RECONNECT CHINA

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Getting China Onboard a Global Debt Governance System

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Executive summary

China has become the number one provider of development finance in the world. Because of its significant share in Low and Middle Income Countries' (LMICs) external debt, China should take up responsibilities and cooperate with traditional development finance providers, but its particular lending style and distinct approach to debt management pose many challenges and do not make international cooperation straightforward.

Although some progress could be observed over the past couple of years under various initiatives such as the Debt Service Suspension Initiative, the Common Framework and the Global Sovereign Debt Roundtable, more remains to be done.

But as China is increasingly faced with the same difficulties as other lenders, and in particular with rising risks of default, one may be reasonably confident that China will behave increasingly like other lenders.

Policy recommendations

In concrete terms, the EU should push the topic of debt management on the G20 agenda so as to encourage a constructive discussion with China. It is also important to avoid ill-founded criticisms that are simply counterproductive. The EU should call for more transparency and encourage the streamlining of lending practices and approaches to debt restructuring. It is in all countries' interest to design an effective multilateralized debt management mechanism.

Introduction

For a long time, China's ample foreign exchange reserves were invested in US treasury bills (TBs), making China the second-biggest foreign investor in U.S. treasuries after Japan. Although China's claims on the US remain large, they have fallen to a 14-year low at US$ 769.6 billion (in October 2023) from around US$1.1 trillion in 2021[1], and down more than 40% from a decade earlier. They have remained around this relatively low level ever since. The reasons behind this shift are manyfold. They may have to do with the trade war raging between the two countries, as well as with Beijing's attempt to prop up the value of the yuan.

Interestingly, China's financial strategy has moved away from buying classic US reserve assets toward using its surplus foreign exchange to further its global ambitions by developing a network of ties (mostly with developing countries) that would cement its place as a global rival to the US.[2]

China has been using economic aid, loans, and business deals to expand its strategic influence around the world, with a focus on the developing world.[3] As a result, China has become a key player in the field of international development finance and the most important bilateral creditor nation.

China is often criticized for not adhering to the same principles as Western lenders, for pushing developing countries into a debt trap and for refusing to cooperate on debt management issues. These various issues will be examined in turn.

CHINA AS THE NUMBER ONE BILATERAL LENDER TO THE DEVELOPING WORLD

Over the past two decades or so, China has significantly expanded its overseas development finance program, and established itself as a financier of first resort for many low- and middle-income countries (LMICs). By 2017, its outstanding claims in developing and emerging economies were said to surpass those of the World Bank or those of all Paris Club Governments combined.[4]

What has made China such a dominant global creditor is the combination of abundant foreign exchange reserves fueled by a strong export-led growth and the "Going Global Strategy" which was launched in 1999 to foster Chinese investment abroad. In the following years, the Belt and Road Initiative (BRI), Beijing's flagship development program launched in 2013, has mobilized much of the investment in developing countries, with most of the lending concentrated in large investments in infrastructure, energy and mining projects. During the first decade of BRI implementation, China has advanced more than US$330 billion, which is about 80% of the lending of the World Bank over that period.[5]

According to the World Bank's International Debt Report 2023, LMICs' combined public and publicly guaranteed debt obligations to China totaled US$180 billion at end-2022, accounting for 4% of the total, and 31 % of these countries' bilateral debt.[6] The largest chunk (44%) was accounted for by Sub-Saharan countries (followed by South Asia – with Pakistan as the major target –, East Asia and the Pacific, Europe and Central Asia, Latin America, and the Middle East and North Africa). For Sub-Saharan countries as a whole, China's share stood at 11% of the total (and 55% of total bilateral debt). The share of Chinese debt in total external debt often exceeds 30 % in individual African countries. By 2021, China held more than 40 % of low-income countries' total official bilateral debts worldwide.[7]

Although China's commitments are undoubtedly very large, their actual magnitude is not easy to gauge as a substantial portion (about half, according to some estimates) of Chinese lending goes unreported.[8]

A first reason is that the figure for debt obligations to China does not include significant lending by China to private sector entities in LMICs without a sovereign guarantee.

As part of the BRI, the majority of China's overseas lending (about 70%) is now directed to state-owned companies, state-owned banks, special purpose vehicles, joint ventures, and private sector institutions, while in the past it was primarily directed to sovereign borrowers (i.e., central government institutions). As a result, these debts generally do not appear on government balance sheets in LMICs, although most of them benefit from explicit or implicit forms of host government liability protection.[9] This practice has blurred the distinction between private and public debt.

