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Does China Engage in Debt-Trap Diplomacy?

According to the Washington-based Institute of International Finance (IIF)[1], the People's Republic of China (PRC) is the world's largest official creditor nation with its outstanding debt claims on the rest of the world totalling an estimated US$5.5 trillion in 2019 or more than 6 percent of global GDP (IIF 2019). However, given Beijing's very limited transparency in its disclosures when it comes to its external lending, and now its culpability in the spread of the deadly coronavirus, the accusation that the PRC has for years engaged in "debt-trap diplomacy"[2] has come under renewed scrutiny (e.g., Brautigam 2020; Chellaney 2017). Specifically, the charge is that the Chinese government, which is the world's leading creditor lending via its multi-billion dollar "Belt and Road Initiative" (BRI) as well as various state-owned and controlled entities, lures developing countries, its particular, the low-income countries with easy money to fund often economically unviable projects. Its ultimate goal is to get access to the borrowers' local markets and natural resources and indirectly to control or outright seize assets and resources, including extracting economic and political concessions when these countries fail to service their loans, which is often given at market or above market interest rates and carry shorter maturities, thereby requiring regular refinancing[3] (Wang 2019). Some critics even claim that Beijing, like the Trojan horse brings gifts which does irreparable harm to vulnerable and unsuspecting recipients who are forced to cede part of their sovereignty to an unscrupulously predatory authoritarian power (TRT World 2019).

However, Beijing's widening global reach may be nothing more than a rising power trying to expand and consolidate its economic, diplomatic, and geostrategic interests

[1] IIF is an association of the financial industry with over 450 members from more than 70 countries.
[2] To the best of my knowledge, the term "debt-trap diplomacy" was first coined by Brahma Chellaney, one of India's leading foreign affairs expert (see Chellaney 2017).
[3] In May 2019, Secretary of State Mike Pompeo criticized China for peddling "corrupt infrastructure deals in exchange for political influence," and using "bribe-fuelled debt-trap diplomacy" to undermine good governance (see Wang 2019).

commensurate with its growing capabilities. Given Beijing's huge, indeed excess, financial reserves, China's emergence as the world's banker should hardly come as a surprise. Arguably, the motivation behind Beijing's extensive lending and its unapologetically ambitious BRI is to allow China to more efficiently utilize its excess financial reserves by investing abroad, including consolidating the comparative advantage it enjoys in large-scale engineering and construction. Moreover, China's outbound investments not only enable Beijing to secure markets that can provide it with essential goods and resources but also fill deficiencies in developing country infrastructure, energy, agricultural sectors, which are welcomed as they provide much needed employment and help boost economic growth (Hurley et al. 2019). However, since lending and borrowing are inherently risky and occasionally go sour, it does not necessarily mean that some capricious debt-trap diplomacy is at work. It is also important to note that the PRC has invested billions of dollars in developing countries despite cognizant of the fact that many of these countries have a history of debt sustainability problems, including habitually defaulting, which is contrary to the conventional belief of both authoritarian and democratic governments. Finally, the common refrain that developing countries are reluctant to borrow from the World Bank and Western governments because, unlike Beijing, they require transparency, oversight, environmental sustainability, respect for human rights, among other conditions, is only partially true. It is equally true that World Bank and International Monetary Fund (IMF) lending is unduly intrusive, with cumbersome and time consuming red-tape, with the funds often not forthcoming either due to insufficient resources or hesitation to invest in costly infrastructure, but, which developing countries sorely need (Humphrey 2015).

However, the debt-trap narrative is often privileged because of the excessively secretive nature of Chinese diplomacy. For example, despite being a major global creditor, the Chinese government does not provide official data on its international lending, nor does it disclose details regarding the volume nor the terms of the loans it provides, much of which is between governments, and how the debt negotiations are adjudicated if the borrower cannot service its debts. For their part, borrower countries have also not been forthcoming on the details of their financial transactions with the PRC. In fact, China lends more to developing countries than all other bilateral creditors put together, including the World Bank, because developing country borrowers are willing customers. However, this does not necessarily mean that Beijing is a more generous lender. Morris et al. (2020), based on the analysis of a new dataset of 157 countries to compare Chinese lending terms (interest rates, grace periods, and maturities) to International Development Association (IDA) and International Bank for Reconstruction and Development (IBRD) lending terms over the 2000-2014 time period, as well as Chinese lending terms and concessionality[4] relative to World Bank, finds that "China's official financing is less concessional than World Bank financing in comparable settings; however, nearly all Chinese loans have some degree of concessionality, which may help to explain the attractiveness of Chinese financing compared to market sources of finance" (Morris et al. 2020, Abstract).

