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Restoring Debt Sustainability in African Heavily Indebted Poor Countries

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Key Points

- Debt sustainability among the 30 African low-income countries (LICs) that previously received debt relief has deteriorated sharply. More than one-third are either back in, or at high risk of, debt distress.
- Outcomes of the 2017 review of the International Monetary Fund (IMF) and the World Bank Debt Sustainability Framework for Low-Income Countries (LIC-DSF) and improvements in country-specific debt sustainability assessments (DSAs) can help strengthen the diagnosis of debt vulnerability and improve the quality of policy recommendations respectively.
- By themselves, these factors will be insufficient to address underlying causes of debt vulnerability. A series of initiatives are needed, including a new generation of DSAs; new and updated lending instruments and access limits; and greater international policy coherence and greater financial innovation. A new debt relief mechanism is also needed for the most indebted African heavily indebted poor countries (HIPCs).

Introduction

From 1996, the HIPC initiative and Multilateral Debt Relief Initiative (MDRI) both helped eligible LICs to address rapid, unsustainable buildups in external debt through targeted debt relief. Thirty African countries were the largest beneficiaries, receiving over US$100 billion, enabling them to reduce debt service costs and increase spending on the eight Millennium Development Goals (MDGs) established in 2000. This achieved many positive social impacts including reducing poverty, extreme hunger, infant, neonatal and under-five mortality rates, the incidence of tuberculosis and prevalence of HIV/AIDS. Debt relief also allowed for an increase in spending on primary education and health (Ondoa 2017).

Since the 2008 global economic crisis, however, debt sustainability has subsequently deteriorated and risks to debt distress have sharply escalated. In 2014, none of the 30 African HIPCs were assessed to be in debt distress, and only five were at high risk. In 2018, more than one-third are back at, or near, their pre-HIPC starting point. Two countries (Chad and Mozambique) are in debt distress and a further nine (Burundi, Cameroon, Central African Republic, Ethiopia, The Gambia, Ghana, Mauritania, São Tomé and Príncipe and Zambia) are now at high risk of debt distress. Only four of the 30 countries are at low risk. The resumption of risks to debt sustainability across so wide a range of African HIPCs signals that these countries and their lenders have yet to resolve how to break out of chronic cycles of debt accumulation and forgiveness.

About the Author

Cyrus Rustomjee is a CIGI senior fellow with the Global Economy Program. At CIGI, Cyrus is looking for solutions to small states' debt challenges and exploring the benefits of the blue economy. His research looks into how small countries in the Pacific, the Caribbean and elsewhere can benefit from greater reliance on the use and reuse of locally available resources, including those from maritime environments.

As risks have escalated, there has been no dearth of analyses of the immediate causes. These include increased recourse to external private capital, higher borrowing costs, declining commodity prices and lower growth (see, for example, World Bank 2016; IMF 2017a). Equally, there has been little progress in identifying and finding ways to address the underlying causes of debt accumulation and vulnerability in African HIPCs. Although much more is needed, two recent developments can help provide new momentum for this process.

IMF and World Bank Debt Sustainability Framework

The first development occurred in October 2017, when the IMF and the World Bank released the findings of their fourth major review of the LIC-DSF (IMF 2017b). Established by the World Bank and the IMF in 2005, the LIC-DSF framework has subsequently been used as a diagnostic tool by both institutions to assess risks to debt sustainability in LICs (IMF 2005). The framework assigns risk ratings of external debt distress by estimating threshold levels for selected debt burden indicators and evaluating baseline projections and stress test scenarios relative to these thresholds.

The review strengthens the tools used to diagnose LIC debt vulnerability and addresses several earlier critiques of the existing DSF framework, including its unduly complex and mechanical approach, the errors in estimating the impacts of fiscal adjustment and future growth and the framework's inflexibility to country-specific debt vulnerabilities, including exchange rate and export price volatility (see, for example, Martin 2015; Nissanke 2013). Proposed changes include: new tools to assess the plausibility of baseline macroeconomic projections, including the realism of projected fiscal adjustment and projected impact of public investment and fiscal adjustment on growth; better tailored scenario stress tests, including risks arising from natural disasters, volatile export prices, market-financing shocks and contingent liability exposures; and streamlining and reducing the number of debt indicators, thresholds and standardized stress tests.

