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The event of **default clauses in the four Hambantota Port China Eximbank loans did not feature any asset seizure** clauses and the port assets were not included as collateral.

In the year the port was leased to China Merchant Ports, **port loans accounted for only 2.4%** of Sri Lankan government's total foreign debt repayments.

Chinese lending at the end of 2021 came to **19.6% of public external debt,** much higher than the often-quoted 10-15% figures.

During 2008-2021, **the effective interest rate on overall Chinese lending averaged 3.2%, higher than average rates** on Japanese, World Bank, and ADB loans to Sri Lanka (0.9%-1.6%). But Chinese rates were significantly lower than Eurobonds which averaged 6.9%.

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Evolution of Chinese Lending to Sri Lanka Since the mid-2000s - Separating Myth from Reality

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ABSTRACT

SAIS-CARI BRIEFING PAPER NO. 8 | NOV 2022:

"Evolution of Chinese Lending to Sri Lanka Since the mid-2000s – Separating Myth from Reality"

by Umesh Moramudali and Thilina Panduwawala

CHINA IS SRI LANKA'S LARGEST BILATERAL CREDITOR and has a significant role to play within the sovereign debt restructuring process that the crisis-stricken island nation is currently going through. This working paper provides a deep dive into China's lending to Sri Lanka over the last two decades and situates China within the overall changes in Sri Lanka's public external debt profile through its middle-income transition.

Chinese lending to Sri Lanka has evolved through five distinct phases since 2000, expanding from bilateral lending to export credit and eventually balance of payments support through China Development Bank term loans since 2018 which became an alternative to raising eurobonds. The fifth phase is focused on Sri Lanka's historic sovereign default, and debt restructuring negotiations, which could define not only the future of Chinese lending to Sri Lanka but also to other BRI countries going through debt distress, including those in Africa.

The ongoing debt restructuring process is not the first time Sri Lanka's government has asked for a loan restructuring from China Eximbank. In 2014, the then government proposed to restructure all Chinese loans obtained for the Hambantota Port project and create a joint venture with two Chinese SOEs to further develop the port terminals. While an election ended the earlier negotiations, the 99-year lease of the port in 2017 was a measure to address severe balance of payments issues, which the earlier plan had not tackled. The lease proceeds helped improve foreign currency reserves and there was no debt-to-equity swap nor an asset seizure, contrary to popular narrative.

We found no deliberately 'hidden debt' in China's lending to Sri Lanka's public sector. Publicly available data from a number of Sri Lanka's public institutions provided full visibility for the US$ 7.4 billion in Chinese debt outstanding at end-2021. Chinese lending was then 19.6 percent of public external debt, much higher than the often-quoted 10-15 percent figures. A significant portion of Chinese debt has been recorded under state-owned enterprises, not the central government, but all of the Chinese debt was reported to the World Bank's *International Debt Statistics*. The nuances involved in ensuring full visibility of this debt show that public discourse, whether driven by media or academia, needs to take into account the complexities involved in how public debt is classified and reported in a country. At the same time, governments should ensure that public debt reporting is as simple, clear, and widely available as possible to facilitate open conversation.

1. INTRODUCTION

In June 2018, the *New York Times* published an article titled "How China Got Sri Lanka to Cough Up a Port" which portrayed the 99-year lease of Hambantota Port, initiated in 2017 and completed in 2018, as an "asset seizure".[1] The lease of this loss-making Hambantota Port to a joint-venture led by China Merchant Port (CM Port), a partially state-owned enterprise (SOE), was a pivotal factor in creating the "Chinese debt trap" narrative.[2]

This was not the first time Sri Lanka had been dragged into the global discussion about China's rising role as a capital exporter, either through debt or equity investment. President Xi Jinping's September 2014 inauguration of the Colombo Port City project, an equity investment by China Harbour Engineering Corporation (CHEC), was followed by Indian protesting of the docking of a Chinese submarine at CM Port-managed Colombo South Terminal in November 2014 and allegations of the Chinese funded Lotus Tower being a Chinese listening post.[3]

Sri Lanka has been in sovereign debt default since April 12, 2022, with China as its largest bilateral creditor, accounting for about 19.6 percent of Sri Lanka's public external debt (in 2021) when including both concessional and commercial lending. Sri Lanka is back in the "China debt trap narrative" spotlight. China will have to play a major role in Sri Lanka's debt restructuring process, with US$ 7.4 billion or 19.6 percent of outstanding public debt owed to China at the end of 2021 (out of a total of US$ 37.6 billion in total public external debt excluding central bank debt), and it will be the first time a major Asian Belt and Road Initiative borrower is going through the process. But given the severe balance of payments (BOP) and debt distress being experienced by most developing countries, this will definitely not be the last Chinese debt restructuring. China's approach to Sri Lanka's debt restructuring and the extent of debt relief offered will set a precedent for China's role and behavior in other countries as well. With China's two main policy banks, China Exim Bank (ChEXIM) and China Development Bank (CDB), as the largest Chinese lenders to Sri Lanka accounting for US$ 4.3 billion and US$ 3.0 billion, respectively, in outstanding debt to Sri Lanka at the end of 2021, it will also be a testament to how the banks work alongside each other and how Beijing coordinates the process.

In this paper, we explore Chinese lending in Sri Lanka since 2000 and how it has evolved over the past two decades, separating myth from reality. We analyze, in some depth, the Hambantota Port project, and situate Chinese lending in the context of Sri Lanka's public sector debt data over the last few decades, particularly since 2000. This history of China's role in Sri Lanka since the turn of the millennium sets the stage for China's vital role in Sri Lanka's current debt restructuring process.

We argue that there was no immediate issue for Sri Lanka to service Chinese loans for the Hambantota Port in 2017 when Sri Lanka decided to lease the port to the CM Port-led joint venture. This decision was the end result of a negotiation process over the future of the Port started under the previous government in 2014. It was a decision meant to return the state-owned Sri Lanka Port

Authority (SLPA) to profitability, ensure effective use and investment at the Port, and raise non-debt inflows into the country's foreign currency reserves via foreign direct investment (FDI). Describing the detailed history of the Hambantota Port project provides the background to delve into the history of Chinese lending to Sri Lanka since 2000 and identify five distinct phases through which China's role has evolved.

The paper is organized as follows. Section 2 will explore the Hambantota Port project in detail to firmly separate myth from reality. Section 3 frames the increase in Chinese lending since the 2000s within the wider changes in Sri Lanka's public external borrowing. Section 4 explores the evolution of Chinese lending to Sri Lanka and identifies five distinct phases through which Chinese lending to Sri Lanka has evolved, ending with China's role in Sri Lanka's debt restructuring and why it will be pivotal not just for Sri Lanka but for all developing countries with substantial exposure to Chinese lending, especially those in Africa facing debt distress.

SECTION 2: HAMBANTOTA PORT AND CHINESE DEBT

With its location in the home district of the Rajapaksa family, which has led Sri Lanka's governments from 2005-2014 (under former President Mahinda Rajapaksa) and from 2019-2022 (under former President Gotabhaya Rajapaksa), the Hambantota Port project has been identified as a politically motivated infrastructure project. While port construction began during President Mahinda Rajapaksa's tenure, the first feasibility study was conducted by Canada's SNC-Lavalin, with funding from the Canadian International Development Agency, in 2003.[4] The 2003 feasibility study recommended a joint venture between the state-owned SLPA and a private-consortium on a build-own-operate-transfer basis. But with the change in the Sri Lankan government in 2004, the Canadian project did not move forward.

The change in government made Mahinda Rajapaksa Prime Minister in April 2004 and President in November 2005. Following the December 2004 tsunami, urgency grew for infrastructure development in the coastal regions, including Hambantota. The promise of an international port in Hambantota was included in Mahinda Chinthana, the 2005 presidential election manifesto. Rajapaksa had political reasons to construct a port in Hambantota. It was his electoral district, which he had represented in Parliament since 1970. It was also among Sri Lanka's poorest regions with regular droughts, making a non-agriculture employment-generating investment politically attractive.

A second feasibility study was conducted by Denmark's Ramboll in 2006 and provided similar recommendations as those by SNC-Lavalin. The study argued that the port should initially aim for non-containerized traffic given the ongoing expansion at the Colombo port, which has consistently been the busiest port in South Asia. Unlike Colombo, Hambantota provided plentiful space for the port, related industries, and services to expand. But Sri Lanka was unable to find partners for the project.

Box 1: Sri Lanka's Sovereign Debt and Default

Sri Lanka is a perpetual twin deficit economy, with persistent fiscal balance and external current account deficits. Government revenue was over 20 percent of gross domestic product (GDP) until 1996, but has gradually declined to an 8.3 percent low in 2021.[5] Government expenditure has reduced as a share of GDP, but fiscal deficits have been above five percent of GDP since 1990. Sri Lanka has a history of providing open-ended subsidies, lately the most prominent has been SOEs selling fuel and electricity below cost.

With persistent fiscal deficits, this is not the first period in which government debt surpassed 100 percent of GDP; having done so in the late-1980s and early 2000s. The difference this time around is the composition of external debt. Following the 1997 upgrade to lower-middle income country status, Sri Lanka gradually lost access to most concessional financing. Therefore, the domestic infrastructure and consumption driven growth strategy of the first Rajapaksa government (2005-2014) was financed by a rapid increase in borrowing from external creditors. Prominent amongst the new loans were *International Sovereign Bonds* (ISBs), and loans from ChEXIM. The prioritization, investment case, and modality for several infrastructure projects have been questioned, especially those built in Hambantota, the home district of the Rajapaksa family (which led the government from 2005 to 2014 and again between November 2019 and July 2022).

With this growth strategy, GDP growth well outpaced export growth. As a share of GDP, exports of goods and services dropped from 39 percent in 2000 to 17 percent in 2021. While growth in remittances provided some cushioning, this exports trend meant that Sri Lanka's growth has been highly dependent on continued access to foreign capital inflows. Given the persistently low FDI levels Sri Lanka has managed to attract, this has meant dependence on debt inflows with the largest foreign borrower being the public sector (excluding the Central Bank) accounting for US$ 37.6 billion of the US$ 55.8 billion in outstanding external debt at the end of 2021.[6] By 2021, commercial borrowing was 44.7 percent of central government external borrowing, rising from just 4.4 percent in 2006.[7] The result has been rising public sector external debt service obligations, forecasted to be US$ 4-5 billion a year in the 2021-2025 period, with ISB maturities arising every year.[8] The risks created by this situation were understood between 2016 and 2019 when Sri Lanka was within an IMF Extended Fund Facility program. Several policy measures were taken including tax reforms and a fuel pricing formula, which allowed the fiscal situation to improve with a primary balance surplus of 0.6 percent of GDP with government revenue at 12.6 percent in 2018. But most of these measures were reversed or ignored following the change to a new Rajapakse-led government in November 2019, the same year GDP contracted 0.2 percent.

This explains the decision by Sri Lankan authorities to engage in monetary easing since May 2019, after the Easter Sunday terrorist attacks in April 2019, and to introduce large tax cuts in November 2019 hoping to support economic recovery. Sri Lanka could have reversed course during the early stages of the pandemic had it re-engaged with the IMF for emergency financing via a Rapid Financing Instrument. But the government was unwilling to reverse its tax cuts or do pre-emptive external debt restructuring despite a further 3.5 percent GDP contraction in 2020. Thus, fiscal and monetary easing measures were sustained throughout the COVID-19 pandemic, with the government hoping a recovery in growth would strengthen fiscal balances over time.

Sri Lanka's macroeconomic fragility meant that monetary and fiscal easing over a prolonged period was highly imprudent. By downgrading Sri Lanka's sovereign credit rating in 2020 and 2021, credit rating agencies highlighted these concerns. The loss of access to international capital markets to refinance maturing ISBs meant that Sri Lanka kept running down its foreign currency reserves, from US$ 7.6 billion at the end of 2019 to US$ 3.1 billion at the end of 2021, using central bank financing for the large fiscal deficit. Adding on to the reserve depletion was the decision to keep the Sri Lankan Rupee pegged around the 200/$ level from April 2021 to Feb 2022, with the central bank selling down its dwindling foreign exchange (forex) reserves to maintain the Rupee value against the US Dollar. When the Rupee was eventually floated in March 2022, usable foreign reserves were near zero and the Rupee depreciated rapidly to stand around 360/$ by July 2022. Year-on-year inflation reached 69.8 percent in September 2022 driven by depreciation and shortages due to a misguided chemical fertilizer ban intended to promote organic farming leading to a sharp reduction in agriculture output and an inability to import amidst a lack of dollar liquidity in the banking system. It was in this context that the decision to suspend external debt was taken on April 12, 2022, triggering sovereign default.

