Chinese foreign aid goes offtrack in the Philippines

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Over a 32-kilometer stretch north of Manila where a Chinese state company is building a US$503 million railway to boost transport links to the Philippine capital, the impact of Chinese aid money on development in the poor Southeast Asian country is easy to miss. There is hardly any.

Six years after China approved a US$400 million loan for the railway in 2004, there are neither trains, stations nor even a single kilometer of track. Many segments of the line are still occupied by illegal structures, including multi-storey office buildings and factories. But even on most segments cleared of illegal dwellers, there is no construction activity.

Only in a handful of sites can one see heavy equipment and laborers working to drive or bore huge concrete piles to lay the foundation of the giant posts for the elevated segments of the railway.

Indeed, the project contractor, China National Machinery and Equipment Group (CNMEG, which recently changed its acronym to Sinomach), has only completed 15% of the work, according to Elmer Ramoneda, vice president of the North Luzon Railways Corp. (NLRC), the Philippine government firm that is implementing the project. He adds that CNMEG may take until 2012 to complete the project, two years after the revised target of 2010.

The North Luzon railway project (Northrail, which also refers to the management assigned to it), which aims to ferry over 150,000 passengers daily to and from Manila, is the recipient of the biggest Chinese state loan in the Philippines. It includes a second section, costing about US$673 million, that will extend the line by another 48 kilometers and connect Manila to the former United States (US) air force base in Central Luzon that is now an international airport and a special economic zone.

The second section is to be funded by a fresh US$500 million loan from the Export-Import Bank (Eximbank) of China, bringing total Chinese funding to US$900 million and making the entire Northrail project one of the biggest Chinese funded projects in Southeast Asia.

When Philippine and Chinese officials broke ground for the project in April 2004, the US$400 million China Eximbank loan approved just two months before was hailed by both Chinese and Philippine officials for setting a few milestones in terms of size and cost.

Minister Xiao Qian of the Chinese Embassy called it the "largest Chinese project in Southeast Asia," and the first 20-year concessionary loan ever extended by China to any government at 3% interest including a five-year grace period.

Jose de Venecia Jr., then the Speaker of the House of Representatives, said the extraordinary lending concessions from China Eximbank came about because the project won support at the highest levels of Chinese state organs. He claimed credit for "convincing two Chinese presidents, two Chinese Prime Ministers, two Speakers of Parliament, and three Chinese Ambassadors to the Philippines for China to undertake the project."

He added: "This will be a lasting legacy of President Arroyo to the Filipino nation. The railways will open up communities to greater trade and economic opportunities and will unite our people."

Almost six years later, not only is Northrail terribly delayed but it risks getting off-track.

Even President Gloria Macapagal-Arroyo herself is hesitating to firm up a deal for the second tranche, amounting to US$500 million, of the China Eximbank loan that will finance the second section of the Northrail project. The loan agreement has been negotiated but Arroyo is said to be reluctant to activate the loan. "Forget about the Chinese loan," she reportedly told officials managing the project during a meeting last year, according to a person present.

Northrail officials are still pressing her to activate the loan but are also exploring the possibility of inviting a private sector partner to raise funding for building most of the stations and to purchase rolling stock.

The financing uncertainty adds to the judicial and political risks surrounding the project. The presidential candidate leading in opinion polls to replace Arroyo in June 2010, Benigno "Noynoy" Aquino III, is surrounded by advisers who filed a suit challenging the legality of the Northrail contracts. It is not that farfetched to think that a hostile president would scuttle the project. In 2005, Arroyo revoked the contract for a new international airport terminal even though it was already 95% complete.

A local court continues to hear a legal suit alleging the supply deal between CNMEG and Northrail is unlawful because it did not go through a public bidding as required by Philippine law on government procurement. In May 2009, the Supreme Court turned down CNMEG's petition to stop the judicial proceedings. The lower court has initially issued a finding that the supply deal does not qualify as an executive agreement between the governments of China and the Philippines, which would have exempted it from the procurement law, bolstering the case of those who want to void the contract.

