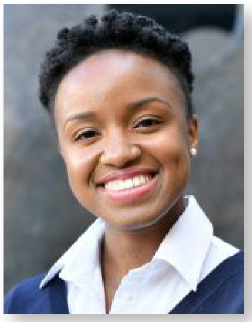

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Demystifying Chinese Overseas Lending and Development Finance

WHY CHINA BECAME THE WORLD'S LARGEST OFFICIAL BILATERAL LENDER

OYINTARELADO MOSES, CECILIA SPRINGER, KEVIN P. GALLAGHER[1]

EXECUTIVE SUMMARY

To achieve climate and development goals, developing countries must mobilize $2.4 trillion annually through 2030, $1 trillion of which must come from external sources (Songwe 2022). However, traditional sources of financing are falling short of this annual amount, and the 'polycrisis' of the pandemic, debt and climate change facing developing countries is further hampering progress on climate and development goals.

China's overseas development finance (ODF), which is specifically finance from the China Development Bank and the Export-Import Bank of China, has emerged in part to meet this need, mobilizing nearly $500 billion from 2008-2021 (GDP Center 2023). Yet, the rise of China as the world's largest official bilateral creditor has not come without debate. Within US policymaking circles, there are concerns about whether finance from China leads to asset seizure and whether Chinese finance boosts or hampers economic growth.

This policy brief aims to demystify China's overseas lending and development finance (OLDF) by discussing its drivers, demonstrating empirical evidence of both benefits and risks and suggesting a

[1] Acknowledgments: The authors thank Keyi Tang for research assistance support.

way forward for empirically driven discourse.[2] It provides insights into the determinants and impacts of Chinese OLDF, discussing what led to the increase of Chinese loans and how this finance has impacted recipient countries.

The brief also investigates the veracity of the debt trap diplomacy narrative surrounding Chinese OLDF. Despite claims to the contrary, we found no evidence that China lends with the end goal of seizing a strategic public asset or gaining strategic leverage in the event of non-repayment. What is more, empirical evidence shows that China's OLDF is associated with economic growth that benefits host countries. However, this finance can pose social, environmental and debt sustainability risks. It is important for China to promote low-carbon, resilient and socially inclusive growth abroad, as well as participate in debt relief and emergency financing efforts.

These findings highlight the need for transparency and accountability regarding China's overseas economic activity. To that end, we propose several policy recommendations for US policymakers:

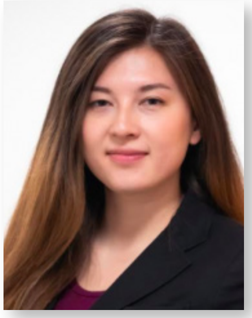
- US policymakers should refrain from using the term "debt trap diplomacy" due to its conceptual issues, lack of empirical basis, and the fact that the rise in Chinese finance has highlighted a legitimate need for more finance to address financing and infrastructure gaps in EMDEs.
- Based on empirical understandings of pull factors in countries seeking finance, US policymakers should ensure that development initiatives such as the Partnership for Global Infrastructure and Investment (PGII) are effectively implemented and that the recipient country demand is integrated into implementation.
- US policymakers should seek to engage with China on improving the transparency and accountability of China's OLDF to address recipient country concerns and assess trends in the impact of its finance.

Various infrastructure and finance gaps loom throughout EMDEs, and the current crises show the need for additional finance from a variety of external actors and partners to recipient countries. Both the US and China must play a role in partnering with host countries to address these needs, as one country alone cannot address such gaps. For engaging in constructive discussions about Chinese OLDF, the focus must ultimately center on addressing the infrastructure and climate financing gaps and setting a stronger foundation for achieving the UN 2030 Sustainable Development Goals (SDGs) in recipient countries.

INTRODUCTION

Countries with emerging market and developing economies (EMDEs) need to mobilize $2.4 trillion annually through 2030, of which $1 trillion must come from external sources, to meet the UN 20230 Sustainable Development Goals (SDGs) and align with the Paris Agreement on climate change (Songwe et al. 2022). Even before the COVID-19 pandemic and recent global instability, traditional public and private sources of financing have been falling far short of this annual amount. The "polycrisis" of pandemic, debt and climate change that many developing countries face today is further stymieing progress on climate and development goals (World Economic Forum 2023).

