



# COMMENTARY

## TWO GIANTS, ONE ISLAND: THE ROLE OF ECONOMIC SECURITY IN SRI LANKA'S DIPLOMATIC DANCE WITH INDIA AND CHINA

MATHISHA ARANGALA



# SOUTH ASIAN FUTURES FELLOWSHIP

THE SOUTH ASIAN FUTURES FELLOWSHIP ANNUALLY SUPPORTS EARLY CAREER RESEARCHERS BASED IN THE SOUTH ASIAN REGION, INTERESTED IN EXPLORING THE IMPACT OF GEOPOLITICS ON REGIONAL COOPERATION. FELLOWS ARE AT DIFFERENT STAGES OF THEIR CAREERS WITH EXPERTISE ON NON-TRADITIONAL SECURITY ISSUES; THEY PARTICIPATE IN WORKSHOPS, PRODUCE POLICY PIECES, AND ARE PROVIDED THE OPPORTUNITY OF A 1-MONTH RESEARCH RESIDENCY IN A SOUTH ASIAN CITY. DURING THIS RESIDENCY THEY WORK AT A PARTNER THINK TANK, ENGAGE WITH EXPERTS, AND CONDUCT FIELD STUDY ON A TOPIC OF THEIR INTEREST. THE FELLOWSHIP PRODUCES, AND ENGAGES WITH, REGIONAL NARRATIVES AND FACILITATES KNOWLEDGE EXCHANGE ON SHARED CHALLENGES IN AN EVOLVING GEOPOLITICAL CONTEXT IN THE SOUTH ASIAN REGION.

## ABOUT THE AUTHOR

MATHISHA ARANGALA IS AN ECONOMIST CURRENTLY EMPLOYED AS A LEAD ECONOMIST AT VERITÉ RESEARCH, A SRI LANKAN THINK TANK. HE COMPLETED HIS BACHELOR'S DEGREE IN BUSINESS AND COMMERCE, SPECIALIZING IN ECONOMICS AND BANKING & FINANCE, FROM MONASH UNIVERSITY MALAYSIA. HE ALSO HOLDS A HIGHER DIPLOMA IN INTERNATIONAL RELATIONS FROM THE BANDARANAIKE CENTRE FOR INTERNATIONAL RELATIONS, SRI LANKA. HIS INTERESTS AND SPECIALIZATIONS INCLUDE INTERNATIONAL TRADE, INTERNATIONAL RELATIONS, PUBLIC PROCUREMENT, FOREIGN DEVELOPMENT ASSISTANCE, AND GEOPOLITICS IN SOUTH ASIA. HIS WORK EXPERIENCE SPANS PROJECTS ON TRADE ADJUSTMENT ASSISTANCE, EXPORT REGULATIONS FOR AGRICULTURAL PRODUCTS, SRI LANKA'S INFRASTRUCTURE FINANCING THROUGH CHINA AND CONTRIBUTIONS TO PUBLICATIONS ON SRI LANKA'S RELATIONSHIP WITH THE EU'S GSP+ AND DATA DISSEMINATION PRACTICES IN SRI LANKA CUSTOMS.

## **Two Giants, One Island: The Role of Economic Security in Sri Lanka's Diplomatic Dance with India and China**

Since independence, Sri Lanka has outwardly portrayed a non-aligned foreign policy stance. However, in practice, the country's allegiances have shifted among the powers of the time, usually influenced by its prevailing interests.<sup>1</sup> Former President J.R. Jayewardene best illustrated this duality at the height of the Cold War; while publicly stating that non-alignment was "the silver thread that ran through Sri Lanka's foreign policy", he privately claimed that there were only two non-aligned countries in the world, the United States and the Soviet Union.<sup>2</sup> For instance, the past decade saw Sri Lanka increasingly aligning with China, owing to the latter's willingness to fund Sri Lanka's infrastructure projects and its support amidst various human rights allegations against the country. Today, with India's rising influence as a regional powerhouse, Sri Lanka's foreign policy finds itself in a geopolitical tug-of-war, forced to balance India's increasing influence while maintaining its commitments to China.<sup>3</sup> While accommodating the interests of major regional powers is not new to Sri Lanka, it is certainly more pronounced now and has raised concerns about the potential compromises Sri Lanka has had to make to appease the interests of these powers. This article highlights these compromises along the following lines: 1) compromises to the integrity of Sri Lanka's governance framework in accommodating various conditions of external funders and 2) the compromise to the degree of agency in the Sri Lankan government's investment decisions in its port infrastructure when balancing the interests of different powers.

