DISCUSSION PAPER

Is China Creating Debt Traps in the Developing World?

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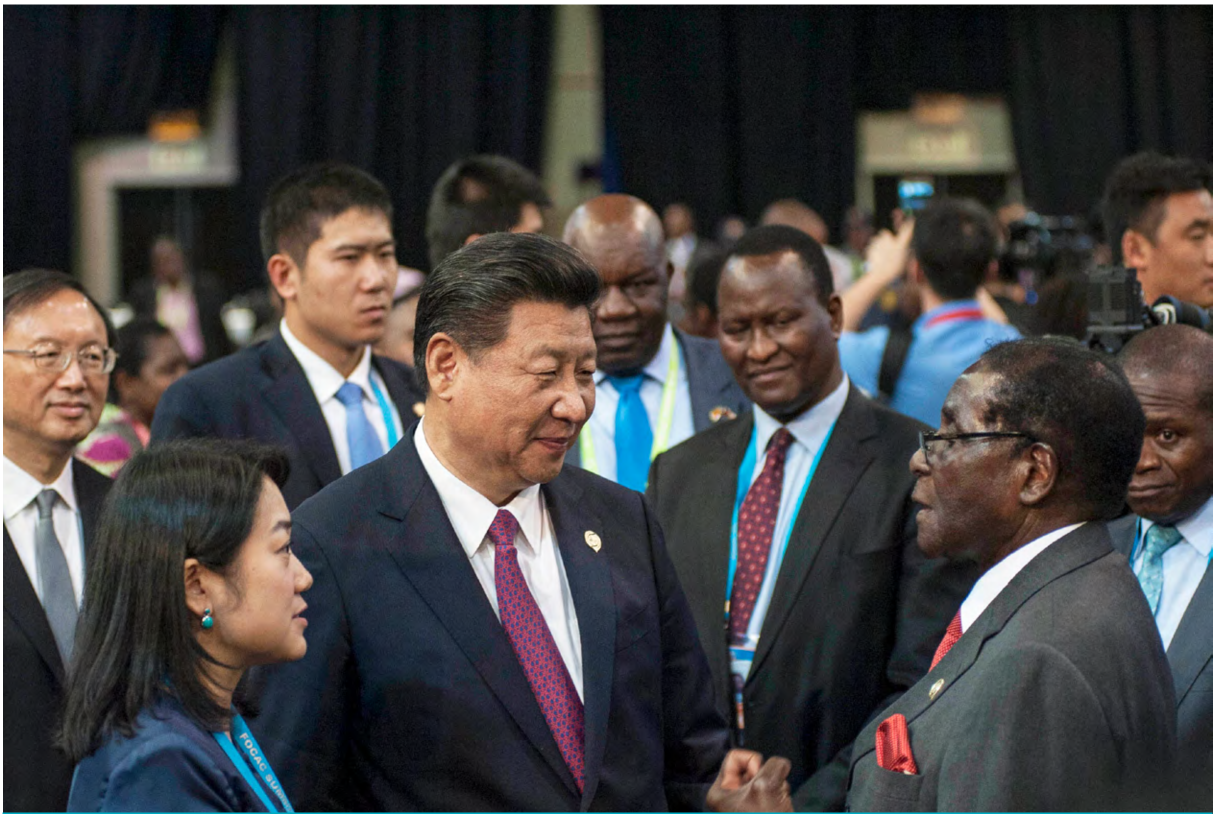
Introduction

There has been increased discussion regarding China's financial relations with developing countries in recent years. The US State Department, along with a number of analysts accuse China of pursuing what is referred to as "debt-trap diplomacy" in developing countries. Poor nations, they say, have been borrowing heavily from China, and Beijing is abusing this situation for geopolitical and economic advantage. Some even claim that this is a new form of colonialism whereas others see Chinese engagement with the developing world as an opportunity. This paper provides a summary of this discussion as well as a reflection on how this recent and ongoing process should be understood from the perspective of developing countries. The analysis involves claims about how the IMF and the US have also done the same for decades and, depending on developing country governments' degree of autonomy, a competition between Western funders and China can be seen as an opportunity for African countries.

