FEATURE

# India's Extraordinary Support during Sri Lanka's Crisis

## Motivations and Impacts

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### Abstract

India responded to Sri Lanka's 2022 economic crisis and sovereign default with USD 4 billion in financing facilities. This support enabled Sri Lanka to sustain essential imports and maintain sufficient foreign currency reserves to avoid defaulting on multilateral creditors. While India's assistance averted a deeper crisis, it was also driven by strategic motives. India's foreign policy hierarchy viewed Sri Lanka's crisis as an opportunity to counter China's influence on the island and to demonstrate India's growing capabilities in regional competition. Stabilizing the situation was crucial for protecting critical economic links and the interests of Indian firms operating in Sri Lanka. The goodwill generated by India's support facilitated Indian investments in Sri Lanka's strategic sectors and advanced several bilateral initiatives aimed at increasing economic integration. However, deeper engagement faces challenges from underlying anti-India sentiment in Sri Lanka and the need for Sri Lanka to balance relations with multiple major economies. Despite India's efforts, China remains a significant player in the island nation's economy.


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Sri Lanka entered sovereign default in April 2022, a consequence of successive policy mistakes and an economic crisis that had intensified since mid-2021. The severe economic and social crisis triggered a political upheaval, with large public protests leading to a change in government. In response, India provided USD 4 billion in financing facilities to Sri Lanka, amounting to around 5 percent of Sri Lanka's precrisis gross domestic product (GDP), just under 1 percent of India's official foreign reserves, and exceeding the USD 3 billion the International Monetary Fund (IMF) is providing to Sri Lanka from 2023 to 2027. With Sri Lanka having lost access to most other sources of foreign financing by early 2022, India effectively became its lender of last resort.[1]

[1] A *lender of last resort* is the place a person, firm, financial institution, or country to which a country turns when in urgent need of funds. As the term suggests, a lender of last resort is the only chance once all other options have been exhausted. While the International Monetary Fund (IMF) is the global institution that is meant to be the lender of last resort for sovereign states, the delays in governments' approaching the IMF and the length of the IMF's processes can often mean that other countries or institutions need to step in to provide emergency financing before IMF funding kicks in. For instance, the United States acted as a lender of last resort during Mexico's 1994 crisis.

This article explores the motivations behind India's decision to assume this role and evaluates the impact of its support on Sri Lanka, the bilateral relationship, and regional geopolitics. In examining India's motivations, the article delves into the evolution of Indian foreign policy under the Modi government, focusing on its approach towards its neighborhood, the Indian Ocean region, and China. The article argues that New Delhi's extraordinary financial support to Sri Lanka was an opportunistic move to demonstrate India's ability to compete with China and improve bilateral relations with Sri Lanka. However, beyond opportunism, there was a fundamental need to prevent Sri Lanka's economic crisis from escalating into a severe humanitarian disaster and to protect critical economic linkages, such as container transshipment through the Colombo port.

Assessing the impacts of India's intervention, this article examines how India has leveraged its financing to boost its trade share with Sri Lanka and increased Indian investments in strategic assets on the island. The critical medium-to-long-term impact hinges on whether the continued implementation of several bilateral initiatives can deepen Sri Lanka's economic integration with India. While there has been some progress, as explored in the article, upcoming national elections in Sri Lanka during 2024–2025 could disrupt this integration due to long-standing, underlying anti-India sentiment. Controversies surrounding Adani investments in Sri Lanka, which allegedly bypassed due process and competitive tenders, also threaten the goodwill generated by India's lender-of-last-resort actions. For Japan, Australia, the United States, and other countries with regional interests, India's expanding role in Sri Lanka and China's potential reactions will be crucial in shaping their own approaches to Sri Lanka.

## India's Neighborhood Foreign Policy, China, and Sri Lanka's crisis

India's current foreign policy hierarchy views its intervention in Sri Lanka's 2022 crisis as a significant triumph within the Neighbourhood First Policy (NFP). Minister of External Affairs Subrahmanyam Jaishankar has emphasized this, even suggesting it helps counterbalance the negative impacts of India's interventions in Sri Lanka's civil conflict during the 1980s.[2]

Despite the NFP's long history, India has had a contentious record in applying it, with different administrations offering their own interpretations. The Indira Gandhi government's support for Tamil separatist groups in Sri Lanka left a lasting negative impression. This was compounded by Rajiv Gandhi's direct interventions through the Indo-Sri Lanka accords and the deployment of the Indian Peace

[2] S. Jaishankar, *Why Bharat Matters* (New Delhi: Rupa Publications India, 2024), Kindle.

Keeping Force (IPKF) in 1987, which signaled India's assertion as the regional hegemon. Such heavy-handed tactics fostered apprehension among smaller neighbors with asymmetrical relationships with India, prompting Sri Lanka to seek closer ties with other regional powers, including Pakistan and China.

As China's economic performance far exceeded India's, India struggled to counter China's growing influence in South Asia from the 2000s onward. Minister Jaishankar acknowledged this, highlighting China's capacity to invest substantial resources in regional countries through the Belt and Road Initiative (BRI).[3] Sri Lanka's pivot toward large Chinese financing began before the BRI's official launch in 2012, with major projects like Norochcholai, Hambantota Port, and the Airport Expressway.[4] India attempted to step in with significant financing for postconflict reconstruction during 2011–2013, but even this was dwarfed by Chinese financing (fig. 1).

With Chinese state-owned enterprises (SOE) acquiring strategic assets such as Colombo Port City, Colombo International Container Terminal, and Hambantota Port, India frequently voiced concerns about China's role in Sri Lanka during this period. Indian scholars were instrumental in framing Chinese financing as *debt-trap diplomacy*, portraying it as a strategy to seize strategic assets from indebted developing countries.[5] Even the COVID-19 pandemic did not slow China's involvement in Sri Lanka, with Chinese financing maintaining its dominance during 2020–2021.

