China's rise and the reshaping of sovereign debt relief

MUYANG CHEN*

China has become the world's largest bilateral creditor of developing countries.[1] This raises the question as to how China interacts with western-led multilateral institutions governing sovereign debt relief—namely the International Monetary Fund (IMF), which monitors countries' financial balances, the World Bank, which regulates multilateral development financing to low- and middle-income regions, and the Paris Club, a forum for official bilateral creditors to coordinate collective debt restructuring.[2] Soaring global indebtedness in the era of the COVID–19 pandemic has put China on the front line of debt relief and has further increased the urgency for discussions around incorporating the emergent creditor in global debt governance.

Despite continuous efforts to engage China, hoping that it would conform to the existing rules of collective debt relief, multilateral institutions have not succeeded in shaping China's behaviour. In 2016, when it hosted the G20 Summit in Hangzhou, China showed an interest in working further with the Paris Club, raising expectations that it might officially join the latter.[3] However, it has not made any move in that direction since. In April 2020, against the backdrop of the pandemic, the G20 announced the Debt Service Suspension Initiative (DSSI) which deferred official debt service due by mostly low-income countries to December

* For this project, the author received funding from the National Social Science Fund of China's Young Scientist Program (21CGJ004).

1 Sebastian Horn, Carmen M. Reinhart and Christopher Trebesch, *China's overseas lending*, National Bureau of Economic Research Working Paper No. 26050, 2019, http://www.nber.org/papers/w26050; World Bank, *International debt statistics 2021* (Washington DC: World Bank, 2020), p. 16; Rebecca Ray, Kevin P. Gallagher, William Kring, Joshua Pitts and B. Alexander Simmons, 'Geolocated dataset of Chinese overseas development finance', *Scientific Data* 8: 241, 2021, https://doi.org/10.1038/s41597-021-01021-7; Ammar A. Malik, Bradley Parks, Brooke Russell, Joyce Jiahui Lin, Katherine Walsh, Kyra Solomon, Sheng Zhang, Thai-Binh Elston and Seth Goodman, *Banking on the Belt and Road: insights from a new global dataset of 13,427 Chinese development projects* (Williamsburg, VA: AidData at William & Mary, 2021). (Unless otherwise noted at point of citation, all URLs cited in this article were accessible on 17 Apr. 2023.)

2 The Paris Club is an informal group of official creditors mostly from industrialized countries engaged in negotiating bilateral debt restructuring. It has 22 permanent members, including Russia, Brazil and 20 members of the OECD.

3 The G20 leaders' communiqué stated that the G20 welcomed 'China's continued regular participation in Paris Club meetings and intention to play a more constructive role, including further discussions on potential membership'. G20 Leaders' Communiqué Hangzhou Summit, 4–5 Sept. 2016; Reuters reported that a high-level central bank official from China said China was considering officially joining the Paris Club. See 'Zhongguo kaolv chengwei bali julebu zhengshi chengyuan—zhongguo yanghang guanyuan [China considers becoming an official Paris Club member, according to Chinese central bank official]', Reuters, 4 July 2016.

International Affairs **99**: 4 (2023) 1755–1775; DOI: 10.1093/ia/iiad108

2020 and subsequently to the end of 2021. Six months later, the G20 launched the Common Framework for Debt Treatments, which would include China in collective debt relief alongside Paris Club creditors. Chinese government officials have repeatedly stated that China had extended significant volumes of debt suspension under the G20 frameworks.[4] Yet multilateral institutions have viewed China's response to the frameworks as rather 'reserved', constantly urging China to engage more and speed up in offering debt relief to developing countries.[5]

Existing analyses have interpreted China's behaviour in two ways. Some suggest China is *free-riding* on the international sovereign debt regime.[6] When the same debtor owes multiple creditors, any of the creditors can benefit from the others' debt relief and therefore has an incentive to free-ride.[7] The Paris Club and the regulation of the Bretton Woods institutions (the IMF and the World Bank) serve as collective mechanisms to constrain such free-riding. In a sense, therefore, non-participant creditors could be said to be taking advantage of participants. Yet this interpretation does not specify the different debt-relief approaches favoured by distinctive creditors, which are crucial in understanding their (non-)participation in existing frameworks. A second interpretation is that China is *contesting* the rules set up by advanced industrial economies, practising an idiosyncratic means of debt relief which differs from that practised by traditional creditors.[8] Specifically, through collateralized lending, which western official bilateral creditors do not normally offer, Chinese banks are implementing a so-called 'debt-trap' diplomacy, securing natural resources (as collateral) and gaining political leverage over debtors, thereby increasing China's global influence.[9] Yet collateralized lending is a common practice in commercial banking and China's banks are not the first to practise it. This points to the necessity of further discussing how emergent and traditional creditors treat sovereign debts differently.

4 See, for example, Foreign Ministry of the People's Republic of China, 'Waijiaobu fayanren Wangwenbin zhuchi lixing jizhehui [Spokesperson of the Ministry of Foreign Affairs Wang Wenbing chaired a press conference]', 17 Feb. 2020, https://www.fmprc.gov.cn/fyrbt_673021/jzhsl_673025/202202/t20220217_10643117.shtml; Xinhua, 'Full text of Xi's remarks at Session I of G20 summit in Bali', *China Daily*, 15 Nov. 2022.

5 See, for example, Andrea Shalal and Jorgelina Do Rosario, 'Global finance leaders single out China as barrier to faster debt relief', Reuters, 15 Oct. 2022, https://www.reuters.com/markets/europe/global-finance-leaders-single-out-china-barrier-faster-debt-relief-2022-10-14/.

6 Thomas M. Callaghy, 'The Paris Club, debt, and poverty reduction: evolving patterns of governance', in Rorden Wilkinson and Jennifer Clapp, eds, *Global governance, poverty and inequality* (London and New York: Routledge, 2010), pp. 178–9; Julian Gruin, Peter Knaack and Jiajun Xu, 'Tailoring for development: China's post-crisis influence in global financial governance', *Global Policy* 9: 4, 2018, https://doi.org/10.1111/1758-5899.12566, pp. 467–78 at p. 474; Homi Kharas, 'What to do about the coming debt crisis in developing countries', Brookings, 13 April 2020, https://www.brookings.edu/blog/future-development/2020/04/13/what-to-do-about-the-coming-debt-crisis-in-developing-countries/.

7 Jeffrey D. Sachs, 'A strategy for efficient debt reduction', *Journal of Economic Perspectives* 4: 1, 1990, pp. 19–29, http://dx.doi.org/10.1257/jep.4.1.19; Eric Helleiner, 'Filling a hole in global financial governance? The politics of regulating sovereign debt restructuring', in Walter Mattli and Ngaire Woods, eds, *The politics of global regulation* (Princeton, NJ: Princeton University Press, 2009).

8 Lex Rieffel, *Normalizing China's relations with the Paris Club*, Stimson Center Policy Paper, 2021; Meibo Huang and Donghang Niu, 'How China lends: truth and reality', *Global Times*, 28 July 2021.

9 Brahma Chellaney, 'China's debt-trap diplomacy', Project Syndicate, 23 Jan. 2017; US Secretary of State Rex Tillerson, 'US–Africa relations: a new framework', speech delivered at George Mason University in Fairfax, Virginia, 6 March 2018.

This article advances existing discussions by drawing a historical parallel between China's current debt-relief approach and the United States' as well as the multilateral institutions' approach to debt relief during and after the debt crisis of the 1980s. The crisis four decades ago is relevant for two reasons. First, the current rules, norms, and practices of the international sovereign debt regime took form as the traditional creditors' response to global indebtedness beginning in the 1980s.[10] Second, as the analysis below will illustrate, Chinese policy-makers have specifically looked into this historical episode and have attempted to draw lessons from the experience of the traditional creditors. Examining the history is therefore crucial in understanding the current wave of developing-country debt restructuring.

