China's Developing Countries Debt Problem:

Options for Win-Win Solutions

Ishac Diwan, Finance for Development Lab
Shang-Jin Wei, Columbia University

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Table of Contents

Introduction

In parallel to its rise as a major trading partner, China has emerged as a large development financier to many developing countries (DCs), especially in Sub-Saharan Africa (SSA) and in Asia. Financial flows rose in 2000s and accelerated after 2013 in the context of the "Belt and Road Initiative" (BRI). Besides providing official assistance, banks and firms were encouraged to do business globally. China's overall involvement in BRI countries is estimated at $1 trillion.[1]

Amidst the current global slow-down, the debts of many low and lower middle-income countries (LMICs) are reaching unsustainable levels. In Sub-Saharan Africa (SSA), public debt has on average risen to 50% of GDP by 2019, and external debt to 35%. The Covid-19 crisis added up about 5 points of GDP to public debt and 2 points to external debt. The Ukraine war and the ensuing rise in food and fuel prices, followed by the increase in global real interest rates and the tightening of capital markets, amount to large new shocks. Already, financial flows to DCs are falling - from the market, but also from China.

As a result, the need for debt restructuring has become more pressing. However, compared to the debt crisis of the 1980s, the heterogeneity of creditors complicates debt workouts. The dominant creditor groups are now the private sector, multilaterals, and China. The Paris Club creditors are relatively smaller, having largely shifted to grants after the Heavily Indebted Poor Countries (HIPC) process. Without cooperation between those groups of actors, a win-win solution is unlikely to emerge. There is a significant downside to allowing this situation to get stuck: each creditor would refrain from providing new loans due to fear of benefitting the others. This would push debtors further into insolvency, hurting the country and its creditors.

Recent progress holds promise. In September, Zambia became the first country to reach an agreement with its official creditors committee under the G20-Paris Club Common Framework (CF), though two years after it applied for debt relief. Although negotiations are ongoing, this attests that burden sharing has become more desirable to China than in the past, when its small size allowed it to act unilaterally. But the lack of progress in Ethiopia, another CF country, suggests that many hurdles continue to complicate reaching a multi-stakeholders deal between the debtor countries, public and private creditors, and the IMF. This also seems to be discouraging countries in need of debt restructuring from requesting it.

This paper's main contribution is to provide a conceptual framework to clarify when, and how, China could participate in debt restructuring processes. It does so in four steps.

First, the paper analyzes the composition of China's debt to DCs and finds that China's exposure to sovereign debt risk is relatively large. China's main lending institutions could thus suffer from large losses if they fail to address those risks.

Second, the paper asks if and when China has an interest to cooperate with other creditors. The theory of debt negotiations tells us that creditors have an interest to free ride – i.e., allow other creditors to take losses and keeping a

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[1] Malik et al. 2021; Horn, Reinhart, and Trebesch 2019.

maintained claim on the sovereign – when it is sufficiently small. Otherwise, debt overhang remains and large creditors cannot be paid. Conversely, when a creditor holds most debt, it can negotiate specific arrangements. Currently, external debt is divided in a balanced way between China, other bilateral and commercial creditors. China has an interest to seek ways to cooperate with other creditors to be able to share the cost of default with them. There are only a few cases where China dominates the other creditors and can gain by playing-it-alone.

The third part of the paper investigates how China can use its bargaining power to affect debt restructuring deals. The IMF plays a central role in debt restructuring deals: it defines key parameters of debt relief through Debt Sustainability Analyses (joint with the World Bank for countries eligible to the Poverty and Growth Trust, PRGT); it is the lender of last resort in distress situations, against which it enforces conditionality. Its Lending Into Arrears (LIA) and Lending Into Official Arrears (LIOA) policies provide it with a tool to discipline recalcitrant creditors, although with some limitations in the case of official creditors. The Paris Club plays an important role of counterpart in setting the rules, in particular through the role of financing assurances. These rules must now evolve and take into account China's size as a creditor.

Lastly, we consider the complex landscape of Chinese lending institutions. With heterogenous actors and fragmented power, it has slowed down, and occasionally reversed, restructuring processes. We suggest that the ability to coordinate domestic lending institutions should allow the country to improve its bargaining position. This could be achieved through a menu approach to replace "old debt instruments", held by lending institutions, with "new debt', with intervention of the central government, which would be more adapted to the needs of creditors and debtors.

Taken together, the implication of the analysis is that the Common Framework needs a complete overhaul. The institutional structure created by the G20 is valuable, as it brings the key actors under one roof. But substance needs to match form: the most prominent creditor, China, should be able to shape its key principles and rules. Without that, debt restructuring agreements will continue to be negotiated on a slow case-by-case basis.

A. How risky is China's loan portfolio to developing countries?

Getting numbers right on Chinese lending

There are various estimates of China's debts to DCs, none very precise. We focus in this paper on all sovereign country debt owed to China's institutions, whether they are classified formally as public or private. The World Bank's Debtor Reporting System aims to cover in its International Debt Statistics database (IDS) all external debt, but it is more comprehensive in its coverage of "Public and publicly guaranteed" (PPG) debt.

Using IDS 2022, which provides data up to end 2020, there was about $3.4 Trillion of PPG external debt at the end of 2020 in LICs, LMICs, and MICs together.[2] Of these, about $170b were owed to China, or 5.3% of the total. Most of this total is owed by LMICs ($120 billion), a smaller amount by UMICs ($31 billion) and the remainder by LICs ($19 billion). In terms of regions, Sub-Saharan Africa is a significant borrower, with $77 billion in debt outstanding to Chinese creditors.

The China exposure of PPG debt as reported by IDS is smaller than it appears in other sources. These differences are due to several factors:

i. *Conceptual differences*: a debt is considered publicly guaranteed by the IMF/World Bank DSAs when it is taken by a State-Owned Enterprise or by the private sector with an explicit government guarantee (with some exceptions). Coverage of other sources could be different.

ii. *Reporting differences*: some debt is not correctly reported by the borrower, for instance due to a lack of capacity of the Debt Management Office to collect information from line ministries. Academic approaches can rely on a variety of sources (press, civil society organizations, etc.) to obtain more accurate estimates.

iii. *Accounting differences*: academic papers often rely on public announcements which are termed in commitments. Actual disbursements can be different: projects take time, are revised, etc. In addition, information on principal repayments is not always subtracted.

A prominent exploration of the data by Horn, Reinhart, and Trebesch (2019), on the basis of individual contracts, finds estimates for Chinese lending to DCs between $195 and 255b in 2017, of which 40 to 80% is not accounted for in the IDS in that year.[3] A share of this "hidden debt" might not materialize for the reasons indicated above (some of it might never be disbursed). Another may account for non-guaranteed debt.[4]

[2] LICs, LMICs, and MICs are respectively low income, lower middle income, and middle-income countries. In the paper, the MIC group includes LMIC countries.
[3] In Horn et al, 2019, the raw data is based on public commitments, from which debt stocks are estimated, based on hypotheses on disbursement and repayment rates. Their work builds on the data collected by AidData (Malik et al 2021).
[4] In the recent Zambia debt restructuring case, most unguaranteed loans from Chinese institutions to SOEs ended up being part of the debt negotiation. While IDS reported that in 2020, China had $3.8b of PPG debt, the debt deal ended up including about $8b of Chinese debts.