It was no surprise that India fully capitalized on Sri Lanka's 2022 economic crisis to expand its NFP and demonstrate its capacity to mobilize significant financial resources swiftly. Minister Jaishankar stated that New Delhi stepped forward in an unprecedented way, altering the region's perception of India.[6] His role in leveraging this moment to enhance India's NFP was crucial. During 1988–1990, as First Secretary in Sri Lanka and political advisor to the IPKF, Jaishankar gained firsthand experience of India's foreign policy missteps in Sri Lanka. He also served as India's longest-serving ambassador to China from 2009 to 2013, handling a flare-up in the Indo-China border conflict. As a career Indian Foreign Service official turned Minister, Jaishankar has actively shaped and guided Prime Minister Narendra Modi's foreign policy. In South Asia, this involved a

[3] S. Jaishankar, *The India Way: Strategies for an Uncertain World* (Gurugram: HarperCollins India, 2022), Kindle.

[4] Umesh Moramudali and Thilina Panduwawala, "Evolution of Chinese Lending to Sri Lanka since the Mid-2000s: Separating Myth from Reality," China Africa Research Initiative, School of Advanced International Studies, John Hopkins University, Briefing Paper No. 8 (November 2022), https://papers.ssrn.com/.

[5] Deborah Brautigam, "A Critical Look at Chinese 'Debt-Trap Diplomacy': The Rise of a Meme," *Area Development and Policy* 5, no. 1 (2020): 1–14, https://doi.org/.

[6] "India facing 'very complicated challenge' from China, ensuring no attempt made to change status quo in border areas unilaterally: Jaishankar," *The Hindu*, 28 May 2023, https://www.thehindu.com/.

robust return to the NFP and expanded engagement within the Indian Ocean region (IOR) and the Bay of Bengal.

Jaishankar closely coordinated with Sri Lankan authorities during the COVID-19 pandemic, particularly in supplying vaccines and medical supplies. The relationships built during the pandemic transitioned into support during Sri Lanka's economic crisis. As 2022 began, Colombo was hoping for a miracle when India announced its first set of financing packages in mid-January, following direct negotiations in early December between India's External Affairs and Finance Ministers and Sri Lanka's then Finance Minister, Basil Rajapaksa.[7] Jaishankar followed up with visits to Sri Lanka in March and October 2022, accompanied by additional financing and aid. In contrast, despite an official visit in January 2022 to Colombo by Wang Yi, China's then-Foreign Affairs Minister, no new financing from China was received (fig. 2). At a moment when China appeared to distance itself from Sri Lanka, India stepped up its support with unprecedented vigor and effort. As explored in subsequent sections, this was facilitated by expanding the financial capacity and tools available to India, particularly through the Reserve Bank of India (RBI) and state-owned financial institutions.

## India's Extraordinary 2022 Financing Package to Sri Lanka

In January 2022, Sri Lanka faced a precarious external financing situation. The Central Bank of Sri Lanka (CBSL) estimated the government's and central bank's foreign currency repayment obligations for 2022 at USD 6.9 billion, including a USD 500-million international sovereign bond (ISB) maturing that January. However, the CBSL held only USD 1.6 billion in usable foreign reserves at the end of 2021, less than a quarter of the foreign currency debt repayments due in 2022. Sri Lanka was also unable to raise new foreign currency debt in international capital markets because its credit rating had been downgraded to just above default by late 2021, signaling a significant risk of default.[8]

Domestically, segments of the local business community and civil society were urging the government to consider a pre-emptive default on its external debt from late 2021 onward, before foreign reserves were fully depleted. Sri Lankan authorities, led by then-Governor of CBSL Nivard Cabraal, responded with vague plans to raise foreign currency financing from various sources, including currency swaps with other central banks, state asset sales, and bilateral credit lines to finance

[7] High Commission of Sri Lanka in India, "Finance Minister Basil Rajapaksa concludes a successful visit to New Delhi," 3 December 2021, https://slhcindia.org/.

[8] "Moody's downgrades Sri Lanka sovereign rating to Caa2," *EconomyNext*, 28 October 2021, https://economynext.com/.

imports. None of these materialized, except for drawing down the unusable Chinese swap facility, until India stepped in with several financing facilities.[9] Thus, the Sri Lankan government sought a major support package from India due to the lack of any other alternatives.

In January 2022, India provided Sri Lanka with a critical set of financing facilities. These included a USD 400-million currency swap via the Reserve Bank of India's (RBI) South Asian Association for Regional Cooperation (SAARC) swap facility and the deferral of about USD 500 million in trade liabilities accumulated through the Asian Clearing Union (ACU), primarily from imports from India, which were otherwise due for repayment in January.[10] These measures helped bolster Sri Lanka's foreign reserves, allowing for the repayment of external debt from reserves during the January to March 2022 period. While this provided some breathing room, internal disagreements over emergency steps, particularly regarding entering an IMF program, crippled the government.

Amid an escalating economic crisis, with growing public protests and rolling blackouts, key members of the Rajapaksa government hesitated to commit to severe austerity measures. These measures, including interest rate hikes, significant tax increases, expenditure containment, and substantial energy price hikes, were necessary to meet the prior actions required to enter an IMF program.[11]

Since mid-2021, the banking sector had struggled to process letters of credit for imports and conduct regular forex transactions due to a foreign currency shortage.[12] State-owned banks, which accounted for about 40 percent of the banking sector,

[9] A right to information request from the CBSL revealed that for the RMB 10-billion swap to be usable for transactions, the PBOC requires CBSL's forex reserves should be large enough to cover 3-months of goods imports and/or be larger than the predetermined net FX drains Sri Lanka faces in the next 12 months. But from December 2021, the CBSL's forex reserves have been below both metrics until late-2023. Therefore, throughout the crisis period the PBOC swap remained unusable as a reserve asset. But since it had been drawn down into a CBSL account, it had to be reported as part of CBSL's forex reserves.

[10] "Dr. S. Jaishankar and Hon'ble Basil Rajapaksa finalize large Indian support to Sri Lanka" (press release, High Commission of India in Sri Lanka, 16 January 2022), https://hcicolombo.gov.in/. The Asian Clearing Union (ACU) is a payment arrangement whereby the participants settle payments for intraregional transactions among the participating central banks on a net basis. It consists of seven South Asian countries (excluding Afghanistan) plus Myanmar and Iran. While the transactions occur through the banking system, outstanding net amounts are liabilities of the central banks and cleared on a net basis every two months. In effect, it allows the participating central banks to reduce the amount of dollar liquidity needed to settle trade between the member countries.

