Pacific Institute of Public Policy

UNSURE REFUGE

Rash, unsound borrowing and predatory lending practices are leading some Pacific island countries toward insolvency

Discussion Starter: 25

KEY MESSAGES

1. The Pacific has witnessed a sudden increase in borrowing to pay for ill-considered infrastructure projects.

2. Much of the lending has been based on flawed analysis - we can't afford to keep making these mistakes.

3. Our tolerance for debt must be a lot lower - our economies are too small and fragile to continue taking on more loans.

4. The rising cost of servicing debts means governments have less money to spend on services such as health and education.

Pacific Institute of Public Policy

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The Pacific Institute of Public Policy is the leading independent, non-partisan think tank serving the Pacific islands region. We exist to stimulate and support informed and inclusive policy debate in and about Pacific island countries.

Our discussion starters are short papers that draw on original investigation and/or a synthesis of relevant existing research to advance thinking and debate on pressing policy issues affecting our region.

UNSURE REFUGE

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On 31 August 2012, a tiny but crucial change to Vanuatu's Public Finance and Economic Management Act came into force. The amendment altered one piece of punctuation and a single sentence. It also effectively removed parliamentary oversight prior to the government signing on to new debt. The day this amendment came into effect, the caretaker minister of finance signed a loan agreement worth nearly USD 11 million with the Asian Development Bank[1]. People close to the process felt that ADB representatives were among those who pressured politicians for this amendment - not wanting to wait until after the election or to face the possibility of renewed negotiations with the next government.

The amendment also cleared the way for a number of memoranda signed in the preceding months with Chinese contractors for lavish rural infrastructure projects. Under the new legislation, Parliament - and the public - won't be shown the details of these loans until it's too late.

Nobody disputes the value of sober, debt-driven investment.

Increasingly, however, a number of Pacific island countries are falling victim to predatory lending. Aristotle famously said that true friends are a sure refuge. But are our development partners acting like true friends?

(1) The loan is for an interisland shipping support project (ADB Loan No. 2820) - http://www.adb.org/projects/42392-013/main

It started with a kiss…

Borrowing motivated by political expediency has been happening in this region for decades. But over the last few years, we have witnessed a sudden increase in lending[1]. The debts are imposing an increasingly heavy financial burden on our economic future. A few countries, including Samoa and Tonga, are already on the path toward what economists call distressed debt - at risk of falling into default. Others, including Vanuatu, seem intent on heading down that road, too.

As in Vanuatu, financial management processes in a number of Pacific island countries are becoming increasingly opaque. Details on exactly how and when project funds are spent, and by whom, are sparse in the public domain. In some cases, it's not even clear whether governments have irrevocably committed themselves to loans. This is not, in all likelihood, evidence of deliberate secrecy, misdeed or ill intent. In most cases, what we see is well-intentioned people in a hurry to get going on projects that they hope will legitimately improve conditions. But lamentably poor due diligence and lack of prudent consideration has led some countries toward financial crisis, and others into obligations that will severely restrict government spending options in years to come.

The borrowing phenomenon is exacerbated by multilateral agencies which often look for reasons to lend without properly considering the necessity or even the usefulness of the loan. If you were to add up all the loans on offer from all multilateral agencies, the total amount would likely exceed what any individual country could possibly absorb or pay back. When confronted with this fact most lenders will blame each other rather than reduce the size of their own programme.

Nobody seems to notice that a scandalous number of multilateral loans in the Pacific have been based on lax, flawed economic analysis. Few advisors stir themselves to return to the project site after the ribbon cutting. In the world of development finance, it doesn't pay to ask, 'Why are we paying for wharves that don't exist, defunct development banks, roads that have deteriorated even before payments begin, institutions that are weaker than ever?'

An increasing amount of government revenues are being diverted to service debt repayments. The proportion of revenues may appear relatively low, but the monetary amounts are significant for small and fragile economies.

Governments across the region face the challenge of keeping up with growing demand for public services. Yet the resources to do so are increasingly being diverted to paying-off public debt, driven to a large extent by concessional loans. In 2013 Samoa's spending on servicing debt will be equivalent to almost three quarters of government spending on education. Tonga will spend about the same on debt servicing as it does on health, and the government in Vanuatu will spend more than its current health budget on paying back its debt.

Source: Author based on IMF Staff Reports (2013)

The Asian Development Bank, along with its global sibling the World Bank, portrays itself as a partner in development. But both the ADB and the World Bank are, first and foremost, lending institutions, and it should come as no surprise that they sometimes focus on lending to the exclusion of other alternatives. More regrettably, they have at times seen obstacles to lending as obstacles to development itself. But careful study, sober analysis and solidly conservative attitudes toward debt are a necessity in the Pacific – and public scrutiny of the nation's finances should never be subverted. And yet, their actions have directly undermined public financial management processes. We can't afford to make mistakes. Our economies are so small and fragile that even a moderate shock can prove devastating. A lesson that sometimes seems to have been forgotten.

