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## **China's international development finance**

Past, present, and future

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**Abstract:** China is emerging as perhaps the most globally significant development finance provider, going far beyond concessional foreign aid. With China's initiatives to create and foster new multi-lateral finance institutions, and to work in terms of large economic landscapes in Africa, Eurasia, and Latin America, it becomes important to understand how China's own experience with rapid industrialization/urbanization processes and regional development is influencing its visions and financial instruments for development across the world. This paper examines how China's domestic development experiences have informed its approach to development finance abroad and explores what kinds of challenges and opportunities China will bring as it moves to the centre stage of international development finance.

**Keywords:** foreign aid, development finance, China

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## 1 Introduction

In this paper, we attempt to chart China's development finance across its distinct categories, how these various modalities began, and how they have evolved over time. We then ask how China's global development role might evolve in the coming decades as China moves to fulfil its objective of becoming a moderately prosperous nation of 1.5 billion people by mid-century through wide-ranging interrelated reforms. At one level, these reforms involve managing the macroeconomic challenges of rebalancing its real economy towards more consumption and less investment. At another level, they simultaneously involve shifting employment into higher productivity activities and new kinds of value-creation with Chinese entrepreneurial firms working on a global scale. While at a third level, China's agenda involves wide-ranging reforms of the financial system, state enterprises, and social protection.

It is now widely understood that China's development finance ranges well beyond its traditional official aid programme.<sup>1</sup> As described and quantified in its two recent White Papers on Foreign Aid, this traditional aid programme includes grant aid, interest-free loans, and the concessional loans channelled through the ExIm Bank with interest rate subsidies funded from the budget for the Ministry of Commerce (MofCom), which has the role of convener of the inter-ministerial aid coordination system and country level supervisor (State Council 2011, 2014). This traditional Chinese foreign aid involves fiscal transfers allocated in its annual budget and corresponds more or less with the Development Assistance Committee (DAC) definition of Official development assistance (ODA). On the basis of the MofCom budget allocation and adding in multi-lateral aid, China's traditional aid programme amounted in 2013 to some USD3bn.<sup>2</sup> Adding in aid programmes of ministries that are not funded via MofCom and who do not report their aid via MofCom, may increase this number to as much as USD7bn (Kitano and Harada 2014). The traditional programme has been growing fast, and capacity limits in terms of both modalities and staff are clear to those working inside the system.

However, much greater in scale is the lending to developing countries from two key state-owned 'policy banks' established in 1994, the China ExIm Bank and the China Development Bank (CDB), funded on Chinese and global financial markets and enjoying sovereign status. They both support large resource-backed loans and associated project financing and also help to finance China's 'going out' policy by assisting Chinese companies to develop off-shore business and foreign subsidiaries, and capture market share in strategic global industries (Brautigam 2009; Sanderson and Forsythe 2013; Dreher et al. 2015).

As elaborated further below, analysis of ExIm annual reports suggests that preferential export buyer's credit loans to developing countries may have amounted to USD7bn in 2013, up from USD1bn in 2008 (Kitano and Harada 2014). Meanwhile the foreign currency loans outstanding from the CDB, which are not concessional, have risen from USD64.5bn in 2008 to USD225bn in 2012 and USD251bn in 2013, with an average rate of increase of more than 30 per cent over this period; probably a reasonable proxy for the CDB's growing international development role (OECD 2015a). Thus the 'beyond ODA' development finance from these two Chinese policy

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<sup>1</sup> Tracking China's aid and other development finance is a difficult and contested field of research particularly at country and project level (Dreher et al. 2015; Brautigam 2009, 2010, 2015; China-Africa Research Initiative 2015). In this paper, we use published statistics at the aggregate level from Chinese institutions.

<sup>2</sup> China does not participate in the DAC reporting systems and the calculation of the grant element of its subsidized loans under the revised definition of ODA agreed at the end of 2014 (DAC 2014) would require country allocation data from the Chinese authorities, which is not available in the public domain.

banks looks to be some four to five times greater than the high estimate of the ODA-like flows described above, and ten times larger than the official Chinese figures for foreign aid (and the corresponding OECD estimate of Chinese bi- and multi-lateral aid).

This paper is organized as follows. We begin in this section by looking at China's traditional foreign aid programme, where it now stands after more than 60 years of experience and how its current challenges and reform needs are articulated by Chinese policy experts. We bring these issues back into our final section discussion on the future for Chinese development finance. In Section 2, we move to a brief overview of China's experience in financing its own development process since the decisive 'opening-up' reforms of the late 1970s. On this basis, in Section 3, we trace how the financial engineering devised to promote the rapid urbanization and industrialization process in China, based on explicit and implicit state guarantees, has been applied to China's going out strategy of developing a significant Chinese business capacity in strategic world markets and in developing countries. In Section 4, we bring these various strands together to consider how they may play out in the context of China's evolving situation as it (1) implements its reform programme giving a decisive role to market forces and entrepreneurship; (2) continues to grow in global macroeconomic weight; and (3) follows through with its new regional initiatives, working on transformational development programmes on a continental scale, using new China-based multi-lateral institutions and expanded co-operation with other donors and multi-lateral institutions alongside its key policy banks.

Before launching into this storyline, there are three overarching points that are best made upfront, on which we have written elsewhere and are fundamental to understanding Chinese development finance and related global economic governance issues (Xu and Carey 2014, 2015a, 2015b). While they will emerge below in various ways, we note them here as essential background, so that the arguments of this paper can be set out more readily.

