What Risks May Lurk: China’s Investments and Lending in Emerging Democracies

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One need not look far to find news stories today about China’s overseas ambitions. Barely a month passes without another headline announcing yet another China-funded project in yet another country with so many billions of dollars that one can’t help but wonder if the newspaper editors included extra zeros by mistake. The extension of state-driven loans and investment into emerging markets is an increasingly common element of China’s foreign policy, and from the year 2000 to 2017, capital exports from China grew exponentially in regions across the globe. Indeed, China recently emerged as the world’s largest official creditor.

It is well documented that state-driven capital from authoritarian governments often corrodes democratic governance in emerging markets that receive it. CIPE calls this “corrosive capital” – state-driven capital from authoritarian governments flowing into the world’s new and struggling democracies.

There is considerable evidence that China seeks commercial concessions, asset control, resource extraction and political leverage in emerging markets. This underscores the urgent need for the democracy community to respond. If advocates for democracy fail to address the corrosive effects on governance in new and struggling democracies of capital exports from authoritarian states, such corrosive capital flows will degrade the very democratic institutions that emerging markets have worked so hard to build.

**China is the World’s Largest Official Creditor**

China’s direct loans overseas exceeded $1.6 trillion in 2018, up from almost zero in 1998. Unlike today’s other major economies, nearly all of China’s overseas lending and investment is official, rather than private, meaning it is directed by the Chinese government or the Chinese Communist Party (CCP).¹ This makes China, by far, the world’s largest official creditor.

In contrast, the vast majority of American, Japanese, and Australian overseas lending and investment is private, meaning the capital originates in non-governmental for-profit companies.

China’s direct loans overseas go predominately to low income developing countries (LIDCs). So much so, that the Chinese state now

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accounts for 25 percent of all lending to these emerging markets, and China now holds an average of 40 percent of these countries’ total outstanding debt. For perspective, these countries are far more indebted to China than to all other official creditors combined.

The term “debt-trap diplomacy” was coined by Indian academic Brahma Chellaney in his description of China’s lending practices in which poor countries would be overwhelmed with unsustainable loans and would be forced to cede control of strategic assets to China. Several features of Chinese capital exports lend credence to this term, including the secrecy


FIGURE 1: Debt Owed to China vs Debt Owed to Other Official Creditors

Source: Horn, et al. 2019
surrounding Chinese capital exports, the terms of Chinese credit facilities, and the collateralization of Chinese loans with recipient country sovereign resources. These features of Chinese capital exports, described in greater detail below, help explain why state-driven capital from authoritarian governments can corrode democratic governance in emerging markets that receive it.\textsuperscript{5,6,7}

These features of Chinese capital exports, and the adverse governance outcomes they engender, differ greatly from other official lenders of today.

**Hidden Debt**

There is a widely-held belief that loans from China are desired by emerging market governments because Chinese loans come with “no strings attached” as opposed to loans from the World Bank and democratic donors that involve difficult questions about human rights and corruption. This is false. The “strings” attached to loans from China are simply different.

Among the most common characteristics of debt from China is the requirement that projects funded by Chinese capital be sole sourced to Chinese firms (often in violation of local procurement laws). Other commonly encountered characteristics of Chinese capital exports include the mass importation of Chinese laborers (often in violation of local labor and immigration laws), China requiring dominant equity shares of projects, or intelligence sharing.\textsuperscript{8}

The attachment of conditions on commercial loans from China that conflict with local laws in the recipient country highlights what is perhaps the most problematic characteristic of Chinese loans – secrecy. The terms of loans from China are rarely available to the public, especially while the terms are being negotiated.\textsuperscript{9} Indeed, keeping the terms of Chinese loans hidden from the public is often an explicit condition of the loan terms themselves.\textsuperscript{10} This precludes

\textsuperscript{5} Isaksson and Kotsdam (2016) *Chinese Aid and Local Corruption*

\textsuperscript{6} Kishi and Raleigh. *Chinese Aid and Africa’s Pariah States*

\textsuperscript{7} Pei, Minxin (2018 NED Journal of Democracy). *A Play for Global Leadership*


\textsuperscript{9} “Governance of International Financial Aid in State-Owned Infrastructure Companies – Argentina,” CIPPEC, 2018, 34.

