CHAPTER 12

Debt risks in sub-Saharan Africa and beyond[1]

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INTRODUCTION

Even before the Covid-19 pandemic, many countries in sub-Saharan Africa were at high risk of economic and financial distress. The collapse in economic activity brought about by the pandemic and the need to redirect money that had been earmarked for other government expenditures, including external debt service, to defray Covid-related expenses has increased the number of countries likely to face debt crises in the coming months.

A key official sector response to this situation was the Debt Service Suspension Initiative (DSSI), originally proposed by the president of the World Bank and the managing director of the IMF in March 2020 and adopted by the G20 on 15 April. The objective of the initiative was to give 73 low-income countries a debt holiday for the rest of 2020 and hope – via exhortation – that the private sector would voluntarily follow suit in providing equivalent relief. As of 10 January 2021, 45 countries have applied for relief under the DSSI and no private sector relief has been provided.

The sudden stop in capital flows to emerging and developing countries that followed the eruption of the pandemic was temporary. Thanks to infusions of money by central banks in advanced economies, capital began to flow back to some developing countries. Financial markets, however, are fickle and a tightening of financial conditions could lead to a situation comparable to the Latin American debt crisis of the 1980s. The costs of not having mechanisms in place to deal with such an event are potentially catastrophic.

After describing the effect of the Covid-19 pandemic on debt sustainability in Sub-Saharan Africa, this chapter defines some options for providing temporary legal protection to debtor countries in the event of a global debt crisis.

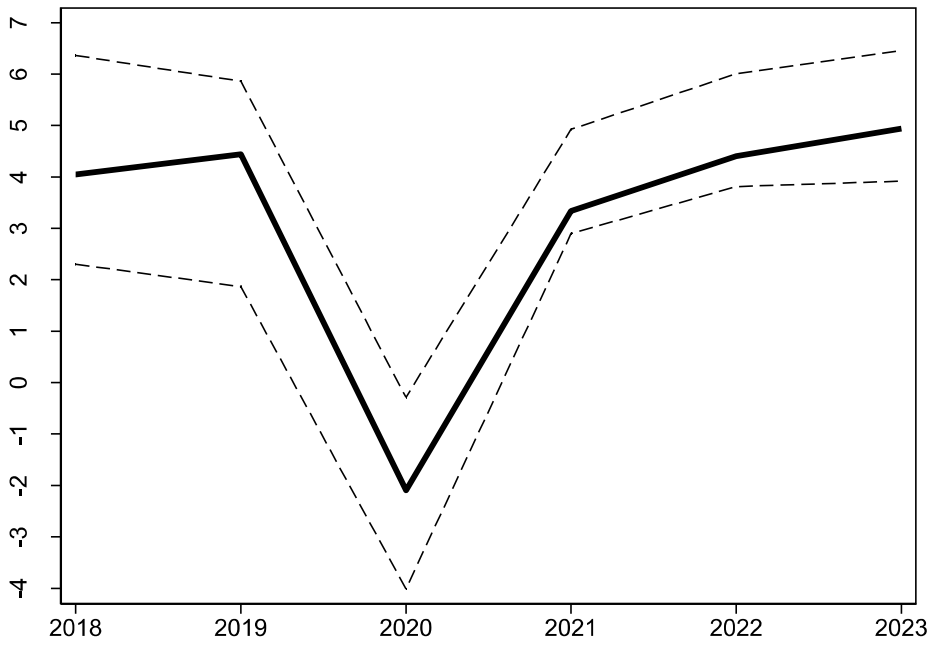
1 This chapter draws on Bolton et al. (2020) and on Bolton et al. (2020b) and Bolton et al. (2020d).

DEBT VULNERABILITIES BEFORE AND AFTER COVID-19

In February 2020, the IMF released a report on the evolution of public debt vulnerabilities in low-income countries (IMF 2020a). In 2013, less than a quarter of surveyed countries, most of them in sub-Saharan Africa, were either in debt distress or at high risk of debt distress, with the remaining countries deemed to be at moderate or at low risk of debt distress (43% and 34% of the total, respectively). The debt sustainability analysis exercise conducted by the IMF and World Bank in 2019 (before the explosion of Covid-19) classified 51% of covered countries as being either in debt distress or at high risk of debt distress. A further 30% were classified as being at moderate risk of debt distress and only 19% were deemed to be at low risk of debt distress.

This was a bleak picture pre-pandemic; the pandemic is making things worse. According to IMF estimates, in 2020 GDP in the median African country contracted by about 2% (a 4% contraction in the country in the 25th percentile of the distribution) – six percentage points below 2019 growth (Figure 1). The IMF forecasts that it will take at least three years to return to 4% growth and many more years to recover the output lost over 2020-2023. Moreover, the pandemic is likely to increase the already large informal sector of the economy that characterizes many sub-Saharan African countries (Daniel et al. 2020). A large informal economy will both complicate the implementation of Covid-19 containment measures and reduce the ability to raise government revenues to implement such policies.

