CIGI PAPERS

NO. 45 — SEPTEMBER 2014

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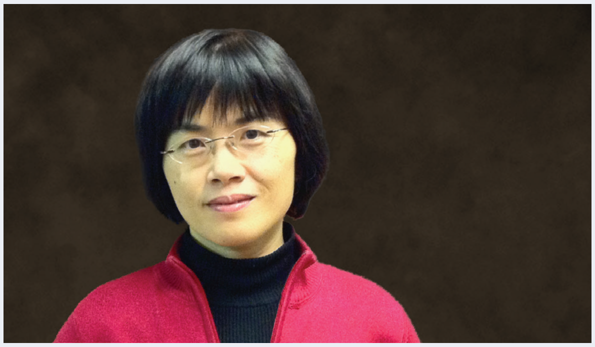

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ACRONYMS

BRICS	Brazil, Russia, India, China and South Africa
CACs	collective action clauses
CRA	Contingency Reserve Arrangement
G77	Group of 77
IIF	Institute of International Finance
IMF	International Monetary Fund
NDB	New Development Bank (BRICS)
RMB	renminbi
SDDRF	Sovereign Debt Dispute Resolution Forum
SDRM	Sovereign Debt Restructuring Mechanism
UN	United Nations

EXECUTIVE SUMMARY

More than a decade after it put forth the idea of the Sovereign Debt Restructuring Mechanism (SDRM) in the early 2000s, the International Monetary Fund (IMF) is again seeking to engage various stakeholders in a new round of discussions about improving sovereign debt restructuring. As a major international creditor, China is an important force to reckon with. So far, the Chinese government has said little publicly regarding the recent IMF reports on this issue. Chinese policy makers and analysts are supportive of the IMF's attempt to explore ways for earlier and more orderly debt restructuring, but they find the proposed reforms to be only marginally useful. From China's point of view, the most important question in debt management is how to prevent excessive borrowing and lending and reduce the likelihood of unsustainable debt. It sees discussions about the mechanisms of sovereign debt restructuring as having little effect on this question. As an international creditor, China's main concern has to do with safeguarding the value of its overseas assets from the detrimental effect of macroeconomic policies of Western countries, especially the United States. This is not an issue that can be addressed by improved debt restructuring mechanisms. China remains deeply concerned about the power imbalance between developed and developing countries in the international financial system. Going forward in the global dialogue over sovereign debt restructuring, China's priority will be to minimize international financial instability while protecting the development needs of developing countries.

INTRODUCTION

Debt crises have long been a part of the international financial system. Until recently, this was primarily a problem for the developing countries. Lacking adequate financial resources at home, many developing countries borrowed from international lenders to finance their economic development. When they faced unsustainable debt service payments, they would typically seek assistance from the IMF. The IMF would provide short-term financing in return for macroeconomic adjustment and structural reform that would increase the borrowing countries' debt service capacity in the medium run. In cases where a debtor country's needs exceeded IMF financing and domestic adjustment, the IMF encouraged debt restructuring either through rescheduling or reduction. But, more often than not, both debtors and creditors were reluctant to begin debt restructuring, delaying it as long as possible, causing economic dislocation and financial instability.

In the early 2000s, the IMF proposed radical reforms aimed at earlier and more orderly sovereign debt restructuring. Due to a lack of support from major stakeholders, the reforms never got off the ground. In 2013, the IMF launched another round of debate and consultation over how to improve sovereign debt restructuring in terms of its timeliness, efficiency and fairness. This has taken place in the shadow of the European debt crises and the legal battle between Argentina and its holdout creditors. The former indicates that debt sustainability is no longer just a problem for the developing countries; the latter highlights the growing problem of coordination among large numbers of diverse creditors in today's international debt market. Both trends call for new ways to manage the debt problem.

The IMF's efforts to explore reform options are ongoing and will need international support to be effective. China, as the second-largest economy and a major global creditor, is an importance force to reckon with.[1] So far, the Chinese government has said little publicly about the IMF's proposed reforms. This paper offers a context for understanding China's policy position, if and when it becomes official, by reviewing Chinese reactions to the last round of debate about sovereign debt restructuring in the early 2000s, and by examining recent Chinese discourse and initiatives regarding sovereign debt management.

1 China's net creditor position is largely due to its current account surplus. China has invested that surplus in overseas equity, real estate holdings, debt holdings, etc. This paper focuses on its lender's position through debt instruments.

THE DEBT RESTRUCTURING DEBATE IN THE EARLY 2000s

The sovereign debt crises of the 1980s and 1990s caused serious financial turmoil in the world and painful losses to the countries involved. In an effort to achieve a more orderly solution of debt problems, the IMF proposed a daring reform in the early 2000s. Anne Krueger (2002), first deputy managing director of the IMF, put forth the idea in a speech at the National Economists' Club. She pointed out that the world lacked incentives to help countries with unsustainable debt burdens to resolve the issue in a timely and orderly fashion. In order to fill this gaping hole in the international financial system, it would be useful to apply the domestic bankruptcy model to sovereign debt management. At the heart of the IMF proposal was an SDRM. When countries recognized their debt burden to be unsustainable, they would activate the SDRM and submit their debt information to the Sovereign Debt Dispute Resolution Forum (SDDRF), an independent forum made up of professionals to verify claims, ensure the integrity of the voting process and adjudicate disputes. Creditors would register with the SDDRF and become party to the resolution agreement, and debtor countries and creditor countries would negotiate the terms of debt restructuring. When supported by the debtor country and over 75 percent of the creditors, the agreement would be binding for all parties. The goal of establishing this legal framework was to facilitate the resolution of debt problems earlier and faster than in the past. Compared to the traditional way of dealing with debt crises, this new approach would: confront the debt problem sooner and provide better protection for the debtor; minimize the negative impact of debt crisis on the economic recovery of the debtor country and on the stability of the international financial system; and help preserve value for the creditors while reducing the moral hazard of excessive lending.

The IMF's proposal generated various reactions (Setser 2005; Helleiner 2009). On the whole, European countries were the most supportive of the idea of the SDRM. They welcomed the prospect of fewer IMF bailouts, if the SDRM would be able to tackle debt problems early on, and, unlike the Americans and the British, Europeans were less worried about the potential of the SDRM contradicting their domestic laws, as most international bonds are governed by US or English law.

