Briefing note

Africa's rising debt

How to avoid a new crisis

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Key messages

- Public external debt in sub-Saharan Africa is on the rise, with 18 countries at high risk of debt distress – a number that has more than doubled since 2013 – and eight countries already in distress.
- The composition of public external debt has changed dramatically over recent years, with declining concessionality and increased borrowing from non-traditional official and private lenders. Past debt relief mechanisms will not be the solution for dealing with debt problems in this new financing landscape.
- Despite the growing need for effective debt management, many sub-Saharan Africa countries have weak or lagging capacity in this area.
- Responsible debt management requires transparency and information-sharing among borrowers and lenders, but this remains a challenge, exacerbated by the rise of new lenders and more complex types of debt financing.
- State-contingent debt instruments with official sector support from lenders can build fiscal resilience to exogenous shocks.
- Further strengthening debt management capacity and analytical tools for debt management in sub-Saharan Africa remains a priority, and requires up-front country ownership and political commitment, as well as commitment from donors and technical assistance providers.

Introduction

Almost 40% of countries in sub-Saharan Africa (SSA) are in danger of slipping into a major debt crisis. The number of countries at high risk of debt distress – 18 in all – has more than doubled since 2013, while eight countries[1] are already in distress (World Bank, 2018). A country is seen as being in debt distress when it is struggling to service its debt, as demonstrated by arrears, the restructuring of its debt or other clear signs that a debt crisis is looming.

This briefing paper offers policymakers and practitioners an overview of the risks faced by SSA countries as they try to keep their debt on a sustainable track, particularly the challenges relating to relatively new sources of finance. Based on this evidence, we recommend critical reforms for both borrowers and lenders to ease vulnerabilities and build resilience into debt management.

While strong economic growth and sound macroeconomic management – both fiscal and monetary policies – matter to debt sustainability, this briefing paper focuses on selected reforms to deal directly with debt vulnerabilities: building the capacity of borrowing countries to manage their debt responsibly; enhancing transparency across borrowers and lenders; and developing state-contingent debt instruments (SCDIs). The paper focuses on sovereign borrowers and foreign lenders.[2]

Although borrowing is often seen as a prerequisite for growth, unsustainable debt poses significant risks to global commitments to end extreme poverty, including the Sustainable Development Goals (SDGs). Unsustainable debt burdens compel governments to spend more on debt servicing and less on education, health and infrastructure. Indeed, one key motivation for debt relief programmes – the Heavily Indebted Poor Country (HIPC)[3] group that began in 1996 and the Multilateral Debt Relief Initiative (MDRI)[4] that began in 2006 – was to reduce debt service and free up resources for social spending and investment in infrastructure.

High debt also creates uncertainty, deterring investment and innovation, and has a negative impact on economic growth (Cordella et al., 2005; Reinhart and Rogoff 2010; Reinhart et al. 2012). A poorly managed debt crisis would not only undermine progress towards the SDGs, but it could also reverse the development progress made over the past decade.

The recent volatility of commodity prices, as well as exchange and interest rates, has highlighted the need for more responsible borrowing and lending in SSA. However, institutions and capacity to manage debt specifically, and public finances in general, continue to suffer from serious weaknesses in many countries. These are exacerbated by the lack of effective global economic governance structures to better support responsible debt financing by borrowers and lenders for sustainable development. Looking ahead, debt dynamics in several countries are susceptible to fiscal slippages, subdued economic growth, exchange rate depreciations and tighter financing conditions, which could coincide with higher refinancing needs for many countries across SSA.

The paper is based on previous research by the Overseas Development Institute (ODI) on the implications for debt sustainability linked to different financing sources (Mustapha and Prizzon, 2018; 2014), the practical experience

1 This includes Chad, Mozambique, Republic of Congo, São Tomé and Principe, South Sudan, Sudan, The Gambia and Zimbabwe.

2 Domestic debt (defined on a currency basis) has been rising in SSA (IMF, 2015; World Bank, 2018).

3 HIPC, which began in 1996 is a group of 37 developing countries with high levels of poverty and debt overhang that are eligible for special assistance from the International Monetary Fund (IMF) and the World Bank.

