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Infrastructure Financing in Sri Lanka: Lessons Learnt and Future Collaborations

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Abstract

Over the past decade, Sri Lanka has seen a steady rise in foreign debt, largely as a result of unsustainable infrastructural loans. This debt was exacerbated by the effects of the Covid-19 pandemic, with the highly remunerative tourism sector majorly impacted. In early 2021, the government was forced to declare a state of economic emergency amidst a distressing fall in the value of the Sri Lankan Rupee.

This policy brief will first discuss the possible causes for Sri Lanka's indebtedness, assessing both domestic and external factors. Second, it will look into the beneficial impact alternative partners may have through investing in the country. Third, it will enumerate the lessons learnt from the Sri Lankan experience, and how small and medium countries can avoid ending up in similar situations. Finally, this policy brief will provide a set of policy proposals for the EU in order to enhance its presence in the region, while offering corresponding benefits for Sri Lanka.

Keywords*: Sri Lanka, Investment, China, Debt-trap Diplomacy, EU, European Union, India, South Asia, Hambantota Port, Colombo, Infrastructure financing*

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Infrastructure Financing in Sri Lanka: Lessons Learnt and Future Collaboration

Over the past decade, Sri Lanka has seen a steady rise in foreign debt, largely as a result of unsustainable infrastructural loans. This debt was exacerbated by the effects of the Covid-19 pandemic, with the highly remunerative tourism sector majorly impacted. In early 2021, the government was forced to declare a state of economic emergency amidst a distressing fall in the value of the Sri Lankan Rupee. However, in 2020 Sri Lankan debt had already ballooned to 101% of its GDP. With foreign reserves severely affected by the pandemic, the country has yet to meet sovereign bonds repayments of roughly 500 million USD and 1 billion USD maturing in January and July 2022 respectively. While much of the debt is due to market borrowings, Sri Lanka also owes large amounts directly to bilateral partners such as China and Japan, as well as to multilateral international organisations such as the World Bank and the Asian Development Bank (ADB). According to Fitch Ratings, the Sri Lankan government will have to allocate around 29 billion USD between now and 2026 to service debt repayments alone.

The Sri Lankan government is looking to avoid another situation like that of the 2008-signed Hambantota Port Development Project. After construction began in 2010, the government was soon faced with an inability to repay the project loan owing to the scarce revenues generated by the port. This culminated in the handover of Hambantota Port to China Merchants Port Holdings with a 99-year lease on operations in 2017. The concept of debt-for-asset swap, i.e. exchanging equity in lieu of debt repayment, concerning this type of lease sets a precedent which risks reoccurring. In order to prevent it from happening again, Sri Lanka is now looking to diversify its sources of foreign financing. This move would help increase the amount of foreign exchange available to Colombo and reduce the hazard of economic dependence on individual partners. However, diversification may result in more complications as last year's downgrade of Sri Lanka's credit rating to CCC+ means investments in the country can entail risks and scare off external partners due to fiscal instability, and can therefore hamper Sri Lanka's economic recovery.

Despite this, in September 2021 the Indian Adani group was awarded a tender to develop Colombo's West International Container Terminal. Having signed a Build-Operate-Transfer agreement with John Keells Holdings and the Sri Lanka Ports Authority, the 700 million USD investment is one of the largest foreign investments in the Sri Lankan port sector to date. The deal came only six months after Sri Lanka unilaterally cancelled the trilateral 2019 Memorandum of Understanding (MoU) with India and Japan to develop the Colombo East Container Terminal. The deal was lauded as a good move by maritime experts, as India is Sri Lankan ports' largest user, and is seen as helpful to Sri Lanka's economic recovery amidst a push to meet their debt repayment requirements.

