

China Development Aid in Emerging Markets: Project Financing versus Government Debt

Erica Perego
CEPII
erica.perego@cepii.fr

Pablo Winant
ESCP Business School, CREST, CEPII
pablo.winant@gmail.com

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Introduction

Geopolitical context

Development Aid to Emerging Market Economies (EMEs) has a long history featuring long-standing lenders such as the IMF, the World Bank, Paris Club governments, and more recently China as a new top player. Since 2014 China has become the largest official creditor to developing countries. This outcome results from the “Going Global Strategy” of China coupled with the increases in China’s GDP and current account around the years 2000. The strategy, aimed at increasing investment abroad, started in 1999 and was revitalized by the launch of the “Belt and Road Initiative” (BRI) in 2013 which financed large-scale infrastructure investments in developing countries.

The rapid rise of China as an international lender creates concerns at the world level on both geopolitical and economic grounds. On the one hand, it raises fears that China’s development aid policy is actually concealing Chinese objective of increasing its trade and political presence in EMEs; on the other hand, Chinese lending policy has importantly increased the level of debt-to-GDP in these countries and now many EMEs are having troubles repaying their debt. Outside of multilateral debt restructuring agreements, further rescue loans from China can potentially worsen debt sustainability concerns.

Research question

This paper contributes to a broader understanding of how China lends and which are the implications of its strategy. There seems to be a clear pattern in China development Aid financing in EMEs: via sovereign debt borrowing until 2000, via project-financing (mostly in infrastructure) with the BRI, and again via sovereign debt financing in the form of rescue loans after many EMEs faced BRI’s loans repayment difficulties.

Our analysis takes the point of view of an emerging market small open economy by looking at the implications for EMEs of project-oriented loans with respect to government debt lending. Is there a preferable way of financing infrastructure development? Is there an optimal combination? Is there a market explanation for why China has become the 1st lender to EMEs?

More specifically, we give a rationale for why a small open economy would transition from being mostly financed by government loans to an infrastructure-project financing model and then again to government debt financing. We investigate whether these shifts are due to–or influenced by– i) the development stage of a country; ii) local investment capabilities; iii) government fiscal space; and/or iv) lenders’ preferences/project riskiness evaluation.

Research approach

To do so, we first provide evidence of the new trends in China’s lending and in particular on the shift in development aid financing procedures in EMEs. We then build a state-of-the-art quantitative economic model to rationalize these facts focusing on the choice between project financing and government borrowing. We then use the model to build hypothetical scenarios, which highlight and disentangle the role of factors i)–iv).

Trends in China’s Lending

Since 2014 China has become the largest official creditor to developing countries.¹ Figure 1 shows the increase in China lending to emerging countries from the year 2000 to 2017.

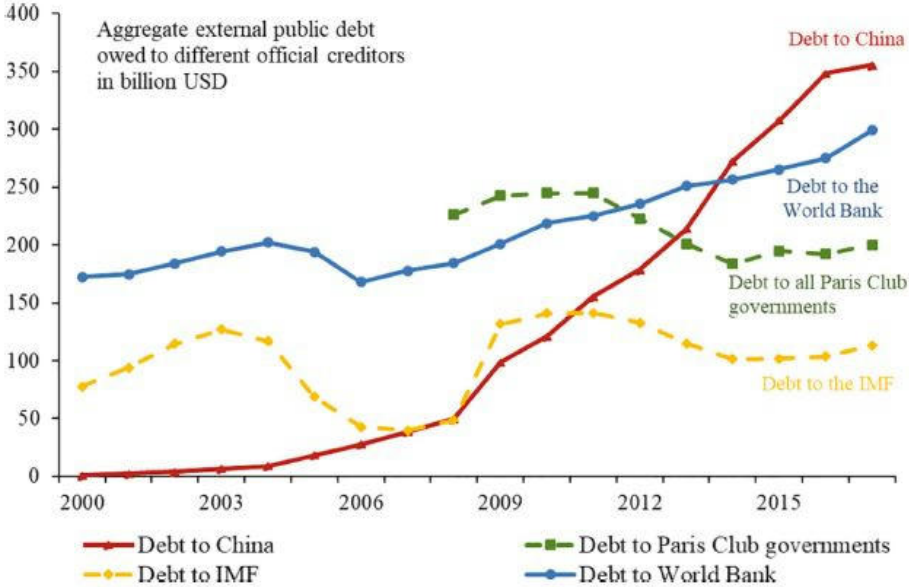


Figure 1: China is the largest official creditor to the developing world. Note: This figure shows aggregate public debt to different official creditors for all developing and emerging market countries contained in the World Bank International Debt Statistics (excluding China).²

Compared to traditional lenders, these lendings are mostly characterized by higher interest rates (around 5% for non-concessional loans with respect to around 2.5% of the World Bank and IMF) and shorter grace periods (around half of the World Bank’s period). In many dimensions, they resemble more commercial loans rather than concessional loans normally offered by other official lenders, such as the World Bank or OECD governments.³

¹According to Gelpert et al. 2022, these loans have been provided mostly to African countries (47%), to Latin America (27%) and much less so to Easter Europe (11%), Asia (10%) and Oceania (5%); and more to lower middle income countries (54%) with respect to upper middle income (36%), low income (8%) and high income (2%).

