ISSUE BRIEF

Toward equitable debt contracts

Preventing de facto seniority-clause escalation in the sovereign lending space

MARCH 2025 LILI VESSEREAU

The limitations of the Group of Twenty (G20) "Common Framework" have been extensively discussed and actionable solutions have been put forward. Tackling those limitations of the Common Framework is crucial for countries currently in debt distress, which experienced "significant delays" in the obtention of debt relief. As stressed by Kristalina Georgieva, managing director of the International Monetary Fund, "The framework can and must deliver more quickly."

What's hampering progress? Coordination issues, for one thing, but numerous voices also point to China's role in hindering progress toward resolving the global debt crisis. The People's Republic of China—a member of the IMF—has not only lent significant sums to borrower nations but also has the capacity to slow down processes because of the preferential terms in its lending agreements.

Overall, 147 countries—representing two-thirds of the global population and 40 percent of the world's gross domestic product (GDP)—have either benefited from China's Belt and Road Initiative (BRI) projects or shown interest in joining the program. By 2023, Chinese investment had begun to rebound since China's zero-COVID policies, but China's resistance to debt relief for its low-income borrowers will fuel sovereign defaults for years to come. China has spent an estimated $1 trillion through the BRI, thereby considerably strengthening its influence across Asia, Africa, and Latin America. Laos, for instance, owes almost half of its external debt (65 percent of its GDP) and is struggling to repay the debt that financed infrastructure like the high-speed Laos-China railway. China's ownership of around 17.6 percent of Zambia's external debt also slowed down Zambia's debt restructuring negotiations significantly, contributing to a lengthy negotiation of two and a half years.

This piece outlines how China's lending practices harm low-income borrowers and hinder debt restructuring negotiations through the use of debt clauses giving it de facto seniority. It further outlines ways for the Bretton Woods institutions to collaborate to change these dynamics and improve financing prospects of borrower countries and a more level field for lenders.

The **GeoEconomics Center** develops data-driven programs, publications, and thought leadership at the nexus of economics, finance, and foreign policy. The Center aims to bridge the divide between these oft-siloed sectors with the goal of helping shape a more resilient global economy.

The **Bretton Woods 2.0 Project** examines the deep challenges facing the Bretton Woods Institutions and leverages data, research, and convening to propose new solutions for the future of the IMF, World Bank, and World Trade organization.

