

# **Debt Sustainability and Development Implications of Moderately Concessional Lending Terms for ADF Countries**

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### Introduction

Since the November 2015 mid-term review of ADF-13, it has become increasingly clear that donors' capacity and willingness to provide pure grants has diminished on account of entrenched fiscal and political problems in their own countries. One consequence has been the potential inclusion of concessional loan instruments in the funding mix for ADF, something that has already transpired for the recently concluded ADF-14 replenishment. This "new reality" has prompted donor concern that less-concessional lending terms to ADF countries, needed for preserving the financial viability of ADF itself, might trigger another round of debt sustainability problems.

In response, the ADF Policy Innovation Lab ("ADF Lab")<sup>2</sup> examined the impact of less-concessional lending terms on debt sustainability for ADF countries. The findings reported in this working paper are based on debt sustainability calculations for 33 out of the 38 ADF countries. Comoros, Eritrea, Somalia and South Sudan were excluded because of insufficient data and Nigeria was excluded because it is in transition status and expected to graduate soon from ADF. In addition, the ADF Lab visited 5 countries: Cote d'Ivoire, Ghana, Mozambique, Rwanda and Uganda, to obtain feedback on the debt sustainability findings.

### *Moderately Concessional Loan (MCL) Terms*

The ADF Lab adopted the following working definition for less-concessional lending terms, which we label "moderately concessional": a 40-year US dollar (USD) loan with 10 years' grace and charging an interest rate of about 3% benchmarked off the current 30-year US Treasury bond yield. Annex 1 examines the concessional embedded in MCLs relative to ADF and IDA lending terms and shows that MCLs compare favorably.

There is, however, a point worth emphasizing. The progressive hardening of terms in ADF and IDA typically involve both raising interest rates above concessional levels *and* shortening grace periods and loan maturities. The ADF Lab considers higher interest rates (but still well below commercial terms) preferable to shortened grace periods and loan maturities. The reason is that the large investments in infrastructure and human capital needed to spur development have exceptionally long payback periods.

It is also noteworthy that MCL terms are far superior to the terms ADF country governments have been obtaining on their Eurobond issues or other commercial loans, including those obtained by parastatals.

### *Main Findings*

The main findings from the debt sustainability assessments and five country visits are as follows:

(1) 17 countries possess high potential eligibility for MCLs based on government marginal borrowing cost considerations. These predominantly include countries which have issued Eurobonds or domestic (local currency) debt on commercial terms or both. But there is no presumption of automatic access to MCLs, which will require demonstrating the capacity to absorb and use the money well in the context of an enhanced policy dialogue (EPD), the reasons for which are spelled out in this working paper. The remaining 16 have low potential eligibility, with MCL terms likely to exacerbate debt sustainability problems in 6 countries while the remaining 10 are relatively better off. These countries are generally poorer and fragile on account of the Ebola epidemic, regional insecurity or domestic political crises. Their Country Policy and Institutional Assessment (CPIA) ratings tend to be at the lower end of the scale with generally weak economic governance.

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<sup>2</sup> The ADF Policy Innovation Lab was created under the Bill & Melinda Gates Trust Fund as an independent think-tank in the AfDB Group. It comprises a high level panel of eminent persons and an advisory team.

(2) MCL terms are unlikely to be a tipping point for public debt sustainability (DS) problems in the 17 countries with high potential eligibility for two reasons. First, in most cases, MCLs will be less costly and of longer maturity than the market borrowing alternatives being pursued domestically and via Eurobonds. Second, poor use of public funds (not just from ADF, but overall fiscal revenues, including especially proceeds from natural resources), insufficient emphasis on value for money and exchange rate collapses are much more important for debt sustainability than the envisaged MCL interest rate.

(3) An acute tension exists in ADF countries between the vast public investment requirements needed on the one hand and public debt sustainability on the other. African countries urgently need funds for infrastructure and human capital investments in order to maintain their growth momentum, combat poverty, and take advantage of the demographic transition and "youth bulge" over the next 20-30 years.

(4) The capital market is unlikely to be a good or stable source of development finance--it is too myopic and unforgiving, and costs quickly rise with successive bond issues. At the other extreme, concessionality in the post-HIPC-MDRI world has not delivered either sustainable public debt profiles (in spite of significant debt write offs) or a strong foundation for sustained growth and development.

Findings (2), (3) and (4) point to the need for a fundamental rethink of the present configuration governing Official Development Assistance (ODA). ADF countries need frontloaded development funding for the vast investment requirements in connection with the Sustainable Development Goals (SDGs). For example, the UNCTAD 2016 Economic Development report on debt dynamics and development finance for Africa notes that financing the SDGs could require investments of between \$600 billion and \$1.2 trillion per year, with infrastructure alone costing \$93 billion, of which Africa can raise only half (UNCTAD 2016). But ADF countries must simultaneously demonstrate their capacity to use the funds well, and innovative financing mechanisms must be found that will lower the fiscal burden on donors.

(5) Donor fiscal and political constraints combined with the first four findings indicate the need for rejuvenating the African country-donor relationship by defining a new middle ground with the following features:

- Funding instruments that frontload ODA while simultaneously lowering the fiscal burden on donors. This can be achieved by securitizing a portion of grants now given to African countries so as to raise a large amount of money upfront by using mechanisms similar to Gavi and IFFIm (International Finance Facility for Immunisation). By on-lending the funds to ADF countries via MCLs that are eventually repaid, the demand on donors for future ODA will decline
- A higher bar for MCL access combined with an EPD that focuses on debt sustainability via better management of the public finances and improved growth policy. A portion of front-loaded funds can be used for regional infrastructure projects (where the ADB Group has a comparative advantage) with the balance going to countries which fulfil stringent criteria on public financial management and have demonstrated absorptive capacity
- A two-tier structure consisting of the current Performance Based Allocation (PBA) system with a focus on countries not currently eligible for MCL access plus a new window for MCLs with more stringent criteria
- Active collaboration between ADF and IDA as well as with other development agencies operating in Africa to make frontloaded ODA and the EPD a success.

