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CABRI – Collaborative Africa Budget Reform Initiative

NEWSLETTER

for Public Debt Managers in Africa

Back to basics

Dear reader,

Welcome to the third edition of CABRI's bi-monthly newsletter for public debt managers in Africa and the broader public finance community. As with the previous editions, this edition, dated 30 September 2021, will cover notable developments in Africa and internationally, pertaining to the management of public debt.

With the world facing unprecedented levels of sovereign debt, the vulnerabilities in debt portfolios are also rising. In Africa, borrowing requirements remain high. Even good performing state-owned entities are now experiencing cash flow problems - making fiscal choices and determine priorities extremely difficult. This edition of the newsletter unpacks several of the challenges that face African governments, shares information on available facilities, and provides advice on ways to improve the management of public debt. This edition will cover:

- Back to basics: Preventing debt crises are better than ex-post interventions
- Using the IMF's Special Drawing Rights (SDRs) prudently
- Low-Cost Financing for African Sovereign backed projects: Tapping Export Credit Agency (ECA) financing for long-term low-cost debt
- Building Public Debt Management Capabilities in Africa: Making smarter decisions on when and how to intervene to support SOEs.
- Country spotlight: Angola's commitment to prudent and proactive public debt management

Back to basics: Preventing debt crises are better than ex-post interventions

The world is currently facing an unprecedented level of sovereign debt – and debt is continuing to surge amidst increasing debt vulnerabilities. Lower-income countries that are most at risk are those exposed to international capital outflows and exchange rate pressures due to large portions of their debt being issued in foreign currencies, such as the US dollar.

Since the outbreak of the COVID-19 pandemic, the international community has focused on mobilising international policy action to help poor countries service existing debt, extend maturities or restructure it. Initiatives such as the G20-led Debt Service Suspension (DSSI) or the Common Framework are commendable, but do not go far enough to address the underlying causes of the debt crises. To prevent excessive indebtedness and build financial resilience to manage exceptional events like a pandemic or environmental catastrophes, ex-ante measures are needed.

A CABRI paper highlights critical preventative measures that African government should prioritise to preserve debt sustainability and keep balance sheets in good order. These include a debt management strategy, transparency, and accountability. Although there are many frameworks in place that should help manage debt accumulation, these are not always applied effectively. Governments need to have a proper debt management strategy in place that manage risk exposures arising from the debt portfolio. In terms of transparency, a major concern is the new forms of bilateral credit arrangements that are often performed via alternative financing methods, such as off-balance sheet lending, execution of swap agreements, or via the participation of SOEs. In most of those cases, it is difficult to obtain a clear picture of the facilities' terms and conditions, given the nature of confidentiality clauses that are usually included. Transparency and a debt management framework are not panaceas, but they can contribute significantly to reducing debt vulnerabilities. To achieve debt sustainability, good lending practices are equally important borrowing practices. Debt sustainability requires a sense of shared responsibility among all stakeholders. The final building block is accountability, i.e., assuming responsibility, which can only be built on the back of a strong rule of law.

These measures may seem basic, but they are worth emphasising. A recent evaluation of countries' debt management performance found that several IDA-eligible countries do not meet minimum standards for debt management institutions and practices. In fact, scores for African countries stagnated over the evaluation period (IEG, 2021). A lack of progress may be a symptom of reforms that have not been sufficiently adapted to local conditions and problems. Effective institutional and technical capacity building and associated change management also takes sustained effort and political commitment and is therefore difficult to establish over the short term.

Ultimately, governments in Africa as well as multilateral institutions need to prioritise ex-ante interventions that lower the risk of debt distress. Ex-post interventions tend to be painful and costly for both the borrower and the creditors (as highlighted by the experience of the 2020 Argentine debt restructuring). Moreover, despite efforts to improve the sovereign debt restructuring process through the G20 Common Framework, debt restructuring is likely to be onerous because of the short-term costs and long-term reputational effects. Ex-post intervention is costly and painful and should not be the default option for financially vulnerable countries.