[11] These internal government disagreements and apprehensions are covered in detail in Sri Lanka's Supreme Court Judgements for Fundamental Rights petitions No. 195_2022 and No. 212_2022, provided on 14 November 2023, https://www.supremecourt.lk/.

[12] *Financial System Stability Review 2022* (Colombo: Central Bank of Sri Lanka, December 2022), https://www.cbsl.gov.lk/.

particularly struggled to source foreign currency and issue letters of credit to import fuel for the Ceylon Petroleum Corporation (CPC). The CPC, in turn, supplied fuel to the Ceylon Electricity Board (CEB), the monopoly electricity supplier. Both SOEs were suffering losses due to below-cost energy pricing imposed by successive governments.

In this context, the second set of financing facilities provided by India was crucial for allowing Sri Lanka to import essentials, especially fuel, food, and pharmaceuticals. The EXIM Bank of India provided a USD 500-million fuel import credit facility in March 2022, and the State Bank of India extended a USD 1-billion import credit facility in April 2022.[13] Additionally, although not officially announced, Sri Lanka was permitted to accumulate up to about USD 2 billion in ACU trade credit, effectively allowing for an additional USD 1.45 billion in imports from India. In June 2022, the EXIM Bank of India followed up with a USD 55-million facility to finance fertilizer imports, critical for Sri Lanka's agriculture sector.[14]

Combined, these financing facilities meant that India had provided close to USD 4 billion in financing to Sri Lanka in 2022, covering over 80 percent of merchandise imports from India that year. Most of this financing was made available during the January–April 2022 period, a time when Sri Lanka faced significant uncertainty regarding sovereign default and entering an IMF program.

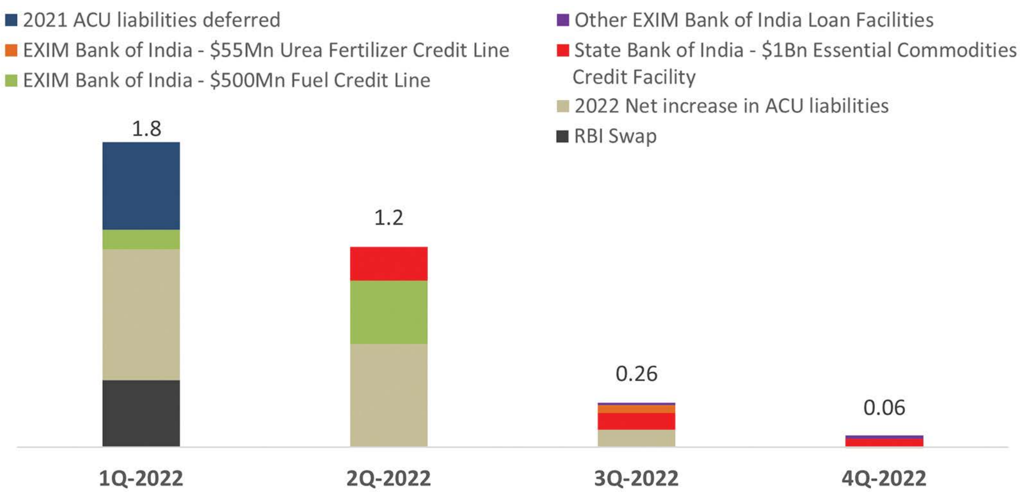


**Figure 1. Breakdown of Indian financing facility disbursements in 2022 by quarter, USD billion.** (Source: Author compiled based on External Resources Department (ERD) and CBSL data)

[13] Press Trust of India, "SBI signs agreement to provide $1-bn credit facility to Sri Lanka," *Business Standard*, 17 March 2022, https://www.business-standard.com/.

[14] "US$ 55 million LOC for procurement of Urea Fertiliser" (press release, High Commission of India in Sri Lanka, 10 June 2022), https://hcicolombo.gov.in/.

Sri Lanka utilized USD 3.3 billion of the USD 4 billion in Indian financing made available in 2022. Of this, USD 926 million was through the central government, and the remainder was through the CBSL. The scale of Indian financing becomes more apparent when compared to past Indian financial flows to Sri Lanka, especially against China, the largest bilateral creditor over the previous decade. Prior to 2022, India's share of foreign debt disbursements to Sri Lanka's central government had never exceeded 10 percent. In 2022, this share surged to 38 percent (fig. 2). In contrast, China's share had exceeded 10 percent every year since 2009, peaking at 42 percent in 2013. However, after significant financing in 2020 and 2021, China's share plummeted to just 3 percent in 2022, underscoring the difference in crisis support from India and China. When adjusted for repayments, Sri Lanka's government had net repayments of USD 266 million to China, compared to a net inflow of USD 878 million from India in 2022.


**Figure 2. China and India share of foreign debt disbursements to Sri Lanka's central government.** (Source: Author compilation based on ERD data)

Despite being a smaller bilateral lender to the Sri Lankan government, India has historically utilized central bank facilities to support trade continuously through the ACU and bilateral swap facilities from the RBI.[15] The RBI's bilateral swaps were notably provided during periods of economic strain even before 2022, such as the USD 1.5 billion extended in mid-2015 when Sri Lanka's reserves were dwindling ahead of an IMF program that was finalized only in mid-2016. The use of ACU trade credit also saw an uptick during previous balance of payment crises in 2008, 2011, and 2015–2016. Therefore, the significance of utilizing ACU credit and RBI swaps in 2022 lay not in deploying new tools but in the magnitude and speed with which they were employed early in the year.

[15] The Reserve Bank of India's SAARC swap facility has been available to all SAARC member countries since November 2012.