\textsuperscript{10} Rivas, Ralph. “Made in China: Loan Terms with Waivers, Shrouded in Secrecy,” *Rappler*, March 27, 2019
any external checks and balances to hold the recipient government accountable. As these external checks and balances are already weak in most developing democracies, this is an example of authoritarian capital flowing through governance gaps in recipient countries.

This issue of secret debt from China is immense in scale, as approximately half of China’s overseas direct lending is “hidden.”¹¹ Neither the World Bank, the IMF, nor private credit rating agencies can report on these hidden debt stocks of dozens of emerging market countries. The Chinese government does not release data on its international lending activities, nor on the activities of its proxy state-owned firms. “The problem of ‘hidden’ Chinese debts is particularly severe in crisis countries such as Venezuela, Zimbabwe, and Iran. Indeed, China does not report any bank claims towards these countries.


**FIGURE 2: Why China’s Overseas Lending is ‘Hidden’ From View**

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<td>Data reported by debtor country. Gaps if recipient is public company (50% of Chinese loans missed).</td>
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<td>Paris Club/OECD</td>
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<td>China is not a member (China does not share data on its official lending and debt abroad).</td>
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<td>Trade Credit Agencies (Berne Union, OECD)</td>
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<td>People’s Bank of China</td>
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Source: Horn, et al. 2019
to the BIS (Bank for International Settlements), despite substantial known lending flows over the past 15 years.”

“The debtor countries themselves have an incomplete picture on how much they have borrowed from China and under which conditions.” In addition to the corrosive effects on democracy, the rule of law, and human rights of this ‘hidden debt’ from authoritarian lenders, the potential market distortions it engenders cannot be overstated. If a large fraction of a country’s sovereign debt is unknown, the price of the country’s debt (i.e. interest rates) will not accurately reflect the risk of that debt. Disconnects between the price of risk and the true level of risk have contributed to countless financial crises throughout history, including the 2008 financial crisis that emanated from U.S. banks. The threats to the world economy posed by this growing deluge of hidden debt flowing into emerging markets are further explained below.

Previous CIPE reports described an example of “hidden debt” in Argentina, where an ongoing CIPE project documented billions of dollars in previously undisclosed loans by government ministries from state-owned banks in China. The public works that were financed by these loans were not competitively bid, but rather were sole sourced to state-owned companies in China. As these were commercial (not concessional) loans, this circumvented Argentine procurement laws, along with Argentina’s environmental and labor codes. Most troubling is that these sovereign loans remain off-the-books, meaning they are not reflected in Argentina’s sovereign debt ledger. Given that CIPE’s review of corrosive capital in Argentina was not intended to be exhaustive, it is unlikely that Argentina’s hidden debts to China are limited to the cases CIPE identified.

**Hidden Debt, and the Corrosion of Democratic Governance**

Transparency in public finances is at the heart of democratic governance. *Knowing how their government is spending money empowers citizens to move from passive consumers of government decision-making to active participants in the definition and delivery of those decisions.* Therefore, the utter lack of

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12 Ibid.
13 Ibid.
14 CIPE. *Channeling the Tide.* 2018.
transparency surrounding the inflows of capital from China into emerging markets are among the primary ways that democratic institutions in recipient countries are undermined, human rights are ignored, and governments are manipulated.

Sri Lanka’s Hambantota port provides an example. In this much-publicized case, then President Mahinda Rajapaksa secured loans on commercial terms from a state-owned Chinese bank for a port in Rajapaksa’s home district. The loan terms were negotiated in secret, construction of the port was sole sourced to a state-owned firm from China, and was implemented despite feasibility studies that questioned the economic viability of such a port. The Rajapaksa government agreed to several loan revisions sought by China, such as higher interest rates, and the Chinese construction company gave several million dollars to Rajapaksa’s political campaigns. When the debt burden become untenable for Sri Lanka, the government acquiesced to China’s demands that the Hambantota port and 15,000 acres of adjoining land be ceded to the People’s Republic of China.