(1) For example: Fiji's current economic strategy includes a number of ambitious plans costing in excess of USD 240 million, many of which will be funded by loans from the Export-Import Bank of China (China Exim Bank) - see http://www.pmoffice.gov.fj/index.php/projects/chinese-soft-loan.

During last year's election campaign, Papua New Guinea's prime minister, Peter O'Neill, announced a soft loan from the China EXIM Bank of well over USD 2 billion - the opposition accused the prime minister of mortgaging the country's yet-unrealised resource extraction income - see http://www.emtv.com.pg/news-app/item/opposition-slams-government-over-k6-billion-loan-controversy.

Nothing to show - a case study

In 1996 Vanuatu took out a USD 10 million loan from the ADB (Loan No. 1448) for urban roads, drainage and sanitation. Works were completed in 2003, with loan repayments to commence after a 10 year grace period. As this paper was being prepared, PiPP tried to find details concerning the loan. While we received confirmation from government personnel that repayments had indeed begun, the Vanuatu page on the ADB website displays no information concerning the loan - no evidence of the loan's effectiveness, of the quality of work done, or the impact on future planning. What evidence we did have was the road system itself, which became so degraded - well before the first loan payment was made - that it's now a source of general ridicule. Lending agencies might be expected to know this; the roads run right through the heart of Port Vila, the capital. They drive on them every day.

With more digging and a little luck, we stumbled across the ADB's project completion report from June 2003[1] (according to Google, the ADB intentionally blocks indexing of the contents of these reports). The report finds the loan overall to be 'successful' although it raises concerns about sustainability and the fact that the 'design of some project subcomponents was found to be incomplete during the design and tendering phases of implementation' and that '[i]nsufficient attention was paid to the drainage requirements of the urban roads component'. Poor design and lack of drainage have contributed to the near complete deterioration of the road system. Yet Vanuatu is now paying back the principal of this loan to the tune of around USD 250,000 a year (rising to USD 500,000 in 2017) plus USD 100,000 a year in interest payments. The repayments will continue until 2036.

In 2012, Vanuatu took out another USD 5 million loan from the ADB for urban roads, drainage and sanitation (Loan No. 2832)[2]. The two loan agreements are remarkably similar. After 10 years it seems we have learned nothing. When asked about the failures of the 1996-2003 loan, the ADB representative advising on the 2012 loan replied that he was not aware of it.

The laxity of reporting, analysis and even record keeping on public debt should be raising eyebrows. Little information is freely available in the public domain, but it is understood that Vanuatu is paying back a further eight ADB loans. Together with other external and domestic borrowings, it is estimated that in 2013 the government will be paying USD 19.6 million servicing its loans - by comparison the national health budget is USD 17.2 million[3].

(1) www.adb.org/sites/default/files/projdocs/2003/26316-VAN-PCR.pdf

(2) The works to be carried out under this loan form part of a larger project that is also funded through an AusAID grant of USD 31 million and a Vanuatu Government contribution of USD 4 million.

(3) Source: IMF Staff reports (2013) and Government of Vanuatu Budget (2013)

… never thought it would come to this

Lax, even negligent, public finance processes have opened the floodgates. Lending activity originating from contractors brokering funding from the Export-Import Bank of China (or China Exim Bank) has increased dramatically in the past two years. It's hard to imagine how Pacific leaders would sign their respective countries up to record levels of debt if they weren't being led to believe that some of it, at very least, would be forgiven. That may be a false hope.

National export/import banks are often confused with development banks, but their focus is fundamentally different. China EXIM Bank, for example, states that: '[t]he Bank's main mandate is to facilitate the export and import of Chinese mechanical and electronic products, complete sets of equipment and new- and high-tech products, assist Chinese companies with comparative advantages in their offshore project contracting and outbound investment, and promote international economic cooperation and trade'.

If development is numbered among its goals, it's China's development, not ours.

We need to understand that an EXIM bank's primary role is not to be our friend, but to be the contractor's friend. Many infrastructure projects currently under consideration are predicated on financing being made available by an EXIM bank, most commonly the Chinese. Because China EXIM Bank's purpose is to promote its own industry, work is effectively sole-sourced to Chinese contractors, or not done at all.

