

China's role as 'buyer of last resort' will complicate EM/FM Eurobond defaults

November 12, 2020

Despite the global focus on the drama of the US elections, China is quietly cementing its role as the dominant buyer of last resort for global emerging and frontier market bonds. This position will dramatically complicate any expected restricting of defaulting EM and FM bonds in 2021. In October G20 leaders held a global conference call where the participants agreed "to extend the DSSI [Debt Service Suspension Initiative for the Poorest Countries] by 6 months, and to examine by the time of the 2021 IMF/WBG Spring Meetings if the economic and financial situation requires to extend further the DSSI by another 6 months."

Beyond the bland committee language, there were a distinct feeling of foreboding despite US treasury's effort to put a positive spin on it in an earlier communique: "43 of the 77 eligible countries have participated in the DSSI programme and freed up \$5bn in fiscal space to fund social, health, and economic measures to respond to the pandemic."

The truth is, as US Treasury acknowledged, "DSSI implementation has faced shortcomings that have prevented the initiative from delivering its full potential. In particular, we strongly regret the decision by some countries to classify large state-owned, government-controlled financial institutions as commercial lenders and not as official bilateral creditors, without providing comparable treatment nor transparency, thus significantly reducing the magnitude of the initiative and the benefits of the DSSI for developing countries." China knows, without being named, it is seen as the main obstacle why things failed to make any meaningful progress.

China's spendthrift commercial lending to EMDEs

To fully appreciate the situation, a useful guide is a new report by Bank of International Settlement (BIS) which sheds further light on China's lending spree, particularly to so-called 'Emerging Developing Economies' (EMDEs).

Banking Across Borders: Are Chinese Banks Different? (BIS Working Papers No 892, Oct-20) the report answers the title question with a firm 'yes' and offers six valuable insights:

1. Chinese banks have a relative low market share (2.4%) in advanced economies (AE).
2. Chinese banks are the most important creditor for 66 (out of 185) borrow countries, more than any other banking system.

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Chinese Loans to African Governments vs. Eurobond Debts

