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# China–Sri Lanka Economic Relations: An Overview<sup>1</sup>

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*This article fills a gap in the literature by focusing on the growing economic links between China and Sri Lanka. Starting from the 1952 Rubber-Rice Pact, the economic relations between the two countries have grown over the years with an unprecedented growth since 2005. Chinese military assistance helped overcome three decades of conflict in North/East Sri Lanka and Chinese financial assistance to other areas of the Sri Lankan economy, in particular, infrastructure development have also strengthened. Although Sri Lanka's trade and investment links with China are not very strong, the increased Chinese financial assistance has had some spill over effects in strengthening these in recent years. Sri Lanka will sign a Free Trade Agreement with China most probably in 2014 but growing economic relations with China present both opportunities and challenges to Sri Lanka.*

**Keywords:** China–Sri Lanka FTA, Asia Pacific Trade Agreement

## BACKGROUND

*In recent years* the relations between China and Sri Lanka have been growing at a rapid pace, so much so, that the two countries are on the verge of signing a bilateral Free Trade Agreement (FTA) in early 2014. The relations between the two countries have been documented from time to time. However, there is little literature on the economic areas which are currently strengthening. This article intends to analyse the growing economic links between the two countries.

<sup>1</sup> This is an updated version of a lecture delivered on the subject at the 61st National Anniversary of China organised by the Sri Lanka–China Society, Bandaranaike Centre for International Studies, Colombo, 29 September 2010. I am grateful for research assistance from A. Abeysekera of the Institute of Policy Studies of Sri Lanka, Colombo.

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Relations between China and Sri Lanka dating back over 20 centuries have historically been strengthened by shared religious and cultural values. With Zheng He, a Chinese navigator of the Ming Dynasty, sailing to Sri Lanka many times, the initial foundation for trade and cultural exchanges between the two countries were laid (Wickremasinghe 2005). The signing of the Rubber-Rice pact in 1952, was a landmark in the bilateral ties between these two nations, as it was done ignoring the sanctions placed on China by Western nations and represented one of the first agreements that China had ever signed with a non-communist country. Through this pact Sri Lanka guaranteed to import 270,000 metric tons of rice each year, while China guaranteed to purchase 50,000 tons of rubber each year for a period of five years. The agreement was renewed every five years until 1982. With China offering 40 per cent more than the market price for rubber and selling rice for less than a third of the market value, this agreement has been the most useful trade agreement negotiated by Sri Lanka, and having been in operation for 30 years, it is considered one of the most successful and durable South-South trade agreements in the world (Kelegama 2004). Further, this pact paved the way for the increased formal diplomatic relations between the two countries.<sup>2</sup>

After the establishment of diplomatic relations with China in 1957, China and Sri Lanka signed the first agreement on Economic and Technological Cooperation in 1962 and a maritime agreement in the following year which ensured that all commercial vessels engaged in cargo and passenger services between the two countries or a third country will be treated based on Most Favoured Nation (MFN) status. The state visit of Prime Minister, Sirimavo Bandaranaike to China in 1972 was a turning point in Sri Lanka-China economic relations with Chinese bilateral aid packages gradually increasing, with the initiation of the construction of the Bandaranaike Memorial International Conference Hall (BMICH).

The year 1981 marked the formation of the Sri Lanka-China Society with an aim to strengthen the friendship links between the two nations without any vested political interests (Jayasekera and Tennakoon 2007). While the Sino-Lanka Joint Trade Committee and Sino-Lanka Economic and Trade Cooperation Committee were signed in 1982 and 1984 respectively, they were amalgamated to form the Sino-Lanka Joint Commission for Economic and Trade Cooperation in 1991 (MOFA 1998: 189). A further attempt to strengthen long-lasting economic relations between the two countries was seen in 1994, with the formation of the Sri Lanka-China Business Cooperation Council.

The relationship between China and Sri Lanka reached a new peak under the post-2005 administration. In a landmark state visit to China in 2007 on the occasion of the golden jubilee celebrations of diplomatic relations, President Mahinda Rajapaksa signed the following eight bilateral agreements and MOUs with China:

1. Agreement on Economic and Technical Cooperation between China and Sri Lanka

<sup>2</sup> After gaining independence in 1948 from British colonial rule, Sri Lanka had little diplomatic links with the Communist countries and most of the links at that time were with Western countries.

2. MOU between the Ministry of Construction of China and the Ministry of Urban Development and Sacred Area Development of Sri Lanka
3. Agreement between the city of Guangzhou of China and District of Hambantota of Sri Lanka on the establishment of Friendship City Relationship
4. MOU on two-way investment promotion cooperation between the Investment Promotion Agency of the Ministry of Commerce of China and the Board of Investment of Sri Lanka
5. MOU on Cooperation in the Film Industry between the Film Bureau of the State Administration of Radio, Film and Television of China and the National Film Corporation of Sri Lanka
6. MOU for the Donation of Eye Corneas and Promotion and Cooperation, exchanges, Technical and Technology Transfer between the Red Cross Society of China and the Eye Donation Society of Sri Lanka
7. MOU between the Chinese Academy of Agriculture Mechanization Sciences and Department of Agriculture of the Ministry of Agriculture of Sri Lanka
8. MOU of Academic Exchange between the Beijing Foreign Studies University of China and University of Kelaniya of Sri Lanka

