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Ocean of debt? Belt and Road and debt diplomacy in the Pacific

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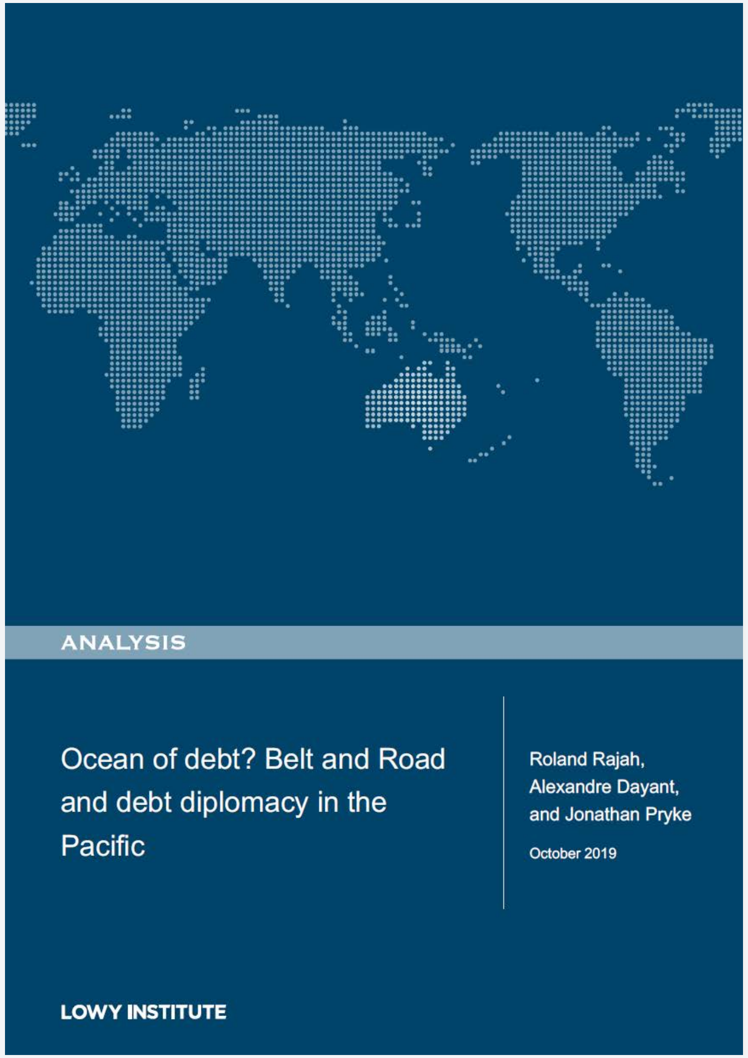
Debt diplomacy and sustainability in the Pacific

- Based on new Lowy Institute research paper: *"Ocean of debt? Belt and Road and debt diplomacy in the Pacific"*
- Leveraging unique data from the Pacific Aid Map
- A systematic and evidence-based assessment of China's debt practices in the Pacific as well as Australia's own new infrastructure lending plans



Defining 'debt trap' diplomacy?

'Debt trap' diplomacy = purposely pushing countries into debt sustainability problems so as to extract geopolitical concessions in exchange for debt relief

Debt sustainability = the ability to service public debt without debt relief while avoiding economic instability or painful fiscal adjustment

E.g. Hambantota Port – Chinese state firm gained majority equity stake to operate a strategically located Sri Lankan port on a 99-year lease after the country ran into debt sustainability problems (*Note:* debatable whether this really is an example of debt trap diplomacy though)

Prima facie reasons to be concerned #1 – global story around BRI raises obvious questions

Lack of transparency:

- China does not report aid to OECD or bilateral lending to other bodies
- Horn et al (2019) finds that half of Chinese overseas lending is ‘hidden’

