FT Series **China's debt threat**

Silk Road

China's Belt and Road projects drive overseas debt fears

Ambitious programme dogged by doubts over ability to pay or high price tags

James Kynge in London YESTERDAY

China's leader, Xi Jinping, has called it the "project of the century" and said it will usher in a "golden age" of globalisation.

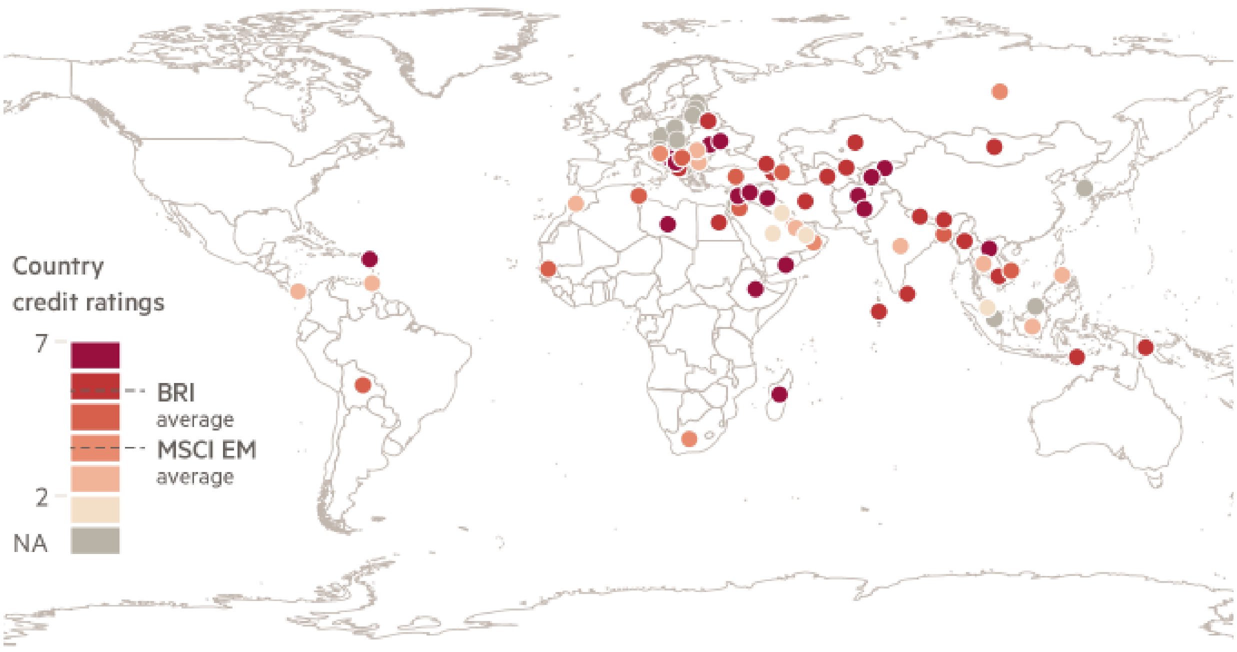
With Beijing-backed projects in 78 countries, the "Belt and Road Initiative" (BRI) is one of the world's most ambitious development programmes. But critics fear it could become the conduit through which some of China's debt problems are transmitted overseas.

A series of controversies that have flared in countries as far apart as Pakistan, Sri Lanka, Laos, Malaysia, Montenegro and others are all related to debt sustainability — either because of the perceived inability of countries to handle outsized debts to China, or because some Beijing-funded infrastructure projects do not appear likely to justify their price tag.

"Disconnects between the creditworthiness of a project or a country and the size of the loans that China offers have led to project delays, political turmoil and allegations of wrongdoing in contract award procedures," said Andrew Davenport, chief operating officer at RWR Advisory Group, a Washington-based think-tank.

