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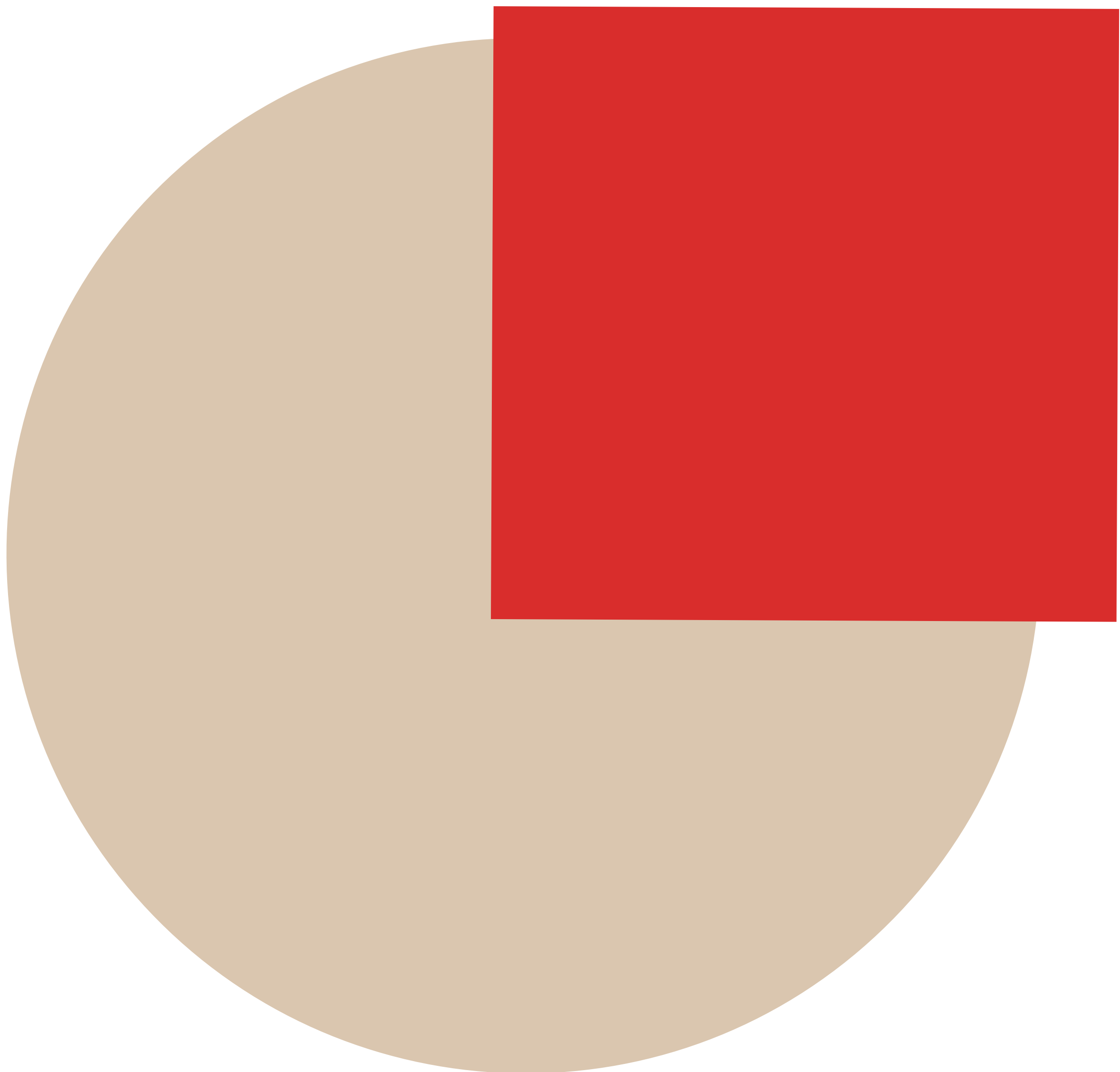
How to treat Africa's Covid-contaminated debt? An innovative proposal



Groupe d'études géopolitiques

Sub-Saharan Africa

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How to treat Africa’s Covid-contaminated debt? An innovative proposal

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Foreword

Public actors, at all levels of government, have to take innovative and rapid action to respond to the exceptional circumstances of the COVID-19 crisis. One area of action is financing the increased expenditures required to save lives and mitigate the socio-economic impacts of the measures adopted to contain the virus. Addressing the increased need for financial resources is seemingly complex for any country, but strikingly more so for emerging and developing countries.