[2] China's overseas development finance (ODF) refers to finance specifically from China's development finance institutions (DFIs) — China Development Bank (CDB) and the Export-Import Bank of China (CHEXIM), while overseas lending and development finance (OLDF) refers to lending from China's DFIs, commercial banks, companies and other government institutions.



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Despite criticism that Chinese overseas lending and development finance (OLDF) is motivated by ensnaring borrowers in "debt traps" to gain strategic leverage, the rise in this financing is a function of matching a unique set of Chinese and developing country interests, including push factors driving China's outward supply of OLDF and pull factors determining recipient country demand for such financing. In addition, empirical evidence shows that China's OLDF is associated with short-term economic growth that benefits recipient countries (Dreher et. al. 2021).

China does have room for added leadership on its OLDF. In addition to demonstrated economic benefits, China's OLDF also poses social, environmental and debt sustainability risks. In these crucial times, it is paramount that China fosters low-carbon, resilient and socially inclusive growth abroad, as well as participate constructively in debt relief and emergency financing efforts.

This policy brief brings an evidence-based approach to decipher politically charged narratives that exacerbate tensions between the United States and China over development finance in a time when global coordination is of the utmost urgency. The brief aims to demystify China's OLDF by discussing drivers of Chinese lending, demonstrating empirical evidence of both benefits and risks and suggesting a way forward for empirically driven discourse.

THE NARRATIVE LANDSCAPE OF CHINESE LOANS AND DEBT

Concern about Chinese lending has accompanied the rise of China as the world's largest official bilateral creditor. After the 2008 global financial crisis, Chinese OLDF significantly increased and expanded to peak amounts in 2016, three years after the announcement of the Belt and Road Initiative (BRI) (GDP Center 2023). While EMDEs sought financial support for projects that would promote sustainable development, the United States has increasingly become wary of Chinese finance, especially after narratives of Chinese "debt trap diplomacy" spread throughout policy circles in the years following peak Chinese finance. The debt trap diplomacy narrative alleges that China deliberately lends to countries with the end goal of seizing a strategic public asset or gaining strategic leverage in the event of non-repayment (Brautigam 2019).

The Chinese debt trap diplomacy narrative became prominent in 2018 when prominent media outlets used it to describe events surrounding the loan-financed Hambantota Port in Sri Lanka, which later received an equity stake investment from China Merchants Port (Abi-Habib 2018). When this narrative rose to prominence, alarm bells rang through US policymaking circles about the Sri Lanka case, and the US media reported several examples of other supposed debt trap cases in Asia, Africa, the Americas and Europe. The narrative's pervasiveness underscored the need for empirical evidence to evaluate the debt trap claim. Since 2021, several researchers have provided ample evidence that debunks the debt trap diplomacy narrative (see next section).

Despite this evidence, the China debt trap narrative and associated concerns is pervasive and continues to evolve. For example, during a hearing before the State, Foreign Operations and Related Programs subcommittee of the US House Appropriations Committee in March 2023, US Secretary of the Treasury Janet Yellen stated, "I am very, very concerned about some of the activities that China engages in globally, engaging in countries in ways that leave them trapped in debt and don't promote economic development (House 2023, Lawder and Singh 2023)." These concerns appear legitimate, as it is important to partner with EMDEs to achieve their development goals, not worsen economic situations. However, there needs to be an evaluation of whether these claims are substantiated with evidence from rigorous and empirically based research.

THE DRIVERS AND IMPACTS OF CHINA'S OVERSEAS LENDING AND DEVELOPMENT FINANCE

According to the China's Overseas Development Finance (CODF) Database, managed by the Boston University Global Development Policy (GDP) Center, China's development finance institutions (DFIs), China Development Bank (CDB) and the Export-Import Bank of China (CHEXIM), have extended $498 billion to countries around the world from 2008-2021 — not far from the $601 billion the World Bank provided during that same period (GDP Center 2023).

A series of interconnected supply "push" and demand "pull" factors within country and sector specific contexts, has enabled this tremendous amount of development finance from China (Kong and Gallagher 2020, Li et. al. 2021). Push factors refer to the internal forces within China that are driving its supply of OLDF. Pull factors refer to the external forces outside of China that are driving the demand for its OLDF.

