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Debt Sustainability and Development Financing in Sub-Saharan Africa: Recent Dynamics

By Badr Mandri & Lotfi El Jai[1]

Summary

Countries in Sub-Saharan Africa (SSA) currently face a yearly infrastructure financing gap ranging between $68-$108 billion along with other socio-economic challenges (AfDB, 2019). Debt financing remains a major source of growth as countries in the region work to achieve their developmental needs and the Sustainable Development Goals (SDGs). The levels of official development aid (ODA) and foreign direct investments (FDIs) remain volatile to fully meet the region financial needs. However, the sustainability of SSA external debt raises serious concerns if one looks at the rapid debt accumulation in recent years. This brief will highlight the recent changes in the nature and quality of debt in SSA along with details of the risks related to the shift in the creditors base. Finally, this brief aims to demonstrate the impact of these risks on debt sustainability and the future of development financing in SSA.

Debt levels are surging again in SSA and it should be alarming

In the early part of the 21st century, debt sustainability challenged Sub-Saharan Africa (SSA) as it sought to reach the Millennium Development Goals (MDGs). Following two episodes of debt relief (HIPC and MDRI[2]), the average debt-to-GDP ratio has decreased from over 100% in 2000 to less than 40% in 2010 (figure 1), representing a debt stock reduction of almost $100 billion (IMF, 2017). This was a breath of fresh air that would have allowed SSA countries to sustain their current and future debt levels and promote development expenditures in the region.

However, with the stagnation in the level of official development aid following the Global Financial Crisis of 2007, and the difficulties of the region's countries in mobilizing domestic resources to finance their infrastructure and socio-economic development needs,

1 Many thanks to Pr. Ugo Panizza and Mouhamadou Ly for their review.
2 Heavily Indebted Poor Countries and Multilateral Debt Relief Initiative.

debt re-accumulation in the region began as of 2011. By 2013, exchange rate volatility had significantly contributed to the worsening of debt profile in several SSA countries. Large exchange rate depreciations, particularly in oil exporters and countries with worsening economic conditions have inflated the size of external debt (Adeniran et al., 2018). During the same period, the region also experienced weak economic growth and a deterioration in public and external finances. Sub-Saharan Africa's real GDP growth declined from 5.2% in 2013 to 1.4% in 2016 and 2.9% in 2017, while the average fiscal deficit widened from 3.1% of GDP in 2013 to 4.7% in 2017. Consequently, more than two-thirds of the countries in Sub-Saharan Africa saw their public debt relative to GDP rise by more than 10 percentage points, while one-third of the countries experienced an increase in the debt-to-GDP ratio of more than 20 percentage points (Africa's Pulse, 2018). Currently, the level of public debt averages almost 60% of GDP (Figure 1).

These levels of higher indebtedness across SSA have sparked worry of returning to unsustainable debt levels in the future. As some SSA debt levels are approaching pre-HIPC ratios, the signs of debt distress are mostly present in SSA countries that are categorized as "fragile states". Currently, almost one-third of SSA countries are either currently facing (7 countries) or at high risk of debt distress (9 countries), numbers that have doubled since 2014 (Regional Economic Outlook, 2019)[3]. This increased risk is often attributed to the change in the nature of the debt, which has become challenging with the region's new creditors. This was more apparent in the increase in debt service across SSA, which has grown to an average of 9% per year since 2012, with a projected growth of 11% in 2020. Similarly, interest on debt grew on average at 15% since 2012 (Regional Economic Outlook, 2019). As a result, the size of debt service as a share of government revenues has increased to almost 39% in 2018 (Figure 2). It is projected to rise by almost 2 percentage points in 2020, which is the highest it has been in the last 20 years.