FIGURE 1 GDP GROWTH IN SUB-SAHARAN AFRICA

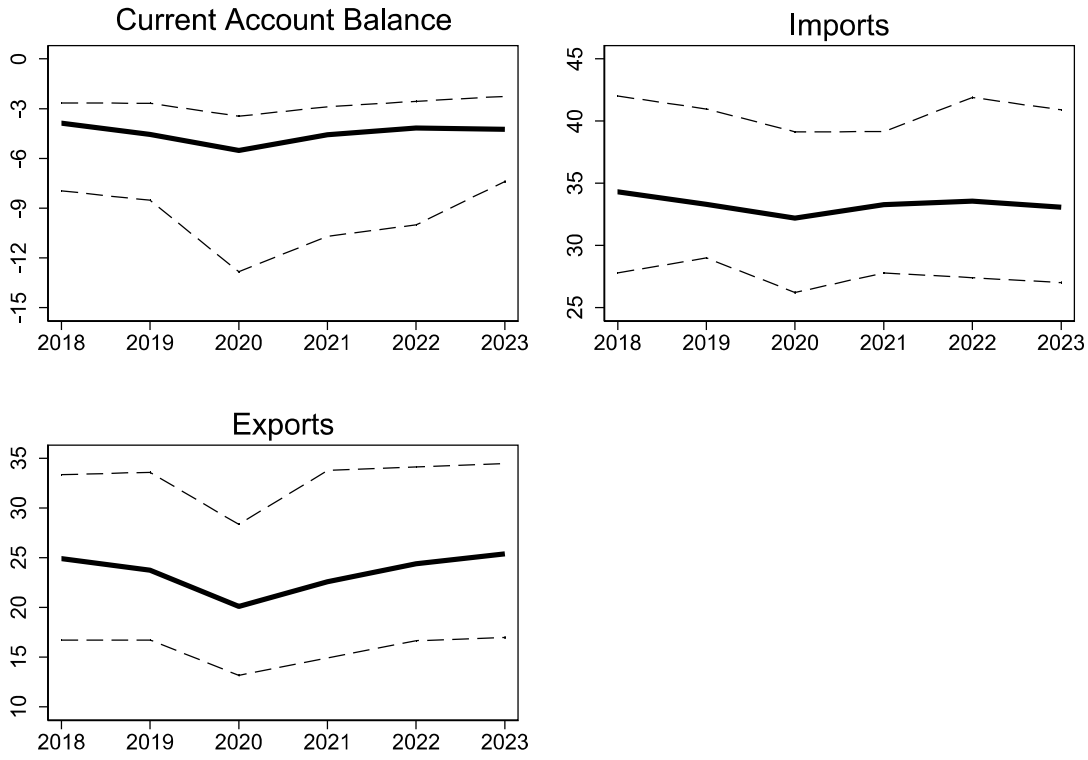


Note: The solid line plots median GDP growth and the dashed lines the interquartile range for a sample of 48 sub-Saharan Africa countries.

Source: Own elaborations based on IMF WEO forecasts.

Countries in sub-Saharan Africa will also need to finance larger current account deficits (a one percentage point deterioration for the median country; see Figure 2). These financing needs are not driven by an increase in imports, which would be optimal from a consumption smoothing perspective. Instead, they are due to a contraction in imports of about one percentage point and a larger (about three percentage point) contraction in exports.

FIGURE 2 EVOLUTION OF THE CURRENT ACCOUNT AND ITS MAIN COMPONENTS



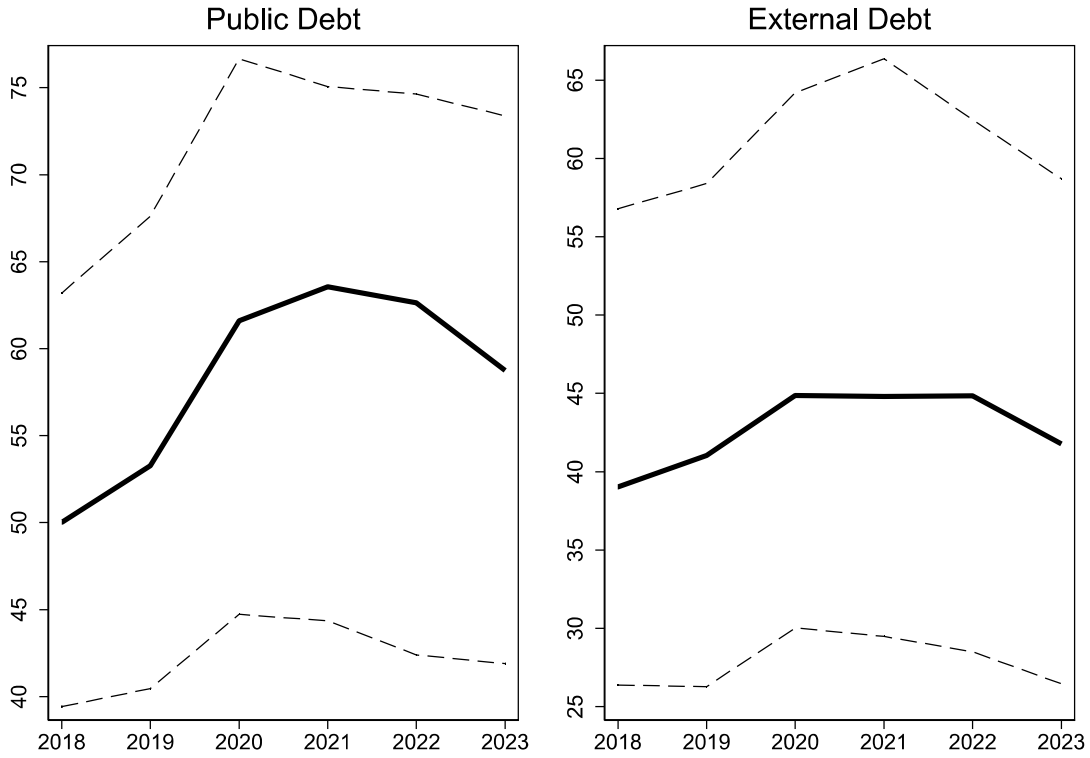
Note: The solid lines plot the median current account, imports, and export as a percentage of GDP and the dashed lines the interquartile ranges for a sample of 48 sub-Saharan Africa countries.

