The Chinese Nightmare: Debt Risks Along the Silk Road

Matthias Diermeier, Florian Güldner and Thomas Obst

China has paid dearly for its geopolitical rise. The Corona crisis is the latest example of the risks involved with massive investment in the Silk Road. The megaproject, which is also known as the Belt and Road Initiative (BRI), was launched in 2013 to underpin the rapid expansion of China's economy by outbound investment beyond its own national borders. It encompasses infrastructure investments, development policies, investment and trade relations, and financial cooperation with the BRI partner countries. Moreover, it represents a crucial policy to foster China's geopolitical rise, i.e., by internationalising China's financial system and its currency, enabling a strong export-driven economy.

The recent pandemic has caused substantial economic downturn and led to an outflow of capital in many BRI countries. The outbreak adds a new hurdle to the trade and infrastructure programme by prompting delays and disruptions, e.g., through labour shortages caused by quarantine measures. This amplifies risks attached to financing investment projects in less politically and economically stable developing countries. However, not only are many countries caught in a Chinese debt-trap, but China itself needs a strategy for managing non-performing loans amid the crisis. Loan defaults on the Silk Road could jeopardise the Chinese mega-project.

China is facing the costs of global expansion

The rapid ascension of the Chinese economy to be the industrial hub of the global economy has not been without consequence for its competitors. Even in European economies, where China has long been courted for the promise of new markets, the tide has turned. The introduction of a European investment screening and the ongoing discussion about a new industrial policy reflect fears of Chinese economic policy, which is increasingly perceived as aggressive. And it is precisely now, in the Corona crisis, that concerns about (state-subsidised) takeovers by Chinese investors return to the forefront of the political agenda.

The US government, which does not shy away from pressuring allies to block Chinese competitors from their markets, has a long history of being openly critical of Chinese investments – illustrated by the examples of Huawei and TikTok. Protectionist arguments follow either security or competition policy considerations and are increasingly endorsed by mainstream European politicians.

Chinese financing is the next battleground

While China's increasing role in global manufacturing and world trade is well documented, their growing capital exports and their financing are largely obscure. Scholars struggle to quantify the level of private debt in China. In 2019, a World Bank estimate put it at more than 160 percent of GDP.

China's investment funding abroad is even less transparent. There are limited official data sources: reliable aggregate data from international databases is extremely scarce, and the Chinese government itself does not report on its international financing projects. In comparison to other large economies where foreign investments are largely funded by the private banking system, external loans from China are all granted by state-run banks. Thus, these loans are off the radar of rating agencies, generally complicating the evaluation of Chinese cross-border capital flows.

China is a global financial lender

Within the lively debate on the actual level of Chinese investments and their financing in emerging and developing countries, a recent study estimates that China has become one of the world's largest lenders over the past two decades, with outstanding loan claims amounting to more than 1.5 percent of global output.

What is more, the share of outstanding loans to China in emerging and developing countries exceeds the aggregate debt held by "Paris Club" governments – the informal body that traditionally negotiates distressed loans, with established economies acting as creditors. Nevertheless, recent estimates by different institutions and scholars concerning China's lending still differ and illustrate the difficulties in appropriately assessing the risk of outstanding debt.

Issues of incomplete data and/or different approaches to verifying outstanding debt (e.g., only counting actual disbursements or announcements) have contributed to the debate on the 'true' scope of Chinese lending. Also, the definition of what counts as public debt might be stretched and depends on how loans will be repaid.

China's foreign lending is of an unprecedented scale

Much of China's investment and credit comes from the giant project that the government decided to launch in 2013 in the context of demographic ageing, slowing domestic migration, declining returns on infrastructure investment, and declining competitiveness of manufacturing exports: the new Silk Road, or BRI.

In comparison with the Marshall Plan of the late 1940s ($130 billion, in today's figures), which contributed to Europe's post-war reconstruction, the importance of the BRI becomes evident: according to original plans, China is targeting investments amounting to $890 billion in the participating countries – nearly seven times the magnitude of the Marshall Plan.

These projects are financed through institutions created specifically for this purpose or existing entities upgraded with new responsibilities, some of which have already gained experience with foreign investments.

