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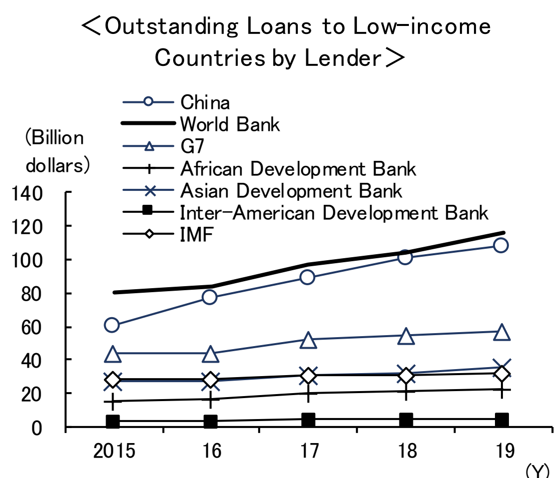
Topics *China's expansionary foreign policy is at a critical juncture*

In the wake of the external debt crisis triggered by the COVID-19 pandemic, an increasing number of developing countries have become wary of their loans from China. There are also signs of "loan fatigue" in China. The Xi Jinping administration's expansionary foreign policy is at a crucial stage.

■ China's outstanding loans are comparable to those of the World Bank

Through the World Bank, China revealed for the first time the actual situation of its loans to low-income countries. China's outstanding balance of loans as of the end of 2019 stood at 108.5 billion dollars, a level comparable to that of the World Bank. Under these circumstances, many low-income countries that receive large amounts of loans from China are facing a debt crisis amid the COVID-19 pandemic, as shown in Zambia's default in November 2020.



Source: Prepared by Japan Research Institute, Limited based on the World Bank's Debtor Reporting System, October 16, 2020
Note: Out of the 73 countries covered by the Debt Service Suspension Initiative (DSSI), an international framework for debt sustainability, the total outstanding loans to the 68 countries for which data is available are shown. The amount of outstanding loans indicates the sum of bilateral government loans and private loans.

How will China, which has emerged as a creditor nation, respond to the debt crisis in low-income countries? This issue will have a decisive impact on whether or not the debt crisis can be avoided. At the request of the International Monetary Fund (IMF) and the World Bank, the G20 Finance Ministers and Central Bank Governors agreed at a meeting held in October 2020 to extend the repayment of bilateral government debt of low-income countries until June 2021, and in November agreed on a framework for debt reduction and extended repayment periods.

Since China is a member of the G20, it seems to be interested in avoiding the debt crisis. However, while the Chinese government has accepted a moratorium on debt repayments, it has refused to cut back on debt repayments. It has also insisted that the China Development Bank, which is 100% owned by the government, is a private creditor and not subject to a moratorium on debt repayments, thus disrupting international efforts to avert a crisis. By the end of September 2020, the China Development Bank had concluded a debt relief agreement of 750 million dollars with some low-income countries, but the size of the agreement is too small in light of China's outstanding loans to low-income countries.

In October 2020, Ghana's Finance Minister Ken Ofori-Atta criticized China in an article that he contributed to the Financial Times, saying that while the IMF and the World Bank extended credit lines to the entire African continent, China stuck to bilateral negotiations and exacerbated fears among other creditors that China was trying to receive debt repayments preferentially. The reality is that China was not acting to avoid the debt crisis, and as it has failed to win over developing countries to its side, it had no choice but to join the G20 discussions on debt moratorium and debt reduction.

■ China is actively extending loans to priority countries

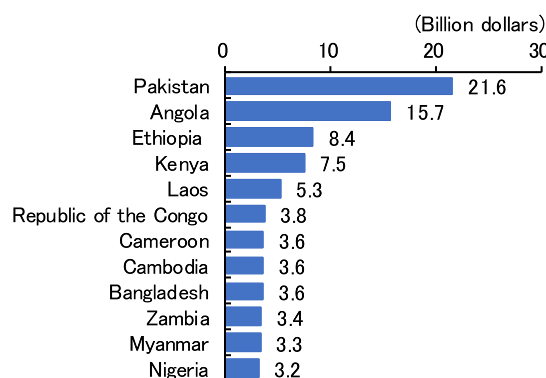
Looking at China's outstanding loans by country in 2019, there were two countries, namely Pakistan and Angola, that had outstanding loans exceeding 10.0 billion dollars. The amount of Pakistan's outstanding loans is 21.6 billion dollars and that of Angola is 15.7 billion dollars, accounting for 19.9% and 14.5% of the total, respectively. This is followed by Ethiopia (8.4 billion dollars, 7.7%), Kenya (7.5 billion dollars, 6.9%) and Laos (5.3 billion dollars, 4.8%). China places emphasis on Pakistan and Angola because they are indispensable for promoting its Belt and Road Initiative (BRI) and for securing resources.

