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CHINA GLOBAL NEWSLETTER

Tracking the latest developments in China's role in global investment and finance, published by Inclusive Development International

COVID-19 and its Impacts on Chinese Overseas Investment

The COVID-19 pandemic plunged the world into chaos. While some countries have suffered more severe impacts than others, and different countries have managed the pandemic with varying degrees of success, the economic effects are being felt in every corner of the world.

These impacts are diverse and vary by country and sector. This first newsletter in our China Global series looks at how the pandemic has affected Chinese overseas projects, how the Chinese state has responded, and how these trends may manifest in the longer-term, as China manages the economic fallout against a background of heightened geopolitical tensions.

This newsletter covers:

IDI Inclusive Development International

Impacts of COVID-19 on Chinese Overseas Projects

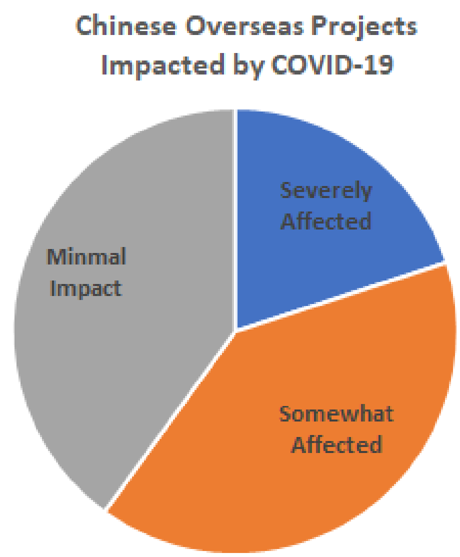
China was the first country to feel the effects of the pandemic. The rapid spread of the virus around the world has since impacted a thoroughly globalized China as overseas projects stalled, and global supply chains contracted.

In June, an official from China's Ministry of Foreign Affairs revealed findings of a survey it had conducted claiming that around 20% of overseas projects had been "seriously" impacted by the pandemic, 30-40% were "somewhat" affected, and 40% had experienced minimal impact.

Chinese business media has reported on challenging times for China's state sector, with central state-owned enterprise profits down almost 60% in the first quarter of 2020. Business picked up in the second quarter, but profits for first half of the year were down 37% on the same period last year. During the same period, China's commercial banks posted a 9.4% profit drop, the biggest decrease in 10 years.

Many Overseas Projects Hit Roadblocks...

Overseas projects were hit hard by the logistical challenges COVID-19 created. For a period, almost all international air travel was impossible.



With the pandemic taking hold over the Chinese Spring Festival period, many overseas company staff and laborers who returned to China for the holidays became stuck there. Flights are now increasing in frequency, but cost, travel restrictions and quarantine requirements mean this is still a major bottleneck.

Movement of goods was also severely impacted by the lockdown, and materials and equipment required for some projects remained in China or stuck on route as global logistics chains ground to a halt. This backlog is now shifting but has likely set many projects back by months. Lockdown rules in host countries have also limited in-country travel and movement of goods and equipment.

In addition to the survey results from China's foreign ministry, media reports have provided more qualitative accounts of projects that have stalled across the world, including in Pakistan, Bangladesh, Cambodia, Kazakhstan, among many others. In some cases, the COVID outbreak created new challenges to project activity. In others, the pandemic impacted projects that were already experiencing development problems, including projects linked to harmful social and environmental impacts. Two cases from Indonesia illustrate this well: the Batang Toru hydropower dam, and the Bandung-Jakarta high speed railway.

The Batang Toru dam hit headlines in 2019 largely due to its potentially disastrous impacts on the critically endangered Tapanuli orangutan. Local groups and international conservation organizations including IUCN pushed for the project to be scrapped. In response, Bank of China promised to review its funding of the project. In July, a representative of the Indonesian state-owned utility stated that the project would likely be delayed for three years due to both Bank of China stepping away from the project, and the impacts of the pandemic.

For several years, civil society groups have documented concerns regarding the Jakarta-Bandung high speed rail project. Local groups criticized the project for violations of local law in its planning and implementation, substandard impact assessments, resettlement of local people and destruction of farmland. The project was supposed to be operational by mid-2019, but was delayed by these controversies. In March this year, construction was suspended for two weeks after soil dumped around drainage canals was found to have caused floods. The pandemic extended this suspension to over three months. The project remains incomplete and behind schedule.