With annual international development finance commitments hovering around US$85 billion a year, China now outspends the U.S. and other major powers on a 2-to-1 basis or more.[10]

Moreover, China is also providing liquidity or 'lender of last resort' finance through the People's Bank of China (PBOC, in direct competition with IMF funding)[11], and China's state-owned banks also provide balance of payments support to troubled BRI borrowers.

As a major player in development financing, China has to be accounted for by traditional players, but the opacity in its lending practices also comes as a challenge to them.

CHINESE STYLE LENDING

China's bilateral development finance is generally provided by one of four sources:

1) the China International Development Cooperation Agency (CIDCA), the country's official aid agency;

2) two "policy banks": the Export-Import Bank of China (China Exim) and the China Development Bank (CDB);

3) large state-owned commercial banks such as the Industrial and Commercial Bank of China (ICBC), the Bank of China (BoC), and the China Construction Bank (CCB).

4) other players such as Sinosure (China's Export & Credit Insurance Corporation), which is a state-funded insurance company in charge of promoting the country's

foreign economic and trade development and cooperation.[12]

Each of these actors operate on their own terms. The CIDCA lends at very low interest rates or interest-free, China Exim, which receives some budgetary revenue, grants concessional loans, while CDB is more "commercially oriented" [13] and lends at higher than market rates. Commercial banks offer short and medium-term loans, often insured by SINOSURE. Since the launch on the BRI, they have played an increasingly important role by organizing lending syndicates and other co-financing arrangements that are necessary for big-ticket infrastructure projects.

In contrast to Western aid, China offers little in the form of outright grants or below-market interest rates.[14] Since the introduction of the BRI, China has maintained a 31-to-1 ratio of loans to grants and a 9-to-1 ratio of Other Official Flows (OOF) to ODA. [15] The lending terms of China's official overseas loans tend to resemble commercial lending transactions in that most loans have short maturities and relatively high interest rates. [16]

An important feature of Chinese lending, which makes it particularly attractive, is that it comes with "no strings attached". In other words, Chinese loans are not subject to the conditionalities generally imposed by the World Bank and the IMF, and supported by most bilateral lenders that make up the Paris Club.

Another characteristic of China's lending style is the use of repayment safeguards, with collateralization as a standard practice, in particular in the case of CDB's lending. As highlighted earlier, in contrast to traditional Western development assistance, Chinese programs are largely loans at or near market rates, but what sets them even further apart is that they almost systematically include requirements for collateral, and other guarantees[17], and the increasing levels of credit risk have created further pressure for stronger repayment safeguards. Chinese loans are often collateralized against future commodity export receipts to minimize repayment and fiduciary risk and priced at relatively high interest rates (nearly 6%).

China's official lending overseas is thus not comparable to the lending activities by most other creditor governments, in particular, those organized in the OECD and Paris Club.

Lastly, the lack of transparency in Beijing's lending activities makes it challenging for bilateral aid agencies and multilateral development banks to determine how they can compete—or coordinate and collaborate—with China to address issues of global concern. Such collaboration is made even more challenging as 75% of Chinese loan contracts contain "no Paris Club" clauses, forbidding borrowers from restructuring their debts to Chinese creditors under Paris Club terms or including Chinese debts in restructuring operations with other bilateral creditors. Such clauses may only serve as a deterrent, but they illustrate Chinese creditors' reluctance from the outset to participate in multilateral debt relief efforts.[18]

THE MYTH OF THE "DEBT TRAP DIPLOMACY" DEBUNKED[19]

An oft-heard major concern relates to the risk for LMICs receiving financing from China to be dragged into a "debt trap", with Sri Lanka as a case in point. Critics refer to this as "debt-trap diplomacy," in which China deliberately provides loans to countries it knows are unable to pay, with the hope of gaining political leverage.

All this needs to be qualified. In the case of Sri Lanka for instance, it would be erroneous to argue that China actively and deliberately pushed the country into a debt trap: Sri Lanka was already heavily indebted when China stepped in, and China was not Sri Lanka's primary creditor. In early 2019, China accounted for around 15 % of Sri Lanka's bilateral debt and 10 % of the country's total foreign debt, up from less than 5 % a decade ago, but the debt owed to China was merely the tip of the iceberg and Sri Lanka's debt problem went well beyond China.