In Pakistan, the development of the "China-Pakistan Economic Corridor (CPEC)," which will enable overland transportation from the Indian Ocean to China, is in progress. CPEC is regarded as one of the

most important projects that symbolizes the BRI. Angola is the second largest oil producer in Africa after Nigeria, and the second largest crude oil exporter to China after Saudi Arabia, Russia and Iraq.

Meanwhile, the outstanding amount of loans extended by China as a percentage of GDP is highest in Djibouti, at 35.7% of its GDP, followed by the Republic of the Congo (29.9%), Laos (27.6%), Kyrgyzstan (21.0%), and Maldives (20.2%). Djibouti and Kyrgyzstan are indispensable as regional hubs for the BRI; Laos as an obstacle to ASEAN's solidarity against China over territorial disputes in the South China Sea; the Republic of the Congo as a supplier of copper, cobalt and other resources, and the Maldives as a foothold for expansion into the Indian Ocean.

<Countries with the Largest Amount of Outstanding Loans from China (2019)>

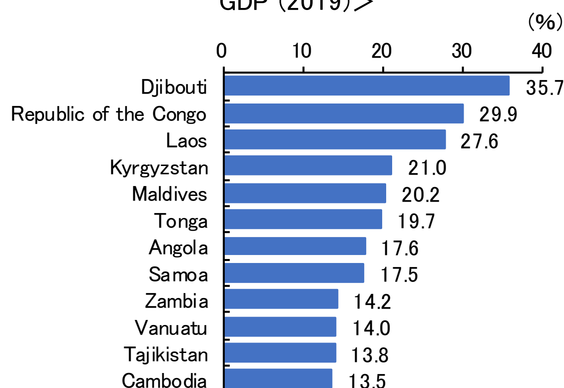


Source: Prepared by Japan Research Institute, Limited based on the World Bank's Debtor Reporting System, October 16, 2020

■ China's expansionary foreign policy is expected to reach its limit

According to a new study published by Boston University in December 2020, China's outstanding external loans amounted to 467 billion dollars at the end of 2019, and loans to low-income countries accounted for only 20% of the total. China has actively approached developing countries other than low-income countries by extending loans to enable the development of large-scale infrastructure, such as high-speed railways, nuclear power generation plants, and ports, as well as loans to secure resources such as crude oil, and has promoted the BRI, thus developing a sphere of influence to compete with the United States.

<Countries with the Largest Amount of Outstanding Debt to China as a Percentage of GDP (2019)>



Source: Prepared by Japan Research Institute, Limited based on the IMF, WEO, October 2020 and the World Bank's Debtor Reporting System, October 16, 2020

But China's expansionary foreign policy is expected to reach its limit. Part of the reason is that developing countries have become wary of obtaining loans from China, which imposes high interest rates and is reluctant to reduce its debt. In Pakistan, railway construction is being carried out using loans from China, but there is a possibility that construction scheduled to start in January 2021 will be postponed because the two countries cannot reach an agreement on the interest rate. Angola has sought to stabilize its economy through loans from the IMF, not China.

The other is signs of "loan fatigue" in China. According to Boston University, the amount of China's new lending in 2019 dropped to 3.9 billion dollars, which is one twentieth of the amount at the peak in 2017 of 75.0 billion dollars. Dai Xu, a professor at the Center for Strategic Studies at China's National Defense University and a hawkish critic, said, "China has been generous in providing aid to the world, but no country has expressed sympathy or support for China as the U.S.-China conflict escalates," questioning the effects of the aid to developing countries. At the November summit of the Asia-Pacific Economic Cooperation (APEC) forum, Chinese President Xi Jinping expressed that China would positively consider participating in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (TPP-11), which China had previously ignored. It seems reasonable to assume that the Chinese government sensed a change in the environment in which it was becoming difficult to seek an overwhelming unifying power from loans.

