"As an editor and contributor, Dr. Fingar has joined breadth with focus, and parsimony with insight. This fine comparative study importantly suggests that to understand China's ever-changing foreign policy ties, we must understand what Beijing thinks countries can do for it and do to it."

David M. Lampton, Johns Hopkins-SAIS and author of Following the Leader: Ruling China from Deng Xiaoping to Xi Jinping

"The New Great Game is a timely and learned contribution to our understanding of an understudied and increasingly important subject: China's relations with its Western neighbors."

Thomas J. Christensen, Princeton University and author of The China Challenge: Shaping the Choices of a Rising Power

"Beijing's ambitious plans for 'Silk Road' initiatives strengthening transportation, communications, and trade could transform Eurasia and deeply engage great powers such as Russia and India. Anyone interested in tracking these developments will find this book a godsend, filled with fascinating insights into the interplay of economic, historical, and geopolitical factors that will shape the outcome of this new great game."

J. Stapleton Roy, Founding Director Emeritus, Kissinger Institute on China and the United States

China's "rise" has inspired much writing, but this coverage depicts events as determined almost entirely by Beijing's goals and approaches. Such accounts minimize what other actors do to attract, shape, exploit, or deflect Chinese involvement. The New Great Game analyzes how China's policies and priorities interact with the goals and actions of its neighbors in South and Central Asia. Seeking to discover what happened—and why—during the three decades of China's rise, The New Great Game will deepen understanding of Chinese and other national priorities and policies, and illuminate patterns among countries and issues.

Thomas Fingar is Shorenstein Distinguished Fellow in the Freeman Spogli Institute for International Studies at Stanford University.

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China as a Balancer in South Asia
An Economic Perspective with Special Reference to Sri Lanka

Samuel Kelegama

China’s rise as an economic superpower over the past two decades has been remarkable. With growth rates averaging to percent annually and strong indications that it will soon overtake all other major powers in economic terms, China has also increased its diplomatic influence. Smaller South Asian countries welcome China’s increased economic and diplomatic power as a counterbalance to that of the United States and India.

The implications of China’s rise for the regional and international order are enormous. The extent to which China’s rise offers opportunities or threatens national interests varies from country to country and, within South Asia, countries have responded in different ways. Many countries have chosen to foster close diplomatic and economic ties in order to leverage China’s growth to accelerate their own economic development. Others, notably the region’s larger economies—particularly India—are apprehensive about China’s vast size, exporting capacity, and massive inflows of foreign direct investments (FDI). The South Asian democracies are more apprehensive about China’s increasing political and military power than about its economic challenge. They worry that the emergence of an authoritarian world power will have a detrimental impact on the global system. Their concern is heightened by the modernization of China’s armed forces, which is viewed with suspicion because of uncertainty about China’s future role and intent in world affairs.

South Asia feels the effects of China’s rise with particular intensity because of its geographic proximity. For example, China’s need to secure the flow of energy resources from the Persian Gulf and ensure the security of sea lanes for trade of all kinds has prompted China to build surveillance and support facilities and to maintain a substantial naval presence in the Indian Ocean. The People’s Liberation Army Navy has established relations with Indian Ocean rim countries and has offered to sell military equipment to South Asian countries at attractive prices. It has also established a foothold in major ports including Chittagong in Bangladesh, Hambantota in Sri Lanka, and Gwadar in Pakistan.

For many South Asian countries, the principal reason for fostering deeper integration with China is to capitalize on the potential for economic gains. China’s remarkable transition from extreme poverty to impressive growth has sparked regional interest in learning from China’s experience since the adoption of reforms in 1978. Moreover, China’s rapid economic growth creates new trade and investment opportunities for South Asian countries. Such opportunities are welcome because spillover benefits from India’s economic growth have been limited and the South Asian Association for Regional Development (SAARC) has been ineffective in achieving enhanced regionalism during its twenty-five-plus years of existence. As a result, China’s engagement with individual South Asian countries is widely perceived as potentially beneficial.