Through a comparative lens, the article finds that towards the end of the 1980s the US transitioned from employing a *new-money* approach—the continued refinancing, rescheduling and restructuring of existing projects—to a *haircut* approach, reducing the principals of loans; around the same time, western public creditors and multilateral institutions also started to shift gears and became increasingly receptive to debt forgiveness. Meanwhile, China primarily employs a commercially oriented new-money approach. The emergent creditor, therefore, has been revitalizing an approach that was once common practice for western private banks, thereby weakening the international sovereign debt regime that took shape from the late 1980s.

The article makes empirical, conceptual, and policy contributions. First, it offers a detailed account of how China and traditional creditors conduct debt relief similarly/distinctively, demonstrating and characterizing two approaches. The finding that China's current approach is much the same as that employed by western private banks in the 1980s challenges prevailing perceptions that China contests the West with its *sui generis* practices.

Second, the empirical analysis advances the conceptualization of Chinese development finance and adds nuances to the discussion on how China's rise affects western-led international orders and global governance. Despite state ownership, China's main financiers follow a commercial rationale—averse to haircuts subsidized by fiscal revenue and preferring to employ market instruments to resolve debt issues. China's rise, therefore, is revitalizing old western practices rather than simply challenging western-led rules.

Third, the article sheds light on ongoing policy discussions around the challenges of incorporating China into a collective debt-relief mechanism. While traditional creditors perceive China's policy banks as equivalent to western official bilateral creditors, and therefore have urged China to offer more generous debt treatments, this article reveals the commercial rationales underlying the banks' operating mechanisms, thus making sense of China's cautious attitude towards western-led debt relief frameworks.

10 Thomas M. Callaghy, *Innovation in the sovereign debt regime: from the Paris Club to enhanced HIPC and beyond*, World Bank Operations Evaluation Department Working Paper (Washington DC: World Bank Operations Evaluation Department, 2002); Helleiner, 'Filling a hole'.

The sections below proceed as follows. The first section discusses existing interpretations of China's interplay with multilateral institutions on sovereign debts. The second section examines the debt-relief approaches employed by the US and multilateral institutions in response to the debt crisis four decades ago. Focusing particularly on the debate between a new-money approach and a haircut approach, the section illustrates a major transition in global debt governance since the late 1980s. The third section scrutinizes how China has conducted a commercially oriented new-money approach that resembles the old practices of western private banks and the impact of such Chinese practices on the multilateral institutions. The last section concludes with a discussion of the potential changes in China's debt-relief approach.

China's rise and the global governance of sovereign debt relief

The impact of China's rise on the global governance of sovereign debt relief has drawn increasing attention as China has become a major creditor to developing countries. Discussions have arisen as to how China interacts with western-led multilateral institutions, namely the IMF, the World Bank and the Paris Club. Some observers have suggested that China is free-riding on the international sovereign debt regime, which entails collective mechanisms which restrain creditors from taking advantages of one another's debt relief:[11] The Paris Club, for example, requires its member states' official bilateral creditors to share credit information and decide debt relief jointly; the IMF and the World Bank's regulation constrains commercial creditors from free-riding on multilateral institutions' debt relief.[12] This view explains why any non-participant might be reluctant to join in collective debt relief, but does not specify the different debt-relief approaches favoured by distinctive creditors, which are crucial in determining creditors' (non-)participation in existing frameworks.

Other observers suggest that China has been contesting the existing rules of global debt governance by practising its distinctive means of debt relief, seeking to be a rule-maker rather than a rule-taker.[13] This view falls under the broader narrative that China's 'illiberal' rise in the twenty-first century has challenged a rule-based liberal international order led by the US.[14] Evidence of this line of argument includes, for instance, the inclusion by Chinese banks of 'No Paris Club' clauses in their contracts. These clauses stated that debts owed to China should be treated

[11] Callaghy, 'The Paris Club', pp. 178–9; Gruin, Knaack and Xu, 'Tailoring for development', p. 474; Kharas, 'What to do'; Ngaire Woods, 'Whose aid? Whose influence? China, emerging donors and the silent revolution in development assistance', *International Affairs* 84: 6, 2008, pp. 1205–21, https://doi.org/10.1111/j.1468-2346.2008.00765.x.

[12] Jiajun Xu and Richard Carey, 'Post-2015 global governance of official development finance: harnessing the renaissance of public entrepreneurship', *Journal of International Development* 27: 6, 2015, pp. 856–80, https://doi.org/10.1002/jid.3120.

[13] Rieffel, *Normalizing China's relations*; Huang and Niu, 'How China lends'.

[14] See, for example, Jessica Chen Weiss and Jeremy L. Wallace, 'Domestic politics, China's rise, and the future of the liberal international order', *International Organization* 75: 2, 2021, pp. 635–64, https://doi.org/10.1017/S002081832000048X.

separately from those owed to Paris Club creditors.[15] Moreover, Chinese banks sometimes request the borrower to pledge future receivables (such as raw materials export revenues) as repayment for loans, which might enable China to jump the 'seniority queue' of repayment *vis-à-vis* traditional creditors.[16] Prevailing policy analyses highlight the geopolitical implications of such collateralized lending, viewing it as China's 'debt-trap diplomacy'. This view assumes that China is seeking to seize resources and gain political leverage over developing countries.[17] Nonetheless, collateralized lending is a common financial practice in commercial banking, and China's banks are not the first to practise it. Developing countries have had decades of experience collateralizing resources to acquire loans from traditional creditors: indeed, this was one of the factors leading to the debt crisis of the 1980s.[18] This points to the necessity of further examining how China—if it is creating its own rules and practices—differs from western creditors in terms of their approaches to debt relief.

Literature examining the developing-country (notably Latin American) debt crises of the 1980s has characterized and contrasted a new-money approach and a haircut approach to debt relief.[19] The former involves continued refinancing, restructuring and rescheduling schemes for existing projects. The underlying logic is that, given more time and money, indebted countries would eventually correct their finance and repay their debts. The latter approach—also referred to as debt reduction, debt cancellation, debt forgiveness, write-offs or write-downs—implies a partial or complete reduction in the principal of loans. The underlying logic is that creditors benefit from some level of reduction in the face value of existing loans if the borrower owes too much debt, or, to use Krugman's words, if the borrower is on the wrong side of the 'debt Laffer curve'.[20] Debt forgiveness by official bilateral and multilateral creditors has, however, been controversial, as the practice involves state intervention—the use of government revenue (through budgetary allocation or member states' donations) to bail out business-oriented financing in debtor countries.[21] That said, and as is demonstrated in greater detail in the next section, there was a clear shift in the mainstream debt-relief approach

15 Anna Gelpern, Sebastian Horn, Scott Morris, Brad Parks and Christoph Trebesch, *How China lends: a rare look into 100 debt contracts with foreign governments* (Peterson Institute for International Economics, Kiel Institute for the World Economy, Center for Global Development and AidData at William & Mary, 2021).

16 Gelpern et al., *How China lends*.

17 Chellaney, China's debt-trap diplomacy'.

18 Jeffry A. Frieden, *Global capitalism: its fall and rise in the twentieth century* (New York: W. W. Norton & Company, 2007), p. 370.

19 Ian Vásquez, 'The Brady Plan and market-based solutions to debt crises', *Cato Journal* 16: 2, 1996, pp. 233–43; William R. Cline, *International debt reexamined* (Peterson Institute for International Economics, 1995), pp. 203–42.

20 Paul Krugman, 'Market-based debt-reduction schemes', in Peter Wickham, Jacob A. Frenkel and Michael P. Dooley, eds, *Analytical issues in debt* (Washington DC: International Monetary Fund, 1989), pp. 258–78.

