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Grappling with Great Power Rivalries: Reflections on Sri Lanka's Engagement with the United States and China

Revised Draft[1]

Ganeshan Wignaraja

Introduction

Sri Lanka is once again on the radar of the world's great powers. After emerging from a costly twenty-six-year civil conflict in 2009, this classic Asian small power experienced relative calm and graduated to an upper middle-income economy in 2018 with a per capita GDP of $4,102 and a population of about 22 million. As it cannot afford a significant military capability (see Meegoda, 2018), Sri Lanka has historically pursued a non-aligned foreign policy of being friends with everyone and enemies with no one. In an era of intensifying great power competition, the post-conflict decade has seen the US and China stepping up their engagement in the economic and security spheres with Sri Lanka. While some research exists on Sri Lanka's-China relations (e.g. Kelegama, 2014; Asirwatham, 2018; de Silva, 2018), a comparative analysis of the country's engagement with both great powers is lacking.

This paper reflects candidly on Sri Lanka's foreign relations with the US and China in the post-conflict period and the influence of domestic constraints in shaping Sri Lanka's agenda. It is a historic analysis covering the period January 2010 to October 2019. The review is timely as Sri Lankan voted in Gotabaya Rajapaksa as the country's 7th executive resident on 16th November 2019 with an ambitious vision to build a high-income economy and to assert non-alignment to Sri Lanka's development advantage. After discussing why great powers may be interested in Sri Lanka, it focusses on bilateral trade and foreign direct investment (FDI), development assistance and security cooperation. It concludes by

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drawing some lessons from the Sri Lankan experience on engagement between small powers and great powers.

Why China and the US Might Take Sri Lanka Seriously

Being a small power can matter to a significant extent in the contemporary international system (Long, 2019). There are three related reasons why the US and China might take a small power like Sri Lanka seriously in the post-conflict period.

First, a strategic geographical location. Asia global rise, driven partly by rapid growth in China and the rest of East Asia, has transformed the Indian Ocean into one of the world's busiest East–West trade corridors. It carries two-thirds of global oil shipments and a third of bulk cargo. Growth in the Indian Ocean has been robust compared to the world economy even since the global financial crisis[2], benefiting from a rich natural resource base, vast fish stocks, a talent pool of educated youth, a rising China and India, and a host of smaller outward-oriented economies. A strategic geographical location in centre of the Indian Ocean means that great powers consider Sri Lanka's role to be a prime example of a small economy punching above its weight class.[3] The country is about ten nautical miles off the main East-West maritime trade route which sees some 60,000 ships passing through annually and only 34 nautical miles off the Southern coast of India with an expanding economy and significant military capability.

Second, an aspiring regional trading hub. This represents a huge economic opportunity for Sri Lanka as well as US and Chinese business seeking to gain a first mover advantage in Sri Lanka (Wignaraja, 2019a). The country has long aspired to become a regional trading, logistics and finance hub, situated between the leading global hubs of Dubai and Singapore. Major investments to handle containerized cargo since the early 1980s (including building four new container terminals and deepening of the main channel to handle large container ships) has led to the emergence of Colombo Port as an important container port in South Asia. The adjacent Colombo Port City is also being built on 249 hectares of reclaimed land from the sea and will eventually triple office space in Colombo and spur service-sector-led development. Furthermore, Sri Lanka is South Asia's most open economy (with average import tariffs of only 5%) having begun trade liberalisation in 1977. To overcome the disadvantage of a small domestic market in the eyes of foreign investors, Sri Lanka is attempting to secure preferential market access to the dynamic Asia market through a strategy of bilateral free trade agreements (FTAs) with China, India, Singapore and Thailand.

Third, a contributor to global public goods. Sri Lanka has been actively supporting multilateralism and global rules-based order which has traditionally balanced the interests of large and small powers alike. This commitment is rooted in Sri Lanka joining the United Nations in 1955 and being a founder member of the Non-Aligned Movement (NAM) in 1961. More recently, the country played a key role in formulating the 1982 United Nations Convention on the Law of the Sea (UNCLOS) which provides customs and rules to maintain order and peaceful relations on the sea and signed the 2016 Paris Agreement on Climate Change to tackle climate change and to intensify the actions required for a sustainable low carbon future. Sri Lanka has also contributed about 18,000 troops to United Nations Peace Keeping operations having first deployed a small continent of peacekeepers

[2] See Wignaraja (2019a).
[3] See de Silva (2017).

to the UN Mission in the Democratic Republic of Congo in 1960. This has reduced the burden on great powers to provide troops for peacekeeping operations.