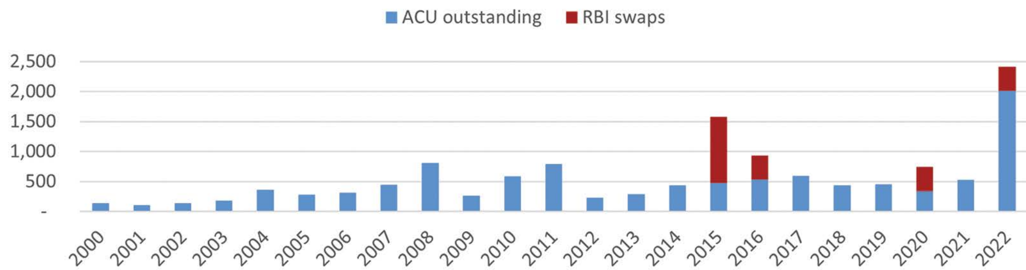


**Figure 3. Central Bank financing facilities from India outstanding at year end, USD million.** (Source: Author compilation based on CBSL data)

## Indian Financing Sustained Essential Imports

India and China have been the largest sources of merchandise imports for Sri Lanka in recent years, with India accounting for 20.4 percent and China (including Hong Kong) for 21.9 percent of imports during 2019 to 2021. In 2022, Sri Lanka's merchandise imports contracted by USD 2.35 billion compared to 2021, with imports from China experiencing the steepest decline of USD 1.47 billion.[16] Conversely, imports from India increased by USD 113 million. This increased India's share of Sri Lanka's imports to 26 percent in 2022, while China's share decreased to 18 percent (or 19.4 percent including Hong Kong).

Although India and China had similar import shares from 2019 to 2021, the composition of their imports differed significantly. Indian imports comprised substantial amounts of essential food and fuel, whereas Chinese imports were predominantly investment goods, machinery, and industrial inputs. During the 2022 crisis and recession, nonessential consumption, industrial activity, and investment contracted significantly. As a result, imports of construction materials, machinery/equipment, consumer durables, and industrial inputs declined, while Sri Lanka prioritized sustaining essential imports such as fuel, food, and medicines. Consequently, imports from China saw a sharper decline, while essential imports from India continued to flow. Indian financing played a crucial role in ensuring the continuity of these essential imports, particularly fuel and food, which increased in 2022 compared to 2021 (fig. 4). Maintaining the functionality of the Sri Lankan economy was also vital for India due to critical linkages, notably the Colombo Port's significant role in transshipment of container traffic to and from Indian ports. Avoiding a full-blown humanitarian crisis on its southern coast was imperative for India, given the potential costs involved.

[16] Calculated from *Central Bank of Sri Lanka Annual Report 2022*, Special Appendix.

In 2022, of the Indian credit lines extended, USD 700 million was allocated specifically for fuel imports, all of which were fully utilized, bolstered by the Indian Oil Corporation's (IOC) presence in Sri Lanka's fuel market since 2003. Fuel imports from India surged to USD 1.156 billion in 2022, compared to USD 605 million in 2021 and just USD 447 million in 2019. Consequently, India supplied 30 percent of Sri Lanka's fuel imports in 2022, up from 13 percent in 2019. Food imports from India also saw a significant increase in 2022, reaching USD 1.018 billion, compared to USD 787 million in 2021 and USD 404 million in 2019. About 48 percent of Sri Lanka's food imports originated from India in 2022, up from 20 percent in 2019.[17] These substantial rises in imports from India across these critical categories were facilitated by emergency Indian financing, countering declines seen in other import sectors, which was not the case for China. While China provided some aid grants, they were sharply smaller in comparison to India's support.

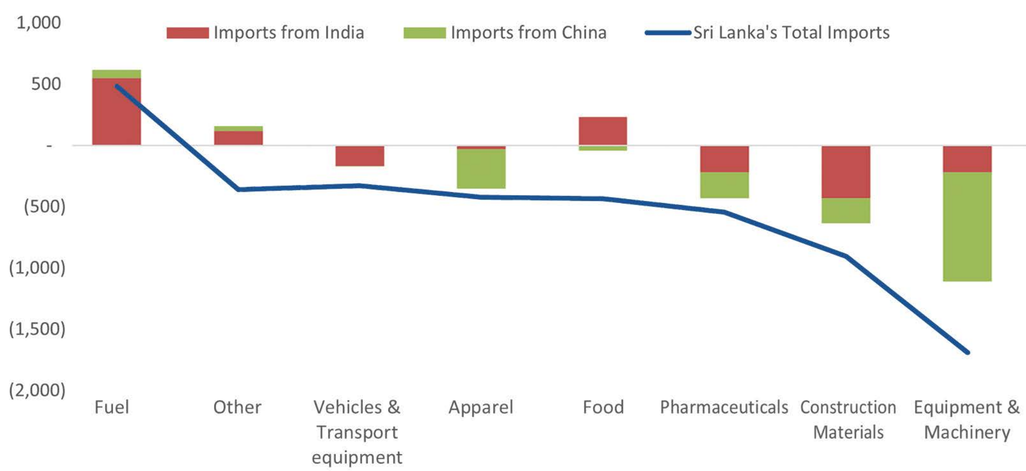


**Figure 4. Change in imports by major category in 2022 compared to 2021, USD million.**
(Source: Author compiled using ITC data)

Sri Lanka's capacity to import from India was further strengthened by higher Sri Lankan merchandise exports to India compared to China, despite both countries being smaller export destinations for Sri Lanka. Since 2019, India has typically accounted for about 6 percent of Sri Lankan merchandise exports, whereas China's share has been around 2 percent. Including exports to Hong Kong with China raises the combined share to approximately 3 percent.

[17] Calculated from data obtained via International Trade Centre, "Trade Map," n.d., https://www.trademap.org/.

The India-Sri Lanka Free Trade Agreement (ISFTA), effective since 2000, significantly bolstered Sri Lankan exports to India. The ISFTA facilitated substantial export growth in the early 2000s, with 31 percent of export expansion during 2000–2005 attributed to India. Export growth continued steadily post-2009, reaching more than USD 800 million by 2022. In contrast, annual exports to China and Hong Kong grew more gradually, surpassing USD 400 million by 2015 and remaining in the USD 300–400-million range thereafter, with the China-Sri Lanka Free Trade Agreement still under negotiation.