The attitude of the US government was initially positive. Treasury Secretary Paul O'Neill agreed that there should be an international sovereign bankruptcy law, but his position was soon contradicted by the deputy for international affairs, John Taylor. The eventual US opposition to the SDRM should not be surprising. After all, the SDRM takes a statutory approach to debt management, which goes against the general preference for market-based solutions of US policy makers. Any framework that would give a prominent role to international authorities, such as the IMF or a new international organization, would most likely be rejected by the US Congress.

Meanwhile, many countries in the developing world were skeptical about the proposed SDRM, fearing it would lead to reduced assistance by the IMF in times of crisis. They were also concerned that, while this framework would protect them in case of unsustainable debt payments, it would make investors less willing to buy their bonds and thus increase the cost of their borrowing. In addition, they did not like the implications of the SDRM for their national sovereignty, including the likelihood of an international organization having jurisdiction over their domestic-law debts held by non-residents.

Finally, private creditors were strongly against the SDRM. They argued that market-based alternatives would be superior to the statutory approach. In particular, they advocated the inclusion of collective action clauses (CACs) in more debt contracts. CACs allow a supermajority of bondholders to agree to changes in bond payment terms and to have that agreement binding for all the holders of the bond. This clause was already included in the bonds issued under English law. In the aftermath of the SDRM debate, CACs became common among New York law-governed bonds as well. In early 2004, the Institute of International Finance (IIF), which claimed to represent many of the private creditors, issued the Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets, which calls for transparency, information sharing among debtors and creditors, timely consultation, good faith negotiations, protection of property rights, fair treatment of all parties and voluntary agreements (IIF 2004). It was an effort to take the wind out of the SDRM and other statutory attempts to address the debt problem (Helleiner 2009).

China's response to the debate around SDRM was supportive but non-committal. In September 2002, Dai Xianglong, then governor of the Chinese central bank, spoke at the IMF's International Monetary and Financial Committee (Dai 2002). He stated that a fair and effective SDRM had an important role to play in crisis prevention and resolution, and that China welcomed the IMF's effort in developing a new approach. The Chinese government believed that statutory and contractual approaches complemented each other. With regard to the statutory approach, he emphasized that the proposed SDDRF must be independent and impartial, and that it should have adequate representation of the developing countries (ibid.). Dai stated that China would like to see further specifications and clarification of the SDDRF's operational mechanism, the rules of selecting its members and its relationship with the IMF (ibid.). He urged the Fund to carefully consider the practicality of amending its Articles of Agreement. In terms of the contractual approach, Dai stressed that it must fully reflect the principle of voluntary implementation (ibid.). He expressed skepticism about the desirability and feasibility of enforcing a contract-based framework through IMF conditionality, and concern as to how the market would react to CACs, noting that if they were to increase the financing cost for developing countries they would be less feasible (ibid.).

In April 2003, Li Ruoguo, an assistant governor of the Chinese central bank, again welcomed the IMF's research on the issue of sovereign debt restructuring (Li 2003a). He reiterated the positions expressed by Dai that a fair SDRM would be important both for crisis prevention and resolution and added that it was good for private sector participation (ibid.). At the same time, Li was more specific than Dai had been in identifying the flaws of the existing proposals. In particular, he argued that the automatic stay mechanism of the SDRM would help ensure the smooth conduct of restructuring negotiation, but would "widely involve the revision of laws of all countries and amendment of the IMF Articles of Agreement" (ibid.). This, he believed, would not be practical in the near term. He was also doubtful about the independence and fairness of the SDDRF and the solution to its many technical problems. As for CACs, he pointed out that they could not solve the collective action problem for multiple sovereign debts, which was a major reason for the statutory approach of the SDRM (ibid.). Like Dai, Li expressed concern about the impact on the bond-issuing cost for emerging markets and urged that they be designed in a way to facilitate capital flows to developing countries (ibid.). He repeated that it would be important for CACs to be applied according to the voluntary principle. Echoing Dai, he argued that statutory and contractual approaches to debt restructuring should supplement each other (ibid.). He also commented on the code of conduct being discussed among various private and public actors, which later became the Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets in 2004, emphasizing that it should not include coercive terms aimed at developing countries (ibid.).

Earlier in 2003, Li (2003b) published an article that pointed out that the IMF was playing an *ex post* role in dealing with the debt problem, providing rescue after a financial crisis. In playing such a role, the IMF was not only limited by its resources, but was also blamed for either creating moral hazard or being too demanding with its conditionality (ibid.). This, he explained, was the context of the recent IMF reform proposals. He argued that many technical problems in the reform proposals would be hard to solve, including how to prevent the abuse of the mechanism by debtor countries, how to operate the SDDRF, whether bilateral official debt and domestic debt should be included, and how to ensure transparency among different types of creditors regarding separate restructuring negotiations (ibid.). He observed that, because of these and many other practical difficulties, the SDRM would not be implemented for several years, but he saw the approach taken by the IMF as a welcome attempt to improve the stability of the international financial system (ibid.).

Later in 2003, Zhou Xiaochuan, the new central bank governor of China succeeding Dai, spoke briefly at the IMF about the issue of sovereign debt restructuring (Zhou 2003). He called for the IMF to widely consult all parties and reiterated that the use of CACs should be decided by sovereign countries according to their own situation. He also stated that the proposed code of conduct should be practical and serve as a useful reference for the members (ibid.).

Alongside the government's cautious response to the SDRM debate, a small number of articles and books were published by analysts and scholars, reflecting mixed views of the reform. They were mostly descriptive of the proposals being discussed at the IMF and elsewhere, though there was some analysis of the background of the debate, the weaknesses and strengths of the proposals, and their feasibility.

A policy report co-authored by a researcher in China's central bank identified several advantages of the SDRM. It argued that the SDRM aimed to establish a predictable and orderly mechanism for sovereign debt restructuring (Zhang, Rong and Yan 2003). Compared with the Paris Club's restructuring of bilateral official debt and the Heavily Indebted Poor Countries initiative, the SDRM put greater emphasis on crisis prevention and private sector participation. The SDRM was also superior to CACs in that it would tackle existing as well as future debt. In contrast, CACs only covered newer debt with such clauses or older debt after their conversion. In addition, CACs would only apply to individual bond series, while the SDRM would be more capable of aggregation across different bond series. Finally, the establishment of a SDDRF could facilitate faster and fairer debt restructuring. On the other hand, the article argued that both the SDRM and CACs were merely meant to save the IMF from endless bailouts and to involve the private sector in the resolution of debt problems, especially those due to illiquidity (ibid.). They could not overcome the disadvantage of developing countries in the international debt market, which was rooted in their poor property rights protection and the political tendency to over-borrow (ibid.).

