Time For a New *Sovereign Debt* Restructuring Regime

Can Chinese creditors navigate through a potential global debt crisis?

BY DEBORAH BRAUTIGAM

During the boom years of the 2010s, lending to low- and middle-income countries expanded dramatically, led by two new groups of creditors: bondholders and Chinese banks. Since the Covid-19 pandemic began, Argentina, Belize, Ecuador, Lebanon, Suriname, Zambia, and now Sri Lanka have all declared bankruptcy: defaulting on their sovereign bonds, and actively seeking debt restructuring. Others are sure to follow. How are Chinese creditors going to navigate what may become a systemic global debt crisis?

HISTORIC SHIFT IN THE RESTRUCTURING ARCHITECTURE

Since 1956, the treasury departments of industrialized countries with large outstanding loans to developing country governments have negotiated debt restructuring as an informal cartel known as the Paris Club. Although sometimes present as observers, China and most other developing country lenders had never joined. The economic challenges of the Covid-19 pandemic, however, have led to a potentially historic shift in the financial architecture of sovereign debt management. In April 2020, China joined with other G20 members, including Turkey, South Africa, and India, in launching the Debt Service Suspension Initiative.

The DSSI allowed seventy-three low-income countries that were not in arrears with the World Bank or International Monetary Fund to apply for a suspension of interest and principal payments on their official bilateral external debt between May

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2020 and December 2021. The G20 called on private and multilateral creditors to join them in pandemic debt relief.

The DSSI was temporary, allowing modest gains in liquidity for borrowers. In November 2020, the G20 joined with the Paris Club to launch the Common Framework for Debt Treatments Beyond the DSSI. Through the Common Framework, the same group of low-income countries can apply for debt restructuring (middle-income countries like Sri Lanka are not currently eligible). As of July 2022, only three countries (Chad, Ethiopia, and Zambia) have asked for a Common Framework treatment.

DIMENSIONS OF CHINESE LENDING

By 2020, according to the World Bank's International Debt Statistics, bondholders controlled 51 percent of all outstanding public and publicly guaranteed (PPG) debt in low- and middle-income countries. Chinese banks held 5 percent, with 23 percent held by the World Bank and other multilateral lenders. Chinese lending has a larger footprint in the seventy-three countries eligible to join the G20's DSSI. In 2020, Chinese banks accounted for 20 percent of overall debt and 29 percent of scheduled debt service in the low-income DSSI countries. This lending was highly concentrated. Just two DSSI countries, Angola and Pakistan, accounted for half of all the debt service due to Chinese creditors.

FRAGMENTED CREDITOR LANDSCAPE

China's rise as a creditor complicates the restructuring scenario. While the fractionalized nature of bond markets is well known, Chinese lending is also fragmented. China Africa Research Initiative data show that in Africa alone, over thirty Chinese financiers—policy banks, commercial banks, and Chinese companies—have lent to governments and their state-owned enterprises. China's official export credit agency, China Eximbank, began lending overseas in 1994 and holds the lion's share of this debt. However, between 2010 and 2020, other Chinese creditors—including China Development Bank, Industrial and Commercial Bank of China, and Bank of China—accounted for half of all new lending commitments in Africa.

PAST EXPERIENCE

In the past two decades, Chinese creditors have accumulated a variety of experiences in addressing defaults and debt distress. Starting in 2000, in the highly indebted poor countries, the Chinese government began writing off the outstanding balance of zero-interest foreign aid loans (ZILs) that had reached their maturity date. These government loans are now managed by China's new aid agency CIDCA (China International Development Cooperation Agency). Like grants, ZILs are fully accounted for in the government's annual budgets and do not require additional transfers, which simplifies debt relief.

On numerous occasions over the past twenty years, borrowers have also been able to obtain debt restructuring from other Chinese creditors. Sometimes, as in 2011 in the Seychelles, borrowers requested, and received, comparable treatment from China Eximbank under a Paris Club restructuring. Sometimes Chinese creditors acted without the Paris Club, but aligned with an IMF program requiring debt to be brought to sustainable levels, as in the Republic of Congo in 2017–2019. Chinese creditors negotiated debt relief separately. Our 2020 review of China's past restructuring concluded that Chinese creditors were "muddling through" without much central coordination.