Concerning the first compromise on Sri Lanka's governance framework, a key case study is Sri Lanka enacting a special framework in 2010 under the purview of the

Standing Cabinet Appointed Review Committee (SCARC) to accept Unsolicited Proposals (USPs) for public infrastructure projects, circumventing the national procurement guidelines, which insisted on competitive bidding for public infrastructure.<sup>4</sup> This ad-hoc framework was enacted to accommodate funding from foreign export credit agencies like China EXIM Bank, which often preferred unsolicited proposals over competitive bidding. This set a concerning precedent as USPs are often discouraged, especially for public infrastructure, as they lack transparency, are susceptible to corruption, and are prone to cost escalations, often failing to ensure value for money to the taxpayers.<sup>5</sup> A striking example of such a USP is the China funded Mattala International Airport, deemed the world's emptiest airport. This special framework operated from 2010 to 2016 and approved over USD 3.4 billion worth of public projects originating as USPs, 91% of which were funded by China.<sup>6</sup> However, it should be noted that while Chinese-funded projects in Sri Lanka are often more noticeable due to the considerable size of the funding, Sri Lanka also accommodated projects from India and various European credit agencies without going through a competitive bidding process.<sup>7</sup> As such, it is essential to understand that the fault of these scenarios cannot be attributed entirely to external influences. They highlight inherent susceptibilities in Sri Lanka's governance system that foreign entities have merely exploited. For instance, in the case of Sri Lanka accommodating these USPs, it is clear that for Sri Lanka to avoid these circumstances, it must overhaul its procurement framework, making it more transparent, committed to competitive bidding and, as a result, resistant to misuse.

The second compromise concerns the impediment to the agency of the Sri Lankan government in its investment decisions concerning critical infrastructure. Sri Lanka's attempts to balance the interests of India and China regarding strategic assets

constrain its ability to select the most suitable investors for pivotal projects through a transparent, competitive bidding process.

A noteworthy example of this balancing act is China and India's recent investments in Sri Lanka's port infrastructure.<sup>8</sup> Chinese companies already hold significant maritime assets in Sri Lanka, like the Hambantota Port and the CICT Terminal inside the Colombo Port. In response, India has also been keen to establish its presence in Sri Lanka's ports. In 2021, the Sri Lankan government allocated the Colombo West Terminal to a joint venture between India's Adani Group and Sri Lanka's John Keells.<sup>9</sup> Seemingly in sync with India's investment, in mid-2023, the Government awarded China Merchants Port Holdings Company (CMPH) an 85% stake in a strategically placed logistics facility within the Colombo port.<sup>10</sup>

Notably, these investments were awarded unilaterally, sidestepping the standard competitive bidding process, with little transparency on the selection process despite such transparency being mandated in Sri Lanka's laws. This trend, evident in several government dealings involving strategic assets, has raised concerns among industry leaders. They worry that certain assets have been undervalued. They argue that crucial assets, like port infrastructure, should be sold to the most qualified investors through competitive bidding to maximize returns.<sup>11</sup> Moreover, limiting the pool of investors based on geopolitical considerations raises questions about the government's ability to make investment decisions that truly serve Sri Lanka's interests. This is particularly concerning when decisions are made in an ad-hoc manner, without a thorough evaluation of the potential economic consequences. For instance, Sri Lanka has an immense opportunity to leverage its strategic location to finally integrate into regional supply chains through a resurging India.<sup>12</sup> Yet, considering India's security concerns over the potential dual use of Chinese port infrastructure in Sri Lanka, Sri Lanka's decisions to hand over critical port

infrastructure to China on the pretext of balancing China may hinder its ability to attract much-needed Indian investors to key logistics hubs. On the flip side, being subject to increased scrutiny by India over security concerns concerning Chinese presence also constrains Sri Lanka's ability to pursue meaningful economic interests with China. Furthermore, while more economic engagement with India is the future for Sri Lanka, completely disengaging from China is not a viable option, at least in the short run, due to prevailing trade obligations and debt obligations to China, which Sri Lanka is currently negotiating to restructure. As such, Sri Lanka is confronted with the challenge of balancing its commitments to China while benefiting from India's economic growth without compromising its national interests.