In these countries, State capacity to finance public action with fiscal revenues is generally low and, with a few exceptions, lower than in developed countries. OECD countries collect taxes amounting to an average of 34,3% of their GDP. Latin American countries have a much lower capacity to do so, with an average of 23.1% of GDP. Capacity in African countries is even lower at 17.2%. In Asia, tax revenues for a large country like Indonesia amount to a mere 11.5% of GDP, with Thailand at 17.6%. Moreover, monetary conditions in many developing countries are less favourable than in OECD countries, as the margin of manoeuvre on liquidity and interest rates is limited.

The COVID-19 crisis further aggravates weak State fiscal capacity in developing countries. As a result, developing countries will significantly need to rely on international markets to raise funds. Growth is plunging into downturn, and even recession, further slashing states' fiscal revenues. The numbers are alarming. While the average annual growth rate in emerging Asia stood at 7,8% between 2000 and 2018, the expected rate for this year is only 1%. The respective numbers in Africa were 4.6% over the last two decades and this year stands at -1,1% , a negative result. Latin America had an average growth rate of 2.6% and this year is at -5,3%, a huge negative result.

These numbers show an economic crisis that reflects both the impact of measures adopted locally to contain the virus and the powerful erosion caused by international transmission mechanisms operating independently from the extent to which COVID-19 has directly affected any given country. Let us describe some of these transmission mechanisms. The considerable (and unpredicted) decline in commodity prices has put additional pressure on the public finances of the many economies that depend on commodity production. The weakened consumption in countries that are traditional trade partners of the developing world - such as US, China and Europe – is affecting developing countries' exports, income and fiscal revenues. Foreign direct investments that where already low before the crisis, are expected

to decline even further by around 40%-60%. At the same time, immigrant remittances – i.e. one of the most important international financial flows to developing countries – are expected to decrease by at least 20%. Not to mention that the outward movement of capital from developing countries has already reached levels higher than those of the 2008 crisis.

In short, public debt management is high on developing countries agenda, as their resources to respond to both the socio-economic crisis and debt obligations, are limited. However a lack of response by these countries will either increase poverty and social unrest (many of these countries have high levels of informality and workers do not benefit from effective automatic stabilisers) or seriously affect their reputation. In the latter case, the paradox would be evident: these countries would face a debt crisis, harming their reputation, not because of unsustainable macroeconomic policies of their own making, but caused by a global, unexpected health crisis and its exogenous consequences.

Now is therefore the time to put forward and brainstorm on ideas and proposals for international solidarity and co-operation on public debt management in the COVID-19 era. The hope is to support and facilitate the work of prestigious institutions, like the Club of Paris, to negotiate and adopt effective measures. Some of these proposals have already been circulating since the beginning of the crisis and are the result of academic or institutional initiatives. Alexandre Pointier and Olivier Vallée present us with one here, others may follow.

Going through these proposals on the payment of public debt and avoiding widespread defaults, some recurrent figures of debate seem already to appear.

First, there is a general intent that any coordinated measure (e.g. debt standstill/moratorium, debt relief, etc.) should mitigate reputational risk for emerging and developing economies. In fact, these countries cannot be suspected of moral hazard given that the pandemic crisis is largely imported and affects a given country via huge exogenous factors. Actions that are agreed today should not affect access to capital markets in the future, nor should they condition the development of domestic capital markets. The present circumstances require exceptional action, not permanent norms.

