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Understanding Debt and Diplomacy

China, 'Debt Traps' and Development in the Global South

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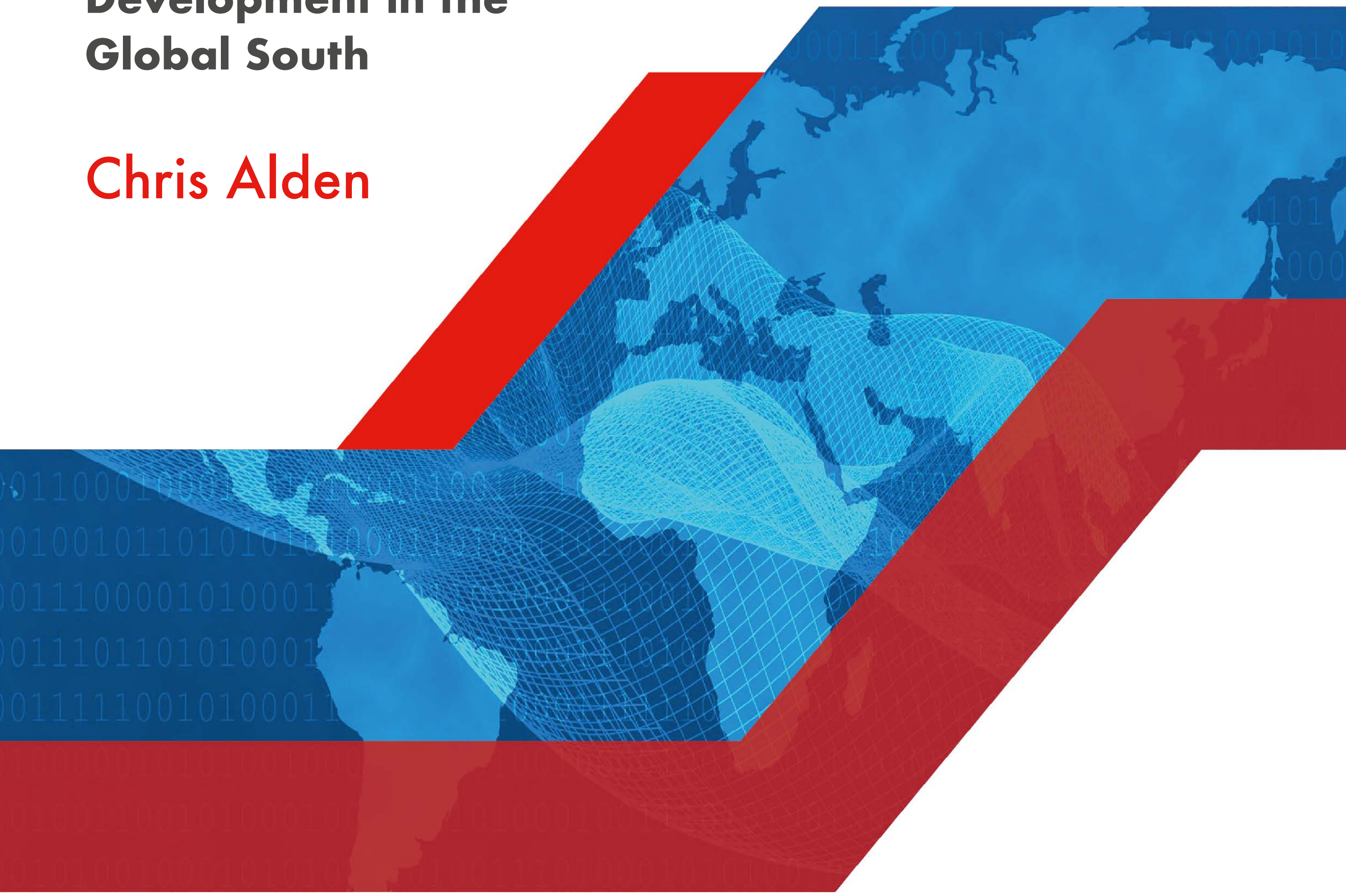

ABSTRACT

China, held up as an unabashed supporter of non-conditional finance for rapid development in the Global South, is accused by the US government and other Western leaders of using massive loans to saddle developing economies with unsustainable debt, seemingly playing to Beijing's foreign policy goals. Citing examples as wide-ranging as Sri Lanka and Kenya, critics contend that unrestricted borrowing—the keystone of Chinese influence in many parts of low-income developing and emerging countries—undermines prospects for sustainable development and even is a deliberate policy tool to acquire strategic assets in these countries.