²Source: Horn, Reinhart, and Trebesch 2021.

³See Horn, Reinhart, and Trebesch 2021, Morris, Parks, Brad, and Gardner 2020, Horn, B. C. Parks, et al. 2023)

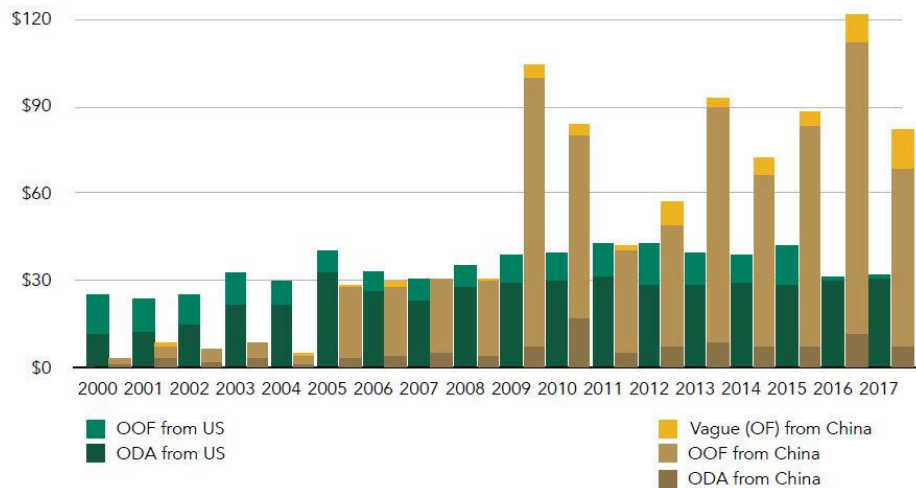


Figure 2: Official Development Assistance (ODA) and Other Official Flows (OOF) from the U.S. and China, 2000-2017. Source: OECD-DAC and AidData, Malik et al. 2021.

In fact, Figure 2 shows the proportion of Official Development Assistance (ODA) –which is concessional finance– versus Other Official Flows (OOF) –which is not–, comparing the lending from China and from the US. While the US lends more on concessional terms, China mostly lends on commercial terms (OOF) and more so in the more recent years.

Finally, the recipients’ institutions for these loans are composed of both the official government sector and a broad “non-official government” sector which is composed of state-owned enterprises (SOEs), special purpose vehicles (SPVs), and the private sector. The “non-official government” sector group represents the majority of recipients’ actors for China lending. This evidence suggests a global shift from China toward *project financing*, consistent with the publicly stated goals of the Belt and Road initiative.

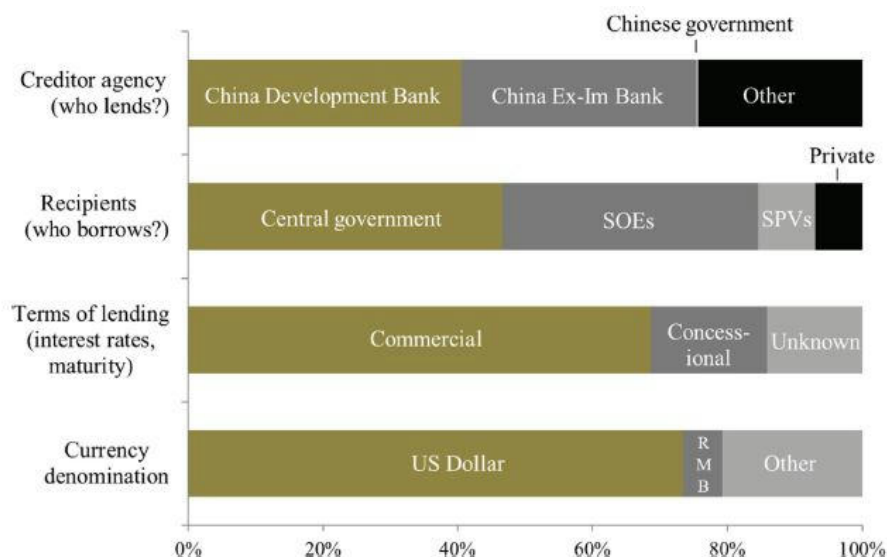


Figure 3: Characteristics of Chinese official overseas loans. Source: Horn, Reinhart, and Trebesch 2021.

