



# Sri Lanka's 2022 Debt Default Crisis: Geopolitics and Foreign Policy Developments

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## Summary

*Since the 2022 debt default, Sri Lanka has had significant foreign policy and geopolitical developments, marked by a balancing act between the major powers and regional alliances. The country continued to navigate its relationships with traditional bilateral partners such as India, China and the West while also engaging with emerging partners in the Southeast Asian region. Amidst these diplomatic endeavours, managing domestic political interests remains challenging, particularly in light of past ethnic and religious tensions and social instability during the 2022 economic crisis.*

## Post-debt Crisis Foreign Policy

In 2024, Sri Lanka is scheduled to hold elections, the first since the country defaulted on its debt repayments and declared economic bankruptcy in 2022. In the wake of the economic crisis, Sri Lanka's foreign policy has prioritised economic recovery.<sup>1</sup> These efforts occur against a backdrop of regional and global geopolitical developments such as the Russia-Ukraine war, the Israel-Palestine conflict and global recession. This paper examines recent developments in Sri Lanka's external relations and what they mean for the elections in 2024.

Managing the economic conditions in the country since 2022 has been an uphill task for the current government, and the economic aspect will be the predominant issue in the upcoming elections. In March 2023, Sri Lanka embarked on its 17<sup>th</sup> agreement with the International Monetary Fund (IMF), securing crucial financial aid to alleviate its balance of payments crisis and escalating debt load. Nevertheless, negotiations have proved complex, as Sri Lanka navigates the conditions linked to IMF loans. In mid-December 2023, the IMF cleared a second tranche of US\$337 million (\$\$461.69 million) of the Extended Fund Facility (EEF).<sup>2</sup>

The economic recovery of Sri Lanka and its eligibility for IMF funding hinge significantly on the restructuring of its foreign debt. In November 2023, Sri Lanka reached an agreement with several lenders, including India and members of the Paris Club Group, to restructure a

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<sup>1</sup> Peter Breuer and Krishna Srinivasan, "Sri Lanka's Economic Reform Program is Starting to Work—Keep at It for a Full Recovery", International Monetary Fund, 22 February 2024, <https://www.imf.org/en/News/Articles/2024/03/01/022224oped-srilanka-economic-reform-program-is-starting-to-work>.

<sup>2</sup> Meera Srinivasan, "IMF clears second tranche of \$337 million for Sri Lanka", *The Hindu*, 13 December 2023, <https://www.thehindu.com/news/international/sri-lanka-to-get-access-to-337-million-from-imf-to-stabilise-economy/article67633571.ece>.

portion of its debt owed to them.<sup>3</sup> Additionally, China, a major bilateral creditor, and a primary source of Sri Lanka's debt, has also agreed to ease some of the terms of loan repayment.<sup>4</sup> A senior representative of the IMF, based in Washington, noted that Sri Lanka's agreements-in-principle with the Official Creditors Committee and Export-Import Bank of China on debt treatments align with the targets set by the EFF.<sup>5</sup> These agreements mark a significant milestone in putting Sri Lanka's debt on a trajectory towards sustainability.

In addition to these developments, Sri Lanka is pursuing increasing foreign economic cooperation and integration. This can be understood as a strategy to diversify its foreign relations so that it maximises economic integration and offsets geopolitical tensions that rise when one set of countries is prioritised over others.

## **Sri Lanka's 'Look East' Foreign Economic Relations**

Sri Lanka's current largest export destinations are in Europe and the United States, and the government appears to be keen on diversifying national interests by entering into economic agreements with South, Southeast, and East Asian states.<sup>6</sup> This is best seen in the free trade agreements (FTAs) that were recently signed or are under discussion, as well as Sri Lanka signalling interest in joining broader regional economic initiatives such as the Regional Comprehensive Economic Partnership (RCEP).

The recently signed FTA with Thailand, in February 2024,<sup>7</sup> is part of Sri Lanka's general push to further integrate economic ties with the Southeast Asian and East Asian states. According to a statement from the media department of the Sri Lankan president, the FTA with Thailand aims to expand market opportunities by addressing various aspects such as trade in goods, investment, customs procedure and intellectual property rights.<sup>8</sup>

Sri Lanka signed an FTA agreement with Singapore in 2018, and there are said to be ongoing discussions with other Association of Southeast Asian Nations (ASEAN) member states. Sri Lanka's Foreign Minister Ali Sabry highlighted the government's commitment to continue work to establish FTA arrangements with Indonesia, Malaysia, Vietnam and China.<sup>9</sup> The Sri

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<sup>3</sup> "Sri Lanka agrees debt restructuring with Paris Club creditors", *Financial Times*, 29 November 2023, <https://www.ft.com/content/a3fba616-4be5-4b38-938e-0e68420f37c8>.