Using the IMF's Special Drawing Rights (SDRs) prudently

The largest allocation of Special Drawing Rights, or SDRs, in history – about $650 billion – came into effect in August 2021. The SDR allocation will provide additional liquidity to the global economic system allocation, with US$375 billion allocated to advanced economies and roughly $33.6 billion allocated to African countries based on their IMF quota shares (IMFa, n.d). Importantly, SDRs are not a currency but a claim on other currencies that can be used in a variety of ways. For example, if a country is running low on currency to pay its foreign obligations, it can exchange its SDRs for a freely usable currency.

Although the SDR allocation is expected to have important macroeconomic benefits for the global economy and for member countries, the allocation also entails risks that need to be considered and carefully managed by recipients. The IMF has prepared a Guidance Note to help IMF country teams develop policy advice consistent with macroeconomic sustainability (IMF, 2021). **The four key messages relevant for public debt management are summarised below:**

1. Use of SDRs – A country is free to use any or all its SDRs at it sees fit, subject to local laws and any conditions from the IMF. Potential uses include budget support, retiring public debt and reserve management. For countries whose foreign exchange reserves have been very hard hit by the pandemic, the best course may be to leave the SDRs in the central bank (or the entity that acts as a member's fiscal agent) to boost reserve buffers. Where the level of reserves is not a concern, SDR holdings can be used to reduce expensive domestic public debt or domestic arrears. The decision should be taken within the framework of an overall debt management strategy and respecting domestic institutional arrangements.

2. Debt sustainability – The SDR allocation, by itself, does not negatively impact members' debt sustainability and could even enhance it by strengthening reserve buffers and resilience. However, if the authorities use the policy space provided by the allocation, the overall impact of the SDR allocation on debt sustainability depends on how the allocation is used. For example, if a country uses its SDRs to finance an increase in the fiscal deficit then this use would impact debt sustainability through the higher net interest obligation.

3. Costs of SDRs – The use of SDR holdings is effectively charged at the variable non-concessional SDR interest rate. Though currently at historical lows (0.05 percent), it is updated daily, based on global reference interest rates and could increase rapidly, exceeding the costs of other sources of financing available to low-income countries (LICs). A return to more normal conditions in financial markets could see this rate climb above 2 percent. Weekly SDR interest rate can be found here (IMFb, n.d).

4. Debt restructuring – If a country's debt is assessed as unsustainable, the allocation should not substitute for debt restructuring. Moreover, in the context of a restructuring, the use of SDR holdings should not undermine fair burden sharing among creditors (e.g., using SDRs to settle any claims before an agreement with all creditors are reached), as this could complicate the subsequent restructuring process.

Future newsletters will keep readers informed about any decisions for reallocating SDRs among countries. Each of the proposals currently being considered (Plant, 2021; UNECA 2021) have various technical issues that need to be worked through, but these hurdles are not insurmountable if there is political will. Given the enormity of the challenges facing the globe from the twin global crises of health and climate, leveraging SDRs to provide the financial firepower to confront these challenges seems a sensible thing to do.

Low-Cost Financing for African Sovereign backed projects: Tapping Export Credit Agency (ECA) financing for long-term low-cost debt

Each year the Export Credit Agency (ECA) market supports over US$100bn of new issuances. Such debt can be for up to 20 years and, for African sovereigns, issued at an all-in cost that is significantly cheaper than any other form of commercial debt, including the bond market.

African governments undertaking capital expenditure that involves procurement from a developed nation can be eligible for financing via the ECA market. The project can include a variety of sectors from social infrastructure (e.g., hospitals / housing / water / power) to major infrastructure (such as roads, rail, airports, and general transportation). Renewable energy has special extended terms that make the overall debt even more attractive.

Key features: If the sovereign borrower covers the importation of goods and services, then an ECA backed financing package can cover hard currency financing up to 85% of the contract value; up to 50% of the contract value for local costs; and interest during construction. Other key characteristics include fixed rate financing – often without commitment fees; drawings on a milestone-by-milestone basis; and repayments generally on equal semi-annual installments starting post-delivery / installation.