The use of development assistance in the form of loans, grants, and other forms of economic engagement with another country is characterised by International Relations scholars as 'economic statecraft'. Understanding the general use of debt as an instrument of economic statecraft, as well as its appropriation and application by China in the emblematic cases in Global South, is crucial to any assessment of its significance for Latin America and the Caribbean. This policy brief, therefore, explores the historical and contemporary context of debt-trap diplomacy, its application as part of China's economic statecraft and, finally, assesses the significance of development finance and debt for the region.

The spectacle of debt-trap diplomacy, the deliberative use of development finance to entrap economies with the aim of advancing foreign and economy policy objectives, is once again haunting the world. China, held up as an unabashed supporter of non-conditional finance for rapid development in the Global South, is accused by the US government and other Western leaders of using massive loans to saddle developing economies with unsustainable debt, seemingly playing to Beijing's foreign policy goals. Citing examples as wide-ranging as Sri Lanka and Kenya, critics contend that unrestricted borrowing—the keystone of Chinese influence in many parts of low-income developing and emerging countries—undermines the very prospects for sustainable and sovereign development that Beijing purports to support. Moreover, the cost of alleviating such debt burdens has led to, as the Sri Lankan case apparently demonstrates, Beijing's acquisition of a 99-year lease for one of the country's strategic ports.

The use of development assistance in the form of loans, grants, and other forms of economic engagement with another country is characterised by International Relations scholars as 'economic statecraft' (Norris 2016:13-14). Put another way, debt-trap diplomacy is one of a number of approaches that states employ to achieve foreign policy aims through the active application of positive and negative inducements (Matsanduno 2012). Positive inducements include financial assistance, as indicated above, as well as policies such as trade incentives and preferential market access; negative inducements focus on restricting financial flows to the target country, limiting access to markets, and other punitive economic actions falling under the heading of sanctions.

Understanding the general use of debt as an instrument of economic statecraft, as well as its appropriation and application by China in the emblematic cases in Global South, is crucial to any assessment of its significance for Latin America and the Caribbean. This policy brief, therefore, explores the historical and contemporary context of debt-trap diplomacy, its application as part of China's economic statecraft and, finally, assesses the significance of development finance and debt for the region.

I. THE DEBT TRAP DEBATE IN HISTORICAL PERSPECTIVE

There are many cases of countries in the 19th and early 20th century, the high-water mark of European colonialism and imperialism, using debt-funded infrastructure projects to embark on rapid modernisation. For instance, the French-led design and construction of the Suez Canal—which involved the issuing of £3.3 million's worth of Egyptian bonds in 1863 on behalf of the Egyptian Khedive, as well as his commitment to provide labour and a 99-year operational lease to the French firm—took ten years to complete (Toussaint 2016). This 'build, operate and transfer' (BOT, to use today's parlance) agreement, involving a million local labourers, ran dramatically over budget and required raising additional capital, ultimately saddling the Egyptian government with massive debt. As bankruptcy loomed, the Khedive was obliged to sell the Egyptian government's shares in the Suez Canal, turning to British and French banks to meet long and short-term loan contingencies at inflated interest rates. To meet its mounting debt obligations, the Egyptian government was forced to accept unfavourable payment terms including hikes in tax revenues as imposed through the Public Debt Fund (a committee of creditors) (Toussaint 2016). As a result, from 1875 to 1885, the country endured a series of economic crises contributing to the widespread social unrest that ended with British military intervention, the overthrow of the Khedive, and Anglo-French control over public finances and key institutions.

Closer to home, many Latin American countries in this period borrowed heavily from European and later US sources to fund capital projects like railroads, canals, and port modernisation. Cyclical dependency between Latin American government borrowers and European and US banking creditors contributed to a series of crises running from 1820 through to the 1930s Great Depression (Marichal 1989). The City of London's considerable role in financing railways, modernisation of ports, and other infrastructure projects in the economies of Argentina, Brazil, and Chile in the 19th century earned the region the appellate as Britain's 'informal empire' (Gough 2014). Fluctuating commodity prices, inflationary pressures, and collapsing local currencies were among the causes of the surge in national indebtedness of which Western creditors took advantage to carve out concessions and market share in Latin America. Governing elites—'gentlemen capitalists'—and ministries played a key role shaping British imperial strategy during this period, managing expansion and ultimately staving off decline (Cain and Hopkins 2016). Nevertheless, historians still debate the extent to which Western imperialism was motivated by colonialist aspirations and imperialist intentions throughout, with some cases clearly documented as deliberative tools of market and territorial expansion; other cases, seemingly driven by patchwork of parochial interests, were disconnected from nationalist policy aspirations. Irrespective of these debates on intent, such actions nonetheless ended in favourable commercial and political concessions or outright territorial acquisition by Western powers on a global scale (Jones 1980; Marichal 1989; Dumett 2014).