A key strategy for Sri Lanka to overcome the complexities of this balancing act and regain greater agency in its decisions would be to ensure that investment decisions (like the ones discussed above) are subject to international competitive bidding, allowing space for potential investors from all countries, including local firms. This also entails ensuring transparency over the selection process and the contracts signed between the parties as is already mandated by Sri Lanka's law.

Such measures can: 1) help expand options for the government regarding investors for key assets beyond just India and China to ensure that the best qualified value-for-money investor is selected, 2) ensure that 'middle powers' like Japan and South Korea are also included in its investment decisions through international competitive bidding, which neither India nor China may object to,<sup>13</sup> and also 3) help alleviate India's security concerns, over the nature of Chinese investments. For instance, if a Chinese company is selected for a project through a competitive bid in a transparent manner that allows both Indian and Chinese companies to bid, Indian security concerns over such Chinese investments can be somewhat alleviated.

Sri Lanka is currently at a crucial geopolitical crossroads when dealing with India and China. As such, it's imperative that Sri Lanka doesn't compromise on its governance frameworks and formulates a cohesive, well-defined foreign policy that doesn't create financial or diplomatic dependencies while balancing its economic aspirations with geopolitical realities.

## Endnotes

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<sup>1</sup> "Non-alignment and SL's Foreign Policy." *Ministry of Foreign Affairs - Sri Lanka*, 10 Jan. 2012, at <https://mfa.gov.lk/non-alignment-and-sls-foreign-policy/>

<sup>2</sup> "Non Alignment: Will Lanka Abandon Principles." *The Sunday Times Sri Lanka*, 25 Sep. 2016, at <https://www.sundaytimes.lk/160925/editorial/non-alignment-will-lanka-abandon-principles-209052.html>

<sup>3</sup> Sri Lanka is highly dependent on both India and China for its trade. In particular, up to 40% of Sri Lanka's total imports are from India and China, more or less split equally between the two countries to varying degrees over the past decade. China, in particular, has emerged as a key source of funding for Sri Lanka's infrastructure aspirations, having funded multiple highway, energy, water and other projects. As a result, China has emerged as the largest bilateral lender to Sri Lanka, with up to USD 7bn in accumulated debt. However, India's emerging as a key manufacturing hub in the region has presented Sri Lanka with an immense opportunity to finally integrate into global value chains and realise its ambitions towards export and foreign direct investment-driven growth. Today, India has emerged as Sri Lanka's largest source of imports, having replaced China over the last 2 years. India is currently Sri Lanka's 3rd largest export destination after the US and the UK and the largest source of tourists. Over the past 5 years, India has also surpassed China in terms of FDI inflows to Sri Lanka. India has also been actively involved in assisting Sri Lanka during the prevailing crisis, having provided lines of credit of up to USD 4 billion.

<sup>4</sup> Verite Research, "Foregoing Competition to Secure Funding for Public Infrastructure: One-third of funding secured was non-concessional", 2022, at <https://www.veriteresearch.org/wp-content/uploads/2023/06/20230626EconCipe07PfpScarcBriefF.pdf>

<sup>5</sup> An OECD study highlighted that foregoing competitive bidding in favour of USPs could inflate project expenses by 15-30%. Source: Catrinus J. Jepma. "The tying of aid." OECD, 1991, at <https://www.oecd.org/dev/pgd/29412505.pdf> .

