Is China Actually Helping Improve Debt Sustainability in Africa?

Helmut Reisen

China has become, by a large margin, the largest creditor in the group of 'new' donors active in Africa. 'Old' donors are accusing China of "free-riding" on the development efforts deployed by the international community and impairing debt sustainability in low-income countries (notwithstanding the fact that China has also granted debt relief). It is argued that corruption is enhanced, democracy impaired, and debt tolerance weakened by China's financing practices.

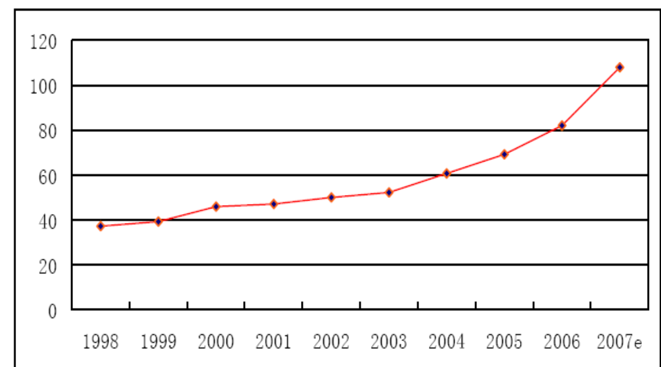
This Policy Brief deals with these points. It points to the sectors and countries where China engages particularly in Africa. It provides an estimate of the grant element of China's concessional loans. It argues that the 'free-riding' concern is misplaced, and traces China's impact on debt vulnerability in Africa. China is found to have a positive impact on debt tolerance through stimulating exports, infrastructure investment and GNP.

China in Africa: Renewed presence, aid, lending and bashing

China's income is doubling every seven years at the current pace. To sustain this growth, China needs, first and foremost, natural resources, oil, industrial metals, and increasingly, agricultural resources. Resource-rich Africa can deliver. As a result of intensified trade links with China, Africa has enjoyed higher growth rates, better terms of trades, increased export volumes, higher public revenues (Goldstein *et al.*, 2006). At the AfDB summit in Beijing attended in May 2007 by nearly 50 African heads of state and ministers, China pledged to double its aid to Africa and to provide $5bn in loans and credits over the next three years. Further, the Asian giant has put in place a China-Africa Development Fund that will eventually reach $5bn.

Figure 1. **China's foreign aid expenditure increases, 1998-2007**

Unit: RMB 100 million



Source: Qi Guoqian (2007). "China's Foreign Aid: Policies, Structure, Practice and Trend". Presented at Oxford/Cornell University Conference 'New Directions in Development Assistance', 11-12 June.

Note: The figures cover aid in the forms of grants, interest-free loans, preferential loans, cooperative and joint venture funds for aid projects, science and technology cooperation, and medical assistance, on a bilateral basis. Note that *Chinese aid figures do not include debt relief, unlike DAC donors' reported ODA.*

There are three forms of aid provided by China: grant aid (Ministry of Commerce): mainly aid in kind; zero interest loans: Chinese authorities consider that more than 90% of these loans will be written off over time; concessional loans (China EXIM BANK): these loans are given an interest subsidy by MOFCOM (the subsidy is the difference between China's central bank base rate and the preferential loan rate. Other financial flows to Africa seem to mainly take the form of commercial loans (neither the size nor the terms of these loans are currently being revealed), and investment, mostly in natural resources, through joint ventures or acquisition of licenses for

production. FDI flows may, at times, be the counterpart of the provision of loans, a phenomenon observed in Angola, Nigeria or Sudan. The main arm of the Chinese government for bilateral aid to Africa is China ExIm Bank, which is involved in financing almost all the most important projects.

China engages mostly in infrastructure for resource extraction, telecommunications and transport. As business is often operated on a barter basis, financial transparency is difficult to establish. Take the *Angola Mode*, where funds are not directly lent to the recipient country, but the Chinese government will mandate a Chinese construction company (that usually receives support credit from China Exim) to undertake the construction work after the approval of the recipient country. Then, in exchange for the infrastructure provision, the borrowing government will give to a Chinese company operating in the field of natural resources (mostly oil or minerals) the right to mine natural resources through acquisition of equity stakes in a national oil company or through acquiring licenses for production.

Table 1: Grant Element of a Typical China ExIm Bank Export Buyer Credit, July 2007

Concessional Export Buyer Credit • 2% annual interest rate • 0 grace period • 15 year maturity
ODA Grant Equivalent • Cash inflow at start = 1000 • Constant annuities = 77.83 • Net present value at 10% discount rate = 591.9 • => Grant element = 1000 – 591.9 = 408.1

Note: Author's hypothetical calculations based on China ExIm Bank information on average terms of export supplier credits to Africa.

China ExIm Bank reveals no precise information about the size and terms of export buyer credits to Africa, but only the average terms: 2% interest rate, 10-15 year maturity, no grace period, and the renminbi as debt currency. Table 1 applies a simplified grant-element formula (with a discount rate of 10% - the donor opportunity cost of giving) by assuming constant annuities, a 15-year export buyer credit with no grace period carries a grant element of 40.81% (see Table 1). While the grant element is high enough for DAC to count such concessional export as aid, export credits are excluded generally from the DAC definition of ODA. As the Chinese just account for the implicit interest subsidy in their aid statistics, the difference of the 3Y central bank bill (currently at 2.49%) and the concessional rate (2%) would translate into just $5 in Chinese aid statistics.