First, China's development co-operation model remains based on the non-interference and mutual benefit principles established in the 1950s and 1960s, and is regarded by the Chinese authorities as part of the South South co-operation framework initiated at Bandung in 1955. Aid, trade, and investment are seen as interconnected in a mutual benefit framework. Meanwhile, the concept of Official Development Assistance (ODA) formulated by the OECD Development Assistance Committee in 1972 and reinforced in 2014 (DAC 2014) has at its heart a one-way transfer of wealth from rich countries to poor countries, with any commercial or financial benefits rigorously excluded by accounting rules and policy regimes. At the same time, national interests and foreign policy objectives are part of the scenery of all development co-operation and changing contexts are bringing significant departures from established principles on all sides.

Second, officially supported market-based loans from DAC countries are excluded from ODA and regulated by OECD export credit rules and IMF/World Bank debt sustainability assessment processes. Meanwhile, as outlined above, China has established a wide range of such financing, funded from financial markets with implicit and explicit Chinese government guarantees, with the CDB and the ExIm Bank playing a 'public entrepreneurship' role, supplying vision, action and innovation at a scale and speed that has outstripped OECD and Bretton Woods development institutions.

Third, while OECD statistical systems, rules, and policy review mechanism processes require and facilitate transparency in development finance flows at least among finance-providers, the transparency of China's aid and broader development finance is limited, with recent progress confined to the provision of aggregate information in the first two White Papers on China's Foreign Aid published in 2011 and 2014. Little progress has been made with the establishment of a Chinese government foreign aid statistical system envisaged in a draft set 'Measures for the

Management of Foreign Aid' issued in 2014 (MofCom 2014). Hence the ongoing difficulties in understanding and quantifying China's external development financing, concessional and non-concessional (China-Africa Research Initiative 2015).

In the papers on the governance of development finance cited above (Xu and Carey 2014, 2015a, 2015b), we have suggested that existing global governance systems will need to adjust to the new realities of more ambitious and entrepreneurial development finance with China at the forefront. At the same time, China now has very strong reasons to become more transparent as it seeks to engage others in its wide-ranging initiatives, as it becomes heavily dependent on the existence of effective states and markets for the functioning of its commodity supply chains, and for the success of burgeoning global investments by innovative Chinese firms in advanced sectors backed by market-based official finance from policy banks with sovereign status.

## **2 China as a provider of foreign aid**

In this section, we first present a brief history of China's foreign aid, and then examine its new regional initiatives. Finally, we explore the future directions and reform issues of China's foreign aid programme.

### **2.1 History**

The history of Chinese aid goes back to the 1950s and 1960s. Mao Zedong's Five Principles of 1953, the Bandung conference of 1955, and Zhou Enlai's Eight Principles of China's Foreign Aid laid out in Accra in 1964, together encompass the key ideas of equality and mutual benefit, knowledge sharing, non-interference, helping to generate self-reliance and independent development pathways, the own-responsibility of developing countries for their development, and South South solidarity. Aid relationships were a part of China's own search to establish its identity and position in the international community, particularly the competition with Taiwan for China's seat in the UN, eventually assumed in 1971. Hence, aid policy was decided and conducted at the highest political level, domestically and bi-laterally, a continuing feature of Chinese aid policy. A large-scale aid programme emerged, reaching 6-7 per cent of national budget expenditure in 1973. Support for liberation movements was a leading theme, a high point being the construction of the Tanzania-Zambia railway completed in 1976, a year that was also a key turning point in China's political history with the death of Mao Zedong.

From 1976 on, a strong effort to ensure effectiveness and financial discipline in aid projects was applied and the aid budget fell to less than 1 per cent of national fiscal expenditures by 1979. In the 1980s, as the economic reform process got underway, China itself became a significant recipient of aid from DAC countries, articulating its 'dual role' as a provider and a recipient, and absorbing the lesson that foreign aid could play a catalytic role in economic transformation.

In the 1990s, as the reform process towards a socialist market economy was confirmed, China's foreign aid became a toolkit for broader economic co-operation. In 1995, a Conference on Reforming Foreign Assistance produced a policy decision to establish joint ventures between enterprises from both China and its recipient countries to invest in projects of high return. The ExIm Bank, created in 1994 as a 'policy bank' (along with the CDB and the Agricultural Development Bank of China), saw the introduction of concessional loans, with interest subsidies funded from the general budget, to leverage commercially oriented flows. A Foreign Aid Fund for Joint Ventures and Cooperative Projects was established. Provincial governments were enlisted on a pragmatic basis to implement projects, drawing on their own development experiences in China. The main fields of activity were agriculture, education and training, health, and infrastructure.

## 2.2 New regional initiatives

In 2000, the Forum for China-Africa Cooperation (FOCAC) was founded, where aid, trade, financial credits, and private equity have been drawn together. FOCAC is a triennial process at Heads of State level, bolstered by systematic annual visits to African countries by top Chinese leadership. In this framework, China-Africa trade soared, with China's growth trajectory generating a global commodities boom and China's globalization policies gaining African markets. Chinese foreign investment in Africa began to increase dynamically. A China Africa Development Fund (CADF) was established, as a subsidiary of the CDB, to inject equity capital into Chinese ventures in Africa. The most recent FOCAC outcome documents and action plans have extended the agenda to embrace support for regional integration and regional infrastructure, industrialization, and peace building, including financial assistance for the African Standby Force, which is to be operational from 1 January 2016.