More recently in 2009, an investment facilitation agreement was signed by the China Development Bank and the Central Bank of Sri Lanka, under which the China Development Bank places a US Dollar deposit with the Central Bank of Sri Lanka, while also working towards long-term economic ties between the two institutions (*The Island* 2009). In addition to the above mentioned agreements and programmes aimed at strengthening bilateral ties, China has also been a major provider of aid, technical assistance and has contributed towards numerous large-scale projects in Sri Lanka. Such contributions made by China will be discussed in this article, which is divided into nine sections—Section 2 is on trade relations, Section 3 on the Asia Pacific Trade Agreement, Section 4 on investment relations, Section 5 on aid and technical assistance, Section 6 on human resources development links, Section 7 on Sri Lanka's contribution to China, Section 8 on prospects and Section 9 with some concluding remarks.

## TRADE RELATIONS

As the Chinese economy has grown at a rapid rate of above 9 per cent annually for the past decade, with a high of 14.27 per cent in 2007,<sup>3</sup> the share of Sri Lanka's imports from China has steadily increased to 13.9 per cent in 2012. The share of Sri Lanka's exports to China however has remained low at 1.2 per cent in 2012 (Central Bank of Sri Lanka Annual Report 2012). Thus, while bilateral trade has grown, the trade balance has been representative of the trading strength of the two nations.

<sup>3</sup> Chinese GDP growth rates based on data from the World Bank (2012).

**Table 1**  
**Sri Lanka's Exports, Imports and Trade Balance with China: 2005–12**

<i>Year</i>	<i>Exports to China (US\$ Mn)</i>	<i>Imports from China (US\$ Mn)</i>	<i>Trade Balance (US\$ Mn)</i>
2005	29	631	-602
2006	25	780	-755
2007	34	924	-890
2008	47	1114	-1067
2009	56	1029	-973
2010	72	1240	-1168
2011	103	2092	-1989
2012	108	2667	-2559

**Source:** Sri Lanka Customs data, Colombo (2013).

As Table 1 shows, the total trade between the two countries has been steadily increasing over the years and has more than doubled over the two-year period from 2009 (US\$1,085 million) to 2012 (US\$2,775 million) (Central Bank of Sri Lanka 2009, 2012). In 2009 however, there was a drop in trade to US\$1,085 million from US\$1,161 million in the preceding year. This resulted from the reduction in imports (from US\$1,114 million to US\$1,029 million) caused by the global economic downturn. While Sri Lankan exports to China have grown over the last five years, imports from China have grown at a significantly larger rate, resulting in a rapidly expanding trade deficit of US\$2559 million in 2012, which is more than double the deficit of US\$973 million in 2009. In the current globalised world, expanding trade deficit with major suppliers of imports should not be a major concern for the country facing the deficit.

These figures are further enlarged when Sri Lanka's trade with China plus Hong Kong is also considered (see Table 2). Total trade between Sri Lanka and China + Hong Kong was US\$3,485 million in 2012, which represents the second largest source of imports (US\$3,272 million), exceeded only by India (US\$3,640 million) and the tenth largest destination for Sri Lankan exports (US\$213 million). Today, China (and Hong Kong) is Sri Lanka's third largest trading partner after India and USA; however, for China (and Hong Kong), Sri Lanka is not a major trading partner.

From a South Asian regional perspective, China is the largest trading partner of both Pakistan and Bangladesh while it is the second largest trading partner of both India and Nepal.<sup>4</sup> One can argue that had a free trade agreement not existed between India and Sri Lanka, perhaps China would have become the largest trading partner of both Sri Lanka and Nepal by 2012. India-China trade is currently running at US\$75 billion.

<sup>4</sup>Note that China and Pakistan have a FTA since 2006. India's largest trading partner is UAE due to large amount of entrepot trade and Nepal's largest trading partner is India due to the India-Nepal FTA (Kelegama 2013a).

**Table 2**  
**Sri Lanka's Export, Import, and Trade Balance with China + Hong Kong: 2005–12**

<i>Year</i>	<i>Exports to China + Hong Kong (US\$ Million)</i>	<i>Imports from China + Hong Kong (US\$ Million)</i>	<i>Trade Balance (US\$ Million)</i>
2005	93	1279	-1186
2006	97	1439	-1342
2007	100	1649	-1549
2008	151	1809	-1658
2009	125	1546	-1421
2010	170	1820	-1650
2011	218	2724	-2506
2012	213	3272	-3059

**Source:** Sri Lanka Custom's data, Colombo (2013).

As can be seen from Table 3, Sri Lanka's major exports to China have varied considerably over the years. Exports of raw coconut coir in particular have grown exponentially from 2009 to 2010, with further growth in 2011, indicating China's continuously growing demand for Sri Lankan coconuts. A similar hike can be seen in the value of rubber exports which grew nearly tenfold in 2010 and then again doubled in 2011.

The only major export to China that declined in 2011 was that of diamonds and precious stones. This was immediately following the growth in diamond exports from US\$7.3 million in 2009 to US\$20 million in 2010. Further analysis is required to assess whether the export decline seen in 2011 is temporary or is indicative of a more permanent decline in Chinese demand for Sri Lankan diamonds and precious stones. The value of tea exports to China has steadily increased over the six-year period, while exports of apparels and clothing accessories have also shown a general upward trend despite a decrease in 2010.