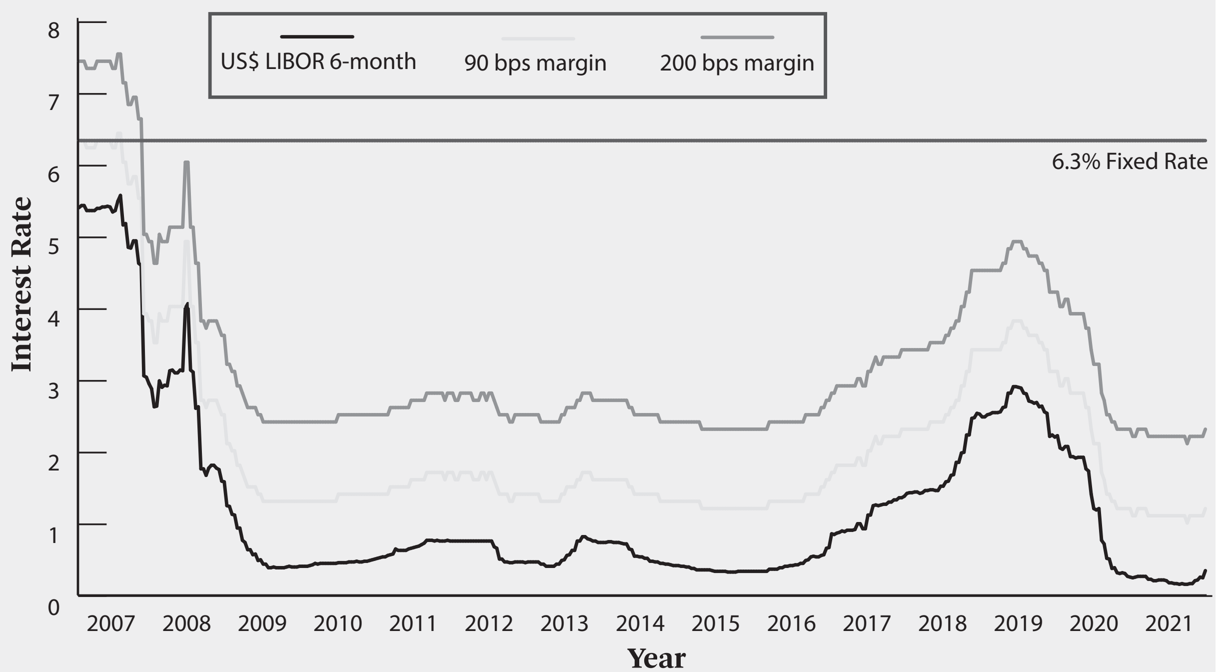
At the time, the China Harbour Group was involved in reconstructing the Hambantota Fisheries port as part of post-tsunami reconstruction efforts. They were interested in taking up the Hambantota International Port project and lobbied hard to arrange financing from Chinese lenders. Signed in October 2007, ChEXIM agreed to provide a US$ 307 million 17-year commercial loan, with a six-year grace period on principal repayment, at a floating interest rate of US$ 6-month LIBOR + 90 basis points (0.9 percent) margin for Phase 1 of the port.[9] On average US$ 6-month LIBOR was 5.1 percent in October 2007 (Figure 1), making the effective interest rate payable on the loan at that point about 6.0 percent. This Phase 1 loan was given as a non-concessional buyer's credit loan which typically carried higher interest rates.[10] For a country that was just emerging from the tsunami and going through a reescalation of its civil war, obtaining such a loan for a major project was a huge deal. In 2006 Sri Lanka managed to get an international credit rating and in October 2007 raised a US$ 500 million five-year ISB at 8.25 percent. Both borrowings set the trend for Sri Lanka's debt build up over the next 15 years, driven by export credit and commercial borrowing, culminating in the April 2022 sovereign debt default.

The context of the post-global financial crisis meant that the US$ 307 million interest cost of the Phase 1 loan was highly uncertain, with the US$ 6-month LIBOR rate dropping to an average of just 1.1 percent in 2009, making the effective interest payable on the loan just two percent, when interest repayments commenced in 2010.[11] However, as the LIBOR rate declined, the Phase 1 ChEXIM loan was technically restructured in October 2008 from a floating interest rate to a 6.3 percent fixed interest rate, retaining the near six percent interest rate that existed at the point of signing the agreement in October 2007.[12]

On September 2, 2008, President Rajapaksa in his capacity as Minister of Finance submitted Cabinet memorandum No. 08/1687/306/108 "Hambantota Port Development Project - Buyer's Credit Facility of US$ 307 million from the EXIM Bank of China" proposing to amend the loan agreement including the interest rate and was approved October 2, 2008. According to the memorandum and its annexures, ChEXIM requested to amend the interest rate citing an increase in its funding cost to US$ 6-month LIBOR + 175 basis points, much higher than the loan's original interest rate of LIBOR + 90 basis points. ChEXIM provided two options for the higher amended interest rate, a fixed interest rate of 6.3 percent and a floating interest rate of LIBOR + 200 basis points. The Ministry recommended the fixed interest rate over the floating rate for predictability of debt servicing costs.[13] The Ministry of Finance at the time stated, "it is prudent to consider the proposed revision since finding alternative financing for such a large project is not an option", showing that the need to push on ahead with the project was the major reason to acquiesce to ChEXIM's amended loan agreement.[14]

The first phase of the Hambantota port was declared open on November 18, 2010, after Rajapaksa secured a landslide victory to become the President for a second consecutive term. In his policy manifesto, the Mahinda Chinthana, updated for the 2010 election, developing the Hambantota port was reaffirmed as one of the major infrastructure projects to boost growth. It was part of his campaign slogan to make Sri Lanka the 'Wonder of Asia' as a hub economy.[15]

Figure 1: US$ LIBOR 6-month and Phase 1 Loan Interest Rate



Source: Author calculations based on Office of the Cabinet of Ministers in Sri Lanka and https://gee.bccr.fi.cr/indicadoreseconomicos/cuadros/frmvercatcuadro.aspx?idioma=2&codcuadro=%20342 (For LIBOR data).

While the Ramboll feasibility study recommended waiting for Phase 1 to generate revenue through handling bulk cargo before expanding the port, the Rajapaksa government proceeded immediately to launch Phase 2, a container port, with a new loan from ChEXIM. This time, the Chinese bank provided preferential export buyers' credit and government concessional loans with a much lower two percent fixed interest rate.

The manifesto, election propaganda, and government media equated the success of the Hambantota Port to the success of Mahinda Rajapaksa's economic vision for Sri Lanka. Therefore, making the port functional within a short time period was crucial to cementing the image of Mahinda as a successful leader on the economic front, in addition to his success in the civil conflict. Economic success was meant to ensure re-election for a third term as President, as the two-term limit was removed in 2010 by constitutional amendment. The opposition was already hurling criticisms about the port investment around the 2010 election, including allegations that the presence of a large rock under the port entrance prevented the port from accommodating large ships.[16] Thus, it is possible that the decision to rapidly move from Phase 1 to Phase 2, ignoring feasibility study recommendations, was a political decision meant to accelerate expanded operations at the port and show it could accommodate larger ships before the next presidential election.

The Rajapaksa government expected the SLPA to subsidize Hambantota port's startup costs from profits made by the Colombo Port.[17] In 2014, realizing that the SLPA did not have the expertise, nor the financial resources to effectively develop the port, the Sri Lankan government decided to concession the port to private investors.

The Hambantota Port ChEXIM Loans

We identified six loans, of different types, committed in relation to the Hambantota Port project by ChEXIM from 2007 to 2013, amounting to a total approximate US$ 1.326 billion value.

Table 1: ChEXIM Loans Committed and Signed Relating to Hambantota Port

Loan	Agreement Date	Currency	Loan Value (US$ millions)	Grace Period (Years)	Payback Period (Years)	Annual Interest Rate	Principle Repayment Starting Year
Hambantota port development project - Phase 1 - *Buyers Credit Loan*	Oct. 30 2007	US$	307	4	17	6.3%	2014
Bunkering Facility and Tank Farm project at Hambantota - *Buyer's Credit Loan*	Aug. 6 2009	US$	65	3	15	6.5%	2014
Hambantota Port Development Project Phase II - *Government Concessional Loan*	Sept. 17 2012	CNY	156	7	20	2%	2022
Hambantota Port Development Project - Phase II - *Preferential Buyers Credit Loan*	Sept. 17 2012	US$	600	6	19	2%	2020
Hambantota Port Development Project - Phase II - *Preferential Buyers Credit Loan*	Sept. 17 2012	US$	51	4	15	USD LIBOR 6 months + 4%	Canceled in 2019. Not disbursed.
Hambantota Port Development Phase I for Ancillary Work and Supply of Equipment Project - *Government Concessional Loan*	Apr. 24 2013	CNY	147	5	20	2%	2018
Total Committed Loan Value				**US$ 1.326 billion**			

Note: Grace period for principal repayments begins from the point at which the loan is considered effective from and interest payments begin, it does not mean the date of signing the agreement nor the start of project construction. Given cancellation of one loan, only about US$ 1.275 billion was disbursed - US$ 972 million and the rest in Renminbi. The US$ 65 million "Bunkering Facility and Tank Farm project at Hambantota - Buyer's Credit Loan" was considered separate from the Hambantota Port project loans and was not moved under the SLPA as the other four loans were. It was always listed under central government debt and serviced by the government. But the bunkering facility is part of the port and was included in the port valuation during the lease agreement negotiations so is considered alongside the other loans here.[19]
Sources: Author compiled using data from ERD and Parliament of Sri Lanka

Loan agreement nuances

Going through the five Hambantota port loan agreements we obtained from the Ministry of Finance, we noticed a few nuances that are important to note, some of which are summarized in Table 2.[20]

1. All five loans were signed by the Government of Sri Lanka (GoSL) as the borrower (as represented by the Ministry of Finance and Planning, with the SLPA as the end-user). This clearly explains why the External Resources Department (ERD) continues to track all five loans, even though the four Phase 1 and Phase 2 port loans were recorded under SLPA from 2013 to 2017 and are classified as foreign loans of SLPA without public guarantee by the Central Bank of Sri Lanka (CBSL) (See Appendix A).

2. All five loan agreements refer to contracts signed between SLPA and a Chinese supplier or contractors responsible for constructing the port, signed months ahead of the loan agreement signed between the GoSL and ChEXIM. This shows that in the case of the Hambantota Port Phase 1, Phase 2, and the Bunkering Facility projects, Chinese contractors were selected before the funding, possibly due to the use of unsolicited bids to select the contractors without competitive bidding.[21]

3. The 2007 Phase 1 loan and the 2009 Bunkering Facility loan covered only 85 percent of total project costs specified in project contracts with Chinese contractors. The remaining 15 percent was to be financed by Sri Lanka. The two Phase 2 loans only covered about 93 percent total project cost, with a third US$ 51 million loan agreement signed to cover the remaining seven percent, but was not disbursed and canceled in 2019.

4. All loans involved management fees and commitment fees and in the case of the two buyer's credit loans exposure fees. Management fees were paid within 30-days of signing the loan agreements and the commitment fees were to be paid semi-annually on any undisbursed loan amounts. These fees and charges meant that the net amount available for project costs were less than the principal amount of the loan. But it also means that the government would have incurred costs related to management fees and commitment fees for the loan agreements signed but not disbursed, as in the case of the third Phase 2 loan for US$ 51 million.

5. The two government concessional loan agreements denominated in Renminbi specify that the two percent interest rate is subsidized by the Chinese government, making them concessional. They also have a clause that allows the Renminbi amounts to be drawn down in and repaid in US$ if needed, but ChEXIM is not liable for any exchange rate related losses.

6. Both buyer's credit loans specify that in case of arrears on interest payments, the borrower is expected to pay interest on those arrears at an annualized rate equivalent to the interest rate on the respective loan. In case of arrears on interest and principal, then the borrower is expected to pay interest on those arrears at an annualized rate equivalent to the interest rate on the respective loan plus one percent. These points are important within the restructuring process as the arrears and interest on arrears accumulate as new liabilities until a restructuring deal. Whether ChEXIM will capitalize the arrears on to the outstanding principal in the restructured loans or whether the arrears will be waived off will likely be part of the negotiations.

7. All five loan agreements have a clause whereby the borrower warrants that the relevant obligations and liabilities

    > "are independent and separate from those stated in agreements with other creditors (whether official creditors, Paris Club creditors or other creditors), and the Borrower shall not seek from the Lender any kind of comparable terms and conditions which are stated or might be state in agreements with other creditors". *Extracted from Hambantota Port Project Phase 1 Loan - Buyer's Credit Loan Agreement, October 2007.*

    This is a clause that appears in most Chinese loan agreements in general, even outside Sri Lanka, which while being unenforceable in a court of any major financial jurisdiction might create complications in bringing China to the same table as other bilateral lenders. [22]

8. All five loan agreements have clauses which submit the loans to Chinese governing law and arbitration before the China International Economic and Trade Arbitration Commission.

The first attempt at divesting the Port

On September 12, 2014, in a letter to the EXIM Bank of China, Treasury Secretary Dr. P.B. Jayasundara requested to restructure the loans obtained to construct Hambantota Port in order to facilitate a proposed Supply, Operate, and Transfer (SOT) agreement between SLPA and Joint Venture company involving CM Port and CHEC to further expand the port and operate the terminals. The Sri Lankan Treasury noted the high debt servicing cost of these loans and identified those costs as a burden for a smooth functioning of the proposed SOT, emphasizing the need to have longer repayment terms. The Treasury's request proposed an increase in the payback period up to 30 years, increase in grace period up to 10 years, and a reduction of the buyer's credit loan interest (from 6.3 percent to 2 percent) for the Phase 1 loan.

The agreement of the proposed SOT's key terms was signed on September 16th, in the presence of President Mahinda Rajapaksa and Chinese President Xi Jinping during his visit to Sri Lanka.[23] CM Port announced that they, together with CHEC (collectively, the "China Joint Venture"), had entered into an agreement on key terms with SLPA to develop and operate a container terminal at the port.[24] The agreement proposed to set up a project company in Sri Lanka to implement the SOT project.[25] According to the agreement, China Joint Venture would agree to invest US$ 391 million in the company, in exchange for 65 percent of the company's shares. SLPA agreed to invest US$ 216.75 million (mostly for civil work estimated at US$ 167 million) and hold 35 percent of the company's shares. The total investment under the SOT project would be US$ 600 million. The project company would have the right to operate the container terminal built under Phase 2 of the Hambantota Port Development Project, which needed a further US$ 600 million investment to ensure full scale operations.[26]

The preliminary agreement noted that under the proposed SOT, the concession period would be 35 years with an option to extend by a further five years during which the project company would be operating the container terminal. The proposed SOT agreement itself, including the details of

Table 2: Five Disbursed Hambantota Port Loans - Additional Details

Loan	Loan Value (US$ mil)	Interest Rate	Bor-rower	End-User/ Foreign Importer	Chinese Supplier	Supplier Contract Sign Date	Full Contract Value (US$ mil)	Contract Share Covered by Loan	Mgmt. Fee	Comitt-ment Fee	Exposusure Fee
Hambantota port develop-ment project - Phase 1 - *Buyers Credit Loan*	306.7	USD 6-month LIBOR + 0.9%	GoSL	SLPA	CHEC-SCL JV	Mar. 12 2007	360.8	85%	0.30%	0.30%	6% in two equal annual install-ments, two years from signing
Bunkering Facility and Tank Farm project at Hambantota - *Buyer's Credit Loan*	65.1	6.5%	GoSL	SLPA	HQCEC	Jun. 13 2008	76.6	85%	0.30%	0.30%	6% within 30 days of signing.
Hambantota Port Develop-ment Project Phase II - *Government Concessional Loan*	156	2%	GoSL	SLPA	CHEC	Dec. 31 2010	808.1	19%	0.5%	0.50%	-
Hambantota Port Develop-ment Project - Phase II - *Preferential Buyers Credit Loan*	600	2%	GoSL	SLPA	CHEC	Dec. 31 2010	808.1	74%	0.5%	0.50%	-
Hambantota Port Develop-ment Phase I for Ancillary Work and Sup-ply of Equip-ment Project - *Government Concessional Loan*	147	2%	GoSL	SLPA	CHEC - SCL JV	May 17 2012	147	100%	0.25%	0.25%	-

CHEC = China Harbour Engineering Company; SCL = Sinohydro Corporation Ltd.; JV = Joint Venture; HQCEC = HuanQiu Construction & Engineering Company; GoSL = Government of Sri Lanka; SLPA = Sri Lanka Port Authority

Note: Management Fee was as a share of total loan value payable within 30-days of signing the agreement. Commitment Fee was payable on unutilized portion of loan semi-annually. Exposure Fee was as a share of total loan value. The Phase 1 Buyer's Credit Loan was restructured in October 2008, with the interest rate changed to a fixed 6.3% and the Exposure fee being replaced with an Insurance Fee to Sinosure for $31.8 million.

