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China's role in African sovereign debt: Implications for Europe

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Summary

This brief looks at Chinese engagement in sovereign debt relief and restructuring in Africa and provides a better understanding of Chinese practices and positions. It highlights options for the EU to move this agenda forward.

After Chad, Zambia is the second country in Africa which recently restructured its sovereign debt. Despite the optimism from this news, international action on the sovereign debt agenda has been too slow and limited. The 2023 Africa Climate Summit made it crystal clear: a more climate-positive African position is contingent on a decisive answer to the sovereign debt crisis faced by many African economies. If not addressed properly, several African countries are looking at a potential default in the short term, while others – due to their debt vulnerability – may not have the required fiscal space to make critical investments, which would have a severe impact on human

development and effective climate action. In this context, the limited cooperation between the West, China and the absence of private creditors from debt restructuring are key barriers to progress on sovereign debt reform.

A better understanding of China's engagement in debt will help European creditors and policymakers identify and create new incentives which can influence a structural and systemic engagement of China in debt relief and restructuring. Furthermore, approaches from both the West and China should be more compatible with a focus on investments in sustainable development where even more avenues for collaboration could be explored.

Introduction

Multilateral sovereign debt reform has failed to pick up pace despite a growing number of countries in debt distress and at risk of default. This lack of progress is partly due to the highly fragmented global debt landscape, characterised by the increasing weight of the private sector and Chinese owned debt (US$ 273.47 billion and US$ 63.23 billion respectively in 2021), and a shrinking footprint of Paris-Club creditors. Chinese and private creditors account for the largest share of the lending boom since 2010, and tend to use higher interest rates than those of multilateral and Paris Club lenders. Chinese bilateral loans have an average interest rate of 3.2%, while private creditors' loans average at 6.2%. This helps explain the high debt servicing costs of many African countries, which amounted to no less than $68.9 billion collectively in 2023. Economic recovery in African countries has been far slower than in advanced economies, which puts additional strain on borrowing countries' capacity to invest in their sustainable development. To be able to structurally address sovereign debt vulnerabilities it is crucial that Chinese and private creditors participate in debt relief and restructuring – but this is easier said than done.

Chinese and private creditors not only have very different interests to Paris Club lenders, they also have a different track record and protocols for debt restructuring. Neither were also part of past debt sustainability efforts like the Heavily Indebted Poor Countries initiatives (HIPC) in the 1990s. All this makes the debt relief and restructuring process more complex, difficult and slower

than in the past – though not impossible as seen in the case of Zambia (see below).

This note zooms in on Chinese lending. While it is clear that the country holds the key to getting sovereign debt reform out of its current deadlock, the reality is that geopolitical and economic tensions/interests continue to undermine its effective participation. This note seeks to provide a better understanding of Chinese practices and positions on debt relief and restructuring and highlights options for the EU to move this agenda forward.

Overall, European creditors and policymakers need a more fine-grained understanding of Chinese lending practices, to identify and create new incentives that can influence a structural and systemic engagement of China in debt relief and restructuring. In particular, efforts should be dedicated to making the West and Chinese approach to sovereign debt restructuring more compatible. Discussions on sovereign debt restructuring and relief should also be better articulated with those focusing on investments in sustainable development where even more avenues for collaboration could be explored.

The 2023 Zambia debt deal: a positive, but one-off signal

Zambia had been in default since 2020, before a deal was made with its creditors under the G20 Common Framework in June 2023. China especially was said to have delayed the agreement, which took over 1.5 years to be finalised. It argued that if Chinese lenders were expected to take a haircut, the

World Bank and IMF should do the same. In doing so it questioned the preferred creditor status of these multilateral organisations, which plays a key role in their business model. Ahead of the June 2023 Paris summit for a new global financial pact, China finally agreed to restructure about US$4 billion of Zambia's sovereign debt (excluding debt owed to the ICBC), lowering the coupon to 1% for the remainder of the IMF's Zambia programme. This was a real concession: the calculated NPV reduction is around 40% (using a 5% discount rate). While some observers heralded the deal as a landmark moment for Chinese debt relief, others argue that the Chinese decision to engage was mostly to signal that China is not blocking negotiations, and is open to working together with the West to find adequate solutions to the sovereign debt crisis. Regardless of the defining factor in Zambia, the case confirms that (1) international pressure does matter, but also (2) that Chinese lenders will likely continue to prefer negotiations separately, much like it is currently doing with Sri Lanka. Just as other official creditors, China also made it clear that it does not consider the Zambia deal as a precedent: in other words, a deal was struck but it was not a structural or replicable solution.

