China's influence in South and Central Asia: Competition in the Indian Ocean and China's engagement with Sri Lanka and the Maldives

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Editor’s Note

This brief was given as testimony by Samantha Custer, AidData Director of Policy Analysis, before the U.S.-China Economic and Security Review Commission for a hearing on “China’s Influence in South and Central Asia” and the panel “Competing Visions for the Indian Ocean” on May 12, 2022.

Introduction

Economic opportunity is routinely cited as an explanation for what attracts countries to engage with the People’s Republic of China (PRC). Political leaders see infrastructure as the gateway to economic growth for their countries and increasingly view the PRC as a lender of first resort. Citizens and private sector leaders see the PRC as important to their livelihood prospects—creating jobs, offering capital, and generating revenues from tourism or trade. But these economic ties can also constrict autonomy of action for smaller countries like Sri Lanka and the Maldives, creating obligations to back Beijing’s preferred policies, avoid criticism of its actions, and grant political or security concessions.

This brief describes how Beijing was able to position itself as an indispensable economic partner to Sri Lanka and the Maldives by being responsive to domestic shocks that created an opening, opportunistic to befriend leaders isolated by international criticism, and flexible to adapt its tools to align with the priorities of its counterparts. Second, the brief assesses the extent to which Beijing has been able to exploit its superior economic clout to advance its economic, security, and geopolitical objectives in these two South Asian countries. Third, it discusses how the PRC’s engagement in Sri Lanka and the Maldives has changed their relations with India and other development partners. The brief concludes with six recommendations for the U.S.-China Economic and Security Review Commission to consider moving forward. The analysis reflects the author’s views alone and does not represent the official position of AidData, a research lab at William & Mary’s Global Research Institute, or any of its funders.

What motivates Beijing's engagement with Sri Lanka and the Maldives and vice versa?

The People's Republic of China (PRC) is an undisputed economic heavyweight: the number one trading partner to 70 percent of the world's countries has enjoyed nearly three decades of trading surpluses, accumulating $3.2 trillion dollars of foreign exchange reserves.[1] But Beijing has an Achilles Heel—state-led industrial policies have created an oversupply in its construction, steel, and engineering industries relative to demand at home.[2]

One of the most important goals for the PRC's engagement in Sri Lanka and the Maldives, therefore, is economic. Beijing must put the excess financing of state-owned banks and implementation capacity of state-owned firms to productive use abroad by generating interest payments and export markets for Chinese goods, services, and capital. Over the last two decades, the PRC positioned itself as a major trading partner to the two countries and bankrolled more than 235 development projects to the tune of US$15.7 billion.[3] Sri Lanka attracted the lion's share of this financing in absolute terms (US$13.8 billion, 163 projects), but the PRC's overtures cast a longer shadow over the Maldives' smaller economy.

But the PRC is better thought of as a "banker, rather than a benefactor."[4] Globally, for every dollar of aid it provides to low- and middle-income countries, it provides 9 dollars of debt.[5] Sri Lanka and the Maldives are no exception to this rule, with much of the PRC's economic assistance coming in the form of loans and export credits, rather than grants. The scale of this lending has prompted concerns of debt sustainability, giving the Chinese Communist Party a powerful lever to exploit economic vulnerabilities of countries struggling to repay their debts.

Security is a second motivation for the PRC's engagement in Sri Lanka and the Maldives. Approximately 80 percent of the PRC's oil imports pass through the busy Malacca Strait, one of the world's busiest shipping lanes.[6] Chinese leaders are concerned about chokepoints for the U.S. and its allies to apply pressure to cut off access. Beijing's ability to cultivate friendly relations with Colombo and Malé not only helps secure its maritime trade but also access "dual use" ports for its naval vessels to project power vis-à-vis India and the U.S. in the Indian Ocean.[7] The PRC must also contend with discontent over economic inequality between its prosperous coastal regions and underdeveloped interior. For this reason, Chinese leaders have sought to position Chinese President Xi Jinping's signature Belt and Road Initiative as delivering economic opportunity to mitigate further instability in its southwestern and western provinces.[8]

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[1] Trading Economics. (2022). China Foreign Exchange Reserves. Accessed from: https://tradingeconomics.com/china/foreign-exchange-reserves

[2] Custer, S., and M. Tierney. (2019). "China's Global Development Spending Spree: Winning the World One Yuan at a Time?, In: Strategic Asia 2019: China's Expanding Ambitions, by Ashley J. Tellis, Alison Szalwinski, and Michael Wills, eds. (National Bureau of Asian Research: Washington, DC).

[3] This estimate is based upon the best available data AidData has been able to capture on Chinese state-financed overseas development projects over a 19-year period between 2000 and 2018. These figures are drawn from AidData's Global Chinese Development Finance Dataset, Version 2.0, which includes 2000-2017, with the addition of the as-yet unpublished data for 2018. Custer, S., Dreher, A., Elston, T.B., Fuchs, A., Ghose, S., Lin, J., Malik, A., Parks, B.C., Russell, B., Solomon, K., Strange, A., Tierney, M.J., Walsh, K., Zaleski, L., and Zhang, S. (2021a). Tracking Chinese Development Finance: An Application of AidData's TUFF 2.0 Methodology. Williamsburg, VA: AidData at William & Mary.

[4] Dreher et al. (2022). Banking on Beijing: The Aims and Impacts of China's Overseas Development Program. Cambridge University Press. Note: Official publication forthcoming on May 5, 2022.

[5] Ibid.

[6] Hillman, J., and D. Sacks. (2021). China's Belt and Road: Implications for the United States. Independent Task Force Report No. 79. Council on Foreign Relations.

[7] Custer, S., Sethi, T., Solis, J., Lin, J., Ghose, S., Gupta, A., Knight, R., and A. Baehr. (2019). Silk Road Diplomacy: Deconstructing Beijing's toolkit to influence South and Central Asia. December 10, 2019. Williamsburg, VA. AidData at William & Mary.

[8] Scobell, A., Ratner, E. & Beckley, M. (2014). China's Strategy Toward South and Central Asia: An Empty Fortress. Santa Monica, CA: RAND Corporation.

