# Section 5
# China's Rise as the World's Top Creditor Nation: The Risks and the Outlook

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## 1. Introduction

The COVID-19 pandemic caused the sharpest contraction of global output since WWII. Its impact on developing countries has been disproportionately large—as many as 150 million people have been driven into extreme poverty (World Bank, 2021a). While the governments of developed countries have been able to finance robust counter-cyclical fiscal responses to the crisis, the governments of developing countries, which face higher interest rates, are either struggling to service their debt or are directing finance that could be used to support health and social sectors toward repaying debt. Recent reports by the World Bank and influential economists alike have emphasized the huge role of China in the accumulation of that debt, and have warned that developing countries' dependence on China might and limit their policy options and thereby complicate their recovery from a COVID-19-related debt crisis.

Considering the global importance of this issue, this article first elucidates China's increasingly big role in official overseas lending by outlining the history of Chinese lending, its characteristics, its extent and geographical distribution. The article then outlines the concerns related to Chinese lending, including fears that China might resort to debt-trap diplomacy or cause a debt crisis in developing countries. Finally, the article evaluates the possibility for these concerns to materialize.

Since the focus of this analysis is official lending, i.e., lending to governments rather than firms or individuals, this article focuses exclusively on long-term public and publicly guaranteed debt (PPG), also called government debt. As of 2019, PPG debt ($3.1 trillion) represents more than half of the long-term external debt ($5.8 trillion) of the 120 developing countries covered by World Bank statistics, the remaining part being private sector non-guaranteed debt (Figure 1-5-1).

Of PPG debt, one-third ($1.1 trillion) is owed to official creditors, including multilateral creditors (like the World Bank) and bilateral ones (like China). The latest debt statistics by the World Bank show that about 35% of the $439 billion bilateral official PPG debt owed by all developing countries is owed to China (36% if China is excluded). This ratio more than tripled between 2010 and 2019

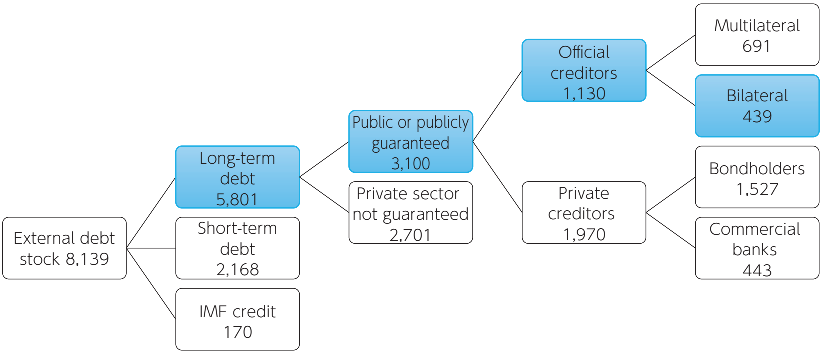


**Figure 1-5-1** The components of global external debt in 2019 (Units: Billion USD)

Source: Based on "International Debt Statistics 2021" by the World Bank

(Figure 1-5-2).

Although the amount owed to China might seem minuscule compared to the total amount of long-term debt (less than 3%), the speed with which it has risen has raised serious concerns, as it might have far-reaching geopolitical consequences. What has aggravated these concerns even more is a recent influential study by Horn, Reinhart & Trebesch (2019), which shows that more than half of PPG debt to China goes unreported, and suggests that China is the single largest creditor to developing countries. Reading this, one wonders how China became the epicenter of international official lending.

## 2. The rise of China as a top creditor nation

After WWII, many developing countries tried to industrialize. This required large-scale investment, which was funded mainly by external borrowing from commercial banks in developed countries. Banks in rich countries were eager to lend, as at the time it was believed that governments are too big to default. However, the oil crises in the 1970s caused major changes in the global financial system, due to which of developing countries' external debt increased to unsustainable levels.

