

## **China's Infrastructure Development in the Indo-Pacific Region: Challenges and Opportunities**

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### **Introduction**

More than five years have passed since Chinese President Xi Jinping first announced the “One Belt One Road Initiative (OBOR),” subsequently renamed as the “Belt and Road Initiative (BRI),” in the fall of 2013. Yet the initial optimism about BRI has already turned into growing concern among neighboring countries in Asia and beyond because BRI has created more challenges than solutions for development in the region. China has contributed to developing hard and soft infrastructure in BRI countries, enhanced its connectivity with and within the region, and boosted trade and investment between China and BRI countries. China’s increasingly active engagement in infrastructure development, however, posed new challenges to the Indo-Pacific region.

Some developing countries suffer from the ballooning amount of debt from China, and their growing dependence on Chinese infrastructure financing raises concerns among policymakers. At the same time, the scale of Chinese loans is so large that it might undermine the stability of the international financial order as a whole if China’s infrastructure lending triggers a chain of debt defaults. Now is the time for major countries such as the United States and Japan to take the initiative in adopting preventive measures and avoiding unintended and unnecessary consequences. The Free and Open Indo-Pacific (FOIP) vision, a potential framework for enhancing cooperation among like-minded countries in the region, can play a significant role in this respect.

### **Historical Background**

Japan has been playing an essential role in supporting infrastructure investment in Asia. The Japanese government has provided concessional yen loans, the primary modality of Japan’s Official Development Assistance (ODA), to developing countries mainly to build economic and social infrastructure since 1958, when the first concessional yen loan was offered to India.

Nowadays, however, Chinese loans offered primarily by Chinese policy banks, such as China Development Bank (CDB) and China Export-Import Bank (China Exim Bank), have rapidly

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increased China's presence in infrastructure financing in Asia. There has been a growing need for Chinese loans in developing countries mainly because of unmet massive infrastructure needs in the region and the lack of necessary support for developing countries by the multilateral development banks (MDBs).

### *Massive Unmet Infrastructure Needs*

A joint study conducted by the Asian Development Bank (ADB) and Asian Development Bank Institute in 2009 concluded that from 2010 to 2020 approximately US\$8 trillion was needed to meet the infrastructure gap in Asia.<sup>2</sup> In 2017 ADB released a new estimate that the region will require infrastructure investment worth US\$26.2 trillion from 2016 to 2030, or US\$1.7 trillion annually: US\$14.7 trillion for power, US\$8.4 trillion for transport, US\$2.3 trillion for telecommunications, and US\$800 billion for water and sanitation.<sup>3</sup> According to ADB, each subregion requires the following amount of investment: US\$565 billion for Central Asia, US\$16.1 trillion for East Asia, US\$6.3 trillion for South Asia, US\$3.1 trillion for Southeast Asia, and US\$46 billion for the Pacific.<sup>4</sup> The study estimated that the amount of infrastructure investment in Asia is currently US\$881 billion<sup>5</sup>; thus, the region still lacks almost half of the needed infrastructure investment.

Yet concessional aid loans are not necessarily the dominant modality of foreign assistance today. Among Organization for Economic Cooperation and Development (OECD) countries, only four members—Japan, Germany, France, and South Korea—provide a decent amount of concessional aid loans.<sup>6</sup> Japan has been offering the largest amount of concessional loans among the four countries, although its concessional yen loan disbursement in 2016 accounted for approximately US\$7.89 billion,<sup>7</sup> which is far below the expected amount of infrastructure investment in Asia.

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<sup>2</sup> Asian Development Bank and Asian Development Bank Institute, *Infrastructure for a Seamless Asia*, Asian Development Bank Institute, 2009, 4.

<https://www.adb.org/sites/default/files/publication/159348/adbi-infrastructure-seamless-asia.pdf>

<sup>3</sup> Asian Development Bank, *Meeting Asia's Infrastructure Needs*, Asian Development Bank, 2017, xi.

<https://www.adb.org/sites/default/files/publication/227496/special-report-infrastructure.pdf>

<sup>4</sup> *Ibid.*, xiv.

<sup>5</sup> *Ibid.*, x.