In contrast, an academic analysis of sovereign debt restructuring was quite critical of the proposed SDRM (Study Group 2003). It expressed skepticism about the implementation of the SDRM, due to the impracticality of imposing international jurisdiction over sovereign debt, and the difficulty of incentivizing debtor countries to restructure their debt in a timely fashion while preventing them from abusing the mechanism (ibid.). It offered several critiques against the SDRM. First, the assumption about holdout creditors was far from reality. Few rogue creditors had disrupted debt restructuring in the past. Second, the burden sharing embedded in the SDRM between debtors and creditors in dealing with debt crises would inevitably and drastically reduce the flow of capital to developing countries. Third, the current market-based approach to debt restructuring seemed to be working well and the SDRM did not appear to offer any improvement. Fourth, it would be important to pay more attention to protecting the rights of creditors. Fifth, the greatest problem of the existing financial system was a lack of policy mechanisms to prevent financial crises from happening, rather than the lack of an orderly debt restructuring mechanism after a crisis (ibid.).[2]

In addition to being doubtful about the effectiveness of the SDRM, the study group was concerned about its consequences for national sovereignty. The authors argued that the fact that the SDRM received majority support among IMF members indicated that it suited the interest of the developed countries (ibid.). In their view, "state bankruptcy" would enable developed countries to control developing countries, forcing them to open their markets and to carry out economic and even political reforms according to the preferences of the developed countries (ibid.). They believed that many developing countries would hope to get debt relief through this mechanism, even though voting for such an option meant that they would lose their leverage and freedom in negotiating debt restructuring. As for the impact of debt restructuring on China, the study group was not concerned because China was not a deeply indebted country.

The study made several policy recommendations. First, it suggested that given the difficulty in setting up an international bankruptcy court, it would be sensible to use national judicial systems. It would be better to use the judicial system of the debtor countries than the creditor countries because this would give developing countries jurisdiction over debt restructuring. Second, it called for developed countries to increase aid rather than lending to developing countries. Third, it suggested that developing countries should demand an "international debt restructuring fund" that would compensate for the potential reduction of capital flow to them under CACs or the SDRM, and assist the transition to these new mechanisms of sovereign debt restructuring (ibid.).

Another academic study by Beijing Normal University's He Liping was more positive about the IMF's proposal (He 2002). This study pointed out that the main issue the IMF sought to address was the applicability of the domestic laws of developed countries to resolve international debt crises. It argued that this was a new venture for the IMF, beyond its traditional role as a lender of last resort in addressing short-term balance-of-payment problems (ibid.). This, according to He, was logical and reflected the growing integration among national economies and between the private and public sectors in international finance (ibid.). He's main criticism of the IMF was its inconsistent application of rescue criteria (for example, between Turkey and Argentina in 2001). The study called for the IMF to be more consistent and not to push debtor countries to seek bilateral debt restructuring, as Argentina was forced to do with the United States after the IMF refused to provide it with timely assistance (ibid.).

Clearly, Chinese analysts had varying and sometimes contradictory views on the different approaches to sovereign debt restructuring under discussion. The official Chinese position was supportive of the IMF's initiative to reform the existing framework for dealing with the debt problem. The Chinese government was sympathetic toward the SDRM, but agreed that it and CACs could, and should, complement each other. Chinese policy makers seemed to be primarily interested in making sure that the new mechanisms for debt restructuring would be respectful of the sovereignty of the debtor countries, the SDDRF would be fair to developing countries and the change would not have a negative impact on the capital flow to the developing countries. They believed that it would take a long time for the details to be worked out for the SDRM, if it were ever to materialize.

THE CURRENT DEBATE ON SOVEREIGN DEBT RESTRUCTURING

More than a decade after the IMF brought up the idea of the SDRM, it began a new round of discussions about sovereign debt restructuring in 2013. In light of important developments in debt restructuring in the last decade, especially the Greek and Argentine cases, the IMF has been reviewing its policies and practices. It is also monitoring a host of proposals being developed elsewhere, such as a European Crisis Resolution Mechanism (von Hagen et al. 2010), an International Debt Restructuring Court (United Nations 2009) and a Sovereign Debt Forum (Gitlin and House 2014), all of which seek to strengthen the current debt restructuring mechanisms (IMF 2013).

In June 2014, the IMF released a report that put forth two major proposals to reform the current framework of the Fund's lending (IMF 2014). First, it proposes to modify the Exceptional Access Framework established in 2002, which required debt restructuring when the IMF could not determine the member's debt was sustainable with high probability. Arguing that this led to restructuring when it might not have been needed, the new proposal seeks to inject more flexibility into IMF lending. If a member has

2 This seems to contradict Chinese representatives' statements that the proposed SDRM would be helpful to both the prevention and the solution of debt crises. This is probably because the notion of "crisis prevention" in the official speeches meant earlier intervention and pre-emptive restructuring, whereas in this study and in Chinese discourse generally, "crisis prevention" means the avoidance of unsustainable debt more broadly.

lost access and its debt is considered sustainable, but not with high probability, IMF support would be conditional on an extension of the maturity of bonds (ibid.). The hope is that such "reprofiling" of debt would allow for more gradual adjustments than debt reduction up front.

Second, the IMF report proposes to eliminate the so-called "systemic exemption" to the 2002 framework. Introduced in 2010 in response to the euro-zone debt crisis, the systemic exemption allowed some countries to receive financing even if the IMF could not say that their debt was sustainable with high probability, as was the case with Greece (ibid.). The rationale used for the exemption was to prevent contagion from Greece that would cause systemic instability in Europe and beyond. The new study recognizes the exemption as inequitable and excessively open-ended. It also failed to contain contagion because it did not address the underlying concerns regarding sustainable debt payment.[3]

While this report does not directly address the problem of collective action in debt treatment, it states explicitly that "it relies on a contractual — rather than statutory — solution to the problem" (IMF 2014, 8). It is ironic that the IMF seems to have completely abandoned the statutory approach to debt restructuring embodied in its earlier proposal of the SDRM, while a growing number of experts argue that there is a stronger case for a statutory approach to debt structuring today than a decade ago (see, for example, Committee on International Economic Policy and Reform 2013). The position of the IMF on this question may reflect the strong influence of important stakeholders, such as the US government and the private sector.[4]