21 Graham Bird and Robert Powell, 'Debt relief in low-income countries: background, evolution and effects', in James M. Boughton and Domenico Lombardi, eds, *Finance, development and the IMF* (Oxford: Oxford University Press, 2009) pp. 175–90; Øygunn Sundsbø Brynildsen, *Exporting goods or exporting debts? Export credit agencies and the roots of developing country debt* (Brussels: European Network on Debt and Development—Eurodad, 2011); Pamela Blackmon, 'Determinants of developing country debt: the revolving door of debt rescheduling through the Paris Club and export credits', *Third World Quarterly* 35: 8, 2014, pp. 1423–40, https://doi.org/10.1080/01436597.2014.946260.

towards the end of the 1980s, during which time the US and the global governance of sovereign debt relief transitioned from opposing any form of reduction to embracing debt forgiveness.[22]

Emergent empirical research indicates that China has demonstrated a preference for a commercially oriented new-money approach over an interventionist haircut approach, despite the fact that the major Chinese banks are state-owned. China has written off zero-interest foreign aid loans capitalized by government revenue, which account for a rather small portion of its overseas development finance, but insists on not writing off bank loans, which represent the vast majority; while it has frequently restructured loans, it has rarely made changes in interest rates or reduced their principal.[23] China's debt-restructuring practices appear to coincide with those of private creditors, focusing more on flow treatments than on significant principal reduction.[24] These recent findings accord with emergent findings about China's overseas lending which highlight a commercial rationale underlying the operating mechanisms of China's state banks. The banks have supported not only the state's policy imperatives, but also Chinese firms' pursuit of commercial interests.[25] They have employed various financial instruments to increase the creditworthiness of projects, allowing the latter to be funded in a market-based way.[26] As well, they view cyclical downturns as a chance to gain cheap assets and exploit long-term business opportunities.[27]

This article advances emergent study of China's development finance by demonstrating and conceptualizing a 'commercial rationale' reflected in the state banks' debt-relief mechanisms, contributing to the broader discussion on the role of the state in China's political economy.[28] Instead of writing off debts, which would involve direct state intervention—bailouts with government revenue—Chinese state banks prefer to use market engineering in resolving debt issues. This

[22] Vinod K. Aggarwal, *Debt games: strategic interaction in international debt rescheduling* (Cambridge, UK and New York: Cambridge University Press, 1996); Callaghy, 'The Paris Club', pp. 178–9; Gong Cheng, Javier Díaz-Cassou and Aitor Erce, 'Official debt restructurings and development', *World Development*, vol. 111, 2018, pp. 181–95, https://doi.org/10.1016/j.worlddev.2018.07.003.

[23] Kevin Acker, Deborah Brautigam and Yufan Huang, *Debt relief with Chinese characteristics*, Working Paper No. 2020/39 (Washington DC: China Africa Research Initiative, School of Advanced International Studies, Johns Hopkins University, 2020); Yan Wang, Ying Qian and Kevin P. Gallagher, *Debt distress and development finance in the COVID–19 era*, Global China Initiative Policy Brief 013 (Boston, MA: Boston University Global Development Policy Center, 2022).

[24] Gatien Bon and Gong Cheng, 'Understanding China's role in recent debt relief operations: a case study analysis', *International Economics* 166, 2021, pp. 23–41, https://doi.org/10.1016/j.inteco.2021.02.004.

[25] Ching Kwan Lee, *The specter of global China: politics, labor, and foreign investment in Africa* (Chicago: University of Chicago Press, 2017); Lee Jones and Yizheng Zou, 'Rethinking the role of state-owned enterprises in China's rise', *New Political Economy* 22: 6, 2017, pp. 743–60, https://doi.org/10.1080/13563467.2017.1321625.

[26] Lixing Zou, *China's rise: development-oriented finance and sustainable development* (Singapore: World Scientific, 2014); Gregory T. Chin and Kevin P. Gallagher, 'Coordinated credit spaces: the globalization of Chinese development finance', *Development and Change* 50: 1, 2019, pp. 245–74, https://doi.org/10.1111/dech.12470; Muyang Chen, 'Beyond donation: China's policy banks and the reshaping of development finance', *Studies in Comparative International Development* 55, 2020, pp. 436–59, https://doi.org/10.1007/s12116-020-09310-9.

[27] Stephen B. Kaplan, *Globalizing patient capital: the political economy of Chinese finance in the Americas* (Cambridge, UK: Cambridge University Press, 2021).

[28] Barry Naughton and Kellee S. Tsai, *State capitalism, institutional adaptation, and the Chinese miracle* (Cambridge, UK: Cambridge University Press, 2015); Yongnian Zheng and Yanjie Huang, *Market in state: the political economy of domination in China* (Cambridge, UK: Cambridge University Press, 2018); Tobias ten Brink, *China's capitalism: a paradoxical route to economic prosperity* (Philadelphia: University of Pennsylvania Press, 2019).

conceptualization adds nuances to the discussion on the interplay between China and western-led rules: rather than contesting the 'liberal' international rules with 'illiberal' practices, China has in fact been revitalizing the old practices of western private banks, thereby weakening the current international sovereign debt regime that has taken shape since the late 1980s.

Towards debt forgiveness: a transition in global debt governance

For decades, western creditors preferred refinancing, rescheduling and various market-based schemes (such as securitization, buy-backs, and debt-equity swaps) for developing-country debt relief. They did not widely accept write-offs until around 1989, after years of policy debate on the Latin America debt crisis. The US's response to the crisis went through three overall phases: concerted lending in 1982–84, with the IMF mobilizing commercial banks to continue financing existing debts; the 'menu approach' in 1984–88, with creditors employing market instruments to restructure debts; and the Brady Plan in 1989–93, which entailed a major shift towards debt forgiveness.[29]

The Latin American debt crisis began in 1982 with Mexico's inability to repay its debt to US commercial banks, which had loaned massively to developing countries in the 1970s. Against the backdrop of the oil shocks, oil-exporting countries such as Mexico collateralized resources to borrow from the international capital market and finance domestic industrial development, which resulted in an accumulation of large volumes of unsustainable debt. In response to Mexico's moratorium, the IMF guided commercial banks to reschedule repayment of principals and to refinance for interest payments. Debt distress in the early 1980s was mostly perceived as a liquidity problem. The idea was that debtors would eventually be able to make repayments if they were given more time and money. However, the IMF-guided involuntary lending did not increase the commercial banks' voluntary lending. A sense began to emerge that a departure from this approach was needed. In 1984, plans incorporating debt reduction instead of further financing began to circulate outside the US government.[30]

Yet the US government did not immediately switch to debt forgiveness; it remained opposed in the mid-1980s to any debt-relief scheme that would involve direct reduction. Treasury Secretary James Baker, who took office in 1985, proposed a reinforcing strategy of concerted lending, dubbed the Baker Plan. This set goals for private banks' new lending and called for long-term structural reforms in debtor countries.[31] Around the same time, a more market-based approach to debt relief—the 'menu approach'—emerged. Incorporating a menu of financial options such as debt-equity swaps, securitization and buy-backs, this approach offered possibilities to resolve debt issues without reduction. Mexico, Brazil, Chile, and Argentina instituted debt-equity swap programmes. In 1986/87,

[29] See, for example, Aggarwal, *Debt games*, pp. 361–75.
[30] Paul R. Krugman, Thomas Enders and William R. Rhodes, 'LDC debt policy', in Martin Feldstein, ed., *American economic policy in the 1980s* (Chicago: University of Chicago Press, 1994), p. 697.
[31] Cline, *International debt reexamined*, p. 208.

the notion that financial engineering could solve debt problems dominated policy discussions.[32]

Yet the combination of continued new lending and the market-based schemes did not alleviate Latin American indebtedness. In February 1987, Brazil, then the largest Latin American debtor, announced an indefinite suspension of interest payments which it owed to foreign lenders.[33] Brazil's moratorium stimulated a series of reactions in the market. In May 1987, Citibank of the US increased its loan loss reserves for developing-country loans, and many other private banks soon followed, signalling that the overall level of debt distress was not improving. Meanwhile, novel market-based schemes continued to emerge. In December 1987, the Morgan Guaranty Trust Company offered banks with outstanding loans to Mexico the opportunity to exchange loans for discounted bonds, for which repayment was insured by the US Treasury's zero-coupon bonds.[34] The Morgan–Mexico deal was a step closer to debt reduction, as it was both market-based and interventionist. On the one hand, it involved a loan-to-bond conversion; on the other hand, the Treasury's credit enhancement ensured investors' confidence in buying those bonds. This scheme became the basis for the Brady Plan.