It is evident now that China is gradually becoming a major actor in global politics. It continues to build new economic and political ties in various regions ranging from Africa to Central Asia and the Middle East to Europe. Economic relations with developing nations mostly involve the sale of China's manufactured goods and the purchase of primary products by China. However, in the last two decades China's economic ties to the developing world have moved beyond trade and have started to also include both finance and direct investment. China continues to extend increasing amounts of credit to poor nations, most of which is used for building infrastructure, which often also undertaken by Chinese companies. These Chinese investments and infrastructure projects in developing countries have of course contributed to these countries' economic growth and have been mostly welcomed by their governments.

However, there are also rising suspicions of a possible hidden agenda in China's growing financial relations with the developing world. According to the American government, this is part of China's larger geostrategic plan; Beijing is creating "debt traps" for poor developing countries, especially in Africa, thereby increasing its influence in those regions. Specifically, debt-trap diplomacy refers to a situation where a rich country or institution allows a poor country to borrow excessively in order to increase its leverage in bilateral relations. The debtor party extends credit, knowing that it will never be paid back, so as to trap the borrowing country in a weak position. The debtor country then abuses this situation to take over strategic assets, acquire economic and political concessions, and advance its geostrategic agenda. Both the Obama and Trump administrations have accused China of doing exactly this.

Perverse financial practices are not an invention of the Chinese government. The US government and international financial institutions such as IMF, World Bank, or WTO, have been using their financial power over poor nations to gain political and economic concessions for a long time. Now, there seems to be a new player in the game. This may lead to even more stress on developing countries. However, the more likely outcome seems to be that poor nations will actually benefit from a competition between major powers for influence. This is reminiscent of the Cold War when the competition between the Soviet Union and the US expanded the policy space for developing countries.



President of China Xi Jinping talks to President of Zimbabwe Robert Mugabe during the the closing ceremony of the Forum on China-Africa Co-Operation (FOCAC) at the Sandton Convention Centre in Sandton, Johannesburg on 05 December 2015. (Ihsaan Haffejee - Anadolu Agency)

China: The World's New Banker

Over the last four decades, China has experienced a dramatic economic transformation. Beginning in1978 when President Deng Xiaoping came to power, over the last four decades, the country has recorded the fastest economic growth episode in modern history. In the process, China transitioned from an underdeveloped agricultural economy to a modern industrial one and became a manufacturing powerhouse. Combined with its huge population, rising productivity in the urban economy has created a gigantic economy, with GDP levels ranking second globally only to the US, giving Beijing the means to become a global economic and political superpower.

China's economic success has been largely tied to high and increasing amounts of trade surpluses with the rest of the world. Thanks to its cheap labour stock and abundant natural resources, the country attracted significant foreign investment and created a huge international trade sector. Over time, the People's Bank of China, the country's central bank, has accumulated hundreds of billions of dollars in reserves thanks to the country's impressive trade surpluses. According to the critics of Chinese government, Beijing is now using these resources to advance its economic and geopolitical agenda around the globe. Especially since the early 2000s, China's economic expansion in its immediate neighbourhood and in other regions, extending from Central Asia to the Middle East and especially Africa, has become more and more apparent.

In recent decades, China's expansionism has also included forming financial ties with developing countries. In particular, China has been increasingly mentioned as a financier of late development (investments in poor countries designed to allow them to catch up with developed economies). In the 2000s, more than 150 countries around the world, including almost 'all' African countries, have borrowed heavily from Chinese banks in order to finance huge infrastructure investments and accelerate their economic growth. According to the Institute of International Finance (IIF), China is currently the largest official creditor of the world surpassing IMF, World Bank, and all OECD governments combined. In 2019, China's total debt claims on the rest of the world reached approximately $5.5 trillion, which accounts for more than 6% of the world's GDP (IIF, 2020). Unlike capital flows from the US and Europe, most of this finance flows through state-owned enterprises along with various public banks, most prominently the Exim Bank of China. In other words, the vast majority of this financing is either directly or indirectly controlled by the state (Horn et al., 2020).

