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China's role in sovereign debt restructuring

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Abstract

As the world's largest bilateral lender to low- and middle-income countries (LMICs), China faces challenges dealing with some sovereign borrowers in debt distress under the Belt and Road Initiative (BRI). The current global sovereign debt landscape suggests that the fundamental challenge of sovereign debt restructuring in the developing world is not China, but rather how to equitably address unsustainable debt owed to multiple categories of creditors. Nonetheless, by offering early-stage debt relief, China can alleviate the burden on borrowers who disproportionately owe significant debt to China and prevent trapping itself in unpaid debts. China's policy decision will determine whether it can avoid the same mistake that Western creditors made of eventually losing all financial claims on many debt-distressed, heavily indebted poor countries (HIPCs) by the mid-2000s. Furthermore, a considerate approach by China is key to achieving the dual goals of mitigating LMICs' debt distress and vulnerabilities to climate change by applying a climate-centered approach toward sustainable socio-economic development. China can contribute to creating better global debt governance, which should go hand in hand with global environmental governance and have critical economic, political, and social implications.

Keywords Belt and Road Initiative (BRI) · China · Debt restructuring · HIPCs · Paris Club · Sovereign debt

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1 Introduction

As the world's largest bilateral lender,[1] China faces challenges dealing with some sovereign borrowers in debt distress under the Belt and Road Initiative (BRI). China owns $181 billion of $6.2 trillion of the total external debt owed by low- and middle-income countries (LMICs)[2] at the end of 2022 (World Bank 2023). Among low-income countries (LICs),[3] nine countries[4] are assessed as being in debt distress,[5] and 25 countries with a high risk of debt distress as of April 2024 (International Monetary Fund (IMF) 2024). Out of the nine debt-distressed countries, Lao P.D.R., Zimbabwe, the Republic of Congo, and Zambia owe a disproportionately large share of their public and publicly guaranteed (PPG) debt to China of 51%, 43%, 27%, and 24%, respectively at the end of 2022 (World Bank 2023). Among middle-income countries, Sri Lanka, a lower-middle-income country in a deep debt crisis, owes 16% of its PPG debt to China (World Bank 2023).

Against this background, China's BRI provoked criticism with an unfounded "debt-trap diplomacy" narrative from parts of the Western world. Although increasing research has evidenced such a narrative as a myth (Brautigam 2020; Acker et al. 2020; Jones and Hameiri 2020), the critical tones against China persist, explicitly or implicitly, in certain policy circles and the media (White House 2023; Ministry of Foreign Affairs (MOFA), Japan 2023; Chellaney 2023; Zhou 2024). Brautigam (2020) characterizes the Chinese debt-trap diplomacy narrative as a meme spreading out of a "negativity bias" based on fear, especially in the United States, about China's possible global dominance. Council on Foreign Relations (CFR) (2021) warns the U.S. diplomatic circles that "BRI has filled a void left by the United States and its allies" and stresses "how essential it is that the United States reassert its leadership."

Despite the rhetoric of the BRI, China's lending spree has been driven by economic motivation rather than geopolitical goals. Jones and Hameiri (2020, 6) interpret the BRI's true intention as an approach to stimulate "external demand for Chinese goods, services and capital" and characterize it as "externalizing domestic problems" of overcapacities, diminishing returns, and excessive indebtedness. Furthermore, at a micro level, the BRI's early stage was driven by the commercial motives of actors in China with unfavorable domestic business prospects. This

[1] Custer et al. (2023) provide a dataset to demonstrate China as "the single largest source of international development finance in the world" (Parks et al. 2023, 7).

[2] Low- and middle-income countries comprise low-, lower-middle, and upper-middle-income countries the World Bank Group assigns to the world's economies based on the Gross National Income (GNI) per capita.

[3] Low-income countries are defined here as those eligible for concessional financing from the International Monetary Fund (IMF) under its Poverty Reduction and Growth Trust (PRGT). The PRGT is the IMF's primary vehicle for providing interest-free loans to low-income countries and is funded by loan and subsidy resources from some member countries.

[4] The nine debt-distressed countries are the Republic of Congo, Ghana, Grenada, Lao P.D.R., Malawi, São Tomé and Príncipe, Sudan, Zambia, and Zimbabwe.

[5] "Debt distress" means the debtor is unable to meet its financial obligations and must resort to debt restructuring.

created problems for both recipient countries and China as lending grew rapidly. China's fragmented governance regime vis-à-vis the BRI[6] may have resulted in a lack of coordination and caused project failure in some cases. It turned out to be a "lending trap for China," as coined by Brautigam (2020, 8), and it can be characterized as a double-edged debt trap for both lenders and borrowers (Nishizawa 2023).

History tells us that economic logic eventually overrides geopolitical and commercial motives. Here, "economic logic" refers to the market forces of supply and demand that either drive or collapse economic activities by individual actors, while "commercial motives" are the driving factors that push commercial actors to maximize their profits. The cost of failed policy and commercial attempts will ultimately fall on someone's shoulders.

Borrowing enables a state or commercial actor to increase its possession of various resources beyond its current holdings to help generate future value, income, and wealth. However, overborrowing and excessive indebtedness tend to occur in a state of euphoria for future wealth, creating a bubble that ends with a bust. Reinhart and Rogoff (2009, 15) warn us in describing "eight centuries of financial folly" that human nature does not change and repeats the same mistake by believing "financial crises are things that happen to other people in other countries at other times; crises do not happen to us, here and now." Such human nature leads to what they call the this-time-is-different syndrome. China's lending spree at the early stages of the BRI may be indicative of euphoria on the lender and borrower fronts. One question that arises is why the BRI's intention to externalize domestic problems resulted in the same excessive indebtedness outside of China. In sum, debt overhang is a channel to make "countries vulnerable to abrupt changes in market sentiment, jeopardizing both stability and growth" (IMF 2022, 2). Therefore, ensuring debt sustainability and adhering to economic logic is crucial.