| Country | China Eximbank | CDB | China Supplier's Credits | TOTAL Chinese Debt | Total Eurobonds as of 2019 | Total Chinese Debt as % of Eurobonds | DaMina Risk of Eurobond Parity Default following China 'Brady' Plan |
|-------------------|------------------|------------------|--------------------------|--------------------|----------------------------|--------------------------------------|---|
| Angola | \$ 8,272 | \$ 26,589 | \$ 22 | \$ 43,145 | \$ 5,000 | 863% | High |
| Cameroon | \$ 5,034 | \$ 2 | \$ 2 | \$ 5,561 | \$ 750 | 741% | High |
| Tanzania | \$ 2,378 | \$ 200 | \$ - | \$ 2,640 | \$ 600 | 440% | High |
| Mozambique | \$ 2,018 | \$ 179 | \$ - | \$ 2,290 | \$ 727 | 315% | High |
| Zambia | \$ 3,760 | \$ 1,002 | \$ 673 | \$ 8,634 | \$ 4,250 | 203% | High |
| Benin | \$ 1,686 | \$ - | \$ - | \$ 1,909 | \$ 1,089 | 175% | High |
| Kenya | \$ 7,878 | \$ 867 | \$ - | \$ 8,900 | \$ 7,000 | 127% | High |
| Rwanda | \$ 222 | \$ - | \$ - | \$ 290 | \$ 400 | 73% | Medium |
| Senegal | \$ 1,998 | \$ - | \$ - | \$ 2,019 | \$ 4,189 | 48% | Medium |
| Namibia | \$ 270 | \$ - | \$ 223 | \$ 538 | \$ 1,250 | 43% | Medium |
| Cote d'Ivoire | \$ 2,710 | \$ - | \$ - | \$ 2,783 | \$ 8,113 | 34% | Medium |
| Ghana | \$ 1,585 | \$ 1,000 | \$ 599 | \$ 3,499 | \$ 11,082 | 32% | Medium |
| Nigeria | \$ 4,903 | \$ - | \$ 390 | \$ 5,293 | \$ 18,642 | 28% | Medium |
| Gabon | \$ 450 | \$ - | \$ - | \$ 735 | \$ 3,409 | 22% | Medium |
| Seychelles | \$ 34 | \$ - | \$ - | \$ 34 | \$ 169 | 20% | Medium |
| Morocco | \$ 1,022 | \$ - | \$ - | \$ 1,030 | \$ 6,695 | 15% | Low |
| Egypt | \$ 767 | \$ 2,600 | \$ - | \$ 3,421 | \$ 29,014 | 12% | Low |
| South Africa | \$ - | \$ 3,131 | \$ - | \$ 3,819 | \$ 40,176 | 10% | Low |
| Mauritius | \$ 414 | \$ - | \$ - | \$ 492 | \$ 7,020 | 7% | Low |
| Liberia | \$ 50 | \$ - | \$ - | \$ 50 | \$ 950 | 5% | Low |
| Tunisia | \$ 143 | \$ - | \$ - | \$ 146 | \$ 8,038 | 2% | Low |
| Sudan | \$ 5,027 | \$ - | \$ 598 | \$ 6,495 | \$ - | 649500% | *No Eurobonds |
| Rep of Congo | \$ 4,812 | \$ - | \$ 238 | \$ 5,070 | \$ - | 507000% | *No Eurobonds |
| DRC | \$ 3,325 | \$ - | \$ - | \$ 3,345 | \$ - | 334500% | *No Eurobonds |
| Zimbabwe | \$ 2,692 | \$ 40 | \$ 290 | \$ 3,288 | \$ - | 328800% | *No Eurobonds |
| Uganda | \$ 3,110 | \$ - | \$ - | \$ 3,181 | \$ - | 318100% | *No Eurobonds |
| Equatorial Guinea | \$ 1,198 | \$ - | \$ 478 | \$ 1,699 | \$ - | 169900% | *No Eurobonds |
| Djibouti | \$ 1,261 | \$ - | \$ 150 | \$ 1,467 | \$ - | 146700% | *No Eurobonds |
| Mali | \$ 909 | \$ - | \$ - | \$ 989 | \$ - | 98900% | *No Eurobonds |
| Botswana | \$ 90 | \$ - | \$ - | \$ 931 | \$ - | 93100% | *No Eurobonds |
| Togo | \$ 773 | \$ - | \$ - | \$ 853 | \$ - | 85300% | *No Eurobonds |
| Niger | \$ 332 | \$ - | \$ 352 | \$ 703 | \$ - | 70300% | *No Eurobonds |
| Guinea | \$ 273 | \$ - | \$ 335 | \$ 646 | \$ - | 64600% | *No Eurobonds |
| Eritrea | \$ 589 | \$ - | \$ - | \$ 605 | \$ - | 60500% | *No Eurobonds |
| Chad | \$ 586 | \$ - | \$ - | \$ 590 | \$ - | 59000% | *No Eurobonds |
| Madagascar | \$ 435 | \$ - | \$ - | \$ 435 | \$ - | 43500% | *No Eurobonds |
| Mauritania | \$ 381 | \$ - | \$ - | \$ 431 | \$ - | 43100% | *No Eurobonds |
| Malawi | \$ 262 | \$ - | \$ - | \$ 262 | \$ - | 26200% | *No Eurobonds |
| Sierra Leone | \$ 48 | \$ - | \$ 176 | \$ 224 | \$ - | 22400% | *No Eurobonds |
| South Sudan | \$ 158 | \$ - | \$ - | \$ 158 | \$ - | 15800% | *No Eurobonds |
| CAR | \$ - | \$ - | \$ 60 | \$ 103 | \$ - | 10300% | *No Eurobonds |
| Burundi | \$ 36 | \$ - | \$ - | \$ 86 | \$ - | 8600% | *No Eurobonds |
| Cape Verde | \$ 43 | \$ - | \$ - | \$ 49 | \$ - | 4900% | *No Eurobonds |
| Comoros | \$ 39 | \$ - | \$ - | \$ 39 | \$ - | 3900% | *No Eurobonds |
| Lesotho | \$ 27 | \$ 2 | \$ - | \$ 37 | \$ - | 3700% | *No Eurobonds |
| Ethiopia | \$ 8,069 | \$ 655 | \$ 4,165 | \$ 13,796 | \$ - | 1380% | *No Eurobonds |
| Algeria | \$ - | \$ - | \$ - | \$ 9 | \$ - | 900% | *No Eurobonds |
| TOTAL | \$ 80,561 | \$ 36,772 | \$ 8,751 | \$ 145,729 | \$ 158,563 | 92% | |