A symbol of Chinese economic expansion in recent years is the sensational Belt and Road Initiative (BRI), which was announced by Beijing in 2013 as a $1-trillion global infrastructure development strategy. "Belt" refers to China's land connection to Central Asia and Europe while "Road" stands for the country's maritime connections with Africa and the Middle East through the Indian Ocean. Through the BRI, China is hoping to create transportation and telecommunication links and form new trade lines with more than 60 countries across three continents. Beijing expects these new trade routes to provide new blood to the Chinese economy as well as the local economies it connects. It will secure access to resources and provide Chinese industrialists with new markets to sell their products.

Surely, developing countries that are involved in the BRI are willingly accepting Chinese 'help' for building their roads, railways, ports, or airports, which can enable these countries grow faster. It has been argued, however, that China's economic engagement with these countries is not simply a pursuit of economic partnership. As part of the programme, Beijing extends loans for expensive infrastructure projects. Most of the money flowing to these economies is not aid or even cheap credit but loans at market price (Horn et al., 2020). They are extended exclusively for infrastructure projects that are most-often undertaken by Chinese companies, some of which are owned by the state, so the money eventually trickles back into the Chinese economy. At the end of the day, these projects are built by Chinese companies, financed by Chinese banks at market prices, and eventually become a part of Beijing's major plan, the Belt and Road Initiative, to connect the Chinese economy to other parts of the world.

Figure 1: **The Countries Most in Debt to China in 2017** *- % of GDP*

Source: Horn et al., 2020; cited in Buchholz, 2019

Neo-Colonialism?

It has been argued both in policy circles and academia, especially in the US, that China's relations with developing countries in recent decades has been disturbingly reminiscent of the old colonialism of Europe. In particular, the financial relations China has formed with poor nations have been accused of being exploitative. As early as in 2011, in a visit to Zambia, then-Secretary of State Hillary Clinton was already warning against "new colonialism" in Africa. Clinton claimed that just like in colonial times, China "come in, take out natural resources, pay off leaders and leave" whereas the US "is investing in the people of Zambia, not just the elites, and we are investing for the long run" (Reuters, 2011).

In recent years, this rhetoric has gradually intensified. In particular, the term "debt-trap diplomacy" was first coined in 2017 by famous Indian analyst Brahma Chellaney, who argues that China is giving excessive loans to poor countries, which Beijing knows will never be paid back, so these governments find themselves trapped in debt servitude to China and end up granting political and economic concessions. This subordination through lending, Chellaney argues, is an instrument of China's geostrategic vision to become an economic and political superpower (Chellaney, 2017).

The Sri Lankan town of Hambantota is often used as a showcase for those who wish to point out the consequences of what they see as China's debt-trap policy. In 2009, as the country's decades-long civil war was ending, the Sri Lankan government decided to turn Hambantota, the hometown of then-president Mahinda Rajapaksa, into a trading hub as a symbol a new era in the country. The project involved the building of the country's second-largest airport as well as a deep-water port, a cricket stadium, and a highway connecting to the newly built airport, all financed and built by Chinese banks and manufacturing companies. However, contrary to initial expectations, the project did not pay off. The airport, which has a capacity to host 1 million passengers a year, is now referred to as the world's emptiest airport, hosting only a few hundred passengers in total. Sri Lanka ended up paying most of its total public revenue on debt servicing to China, which eventually led to a decision to sell off some of these investments altogether. Unsurprisingly, it was China that took control of these investments in return for writing off some of Sri Lanka's debts (Larmer, 2017).

Many argue that what happened in Hambantota is in fact happening in many places, though in more subtle ways. China gives big loans for the construction of strategic infrastructure in poor countries, particularly in Africa, leading to increasing foreign debt loads that put significant stress on these small economies. It is often the case that developing countries borrow excessively when they can, but when the short to middle term return on these investments fail to cover the initial expenses, countries struggle to service their debts, and sometimes end up spending most of the general government budget on high-interest rates. According to the "debt-trap diplomacy" rhetoric, China uses this weakness of poor nations as an opportunity to seize control of these countries' strategic assets and demand dramatic concessions in return for debt relief.