4 The MDRI provided for 100% relief on eligible debt from three multilateral institutions to a group of low-income countries. The initiative aimed to help eligible countries advance toward the United Nations' Millennium Development Goals (MDGs) focused on halving poverty by 2015. As there is no longer any MDRI-eligible debt to the IMF, staff have initiated the liquidation of the MDRI Trusts.

of ODI staff in providing technical assistance in these areas, and a review of the most recent literature on these topics.

How sustainable is Africa's debt after 20 years of multilateral debt relief initiatives? An analysis of trends and their drivers

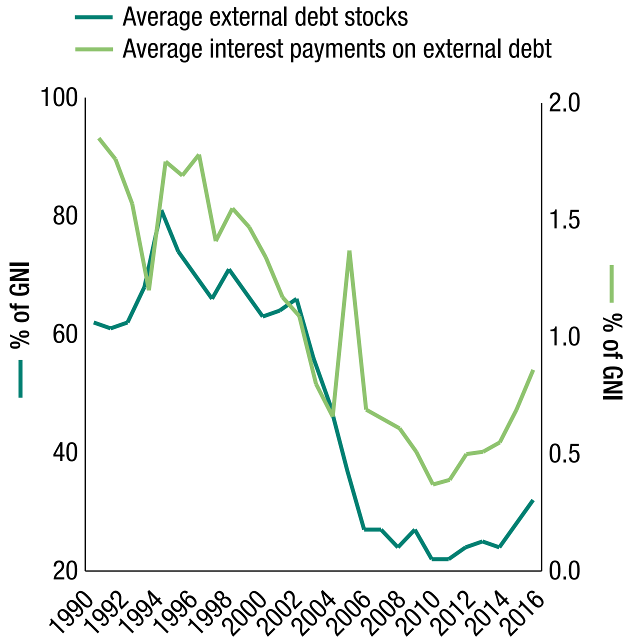
Both external debt and debt service are on the rise across sub-Saharan Africa

External debt[5] *is on the rise across SSA*. The combination of debt relief initiatives and sustained growth performance in most countries in the region has seen debt ratios plummeting since the mid-1990s. However, this trend is starting to reverse as a result of the falling number of countries that have benefited from debt relief since 2007, worsening fiscal positions and exchange rate depreciations[6], particularly for countries dependent on commodity exports (IMF, 2018a). While external debt stocks and debt service have not returned to their pre-HIPC and MDRI levels, they are greater than they were in 2006, when MDRI began to operate (Figure 1).

Regional averages mask a diverse picture across SSA countries, but it is clear that ratios of debt and debt service to GNI have been increasing in most countries across the region since the early 2010s (Figure 2).[7]

The risk of future debt distress is also rising across SSA. When debt relief was granted, the number of countries in the region at high risk of debt distress fell. However, Debt Sustainability Framework (DSF) ratings for low-income countries (LICs) began to deteriorate after 2014,

Figure 1 External debt and debt service are on the rise across sub-Saharan Africa



Note: excluding SSA high-income economies.
Source: World Bank World Development Indicators. Accessed September 2018.

signalling the re-accumulation of public debt. By March 2018, 18 countries were at high risk of debt distress, more than twice as many as in 2013 (World Bank, 2018).[8]

Taken at face value, growing debt stock and debt service should not be interpreted as signals of a future crisis and an inability to pay. HIPC and MDRI, for example, also aimed to restore market confidence, enhance the ability to borrow and build fiscal space to service debt obligations. However, more attention needs to be paid to the changing composition of debt since the pre-crisis period of the early 1990s as well as the emerging