The end of the Bretton Woods system in 1971 led to a shift in economic policy making in the United States and the United Kingdom, whereby interest rates started to be increasingly utilized as a means to control inflation. With prices expected to rise sharply as a result of the oil shocks, interest rates were increased significantly in an effort to contain inflation. The increase was particularly steep during the second oil crisis in 1979.

Rising oil prices combined with high interest rates meant that poor countries were faced not only with higher debt as oil importers, but also with higher debt interest payments. To make matters worse, funding from the Soviet Union, which had often lent to developing countries as part of the Cold War, started to decline. All this led to a debt crisis in many developing countries in the 1980s (Hurt, 2021).

During that period, the World Bank and the International Monetary Fund (IMF) became key players by offering conditional loans and advice to help manage the debt of developing countries. The conditions of the loans, however, were often too strict from the perspective of developing countries. Some of those conditions severely limited borrower countries' policy options, and have received much criticism.

In the 2000s, however, China emerged as a major global economic power, and it proactively started providing loans free of those strict conditions, which made them very popular in developing countries.[1)] In particular, African governments rapidly increased their borrowing from China, as they sought to end their dependence on the IMF and the World Bank, who demand market liberalization in exchange for loans—conditions that China does not impose.

The Global Financial Crisis accelerated the global expansion of Chinese investment and lending, due to the divergence in the economic trajectories of the West and China. Declining economies made western nations more inward looking and busy dealing with their own economies. China, whose economy was thriving, took the opposite direction.

In 2009, the China Banking Regulatory Commission (CBRC) reported that five large commercial banks had set up 86 branches outside of China in order to tap the opportunities provided by international financial markets. Since then, the extent of China's overseas lending has surpassed that of the World Bank and the IMF (HRT, 2019). In 2016, China (including Hong Kong) surpassed any other nation in terms of net international investment (NIIP)[2)], and replaced Japan as the world's biggest creditor nation.

The culmination of China's global engagement was the famous Belt and Road Initiative, unveiled by Chinese leader Xi Jinping in 2013 and eventually

1) In the late 1990s the Chinese government announced a new strategy aimed at encouraging Chinese enterprises to invest abroad. The Chinese government started actively promoting Chinese investments abroad—an effort that culminated with the establishment of the "Go Out Policy" (走出去战略). China's accession to the WTO in 2001 effectively incorporated the country into the global economy.
2) A positive NIIP value indicates that a nation is a creditor nation, while a negative value indicates that it is a debtor nation.

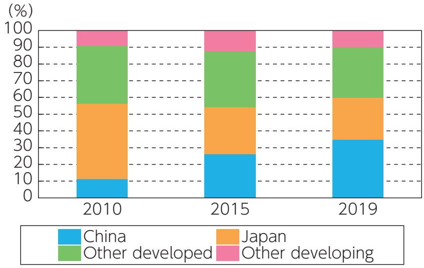


Figure 1-5-2 Creditor composition of debt owed to bilateral by all developing countries

Source: Based on "International Debt Statistics 2021" by the World Bank

incorporated into the Constitution of China in 2017. Being arguably the largest infrastructure investment project in human history, it is also perhaps the most controversial. Several Western governments have accused the Belt and Road Initiative of being neocolonial, ensnaring many countries into China's sphere of influence through the means of debt-trap diplomacy. These concerns have become especially conspicuous since the onset of the COVID-19 pandemic, when the economies of almost all developing countries contracted, which gave rise to fears of a looming debt crisis.

## 3. The COVID-19 pandemic and the DSSI initiative

In view of the debt crisis that could be triggered by the COVID-19 pandemic, the World Bank and the International Monetary Fund urged G20 countries to establish the Debt Service Suspension Initiative (DSSI). The purpose of the DSSI was to provide a temporary suspension of debt-service payments owed by 73 particularly vulnerable countries to their official bilateral (but not multilateral) creditors, thereby helping them concentrate their resources on fighting the pandemic and safeguarding the livelihoods of their poorest citizens. The suspension period took effect on May 1, 2020, and was set to end in December 2021.

