INDIA, CHINA IN INVESTMENT 'GREAT GAME' OVER LANKA

by ROHAN GUNASEKERA

India and China are pouring money into Sri Lanka. The amount of aid, loans and investments the two rising Asian powers have been putting into the island has increased markedly since the end of the ethnic war. It's a tricky game - and how the country strikes a balance between the competing interests of these two emerging Asian giants will decide whether its own future will be stable or troubled by econtinuing instability

photograph by SHAFRAZ FAROOK

DR SAMAN KELEGAMA, Executive Director of the Institute of Policy Studies, says India and China are driven by both commercial and geo-strategic interests in their economic support to Sri Lanka

It is a contest that in some ways can be compared with the 19th century tussle for influence in Central Asia between the Russian and British empires that came to be called 'The Great Game'. That geo-political rivalry between the main world powers of the time was marked by intrigue, espionage and occasional military excursions. The modern-day contest between the rising Asian powers, India and China, is for supremacy in the Indian Ocean region, in which Sri Lanka has a role. The Indian Ocean is seen by commentators as the ocean where the 21st century struggle for supremacy will be played out. This one's played by bureaucrats and businessmen. Aid and investment are the instruments of influence. Both countries were the dominant global economic forces before the colonial era and the industrial revolution. Now they are set to regain their position of significance in the world economy.

A flurry of visits by Indian and Chinese state and business delegations to the island in recent years has been followed by regular announcements of large aid and investment agreements. The projects range from power plants, ports and airports to expressways, roads, hydropower reservoirs and railways. (See map) Also in the pipeline are top-class hotels, while industrial projects including vehicle assembly and manufacturing are being talked about for the future. Less visible but highly influential nevertheless are the instruments of 'soft power': investments like training and education.

Both countries have been helpful to Sri Lanka, providing critical military support to end the war, and aid and investment to keep the economy ticking at a time when support from Western powers and multilateral agencies had waned. They have now become the main post-war economic partners. While India has emerged as the top source of tourists to Sri Lanka, the number of visitors from China is rising rapidly.

Economic transactions are invariably influenced by geo-political considerations and how good or bad relations are between countries. While Sri Lanka appears eager to get economically closer to China, it is less enthusiastic in its response to Indian overtures for greater economic integration, as demonstrated by delays in signing the proposed Comprehensive Economic Partnership Arrangement between the two neighbours. Undoubtedly, India's initial support for Tamil separatists and post-war pressure to devolve power, and China's unqualified backing during the war shape these attitudes.

The recent bombshell remark by Economic Development Minister Basil Rajapaksa that Sri Lanka does not need the CEPA any longer appears part of the brinkmanship that marks its ties with India. Rajapaksa was quoted as saying the Sri Lankan business community felt it did not need the CEPA as they had found good markets. But just weeks before the head of the Ceylon Chamber of Commerce Suresh Shah himself had called for its implementation without further delay, while acknowledging concerns of becoming too dependent on India. Sri Lanka's show of reluctance over the CEPA comes soon after the visit to Colombo by

BOTH INDIA AND CHINA NOW WANT TO CREATE THEIR EXTERNAL SPACE TO ASSERT THEIR GLOBAL POWER, **WHICH THEY COULD NOW AFFORD TO DO WITH LARGE AMOUNTS OF FOREIGN RESERVES IN THEIR POSSESSION.**

Indian National Security Advisor Shivshankar Menon who insisted Sri Lanka stick to the commitments it made on devolving power, and followed India's vote against it at the UN human rights council.

Their geographical proximity means the two countries are inextricably linked, sharing close economic and cultural relations over a long period. Sri Lanka's own growth depends to a significant extent on the growth story in India, as indicated by the reliance of Colombo's hub port on transhipment cargo from India.If Sri Lanka alienates India with its pronounced tilt towards China it runs the risk that existing irritants in bilateral ties such as poaching could linger. Other, potentially more dangerous tensions could arise like India retaking Kachchativu, on which a petition has just gone before the Indian Supreme Court.