Geopolitically, Sri Lanka and the Maldives present an attractive opportunity for Beijing to win over foreign publics and elites wary of India's influence in their domestic politics and status as a regional hegemon. These countries may be small, but they are also strategic, as they have voting power in international fora such as the United Nations which can help insulate Beijing from international censure for its domestic human rights practices (e.g., Taiwan, Tibet, Xinjiang) and its assertive pursuit of maritime and land-based territorial claims. President Xi Jinping has also spoken at length about his intent for China to win the world's admiration for its civilization and economic success following a "century of humiliation."[9]

Chinese economic assistance varies widely in its level of concessionality. Several different factors influence how costly it is for countries to access Beijing's financing. Is the money given with the expectation of repayment? When do they need to start and complete paying off the loan? How much interest do they need to pay on top of the principal? Do they need to put forward any collateral in case of a default? Beijing supplies more costly financing to projects where it expects to see a financial return,[10] such as offering a loan to build a commercial power plant or an airport at market rates. Conversely, Chinese leaders provide the cheapest financing for visible symbols of the PRC's generosity, such as renovating government office buildings or building hospitals with grants or low-interest loans.[11]

Just as Beijing has goals for its economic engagement, so to do countries on the receiving end of its overtures. In Sri Lanka and the Maldives, for example, political leaders have emphasized public infrastructure as a gateway to economic growth for their countries. This includes physical structures such as roads, ports, airports, electricity, and water supply, as well as digital telecommunications. The PRC has proven itself to be a willing partner with an unlimited appetite to bankroll infrastructure projects at a scale unmatched by most traditional development partners. As a case in point: 70 percent of Sri Lanka's public infrastructure projects—including several highways, a large water reservoir, and a coal-fired power plant, among other examples—were funded and constructed by Beijing between 2005 and 2015.[12] Chinese leaders also financed high-profile projects related to bridges, airport runways, and electricity generation in the Maldives.

Beyond infrastructure financing alone, Sri Lanka and the Maldives view Beijing as critical to their tourism-dependent economies. Although this has tapered off due to COVID-19 related travel restrictions, the PRC was consistently among the top suppliers of tourists and revenue for the hospitality industry in both countries.[13] Chinese leaders have a unique ability to control which countries Chinese tourists visit through its "approved destination status" system, which allows for overseas group package tours to a list of preferred countries that have pre-negotiated agreements with the PRC.[14] The promise to include or exclude a country from its list of approved tourist destinations is a powerful carrot or stick, as leaders in Sri Lanka and the Maldives recognize that this system gives Beijing implicit leverage to "turn the tourism valve on or off."[15] Both Sri Lanka and the Maldives view the PRC as a major trading partner, though these relations are more heavily driven by imports from, rather than exports to, China.

Economic considerations are by far the strongest motivator for Sri Lanka and the Maldives to engage with China; however, geopolitical considerations are an important secondary concern. Smaller countries such as Sri Lanka and the Maldives have at times been wary of India's influence in their domestic politics and status as a regional hegemon. The most apt example of this is the current "India Out" campaign promoted by the political opposition in the Maldives, which aims to portray the incumbent government of President Ibrahim Mohamed Solih as too cozy with New Delhi at the expense of the island country's autonomy.[16] In other cases, political leaders have cultivated

[9] Tischler, M. (2020). China's 'Never Again' Mentality. The Diplomat. August 18, 2020. https://thediplomat.com/2020/08/chinas-never-again-mentality/

[10] Dreher et al. (2022).

[11] Ibid.

[12] Smith, J. M. (2016). China's Investments in Sri Lanka, Foreign Affairs, May 23. Accessed at: https://www.foreignaffairs.com/articles/china/2016-05-23/chinas-investments-sri-lanka

[13] Custer et al. (2019).

[14] Arita, S., La Croix, S., & Mak, J. (2012). *How China's Approved Destination Status Policy Spurs and Hinders Chinese Travel Abroad.* College of Social Sciences, Department of Economics. Accessed from: https://uhero.hawaii.edu/wp-content/uploads/2019/08/WP_2012-6R.pdf

[15] Custer et al. (2019).

[16] Shivamurthy, A. G. (2022). A blurring dichotomy: Can the new bill prevent the Maldives diplomatic disruptions. Observer Research Foundation. Accessed from: https://www.orfonline.org/expert-speak/a-blurring-dichotomy/

closer relationships with Beijing to blunt the influence of the U.S. and its allies in their domestic politics, such as when President Mahinda Rajapaksa turned to the PRC to take the place of Western powers which cut their economic assistance in half during the Sri Lankan civil war.[17]

Third, we should not underestimate self-interest as an incentive for politicians and bureaucrats to exploit Beijing's economic assistance to advance personal agendas over the public good. To fast-track approval and implementation, Beijing typically goes directly to senior political leaders to ask what they want and then requires countries to use Chinese firms to implement agreed upon projects without open and competitive bidding.[18] Taken together, this creates heightened risks that political leaders will propose politically expedient but less financially sound projects to win votes, reward allies, or satiate constituents. Meanwhile, wealth-maximizing bureaucrats may seek out opportunities to collude with firms implementing projects to artificially prop up costs, cut corners, and pocket the illicit proceeds from these deals.[19]

[17] Dreher et al. (2022).

[18] Ibid.

[19] Ibid.

How consistent or variable is Beijing's engagement over time and between the countries?

The PRC's engagement with Sri Lanka and the Maldives was fairly limited until the 2000s. In both countries, Beijing was able to position itself as an indispensable partner by being responsive to domestic shocks that created an opening, opportunistic to befriend leaders isolated by international criticism, and flexible to adapt its tools to align with the priorities of its counterparts. Economic assistance and relationships with political elites have long been the cornerstone of the PRC's engagement throughout the region, but Chinese leaders have had to modify their strategy in recent years. Election upsets in both Sri Lanka and the Maldives placed Beijing on the defensive in weathering a backlash to its development projects, and Chinese leaders began to pay closer attention to popular perceptions of its overtures and diversify its relationships.

Phase One: Opening and Initial Enthusiasm

Beijing initially supplied weapons, aid, and diplomatic cover during the Sri Lankan civil war (2007-2009) and befriended the Maldives with post-tsunami relief and reconstruction in 2004.[20] The PRC's timely assistance at these critical junctures generated goodwill and stoked demand for Chinese state-backed development projects. In Sri Lanka, Beijing helped President Mahinda Rajapaksa (2005-2015) bankroll his post-war reconstruction and economic development priorities, which included turning his birthplace and home district of Hambantota into an international shipping, commercial, and cultural hub.[21] Criticized by the West for his human rights practices and unsustainable borrowing, President Abdulla Yameen (2013-2018) instead found a willing partner with deep pockets in Beijing to bankroll his vision of infrastructure-led growth in the Maldives.[22] This led to a series of signature projects such as the Sinamalé bridge, a second runway for Malé International Airport, and an apartment complex on reclaimed Hulhumale island.[23]

Phase Two: Backlash and Reset in Relations

PRC-backed infrastructure projects fueled economic growth in Sri Lanka in the early years,[24] but enthusiasm waned over a proliferation of white elephant projects—from unprofitable airport and port facilities to an empty stadium and

[20] In the first year of the Rajapaksa administration (2005), Western donors gave the country US1.1 billion in official development assistance, but this contracted to less than US$500 million per year. By comparison, the PRC committed US$12.4 billion between 2005 and 2014, an annual level of financing of US$1.2 billion/year. Custer et al. (2019) and Dreher et al. (2022).

[21] The PRC backed Hambantota's development via a series of loans to construct a deep seaport (US$1.5 billion), an airport (US$200 million), a road from the seaport to the airport (US$412 million), an expressway connecting Hambantota to the capital city of Colombo (US$180 million), and fast-tracked construction of various additional developments (convention center, cricket stadium, botanical garden, Tele Cinema Park, oil refinery, sports complex, luxury hotels and housing complexes). Dreher et al. (2022).