Trade and FDI

There are positive and negative aspects of Sri Lanka's trade and FDI relations with great powers. From a low base, trade between Sri Lanka and both great powers expanded in the post-conflict period but with differing implications for Sri Lanka's trade balance. Bilateral FDI inflows from great powers into Sri Lanka lags trade relations. In spite of years of trade talks, Sri Lanka lacks a bilateral FTA with either the US or China.

Table 1. US and China Economic Ties with Sri Lanka (*US$ Millions)*

	China	US
Development Assistance (a) *Cumulative (2010-2019)*	10,059	463
Trade Deficit/Surplus *Period Average (2010-2012)* *Period Average (2016-2018)*	(1,877) (3,935)	1,732 2,388
Foreign Direct Investment Inflows *Cumulative (2013-2018)*	2,563.6	134

Notes:

(a) Grant aid and loans

Sources: USAID, Dept. of External Resources at the Ministry of Finance; Sri Lanka; ITC TradeMap, IMF Direction of Trade Database, Board of Investments, Sri Lanka & The Central Bank of Sri Lanka.

Sri Lanka's bilateral trade surplus with the US rose annually from $1.7 billion to $2.4 billion between 2010-2012 and 2016-2018 (see Table 1). The US remains Sri Lanka single largest export destination with a quarter of total exports. Garments dominate making up nearly three-quarters of Sri Lanka's exports to the US. The Sri Lankan garment industry has built its competitive advantage on value-addition rather than cheap production cost, focusing on product quality and the ability to manufacture niche items. Many Sri Lankan garment firms have long-term manufacturing relations for leading U.S. garment buyers/brands. Some large Sri Lankan garment firms have invested in plants in Mexico and Haiti to resourcefully used trade agreements to gain preferential access to the US market.

However, US FDI inflows into Sri Lanka – totaling only about $134 million during 2013-2018 - have been modest with very little going into the manufacturing sector (see Table 1). This partly reflects Sri Lanka being geographically far from the US and having a very small market. It could also reflect potential US investors viewing Sri Lanka as more risky location for manufacturing activities than other locations in Southeast Asia. A perceived lack of political stability given the legacy of a long civil conflict and the Easter Sunday attacks in 2019 is one issue. Another may be that Sri Lanka is not regarded as a very friendly place to conduct business. For instance, Sri Lanka ranks 99th out of 190 countries in the World Bank's 2020 Doing Business Study which is indicative of a cumbersome domestic business environment. Sri Lanka underperforms others in Southeast Asia particularly in enforcing contracts and registering property.

The US-Sri Lanka bilateral Trade and Investment Framework (TIFA) signed in 2002 provides a framework for the two countries to discuss and resolve frictions at an early stage. Some 13 meetings have been held as of 2019. TIFAs are sometimes a prelude to a prized goal of a bilateral FTA with the US. There is a lengthy queue of countries seeking FTAs with the US and the US seeks comprehensive FTAs which involve substantial market opening of partner economies. Sri Lanka is not on the US FTA radar because of a small domestic market, remoteness from the US and red tape affecting business.

A major challenge for Sri Lanka is a rising bilateral trade deficit with China, which doubled annually from $1.9 billion to $3.9 billion between 2010-2012 and 2016-2018. This is underpinned by a surge in capital goods and intermediate imports from China for infrastructure projects in Sri Lanka (see below). The import surge reflects a combination of long-term supplier relations between Chinese SOEs, heavy state subsidies to highly protected firms based in China and artificially low export prices, and the lack of a capital goods industry in Sri Lanka. Chinese FDI into Sri Lanka (totaling $2.6 billion in 2013-2018) is much larger than US FDI inflows but is nearly all destined into infrastructure projects. The limited interest shown by Chinese investors in the Sri Lankan manufacturing sector could be linked to the same factors mentioned above for US FDI inflows.

