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Focus :

The Debt Distress of African States: A Sense of Déjà Vu

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The Debt Distress of African States: A Sense of Déjà Vu

Over a year after the moratorium on debt service put in place by the G20 (granting the world's poorest countries a suspension of the debt service repayments due between May and December 2020, and then those due in 2021), the debt of African states has continued to increase as a consequence of the health crisis. While many faced repayment problems in early 2020 following the spread of Covid-19, the ensuing paralysis of the global economy only precipitated a situation that many, including the IMF and the World Bank, considered worrying even before the virus appeared. The Covid crisis has thus revealed the debt problems encountered by these states, the result of an accumulation dynamic that started when debt cancellation initiatives ended in the mid-2000s.

When the structural factors of public debt distress in low-income countries (LICs) that caused the crises of the early 1980s and late 1990s are examined under the "macroscope," history seems to repeat itself. Indeed, several retrospective analyses (bearing on previous crises) have shown that the hypotheses formulated regarding the evolution of commodity prices, the irreversibility of public spending, the absorptive capacity of external financing by many LICs (those in sub-Saharan Africa in particular), or the abundance of liquidity at the global level strongly contributed to this massive accumulation of public debt (see Ferry and Raffinot (2019) for a literature review).

The recent developments in the debt of certain sub-Saharan states before the outbreak of the virus have once again underlined the contribution of these factors to the current debt distress faced by these states. This situation fuels a sense of déjà vu, as if it was impossible to deviate from some form of determinism, which is both harmful for debtor states and destabilizing for the architecture of international development finance.

The end of the concessional paradigm?

Several members of the DIAL research team have addressed these issues. Through two articles co-written for The Conversation with Babacar Sène, a professor at Cheikh Anta Diop University in Dakar, Marc Raffinot and Marin Ferry first discuss the consequences that the first responses from traditional lenders to contain this situation, such as the DSSI, could have for the funding of development. The three researchers underline that this umpteenth debt restructuring initiative once again has been a shock to the "concessional paradigm," a characteristic of funding for developing countries, which has been undermined since the end of the 1980s.

First of all, they point out that until the middle of the 20th century, developing and industrialized countries financed each other on international and domestic markets. The 1944 Bretton Woods Conference subsequently created the International Bank for Reconstruction and Development (the future World Bank) to fund development projects in the (supposedly temporary) absence of private flows, under conditions identical to those on the markets. Development aid, a major innovation of the post-war period, was then entrusted to other organizations within the United Nations system, and consisted mainly in technical assistance financed by donations. It was only later, in 1960, that a specific financing system for LICs appeared, heralding the "concessional paradigm." The system was organized around specialized public organizations, such as the International Development Association (IDA), a subsidiary of the World Bank specifically created for this purpose. This system, which is more relevant than ever, finances the development of the poorest countries through "concessional" loans (low interest rates, and long terms and grace periods) which, while they are not donations as such, are necessarily subsidized. In addition, these states want to retain some control over the use of these cheap resources, through a system of conditionalities. Thus, the system established in 1960 divides developing countries into two groups: LICs, which are financed cheaply by specialized public organizations; and other countries, which are financed on the financial markets. Sometimes referred to as "quasi-donations" because of their advantageous conditions, these concessional loans nevertheless constitute real debt for the countries which benefit from them. IDA and the IMF, whose mission is to promote the development of their clients, however stake their claim as "privileged" creditors (reimbursed first), which partly explains their late participation in the debt cancellation initiatives of the 2000s, and their current reluctance to join the DSSI, as they have preferred to make emergency financing available to countries with debt distress.

The logic of the concessional paradigm is therefore the reverse of that of the markets, with poverty being associated with lower interest rates. Going even further, IDA has decided since 2006 to only grant donations to heavily indebted LICs (reducing the amount of these donations compared to the loans it would have granted in a healthy debt situation). Despite these favorable conditions, LIC debt became unsustainable in the late 1980s. To avoid the collapse of the system, after much resistance, the concessional paradigm was supplemented with a series of debt reduction initiatives.