Figure 1 : SSA General government debt as a percent of GDP

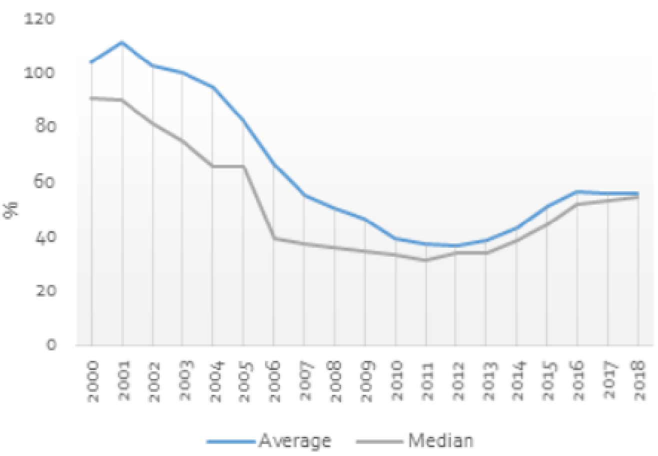
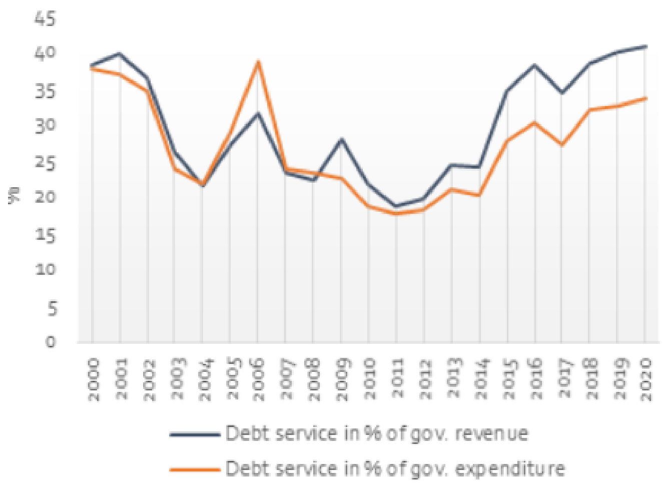


Figure 2 : SSA average Debt service as a percent of government revenue/expenditure



Source: IMF World Economic Outlook; Author's calculations

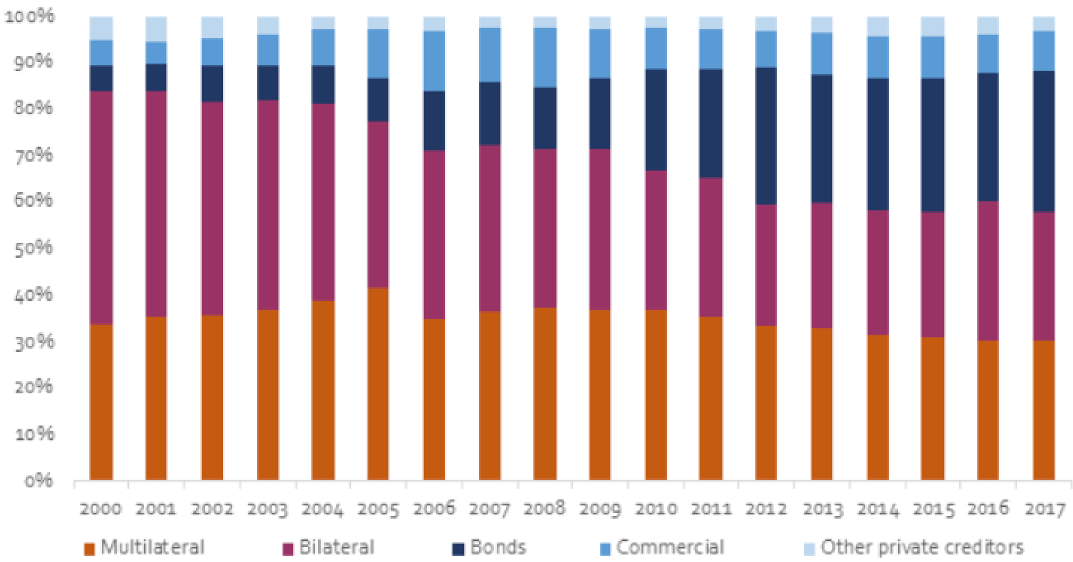
3 Countries in debt distress: Republic of Congo; Eritrea; Gambia; Mozambique, São Tomé and Príncipe; South Sudan; Zimbabwe.
Countries at high risk of debt distress: Burundi; Cameroon; Cape Verde; Central African Republic; Chad; Ethiopia; Ghana; Sierra Leone; Zambia.

Private debt size has increased across SSA

At the turn of the century, most of SSA's public debt was owed by multilateral institutions and some bilateral Paris Club creditors. Following debt relief initiatives, SSA countries were able to rebuild their debt capacity which allowed them to have a better access to market-oriented debt instruments (Figure 3).