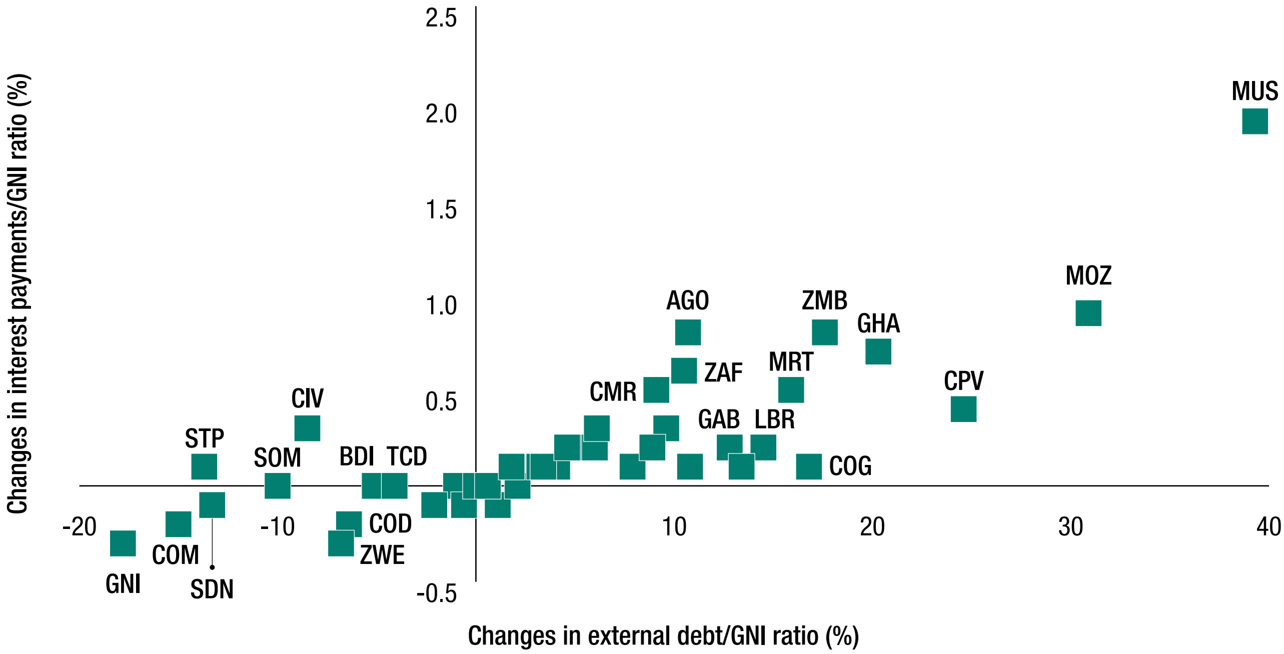
5 We focus on external public debt in this section because domestic government debt markets in most countries in the region are relatively new, and because data availability is limited across countries.

6 Some cases were also affected by negative growth, reporting of previously undisclosed debt and below-the-line operations such as the accumulation of arrears, incomplete recording of public transactions, operations of state-owned enterprises and carry-over of unspent appropriations above and beyond the annual budgetary process (IMF, 2018a).

7 With the exception of eight countries where debt service has been falling, and 13 countries where debt ratios have already fallen.

8 The number of countries in SSA for which LIC Debt Sustainability Analyses (DSAs) have been prepared has changed over time. As of 2018, DSAs are available for 37 International Development Association eligible countries, including three inactive countries and countries in arrears to the World Bank: Eritrea, Sudan and Zimbabwe. Somalia does not have an official LIC DSA and is excluded.

Figure 2 Rising interest payments (and debt stocks) in most countries across sub-Saharan Africa, 2011–2013 versus 2014–2016



Note: excluding SSA high-income economies.
Source: World Bank World Development Indicators. Accessed September 2018.

risks. The changing lender landscape also means that previous solutions in the form of debt relief are unlikely to be feasible in the event that debt ratios and debt service start to spiral upwards once more.

Changing composition of public external debt and emerging risks

The global development agenda is creating both pressure and rhetoric to mobilise 'trillions' of dollars in financing resources and long-term ambitious national development strategies to move low-income countries to middle-income status. This raises a question: who is going to foot the bill? Borrowing remains one of the few options to support both global goals and national strategies, given low growth in tax revenues or only limited space for their further expansion (Marcus et al., 2018), as well as low equity investment inflows and flat-lining aid budgets.

Against this backdrop, the composition of public external debt [9] *in SSA has changed dramatically over recent years*. First, *the share of multilateral and concessional debt (from bilateral and multilateral sources) in external debt has declined steadily in SSA since its peak in 2005*. As of 2016, multilateral debt accounted for less than 40% of external public debt on average, down from 53% in 2005. More flexible guidelines on external debt limits introduced by IMF-supported programmes allow LICs to take on more debt to support investment in potentially high-return critical infrastructure (IMF, 2013). Many more countries are also becoming middle-income countries, which means, in the medium-term, their graduation from the concessional windows of multilateral development banks (MDBs) and the phasing out of donors' bilateral programmes (Kharas et al., 2014).