Source: Loan agreements obtained from External Resource Department, Ministry of Finance.

Table 3: Proposed Terms for Hambantota Port Loan Restructuring in 2014

<table>
<tr><th rowspan="2">Loan Type</th><th rowspan="2">Amount</th><th colspan="2">Current Terms</th><th colspan="2">Proposed terms</th></tr>
<tr><th>Interest</th><th>Repayment</th><th>Interest</th><th>Repayment</th></tr>
<tr><td>Hambantota port development project - Phase 1 - Buyers Credit Loan</td><td>US$ 307 million</td><td>6.30%</td><td>15 years including 4 year grace</td><td rowspan="2">2%</td><td rowspan="2">30 year repayment including 10 year grace</td></tr>
<tr><td>Hambantota Port Development Phase 1 for Ancillary Work and Supply of Equipment Project - Government Concessional Loan</td><td>US$ 147 million</td><td>2%</td><td>20 years including 5 year grace</td></tr>
<tr><td>Hambantota Port Development Project Phase II - Preferential Buyers Credit Loan</td><td>US$ 600 million</td><td>2%</td><td>20 years including 7 year grace</td><td rowspan="2">2%</td><td rowspan="3">30 year repayment including 10 year grace</td></tr>
<tr><td>Hambantota Port Development Project - Phase II - Government Concessional Loan</td><td>US$ 156 million</td><td>2%</td><td>20 years including 7 year grace</td></tr>
<tr><td>Hambantota Port Development Project - Phase II - Buyer's Credit Loan</td><td>US$ 51 million</td><td>LIBOR + 4%</td><td>15 years including 4 year grace</td><td>LIBOR + 4%</td></tr>
</table>

Sources: Committee on Public Enterprises (COPE) of the Parliament of Sri Lanka.

investment ratios of two Chinese companies, remained to be finalized. Just two months after signing the agreement, on November 20, 2014, President Mahinda Rajapaksa called for a presidential election.[27] During this election campaign, the opposition jumped onto the anti-China narrative bandwagon that had been building up with China's increased presence in Sri Lanka. The proposed SOT too was subject to criticism by the media as well as by opposition politicians who raised geopolitical concerns regarding China's increasing presence in Sri Lanka.[28]

In January 2015, Mahinda Rajapaksa lost the presidential election and along with the appointment of new President Maithripala Sirisena, came a newly appointed cabinet of ministers. The new government did not immediately proceed with the proposed SOT.[29] Ultimately, government reports and data indicate that the ChEXIM Bank loans obtained to construct Hambantota port were not restructured and the proposed SOT and the key terms agreement were disregarded. Later, when the Ranil Wickremasinghe-Maithripala Sirisena government signed a lease agreement with CM Port in December 2016 to operate the Hambantota port as a joint venture with SLPA, former President Mahinda Rajapaksa claimed that the government completely disregarded the SOT signed in 2014, and made an unwise decision to lease the entire port instead of granting the right to only operate the container terminal.[30]

The rationale behind entering into a SOT and debt restructuring was to reduce the port's losses and further develop the port without obtaining further public sector loans. From the beginning of operations, the port was incurring losses due to low revenue which was insufficient to cover the repayments due. It is clear from Table 4 that interest cost and forex fluctuations on the loan values were driving the expenditures higher and accounted for 83 percent (on average) of the port's losses from 2013-2016. Through the proposed restructuring of Hambantota port loans, the expectation was to reduce interest costs (with a reduction in interest rates) and reduction of annual principal payment, thereby reducing the Hambantota Port losses.

Table 4: Profit/Loss Statement for Hambantota Port Prior to Lease (in LKR millions)

Year	2013	2014	2015	2016
Total Revenue	585	1,237	2,145	2,042
Total Expenditure	11,602	6,271	20,928	12,903
Personal Emoluments	67	66	78	67
Overtime	14	15	17	15
Fuel, Electricity and Others	1,553	519	844	833
Depreciation	1,646	2,094	3,451	2,754
Asset Maintenance	9	8	3	3
Loan Interest	2,525	2,418	2,701	2,768
Foreign Exchange Fluctuation	7,136	1,151	13,834	6,462
Other Comprehensive Income	-	-	-	1
Previous Year Adjustment	(1,348)	-	-	-
Profit/(Loss)	**(11,017)**	**(5,034)**	**(18,783)**	**(10,861)**

Note: Operations of the Port were handed over to the Joint Venture company on 09 December 2017 following the lease agreement, so SLPA did not incur any expenditure nor receive revenue after that point. Foreign exchange fluctuation refers to change in rupee value of foreign currency loans due to depreciation of the rupee. Previous year adjustment refers to adjustments made to loan interest and foreign exchange loss figures relating to the loans obtained for the construction of the Port.
Source: Data obtained from Sri Lanka Port Authority (SLPA) through RTI requests

The proposed loan restructuring was merely addressing SLPA's losses. However, during this time Sri Lanka was grappling with a far bigger issue - BOP vulnerabilities. As foreign debt servicing costs increased and exports stagnated, Sri Lanka's external financing gap increased. Sri Lanka's external debt ratio peaked in 2015 at 28.2 percent and the country was compelled to increase foreign currency inflows through debt and non-debt creating inflows. One strategy to increase foreign currency inflows was to enroll in the IMF's Extended Fund Facility program. Given the massive external financing gap, Sri Lanka needed to seek non-debt creating inflows. Leasing Hambantota Port was identified as a potential non-debt creating foreign currency inflow which would help offset rising foreign debt repayments.[31]

At this point it was crucial to have a high level of foreign currency reserves for Sri Lanka to repay two Eurobonds worth US$ 1.5 billion in 2019.[32] The government decided to lease Hambantota Port and abandon the proposed SOT, considering the potential of the lease to address larger macroeconomic concerns. The framework agreement to lease the port and operate it as a joint venture between the GoSL and CM Port was signed December 18, 2016.[33]

"We obtained US$ one billion through leasing Hambantota Port. That money was injected to country's foreign reserves. Interest rates for the loans obtained to construct Hambantota Port were lower than commercial rates. Had we used US$ one billion to pay off Hambantota port loans, we would have had to borrow one billion on commercial rates. Because of this lease, we managed to secure funds to manage the economy."[34]

-Current President Ranil Wickremesinghe, addressing Parliament December 2, 2021 (as a member of Parliament).

The 2017 Hambantota Port lease

The Ranil Wickremasinghe-Maithripala Sirisena government that came into power in 2015 was critical of the Rajapaksa government's 'white elephant' infrastructure projects which they portrayed as loss-making and corruption plagued. They commenced their tenure by suspending construction of the Colombo Port City project.[35] But by 2016 the tables had turned. The BOP crisis and foreign reserve depletion forced the government into an IMF program by June 2016 and the Port City project agreement was renegotiated so construction could resume.

As the external debt servicing ratio increased, the government was compelled to attract more FDI to bridge the foreign currency deficit. While bridging the foreign currency deficit, it was also essential to meet IMF reform benchmarks, including addressing loss-making SOEs and reducing budget deficits.[36]

It is in this context that the government sought foreign investors for the Hambantota port to form a joint venture with the SLPA. Two China based entities with a presence in Sri Lanka came forward; CM Port, which already ran the Colombo South Terminal, and CHEC which constructed the Hambantota Port and was investing in Colombo Port City. CM Port, the one with clear experience running ports, was eventually selected to lead the joint venture, Hambantota International Port Group (HIPG), with a US$ 974 million investment for an 85 percent shareholding. The remaining 15 percent is held by SLPA. The Port is leased to HIPG for a 99-year period, with provisions for the SLPA to increase its shareholding during that period if it wishes to do so. The proceeds of the US$ 974 million joint venture share purchase were received by the government in three tranches: US$ 292 million in December 2017, US$ 97 million in January 2018, and US$ 584 million in June 2018.[37]

There are two myths related to the Hambantota Port lease which need to be addressed; first, that it was an asset seizure by China in response to Sri Lanka's inability to service loans to ChEXIM and second, that it was a debt-for-equity swap.

While Sri Lanka was facing a BOP crisis in 2016, it was continuing to service the Hambantota port loans. The SLPA recorded servicing the loans by utilizing revenue from the Colombo Port. The Hambantota Port loans were not a significant part of Sri Lanka's overall public external debt servicing costs (Table 5), accounting for just 3.2 percent of total foreign debt repayments in 2016. Principal repayments on the Phase 1 port loan started in 2014, while principal repayments for the other three active loans were to begin in 2018, 2019, and 2022.

Table 5: Capacity to Service Debt in Terms of Exports & Gov't Revenue in Continuous Decline

	2000	2006	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Exports of Goods & Services to GDP Ratio	38.5%	29.7%	20.9%	19.8%	20.3%	21.1%	19.9%	19.8%	20.2%	21.4%	21.8%	15.5%	16.9%
Government Revenue to GDP Ratio	17.2%	17.3%	13.6%	12.2%	12.0%	11.6%	13.3%	14.1%	13.8%	13.5%	12.7%	9.1%	8.7%

Source: Author constructed based on CBSL data and latest GDP series for 2015 base year.

But loan repayments for a loss-making port were imposing a significant burden on the SLPA's profitability and hindered its ability to invest further in any of the port infrastructure it owned and managed (Table 6). It was in this context that CM Port was selected to invest in Hambantota. Although the port was operational by 2017, it required a further US$ 600 million investment to add container terminal facilities and subsequent to the lease CM Port is anticipated to invest further US$ 600 million for that.[38] Leasing the port not only increased foreign currency inflows, but also prevented SLPA from incurring further losses.

Table 6: Loan Repayments for Hambantota Port Construction (excl. Bunkering Facility)

Debt Repayment Fiscal Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Hambantota Port Loan Repayments (US$ millions)	7.3	16.5	18.2	21.5	55.2	58.8	58	57.2	60.2	62.6	107.3	105.4
Total External Debt Repayments (US$ millions)	832	1,027	1,666	1,236	1,411	2,041	1,798	2,352	3,043	4,643	4,291	4,071
Hambantota Port Loan Payments as % of Total External Debt Repayments	0.9%	1.6%	1.1%	1.7%	3.9%	2.9%	3.2%	2.4%	2.0%	1.3%	2.5%	2.6%

Sources: Author compiled using data obtained using information requests from ERD and Parliament of Sri Lanka. Hambantota port loan repayments include interest and principal payments for the four Phase 1 and Phase 2 loans, but does not cover the loan for the Bunkering facility. Total external debt repayments excludes SOE guaranteed debt, Foreign held domestic bonds and CBSL liabilities.

Table 7: Sri Lanka Port Authority (SLPA) Financials - in LKR billions

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Revenue	37.1	35.2	36.7	40.2	43.0	36.9	38.5	40.8	38.9	45.5
Expenditure	31.9	33.6	27.8	54.3	31.9	28.5	30.2	37.0	29.7	32.9
of which Forex loss	-	-	-	*-20.2*	*-10.0*	*-2.2*	*-11.3*	*1.4*	*-1.1*	*-1.3*
Profit	5.2	1.6	8.9	-14.2	1.0	13.3	4.2	11.6	18.7	20.7
Outstanding Debt	146.8	195.8	218.2	233.1	237.3	73.0	79.2	71.0	65.2	60.3

Note: SLPA suffered a loss in 2015 as foreign currency denominated debt, mostly loans for Hambantota port, repayments kicked off from 2014 onwards, forcing it to recognize forex losses due to currency depreciation. From 2017 onwards, the four Phase 1 and Phase 2 Hambantota Port loans were removed from the SLPA balance sheet, reducing its outstanding debt by a third.
Source: Ministry of Finance Annual Reports.

The port lease was not a debt-to-equity swap. The US$ 974 million paid by CM Port for its 85 percent stake in the joint venture was deposited into a special account of the Treasury at the CBSL and was thus included in the country's forex reserves. The funds were gradually used for the government's overall foreign exchange payment needs, including debt repayments in 2018 and 2019 by being drawn down as revenue; Rs. 43.8 billion (about US$ 270 million) in 2018 and Rs.120.6 billion (about US$ 700 million) in 2019.[39] It allowed the government to record a 0.6 percent of GDP primary balance surplus in 2018 for just the fifth time since independence in 1948.

"Leasing Hambantota Port greatly assisted to improve Sri Lanka's economic situation. If not for that lease, Sri Lanka's debt burden would have increased by another $1 billion. Port lease also helped Sri Lanka to record a primary surplus and strengthen foreign currency reserve position."[40]

Current President Ranil Wickramasinghe in a local media interview on July 20, 2020.

The port deal helped Sri Lanka reduce the budget deficit due to the significant increase of non-tax revenue and addressed BOP issues through forex inflows close to US$ 1 billion which were utilized to strengthen Sri Lanka's foreign currency reserve position. The lease of the port also resulted in reduction of losses incurred by the SLPA. As port operations were handed over to CM Port, operational and investment costs borne by the SLPA were reduced. Loan repayment burden was taken away from the SLPA as the proceeds of the lease were utilized by the Treasury. These two changes reduced SLPA's expenses helping it make steady profits (Table 7).