Negotiations have been on-going for a Sri Lanka and China FTA since 2014. But six rounds of talks stalled in 2017 due to disagreements regarding the level of trade liberalization under the proposed FTA. Sri Lanka had proposed a gradual trade opening with China by liberalizing 90% of tariff lines in a phased-out manner over a 20-year period. However, China has insisted on faster liberalization of tariff lines between the two countries and objected to a review clause to reassess the FTA after 10 years. Small and medium enterprises (SMEs) in Sri Lanka have expressed concerns about competition from cheap Chinese imports, which benefit unfairly from state subsidies, and have lobbied against radical trade opening with China. Accordingly, there seems little end in sight for a Sri Lanka-China FTA.

Development Assistance

Using different foreign aid frameworks, both the US and China have upped their engagement with Sri Lanka in the area of development assistance in the post-conflict period. In essence, the US aid is in the form of relatively small grants which does not have to be repaid by Sri Lanka while China provides large commercial loans for infrastructure projects on which the capital and interest have to be repaid.

Since 1956 the United States Agency for International Development (USAID) has provided development and humanitarian assistance to Sri Lanka. During the coalition government in Sri Lanka from 2015-2019 November, there was some shift in USAID priorities to strengthen democratic systems, promote sustainable economic growth, and support marginalized and disaster-affected communities. Partly reflecting Sri Lanka's graduation away from concessionary aid as a middle-income economy, however, USAID grants to Sri Lanka were relatively small totalling $463 million during 2010-2019 July.

As a sign of increased US engagement to promote economic development, the Millennium Challenge Corporation (MCC) approved a large compact programme for Sri Lanka in early

2019. Sri Lanka was fortunate as compacts are usually awarded to countries below upper middle-income status on the basis of them meeting MCC eligibility criteria of good governance, economic freedom and investment in its citizens. Worth $480 million over a five-year period, the compact consisted of (1) a transport project to improve the road and bus network and (2) a land project to improve land administration. A vibrant debate has ensured with critics arguing that the compact raises a host of legal, environmental and external political interference issues. On 29 October 2019, just over two weeks before the Presidential Election, the coalition government in Sri Lanka approved the compact and said that it will be submitted to parliament for enactment. Not surprisingly, several opposition presidential candidates criticised the decision and there was considerable activity on social media about the possible negative effects of the compact.

The choice of projects was based on a growth diagnostics study undertaken by foreign experts from Harvard University and it seems that insufficient consultations were undertaken with stakeholders in Sri Lanka including development partners or local think tanks. For instance, there appeared to be little coordination on the transport project with multilateral development banks who dominate the transport development finance space in Sri Lanka. Additionally, the land project has been widely questioned as land ownership is a politically sensitive topic (Wignaraja, 2019b). Improving agricultural productivity and irrigation systems may been a better project because of its positive impact on improving depressed farm incomes and rural development. More generally, public communications throughout the process were poor and the text of the compact agreement was belatedly released during the presidential election cycle. Thus, in the absence of transparency, the general public equated the compact as part of a sweetener for Sri Lanka signing defence agreements with the US (see below).

China's development assistance for infrastructure development in Sri Lanka can be traced to the early 2000s predating introduction of the Belt and Road Initiative (BRI) in 2013. After the BRI, Chinese assistance was upscaled. Rather than grants, it was a commercial relationship based on commercial interest-bearing loans and infrastructure related FDI in transport, energy, telecommunications and water and sanitation projects. The total value of Chinese commercial loans, along with some infrastructure-related FDI, to Sri Lanka amounted to $10.1 billion between 2010-2019 July. Strikingly, this figure is over 20 times larger than grant-based development assistance provided by USAID during the same period.

The Hambantota Port was a signature project. A decision was taken during the regime of President Rajapaksa to accelerate the development of Hambantota - a economically backward region in Southern Sri Lanka with high levels of youth unemployment - through infrastructure investment. A key project was a major transhipment port at Hambantota in the early 2000s, which was expected to become the country's second largest port after Colombo Port. It was financed by variable interest rate loans from the Export Import Bank of China and two Chinese state-owned enterprises (SOEs) constructed the port. It seems that comprehensive technical feasibility and market studies were not undertaken for the port project. Taking longer than expected to come on stream, the project incurred financial losses and put a strain on Sri Lanka's public finances. This chequered history has led to