Second, *the share of non-Paris club* [10]*sovereign creditors among bilateral creditors has risen*. The share of non-Paris Club creditors in total public

9 We are referring to public and publicly guaranteed external debt.

10 The Paris Club is an informal group of 22 sovereign lenders, hosted at the French Treasury, which aims to coordinate solutions to the payment difficulties experienced by debtor countries.

and publicly guaranteed external debt doubled, from 15% in 2007 to 30% in 2016. At the same time, the share of Paris Club bilateral debt plummeted from 25% to 7%. While Paris Club members aim to coordinate debt relief actions, many of the emerging bilateral lenders are not permanent members of the Paris Club, and this can delay and complicate future restructurings by making it difficult for the distressed debtor to reach a consensual rearrangement of its debt burden with all of its creditors.

While lending from China, which is not a Paris Club member,[11] finances much-needed infrastructure development in the region, its lending is increasingly seen as a threat to debt sustainability (Brautigam and Hwang, 2016; Hurley et al., 2018). This is because of the large scale of the projects that are being financed, such as railway projects in Ethiopia and Kenya (Jalles d'Orey and Prizzon, 2016), and the lack of transparency of the terms and conditions, which can vary widely, according to anecdotal evidence. Our literature review did not substantiate such claims about the negative impact of Chinese loans (Prizzon and Mustapha, 2014). However, these loans to SSA have grown rapidly since the early 2010s (SAIS-CARI, 2018) and often fund large-scale infrastructure that could pose repayment challenges if projects do not generate sufficient returns, especially in foreign exchange.

Third, *SSA countries have tapped international markets at an increasing pace*. SSA countries have issued bonds with issuances of considerable size. Low interest rates and an appetite for riskier financial investment opportunities, together with positive growth prospects, are fuelling high and steady demand from international investors. This has allowed countries to borrow large volumes in a short time span and diversify their investor base (Tyson, 2015). However, sovereign bonds expose countries to exchange and interest rate risks, with far higher interest rates than non-concessional borrowing from MDBs, for example. International sovereign bonds that involve bullet payments[12] can also create significant refinancing risks.

An uncertain global environment and shifting market sentiments now pose additional challenges to the sustainability of external public debt in SSA. The rapid build-up of external debt in several countries occurred during favourable macroeconomic conditions, with low global interest rates and sustained growth. At the international level, however, an environment of low interest rates, coupled with the quantitative easing of advanced economies is expected to shift, with interest rates already rising in the US, and a loss of appetite for the sovereign debt of emerging economies that has fuelled the rise in international sovereign borrowing in the past (Tyson, 2015).

In addition, international bonds will start to mature in 2021, with large repayments posing a significant refinancing risk for the region. While commodity prices for energy and metals are set to rise still further (World Bank, 2017), global growth is expected to slow in the next few years. National authorities tasked with keeping public debt on a sustainable path must, therefore, take these emerging risks into account.

Challenges for responsible borrowing

Weak debt management persists in several countries in sub-Saharan Africa

A stronger focus on the management of overall public debt at country level could help countries limit the impact of the risks to the current global macroeconomic outlook. In general, diversification of financing is perceived as beneficial by recipient governments, given their huge financing needs and the relative decline in concessional financing from traditional creditors (Prizzon et al., 2016). However, new types of external debt financing are exposing debt portfolios to more financial risks.

One important aspect of responsible borrowing is managing the costs and risks associated with potential sources of financing. This is, however, operationally complex and requires country officials to solve difficult trade-offs.

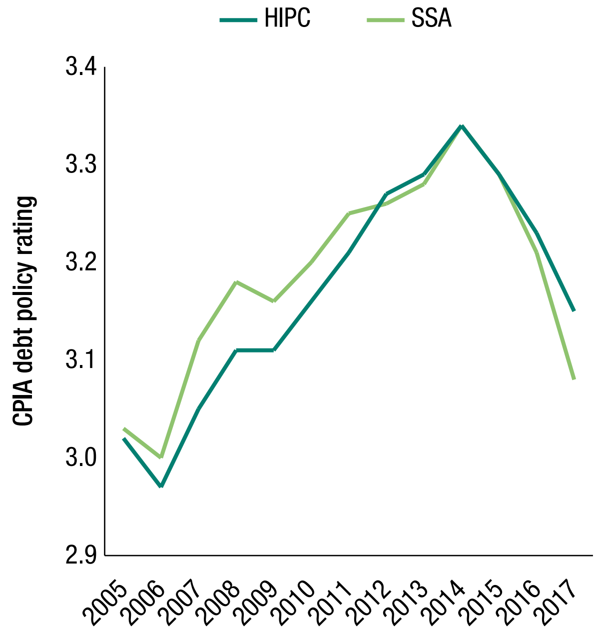
11 China does, however, participate in the Paris Club in an ad hoc manner.