Of the loan agreements signed between ChEXIM and GoSL for the port, none had a clause specifying the port as collateral to the loans provided in case of an inability to service the loans.[41] Event of default clauses in the four Hambantota port loan agreements do not refer to the port as collateral in the event Sri Lanka is unable to make loan repayments. There is no reference to a lien or mortgage on the port, which would be required if the port was subject to seizure in the event of default.[42]

The loan agreements also recognize the borrower stopping or suspending payments to its creditors in general due to an inability to pay external debt as a valid event of default. Therefore, the April 12,

Box 2: Muddled Records and the Hambantota Port Loans

The Hambantota port assets related to the joint venture are still vested under SLPA.[43] But the Treasury (Ministry of Finance) is required to provide the funds to the SLPA for repayments on the Hambantota Port loans, making the Treasury responsible for the debt repayments.[44] While this is a restructuring of the debt repayment *mechanism*, the port lease did not result in changes to loan terms/commitments, loan repayments, or payment rescheduling.[45] Shifting debt repayment obligation from the SLPA to the Treasury cannot be identified as a change of public debt stock, since the foreign debt of the SLPA, which is an SOE, is included within the CBSL's public debt definition and debt servicing is reported by the ERD as the loans feature the Government of Sri Lanka as borrower.

There was much confusion as to how to record the port loans. Proceeds of the port lease were received by the Treasury and not by SLPA, even though the four Phase 1 and Phase 2 port loans were recorded as liabilities of the SLPA. The Auditor General noted that the outstanding balance of four ChEXIM loans for Hambantota port construction were not recorded in the government's outstanding debt stock.[46] While debt repayments were made on time by the Treasury and tracked by the ERD, outstanding loan amounts were not recorded by the SLPA or the Treasury in annual balance sheets.

The SLPA removed the outstanding loan amount from their liabilities, claiming lease payment proceeds were received by the Treasury. On March 1 2019, Treasury acknowledged that debt servicing of these loans was their responsibility and they would bear the debt servicing burden.[47] However, Treasury instructed the SLPA to record the four ChEXIM loans for Hambantota Port Project as SLPA liabilities since they own the port property and they are a joint venture partner with the current port management company. This did not happen. In 2021, these four loans, now amounting to about US$ 805 million were neither recorded as outstanding debt of the Treasury nor the SLPA.[48] However, the CBSL has been reporting these loans under the SLPA in its coverage of Public Debt in the CBSL Annual Reports and ERD tracks the debt servicing in keeping with the cabinet decisions.

There is incoherence amongst public institutions recording the four port loans, but it is clear that loans obtained from ChEXIM to construct the port and leasing the port to CM Port are two different sets of transactions that are not directly linked to one another.

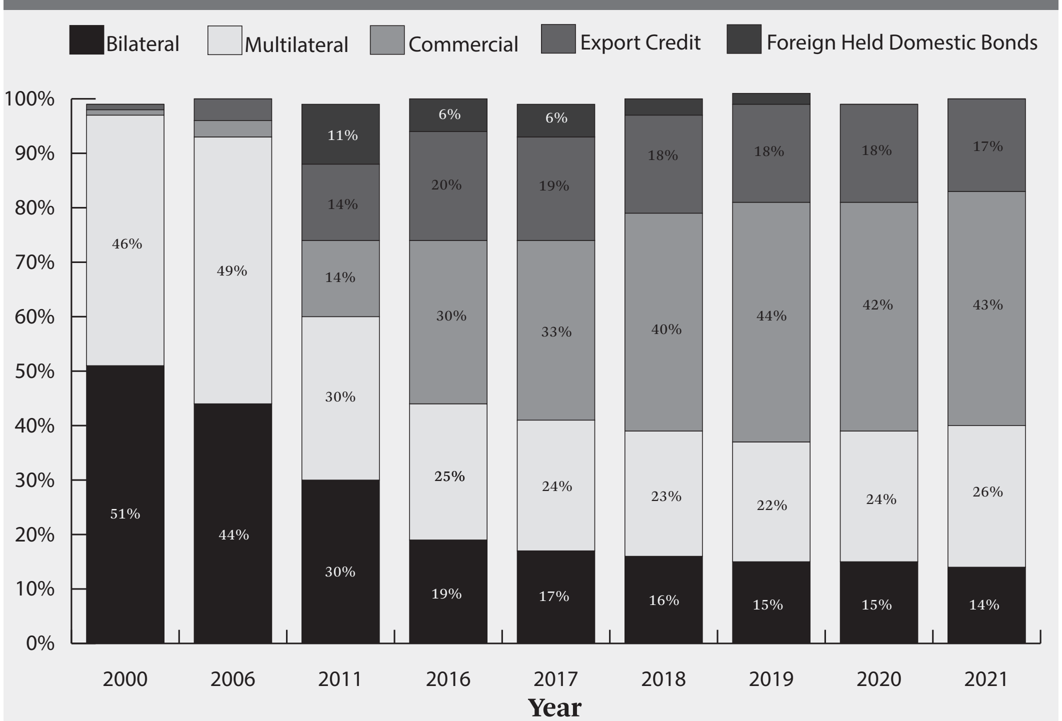
2022 decision by the GoSL to suspend external debt repayments (except for multilaterals) is also valid for the five Hambantota loans.

The lease was neither an asset seizure nor a debt-to-equity swap, but it is still very unusual to award a 99-year lease on a Port. Previously, Sri Lanka has leased two terminals at the Colombo Port to private sector investors on 35-year terms.[49] The lease is also unique by including an 800 ha industrial zone surrounding the Hambantota Port.[50] The 99-year lease and expanded mandate appears to have driven CM Port to take full ownership and responsibility for the growth of the Hambantota Port. Since taking over, CM Port has continued to invest in the port's capacity and attracted a number of foreign investments into the port's industrial zone.[51] The lease of Hambantota port therefore is a non-debt creating foreign currency inflow or an FDI that has helped reduce Sri Lanka's fiscal deficit, BOP vulnerabilities, and SPLA's losses.

SECTION 3 - SRI LANKA'S TURN TO COMMERCIAL DEBT AND EXPORT CREDIT

With Chinese lending rising from less than one percent of outstanding public external debt in 2000 to almost 20 percent by 2021, shown in isolation, it appears as if Chinese debt has been the driver of Sri Lanka's rising foreign indebtedness and debt distress. But in reality, it occurred alongside other changes to Sri Lanka's public sector borrowings, especially the increased dependence on commercial borrowings and export credit, which increased from three percent in 2000 to 60 percent in 2021, at the expense of a reduced share of multilateral and bilateral borrowings.

Figure 2: Share of Government External Debt by Type



Note: Only covers government external debt. It excludes publicly guaranteed SOE debt and CBSL liabilities. Bilateral, Multilateral, Export Credit and Commercial categories are based on ERD data classification. Commercial includes ISBs and loans from foreign banks. Foreign held Domestic Bonds includes foreign investment in domestically issued rupee denominated Treasury bills, Treasury bonds and dollar denominated Sri Lanka Development Bonds, as reported by CBSL.
Source: Author calculations based on External Resources Department and CBSL data

Data shows that a major driver of Sri Lanka's increased commercial borrowings was dollar denominated ISBs or Eurobonds borrowed from international capital markets. By end-2021, Sri Lanka had US$ 13 billion in ISBs, about 35 percent of total government foreign debt. In 2021 alone, the government repaid US$ 1 billion in principal and a further US$ 934 million in interest on its dollar denominated Eurobonds.[52] These repayments amounted to approximately 47.5 percent of government external debt servicing in 2021, more than twice the share of Chinese debt. This means, while Chinese debt is not the largest contributor to the rise in Sri Lanka's large external debt servicing obligations, the increase in debt servicing on Chinese debt compared to the mid-2000s is significant. It is important to understand how and why Sri Lanka grew to depend so much on ISBs.

Table 8: Share of Government External Debt Servicing - ISBs vs. China

		2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Total Debt Service	ISBs	8%	14%	42%	18%	19%	40%	23%	20%	22%	50%	47%	47%
	China	4%	6%	6%	12%	20%	19%	25%	20%	16%	12%	15%	20%
Principle Payments	ISBs	-	-	42%	-	-	35%	-	-	-	45%	35%	36%
	China	2%	3%	2%	7%	18%	18%	29%	22%	18%	11%	15%	22%

Note: Only covers public external debt service tracked by ERD, so excludes foreign held domestic bonds, publicly guaranteed SOE debt and CBSL liabilities.
Source: Author calculations based on ERD data

For a majority of the post-independence era (since 1948), Sri Lanka had fiscal and current account deficits. This meant the country was compelled to borrow in foreign currency to bridge the external financing gap. Throughout the 1950's to mid-1970s Sri Lanka relied increasingly on foreign borrowings for consumption needs such as food imports, infrastructure development, and state-owned industrial capacity, which were not always concessionary. Sri Lanka liberalized the economy in 1977 and increased foreign financing substantially, especially to fund large scale infrastructure development projects, which were financed through concessional foreign loans and grants provided by the World Bank, Asian Development Bank (ADB), Japan, the US and a number of other bilateral partners.

These loans were provided at low interest rates with long grace periods and pay-back periods. For example, the Mahaweli River development project financed by the World Bank in three stages in 1970, 1977, and 1981 had interest rates of 0.75 percent, 10-year grace period and 50-year payback period.[53] Similarly, the Baseline Road project and regional telecommunication development project were financed by Japan through loans provided at 2.6 percent interest rate with 10-year grace period and 30-year payback period. Sri Lanka continued to obtain many similar loans in the 1980s and 1990s. Access to such concessionary financing allowed Sri Lanka to finance development activities while ignoring the need to address the twin deficit even amidst an escalating civil conflict raising military expenditures. However, given the concessional nature of this debt, increased debt burden did not pose a sovereign default threat. Sri Lanka used the IMF as a go to avenue to address BOP issues caused by debt burden and twin deficit, with IMF packages in 1988, 1991, 2001, 2003, 2009, and 2016 assisting Sri Lanka to muddle through the BOP crises.

Sri Lanka's access to such concessional lending gradually reduced after the country was upgraded into middle income country status in 1997.[54] The World Bank upgraded Sri Lanka from the International Development Association (IDA) to the Blend category in 2010, and subsequently to the International Bank for Reconstruction and Development (IBRD) category in 2017.[55] While access to concessionary lending was being reduced, the upgrade to middle income status with higher GDP per capita allowed Sri Lanka to gain access to international capital markets. But Sri Lanka still had many unmet infrastructures needs of a middle-income country. Rapid economic growth and infrastructure development have underlined the political promises of successive governments of both major political groupings in Sri Lanka, as was reflected both in the Ranil Wickramasinghe government's 2002 Regaining Sri Lanka manifesto and in Mahinda Rajapakse's 2005 Mahinda Chinthana manifesto.

While in hindsight it is clear Mahinda Rajapakse became a populist leader, his popularity was not so clear when he won the Presidential election in 2005 by a small margin and commanded a weak government in parliament. Even as he prosecuted a military solution to the civil conflict it was important to galvanize public support through improvements in economic sentiment. Implementing long-promised large scale infrastructure projects was a key tool. Doing so amidst a civil conflict and weak fiscal balances, while losing access to concessional financing, was the challenge.

Traditional multilateral and bilateral lenders were also increasing the stringency of standards and conditionalities associated with infrastructure project financing, just when Sri Lanka's political decision makers were ready to flaunt some environmental and social standards to implement long delayed infrastructure projects. Sri Lanka found recourse in two alternatives to finance the infrastructure development projects. One was to borrow from international capital markets through issuing ISBs or Eurobonds, which were not earmarked for specific expenditures. The first ISB issued in 2007 for US$ 500 million for a five-year maturity at 8.75 percent was followed by successive issuances almost every year between 2009 and 2019. Syndicated loans from foreign banks were also used. From 2007 on the government also attracted foreign investments into rupee denominated Treasury bills and bonds - supported by a policy of using scarce forex reserves to maintain the Sri Lanka Rupee stable against the US Dollar - and to dollar denominated Sri Lanka Development Bonds (SLDBs) from 2014 on. The dollars raised through ISBs, SLDBs, and higher rupee borrowings facilitated through foreign investments into local bonds gave the government a free rein on expenditure prioritization.

Second, financing for specific infrastructure projects was obtained through export credit, especially ChEXIM with minimal conditionalities attached compared to multilaterals financing. Therefore, from 2000 to 2016, the government's external debt composition changed significantly with China moving from 0.4 percent to 16 percent of the total and ISBs accounting for 28 percent from zero. The face value of foreign held domestic bonds were as high as US$ 3.6 billion in 2013, accounting for about 15 percent of the government's external debt.

The result was that the share of multilateral and bilateral borrowings reduced significantly. World Bank and ADB, which accounted for 47 percent of government external debt in 2006 and was reduced to 25 percent by 2021. Japan, which was the largest bilateral lender with 32 percent share in 2000, reduced to nine percent by 2021, alongside other bilateral lenders like the US and Germany as China rose to become the largest bilateral lender. Other smaller bilateral lenders also increased their shares, including India, especially through their export credit agencies.

The shift towards increased commercial external debt was challenging to Sri Lanka as ISBs, syndicated loans, and rupee treasuries had higher interest rates. ISBs have large one-off principal repayments unlike loans and foreign investments into rupee treasuries involve volatile forex flows. In fact, the net outflow of foreign investments in rupee bonds after 2014 led to BOP pressure, prompting further ISB issuances. Therefore, this shift to commercial lending rapidly increased Sri Lanka's public external debt repayments and volatile forex flows.