Under the Trump administration, in the context of the trade war with China, these allegations were repeated by the most senior politicians, especially at the State Department. Vice President Mike Pence, for instance, argued that "debt-trap diplomacy" is an instrument of China's military ambitions and warned developing countries in his Latin America tour while Attorney General William Barr said Beijing is "loading poor countries up with debt, refusing to renegotiate terms, and then taking control of the infrastructure itself" (Brautigam & Rithmire, 2021). Alice Wells, the senior official responsible for South Asia at the State Department claimed that China's investments "don't have an economic basis" and they "lead to countries ceding sovereignty" (Stone, 2019).

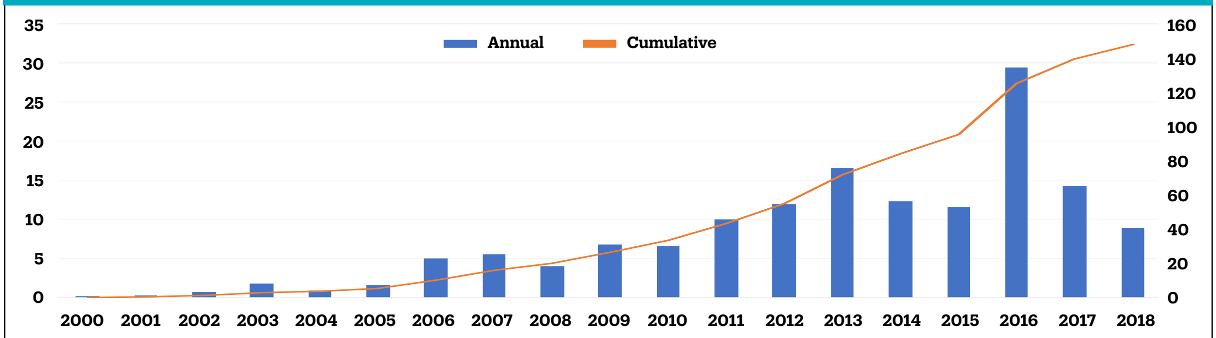
How much of these allegations are true is of course open to discussion. There are vastly differing estimations about how much of the public debt in developing countries is owned by China. According to the China–Africa Research Initiative (CARI) at John Hopkins University, the total amount of credit that has flown from China to African states between 2000 and 2018 amounted to $148 billion (CARI, 2020). This is not a negligible amount especially for poorer economies in Africa; however, according to Brautigam (2020), director of CARI, there are no cases of China trapping governments in Africa for asset seizures. Horn et al. (2020), however, argue that the extent of China's lending in developing countries is mostly "hidden" because the Chinese government purposefully conceals information.

Furthermore, according to them, Chinese lending has started to rise dramatically, especially since 2010, and contrary to the practices of IMF and World Bank, most of the loans are backed by collateral.

More recently, Kenya's financial relations with China have become the centre of attention. Kenya has built a number of major infrastructure projects with funds from China, including a $3.3 billion railway project between the port city of Mombasa and the capital Nairobi as part of the BRI. However, the railway project has so far failed to create enough revenue to service the debt obligations to China (Miriri, 2019). According to one estimate, Kenya now owes China $6.5 billion, 21 per cent of all its debt obligations. There are talks of a possibility that Kenya may hand over the Mombasa port as collateral to China. The Mombasa port is not only the largest in East Africa and a lucrative business site but also of high strategic importance as it is the main trade route to inland Kenya and Kenya's landlocked neighbours, including Burundi, Congo, South Sudan, Uganda, and Rwanda. There have also been reports about China taking over Zambia's Kenneth Kaunda international airport in Lusaka as the country is struggling to pay its debts (Servant, 2019).