The Chinese government recognized the adverse outcomes of overlending and scaled down BRI lending commitments since 2017 (Wooley 2023; World Bank 2023, 23). It changed its course of action by allowing bailouts to debt-distressed BRI borrowers. Moreover, China has shifted the sectoral composition of its lending portfolio abroad from large-scale infrastructure projects to emergency rescue lending and suspended or canceled an increasing number of infrastructure projects in recent years (Parks et al. 2023, 14 and 21).

Another exposition can be, as Clark (2023) speculates, that the decline of new BRI projects since 2017 was due to Chinese contractors' realization of their limited capacity to successfully carry out massive infrastructure projects and the increasing difficulty in finding willing host country partners. Such an interpretation aligns with a hypothesis to consider commercial motives as driving forces behind the BRI.

[6] Principal actors include the Communist Party of China (CPC), National Development and Reform Commission (NDRC), Ministry of Foreign Affairs (MOFA), Ministry of Commerce (MOFCOM), Ministry of Finance (MOF), State-owned Assets Supervision and Administration Commission (SASAC), China Development Bank (CDB), Export–Import Bank of China (CEXIM), China Export & Credit Insurance Corporation (SINOSURE), and state-owned enterprises (SOEs) such as China Railway Engineering Corporation (CRECG). Brautigam and Huang (2023) name the nature of Chinese bureaucratic politics as "fragmented authoritarianism"

Regardless, the challenge was a sizeable unsustainable debt stock accumulated due to aggressive lending over the years, requiring debt restructuring.

Even with China's efforts, the effectiveness of its bailout approach is questionable because Chinese lenders typically only seek to prevent immediate default through payment deferral or new money provision (Acker et al. 2020; Horn et al. 2023). China also provides liquidity through bilateral swap arrangements between the People's Bank of China (PBOC) and debtor countries' central banks (Horn et al. 2023). This remedial approach, without substantial debt restructuring, addresses the short-term liquidity shortage but does not resolve the underlying solvency issue. The level of liquidity, or typically of available foreign exchange reserves, indicates the sovereign borrower's ability to access funds to honor its debt obligations. Solvency refers to the sovereign borrower's ability to meet all its current and future financial obligations. Chen (2023, 1772) quotes a policy bank official's perception describing "the current global indebtedness as 'essentially a problem of liquidity'," implying the nature of China's bailout efforts. China's approach parallels that of Western creditors, who also procrastinated before adopting debt forgiveness for many heavily indebted poor countries (HIPCs)[7] in the 1990s. The outstanding debt stock remains high or even increases with payment deferral, capitalized arrears, and new money, and puts debt sustainability at risk.

This paper presents the rationale for China's early-stage debt relief action for debt-distressed sovereign borrowers owing disproportionately a large share of their debt to China under the BRI. An early-stage debt relief, if implemented, addresses the debtor's insolvency, and prevents China from trapping itself in unpaid debts. China can learn a lesson from the mistakes made by Western creditors who eventually lost all financial claims on many debt-distressed HIPCs by the mid-2000s. Following the introduction, section two gives an overview of the status of China and other actors in the global debt landscape and touches on the rationale for debt relief. Section three illustrates the debt relief history over the past decades led by the Paris Club and the evolution of Paris Club debt restructuring toward the Initiative for the Heavily Indebted Poor Countries (HIPC Initiative) and Multilateral Debt Relief Initiative (MDRI). Section four identifies the salient features of the recent sovereign debt restructuring and suggests a connection with climate challenges, followed by a description of China's policy stance on LMICs' debt distress in section five. The last section concludes the paper with policy options for China to contribute to creating better global debt governance hand in hand with global environmental governance because both have critical economic, political, and social implications.

[7] Initially, a group of 41 developing countries was named HIPCs for analytical purposes in 1996, but the country coverage has changed while implementing the assistance. Thirty-nine countries are qualified for, eligible, or potentially eligible and may wish to receive the assistance as of January 2023 (International Monetary Fund (IMF) (2024)).

2 The rationale for debt relief in the changing global debt landscape

2.1 China and other actors in the global debt landscape

Even before China emerged as the world's largest bilateral lender to LMICs, the global debt landscape had changed dramatically over the past two decades. At the end of 2000, LMICs' outstanding PPG debt amounted to $1.2 trillion, with the official creditors' claims of $730 billion (60% of the total) and the private creditors' of $481 billion (40%) (Table 1). The shares of the official and private creditors reversed to $1.3 trillion (38%) and $2.1 trillion (62%) by the end of 2022 (World Bank 2023). Concurrently, private nonguaranteed (PNG) debt owed by LMICs expanded from $461 billion to $2.8 trillion. The growing presence of private creditors is a result of abundant liquidity in the global financial markets since the aftermath of the 2008 Global Financial Crisis. This liquidity has allowed LMICs to expand their market-based financing by issuing bonds or borrowing from commercial banks on favorable terms.

Furthermore, the composition of official creditors' claims with LMIC's PPG debt has changed remarkably. Claims made by bilateral creditors' remained at $464 billion at the end of 2022, not far above $416 billion at the end of 2000, while multilaterals' claims more than doubled from $315 billion to $860 billion during the same period. China's claims in LMIC's PPG debt among bilateral creditors was negligible at $6 billion at the end of 2000 but expanded to $149 billion at the end of 2022 (World Bank 2023).

The creditor composition varies from country to country. Despite China's emergence, the global debt landscape suggests that the fundamental challenge of sovereign debt restructuring in the developing world is not China, but rather finding a fair solution to the issue of unsustainable debt owed to multiple categories of creditors. Nevertheless, the larger the share of any particular creditor, the more dominant the impact of such a creditor in the debt restructuring process to ensure debt sustainability.