On average, China is a large, but not dominant, lender

IDS figures reveals that while China's total debt is far from marginal, it is not dominant either (Table 1). Even if China's debts were 50% higher than reported in the IDS, this conclusion would remain broadly robust. More precisely, IDS data indicates that China's share as a creditor to SSA sovereigns is large (17% of total PPG debt). This is also the case for LICs (15.1%) and to a lesser extent for LMICs (9.4%) and MICs (4.6%). In terms of creditor groups, China's share of total debt is smaller than that of the multilaterals in these four groups. Except in LICs, it is also smaller than private creditors in all other groups, and notably in SSA, where the share of private creditors is double China's. But China is large relative to other bilateral creditors - larger than them together in SSA, but somewhat smaller when considering LICs only. This largely reflects the fact that most bilateral creditors have moved in recent years from providing loans to providing grants in poor countries.

Table 1: Total Long Term external debt stocks (Public and Publicly Guaranteed), end 2020

	SSA	LICs	LMICs	UMICs
PPG external debt stock ($mil)	453,946	123,812	1,283,672	2,037,191
China debt stock ($mil)	76,951	18,721	120,201	31,532
China (%)	17.0%	15.1%	9.4%	1.5%
Multilateral (%)	31.6%	51.1%	32.7%	15.1%
Bilateral ex-China (%)	10.3%	22.3%	16.5%	3.9%
Private creditors (ex-China) (%)	41.1%	11.4%	41.4%	79.5%

Source: IDS, WB, 2022. PPG is public and publicly guaranteed debt. SSA excludes high-income countries.

While debt attracts a lot of attention, other flows also play a major economic role. Grants are four times larger in magnitude than lending flows in LICs. Foreign Direct Investments (FDIs) represent amounts equivalent to loans. The composition changes across income groups and regions: grants are less relevant for middle-income countries and FDI increases in share. While they are not directly considered as part of debt restructuring, those other flows influence economic performance in normal times and are a key part of the financing equations during the restructuring process.

Recent net flows have been decreasing

Outstanding debt provides a static picture after a decade and a half of rapid changes. Debt flows from China have risen very fast starting in the 2000s, peaking around 2015, but decreasing in recent years. In SSA, the share of China's debt flows in total debt flows rose from less than 1% in 2000, to 17% in 2020, reflecting a strategic decision by China to invest in developing countries, which included rising FDI and more involvement with international organizations.

China was not the only source of increasing flows to DCs, but its rise as a financier contributed to a series of developments that ushered a golden period of growth convergence during 2000-2015 for SSA and other DCs. In SSA, from $20b in 2000, total inflows crossed the $100b mark by 2011. The growth in flows was equally impressive in the broader LMIC group, going from $50b in 2000 to $300b by 2014. This included a massive rise in private loans; a fast rise of grants (for poor countries); and a significant rise of FDI. Debt flows from China also rose fast after 2000. They crossed the $1b/year in 2005 in LMICs and SSA, the \$10b/y mark by 2014-15, and while stabilizing afterwards in SSA, they rose further to about \$20b/y in LMICs.[5] DCs also witnessed a commodity boom, and a fast growth of their domestic capital market. It is unlikely that such a favorable combination of factors will line-up again anytime soon.

Table 2. Total (net) Capital Flows on external debt

Avg. 2018-2020	SSA	LICs	LMICs	MICs
Total (net) flows (\$m)	79,204	54,603	228,162	725,710
FDI (net) flows (\$m)	20,227	9,370	121,448	468,129
Total grants* (\$m)	29,804	39,001	23,720	37,362
Debt (net) debt flows (\$m)	29,173	6,232	82,994	220,219
From China (%)	12.60%	7.30%	12.20%	3.70%
From Multilateral (%)	42.50%	75.60%	36.30%	18.70%
From bilateral (ex-China) (%)	5.60%	11.70%	8.40%	2.50%
From private creditors (ex-China) (%)	39.20%	5.50%	43.10%	75.20%

Source: IDS, WB, 2022

In recent years, new lending from China and from private sources have started to decrease. In 2019 and 2020, new disbursed flows have been flat. At the same time, debt service has increased, leading to declining net transfers (NTs, the difference between new loans and debt service). This change especially affected SSA countries and LMICs.

In SSA, NT on debt collapsed from \$20.8 to \$1.7b between 2019-20. In LMICs, NT fell from \$55b to \$33b. Most of these evolutions stemmed from private creditors. Private NTs turned negative in 2020, with a large net transfer of -\$10.5b from SSA countries to their creditors. For LMICs, this amount was \$11.5 billion. Flows from China followed a similar trend, though less large. In 2020, NT was also negative for SSA for the first time, at -\$1b. In the most recent China-Africa High-level Forum in 2022, China's pledges for future loans were cut in half, at a time when debt service is rising.[6]

There are various reasons why debt flows from China are falling and negative: its lower external commercial surpluses, a strategy to shift investment from lending to FDI. Those evolutions were encompassed by the move beyond the BRI to a more comprehensive developmental paradigm with its Global Development Initiative announced in 2021. But emerging debt sustainability tensions, and the fear that new flows would be used to financed debt service to private creditors undoubtedly played a role in rethinking financing linkages between China and developing countries.

[5] Early flows in the 2000s went largely from official Chinese sources to states, but by the 2010s, they increasingly came from Chinese financial institutions to State-owned-enterprises – the so-called hidden debts not captured by the IDS data. As a result, the growth of flows from China over time, as accounted by the IDS, must be more under-estimated in the outer years (Horn et al 2021, ODI 2021).

[6] The negative net transfers from China are connected to the high share of debt servicing going to China in recent years, which is due to grace periods for large loans coming to an end, and to interest rates higher that those charged by MDBs (but lower than by private lenders).

Table 3. Net Transfers on external debt (PPG)

	SSA		LICs		LMICs		MICs	
	2019	2020	2019	2020	2019	2020	2019	2020
Total NT	20,833	1,760	4,016	4,978	55,002	33,864	78,659	141,281
China	799	-1,040	-477	337	4,747	-1,015	-1,704	-4,038
Multilaterals	11,385	11,770	3,811	4,459	18,886	37,509	13,819	50,707
Bilaterals	1,054	1,530	897	434	1,378	8,808	-3,496	5,615
Private	7,596	-10,499	-215	-253	29,992	-11,438	70,040	88,996

Source: World Bank, IDS, 2022

Multilaterals have not been able to sufficiently increase their flows to compensate, and especially so in LMICs. Savings from the DSSI helped the LICs but have now stopped. A few DCs did manage to go back to market in 2020, but the more recent rise in global interest rates is leading to a flight to quality, with a growing list of LMICs losing market access. The capital flows situation is thus clearly in the midst of a dramatic transformation, and the dwindling of Net Transfers worsens the incentives of countries to repay their debts in the absence of new support, especially amidst the terms of trade and interest rate shocks emanating from the global economy.