Large scale lending planned for BRI

- Initial talk of trillions of dollars

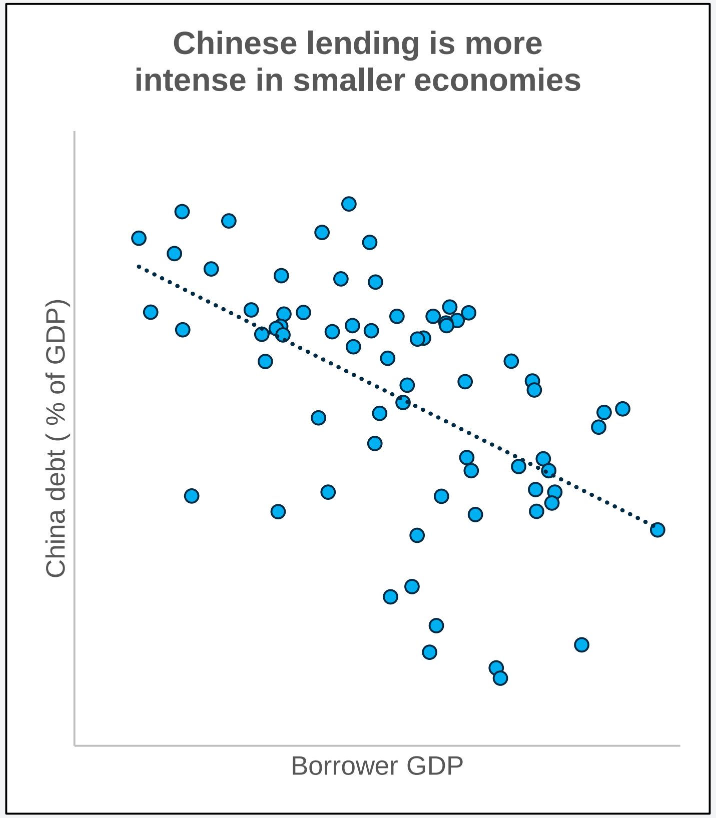
Mostly provided on non-concessional or commercial terms

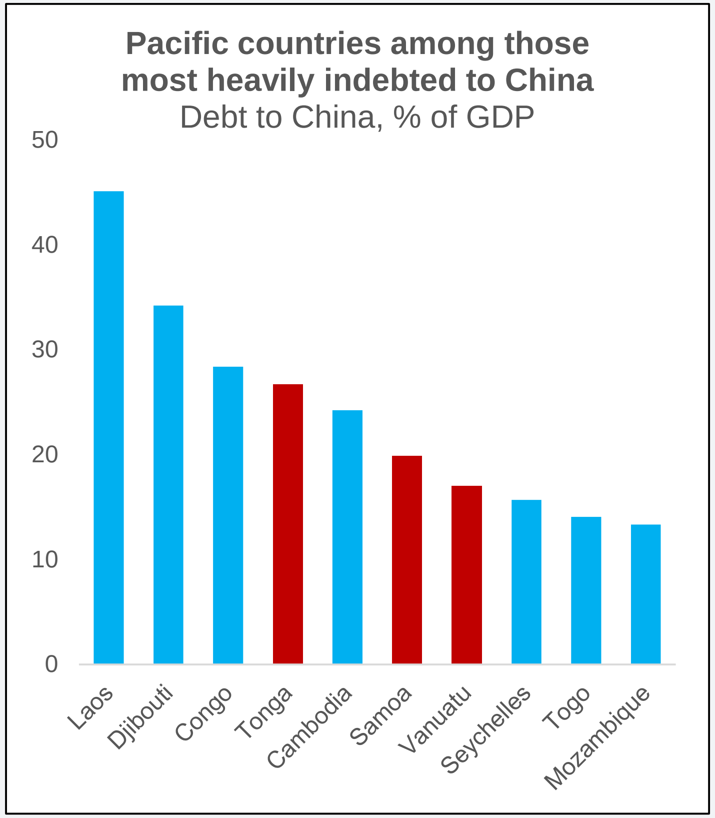
- E.g. AidData finds OOF-like flows account for about 75% of total

Other BRI debt studies:

- CGD (2018) find 8 countries at risk of debt problems due to BRI
- World Bank (2019) finds 12 at risk over medium term

Prima facie reasons to be concerned #2 – Pacific nations are especially vulnerable





Pacific countries especially vulnerable to debt sustainability problems

- Economic geography limits growth prospects
- Heavy dependence on narrow income sources
- High vulnerability to natural disasters
- Weak institutions hamper growth and economic management
- Very high development financing needs

Source: Government documents and IMF for Pacific countries; for all other countries, Cerutti and Zhou (2018)

Is China engaged in debt trap diplomacy?

If true, you might expect:

1. China to already be the primary driver behind worsening debt sustainability risks across the Pacific
2. China to be the dominant creditor or source of new loans in the Pacific
3. Chinese loans to be much more expensive than other official lenders
4. Chinese lending to be overly skewed towards countries already facing elevated debt risks

Has China been the primary driver behind rising debt risks?