Understanding the composition of claims to a debtor is critical for successfully restructuring debt when it becomes unsustainable. For example, according to the World Bank (2023), at the end of 2022, Malawi owes 86% of its PPG debt to multilateral creditors and only 8% to China, while Lao P.D.R. owes 51% to China alone (Table 2). Trapped in debt, Sri Lanka owes 32% to international bondholders, 29% to multilaterals, and 16% to China. Jones and Hameiri (2020, 13) conclude, "Sri Lanka's debt distress was unconnected to Chinese lending, arising instead from excessive borrowing on Western-dominated capital markets." The excessive borrowing and reliance on a single source of external finance raises serious concerns for the debtor.

An increasing tendency in the Western world, similar to the commercial orientation of Chinese lenders, to promote market-based borrowing by LMICs for geopolitical motives is a matter of concern because it can contradict debt sustainability.

Parks et al. (2023, 12) point out that "Washington is seeking to compete with Beijing via emulation rather than differentiation." Other official flows (OOF),[8] or non-concessional official financial flows, from the United States soared to $21.8 billion in 2021 from $1.4 billion in 2020 due to expanded activities of the U.S. International Development Finance Corporation (DFC). Parks et al. (2023, 14–15) suggest, "the U.S. and its allies … ramping up non-concessional lending (OOF)" suggests the Western nations are trying to "compete with a version of BRI (BRI 1.0) that no longer exists."[9]

Another concern is the so-called vulture fund. A vulture fund is a hedge fund that purchases marketable securities in distress available at a significant discount. The fund takes advantage of court rulings and negotiates with the debtor to recover the full payment to earn a substantial financial return. This business model can risk orderly debt relief efforts and threaten global debt governance. Parkin and Cotterill (2024) report the case of an attempt by Hamilton Reserve Bank, a non-member of the bondholder committee for Sri Lanka, to seek immediate payment of about $250 million through a lawsuit in the United States against Sri Lanka.

2.2 The rationale for debt relief

Debt involves a contract between the debtor and the creditor to share future net gains over the debt stock, which is exposed to uncertainties and risks. The balance sheet concept elucidates risks involved in debt by shedding light on the asymmetric nature of assets and liabilities. Based on the fundamental equation to show "assets equal liabilities plus owner's equity," the balance sheet is an accounting system used to track and record what you owe and what you own over time. If viewed side-by-side, the debtor and creditor balance sheets illustrate debtor-creditor interdependence, implying the two-sided nature of debt. Unless the debtor has the capacity to create value by effectively utilizing its assets, the creditor may not be able to get paid.

Balance sheets have asymmetricity. Liabilities entail pre-determined debtor obligations. Assets are exposed to uncertainties with various downside risks, and investment returns are not assured. As the economic logic of diminishing marginal returns suggests, they can lessen as the assets grow. In the case of a sovereign state, the tax collection authority may be considered an intangible asset on its balance sheet, but utilizing it is not easy politically, particularly during challenging periods.

[8] Organisation for Economic Co-operation and Development (OECD) (2024) defines OOF as "official sector transactions that do not meet official development assistance (ODA) criteria," which include "grants to developing countries for representational or essentially commercial purposes; official bilateral transactions intended to promote development, but having a grant element of less than 25%; and, official bilateral transactions, whatever their grant element, that are primarily export-facilitating in purpose".

[9] Since the second Belt and Road Forum (BRF) in April 2019 hosted by the Chinese government, the term "BRI 2.0" has been used as a symbolic term for China's pledging for reform (Rana and Ji 2019) and its pursuit of international legitimacy and credibility (Cao 2019). Christine Lagarde, the then IMF Managing Director, used the term BRI 2.0 as "Stronger Frameworks in the New Phase of Belt and Road" (Lagarde 2019).

Table 1 LMICs' debt outstanding by creditor category (billions of U.S. dollars). *International Debt Report* 2023

	2000	2010	2019	2020	2021	2022
Public and publicly guaranteed debt	1211	1565	3139	3371	3489	3448
Official creditors	730	822	1142	1257	1285	1324
Multilateral	315	467	694	779	811	860
Bilateral	416	355	448	478	473	464
o/w: China	6	36	144	150	155	149
Private creditors	481	743	1996	2115	2205	2123
Bondholders	299	462	1513	1632	1706	1626
Commercial banks and others	181	281	483	482	498	498
o/w: China	1	6	31	32	33	32
Private nonguaranteed debt	461	1457	2809	2906	2937	2760
Bondholders	75	210	573	676	694	618
Commercial banks and others	386	1248	2236	2230	2243	2142
Total	1672	3022	5947	6278	6427	6207

Source: World Bank (2023)

The debtor and creditor must agree to share the loss when a borrowed and invested fund does not generate a sufficient return to cover interest costs or falls short of the debt stock. The original contract represents a promise for the debtor to pay the principal and interest fully on time. Nevertheless, if the debtor is unable to pay, the creditor either gives up some of the claims agreed upon in the original contract or remains in limbo with unpaid debt.

A restructuring negotiation with creditors is the only orderly remedy for sovereign debtors to restore debt sustainability. For the private debtor, bankruptcy can be an option, but the sovereign debtor is not subject to the bankruptcy code.[10] Sovereign states do not go bankrupt. A concept close to "going out of business" for a private corporation is a "failed state." This term refers to a state that has lost its governing capacity and cannot perform the fundamental functions of the sovereign state. However, even if a sovereign state becomes dysfunctional, it continues to exist. Unlike corporations, a sovereign state in our present era does not cease to exist.[11] The sovereign debtor and creditors remain equally trapped in distressed debt until both sides agree to debt restructuring terms.

[10] The IMF proposed a statutory sovereign debt restructuring mechanism (SDRM) as "international legal protection for bankrupt sovereign" in 2002 but failed to gain support from borrower and creditor ends (Setser 2010).

[11] A state may be extinguished, but state succession ensues to replace its sovereignty with that of one or more successor states, as was the case with the Union of Soviet Socialist Republics (USSR).