How China blends diplomacy with financial power

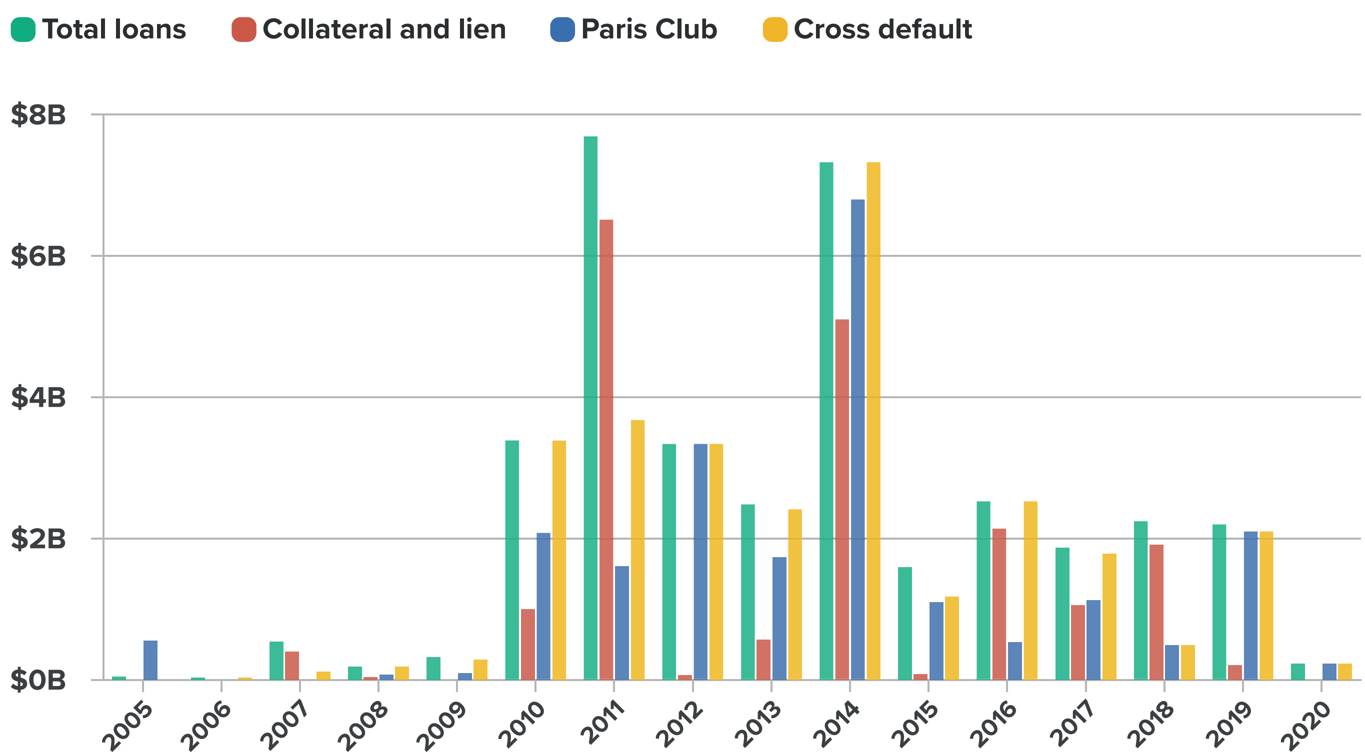
Chinese lending terms undercut borrowers and debt restructuring talks

Chinese lending is characterized by clauses for cross default, special accounts, and exclusion of Paris Club involvement (as discussed below), all of which are detrimental to borrower countries and lead to very difficult debt restructuring negotiations when countries default.

Chinese development contracts contain cross-default clauses that entitle the lender to terminate the agreement and demand full repayment if the borrower defaults on third-party financing. In the sample studied by AidData, 50 percent of the contracts also link cross-default to any actions that would be "adverse to the interests of a PRC entity." Such a clause, if applied to large shares of the debt, can put a borrower under high pressure if the lender asks for immediate repayment of projects that were supposed to be repaid over several years. AidData's examination of one hundred debt contracts between Chinese state-owned entities and government borrowers found that 50 percent of China Development Bank (CDB) contracts include cross-default clauses designed to protect Chinese direct investment and other business activities in the borrowing country.

Chinese development contracts also include "special account" or "cash collateral" clauses. In this kind of agreement, a borrower is required to set aside or deposit a certain amount of cash or liquid assets as collateral to secure the loan. These accounts are funded either with revenue from the project financed by the lender or from other cash flows. According to the AidData study, 30 percent of contracts require the sovereign borrower to maintain a special bank account, typically with a bank approved by the lender, which acts as collateral for debt repayment. In 70 percent of these Chinese transactions involving a special account, all revenues generated from the associated projects must be deposited into the account. Furthermore, in five of these contracts,

Fig. 1: How China Lends: Lending Practices over 100 Chinese Contracts (Loan commitments)



Source: AidData.