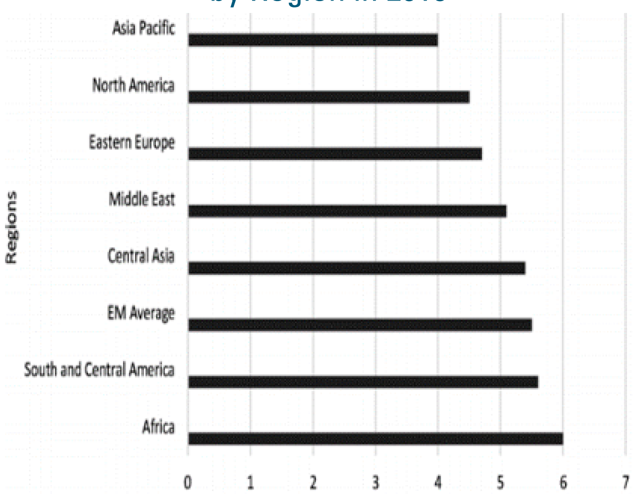
Thus, 16 sub-Saharan countries have entered the Eurobond market since the Global Financial Crisis, taking advantage of the prolonged period of low interest rates that followed and the strong demand from private investors (Tyson J.E., 2015). The latter sought alternative low rates served by developed countries, were attracted by the yield prospects offered by African sovereign bonds (Figure 4). This has led to a cumulative total Eurobond issuance in SSA of $20.3 billion by 2016, with almost 80% of it being issued between 2013 and 2015. Two years later, the total issuance level increased by almost 83% following the largest yearly issuance in the previous decade of $17 billion (Figure 5). This momentum slowed in 2019, with only three issuances completed so far, for a total of $5.7 billion (Cytonn Report, 2019). However, it is expected to pick up from 2021 onwards, when a large number of Eurobonds will set to mature, requiring refinancing.

Figure 3: Share of private, bilateral, and multilateral debt in SSA external debt



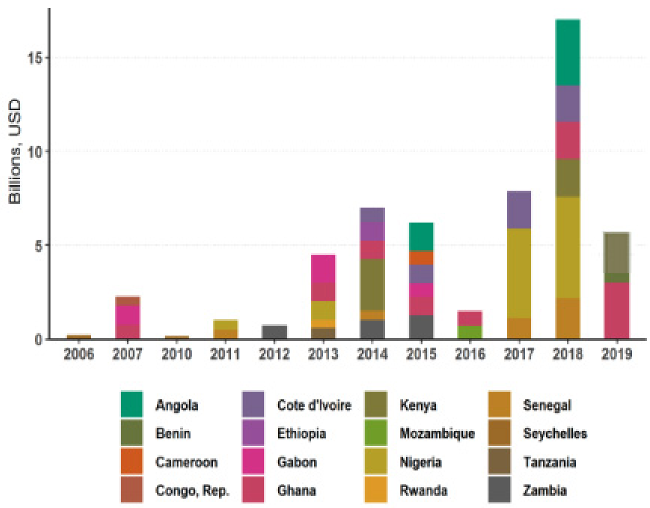
Source: The World Bank; International Debt Statistics; Author's calculations

Figure 4 : Average Return on Sovereign Bonds by Region in 2018



Source: Bloomberg [5]

Figure 5: Eurobond issuances in SSA (2006-2019) [4]



Source: Bloomberg; Coulibaly et al. (2019)

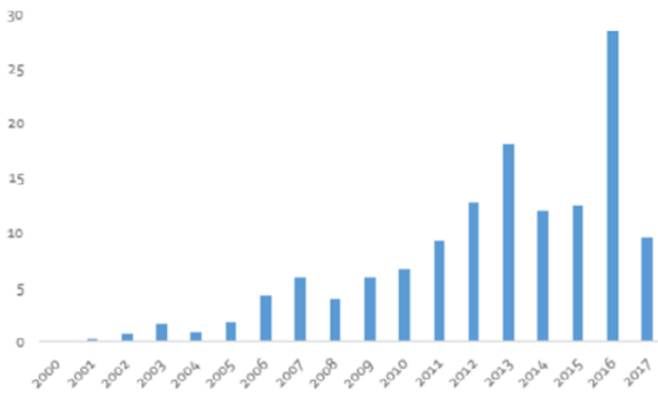
4 Data as of July 2019.
5 Bloomberg. March 2018. "Africa's Eurobond Love Fest Set to Continue as Issuers Line Up".

As a result, we see an important shift in the composition of creditors across the region, where the size of private creditors in the region's debt has reached almost 40% by 2017, up from less than 20% in 2000 (Figure 3).