Table 2 PPG debt creditor composition of the nine debt-distressed LICs at the end of 2022 (%). *International Debt Report* 2023

	Official creditors			Private creditors		
	Multilateral	Bilateral	o/w: China	Bondholders	Commercial banks and others	o/w: China
Congo, the Republic of	18	38	27	3	41	–
Ghana	30	12	6	45	13	–
Grenada	68	17	4	15	0	–
Lao P.D.R	18	66	51	11	5	–
Malawi	86	14	8	–	–	–
São Tomé and Príncipe	25	72	–	–	3	–
Sudan	22	49	6	0	29	–
Zambia	25	31	24	18	26	–
Zimbabwe	25	67	43	–	8	–
Cf. Sri Lanka	29	31	16	32	8	–

Sources: IMF (2024); World Bank (2023)

3 Debt relief history over the past decades

3.1 Paris Club debt restructuring in the global context

The Paris Club has been an informal yet established forum of 22 permanent members[12] of mostly advanced Western nations since 1956 to find coordinated resolutions with inter-creditor equity to debtor countries' payment difficulties (Paris Club 2024). Debtor countries in need of debt relief can request Paris Club members to discuss a debt restructuring, with the condition that debtor countries have an IMF-supported program committed to restoring their economic and financial soundness. To ensure inter-creditor equity, safeguard the agreed debt relief terms, and address the heterogeneity of debtors, Paris Club creditors follow the six core principles: solidarity, consensus, information sharing, comparability of treatment, conditionality, and case-by-case approach (Paris Club 2024). Debt restructuring involves interaction between creditors and a debtor, as well as between various creditors seeking inter-creditor equity.

The number of debt treatments under the Paris Club increased in the 1980s due to debt accumulation amid the so-called "petrodollar recycling" boom in the late 1970s. The petrodollars, a large surplus of crude oil trade denominated in dollars by oil exporting countries, became available for developed countries to finance the budget deficits without raising borrowing costs in the post-1973 period. The

[12] The Paris Club's 22 permanent members are Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Ireland, Israel, Italy, Japan, Netherlands, Norway, Russian Federation, Korea, Spain, Sweden, Switzerland, United Kingdom, and United States.

availability of petrodollars also enabled international money-center banks[13] in developed countries to channel funds back to developed and developing countries that were not oil-exporting countries. Developing countries benefitted from petrodollar recycling after 1973, but eventually faced excessive indebtedness, resulting in subsequent sovereign debt crises. By the mid-1970s, commercial bank lending outstripped bilateral and multilateral official financing due to the boom in petrodollar recycling (Eichengreen et al. 2021, 141–142).

The consequence of the rising trend of global debt became observable when the Mexican government announced its inability to service its debt to commercial banks in August 1982, followed by similar announcements made by other Latin American countries. This incident is known as the "Latin American debt crisis," also called "the Lost Decade." The borrowing countries were in debt distress, and commercial banks also suffered from the inability of their clients to service their debt. As commercial banks accumulated non-performing loans, the banking system faced a possible dysfunction or collapse, called a systemic risk. This negative feedback loop implies an interdependence between debtors and creditors—lending and borrowing are two sides of the same coin.

Following short-term remedial measures led by the U.S. government and the IMF, troubled Latin American countries under the IMF-supported program gained concessions of delayed debt repayment from creditor banks as a precondition for the IMF's financial support. The ensuing event was what Eichengreen et al. (2021, 145) coin "extend and pretend," which means "extend the duration and capitalize arrears in the hope that the loans might somehow, someday, be repaid." To operationalize this approach, regulatory forbearance was granted to allow banks to avoid acknowledging losses, new money was encouraged, and structural reforms in troubled countries' end were emphasized (Eichengreen et al. 2021, 145).

However, this approach launched in 1985, known as the Baker Plan, named after former U.S. Treasury Secretary James Baker, faced tough obstacles on multiple fronts. The limited progress eventually reminded policymakers and bankers that the real challenge was solvency rather than liquidity before the creditor banks "set aside loan-loss provisions for half their LDC[14] exposure" (Eichengreen et al. 2021, 146). By 1987, "commercial banks started to announce large provisions against losses," which led to the next stage of market-based private creditors' debt restructuring (Daseking and Powell 1999, 8). Concurrently, the Latin American debt crisis coincided with a turning point in the Paris Club's engagement, where an increasing number of multiple debt relief agreements were made for troubled countries, mainly in Latin America and Sub-Saharan Africa (Paris Club 2024).[15]

Unaccomplished goals under the Baker Plan paved the way for the Brady Plan, named after another former U.S. Treasury Secretary Nicholas Brady, which aimed to break the debt impasse by removing nonperforming loans from the balance

[13] A money center bank is a type of bank mobilizing fund from money markets rather than deposits and engaging in international banking business to hold large-scale cross-border assets.

[14] Less-developed countries.

[15] A series of debt crises began in Latin America and spread worldwide until finally subsiding in the late 1990s.

sheets of creditors and debtors. Its approach was to combine the use of funds mainly from the IMF and the World Bank with a market-based debt reduction. The heavily indebted sovereigns typically used loans from the official lenders as collateral in exchanging their existing bank loans for "discounted bonds" worth less than the original face value in the secondary market. Incidentally, according to Chen (2023, 1773–1774), Chinese researchers propose a mechanism similar to the Brady Plan for market-based debt-to-bond conversions to address the ongoing debt distress in the developing world in the context of renminbi internationalization.

Policy efforts to reduce crisis-hit countries' debt burden by converting commercial bank loans into marketable debt securities or "bonds" enabled the restoration of indebted countries' market access. At the same time, the decade-long debt crisis in developing countries since the 1980s ended with a precondition for the next stage of debt accumulation through bond issuance in international capital markets.

