Pathfinder China Watch 4

The Chinese Maritime Silk Route: An Opportunity to be Seized

Recreating History

China has launched a new initiative to build a **"Maritime Silk Route"** linking the Pacific and Indian oceans. It was first proposed by President Xi Jinping during a visit to Indonesia in October 2013. Furthermore, Premier Li Keqiang has announced the establishment of a Yuan 3 billion ($500 million) maritime cooperation fund to promote this initiative.

Sri Lanka became the first country to welcome the plan when Foreign Minister Peiris visited Beijing recently. A range of countries have been sounded out about the concept. President Xi and Premier Li have visited South East Asia. Russia and India have also been brought into the discussions. The Chinese sought support for the initiative during Prime Minister Manmohan Singh's recent visit to Beijing, having invited India to be a part of the initiative during the 17th round of India-China Special Representatives Talks on border issues, in New Delhi last year.

The Rationale for a Modern Silk Route

The underlying rationale behind China's new maritime silk route initiative is based on economic gains and the security of sea lanes. Some analysts have suggested that the initiative is designed to counter the "String of Pearls Theory" which claims that China has intended to build naval facilities in Bangladesh, Sri Lanka and Pakistan. It has also been claimed that this initiative was intended to address regional anxieties about China's rapid rise, including its expanding naval capabilities, as well as territorial tensions that have surfaced in the South China Sea.

The initiative also seems a continuation of China's policy of building trust with India and Indonesia, two other rising Asian countries. The maritime silk route seeks to bring together these three large Asian countries into a framework of economic cooperation. It also provides a platform to upgrade China's ongoing strategy of engaging with smaller countries along the envisaged sea-route.

Partnership for Prosperity

This provides an opportunity for Sri Lanka to further enhance bilateral cooperation with China to promote prosperity through win-win outcomes. The Chinese have spoken of strengthening maritime connectivity, marine economy, fisheries, disaster prevention and mitigation as well as maritime rescue assistance. They have also made it clear that they are in consultation mode and would welcome suggestions as to how the substantive content of the initiative should be developed. Sri Lanka's excellent relations with China, which goes back to the Rubber-Rice Pact (1952), provides a valuable opening for Sri Lanka to work out how best it can benefit from

China's initiative. Through this article, the Pathfinder Foundation (PF), seeks to initiate a discourse on how Sino - Lanka economic relations should be structured to maximize the benefits for this country through this initiative.

Since the end of the war, the Chinese have played a major role in supporting the government's very extensive infrastructure development program, including the Hambantota Port, Mattala Airport, the Katunayake – Colombo Expressway, segments of the Southern Highway and the Outer Colombo Circular Road, as well as the Norochcholai power plant. These large scale projects have been financed through loans received from the China Development Bank and the EXIM bank of China. There has also been equity investment in the Colombo South Port Expansion. The Northern Highway is being developed on a PPP basis. In addition, the Colombo Port City and Lotus Island (Hambantota) are other major developments with equity-like characteristics (no loans involved; instead reclaimed land has been given to the developers). As the headroom for further foreign commercial borrowing becomes more constrained, it is in the mutual interest of both Sri Lanka and China to shift from loans to equity, including PPPs.

In this connection, it is important to note that China today is in a similar situation to Japan in the 1980's. At that time, Japan revalued the Yen following the G7's Plaza and Louvre Accords. In addition, domestic costs, including labour were rising rapidly. This prompted the Japanese to initiate a systematic process of exporting capital on the back of a strong Yen and massive foreign reserves. At the center of this was the Asian industrialization program. Four countries were chosen as production platforms: Indonesia, Malaysia, Sri Lanka and Thailand. Sadly, Sri Lanka lost this opportunity due to the escalation of the conflict. However, the development trajectory of the other three countries experienced a step-jump. Japanese FDI – driven exports were a major explanatory factor for the success of these economies.

Though Sri Lanka lost out on that occasion, the opportunity now exists to take advantage of the current situation in China. The Yuan is appreciating steadily and it is expected to get stronger as this is an integral component of China's strategy to rebalance its economy from external to domestic demand. In addition, domestic costs, including wages, are rising. The Chinese authorities have begun encouraging Chinese enterprises, which are experiencing competitiveness challenges, to go abroad. Sri Lanka is well positioned to take advantage of this opportunity. The excellent relations between the two countries would provide potential Chinese investors with a conducive background landscape. In addition, with the finalization of the FTA with China, which is expected early next year, Sri Lanka will have preferential access to a market of 2.5 billion people (due to the FTA's with both China and India). This would provide Chinese companies with incentives to locate in Sri Lanka both to sell into the Indian market using the Indo-Lanka FTA and sell back into their domestic market using the Sino-Lanka FTA. Another dimension of the positive investment climate narrative would be the soon to be introduced commercial hub legislation which would create entrepots at Hambantota port and Katunayake airport, as well as bonded areas. This would enable potential Chinese investors to operate in an offshore environment that would be extremely conducive for FDI – driven exports.

However, it is important to recognize that Sri Lanka is no longer a low labour cost investment destination. It can't compete with the likes of Bangladesh, Cambodia and Laos on that front. It is important, therefore, to identify niches of higher value exports where this country can become competitive. Noritake and Colombo Dockyard are good examples of such product lines developed in the past. It is also important to recognize that labour is already a significant constraint (see PF Economic Alert Number 56. Training and skills development should be geared to support a major Chinese investment drive into the country. China's competitive advantage is in manufacturing. Developing the human resources necessary for light-engineering would, therefore, be a pre-requisite for attracting Chinese investors who are moving offshore. In this connection, it must also be pointed out that it is not necessary to focus only on finished goods. As the PF has pointed out in the past, Asian intra-firm trade is the most dynamic component of the international trading system. Hence, an important aspect of the way forward is to take advantage of Chinese FDI to create capacity to plug into the supply chains of companies (domestic and foreign) operating in China and India, utilizing the FTA's with the two countries.

A Win-Win Scenario

Chinese FDI can have a transformative impact on Sri Lanka's development prospects in the same manner that Japanese FDI benefited Indonesia, Malaysia and Thailand in the 1980's. However, with low cost labour no longer an advantageous domestic endowment, Sri Lanka needs to be 'smart' about creating the conditions that are conducive for Chinese investors who are hard-nosed in their search for returns on their investment. Excellent bilateral relations at the political and cultural links are not enough. Equity is also different from contracts for large projects backed by Chinese loans. Sri Lanka has to provide a competitive investment platform to benefit from a wave of Chinese FDI. The FTAs with India and China, along with the commercial hub legislation, is an encouraging start. However, issues related to availability of skilled labour, land for industrial parks and efficient services need to be worked upon. The new silk route initiative can be the basis for a major Chinese initiative to export capital to friendly countries like Sri Lanka, thereby bringing about win-win outcomes. Sri Lanka would mobilize much needed FDI and the Chinese would be able to meet the twin objectives of relocating uncompetitive domestic industries and recycling their enormous reserves in an advantageous manner.

This is the Fourth article in the series of China Watch. Readers' comments are welcome at www.pathfinderfoundation.lk

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