Chinese lending portfolio to developing countries: concentrated and increasingly risky

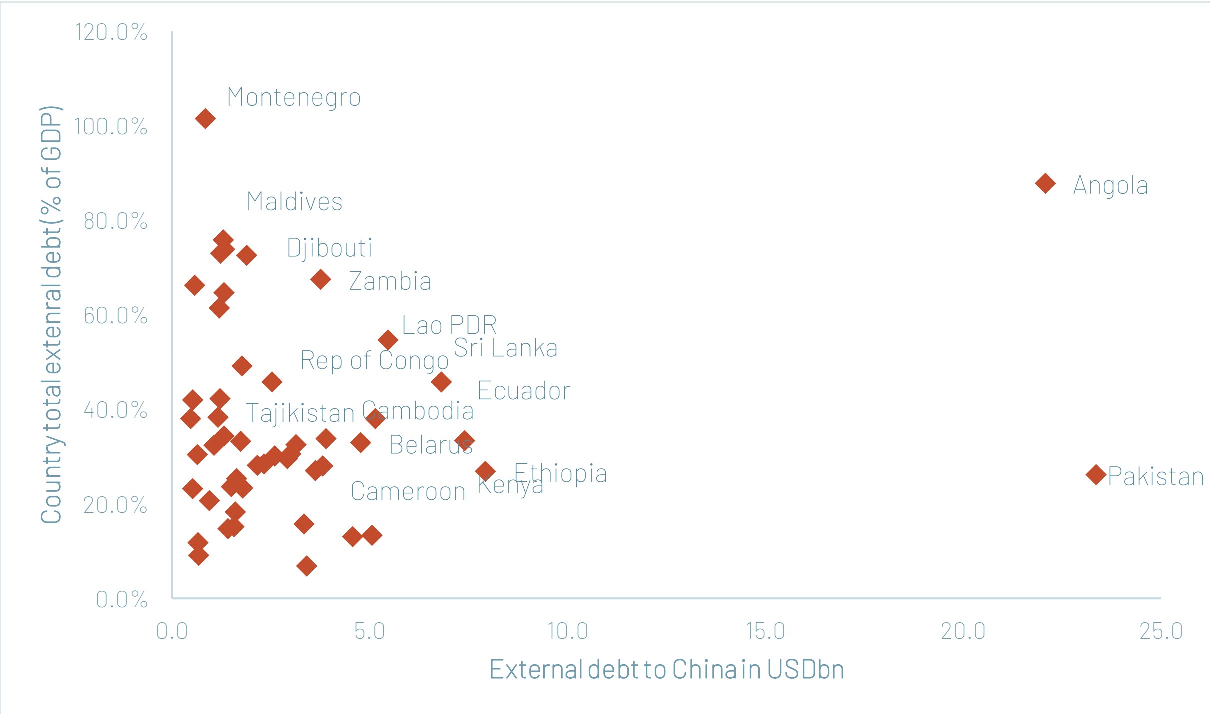
In this deteriorating context, how risky is China's debt portfolio? This depends on its distribution across debtor countries, and on the riskiness of each country. On the first score, a characteristic of China's portfolio is that it is relatively concentrated in a few countries (Figure 1).[7] Four countries account for 20% of total Chinese debt to DCs, 10 countries for one third, and 24 countries for about 50% (Table 4). The largest amounts are owed by Pakistan ($23.4b), Angola ($22.1b), Ethiopia ($7.9b), Kenya ($7.9b), Sri Lanka ($6.8b), Lao PDR ($5.5b), Brazil ($5.1b), Ecuador ($5.1b), and Belarus ($4.8b).[8]

To assess the effect of the second country riskiness measure on the riskiness of China's loan portfolio, we use two measures of risk. First, we use measurements from the IMF's DSA for the so-called PRGT countries, which broadly correspond to the LICs and LMICs. Second, we complement this with measures of solvency from rating agencies for the richer Emerging Market countries. Overall, it appears that China's loan portfolio seems to be relatively risky. Over 10% of it is in distress, and around 20% at high risk. Among the top ten largest debtors, risky debts (in distress or in high risk) add up to $61b; among the largest 50 borrowers, they add up to $90b. Adding the estimated hidden debt as part of the public debt perimeter can potentially double these figures.[9] These are large sums, which are likely to grow further

[7] This has been noted in Yue and Wang 2020, Nedopil and Yie 2020.
[8] Richer debtor countries include Iran (about $30b), Venezuela ($24b), Russia and South Africa.
[9] While the inclusion of the hidden debts raises China's risk, it is unlikely to do so dramatically as countries with larger hidden debt are not particularly at risk and prominent in China's overall portfolio. In the Horn et al 2019 data, the 10 countries with largest hidden debts are Democratic Republic of the Congo, Papua New Guinea, Angola, Mozambique, Namibia, Brunei, Kazakhstan, Tonga, Turkmenistan, and Laos. Of these, two are larger than 2% of China's portfolio (Angola and Lao PDR), one is in the distressed category (Mozambique), and two are in the high-risk group (Lao and PNG).

as/if the debt crisis worsens. Clearly, China has an important interest in managing this crisis as efficiently as possible.

Figure 1. China exposure ($ billion) and country total external debt (% GDP)



Source: World Bank IDS, 2022

Table 4. Top 50 countries in China debt portfolio and their quality

Low risk	Moderate risk	High risk	Debt distress	% China loans	Cum. Share
	Angola	Pakistan		8% each	16%
		Kenya	Ethiopia	3% each	21%
Bangladesh	Brazil	Lao PDR, Ecuador	Sri Lanka, Belarus	2% each	32%
Indonesia, Myanmar, Turkey Uzbekistan	Egypt, Cote d'Ivoire, Uganda, Tanzania, Kyrgyz, South Africa Cambodia	Cameroon, Nigeria, Argentina	Zambia, Congo Mozambique Zimbabwe	1% each	49%
Kazakhstan, Serbia	Vietnam, Guinea Senegal	Djibouti		0.5% each	52%
Morocco	Bolivia, Congo DR Turkmenistan, Mali Jamaica, N. Macedonia	Maldives, Mongolia Gabon, Tajikistan Togo, PN Guinea	Sudan	< than 0.5%	57%

Sources: For LICs and LMICs: latest DSA under the joint IMF-WB LIC-DSF. For MICs: Moody's ratings, with index [1,24] built according to index division: <12; 12-15; 15-20; >20, as in Bhatia (2002).