In addition to the items mentioned in Table 3, titanium ore, zirconium ore and activated carbon also represent significant Sri Lankan export items to China. It should

**Table 3**  
**Sri Lanka's Major Exports to China: 2006–11**

<i>Description</i>	<i>Value (US\$ Million)</i>					
	<i>2006</i>	<i>2007</i>	<i>2008</i>	<i>2009</i>	<i>2010</i>	<i>2011</i>
Raw coconut coir	5.6	2.5	8.7	3.2	26.8	29.6
Articles of apparel and clothing accessories	0.9	1.6	4.2	8.6	3.4	8.9
Tea whether or not flavoured	1.9	3.0	3.6	3.5	6.4	11.4
Rubber and articles thereof	1.5	1.6	3.1	1.4	10.9	22.4
Diamonds and other precious stones	0.2	1.8	2.9	7.3	20.0	3.4

**Source:** Sri Lanka Custom's data, Colombo (2013).

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be noted that with the exception of apparels and clothing accessories, all of Sri Lanka's major exports to China are concentrated in the primary sector of the economy. This in turn is indicative of Sri Lanka's comparative advantage in the extraction of natural resources.

Similar to the exports, the import values of Sri Lanka's major imports from China have noticeably varied in the six-year period. As can be seen from Table 4, machinery, boilers and cotton are clearly the most dominant Chinese imports to Sri Lanka. The import value of electrical machinery and equipment more than doubled in 2011, following a year in which the import value actually declined. On the other hand, import values of boilers and machinery and machine parts grew steadily up until 2010 and then more than doubled in 2011. With the exception of iron and steel imports which declined in 2010 but then recovered in 2011, the rest of Sri Lanka's major imports from China have shown a general upward trend, with the sharpest rise in imports coming from fertilizer which grew from US\$24.03 million in 2010 to US\$114.13 million in 2011. This was mostly due to the escalating global oil prices, which is an input in the production of fertilizer.

In addition to the items mentioned above, railway locomotives, organic and inorganic chemicals along with coated, covered or laminated fabric also represented significant imports from China to Sri Lanka. Further, looking at Table 4 it is evident that with the exception of cotton, all of Sri Lanka's imports from China are from the secondary sector of the economy that deals with manufacturing, construction and processing. Contrasting this with Sri Lanka's exports to China which consisted mainly of primary goods, which are generally of lower value than secondary goods, one can observe a reason for the large and growing deficit Sri Lanka faces in its trade balance with China.

Despite the much larger scale of imports, there seems to be a positive correlation between Sri Lanka's exports to China and Sri Lanka's imports from China, with the decline in imports in 2009 corresponding with the decline in exports in the same year.

**Table 4**  
**Sri Lanka's Major Imports from China: 2006–11**

<i>Description</i>	<i>Value (US\$ Million)</i>					
	<i>2006</i>	<i>2007</i>	<i>2008</i>	<i>2009</i>	<i>2010</i>	<i>2011</i>
Electrical machinery and equipment	97.8	114.1	130.5	166.0	136.3	298.0
Boilers and machinery and parts	79.0	88.9	113.6	144.1	151.9	313.9
Cotton	74.4	98.1	102.8	83.0	127.5	191.9
Iron or steel and its articles	61.9	73.9	93.9	91.0	31.0	61.5
Man-made staple fibres	61.9	66.2	64.6	53.8	69.7	122.6
Knitted or crocheted fabrics	55.4	55.1	56.2	67.4	94.9	159.6
Fertilizers	14.0	42.5	45.3	18.4	24.0	114.1

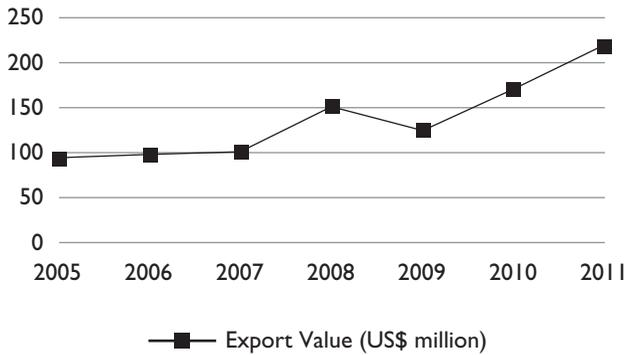
**Source:** Sri Lanka Custom's data, Colombo (2013).

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The sharp decrease in exports in 2009 is mainly due to the fall in raw coconut coir exports to China, while the import decline in 2009 can be attributed to a fall in the import values of fertilizer, man-made staple fibres and cotton. Further, the general upward trend in both export and imports in 2010 and 2011 as shown in Figures 1 and 2 is indicative of the increasing value of trade being carried out between Sri Lanka and China.

