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Revisiting debt sustainability in Africa

Note by the UNCTAD secretariat

Executive summary

On average, Africa's external debt levels are below 23 per cent of gross domestic product (GDP), which should be sustainable for most countries. Global investors attracted to emerging sovereign debt markets have enabled many African countries to tap international bond markets. The sovereign debt of several African countries has increased in recent years and is becoming a source of concern to policymakers, analysts and multilateral financial institutions, particularly the International Monetary Fund (IMF). While the continent's current debt ratios are manageable, their rapid growth in several countries is worrisome and requires action to avoid a repetition of the African debt crisis of the 1980s. Against a backdrop of falling commodity prices, rising debt levels a resurgent dollar and forecasts for higher global interest rates, the dangers of a new debt trap in Africa should not be ignored. This paper suggests that there are important lessons to be learned as African Governments strive to balance the competing objectives of financing development spending and of avoiding a new round of debt crises.

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Introduction

1. The sovereign debt of several African countries has increased in recent years and is becoming a source of concern to policymakers, analysts and multilateral financial institutions, particularly the IMF.[1] While the continent's current debt ratios are manageable, their rapid growth in several countries is worrisome and requires action if a recurrence of the African debt crisis of the 1980s is to be avoided. According to 2013 data, two African countries with relatively high external debt-to-GDP ratios are Mauritania (102 per cent) and Cabo Verde (92 per cent). The swelling debt of several African countries can be explained by the fact that African countries enjoy better access to international financial markets because the continent is growing faster than before.[2] In relation with this, investors are seeking better yields in Africa, given slow growth in advanced countries, and higher rates of return based on the perceived risk of investing in Africa. The rise of other developing countries has also opened up new sources of external finance that African countries are content to take advantage of, often without the imposition of conditionalities. As a result of this favourable external environment, countries such as Côte d'Ivoire, Ghana, Kenya, Senegal and Zambia have successfully issued sovereign bonds (Standard and Poor's, 2014).

2. A crucial feature of Africa's debt has implications for sustainability: today African Governments are borrowing from private lenders, unlike in previous years when they borrowed mostly from official lenders such as IMF, the World Bank and the African Development Bank. For example, large corporate bonds have been issued in Ethiopia, Mozambique, Nigeria and South Africa. When these bonds are in foreign currencies, countries become susceptible to currency fluctuations. In addition, borrowing from private lenders is challenging because renegotiation is generally more difficult when a country is unable to service its debt, and conditions for renegotiation come at a very high cost. Borrowing from private lenders also exposes African countries to litigation by vulture funds and investment arbitration. Zambia, for example, has been subjected to costly legal action by vulture funds in recent years (Al Jazeera America, 2015).

3. African countries find international bond investors attractive because they do not impose conditions on how funds are used. Official lenders and bilateral creditors often set conditions on how borrowed funds can be used; this has been a source of disagreement between African countries, and bilateral and multilateral lenders. African countries argue that it limits their policy space; moreover, they would like more room to adopt policies that they deem appropriate in light of domestic realities.

4. However, warning signs indicate that current macroeconomic conditions partly resemble those prevailing before the debt crises of the 1980s. Much as today, there was a combination of buoyant commodity prices, optimistic growth forecasts in resource-rich countries and low interest rates. As international commodity prices are expected to fall, and have already declined in some sectors such as the oil industry, a waning of private lender confidence may be expected in the near future. It is therefore reasonable to ask whether Africa is at risk of falling into another debt trap.

5. This paper reviews the extent to which "new" debt-creating financial flows – stemming from other developing countries, foreign currency bonds[3] and domestic debt may jeopardize debt sustainability in Africa. What are the potential policy implications of these

[1] See IMF, 2013 and *The Financial Times*, 2014.

[2] Since the late 1990s, African countries have endeavoured to focus on macroeconomic stability and the importance of maintaining policy buffers, aligning fiscal and debt sustainability policies, which probably enhanced their resilience during the 2008–2009 global financial crisis (UNCTAD, 2014).

[3] These are also known as Eurobonds.

trends? Given the changing composition of debt, what should African Governments, multilateral development banks and development partners do to avert the risk of another debt crisis?

I. What is the current debt situation?

6. In 2012, African countries spent about 10 per cent of their export earnings on servicing their external debt, which stood at $457 billion. Although this is much lower than debt levels of the 1990s, when debt service often exceeded 40 per cent of export earnings, many African countries have since 2012 become increasingly concerned that a debt boom is beginning to get out of hand. As structural transformation has been slow, most countries remain natural-resource-dependent exporters of unfinished commodities, which are vulnerable to wide fluctuations in commodity prices. And these prices are currently declining. It could thus be argued that the structural foundations for a repetition of the 1980s debt crisis have been laid, and such a crisis is in danger of reoccurring. Between 2006 and 2012, public and publicly guaranteed external debt stocks in current dollars grew faster in Africa than in the rest of the developing world (IMF, 2013).