There are companies operating in the Pacific whose job it is to broker EXIM loan-financed projects to governments. Those involved, even those who tout the benefits of such practices, are unwilling to speak on the record. But input from numerous sources shows that the typical scenario runs like this: A company representative will visit a government official and offer a project – say a road or a building in his constituency. The project will have very few design specifications (one proposal was reported to be less than ten pages in length) but will promise high construction quality, speedy implementation – in short, everything a politician could want. The company representative then says the government need not worry about finance. They can arrange a concessional loan from the China EXIM Bank. Provided, of course, that the government agrees not to offer the project to anyone else. Facing the prospect of new construction with virtually none of the fuss and bother of other projects - and ironically, an equally small likelihood of success - the politician is overjoyed.

Given the strongly nativist undercurrents in many Pacific islands societies, one can see why politicians seeking China EXIM Bank funding might be leery of public discussion of major projects that by definition will involve large numbers of consultants, experts and labourers from overseas, and the bulk of whose profits will be realised outside their borders. The net result is the further diminishing of financial oversight and due diligence.

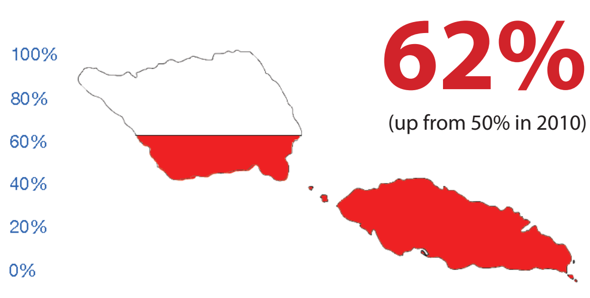
Especially when seeking EXIM funding, the onus is squarely on Pacific island governments to invest the time and effort necessary to determine the necessity of the work, its benefits, and the quality of the implementing partners. Most importantly of all, politicians need to recognise and adapt to their own limited national financial capacity. Not all of them do. In 2012, a parliamentary select committee questioned the legality of Tonga's TOP 119 million EXIM loan for the reconstruction of the capital's business district in the wake of the 2006 anti-Chinese riots. The newspaper Matangi Tonga wrote:

> *The report also claimed that about 58 percent of the $119 million loan was illegally spent and was indifferent to the initial loan agreement that the Tonga parliament agreed to, which was for the reconstruction of buildings that were burnt in the 2006 riots. Among projects the report claimed were illegally funded with the Chinese loan were the $31.9 million Vuna Wharf Project and the $13.7 million Royal Palace Extension Project.*[2]

Experience has taught politicians the wrong lessons. Few seem to understand the difference between the Bank of China and the China EXIM Bank. The EXIM Bank, despite being wholly owned by the government, is a very different creature. Some Pacific governments, however, seem to think that China will forgive EXIM debt with the same wink-and-a-nod as it did for Bank of China debt in the 1980s and 1990s. That may yet happen, but it would be rash to take it for granted.

Still, it's hard to imagine what else might have spurred Samoa, for example, to accumulate an external debt load equal to 62% of the country's total economy (or GDP). Tonga has taken on so much Chinese debt - about 60% of its overall external load - that the International Monetary Fund issued a warning, reporting that the debt 'pose[s] an excessive exposure to a single foreign currency.'[3]

Some countries are increasingly financing investment by borrowing abroad



Samoa external public debt as percentage of GDP in 2013

Source: Author based on IMF Staff Reports (2013)

(2) http://matangitonga.to/2012/09/02/ndc-parliamentary-select-committee-questions-legality-119m-loan-china

(3) http://www.imf.org/external/pubs/ft/dsa/pdf/2013/dsacr13234.pdf

In fairness, Tonga seems to be coming to the realisation that the recent spate of EXIM loans might not be the gift they thought it was. Only days before the first payment on their reconstruction loan was due, Tonga's prime minister reported that China EXIM Bank had agreed to defer the loan, but that they would not confirm how long the extension would last. Tonga had asked for another five to 10 years.

The government also announced that it would not be adding to its external debt burden in the near future. And when it decided to initiate a project to pull a fibre-optic cable from Fiji to its own shores, Tonga Cable Ltd (which is 80% government-owned) convinced the World Bank and the ADB to translate a USD 30 million loan into a grant.

History repeated

In the 1970s and 1980s in Africa and South America, the European and American EXIM Banks contributed to a debt crisis spreading across the developing world. This eventually resulted in the Jubilee Campaign[4] that led to the major multilateral donors agreeing to write off debts. The overall impact of these efforts was limited, because they affected mostly intergovernmental loans. Very little of the actual EXIM debt was written off.

Under international law, debt-holding banks can gain access to, and control over, state assets such as land or natural resources. This is the real story behind how Africa lost its land[5].

This 'leverage and lose it' phenomenon is now manifesting itself here in the Pacific. In Fiji, massive borrowing from India's EXIM Bank did nothing to improve the country's sugar milling operations[6]. Many blame the Indian subcontractors as much as the mill operators themselves. It appears now that the government is left with no choice but to throw good money after bad: Another (smaller) loan has been obtained, and in September[7], the government announced that they were buying the company outright and taking over management.

