https://www.wsj.com/articles/china-props-up-belt-and-road-borrowers-via-unusual-channel-11670727153

China Props Up Belt-and-Road Borrowers Via Unusual Channel

People's Bank of China uses currency-swap lines to support governments that borrowed heavily from Chinese banks

By Jason Douglas Follow

Dec. 11, 2022 8:00 am ET

Hungry for foreign currency to shore up their dwindling reserves, some troubled countries have in recent years turned to an unusual source of funds: The People's Bank of China.

China's central bank has funneled billions over the past decade to around 20 countries, including Pakistan, Sri Lanka, Argentina and Laos, via swap lines that allow overseas central banks to exchange their domestic currencies for Chinese yuan.

The transactions, researchers say, are part of a broad but opaque effort by Chinese authorities to prop up governments that borrowed heavily from Chinese banks as part of Beijing's $1 trillion Belt and Road Initiative to finance infrastructure projects and win influence across the world.

By replenishing other countries' reserves, the PBOC may be helping some of the world's most indebted countries avoid rising borrowing costs. But economists say the swaps also help paper over problems that led to their financial troubles in the first place.

Throwing heavily indebted countries such financial lifelines without insisting on economic overhauls is akin to "sticking your fingers in a dam," said Gabriel Sterne, head of global emerging markets research at consulting firm Oxford Economics in London.

The transactions also represent another potential liability for borrowers as rising interest rates, rocketing inflation, slowing growth and sinking currencies squeeze countries' ability to repay their debts. The swaps are often rolled over, sometimes for years, and researchers estimate the average interest rate for using them has been around 6% of the value drawn. That is higher than what the Federal Reserve charges other central banks to swap their currencies for dollars as well as their currencies for dollars as well as the rate on typical International Monetary Fund loans to poor countries.

The PBOC says the swap lines are there to help grease the wheels of international trade, ensure financial stability and further the adoption of the yuan in a world where trade and finance are dominated by the U.S. dollar. The PBOC didn't respond to a request for comment for this article.

The swap lines serve another purpose for China—helping to ensure its borrowers can repay their loans when those borrowers are under growing financial stress, according to researchers. Chinese lenders are less likely to get repaid on time if costs soar for their borrowers and the risk of a sovereign default goes up, said Brad Parks, executive director of AidData, a research lab at William & Mary, a university in Williamsburg, Va., and one of the authors of a forthcoming paper on PBOC swap lines alongside economists with the World Bank.

"They are trying to prevent a problem from getting much worse," he said.

Currency-swap arrangements are nothing new. The Fed maintains permanent swap lines with major counterparts including the European Central Bank, Bank of England and the Bank of Canada. They were a critical conduit for channeling dollars to teetering banks worldwide at the height of the 2008-09 financial crisis, and played a role in backstopping the global financial system during the pandemic.

Those facilities are narrowly focused on maintaining stability in a financial system that revolves around the U.S. dollar. The PBOC's swap lines are broader in scope, and can be used by foreign central banks to address balance of payment needs. Other central banks such as those of Qatar and Japan are authorized to offer similar assistance to counterparts overseas, but researchers say none can offer similar assistance to counterparts overseas, but researchers say none can match the PBOC in scale or extent of usage.

“The big difference in how China uses these swap lines is it effectively uses it as a bailout mechanism,” said Christoph Trebesch, a professor at Germany’s Kiel Institute for the World Economy who has co-written several papers on China’s lending overseas.

The PBOC’s swap network is the largest of its kind, according to the World Bank. The PBOC said in a 2021 report that it has swap facilities with 40 countries with a combined capacity of almost 4 trillion yuan, or about $570 billion.

Major central banks tend to be cautious about who they extend swap lines with to minimize the risk of losses. The PBOC, though, has extended swap lines to many countries with a history of debt-repayment problems. Both Sri Lanka and Pakistan have recently had to turn to the IMF for financial assistance as their debt troubles mounted.

“It is unusual for the PBOC to have done so many swaps with so many countries that are clearly high risk,” said Brad Setser, a senior fellow at the Council on Foreign Relations and former adviser to the U.S. Trade Representative in the Biden administration.

To use the Fed as an example of how a swap line works, a foreign central bank requests a certain amount of U.S. dollars in exchange for an equivalent amount of its own currency in return, at an agreed exchange rate. The Fed credits the foreign central bank’s account at the Fed with those dollars and gets foreign currency at its corresponding account overseas.