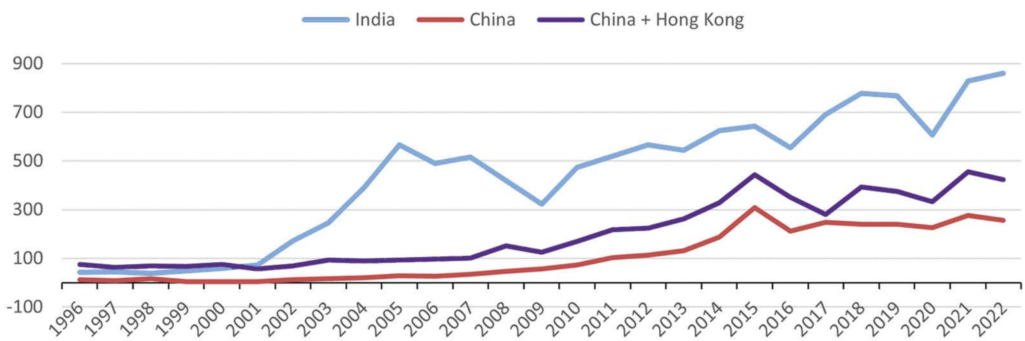


**Figure 5. Sri Lanka's merchandise exports to India and China, USD million.** (Source: Central Bank of Sri Lanka)

As a result of increased exports to India, Sri Lanka has maintained a smaller trade deficit with India compared to its combined deficit with China and Hong Kong from 2016 to 2021, although it remains significant. These deficits have been offset by Sri Lanka's trade surpluses with North American and European markets, remittances from the Middle East, tourism earnings, and foreign borrowings.

While substantial Chinese loans from 2005 to 2021 helped finance part of the deficit with China, such financial support did not materialize in 2022 to assist in financing the USD 3-billion trade deficit with China. In contrast, the USD 3.3-billion Indian emergency financing utilized in 2022 covered approximately 85 percent of the USD 3.8-billion trade deficit with India that year.

## Preventing a Default to Multilateral Creditors

By the end of March 2022, Sri Lanka's usable reserves stood at approximately USD 343 million, barely sufficient to cover upcoming foreign debt repayments and fuel imports. This amount would have been depleted entirely if not for the USD 400-million currency swap provided by the RBI in January 2022, which was unconditional compared to the People's Bank of China (PBOC) swap. Furthermore, Indian import credit facilities helped reduce the drawdown of reserves for essential imports. Without these measures, Sri Lanka's usable reserves would have dwindled to zero even before the decision to default in April (fig. 6).

Without Indian financing, Sri Lanka faced the risk of defaulting on repayments to multilateral creditors such as the IMF, World Bank, and ADB, which amounted to about USD 900 million in 2022. Defaulting on these obligations would have barred Sri Lanka from accessing further funding from these institutions, as seen in the case of Zimbabwe.[18] By preventing default to multilateral lenders, India's financing effectively functioned as a lender of last resort. Continuing to honor its commitments to multilateral creditors throughout 2022 enabled Sri Lanka to negotiate toward an IMF program and access some World Bank and Asian Development Bank financing even before the IMF program started in March 2023. India's proactive measures were recognized by exempting the emergency financing from debt restructuring, similar to the preferred creditor treatment (PCT) enjoyed by multilateral creditors.[19]

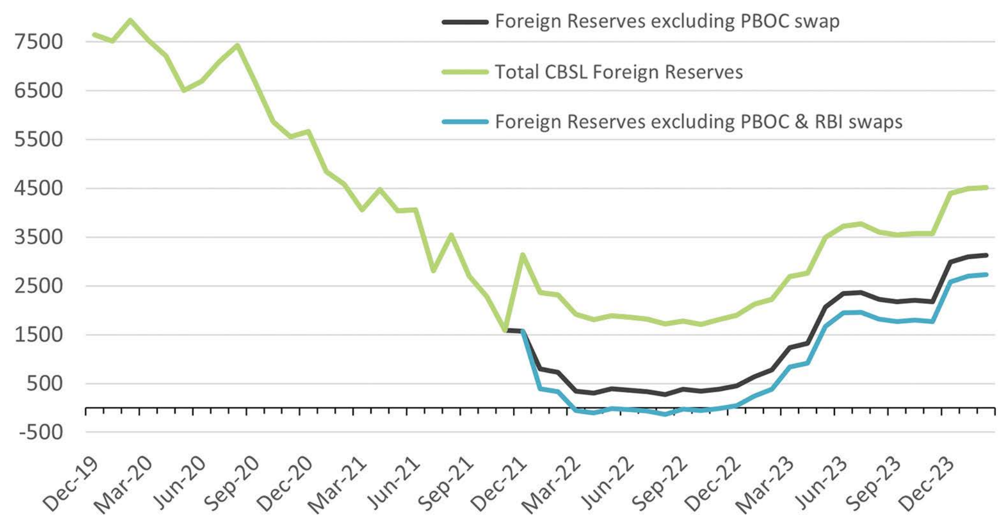


**Figure 6. Sri Lanka's Central Bank Foreign Reserves accounting for bilateral swaps, USD million.** (Source: Author compiled based on CBSL data)

[18] N. Roubini, B. Setser, *Bail-Outs or Bail-Ins? Responding to Financial Crises in Emerging Economies,* Peterson Institution Press, Peterson Institute for International Economics, No. 378 (2004): 280.

[19] PCT means that multilateral creditors continue to be repaid even when a country restructures debt to private and bilateral creditors, despite no strong legal backing for such a privilege. Tito Cordella and Andrew Powell, "Preferred and Non-Preferred Creditors," Policy Research Working Paper 8941 (working paper, World Bank Group. Washington, DC, July 2019), https://documents1.worldbank.org/.

## India's Prominent Political Role in Sri Lanka's External Debt Restructuring

As Sri Lanka entered sovereign default, its ability to borrow externally was primarily limited to multilateral lenders. Even their lending was contingent upon Sri Lanka taking steps to restructure its external debt and emerge from default status. When Sri Lanka initiated its external debt restructuring process in 2022, it became evident that dealing with bilateral creditors would pose challenges. By the end of June 2022, China held 40.1 percent and India held 15 percent of Sri Lanka's bilateral debt, totaling 55.1 percent—larger than the Paris Club's share of 41.7 percent.[20] Unlike the standardized process followed by Paris Club creditors for debt relief and restructuring, non-Paris Club creditors like India and China lacked such a uniform framework.[21] Therefore, Sri Lanka had to establish a platform where diverse bilateral creditor groups could discuss, coordinate, negotiate, and finalize debt-relief terms that each creditor found acceptable and comparable.

