

IT'S A (DEBT) TRAP! MANAGING CHINA- IMF COOPERATION ACROSS THE BELT AND ROAD

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Five years ago, Chinese President Xi Jinping announced his flagship foreign policy project, the Belt and Road Initiative (BRI). Currently, total Chinese BRI investment is estimated at over \$1 trillion, more than eight-times the size of the Marshall Plan in today's dollars.¹ When it was launched, China heralded the BRI as a “golden opportunity” to “revitalize” the region. Today, many countries are wary about China's intentions. Unlike the Marshall Plan, which mainly dispersed aid in the form of grants that did not have to be repaid, China uses loans that often come at commercial interest rates. While the BRI provides vital infrastructure funding to developing countries, it also leaves many with

unsustainable debt. For example, China is funding a high-speed rail line in Laos that will cost equivalent to half the country's GDP.²

The International Monetary Fund (IMF), China, and other stakeholders should cooperate to help countries along the Belt and Road facing financial imbalances and high debt. This will not be easy. Before providing aid, the IMF will require transparency into BRI loan terms, which are notoriously opaque and can burden countries with high debt.³ China has resisted international involvement in the BRI, yet the foundation for cooperation already exists. To reconcile these competing perspectives, the IMF and China should expand communication channels and launch pilot reforms that address problems on both sides. If these conditions are met, the United States should encourage IMF assistance to BRI countries to protect sovereignty and promote higher lending standards.

BRI spending in developing countries has raised serious concerns about debt sustainability. A recent Center for Global Development report found that eight BRI recipient countries—Djibouti, Kyrgyzstan, Laos, the Maldives, Mongolia, Montenegro, Pakistan, and Tajikistan—are at a high risk of debt distress due to BRI loans.⁴ These countries will all face rising debt-to-GDP ratios beyond 50 percent, with at least 40 percent of external debt owed to China once BRI lending is complete. These countries will need support to service BRI loans as repayments peak and will likely turn to the IMF and other smaller lenders. Discussions for an IMF bailout have already begun in Pakistan, where China has invested \$62 billion, or one-fifth of Pakistan's GDP, in infrastructure and energy projects.⁵

The IMF has scrutinized multiple aspects of the BRI, repeatedly warning of unsustainable debt levels, predatory lending, and the lack of project transparency.⁶ To assuage these concerns, the IMF will request greater clarity on foreign currency

payments, including the details of BRI loans, before authorizing a credit line. An IMF program should include BRI debt restructuring or reevaluating proposed infrastructure investments to determine if they are financially sound. At a minimum, the IMF will need to see the terms of BRI loans to complete the necessary debt sustainability analysis.⁷

Given these constraints, there is a possibility for disagreement between the IMF and China over the future of BRI projects in debt-distressed countries. Chinese loans violate several international lending best practices involving procurement, transparency, and dispute settlement. Chinese contractors dominate infrastructure projects, and Chinese-funded loans are less transparent than those from multilateral development banks.⁸ Beijing has demonstrated a reluctance to abide by international investment standards, establishing two courts to resolve BRI-related disputes outside of existing settlement venues.⁹ China also enshrined BRI into its constitution last year, putting pressure on state companies and officials to continue lending.¹⁰

WORKING WITH THE INTERNATIONAL COMMUNITY WOULD HELP CHINA FURTHER REDUCE RISKY LOANS AND ENSURE SUSTAINABLE RETURN ON INVESTMENT.

However, China is now publicly recognizing the need to reform BRI lending terms to address international and domestic concerns. In the wake of Malaysia's decision to cancel two large Chinese-funded projects, Beijing launched a publicity blitz to defend the BRI.¹¹ Deputy Chairman of the National Development and Reform Commission Ning Jizhe said China should be "objective and rational"

when addressing debt concerns and work to facilitate international cooperation.¹² Beijing has also agreed to open investment in BRI projects in Pakistan to foreign companies, although it did not name any specific partners that would be joining.¹³ At home, President Xi has prioritized fighting China's "three tough battles" of limiting financing risk, reducing poverty, and curbing pollution.¹⁴ As part of this effort, Beijing has pulled back on profligate BRI spending, signing 6 percent fewer contracts in the first five months of 2018 than during the same period in 2017.¹⁵ Working with the international community would help China further reduce risky loans and ensure sustainable return on investment.

Beijing can demonstrate its commitment to addressing concerns about the BRI by partnering with the IMF to improve lending practices. The two sides have already improved communication and expertise sharing this year. In April, the IMF announced the opening of the Chinese funded China-IMF Capacity Development Center to help train development officials and support the BRI.¹⁶ China also unveiled its International Development Cooperation Agency in April in an effort to put BRI decisionmaking under a single agency, a decision the IMF applauded.¹⁷ The next steps will be to deepen these channels and launch targeted pilot reforms to boost confidence on both sides. A successful program for both sides could set the stage for broader changes.

A model for serious reforms palatable to Beijing can be found within one of China's own initiatives, the Asian Infrastructure Investment Bank (AIIB). The Beijing-led development bank was launched in 2015 and, despite some initial skepticism, the organization's operating procedures follow international standards.¹⁸ A majority of its projects are co-funded with Western-backed institutions and have clear documentation.¹⁹ In April 2017, the AIIB announced a memorandum of understanding with the World Bank to deepen cooperation, a framework that China can apply to discussions with the IMF on debt relief.²⁰ Adopting these reforms will help legitimize the BRI and ease some of the economic tension between China and the United States.

Under the current circumstances, U.S. concerns about IMF assistance being used to bail out Chinese creditors are valid. However, if Beijing commits to cleaning up its act, Washington should encourage IMF involvement in BRI countries. In doing so, the United States can encourage vital investment in developing countries while working through the IMF to encourage China to improve investment standards. At a minimum, the IMF process will improve the transparency of projects and put countries on a path to debt sustainability. More importantly, it will reduce the risk that recipient countries forfeit strategically important assets in return for Chinese debt forgiveness. Without the IMF, countries facing financial distress from BRI loans will have limited options for support outside of China and will fall deeper into debt.

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ENDNOTES

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