Risks high in Belt and Road countries

OECD measure of country risk in 78 countries involved in the Belt and Road Initiative
(0 = lowest country risk, 7 = highest country risk)



Source: OECD, FT research   Graphic: Jane Pong, James Kynge

Some mismatches are baked in to the BRI's design. A Financial Times study shows that the 78 countries selected by China to participate include many of the world's most risky economies, according to OECD rankings of country risk.

Out of a scale on which seven represents the highest level of country risk, the BRI countries show an average of 5.2, considerably worse than the 3.5 average for emerging markets, according to the FT study (see map).

A similar result is found by Moody's, the credit rating agency, which says that the median credit rating of the 78 countries is Ba2 — signifying a non-investment or "junk" level of default risk.

Pakistan, which rates a seven on the OECD risk scale, offers a pressing example of BRI stress. Islamabad confirmed this month that it is considering asking the IMF for a bailout after its hefty import bill for Chinese capital goods and its debt repayment obligations have contributed to a critical shortage of foreign currency.

“[Pakistan] is on the verge of a balance of payments crisis which has been largely caused by a surge in imports of capital goods related to a series of massive Chinese infrastructure projects,” said Alex Holmes, Asia economist at Capital Economics, a research firm.

Montenegro ‘Highway to nowhere’

© Reuters

Cost: €809m for first phase

Montenegro had its credit rating cut by Moody’s after borrowing from China to fund the 41km first phase of this motorway, which costs an amount equivalent to one-fifth of GDP. Doubts abound over how to fund the remaining 136km of the road.

At the start of June, Pakistan’s central bank had just $10bn in foreign currency left, considerably short of the $12.7bn in external repayments due next year. But in spite of Islamabad’s fragile finances, Beijing is running its biggest single BRI programme in the country, financing and building infrastructure worth $62bn.

Cambodia, another big recipient of BRI lending, is also showing signs of stress. A surge in imports of capital goods to supply construction projects has caused Phnom Penh’s trade deficit to widen to 10 per cent of gross domestic product. If foreign investment inflows were to decline, the country could struggle to finance its foreign liabilities, Mr Holmes added.

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Several other countries have hit similar problems. Sri Lanka had to transfer the strategic port of Hambantota to Chinese ownership after it could no longer keep up with its debt repayments to Chinese creditors. Montenegro had its credit rating cut by Moody's after borrowing from China to fund the first phase of a motorway costing €809m, an amount equivalent to nearly one-fifth of the country's GDP.

Laos has signed up to a Chinese-funded railway costing $6bn — equivalent to about 40 per cent of the country's GDP in 2015 — necessitating machinery imports that have contributed to a yawning trade deficit.

Malaysia's BRI difficulties are different. Kuala Lumpur does not face balance of payments problems, but its new prime minister, Mahathir Mohammed, has suspended about $23bn in China-backed infrastructure undertakings while his government reviews "unequal treaties".

Laos high-speed railway

© Alamy

Cost: $6bn

China Railway Group is building this high-speed line with dozens of tunnels and some 170 bridges in Laos. The cost amounts to about 40 per cent of the south-east Asian country's GDP.

A study by RWR Advisory has calculated that controversies over debt — as well as public opposition to projects, objections over Chinese labour policies, performance delays and concerns over national security — have swelled the proportion of “troubled” BRI projects to about 270 of the total 1,814 projects undertaken since 2013. These projects represent about 32 per cent of the total value of the projects.

Debt problems also exist at company level. This is because the big Chinese state-owned enterprises that build, operate and invest in many BRI projects are — on average — extremely highly leveraged.

A study by the Financial Times shows that the top 10 Chinese construction and engineering contractors active outside China are nearly four times more highly leveraged than the top 10 non-Chinese companies.

‘Belt and Road’ companies are hugely indebted

Total debt to Ebitda measures a company’s ability to repay its debts from earnings.