This agenda was amplified by Prime Minister Li Keqiang in a speech to the African Union in May 2014, linking the Chinese Dream with the African Dream (the AU Africa 2063 agenda), via major investments in connectivity, embracing high speed rail, regional aviation, and ICT infrastructure and systems, urbanization, industrialization, and peace and stability, thus bringing together the 'modernization of two continents' (Li 2014). It was backed up the following month at the African Development Bank Annual Conference with an 'Africa Growing Together' Fund of USD2bn co-financing money over 10 years, financed by the People's Bank of China and open to procurement and participation of all African Development Bank members. At the same time, the USD20bn credit line extended in FOCAC V, which ends in 2015, was increased to USD30bn and the China Africa Development Fund (providing private equity capital) was boosted from USD3bn to USD5bn (Li and Carey 2014). The Johannesburg Action Plan for 2016-2018 emerging from FOCAC VI in December 2015, boosted the credit line to USD35bn for the new triennium, increased the China Africa Development Fund to USD10bn, the special loans for SMEs from USD1bn to USD6bn, and created a new China-Africa Production Capacity Fund with an initial amount of USD10bn (FOCAC 2015).

China has launched two further wide ranging geographical initiatives, with the Community of Latin American and Caribbean States (CELAC) for Latin America (Xinhuanet 2015a) and the Silk Road Initiatives (Xinhuanet 2015b). These geographical initiatives are not concessional aid programmes but broader multidimensional economic co-operation programmes with non-concessional loans and equity investments from the policy banks aiming to crowd in other actors and investment (Xu and Carey 2015a).

## 2.3 Future directions and reform issues

The broad history sketched above has been described as a move through three major phases (Huang and Wei 2015): (1) the political orientation of the period from 1950-1976; (2) an economic development orientation from 1978-2015; and (3) now a strategic orientation underpinning China's position in a global economy with a new economic geography, as captured in the initiatives noted above linked to its interests and capacities as a major creditor country, transforming its excess foreign reserves into real investments with returns stretching into the long term future (Yu 2013).

China is thus moving, very suddenly, from its traditional largely passive role in international development governance to a new role as a proactive institutional and conceptual innovator based around a large view of geography and development. Hitherto, the prevailing critiques of traditional Chinese aid by Chinese academics (IDS 2014; CIDRN 2015; Zhang et al. 2015) have been that:

- A more strategic, thematic approach to aid programming is needed to supplant the heavily project-based, bottom-up character of Chinese aid (Xue 2014);
- This requires strengthening analytical and research capacities in universities and think tanks and the availability of more data;
- Policy and administrative structures need to be more concerted (a working committee at State Council level, with a substantive and independent secretariat is one suggestion);
- A systematic evaluation function should be introduced;
- A significantly larger professional staff is needed to co-ordinate and implement China's development programmes.
- Civil society, the private sector, and the Chinese public should now be brought into what is a very closed and even secretive system of policy making (despite the White Papers introduced following China's participation in the Accra High Level Forum on Aid Effectiveness in 2008 and the ongoing activities of the China-DAC Study Group).<sup>3</sup>
- Efforts to involve local stakeholders are judged to be inadequate and more training for Chinese actors in the appreciation of local contexts should be a priority (needs also evident in the Chinese enterprise sector).
- China should now take an active part in the new global development partnership agenda, based on its own experience and principles, driven by the real demands of the developing world and thus help to reshape the global development governance structure (Li and Wang 2015).

On this last point, with China's active support for the Sustainable Development Goals (SDGs) and new Climate Change Framework (UNFCCC 2015), and with its Presidency of the G20 in 2016, the articulation of a current Chinese perspective on development strategies will no longer be a missing element in global governance discussions. As a sign of a new China-based development discourse, the Development Research Centre (DRC) of the State Council is launching an International Knowledge Centre on Global Development, as announced by President Xi Jinping at the 2015 UN session on the SDGs (Xi 2015). The DRC is also launching a Silk Roads Think Tank Network and is building up its own new International Development Department on a significant scale.

Thus, with its new regional programmes, multi-lateral institutions, and its ambition to transform its excess foreign reserves into real investments around the world with returns stretching into the long-term future (Yu 2013), China is among the most entrepreneurial of development finance providers. There is a case now for connecting its traditional aid system with its new initiatives. That prospect has indeed been advanced by a set of new regulations applied to the traditional aid programme on a trial basis (a technique commonly used in China to test policy reforms). Introduced in November 2014 and so far available on the MofCom website in Chinese only (but press conference script available in English), these regulations include provision for the Ministry of Commerce to collaborate with other agencies to formulate long-term policy planning and country strategy papers. MofCom officials explicitly envisage that such an inter-agency process will generate strategic planning frameworks for their development co-operation with countries and regions, and

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<sup>3</sup> The China-DAC Study Group was inaugurated in 2009, with the International Poverty Reduction Centre in China and the DAC Secretariat as co-Chairs (OECD n.d.).

a basis for linking up the traditional aid system with the activities of the Policy Banks and China's new regional and institutional initiatives, with a better connection to local contexts and stakeholders, and with greater local ownership. (MofCom 2014a, 2014b).

The current structure of aid policy making lies under the State Council, chaired by the Prime Minister. China's traditional aid programme is co-ordinated by the Ministry of Commerce Department of Aid to Foreign Countries, supported by the Ministry of Foreign Affairs and the Ministry of Finance and involving some 27 other Government departments. The Ministry of Foreign Affairs co-ordinates the FOCAC through a similar structure and the Ministry of Finance co-ordinates China's participation in multi-lateral development banks.