Source: Johns Hopkins SAIS/BIS/ DaMina

3. They extend about 24% of total cross-border bank lending to EMDEs – twice as much as Japanese banks which are the second largest lender (11.2%) to EMDEs.
4. Out of 143 EMDEs, Chinese banks are also the most important creditor for almost half, namely 63 borrower countries, more than six times larger than the 10 EMDEs for which French banks count as the most important lender.
5. Chinese banks display the strongest complementarity with respect to EMDE borrowers. A 1% increase in bilateral cross-border trade is associated with an almost 1.2% increase in US dollar claims of Chinese banks on EMDE borrowers. This rise is only about 0.6% in the case of US banks and Japanese banks.
6. If trade tensions or the aftermath of the COVID-19 crisis translate into a persistent decline in global trade, cross-border bank lending to fall in parallel. It could be more pronounced for Chinese banks as they display significantly higher correlations than some of their peers, but the ongoing and planned liberalization reforms in the Chinese bond market could foster further inward and outward portfolio investment.

Measures of global relevance by bank nationality: Top cross-border creditors and market share

Excluding claims of foreign affiliates on home country, as of Q2 2018

Table 1

| | CN banks | JP banks | US banks | UK banks | CH banks | FR banks ² |
|--|----------|----------|----------|----------|----------|-----------------------|
| Borrowers Worldwide(185)¹: | | | | | | |
| Number of borrower countries | 176 | 136 | 156 | 175 | 179 | 175 |
| Total credit (in USD bn) | 2,101 | 4,540 | 3,318 | 2,808 | 1,875 | 3,341 |
| Share in total outstanding (%) | 7.1 | 15.4 | 11.3 | 9.5 | 6.4 | 11.3 |
| Number of countries for which banks are the top creditor | 66 | 11 | 11 | 5 | 7 | 16 |
| Borrowers in AEs(31)¹: | | | | | | |
| Number of borrower countries | 30 | 30 | 30 | 31 | 31 | 31 |
| Total credit (in USD bn) | 488 | 2,953 | 2,215 | 2,081 | 1,164 | 2,715 |
| Share in total outstanding (%) | 2.4 | 14.8 | 11.1 | 10.4 | 5.8 | 13.6 |
| Number of countries for which banks are the top creditor | 0 | 3 | 1 | 0 | 1 | 6 |
| Borrowers in EMDEs(143)¹: | | | | | | |
| Number of borrower countries | 135 | 98 | 115 | 133 | 137 | 133 |
| Total credit (in USD bn) | 919 | 434 | 277 | 303 | 120 | 312 |
| Share in total outstanding (%) | 23.7 | 11.2 | 7.1 | 7.8 | 3.1 | 8.1 |
| Number of countries for which banks are the top creditor | 63 | 6 | 9 | 5 | 4 | 10 |

¹ The number of borrower countries/jurisdictions in our estimation sample is 185, while the total number of borrower countries/jurisdictions that potentially exists in the BIS data is 216. As some of these countries /jurisdictions have missing observations in the other datasets, we lose 31 mainly very small jurisdictions (see Annex Table A3 for the complete list). ² Shares and numbers of French(FR) banks are the highest among euro area reporting nationalities. The 12 other euro area bank nationalities that report to the BIS are Austria, Belgium, Cyprus, Finland, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain.

Sources: BIS locational banking statistics (by nationality); authors' calculations.

Generally China provides either concessional loans where the lenders don't charge any/low interests (small proportion of the total loan outstanding) or preferential export buyer's credit, which is often used to finance purchase of Chinese equipment/machinery/management expertise where the lenders charge a below market rate, c. 3%, and classified them as commercial (bulk).

While all of loans comes from top 4 commercial banks, state-controlled China Development Bank, Silk Fund etc, Export-Import Bank of China is the *only* bank with a formal concessional loan mandate – e.g. providing foreign aid.