The Fiji Sugar Company's role in the national economy is integral, and stakes are high where its survival is concerned. But it is telling that even after years of upgrades and massive, arguably unrecoverable investment, the government felt compelled to send troops to deal with labour unrest when, incensed by low wages, sugar union members recently voted in favour of strike action.[8] This might well prove to be Fiji's 'too big to fail' moment.

(4) For more details see http://jubileecampaign.org

(5) http://www.theguardian.com/global-development/poverty-matters/2013/feb/25/indian-land-grabs-ethiopia

(6) http://www.fijitimes.com/story.aspx?id=209753

(7) http://www.fijisun.com.fj/2013/09/10/fsc-draws-12m-from-exim-loan-to-address-issues/

(8) http://www.stuff.co.nz/world/south-pacific/9071559/Soldiers-move-to-intercept-Fiji-strike

Avoiding default, disaster and disorder

Easy lending pleases everyone. Politicians are happy; they get to show progress, however unwise or unsound. Careerist civil servants are happy; they often get higher paying jobs as local advisers. Donor nations are happy; they're seen to be spending money, but not their own, so the giver can burnish their reputation at the receiver's expense. Everybody wins… except for citizens and their children. The poorest and the least able, the ones who benefit least from this lending – these are the ones who will have to pay the money back.

The important thing to note is that taking on debt always means giving up some of the current spending on education, health etc. This might make sense if there is some expectation that there is some return from the investment (perhaps socially/financially). As we have seen over and over again, for many Pacific Island states the returns on investment are simply not there, and in some instances become direct liabilities to the government. So in effect what we are doing is reducing what we have to spend on essential services such as health and education, but we are receiving little from our investments for this sacrifice.

Despite the warning signs, politicians of today do not see the need to worry about the debts of tomorrow. Extended, sometimes elastic, grace periods ensure that those who sign up to the worst loans feel the least pressure. Likewise, mixing grants in with loans often leads to confusion and naïve assumptions about not only the terms of payment, but whether repayment is necessary at all.

But experience shows that these debts will be paid, either by or cutting essential services like health and education or by selling state assets, or both. Some experts have questioned whether we should be borrowing on infrastructure at all. They feel the opportunity costs are just too high.

Alienation of people from their assets and continuing lack of development gains for the local population will lead to social unrest. We have seen this before; and resentment is growing daily as citizens watch their own conditions deteriorating while foreign businesses and local elites prosper without consequence.

It doesn't have to be this way. Beijing is not to blame, but officials in the Chinese capital must start scrutinising what their companies and their EXIM Bank are doing in the region. Similarly, our partners in Canberra, Wellington, Washington and Manila will have to get tougher on some of the frankly shoddy analysis performed in the name of selling a loan.

In private, most of the development officials we've spoken with were comfortable with the idea of debt forgiveness, but believe default could quickly become a reality. Even though debt cancellation is perhaps the most logical solution to the problem, the political reality of aid is such that it could not happen even if there were a Jubilee-style campaign aimed at the Pacific.

There is another alternative: high-level multilateral talks with Beijing to collectively ask that the Chinese government buy back all the EXIM Bank loans in the interest of protecting their own investments and citizens from unfair persecution. This would not necessarily have to be coupled with a moratorium on new EXIM lending in the region, but tighter government regulation would have to be put in place.

At the same time there should be high-level talks with donors and multilaterals to see if bad loans can be effectively re-financed on a country-by-country basis. This, accompanied by grant-based budget support, itself linked to meaningful structural and institutional reform, would help avoid the real prospect of the financial collapse of several Pacific island states. If Pacific countries are to continue to develop, massive infrastructure investment is necessary, but it cannot be funded entirely by debt. The returns are too small, and the cost of failure too high. Moreover, without committing to long term maintenance requirements and funding these massive infrastructure investments will only end up as liabilities for Pacific governments.

Finally, there is a need for a sort of truth and reconciliation process in which all external loans to Pacific island countries over the past two decades are reviewed by independent experts and the findings presented to the public. It will take significant collective goodwill and honesty to see beyond the shame of past endeavours, and more importantly to forebear from making short-term political hay with the results.

We may not be able to undo the mistakes of the past. We may end up risking our economic stability, losing our assets, and sacrificing our ability to spend on health, education and other social priorities. But we owe it to the peoples of this region at very least to try and remedy this imminent crisis before it's too late.

If development banks and governments indeed want to provide the 'sure refuge' of true friendship, then they need to learn to invest with more transparency, better research and analysis and, most importantly, with an understanding of the Pacific's unique economic limitations. And they should help carry that load.

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