<sup>6</sup> The amount of gross disbursement of bilateral concessional aid loans these countries extended in 2016 was as follows: Japan US\$7857 million, Germany US\$4991 million, France US\$3334 million, and South Korea US\$637 million. Ministry of Foreign Affairs, *White Paper on Development Cooperation 2017*,

<https://www.mofa.go.jp/policy/oda/white/2017/html/honbun/b4/sanko1.html> (Accessed on February 21, 2019).

<sup>7</sup> Ministry of Foreign Affairs, *White Paper on Development Cooperation 2017*,

<https://www.mofa.go.jp/policy/oda/white/2017/html/honbun/b3/s1.html#link01> (Accessed on March 2, 2019).

Meanwhile, German and French foreign aid has a specific regional focus. Germany offers foreign assistance to 67 selected partner countries: 24 countries in Africa, 18 countries in Asia, nine countries in Central and South America and the Caribbean, seven countries in Central and Eastern Europe and the Caucasus, and nine countries in the Middle East.<sup>8</sup> Although Asia is one of the top priorities, Asia's share of total German foreign aid has declined significantly over the past few years—from 28.3 percent in 2014 to 21.8 percent in 2015 and 14.7 percent in 2016.<sup>9</sup> The situation is similar in France. Approximately half of French foreign aid goes to countries in Africa and less than 15 percent of foreign aid is allocated to Asia: 14.1 percent in 2015, 12.0 percent in 2016, and 12.4 percent in 2017.<sup>10</sup>

In 2015, South Korea identified 24 priority countries for foreign assistance: 11 countries in Asia (Bangladesh, Cambodia, Indonesia, Nepal, the Philippines, Pakistan, Laos, Mongolia, Myanmar, Vietnam, and Sri Lanka), seven countries in Africa, two countries in Central Asia and the Caucasus, and four countries in Central and South America. In 2017, the largest share of total foreign assistance, 38.1 percent, went to countries in Asia. However, the total volume of South Korean foreign assistance in 2017 was approximately US\$2.27 billion, and concessional loans were just US\$820 million.<sup>11</sup> Therefore, South Korea's financial contribution is still limited in the region.

In sum, the amount of aid loans these OECD countries extend is far below what is needed. Chinese money under BRI is undoubtedly a useful addition to the field of infrastructure finance.

### *MDBs' Lack of Necessary Support for Developing Countries*

Such growing infrastructure needs have not been adequately addressed by traditional multilateral development banks (MDBs), neither in terms of volume of financing nor their business practices. The World Bank Group has been increasing its loan commitments over the past few years. For instance, the total commitments of the World Bank Group, which consists of the International Bank for Reconstruction and Development (IBRD), International Development Association (IDA), International Finance Corporation (IFC), and Recipient-Executed Trust Funds (RETF), increased from US\$58.19 billion in fiscal 2014 to US\$61.783 billion in fiscal 2017. Yet loan disbursements

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<sup>8</sup> Gaimusho, Kaihatsukyoryoku Sankoshiryoshu [Ministry of Foreign Affairs, "Reference Materials for Development Cooperation"], 2018, 184, <https://www.mofa.go.jp/mofaj/gaiko/oda/files/000409546.pdf> (Accessed on February 23, 2019) .

<sup>9</sup> Ibid., 186.

<sup>10</sup> Ibid., 183.

<sup>11</sup> Ibid., 222.

still have not caught up with the pace of those commitments: US\$44.398 billion dollars in fiscal year 2014 compared to US\$43.853 billion dollars in fiscal year 2017.<sup>12</sup>

Moreover, the Indo-Pacific region received only around 30 percent of IBRD loans on a commitment basis from fiscal year 2014 to fiscal year 2017. The region also has been less significant for IDA in recent years, as the shares of East Asia and Pacific and South Asia combined dropped from 47.6 percent in fiscal year 2014 to 33.6 percent in fiscal year 2017. Although the amount of loan commitments to the Indo-Pacific region reached US\$7.1 billion in fiscal 2017, that is far below the level of what is needed.<sup>13</sup>