- Rely on IMF debt ratings – point to high and worsening risks across the Pacific
- But China is not an active lender in many
- Among others, lots of other things going on:
  - ➢ Economic mismanagement
  - ➢ Big natural disasters
  - ➢ Changes to IMF methodology exaggerate degree of deterioration

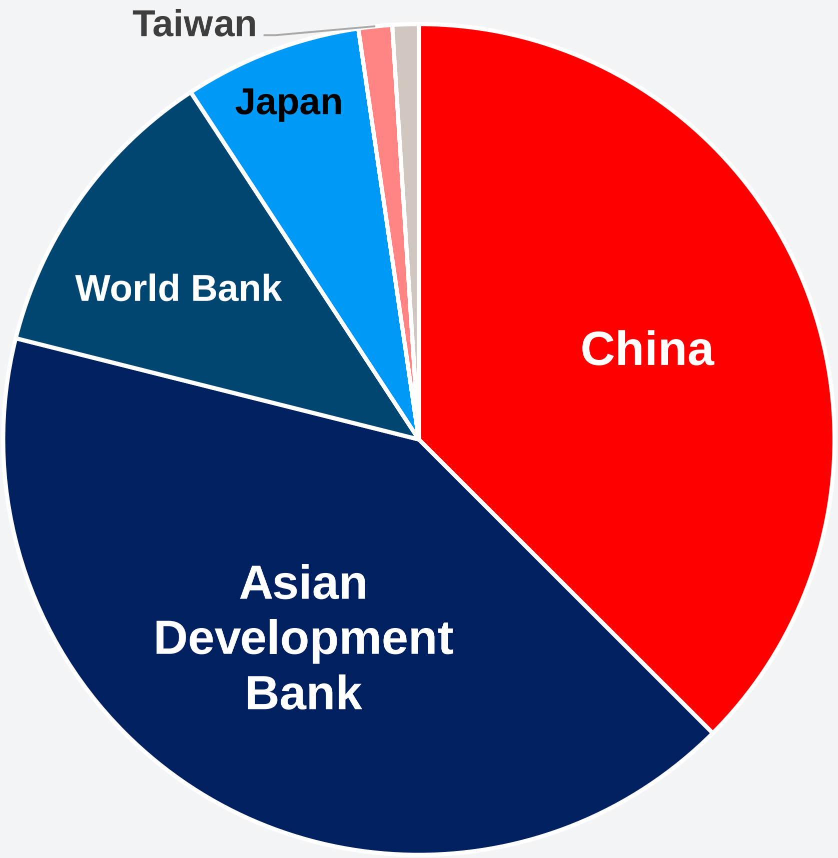
	2011	2012	2013	2014	2015	2016	2017	2018
Kiribati	High	High	High	High	High	High	High	High
Marshall Islands	No DSA	No DSA	High	High	High	High	High	High
Micronesia	No DSA	No DSA	High	High	High	High	High	High
Solomon Islands	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate
Tuvalu	No DSA	High	High	High	High	High	High	High
Nauru	No DSA	No DSA	No DSA	No DSA	No DSA	No DSA	Sustainable	Sustainable
Palau	No DSA	No DSA	No DSA	Low	Low	Low	Sustainable	Sustainable
Fiji	Sustainable	Sustainable	Sustainable	Sustainable	Sustainable	Sustainable	Sustainable	Sustainable
Papua New Guinea	Moderate	Low	Low	Low	Low	Low	Moderate	Moderate
Samoa	Low	Moderate	High	High	Moderate	Moderate	High	High
Tonga	High	High	Moderate	Moderate	Moderate	Moderate	High	High
Vanuatu	Low	Low	Low	Low	Moderate	Moderate	Moderate	Moderate

Source: IMF Article IV Staff Reports

Has China become a dominant lender in the Pacific?