For India, however, China’s increasing presence in the region has produced serious concerns. Although Sino-Indian relations have improved significantly over the last decade, especially in the economic arena, this has not prevented the emergence of politically contentious issues. Moreover, because India sees itself as the dominant power in South Asia, it is suspicious of and discomfited by China’s growing involvement in the region. Some analysts have observed that India sometimes views China as posing a “formidable constraint” to its influence in smaller neighboring economies. Factors that have contributed to this view include China’s vast foreign exchange reserves, increasing presence in Africa, veto power in the UN Security Council, acknowledged emphasis on noninterference, and aversion to holding others accountable on human rights and governance issues. China’s historical friendship with India’s unfriendly neighbor Pakistan also contributes to India’s growing suspicions. Taken together, these developments have “transformed the region from India’s near abroad” into China’s own backyard.13

Much has been written about China’s strategic interests in the South Asian region and the dynamics and complexities involved in China’s
relationships with India and Pakistan, the two largest economies in the region. The views of the smaller economies in South Asia have received much less attention, and the studies that do exist focus on security and political issues. The manner in which relationships are developed, both bilaterally and multilaterally, will have a significant impact on the economic dynamics of the region. Do these countries view China as an important contributor to the realization of their own economic development agendas or as a threat to their own development? More importantly, do they see the increasing Chinese presence as a counterbalance to India's leading position and role in the region, both economically and diplomatically? This chapter addresses these questions in part, but it focuses on how the smaller South Asian countries view economic issues related to China's rise by using Sri Lanka as a case study.

China's Rise: Perspective of Smaller South Asian Countries

China's rise has been driven by a combination of factors, including three decades of sustained and outstanding economic growth, fast military modernization, and the ability to participate in multilateral institutions and organizations and contribute to international efforts to resolve conflicts. This has earned appreciation from countries around the world, including South Asia. This point is noteworthy because South Asia is one of the regions closest to China and because the way the smaller South Asian countries view China's rise is influenced by the simultaneous rise of India, the largest economy in their own region.

The smaller South Asian countries are generally more comfortable with a rising China than is India and tend to view China in a more positive light. However, the smaller economies do not all perceive China's rise in the same way. Bangladesh, Sri Lanka, Maldives, and Nepal view China as an important source of economic and non-economic assistance and also as an increasingly important counterbalance to India's role in the region. When China applied for observer status in SAARC in 2007, these four countries joined Pakistan in enthusiastically supporting the application. Ultimately, the other South Asian members agreed to go along, but the others did not support China with the same degree of enthusiasm.

Afghanistan and Bhutan perceive China somewhat less positively. Although Afghanistan regards China as a friendly neighbor, it does not view China as a counterbalance to India and would probably prefer that Beijing do more to constrain Pakistan. Bhutan's strong historical ties to and heavy reliance on India for its foreign policy and domestic economic performance constrain its relationship with China. The following section examines the contrasting perceptions of these two groups in greater detail.

Judging the way one country perceives another is a complicated task for several reasons. One is that diverse constituencies and stakeholders do not have identical interests and, therefore, do not perceive other countries in the same way. Also, perceptions, although often based on reality, are not necessarily identical with reality because they are shaped by factors such as experience, exposure, and the nature of engagement and thus are subject to change depending on circumstances. The perceptions discussed in this chapter are based on the general overarching perceptions prevalent in each country at the current point in time.

Economic Opportunities

The smaller states of South Asia view China's rise primarily in terms of the opportunities it creates for their own economies. China's phenomenal economic growth during the first decade of the twenty-first century has made it significantly better able to respond to their trade and investment needs, and China has gradually strengthened its links with growing South Asian markets to support its own export-led growth. Three examples illustrate the kinds of changes now taking place:

- In 2000, membership in the former Bangkok Agreement was expanded to include China and renamed Asia-Pacific Trade Agreement (APTA). APTA includes three South Asian members. 
- China and Pakistan signed a free trade agreement in late 2006, and it came into operation in 2007. 
- China obtained Dialogue Partner status in the Indian Ocean Rim Association for Regional Cooperation in 2001; India, Sri Lanka, and Bangladesh were already members. 

By 2012, China had become the largest trading partner of three South Asian countries (Pakistan, Bangladesh, and Nepal) and the second largest trading partner of Sri Lanka. Although China has no free trade agreement with India, Sino-Indian trade increased from $1.5 billion in 2001 to $30 billion in 2011, and
China has become India's second largest trading partner (second to the United Arab Emirates [UAE]). Partly as a result of these institutional arrangements but primarily because of China's rapid growth, trade between China and the smaller regional countries has evinced steady increases in recent years, increasing from $5.7 billion in 2001 to $97 billion by 2011.17

This growth in trade with China is in marked contrast to the trade of smaller countries with India. As noted earlier, historical rivalries and political tensions have been a constant obstacle to expanding trade flows within the region, despite the existence of the SAARC Preferential Trade Arrangement (SAPTA) since 1995 and the South Asia Free Trade Agreement (SAFTA) since 2006. Some of India's neighbors complain that India has adopted heavily protectionist measures that hamper regional integration and the ability of other SAARC members to realize the benefits of better integration. Moreover, since SAARC countries traditionally have produced similar goods, they compete with one another for access to Western markets. This sense of competition and rivalry has hindered cooperation as trade partners in pursuit of mutual economic gain. Despite working out free trade agreements with Nepal (1996), Sri Lanka (1998), and Bhutan (over many years), India still has not provided significantly greater market access to the smaller regional economies. Trade growth is also impeded by the inadequate supply capacity of the smaller countries.