7. The table shows that Africa’s total external debt-to-GDP ratio in 2013 remains a low 23 per cent, because GDP has been growing fast. This ratio fell below 30 per cent in 2006, owing to heavily indebted poor countries’ initiatives and the recent commodity price boom. However, in some countries, debt is now approaching 60 per cent of GDP or beyond. For example: Mauritania’s debt-to-GDP ratio is 102 per cent, Cabo Verde’s is 92 per cent and Zimbabwe’s is 87 per cent; those above 60 per cent include Sao Tome and Principe, and Senegal. Debt service as a share of exports of goods and services in 2013 was 10.7 per cent and at the time of writing of this paper, was forecast to rise to 12.1 per cent in 2014. Total debt outstanding as a share of exports of goods and services rose from 50.8 per cent in 2008 to 68.5 per cent in 2013 (see table). Further, government deficits in many African States are rising, especially in West Africa. General Government net lending and borrowing as a share of GDP are at continental averages or above in Liberia, Guinea and Sierra Leone. West Africa’s Ebola outbreak has severely disrupted economic activity in Guinea, Liberia, and Sierra Leone, and slow growth in these countries in 2014 is likely to have led to the acquisition of debt to finance widening fiscal deficits. As a result, it is likely that debt-to-GDP ratios for these countries, with spillover effects on their neighbours, worsened in 2014.[4]

[4] In February 2015, these countries were granted debt relief of about $100 million by IMF, which has been under pressure to relieve their financial burden. The Fund has urged other international lenders to take similar action, as it set up a catastrophe containment relief trust to provide grants to countries affected by epidemics and other natural disasters.

Africa: Selected external debt positions, 2000–2013

	2000	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*
Multilateral debt (as percentage of total debt outstanding)	23.7	24.8	25.8	27.0	27.9	29.5	24.5	23.2	24.1	25.4	24.5	..	..	..
Total debt outstanding at year end (as percentage of gross domestic product)	53.4	53.6	54.3	48.7	41.9	32.7	25.3	23.6	21.5	23.7	22.1	22.0	22.5	23.2
Total debt outstanding at year end (as percentage of exports of goods and services)	165.2	172.5	173.3	149.0	121.3	87.2	64.0	59.7	50.8	72.8	64.3	61.7	63.9	68.5
Total debt service: interest and amortization paid (as percentage of exports of goods and services)	27.1	28.0	28.3	23.4	19.2	19.3	21.6	11.6	10.6	13.7	9.3	8.9	9.6	10.7

Source: Data Portal, African Development Bank Group. Available at http://dataportal.afdb.org/Default.aspx (accessed 14 April 2015).

8. As poor infrastructure (power, transportation and water) remains a critical and binding constraint on economic development and competitiveness, many African Governments have aimed to raise the levels of infrastructure investment by the public sector.[5] Infrastructure projects are increasingly attracting finance from non-Development Assistance Committee bilateral sources such as other developing countries. Moreover, many African countries have increasingly raised funds from international capital markets. In the third quarter of 2013, $4.75 billion was raised in sub-Saharan Africa, compared with $3.25 billion for the same period in 2012 (World Bank, 2014).[6]

9. As previously noted, many African countries have recently issued foreign currency bonds denominated in United States dollars. Sovereign bonds issued on international capital markets (Eurobonds) generally carry a fixed coupon payment, and mostly have a 5- to 10-year maturity. This means that, in principle, interest rate risk is relatively low. Although seven African countries have issued Eurobonds since 2013, only the bonds of Gabon, Ghana, Nigeria and South Africa will mature in the near to medium term (before 2018) (Mecagni et al., 2014; IMF, 2014). Many of these countries have issued debt with maturities beyond 2018. Given the relatively favourable market conditions, interest rate shocks may not have an immediate impact. However, there are other types of risks, such as political risk, which also have a bearing on the overall perceived risk of investors; investor confidence can quickly wane if their risk perception is affected, and trigger movements in sovereign bond markets.

[5] These include the Governments of Ethiopia, Ghana, Namibia, the Niger, Nigeria and South Africa.
[6] For example, Eurobond issues in 2013 of $400 million for Rwanda, $1 billion for Nigeria and $750 million for Ghana.