<sup>4</sup> "IMF resumes Sri Lanka bailout after China's debt deal", *The Economic Times*, 13 December 2023, <https://economictimes.indiatimes.com/news/international/world-news/imf-resumes-sri-lanka-bailout-after-chinas-debt-deal/articleshow/105955355.cms?from=mdr>.

<sup>5</sup> Meera Srinivisan, "IMF clears second tranche of \$337 million for Sri Lanka", *The Hindu*, 13 December 2023, <https://www.thehindu.com/news/international/sri-lanka-to-get-access-to-337-million-from-imf-to-stabilise-economy/article67633571.ece>.

<sup>6</sup> Ibid.

<sup>7</sup> "Sri Lanka signs free trade deal with Thailand to revive economy", *Al Jazeera*, 3 February 2024, <https://www.aljazeera.com/news/2024/2/3/sri-lanka-signs-free-trade-deal-with-thailand-to-revive-economy>.

<sup>8</sup> "Sri Lanka looks to create more trade agreements with Asia", *Economynext*, 26 October 2023, <https://economynext.com/sri-lanka-looks-to-create-more-trade-agreements-with-asia-136979/>.

<sup>9</sup> "Sri Lanka Prez Stresses Reevaluation of Foreign Relations For Island Nation's Economic Growth", *ABP News LIVE*, 7 February 2024, <https://news.abplive.com/news/world/sri-lanka-president-ranil-wickremesinghe-stresses-reevaluation-foreign-relations-for-economic-growth-1662608>.

Lankan government has also already submitted its Letter of Intent to join the RCEP.<sup>10</sup> This move will further strengthen its economic ties with ASEAN and ASEAN-Plus countries.

Meanwhile, Sri Lanka also aims for greater economic integration in the South Asian region. Currently, Sri Lanka has FTAs with Pakistan and India and is set to enter the 12<sup>th</sup> round of negotiations on the proposed Economic and Technology Cooperation Agreement with India.<sup>11</sup> Furthermore, Sri Lanka has access to the South Asian markets through regional trade agreements such as the South Asian Free Trade Area and the South Asian Association for Regional Cooperation Preferential Trading Arrangement.<sup>12</sup> The deepening of economic and political relations with India in the recent past is particularly significant.

## Managing the India-China Equation

During the 2022 economic crisis, India provided Sri Lanka with economic and humanitarian assistance of over US\$4.5 billion (S\$6 billion) and supported Sri Lanka's debt restructuring efforts. Among the most significant development and investment initiatives by India in Sri Lanka since are the Trincomalee energy-hub development, port development and oil refinery. Furthermore, Sri Lanka granted provisional approval to Adani Green Energy for two wind projects to be constructed in Northwest Mannar and Pooneryn. There are also ongoing discussions on Sri Lanka's government engaging India's Adani Group to oversee the management of key international airports in Sri Lanka.<sup>13</sup> In the same month, India introduced its Unified Payment Interface in Sri Lanka.<sup>14</sup>

These developments indicate the growing India-Sri Lanka economic relations and financial connectivity between the two countries, with the authorisation of the Indian Rupee as a designated currency in 2023.

Meanwhile, China is still Sri Lanka's largest bilateral creditor and it reached an agreement with the Sri Lankan government's approval to build a US\$4.5 billion (S\$6 billion) refinery in the southern port of Hambantota in November 2023.<sup>15</sup> The project is the largest investment received by Sri Lanka since 2022.<sup>16</sup> The project has strategic importance as the state's sole refinery, built in 1969, has been struggling to meet the demand of the population and relying on imported fuel.<sup>17</sup> Previous Chinese loans have been utilised to finance a number of

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<sup>10</sup> "Sri Lanka looks to create more trade agreements with Asia", op. cit.

<sup>11</sup> Ibid.

<sup>12</sup> Ibid.

<sup>13</sup> "Indian firm to manage three international airports in Sri Lanka", *DailyFT*, 13 February 2024, <https://www.ft.lk/front-page/Indian-firm-to-manage-three-international-airports-in-Sri-Lanka-Harin/44-758426>.