As part of the effort to support the DSSI, the World Bank recently published the specific debt statistics of these 73 countries. The data highlighted the huge extent of China's lending to DSSI countries—close to 60% of their official bilateral PPG debt is owed to China, almost double the ratio officially owed by all 120 developing countries (35%, Figure 1-5-2 above).

In the case of debt service payments, which include newly accumulated interest, and have to be dealt with more urgency in the short-term than debt stock, the ratio is even higher. Of DSSI countries' debt service payments due in 2021, an astonishing 64% was due to China. The 2022 ratio is even higher (Figure

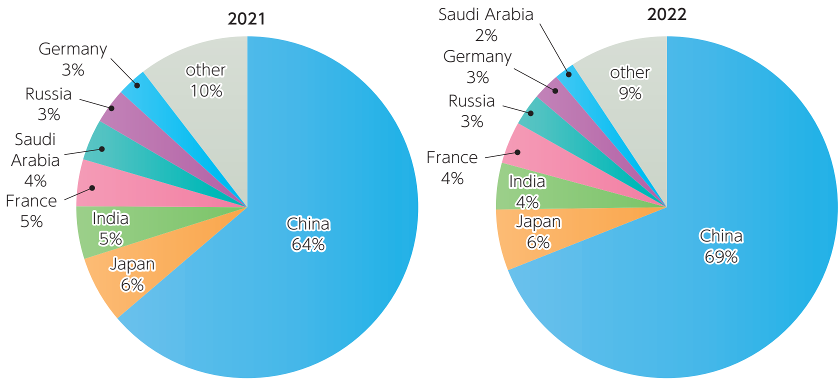


**Figure 1-5-3** Debt service payments due by DSSI counties to creditor countries in 2021 and 2022

Source: Based on World Bank (2021b) data

1-5-3).

This data, however, is only the tip of the iceberg, as DSSI countries are only 73 of the 120 developing countries, and the remaining 50, for which no bilateral data has been disclosed, include some of China's largest borrowers. Indeed, the official bilateral PPG debt stock owed by DSSI countries ($178 billion) is only about 40% of the official bilateral PPG debt owed by all 120 developing countries ($439 billion, see Figure 1-5-1).

While there is no bilateral data for each of the remaining 50 countries, the World Bank does publish aggregate data, which shows that the ratio of official bilateral PPG debt stock owed to China by all 120 developing countries more than tripled between 2010 and 2019, reaching about 35% (or 36% if China's debt is excluded, Figure 1-5-2). However, according to an influential and widely cited 2019 by Horn, Reinhart & Trebesch, (hereafter HRT), this number is vastly underestimated.

HRT collated details on almost 5,000 loans and grants extended by the Chinese government and state-owned creditor agencies to more than 150 countries worldwide, with total commitments of $520 billion.[3)] A main insight from the data is that over half of Chinese official bilateral lending remains unreported. HRT estimate that the real amount was about $350 billion in 2017, meaning that

3) HRT (2019) rely on data Institutes like the China Africa Research Initiative (CARI) and AidData, which collect information about Chinese loans from a wide range of public sources. However, those numbers show only China's loan commitments, and it is difficult to know how much of those commitments have been actually disbursed and repaid.

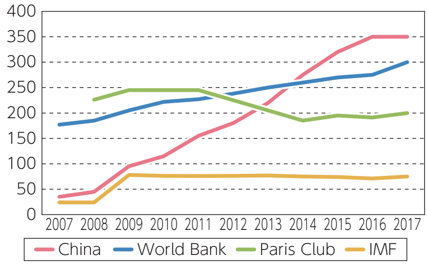


**Figure 1-5-4** External debt stock owed to China versus multilateral creditors (Units: Billion USD)

Source: Based on Horn, S., Reinhart, C. M. & Trebesch, C. (2019)

China has effectively become the largest official creditor, easily surpassing the World Bank and IMF (Figure 1-5-4).