## Conceptual Framework

The ADF Lab focused on *public* debt sustainability in examining the implications of MCLs. In contrast, the IMF-World Bank Debt Sustainability Framework for Low-Income Countries (DSF) assesses debt distress in relation to total *external* debt, public plus private. Three reasons explain the Lab's focus on public debt:

- i. The immediate impact of less-concessional terms will be on the public finances and public debt
- ii. Fuller debt coverage is enabled, since both public and publicly guaranteed external debt *and* domestic debt are included. Domestic (local currency) debt has become increasingly important at the margin for governments and is typically at commercial terms
- iii. Addressing unsustainable debt requires policies to remedy public debt dynamics (via fiscal policy, domestic revenue mobilization, etc., and growth policy).

In addition to public debt dynamics, the vulnerability of ADF countries to shifting market sentiment has grown, especially in countries where external financial integration is high and non-residents hold a large fraction of local currency government debt. Likewise, current account deficits, total external debt and foreign exchange reserve adequacy are becoming increasingly important, and these variables are touched upon where relevant. The 2016 review of the IMF-World Bank DSF launched during the 2016 Spring Meetings echoes many of the above concerns, in particular, the need to pay more attention to public debt and market borrowings (IMF 2016a).

As with an earlier working paper examining the debt sustainability implications of less-concessional lending terms for a sample of ADF countries (ADF Lab 2016), two questions were posed for each ADF country: (i) is there any evidence of deterioration in public debt dynamics based on outcomes for 2013-15, and if yes, what are the main causes? And (ii) what is the prime determinant of the marginal cost of borrowing, official funds or market borrowing?

The answer to question (i) is obtained by using the standard framework for public debt sustainability based on primary fiscal deficits (total revenue minus non-interest spending), the interest rate on public debt and the GDP growth rate. These three variables determine public debt dynamics, that is, the path of the ratio of public debt to GDP (the “debt ratio”) over time. For example, if the government is running a primary deficit and interest rates exceed growth rates, the debt ratio will grow without bound in the absence of corrective fiscal policy, eventually resulting in a crisis. Similarly, a rise in the ratio of the primary deficit to GDP, or an increase in interest rates or a collapse in growth rates or some combination of these outcomes will worsen debt dynamics and could precipitate a crisis.

The exchange rate has become a key variable impacting public debt dynamics in ADF countries. This is because the average share of public debt denominated in foreign currency (“forex debt”) is close to 70%. Large currency depreciations such as we have witnessed over the last couple of years quickly increase the burden of forex debt and the debt ratio. Therefore, the framework incorporates calculations that enable the impact of currency volatility on forex debt to be captured. These show that the strong appreciation of the US dollar, which started in 2014, along with the collapse in commodity prices linked to the slowdown in China’s growth rate, has been a major factor in increasing debt ratios in ADF countries over the past three years.

Similarly, debt ratios can be adversely affected by contingent liabilities from state-owned enterprises and commercial banks. If the state-owned energy company, or a failing bank, needs a bailout, this will add to the public debt burden.

Question (ii), on the marginal cost of borrowing, is relevant when assessing whether a country can cope with MCLs. A country issuing a \$1 billion Eurobond at a 10% yield with a bullet payment at the end of 10 years could actually improve its debt profile by obtaining USD funds from official MCLs at 3-4% with 40 years maturity and 10 years grace. But this crucially assumes that MCLs are accompanied by an expanded envelope of official resources which will displace more expensive market borrowing. This is an important consideration given the vast and immediate investment needs in Africa to meet the SDGs, as noted above.

The two questions taken together enable the impact of MCLs on debt sustainability to be assessed. Since debt sustainability is essentially a forward-looking exercise, the conclusions about countries’ ability to cope with MCLs reflects the judgment of the ADF Lab on how key variables are likely to move in the light of the medium-term macroeconomic outlook for Africa.<sup>3</sup>

### *Development Issues*

Debt sustainability is not an end in itself but a necessary foundation for long-run growth and development. Therefore, this working paper also dwells on issues falling under the rubric of African development. The guiding principles draw from:

- i. Development economics and the notion of diminishing marginal returns to capital, which in principle imply high returns to investment, public and private, in Africa
- ii. Estimates of the sources and marginal cost of government borrowing especially as public investment is ramped up, subject to data availability. And:

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<sup>3</sup> A recent comprehensive assessment of Africa’s macroeconomic situation is contained in [IMF](#) (2016b). [World Bank](#) (2017) contains an excellent account of key economic issues, including Africa’s Infrastructure deficit.

- iii. The importance of long debt maturities and grace periods. This is essential considering that Africa will need substantial time, possibly at least another generation, to establish a solid foundation for long-run growth. Based on the Solow Model and development economics, this would require convergence in technology (faster total factor productivity growth) and capital deepening (raising capital/labor ratios, importantly through large public investments in infrastructure), as well as sustainable public finances, and good governance, leadership and institutions to underpin the management of economic and political volatility.

This combination of debt sustainability and development is the perspective adopted by this working paper. The country assessments are contained in Annex 3. Annex 2 contains a guide to interpreting these country assessments, while Annex 4 contains the derivations of the formulas used for calculating the interest rate on public debt as well as its two sub-components, that on local currency debt and that on foreign currency debt, expressed in local currency-equivalent terms. Doing so captures the effect of exchange rate movements on debt dynamics.

## Country Results: Debt Sustainability

Four broad results emerge from the ADF Lab's assessment of public debt sustainability in ADF countries.

First, debt dynamics have become more challenging and are likely to remain so over the medium-term. While the deterioration is most obvious for commodity exporters (owing to diminished medium-term prospects for growth, fiscal revenues and the terms-of-trade), it applies to other countries as well.

Second, the external financing constraint is binding. African countries need to frontload infrastructure investments as a foundation for long-run growth and development. Such investments will pay off only over the longer run. But there will be an immediate and sizable upward impact on public and external debt and current account deficits owing to the paucity of national savings. Indebtedness will then have to be brought down to sustainable levels. The latter rests on being able to increase growth, domestic revenue mobilization and exports. But this assumes that the selection and implementation of public investments is of high quality and that the necessary investment in human capital, production and exports takes place and bears fruit.