[22] The international community was critical of the Yameen administration, and several donors reduced their financial support to the Maldives. For example, the IMF curbed the Maldives' access to concessional financing due to unsustainable borrowing practices, while the US and the EU considered sanctions for human rights violations. Although previously President Mohamed Nasheed (2008-2012) also turned to Beijing for financing to support several public housing projects, the scale of these projects and the associated financing was more bounded and the Maldives' relations with other foreign powers more varied. Custer et al. (2019).

[23] Ibid.

[24] During the first seven years of President Mahinda Rajapaksa's administration (2005-2011), Sri Lanka sustained 8 percent growth rate per year. But by the end of Rajapaksa's time in office, Sri Lanka's debt had increased three-fold to US$44.8 billion, including US$8 billion owed to the People's Republic of China. Dreher et al. (2022).

artificially expensive roads[25]—and mounting public debts.[26] This combustible status quo enabled the opposition led by Maithripala Sirisena (2015-2019) to unseat Mahinda Rajapaksa in the 2015 election, which was largely seen as referendum on the government's ties to Beijing and discontent over debt and corruption. Chinese leaders stoked animosity by openly campaigning and channeling money into Mahinda Rajapaksa's campaign in a bid to keep its ally in office.[27] The newly installed President Sirisena subsequently launched a review of all major PRC-backed infrastructure investments, placed several major projects on hold to assess possible irregularities, and sought to renegotiate the country's debts.[28] During the 2019 grand opening of the Lotus Tower, Sirisena alleged that the Chinese firm contracted to implement the project had disappeared with US$11million in state funds.[29]

The tide ultimately turned for Beijing through a combination of old and new tactics. Not unlike its overtures to Mahinda Rajapaksa, Chinese leaders attempted to buy Sirisena's goodwill, approving a US$100 million grant to construct a hospital in the new president's hometown of Polonnaruwa and allowing Sri Lanka to renegotiate its debts three times in 2016, 2018, and again in 2019.[30] There was a marked uptick in Chinese officials engaging with Sri Lankan media outlets and academia in a robust public relations effort to counter negative perceptions about its state-backed infrastructure projects, reflecting a new awareness of the importance of public opinion.[31] Beijing also provided a politically convenient way for President Sirisena to proceed with Chinese-financed infrastructure projects via special purpose vehicles—independent legal entities with their own assets and liabilities—which take debts and associated revenues off the public books.[32]

Beijing was ultimately rewarded for its perseverance as, following review and renegotiations, the Sri Lankan government restarted all major Chinese government-financed projects. The decision of Sri Lankan authorities to grant Beijing an ownership stake and a 99-year lease to operate Hambantota's deep-water port in exchange for US$1.1 billion in debt forgiveness sparked an international outcry,[33] but the domestic reaction was more sanguine. Noticeably, Sri Lankans largely blamed the Mahinda Rajapaksa administration, rather than Beijing, for the country's glut of white elephant projects and the PRC's willingness to renegotiate debts alleviated public angst.[34] Moreover, Sri Lankan political leaders and the public saw the West as overreacting to the incident, saying that the negotiated settlement was necessitated more by Colombo's overall debt burden, rather than its specific inability to repay the Chinese government.[35]

In a similar refrain, Chinese leaders were caught by surprise during the 2018 election in the Maldives, when voters unseated President Yameen in favor of Ibrahim Mohamed Solih who rose to power with a pledge to root out corruption, contain runway debts, and temper the pivot to Beijing that had strained relations with New Delhi and the West.[36] The political opposition characterized the PRC as an enabler of Yameen's rampant corruption due to its

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[25] The Mattala Rajapaksa International Airport 10 miles from Hambantota attracted public scorn as the "world's emptiest airport." By 2012, the deep-sea port and related projects were deemed to be minimally used and unprofitable. A 30-kilometer road connecting the president's home district to the capital city became the single most expensive road project (in unit cost terms) ever built in Sri Lanka, as observers estimated that collusion between Sri Lankan officials and Chinese companies led to inflation of true costs by 545 percent. Dreher et al. (2022).

[26] One of the binding constraints behind the scenes was that some of the most expensive of Sri Lanka's public infrastructure projects were funded by loans with interest rates approaching market rates, rather than grants. If the resulting projects were profitable, that may have offset the costs of debt financing, but as most projects were losing money, that further exacerbated the challenge for Sri Lanka's authorities to repay their debts.

[27] Custer et al. (2019).

[28] Ibid.

[29] Ibid.

[30] Custer et al. (2019). Dreher et al. (2022).

[31] Custer et al. (2019).

[32] Dreher et al. (2022).

[33] This episode fueled growing speculation that the Chinese government had intentionally sought this outcome to secure a strategic port in the Indian Ocean at the expense of Sri Lanka's sovereignty. Custer et al. (2019).

[34] Ibid.

[35] Ibid.

[36] Ibid.

opaque dealings and collusion to artificially inflate prices.[37] The most egregious example was the PRC's issuing of a US$125 million export buyer's credit loan to the Irufen Island Resort Project owned by President Yameen's close friend Ahmed Siyam Mohamed but guaranteed by the government.[38] Frustration and confusion over how much debt the country owed Beijing boiled over into a social media spat between the Chinese Ambassador and the Speaker of the People's Majlis (parliament), former President Mohamed Nasheed.[39]

With Yameen out of power, Beijing had to navigate some headwinds in its engagement with the Maldives: greater scrutiny of past deals and less enthusiasm for new debt-financed public infrastructure projects. As the new government embarked on an "India First" foreign policy, Chinese leaders sought assurances that President Solih (2018-present) would honor the previous administration's agreements.[40] Ultimately, Beijing lost some ground but weathered the storm. The Solih administration conducted a full "forensic audit" of the Yameen administration's dealings, hiring external audit firms to scrutinize loan agreements and the finances of state-owned enterprises to root out any instances of fraud.[41] But President Solih's administration did not cancel all the legacy projects financed by the Chinese government, though officials maintain their right to review these past deals and remedy any instances of corruption.[42]

In a bid to regain favor with the Maldivian public, Beijing invested in education and cultural exchange activities, such as sponsoring scholarships for Maldivian students and professionals to study abroad in China, as well as facilitating Mandarin language learning opportunities. One Solih administration official estimated that 70 percent of the 200 students the Maldives sends to study in China each year receive scholarships from a Chinese institution.[43] Although Confucius Institutes and Classrooms are not permitted in the Maldives due to religious sensitivities, Beijing established a Mandarin Language Learning Center in Malé and placed volunteer Chinese teachers in the Maldives National University.[44]

Phase Three: A New Normal?

