The Big Read Chinese economy

China reckons with its first overseas debt crisis

The Belt and Road Initiative has seen a surge in loans going bad, prompting Beijing to issue countries with emergency credit

James Kynge in London, **Kathrin Hille** in Taipei, Ben Parkin in Colombo and **Jonathan Wheatley** in São Paulo 13 HOURS AGO

The 350m Lotus Tower that looms over the skyline in Sri Lanka's capital Colombo is one of the tallest buildings in South Asia. Funded by a Chinese state bank and designed to look like a giant lotus bud about to burst into flower, it was intended to be a metaphor for the flourishing of Sri Lanka's economy and the "brilliant future" of the bilateral co-operation between Beijing and Colombo.

Instead, the tower has become a symbol of the mounting problems facing China's overseas lending scheme, the "Belt and Road Initiative". The construction suffered from lengthy delays and an allegation of corruption levelled by Sri Lanka's then-president Maithripala Sirisena against one of the Chinese contractors. Now, three years after its official launch, the tower's amenities including a shopping mall, a conference centre and several restaurants stand either unfinished or largely unused while outside on the streets outrage over Sri Lanka's financial mismanagement has boiled over into popular protests.

"It is something we would have done better without," says Athula Kumarasiri, a bookshop owner, as he motions towards the tower. "What is the need for this? It is a complete white elephant."

Sri Lanka is one of dozens of countries in the developing world that hoped to take advantage of the surge in Chinese overseas lending over the past decade under the Belt and Road Initiative — a scheme that ranks not only as Beijing's biggest foreign policy gambit since the founding of the People's Republic in 1949 but also the largest transnational infrastructure programme ever undertaken by a single country.

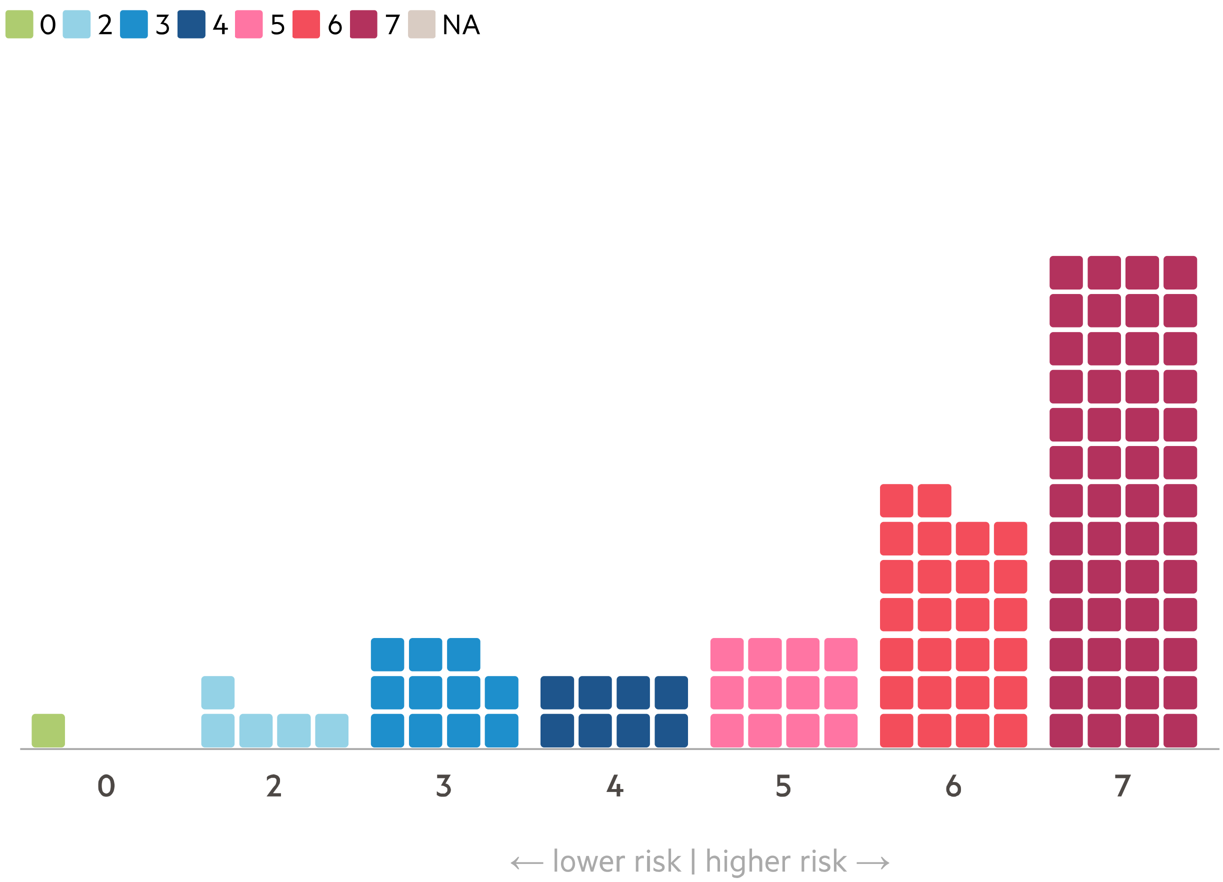
However, a large number of projects, such as the tower, have failed to yield a commercial return while the huge loans it takes to build such infrastructure can exacerbate financial pressures on vulnerable governments.