During the Cold War, and after the twin oil shocks of the 1970s and subsequent collapse of commodity prices that hung over the global economy through the 1980s, the possibility of Latin American debt default loomed large. Faced with massive exposure to a number of Latin American debtor countries, the US government took a hard line on repayment on market terms, seeking to hold off default through aggressive structural reform of Latin American economies in an effort to offset or recoup losses to US commercial banks. From the mid-1980s onwards, neo-liberalist tenets linked debt repayment to 'conditionalities' imposed by Western-dominated multi-lateral institutions like the International Monetary Fund (IMF) that focused on reducing public spending and privatising state-owned assets. In some cases, donor and multi-lateral conditionalities were later extended to governance criteria like electoral democracy. To address their debt obligations, debtor countries faced an unenviable set of choices ranging from debt rescheduling, suspension of debt repayments, threats of debt default, and outright defaults. Over time, creditor countries increasingly recognized these options to be unsustainable.

The introduction of the US Treasury's Brady Plan in 1989, a managed programme of debt rescheduling coupled to fiscal measures, marked a recognition on the part of the US policymakers of the limits to this approach (Sachs 1989; Silva Dalto 2019). Innovative policies such as reducing the value of debt, collateralising debt, and repurchasing debt on secondary markets were all encouraged. Nevertheless, while the Brady Plan staved off sovereign defaults and re-established regular debt payments, it produced persistent low growth in Latin American economies. This compounded the region's decade long inability to attract foreign capital, the continuing transfer of domestic savings to service interest repayments, and the danger that all of this posed to newly established democracies (Foxley 1987: 90-94).

During this period, debt forgiveness was traditionally avoided unless it was tied to diplomatic considerations (allies or related externalities) for the implicit moral hazard it created. Towards the end of the 1990s, however, high-profile diplomacy, alongside media and social campaigns, pressured governments to embark on a wave of bilateral and multilateral debt write-offs for highly indebted poor countries (HIPC). This erasure of sovereign debt set the stage for the economic take-off experienced by low-income developing and emerging economies in the first decade of the 2000s (World Bank 2018).

II. CHINA AND DEBT FINANCING OF DEVELOPMENT

China's position as a provider of global development finance is, alongside the booming two-way trade, the most significant and visible form of its economic engagement in Latin America and the Caribbean. The state and its institutions, under the guidance of the Chinese Communist Party (CCP), broker loans with governments and implement these debt-financed development projects principally through state-owned enterprises (SOEs). The profile of Chinese development finance, it should be noted, is focused almost exclusively on trade provisions (export credits etc.) and infrastructure or infrastructure-related projects, though this is beginning to change with its lending portfolios shifting slightly towards services (Weinland 2018). Given that the CCP's mandate to rule is inextricably tied to its ability to deliver continuous economic development and prosperity at home, the drivers of development finance are firmly aligned with achieving these overarching aims and accompanying interests (Norris 2016: 19-20).

The principal instruments for development finance are the policy banks—the China Export-Import Bank and China Development Bank (CDB)—that draw from Beijing's three trillion dollars in foreign reserves to meet their capital requirements. Preferential or concessional terms feature in some of the loans but, as pointed out by analysts, the bulk of lending is at near commercial or even commercial rates (Brautigam 2009). Furthermore, as conditionalities attached to Chinese loans require the use of Chinese firms to carry out projects, the Ministry of Commerce (MOFCOM) plays a crucial role in the tendering of contracts for construction and project-related implementation. SOEs, which provide the bulk of contracted implementation, are themselves under the oversight of the State-owned Assets Supervision Commission (an agency within the State Council). Norris contends that, despite formal state control, there is a strong degree of autonomy visible in the conduct of SOEs (Norris 2016). The Ministry of Foreign Affairs (MOFA) provides input into risk assessment for proposed projects and related diplomatic concerns in the course of negotiations and project implementation, while Sinosure, another state body, insures lending against everything from trade disruption to sovereign default. The China International Development Cooperation Agency (CIDCA), established in 2018 out of the Department of Foreign Aid in MOFCOM, is mandated to develop and coordinate aid strategy and implementation (CIDCA 2020). These organizations all operate under the auspices of the State Council, whose oversight committees ensure that processes and conduct conform with government regulations.

