My borrowers, your borrowers

Uwe Hoering, May 2021

The label of "debt diplomacy" is a popular refrain in the intensifying debate about China's economic and political expansion. The narrative is simplistic: Lending by state-owned banks, it is said, is not transparent, would encourage corruption, and would primarily serve Chinese corporations. It would lead inevitably to a debt trap, to a policy of coercion and even to "debt bondage," according to the German business weekly *Wirtschaftswoche* at the beginning of May.[1] The beam in one's own eye is overlooked. This gives the impression that Beijing's policy is far more ruthless than the practice of international financial institutions, governments of Western industrialized countries or large commercial banks.

China ante portas

A recent case in point is the construction of a highway in Montenegro, since 2010 a candidate for EU membership in the Balkans. It is to link the port city of Bar with Serbia, Beijing's closest friend in the region, and boost economic development for the country, which has so far been in the lee of European integration. The *European Investment Bank* had refused to finance the project. Its justification for this was doubts about the economic viability of the project, i.e. its creditworthiness, and environmental concerns. Beijing then stepped into the gap in 2014 with a loan of almost one billion U.S. dollars from the state-owned *ExIm Bank*.

The first repayment instalment is now due in July - 67.7 million US dollars, in other words peanuts. However, due to delays and planning deficiencies, which are common practice in large infrastructure projects, the anticipated toll revenues are not forthcoming. The *Wirtschaftswoche* was quick to speculate about the new Huns from the Far East, who had pushed Montenegro into the "debt trap": "For the first time, an entire country in the middle of Europe is threatening to become dependent on China.

At the same time, the Montenegrin government can certainly invoke "force majeure". Because of Corona, the tourism industry, the country's most important economic sector, has collapsed. And since she joined the European sanctions against Moscow, Russian investments fell. In addition, she has a two-fold bonus: The loan was taken out by her Beijing-friendly predecessor government, while she has positioned herself as pro-European. Nevertheless, the EU Commission rebuffed the government's request for financial assistance in early April: European solidarity does not apply to third-party payment obligations. But at the same time, the EU offered to help with the financing of further construction, despite negative feasibility studies. Games, Brussels play.

[1] https://www.wiwo.de/technologie/wirtschaft-von-oben/wirtschaft-von-oben-104-autobahn-montenegro-auf-der-seidenstrasse-in-die-schuldknechtschaft/27143668.html

Risk premium

There can be no doubt that there is little transparency when it comes to Chinese loans. A new study, which for the first time evaluates around 100 contracts with 24 countries, provides deeper insights.[2] It confirms that Beijing is "a muscular and commercially-savvy lender to developing countries" that clearly formulates the terms of agreements to its own advantage: "Chinese contracts contain more elaborate repayment safeguards than their peers in the official credit market, alongside elements that give Chinese lenders an advantage over other creditors." Naturally, this irks Western governments, international financial institutions, and banks, and "has already created tensions" among the various parties.

As with Montenegro, Chinese banks are often 'lenders of last resort.' They are prepared to provide loans to states that are already heavily indebted and for projects that do not meet Western project appraisals. Consequently, risk premiums and hedges are common, as they are for countries with unstable political regimes. "Chinese state-owned banks use contract tools to manage these and other risks. They adapt legal and financial engineering tools to protect their investments and climb the "seniority ladder", potentially gaining repayment advantage over other creditors", the study concludes.

Welcome to the Club

Nevertheless, the analysis of Chinese contracts also states that „even when we find troubling terms in debt contracts between sovereign borrowers and China's state-owned entities, we cannot conclude that they violate international standards." Indeed, Western borrowing is not characterized by excessive openness either, imposes at times harsh economic and political conditions, and of course also benefits primarily companies from donor countries. „All creditors, including commercial banks, hedge funds, suppliers, and export credit agencies, seek a measure of influence over debtors to maximize their prospects of repayment by any legal, economic, and political means available to them." To summarize: the competition for the international credit market, with a volume of many billions of U.S. dollars, is being fought tooth and nail by all parties involved.