Third, the natural resource curse appears to be alive and well.<sup>4</sup> Now is a good time to combat it given the indifferent outlook for hydrocarbon and mineral and metal prices over the medium term. Besides, as some African policymakers have noted in conversations with the ADF Lab, adversity and crisis could have positive benefits by concentrating the mind on difficult policy and institutional reforms.

Fourth, the foundation for sustained long-run growth and development is far from established. This includes the transparent and effective management of the public finances, establishing local currencies as a credible store of value, raising national savings rates and developing solid financial systems to mobilize and invest such savings, and managing economic and political volatility by strengthening governance, institutions and leadership. Also important is the agenda for diversifying away from commodities and the integration of the African continent. The ADF Lab's assessment is that it will take another generation to address these topics in a convincing manner.

ADF countries were divided into three groups in order to extract the insights on the impact of MCLs:

1. Countries which have issued Eurobonds
2. Countries with GNI per capita (2012-14 average) less than USD 500 and have never issued a Eurobond
3. Remaining countries (GNI pc greater than USD 500, never issued a Eurobond).

One country, Ethiopia, overlaps categories 1 and 2. In principle, Groups 1 and 2 represent the two extremes in terms of potential eligibility for MCLs while Group 3 is somewhere in the middle. Table 1 provides a snapshot of public debt dynamics as of 2015.

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<sup>4</sup> An oil or copper boom can be thought of as having two effects. The first is the so-called Dutch Disease effect, whereby the real appreciation of the exchange rate leads to a shrinkage of agriculture and manufacturing, leading to a concentration of the commodity in exports and fiscal revenues. The key issue is to smooth real appreciation by recognizing that the boom will not last forever. The second is the failure to use natural resource wealth well because of weak institutions and corruption. The "curse" refers to the latter set of effects.

### Group 1: Countries issuing Eurobonds

The first set includes the 10 countries which have issued Eurobonds, listed here in descending order of the CPIA score for the 2016 ADF PBA (performance-based allocation): Rwanda, Senegal, Kenya, Tanzania, Ethiopia, Cameroon, Ghana, Côte d'Ivoire, Zambia and Mozambique. Annex 5 lists Eurobond issuances up to the end of 2016.

Five observations are worth making.

First, Ghana, Zambia and Mozambique have obvious debt sustainability problems in spite of having benefited only recently from HIPC-MDRI debt reduction. These countries could benefit from MCLs on cost and maturity grounds. For example, Ghana issued yet another Eurobond in September 2016 for \$750 million at 9.25% with an average maturity of just 5 years; its average Eurobond issuance of \$450 million per year since 2007 dwarfs its ADF 2016 allocation of UA 47 million (approximately \$64 million). But access to MCLs needs to be conditioned on clear improvements in economic governance.

**Table 1 - Snapshot of Public Debt Dynamics for 2015**

	Public Debt		Debt dynamics (2015)					Non-interest current account deficit (2015)
	End-2015	Change 2013-2015	Primary deficit	Nominal GDP Growth	Nominal interest rate			
					Composite	Local currency	Forex	
	% GDP	p.p. GDP	% GDP	%	(%)			
Countries which have issued Eurobonds								
Rwanda	35.40	8.60	3.90	8.18	10.03	9.40	10.18	12.70
Senegal*	54.40	7.80	2.90	5.31	12.04	6.91	13.82	7.00
Kenya*	52.70	8.60	5.40	12.89	13.12	10.86	15.49	7.40
Tanzania	30.60	0.90	1.60	13.21	20.06	15.75	21.46	8.20
Ethiopia	50.70	13.00	7.10	16.59	5.86	5.06	6.54	11.60
Cameroon*	32.60	13.40	4.90	7.91	14.80	1.60	21.33	4.80
Ghana	73.80	15.70	-0.20	23.43	23.61	19.16	26.51	4.50
Côte D'Ivoire*	42.60	8.40	3.10	10.68	7.79	2.92	12.48	1.60
Zambia*	40.30	11.70	4.90	13.52	18.74	12.34	24.58	-0.70
Mozambique*	73.40	22.50	4.70	11.72	31.46	8.04	35.60	29.10
Countries with GNI pc (2012-14 average) less than USD 500								
Niger*	43.10	16.00	6.50	6.17	10.62	4.14	12.74	17.00
Guinea	55.70	12.90	8.10	6.71	9.20	5.21	12.27	22.10
Malawi	53.80	3.20	2.00	24.61	36.03	20.98	42.81	8.00
Liberia*	24.60	12.20	8.20	4.39	5.04	-	-	33.50
Burundi*	30.40	-2.30	0.40	11.72	5.84	6.60	5.25	13.20
Congo, Dem. Republic*	18.00	-1.40	-1.10	11.60	2.36	2.30	2.38	7.20
Madagascar	41.00	7.10	2.40	10.94	18.68	5.99	24.61	1.60
Gambia*	101.50	18.20	-3.30	11.20	15.46	15.22	15.67	13.50
Central African Republic	48.50	10.00	0.10	11.30	4.33	0.78	12.94	12.50
Countries that never issued Eurobonds but with a GNI pc (2012-14 average) greater than USD 500								
Uganda	31.10	7.80	3.00	9.41	23.09	15.35	28.04	6.90
Burkina Faso	32.10	2.50	1.00	5.66	12.06	4.55	14.99	6.10
Benin	37.10	11.70	5.10	6.04	8.79	5.24	10.70	11.00
Mauritania	93.30	25.50	2.30	-3.70	9.23	4.90	9.61	17.50
Lesotho	48.10	4.70	2.90	7.63	13.93	9.41	14.10	6.20
Mali	36.50	5.10	2.40	8.26	10.60	6.40	11.84	2.20
São Tomé and Príncipe	59.00	14.80	8.60	12.63	11.96	-	-	16.40
Djibouti*	74.30	17.50	11.50	9.69	4.03	-	-	25.40
Chad	42.60	12.30	2.80	4.85	13.41	2.28	17.23	11.30
Togo*	62.50	12.40	4.00	8.03	7.48	3.63	11.99	12.20
Sierra Leone	43.80	13.30	3.80	-1.61	12.72	5.75	15.68	15.50
Guinea-Bissau*	50.90	1.10	-0.10	10.88	5.11	2.30	10.78	3.50
Zimbabwe	70.80	4.90	0.30	-0.21	0.99	-	-	10.60
Sudan	72.90	-17.00	-0.80	20.53	5.93	6.40	5.86	5.80

Source: IMF data and own calculations. Countries listed in descending order of CPIA within each group. \* Projections.