Determinants of Lending - Push Factors

Several key push factors have driven Chinese OLDF abroad: China's current account surplus, overcapacity in key infrastructure sectors in China, the need to secure imports and government policies and mechanisms specifically encouraging outward finance.

China's current account surplus has been a significant driver of China's OLDF. A current account surplus occurs when a country exports more goods and services than it imports, resulting in a net inflow of foreign currency. China has had a persistent current account surplus for several decades. Empirical research shows a positive association between the levels of China's foreign currency reserves and its OLDF (Dreher et al. 2021).

Overcapacity in key infrastructure sectors in China has also driven OLDF. In particular, hydropower and coal-fired power generation within China reached a point of excess manufacturing capacity while facing slowing electricity demand growth, and empirical evidence has confirmed the correlation of domestic overcapacity with ODF for these types of power plants abroad (Kong and Gallagher 2021, Kong 2021, Li et al. 2022). Both industries had significant experience domestically, and surplus capital to export abroad. Via the coordinated credit space, CDB and CHEXIM helped provide financing for firms in the energy sector to go abroad (Chin and Gallagher 2019).

Securing the import supply of key commodities is a significant driver of China's OLDF. As China has become increasingly dependent on imports for a range of critical commodities, including oil and gas (Kong and Gallagher 2017), transition materials (Albright et al. 2022) and agricultural products (Ray et al. 2022), ensuring a stable and uninterrupted supply has become a top priority for the country's policymakers. The need for stable supply chains has motivated various forms of Chinese finance for overseas production and infrastructure projects for key sectors.

Finally, the above drivers have been coordinated and encouraged by specific government policies, starting with the "Going Out" strategy launched in the early 2000s to encourage Chinese companies to invest abroad, to the BRI launched in 2013 to promote infrastructure connectivity. These overarching initiatives and strategies are supported by specific policies and connect China's OLDF to broader policy and economic goals. In addition, the ability of Chinese financial institutions, government ministries and firms to work together in a coordinated credit space has also enabled large amounts of Chinese OLDF (Moses and Zhu 2022). Finance for individual projects is coordinated with larger goals of developing markets while mitigating risk by coordination between DFIs, commercial banks and government leadership (Chin and Gallagher 2019).