B. To cooperate or not to cooperate?

For creditors, including for China, deciding whether to coordinate debt restructuring with other creditors depends on costs and benefits. The broader the perimeter of the creditor group, the lower the burden of debt reduction on each creditor. But coordination has costs. A central issue is thus whether China will be interested in cooperating with the other creditors – public, private, and multilateral. While the IFIs are likely to remain considered as senior creditors and not to participate in debt reduction, they play a role by extending new (often concessional) loans in a situation where countries have few options.[10]

China has a long history as a lender to developing countries and has frequently restructured debt with borrowers in distress (Bon and Cheng, 2020), but most of debt workouts have either been on relatively small amounts or with maturity extension and interest rate reduction. Those were almost exclusively independent from multilateral, negotiated, creditor processes. Can this change?

With the Debt Service Suspension Initiative (DSSI) and the Common Framework, China has become an important player in multilateral debt restructuring processes. It was by far the largest contributor to the DSSI (about $6b) as IFIs were excluded and the private sector stayed out. China is also a major contributor to multilateral bodies: it is active at the UN, WTO, World Bank, IMF, and in several regional development banks (ODI 2021). And it has pledged to re-channel $10 billions of SDRs towards African countries.

Until HIPC, the major milestone of the sovereign restructuring process was an agreement between the Paris Club and borrowing countries. Negotiations with other official creditors and private creditors would then take the parameters of the agreement and were tasked to reach a deal with a "comparable treatment". With "credible and specific" financing assurances at hand, the IMF was then able to lend into arrears, thus providing borrowing countries with leverage against private (and other official) creditors. This worked well but not perfectly - debt workouts took time, especially when involving haircuts; debt reduction was often too small, leading to repeated restructurings; and recent research has shown that comparability of treatment for private creditors was actually not reached in practice, with smaller Net Present Value reductions.[11] Now that China has become a more central creditor, the question is whether it wants to work alone, or with others, including the IMF, in shaping debt restructuring deals, and if so, how it would want to engage with the other creditors and with the MDBs.

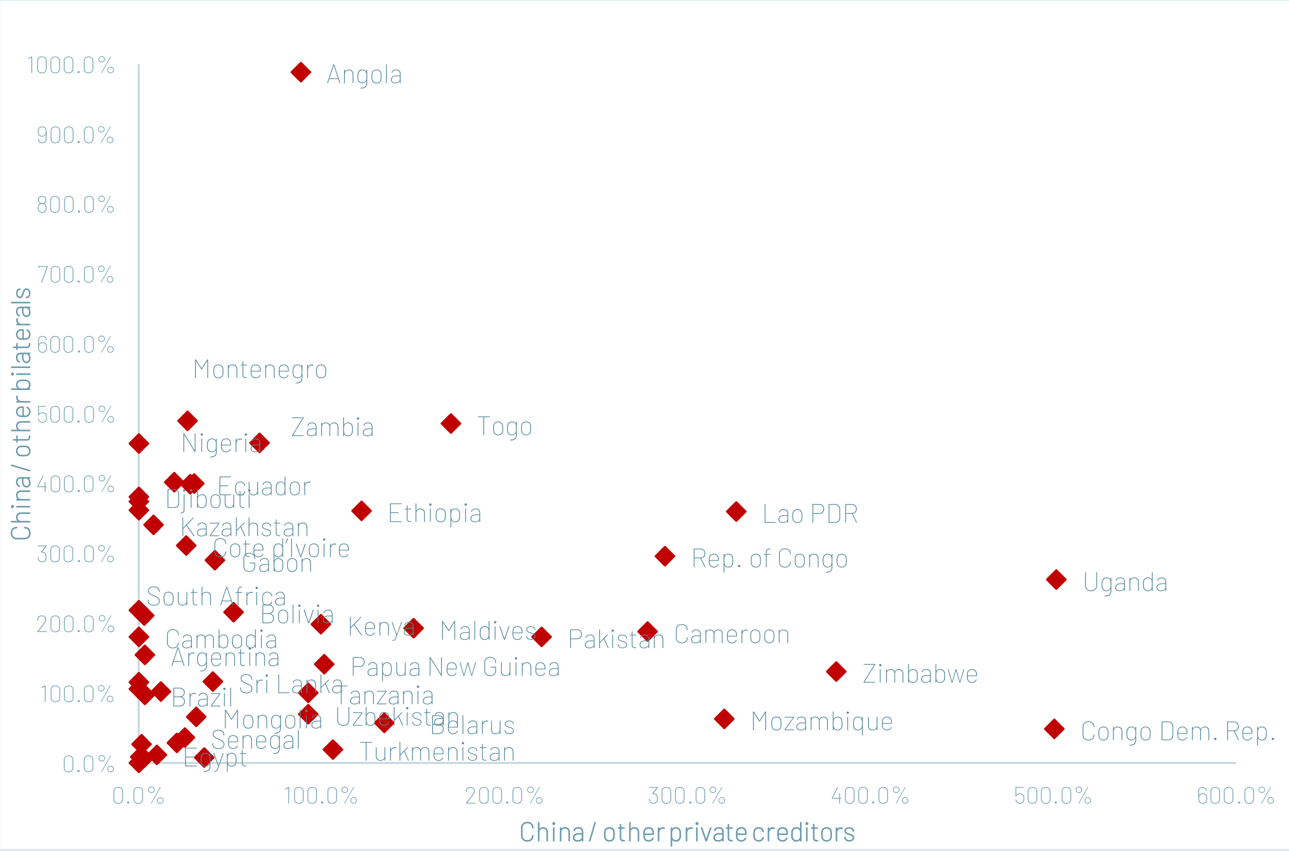
A frequent criticism is that China has shown a marked preference for rescheduling, which could prevent its participation in debt reduction deals.[12] But a preference for refinancing over haircuts does not constitute a conceptual difficulty, since rescheduling a below market interest rate also involves a cut in its present value. But because the comparability calculations depend so much on the method used, there is a need for transparent agreements on rules. There are two areas of contention: the discount rate used for present-value calculations; and the definition of the denominator, which can be the par value of the loan, or its present value (Lazard 2021). Now, the method used is negotiated each time, which vastly

[10] In G20 settings, China has contested MDBs seniority status, suggesting it could be included in restructured claims.
[11] Kose et al 2021; Schlegl, Trebesch, and Wright 2019.
[12] China has provided debt relief to at least 26 African countries in recent years. But debt forgiveness has been limited to "zero-interest loans". For other types of loans, it has sown a preference for rescheduling. See: Acker, Brautigam, and Huang 2020, Rudyak and Chen 2021, Bon and Cheng, 2020.

complicates the bargaining process. Ideally, the method would be agreed upon, with China part of the decision, and it would be used systematically and in a transparent way.

The benefits of cooperation eventually hinge on the distribution of debt among creditor type. If each type had "its own" countries, coordination would have little benefit. On the other hand, a more even distribution would make coordination potentially more beneficial. Figure 2 depicts the multiple of China's debt relative to those of the other bilateral and private creditors, for the 50 countries with the largest size of Chinese debts. The figure shows a great diversity of circumstances. In some countries, China dominates both public and private creditors (e.g., Lao, Rep. of Congo). In others, it dominates one group – the public sector creditors (e.g., Angola), or the private creditors (e.g., Congo DR). There are also many countries where China is small relative to both other types of lenders.