Source: Own elaborations based on IMF WEO forecasts.

Debt ratios are expected to increase substantially, with most of the increase in debt associated with the issuance of domestic debt (Figure 3). While domestic debt financing can reduce vulnerabilities associated with currency mismatches (Eichengreen et al. 2005), it does not allow for risk sharing and may have negative implications in terms of future inflation and financial repression. In fact, the limited increase in foreign borrowing is likely to be due to a lack of access to the international capital market, even under the current favourable financial conditions. While the sudden stop of March 2020 was short-lived and by the summer capital flows to emerging and developing countries reached record levels (Esteves and Sussman 2020), not all countries benefited from the expansionary policies implemented by most advanced economies. While more than two-thirds of middle-income emerging market countries that lost market access in March

regained access in June, the number of low-income countries that regained market access was much smaller. And that latter category includes most of the nations in sub-Saharan Africa.

FIGURE 3 TOTAL PUBLIC DEBT AND EXTERNAL DEBT



Note: The solid lines plot the median public and external debt as a percentage of GDP and the dashed lines the interquartile ranges for a sample of 48 sub-Saharan Africa countries.

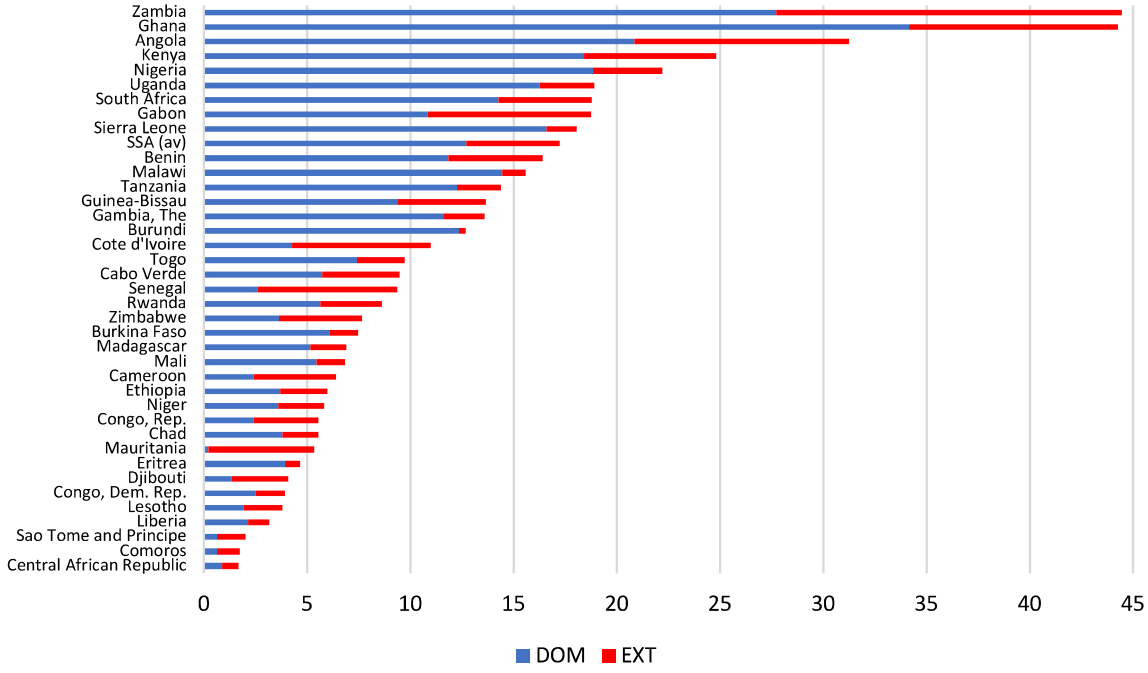
Source: Own elaborations based on IMF WEO forecasts.

Even without considering rollover needs, staying current on interest obligations on the existing stock of debt could be a challenge for many countries in sub-Saharan Africa. The top panel of Figure 4 shows that in nearly half of the countries for which we have data, interest payments will absorb more than 10% of government revenues in 2021. This share is well above 20% in Nigeria, Kenya, Angola, Ghana and, Zambia (the latter defaulted on its debt in November 2020).

