CIVIC IDEA

NED NATIONAL ENDOWMENT FOR DEMOCRACY — SUPPORTING FREEDOM AROUND THE WORLD

CAPS unlock — CENTRAL ASIAN POLICY STUDIES

THE HIDDEN TRAPS OF PRC'S DEBT POLICY

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In this paper, we aim to provide a concise overview of the key issues surrounding China's credit policy, illustrated with examples from various countries.

Why is it relevant to us?

The Georgian Dream government highlighted the increased potential for receiving credit from China as a significant achievement of the July 2023 strategic statement. According to the strategic partnership agreement, "China will study the provisions of preferential loans for Georgia's implementation of social and infrastructure projects."

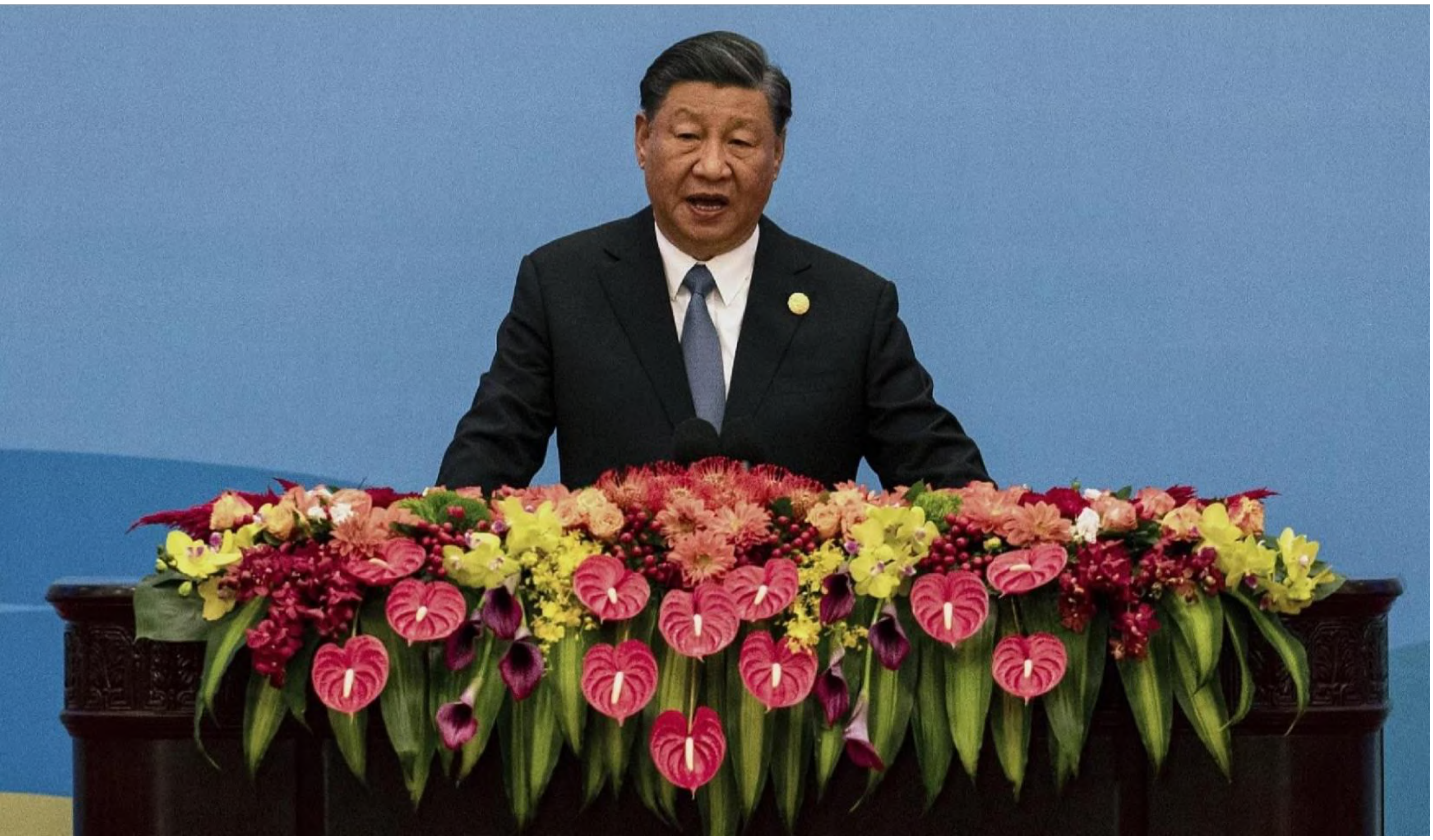
The primary challenges countries encounter when obtaining substantial credit from China include:

- Lack of transparency in agreements;
- "No Paris Club";
- difficulty of debt restructuring;
- Cross-default clauses;
- Collateral arrangements.