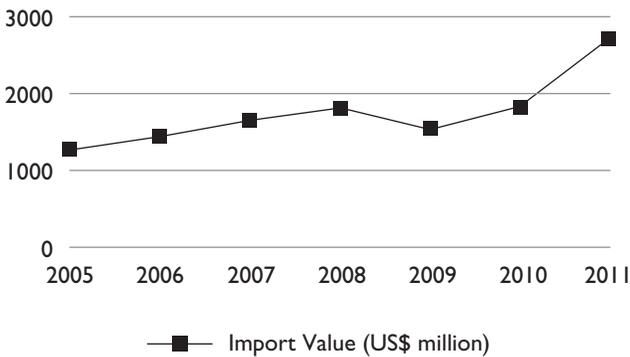
China-Sri Lanka trade has gathered momentum in recent years due to strengthening bilateral relations between the two countries.

*Figure 1*  
Sri Lanka's Exports to China + Hong Kong



**Source:** Prepared using Central Bank of Sri Lanka data (various years).

*Figure 2*  
Sri Lanka's Imports from China + Hong Kong



**Source:** Prepared using Central Bank of Sri Lanka data (various years).

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### ROLE OF THE ASIA PACIFIC TRADE AGREEMENT

The Asia Pacific Trade Agreement (APTA), formerly known as the Bangkok Agreement, of which both Sri Lanka and China are members is a preferential tariff agreement that aims to promote intra-regional trade through the exchange of mutually agreed concessions by member countries (United Nations, Economic and Social Council for Asia Pacific). Consequently, the members give each other a margin of preference (MOP) over the general tariff level. Although the APTA has been under-utilised thus far, with studies showing Sri Lanka under-utilising the APTA concessions by 50 per cent (*Invest Sri Lanka* 2010), it is a potential avenue by which trade between the two countries can be significantly expanded.

Under the APTA, China already provides tariff concessions for over 1,700 products being imported from Sri Lanka at a MOP of 27 per cent, which covers around 50 per cent of Sri Lanka's total exports to China. These concessions are expected to increase to cover over 2000 export products within the next few years. However, out of the APTA eligible exports 15 per cent are untouched by SL exporters. While the important export category, titanium ores and concentrates and retreaded or used tyres, receives no preferences under APTA, major exports such as tea and coconut products receive MOPs of 50 per cent, and 20 per cent respectively.

The APTA can provide ample opportunities for business expansion, sourcing and attracting foreign direct investment (FDI) to Sri Lanka. Yet, as most exporters are not aware of the APTA concessions, it is crucial that trade authorities raise awareness among exporters about APTA usage. Major export products to China such as coir fibre, rubber, rubber products and tea are already eligible for duty cuts under APTA, but exporters are not using these concessions. Exporters need to check on what items qualify for duty cuts and then must get the APTA certificate of origin to qualify for duty cuts into China. It has been found that some exporters go to China without the APTA certificate of origin and thus do not get the duty reductions.

December 2009 marked the fourth round of APTA negotiations which aimed to widen the coverage of preferences to at least 50 per cent of the number of tariff lines and provide a tariff concession of at least 50 per cent. Further, in order to deepen trade cooperation and integration these negotiations extended into areas like trade facilitation, non-tariff measures and investments, which lie beyond traditional tariff concessions. In addition, an official from the Department of Commerce of Sri Lanka stated in October 2010 that the three giants in the APTA, Korea, India and China were prepared to recognise Sri Lanka as a less developed country and give it a near-zero (90 per cent) duty concessionary entry into their markets on average under certain tariff lines. However, as stated by the official of the Department of Commerce of Sri Lanka, 'reaching a consensus under the 4th round of APTA talks which would make these concessions a reality has been delayed due to disagreements by India, but those disagreements are not with SL' (*Invest Sri Lanka* 2010). The APTA is thus, a useful forum for Sri Lankan trade officials to exchange views with their Chinese counterparts.

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## INVESTMENT RELATIONS

Over the past few years the role played by China (including Hong Kong) as a source of investment for Sri Lanka has steadily increased. The realised value of FDI from China + Hong Kong which was US\$101.2 million in 2008 progressively grew to US\$149.3 million in 2011. Further, one can obtain an insight into the changing trends in Sri Lanka's major sources of FDI in Table 5.

Although it is evident that the largest value of FDI to Sri Lanka in 2011 came from Mauritius, it should be noted that Mauritius has not traditionally been a major source of FDI as even in the two years immediately preceding 2011, FDI from Mauritius only amounted to US\$1.74 million and US\$15.06 million, respectively.<sup>5</sup> China on the other hand, has progressively climbed up the list of Sri Lanka's major sources of FDI. However, the vast majority of the US\$149.25 million FDI from China + Hong Kong has been from Hong Kong (US\$138.80 million) with just US\$10.45 million coming from mainland China. For instance, foreign investment of US\$1 billion will flow into a 500-room hotel by Honk Kong-based Shangri La Asia. Further, looking at FDI coming only from mainland China, a decreasing trend can be seen over the four-year period with the US\$10.45 million received in 2011 being significantly lower than the US\$27.36 million received in 2008. However, it is reported in the media that a shopping mall by China National Aero Technology Import and Export Corporation (CATIC) will be established in Colombo, the largest investment so far (Aneez 2011).