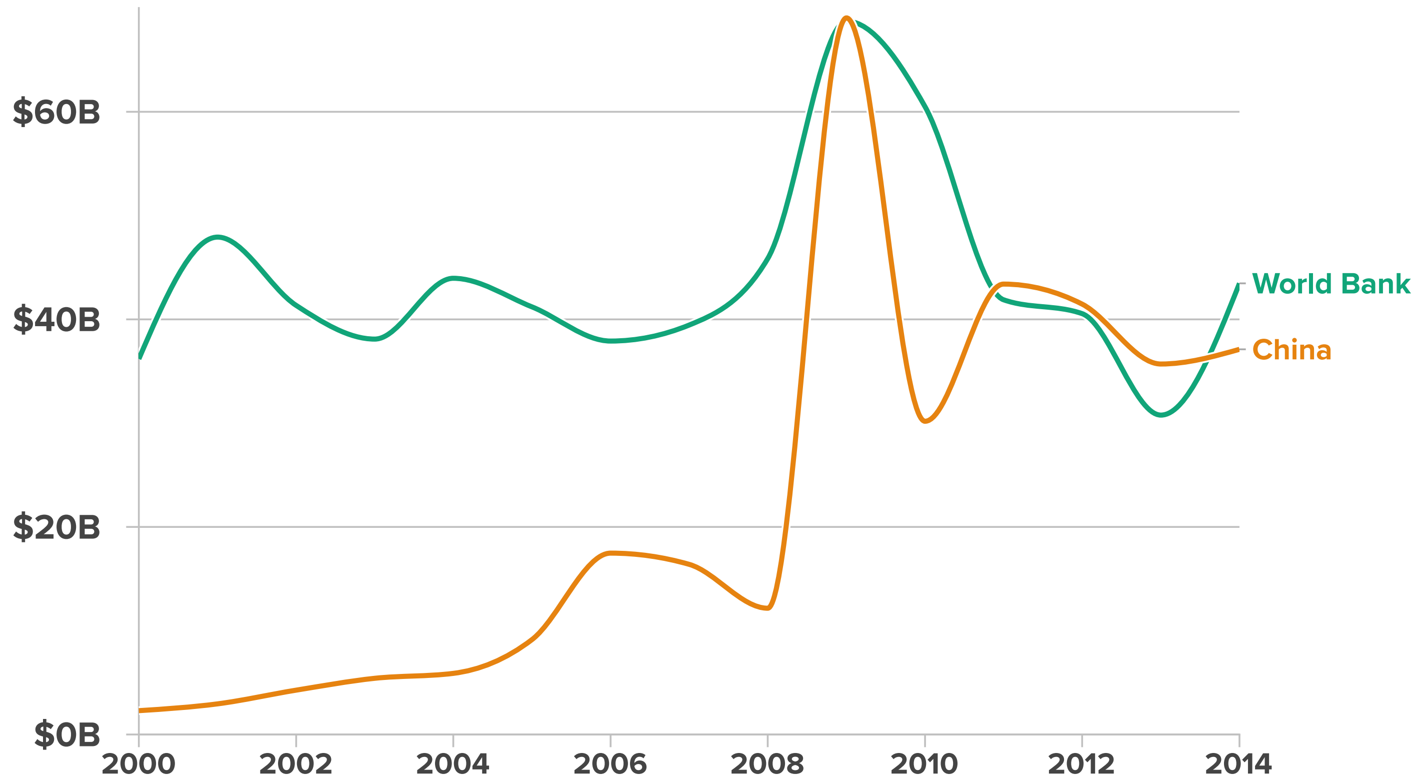
A truck is seen outside a tunnel, at the construction site of a new Chinese mega port, in Chancay, Peru August 22, 2023. REUTERS/Angela Ponce.

the lender is granted the authority to block the borrower from accessing the funds. These clauses give de facto seniority to China in case of default and prevent countries from accessing government revenues to address urgent political and economic issues. The Uganda Entebbe Airport contract is an example: The borrower has to maintain a minimum balance in a lender-controlled bank account, giving the Export-Import Bank of China (CHEXIM) access to fully liquid collateral. Further, the contract provides that "all of the revenues generated . . . be used to repay the loan on a priority basis for 20 years."

Chinese lending often exhibits seniority-seeking patterns through inclusion of "no Paris Club" clauses in its loan contracts. A Paris Club arrangement allows creditors to negotiate collectively for debt settlement, ensuring equitable terms for all involved. This suggests that lenders may believe they can achieve better terms unilaterally, potentially due to the significant size of Chinese loans. An exclusion of such a possibility is unusual in international sovereign lending but common in BRI lending. Out of the AidData sample, 75 percent of the contracts contains "no Paris Club" clauses. Such clauses contradict the very idea behind the G20 Common Framework, which requires private creditors to participate on comparable terms to overcome collective action challenges, coordinate to provide debt relief consistent with the debtor's capacity to pay, and maintain essential spending needs. For example, after Sri Lanka defaulted in 2022, CHEXIM led an official creditors' committee—separately from the Paris Club.