<sup>14</sup> "India launches UPI payment services in Sri Lanka, Mauritius; PM Modi says 'our policy is neighbourhood first'", *Mint*, 12 February 2024, [India launches UPI payment services in Sri Lanka, Mauritius; PM Modi says 'our policy is neighborhood first' | Mint \(livemint.com\)](https://www.livemint.com/India-launches-UPI-payment-services-in-Sri-Lanka-Mauritius-PM-Modi-says-our-policy-is-neighborhood-first/).

<sup>15</sup> Cissy Zhou, "Sri Lanka's China 'debt trap' fears grow as Beijing keeps investing", *Nikkei Asia*, 2 January 2024, <https://asia.nikkei.com/Spotlight/Asia-Insight/Sri-Lanka-s-China-debt-trap-fears-grow-as-Beijing-keeps-investing>.

<sup>16</sup> Ibid.

<sup>17</sup> Ibid.

large infrastructure projects, including highways, an airport and a port.<sup>18</sup> Moreover, as mentioned earlier, China is crucial to Sri Lanka's attempts to restructure its foreign debt.

While economic relations with India and China continue unabated, Sri Lanka's political relations with India appear to have taken the front seat since 2022. This is a result of location, that is, India being the largest immediate neighbour to Sri Lanka, and is also a result of historical relations between the two countries. India's political support or the lack of it in the past has determined to a significant extent the trajectory of internal events, such as the 26-year-long civil war.

Since 2022, Sri Lanka has developed significantly close relations with India and is aligning with India on international issues. For example, in September 2023, when the Canadian Prime Minister alleged that there were credible links between the killing of a leader of the Khalistan movement and government agents of India, Sri Lankan Foreign Minister Ali Sabry came out in support of India and criticised Canadian Prime Minister Justin Trudeau's claim against India.<sup>19</sup> In his statement, Sabry claimed that Trudeau made "some outrageous allegations without any supporting proof", and in reference to the Sri Lankan Civil War, said that Canada did "the same thing...against India".<sup>20</sup>

Another example is the Sri Lankan government declaring an immediate moratorium of one year on foreign vessels conducting research in the island's Exclusive Economic Zone (EEZ) in December 2023.<sup>21</sup> It was declared after the arrival of the Chinese research vessel Shi Yang 6 on 25 October 2023, although Sri Lanka emphasised that the ban encompassed vessels from all nations. The imposition of the Sri Lankan ban was seen as being influenced by pressure from India and the US, with a focus on Chinese vessels. In March 2024, a German research vessel, the Sonne, was allowed to dock at Colombo Port, which was protested by Chinese counterparts.<sup>22</sup>

Relations between India and Sri Lanka also grew stronger following Prime Minister Narendra Modi's visit to Lakshadweep in January 2024. The PM's attempts to promote Lakshadweep as a tourist destination were criticised by several Maldivian MPs, leading to growing tensions between India and the Maldives. Sri Lanka was thereafter promoted by many Indians, including high-level officials, as a tourist destination for Indians. Subsequently, the Maldives' new president, Mohamed Muizzu, made his first official visit to China instead of India, breaking with tradition.<sup>23</sup>

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<sup>18</sup> Ibid.

<sup>19</sup> Rathindra Kuruwita, "Sri Lankan Foreign Minister wades into India-Canada Controversy", *The Diplomat*, 5 October 2023, <https://thediplomat.com/2023/10/sri-lankan-foreign-minister-wades-into-india-canada-controversy/>.

<sup>20</sup> Ibid.

<sup>21</sup> Asangya Abeyagoonasekera, "Moratorium on Chinese research ships and Buddhist soft power diplomacy in Sri Lanka", Observer Research Foundation, 1 February 2024, <https://www.orfonline.org/expert-speak/moratorium-on-chinese-research-ships-and-buddhist-soft-power-diplomacy-in-sri-lanka>.

<sup>22</sup> Shihar Aneez, "China protests against Sri Lanka allowing German research ship amid 1-year ban: sources", *Economynext*, 19 March 2024, <https://economynext.com/china-protests-against-sri-lanka-allowing-german-research-ship-amid-1-year-ban-sources-155237/>.

<sup>23</sup> Varuna Dayaratne, "Next time you want to take a holiday, go to Sri Lanka – Indian FM", *Daily News*, 1 February 2024, <https://www.dailynews.lk/2024/02/01/admin-catagories/breaking-news/376660/next-time-you-want-to-take-a-holiday-go-to-sri-lanka-indian-fm/>.

