EMERGING MARKETS: HEADING FOR A CHINA-LESS RECOVERY?

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China played a crucial role in the global economic recovery after the 2008-09 financial crisis, but the post Covid-19 recovery will be different: We expect China to slow its international engagement over the next few years. In this context, Angola, Kenya, Ethiopia, Ecuador and Ghana, along with Brazil and South Africa, could struggle to find alternative international sources for funding, investment and trade to sustain their economic growth. The Chinese economy is likely to experience profound changes in the medium to long run, with a shift in the country's priorities (dual circulation strategy), the slowdown of economic growth and a heavy domestic debt burden (see our recent report for more details). As a result, we expect China's role as the global growth driver to recede in the coming years. To identify what this could mean for low- and middle-income countries, we look at three different channels of impact: debt, investment and trade.

Figure 1 – Vulnerability to China turning inwards via the debt, investment and trade channels

	Debt channel		Investment channel			Trade channel	
	External financing needs (as % of GDP), 2021-2025	Debt owed to China (as % of total external debt), latest	Stock of total FDI (as % of GDP), 2018	Stock of FDI from China (as % of GDP), 2018	Change (%) in stock of FDI from China, 2018 vs. 2012	Total exports (as % of GDP), 2019	Exports to China (as % of total exports), 2019
Argentina	109%	6%	14.0%	0.3%	76%	13.5%	10.6%
Brazil	42%	9%	30.4%	0.2%	163%	12.2%	28.0%
Ecuador	55%	21%	17.3%	1.2%	204%	20.1%	13.0%
Angola	71%	30%	21.5%	2.2%	85%	38.8%	67.6%
Egypt	54%	5%	47.1%	0.4%	135%	10.2%	1.7%
Ethiopia	36%	49%	27.9%	3.2%	323%	4.3%	8.8%
Ghana	62%	14%	55.1%	2.7%	256%	25.1%	16.7%
Kenya	63%	37%	16.4%	2.0%	336%	4.1%	3.8%
South Africa	133%	16%	37.6%	1.8%	37%	25.7%	10.7%
Zambia	37%	45%	74.9%	13.4%	76%	31.4%	20.6%

Sources: national statistics, Euler Hermes, Allianz Research

First, China is likely to gradually disengage from the debt-financing of low- and middle-income countries amid on-going repayment challenges. For our sample of ten economies[1], this would result in a USD47bn external financing gap by 2025. Over the past decade, Chinese financing to capital-scarce emerging and least developed economies had grown significantly[2], in line with its strategic objectives and the Belt and Road Initiative (BRI launched in 2013, see Appendix). This lending definitely helped some countries bridge their infrastructure gaps (e.g. Ethiopia, Kenya, Zambia). However, China also granted large amounts of

[1] Our sample consists of ten African and Latin American countries that have benefited from strong Chinese engagement since 2010: Argentina, Brazil, Ecuador, Angola, Egypt, Ethiopia, Ghana, Kenya, South Africa and Zambia.
[2] For the 50 largest recipients of Chinese direct lending, the average stock of debt owed to China would increase from less than 1% of debtor country GDP in 2005 to over 15% of GDP in 2017 (https://www.nber.org/system/files/working_papers/w26050/w26050.pdf).

commercial loans to countries with high default or sovereign risks, such as Argentina, Ecuador and Angola[3]. These loans were sometimes backed by natural resources (see Appendix), ensuring that borrowing countries enjoyed acceptable interest rates depite a sensitive credit rating. Such asset-backed loans were generally accompanied by agreements for Chinese firms to own part of oil fields or refinery projects, offering an alleged "win-win solution" to both parties.

But the tide turned in 2020 (and even before the Covid-19 outbreak), with increasing repayment difficulties of debtors and debt renegotiations[4]. Ongoing partial defaults and payment deferrals have certainly paved the way for a slow decline in Chinese outbound lending in the coming years, accompanied by a more selective lending strategy. Indeed, the restructuring of Chinese commercial loans appears complex and incurs important losses for China. Moreover, the physical seizure of commodities and/or assets[5] by Chinese entities has turned out to be hard to implement in practice.

For each of the ten countries in our sample, we use the share of external debt to China in total external debt as a proxy for Chinese engagement[6]. We obtain a total financing gap of USD47bn (see Figure 2), accounting for 1.4% of total 2019 GDP of these countries. This represents a financing gap of 7% of 2019 GDP in Kenya, 6% in Angola, and close to 5% in Ethiopia and Zambia. The financing gap accounts for 2.2% of our sample's total forecasted external financing needs[7] by 2025. Breaking it down by country, this means **15% of Ethiopia's external financing needs by 2025 would be left uncovered amid China's partial disengagement, while the share is 13% for Zambia and 11% for Kenya.**

These countries would have to secure funding from elsewhere (official international lenders and financial markets) to refinance the large amounts of eurobonds maturing in 2022 and 2023. Yet, already high debt stocks with other official international lenders and the record-high borrowing costs on international markets would make it difficult to offset these China-related financing gaps.