INTRODUCTION

In 2013, the PRC's President Xi Jinping introduced the Belt and Road Initiative (BRI), a visionary plan also known as the New Silk Road. This initiative laid the groundwork for a vast infrastructure plan, aimed at establishing two significant trade corridors connecting China with the rest of the world. The BRI seeks to create a self-sustaining market for China while enhancing its political and economic influence globally. Over the past decade, the initiative has expanded to include numerous countries across Africa, the Asia-Pacific region, and Latin America. Remarkably, around 147 countries have either signed agreements or expressed interest in participating in the Belt and Road Initiative.

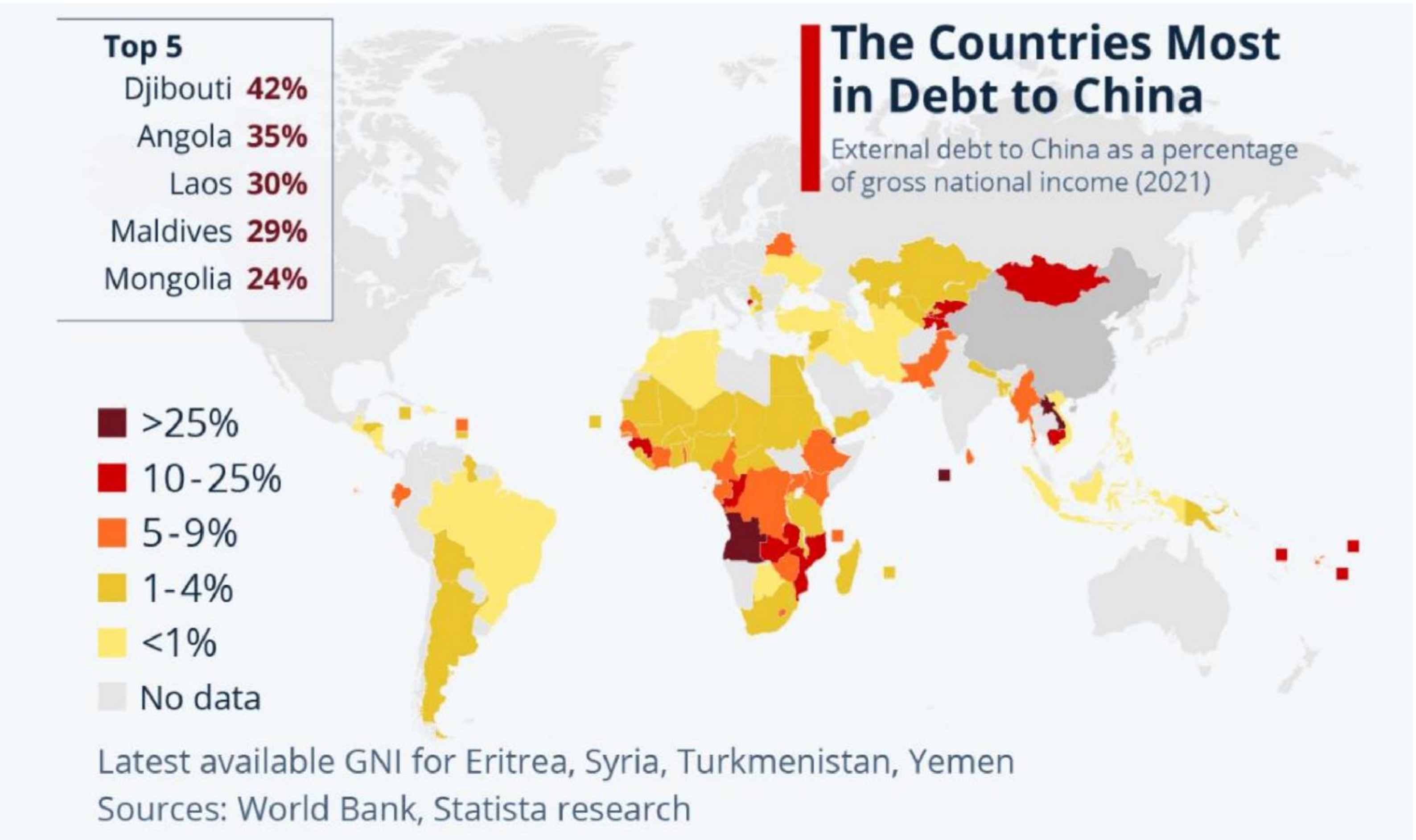
In 2023, at the Belt and Road Forum, the President of the People's Republic of China, Xi Jinping, mentioned that Chinese banks, in particular, the China Development Bank and the Export-Import Bank (Eximbank), planned to provide financing worth 350 billion yuan. While this announcement appeared promising for many developing countries involved in the initiative, Indonesian President Joko Widodo highlighted underlying concerns. He cautioned that Belt and Road projects “should not complicate (countries') fiscal situations”, bringing to light the apprehensions shared by many developing countries.



