Special Report: Should we be worried about Chinese loans for infrastructure buildup? (Part 2)

Czeriza Valencia – May 17, 2018

https://www.philstar.com/business/2018/05/17/1815829/special-report-should-we-be-worried-about-chinese-loans-infrastructure-buildup-part-2

JICA is known for providing loans on a concessional basis, meaning interest rates that are below commercial market rates. The rates and tenor of JICA loans are based on the income classification and the economic conditions of the borrowing countries.

With commercial loans, interest rates are lower for high income countries as they are considered low risk and capable of making repayments.

"But it's vice versa in our case. So the higher the risk, the lower the income level of the specific country is, and then we will be able to give softer loans with lower interest and longer tenor," Yamada said.

The Philippines is classified as a lower middle-income country and thus for the Metro Manila Subway Project, it was granted a tied loan with an interest rate of 0.1 percent and repayment period of 40 years with a 12-year grace period.

With tied loans, the implementing agency is required to procure 30 percent of the project contents – equipment, services or facilities – from Japan. The rest can come from any country. This type of loan is recommended for projects needing high technology from Japan such as the subway project. These comprise the rolling stocks, and the main engineering work.

With untied loans, on the other hand, the contents of the project can be procured from any origin.

Japanese ODA is not secured by physical assets, Yamada said, as the loans are guaranteed by the Philippine government.

"No collateral is necessary (for the loans). It's government-to-government lending so we take the sovereign risk. That is the only risk that we take and we basically do not require any collateral or security so long as it is secured by the government of the Philippines to repay the loan," Yamada said.

The Philippines has so far not defaulted on any of its obligations with the Japanese government. But in the event of a default or a possible default, Yamada said JICA takes specific remedial measures to get the creditor country back on a repayment schedule.

"We don't normally allow the borrower to be exempt from obligations. We ask them to reschedule the terms so they can repay the obligations. The terms and conditions may be altered in the event of a default but it needs to be coordinated," he said.

JICA also coordinates with other international creditors like the World Bank and International Monetary Fund regarding default and possible default events with the purpose of keeping them informed and to explore refinancing options through economic recovery programs. This method, however, is less desired than restructuring of loans.

JICA's strong ties with multilateral lenders also extend to the sharing of the debarment list for contractors found to be engaged in unscrupulous business practices as a way of protecting the integrity of its funded projects.

"We have a sanction system wherein we say no to such companies to participate in tenders financed by JICA. We even have a cross debarment system with the World Bank and the ADB," Yamada said.

What else should we know about Chinese loans?

Given the normally tedious nature of ODA, do Chinese loans fit the traditional definition of ODA?

"It's definitely not ODA. These are commercial loans. They are not giving away, they are lending to make money. Our concept of ODA has something to do with the Japanese. In the past, there was a war and they were repaying. And after repaying, they probably felt they have not paid enough. Maybe that's the thinking," Ang said

China has been known to aggressively provide financing to countries that lie along the trade route of its Belt and Road Initiative.

The Philippines is not on the major routes but is situated near countries that have signed up for the initiative and is currently embroiled in a territorial dispute with the Asian superpower over portions of the West Philippine Sea.

"We are not even part of that (Belt and Road Initiative)." Ang said. "It's (loans) only an accommodation because the Philippines is friendly to them. And they are here in disputed territory and they think if they can help us, maybe issues can be managed rather than come up with a head-to-head challenges," Ang said.

As Chinese loans do not conform to traditional ODA standards, it may also mean that conditions may favor China more than the Philippines.

For instance, they can demand stakes from projects funded by their loans in the event of a default and can demand exclusive use of Chinese contractors.

"The operation of ports, for example, yes. It is a business proposition, a business transaction" said Ang of the situation Sri Lanka found itself in.

But the line can be drawn on land as is dictated by the Constitution, he said.

"You cannot collateralize our islands. No government can use national patrimony (as collateral). Our constitution bars it. Foreigners cannot own land (in the Philippines)," he said.

Economic managers can also keep the territorial dispute issue separate from the conditions of the loans by specifying it in the contract.

"Very clearly, that can be stated in the contract. That is is a contract to borrow money to finance infrastructure," he said. "The underlying thing here, after all, is friendship."

Preventing a debt trap

Gilbert Llanto, former president of state-run think tank Philippine Institute for Development Studies (PIDS) said in accepting ODA, the socio-economic benefits for the borrowing country – employment generation, economy-boosting capacibilites etc. – of projects must far outweigh the costs.

"The estimated benefits must exceed perceived costs and must have high social return," Llanto said adding, "a public project failing this general scrutiny should be very carefully reviewed, and rejected if it fails to pass these tests."

Economic managers, he said, should also be wary of currency risks associated with foreign loans.

"ODA is a good way to finance infrastructure. It is cheaper than loans obtained from the capital market but one risk is currency risk," Llanto said.

Ang said the Philippines may only borrow a small portion of its infra funding needs from China as the country can look at other sources of funds as it is now rated investment grade.