Paucity giving foreign aid

A fundamental but overlooked question is *how do China actually see its role in developing economies?* The Western standpoint is it see itself as provider a commercial opportunities (lending) as well as for humanitarian, political reasons quite offer aid/grants to spur growth/changes.

China doesn't believe in that model. At least that is the conclusion found in the Centre for Global Development's (CGDEV) paper (Working Paper 529, April-20) *Finance for International Development (FID) A New Measure to Compare Traditional and Emerging Provider Countries' Official Development Finance Efforts, and Some Provisional Results*.

To start with. CGDEV stresses the need to properly define foreign aid and opt for the term finance for international development (FID), which consists of three parts :

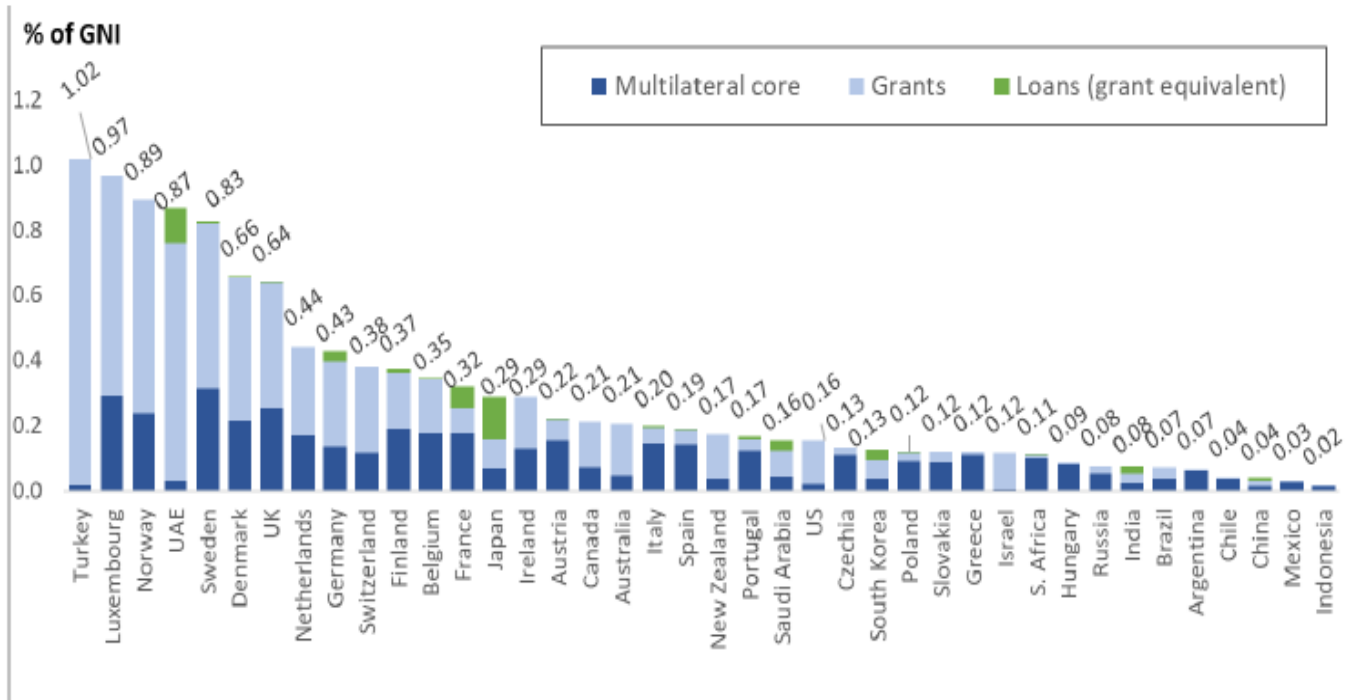
1. Bilateral grants to developing countries
2. The grant element of bilateral loans for development
3. Financial contributions (grants, equity) to multilateral development organisations

FID deliberately *excludes* spending in the provider country (refugee camps, scholarships, aid administration and aid awareness) as it has limited/questionable impact on development projects in EMDEs.

