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Eckhardt Bode

African Sovereign Defaults and the Common Framework: Divergent Chinese Interests Grant Western Countries a "Consumer Surplus"

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OVERVIEW/ÜBERBLICK

- China has become a major player in sovereign lending towards Africa during the past two decades but has recently been faced with increasing defaults. A new African debt crisis is looming.
- Differences in the motives of sovereign lending between China and Western creditor countries contribute to preventing effective global sovereign debt management under the "Common Framework for Debt Treatment" in this looming African debt crisis. Chinese lending during the past two decades was motivated primarily by its own economic interests while most of the Western countries' lending appears to be at odds with their self-interests but is not yet well-understood.
- Debt settlements under the Common Framework that involve China are less generous than past settlements with the Paris Club alone. This is an obstacle to a rapid and sustainable economic recovery of financially distressed African countries.
- Western countries derive a kind of "consumer surplus" from the agreements under the Common Framework because they are prepared to make greater concessions than China. They could transfer this hypothetical surplus as additional (conditional) Official Development Assistance to the defaulted African countries to alleviate social hardship.

Keywords: Sovereign Debt, Africa, Motives of Lending, China, Western Countries, Common Framework, Con-sumer Surplus

- China hat sich in den letzten zwei Jahrzehnten zu einem wichtigen Akteur bei der Vergabe von Staatskrediten an Afrika entwickelt, sah sich aber in letzter Zeit mit zunehmenden Zahlungsausfällen konfrontiert. Eine neue afrikanische Schuldenkrise zeichnet sich ab.
- Unterschiede in den Motiven für die Kreditvergabe zwischen China und westlichen Gläubigerländern tragen dazu bei, dass in dieser sich abzeichnenden afrikanischen Schuldenkrise ein wirksames globales Staatsschuldenmanagement gemäß dem "Common Framework for Debt Treatment" verhindert wird. Die chinesische Kreditvergabe war in den vergangenen zwei Jahrzehnten in erster Linie durch eigene wirtschaftliche Interessen motiviert. Die Motive der Kreditvergabe der westlichen Länder scheinen deren wirtschaftliche Interessen dagegen zu widersprechen, sind aber noch weitgehend unerforscht.
- Umschuldungen unter dem Common Framework unter Beteiligung Chinas sind weniger großzügig als frühere Regelungen mit dem Pariser Club allein. Dies ist ein Hindernis für eine rasche und nachhaltige wirtschaftliche Erholung der finanziell angeschlagenen afrikanischen Länder.

- Die westlichen Länder erzielen aus den Umschuldungen unter dem Common Framework eine Art "Konsumentenrente", weil sie zu größeren Zugeständnissen bereit sind als China. Sie könnten diesen hypothetischen Ertrag als zusätzliche (bedingte) öffentliche Entwicklungshilfe an die insolventen afrikanischen Länder weiterleiten, um soziale Härten zu mildern.

Schlüsselwörter: Staatsverschuldung, Afrika, Motive der Kreditvergabe, China, westliche Länder, Common Framework, Konsumentenrente

Eckhardt Bode
Kiel Institute for the World Economy
Kiellinie 66
24105 Kiel
Tel.: +49 431 8814 462
Email: eckhardt.bode@ifw-kiel.de

AFRICAN SOVEREIGN DEFAULTS AND THE COMMON FRAMEWORK: DIVERGENT CHINESE INTERESTS GRANT WESTERN COUNTRIES A "CONSUMER SURPLUS"

Eckhardt Bode[1]

1 CHINA AND THE LOOMING AFRICAN DEBT CRISIS

China has become a major player in development finance in Africa during the past two decades (Figure 1). Its contribution to sovereign lending to the continent exceeds that by the World Bank or the Western countries (Mihalyi and Trebesch 2023). In recent years, there have been increasing signs of an impending debt crisis on the continent, however. As a result of the multiple global crises since the mid-2010s, including a commodity price crash, the Covid-19 pandemic and Russia's invasion of Ukraine, Africa is currently at risk of being trapped in a vicious cycle in which increasing macroeconomic imbalances, rising financing costs, and dwindling financing opportunities may reinforce each other.[2] Several countries, including Chad, Ethiopia, Ghana and Zambia, are currently in default, and more may follow (AfDB 2023). While China has virtually withdrawn as a supplier of fresh money in the meanwhile, many of its loans have become non-performing (Horn et al. 2023a, IMF 2023, Brautigam and Huang 2023). Horn et al. (2023a) estimate that Chinese distressed loans currently amount to up to 60% of China's total overseas lending.