Fig 1*: Locations of Colombo and Hambantota Ports, Sri Lanka*

Sri Lanka is now looking to expand investments in critical physical areas, where regional and external partners may be highly tempted to invest. Accordingly, the government has finalised a chart of physical investment opportunities, such as in urban development, fisheries and aquaculture, power and energy, pharmaceuticals, and real estate, which could be alluring for many countries and organisations. For example, from the sectors mentioned above, China has permanent interests in expanding its real estate and urban development portfolios, while India is heavily involved in sectors such as pharmaceuticals, along with energy. Amongst Sri Lanka's external partners, the EU has an opportunity to promote environmentally friendly urban development, sustainable fisheries, and aquaculture, as well as advancing the expansion of green power and energy production, as part of its commitments to reduce global emissions.

This policy brief will first discuss the possible causes for Sri Lanka's indebtedness, assessing both domestic and external factors. Second, it will look into the beneficial impact alternative partners may have through investing in the country. Third, it will enumerate the lessons learnt from the Sri Lankan experience, and how small and medium countries can avoid ending up in similar situations. Finally, this policy brief will provide a set of policy proposals for the EU in order to enhance its presence in the region, while offering corresponding benefits for Sri Lanka.

China's role and responsibility in Sri Lankan indebtedness

Sri Lanka is among the countries at high risk of debt distress. At the end of 2020, the country's idle economic performance was evidenced by its soaring public debt, reaching 101% of its GDP, up from 86.8% at the end of 2019. According to the Sri Lankan Ministry of Finance's Medium Term Macro Fiscal-Framework from 2021 to 2025, the Central government's debt is expected to decrease from 102.8% of GDP in 2021 to 89.2% of GDP in 2025. The ailing economy is said to pick up a sustained growth trajectory in the mid-term after the Covid-19-induced setback, while its financial instability has been exacerbated by an increasing import bill that has plunged the country further into debt. The country's mid-term recovery over the next ten years has been made more complicated by the downgrade to CCC+/C or junk debt in December 2020 by rating agencies such as Standard & Poor's. The decision was grounded in the fact that "the country's fiscal position is expected to deteriorate over the next few years due to a lack of favourable economic and fiscal conditions". These conditions include the fallout from the Covid-19 pandemic, high fiscal deficits and excessive domestic liquidity. Therefore, it is now more difficult for Colombo to raise money on global financial markets. Attracting foreign investments is even more difficult given Sri Lanka's ranking as 99th in the World Bank's 2020 Doing Business Index, due to its low scores in enforcing contracts, paying taxes, registering property and obtaining credits.

Sri Lanka's government has, however, been implementing measures to cope with its enormous external debt. For instance, Colombo is now exploring "options to use local resources and the local construction industry for higher domestic value addition" as the Annual Report states. This way the country managed to reduce foreign debt exposure to 40% by the end of 2020. Despite these efforts, there remains a 28% probability for the Sri Lankan economy to default in 2022. As a result of the steep decline in the country's main sources of revenue throughout 2020 and as the Sri Lankan debt to GDP ratio crossed the 100%-threshold, some estimate that the debt/GDP ratio may grow up to 107% in 2022 and hence become unsustainable. While crossing the 100%-threshold by itself is not automatically unsustainable, Sri Lanka's increasing levels of debt are critical because the country continues to generate more external debt to finance its short term debt maturities. It has become a self-reinforcing debt spiral, as Sri Lanka continues to rely on foreign investments to replenish state coffers. Adding to this, Standard & Poor's, Fitch and Moody's reconfirmed downgrade of Sri Lanka to CCC+ in 2021 may certainly further scare off international investors as the country's insolvency risk persists.

In order to address the financial distress, Sri Lanka could negotiate debt-restructuring programs with international financial institutions, such as the International Monetary Fund (IMF) or the Paris Club. However, the debt-restructuring program proposed by the IMF was met with distrust by Sri Lanka, due to the austerity measures it entails. Through its programs, the IMF offers support to its members showing balance of payment difficulties in rearranging domestic policies in order to reduce and prevent macroeconomic instabilities. The pillars of Sri Lanka's IMF Program include lowering the budget deficit, introducing monetary policy reforms so as to keep low inflation rates, reforming the tax system, and strengthening public financial management by keeping a closer oversight of public spending. Sri Lanka has long deemed such support not useful in stimulating the economy due to the policy prescriptions it requires, preferring foreign investments and bilateral loans as more assuring, conducive to swifter and more tangible economic results. Moreover, IMF programmes have been seen as expedient and unwilling to touch deeper structural issues in the country over the past 70 years. On one hand, the structural adjustment policies advocated by the IMF, particularly fiscal discipline which could reduce the budget deficit, may help Sri Lanka restructure its economy by directing it over a more resilient and sustained growth trajectory. On the other hand, the need to service its outstanding debt, especially to foreign creditors, makes the decision of accepting IMF support politically difficult for the government due to sovereignty concerns.