In March 1989, the new treasury secretary, Nicolas Brady, proposed a debt-relief approach differing significantly from its predecessors, which had been based on the expectation that all bank loans would be repaid on market terms. The Brady Plan called for haircuts by commercial banks combined with loan-to-bond conversions and financial support from the IMF/World Bank; the menu of options offered in the plan included discount bonds, par bonds, debt-equity swaps, buy-backs and new loans.[35] Mexico was the subject of the first Brady-style restructuring in 1989, in which commercial banks were offered three options: 1) converting loans into newly issued 30-year bonds, the principal of which would be discounted (also known as discount bonds); 2) converting loans into bonds with the same face value as the loans (par bonds), which paid interest at a discounted rate; or 3) issuing new loans to Mexico in the ensuing four years to the extent of 25 per cent of their total medium- and long-term exposure to Mexico. Under the first two options, Mexico's repayment of the Brady bonds would be guaranteed by zero-coupon bonds issued by the US Treasury. Mexico's purchase of the zero-coupon bonds would be supported by IMF/World Bank funding and held in escrow.[36] In other words, the Bretton Woods institutions and the US Treasury backed the commercial banks' loan-to-bond conversions.

Existing analyses have offered several explanations as to why the US shifted its debt approach in the late 1980s. Major factors are thought to include 1) the collapse of oil prices, which constrained borrowers from obtaining more oil-backed loans; 2) the bargaining strategies of borrower countries—Mexico's president-

[32] Krugman, Enders and Rhodes, 'LDC debt policy', p. 698; Cline, *International debt reexamined*, p. 212.

[33] Richard House, 'Brazil halts payments on debts', *Washington Post*, 21 Feb. 1987.

[34] Robert A. Bennett, 'Morgan Bank outlines its Mexican debt plan', *New York Times*, 31 Dec. 1987.

[35] Lex Rieffel, *Restructuring sovereign debt: the case for ad hoc machinery* (Washington DC: Brookings Institution Press, 2003), p. 173.

[36] Ross P. Buckley, 'Turning loans into bonds: lessons for East Asia from the Latin America Brady Plan', *Journal of Restructuring Finance* 1: 1, 2004, pp. 185–200 at pp. 188–9, https://doi.org/10.1142/S0219869X04000147.

elect Carlos Salinas de Gortari negotiated for debt reduction; and 3) the new US Treasury team's pursuit of a debt approach that differed from its predecessor's.[37] Regardless of which factor(s) directly caused the transition, the formal recognition of debt reduction as an essential part of the US's debt-relief approach was an outcome of a difficult and gradual process fraught with debate. Private creditors opposed haircuts, as they did not wish to bear the losses, and yet continued financing had failed to alleviate the debt distress. The US government's intervention was crucial in facilitating a compromise between the commercially oriented banks and the indebted countries,[38] as the government's official enhancement of the creditworthiness of the Brady bonds ensured full payment of the bonds upon maturity, making the plan more palatable for the banks.

Around the same time, official bilateral creditors which had been restructuring developing-country debts through the Paris Club forum also realized that the new-money approach was not going to solve problems in their essence, and began to undertake a series of changes. Haircuts by official bilateral creditors have always been controversial, as they are essentially bailouts capitalized by the fiscal revenue of the creditor governments, which use aid budgets to cover losses incurred by national export credit agencies.[39] Yet the late 1980s witnessed the Paris Club's acceptance of debt forgiveness. In October 1988, Paris Club creditors agreed to implement the Toronto terms, which introduced, for the first time, a partial cancellation of debts owed by the most heavily indebted countries.[40] The inclusion of the Toronto terms was a turning point in the Paris Club's history, as it began the forum's transition from a debt collector to a relief provider.[41] Up to that point, the Paris Club had been solely implementing the 'Classic terms', under which loans were rescheduled at appropriate market rates. In the 1990s, the Paris Club went on to adopt the Houston terms (1990), the London terms (1991), the Naples terms (1994), and the Lyon terms (1996), increasingly raising the level of generosity of debt treatments and expanding the pool of debtors eligible for the concessional terms.[42]

Multilateral financial institutions—the most senior creditors, which are supposed to be the last to write off debts—have also been transitioning towards acceptance of debt forgiveness since the 1990s. In 1996, the IMF and the World Bank launched the Heavily Indebted Poor Countries (HIPC) Initiative, which offered debt reduction to more than 30 IDA-only countries.[43] Pressure from civil society organizations advocating poverty reduction—namely Oxfam, the

[37] Cline, *International debt reexamined*; Aggarwal, *Debt games*.

[38] Vinod K. Aggarwal, 'Exorcising Asian debt: lessons from Latin American rollovers, workouts, and write-downs', in Uri B. Dadush, Dipak Dasgupta and Marc Uzan, eds, *Private capital flows in the age of globalization: the aftermath of the Asian crisis* (Cheltenham: Edward Elgar, 2000), pp. 117–18.

[39] Brynildsen, *Exporting goods or exporting debts?*.

[40] Club de Paris/Paris Club, 'Historical development', undated, https://clubdeparis.org/en/communications/page/historical-development.

[41] Cheng, Díaz-Cassou and Erce, 'Official debt restructurings and development', p. 184.

[42] Club de Paris/Paris Club, 'Historical development'.

[43] 'IDA-only countries' refers to countries that are eligible to borrow from the International Development Association (IDA) of the World Bank, which offers multilateral development finance with the highest level of concessionality to developing countries.

European Network on Debt and Development (Eurodad), and Jubilee 2000—catalysed this shift.[44] In 2005, the Bretton Woods institutions created the Multilateral Debt Relief Initiative to further facilitate the HIPC. Under this framework the IMF, the World Bank and the African Development Fund would offer grants or reduction on eligible debts for countries completing the HIPC process.[45] In 2006 at the 50th anniversary of the Paris Club, Stanley Fischer, the governor of the Bank of Israel and former first deputy managing director of the IMF, said, 'For many years the Paris Club protected the senior status of the IMF and the World Bank, and did not request any debt reduction on their part. The logic of this approach was quite simple: generally the Fund and the Bank provided new money. This principle has now been breached'.[46]

Alongside the change in the multilateral institutions' debt-relief approach, there emerged an *ex ante* deterrence mechanism of global debt governance, which constrained private creditors' new lending to existing debtors.[47] Grants and debt forgiveness by public creditors and multilateral institutions—which are essentially funded by tax revenues of creditor/contributor governments—incentivize private creditors to free-ride,[48] or, as the World Bank put it in 2006, 'cross-subsidize lenders that offer non-concessional loans'.[49] In 2005, to discourage imprudent finance and limit free-riding, the IMF and World Bank introduced a new Debt Sustainability Framework, which disciplined low-income countries' borrowing by assessing their debt sustainability and setting up debt-burden thresholds. In 2006 the World Bank introduced the Non-Concessional Borrowing Policy, which disciplined IDA countries' borrowing from commercial creditors by regulating the allocated volumes/terms of assistance to these countries.[50] One result of this IMF/World Bank-led deterrence mechanism was that private banks began to limit their non-concessional finance for development-oriented projects in low-income countries, as they would otherwise be violating the rules. In fact, ever since the late 1980s western private banks had been embracing a novel form of finance in the developing world. The Brady Plan incentivized them to purchase government bonds instead of offering direct loans, which facilitated the rise of an emerging-market bond market.[51]

[44] André Broome, 'When do NGOs matter? Activist organizations as a source of change in the international debt regime', *Global Society* 23: 1, 2009, pp. 59–78, https://doi.org/10.1080/13600820802556769; Callaghy, 'The Paris Club', p. 166.

[45] International Monetary Fund, 'Multilateral debt relief initiative—questions and answers', 28 July 2017, https://www.imf.org/external/np/exr/mdri/eng/index.htm.