China, in contrast, is relatively unburdened by such competitive rivalries (except in a few product areas such as ready-made garments and toys) and, therefore, is emerging as a less problematic trading partner for South Asia. China and India have the highest degree of trade complementarities, but China's trade with the smaller economies, such as Bangladesh, Sri Lanka, and Nepal, is growing, albeit not yet as fast as trade with India.13 Better utilization of the APTA preferential tariff lines is important in this context.

Constraints on the extent to which smaller countries in the region have been able to benefit from India's growth have been partially compensated by the increasing trade opportunities offered by China's rise. Figures 9.1 and 9.2 illustrate the ratio of imports from smaller regional countries imported by India and China as a share of their imports from the world. As can be seen, India's share of imports from the region has shown a declining trend in many of the countries, whereas the share imported by China has been on the rise, particularly in the cases of Bangladesh and Sri Lanka.
China is Bangladesh’s largest trade partner. Under the APTA, a range of Bangladeshi products have received duty-free access to the Chinese market. Furthermore, despite a history of competition between the two countries for the manufacture of ready-made garments, China has taken steps to ease tensions by outsourcing some ready-made garment jobs to Bangladesh, where labor costs are lower. In return, Bangladesh has offered China exploitation rights to its reserves of coal, natural gas, and oil. China’s share of Sri Lankan exports has also increased from 0.4 percent in 2006 to 1.2 percent in 2011.

**Investment**

Chinese outward FDI has increased at an exceptional average growth rate of 49.9 percent per year, from $2.7 billion to $68.8 billion during the period from 2002 to 2010. The South Asian region has been an important recipient of such FDI flows; the share of Chinese outward FDI to South Asia has risen from a mere 0.08 percent in 2004 to 40 percent in 2010. Although the bulk of these flows go to Pakistan and India, Chinese FDI into smaller countries, particularly Sri Lanka and Bangladesh, has been on an upward trajectory in more recent years (Figure 9.3).

![Graph showing China’s outward FDI flows to selected South Asian countries, 2004-2010](image-url)

**Financial Assistance**

China has become an increasingly important source of economic and technical assistance, interest-free loans, interest-subsidized preferential loans, and grants for projects in infrastructure development, power, communication, telecommunications, energy exploration, and mineral extraction in many smaller countries in the region. Such projects, particularly in infrastructure, energy, and mineral extraction, benefit the recipient countries but also assist China’s efforts to gain a strategic foothold in the Indian Ocean region. Several scholars assert that financial support for the development of ports in Pakistan (Gwadar), Bangladesh (Chittagong), Sri Lanka (Hambantota), and Myanmar (Sittwe) is an important part of China’s naval strategy (more than 85 percent of China’s energy imports from the Middle East and mineral resources from Africa transit through the “string of pearls” ports of Hambantota, Gwadar, Chittagong, and Sittwe). China is also establishing rail and road connections with Pakistan, Nepal, Bhutan, and Myanmar. Other
activities now under way include exploration of oil and gas resources in Sri Lanka and Myanmar and possible energy pipelines linking China with Myanmar, Bangladesh, Pakistan, Afghanistan, India, and Iran.

In Sri Lanka, China has been an important provider of financial assistance for infrastructure development since the end of the separatist war in 2009. The most notable projects receiving Chinese assistance are the Hambantota Port Development Project, construction of the Norochcholai energy power station, exploration for oil in the Cauvery Basin sea, a second international airport in Mattala, the building of an expressway from the airport to Colombo, and modernization of the island’s railway carriage. Nepal has also benefited from increased Chinese aid, including financing of a railway line from the Tibetan capital of Lhasa to Kathmandu.24

China is playing an increasingly vital role in Bangladesh, where it is building six major “friendship bridges” and has provided assistance to the development of two 210 MW power plants in Chattagong and two 250 MW Barapukuria Coal-fired Thermal Power Plant.25 China runs a trade surplus with each of these countries and the provision of aid is perceived to be a way of ensuring that the relationship is beneficial to both parties. Indian financial assistance to other countries in South Asia is smaller and less significant.