Getting Off-track

In turning from a milestone of development lending into an embarrassing millstone around the necks of both China and the Philippines, the Northrail project could offer important lessons not only for the two countries but also other potential borrowers, particularly in the rest of Southeast Asia where Chinese official development assistance is also soaring.

Amid the paucity of information on Chinese-funded projects in the rest of Southeast Asia where public access to information is severely constrained, a closer look at how the Northrail project took shape and was implemented could yield helpful insights into the dynamics of Chinese foreign aid and investments in the region.

At heart, the Northrail project is a tragic tale of what happens when cheap Chinese aid money hooks up with weak governance in a borrowing country.

From talks with current and former Philippine planning and Northrail officials, it is clear that a major driver for the project was the extreme concessionality of Chinese financing: an unprecedented 3% annual interest rate, five-year grace period, and 20-year maturity.

Amid early criticism that the project may be overpriced because the supply contract was not subjected to bidding, former Economic Planning Secretary Romulo Neri said in early 2004 that even if it's somewhat overpriced, the loan is so cheap that the project will yield more benefits than if other lenders or suppliers were involved.

Critics of the project such as lawyer Harry Roque, who filed the legal suit against the project, believe that corruption was also a key factor in getting Northrail approved. "The Chinese zeroed in on what local politicians wanted, which is why in the contract there was a 30% up-front payment in the financing. You have to wonder, why this up-front payment? Who was this to benefit?" said Roque, who was quoted in Joshua Kurlantzick's book *(Charm Offensive: How China's Soft Power is Transforming the World.)*

Because of top-level pushing from de Venecia and other Central Luzon politicians keen to see their territories linked via rail to Manila soonest, the Philippines began talks on a supply contract with CNMEG even though Northrail was not yet ready. It lacked experienced rail engineers and did not even have a proper office. The feasibility study used to win approval for the project from the National Economic and Development Authority (NEDA), which clears all major infrastructure projects, was done by CNMEG itself for free.

As a result, Northrail officials agreed on a supply agreement with CNMEG that lacked detailed technical specifications and a bill of quantities that should have listed the exact type and quality of the various components of the railway project or defined the performance criteria to be applied.

Observers noted that while the agreement's technical annex listed broad parameters for civil and track works, none was specified for rolling stock i.e. rail cars, capacity, speed, performance, air-conditioning, auxiliary equipment, and others. Worse, the agreement seemed to have handed to CNMEG the power to say what the parameters are because "technical specifications" was defined in the contract as "documents prepared by the contractor, which shall contain detailed technical requirements for the contractor to execute the contract property, including scope of works, contractor's establishment, specifications for materials, plant, construction equipment, workmanship, testing, measurement, etc."

The late Northrail president Jose Cortes, interviewed in 2005, was aware of the potential problems of the supply contract but expected it could be set right when Northrail hires a project management support team that will review the detailed engineering designs and technical specifications to be submitted by CNMEG.

However, from 2004 to 2006, Northrail was unable to hire project management consultants because it lacked money. It was only in 2007 that Northrail finally hired a project management support team – a French rail engineering consulting firm called Systra.

The entry of Systra triggered conflicts with CNMEG in part because Northrail, still lacking technical personnel, pretty much left the two parties to resolve problems on their own rather than exercise its judgment and prerogatives as ultimate owner of the project. "Systra was no longer just a consultant but was taking on some of the functions that Northrail failed to do," said a Northrail insider.

Less than a year after Systra was hired, CNMEG suspended work on the project unilaterally in February 2008 because of unresolved disputes with Systra and NLRC. It also demanded additional compensation of US$299 million on top of its original price of US$421 million.

Outraged by CNMEG's demands, Northrail considered terminating the contract or asking the Chinese firm to assign the project to another engineering firm. However, top leaders of both countries interceded and helped Northrail and CNMEG to come up with a revised agreement that amended the design and scope of the project and raised the cost by US$99 million towards the end of 2008.