Graphic: Jane Pong, James Kynge
Source: S&P Global Market Intelligence, ENR, FT research
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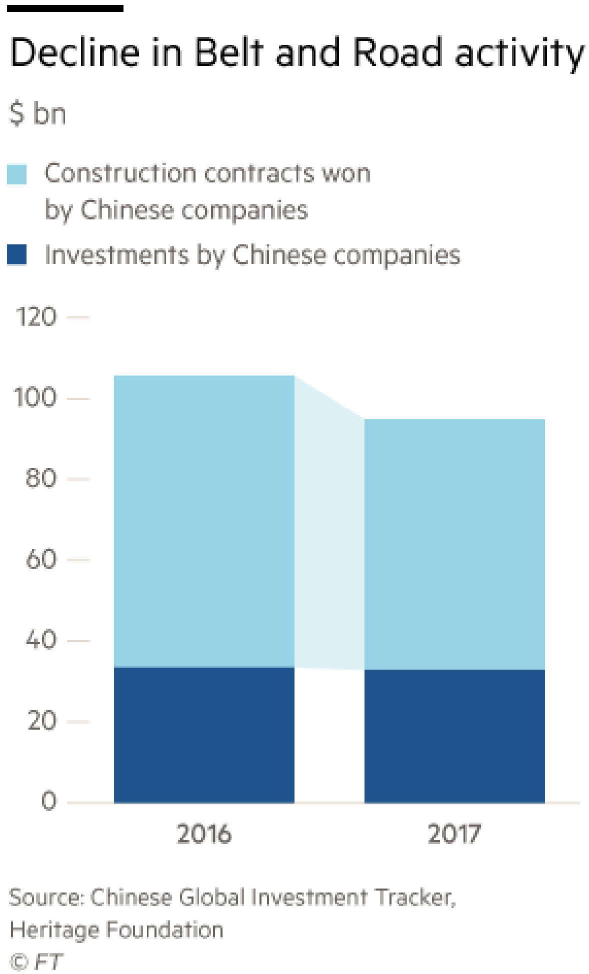
*The total debt to ebitda numbers come fr
the latest period reported, mostly 2017 res
** Excludes contractors that did not publish audited accou

The data show that in terms of total debt to ebitda (earnings before interest, tax, depreciation and amortisation), a common measure of a company’s ability to repay its debts, the top 10 Chinese contractors had an average multiple of 9.2 times, signifying extreme indebtedness. Their non-Chinese counterparts had an average multiple of 2.4 times.

“The big state-owned enterprises are run by Communist party politicians,” said a senior Chinese official, who spoke on condition of anonymity. “They are rewarded for political loyalty and motivated by a desire to please their party bosses by getting involved with big BRI projects. Debt is just not a big concern for them.”

In some cases, “white knight” Chinese investors are far more heavily indebted than the companies they “rescue”. Cosco Shipping Holdings, parent of China Cosco Shipping, which bought a controlling stake in Greece’s largest port in 2016, was six times more leveraged than the Piraeus Port Authority it bought.



The Piraeus investment has proven successful, driving new business to the Greek port. However, the debt mismatch shows that Chinese companies — especially the 98 huge corporations that are owned by SASAC, a central government holding company — are playing by different rules. Because these companies are centrally owned by China’s government, they can run up massive debts without fear of bankruptcy.

But this is starting to change— and in ways that may affect BRI investments. In May this year, Beijing ordered SASAC companies to bring down their debt-to-asset ratios by 2020.

Analysts said this was likely to entail a greater focus on the quality of overseas investment projects.

"As China deepens its deleveraging campaign domestically, policy focus will shift toward the quality of leverage rather than the quantity," said Jinny Yan, chief China economist at ICBC Standard Bank. "This means that debt sustainability will be increasingly scrutinised, particularly in high risk countries along the Belt and Road."

Some BRI investment deals that are deemed too risky may be unwound, while the pace of new investments may fall off, said the senior official. "There has been a re-assessment of BRI in Beijing. We need to ensure that the reputation of BRI is safeguarded by making sure that BRI projects are high quality."

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