Compared with the early 2000s, when the last round of the IMF-led debate took place, China's position in the international financial system has changed significantly. China's involvement in the international debt market has grown rapidly. By the end of June 2014, China's holdings of US Treasury bills was US$1.27 trillion (Department of the Treasury/Federal Reserve Board 2014). China's holdings of euro-denominated assets are estimated to be around US$1 trillion (Otero-Iglesias 2014). China has also delivered tens of billions of dollars to other countries through aid and government-sponsored investments (Gallagher, Koleski and Irwin 2012; Wolf, Wang and Warner 2013).[5] Surprisingly, the Chinese government has not said much in public about the IMF's recent proposals, nor has there been a lot of open discussion among Chinese academics of the current debate on sovereign debt restructuring. However, conversations with Chinese officials and policy analysts provide some insights into their views on some of the key questions being debated.[6]

With regard to the option of reprofiling sovereign debt in some cases, Chinese officials and analysts are positive, but not enthusiastic. They see such an option as potentially useful in dealing with problematic debts, especially if the problem is due to a short-term bulge in debt-service obligations. However, they see its effect as limited. For instance, reprofiling would not have meaningfully changed the situation in Greece in 2010, where the average maturity of the public debt was eight years. The European Union would not have been any more inclined to support reprofiling than a haircut to principal at the outset of the Greek crisis. Chinese experts also wonder what would happen if reprofiling fails to address a country's debt payment problem. In the likely event of an eventual reduction of debt, the process of restructuring would be even messier than a straightforward haircut.

Chinese analysts are quite positive toward the second proposed reform — i.e., the elimination of the systemic exemption in exceptional access arrangements. They view the exemption, which overrode standard IMF practice in the approval of the 2010 program for Greece, as inequitable because countries outside major currency unions are unlikely to qualify for it. They also do not believe the exemption is an effective way to address the problem of contagion, as it was proclaimed to be in the Greek case. Contagion has to be contained by a credible program rather than relaxing the conditions for IMF lending.

While the IMF is trying its best to distance itself from the SDRM proposal of the early 2000s, China has maintained that both statutory and market-based approaches are useful to debt restructuring. On the one hand, China has expressed support for the IIF's principles. In 2011, Governor Zhou Xiaochuan became a co-chairman of the Group of Trustees of the Principles, a group made up of senior officials from emerging market and mature economies, and senior representatives of the financial industry, which meets annually to review the implementation of the principles. On the other hand, China remains open to the statutory approach to debt restructuring embodied in the SDRM. In 2009, the United Nations held a conference

3 For an early and insightful critique of the "systemic risk waiver" that began with the IMF's lending to Greece, see Schadler (2013).

4 Just like the debate over sovereign debt restructuring in the early 2000s, since the IMF launched its latest study program on this issue, the private sector has responded with its own proposals. The IIF has closely followed the IMF study in 2013 and argued vigorously in favour of improvements of market-based solutions, including promoting more robust aggregation clauses and creditor engagements provisions. The main message of the private creditors it represents is that the current contractual approach to sovereign debt restructuring works very well and there is no need for the IMF to reinvent the wheel (IIF 2014).

5 On China's role as an increasingly important bilateral creditor to many African countries, see Brooks, Lombardi and Suruma (2014).

6 The next two paragraphs draw from the CIGI commentary about the workshop on sovereign debt restructuring CIGI co-sponsored with the Chinese Academy of Social Sciences in Beijing in July 2014 (House, Wang and Xafa 2014).

on the World Financial and Economic Crisis and Its Impact on Development. In the negotiation process for the conference, China and the Group of 77 (G77) reiterated the idea of an SDRM, including the possibility of an independent international bankruptcy court that would enable countries facing debt distress to have recourse to a debt standstill, facilitate burden-sharing and allow for continued lending to the debtor country. The outcome document of the conference called for a more structured framework for international cooperation in the area of sovereign debt restructuring (UN 2010).

China's interest in a multilateral legal framework for sovereign debt restructuring has been strengthened by the experience of Argentina, which highlights the weakness of the market-based system of debt management. The recent decisions by the US Supreme Court on Argentina regarding the limits of sovereign immunity and the meaning of *pari passu* clauses, undermined the earlier debt-restructuring agreements Argentina had reached with the majority of its creditors, and exposed the country to hundreds of billions of dollars in debt obligations (Russo and Porzercanski 2014). In the midst of the legal battles, in June 2014, the G77 and China expressed full solidarity with and support for Argentina against the vulture funds. They argued that debt restructuring should focus on real payment capacity and not undermine sustainable development. The Declaration of Santa Cruz that came out of the group's summit pointed to "the urgent need for the international community to examine options for an effective, equitable, durable, independent and development-oriented international debt resolution mechanism" (G77 2014). In September 2014, the UN General Assembly passed a resolution put forth by the G77 and China to elaborate and adopt a multilateral legal framework for sovereign debt restructuring processes (UN 2014).

Besides the case of Argentina, China's favourable disposition toward a multilateral mechanism of sovereign debt restructuring may have also been encouraged by its recent experience in dealing with the debt crisis in Europe, which has revealed that bilateral and regional mechanisms can be problematic. When the debt crisis broke out in Europe, the Chinese government quickly expressed support of efforts to solve the crisis. Chinese officials often said that they had faith in Europe's ability to manage its business and that Chinese investment in Europe would not be affected by short-term difficulties (see Xinhua 2011). Instead of heading toward the exit, China continued to buy European debt and made new investments in various projects, including infrastructure and real estate in Greece at the height of the crisis in that country (Pham 2010).

As individual European countries and the European Financial Stability Facility approached China requesting it inject rescue funds, many commentators in China saw this as a valuable opportunity for China to use its economic leverage for political gains. They suggested that China provide aid to Europe in order to improve China's image and improve European relations with China. However, it soon became clear that such perceived political opportunities did not exist due to strong anxiety in Europe about being "rescued by China" (Zheng 2012; Liu 2013). China had hoped to receive market economy status from European governments.[7] It had also tried to persuade European governments to lift the arms embargo that began in the aftermath of the Tiananmen Incident in 1989. But Europe rejected China's requests on both issues, even as it sought Chinese assistance in dealing with the debt crisis. This was deeply disappointing to the Chinese government (BBC 2012).

The Chinese government shifted its position after 2011. Vice Foreign Minister Fu Ying clearly stated that the argument that China should rescue Europe did not stand, but that China was an active participant in the international effort to help Europe (*China Daily* 2011). China then began to work with the IMF to assist Europe in the debt crisis. In 2012, President Hu Jintao announced that China would provide US$43 billion to the IMF to increase its capacity to lend to Europe. Chinese officials argued that contributing funds to the IMF was a good policy option for several reasons: it would enable the IMF to better help solve the debt crisis; it would increase China's voice at the IMF; and, in addition, China's lending to the IMF would be safe and generate high returns (Xinhua 2012).[8]

While China officially supports multilateral arrangements to address debt crises, so far the Chinese government has said little about its positions on the specific proposals in recent IMF reports, and Chinese analysts have shown limited interest in this subject. This may be due to two reasons — that these mechanisms do not address the root cause of over-borrowing and over-lending, and that they are largely irrelevant to the type of perceived threat to Chinese overseas assets.