Second, the proposals look at whether a few or all emerging and developing economies should be included in the discussions, regardless of their level of income. In the latter case, they look at whether solutions should be graduated according to countries' fiscal conditions before the crisis, i.e. were they solvent or not.

Third, many proposals consider that a wide series of actors should be involved in the discussions. They suggest that all bondholders should be part of the solution, including private creditors and "new country" creditors, such as China. In the case of debt restructuring, Collective Action Clauses

(CACs) and other similar provisions that have appeared in bond markets since the early 2000s, should contribute to manage private creditors' involvement efficiently.

Finally, an issue raised is if countries do benefit from a debt reduction and enjoy additional fiscal space to face their increased crisis-related expenditures, how can they be made transparent and what role should other countries and multilateral institutions play in monitoring them?

These topics of debate should contribute to a well-organised process to respond to public debt management under the exceptional circumstances of the COVID-19 crisis. The agenda is vast and ambitious. It requires the involvement and solidarity of several actors. It also requires rapid action to mitigate the impact of COVID-19 on citizens' wellbeing.

Executive Summary

The Covid-19 pandemic reveals and accentuates structural economic imbalances, including high indebtedness, for most African countries. The latter has been transformed over the last decade by a combination of market instruments and debts which, in principle, cannot be rescheduled with regards to multilateral financing institutions. Alleviating the debt burden for low-income African economies which nonetheless bear specific debts, is therefore a puzzle that leads to the examination of diverse and probably complementary solutions.

- the debt service moratorium for 77 countries, announced on 15 April 2020 by the G20 finance ministers, at least partially responds to the liquidity problems encountered by poorest countries in the context of the Covid crisis but leaves aside the solvency issues ;

- the solvency objective can be achieved through a combination of three initiatives, but which must be adapted to the specific context of each country: a restructuring and securitisation operation for external commercial debt leading to standardised relief, a large-scale refinancing operation for domestic debt and, finally, relief for bilateral public debt ;

- in order to ensure the coherence of such operations, they should be framed by a single supervisory and coordination mechanism.

The objective of this paper is to provide a synthetic overview of the challenges akin to African debt restructuring. The three outlined mechanisms, as well as the supervision and coordination system, could be the subject of more detailed analyses.

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How to treat Africa's Covid-contaminated debt? An innovative proposal

In order for the poorest countries to meet the financing needs generated by the Covid 19 crisis, G20 finance ministers and Paris Club creditors agreed, on 15 April 2020, on a temporary suspension of debt servicing for 77 countries, including around 40 in sub-Saharan Africa. This moratorium covers the period from May to December 2020 and could be extended in 2021. All bilateral official creditors, including France, the United States, Russia and China[1], are involved in the initiative and private as well as multilateral creditors have been invited to participate. However, this initiative cannot be a definitive response to the crisis. It is important to give visibility as soon as possible on the medium-term solvency of States whose financing depends on a wide range of creditors, including private ones. We refer to this group of African countries as border States (see annex 1). This paper puts forward some proposals to seek medium-term solvency by addressing the three main categories of creditors within the framework of an overall agreement concerning: 1) bilateral and multilateral official creditors, 2) syndicated or securitised external commercial debt and 3) primarily bank-based domestic debt.

1. A moratorium on official bilateral and multilateral debt, leading to "Paris Club-style" relief

Although the moratorium decided by the G20 partially responds to the liquidity issues faced by the poorest countries in the context of the Covid-19 crisis, it leaves aside the solvency issues. Major public creditors (Paris Club, G20) will certainly want to wait 9 to 15 months before addressing this issue, so that they can accurately measure the impact of the crisis on the solvency of States (i.e. on debt sustainability). This approach creates a great deal of uncertainty, which, in turn, could lead to a partial withdrawal of many public and private bilateral creditors, even though financing needs far exceed the liquidity provided by the moratorium[2]. This is one of the reasons why several countries might not apply for the moratorium (Kenya, Togo, etc.)[3].

In the absence of a guarantee that the IMF and the main multilateral banks alone will be able to meet the financing needs of border states, the challenge for those states is therefore to give visibility to all creditors on their post-crisis solvency as soon as possible.

