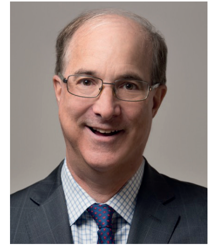
International Insolvency & Restructuring Report 2023/24

capital
markets
intelligence
cmi

The brave new world of sovereign debt restructuring: the China conundrum and other challenges



By Steven T. Kargman

The past few years have not been kind ones generally for emerging economies and developing countries around the globe. These economies were hard hit by the economic fallout from the two external shocks without precedent in recent history, namely the once-in-a-century COVID-19 pandemic and then the Ukraine war, the first major ground war in Europe in 75 years. Apart from a relatively strong economic recovery in 2021 in which these economies grew by nearly 7% (according to the International Monetary Fund (IMF)), these economies experienced less-than-stellar growth in 2022 in the range of 3.4 to 4% according to the World Bank and the IMF, respectively, and much improved results are not expected for either 2023 or 2024.

Perhaps more troubling is that slow growth for the emerging and developing economies is expected to continue over the remainder of the 2020s. In fact, the World Bank recently published a report indicating that these economies may experience an average growth rate of 4% over the 2020s compared to an average growth rate of 6% in the period 2010-2020, and the report suggested that that the actual growth rate for the 2020s could even turn out to be lower in the event of a global recession or global financial crisis. Some commentators are even raising the specter of a "lost decade" in the 2020s for emerging economies and developing countries, something that the countries of Latin America experienced in the sovereign debt crisis of the 1980s.

The current sovereign debt landscape for emerging economies and developing countries

Sluggish growth, however, is not the only problem facing these economies. Many of these economies are now suffering from a broad array of economic ills, including high inflation (especially with respect to food and energy costs), depreciating currencies, widening balance of payment deficits, dwindling foreign exchange reserves, and shortages of critical commodities and supplies.

The economic travails of these emerging and developing economies are only likely to continue to get worse if global interest rates remain at relatively high levels and/or if, as some predict, the global economy slips into a worldwide recession in the coming months. Furthermore, China's slower-than-expected post-pandemic economic recovery may well have a dampening effect on the global economy in general and the emerging economies and developing countries in particular.

Against this backdrop, it is perhaps therefore not surprising that many emerging economies and developing countries are currently experiencing sovereign debt distress or are at risk of experiencing such distress in the coming months. Many of these economies incurred substantial new debt during the pandemic on top of what were already historically high debt levels that existed pre-pandemic. (The IMF considers a country to be in debt distress when, particularly as a result of an unsustainable debt burden, "a country is unable to fulfill its financial obligations and debt restructuring is required.")

By the reckoning of the IMF, as of January 2023, 60% of low-income countries were either in debt distress (15% of low-income countries) or at high risk of debt distress (45% of low-income countries), and the IMF indicated that the 60% figure was double the corresponding percentage in 2015. In addition, as of late 2022, according to a Bloomberg index of 72 emerging economies, at least 15 emerging economies had debt trading at

distressed debt levels (i.e., 1000 basis points over US Treasuries).

Debt servicing costs, particularly in view of the currently prevailing higher interest rate environment and the marked depreciation of local currencies (which affects the cost of servicing hard currency-denominated debt), are eating up an ever-increasing percentage of government revenues in many developing countries. This is perhaps nowhere more evident than in the countries of Africa, especially those of sub-Saharan Africa. For African countries as a whole, 17% of government revenues are spent on debt servicing costs which is the highest level since 1999, according to a report in *The Economist*. As a general matter, external debt servicing costs for sub-Saharan countries are expected to rise 50% from 2019 to 2026, according to a December 2022 article in Bloomberg.

At a very concrete level, this means that debt servicing costs in a number of countries are eclipsing the amount of government revenues that can be devoted to government expenditures on health, education, and other social services—i.e., expenditures intended to meet the basic human needs of the local populations. As noted recently in *The Economist*, "In 2010 the average sub-Saharan country spent 70% more on health per person (US$38) than on external debt (US$22). By 2020 spending on debt service was 30% higher."

The China conundrum

In terms of the international financial community's reaction to this situation, the good news is that the issue of sovereign debt distress in the emerging and developing economies is now receiving the high-level attention it deserves. Thus, this issue was front and centre at the recent annual spring meetings of the World Bank and the IMF.