At the same time, the study also puts into perspective another feature of the prevalent media and political narrative, which is the allegation that China's lending is designed to grab strategic facilities in poorer countries: There are rumours that China could get control of the port of Bar in Montenegro as compensation, and thus possibly even a naval base in Europe! But the study finds „little evidence that China's state-owned banks routinely use physical infrastructure—like a seaport or a power plant—as collateral". They apparently prefer collateral in the form of bank accounts that can be seized in the event of default. In comparison, intangible assets are more costly to secure and sell, are

[2] https://www.aiddata.org/data/how-china-lends-dataset-version-1-0

not as easy to conceal, and are more likely to generate negative media coverage and political controversy.

Everyone against everyone else

Montenegro is by no means a special case. There has been a new debt crisis building up over the years, made worse by the pandemic and the collapse in commodity prices. With a few exceptions, however, China is not the bad guy in this process, and not the only one responsible for the financial burdens under which many countries are now suffering. In just a few cases, its share of the debt[3] is alarmingly high. For Montenegro, it is a 20 to 25 per cent of its total foreign debt.

Any kind of collective debt management or multilateral debt relief, which would also have to involve private lenders, is difficult. As experience shows, creditors only become active when there is a threat of serious payment defaults that would harm themselves. After all, they all want as much of their money back as possible. In this process, everyone fights everyone else and watches closely "if someone else is getting a better deal," according to *The Economist*[4].

A comprehensive restructuring or debt relief has also become more difficult because the number of creditors has grown. Previously, there was mainly the group of international financial institutions such as the *World Bank*, the IMF or the *Asian Development Bank* ADB, a handful of big banks and the governments of rich countries. In the 'Paris Club' they were able to coordinate and jointly put pressure on debtors. Meanwhile, China has emerged as the largest bilateral creditor, providing countries with alternatives, as have China-promoted funders such as the *New Development Bank* NDB (also known as the BRICS Bank) and the *Asian Infrastructure Investment Bank* AIIB. Additionally, with interest rates low, many countries have been borrowing much more on a commercial basis.

Generous creditors sought

However, the Corona crisis and the worsening debt situation have also brought some momentum into the discussion. For the first time, Beijing has joined a multilateral *Debt Service Suspension Initiative* (DSSI) that defers due repayment until the end of 2021 for more than 70 of the world's poorest countries. According to the World Bank, this has so far brought an estimated five billion US dollar in debt relief. But this is little more than a stopgap measure, no genuine relief.

A particularly hot area of debate is what is known as illegitimate debt, which was incurred through environmentally damaging schemes, such as fossil fuels, or taken on for projects that have flopped or led to displacement. Cancelling

[3] http://www.sais-cari.org/data

[4] https://www.economist.com/international/2021/03/04/poor-countries-struggling-with-debt-fight-to-get-help

this debt, called for by civil society organizations[5], would release public funds for areas critical to basic needs and be a matter of justice.

In this situation, Beijing would have an opportunity to be generous. China, which is not a member of the Western creditor cartel 'Paris Club', has already made bilateral debt relief[6] in one form or the other, especially for interest-free loans. By doing so, it can make good weather with its clientele, the countries of the Global South. Furthermore, widespread repayment problems and defaults might fall on its own feet.

It would also be a chance for the EU to gain points. Serbian political consultant Stefan Vladisavljev recommends an interim payment for Montenegro.[7] That would help to polish the EU's image in the Western Balkans, which has already suffered badly from uncertain accession prospects on the one hand, and generous Chinese and Russian actors on the other. In this way, countries that are seen as China's "Trojan horses" could possibly be won back and Beijing's influence in the region pushed back.

It will therefore be interesting to see which creditor moves first, not only in the case of Montenegro, where it is merely a matter of petty cash. Given the billions at stake, not only debtors but also creditors have a problem when it comes to payment problems. The fundamental question, however, is: How can countries be enabled economically to service their loans on time and in an orderly manner? And who has the more effective concepts for doing so in the "systemic competition" with China?

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[5] https://www.cadtm.org/APMDD-Statement-on-the-54th-Annual-Meeting-of-the-Asian-Development-Bank

[6] http://www.sais-cari.org/debt-relief

[7] https://chinaobservers.eu/why-the-eu-must-deal-with-montenegros-chinese-debt/