To complicate the matter, Sri Lanka will soon have to meet its short and mid-term debt obligations to numerous bilateral and multilateral donors. More precisely, the short term debt maturities amounted to nearly 11 billion USD toward the end of 2020. Meanwhile, the medium-to-long term debt amounts to 34 billion USD, according to data published by the Treasury of Sri Lanka. Among the largest donors, the Asian Development Bank and the World Bank stand out with over 600 million USD in disbursement (as of 2020). China, Japan and France are Sri Lanka's largest bilateral donors, with China alone accounting for more than half of total bilateral financing and over 15% of Colombo's total outstanding debt. Yet, the declining foreign reserves are not significant enough to repay the pending maturities, having dropped from 5.7 billion USD in 2020 to 2.3 billion USD in October 2021. As a result, should Sri Lanka miss the deadlines, it faces a high risk of sovereign debt default.

China has been a generous provider of development support since the Sri Lankan Civil War ended in 2009. Most bilateral loans, in the forms of infrastructure projects such as roads, ports and the Mattala Rajapaksa International Airport, came with no strings attached, making China a preferential bilateral investment partner. While a comprehensive official account of all Chinese infrastructure investments in Sri Lanka is not publicly available due to confidentiality clauses, some estimate it to amount to a total of 12.1 billion USD by the end of 2019. Of these projects, those with a loan exceeding 1 billion USD include the Southern Expressway (1.5 billion USD), Hambantota Port (1.3 billion USD), and Norocholai power station (1.3 billion USD). Colombo Port City (1.3 billion USD) and Colombo International Container Terminal (CICT), counted as investment projects, are reportedly worth 1.3 billion USD and 500 million USD.

Despite the large sums invested by China in Sri Lanka, it is only since the news of the 99-year lease of the Hambantota port circulated in 2017 that threat perceptions around Sri Lankan debt to China intensified. By then, China had already been denoted as a perpetrator of the "predatory debt-trap diplomacy" by foreign analysts, in that the loans and concessions extended to developing countries were perceived as unsustainable and therefore leading borrowing countries to a debt-for-equity, debt-for-asset exchange. The Hambantota port lease was signed in 2017 as the project incurred skyrocketing costs to be finalised, and was registering financial losses by the third year of operations. The lease agreement set forth the transfer of port operations to China Merchants Ports Holdings Company Ltd., in exchange for 1.2 billion USD handed directly to Sri Lanka.

The question of whether Sri Lanka is entangled in a debt-trap has been extensively debated among scholars and diplomatic circles, and voices in favour or against the definition have attempted to provide fact-based arguments to support their respective claims. Taking the Hambantota Port as a case study, a 2020 research project conducted by Chatham House evidenced that the so-called debt trap diplomacy is not being actively pursued by China, as the BRI presents itself as a loosely guided initiative over which the Chinese Ministry of Foreign Affairs (MFA) is able to exert little influence. This result seeks to suggest that the BRI may not be part of a grand geopolitical strategy. According to the conclusions of the Chatham House study, the BRI may rather be intended as an economic-driven quest for new markets as a response to domestic overcapacity, and sometimes also a bail-out solution for Chinese SOEs. More recently, particularly as a consequence of massive state interventions on SOEs and changing domestic priorities, the BRI has curbed public investments, and more corporate investments are expected to finance BRI projects in the future, further signalling that the BRI stands far from being part of a geopolitical strategy endorsed by China to gain greater power.