Mozambique has decided to restructure its sovereign debt with IMF support. Ghana already has an IMF program while Zambia is engaged in discussions on an IMF program. For these countries, growing out of their debt problems is unlikely if the emerging market (EM) experience is any guide, not to mention indifferent medium term prospects for economic growth and the terms of trade. The focus must be on raising the primary surplus (through higher domestic resource mobilization and current expenditure rationalization) and lowering country risk, thereby reducing the interest rate. The short-term growth impact will be negative, but the alternatives of defaulting on forex debt and inflating away domestic (local currency) debt are less palatable. Reestablishing policy credibility the old-fashioned way, by raising primary surpluses and lowering the country risk, would emulate the response of countries like Brazil and Turkey to their debt problems between 2001 and 2008.<sup>5</sup>

An EPD focusing on achieving sustainable public debt trajectories along the lines described combined with access to MCLs as policy credibility gets re-established would serve as a signal that the ADF and the MDBs more generally are not going to bail out African countries when they get into debt problems.

*Second*, banking on natural resource (NR) wealth has played a role in all three countries. Without appropriate institutions and policies, NR wealth could be squandered instead of helping with long-run development. Mozambique is only the most recent illustration. The collapse of natural gas prices has drawn attention to the need for more transparency regarding the public finances and debt, and eventually on the use of NR wealth to benefit the country, including future generations, instead of enriching only a well-connected few.

In the case of Ghana, once the poster child for HIPC-MDRI debt relief, the ADF Lab's visit in February 2017 indicated relying heavily on revenues from new oil fields as well as issuing Eurobonds (to avoid soaring interest costs in the domestic market) as a strategy for lowering the public debt-to-GDP ratio. This approach can be at best a temporary palliative. Instead, Ghana needs to address its fundamental fiscal imbalance which requires implementing "the new government's intentions to reduce tax exemptions, improve tax compliance and review the widespread earmarking of revenues".<sup>6</sup> In short, ensuring that the public finance management (PFM) system works and public investments are carefully selected and executed is highly important. Indeed, Ghana's fiscal consolidation suffered a setback in 2016, with the eventual cash fiscal deficit estimated at 9% of GDP compared to its target of 5.25%. Public debt rose to 74% of GDP at end 2016 compared to a projected 70.4% in the debt sustainability analysis contained in IMF (2016c). An important reason was "significant public spending commitments that bypassed PFM systems".

*Third*, relying on market-based finance is unlikely to be a feasible strategy for long run growth and development. In the case of EMs, tapping the international capital markets has tended to enhance macroeconomic vulnerability instead of promoting long-run growth. In fact, the fastest growing EMs have tended to self-finance the investment needed for their growth by increasing saving and running current account surpluses.<sup>7</sup> But this latter course would not be easy for African countries given their relatively low per capita incomes.

From a development perspective, even for countries that can access Eurobonds at reasonable rates, the volume of funds that can be raised by this route is unlikely to be sufficient to meet the development spending needs. In addition, the cost is very likely to increase with each successive Eurobond issue, not to mention the risk associated with the currency mismatch. Similarly, the typical maturity of 10 years for a Eurobond is not long enough to obtain the growth and revenue payoff needed for servicing the debt.

*Fourth*, Kenya is an outlier. It is neither NR-rich nor has it benefited from the HIPC-MDRI debt write off. Yet its economic performance has been among the best in Sub-Saharan Africa and it is currently the highest rated ADF sovereign credit. Nevertheless, Kenya has public debt sustainability issues even though it is rated at low risk of external debt distress (see Annex 3). Similarly, other countries issuing Eurobonds such as Cote d'Ivoire, Ethiopia and Rwanda have fared much better than Ghana, Zambia and Mozambique. Nevertheless, even in these countries, the tension between the need for frontloading human capital and infrastructure investment and keeping public debt sustainable is ever-present, in addition to current account deficits that are worryingly large when compared with EMs. For example, five EMs were singled out as being exceptionally vulnerable when the chair of the US Federal Reserve Board first mentioned tapering its asset purchase program in May 2013: Brazil,

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<sup>5</sup> Details may be found in [Pinto \(2014\)](#).

<sup>6</sup> This quote and the one below are from [IMF's February 10 2017 Press Release 17/43](#).

<sup>7</sup> [Gill and Pinto \(2005\)](#). [Aizenman, Pinto and Radziwill \(2007\)](#).



India, Indonesia, Turkey and South Africa. They were labeled the “Fragile Five”, but their current account deficits were in the 3-5% of GDP range, far lower than in most ADF countries.

Ethiopia is the only Eurobond issuing country with a GNI per capita less than USD 500. While it does not face overt debt sustainability problems, concerns exist about its heavy reliance on public investment as a growth driver (Annex 3). Another important question is whether a country can design a development strategy which includes financial repression and real overvaluation of the exchange rate as important drivers. Both can give the appearance of sustainable debt dynamics, the first by keeping domestic interest rates artificially low, the second by lowering the birr equivalent of interest rates on forex loans; but the ability to maintain such policies indefinitely is questionable.

*Fifth*, the conversations of the ADF Lab with policymakers in countries issuing Eurobonds led to a few salient points. An important one is about the secondary role of the interest rate on forex loans compared to how money is used and currency volatility. The need for hard budget constraints to incentivize governments to implement difficult reforms was emphasized, as well as the crucial importance of anticipating and addressing the NR curse.