With the election of President Gotabaya Rajapaksa (2019-present), the former president's brother, Beijing's economic engagement strategy vis-à-vis Sri Lanka appeared to shift yet again, this time to emergency lending. Over the last two years, Sri Lanka's foreign exchange reserves have plummeted by over two-thirds due to several compounding factors: chronic budget deficits since the early 2000s, massive tax cuts introduced by the new administration, reduced tourism and remittance revenues during the COVID-19 pandemic, and unsustainable borrowing on the international market to defray costs.[45] Rather than immediately turn to the International Monetary Fund (IMF) for emergency assistance, Colombo instead engaged in a desperate bid to ward off default with help from Beijing. The Central Bank of Sri Lanka signed a series of balance of payment agreements (e.g., currency swaps, foreign currency

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[37] This price inflation (or 'overcosting') can compound the problem of indebtedness, as the revenues are insufficient to offset the bills due.

[38] By issuing a sovereign guarantee in support of the loan, the Maldives's government was responsible for the repayment if the private company involved defaulted on its loan obligations. This risk of privately held, but publicly guaranteed debt came to the forefront amid the COVID-19 fallout on the tourism economy in the Maldives. On July 21, 2020, Ahmed Siyam Holdings Pvt Ltd failed to meet its $10 million loan obligation, prompting China Eximbank to issue a warning to the government that failure to ensure timely repayment would be a sovereign default, jeopardizing the country's international credit rating. The issue was only resolved when the Solih government threatened to exercise its mortgage rights if Ahmed Siyam Holdings Pvt Ltd did not deposit the overdue payment within five business days. Custer et al. (2021a).

[39] Custer et al. (2019).

[40] Ibid.

[41] Reuters (2018). Maldives New President Warns Treasury Looted During China-Led Boom. Accessed from: https://www.theguardian.com/world/2018/nov/18/maldives-new-president-warns-treasury-looted-during-china-led-boom

[42] Custer et al. (2019).

[43] Ibid.

[44] Ibid.

[45] Fernando, Y. (2022). Paradise squandered – what really happened to Sri Lanka's economy. March 31, 2022. DevPolicyBlog. Australian National University. Accessed from: https://devpolicy.org/paradise-squandered-sri-lankas-economy-20220331/

facility agreements) with the PRC to prop up foreign currency reserves and inject liquidity into the system so that Sri Lankan authorities could use new debt to repay old debts.[46]

Nevertheless, following an April 2022 announcement that it would default on servicing its US$51 billion in external debts,[47] Sri Lankan authorities began negotiations with the IMF on measures to stabilize their economy. In a press release issued on April 23, the IMF reported that it had "fruitful technical discussions on the authorities' request for an IMF-supported program" and spoke about "the need for implementing a credible and coherent strategy to restore macroeconomic stability."[48] Although the exact terms and total assistance package are still months away from resolution, early reports indicate that the IMF will likely grant Sri Lanka a combination of short-term assistance to purchase essential food and medicines, along with longer-term financing to stabilize the economy, but the government will need to be prepared to carry out painful reforms in return.[49] Shortly thereafter, the PRC's Ambassador in Colombo expressed regret that the Sri Lankan government had turned to the IMF for assistance and indicated that the outcome would likely impact future bilateral assistance from Beijing.[50]

In the Maldives, Beijing's economic activity appears to be settling into a new normal under the administration of President Solih. The heyday of large-scale megaprojects may be over, but the Solih administration has still signed agreements with the PRC to pursue new Chinese-financed public infrastructure at a smaller scale, such as renovations to the foreign ministry building or to support electricity generation.[51] Nevertheless, there is uncertainty ahead of upcoming elections in 2023, as political parties have split along pro-India and pro-China lines. The political opposition appears prepared to mount a campaign for the presidency that argues against the dangers of the Solih administration's pivot to New Delhi and advocates instead for the country to adopt an "India Out" (rather than an "India First") foreign policy,[52] which could change the political calculus for Beijing's future engagement.

Political parties are not the only actors in the Maldives divided on the merits of cooperating with India versus the PRC. Government and private sector leaders who favor working with the PRC argue that Chinese firms have superior resources and expertise to complete projects quickly and cost effectively.[53] Comparatively, they cite delays with projects implemented by Indian and Saudi Arabian companies. However, others express frustration with the lack of spillover benefits from Chinese-financed development projects to the local economy, as materials and labor are imported from China and Chinese companies seldom pursue joint ventures with Maldivian companies. Moreover, some private sector leaders argue that the use of Chinese firms for PRC-financed public infrastructure projects undercuts the competitiveness of Maldivian companies, giving the former a foothold to compete with local businesses for commercial ventures.

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[46] For example, the China Development Bank and the Government of Sri Lanka signed a series of foreign currency term financing facility (FCTFF) agreements with the intent to "shore up official foreign reserves and meet outstanding debt obligations" including: US$1 billion on October 12, 2018; US$500 million on March 18, 2020; US$500 million on April 12, 2021; and RMB 2 billion (US$303 million) on August 17, 2021. The proceeds of the loan were to be used by the borrower (the Government of Sri Lanka) to shore up official foreign reserves and meet outstanding debt obligations (i.e., repay other loans). The People's Bank of China (PBOC) signed a RMB 10 billion (US$1.5 billion) bilateral currency swap agreement with the Sri Lankan Central Bank on a three-year term to "facilitate trade and improve foreign currency liquidity" on March 19, 2021. Multiple sources indicate that Sri Lanka drew down on the entirety of this facility in the first quarter of 2022. Much thanks are owed to AidData Executive Director Brad Parks for his assistance in pulling together these agreement details.

[47] Jayasinghe, U. and J.D. Rosario. (2022). Sri Lanka unilaterally suspends external debt payments, says it needs money for essentials. April 12, 2022. Reuters. Accessed from: https://www.reuters.com/world/asia-pacific/sri-lanka-temporarily-suspend-foreign-debt-payments-c-bank-governor-2022-04-12/

[48] IMF (2022). IMF Team Statement on Sri Lanka. April 23, 2022. Accessed from: https://www.imf.org/en/News/Articles/2022/04/23/pr22129-IMF-Team-Statement-on-Sri-Lanka

[49] France24 (2022). Crisis hit Sri Lanka says IMF bailout three months away. April 29, 2022. Accessed from: https://www.france24.com/en/live-news/20220429-crisis-hit-sri-lanka-says-imf-bailout-three-months-away

[50] Krishnasi, A. (Ed.). China 'unhappy' with Sri Lanka for seeking bailout from IMF says envoy. WIOW News. Accessed from: https://www.wionews.com/south-asia/china-unhappy-with-sri-lanka-for-seeking-bailout-from-imf-says-envoy-473662

[51] Custer et al. (2019).

[52] Shivamurthy, A. G. (2022).

[53] Custer et al. (2019).

How has Beijing converted economic power into influence in Sri Lanka and the Maldives? To what extent have countries been able to counter China's influence or change its behavior?

Beijing has employed economic tools in myriad ways to advance its interests in Sri Lanka and the Maldives. It can induce behavior change by using trade, aid, or investment as carrots or rewards for desired actions. For example, this brief described above how Beijing sought to ingratiate itself with political leaders by gifting projects that would build goodwill with their home constituencies. But Beijing can employ the threat of removing economic benefits as sticks to coerce countries to change their behavior to avoid penalties. The concern expressed by Maldivian leaders over the fear of losing the country's status as an approved tourism destination is a case in point.