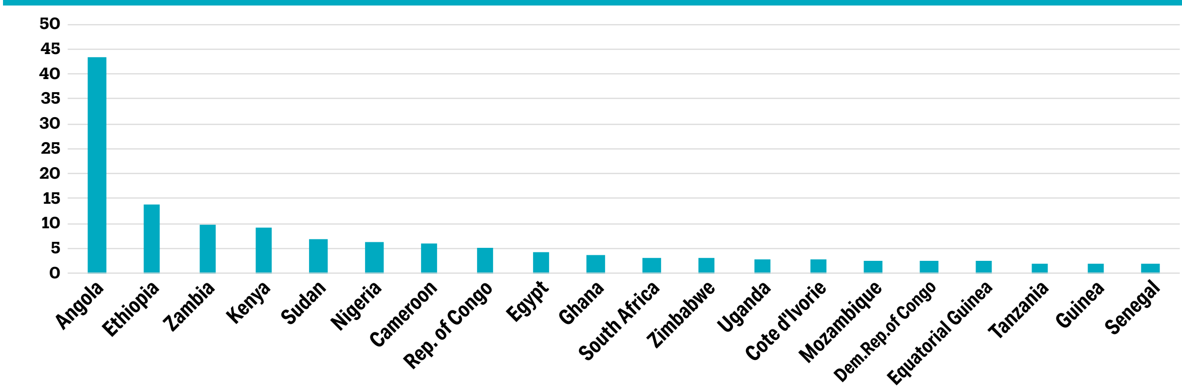
Similar to Kenya, Ethiopia has also borrowed from China in order to build up its infrastructure. However, in 2018, as Ethiopian government was struggling financially, $12 billion in debt repayments had to be restructured by China. Similarly, countries including Djibouti, Angola, Pakistan and Kyrgyzstan are currently struggling to pay their debts back and are looking for their debts to be restructured. According to Horn et al. (2019), as of 2017, in seven countries including Djibouti, Niger, the Republic of Congo, Kyrgyzstan, Laos, Cambodia, and Maldives, total debts to China exceeded 25 per cent of these countries' total annual output. With Covid-19, the financial pressure on all these countries has reached its peak (Reinhart, 2020; Basbay, 2020). It should be noted, however, that the allegations about the extent of asset takeovers and if China is doing this intentionally remain controversial and require more evidence to arrive at any definite conclusions.

Figure 2: **Loans from China to African countries** - *$ Billion*



Source: CARI, 2019

Figure 3: **African Countries with the Highest Debt to China** - *$ Billion*



Source: CARI, 2019

Wider Implications of a Rising China

Chinese investments in poor countries do not necessarily mean that these countries are at a disadvantage. Beijing insists that bilateral agreements as part of the BRI are beneficial to all parties involved and that unlike former colonial powers, China is there to trade on a win-win basis and carries no intention to intervene in the domestic affairs of others. From China's perspective, China as a creditor of developing countries is providing an alternative to Western nations and the international institutions dominated by them; an alternative partner that is – in theory - there to trade in a mutually beneficial and respectful manner, not to extract resources by leveraging its economic and political power. After all, Sri Lanka, Kenya, Ethiopia, and many others in Africa and Asia have requested these loans and infrastructure investments themselves.

Regardless of China's assertions to the contrary, however, the practical difference between China's practices and what Colonial power did in the past is questionable. After all, most of what was involved in the economic dimensions of colonialism is the transfer of natural resources and raw materials to the 'home country' and selling of manufactured goods in the colonised country. The colonisers had the power to impose conditions on trade, including opening of borders to foreign companies, forced selling of their lucrative national assets, and buying local products, mostly raw materials, at low prices. In many ways, China's economic engagement in Africa looks similar. Of course, China does not impose its terms through military force, however, its trading partners often find themselves in a situation where they are forced to hand over sovereignty and are deprived of the power to negotiate the terms of their engagement.

China presents itself as a gentler and non-interventionist outside force in the developing world, compared to former colonial powers or the US. It is indeed true that China has so far refrained from using the language of hard power or intervening into domestic politics. However, for how long China can continue to play this "gentle" role in its relations with developing countries is also questionable. There is already growing antagonism against Chinese penetration in many of these countries. No one knows what will happen when leaders in Africa or elsewhere start to act on those popular feelings of distrust and anger against Chinese businesses. For instance, how will China react if African governments decide to take back certain assets, which they handed over to China, or refuse to honour their debt obligations? As Larmer (2017) notes, Britain was also considered a 'gentle' coloniser but only until its interests were threatened by angry locals, to which Britain reacted with violence.

One may reverse this reasoning and ask how Western governments' and institutions' engagement with the developing world is different from what China is trying to do. Long before China became a lender to developing nations, the US and US-dominated international institutions were playing that role. For decades, the IMF has been the lender of last resort for countries in financial distress; when countries are in need, IMF provides the necessary credit but only in return for committing to sweeping 'reforms', including financial and trade liberalisation or privatisation and deregulation of local businesses. Similarly, World Bank conditions most of its development funds on neoliberal, pro-business policies and reforms. Beginning in earnest in the 1980s, it has mainly been through these institutions that neoliberalism has been exported to developing countries.

