

Debtbook Diplomacy

China's Strategic Leveraging of its Newfound Economic Influence and the Consequences for U.S. Foreign Policy

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1. Executive Summary

Over the past decade, China has extended hundreds of billions of dollars in loans to countries that often can't afford to repay them. Through a process the authors have termed "debtbook diplomacy," China has begun to leverage this accumulated debt to achieve its strategic aims.

Three primary strategic goals the authors believe China could target with this technique are: filling out a "String of Pearls" to solve its "Malacca Dilemma" and project power across vital South Asian trading routes; undermining and fracturing the U.S.-led regional coalition contesting Beijing's South China Sea (SCS) claims; and enabling the People's Liberation Army Navy (PLAN) to push through the "Second Island Chain" into the blue-water Pacific.

The goal of this report is to analyze the future of debtbook diplomacy: which countries are vulnerable to Chinese coercion; how U.S. strategic interests will be impacted; and how U.S. policymakers can mitigate the effects of this strategy.

This paper identifies 16 potential targets of China's debtbook diplomacy, grouped into three primary categories based on the three strategic goals outlined above: Debtbook West/String of Pearls; Debtbook South/SCS Influence; and Debtbook East/Second Island Chain and Beyond.

For Debtbook West, Pakistan, Djibouti, Myanmar, and Sri Lanka are identified as priority concerns: countries that have already ceded either a key port or military base to China, are continuing to sink deeper into its debt trap, and where U.S. interests are at stake.

In the second category, Debtbook South, no single country constitutes an immediate primary concern, given a lack of individual diplomatic clout, favorable relations with U.S., and/or relatively stable debt situations. However, the cumulative effects of Chinese debt holdings in Cambodia, Laos and the Philippines may give China a proxy veto in ASEAN, depriving the U.S. of regional support

to contest Chinese SCS claims as China challenges the legitimacy of the U.S.-led, rules-based international order.

Finally, in the third category, Debtbook East, the Compact of Free Association (COFA) states pose the most immediate challenge, with the expiration of Compact funding threatening to drive these countries into China's orbit. This would threaten the unfettered basing access and right of strategic denial the U.S. has enjoyed since World War II, and help the Chinese navy extend its reach past the First Island Chain into the blue-water Pacific.

For more than a half-century, U.S. interests in Asia have been underpinned by an effective naval monopoly over the Strait of Malacca and other key regional trading routes, a united coalition of South Asian partners, and an unfettered and exclusive presence in the Second Island Chain to project power and contain China's navy. Debtbook diplomacy may play an important role in China's multifaceted campaign to erode these strategic advantages and shift the balance of power in Asia.

To help the U.S. and its allies offset these consequences, this report proposes three sets of U.S. government recommendations for targeting and streamlining investment, strengthening alliances, and managing debt burdens. Targeting and streamlining investment should include continued efforts to coordinate U.S. private-public partnerships overseas by consolidating the Overseas Private Investment Corporation and USAID's Development Credit Authority into a single entity, to recruit allies into joint investment ventures, and to focus limited resources in areas of comparative advantage like digital infrastructure. To strengthen alliances, the U.S. should bolster India's role as a regional leader and and revitalize Quad- the loose U.S.-India-Japan-Australia network of maritime Asian democratic powers- by clarifying its mission as a rules-based collective and enhancing economic and maritime security cooperation amongst its members. To manage debt burdens, the U.S. should consider leveraging tariff relief and support for the Asian Infrastructure Investment Bank (AIIB) as bargaining chips to entice China into becoming a more-responsible creditor—through initiatives like the Paris Club and G20's Sustainable Financing Agenda—and provide support for debt assistance and best-practice facilities hosted by multilateral institutions like The World Bank.

Beyond these tactical steps, the U.S. will need to answer difficult strategic questions about the shifting regional balance of power, prioritizing its truly vital interests and coordinating its finite resources to meet the most pressing challenges posed by debtbook diplomacy.

2. Introduction

In its 2018 National Defense Strategy, the U.S. warned that China is leveraging “predatory economics” as a means to achieve both regional and global strategic ends.¹ One such type of predatory economics is what the authors have termed “debtbook diplomacy,” the coercive leveraging of debt to acquire strategic assets or political influence over debtor nations.

Debtbook diplomacy is by itself neither an economic tool nor a strategic end. Rather, it is an increasingly valuable technique deployed by China to leverage accumulated debt to advance its existing strategic goals. Three strategic targets for debtbook diplomacy would be: filling out a “String of Pearls” to project power across vital South Asian trading routes; undermining U.S.-led regional opposition to Beijing’s contested South China Sea claims; and supporting the PLAN’s efforts to break out of the First Island Chain into the blue-water Pacific.

The U.S. government is beginning to acknowledge the power of debtbook diplomacy as a new instrument in China’s geo-economic arsenal. In March 2018, then-Secretary of State Rex Tillerson warned that Chinese economic diplomacy “encourages dependency using opaque contracts, predatory loan practices, and corrupt deals that mire nations in debt and undercut their sovereignty, denying them their long-term, self-sustaining growth.”²

This was the case in Sri Lanka, where China converted large debt holdings, brought about by opaque lending practices and questionable commercial viability, into an 85 percent stake in a major port in Hambantota on

¹ U.S. Department of Defense. *Summary of the 2018 National Defense Strategy of The United States of America*, 19 Jan. 2018.

² Tillerson, Rex W. “U.S.-Africa Relations: A New Framework.” 6 March 2018, George Mason University, Fairfax, VA.

a 99-year lease. This has sparked fears that Hambantota could one day become a Chinese naval hub, and sent a worrying signal to other debt-strapped developing nations.

Hambantota also alarmed U.S. and Indian security experts. In March, U.S. Pacific Fleet Commander Admiral Scott Swift addressed this new application of economic power, warning that China would “increase debt in a given country and then turn around and ask for something in return that was not part of the original negotiation.”³

China has, thus far, employed rather consistent methods to accrue and exert its debt leverage, making it possible to delineate different stages of the debtbook diplomacy cycle and identify countries that may follow Sri Lanka’s trajectory. First, there is the investment stage. China has greatly expanded its infrastructure investments under its signature Belt and Road Initiative (BRI). Working primarily through the China Development Bank and Export-Import (EXIM) Bank of China—which together hold more assets than the combined sum of all Western-backed multilateral development banks⁴—China is able to provide extended grace periods and longer-term loans than other institutions. These terms are particularly appealing to economically weaker countries less able to access international financing and to corrupt or authoritarian leaders looking for political legitimacy and personal financial gain. These politicians have tended to sign opaque contracting and financing arrangements on projects of questionable economic viability knowing they will be out of office long before the bill comes due.

The second phase is construction and operation. Chinese projects have a reputation for running over budget, with poor construction quality and lax safety standards. Once completed, many of these projects have yielded underwhelming returns, which are mostly routed back to China, making debt repayment all the more challenging. In countries such as Sri Lanka and Myanmar, public protests have erupted over projects prioritizing Chinese interests, failing to create local jobs, worsening environmental conditions, exacerbating corruption or compromising state sovereignty. In

³ Moriyasu, Ken. “China’s Economic Coercion Worries Retiring US Navy Commander.” *Nikkei Asian Review*, 7 Mar. 2018.

⁴ “China Goes Global with Development Banks.” *Bretton Woods Observer*. 5 April 2016.

certain cases, this public pressure has led governments to freeze or cancel Chinese contracts.

The final phase is debt collection. When countries prove unable to pay back their debts, China has already and is likely to continue to offer debt forgiveness in exchange for both political influence and strategic equities. As analyst Xiaochen Su describes “by ensuring that these debts are paid in some form or the other, whether it is economic concessions, political agreements, or a combination of both, China may in the long term formulate a new kind of diplomatic relationships with these foreign countries.”⁵

Of course, this strategy carries costs and risks for China. Dr. Joel Wuthnow of the *Institute for National Strategic Studies* cautions that continued debt forgiveness could put “a strain on [Chinese] government coffers and underscore the poor decision-making that contributed to non-performing BRI loans.”⁶ These non-performing loans could exacerbate China’s growing domestic debt burden, which has risen to from 141 to 256 percent of its GDP since 2008.⁷ In the short run, however, these long-term risks are likely to be overlooked given the substantial leverage China gains by holding billions of dollars in sovereign debt.

This paper will seek to identify countries at various stages of the debtbook diplomacy cycle in order to understand which debtor nations may become vulnerable to this kind of pressure; what assets, resources or influence Beijing is likely to target; which cases will be most consequential for American strategic interests; and, finally, how the United States and its allies can address this challenge.

5 Su, Xiaochen. “Why Chinese Infrastructure Loans in Africa Represent a Brand-New Type of Neocolonialism.” *The Diplomat*. 9 June 2017.

6 United States.Cong. U.S.-China Economic and Security Review Commission. *Hearing on China’s Belt and Road Initiative: Five Years Later*. 25 Jan. 2018. (Statement of Dr. Joel Wuthnow, Research Fellow, Center for the Study of Chinese Military Affairs, U.S. National Defense University).

7 Orlik, Tom, et al. “Sizing Up China’s Debt Bubble: Bloomberg Economics.” *Bloomberg Markets*. 8 Feb. 2018.

3. Debtbook Diplomacy and China's Geoeconomic Toolkit

"How do you deal toughly with your banker?"

—then-Secretary of State Hillary Clinton⁸

China is aggressively seeking to deploy its newfound economic power to advance its national interests. In their 2016 book, *War by Other Means: Geoconomics and Statecraft*, Robert Blackwill and Jennifer Harris argue that China "is the world's leading practitioner of geo-economics, but it has also been perhaps the major factor in returning regional or global power projection back to an importantly economic (as opposed to political-military) exercise."⁹

Beijing has accumulated a broad portfolio of economic instruments—trade, loans, investment, tourism, etc.—and has demonstrated a willingness to use them coercively to achieve its strategic ends of securing energy supplies, increasing power projection capabilities, challenging the U.S.-led international order, and displacing the U.S. as a regional hegemon.

China's portfolio of economic instruments continues to broaden and deepen. China's GDP (in PPP) more-than tripled in the decade leading up to 2014 when it surpassed the U.S. as the world's largest economy.¹⁰ It overtook the U.S. as the world's largest trading nation in 2013, and—while the two countries have competed for that title over the past several years—it has expanded its dominance over the U.S. in regional trade.¹¹ In 2016, Chinese tourists spent \$260 billion overseas, more than double the total of any other country.¹² And Xi Jinping has promised more than \$1 trillion in loans and investment for his Belt and Road initiative, which will stretch to nearly 70 countries. As developing countries deepen their reliance on Chinese goods and infrastructure funding, this portfolio will only continue to deepen.

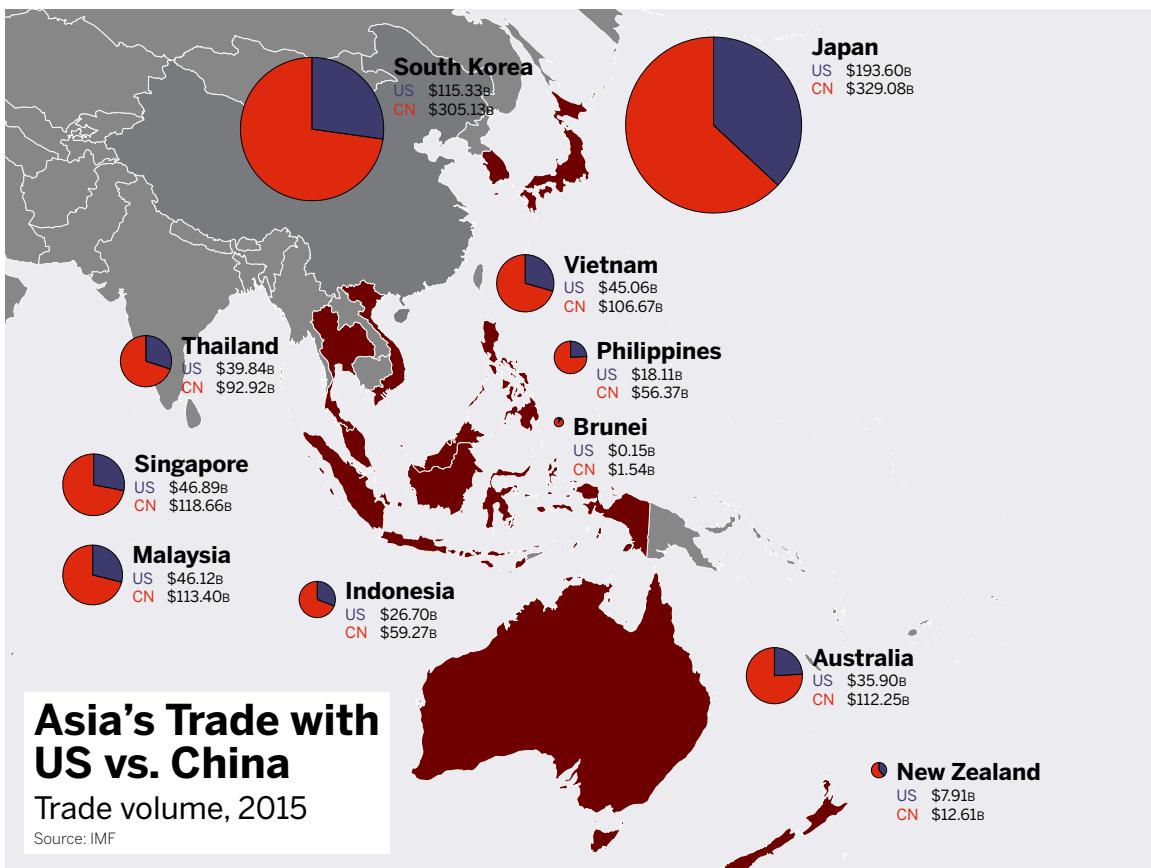
8 MacAskill, Ewen. "WikiLeaks: Hillary Clinton's Question: How Can We Stand up to Beijing?" *The Guardian*, 4 Dec. 2010.