The report offers sobering conclusions. China on annually provides measured on a 'grant equivalent basis' - defined as financial assistance which nations provide officially and concessionally across borders to support development – gives c. \$5.1bn a year, slightly ahead of Sweden's \$5.4bn – or one-third of the UK's or Germany' and about a sixth of US's foreign aid. And in terms of relative performance, China today has an income/capita just above UK in 1960; in that same year, UK provided 0.56% of Gross National Income (GNI) in aid. Hence on a relative development basis, China is an extreme outlier.

Possibly the most controversial data point is that China gives only 0.04% of GNI which makes it the least generous donor globally, bar Mexico and Indonesia.

Figure 3. FID as a share of current national income 2017, (%)



Source: BIS

Such paucity is not going unnoticed in EMDEs. An AidData 2017 *Listen to Leaders Survey* found that borrowing countries in terms of helpfulness ranked China ranks no. 31 out of 35 bilateral and multilateral development partners; and 21 in terms of influence ranking.

The G20 debt plan not fit for purpose

It's clear that China has a mercantilist view about dealing with developing countries, making the G20 debt plan not fit for purpose. Two recent developments hammers in that point.

Firstly, in the recent request by the **Zambian** government to delay interest payments for six months, the group of foreign Eurobond shareholders rejected the proposal, paving the way for a potential default. They are unsure whether they will be treated on equal basis as Chinese lenders. That looks unlikely as main borrower is Zesco, the national power company, which accounts for nearly 50% of Zambia's outstanding external debt, according to Africa Energy; Power China, the parent company of Sinohydro, is the largest creditor, with more than 60% of total. The lender to the project is China Development Bank, which lends on commercial terms as highlighted earlier.

Secondly, in September Chinese media reported that **Laos** had given a majority stake in the state-controlled Electricite du Laos (EDL)m - the national utility company - to China Southern Power Grid Co, a state-controlled

company after the country had failed to pay its debt. In this case it was also Sinohydro, which had received funding from China Development Bank to build a hydropower project. Laos is not participating in the DSSI initiative, and the majority of its debt is believed to be owned by China. Prior this, Moody's had downgraded (25 Aug) Laos by two notches to Caa2 from B2 and changed outlook to negative from stable, citing heightened government liquidity risks.

Chinese Brady Plan

For the Beijing top nomenclature to find a resolution on its huge debt portfolio it needs to follow the lead of the US which after it had over-extended itself in Latin America during the 1980s set up a market-driven debt resolution – the Brady Plan – something discussed in our note **China's \$145bn 'Brady Bonds Plan' for African debtors may trigger Eurobond defaults (Jun 18)**.

There are no details whether that will happen. However two facts lend support for that to occur sooner rather than later: (1) during the 14th 5-year plan the Chinese market is set to eclipse the US in terms of size and, subsequently, EM/FM loans could be attractive investments for local and foreign bond investors; (2) recently FTSE World Government Bond Index decided to add China in 2021, meaning that a lot of passive investors/global asset allocators will be asked to allocate more capital to China.

Old People's Club

A thorny but related issue is what role/power China and other leading developing countries *exactly* are supposed to play at the global banking's high table.

Moot point is BIS. Since its founding in 1930, BIS which "fosters international monetary and financial cooperation and serves as a bank for central banks" has gradually grown to include 62 central bank/monetary authorities of which 35 are in Europe, 14 in Asia, 5 in South America, 3 in North America, 2 in Oceania and 3 in Africa.

BIS has three offices - Basel, Hong Kong and Mexico - and with the exception of Mexico, BIS has *never* had a Chairman or General Manager – the most senior positions – from either China or the other G20 non-Paris Club bilateral lenders (India, Saudi Arabia, South Africa and Turkey).

China joined in 1996, but only started (together with Russia) contribute banking data in December 2016. The Chinese regulator, SAFE (State Administration of Foreign Exchange) said "the BIS move showed China's statistics on balance of international payments are internationally recognized thanks to continuous improvement on transparency."

Over the weekend, Jack Ma, the Chinese multi-billionaire and founder and major shareholder of Alibaba and its subsidiary Ant Group, which is set to become a mammoth dual IPO in Hong Kong and Shanghai next month, made this comment about BIS: "Basel Accords are like an old people's club . . . we can't use yesterday's methods to regulate the future."

When China's most famous businessman talks (and presumably endorsed by the government given his Chinese Communist Party membership), Eurobond investors can ill afford ignore the new tone coming from Beijing.

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