As projects ground to a halt, Chinese workers were in many cases left in limbo. Laborers have found themselves without projects to work on, leaving them in dire straits as many are informally employed and living paycheck to paycheck. From Singapore, to Cambodia, Nigeria to Kazakhstan, many construction workers have found themselves stuck in cramped dormitories, unable to return home and with their limited cash supplies rapidly dwindling.

CHR highspeed train, Shanghai / Alancrh (Creative Commons Attribution-Share Alike 3.0)

...While Other Projects Move Forward

Although much of the media focus has been on projects that have struggled, there are many examples of projects and initiatives that have moved forward or restarted, with reports beginning to increase in the June-July period. Several of these projects have raised environmental concerns.

Chinese state media reports indicate that the $6 billion Eximbank funded China-Laos railway continued to move forward at pace. In Cambodia, a loan contract was signed for a new 700MW coal power plant via an online "cloud signing" ceremony between Beijing, Hong Kong and Cambodia, joined by developer Huadian, embassy representatives and Industrial and Commercial Bank of China.

Elsewhere in Southeast Asia, one project that managed to weather the storm and move forward was a zinc mine in North Sumatra, Indonesia, developed by a joint venture of a China Nonferrous Metal Mining Group subsidiary and a local partner.

However, in July it became public that local villagers had filed a complaint to the World Bank's International Finance Corporation (IFC), alleging that loans to the project developer from China Postal Savings Bank, an IFC client, violated its safeguards. This marks the first time the IFC has investigated a complaint against a Chinese financial institution.

August saw the long-awaited approval of a joint-venture between a subsidiary of Chinse state-owned CITIC and a Myanmar government committee to move forward the development of a major port within the proposed Kyaukphyu Special Economic Zone. First approved under the military government and then later renegotiated by the elected government, the zone has proved controversial due to lack of transparency, displacement and livelihood impacts. Before the pandemic hit, the project had already faced several years of delays, but after the terms were renegotiated, the size scaled back and ownership adjusted to give Myanmar a larger stake in the project, it began to move forward again.

The Kyaukphyu SEZ is recognized by Chinese leadership as one of the “three pillars” of the China Myanmar Economic Corridor (CMEC). CMEC is seen as a vital geographical and trade route in the Belt and Road Initiative, as is the China-Pakistan Economic Corridor (CPEC). CPEC has also seen movement during the pandemic period with state-owned Gezhouba signing a concession agreement to build the 700MW Azad Pattan Hydropower Project under its framework.

In addition to new contracts being signed and projects moving to completion, a number of bilateral agreements have also progressed. This includes agreement of the draft text of a Free Trade Agreement between China and Cambodia, which was reportedly pulled together via video conference in just six months and is due to be signed by the end of the year.

With China bringing the spread of the pandemic under control, companies are now in a stronger position to restart suspended projects and move them forward, but much depends on the situation in the host country. Beyond that, a more complex question is how Chinese projects are likely to be impacted in the longer term by global supply chain issues, host country debt, and the global economic contraction created by the pandemic.

In addition to challenges in executing projects, there is less demand for Chinese products.

With consumers around the world facing financial hardship, manufacturing orders are down. The slowdown in partner country infrastructure investment and potential tightening of Chinese state credit for overseas ventures means there are fewer orders for Chinese equipment and materials, and potentially fewer international contracting opportunities for China’s state-owned engineering firms.