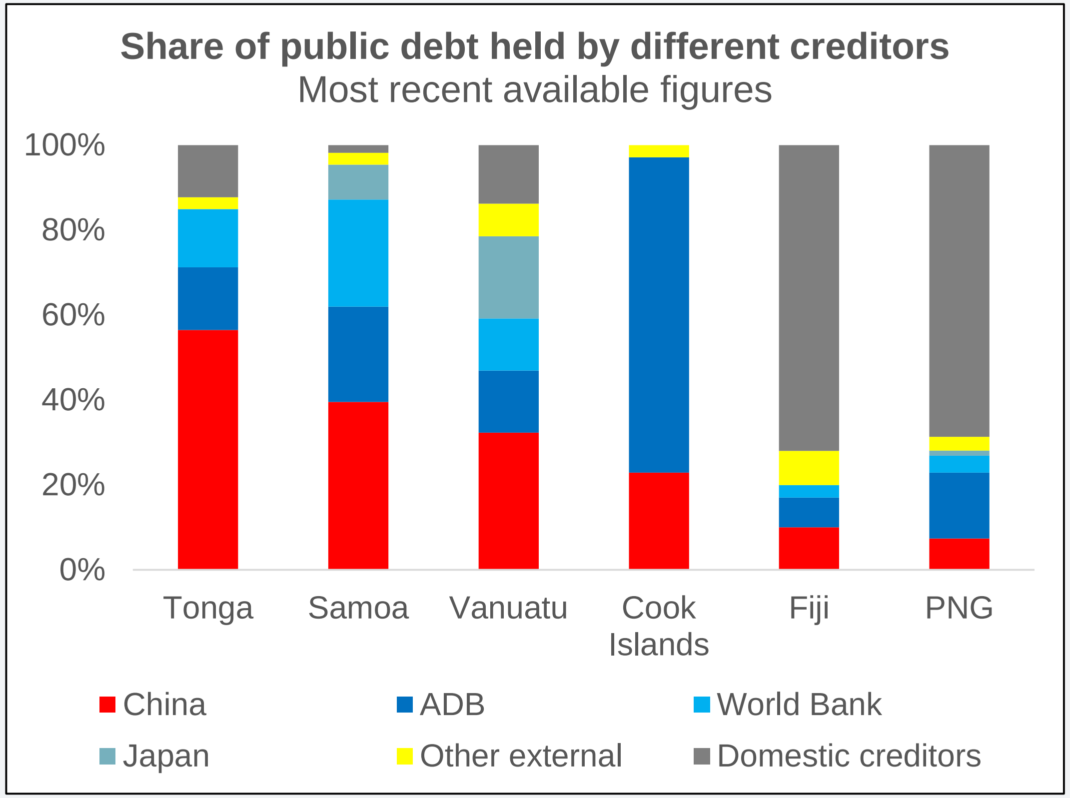
Over 2011-2017:

- China has been a major lender
- But the ADB is still the single largest
- Traditional donors (ADB, WB, Japan) still provide >60% of all new loans
- Pacific still has plenty of options following traditional global standards



Source: Lowy Institute Pacific Aid Map

A similar picture in terms of holdings of existing debt



- China holds > half of all debt in Tonga
- But elsewhere traditional donors and domestic creditors are more important
- (China is not an active lender in other Pacific countries not shown here)

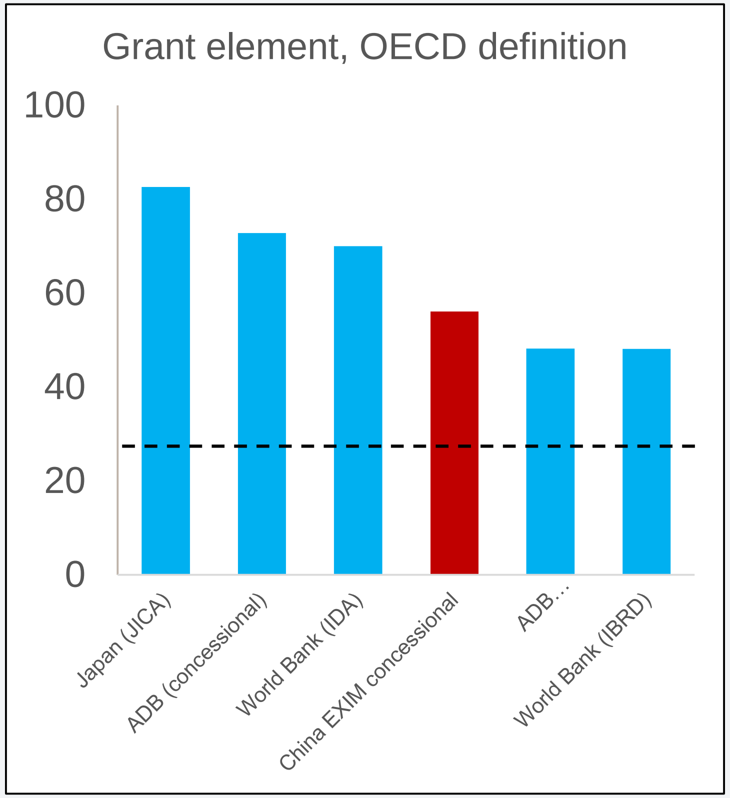
Source: Government budget documents, IMF