Strengthening the LIC-DSF framework constitutes a welcome and critically important step for African and other LICs, helping to fundamentally re-evaluate country risks to unsustainable debt accumulation and debt distress.

Recent DSAs for Most Vulnerable African HIPCs

The second development to address the underlying causes of debt accumulation and vulnerability in African HIPCs is the recent improvements in the analytical content of country-specific DSAs among the most highly indebted African HIPCs. DSAs are country-specific assessments prepared by the IMF and the World Bank. They yield specific fiscal, financial and macroeconomic policy recommendations to achieve sustainable debt levels, determine the extent and composition of IMF and World Bank lending and influence the lending policies of other multilateral development banks.

Country-based DSAs have frequently been criticized on many fronts: for focusing on the fiscal and macroeconomic impacts of debt accumulation and on strengthening debt management, while downplaying the impacts of exogenous shocks, unpredictable aid flows and institutional, capacity and resource constraints in LICs; for using inappropriate measures to assess institutional and policy environments as causes of debt distress (Nissanke 2013); and for paying insufficient attention to the relationship between debt-financed public investments and growth (Mustapha 2015) and to the close linkages between trade and debt. DSAs often ignore the human dimension to development, which includes ensuring financing is available to provide basic needs, such as food, health, education and shelter, when determining sustainability and the level of debt servicing needed to achieve this (Caliari 2006).

However, a scan of 11 recent DSAs prepared between 2015 and 2018 for 11 African HIPCs that were in debt distress, or at high risk of debt distress, suggests that while many of these criticisms remain, some of the underlying causes of debt vulnerability in African HIPCs are now beginning to be better identified.

These recent DSAs continue to emphasize the policy recommendations typically found in DSAs. This includes universal recommendations for fiscal policy adjustment and consolidation as key policy levers to reduce debt, for example, calling for strengthened fiscal adjustment, resolute and effective fiscal consolidation (Cameroon) and sound public debt management, anchored in a medium-term debt management strategy and medium-term fiscal framework, to guide prioritization of future public investments and their financing (São Tomé and Príncipe).

Almost all recent DSAs also emphasize strengthened debt management, including recommending moves to longer-maturity debt-management instruments to reduce rollover risks and lower near-term debt servicing costs (The Gambia); finalizing a new law on public debt that provides an overreaching legal debt framework and putting in place a comprehensive medium-term debt strategy (Burundi); strengthening public debt management as well as overall economic policy to improve a country's risk rating (Cameroon); and improving capacity to monitor and record public debt (Mauritania). The most recent DSAs also recommend country commitments to avoid new non-concessional debt, including recommendations to secure grants to finance investments and contract highly concessional loans in exceptional circumstances (Central African Republic, The Gambia and Burundi). Recent DSAs have also increased their emphasis on longer-term drivers of debt accumulation in African and other LICs, a strong acknowledgement of some of the structural factors that impede growth and the overwhelming impact of trade structure in constraining growth. The Central African Republic DSA acknowledges that the country is saddled with structural weaknesses that constrain a stronger economic rebound. DSA recommendations include structural policies to improve the business climate, boost productivity and diversify exports. In São Tomé and Príncipe's case, the DSA recommends structural reforms to improve the business environment to support private sector-led growth and to attract private investment to broaden the export base. For Chad, vulnerability to negative climatic shocks is recognized as affecting prospects for agricultural growth and for significantly reducing GDP growth.

Discussion of trade structure is beginning to feature more prominently in some DSAs. This includes countries' limited abilities to diversify, due to features such as narrow production structures, the concentration of exports in a narrow basket of predominantly primary commodities and, more prominently, a country's inability to improve export performance. While causes differ, in recent DSAs the debt-to-export threshold is breached under the baseline scenario for almost all African HIPCs in, or at high risk of, debt distress, including Burundi, Cameroon, Central African Republic, Mauritania, São Tomé and Príncipe and The Gambia. Standard stress tests suggest that Ghana is particularly vulnerable to a decline in exports.