[46] Stanley Fischer, 'The Paris Club at fifty', address given at the celebration of the 50th anniversary of the Paris Club, 14 June 2006, https://www.bis.org/review/r060623b.pdf.

[47] Xu and Carey, 'Post-2015 global governance of official development finance'.

[48] Helleiner, 'Filling a hole'.

[49] World Bank Group, *IDA countries and non-concessional debt: dealing with the free-rider problem in IDA 14 grant-recipient and post-MDRI countries (English)*, Washington DC: World Bank Group, 2006), p. 3.

[50] World Bank Group, *IDA countries and non-concessional debt*.

[51] Rieffel, *Restructuring sovereign debt*.

China's approach: state creditors with commercial rationales

While the post-transition global debt governance constrains commercial lending in low-income countries, China has been addressing this gap since the 2000s. By 2021, China held more than 40 per cent of low-income countries' total official bilateral debts worldwide (table 1).

Table 1: Public and publicly guaranteed debt stocks of low-income countries by 2021, in US$ million

	World	*China*	*China as % of world*
Official creditors	117,635.50	21,771.60	19
Multilateral	66,765.10	n.a.	n.a.
Bilateral	50,870.40	21,771.60	43
Private creditors	21,801.70	2,214.90	10
Bondholders	5,822.70	n.a.	n.a.
Commercial banks and others	15,979.00	2,214.90	14

Source: The World Bank, 'International Debt Statistics', https://datatopics.worldbank.org/debt/ids/regionanalytical/lic/counterpartarea/730, and author's calculation.

China's bilateral development finance is generally provided by one of three sources: 1) the China International Development Cooperation Agency (CIDCA),[52] the country's official aid agency, 2) two policy banks, the Export-Import Bank of China (China Exim) and the China Development Bank (CDB), and 3) large state-owned commercial banks such as the Industrial and Commercial Bank of China, Bank of China, and the China Construction Bank.[53]

CDB and China Exim have been China's primary global creditors. Between 2009 and 2017 their total overseas lending amounted to US$30 billion–$70 billion per year,[54] much larger than China's government foreign aid (bilateral grants and interest-free loans), which came to just $1.8 billion–$3.0 billion per year between

[52] CIDCA was established in 2018. Before that, the Chinese government's foreign assistance was mainly coordinated by the Ministry of Commerce.

[53] Chen, 'Beyond donation'.

[54] The policy banks do not disclose their lending volumes on an annual basis. This estimate comes from Rebecca Ray and Blake Alexander Simmons, 'Tracking China's overseas development finance', Boston University Global Development Policy Center, 7 Dec. 2020. *Almanac of China's Finance and Banking* (Beijing: China Financial Publishing House, 2005–2015), which is published annually by China's central bank, records that the CDB's annual foreign-currency loan issuance grew from $2.6 billion to $82.5 billion between 2003 and 2013; China Exim's annual total loan issuance grew from $8.3 billion to $150.5 billion between 2004 and 2014. Official data for subsequent years have not been disclosed.

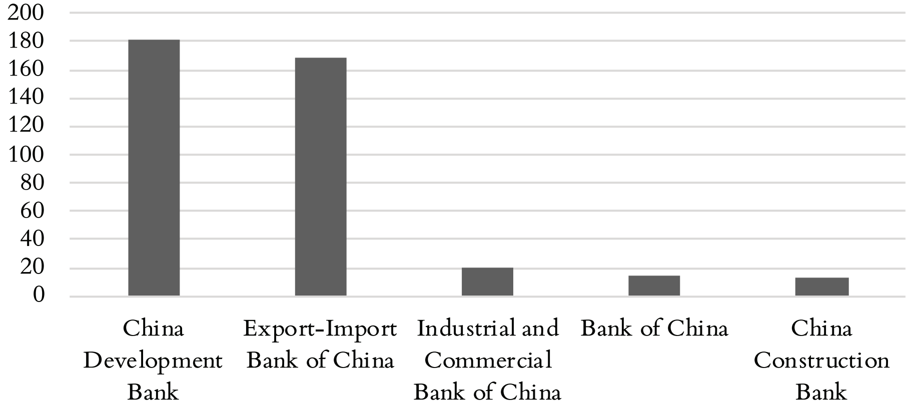
Table 2: Types of Chinese bilateral development finance by agency and funding source

Type of finance	*Agency*	*Source of funding*
Foreign aid: grants and interest-free loans	China International Development Cooperation Agency	Government budgetary revenue
Policy-bank lending	China Development Bank	Self-raised funds
	Export-Import Bank of China	Self-raised funds; government subsidy for concessional loans
Commercial bank lending	Industrial and Commercial Bank of China, Bank of China, China Construction Bank, among others	Self-raised funds

2009 and 2019.[55] Despite state ownership, policy banks raise funds primarily through issuing bonds on the capital market or drawing deposits from their clients, and do not receive regular budgetary funding from the Chinese government.[56] Only a trivial proportion[57] of China Exim's concessional loans were subsidized by budgetary revenue.[58] Chinese state-owned commercial banks have had increasingly important roles in overseas finance, and yet their total outstanding loan balances in foreign currencies by 2019 were still much smaller than those of the policy banks (see figure 1).[59] China has written off government-funded foreign aid loans, which accounted for a relatively small proportion of its total overseas development finance, but not loans capitalized by the state banks, which comprised the vast majority.

55 Naohiro Kitano and Yumiko Miyabayashi, 'Estimating China's foreign aid: 2019–2020 preliminary figures', JICA Ogata Sadako Research Institute for Peace and Development, 2020.
56 Muyang Chen, 'State actors, market games: credit guarantees and the funding of China Development Bank', *New Political Economy*, 25: 3, 2020, pp. 453–68, https://doi.org/10.1080/13563467.2019.1613353.
57 According to *Almanac of China's Finance and Banking* (2005–2015), the portion of subsidized government concessional loans was no more than 4% of China Exim's total lending in 2004–14.
58 State Council Information Office of the People's Republic of China, *China's foreign aid*, White Paper, 21 April 2011, http://www.gov.cn/zhengce/2011-04/21/content_2615780.htm.
59 The state-owned commercial banks do not disclose their overseas lending volumes on an annual basis. AidData compares China's policy bank lending and commercial bank lending in 2000–2017: see Malik et al., *Banking on the Belt and Road*, p. 26. *Almanac of China's Finance and Banking* (2020) records the medium- and long-term foreign-currency loan balances of major banks, which is an approximation of their overseas finance volume: see figure 1.

Figure 1: Medium- and long-term foreign-currency loan balances by 2019 by lending institution, in US$ billion



Source: *Almanac of China's Finance and Banking 2020*.

Chinese policy banks continue to strongly resist debt reduction, much as the western private banks did in the 1980s. Debt policy debate in response to the COVID–19 pandemic reflected this stance. In 2020 Hu Xiaolian, then president of China Exim, stated publicly that 'debt suspension … is neither debt reduction nor debt forgiveness. One should not take the opportunity [of the pandemic] to harm China's interests and take advantage of China'.[60] While the World Bank sought to bring the CDB into the DSSI in 2020, China argued that the bank was a commercial lender and therefore should not be included.[61] In fact, the 'commercial aspect' of the two policy banks, especially the CDB, is often highlighted in a Chinese context. Some Chinese scholars even argued that the CDB was 'in essence a commercial bank'.[62] This stance differs starkly from the 'common knowledge' (which took shape in the post-1980s era) that official bilateral creditors should provide generous debt treatments.

The policy banks' aversion to debt reduction and the Chinese government's endorsement of this preference can be traced back to the banks' inception—they were products of China's market-oriented financial reforms. China's Reform and Opening-up was launched in 1978 with a state-dominated credit allocation system, under which the People's Bank of China, the country's only 'bank' at that time, directed the financing for almost all economic activities.[63] Since then, the state has

[60] Export-Import Bank of China, 'Jinchukou yinhang dangweishuji, dongshizhang Hu Xiaolian chuxi 2021 Boao yazhou luntan xiangguan huodong [The Party Secretary and President of Export-Import Bank of China Hu Xiaolian attends events at the 2021 Boao Asia Forum]', 20 April 2020, http://www.eximbank.gov.cn/info/news/202104/t20210420_30419.html.