Surge of new non-traditional creditors in the region: China

Along with the increase of private creditors in SSA, the profile of bilateral creditors has also changed. The share of debt held by traditional Paris Club members fell by 8% between 2010 and 2017, while China strengthened its position as the main lender to Sub-Saharan Africa. (Africa's pulse, 2019). According to data from the China-Africa Research Initiative (CARI), China lent more than $135 billion to sub-Saharan African countries between 2000 and 2017. These loans have accelerated since 2010, from an average of $3 billion between 2000 and 2010 to about $14 billion per year over the last decade (Figure 5). Currently, it is estimated that 20% of SSA's total external debt is owed to china (Jubilee Debt Campaign, 2018). This share is likely to increase in the next years since China announced, in September 2018 at the 7th Forum on China-Africa Cooperation, an additional commitment of $60 billion in African financing.

Figure 6 : Chinese loans to Sub-Saharan countries (in Billions $)



Source : China-Africa Research Initiative data

Several parties are accusing China of financially strangling Africa and some are comparing the situation in some African countries to the one in South-East Asia, with some analysts referring to a "debt trap" or "trapped debt diplomacy". However, according to a recent analysis of CARI data, China holds most of the external debt in only two of the "debt distressed" or at high risk countries, namely the Republic of Congo and Zambia (Eom et al., 2018). Chinese loans in the two countries total about $14 billion, which represents just over one-tenth of its total lending to the African countries.

This change in debt composition has heightened the risks The recent shift in the creditor's base, shows an important investor confidence and interest in the region, who continue to believe in the region's good economic prospects. Nonetheless, the current situation can present enormous risks related, inter alia, to currency, global movement of interest rates, and governance issues, which could jeopardize debt sustainability in the region.

1- SSA countries are more exposed to changes in interest and exchange rates

Bonds are mainly issued in US dollar (USD)[6], which make countries vulnerable to currency fluctuations. Depreciation of the exchange rate of a local currency increases the real value and debt burden denominated in foreign currency. For example, Ghana and Zambia have already suffered the depreciations of the Cedi and Kwacha respectively in 2014, leading to a 10% increase in the external debt-to-GDP ratios of both countries (Van Cauwenbergh and Laleman, 2018). Currently, international reserves in several countries have recovered, however, their commodity prices remain relatively low. Pressures on African foreign exchange markets persist, according to the latest data from the EMPI index (Regional Economic Outlook, 2019). Further depreciation/devaluation cannot be ruled out in the future, this would depend on many factors beyond the control of SSA countries, and in particular on the evolution of FED rates, which would be mechanically reflected in the value of the US dollar against African local currencies.

The recent trajectory of FED funds rate (9 increases between late 2015 and late 2018), reflecting the U.S. institution's intention to normalize its monetary policy after 10 years of Quantitative Easing, had gradually increased risk aversion for emerging and frontier markets, which was reflected in borrowing costs. In 2018, some issuances were traded on more expensive terms (Regional Economic Outlook, 2019). The FED's latest decision to cut its main interest rate (by 25 basis points) would be good

6 89% of international bonds issued by SSA countries are denominated in dollars while 11% are in euros.

news for sub-Saharan countries as the cost of debt would fall in the short term. However, it is difficult to pronounce on the evolution of US monetary policy over the medium term and consequently on borrowing conditions on the debt market in the coming years. A possible tightening of borrowing conditions would represent a major risk for SSA countries, especially considering that a large proportion of the region's bonds will mature from 2021 onwards, and that refinancing of these debts is necessary to ensure the continuity of the major investment projects to which the regions' countries have committed.

2- The new trend in commodity-linked financing is also a cause for worry

Another major risk could arise from the increasing use of new debt instruments such as commodity-linked loans. These loans allow SSA countries to access more financing while reducing risks for creditors. Much of the commodity-linked finance, borrowed on commercial terms, has originated from bilateral lending from China. It is estimated that export commodities have been used to guarantee one third of Chinese loans in Africa (Brautigam and Hwang, 2016). Other creditors such as the Africa Export Import Bank, Glencore and Trafigura also link the servicing of loans to governments and state-owned enterprises to commodity revenues (Atingi-Ego, 2019).

These types of contracts can be detrimental to borrowers in a context of high commodity price volatility. A negative terms-of-trade shock would increase the debt burden, with other implications for the rest of the economy. Chad has already experienced this situation in 2014 when the Chadian public oil company obtained a large loan from Glencore, at a time when the price of crude oil was over $100 per barrel. "Under the contract, revenues from future sales of crude oil would service the loan. Two months after the issuance of the loan, the price of crude crumbled, and Chad found itself with debt payments cannibalizing 85% of oil revenues" (Coulibaly et al., 2019).