The creation of a host of financial institutions associated with the Belt and Road Initiative (BRI) such as the Asian Infrastructure Investment Bank (AIIB), has added complexity to the picture, but they are largely focused on Eurasia and Southeast Asia with little actual lending in Latin America to date (Mendez and Turzi 2020). The BRICS (Brazil, Russia, India, China, and South Africa) grouping's New Development Bank does operate in one Latin American member state, Brazil, but has not yet evolved to finance projects in non-member states.

Recent World Bank assessments of BRI lending found that, on average, Chinese loans to low-income developing countries (LIDCs) have a fixed interest rate with a median rate of two percent, a grace period of six years and a maturity of 20 years, while loans to emerging markets (EMs) fluctuate between 12 and 18 years with a grace period between three and five years (Bandeira and Tsiropolous 2019: 9). Overall, this tranche of loans in the first two decades of China's lending are higher than concessional rates, bordering on being commercial loans with limited flexibility. More recently, there is evidence that interest rates on loans to EMs are becoming more flexible and benchmarked to the six-month LIBOR rate.

China's position as a creditor is an unfamiliar one for Beijing and, unlike Western governments with many decades of experience in the post-WWII order, holds risks at the firm, institutional, and reputational levels. Indeed, the rapid expansion of the 'debt-trap diplomacy' discourse is testimonial to the inherent reputational dangers of being a creditor state in the development sphere. So far, Beijing's approach to debt has been cautious, with the CCP seemingly uncertain as to how to tackle this issue, while resolving payment shortfalls by clients and retaining maximum latitude for action. In managing the debt question, a number of options are available, some of which—such as debt restructuring, debt forgiveness and debt-for-equity swaps—China has already tentatively broached.

Debt restructuring is one option that Beijing has pursued to handle recipient countries' debt distress. This is reportedly the approach China has adopted towards some outstanding payments on dollar-denominated loans by oil-rich countries in Africa (Cameroon, Chad, and the Republic of Congo) and Latin America (Venezuela and Ecuador), which were compromised by the sharp fall in commodity prices, though only selective public details on these arrangements are available. As the case of Venezuela illustrates, however, loans tied to a prescribed volume of oil exports at a fixed price and sold onto Chinese SOEs are expected to be made up when market prices fall below that price by providing additional exports to the SOEs (Ezrati 2019). When Venezuela was unable to meet the additional export requirements in 2016 and 2018, Beijing was forced to extend 'forbearance arrangements' which in effect placed additional debt obligations on Venezuela linked to the price of US treasury bonds. This sort of debt refinancing is another possible means of addressing debt distress in this situation, as it provides short-term arrangements to debtor countries experiencing payment difficulties, but their success depends on the underlying economic conditions for debtor countries changing. The dilemma for China is that evidence from cases in Africa and Latin America suggests that this alone does not resolve the fundamentals involved in debt distress but rather merely prolongs it at a greater cost to both creditor and debtor countries.

Debt reduction and outright cancellations, following from the examples offered by traditional donors, are often featured as part of larger financial packages promoted by Beijing. These are, at least as applied in specific cases to date, financially insignificant but legacies of Maoist-era borrowing practices: They are of symbolic value to both countries and set the stage for a new cycle of borrowing. Debt write-offs in the current cycle, however, are less frequent and, so far, have only applied to interest-free loans representing less than 10% percent of Chinese development financing between 2010-12; grants and concessional loans in the same period consisted of 36.2 percent and 55.7 percent, respectively (State Council of China 2014). Mozambique's default in 2017 caused China, when faced with this fait accompli, to write-off four loans (Macauhub 2017). This may represent a new trend.