Those pressures have converged in Sri Lanka, which defaulted on its sovereign debt in May, the first Asia-Pacific country to do so for more than two decades.

Such cases are becoming much more common. A Financial Times examination of the financial health of the Belt and Road Initiative — once hailed by Chinese leader Xi Jinping as the "project of the century" — has uncovered a mountain of non-performing loans.

Many Belt and Road countries show a high level of economic risk

OECD measure of country risk in 148 countries involved in the Belt and Road initiative *(0 = lowest risk, 7 = highest risk)*



FINANCIAL TIMES Sources: OECD, Green Finance & Development Center

In several countries in Asia, Africa and Latin America, the project risks metastasising into a series of debt crises. The issue is of crucial importance to the developing world because of the vast scale of the Belt and Road Initiative. Since the programme was first proposed in 2013 the value of China-led infrastructure projects and other transactions classified as "Belt and Road" in scores of developing countries had reached $838bn by the end of 2021, according to data collected by the American Enterprise Institute, a Washington-based think-tank.

But the loans that finance those projects are now turning bad in record numbers. According to data collected by Rhodium Group, a New York-based research group, the total value of loans from Chinese institutions that had to be renegotiated in 2020 and 2021 surged to $52bn. This was more than three times the $16bn of the previous two years.

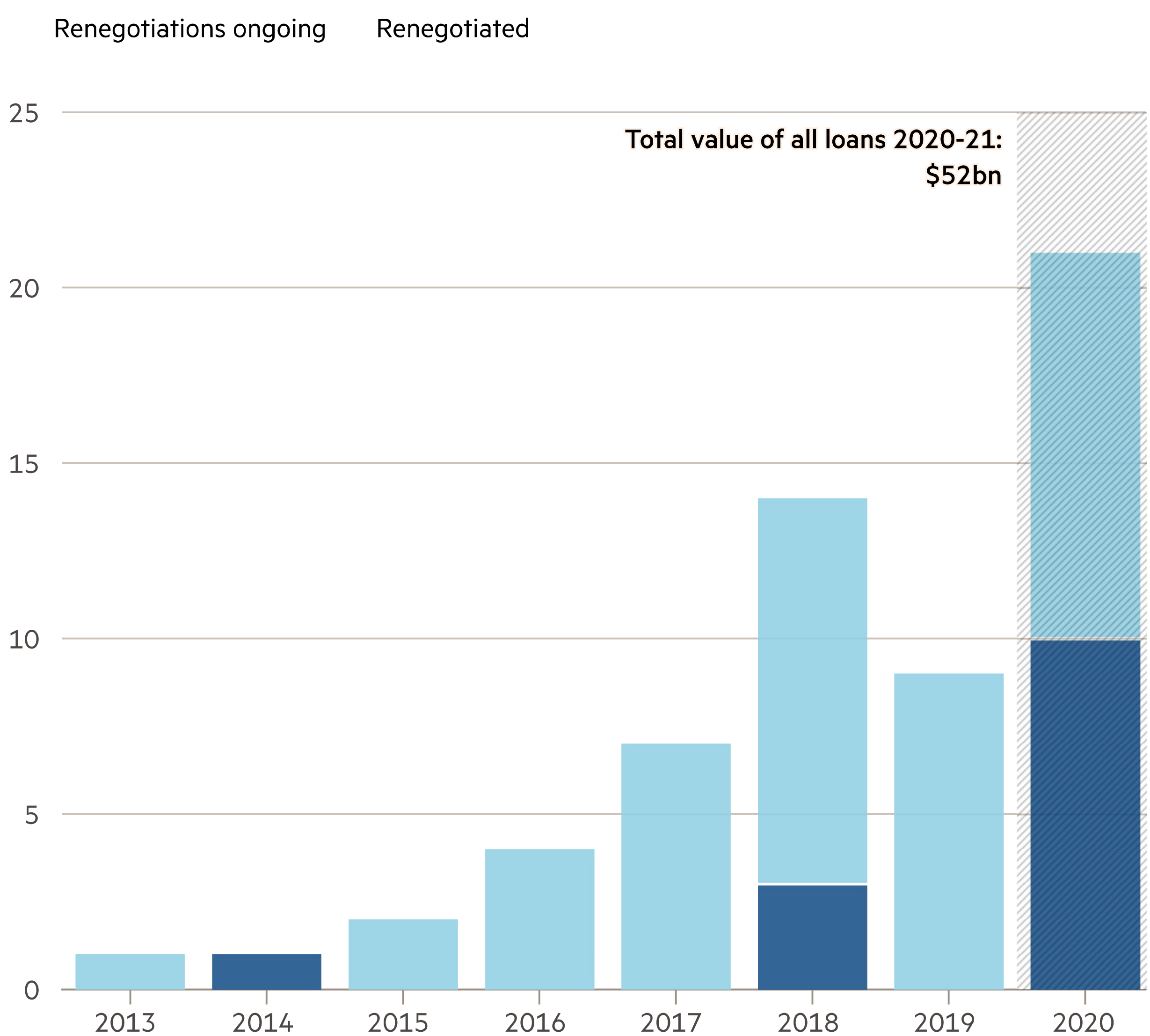
This sharp deterioration brings the total of Chinese overseas loans to have come under renegotiation since 2001 to $118bn — or about 16 per cent of the total extended, Rhodium estimates.

China has had to manage a number of defaults on sensitive overseas loans in recent years but the cumulative impact of the multiple renegotiations that Beijing currently faces amount to the country's first overseas debt crisis.

"This is the worst period of debt pressure since the start of the Belt and Road Initiative," says Matthew Mingey, senior research analyst at Rhodium Group. "The Covid-19 pandemic took existing problems and supercharged them."

A growing number of BRI loans are being renegotiated

Number of renegotiated Chinese loans



Source: Rhodium • Renegotiated includes loans written off, deferred, refinanced, witheld further financing or denied

Many of these loan renegotiations involve write offs, deferred payment schedules or a reduction of interest rates. But as increasing numbers of Belt and Road loans blow up, China has also found itself sucked in to providing "rescue" loans to some governments to prevent their debt distress from morphing into full-blown balance of payments crises.

Bradley Parks, executive director of AidData at the College of William and Mary in the US, says that while the drip feed of rescue loans helps to avert defaults, it does little to resolve underlying financial problems. "I think Beijing is now learning that in some cases the fundamental problem is not liquidity but solvency," says Parks.