As a result of Sri Lanka’s inability to service its Chinese-held debt, for the next 99 years the CCP will possess a deep-water harbor on the Indian Ocean. Similarly in Pakistan, the CCP will possess the port of Gwadar for the next 40 years. China “will get a 91 percent share of the revenue from the operations of the [Gwadar] port and 85 percent of the revenue generated by the [adjacent] free zone.” These strategic territories in Sri Lanka and Pakistan join Chinese territories in Djibouti, Vanuatu and the string of artificial islands China is constructing across the South China Sea.

The modern-day cases of Sri Lanka, Pakistan and elsewhere demonstrate how “foreign financial and economic enterprises have political consequences, when connected with a national policy of the lending state.”

There is mounting evidence of China using the indebtedness of emerging markets as a cudgel to coerce policy decisions. For example, in

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16 Abi-Habib, “How China Got Sri Lanka to Cough Up a Port.”
17 Center for Strategic and International Studies. *Pakistan’s Gwadar Port: A New Naval Base in China’s String of Pearls in the Indo-Pacific*. April 2, 2018
January 2018, China’s ambassador to Vanuatu unequivocally stated China’s expectations of countries to which it lends money. In this case, the expectation was for Pacific nations to support Chinese positions at the UN and in the region. Around that same time, Papua New Guinea downgraded its relationship with Taiwan under pressure from Beijing, a worrisome move by the largest country in a region that is home to one-third of Taiwan’s diplomatic partners.

This does not suggest that China seeks to fully and formally colonize other nations. However, it does demonstrate how the submersion of a...
weaker state in debt owed to a stronger one provides a path for a foreign power to gain political influence.

**The World’s Largest Loan Portfolio**

Theories abound as to the motives underlying China’s “going out” geopolitical strategy. And the country’s repression of information and suppression of public debate largely precludes an examination of how the myriad pieces of China’s outbound strategy, such as state-owned banks and state-owned industrial conglomerates, are centrally coordinated by Beijing.

Regardless of the CCP’s strategic motive, certain facts about China’s overseas ambitions are indisputable: China is the world’s largest official creditor (meaning the loans are directed by the Chinese government), its direct loans go predominantly to emerging markets, and China is driving the debt levels of these developing nations to unsustainable levels. Moreover, a growing volume of literature documents the corrosive effects Chinese capital can have on democratic governance and human rights in many developing nations that receive it. Most worrisomely, there is also growing evidence of China utilizing its loans to poor countries as a means of extracting resources, seizing territory, and manipulating the foreign policies of debtor nations.

While China’s tactics with regards to its overseas lending are not unprecedented, the sheer volume of the overseas lending by the Chinese state is. With the overwhelming majority of Chinese overseas lending being directed by the state, and with the overwhelming majority of those loans being commercial (rather than aid, as it is often portrayed), the Chinese government is the single largest lender on earth.

In the world’s advanced economies, Chinese lending mostly comes in the form of bond purchases. In this respect, the market and regulatory institutions in those countries require China to operate by (largely) the same rules as any other lender or investor. However, China’s lending to emerging markets is almost entirely in the form of direct loans. In fact, the 50 countries most indebted to China, in terms of GDP ratio, are all emerging markets. Some 34 of those 50 emerging market nations are low income developing countries (LIDCs), and 19 are former highly-indebted poor countries (HIPC who

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21 “Global Chinese Official Finance Dataset,” AidData, 2017, Version 1.0
benefitted from large-scale official debt relief in the 1990s and 2000s. These 19 HIPC countries that are among the most heavily-indebted nations to China comprise more than half of the total number of HIPC countries.

