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China's role as EM creditor evolves

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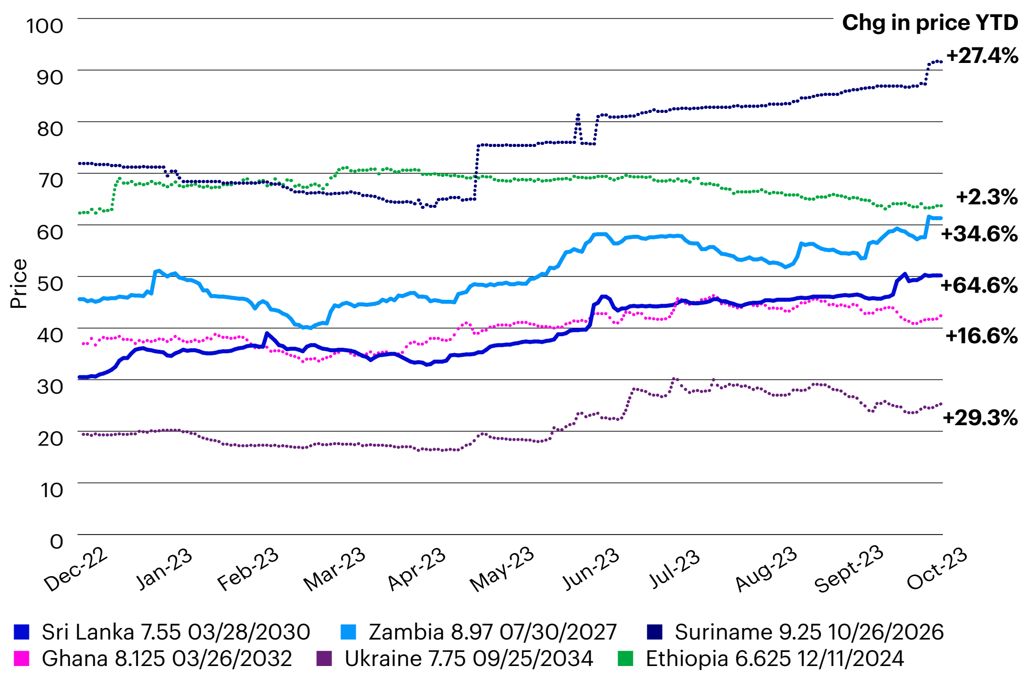
Overview

- Zambia's agreement with official creditors in June marks an important breakthrough in EM debt restructuring.
- After a long impasse, agreements with China, an important creditor, have enabled the process to move forward, including the treatment of eurobonds.
- We believe Zambia's agreement provides a potential template for other EM countries seeking to restructure external debt, including to China, and could encourage investment flows to the asset class.

The June 2023 agreement between Zambia and its official creditors on a comprehensive debt restructuring marked a turning point for emerging market (EM) sovereign debt. It solidified a trend that breaks an impasse between various lenders, such as China, the European Union, the US, international bondholders, and debtor countries that borrowed heavily from China over the last ten years. While by no means a panacea, the restructuring of Zambia's Chinese debt – with Sri Lanka soon following suit – is an important development for the portion of JP Morgan's Emerging Market Bond Index (EMBI) comprised of low-income countries indebted to China and with limited ability to access financial markets.

Zambia's agreement with official creditors has already borne fruit by paving the way for a subsequent interim deal with commercial creditors – including holders of Zambia's eurobonds. At the end of October, Zambia reached an agreement in principle to restructure these bonds, in a deal that came faster than expected. Notably, Zambia and Sri Lanka's eurobonds have outperformed their defaulted EMBI peers year-to-date (Figure 1). Below, we discuss the developments leading up to the recent breakthrough and prospects for a more favorable EM debt restructuring landscape going forward.

Figure 1: Defaulted EMBI countries that have resolved debt issues with China have performed best year-to-date



Source: Bloomberg L.P. Data from Dec. 30, 2022 to Oct. 31, 2023.