Another debt crisis episode was with LICs. Newly independent nation-states, mainly in Africa, also accumulated debt since the 1960s and requested debt relief after becoming debt-distressed. During the era of debt crises, Paris Club creditors addressed the unimproved debt servicing prospects on a case-by-case basis since the 1970s. The Paris Club agreed on a debt treatment with Zaire (now the Democratic Republic of Congo) in 1976 as a first-time African debtor, followed by Sierra Leone, Togo, Sudan, and Liberia for debt treatments (Paris Club 2024). A group of world-poorest countries without access to commercial bank lending, mainly in Africa, relied on bilateral and multilateral official financing in the 1980s. As the poorest indebted countries faced difficulties servicing their debt, Paris Club members introduced various debt treatment terms in debtor countries' favor, including debt cancellation in 1988 and debt stock reduction in the 1990s.

3.2 Toward the HIPC Initiative and MDRI

Paris Club debt restructuring evolves progressively under the treatment categories with an increased degree of concessionality[16] in debtor countries' favor. The classic terms represent the standard debt treatment for any country needing debt relief with an IMF-supported program. Official development assistance (ODA) and non-ODA debts are rescheduled at the "appropriate market rate," and repayment periods are agreed upon on a case-by-case basis. The Paris Club first applied non-classic terms called "Houston terms" in 1990 for Morocco as a debt treatment for highly indebted lower-middle income countries with three enhanced features to the classic terms. With the Houston terms, both ODA and non-ODA debts are offered a longer repayment period and ODA debts can gain net present value debt reduction[17] by applying

[16] In the context of debt relief, Paris Club (2024) defines concessionality as achieved "either through cancellation of part of the claims or through rescheduling of the claims over a long period with an interest rate lower than the appropriate market rate. When a debt treatment reduces the net present value of the claims rescheduled, it includes concessionality".

[17] "The net present value (NPV) of debt is defined as the sum of all future debt-service obligations (interest and principal) on existing debt, discounted at the appropriate market rate. Whenever the interest rate on a loan is lower than the market rate, the resulting NPV of debt is lower than its face value." (Paris Club 2024).

the original concessional interest rate to rescheduled debt. The Houston terms also allowed the possibility for creditor countries to conduct a bilateral and voluntary debt swap[18] with the debtor country.

Before the Houston terms, the poorest countries gained from a treatment called "Toronto terms," introduced in 1988 with a debt reduction feature of 33.33% for the first time in Paris Club history. Non-ODA creditors were allowed to choose one of the three options, namely, "debt reduction option," "debt service reduction option," and "commercial option." ODA credits were treated with net present value debt reduction because the original concessional interest rate was applied to the rescheduled debt. In 1991, Paris Club creditors agreed to introduce another treatment called "London terms," with a higher debt cancellation of 50% to replace the Toronto terms. The London terms provided four options, namely "debt reduction option," "debt service reduction option," "moratorium interest capitalization option," and "commercial option." Paris Club agreements under the London terms onward, designed for the poorest countries, incorporated a provision that allowed creditors to voluntarily engage in debt swaps. These debt swaps could take various forms, such as debt-for-nature, debt-for-aid, debt-for-equity, or other local currency debt swaps.

Some low-income countries repeatedly requested Paris Club rescheduling, while multilateral development banks with the de facto preferred creditor status[19] provided program lending aimed at structural adjustment. As a result, a relative share of non-reschedulable multilateral debt rose. A relatively large share of non-reschedulable multilateral debt constrained the effectiveness of the Paris Club debt treatment. In 1994, the London terms were replaced by the "Naples terms" for HIPCs with two enhanced features of the level of debt cancellation up to 67% and stock treatment.[20]

Despite creditors' efforts to address low-income countries' debt problems by offering increasingly favorable terms, many of them continued to suffer heavy debt burdens in their pursuit of economic development. Paris Club creditors eventually realized protracted rescheduling was due to solvency, not liquidity, problems. This was no different from the Latin American debt crisis in the 1980s. Against this backdrop, the Interim Committee of the IMF's Board of Governors[21] and the Development Committee[22] endorsed the HIPC Initiative in 1996. The Initiative aims to

[18] A debt swap typically involves the debtor country directing debt services to finance domestic development projects or the creditor government selling debt claims to an investor, who in turn sells it to the debtor government in return for a local company's share or local currency to be used for domestic projects (Paris Club 2024).

[19] Preferred creditor status represents a market practice to keep sovereign debtors to service their debt obligations to multilateral development banks and the IMF even when debtors default on other claims, giving a de facto seniority to multilateral lenders.

[20] Paris Club has two approaches to its debt treatment. One is "flow treatment," which involves rescheduling debt service payments that fall due in an agreed-upon period ("consolidation period"). The other is "stock treatment," which deals with the entire debt stock at a given time.

[21] The Interim Committee was transformed into the International Monetary and Financial Committee of the Board of Governors (IMFC) in 1999.

[22] Formally, the Joint Ministerial Committee of the Boards of Governors of the Bank and Fund on the Transfer of Real Resources to Developing Countries is a ministerial forum of the World Bank Group and the IMF.

provide exceptional assistance to eligible countries in reducing their heavy debt burden to sustainable levels in stages as a coordinated action by official bilateral and multilateral creditors.

Paris Club creditors agreed in 1996 to raise the level of debt cancellation to 80% in the context of the HIPC Initiative by introducing the "Lyon terms," which was replaced by the "Cologne terms" in 1999 with debt cancellation of up to 90% or more. In 2005, G8 Heads of States proposed and put into action the MDRI as a debt relief initiative calling for the 100% cancellation of the claims of the IMF, the International Development Association (IDA) of the World Bank Group, and the African Development Fund (AfDF) on countries at or nearly at the completion point[23] under the enhanced HIPC Initiative.[24] The MDRI enabled a full cancelation of multilateral debt with the cost borne by the shareholders, even though multilateral creditors are conventionally granted the de facto preferred creditor status.