These initiatives started at the bilateral level ("Toronto terms" in the Paris Club, 1989), then continued with the Heavily Indebted Poor Countries (HIPC) Initiative (1996 and 1999), and ended in 2005 with the Multilateral Debt Relief Initiative (MDRI). The implementation of these debt cancellation programs for heavily indebted poor countries constituted a first shock to the rather paradoxical concessional paradigm: the countries whose debt was erased were nevertheless those which borrowed at a lower cost.

The dynamics of certain states incurring new debt at the end of the debt relief was a second shock to the paradigm. Hardly were they out of debt than a number of them wanted to emancipate themselves by borrowing in the market and/or by increasing their borrowing from foreign commercial banks. The coexistence of two financing systems, one linked to "aid" and the other to profit, is a source of inconsistency. A third shock has come from the historic drop in interest rates which has blurred the lines. Market interest rates are now so low that it is possible to offer concessional financing, which meets development "aid" standards, while making a profit. Conversely, commercial loans may qualify as aid.

Is the attitude of private creditors justified?

Finally, the coup de grace was delivered with the establishment of the DSSI in April 2020. It goes without saying that while the extension of debt service repayment deadlines by public organizations have made it possible to alleviate the budget constraints of LICs in the face of the spread of the virus (to a certain extent only given certain states' low share of debt owed to public organizations), this measure has also facilitated the repayment of debt held by private creditors, which amounts to subsidizing them indirectly. However, these creditors and holders of African Eurobonds do incorporate the risk of default in the interest rates at which they lend or subscribe to the bonds. Subsidizing them thus only leads to securing their repayment and rendering obsolete the very notion of risk premium, which is precisely supposed to take into account their losses in the event of default.

Private creditors were invited on a voluntary basis by the G20 to participate in the DSSI; they justified their withdrawal by the non-transparency of certain debtors as to the structure of their outstanding debt (such as Zambia for example). Above all, they explained that accepting a deferral of repayment would lead to the exclusion of LICs from international financial markets. However, an article by Marin Ferry, Marc Raffinot, and Baptiste Venet recently published in the *International Review of Law & Economics* shows that the HIPC and MDRI debt cancellation initiatives, through which many private creditors' debts were unilaterally canceled by official creditors, have contributed to an increasing use of these unconventional loans. Indeed, based on difference in differences, as well as a synthetic control group, the results of this study suggest that following the debt cancellation granted under the HIPC initiatives and especially the MDRI, the recipients have become more indebted with foreign commercial banks compared to other developing countries that did not participate in these initiatives. The results show that even in cases where the cancellation of private debts has led some HIPC states and private donors to court for the latter to recover (at least part of) their debt, the rulings, most often against debtors, have in no way impacted the more marked propensity of HIPC states to turn to private creditors, their strong repayment capacities ("fiscal space") overcompensating for the negative signal of "default." Finally, the authors also highlight the impact of international financial cycles on the surge of this unconventional new debt which occurred when the markets were bearish. The low rates of return observed in OECD economies and the worldwide abundance of liquidity may then have encouraged private investors to turn to LICs, among which those with a higher borrowing (and therefore short-term repayment) capacity, in particular former HIPCs, may have been favored.

Based on what the results of this article suggest, and those more recent from a working paper by Lang et al. (2021) underlining a more marked drop in spreads for the countries that benefited from the ISSD, it seems that the main argument put forward by private creditors to justify their withdrawal from the efforts undertaken is hardly acceptable.

As a reminder, in 2019 private creditors (banks, financial institutions, and bondholders) held nearly 45% of total public external debt in sub-Saharan Africa. Although hypothetical (or even utopian), their contribution to the restructuring of the public debt of LICs (and in particular of sub-Saharan African countries) therefore seems necessary. Maintaining the status quo, or a greater effort on the part of official creditors through new debt cancellation measures (considered as official development assistance, ODA) would put an end to the concessional paradigm, leaving room for a paradoxical situation in which private credit claims would be guaranteed and reimbursed by development agencies. It is unclear whether taxpayers, who finance part of these agencies' activities, would appreciate this. What is more, the very notion of ODA would have to be reconsidered, since its main objective is to promote economic development and improve the standard of living of developing countries. It is also unclear whether subsidizing private creditors contributes to this aim.

Marin Ferry and Marc Raffinot

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