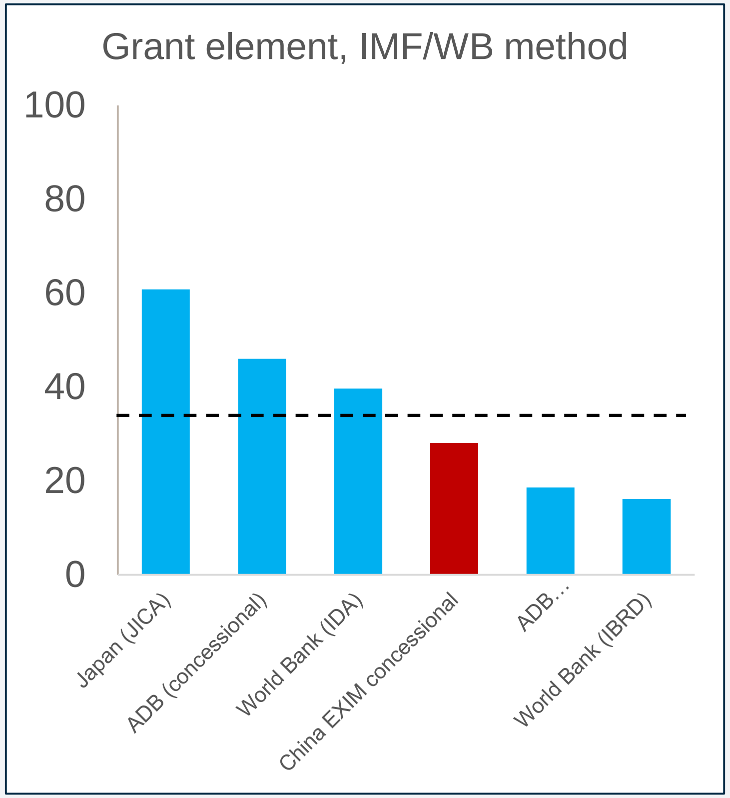
Are China’s lending terms too expensive or even predatory?

- Global studies suggest most Chinese official lending is on commercial terms
- But in Pacific a different picture – 97% of Chinese loans have been concessional EXIM loans
    - 2% interest rate, 15-20 year maturity, 5-7 year grace, denominated in RMB
- Are these terms sufficiently concessional? Apply the OECD criteria for ‘official development assistance’ (i.e. aid)

Are China’s loans sufficiently concessional?

- China’s loans are concessional by OECD
- Middle of pack compared to other major lenders
- But not necessarily concessional enough
- Do not meet stricter IMF/WB standard for countries already at risk