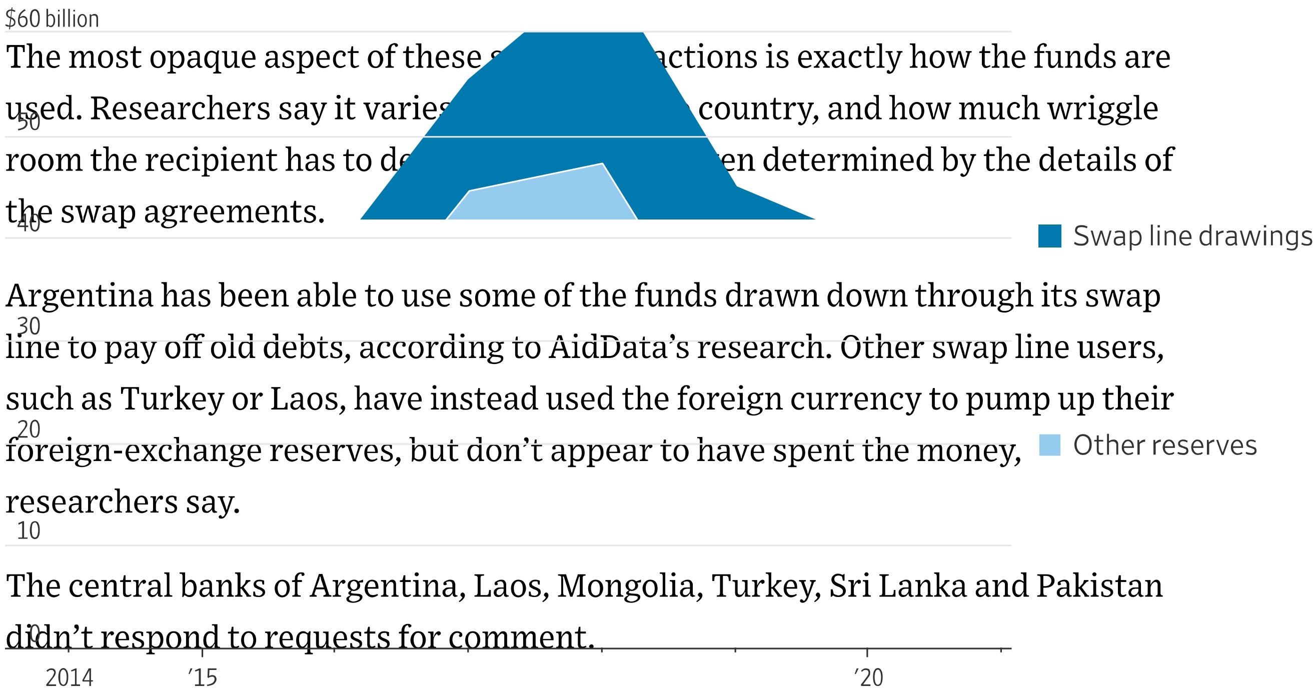
Swap transactions between central banks are usually unwound after a few months. The foreign central bank must return the same amount of dollars to the Fed at the exchange rate originally agreed, while the Fed hands back the foreign currency.

The Fed charges interest for other central banks to draw on its U.S. dollar swap line. Through 2020 and 2021, the interest rate under the Fed’s swaps was around 0.3%, according to New York Fed data, though it has increased sharply this year as interest rates have risen, and now stands at around 4%.

Unlike a typical Fed transaction, the PBOC’s swap lines are often extended after their original term expires, researchers say. That means the transaction isn’t unwound and the liability persists.

Argentina's central bank, for instance, has repeatedly drawn on a swap line first established in 2009, and by the end of 2021 had accumulated liabilities under the swap—as well as corresponding foreign-exchange assets—of $20 billion, according to the central bank's annual report. Argentina has been plagued by debt trouble, default and high inflation for much of its history and in March refinanced a $44 billion IMF program to help steady its economy.

For some countries, the sums involved with the swaps are substantial compared with the size of their economies, a source of concern for international monitors. Mongolia's $1.8 billion facility with the PBOC is equivalent to 14% of its 2020 gross domestic product, making it "a significant external liability," according to the IMF.



The most opaque aspect of these s[...]actions is exactly how the funds are used. Researchers say it varie[...] country, and how much wriggle room the recipient has to d[...]en determined by the details of the swap agreements.

Argentina has been able to use some of the funds drawn down through its swap line to pay off old debts, according to AidData's research. Other swap line users, such as Turkey or Laos, have instead used the foreign currency to pump up their foreign-exchange reserves, but don't appear to have spent the money, researchers say.

The central banks of Argentina, Laos, Mongolia, Turkey, Sri Lanka and Pakistan didn't respond to requests for comment.

Part of the attraction of swap lines to the borrower is central bank liabilities sometimes don't show up as debt on the central government's balance sheet, while the foreign-exchange assets obtained through the transaction are recorded as an influx of reserves, even if they can't be spent. Short-term borrowing through currency-swap agreements, even if rolled over, isn't always counted toward a country's external debt, where maturities are typically measured in years.

A thorough assessment of a country's debt sustainability should take account of both sides of such swap transactions, and especially if the money has been spent, said Mr. Setser.

"If drawn and used, it is a loan and it is a burden," he said.

Write to Jason Douglas at jason.douglas@wsj.com

Appeared in the December 12, 2022, print edition as 'China Props Up Foreign Borrowers'.