

The impact of China's lending on Emerging Market Debt

The increasing prominence of China as a financier of developing nations has changed the landscape of emerging market debt investing. In the future, we expect China to take a more selective approach to overseas lending. Such a dynamic could contribute to divergent performance between weaker emerging markets, with a handful of commodity-rich and strategically important high yielders continuing to benefit from a “Chinese put.”

When and why did China's overseas lending start

Following earlier initiatives, it was the “Going Global Strategy” in 1999 which marked a first deliberate departure from the Maoist mindset of self-reliance.

The **Belt and Road Initiative (BRI)**, which was launched in 2013, is the centrepiece of President Xi Jinping's foreign policy. The economic rationale behind the BRI is clear. China wanted to invest abroad to develop new sources of aggregate demand, push forward the internationalisation of the renminbi (RMB), move up the global value chain, establish more balanced regional growth at home, and earn a better return on capital than the low interest rates on US Treasuries. Xi's vision sees this being achieved with infrastructure development investment to the tune of -US\$1 trillion, greater than the WW2 Marshall Plan, adjusted for inflation.

The difficulty that we have in tracking China's lending stems from the opacity of the process and the lack of any systemic reporting by the Chinese government.

China's mechanisms for overseas lending have been varied. The three policy banks are the most conspicuous, and of these China Development Bank and the Export-Import Bank of China have been more active than the Agricultural Development Bank.

How has the policy evolved in the recent past?

Available data would suggest that **China's BRI lending has fallen** off a cliff since 2017.

Three factors help explain the slowdown in China's overseas lending:

- The evolution of China's own economy.
- The experience that China has had lending abroad.
- The geopolitical developments.

Looking first at China's macro evolution, the decline in the current account surplus and moderation in the relative strength of the country's

FX reserves demonstrate why China is being more selective about lending overseas. The current account surplus has kicked up in recent quarters because of COVID-19, but we expect the downward trend to remain in place over the medium term.

FX reserves have been stable in absolute terms but are looking less generous relative to the size of the economy.

If one of **China's motives for lending** overseas was to achieve a better return on FX reserves than holding US Treasuries, then high-profile stumbles on some of these loans (e.g., Venezuela, Pakistan, Sri Lanka) will have impacted the assessment of risk/reward. It is thought that at the end of September 2020, Beijing was still negotiating restructurings with 12 countries covering US\$28 billion loans.¹ It is understandable why critics are revelling in what they see as the collapse of this experiment and a lesson for China as a rising global power.

The third explanation for China's pullback in lending overseas is the changing geopolitical landscape. At the very least, frosty relations with the United States and the associated economic uncertainty encouraged China to concentrate its focus on its strategic priorities.

We believe **the economic and strategic threshold for lending abroad has increased**, but the lending has not stopped completely, and neither should we expect it to stop in the future.

Looking ahead: a more selective approach

We expect China's approach to be increasingly selective. All other things being equal, we also expect the greatest lending to continue to those countries that have direct access to collateralisable assets (such as oil) as well as those that play a clear role furthering China's strategic or security interests. Anti-corruption and sustainability factors may also play a greater role in the Chinese decision-making function, in light of some of the global criticism around earlier lending practices.

US-China **competition for influence** is already playing out in some EMs, including a recent example in Ecuador, where the United

States provided bilateral support for the country in return for an explicit security agreement around use of Chinese telecoms.

A drive of performance in Emerging Market Debt

As discussed above, the nature of China's ever more selective approach has the potential to be an increasing **driver of performance dispersion within emerging market debt**, particularly for sovereigns at the lower end of the quality spectrum.

We see great **value in applying a country-by-country fundamental approach** to identify where geopolitics, including the nature of China's bilateral lending, supports or hinders a sovereign's creditworthiness.

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Read the full paper
www.ftinstitutionalemea.com/china-lending

FOOTNOTE

¹ Source: Rhodium Group, “Seeking Relief: China's Overseas Debt After COVID-19,” 8 October 2020



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