

Pathfinder *China Watch* – 1

Great Leap Forward in Sino-Lankan Relations- A way forward

China's Steadfast Friendship

Sino-Lankan relations are on the threshold of a transformative leap forward. Contacts between Sri Lanka and the Middle Kingdom go back several centuries to the visits by the monk/scholar Fa Hsien and the impressive naval fleet of Admiral Zheng He. In the post-colonial era, the historic Rubber-Rice Pact (1952) was the landmark that initiated the very cordial relations that have prevailed between the two countries during the subsequent decades. China has been a steadfast friend which has played a very important role in protecting the unity and territorial integrity of the country.

China's Massive Role in Infrastructure Development

Since the end of the conflict in 2009, China has been the lead player in assisting Sri Lanka's unprecedented accelerated infrastructure development program. Chinese funding have, inter alia, supported the development of the Norochchola Power Plant, the Hambantota Port, Mattala Airport and the road development program (including Katunayake – Colombo Highway, a part of the Southern Highway and the Northern Road Rehabilitation Project). The significant backlog of infrastructure development that has plagued the country for several decades could not have been addressed so expeditiously without Chinese funding and technical assistance. While there is a debate to be had in terms of the current rates of return on some of these projects and the opportunity cost involved, the fact is that these critically important assets have been created and the conditions have been generated to strengthen the growth framework of the economy is highly commendable.

China has provided assistance to the tune of US\$5.8 billion, since 2005. Of this 84% have been commercial loans from the EXIM Bank (69%) and China Development Bank (15%). As Sri Lanka's headroom for additional commercial debt becomes more constrained, China has shifted its focus to FDI (equity). Already, China Merchant has an 85% stake in the Colombo North Port Development. During the President's recent visit to China, it was also announced that China Harbour would invest in the Colombo-Kandy- North Highway. This is likely to be the tip of the iceberg. China seems to have identified Sri Lanka as a strategic destination for the Chinese investment. This has also paved the way for large scale implementation of Public Private Partnerships (PPPs) for infrastructure development in Sri Lanka.

The Stage is Set for a Great Leap Forward

There are a number of factors that are currently working in favour of a "great leap forward" in Sino-Lankan economic relations.

- The excellent political relations between the two countries provide a robust foundation for stronger economic ties.
- China has expressed concern at the highest level about Sri Lanka's large deficit in the bilateral trade between the two countries. Sri Lanka's exports to China amount to US\$ 976 million (2012) while imports from China were \$3.2 billion. This has provided the impetus for the much-needed bilateral FTA which is expected to be completed before the end of 2013.
- The FTA is likely to provide preferential access for traditional Sri Lankan exports, such as apparel and tea, as well as for other nontraditional goods and services. The Chinese Ambassador was recently quoted as saying that Sri Lanka should focus on higher value manufactured exports into the Chinese markets.
- The proposed market opening through the FTA is very opportune at a time when China's overriding priority is to re-balance its economy from external (exports) to domestic demand. This will create new opportunities for China's trading partners, particularly those with preferential access to the enormous Chinese market, including the rapidly rising demand for high value goods.
- The prospects of attracting Chinese FDI to create export capacity to generate competitive supplies to sell into the Chinese market have also been enhanced. The combined effects of the strengthening Yuan; increasing domestic costs, including labour; and the priority attached to diversifying the investment strategy for China's massive external reserves have meant that Chinese companies are increasingly seeking to invest abroad. Sri Lanka seems to have been identified as a strategic partner in this connection.
- The combination of all these factors will offer increased opportunities not only for exporting finished goods but also for penetrating the supply chains of Chinese companies.
- Some Chinese companies are also likely to be attracted by the market prospects offered by Sri Lanka's FTAs with India and Pakistan.
- The recent decision by the government to create entrepôts and bonded areas will further incentivize potential Chinese (and other) investors as this will enable them to avoid some of the macroeconomic and other business environment related constraints that have hindered export development in the country (see Economic Flash 34 at www.pathfinderfoundation.org).
- There is considerable potential for growth in Chinese tourists to Sri Lanka. It is expected that there will be a total of 90 million outbound tourists from China in 2013. They have now become the highest tourist spenders in the world. It is encouraging, therefore, that there has already been a 70% increase in Chinese arrivals this year. The ongoing aggressive promotion campaign by the government, the private sector and non-state actors is to be commended and encouraged. The mega tourism projects that are currently begin implemented will significantly improve the local tourism infrastructure and increase the attraction of Sri Lanka as a destination for high-end Chinese visitors.

A Dosage of Realism

A combination of political will and propitious economic factors have created a massive opportunity for a great leap forward in Sino-Lankan economic relations. However, it is important to infuse a note of caution. Geo-political realities cannot be wished away. Sri Lanka is very much within India's defense perimeter. This is an immutable fact that China also recognizes. It is likely that this message has been communicated at the highest levels. In such a context, Sri Lanka's diplomacy and economic relations should be focused on maximizing the benefits from the rise of both Asian giants: China and India.

In this context, it is clear that stronger the Sino-Indian relations the greater will be the scope for Sri Lanka to build its bilateral economic relations with China. In this connection, there are grounds for optimism:

- India and China have reset their bilateral relationship. There are regular contacts at the highest levels at the political and defense establishment fronts. Despite tensions that arise from time-to-time, particularly on border issues, bilateral mechanisms are in place to reduce mistrust.
- China and India are also working together on an expanding common agenda within the BRICS framework. This too should serve to create greater trust between the two Asian giants.
- Sino-Indian trade has increased from \$1.5 billion in 2000 to \$ 50 billion in 2012.

Broader Perspective for the Future

With the dawn of peace, Sri Lanka has been able to make a remarkable progress in infrastructure which is a necessary condition for sustainable economic development. Role of the Chinese assistance in this regard was the most crucial factor.

The next phase of Chinese assistance, hopefully will also include international marketing of the hard infrastructure already developed, especially seaports, airports and highways making Sri Lanka a regional hub for aviation, shipping and logistics.

What has become possible today would not have been possible five-ten years ago. It would be greatly advantageous to Sri Lanka if Sino-Indian relations continue to improve so that the full potential for a great leap forward in Sino-Lankan relations can be realized.

The Pathfinder Foundation (PF) has established a partnership with the Chinese People's Association for Peace and Disarmament (CPAPD). This is leading to a growing volume of collaborative work between the two organizations. The PF will be publishing regular editions of its China Watch.