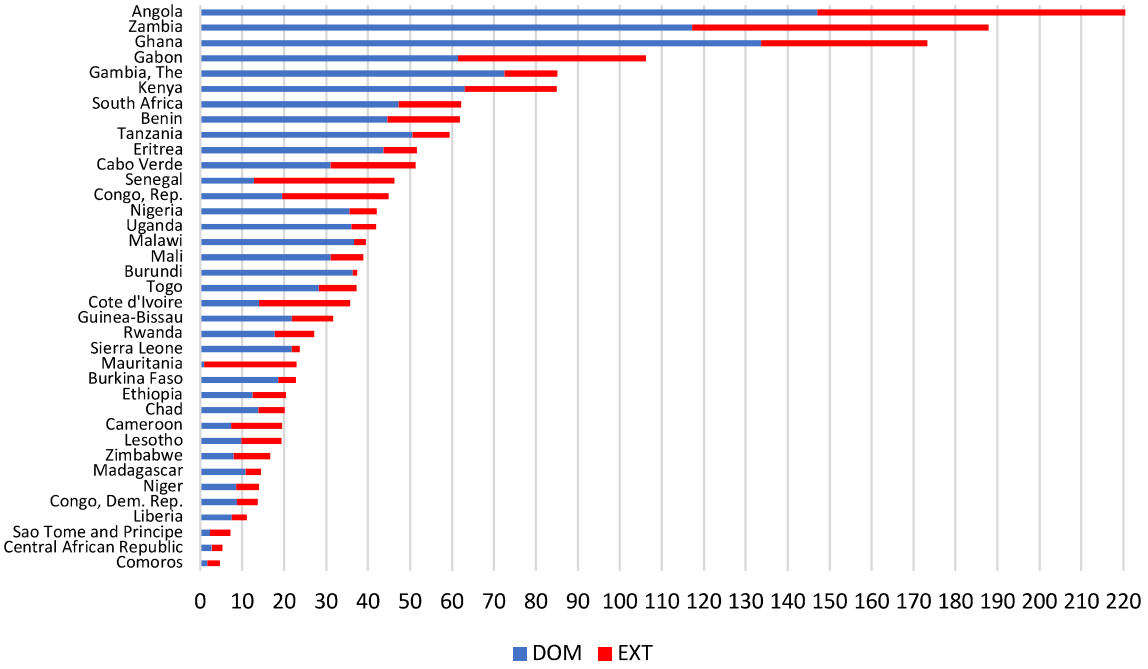
The situation looks worse if we compare interest payments with government health expenditure. There are four countries – Angola, Zambia, Ghana, and Gabon – for which interest payments are well above 100% of health expenditure and 21 countries for which interest payments are more than one-third of health expenditure.

FIGURE 4 INTEREST PAYMENT ON DOMESTIC AND EXTERNAL PUBLIC DEBT, 2021

a) Percentage of government revenues



b) Percentage of health expenditure

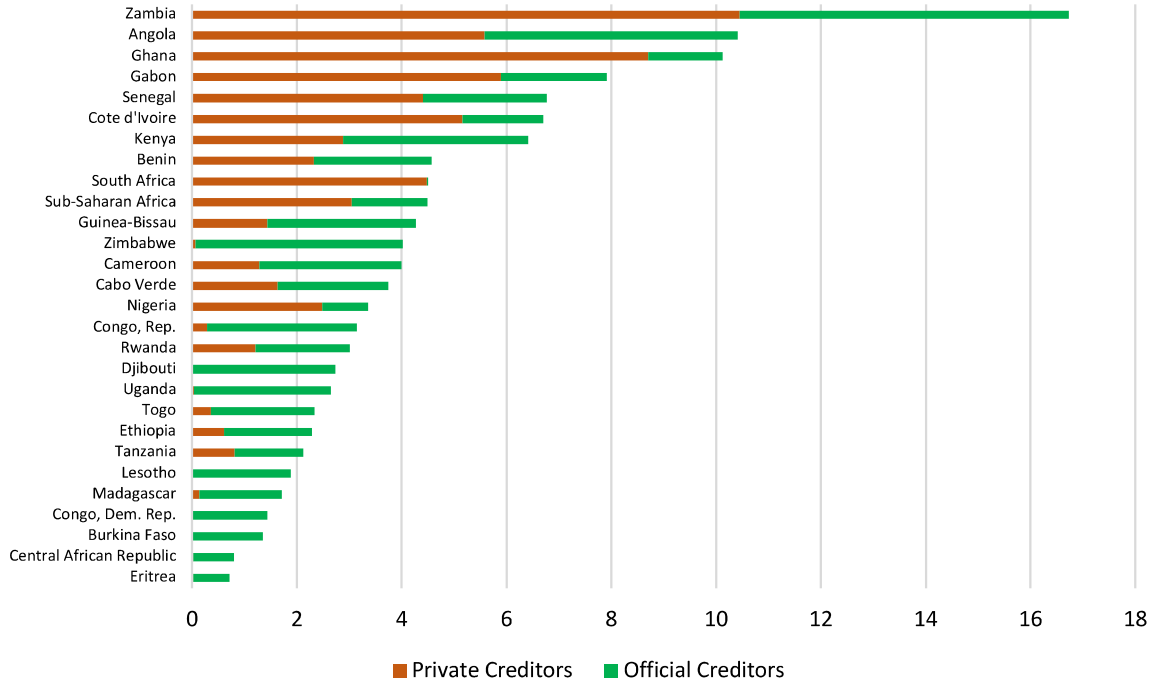


Note: Health expenditure figures are for 2017.