For countries whose debt trajectory was deemed viable before the crisis, an effective way to restore this trajectory would be to deal with the effect of crisis-related debt ex-ante, i.e. «Covid debt». While this will only be definitively known in one to three years, it is likely to reach 15 to 20 GDP points. Indeed, (i) the latest IMF forecasts (WEO of April 2020) already predict an increase in deficits of 4 to 8 GDP points in Africa, (ii) these figures are certainly underestimated[4] and (iii) the impact of the crisis will undoubtedly continue, at least until 2021.

Thus, the G20 could announce a cancellation of 15 GDP points of debt for all border countries on the basis of the stock of public debt. This option would have the advantage, because of its lump-sum and systematic nature, of providing the expected visibility for all States whose debt was deemed to be sustainable before the crisis. On the other hand, the reluctance of some countries during the negotiations on the moratorium (China in particular wanted the participation of multilateral and private creditors) suggests that it will be very difficult to obtain such an agreement.

2. Restructuring and securitization of all external commercial debt leading to standardized debt relief for all border countries

Private creditors should participate in a cooperative and coordinated scheme for the rapid restructuring of border countries' debt.

In order to obtain broad support from private creditors and thus have a significant impact on the debt burden

1. Russia and China are not members of the Paris Club

2. As an example, the estimated gain from a bilateral moratorium for Senegal is around €150 M. This amount must be compared to the total financing needs, which include the financing of crisis-related measures (Senegal announced a €1,500M response fund in March), as well as the financing of the pre-crisis budget deficit and the refinancing of multilateral and commercial debts maturing in 2020 (again €1,500M, including €675M deficit in the BIA and €825M in refinancing), i.e. a total of around €3,000M just over the year 2020
3. As of 19 May 2020, four countries had signed the moratorium and some 20 countries were finalizing their actions
4. J. Sandefur and A. Subramanian (2020), The IMF's Growth Forecasts for Poor Countries Don't Match Its COVID Narrative.

of concerned countries[5], Brady bonds could be brought back into fashion, this time with a guarantee provided by major multilateral institutions (African Covid-bonds, see Annex 2). This scheme would enable private creditors who so wish to exchange credits on border states (bond debt and bank debt) with a new credit, at a lower rate and with a longer maturity, guaranteed by a highly rated development institution or group of institutions. Private creditors would then forgo part of their gains on low-income economies in exchange for an increase in their credit risk. Multilateral institutions, on the other hand, would take a risk exposure on the total amount but would not have to provide financing. This intervention would also give them the legitimacy to act as advisors/coordinators of other debt reduction initiatives - see 1) and 3) -. While this option appears realistic in its design, at least for unsecured debt[6], it may take some time to be implemented.

3. A large-scale refinancing operation for domestic debt

In order not to put countries that have developed their domestic capital markets at a disadvantage, it is important to address the issue of domestic debt.

A plan to reduce domestic debt could be organised, with the assistance of central banks (BCEAO and BEAC in particular), by making it possible to repay all or part of the stock of domestic debt by issuing long-term bonds at low interest rates, which would be taken by central banks. Unlike African Covid bonds, where private creditors are kept unchanged by modifying the credit risk through the provision of a guarantee, the idea here is to keep the same credit risk but to have it borne by a central bank, on a model similar to what is happening in Europe or the United States. It is essential that this exercise be supervised and assisted by multilateral institutions (IMF/WB), in order to ensure its monitoring and credibility.

This mechanism would also help to ease any liquidity constraints on national banking systems.

4. Conclusion

The answer for each country must in fact be a combination of those three elements. Indeed, since sovereign debt restructuring has the classic characteristics of collective action problems, the more each of the major categories of lenders is involved, the more creditors will be inclined to participate in the exercise. However, there is a whole category of para or quasi-public creditors that could escape this treatment if external commercial debt is not also treated under similar conditions. It is therefore important to associate this official treatment with treatment of commercial debt. In particular, the participation of private and multilateral creditors should facilitate China's adherence to a Paris Club cancellation initiative and to the transparency exercise required. The Paris Club, enlarged to include China, could, for example, announce an intervention as a last resort to guarantee a minimum level of debt cancellation (corresponding to a lump-sum level of «Covid debt»), after implementation of schemes involving other creditors.