The telecommunications and power and energy industries attracted most of the FDI from China, while Chinese businesses have also made significant investments in garments, leather and electronics manufacturing facilities in Sri Lanka. The latter three sectors are of particular importance as they represent export items and thus play an important role in the overall economic performance of the country. The rising FDI into these sectors has been a result of the government actively encouraging Chinese

*Table 5*  
FDI into Sri Lanka over the period 2008–11 (US\$ Million)

<i>Country</i>	<i>2008</i>	<i>2009</i>	<i>2010</i>	<i>2011</i>
China + Hong Kong	101.2	46.2	32.9	149.3
India	125.9	77.7	110.2	146.8
Malaysia	150.4	164.5	72.7	89.5
UK	87.4	89.0	61.8	52.0
Singapore	20.6	21.6	42.4	53.0
Mauritius	0.00	1.7	15.1	263.3

**Source:** Data Base, Research Department, Board of Investment of Sri Lanka, 2012.

<sup>5</sup> Like in India where there is substantial investment from Mauritius, some investors in Sri Lanka may be using Mauritius as an FDI location due to various tax advantages in Mauritius.

investors to locate in Sri Lanka. For example, entrepreneurs from China have been provided with an exclusive Export Processing Zone (EPZ) in Mirigama, and depending on the progress and success of this zone, additional space is planned by the government of Sri Lanka at Godagama, Matara and the Eastern Province of Sri Lanka. In addition, all Chinese entrepreneurs who invest a minimum of US\$25 million are provided with a Sri Lanka passport on the basis of a 'second home' passport.

In terms of individual projects, Textured Jersey Lanka PLC, Mega Ten Bio Energy Pvt Ltd, Taprobane Seafoods (Pvt) Ltd, Vedanta Lanka (Pvt) Ltd and Creative Cycles (Pvt) Ltd, are just some of the leading Chinese projects in Sri Lanka in terms of realised investment and employment (Department of Research, Board of Investment of Sri Lanka 2012). In addition, Hong Kong-based conglomerate Huichen Investment Holdings Ltd invested US\$28 million to develop the zone located at Mirigama, while China's Huawei Technologies has heavily invested in Sri Lanka and has agreements with all telecom companies in Sri Lanka.

The Sri Lanka-China Business Cooperation Council (SLCBCC) has played a key role in facilitating Chinese investments such as those mentioned above. It has provided potential Chinese investors with key information and insight by sending business delegations to China while also graciously receiving delegations from China. Consequent to these initiatives, Sri Lankan business delegates have been actively participating in the Kunming Trade Fair in Southern China, with the Sri Lankan Prime Minister leading the delegation in 2011 and 2013 and the Minister of Trade and Industry leading the delegation in 2012. Further, the SLCBCC has organised seminars on 'How to do business in China', which has provided local businesses and entrepreneurs with an opportunity to better understand the business culture and practices in China. Finally, through the organisation of trade fairs and exhibitions the SLCBCC has assisted in linking Chinese investors with Sri Lankan businesses and thus has better exposed Sri Lankan investment opportunities to potential Chinese investors.

#### BILATERAL AID AND TECHNICAL ASSISTANCE

Apart from being one of Sri Lanka's key trading partners and investors, China has also been a most important donor to Sri Lanka, providing aid and technical assistance. Over the years, China has contributed to several major projects in Sri Lanka including, as stated earlier, the building of the *BMICH, Nilabe hydropower station, central mail and telegram complex, Supreme Court complex, Gin Ganga flood protection project, Udawalawe fresh water fish breeding and experimental station, Polonnaruwa water supply project, Veyangoda and Pugoda textile mills, the restoration of Abayagiri Dagoba, and the Southern Highway* (Ministry of Finance and Planning 2012).

More recently, China funded the Nelum Pokuna (Lotus Pond) Mahinda Rajapakse Theatre, which was opened in December 2011, at a cost of US\$30million and the Mattala International Airport which was opened in March 2013, at a cost of US\$210

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million. The Lotus Tower in central Colombo is currently being funded by the Chinese government. From 2007, Sri Lanka has been trying to launch a communication satellite, for which China has agreed to provide financial and technical assistance. With the financial assistance, the launch took place in November 2012 and was to be followed up in 2015 (*Lanka Business Online* 2012).

Between 1971 and 2012 China provided US\$5.1 billion worth of financial assistance to Sri Lanka out of which US\$4.8 billion came during 2005–12. In other words, close to 94 per cent of Chinese grants/loans have come during the last eight years. There are a number of reasons for this: First, the post-2005 government did not want any conditionalities from donors and wanted quick loans with minimum procedures and China fitted well for this requirement. Second, with Sri Lanka becoming a lower middle-income country, concessional aid from multilateral financial institutions were drying up and whatever loans available came with many conditions.

Sri Lanka mobilised loan assistance from China mainly from the Exim Bank of China, China Development Bank and Industrial Commercial Bank of China. According to the Ministry of Finance and Planning Annual Report (2012), sectoral distribution of Chinese loans were as follows: 40 per cent for roads and bridges, 37 per cent for power and energy, 23 per cent for ports and shipping and 6 per cent for aviation. It should be noted that most of these projects require technical assistance which too has been provided by China.

During the 2008–12 period, China made a total commitment of US\$3,609 million comprising loan of US\$3,559 million (see Table 6), The Ministry of Finance and Planning recently reported that China has given Sri Lanka a US\$278.2 million loan to finance the first part of a new railway track running from the Southern town of Matara to Kataragama (*Invest Sri Lanka*, 2012). This further adds to the series of infrastructure projects including a port, airport and roads that China has financed through loans.