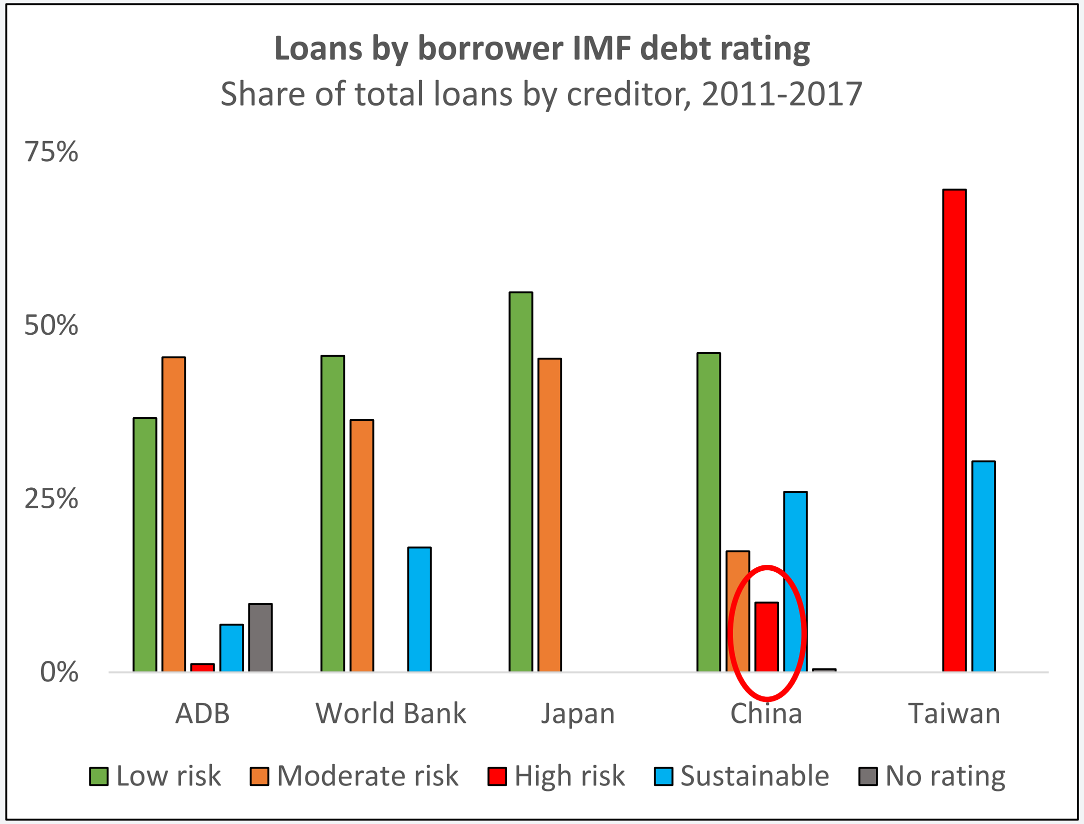




Source: Author’s calculations

Is Chinese lending skewed towards high risk countries?

- Matched loans in the Pacific Aid Map with the IMF debt rating at the time
- Confirms some problematic aspects - 10% of loans to high risk countries
- But: China doesn't look that bad
  - ➢ 90% of its loans broadly sustainable
  - ➢ Taiwan a much more significant outlier



Source: Lowy Institute Pacific Aid Map, IMF Article IV Staff Reports, author's calculations

So, is China engaged in debt trap diplomacy?

If true, you might expect:

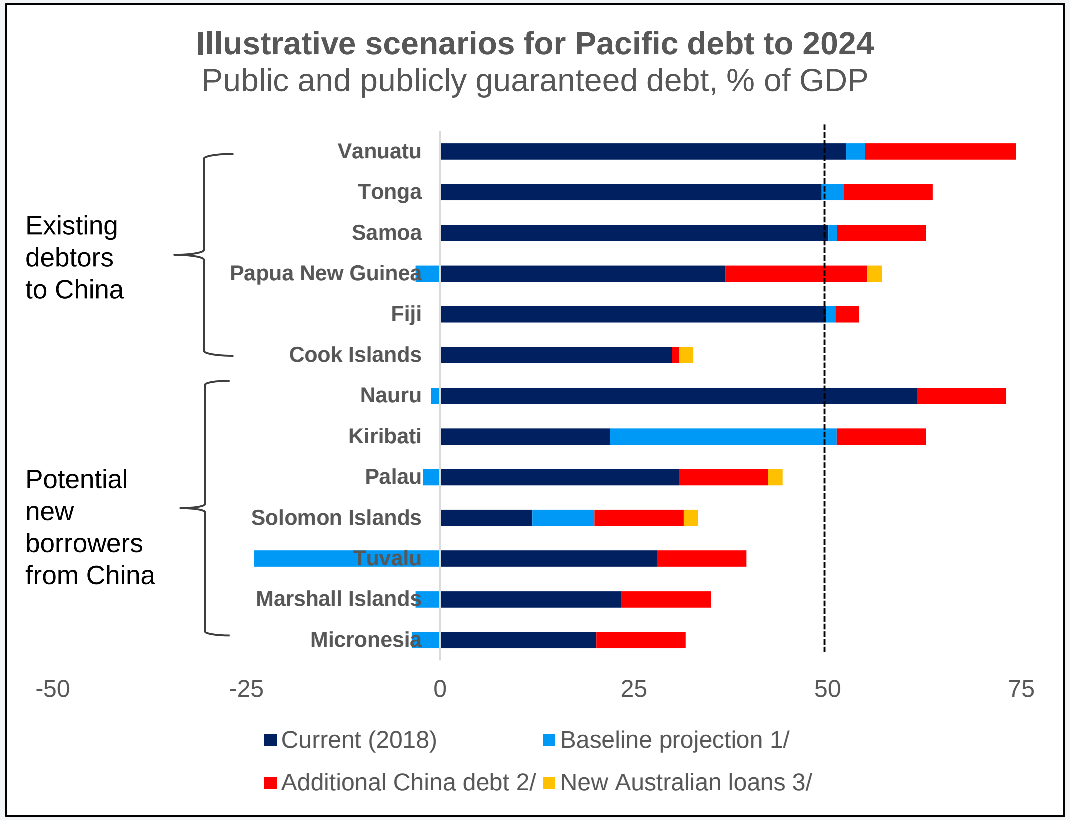
1. China to already be the primary driver behind worsening debt sustainability risks across the Pacific – *Not true*
2. China to be the dominant creditor or source of new loans in the Pacific – *Not true*
3. Chinese loans to be much more expensive than other official lenders – *Mostly not true*
4. Chinese lending to be overly skewed towards countries already facing elevated debt risks – *Mostly not true*