Figure 2. China's debt relative to bilateral and private debts



Source: IDS 2022

Thinking in game-theory fashion, from China's perspective, there seems to be three types of situations, each with different incentives for coordination with other creditors:

- China is small enough, meaning that the rest of the creditors would try to reach a positive-sum outcome in negotiation with the debtor country irrespective of China's response.
- Middling China - without China's participation, a positive sum game cannot be reached as other creditors would fear that financial support will benefit China. But conversely, the participation of other creditors is needed to allow spreading the cost of debt relief more widely. This is a case where the cost of coordination can be small relative to the gains.

- China is large relative to other creditors: it can make a positive-sum deal with the debtor country and come ahead even if the rest of the creditors free ride, and still end up ahead because of savings on coordination cost.

In Table 5, we illustrate what such a 3-way typology looks like by picking broad cut-offs borders: we separate cases where China's loans are at below half the other types of loans (non-China bilaterals, non-China private sector), between half and twice, and more than twice. The middling category includes all countries where at least one of the other creditor types has a size comparable to China's. This category includes five cells, depicted in Table 5 in orange. The group comprises 23 out the largest 50 largest country exposures to loans from China. It also includes 6 of the top 8 exposures in China's portfolio. The group where China is too small to care, colored pink, includes 18 countries out of 50. Finally, the group where China is dominant includes just 6 countries, with only two of China's top 8 exposures. Other cut-off points would produce different lists, but the dominance of the middling case is too strong to go away.[13] The group of countries where China is dominant would remain an important group, but not one so large as to advantage a go-it-alone strategic stance.

Table 5. Three types of debtor countries

		Total China relative to other bilateral creditors		
		Below half	Between half and twice	Above twice
Total China relative to all other private creditors	Below half	Egypt Indonesia Morocco Senegal Serbia Turkey Vietnam	Argentina Brazil Cambodia Malawi Mongolia Sri Lanka	Ecuador Gabon Ghana Jamaica Kazakhstan Kyrgyz Montenegro Macedonia Nigeria
	Between half and twice	Turkmenistan	Belarus Kenya Maldives Papua New Guinea Tanzania Uzbekistan	Angola Bolivia Togo Zambia
	Above twice	Bangladesh CongoDR	Cameroon Mali Mozambique Myanmar Pakistan Zimbabwe	Ethiopia Guinea Lao PDR Lesotho Congo Uganda

Source: World Bank IDS and authors calculations

Let us consider each category separately, asking whether China would be better off playing cooperatively or alone, and under which conditions.

Middling Chinese exposure: possible cooperative agreements

This is the most interesting category. There were no similar cases of debt overhang in the past, with large exposures to both China, and either the Paris Club, and/or private creditors. These new situations may require new procedures. And it is the dominant model of indebtedness among China's top 50 borrowers. In all these cases, China, as well as other creditors, should be interested in supporting a coordinated resolution of debt distress as they would be keen to share losses with others by espousing the principle of comparability of treatment. From a bargaining position too, China, other creditors, and the debtor

[13] The typology barely changes when we include estimates of hidden debts: several countries cross categories, and the China-intensive group ends with 9 countries instead of 6 – see Appendix Table A1.

country all have the means to oppose a veto to a solution they dislike. Thus, paradoxically, these are cases where deals are the hardest to reach, but with most potential gains for all to share. The country stands to benefit from debt restructuring by stabilizing its economy and improving growth prospects. China and other creditors stand to do better than in a situation of no deal thanks to an improved economy.

But such deals are difficult to reach in practice, since they involve different groups bargaining, each with its own incentives and constraints. This tension probably explains why it took two years to reach an agreement under the auspices of the Common Framework with the Zambian government. One can expect that this precedent would make future deals easier to reach. However, after the agreement between the official creditors committee and Zambia, considerable work remains to obtain specific deals with each creditor. Those burden sharing decisions remain to be finalized.

Countries where the relation with China dominates

There are no more than a handful of countries where China dominates both (non-Chinese) bilateral *and* private lenders. In these cases, China may benefit by going-it-alone and capturing much of the efficiency gains without having to pay the costs of coordination. Other creditors may free ride and get repaid in full, but that would not be costly enough to push China to condition a deal on loss-sharing agreement with them.

It is not inconsistent for China to try to "play" some country cooperatively and not others. All it needs to do is to convince some countries not to go to the IMF (e.g., Angola). However, it is also possible that as China deals with more countries in a cooperative fashion, its working relation with the IMF and other MDBs would improve sufficiently to allow for cooperation on the harder countries as well. Trust would have to involve some changes in IMF rules that go closer to China's preferences, as discussed in the next section.[14] After all, the IMF has unique advantages that allow it to finance a country out of a state of illiquidity, while convincing it to adjust its internal and external accounts in ways that re-establish macro balances. China has found these functions difficult to fulfill. In Pakistan and Sri Lanka, its bailout attempts did not manage to stabilize these countries, which at the end had to go to the IMF. The actual tension in these cases will likely be on the size of debt reduction. More than in type B situations, China would want to insist on low levels of debt reduction, since it would bear most of the burden itself. But if debt reduction is too low, the IMF and MDBs would under-provide new loans, to minimize their exposure to risk, while insisting on a large adjustment effort, which the debtor country would resist. The case of Ethiopia now illustrates this type of tensions.

Countries where China is marginal

In many cases, China does not really care -- these are countries with small debts to China, an/or where China represents a small share of the country's debt (e.g., Ghana). Coordination costs in these cases can be perceived as higher than possible gains. Here, China has an incentive to provide minimal relief. However, free riding is less of an option if China wants to develop a relation of trust with the IMF and the

[14] Currently, improved trust between the IMF and China is to some extent hostage of the widening geo-political differences between the West and China. For the West not to block a rapprochement between the IMF and China, the current implicit modus vivendi that allows for collaboration on development and climate change -- even as disagreements rise on other domains -- would need to be consolidated.

finance for development community, which it needs to advance its own interests. Its unresponsiveness in these cases would weaken discipline in the middling cases it cares about.

C. A shared understanding between China and the IMF is a central tenet for a successful restructuring architecture

Cooperation among creditors and with the debtor country can lead to several types of benefits, which can then be shared by all. On the other hand, the absence of coordination can turn a liquidity problem into an insolvency situation, as each creditor refrains from refinancing its own debt, fearing that it would benefit the other creditors. Moreover, in the absence of coordination among creditors, the debtor country cannot borrow anew (because of the long queue of creditors) to finance profitable opportunities, producing losses for all. Coordination can thus produce a positive sum game that not only prevents the debtor's economy from collapsing, but also allows it to take advantage of new growth opportunities.[15] In the absence of a deal on how to share the new payoffs, no single creditor group would lend for new projects, fearing that the investment will not be undertaken, either because the funds are used to repay other creditors, or to fund consumption. Debt reduction, new money, conditionality, and fair burden sharing are all elements that are needed to produce a win-win cooperative solution (Diwan and Rodrik 1995).