Since the late 1980s, South Asia has been looking for an external investor to create a stimulus for intraregional trade.26 It is worth recalling that Japanese FDI during the 1980s played a key role in stimulating intraregional trade among East Asian countries. South Asia failed to attract Japanese FDI in the 1990s because of policy uncertainty and conflict in the region. In the mid-2000s, however, Chinese financial assistance for infrastructure development began to play a significant role in enhancing the supply capacity in the South Asian region, especially in the small South Asian countries. Although the impact of this aid may not be felt immediately, it will stimulate more trade in the long run. Smaller South Asian countries value this stimulus from China because there is no other large source of investment in the region, and there is little resistance to the terms of Chinese financial assistance, including the use of Chinese labor.27

China as a Model of Economic Development

China is viewed by most South Asian states as an important model of economic development because of its success in making the transition from extreme poverty to impressive growth since adopting market reforms in 1978. The reforms introduced to improve agricultural productivity in the 1980s were studied with keen interest by South Asian countries even before they had begun to produce sustained results. Even though many of these countries had very different socioeconomic conditions than did China and lacked strong political systems to streamline rural labor and agricultural productivity, they undertook to learn from Chinese best practices.28 China’s phenomenal success in mobilizing FDI to build a robust manufacturing sector has attracted the attention of the smaller South Asian countries. So, too, have China’s high rates of domestic savings and financial and banking reforms to facilitate the availability of credit for manufacturing and export ventures. Interest in learning lessons from China’s experience increased even further after the 2008 global financial crisis and China’s impressive performance in its aftermath.

South Asian observers attribute China’s success to its combination of economic liberalization and political stability, with the latter coming from an authoritarian political system. Indeed, some of the smaller regional states, such as Bangladesh, Sri Lanka, and Maldives, seem to be moving toward more authoritarian systems.

Despite SAFTA, India’s imports from the region constitute only 4 percent of its total imports, and India’s FDI into the region is still not very significant. India’s limited involvement within the region has not only hindered the initiation of meaningful projects for regional integration but also limited the potential spillover benefits that India could offer its neighbors, including knowledge and technology transfers from its booming services sector. The plethora of non-tariff barriers and other impediments associated in doing business with India make it difficult for other countries to enter its market despite advantages afforded by geographical proximity. Moreover, Indian manufacturing processes have not become as fragmented and globalized as those observed in China and other East and Southeast Asian countries and, therefore, do not enable neighboring countries to use SAFTA provisions to enter Indian supply chains.29 Studies of vertical industry links in South Asia show that intra-industry trade remains at an extremely low level compared to other regional groupings like the Association of Southeast Asia Nations.30 In contrast, China’s manufacturing sector is strongly linked to global supply chains, particularly in Asia.

The tendency of the smaller regional states to look to China—rather than India—as the economic role model, leader, and catalyst for achieving
integrated growth has prompted India to adjust its own approach to regional integration. The shift can be seen by the following gestures by India:

- On January 1, 2008, India offered duty-free-market access to the Indian market for exportable products of less developed SAARC member states (subject to a negative list).
- In 2010, India contributed $100 million to the Social Window of the SAARC Development Fund.
- In 2011, India unilaterally reduced its SAFTA negative list at the Seventeenth SAARC Summit in Adu City.31

Clearly, China has indirectly galvanized SAARC, with India taking an active role.

Military Assistance

China has also emerged as a significant provider of military equipment. Pakistan has traditionally looked to China for the import of arms, but now smaller countries like Bangladesh, Sri Lanka, and Nepal also rely more heavily on China. As indicated in Table 9.1, Bangladeshi imports of arms from China have been increasing at rapid rates in recent years.

Defense cooperation between China and Bangladesh began soon after China accorded recognition to Bangladesh in 1975. This cooperation includes personnel training, material support and production, and equipment and armaments upgrades. Over the years, China has emerged as the largest and most important provider of Bangladesh's military hardware and training of its armed forces. In Sri Lanka, Chinese-supplied arms were instrumental in winning the separatist war with the Liberation Tigers of Tamil Eelam (LTTE) during 2008 and 2009. In the face of India's inability to supply the needed arms, China became an important supplier. It also gave Sri Lanka the freedom from political conditionality being imposed by India, the United States, and other members of the international community. Nepal has also approached China for the supply of arms at times of rebellion against the government, in part because of India's refusal to do so. Some notable instances in which China has come through for Nepal are in the 1960s, 1988, and 2009. China has thus emerged as a reliable partner in the field of security, specifically rising to the occasion in the face of India's inability to oblige because of domestic political imperatives. This is yet another manifestation of the balancing role being played by China in the South Asian region.

Table 9.1

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Upholding Sovereignty and Independence

China's diplomatic relations with smaller South Asian states is another interesting area of study. Through the use of both multilateral institutions and bilateral relations, China has politically assured smaller states that it supports their sovereignty and independence. Multilaterally, China has used its veto power and political clout in the UN Security Council to block Bangladesh's admission to the United Nations and to indicate solidarity with Pakistan and show that it did not approve the breakup of Pakistan's territorial integrity. When the West criticized the Sri Lankan government for its conduct with respect to the humanitarian crisis during the last phase of the separatist war against the LTTE, China provided support and assistance to Colombo.

