Background Paper

Regional Conference on Public Debt Management and Sustainable Economic Growth in Sub-Saharan Africa

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Ministry of Foreign Affairs of the Netherlands

ODI

Background

About the conference

Debt financing provides a vital source of funds needed for development and when used wisely can help to boost a country's economy. Major changes in the composition of external public debt in sub-Saharan Africa (SSA) over the past decade, while giving sovereign borrowers more choice, have made prudent debt management more complex.

This conference's objective, which sets it apart from other discussions, is to empower public debt managers and those involved in public debt and financial management in SSA by identifying practical steps they can take, including how they can cooperate, to ensure that external borrowing is used to ultimately foster sustainable economic growth and that the terms and conditions of debt are more favourable to this end.

The conference is a unique opportunity to bring together senior government officials from across SSA along with a wide range of experts and stakeholders to untangle the complexity facing sovereign borrowers in SSA and focus on ways forward for getting the best deal for financing national development plans and meeting the Sustainable Development Goals (SDGs).

The conference is co-organised by the Ministry of Finance, Planning and Economic Development of the Government of Uganda, the United Nations Department of Economic and Social Affairs (UN DESA), the Ministry of Foreign Affairs of the Government of Netherlands, and the Overseas Development Institute (ODI).

During the interactive three-day conference, participants will discuss current challenges and trends in debt financing across SSA, exchange ideas and perspectives and identify policy options and follow-up actions to tackle shared challenges.

The conference will be under the Chatham House rule so participants can speak freely, while the conclusions and recommendations agreed will be summarised in a report to be presented at the IMF and World Bank Spring Meetings in April 2020.

Purpose and structure of this paper

This paper acts as a guide to the conference agenda and is structured to mirror the conference sessions. It provides a succinct summary of some of the key issues to be discussed to help participants understand the purpose of each session.

Suggested further reading

Participants who want to deepen their understanding of key issues in advance of the conference are encouraged to examine the following papers:

- *Macroeconomic developments and prospects in low-income developing countries 2019* (IMF 2019)
- *Making debt work for development*, Chapter 4 in *Trade and Development Report 2019* (UNCTAD 2019)
- *Global waves of debt: Causes and consequences* (World Bank 2019)
- *Debt and debt sustainability*, Chapter IIIE in *Financing for Sustainable Development Report 2019* (UN 2019)
- *Principles on promoting responsible lending and borrowing* (UNCTAD 2012)

1. Debt and development – challenges and opportunities

Many SSA countries have grown strongly over the past decade. The IMF forecasts that non-resource-intensive SSA economies will continue to grow at 6% per year, though resource-intensive countries are forecast to grow at less than half that pace (IMF 2019). Predictions are difficult, however, given that the sub-Saharan economy has in the past been severely affected by global economic conditions, such as the commodity price shock of 2015, as well as international currency fluctuations. The global economic outlook remains uncertain with heightened trade tensions, weaker growth and subdued commodity prices. High and rising levels of global debt – both public and private – also point to significant risks in the financial sector. Climate change and security challenges continue to pose particular problems for the region. SSA countries need to invest in their economies to support sustainable economic growth, realise the SDGs, and overcome climate-related risks.

Public debt in SSA – both external and domestic – has been rising since around 2012. At the same time, debt has becoming more expensive, potentially risky[1] and more complex as a result of changes in whom debt is borrowed from, with a rise in non-Paris Club bilateral lenders and private sector lenders. Sovereign bond issuance in SSA reached a new record of $17.4 billion in 2018, for example (World Bank 2019a: 9). As a result of higher debt levels and increased costs of servicing debt, several SSA countries are currently facing serious challenges, while many remain vulnerable to debt shocks as a result of shorter maturities, contingent liabilities, foreign exchange exposure and a more complex climate for debt restructuring. For example, a survey of Eastern and Southern African countries found contingent liabilities of between 4% and 31% of GDP (Mauro et al. 2015). By November 2019,[2] 11 SSA countries were classified as being at high risk of debt distress,[3] and eight were already in debt distress.[4] This overall picture, however, masks a diversity of experience across the continent, with some countries managing debt effectively and growing strongly.