Moving on to China's role in Sri Lanka's development plans, four Chinese companies are funding Sri Lanka's mega development projects. With close to 26,000 semi-skilled and unskilled Chinese workers involved in these projects, Chinese companies have

**Table 6**  
**Commitments from China: 2008–12 (US\$ Million)**

<i>Year</i>	<i>Loan</i>	<i>Grant</i>	<i>Total</i>
2008	–	–	–
2009	1204	2	1206
2010	821	8	829
2011	760	–	760
2012	1056	–	1056
Total	3841	10	3851

**Source:** *Annual Report*, Ministry of Finance and Planning (2012).

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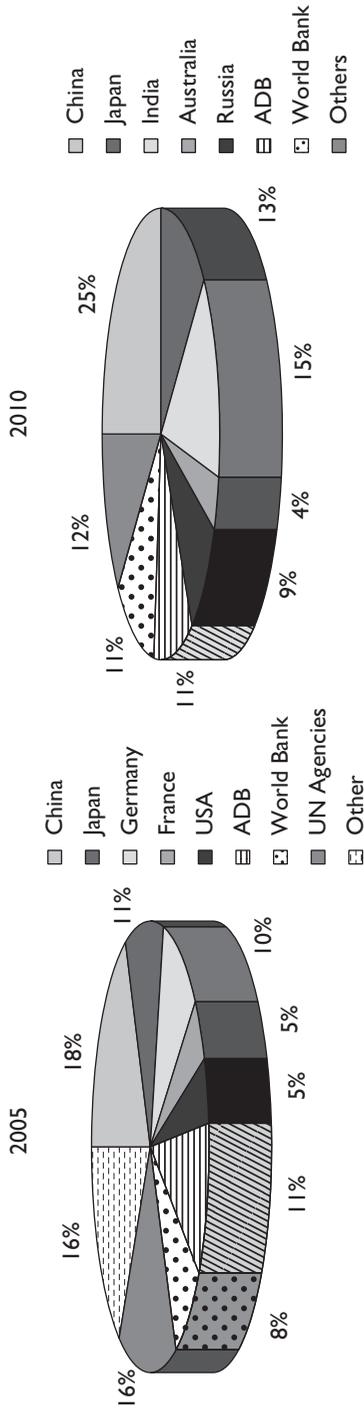
or are presently handling a special economic zone (Mirigama), a 1,000-acre Tapioca farm, the Hambantota port, a coal fired Norochcholai power plant, the Colombo-Katunayake Expressway, the Palai-Kankasanthurai rail line and a Jaffna housing complex for the army.

The inflow of aid from China grew considerably in the years following the end of Sri Lanka's separatist war. The aid coming from China which was around a few million US dollars in 2005, jumped to approximately US\$1 billion in 2008 and US\$1.2 billion in 2009 as China replaced Japan as the major donor nation to Sri Lanka. While providing US\$1 million as humanitarian aid for internally displaced persons and technical assistance for de-mining operations in Northern and Eastern provinces, China has also assisted in the resettling of people who live in the previously war torn areas, giving US\$1 million in humanitarian aid to Sri Lanka to help the civilians affected by the separatist conflict and a further 20 million Yuan worth of tents for the rehabilitation exercises. In addition to the post-war period, China also aided Sri Lanka following the devastating Tsunami of 2004, by undertaking reconstruction projects in tsunami-affected areas (China-SL Friendship Village, China-Sri Lanka Red Cross Village, restoration work in three fishery harbours).

In the year 2000, for instance out of the total foreign finance commitments, 27 per cent came from the ADB, 20 per cent from Japan and 7 per cent from Germany. By 2005, the scenario started changing as depicted in Figure 3 and by 2010, China became the primary source of foreign finance, accounting for 25 per cent of the total foreign commitments. The bulk of such finance has been committed towards infrastructure projects. In 2010, for instance, 58.8 per cent of China's foreign finance commitments were directed towards infrastructure projects (IPS 2012). Further, this aid from China has contributed in areas such as power generation, where most of Sri Lanka's other major donors have not been forthcoming in assistance. However, a major criticism that has been levelled against Chinese aid is that they are coming in at a high interest rate and through non-transparent procedures (undisclosed terms) (Shauketaly 2012) and there is little technology transfer as most of the infrastructure projects related aid brings in Chinese labour (IPS 2012).

A consequent further switch away from the West and toward China can be seen through the emergence of China as the major provider of military equipment and assistance to Sri Lanka, with China's defence exports to Sri Lanka having tripled in the recent past. China exports ammunition, anti-tank guided missiles, rocket launchers and shoulder-fired surface-to-air missiles, Deep penetration bombs and rockets, mortar ammunition, night vision devices, artillery armour mortars, security equipment, tanks, F7G jets, naval vessels, radars and communication equipment have been provided by China to Sri Lanka as military assistance (*Jane's Defense Weekly*, various years). These supplies came on an installment payment basis thus reducing the budgetary burden on Sri Lankan macroeconomic management during that crucial period. China and Sri Lanka are also cooperating in the area of military training and exercises with China helping to modernise and expand Sri Lanka's defence force.