Rightly or wrongly, the smaller South Asian states believe that China is an important counterbalance to political pressure from India and other countries. In return, China has always sought reiteration of their "one China" policy and support for the principle of noninterference. Bilaterally, China has produced statements to show unity and support to smaller states in the region whenever they face pressure from the West and, more significantly, from India. In 1962, the then Chinese defense minister made a statement assuring Nepal that any attack on Nepal would also be treated as an attack on China and would be defended accordingly. China subsequently issued similar statements pledging support for the sovereignty and independence of
Pakistan, Bangladesh, Nepal, and Sri Lanka when they were under pressure from India. 

In contrast, India has largely failed to establish enduring political and diplomatic ties in the region, and ties that traditionally have been considered strong have been deteriorating. The case of Nepal illustrates India’s counterproductive diplomacy and lack of political vision. New Delhi had earned significant goodwill in Nepal for its positive role in the 2006 Jana Andolan-II (People’s Movement II), but it dissipated this goodwill in a period of two to three years. By 2009, India was one of the most unpopular countries in the eyes of the main Nepalese communities. India’s support for the former Maldives president Mohamed Nasheed caused the successor government to regard India with suspicion, so much so that India’s GMR Group lost a contract to run the Male airport. The tensions between South India and Sri Lanka since the end of Sri Lanka’s war, which became more intense in the recent past, is another example of failed Indian diplomacy. These developments were not caused or shaped by China, but China has been a beneficiary of Indian missteps in the region.

One reflection of perceptions that China is benefiting from and seeks to take advantage of Indian mistakes in the region is the prevalence of speculation in India that China was wresting projects from India in smaller regional states. For example, a well-known Indian reporter noted that contracts for power projects in Sri Lanka and Bangladesh initially awarded to India might be taken over by China. One project is the joint venture between India’s state-run National Thermal Power Corporation (NTPC) and the Ceylon Electricity Board to build a 300 MW power plant in Sri Lanka’s Eastern Province, which had been subject to substantial delays. The speculation proved unfounded. Similarly, NTPC’s proposal to set up coal-based power projects in partnership with the Bangladesh Power Development Board has not been so far successful. Although NTPC may ultimately proceed with the Khulna project, its fate is highly uncertain because of disagreements over tariffs and the use of Chinese equipment. Meanwhile, the Chinese are aggressively seeking to build a 1,320 MW project in Chittagong. Even if unfounded, speculation and suspicion about Chinese intentions are widespread in India.

**Concerns and Apprehensions**

As noted previously, Bhutan’s perceptions of a rising China are somewhat different than those of the other small regional states. The reason is that Bhutan’s economy is heavily dependent on India. For example, its currency, Ngultrum, is pegged to the Indian rupee. A free trade agreement that has been in effect for many years facilitates preferential trade and allows Bhutan’s imports and exports from other countries to transit via India. Bhutan’s military is trained in India. Bhutan and China have had friendly exchanges, especially in the recent past, but trade between them is minimal and there are no economic aid or investment flows from China into Bhutan. China’s economic incentives for engaging with Bhutan are increasingly apparent, but Bhutan’s dependence on India precludes using relations with China as a counterbalance to India. The strength of the relationship between India and Bhutan has constrained ties between Bhutan and China to a level of friendship rather than intimacy. Even if Bhutan sees China as a more important future trade partner, tensions between China and India will constrain how far Bhutan is willing to go.

Even though most of the smaller regional states see many potential advantages from a rising China, they also see reasons for concern. One such concern arises from their trade relationships. The expanding trade and investment relations between China and the smaller regional states unquestionably have many positive effects, but the large trade imbalance in favor of China has become a source of worry even though running a trade deficit with a country as large as China is unavoidable. Given the vast difference in size and economic power, China’s exports to the region naturally far exceed its imports from the region. Moreover, many of the small regional countries export primary products to China and import value-added manufactured goods from China. However, unable to compete with imported Chinese consumer goods, regional states have been compelled to close industries manufacturing similar products. Examples include India’s toy industry, Sri Lanka’s umbrella industry, and Pakistan’s ballpoint pen industry. In response, regional countries have imposed non-tariff barriers to shield the effects of the influx of Chinese consumer durables. Some have also resorted to antidumping legal action.