However, when considering the total external debt undergoing restructuring, China held a larger share while India's share was smaller. This disparity arises because the China Development Bank (CDB), a state-controlled policy bank, provided around USD 3 billion in commercial lending to Sri Lanka outside the bilateral framework. Similarly, a significant portion of India's outstanding bilateral loans to Sri Lanka, particularly the emergency credit facilities provided in early 2022, were exempted from restructuring. Of the total external public debt stock of USD 38.2 billion at the end of 2022, approximately USD 27 billion was subjected to debt restructuring. While all debt from China (both bilateral and from CDB) fell under restructuring, about USD 893 million of Indian lending through emergency credit facilities in 2022 was exempt. Consequently, only 4 percent of the external public debt undergoing restructuring in 2022 was from India, compared to 27 percent from China (16-percent bilateral and 11 percent from CDB).

[20] Ministry of Finance, "Investor Presentation – 23 September 2022," 19 October 2022, 18, https://www.treasury.gov.lk/.

[21] The Paris Club is an informal group of official bilateral creditors who work together to resolve debt repayment crises faced by debtor countries. The members of the Paris Club that are creditors of Sri Lanka and are part of the Official Creditor Committee (OCC) include Australia, Austria, Belgium, Canada, Denmark, France, Germany, Japan, Korea, the Netherlands, Russia, Spain, Sweden, the United Kingdom, the United States.

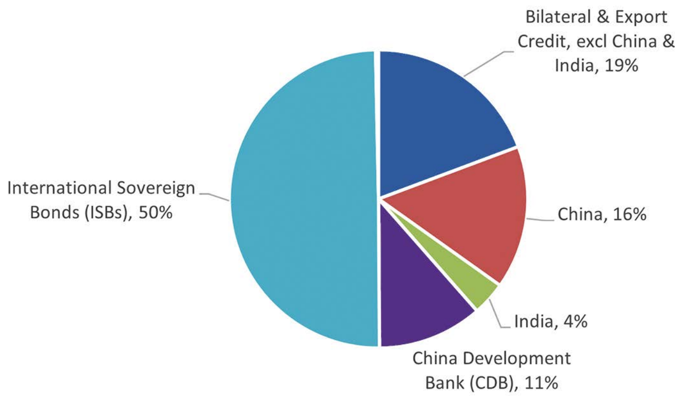


**Figure 7. Sri Lanka's external public & publicly guaranteed debt under restructuring at end-2022, by type of creditor.** (Source: Author compiled based on Ministry of Finance Public Debt Summary at end-2022)

Despite India's limited role in providing debt relief, New Delhi was the first creditor to offer the financing assurances required ahead of the IMF program board approval in March 2023. China, in alignment with IMF requirements, provided similar assurances only in early March 2023, a month and a half after India.[22] The perceived delay in China's response on its approach to debt relief and financing assurances drew criticism both internationally and domestically in Sri Lanka. India emphasized its prompt action in providing necessary financing assurances, portraying it as a continuation of its exceptional support since early 2022.

When the Official Creditor Committee (OCC) was established in April 2023 for bilateral debt restructuring negotiations, it was jointly chaired by Japan, India, and France, with no official representation from China. India has assumed a significant diplomatic role in Sri Lanka's external debt restructuring process, despite its smaller share of the debt undergoing restructuring.

While India cannot offer substantial debt relief in restructuring Sri Lanka's government external debt, it effectively restructured the central bank financing facilities provided in 2022. The RBI's USD 400-million currency swap and approximately USD 2 billion in ACU trade credit were originally intended as short-term facilities to be repaid promptly. The IMF's March 2023 report anticipated

[22] *Sri Lanka*, IMF Country Report No. 23/116 (Washington: IMF, March 2023), https://www.imf.org/.

repayment between 2023 and 2024. However, in October 2023, the RBI de facto restructured these facilities into a single USD 2.6-billion currency swap (including about USD 200 million in interest payments). This restructuring extended the maturity period, with repayments scheduled in monthly installments of USD 75 million from November 2024 to August 2026. This adjustment reduced pressure on Sri Lanka's foreign exchange reserves postcrisis.[23]

## India's Opportunity at Investing in Sri Lanka's Strategic Assets

The Indian government's significant involvement in emergency financing for essential imports and leadership in Sri Lanka's debt restructuring has been complemented by Indian firms investing in strategic sectors of the island nation. This is particularly crucial as Sri Lanka seeks foreign investment and aims to showcase successful investment stories to attract more investors, especially given its historically low levels of foreign direct investment (FDI), averaging less than 1.5 percent of GDP.[24]

From 2013 to 2022, based on available country-specific data, approximately 28.8 percent of FDI inflows into Sri Lanka originated from China and India combined, with 14.2 percent from China and 14.6 percent from India. However, this figure may underestimate the actual FDI flows from Chinese and Indian firms, as many investments are routed through other jurisdictions such as Hong Kong and Mauritius. Around two-thirds of FDI flowing to and from mainland China passes through Hong Kong, while Mauritius serves as an offshore financial center with a significant role in reported FDI into India.[25] When considering investments routed through Hong Kong alongside those from mainland China, and investments through Mauritius alongside those from India, the combined FDI shares for China and India in Sri Lanka increase to an average of 20.3 percent and 19.1 percent, respectively.

[23] *Sri Lanka*, IMF Country Report No. 23/116.

[24] FDI data is obtained from the CBSL's annual reports and exclude foreign loans (other than intercompany loans) obtained by Board of Investment–registered FDI firms.

[25] Seth O'Farrell, "Mauritius can be a jurisdiction of repute, says minister," *fDi Intelligence*, 14 November 2023, https://www.fdiintelligence.com/.