Hambantota Port being portrayed by some as a case study of unprofitable infrastructure investment and China's "debt trap diplomacy".[4]

However, this portrayal seems a one-sided and somewhat dated narrative of the Hambantota Port Project. To stem the financial losses, in 2017 the coalition government of President Sirisena agreed to give China a controlling interest in managing the port on a 99-lease. Under the risk sharing agreement, Sri Lanka received a sum of $1.12 billion which was used to bolster the country's foreign exchange reserves. Furthermore, the management of the Hambantota Port moved to one of China's best run SOEs - China Merchant Port Holdings Company Limited. This global port operator is not only developing Hambantota Port and the adjacent industrial zone but also working to diversify the range of port related services (e.g. ship repairing and bonded warehousing and distribution). Once Hambantota Port becomes fully operational over the next few years, container traffic through Sri Lanka may double to some 16 million TEUs. The industrial zone is expected to attract new FDI and create jobs. Interestingly, cross-country analysis of BRI debt profiles against national total debt reveals that Sri Lanka is not in the high-risk category of BRI indebted countries in Asia (Wignaraja *et al.*, 2018). Nonetheless, it would be prudent for the country to undertake detailed cost benefit analysis of future BRI projects and strengthen its national debt management capability.

Security Cooperation

Historically, China has been a notable defence partner for Sri Lanka and has assisted in building the country's defence capability. China provided diplomatic support, armaments and military training during the civil conflict when the US was hesitant to step up due to various concerns such as human rights issues. However, in the post-conflict era and particularly from 2015 onwards, under its Free and Open Indo-Pacific Strategy (FOIP), US bilateral cooperation on security has increased (Smith, 2019). These efforts have largely involved gifts of military equipment, capacity building and policy dialogue primarily in the maritime domain. This seems part of a trend where great powers as well as regional powers like Australia and India are seeking to improve security ties with key Indian Ocean littoral states like Sri Lanka. This reflects growing international concerns about non-traditional maritime security threats like piracy, maritime terrorism, climate change, illegal, unreported and unregulated (IUU) fishing, illegal immigration, and smuggling of arms and drugs (Chatterjee, 2014).

Gifts of naval vessels

Until recently, Sri Lanka Navy remained a relatively small naval force in terms of its power projection capabilities. During the conflict, the Navy fought one of the most advanced insurgency groups in the world with a nimble and deadly sea wing. The Navy's focus has changed since the end of hostilities to patrolling Sri Lanka's maritime boundaries against a variety of non-traditional security threats. The transnational nature of many of these crimes have prompted the US to provide some much-needed military aid like equipment that will allow the Sri Lanka Navy to increase its capacity in monitoring Sri Lanka's vast

[4] Thorne and Spevack (2017) explore the link between China's investment in the Hambantota Port and geopolitical strategy. They argue that the terms of 99-year lease on Hambantota Port favour China, that the investment generated political influence and that Chinese debt constricts Sri Lankan policy. This narrative on Sri Lanka has been challenged by Weerakoon and Jayasuriya (2019), among others.

maritime domain. The first of these vessels, a former medium endurance cutter, was transferred from the US Coast Guard in 2004. In 2018, another ship - a high endurance cutter (Hamilton class) - was also transferred from the US Coast Guard. It remains the largest vessel that is currently in Sri Lanka' Navy's inventory with a displacement of approximately 3,340 tons. While remaining highly versatile, these vessels are designed for high-endurance, long range missions and are ideal for Sri Lanka's maritime security needs including drug interdiction, illegal immigrant interception, and fisheries patrol.

China's contribution to developing the Sri Lanka Navy's high endurance capacity was a gift of a Type 053H2G frigate which is currently the second largest vessel by displacement belonging to the Sri Lanka Navy. The frigate may not be the most sophisticated Advance Offshore Patrol Vessel (AOPV) that China could have granted to Sri Lanka, but it is sufficient for Sri Lanka's maritime patrolling needs. The decision to remove surface to air missile system before handing the vessel over to Sri Lanka has effectively made the ship a patrol vessel rather than a war fighting ship.

The Sri Lanka Navy does not have a marine aviation wing at present but both the US and Chinese gifted ships contain hangars and landing pads for helicopters. This potentially adds air power in the future to Sri Lanka' naval capabilities which would increase the operational reach of the Sri Lanka Navy in the maritime domain.