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[2] See Mihalyi and Trebesch (2023), AfDB (2023), IMF (2023), Hurley et al. (2019), Acker et al. (2020), Horn et al. (2023a, 2023b) and Berensmann (2023), among others.

2 INSUFFICIENT GLOBAL SOVEREIGN DEFAULT MANAGEMENT

The current institutional framework for coordinated sovereign default management is deficient. Until 2020, China dealt with defaulted loans in an ad hoc and uncoordinated manner below the radar of the global public.[3] After concluding an agreement with a defaulted debtor, China often withdrew from further lending, as in the case of Mozambique.[4] This isolated, non-cooperative behavior has created information asymmetries and further increased distrust of China in the West. In 2020, the Chinese government agreed to cooperate with the Paris Club of major Western lenders in joint negotiations of debt restructuring with defaulted developing countries under the "Common Framework for Debt Treatment" (CF). Many commentators consider this agreement a major step towards improving global default management but fundamental conflicts of interest between China and the Western countries remain an obstacle to rapid and sustainable debt restructuring (e.g., Brautigam and Huang 2023, Setser 2023).

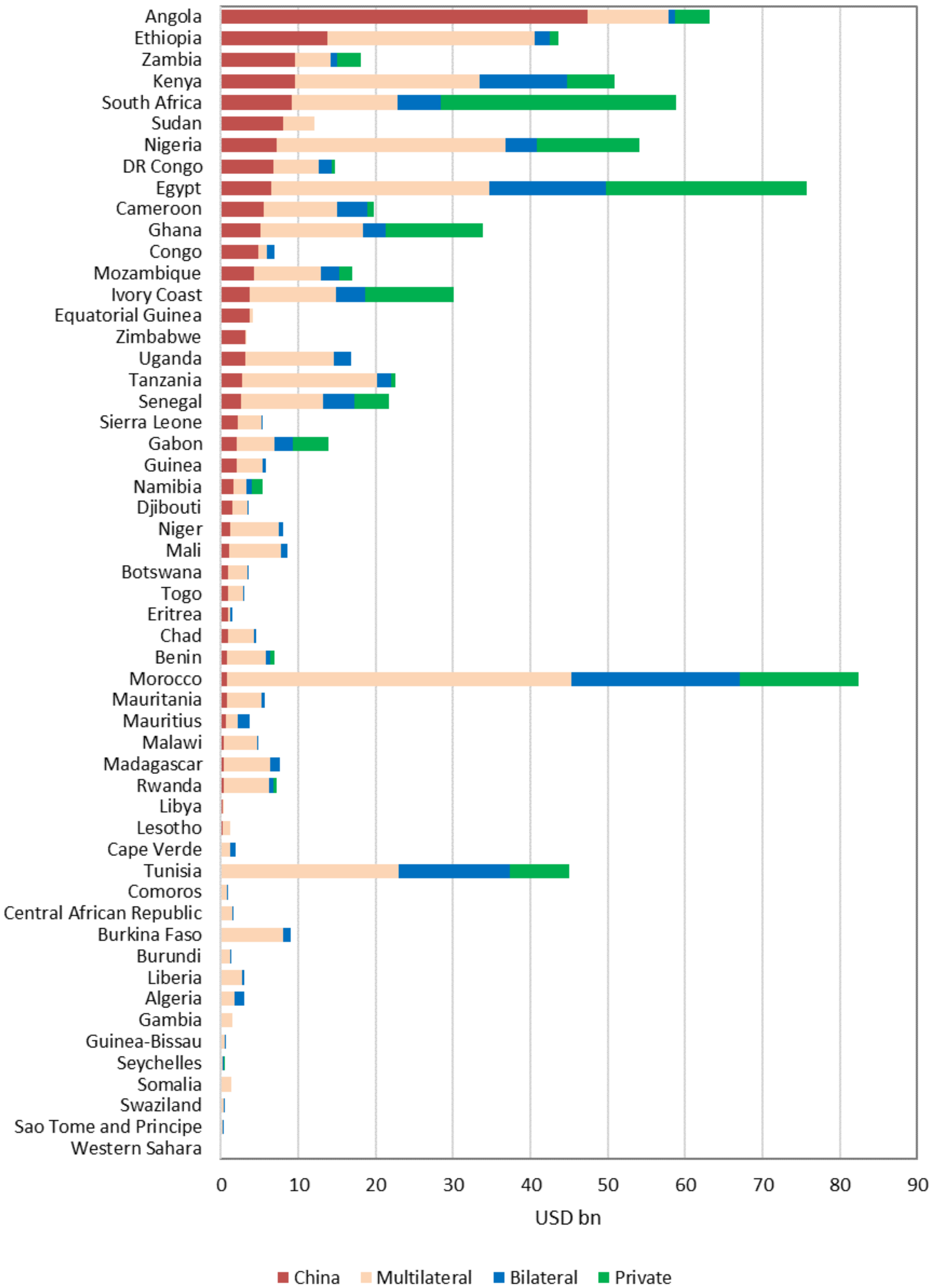
3 DIFFERENT MOTIVES FOR CHINA'S AND WESTERN COUNTRIES' SOVEREIGN LENDING TO AFRICA