9 Blackwill, Robert D., and Jennifer M. Harris. *War by Other Means*. Harvard University Press, 2016.

10 Allison, Graham. "The Thucydides Trap: Are the US and China headed for war?." *The Atlantic* 24 (2015).

11 Hara, Katsuhiko, and Issaku Harada. "US Overtake China as Top Trading Nation in 2016." *Nikkei Asian Review*, 13 April 2017

12 Chen, Tracy. *Chinese Tourists Are Reshaping World Economy*. Bloomberg, 29 Jan. 2018.



China's political and economic structure provides it with unique advantages for directing these growing economic resources towards a national geo-economic strategy. Companies in traditional market economies like the U.S. operate independently of government direction, have limited capacity to absorb debt, and concern themselves solely with profitability and their bottom line. But China's state-owned enterprise (SOE) system offers effective government guarantees for Communist Party-led companies to take on massive debts and operate at losses that would bankrupt independent companies.¹³ China Railway Corporation, for example, carries nearly \$600 billion in debt but survives because the Party believes the national benefits its railways provide justify perennial financial losses.¹⁴ In the context of debtbook diplomacy, this system allows SOEs to go where purely profit-motivated companies will not, providing government-backed financing for major international infrastructure projects, where strategic collateral can justify questionable financial viability.

13 Kynge, James, et al. "China's Railway Diplomacy Hits the Buffers." *Financial Times*, 17 July 2017.

14 Ibid.

Already, Beijing has demonstrated a willingness to creatively and coercively leverage every instrument in its economic portfolio, from banning Chinese tour groups from visiting South Korea to protest THAAD deployment, to squeezing Norwegian salmon exports after a Chinese dissident was awarded a Nobel Prize.¹⁵ *Carnegie Endowment's* Evan Feigenbaum categorizes Beijing's use of economic leverage into five types: passive, active, exclusionary, coercive, and latent.¹⁶

Passive leverage relies largely on China's size and market power, counting on foreign entities with a stake in China's economy to pressure their home governments to pursue friendly relations with China. Active leverage involves a more direct role, using that economic power or BRI investment to push countries into adopting China-friendly conditions or political stances. Exclusionary leverage wields access to China's domestic market as a cudgel, recently demonstrated by Beijing effectively expelling South Korean companies to protest THAAD deployment. Coercive leverage is targeted active leverage imposing discrete punishments for offenses, like throwing the whole toolbox at countries that host the Dalai Lama to discourage others from considering it. Finally, Feigenbaum categorizes latent leverage as the coercive cards China holds but has chosen not to play yet, like its broad economic sway over North Korea.

Within this typology, debtbook diplomacy sits mostly at the transition from passive to active leverage, depending on whether the "ask" is implicit or explicit. Some countries deeply indebted to China may recognize their economies' dependence on Beijing's goodwill and debt forgiveness, and move proactively to adopt China-friendly policies. Laos or Cambodia proactively supporting China's SCS claims without China applying direct pressure (as far as we know) would fall under this category. But China's most consequential and controversial gains from debtbook diplomacy will likely result from Beijing's use of active leverage to pry strategic equities from indebted countries.

¹⁵ Feigenbaum, Evan A. "Is Coercion the New Normal in China's Economic Statecraft?" *Carnegie Endowment for International Peace*, 25 July 2017.

¹⁶ Ibid.

Debtbook in Action: Anatomy of a Deal

It can be tempting to compare some of China’s troubling, debt-intensive projects to a predatory student or car loan: a bank offering a low-income worker a high-interest loan to buy a car he can’t afford, expecting to end up repossessing the car when the lessee defaults. But this analogy doesn’t quite fit, as no common commercial loan example stretches beyond a pure profit motive to capture the strategic dynamics at play.

The easiest way to explain the dynamics of debtbook diplomacy is to walk through what has become the case study example. The construction and transfer of Sri Lanka’s Magampura Mahinda Rajapaksa Port in Hambantota serve as a template both to understand the financial dynamics of these deals and to identify potential future “Hambantotas” that could be leveraged by China.

China stepped into Hambantota in 2007, during the final years of a brutal Sri Lankan civil war that cut the country off from diplomatic allies and financiers. Sri Lanka had reached out to Japan, India, the IMF, the World Bank, and the Asia Development Bank to fund the construction of a major port in the undeveloped backwater of Hambantota (the hometown of President Rajapaksa), but was denied funding amidst concerns about human rights and commercial viability.¹⁷

China then offered to provide the funding, not as foreign direct investment, but as a Sri Lankan project financed by Chinese loans and built by a Chinese company—with Sri Lanka’s government on the hook for the project’s debt obligations.¹⁸ The original price tag was only \$361 million in near-market-rate loans, but the port’s failure to generate revenue after opening in 2010 trapped Sri Lanka into seeking additional funding in the hopes of achieving commercial viability.¹⁹ From 2009-2014, Sri Lanka tapped China for an additional \$1.9 billion in loans to upgrade the port

17 Freymann, Eycck. “The Invention of the New Silk Road: Mapping Xi Jinping’s Strategic Vision.” *Harvard Kennedy School Working Paper*, 2018.

18 Ibid.

19 Ibid.

and build a nearby airport (now infamous as “the world’s emptiest”) and economic zone.²⁰ The port has still yet to generate a profit.²¹

By 2017, with Sri Lanka owing more than \$8 billion to Chinese-controlled firms, the Sri Lankan government handed over the port to China on a 99-year lease, granting a Chinese-led joint venture an 85 percent stake in an opaque and contentious deal valued at \$1.1 billion.²² Sri Lanka’s parliament also granted the joint venture tax concessions for further development of the port.²³

The port had become a debt trap. Once Sri Lanka made the initial commitment, the sunk cost and need to generate profit to pay off the original loans drove it to take out additional loans, a cycle that repeated itself until it gave up the port in a debt-for-equity swap.

Each of these debtbook cases is unique, but the template fits—at various stages—for a number of countries analyzed in this report. The goal of this analysis is to determine what projects could become the next Hambantota, and how they might impact U.S. strategic interests.

20 Ibid.

21 Ibid.

22 Ibid.

23 Ibid.

4. U.S. Interests at Stake

U.S.-China geo-economic competition is not zero-sum, nor is Chinese infrastructure investment in developing countries inherently against U.S. or global interests. China's debtbook diplomacy becomes cause for concern when it A) creates leverage that China can use to achieve strategic aims counter to U.S. interests and/or B) saddles a host country, where the U.S. has strategic interests, with unsustainable debt that undermines the country's domestic stability. Analyzing why this issue matters for the U.S. and where it matters most is an important first step in directing limited U.S. resources and bandwidth towards protecting the most important U.S. national security interests at stake.

1. *Maintain Advantageous Strategic Balance vis-a-vis China:* China's expanding regional influence and access to South Asian and Pacific Island ports has the long-term potential to alter the regional balance of power away from effective U.S. naval dominance. A successful String of Pearls strategy could expand Chinese power projection capabilities in South Asia and around the Strait of Malacca, while engagement with the Pacific Island Countries (PICs) could erode the U.S.' ability to contain China's navy to the First Island Chain. U.S. power projection capabilities will remain well ahead of China's for the foreseeable future, but China's acquisition of strategic infrastructure overseas could help it narrow the gap.
2. *Prevent China from diminishing U.S. leverage with key partners:* China's loans undermine the U.S.' ability to use its own economic assistance to promote U.S. security objectives. This assistance has provided the U.S. a powerful means to advance its nuclear security and counterterrorism interests in Pakistan. It has also underwritten the U.S.' relationship with the PICs. If these countries were to turn to China, it could undermine U.S. strategic denial and exclusive basing rights, eroding U.S. advantage in any future U.S.-China conflict.
3. *Ensure viability and stability of trade routes and energy markets:* A significant driver of China's debtbook diplomacy strategy is its need

to solve its “Malacca Dilemma,” which China knows would be its Achilles Heel in the event of a conflict with India or the U.S. Establishing alternative routes for its energy imports and expanding its naval footprint could make China more willing and able to interfere with this critical artery in the event of a conflict, which would have wide-reaching implications for global markets.

4. *Promote U.S.-India relations:* When it comes to China, U.S. and Indian strategic interests are increasingly aligned. China’s recent port acquisitions in Sri Lanka and Pakistan have stoked India’s fears of encirclement, and after decades of non-alignment, New Dehli is warming to a closer strategic partnership with the U.S. In the long run, no Asian country will play a larger role than India in checking Chinese continental ambition. Therefore, a strong partnership will be crucial to countering debtbook diplomacy and implementing the U.S.’ Indo-Pacific strategy more broadly.
5. *Encourage acceptance and legitimacy of international rule of law:* The legitimacy of international law and peaceful dispute resolution are key pillars of the rules-based international order. China’s disregard for the UN tribunal ruling on its SCS claims threatens to erode that legitimacy. Despite losing its case, Beijing is attempting to use debt to buy diplomatic support for its claims and acquiescence to its militarization of disputed territories. A successful campaign to splinter the U.S.-led coalition supporting the UNCLOS ruling would set a worrisome precedent for future disputes.
6. *Discourage massive human rights violations:* China’s offer of conditions-free financing offers an attractive funding alternative to countries isolated by the international community. This practice undercuts the U.S.’ ability to use its own economic and diplomatic leverage to promote human rights and good governance abroad, insulating countries like Myanmar from international pressure.

5. Criteria for Assessing Strategic Vulnerabilities

To assess the likelihood and effectiveness of China's debtbook diplomacy strategy and the implications for U.S. interests, this report examines where Chinese efforts could: provide China with the greatest strategic benefit; significantly undermine U.S. interests (sometimes, but not always, a zero-sum game); be enabled by economic largesse or debt leverage; appear to already be underway; or be facilitated by disrupted or weak U.S. relations with the target country.

These criteria are separated into five primary categories:

1. *Strategic Desirability for China*

- Strategic location (e.g. Strait of Malacca; Second Island Chain).
- Potential port or base/airfield access, or valuable natural resources.
- Value as a diplomatic ally (e.g. ASEAN voting rights).

2. *Strategic Value for U.S.*

- Location near key trade routes or military bases.
- Support for U.S. diplomatic initiatives and military operations in the region.
- Role in allied coalitions (e.g. ASEAN).

3. *Long-Term Debt Trends*

- Total existing debt, maturity schedule, ability to pay, and overall financial health.
- Loans owed specifically to China and Chinese-controlled companies.
- Magnitude and financial viability of announced Belt and Road Projects.

4. Debtbook Progression

- Intended project announced, loan agreement signed, construction, operation, debt-for-equity or other strategic consideration.

5. Balance of Relations

- Treaties, access allowed, guaranteed aid, military cooperation.
- UN voting patterns, Taiwan recognition.
- Level of satisfaction with U.S. partnership vs. relations with China.
- Identifiable foreign policy reevaluation or inflection points (e. g. end of Compact of Free Association funding).

6. Country Vulnerability Assessment

The table below reflects the authors' scoring of each country in the analysis based on the given criteria. Scores range from 1 (lowest concern) to 5 (highest).