Transparency and competition: Whilst the ECAs are governed by the OECD Consensus Rules and thus should all offer the same attractive terms they do differ from each other. Some ECAs have greater flexibility, with the ability to offer funding at the OECD Commercial Interest Reference Rate (CIRR). **Thus, it is important for the Sovereign to take control of the whole process.** One way to do this is to introduce competitive tension to get full transparency and best terms.

A Tender Panel is a highly efficient solution for making the ECA financing process more competitive. It is a process where potential ECAs and funds providers compete for the funding. It creates maximum price competition and drives liquidity. Importantly, it also provides internal accountability and true price transparency for the Sovereign both for now and for future records. Many Sovereigns use this process in furtherance of their value for money evaluation and accountability requirements.

Start early and negotiate: ECA financing needs to be in place before the commercial contract is signed. ECAs may not lead with the best offer. You may need to negotiate and ensure that the terms are suited to your needs rather than that of the ECA or supplier. If you are unfamiliar with the process or feel that you are not obtaining best terms appoint an ECA Advisor to be on your side of the table. This will help ensure that:

- There is transparency and accountability
- The debt is properly structured to the needs of the project, and the best terms and conditions are achieved
- Potential embedded risk management tools to suit your debt management goals are taken
- Issues like premium, covenant and legal package are all at "market"

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Building Public Debt Management Capabilities in Africa: Making smarter decisions on when and how to intervene to support SOEs

Contingent liabilities are considered as one of the largest sources of fiscal risks. Even before the COVID-19 crisis, many state-owned entities in Africa already faced difficult financial conditions and were a drain on public finances (subsidies, on-lending and capital injections).

ESKOM, South Africa's electricity utility's debt alone is about 10 percent of GDP of which 80 percent is guaranteed by government. The company's direct cost to the fiscus has exceeded 9 percent of GDP since 2008/9 (Harris et al., 2020). In Zimbabwe, many state-owned entities accumulated around 2.8 percent of GDP from 2011 to 2014 (Harris et al., 2020). In some countries, state-owned entities have increasingly benefited from government guarantees, which have exacerbated already high public debt burdens and significant increase in fiscal risks.

Given the budgetary pressures stemming from the pandemic and significant uncertainty regarding the region's economic recovery, governments in Africa must take a critical look at when and how they support state-owned entities to make the best use of the limited budgetary resources amidst competing priorities.

COVID-19 pandemic and economic fallout has created financial challenges for many state-owned entities in Africa. As a result of the COVID-19 crisis, financing requirements have increased due to pressures to spend more on health, social protection and security. Given the primary responsibility of the debt manager to raise finance for the government, extensive monitoring of contingent liabilities may be neglected during a crisis period. Alternatively governments may be postponing tough decisions.

Due to the economic slowdown during COVID, more SOEs are experiencing cash flow problems. Not only are entities that were in trouble prior to COVID experiencing financial difficulties, but SOEs in industries directly affected by COVID-19 (e.g., national airline companies), are now experiencing revenue shortfalls or difficulties servicing debt. Some investors or creditors of SOEs are also becoming increasingly reluctant to roll over their debt with SOEs and are requesting full repayment upon maturity. The request for bailouts and other types of government support to SOEs has intensified, raising the questions of whether and when to support SOEs and how to deliver this support.

This is a huge challenge requiring high-level political intervention, smart policy choices, and sound technical advice to balance priorities. The critical question is how governments will decide which SOEs will receive support, and which will be excluded as there are not enough fiscal resources to support all SOEs. Intervention at the highest level is needed and is certainly not an easy task. Governments need to make decisions on when and how they support SOEs and avoid deferring the problem to a later stage. Some SOEs will require temporary and exceptional support to weather the pandemic storm. However, not all SOEs should receive the same type of support, as those that are more strategically and systematically relevant, may receive priority. Governments may also consider other options, than guarantees, to ensure the financial health of SOEs. South Africa has recently issued more stricter criteria for the approval of guarantees (Government of South Africa, 2021).