SSA has suffered from having relatively low levels of other development finance resources. For example, the African region has the lowest overall government revenue to GDP ratio of any region in the world, standing at 21% in 2018, though some countries such as Rwanda and Burkina Faso have made significant improvements in recent years (UNECA 2019, 30). UNECA estimates that these levels could be increased significantly through improved policies, enlarging the tax base, improving administration and tackling tax avoidance and evasion (UNECA 2019). Official Development Assistance (ODA) flows to SSA have been in decline, dropping by 4% to $26 billion in 2018, and global ODA levels delivered by developed country donors overall are far from the UN target of 0.7% of GNI, standing at 0.31% in 2018.[5] Having declined in 2016 and 2017, Foreign Direct Investment (FDI) to SSA rose in 2018 to $32 billion, driven by increases in North and Southern Africa (UNCTAD 2019), but this figure remains low in comparison to other regions.

To set the scene for the conference, this session will provide an overview of the past decade's debt trends and developments and key shifts in the role of debt in supporting development in relation to other sources of financing. It will reflect on the lessons that could help countries meet financing needs in a sustainable way while dealing with shocks such as falling commodity prices, changes in terms of trade, changes in international liquidity conditions, natural disasters and realisation of contingent liabilities.

Key questions:

- How has the development finance landscape evolved across SSA in the last decade?
- How vulnerable are SSA countries to shocks and what has been the impact of these shocks on debt sustainability in SSA?
- What key lessons should be learned about meeting SSA financing needs in a sustainable way, reducing the risk of shocks, and what could external actors do to help?

1 For example, the rise in private sector lending can expose sovereign balance sheets to greater rollover and exchange rate risk.
2 See www.imf.org/external/Pubs/ft/dsa/DSAlist.pdf
3 Burundi, Cameroon, Cabo Verde, Central African Republic, Chad, Djibouti, Ethiopia, Ghana, Mauritania, Sierra Leone and Zambia.
4 Democratic Republic of Congo, Gambia, Mozambique, São Tomé and Príncipe, Somalia, South Sudan, Sudan, and Zimbabwe.
5 See www.oecd.org/dac/financing-sustainable-development/development-finance-data/ODA-2018-detailed-summary.pdf

2. Why borrow and what for? Linking borrowing to strategies for sustainable growth

If borrowing is to support national development strategies, help achieve sustained economic growth, and meet the SDGs, then better public investment management is critical. Borrowers and lenders tend to assume that debt used to finance productive investments, particularly physical infrastructure, will gradually repay itself via higher economic growth and then higher tax revenues, but the evidence for this is mixed. In any event, increased debt levels may not always be linked to increases in investment levels. For example, the IMF estimates that, of the two-thirds of low-income developing countries that have seen widening fiscal deficits in recent years, only in 30% of cases is this accounted for by higher public investment levels (IMF 2018).

The quality of the investment is also critical. Low rates of return, inefficient public investment, or low absorptive capacity can contribute to an unsustainable public debt burden. For example, a study of 52 countries found that investment in physical infrastructure assets made a contribution to economic growth but that the effect was driven by the quality of the investment, in particular how well projects were selected and implemented (Gupta et al. 2014).

It is not just investments in physical capital that can boost long-run growth rates: human capital investments can be just as important, though their effects may take longer to realise. For example, one study of 46 developing countries suggested that significantly increasing the educational outcomes of 15-year-olds[6] could boost long-run growth by over 2% above the baseline trend (UNESCO 2012). At least 10–30% of differences in per capita GDP differences are estimated to be due to cross-country differences in human capital (World Bank 2019b, 49–68).