For Burundi, all scenarios suggest that the country's narrow export base is the most significant risk to debt sustainability with the present value of debt-to-exports ratio projected to remain above 100 percent until beyond 2030 and with prospects for graduating from high risk of debt distress hinging on improved export performance. DSA recommendations include expanding the export base beyond the traditional coffee sector and diversifying export markets. For the Central African Republic, the breach reflects its narrow export base and remains above the threshold under the extreme scenario throughout the 20-year DSA projection period, while for São Tomé and Príncipe the breach under the baseline scenario is projected for several years into the future. Similarly, these DSAs highlight acute vulnerability to commodity price fluctuations and terms-of-trade shocks, as constraints to effective debt management debt.

Key Actions

Strengthening the DSF and bringing greater attention to the longer-term structural constraints to growth in African and other LICs represents an important step in helping these countries address debt sustainability. With more than one-third of these countries now already in, or at high risk of, debt distress, restoring sustainable debt while achieving growth and sustainable development will require a much broader collective set of initiatives by the IMF and the World Bank, LICs and their development partners.

First, future DSAs, building on the new LIC-DSF methodology, can include more extensive treatment of the implications of longer-term structural challenges faced by African and other LICs. These DSAs will need to better recognize the policy trade-offs and limited policy space that authorities confront when pursuing debt accumulation and debt management given acute structural constraints, while pursuing growth and sustainable development objectives. Future DSAs will also need to better connect risks to debt sustainability with production and trade structure and include the costs of financing infrastructure, the Sustainable Development Goals (SDGs) and integration of the implications, in the assessment of a country's ability to service debt. Finally, these DSAs can provide more candid and urgent recommendations for substantial escalated international financial, technical and policy support to help LICs bridge and overcome these structural constraints.

The need to do so is compelling. Two decades since the HIPC Initiative, African HIPCs continue to be challenged by multiple structural impediments to growth, including a continuing lack of diversification of production and exports, limited participation in global value chains, inability to expand the share of manufacturing in GDP and, increasingly, jobless growth. Many HIPCs continue to face extreme hunger, poverty and inequality. Across the continent, reducing poverty will necessitate sustained growth of more than seven percent over the medium term, in turn requiring investment rates of above 25 percent of GDP. Yet average investment rates have been falling short, at 19 percent, in comparison with similar rates for developing countries as a whole of 26 percent (United Nations Conference on Trade and Development [UNCTAD] 2015).

The second key action to help strengthen future DSAs should be the inclusion in DSAs of the likely costs of achieving the SDGs in order to provide a more realistic assessment of a country's ability to service debt while financing its growth and development objectives. Infrastructure financing costs, for example, are rapidly escalating. The continent's annual costs of infrastructure in energy, road systems, water, sanitation, information and communication technologies and broadband, previously estimated to have been approximately US$93 billion per year, are now estimated to be approximately US$130 billion to US$170 billion, resulting in an annual financing gap of US$103 billion (African Development Bank [AfDB] 2018). To address these challenges, African HIPCs need steady increases in productive capacity, investment, technology and finance together with persistent trade policy support.

Third, in the immediate aftermath of the DSF review and as a short-term measure to support the most vulnerable LICs, a rapid revision of DSAs for all LICs currently in debt distress, or at high risk of debt distress, should be conducted. Current DSA policy recommendations for these countries should be adjusted in light of the review, while also identifying lessons for all future DSAs.

Fourth, an early review and reassessment of both LIC grant and loan access limits and World Bank and IMF financial instruments is needed to help bridge widening financing gaps and to provide counter-cyclical financing, as the impacts of market and price volatility on revenue, growth and fiscal policy are better recognized and identified in DSAs prepared with the new LIC-DSF framework.