Collateralization of loans to commodities are very frequent in Chinese debt contracts. Resource or commodity-backed loans provide that repayment is made directly in natural resources or where a natural resource asset serves as collateral. Of commodity-backed loans from China, 77 percent have been contracted with Latin American and sub-Saharan African countries since 2004, for a total of $152 billion of oil-, mineral-, and metal-backed loans. Commodity-backed loans often fall outside of usual budgetary and audit procedures, making them more susceptible to governance issues. Valuing the commodities also is difficult, with instances of severe undervaluation. In the Democratic Republic of Congo (DRC), a group of Chinese investors including state-owned enterprises such as Sinohydro entered a project valued at $6.2 billion to run a copper and cobalt mine. In return, China would use the proceeds from the mine to build infrastructure valued at $3 billion. A February 2023 report by the DRC state auditor raised issues with the deal, notably with the valuation of the mine, and demanded an additional $20 billion in investments. Additionally, borrowing countries can become vulnerable to volatile commodity prices causing financial stress. In 2014, the oil price crash hit Congo and Chad because of their inability to "allocate physical cargoes of crude as debt repayments while also maintaining sufficient income."

Fig. 2: Chinese and World Bank Lending (Volume of financing over time)



Source: Center for Global Development.

Institutional fragmentation and diplomatic leverage are hallmarks of China's approach

One of the key characteristics of Chinese lending is that it is highly fragmented. Deborah Bräutigam, director of the China Africa Research Initiative (CARI) at Johns Hopkins University, underscores that there is no "single China" but rather a "fragmented authoritarianism." Chinese policy banks, CHEXIM, and the CDB raise funds through bond issuances that receive an implicit sovereign guarantee from the Chinese government. These bonds are mostly purchased by Chinese state-owned commercial banks in order to meet their capital requirements.

Though policy banks are seen as responsible for managing their own books, they cannot write off bad loans without seeking the case-by-case approval of China's State Council, notes Shahar Hameiri of University of Queenslands. This effectively limits both write-offs and the extent to which claims of full independence and fragmentation can be sustained. However, this fragmentation also hinders the extent to which Chinese actors can effectively coordinate, as showcased by the very different terms and conditions under which loans were made to Zambia. Those differing terms and conditions are an additional hindrance to restructuring negotiations.

The extent to which the risk appetite of China, compared to other lenders (including other Bretton Woods institutions), contributes to the high recourse to Chinese loans is unclear. AidData argues that "limited availability of concessional loans from Paris Club creditors, especially in high-risk countries and for infrastructure" push countries to borrow more from China. The United Nations Development Programme (UNDP) notes, on the contrary, that "in terms of the country risk distribution, the CDB and CHEXIM record a smaller number of larger projects in higher-risk economies compared to the World Bank. The average country risk of Chinese policy banks' overseas energy loans is higher, at 5.07, compared to 4.22 for the World Bank (based on a range between 0 and 7, where a higher score indicates higher risks)."

By using cross-default clauses, cash collateral or special account clauses, resource-backed loans, and other tools, Chinese loans use legal threats to increase the chances of repayment and protect their investment. As a result, the contracts written by Chinese banks give them discretion on debt restructuring or default remedies that increases economic pressure on the debtor to repay.

Current restructuring negotiations reflect merged financial and diplomatic approaches. This merged approach can be exemplified by the mention in all Chinese Development Bank contracts that all diplomatic relations will be terminated with a borrowing country in case of default, which entitles the lender to demand immediate repayment. Conversely, as mentioned above, some loans come with geopolitical strings attached, as political actions toward China can trigger cross default. This also becomes evident when examining how China has stepped up as an international crisis manager by developing a system of "bailouts on the Belt and Road." Laos, China's gateway to Southeast Asia, received an opportunity to defer its debt payments in exchange for control over its electrical grid. Overall, China has become the world's largest official bilateral creditor—and the special lending conditions under which they were made empowered China to slow down debt restructuring negotiations significantly.