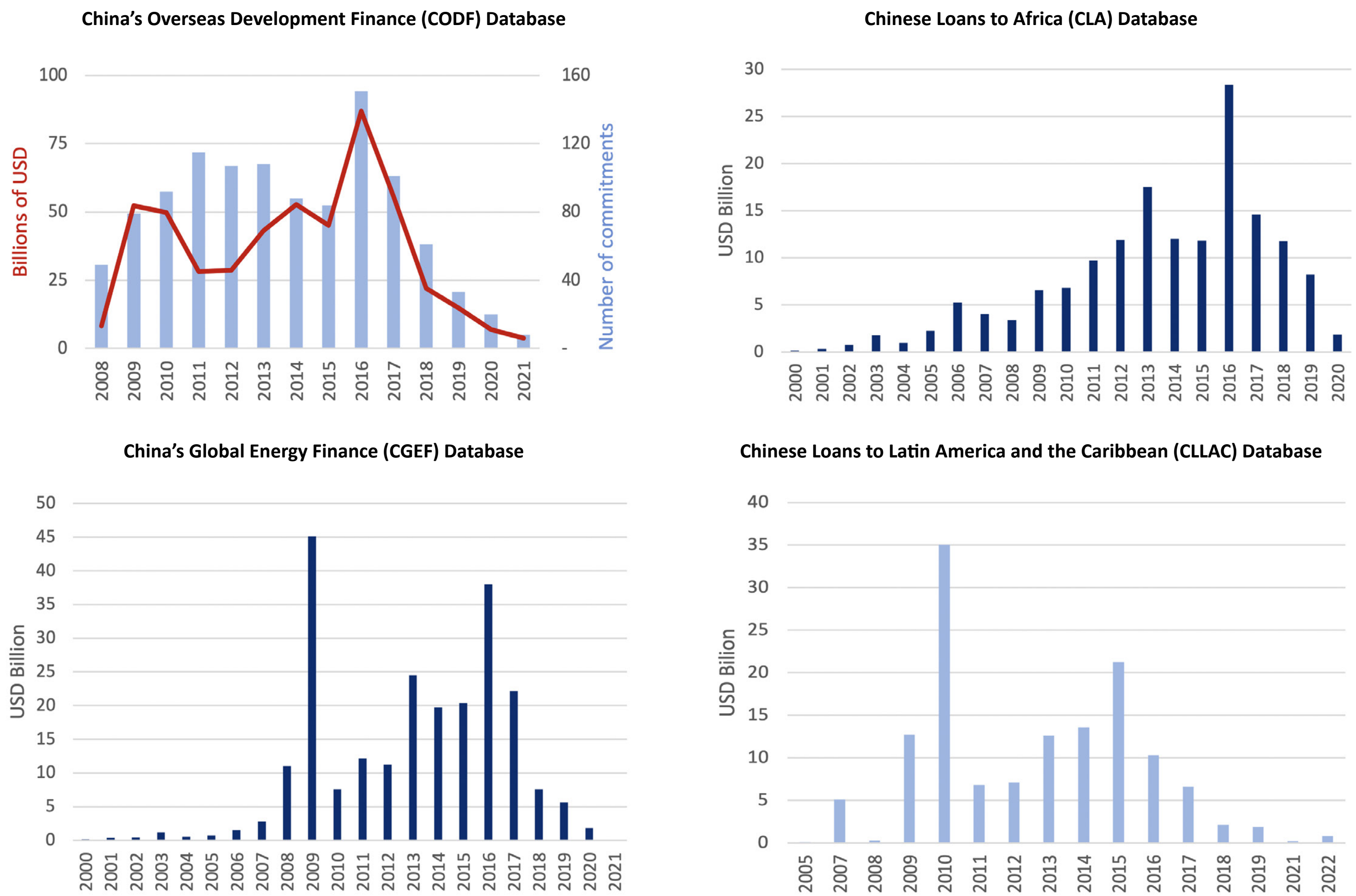
Determinants of Lending - Pull Factors

Several pull factors represent recipient country demand: the need for filling finance gaps, addressing core infrastructure needs and a preference for Chinese finance. Ultimately, the demand for external finance is based on recipient countries' policy goals and priorities.

EMDEs face vast financing gaps. To reach the UN 2030 Sustainable Development Goals (SDGs) targets by 2030, an additional $1.4 trillion or 2 percent of global gross domestic product (GDP) is needed annually for core infrastructure investment, and roughly $700 billion per year of climate finance is required to reach net zero emissions by 2050 (Bhattacharya et. al. 2019, Springer 2022). Lack of core infrastructure (power generation and distribution, transport, water and sanitation and telecommunications) and inaccessibility to affordable energy impedes economic growth and poverty reduction throughout many EMDEs. Countries need external finance to address these gaps, and often, loans are sought out as a financial tool to fund large public infrastructure projects.

For example, within the energy sector, the need for expanded and affordable electric power has driven recipient countries' demands for Chinese ODF in the form of loans (Kong and Gallagher 2020, Li et. al. 2021). Countries have turned to China to finance such projects in preferring China's favorable interest rates, quick disbursement of funds, closer alignment with policy priorities, financing with

Figure 1: Trends in China's Overseas Lending and Development Finance



Source: Boston University Global Development Policy Center, 2023.

fewer policy conditions and quick turnarounds on projects (Kong and Gallagher 2020, Horigoshi et. al. 2022). Furthermore, Chinese financing is complementary to World Bank financing, as recipients have largely requested finance from both lenders, seeking finance for social projects such as public administration from the World Bank and infrastructure finance from China (Ray 2023).

Overall, these push and pull factors show the dynamics of supply and demand between Chinese financiers and country recipients that has led to the rise of Chinese OLDF (Figure 1), although research shows loan commitments are becoming more targeted and smaller in value (Ray 2023). In regions such as Latin America and the Caribbean, Chinese DFIs have signed $136 billion in loan commitments with LAC government borrowers from 2005-2022 (Ray and Myers 2023). From 2000-2020, Chinese DFIs and other financiers (commercial banks, companies and other government entities) have signed $160 billion in loan commitments with African government borrowers (GDP Center 2022). Contrary to many beliefs within US policymaking circles, debt trap diplomacy is not a determinant of Chinese finance. The following section debunks this narrative by providing an overview of the existing research on several cases.