However, the bad news is that the issue does not lend itself to easy or straightforward solutions that are palatable to both sovereign debtors and their creditors (whether such creditors are, for example, international financial institutions such as the World Bank and the IMF, private sector creditors such as bondholders or commercial banks, or bilateral creditors/national governments). Moreover, the issue appears to have become subject to geopolitical tensions between the US and the West, on the one hand, and China, on the other hand.

There are several ongoing high-profile situations of sovereign default and sovereign debt restructuring discussions, including among others Zambia and Sri Lanka, and yet after extended periods of time, sovereign debt restructuring deals have not been reached between the respective sovereigns and their creditors. To take but one example, Zambia defaulted on its sovereign debt over two-and-a-half years ago (and thereby became the first sub-Saharan nation to do so in recent years), and it still has not reached a restructuring deal with its creditors.

Zambia, which is estimated to have an external debt burden of approximately US$20bn, has a very diverse creditor body, including bondholders (both foreign and local), bilateral/national government creditors (other than China), Chinese lenders, multilateral institutions, and banks. But Chinese lenders have far and away the largest exposure, estimated to be approximately US$6bn or just under one-third of Zambia's overall external indebtedness.

China is an actor in so many of the current wave of sovereign debt restructuring situations because it is the largest bilateral creditor to emerging economies and developing countries taken as a whole, with much of the Chinese lending in the last decade having been connected to China's Belt and Road Initiative.

Other non-Chinese creditor constituencies have the following exposures to Zambia, according to a recent report in *The Financial Times*: international development banks (US$2.7bn), various Western governments (US$1.3bn), banks (US$1.6bn), local currency-denominated bonds held by foreigners (US$3.3bn), and international dollar-denominated bonds (US$3.3bn).

Criticisms from the Western international financial community

In the lead-up to and during and the recent IMF-World Bank spring meetings, China came in for unusually harsh criticism from US Treasury Secretary Janet Yellen, outgoing World Bank president David Malpass, and IMF Managing Director Kristalina Georgieva, all of whom asserted that China was a major, if not the primary, obstacle holding back progress in these sovereign debt restructuring situations.

As Treasury Secretary Yellen said in a speech in late April, "China's participation is essential to meaningful debt relief, but for too long it has not moved in a comprehensive and timely manner. It has served as a *roadblock to necessary action*" (emphasis added). For her part, IMF Managing Director Kristalina Georgieva said in early April, "China has been very slow to recognise that multilateral debt restructuring requires China to *play by the rules* that are already established" (emphasis added). World Bank President David Malpass has criticised China for "asking lots of questions in the creditors committees,"seemingly suggesting that China is simply looking for a way to slow down, if not stall, debt restructuring discussions.

The US Treasury, the IMF and the World Bank, as well as Western creditors and Western governments generally, criticise China's role in these debt restructuring situations on several grounds. (For ease of reference, I will use the term "Western international financial community" to describe collectively all of these parties.) First and perhaps most importantly, they maintain that China is unwilling to consider debt forgiveness (aka 'haircuts') which they believe must be an indispensable element of any overall sovereign debt restructuring solution for the countries in question.

They also believe that many of the countries in question are facing debt burdens that are manifestly unsustainable and that these countries therefore require debt forgiveness as opposed to merely loan rescheduling (which has been China's traditional approach to sovereign debt restructuring). The Western international financial community believes that loan rescheduling is a grossly inadequate response in light of the degree of debt distress currently facing many sovereigns.

Second, Western creditors, whether private creditors (such as bondholders) or bilateral creditors, do not wish to forgive debt if that means essentially that the debt they have forgiven could then effectively be used by the relevant sovereign to continue servicing the debt of Chinese creditors. Furthermore, it seems that the IMF would be reluctant to lend into a situation where such IMF loans could be used to service the unrestructured debt of Chinese creditors.

Third, the Western international financial community points out that China does not like to engage in multi-creditor restructurings and instead prefers to work out bilateral restructurings between itself and the sovereign. They believe China does not wish to share information with other creditors as is often the case in many multi-creditor restructuring situations and that China instead prefers to handle these restructurings on an opaque basis.