The Chinese declined to be interviewed for this story. The Indians were more obliging. That probably reflects the differences in the two societies and their ruling elites. China, still largely a closed society, dominated by the Communist Party whose command and control of its capitalist experiment has made it the world's second largest economy - and the world's biggest in many things, both in manufacturing and consumption. India, on the other hand, a chaotic democracy, mired in red tape and delays, but far more liberal and open.

In this feature, Dr Saman Kelegama, Executive Director of the Institute of Policy Studies, a think-tank, describes Sri Lanka's burgeoning economic relations with India and China and the risks and rewards of closer ties in the question and answer interview that follows. We also interviewed M. Manish, Economic and Commercial Counsellor at the Indian High Commission in Colombo, who spoke about Indian aid and investment.

To what extent has India and China replaced multilateral lenders, Western powers and Japan as Sri Lanka's main external economic supporters?

Clearly, one can see a shift from multilateral agencies like the Asian Development Bank and the traditional donor Japan to new bilateral donors like China and India.

There are a number of reasons for this shift. First, multilateral donors although they provide loans at a lower interest rate, these often come with conditions. Second, both India and China now want to create their external space to assert their global power, which they could now afford to do with large amounts of foreign reserves in their possession. Thus, they are able to offer attractive loans to developing countries. Third, the preference given to Chinese assistance is due to: (a) they are readily given with only a short processing period; (b) any amount is often available; and (c) no strict conditionalities are imposed.

In regard to Chinese financial assistance to Sri Lanka, another point can be highlighted. At the peak of the North-East war during 2006-2009, China was the major provider of military equipment and assistance to Sri Lanka, with China's defence exports to Sri Lanka having tripled.

China and Sri Lanka are also cooperating in the area of military training and exercises with China helping to modernize and expand Sri Lanka's defence force. China emerging as a major provider of defence equipment also facilitated the switch away from the West and toward China for other financial assistance.

What's driving what appears to be an investment 'Great Game' in Sri Lanka by India and China? Are these purely commercial exercises? How far are they driven by geo-strategic interests?

There are commercial interests as well as geo-strategic interests. China has commercial interests in the African continent as well as energy resources in the Gulf, thus it gives importance to free travel and trade in the Indian Ocean. China has provided financial support to develop many ports in the Indian Ocean such as Gwadar (Pakistan), Hambantota (Sri Lanka), Chittagong (Bangladesh), and Sittwe (Myanmar). Over 85% of China's energy imports are from the Middle East and mineral resources of Africa transit through these ports. A recent article in the London Economist (June 8th 2013 issue) argued that China's growing empire of ports abroad is mainly for trade, and not for aggression.

On the other hand, many commentators have argued that these ports reflect a "string of pearls" around India. One cannot totally dismiss this view. China's involvement in the region is unlikely to be taken light-handedly by India. India sometimes views China as posing a "formidable constraint" to its influence in smaller neighbouring economies. China's vast resources, its strategic aims to gain access to the world's key oil shipping lanes, its veto power in the UN Security Council, its acknowledged emphasis on non-interference and its aversion to holding others accountable on human rights and governance issues are important factors that have contributed to this view. China's historical friendly linkages with India's unfriendly neighbour Pakistan also adds to India's cautious approach.

TURF WAR

Projects funded by Chinese and Indian aid and investment can be found all over the island, with some concentrations evident. They now dwarf those supported by Western countries and multilateral lenders — formerly Sri Lanka's main economic partners.