Debt Trap Diplomacy is Not a Driver of China's OLDF

Debt trap diplomacy has been cited as a driver of China's OLDF (see Introduction). However, there is no empirical evidence to support this claim. In addition, there are several problems with the China debt trap diplomacy narrative. The narrative first supposes intention and deliberation, where it assumes a calculated strategy by Chinese lending institutions to entrap countries in debt. It also assumes Chinese lenders are in the business of seizing and maintaining national strategic assets of other countries. Lastly, the narrative supposes that Chinese lenders know that countries will not repay. These assumptions are highly unlikely given the fragmentation inherent in the Chinese development financing system (Jones and Hameiri, 2020).

There are also several conceptual issues with the debt trap narrative that undermine the dynamics at play between push and pull factors discussed. First, the narrative ignores that Chinese-financed projects are driven in part by recipient country demand and countries are knowingly choosing loan finance from Chinese banks for their development projects. Second, by removing recipient country agency by assuming recipient countries do not hold close control over their public assets and would willingly give them up, the narrative perpetuates the idea that recipient countries are victims of Chinese economic statecraft. It assumes recipient countries have no leverage or know-how to negotiate these deals with China or independently make decisions about aligning with China on different policy areas. Third, the narrative ignores the fact that Chinese financiers, like global financiers, emphasize making profits and seek to avoid non-repayment. This is evident in many of the debt negotiations where Chinese lending institutions have preferred to defer debt payments or restructure debts.

The following is a comprehensive set of eight Chinese debt trap diplomacy allegations. Table 1 summarizes these allegations with text explaining why there is no evidence of a debt trap.

Table 1: Comprehensive Summary of Allegations of Chinese Debt Trap Diplomacy

Case	Country	Allegation	Evidence Debunking Debt Trap	What Happened Instead of Asset Seizure	Sources
Hambantota Port	Sri Lanka	US think tank and *New York Times* investigation, 2018: "How China got Sri Lanka to Cough Up a Port."	Port not seized after Sri Lanka's default in 2022; Sri Lanka still retains sovereignty over the port and has not given any access rights to China's navy.	Sri Lankan government was looking for FOREX inflows, so they leased a 70 percent stake of the port to China Merchants through a 99-year lease for a $1.12 billion cash infusion into FOREX reserves to pay back upcoming maturity of international sovereign bonds.	Moramudali, 2019 Moramudali, 2020 Brautigam and Rithmire, 2021
Mombasa Port (asset), Kenya Standard Gauge Railway (borrowing project)	Kenya	Kenyan auditor-general, 2018: CHEXIM will become principle over Kenya Ports Assets if Kenya Railway Company defaults.	Assets not seized after default occurred in October 2022; initial allegation based on a misunderstanding of sovereign immunity waiver.	The Kenyan port authority is not a borrower - Kenya's Treasury is the borrower instead. Waiving sovereign immunity is a common practice in project finance to ensure lenders have dispute mechanisms.	Brautigam et. al, 2022 *The Hill*, 2022 Brautigam, 2022
Entebbe Airport	Uganda	Ugandan newspaper, 2021: "Uganda surrenders key assets for China cash."	Loan contract published; airport was not listed as collateral.	CHEXIM designated cash deposits in an escrow account as the collateral, which gave CHEXIM access to liquid collateral. This is a common practice in project finance.	Parks et. al, 2021 Mugerwa, 2021
Bar Boljare Motorway	Montenegro	European and US media headlines, 2021: "Montenegro, the first victim of China's debt trap diplomacy", "Montenegro mortgaged itself to China," etc.	Allegation based on a misunderstanding of sovereign immunity waiver.	The sovereignty waiver clause is a standard practice for public infrastructure projects contracts, as it enables the parties to submit their case for review to an arbitral or judicial tribunal in the case of a dispute.	Deron et. al, 2021 *France24*, 2021
National ICT Backbone Phase II	Nigeria	Nigeria House of Representatives hearing on China-Nigeria agreements and subsequent media coverage, 2020: CHEXIM loan agreement "wills the sovereignty of Nigeria" to China.	Allegation based on a misunderstanding of sovereign immunity waiver.	Same as Montenegro above; Nigeria's inherent sovereignty remains untouched by the signature of such a clause.	Hon, 2020 *Tribune Online*, 2020 Mondaq, 2020 Deron, 2020
Doraleh Container Terminal	Djibouti	Regional and international media, US Senate letter, 2018: "As Djibouti increases its dependence on China, there are fears that China will gain control of the Doraleh Container Terminal."	No evidence indicating that China lent to Djibouti with the hope of seizing the Doraleh Container Terminal.	In 2018, the government of Djibouti nationalized the Djibouti Doraleh Container Terminal. The China Merchants is only operating the terminal and has long held a 23.5 percent stake in Port de Djibouti.	Connars, 2018 Wright, 2019 *Reuters*, 2018 Paris, 2019 United States Senate, 2019 Kuo, 2019 *WCN Editorial*, 2022