As we have seen, Chinese leaders have attempted to pick political winners (and losers) by aiding either the incumbent government or the political opposition in their election campaigns, though this is a risky proposition that can just as easily backfire. They can also sell the image of prosperity to attract leaders and publics to view the PRC's development model as one to emulate. It is notable that in two surveys conducted by AidData in 2020 and 2021, South Asian leaders (including those in the Maldives and Sri Lanka) identified Beijing as one of the most influential development partners in shaping domestic priorities and attributed this influence primarily to the PRC's economic importance to their countries.[54] Beijing also attempted to influence the rules of the game that dictate how countries interact with each other by positioning itself as an alternative emergency lender to the IMF. But translating economic tools into measurable influence able to shift popular opinion or leader behavior is "neither straightforward, nor quick."[55]

Beijing has come closest to achieving its economic objectives vis-à-vis Sri Lanka and the Maldives; however, even these gains are difficult to sustain over time. Chinese leaders have been able to put excess foreign exchange reserves and construction capacity to productive use, implementing an estimated 235 development projects in the two countries worth US$15.7 billion over a 19-year period. When these projects are financed with debt (i.e., loans or export credits), this further allows Beijing to generate revenues in the form of interest payments. Beijing has parlayed these projects to position the PRC as one of the major exporters of goods and services to both countries. In the case of the Maldives, Chinese firms have used their work on public infrastructure projects to gain a foothold to compete with local businesses for commercial contracts in the tourism sector. Local businesses have complained that Chinese firms exploit loopholes in domestic procurement processes and provide kickbacks or "sweeteners given under the table to civil servants" to win contracts.[56]

In other respects, Beijing's ability to sustain economic leverage vis-à-vis counterpart countries has been more fleeting. In the Maldives, the clearest indication of local counterparts succumbing to economic coercion was the passage of the 2017 Free Trade Agreement with China under the Yameen administration, which critics described as being steamrolled through parliament with inadequate consultation, insufficient review, and unfavorable terms for the country.[57] However, the Solih administration subsequently indicated that it might pull out of the Free Trade

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[54] Custer, S., Sethi, T., Knight, R., Hutchinson, A., Choo, V., and M. Cheng. (2021c). Listening to Leaders 2021: A report card for development partners in an era of contested cooperation. Williamsburg, VA: AidData at the College of William & Mary. Also, Custer et al. (2021b).

[55] Custer et al. (2019).

[56] For example, Custer et al. (2019) noted several past loopholes raised by interviewees, such as the ability to eschew open bidding if the tender involved a Maldivian state-owned enterprise, no explicit requirement that foreign firms use local partners or materials, as well as the inclusion of criteria that make local firms less competitive.

[57] Maldivian interviewees involved in the negotiations described the process as giving parliamentarians approximately 10 minutes to review and approve a 1,000-page agreement that disadvantaged the country's tuna industry. Custer et al. (2019).

Agreement with China (which has yet to be ratified)[58] and seek to renegotiate more favorable terms.[59] In Sri Lanka, Beijing may have benefited initially from President Gotabaya Rajapaksa's decision to decline assistance from the IMF in 2020 and reject a US$480 million grant offered by the Millennium Challenge Corporation,[60] but as the balance of payment crisis worsened ,Sri Lankan authorities ultimately began negotiations with the IMF.

Despite their asymmetric relationships with Beijing, Sri Lanka and the Maldives have exerted agency to protect their economic interests and curb external influence. Countries may have the strongest hand to renegotiate and reset their relations with Beijing during and following national elections. This dynamic was most clearly seen with the shift from Mahinda Rajapaksa to Sirisena in Sri Lanka and Yameen to Solih in the Maldives. As Chinese leaders lost their allies in Colombo and Malé, the new administrations were able to press Beijing to renegotiate the terms of past assistance and influence new norms for projects moving forward, such as greater transparency, open procurement processes, a recalibration away from large-scale public infrastructure, and more.

Substantive support from the international community is also critical to strengthening the position of smaller countries like the Maldives and Sri Lanka. President Solih had a better negotiating position with Beijing because he had India, another motivated alternative partner, waiting in the wings. President Gotabaya Rajapaksa has similarly proven willing to say no to Beijing—banning fertilizer imports, cancelling energy projects, negotiating with the IMF on emergency lending—to the extent that he believes that Sri Lanka can access commensurate support from New Delhi or other international partners.[61] Conversely, we have seen the unintended consequences of the international community's inattention or censure, which created windows of opportunity for Beijing to gain unrivaled influence with the Mahinda Rajapaksa and Yameen regimes in the absence of alternative partners.

Beijing has achieved mixed results when it comes to advancing its geopolitical objectives vis-à-vis Sri Lanka and the Maldives. The clearest success has been in areas that are less costly foreign policy concessions for South Asian countries to cede but are nonetheless highly prized wins for Beijing. Sri Lanka and the Maldives abide by the PRC's One China policy and do not recognize Taiwan. Leaders interviewed in both countries acknowledged that the combination of their small size and the PRC's economic importance makes them more reluctant to condemn Beijing's actions related to human rights or maritime aggressions for fear of reprisal.[62] Globally, countries that receive more financing from Beijing are also more likely than their peers to vote with the PRC in the United Nations General Assembly.[63] As a case in point: Sri Lanka voted in lockstep with China (a 99 percent similarity in voting record) in the United Nations General Assembly for nearly a decade between 2006 and 2014.[64]

In terms of popular perceptions, Sri Lanka is a battleground country where no one foreign power had a clear edge over the others. India has historically garnered modestly higher approval rates with the Sri Lankan public, but attitudes towards foreign powers overall have been relatively tepid across the board, and the U.S. and the PRC are relatively close behind, according to public opinion barometers such as the Gallup World Poll (2006-2020).[65] Nevertheless, Beijing has been able to ward off highly negative perceptions in Sri Lanka, most notably garnering its highest approval rating in Sri Lanka (56 percent) in 2020, despite heated controversy over the Hambantota port agreement. Moreover, public perceptions of Sri Lanka's debt crisis and economic woes appear to cast the blame more at the feet of domestic politicians, underscored by their declining job approval ratings, than Beijing.

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[58] China MOFA. (2022). Maldivian President Ibrahim Mohamed Solih Meets with Wang Yi. January 9, 2022. Ministry of Foreign Affairs of the People's Republic of China. Accessed from: https://www.fmprc.gov.cn/mfa_eng/wjdt_665385/wshd_665389/202201/t20220109_10480367.html

[59] Chaudhury, D.R. (2020). Maldives considers scrapping Free Trade Agreement (FTA) with China. Econonic Times India. October 12, 2020. Accessed from: https://economictimes.indiatimes.com/news/international/business/maldives-considers-scrapping-free-trade-agreement-fta-with-china/articleshow/78612972.cms

[60] MyRepublica. (2020). Sri Lankan president says he will not sign MCC deal even in dream: Report. November 1, 2020. Accessed from: https://myrepublica.nagariknetwork.com/news/sri-lankan-president-says-he-will-not-sign-mcc-deal-even-in-dream-report/

[61] Pant, H.V. (2022). As India and China compete smaller states are cashing in. Foreign Policy. Accessed from: https://foreignpolicy.com/2022/01/24/india-china-competition-investment-sri-lanka-maldives/

[62] Custer et al. (2019).

