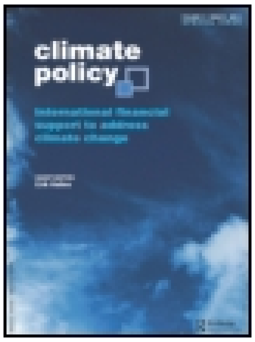

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Revising the 'host country standard' principle: a step for China to align its overseas investment with the Paris Agreement

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OUTLOOK ARTICLE

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from this perspective, and particularly so given the pace of decarbonization of China's power generation and transport systems. Of similar importance is the decarbonization of China's outbound investment portfolio.

Concerns over the environmental sustainability of China's overseas investment are compounded by the lack of transparency of China's main development finance arms – the Export-Import (EXIM) bank of China, the China Development Bank (CDB) and the myriad of thematic and regional funds that China has set up over the last ten years.

We collate in this paper the most recent estimates of China's overseas investment and development finance (section 2). We then review the regulatory initiatives taken by China to mitigate the environmental consequences of its overseas finance flows, and put these within the broader perspective of the commitments of multilateral development banks to combat climate change (section 3). From this, we derive policy measures that China could take to further align its overseas investment with the Paris Agreement's target to limit global temperature rise to well below 2°C (section 4).

2. The state of China's overseas investment and development finance

China's overseas investment flows reached a record peak of US$ 183 billion in 2016, second only to figures for the US (UNCTAD, 2018). China is the largest investor in least developed countries and in developing Asia, ranking third in Russia, Central Europe and East Asia. In just over a decade, China has doubled the amount of development finance in the world economy (Gallagher, Kamal, Jin, Chen, & Ma, 2018). With the Belt and Road Initiative (BRI) now enshrined in the Chinese Communist Party's Constitution, 'China is now poised to become the largest source of foreign direct investment and overseas development assistance in the world' (Gallagher & Qi, 2018, p. 2).[3]

Outbound investment to developing countries and development finance[4] are closely dovetailed in the particular case of China, because they originate from within the same complex policy and political ecosystem. The main actors are Chinese development banks, also called 'policy banks', namely China's official export credit agency (China Export-Import Bank or EXIM bank) and China Development Bank (CDB). State-owned commercial banks, such as the Bank of China and the Industrial and Commercial Bank of China (ICBC), are also part of this ecosystem. In addition, the Ministry of Commerce provides a modest amount of zero-interest foreign aid loans, grants, and in-kind aid, while the state-owned China Export and Credit Insurance Corporation (Sinosure) offers insurance to Chinese exporters against political, commercial and credit risks. Large Chinese companies also offer supplier credits directly to borrowers (Brautigam & Hwang, 2016). With the exception of EXIM bank, all the aforementioned Chinese banks operated primarily in the domestic market before turning outward in the first decade of this century. Additionally, 15 thematic or geographical Chinese sovereign-backed funds such as the China–Africa Industrial Cooperation Capacity Fund, the China–Africa Development Fund, the China-Latin America Infrastructure fund, and the Silk-Road Fund have been established. These funds are financed through different parts of the Chinese central government such as the aforementioned development banks, the State Administration of Foreign Exchange, or the China Investment Corporation (a Chinese sovereign wealth fund).

The lack of any unified registry or harmonized database of outbound Chinese financial flows makes it difficult to accurately estimate the amount of international development finance provided by China through this myriad of institutions, and in turn, to assess the 'greenness' of their funding. Yet recent initiatives have progressively narrowed our knowledge gap. These include, in particular, the American Enterprise Institute and the Heritage Foundation's China Global Investment Tracker (CGIT),[5] Johns Hopkins University's China Africa Research Initiative (CARI) at the School of Advanced International Studies (SAIS),[6] and Boston University's China Global Energy Finance (CGEF) database (Gallagher, 2017).[7]