Another major issue is that a rising share of Sri Lanka's debt has been contracted on commercial and not on concessional terms. And the external debt servicing to exports ratio has risen from about 8 % in the early 2000s to about 22% in 2017[20]. However, over 60 % of the debt owed to China was contracted on concessional terms. Sri Lanka's problem was thus a much wider current account problem and has more to do with Sri Lanka's macroeconomic policy mistakes. [21]

What holds true for Sri Lanka holds true for many other LMICs. The debt trap diplomacy narrative is widely exaggerated.

Moreover, arguing that China may gain political leverage through its financing is debatable, since China tends to lend to countries that are already "friendly".

Yet, as explained earlier, there is no denying that China seeks protection by using guarantees. But claiming that this can be interpreted as a trap is a bit of a stretch. Such guarantees may be problematic, however, in case of risk of default, and in the case of debt restructuring negotiations.

China's Rising Concerns and Shift in Lending Strategy

As the debts to Chinese lenders have mounted, the number of suspended or cancelled projects has also increased. The share of Beijing's overseas lending directed to borrowers in financial distress increased from 5% in 2010 to 60% in 2022,[22] and an estimated 80% of its overseas lending portfolio in LICs is now supporting countries in financial distress. With a high share of lending directed towards countries in, or at risk of, financial distress, Beijing is now increasingly worried about the risk of defaults.[23]

Due to the lack of commercial viability and debt sustainability challenges associated with some of the projects, China's overseas lending under the BRI started to slow down. According to some estimates, commitments from China's two main institutional lenders (CDB and China Exim) fell from a peak of US$87bn in 2016 to US$3.7bn in 2021.[24] The recent drop in Chinese lending is also the result of a sharp decline in its foreign exchange reserves resulting from the post-Covid economic slowdown.[25]

As a result, the share of infrastructure project lending has been declining. While it accounted for more than 60% of China's loan portfolio in 2015, by 2021, the share was just over 30%, with emergency lending accounting for nearly 60%.

As explained earlier, China has engaged in various rescue operations. These operations are of course not altruistic (Chinese authorities simply try to rescue their own financial institutions)[26], and they are not cheap. The average interest rate attached to Chinese rescue loans is 5%, compared with 2% for a standard rescue loan from the IMF.

The rising difficulties of heavily indebted countries call for some form of debt management (rescheduling, restructuring, partial write-offs) and for cooperation between all lenders. Due to its large exposure, China has been looking for solutions but the opacity in its practices makes discussions about multilateral debt management challenging.

Moreover, although China's capacity to act as an alternative to the IMF should not be exaggerated[27], there is no denying that its rescue operations also make cooperation with other players more necessary albeit also more complex.

Getting China's Debt Management Right

There is a widespread tendency to blame China for the difficulties in multilateralized debt restructuring. While there is a grain of truth in this claim, what makes cooperation on debt management challenging is the fact that China and Western creditors are at variance over some important issues.

First, China prefers to act bilaterally rather than collectively. This is often criticized by the rest of the international community as allowing China to engage in non-transparent restructuring process and potentially to enjoy benefits of free-riding.

Secondly, China tends to favor adjustment in the terms of a loan over so-called "haircuts". Chinese policy banks' aversion to debt forgiveness/reduction is a well-known fact that, again, does not make cooperation easy. Also, China's state banks prefer a commercially oriented "new-money approach" rather than an interventionalist haircut approach (as now favored by Western lenders).

Lastly, China tends to question the preferred creditor status of MDBs, asking them to share in losses and accept haircuts along with bilateral creditors.

To be fair, however, things have been gradually changing and China has shown some goodwill and readiness to cooperate with other creditors, while it has stepped back on its criticisms of MDBs.

Although not a member of the Paris Club, China agreed to participate in the Debt Service Suspension Initiative (DSSI), led by the IMF and the World Bank in the wake of the Covid-19 pandemic.[28] The DSSI marked the first time that Beijing participated in a multilateral sovereign debt relief effort, and quite successfully according to some analysts.[29] Indeed, Chinese lenders provided a large share of the relief to Africa under the DSSI. The heavy burden shouldered by Chinese lenders reflected their status as leading creditors to low-income countries.