Despite this evidence, the perception of China seeking to expand its strategic reach in the Indo-Pacific through infrastructure projects still remains. To some extent, Sri Lanka may well fit into Chinese plans owing to its nodal location along important sea lines of communication (SLOCs) in the Indian Ocean. Threat perceptions emerged in neighbouring India back in 2014, being entangled in a strategic rivalry with China, when a Chinese submarine and a warship, part of the People's Liberation Army's anti-piracy fleet docked at Colombo Port for refuelling. In particular, New Delhi referred to the Indo-Lanka Peace Accord signed with Sri Lanka in 1987, stipulating that "activities prejudicial to each other's unity, territorial integrity and security" would not be allowed in the respective territories. Since 2017, Sri Lanka has denied access to Chinese naval ships. However, China's expansionist activities in pursuit of its supposed String of Pearl Strategy are nevertheless still widely perceived as a security threat by both regional and non-regional actors, such as India and Japan. In particular, Chinese investments in ports along the routes of the Indo-Pacific are believed to be Beijing's foothold in the region to secure a safe passage for cargo.

More suspicions over Beijing's strategic choices are linked to the legal status of some investments poured into the construction of Overseas Economic and Commercial Cooperation Zones (OECCZs), such as the Port City Colombo project in Sri Lanka. As explained by Thierry Pairault, OECCZs are special economic zones intended as areas "designed by a Chinese company appointed by China to create a haven in another country's territory to accommodate Chinese companies, which are *de facto* subject to Chinese law, and thus boost Chinese economic development". The legal designation for it under Chinese law clearly specifies that such OECCZs are "incorporated within the national territory of the People's Republic of China". Hence, as a Chinese exclave run by a designated Chinese company, the profits are earned by the operating company, and the applicable law is the Chinese law alone, with a significant impact on state sovereignty. The government of Mahinda Rajapaska was insistently pressured by China to pass a bill exempting the future financial hub of Port City Colombo from Sri Lankan jurisdiction, which was finally approved in 2021. The 15 billion USD project is currently under construction by the China Harbour Engineering Company (CHEC), in close proximity to the China-operated Colombo International Container Terminal (CICT), over a reclaimed land area.

Alternative Partners

Aside from India and China, Sri Lanka has attracted the attention of other external investors. Colombo's development needs – especially regarding port infrastructure – also present opportunities for investment partners such as Japan and the EU. In particular, as China and India compete for tenders, Tokyo and the EU do not want to stay behind and risk being left out of lucrative future development projects in the Indian Ocean.

The rapprochement between Japan and India has given birth to synergies between the two Asian powers. Since 2007, Tokyo has been looking Westwards, underlining the "confluence" of the Indian and Pacific Oceans brought about by increasing economic collaboration and common security challenges. With the revival of the Quad in 2017, Tokyo and Delhi found a platform to discuss common infrastructural development policies in this area of expanding interdependence. In particular, with the expansion of China's BRI, India, Japan, and the other Quad partners – i.e. Australia and the US – decided to coordinate their efforts to provide an alternative to the BRI, given the concerns that have risen regarding the debt sustainability and strategic implications of Chinese overseas investments.

After the lease of the Hambantota port to China Merchants Ports Holdings in 2017, Sri Lanka has welcomed infrastructural development partnerships with Japan and India. By diversifying its sources of investment, Colombo aimed at leveraging the prospects of competition between investment providers to reach more advantageous terms for its infrastructural projects, both old and new. Hence, in August 2018 Sri Lanka welcomed Japan's then Defence Minister Itsunori Onodera, bringing him on a tour of ports on the Eastern coast. In particular, the counterparts discussed possible collaborations in the development of the Trincomalee port with the aid of Tokyo and Delhi.

In March 2021, the Sri Lankan Government approved Japanese and Indian participation in the development of the West Container Terminal of the Colombo port. This came a few weeks after its decision to invalidate the deal with the two countries to develop the East Container Terminal, citing resistance to "foreign involvement". However, Sri Lankan authorities recently made the decision to award the East Container Terminal project to China following a competitive bidding process. This series of U-turns exemplifies the value of attracting several foreign providers for a small-medium country like Sri Lanka. By putting donors and partners in competition with one another, Colombo can be assured of a better deal, benefiting them through more advantageous terms.