How might the Chinese co-ordination structures be reformed to underpin and follow through on the ambitious new initiatives? Three options have been identified by Chinese scholars for reforming the traditional foreign aid programme (Huang and Wei 2015):

1. bringing the planning and co-ordination function inside the Ministry of Foreign Affairs;
2. establishing a new comprehensive aid agency outside of the existing departmental structures;
3. set up a new central foreign aid leader group under the State Council.

Given the long tradition of top leadership involvement in aid policies in China and the State Council's role in supervising the policy banks, this latter option may have particular advantages. Such a leader group would potentially promote strategic co-ordination with the new geographical and institutional initiatives, which have been generated outside of the traditional aid programme, involving the policy banks and the new multi-lateral institutions and fora in which China is now heavily investing. The strengthening of the professional human resources, aid modalities, programme design, and evaluation processes would be a necessary complement to any of these options.

Against this background we now turn to what we see as the central global interest in China's development finance—its role as an innovator in leveraging the sovereign guarantees enjoyed by its Policy Banks to scale up massively support for infrastructure, renewable energy, and mobile technology—key components of the UN 2030 Agenda for Global Action adopted by Heads of State at the September 2015 UN Summit under the heading of *Transforming our World* (UN 2015b). We argue that China, acting as a global public entrepreneur supplying vision, action, and innovation, and engaging via both its state-owned and private companies, will make a central contribution to the scaling up of sustainable development and employment generation needed for economic transformation.

### **3 China's domestic development finance**

In this section, we first examine the history of China's domestic development finance since it adopted the opening-up and reform policy in the late 1970s, and then take a close look at the role of CDB in scaling up long-term finance.

#### **3.1 History**

China's economic take-off began in the rural sector, when a bottom up reform of land tenure arrangements originating in a single small village spread across China, incentivizing a large increase in agricultural output and in the words of the current Prime Minister, Li Keqiang, 'solving



the centuries old problem of hunger in China within two years' (Li 2015). Public investment in rural infrastructure and schemes to promote rural enterprises created rural employment and lifted incomes. Farm investment was essentially provided by household labour. Food supply and prices for urban consumers provided the basis for an urbanization process to begin, with the rural sector effectively subsidizing the urban sector (Lin 2011).

With low savings and no adequate financial institutions, the modernization and expansion of Chinese industries and infrastructure in the first decade of the reform process (in the 1980s) was financed notably by a series of key ODA loans from Japan, amounting to some USD9bn between 1979 and 1995 (Brautigam 2009). These were resource-backed loans, with repayments made from oil exports to Japan. Here, China learned the model that it has later applied in its loans to developing countries (Brautigam 2009). Other bi-lateral finance helped as the modernization process got underway. The World Bank provided not only finance but also crucial advice and training in infrastructure project selection, design, and management; procurement via competitive bidding processes; and how to raise financing in international bond markets and apply associated debt management techniques. The World Bank also provided advice and training in investment banking. Thus, China's recognized capacity to learn from its donors and other providers of development finance across a wide range of sectors, applied equally to the development finance sector itself. While China used ODA and other official finance extremely effectively via robust internal management systems and a dedication to learning from its partners, ODA was a relatively small fraction of China's total external finance through the reform period (Zhou et al. 2015).

In the early 1990s, domestic savings and state-owned banking institutions began to come into place. But the investment financing demands of an urbanization/ industrialization/ globalization growth dynamic were outstripping supply, and this capital shortage was compounded by a major tax reform that sharply reduced the share of tax revenues raised at the local level, while local governments were prohibited from raising funds on capital markets themselves or borrowing from banks. It was at this point that the CDB was created as one of a suite of three state-owned 'policy banks' directed at helping China to accelerate its growth process, alongside the China ExIm Bank and the China Agricultural Bank.

#### **4 The China Development Bank and the financial engineering of superfast growth**

In its initial years, there was little discipline in CDB operations and it accumulated nonperforming loans equivalent to 40 per cent of its loan portfolio. In 1996, a new President of the CDB, Chen Yuan, introduced a strong loan approval process and bad debts were transferred off its balance sheet (Harvard Business School 2011). At the same time, in the context of the purchase and transfer to China of a closed down UK automobile plant, the CDB developed in association with the city of Wuhu, a financing model based on the creation of what was to be the first Local Government Financing Vehicle (LGFV). These structures allowed local governments to raise money off their budgets and balance sheets, effectively getting around the financial constraints imposed by the fiscal reforms of 1994. Essentially, the LGFVs raised revenue from sales of requisitioned farmland and its absorption into the urbanization process. This revenue was dedicated first to repaying loans from financial institutions used to finance urbanization (Sanderson and Forsythe 2012).

In a somewhat parallel fashion to the land reform of 1978, an initiative of one village then replicated across China, the LGFVs were an innovative response to a specific local opportunity that quickly became a standard part of the urban/industrial development process across China (more than 10,000 LGFVs were eventually created). CDB assistance and loans mobilized a further tier of lending from China's state-owned commercial banks. The CDB raised its own funding from

bond issues purchased by these commercial banks, whose funding came from their deposit bases. CDB bond issues were and continue to be state guaranteed. A move to reclassify the CDB from ‘policy bank’ to ‘commercial bank’ under the previous government has never been confirmed. Indeed, recently in March 2015, the State Council re-emphasized that CDB should continue to rely on sovereign creditworthiness and deploy market mechanisms in an effort to achieve its public mandates such as stabilizing economic growth, adjusting economic structures, and further scaling up support for priority sectors and underprivileged regions.