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<sup>6</sup> Verite Research, "Foregoing Competition to Secure Funding for Public Infrastructure: One-third of funding secured was non-concessional", 2022, at <https://www.veriteresearch.org/wp-content/uploads/2023/06/20230626EconCipe07PfpScarcBriefF.pdf>

<sup>7</sup> Verite Research, "Financing infrastructure: The (non) concessionality of Concessional loans", 2020, at [https://www.veriteresearch.org/wp-content/uploads/2020/08/VR-Report\\_Financing-Infrastructure-%E2%80%93-The-Non-Concessionality-of-Concessional-Loans\\_June\\_2020.pdf](https://www.veriteresearch.org/wp-content/uploads/2020/08/VR-Report_Financing-Infrastructure-%E2%80%93-The-Non-Concessionality-of-Concessional-Loans_June_2020.pdf); Verite Research, "Foregoing Competition to Secure Funding for Public Infrastructure: One-third of funding secured was non-concessional.", 2022, at <https://www.veriteresearch.org/wp-content/uploads/2023/06/20230626EconCipe07PfpScarcBriefF.pdf>

<sup>8</sup> Another example of this balancing act was the Government's decision to grant the license for China's Sinopec to enter Sri Lanka's fuel market, with Sinopec even being allowed to sell fuel below the government-set retail price. This pits Sinopec in direct competition with Lanka Indian Oil Corporation, which has operated in Sri Lanka since 2003. With Sinopec's emergence, Lanka IOC plans to add 30 new stations to its existing 250, indicating a brewing India-China rivalry in Sri Lanka's oil sector. This balancing act has also revealed a geographic dimension. The Sri Lankan government gives India priority in Sri Lanka's north, with India leading projects like rebuilding the northern railway and Trincomalee port. While China dominates the south, funding the southern railway line and expressways and leading investments in the Hambantota port. (Source: Dutta S. "China Major Seeks to End IOC Subsidiary's Lanka Dominance." *Times of India*, 21 Aug. 2023, at <https://timesofindia.indiatimes.com/world/china/china-major-seeks-to-end-ioc-subsidiarys-lanka-dominance/articleshow/102881256.cms?from=mdr>)

<sup>9</sup> Iyer, Ramita, and Chulanee Attanayake. "Indian Investment in Colombo Port: A Game Changer in Sri Lanka's Port Industry?" Institute of South Asian Studies, Singapore and Pathfinder Foundation, Sri Lanka, May 2023, [https://www.isas.nus.edu.sg/wp-content/uploads/2023/05/SADP\\_SpecialReport25\\_Complete.pdf](https://www.isas.nus.edu.sg/wp-content/uploads/2023/05/SADP_SpecialReport25_Complete.pdf)

<sup>10</sup> Balachandran, P.K. "China Strengthens Grip on Sri Lanka's Colombo Port." *The Diplomat*, 3 May 2023, at <https://thediplomat.com/2023/05/china-strengthens-grip-on-sri-lankas-colombo-port/>

<sup>11</sup> Ibid.

<sup>12</sup> Leveraging its logistical strengths, Sri Lanka could become for India what Hong Kong and Singapore were to China. Already, the Colombo port is India's primary transshipment hub, and this role is expected to grow along with possibilities of engaging in more value-added services, such as entrepot trade, component supply, HQ operations and warehousing. (Source: Abeysinghe S and Arangala M. "ETCA with India: Time to shift focus from Market Integration to Supply Chain Integration." *Daily Mirror*, 27 April 2023, at <https://www.dailymirror.lk/opinion/ETCA-with-India-Time-to-shift-focus-from-Market-Integration-to-Supply-Chain-Integration/172-258252>)

<sup>13</sup> Asanga Abeyagoonasekera's book "Conundrum Of An Island: Sri Lanka's Geopolitical Challenges" argues that Sri Lanka should consider collaborations with middle powers to sidestep the dilemma of choosing between great powers. (Source: Xavier C. "Still Non-Aligned? Sri Lankan Politics and Foreign



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Policy." Centre for Social and Economic Progress, 04 Aug. 2023, <https://csep.org/blog/still-non-aligned-sri-lankan-politics-and-foreign-policy/>)

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