The EU and its Member States have thus far not taken part in this competition between donor countries for the development of strategic infrastructure. According to data released by the European External Action Service, the European Investment Bank has signed several agreements with Sri Lanka in 2021, providing an aggregate of 160 million EUR to fund small and medium-scale projects in infrastructure, tourism, energy, and telecommunications. Notably, the EU has primarily invested in adaptation and mitigation against the effect of natural disasters triggered by climate change. This contrasts with the bloc's approach to East Asia, which, since the adoption of the 2016 EU Global Strategy, has focused on tapping into the dynamism of Southeast Asian and East Asian economies by increasing connectivity. This could be due to existing disagreements in the EU-Sri Lanka bilateral relationship, which have led the European Parliament to call for its withdrawal from the list of countries with access to the EU's Generalised Scheme of Preferences + (GSP+). For example, the EU has repeatedly raised concerns about abuses under the notorious Prevention of Terrorism Act (PTA), which has long enabled prolonged arbitrary detention, torture and sexual abuse.
In a resolution, the European Parliament also denounced the Sri Lankan government's obstruction of efforts to secure accountability for widespread human rights abuses during the country's decades-long civil war. The resolution states that "one of the key commitments of Sri Lanka was to fully align its counter-terrorism legislation with international human rights conventions," and calls upon the European Commission to "use the GSP+ as a leverage to push for advancement on Sri Lanka's human rights obligations."

However, with the coming of the new European Commission under Ursula von der Leyen, which has promised to be a "geopolitical Commission", the EU might seek to increase its role as a key strategic development partner in the region. The recent launch of infrastructural investment schemes such as the "Global Gateway" is an indication of this ambition, pledging to mobilise up to 300 billion EUR in investments by 2027 in digital, energy and climate, transport, health, education and research.

Lessons learned

Since the end of the civil war in 2009, poor debt management and dependence on foreign loans and imports have left Sri Lanka in a desperate need for external financial support to mitigate its critical economic and debt crisis. The structural weaknesses of the Sri Lankan economy have been worsening by Covid-related setbacks and by forthcoming debt maturities, as explained in section 1. In recent years, the country has tilted toward bail-out solutions from its powerful neighbour China, even though more recently loans and currency swaps from India, Bangladesh, and Western investors have become a viable alternative.

While it would be advisable to differentiate the pool of creditors to avoid so-called "debt-trap" situations, Sri Lanka continues to rely on a few preferential partners. For instance, the grants and debt relief programs offered to Sri Lanka by the US in 2020, such as through the Millennium Challenge Corporation (MCC) grant, were met with stark opposition by current president Rajapaksa and by the Sinhala nationalist groups, who have been very vocal about state sovereignty. Specifically, the MCC grant, also known as Sri Lanka Compact, was a grant-based development instrument designed by the US Foreign Assistance Agency to spur growth in Sri Lanka through a series of infrastructure projects. The Compact included projects aimed at improving public transport, reducing traffic congestion, upgrading provincial roads, and controlling air pollution, while also providing secure land titles to farmers. The rejection of the 89 billion LKR (471 million USD) MCC grant was justified by the conditions attached to it. The US would only extend the grant when commitments were made to step up efforts in country ownership, transparency, and accountability (good governance, fighting corruption and respecting democratic rights).

In addition to improving debt management and accurately choosing its foreign financiers, Sri Lanka should ameliorate the terms of critical infrastructure investment deals. By allowing its 'all-weather friend' China to jointly run the development project of the East Container Terminal in Colombo, in addition to the two container terminals currently under construction, Sri Lanka is once again entrusting a strategic asset in foreign hands. In particular, at the end of November 2021, Sri Lanka and China Harbor Engineering Company, the Chinese SOE developing Port City Colombo, signed an agreement for the second phase of the development project of Colombo's East Container Terminal, formerly awarded to India and Japan under the tripartite Memorandum of Understanding (MoU) in 2019. Yet, this time the terms seem to favour a stronger presence of the Sri Lanka Port Authority (SLPA), responsible for operational activities of the container terminal under the new deal. This news may signal a potentially rising Sri Lankan awareness in retaining a tighter oversight and control over strategic state assets.