Under the right conditions, China should be interested in cooperating with the IMF, which currently plays a central role in debt deals. It does this in three ways.

- It is a lender of last resort. The IMF provides needed liquidity, and it crowds in MDBs lending. This is valuable because debt service reduction alone is unlikely to provide sufficient liquidity to put the country on a renewed growth path. In addition, while commercial banks can be cajoled into providing what was called "forced lending", there are no equivalent mechanisms for bondholders.
- The IMF enforces conditionality, so that new liquidity and debt reduction are used to finance investment and not consumption. In the absence of conditionality, the time inconsistency of country pledges would not allow win-win deals to be reached.
- The IMF's lending into arrears policy can be used to enforce burden sharing among creditors when needed. LIA is used when it is conducting negotiations in good faith with private creditors. LIOA can be used with official creditors provided they assent to IMF lending.

Disagreements with the IMF abound. For instance, Debt Sustainability Analysis is the key analytical underpinning of IMF programs. It requires many underlying assumptions. One issue of potential tension between China and the IMF relates to the depth of debt reduction needed. Several Chinese scholars have insisted that DSAs conducted by the IMF tend to be too "conservative" in the sense of pushing too often

[15] This is especially the case now for projects that support adaptation to climate change, which have been estimated to have very high rates of return (Bhattacharya et al 2020).

for debt reduction. This view is bolstered by the potential conflict of interest as the IMF is both the referee, and a creditor itself with often large outstanding debts -- the IMF stands to benefit from deep debt reduction, as this reduces the riskiness of its own exposure and protects its de jure seniority. A more systematic approach, which accounts for balance sheet effects, would result in a more precise and less conservative estimate of debt sustainability, at least in countries where external finance was invested in infrastructure (Lin and Wang, 2014, 2021).

Another common critique of IMF conditionality is that it puts too much emphasis on austerity and too little on structural transformation and growth. Clearly, growth is preferable. But growth requires promises of future investment and reforms. The problem lies with the credibility of these promises. The HIPC process had innovated by extending the debt restructuring process and conditionality over time, providing liquidity relief early, and making final stock relief conditional to policy performance over several years. Similar provisions would make sense in the current circumstances.

A third problem is that on the face of it, the provision of new loans by the IMF and other MDBs may seem to require more debt reduction to create the debt space needed. But it should also be recognized that to the extent that new loans raise growth rates, they should lead to *less* debt reduction. The debtor country, and the private and bilateral creditors, should insist that the MDBs share the burden of adjustment by providing more new lending in ways that *boost* growth opportunities. Indeed, one critique of the agreement with Zambia is that the MDBs did not provide sufficient financing assurances to extend investment loans in the next years, which would have allowed to project larger growth rates in the future (the program presumes medium-term growth rate of only 3%) and which would have resulted in lower haircuts.

As both a large creditor and a promoter of sustainable development, China has therefore an opportunity to support innovations that benefit DCs. Besides the issues raised above, there are other possibilities, especially drawing from its own history as a highly successful development practitioner. In the current context, three lessons stand out. First, China is likely to encourage pushing some of the adjustment burden to domestic debtholders, in keeping with its own tradition of financial repression as an active macro-management tool. Second, China could put emphasis on ensuring that public infrastructure assets are well maintained to prevent their decay, and that they provide improved cash flows. Third, China would tend to encourage improved management of capital flows, including a shift towards FDI, to reduce risk and provide better incentives.

Issues surrounding domestic debt merit more attention. Domestic debt has risen to levels unseen in the previous debt crisis and are on average around a third of total public debts in SSA and LMICs, and close to half in UMICs. Domestic debt can be reduced over time by paying low or negative real interest rates. This is often implemented through "financial repression" - typically low nominal rates in an inflationary environment. This strategy requires closing the capital account. There is a risk of leakages connected to informal foreign exchange markets and illicit capital flight. To be effective, financial repression needs to rely on a moderate "tax" on capital and to operate over long periods. A large (implicit) tax on capital creates many risks – including of a blow-out of the banking system.

A related concern is over the debt-restructuring perimeter, and whether it should include or not the external *private* debt. There is an argument for leaving private creditors out of the debt reduction perimeter (including Chinese private lenders) when this procedure is not too costly in terms of burden sharing. This is especially the case for LMICs, who are supposed to be weaned out from ODA, and should therefore be encouraged to cultivate links with private creditors and investors. This argument does not find support among the IFIs, as the official line insists on equal treatment to all creditors, even as special efforts are promised to LMICs so they could quickly regain market access after debt reduction, in the form of loan enhancements.

D. Coordination within China around a menu approach

There is a wide variety of lenders in China with exposure to DC debt. The Chinese government extends foreign grants, zero-interest loans, and concessional loans. The main policy banks - China Exim Bank and China Development Bank (CDB) behave like MDBs. But development cooperation takes many more forms, including commercial loans by Chinese state and regional banks, and FDI-like investments by public and private entities. During past debt crisis, external claims were divided into two categories: public/bilateral and private, and these were treated sequentially, and in different fora (the Paris Club and the London Club), but in ways that ensured fair burden sharing. In China however, the line between public and private is blurrier, giving local Chinese institutions more of a choice as to which group they prefer to join.

The different Chinese creditor organizations should ideally coordinate their interests so as to be able to negotiate with the debtor country and other creditor as one creditor group, since their control over a larger share of debt would improve their bargaining power. But doing so is quite difficult because the members of the group are themselves heterogeneous. Different institutions hold different claims. While all these claims are subject to country risk, they face different types of risks – some state-related, others connected to the performance of autonomous enterprises. They also have different needs – some would like to exit at a loss, while others cannot afford to lose capital.

To foster within-China coordination, several principles can be considered. The China Development Bank and China Exim Bank, being the largest creditors, are likely to play a leadership role, in coordination with the Bank of China, Sinosure, and the main ministries involved. Their claims can be considered de facto official claims. Other claimants may choose, if they prefer, to opt out to be part of the public pool, and not participate in the private sector negotiation.[16] In order to attract different institutions with diverse interests to the public pool, once the level of the haircut has been agreed with the debtor country and other country creditors, the China lead-negotiator can develop a menu of options with equal NPVs, from which Chinese claimants can choose from.[17] Unlike the approach taken in Latin America, where menu items where offered by the debtor country to creditors from all nationalities, the proposed approach is to reserve the China menu to Chinese creditors only.

The menu needs to contain appealing instruments. Since different institutions face different financial and regulatory constraints, they will have preferences for different types of restructured debt

[16] There are proposals to merge the two tracks (Chorzempa, and Mazarei, 2021).

