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The Rise of ‘Sharp Power Lending’

Timothy Ash, EM Senior Sovereign Strategist – May, 2019

New lenders with their own agendas may have reduced default risk, or merely deferred it.

- ‘Sharp power lending’ (SPL) is a relatively new phenomenon, and is typically driven by the desire of lenders to promote economic/ geopolitical influence over recipient countries.
- SPL can act as an alternative to traditional multilateral lending.
- We believe SPL has probably served to reduce sovereign default risk thus far.
- Where SPL has not been accompanied by reform conditionality, it may increase risks by accentuating macro imbalances.

In 20 years working as a sovereign debt analyst, my job has changed significantly.

For many years, the priority was to figure out which countries were heading into crises that would challenge their ability to pay (foreign) creditors — be they balance of payments, sovereign debt/ fiscal or banking crises.

The second challenge was determining when the IMF would be called in — often political/social issues domestically can stall the decision to make the call, which can make bad situations even worse.

The third element was thinking through the shape of any programme and what it could mean for foreign creditors, including bondholders, particularly whether ‘burden sharing’ or private sector involvement (PSI) was part of the solution. You could also add in scenarios where a country could pay, but for some reason, decided not to — an ‘ability versus willingness’ conundrum.

One of the biggest changes for sovereign debt analysts, in my view, has come in the period since the global financial crisis, with the rise of large bilateral bailouts by emerging powers eager to use ‘sharp power’ to promote their economic and geopolitical interests.

Three big bilateral sharp power lenders (SPLs) have emerged as alternatives to IMF lending, namely China, Saudi Arabia/ UAE and Russia.

The use of 'sharp power' by these new emerging powers (or resurrected power, in the case of Russia) has typically been as an alternative to IMF lending programmes (e.g. Bahrain and Belarus), albeit they have also, on occasion, been in conjunction with IMF programmes (e.g. Armenia, Egypt, Sri Lanka and Jordan).

This has created another challenge for the sovereign debt analyst:

- Is a country in need of external support?
- Is there a bilateral friend willing to bail it out?
- If so, is IMF lending still required, and what does that mean for foreign private sector lenders/bondholders?

Reviewing recent SPL bailouts, I would highlight the following:

Armenia: 2014+ with the provision of financial support (cheap loans/energy) by Russia, but also in conjunction with an existing IMF programme. The Russian support was partly driven by the country's geopolitical desire to encourage Armenia to refrain from following Ukraine and signing a free trade agreement (DCFTA) with the EU.

Belarus: 2014+, provision of financial support, cheap energy and trade access by Russia, and membership of the Eurasian Economic Union. Russia's desire, as per the Armenian case, was to keep Belarus in its 'sphere of influence' and not to agree to sign an association agreement/DCFTA with the EU.

Bahrain: Saudi Arabia/UAE/Gulf backing via a USD10 billion programme agreed in 2018 and still ongoing, designed to counter the perceived threat to the region from Iran.

Sri Lanka: An IMF programme, augmented by SPL from India and China, which both see Sri Lanka as being on a key trade route. In part, Sri Lanka is playing China off against India.

Egypt: An IMF programme supported by SPL from Saudi/UAE/Gulf, primarily aimed at countering the threat posed by the Muslim Brotherhood to the Gulf monarchy form of rule.

Turkey: In 2018, USD15 billion was pledged by Qatar, linked to Turkish and Qatari support for the Muslim Brotherhood's Middle East democratisation agenda.

Pakistan: Ongoing SPL from China, Saudi Arabia and the UAE, but also possibly leading to an IMF programme. Chinese lending to Pakistan is arguably driven by its view of Pakistan as a counterbalance to India, plus Pakistan's role as a conduit for trade in the Belt and Road Initiative (BRI). Saudi Arabia/Gulf states view Pakistan, like Egypt, as a bulwark against Islamic fundamentalism but also a Sunni ally against Iran.

Oman: Ongoing limited SPL from Qatar and China. China likely sees Oman as an important energy supply, trade route conduit. Qatar has seen Oman as a potential trade route conduit following its own recent blockade by Saudi and its Gulf allies.

Tunisia: Some backing from Qatar/Turkey, which see Islamists in Tunisia as part of their broader democratisation of the Middle East agenda, and recently by UAE/Saudi Arabia backing for secular groups in government and in the run up to elections this year. This UAE/Saudi lending is in conjunction with an existing IMF programme, alongside strong backing from the EU/US.

Lebanon: One of the earliest examples of SPL from Saudi Arabia and the Gulf, to counter the threat from the rising power of Iran and Hezbollah in Lebanon and the region.

So far, there have been no occasions where a country has got into difficulty, secured bilateral backing from one of these new SPLs and been forced into a 'bailing in'/PSI scenario. SPL thus far seems to have reduced sovereign default risk — but the question is whether this assumption will hold going forward.

It could be said that the increasing importance of these new SPLs has reduced the risks of bailouts/PSI (default risk) scenarios for foreign private sector creditors.

But it also seems to have reduced the need to resort to the IMF, albeit it is not clear as yet whether the reduced reliance on IMF lending, and hence on IMF reform conditionality, is also perhaps storing up potential problems up for the future and delaying inevitable defaults further down the line.

Interestingly, SPLs, absent the IMF, have on occasion also been accompanied by reform conditionality — herein I am thinking of the Saudi/Gulf bailout of Bahrain in 2018/19 and the Russian bail-out of Belarus from 2014/15 onwards.

In both those cases, the provisions of bilateral SPL bailouts were also conditional on the countries in difficulty adopting economic reform programmes, monitored by the bilateral lenders — in the case of Belarus, Russian financial support partially provided by the Eurasian Fund for Stabilisation & Development, a Eurasian Economic Union version of the IMF.

There are also occasions where SPLs have not been particularly rigorous in attaching reform conditionality. This seems to be particularly the case with Chinese lending as per the Belt and Road Initiative (BRI), which might reflect the fact that much of this lending is decentralised to Chinese banks and corporates, rather than state-to-state lending to the country concerned, as has tended to be the case with Russian and Saudi/UAE SPL.

Hence, there seems to be less top-down, joined-up thinking by China — and less consideration of the full impact of this lending in terms of the broader macroeconomic setting and how it might impact on the ability for the recipient to pay back all creditors.

Additionally, there have been recent examples where SPL from China imposed unsustainable debt burdens/macro imbalances on countries, and this subsequently forced IMF bailouts — an example herein would be Mongolia in 2017, and this looks set to be the end game in Pakistan.

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