It is not within the scope of this paper to review the costs and benefits of this whole phase of China’s financial and economic history and the legacy issues associated with it, including the investment boom associated with China’s response to the 2008 financial crisis and local government debt burdens. Suffice it to say that the CDB has been at the origin and at the core of the financial engineering underlying China’s modern urban infrastructure and special economic zones, the completion of major projects such as the Three Gorges Dam and the Pudong district of Shanghai, the involvement of the west of China in the development process, linking up China’s cities and regions with advanced transport infrastructure, and investing in some of China’s most entrepreneurial private companies. It has also moved into financing environmental protection and clean-up programmes. Suffice it to say also that mistakes and risks as well as success provide important lessons for China and for other countries, including the importance of the social and environmental dimensions of development, responsibilities and revenues at different levels of government, and the efficiency of public investment, all of which are the subject of intensive study and debate in China itself—an important current reform.

For our purposes here, the key point is that the CDB has through this history, become a development financing institution of global importance with financial and professional skills, experience, and connections that are huge assets. Reporting directly to the State Council, a high-level international advisory board has been part of its corporate governance structure. Its recent moves into private equity financing, with international partners, and its involvement in financing highly entrepreneurial Chinese firms with global reach and ambitions, underline its capacity to act at the frontiers of development, with a long-term perspective, a creative learning by doing approach, and innovative financial engineering (Sanderson and Forsythe 2013).

#### **4.1 China as a provider of market-based official development finance**

After examining ideas and practices of China’s development finance, we move to explore the role of China as a significant provider of market-based official development finance abroad. We first illustrate how Chinese policy banks have sparked a renewed interest in market-based official finance among advanced economies, and then take a step further to explore opportunities and challenges of market-based official development finance as a fast growing sector of development finance.

#### **4.2 The Chinese Policy Banks spark a reawakening interest in market-based official finance**

The CDB and the China ExIm Bank constitute development institutions that rank in scale and capacities with the multi-lateral development banks. As noted in the introduction above, at year-end 2013, ExIm Bank had outstanding buyer’s export credits of USD31bn and lent USD8.7bn in that form in that year. At the same point in time, the CDB had outstanding foreign loans of USD251bn, a net increase of USD26bn over 2012. These numbers are drawn from a consultant’s report commissioned by the OECD (OECD 2015d), based on the annual reports of the two institutions, which notes that both institutions are less transparent on the breakdown of these activities than previously. However, the CDB does indicate that its USD251bn stock of foreign

lending extends over 114 countries and 5 continents, with USD67.3bn in Asia-Pacific, USD54.3bn in Eurasia, USD18.9bn in Eurafrica, USD16.3bn in Africa, and USD58.7bn in the Americas.<sup>4</sup> Its foreign loans amounted to 22 per cent of its total loan book, up from 15 per cent in 2008. The ExIm total foreign loan book at year-end 2013 was USD96bn (OECD 2015d). While it is not possible to make precise comparisons, to have some idea of relative magnitudes, in FY 2013 the World Bank Group disbursements were USD40bn, including USD19bn from the IBRD, USD11bn from IDA, and USD10bn from the IFC. A further USD3.3bn was disbursed from trust funds. Loans outstanding were USD155bn at the IBRD, USD127bn at IDA, and IFC had a committed portfolio of USD50bn, adding up to USD332bn (IBRD 2015; IDA 2015; IFC 2015). The total loan book of the CDB at year-end 2013 was USD1.154bn and for the ExIm Bank, USD234bn.

Like the multi-lateral development banks, the ExIm Bank and the CDB are providing an intermediation function between financial markets and developing countries that is based on sovereign guarantees that underpin their access to financial markets. Both the CDB and the ExIm Bank are funded by renminbi bond issues and other financial instruments, purchased by Chinese banks and with the same credit rating as Chinese government bonds. The CDB has launched successful international bond issues as well. Such development finance is official in the sense that it relies on sovereign creditworthiness to raise funds and market-based, and do not involve direct fiscal transfers. The CDB (with staff of 8,500) does not aim at maximizing profits but at ‘achieving the economic result of break-even with thin profits characteristic of developmental finance’ (OECD 2015d). Similarly, the ExIm Bank (with staff of 2300) is financially self-sustaining with a thin profit margin of 0.23 per cent of total assets in 2013. Its subsidized concessional loans are part of Chinese foreign aid, but no specific numbers are reported. It offers preferential buyers credits outside of the aid programme, but again no reporting is provided. Beyond these categories, ExIm and CDB are providing non-concessional finance based on borrowing at sovereign rates, which enables them to provide borrowers with attractive terms.

The role of market-based official development finance is in the process of being rediscovered, not least because of the scale of the financing needs foreseen moving from billions to trillions in the words of a recent report relating the collective thinking in the established MDBs and the IMF (Rogerson et al. 2014; World Bank/IMF 2015; ODI 2015; Spratt 2015). In the Addis Ababa Action Agenda (4A), the MDBs are encouraged to carry further their collective thinking about their own role, scale, and functioning. On the bi-lateral front, the actions of a number of DAC country agencies to borrow on financial markets to finance loans that have then been reported as ODA, even without any fiscal transfer involved, has provoked a significant tightening up of the ODA definition of concessional lending, with incentives built in to encourage highly concessional lending to the poorest countries and discourage loans to upper middle income developing countries. Alongside this adjustment to what finance qualifies as ODA, is the proposal to create a new measure—Total Official Support for Sustainable Development (TOSSD)—to capture market-based official support for development finance from all sources, both developed and developing countries (UN 2015b).