4 Sovereign debt restructuring in the changing global debt landscape

4.1 Salient features of the recent sovereign debt restructuring

The changing global debt landscape has been accompanied by several salient features in the recent sovereign debt restructuring of developing countries, compared to the earlier norms and practice.

LMICs owe three-fifths of their PPG debt to private creditors, such as bondholders and commercial banks, due to their growing access to market-based borrowing since the early 2010s. Bondholders own $1.6 trillion out of $2.1 trillion of LMICs' PPG debt owed to private creditors, followed by multiple lenders ($240 billion), and private creditors from the Netherlands ($74 billion), China ($32 billion), the United States ($28 billion), and the United Kingdom ($27 billion) at the end of 2022 (Table 3). Even with some LICs, private creditors dominate. Among the nine debt-distressed LICs, private creditors have the largest share of PPG debt, with Ghana at 58%, the Republic of Congo at 44%, and Zambia at 44% at the end of 2022 (Table 2).

Non-Paris Club creditors, most notably China, have emerged as major actors (Table 4). At the end of 2022, LMICs owed $149 billion, 32% of LMICs' total PPG debt to bilateral creditors, to China's official creditors alone. Among the top ten bilateral creditors, five are non-Paris Club member countries, and six are non-DAC[25] member countries.

[23] A point in time at which the country receives assistance under the HIPC Initiative without any further policy conditions.

[24] The original HIPC Initiative was strengthened in 1999 to provide faster, deeper, and broader debt relief for eligible countries.

[25] The Development Assistance Committee (DAC) is one of the Organisation for Economic Co-operation and Development (OECD) committees that deals with development cooperation matters. Thirty-two

Multilateral creditors' share in LMIC's PPG debt has remained around 25% whereas the bilateral creditors' share has declined from 34% to 13% over the past two decades. Among 25 LICs with a high risk of debt distress as of April 2024 (IMF 2024), 16 countries owe the largest share of their PPG debt to multilateral creditors. Malawi and Grenada, in debt distress, owe the largest share of PPG debt to multilateral creditors at 86% and 68%, respectively.

Reflecting the changing global debt landscape, debt relief is now being discussed and negotiated under international forums that have evolved from single-centered to multi-centered models. These forums have also witnessed broader participation, extending beyond Paris Club creditors. At the onset of the COVID-19 pandemic, Paris Club creditors and the G20 agreed to implement the Debt Service Suspension Initiative (DSSI),[26] which was followed by the G20 Common Framework for Debt Treatment beyond the Debt Service Suspension Initiative (Common Framework)[27] launched in November 2020.

The recent cases of multi-centered debt restructuring practice include Zambia and Sri Lanka. At the request of the government of Zambia in February 2021, 16 countries formed an official creditor committee (OCC) in June 2022. The OCC was co-chaired by China and France, with South Africa serving as the vice-chair, to discuss debt treatment under the Common Framework. The OCC had engaged Zambia, official bilateral creditors, the IMF, the World Bank, and bondholders to seek debt treatment terms consistent with the IMF-supported program. The agreement was reached in June (Paris Club 2023a) and formalized in October 2023, pending Zambia's good faith engagement with all its commercial external creditors for concluding restructuring agreements aligned with the comparability of treatment principle (Ministry of Finance and National Planning (MOFNP), 2023).

Following Sri Lanka's request for debt treatment, 17 countries formed an OCC in May 2023, co-chaired by France, India, and Japan. The OCC engaged with the Sri Lankan government, its members, the IMF, the World Bank, China, and private creditors. The OCC and Sri Lanka agreed on debt treatment terms consistent with the IMF-supported program (Paris Club 2023b). As early as January 2024, however, Parkin and Cotterill (2024) reported that the international bondholder committee complained about a lack of feedback from the Sri Lankan government and official creditors regarding the terms of the debt relief deal they agreed to. As of April 2024, the OCC needs to evaluate the comparability of treatment among various creditors

Footnote 25 (continued)

DAC members are Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Lithuania, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, the United Kingdom, the United States, and the European Union.

[26] The Debt Service Suspension Initiative (DSSI) is a G20 initiative launched in April 2020 to allow a time-bound suspension of debt service payments for the poorest countries (73 low- and lower-middle-income countries) that request the suspension in response to the COVID-19 pandemic (Paris Club 2020).

[27] The Common Framework aims to deal with the insolvency and protracted liquidity problems of LICs under an IMF-supported program to bring official creditors to provide debt relief consistent with the debtor's capacity and to require private creditors' participation on comparable terms to ensure fair burden-sharing (G20 and Paris Club 2020).

Table 3 LMICs' PPG debt stock owed to the top ten private creditors by origin† (billions of U.S. dollars). *International Debt Report* 2023

	2000	2010	2022
Bondholders	299	462	1626
Multiple lenders	77	167	240
Netherlands	2	4	74
China	1	6	32
United States	14	18	28
United Kingdom	12	13	27
Austria	3	7	12
France	12	13	11
Germany	18	15	11
Singapore	2	6	10
World	481	743	2123

Source: World Bank (2023)

† Public and publicly guaranteed debt stock owed to private creditors, such as bonds either publicly issued or privately placed, commercial bank loans from private banks and other private financial institutions, and other private credits from manufacturers, exporters, and other suppliers of goods, and bank credits covered by a guarantee of an export credit agency

Table 4 LMICs' PPG debt stock owed to the top bilateral creditors† (billions of U.S. dollars). *International Debt Report* 2023

	2000	2010	2022
China	6	36	149
Japan	125	144	112
France	29	25	36
Germany	32	28	30
Russian Federation	30	16	28
Saudi Arabia	3	4	16
Kuwait	6	7	12
India	0	3	12
United Arab Emirates	2	2	11
Korea, Republic of	2	4	9
Cf. United States	29	13	7
World	416	355	464

Source: World Bank (2023)

† Public and publicly guaranteed debt stock owed to bilateral creditors by low-and middle-income countries includes loans from governments and their agencies (including central banks), loans from autonomous bodies, and direct loans from official export credit agencies

and urge the Sri Lankan government to seek an agreement with private creditors on terms at least as favorable as the OCC's agreement.