Table 9: Share of Outstanding Government External Debt - by Specific Creditor

Creditor	2000	2006	2011	2016	2017	2018	2019	2020	2021	May 2022
World Bank	24%	22%	13%	10%	10%	9%	9%	9%	10%	10%
ADB	21%	25%	16%	13%	13%	13%	12%	13%	15%	15%
Japan	32%	28%	22%	11%	10%	10%	9%	10%	9%	8%
India	0.2%	1%	2%	3%	3%	3%	2%	2%	2%	4%
China	0.4%	1%	9%	16%	15%	17%	17%	18%	20%	19%
Other Bilaterals	19%	14%	7%	4%	4%	4%	4%	4%	3%	3%
ISBs	-	-	14%	28%	29%	35%	40%	38%	36%	36%
Foreign Held Domestic Bonds	-	-	11%	6%	6%	3%	2%	0.2%	0.1%	0.1%
Others	4%	8%	6%	8%	10%	7%	6%	5%	4%	4%

Note: Only covers government external debt. It excludes publicly guaranteed SOE debt and CBSL liabilities. China includes ChEXIM and CDB loans. India includes EXIM Bank of India and State Bank of India loans. 'Others' category includes multilateral, commercial and export credit debt not covered by the other categories. Foreign held Domestic Bonds includes foreign investment in domestically issued rupee denominated Treasury bills, Treasury bonds and dollar denominated Sri Lanka Development Bonds.
Source: Author calculations based on External Resources Department and CBSL data

This period also coincided with the continued deterioration in Sri Lanka's tax to GDP and exports to GDP ratios, leading to persistent fiscal and current account deficits. FDI inflows also remained meager. Therefore, the ability to continuously access the international capital market became vital if Sri Lanka was to keep refinancing its rising external debt and finance its twin deficits. Which was tricky to ensure when debt servicing capacity in terms of taxes and exports was deteriorating, and credit ratings were weak.

The average of the foreign debt servicing to merchandise exports ratio rose to 25.2 percent during 2011-2020 from 13.4 percent during 2001-2010. The consistent increase in foreign debt servicing put pressure on the BOP. This increase was largely caused by the ISB repayments which amounted to 31.1 percent of total external debt repayments on average during 2011-2020. During the same period, Chinese debt repayments also increased significantly and soared to 15.2 percent on average from 1.9 percent during 2001-2010. This increase in debt service repayments is in line with the significant increase in debt disbursements from China in this period.

External Debt outstanding at present

Going beyond the central government debt figures typically cited and providing the widest possible coverage of public external debt, we identified US$ 40.654 billion in outstanding public external debt at end-2021 - of which US$ 37.615 billion was debt borrowed by the central government and guaranteed SOE debt (refer to Appendix A for our methodology and further debt breakdown). Our identification has been confirmed by the Ministry of Finance's November 2022 outstanding debt disclosures, part of the ongoing debt restructuring process updated through to the end of June 2022 to account for debt repayments before the external debt service suspension on April 12, 2022 and arrears accumulated since then.

Our expanded identification of public external debt was vital to reveal the true extent of Chinese lending to Sri Lanka's public sector. By the end of 2021, that sum stood at US$ 7.385 billion or 19.6 percent of the total, rising to US$ 8.958 billion or 22 percent if the People's Bank of China's currency swap is also accounted for. By the end of June 2022, these figures had reduced slightly to US$ 7.141 billion (19 percent) and US$ 8.574 billion (21.1 percent), respectively. Overall, we identified six Chinese entities lending to Sri Lanka's public sector, with ChEXIM and CDB as the largest.

SECTION 4 - EVOLUTION OF CHINESE LENDING TO SRI LANKA

The China-Sri Lanka economic relationship goes back 70-years to the Rice-Rubber Pact signed between the two countries in 1952 as one of the first trade agreement between China and a non-Communist country after the 1949 Chinese revolution. Since 1952, China has provided bilateral support to Sri Lanka, including bilateral loans, especially in periods in which Sri Lanka's government was left leaning.[56] China's role as a creditor to Sri Lanka's public sector waned after the mid-1970s and was revived only from the mid-2000s. As Figure 5 shows, of total public and publicly guaranteed (PPG) external debt, China accounted for 10.1 percent in 1974 and only in 2011 does its share recover to 10 percent, from only 0.3 percent at end-1999. By 2021 the share had increased to nearly 20 percent.[57]

Bilateral official-aid loans provided by China appear to be interest free loans, similar to countries in Africa, with data showing only amortization/principal payments on Chinese lending prior to

2002. The first ChEXIM disbursement occurred in 2001, with relevant interest payments beginning in 2002; the government obtained a US$ 72 million ChEXIM loan for Ceylon Petroleum Corporation, a SOE, to finance the Muthurajawela Oil Tank Farm project. This loan was interest payable, carrying a 20-year maturity and a five-year grace period.[58]

Table 10: Chinese Lending to Sri Lanka's Public Sector (US$ millions)

	2019	2020	2021	June 2022
Central Government Borrowed Debt	**6,318**	**6,766**	**7,114**	**6,845**
China Development Bank	1,754	2,181	2,803	2,755
ChEXIM Bank	4,550	4,570	4,296	4,076
Government of China	14	15	16	15
Guaranteed SOE Debt	**140**	**144**	**271**	**296**
China Development Bank	62	62	200	226
ChEXIM Bank	41	32	23	19
China National Chemical Engineering No. 14 Const.	14	19	22	24
Industrial and Commercial Bank of China Limited	23	31	27	27
Total of Above	**6,458**	**6,910**	**7,385**	**7,141**
China Development Bank	1,817	2,243	3,003	2,981
ChEXIM Bank	4,591	4,602	4,319	4,094
Government of China	14	15	16	15
China National Chemical Engineering No. 14 Const.	14	19	22	24
Industrial and Commercial Bank of China Limited	23	31	27	27
Central Bank of Sri Lanka	-	-	**1,573**	**1,433**
People's Bank of China RMB Currency Swap	-	-	1,573	1,433
Total Outstanding with Swap	**6,458**	**6,910**	**8,958**	**8,574**

Source: Ministry of Finance, External Resources Department.

The five phases of evolution since 2000

The evolution of Chinese lending to Sri Lanka's public sector since 2000 can be classified into five major identifiable phases.

The first phase involved the introduction of ChEXIM lending in addition to the official aid loans and grants provided by the Government of China. This began with the loan for the Ceylon Petroleum Corporation's oil tank farm project in 2001 and expanded in 2005 with the signing of the Puttalam Coal Power Plant loan. Chinese SOEs, like CHEC and China Metallurgical Corporation, also entered infrastructure development in Sri Lanka in the aftermath of the 2004 tsunami as part of China's official aid projects.[59]

The second phase of rapid increase in disbursements occurred in the 2007 to 2010 period, with China switching from being a small bilateral lender to a large-scale lender.[60] The Sri Lankan government embarked on a number of high-profile infrastructure projects with borrowings from the EXIM Bank of China; namely the Norochcholai Puttalam Coal Power Plant, Hambantota Port, Mattala International Airport, and the expressway network. High interest rates persist in some of

Box 3a: Public External Debt Repayments

The external debt repayments data available to us is more limited than the entire stock of public external debt we have tracked. Through the ERD data we can track most public external debt repayments covering about US$ 35.9 billion in debt outstanding at end-2021, except for foreign held domestic bonds, guaranteed SOE debt, and CBSL liabilities.

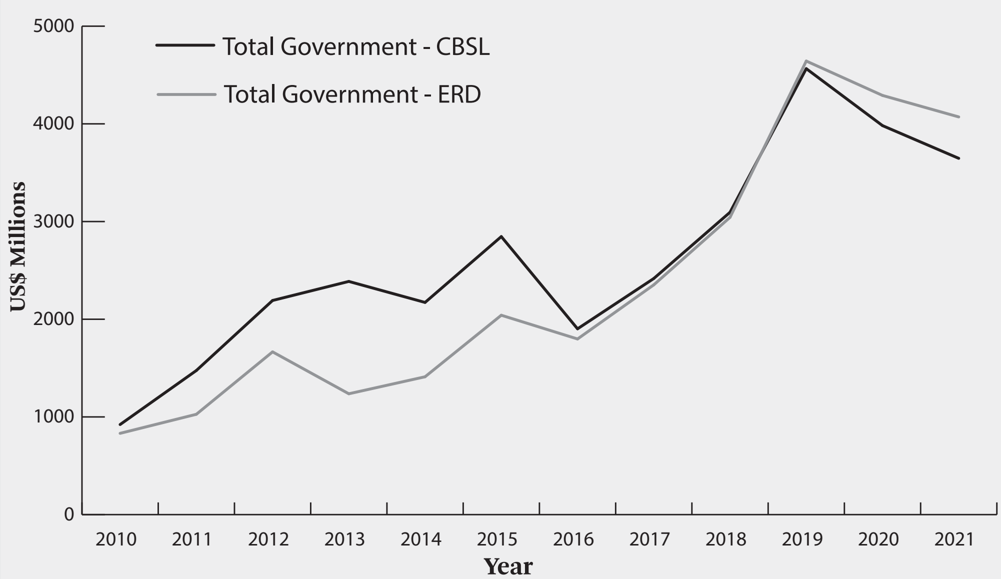
Table 11: Share of Government External Debt Repayments by Major Lender & ISBs - ERD Coverage

Lender	2000	2006	2011	2016	2017	2018	2019	2020	2021
World Bank	9%	10%	9%	6%	6%	5%	4%	5%	6%
ADB	9%	13%	16%	12%	9%	9%	7%	7%	8%
Japan	41%	39%	32%	14%	10%	8%	5%	6%	6%
India	1%	0%	1%	4%	4%	4%	3%	3%	3%
China	1%	2%	6%	25%	20%	16%	12%	15%	20%
Other Bilaterals	22%	21%	12%	6%	5%	4%	3%	3%	3%
ISBs	0%	0%	14%	23%	20%	22%	50%	47%	47%
Others	17%	15%	9%	10%	26%	32%	17%	15%	8%

Note: Excludes foreign held domestic bonds, guaranteed SOE debt and CBSL liabilities
Source: Author calculations based on ERD data

While these excluded public debt categories have been small in recent years, foreign held domestic bonds category in particular was a substantial portion of domestic debt as a share of government external debt until 2017. Therefore, shares until 2017 are overestimated when using ERD data compared to actual repayments which were higher. As a result, there is a big difference between the government external debt repayment numbers of ERD and the CBSL, which includes repayments on foreign held domestic bonds but excludes all debt under SOEs. It is with that caveat that the debt repayment shares in Table 11 should be interpreted.

Figure 3: Divergence in Government External Debt Repayments Covered by ERD and CBSL



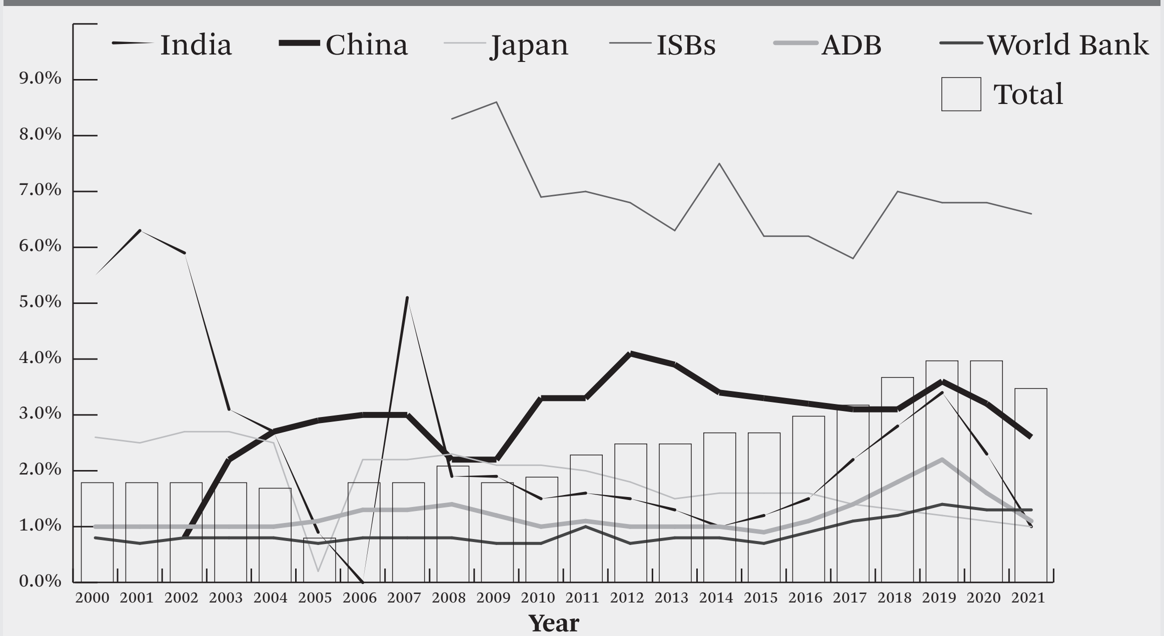
Sources: ERD and CBSL Annual Reports.

Box 3b: Public External Debt Repayments

Since 2019 the CBSL number has been lower than the ERD number due to two reasons. One, the rising debt repayments on SOE loans recorded under SOEs but serviced by the government which are included in ERD data but not in CBSL data. Two, the decision of CBSL to separately report ISBs held by resident Sri Lankan investors since 2019 and exclude those ISB portions from external debt, while ERD continues to treat all ISBs as external debt. For CBSL this is logical because its definition of external debt depends on residency of the debt security holder. For ERD this is logical because the government has to transfer the dollar repayments on ISBs to the Trustee based abroad, who will in turn remit the repayments to individual ISB debt holders.