Misconceptions and perceptions around Chinese debt

Western analysts and politicians are often quick to complain about the lack of Chinese engagement in multilateral debt relief frameworks like the G20 Common Framework, citing a general lack of transparency around Chinese debt. Western, especially US politicians often use the persistent narrative of Chinese debt-trap diplomacy, i.e. that China deliberately lends to countries

with the end goal of seizing strategic public assets, put up as collateral or gaining strategic leverage in the event of non-repayment. However, this narrative, beyond being counter-productive to fostering collaboration, has been proved by several academics to be not evidence-based and misleading. This somehow illustrates the limited understanding of Chinese lending practices among some of Western observers.

A closer look reveals that while different, China in fact does engage in debt relief and restructuring, including through multilateral frameworks. It participated in the G20 Debt Service Suspension Initiative (DSSI), and ultimately provided more than contributed 63% of debt service suspensions. It contributed to the launch of the G20 'Common framework for debt treatment beyond the DSSI', and its implementation in Ghana (where China agreed to co-chair the committee of Ghana's official creditors) and Zambia.

One of the key issues often raised by China is the need for fair burden sharing, and that other major creditors, including multilateral banks such as the World Bank but also commercial lenders, should participate alongside bilateral lenders.

Yet while Western analysts tend to look at Chinese practices through the lens of past multilateral debt relief efforts, Chinese bilateral lenders employ their own tools and conditions for debt relief and restructuring. Table 1 below gives a brief overview of the most common bilateral loan instruments, and the debt sustainability tools that Chinese creditors use.

Type of finance	Agency	Source of funding	Debt sustainability objective	Approx. amount (of medium – and long-term foreign-currency loan balances by 2019 in $ billion)	Examples
Grants and interest-free loans (foreign aid) *Comparable to official development assistance (ODA). These interest free loans are a largely diplomatic tool supporting development priorities in partner countries*	China International Development Cooperation Agency	Government budgetary revenue	Debt restructuring (debt cancellation)	+20	Provided 23 interest-free loans to 17 African states that had expired at the end of 2021
Policy-bank lending *Similar to development finance institutions. Chinese so-called 'Policy Banks' provide loans with interest rates below those of the market.*	China Development Bank	Self-raised funds	Debt restructuring	+180	Provided Debt suspension in Angola
	Export-Import Bank of China	Self-raised funds; government subsidy for concessional loans	Debt relief (grace period, longer maturities)	+160	Provided USD 4.1 debt restructured in Zambia, treated as bilateral debt
Commercial bank lending	Industrial and Commercial Bank of China	Self-raised funds	Debt relief (grace period, longer	+50	Treated as commercial debt under

Similar to commercial banks. These loans are on commercial terms, and therefore have higher interest rates than policy bank loans.	(ICBC); Bank of China, China Construction Bank, Sinosure among others		maturities)		the G20 Common Framework implemented in Zambia

Source: Adapted from Chen 2023

In addition and going beyond the realm of the sovereign debt restructuring agenda, China is currently also considering new instruments, including the use of debt for development swaps, as shown by the recent interest of (and research undertaken by) Chinese government-related institutions.

Different technical approaches and geostrategic interests

At the core of the differences between Chinese and Western- or multilateral-owned debt is that Chinese and Western lenders tend to use different approaches, terms and categories, which are not always aligned. The differences in 'lending culture' also translate to a different toolbox for debt sustainability and restructuring, making it difficult to apply 'standard' Paris Club categories on Chinese loans. These conceptual differences have made it difficult to move beyond piecemeal progress on debt relief since the 2020 COVID-19 economic crisis.

China has two major policy banks, five big state-owned commercial banks and an export credit agency called Sinosure (ECA). Contrary to the Paris Club approach, the claims backed by Sinosure are not considered to be part of the official debt stock, but instead treated as commercial debt. In the case of Zambia, this means that China negotiated to treat around US$ 2 billion held by Sinosure as commercial debt. In addition, the majority of Chinese loans, be it provided by China's two major policy banks, or large (state-owned) private banks like the ICBC, are issued on competitive, at times concessional terms, but Chinese officials still consider these to be commercial activities rather than a form of international assistance.

The 'Western' understanding of commercial activities, by contrast, entails private and not state-owned entities. This may explain why China prefers to apply 'private sector practices' to debt relief and restructuring (more information below). Chinese creditors rarely go for haircuts, but instead prefer to adjust the terms of a loan (tenor, interest rates, grace period etc.) – a commercially-oriented approach that was widely used by the US before the 1980s. Beyond the principle, this approach is also seen as more pragmatic for China given that i) debt cancellation requires approval by the Chinese State Council; and ii) China is facing domestic debt issues. With the exception of interest-free loans, Chinese lending also does not have standard regulations for debt forgiveness in the case of a (risk of) default. Instead, Chinese lenders consider debt restructuring on a case-by case basis. This creates additional difficulties in multilateral creditor negotiations.