Further, MDBs have placed less emphasis on infrastructure financing. The primary objective of the World Bank initially was to support European reconstruction and economic development by building infrastructure and it therefore prioritized infrastructure financing. However, the top priority has shifted over time from infrastructure financing to social-oriented lending and programmatic and policy operations, reflecting the widely shared belief among development economists that project lending did not lead to economic development.<sup>14</sup> One such specialist, Chris Humphrey, pointed out that IBRD and IDA operations focused increasingly on other areas over time. Whereas more than 70 percent of the operations focused on infrastructure projects in the 1950s and 1960s, that share dropped to 19 percent in 1999 but has since recovered somewhat to the 30-40 percent range today.<sup>15</sup> Humphrey also found that regional MDBs generally show a similar pattern to the World Bank. The share of infrastructure lending among total investment commitments by the World Bank Group was approximately 30 percent from 2004 to 2013, whereas the share of regional MDBs' commitments during the same period were somewhat higher but also remained relatively low, with 42 percent for the African Development Bank, 52 percent for ADB, and 60 percent for the European Investment Bank (EIB), among others.<sup>16</sup>

Developing countries have also criticized the business practices of MDBs. MDBs impose considerable costs and burdens on borrowers, causing some of them to look for alternative financing sources. MDB loans are not necessarily attractive to developing countries for several reasons.

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<sup>12</sup> A fiscal year starts on July 1<sup>st</sup> and ends on June 30<sup>th</sup>. World Bank, "The fiscal Year 2018 Data," <http://www.worldbank.org/en/about/annual-report/fiscal-year-data> (accessed on February 24, 2019).

<sup>13</sup> Ibid.

<sup>14</sup> Chris Humphrey, *Infrastructure Finance in the Developing World: Challenges and Opportunities for Multilateral Development Banks in 21<sup>st</sup> Century Infrastructure Finance*, Working Paper Series, Intergovernmental Group of Twenty Four, June 2015, 2.

<sup>15</sup> Ibid., 3.

<sup>16</sup> Ibid., 4.

First, the project approval review process is very lengthy and cumbersome. According to the World Bank Corporate Scorecard 2017, it took 22.3 months on average from concept note approval to the first disbursement for World Bank-supported projects<sup>17</sup> because of a lengthy review process. As Humphrey writes, “(a)t the World Bank, most investment loans involve four separate country missions (identification, pre-appraisal, appraisal, and negotiations) as well as four full formal internal reviews (concept, quality enhancement, a decision to appraise, and Board approval).”<sup>18</sup>

Moreover, borrower governments must go through a procurement process after the World Bank Board approves a project. The process for infrastructure projects can take even longer, up to one year.<sup>19</sup> Developing countries have to learn the complicated bidding rules of MDBs, which impose additional burdens on borrower governments. Given that the private sector disburses money without requiring recipients to follow the steps mentioned above, it is much faster and easier for developing countries to borrow from commercial banks.

Second, stringent environmental and social safeguard policies of MDBs further delay the time for operational delivery. When a project triggers a safeguard, a borrowing country has to fulfill additional requirements such as conducting studies by third-party experts at the borrowing country’s cost, participating in consultations with relevant actors, taking mitigation measures, and going through public disclosure and comment periods.<sup>20</sup>

These lengthy procedures undoubtedly burden the borrowing countries’ governments even further. The entire process takes a long time and is so costly that developing countries look for other options for funding. Therefore, developing countries do not necessarily have enough options for infrastructure financing.

Against this backdrop, China has recognized the lengthy procedures of the World Bank and regional MDBs as significant weaknesses and succeeded in attracting developing countries with its “borrower-friendly” loans to address the infrastructure gap in Asia.

## **Key Issues**

### *China’s New Financial Institutions and Multilateral Banks*

China has actively created new financial institutions in the past few years. In December 2014, China established the Silk Road Fund (SRF) for BRI infrastructure projects with initial capital of

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<sup>17</sup> World Bank Corporate Scorecard 2017, <http://scorecard.worldbank.org/tier3-performance> (accessed on February 25, 2019).

<sup>18</sup> Humphrey, 13.

<sup>19</sup> *Ibid.*, 14.

<sup>20</sup> Humphrey, 15.