Source: https://www.euronews.com/business/2023/10/18/china-announces-billions-ininvestments-in-developing-countries-and-pledges-market-opening

THE LARGEST "DEBT COLLECTOR" COUNTRY

In terms of financing international development, China has emerged as a dominant player, particularly since 2013, when it began actively extending loans to developing countries. Between 2013 and 2017, China surpassed the United States in terms of the volume of funds provided to low- and middle-income countries. By the end of 2022, the external debt from China to these countries reached $180 billion. However, many of the recipient nations are now struggling to repay these loans. Notably, 55% of China's loans to low- and middle-income countries have already entered the principal repayment period, and numerous debtor nations are finding it difficult to meet their obligations. Consequently, China's role is shifting from a lender to a debt collector. This transition poses a significant challenge to China's foreign policy narrative, as Beijing traditionally frames its lending practices as acts of goodwill.

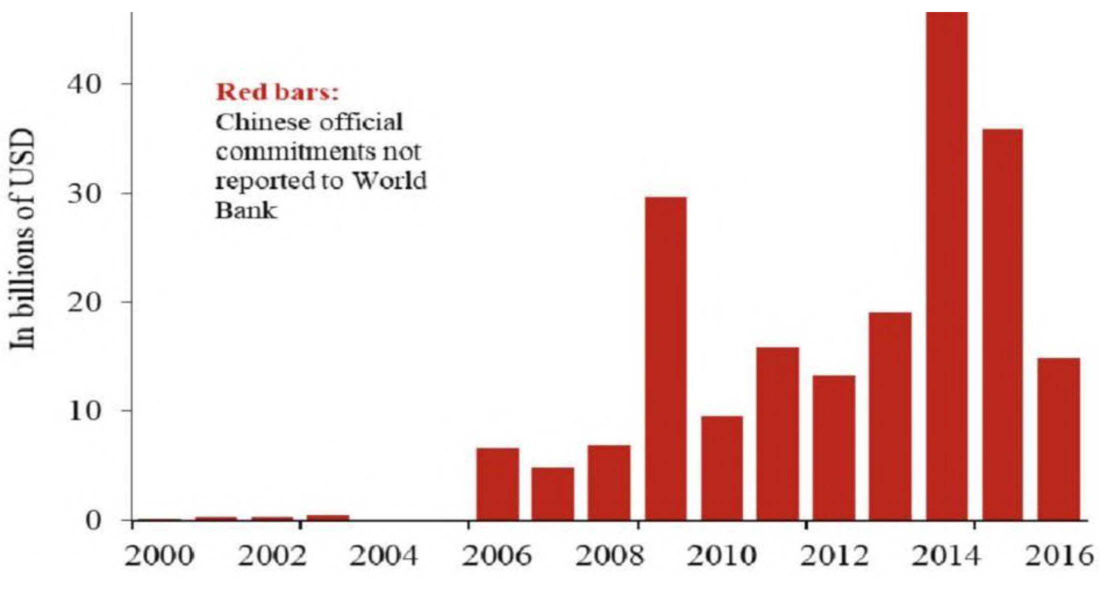


Source: https://www.statista.com/chart/19642/external-loan-debt-to-china-by-country/