12 The principal is due when the bond matures.

The medium-term debt management strategy (MTDS)[13] is an important tool for this, and has been one of the key capacity building areas supported by both the IMF and World Bank. Other important aspects of debt management include establishing a clear legal and organisational framework, as well as reporting policies to ensure accountability and transparency. It is also critical to establish systems and procedures to ensure timely debt recording and debt service payments. Looking ahead, effective debt management will require the increasingly active use of mitigating measures[14] to address debt vulnerabilities, especially in frontier countries.[15]

Despite the growing need for effective debt management, the capacity in many SSA countries in this area remains weak, according to existing measures of debt management capacity. The average Country Policy and Institutional Assessment (CPIA)[16] debt policy indicator for SSA has deteriorated marginally since 2007 (3.08 in 2017, compared to 3.12 in 2007, on a rating scale from 1 to 6). In contrast, members of the HIPC group – most of them SSA countries (although not all SSA countries benefited from debt relief initiatives) – still perform slightly better than they did in the mid-2000s (Figure 3). These figures, however, mask a dramatic deterioration in Mozambique, Cape Verde, Eritrea, Ghana and the Gambia, and conceal the fact that roughly half of the 39[17] SSA countries with data scored 3 or lower, out of the maximum 6, for this indicator in 2017.

Figure 3 Deteriorating debt management capacity (on average) in sub-Saharan Africa



Source: World Bank (2018).

The CPIA reflects some subjective judgement, so it is useful to compare it with alternative assessments of debt management capacity that are based on clearly defined and transparent criteria, offering more insights at a more disaggregated level. These include the World Bank's Debt Management Performance Assessment

13 The purpose of the MTDS is to determine the appropriate composition of the debt portfolio based on projections of costs and risks over the medium term with a view to reduce vulnerabilities while ensuring that funding needs are met and costs are contained.

14 For example, buyback and exchange operations.

15 A frontier country is a developing country that is more economically advanced than the least developing countries, but whose economy is still too small to be considered an emerging market.

16 The debt policy rating assesses whether the debt management strategy is conducive to minimising budgetary risks and ensuring long-term debt sustainability (1=low to 6=high).

17 This average includes Somalia and South Sudan, since they had a score in 2017 but none in the previous years. There is no data for nine SSA countries.

(DeMPA)[18] and Public Expenditure and Financial Accountability (PEFA)[19] assessment.[20]

A recent evaluation of debt management institutions and capacity based on the DeMPAs of 22 African countries (World Bank, 2018) found that less than 50% of countries fulfil the minimum requirements for sound international standards in the legal framework for debt management to ensure segregation of duties and avoid conflicts of interest. Only 40% adhere to sound practice for domestic borrowing, and only 22% meet the minimum requirements for the effective management of loan guarantees, on-lending and the issuance of derivatives. There have, however, been some improvements: the most notable being the significant increase in the countries approving a formal debt management strategy.

Comparing the quality of debt management institutions (as measured by their most recent PEFA assessment) in SSA countries on the basis of their risk of debt distress reveals some common strengths and weaknesses. Figure 4 translates the alphabetical PEFA scores, which range from the maximum score of 'A' to the minimum score of 'D', to numerical scores ranging from 4 to 1, with higher scores denoting better performance.[21]

First, at a disaggregated level, countries with a low or moderate risk of debt distress outperform countries in four areas critical to debt sustainability measured by PEFA, with the greatest difference seen in the quality of debt recording and reporting. Second, the conduct of Debt Sustainability Analyses (DSAs) is a strength for most countries, with 24 out of the 36 countries with data scoring the maximum 'A' or '4' (i.e. undertaking a DSA annually for external and domestic debt over the last three years). This indicator does not, however, measure whether countries actually use the results of the DSA to inform their borrowing decisions. Third, most countries, even those with a favourable debt distress rating, tend to perform poorly in terms of monitoring aggregate fiscal risk arising from activities at the sub-national levels of government, and across state-owned enterprises (30 of the 36 countries with data score 'C' or lower). This is a potential problem because poorly managed debt at these levels can eventually form part of the debt burden of central government.