[63] Dreher et al. (2022).

[64] Ibid.

[65] Custer et al. (2021b).

Unfortunately, we do not have comparative data from the Gallup World Poll for the Maldives, which is not included in its coverage.

Beijing may have a tougher time achieving its security aims, given the long-standing security presence of India and the U.S. in the region, as well as the changeable political fortunes of potential allies in electoral democracies. In Sri Lanka, some view the granting of an ownership stake and 99-year lease to the PRC government to operate the deep-sea port at Hambantota as an example of economic leverage resulting in security concessions.[66] However, this case is more complex, given the interest of Sri Lankan authorities in easing their broader debt situation, as opposed to isolated concerns about repaying the PRC specifically. The Maldives does not permit foreign military bases, though some argue that Yameen's willingness to lease two islands to Beijing could allow the PRC to establish a security presence in fact if not name.[67] Nevertheless, Solih rejected a 2018 (Yameen-era) proposal which would have allowed the PRC to establish a Joint Ocean Observation Station in Makunudhoo, a northwestern atoll close to India.[68]

It is highly likely that the degree of diversification of willing partners is as important to strengthening the position of countries to counter the PRC's geopolitical and security influence as it is in the economic arena. For example, under Nasheed's tenure, the Maldives signed a defense cooperation agreement with India in 2009 and agreed to pursue joint maritime surveillance and patrolling activities.[69] Solih signed a defense agreement with the U.S. in 2020 and routinely holds joint military exercises and surveillance activities with India.[70] Moreover, the ability of Beijing to exert economic leverage to secure geopolitical concessions also depends upon how countries assess the attractiveness of alternative partners and their willingness to engage. If Sri Lankan and Maldivian leaders feel their choices are constrained when it comes to revenues from tourism and trade or access to ready capital, then geopolitical concessions may be a relatively costless price to pay. Their strategic calculus may shift, though, when there are more trading, tourism, and investment partners from which to choose.

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[66]Custer et al. (2019).

[67] Ibid.

[68] Mitra, R. (2022). The China-India Cold War in the Maldives. January 19, 2022. The Diplomat. Accessed from: https://thediplomat.com/2022/01/the-china-india-cold-war-in-maldives/

[69] Ibid.

[70] Ibid.

How has China's economic engagement affected India's relations with Sri Lanka and the Maldives?

Politicians and cultural icons alike have referred to a long-standing familial dynamic between India, the regional hegemon and big brother, and the smaller South Asian countries of the Maldives and Sri Lanka as the little brothers in the relationship.[71] This imagery aptly conveys on one hand the deep cultural, linguistic, and historical ties between these three South Asian nations that would be hard to completely break,[72] paired on the other hand with an undercurrent of resentment between the stronger and weaker members of the family that creates an opportunity for Beijing to insert itself into the situation as a counterbalance to New Delhi.[73]

India has both natural advantages and disadvantages in sustaining close economic, security, and geopolitical ties with Sri Lanka and the Maldives. India is geographically proximate[74] and was the primary economic and security partner to the two countries many decades prior to when Beijing's overtures to Malé and Colombo began in earnest.[75] As the world's largest democracy, Indian leaders can also draw upon shared political norms and institutions as a foundation to partnerships with Sri Lankan and Maldivian counterparts. However, these same characteristics also have given rise to tensions between India and other South Asian nations over the years—from allegations of New Delhi's interference in domestic politics to its willingness to side with Western powers in criticizing human rights abuses or unsustainable borrowing practices.

Complicating the situation further, foreign policy in the Maldives and Sri Lanka has become highly politicized along pro-China versus pro-India lines. Some of this contestation appears to be rooted in substantive differences between the priorities and preferences of political parties, but there are other elements that may be more akin to "political theater," where criticizing New Delhi or Beijing is primarily a bid to win votes rather than change policies.[76] Consistent with this, India's engagement with the two countries has fluctuated depending upon whether the political leader in power views themselves as advancing a pro-China or pro-India foreign policy.

In the Maldives, New Delhi has substantially ramped up its engagement with Malé since late 2018, in response to the window of opportunity created by Solih's explicit "India First" foreign policy which prioritized rebuilding relations with India and Western powers in the post-Yameen era. India has now outstripped the PRC as a supplier of tourists to the Maldives, as compared to 2019, when the PRC was by far the largest source of tourism revenues.[77] Seeking to signal that it too could be a major financier of development projects, New Delhi rapidly began working with Malé on

[71] In a media interview on April 8, 2022, Roshanan Mahanama, a former Sri Lankan cricket player, urged the Indian government to support his country through its current economic crisis, much like the "elder brother" that had always stood by Sri Lanka in the past. Jalhotra, R. (2022). India Always Stands for Sri Lanka Like Elder Brother Says Roshan Mahanama. Accessed from: https://theprint.in/world/india-always-stands-for-sri-lanka-like-elder-brother-says-roshan-mahanama/908153/. Meanwhile, several years prior, Maldivian ambassador to the PRC Mohamed Faisal raised eyebrows in 2018, when he described India as a brother but China as a long-lost cousin. Times of India (2018). India is a Brother, China is Like a Long-Lost Cousin. March 24, 2018. The Times of India. Accessed from: https://timesofindia.indiatimes.com/india/india-a-brother-china-is-like-a-long-lost-cousin-maldives-envoy/articleshow/63437113.cms

[72] Jain, B. M. (2017). China's Soft Power Diplomacy in South Asia: Myth Or Reality?. Lexington Books. Chicago.

[73] Wagner, C. (2016). The Role of India and China in South Asia. Strategic Analysis, 40(4), 307-320.

[74] "The Maldives is a mere 70 nautical miles away from Minicoy Island in India's Lakshadweep archipelago and 300 nautical miles away from India's west coast." Kugelman, M. (2021). The Maldives: An Island Battleground for India-China Competition. July 16, 2021. Accessed from: https://gjia.georgetown.edu/2021/07/16/the-maldives-an-island-battleground-for-india-china-competition/ The shortest distance between Sri Lanka and India via the Palk Strait is only 30 nautical miles.

[75] Pal, D. (2021). China's Influence in South Asia: Vulnerabilities and Influence in Four Countries. October 13, 2021. Carnegie Endowment for Democracy. Accessed from: https://carnegieendowment.org/2021/10/13/china-s-influence-in-south-asia-vulnerabilities-and-resilience-in-four-countries-pub-85552. Also, Kugelman, M. (2021).