### *Group 2: Countries with GNI per capita less than USD 500*

Nine ADF countries fall into this category, in descending order of the January 2016 CPIA: Niger, Guinea, Malawi, Liberia, Burundi, Democratic Republic of Congo (DRC), Madagascar, The Gambia, and Central African Republic (CAR).

Five of the 9 countries are NR-dependent (Niger, Guinea, Liberia, DRC and CAR) and three are small, with population size below 5 million (Liberia, The Gambia, CAR). Of the 9 countries all have unsustainable debt dynamics except for DRC, which has maintained prudent fiscal policies (although domestic arrears have accumulated over the years) and managed to keep currency volatility low. But, like The Gambia and Burundi, DRC has been rocked by political instability related to the inability to ensure a smooth transfer of power following presidential elections (and in the case of DRC, the postponement of elections).

The other 8 countries all have elements of unsustainable debt dynamics stemming from large primary deficits (Niger, Guinea, Malawi, Liberia), currency depreciation leading to a rise in the forex interest rate (Niger, Guinea, Malawi, Madagascar and The Gambia) or sluggish growth. Yet, most of them also have high shares of domestic debt in total public debt, which is typically at commercial terms.

Four countries appear incapable of handling MCLs: Liberia, Burundi, Madagascar and CAR. The reasons include political fragility and recovering from the Ebola epidemic. Another four, namely, Guinea, Malawi, DRC and The Gambia, are better off but nevertheless vulnerable on account of dependence upon a single commodity (DRC, Guinea), weak economic governance (all) and fallout from the Ebola epidemic (The Gambia, Guinea).

For these countries, exchange rate collapses have been a major factor spurring unsustainable public debt outcomes over the past few years. Minimizing exchange rate volatility requires good macroeconomic policy, economic diversification and making local currencies a credible store of value through transparent and sound monetary policy. But this is a medium-to-long term program. There are no immediate fixes. Donors can help by lengthening loan maturities beyond 40 years while also increasing grace periods. This will give African countries time to implement policies and reforms that will spur growth and total factor productivity growth, enabling some real appreciation via the so-called Balassa-Samuelson result.

From a development perspective, it is notable that none of the countries in Group 2 has a CPIA above 4.0. The fact that a significant fraction of African countries remains poor and beset with debt sustainability problems is a stark reminder that concessionality of official loans combined with HIPC-MDRI has not guaranteed either debt sustainability or a firm foundation for economic development. Other variables, such as the quality of governance and level of corruption, are likely to have interfered with economic outcomes, leading to poor economic performance and unsustainable public finances. These variables need to be given due prominence as part of a more candid policy dialogue that the ADB Group is in an ideal position to lead in collaboration with other African development partners and IDA and the IMF.

The policy dialogue should also aim to minimize the NR curse, since mismanagement of NR wealth for even a few years can have long-term adverse consequences. Thus, Nigeria took a full generation to resolve the debt overhang it had developed in the mid-1980s as a result of poor management of the oil windfall it received from the oil price shocks of 1973-4 and 1979-80, not to mention the destructive effects on agriculture and manufacturing of the exchange rate policy it pursued after oil prices collapsed in the early 1980s. The debt



overhang was finally resolved by its 2005 agreement with the Paris Club.<sup>8</sup> Unfortunately, Nigeria has repeated the same mistakes on exchange rate policy after the most recent collapse in oil prices.<sup>9</sup>

### *Group 3: Remaining Countries*

The remaining countries include those with a per capita GNI greater than USD 500, but which have never issued a Eurobond. 14 countries belong to this group, in descending order of CPIA: Uganda, Burkina Faso, Benin, Mauritania, Lesotho, Mali, São Tomé and Príncipe (STP), Djibouti, Chad, Togo, Sierra Leone, Guinea-Bissau, Zimbabwe and Sudan. These countries exhibit wide variance in performance and prospects. Four are small (population less than 5 million): STP, Lesotho, Mauritania and Djibouti.

Of the 14, two are clear-cut cases where MCLs would cause DS problems: Mali and Zimbabwe. Most of Mali's debt is in forex and from official sources, meaning a low marginal cost of borrowing. It remains fragile and must increase spending in connection with the peace deal signed in June 2015. Zimbabwe is a storied case of poor governance destroying the economy and is now in a situation where it must settle arrears to ADB, IDA and IBRD and garner support for a Paris Club agreement.

Another 5 countries, STP, Sierra Leone, Chad, Guinea-Bissau and Sudan, present a dilemma in that they have elements of unsustainable debt dynamics for various reasons, including regional insecurity and economic problems caused by epidemics like Ebola. Yet all are NR-rich, pointing to the need for better institutions and an EPD along a path to MCL access. A sixth country, Togo, has been accumulating public debt at a rapid pace after HIPC-MDRI and is now vulnerable to high fiscal and current account deficits increasingly financed by local currency borrowings. These 8 countries (the 6 mentioned in this paragraph plus Mali and Zimbabwe) exhibit the lowest CPIA ratings among the countries in Group 3 and are also dogged by fragility.

Yet even in the remaining 6 countries in Group 3, of which Uganda has the highest CPIA rating, serious challenges remain in establishing a stable foundation for long-run growth and development. This is evident from the ADF Lab's informal discussions held in September 2016 in Kampala with senior policymakers as well as NGOs focused on debt issues to discuss the findings of ADF Policy Innovation Lab (2016). Uganda is in the IMF's Policy Support Instrument (PSI) program, meaning that the IMF endorses its macroeconomic policies. It certainly redounds to Uganda's credit that it has so far refrained from issuing a Eurobond given the currency and maturity mismatches associated with these on any ADF government's balance sheet. And the Bank of Uganda hiked its policy rate by 600 basis points in 2015 to meet inflation targets, a healthy sign of independence and the determination to make its currency a credible store of value.