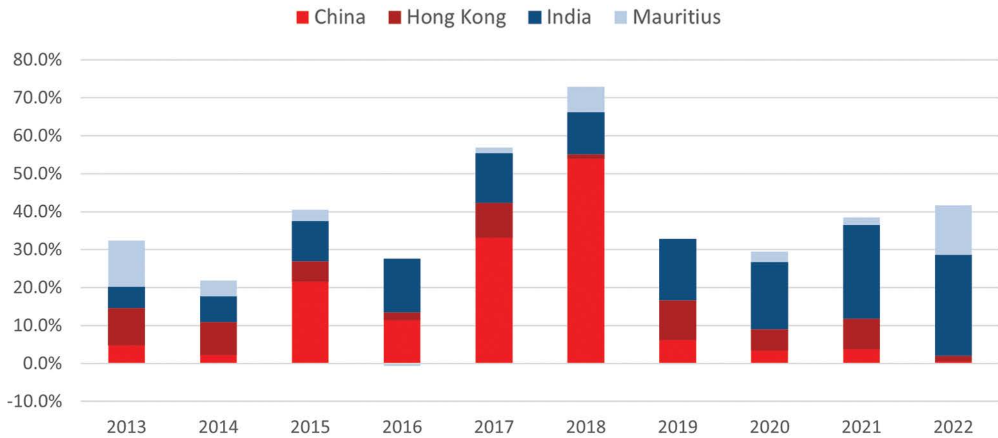


**Figure 8. Share of FDI inflows to Sri Lanka, % of total FDI inflows.** (Source: Author compilation based on Board of Investments of Sri Lanka data)

In China's case, the largest FDI inflow to Sri Lanka was the USD 1.5-billion Colombo Port City project by China Harbor Engineering Company (CHEC), with investments coming gradually since 2014. Another significant FDI was the 2017 lease of the Hambantota Port to China Merchant Port Group (CM Port) for 99 years, involving a USD 972-million investment disbursed during 2017 and 2018, marking a notable increase in Chinese FDI during those years. Excluding these two key projects—both of which drew considerable attention from India—FDI from China to Sri Lanka has been relatively modest and has decreased since 2019, falling behind investments from India.

In contrast, FDI inflows from India have shown less volatility, with a greater number of individual investments due to the substantial presence of Indian firms operating across various sectors in Sri Lanka. However, until recently, apart from the IOC's stake in the petroleum sector, Indian firms did not hold stakes in Sri Lanka's strategic assets such as electricity, ports, airports, telecom, and other critical infrastructure.

Adani's entry into Sri Lanka with two major investments has shifted this landscape significantly. This includes a 51-percent stake in the Colombo Port's West Container Terminal and investments in wind power projects in Mannar and Pooneryn. The port terminal project received backing from the United States through a USD 553-million loan from the US International Development Finance Corporation (DFC), positioned as an alternative to China's BRI.[26] In fact, this

[26] Benjamin Parkin and Chloe Cornish, "US lends $553mn to majority Adani-owned port in Sri Lanka," *Financial Times*, 8 November 2023, https://www.ft.com/.

loan ranks as DFC's sixth-largest single financing program, and with nearly USD 1 billion in total commitments from DFC in recent years, Sri Lanka ranks among the largest recipients of DFC financing globally, second only to India in South and Southeast Asia.[27]

However, both Adani investments bypassed competitive international bidding, with Sri Lankan authorities citing them as government-to-government initiatives aimed at circumventing legislative barriers that mandate competitive bidding for electricity-generation projects.[28] While the absence of competitive bidding sparked public outcry from opposition groups and civil society, the severity of the economic crisis provided ample grounds for protest on multiple fronts. The government also emphasized the urgent need for foreign investment to bolster the economy, and the goodwill generated by India's economic support helped mitigate broader opposition.

Apart from the Adani group, the IOC expanded its footprint in Sri Lanka, capitalizing on the liberalization of the petroleum sector. The IOC has doubled its market share in Sri Lanka and, even before Sri Lanka defaulted, took on expanded operations at the Trincomalee oil tank farm. HCL Technology Group also established a significant operational center in Colombo, supported by substantial tax concessions.

With ongoing Indian financing—amounting to USD 142 million in loans disbursed to the Sri Lankan government in 2023—Indian firms have sustained existing contracts and secured new ones for infrastructure projects commissioned by the Sri Lankan government.[29] Several Indian firms have submitted bids for state-owned assets slated for divestment by the Sri Lankan government, including Sri Lanka Telecom, Lanka Hospitals, and Sri Lanka Insurance.

## Success Generates Challenges for India's Future Role in Sri Lanka's Economy

While Adani's and other Indian firms' investments in Sri Lanka underscore India's growing economic influence postcrisis, other significant developments are also unfolding. Central to these are advancements in bilateral initiatives that had previously stagnated, partly due to public resistance toward deeper economic ties with India. The goodwill fostered by India's substantial support has enabled Sri Lanka's government to advance these initiatives. These include integrating Indian rupee payment systems into Sri Lanka's financial framework, progressing negotiations toward a

[27] Author's calculation based on DFC active projects data as of the end of 2023: https://www.dfc.gov/.

[28] Nirupama Subramanian, "To Legalise Power Project Given to Adani Without Tender, Sri Lanka Wants it Turned Into Govt-to-Govt Deal," *The Wire*, 4 September 2023, https://thewire.in/.

[29] "Foreign Financing Disbursements 2023," External Resource Department, 2024, https://www.erd.gov.lk/.

comprehensive bilateral trade agreement, establishing an electricity grid interconnection, and exploring potential gas and oil pipeline connections. Successful implementation of these initiatives would enhance bilateral economic integration and attract more Indian FDI into Sri Lanka.

Looking ahead to the upcoming elections in late 2024, the prospects for further progress on these fronts remain uncertain. Sri Lanka has historically favored maintaining some distance from India, influenced significantly by past events, notably Indian involvement in Sri Lanka's civil conflict. These historical factors continue to shape the political landscape and pose challenges to deeper economic cooperation with India.

Previous attempts to deepen integration with India have met resistance in Sri Lanka's political landscape. The Indo-Lanka Accords of 1987, which brought the IPKF, triggered widespread antigovernment protests and civil unrest from 1987 to 1989. Subsequent efforts, such as the Comprehensive Economic Partnership Agreement (CEPA) finalized in 2005, faced setbacks under Mahinda Rajapaksa's administration due to opposition from nationalist factions crucial to his political base, stalling its signing. Similarly, the Economic and Technology Co-Operation Agreement (ETCA), intended as a follow-up to CEPA, encountered obstacles after 2019 with another change in government toward the Rajapaksas, amid concerns over competition from Indian imports and labor influx.