It is important to also examine public investment borrowing decisions in the context of the national strategy to boost overall investment and efficiency in the economy, including in the private sector. The need for a clear policy direction and strategy, including the creation of a sound investment environment, is becoming more important as countries turn to more expensive domestic and external debt sources. The level of government domestic borrowing also affects the private investment through influencing interest rates (Nautet and Meensel 2011) and through affecting the availability of finance for the private sector.

Debt is also an essential and flexible financing source for balancing out public income and public expenditure and for responding to challenges, especially short-term shocks. Periods of unusually high expenditure can be the result of various shocks such as wars or natural disasters (Fatás et al. 2019). Increasing spending during recessions can also smooth the business cycle which can potentially help raise employment, output and incomes.

This session will explore the experience of SSA governments in sourcing and investing borrowed funds to enhance future economic prospects.

Key questions:

- What are the challenges that SSA governments face in using debt financing to make productive public investments?
- What are the lessons that can be learned from countries that have linked their national development strategies to their borrowing decisions and debt management strategies without creating unsustainable debt burdens?
- What public investment practices should be avoided, which promoted, and how can borrowing decisions be best evaluated and monitored?

6 Getting an extra 75% of 15-year olds to reach the minimum mathematics benchmark in OECD's Programme for International Student Assessment (PISA) test at the end of a ten-year period.

Improving the negotiation process: ideas and solutions

In many cases the balance of power between borrower and lender can affect the negotiation process. The ability of SSA countries to negotiate favourable financing terms and conditions with a development partner or lending agency is in some cases weakened by the absence of a well-formulated and adhered-to negotiation process. Even in cases where a process exists, there may be problems caused by political interference. The urgency of the need for financing, the perceived lack of alternatives, information asymmetries between borrowers and creditors, and inadequate preparation may also cause problems. Understanding how to avoid and overcome these and other difficulties in the negotiation process is important for improving negotiation outcomes.

UNCTAD's Principles on Responsible Lending and Borrowing (UNCTAD 2012) are the most complete and detailed guide to the responsibilities of both lenders and borrowers. If adhered to, they can improve the negotiation process to the benefit of the borrower and lender. The UNCTAD principles make clear that the lender has a due diligence responsibility to provide full information to borrowers and to ensure that it is understood, and to estimate the likely impacts of project financing, including social and environmental impacts. The UNCTAD principles also highlight that lenders also have a responsibility to consider the wider debt situation of the countries they are lending to, including the broader financing situation and contingent liabilities. This in turn requires the sovereign borrower to provide lenders with the information required to analyse that risk properly before agreeing to finance the investment. One key problem is that these principles remain voluntary and there are no mechanisms to ensure that they have traction. In addition, not all countries have formally endorsed them.

A further set of principles has been produced by the Institute of International Finance. The *Principles for Stable Capital Flows and Fair Debt Restructuring* (or IIF Principles) are supported by many market participants (IIF 2019) and incorporate voluntary, market-based, flexible guidelines for the behaviour of sovereign debtors and private creditors.

There is considerable room for improvement in debt transparency at the country level so that domestic citizens and parliaments can provide incentives for governments to improve debt contraction, use, and management. This can mean strengthening the transparency of both the process of debt contracting and management and the *data* needed to examine and understand debt issues. On process, strengthening public debt laws to improve transparency and accountability in debt management operations is an important step. At the same time, data on public debt levels is inconsistent, incomplete and may significantly understate the problem, so improving the production and publication of data is important (IMF 2015). G20 leaders recently recognised the importance of both lenders and borrowers improving transparency, referencing the work of the IIF on the Voluntary Principles for Debt Transparency. These principles are only intended to apply to private creditors and, at least to start with, only to Poverty Reduction and Growth (PRGT)-eligible[7] countries and to external lending. The principles request that lenders disclose a list of relevant facts about each loan, guarantee or other debt instrument, including amounts involved and the costs. The intention is to make this information public.