Indeed, China's initial lending to the countries in question is often shrouded in secrecy and confidentiality so that basic information about the loans (including the size of the loans, the interest rate on the loans, the maturity structure of the loans and any security attached to the loans) remains unknown to the sovereign's other creditors. This approach runs absolutely counter to one of the central principles of the Paris Club, specifically the notion of transparency and information-sharing among the parties.

China committed to working with other bilateral and private creditors when it signed up to the Common Framework unveiled by the G-20 countries in 2020, the framework which was supposed to bring Western bilateral creditors, China, and private creditors such as bondholders into a unified, Paris Club-like restructuring process. Nonetheless, the Western international financial community basically believes that China has been dragging its feet in living up to the terms

of the Common Agreement, even if, for example, China has agreed to serve as the co-chair, along with France, of the creditors' committee for Zambia. (The Common Framework has only been relied upon by four sovereign debtors—namely, Chad, Ethiopia, Zambia, and Ghana—and only one sovereign, Chad, has completed a sovereign debt restructuring under the Common Framework. However the Chad restructuring involved only the rescheduling, but not the forgiveness, of Chad's debt.)

Finally, the Western international financial community faults China for questioning the so-called 'preferred creditor status' of international financial institutions such as the World Bank and IMF. By virtue of the 'preferred creditor status' claimed by these institutions, they are excluded from participating in any restructuring of the sovereign's debt (i.e., taking a 'haircut') in contrast to other creditors such as bilateral creditors, private sector creditors, and others. China has argued that there needs to be "fair burden-sharing" for *all* creditors, including the international financial institutions that claim preferred creditor status, and thus, in China's view, *all* creditors should participate in sovereign debt restructurings.

However, the Western international financial community is adamantly opposed to eliminating the 'preferred creditor status' for institutions such as the World Bank and the IMF. For example, they argue, that the World Bank would not be able to provide concessional financing or grants to its borrower countries if it did not have its 'preferred creditor status', because otherwise it would lose its top credit rating assigned by the rating agencies and thereby be impeded in its ability to access cheaper financing in the international capital markets.

It should be noted that, although it is sending some mixed signals, China has recently given some indications that it may be softening its position on opposing special treatment for institutions claiming 'preferred creditor status.' In return, China would expect institutions such as the World Bank to provide concessional financing to the sovereign debtor undergoing a sovereign debt restructuring.

China, of course, has countered the foregoing arguments with various defenses of its own. For example, China has claimed that much of the sovereign debt distress that now exists among many developing countries and emerging economies is attributable to the interest rate hikes initiated by the Federal Reserve over the past year. Further, China argues that the bulk of its lending, as it is tied to infrastructure projects, is enhancing the productive capacities of the countries in question whereas the loans from the international financial institutions, for example, are used for general financing purposes, such as closing budget gaps and meeting external financing requirements. To be sure, many of the BRI projects have not worked out as intended.

Clash of systems and world views

It is clear to many observers that China does not want to play by the sovereign debt restructuring rules established by Western powers (particularly under the leadership of the US) and effectuated through institutions such as the Bretton Woods institutions of the IMF and the World Bank and the debt restructuring club for the advanced Western economies, the Paris Club (Importantly, China is not a member of the Paris Club).

But fundamentally China's unwillingness to play by those rules may reflect the fact that China is trying to construct its own China-centric international financial system, with its own parallel set of institutions (including the Asian Infrastructure Investment Bank (AIIB), and the New Development Bank (the so-called BRICS Bank)) and its own ambitious development programs such as the Belt and Road Initiative. China does not believe that its voting power in existing international institutions such as the World Bank and the IMF is commensurate with its economic standing in the global economy. China is also seeking a broader international role for its own currency, the renminbi, in international

financial transactions, a move that appears to have gained some momentum in the wake of the Western sanctions that were imposed against Russia after the start of the war in Ukraine.

Furthermore, China has its own distinctive way of looking at the world. China does not see itself as a secondary or subservient player on the international stage but rather views itself as occupying a, if not *the*, central role in the international system (whether this is attributable to China's traditional conception of itself as the 'Middle Kingdom' in the international system or to some other factor or dynamic). And this is particularly true now that China has the second largest economy in the world measured in nominal GDP or, as of a few years ago, the largest economy in the world measured in terms of purchasing power parity (PPP).