Case	Country	Allegation	Evidence Debunking Debt Trap	What Happened Instead of Asset Seizure	Sources
Kenneth Kaunda International Airport and ZESCO power utility	Zambia	Regional media, US government officials, 2018: China in talks to take over Zambia's utility and airport.	Zambian and Chinese officials denied these claims; no evidence to demonstrate such discussions.	Both the Kenneth Kaunda Airport and ZESCO power utility are owned by the Zambian government. The China Jiangxi Corporation for International Economic and Technical Cooperation (CJIC) serves as the contractor of the airport. ZESCO has always been state-owned as the main utility authority of Zambia.	*Lusaka Times*, 2018[a] Servant, 2019 African Confidential, 2018 *Lusaka Times*, 2018[b]
Gwadar Port / China-Pakistan Economic Corridor (CPEC)	Pakistan	Indian media, 2019: "If Pakistan fails to meet its debt obligations, China will seize control of its collateral."	No evidence indicating that China is seeking to seize infrastructure in Pakistan in the event of default.	Gwadar port and Gwadar Free Zone were developed and leased to the China Overseas Port Holding Company (COPHC) for operation for 40 years. The lease does not equal ownership.	*The Diplomat*, 2015 *The Nation*, 2017 Ghosh, 2019 Shaikh & Chen, 2021 Khalid, 2021

Source: Authors'compilation.

We also found that in Laos, Kyrgyzstan, Angola and the Maldives, specific infrastructure projects have been held up as examples highlighting the high amount of debt stock each country owes to China, and that these projects are joint ventures where Chinese companies take a significant equity share or will operate for a long time under the build-operate-transfer (BOT) scheme. However, we did not find specific allegations of potential asset seizure of these projects under debt distress. In fact, the nature of joint ventures and BOT and build-own-operate-transfer (BOOT) arrangements may create confusion about ownership, but these are common approaches to using equity to finance infrastructure projects and do not represent asset seizure per the debt trap diplomacy definition.

These cases highlight several trends. First, allegations of debt trap diplomacy largely started after 2017, around the time China's ODF peaked. Second, most cases are in Africa, likely due to discourse on US-China rivalry on the African continent. Third, a number of debt trap allegations arose from misunderstandings about the legal implications of sovereign immunity waivers. Finally, by tracing debt trap allegations across multiple media sources, it is clear that many allegations arose in local or regional media outlets, but were picked up by international media, with some allegations ending up in statements by US policymakers.

The final evidence against the narrative that China seizes assets due to non-repayment is the number of actions China has taken to address non-repayment. In fact, if ever there were a time when China would seek to seize assets, it would be during the current debt crisis. However, instead of seizing assets, China has negotiated with debtors by deferring debt payments, restructured repayment terms and interest rates and forgiven overdue interest-free loan debts for distressed borrowers. During the G20 Debt Service Suspension Initiative (DSSI), China rescheduled debts amounting to $8.2 billion and contributed 63 percent of debt suspensions for the 46 countries that participated in the DSSI (Brautigam and Huang 2023). Chinese officials suspended about 43 percent of debt due to Chinese creditors, roughly comparable to Germany (45 percent) (Brautigam and Huang 2023). China historically has preferred to restructure debts when debtors encounter difficulties. In 2020 alone, around $28 billion worth of debt was undergoing renegotiation between Chinese creditors and requesting countries (Kratz et. al. 2020, Kynge 2023). In 2022, China also canceled overdue interest-free loans for distressed African borrowers estimated to be $45 million to $610 million (Moses and Hwang 2022). Lastly, China has offered various rescue loans in the form of swaps and liquidity support (Horn et. al. 2023).