It would be advisable for Sri Lanka to further increase the number of infrastructure projects fully operated by domestic Public-Private Partnerships (PPP). This would help Colombo avoid further soaring external debt obligations, while also being assured of compliance with Sri Lankan laws and regulations. The move could also strengthen the development of new domestic corporations and their competitiveness, potentially benefiting from a favourable incentive regime consisting of tax exemptions or reduced corporate income tax (CIT). Sri Lanka could also opt to drive investments towards pre-existing facilities, upgrading them with the most advanced and sustainable technologies, instead of signing loan deals for the construction of new onerous projects. This way, Colombo would reduce the cost for completion, obtain returns on investment in shorter periods of time and enhance its sustainable development commitments.

Should there still be insufficient expertise among domestic infrastructure developers, Sri Lanka could attract more investors through international organisations such as the EIB, the Asian Development Bank, the World Bank or the AIIB. Multilateral development institutions make for more reliable partners to vulnerable economies such as Sri Lanka, in that they offer technical assistance, for example in conducting the necessary preliminary feasibility studies, and provide assurances in negotiating investment deals, for instance by granting a clause for extended debt repayment grace periods in case a borrower misses the maturity term.

If Sri Lanka managed to cope with its debt, it could set an example for other South Asian and Southeast Asian countries with soaring external debt obligations to international investors. For instance, Lao PDR is at a similarly high risk of debt distress according to the World Bank, owing to its high external indebtedness, mostly to China. The 2019 joint World Bank-IMF Debt Sustainability Analysis shows that the country's economy is suffering from depleting foreign reserves and high debt rates. Lao PDR is therefore regarded as highly vulnerable to external shocks deriving from the depreciation of its national currency and to pending debt maturities. While the opening of the China-Laos railway in December 2021 may contribute to economic development, it also leaves the country with a 5.9 billion USD loan to be repaid to Chinese state-owned banks.

The Maldives provide a further example of staggering external debt figures. In 2020 the World Bank estimated the Maldives to be the South Asian economy most affected by Covid-19-related recession, with international investors, particularly in the infrastructure development sector, fleeing the country. At the end of 2020, the Maldives' central government debt rose to nearly 80% of its GDP, with 45% of debt maturities owed to China's EXIM Bank, Commercial Bank and Development Bank.

As the next section explains, external partners such as the European Union have a role to play in the sustainable development of countries such as Sri Lanka, Laos or the Maldives, as it plans to further increase its presence in the Indo-Pacific as outlined in the EU's recent Strategy for the Indo-Pacific.

EU Policy Proposals

While the EU has very good avenues to pursue investment in Sri Lanka, it also risks creating duplications and inefficiencies. As such, it may be more appropriate to focus its energies on specific areas of EU interest and specialisation.

First, the EU can help the country engage in an environmentally friendly development, expand green power and energy production, and help increase sustainable fishery management and aquaculture. Being a low-lying island nation, Sri Lanka is particularly exposed to the effects of climate change. Climate change can adversely affect Colombo's territorial resilience and mitigation policies, as well as exacerbate the food security problems already facing many parts of the country. Rising temperatures and higher sea levels will have an impact on the growth of agricultural foodstuffs, as well as export crops such as tea, bringing about greater risk of food scarcity. Such an approach will provide the EU with an easier inroad to promote sustainable development and share expertise on modern and cleaner industrial practice. The EU retains its competitive advantage in this matter, and effective and direct aid, whether monetary or professional, can help foster goodwill and deepen integration between the two parties. This expertise or funding can be fully realised through programmes such as the Multiannual Financial Framework (MFF) or NextGen EU. Further, investing in less politicised areas such as mitigation and adaptation has the added benefit of helping the EU avoid confrontational positions *vis-à-vis* the US and China and keeping its portrayal as a middle way for third country investments. It also keeps the possibilities open of cooperating with either power in pursuit of their COP26 commitments and Sustainable Development Goals (SDGs).