Parks says that for almost five years, China's state financial institutions tried to keep the government of Sri Lanka liquid enough to service its old project debts and to avoid sovereign credit rating downgrades. However, he adds: "Their effort was a spectacular failure. So, the big question that Beijing needs to answer is whether it wants to be in the rescue lending business in the long run."

The transition that Parks alludes to is a critical one. As China has financed roads, railways, ports, airports and a gamut of other infrastructure over the past decade, it has found itself in competition with international development lenders — most notably the World Bank. Now, as its lending shifts to focus more on preventing defaults, it is starting to mirror the role usually fulfilled by the IMF — which provides emergency loans to get countries through economic crises.

The magnitude of debt distress in Belt and Road countries is also capturing the attention of world leaders. In May, German Chancellor Olaf Scholz raised the alarm over China's lending spree in poorer countries, particularly in Africa. "There is a really serious danger that the next major debt crisis in the global south will stem from loans that China has granted worldwide," Scholz said.

Such warnings reinforce a more general level of concern expressed by the World Bank last month that developing countries may be headed towards a debt crisis on a scale last seen in the 1980s. The war in Ukraine, rising inflation, tightening global financial conditions and tensions between the US and China are all underpinning such dire scenarios.

"These are all material risks and if they materialise at the same time it will be a perfect storm for the global economy," said Ayhan Kose, head of the World Bank's forecasting storm for the global economy," said Ayhan Kose, head of the World Bank's forecasting unit. "So, of course, we are worried that more countries will be unable to roll over their debts."

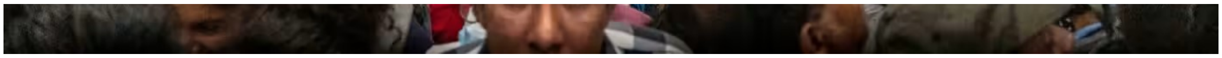
Distress leading to a spate of bailouts

China is fighting debt fires on several fronts. AidData has uncovered evidence of tens of billions of US dollars in "rescue loans" being extended by China's state institutions generally in the form of short-term injections of hard currency that allow debtor countries to service their loans and avoid default.

Countries receiving such loans so far have included Pakistan, Argentina, Belarus, Egypt, Mongolia, Nigeria, Turkey, Ukraine and Sri Lanka, AidData says. Each of these countries has a credit rating of "junk" from agencies such as Moody's and Standard and Poor's, meaning that the risk of default on their sovereign debt is regarded as significant.

When defaults do occur, the economic and political effects can be swift. Sri Lanka, which has international debts of more than $50bn, has been wracked by severe shortages of essential goods since it effectively ran out of foreign currency reserves.

President Gotabaya Rajapaksa was forced out of office last week after tens of thousands of people, angered by the shortages and soaring prices, marched in the capital Colombo and an angry throng occupied the president's official residence.



Sri Lanka's president was forced out of office last week after an angry throng occupied his official residence and tens of thousands protested against shortages and soaring prices © Rafiq Maqbool/AP

Sri Lanka's default was not caused solely by Chinese loans, which total about $5bn, but Beijing's lending to the island state of 22mn people has proved particularly controversial. Critics argue that the Belt and Road credit was extended at high interest rates for infrastructure projects — like the Lotus Tower, and a port and an airport in the southern city of Hambantota — that have often failed to generate returns.

The money from the binge in foreign borrowing was misspent on "ports, airports, cricket stadiums, all sorts of stupid-looking towers . . . all bullshit," says Harsha de Silva, a member of parliament from Sri Lanka's opposition Samagi Jana Balawegaya party.

These mounting problems do not obscure the fact that the vast construction of infrastructure in many developing countries around the world with Chinese finance has helped to drive development.