SHIFTING EXTERNAL FINANCIAL SUPPORT

In 2000, out of the total foreign finance commitments

27% came from the ADB

20% from Japan

7% from Germany

4% from IDA

A decade later, in 2010, the scenario was different with

25% from China

15% from India

13% from Japan

11% from ADB

TOP SOURCES OF FOREIGN FINANCING IN 2012

China **US$ 1 billion**

India **US$ 700 million**

Japan **US$ 524 million**

Between 1971 and 2012, China has provided **US$ 5.1 billion** to Sri Lanka, out of which US$ 4.8 billion came during 2005-2012. That is, close to **94%** of Chinese loans/grants have come during the last 8 years.

SOURCES OF CHINESE FINANCING

Exim Bank of China - **81%**

China Development Bank - **17.6%**

Industrial and Commercial Bank of China and other such agencies account for the balance

SOURCE - MINISTRY OF FINANCE AND PLANNING 2012 ANNUAL REPORT, MID-YEAR FISCAL POSITION REPORT 2013

AREA SHOWN ON THE MAP

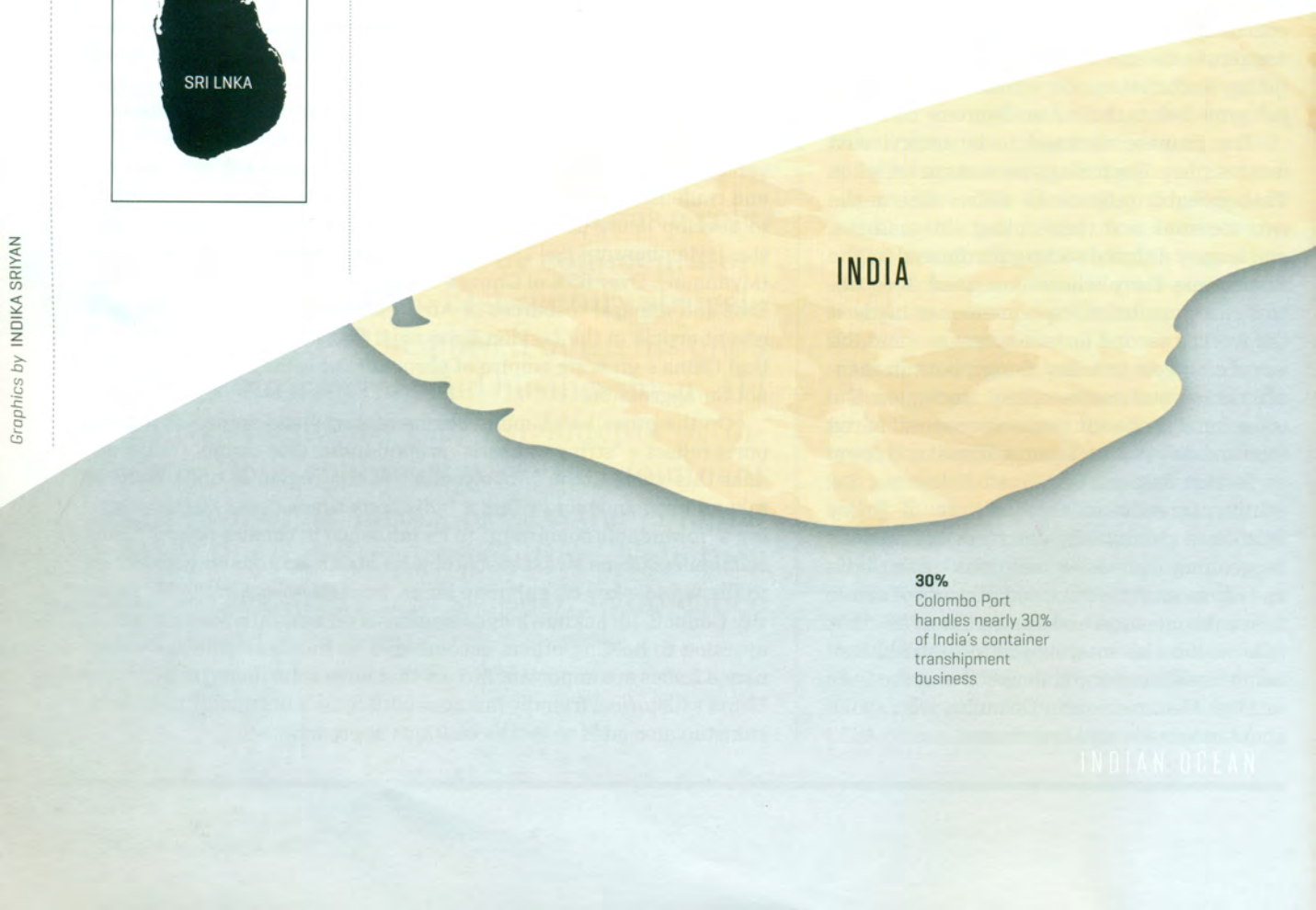
POINTS OF INTEREST

Icon shows type of Infrastructure

ROADS AND RAILWAYS

EXPRESSWAY

RAILWAYS



30%
Colombo Port handles nearly 30% of India's container transhipment business

Graphics by INDIKA SRIYAN

CHINA

COLOMBO:

US$108 MILLION China Exim Bank loan to build 350 metre Lotus Tower communications

US$500 MILLION deep water container terminal by China Merchants Holdings

US$400 MILLION 661-room hotel by Hong Kong-based Shangri-La Hotles and Resorts

RAILWAY ELECTRIFICATION from Veyangoda to Kalutara South by Dongfang Electric Corporation

HAMBANTOTA:

Hambantota Port Phase I with **US$360 MILLION** China Exim Bank loan and bunkering facility with US$ 65 Exim Bank buyer's credit

US$303 MILLION contract to China State Construction Engineering Corporation to build roads and flyovers

China to have **INDUSTRIAL ZONE**

Proposed **SHANGRI-LA** 375-room resort

US$138 MILLION Exim Bank loan for Matara to Kataragama section of Southern Expressway

TRINCOMALEE:

Hunan Road and Bridge Company to build **US$260 MILLION** 47km circular highway around Trincomalee with financing from Industrial and Commercial Bank of China