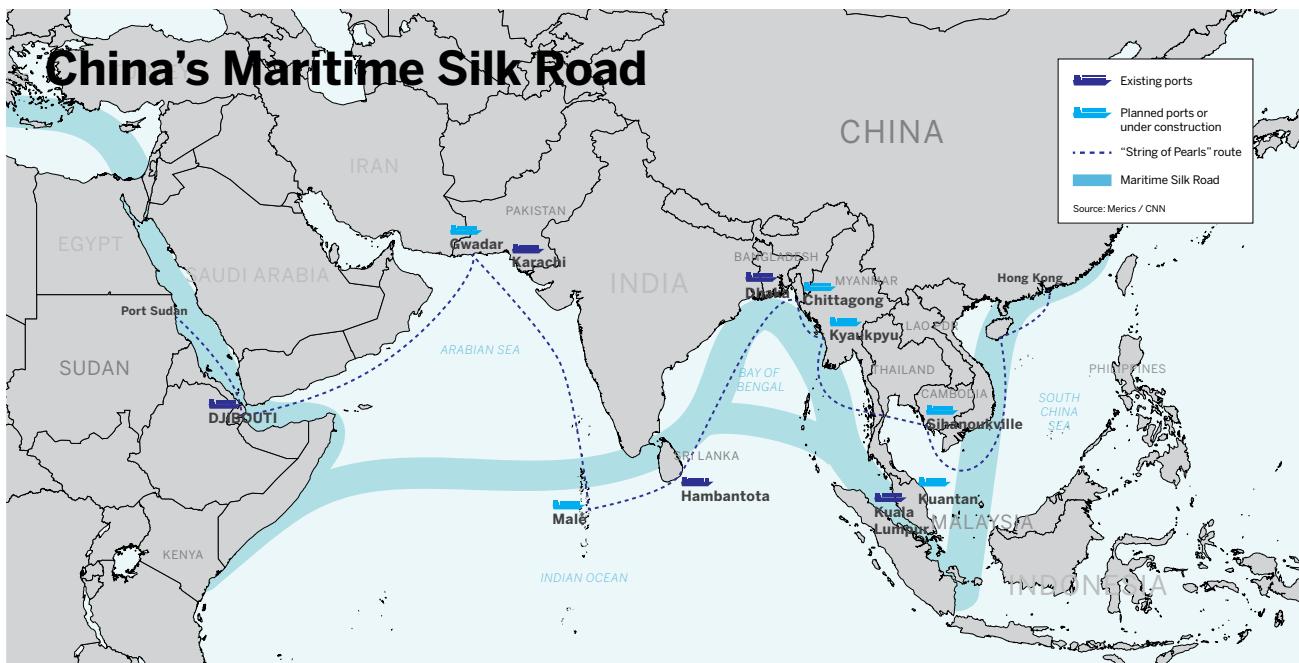
The scores are not scientific and the weighted average generated for “overall concern” is not a perfect representation of the authors’ assessment of each country. Each case study is analyzed in depth in section VIII, but these scores and rankings are designed to offer a high-level, comparative overview of debtbook risk.

Country Vulnerability Assessment						
Country	Desirability for PRC	Value for U.S.	Long-term Debt Trends	Debtbook Progression	Balance of Relations	Overall Concern
<i>Debtbook West / String of Pearls</i>						
Pakistan	3.5	5	4.5	4	4.5	4.3
Djibouti	3	4	5	5	2.5	3.9
Sri Lanka	4	2.5	4	4.5	4	3.8
Malaysia	5	3	2	3	4	3.4
Myanmar	4	3	3	3	4	3.4
Thailand	3	2.5	2	1	2	2.1
Kenya	2	2	2	1.5	2.5	2
<i>Debtbook South / SCS Influence</i>						
Laos	3	2.5	5	3	3.5	3.4
Cambodia	3	2.5	3.5	2	5	3.2
Philippines	3	3	4	2	3	3
<i>Debtbook East / Second Island Chain and Beyond</i>						
COFA States	4	4	4.5	2.5	3	3.6
Tonga	2	2	5	3	3	3
Vanuatu	3	2	3	2	4	2.8
PNG	2.5	1.5	3	1.5	3	2.3

7. Strategic Outlook

This report analyzes 16 countries that meet the criteria for potential targets of Chinese debtbook diplomacy. This list is not exhaustive, but rather represents key cases in three strategically important sub-regions of the Asia Pacific.

In some countries, the debtbook process is at an advanced stage, with China having already secured control of a strategic asset (Sri Lanka/Djibouti); in others, China has amassed debt leverage but not yet utilized it (Thailand/PNG); and, finally, some countries are currently in stable debt situations, but the long-term economic trends point to a future accumulation of Chinese debt influence that might still be avoided (COFA states/Philippines).



The authors have grouped these countries into three primary categories based on China's aforementioned strategic goals: Debtbook West/String of Pearls; Debtbook South/SCS Influence; and Debtbook East/Second Island Chain and Beyond.

Debtbook West/String of Pearls

This category covers seven South Asian and African countries where China could use debtbook diplomacy to fill out its String of Pearls and solve its Malacca Dilemma, eventually providing China's navy strategic footholds to reach into the Indian Ocean and beyond to either secure or disrupt Asia's critical trading arteries. The Pentagon estimates that more than 80% of Chinese oil imports pass through the Strait of Malacca, and since World War II the U.S. Navy has had an effective monopoly to protect and—if necessary—cut off trade through this strategic chokepoint.²⁴ A significant Chinese naval footprint in the Indian Ocean would challenge this control, potentially eroding a massive advantage in the case of potential U.S./China conflict. Even without U.S. involvement, Chinese conflict with a regional neighbor resulting in Chinese interference with shipping routes could still significantly damage U.S. trade and global markets.



²⁴ Bender, Jeremy, and Armin Rosen. "This Pentagon Map Shows What's Really Driving China's Military and Diplomatic Strategy." *Business Insider*, 13 May 2015.

In this category, Pakistan, Djibouti, Myanmar, and Sri Lanka are identified as priority concerns: countries that have already ceded either a key port or military base to China, are continuing to sink deeper into its debt trap and where U.S. interests are at stake. Malaysia is not as far along in the debt-book cycle, but its strategic location, economic ties to China, and rapidly accumulating loan burden create causes for concern. For now, Thailand and Kenya are less worrisome concerns but should be monitored as potential targets for a Chinese naval base or the development of a discussed canal through Thailand.

Debtbook South/SCS Influence

China is continuing its construction on disputed SCS territories in defiance of UN rulings. While the U.S. firmly opposes its claims, China's strategy is to use construction to change the facts on the ground while leveraging economic influence to silence other claimants and stifle regional opposition.

Laos and Cambodia have become so dependent on Chinese trade and burdened by mounting debt obligations that they've proven willing to act as Beijing's proxies in ASEAN, blocking resolutions, reaching external settlements (despite not being SCS claimants), and undermining the bloc's collective exercise of influence. Philippine President Duterte is negotiating with Beijing for massive infrastructure investments that his own Vice President has warned could sink it firmly in China's debt trap, and has recently ordered his military to stop construction on a disputed reef.²⁵ In an Asia without a U.S.-led Trans-Pacific Partnership, ASEAN provides the U.S. with valuable coalitional support to counter China's expansion. As China sinks the debt hook deeper into these ASEAN members, they will continue to weaken the organization's cohesion and potentially isolate the U.S. on the South China Sea and other regional issues.

²⁵ Villamor, Felipe. "Philippines Halts Work in South China Sea, in Bid to Appease Beijing." The New York Times, 8 Nov. 2017.

Debtbook East/Second Island Chain and Beyond

In the 1980s, PLAN commander Admiral Liu Huaqing set “command of the sea out to the First Island Chain” as the initial goal for modernizing China’s navy.²⁶ Historically, this First Island Chain—stretching from South Korea down past Taiwan and the Philippines to Malaysia—has constituted a U.S.-dominated outer barrier for significant Chinese naval presence. But as China’s navy continues to modernize, *Australian Strategic Policy Institute*’s Eli Huang writes that “China’s maritime strategy is clearly moving beyond the traditional ‘island chain’ boundary,” potentially creating a “more contested security outlook for Taiwan” among other concerns regarding Chinese power projection.²⁷



26 Huang, Eli. "China's PLAN-Breaking out to Blue Waters." The Strategist, Australian Strategic Policy Institute, 17 May 2017.

27 Ibid

U.S. Pacific Command planners express concern that a permanent Chinese presence in the Second Island Chain could offer the PLAN a springboard past the U.S.-dominated first chain into the Pacific, potentially compromising U.S. sea lines of communication and the security of U.S. bases on Guam and in the Marianas.

The Compact of Free Association states (Micronesia, Palau, and the Marshall Islands) have offered the U.S. military unfettered basing access and the right of strategic denial since World War II. But the U.S. funding that buys this support is set to expire in 2023, potentially crippling these economies just as China dramatically increases its trade and investment. As of now, Tonga and Vanuatu do not have strategic assets of significant concern to the U.S. but are already deeply in debt to China and some experts suggest they have the potential to become China's bridge to South America. Papua New Guinea has historically been in Australia's orbit and is not yet a significant concern, but it has been rapidly taking on Chinese loans it can't afford to pay and offers a strategic location in addition to significant LNG and resource deposits.

The following section will explore each of these countries and sections in detail.

8. Case Study Country Analysis

8.1 Debtbook West: String of Pearls

Country	Desirability for PRC	Value for U.S.	Long-term Debt Trends	Debtbook Progression	Balance of Relations	Overall Concern
<i>Debtbook West: String of Pearls</i>						
Pakistan	3.5	5	4.5	4	4.5	4.3
Djibouti	3	4	5	5	2.5	3.9
Sri Lanka	4	2.5	4	4.5	4	3.8
Malaysia	5	3	2	3	4	3.4
Myanmar	4	3	3	3	4	3.4
Thailand	3	2.5	2	1	2	2.1
Kenya	2	2	2	1.5	2.5	2

South Asia/Indian Ocean Region

In the Indian Ocean region, debtbook diplomacy provides China the economic leverage to achieve several geopolitical goals, including filling out its String of Pearls, addressing its Malacca Dilemma and projecting power over significant South Asian trading routes. By ramping up investment in commercial ports with dual-use potential, China is well positioned to challenge U.S. regional interests and traditional spheres of U.S. and Indian influence. Sri Lanka's Hambantota port and Pakistan's Gwadar port provide a blueprint of China's tactics but also a warning to other regional countries, such as Malaysia, Thailand, and Myanmar, which are teetering on the edge of the debt trap. In all five of these cases, China has been able to exploit a vacuum created by deteriorating relations with the U.S. and/or the West and provide a no-strings-attached funding alternative. This approach has undermined the potency of U.S. human rights and democracy promotion while undercutting U.S. strategic leverage in South Asia and Africa.

Sri Lanka offers one of the clearest and most advanced examples of debt-book diplomacy in action. A decade ago, when China began to offer massive loans for infrastructure projects, Sri Lanka met all of what we now recognize as the warning criteria for debtbook diplomacy: a poor country desperate for investment and infrastructure development; shunned by the international community over its civil war; and sitting in a strategic location astride the Indian Ocean trade routes that China depends on. Economic need, diplomatic isolation, and valuable assets combined to make Sri Lanka a prime target.

Beijing has offered nearly \$15 billion in loans, including more than \$1 billion to develop a major port in the then-president's hometown of Hambantota.²⁸ The port proved wholly unprofitable, and with Sri Lankan debts to China exceeding \$8 billion, its government ceded control of the port to China in a debt-for-equity swap. *Carnegie Endowment* analyst Constantino Xavier characterized this as part of “a larger modus operandi by China in the region,” where “Beijing typically finds a local partner, makes that local partner accept investment plans that are detrimental to their country in the long term, and then uses the debts to either acquire the project altogether or to acquire political leverage in that country.”²⁹ China is not necessarily structuring deals purposely detrimental to host countries, but those countries’ financial stability is often not China’s primary or even secondary concern.

India was particularly alarmed by the deal and—panicked that Hambantota could one day become a Chinese naval hub in the region—has since been attempting to outbid China for control of a nearby (Chinese-built) airport derided as “the world’s emptiest.”

28 American Enterprise Institute Global Investment Tracker. <http://www.aei.org/china-global-investment-tracker/>

29 Stacey, Kiran. “China Signs 99-Year Lease on Sri Lanka’s Hambantota Port.” Financial Times, 11 Dec. 2017.

Sri Lanka's ports and shipping minister justified the Hambantota deal by saying "we had to make a decision to get out of this debt trap."³⁰ But Sri Lanka's predicament also highlights the durability of China's debt trap.