Examples of useful projects abound. A 750km railway line from Addis Ababa to Djibouti has cut the journey time between the Ethiopian capital to the key port from about three days to about 12 hours. Similarly, a new line from Mombasa to Nairobi in Kenya, which cost $3.2bn, cuts journey times significantly. Hydropower dams built by Chinese contractors in Uganda have been opened as destinations for tourists. Roads and pipelines built across Central Asia and south-east Asia have driven development in those countries.

But where debt burdens prove unsustainable, China often finds itself obliged to issue new loans or face the broader distress that follows a default. Pakistan, the biggest single recipient of Belt and Road financing worldwide with a total of $62bn in Chinese finance pledges, is a case in point.

Islamabad, which styles itself as China's "all-weather friend", has received a string of rescue loans aimed at averting a sovereign default. The latest was a $2.3bn facility under which a consortium of Chinese banks pledged last month to bolster the country's supply of hard currency, allowing it to pay creditors for at least a while longer.

Chinese construction workers in Colombo, Sri Lanka. Vast infrastructure projects in many developing countries around the world have been undertaken with Chinese finance © Paula Bronstein/Getty Images

But Pakistan's foreign exchange reserves remain on a knife edge, having fallen to less than two month's worth of the cost of imports. Earlier this month, the IMF agreed to lend $1.2bn, part of a $7bn relief package, to avert a balance of payments crisis in the south Asian nation but analysts say Islamabad's finances remain strained.

Just as in Sri Lanka, there are questions in Pakistan over the viability of some infrastructure projects undertaken. A big port project in Gwadar, located on the Arabian Sea at the strategically important mouth to the Strait of Hormuz, has long been regarded as a jewel in the Belt and Road Initiative.

But a company boss living in Gwadar, who declined further identification, says that construction on the port project has been mothballed. "There is almost nothing going on in terms of building. We keep on waiting for China's promises to follow through but there has been very little so far," he says.

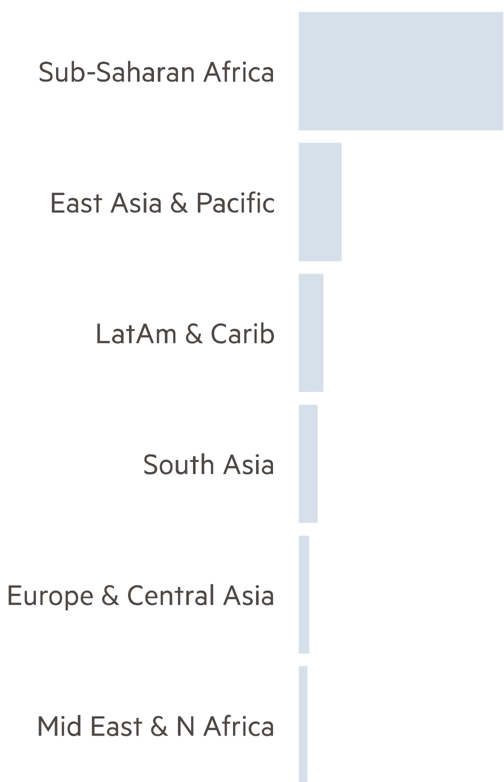
Another big recipient of Chinese loans is Zambia, which defaulted in 2020 on its external debt. China is Lusaka's biggest bilateral lender with about $6bn out of the country's $17bn of external debt.

Zambia had been presented as a star of the Belt and Road Initiative on the African continent. As recently as 2019 — just months before the country's default — the Chinese embassy in Lusaka was extolling the virtues of the scheme in a public statement.

statement.

The biggest problem for BRI loans is in Sub-Saharan Africa

Number of loans extended by Chinese creditors that have had to be renegotiated since 2001 (by region)



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Source: Rhodium

Indeed, the number of intended Belt and Road schemes in Zambia was breathtaking. A huge hydropower dam, two international airports, a railway connecting the country to Tanzania, two sports stadiums and a hospital have all been commissioned.