Public debt managers play an important role in sensitizing politicians to the risks that decisions taken today on SOEs, particularly guarantees, will potentially have on the future of the fiscus. Contingent liabilities realisations tend to occur at times of crisis and many of these materialisations occur at the same time. From a fiscal perspective: When it rains, it pours.

Support to SOEs during the crisis can provide an opportunity to accelerate existing or introduce new structural reforms to improve SOE governance, and assess its strategic value and performance.

Given the budgetary pressures stemming from the pandemic and significant uncertainty regarding the region's economic recovery, governments in Africa must take a critical look at when and how they support SOEs to make the best use of the limited budgetary resources amidst competing priorities.

Country Spotlight: Angola's commitment to prudent and proactive public debt management

Angola has recently recorded a gradual recovery from the COVID-19 shock, amid higher global oil prices, low levels of reported COVID-19 infections and the start of a vaccination campaign. Moody's has also upgraded the Government of Angola's long-term issuer ratings to B3 from Caa1. The upgrade is driven by Moody's assessment that Angola's sovereign credit profile is improving and governance is strengthening, in particular in the quality of the country's executive and legislative institutions (Moody's 2021). Fiscal metrics as well as liquidity and funding risks are also expected to improve. However, S&P & Fitch ratings are still in the Cs and weigh on the profile.

The risks to the fiscus remains with high government debt levels as the biggest threat to financial stability. Given high public debt levels (peaking at 135% of GDP in 2020 and projected to reduce to 86% by 2024), debt service payments are increasingly crowding out other essential spending on the budget. However, higher oil prices compared to last year, and a stable exchange rate, will allow the positive impact of fiscal consolidation efforts and structural improvement in debt and public finance management to be visible in a downward-trending debt burden. The government's decision to save the bulk of the oil revenue windfall this year is an example of fiscal discipline (IMF, 2021b).

To reduce cost, create fiscal space and support a steadily declining debt-to-GDP ratio, the Government of Angola has opted for debt relief and reprofiling of the debt portfolio, by means of a formal request under the G20 Debt Service Suspension Initiative (DSSI). Angola has suspended principal and interest payments on outstanding debt as of September 2020, while they make progress on signing a Memorandum of Understanding (MOU) with their creditors. The debt reprofiling operations, including DSSI, will help bring the annual gross borrowing requirement to more manageable levels throughout 2021–25 (projected average of 8.7 percent of GDP). Together with a moratorium on debt repayments for the next three years, Angola will cumulate cash flow relief of $6.9 billion in 2020-22, which will increase further with the extension of the DSSI.

Despite the debt reprofiling and strong fiscal consolidation, total debt service will remain high and warrants careful management. It is projected to exceed 100% of fiscal revenues in 2020, but decline to around 80% in the medium run (IMF, 2021b).

Angola's debt profile also remains subject to significant vulnerabilities. These include exposure to currency risk, exposure to interest rate risk, and narrow creditor base, especially in the domestic market.

Recognising these challenges, the Government of Angola is committed to the continued implementation of a prudent and proactive debt management debt strategy to support debt sustainability. Angola will therefore:

- continue to abide by the ceilings for issuance of debt guarantees by the State,
- align interest rates in domestic markets with market rates,
- developing the domestic debt capital markets,
- lengthen the maturity profile of the domestic debt,
- implement debt management strategies to reduce costs and risks,
- budget according to needs and priorities

Much support is currently being provided by the international community to Angola to ensure financial stability, address vulnerabilities, and mitigate possible shocks to the economy. Political will and buy-in from high-level policy and decision makers to support reforms initiatives is critical. Angolans fully understand what is required and are committed to the process to stabilise the economy, restore credibility, and make Angola an attractive investment destination again.

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