When developing countries liberalise their trade (for instance by lowering their tariffs) in order to meet IMF or World Bank conditions, they effectively become an open market to highly competitive companies from developed countries, which in most cases implies the flooding of domestic markets with foreign products and crowding out of domestic producers. This is not so different from what China is trying to accomplish in many developing countries. Similarly, privatisation imposed by the IMF as a condition for lending often implies that developing countries' most valuable public assets end up in the hands of foreign investors most of whom are from developed countries. In addition, financial liberalisation intensifies the vulnerability of developing countries to outside influence; namely, simple diplomatic threats coming from developed nations, especially the US, are enough to tip a developing country with liberalised financial markets into a financial crisis. This makes it much easier for developed countries to extract political and economic concessions from developing countries.

The effective transfer of sovereignty under financial stress has very much been the case with Western lenders as well. In many cases, developing countries were forced to change their policies and transform their

Chinese President Xi Jinping and Turkmenistan President Gurbanguly Berdimuhamedov attend the opening ceremony of the natural gas processing plants in the Galkınıs field located in the south of Turkmenistan. The facilities were built by Chinese companies in the second largest natural gas field of the world. 4 September 2013 (Merdan Chariyev - Anadolu Agency)

economies in dramatic ways against their own will, with serious implications for their development trajectories. These governments effectively have no bargaining power because they are in immediate need of liquidity, which the IMF provides. In such cases, IMF officials and policy guidelines often play a more decisive role than democratically elected politicians in shaping policies and determining the future of these countries. There are dozens of developing countries that have experienced this very scenario since the 1980s. According to historian Eric Hobsbawm (1999):

> As these newly industrialized economies, which are relatively weak and almost always heavily indebted, become incorporated into the global economy they become vulnerable to the pressures of the International Monetary Fund and other centres of international credit, in which the political weight of the United States is predominant. (p. 13)

Even in a developed country like Greece after the European debt crisis in 2010, this was very much the case; official lenders, including the IMF, forced the country to adopt austerity policies which led to a decade-long depression in the Greek economy.

Overall, whether one labels it as colonialism or not, the economic engagement of rich and powerful countries with developing countries tends to be exploitative in nature unless developing countries have enough policy space and autonomy to bargain for more advantageous terms. In recent decades, China has approached underdeveloped economies as another major power and formed its own ties with the developing world. One might have a pessimistic view of this process and say that, following Western colonialist powers, China also comes as an exploitative power, which means more suffering at the hands of another abusive power. According to this view, a rising China will come to extract even more resources from developing countries in different ways. There are indeed signs of China engaging in predatory behaviour in some poor countries in recent years, most notably in Africa. Debt-trap diplomacy, even though it is difficult to grasp its true extent, is a real source of concern for poor developing countries.

However, one may also have a more optimistic view and say China may actually represent a breath of fresh air for developing nations. Especially since the 1980s, developing countries' policy-space has been dominated by the international financial institutions mentioned above, which squeezed developing countries into following policies that were ultimately proven to be disadvantaging poor nations' development prospects. China, as a competitor of the West, can empower developing countries vis-à-vis powerful Western countries and institutions by giving them another option, similar to what happened during the Cold War era when the competition between the Soviet Union and the US expanded the policy space of developing countries and gave them more autonomy over their trade relations and economic decisions.

It is known that, prior to the collapse of the Communist Block, the rivalry between the two power blocks for influence over the so-called 'third-world' provided these countries with more space, at least in certain aspects of policy-making. The US and Soviet Union competed to extend and maintain their spheres of influence in the third world, which often required keeping these countries happy and not pushing them too much, because they always had the option of allying with the other. The US, in particular, provided economic support to these countries to keep them close (Hobsbawm, 1999). There are reasons to believe that the rise of China as another global super-power will mark the end of the post-Cold War unipolar moment and may again give rise to a balance of power. We will see in the coming years how this increased great power competition will play out in developing countries, especially in terms of the financial options they are presented.