US\$40 billion. This purely Chinese fund had invested in 15 projects worth around US\$6 billion by the end of March 2017.<sup>21</sup> China then established a new MDB, the Asian Infrastructure Investment Bank (AIIB), in December 2015. Together with the BRICS countries (Brazil, Russia, India, China, and South Africa), China also helped establish the New Development Bank (NDB) in July 2015 and started operations, headquartered in Shanghai, in February 2016.

China has undoubtedly contributed to infrastructure development in the Indo-Pacific region with funding from its policy banks and newly established financial institutions. An examination of these various projects indicates that initiatives under multilateral institutions led by China tend to reflect general development funding principles such as economic viability. In contrast, infrastructure projects financed by China unilaterally, through Chinese banks such as CDB and China Exim Bank, more often provide funding for the construction of strategic facilities outside China that can be used as collateral if recipient countries default on their loans. Thus, the source of funding is one useful criterion for assessing China's intentions.

AIIB is a multilateral development bank with a strong focus on infrastructure development in Asia, and China maintains a veto with 26.5443 percent of the voting rights. As of the end of 2018, AIIB had approved 33 projects worth more than US\$7.4 billion and six projects worth US\$5.2 million under a special fund.<sup>22</sup> AIIB's approved projects were categorized as follows: 13 in the energy sector; ten in transportation; five in urban development; four in water; five in multi-sector; and one in "others." Transportation is the second most important sector for AIIB, and most of the projects are for roads and urban transportation such as metro systems. There is only one project, the Duqm Port Commercial Terminal and Operational Zone Development Project in Oman, related to sea-port development. AIIB has extended loans to 16 countries, mostly in Asia, for the past three years and India received US\$2.069 billion for eight projects, the largest recipient both in terms of total number of loans and the number of projects.

NDB has been extending loans only to BRICS countries. As of the end of 2018, NDB had funded 30 projects worth US\$ 8.06823 billion.<sup>23</sup> Interestingly, NDB's loan portfolio mirrors AIIB in that energy and transportation are two of the most important sectors for NDB. NDB has launched 11 projects in the energy sector, nine in transportation, four in water, three in urban development, two in the environment, and one in social infrastructure. Like AIIB, NDB transportation projects focus

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<sup>21</sup> Silk Road Fund, "Scope of Investment," <http://www.silkroadfund.com.cn/enweb/23798/23805/index.html> (accessed on March 3, 2019).

<sup>22</sup> Asian Infrastructure Investment Bank, "Approved Projects," <https://www.aiib.org/en/projects/approved/index.html> (accessed on January 2, 2019).

<sup>23</sup> New Development Bank, "Projects," <https://www.ndb.int/projects/list-of-all-projects/> (accessed on January 2, 2019).

mainly on roads, bridges, and urban transportation, and there is only one project, the Durban Container Terminal Berth Reconstruction Project in South Africa, related to sea-port development.

SRF is one of the most important financial institutions to support BRI, but it is hard to compile a list of its projects because details are unavailable. Based on a review of SRF's scope of investments, most of the approved projects seem to fall under either the energy sector or financial cooperation, and only one initiative, the purchase of shares of Pirelli, an Italian tire manufacturer, appears related to the transportation sector.<sup>24</sup>

China's unilateral infrastructure financing has several sources. According to Annual Reports published by the CDB, as of December 2017, the bank's foreign currency loans reached US\$261.7 billion, and its annual BRI related loans were much larger than those offered by AIIB and NDB over the last three years: US\$14.9 billion in 2015,<sup>25</sup> US\$12.6 billion in 2016,<sup>26</sup> and US\$17.6 billion in 2017.<sup>27</sup>

China began to offer concessional yuan loans after 1994 when the China Exim Bank was established, but the bank does not disclose the number of concessional yuan loans it offers each year. According to the first white paper on China's foreign aid, the total amount of concessional yuan loans China had offered by the end of 2009 was RMB73.55 billion,<sup>28</sup> and it issued RMB49.76 billion in concessional yuan loans from 2010 to 2012.<sup>29</sup> Chinese concessional yuan loans are long-term, with a 15-to 20-year repayment period and a five-seven-year grace period. It is fair to assume that many of China's concessional yuan loans will start coming due after the next few years. China needs to take effective measures to avoid debt defaults unless it is willing to roll over these loans.