**Figure 3**  
Sources of Foreign Finance Commitments to Sri Lanka: 2005 and 2010



**Source:** Department of External Resources, *Performance Report* (various years).

**Note:** The data refers to foreign loans, aid, and grants. Commitments above 4 per cent of the total Foreign Finance Commitment are shown in the Charts. Indian assistance did not exceed 4 per cent in 2005 and thus not shown in the Chart for 2005.

## HUMAN RESOURCES DEVELOPMENT ASSISTANCE

The link between these two nations in terms of human resources development began in 1974 when China provided seven scholarships to Sri Lankan students. Since then, the number of Sri Lankans travelling to China for their higher education has steadily increased, with China providing approximately 23 scholarships to Sri Lankan students annually. 2007 was a particularly significant year for the educational ties between the two nations as, in addition to 100 Sri Lankan students receiving scholarships from China, a series of training programmes for Sri Lankan government officials, scholars, journalists and entrepreneurs were also arranged in China. In May of the same year, the Confucius Institute of the University of Kelaniya was inaugurated, in order to facilitate academic exchange between China and Sri Lanka.

As growth in the number of successful entrepreneurs and industries is critical for Sri Lanka to achieve sustainable economic growth and become more competitive globally, the strengthening of human resources development link between the two countries is an invaluable asset that should be effectively utilised. Technical education and training received in China could greatly benefit Sri Lankans whom after receiving the training have the ability to establish their own industries in Sri Lanka and operate them efficiently. Further, this relationship is not one-sided as China too benefits from unique educational opportunities in Sri Lanka. For example, Chinese students have been coming to Sri Lanka to study and do research in subjects such as Buddhism, Sinhala and the cultivation of tea. Additionally, in order to enhance the existing relationship between the two nations there has been growing support for the teaching of Chinese languages in Sri Lanka.

## SRI LANKA'S CONTRIBUTION TO CHINA

Given the vast differences in terms of size and pace of economic growth many may consider the China-Sri Lanka economic relationship to be one-sided with all the benefits flowing to Sri Lanka from China. This is inevitable. However, Sri Lanka has contributed through other means towards China's growth and increasing world prominence, even if in a small way. Much of this has been in the form of diplomatic support, particularly in the case of multilateral organisations like the United Nations (UN). For example, by consistently opposing Taiwan's numerous attempts to become a member of the UN or any such organisation of sovereign states, Sri Lanka has been a strong supporter of the 'One China Policy'. Sri Lanka has taken a similar stance with respect to Tibet. Further, in 1971, Sri Lanka co-sponsored a draft resolution that aimed to restore China's legitimacy in the UN. Moreover, in 1997 by signing a special agreement with China, Sri Lanka strongly supported the Chinese admission into the Asia Pacific Trade Agreement, after which both countries have significantly benefited from tariff concessions.

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More recently in 2000, the Sri Lankan government rendered valuable support for China's entry into the World Trade Organization (WTO) and also played a key role helping China obtain 'observer status' to SAARC (South Asian Association for Regional Cooperation) and Dialogue Partner status in the IOR-ARC (Indian Ocean Rim Association for Regional Cooperation). Sri Lanka also assisted China during the earthquake in Sichuan Province and for the Beijing Olympics in 2008. Furthermore, Sri Lanka set up a consulate in Shanghai to increase its diplomatic representation in China, and opened another consulate in Chengdu by October 2009. The consulate in Shanghai coordinated the signing of 3 Sister City Agreements between Sri Lanka and Eastern China, which will entail cooperation in economy, trade, science, technology and tourism while also harnessing resource mobilisation for economic and infrastructure development and greater market access. The three sister city agreements were signed between Hambantota and Guangzhou, Nuwara Eliya and Yongzhou, and Sri Jayawardenapura Kotte and Hangzhou.

### PROSPECTS

Sri Lanka's ability to reap the benefits of fast-growing China was significantly enhanced in 2009, when Sri Lanka became a dialogue partner of the Shanghai Cooperation Organization (SCO), of which China is a key member. This position paves the way for Sri Lanka to influence the global debate on trade and financial issues via the BRICS (Brazil, Russia, India, China, and South Africa), where three members of it are closely associated with the SCO. In terms of China's changing demographics, a rapidly growing middle class which is projected to represent 40 per cent of the Chinese population by 2020, will have increasingly differentiated tastes and thus provide major opportunities for Sri Lankan exporters to successfully capture niches within the Chinese market. In such cases, the tariff concessions resulting from the APTA received by Sri Lankan exporters would further aid exports in beating out foreign competition and effectively penetrating the Chinese market.

China's recent move to open up its borders to Sri Lankan tea could also bring numerous benefits to Sri Lankan exporters who have the potential to penetrate China's huge market for tea. In fact, the Sri Lankan government has actively promoted tea exports to China, particularly by encouraging exporters to participate in tea fairs such as those in Hong Kong as a means to get closer to the Chinese market. Attempting to penetrate the Chinese market, the Sri Lankan tea company 'Heladiv' opened three exclusive tea boutiques in the Fujian province and Beijing in August 2009. This has now grown to 20 outlets in China at present and given the success they have achieved, 'Heladiv' aims to further expand into this lucrative market and open more tea boutiques across China in the future (News360.lk 2011, Daily FT 2011). Another industry that has potential to export and be successful in China is that of gems and jewellery. The case for this industry results from the increasing Chinese demand for such luxury goods

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as the population's income continues to rise (Senewiratne 2013). This is backed up by the fact that Sri Lanka has a Margin of Preference under the APTA and these tariff concessions when exploited could dramatically increase the competitiveness of Sri Lankan gems and jewellery. Other Sri Lankan products that have potential in the Chinese market are herbal products, spices, seafood, vegetables, coconut shell charcoal and rubberised coir cushions.