Chinese policy makers and analysts see moral hazard as a major cause of over-borrowing and over-lending. They do not believe that debt restructuring, with its reputational costs and the accompanying loss of market access, is adequate in countering this problem. It has not deterred debtor countries from over-borrowing because the international debt market has a short memory; for instance, Greece regained its standing in the international capital market not long after its debt was restructured. Nor has debt restructuring stopped investors from over-lending.

7 This would narrow the gap between the constructed normal value of goods and the prices of Chinese exports and, thus, reduce the anti-dumping duties imposed on Chinese exports.

8 Statements of this kind were, in part, directed at the domestic audience. The government was well aware of the potential opposition among the Chinese public to using Chinese money to save the rich countries in Europe (Ding and Zhao 2014; Otero-Iglesias 2014).

Managers of mutual funds and other vehicles invest other people's money and are strongly motivated to search for yield rather than safety. Banks and insurance companies are under pressure to hold highly rated sovereign papers under capital-adequacy standards. Improved debt restructuring mechanisms do not provide a real solution to these problems (House, Wang and Xafa 2014).

In addition, China is in some ways very different from many other international creditors. Since 2010, roughly 65 to 70 percent of its total foreign assets have been foreign reserves and only around seven percent are debt securities and loans (State Administration of Foreign Exchange 2014). In other words, the vast majority of China's lending is through its official reserves. Moreover, most of China's foreign reserves are held in dollars and invested in US government bonds. As the United States borrows in its own currency, it is likely to print dollars to pay its debt rather than to default, and this is China's main concern. Many Chinese analysts and commentators have criticized the quantitative easing policy adopted by the US Federal Reserve after the financial crisis in 2008. They see it as a convenient and immoral way for the United States to reduce its debt burden at the expense of the creditor countries (Zhang 2012; Yu 2013). More recently, they argue, European countries have adopted the same method through their own version of quantitative easing (Ding and Zhao 2014). Chinese leaders and representatives have often urged Americans and Europeans to "safeguard" the value of Chinese assets (*People's Daily* 2009; Spiegel 2011). Sovereign debt restructuring arrangements are not able to deal with this type of debt dilution.

SOVEREIGN DEBT GOVERNANCE AND REFORM

Although Chinese officials and analysts have so far shown limited interest in the IMF-led discussion about sovereign debt restructuring, it does not mean they are not concerned about the problems of sovereign debt management. This section examines Chinese views about sovereign debt governance broadly, which could provide some clues as to what China's goals and priorities may be regarding sovereign debt restructuring.

An overarching theme of Chinese discourse on international debt governance is that the current international financial system, dominated by Western countries, is fundamentally unfair to countries in the developing world. In fact, some Chinese analysts have expressed deep cynicism that fair and effective new rules regarding debt restructuring will emerge under such a system (Zhong 2013; Ding and Zhao 2014). They argue that, historically, Western countries used political, diplomatic and even military means to secure payments from debtor countries, as well as using their domestic laws to maximize their interests as creditors (ibid.). However, as industrialized countries face their own unsustainable debt, they may well change the rules of the game and not provide developing country creditors with equal protection of their rights (ibid.). For example, in 2012, the governor of China's central bank, Zhou Xiaochuan, suggested that countries borrowing internationally — including industrialized countries — should come under the oversight and discipline of international institutions such as the IMF (Zhou 2012). But Chinese officials have no expectation that Zhou's suggestion would be acceptable and that the IMF would impose conditions on sovereign borrowers in the West (House, Wang and Xafa 2014).

Furthermore, the current financial system is dominated by the "structural power" of the West, in particular the United States.[9] China, like other developing countries, lends and borrows in dollars and euros. Whether as a creditor or a debtor, its financial interests are vulnerable to the macroeconomic policies of Western countries and to exchange rate risks. As mentioned earlier, the main concern for Chinese policy makers and analysts regarding its holdings of US and European debt is the use of inflationary policy by debtor countries to dilute their debt obligations. They also point out that Chinese assets and liabilities both face exchange rate risks. If the renminbi (RMB) appreciates against the dollar or the euro, Chinese overseas assets will lose value in terms of RMB. If the RMB depreciates, China's external debt burden will increase (Wang 2007).[10]

How, then, does China plan to address the unfairness of the current sovereign debt system? Since Chinese policy makers see the dominance of the US dollar as a key problem working against China and other developing countries, an important reform of the international financial system is to reduce the role of the dollar. Governor Zhou Xiaochuan of China's central bank famously stated the need to increase the use of the IMF's special drawing rights as an international reserve currency, reducing the world's dependence on the dollar (Zhou 2009). Although the Chinese government backed off somewhat from that position, China has continued to promote diversification from a dollar-dominated international currency system.

There has been a clear movement toward internationalization of the RMB in the last few years. In July 2009, China began a pilot scheme to use the RMB in trade settlements with Southeast Asian countries and with Hong Kong and Macau. By mid-2013, about 17 percent of China's total foreign trade was settled in RMB. Since early 2012, about one-third of incoming and outgoing foreign direct investment has been denominated or settled in

9 The concept of "structural power" comes from Strange (1988).

10 The "loss" based on changes in the exchange rate may not be material. To the extent China holds its reserves in US dollars or euros, the dollar and the euro are accounting units. The value of the reserves in RMB terms goes down when the RMB appreciates, however, that is largely symbolic unless China actually converts the reserves into RMB.

RMB. Offshore RMB bond issuance in Hong Kong has also risen rapidly, standing at around US$10 billion in late 2013 (Eichengreen and Kawai 2014).

Meanwhile, China has also been keen to encourage the use of other currencies besides the US dollar. During the debt crisis in Europe, China offered assistance not only out of short-term economic and financial considerations, but also long-term political considerations. China did not want to see the euro zone undermined by the debt crisis. From its perspective, a healthy euro zone is an important pillar of a multi-polar world (Otero-Iglesias 2014). Likewise, in July 2014, China and the other members of the BRICS (Brazil, Russia, India, China and South Africa) launched a New Development Bank (NDB). Headquartered in Shanghai, the new bank will provide financing for infrastructure and other development projects in the emerging economies, while increasing the use of a variety of currencies other than the US dollar. The BRICS have also formed a Contingency Reserve Arrangement (CRA), which will provide assistance to member countries facing balance -of-payment crises. Some hope the NDB and the CRA will be "the forerunners of a new multi-currency world that breaks US dollar hegemony" (Saidi 2014). Others are far less optimistic about such a breakthrough (Schuman 2014).