Impacts of Chinese Overseas Lending and Development Finance

This policy brief has demonstrated that China lends due to various push and pull factors. Now we briefly summarize the impacts of China's OLDF based on existing research about the benefits and risks of China's overseas economic activity. Empirical evidence suggests that China's OLDF has brought both positive economic benefits, as well as social, environmental and debt sustainability risks to host countries.

China's OLDF has demonstrated several economic benefits. It has the potential to unlock growth potential through increased trade and transport, which could increase global real income by up to 3 percent (Ruta et al., World Bank 2019). In addition, it has helped to overcome infrastructure bottlenecks in developing countries (Wang and Lin 2018) and has boosted short-term economic growth (Dreher et al. 2021, Mandon et. al. 2023). Furthermore, China's ODF has eased liquidity constraints and given developing countries more choices and competitive finance (Sundquist 2021). The benefits of China's overseas finance stem from its ability to provide "patient capital," namely, long-term finance with a higher risk tolerance that leverages China's vast domestic resources. China's patient capital also lacks policy conditionality and fiscal austerity requirements of Western multilaterals, which has given developing countries more options for infrastructure financing (Kaplan 2021).

However, there are also risks associated with China's OLDF, particularly in terms of social, environmental and debt sustainability impacts. A significant proportion of China's ODF is directed towards fossil fuel infrastructure, which contributes to global greenhouse gas emissions that cause climate change (GDP Center 2022a). Annual carbon dioxide emissions from currently operating power plants that have received development finance or investment from China total about 245 million tons, on par with the energy-related emissions from a country the size of Spain or Thailand (Springer et al. 2022). China's overseas fossil fuel power plants could lock in 12 gigatons of carbon dioxide emissions by 2060 (Chen et al. 2021). Furthermore, Chinese OLDF financed projects have tended to site in areas that pose risks to biodiversity and Indigenous peoples' lands, though this risk has been decreasing over time (Yang et al. 2021, Ray 2023). Lastly, Chinese OLDF is predicted to be associated with debt sustainability risks as several countries receiving finance already faced high debt levels, which could impact the medium-term outlook on debt sustainability (Ruta et. al., World Bank 2019).

To place these benefits and risks in context, comparing Chinese OLDF to World Bank lending, empirical evidence shows that World Bank lending has not produced that same economic growth benefits (Dreher et al. 2021), but Chinese OLDF has posed greater risks to biodiversity areas and Indigenous peoples' lands in comparison with World Bank projects (Yang et al. 2021).

POLICY RECOMMENDATIONS

This policy brief has summarized the empirical evidence demonstrating China's motivations for OLDF regarding persistent narratives of China's overseas lending as a form of debt trap diplomacy, we have collected and debunked specific allegations of debt trap diplomacy to show that it has not been a driver for China's overseas finance. Finally, we summarized the impacts — both positive and negative — of China's OLDF.

These findings highlight the need for transparency and accountability around understanding China's overseas economic activity, and we propose several policy recommendations for US policymakers:

- US policymakers should refrain from using the term "debt trap diplomacy" due to its conceptual issues, lack of empirical basis, and the fact that the rise in Chinese finance has highlighted a legitimate need for more finance to address financing and infrastructure gaps in EMDEs.

- Based on the empirical understanding of pull factors in countries seeking finance, US policymakers can ensure that development initiatives such as the Partnership for Global Infrastructure and Investment (PGII) are effectively implemented and that the recipient country demand is integrated into implementation.

- US policymakers can seek to engage with China on improving the transparency and accountability of China's OLDF in order to address recipient country concerns and assess trends in the impact of its finance.

Various infrastructure and finance gaps loom throughout EMDEs, and the current crises show the need for additional finance from a variety of external actors and partners to recipient countries. Both the US and China have a role to play in partnering with host countries to address these needs. For engaging in constructive discussions about Chinese OLDF, the focus needs to ultimately center on increasing effectiveness in addressing the infrastructure and climate financing gaps around the world and setting a stronger foundation for achieving SDG targets in EMDEs.

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