BUT: *China's track record still points to future risks*

Assessing future debt sustainability risks

- Conduct similar exercise to BRI debt studies by World Bank and CGD
- Project out future debt levels over next 5 years under a BAU scenario for Chinese lending as well as if this were similarly expanded to additional Pacific countries
- Compare this to a simple debt warning indicator of 50% of GDP
- Also incorporate new Australian infrastructure lending plans under DFAT and EFA

Assessing future debt sustainability risks



Several Pacific nations would be at risk

- ➢ Notably Vanuatu, Tonga and Samoa
- ➢ PNG and Fiji breach warning threshold
- ➢ Kiribati and Nauru also would be at risk

Scope for sustainable Australian lending

- ➢ Relatively modest scale
- ➢ Use of clear sustainable lending rules
- ➢ Though not that concessional – raises questions about competitiveness v China

Source: author's calculations, Lowy Institute Pacific Aid Map, IMF

Policy implications

- China will need to significantly restructure its approach to avoid causing debt sustainability problems or fulfilling the ‘debt trap’ accusations of its critics
- China appears to be taking debt sustainability more seriously – e.g. commitments at the G20
- But this needs to be properly operationalised. China should adopt clear sustainable lending rules to better protect the debt sustainability of borrowing countries.
- Australian lending plans look sustainable, largely as it remains modest in size. If Australia wants to do more, it should increase the size of its overall aid budget.
- Competitive donor landscape might allow Pacific to push for more favourable financing
- Big risk is geopolitically-driven aid undermines incentives for reform and good governance

Thanks for listening!