A recent study suggests that these conflicts of interest between Western countries and China may be rooted in significant differences in the motives of lending during the 2000s (Bode 2024). While Chinese lending mainly served its own economic or geopolitical objectives, which is well-known from the existing literature, Western countries' lending also pursued objectives that appear to be at odds with their self-interests but whose precise nature is not yet well-understood. For example, China lent preferably to African countries with richer resources, lower risk of default and higher willingness to pay for credit while Western countries lent preferably to resource-poor and highly indebted African countries (Table 1). China also lent preferably to African countries that supported it in international organizations and in enforcing its One China principle while Western countries lent preferably to African countries with better institutions.

[3] See Acker et al. (2020), Acker and Brautigam (2021), Dreher et al. (2022), Vines et al. (2022), Berensmann (2023), Brautigam and Huang (2023), Chen (2023), Horn et al. (2023b), Henning (2023) and Gelpern et al. (2023).

[4] Following Mozambique's sovereign debt default in 2016, Chinese banks have extended rescue loans to Mozambique in 2017, totaling almost USD 2bn, but have subsequently withdrawn from lending to Mozambique, according to the Africa Debt Database (ADD, see Mihalyi and Trebesch 2023). Apart from very expensive sovereign bonds issued by the government of Mozambique in 2019, only multilateral creditors, primarily the World Bank's International Development Agency (IDA), committed larger amounts of highly concessional loans at zero interest to Mozambique, complemented by a technical assistance program by the World Bank to address institutional weaknesses (Haile Gebregziabher and Pijuan Sala 2022).

Figure 1:
Sovereign Lending to African countries 2000–2019 by creditor group[a]



[a]Private: Sovereign bonds issued by African countries at international capital markets.

Source: Africa Debt Database (Mihalyi and Trebesch 2023)..

Table 1:
Motives of Chinese and Western countries' sovereign lending to Africa 2000-2019[a]

Motive	Correlation (likely category of motive for lending)	
	China	Western countries
Securing access to important African suppliers of resources	0	+ (economic)
Gaining access to additional African suppliers of resources	+ (economic)	0
Access to supply of other merchandize from Africa	+ (economic)	0
Access to African sales markets (stimulate declining export demand)	– (economic?)	– (economic?)
African countries' resource endowments	0	– (other)
Investment security	+ (economic)	– (other)
Quality of African countries' institutions	– (economic or geopolitical)	+ (economic or geopolitical)
Alignment with lending from multilateral organizations	++ (possibly economic)	+ (possibly development assistance)
Alignment with sovereign bonds issued by African countries	+ (possibly economic)	0
Investment of foreign currency reserves (only until mid-2010s)	+ (economic)	0
African countries' support of One China principle	++ (geopolitical)	+ (?)
African countries' support in UN General Assembly	+ (geopolitical)	0

[a]Plus ("+") and minus ("–") refer to the signs of the corresponding parameters in the regressions of the probability of lending on the respective indicators for the motives ("++", "–": Motive is more important for China) while "0" indicates no systematic association. "Other" motives may include unobserved economic or geopolitical motives, or development assistance.

Source: Bode (2024).