Fifth, greater international cooperation, more cohesive support and better policy advice are needed among all development partners, in particular for heavily indebted LICs that have proved persistently unable to grow out of their debt overhang. The 2030 Agenda for Sustainable Development recognizes the interlinked character of sustainable development challenges, such as debt sustainability, calls for policy coherence and an enabling international economic environment, including coherent and mutually supportive world trade and economic governance. Achieving these objectives in the presence of high levels of debt presents immediate policy conflicts between the needs of these countries to invest, diversify and trade to achieve growth and fiscal policy management to contain debt and debt-servicing costs. In practice, for the most debt-vulnerable LICs, resolving these challenges requires a multifaceted approach. This includes: acknowledging the need for new rights-based approaches when defining debt sustainability and recalibrating fiscal policy program recommendations accordingly to afford policy makers greater scope to prioritize basic human needs before debt servicing; strengthening analysis of the debt-investment-growth nexus in LICs; and providing greater scope and financing for countries to invest in growth-inducing economic infrastructure. International cooperation is also needed to enable LICs much greater opportunities to participate in global trade and in global value chains, to establish much greater concessional and grant resources to help finance the SDGs in highly indebted LICs and to develop new long-term financing mechanisms that help these countries adjust to the impacts of natural disasters, terms of trade and other shocks.

Thus far, few practical steps have been taken. New cooperative initiatives could include developing joint interagency DSAs by the IMF, the World Bank, UNCTAD and the World Trade Organization that include colloborative assessments of the underlying causes of unsustainable debt in African HIPCs and common policy recommendations. Enhanced interagency diagnostic, technical and financial support can also be applied, in particular where baseline scenarios project persistent unsustainable debt beyond a specified future date, for example, 2022, or approximately the halfway point to the 2030 Agenda for Sustainable Development.

Sixth, greater financial innovation and emulation of known successes is needed by African HIPCs and development partners alike, such as the AfDB, to help restructure and reduce unsustainable debt in African HIPCs, including debt swaps, diaspora savings and other innovations that help restructure or reduce debt. The Seychelles, for example, recently used debt for climate finance swaps to eliminate US$21 million of commercial debt while financing longer-term marine conservation. Nigeria has recently issued a US$300 million diaspora bond, helping diversify sources of external finance and attract investment interest from its diaspora population. An annual conference convened by the AfDB highlighting successful innovative local and international debt-reducing financing mechanisms can also help foster this process.

Finally, large, persistent risks to debt distress in an increasing number of African HIPCs also suggest that the case for a new post-HIPC and MDRI debt relief initiative, for some African HIPCs, is growing. In 2018, two HIPCs are already either in debt distress; 11 are at high risk of debt default and among these are five that are projected to have unsustainable debt levels in 2022, the halfway point for the SDGs. With large, persistent structural challenges that are unlikely to be resolved in the short term, and despite a decade of high growth, high commodity prices and low borrowing costs, there is a strong case to provide further debt reduction to these countries if they are to achieve a fresh start in sufficient time to make progress with their SDGs. While criteria and modalities to determine the eligibility, scale and nature of such relief will need to be determined, a number of approaches have been proposed and can be explored (see, for example, Kaiser 2017).

Conclusion

Debt sustainability levels for more than one-third of African HIPCs are back to the point they were two decades ago. Shifting this trend requires a new menu of options, building on the findings of the recent LIC-DSF review and recent improvements in debt analysis in recent DSAs. Key ingredients include better recognition of the structural constraints to growth, new financing instruments, greater international policy coherence, financial innovation and, if necessary, new mechanisms for debt relief.

Acronyms and Abbreviations

AfDB	African Development Bank
DSAs	debt sustainability assessments
HIPCs	heavily indebted poor countries
IMF	International Monetary Fund
LICs	low-income countries
LIC-DSF	Debt Sustainability Framework for Low-Income Countries
MDGs	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
SDGs	Sustainable Development Goals
UNCTAD	United Nations Conference on Trade and Development

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