In all likelihood, the central role of the dollar is likely to continue for the foreseeable future. In fact, China's own policy has been a contributing factor. In order to keep the value of the RMB stable and low, the Chinese government has more or less pegged its currency to the dollar and accumulated vast dollar reserves in recent years. Together with a number of other economies in the East Asia region, which rely on fixed or semi-fixed exchange rates to promote exports, China has enabled the United States to finance its large current account deficits and sustain the role of the dollar. Some scholars have labelled this as a Bretton Woods II international monetary system (Dooley, Folkerts-Landau and Garber 2004). China may have suffered financial losses from accumulating massive foreign reserves, but it has gained enormous economic benefits from the export-led development model. The Chinese government has been calling for a shift toward a domestic consumption-based model of growth for over a decade, but the change has been slow in coming because of formidable political obstacles (Wang 2014). Relatedly, the push to internationalize the RMB is not likely to go further without exchange rate liberalization and financial liberalization more generally in China. If the Chinese government is unwilling or unable to adopt these reforms, which has been the case so far, it is difficult to imagine how the RMB will become an international currency, especially as a reserve currency.

Chinese policy makers have no illusion about the imminence of a new international financial order. They recognize that for the foreseeable future, the dollar will remain the central currency in the international debt market, and the existing international financial institutions will remain key players in global debt crises management. Chinese analysts have gone out of their way to describe new financial institutions that China has co-created, such as the regional reserve pool of Chiang Mai Initiative Multilateralized, the NDB and the CRA, as complementary institutions to the World Bank and the IMF, even as China uses these new institutions to promote reform at the World Bank and the IMF (*China Youth Daily* 2014). Whatever its long-term goals may be in reforming the international financial system, China will continue to cooperate with the IMF and other international financial institutions.

As discussed previously, China has been supportive of the IMF's efforts to explore new approaches to sovereign debt restructuring since the early 2000s. Some Chinese financial commentators explicitly urge the IMF to redefine itself as not only a lender of last resort, but also as a restructurer of sovereign debt. Injecting new funds is not a fundamental solution of the debt crises. To maintain financial stability, the IMF must combine its function of debt financing with debt restructuring (see Zuo 2012). China's support of the IMF in this regard has probably been encouraged by its improved representation at this institution. An ad hoc increase of quotas in 2001 — as a result of China's resumption of sovereignty over Hong Kong — raised China's voting power. In 2010, the IMF approved a plan to further increase the quotas of China and other dynamic emerging markets. Once implemented, this new plan will make China the third-largest member in the IMF. With greater representation, China is developing a greater stake in the organization.

Besides the IMF, the Paris Club is another important multilateral institution dealing with sovereign debt problems. It works closely with the IMF. For instance, under the policy of non-toleration of arrears to official bilateral creditors, IMF lending relies on Paris Club members to provide debt relief to the debtor countries in question. Made up of 19 permanent members — almost all Western industrialized countries — it is an informal group of official creditors that gets together regularly to deal with bilateral sovereign debt problems.[11] Since its establishment in 1956, it has reached 430 agreements with 90 debtor countries.

The effectiveness of the Paris Club in addressing sovereign debt issues is coming under question as a growing number of emerging economies outside the club have become major creditor countries (Brooks, Lombardi and Suruma 2014). In 2013, the Paris Club had a joint meeting with the G20 as a gesture to non-members (Morris 2013). The major creditor countries in the developed world recognize that they need to harmonize the terms of lending and

11 In contrast, the debt restructuring mechanism proposed by the IMF primarily deals with sovereign borrowing from private lenders. Both, however, relate to the overall debt regime.

restructuring with new creditor countries from the developing world (Weiss 2013). This is also the view of Chinese policy makers. China has begun attending some Paris Club meetings on an ad hoc basis, both to deal with specific debt problems and to learn about its processes, but has not yet become a permanent member. China is likely to stay outside the Paris Club because membership in this quintessential "rich countries' club" could cast a shadow on China's much cherished identity as a developing country, and raise questions about its claimed solidarity with other developing countries. China's ambivalence about, and ultimate rejection of, membership in the Group of Eight a few years ago may be indicative of its disinclination to join a rich countries' club such as the Paris Club.

While working with the IMF and the Paris Club, China has its frustrations with both institutions. With regard to the IMF, the main issue is the slow pace of its governance reform. The 2010 agreement to shift more votes to developing countries has not been implemented thus far, prolonging the overrepresentation of Western countries in the organization. With regard to the Paris Club, Chinese officials recognize the need for it to be more inclusive of new creditors. But they are skeptical that once enlarged its tradition of operating on consensus will still be workable (House, Wang and Xafa 2014). In recent years, China has also used other international channels to express its views on the issue of sovereign debt management.

As discussed previously, in the last few years the Chinese government has often joined other developing countries in raising this issue at the United Nations. In September 2013, the foreign ministers of the G77 and China met at the United Nations. Their Ministerial Declaration not only highlighted the urgent need for the international community to examine options for development-oriented debt restructuring and resolution mechanisms, it also specifically urged countries to promote and contribute to the discussions within the United Nations and other appropriate forums (G77 2013). In the Declaration of Santa Cruz of June 2014, China and the G77 called on the UN General Assembly to launch a process to reform the international financial and monetary system, including over debt restructuring. They expressed support for exploring the establishment of a UN intergovernmental mechanism under the General Assembly to monitor international financial flows and policies to prevent economic and financial crises from spreading among countries (G77 2014). And, as noted earlier, China and the G77 have recently pushed through a UN resolution calling for an international legal framework for sovereign debt restructuring (UN 2014).

While developed countries argue that sovereign debt restructuring should be discussed at the IMF or the G20 rather than the United Nations because the latter lacks expertise, China and other developing countries have strongly defended the legitimacy and mandate of the United Nations in handling this issue (Muchhala 2014). On one hand, this may be a matter of convenience. Declarations at the United Nations tend to proclaim broad principles rather than legal and technical details, and China is typically comfortable endorsing principles such as justice and development. On the other hand, it follows naturally from China's critical view of the power imbalance in the international financial system. Compared with the IMF (let alone the Paris Club), the United Nations offers a more egalitarian platform that gives greater voices to the developing countries. China has long claimed to be a member of the developing world, and in recent years, it has broadened and strengthened initiatives of South-South cooperation for both political and economic reasons. Standing with the developing countries on debt governance is likely to win China more friends in the Global South.