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THE DSSI: A POST-MORTEM

The G20 Initiative was hastily drafted and the initial two-page term sheet failed to clarify a number of important elements, including how countries should apply for the relief and whether or not they needed to ask all their creditors for comparable relief (a requirement of Paris Club relief), whether borrowers needed to clear their bilateral arrears before receiving relief, and what practice creditors should adopt regarding continued disbursement on existing loans. Most contentiously, the G20, the World Bank, and the International Monetary Fund had never agreed on a definition of official bilateral creditor.

The World Bank's Debtor Reporting Manual states that "as creditors all commercial banks are classified as private, whether publicly or privately owned." China had designated two financiers as "official" creditors: CIDCA and China Eximbank. Beijing made it clear that state-owned China Development Bank, a significant lender to

Angola (but not elsewhere in low-income Africa), was considered a commercial lender. At least one other G20 member had a similar policy: Germany's state-owned bank KfW-IPEX did not participate in the DSSI.

In keeping with the G20 resolution, in June 2020, Chinese President Xi Jinping called on Chinese financial institutions to "hold friendly consultations" with African countries and "work out arrangements for commercial loans with sovereign guarantees." Several months later, Angola successfully negotiated debt relief with CDB and ICBC. Zambia and Kenya also received debt relief from CDB. There was no equivalent public push from top leaders in the wealthier countries.

The DSSI was renewed twice, ending in December 2021. Ultimately, only forty-eight debtor countries participated, and of these, only thirty-four participated in all three phases. Some concluded that the risks of credit rating downgrades were not worth the temporary reprieve. Others decided that the DSSI's reporting requirements (recipients were closely monitored on how they spent their "savings") and the difficulty in negotiating details of three separate suspensions across multiple creditors required considerable work for modest benefit.

Kenya was a particularly complicated case. The government declined to apply for DSSI in 2020, but requested suspensions for the second phase (January through June 2021). China Eximbank provided relief for January–June 2021. However, when Kenya applied for the third phase, the Chinese bank stalled. Soon, contractors on multiple Chinese-financed projects began to complain to the Kenyan government that China Eximbank had stopped disbursements. Kenya then withdrew its request for the final phase.

China Eximbank never explained to the Kenyans why it was reluctant to continue Kenya's debt service suspension. It is possible that Kenya's decision to continue to service its other commercial debt, and to issue a new $1 billion commercial bond priced at 6.3 percent in June 2021, made it politically hard for Chinese policymakers to continue to press China Eximbank to provide significant debt service suspension. Despite the Kenya case, as of October 2021, available data showed that Chinese banks had provided $5.7 billion in suspensions, 55 percent of the total DSSI debt relief, despite being responsible for 29 percent of the debt service due.

COMMON FRAMEWORK

The Common Framework involves three challenges. First, it is a learning process for the Chinese government, which has taken on the task of coordinating not just its official policy banks but the major commercial banks. While to many outsiders "China" appears to be a unified entity, Chinese banks compete actively with each other overseas, resist information sharing, and their leaders can outrank the officials who are trying to corral them.

Second, restructuring with debt write-downs is not simply a technical process; it is deeply political. It took thirty-two years—from 1956 to 1988—for the wealthy Paris Club countries to build the political will to provide developing country borrowers with "haircuts," that is, reductions in the value of their debts. Chinese citizens are unlikely to be happy to see the Chinese government, which owes overseas creditors $415 billion, reduce the principal on debts.

Third, the Common Framework has not yet developed mechanisms to ensure fair burden-sharing among official creditors and the bondholders and commodity traders that in many cases hold the bulk of distressed countries' debts. As presently designed, even well-organized creditor committees of private lenders need to wait for the official G20 and Paris Club creditors to meet and decide on their offer of assistance. Once the official creditor committees have committed to debt relief, the borrower is required to ask its private creditors for comparable treatment. Yet borrowers have little leverage to compel private lenders to provide the same terms.

Perhaps now is the time to break from the past and re-invigorate the idea of a new regime for "Chapter 11" sovereign debt restructuring.

BREAK FROM THE PAST

The introduction of the Common Framework does not solve the challenge of bringing official and private sector creditors together in the same room. Perhaps now is the time to break from the past and re-invigorate the idea of a new regime for "Chapter 11" sovereign debt restructuring. Creditors and borrowers would benefit from a regime that is fair, transparent, and efficient. As a country that values the rules-based United Nations and Bretton Woods systems and its relationship with the Global South, China could be encouraged to take a leadership role in crafting such a new regime. ◆