The estimate implies a ratio of indebtedness of developing countries to China closer to 57% rather than the above-mentioned 36%, if China's debt is excluded. According to their estimates, in some countries the ratio of indebtedness to China is over 80% of total (bilateral and multilateral) PPG, a ratio which is far higher than the World Bank figure of 60% for the DSSI countries' bilateral PPG. Such are the cases of Laos and the Maldives* in Asia; Angola*, Djibouti*, the Republic of Congo*, South Sudan and Zambia* in Africa; Fiji* and Tonga* in the Pacific; and Venezuela and Ecuador in Latin America (DSSI countries are marked with an asterisk).

According to the authors, the main reason why official data does not reflect the true extent of Chinese lending is the secretive nature of China's overseas lending mechanism. The next section sheds some light on its specificities.

## 4. Why is China's overseas lending so opaque?

Unlike other major economies, almost all of China's overseas lending is official, meaning that it is undertaken by the Chinese government, state-owned companies, or the state-controlled central bank. The two most important overseas creditors, by a large margin, are China's two state-owned policy banks: China Export-Import Bank and China Development Bank. Both operate under the direct ownership and supervision of the Ministry of Finance and the State Council.

The Chinese government does not disclose data on its lending activities, and the fact that China's lending is entirely official means that it is not accounted for by rating agencies like Moody's or Standard and Poor's who monitor sovereign borrowing from private creditors only. Commercial providers, such as Bloomberg or Thomson Reuters, do not keep track of China's official overseas loans either. The Paris Club does not either, as China is not a member of the club and is therefore not subject to the standard disclosure requirements. In addition, China does not divulge data on its official flows with the OECD's Creditor Reporting System, and it is not part of the OECD Export Credit Group, which provides data on long- and short-term trade credit flows. The financial industry does not monitor China's state-driven cross-border lending flows either. China did join the list of countries reporting to the Bank for International Settlements (BIS) in 2015, but the Chinese government has not agreed to publicly release any bilateral data.

On the other hand, the use of state-owned policy banks means that the credits are rarely de facto borrowed bilaterally, i.e. government-to-government. While the Chinese government provides credit mostly through two state-owned policy banks, the recipients also tend to be state-owned enterprises rather than governments, meaning the transaction is essentially the same as company-to-company lending. As such, it is often not collected by the statistical offices of recipient countries. Low-income countries are particularly bad at accounting for such transactions. As a result, the debtor countries themselves have an incomplete picture on how much they have borrowed from China and under what conditions.

Another characteristic of Chinese lending is what HRT describe as a "circular" lending strategy that minimizes the risk of default. For risky debtors, China's state-owned policy banks often choose not to transfer any money to accounts controlled by the recipient. Instead, the loans are disbursed directly to the Chinese contractor firm that implements the construction project abroad. The loans thus remain within the Chinese financial system, making it harder for recipient countries to misuse the money. Because this type of overseas loan is not actually transferred abroad, there is no cross-border flow to report.

Last but not least, an analysis by Gelpern et al. (2021) found that Chinese lending contracts contain unusual confidentiality clauses that prevent borrowers from revealing the terms, or even the existence of their loans. Chinese contracts before 2015 rarely contained such clauses but virtually all contracts signed after 2015 did. Chinese financial institutions tend to seek more favorable terms than other creditor countries and international financial institutions, using collateral arrangements such as lender-controlled revenue accounts, as well as promises not to engage in collective restructuring. Gelpern et al. argue that this limits the sovereign debtor's crisis management options and complicates debt renegotiation.

The characteristics of Chinese lending have therefore raised concerns that heavy borrowers of Chinese money might become China's geopolitical hostages. To shed more light on these concerns, the next section outlines the circumstances of the most indebted countries, and the potential risks they are facing.

## 5. Are nations borrowing from China at risk?

Figure 1-5-5 shows the geographic distribution of China's lending based on the estimates by HRT (2019). Clearly, the heaviest borrowers of Chinese money (by percentage of GDP) are concentrated in Africa. In Asia, low-income countries around China stand out, including Pakistan, Laos, Cambodia, Kyrgyzstan, and Tajikistan. In Latin America, it is oil-rich Venezuela and Ecuador.

