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Chinese Projects in South Asia under the Belt and Road Initiative: Disrupted by Debt?

Moody's downgrade of China's currency ratings has refocused attention on the pitfalls of high public debt in China. Apart from long-term macroeconomic risks, rising indebtedness has serious implications for China's ability to invest in the overseas projects it has committed to. This paper studies the implications in the context of the Belt and Road Initiative (BRI) from a South Asian perspective. It argues investments under the BRI in recipient South Asian countries might be affected and new conditionalities for ongoing projects might be insisted as China struggles to balance conflicting goals of reducing debt and sustaining external investments.

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China's long-term local and foreign currency issuer ratings have been downgraded by the Moody's Investor Services in its latest assessment of the Chinese economy.[2] Explaining the downgrade in its report released on 24 May 2017, Moody's underlined the rising public debt in the Chinese economy and its expectation of such debt increasing further following policy stimulus for maintaining robust growth, as the main reasons influencing the revision in rating.

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[2] 'Rating Action: Moody's downgrades China's rating to A1 from Aa3 and changes outlook to stable from negative', Moody's Investors Service, 24 May 2017; https://www.moodys.com/research/Moodys-downgrades-Chinas-rating-to-A1-from-Aa3-and-changes--PR_366139. Accessed on 8 June 2017.

Apart from the historical significance of this being the first downgrade of China by Moody's in more than two decades, the decision reflects the rating agency's concern over public debt becoming a fundamental obstacle to China's future economic prospects. The concern assumes significance in the context of China's hugely ambitious plans to finance connectivity in Asia. Indeed, it is perhaps ironical that Moody's sombre message on the pitfalls of the debt pile building up in the Chinese economy came only days after the organisation of the first global gathering on the Belt and Road Initiative (BRI) in Beijing on 14 and 15 May 2017. Addressing a large gathering of world leaders on the occasion, Chinese President Xi Jinping described it as the 'project of the century' poised to bring in a new period of economic globalisation.[3] The massive infrastructure-building initiative planning to connect China to Europe through an elaborate network of land and sea routes encompassing Southeast Asia, South Asia, West Asia, Central Asia, Russia and parts of Africa is China's biggest enterprise to sustain economic growth and enhance continental geo-strategic influence through extensive funding of new public goods.

While public debt in China is a serious problem, it does not entail a macroeconomic crisis for the Chinese economy, at least not in the near term, given the economy's strong macroeconomic parameters like large foreign exchange reserves and substantive household savings. Nonetheless, the economic implications of high public debt are serious and can have repercussions on the ability of Chinese companies to continue investing in overseas infrastructure projects. This is certainly not encouraging news for South Asian economies that are looking forward to investments from China in BRI projects.

China's Debt: Structural and Perpetuating

Public debt in China has been expanding steadily over several years with the debt-gross domestic product (GDP) ratio now having crossed 40 per cent. Moody's expects the ratio to become as much as 45 per cent by the end of the decade.[4] Since 2006, the debt-GDP ratio has increased rapidly reflecting an expansion of more than 10 percentage points. The increase has

[3] China's Xi lays out $900bn Silk Road vision amid claims of empire-building', theguardian, 14 May 2017; https://www.theguardian.com/world/2017/may/14/china-xi-silk-road-vision-belt-and-road-claims-empire-building. Accessed on 8 June 2017.

[4] 'Rating Action: Moody's downgrades China's rating to A1 from Aa3 and changes outlook to stable from negative', *op cit.*

been driven by the expansionary economic policies adopted since the outbreak of the global financial crisis in 2008 to maintain robust economic growth. Economic expansion in China is primarily driven by loose monetary policies allowing easy borrowing from banks by corporates and households. The financial characteristics of the Chinese economy underscore the prevalence of bank credit as the main mode of supporting economic activity and fuelling expansion. Chinese companies have little option other than financing investments through bank loans and households have no choice other than banks to park savings due to an underdeveloped capital market, and the lack of alternative financing means and investment products. The preponderance of bank credit in economic growth has been perpetuated by keeping deposit rates on savings low, allowing banks to lend at low rates of interest. Furthermore, interest rates are capped for making the loans affordable and attractive for businesses and households. The result of these policies – resembling a situation often described as 'financial repression' – has been to generate high liquidity and credit flow in the Chinese economy.