Industry Focus: The Oil Sector

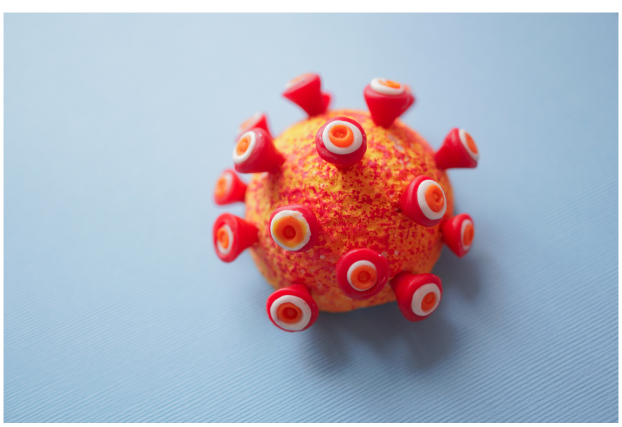
This spring, the dual crisis of OPEC production cuts and the COVID-influenced freefall in global oil demand created an unprecedented drop in oil prices. Chinese buyers capitalized on the low prices and bought a huge portion of the world’s crude supply. By July, China had 73m barrels of crude stored around its coast awaiting docking or a price rebound.

China’s relatively quick economic rebound brought its domestic oil consumption close to pre-COVID levels, but its excess supply at sea, and a worse-than-expected global economic recovery continues to depress oil prices, with analysts predicting limited rise in the near-term. Sustained lower-than-forecast prices and decreased importation from China could dramatically hurt oil exporters who are disproportionately reliant on exports to China, including Angola, Brazil, Colombia, Nigeria, and Venezuela.

China's Policy Responses

During the Belt and Road International Cooperation meeting held remotely in June 2020 and attended by 25 ministers from BRI countries, China's foreign minister said Beijing wished to "see key belt and road infrastructure projects restarted as early as possible" to "help countries preserve jobs and contribute to economic stability".

An important intervention in this direction came in late February, when China's Ministry of Commerce (MOFCOM) and China Development Bank (CDB) issued a joint notice calling for development finance to be utilized to support the "high-quality and cooperative construction of the Belt and Road". The notice stated that the CDB would mobilize capital under flexible terms to support projects that were negatively impacted by the pandemic. Working in partnership, MOFCOM, CDB and provincial commerce departments set up a mechanism to gather a list of impacted projects and assess which would require additional finance.



Crucially, this notice specified that projects must be "high quality", legally compliant and with controllable risks. In response, a group of 265 civil society organizations from around the world signed a joint statement to MOFCOM and CDB urging them to ensure that this financing truly does flow to projects that meet these important three criteria, and not to projects that have or are likely to do harm.

This was just one of many policy interventions from China that have sought to minimize the impacts of COVID-19 on overseas projects. MOFCOM issued various circulars, several in partnership with other institutions, including Sinosure, Eximbank and ICBC, focused on expediting processes, sharing information, providing insurance and credit, and supporting cross-border economic zones, all in an attempt to mitigate the impacts of the pandemic and ensure projects restart and stay on track.

COVID-19 and the Global Debt Crisis

As the pandemic began to take hold around the world, the issue of debt rapidly came to the forefront of discussions around Chinese overseas finance. The debt burden faced by many developing nations is not a new phenomenon, but this unexpected crisis has hit many indebted countries hard, especially those with fragile health systems and undiversified economies.

Debts owed to China are significant. For example, China is the largest bilateral creditor in Africa, where it holds 20% of all debt. Although, for context: 32% is owed to private lenders and 35% to multilateral institutions such as the World Bank.

As the crisis took hold, borrowing countries called on creditors to provide debt relief. At a meeting of G20 finance ministers in April, a collective agreement was made to suspend debt payments until the end of 2020 for the world's poorest countries. China supported this initiative and in June announced it had suspended debt repayments for 77 developing countries and pledged $2 billion in aid to support countries and multilateral organizations to fight the epidemic.

Prior to the pandemic, China has periodically cancelled zero interest loans, but this is a small part of its lending. In June, Xi Jinping committed at a China-Africa summit that China would cancel all such loans that are due in 2020. Xi also urged Chinese financial institutions including Eximbank and CDB "to conduct consultations with African countries on commercial sovereign loan arrangements".

Interest free loans are by far eclipsed by concessional loans, preferential buyers' credits and commercial loans from China's policy and commercial banks. China has historically not cancelled these types of debts, although it does renegotiate repayment terms in certain cases where lenders are unable to repay.

Given the size of these loans and the huge loss that would come with cancelling them, it is unlikely that China will change this practice.