II. The changing composition of debt in Africa

10. Similarly, a worrying trend concerns the shift from most of Africa's borrowing being public, that is to say, multilateral[7] and bilateral lending to private lending, which accounted for 49 per cent of total outstanding external debt in Africa in 2012 (African Development Bank et al., 2014); rescheduling government debts or borrowing more from private lenders is generally much harder than from multilateral lenders. As much of Africa's growing sovereign debt is denominated in dollars, currency fluctuations may prove problematic later on. Almost 15 years of steady economic growth and lower external debt-to-GDP ratios have begun to attract private investors to the market.

11. Most Eurobond issues since 2013 have been oversubscribed, reflecting the growing appetite for investing in African economies, compared with investment opportunities elsewhere. However, there are also some risks to this process. First, market sentiments matter. Since 2009, low global interest rates and the quest for higher returns outside Europe and the United States of America led to increased demand for African countries' debt in 2012 and 2013. However, since the third quarter of 2014, there has been a consistent selling of African Eurobonds as markets reacted to falling oil prices and a return to "less risky", albeit lower return mature markets (*The Financial Times*, 2014). Second, although most international investors are attracted to Eurobonds because the exchange rate risks are negligible, the risk remains with the issuing African Government, and this can be significant. Local currency risks can be high, as witnessed in Ghana in 2014, when the cedi fell sharply against the dollar, making the settlement of foreign-currency-denominated debt much more costly.[8] Most African economies issuing Eurobonds are relatively small in global terms and are relatively more vulnerable to exogenous global fluctuations in capital and commodity markets, thus greater exposure to global finance and related risk must be more effectively managed by their Governments. This is inherently much more complex when the sentiment of global markets is taken into account, as serious financial penalties can result from sizable exchange rate shifts. During the 1980s, exchange rate fluctuations resulting in a stronger dollar contributed to the escalation of the African debt crisis in many countries. Therefore, the currency composition of external debt can have major implications for future debt sustainability (Ibi Ajayi and Khan, 2000).

12. Many African countries still borrow on concessional terms from the Bretton Woods multilateral organizations. Multilateral lending accounted for 21 per cent of total outstanding external debt in Africa in 2012 (African Development Bank et al., 2014). In general, these loans carry fixed interest rates or predetermined charges, which means that interest rate risk on these instruments is limited. This is also the case for most bilateral loans, for example from the Paris Club. However, some African States also have variable-rate external public and private debt. Angola, Botswana, Côte d'Ivoire and South Africa have the highest levels of variable-rate external debt in Africa, making them acutely vulnerable to major fluctuations in global interest rates (World Bank, 2014).

13. Although concessional loans remain important for many African countries, new forms of accumulating debt through South–South bilateral loans and sovereign bonds have risen in importance. For example, in Senegal sovereign bonds accounted for 15 per cent of

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[7] For example, the World Bank and IMF.

[8] By 2014, despite Ghana's high GDP growth (14.5 per cent in 2011) the unsustainable state of the country's finances meant that the cedi had declined nearly 40 per cent against the dollar by August; and GDP growth fell to 5 per cent. Assistance from IMF enabled Ghana to launch its third Eurobond in September 2014. The issue had a 12-year maturity and raised $1 billion at 8.1 per cent, compared with 5.6 per cent, 6.6 per cent and 6.8 per cent for the 2014 issues by Côte d'Ivoire, Ethiopia and Kenya respectively, stabilizing the cedi. The bond issue was dependent on conditional IMF support, requiring cuts in public expenditure amounting to 3.5 per cent of GDP (Adams, 2015).

public external debt in 2013. Semi-concessional loans from the Government of China to Mozambique accounted for a third of its debt stock (Mecagni et al., 2014). Ghana has utilized both mechanisms to increase its debt stock indicators. While there is no immediate likelihood of widespread sovereign default, the nature and consequences of financial mismanagement should not be ignored.

14. A major challenge for Africa's policymakers is to ensure that the last decade of relative macroeconomic and fiscal stability is maintained, while continuing to build productive capacities to promote inclusive growth. Although rising, its average external debt-to-GDP ratios at 23 per cent in 2013, are moderate. These vary widely across the continent, as low as 7 per cent in Equatorial Guinea and as high as 92 per cent in Cabo Verde. A few countries such as Ghana and Senegal have witnessed a rapid increase in government gross debt ratios in recent years. However, the number of African countries evaluated as being in debt distress or at high risk of distress fell from 17 to 7 between 2006 and 2012, while the number of countries at low risk more than doubled (13) during this period (World Bank, 2014).