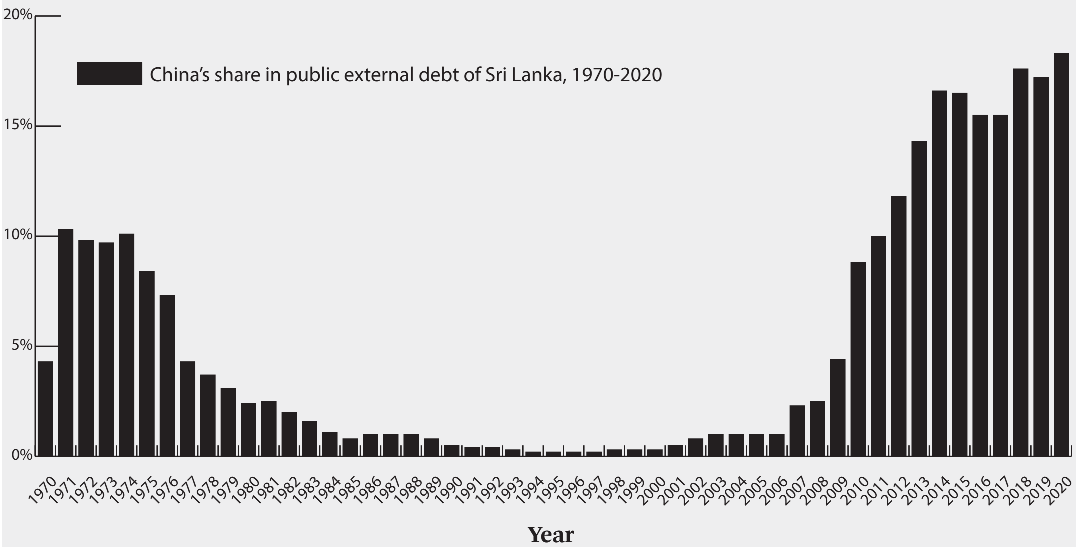
When looking at debt repayments, it is also important to consider the cost of the borrowing from various lenders. For this we looked at the effective interest rate which measures the interest paid in a year on the debt outstanding at the end of the previous year. Use of this measure allows to avoid volatility caused by large net repayments or net disbursements happening in one year, distorting the interest cost on the debt stock from a particular lender or instrument. Based on ERD data, we can see that ISBs have had an effective interest cost of six to seven percent since 2009, which is by far the highest of the major lenders. In the case of China, considering both ChEXIM and CDB, the effective rate rose to four percent by 2012, but has again trended downwards to below three percent by 2021. Japan, ADB, and World Bank, the largest traditional lenders, have had effective rates well below two percent over the period since 2000. So, it is clear that China and ISBs have contributed to the uptick in the effective interest rate, to around four percent by 2020, on the government external debt tracked by ERD. But ISBs by far have been the largest contributor, being the most expensive and largest lender group in Sri Lanka's external debt stock.

Figure 4: Effective Interest Rates of Major Lenders and ISBs



Note: Effective Interest Rate = Interest paid in a year divided by the Outstanding debt at the end of the previous year. Above does not cover foreign held domestic bonds, publicly guaranteed SOE debt, and CBSL liabilities.
Source: Author calculations based on ERD data

Figure 5: China's Share in Sri Lanka's Government External Debt (1970-2020)



Note: Includes Public and Public Guaranteed Debt (PPG debt)
Source: International Debt Statistics, World Bank.

these loans (refer to Table 12) given Sri Lanka was still engaged in a civil conflict until 2009 and the global economy was embroiled in the Global Financial Crisis.

In this second period Sri Lanka also saw a rise in unsolicited bids for projects. This is where a public investment project is considered by the Cabinet of Ministers without a call for competitive bids for supplier/contractor, with changes made to Sri Lanka's public procurement practices to enable such unsolicited bids.[60] Hambantota Port and Mattala International Airport were among such projects as highlighted in Section 2.

Unlike in several African countries where Chinese lending was dominated by the resource-backed lending model, most lending to Sri Lanka during Phase 2 had been project financing in the form of

Table 12: Major Loans from China in Phase 1 and Phase 2

Project Name	Agreement Date	Principal Repayment Starting Year	Loan Amount (US$ millions)	Loan Period (Years)	Interest Rate (%)
Puttalam Coal Power Project - *Preferential Buyer's Credit*	Aug. 30 2005	2012	300	21	2
Puttalam Coal Power Project - *Buyer's Credit Facility*	Sept. 8 2006	2015	153	18	USD LIBOR 6-month + 1
Hambantota Port Development Project - Phase 1	Oct. 30 2007	2013	307	17	6.3
Bunkering Facility & Tank Farm Project at Hambantota	Aug. 6 2009	2014	65	15	6.5
Colombo Katunayake Expressway (CKE)	Aug. 6 2009	2013	248	16	6.3
Puttalam Coal Power Project - Phase 2	Dec. 25 2009	2014	891	20	2
Mattala Hambantota International Airport Project	Mar. 5 2010	2016	191	20	2

Source: External Resources Department, Ministry of Finance export or buyers' credit for infrastructure. Since China's export credit agency, like nearly all export credit agencies, is tasked with supporting the country's firms in overseas markets, Chinese SOEs took on the contracts for implementing these projects as well.

A third phase of rapid increase in disbursements occurred in the 2011 to 2014 as the government borrowed further from ChEXIM for expanding on the above projects and some new transport sector projects. There was also some project financing obtained from CDB in this period. Phase 2 saw the inclusion of these ongoing projects under the umbrella of China's One Belt One Road and Maritime Silk Route initiatives. Phase 3 coincided with the end of the grace periods on principal repayments of some of the initial loans obtained in Phase 1 and 2, with principal payments increasing significantly from 2013 onwards (refer to Figure 7).

Table 13: Major Loans from China in Phase 3

Project Name	Agreement Date	Principal Repayment Starting Year	Loan Amount (US$ millions)	Loan Period (Years)	Interest Rate (%)
Northern Road Rehabilitation Project	Sept. 9 2010	2015	302	15	USD LIBOR 6-month + 2.4
Southern Expresswway Extension Project - Phase 1	Feb. 17 2011	2017	74	15	USD LIBOR 6-month + 2.4
Southern Expresswway Extension Project - Phase 2	Feb. 17 2011	2016	55	15	USD LIBOR 6-month + 2.4
Improvement and Rehabilitation of Priority Roads	Mar. 31 2011	2014	500	15	USD LIBOR 6-month + 2.9
Hambantota Port Development Project - Phase 2	Sept. 17 2012	2022	156	22	2
Hambantota Port Development Project - Phase 2	Sept. 17 2012	2018	600	19	2
Southern Railway Line Extension Project - Phase 1	Feb. 19 2013	2020	200	19	2
Hambantota Port Development Phase 1 for Ancillary Work and Supply of Equipment Project	Apr. 24 2013	2018	147	20	2
Southern Railway Line Extension Project - Phase 2	May 28 2013	2021	83	21	2
Improvement and Rehabilitation of Priority Roads Project 3 - Phase 1	Mar. 11 2014	2017	300	15	USD LIBOR 6-month + 2.95
Construction of Outer Circular Highway Project - Phase 3	Sept. 16 2014	2020	494	20	2
Extension of Southern Expressway - Section 4	Sept. 16 2014	2020	408	20	2
Hambantota Road and Infrastructure Development Project	Sept. 16 2014	2020	251	20	2
Extension of Southern Expressway - Phase 3	Dec. 23 2014	2020	684	21	2

Source: External Resources Department, Ministry of Finance

The interest rates on a significant portion of the ChEXIM Bank loans are floating rates based on US$ LIBOR 6-month rate plus a fixed margin, and it appears that even those with fixed rates have their rates based on the persisting LIBOR rate as we saw with the restructured Hambantota Port Phase 1 loan. This link to LIBOR rates contributes to interest costs rising during periods of global financial volatility, such as during the global financial crisis and the 2018/2019 period of emerging market volatility. But it also benefited Sri Lanka during periods of low LIBOR rates, like 2010-2016 (Figure 1).

The fourth phase of Chinese lending emerged in 2017, following a slowdown in disbursements in 2015-2016. In October 2018, CDB provided a US$ 1 billion foreign currency term financing facility (FCTFF) as direct budgetary financing, replacing earlier syndicated loans obtained from foreign banks. This eight-year CDB facility, with a three-year grace period on principal payments, was the first large scale Chinese lending not earmarked for particular project financing in the form of export credit or buyers' credit. Further, CDB FCTFFs were provided in the subsequent years and proved vital in tiding over external financing amidst the COVID-19 pandemic's impact; US$ 500 million in March 2020, US$ 500 million in April 2021, and RMB 2 billion in September 2021. These FCTFF disbursements allowed China to retain a positive net resource transfer to Sri Lanka's public sector even as debt service payments on the project related lending continued to increase. In essence, China focused on refinancing its previous lending to Sri Lanka. Yet, with Sri Lanka moving towards debt restructuring in 2022, the evolution of Chinese lending to Sri Lanka appears to have entered a fifth phase.

Debt flows during the four phases from 2001 to 2021

While ChEXIM has been the largest creditor during the period, CDB increased its presence from 2011 onwards, taking over as the largest Chinese lender in 2018, 2020, and 2021. During this period

Table 14: Major Loans from China in Phase 4

Project Name	Agreement Date	Principal Repayment Starting Year	Loan Amount (US$ millions)	Loan Period (Years)	Interest Rate (%)
Extension of Southern Expressway - Phase 3	Jul. 4 2016	2021	360	20	2
Foreign Currency Term Loan Facility (FCTFF)	Mar. 24 2018	2021	1,000	7	LIBOR + 2.56
Central Expressway Project - Section 01	Mar. 22 2019	2025	989	20	2.5
Foreign Currency Term Loan Facility (FCTFF)	Mar. 19 2020	2023	500	7	LIBOR + 2.51
Foreign Currency Term Loan Facility (FCTFF)	Apr. 12 2021	2024	500	10	LIBOR + 2.51
Foreign Currency Term Loan Facility (FCTFF)	Aug. 17 2021	2024	310	10	LPR* 5-year + 0.20

*LPR 5-year = Five-year loan prime rate is a Chinese domestic benchmark interest rate for renminbi denominated loans.
Source: External Resources Department, Ministry of Finance.

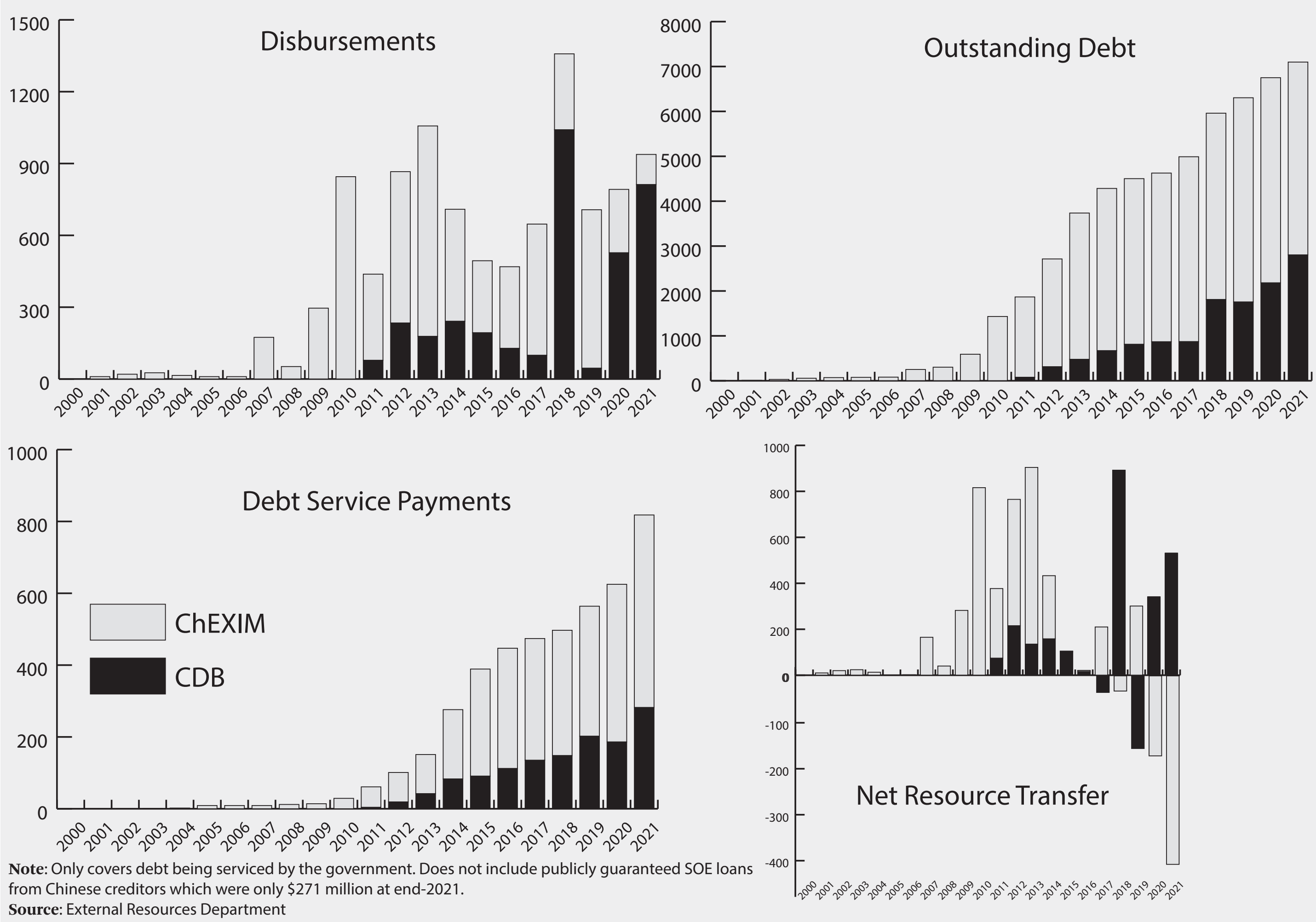
there were three much smaller Chinese creditors as well, the Government of China, ICBC, and China National Chemical with US$ 64 million in combined exposure to Sri Lanka's public sector by end-2021.

The importance of Chinese lending to Sri Lanka's public sector since the mid-2000s is clearer when looking at the net resource transfer metric (Figure 8). Despite rising debt service payments to China, new disbursements from China have been consistently large enough to retain the net resource transfer in positive territory throughout the period.[62] So, repayments to China were not a drain on Sri Lanka's foreign currency reserves in 2020 and 2021, while other creditors overall have seen net repayments out of Sri Lanka since 2020, driven largely by ISB repayments.