In the medium term, the international community will also need to speed up work to standardise loans and obligations, by defining new contractual standards that apply to all types of debt and allow for the restructuring of a range of debts. Automatic standstill clauses could also be considered[7].

5. For example, in Senegal, commercial debt accounts for 34% of the debt stock and more than 50% of debt service
6. The interest of a private creditor to exchange a pledged loan for an obligation guaranteed by a multilateral institution will depend on its perception of the relative value of the collateral and the guarantee
7. Collective action clauses have been introduced in most bond issuance since 2003. They allow a qualified majority of creditors to modify the terms of the contract for all creditors of the same bond. However, on the one hand, these clauses do not easily manage the restructuring of a set of bonds of different maturities and, on the other hand, they have no equivalent for loans from credit institutions, which account for 80 per cent of the debt of low-income countries.

Annex 1.
Major Cases in Africa

Three groups of African countries can be distinguished according to their level of per capita income and debt structure.

The first group includes the heavyweights in terms of GDP: South Africa, Morocco, Egypt and Nigeria. Their external debt accounts for 40% of Africa's external debt, i.e. $190 bn. Most of their creditors are private, but the share of debt owed to lender countries remains substantial. The Chinese are not dominant lenders and, before Covid-19, these countries were able to solicit financial markets. These countries should be able to get through the crisis, even if there are of course sources of concern. For example, Morocco has a very large Eurobonds maturity in October 2020 and Nigeria, whose debt is mainly domestic, has to finance the large twin budget and current account deficits.

Intermediate, but located on a dangerous border, 17 economies that have had access to the Eurobonds market make the second group (border states). Their debt accounts for 46% of Africa's external debt, i.e. $220bn (+175% since 2010), and is equally divided between private, bilateral and multilateral debt. A retrospective analysis of this debt highlights two major changes since the period 1990-2000, which saw a first wave of debt restructuring: on the one hand, debt owed to countries outside the Paris Club (China in particular) has risen sharply and, on the other hand, debt owed to private entities (Eurobonds, syndicated loans and facilities secured by commodities) has also sharply risen. All this in a context where these two categories of debt are not always well reported[1].

This group itself contains a particular sub-group of countries with a high share of domestic debt with regards to total debt (Togo and Benin in particular).

Far from the financial markets, other African countries, group 3, carry only 14% of Africa's external debt, i.e. $65 bn. This group covers countries such as Mali, Burundi and Uganda, which cannot go to banks and private lenders, but also Mauritius and Botswana, which do not need their services.

TABLE 1

Group 1	Group 2	Group 3
South Africa	Angola	Algeria
Egypt	Bénin	Botswana
Morocco	Cameroon	Burkina Faso
Nigeria	Ivory Coast	Burundi
	Ethiopia	Cape-Verde
	Gabon	Comores
	Ghana	Djibouti
	Kenya	Gambia
	Mozambique	Guinea
	Namibia	Equatorial Guinea
	Democratic Republic of Congo	Guinea-Bissau
	Rwanda	Lesotho
	Senegal	Liberia
	The Seychelles	Libya
	Tanzania	Madagascar
	Togo	Malawi
	Tunisia	Mali
	Zambia	Mauritius
		Mauritania
		Niger
		Uganda
		Sahrawi Arab Democratic Republic
		Central African Republic
		Republic of Congo
		Sao Tomé-et-Principe
		Sierra Leone
		Somalia
		Sudan
		South Sudan
		Swaziland
		Chad
		Zimbabwe

1. Official World Bank statistics may particularly underestimate China's lending by 50% eg. f. Horn S., Reinhart C. and Trebesch C. (2019), 'China's overseas lending'.

Annex 2.
African Covid bonds