The current account deficits of the smaller regional states are largely offset by significant capital inflows from China into their capital accounts, and the concerns noted earlier are far outweighed by the overall economic benefits and soft support offered by China. For example, Bangladesh has made its trade deficit with India a political issue but addressed its deficit with China through diplomatic channels. Indeed, when visiting China in the last week of May 2013, Sri Lanka’s president suggested appointing a
team to study the possibility of working out a free trade agreement between China and Sri Lanka.\textsuperscript{31}

China’s military modernization is not viewed as a threat by the smaller regional states. In fact, as beneficiaries of Chinese arms transfers, they look to China for newer and cheaper weapons. China’s military support to the smaller states does not prevent it from seeking a strategic foothold in the region by exercising its political and economic clout. As S. D. Muni and Tan Tai Yong have shown, the principal cause of anxiety among the smaller states is the possibility that China will become more assertive and intimidating when it becomes a major world power.\textsuperscript{52} All small regional states support the “one China” policy, but they are somewhat uncomfortable about the treatment of the minority peoples in Tibet and Xinjiang. The small South Asian countries also worry about a possible military conflict between China and India but do not have a strategy to hedge against possible adverse effects.

\textbf{China as a Balancer to India: The Case of Sri Lanka}

Encircled by the two emerging global powers, Sri Lanka increasingly looks to China as a counterbalance to India.\textsuperscript{39} Sri Lanka has had important cultural, historic, and religious ties to both India and China since ancient times. However, the relationship with India was naturally the closer one, given geographical proximity and greater cultural similarities. China was perceived as a huge, powerful, and distant Asian power. In recent times, however, Sri Lanka’s relationship with these two emerging economic powers has changed. For political reasons, Sri Lanka increasingly looks to China for both political and economic support. Assistance from India is gradually declining relative to that from China.\textsuperscript{44}

Since achieving independence, Sri Lanka has appreciated the importance of its relationship with India but remained wary of New Delhi’s unilateral and authoritarian tendencies in the region. Accordingly, it has often sought to balance its relationship with India by reaching out to other powers. The significant role played by India in Sri Lanka’s post-independent political life has sometimes strained Indo-Sri Lanka relations. From Indira Gandhi’s decision to arm Tamil militants in the early 1980s and Rajiv Gandhi’s decision to send the Indian Peacekeeping Force to implement the 1987 India-Lanka Political Accord, to India’s support for Sri Lanka’s war against the LTTE in 2009, the violent conflict between Tamil nationalist activists and the Sinhalese-dominated Sri Lankan state has always been influenced by policies and attitudes in New Delhi and in the southern state of Tamil Nadu. Such interventions by India have created a sense of distrust, which has affected socioeconomic relations between the two countries. Many Sinhalese view India as favoring Tamils and as wanting to weaken or divide the country. Tamils, on the other hand, see India as having continually broken promises to defend their rights and protect their lives, especially during the final phase of the war in 2009. India’s unwillingness to supply the requested arms during the war paved the way for China to gain a foothold in Sri Lanka. Beijing has been Sri Lanka’s largest arms supplier for some time, but the amount of its support escalated from a few million dollars in 2005 to approximately $1 billion in 2008.\textsuperscript{55} Beijing’s support enabled Sri Lanka to win the war with less support from India while ignoring concerns of the West. India’s 2009, 2012, and 2013 votes in Geneva in support of the US-sponsored UN resolution on Sri Lanka for promoting reconciliation and accountability and China’s vote against the resolution are important cases in point.

Several factors constrain economic relations between Sri Lanka and India. One is the reemergence of fishing disputes. Since January 2018, there have been numerous reported cases of fishermen from both sides being arrested, and in some cases killed, after crossing maritime boundaries. The 2012–2013 harassment of Indian fishermen by Sri Lanka’s navy and attacks on Sri Lankan pilgrims and Buddhist monks in Tamil Nadu triggered protests and intense anger that further strained relations between the two countries.\textsuperscript{56}

India has offered substantial humanitarian assistance and reconstruction aid to rebuild the war-torn Northern and Eastern provinces of Sri Lanka, but implementation has been slow. One example is the previously mentioned construction of a 500 MW coal-fired power plant in Trincomalee. That project has been subject to substantial delays that take on added significance because of the contrast to the speedy completion of the first phase of the Chinese-built power plant in Puttalam. Delays in India’s project to build and repair fifty thousand houses, mostly in the North, are both cause and reflection of Sri Lankan reluctance to deepen its engagement with India, even in instances such as reconstruction where Sri Lanka stands to gain.\textsuperscript{57}