That same year, Arroyo appointed a close political adviser, Edgardo Pamintuan, as president of Northrail. The company finally beefed up its engineering staff to 70 from less than 10 with money from a US$90 million loan from Barclays, which was closed earlier that year.

Personal and cultural factors fuelled the conflicts. CNMEG's country manager did not speak English, hampering communication with executives of Northrail and Systra who did not know Chinese. "We used a lot of interpreters but we are not sure if they were translating correctly," said a Northrail official. "Filipino translators did not last long in the job because they seemed uncomfortable with the CNMEG executives who cussed a lot."

To Roderick Planta, chief of NEDA's project monitoring staff, the root of the problems could be traced mainly to the vagueness of the supply agreement, making it subject to varying interpretation by the two parties. With few engineers, Northrail even had to ask the help of the Department of Public Works and Highways to resolve disputes in the approval of CNMEG's proposed engineering drawings.

Still, relations between Northrail and Systra on one hand, and CNMEG on the other, seem to have improved recently after the French firm assigned an ethnic Chinese who is also a French national to head its team in the Philippines. Northrail also sought to improve communication by moving its offices from Fort Bonifacio in Manila to Bulacan where it shares the same building with Systra and the commercial unit of CNMEG. "Now, we can get together and drink *motai* every now and then," said a Northrail engineer.

It remains to be seen if better communication and relations between Northrail, Systra and CNMEG may finally get the stalled project going again. But not just money but also political support is running out for the project, especially with the upcoming May 2010 polls that could see the rise of a new Philippine president hostile to the project.

Rise in Chinese Aid

China Eximbank funding for the Northrail project, which began in 2004 and followed by a second credit in 2007, catapulted China into one of the Philippines' biggest sources of official development assistance (ODA).

From a miniscule US$60 million in 2003, Chinese concessional lending to the Philippines surged to US$460 million by 2004 and has more than doubled to US$1.1 billion as of 2007, making China the fourth biggest development lender after Japan, the Asian Development Bank (ADB), and the World Bank (WB).

Chinese loans for the Philippines were poised to triple to almost US$3 billion if a kickbacks scandal over Chinese telecommunication firm ZTE's contract to supply the National Broadband Network (NBN) project did not prompt Arroyo to scuttle talks for several Chinese loans, including US$1 billion for the Laiban dam, another ambitious project to increase drinking water supply in Metro Manila, the capital, by half.

Her economics planning secretary revealed that the elections chief, who has been helping ZTE win the supply contract, offered him a Php200 million bribe to approve the NBN project. Arroyo herself was dragged into the controversy after photographs surfaced of her playing golf with the election chief and ZTE executives in China. Worse, a ZTE rival accused her husband of trying to bully him into withdrawing a bid for the project.

The rise in Chinese aid money for the Philippines seemed to follow the same pattern of rising Chinese ODA and government-supported investments in Southeast Asia and the developing world.

According to the New York University (NYU) Wagner Graduate School of Public Service, which conducted a study that carefully monitored press accounts of Chinese foreign economic assistance between 2002 and 2007, the amount of Chinese aid money for Southeast Asia rose from only US$36 million in 2002 to US$6.7 billion by 2007. Globally, Chinese aid surged from only US$51 million in 2002 to US$25.1 billion five years later.

The NYU-Wagner study found that the Philippines was among three Southeast Asian countries with large reported China aid and investment projects. The total amount of Chinese money going to the Philippines reached US$5.4 billion between 2002 and 2007 compared to US$3.4 billion for Vietnam and US$3.1 billion for Burma. The major types of projects in the Philippines were infrastructure, particularly railway, mining, and military training. The projects were mostly in power, shipyards and mining in Vietnam, and in hydropower and nickel ores in Burma.

The big aid and investment numbers may be impressive, but in the Philippines, many of the reported projects never get to see the light of day. Apart from China Eximbank loans worth almost US$2 billion that were scuttled because of the kickbacks scandal, none of the big Chinese investments in Philippine mining projects have pushed through because of disputes with local partners.