Bretton Woods institution must address capacity and credit access issues, as well as serve as a forum for de-escalation

Decreasing dependence on Chinese loans

Chinese state-owned institutions lend at an average commitment-weighted interest rate of 3.2 percent, which is higher than the concessional loans provided by multilateral institutions (2.0 percent), Paris Club creditors (2.1 percent), and other non-Paris Club bilateral creditors (2.3 percent). The recourse to Chinese loans thus cannot be explained by pure financial interest. Factors like misperception of economic policymakers, the limited amount and scale of loans provided by Paris Club creditors, and available concessional loans must play a role.

Interviews with more than a hundred current and former debt managers, economic policymakers, lawyers, and market participants suggest that borrowing country officials tend to disregard contingency planning for restructuring as a factor in selecting nonfinancial contract terms. Low-income countries with limited international borrowing experience often accept claims of standard terms without question, understanding that enforcement may be challenging. Their negotiation efforts typically prioritize minimizing immediate borrowing costs. However, this approach can lead to challenges when supposedly standard terms contain nonstandard variations, such as the expansive CDB cross-default clause or policy-based cancellation clauses. These clauses can significantly impact debt contracts with state-owned policy lenders, potentially functioning as discretionary triggers affecting loan agreements. To empower countries with limited international borrowing experience in their debt contracting negotiations, the World Bank and International Monetary Fund should provide very high-level officials with capacity training focused on debt negotiation and also incentivize borrowing countries to share their experiences, fostering more transparency and enabling them to bargain more efficiently.

Notably, China's state-owned lenders' average commitment-weighted interest rate of 3.2 percent is lower than the rates of private external bank loans (3.7 percent) and international bonds (5.6 percent). Multilateral banks and Paris Club loans tend to be significantly smaller than loans from Chinese banks. Between 2000 and 2014, Chinese loans were on average twice as big as ones from the World Bank ($307 million and $148 million, respectively). Concessional loans from Paris Club creditors have a very limited availability, especially for high-risk countries and infrastructure projects, which also explains why developing countries turn to China. In addition to providing concessional loans, the World Bank can therefore play a pivotal role in derisking to grant access to finance for developing countries.

By offering guarantees that address credit and inflation risks, along with measures to manage governmental performance risks through agreements and partial risk guarantees, the World Bank can enhance the attractiveness of investments in infrastructure projects. Despite the challenges of accessing long-term local currency loans at competitive rates, the World Bank's interventions can mitigate these obstacles, fostering financial stability and supporting sustainable development in developing nations. Research has shown how Chinese lending also led to emulation, where the World

The People's Bank of China Governor Pan Gongsheng, the International Monetary Fund (IMF) Managing Director Kristalina Georgieva, Shanghai Party Secretary Chen Jining, and Shanghai Mayor Gong Zheng attend the launch ceremony of the Shanghai regional center of International Monetary Fund (IMF) on June 19, 2024 in Shanghai, China. The International Monetary Fund (IMF) announced the establishment of a regional center in Shanghai, China, at the Lujiazui Forum on June 19. Photo by VCG/VCG.

Bank responds to competitive pressure from China by emulating the Chinese emphasis on infrastructure. To enable more actors, including private ones, to lend to infrastructure projects in developing countries, the World Bank should offer some level of derisking through guarantees. This would ensure competition with China and offer an alternative to the current Chinese derisking strategies, including preferential clauses. Doing so "on budget" would require increasing the concessionality of World Bank guarantees (i.e., financing more at below market rates to advance development goals) in exchange for lower amounts of grants, using the lower weight of guarantees on its balance sheet and the multiplier effect of guarantees, which unlock additional funds from lenders.