New Sri Lankan President Maithripala Sirisena ran for office promising to distance the country from China, but has found it nearly impossible to do so and is likely to sink the country deeper into debt. Paikiasothy Saravanan-muttu, executive director of the *Centre for Policy Alternatives* in Colombo, warned that "given the agreements entered into by the previous regime and the colossal debt incurred, I do not think the government has much choice but to continue with Chinese investment."³¹ Chinese companies are in the midst of a \$1.4 billion development of Colombo Port City, continuing to develop the Hambantota port, and are in discussions to build a \$3 billion oil refinery nearby.³²

These debts are taking a toll on Sri Lanka's economy. Economic growth has slowed to its weakest rate in 16 years, and the Sri Lankan rupee has depreciated to its weakest point ever—creating a cycle where debt concerns cause investors to devalue the rupee, increasing the country's debt obligations (half of its loans are denominated in foreign currency).³³ This year, debt repayment costs are expected to reach 14.1 percent of GDP; government revenue is only 14.4 percent.³⁴ With its revenue tied up in debt repayment, Sri Lanka is forced to borrow more to finance infrastructure costs. In May 2018, it signed on to a new \$1 billion loan from China's EXIM bank to build a highway. Far from escaping China's debt trap, Sri Lanka continues to sink deeper.³⁵

30 Kuronuma, Yuji. "Sri Lanka's Currency Suffers as Debt Trap Deepens." *Nikkei Asian Review*, 29 Apr. 2018.

31 Blinch, Russell. "China's Lucrative Embrace of Sri Lanka Stirs Unease." *The Straits Times*, 16 Oct. 2017.

32 Ibid.

33 Kuronuma, Yuji. "Sri Lanka's Currency Suffers as Debt Trap Deepens." *Nikkei Asian Review*, 29 Apr. 2018.

34 Ibid.

35 "China Approves \$1 Bln Loan for Sri Lanka Highway - Sri Lanka PM's office." *Reuters*, 14 May 2018.

Sri Lanka's debt position with China is likely to deteriorate further. That growing debt leverage could help China push for expanded control of the port, potentially leading to a Chinese naval foothold in the Indian Ocean, either as a logistics hub or eventual full-fledged base. If China can convert its debt leverage to gain a naval presence in regional ports, it will be in striking distance of the world's trade artery, potentially challenging the U.S. navy's effective monopoly and worrying Asian neighbors dependent on those routes. The U.S. is still rebuilding ties with Sri Lanka and has minimal direct leverage. Hambantota served as a wake-up call for India on Chinese aims in their backyard, but without support from the U.S., it's unlikely that they have the financial resources to protect against Chinese debtbook diplomacy.

Pakistan

China's expansive entrenchment in the Pakistani economy makes Gwadar Port a possible target for China's second overseas naval base. A more permanent presence at Gwadar could enable China to project power across the Arabian Sea and Gulf of Oman, while further elevating India's fears of encirclement.

China has thus far pledged up to \$62 billion dollars for the China-Pakistan Economic Corridor (CPEC), funding that is opaque to even some of Pakistan's top officials. The governor of the State Bank of Pakistan admitted in 2015 that he was unsure out of the total funding "how much is debt, how much is equity and how much is in kind."³⁶ This question of payment "in kind" is most relevant when considering the Gwadar Port and Industrial Free Trade Zone.

Under the build-operate-transfer contract, signed April 2017, the China Overseas Port Holding Company (COPHC) will manage the port for 40 years, until 2059. Under the agreement, COPHC will receive a 91 percent

³⁶ Houreld, Katherine. "Pakistan should be more transparent on \$46 bn China deal, state bank head says." *Reuters*. 4 Dec. 2015

share of the port’s gross revenue and an 85 percent share from the surrounding “free zone.”³⁷

While the port’s revenue will flow almost entirely to the Chinese company, Pakistan is on the hook for repaying Gwadar’s debt obligations. According to Pakistan’s federal minister for ports and shipping, Mir Hasil Bizenjo, Pakistan is obligated to pay back \$16 billion in loans obtained from Chinese banks for the development of Gwadar port, the free-trade zone, and all communications infrastructure, at interest rates exceeding 13%, inclusive of 7% insurance charges.³⁸ In July 2017, the IMF warned these and other CPEC loans were creating “rising medium-term external repayment obligations,” nearly 7.5% of Pakistan’s GDP.³⁹

Along with high interest rates and minimal revenue shares, there are several other factors straining Pakistan’s ability to pay back its debts. Pakistan granted COPHC a 23-year exemption from income and sales taxes and federal excise duties, further undercutting its potential revenue.⁴⁰ Further, by the time the port is returned to Pakistan, its 40-year-old facilities will likely require significant maintenance. If Pakistan is set on regaining control of the port, it may have to go back to China to finance these repairs, further solidifying the cycle of debt entrapment. Pakistan’s significant debt obligations and its limited stake in the port’s revenue put China in an increasingly favorable position to one day offer debt forgiveness in exchange for extending its lease on Gwadar or negotiating access for its naval vessels and aircraft.

Chinese and Pakistani officials have both repeatedly denied that China plans to one day convert the commercial deep-water port for military use. However, in 2017, a senior foreign ministry official in Islamabad told the *FT* that “as Gwadar becomes more active as a port, Chinese traffic both commercial and naval will grow to this region. There are no plans

37 Jorgic, Drazen. “Hoping to Extend Maritime Reach, China Lavishes Aid on Pakistan Town.” *Reuters*. 16 Dec. 2017.

38 Shakil, F.M. “Bad terms: Pakistan’s Raw Deal with China over Gwadar Port.” *Asia Times*. 29 Nov. 2017.

39 International Monetary Fund. Middle East and Central Asia Dept. “Pakistan : 2017 Article IV Consultation-Press Release; Staff Report; Informational Annex; and Statement by the Executive Director for Pakistan.” Country Report No. 17/212. 13 July 2017.

40 Shakil, F.M. “Bad terms: Pakistan’s Raw Deal with China over Gwadar Port.” *Asia Times*. 29 Nov. 2017.

for a permanent Chinese naval base. But the relationship is stretching out to the sea.”⁴¹

There are some signs that Pakistani policymakers are slowly realizing CPEC’s negative long-term financial implications and may move to slow the country’s debt accumulation, which the IMF has warned could reach upwards of 70 percent of GDP in the event of an adverse shock.⁴² In November 2017, Pakistan withdrew its request to include the \$14 billion Diamer-Bhasha dam project in CPEC—citing lack of transparency and strict monetary conditions⁴³—instead opting to rely on local resources.⁴⁴ While this episode alone does not signal CPEC’s collapse, it is significant that Pakistan was willing to prioritize long-term sovereignty concerns over its immediate energy needs.

Outlook

In the short run, Chinese loans can be a much-needed lifeline for Pakistani economic development, serving both Chinese and U.S. interests. However, Chinese investment also dilutes the potency of U.S. security assistance, weakening U.S. leverage to address its nuclear security and counterterrorism interests in country.

In the long run, the sheer magnitude of Chinese loans, coupled with high interest rates, insufficient infrastructure revenue, and shrinking access to international markets and institutions—a result of a recent Financial Action Task Force decision to put Pakistan back on its terrorist financing watch list—is likely to create Pakistani dependence on Chinese debt restructuring or forgiveness.⁴⁵ This deepening Chinese involvement will continue to crowd out limited U.S. leverage while jeopardizing Pakistan’s long-term financial health.

41 Kynge, James, et al. “How China Rules the Waves.” *Financial Times*. 12 Jan. 2017

42 Hurley, John, Scott Morris, and Gailyn Portelance. “Examining the Debt Implications of the Belt and Road Initiative from a Policy Perspective.” *Center for Global Development*. CGD Policy Paper 121. March 2018.

43 Jamal, Umair. “What Pakistan’s Decision to Pull Out of a Mega Dam Project Tells Us About the Future of CPEC.” *The Diplomat*. 11 Jan. 2018

44 Rana, Shahbaz. “After Much Delay Diamer-Bhasha Dam Wins Approval.” *The Express Tribune*. 20 March 2018.

45 Masood, Salman. “At U.S. Urging, Pakistan to Be Placed on Terrorism-Financing List.” *The New York Times*. 23 Feb. 2018.

China's increased investments in Malaysia may enable it to expand its influence over the strategically-situated country, a crossroads between the Malacca Strait and the South China Sea.

Under former Prime Minister Najib Razak, Malaysia significantly expanded its economic relationship with Beijing, and in 2017, was the fourth-largest recipient of China's overseas direct investment.⁴⁶ Najib secured \$34.2 billion in BRI-related infrastructure projects, sparking accusations he was "selling" Malaysia's sovereignty for his own self-preservation.⁴⁷

This sentiment was shared by many Malaysian voters, who in early May 2018 voted out Najib's ruling party in favor of opposition leader Mahathir Mohamad. The new Prime Minister has promised to swiftly review all Chinese deals and "renegotiate the terms" of any "unequal projects" to prevent Malaysia from taking on unsustainable levels of debt.⁴⁸ "We have made it clear that we are going to look into all these contracts again because they are very costly for the government and will incur huge debts which we cannot pay," said Mahathir.⁴⁹

The East Coast Rail Link is one such contract that has faced particular scrutiny. The \$14bn project—which launched last year and received 85 percent of its funding from China's EXIM bank⁵⁰—would connect two strategic access points: Malaysia's east coast on the South China Sea and the west coast along the Strait of Malacca. However, members of Malaysia's new government have questioned the project's economic potential. "This thing is not going to be economically viable, it is not going to pay for itself,"

46 Ming, Cheang and Huileng Tan. "The shocking Malaysian election result could hit Chinese investments." *CNBC*. 10 May 2018.

47 "Malaysia may renegotiate some deals with China- Mahathir." *Reuters*. 10 May 2018.

48 Bland, Ben. "China's south-east Asia push threatened by new Malaysia regime." *Financial Times*. 15 May 2018.

49 Jaipragas, Bhavan. "Malaysia's Chinese Projects: Mahathir to Respect all Agreements." *South China Morning Post*. 17 May 2018.

50 Bland, Ben. "China's south-east Asia push threatened by new Malaysia regime." *Financial Times*. 15 May 2018.

said Jomo Kwame Sundaram, a veteran Malaysian economist, in an interview just before he was appointed to Mahathir's advisory council.⁵¹

The Melaka Gateway Port and Industrial Zone is another project which has seen its commercial viability called into question. The \$11 billion harbor project, which began construction in 2016, is being financed and constructed by state-owned Chinapower in partnership with local KAJ Development,⁵² which holds a 51% stake in the project.⁵³ A 2015 World Bank study, commissioned by Malaysia's government, found that a new port on its west coast, where Melaka is located, is "not necessary, as existing facilities had yet to reach capacity."⁵⁴ Mahathir echoed this sentiment in March 2017, saying "we have adequate facilities in this country. We already have enough ports and the necessary infrastructure to attract tourists. This [Melaka Gateway] is unnecessary."⁵⁵

Outlook

It remains to be seen whether the Mahathir government will act on this criticism and fulfill its promises to reassess several China-funded projects. Similar to Sri Lankan President Sirisena, Mahathir may find that it's simply too late. The sheer scale of Chinese investments leaves Malaysia in a weak bargaining position to renegotiate the terms of the East Coast Rail Link. Further, should Mahathir attempt to freeze the project all together, it would likely incur penalties providing China additional negotiating leverage, as Myanmar found when it canceled the Myitsone Dam project. This scenario would put China in an even more favorable position to bargain for a majority stake in the Melaka Port. A controlling stake in Melaka Port could eventually provide China with direct power projection capability across the Strait of Malacca, challenging U.S.-Singaporean military predominance over the strait. More broadly, China's entrenchment within Malaysia could

51 Ibid.

52 Maresca, Thomas. "China's Growing Ambitions in Malaysia Raise Questions about Beijing's True Motives." *USA Today*. 5 July 2017.

53 Choo, Ching Yee. "Malaysia and China Ink \$7.3bn Melaka Gateway Project." *Nikkei Asian Review*. 3 Sept. 2016.

54 Teoh, Shannon. "Malacca harbour plan raises questions about China's strategic aims." *Straits Times*. 14 Nov. 2016.

55 Jaipragas, Bhavan. "Can China Really Deliver Malaysia's Singapore Slayer?" *South China Morning Post*. 15 April 2017.

be used to further undermine ASEAN cohesion and gain another foothold along the South China Sea.

Myanmar

Myanmar's increasing isolation from the west over the Rohingya crisis constrains its international financing options, creating a vacuum for China to expand its economic ties to the Suu Kyi government. Beijing is accruing significant economic leverage that could one day be used to push for a strategic foothold along the Bay of Bengal.