Even large Chinese state firms with deep pockets such as the Baosteel group and Jinchuan Nonferrous Metals Corp. had failed to make progress since signing agreements several years ago to rehabilitate a mothballed nickel refinery in southern Philippines. The rehabilitation of the nickel refinery, which was estimated to cost US$950 million, was potentially the Philippines' biggest mining investment in decades and expected to boost Philippine mineral exports by US$300 million a year, mostly to China, and to employ at least 3,000 people from 2010.

Despite rapid growth in recent years, Chinese aid and investments in Southeast Asia still pale in comparison with the US, Japan and Europe. According to the statistics compiled by the Association of Southeast Asian Nations (ASEAN) secretariat, foreign direct investment (FDI) from China to the region rose from US$1 billion in 2006 to US$1.4 billion in 2008, which was just about 2.4% of total FDI. The main sources of FDI are still the European Union, which invested US$14.9 billion in 2008; Japan, US$7.6 billion, and the US$3.2 billion.

According to the NYU-Wagner study, China is considered a major source of economic assistance in Southeast Asia but this often refers to infrastructure projects and natural resource extraction ventures rather than ODA, as defined by the Organization of Economic Cooperation and Development (OECD). The NYU-Wagner study found that of the US$12.6 billion in economic assistance pledged to Southeast Asian countries between 2002 and 2007, 59% was for infrastructure, 38% was for natural resources development, and only 3% was intended for humanitarian assistance, military assistance, and cultural and sports facilities.

Still, Chinese foreign aid to members of the ASEAN is likely to increase even more after China announced plans last year to establish a US$10 billion China-ASEAN investment cooperation fund for infrastructure, energy, resources, and information and communications projects in the region.

China also plans to offer credits of US$15 billion to ASEAN countries over the next three to five years. The amount includes loans with preferential terms of US$1.7 billion to fund so-called cooperation projects.

In addition, China said it would offer US$39.7 million in special aid to Cambodia, Laos and Burma to meet urgent needs, contribute US$5 million to the China-ASEAN Cooperation Fund, and donate almost US$1 million to a common cooperation fund of the ASEAN, China, Japan and Korea. It also promised to provide 300,000 tons of rice for the emergency East Asia rice reserve to help boost security in the region. Chinese leaders also offered over 2,000 scholarships for public administration students in ASEAN member countries in the next five years.

The rapid increase in Chinese foreign aid and investments in Southeast Asia has given rise to international criticism of China similar to the flak it got after moving heavily into Africa several years ago.

Last December, Beijing came under fire for promising US$1.2 billion in aid to Cambodia hours after Phnomh Penh deported 20 Uighurs to China. The members of the Muslim minority in China's far west had sought asylum after fleeing ethnic violence but were sent back to China despite protests from the United States and the United Nations, which feared the deportees could be imprisoned or even executed.

Chinese Vice President Xi Jinping, who arrived on a previously scheduled visit just hours after the Uighurs left, pledged US$1.2 billion to Cambodia and thanked the country for the deportations. The criticisms prompted a rare response from China's government, which said there were "no strings attached" to the aid package. Cambodia said it was expelling the Uighurs because they had illegally entered the country.

China is also accused of under-pricing gas purchases from Burma in exchange for protecting the military junta against international sanctions. PetroChina Company Ltd, the listed arm of China's biggest old producer that has been vying to secure access to large quantities of natural gas from the Shwe gas field, signed in early 2006 a memorandum of understanding with Burmese authorities to buy 180 million cubic meters of gas, at prices significantly below what rival India had bid. Analysts suggest that this preferential treatment of China – which could cost Burma US$2.35 billion over the productive life of the field – was essentially the price of China's diplomatic protection over the military regime.

Understanding Chinese Aid

Rather than a sign of Chinese exceptionalism, the mounting troubles surrounding Chinese foreign aid and investments – whether it is corruption in the Philippines, support for dictators in Burma or destruction of the environment in Laos – suggest, in fact, commonalities with Western ODA.