This success needs to be qualified, however. Although the DSSI reflected China's willingness to participate in an international debt relief effort, debt suspensions between sovereigns and Chinese creditors were conducted separately to Paris Club relief efforts, reflecting Chinese lenders' persistent reluctance to act collectively.

China later contributed to the launch of the G20's "Common Framework for Sovereign Debt Restructuring beyond the DSSI" (hereafter the Common Framework – CF). Introduced in 2020, the G20 CF was a breakthrough, allowing all G20 creditor countries (Paris Club members and non-Paris Club members alike) to participate in debt treatment negotiations for LICs.

China also agreed to participate in the Global Sovereign Debt Roundtable (GSDR) that brings together debtor nations and their creditors, including private sector creditors. The objective of the GSDR is to build greater common understanding among key stakeholders involved in debt restructurings, and contribute to improve debt restructuring processes both within and outside the CF.

Despite these shows of goodwill, China is often accused of seeking to take advantage of the many weaknesses of the mechanism.

In the discussion, a major problem has to do with the fragmentation of China as a creditor, as all Chinese players identified earlier do not share the same views nor interests. By way of illustration, although China acceded to the CF, Chinese lenders as a group have not embraced debt restructuring within it proactively.[30] Also, while the PBoC is known to be the most favorable toward participation in multilateral debt restructuring, having advocated for the country's membership in the Paris Club, MOFCOM and the policy banks are generally opposed. This fragmentation does not make a discussion easy.

At the time of writing, Zambia is the only country that resorted to debt relief under the G20 CF. The deal that was founded in June 2023 suggests that coordination among official creditors remains strained. China [31] is accused of having delayed the negotiation by asking that MDBs also accept a haircut. However, it finally agreed to restructure about US$4 billion of Zambia's sovereign debt, except for debt owed to the ICBC that is considered "commercial". [32] And China also finally accepted to respect the MDBs' preferred creditor status.

There are two ways to look at the deal: the first (optimistic) reading is to see that as a positive move by China, while the more pessimistic view is to stress the incompleteness of the move.

Although the Zambian case suggests that China can sometimes agree to make concessions and act in tandem with other lenders, whether this can be replicated elsewhere is unlikely since China made it clear that Zambia should not be considered as a precedent.[33] And China refused to participate in debt restructuring in Sri Lanka in September 2023. [34] Chinese lenders remain overall suspicious of entering into multilateral debt negotiations.

CONCLUSION: A PROMISING AREA OF COOPERATION

The growing number of countries in debt distress and at risk of default calls for an effective debt management mechanism. As the world's largest bilateral creditor, China is central to talks on making tangible progress in providing debt relief and setting up a global debt governance system.

While China's integration into the Paris Club might be the first-best solution, it is still deemed to be out of reach under current circumstances. Relying on the CF for LICs' debt negotiations remains the only possible solution, but it would require significant improvements.

To that end, a better understanding of China's practices and positions on debt relief and restructuring is called for. A fair and candid assessment of China's role and contribution to debt management should be encouraged, dropping in particular the ill-founded accusations of debt trap diplomacy but also of EximBank's refusal to contribute to the DSSI. Such accusations are not backed up by evidence and are counterproductive for international cooperation.

The EU should avoid taking a geopolitical approach to the debt issue and continue to promote a collaborative approach in international fora (e.g. G20, G7) and multilateral institutions (IMF, WB). It is important to avoid a prisoner's dilemma situation, where both parties adopt a wait and see attitude to prevent the other side from engaging into free riding. Those losing in this game are the financially distressed countries.

The challenge for the EU is to find the right incentives to convince Chinese creditors to participate more proactively in multilateralized debt restructuring. An option would be to induce Beijing to provide comparable treatment if it decided not to participate in debt negotiations with other official creditors. If there is an agreement that non-participating official creditors will not be able to redeem what they are owed unless they provide comparable treatment, the incentive will be strong to have them participate in the negotiations to begin with.

Debt management should definitely rank high on the agenda of the forthcoming G20 summit to be held in Brazil. The G20 is probably the right venue to get China to cooperate as Beijing is rightly concerned with its reputation and image within the group.

China has gradually changed its approach and it is important that other creditors acknowledge this change and seek to build on these efforts. One may be reasonably confident that China will behave increasingly like other lenders as it is faced with the same issues, but positive signals must be sent to China alongside some form of pressure.

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ENDNOTES

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