China's overseas lending is evidently highly correlated with the abundance of natural resources[4] and China's geopolitical interests. In addition, many of the countries that borrow heavily from China have authoritarian regimes and high levels of domestic instability, and are often subject to sanctions imposed by Western countries, making bilateral borrowing from rich countries difficult. Loans from the World Bank and IMF, which demand political reforms such as democratization and economic liberalization, are also inaccessible to such countries. This makes loans from China, which impose no such conditions, enor-

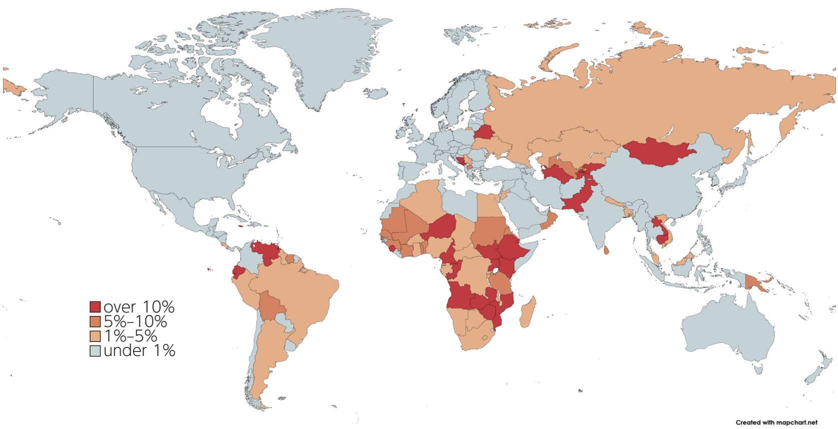


Figure 1-5-5 Debt owed to China by country (% of GDP)

Source: Based on Horn, S., Reinhart, C. M. & Trebesch, C. (2019)

4) The reason often cited for this is that China does not have enough natural resources to meet its own industrial demand.

mously attractive.

An example of natural resource-backed lending is Venezuela, which has been ruled by an authoritarian socialist government since the Bolivarian Revolution in 1999. The oil-rich country has been plagued by a severe socio-economic crisis. Diplomatic ties with the United States were severed, and instead the Venezuelan government established very close political and economic ties with presumably ideologically similar China, which provides easy loans in return for oil. Very similar is the case of African countries, where the lending conditions imposed by the World Bank and the IMF have arguably led to currency devaluation, lower growth rates and widespread dissatisfaction. As a result, many African governments, especially of countries like oil-rich Angola, copper-rich Zambia, and of metal, mineral and timber-rich countries in central and eastern Africa, have resorted to raising funds in other ways, with Chinese lending presenting itself as an easy alternative.

On the other hand, an example of geopolitical interest-driven lending is Pakistan, China's strategic ally against India. China supplies Pakistan's defense forces with a variety of modern weapons and supports Pakistan's stance on Kashmir. In turn, Pakistan supports China on the issues of Xinjiang, Tibet, and Taiwan.

Concerns about China's practice of lending to distressed countries culminated in 2018, when the US Trump administration accused China of engaging in "debt-trap diplomacy," citing unpayable debt in places of geopolitical interest to the Chinese government and in low-income resource-rich countries (Trump White House, 2018).

The main concern is that by using debt as a political tool, China may place various restraints on the policies of the debtor countries, or that the debtor countries might even fall under the effective control of China. Specifically, the Trump administration cited the case of Venezuela repaying its debt to China with oil, and the case of Sri Lanka, which transferred more than 6,000 hectares of land around the Hambantota port to China on a 99-year lease, as it was unable to repay its debt. There are now concerns about Chinese control of similar port projects in Gwadar in Pakistan[5)], Kyaukphyu in Myanmar, Mombasa in Kenya, and Piraeus in Greece.