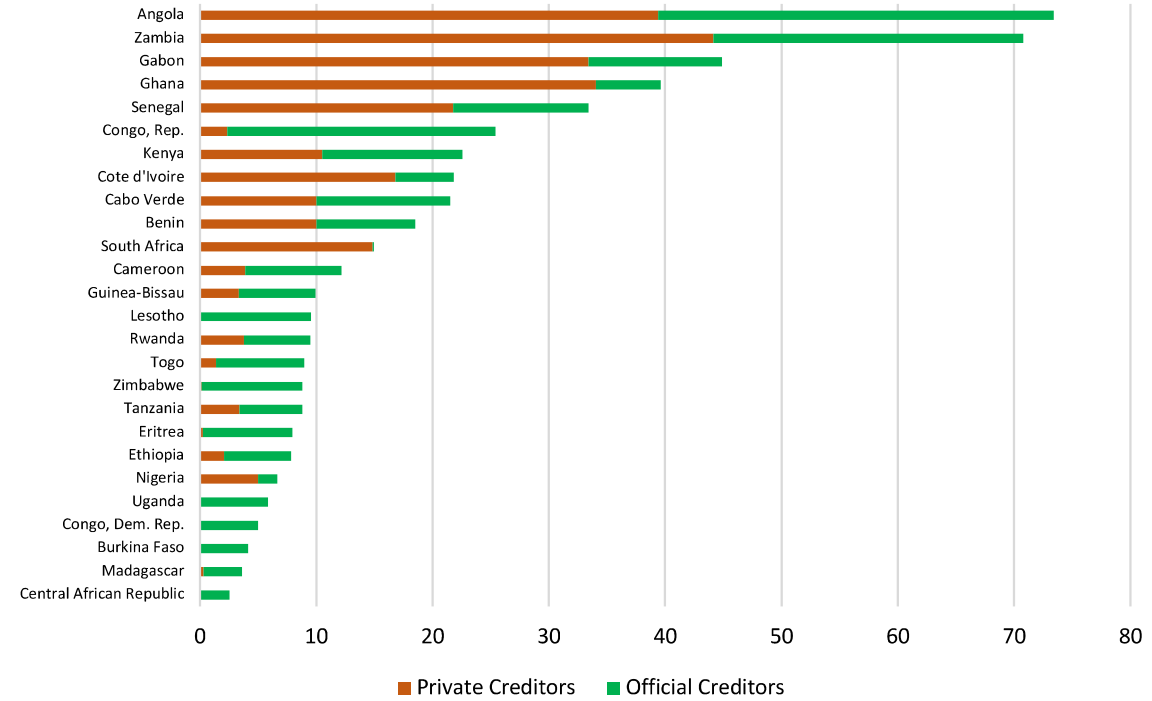
Source: Own elaboration based on IMF and World Bank data.

FIGURE 5 INTEREST PAYMENT ON EXTERNAL PUBLIC DEBT, 2021

a) Percentage of government revenues



b) Percentage of health expenditure



Note: Health expenditure figures are for 2017.

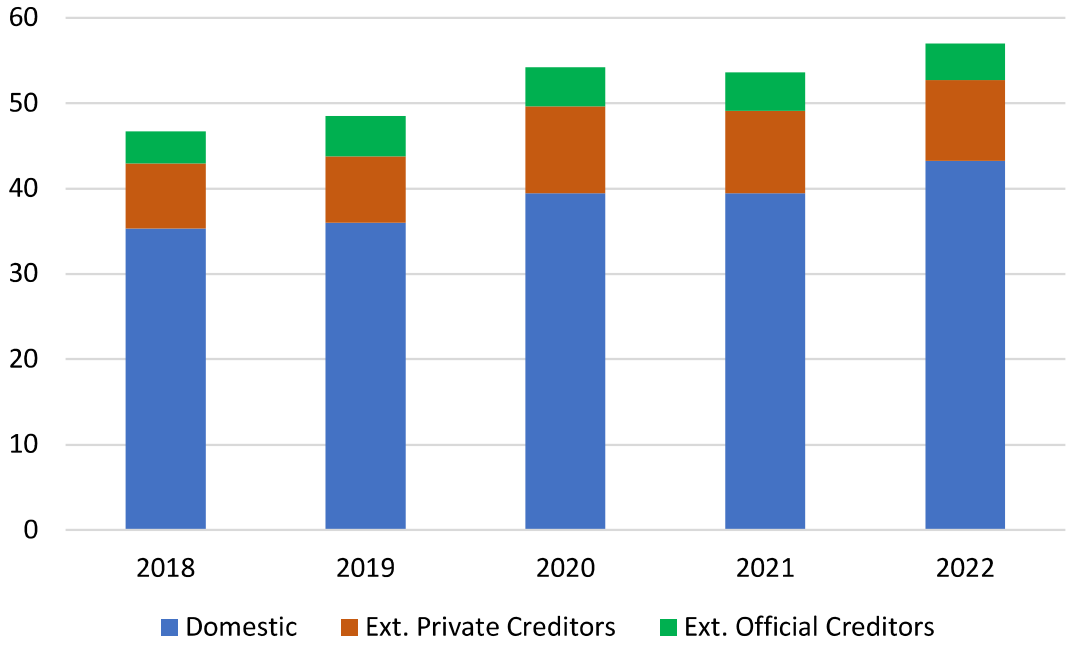
Source: Own elaboration based on IMF and World Bank data.