JAFFNA:

Palaly-Kankesanturai **RAILWAY** line construction by China

Moragahakanda hydro power project - **US$ 214 MILLION** loan from Chinese Development Bank

INDIA

COLOMBO:

US$400 MILLION Indocean Developers residential & commercial tower development

US$140 MILLION ITC Ltd mixed development/hotel project

US$ 460 MILLION Krrish Transworks towers residential & commercial project

US$400 MILLION Tata Housing Development Company Ltd mixed development

TRINCO:

Indian Special Economic Zone

HAMBANTOTA:

$220 MILLION Renuka Sugar refinery

JAFFNA:

US$25 MILLION Indian government grant for Kankesanturai harbour rehabilitation

Mirigama - **$20 MILLION** Dabur India fruit juice plant

Northern Railway reconstruction - by IRCON International Ltd under **US$800** million Indian soft loan

India, on the other hand, sees itself as the South Asian regional power. It is the largest country in the SAARC and has bilateral Free Trade Agreements with Sri Lanka, Nepal, and Bhutan. India sees commercial presence and economic linkages with the neighbouring countries as one way of overcoming the political problems it has with its neighbours. Moreover, India is now seeking a seat in the UN Security Council and in that context, it would like to have good relations with its neighbours and one way of gaining good relations is via the economic channel of trade, investment, and aid. If China stands as a roadblock to this objective, India will have serious concerns.

In addition to these recent economic links, India also has ancient historical and cultural links with its neighbours. So being the dominant country in the region, India would like to see its neighbourhood free from strong external presence that it would consider as a threat to its security.

What are the differences in types of investments and for Sri Lanka costs and repayment terms? Are Chinese investments largely by the state or entities ultimately controlled by the state and Indian investments largely by the private sector?