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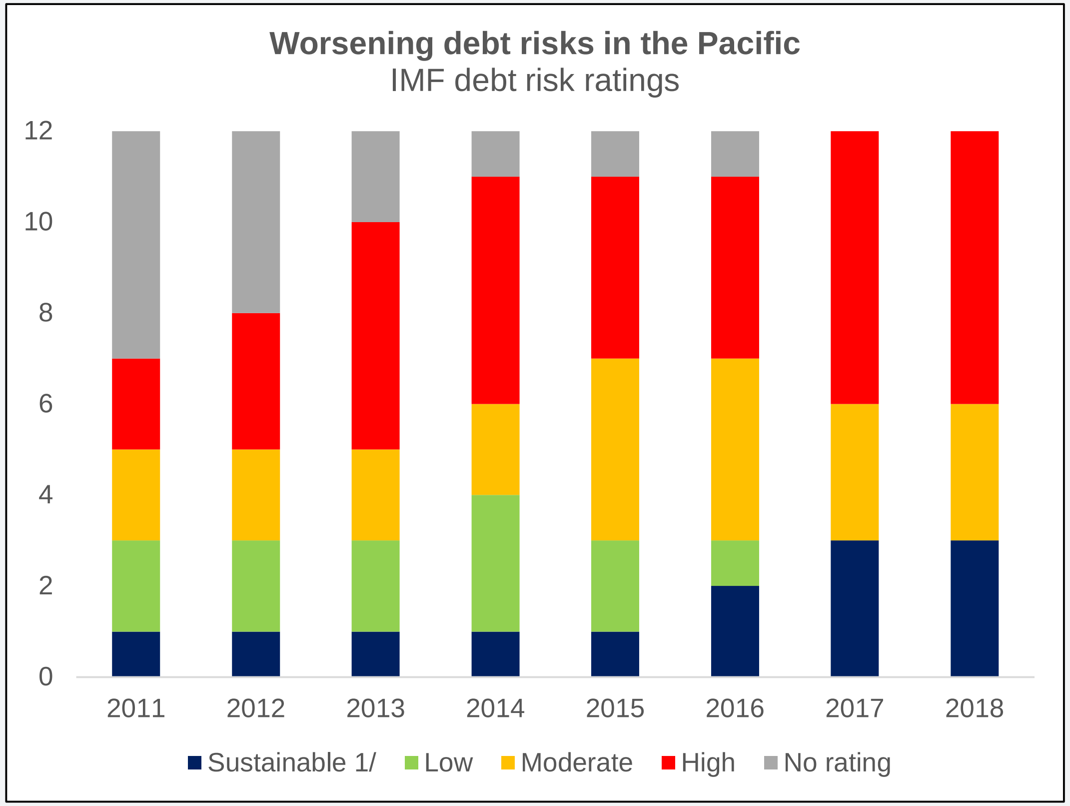
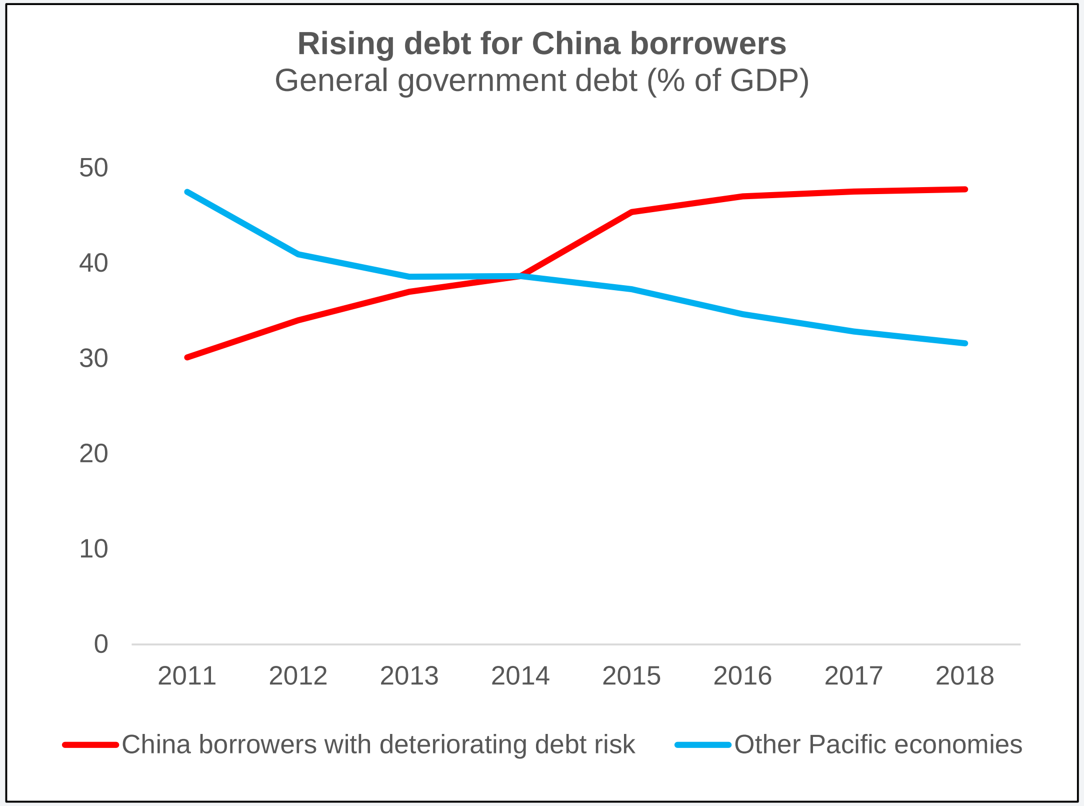
Prima facie reasons to be concerned #3 – debt and debt risks have been rising in the Pacific





Source: International Monetary Fund Article IV staff reports

Source: International Monetary Fund *World Economic Outlook* database

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Note: we focus on ‘pure’ debt sustainability issues

We do not directly incorporate the quality of projects:

- Weak link between infrastructure investment and growth in Pacific
- Implies debt impact more analogous to general deficit financing
- Whether a bad project endangers debt sustainability depends on loan size, borrowing terms, + broader debt position – i.e. things we directly examine

We do not examine issues of corruption:

- Though important it is a more general concern not specific to debt
- Important to delineate between different channels of Chinese impact – in this case debt sustainability rather than corruption