In a joint article by the chairman of state-owned CITIC Group's board of supervisors and Chief Economist from a CITIC subsidiary, the authors estimated that China's debt exposure overseas is as much as $250 billion, most of which falls outside the G20 pledge. They state that much of this could be subject to requests for debt relief: "For us not to respond to such pleas would be unreasonable … but response will create a precedent for a flurry of renegotiation requests that we may not be able to handle."

> **Podcast: Assessing China's "Corona Diplomacy" in Africa**
> Lidet Tadesse Shiferaw, European Centre for Development Policy Management

Rather than cancel such debt, China will negotiate with partners on a bilateral basis, delaying payments, lowering interest rates and/or providing maturity extensions. One of the largest reported COVID debt deals reached thus far is with Ecuador, which was granted a one-year grace period by the CDB, which delayed repayment of $417 million.

In recent years "debt-trap diplomacy" – the idea that China is pushing unsustainable debt loads on smaller countries with the intent of default and finally asset seizure – has become a dominant narrative within the study of the Belt and Road.

While still contested, evidence of debt trap diplomacy is sparse. However, the first example of a potential equity for debt deal in the context of the COVID crisis has materialized in Laos, where the heavily indebted country reached a deal with China Southern Grid to hand over majority control of its national energy transmission system. Details on this deal are scarce, but the deal was likely brokered to pay off debts to Thai commercial creditors and restructure debts to China.

Angola is also considering offering preferential investment access and selling additional equity shares in oil fields to Chinese state-owned firms at a time when the country is also seeking major debt relief from China. Agreements have not yet been made but Angola is unique because of its specific oil-for-infrastructure contracts and the disproportionate amount of debt the country owes to China.

This still fell short of some environmentalists' expectations as it retains investment in oil and gas related projects as well as large-scale hydropower. Nonetheless, these changes could result in increased involvement in China's green bond market from international investors who currently have to steer clear of China's green bonds as the inclusion of coal goes against their own internal policies.

AIIB Headquarters / China Daily

Other Policy Developments

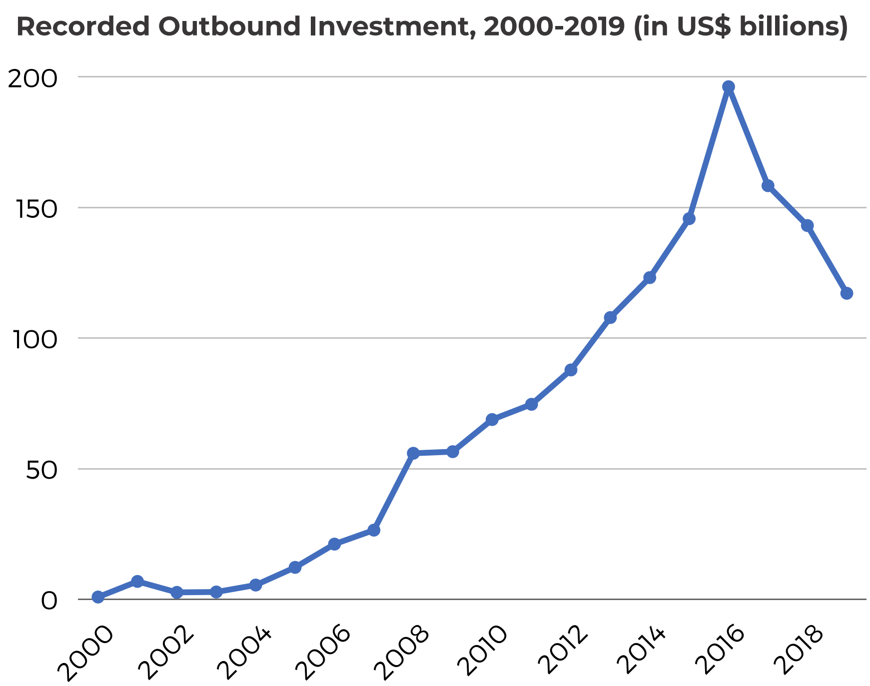
While the pandemic response continues, other policy developments continue to move forward. In July, the People's Bank of China, National Development and Reform Commission and China Securities Regulatory Commission issued a consultation draft of the 2020 Green Bond Catalog. This draft aligns China more closely with international standards around green bond classification by removing "clean" coal use, coal-fired power, coal mining and coal washing from the catalog that has been in place since 2015.