Similarly, because Chinese lending practices are opaque with only limited transparency in disclosure, even the world's premier credit rating agencies such as Moody's or Standard & Poor's can only provide rough estimates on the size and volume of the loans Beijing disburses to recipients. In fact, global multilateral financial organizations such as the World Bank and IMF, of which China is a member, do not provide much data on Chinese external lending in their country data for sovereign debt. Concerns and suspicions regarding Beijing's intentions have been further compounded by President Xi Jinping's signature program, the ambitious Belt and Road Initiative, which, since its inception in 2013, has generously disbursed billions of dollars of state-backed loans to finance an extensive web of infrastructure linkages via rail,

[4] Morris et al. (2020) "use two measures of concessionality: loan concessionality, measured as the grant element of an individual loan; and portfolio concessionality, which captures the overall generosity of a portfolio of funding to a country or group of countries by including grant funding alongside grant elements of concessional and non-concessional loans" (Abstract).

road, sea, and air connecting China to the Asia, Africa, and Europe. According to the IIF, the BRI has funded some $730 billion in infrastructure investments in over 112 countries (IIF 2019). Indeed, an innovative study (Horn et al. 2020) that painstakingly built a database of China's capital exports by examining 5,000 loans and grants that the PRC has given to 152 countries between 1949 and 2017 concludes "that China has extended many more loans to developing countries than previously known. This systematic underreporting of Chinese loans [about 50 percent of China's lending to developing countries is not reported to the IMF or World Bank] has created a 'hidden debt' problem – meaning that debtor countries and international institutions alike have an incomplete picture on how much countries around the world owe to China and under which conditions. In total, the Chinese state and its subsidiaries have lent about US$1.5 trillion in direct loans and trade credits to more than 150 countries around the globe. This has turned China into the world's largest official creditor — surpassing traditional, official lenders such as the World Bank, the IMF, or all OECD creditor governments combined." Similarly, it is estimated that about "[US]$200 billion of emerging-markets debt owed to China has gone unreported in official statistics in recent years" (Spegele and Isaac 2020).

However, Brautigam et al. (2020), drawing on data from the China Africa Research Initiative of John Hopkins' School of Advanced International Studies (SAIS) and the World Bank, and data on African borrowing and debt levels from the World Bank and the IMF's International Debt Statistics, find "that Chinese loans play a more modest role in Africa's struggle with debt sustainability than conventional wisdom would suggest" (p. 1). Although they admit that "the picture varies sharply across the continent's 54 countries," and overall, they find "that China makes up 22% of public debt stock (2018) and 29% of debt service (2020) in low-income Africa" (p. 1). "Chinese lenders are now a significant part of the debt picture in Africa, but their role should not be overestimated. In over half of the low-income countries most at risk of, or already in, debt distress, Chinese lending is relatively small, with less than 15 percent of debt stock. That is to say, their debt problems are largely caused by lenders other than China" (Brautigam et al. 2020, p. 12).

Clearly, based on the existing macro-level evidence, it is difficult to emphatically prove that the PRC engages in debt-trap diplomacy. Rather, country experience shows much nuance and heterogeneity, including the case of Sri Lanka, which has become the poster-child to illustrate Beijing's duplicity and complicity. Specifically, when the island nation of Sri Lanka ceded control of the strategic port of Hambantota, critics blamed "debt-trap diplomacy" at work. However, the picture is far more complex with the evidence suggesting that imprudent lending and borrowing sowed the seeds for debt problems, albeit, prima facie, the case may look like a deliberate debt-trap. After the civil war, as Sri Lanka began to rebuild its damaged economy, in particularly, its much neglected and crumbling infrastructure, it turned to China for economic assistance. Beijing flushed with cheap credit was happy to bankroll the project on short notice. Although Beijing's lending rate was not any better (and in hindsight, slightly higher) than those offered by the World Bank and other Western governments, it did not demand strict conditionality, including the standard ones such as transparency, environmental sustainability, and respect for human rights. Of course, the Sri Lankan government, given its good credit ratings, would not have had difficulty obtaining credit from the private financial market, but it chose to go with Beijing.

Financed with loans from the Export-Import Bank of China (mostly at commercial rates with a grace period of five years and a payback period of 15 years), the massive Hambantota port complex was constructed in phases from 2007 to 2016. Although, concerns were raised about the cost and financial viability of the massive "vanity project," the Sri Lankan government took the gamble as it believed that Hambantota strategically located in the Indian Ocean would become the premier shipping and trade hub linking Europe, Africa, and the

Middle East to rest of Asia. However, from its inception, the port failed to generate the expected revenue. It not only failed to break even, but also simply did not earn enough revenue to meet its debt obligations. In mid-2017, in lieu of default, the Sri Lankan government proposed a "debt-for-equity swap" agreeing to relinquish majority control over the port by leasing it to the China Merchant Port Holdings Limited for an 85 percent stake and a 99-year lease (including control over 15,000 acres of land around the Hambantota port) in exchange for US$1.12 billion. US Vice-President Pence (2018) seized on this stating that "China uses so-called debt diplomacy to expand its influence. The terms of [its] loans are opaque at best, and the benefits invariably flow overwhelmingly to Beijing… Just ask Sri Lanka, which took on a massive debt to let Chinese state companies build a port of questionable commercial value. It may soon become a forward military base for China's growing blue-water navy" (also see Fernholz 2018; Macan-Markar 2018).