However, feedback received during the ADF Lab visit indicates that Uganda is "starved of long-term capital" and "we are not saving". Agriculture as a sector must be engaged. Infrastructure must be linked to agriculture. But smallholder agriculture and land tenure are severe obstacles, with only a small fraction of land titled. On commodity prices, it is a "different world from 10 years ago", with much bleaker prospects. There is a shortage of medium-sized firms that can produce tradables and save to accumulate capital. It was observed that the economic situation would be tough for the next 5-10 years.

Uganda also illustrates the ever-present tension in ADF countries between the infrastructure investments needed and macroeconomic sustainability as well as the need to ensure sound use of public resources. The IMF noted in a January 2017 press release: "The scaling-up of infrastructure investment implies a temporary increase in debt, putting a premium on domestic revenue mobilization and ensuring that public investment yields the intended growth dividend."<sup>10</sup> In the ADF Lab's view, the scaling up of investments is going to cause much more than just a temporary increase in debt. This is going to be a persistent medium-to-long term challenge. On the use of public resources, in September 2016, the World Bank issued a statement on the freezing of new lending to Uganda: "We continue to actively work with the Ugandan authorities to address the outstanding performance issues in the portfolio, including delays in project effectiveness, weaknesses in safeguards monitoring and enforcement, and low disbursement."<sup>11</sup> A related issue pertains to the use of Ugandan oil wealth anticipated to the tune of \$1.5-2 billion per year starting in 2020. During the ADF Lab's country visit, some policymakers saw this as a solution, with oil revenues used to jumpstart agriculture, while others were more circumspect. One

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<sup>8</sup> See [Okonjo-Iweala \(2012\)](#).

<sup>9</sup> Pinto ([1987](#), [2014](#) Box 3.6).

<sup>10</sup> See [IMF Executive Board Completes the Seventh Review Under the Policy Support Instrument for Uganda, January 2017](#).

<sup>11</sup> See [World Bank Statement on Withholding New Lending to Uganda, September 2016](#).

suggestion was to keep a list of flagship public investment projects ready to make sure the oil wealth becomes a boon for development.

More insights from the 5 country visits are contained in the next section.

## Insights from Country Visits

Three hypotheses drawn from ADF Lab (2016) were discussed with senior policymakers in the ministries of finance, central banks, debt management offices, NGOs and the private sector in the five countries visited. The first was that MCLs are unlikely to be the pivotal factor in causing DS problems. Weaknesses in fiscal and financial institutions, governance failures and exchange rate collapses are much more important. In general, there was little opposition to this hypothesis, which fits with the evidence from the country DS assessments. A point repeatedly highlighted was that how public resources are used is the key variable; public resources include not just borrowed funds, but also fiscal revenues, including those from natural resource wealth where applicable. The interest rate on the official component of loans is secondary. It is the waste of public resources that hurts the most.

The second hypothesis was that countries would welcome MCLs if accompanied by a bigger envelope of resources that would reduce the dependence on market borrowings. This hypothesis was not seriously disputed and once again, this squares with the evidence. Even countries that have not issued Eurobonds have often borrowed at commercial terms from the domestic market or on semi-concessional terms for various public investment projects, including from China. While data on these borrowing terms are not systematically available, examples suggest that MCLs would compare favorably. However, scepticism was expressed about whether donors would actually increase the overall envelope of funding resources, even with MCLs.

The third hypothesis was that MCLs could serve as a wake-up call for improved governance by signaling that the era of cheap money is over. But one view was that even a 3% interest rate on USD loans would not be high enough to improve government behavior and the use of public resources. It would take a crisis to persuade governments to implement difficult reforms. This response underlines the importance of accompanying front-loaded development finance with an EPD.

Only in the case of Mozambique (embroiled in a serious debt and foreign exchange crisis) was the ADF Lab asked to justify how MCLs squared with the ADF's mandate of concessionality. The answer given was two-fold. First, ADF countries in principle should be able to easily pay a 3-4% on 40-year USD loans since the return to capital should be high given its scarcity in Africa and the untapped economic potential there. Second, concessionality has not prevented debt sustainability problems from re-emerging in the post HIPC-MDRI world (Mozambique has benefited from this program), while a solid foundation for long-run growth is lacking. Besides, it would be reasonable for donors to expect African countries to do more for themselves, especially when massively endowed with NR wealth, as Mozambique is.

Three other insights from the country visits are worth highlighting:

1. The current macroeconomic deterioration is more than just a rough patch and African countries need a major structural adjustment to diversify away from commodities and increase national saving. Most African countries have current account deficits as a ratio of GDP far higher than in the emerging markets deemed vulnerable, such as the so-called Fragile Five in 2013, as noted above. With external financing conditions deteriorating and commodity prices falling, external finance is likely to become the binding constraint on public investment and growth.
2. Senior policymakers do not expect ODA to last forever and are cognizant that it is steadily declining as a share of public budgets. Anyone who thinks ODA will last forever "is dreaming. It's in the process of ending." In this context, a hopeful nascent trend is the growing public insistence on value for money and accountability on the part of government officials, issues singled out during Ghana's recent elections, the others being corruption and the electricity shortage.
3. The donor community places considerable emphasis on greater DRM and leveraging the private sector. The country visits underline the importance of accompanying greater DRM with simultaneous assurance that the funds will be used well and that tax collection is based on rules and computerized filing rather than being negotiated face-to-face with officials in the countries' revenue authorities, a concern voiced by everyone in Ghana, from taxi drivers to think-tanks, to give a striking example. Similarly, the idea of engaging the private sector to solve Africa's economic problems must be tempered with realism. The

investment climate needs improvement and macroeconomic and political stability assured before the private sector, domestic or foreign, would be willing to make long-term commitments to Africa. This will require persistent effort for several years.