[3] In contrast to IMF lending, Chinese lending does not ask for conditionality related to fiscal discipline or a cap on contracting additional foreign debt, which would ensure greater sustainability of debt dynamics.

[4] Following the 2015 oil shock, China's major commercial borrowers (Angola, Zambia, Ecuador) had started to encounter severe external debt stress. The Covid-19 outbreak and commodity price slump in 2020 also led to a series of debt restructuring. **Ecuador** was the first to reach a debt restructuring arrangement with the China Development Bank (CDB), postponing USD417mln in loan payments for a year while maintaining initial interest rates. **Zambia** has also requested from China debt service suspension (private and public) for USD383bn, while it also needs restructuring plans for the USD200bn arrears that it owes to China. **Angola** also reached a deal with China but did not disclose the conditions yet. **Kenya** is also negotiating a restructuring agreement with China.

[5] We only one such case so far, with Sri Lanka granting in 2017 a 99-year concession to China on the Hambantota Port and China Merchant Port Holdings acquiring 70% of the port's operating company.

[6] We then forecast a downward trajectory in this proxy to determine by how much debt financing will drop by 2025: for most countries, we apply a 1/3 reduction in financing; for countries with debt issues and prospects of restructuring, we apply a 1/2 reduction.

[7] For external financing needs, we sum the current account balance, short-term debt and principal repayments of long-term debt due each year.

Figure 2 – 2021-2025 Projected China debt financing gap

	Debt financing gap over 2021-2025		
	USD bn	as % of 2019 GDP	as % of 2021-2025 external financing needs
Ethiopia	4.7	5.3%	14.7%
Zambia	1.1	4.9%	13.3%
Kenya	6.6	6.9%	11.0%
Angola	5.2	6.3%	8.9%
Ecuador	3.8	3.5%	6.4%
South Africa	10.2	2.9%	2.2%
Ghana	0.9	1.3%	2.1%
Brazil	8.8	0.5%	1.1%
Argentina	4.1	0.9%	0.8%
Egypt	1.3	0.4%	0.8%
Total (10 countries)	**47**	**1.4%**	**2.2%**

Sources: various, Euler Hermes, Allianz Research

Second, the slowdown of the Chinese economy and higher control and selectivity over foreign investment could put Kenya, Ecuador and Ghana the most at risk in the coming decade. China's outward FDI (OFDI) picked up after 1999 with the "Going Out" policy, under which China relaxed or eliminated many rules on outbound investment and actively promoted it. According to official sources, the stock of non-financial OFDI from China increased eightfold from 2009 to 2018 (from USD246bn to USD1,982bn). Nonetheless, flows of OFDI have slowed in the past few years and while we do not expect China's dual circulation strategy to halt OFDI in emerging countries, it could continue to slow down going forward for four reasons:

(i) In the wake of renminbi scares in 2015-16, the government moved to tighten regulation around OFDI to control capital outflows. It set limits on state-owned enterprises' overseas investments and increased scrutiny of large outward transactions by private firms.

(ii) There have been implementation challenges in the BRI (see here for more details), now exacerbated by the Covid-19 crisis. These challenges probably call for foreign investment being more disciplined around national economic targets, e.g. industrial autonomy and innovation.

(iii) Some emerging countries could follow the U.S. and EU by increasing scrutiny over foreign investment and acquisitions, especially as international opinion of China is turning less favorable. For example, Indian authorities revised the FDI policy in October 2020[8], increasing scrutiny of investment carried out by entities of neighboring countries that share a land border with India (thus including China).

(iv) The structural slowdown of the Chinese economy and large stock of debt domestically (see here for more details) mean that outward investment is likely to slow in the coming decade. In particular, we find a 70% positive correlation between growth in the stock of China's OFDI, and real GDP growth with a 2-year lead.

In our sample, Zambia, Ethiopia and Ghana are the countries most reliant (as a share of GDP) on FDI inflows from China. These three countries have witnessed the fastest increase in inward Chinese FDI over the past few

[8] https://dipp.gov.in/sites/default/files/FDI-PolicyCircular-2020-29October2020_0.pdf

years, thanks to the BRI (launched in 2013). If we assume that China's OFDI will follow the same path of slowdown as GDP in the coming decade, this means that in absolute terms, Kenya, Ethiopia and Ghana would be the countries with the highest cumulative loss of China OFDI by 2030, amounting to up to USD63mln, USD61mln and USD48mln, respectively (see Figure 3). In relative terms, the most exposed countries are Kenya, Ecuador and Ghana, with the cumulative loss of OFDI from China by 2030 amounting to up to 3.6%, 3.1% and 2.7% of respective stocks of OFDI from China in 2018.