The case of the CDB and the China ExIm Bank has undoubtedly helped to stimulate this reawakening and the initiatives of some DAC countries to expand or create such development financing entities are likewise inspired at least indirectly by the Chinese example. And when the United States (US) EXIM Bank was allowed by the US Congress to descend into legislative limbo in mid-2015 (a situation remedied in December 2015), researchers with close knowledge of the US development system proposed establishing a US development bank with a wide remit adapted to

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<sup>4</sup> The balance of USD35bn is not specified.

leveraging US entrepreneurship (Moss and Leo 2015). The Addis Ababa Action Agenda endorses the expansion of development banks as an instrument for intermediation between financial markets and scaled up development programmes (Spratt 2015; UN 2015a).

A distinguishing feature of the CDB and ExIm Bank's operations in developing countries is the level of ambition and scale and the associated search for transformative impact. They involve large packages of financing in often politically risky situations, such as the USD2bn ExIm multi-sector package for Angola in 2004 leading on to further large involvement in Angola's development process; the USD6bn CDB package for the DRC in 2010; a USD10bn CDB country loan to Brazil, the subject of a Harvard Business School case study (Harvard Business School 2011); a cumulative USD40bn of lending to Venezuela; a series of major infrastructure development loans to Ecuador; the financing of industrial development zones in Africa, with associated urban development lending as in Ethiopia; the credit lines made available under the FOCAC action plans; and most recently a USD46bn financing package for Pakistan to create a China-Pakistan economic corridor.

These packages are in almost all cases contractually linked to repayment from resource revenue streams generated by projects within the packages, but the activities include support for broader development investments and associate other Chinese financial institutions and investors, contractors and provincial level actors. The financial transactions involved in project financing pass through Chinese channels, and for the most part procurement is tied to Chinese procurement though this can be relaxed. As mentioned earlier, many of the techniques and packages and association of national actors are learned from the Japanese resource-backed loans to China in the 1980s. The Chinese policy banks do not provide any detailed reporting on these loans, the progress of implementation, disbursement, or completion reviews, hence the various attempts by external researchers to track and estimate projects, status, and disbursements (AidData 2015; InterAmerican Dialogue 2014).

Nor is there any information on the terms of the resource-backed loans that might indicate whether the major fall in commodity prices, associated in part with China's shift to a lower 'new normal' rate of growth, is endangering their viability. Any such risks have yet to show up in non-performing loan data from the policy banks, or in any public renegotiation of such loans.

### **4.3 The Chinese policy banks as 'public entrepreneurs'**

The CDB and ExIm are by no means dedicated to providing development financing to developing countries. Much of their international business is with developed countries, including Australia and Russia. CDB financing for a large new UK nuclear energy plant, in conjunction with the French state electricity multinational (EDF) has now been agreed. In addition, the CDB and ExIm Bank provide major credit lines to Chinese enterprises, not just state-owned but also private companies such as Huawei, Alibaba, and solar and wind-power companies. For these private companies, the loan terms for ExIm and CDB credit lines are not concessional, but they provide the confidence to work with long-term horizons and to scale up. They also crowd in financing from other financial institutions, both Chinese and international (Sanderson and Forsythe 2013).

It is in this sense that we see the Chinese policy banks as a central part of the 'public entrepreneurship' that has enabled China to overcome the first mover problem long identified by development economists, whereby the development process must be co-created by the public sector and the private sector in close interaction (Klein et al 2010; Xu and Carey 2015b). The state capitalism mode so often used to describe China's development model misses how the public and private sectors have interacted in China's development process at a decentralized level. The policy banks have assisted the emergence of a creative, entrepreneurial private sector that has driven Chinese growth and employment and is currently beginning to impact on advanced

industries globally with new business models with fast reaction times (Tse 2015). China does not have a planned economy but a networked private sector-driven economy with decentralized decision-making in a context of centralized policy vision and authority that is moving a complex country along a comprehensive, ambitious reform path in an established trial and error tradition (Lardy 2014).

How then is the Chinese development banking function to be regarded and assessed in terms of its roles and impacts, and the extent to which it repairs market failures, or creates distortions in resource allocation and institutional incentives? And what is the contribution to international development finance in terms of ideas?

A first point here is that these two ‘policy banks’ are intensely focused on financing the real economy and its transformation via actors at multiple levels and across sectors, supplying creative, adventurous financial intermediation. A common critique of the global financial industry and indeed of the OECD corporate sector is that it is engaged in socially unproductive financial and fiscal engineering and the accumulation of profits that are returned to shareholders rather than invested in the future (Kay 2012; Haldane 2015). While entrepreneurship is still very much alive in the developed world, problems of short-termism and low returns on pension fund assets are major policy preoccupations, not least at the level of the G20. In the field of development financing, a current conundrum is how to mobilize large pools of long-term savings into long-term investments in infrastructure (a conundrum applying in OECD countries themselves), lifting economic performance, and hence income streams from investments in developing countries’ real and financial assets stretched over the longer term. Sovereign guarantees of one kind or another are now widely accepted as a necessary part of the solution to this market failure. The Chinese policy banks are using their sovereign status to solve exactly that conundrum, taking the view that investment on a large scale is needed to produce the economic and social transformations required for developing countries to raise their growth rates and to generate the capacity to service such growth-producing finance. The former president of China’s ExIm Bank has laid out this case explicitly (Li 2007).