[61] Ye Yu, 'How to assess China's participation in the G20 Debt Service Suspension Initiative', East Asia Forum, 7 Oct. 2020, https://www.eastasiaforum.org/2020/10/07/how-to-assess-chinas-participation-in-the-g20-debt-service-suspension-initiative/. The CDB did offer debt suspension to DSSI-eligible countries, but not as a participant of the DSSI.

[62] Huang and Niu, 'How China lends'.

[63] Franklin Allen, Jun 'QJ' Qian and Meijun Qian, *China's financial system: past, present, and future*, 2005,

created financial agencies and employed market instruments to capitalize industrial development.[64] Between 1979 and 1984, China established or revitalized four specialized banks to fund different areas of economic activity. In 1988 six specialized investment companies were established to undertake the state's investments in key industries. Although the initial objective of these institutional creations was to alter the means of credit allocation from spending to lending and investment, thereby making the use of state capital more efficient, the specialized financial agencies failed to distinguish policy-serving projects from commercially oriented ones, and consequently generated large amounts of non-performing loans (NPLs) owed by state-owned enterprises (SOEs) of strategic industries. To solve this problem, the government established three policy banks—the CDB, China Exim and the Agricultural Development Bank of China— to take over responsibility from the four specialized banks for policy-serving projects. This was meant to allow the specialized banks to focus solely on commercially oriented projects and to operate in a financially sustainable way. The specialized banks henceforth became state-owned commercial banks. The specialized investment companies were incorporated into the newly established CDB. From the beginning, a major task of the development bank was to clear up the inherited NPLs.[65]

China's approach to resolving the NPLs was not debt forgiveness, but market engineering. In 1999, the government initiated a process of downsizing the NPLs of SOEs, establishing four financial asset management companies (FAMCs)—Cinda, Orient, Great Wall and Huarong—to practise debt-equity swaps. Assuming NPLs from their original creditors, the FAMCs became the equity holders of domestic industrial projects associated with the debts,[66] and were allowed to transfer or resell the equity shares to other investors, including the original SOEs.[67] In 1999, Cinda acquired RMB 60.8 billion NPLs from the CDB, becoming the equity holder of the projects of 165 SOEs.[68] The CDB practised debt-equity swaps with its remaining RMB 75.5 billion NPLs, mostly owed by China's major industrial champions. Some of the SOEs refused to make repayments, hoping that the CDB would eventually write off their debts—after all, it was a 'state bank'. Yet the CDB declined to take a haircut. By 2003, the bank had filed lawsuits with respect to 202 projects, collecting RMB 1.895 billion from companies that had planned to repudiate their debts.[69] Between 1997 and 2003, its NPL ratio (the proportion of NPLs in its total lending) fell from 42.65 per cent to 1.34 per cent.[70] The CDB was

http://dx.doi.org/10.2139/ssrn.978485.

64 Yingyao Wang, 'The rise of the "shareholding state": financialization of economic management in China', *Socio-Economic Review* 13: 3, 2015, pp. 603–25, https://doi.org/10.1093/ser/mwv016.

65 *Almanac of China's Finance and Banking 1995* (in Chinese) (Beijing: China Financial Publishing House).

66 Carl E. Walter and Fraser J. T. Howie, *Red capitalism: the fragile financial foundation of China's extraordinary rise* (Hoboken, NJ: John Wiley & Sons, 2011), pp. 49–82.

67 State Economic and Trade Commission and People's Bank of China, 'Guojia jingmaowei, zhongguo renminyinhang guanyu shishi zhaiquan zhuan guquan ruoganwenti de yijian [Opinions of the People's Bank of China and the State Economic and Trade Commission on several issues concerning the implementation of debt-equity swaps]', 30 July 1999, http://fgcx.bjcourt.gov.cn:4601/law?fn=chl341s280.txt.

68 China Development Bank, *China Development Bank History* (in Chinese) (Beijing: China Financial Publishing House, 2013), p. 189.

69 China Development Bank, *China Development Bank History*, p. 94.

70 China Development Bank, *China Development Bank History*, p. 500.

very proud of its achievements in using market instruments to downsize NPLs, and was generally considered the most successful of the three policy banks in this respect. Partly because of its progress in pursuing financial sustainability, the CDB now constitutes a distinctive category in China's financial regulatory system, being categorized as a 'development-oriented financial institution', as opposed to the other two policy banks, which are categorized as 'policy-oriented financial institutions'.

Unlike the CDB, China Exim receives budgetary revenue to subsidize its small share of concessional lending and is therefore considered less 'commercial'. Its status as an official bilateral creditor participating in the DSSI is clear. Yet, like the CDB, China Exim has undertaken strenuous efforts to reduce its reliance on the government's fiscal assistance. In 2006, China Exim began to undertake what it called 'self-run' (as opposed to 'state-run') business, under which interest rates were determined by the market instead of being subsidized by government revenue. This has allowed the bank to use profits gained from commercially viable projects to cover losses from policy-serving, less profitable ones. In 2008, China Exim became profitable for the first time.[71] Now non-subsidized self-run business accounts for the dominant share of the bank's total business. Indeed, the mainstream narrative of China's financial development in the post-1978 era has been 'marketization'. All state banks—including policy and commercial banks—and major SOEs needed to lower their reliance on budgetary revenue for their operation. Resolving insolvency through fiscal bailouts would therefore be against the operating rationale of the state banks—which are seeking to enhance their financial sustainability—and would be reversing the process of China's state-led marketization.

China's approach to domestic local governments' debt insolvency has demonstrated a similar commercial rationale. Since the late 1990s the CDB has increasingly become a major financier of Chinese local governments' infrastructure projects. Assisting them in creating local government financial vehicles (LGFVs), the CDB collateralized local governments' future land and fiscal revenues, enabling them to leverage state-owned assets and borrow not only from the bank *per se* but also from various financial agencies operating within China's domestic capital market.[72] Large volumes of collateralized lending, however, resulted in soaring LGFV debt (or implicit local government debt) in the 2000s.[73] The debt expansion accelerated after the global financial crisis which began in 2007, as the Chinese government initiated a RMB 4 trillion fiscal stimulus package to revive

71 Zhang Yuzhe, 'Li Ruogu xiangjie jinchukou yinhang zhilu [Li Ruogu explains the development of the Export-Import Bank of China in detail]', *Caixin Weekly*, 7 June 2013, http://magazine.caixin.com/2010-06-06/100150319.html.

72 Henry Sanderson and Michael Forsythe, *China's superbank: debt, oil and influence—how China Development Bank is rewriting the rules of finance* (Hoboken, NJ: Bloomberg Press, 2013); Yuan Chen, *Between government and market: China's exploration on development finance* (in Chinese) (Beijing: CITIC Publishing Group, 2012). Jean C. Oi, Adam Y. Liu and Yi Zhang, 'China's Local Government Debt: The Grand Bargain', *The China Journal*, vol. 87, 2022, pp. 40–71, https://doi.org/10.1086/717256.

73 The debts are 'implicit' because they are calculated as debts of local government financial vehicles, whose relations with local governments remain ambiguous.

economic growth, incentivizing banks to lend massively. Expanding LGFV debt has spurred years of policy debate and adjustments of the extent to which local governments can use financial instruments to fund infrastructure development, as China's policy-makers seek to control debt levels and insolvency rates on the one hand and maintain economic growth at local levels on the other.