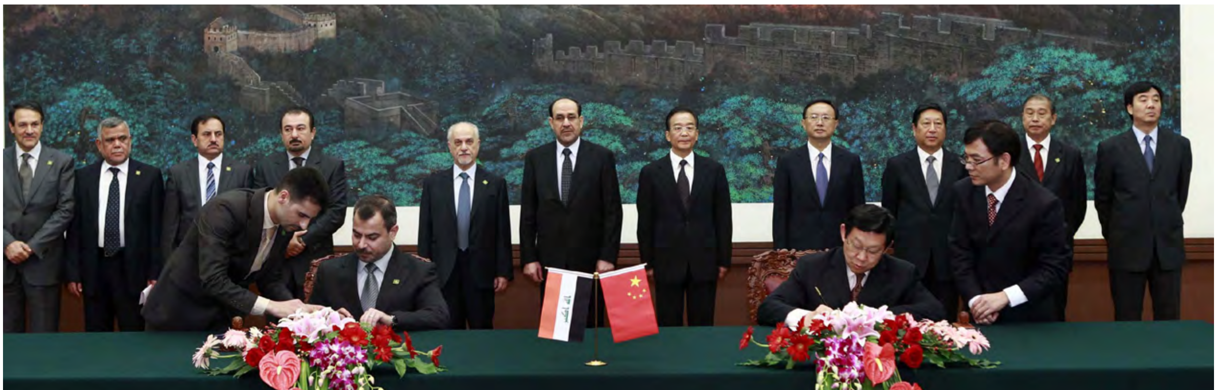
Conclusion

Beginning from the early 1980s, China has risen as a source of economic power in global politics. China's growing manufacturing economy, increasing productivity over a vast range of economic activities, and persistently high trade surpluses have empowered China and have given Beijing the means to expand its sphere of influence. In the last two decades, China has begun building new ties with developing nations, which involve Chinese banks and state funds acting as creditors. In particular, China finances major infrastructure projects in developing countries across the globe, most of which are realised by Chinese construction companies. Moreover, some of these projects form an integral part of China's ambitious Belt and Road Initiative, China's major development plan to connect the Chinese economy with economies across the world through better communication and transportation links

Many analysts criticise China's increasing economic and financial inroads into developing countries. Specifically, in an argument most prominently advanced by the US State Department, China has been accused of engaging in "debt-trap diplomacy"; Chinese state banks are giving huge loans, which they know will never be paid back, in order to increase their leverage on these countries. According to this argument, they then use (or abuse) this position to gain unfair advantages from developing countries, such as taking over major assets and extracting geopolitical and economic concessions in return for debt relief. Simultaneously, Chinese companies are penetrating these markets; these economies provide natural resources and raw materials for Chinese producers as well as a market for Chinese manufactured products.

It remains unclear whether China is intentionally engaging in 'debt-trap diplomacy' as the US government claims. However, several incidents in developing countries such as Sri Lanka, Kenya, or Djibouti have shown that China's financial practices can indeed be problematic and effectively amount to exploitation under financial duress. Furthermore, in the near future such incidents have the potential to intensify and spread with the increasing Chinese presence in developing countries, particularly because there appears to be a growing popular antagonism and a backlash against Chinese economic activism. The nature of China's relations with these developing countries has some disturbing similarities to former colonial practices and there are reasons to expect more conflict between locals and Chinese investors.

Overall, it is too early to say if a rising China is bad news for developing countries or not. On the one hand, there may be increased pressure on developing countries as there is another major player in the game looking for economic gains in resource-rich developing countries, especially in Africa. Indeed, China does not seem to hesitate in using its financial power to leverage economic and political gains. Countries that are heavily in debt to China risk losing their major assets or giving geostrategic concessions in return for debt relief. On the other hand, however, the power struggle between China and Western powers may create an advantageous situation for some developing countries. As in the context of the Cold War, governments of developing countries may enjoy increased autonomy and more bargaining power due to the competition between major powers for influence.



On an official visit to China, Iraqi Prime Minister Nuri al Maliki oversees the signing of bilateral cooperation agreements with the Prime Minister of the People's Republic of China, Wen Jiabao. 19 July 2011 (Xinhua / Anadolu Agency)

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