Such developments are far from being a historical precedent. China's foreign lending shares many characteristics with the foreign lending of France, Germany, and Britain in the 19th century. Another historical analogy is the lend-

5) Pakistan has already given China exclusive rights and tax exemptions to operate the Gwadar port for the next 40 years, giving China 91% of the port's revenue.

ing boom to developing countries in the 1970s, which resulted in a debt crisis. This analogy raises serious concerns about a debt crisis similar to that in the 1980s, especially in view of the COVID-19 pandemic.

## 6. Is Chinese lending going to cause a debt crisis?

At present, there is limited evidence to claim that Chinese lending could cause a debt crisis in developing countries. In the past, China has provided debt relief to various countries on multiple occasions, and most importantly, it is currently participating in the DSSI initiative outlined above. According to a Johns Hopkins University study (Acker et al., 2021), as of March 2021, China has already provided relief to 23 DSSI countries, and is also negotiating with heavily indebted poor countries in Africa on debt restructuring.

These developments are a good omen, and it is believed that China may expand the scope of the suspension of debt repayment. Another positive sign was a speech Chinese leader Xi Jinping delivered on June 17, 2020, in which he encouraged Chinese financial institutions to comply with the DSSI initiative and to hold consultations with African countries to work out arrangements for commercial loans with sovereign guarantees.

However, China's approach to debt restructuring is not standardized across countries, and the fact that debt relief is handled on a case-by-case basis makes the outlook less certain. In addition, China is unlikely to resort to debt cancellation. According to Kratz et al. (2020), debt write-offs are mostly limited to small zero-interest loans, and are less likely for large loans. Past and present examples suggest that deferral (rescheduling principal repayments and sometimes excluding interest payments) is the preferred solution for the Chinese government. This means that China is unlikely to wipe away bilateral debt in exchange for control of strategic assets. In other words, it is improbable that China will resort to debt-trap diplomacy.

## 7. The outlook

In the short term, especially in view of the COVID-19 pandemic, it seems likely that China will limit its overseas in the face of unsustainable debt repayments by borrower countries. More importantly, however, China's lending seems highly unlikely to recover in the medium-to-long term either.

The main reasoning behind this forecast is the fact that China's external lending is fundamentally motivated by internal factors, not external ones. HRT (2019) find that the standard push factors of capital flows identified in the academic literature have limited explanatory power with regard to Chinese lending. Rather, its main drivers appear to be China-specific push factors, in particular China's economic growth. Therefore, the future of China's external lending will most likely depend on China's growth performance, and virtually all current economic, political and demographic trends[6] point to the inevitable slowdown of the Chinese economy. All major institutions, including the Chinese government itself, have already downgraded their forecasts for China's future GDP growth. The Chinese Academy of Social Sciences and the People's Bank of China estimate China's potential growth rate to be about 5.5% in 2022. While most analysts expect GDP growth of around 5%, some have even lower expectations, with Nomura Securities forecasting a modest 4.3% in 2022.

In addition to this, the following three trends also suggest that Chinese overseas lending has already passed its peak: (1) China's foreign exchange reserves have been decreasing since their peak in 2013–2014; (2) China's current account surplus as a percentage of GDP keeps declining; (3) China is turning inward, as exemplified by the government's new economic plan, which envisions China's future growth as largely based on domestic consumption and aims to reduce China's reliance on international trade and foreign investment.[7]

Finally, considering the fact that most developing countries began borrowing from China in the first place precisely because they were unable to raise funds from traditional sources (rich countries and international institutions), one might speculate that the future of China's overseas lending will also depend on whether developed countries and international financial institutions will be willing to extend loans and aid to developing countries on looser terms.

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6) Short-term factors include the recent disruption in global supply chains, semiconductor and commodity shortages, and the unfavorable climate in the Chinese real estate sector exemplified by Evergrande's near-bankruptcy. Long-term factors are centered around the rapid and inevitable aging of the Chinese population and ensuing shrinkage of the workforce.

7) China's 14th Five-Year Plan was drafted during the fifth plenum of the 19th Central Committee held from 26 to 29 October 2020.

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