Writing about Chinese foreign aid in Africa, which has come under widespread criticism from the West, Firoze Manji, in a Monthly

Review piece in April 2008, said: "Just like other Western powers, China has used aid strategically to support its commercial and investment interventions in Africa. Aid has taken the form of financial investments in key infrastructural development projects, training programs, debt relief, technical assistance, and a program of tariff exemptions for selected products from Africa, not dissimilar to the agreements that Africa has had with Europe, the US, and other Western economies."

But there are still important ways that China's aid system is unlike the West's, and these discrepancies often spell both problems as well as possibilities for borrowing countries.

One of the biggest differences is that China's aid is usually part of a bigger package that includes trade deals and investments and even debt relief. A sizeable part of Chinese economic assistance comes in the form of materials as well as labor, making Chinese-built infrastructure cost relatively lower.

Benito Lim, a professor of Chinese studies at the Ateneo de Manila University who visited China last year to research on Chinese foreign aid, said China believes that that economic growth is possible only with higher levels of production and trade, and looks at aid as a way to support economic activities in the recipient country.

"The Chinese are interested in creating an economic base, not just projects," he said.

China also lacks a centralized aid agency affiliated with its foreign affairs ministry. Instead, Chinese aid is primarily administered by the Ministry of Commerce through its Department of Aid to Foreign Countries and the China Eximbank and other lenders.

While major policy decisions on aid are made by the State Council, the highest government organ in China that is made up of the premiere, vice premieres and ministers, and Chinese ambassadors also propose aid projects for their host countries which are vetted by country desk officers in the Ministry of Foreign Affairs.

Oddly for a country that is emerging as a top provider of economic assistance, China does not release official statistics on its foreign aid activities. Many analysts believe that China does not want to be considered as a major provider of international aid because it continues to receive foreign assistance itself. Also, Beijing is wary of possible objections by its own citizens why China is spending so much abroad when the money is still badly needed at home.

Many of the reforms that China is considering for its foreign aid mechanisms would align it much closer to the Western system, such as creating a dedicated aid agency, instituting evaluation and monitoring systems, and professionalizing staff in charge of managing foreign aid.

However, China also wants to project a uniquely Chinese brand on foreign aid, which draws on its experience with pervasive poverty and how to lift hundreds of millions of people from its claws.

"They clearly do not want to be identified as just one more member of the rich countries' aid clubs," wrote Carol Lancaster in a 2007 essay on the Chinese aid system for the Center for Global Development, a Washington D.C.-based think tank. "For political reasons they want to project their own distinctive image in Asia, Africa and Latin America—one of South-South cooperation, of a special understanding and sympathy that comes from sharing problems of poverty; one of having emerged rapidly (but not yet completely) from those problems; and one that will provide them with a separate and privileged relationship with the governments they are helping and cultivating."

One of the features of Chinese aid is the willingness to fund projects in difficult or risky sectors such as railways or dams as that Western governments and multilateral lending organizations have avoided. Indeed, Japan and Korea have shied away from the Northrail project because of the potential controversy over the thousands of poor illegal dwellers that have to be moved from the rail tracks. Only the Chinese were willing to consider funding the project.

"China also lends money without imposing conditions on opening up markets or trade liberalization," says Lim, making it an attractive alternative to loans from the WB, ADB and most Western lenders.

In the Philippines and elsewhere, Chinese aid and investments can be harnessed either as alternative or supplement to development financing coming from the West. And even as China seeks to differentiate itself from other donors and lenders, Beijing is also beginning to reform its aid system to make it more accountable and meaningful to China and developing countries alike.

Some of these reforms are apparent in the Philippines. For example, China is now amenable to allowing limited competitive bidding among Chinese firms for projects it is funding. It used to insist on unilaterally nominating contractors for Chinese-funded projects. China has also begun to join dialogues with other donors and Philippine planning agencies on improving foreign aid in the country.

Too bad these developments could do little for the Northrail project – terribly late and over the budget – whose precarious fate is up to the next president to decide.

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