Despite intermittent negotiations, progress on the ETCA stagnated until late 2023 when discussions resumed. However, the upcoming 2024 elections could once again disrupt Sri Lanka's commitment to these agreements.

The visible expansion of Indian presence in Sri Lanka, including Adani's involvement bypassing competitive tenders, risks eroding the goodwill fostered by India's crisis support. Discussions about a potential physical land bridge across the Palk Strait between the two countries further exacerbate such erosion.[30] Historically, anti-India sentiment has been exploited by nationalist politicians and the People's Liberation Front (JVP), which leads a prominent political alliance poised as a major contender in the upcoming presidential elections in 2024.

Recent developments in the Maldives serve as a cautionary tale for those guiding Indo-Sri Lanka bilateral engagements. Maldivian politics have become polarized between pro-India and pro-China factions, complicating efforts to maintain a strategic balance between these crucial economic partners in tourism and financing for the archipelago. In times of fiscal constraint, politicians often capitalize on

[30] Dinuli Francisco, "India, Sri Lanka talks on land bridge," *Sunday Observer*, 7 April 2024, https://www.sundayobserver.lk/.

their inability to deliver economic promises by resorting to noneconomic, emotionally charged rhetoric against India or China.

Sri Lanka witnessed a similar dynamic on a smaller scale in 2015, following the electoral defeat of the Rajapaksas. The new government suspended China-backed projects like the Colombo Port City, previously touted as symbols of development by the Rajapaksas. Despite this suspension and a slowdown in Chinese lending during 2015–2016, Chinese investment and financing regained momentum from 2017 onward. The anti-China sentiment that surfaced during the 2015 elections yielded to priorities of economic growth, attracting FDI, achieving fiscal consolidation, and bolstering foreign reserves. This led to the resumption of projects such as the Port City, the lease of Hambantota Port, and the expansion of expressways.

Like its experience with China, Sri Lanka's current governments must pragmatically seek sources of economic growth and external financing. India, as a rapidly expanding economy and emerging creditor, presents both opportunities and challenges. Balancing potential anti-India sentiments, particularly in the lead-up to elections, with strategic policy priorities is crucial. Thus, despite domestic political maneuvering and concerns over Indian influence, advancing bilateral initiatives is likely to progress over time, albeit with occasional delays.

While tourism and remittance inflows have provided some relief to Sri Lanka's immediate foreign currency pressures, its non-tourism and non-remittance foreign earnings have remained stagnant in recent years. As previously noted, the period of increased economic integration with India through the ISFTA saw New Delhi contribute to 31 percent of export growth from 2000 to 2005. Leveraging India's economic growth and its integration into global supply chains could similarly benefit Sri Lanka in the coming years.

However, there is a risk that Indian entities could engage irresponsibly at a time when Sri Lanka is in dire need of foreign financing and investment. Concerns over procurement and tendering processes involving Chinese SOEs and firms were raised before Sri Lanka's sovereign default, potentially leading to overspending on certain projects.[31] The bypassing of tender processes and the awarding of a higher guaranteed tariff rate for Adani's wind-power project in Mannar serve as reminders that Sri Lanka must improve governance standards regardless of the investor's origin.[32] Enhancing governance and public-sector capacity is an area

[31] Subhashini Abeysinghe et al., *The Lure of Chinese loans: Sri Lanka's Experiment with a Special Framework to Finance Its Infrastructure Investments* (Colombo: Verite Research, August 2022), https://www.veriteresearch.org/.

[32] "Adani deal symptomatic of Sri Lanka's high costs from lack of competition: Analyst," *EconomyNext*, 15 May 2024, https://economynext.com/.

where countries like the United States, Japan, and the European Union have a vested interest in supporting Sri Lanka.

The United States has demonstrated its ongoing commitment to its interests in Sri Lanka in recent years, highlighted by the USD 480-million Millennium Challenge Corporation (MCC) grant until 2019 and increased financial activities through USAID and DFC since the 2022 crisis. Like India, the United States also aims to compete with China in the region, viewing Sri Lanka as strategically significant. Sri Lanka played a pivotal role in shaping the narrative around Chinese debt-trap diplomacy, which has influenced US policy makers' regional strategies.

However, akin to India's experiences, the United States encountered political uncertainties in Sri Lanka, illustrated by the MCC grant's failure to materialize after the 2019 elections. Therefore, both the United States with its *Indo-Pacific Strategy* and India with its NFP in Sri Lanka should anticipate potential setbacks during Sri Lanka's electoral cycles.

## Balancing (Geo)Politics

Since 2022, India has ramped up its engagement in Sri Lanka, narrowing the gap with China in terms of economic influence. However, this does not imply that Sri Lanka will become excessively dependent on or fully integrated with India overnight. Sri Lanka maintains a diversified economy with substantial ties to other major economies. Its primary export markets remain the United States and European Union, and imports from China have begun to rebound as of early 2024. Despite Chinese policy banks refraining from new financing since late 2021, Chinese firms continue to operate and invest in Sri Lanka. Sinopec has expanded into the petroleum sector, securing approval for the country's second oil refinery, while CM Port is expanding operations at Hambantota Port. Moreover, a Chinese consortium has submitted bids for the divestment of government shares in Sri Lanka Telecom.

Even following debt restructuring, Chinese policy banks are likely to provide sufficient new loans to refinance existing repayments, following precedents set in countries like Ecuador. These banks also have exposure to Chinese SOEs invested in Sri Lanka, underscoring their interest in supporting Sri Lanka's economic recovery.

Given the long-term interests of both China and India in the island, Sri Lanka faces the challenge of balancing relations between these two Asian economic giants. A critical consideration is whether India can sustain a consistent and substantial flow of project financing, especially as China already has a pipeline of projects funded from its precrisis activities in Sri Lanka. For other major economies with stakes in Sri Lanka and the broader Indian Ocean region, such as the United States and Japan, India and Indian firms may serve as convenient partners for financing and investments. The Adani investment in the Colombo Port serves as a promising example that could potentially evolve into joint ventures rather than mere loans. Engaging partners from diverse countries could mitigate concerns about India's perceived dominance in new projects and investments, which has the potential to stir domestic anti-India sentiments and dampen political support for deepening engagement with India. ✪

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