Table 1 summarizes the main flows tracked and their estimated value in US dollar terms according to these sources. Differences in methodology and scope lead to a quite broad range of figures. Yet when comparing *development finance* estimates at large, the yearly average lies within the range of USD 23.6–67.1 billion per year, and this range is further narrowed when comparing data for the 2014–2018 period. The order of magnitude of China's *overseas investment finance* to developing countries lies between USD 38 billion (2014) and USD 45 billion (2018) per year. This represents between 27% and 32% of global official development assistance (ODA). CDB and EXIM bank now provide as much energy finance to foreign governments as do all the multilateral development banks (MDBs) combined (Kong & Gallagher, 2017).

Table 1. Chinese development finance flows according to different sources (USD Billion).

Source	Scope	Cumulated	Average/year	Latest year
CGIT	Development finance	940 (2005-2018)	67,1	45.6 (2018)
CGEF	Development Energy finance*	194.2 (2000-2018)	10.2	8.62 (2018)
CARI	Development finance to Africa	86.3 (2000-2014)	5,7	13.6 (2014)
AidData	Development finance	354.3 (2000-2014)	23,6	38 (2014)

Sources: CGIT data available at www.aei.org/china-global-investment-tracker/?ncid=txtlnkusaolp00000618; CGEF data available available at www.bu.edu/cgef; CARI data available at www.sais-cari.org/data/; AidData available at www.aiddata.org

*Total overseas energy finance from China amounts to USD 244,2 Bn (cumulated, 2000-2018) according to CGEF data. After subtracting China's energy finance to OECD countries (namely UK and Italy) and Russia, we end up with the cumulated estimate of USD 194,2 Bn.

3. How green is China's development finance?

China is a major funder of coal plants that are currently under consideration, along with Japan and South Korea (Doukas et al., 2017). Slightly less than half (48%) of all Chinese overseas energy investment is in renewable energy, although the vast majority is concentrated in the hydroelectric power sector. Without hydropower, Chinese overseas renewable energy financing amounts to 13% of all its overseas energy investment in power plants (Muñoz Cabré, Gallagher, & Li, 2018).

Against this backdrop, in 2007, the China Banking Regulatory Commission (CBRC) launched *Green Credit Guidelines*, updating them in 2012. The *Guidelines* commit banking institutions to identifying, measuring, monitoring and controlling the environmental and social risks of their credit activities and to establishing environmental and social risk management systems (Ren, Zhang, Zhu, & Zhang, 2017). In 2016, the People's Bank of China, along with the Ministry of Finance and five other ministries, issued *Guidelines for Establishing the Green Financial System*. Yet as of 2017, the only policy document which specifically focuses on reducing the environmental impacts of Chinese companies operating overseas is the *Guidelines on Environmental Protection in Overseas Investment and Cooperation*, issued by the Ministry of Commerce and the Ministry of Environmental Protection in 2013. The goal of these guidelines is to guide Chinese companies 'to identify and preempt environmental risks in a timely manner and actively fulfil their social responsibility in environmental protection' (MOFCOM, 2013).

A close look at these documents confirms previous findings (Gallagher & Qi, 2018; Ren et al., 2017). First, they promote commitments abroad to green(er) practices that are voluntary in nature. Even in the case of policies containing an enforcement mechanism, there are no public reports of any companies that have been penalized due to environmentally harmful overseas investments. Second, Chinese companies are required to comply with host country environmental regulations. Hu (2013) recalls that in the process of setting up the *Guidelines on Environmental Protection in Overseas Investment and Cooperation,* the Ministry of Commerce opposed mandatory environmental regulations, against the view of the Ministry of Environmental Protection. The Ministry of Commerce eventually won the case. In spite of several attempts to influence the formulation and issuance of guidelines to green China's overseas investment, the Ministry of Environmental Protection has ever since upheld the official government position that Chinese companies operating abroad should observe environmental laws in the host country (Gallagher & Qi, 2018). Bearing in mind that environmental regulations are much less stringent in many of the developing countries that are part of the BRI compared with those of China, the 'host country principle' actually relaxes the environmental constraint facing China's overseas investment, when compared to investment in mainland China where standards and regulations are legally enforceable. De facto, when companies or banks seek approval to send funds overseas from the Ministry of Commerce and then the State Administration of Foreign Exchange, the Ministry of Commerce only restricts those transactions that fail to meet the host country's environmental standards, so that ultimately 'the laws of host nations must control the environmental and social risks of projects with Chinese investors' (Davies, Reineking, & Westgate, 2017).