"Those countries that fell into a debt trap are not investment grade. We can play around with whom we can borrow so I think China will only fund a small portion of it. How can we fall into a debt trap if China is not the main source of loans? Japan will fund most of it," he said.

While accepting loans from China come with political considerations, economic managers must also ensure that doing so will not just be for political accommodation, Ang said.

"A debt trap cannot possibly happen if you have good economic managers. I believe they know history, they are seasoned people. I'm banking on their experience and knowledge that they are not going to test China for the sale of friendship alone but there is economic logic to it," he said.

Looking forward

As the economy continues to reach new heights, Yamada sees the country's infrastructure needs evolving to more sophisticated ones that would require even greater financing in the long term.

"The level of income of the country is getting over $3,000 per annum per head. It's really a time when people spend more. So you see more diversification in the country's need to develop infrastructure such as transport and power," he said.

These projects, he said, can expand to include those for disaster and risk reduction management, which are often overlooked if a country has limited funding options.

"All of these things are emerging. In the mid to long term, we will see a diversification of infrastructure needs to catch up with the growth. And a lot of funds will be needed for this. The country is getting better on managing macroeconomic fundamentals. Sovereign rating is investment grade and the country can raise funds from more sources. With the speed of growth, you will need to borrow from more sources like us. So my perspective is we will have a more diversified and growing relationship in terms of developing infrastructure," Yamada said.

Despite the challenges brought about by the ambitious building program by the Duterte administration, JICA is pleased that the wheels are finally set in motion as this is encouraging to investors.

"Lack of infra has always been the largest bottlenecks in doing business for investors here in this country. I think removing these bottlenecks, especially in transport in the metropolitan area, is one of the concerns the Japanese companies have. I think so far, private companies in Japan are really supportive of what we are doing especially in terms of public transport," he said.

“Compared with the past administration, there were plans but nothing got through. But with this administration, we are actually seeing projects moving forward. It?s always good to see that there is development in terms of getting projects done at maximum speed. This makes foreign investors feel secure and encouraged as to the capability of the government. That is really an encouraging message,” Yamada concluded..

Special Report: Should we be worried about Chinese loans for infrastructure buildup? (Part 1)

Czeriza Valencia – May 16, 2018
https://www.philstar.com/business/2018/05/16/1815493/special-report-should-we-be-worried-about-chinese-loans-infrastructure-buildup-part-1

The Duterte administration has trillions of pesos worth of projects slated for funding or co-funding with official development assistance (ODA) loans from various sources.

ODA is deemed a crucial component of infrastructure financing under the Duterte administration's ambitious Build Build Build (BBB) program as the government now favors the use of hybrid public-private partnership (PPP) in project procurement delivery, through which the hard infrastructure would be built by the government using ODA funds, while the operation and maintenance would be auctioned off to the private sector.

The hybrid PPP scheme is deemed more efficient in project procurement as opposed to the "tedious" traditional PPP mode that is often marred by corporate squabble and other delays.

ODA loans are cheaper sources of financing as they bear "softer" conditions than commercial loans in the form of lower interest rates, and longer grace and repayment periods.

As a newly labeled investment grade country, the Philippines has the option of tapping more sources of funding overseas.

Most of the ODA loans programmed for availment under the Duterte administration's infrastructure program would come from Japan, a long-standing development partner and top assistance provider over the decades.

Lately, however, the government has been communicating increased preference for the use of loans from China. The Department of Finance also announced early in March that loan agreements would be signed within the year for at least three big-ticket projects – New Centennial Water Source-kaliwa Dam (P10.9 billion), Chico River Pump Irrigation Facility (P3.68 billion), and the Philippine National Railways South Long Haul Railway (P151 billion).

China has pledged to provide over $7 billion in loans and grants to the Philippines for its infra program.

Red flags, however, have been raised about accepting loans from China, which has an existing territorial dispute with the Philippines.

In particular, there are prevailing concerns about the higher interest rates, the possibility of the country falling into a debt trap, and having state assets and islands being offered as collateral to secure the loans.

These fears stem from the experience of countries like Sri Lanka which had been forced to hand over its strategically-situated Port Hambantota on a 99-year lease to Chinese state firms because it can no longer pay its debt.

Projects such as these ventures fit neatly into China's so-called Belt and Road Initiative, a long-term strategy that seeks to link more countries in Asia and the Pacific, Africa, the Middle East, and Europe through a massive connections of roads, ports, and railways.

Among the reasons cited by economic managers for the Duterte administration's increased interest for Chinese loans – which bear heftier interest rates of two to three percent compared with Japan's 0.1 to 1.5 percent – is the relative slowness in the processing of Japanese ODA loans and the limitations on assistance that can be provided by the Japanese government.

Another reason would be the so-called "friend to all" foreign policy that, ideally, seeks to reflect an independent foreign policy.

With relative ease and speed by which such loans from China are being offered, many wonder if it is indeed a good idea that the country is considering taking out such massive loans from China.