On the other hand, it is also a very real possibility that with the increasing trade between the two nations, Chinese imports could flood the domestic market. In fact, this would have a severe negative impact on the local economy as domestic producers are driven out. This is obviously a threat, which could be to some extent mitigated by not offering tariff preferences under APTA to sensitive items of Sri Lanka. But increased non-competing imports from China could also have positive impacts. For example, Chinese imports could make consumers better off by providing them with low cost, but high-quality alternatives. Further, as these imports could also be a source of low cost raw materials and components, it could effectively increase the competitiveness of domestic manufacturers and Sri Lankan products in foreign markets.

In May 2013, when the President of Sri Lanka visited China, a decision was made by the two leaders to embark on a FTA between the two countries by early 2014. At a time when Sri Lankan exports have not been having the usual market access to the EU market and facing slow export growth in the US market, having access to a new growing market like that of China will be beneficial. However, building 'special and differential treatment' for Sri Lanka in the FTA to take into account the asymmetry between the two countries like in the case of the India–Sri Lanka FTA will be vital to work out a 'win-win' situation from the FTA.

Many Chinese investors have been closely studying possible investment in Sri Lanka: FAW and SIAC Car Company is looking at setting up a car manufacturing plant, while DMC-China is looking at a joint car project with MICRO Sri Lanka. The Chinese National Petroleum Corporation has begun oil exploration work in the Gulf of Mannar. In addition to increased trade and investment from China, the overall China influence has also brought about positive changes to community life and agriculture in areas such as Hambantota. As a large number of farmers in Hambantota provide Chinese-type green vegetables to the numerous Chinese workers at the Hambantota construction site, not only did they enjoy higher demand for their produce, but also benefited from learning how to grow new types of vegetables in Sri Lankan soil.

Finally, the growing trade and closer relations between China and Sri Lanka has also presented China as a potential source of tourism. While the number of tourists from China steadily increased between 2000 and 2006 rising from 2,208 to 16,274, a growth of 637 per cent, there was a decline in 2007 and 2008 resulting from the separatist war and the financial crisis. Yet, there is potential for significantly larger numbers of tourist arrivals and Sri Lanka has pinned its hopes on Chinese visitors to boost the nation's flagging tourist industry. As improved air connectivity will play a key role in enhancing tourism, steps have already been taken to increase the ease with

which one can travel between the two nations. The number of direct flights between Colombo and Beijing has steadily increased, as has the number of direct flights between Colombo and Hong Kong. In addition, Sri Lankan Airlines has had numerous promotions offering cheap airline tickets to China and visa procedures have been simplified for Chinese citizens entering Sri Lanka.

### CONCLUDING REMARKS

The close cultural and historical links between China and Sri Lanka have grown in the past five decades as the economic and diplomatic ties between the nations have strengthened. Particularly under the post-2005 period, bilateral relations have reached a new peak with Sri Lanka enjoying a steady source of aid and economic assistance. This is due to the fusion of two forces, viz., the post-2005 government increasingly going for bilateral loans, where no strings are attached and where the period of repayment is negotiable. China is increasingly attempting to assert its global power and the Asian regional presence via bilateral loans to developing countries. In addition to economic support, China has also been a crucial source of diplomatic support having consistently backed the Sri Lankan government in international forums and multilateral organisations such as the United Nations. China has not interfered in the domestic policy in Sri Lanka and therefore is not regarded as a ‘bully’ by the public of Sri Lanka.

China has become a noteworthy export market, source of FDI, and source of low cost imports. However, China is yet to acquire the position of India as a large market for exports, largest source of imports, and a significant source of FDI although China is far ahead of India in terms of financial and technical assistance (Kelegama 2013b). Thus far, Sri Lanka has not made full use of the strong relationship with China predominantly in terms of trade and the APTA remains under-utilised. Sri Lanka is expecting the proposed FTA to trigger more trade between the two countries.

Relations with China present both opportunities as well as threats. While Sri Lanka has already gained significantly as a result of its close relationship with China, the future presents Sri Lanka with an ideal opportunity to gain even more with high growth in China. As China continues its rapid pace of growth and becomes increasingly dominant in the world economy, many nations see China as a possible threat. And this is particularly so for China’s rival in the region, viz., India. Sri Lanka has to have the best of relations with India which is its only neighbour, with whom there is both a regional agreement (SAARC) and a free trade agreement. The strengthening relations between China and Sri Lanka should not come at the cost of geo-political security concerns of India (Kelegama 2013a, 2013b). If that happens, the threat will offset all opportunities from China and it is imperative for the government of Sri Lanka to work out a reasonable balance in its bilateral relations between the two emerging giants of Asia to work out a ‘win-win-win’ situation.

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