Zambia's deal: an EM debt restructuring turning point

In 2000, an initiative to alleviate the long-time debt burdens of highly indebted poor countries (HIPC) resulted in a 63% net present value reduction in Zambia's external debt owed to rich countries, or around USD3 billion in cash flow relief. After a period of strong growth and low debt, the country began to borrow again, gradually at first and then at a more worrying pace. From 2011-2019, Chinese loans grew from under USD1 billion to almost USD6 billion. Even after Zambia's bonds reached distressed price levels (signaling market fears of a default), the Chinese continued to disburse loans and sign new commitments. In the wake of the COVID pandemic, Zambia eventually breached the International Monetary Fund's (IMF) debt sustainability limits and was unable to pay its external debt obligations. This mattered because the IMF's determination that Zambia's debt was unsustainable meant that any emergency IMF funding would require a full debt restructuring, including the restructuring of Zambia's eurobonds.

Following the default, bilateral creditors struggled to jointly determine how to restructure their loans in the context of the IMF's assessment of how much debt Zambia could sustain going forward. This group of bilateral creditors was split into two. On one side was the Paris Club (PC), made up of wealthy developed countries, who were historically the only significant bilateral lenders to developing countries.[1] On the other side, was a relative newcomer to bilateral lending – China.

The process was long and contentious, but this summer's deal finally broke a two-and-a-half-year impasse. China ultimately conceded some important points: It implicitly dropped its demands to negotiate with the Zambian government one-on-one, clarified the status of each Chinese lending entity in a way the PC found acceptable and dropped its demand that multilateral lending institutions, like the World Bank, take haircuts (the forgiveness of some or all of the debt's principal). However, China won some concessions, including a cap on foreign participation in Zambia's local debt market and a commitment from multilaterals that, rather than merely rolling over their existing debt, they would try to contribute net new money to plug Zambia's financing gaps.

Figure 2: Zambia public debt as of December 2021 (USD million)

Total Debt	**32,466**
External Debt	15,442
Multilateral	2,655
IMF	-
WB	1,405
Other	1,250
Bilateral	7,952
Paris Club	1,332
Non-Paris Club	6,620
China	5,935
India	685
Commercial	4,835
Eurobonds	3,280
Other	1,555
Various Arrears	1,231
Domestic Debt	17,024

Source: IMF. Data as of Dec. 31, 2021.

1. The Paris Club members include Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Ireland, Israel, Italy, Japan, the Netherlands, Norway, Russia, South Korea, Spain, Sweden, Switzerland, the United Kingdom and the United States.

What has been the market reaction?

The market reaction to this development has been subdued. However, in our view, this newfound procedural clarity is a meaningful turning point for countries that owe significant amounts of money to China and may need to restructure. Many factors weighed on high yield EM sovereign debt earlier this year, such as volatile US interest rates, geopolitics and countries' internal political dynamics. But uncertainty over Chinese lenders' alignment with existing sovereign debt restructuring precedents and norms also played a significant role. We believe developments in Sri Lanka and Zambia constitute a trend toward smoother and more predictable EM debt restructurings.

Roughly a quarter of the EMBI is comprised of frontier markets with outstanding debt to China, a history of uneven repayment, and limited institutional capacity to manage their debt, much less a complex restructuring. Of the 15% of the EMBI trading at distressed levels (yields above 10%), the majority have borrowed from China at some point in the recent past. We believe the progress achieved on these individual debt restructurings should, over time, lower the overall risk premium implied in this distressed segment of the EMBI.

The historical sovereign restructuring process

Sovereign debt restructuring is nothing new. Though the process has changed considerably over the decades, by the 2000's the world had a rough but identifiable system for restructuring a sovereign's debt – including its eurobonds.

A country in default on its external debt almost always owed money to three distinct types of entities, and a general system of precedent and norms governed their interplay. Countries owed money to multilateral lending institutions like the IMF and the World Bank, other countries ("bilateral" debt), which was almost always owed to members of the PC, and "the market", which includes eurobonds and syndicated loans. The debt restructuring process typically moved from one creditor class to the next, in the order listed above.