While China has held a generally critical view of international debt governance for quite a while, there have been some subtle changes in recent years. First, there has been a shift in China's attitude toward the balance between debtor and creditor rights and obligations. In the past, China emphasized the rights of the debtor countries in the developing world. In its contribution to the last round of IMF-led debates over a decade ago, Chinese officials were eager to ensure that sovereign debt restructuring would respect the sovereignty of the debtor countries, that the SDDRF would be fair to developing countries and that any reform would not hinder capital flow to the developing world.

As China has taken on the role of a major international creditor in the last several years, it has become more interested in institutional arrangements that will rein in irresponsible debtors. For instance, in 2012, Zhou Xiaochuan made a radical proposal that countries should limit their sovereign borrowing to their domestic markets (Zhou 2012). Domestic investors are more likely to be concerned about the microeconomic consequences of government debt, which would rationalize the pricing of debt. In the event of a debt crisis, it would be easier for the public to achieve consensus over what adjustment policies to adopt.[12] In cases where countries borrow from international creditors, they should come under the oversight and discipline of international institutions such as the IMF (ibid.).

As a new international creditor, China sees excessive borrowing as a problem that both developing and developed countries must seriously address. In the last few years, Chinese analysts have noted with concern the rapid

12 Commentators such as the *Financial Times*'s Martin Wolf (2008) have expressed similar views in the past, on the grounds that this would make future restructurings proceed more easily as the creditor universe would be more limited and better known. Additionally, domestic legislation could coordinate creditors more effectively than even reformed CACs.

expansion of debt in the developed countries. In response to the recent debt crisis in Europe and the growing debt problem in the United States, Chinese analysts and officials have repeatedly called on governments in the developed countries to better control their sovereign debt and avoid excessive indebtedness (He 2010; Zhou 2012).

Interestingly, although the latest debt crisis took place in Europe, Chinese analysts seem to be even more worried about the debt problem in the United States (see He 2010). Debt crises in general, but a US debt crisis in particular, would undermine the stability of the international financial system, in which China has an important stake. Moreover, given China's deep involvement in US debt, it has much to lose financially if the United States fails to meet its debt obligations. In the last few years, more than a few commentators have strongly urged China to reduce its US debt holdings (see Zhang 2010; Li 2013).

A second and related trend in China's approach to sovereign debt management is its evolving attitude toward national sovereignty. In the early 2000s, China warned that reform of debt restructuring should not undermine national sovereignty, especially that of the developing countries. The emphasis on protecting developing countries' sovereignty was, in part, a reaction to the IMF's handling of the Asian financial crisis. Chinese policy makers were deeply struck by the intrusion of international intervention in debtor countries' sovereignty. In recent years, China's position has become more nuanced. On the one hand, Chinese analysts remain sensitive to national sovereignty. One of the lessons they draw from the recent legal battles over Argentina's sovereign debt is the importance of maintaining economic sovereignty. They see Argentina's involvement in protracted litigation as due to the fact its debt was arranged and restructured in the United States under US law, which made Argentina subject to the decisions of US judges (Xinhua 2014). On the other hand, China is now more flexible toward national sovereignty, especially that of the developed countries. In the case of litigation by the vulture funds against Argentina, China has joined the G77 in advocating an international mechanism for debt restructuring that overrides the ruling of the US judicial authorities. With regard to the debt management of the industrialized countries, whose debt problems are seen as a result of irresponsibility rather than of poverty, China has called for disciplined macroeconomic policies, not only serving its own narrow national interests, but also ensuring the interests of foreign creditors. As noted earlier, China's central bank governor has spoken favourably about IMF conditionality as a way to discipline countries borrowing internationally, which marks a major departure from China's traditional position regarding this question (Zhou 2012).

CONCLUSION

In the early 2000s, China was not deeply involved in the international debt market, either as a debtor or a lender. When the IMF came out with a radical proposal of the SDRM, the Chinese government welcomed the idea, even though officials and analysts saw many problems and complications with its implementation. They did not see this issue as having any immediate impact on China. Their concern was largely that the reform should not undermine national sovereignty and the development needs of the developing countries.

Since that time, China has become more integrated in the international financial system, and its new status as an international lender has made it more sensitive to sovereign debt management. It has much at stake in international financial stability and debt sustainability. Ironically, China has been less active in contributing to the current round of IMF-led debate over sovereign debt restructuring.

Part of the reason why the Chinese government has not expressed any strong opinions about the IMF's recent proposals may be their relatively narrow focus on specific mechanisms of debt restructuring. China's interest goes well beyond this question. From its point of view, the most important question in debt governance is the prevention of unsustainable debt. Chinese policy makers do not see the sovereign debt restructuring proposals coming out of the IMF and elsewhere as adequate for addressing the sources of debt crises, i.e., excessive borrowing and lending. Besides, as an international creditor, China's main concern has to do with safeguarding the value of its overseas assets from the detrimental effect of inflationary policies of Western countries, especially the United States. This, unfortunately, is not an issue that can be resolved by improved debt restructuring mechanisms.

To the extent the Chinese government has publicly expressed its position regarding sovereign debt restructuring, it has done so most vocally at the United Nations. Its recent collaboration with the G77 in calling for an international legal framework for debt restructuring that serves equitable growth and sustainable development indicates that China remains deeply concerned about the unfairness of the current international financial system and the power imbalance between developed and developing countries. The Chinese government may not have strong preferences regarding the particular mechanisms of sovereign debt restructuring because of the limited stakes China has at this point, given that only a small portion of China's foreign assets are debt securities and loans. Going forward in the global dialogue over sovereign debt restructuring, minimizing international financial instability while protecting the development needs of developing countries will likely remain the parameters of China's position.

ACKNOWLEDGEMENTS

I would like to thank Stuart Brown, Robert Cox and Eric Helleiner for their comments on an earlier draft, and Shanshan Ni for her research assistance. I would also like to thank Brett House, Domenico Lombardi and Miranda Xafa for extended discussions of this topic. I am also grateful to three reviewers of the paper, whose comments have been very helpful. In addition, this paper has benefited greatly from a workshop on sovereign debt restructuring co-sponsored by CIGI and the Institute of World Economics and Politics at the Chinese Academy of Social Sciences in July 2014.