China has promised large-scale financing to build roads, railways, ports, and oil pipelines in Myanmar.⁵⁶ Its largest such pledge is \$10 billion dollars to finance Kyaukpyu Port and surrounding special economic zone,⁵⁷ which will be built by the Chinese state-run CITIC Group Corporation. CITIC has negotiated a 70 percent stake in the port and, under the build-operate-transfer deal, will run Kyaukpyu for 50 years with a possible extension of another 25 years.⁵⁸ The port, which serves as the entry point for two cross-border oil and gas pipelines, will help secure Beijing's energy needs and allow it to reduce its dependence on energy imports through the Strait of Malacca.

Myanmar is expected to contribute \$2.2 billion for its 30 percent share of the port,⁵⁹ raising concern it may have to turn to Chinese loans to finance its portion of the project. This would increase the country's significant debt burden, which already includes some \$800 million in penalties for freezing the (Chinese-built) \$3.6 billion Myitsone Dam project in 2011.⁶⁰ Greg Poling, director of the Asia Maritime Transparency Initiative at the *Center for Strategic and International Studies*, notes that "the real danger of the port is that its extreme expense could lead the Myanmar government to take out an unsustainable level of debt," which "in combination with other

56 Zhen, Liu. "Myanmar Eyes China's Trade Plan as Crisis in Rakhine Goes On." *South China Morning Post*, 6 Oct. 2017.

57 Sun, Yun. "Winning Projects and Hearts? Three Cases of Chinese Mega-Infrastructure Projects in South Asia." *The ASAN Forum*, 3 Nov. 2017.

58 Ibid.

59 Ibid.

60 Lee, Yimou, and Shwe Yee Saw Myint. "China May Scrap Divisive Dam in Myanmar to Advance Other Interests: Sources." *Reuters*. 5 April 2017.

current and future projects in Myanmar, could in the coming years lead to a debt trap.”⁶¹

While China has spent years pushing for the resumption of the dam project, it has recently softened its stance,⁶² signaling that it may be willing to trade debt forgiveness on the dam project for preferential access or an extended contract for Kyaukpyu port. According to Mohan Malik, professor at the *Asia-Pacific Center for Security Studies*, Myanmar now faces “intense pressure” to raise China’s stake as high as 85 percent and lease it for 99 years.⁶³ This arrangement would give China more autonomy in the development and potentially the use of the strategic port, including as a naval or dual-use facility.

Outlook

Facing diplomatic and economic isolation from the West over its human rights abuses, Myanmar is likely to drift further into China’s orbit. Deepening China-Myanmar ties could undermine international efforts to push for an end to the Rohingya crisis, provide China with a potential pearl astride the Strait of Malacca, and further weaken ASEAN cohesion on South China Sea disputes. As long as Myanmar continues its persecution of the Rohingya, there are very few carrots the U.S. and its allies can or should offer to blunt the expansion of Chinese influence.

Thailand

China is capitalizing on Thailand’s lagging post-coup economic recovery and a downturn in U.S.-Thai relations to increase its infrastructure investments. In the short run, these investments will strengthen China’s ties to Thailand’s military junta and may further increase its influence within ASEAN. In the long run, they could give China leverage to assert influence over signature projects such as the proposed Kra Canal. While it’s unlikely

61 Koutsoukis, Jason. “The Fishing Port That May Become a \$10 Billion Chinese Debt Bomb.: Bloomberg, 10 May 2018.

62 Ibid.

63 Jennings, Ralph. “China’s Expansion Will Lift Three Countries in 2018 and Anger One.” *Forbes*. 8 Jan. 2018.

the U.S. will “lose” Thailand to Chinese influence any time soon given the depth of the military relationship, U.S.-Thai disagreements over the direction of Thailand’s government have moved Thailand closer to China.

For China, Thailand is another natural bridge to ASEAN, given that Thailand does not have any SCS claims but is a strong voice within the body. Meanwhile, the military junta has touted its relations with the Asian superpower and promoted Chinese-financed infrastructure projects to shore up its legitimacy. These investments, including China’s \$5 billion for the Thai-Chinese railway project,⁶⁴ which began construction this December,⁶⁵ are particularly impactful given total FDI in Thailand was just \$1.55 billion in 2016, down 70% from the year prior.⁶⁶

Nonetheless, the railway and other investment projects could just be China’s foot in the door to securing a much bigger prize down the line: the Kra Canal. Reports have recently resurfaced⁶⁷ that Thailand, with Chinese financing, is planning to build the canal—linking the Gulf of Thailand and the Andaman sea. The estimated \$28 billion project would provide an alternate route to the Strait of Malacca and cut up to three days’ sailing time for ships passing between the Indian and Pacific Oceans.⁶⁸ The idea has been around for centuries, repeatedly dismissed on both economic and environmental grounds. However, China has recently expressed interest in revisiting the project as part of its Maritime Silk Road.⁶⁹ If the project were to get off the ground it would allow ships to bypass Singapore, threatening Singapore’s supremacy in providing shipping services and undermining U.S.-Singaporean control over the Strait. Thailand remains hesitant to greenlight the project, mindful of the ramifications for Singapore’s economy and wary of undercutting ASEAN unity.

64 Zhen, Liu. “Thailand approves long-delayed US \$5.2b rail link to China.” *South China Morning Post*. 11 July 2017.

65 “After delays, ground broken for Thailand- China railway project.” *Reuters*. 21 Dec. 2017.

66 Ono, Yukako. “Thai Junta Beseeches Foreign Investors: ‘Please Come Now.’” *Nikkei Asian Review*. 23 June 2017.

67 Brewster, David. “The Kra Canal: Double Bypass.” *The Lowy Institute*. 14 Aug. 2017.

68 Ibid.

69 Shira, Dezan and Associates. “Kra Canal Project Revisited As Part Of China’s Maritime Silk Road.” *ASEAN Briefing*. 11 Sept. 2017.

Going forward, Thailand is likely to continue to balance between the two powers: expanding its economic and military ties with China while broadening its military alliance with the U.S. In the short run, this poses a limited risk to U.S. interests, beyond the further erosion of ASEAN cohesion. However, China may one day choose to leverage its growing debt holdings, along with its strengthened ties to the regime, to finally get the canal project off the ground, but it remains too soon to tell.

Africa

China's long-standing economic ties to Africa are paying newfound strategic dividends as China cashes in on decades of accumulated debt and further expands its infrastructure investments under the BRI umbrella. In 2016, China established a \$60 billion fund to finance infrastructure projects across Africa, providing no-strings-attached loans that in the long run are likely to saddle impoverished countries, which already have weak economic governance and underdeveloped financial systems, with crippling debt.⁷⁰

As Xiaochen Su put it, “given the ballooning amount of debt from more and more loans taken on to finance infrastructural developments in the future, African states are likely to require more than just portions of their limited budgets to complete repayment. More likely than not, many states will have to resort to payments in kind.”⁷¹ We’ve already seen this play out in Djibouti, where China used its economic entrenchment to help negotiate its first overseas naval installation. China may be looking to follow this model in other African states, trading debt forgiveness for both commercial and strategic assets, along with continued support for China’s policy positions on Taiwan and at the United Nations. While a Chinese military presence in Africa may contribute to the common good by supporting China’s expanding peacekeeping and anti-piracy efforts, it also provides China the ability to project power further from its shores and in ways counter to U.S. interests.

⁷⁰ Su, Xiaochen. “Why Chinese Infrastructure Loans in Africa Represent a Brand-New Type of Neocolonialism.” *The Diplomat*. 9 June 2017.

⁷¹ Ibid.

Djibouti is the most advanced example of passive Chinese debtbook diplomacy in action.

Just four years after entering Djibouti under the guise of commercial gain, China announced in 2016 it was building its first overseas naval base, signing a 10-year, \$20 million a year contract. By that point, China had invested \$1.4 billion—the equivalent of 75% of Djibouti’s GDP⁷²—into critical infrastructure, including three ports, two airports, the Ethiopia-Djibouti railway and a pipeline to bring water from Ethiopia.⁷³ By 2016, Djibouti’s public external debt had risen from 50 to 85 percent of GDP in two years, with 77 percent of total government-guaranteed public debt owed to China’s EXIM Bank.⁷⁴ Djibouti’s debt obligations are likely to grow further. Last November, Presidents Guelleh and Xi signed a new agreement for China to provide an undisclosed amount of loans.⁷⁵

These debt holdings have given China a favorable position to capitalize on Djibouti’s February seizing of the Doraleh Container Terminal from Dubai-based DP World. Initial reports indicated that the government intended to strike a deal with a Chinese-state controlled company to run the port.⁷⁶ Meanwhile, in March, the government signed an agreement with a Singapore-based company that works closely with China Merchants Port Holdings Co., already a large stakeholder in the nearby Doraleh Multipurpose Port.⁷⁷

Marine General Thomas Waldhauser, the top U.S. general for Africa, told the House Armed Services Committee in March that if China took over

72 Hurley, John, Scott Morris, and Gailyn Portelance. “Examining the Debt Implications of the Belt and Road Initiative from a Policy Perspective.” *Center for Global Development*. CGD Policy Paper 121. March 2018

73 Jacobs, Andrew. “Joyous Africans Take to the rails, With China’s Help.” *The New York Times*. 7 Feb. 2017.

74 “Djibouti: Staff Report for the 2016 Article IV Consultation- Debt Sustainability Analysis.” *International Monetary Fund*. 7 Feb. 2017.

75 Zheng, Sarah. “China Offers Loans to Djibouti As They Vow to Establish Closer Ties.” *South China Morning Post*. 23 Nov. 2017.

76 Lohande, Nikhil and Matina Stevis-Gridneff. “Djibouti Seizes Strategic DP World Container Terminal.” *The Wall Street Journal*. 23 Feb. 2018.

77 Manek, Nizar. “Djibouti Sees China Involvement in Port as No Threat to U.S.” *Bloomberg Politics*. 14 March, 2018.

the port, “the consequence could be significant,” pointing to its potential effects on resupplying the U.S. base in Djibouti, refueling U.S. Navy ships and enabling greater Chinese control over the vital Bab el-Mandeb strait.⁷⁸ The U.S. has long been concerned about the two militaries operating in such close quarters, fears substantiated by a May 2018 incident in which Chinese military personnel targeted U.S. flight crews using high-power lasers.⁷⁹ Richard D. Fisher, a Senior Fellow at *the International Assessment and Strategy Center*, recently speculated before Congress that the incident may have even been “intended to spark a U.S. response that China could then use to further pressure Djibouti to reduce the U.S. presence.”⁸⁰

In March, Djibouti’s Inspector General, Hassan Issa Sultan, insisted the port will stay in state hands as it seeks new investment.⁸¹ For now, the U.S. will have to wait and see whether China will attempt to use its passive influence or actively apply pressure to gain a controlling stake in the container port.

Outlook

Djibouti is a microcosm of the larger tension between cooperation and competition in the U.S.-China relationship. While China’s presence provides new opportunities for joint anti-piracy, demining and naval deconfliction exercises, the U.S. will also need to hedge against any attempts to undermine its Djibouti-based operations to counter a range of terrorist threats and secure energy routes along the Horn of Africa.

⁷⁸ Ali, Indrees and Phil Stewart. “‘Significant’ consequences if China takes key port in Djibouti: U.S. general.” *Reuters*. 6 March 2018.

⁷⁹ Lubold, Gordon and Jeremy Page. “Laser From Chinese Base Aimed at U.S. Military Pilots In Africa’s Skies, Pentagon Charges.” *The Wall Street Journal*. 3 May 2018.

⁸⁰ United States, Cong. House Permanent Select Committee on Intelligence. *Hearing on China’s Worldwide Military Expansion*. 17 May 2018. (Statement of Richard D. Fisher Jr., International Assessment and Strategy Committee.)

⁸¹ Fick, Maggie. “Djibouti Says its Container Port to Remain in State Hands.” *Reuters*. 14 March, 2018.

Kenya provides China a gateway to East and Central Africa, a symbol of the expansive reach of BRI and another potential access point to the Indian Ocean.

Between 2010 and 2015, China provided \$6.3 billion in loans to the Kenyan government, making it Kenya's largest creditor and⁸² accounting for 57% of Kenya's total external debt of \$4.51 billion.⁸³ In 2016, the World Bank warned that Kenya "has a heavy debt burden and China's loans can bring debt to unsustainable levels."⁸⁴

Exacerbating these debt concerns is the \$3.6 billion in loans—equivalent to a fifth of Kenya's national budget⁸⁵—provided by China's EXIM bank to finance the Mombasa-Nairobi Standard Gauge Railway.⁸⁶ The project was built by the state-owned China Road and Bridge Corporation, which will operate the railway for the first five years. Since its inauguration, in May 2017, the railway has seen significantly less cargo traffic than needed to begin paying down the debt. While in 2013 the World Bank warned the railway would only be feasible if it moved all Mombasa Port's cargo,⁸⁷ in its first month, the line moved just 1,600 containers of the 80,000 processed at Mombasa.⁸⁸ If the railway does not make enough to even cover its operating costs, Kenya may have to go back to China to fund railway maintenance, further sinking Kenya into China's debt trap.

82 China Africa Research Initiative. "Data: Chinese Loans to Africa." *Johns Hopkins University School of Advanced International Studies*.

83 Sanghi, Apurva and Dylan Johnson. "Deal or No Deal: Strictly Business for China in Kenya?" World Bank Group, *Macroeconomics and Fiscal Management Global Practice Group*. March 2016.

84 Ibid.

85 Kaiman, Jonathan. "'China has Conquered Kenya': Inside Beijing's New Strategy to Win African Hearts and Minds." *Los Angeles Times*. 7 Aug. 2017.

86 Pilling, David. "Chinese Investment in Africa: Beijing's Testing Ground." *Financial Times* 13 June 2017.

87 Ibid.

88 "Did Kenya get a loan to build a railway, or vice versa?" *The Economist*. 22 Mar. 2018.

Relative to other countries in this analysis, Kenya's limited strategic assets and long debtbook timetable do not rise to the level of a priority concern for U.S. interests.

Underwhelming railway returns and recent political instability—likely to hamper Kenya's economic growth—will make it increasingly difficult for Kenya to service its debt payments. But it remains to be seen what exactly, if anything, China will want when loans for the railway and other projects become due in 15 to 20 years. In the short run, China is likely to continue to accumulate political influence, with Chinese loans undermining the U.S.' ability to use its own aid and investment as leverage to improve Kenya's worsening human rights situation. In the long run, China may be able to exert greater influence over Mombasa Port, but at this stage, this is still largely a speculative assessment.

8.2 Debtbook South: ASEAN and Southeast Asia Maritime Influence

Country	Desirability for PRC	Value for U.S.	Long-term Debt Trends	Debtbook Progression	Balance of Relations	Overall Concern
<i>Debtbook South / SCS Influence</i>						
Laos	3	2.5	5	3	3.5	3.4
Cambodia	3	2.5	3.5	2	5	3.2
Philippines	3	3	4	2	3	3

In Southeast Asia, China's debt leverage provides a means to serve multiple strategic ends: control of strategic resources and access to ports, but also political influence in international institutions like ASEAN and acquiescence on contested issues like its South China Sea claims. China already has significant leverage over Laos and Cambodia's economies and is negotiating large-scale infrastructure loans with the Philippines. It is likely to use debtbook diplomacy to attempt to isolate the U.S diplomatically in this important region.

Former Australian Foreign Minister Gareth Evans recently characterized Laos and Cambodia as “wholly owned subsidiaries of China.”⁸⁹ These countries’ relatively poor economies are deeply dependent on Chinese trade and investment and have been accumulating unsustainable debt loads. While they do not offer obvious, physical strategic equities like resources or ports that China might covet, their membership in ASEAN makes them diplomatically valuable. Prodded by China, Laos and Cambodia have already undermined the U.S./ASEAN position on disputed SCS territories. As China’s debt leverage continues to grow, so too will its ability to coerce these countries to create and exploit cracks in regional coalitions hoping to manage China’s rise.

As of 2016, China was involved in 760 projects—primarily infrastructure and hydropower—in Laos worth a total of \$6.7 billion, in a country with a GDP of barely \$12 billion.⁹⁰ Laos’ debt will continue to grow as it becomes more deeply involved in a \$6 billion rail project linking the two countries. A 2013 IMF analysis of the proposed project warned that “the additional external borrowing amounts to US\$ 6.7 billion over 5 years” and would cause “total external debt [to] surpass 125 percent of GDP.”⁹¹ While Laos renegotiated the terms somewhat before reaching an agreement last year, both countries refused to disclose the interest rates. China owns more than 40% of Laos’ public debt, and a new IMF report released last year warned that the risk of “external debt distress” in Laos has risen from moderate to high.⁹²

Laos has also long been engaged in “land-for-development” schemes, that have seen the government “pay back” its accumulated debt by conceding more than a million hectares of state land to foreign-backed investors.⁹³ In recent years, Vientiane has been working to curb this practice, but the

89 Class Lecture, Harvard Kennedy School. 7 Feb, 2018.

90 Corben, Ron. “Can Obama Help Laos Emerge from China’s Shadow?” *South China Morning Post*, 5 Sept. 2016.

91 “Lao People’s Democratic Republic: Staff Report for the 2013 Article IV Consultation—Debt Sustainability Analysis.” *International Monetary Fund*. 31 Oct. 2013.

92 “Lao People’s Democratic Republic: 2016 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for Lao People’s Democratic Republic.” *International Monetary Fund*. Feb. 2017.

93 “Lao Prime Minister Moves to Stop Land-for-Capital Deals.” *Radio Free Asia*. 16 Dec. 2016.

precedent of essentially small-scale debtbook diplomacy bears watching as the country's debts continue to mount.

Cambodia's debt situation is not yet as severe, but its economy may be even more dependent on China. Cambodian Prime Minister Hun Sen has called China Cambodia's "most trustworthy friend," and the two countries have been increasing joint military exercises a year after Cambodia suspended exercises with the U.S. indefinitely, saying it was too busy holding elections.⁹⁴⁹⁵ The U.S. and EU have condemned a crackdown on political opposition by Chinese-backed Prime Minister Hun Sen, who responded by accusing the U.S. of staging a "color revolution" to overthrow his government.⁹⁶

Between 2011 and 2015, Chinese firms provided Cambodia nearly \$5 billion in loans—70% of the latter's total industrial investment—and last December, Chinese companies pledged an additional \$7 billion in investments.⁹⁷ They have also proposed a massive highway plan that would cost an estimated \$26 billion.⁹⁸ China owns about half of Cambodia's \$6.5 billion in public debt,⁹⁹ and Ou Virak, president of the Cambodian think tank *Future Forum*, warned that continuing to accrue debt could push Cambodia into a "Chinese trap," that could pose "a danger to [the] national security, politics, and the economy" of Cambodia.¹⁰⁰

While China holds immense influence over these two countries, they have few desirable strategic assets that would be obvious debtbook diplomacy targets. The strategic value of these countries is not in assets but in influence over institutions. Both are ASEAN members and have been working on China's behalf to undermine the group's unity on South China Sea issues. Cambodia, which has been described as China's proxy in ASEAN,

94 Peel, Michael, et al. "FT Investigation: How China Bought Its Way into Cambodia." *Financial Times*. 8 Sept. 2016.

95 Thul, Prak Chan. "Cambodia Kicks off Drills with 'Great Friend' China as U.S. Ties Sour." *Reuters*. 17 Mar. 2018.

96 Ibid.

97 "Why Cambodia Has Cosied up to China." *The Economist*. 21 Jan. 2017.

98 Spiess, Robin. "Belt and Road Could Bring Risks for Cambodia Debt." *Phnom Penh Post*. 27 Mar. 2018.

99 Ibid.

100 Kimseng, Men. "Rising Debt to China 'Worrying', Analyst Says." *VOA Khmer*. 6 Dec. 2017.

has repeatedly blocked ASEAN statements criticizing China's SCS claims, and in 2016 joined with Laos to make a pact with China on SCS consensus that ASEAN's former Secretary General said amounted to "interfering with the domestic affairs of [ASEAN]."¹⁰¹

Outlook

With the demise of TPP, ASEAN has become even more important as a regional framework to help balance and manage China's growing influence, providing its smaller rivals a forum to strategize and exercise collective power. Yet the organization relies on consensus, and the presence of one or two Chinese satellites would effectively give Xi veto power on any ASEAN statements or actions viewed as detrimental to Beijing's interests. The dis-integration of ASEAN unity on the South China Sea issue has undermined U.S.-led opposition to China's territorial claims and an ineffective ASEAN could continue to deprive the U.S. of regional support for efforts to protect U.S. strategic interests and counter Chinese expansion.

Philippines

The Philippines is another ASEAN member pursuing Chinese loans that could mire its economy in a debt trap. President Duterte has promised his people \$167 billion in infrastructure spending for his "Build, Build, Build" campaign, likely to be financed by Chinese loans at such high interest rates that *Corr Analytics* founder Anders Corr warns they could balloon to \$452 billion in 10 years, which could lead "to virtual Philippine debt bondage to China."¹⁰² Corr's analysis warned that "the Philippines will have to give political and economic concessions to China in order to repay annual interest," which could include concessions on oil rights or territory in the South China Sea or agreements to sell exports to China at below-market rates.¹⁰³

¹⁰¹ Ismail, Saifulbari. "China's pact with Cambodia, Laos an interference in ASEAN's domestic affairs: Former Sec-Gen." *Channel News Asia*. 25 April 2016.

¹⁰² Corr, Anders. "New Philippine Debt of \$167 Billion Could Balloon To \$452 Billion: China Will Benefit." *Forbes*. 13 May 2017.

¹⁰³ Ibid.

Speaking on just one \$3 billion project of Duterte's initiative, Philippines Vice President Leni Robredo recently warned that "our fear is we might get stuck in a debt trap like the one experienced by Sri Lanka."¹⁰⁴ Gary Alejano, an opposition lawmaker, warned against a borrowing spree, cautioning that states "trapped in debt with China are at risk of losing not only their valuable natural resources and strategic assets but also their sovereignty. We may end up giving up our rights to our territory in the West Philippine Sea."¹⁰⁵ The West Philippine Sea is known by China as the South China Sea.

Outlook

The Philippines is still in the very early stages of a debtbook diplomacy cycle, but may soon ramp up its Chinese loan intake dramatically. U.S.-Philippine relations have rebounded in the past year, but the U.S. cannot feasibly offer an alternative to Chinese infrastructure funding. Concessions, or at least silence, on South China Sea issues would be an obvious Chinese "get" in exchange for debt relief. As Duterte courted Chinese loans, last November he ordered his military to stop construction on a disputed South China Sea territory. The Philippines is the largest SCS claimant outside of China and won a major 2016 UNCLOS ruling that China has refused to recognize. Any agreements China could extract from the Philippines on disputed territory would further diminish regional support for U.S. efforts to contest Chinese claims.

¹⁰⁴ Nonato, Vince. "Robredo Warns of China Debt Trap, Cites Sri Lanka." *Philippine Daily Inquirer*. 22 Oct. 2017.

¹⁰⁵ Morallo, Audrey. Philippines May Be Trading Natural Resources for China Funds, Alejano Warns. *The Philippine Star*, 8 May 2018.

8.3 Debtbook East: The Second Island Chain and Beyond

Country	Desirability for PRC	Value for U.S.	Long-term Debt Trends	Debtbook Progression	Balance of Relations	Overall Concern
<i>Debtbook East / Second Island Chain and Beyond</i>						
COFA States	4	4	4.5	2.5	3	3.6
Tonga	2	2	5	3	3	3
Vanuatu	3	2	3	2	4	2.8
PNG	2.5	1.5	3	1.5	3	2.3

By increasing its economic influence in the Second Island Chain, China is positioning itself to capitalize on the impending fiscal distress of Pacific Island Countries. Such an influence shift in countries like the Compact of Free Association (COFA) states (Micronesia, the Marshall Islands, and Palau) Tonga, and Vanuatu could jeopardize U.S. strategic denial and exclusive basing rights, while potentially providing China with both a springboard to the “Far Sea” beyond and a foothold to threaten sea lines of communication and shipping to U.S. bases on Guam and the Marianas.

Compact of Free Association States

To China, U.S. influence and military positioning in the “Second Island Chain” represents a remnant of U.S. Cold War containment strategy designed to block the PLAN’s eastward reach and development as a blue-water navy, while serving as a staging point for current U.S. military operations. The COFA states are particularly valuable, offering the U.S. exclusive and unfettered military access.

But while the U.S. and the COFAs have been steadfast allies for 70 years, new economic developments are threatening to undermine the relationship. Just as Chinese economic influence—through growing trade, investment, aid, and tourism—threatens to displace America’s, the COFA states are beginning to panic about the prospect of the U.S. shutting off the aid tap propping up their economies and underwriting the strategic partnership.

The 2023 expiration of this defined U.S. funding could throw these countries into fiscal distress overnight, providing a catalyst for them to reevaluate their long-term superpower relations. In the Federated States of Micronesia, \$130 million in U.S. Compact aid is equivalent to nearly half of GDP. An updated Compact Agreement signed with Palau in 2010 had promised roughly \$16 million per year, but it took eight years for Congress to appropriate the funding. And when that funding runs out in 2023, half of Palau's government revenue could disappear overnight.¹⁰⁶

Outlook

Perceived U.S. inattention and tenuous commitment have stoked these countries' frustration and panic. Meanwhile, Beijing has positioned itself to step in as an enthusiastic replacement, wooing leadership with state visits and no-strings-attached aid, offering the funding, political support, and recognition that these nations crave. Since World War II, the Compact Agreements have provided the U.S. with cheap leases on valuable real estate; with U.S. rent payments set to expire, American strategic thinkers should consider the cost of allowing a new tenant to move in.

Indebted Pacific Island Countries

Over the past decade, Chinese loans have financed a construction boom in Oceania. As the grace periods begin to expire, these countries are finding themselves financially distressed. While these smaller PICs may not yet be able to offer strategic assets of significant concern to the U.S., their deep ensnarement in China's debt trap raises long-term concerns about potential Chinese naval facilities in the Second Island Chain and beyond—staging points that could help the PLAN cover key trading routes and U.S. lines of communication and supply.

"The Chinese will take over running the country in a few years time," said Tongan Prime Minister Akilisi Pohiva in a May 2018 press conference.¹⁰⁷ Back in 2013, Prime Minister Pohiva had warned that "our hands and feet

¹⁰⁶ 2013 Investment Climate Statement - Palau. U.S. Department of State. Feb. 2013.

¹⁰⁷ Fonua, Pesi. "'Chinese Will Take over the Country' PM Pohiva Proclaims, While Digging Canals at Popua." *Matangi Tonga Online*, 15 May 2017.

have already been tied” and that one of the few possible remedies could be that “China might say well we can write off your loan, but Tonga must agree to have a Chinese naval base.”¹⁰⁸ From 2008-2010, Tonga—with a current GDP under \$400 million—borrowed \$311 million from China.¹⁰⁹ When the first payments came due in 2013, the IMF had to step in and declare Tonga at risk of “debt distress” to convince China to extend a five-year grace period.¹¹⁰ That grace period expires this year, and Tonga now faces even higher payments on a debt they have little means to repay.

Vanuatu is in a similar—if less extreme—position. From 2008-2004, it took \$270 million in Chinese loans, worth nearly 35% of its \$775 million GDP.¹¹¹ Its debts are still relatively manageable, but growing; Vanuatu’s Finance Ministry expects foreign debts to grow from 18% of GDP to 33% by 2022—with nearly half that debt owed to China.¹¹² It has been forced to establish a debt management unit, raise its value-added tax, and consider introducing a first-ever income tax—which could have major implications for a country that serves as an international tax haven.

The Luganville Wharf bears monitoring as Vanuatu’s potential mini-Hambantota; financed by Chinese loans and shoddily built by a Chinese company, it is the largest wharf in the region, yet struggling to generate revenue. The business case for its development was based on tourism from cruise ships, however, a shipping tracking service recorded only four cruise ships docking in the first three months of this year.¹¹³ The CEO of the wharf’s stevedoring company defended its fundamental viability, but acknowledged that it wasn’t meeting revenue expectations, saying that “the investment in cruise ships hasn’t panned out the way they would have liked it. That’s a pure and simple fact,” and that “it’s just not working out at this point in time.”¹¹⁴

108 Latu, Kalino. “Akilisi Pohiva: Tonga Is Lost to China.” *Kaniva Tonga*. 12 May 2013.

109 Klan, Anthony. “Pacific Nations Drowning in Chinese Debt.” *The Australian*. 29 Jan. 2018.

110 Ibid.

111 Ibid

112 Ibid

113 Wroe, David. “The Great Wharf from China, Raising Eyebrows across the Pacific.” *The Sydney Morning Herald*, 12 Apr. 2018.

114 Ibid.

Earlier this year, Australia's *Fairfax Media* reported that there had been "preliminary discussions between the Chinese and Vanuatu governments" about a potential Chinese "full military base" in Vanuatu—specifically citing the Luganville Wharf.¹¹⁵ The report suggested that "Beijing's military ambition in Vanuatu would likely be realised incrementally, possibly beginning with an access agreement that would allow Chinese naval ships to dock routinely and be serviced, refuelled and restocked. This arrangement could then be built on."¹¹⁶ China and Vanuatu denied the reports, but they were taken seriously by Australia, where Prime Minister Malcolm Turnbull expressed "great concern" about the prospect of a Chinese base in the region.¹¹⁷

Outlook

These countries do not pose significant strategic risks to the U.S. in the short-term, but their deep indebtedness to China creates concerns that Beijing could extract dual-use facilities or other concessions in the long run. The U.S. should monitor Chinese debt loads in these countries and encourage Australian engagement, but they do not rise to the level of an immediate priority.

Papua New Guinea (PNG)

PNG occupies valuable strategic real estate at the intersection of South-east Asia and the South Pacific and holds massive deposits of gold, nickel, and natural gas. Since Australia granted PNG's independence in 1975, it has served as its primary partner and patron. But in recent years PNG has readily accepted conditions-free Chinese funding as an alternative to restricted Australian aid and investment. China imports large quantities of natural gas from PNG and has invested heavily in LNG development, as

¹¹⁵ Wroe, David. "China Eyes Vanuatu Military Base in Plan with Global Ramifications." *The Sydney Morning Herald*, 10 Apr. 2018.

¹¹⁶ Ibid.

¹¹⁷ "Chinese Military Base in Pacific Would Be of 'Great Concern', Turnbull Tells Vanuatu." *ABC News*, 10 Apr. 2018.

well as major nickel mines and hydro projects, and a Chinese company has been redeveloping Lae Port facilities.¹¹⁸

PNG's debts to China are opaque, but growing rapidly. In 2017, PNG admitted that its *public* debt had reached \$6.6 billion, a 258 percent increase since 2012.¹¹⁹ But this figure obscures debt owed by state-owned companies, including a \$1.8 billion loan from China's EXIM Bank and a \$900 million loan from UBS.¹²⁰ Total debt has been estimated at \$9 billion, and the IMF has warned that PNG's "debt servicing costs now exceed national spending on either education or health."¹²¹ Those costs of servicing its debts to China have exploded from \$2m to \$26m in the past five years and will likely continue to rise.¹²²

Increasing Chinese influence and leverage in PNG alarms Australia more than it does the U.S., but it remains to be seen whether Australia will make a concerted attempt to strengthen ties and keep PNG in its orbit. To China, PNG is attractive as a regional leader in Oceania, for its LNG and other strategic resources, and potentially someday for its ports.

Outlook

China's pursuit of key natural resources and strategic infrastructure in PNG represent primarily long-term strategic challenges, unlikely to directly impact U.S. interests in the short-term. But the speed and scale with which China is acquiring natural resources and amassing debt raise long-term concerns.

¹¹⁸ Tlozek, Eric. "Infrastructure Investment Has Australia Uneasy over Chinese Influence in PNG." *ABC News Australia*. 12 Feb. 2017.

¹¹⁹ Blades, Johnny. "Papua New Guinea's Economy Has 'Fallen off a Cliff.'" *Radio New Zealand*. 3 April 2017.

¹²⁰ Ibid.

¹²¹ "Papua New Guinea: Staff Report for the 2016 Article IV Consultation- Debt Sustainability Analysis." International Monetary Fund. 11 Nov. 2016.

¹²² Tlozek, 2017.

9. Recommendations

Since World War II, the U.S. has enjoyed effectively unchallenged U.S. economic and military dominance in the Pacific, buttressed by a strong alliance system and an unparalleled basing network to support American power projection. But China's rise is upending that favorable landscape. It has compromised and may overtake America as a regional—and potentially global—economic power. Over the next ten, twenty, and fifty years, the great power game in the Asia-Pacific will look very different, the board increasingly unfavorable to U.S. interests.

This report will not delve deeply into the complex future of the U.S.-China relationship or propose what America's grand strategy should be to confront a rising China. But it will offer recommendations for how the U.S. should respond specifically to Chinese debtbook diplomacy, within the context of the shifting balance of power in the Pacific.

In responding to debtbook diplomacy, the authors believe America must be cognizant that in many areas it no longer holds the upper hand. On a macro level, the U.S. lacks the will and the resources to remotely challenge the massive scale of Chinese BRI investment. Developing countries desperate for infrastructure funding will continue to seek out Chinese loans, and China will continue to accumulate and leverage this debt coercively to advance its strategic goals. There is little the U.S. or its allies can do to interfere with this cycle.

The U.S. can, however, offset some of the most harmful consequences of debtbook diplomacy. This will first require a tough assessment of which interests are truly vital, in order to maximize the effectiveness of America's own finite resources. Vital American interests in play are the stability of the rules-based international order, the viability of global trading arteries and financial markets, and the well-being and security of major regional partners, such as India, Japan, South Korea, and Australia. Other interests often considered vital—a naval monopoly in the Strait of the Malacca; leverage over Pakistan; upholding rule of law in the South China Sea; and the promotion of democracy and human rights—are extremely important, but they are not *vital* to American security and stability. Over the past 70

years, the U.S. could devote resources to preserving all of these interests at once, but in the coming decades, it will be forced to make tough choices on where it can afford to outbid and outcompete China, and where it cannot.

In the coming decades, debtbook diplomacy could—in a worst-case scenario—help China acquire several active naval bases across South Asia and the Strait of Malacca; force tacit or overt acquiescence from U.S. allies on militarized SCS islands; enable continued human rights abuses in Myanmar and elsewhere; and extend its naval reach deep into the Second Island Chain and beyond. This will unquestionably present a darker strategic picture for U.S. interests and the U.S. military, and the U.S. government should make a concerted effort to keep these developments from unfolding. But it is unclear that any truly core U.S. interests will be irreparably damaged.

The interests at play do still range from important to extremely important, and the U.S. can and should take a number of steps to protect them. A concerted, but proportional application of American economic, diplomatic, and military power can demonstrate regional commitment and contain the worst damage to U.S. interests. To that end, this report offers three sets of U.S. government recommendations to target and streamline investment, strengthen alliances, and manage debt burdens.

Target and Streamline Overseas Investment

The U.S. and its allies cannot offer public-private investment at anywhere the scale of Chinese BRI funding. But they can take significant steps to align U.S. investment with foreign policy interests, coordinate resources among partner nations, and focus limited resources in areas of comparative advantage like digital infrastructure.

Pass and Implement Legislation Creating the Development Finance Corporation (DFC)

- Bills pending in both Houses of Congress would combine the Overseas Private Investment Corporation (OPIC) and USAID's Development Credit Authority (DCA), Enterprise Funds, and

Office of Private Capital and Microenterprise to create the DFC, a single entity charged with leveraging private sector investment to advance U.S. foreign policy interests.¹²³

- While the DFC would not be able to rival the scale of Chinese-state directed investment, consolidating development finance under a single entity would allow the U.S. government to more efficiently harness private investment as an alternative to high-risk Chinese projects.

Coordinate Limited Resources with Partner Nations

- Last November, President Trump announced that OPIC would join with Japanese partners “to offer high-quality United States-Japan infrastructure investment alternatives in the Indo-Pacific region.”¹²⁴
- These multilateral initiatives employ partner resources as a force multiplier, allowing for more efficient coordination and focus on comparative advantages.
- The U.S. should work to expand this initiative and to include other regional partners like Australia, South Korea, and India.

Focus on Comparative Advantages in Digital Infrastructure¹²⁵

- U.S. investment should capitalize on American companies’ comparative advantage in the digital domain.
- The U.S. and its partners should consider launching a Digital Development Bank, offering digital financing to businesses and governments in Asia, which could help developing governments in reducing opportunities for corruption, targeting spending more precisely, and improving tax collection.¹²⁶

¹²³ Hill, Thomas M. “On Development Finance, Trump’s Budget Request Makes Sense.” *Brookings Institution*. 13 Mar. 2018,

¹²⁴ “President Donald J. Trump’s Visit to Japan Strengthens the United States-Japan Alliance and Economic Partnership.” *White House Fact Sheet*. 6 Nov. 2017.

¹²⁵ Kliman, Daniel. “Responding to China’s Belt and Road Initiative.” *Center for New American Security*. 13 Nov. 2017.

¹²⁶ Manyika, James, and Rodger Voorhies. “What Digital Finance Means For Emerging Economies.” *Fortune*. 24 Oct. 2016.

- Digital financing could be high-yield—*McKinsey* assesses that digital accounts can be 90% cheaper than conventional ones to maintain. It could also be high-impact, growing American soft power by spreading financing to thousands of low-income individuals or businesses for the same cost as one traditional infrastructure project.¹²⁷
- This digital infrastructure proposal was first suggested by Daniel Kliman of the *Center for a New American Security*.

Strengthen Alliances

China has no true strategic allies. This makes America's most significant enduring advantage in Asia-Pacific competition will be its robust, interwoven alliance and partner network. Key U.S. partners like India, Japan, and Australia are increasingly concerned by China's efforts to acquire strategic infrastructure and buy allies as part of a larger campaign to upend the region's balance of power. The U.S. should capitalize on this concern and deepen these partnerships by reviving the Quad and strengthening its ties to India.

The resurgence of the Quad, the loose U.S.-India-Japan-Australia network of maritime Asian democratic powers, provides a powerful new resource in the effort to combat debtbook diplomacy. But considerable challenges remain to unlocking the full potential of this regional collective: balancing members' security ties to the U.S. with economic ties to China; defining a mission that serves the needs of all parties without provoking Chinese backlash; and overcoming trust deficits and members' differing operation capabilities. While the U.S. addresses these challenges, it should also work to expand its bilateral partnership with New Delhi as it begins to grow into a significant leadership role.

Frame the Quad's Role as a Rules-Based Partnership

- The Quad must first define what it is and what it is not. It should not define itself or be seen as solely a counter-China coalition.

¹²⁷ Ibid.

Rather, it should frame its role as a rules-based collective promoting a “free and open Indo-Pacific”, open to all countries willing to play by the rules.

- The U.S. should encourage economic and maritime security cooperation amongst Quad members to foster high-quality, transparent regional connectivity initiatives and ensure free and open sea lanes to the benefit of all, including China.
- The reformation of the Quad provides a mechanism to build trust, boost partner interoperability, and develop a foundation of regional cooperation. It should focus on lower-profile, more tangible initiatives, rather than on large, symbolic gestures to achieve these aims.

Expand Quad Cooperation

- Make the Asia-Africa Growth Corridor (AAGC) a Quad Initiative. In May 2017, the Indian and Japanese governments jointly presented a vision document for the AAGC- an initiative to establish several sea corridors linking Africa to South and South-East Asia. Increased funding and coordination amongst Quad members could help get the proposed project off the ground.
- Create a Quad Indo-Pacific humanitarian assistance and disaster response cell to build partner capacity in addressing future regional challenges.¹²⁸
- Encourage Quad members to engage in joint-venture investments with China on select BRI projects. While it may be politically untenable for the U.S. to join itself, Quad member involvement could enable allies to shape projects from within and ensure higher quality investment and construction standards.

¹²⁸ Ayres, Alyssa. “Creating an India-US advantage in the Indo-Pacific: Four steps that would boost security cooperation and regional stability.” *The Times of India*. 1 March, 2018.

Support India's Growing Economic and Military Role in the Region

- Support India's efforts to join the Asia-Pacific Economic Cooperation forum.¹²⁹
- Bolster Indian operational awareness by fast-tracking negotiations to sign the Communications, Compatibility and Security Agreement (COMCASA) and Basic Exchange and Cooperation Agreement (BECA) to expand technology, communication, and intelligence sharing.
- Expand U.S.-India coordination in the western Indian Ocean region by inviting Indian Navy liaisons to CENTCOM and AFRICOM and establishing anti-piracy/humanitarian relief exercises.¹³⁰

Manage Debt Burdens

Diplomatic, Creditor-Focused Debt Management

The U.S. should push China to become a more responsible creditor. Most unprofitable BRI projects offer China no real strategic collateral, and the U.S. should advocate that it's in Beijing's interest to adopt more restrained and transparent lending standards. Three suggested goals for Chinese behavior are: entry into the Paris Creditors Club; create buy-in for China-led G-20 sustainable financing agenda; and encourage adherence to World Bank standards for more BRI projects.¹³¹ U.S. bargaining chips could include leveraging tariffs/tariff relief as carrots and sticks, as well as official recognition and potential support for Asian Infrastructure Investment Bank (AIIB).

129 Moore, Evan. "Strengthen the U.S.-India Relationship." *The National Review*. 1 Feb. 2018.

130 Lalwani, Sameer. "Take Small Steps to Advance the US-India Relationship." *Defense One*. 21 Dec. 2017.

131 Hurley, John, et. al. "Examining the Debt Implications of the Belt and Road Initiative from a Policy Perspective." *Center for Global Development*. March 2018.

Negotiate Chinese entry into the Paris Club¹³²

- The Paris Club is an informal group of official creditors whose role is to find coordinated and sustainable solutions to the payment difficulties experienced by debtor countries.¹³³
- China has engaged with the group on an ad hoc basis, but momentum towards membership appears to have subsided. China may appreciate the collective action and reputational benefits of membership, and including China may help the U.S. dissuade Beijing from seeking strategic assets as debt repayment.

Push to Implement China-led G-20 Sustainable Financing Agenda

- The “G-20 Agenda Toward a More Stable and Resilient International Financial Architecture” was passed by the G-20 under China’s 2016 presidency. Desire for G-20 prestige may make China more amenable to provisions because it’s nominally their agenda and their leadership.
- The agenda calls for:
 - “enhanced information sharing with respect to debt sustainability, including signaling to IFIs’ staff if large public liabilities appear not to be included in the DSA of a debtor country”;
 - “as a general policy, information on past debt restructurings from official and private creditors should be made public”;
 - a shared responsibility between borrowing countries and sovereign lenders in maintaining debt on a sustainable path, including recognition of the “applicable requirements of the IMF’s Debt Limit Policy and of the International Development Association’s Non-Concessional Borrowing Policy.”
- This would be a modest step, but offering China an opportunity for high-profile international leadership may motivate Beijing to make some concessions on loan terms and debt repayment.

¹³² The recommendations on the Paris Club, G-20 agenda, and World Bank standards were drawn from the March 2018 Center for Global Development report cited in the previous footnote.

¹³³ Paris Club website. Accessed on 25 March 2018. <http://www.clubdeparis.org/>

Encourage Adherence to World Bank Standards for BRI projects

- Multilateral development banks (MDBs), such as the World Bank, ADB, AIIB, and European Bank for Reconstruction and Development currently lend their imprimatur to BRI, but only insist that it meets their standards on the small fraction of projects that they finance.
- Push China and MDBs for a more detailed agreement requiring more BRI projects to meet MDB standards.

Support for AIIB as a Carrot to Achieve these Goals

- The U.S. has opposed the AIIB since its inception, but diplomatic efforts to discourage allies from joining have largely proved unsuccessful. Nearly 90 states have signed on to AIIB, and by this point, the U.S. gains little for its tacit opposition. China may be willing to bargain for the U.S. “acquiescence” to the AIIB, which could take several forms: removing opposition to remaining allies (like Japan) from joining; observer status; or full membership.
- *Council on Foreign Relations* Elizabeth Economy argues that membership would allow the United States a seat inside the tent as an advocate for best governance practices and an internal critic if things go awry. Membership would also likely help ensure that U.S. companies have fair access to AIIB’s bidding opportunities.¹³⁴
- This report does not recommend an immediate push for full membership. But the U.S. should at least assess the pros and cons and take China’s temperature on whether there is a bargain to be made.

Technical, Debtor-Focused Debt Management

The recommendations in this section are largely drawn from *The Center on Global Development's* March 2018 report on BRI debt implications.¹³⁵ While the U.S. cannot compete on a large scale with Chinese BRI investment,

¹³⁴ Economy, Elizabeth. "The AIIB Debacle: What Washington Should Do Now." Asia Unbound Blog. *Council on Foreign Relations*, 16 Mar. 2015.

¹³⁵ Hurley et al., 2018.

it can—with its partners—support initiatives by multilateral institutions designed to help debtor countries manage their debt loads, share information about predatory practices, and develop higher-quality projects.

Fund an International Legal Support Facility for Debtor Nations

- Support the creation of MDB-hosted (potentially Asian Development Bank-hosted) facility that would secure expert counsel to advise debtor nations on the negotiation of debt operations.
- Model after the African Development Bank’s African Legal Support Facility (ALSF). The ALSF provides assistance to African countries to strengthen their legal expertise and negotiating capacity in debt management and litigation, natural resources and extractive industries management and contracting, investment agreements, and related commercial and business transactions. The ALSF also grants and advances funds to African countries for legal advice from top legal counsel in these areas.¹³⁶

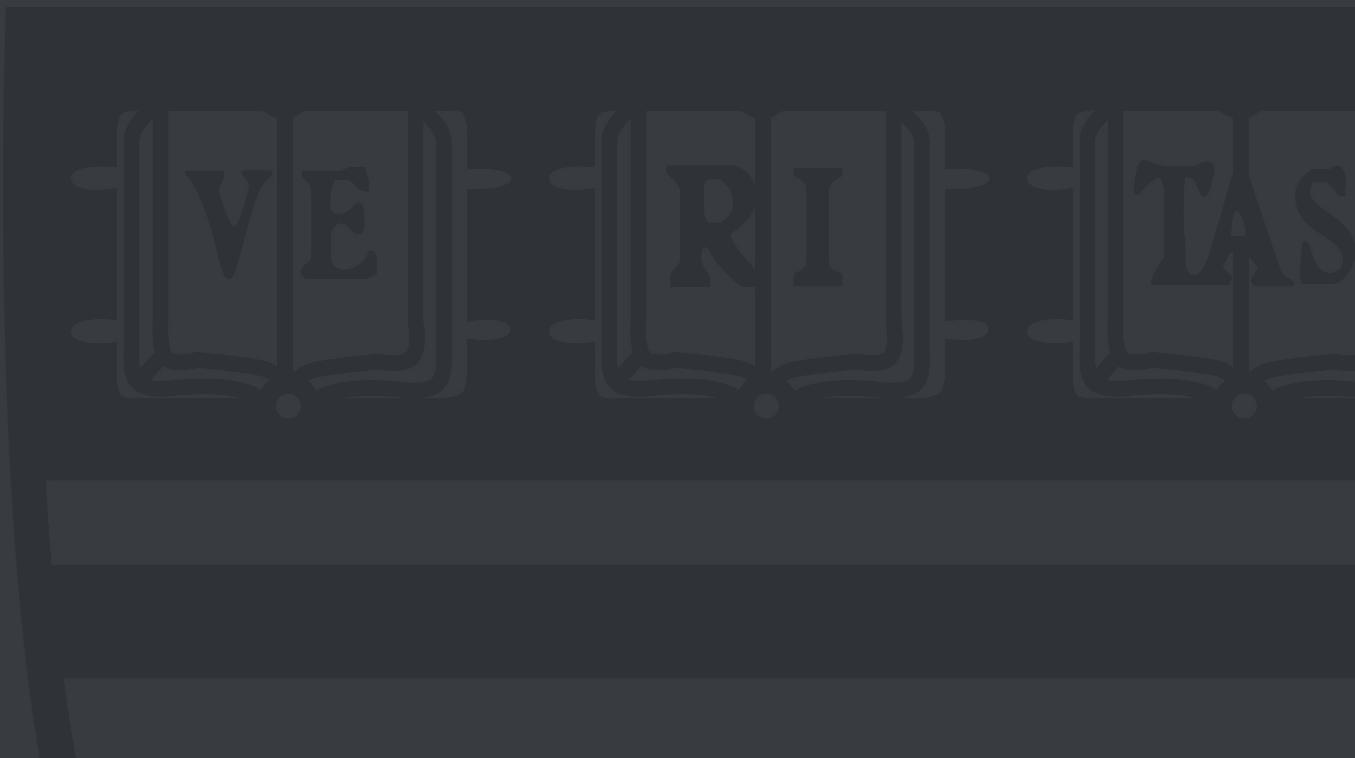
Increase Donor Support and Encourage Partner Nations to Support Debt Management Facilities

- Facilities could include the World Bank-IMF Debt Management Facility and UNCTAD’s Debt Management and Financial Analysis System. Both initiatives provide technical support to developing country governments to improve debt management practices.

Support “Best Practice” Initiatives Run by Multilateral Institutions

- The ADB’s Asia Pacific Project Preparation Facility works to improve the preparation, structuring, and placement of higher-quality projects and public-private partnerships.
- The G-20’s Global Infrastructure Hub works to promote better knowledge sharing, highlighting reform opportunities and facilitating connections between the public and private sectors on infrastructure development.

¹³⁶ African Development Bank Group website. Accessed on 25 March 2018. <https://www.afdb.org/en/topics-and-sectors/initiatives-partnerships/african-legal-support-facility/>



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