

Chinese Concessional Loans Part 2 – Pacific Indebtedness

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This In Brief is the second of a two-part series on Chinese concessional loans. The [first paper](#) discusses the nature of the loan schemes and three common misperceptions. This paper focuses on two aspects: (1) the possibility of debt-for-equity deals in the Pacific; and (2) what happens if Pacific states default on repayments. It aims to enrich the debates by adding a Chinese perspective.

The research notes that currently China is not a main lender to Pacific Island countries (PICs) and argues that loan forgiveness is extremely difficult and extension is more practical.

Pacific Island debt

Debt is a problem in the Pacific. Six PICs are at high risk of debt distress: Kiribati (as of 2017), Marshall Islands (as of 2018), Tuvalu (as of 2018), Micronesia (as of 2017), Samoa (as of 2018) and Tonga (as of 2017) (Fox and Dornan 2018). Another three PICs have moderate risk: Papua New Guinea (as of 2017), Solomon Islands (as of 2017) and Vanuatu (as of 2018) (ibid).

The rapid growth of Chinese concessional loans to the Pacific, a recent phenomenon since 2006, creates a misperception that China is a main lender to the region. In fact, except for Tonga, Pacific debt distress is not caused by Chinese lending as it accounts for less than half of lending in any single Pacific state and China holds about 12 per cent of total debt owed by the region (ibid). Tonga, Samoa and Vanuatu are the main debtors to China. Chinese lending makes up 56 per cent (as of 2018), 38 per cent (as of 2017) and 35 per cent (as of 2018) of these countries' debts respectively (ibid).

These figures differ from the findings of *The Economist*, especially for Vanuatu. Based on a [report in The Economist](#) of April 2018, Tonga's external debt is half of its gross domestic product and two-thirds of it is owed to China;¹ Samoa's external debt stands at half of GDP and 40 per cent is owed to China; and Vanuatu's external debt amounts to a third of GDP, half of which is held by China. The contradictory figures for Vanuatu demand more investigation.

Repayment of concessional loans

It is extremely difficult for China to write off concessional loans. First and foremost, concessional loans are borrowed by the China Export-Import Bank (China Exim Bank) from the capital market and need to be repaid. Second, setting a precedent could be risky. Writing off one country's concessional loans may lead to other countries raising similar requests. Accountability is a third factor. China Exim Bank officials tend to turn down requests for loan forgiveness. Being the ones who approved the loans in the first place, their careers could be affected if loan repayments are not honoured (Interview 1). Also, concessional loans and the other two components of Chinese aid (grants and interest-free loans) are different categories. Turning concessional loans into interest-free loans or grants involves a complicated bureaucratic process. As a former Chinese aid official explained, to a great extent, to write off concessional loans 'is not an issue of affordability for China, but of bureaucratic complexity' (ibid).

When Chinese concessional loans become due and the recipient country has difficulties in making repayments, they are required to notify China Exim Bank as early as possible. Bank officials will report this to the Chinese government, especially the ministries of Finance and Commerce. Meanwhile:

bank officials will spare no effort in persuading the country not to default on repayment in order to keep a clean record. Failure to repay will trigger the Bank's risk alarm, forcing it to downgrade the Bank's internal credit rating of the country, which will have a widespread negative impact on lending to the country by all Chinese financial institutions (Interview 1).

In some cases, the bank may turn a blind eye to the fact that the country applies for new loans to repay the old:

To the Bank, the paramount task is to make sure the recipient country does not default on the repayment (Interview 1).

Repayment difficulties

Countries can request meetings with Chinese officials to discuss options when they lack repayment capacity. Loan extension (*zhaiwu zhanqi*, 债务展期) is the most practical option. Beijing may extend the repayment period in consideration of bilateral relations and the financial situation in the recipient country, as in the case of Tonga. In the loan agreement, the only clause on dispute settlement is, 'Any dispute should be dealt with through amicable consultations or negotiations' (Interviews 2 and 3). This opens up possibilities to renegotiate debt repayment. A former Tongan senior official deeply involved in Tonga's loan arrangements with China said, 'it is important for the Tongan side to understand the meaning of these words, and think how they can turn those friendly discussions into actions that really help them' (Interview 2). A former Tongan minister of finance shared this view:

The Chinese side is well aware of the [Tongan] government debt obligation and its potential adverse implication to the Tonga national development if the debt services becomes unbearable. Both governments are constantly reviewing the fiscal and debt situation. China is willing to assist Tonga in making sure that its loan commitments would not endanger its macro economic and fiscal stability. China can assist with the extension of the grace period for loan repayment and also other forms of concession (Interview 3).

For the former Tongan minister of finance, turning concessional loans into interest-free loans or grants is a possible scenario. He may be over-optimistic, but given Pacific states' growing importance in the revitalised diplomatic tug-of-war between China and Taiwan, they are in a good position to renegotiate repayment with China.

A lesson to learn from the case of Tonga is that conveying the message clearly and consistently to China is useful. The Tongan government received US\$68.7 million (RMB 440 million)-worth of Chinese concessional loans to rebuild the central business district of its capital city Nuku'alofa which was burned down in a riot in November 2006. Tonga had financial difficulties in repaying the loans which were due in 2013. The Tongan side raised the debt issue with China during high-level meetings and regular talks with Chinese ambassador (Interview 3). Beijing extended Tonga's repayment period for five years to 2018. It is worth noting that in August 2018, Tongan Prime Minister Akilisi Pohiva [attempted](#) to unite Pacific states to press China for debt relief. It is also worth noting that, as a former Tongan senior official has suggested, Pacific

states should avoid asking for too much, as they did on many occasions in the past (Interview 2), and give due consideration to future debt risks.

The Tongan Prime Minister's attempt to involve other Pacific states in promoting debt relief was mocked by China's nationalist newspaper, the *Global Times*. It was described as a greedy move amounting to '*asking for the cow after milk is given*'.

Currently, a common practice is that China-funded projects overseas are packaged as part of China's Belt and Road Initiative (BRI), a signature project of President Xi Jinping. China could offer more concessional loans to the Pacific under BRI² in the near future and, quite possibly, more debt relief (interest-free loans) and loan extension (concessional loans). It has been reported that in mid-November 2018, at the same time as the Tongan government signed up to China's Belt and Road Initiative, Beijing offered a second five-year deferral of Tonga's debt repayment (ABC/Reuters News 2018).

Author notes

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References

- Fox, R. and Dornan, M. 8/11/2018. [China in the Pacific: is China engaged in 'debt-trap diplomacy'](#)? Devpolicy blog.
- Zhang, D. 2018. [Chinese Concessional Loans Part 1 – Perceptions and Misperceptions](#). In Brief 2018/23. Canberra: ANU.
- Interview 1, former Chinese aid official, July 2018.
- Interview 2, former Tongan senior official, October 2018.
- Interview 3, former Tongan minister of finance, November 2018.

Endnotes

1. Based on Interview 3, Chinese concessional loans account for 66 per cent of Tonga's total debt.
2. All eight PICs with diplomatic relations with China have signed up to BRI.