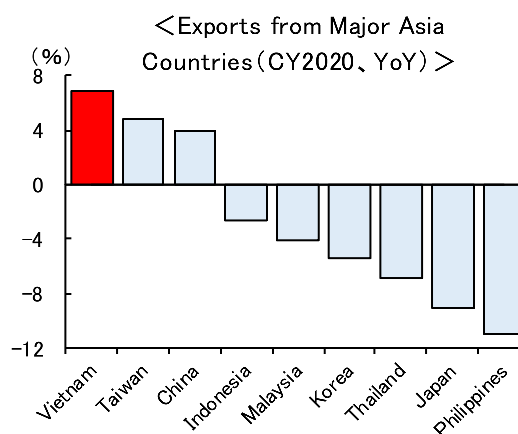
(Yuji Miura)

Topics *Vietnam gains competitive advantage as "China Plus One"*

Even amid the COVID-19 pandemic, Vietnam has maintained positive growth in contrast to other ASEAN countries. Vietnam's low wages, proximity to China, and its aggressive moves toward the conclusion of trade agreements have increased the competitive advantage of Vietnam as a destination for production transfers from China.

■ Vietnam has maintained positive growth even amid the COVID-19 pandemic

The real GDP growth rate of Vietnam in 2020 was 2.9% over the previous year. Although Vietnam's growth slowed sharply from the year-on-year growth rate of 7.0% a year earlier, it was higher than that of 2.3% in China, which recovered quickly from the economic downturn caused by the spread of COVID-19 infections. Vietnam's growth is in contrast to other major ASEAN countries, which are expected to post negative growth.

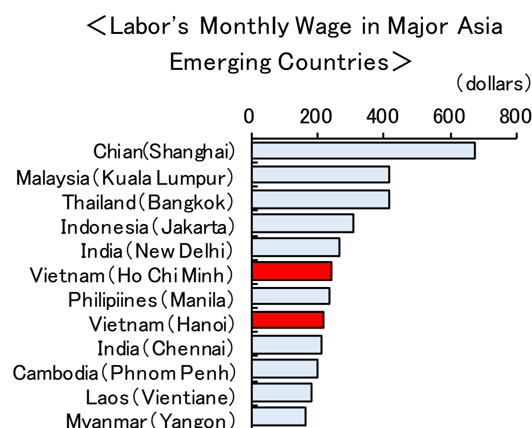


Source：Each Country's Statistics, CEIC
Note ：Japan, Malaysia, Philippine and Thailand are from January to November

Vietnam's brisk economy has been supported by exports. In 2020, Vietnam's dollar-denominated exports grew 7.0% from the previous year, far exceeding those of other major Asian countries. One reason for this is the rapid spread of remote working due to the global outbreak of the COVID-19 pandemic and the subsequent introduction of measures to restrict activities, which led to special demand for IT-related export goods such as PCs and semiconductors, which have production bases in Vietnam. In addition to these demand-side trends, supply-side factors have increased production capacity in Vietnam, where companies have shifted their production bases from China due to the intensification of the U.S.-China conflict in recent years. This is also a sign that Vietnam has become the most promising candidate as the destination for the transfer of production bases, amid the trend among companies to reduce their dependence on China through "China Plus One," which is the business strategy of avoiding the risks of concentrating overseas business operations in China and diversifying investments into other countries and regions.

■ There are three factors behind the transfer of production bases to Vietnam

However, the business environment in Vietnam has not improved significantly compared with other ASEAN countries. In the World Bank's "Doing Business" ranking, since 2017, Vietnam has ranked around 70th, lower than Malaysia (ranked 12th in 2019) and Thailand (ranked 21st in 2019) in the ASEAN region, and not far behind Indonesia (ranked 73rd in 2019). There are the following three reasons why companies choose Vietnam as a destination for production transfers from China, despite the fact that its business environment is not very well developed.



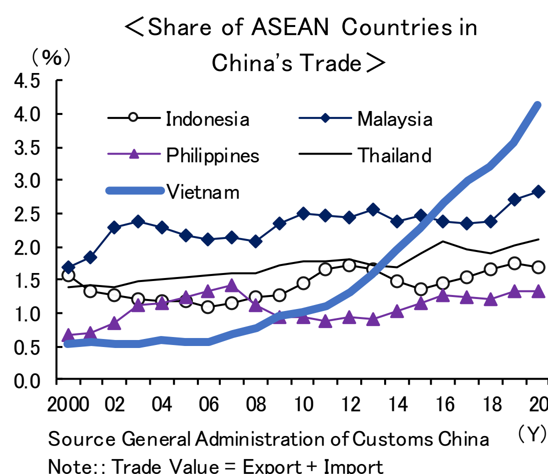
Source：JETRO

The first factor is cheap labor cost. In addition to the labor-intensive apparel industry, the movement of production transfers to Vietnam is also happening in the electric and electronics industries. The latter is also not a capital-intensive manufacturing process, but a labor-intensive manufacturing process, such as final assembly. Vietnam has benefited from the fact that wages for general laborers in Vietnam are lower than those in other ASEAN countries. In fact, Vietnam's wage levels are 55% of those in Malaysia and Thailand and 75% of those in Indonesia, making the country as competitive as the Philippines in labor costs.