## Conclusions and the Way Forward

Table 2 lists ADF countries based on their potential eligibility for MCL access. Of the 33 ADF countries examined, 17 exhibit high potential eligibility for MCLs based on the government's marginal borrowing costs. This list includes: Rwanda, Senegal, Kenya, Tanzania, Ethiopia, Cameroon, Ghana, Côte d'Ivoire, Zambia and Mozambique (have issued Eurobonds in the last 5 years); Niger (average per capita GNI over 2012-14 less than USD500); and Uganda, Burkina Faso, Benin, Mauritania, Lesotho, and Djibouti (per capita GNI more than \$500, have never issued a Eurobond but borrow on commercial terms in the domestic market or on semi-concessional terms from China).

As emphasized above, however, there is no presumption of automatic access to MCLs. Thus, Mozambique is seeking to restructure its external debt and this process will need to be completed. Ghana is already in an IMF program to address its debt sustainability problems while Zambia is engaged in discussions on an IMF program. Access to MCLs would require sufficient progress on re-attaining debt sustainability combined with an EPD.

Cameroon, Ghana, Mauritania and Djibouti are all classified as being at high risk of external debt distress by the IMF-World Bank Debt Sustainability analyses. Yet all are above the operational GNI per capita cutoff income level for ADF and three (Cameroon, Ghana and Mauritania) are NR-rich while Djibouti reaps rents from its strategic military location. On incentive grounds, there is good reason to charge these countries MCL rates, combining this with an EPD aimed at diversification and restoring sustainable debt profiles.

The remaining 16 countries exhibit low potential eligibility for MCLs, which are likely to exacerbate debt sustainability problems in 6 countries: Liberia, Burundi, Madagascar and Central African Republic from Group 2, and Mali and Zimbabwe from Group 3. Another 10 are somewhat better off but still vulnerable: Guinea, Malawi, DRC, The Gambia (Group 2), São Tomé and Príncipe, Sierra Leone, Chad, Togo, Guinea-Bissau and Sudan (Group 3).<sup>12</sup> The reasons include fragility from regional insecurity or epidemics such as Ebola, or weak ability to use NR wealth to promote development or poor governance, or some combination of these factors.

However, even countries with low potential eligibility can transform themselves over the next 5-10 years, if not sooner. Thus, Guinea and Togo both have a high share of local currency debt in public debt, which is typically at short maturities and at commercial terms. Both have ambitious public investment programs. For example, Guinea is planning a 550 MW hydroelectric dam at Souapati at a cost of around 20% of GDP. Its financing will not be feasible based on available instruments. Access to MCLs at some point could help because of the very long maturities involved, assuming the project has been adequately vetted. Such potential access could serve as a powerful incentive for reform.

### *Frontloading ODA via the Big Bond*

Africa's vast development needs argue for frontloading ODA on two grounds. First, growth momentum needs to be restored. With China's slowdown and the collapse in commodity prices, Sub-Saharan African growth has slowed dramatically from the 5-7 percent range during 2005-14. This slowdown is worrisome because of the vital importance of fast growth for poverty eradication, lowering infant mortality and fighting malnutrition. Fast growth is also vital for Africa's burgeoning youth, in order to create jobs for them and prevent an uncontrolled exodus of refugees to OECD countries. At the same time, the average country size in Africa is relatively small and integrating the continent and helping landlocked countries through appropriate regional infrastructure projects is vitally important.

Second, the investment needs for restoring growth momentum, creating jobs and regional integration are vast, as demonstrated in ADF Policy Innovation Lab (2017). The related financing requirement is unlikely to be met either by a ramp-up in domestic savings in view of Africa's relative poverty or by the market owing to its myopic and unforgiving nature. Rwanda, the highest ranked ADF country based on the January 2016 CPIA, was downgraded by S&P from B+ (negative outlook) to B (stable outlook) in September 2016, five levels below investment grade, because of its growing current account deficits. But these deficits have been necessitated by

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<sup>12</sup> In all groups or sub-groups, countries are listed in descending order of the CPIA.

infrastructure imports for supporting its long-run development. Ghana and Zambia's successive Eurobond issues have been done at rapidly rising interest rates and with maturities much shorter than those needed for long gestation infrastructure projects. The only feasible option left is to frontload ODA. But asking donors to do more seems a tall order in view of their own fiscal and political problems.

In these constrained circumstances, the ADF Lab proposes a win-win solution involving frontloading via the "Big Bond". Similar frontloading has been successfully used for financing vaccines and saving lives by the International Finance Facility for Immunisation (IFFIm) under the aegis of Gavi. Donor countries can take advantage of the fact that interest rates in their countries are close to their historical lows. Official development assistance (ODA) to Africa is about \$50 billion per year, of which approximately \$34 billion consists of pure grants. With the 30-year US Treasury currently at about a 3 percent yield, securitizing about \$5 billion, or less than 15 percent of the annual \$34 billion in grants, would enable donor countries to raise \$100 billion upfront. By on-lending the Big Bond proceeds to ADF countries via MCLs, donors would be fiscally better off in a net present value sense.

MCLs combined with larger funding volumes enabled by the Big Bond could actually bolster debt sustainability in the 17 countries with high potential eligibility because the interest rate would be lower than the marginal cost of their commercial borrowings. Moreover, the far longer maturities and grace periods compared to market finance would reduce the growing pressure on foreign exchange reserves.

Two guidelines can be followed in allocating the proceeds of the Big Bond. First, part of the proceeds can be used to finance a big push on African growth through regional infrastructure projects. Examples include projects that have long been stuck, such as the East Africa Railway connecting Tanzania, Rwanda, and Burundi, and a highway stretching from Nigeria to Côte d'Ivoire.

Second, a portion of the proceeds can be targeted at country-level infrastructure projects in the 17 countries with high potential eligibility for MCLs. Doing so will serve as an attractive carrot for an EPD aimed at strengthening the foundations for long-run development in these countries along the lines set out above. This structure could co-exist with the existing PBA system by creating a new window for disbursing the Big Bond proceeds. Such a two-tier system with a higher bar for accessing Big Bond funds will increase the incentives for all ADF countries to make the grade.