Negotiation does not stop at the execution of the contract: restructuring is sometimes necessary to put debt on a sustainable path. In the absence of an insolvency regime for sovereigns, a country facing difficulties often has to enter protracted negotiations with its creditors, a process that has frequently proven to be painful and costly to both sides. Evidence shows that restructuring is a common feature of sovereign debt markets (Schlegl, Trebesch, and Wright 2019), suggesting that the focus should be on how to do this better, particularly before countries reach crisis point.

In 2015 the UN General Assembly passed a resolution setting out internationally agreed principles for sovereign debt restructuring (UNGA 2015), which, though very high-level, set out important principles. These include:

- the need for transparency in order to enhance accountability
- the need for a sustainable end point where the debtor's situation is stable, including the consideration of human rights and social and environmental impacts
- the stipulation that a minority of creditors should not be allowed to hold up restructuring if a majority of creditors are in agreement.

7 See www.imf.org/external/Pubs/ft/dsa/DSAlist.pdf [Accessed 22/07/2019 at 15:33]

A more detailed set of proposals on how to improve restructuring was set out in UNCTAD's Roadmap and Guide on Sovereign Debt Workouts (UNCTAD 2015). The guide's starting point is that the debtor state should take the lead in the process. In practice this has proved difficult, in part because of political economy problems in indebted countries (Trebesch 2019) and because debtors are wary of the ramifications of signalling that they are having problems.

The development of a permanent mechanism for resolving sovereign debt problems – also known as a Sovereign Debt Resolution Mechanism (SDRM), a Sovereign Debt Workout Mechanism – has long been on the international agenda. The objective of such an institution would be to ensure that debt crises were resolved rapidly and fairly, but it should also help to reduce the number of such crises, as creditors in particular would moderate their behaviour knowing that a binding mechanism existed. Such a mechanism would require political support from UN member states and a revival of previous attempts to get international agreement on this.

Finally, through better and more structured coordination among borrowing countries and by establishing a better common understanding of the key issues and best practices, borrowing countries could substantially strengthen their position in their negotiations with creditors.

Key questions:

- What common problems arise in the debt negotiation process, and what impact do they have on negotiation outcomes for countries in SSA?
- What has been done or could be done by sovereign borrowers and lenders to improve the negotiation process to drive better outcomes for SSA countries?
- What has been done or could be done by borrowers and lenders to improve the negotiation process for restructuring sovereign debt?

WORKSHOP A: How to achieve more favourable borrowing terms and conditions

Responsible borrowing depends not only on what you borrow for, but also on the terms and conditions under which the debt is incurred. Negotiating fair and balanced contracts with external lenders, however, is an area that some SSA governments struggle with, particularly with respect to commercial creditors, relatively new bilateral sovereign lenders and more complex instruments, such as collateralised debt. This is partly because the terms and conditions contained in these contracts and their implications are often not fully clear to decision-makers and their technical advisors or may be presented as 'non-negotiable' by creditors. For example, IMF teams found that, for commercially contracted debt, their country teams deemed the terms and conditions clear or fairly clear in fewer than half of the cases (IMF 2018).

Negative pledge, cross default, *pari passu* and collective action clauses (CACs) are examples of standard clauses which can have far-reaching implications, especially in times of crisis (Olivares-Caminal 2017). Getting them right is of the utmost importance. Over the past five years there has been an effort to improve collective action clauses (to make restructuring easier) and *pari passu* clauses (to prevent the problems experienced by Argentina in 2016–2017) in sovereign bond contracts. The IMF's most recent update shows that CACs were included in close to 90% of sovereign bond issuances between October 2014 and September 2017, though the stock of outstanding debt without them remains large.

Concerns have been raised about increasing levels of collateralised debt, which may be significant for some countries, though relatively little analysis has been conducted on this issue.[8] One concern is the fact that Chinese bilateral lending sometimes contains collateral clauses that mean that repayment is made through the proceeds of commodity exports, particularly oil (Horn, Reinhart, and Trebesch 2019, 4). A recent study of the seniority structure of sovereign debt found that, in practice, bond-holders and multilateral creditors tend to be senior lenders, and private creditors tend to be more senior than official creditors (Schlegl, Trebesch, and Wright 2019), helping explain why some bilateral creditors are keen to raise their seniority through collateralisation.