Figure 5 focuses on public external debt. While the majority of countries in sub-Sharan Africa mostly borrow from official creditors (both bilateral and multilateral), there are at least ten countries in which interest owed to external private creditors amounts to more than 10% of health expenditure, and four countries (Angola, Gabon, Ghana, and Zambia) for which these interest obligations account for more than one-third of public sector health expenditure.

Figure 6 plots the evolution of interest payments as a share of health expenditure for the whole subcontinent. They show that these payments grew rapidly in 2020 and are expected to remain high in 2021-22, with payments to external private creditors representing about 10% of health expenditure for the continent as a whole.

FIGURE 6 INTEREST PAYMENTS ON DOMESTIC AND EXTERNAL PUBLIC DEBT AS A % OF HEALTH EXPENDITURE

(sub-Saharan Africa, weighted average)



Note: Health expenditure figures are for 2017.

Source: Own elaboration based on IMF and World Bank data.

POLICY RESPONSES

Since early 2020, more than 100 countries have applied for IMF financial assistance to deal with the pandemic. Realising that, in addition to emergency financing from official sources, countries may need to suspend debt service payments for a temporary period in order to redeploy those funds for Covid-related expenses, on 25 March 2020 the president of the World Bank and the managing director of the IMF called on official bilateral creditors to suspend debt payments from a group of low-income countries. The

initial response of the private sector to this call to action was encouraging. On 9 April, the Institute for International Finance (IIF) wrote an open letter suggesting that both bilateral and commercial creditors should commit to "forbear payment default" until the end of 2020 for the poorest countries affected by the pandemic.

On 15 April 2020, the G20 issued a communiqué supporting a Debt Service Suspension Initiative aimed at allowing for a suspension of debt service payments to official bilateral creditors for the poorest countries that request such forbearance. The G20 called upon private creditors, working through the IIF, to participate in the Initiative on comparable terms. At about the same time, Bolton et al. (2020a, 2020b) put forward a plan which would provide the right incentives, in terms of sticks and carrots, for private sector participation in the initiative.

On 1 May, the IIF responded to the G20 call with a second letter which mentioned a "complex landscape" and several obstacles to private sector participation to the DSSI (see Bolton et al. 2020c for a timeline of events).

In mid-May, Paris Club creditor countries started signing Memoranda of Understanding implementing the DSSI with participating IDA countries. These MOU require the beneficiary countries to commit to seek from all other bilateral creditors a debt service treatment that is "in line with" the terms set out in the MOU. No mention was made of private creditors.

On October 2020, the G20 agreed to extend debt suspension by six months until June 2021 and agreed to examine the need for a further extension before the 2021 Spring Meetings of the IMF and the World Bank. The G20 also proposed a Common Framework for debt restructuring with the aim of achieving comparable treatment of all official bilateral creditors, including those that are not part of the Paris Club, and including the private sector. The Common Framework states that:

> The key parameters will be established so as to ensure fair burden sharing among all official bilateral creditors, and debt treatment by private creditors at least as favourable as that provided by official bilateral creditors.[2]

We are unsure as to how this comparability of treatment goal will be implemented; best we can tell, there appears no mechanism to enable that as yet. But we put that rather large fly in the buttermilk aside for now. More concretely, as of this writing, 45 out of the 73 eligible countries have applied for debt service suspension, and the private sector has not participated. The most recent estimations suggest that the DSSI delivered $9.5 billion of debt relief (if all eligible countries had applied, total debt relief would have been close to $12 billion; see Table 1 in the Appendix).

2 https://www.imf.org/-/media/Files/News/news-articles/english-extraordinary-g20-fmcbg-statement-november-13.ashx

Some countries did not apply for debt suspension because they were afraid that participating in the initiative would have a negative effect on their reputation on the international capital markets. Recent research from the IMF, however, shows little evidence for such a negative reputational effect (Lang et al. 2020).

PREPARING FOR A WAVE OF DEFAULTS

The debt situation of many countries in sub-Saharan Africa has deteriorated dramatically and some of these countries have been able to avoid a full-fledged debt crisis only because of abundant global liquidity. But things can change. A turn of market sentiments could lead to a sudden stop in capital flows that, in turn, would trigger an international financial and humanitarian crisis.

Over the past decades there has been progress in the design of instruments to deal with sovereign debt crises. However, the current design of the international financial architecture is not well equipped to deal with a situation in which a large number of countries default at the same time as a result of an exogenous shock. If all creditors could be coordinated, they would presumably agree that they would benefit from a standstill that allows the affected sovereigns to use their scarce resources to fight the pandemic and get their economies back on track. At the centre of such a coordination mechanism would be a stay on creditor litigation, so that the crisis countries can undertake an orderly debt work-out. This is akin to the debtor-in-possession regime under US corporate bankruptcy.