The Sri Lankan government can afford to decline Indian financial assistance because it has been increasingly successful in obtaining assistance from China. In addition to serving as a provider of political and military
China is currently the primary source of foreign finance in Sri Lanka, accounting for $784.7 million in 2011, or 58 percent of total commitments, compared to 12.4 percent in 2006. The weighted average interest rate of the $3.6 billion loans from the Exim Bank of China is 2.3 percent. This includes concessional loans to the government ($0.56 billion) and preferential buyer credit totaling $1.8 billion, both at an annual interest rate of 2 percent with repayment periods of twenty years, including a five-year grace period. However, there is also a $1.3 billion buyer credit at an annual interest rate of the London Interbank Offered Rate (LIBOR) plus 2.4 percent with repayment period of fifteen years with a three- to four-year grace period. The China Development Bank Corporation has higher rates of LIBOR plus 2.9 percent. Clearly, some of the Chinese loans carry high interest rates that could become a heavy burden on Sri Lanka's foreign reserves.

The construction by China of the massive port at Hambantota on the southeastern coast of Sri Lanka has been the most significant development and a major cause of concern to India. This project is part of a $1.5 billion development zone that also features a fuel bunkering facility and oil refinery. The invitation to build the port was initially given to India, but bureaucratic and other procedural delays prompted the Sri Lankan government to look to China instead. This strategic investment has also brought many benefits to China, which could use the seaport as a refueling and docking station for the Chinese Navy. Some argue that Sri Lanka has become a jewel in China's "string of pearls" naval strategy in the Indian Ocean region.

China has also undertaken the task of building the Lotus Tower in Colombo, an ultramodern telecommunications structure that will be South Asia's tallest structure. Other major projects funded by China include an expansion of the main port in Colombo, the construction of a second international airport at Mattala, also near Hambantota, the extension of the Southern Expressway from Galle to Matara, and the reconstruction of railways.

Using cheap commercial credit and imported Chinese labor, Beijing continues to be heavily involved in the building of roads in war-torn northern Jaffna and the eastern Trincomalee and Batticaloa regions, while also constructing a modern performing arts theater in Colombo. The influx of Chinese funds, particularly to the North and East of Sri Lanka, which is both geographically and culturally closer to India, is yet another indication...
of China’s emergence as a major competitor to India’s influence in Sri Lanka and the wider South Asian region.

As indicated in Figure 9.4, the year 2012 witnessed a spectacular surge in Chinese FDI flows into Sri Lanka, increasing from $10.5 million in 2011 to $185 million in 2012. Consequently, China now ranks as the third largest source of FDI in Sri Lanka, up from the fifteenth position in 2011. India, on the other hand, has dropped from second to fourth position in the same time period. Chinese investment has also spread to the electronic and garment industries, for which the Sri Lankan government has established a special free trade zone exclusively for China in Mirigama.65

Trade relations between China and Sri Lanka, which date back to the historic China-Sri Lanka Rubber-Rice Agreement signed in 1972, are also on the rise.66 China’s share in Sri Lanka’s total exports has tripled from 0.4 percent in 2006 to 1.2 percent in 2012, and China (including Hong Kong) has become Sri Lanka’s second largest source of imports, accounting for 13.9 percent of the total.67 India remains the principal import source and third most important export destination for Sri Lanka, but the share of imports gap between India and China is gradually narrowing. In 2008, India accounted for 24.5 percent of imports, whereas China accounted for only 7.9 percent. By 2012, the shares had changed to 19 percent and 13.9 percent, respectively. Sri Lanka recently proposed a free trade agreement with China similar to the one that already exists with India.68

**Conclusion**

This chapter examines China’s growing presence and involvement in the South Asian region and the possibility of China emerging as a balancer to the role played by India. Most of the smaller states in the region see benefits in maintaining closer ties with China, especially in the context of India’s failure to meet their needs. This has contributed to the improvement in China’s image and position in the region.69 The smaller South Asian states will continue to regard China as a counterbalance to India unless and until political tensions and the large imbalances characteristic of relations between India and the smaller states change. India’s policy in the region is challenged and influenced by multiple historical and cultural links as well as by political, social, and economic considerations, but China’s situation is far less complex with little if any areas of friction and conflict. This creates a “natural comfort level” with a more distant but generous and accommodating power.64 In the context of limited integration under SAARC, a distinct shift in approaches to regionalism in South Asia is becoming apparent, with smaller states beginning to look to China, rather than India, for assistance in achieving integrated and sustainable growth.

From China’s standpoint, increased funding and investments in South Asia’s smaller economies are crucial to gaining a strategic foothold in the Indian Ocean region. It thus appears to be a win-win situation, with mutual benefits for both parties. Resolving contentious issues with countries like Pakistan and ensuring that India’s economic success is carried forward into other neighboring countries are the only means of reducing the tendency for smaller states to look outside the region for support and assistance. Given China’s strong interest in cultivating relationships, the small South Asian economies are likely to continue to enhance their engagements with China bilaterally and through multilateral channels, such as the AFTA.