While China has recently increased its participation in multilateral debt sustainability initiatives, it often takes issue with the use of an architecture over which it has only limited or partial control. China, for example, sees the IMF's Debt Sustainability Analysis (DSA) for debt distressed countries[1] as a barrier for its effective participation in debt relief operations, due to its lack of transparency to creditors. The ongoing revision of the IMF's DSA offers the opportunity to develop, if not a common methodology, at least one that is more compatible with both Western and Chinese systems.

These conceptual and institutional differences have been a persistent point of friction between the West and China throughout the current debt crisis. In the case of Zambia, this led to what has been called the 'Common Framework Cold War', where one side was accusing the other of delaying the negotiations. While eventually, a deal was struck, most of these differences remain largely unresolved.

Debt relief is also a geopolitical game

Debt relief and restructuring is as much about geopolitics as it is about balance of payments. By providing relief, creditors can not only avoid the risks and costs of default, but they can also use it for (geo)political gains. Creditors (and debtors) often make big announcements of debt restructuring operations, as it is seen as an opportunity to strengthen political ties. At the same time, debt relief is also a major collective action problem. If one creditor takes the first move and accepts a 'haircut', this may directly benefit other creditors, who take a more conservative approach. This has led to the rather

hesitant use of multilateral mechanisms such as the G20 Common Framework since the COVID-19 economic and sovereign debt crisis, and continues to inspire a wait-and-see approach by both Chinese and Western creditors, as well as the bulk of private lenders.

China maintains very close bilateral ties with most African countries, at the same time, it keeps the door open by participating in the G20 mechanism, however, international efforts do not appear to provide a strong incentive for China to take a more proactive, or lead role in debt relief efforts as a senior creditor in a large number of global South countries.

While Zambia's restructuring deal is not likely to be replicated elsewhere, it may pave the way for future reforms of multilateral debt sustainability initiatives, as it sheds a new light on the interests and incentives of Western and Chinese creditors, as well as the political benefits of cooperation. All this will be crucial for achieving more structural or systemic solutions for debt sustainability. This will require a stronger effort to integrate Chinese systems in the international sovereign debt architecture, and devise mechanisms that are compatible, and politically consistent with both Chinese and Western concerns. Doing so would help break through the cycle of powers ‘passing the ball’, and delaying, undermining or even blocking negotiations at the expense of debtor countries and their populations.

Reasons for (cautious) optimism

There are some signs of openness from both China and Western creditors to work towards a more collaborative multilateral debt relief. At the 2023 high-level sovereign debt roundtable linked to the Spring Meetings, China dropped its longstanding demand that multilateral development banks take a haircut alongside other creditors in sovereign debt restructurings. This is a positive development since their preferred creditor status allows MDBs to invest in riskier contexts without charging a risk premium, as well as provide below market or even concessional lending as in the case of the IDA. This can be done because they can access capital markets' financing at a very low rate due to their often AAA rating. In fact, recent analysis shows that inflicting haircuts on MDBs would be inefficient and unfair given their role in providing concessional finance, and that it may be more desirable to explore alternative solutions, one of the them being to have MDBs invest the equivalent of a haircut in grants or highly concessional loans.

China is also increasingly formalising its agenda for reforming the multilateral system from within. The 2023 Chinese Foreign Relations act, for example, makes it a priority to "preserve" and "reform" aspects of the international order, emphasising that Beijing will focus on working within the global system instead of creating parallel channels. Some efforts are also being made to better meet Chinese interests. The IMF, for example, recently agreed to provide earlier debt sustainability information to creditors, ahead of the publication of the DSA, so they can better prepare for restructurings. This gives the country

more influence in determining the final outcomes of a possible debt restructuring exercise.

While this is encouraging, it is a very incremental and partial convergence of interests in the multilateral space, and still far from the structural reforms of the sovereign debt architecture that developing countries demand.

What now?

There is common agreement that the current efforts are often too little and too late. While some progress is being made with bilateral and commercial debt for climate swaps and investment agenda, they are not a substitute for debt restructuring. For the EU and European creditors, however, slow multilateral progress should not be an excuse for inaction. They can and should build on the emerging consensus on the need, value and benefits of proactive debt reform, and act both at an international, political and technical level to move the debt agenda forward.

This could go a long way in strengthening European ties with African countries, and strengthen its geopolitical influence across the Global South. More specifically, Europe could:

1. **Champion reforms of the existing sovereign debt architecture**
   Take the lessons learnt of the G20 Common Framework experiences, to help reform it, in collaboration with African countries – which were not represented in the G20 until the African Union got a seat in 2023 – and China. Reforms should aim to facilitate collaboration between

China and the West (including commercial creditors), minimise disagreements and foster information sharing. To make the common Framework effective it should also be made eligible for middle-income countries. European member states can use their influence to foster the use of the International Monetary Fund (IMF) to 'lend into arrears'[2], which can be used only when the IMF has the full backing and political cover of its major shareholders. This tool is key to get private creditors to the negotiations' table.