Figure 3 – Cumulative loss of FDI by 2030 caused by Chinese slowdown

	Cumulative loss of FDI from China by 2030			
	China slowdown scenario (1) reforms		China slowdown scenario (2) no reforms	
	USD mln	% of 2018 stock of FDI from China	USD mln	% of 2018 stock of FDI from China
Kenya	46	2.6%	63	3.6%
Ecuador	28	2.3%	38	3.1%
Ghana	35	2.0%	48	2.7%
Ethiopia	44	1.7%	61	2.4%
Egypt	19	1.7%	25	2.3%
Argentina	10	0.7%	14	0.9%
Brazil	22	0.6%	31	0.8%
Angola	12	0.5%	16	0.7%
Zambia	10	0.3%	14	0.4%
South Africa	5	0.1%	7	0.1%
Total (10 countries)	**232**	**0.9%**	**317**	**1.2%**

Sources: various, Euler Hermes, Allianz Research

Lastly, beyond the positive trade impulse in the short-term, the structural slowdown and rebalancing of the Chinese economy is expected to trigger a cumulative loss of exports of up to USD24bn by 2030 for the ten countries in our sample. Being the first economy in and out of the slump, China is leading the global recovery out of the Covid-19 crisis in 2020. The strong rebound of the Chinese economy since Q2 2020 has mostly been driven by surprisingly resilient exports (see here for more details), together with robust activity in the construction and infrastructure sectors. Obviously the latter sectors are also good news for China's trade partners, mainly for commodity exporters.

However, in the long run, the Chinese economy is on a path towards a structural slowdown under the impact of a declining labor supply and capital accumulation, as well as slowing productivity gains. We estimate that China's GDP growth could average between +3.8% and +4.9% over the coming decade (after +7.6% in the 2010s), depending on the success of structural reforms in lifting potential growth (see here for more details). Furthermore, increasing protectionist rhetoric across the globe, along with the dual circulation strategy launched this year, are likely to transform the country's foreign trade. In particular, China's trade strategy seems to prioritize maintaining export market shares while reducing reliance on imports.

Taking into account these structural changes, we can quantify the amount of Chinese domestic demand[9] that will be 'lost' compared to a situation

[9] We remove exports and add to imports to GDP, which thus consists in private consumption, public consumption, investment and imports.

with growth similar to the 2010s for countries exporting to China. **We find that in value terms, Brazil, Angola and South Africa would incur the largest cumulative loss of exports by 2030, amounting to up to USD14bn, USD5bn and USD2bn, respectively** (see Figure 4). In relative terms, Angola, Zambia and Ghana would be the most hit, with the cumulative loss of exports by 2030 amounting to up to 5.8%, 1.4% and 0.9% of their respective GDPs.

Figure 4 – Cumulative loss of exports by 2030 caused by Chinese structural changes (slowdown and rebalancing)

	Cumulative loss of exports to China by 2030			
	China slowdown scenario (1) reforms		China slowdown scenario (2) no reforms	
	USD mln	% of 2019 GDP	USD mln	% of 2019 GDP
Angola	3,743	4.6%	4,717	5.8%
Zambia	264	1.1%	333	1.4%
Ghana	492	0.7%	620	0.9%
Brazil	11,018	0.6%	13,885	0.8%
South Africa	1,693	0.5%	2,133	0.6%
Ecuador	508	0.5%	640	0.6%
Argentina	1,108	0.2%	1,397	0.3%
Ethiopia	60	0.1%	76	0.1%
Egypt	98	0.0%	123	0.0%
Kenya	26	0.0%	33	0.0%
Total (10 countries)	**19,009**	**0.6%**	**23,957**	**0.7%**

Sources: various, Euler Hermes, Allianz Research

Appendix

China's lending activity in developping and emerging economies is essentially carried out by the China Development Bank and Exim bank. While Exim offers both concessional/preferential and commercial loans, China Development Bank (CDB) officially issues only non-concessional loans. In some cases, China's main commercial Banks – ICBC, Bank of China, China Construction Bank and Agricultural Bank of China – may also compete and cooperate with these two major policy banks. Yet commercial banks, which tend to prioritise project viability and adequate pricing of risk, remain minor players in China's total lending.

Figure 5 – Largest Chinese asset-backed loans

	Year	Purpose	Chinese lender	Total Amount	Interest rate
Angola	2011,2012, 2014,2015	Oil & Gas	CDB	USD14 bn	N/A
Ecuador	2010,2011, 2016,2017	Budget Support + oil industry	CDB	USD5bn	between 6% and LIBOR+6.20%
Ghana	2007,2011	Budget Support + Gas industry	CDB - Exim	USD3.5bn	between 2% and LIBOR +3%

Sources: national statistics, Euler Hermes, Allianz Research

Unlike foreign aid, the Chinese government does not release any systematic report on the country's overseas commercial lending. CDB's 2018 Annual Report signals an outstanding foreign currency loan balance of USD215bn, and about RMB95.7bn (approximately USD13.5bn) of outstanding RMB-denominated cross-border loans in end-2018. On the other hand, China EXIM's annual report displays total lending of RMB1,380bn (approximately USD195bn) at end 2018 (outstanding balances of export sellers and buyers' credits and international cooperation loans). **The African continent stands out as the largest recipient of Chinese funding, with the debt stock with China exceeding USD150bn.**

These assessments are, as always, subject to the disclaimer provided below.