If a country entered a crisis, it would eventually turn to the IMF and World Bank for help. These multilaterals are considered senior to other creditors and never took write-downs so they could maintain their low cost of capital and continue vital lending at concessional rates to countries in crisis. The IMF and World Bank would traditionally design a bailout program that offered the final word on the size and scope of any debt relief a country might need post-crisis, plus the mix of macroeconomic and monetary policies the country should implement in exchange for debt forgiveness. The PC would follow the IMF's recommendation and offer the borrower government "financing assurances" that would involve some combination of principal losses (haircuts), maturity extensions and interest rate reductions, or new loans. With this new map of future interest and principal payments, the IMF could feel confident in its long-term plan for the economy and have a sense of how much money was left to pay holders of commercial debt. Finally, the banks and bondholders would receive "comparable treatment" to the PC (though this term was never formally defined). Bondholders would typically receive a deal that provided the country with breathing room without being overly generous. This arrangement was favored by the IMF and the PC who wanted these countries to eventually support themselves through international capital markets by issuing bonds at some point in the future.

Then along came China – a creditor difficult to categorize. At first, increased Chinese lending to developing governments – largely through the Belt and Road Initiative (BRI) – was welcomed by all, especially borrower governments who loved the low-reform or no-reform conditionality in the loans – compared to IMF or World Bank loans – and the speed with which China could disburse money. China liked aiding in global development, using the loans to finance projects that meant more business for Chinese engineering and construction firms, and the prestige and influence of being a significant bilateral lender.

Over time, closer scrutiny of Chinese loans revealed problematic ambiguities that would arise if a country entered distress or default. The loans were made by many Chinese entities, including the Chinese government itself, government-owned banks at concessional rates, government-owned banks at market rates, private banks, insurance companies, etc. – and nobody knew quite where they would all fit in a potential restructuring. Were they bilateral or commercial or a new category? When it became clear that China's role straddled multiple different interest groups, the second step in the traditional debt restructuring process stalled. As it stalled, eurobonds were left in default and waiting for a resolution.

Being unable to proceed past the multilateral stage delayed the rest of the process, making the final approval of an IMF program take about five times longer than usual. A Reuters analysis of IMF programs signed in the last ten years measured the time between a staff-level agreement (when IMF technicians negotiate a workable agreement with a debtor country) and board approval (when IMF member countries approve the program developed by the staff and disburse emergency funds). The key component allowing the process to move from staff to board approval is the "financing assurances" step.

In some cases, in which China was a major creditor, they were able to act quickly. However, in most cases, it proved more difficult. In four complex debt restructurings involving China – Chad, Suriname, Zambia and Sri Lanka – the average time from staff to board approval was 256 days, versus the median of 55 days in all other instances, according to Reuters' analysis (Figure 3).

Figure 3: Days from IMF staff approval to board approval

Chad	317
Suriname	237
Zambia	271
Sri Lanka	200
Average	256
Median 2013-2023	55

Source: Reuters, IMF. Data as of March 31, 2023.

Without the other creditors sorted and an IMF program on-track, eurobonds typically cannot be restructured. An analysis by Morgan Stanley in October 2022 found that since 1999, the average eurobond restructuring typically takes 18 months from the announcement of a default to a full restructuring. Most instances involving China have – or are expected to – run longer (Figure 4).

Figure 4: Months from default to final restructuring agreement

		Default
Zambia (ongoing)	35	Nov-20
Sri Lanka (ongoing)	18	Apr-22
Suriname	25	Apr-21
Average	26	
Average 1999-Present	18	
Median 1999-Present	10	

Source: Morgan Stanley. Data as of October 31, 2022.

The time without repayment negatively impacts cash flows to existing investors and leaves these countries and their companies with a higher cost of capital. Equally important, long periods without payment also dissuade so-called "cross-over" investors (investors with global mandates versus dedicated EM investors) from considering EM as a potential allocation, all of which makes capital scarcer for EM issuers.

Market implications

With Zambia's and Sri Lanka's official debt restructuring processes settled, the emergence of a rough template for restructuring sovereign bonds has replaced a system that seemed broken. This newfound clarity should help distressed sovereign bonds in two ways: First, improved dedicated EM investor engagement and comfort with this distressed segment should promote better liquidity and improve price discovery. Second, with a greater ability to assess the timing and terms of the debt restructuring process, sophisticated non-dedicated EM investors should be able to engage in the space with greater confidence.

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