Chinese investments mainly come from state-owned banks in China for infrastructure investment. China is not a major player in the Sri Lankan FDI market compared to India although China is the largest foreign aid donor to Sri Lanka. But when Hong Kong and China are considered together, the FDI from greater China is quite large but still below that from India. Indian investment, in contrast to China, is from private companies like Bharti Airtel, CEAT, Taj Hotels, ICICI Bank and Ambuja Cement.

Of course, Chinese loans related to project investment will have to be repaid. Perhaps repayment periods can be negotiable since the banks are state-owned. But if non-negotiable, and Sri Lanka finds it difficult to repay the loans, then some other arrangements should be worked out. One leading Minister of the government mooted sometime back that Chinese loans can be converted to equity. While this can be done, its implications for Sri Lanka's sovereignty and its cordial relations with India will certainly not be favourable.

LENDING RATES

US$ 1.3 billion buyers credit are at an annual interest rate of LIBOR (US$ 6 months) plus 2.4% with repayment period of 15 years with a 3 - 4 year grace period. The China Development Bank Corporation has higher rates of LIBOR (US$ 6 months) plus 2.9%.

There have been some concerns about the lending rates of Chinese loans. Clearly, one can see that some of the Chinese loans, not all, carry high interest rates that can become heavy on Sri Lanka's foreign reserves. On the other hand, Indian loans have mostly gone for reconstruction and resettlement in the conflict affected areas, railway line modernization, water supply projects, etc. The interest rates for some of these loans given during the first four months of 2013 have been LIBOR (US$ 6 months) plus 0.5%.

Are there indications that Sri Lanka is making things difficult for Indian investors (such as delays in approvals, new conditions, seeking to change agreements) while facilitating Chinese investments?

It was reported in the newspapers that the Sampur Coal Power Project with the National Thermal Power Corporation of India is getting unnecessarily delayed due to protracted negotiations on the technicalities. While this is the case, I do not think that it is deliberately done. Given the fact that the Norochcholai coal power project that started quickly is giving considerable trouble by frequent breakdowns it may be prudent to spend more time on Sampur before executing the deal to get the best results from it. There are many events that have taken place vis-à-vis Indian projects and FDI that can lead someone to point out that these are deliberate government attempts to discourage Indian investment. However, this is not the case, and had it been so, the two new Indian investments by Dabur India and Renuka Sugar would have not taken off; neither would have the Indocean Developers and ITC Hotel project taken off.

Having said this let me say that deals can be executed faster with the Chinese compared with any other nationality. Chinese very rarely get into protracted negotiations with their partners and their entrepreneurial skills are relatively superior to most other nationalities.

Sri Lanka appears to be reluctant to go for further economic integration with India given the backpeddling on the Comprehensive Economic Partnership Arrangement while being eager to have a free trade deal with China. How is this stance influenced by Indian pressure to devolve power and Chinese military support to end the war and 'diplomatic cov-

er' to fend off pressure on human rights allegations?
CEPA got entangled in nationalism and patriotism after the war victory. Moreover, a whole lot of misconceptions and often untruths like saying Indian dhobys and barbers will come and take our jobs basically gave a bad name for CEPA. Neither did it have any private sector or political leadership to carry it forward. Some said CEPA was the first step towards economic colonization of Sri Lanka by India. All these allegations halted the CEPA negotiations and it is in limbo now.

With India, Sri Lanka's problems are well known at present. These include issues such as political devolution of power, problems relating to Indo-Sri Lankan fishing and many other issues. Neighbours are bound to have problems, for example, Singapore and Malaysia, Thailand and Myanmar, Nepal and India, and USA and Mexico. However, many of these irritants between neighbours get submerged or sorted out if the economic bonds are strong between them and this is applicable to India-Sri Lanka relations also. It is in this context that a framework for rules-based economic exchanges like CEPA becomes important.