In 2014, China passed a revised Budget Law, which notably gave local governments the power to issue bonds.[74] This opened up a channel for local governments to swap LGFV debts with local government bonds and continue borrowing from the domestic capital market, as Chinese commercial banks purchased most of the bonds.[75] In addition to expanding into new sources of finance, local governments and LGFVs have proactively sought debt restructuring with their major creditors. As the main financier of many infrastructure projects, the CDB has played a leading role in coordinating creditors. Perhaps one of the most frequently reported cases of debt restructuring on the part of the CDB concerned the highway projects of Shanxi Transportation Holding Group, an LGFV based in Shanxi province. In 2019, the CDB syndicated with several large commercial banks and collectively swapped the LGFV's RMB 233.7 billion debts for longer-term loans with lower interest rates.[76] The same financial scheme was implemented in the debt restructuring of LGFVs in Hubei and Gansu provinces in 2020.[77] The logic behind these swaps was the same as had underpinned US banks' debt-relief approach in the early 1980s—with more time and money, debtors would eventually be able to repay their loans. Despite rising suspicion and criticism that these swaps would only postpone the problem, not resolve it, a haircut approach has not yet been practised. After all, the objective of creating LGFVs was to employ a market-driven means to fund projects that fiscal revenue could not fund alone, thereby accelerating local economic growth. Debt write-offs, which would involve bailouts capitalized by budgetary revenue, contradicted the fundamental rationale of China's domestic development finance.

The policy banks' international financial activities have reflected the same rationale. As described above, perhaps China's most controversial practice was its collateralized lending to developing countries. Cases discussed in depth have included the CDB's oil-backed loans to Venezuela from 2007 and China Exim's oil-backed loans to Angola from 2004.[78] On the one hand, China's overseas collat-

74 Before that, local governments could not hold liability and therefore had to create LGFVs as legal borrowing entities.

75 By 2021, Chinese commercial banks had purchased over 80% of local government bonds, according to China Central Depository & Clearing Co., Ltd., *Zhongguo Zhaiquan shichang gailan [An overview of China's bond market]*, 2021, pp. 92–3; see also W. Raphael Lam and Jingsen Wang, *China's local government bond market*, IMF Working Paper WP/18/219 (Washington DC: International Monetary Fund, 2018).

76 Yang Zhijin, 'Luodi! Shanxi jiaokong xiang guokaihang deng yintuan pingyi zhihuan zhaiwu 2337yi [Settled! Shanxi Transportation Holdings swapped 233.7 billion yuan of debt with China Development Bank and other syndicates]', *21st Century Business Herald*, 26 Aug. 2019, https://m.21jingji.com/article/20190826/herald/fee933845d73a1a4f085ea4d07a8861a.html.

77 Wei Qian, 'Huajie yinxing difang zhaiwu fengxian, duodi dashoubi pingyi zhihuan qianyiyuan gonglu zhaiwu [To resolve hidden local debt risks, many local governments swapped hundreds of billions of yuan of highway debt]', *Shanghai Securities News*, 6 June 2020, https://news.cnstock.com/news,yw-202006-4544651.htm.

78 See, for example, Erica S. Downs, *Inside China, Inc: China Development Bank's cross-border energy deals* (Wash-

eralized lending is an extension of its domestic finance—the CDB had rehearsed the same scheme with Chinese local governments' projects, starting from the late 1990s, before practising it abroad in the 2000s. On the other hand, the collateralized lending reflects how China could potentially emulate international practices. Japan, for example, offered China oil-backed loans in the 1970s to finance the development of oilfields in north-east China, providing insights for China on how such a financial scheme might be practised;[79] memoirs published by Chinese government officials in Angola indicated that it was the host government, which had been collateralizing oil exports to obtain international finance long before Chinese banks arrived, that had introduced the loan-for-oil scheme.[80] Indeed, resource-rich countries in Africa and Latin America have widely practised collateralized lending in order to borrow from western commercial banks. Regardless of whether China was emulating its international predecessors or globalizing its domestic practice, offering collateralized lending in the current era has made the policy banks distinctive, as western private banks generally downsized their collateralized lending to developing countries after the transition of the late 1980s.

Another distinctive feature of the policy banks has been their new-money approach to developing-country debt relief. For example, Venezuela has experienced difficulties in repaying some of its oil-backed debts to the CDB since the death in 2013 of its incumbent president, Hugo Chávez, and the domestic political vicissitudes which ensued. The Chinese creditors did not exit the market immediately, but continued extending new loans to Venezuela until 2017, and offered several moratoriums for the repayment of principal.[81] These debt treatments were both a result of the Venezuelan government's bargaining for China's continued financial and political support and a reflection of the policy banks' preference for debt relief, which was based on the assumption that money and time would resolve the liquidity problem. Kaplan and Penfold view policy-bank loans as patient capital with a long-term horizon, although they believe continued refinancing has ensnared the banks in a 'creditor trap'.[82]

Similarly, China has continued offering new money to Sri Lanka, the location of the highly controversial Hambantota Port project. Financially supported by China Exim in the 2000s, the port is often cited as evidence of China practising 'debt-trap' diplomacy. In 2017, China Merchants Group, a large Chinese SOE, acquired partial ownership of the port project from the Sri Lanka Ports Authority. The equity investment brought in $1.12 billion in cash that allowed the Sri Lankan

ington DC: Brookings, 2011). Vivien Foster, William Butterfield, Chuan Chen and Nataliya Pushak, *Building bridges: China's growing role as infrastructure financier for sub-Saharan Africa*, Trends and Policy Options No. 5 (Washington DC: World Bank Group, 2008).

79 Deborah Brautigam, *The dragon's gift: the real story of China in Africa* (New York: Oxford University Press, 2009).

80 Wei Jianguo, *Cisheng nanshe shi feizhou [Nostalgic memories of Africa]* (Beijing: China Commerce and Trade Press, 2013), p. 322.

81 Stephen B. Kaplan and Michael A. Penfold, *China–Venezuela economic relations: hedging Venezuelan bets with Chinese characteristics* (Washington DC: The Wilson Center, 2019); Margaret Myers and Rebecca Ray, *What role for China's policy banks in LAC?*, Working Paper (Boston, MA: The Dialogue/Boston University Global Development Policy Center, 2022).

82 Kaplan, *Globalizing patient capital*; Kaplan and Penfold, *China–Venezuela economic relations*, p. 3.

government to repay some of its debts to non-Chinese creditors.[83] During the COVID–19 pandemic, China signed an agreement in March 2020 that the CDB would offer Sri Lanka a $500 million financing facility.[84] The Sri Lankan Department of External Resources announced in April 2021 that the $500 million would be disbursed within a very short time-frame.[85] In August 2021, the CDB signed another credit agreement with the Sri Lankan government, this time for RMB 2 billion.[86] In July 2022 the *Washington Post* reported that Sri Lanka had received $3 billion in 'easy credit' from China in 2020 to help with repayments of its existing loans.[87] The rationale behind China's new money is reminiscent of arguments made in the early 1980s. In an interview with the author, a policy bank official described the current global indebtedness as 'essentially a problem of liquidity', much as the Latin American debt crisis was perceived four decades ago.[88]

Yet the details of Chinese new money are often not disclosed. The degree of concessionality of such capital therefore remains unknown. Moreover, Chinese banks tend to assess the creditworthiness of projects rather than that of the sovereign borrowers, and partly because of this they do not require that debtor countries undertake economic reforms to receive financial support. This means that if it is not sufficiently concessional, the Chinese new money would weaken the current debt surveillance mechanism led by the Bretton Woods institutions, which assesses and monitors sovereign borrowers' creditworthiness and indebtedness, and places a ceiling on non-concessional borrowing to control the free-riding of commercial creditors.

Conclusion and outlook

Contrary to prevailing assumptions, China's state banks prefer a commercially oriented new-money approach relying on market engineering over an interventionalist haircut approach involving fiscal bailouts. Through such an approach, China is not simply contesting western-led rules, but is rather revitalizing the former practices of the West and thereby weakening the international sovereign debt regime that took shape since the late 1980s, when traditional creditors—first private banks and then official bilateral and multilateral creditors—increasingly became more acceptive of debt forgiveness.

[83] Wang Jixian, 'Zhuizong "yidaiyilu shi zhaiwu xianjing celue" de gean—hanbantuotagang de fazhan [A case study of "the Belt and Road Initiative as debt trapping"—the development of Hambantota Port]', Belt & Road Hong Kong Centre, 11 Nov. 2019; Acker, Brautigam and Huang, *Debt relief with Chinese characteristics*.