The emphasis on making credit available to facilitate investments and energise economic growth has led to banks being encouraged to ignore financial viabilities of potential projects and the quality of borrowers. There has been an almost explosive growth in the volume of non-performing loans being held by the Chinese economy that is now estimated to have crossed US$2 trillion (S$2.77 trillion).[5]

One of the biggest concerns is the amount of debt being held by state-owned enterprises (SOEs). Backed by local government guarantees, the SOEs have been among the major borrowers from Chinese banks. However, while being the largest beneficiaries of cheap bank credit and government patronage, the SOEs have been rather poor in the productive utilisation of funds. Studies by China's National Bureau of Statistics point to the SOEs obtaining more than half of total bank credits but investing only a third of it in fixed asset investments.[6] Indeed, the SOEs are primarily responsible for the high leverage – proportion of debt to equity in the capital structure – of the Chinese economy.

[5] 'Fantasy Accounts', Pete Sweeney, BreakingViews, Thomson Reuters, 1 June 2017. https://www.breakingviews.com/considered-view/chinas-growth-obsession-fosters-collateral-fraud/?SID=5763554c3f92a432bf079bdf&content_alert_status=Ready&utm_source=Sailthru&utm_medium=email&utm_campaign=Asia%20Weekly:%20Samsung%2C%20Bain%20buys%20bad%20debt%2C%20Japan. Accessed on 8 June 2017.

[6] 'Monetary Policy and China's soaring leverage problem', Ran Li, East Asia Forum, 31 May 2017; http://www.eastasiaforum.org/2017/05/31/can-monetary-policy-solve-chinas-soaring-leverage/. Accessed on 8 June 2017.

Financial reforms of the SOEs have been incomplete in China. Efforts have been stepped up to address the high leverage of SOEs through initiatives like debt-equity swaps.[7] However, these would take long to produce results. Reforming the SOEs is not easy, given the patronages they enjoy at various levels of the government, particularly local administrations.

Implications for the BRI Projects in South Asia

Does the warning from Moody's on the rapidly increasing public debt in China imply difficulties in honouring its investment commitments? At the present juncture, the situation draws attention to three issues that can affect the prospects for Chinese-funded projects in the Belt and Road programme, particularly those in South Asia, where several projects have already been committed by China. These are:

a) Difficulty of simultaneously following policies that, while controlling bank credit and public debt on one hand, enable Chinese companies to easily access funds for investing in overseas infrastructure projects on the other.

b) Bringing down leverage of the SOEs that are prominent investors in overseas projects.

c) Possible reworking of operational conditions of ongoing and potential projects as pressures increase on Chinese investors to generate higher returns on investment for minimizing non-performing loans.

The Policy Conundrum

The BRI is a demand-side trigger to maintain the growth of the Chinese economy in the medium and long term. It is an extension of the investment-led growth model that the Chinese economy has been accustomed to for several years. Unlike the domestic economy that was absorbing most of the investments earlier, the BRI encourages outward foreign

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[7] 'Is a Chinese sovereign debt default likely?', Yiping Huang, East Asia Forum, 28 May 2017; http://www.eastasiaforum.org/2017/05/28/is-a-chinese-sovereign-debt-default-likely/. Accessed on 8 June 2017.

investment by Chinese companies in other economies. These investments are focusing significantly on projects in Belt and Road geography. According to statistics released by China's Ministry of Commerce, Chinese companies invested US$14.5 billion (S$20.1 billion) in these projects in 2016 and are contracted to invest US$126 billion (S$174.4 billion). Indeed, more than 50 per cent of outward investments which Chinese companies are globally committed to are in the BRI projects.[8] A sizeable part of these investments are in South Asia, essentially Pakistan, Sri Lanka, Bangladesh and Nepal, countries that are important stakeholders in the BRI.