Unlike with India, there is no historical baggage with China. As long as the large imbalance and political tensions between India and the other smaller South Asian countries like Sri Lanka exist, the need for smaller South Asian countries to seek a balancer in China will remain.

While India's policy in the region is challenged and influenced by a plethora of historical and cultural links as well as political, social and economic issues, that of China is far less complex with little if any areas of friction and conflict, hence creating a "natural comfort level" with a more distant but generous and accommodative power. In this context, a distinct shift in approaches to bilateralism in South Asia is becoming apparent, where smaller states are beginning to look to China - rather than India - as the economic role model for achieving integrated and sustainable growth within the region. That is why there is not an iota of protest against Chinese engagement in Sri Lanka, whether one is talking about an FTA with China, more loans, more Chinese workers, or whatever; a major contrast vis-à-vis engagement with India.

EXPORT MARKET SHARE

Sri Lankan export shares in the Indian and Chinese markets have been increasing

	2000	2012
IND	1%	6%
China	0.1%	1.2%
China & Hong Kong	1.03%	2.3

What are the risks and opportunities involved in this shift in market access support, coming at a time when Sri Lanka has lost preferential market access to, and share in, key Western markets?
Sri Lanka has preferential access to both the Indian and Chinese markets which are both growing compared to her traditional markets in EU and US which are in recession.

The six times increase in Sri Lanka exports to India is mainly due to the India-Sri Lanka FTA. Although Sri Lanka has some preferential access to the Chinese market via the Asia-Pacific Trade Agreement it appears that the Agreement has not been very effective in increasing Sri Lanka's exports to China. In this context, the recent announcement of a China-Sri Lanka FTA is positive for more access to the Chinese market.

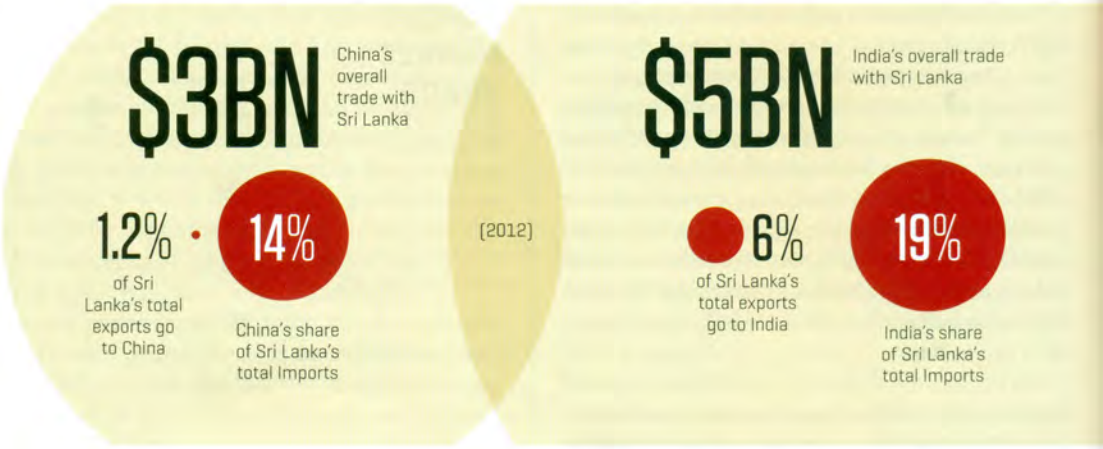
The Deputy Minister of Finance said in his speech at the Sri Lanka Economic Summit 2013 that the Chinese leadership was prepared to purchase all Sri Lankan exports if needed. If this is the case, China should take into account the asymmetry between the two countries and give a large negative list for Sri Lanka while fully granting duty free access to Sri Lankan goods to the Chinese market. A large negative list for Sri Lanka is essential because unlike with India, many locally produced consumer durables like toys, ballpoint pens, umbrellas, etc., will have little chance of competing with similar Chinese products and will be most probably wiped out from the market.