Thus, it is likely that as China looks out on the existing international financial architecture for handling sovereign debt restructuring, it sees a system dominated by Western interests which is not consistent with what China likely considers its proper place in the international financial system. Moreover, in the light of the Chinese notion of 'loss of face,' it is unlikely that China welcomes being publicly upbraided by officials from Western governments and the international financial institutions on how it should (or should not) conduct itself in the sovereign debt restructuring system such as it is.

Finally, as some observers have noted, it may well be that China's position on favoring debt rescheduling over debt restructuring (or loan forgiveness) is driven by the fragile financial condition of many of China's largest financial institutions, particularly its large state-owned commercial banks. These institutions had large exposures to China's collapsed property sector and were also adversely affected by the serious economic fallout from the pandemic-related lockdown of the Chinese economy.

If the fragile financial condition of the Chinese banks is indeed a driving factor behind their position opposing debt restructuring, that may be reminiscent of the position that the US money banks took in the early years of the epic 1980s debt crisis. At that time, these banks were in their own perilous financial condition, given their overexposure to many troubled economies in the developing world and favored rolling over loans to developing countries rather than restructuring those loans, and the US government effectively supported such a stance with the so-called Baker Plan unveiled in 1985. US banks were not in a position to take haircuts until the late 1980s when the banks had rebuilt their capital positions, and that paved the way for the US government's Brady Plan in 1989 and the advent of Brady Bonds (which converted bank loans to bonds).

The foregoing is certainly not in any way intended to defend China's way of doing business in sovereign debt restructurings or in its sovereign lending generally. Among other things, one could rightly be very critical of China's opacity in both its lending and restructuring activities. One could also be equally critical of China's past lending to countries that seemed to contribute to debt sustainability problems for many countries that already had heavy, if not virtually unsustainable, debt burdens prior to the Chinese lending. Further, one could legitimately question whether some of the Chinese lending was used to finance certain infrastructure projects that ended up being totally unviable from an economic standpoint.

Other Challenges

The current sovereign debt restructuring landscape poses several other significant challenges.

Local Debt

In some of the new crop of sovereign debt restructuring situations, a new variable has to be taken into consideration: namely, the role of bonds that the sovereign has issued in the local currency. In the past, as these local currency -denominated bonds generally represented only a small part of the overall debt burden, they were not addressed as part of the overall sovereign debt restructuring solution applicable to external debt.

However, there are now countries such as Ghana where the local bonds represent a relatively significant part of the country's overall debt burden. This is a result of the concerted efforts by governments in many emerging and developing economies in the last decade or longer to develop local capital markets. (Pakistan and Sri Lanka also have considerable local debt components as part of their overall debt burden.)

In Ghana, before its default on its external debt last December, local currency-denominated debt represented 41% of Ghana's GDP whereas its external debt represented 45% of Ghana's GDP. However, as reported in *The Financial Times*, debt servicing costs for its local debt (41% of GDP) actually exceeded debt servicing costs for its external debt (13% of GDP).

Accordingly, in sovereign debt restructurings where there is a large local bond component as part of the overall debt burden, other creditors may want to include the holders of local bonds in the overall sovereign debt restructuring so that there is fair burden-sharing across all creditor constituencies. In fact, in the case of Ghana, the IMF apparently insisted that the government of Ghana include the local debt in its restructuring plan in order to receive an IMF financing package. (There is also the issue of whether there should be different treatment for local holders of local currency debt versus foreign holders of local currency debt).

There is a problem, however, in that many of the bonds issued by the sovereign in the local currency may be held by local financial institutions, such as local banks, pension funds, and insurance companies. Therefore, to the extent that a debt restructuring calls for holders of local currency-denominated bonds to take a haircut, this could potentially cause a big hole in the balance sheet of the country's financial institutions.

In turn, this could risk undermining the stability of the local financial system which would obviously be a very undesirable result of the process of restructuring local currency bonds. Thus, unless the local banks, for example, are recapitalised, what started as a sovereign debt crisis for the country in question could end up also becoming a banking or financial crisis for that particular country.

Pakistan

Today the Zambias, Ghanas, and Sri Lankas of the world may seem like major sovereign debt crises. However, there is one country that is currently experiencing huge economic and financial problems where a sovereign debt crisis in the very near future is not beyond the realm of possibility and whose outstanding debt dwarfs the debt burden of some of the sovereigns currently facing debt crises. That country is Pakistan.