China steps back from the Belt and Road

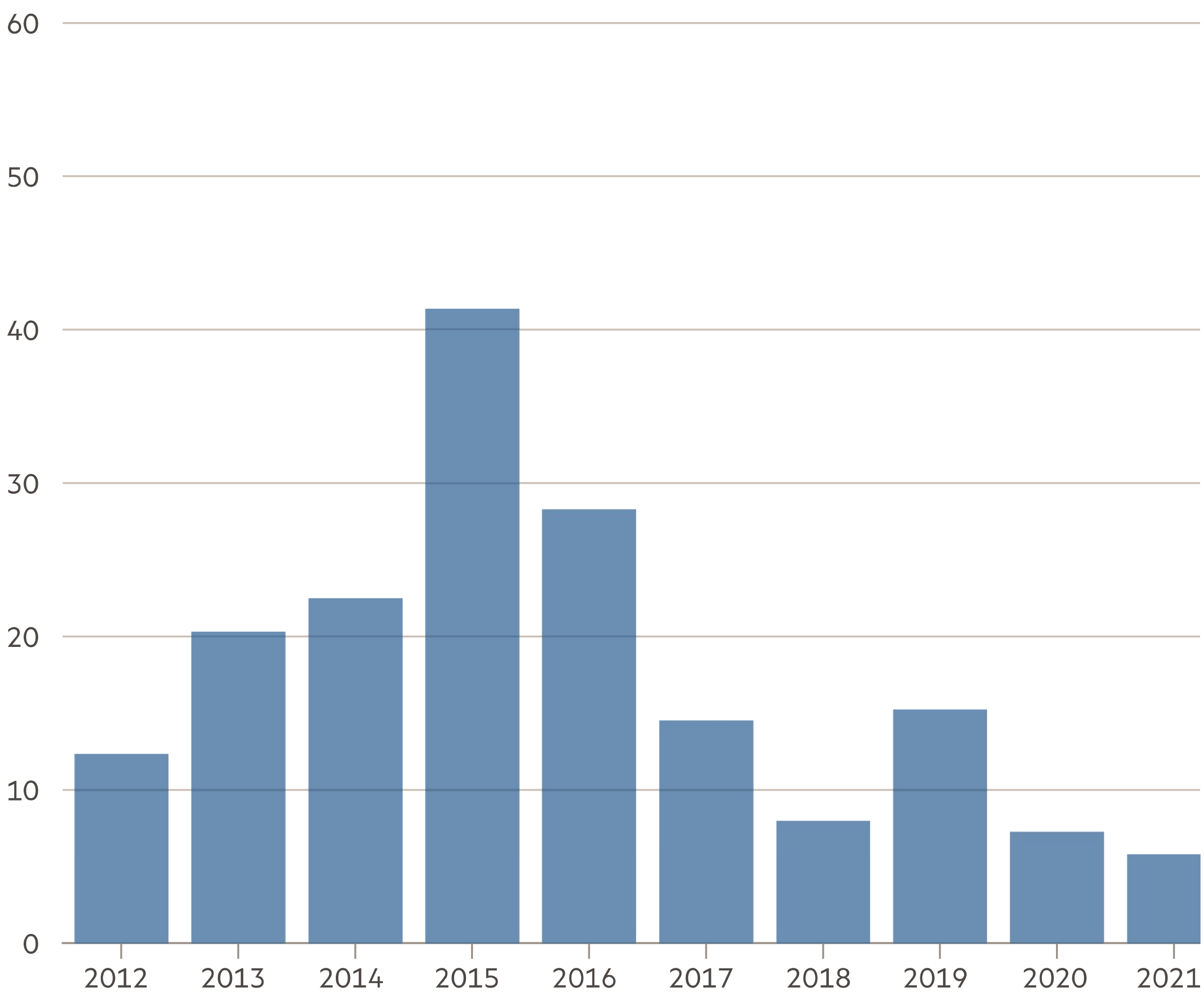
Such financial problems are prompting a quiet but fundamental rethink in Beijing as economic risks around the world rise, says a senior government adviser in Beijing, who declined further identification.