Second, the EU can aid in the monetisation of selected non-strategic and under-utilised state assets. For example, Sri Lanka has set up the Selendiva Investment Company to strengthen loss-making state enterprises and generate revenue by collaborating with the private sector through Public Private Partnerships (PPPs), a body which can tremendously benefit from EU backing. The EU can provide expertise gained through its various European Investment Partnerships (EIPs), helping Sri Lanka streamline coordination between national, regional, and local administration and companies to simplify financial instruments and initiatives.

Alternatively, the EU can help leverage partners and member states to invest in sector-specific Small and Medium Enterprises (SMEs) and human-capital development. It can work in an EU capacity through policies such as the Aid for Trade programme and engage through the EU Global Connectivity Strategy. It can also work through individual member states, or through organisations such as the World Trade Organisation, the Asia Investment Facility of the European Investment Bank (EIB) or the World Bank, which can have immense advantages for Sri Lanka. Indeed, Sri Lanka aims to identify economic sectors that could benefit from foreign aid and development programs, highlighted as priorities in its 2021 budget. These include agriculture, infrastructure, water supply, urban development and housing, development of handloom villages and upgrading facilities for aquaculture and fishing. It can add onto previous policies, such as the 160 million EUR credit line established by the EIB to finance small and medium scale projects in infrastructure, tourism, energy, and telecommunications.

Third, through policies such as the EU-Sri Lanka Trade Related Assistance Project, the EU can invest into the promotion of SMEs in export-oriented sectors, especially those linked to and benefitting from GSP+ policies, like the full removal of duties on 66% of tariff lines. These extend across a wide range of products, including textiles and fisheries-related items, many of which are dominated by SMEs. This would help boost Sri Lanka's GSP+ utilisation ratio, which stood at a low 61.8% in 2019. Increased investments would lead to a better business environment and deepen economic ties between the EU and Sri Lanka. In addition to boosting trade between the two partners, GSP+ could help Sri Lanka bounce back to pre-Covid-19 growth levels while also replenishing the country's depleted foreign reserves. This way, Sri Lanka could ultimately beef up state revenues and repay its external debt.

Finally, it would be advantageous to give assurances to Sri Lanka for the continuation of GSP+ or similar benefits. Currently up for review by the EU as it expires in 2023, GSP+ is naturally linked to a country's level of economic and human development. It is possible for Sri Lanka to graduate from GSP+ and lose these privileges in the future. As these concessions are currently still critical to keep Sri Lanka's industry competitive, given regional competitors such as Bangladesh, it would be wise to anticipate such future scenarios and consider the pre-emptive signing of reciprocal trade agreements, raising Sri Lanka's industrial competitiveness. This would send a sign of commitment to Sri Lanka, and could help enforce the EU's soft power with other potential low/middle-income partner

Conclusion

As evidenced in the analysis, Sri Lanka's debt crisis has stemmed due to numerous reasons, particularly financial mismanagement and large foreign-financed state investments in underperforming infrastructure. The strategy of awarding tenders for new projects to traditional investors such as China, India or Japan adopted thus far has allowed Colombo to attract and use foreign capital to serve its pending loan payments. This, in turn, has critically increased Sri Lanka's outstanding external debt to unsustainable levels. The Hambantota Port 99-lease case was arguably the most uncongenial eye-opening lesson. However, there are positive signs that Colombo has learned from its experiences, as it now conducts due diligence before external partners are invited. The Sri Lankan case also offers wisdom to other debt-ridden countries in Asia to avoid being caught in similar situations. The lessons learnt in this case provide many precautions for countries taking on unsustainable debt for development. It also provides the EU the opportunity to deepen relations with Sri Lanka, and showcases many avenues for engagement that the EU may also apply to other lower/middle-income countries in need of aid or investments.

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