In addition to the national economic interests pursued by the Chinese government, Chinese sovereign lending is likely shaped by the commercial interests of the Chinese state-owned banks that extend and administer the lion's share of the Chinese sovereign loans. These banks, which include the Export-Import Bank of China (China Eximbank), the China Development Bank and the Industrial and Commercial Bank of China, are committed to supporting not only the government in its overall political and economic goals, including its "going global" strategy and its Belt and Road Initiative. They are also committed to the institutional framework of China's financial system, which requires them to act like commercial banks (Chen 2023). These banks' commercial interests are probably another reason for the facts that China lent disproportionately to African countries with richer resources, higher willingness to pay for credit and lower risk of default, and that a significant fraction of these loans is collateralized, mainly by resources, which is uncommon among official creditors (Malik et al. 2021, Dreher et al. 2022, Mihalyi and Trebesch 2023).

4 INSUFFICIENT DEBT SETTLEMENTS UNDER THE COMMON FRAMEWORK THREATEN ECONOMIC RECOVERY OF FINANCIALLY DISTRESSED AFRICAN COUNTRIES

Recent settlements under the CF have been less generous than past settlements with the Paris Club alone, as the restructuring agreement with Zambia in June 2023 exemplifies.[5] This agreement differs in important respects from former Paris Club practice. China insisted on exempting part of its financial claims on Zambia from the negotiations by classifying them as commercial debt, appointed the China Eximbank rather than a government official to represent it in the official creditor committee that negotiated the debt restructuring, opposed a significant haircut, requested a revision clause that will reduce the present value reduction in the future if Zambia’s debt-carrying capacity improves disproportionately, and requested that the restructuring agreement will not be implemented until Zambia reaches a comparable agreement with private creditors.

China is obviously not willing to sacrifice its national economic or its banks’ commercial interests, or just accept established Western rules and procedures. Especially China’s refusal to accept significant haircuts is an obstacle to rapid economic recovery of the debtor countries. Empirical evidence suggests that principal value reduction improves debtor countries’ prospects for economic growth and poverty reduction after default more than mere coupon reductions and maturity extensions like those granted under the CF (e.g., Reinhart and Trebesch 2016, Cheng et al. 2018, Bon et al. 2020). According to Chen (2023), the Chinese lenders’ preference for debt restructuring and against haircuts is also deeply rooted in the institutional framework of China’s financial system. “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” (Chen 2023: 1770).

In addition to this, the deep mutual distrust between China and the Western countries, further fueled by rising geopolitical tension between them, complicates and slows down negotiations on official debt restructuring. A further complication arises from the increasing heterogeneity of creditors and financing instruments, which are becoming increasingly difficult to reconcile (e.g., AfDB 2021). Defaulted African countries will likely remain highly indebted for a prolonged period of time and face greater obstacles to restoring their economic prosperity as a consequence. Analysts argue that the lending and default management by China resembles that by Western commercial banks during the 1970s and 1980s, which ultimately proved unsustainable but left defaulted countries in severe economic and social distress for almost a decade (e.g., Economist 2017, Horn et al. 2023b, Chen 2023).

[5] See MoFNP (2023), Paris Club (2023), Cotterill et al. (2023), Do Rosario and Savage (2023), Fitch (2023) and Tran (2023) for more details.

5 THERE IS SCOPE FOR IMPROVING THE COMMON FRAMEWORK BUT THIS WILL TAKE TIME

Various proposals for improving global default management that may mitigate the negative consequences for low-income countries have been discussed in the literature (e.g., AfDB 2021, Eickhoff and Thiele 2023, Chowdhury and Sundaram 2023). Most analysts agree in that the CF does not yet yield satisfactory outcomes but can gradually be improved and refined by continuous joint efforts in search for compromises and confidence-building measures, e.g., at the Global Sovereign Debt Roundtable. As yet, China is not willing to accept established Paris Club debt resolution mechanisms, and the Western countries are not willing to give them up. China is not willing to bear the substantial financial losses of far-reaching debt relief, and no party is willing to pay for another party's losses. However, China might be willing to trade-off its economic interests against more fundamental changes of the established Paris Club rules. Better integrating commercial creditors, the Global South, or multilateral organizations may help in finding solutions that reduce individual stakeholders' fears of unfair treatment and unequal burden sharing (e.g., Karaki 2023). Additional financial vehicles, including those that proved useful in past debt crises, may expand the toolbox of solutions considered acceptable by the individual stakeholders (e.g., AfDB 2021). And immediate implementation of an agreement of a debtor with a subset of creditors may reduce the debtors' economic costs of the restructuring. For example, Buchheit and Gulati (2023) propose sort of a "most favored nation" clause in early agreements under the CF, i.e., a binding and enforceable provision that commits the debtor country to adjust the terms of this agreement, if later agreements provide other creditors more favorable terms.