A second question is related to the efficiency and viability of the Chinese policy banks. In the perspective of the global investment scene, a recent OECD report on the current financial and business outlook takes the view that the world has a fundamental conundrum, in that OECD governments and companies are underinvesting due to perceived risks, perverse incentives, excessive austerity, and political dysfunctions and hence adding to the savings-investment imbalance that has driven interest rates to zero in many developed countries. At the same time, in emerging countries and China in particular investment rates are subject to market and policy distortions, which have pushed investment up to the point of overinvestment and reduced its productivity with resulting negative value creation. On this view, the world is suffering a marked decline in the global efficiency of investment (OECD 2015b). The resolution of this conundrum is seen to be on the one hand a switch from investment to consumption of around 10 per cent of GDP in China, with a concomitant rise in the efficiency of investment and a rise in public investment ratios in the advanced economies (OECD 2015c). On the Chinese side, this is not a contested question. The Chinese reform programme is geared to such a switch, to making the role of market forces the decisive element in resource allocation, and to making integrity of systems and people a central objective. The deep functional and legitimacy dimensions and political and management complexities of this policy shift are widely acknowledged, not least in China itself. A move to refinance the debt of local governments and to make formal financial channels more competitive is part of this reform. The CDB was an essential actor in a repressed financial system and now using its extensive networks to leverage the enterprise and capacities it helped create to rebalance and ‘green’ the Chinese economy.

A third question is whether China is taking on too much risk in its lending to developing countries with problematic political contexts and complex projects. Is the sovereign guarantee behind the two policy banks being stretched too far? At what point does China in fact depart from its non-interference principle and become engaged in policy dialogue that parallels or contradicts the Bretton Woods Institutions, notably in countries such as Zimbabwe or Venezuela, where the survival of entrenched political regimes is at stake? Will the rebalancing of the Chinese economy drive a more prolonged secular fall in commodity prices undermining debt sustainability in some of its major borrowers? Or will Chinese investments help to drive the transformation process forward in these countries and globally? These questions have become a central part of global policy debates.

Finally, to sum up these issues, does China's development strategy via the use of policy banks and explicit and implicit guarantees amount to a manipulation of market incentives that damages global welfare or does it promote the prospects for sustainable development across the world? We now turn to these questions.

## **5 An entrepreneurial China: impacts of China's international development finance in the future**

Looking ahead, an entrepreneurial China, already a reality, will be a global development force. In its economic transformation, it has acquired management and entrepreneurial resources via inward foreign investment and its high savings ratio has generated huge financial resources. It has a widening range of innovative enterprises that will drive up productivity and value addition, in combination with a new innovation based development strategy announced earlier this year with the objective of spreading entrepreneurship throughout the economy (Li 2014; State Council 2015). Its leading entrepreneurs support the comprehensive reform programme introduced by the Chinese Communist Party in 2013, which involves complex implementation issues with global impacts (Tse 2015). While there are different possible scenarios for China's pathway ahead in terms of its capital flows and reserve accumulation, capital exports via rising outward direct investment and its large regional initiatives seem certain to be a continuing vector, associated with rising Chinese wage rates.

The most fundamental issue is indeed how China's economic evolution impacts on global development prospects and global welfare. Here we focus on three medium term issues with structural development impacts. The impacts would come at three levels: macroeconomic; technologies, business models, and structural transformation; and global development partnerships.

At the macroeconomic level, China's continuing growth at some 'new normal' will influence growth prospects worldwide via commodity prices, global demand, and global confidence. Furthermore, whether or not the rebalancing of investment and consumption in China still leaves China with a net current account surplus, the impulses towards diversification of its foreign reserves and towards becoming a reserve currency will generate significant capital exports. These capital exports will be facilitated by the institutional and technical capacities that China has developed in the years of its infrastructure investment boom, as embodied in large engineering firms such as PowerChina and the railway and road construction industries, but also the new generation of entrepreneurial private companies.

At the level of structural transformation, rising income levels mean rising labour costs and hence a move of labour intensive industries to low income countries associated with rising Chinese foreign direct investment in those countries. Justin Lin estimates that some 85 million low wage jobs will leave China for other developing countries in the next 10 years accompanied by a large flow of

Chinese investment and sees this process as an engine for structural transformation in Africa (Lin and Wang 2014; Poon 2014).

As China moves up the value chain and confronts its domestic challenges and opportunities, it will absorb and generate technologies and business models that will change development prospects. As is happening globally, entrepreneurial companies, including companies from China, will be in the forefront of transformational development advances (Fry 2015). Three critical areas are already apparent here.

First, Chinese companies are driving down the costs of renewable energy, particularly solar technologies, to the point where low carbon development strategies become feasible for developing countries. Solar energy costs have fallen rapidly thanks to Chinese investments (IEA 2014). A significant 45 per cent share of China's incremental energy production over the medium term is forecast to be supplied from renewable sources, with solar energy as a strategic part of the energy system. Off grid solar energy systems already transform the lives of poor people in developing countries. Solar powered street lighting in Mogadishu, made in China and financed by the UK and Norway, has made life secure after dark and can do so in towns and villages everywhere. Affordable electric vehicles and urban mass transport (including battery-powered buses now in production) are a policy priority. The IEA expects that China will account for 46 per cent of global nuclear power expansion in the medium term. Hence, China's strong incentives to deal with its own air pollution and create a green economy at scale promise to generate large positive spillovers for the world as a whole in terms of costs and supply of low carbon energy technologies.

Second, the Chinese contribution to making affordable mobile technology hardware and infrastructure available in developing countries is having a major impact on lives and livelihoods across the developing world. Chinese mobile and internet companies are now moving into the forefront of these sectors, including the development of internet-based financial services, and the supply of low cost smart phones, reshaping current business models in the global smart phone industry and now in the mobile content industry as well. Its contribution to the vibrant mobile industry in Africa, where local firms are in the vanguard of leapfrogging applications of mobile technology, is particularly significant.

