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China’s role in the looming sovereign debt crisis

Blog post by Director Gregor Irwin, 11 June 2020

The covid-19 pandemic has created the perfect conditions for a sovereign debt crisis. The economic impact has already been unprecedented, according to the World Bank – in its suddenness, its severity and its synchronicity. But just as governments the world over are rapidly increasing their borrowing to cover the costs, many developing countries are finding that capital is flowing out and their currencies are under pressure, making the debt positions of some look unsustainable.

In April, the G20 announced a debt service suspension initiative for the poorest countries. Since then, the Institute of International Finance has set out the terms on which private creditors (or at least its members) will participate in the initiative, albeit on a voluntary basis. While this buys time, it does not address underlying debt sustainability problems.

This raises the question of whether the international system is prepared for a round of sovereign debt restructurings, should that prove necessary? Now more than ever before, the answer to that question depends on China.

That is partly an observation based on the sheer scale of Chinese lending to developing countries. Credible estimates suggest that more than $350 bn of official debt is now owed to China by developing countries, higher than the amounts owed to the World Bank, the IMF, or all Paris Club governments combined (Horn et al, 2020).

That financial stake gives China leverage in any restructuring. But it remains to be seen how China might use it. That will have implications, not only for China’s financial relationship with debtor countries, but also for the incentives of other creditors involved in negotiations.

Large-scale sovereign debt restructurings that involve write-downs in the value of the debt are complicated, messy affairs and experience shows they can be drawn out and costly for all sides. There are two principal reasons.

The first is that there is no dedicated legal process for restructuring sovereign debt. There is not even a natural test for the solvency of governments. This means that sovereign restructurings can only ever be concluded by negotiation and inevitably politics plays a big part.

The second, related problem is coordination. There are invariably many creditors and coordinating them can be difficult. Moreover, while it may be collectively rational to accept a restructuring offer, individuals may hold out and reject a deal, in the hope that they will still get paid in full, which means even a good deal can unravel.

The conduct of restructurings, and the contractual relationship between sovereigns and creditors, have both evolved in ways that partially overcome these problems.

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On the contractual side, collective action clauses have been introduced into bond contracts that make it harder for holdouts to refuse a restructuring offer that a sizable majority of creditors accept. These have become standard in external debt issues and increasingly sophisticated, so that now they operate across all affected bond issues, without requiring individual votes for each (Buccheit et al, 2018).

On the conduct side, the IMF has taken on a pivotal role in determining whether a country's debt is sustainable and how much relief is needed to make it so. The IMF, as a preferred creditor, is also able to "lend into arrears" once a restructuring is inevitable, buying time for a negotiation.

But there are other ways in which it has become harder to reach a successful conclusion in large-scale restructurings. It used to be that the Paris Club would move first to agree terms with the debtor. As part of any deal, the Paris Club would also insist on "comparability of treatment" meaning that the debtor must not accept less favourable terms from other creditors. This used to set the bar for negotiations with private creditors. But as the share of debt held by Paris Club creditors has diminished, so has its ability to play this coordinating role.

And that is where China comes in. China is now very often a bigger creditor to developing countries than the Paris Club, with 50 of the most exposed countries now thought to owe an average of 15% of their annual GDP to China (Horn et al, 2020). This means that China must play a pivotal role in any restructuring.

But what role will China play? The temptation may be for China to use its political influence to gain more favourable terms, or to exclude some of its debt, such as that issued by state-linked banks but not the state itself. That temptation to seek special treatment may be increased where the lending agreement is implicitly backed by collateral. In some rare circumstances, it may even be justified, where collateral agreements are explicit and transparent.

Where it is not, the risk is that if a major creditor like China is not seen to act transparently and fairly by all creditors, then debtor countries will find themselves in an impossible situation. Not only will the process of agreeing terms with other creditors become more protracted and risk failing altogether; they may also find that their ability to borrow from others in future in seriously impaired.

So what will China do? Will China, as the dominant party to many negotiations, show leadership, or pursue a narrower and arguably more short-sighted definition of self-interest?

We do not yet know. For sure, China has restructured debts before, but mostly at the modest end of the scale of ambition, involving maturity extensions rather than outright relief.

What China does decide to do – should comprehensive restructurings be needed – will have far-reaching implications for the international financial system and the economic prospects of the countries concerned.