"A lot of investment in Belt and Road countries didn't make commercial sense and was in effect a form of capital flight," the adviser says. "What's more, the economic prospects in many BRI countries, led by African ones, has worsened dramatically in prospects in many BRI countries, led by African ones, has worsened dramatically in recent years. That makes it more imperative for us to think twice before going on another lending spree."

In addition, China's foreign exchange reserves — which peaked at nearly $4tn in 2014 — have fallen back to just over $3tn, making the hard currency that Chinese financial institutions use to lend to Belt and Road countries relatively scarce.

The volume of BRI loans is falling

Announced and actual loans by Chinese lenders (number of transactions over $1bn)



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Source: Janes IntelTrak

Chen Zhiwu, professor of finance at the University of Hong Kong, also sees a clear downsizing under way. "Especially given the changed geopolitical landscape after [Russia's] invasion of Ukraine, China is significantly downsizing the BRI," he says.

"I have not seen the BRI being mentioned so much at all in mainstream Chinese media. It is not the same BRI as a year or two ago."

Going it alone?

The big question now facing China as debt distress spreads amid slowing global growth is whether and to what extent Beijing will participate in multilateral debt resolution programmes in Belt and Road countries.

The destiny of several vulnerable emerging markets appears set to depend on the answer. Both Zambia and Sri Lanka are test cases.

A multilateral approach is counter-intuitive for Beijing because the Belt and Road Initiative has from the start been designed with a strictly bilateral dynamic. The relationships forged have been between each debtor country and its creditors in Beijing, rather than between a collection of countries all enjoying a say. The secrecy embedded into the Belt and Road scheme, along with the multiplicity of participating Chinese financial institutions each with their own agenda, further complicates matters, bankers say.

Some analysts say China has good reason to be cautious about signing up to a multilateral approach led by the IMF and the Paris Club group of wealthy creditor nations.

Kevin Gallagher, head of the Global Development Policy Center at Boston University and an adviser to the Chinese government, says China has "legitimate criticisms" of the conditions attached to IMF programmes that are a prerequisite of sovereign debt restructuring.

Many of the Belt and Road projects, like the 750km railway line from the Ethiopian capital Addis Ababa to the key port of Djibouti, have helped drive development © Houssein Hersi /AFP/Getty Images

"What kind of say are they going to have in something that is so driven by the French and the US?" he says. "They don't think an austerity-led programme is the way to get a country out of recession."

In an online interview with Gallagher in November 2020, Zhongxia Jin, China's executive director at the IMF, said that while IMF conditionality made sense "from a purely economic and theoretical point of view, [in practice] it is very painful for low-income countries . . . Our position on the board is that conditionality . . . should be growth friendly and growth oriented."

However, there are initial signs that Beijing may be willing to countenance at least a measure of co-operation.

After months of resistance, Beijing last month sat down with France as co-chair of the official creditor committee representing Zambia's bilateral lenders. This has brought Zambia a step closer to a $1.4bn rescue package from the IMF. But while the talks were described as constructive, western observers say it is far too early to assume that China will join collective action elsewhere, or even that Zambia's case will reach a successful conclusion.

"It is a commitment they have made," said Emmanuel Moulin, head of the French Treasury and chair of the Paris Club, of China's role in Zambia. "But now they need to deliver."

Its Belt and Road lending has helped to make China the world's biggest bilateral lender. To the 74 countries classed as low-income by the World Bank, it is bigger than all other bilateral lenders combined.

But its unwillingness to engage with other creditors in debt workouts has been a source of frustration at multilateral organisations.

In a statement before last week's meeting of finance ministers and central bank governors from the G20 group of large economies, Kristalina Georgieva, managing director of the IMF, issued the latest in a series of calls for urgent and decisive action on debt treatment "by all involved".

"Large lenders — both sovereign and private — need to step up and play their part," she said. "Time is not on our side."

Additional reporting by Sun Yu in Beijing and Mahendra Ratnaweera in Colombo