THE 'CONFIDENTIALITY' OF THE PRC'S FOREIGN LOANS

China's lending policy stands out from many other bilateral and multilateral credit institutions due to its lack of uniformity and consistency. External debt is primarily extended by Chinese state entities such as government institutions, state-owned banks, and state-owned companies, each operating with their own lending policies and instruments. Generally, these entities follow a profit-maximizing approach in their official foreign lending decisions, distinguishing China's debt issuance practices from those of other multilateral institutions. This approach can be traced back to a strategic shift in China's foreign economic policy since 1999, driven by the country's interests. The catalyst for this new strategy was the anticipated challenges from a trade surplus, which led to an influx of foreign exchange reserves. This surplus raised concerns about inflation and currency appreciation. To mitigate these risks and foster domestic economic growth, the Chinese government decided to invest its foreign exchange reserves abroad. This move marked the launch of the "Going Out" strategy, significantly increasing China's foreign lending activities.

Grant T. Harris, advisor to former President Barack Obama mentioned, "the uniqueness of Chinese loans is in the secrecy of their terms". A key feature of official credit agreements with Chinese government institutions is their confidentiality. These agreements often include clauses that keep the terms—and sometimes the very existence—of the contract secret. By 2018, less than 50% of the loans granted by the PRC to various countries were reported in the World Bank's Debtor Reporting System. Additionally, China itself does not publicly disclose detailed information about the total amount of loans it has issued.



Source: https://www.sciencedirect.com/science/article/pii/S0022199621001197

Непрозрачность китайских займов проблематична с двух точек зрения:

. The lack of transparency in China’s lending practices raises significant concerns for two main reasons:

1. Firstly, public access to information about state debt is a fundamental right. Taxpayers are entitled to know how much of their budget is allocated to repaying foreign debts.

2. Secondly, on the international stage, other lenders need clear and accurate data on a country’s economic status to make informed decisions about providing loans.

Due to its practice of confidential lending policies, China often holds a strategic advantage over other bilateral and multilateral lenders.

ECUADOR

For more clarity, let's recall the example of **Ecuador**. On April 25, 2016, the Ministry of Finance of Ecuador and the China Development Bank signed a loan agreement. Shortly after its signing, investigative journalists in Ecuador released a video detailing the terms of the loan, sparking widespread public outcry and debate over the appropriateness of the debt. Ecuadorians expressed dissatisfaction because the terms of the loan agreement seemed heavily skewed in favor of Chinese interests and were largely obscured. Specifically, the loan agreement was tied to an oil purchase arrangement between Ecuador and Chinese companies. This case highlighted that China's loan agreements are often opaque, leaving taxpayers uninformed about the terms under which their country receives Chinese foreign loans, except in rare instances.

After the aforementioned incident, the China Development Bank invoked the confidentiality clause and sent a letter to Ecuador's Ministry of Finance requesting an investigation into the incident and seeking to mitigate the reputational damage caused. Importantly, the bank's communication included an implicit threat that failure to address the issue adequately could jeopardize Ecuador's ability to access planned financing in the future.

„NO PARIS CLUB”

China's debt default challenges in developing countries are compounded by the difficulty of conducting direct negotiations with the People's Republic. Many agreements signed with Chinese credit institutions include a clause known as "**No Paris Club**," which effectively prevents debtor states from seeking debt restructuring through the Paris Club[1]. Membership in the Paris Club requires transparency in foreign debt disclosures, a requirement that China's official lending policy avoids by not participating in the club. This stance gives China a significant advantage over other creditors and the debtor country itself. On one hand, international lenders lack comprehensive information about China's foreign debts. On the other hand, developing countries facing repayment difficulties must renegotiate directly with China, which holds considerable leverage to protect its own interests.

During bilateral negotiations with China, instances have shown that debtor countries struggle to safeguard their interests, as some have had to relinquish portions of their territory or sovereignty to Beijing in exchange for debt relief.

[1] The Paris Club is an informal group where creditors negotiate debt terms or restructuring with debtor countries.

SRI LANKA

In 2010, Sri Lanka encountered difficulties in repaying debts related to the construction of the Hambantota port by a Chinese company. By 2017, Sri Lanka signed a 99-year lease agreement with China Merchants Port, effectively privatizing 70% of the port to the Chinese company.

Workers hold a Chinese flag at Hambantota port in Sri Lanka on Aug. 16, 2022.