The second factor is proximity to China. In the course of its economic development, China has established itself as the "world's factory," and has succeeded in industrial accumulation in many fields. Companies that expand their operations in China are often unable to significantly change their dependence on China for raw materials and parts when they consider transferring their production bases out of China. In this regard, Vietnam's advantage is that it shares a northern border with China, so goods can be transported by land. Vietnam's total trade volume is similar to that of Malaysia and Thailand, but Vietnam's share of China's total trade volume has increased rapidly in recent years.

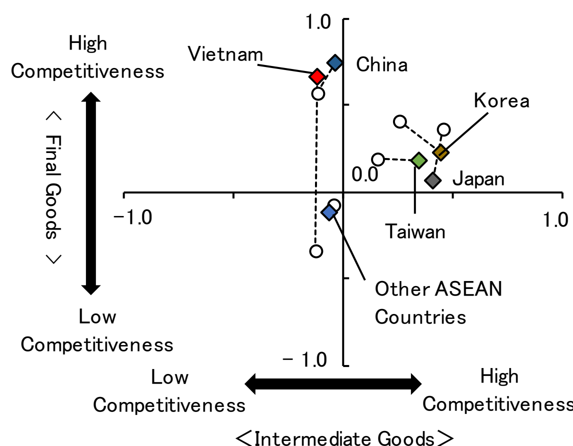
The third factor is the improvement of the export environment through the conclusion of trade agreements. Based on its national policy of international economic integration, Vietnam has been developing an active FTA strategy, and since 2014, the country has concluded not only "ASEAN Plus One" FTAs but also "Vietnam Plus Alpha" FTAs. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the European Union-Vietnam Free Trade Agreement (EVFTA) are also raising expectations for further trade expansion in the future. When a company's business base is located in other ASEAN countries, FTAs can be applied for about 30% of global import markets. When a business base is located in Vietnam, however, 65% of global import markets can be accessed on competitive terms.

<Share of ASEAN Countries in China's Trade>



Source General Administration of Customs China
Note:: Trade Value = Export + Import

<Trade Specialization Index in Electrical Machinery Industry of Major Asia Countries>



Source : RIETI-TID 2018
Note1 : ○ is the average of 2001-2010. ◆ is the average of 2011-2018.
Note2 : Trade Specialization Index = (Export − Import) / (Export + Import)

■ High value-added industrial structure is necessary for future growth

As described above, factors such as (i) low wages, (ii) proximity to China, and (iii) aggressive moves toward the conclusion of trade agreements have increased Vietnam's competitive advantage as a destination for production transfers, leading to a rapid economic recovery at the moment. It is unlikely that the U.S.-China conflict will ease even after a change of administrations in the United States, and the suspension of distribution in China in the wake of the COVID-19 outbreak has further intensified efforts among companies to reduce their dependence on China. As these advantages are not likely to change for the time being, Vietnam is likely to continue strong growth driven by exports.

However, the current situation in Vietnam could be seen as nothing more than growth as "China Plus One." In other words, Vietnam is simply regarded as China's "subcontractor in low-value-added areas." In the electrical equipment industry, where production is being transferred, the export competitiveness of products in the final process, which have relatively low added value, is increasing, but the competitiveness of intermediate goods, including high-value-added electronic components, remains low. If Cambodia, Laos or Myanmar, which have lower wages, expand their acceptance of low-value-added industries in the future, Vietnam may find it difficult to maintain its position.

In order for Vietnam to achieve stable economic development in the medium to long term, it is necessary to break away from being a subcontractor of China in the future and not only accept low-value-added industries but also strengthen the development of higher-value-added industries. To that

end, it will be necessary to carry out institutional reforms in the areas where Vietnam ranks lower in the "Doing Business" ranking by making it easier for shareholders to file lawsuits and by improving legislation to deal with bankruptcy.

(Yuta Tsukada)