2. **Prioritise inclusion over fragmentation in the international system**
   Debt reform is held back as much by geopolitical as technical barriers. The EU and key member states have long sought to adopt a more pragmatic position in the face of US-China tensions, and should continue to promote a collaborative approach in international fora (e.g. G20, G7) and multilateral institutions (IMF, WB). The starting point for a progressive multilateral agenda should be an accelerated and effective integration of global south economies, and particularly African institutions within the G20 framework, as well as an effective translation of developing country demands and initiatives such as the Bridgetown Initiative into concrete reforms in the multilateral architecture. This will not only help in restoring the trust and confidence of debtor countries in the international system, a stronger developing country (and African) position in these fora will also help in diffusing continued Western-Chinese tensions. In addition, the recent BRICS expansion shows that there are alternatives to traditional East-West and North-South divisions. Supporting inclusion will be key not

only to moving the debt agenda forward, but also to maintaining European legitimacy and influence.

3. **Change the game by moving forward on private sector debt**
   The piecemeal approach to international financial system reforms and the sovereign debt agenda is eroding European (and Western) legitimacy more than it affects China's reputation. Even if European creditors only hold part of the key to effective reforms, they could be bolder in a number of highly symbolic areas. Doing so can raise the bar, but also force others to react. Especially bringing private creditors to the table, and holding them to account would be a game changer for any future debt relief and restructuring effort. European policy-makers can build on the draft legislation under discussion in the New York State Assembly: the New York Bill which aims at achieving a more "equitable burden-sharing between public and private creditors."This would be likely to affect Chinese engagement in debt restructuring both from a technical level (in line with the fair-burden sharing principle) and from the geopolitical perspective (to ensure that they maintain close ties with African countries).

4. **Addressing sovereign debt is not enough, African countries need more fiscal space to invest in sustainable development. This can be done by:**

   - **Rechanneling special drawing rights (SDRs) to developing countries:** More EU member states should commit to rechannel SDRs, and move from commitment to actions. They can do so

by i) leveraging the IMF Resilience and Sustainability Trust; and ii) putting pressure on the European Central Bank to review its position on the use of SDRs, which cannot be channelled yet through public development banks[3] (in this context, it is worth noting that the EIB is a SDR prescribed holder); and iii) sharing knowledge and experience around guarantee instruments with African countries, which could leverage SDRs as guarantees to mobilise and attract private sector capital instead of exclusively using SDRs as budget support. Given China's openness to rechanneling SDRs to African countries, this is an area in which European and Chinese officials could work towards a common agenda.

- **Using and scaling up bilateral and commercial debt-for-climate swaps:** the EU and its member states could help develop harmonised debt for SDGs swaps processes at the EU level, and providing guarantees through a dedicated guarantee fund that could be managed by the EIB through its partnership platform for funds (PPF). This could facilitate EU member state engagement, as most of them are already familiar with the PPF. Debt-for-climate swaps can help create the necessary fiscal space to invest in critical infrastructure, clean energy and climate resilience, including as part of the EU's 'Global Gateway'. In addition, while commercial debt for climate swaps have so far mostly involved American commercial and public institutions, the EU, through its member states and its public

development banks could follow a similar path, and opt for a broader set of swaps, focusing on climate as well as social and development outcomes in a way that is gender sensitive.

- **Supporting a carbon taxation regime including a carbon tax on fossil fuel trade, maritime transport and aviation**: this could contribute to support domestic resource mobilisation by African countries, while providing incentives to cut down emissions. It is estimated that such a tax could raise about US$100 billion a year that could be rechanneled to help poorer countries cope with climate change. Linked to the issue of carbon emissions is the development of the Africa Carbon Markets Initiative, where several countries including the UAE committed to buy African carbon credits, which can be used to protect biodiversity and contribute to mitigating/adapting to climate change.

All of these options could help pave the way towards a comprehensive and more systemic solution towards the looming sovereign debt crisis. China remains a highly conservative player in the sovereign debt space, but this should not be used to justify inaction by other creditors. Options exist.

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Endnotes

1. The IMF's DSA is a tool assessing the debt sustainability of a country, with a view to provide estimates of the nature and magnitude of debt relief that will be needed taking into account growth and fiscal projections.
2. The IMF provides funding while the country runs up arrears to private creditors failing to engage constructively in the process.
3. In this context, it is important to note that the EIB is a SDR prescribed holder.