China Amidst Sri Lanka's Debt Default

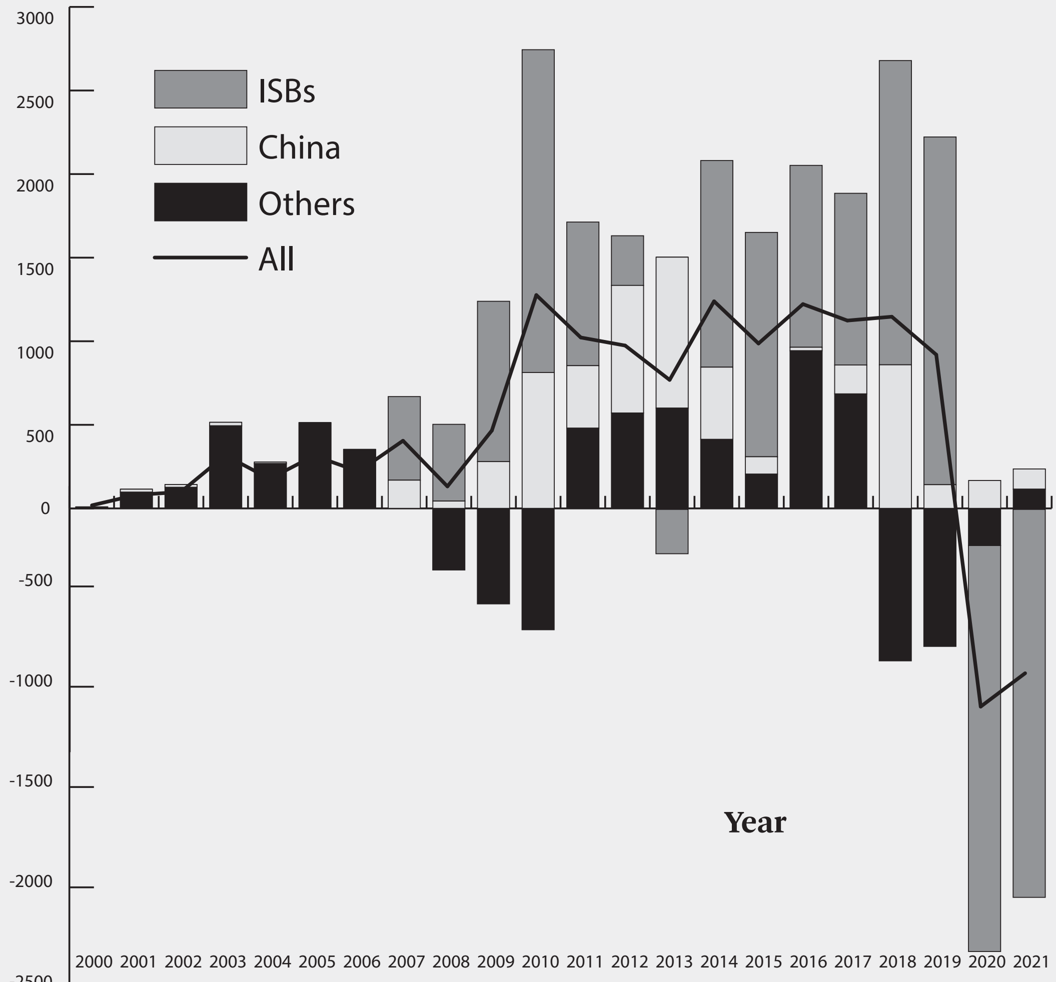
Sri Lanka's space for muddling through ended on April 12, 2022, with the government declaring a unilateral suspension on government repayments of all foreign currency external debt obligations, except for bilateral currency swaps and multilateral debt.[63] With Sri Lanka preparing for a debt restructuring, China will be a major creditor within that process. The government's presentation

Figure 6: Summary of Debt Flows from CDB and ChEXIM, 2001-2021 (in US$ millions)



Note: Only covers debt being serviced by the government. Does not include publicly guaranteed SOE loans from Chinese creditors which were only $271 million at end-2021.
Source: External Resources Department

Figure 7: Net Resource Transfer - Government External Debt: China vs. Others (US$ millions)



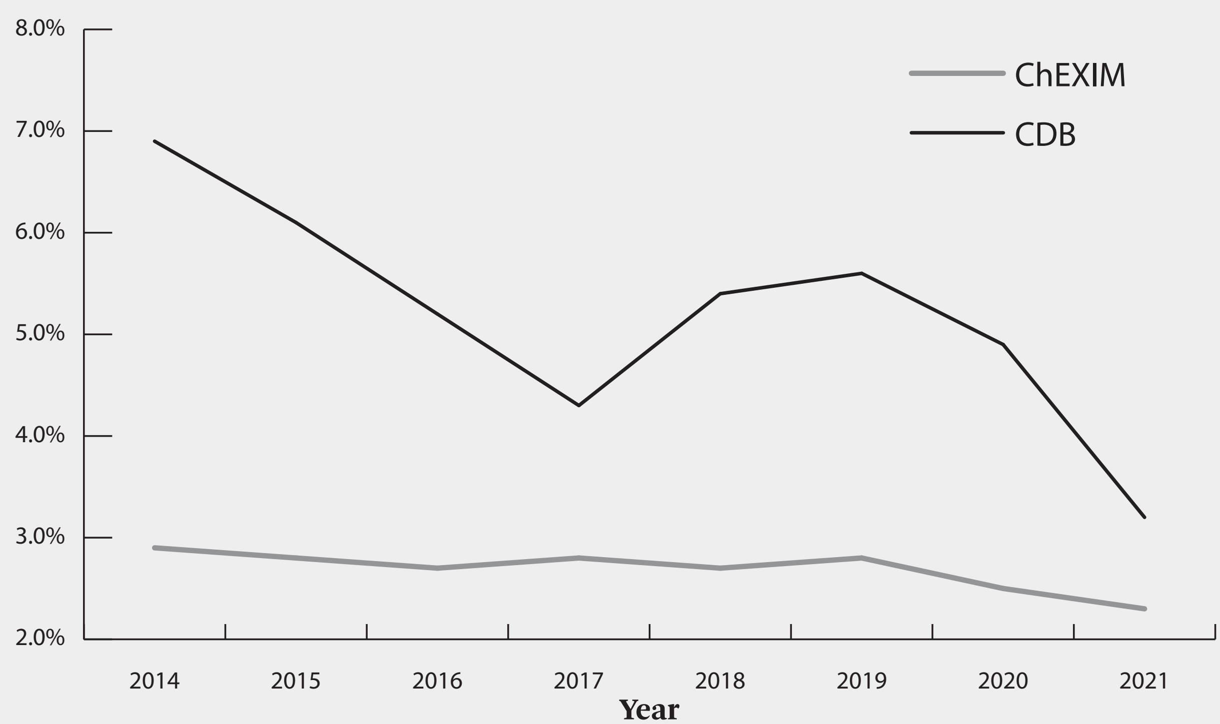
Note: Net Resource Transfer = Debt disbursements minus debt service payments. Only covers government external debt servicing by ERD, so excludes foreign held domestic bonds, publicly guaranteed SOE debt and CBSL liabilities. **Source**: Author calculations based on ERD data.

to creditors in September 2022 showed that 52 percent of bilateral and bilateral related debt (mostly export credit) was owed to China as at end-June 2022.[64]

While ISBs amount to about US$ 12.7 billion outstanding and under suspension, given the highly splintered holding of such bonds individual creditors hold relatively small amounts of ISBs. In contrast, ChEXIM Bank and CDB, with US$ 4.1 billion and US$ 3.0 billion outstanding respectively at end-June 2022, are very large individual creditors. The debt relief China is willing to provide through these two policy banks will be crucial in the success of the overall debt restructuring process. The two are different, with CDB being largely a commercial lender while ChEXIM has concessional lending that is subsidized by the government. This difference is reflected in the effective interest rate Sri Lanka pays on the total debt from each, with ChEXIM having a rate consistently below three percent and CDB being above four percent in the 2014 to 2020 period.[65]

Currently China is involved in debt restructuring processes in Suriname and Zambia, where its willingness to be part of the bilateral creditor committees and agree to accept arrears on debt repayments was critical due to the finalization of IMF programs, though this involved significant delays. In both cases the debt relief China is willing to provide is yet to be clear. But they have finalized a bilateral restructuring with Ecuador in September 2022, two years after Ecuador's main restructuring event in 2020. In 2020, China provided very limited debt relief. The 2022 debt relief involved restructuring about US$ 4.4 billion in loans from the two policy banks with repayments to CDB and ChEXIM reduced by US$ 745 million and US$ 680 million, respectively, over the next three years through maturity extensions and interest rate adjustments.[66] CDB extended maturities to 2027 and beyond and ChEXIM extended to 2032 and beyond. No principal value haircuts seem to have been done on this debt, even though at least some loans had interest rates as high as 7.16 percent and weighted annual average interest rate on Chinese loans taken in 2010-2020 close to six percent.[67]

Figure 8: Effective Interest Rate Paid by Sri Lanka to Each Policy Bank, 2014-2021



Sources: Author calculations based on ERD data.

These indicate that reaching a final agreement on restructuring with China can take time, with interim agreements allowing for IMF lending and other debt restructuring processes to proceed. The IMF's Lending Into Official Arrears policy allows it to proceed towards board approval of a program if all major bilateral creditors agree to having payment arrears, as happened with Suriname and Zambia.[68] This would allow Sri Lanka to receive IMF funds even as it spends 2023 finalizing debt restructuring with the varied creditors, including China. Even then, Ecuador indicates that China is unlikely to provide principal haircuts even on loans that are classified as commercial borrowings.

Regardless of whether principal haircuts happen or not, what will matter in negotiations is whether ISB bondholders, other major bilateral creditors, and Chinese creditors feel that they are all being treated with equity relative to each other. The reduction in the Net Present Value (NPV) of the debt due to various debt relief offered by the different creditors is what would matter in this regard. Longer maturity extensions, especially by ChEXIM on its concessional lending, and interest payment moratoriums can be as effective as principal haircuts in providing NPV reductions. New financing ChEXIM and CDB are willing to provide to Sri Lanka to help meet its fiscal and external financing gaps will also play a role in the negotiations. Sri Lankans should hope the 70-year-old spirit of the Rice-Rubber Pact still holds to some extent.

5. CONCLUSION

The story of Chinese lending to Sri Lanka has been a complicated and controversial one. While the popular narrative of Sri Lanka getting caught in a Chinese debt-trap has been debunked on many occasions, it is constantly repeated like a mantra when Sri Lanka's economic woes are reported or referred to. In the run up to and since the April 2022 default on the government's external debt, the Chinese debt-trap narrative has once again become amplified. Our paper is an attempt to give a detailed account of Chinese lending to Sri Lanka and demystify the evolution of Chinese debt flows to Sri Lanka in the post 2000 era. Our aim was to pay attention to every detail we could find to tell the complete story and separate myths from the reality.

Our findings, based on archival research, information requests and informant interviews confirm that it is incorrect to brand Sri Lanka as a victim of a Chinese debt trap. We paid particular attention to the Hambantota Port project, including the nuances of the ChEXIM loans and the leasing of the Port, given it has been the biggest driver of the Chinese debt trap narrative. With detailed reference to five loan agreements, government documents, Parliamentary proceedings, and debt repayments, we make it clear why claims of the 99-year Port lease being an asset seizure or debt-to-equity swap are myths with no basis in reality. We present clear evidence that the Sri Lankan government was aware of the financial strain from the Hambantota Port loans as early as 2014, presenting proposals to restructure the loans and enter into joint-venture SOT with two Chinese SOEs to further invest in and operate the port. The 2017 lease was the end result of those proposals, albeit under a different government looking for ways to ease the burden of rising debt repayments.

Sri Lanka's debt troubles and sovereign default was largely caused by the country's weak macroeconomic fundamentals and transition since the mid-2000s to being highly dependent on commercial debt and export credits to finance its twin deficits. The large increase in Chinese lending, largely in the form of export credits since the mid-2000s and term loans in recent years, was part of this transition. China's share of public external debt (excluding CBSL liabilities) rose from less than one percent in 2000 to nearly 20 percent by end-2021, becoming Sri Lanka's largest bilateral creditor, replacing Japan, and becoming larger than ADB and World Bank. At end-2021, Chinese lending accounted for US$ 7.4 billion of public external debt, with ChEXIM accounting for US$ 4.3 billion, and CDB for US$ 3.0 billion. The total figure rises to US$ 8.9 billion if the People's Bank of China's currency swap is included. But even more dramatic and impactful on the road to default was Sri Lanka's reliance on ISBs since 2007, which rose to account for US$ 15 billion or 40 percent of government external debt by 2019. ISBs also carried the highest effective interest rate of six to seven percent, while overall Chinese lending has been at an effective rate of three to four percent since 2015.

To confirm China accounted for around 20 percent of the government's external debt in 2021, we had to ensure full coverage of external debt going beyond the most popularly referred to and cited sources, which provide a 10-15 percent figure. This included comparing the data and reporting from multiple public institutions, including the National Audit Office. In doing so, we showed that there was indeed a portion of Chinese lending to Sri Lanka's public sector that is apparently 'hidden' due to the complexities of debt classification and inconsistency of reporting standards across various public institutions and reports, especially with regards to debt recorded under SOEs. But in reality, they are not 'hidden' because at least some public institutions were reporting on these loans in publicly available reports and in data easily obtainable via RTI requests. This debt is currently included within the purview of the official data presented to creditors as part of the debt restructuring process. The debt, including SOE debt, was also fully reflected in the World Bank's International Debt Statistics in 2020.

An interesting episode we discovered was the October 2008 restructuring of the first Hambantota Port Loan at the request of ChEXIM, moving the loan from a floating rate to fixed rate loan before the loan repayments were activated in 2009, citing rising funding costs. While ChEXIM offered a higher floating rate, Sri Lanka opted for a fixed rate for predictability, but we find that predictability came at the cost of paying much higher interest rates. This discovery was facilitated only due to the fact that the Office of the Cabinet of Ministers maintains detailed filings of individual Cabinet decisions, of which this restructuring was one, and is open to RTI requests.