Joint Training Exercises and Regional Dialogue

One highlight of Sri Lanka's recent military engagement with the US is the invitation to participate in the 2018 biennial the Rim of the Pacific Exercise (RIMPAC) exercises. With the participation of 26 nations in 2018, The RIMPAC exercise is the largest maritime warfare exercise in the world. The invitation can be seen as a maturing of Sri Lanka Navy's credibility as a highly trained professional national maritime fighting force.[5] In addition, the US Marine Corps trained with their Sri Lankan counterparts in 2016 and a naval exercise named CARAT (Cooperation Afloat Readiness and Training Exercise) was scheduled 2019 but was called off after the 2019 Easter Sunday attacks in Sri Lanka.

While the security relationship between China and Sri Lanka remains robust, there is little evidence of any significant bilateral military exercises since the culmination of the two-staged 'Silk Route' exercise in 2015. However, Chinese military personnel have frequently participated in other multilateral exercises hosted by Sri Lanka's armed forces such as 'Comoront Strike'.

In addition, Chinese military leaders along with their counterparts from the US, India, Australia, and Japan are regular participants in the annual military forums hosted by the three branches of Sri Lanka's armed forces such as the Galle Dialogue (Sri Lanka Navy), Defence Seminar (Sri Lanka Army), and Colombo Air Symposium (Sri Lanka Air Force).

Defence Cooperation Agreements

While US-Sri Lanka cooperation on joint training and procurement has improved, Sri Lanka has been reluctant to sign formal agreements with the US governing conduct, deployment, and logistics. Defence cooperation agreements like the Acquisition and Cross

[5] A relatively small group of some 25 solders from Sri Lanka's recent marine battalion participated in RIMPAC 2018.

Servicing Agreement (ACSA), and a potential Status of Forces Agreement (SOFA) have become highly politicised domestically (Ramachandran, 2019). An ACSA agreement was first signed in 1995 and was renewed in 2007 and 2017. However, the proposed SOFA agreement if signed need not be renewed, and will remain indefinitely. Several concerns against the signing of a SOFA agreement exist. For instance, the process has been mired in a variety of transparency issues such as a lack of a proper consultation from military leaders, and lawmakers. Furthermore, as far as the content of the agreement is concerned, critics argue that certain exemptions and conditions laid out in the agreement governing areas such as national treatment, and legal frameworks could undermine Sri Lanka's sovereignty. The economic benefit to Sri Lanka from entering into such agreements seems unclear. While there is no evidence to support the claim, there seems also a worry that these agreements could lead to a future agreement to establish a US military base in Sri Lanka.

It not just the US that Sri Lanka are mulling over whether it should sign defence agreements with. Sri Lanka signed a number of MOUs focusing on intelligence sharing, and defence cooperation in the aftermath of the Easter Sunday attacks. The agreements however, have not reached the same level of scrutiny or opposition internally as the ones with the US. Given the fact that versions of the US ACSA agreements were signed by multiple administrations, it may be that the opposition to these agreements could be partially motivated by local partisan political concerns rather than on either principled or evidence-based aversions to cooperation with the U.S.

Counter-terrorism Support

In the aftermath of the Easter Sunday attacks, both China and the US lent their assistance primarily in aiding local investigation efforts. US investigators including from the Federal Bureau of Investigation arrived in Sri Lanka to lend their expertise in explosives detection, and forensic analysis.

China's assistance was multi-pronged and included providing security and surveillance equipment, financial contributions towards funds dedicated to the victims of the attacks, as well as participation in programs designed to help revive tourism shortly after the attacks. The attacks highlighted several gaps in the internal state security structure. Concerns exist to whether Sri Lanka might be the target of similar attacks if defence cooperation were to increase between Sri Lanka and the US. However, a pragmatic approach going forward would be to increase the institutional capacities of the security sector in Sri Lanka to detect and deter future terror attacks.

Conclusion

This paper analysed the evolution of Sri Lanka's economic and security relations with great powers and domestic constraints in the post-conflict period. It attributes the growing US and China interest in Sri Lanka to a strategic geographical location in the vibrant Indian Ocean; an aspiring regional trading, logistics and finance hub; and a contributor to global public goods.