Third, China's urbanization process, still ongoing, has generated many achievements and lessons. The learning by doing basis of the economic growth mechanism, intimately associated with the development of cities and constant interaction of people and the economics of agglomeration, are abundantly evident in China. So are the human and social costs of rapid urbanization and inefficiencies in urban planning. The need for a new urban development model is acknowledged (OECD 2015c). Innovative energy efficient building designs and city layouts are being introduced. Meanwhile, China is helping with urban development in Ethiopia, both in Addis Ababa and secondary cities, and in Angola (Benazeraf and Alves 2014). Again, the scope of actual and potential Chinese assistance and investment in the urban sector is an order of magnitude beyond other bi- or even multi-lateral assistance providers. In all of the above areas, the Chinese policy banks are providing financial support to the Chinese companies involved in the domestic industries concerned and in the international expansion of those industries.

Last but not least, at the level of global development partnerships, evidence increasingly shows that China is ready to take a leadership role in the field of international development. The question of China's approach to global development partnerships has been radically clarified by the announcements of its major regional initiatives—for Africa's modernization, for the creation of land and maritime linkages across Eurasia and beyond (the Silks Road initiative), and for transcontinental linkages in Latin America. In each of these initiatives, China is expressing its desire

to engage other partners. At the same time, these initiatives reflect a readiness to take on leadership roles in the creation of new economic landscapes that have been beyond the scope of the international development agenda so far.

Associated with this leadership role are China's initiatives to establish an Asian Infrastructure Investment Bank and host the New Development Bank being set up by the BRICS Summit members. A Silk Road Fund has also been established, based in Beijing as a provider of equity finance, and a Shanghai Cooperation Organisation Development Bank is also to be set up (India and Pakistan have just become members of the SCO and hence the SCO Bank will have a larger significance than previously foreseen). Again, China is ready to engage with others in these new ventures. The geopolitical impact is evident, particularly in the divided response of G7 countries towards joining the AIIB and the prolonged reluctance in the US Congress to adjust power sharing in the Bretton Woods Institutions, as agreed by the G20 in 2010, to open the way for China to be more influential there (Galan and Ma 2015). In a surprise low-key move, ratification of the IMF reform was incorporated in an omnibus spending bill adopted by the US Congress in mid-December 2015 (IMF 2015). The stakes involved for the US, in terms of the prospects for China's growing influence outside of the Bretton Woods institutions, were evident in the statement by US Treasury Secretary Jack Lew that 'the IMF reforms reinforce the central leadership role of the United States in the global economic system and demonstrate our commitment to maintaining that position' (US Department of the Treasury 2015).

It is clear then, that China is emerging as an architect in the international development system, creating new perspectives on global economic and political geography (Humphrey et al. 2015). The new reality is that a Chinese sponsored set of multi-lateral finance institutions will be a part of the scenery of development co-operation in the future (Reisen 2015). Chinese policymakers increasingly realize that a multi-lateral approach to development finance can not only mitigate risks in politically risky countries and uncharted frontier markets, but also create scope for positive-sum gains for key stakeholders. Moreover, the new multi-lateral institutions bring scope for innovative financial engineering that can generate funding to match the new scale of ambition in the SDGs (Lim and Mako 2015; Reisen 2015).

## **6 Conclusion**

In this paper we have examined how China's domestic development experiences have informed its approach to development finance abroad and explored what kinds of challenges and opportunities China will bring as it is moving to the centre stage of international development finance. A key lesson China brings from its domestic experience is the level of ambition—a readiness to think in terms of creating new economic landscapes involving comprehensive financial packages and assembling multiple actors. The idea of transformative investment has been advanced in the global policy discussion by China and absorbed into the G20 and World Bank vocabulary. China's public entrepreneurship model of development, with policy banks and innovative enterprises playing a key role, is gaining recognition as well as generating global economic governance issues (Xu and Carey 2015b). At the same time, China is moving forward with the lessons of its experience in terms of the social and human capital dimensions and environmental impacts. The strong domestic priority for creating a green economy is generating global spillovers in terms of green energy technologies. These domestic priorities and capacities as well as reputational factors should work to shape the priorities and standards in its international initiatives.

The shift from a passive role in international development discussions to becoming a leader of large new regional initiatives and new multi-lateral finance development institutions is a radical step forward in China's articulation of a strategic approach to its position in the global economy in



which it may soon become the largest actor. For some, the evidence is that China's development co-operation model is not on a convergent path with other development co-operation providers (Kondoh 2014; Humphrey et al. 2015). The new Measures for Management of Foreign Aid currently under trial (Ministry of Commerce 2014a, 2014b) propose more systemic and strategic approaches to development co-operation and more transparency and statistical information. It is possible that the reform ideas emerging from the Chinese development research community will begin to have traction as managing China's external development initiatives stretches the existing administrative system beyond its current shape and size. China is inviting wide participation in its new initiatives. This will require a different and more transparent way of doing business. The new international forums that China is establishing, linked to the State Council, are a significant indication of such a new way forward.

To harness China's growing financial power as a force for good, the international development community needs to take advantage of China's proactive move to utilize triangular co-operation and multi-lateral development institutions (Berglöf 2015). As China moves to work with others and as its common interest in effective states and markets becomes more evident and unavoidable, a decisive move at the highest level to provide significantly greater transparency in Chinese development finance would need to be made (Xu and Carey 2015a). With the transformation paradigm now embedded in the UN 2030 Agenda for 'Transforming the World', China's presidency of the G20 in 2016 provides the context for such a decisive shift in the embedded practices of China's development co-operation.

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