The limited improvement in debt management observed in several countries despite several years of technical assistance has been attributed to institutional and organisational shortcomings. These include the fragmentation of debt management responsibilities across several government entities, lack of high-level ownership and support, and high staff turnover in the debt management units (World Bank and IMF, 2007; 2017).

Lack of demand and political commitment, particularly in countries where much public debt remains concessional, and particularly where it relates to the financing of investment projects, also explains the lack of attention paid by country officials to the development and implementation of an MTDS. The large sums involved in investment projects and their high visibility, coupled with the uneven spread of the costs and benefits of investments, means that decisions are unlikely to be based solely on technical factors such as the rate of return (Miller and Mustapha, 2016).

In addition, continued deficiencies 'at a more basic level' frustrate efforts to build capacity in more technical areas. One 'basic' area that has

18 The DeMPA is a methodology for assessing public debt management performance through a comprehensive set of indicators spanning the full range of government debt management functions. The most recent DEMPAs, however, are not publicly available and cannot therefore be analysed in this paper.

19 PEFA is a methodology for assessing public financial management performance in a country. It measures the extent to which public financial management (PFM) systems, processes and institutions contribute to three desirable budget outcomes: aggregate fiscal discipline, strategic allocation of resources and efficient service delivery.

20 A critique of these diagnostic tools is that they largely measure how systems look, but not how they work in practice ('form' not 'function').

21 This numerical conversion is necessary for calculating the averages for each group.

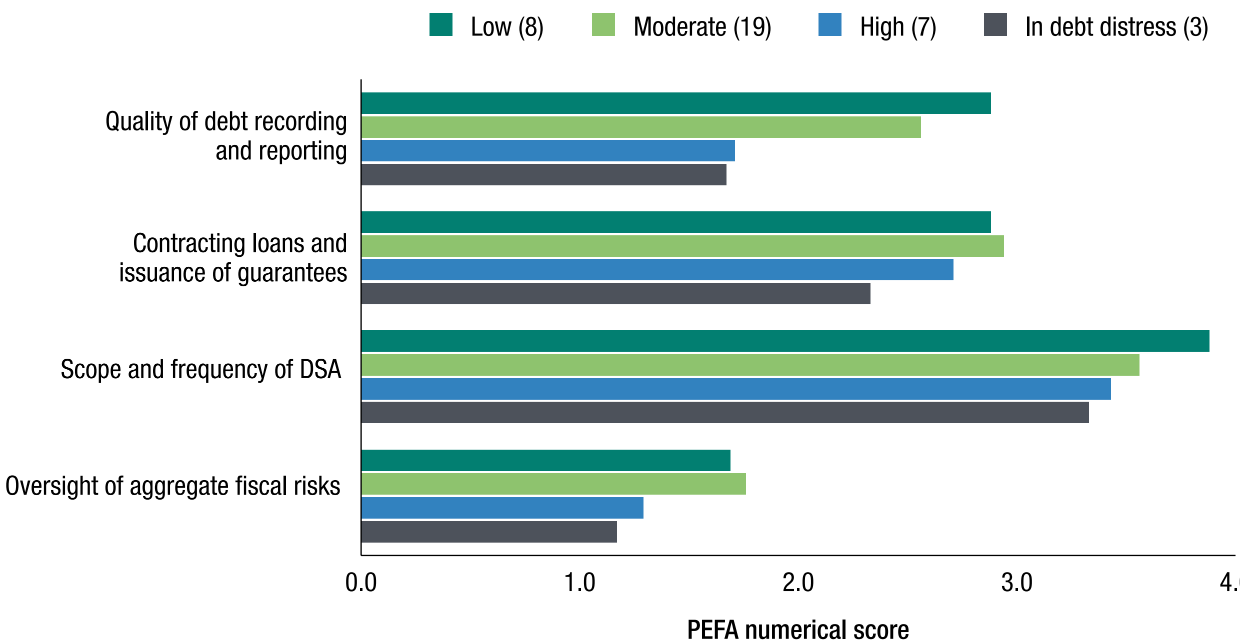
been problematic is the development of a capable and fully functional debt recording system (as shown in Figure 4). Roughly half of the 44 SSA countries with data[22] score higher than 'C' in this area in their most recent PEFA assessment. In addition, comparing the scores between the earliest and most recent assessments reveal that the score for roughly 60% of the countries has either deteriorated or remained static. Data on debt in LICs suffer from substantial gaps, particularly on public guarantees and the debt owed to public sector entities outside the general government. This can result in significant underestimation of public sector liabilities, while undermining the value of DSAs (IMF, 2015).