TAJIKISTAN

By 2022, 60% of Tajikistan's external debt originated from loans provided by the Export-Import Bank of China. Tajikistan serves as a prominent example of a low- or middle-income country heavily reliant on Chinese foreign loans but ultimately unable to repay them. In Tajikistan's case, defaulting on its debt led to the cession of part of its territory or sovereignty. In 2011, the country transferred 1,000 square kilometers of land near the Pamir mountain range to China, which was portrayed by both parties as resolving a longstanding border dispute, albeit at a time when China was Tajikistan's largest investor. In 2019, it came to light that a secret Chinese military base had been operational since 2017 in Tajikistan's mountainous Badakhshan province, located 12-14 kilometers from the Tajik-Afghan border—a strategically significant location for China's Belt and Road Initiative. Additionally, in 2016, the Chinese company TBEA completed the construction of a 400-megawatt power plant in Dushanbe, a project valued at $349 million, with Tajikistan contributing only $17.4 million. Subsequently, in 2019, due to non-payment of debt, Tajikistan granted a Chinese company (TBEA) the rights to exploit gold deposits in the northern part of the country.

MONTENEGRO

In 2014, Montenegro and China reached an agreement on a railway project linking the Montenegrin coastal city with the Serbian capital, Belgrade. Under this agreement, Montenegro received EUR 800 million from China's Eximbank. Despite economic concerns surrounding the project, both parties continued their collaboration. As of 2021, China's foreign loans to Montenegro totaled $994 million, a significant sum for Montenegro's small economy. It's worth noting that the 2014 agreement allows China the right to control portions of Montenegro's territory or assets as collateral in case of default.

CHINA'S STATE MECHANISMS TO ENSURE REPAYMENT OF FOREIGN DEBTS

Many of China's loan agreements include "cross-default" clauses, which impose economic and political restrictions on the debtor. According to these clauses, if the debtor country fails to fulfill other obligations beyond the specific loan agreement, it triggers a default. It is important to note that in many instances, these "other obligations" refer to:

- Other projects funded by the PRC.
- Diplomatic severance with the PRC.
- Major political changes in either the debtor or creditor country.
- Changes in legislation, and so forth

Each of these conditions, along with similar circumstances, is deemed grounds for contract termination. Naturally, this clause enhances China's political influence in developing countries and limits the debtor country's choice.

KYRGYZSTAN

An illustrative instance is the 2015 agreement between Kyrgyzstan's Ministry of Finance and China's Eximbank. According to this agreement, if a substantial change in the debtor or creditor country renders it unable to meet the obligations stipulated, the lender reserves the right to cease financing at any time and demand repayment of the debt.

China's lending policy is characterized by loan collateral provisions that may imply

- liens,
- escrow,
- special accounts.

In the case of China's state-owned banks, the loan collateral is generally in the form of a deposit or special account.

ECUADOR

An agreement signed in 2010 between the China Development Bank and Ecuador's Ministry of Finance stipulated the establishment of a special account as collateral under the control of the Chinese side.

UGANDA

The agreement signed in 2015 stipulates that in the event of default, the airport will be transferred to China. Also, the agreement includes a clause according to which airport revenues are deposited into a specific escrow account and transactions are monitored by Eximbank of China.

Any dispute under this Agreement, whether litigated or arbitrated in the PRC, shall be governed by the laws of the PRC. [2]