Reliance on borrowing in foreign currencies continues to be a major risk factor in many countries in SSA as most revenues continue to be in the local currency. Multilaterals and the international system have done relatively little to provide local currency alternatives and hedging techniques, while other initiatives to boost local currency options remain small.

At the same time, potentially important clauses may not always be considered, such as 'hurricane' clauses in countries likely to be affected by natural disasters. These types of clauses, which link repayment to the ability to repay are known as State Contingent Debt Instruments, remain relatively rare. The introduction of Hurricane Clauses by the Government of Grenada and its creditors and by the *Agence Française de Développement* has shown that this can be done (Mustapha and Prizzon 2018, 12). More recently, Barbados has replaced all its outstanding external debt with climate-resilient instruments. These types of clauses can eventually be tailored to the needs of the borrower, for example to cover risks that may be pertinent to them, such as droughts or floods.

As noted under topic 3 above, the lack of transparency surrounding these terms and conditions can also exacerbate potentially harmful effects. This session will seek to demystify complex concepts and terminology, outline the complications they can present to prudent debt management, and discuss practical steps that can be taken by SSA governments and their creditors to improve the terms and conditions negotiated with their different external lenders.

Key questions:

- Which key terms and conditions offered by different types of external lenders cause problems for SSA governments and why?
- Which are the most important terms and conditions to improve, and how can they be improved to better support a country's development goals?

8 Reports of collateralised debt problems are often in reality linked to other debt issues, as this article on Sri Lanka details: https://thediplomat.com/2019/05/is-sri-lanka-really-a-victim-of-chinas-debt-trap/

WORKSHOP B: Harnessing the opportunities and managing the risks of creditor-driven financing and unsolicited proposals

Although financing is often presumed to be demand-driven, creditors and private sector companies in search of yields also play a major role in driving lending through the products they offer and the ways in which they promote them. For example, private sector companies, some of whom have strong ties to bilateral official creditors, often directly approach governments in SSA countries with new project proposals and offers of financing.

Such unsolicited proposals may be seen by governments to offer opportunities, though these may not always deliver in practice. One key perceived advantage is that such unsolicited financing proposals are seen as overcoming lack of public-sector capacity to identify and develop infrastructure projects, for example. However, a review of experience in the infrastructure sector showed that this promise has not always materialised. Negotiating with a private provider who is already several steps ahead in terms of designing a project can prove more difficult than anticipated. It can take far longer than anticipated and cause controversy in cases where regulations, such as procurement rules, are bypassed (World Bank Group and PPIAF 2018).

A second major rationale for engaging with unsolicited proposals is to harness private-sector innovation and creativity. However, the same study also found that this promise can be hard to deliver in practice. In particular, intellectual property claims made by private financiers in unsolicited financing proposals may not prove to be justified, as similar solutions can often be procured from different actors (World Bank Group and PPIAF 2018).

At the same time, unsolicited financing proposals can also provide greater opportunities for corruption and political patronage by avoiding competition (Turley 2015). In a study in Mexico, 44% of private actors offering unsolicited financing proposals admitted giving part of the proceeds to public authorities (World Bank Group and PPIAF 2018).

The World Bank has recently published guidelines for managing unsolicited financing for infrastructure focused on improving practices at four key stages: submission; evaluation; development; and procurement (World Bank Group 2018).

Key questions:

- Who are the providers of creditor-driven financing and unsolicited proposals, and what are their motives?
- What non-standard terms and conditions tend to be associated with these offers of finance and how can they be improved?
- What measures have been used or could be developed by countries in SSA to ensure that these types of financing proposals are managed well in order to minimise the potential negative consequences?

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