For the 50 countries that receive the most direct loans from China, debt stocks owed to China soared to an average of 17 percent of GDP in 2016, up from less than 1 percent of GDP in 2005. For these countries, debt to China now accounts for more than 40 percent of total external debt, on average. In fact, today’s debt levels in the developing world are “dangerously close” to their levels prior to HIPC.22 Furthermore, more than 40 percent of this debt owed to China is not reported in the official statistics of the debtor countries. In other words, almost half of the debt these countries owe to China remains “hidden” from any public review.

Notwithstanding these immense democratic and economic risks, the impacts of China’s expanding global presence are not entirely negative. Far from it. China’s overseas spending and lending, much of which falls under the broad and imprecise rubric of the “Belt and Road Initiative,” have helped finance infrastructure investments in dozens of developing countries around the world. These countries need this capital, and China can play a critical and irreplaceable role in meeting this need. Furthermore, the scale of China’s capital exports is so immense, and its annual growth rate has been so rapid, that these capital flows will certainly not stop, even if select governments or international organizations want it to.

But when huge amounts of money flow, in secret, into emerging markets where governance is already weak and corruption is already rampant, and when that capital is backed by authoritarian governments not bound by market pressure, the governance distortions caused in recipient countries can outweigh the economic benefits.

For example, the Wilkinson Road project in Sierra Leone was financed by a commercial loan from a Chinese state-owned bank. There was no competitive tender for the construction, and no independent price analysis was conducted. As a result, the government of Sierra Leone paid $4 million per kilometer for the Wilkinson Road project, compared with the average expenditure for similar projects of $600,000 per kilometer. The Deputy Speaker of the Sierra Leonian

Parliament and Chairman of the Public Accounts Committee, Sengepor Solomon Thomas, called this the “most expensive road in the world.”

**World’s Largest Loan Portfolio + Hidden Debt = Risk to Global Economy**

When the largest lender on earth operates its loan portfolio with no transparency or accountability, risk is not only concentrated; it is amplified. The ongoing COVID pandemic, and the accompanying fiscal distress on the part of governments around the world, highlights this risk.

In the event of a sustained economic downturn, there is a real possibility that the world’s largest lender would need to call in its direct loans (which again, are largely concentrated in LIDCs). Given that Chinese-held debt is almost entirely “off-the-books” in emerging markets, and the ability of LIDCs to service foreign debt is, on the best of days, tenuous, this would not merely be a problem for emerging markets, but for the entire interconnected global economy.

The implications for the worldwide economy were honestly assessed in a May 2020 article by Zhu Xiaohuang, Chairman of CITIC, a Chinese state-owned financial conglomerate. This article describes China’s “massive debt exposure overseas” and the resultant risk of widespread “debt defaults [as] the biggest challenge faced by BRI since its creation.” The author goes on to explain how “this risk will not be confined to developing countries, but will inevitably spread to the world.”

“If China’s role in international finance continues in the shadows, global risk assessments and country management [of liabilities] will remain dangerously incomplete,” adds the Harvard Business Review.

**Concluding Observations**

There is considerable evidence that China seeks commercial concessions, asset control, resource extraction and political leverage in emerging markets across Asia. This paper documents that China is utilizing state-driven and politically-motivated capital exports to gain leverage.

Given that the China is now the largest official creditor on earth, and given that most of the

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world’s low income developing countries are borrowing more money from China than from all other official lenders combined, no country is subsuming emerging markets in debt as much as China today. As explained above, this concentration of debt in the hands of an authoritarian government, combined with the secrecy of its loans and the pre-existing fiscal challenges of the emerging markets to which it lends, poses obvious threats to the global economy.

The democratic threats of these corrosive capital flows are equally obvious. The adverse effects on democratic governance of corrosive capital in new and struggling democracies, combined with the massive scale of China’s overseas lending, underscores the systemic threat to democracy posed by corrosive capital. It is likely not a coincidence that this trend – the growth of corrosive capital flowing into emerging markets – coincides with the equally alarming trend of democratic backsliding. If this systemic threat is not addressed, corrosive capital could irrevocably damage the very democratic institutions that emerging markets have worked so hard to build.