One should be careful to not spill the baby with the bath, however. Cooperation between China and the Western countries in global default management will likely be superior to confrontational solutions. Proposals like that by Henning (2023) may be counterproductive on this backdrop. With an eye on China's state-owned banks, Henning proposes that the CF, supported by the IMF, commits debtor countries to punish official holdout creditors by halting all interest and principal payments to them until they agree on restructuring their claims on comparable terms. By official holdout creditors he means those who either refuse to participate in the negotiations under the CF at all, or reject an agreement reached by the majority of the creditor committee. Henning expects that this punishment will increase incentives to participate in the negotiations and will speed up the restructuring process. An agreement reached by the majority can be implemented immediately on the understanding that the holdout creditors will eventually join this—or conclude a comparable—agreement. However, apart from the problem of enforcing the sanctions against holdouts, which Henning (2023) recognizes, this proposal will be either ineffective or may kill the CF. China will likely not agree to the Western countries' request to classify all Chinese state-owned banks as official creditors. As in the negotiations with Zambia, it is likely to insist on at least some of these banks being classified as commercial creditors, to be treated as private creditors, and will not agree to stop servicing the debt owed to these banks.

Gradual improvements and refinements of the CF will take time, however, which will be at the expense of the defaulted debtor countries. They will likely remain highly indebted and will face greater obstacles to rapid and sustainable economic and social recovery.

6 IN THE MEANWHILE, WESTERN COUNTRIES COULD TRANSFER THEIR "CONSUMER SURPLUS" FROM CF AGREEMENTS TO THEIR AFRICAN DEBTORS TO MITIGATE THE NEGATIVE CONSEQUENCES OF INSUFFICIENT GLOBAL DEFAULT MANAGEMENT

Western countries, which are less constrained by own economic or commercial interests than China, could provide some additional support for the African countries that concluded debt restructuring agreements under the CF. If China were not an important creditor, the Paris Club alone would be willing to offer debtors more generous debt relief, as it did in the past. The Western countries therefore suffer lower financial losses from debt restructuring under the CF than they would without China.

The difference between the (hypothetical) maximum net present value reduction they would be ready to grant without China and the actual net present value reduction under the CF including China can be thought of as a kind of consumer surplus of the Western creditors—at least in a short-run perspective.[6] Western creditors might consider passing this surplus on to the debtors on a voluntary basis, e.g., as additional Official Development Assistance (ODA). The Western donors should take precautions to prevent this fresh money from ultimately ending up in the pockets of the Chinese or private creditors, however. If other creditors or the debtor countries anticipated such extra donations in debt restructuring negotiations, they might go for even less concessional settlements. This largely precludes providing this ODA as direct budgetary transfers that merely grant the debtor countries additional fiscal leeway. But it does not preclude conditional ODA in terms of donations for humanitarian projects that mitigate the adverse effects of the sovereign default on the people, or for investments into climate projects. The latter could even be earmarked as the donor country's contribution to meeting its previous commitments like those under the Paris Agreement. It could also include debt for climate swaps.[7]

[6] This surplus may well turn into a loss, though, if the debt settlement turns out to be not sustainable.

[7] See Grigoryan et al. (2021), Simmons et al. (2021), Yue and Nedopil Wang (2021), or Canuto et al. (2023), among others. While debt for climate swaps have also been proposed as a promising vehicle for restructuring the debt of defaulted countries, Chamon et al. (2022) show that they will in most cases not be an economically efficient tool for this purpose. Simply speaking, the gains from debt relief are needed to restore debt sustainability and are thus unavailable for climate investments. They may be more efficient only if the two goals strongly complement each other, which may be the case if climate action significantly reduces the debtors' sovereign risk or enhances their growth potential, for example (e.g., Steele and Patel 2020, Thomas and Theokritoff 2021, Volz et al. 2021).

This concessional ODA will not reduce the principal value of the debts or the debtor countries' tight fiscal constraints. In addition to this, the amounts of these additional ODA will be limited. Western countries frequently account for a rather small share of the defaulted countries' overall debt (see Figure 1). Zambia, for example, owes only 17% of its foreign debt currently in default to Western countries. Still, extra grants that amount to the equivalent of some 10% or 20% of the net present value of the debt owed to the Western countries will help in meeting at least some of the debtors' basic needs, if invested wisely.

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Phone +49 (431) 8814-1
Email info@ifw-kiel.de

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