These deficiencies are worrying, because an accurate, consistent and complete database of public debt forms the basis for all debt management activities, including the cost-risk analysis of the debt portfolio, development of the MTDS, borrowing plans for MTDS implementation, and the provision of accurate forecasts of debt service. Data gaps have also contributed to unpleasant debt 'surprises' in several countries, as public liabilities that were not captured in the debt data have been converted into liabilities for the central government. Therefore, while some SSA countries need more sophisticated techniques both to analyse cost-risk trade-offs and to implement their chosen strategy, several are still in the process of building a solid foundation for debt management.

Effective debt management is necessary, but is not enough to prevent crises

Improving debt management is not a panacea. As noted, the widening of fiscal deficits is a key driver of the recent increase in public debt in SSA. If macroeconomic policy settings are poor, better sovereign debt management can ease the severity of a potential crisis, but cannot always prevent it. In most cases, countries need to make tough fiscal choices to prevent debt burdens from becoming unsustainable. At the same time, there

Figure 4 Comparing the quality of debt management across the risk of debt distress for 37 countries in sub-Saharan Africa



Note: oversight of aggregate fiscal risk indicator has data for 37 countries, while the other three indicators only have data for 36 SSA countries. Risk of debt distress is for the same year as the PEFA assessment. This ranged from 2010 to 2018, depending on the country.
Source: PEFA Secretariat and IMF Debt Sustainability Analysis.

22 This includes the 36 SSA countries included in Figure 4 as well as eight additional countries which do not have a debt distress rating.

are limits to what can be expected, realistically, in terms of raising domestic revenue and reducing expenditure in SSA.

While there is a wide consensus that countries need to mobilise more domestic revenue to ensure debt sustainability, and create fiscal space for much-needed investment and development spending, we have to recognise the limits of domestic revenue mobilisation as a policy lever. Many SSA countries already have revenue-to-GDP ratios that are higher, by historical standards, than they were in today's higher-income countries when they were at similar levels of development (Long and Miller, 2017).

Studies have also shown that SSA countries already exert higher tax efforts than countries at similar income levels in other regions (Fenochietto and Pessino, 2013; Long and Miller, 2017). Placing further pressure on the existing tax base to shoulder the debt repayment burden through new or increased taxes is likely to be counterproductive for the pursuit of the SDGs, impeding private investment and having an adverse effect on the poorest citizens (Long and Miller, 2017). Governments must, therefore, consider tax policy options that raise revenues in a way that is compatible with wider development objectives.[23]

Policy levers on the spending side face similar constraints. While there are no solid rules about how public expenditure should be cut, experience suggests some guidelines. On the one hand, cutting the public sector wage bill can generate major savings, but this is politically difficult and may have devastating social consequences. On the other hand, cuts to spending on public investment and essential operations and maintenance could damage economic growth.

There needs to be a focus on improving the efficiency of public investment to ensure that it helps to drive economic growth. While borrowing to finance public investment projects is justified on the grounds that it can generate higher growth, revenue and exports, leading to lower debt ratios over time, this assumed relationship between debt, investment and growth should not be taken for granted (Pritchett, 2000; Buffie et al., 2012). These are particular concerns for SSA, where public investment efficiency compares unfavourably to other regions (Barhoumi et al., 2018).[24]

Ensuring that the level of public debt and its rate of growth are sustainable requires the anchoring of debt management in sound macroeconomic policies and the efficient channelling of borrowing into productive uses that stimulate economic growth. Given the political nature of public investment and borrowing decisions, however, building robust institutions and capacity to facilitate responsible borrowing is likely to be a long-term endeavour, and one that requires high-level political support and ownership from country officials.

Challenges of transparent and sustainable lending

Promoting transparent and responsible lending

Although the primary responsibility for avoiding the build-up of unsustainable debt lies with the sovereign borrower, lenders should also lend in a way that does not undermine a country's future debt sustainability. Both borrowers and lenders can be adversely affected by sovereign defaults, and both are accountable for their own conduct in these transactions. