THE BROOKINGS INSTITUTION
Dollar and Sense: Economic uncertainty ahead of Davos
January 22, 2018

CONTRIBUTORS

HOST
DAVID DOLLAR
Senior Fellow – Foreign Policy, Global Economy and Development
John L. Thornton China Center

DOUGLAS A. REDIKER
Nonresident Senior Fellow – Global Economy and Development

DOLLAR: Hi I'm David Dollar, host of The Brookings Trade Podcast, “Dollar and Sense.” Today my guest is Doug Rediker, a non-resident senior fellow in Global Development at Brookings and chairman of International Capital Strategies.

What we want to do today is use the World Economic Forum in Davos as a jumping-off point to talk about a range of international economic issues and international political issues for that matter. So, let me start by asking: Doug, how would you characterize the general mood as the corporate elite is meeting up in Davos? A lot of leading politicians will be there, what are some of the key issues that are on people's minds?

REDIKER: I think the general mood can be described as anxious—nervous would be another word, uncertain would be another word…you get the drift. The general rule of thumb going into Davos is…if there's one sentence or one theme that the World Economic Forum has identified as characterizing the world for the year ahead, and I'm not exactly sure that you need more than that one word: anxious. So that's I think the starting point.

And I think the source of that anxiety is generally emanating from down the block, right? The United States which we used to define as somewhat distinct from international issues—you could draw a distinction between the domestic U.S. focus and international everything else—and the U.S. is now basically the source of most of the uncertainty in the international arena. And that's what's going to be on the minds of people in Davos. I think it's economic, it’s political, and it’s strategic.

DOLLAR: Right, and so one of those big uncertainties is U.S.-China trade relations. Originally President Trump was scheduled to go to Davos. He was probably going to meet Chinese Vice President Wang Qishan—long experience dealing with the United States. Those kinds of meetings you don't have actual negotiations but sometimes it gives political impetus to get a trade deal. So President Trump will not be there, but Secretaries Mnuchin, Pompeo, Ross are all going to be there. U.S. Trade Representative Bob Lighthizer. So there's some potential to get some political momentum for moving ahead. So how do you see…the looming deadline is March 1st or March 2nd. That's the end of the 90-day period when the two presidents agreed they should reach some kind of trade deal.

REDIKER: Yeah, I think that the delegation going from the U.S. will make limited impact. I think, as you rightly point out, the big looming cause of the most acute uncertainty as it manifests in both the economic and the financial markets sphere this U.S.-China trade dispute. So without the president being there, and having the past experience of seeing those who allegedly represent the U.S. and this president on the trade arena be undermined, I don't think too many people who are going to be at Davos (a generally sophisticated crowd) are going to listen to what Secretaries Mnuchin or Ross or anyone else says—even Bob Lighthizer—and take it to the bank. I think that this is going to be a maintenance exercise for them. Make sure relationships are maintained. But I don't think the U.S. delegation there is going to move the needle much on U.S. China trade.

I do think the U.S. China trade is the elephant in the room. I think that with that looming deadline there are a lot of people around the world that are looking at this as a make or break for the 2019 economic confidence cycle as well as financial markets. And I say that because both President Xi and President Trump need a success. President Xi is already seeing a dramatic impact on the Chinese economy—somewhat if not mostly driven by tensions with the U.S. and uncertainty around trade. And the U.S. is a little bit of a laggard in seeing the real economic impact of the U.S. China trade, but that's not going to go on forever. And so I think President Trump knows he needs to show success because if he does move ahead with escalating those tariffs from 10 percent to 25 percent he's probably going to see more than just a knee jerk market reaction. He's going to see a real economy impact in this country and he has enough problems on his plate right now. He doesn't need that. So the question then becomes how does the U.S. and China actually move ahead past that March 1st or 2nd deadline into what I think will be a prolonged negotiation through 2019 and show incremental successes so that the real economy doesn't get hit, tariffs are not increased, and the financial markets continue to be somewhat buoyed by the optimistic outcome of “these guys both want a deal, let's make sure that happens.”

DOLLAR: Right. So if I understand you correctly, pretty strong incentive for both presidents to announce some kind of deal by March 1st or March 2nd, but it seems unlikely they're going to work out all the details in the next few weeks. So this is going to linger on continuing throughout 2019, is that right?

REDIKER: Yeah. I think that even if you take the so-called low hanging fruit—China buying more U.S. LNG or soybeans or other agricultural products which seems to be something that they've kind of agreed to already—even that is reflective of the fact that trade deals are all about details. Right? There are these long schedules of lines of goods and tariffs that are attached to them. And of course in this case you're talking about a bilateral agreement between governments where one government is imposing on the other—or at least seeking to do so—to have them through their allegedly quasi private sector entities buying more of our goods. So that's tricky enough under the current trade rules to go down there, but that's the easy part. Then you get into all of the intellectual property stuff, to force technology transfer, and that's not even getting into the really nitty gritty of the structural reforms that the U.S. government is seeking to impose on the Chinese government. Those are very complicated.

So I would say the best case is you get a declaration of success on that March deadline with an agreement that some of the other details are still to come. And those details are more than details, but they are structured so that you have (whether it is monthly or quarterly) negotiations that are ongoing to show progress. I'm not convinced entirely that before the end of this year you're going to have all of those resolved if they ever are, but I do think that you'll see incremental progress as the year progresses. But that doesn't mean there won't be headline risk as the details are hammered out because these are tough structural issues that the Chinese and the Americans fundamentally don't see eye to eye on. And I should point out, it's not necessarily clear the U.S. sees eye to eye on it within the administration itself.

DOLLAR: Right, now I think that's a good point. Let's shift gears a little bit. I think another topic that is likely very much to come up particularly on the sidelines in Davos concerns the World Bank. Recently we had a somewhat surprise resignation by Jim Kim about halfway through his second five-year term as World Bank president. He's leaving to do something else. And so now there will be a search. Traditionally the United States has nominated the person who went on to be accepted as president of the World Bank, but the world's changing. There might be some resistance. There might be some interesting candidates. Do you think the United States still gets to choose the head of the World Bank, and how do you see this playing out?

REDIKER: Well I think it really depends on who the administration settles on as their designated nominee. And I say that because if this administration chooses someone who is a multilateralist, someone who believes in development even if it's a U.S.-style version of development and multilateralism, then I think the rest of the world is going to have a hard time finding a candidate that they can unify behind to challenge that U.S. dominance. And particularly given the antagonism this administration and this president has shown towards multilateralism, I'm not sure they want to pick this fight at this particular time.

Having said that, if this White House decides to overrule what I think seems to be from all the reports we're seeing a relatively normal search process—now under normal it is if the president's daughter is leading it but let's just say within the context of this administration that's more normal than many other things we've seen—if it is a nominee that is actually a bomb-thrower…if this administration decides that their hostility to multilateralism and institutions like the World Bank—which we haven't seen that in the case of the World Bank just as a basic theme they have not been proponents of institutions and multilateralism broadly defined—if they pick a bomb thrower then I think you're going to have a real clash.

Now I don't anticipate that to be the case. I think that whether it is Ivanka Trump or the U.S. Treasury Department which traditionally takes the lead on this sort of thing, if they come up with someone reasonable then I would expect the world will grudgingly (and grudgingly has been the case in the last several nominees anyway) accept the U.S. nominee and select him or her as the next World Bank president.

DOLLAR: Last couple of times this issue has come up there was a lot of speculation that the rest of the world—or a good chunk of the world—would unite around some alternative candidate. But you face the fact that a lot of these countries who really care about development, both wealthy countries giving money developing countries receiving support, a lot of them understand the importance of keeping the U.S. involved. This administration surprised us a little bit by agreeing to a capital increase for the World Bank. So as you say, if they nominate somebody you know a real multilateralist with some credibility, a lot of countries are going to look at this and say we want to keep us engaged so why unite around some other candidate that could potentially drive off the U.S. administration and Congress. So that will be interesting to see who this search comes up with.

Since we're talking about development finance, another issue I want to take up: While the World Bank has been in turmoil at the moment, China is quietly emerging as a leading source of development finance—perhaps the preeminent source. Eventually they will be the largest source of development finance by which I mean, in particular, their financing of infrastructure projects coming through mostly their policy banks like China Development Bank. Some of that is branded as Belt and Road Initiative, but I see it really more as a global effort. So I'd like to get your views on this big Chinese push in the financing infrastructure, Belt and Road, etc. Is this largely a positive thing? Are there factors we should be concerned with? How do you see this?

REDIKER: So it's a nuanced question because on its face how could you argue with China or anybody else providing infrastructure finance to countries that desperately need both finance and infrastructure. So it seems like a really good thing—why even question it? The problem is this is not a concessional finance. This is oftentimes finance that is provided through very highly structured and not necessarily advantageous terms to the recipient country. It is finance that is provided sometimes with ties to who purchases what equipment and other materiel for that infrastructure has to come from China. Who's actually going to be doing the work? A lot of the workers have to come from China. And what are the terms? A lot of it is not exactly the best terms that you could get and oftentimes they require a sovereign guarantee. So even if you take it as a status quo of looking at it as “is the lending on an individual basis good or bad,” sometimes no infrastructure is better than painful infrastructure that ends up damaging the economy both at the local level and the sovereign.

But then take it one step further. What we've seen is the Chinese, both through Belt and Road and through other initiatives, has gone around the world to a lot of emerging markets, frontier markets, low income markets, and has really been the provider of debt capital for many, many years on many, many different projects. In return for that, these countries are not only exposing their balance sheets at the sovereign level, but many of them are pledging oil exports in increasing amounts so that when suddenly you're in a later stage of the cycle there's not a whole lot of oil left for them to export anywhere else and that becomes a real burden.

So now if you look at the sovereign balance sheets for a lot of these countries they are really exposed to—and it's not just China, but it is primarily China—to China at the official sectoral level. When they run into sovereign debt problems—whether it is because they have a fiscal shock or simply because they're overextended—then the traditional place you go is the IMF. What the IMF is finding is that a lot of these countries are coming to the IMF, they're looking at their balance sheet and saying “OK tell me how much debt you have,” and they say “we don't know.” And when they said what do you mean “we don't know?” They say “well we've got all of this debt through all of these projects that are highly structured—

many to China, but there are other sovereigns as well—so we can't even tell you how much debt we have, what the terms are, and how we would go about trying to figure it out."

So you have what is known as the Debt Transparency Initiative. And the U.S. has been a big proponent of this as has the IMF with the management and staff level in trying to get to the bottom of just how much money a lot of these countries owe and to whom and on what basis. And a lot of those roads point back to China. And the great vulnerability here is that China oftentimes doesn't know. It's a big country, it is not as centralized in terms of these sort of decisions as many outside observers would suggest that it is, and what that really means is when a country goes to the IMF and says "we have a debt problem we'd like your help," the IMF is asking questions that country can't answer. When they go to China, it turns out that they are either unwilling—or as I believe it to be the case—unable to provide an answer as well and that makes it very tough for everyone.

DOLLAR: I've tried to do a little bit of research on this myself, Doug. Again, it's very hard to get information out of China. I think you're right, probably a lot of it doesn't exist. There is an academic exercise called AidData which has tried to build up big data set on Chinese funded projects, but also as you mentioned there are other new donors as well: India and some of the Gulf states. And I'm sure it's a partial list, but it's pretty large impressive list of Chinese funded projects. So two things jumped out at me from that basic database.

Only about 25 percent of the Chinese lending is concessional. You know a lot of that… not even that concessional…but let's say 75 percent of it is essentially commercial. And it's a lot of it's in U.S. dollars, which surprises many people. And it's variable interest rates. So ironically as the Fed raises rates, as the U.S. normalizes the cost of these projects are actually becoming higher for developing countries that have taken the loans.

Can we get into any specific countries you can think of that are that are at risk of this kind of debt trap you're describing recognizing we have a lot of problems with the data?

REDIKER: Sure. Well first of all you, can start with Venezuela, but we don't know much about what's going on in Venezuela these days in terms of their economics other than to say it is an abject disaster. But what we do know is that the Chinese have significant exposure to Venezuela, and that as and when Venezuela ultimately has to seek external support from the IMF or elsewhere, that China's role is going to be very, very key. We'll get back to that in a moment I hope.

Congo. “Congo B" as it's known…Congo-Brazzaville…went to the IMF in, I believe it was March of 2017, seeking an IMF program. It is now early 2019 and that program has not yet been provided, not because of the IMF or the target country are unwilling to come to terms, but because Congo can't figure out just how much it owes to primarily China. And China has not been able or willing to provide that data. So here's Congo and it can't get program that it needs.

The one that is the most strategic impact is Pakistan. And Pakistan over the past several weeks and months has just borrowed an additional 15 billion dollars from a combination of China, United Arab Emirates, and the Saudis. And this is important because Pakistan is both strategically important to the U.S. and to the world. It is a nuclear power and it’s, you know, got some very real issues for our security. But also because it really needs an IMF program. They know they really need an IMF program. They've come to the IMF, and the IMF is trying desperately to figure out how to make it—what's known as a debt-sustainability analysis—work. That means: How do they provide capital to make the country after reforms sustainable. That's the goal.

The U.S. Congress and the administration have come out and publicly said they refused to support an IMF program for Pakistan where U.S. taxpayer dollars—which is not entirely an accurate way of seeing the IMF, but that's really the way they see it—where the IMF money is being used to repay Chinese, and in this case, other external officials sector lenders and non-concessional rates. Why should the IMF be using its funding to pay back China and the Emirates and the Saudis for effectively providing no-strings or strings-we-don't-like kind of lending to any country—particularly Pakistan. Makes it extremely complicated.

And let me just go back to sort of the institutional framework here. The way this had worked for many years post-World War II as the current international system sort of developed, we had a Paris Club which reflected the collective interests of what were at the time the lenders at the official sector level led by the United States to these countries that extended themselves to too far and needed some official sector debt relief. There was a means by which these countries could sit around and make sure that they all agreed on how they would treat this country's external debt. They worked hand in glove with the IMF. The problem is that China is not a member of the Paris Club. It is an ad hoc observer, which means it gets to sit in the room, listen to what all the Paris Club members say about what their debts are, but China does not need to disclose in return. They also do not necessarily have to agree to any form of restructuring. So we really don't have a framework by which the IMF, the official sector lending community, China, and others who are Paris Club members, and—by the way an important component here—private sector bondholders are all going to come to agreement on how to provide that funding to a country like Pakistan, which by the way that I mentioned has nuclear weapons. So this is really going to be a big issue moving forward and there's no easy resolution. As I said before, I don't know if it's because the Chinese are able to provide the data or are unwilling to provide the data. It's probably a combination of both.

DOLLAR: All right so if we really have a big crisis as important country like Pakistan, could that propel some pretty rapid structural change where the Chinese are to join the Paris Club or seriously participate in it rather than just observing? I think in the case of Pakistan, a lot of this debt is tied to a relatively small number of big projects, so I guess…my guess would be China would be able to put together a pretty good accounting of what they've lent to Pakistan if they made a serious effort going around to their policy banks, etc. So, could we possibly get a good outcome out of this?

REDIKER: Well I'm not sure—whether it is a country specific resolution as you described in the case of Pakistan or otherwise—I'm not sure that China is anxious to join the Paris Club in part because there is at least a cynical approach that views their lending of all of these funds to all of these countries as not only just an economic play, but also a diplomatic one. And you could argue that the debt diplomacy argument, while it's not necessarily nefarious, has some attractions to the Chinese. So if they were to jump into the Paris Club they would effectively be joining what is seen as a Western club. They don't like. And they'd be joining one which there… they would effectively be giving up a foreign policy strategic advantage. I'm not sure you're going to find that collective will within the Chinese government. They may come to an agreement on a country-by-country basis, Pakistan being strategic enough they may not want to pick that fight with the U.S. at this particular time, but I'm not sure that we're looking at an incremental imminent move towards their becoming a member of the Paris Club anytime soon.

DOLLAR: Right. I was thinking that the Chinese want to get repaid. I think you made this point along the way, and you could imagine a big enough crisis where they're facing the loss of tens of billions of dollars, and if they can't get an IMF program…

REDIKER: Well, I think I'd rather be the Chinese than I would a bondholder in that regard. And I say that only because I think that the Chinese have structured many of their projects so that there are means by which they will benefit one way or another—the most crass way would be a debt for equity swap where you are suddenly you see the Chinese owning certain key strategic assets in any given country in order to reduce their debt. That by the way sounds terrible, but let's just be clear over the past several hundred years this was fairly common as the way that debt diplomacy was undertaken. So while we don't like it if we're talking about the Chinese doing so in key strategic countries, it is not uncommon if you look at it through the prism of history.

DOLLAR: The IMF management would like to get a quote increase. They'd like to have more resources. They're looking at various potential problems around the world, but I believe the U.S. administration is opposed to a quote increase at this point. Could you just talk a little bit about what would it mean and why would the U.S. be opposed?

REDIKER: So the IMF gets funded through a variety of different means. It's supposed to be funded through quota. Quotas effectively an equity shareholding. That has traditionally been the means by which your votes at the board, your representation on the board, is supposed to be reflective of some combination of your share of the global economy and the capital you put in – or the quota. Over the years there's been a second tier of funding that's been provided called the NAB—The New Arrangements to Borrow—which, while not identical to the quota, has been fairly reflective of a similar share to the US and other major countries and that is a second line of financial support. At the height of the financial crisis there was a third tier that was provided of bilateral coordinated credit lines providing, I believe it was 500 to 600 billion dollars of additional capital, and the U.S. refused to participate. So countries that did participate got no voting rights, no representation on the board, in return for their stepping up and writing a provisional check in case the IMF needs more money.

What the U.S. is saying in terms of rejecting the quota increase "is we kind of like it the way it is. We get a lot…we have the veto right at the board"— not at the board actually at the shareholder level—"we have the largest shareholder, and we like the fact that China is woefully under represented. So we're OK keeping it as it is, and by the way we might withdraw from the NAB in 2021, but that's later, so let's just not worry about that for right now."

What other countries are saying—China as one, but amongst many others—saying this is unfair. If the U.S. wants to maintain its largest shareholding role, its quota, its seat at the board, it's over 15 percent veto right, then put up some more money. And the way to do that is, through the way the IMF was originally structured, which was by putting more money into quota. And the U.S. is saying for a variety of reasons: “No.” The main reason seems to be they just don't like the idea of China going from roughly 6 percent right now to, I would assume, somewhere between 10 and 12 percent based on what the economic formula would suggest is their role in the global economy. Now the U.S. is still above 15 percent, but boy that's a big incremental shift for China. And it both looks daunting to the U.S. and it kind of is daunting in terms of how these institutions are governed, so the U.S. is digging in its heels. But it's an unsustainable position longer term because it's not the way the IMF is supposed to be run.

DOLLAR: Right. I guess the longer-term issue is we're looking ahead probably ten years or so until China is the largest economy in the world and it's going to want a greater share. And we're looking at “are they joining Paris club and playing by global rules?” And they're looking at are they getting a fair share in these key institutions. And you know that really seems to be the main conflict we're going through right now.

REDIKER: Yeah it's an almost inevitable clash that's going to come to a head at some point. There is a creative way to structure the formula, as it is known at the IMF, by which quota is determined. It's not simply a GDP-based formula. It's got a lot of different metrics and I'm not sure that there could not be a way to torture that formula to make sure the U.S. maintains its veto right and it’s dominance for a longer period of time. One way to make sure that isn't the case is to just dig your heels in and say no to everything because effectively that prompts the rest of the world to think that there's going to have to be a parallel set of institutions that is going to be created—particularly in the development world, even more than at the IMF. But those will be more, as the Chinese would say, “fair.” As the U.S. would say, “competitive.” And I think the rest of the world is going to find themselves, as the president of Indonesia said at the annual meetings back in October, “winter is coming.” An allusion to the game of thrones.

No countries want to be put in that position, but it seems as if that's almost inevitable if the U.S. continues to…I shouldn't say that… if the U.S. resists coming to grips with the fact that China is a real second to the U.S. in terms of how these institutions are governed. That's just a reflection of reality.

DOLLAR: Well thank you very much Doug. We've covered a lot of terrain and you've highlighted a lot of uncertainties for 2019. Hopefully we'll make some progress on these and see if things get better or not get worse. Any final words?

REDIKER: I think, you know, it's early days. I think I always like to think of these things in terms of uncertainty versus political risk. I think we're living through a period of enormous acute uncertainty. And I guess we like to get back to the days when risk was easier to quantify. Uncertainty basically represents such a wide range of outcomes that it's too big to quantify, and that causes everybody enormous existential angst. I think if we just were able to narrow it down to some specific political risk maybe everybody would still be nervous but at least you get up in the morning and, you know, be able to focus on specifics and not just a general sense of angst. I think that's the theme, going back to your initial question about Davos, I think everybody's going to want to say I'd love to be able to quantify my risks because right now I just feel this sense of unease.

DOLLAR: All right. Thank you very much, Doug.

REDIKER: Thank you.

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