Chinese banks such as CDB and China Exim Bank appear to fund the development of strategic facilities such as ports outside China. In other words, China invests in strategic facilities unilaterally, which creates opportunities to seize them as collateral if and when a borrowing government falls into default. In fact, Chinese loans have accumulated to the extent that some developing countries began to review their contracts with China. For example, China's takeover of Hambantota port in Sri Lanka in December 2017 was a wake-up call for developing countries that have borrowed extensively from China. Former Sri Lankan president Mahinda Rajapaksa built the port in his home district using Chinese money. When Sri Lanka was not able to repay the Chinese loans worth US\$1.1 billion, a Chinese state-owned enterprise, China Merchants Group,

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<sup>24</sup> Silk Road Fund, "Scope of Investment," <http://www.silkroadfund.com.cn/enweb/23798/23805/index.html> (accessed on March 3, 2019).

<sup>25</sup> China Development Bank, Annual Report 2015, 60.

<sup>26</sup> China Development Bank, Annual Report 2016, 52.

<sup>27</sup> China Development Bank, Annual Report 2017, 48.

<sup>28</sup> Information Office of the State Council, The People's Republic of China, China's Foreign Aid, April 2011, 8.

<sup>29</sup> Information Office of the State Council, The People's Republic of China, China's Foreign Aid, July 2014, 3.

gained the right to manage the port on a 99-year lease. Such a deal was not included in the original contract but instead came about through a negotiation process between the two parties. This case illustrates how China can take control of strategic infrastructure in other countries and potentially use them for military purposes.

After China took over the Hambantota port, countries that received funds under BRI started worrying about falling into China's "debt trap," and China was perceived as utilizing loans to gain political leverage over borrowing countries. China's growing loans and investments in developing countries have become a significant source of concern, especially for those countries with significant foreign debt.

### **Policy Recommendations**

China's infrastructure financing will continue to be a serious challenge in the foreseeable future, not only for borrowing countries but also for China and the international community as a chain of debt defaults could undermine the global financial order. China's manner of extending loans does require significant adjustment but borrowing countries as well as major developed economies can take some measures to avoid or mitigate unintended consequences.

In this regard, the United States and Japan together with like-minded countries can take a variety of measures under the Free and Open Indo-Pacific (FOIP) construct. Japan's FOIP vision has three pillars: 1) the promotion and establishment of the rule of law, freedom of navigation and free trade; 2) the pursuit of economic prosperity by improving connectivity; and 3) a commitment to peace and stability, such as capacity building on maritime law enforcement and humanitarian assistance/disaster relief (HA/DR) cooperation.<sup>30</sup> The United States, Australia, and other countries in the region are also exploring avenues for regional cooperation under FOIP, and there is plenty for Japan and its partners to consider in the realm of infrastructure development.

First, developing countries' over-dependence on China economically is unhealthy for the region. We should avoid cases where China is the only provider of strategic infrastructure financing in countries targeted under BRI. Major powers in the Indo-Pacific, namely the United States, Australia, and Japan, should offer more infrastructure financing to developing countries in the region. In May 2015 the Japanese government announced a plan to offer US\$110 billion for quality infrastructure in Asia in cooperation with ADB. And in May 2016, the Japanese government offered to dedicate US\$200 billion over the next five years for infrastructure development around the world.

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<sup>30</sup> Ministry of Foreign Affairs, "A New Foreign Policy Strategy: "Free and Open Indo Pacific Strategy"", <https://www.asean.emb-japan.go.jp/files/000352880.pdf> (accessed on November 6, 2018).



Second, economic capacity building is vital for developing countries. Although the United States and Japan have supported capacity building in the security domain over the past few years, it could also be expanded to the economic domain as a foundation for peace and security. For instance, Japan and the United States can train developing countries in financial management and debt sustainability. Borrowing countries need to make more realistic assessments of the level of foreign debt they can manage and better understand the consequences of over-reliance on foreign loans. Debt cancellation should be the last resort and cannot happen frequently.

Third, if a borrowing country is faced with a debt crisis, the negotiation of debt rescheduling should take place in a fair manner. A borrowing country that is in a vulnerable negotiating position, particularly in bilateral negotiations, may end up sacrificing part of its control over strategic facilities, as in the case of the Hambantota port in 2017. China's acquisition of strategic infrastructure such as seaports, airports, and communication infrastructure could have negative consequences for the borrowing country and beyond.

Against this backdrop, the Paris Club, or "Group of Ten," a group of major creditor nations of the International Monetary Fund (IMF), can be an ideal venue for addressing China's "debt trap." The Paris Club holds informal meetings to discuss the financial relations of IMF member countries. Japan and the United States should consider including China and its loan recipients in the mechanism so that information on China's loans will be shared and borrowing countries' debt can be appropriately managed in cooperation with other lending countries. China's participation in the Paris Club can serve its interests as well. Because China alone has extended a large number of loans to many developing countries, it will suffer a severe blow if a borrowing country collapses economically. China's participation in the Paris Club is essential for effectively managing its loans to borrowing countries and maintaining the stability of the international financial order.

Fourth, Japan, the United States, and other like-minded countries should encourage China to follow the rules-based international order. One way to achieve this is to encourage China to join the OECD as a full member. Given that China is the second largest economy in the world, it is natural for the OECD to include China as a member. This could be achieved over the long run because the OECD has engaged with China as a key partner. Key partners can be invited as invitees or participants without receiving approval from the Council of the OECD, which consists of representatives of all member countries and the European Commission. There are three types of partnerships: invitees, participants, and associates. Invitees can be invited to a meeting which covers non-confidential items on an ad hoc basis. Participants can be invited to non-confidential meetings of all committees. The next step would be to examine whether China is entitled to be an

associate that can attend a committee or a project but must assume the same obligations with OECD members.<sup>31</sup>

China should also become a member of the Development Assistance Committee (DAC) of the OECD because the DAC is the premier forum of international development assistance. Although the amount of China's foreign aid is unclear, it is widely believed that China ranks high as an ODA donor. According to an estimate by Naohiro Kitano, China ranked seventh in terms of net and gross ODA flows in 2016. The United States has the top ranking and is followed by Germany, the United Kingdom, Japan, France, Turkey, and China.<sup>32</sup> China should disclose information on its foreign aid as a major donor. Such activity will enhance China's reputation as a responsible donor.

Finally, China's "debt trap" has several causes. The lack of capital in developing countries and their difficulty in accessing loans are other important reasons for falling into China's "debt trap," in addition to the abundant Chinese loans available for their infrastructure development. As noted above, it is important to acknowledge that MDBs' loans cannot necessarily satisfy developing countries' demand. MDBs can adjust their lending practices to accommodate the needs of developing countries. As the top two shareholders of voting rights in the World Bank and the ADB, Japan and the United States can work together to initiate such reforms.

## **Conclusion**

China's BRI has strategic implications for the Indo-Pacific region in terms of both security and economy. The FOIP vision initially sought to address concerns related to maritime security, and such measures are necessary to maintain the rules-based international order in the region and beyond. At the same time, China's infrastructure development in the Indo-Pacific has also generated concerns about economic security, and this dimension of the China challenge should also be addressed under FOIP. China's infrastructure financing, if unmonitored and inconsistent with established development financing principles, could pose a severe threat to the stability of the international financial order. Now is the time for the United States, Japan, and other countries to formulate a common approach to infrastructure development in the region. Such an approach will likely feature both elements of cooperation and competition with China and balancing the two will prove critical to maintaining economic security in the Indo-Pacific region.

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<sup>31</sup> OECD, "Partnerships in OECD bodies," <http://www.oecd.org/global-relations/partnershipsinoecdbodies/> (accessed on March 22, 2019). In addition to China, Brazil, India, Indonesia, and South Africa are also designated as key partners of the OECD.

<sup>32</sup> Naohiro Kitano, "Estimating China's Foreign Aid Using New Data: 2015-2016 Preliminary Estimating China's Foreign Aid Using New Data: 2015-2016 Preliminary Figures—Contribution to AIIB significantly increased China's aid volume," May 31, 2018, 2, [https://www.jica.go.jp/jica-ri/publication/other/l75nbg00000puwc6-att/20180531\\_01.pdf](https://www.jica.go.jp/jica-ri/publication/other/l75nbg00000puwc6-att/20180531_01.pdf) (accessed on March 4, 2019).