Meanwhile, Sri Lanka continues to cultivate its political relations with China, even if to a relatively lesser degree. For example, Sri Lankan Prime Minister Dinesh Gunawardena participated in a six-day official visit to China in March 2024, during which he held talks with Chinese President Xi Jinping and Premier Li Qiang on ways to further deepen bilateral ties. China's importance to Sri Lanka is not only at the economic level but also as a means of balancing India when relations are not always positive. In the past, for example, Sri Lanka governments have experienced India's pressure on the issue of Tamil minority rights. Most recently, following Modi's comments on Sri Lanka's Kachchatheevu island, which was seen by many as an election tactic to gain more votes in Tamil Nadu, Sri Lanka is constantly reminded of the need to balance its foreign relations than depend too heavily on any one country or bloc.<sup>24</sup>

## **Sri Lanka's Relations with the other Quad Countries**

Sri Lanka's geopolitical positioning in the Indian Ocean has made its relationships with the Quadrilateral Security Dialogue (Quad) countries – the US, India, Japan and Australia – increasingly significant.

Sri Lanka's interactions with the US, Japan and Australia have primarily revolved around economic investments, maritime security and development assistance. These Quad countries view Sri Lanka as a pivotal maritime node in ensuring a free, open and inclusive Indo-Pacific, aimed at countering growing Chinese influence in the region.

Sri Lanka and Japan traditionally had close relations, with Japan being Colombo's largest bilateral lender until it was eclipsed by China in 2016. Since the 2022 economic crisis in Sri Lanka, Japan has re-emerged as a key bilateral player.<sup>25</sup> Since the Sri Lankan government halted a US\$2 billion (S\$2.74 billion) light rail transit (LRT) project in 2020, financed by the Japan International Cooperation Agency, relations between the two states have been tenuous.<sup>26</sup> Since 2022, Sri Lanka has attempted to restart bilateral talks on the LRT and rekindle ties, with a US\$3.4 million (S\$4.65 million) compensation offered to a consultancy led by Japanese firms in February last year.<sup>27</sup> Japan sees its relationship with Sri Lanka as strategically important, as it looks to curb the influence of China in the Indo-Pacific region.<sup>28</sup> Recent indications therefore point to the possibility of a positive direction for Sri Lankan-Japanese relations.

In light of Sri Lanka's economic challenges, Australia also has stepped up by offering US\$75 million (S\$102.75 million) in Official Development Assistance, employing both emergency

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<sup>24</sup> Rajni Gamage and Isha Gupta, "Resolution of the India-Sri Lanka Maritime Border Conflict and Fisheries Dispute", *ISAS Working Paper*, No. 369, 23 August 2023, <https://www.isas.nus.edu.sg/papers/resolution-of-the-india-sri-lanka-maritime-border-conflict-and-fisheries-dispute/>.

<sup>25</sup> Ibid.

<sup>26</sup> Dimuthu Attanayake, "Ball in Sri Lanka's court' as Japan seeks to deepen ties in bid to counter China's Indo-Pacific influence", *South China Morning Post*, 11 March 2024, <https://www.scmp.com/week-asia/politics/article/3254971/ball-sri-lankas-court-japan-seeks-deepen-ties-bid-counter-chinas-indo-pacific-influence>.

<sup>27</sup> Ibid.

<sup>28</sup> Ibid.

funding to United Nations (UN) agencies and re-purposing initiatives within the Australian development cooperation program in Sri Lanka.

Meanwhile, Sri Lanka's relations with the US have deepened, especially since the debt default. In 2022, the US announced nearly US\$12 million (S\$16.44 million) in assistance in response to Sri Lanka's deteriorating food security and economic situation. In addition, the US is involved in development and investment projects, as seen in its commitment in November 2023 to lend US\$553 million (S\$757.61 million) for the development of a container terminal in Colombo, operated by the Adani group.<sup>29</sup> The support from the US is also seen as crucial for Sri Lanka to secure the IMF bailout package and for its debt restructuring process.