Assessing external debt data, we found that the nature of Chinese lending to Sri Lanka changed from non-interest-bearing bilateral lending, which goes back to the 1950s, to interest-bearing export credit from 2001 onwards. It accelerated, matured, and evolved over the last 20 years through five distinct phases. In Phase 4 China moved from export credit to term loans for BOP support as Sri Lanka's debt repayment burden and access to financing worsened from 2018 onwards, reflecting China understood the need to help Sri Lanka refinance maturing debt. But with the debt restructuring process the Chinese lending relationship enters a fifth phase that will define the relationship's future and set a precedent for China's and others' approach to debt restructuring in other BRI debtor countries. In the meantime, Sri Lanka will hope China is willing to move faster on bilateral creditor negotiations after experiences in Suriname, Zambia, and Ecuador. And that the 70-year spirit of the bilateral relationship will hold some effect. ★

APPENDIX A: DEMYSTIFYING CHINESE DEBT TO SRI LANKA

Part of the popular discourse on Chinese debt to developing countries is that there is 'hidden debt' kept out of official government statistics, which are only revealed during crises.[69] One of the reasons for this 'hidden debt' perception is varied debt classification based on respective governments' accounting practices. In Sri Lanka this is definitely the case and understanding the classification of public sector debt is vital to understanding the 'hidden Chinese debt' perception.

Explaining the methodology to ensure comprehensive coverage of public external debt

Only three types of public sector entities can borrow from external creditors: the central government (Treasury), SOEs, and the CBSL. The IMF's Article IV consultation report for Sri Lanka released in March 2022 used the definition of public debt to include: central government debt, SOE debt guaranteed by the central government, IMF lending classified under CBSL, and foreign currency swaps taken by CBSL.[70] However, not all debt classified under SOEs is guaranteed by the central government, so there is a portion of external debt taken by SOEs that is not covered even by the IMF's coverage of public debt. Fortunately, the CBSL recognizes the need to keep track of all SOE foreign debt, so in its coverage of public debt the central bank includes both guaranteed and non-guaranteed foreign debt classified under SOEs.[71]

Within central government debt, external debt is classified into bilateral, multilateral, export credit and commercial banks by the ERD of the Ministry of Finance which keeps track of all external debt and debt repayments of the government. Chinese debt is found under bilateral debt, export credit, and commercial debt. Official development assistance from Beijing and project financing from China Development Bank (CDB) are classified under bilateral debt, while project financing from ChEXIM falls under export credit and foreign currency term financing facilities (FCTFFs or term loan facilities) from CDB are classified under commercial bank borrowings. In addition to these, Chinese lending is also found under SOE guaranteed debt, government foreign loans recorded under SOEs, and CBSL foreign borrowings.

Therefore, for full coverage of Chinese lending one must follow a very broad coverage of public debt as indicated in Table 15. For this we relied on external debt data obtained from the ERD which covers most of the required debt, alongside the Ministry of Finance Annual Reports which provide coverage of SOE guaranteed debt, CBSL data on external liabilities and verification through reports from the National Audit Office and Parliamentary Committee on Public Enterprises (COPE).

The so-called 'Hidden Debt' from China

Historically, media coverage of Sri Lankan public debt has focused on central government debt. In 2013 and 2014 the government transferred some external debt taken for project financing from the central government to the SOEs which implemented those projects and held the assets created as a result, allowing central government debt to be lower as a share of GDP than would have been the case otherwise. Accordingly, ChEXIM loans obtained to construct Hambantota port, Puttalam Coal Power plant, and Mattala Airport, amounting to US$ 1.553 billion at the end of 2021, were categorized under SOE loans;

- The four Phase 1 and Phase 2 Hambantota Port ChEXIM loans were moved under Sri Lanka Ports Authority (SLPA) via Cabinet decision bearing No.13/0040/504/002 dated January 11, 2013.[72] From 2015 onwards the central government did not make budgetary allocations for the servicing of these loans. This decision was reversed after the port was leased in 2017.

- The Norochcholai Puttalam Coal Power plant ChEXIM loans were moved under Ceylon Electricity Board (CEB) as part of the internal debt-equity-swap implemented in 2015 as part of the budget proposals in November 2014, through which CEB's overall indebtedness was reduced by converting some of its debt to government held equity.[73]
- The Mattala Rajapaksa International Airport ChEXIM loans were transferred under the Airport and Aviation Services Limited (AASL) under Cabinet approval on October 23, 2013.[74]

These loans are tracked by the ERD as the loans were originally obtained by the government, although they were later recorded under respective SOEs the debt remains a central government obligation. Our calculations are based on data, which includes this US$ 1.553 billion in ChEXIM loans, obtained from the ERD using Right to Information (RTI) requests. The ERD has not hidden any loan from the government books, and followed instructions from the cabinet of ministers.

Of this US$ 1.553 billion, the National Audit Office of Sri Lanka (NAOSL) reports in its 2022 assessment of public debt that about US$ 1.444 billion was being serviced by the central government even though the loans are supposed to be under the SOEs according to CBSL, namely the Hambantota Port and Puttalam Coal Power plant loans. But the Mattala Airport loan, with about US$ 109 million outstanding, continues to be serviced by AASL.[75]

Table 15: Total Public External Debt Under Extended Coverage - end 2021 (in US$ millions)

Total Public External Debt	**40,654**	
Total Public External Debt (excl. CBSL)	**37,615**	
Central Government	**34,374**	
Bilateral	4,979	
Multilateral	9,456	
Export Credit	4,623	
Commercial Debt	15,315	
	of which, ISBs	*13,050*
	of which, Term Loans	2,223
Recorded Under SOEs	**1,553**	
Export Credit	1,553	
SOE Debt (with Treasury Guarantee)	**1,689**	
Multilateral	439	
Bilateral & Export Credit	990	
Commercial Debt	260	
Central Bank of Sri Lanka (CBSL)	**3,038**	
IMF Lending	1,265	
Bilateral Currency Swaps	1,774	

Note: This includes all external debt to non-residents creditors and so includes non-resident held but domestically issued Treasury bills, Treasury bonds and Sri Lanka Development Bonds under Central Government commercial debt.
Sources: Central Bank of Sri Lanka, External Resources Department, Ministry of Finance Annual Reports

Table 16: Foreign Loans Obtained by MoF, Currently Listed Under SOEs (as of end-2021)

Project Loan	Relevant SOE	Lender	Outstanding Value (US$ millions)
Puttalam Coal Power Plant	Ceylon Electricity Board	ChEXIM	639
Hambantota Port Phase 1	Sri Lanka Port Authority	ChEXIM	84
Hambantota Port Phase 1 Ancillary Work	Sri Lanka Port Authority	ChEXIM	104
Hambantota Port Phase 2	Sri Lanka Port Authority	ChEXIM	618
Total Outstanding Serviced by Sri Lankan Government			**1,444**
Mattala International Airport	Airport and Aviation Services Limited	ChEXIM	109
Total Outstanding			**1,553**

Source: External Resource Department, National Audit Office of Sri Lanka.

The NAOSL, in its 2020 annual report notes that four loans obtained to construct the Hambantota Port were not reported in government books as the SLPA eliminated these four loans from their books subsequent to the lease agreement signed in 2017. This was done without the consent of the General Treasury or the approval of the Cabinet of Ministers and since then, the loan amount had not been included in any government account.[76] Although the loans are not included in the treasury's financial statements, General Treasury was responsible for repaying the above loans and interest as proceeds of the lease were provided to the government, not to the SLPA. However, the Minister of Finance had ordered to include the relevant assets and loans in the books of the SLPA in terms of Section 12 of the Finance Act No. 38 of 1971 and accordingly, the Chairman of the Authority had been informed to make the necessary adjustments in the Financial Statements for the year 2019.

Alongside the ongoing debt restructuring process, Sri Lanka recognized these ChEXIM loans recorded under the three SOEs as part of central government debt obligations which needs to be restructured in presentations to creditors.[77] This recognition was officially announced in the budget speech for 2023 by President Ranil Wickremesighe in November due to be enacted from end-2022 onwards.[78] The stated objective is to strengthen the balance sheets of the three SOEs, but it also provides clarity on these loans for the debt restructuring process. These loans include four loans obtained for the Hambantota Port which were not found on either the Treasury nor the SLPA's annual report balance sheets after the 2017 lease.

There are also loans obtained by the SOEs directly under Treasury Guarantees, which are reported in the Ministry of Finance Annual Reports amounting, but repayment data is not available. Of these loans, Chinese creditors accounted for an outstanding US$ 271 million at end-2021. Combined, the debt from China recorded under SOEs amounted to US$ 1.824 billion at end-2021 in addition to the US$ 5.561 billion recorded under the central government. Therefore, comprehensive coverage of Chinese debt to Sri Lanka needs to include SOE debt.

Furthermore, in the ERD classification of foreign debt, FCTFFs obtained from the CDB are categorized as commercial borrowings since such loans have shorter maturity periods and are obtained on commercial terms. In our categorization, we recognize these FCTFFs from CDB as loans from a Chinese creditor as the individual creditor is clearly identifiable, unlike in the case of ISBs. Once these loans and ChEXIM loans to SOEs are included, Sri Lanka's total public external debt (excluding CBSL liabilities) rises to US$ 37.615 billion (Table 7 - main text), and Sri Lanka's outstanding debt to Chinese creditors is US$ 7.385 billion or 19.6 percent of total outstanding public external debt. The often-referred 10 percent share does not include Chinese loans classified under SOEs and FCTFFs obtained from CDB.

Table 17: Treasury Guaranteed SOE Loans from Chinese Creditors

SOE	Lender	Issued	Expires	Outstanding - US$ millions		
				2019	2020	2021
Telecommunications Regulatory Comission of Sri Lanka	ChEXIM	May 2013	July 2026	40.7	31.8	22.9
National Water Supply & Drainage Board	CDB	Sept. 2016	Mar. 2032	48.8	48.8	157.6
National Water Supply & Drainage Board	CDB	Aug. 2017	Aug. 2042	13.7	13.7	42.5
Ceylon Petroleum Corporation	China National Chemical Engineering No. 14 Construction Co. Ltd	June 2019	Jan. 2031	13.5	18.6	21.7
Ceylon Electricity Board	Industrial and Commercial Bank of China Limited	July 2019	Apr. 2026	23.1	31.0	26.5
			Total	**139.8**	**143.8**	**271.2**

Note: These are not covered by the External Resources Department's debt servicing data and we assume that these loans are serviced by the SOEs themselves.
Source: Ministry of Finance Annual Reports.

In December 2021, a new type of Chinese lending was added to Sri Lanka's public external debt, a RMB 10 billion (about US$ 1.5 billion) currency swap arrangement between CBSL and People's Bank of China (PBOC). If this CBSL liability is included in the wider definition, public external debt rises to US$ 40.654 billion, of which US$ 8.958 billion or 22 percent is from Chinese creditors. While it has been drawn down into the CBSL's balance sheet as a deposit, the PBOC swap is not a usable foreign currency source due to conditions of usage, including forex reserves to imports three-month coverage.[79] On average, Sri Lanka's three-month import cover amounts to at least US$ 4.0 billion and to use this currency swap Sri Lanka requires to have foreign currency reserves more than US$ 4.0 billion.[80] However, Sri Lanka's foreign reserves have been less than US$ 4 billion since May 2021, making the currency swap unusable.

Of the combined US$ 8.958 billion in Chinese debt, the PBOC currency swap is unlikely to be part of the debt restructuring process, leading to US$ 7.385 billion being central government and SOE debt that could be included in debt restructuring. Of this amount, US$ 7.005 billion is debt outstanding that was being serviced by the Treasury (government) at end-2021, while $380 million was being serviced by SOEs.

However, of this public external debt, annual debt servicing payments data is available only for the debt being reported by the External Resources Department, which amounted to US$ 35.927 billion, accounting for US$ 4.092 billion in debt service payments in 2021. Of this, US$ 7.114 billion is Chinese debt whose debt servicing was US$ 817 million, 19.8 percent of the total debt servicing known in 2021.

Table 18: Outstanding Debt from Chinese Lenders by Category & Lender (US$ millions)

	2019	2020	2021
Bilateral Debt Serviced by Treasury			
Government of China	14	15	16
China Development Bank (CDB)	754	681	580
Export Credit Serviced by Treasury			
EXIM Bank of China	2,648	2,835	2,743
Term Loan Facilities Serviced by Treasury			
China Development Bank (CDB)	1,000	1,500	2,223
Recorded under SOEs, Serviced by Treasury			
Total Serviced by Treasury	**6,195**	**6,647**	**7,005**
Recorded under SOEs, Serviced by SOEs			
EXIM Bank of China	123	119	109
Total for which Debt Servicing Can be Tracked	**6,318**	**6,766**	**7,114**
SOE Debt (with Public Guarantee) Serviced by SOEs			
EXIM Bank of China	41	32	23
China Development Bank (CDB)	62	62	200
China National Chemical Engineering No. 14 Const.	14	19	22
Industrial and Commercial Bank of China (ICBC)	23	31	27
Total Serviced by SOEs	**263**	**263**	**380**
Central Bank of Sri Lanka - Currency Swap			
People's Bank of China (PBOC)	-	-	1,573
Total Outstanding Public Debt to China	**6,458**	**6,910**	**8,958**
Excluding PBOC	**6,458**	**6,910**	**7,385**

Source: External Resources Department, Ministry of Finance Annual Reports, National Audit Office of Sri Lanka.

ENDNOTES

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20. We have referred to original loan agreements which were obtained loan agreements using information requests and are in possession through Right to Information requests. All were signed between ChEXIM and Government Sri Lanka. These are:

- Buyer's Credit Loan Agreement on Hambantota Port development project (Phase 1) - Signed 30th October 2007 ($306.7mn)
- Buyer's Credit Loan Agreement on Bunkering Facility and Tank Farm project at Hambantota - Signed 06th August 2009 ($65.1mn)
- Preferential Buyer's Credit Loan Agreement on Hambantota Port development project (Phase 2) - Signed 17th September 2012 ($600mn)
- Government Concessional Loan Agreement on Hambantota Port development project (Phase 2) - Signed 17th September 2012 (RMB 1000mn)
- Government Concessional Loan Agreement on Hambantota Port development Phase 1 for Ancillary Works and Supply of Equipment project - Signed 24th April 2013 (RMB 960mn)

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32. http://www.erd.gov.lk/index.php?option=com_content&view=article&id=51&Itemid=214&lang=en#details-of-sri-lanka-sovereign-bond-issuances; That was the largest amount of Eurobond maturities Sri Lanka had to settle within a year and Sri Lanka was compelled to increase foreign reserves to settle Eurobond maturities.
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- Government Concessional Loan Agreement on Hambantota Port development Phase 1 for Ancillary Works and Supply of Equipment project - Signed 24th April 2013 (RMB 960mn)

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