III. How should African countries balance the competing objectives of financing development spending and of avoiding a new round of debt crises?

15. Although debt portfolios are sustainable for most African countries, there is growing concern that a few countries may be falling back into a debt trap. As African countries increasingly access international capital markets and acquire non-concessional financing, they will need to exercise caution with regard to spiralling debt dynamics and sustainability issues, especially if global interest rates and commodity markets move in an unfavourable direction. If left unchecked, Africa's external debt may begin to impede economic growth and development in the most heavily indebted countries. Although the international community made commendable efforts towards debt relief for some African countries through the Heavily Indebted Poor Countries Initiative and the Multilateral Debt Relief Initiative, reducing the debt burden and achieving debt sustainability remains a daunting challenge. However, four years after receiving assistance from the Heavily Indebted Poor Countries Initiative, eight African countries had raised public-debt-to-GDP levels. Although increased borrowing may reflect better macro fundamentals to facilitate access to global financial markets in the form of bond issuance and bilateral lending, it also raises concerns over the implications of a return to high debt levels, particularly if the new borrowing does not translate into productive investment and faster growth.

16. The World Bank-IMF Debt Sustainability Framework for Low-income Countries, which evaluates the risk of debt distress in those countries, will continue to assist progress in African debt sustainability (Barkbu et al., 2009). The Framework consists of a set of indicative policy-dependent thresholds (such as public external debt as a share of GDP and debt-service as a share of exports) against which projections of external public debt over 20 years are compared to assess the risk of debt distress.[9] The threshold for each debt burden indicator depends on a country's policy and institutional capacity, as measured by the World Bank's country policy and institutional assessment index (World Bank, 2014). Debt sustainability assessments are taken into account to determine access to IMF financing and for the design of debt limits in the IMF-supported programmes while the World Bank uses it to determine the share of grants and loans in its assistance to developing countries.

[9] The Framework analyses both external and public sector debt. Given that loans to low-income countries vary considerably in their interest rates and length of repayment, the Framework focuses on the present value of debt obligations. This ensures comparability over time and across countries.

The Framework's heavy reliance on the conservative quality of borrower countries' policies and institutions assessments and rigid ratings criteria – for example, a country could fail only one of the five debt burden indicators and still be considered in debt distress – may have reduced the potential utility of the Framework initiative for many low-income African countries (Nissanke, 2013; Berg et al., 2014). Thus, a more favourable rating for many low-income African countries could have led to more World Bank support in the form of grants, rather than loans. The Framework could also have contributed more effectively to helping many African countries balance the competing objectives of financing development spending and of avoiding a new round of debt crises (Nissanke, 2013).

17. There are also ad hoc mechanisms such as the Paris Club,[10] which can restructure debt obligations to bilateral creditors and thus help African countries balance the competing objectives of financing development spending and avoiding a new round of debt crises through greater debt sustainability. Today the world is a much more complex place in terms of international capital markets and debt sustainability than in the 1980s. For example, other developing countries have set up robust development assistance programmes, which have raised additional concerns about debt sustainability and transparency in Africa (Reisen, 2007; Strange et al., 2013). The international community is addressing the problem with an improved structure as part of wider financing for development[11] initiatives and the 2012 UNCTAD principles on promoting responsible sovereign lending and borrowing,[12] which aim to create a sustainable debt mechanism.

18. Regarding the United Nations financing for development imitative,[13] debates about this appear to be coalescing around four complementary principles for the allocation of development finance. The first emphasizes the need to expand and target international grants to the most vulnerable and least creditworthy developing countries, especially those with limited domestic resource mobilization capacities. The second concerns boosting access to the market-related finance for developing countries, particularly middle-income countries. The third relates to a new international target for market-related official finance that encourages members of the Development Assistance Committee and other developing countries to increase investment and financial support to developing countries. The fourth principle states that grant aid for climate change should target adaptation financing insofar as possible, given the magnitude of the investment challenge faced by developing countries in mitigating climate change. African countries face relatively benign global capital market conditions in the short to medium term (IMF, 2014), with excellent opportunities to tap them for much-needed infrastructure investments.

19. The UNCTAD principles on promoting responsible sovereign lending and borrowing have started to address gaps in the international financial architecture caused by a lack of institutions to promote responsible financing. The principles make clear that State officials dealing with debt – borrowing or lending – are agents of the citizenry and must adopt accountable and transparent practices. Great emphasis is also placed on the

[10] The Paris Club is a major forum where creditor countries renegotiate official sector debts, those that have been either issued, insured, or guaranteed by creditor Governments. The Paris Club includes 19 member States comprising the major international creditor Governments.