China and Africa's Debt Tolerance

The 'free-riding' concern is misplaced, for a simple reason: The majority of the projects that receive Chinese financing for Africa-based infrastructure projects are undertaken in non-HIPC, resource-rich countries. During the present decade, Angola, Nigeria and Sudan received the bulk of the confirmed Chinese financing commitments in infrastructure.

Apart from free-riding, what does China do to debt tolerance in Africa?

Let us focus on the parameters of debt distress thresholds identified by the literature for low-income countries. In other words: Ask how China is impacting on the parameters of debt build-up, GNP growth, exports, and governance standards; this has not been done yet, to my knowledge, so some back-of-the-envelope calculations may be useful. Unfortunately, China is still not transparent enough on the size and pace of commercial and preferential lending to Africa to allow tracing the China-caused debt build-up; the lack of transparency is not in China's interest as it invites 'happy bashing'. China will be well advised to share common loan criteria and to cooperate on recommendations for a potential *Debt Transparency Initiative* that could imply both official and private lenders.

To be sure, debt vulnerability is still a concern in African raw material exporters, in view of their low governance scores and their exposure to real external shocks, such as a major drop in oil prices. However, even Angola and Sudan, the two African countries where the presence of China is most strongly felt (and which have not benefited from debt relief), show big improvements in their debt indicators. Note also that both countries have been building official foreign-exchange reserves at rapid pace recently, so that their net debt exposure is even lower.

Gross external debt in both Angola and Sudan has grown in the present China-heavy decade at a pace slower than a rate that would imply future debt difficulties. An IMF/World Bank study released in 2006, on debt sustainability in low-income countries, reported that countries in which debt grew by more than 7% of GDP subsequently suffered debt distress in 61% of cases. Countries in which debt grew by more than 5% of GDP went on to experience debt distress in 23% of cases.

Table 2: Debt Distress Indicators, 2000 vs 2005/06

	ANGOLA			*SUDAN*		
In percentage terms	2000	latest	% China effect*	2000	latest	% China effect*
Debt/Exports	114	48	-29	663	308	-74
Debt/GNP	126	41	-24	157	72	-17
Debt Service/Exports	21	9		10	6	
Annual external debt, growth p.a., 2000-05	3.8			2.0		

Source: *World Bank - 2007 Global Development Finance*

Note: * The China 'effect' on exports results from isolating exports to China from total export growth during 2000-05; the income effect results from multiplying the China 'effect' on exports times the country's export share. Export and GNP growth rates are compound annual rates.

What matters equally for debt sustainability and debt dynamics is not just China's lending, but also the push that China gives to exports and income growth. Both Angola and Sudan have seen rapid export and income growth in the present decade. While Angola has an export share of 84%, Sudan is more 'closed' with a share of 23%. But as China is almost the only client for Sudan's exports, China's demand for oil has contributed to income growth fairly similarly, at around a fifth.

While China has a positive impact on debt tolerance through stimulating exports and GNP, many argue that it lowers standards, undermines democratic institutions and increases corruption, particularly in oil-rich countries that suffer traditionally from such a resource curse. If true, this would clearly undermine debt tolerance. But the scores provided by Transparency International for perceived corruption in countries in which China engages relatively strongly are revealing: These countries are perceived as relatively corrupt (except for Mozambique), but China's presence does not seem to have fostered corruption; on the contrary, Angola and Nigeria show significant improvements. China is reconsidering governance issues in partner countries. In February 2007, the Chinese government deleted Nigeria and Sudan from the list of resource-rich countries it is encouraging companies to invest in.

One issue to worry about is the currency in which China lends. As a rapidly growing economy, China is bound to experience trend appreciation of her currency in inflation-adjusted terms, due to the Balassa-Samuelson effect (the rapid rise in non-tradables' relative prices as a result of income growth). There is no way to hedge against long-term real appreciation of the renminbi; there are no future markets for the renminbi, and should they exist, hedging costs for 10-15 year maturities will be exorbitant. Low-income countries have, however, the option of minimizing the currency mismatch of their exchange risk exposure by matching the currency mix of their debt with the currency mix of their cash flows. For oil exporters, this calls for US dollar debt exposure.

Let us not forget that an important goal of the debt-relief programmes, was to restore African credit-worthiness, thus encouraging new investments and boosting economic potential. There rarely has been such rapid and intense investment in African infrastructure as is going on

today. The continent is no longer a *chasse gardée*, and competition is stimulating. Recent trends may bother Western companies and their public co-financiers, but established donors' new rivalry with China is doing more to promote African development than any high-flying governance rhetoric – the credibility of which, by the way, has not exactly thrived on recent corruption scandals involving Western companies such as British Aerospace, Siemens, and Halliburton. The competition now faced by Western financial institutions may strengthen competition across economic-policy paradigms, with recipient countries freer to choose. Ultimately, reform ownership and accountability may thus be strengthened, as power slips away from the old donor cartel.

Helmut Reisen, Counsellor at OECD Development Centre, is working on various aspects of private and official development finance and on macroeconomic interdependence.

Reference:
Goldstein, A., N. Pinaud, H. Reisen, and X. Chen (2006). *The Rise of China and India: What's In It for Africa?* OECD Development Centre, Paris.