The recent multi-centered debt restructuring practice remains unsuccessful in fully engaging private creditors, leaving a room for official creditors' debt relief efforts to bail out private creditors without their fair and equitable burden sharing. The comparability of treatment vis-à-vis private creditors relies on a good faith effort by sovereign debtors without any enforcing mechanism.

An attempt to rewrite a New York law that governs sovereign debt restructuring can be a step toward private creditors' fair burden sharing since "more than half of private creditor contracts are governed by New York State law" (Stiglitz et al. 2023). The bill submitted to the New York State Senate and Assembly is the Hoylman-Sigal/Fahy New York Taxpayer and International Debt Crises Protection Act to enable to "cap the amount investors could recover to what the US government would receive if it were a creditor to the same country, or allow debtors to submit their own restructuring plans through the New York legal system." (Duguid and Cotterill 2024).

4.2 Sovereign debt restructuring and climate challenges

The current debt distress was triggered by a series of challenges, such as the pandemic and regional conflicts, which hampered the effective utilization of fiscal resources to address such adversities. One long-term concern is the vicious cycle in which vulnerabilities to climate change prolong and exacerbate the existing debt distress. This could result in the "climate debt trap" (Alayza et al. 2023) and undermine efforts to address climate challenges and achieve sustainable socio-economic development.

Against this backdrop, Chamon et al. (2022) claim "Climate and debt problems are closely linked." and "debt-climate swaps can be useful instruments when the main constraint to climate investment is a lack of fiscal space." United Nations Development Programme (UNDP) (2023) considers "nature-positive debt reorganizations" by debt-for-nature swap-type instruments beneficial for LMICs facing the dual challenges of sovereign debt distress and environmental risk. On governance and technical fronts, however, many challenges exist, such as government capacity, selection of instruments, and transactional costs (Coenen et al. 2021; Bolton et al. 2023; Clifford Chance 2023) to introduce swap instruments.

5 China's policy stance

Some argue that the commercial motives of Chinese actors drove the lending spree under the BRI without strings attached (Jones and Hameiri 2020; Hameiri and Jones 2024), contrary to the prevailing assertion about China's coerciveness. The counterargument claims that "a non-strings-attached picture is too simplistic, even naïve." (Mattlin 2021, 29). Nevertheless, tangible economic benefits matter for both Chinese and host country actors. During one interview, former U.S. Treasury Secretary Laurence Summers once remarked, "somebody from a developing country said to me, 'what we get from China is an airport. What we get from the United States is

a lecture.'" (Summers 2023). Given the underperformance of certain BRI projects, it is possible that China's stakeholders acted with genuine commercial or phony motives.

Aside from commercial and economic benefits, both China and the host countries are pragmatic enough to understand the geopolitical implications of the BRI outcomes. China wants to avoid being burdened with failed projects and non-performing assets, which could potentially make it look like an unreliable partner to host countries. An example is Lao P.D.R., an ASEAN member in debt distress, with a half of its PPG debt owed to China. Nishizawa (2022) argues that "China-Laos ties symbolize its focus on the Asia Pacific region as opposed to the Free and Open Indo-Pacific, Washington's foreign policy framework" and "China has been enhancing its cooperation with ASEAN members, giving China another reason not to let Laos default." However, Laos' restructuring negotiation with China was not completed as of April 2024, while Ministry of Finance (MOF Lao P.D.R.) (2023) indicates that a large amount of debt service payments to China have been suspended or deferred since 2020, implying other creditors are free-riding on China's temporary debt relief actions to get paid. A gap exists with China's high-level strategic intensions and individual actors' modus operandi as a reflection of the "fragmented authoritarianism" in Chinese bureaucracy suggested by Brautigam and Huang (2023).

As a G20 member, China has agreed to the basic principles in the Common Framework, such as conducting joint creditors' negotiations "in an open and transparent matter" and comparability of treatment, which encourages "fair burden sharing among all official bilateral creditors and private creditors" (MOF China 2020). However, some critics of the Common Framework claim there needs to be more in common between China and other official creditors in financial terms for the framework to be effective (Setser 2023). Aligned with joint action and fair burden-sharing principles, China insists on multilateral creditors' participation in debt treatment and their mobilization of "new and additional concessional resources." (MOF China 2023).

China's frustration over the lack of fair burden sharing by multilateral and private creditors has been intensified, as "Chinese creditors contributed more than their share of suspensions" in the DSSI relief (Brautigam and Huang 2023). However, issues surrounding preferred creditor status as a market practice, which gives a de facto seniority to multilateral lenders, are not likely to be reconsidered and reach a consensus any time soon. Moreover, in substance, multilateral debt relief is inherently a burden sharing among the member states as shareholders. For example, the debt relief provided by the IMF under the MDRI was financed mainly through the IMF's resources and the MDRI-II Trust, which was made up of bilateral contributions provided to the Subsidy Account of the Poverty Reduction and Growth Facility (PRGF) Trust. The IMF's resources, though referred to as its own, come from member states mainly through their payment of quotas or through multilateral and bilateral borrowing arrangements to supplement quota funds.

Comparability of treatment vis-à-vis private creditors depends on a good faith effort by sovereign debtors without any enforcing mechanism. There may be a chance of a move toward a fair burden sharing by private creditors if New York

legislature passes the Hoylman-Sigal/Fahy New York Taxpayer and International Debt Crises Protection Act.

China has been offering bailouts to debt-distressed BRI borrowers while scaling down its lending. Nevertheless, its bailout approach typically seeks to prevent immediate default through payment suspension or deferral for low-income countries and new money for middle-income countries. This remedial approach without substantial debt restructuring, which mirrors Paris Club creditors' procrastination prior to adopting debt forgiveness in the 1990s, does not resolve the solvency problem faced by debt-distressed sovereign debtors with a disproportionately large share of debt owed to China.

