 5 years data in order to make a calculated assumption on whether Sri Lanka's current situation is entirely due to China's debt trap or if other factors such as covid 19, Russia-Ukraine war lead to the situation and when the Sri Lankan economy will climb out of this pitfall.

5. DATA FROM WORLD BANK

Table 1. GDP per Capita and Inflation (2018-2022)

Year	GDP per capita (current US\$)	Inflation, GDP deflator (annual %)
2018	4360.6	4.3
2019	4082.7	3.9
2020	3852.4	3.3
2021	3994.2	8.5
2022	3354.4	48.8

Table 2. Exports, Imports and GDP (2018-2022)

Year	Exports of goods and services (% of GDP)	Imports of goods and services (% of GDP)	GDP (current US\$)
2018	21.4	28.4	94.49 billion
2019	21.8	27.6	89.01 billion
2020	15.4	21.6	84.44 billion
2021	16.9	24.3	88.5 billion
2022	21.5	25	74.4 billion

6. METHODS Description of Database

I've mentioned prior that I would be taking the last 5 years into account for this study as they are the most recent years hence the data available covers covid 19 as well as the Russia-Ukraine conflict. While the numbers from the database vary, I believe that I have recognised similar patterns amongst the database which I will discuss below.

6.1 Table 1 analysis

6.1.1 GDP per capita

In 2018, the GDP per capita was 4360.6 (current US \$) but there has been a decline in GDP per capita in the year 2022. GDP per capita 2019 shows an increase when compared to 2018 however 2020, the same year as covid 19, shows a great drop in GDP per capita. Although 2021 presents a slight increase from 2020, the year 2022 shows a decline once again. Over all, the GDP per capita dropped in the last 5 years. The 2020 drop could be attributed to covid 19 and the 2022 drop could perhaps indicate the impact of Russia-Ukraine war. The occasional spikes could have been due to an increase in loans from China which resulted in a drop in GDP per capita in the following year.

6.1.2 Inflation, GDP deflator (annual %)

Inflation in 2018 was 4.3 however I can see a slight decrease in inflation in the following 2 years. But starting from 2021, I can observe an intense rise when compared to 2020 and the year 2022 shows an abnormal spike in inflation levels. Inflation refers to the rise in price levels, this suggests that the price levels of Sri Lanka increased by a great degree in the past 5 years. Sri Lankan currency also depreciated in terms of exchange rate in the past 5 years. The increase in prices suggests the inability of Sri Lanka to repay its loans back to China. As the year before 2018, that is 2017, China gained leverage over Hambantota International Port Group as China invested in the building of this infrastructure.

6.2 Table 2 analysis

6.2.1 Exports, Imports and GDP

Exports:

Up until the year 2020, the exports declined however they started picking up again from the year 2021. This suggests the country's dependency on exports for their GDP.

Imports:

Imports gradually decreased between the years 2018-2020. However, similar to the exports, the Imports started rising again from 2021. However, they are not up to the mark as they were before as of 2018, they were at 28.4% of GDP but in 2022 they're only at 25% of GDP.

GDP:

GDP decreased from 2018 to 2022 however there was one spike in the year 2021 right before it decreased again in 2022.

6.2.2 Overall Analysis of table 2:

Although the exports and imports in terms of a % of GDP showcase an increase the overall GDP presents a decrease in terms of goods and services produced. This could

perhaps suggest a lack in resources due to the Russia-Ukraine war and a possible unemployment within the country due to which it can be said that all the given resources have not been used fully and efficiently due to which the GDP gradually decreased over the last 5 years.

The unemployment factor and decreased GDP can be tied back to the increase in inflation as suggests the possible lack of the Sri Lankan economy to keep its citizens employed and pay them simultaneously as they are struggling to repay the debt to China.

7. COVID 19 IMPACT

Both the trade and the economy of Sri Lanka were significantly impacted by the COVID-19 pandemic. The economic aftermath has been characterised by unprecedented losses in goods trade, foreign direct investment (FDI) flows, tourism, and cross-border migration. Sri Lanka is likely to face high unemployment, inflation and poverty rates in the future. Despite minor gains in the immediate years before to COVID-19, Sri Lanka's long-term export growth rate was on the decline even before the pandemic. The pandemic in 2020 accelerated this long-term decrease. Exports of goods fell by -15.6% in 2020 compared to 2019, which was caused by both supply and demand shocks.

Sri Lanka's import expenditures decreased even more drastically in 2020 as compared to exports, by as much as -19.5%. There is little question that falling oil prices, weaker private investment, and muted consumer demand contributed to the slump in the economy.

Sri Lankan exports have historically focused on a small number of markets, including the US, UK, and other EU members. Its export portfolio is still very small, with a heavy reliance on T&G and a select few agricultural items.

8. RUSSIA-UKRAINE WAR IMPACT

Given the significant roles both Russia and Ukraine play in international markets for food, fertiliser, and energy, the Ukraine War has had significant effects on food security and agricultural systems all around the world. Together, Russia and Ukraine provide more than 30% of the world's wheat exports and nearly 12% of all agricultural exports measured in calories.

Food security in Sri Lanka, which depends on imports from the Caspian area, was severely disrupted by the conflict between Russia and Ukraine. The effects of this shock have been exacerbated for Sri Lanka, which has been experiencing a severe economic crisis as a result of a lack of foreign reserves, a debt default, rising inflation, import restrictions, and shortage of essential products and services.

9. CONCLUSION

Overall, it is evident that the existing and compounding debts of Sri Lanka played a significant role in bringing Sri Lanka to its current economic situation. However, factors such as covid 19 and the Russia-Ukraine conflict played a major part in the process as well.

Covid-19 majorly impacted the imports and exports of Sri Lanka as well as the tourism industry which perhaps brought down the income of the country. This left Sri Lanka unable to pay back its usual debts and in turn borrow more.

The Russia-Ukraine conflict acted as a catalyst to the whole process as it impacted Sri Lankan food security amidst the ongoing global pandemic and debt crises of the country. On the Global Hunger Index of 116 nations, Sri Lanka was rated 65th, while on the Global Food Security Index of 113 nations, Sri Lanka was placed 77th. This suggests that the war impacted the country to a great extent.

Although, another point to consider here is perhaps the fact that Sri Lanka has had poor government management for the past couple of years. The current economic condition might have been a result of this poor fiscal planning. Among other macroeconomic difficulties, Sri Lanka is plagued with twin deficits, which forces its government to seek outside finance to cover fiscal expenditures, particularly for infrastructure projects.

The Hambantota port was the only one of almost 3000 infrastructure projects that China has funded that was regarded as a classic example of "Debt-trap diplomacy." A case study from Christ University, however, draws on objective assessments and empirical research and finds no support for "Debt-trap diplomacy."

In a nutshell, the present Sri Lankan situation cannot be traced back to one factor but it is rather a making of various factors all together. Starting with the country's defective fiscal management and macroeconomic realities and its existing loans from China from the year 2009 to the recent global pandemic and country conflict.

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