[76] Custer et al. (2019).

[77] This is likely due to a combination of foreign policy considerations, as well as travel restrictions Beijing imposed on its own population to combat COVID-19.

an estimated "45 projects worth more than US$2 billion" by mid-2021.[78] In August 2020, India announced a US$500 million package to support the Greater Malé Connectivity Project, a 6.7-kilometer bridge and causeway to link Malé with three neighboring islands. This prompted news coverage to note that New Delhi's bridge was about "overshadowing" an earlier China-Maldives Friendship Bridge "in length, scale, and price."[79]

Indian leaders have been proactive in seeking to curb the PRC's influence in the Maldives in other ways while they have a relatively friendly counterpart in office in President Solih. In August 2021, the Maldives joined Sri Lanka and India for a trilateral security meeting called the Colombo Security Conclave, where the three agreed to four areas of cooperation to address: terrorism and radicalization; marine safety and security; trafficking and organized crime; and cyber.[80] In the realm of COVID-19 response, the Maldives was the "first country to receive a vaccines from New Delhi—a shipment of 100,000 doses."[81] India also made headlines by offering to help supply the Maldives with assistance to repay its debts to Beijing.[82]

India's embrace of a more "proactive approach" to check Beijing's growing influence in the region is also visible in its dealings with Sri Lanka over the last few years[83]—bargaining to develop and operate Colombo Port's Western Container terminal[84] and jockeying for position to wrest three solar power projects from China's control in the Jaffna Peninsula.[85] Although Colombo initially turned to Beijing for help with renegotiating debts and injecting liquidity into its foreign exchange reserves, President Gotabaya Rajapaksa also sought assistance from New Delhi. Indian leaders responded in various ways—supplying US$2.4 billion in preferential loans and export credits in late 2021, sending essential food supplies (11,000 metric tons of rice) in April 2022,[86] and offering currency swaps after years of withholding similar requests.[87]

As much as New Delhi has made inroads in recent years to rebuild economic and security ties with both the Maldives and Sri Lanka, Beijing is clearly still in the picture. If history has taught us anything, influence gains are fleeting and hard to sustain. As a case in point, Chinese Foreign Minister Wang Yi was still able to sign multiple cooperative agreements—from visa arrangements to economic assistance and infrastructure management—with the Solih government in December 2021 during his visit to the Maldives.[88] Moreover, with the upcoming presidential elections in the Maldives and continued political instability in Sri Lanka,[89] it is highly likely that both New Delhi's and Beijing's engagement strategy will need to evolve yet again in the near future.

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[78] Shivamurthy, A.G. (2021). Balances and Benefits in Southern South Asia: The Maldives and Sri Lanka in 2021. Observer Research Foundation. December 28, 2021. Accessed from: https://www.orfonline.org/expert-speak/balances-and-benefits-in-the-southern-south-asia/. See also Kugelman, M. (2021). For example, New Delhi has discussed plans to collaborate with the Maldives on a diverse range of public infrastructure projects including a hospital, cricket stadium, port facility, and airport upgrade.

[79] The much shorter China-Maldives bridge constructed during the Yameen era was only worth approximately US$200 million. The Edition. November 24, 2020. https://edition.cnn.com/2020/11/24/asia/maldives-india-china-bridges-intl-hnk/index.html

[80] Rajagopalan, R.P. (2021). Colombo Security Conclave: A New Minilateral for the Indian Ocean? August 19, 2021. The Diplomat. https://thediplomat.com/2021/08/colombo-security-conclave-a-new-minilateral-for-the-indian-ocean/

[81] Kugelman, M. (2021).

[82] Ibid.

[83] Pant, H. (2022).

[84] Business Standard. (2021). Adani Group Seals Deal to Develop Western Container Terminal at Colombo Port. September 30, 2021. https://www.business-standard.com/article/companies/adani-grp-seals-deal-to-develop-western-container-terminal-at-colombo-port-121093001398_1.html

[85] Bagchi, I. (2021). India worked for a year to get China off Lanka projects. December 4, 2021. Times of India. https://timesofindia.indiatimes.com/india/india-worked-for-a-year-to-get-china-off-lanka-projects/articleshow/88080863.cms

[86] Khanna, S. (2022). Why India should pull Sri Lanka out of China's debt trap and take it closer to the US. April 16, 2022. The Print. https://theprint.in/opinion/why-india-should-pull-sri-lanka-out-of-chinas-debt-trap-and-take-it-closer-to-the-us/918063/

[87] Pant, H. (2022).

[88] Ibid.

[89] President Gotabaya Rajapaksa announced in late April that his brother Mahinda Rajapaksa would resign as Prime Minister to make way for an interim government and a new Cabinet comprised of all parties in Parliament. Accessed from: https://www.freepressjournal.in/world/sri-lankan-pm-mahinda-rajapaksa-agrees-to-resign

Compared with the U.S., what are China's greatest advantages and weaknesses in its economic engagement with Sri Lanka and the Maldives? How have debt concerns affected the willingness of other development partners to engage in these countries?

The PRC has now eclipsed the U.S. as the single largest bilateral provider of foreign assistance (broadly defined) globally. If we focus exclusively on grants and low or no-interest loans that are typically what the Organization for Economic Cooperation and Development (OECD) considers to be "aid" in a traditional sense, the U.S. still dwarfs China by a sizeable margin. But if we consider the full measure of China's state-directed financing for overseas development, including grants and loans of varying concessionality, the PRC now outspends the U.S. in global development spending by 2-to-1.[90] But it is also important to note that what China offers other countries is decidedly different from what traditional development partners like the United States offer.

Chinese state-backed financing is appealing to countries like Sri Lanka and the Maldives for several reasons. First, the PRC deploys state-directed financing at a scale which outstrips what most bilateral and multilateral actors can offer. The number of "mega projects" financed with loans each worth $500 million or more globally tripled each year during the era of President Xi Jinping's signature Belt and Road Initiative.[91] Second, Beijing's overseas development projects seldom require extensive social or environmental safeguards, which political leaders often view as hampering their ability to deliver on campaign promises quickly and efficiently.[92] Third, the PRC's specialization in infrastructure-led growth is unique compared to most donors and timely, because it is an expressed priority of countries in the Global South which often view Beijing the only partner ready and willing to engage in this area.

Finally, the PRC's assistance is often viewed by counterpart countries as having relatively fewer upfront strings attached. Western donors often make financing contingent upon policy changes (e.g., anti-corruption reforms), which means that governments must pay the costs up front and get the benefits down the road. Comparatively, PRC-backed development projects do not typically include governance conditionalities. Instead, they involve quid-pro-quo obligations that governments can defer to later down the road (e.g., signing economic agreements, abstaining from criticism, and voting with Beijing in multilateral fora).