As of early 2023, Pakistan had an outstanding external debt burden of approximately US$125bn. Of immediate concern, it has been reported that Pakistan has a debt payment of approximately US$3bn coming due in June which it looks unlikely to be able to make, unless it receives a financing package from the IMF or funding from a third country.

Pakistan's economy is in a serious downward spiral, and obviously Pakistan suffered a huge blow with the catastrophic nationwide flooding last summer. It is suffering from very high inflation, its local currency, the Pakistani rupee, has hit all-time lows against the US dollar, and Pakistan has also been experiencing serious shortages of food, fuel, and medicines. There have been widespread power outages throughout Pakistan since, among other things, Pakistan cannot import the fuel that it needs to run its power plants.

Pakistan has also run down its foreign exchange reserves to dangerously low levels. As of mid-March, Pakistan was estimated to have foreign exchange reserves of a mere US$3.6bn, which has been estimated to represent funding for approximately just one month of imports.

The IMF has apparently been mulling a large program for Pakistan, reportedly in the range of US$6.5bn. Nonetheless, while the IMF has noted 'substantial progress,' it wants to see further progress from Pakistan on finalising funding

commitments—or, in IMF parlance, 'financing assurances'—from various countries before it approves any new loan. (Debt restructuring commitments are another form of 'financing assurances' that the IMF looks for before approving an IMF program for a distressed sovereign and/or approving loan disbursements to that sovereign, and that is another reason why China's reluctance to commit to the 'haircuts' in multi-creditor restructuring situtations that are dependent on IMF financing is considered a problem.)

Significantly, it is estimated that as much as one-third of Pakistan's external debt is owed to China and Chinese lenders. Pakistan was one of the major recipients of Chinese lending for China's Belt and Road Initiative projects, and indeed the China-Pakistan Economic Corridor (CPEC), consisting of many different types of infrastructure projects in Pakistan, was considered by China to be a flagship, if not *the* flagship, BRI project. (To be sure, like many BRI projects in various countries around the globe, the CPEC has been beset by a number of problems, including cost overruns, construction problems, debt repayment difficulties, etc.)

Thus, if Pakistan experiences a sovereign debt crisis and requires a sovereign debt restructuring, it could encounter the "China conundrum" discussed above that has been present in some of the ongoing cases such as Zambia and Sri Lanka. But given the size of Pakistan's overall external debt burden, this issue will manifest itself on a vastly larger scale and thus may be even more difficult to resolve than in those other countries.

Private sector creditors

Despite the intense focus in recent public debates on the role of Chinese lenders in sovereign debt restructurings, it should not be forgotten that, for a number of emerging economies and developing countries, the amount of outstanding external debt held by private sector creditors, principally bondholders (but also including commercial banks and non-traditional creditors such as commodity trading firms like Glencore), represents a not insignificant component of their overall debt burden.

In recent years, many emerging economies tapped the international capital markets to raise financing, with some being first-time issuers of eurobonds, including several countries in sub-Saharan Africa. Thus, bondholders have become a critically important creditor constituency in a number of the recent sovereign debt restructuring situations. Yet, the presence of bondholders, especially where there are numerous bondholders and where the bondholders themselves may have differing interests, can potentially complicate the overall sovereign debt restructuring process.

It is not uncommon for bondholders, particularly in large, complex sovereign debt restructuring situations, to have challenges in coordinating among themselves, and such coordination challenges among the bondholders can potentially make it more difficult for all of the relevant stakeholders in a sovereign debt restructuring situation to negotiate and come to a consensus on how the overall debt restructuring should be addressed and resolved. Finally, to the extent that the various types of private sector creditors (e.g., bondholders, commercial banks, etc.) have differing agendas and/or competing interests, that could only make the sovereign debt restructuring process more difficult since intercreditor disputes in these types of situations can be particularly thorny and not conducive to easy solutions.

Author:
Steven T. Kargman
Founder and President
Kargman Associates/International Restructuring Advisers
500 East 77th Street, Suite 1714
New York, NY 10162, US
Tel: +1 212 286 1500
Email: skargman@kargmanassociates.com
Website: www.kargmanassociates.com