[84] Embassy of the People's Republic of China in the Democratic Socialist Republic of Sri Lanka, 'USD 500 million urgent financial assistance extended to Sri Lanka by China', 19 March 2020, http://lk.china-embassy.gov.cn/eng/xwdt/202003/t20200319_1374674.htm.

[85] Department of External Resources, Sri Lanka, 'USD 500 million facility agreement signed between Sri Lanka and China', 2021, http://www.erd.gov.lk/index.php?option=com_content&view=article&id=248:usd-500-million-facility-agreement-signed-between-sri-lanka-and-china-2.

[86] Economic and Commercial Office of the Embassy of the People's Republic of China in the Democratic Socialist Republic of Sri Lanka, 'Sililanka zhengfu zhongguo guojia kaifa yinhang qianshu 20yiyuan renminbi shouxin xieyi [The Sri Lankan government and the China Development Bank signed a RMB 2billion credit agreement]', 18 Aug. 2021, http://lk.mofcom.gov.cn/article/jmxw/202108/20210803189611.shtml.

[87] Ishaan Tharoor, 'China has a hand in Sri Lanka's economic calamity', *Washington Post*, 20 July 2022.

[88] Personal communication with policy bank official, Beijing, 9 Oct. 2021.

Meanwhile, China has come to a watershed in practising the new-money approach, facing a scenario parallel to one its predecessors once faced. Deteriorating debt distress in developing countries and increasing numbers of requests from debtors to renegotiate contracts have pushed China to a point where it has to consider the same questions that traditional creditors struggled to answer before they made their transition: whether new money would eventually lead to solvency and whether haircuts are indispensable for alleviating debt distress.

Recent policy discussions seem to hint at a further drop in the volume of new Chinese overseas lending, which has been shrinking since around 2017.[89] At the third symposium of the Belt and Road Initiative, in late 2021, President Xi Jinping encouraged Chinese enterprises to prioritize projects that are 'small and beautiful', control risks more cautiously, and avoid going to 'chaotic and dangerous places'.[90] Similarly, China's central bank suggested in 2022 that collateralized lending to projects with 'risk–profit mismatch' should be discouraged, to prevent excessive collateralization by debtors.[91] These statements indicate that in the future China is likely to offer fewer loans to support large-scale projects with high risks, and will instead finance smaller projects with greater social impact.

At the same time, China has shown a greater willingness in working with traditional creditors on resolving global debt issues recently than it has in the past. In mid-2022 China and France co-chaired meetings of Zambia's official creditor committee under the Common Framework to discuss debt restructuring, which has been interpreted as a positive signal that China is collaborating with traditional creditors in setting a model for debt relief, although whether China would offer to let its banks take haircuts—and, if so, to what extent—remains unknown.[92]

Indeed, Chinese policy-makers and think tanks are well aware of the historical episode of the late 1980s in which the traditional creditors changed from a new money to a haircut approach to debt relief, and have discussed how China might learn from the US's experience of the Brady Plan to tackle its own current challenges. Nevertheless, most of the ongoing discussions have primarily underscored the market-oriented side of the Brady Plan—i.e. in terms of the loan-to-bond conversions, rather than interventionist debt reduction.

In 2021, Zhou Chengjun, director of the Finance Research Institute of China's central bank, proposed a 'Shanghai model' of debt relief. Recognizing the Brady Plan as a 'successful experience' that converted Mexico's debts into liquid bonds guaranteed by the US government, Zhou argued that China can employ the same approach.[93] That is, debtor governments buy bonds issued by the Chinese govern-

[89] Ray and Simmons, 'Tracking China's overseas development finance'.

[90] State Council of the People's Republic of China, 'Xi Jinping zongshuji chuxi disanci "yidaiyilu" jianshe zuotanhui ceji [Party Secretary General Xi Jinping attended the third "Belt and Road" symposium]', 21 Nov. 2021, http://www.gov.cn/xinwen/2021-11/21/content_5652298.htm.

[91] International Department of the People's Bank of China, *Zhuquan zhaiwu chongzu jizhi yanjiu [A study on sovereign debt restructuring mechanisms]* (Beijing: China Finance Publishing House, 2022), p. 151.

[92] Reuters, 'China raises hope for emerging market debt', 1 Aug. 2022, https://www.reuters.com/breakingviews/china-raises-hope-emerging-market-debt-2022-08-01/.

[93] Zhou Chengjun, Hong Canhui and Wang Hao, 'Goujian zhuquan zhaiwu chongzu de "Shanghai moshi" [Building a "Shanghai Model" of sovereign debt restructuring]', *Guanli Shijie [Management World]*, no. 6, 2021, pp. 87–98.

ment and mortgage these bonds to issue offshore renminbi bonds on the international market. As a financial hub, Shanghai should play a leading role in facilitating the loan-to-bond conversions and the internationalization of the renminbi. Yet, Zhou explicitly excluded the haircut approach entailed in the Brady Plan: 'Although debt reduction can largely shape China's image as a responsible, major global player, it often leads to big losses and even generates a moral hazard—debtors may refuse to make repayments if they know our position [that we may write off their debts]'.[94]

In April 2022, China's leading think tank, the Chinese Academy of Social Sciences (CASS), proposed a similar mechanism centring on debt-to-bond conversions. Under the proposal, multilateral financial institutions (for example the IMF) offer concessional financing to debtors; debtors use such financing to purchase zero-yield Chinese government bonds or policy-bank bonds; the zero-yield bonds serve as collateral, against which debtors issue offshore renminbi bonds on the international market; debtors then swap their old loans owed to Chinese banks with capital raised through bond issuance.[95] Like Zhou's proposal, CASS's proposal underscored that haircuts would incur a moral hazard, and that market-based debt-to-bond conversions would alleviate debt distress while maintaining a certain level of liquidity, making China's lending structure more transparent and advancing renminbi internationalization.

These policy suggestions indicate that even if China worked more closely with traditional creditors and departed from a new-money approach, it might not embrace a haircut approach immediately, nor conform to the existing rules of the international sovereign debt regime. China's 'free-riding' on the regime might in part explain this, as the functioning of the proposed solutions requires financial support from multilateral financial institutions for the purchase of government-guaranteed bonds. Yet the commercial rationale underlying Chinese banks' operating mechanisms that makes them averse to haircuts is likely to be more important. Debt reduction by state banks, which requires bailouts funded by fiscal revenue, is mostly contrary to the market-oriented rationale that has undergirded China's economic transition in the post-Reform and Opening up era. Established for the resolution of financial issues for which the state's fiscal allocation is insufficient, China's state banks naturally prefer market engineering to government bailouts in clearing NPLs and do not wish to reverse the progress they have made in recent decades. In other words, although China's weakening of the current international sovereign debt regime is likely to decelerate as it offers less non-concessional finance to debtors, China is unlikely to conform completely to the rules established by multilateral financial institutions since the late 1980s.

Western policy-makers will therefore have to be patient in engaging major Chinese creditors—especially the CDB—in collective debt mechanisms. While

[94] Zhou Chengjun, 'Guanyu renminbi zhaiquan guoji yingyong de xinshijiao [A new perspective on the international application of RMB bonds]', *Zhai Quan* [*China Bond*], no. 11, 2021, p. 19.

[95] Xu Qiyuan, Lei Yu, Sun Liangying, Xiong Wanting, Xiong Aizong and Hong Shijian, 'Zhaiwu weiji xijuan fazhanzhong guojia, zhongguo ruhe yingdui [Debt crisis swept developing countries, how China should respond]', *Caijing*, 23 May 2022.

China may continue to cancel interest-free loans capitalized by government revenue, it will remain hesitant to write off state-bank loans, which make up the vast majority of China's overseas development finance. It took western creditors over three decades of struggle, fraught with policy debates and controversies, to accept debt forgiveness as a mainstream approach to sovereign debt relief. As a latecomer to global debt governance, China is likely to adopt a stance of extreme caution in making a parallel transition.