Is Hambantota a cautionary tale of debt-trap where Beijing, by tying the borrowers' asset as a collateral, was able to surreptitiously "capture" an important asset with long-term geostrategic value, even if the collateral lacked commercial viability? Or is the Sri Lankan government's inability to meet its debt obligations due to costly and imprudent investment in a project with questionable commercial viability, its already high debt servicing costs (Sri Lanka's debt at 78 percent of its GDP is among the highest in South and Southeast Asia), and deeper structural problems in the economy – in particular, the economy's inability to generate enough foreign reserves, to service its debt (Abi-Habib 2018; Lo 2019)? Indeed, the Sri Lankan government was optimistic that it could service the debt with revenues from fees charged by the port and foreign exchange earned with exports. In the end, neither option proved viable putting the country in a financial and balance-of-payments crisis. Last but not least, given the lack of transparency, an opaque tendering process, including no independent review of the project, domestic corruption and malfeasance cannot be ruled out. Indeed, as the Hambantota port was built in the home district of then-President Rajapaksa, it is alleged that he was paid millions in kickbacks to finance his re-election campaign. Other senior politicians from Rajapaksa's party have also being accused of corruption and collusion with the Chinese investors. In the end, what usually happens is that ordinary Sri Lankan citizens will end up paying for their government's imprudent risk taking.

Yet, as the old adage attributed to John Maynard Keynes reminds us, "If you owe your bank a hundred pounds, you have a problem. But if you owe a million, it has." This saying underscores the paradoxical nature of creditor-debtor relations, namely, that the asymmetry of creditor-debtor power relations does not always favour the creditor. For example, China is the US' major creditor with its debt to China totalling US$1.08 trillion in May 2020. It is China's insatiable demand for the US. Treasuries helps keep interest rates in the US low, and if Beijing ever called in its debt, interest rates and prices in the US would rise with negative impact for economic growth. For many, this economic leverage that China has over the US is a big concern. However, such concerns are exaggerated as all debt is not the same. This is because China has to maintain significant reserves of the US debt to manage the exchange rate of the renminbi. In other words, Beijing buys such huge amounts of US Treasuries because it pegs its own currency to the dollar. This helps keep down the cost of Chinese exports. Thus, if Beijing decided to sharply reduce its reserve holdings, its currency's exchange rate would rise, thereby increasing the price of Chinese exports. Moreover, unlike any other country, the US enjoys the "exorbitant privilege" of being able to borrow abroad using debt instruments denominated in its own currency. That is, the US dollar's unique reserve currency role exempts the American sovereign. This privilege also allows the US to maintain large budget and balance of payments deficits because of the seemingly insatiable global appetite for liquid US treasury securities, which serves as a store for reserves and safe haven and allows Washington to borrow at extraordinarily low interest rates despite the fact that the US deficit-to-GDP and debt-to-GDP ratios are high.

In the aftermath of the coronavirus, developing countries from every region of the world are asking their major banker (China) to renegotiate, restructure, delay, or outright forgive the billions of dollars loans that are coming due this year. This has placed Beijing in a very difficult position. First, given the sharp economic contraction, and in some countries near economic collapse, most developing countries, in particular, the low-income countries are simply not in a position to meet their debt obligations. Second, although Beijing has ruled out debt forgiveness (but signalled its willingness to negotiate debt restructuring with individual countries), it may have no choice but to write-off much of the loans, including outright forgiveness for high-risk debtors. In fact, without significant write-offs, there is high probability that many of the poorest countries will simply default. If Beijing chooses to seize debtor assets, especially in the midst of the pandemic, it will be accused of engaging in heartless debt-trap diplomacy and face a potential anti-China backlash, which it can ill afford at a time when its international image has hit rock-bottom due to its role in the spread of COVID-19. Indeed, seizing debtor assets may not be worth the trouble as much of the infrastructure projects used as collateral are unprofitable "white elephants." Third, Beijing's global lending spree is bound to have domestic ramifications. Not only will the Chinese government lose billions of dollars in unrecoverable loans but also its already highly leveraged financial system straining under a mountain of bad debt accumulated by state-run banks, state-run enterprises, construction companies, and local governments could further undermine the already battered domestic economy, which has shrunk for the first time since the Deng reforms that began in 1978.

Finally, this unprecedented black-swam moment – with severe credit problems afflicting both creditor and debtor at the same time – requires unprecedented collective action.

In March 2020, following the United Nations' call for debt relief for the world's least-developed countries, several G-20 countries and the IMF suspended debt service for the year, besides requesting private creditors to do the same. However, the PRC insisted that it preferred to deal with its debtors individually despite pressure for Beijing to make common cause with the G-20 and other multilateral organizations to help struggling debtor nations, in particular, the world's poorest nations to ride out the current storm. Finally, in late June, Beijing announced that it had suspended debt repayments for several countries as part of the G-20's April "Debt Service Suspension Initiative" (DSSI), designed to provide a coordinated, "time-bound" suspension of payments from May through the end of 2020 by all bilateral official creditors. But its overall commitment and effectiveness remains to be seen. As the key player, Beijing's actions will be closely watched. Certainly, Beijing's meaningful response will go a long way to dispel the charge that the PRC engages in predatory debt-trap diplomacy.

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