Economist Alvin Ang, director of the Ateneo de Manila Center for Economic Research, believes the country stands to benefit politically and economically by accepting Chinese loans, but should toe the line carefully with conditions and should not depend on it heavily to fund its mammoth infrastructure program.

"At the rate of understanding the administration's 'friend of all' policy, I think that is consistent. If that is the foreign policy of the government, then we cannot really say that we cannot borrow from China," he said.

Accepting loans from China, he said, would also strengthen economic ties with the Asian superpower which is also one of the country's top trading partners. At the same time, it can significantly augment ODA loans from Japan and augment the capacity of the private sector that cannot fund and build all projects pipelined under the P8.44 trillion BBB program.

Ang acknowledged, however, that Chinese loans also come at a higher price compared to those provided by Japan.

"Now, the challenge is, is the rates, right? Chinese interest rates are definitely much higher than Japan which is not good for us," he said, adding, "but come to think of it, Japan cannot fund all of our requirements. And also, our problem is most of our Filipino companies are already stretched out."

This is because the constitutional limitation on foreign ownership, especially on foreign contractors, is also putting pressure on the BBB program, Ang said.

"It's because we need to do all these these things at the same time so I guess this China approach is not necessarily bad as long as we manage it well," he said.

Rush to overhaul

The Philippines is rushing to overhaul its decrepit infrastructure backbone which has suffered decades of neglect to keep up with the rapid economic growth seen in recent years and to ease congestion in Metro Manila, which is forecast to become "uninhabitable" in less than a decade's time unless adequate urban infrastructure is put in place.

The Japan International Cooperation Agency (JICA) estimates the worsening traffic in Metro Manila is now costing the Philippine economy P3.5 billion daily in missed economic opportunities and unnecessary expenditure related to congestion. This has risen from the P2.4 billion estimate in 2014.

"The BBB program is ambitious and it requires ambitious funding," Ang said.

The Build Build Build program, after all, entails expenditure of P8.44 trillion in six years.

For this reason, Chinese loans, which can be negotiated in less than two years and can be disbursed without lengthy public consultations and bidding processes, are becoming very attractive to the government.

The selection process for Chinese contractors that will undertake the projects is also relatively more straight forward. The Investment Coordination Committee (ICC) composed of the main economic agencies will serve as the clearing house for Chinese investments. China will have a similar body that will pre-screen companies that will vie for the project. Upon nomination, the ICC through its vetting process, will select the company that will undertake the project.

Slowpoke?

Not really, said Tetsuya Yamada, senior representative of the Japan International Cooperation Agency (JICA), the ODA arm of the Japanese government.

For Yamada, JICA follows the global standard for official assistance aimed at promoting economic progress in developing countries.

“As far as Japan is concerned, we don’t necessarily think that we are slower than anybody else and we are hitting the ceiling as to lending capacity,” he said.

“But having said so, we are aware that there are some criticisms even from the private sector that ODA is slower than PPP (Public-Private Partnership). That is the general sentiment, particularly from private sector proponents. So we do understand that, ” he said.

Japanese ODA undergoes a rigorous technical evaluation and public consultation process – both here and in Japan – that goes upward of three years depending on the complexity of the projects and the political situation in both countries.

Before a formulated project is even subjected to a feasibility study, internal consultative meetings are held by JICA with both Japanese and Philippine government ministers on whether a full-fledged feasibility study should be conducted for a project.

This is followed by a public consultation in Japan in which public and private sectors can join discussions. Usually, business groups and non-government organizations attend these public meetings. Their voices have a bearing on whether ODA-funded projects would materialize as any objections can delay or halt a project.

“The private sector is, of course, interested in business opportunities and for NGOs, they are interested about environmental and social impact of the project,” Yamada said.

“Once we get objections, we have to stop the process immediately. We cannot go ahead and implement the feasibility study,” he said.

But once no negative feedback is generated during the public consultation, the feasibility study is conducted through a private consulting firm.

During the conduct of the feasibility study, an environmental study and resettlement action plan for the project would have to be published in Japan –both in Japanese and English – for a minimum period of 120 days for disclosure purposes. The loan signing for the project cannot push through without the fulfillment of this procedure.

Once the feasibility study is completed, the Philippine government begins the approval process within the Investment Coordination Committee (ICC) of the National Economic and Development Authority (NEDA), ending with approval by the president as chair of the NEDA board.

An official loan request is then prepared by the Philippine government and is submitted for approval by the Japanese government. This is again followed by a series of appraisal meetings within Japan.

Upon approval of the loan request, the borrowing government is notified and the exchange of notes is set. Following this is the signing of the loan agreement.

Only then can the eventual procurement process and implementation of the project can commence. After completion of the project, a post-evaluation process ensues.

“Our resources come from the public, so we need to exercise full accountability to our taxpayers. And the same for the Philippine government to exercise accountability to taxpayers of the Philippines so we need to go through this somewhat tedious process,” Yamada said.