Other options that would potentially lower the overall cost to debtor countries—such as repayment of liabilities in renminbi—are available to Beijing as well. Linkages between development finance, investment, and unpaid debt obligations can also effectively impose restrictions on financial transfers (Machiti 2019). In Zimbabwe, a Chinese investor was unable to transfer investment funds from Chinese banks in 2019 due to an outstanding $60 million debt to Sinosure (Makichi 2019). And, most controversially, there is the possibility of debt-for-equity swaps, with the case of Sri Lanka's Hambantota port serving as the most egregious example of this, as detailed in the next section.

III. CHINA, SRI LANKA AND 'DEBT-FOR-EQUITY' SWAPS

In July 2017, the Sri Lankan government and CMPort (China Merchants Port Holdings Company), a state-owned Chinese company, signed an agreement granting the latter a 99-year lease of the Hambantota harbour and 15,000 acres of land in exchange for $1.2 billion (Abi-Habib 2018). The construction of the harbour, which began under then-Prime Minister Mahina Rajapaksa with the $307 million CDB loan in 2008 and further $757 million loan in 2012 (reportedly at a non-concessional 6.3 percent interest), had been undertaken by the China Harbour Engineering Company (CHEC) and Sinohyro (Abi-Habib 2018). Despite feasibility studies initially questioning the commercial value of the port, citing no significant traffic at the port or even adjacent airport, construction continued until the newly-elected government came into office (Hillman 2018). Faced with a national debt burden of $51 billion (78 percent of GDP) and little prospect for generating sufficient revenue to repay creditors, the government decided to hand over the Hambantota harbour to CMPort in a 'debt-for-equity' swap made in part to alleviate the country's overall debt burden (of which Chinese-held debt is 10.6 percent) (Central Bank of Sri Lanka 2017; Daily Financial Times). By this time, however, local communities and NGOs raised alarm that the Chinese-led special economic zone mapped out over their land as part of the 15,000-acre deal would force them to relocate and have significant environmental costs in the area (TheThirdPole. Net 2018).

Public disclosure of the Sri Lankan debt-for-equity swap touched a raw nerve across the world, giving rise to speculation as to what might happen in other countries with Chinese-funded and constructed infrastructure projects such as in Djibouti, Mombasa (Kenya) or Sihanoukville (Cambodia) (South China Morning Post 2018; Huang 2018; Cambodia Constructors Association 2019). US officials embroiled in heighted trade tensions with China were quick to capitalise on this case as an infringement on sovereignty and, hinting darkly, at an underlying strategic purpose to Chinese-funded infrastructure (Pompeo 2018). World Bank studies concluded that a third of Chinese lending in the context of the BRI is to 'debt-distressed' low-income countries (Bandeira and 2019: 10), underscoring these concerns.

Common to most if not all of the Chinese-funded large-scale infrastructure projects was the lack of transparency, provisions for tied aid to Chinese firms, as well the absence of credible environmental impact assessments and poor consultation with local communities. Some of the blame, as scholars have pointed out, rests with the local government that negotiates the terms of the loan agreement and does not insist on independent assessments or engage in local community outreach (Alden 2007; Brautigam 2009). For instance, China's proposed upgrading of Costa Rica's Moín oil refinery, which officials in the Arias government had supported, was blocked by the courts in 2014 when it was disclosed that feasibility studies were produced by a subsidiary linked to Chinese oil company interests and overstated profit margins (Ortiz 2014). Similarly, Jamaica's $1.5 billion transhipment port to be financed with Chinese-backed loans and built by CHEC was, after public announcements in 2014, shelved two years later due to lack of transparency and environmental concerns (Jamaica Observer 2016). Further afield, countries like Malaysia, once celebrated for their participation in the BRI through China's development financing of major infrastructure project, against a backdrop of deepening debt distress and corruption charges suspended and renegotiated its $20 billion infrastructure project with Beijing in October 2018 (Bandeira and Tsiropoulos 2019: 2).

Chinese diplomacy, though strident in its own official counter-reactions to Western government and media accounts, has tacitly acknowledged aspects of the 'debt-trap diplomacy' problem. First, officials were taken aback by the unexpectedly negative reaction of developing countries to the use of 'debt-for-equity' arrangements which, though long a convention of corporate banking, was greeted by policy makers and publics as posing a fundamental infringement on sovereignty. They have sought to distance themselves from such practices and vigorously denied implied 'imperialist' intent. Second, Beijing increasingly recognises that Chinese loans for infrastructure development underwritten by commodity exports at a fixed price—far from guaranteeing steady loan repayments as envisaged—have actually introduced repayment instability through the loans' links with volatile swings in commodity prices. Developing a better means of underwriting risk has to become a priority. Third, it has become increasingly obvious that unrestrained borrowing by countries with a weak capacity to repay outstanding debt burdens was placing a growing strain on the balance sheets of Chinese policy banks themselves. Stricter review, leading to a more comprehensive approach to development finance, needed to be put into place.