The primary providers of China's development finance are the China International Development Cooperation Agency (CIDCA), the Export–Import Bank of China (CEXIM), the China Development Bank (CDB), and state-owned commercial banks, such as the Industrial and Commercial Bank of China (ICBC).[28] China has written off government-funded foreign aid loans provided by CIDCA and concessional loans by CEXIM, relatively small proportions of its overseas development finance. However, it has not extended the same debt forgiveness to self-funded lending by CDB, CEXIM, and other state-owned commercial banks (Chen 2020; Chen 2023, 1765–1766). Chen (2023, 1767) considers Chinese policy banks' aversion to debt reduction as "products of China's market-oriented financial reforms" dating back to the 1990s. Chen further argues that "Chinese policy banks continue to strongly resist debt reduction, much as the Western private banks did in the 1980s." The cancellation or forgiveness of debt stock is the least preferable option for Chinese policy banks because it would result in loan losses and the need for additional provisioning, which would negatively impact their financial health.

Brautigam and Huang (2023, 5) illustrate China's institutional characteristics in dealing with non-performing loans:

> In China, banks do not write down loans; they adjust the terms. Loan cancellations for foreign governments require approval from the State Council. Regulations and systems of compensation for foreign debt forgiveness do not exist.

Apart from the lenders' perspective, China's current economic and financial woes, which involve significant domestic debt distress (Keith 2023), may explain the government's reluctance toward debt relief and the transparent public communication of any such treatment. This reluctance stems out of fear of creating a moral hazard and being asked to allocate fiscal resources domestically. The government may have concerns about potential domestic backlash due to its preference for foreign borrowers over Chinese debt-distressed borrowers. Furthermore, China's insistence on multilateral creditors' debt relief and new money injection for fair burden-sharing may be a balancing act that reflects domestic political considerations.

[28] The CIDCA is a state organ, while the rest of the primary providers are state-owned financial institutions with a different degree of policy-orientedness. The CEXIM, as a "policy-oriented bank," provides both policy-oriented and commercially-oriented lending. In contrast, the CDB, as a "development-oriented bank," engages in both development-oriented and commercially oriented businesses (Chen 2021, 841–842).

Amid an increasingly popular discourse on climate action and growing concerns over the BRI's negative environmental impacts, China began to promote "eco-sustainability" as early as 2015 (Sun and Yu 2022). Aligned with the green BRI policy, its strategy toward "greening" the BRI has been communicated further since the second Belt and Road Forum in 2019 (State Council, The People's Republic of China 2021). President Xi Jinping announced "promoting green development"[29] as one of the eight major steps China will take to support the joint pursuit of high-quality BRI cooperation at the third Belt and Road Forum in October 2023 (State Council 2023; State Ministry of Foreign Affairs (MOFA), China 2023). However, Coenen et al. (2021, 13) ask "whether the country manages to further move its ambitions from words to action" and point out the importance of BRI partner countries' political willingness and governance capacity.

6 Conclusion: policy options for China

The effectiveness of debt diplomacy as a means for geoeconomics[30] is questionable due to the double-edged sword nature of debt. Here, economic logic eventually overrides geopolitical and commercial motives, but more than economic logic is needed to create a well-functioning global debt governance. Dealing with sovereign debt entails economic, political, and social consequences, requiring public policy and legitimacy consideration. In this light and facing climate challenges, global debt governance should go hand in hand with environmental governance. This is because both have significant economic, political, and social implications.

China has not learned the lessons from the Western creditors' mistakes in the 1980s to 1990s. They were reactive and failed to take early-stage action on necessary debt relief. China remains reluctant to take substantive debt relief measures, only offering payment suspensions or deferrals. As a consequence, China may need to eventually accept outright debt forgiveness, thereby relinquishing their claims to some debt-distressed borrowers. Economic logic takes precedence over other motives.

For now, a two-pronged approach should be a preferred option for China in dealing with sovereign borrowers in debt distress under the BRI.

For debt-distressed sovereign borrowers with a major share of their debt owing to China, it would be advisable for China to consider offering upfront debt treatment that includes substantive debt reduction in net present value terms, if a face-value debt cancellation is not a feasible option. Options include providing a grace period long enough to give debt-distressed sovereigns the breathing space they need for economic recovery and growth, extending maturities on favorable terms like concessional lending, and reduced interest rates.

[29] "China will continue to deepen cooperation in areas such as green infrastructure, green energy and green transportation, and step up support for the BRI International Green Development Coalition".

[30] Geoeconomics is defined as "the use of economic instruments to promote and defend national interests, and to produce beneficial geopolitical results" while taking account of "the effects of other nations' economic actions on a country's geopolitical goals" (Blackwill and Harris 2016, 20).

For debt-distressed sovereign borrowers with a major part of the debt owed to private or multilateral creditors, one option is a case-by-case approach in an international forum. This approach aims to secure comparability of treatment vis-à-vis private creditors and cautioning multilateral creditors against the level of new lending.

China should release itself at an early stage from the risk of being debt-trapped. Otherwise, it may make the same mistake that Western creditors made of eventually losing their financial claims on many debt-distressed HIPCs by the mid-2000s. A climate-centric approach such as a debt-for-climate swap is an additional option supplementary to the net-present-value debt relief, especially if China truly commits to promoting a green BRI.

China can avoid becoming a victim of the "double-edged debt trap" and "climate debt trap" while helping debt-distressed sovereigns from these traps by taking actions beyond the "discourse trap" (Brautigam and Huang 2023). Considerate actions made by China, the world's largest bilateral lender, especially to LMICs, are key to achieving the dual goals of mitigating LMICs' debt distress and vulnerabilities to climate change, thereby fostering sustainable socio-economic development.

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