[17] The menu approach, within concerted deals, was the adopted invented during the Latin debt crisis of the 1980s to accommodate diverse interests among banks – some better capitalized than others in particular. See Diwan and Kletzer 1992.

instruments. Given the unsettled nature of the financial sector, some can prefer rescheduling to conserve their scarce capital, while other may prefer to exit – because they need liquidity, or to redeploy their assets elsewhere. In the current context of a tight financial situation in China, swapping debt for marketable instruments allows the financial institutions that want to exit to make their assets more liquid (Kian 2021). The Brady experience of the 1990s has shown that loans can be transformed into liquid securities with the addition of some level of guarantees.[18] These guarantees must come from the debtor government, but they are financed by a new loan. The IMF however is no longer willing to finance these credit enhancements itself, as it has done in the past (IMF 2021). To produce collateralized bonds, China would therefore have to finance the collateral itself, possibly using its own SDR allocation (which it has pledged to use largely for the benefit of DCs). These partial risk guarantees can be either paid by the Chinese government, in recognition that it was providing implicit sovereign guarantees in the past, or they can be financed by new loans made by the Chinese government to the debtor country.

Besides plain collateralized bonds, there are several other types of bonds with "Chinese characteristics" that can be considered, which can be of special value both in China and for debtor countries. One such innovation concerns the possibility to swap old debt into newly created commodity bonds. Such bonds are interesting to exporters of commodities as they allow them to engage in counter-cyclical strategies of risk management. They can also be appealing to Chinese importers of commodities that can use such instruments to hedge against commodity risk.

A second promising innovation for some debtor country debt is to swap old debt into infrastructure equity. This can be appealing to some Chinese institutions as part of a China strategy to internationalize its corporations. Equity can be superior to debt both from a risk sharing perspective, and from an incentive perspective. Recently for example, there has been criticism of Chinese engineering firms pushing loans for infrastructure, even when they are not financially sustainable. The swap could be into a minority ownership of a national infrastructure fund, as opposed to geared to controlling particular infrastructures. Holding an equity share of the National Infrastructure Fund would allow for the provision of advice on how to manage these assets better, but also, it would provide incentives to offer new financing when new investments are needed to maximize the value of the assets. This may arise to cover maintenance costs for these assets to prevent a fall in value; and to prevent fire sales in the event of a liquidity shortage. Equity is also valuable for corporations involved in manufacturing, improving their incentives to develop export platforms based in developing countries.

Such directions would be in line with the five-year plans announced at the 2022 Africa-China Summit, with its emphasis on consolidation, quality, FDI rather than debt, and trade. Other possible innovations include swaps into green bonds, which would foster China's leadership in green sectors. Also, these swaps could advantage the creation of Renminbi-denominated bonds and speed up the internationalization of the currency.

[18] But unlike the 1980s, it would be onerous to securitize the principal in an environment of low interest rates. But rolling guarantees on interest payments are more affordable.

Conclusions

The main conclusion of the paper is that while the institutional structure created by the G20 is valuable, as it brings the key actors under a roof that can foster cooperation, the construct still lacks detailed principles and rules that can allow for fast debt restructuring agreements to be reached when they become necessary. The current case-by-case approach will build such rules gradually over time, as the debts of different types of countries will come to be treated. But this gradual process will be exceedingly slow and will certainly slow down the wheels of development for one or more decades, as happened in Latin America in the 1980s. A big-bank approach would be highly preferable. This would consist of a high-level agreement on the precise rules of engagement, reached in negotiation between the IFIs, representatives from the developing world, public and private lenders, and the IFIs.

China is in a unique position to take the lead in shaping such a process and extending it to the case of the MIC countries as well. This would be a natural extension of China's rising level of influence on international development finance (Gruin, Knaack and Xu. 2018; Xu and Carey. 2015), commensurate with its recent move to reorganize its external investments in the context of a new Global Development Initiative.

Past instances of global influence include IMF stance towards capital controls, which were softened through China's influence; and the softening of constraints on borrowing by DCs. China has also influenced the development agenda with its insistence on the importance of infrastructure. The paper recommended that to make further progress on the Common Framework, moves in two broad areas – one external, and one internal to China – are desirable, as they would open up new vistas of win-win possibilities.

The first set of innovations is contingent on building trust with the MDBs, especially the IMF, to reform the debt restructuring process in mutually profitable ways. These innovations would be driven by the will to empower debtor countries to develop themselves, with recovery and growth strategies that would become the backbones of debt restructuring deals, backed by financing assurances for new money by the MDBs, adapted conditionalities, and with a fair burden sharing between all creditors.

The second domain concerns domestic innovations to produce a more effective central coordination mechanism that is needed in Beijing. This entails developing a menu of new instruments that Chinese financial institutions can choose to swap their old instruments against. The new instruments can in addition be backed by some guarantees, in order to improve their marketability, and they can also include several possible financial innovations, in order to improve their attractiveness to the financial markets.

These reforms would be made even more effective if a globally accepted umpire can monitor the rules of the game – such as DSA thresholds, or the discount factor for calculating NPVs. The IMF has filled this role in the past, when the main creditors and the main controlling shareholders of the Fund (US and Europe) coincided, but a rethink seems now necessary.

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Annexes

Figure A1 – SSA (in USDm)

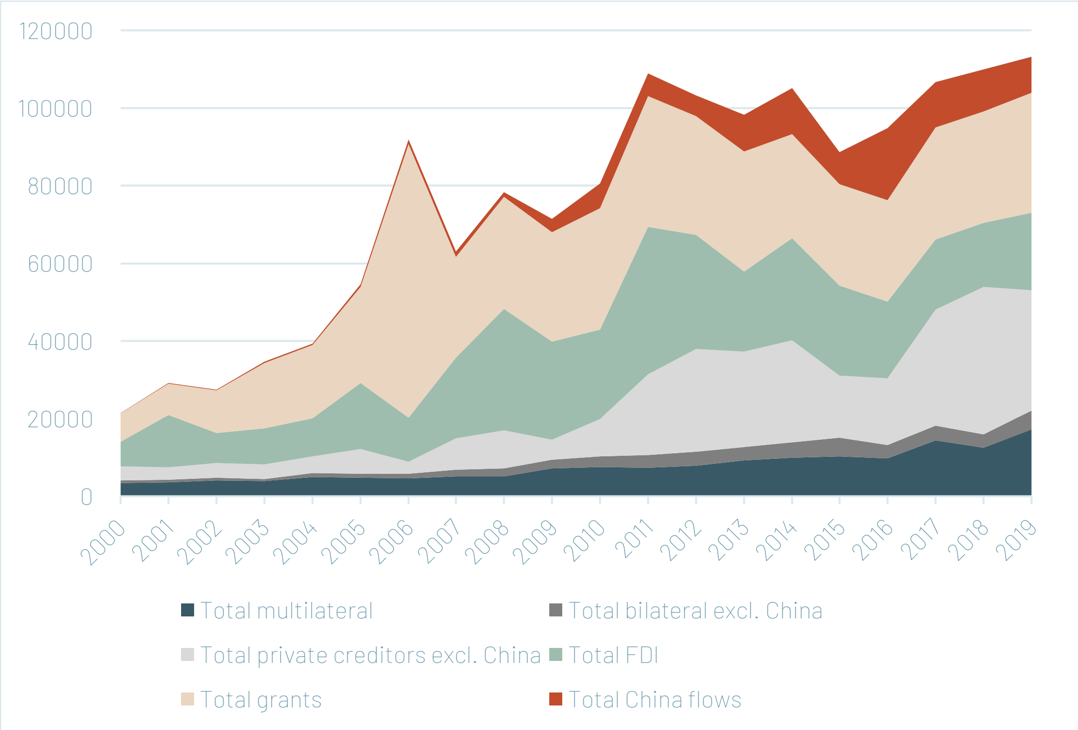

Figure A2 – Flows to LICS (in USDm)