In the realm of multilateral institutions, the Asian Infrastructure Investment Bank, initiated by China in 2015, is in the process of reviewing its Environmental and Social Framework. This "focused" review aims to reflect on the first three years of implementation and update the framework based on these experiences. The second phase of the review process commenced in September and a revised draft framework is now open for public comment (see here for details on this process).

INVESTMENT TRENDS

Unsurprisingly, the COVID-19 pandemic has impacted investment outflows from China. According to statistics from China's Ministry of Commerce in the first half of 2020, outbound direct investment across all sectors amounted to $54.9 billion, down by 4.4% on the first half of 2019. During the same period, newly signed contracts were valued at $60.6 billion, a year-on-year decrease of 13.8%. Of note, this contrasts with investment in the original 64 BRI countries, which increased by 19.4% to $8.1 billion. Overseas mergers and acquisitions hit a 10-year low.

While the impact of the pandemic is unmistakable, it is important to view these figures in context. As data from MOFCOM shows, recorded outbound investment has in fact been dropping since 2016. This dip in investment, despite the fanfare around the BRI and the common assumption that it has driven an increase in overseas investment, is also reflected in academic datasets. Boston University's Global Development Policy Center found that Chinese finance for global energy project dropped from $45.7 billion in 2016 to just $3.2 billion in 2019. Similarly, an online database from the China-Africa Research Initiative at Johns Hopkins University shows a decrease of Chinese loans to Africa between 2016 and 2018 from $29.4 billion to $8.9 billion.



Ministry of Commerce of the People's Republic of China

Battambang Multipurpose Dam / Guangdong Foreign Construction Co.

What Comes Next?

All of this is taking place in the run up to the U.S. general election, where rhetoric around China has been dialled up, with scrutiny of telecommunication companies, social media platforms and state-owned enterprises reaching new levels. This comes against a backdrop of an unresolved trade war with the United States, China's largest trading partner, and targeted sanctions against Chinese government figures and companies.

Although the current situation is unprecedented, prior to the pandemic China was already experiencing an economic slowdown, with GDP growth at its lowest levels since 1992. The economic crisis brought about by COVID has hammered home the urgency with which China must stimulate its domestic economy.

As China moved to control the pandemic and restrictions were lifted, the economy began to make a recovery, and in June GDP growth turned positive for the first time since January. This has been encouraged by measures such as issuance of 3.75 trillion yuan ($540 billion) in local government special bonds and 1 trillion yuan in national special bonds to leverage private capital and stabilize investment. Much of which has gone to domestic infrastructure projects.

In contrast, China's response to the global financial crisis of 2007-9 brought about a huge push of investment into overseas markets.

Beijing's reaction to the current economic crisis and the worsening diplomatic relationships with the U.S. and other western allies appears to be more inward in focus.

In late July, China announced the strategy, termed "dual-circulation" through which it will pursue growth in domestic and foreign trade, but with the priority on the domestic market – rather than the export-oriented growth model that fueled China's rise. Furthermore, the COVID stimulus is expands focus to "new infrastructure" such as 5G networks, data centers, AI and smart energy infrastructure rather than only traditional rail, road and power plants.

Further Reading

Acker, K., Brautigam, D. & Huang, Y., **Policy Brief: Debt Relief with Chinese Characteristics**, China Africa Research Initiative

Lynch, L., Andersen, S. & Zhu, T., **China's, Foreign Aid: A Primer for Recipient Countries, Donors, and Aid Providers**, Centre for Global Development

It remains to be seen how these strategies will play out, but with a potential reduction in demand for overseas projects and China's focus on domestic stability, there may be an emphasis on investing at home and promoting domestic consumption, rather than further expansion of overseas investment, at least in the near-term.

China remains deeply integrated in global supply chains, however, and both state-owned and private enterprises have spent two decades actively embedding themselves in the global economy. They will continue to look towards overseas markets to expand their business opportunities. While a dip in overseas investment is likely, Chinese companies and banks will continue to play a major global role.

In the post-COVID context, as people and economies strive to get back on their feet, it is crucial that investment and financing decisions take full account of potential environmental, social and governance risks, not only economic benefits.

Inclusive Development International

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