At the 2019 BRI Summit, China's President Xi Jinping spotlighted the necessity of addressing debt sustainability, while the Ministry of Finance published Debt Sustainability Framework for Participating Countries of the Belt and Road Initiative in English. The policy document outlines a set of standards to ensure greater debt sustainability, including macro-economic projections for potential borrowers as well as assessments of risk, impact of public investment, and debt-carrying capacity (Ministry of Finance, PRC 2019). Notably, in contrast to the IMF, these measures do not include a blanket recommendation for lending at concessional rates nor do they rule out lending to countries experiencing debt distress conditions. The Chinese policy banks also sought to respond to lending risks, with the China ExIm Bank's chair and party secretary, Hu Xiaolian, declaring that they would in the future pursue 'higher quality' investment (the term 'investment' conflating loans and FDI) (Kenderdine 2018). This meant, accordingly, that stadiums, hotels and other classic Chinese infrastructure projects might no longer receive uncritical endorsement. Finally, the Chinese government began to encourage equity investment by Chinese SOEs and companies under the 'build-operate-own-transfer' formula as a means of transferring some degree of risk to them, in that way enhancing these firms' stake in the sustainable outcomes of lending (Wang Yi 2017).

China's declarative diplomacy on debt is welcome, of course, but will need to be followed up by concrete action from Beijing. In particular, steps will need to be taken to relieve the dire economic conditions confronting low-income and emerging market countries due to high levels of debt in the wake of a sustained drop in commodity prices, the slowdown produced by the US-China trade war, and the continuing economic impact of the coronavirus outbreak on the global economy. In the near term, the existing debt burdens inherited from the lending regime Beijing pursued for the first two decades of its role as a provider of development finance should be reviewed and measures taken to ease the payment obligations as part of achieving debt sustainability. The lack transparency in China's lending not only negatively impacts national development planning but introduces new risks to borrowing for these governments as potential lenders are unable to fully assess debt exposure (with the consequent deepening of reliance on credit from China as only sources willing to lend, presumably because of their insight into non-transparent bilateral debt conditions). Moreover, it impacts creditor-debtor relations more generally, undermining traditional practices of giving multi-lateral debt 'seniority' of repayments over that of bilateral debt—as a result introducing new elements of instability into the global financial system (Reinhart 2018).

Additionally, the underlying belief of Chinese infrastructure financing is that the gains from rapid infrastructure development will in itself be sufficient to fuel high growth rates, thus enabling countries to pay their way out of debt distress, is questionable. According to Bandeira and Tsiropolous' study, out of 43 countries, only eight EMs are expected to increase growth, as a result of BRI, 'to fully compensate for the estimated increased in BRI debt financing over the period 2019-2023' (Bandeira and Tsiropolous 2019: 21). If that is the case, and a global recession seems to ever more likely in the wake of the pandemic, then debt distress will increase and with it the burdens on debtors and creditors alike.

IV. CONCLUSION

China is beginning to develop the framework needed for a comprehensive external debt management system, including workable debt sustainability evaluation protocols and a uniform debt restructuring mechanism for external borrowers, but it has much further to go. There have been no stipulations relating to the circumstances in which loans may be advanced or the qualifications of debtors, nor any specific rules as to when and how to apply debt relief, refinancing, rescheduling or other arrangements (Alden and Jiang 2019). Furthermore, this definitional absence produces the kind of ad hoc, non-transparent response to debt restructuring needs that puts strains on China, its debtors, and the international financial system at large.

Coordination with other creditors and some alignment with their practices—especially as debt to China represents a component of a larger debt portfolio for virtually all low-income developing and emerging market countries—seems inevitable. Chinese officials have recently sought out Western expertise, attending the Paris Club as an observer and holding informal discussions with counterparts amongst the donor community. These steps seem to presage further policy change in China's development finance policy and debt management. But at the core of any such changes is the necessity of challenging the fundamentals of Chinese lending practices to date, in particular the absence of transparency. Without embracing open lending practices, these sub-optimal outcomes will persist, as will the Global South's inherent suspicions of China's intentions. ■

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