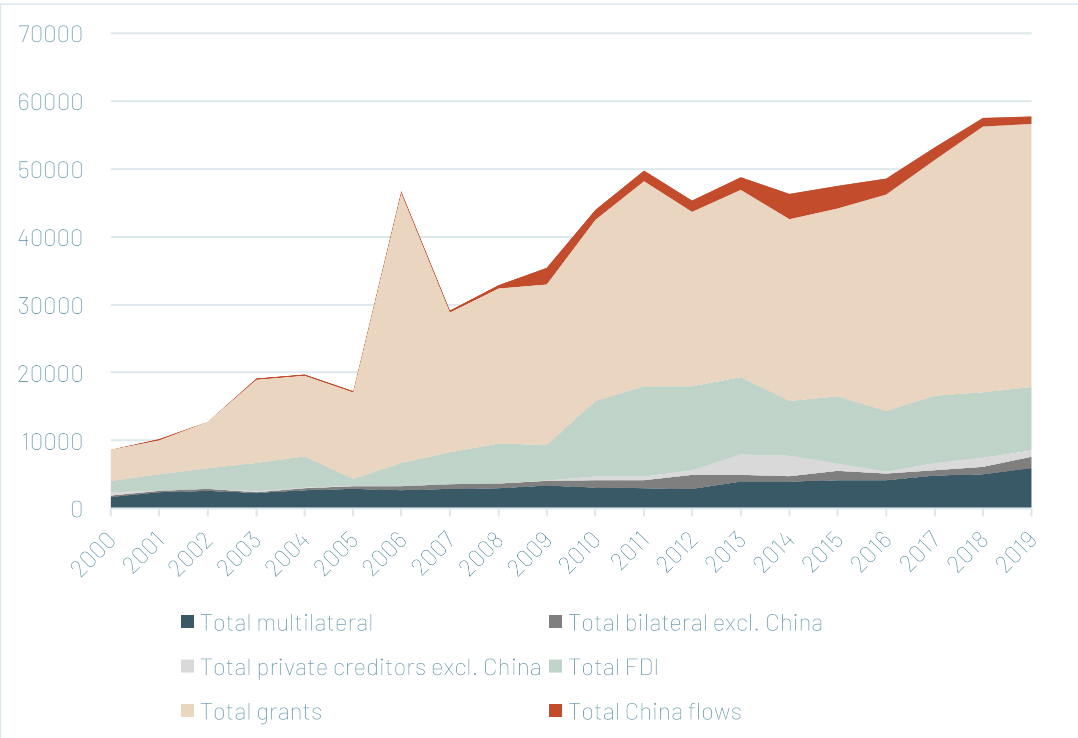

Figure A3 – LMICS (in USDm)

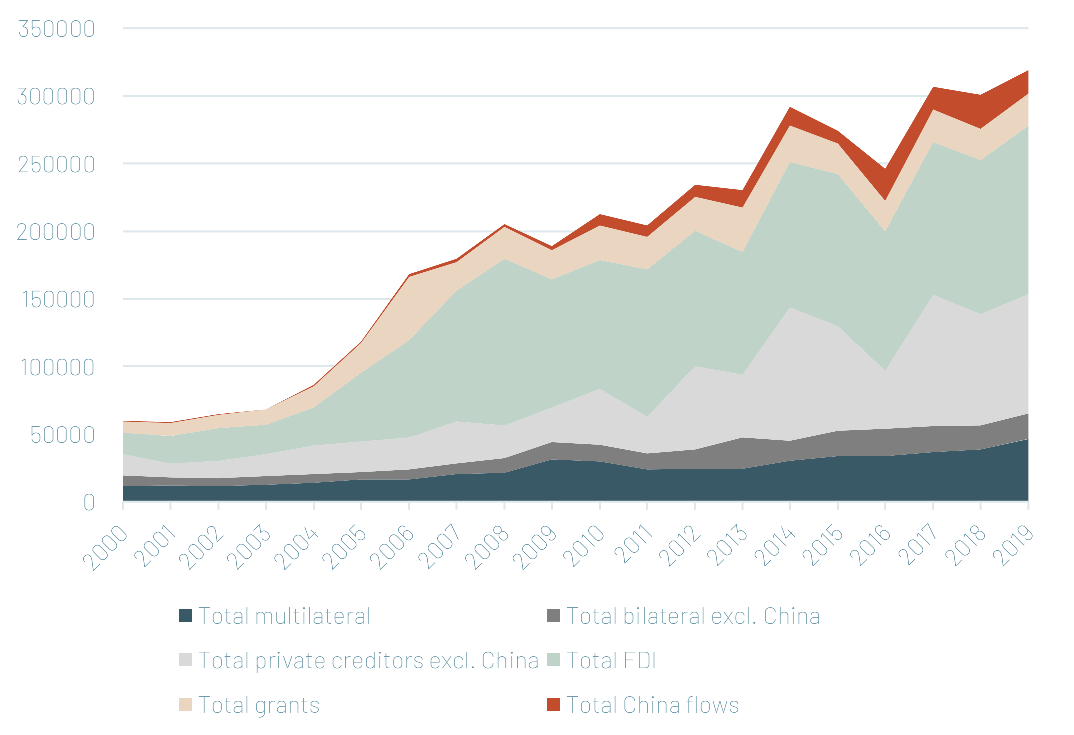

Table A1: Three types of debtor countries, using data from Horn et al (2019)

		Total China relative to other bilateral creditors		
		Below half	Between half and twice	Above twice
Total China relative to all other private Creditors	Below half	Egypt Indonesia Morocco Senegal Serbia	Argentina Brazil Ghana Malawi Turkey	Cambodia Ecuador Gabon Jamaica Kyrgyz Montenegro Macedonia Nigeria
	Between half and twice	Vietnam	Belarus Mongolia Papua New Guinea Sri Lanka Tanzania	Angola Bolivia Kazakhstan Kenya Togo Zambia
	Above twice	Congo DR Turkmenistan	Bangladesh Mali Mozambique Myanmar Uzbekistan Zimbabwe	Cameroon Ethiopia Guinea LaoPDR Lesotho Maldives Pakistan Congo Uganda

Source: Horn et al 2019.

Contact | **Finance for Development Lab**
Communications@findevlab.org
www.findevlab.org