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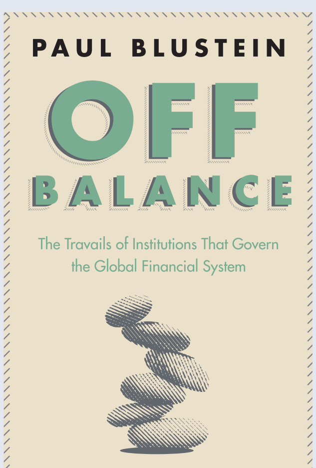

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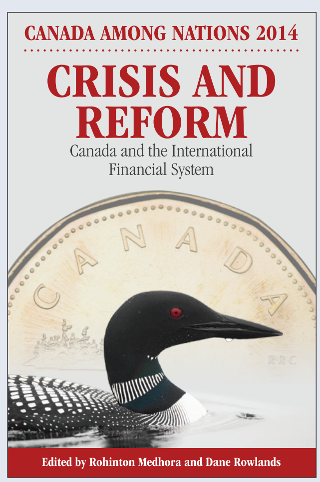

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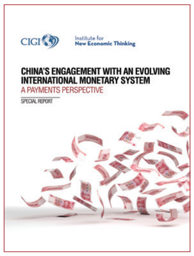
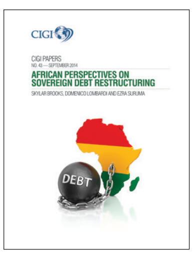


China's Engagement with an Evolving International Monetary System: A Payments Perspective

CIGI Special Report
Paul Jenkins, Thomas A. Bernes, Perry Mehrling and Daniel H. Neilson

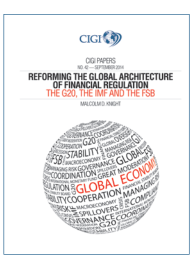
The core of this report, co-published by CIGI and the Institute for New Economic Thinking, is to lay out in practical terms the critical issues China must consider in managing its engagement with the evolving international monetary system (IMS). There are both opportunities and pitfalls, and the hope is that the payments approach used will highlight why, and how, China and the IMS should "talk to one another." While the pace, direction and ultimate goals of reform are for China to decide, what it decides will have implications for China and for the functioning of the IMS. Avenues must be found to discuss and assess these implications from a system-wide, cooperative perspective.



African Perspectives on Sovereign Debt Restructuring

CIGI Papers No. 43
Skylar Brooks, Domenico Lombardi and Ezra Suruma

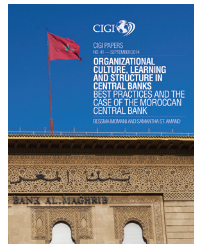
On August 7 and 8, 2014, CIGI's Global Economy Program co-hosted a conference with Uganda Debt Network to discuss African perspectives on sovereign debt restructuring. The aim of this paper is to distill the main insights from conference participants' papers and presentations. Africa's extensive experience with sovereign debt restructuring, as well as the changing nature of its international debt relations, make the perspectives contained in this paper valuable contributions to the ongoing debate over how best to govern sovereign debt at the international level.



Reforming the Global Architecture of Financial Regulation: The G20, the IMF and the FSB

CIGI Papers No. 42
Malcolm D. Knight

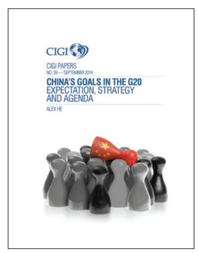
The global financial crisis that began in 2007 and deepened in 2008 exposed major weaknesses in financial and macroeconomic policy coordination, and profound flaws in financial risk management and regulation in a number of advanced countries. This paper undertakes an analysis of how cooperation takes place among three actors — the G20, the IMF and the FSB — to implement the fundamental reforms needed to ensure that the global financial system is better able to withstand shocks than it was in 2007-2008.



Organizational Culture, Learning and Structure in Central Banks: Best Practices and the Case of the Moroccan Central Bank

CIGI Papers No. 41
Bessma Momani and Samantha St. Amand

This paper provides both theoretical and empirical evidence that maintains that a central bank's organizational structure, culture and learning system are important for achieving best governance practices. It argues that a central bank's organizational structure and culture facilitate the effective implementation of governance practices that have been enacted by law or in a strategic plan, with specific reference to central bank independence, communication, transparency, professionalization, technical excellence and reputation risk management.



China's Goals in the G20: Expectation, Strategy and Agenda

CIGI Papers No. 39
Alex He

The G20 has emerged as the lynchpin of China's involvement in global economic governance. It remains the only economic institutional setting where the country can operate on par with major Western powers. China has a strong interest in maintaining the status of the G20 as the premier forum for economic cooperation, and a vested interest in ensuring that the G20 does not degrade into yet another "talk shop" of multilateral diplomacy. However, the Chinese leadership's current approach to the G20 is not driven by a desire to position the country as a leading agenda setter.

Transatlantic Economic Agreements: Parsing CETA and TTIP

CIGI Papers No. 35
Patricia Goff

Both Canada and the United States are in the process of working through two separate trade agreements with the European Union. The Comprehensive Economic and Trade Agreement (CETA) between Canada and the European Union is, allegedly, almost complete, while the Trans-Atlantic Trade and Investment Partnership (TTIP) between the United States and the Europe Union is still in the early stages. This paper examines the similarities and differences between CETA and the TTIP and suggests ways the TTIP negotiations might unfold, especially considering there have been suggestions that CETA is a "template" for the TTIP.

ABOUT CIGI

The Centre for International Governance Innovation is an independent, non-partisan think tank on international governance. Led by experienced practitioners and distinguished academics, CIGI supports research, forms networks, advances policy debate and generates ideas for multilateral governance improvements. Conducting an active agenda of research, events and publications, CIGI's interdisciplinary work includes collaboration with policy, business and academic communities around the world.

CIGI's current research programs focus on three themes: the global economy; global security & politics; and international law.

CIGI was founded in 2001 by Jim Balsillie, then co-CEO of Research In Motion (BlackBerry), and collaborates with and gratefully acknowledges support from a number of strategic partners, in particular the Government of Canada and the Government of Ontario.

Le CIGI a été fondé en 2001 par Jim Balsillie, qui était alors co-chef de la direction de Research In Motion (BlackBerry). Il collabore avec de nombreux partenaires stratégiques et exprime sa reconnaissance du soutien reçu de ceux-ci, notamment de l'appui reçu du gouvernement du Canada et de celui du gouvernement de l'Ontario.

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