[11] The recently released zero draft of the outcome document of the Third International Conference on Financing for Development to be held in Addis Ababa in July 2015 provides a holistic and forward-looking framework and concrete actions aimed at financing sustainable development to deliver the means of implementation for the proposed sustainable development goals and a transformative development agenda.

[12] See http://www.unctad.info/upload/Debt%20Portal/Principles%20drafts/SLB_Principles_English_Doha_22-04-2012.pdf, accessed 15 April 2015.

[13] During 2015, the United Nations will convene several forums and meetings with representatives of Government and civil society from around the world to discuss how to fund the new set of sustainable development goals.

importance of promoting co-responsibility of both parties – borrowers and lenders – to resolve and prevent debt crises.

IV. Conclusions and issues for discussion

20. High public debt levels are a constraint on growth and development, although most countries' levels are relatively modest. The composition of debt in Africa may be changing, and this could have implications creating new challenges for debt sustainability in the future. Public debt-to-GDP ratios have fallen sharply since 2000; however, the steady decline in debt levels was halted by the onset of the global financial crisis of 2008–2009. A few countries, mostly fragile States, have required debt relief. From 2006 to 2012, external public and publicly guaranteed debt stocks grew faster in Africa than in the rest of the developing world. Some African countries with relatively well-developed bond markets have increased issuance of domestic bonds to finance deficits. Most African countries have maintained a reliance on external financing. The extent to which a country's current account is in deficit tends to determine its borrowing needs, hence the importance of countries adopting sound macroeconomic policies, which helps to curtail their demand for credit. Similarly, where debt is acquired, African Governments need to adopt relatively prudent debt management frameworks and policies by using effective capacity and analytical tools to enhance the prospects of debt accumulation leading to the creation of productive capacities. Debt management should be an essential element of an effective system of public finance management with transparency and accountability at its core, key elements of what is often considered best practice in development governance (UNCTAD, 2010). Certainly, efforts to maintain or acquire fiscal policy space and manage debt in Africa would benefit from macroeconomic policies based on clear fiscal rules and medium-term expenditure frameworks. Currently, international interest rates are relatively low; therefore, borrowing now may be sensible for African States if those resources finance high-yielding growth enhancing investments in physical and human capital.

21. While some countries in Africa are not burdened by their debt levels, many could find it difficult to finance larger deficits if there is a significant slowdown in the global economy or a sharp decline in commodity prices. Vulnerability to fluctuations and instability in global commodity prices remains high in Africa, and a decline in the commodity boom is a foreseeable reality. Countries should consider the creation of sovereign wealth funds, such as the Norwegian oil fund, that are managed autonomously and with independence. Additional revenue that is generated through high commodity prices could be placed in such funds during boom periods and used in times when prices fall below expectations to ensure continuity in public spending, especially in the much-needed infrastructure and social sectors, so that African commodity-dependent economies can be more resilient against the boom and bust cycle of commodity markets. Clearly, given the high degree of commodity dependence in Africa, a diversified export base is critical to making export revenues less vulnerable to major commodity price fluctuations, thus reducing resulting indebtedness that occurs as Governments try to finance budget and current account deficits through increased borrowing.

22. In particular, countries that have been recently been exposed to civil war, terrorism and Ebola are the most exposed to a debt trap, even when the most favourable concessional lending is considered. These countries, in particular those hit by the Ebola epidemic, have suffered massive economic and social losses that will require decades of investment and assistance to overcome. Concessional lending obligations pose an additional burden for these countries and could well stand in the way of their recovery. Hence, an initiative to develop effective debt work-out mechanisms for these countries should be considered as a means to assist these countries in their reconstruction and recovery. Lenders, whether multilateral, bilateral or private, need to minimize the risk of imprudent lending and the build-up of debt and contingent liabilities in Africa through the Debt Sustainability

Framework for Low-income Countries and the adoption of the principles on promoting responsible sovereign lending and borrowing.

23. Against this backdrop, the following issues have been identified to guide the panel discussion on the theme of this year's executive session of the Trade and Development Board:

(a) How should African countries balance the competing objectives of financing development spending and of avoiding a new round of debt crises?

(b) What lessons from Africa's past debt crises are of relevance to the current context?

(c) What specific measures should Africa and the international community adopt as part of the financing for development agenda to enhance debt sustainability?

(d) Given the changing composition of debt, what should African Governments, multilateral development banks and development partners do to avert the risk of another debt crisis?

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