China’s image in the South Asian region is thus far unspoiled. Although one could speculate that the smaller South Asian countries might take an increasingly negative view of China’s state-controlled and one-party-dominated policy, this seems unlikely because perceptions in the modern world are driven more by economic interests than by political ideologies.
Notes

1. The South Asian region is clearly dominated by India, in terms of both its size and its economic influence. Currently, India accounts for about 80 percent of the region's GDP, whereas Pakistan accounts for only 10 percent, Bangladesh 6 percent, Sri Lanka 2 percent, and the rest less than 2 percent.


4. See, for example, S. D. Muni and Tian Tai Yong, A Reunited China: South Asian Perspectives (New Delhi: Routledge, 2012).


6. These points are developed more fully in Muni, “An Overview.”


11. The UAE is the largest trading partner of India because Dubai has become an entrepot for Indian trade, and most India-Pakistan trade takes place via the UAE.


13. China has developed as a key manufacturing hub, whereas India has emerged as the key hub for knowledge-based services such as pharmaceuticals, information technology (IT), and engineering. A particular area of importance in this regard has been in the IT sector, where China specializes in the manufacturing of computer hardware, and India is involved in software development.


17. C. M. Shafi Sanu, “Bangladesh: A Partner for Peace and Prosperity,” in Muni and Yong, A Reunited China, 8–42.


25. Muni and Yong, A Reunited China.
37. Nepal facing difficulties with India because of King Mahendra’s dismissal of the democratic system on December 15, 1960. The Nepali Congress Party was fighting against the king’s actions using Indian support and territory.


42. Ibid.


46. Brassard, “Bhutan.”

47. This is a traditional fear that persists even though in a globalized trading environment trade deficits with partner countries should not be a major worry.


49. Soft support refers to various exchange programs (cultural, sports, etc.) that China has with the smaller South Asian countries.

50. Muni and Yong, *A Resurgent China*.


52. Muni and Yong, *A Resurgent China*.

53. India’s balkanization of Sikkim, heavy control over neighboring Bhutan, and growing influence in Nepal, together with open support for the state of Tamil
Nadu on issues pertaining to the minority Tamil community. The Sri Lankan government's decision to reevaluate China as a potential counterbalance,

54. With the defeat of Tamil separatist group LTTE in mid-2009 and the long delay in offering a political solution to the Tamil minority community, international opinion gradually turned against Sri Lanka, especially in the West and in India. China's stance on the Sri Lankan government's handling of the Tamil minority issue and human rights, as was visible during UN Human Rights Council meetings in March 2012 and 2013.


57. A leading Sri Lankan minister stated in India that Sri Lanka no longer needs the India-Sri Lanka Comprehensive Economic Partnership Agreement (IL-CEPA), which was to be the second stage of the existing India-Sri Lanka Bilateral Free Trade Agreement (signed in 1998). The IL-CEPA was negotiated between the two countries for nearly five years, and the Sri Lankan government abandoned it, presumably to reduce Indian influence over the Sri Lankan economy. See Meera Srinivasan, "We Don't Need CEPA Any Longer: Basil Rajapaksa," The Hindu, July 19, 2013, http://www.thehindu.com/business/we-dont-need-cepa-any-longer-basil-rajapaksa/article4928411.ece.

58. Examples include structural adjustment programs such as the IMF Standby Arrangement of $2.6 billion negotiated in July 2009. The conditionality of the policy prescriptions included a standard set of macroeconomic reforms known as the Washington Consensus.


61. Hambantota is located about fifty kilometers from the major sea-lanes of the Indian Ocean. With the presence of the Chinese technicians, the Chinese Navy could always find ways to use the port for its own security purposes in the region, which causes concern in India.

62. See, for example, Patrick Mendis, "Destiny of the Pearl."


64. The China-Sri Lanka Rubber-Rice Agreement, signed in April 1951, is viewed as the first step in a long journey of Sri Lanka-China relations. Rubber, which had dropped in price worldwide, was one of Sri Lanka's key exports at that time, and China had difficulties obtaining rubber because of US sanctions. China had an abundance of rice, which had increased sharply in price, that it could export to Sri Lanka, creating an ideal environment for an agreement that benefitted both countries.


66. Gunasekera, "India, China."

67. India has not reached a state of development that would enable it to provide generous loans to the small South Asian countries, as China is now able to do. Moreover, India has not been successful in providing the required leadership to SAARC, which has become vulnerable to Indo-Pakistani conflicts. These facts are seen by the smaller South Asian countries as limitations of what India can do for them.