De-escalating sovereign lending requires cooperative practices among institutions

It is important to keep in mind that China is not the sole country to use clauses for cross default or cash escrow accounts. For Bretton Woods institutions, antagonizing China—one of its members since 1945—would be counterproductive. As rightfully underlined by Chinese Foreign Ministry spokesperson Wang Wenbin: "The IMF and the World Bank are multilateral financial institutions . . . They are not the 'U.S. International Monetary Fund' or the 'U.S. World Bank.'" For Bretton Woods institutions to retain credibility, all measures and initiatives must be framed as pursuing fairer lending conditions for borrower countries. China has also realized the limitations of its expansive lending policies, which might enable a more constructive dialogue on the matter. As of 2022, 60 percent of China's overseas lending portfolio was owned by borrowers in distress. Following this worrying situation, China's Ministry of Finance published its own Debt Sustainability Framework for Market Access Countries of the Belt and Road Initiative in October 2023.

Arguably, seniority and contingencies can be studied as having a potential for escalation. Bradley C. Parks, the executive director of AidData, notes that this creates "paralysis" among other lenders because China, through its cash collateral clauses, is at the head of the repayment line. It is worrying to anticipate how the global lending landscape could look if other countries were to retaliate and try to get ahead of China in the repayment line. In case of default, lenders need to have higher and better seniority and contingencies to ensure they can get as much repayment as possible—to the detriment of other borrowers. This vision fails to account for the negative consequences of those clauses and contingencies, for instance how cash escrow accounts can block resources that could be used for reforms and public policymaking. Such reasoning is nevertheless useful in understanding how lessons can be drawn from the field of de-escalation and disarmament. Indeed, armament aims to prepare for an eventual trigger event (a conflict) where each party wants to own more military capacity than the other. When writing debt contracts, each borrower wants more seniority and contingencies than the other in case those clauses are triggered (if the country defaults).

Bretton Woods institutions could serve as fora for de-escalation and trust building in the sovereign lending space, starting with transparency. In the disarmament field, the first step often revolves around confidence-building measures, defined as "arrangements designed to enhance such assurance of mind and belief in the trustworthiness of states and the facts they create." Translated to sovereign lending, such measures would undeniably focus on transparency regarding the amounts and conditions under which countries are lending. A recent World Bank working paper using a sample of 146 countries over fifty years highlighted how systematic the underreporting of debt statistics is. Interestingly, this same paper found that hidden debt accumulates during periods of economic growth and is typically revealed during downturns, especially in the context of IMF programs or sovereign defaults. Hidden debt is detrimental to *all* parties, as it is associated with adverse effects on default risk and debt-carrying capacity.

Achieving transparency should be done by exerting pressure on both borrower and lender countries. By exerting pressure on both, the likelihood that countries will report all lent and borrowed debt increases because countries find themselves in a situation akin to the prisoner's dilemma. Arguably, the IMF could impose general debt transparency under section 5 of Article XVIII of its Articles of Agreement. The section indeed states that "the Fund may require members to furnish it with such information as it deems necessary for its activities." The sanctions for not respecting those specifications are listed under Article XXVI and should be sufficient incentives, as they include a declaration of ineligibility to use the general resources of the IMF, the suspension of a member's voting and certain related rights in the IMF's decision-making organs, and compulsory withdrawal of the member from the IMF. In practice, creating consensus on the necessity of this measure among countries before enforcing it seems like a better way to proceed at a time when the IMF is not exempt from criticism. To do so, the executive board could leverage the recent empirical findings of the World Bank on the consequences of debt underreporting.

Ultimately, the goal would be the establishment of binding treaties under the secretariat of Bretton Woods institutions. Multilateral and bilateral agreements would define what maximum set of contingencies are acceptable to request based on a project's risk levels. Continuing the parallel with disarmament, bilateral treaties would function as arms control accords, which support deterrence by means of negotiated agreements to prevent perceived asymmetries from spawning destabilizing or threatening actions. Without infringing on state's rights to negotiate under which conditions they want to loan, multilateral negotiations could be similar to nonproliferation policy, aiming at preventing the emergence of new unjustified requirements in debt contracts for borrower countries. The goal of such policy is to lead to an agreement and consensus on general use cases of clauses giving seniority or contingency to reduce the incentives and raise the costs of challenging this nonproliferation norm.

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