Evidence points to increased economic engagement between Sri Lanka and the two great powers in the post-conflict period. Bilateral trade has expanded from a low base but Sri Lanka enjoys a trade deficit with the US while facing a challenging trade deficit with China.

FDI inflows from great powers into Sri Lanka lags trade and seems linked to domestic constraints such as a small domestic market, concerns over political stability and cumbersome business regulations. Sri Lanka lacks FTAs with either the US or China suggesting that years of bilateral trade talks have produced little concrete outcome. This partly reflects a lack of US interest in an FTA with Sri Lanka and lobbying from SMEs in Sri Lanka against deep trade opening with China.

In terms of development assistance to Sri Lanka, the US and China both have upped their game but under very different aid frameworks. The US provides relatively small grant aid while China provides large commercial loans for infrastructure projects. This has led to international fears of Sri Lanka falling into a "Chinese debt trap" but this narrative seems dated. The famous Hambantota Port project is being transformed into a productive venture under new management and BRI debt is not the largest component of Sri Lanka's national debt. The Sri Lanka-MCC Compact signals an attempt by a US aid agency to upscale grant aid to Sri Lanka but the future seems uncertain due domestic political opposition.

China-Sri Lanka security cooperation appears to have supported Sri Lanka's defence capability building during the civil conflict. However, in the post-conflict era and particularly from 2015 onwards, under its FOIP Strategy, US bilateral cooperation on security has increased. These efforts have largely involved gifts of offshore patrol vessels, capacity building and policy dialogue in the maritime domain. Growing non-traditional maritime security threats in the Indian Ocean has prompted great and major powers to improve security ties with Sri Lanka and other Indian Ocean littoral states.

Sri Lanka's experience over the last decade provides some lessons for better engagement between small powers and great powers. These lessons need to be carefully tailored to the individual national circumstances, development strategies and capacity of small powers.

First, a non-aligned foreign policy can be a useful policy instrument to guide small powers engagement with great powers. However, some small powers have been criticized for advocating non-alignment while tilting towards one or other great power on important issues. One way forward might be for a small power to prepare a written foreign policy defining its national interests and key principles of a non-aligned foreign policy and to apply it in a consistent manner. More generally small powers should lend their support to a multilateral and regional rules-based order, which is under increasing threat, as the optimal route for small and great powers to achieve global peace and prosperity.

Second, an outward-oriented market-friendly strategy offers small powers larger economic gains from relations with great powers than the alternatives. Under siege from protectionist lobbies, some small powers have implemented partial outward-oriented strategies and achieved below potential economic outcomes in terms of growth or job creation. A gradual reform program to achieve outward-orientation seems better than a non-reforming stance. Key elements of such an approach are liberalizing barriers affecting trade and FDI, pursuing bilateral FTAs with great and major powers, streamlining business regulations, investing in world class ports and upgrading human capital. Strong legislation for trade remedies and trade adjustment programs for affected sectors and prudent macroeconomic and debt management are also important.

Third, great powers can support the difficult economic transition from middle-income to high-income status in small powers by moving towards a different relationship that is based on aid and trade to one that eventually emphasizes FDI, trade and aid (Wignaraja *et* *al.* 2018). This means moving away from traditional development assistance frameworks of providing grant aid or commercial loans towards diplomatic and economic cooperation. Transferring knowledge on good practices to sustain outward-orientation, attracting FDI and portfolio investment, capacity building for comprehensive FTA negotiations and strategies for dealing with rating agencies are important aspects of such an approach.

Fourth, there is a need to decouple security cooperation from economic relations in small power-great power engagement. An overemphasis on security cooperation between small powers and great powers can lead to intensifying geopolitical tensions and mistrust with regional powers such as India which are important players in the South Asian region. Furthermore, in an ideal world, security cooperation should primarily focus on developing regional public goods such as maritime patrol capabilities in small powers which can tackle non-traditional security threats and undertake search and rescue at sea.

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Ganeshan Wignaraja is Executive Director at the Lakshman Kadirgamar Institute of International Relations and Strategic Studies, Sri Lanka.

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SWP
Stiftung Wissenschaft und Politik
German Institute for International and Security Affairs

Ludwigkirchplatz 3–4
10719 Berlin
Telephone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org