### *Enhanced Policy Dialogue*

Frontloading ODA via MCLs will be more acceptable to donors if accompanied by a sunset provision for economic aid to Africa, for example, a stipulation that economic aid will be offered only for another generation, say, the next 40 years. This would not come as a big surprise to policymakers based on the ADF Lab's country visits; climate change finance and humanitarian assistance will need to be dealt with separately. An appropriate EPD is essential for making such a structure work. It should focus on growth policy, absorptive capacity and the selection and implementation of public investment projects, strengthened public finance management and safeguards to ensure that NR wealth is used to support development. Above all, the ADF Lab's public debt sustainability assessments and country visits underline the crucial importance of governance, leadership and institutions. African leaders must assume primary responsibility and be held accountable for the continent's development at both the national and regional levels.

The EPD will need to be guided by three principles.

- First, it must build upon the existing PBA framework, which incorporates the CPIA ratings and guidance from the IMF and World Bank's DSF, to focus explicitly on the requirements for making front-loaded ODA a success. The ADF can use its "African franchise value" to urge African leaders to take primary responsibility for economic governance while avoiding the frequent domestic shocks from corruption, political instability and mismanagement of public finances and NR wealth.
- Second, while the ADB Group should spearhead the EPD agenda, it would need to collaborate actively with the IMF, World Bank and other development partners working on Africa.
- Third, the EPD needs to be integrated with the ADB Group's decentralization strategy and its expertise in regional infrastructure and other aspects of regional integration, co-opting other development partners and the private sector as needed.

To conclude, Africa is yet again at a critical juncture as a result of China's growth slow down which, together with a tightening of global financing conditions, has contributed to diminished medium-term growth prospects and uncovered weaknesses in governance and fiscal institutions. Combined with currency depreciation, public debt

dynamics have deteriorated in several countries, most notably in commodity exporters. At the same time, funding requirements for human capital and infrastructure are massive. The “unforgiving” market is unlikely to be a viable source of development funding. But donors are facing their own economic and political difficulties. This is a good time to assess what is working and what is not working in the ADF country-donor relationship.

This ADF Lab Working Paper has attempted to contribute to a reinvigoration of this relationship through its examination of the debt sustainability and development challenges African countries face. It has tabled the Big Bond as an instrument to help maintain Africa’s growth trend while simultaneously lowering the fiscal burden on donors. Lending the proceeds of the Big Bond to eligible countries via MCLs will boost debt sustainability by displacing more costly and shorter maturity market alternatives. This process should be conducted in tandem with the current PBA system in ADF, the focus of which can shift to countries with low levels of eligibility for MCLs. An EPD is an integral part of this package to make sure that all public resources, whether borrowed or not, are used well and contribute to a better economic future for all ADF countries.

**Table 2 - List of ADF countries based on their potential eligibility**

Country	ADF classification	Fragile	MCL potential eligibility	CPIA
<i>Countries which have issued Eurobonds</i>				
Rwanda	ADF-Only		High	4.85
Senegal	ADF-Only		High	4.43
Kenya	Blend		High	4.31
Tanzania	ADF-Only		High	4.24
Ethiopia	ADF-Only		High	4.22
Cameroon	Blend		High	4.19
Ghana	Gap		High	3.96
Côte d'Ivoire	Gap		High	3.65
Zambia	Blend		High	3.57
Mozambique	ADF-Only		High	3.47
<i>Countries with GNI pc (2012-14 average) less than USD 500</i>				
Niger	ADF-Only	Fragile	High	3.68
Guinea	ADF-Only		Low	3.46
Malawi	ADF-Only		Low	3.44
Liberia	ADF-Only	Fragile	Low	3.39
Burundi	ADF-Only	Fragile	Low	3.30
Congo, Dem. Republic	ADF-Only	Fragile	Low	3.30
Madagascar	ADF-Only	Fragile	Low	3.17
Gambia	ADF-Only	Fragile	Low	3.14
Central African Republic	ADF-Only	Fragile	Low	2.41
<i>Countries that never issued Eurobonds but with a GNI pc (2012-14 average) greater than USD 500</i>				
Uganda	ADF-Only		High	4.16
Burkina Faso	ADF-Only		High	4.03
Benin	ADF-Only		High	3.89
Mauritania	ADF-Only		High	3.84
Lesotho	Gap		High	3.76
Mali	ADF-Only	Fragile	Low	3.63
São Tomé and Príncipe	Gap		Low	3.35
Djibouti	Gap	Fragile	High	3.32
Chad	ADF-Only	Fragile	Low	3.31
Togo	ADF-Only	Fragile	Low	3.21
Sierra Leone	ADF-Only	Fragile	Low	3.15
Guinea-Bissau	ADF-Only	Fragile	Low	2.69
Zimbabwe	ADF-Only	Fragile	Low	2.65
Sudan	ADF-Only	Fragile	Low	2.54

\* Classification per ADF-14. Countries in each eligibility group (high and low) are listed in descending order of the CPIA rating

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## Abbreviations and Acronyms

ADB: African Development Bank

ADB Group: African Development Bank Group (Bank Group)

ADF: African Development Fund

ADF Lab: ADF Policy Innovation Lab

CAD: Current account deficit

CPIA: Country Policy and Institutional Assessment

DRM: Domestic resource mobilization

DS: Debt sustainability

DSA: Debt sustainability analysis

DSF: IMF-World Bank Debt Sustainability Framework

EAC: East African Community

ECF: Extended Credit Facility

EFF: Extended Fund Facility

EM: Emerging market

EPD: Enhanced policy dialogue

HIPC-MDRI: Heavily Indebted Poor Countries Initiative and Multilateral Debt Relief Initiative

IBRD: International Bank for Reconstruction and Development

IDA: International Development Association

IMF: International Monetary Fund

MCL: Moderately concessional loans

NR: Natural resource

ODA: Official development assistance

PFM: Public financial management

PSI: Policy Support Instrument

RCF: Rapid Credit Facility

SBA: Stand-by Arrangement

SCF: Standby Credit Facility

REER: Real Effective Exchange Rate

USD: US dollar

UA: Units of Account

XAF: Central African CFA Franc

XOF: West African CFA Franc

WAEMU: West African Economic Monetary Union