3- Fiscal slippages and governance problems are still widely present

In principle, the emergence of private creditors in the region should encourage sub-Saharan countries to make greater efforts in terms of governance and macroeconomic discipline. However, it turned out that the ease of access to these non-traditional sources of financing was the origin of some fiscal slippages. Indeed, in some SSA countries, indebtedness is tied to higher expenditure during political cycles along with the lack of accountability in issuing and tracing debt. Ghana for example has been accumulating relatively large primary fiscal deficits over the past decade, amplified every time the country was approaching elections. Around the 2008, 2012 and 2016 presidential elections, fiscal slippages and unduly spending led to deep holes in the budget and unfavorable debt issuances. As a result of this weak fiscal discipline (in combination with the drop in commodity prices and high investment needs) the Ghanaian public finances have been under serious pressure for years (Van Cauwenbergh and Laleman, 2018).

The surge of non-traditional borrowers into the region has also been linked to certain practices that lack transparency. The cases of Mozambique and the Republic of Congo made headlines in 2017. Mozambique, after a default in payment, was forced to reveal the existence of a hidden debt of €1.8 billion, subscribed by parastatals. A few months later, the Republic of Congo's debt was revalued to 120% of gross domestic product (GDP) - instead of 77% - after similar dissimulations[7]. These poor governance practices have a direct impact on public finances and reduce the countries' creditworthiness.

If risks persist, this may have an impact for development finance and debt sustainability in the region

The growing risks of debt distress adds to the uncertainty on debt sustainability across the region. Ex ante, debt is an important wheel for growth as it allows to mobilize important resources to finance countries' development needs that are not necessarily covered by ODA or FDIs in SSA. However, as it stands now, its sustainability is a "returning challenge" in SSA after two episodes of debt relief, which impact the availability of future borrowing space, thus, access to finance.

The region has an important financing gap estimated

7 Alternatives économiques. March 2018. "L'Afrique s'endette à nouveau".

at between \$68 and \$108 billion (AfDB, 2019), along with very important development plans and the SDGs 2030 agenda that further increase financing needs in SSA. With growing risks that can curve down investors demand of SSA debt, and the rising cost of debt, the borrowing space might be reduced. As result countries will have important difficulties to meet their investment gap through alternative financing mechanisms. There is still a limited capacity to mobilize domestic resources and domestic financial markets are yet to be developed to encourage the private sector in boosting development.

Concluding remarks and policy implications

Sub-Saharan Africa had an important development progress in the last 20 years, as most of the countries in the region were able to reach the MDGs following the HIPC and MDRI. The region saw important fiscal reforms that have allowed having fiscal space for development expenditure, with many countries having reached the SSA tax to GDP frontier of 15% (Regional Economic Outlook, 2018). Nonetheless, there are still important financing needs to meet further development ambitions and improve the state of infrastructure in SSA.

In face of limited equity financing, debt remains an important tool for growth for countries across the region. However, with growing risks of debt distress across SSA, debt sustainability is at risk and needs to be seriously tackled by political agendas across the region. It will ensure the availability of future fiscal space, where the country budget deficit is stable and provides room for essential development financing.

Macro fundamentals and investment decisions need to readjust across countries in the region to generate sustainable revenues and meet the challenge linked to the rise in the cost of debt across the region. Additionally, economic diversification is key in resource-based countries to build buffers for external shocks tied to commodity price fluctuations, and exchange and interest rates. Moreover, risk sharing mechanisms should be taken seriously, which can help alleviate the pressure on SSA government finances and diversify financing and revenue generations mechanisms. This will allow to boost economic diversification and reduce the pressure of the volatility of ODA and FDIs in the region. However, this will be possible only if governance and institutional quality are improved, which will allow to have a better environment for doing business and encourage more private and public partnerships in the region. This will help to ensure sustainable and quality development financing that can reduce public sector burden and improve countries' debt positions

While debt management capacity has improved since the HIPC, it is still not allowing many countries to better coordinate debt issuance with the rapid changes in creditors' compositions. In times of debt restructuring, countries are not able to fully trace their debt, and thus make debt coordination mechanisms an important area for technical assistance moving forward. Also, additional capacity building is needed, so countries acquire more expertise in issuing domestic and local currency debt, which can reduce their currency mismatches and develop local financial markets.

Unless these measures are progressively applied across the region, debt sustainability and development financing will be at an important risk leading to reduced financing for SSA developmental needs.

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The Policy Center for the New South (PCNS) is a Moroccan think tank aiming to contribute to the improvement of economic and social public policies that challenge Morocco and the rest of the Africa as integral parts of the global South.

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