However, no fast and efficient mechanism exists to provide a multi-country stay. The recent G20 Common Framework is a step in the right direction, with its aim of comparable of treatment of Paris-Club and non-Paris Club creditors somewhat allaying concerns that large creditors that do not belong to the Paris Club (such as China and its various state-owned enterprises) would seek better restructuring terms. However, there are at least two problems with the Common Framework.

First, the framework appears to be limited to DSSI-eligible countries, and we suspect that several non DSSI-eligible countries are already in, or on the brink of, debt trouble.

Second, while explicitly mentioning private sector participation, the framework does not detail concrete measures that could induce the private sector to participate in the Initiative. Specifically, countries that request a suspension of official debt service are required to ask for similar treatment from the private sector, but that does not preclude

some private creditors choosing not to get involved and suing debtor countries in default. The Common Framework does not include any legal mechanism that would prevent such suits.[3]

In the absence of such a legal mechanism, countries that want to divert resources from debt service to pandemic-related expenditures risk having to fight a plethora of creditor lawsuits while approaching their creditors for a bespoke debt restructuring. As this requires time and resources – neither of which is in abundant supply – it would be desirable if countries could be temporarily protected against lawsuits. This is the notion of 'legal air cover' that we describe in detail in Bolton et al. (2020d).

We start with the 'reverse acceleration' mechanism built into existing contracts. This provision allows for a simple majority of creditors to reverse attempts by a minority of creditors to accelerate the debt. However, there are several features that make this mechanism unsuitable for dealing with a multi-sovereign default scenario. It is thus unlikely that existing contract mechanisms can produce an immediate and effective stay on litigation in a generalised sudden stop scenario.

Next, we focus on three options which can be put in place quickly, without the need for lengthy legislative wrangling or contract-by-contract and country-by-country negotiations. The air cover they provide may facilitate negotiations with creditors and buy time for conducting debt sustainability analyses, without the fear of a rush to the courthouse. In this sense, the solutions that we propose can be useful to deal with both liquidity and solvency crises in a world that still lacks a statutory mechanism for dealing with sovereign defaults.[4]

The first plausible option is a UN Security Council Immunity Shield similar to that used to restructure the Iraqi debt accumulated by Saddam Hussein. The second option is an executive order by the US president and a similar legislative action by the UK parliament (most international debt is issued under either New York law or UK law). The third option would instead require using the doctrine of Necessity under Article 25 of the International Law Commission's Articles on Responsibility of States for Internationally Wrongful Acts.

There are also challenges related to using these three options. A key challenge has to do with the fact that these options envision a degree of ex-post state intervention in the debt contracts. Under normal circumstances, retroactive modifications of contract terms are

3 Another unresolved issue that goes beyond the objective of this chapter relates to access to financial resources after debt relief is granted. The HIPC and MDRI initiatives came with limits to new borrowing aimed at maintaining debt sustainability in the long run. According to some commentators such debt ceilings were counterproductive because they prevented countries from accumulating much needed human and physical capital. According to others, debt limits by multilateral and Paris Club creditors led to free riding by non-Paris Club official creditors. It remains to be seen if the Common Framework will be able to guarantee continuous access to financing, while preventing free riding by certain groups of creditors.

4 A discussion of the literature on different approaches to sovereign debt restructuring is beyond the scope of this chapter. For a review of recent developments in sovereign debt resolution tools, see IMF (2020b); for a discussion of the trade-offs involved in the creation of a statutory mechanism versus allowing matters to be governed by contract, see Bolton and Skeel (2004) Buchheit et al. (2013), and Panizza (2013).

disfavoured in every modern legal system because they diminish the value of contractual commitments. Ex-post interference with contract terms can, however, be optimal in exceptional circumstances where the parties themselves – had they been able to negotiate a contract provision ex-ante – would have wanted modifications to the contract. Under these circumstances, ex-post intervention in contracts by the state can be welfare enhancing. For instance, Kroszner (1998) shows that the US government's abrogation of gold clauses in the 1930s in the context of the Great Depression did not lead to negative market reactions or spillovers to other asset classes.

The most important recent ex-post contract modification was the Greek government's decision to retroactively insert collective action clauses in all of its local law-governed sovereign bonds. Multiple challenges were brought against the Greek sovereign across a range of international fora with expropriation-type claims being made in each case. In all of these challenges, the courts sided with Greece.

Several observers have suggested that this 'Greek retrofit' would reduce faith in the value of contracts across the EU, and therefore increase the costs of borrowing for sovereigns in the European periphery. In Bolton et al. (2020d), we analyse the validity of these claims by conducting a series of event studies aimed at testing whether the court decisions mentioned above had an effect on the borrowing costs of Ireland, Italy, Portugal, and Spain. We find no evidence of a systematic increase in borrowing costs for other vulnerable European sovereigns as a result of the various tribunals upholding the Greek ex-post modification of contract terms. This result supports the idea that, when justified by exceptional events, ex-post contract modifications do not necessarily have negative repercussions.

CONCLUSIONS

Many countries in sub-Saharan Africa were at risk of debt distress before the explosion of the Covid-19 pandemic, and things are now much worse. So far, a generalised debt crisis has been avoided thanks to exceptionally favourable financial conditions. However, markets are fickle and another sudden stop in the near future cannot be ruled out. When it happens, it will likely lead to a generalised debt crisis.