China's debt-trap diplomacy encircles the globe

For decades, China's investments in developing countries have been executed by the Export-Import Bank of China (Eximbank), the China Development Bank, and others. Chinese Banks granted $152 billion in loans to African countries between 2000 and 2018 alone. According to current figures from the World Bank, China currently holds about 17 percent of Africa's public debt. Chinese debt-trap diplomacy has become the buzzword for the corresponding dependence of many countries on China. Even in large BRI economies – such as Pakistan, Ethiopia, Kenya, Sri Lanka, and Belarus - Chinese debt alone accounts for 10 percent or more of national GDP. These dependencies come with Chinese political influence, but also a corresponding risk for the creditor in Beijing. Back in 2000, China was already forced to accept debt relief in Africa. And today, looking at the African continent, statistics already indicate considerable credit defaults.

Risks from the Chinese approach

Further risks arise from the COVID-19 crisis in emerging and developing countries, with the IMF expecting a lost decade in LIDCs. Many foreign investors have withdrawn their capital from these economies. Current estimates suggest that in March 2020 alone, capital flight will amount to about $83 billion – implying additional pressure on the respective country's exchange rates. Chinese creditors alone hold 25 percent of the debt in these countries.

Given the substantial new Silk Road investments, China faces structural challenges. By 2017, Chinese creditors had accumulated outstanding claims on BRI countries in the amount of $215 billion - equivalent to around 1.5 percent of China's rapidly growing GDP. In 2000, this figure was a negligible $0.64 billion; by 2013, it had risen to around $131 billion (about 1.4 percent of GDP).

The economic turmoil in recent months makes uncertain investments even riskier. In 29 BRI countries, one of the three major rating agencies (Moody's, Fitch, S&P) has either reviewed or downgraded their previous issuer ratings in 2020. In the case of Pakistan, the largest BRI debtor ($35 billion), even the rating, which is currently classified as "highly speculative", was reviewed for downgrade earlier this year. Ethiopia, whose Chinese debt amounts to over $14 billion, has already been downgraded from B1 to B2 within the same risk class. The deterioration in creditworthiness among China's debtors along the Silk Road affects a total of at least $90 billion; due to significant data gaps, the actual sum is estimated to be even higher. In addition, further devaluations are likely to follow.

Implications for the EU-China relationship

The BRI is one of the most important state-driven investment strategies to enhance China's influence abroad, including on the EU and its individual Member States (MS). It entails multiple economic risks and opportunities and reveals the importance of a dual approach – to view China both as a partner and a systemic rival. First, the EU needs its own strategy to counterbalance China's influence while maintaining economic openness. Current examples include the 2018 Europe and Asia connectivity strategy. They provide Europe with the opportunity to set leading global standards. However, they also require substantial financial resources from the state and the private sector.

Second, MS often act on bilateral agreements with China in their own national interest. This might lead to competing investment projects (e.g., 17+1 framework) and undermine institutional coordination in the EU. Third, state-subsidised investments carry risks of introducing market distortions, ultimately limiting business opportunities for European companies, as well as introducing excessive debt to MS. The EU has become more robust in approaching this issue, e.g., by introducing investment screening mechanisms and targeting foreign subsidies by third countries.

Could Chinese debt diplomacy become a debt nightmare?

While it is argued that there is no reason for concern about China's high debt (e.g., because of the high domestic savings rate), it must be clear that China's growth model is strongly driven by credit expansion; its investments are highly risky. Additionally, the collapse of domestic economic growth in the first half of the year resulted in a need for a gigantic economic stimulus package.

Due to the existing debt overhang and the associated credit risks, the Chinese government this time has chosen the path of fiscal policy to stabilise the economy after the outbreak of COVID-19, instead of renewed credit expansion as during the 2008 financial crisis. This makes it clear that more than "just" billion-dollar investments are at stake for China. On the Silk Road, China must undertake a structural decision to either write off, restructure, or refinance loans. Behind this, however, is the question of the sustainability of the Chinese growth model. It could turn out that China will have to pay a high price for its geopolitical rise.

Matthias Diermeier, Florian Güldner, and Thomas Obst *work at the directorate of the German Economic Institute. Matthias Diermeier and Thomas Obst are the personal assistants to the Director. Florian Güldner works as a research assistant. Their work focuses on macroeconomics and globalisation.*

A former version of this article was first published by the German Economic Institute (IW) and you can find the full paper here.

This publication receives funding from the European Parliament.

Editor: Dr. Eoin Drea

Wilfried Martens Centre for European Studies
Rue du Commerce 20
Brussels, BE – 1000
http://www.martenscentre.eu