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DEVELOPMENT REIMAGINED

Breaking the Bias:

Rethinking Debt Sustainability for Africa's Future

6 Recommendations by Development Reimagined

The Reason for this Policy Brief

On Thursday 7th September 2023, Development Reimagined held an event on the sidelines of the Africa Climate Summit in Nairobi. The event, aptly named, Breaking the Bias: Rethinking Debt Sustainability for Africa's Future, focused on key challenges within the IMF and World Bank's Debt Sustainability Analysis (DSA), and what reforms are needed to make the analysis more inclusive of African priorities and needs. Given that the IMF and World Bank are currently reviewing the DSA, we believe there are several priorities which need to be considered from an African perspective.

The event had an all-African line-up of keynote speakers and panellists, including;

- Ms Oluranti Doherty, Director, Export Development (Acting Director, Advisory & Capital Markets), the African Export-Import Bank.
- Ms Hannah Ryder, CEO of Development Reimagined.
- Mr John Asafu-Adjaye, Senior Fellow at the African Center for Economic Transformation.
- Ms Faten Aggad, Senior Advisor on Climate Diplomacy at the African Climate Foundation (ACF).
- Dr Hanan Morsy, Deputy Executive Secretary and Chief Economist of the United Nations Economic Commission for Africa.
- Mr Olivier Pognon, Director and CEO of the African Legal Support Facility.
- Ms Karabo Chadzingwa, Researcher at the African Peer Review Mechanism.
- Mr Jean-Paul Adam, Director, Policy, Monitoring and Advocacy in the Office of the Special Adviser on Africa at the United Nations Secretariat.

From the event, there were six tangible working outcomes for reform of the DSA, which should receive attention during the review process.

1. There is a strong demand from African governments for a reimagined DSA which reflects development and addresses “African risk perception” – African institutions can show leadership on this.

Challenge: There is a need for a new DSA which is more relevant and applicable to the African continent. For instance, the current DSA fails to contextualise the continent’s development history and its colonial underpinnings. Consequently, there is limited scope for domestic revenue mobilisation, and countries have sought external finance in the form of debt to address financing gaps. However, the supply of concessional loans are limited, whilst the level of private finance, which has high interest rates, has increased. These high interest rates stem from a “perception premium” which is – to some degree - based on the DSA.

For instance, in August 2023, there were 70 countries on the DSA list – 39 of these countries were African. From the 26 countries classified as “High Risk”, 13 were African countries. Among the 10 countries classified as “In Debt Distress”, 8 were African.

Solution: African institutions and banks should lead a process, including the IMF and World Bank, to devise a new DSA that aligns with the continent’s own development experience and therefore the continent’s relationship with external finance.

2. A new, reimagined DSA should apply to all countries equally.

Challenge: The DSA framework is currently differentiated by country type/income, and the DSA for low income in particular uses a variety of metrics such as debt-to-GDP, debt service to exports, and debt service to revenue.

However, some of these metrics have a low evidential basis, are not applied to high-income countries, while others such as export to GDP ratios can exacerbate a focus on export of natural commodities and the importation of finished goods, resulting in a development model that continuously exposed Africa to economic shocks such as trade shocks, repeated liquidity constraints, as well as macroeconomic management challenges. They all therefore contribute to risk assumption and in some cases dependency. The result is the creation of a "Market for Lemons".

Solution: The DSA should apply to all countries equally – what is acceptable in surveillance for the G7 or BRICS should be acceptable for the rest of the world, especially African countries.

3. A new, reimagined DSA should account for asset creation with debt and natural capital maintenance, not just liabilities.

Challenge: The DSA fail to account for “positive” or “good debt” and investment in critical infrastructure that has potential positive spillover effects which can contribute overall economic growth. Indeed, we are in an era where there is a push towards investment in renewable energy, clean technologies, and clean transportation, which are both climate-friendly and necessary for development.

Beyond this, there is a need for the inclusion of African country's natural capital which increases the country's longer-term resources, which the current DSA fails to capture. There is a huge amount of economic potential which is unaccounted for through natural capital, therefore further assessments are needed to account for future potential resources.

Solution: The DSA should account for “good debt” which is projected to produce assets with positive spillover effects, including profit, employment opportunities, trade facilitation and so on. Beyond this, the DSA should also seek to capture the value of “natural capital” maintained such as biodiversity assets.

4. Climate factors (esp. risk) should be incorporated into DSA carefully and uniformly across all countries to avoid further excluding African countries from accessing finance.

Challenge: The inclusion of climate risk and loss and damage within the DSA could exacerbate the “Market for Lemons” effect discussed above, as incorporating climate change needs has the potential to inflate risk perceptions. For example, if the DSA accounts for climate risk for countries that are outside of bond markets, it may increase the risk perception of these countries, thus exacerbating the “African Risk Premium”.

Therefore, there is a challenge in how to include climate factors in a balanced way, to ensure that low-and low-middle income countries can widen their lending portfolio, rather than have it further restricted.

Solution: If climate risks are included in the DSA, there needs to be an extremely specific framework on what is included, and what is not. For example, if loss and damage are included with the DSA, it must be specified what the end purpose is of its inclusion. For example, is it to facilitate disaster preparedness terms and conditions to be mandated, or is it to support the country to integrate the eligibility as part of their debt? It must also be made clear how this will become a component of a broader toolkit on how to support African countries, rather than restrict.

5. Support African countries in producing "homegrown" DSAs which consider a range of scenarios and assumptions.

Challenge: Most African Ministries of Finance simply accept the IMF and World Bank DSAs, and do not always understand the various scenarios and assumptions, which are often presented as a black box. However, there are examples of countries such as Argentina who have produced their own DSAs and therefore are able to challenge certain assumptions or scenarios – to forecast different results or possibilities.

For instance, countries often face difficulties in discussing how much of their debt challenges are liquidity-based versus solvency – meaning the definition and application of "debt distress" is not uniform by the IMF/WB. Assumptions such as discount rates are also highly contested by the economic profession but not exposed in the analysis, and again make a major difference to distress analysis.

Solution: African Ministries of Finance should be empowered to deliver their own DSAs and scenarios under different contexts,, including different sustainability contents, interest, currency and discount rate assumptions. This enable countries to design and implement a wider range of policies to lower the cost of capital to align with sustainable development – rather than being mandated to implement IMF designed policies during the point of debt restructuring.

6. Support the creation of an African Credit Rating Agency (CRA), whilst addressing key challenges within the “big three” CRAs.

Challenge: CRAs are largely perception-driven, which subsequently contributes to the risk premiums African countries face. Major challenges with major CRAs include a lack of local presence within the African countries they are assessing, alongside a lack of locally-produced data to inform their analysis.

These two challenges therefore make the ratings by CRAs extremely perception-driven, rather than by realities on the ground. Moreover, as noted in point 2, there is an overwhelming focus on debt as a negative product, as opposed to “debt positive” events, such as examining what debt is funding, and whether it will contribute to wider economic growth.

Solutions: There are two key solutions to the aforementioned challenges. First, there is a need for a private sector-driven, self-funded African CRA which can provide alternative analysis to the “big three” CRAs, and bolster the capacity of the African private sector to conduct their own economic assessments.

Second, there is a need to engage with CRAs to improve their frameworks – as the APRM is currently doing. This information exchange and technical capacity building for the traditional CRAs should be core to the IMF’s DSA framework for the CRAs to provide a more holistic picture of African country's economic circumstances.

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