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PGIM FIXED INCOME

SIX QUESTIONS ON THE IMPLICATIONS OF CHINA'S BELT-AND-ROAD DEBT

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China's Belt-and-Road Initiative (BRI) has been one of the country's more prominent efforts to assert its global presence: the infrastructure program has involved $200 billion across an estimated 60 countries in Asia, Africa, the Middle East, and even Europe. Yet, the BRI has also saddled many relatively poor frontier countries with significant, yet ultimately unknown, levels of debt. The issue is coming to the fore with many of these countries now struggling to meet their external obligations, likely requiring China to restructure the debt in several instances. The following questions and answers provide our perspective on the investment implications of China's Belt-and-Road Debt.

1. What are some of the characteristics of the BRI debt owed to China ?

China optimistically views the BRI as an attractive conduit for development assistance that would replicate its own perceived economic success in large-scale infrastructure investment. Thus, much of the debt is owed to Chinese contractors building major individual projects with financing often provided by Chinese banks that typically inserted collateral clauses into the lending agreements. The borrowers usually have close ties to the sovereign.

Yet, this blueprint of BRI lending neglected two key factors: the borrowers' macroeconomic backdrop and the projects' governance issues. These issues were not considered as part of infrastructure projects in China as de-facto bankrupt local governments and their financing vehicles were bailed out and questionable projects were approved without much opposition. However, the outside world was different, leaving China to now restructure its unsustainable BRI-related debt.

In many ways, China's restructuring approach is re-inventing the wheel as it begins to resemble the one eventually adopted by developed countries following the EM debt crises of the 1970s and 1980s. Even if China does not join the Paris Club, over time, we expect its eventual approach will be similar and will involve comprehensive and reasonably transparent restructurings, some of which will be conditional on macroeconomic policy adjustments by debtor countries.

The current process has substantial room for improvement. Based on the information available, some of China's initial restructurings have compounded the strain on borrowers by only rescheduling amortizations and late interest payments, thus possibly aggravating the net-present value burden. Furthermore, collecting on the collateral can be controversial as observed from the backlash after China assumed control of Sri Lanka's Hambantota port. Given the current backdrop, we expect China's lending to become more selective going forward.

2. Does Chinese bilateral lending represent a systemic risk to the emerging market debt sector ?

We don't believe it poses a systemic risk to the sector. Most of the problematic lending is concentrated in frontier countries rather than spread across the universe of emerging market issuers. Moreover, there are cases, such as in Malaysia and Thailand, where the sovereign takes a very reasonable approach to instances of potentially excessive Chinese debt. However, we continue to monitor for missteps by official and multilateral creditors within the Paris Club's Debt Service Suspension Initiative (DSSI), which could indirectly affect China and pose a larger risk across the sector.

3. Do you consider debt to China as part of a fundamental assessment of a country ?

The credit implications of debt owed to China are an important piece of our fundamental credit analysis, even though some data uncertainty remains. Fortunately, the borrowing countries have become more transparent, and many countries with BRI debt, especially those in Africa, have significantly reduced their borrowing recently.

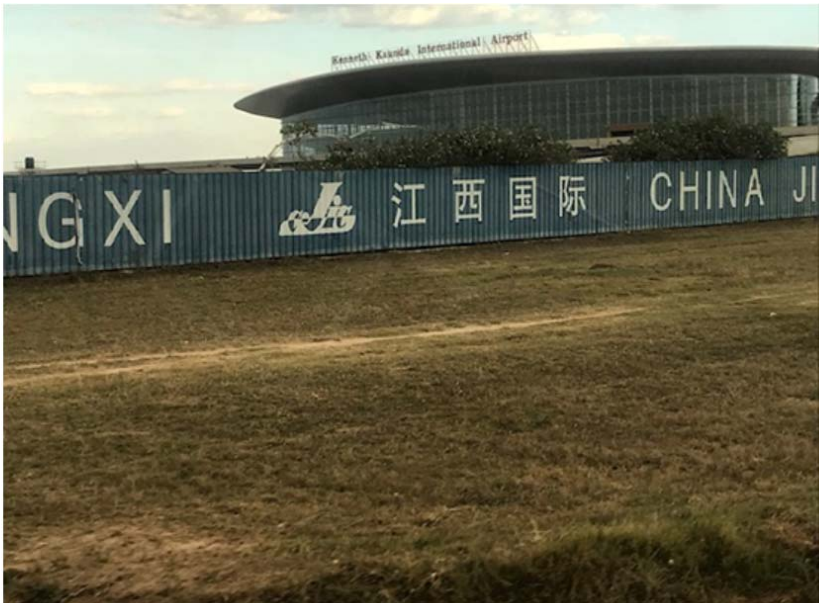
4. Which countries warrant concern regarding their debt to China ?

Debt to China is an important part of many low-income countries' overall debt burden. Many of these frontier countries are receiving debt relief as part of the DSSI, and it is worth pointing out that the two largest beneficiaries - **Angola and Pakistan** - received the greatest benefit from restructuring their debt to China. It is important that China continues its support there.

In Africa, **Ethiopia** is the second largest indebted country to China and was granted some minor debt relief last year. So far, Ethiopia has remained current on its debt service, but its borrowing terms from China remain largely opaque. **Cameroon and the Republic of Congo** have also borrowed significant amounts from China.

Zambia recently defaulted on its external debt that has a large (about one third) Chinese component, yet Chinese banks do not recognize themselves as official lenders, which was also the case in Angola, but did not prevent its participation in the DSSI. The reason for Zambia's default, however, lies in poor domestic policies and "white elephant" projects rather than the behavior of Chinese lenders. As a matter of fact, the Chinese EXIM bank has already granted some debt payment deferral to Zambia.

ZAMBIA'S KENNETH KAUNDA AIRPORT CONSTRUCTED BY CHINESE CONTRACTOR CHINA JIANGXI INTERNATIONAL



Source: Giancarlo Perasso

China played a major role in the construction of the Kenya's Mombasa-Nairobi railway and its expansion inland. The terms of the contract remain unknown and the railway's commercial shortcomings explain the difficulties in servicing the debt. No official statements have been made and with no negotiations in sight, tension between the parties remains high.

5. Is there risk that China pressures some of its debtors to restructure with non-Chinese creditors ?

It is possible, but unlikely. Various developments have negatively impacted China's geopolitical reputation recently, and Chinese authorities will likely try to avoid losing further international goodwill by forcing a borrower's hand. However, China could take an implicit approach to outside restructuring by joining a coordinated initiative to debt issues, including adding involvement from the IMF as a restructuring condition. For example, China's recent reluctance to restructure Sri Lanka's debt without an IMF program, similar to India's approach, could be a harbinger of China's future methodology.

6. How could China's restructuring affect the recovery rates for private bondholders ?

This is uncharted territory and some bumps may lie ahead. The reluctance of Chinese banks to become official creditors has been a key obstacle in more orderly Chinese restructurings. While there have been some signs of progress—pressure from the IMF on the official creditor issue was said to be a condition of Angola's recently obtained program—it's unlikely that China automatically extends the same treatment in other cases.

The risk of not accepting official creditor status is that the relevant creditor banks in China could insist that other private creditors accept similar terms in a restructuring scenario, which could send shockwaves through private debt markets. Ultimately, central Chinese policymakers may get involved to mitigate market-moving shocks, but they may have to witness such an event before they step in.

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