THE COMMERCIAL NATURE OF CHINA'S LOANS

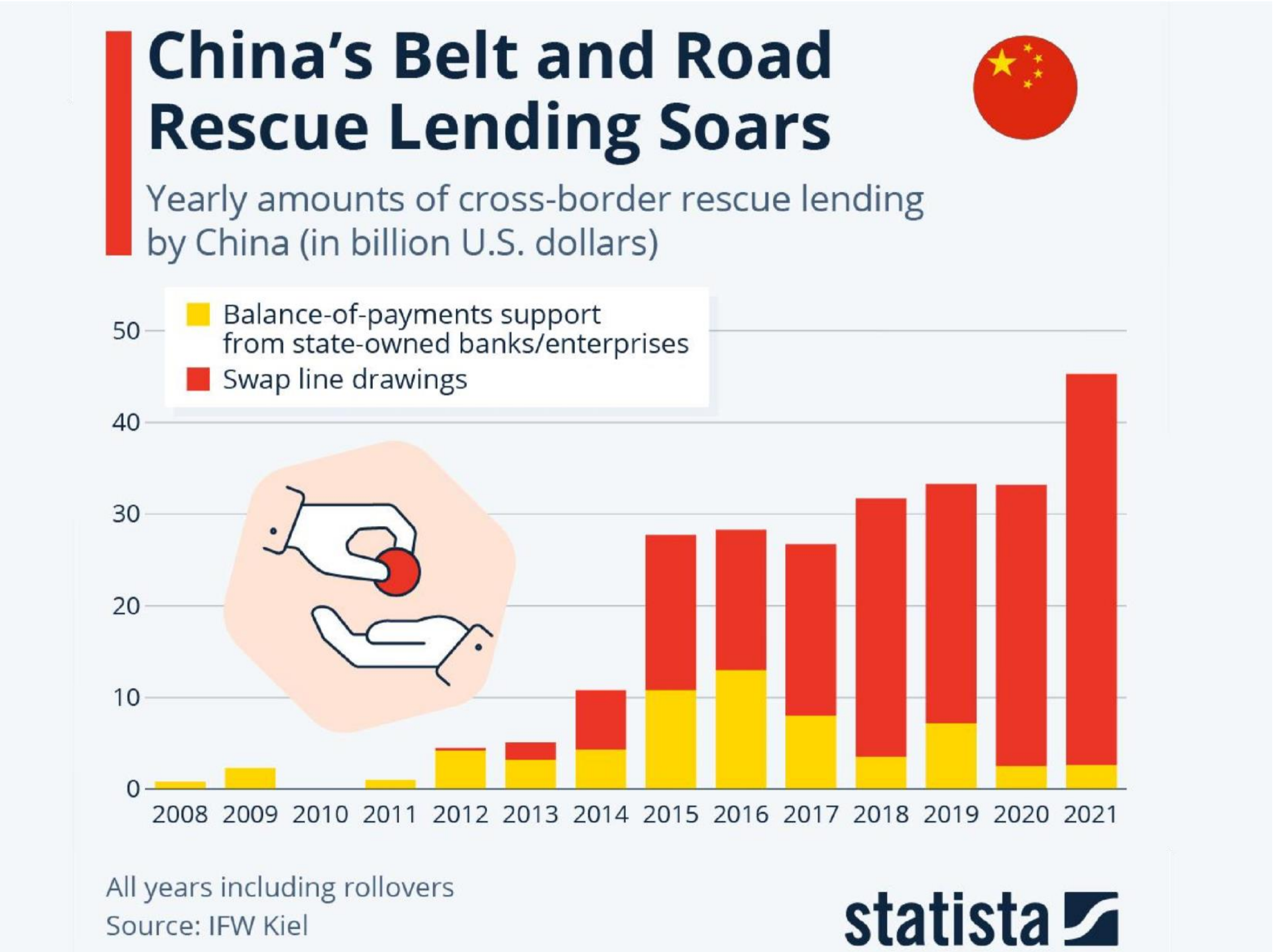
The clauses outlined in China's loan agreements underscore the commercial nature of its loans. Consequently, China operates independently from multilateral institutions such as the World Bank and the International Monetary Fund. Interest rates on China's government loans to low-income countries typically range from 2-3%, whereas the aforementioned multilateral lenders predominantly offer loans at 0% interest. For middle-income countries, China's foreign loans align more closely with market-based conditions. For example, in 2010, Ecuador secured a $1.7 billion loan from China's Eximbank, which carries a 7% interest rate and is repayable over a 15-year period.

It's important to highlight that unlike China's foreign loans, 70% of the funds provided by creditor states within the Paris Club to low-income countries are disbursed as official development assistance. This includes preferential loans with at least a 25% grant element. Additionally, the USA, as a major player in international development financing, often provides grants to its partners, particularly in military and economic cooperation contexts. Consequently, there are notable differences between the practices of the People's Republic of China and Western lenders in international development financing.

[2] Like other agreements, the 2015 agreement is naturally confidential. However, the media's information is derived from Joel Ssenyonyi, chairman of the Ugandan parliament committee, who proposed the agreement in parliament

CHINA AS A "LENDER OF LAST RESORT"

In light of China's debt repayment difficulties in developing countries, the People's Republic has increasingly made emergency/relief loans, making it a "lender of last resort". By 2022, the amount of China's extraordinary loans has reached 40 billion dollars. As a result of the mentioned approach, China competes with such multilateral institutions as the International Monetary Fund, because providing aid loans to countries in crisis was mainly the prerogative of the mentioned institution. And reducing dependence on Western institutions allows the People's Republic of China to gain more political influence in the developing world.



Source: https://www.statista.com/chart/31150/yearly-amounts-of-cross-border-rescuelending-by-china/

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