That said, there are several drawbacks to the PRC's economic assistance for countries on the receiving end of these overtures. One major drawback is that the PRC's assistance is typically provided on less generous financial terms than what other bilateral and multilateral actors can offer. Beijing most frequently relies on loans using market rates which generate interest payments. A typical loan offered by the PRC has a 4.2 percent interest rate, a repayment period of less than 10 years, and may require collateral (e.g., future commodity exports or physical assets).[93] A comparable development loan from Germany, France, or Japan carries a 1.1 percent interest rate, a repayment rate of 28 years, and seldom includes collateral requirements.[94]

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[90] Malik, A., Parks, B., Russell, B., Lin, J., Walsh, K., Solomon, K., Zhang, S., Elston, T., and S. Goodman. (2021). *Banking on the Belt and Road: Insights from a new global dataset of 13,427 Chinese development projects.* Williamsburg, VA: AidData at William & Mary.

[91] Ibid.

[92] This might partly explain why an estimated 35 percent of the PRC's projects implemented under the Belt and Road Initiative have encountered major implementation problems, such as corruption scandals, labor violations, environmental hazards, and public protests.

[93] Ibid.

[94] Malik et al. (2021).

"Circular lending" is a second drawback of the PRC's economic assistance.[95] This term refers to a common practice of the Chinese government to commit financing for a project but require the implementation to be completed by Chinese firms, suppliers, and labor. An estimated 89 percent of Belt and Road Initiative projects are implemented by Chinese state-owned enterprises[96] which have privileged access to low-interest financing that allows them to outbid their competitors.[97] This is a smart risk mitigation strategy for the PRC, as the money never leaves the country so to speak. However, it has been a flashpoint of controversy in borrowing countries, as this creates fewer positive economic spillovers locally in the form of jobs and revenues for domestic companies.[98]

A third drawback of the PRC's economic assistance is that it can be a high-risk proposition. Beijing is willing to lend to countries that have a higher risk of debt default and have fewer alternative sources of capital available. But the PRC requires more stringent repayment terms to issue credit, considering those higher risks. Ironically, the unique features that make the PRC's projects so attractive to local politicians—sourcing project ideas directly from leaders, offering expedited approval, eschewing safeguards, and employing opaque procurement processes—heightens the risks of price inflation, corruption, and negative spillover effects. Taken together with the more stringent repayment terms, these risks can compound the distress of borrowers if projects cannot generate sufficient revenues to repay the high costs of accessing financing.

In the case of Sri Lanka and the Maldives, this discussion of debt distress is not a theoretical one. The IMF estimates that the Maldives will remain at a high risk of debt distress with a projected debt-to-GDP ratio of 123 percent in 2026,[99] largely (though not entirely) driven by its repayment obligations to Beijing.[100] The IMF curbed the Maldives' access to concessional financing during the Yameen administration as a penalty for its unsustainable borrowing practices; however, this created the perverse incentive for President Yameen to rely more heavily on Beijing for capital, which it was ready to supply. The IMF has indicated that it considers the Maldives' debt to be on a sustainable trajectory; however, this is largely due to commitments made by the Solih administration to implement necessary reforms recommended by the international finance institution.

The context in Sri Lanka is very different. Sri Lanka's recent debt default was driven by the country's heavy reliance on international sovereign bonds—debt securities that a government issues to borrow capital on the international market. This source of debt financing alone accounts for nearly half of Sri Lanka's external debt and the effective interest rates are more than double those of most Chinese-state backed loans. Although Sri Lanka was slow to reach out to other development partners beyond Beijing for assistance, the government is now engaged in negotiations with the IMF and several of its bilateral creditors to resolve the current crisis.

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[95] Horn, S., Reinhart, C., and C. Trebesch. (2019). China's Overseas Lending. NBER Working Paper Series. Working Paper 26050. July 2019. National Bureau of Economic Research: Cambridge, MA. Retrieved from: https://www.nber.org/papers/w26050.pdf

[96] Hurley, J., Morris, S. & Portelance, G. (2018). Examining the Debt Implications of the Belt and Road Initiative from a Policy Perspective, CGD Policy Paper 121, March. Accessed at: https://www.cgdev.org/sites/default/files/examiningdebt-implications-belt-and-road-initiative-policy-perspective.pdf

[97] Wuthnow, J. (2019). "China's Belt and Road: One Initiative, Three Strategies.", In: Strategic Asia 2019: China's Expanding Ambitions, by Ashley J. Tellis, Alison Szalwinski, and Michael Wills, eds. (National Bureau of Asian Research: Washington, DC).

[98] Custer et al. (2019).

[99] This includes both total public and publicly guaranteed debt-to-GDP. IMF (2021). IMF Executive Board Concludes 2021 Article IV Consultation with Maldives. https://www.imf.org/en/News/Articles/2021/10/07/pr21287-maldives-imf-executive-board-concludes-2021-article-iv-consultation

[100] IMF. (2020). Staff Report for Rapid Credit Facility Request—Debt Sustainability Analysis. April 16, 2020. https://www.imf.org/external/pubs/ft/dsa/pdf/2020/dsacr20133.pdf

What recommendations should the Commission consider for Congressional action?

When America's core economic and development assistance legislation was signed into law in the 1940s and 1960s, the world looked quite a bit different than it does today. Western democracies were the principal financiers of overseas development. The U.S. enjoyed economic superiority vis-à-vis potential competitors and partner countries had limited alternative financing options available. Grants, along with low- or no-interest loans, were the most popular tools, and low- and middle-income countries had limited access to alternative sources of international capital or private sector investment.

Today, the rules of the game are decidedly more complex. Leaders in the Global South have more suppliers of financing to choose from and the structure of this financing is more varied. Grants and concessional lending from the OECD's club of advanced economies (i.e., traditional official development assistance) has shrunk as a proportion of the total resources available. The level of sophistication and opacity of alternative forms of international financing has grown, making it more difficult to monitor financial indebtedness, political capture, and undue influence of external financiers that may harm U.S. and borrowing country interests. The PRC's economic engagement in Sri Lanka and the Maldives is an important part of this story.

Beijing's influence is strongest in cases where countries lack negotiation leverage in the face of the PRC's growing importance to their economies and political leaders succumb to pressure to take short-term actions that may not be in their national interests. To mitigate this risk, this brief recommends that the Commission consider legislation that will promote the U.S. government's ability to support Sri Lanka and the Maldives in six key areas:

- Help government leaders design public financial management and procurement processes to mitigate the risks of waste, corruption, and debt distress.
- Assist government leaders to develop robust planning processes to assess new projects considering social, economic, and environmental costs and benefits.
- Model transparency in disclosing the terms and amounts of our own foreign assistance, while pressuring other donors to do the same.
- Advise leaders as they undertake reforms to improve the investment climate for private sector investment and mobilize nongovernmental actors to curb corruption, monitor progress, and hold the government and donors responsible for results.
- Invest in public diplomacy activities that enable countries to create space for debate, discussion, and dialogue about their engagement with foreign powers on their own terms.
- Expand efforts to promote investigative journalism, citizen-monitoring initiatives, civil society strengthening, and data science for think tanks and universities, with an emphasis on ensuring countries are getting the most from their engagement with foreign powers.