However, debt sustainability and potential sovereign defaults are becoming new pervasive concerns. Horn, B. C. Parks, et al. 2023 show that by 2022, 60% of China’s overseas lending portfolio was owed by borrowers in distress.⁴ These numbers could even lead to an underestimation of the actual amount

⁴A borrower’s debt in distress is defined as (i) with payment arrears, (ii) in a default or restructuring (with China or private external creditors), (iii) participating in the 2020–2021 Debt Service Suspension Initiative, and/or (iv) at war.

of outstanding debt and default in EMEs and therefore of their capability to repay loans, due to the potential presence of “Hidden debt”

The existence of this “Hidden debt” can be explained on the one hand by “underreported loans” which are loans not properly reported by the borrowers to the only global repository for debt information, the World Bank’s IDS.; on the other hand by “hidden loans” which include all Chinese lending into SOEs, joint ventures (JVs), and SPVs for which there is some degree of host government involvement, but without a formal guarantee.⁵ Closely related, “Hidden defaults” happen when an EME defaults on Chinese’s banks, particularly Chinese state-owned banks, when these defaults typically occur “silently”, without international coverage, in particular by rating agencies, and without disclosure of missed payments and restructuring details (see Horn, Reinhart, and Trebesch 2022).

As an answer to more frequent debt distress situations, China has started to provide rescue financing with a double approach: to low-income countries, China offers debt restructuring by increasing the maturity or grace period but without granting new loans; to middle-income countries China provides new rescue loans to avoid default. The probable explanation is that China’s lending portfolio is more tilted towards emerging markets and rescue lending is targeted at countries with high debt to China.

All in all, China’s lending trends show a shift towards more commercial loans which are project-oriented and characterized by less favorable lending conditions (interest rates, maturities, and grace periods). By now, the majority of Chinese borrowers are in debt distress and China provides them rescue loans further raising their debt-to-GDP ratios leading to debt sustainability concerns. This stimulates the question of why the EMEs borrow from China and what are the implications of project-oriented loans with respect to government debt lending for their economies.

Quantitative Model

Our modeling approach takes the perspective of the borrowing country. It aims at understanding the recent patterns in EME’s borrowing, by modeling a rational decision from the receiving country, rather than as a direct consequence of China’s policies.

We build a small open economy model, where the country must choose between two different ways of financing development. The model allows us to quantitatively weigh the costs and benefits of both approaches, from the perspective of the borrower.

In our baseline, we make no difference between private and public borrowing⁶. Instead, we assume that a central planner chooses alone the type and level of external financing.

First, the government has the ability to finance development projects itself. For this purpose, it borrows on international debt markets, at a world interest rate augmented by a risk premium. Every period, the government can default on the debt, at the expense of durably losing access to world financial markets. This part is very much in spirit with the regular sovereign default literature (see Eaton and Gersovitz 1981, Aguiar and Gopinath 2006, Arellano 2008, Mendoza and Yue 2012). In our framework, it represents the conventional vision of *fiscal space*.

Second, the state can choose to mediate international credits towards risky capital development projects. The risk and return characteristics of those projects stand for *local investment capabilities*. We assume that international investors take a direct stake in the projects and that repayment is indexed to the realized return on investment. The minimal return that is required ex-ante reflects the *preferences of international investors*.

⁵See Brautigam, Huang, and Acker 2020.

⁶The evidence is consistent with most of the external aid going to states and state-owned enterprises.

Finally, the social value of investment is linked in our model to the *degree of development* which we measure, in a neoclassical fashion, as the distance between the aggregate level of capital in one period to its long-term steady-state. This stands in stark contrast to other banking and default models (for instance Gennaioli, Martin Alberto, and Rossi 2014) where the balance sheet of the domestic financial sector is the main variable of interest but ignores the actual justifications for foreign lending, that is to foster development.

The closest paper to ours Kondo, Mkhitarian, and Sosa-Padilla 2021 studies the effect of China's lending on international sovereign debt markets. It does however assume that China's finance flow is exogenous from the perspective of the receiving countries. By contrast we explicitly model the choice between project-based financing and government borrowing.

To our knowledge, our model is the first to directly link the literatures on sovereign default and economic development. By doing so, we shed additional light on the recent trend in EMEs borrowing triggered by China's specific lending policies.

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