The US has also, along with India and other Western countries, generally applied political pressure on Sri Lanka regarding its human rights record and the need for effective and credible post-war reconciliation and transitional justice measures. For example, a statement released by the Core Group on Sri Lanka at the 55<sup>th</sup> Session of the Human Rights Council outlined several concerns on the fundamental rights and freedoms impacted by the Prevention of Terrorism Act.<sup>30</sup> Similarly, concerns were raised over other reforms which could infringe on fundamental freedoms, such as the Online Safety Act, which could be used to criminalise a wide range of expression, suppress dissent and undermine Sri Lanka's digital economy.<sup>31</sup>

The close ties that the current government enjoys with the US have also impacted Sri Lanka's stance on the Israel-Palestine conflict, which has rapidly escalated since 2024. The Sri Lankan government's stance on the geopolitical issue between Israel and Palestine has largely involved balancing positive relations with both sides. In November 2023, the Sri Lankan government signed an agreement with the Israeli government to facilitate the immediate employment of around 10,000 Sri Lankans to work on Israeli farms.<sup>32</sup> The government's rationale is the need to capitalise on any opportunity during a time of economic crisis and is similar to a stance taken by India.<sup>33</sup> This development has raised concerns among many Sri Lankans, including those belonging to the Muslim minority. More recently and likely in response to these concerns, the Sri Lankan government donated US\$1 million (S\$1.37 million) to the UN Relief and Works Agency for Palestine Refugees in the Near East for Palestinian children in Gaza.

## Small States and Climate Diplomacy

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<sup>29</sup> Cissy Zhou, "Sri Lanka's China 'debt trap' fears grow as Beijing keeps investing", *Nikkei Asia*, 2 January 2024, <https://asia.nikkei.com/Spotlight/Asia-Insight/Sri-Lanka-s-China-debt-trap-fears-grow-as-Beijing-keeps-investing>

<sup>30</sup> "The United States Joined the Following Joint Statement at the 55th Session of the Human Rights Council", US Mission to International Organizations in Geneva, 4 March 2024, <https://geneva.usmission.gov/2024/03/04/joint-statement-by-the-core-group-on-sri-lanka-hrc55/>.

<sup>31</sup> "US says it is 'monitoring developments' in Sri Lanka as it deepens ties", *Tamil Guardian*, 12 March 2024, <https://www.tamilguardian.com/content/us-says-it-monitoring-developments-sri-lanka-it-deepens-ties>.

<sup>32</sup> Ibid.

<sup>33</sup> Michelle Buckley and Paula Chakravartty, "Labor and the Bibi-Modi 'Bromance'", *Boston Review*, 11 April 2024, <https://www.bostonreview.net/articles/labor-and-the-bibi-modi-bromance>.



Since 2022, the Sri Lankan government has been emphasising its commitment to combating the effects of climate change, and this is becoming a key component of its foreign policy. Due to its geographical location, Sri Lanka is extremely susceptible to natural disasters and at high risk of experiencing extreme weather conditions.

Speaking at the COP28 summit held in December 2023, Sri Lanka's President Ranil Wickremesinghe highlighted the challenges and disproportionate vulnerability faced by the developing countries, advocated for climate justice that was readily available for all nations, and stressed the urgency of immediate action to find sustainable and effective solutions.<sup>34</sup> Furthermore, one of the initiatives launched by the Sri Lankan president at COP28 was the International Climate Change University.<sup>35</sup> Originally one of the president's proposals at COP27 in Egypt, the Sri Lankan government has now already allocated over 600 acres of land for its establishment and claims to have stakeholders which include countries and major universities in the world.<sup>36</sup>

Wickremesinghe also highlighted the need to coordinate with regional major powers, such as India and China, to bolster the nation's capacity for climate finance and debt relief and stressed the need for global cooperation to effectively tackle climate change and in establishing defined goals to manage issues such as the use of fossil fuel.<sup>37</sup> Issues such as climate change allow for smaller states, such as Sri Lanka, to play a role more significant than its size may imply, at the international level. It, therefore, appears that Sri Lanka is not only diversifying the countries that it has traditionally engaged and integrated with economically but is also diversifying the kinds of issues it is engaged in, such as climate issues.

## Conclusion

Going forward, as the Sri Lankan state attempts to manage its international relations, one of the major challenges it will face is balancing various domestic and external stakeholder interests in a time of economic crisis. While the economic crisis might provide a legitimate reason for Sri Lanka to take certain actions, such as prioritising one country over another or prioritising the international over the domestic, the repercussions may not always be contained. Due to the volatile global and regional context and evolving developments in Sri Lanka's national landscape, tensions and spillover effects are always possible. As a result, foreign policymaking during crisis times appears to be an even more difficult exercise than under more normal circumstances.

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<sup>34</sup> Ibid.

<sup>35</sup> Ibid.

<sup>36</sup> President Wickremesinghe launches International Climate Change University, *The Island Online*, 3 December 2023, [https://island.lk/president-wickremesinghe-launches-international-climate-change-university/#google\\_vignette](https://island.lk/president-wickremesinghe-launches-international-climate-change-university/#google_vignette).

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