In this chapter we describe some options for providing temporary legal protection to debtor countries in the event of a global debt crisis. We also point to empirical evidence suggesting that it is unlikely that the actions that we describe – if implemented with care – would have significant negative repercussion on the functioning of the global debt market. On the contrary, by helping overcome a severe debt-overhang problem, these measures would allow all sides – debtor and creditors – to benefit from avoiding a messy and protracted debt crisis.

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APPENDIX

TABLE 1 DSSI: ELIGIBLE COUNTRIES AND POTENTIAL SAVINGS IN DECEMBER 2020

	Applied	Risk of debt distress		Potential DSSI Savings	
		External	Overall	% GDP	Mill $
Afghanistan	Yes	High	High	0.2	39.3
Angola	Yes	N/A	N/A	2	1,782.9
Bangladesh	No	Low	Low	0.1	331.9
Benin	No	Moderate	Moderate	0.1	16.1
Bhutan	No	Moderate	N/A	5.8	144.5
Burkina Faso	Yes	Moderate	Moderate	0.2	25.9
Burundi	Yes	High	N/A	0.1	4.5
Cabo Verde	Yes	High	High	0.9	18
Cambodia	No	Low	Low	0.8	220
Cameroon	Yes	High	High	0.9	337.3
Central African Republic	Yes	High	High	0.3	7.4
Chad	Yes	High	High	0.6	65.4
Comoros	Yes	Moderate	Moderate	0.2	2.3
Congo, Dem. Rep.	Yes	Moderate	Moderate	0.3	156.3
Congo, Rep.	Yes	In distress	In distress	1.4	181.8
Côte d'Ivoire	Yes	Moderate	Moderate	0.4	225.3
Djibouti	Yes	High	High	1.7	56.8
Dominica	Yes	High	N/A	0.7	4.3
Ethiopia	Yes	High	High	0.5	472.9
Fiji	Yes	N/A	N/A	0.2	13.4
Gambia, The	Yes	High	High	0.6	10.2
Ghana	No	High	High	0.6	377.9
Grenada	Yes	In distress	In distress	0.7	8
Guinea	Yes	Moderate	Moderate	1.1	147.9
Guinea-Bissau	Yes	Moderate	N/A	0.1	2.1

	Applied	Risk of debt distress		Potential DSSI Savings	
		External	Overall	% GDP	Mill $
Guyana	No	Moderate	Moderate	0.3	16.9
Haiti	No	High	High	0.9	76.2
Honduras	No	Low	Low	0.4	104.5
Kenya	No	High	High	0.7	630.8
Kiribati	No	High	High		
Kosovo	No	N/A	N/A	0.1	7.5
Kyrgyz Republic	Yes	Moderate	Moderate	0.6	52.1
Lao PDR	No	High	High	1.7	315
Lesotho	Yes	Moderate	Moderate	0.4	9.8
Liberia	No	Moderate	High	0.1	2.6
Madagascar	Yes	Moderate	Moderate	0.3	35.5
Malawi	Yes	Moderate	High	0.2	17.4
Maldives	Yes	High	High	0.9	50.7
Mali	Yes	Moderate	Moderate	0.5	82.5
Marshall Islands	No	High	N/A		
Mauritania	Yes	High	High	1.2	90.8
Micronesia	No	High	High		
Moldova	No	Low	Low	0.2	23.2
Mongolia	No	N/A	N/A	0.5	69.6
Mozambique	Yes	In distress	In distress	1.9	294
Myanmar	Yes	Low	Low	0.6	379.9
Nepal	Yes	Low	Low	0.1	24.8
Nicaragua	No	Moderate	Moderate	0.3	33
Niger	Yes	Moderate	Moderate	0.2	26
Nigeria	No	N/A	N/A	0	123.5
Pakistan	Yes	N/A	N/A	1.3	3,645.4
Papua New Guinea	Yes	High	High	1.3	326.9
Rwanda	No	Moderate	Moderate	0.1	13.2
Samoa	Yes	High	High	1.1	9.5
Sao Tome and Principe	Yes	In distress	In distress	0.4	1.7
Senegal	Yes	Moderate	Moderate	0.6	139.2
Sierra Leone	Yes	High	High	0.2	8.1
Solomon Islands	No	Moderate	Moderate	0.1	1.5
Somalia	No	In distress	In distress	0	1.7
South Sudan	No	In distress	In distress		
St. Lucia	Yes	N/A	N/A	0.2	5.2
St. Vincent and the Gren.	No	High	High	0.5	4.1
Tajikistan	Yes	High	High	0.8	63.8

	Applied	Risk of debt distress		Potential DSSI Savings	
		External	Overall	% GDP	Mill $
Tanzania	Yes	Low	N/A	0.2	138.9
Timor-Leste	No	Low	Low	0	
Togo	Yes	Moderate	High	0.4	24.4
Tonga	Yes	High	N/A	1.2	6.3
Tuvalu	No	High	N/A		
Uganda	Yes	Low	Low	0.2	91
Uzbekistan	No	Low	Low	0.4	257.3
Vanuatu	No	Moderate	Moderate	0.7	6.1
Yemen, Rep.	Yes	N/A	N/A	0.9	211.5
Zambia	Yes	High	High	0.7	165.4
Total					12,239.9

Source: https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative, retrieved on 7 January, 2021