Efforts to raise the level of stringency of environmental standards have not been conclusive so far. The policy document *Guiding Opinions on Promoting Green Belt and Road* published in 2017 by the Ministry of Environmental Protection and three other ministries is a good case in point. It encourages Chinese companies engaged overseas to release annual environmental performance reports, to adopt low-carbon and energy-saving materials, and to step up efforts to address climate change, among other measures (Gallagher & Qi, 2018). Yet there are no penalties for non-compliance.

Rules governing the environmental performance of Chinese outbound investment are therefore much less stringent than the rules laid down by MDBs and other development finance institutions (DFIs). The environmental and social standards adopted by the World Bank Group and OECD DFIs take into account not only laws and policies of the host country but also the environmental and social norms of the lending country or institution. When environmental standards are inconsistent, the 'best nation standard principle' prevails, meaning the more stringent standard is adopted. Furthermore, mainstreaming environmental protection and climate action has steadily improved across the practices of most MDBs and DFIs, with the progressive and still ongoing adoption of commitments such as climate-related disclosure, internal carbon pricing or climate-related financing proportion targets.

4. A suggested step in aligning China's overseas investment with the Paris Agreement

Like many other DFIs, CDB and EXIM bank have neither elaborated on, nor explicitly integrated, the provisions of the Paris Agreement in their investment strategies. However, there are signs of change. In a speech to the BRI forum in 2019, Chinese President Xi Jinping stated 'We need to pursue open, green and clean cooperation. (…) We may launch green infrastructure projects, make green investment and provide green financing to protect the Earth which we all call home'.[8] The tax incentives and public investment efforts granted to the renewable energy sector in China within the last two five-year plans could trickle down to the export sector, boost green export capacities and, while tapping into economies of scale both at home and abroad, contribute to the greening of China's outbound investment.

There is considerable room for manoeuvre when comparing policies and regulation framing Chinese green investment at home and abroad. The *Catalogue of Investment Projects subject to Government Ratification* revised in 2016 emphasized that domestic investment projects are to be evaluated and managed by the local environmental protection agencies on the basis of their environmental impact; projects associated with high environmental risk are subject to stringent environmental approval procedures and continuous oversight. Industries such as steel, iron, cement and coal mines 1(to)-/T1_21-3175287.nad to prevent or mitigattoovercapacitaysideeffect of which is c-1.2l of pollution and reduction of emissions, because of the close match between overcapacity, pollution and emissions across sectors in China. More stringent environmental regulations also cme into play in the domestic finance sector.

As a step in a process towards aligning Chinese overseas investment with the Paris Agreement, Chinese development banks could revise the 'host cou-1.y standard principle' that curren17528420.8(govern)-8.1(s)-41

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5. Conclusion

In this paper, we have explored some policy considerations facing China when it comes to the environmental sustainability of China's overseas financing under the broad scope of the BRI. Concerns about the environmental impacts of Chinese overseas financing lie in two main factors: the continued financing of high greenhouse gas emitting activities, in particular coal-fired plants, and the application of the 'host country standard principle' with regard to environmental regulations and safeguards. We have shown that there is a gap between China's stance and practices at home and abroad. China can be praised for its efforts to progressively decarbonize its power sector and tighten environmental protection in investment regulation at home. Yet nothing comparable is ongoing as far China's overseas financing is concerned.

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