If such a designed China-Sri Lanka FTA comes into operation, Sri Lanka could to a great extent offset the decline of its exports in the Western markets via the expanding Chinese market. If it does not happen, then Sri Lanka will still have to struggle and hold on to the Western markets in the hope of better times to come.

Who will be an economically stronger partner to Sri Lanka - India or China ?
At present, India still commands a stronger position than China. India is also a strong FDI partner to Sri Lanka with cumulative Indian investment in Sri Lanka amounting to US$ 1 billion. Chinese FDI is far below this amount. However, in terms of financial assistance and external aid, China is a stronger partner than India. In the future, Sri Lanka should strengthen economic ties with both these countries, for they will be the new economic powerhouses of the world by 2050.

TRADE BALANCING ACT

India is the largest and the most balanced trading partner of Sri Lanka. China compared to India is a smaller trading partner but with trade between the two countries rapidly growing.



SOURCE: MINISTRY OF FINANCE AND PLANNING 2012 ANNUAL REPORT / MID-YEAR FISCAL POSITION REPORT 2013

How can Sri Lanka gain from the economic support of two competing Asian powers like India and China? What are the risks of trying to play off one against the other?

The major criticism of Chinese aid is that there is little technology transfer and most aid is linked with Chinese labour. Indian-funded projects and FDI have more technology transfer and use more local labour like the Ashok Leyland project and Kelani-CEAT joint venture. Hence to gain more from Chinese projects, technology transfer must be emphasized in loan negotiations.

We also saw the continuous breakdowns at the Norochcholai power plant. If lack of technology transfer is one reason for long repair times (like bringing engineers from Beijing), then that problem needs to be addressed in future Chinese aid-funded projects.

China's image in the non-Indian South Asian region is thus far unspoiled. A possible factor that could damage China's image in South Asian countries like Sri Lanka is a major internal upheaval within China over unresolved ethnic problems in Tibet and Xinjiang. Sri Lanka's reliance on China could also falter if China's role changes from a peaceful and generous partner to a forceful and encroaching one. Given China's clear strategic interests in pursuing close relationships with smaller South Asian countries like Sri Lanka, this possibility cannot be completely ruled out. Moreover, if tensions between China and India were to deepen, there could be negative repercussions on relationships between China and other South Asian countries like Sri Lanka.

A balancing exercise has been attempted in Chinese and Indian involvement in the Sri Lanka economy. When a plot of sea was given to Cairn India for oil exploration in the Gulf of Mannar, a neighbouring plot was allocated to the Chinese National Petroleum Corporation. When Chinese presence was very visible in Hambantota, India was invited to open a Visa Office there. India has also been invited to reconstruct the Palaly airport and open a Counsellor Division of the High Commission in Jaffna while China is allocated the Palaly-Kankesanturai railway line construction and part of the Northern highway. I do not see this as playing one against the other but balancing excess influence by either one of the countries by the other.

SMALL SOUTH ASIAN NATIONS NEED NOT BE SATELLITES OF EITHER CHINA OR INDIA BUT SHOULD STRIVE TO CREATE A GOOD BALANCE OF BOTH OF THEM FOR THE MAXIMUM BENEFIT OF THEIR OWN ECONOMIES.

A SMALL SOUTH ASIAN NATION SHOULD ALWAYS ENSURE THAT THIS BALANCE IS NOT TILTED HEAVILY TOWARDS CHINA, FOR IT WILL ALWAYS ENCOUNTER PROBLEMS WITH INDIA IN SUCH A SITUATION.

Small South Asian nations need not be satellites of either China or India but should strive to create a good balance of both of them for the maximum benefit of their own economies. Needless to say, this balancing exercise has to be carefully handled as it is not free from political risks. A small South Asian nation should always ensure that this balance is not tilted heavily towards China, for it will always encounter problems with India in such a situation. Whether one likes it or not, this is the geo-political reality.