At the same time, high public debt is a serious problem for China. This was forcefully articulated by Prime Minister Li Keqiang in his work report for the government presented to the National People's Congress in March 2017, along with the measures being taken to reduce leverage of SOEs and debt burdens of local government.[9] The concerns over public debt highlight a policy dilemma on the part of the Chinese authorities. Given the structural characteristics of the Chinese economy, particularly the excessive reliance on bank credit for maintaining investment and aggregate demand to drive GDP growth, a debt containment policy would be antithetical to growth, and it would be intuitively counterproductive for the BRI that aims to support a steady rate of growth for the Chinese economy by funding generation of new public goods in the neighbourhood.

The Chinese authorities would have to take a call on whether they wish to prioritise economic expansion through overseas investments at the risk of incurring more debt. However, pushing the economy down the path of greater indebtedness is unlikely to be a preferred option.

De-leveraging SOEs

The prospects of flow of funds to the BRI projects would depend on the alacrity with which China acts on reining in public debt. Reforming the SOEs has become critical in this respect.

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[8] MOFCOM Department Official of Outward Investment and Economic Cooperation Comments on China's Outward Investment and Cooperation in 2016, Ministry of Commerce, People's Republic of China, 18 January 2017; http://english.mofcom.gov.cn/article/newsrelease/policyreleasing/201701/20170102503092.shtml. Accessed on 8 June 2017.

[9] 'Report on the Work of the Government', Delivered at the Fifth Session of the 12th National People's Congress of the People's Republic of China on March 5, 2017 by Li Keqiang, Premier of the State Council. http://news.xinhuanet.com/english/china/2017-03/16/c_136134017.htm. Accessed on 8 June 2017.

From a recipient country perspective, it is not encouraging to note that the SOEs holding high non-performing loans are financially exposed to several projects in the BRI. Enlarging the scope of deleveraging measures would reduce access of Chinese SOEs to cheap bank credit. While many of these might have initially invested their corporate surpluses in the BRI projects in the first round, later funding would require mobilising substantive debt, which might be hard to obtain. Long-term infrastructure projects not only require large investments, but also funding at regular intervals. Given high gestation lags, cost overruns are very likely, entailing higher capital expenditures. Tight regulations on controlling debt would preclude such steady funding. Choking off of funds and languishing of projects are certainly not what recipient countries in South Asia would look forward to.

Reworking Project Conditions

In the near-term though, China is unlikely to scale down commitment to the BRI. The priority it attaches to the project is evident from President Xi himself monitoring its progress. Furthermore, having already committed huge investments to the project, particularly in key geostrategic components like the China Pakistan Economic Corridor, it is difficult for China to retract, however onerous it might become for its companies to mobilise funds. It would strive to maintain the momentum on the projects while trying to control growth of debt through domestic reforms like debt-equity swap and encouraging local governments to issue bonds. However, saddling mutually-conflicting objectives will have implications for the BRI projects. These include demands for changes in operational conditions of upcoming and new projects.

Going ahead, one of the possible changes could be the insistence of Chinese companies on converting loans to equity over time. This could arise from domestic debt control regulations urging more deleveraged capital structures. The other possibility is investors demanding higher pricing of loans for preventing accumulation of non-performing loans. Both possibilities have complex consequences for recipient countries. Debt-equity swaps would allow Chinese investors strategic ownership of the projects opening up the possibility of their being used for geo-strategic, including military and security, purposes. On the other hand, high prices of Chinese loans would increase debt servicing liabilities. If future reforms to

control debt target the SOEs for effective action on reducing non-performing loans, the former would begin searching higher returns from the BRI by demanding higher interest rates. This would multiply debt servicing liabilities for many recipients like Sri Lanka that are already entrapped in Chinese debt.[10] The visualisation of similar prospects is unlikely to increase the appeal of Chinese investments in the region denting the prospects of the BRI.

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[10] 'Sri Lanka for sale?', Farukkh Saleem, The News, 4 June 2017. https://www.thenews.com.pk/print/208448-Sri-Lanka-for-sale. Accessed on 8 June 2017.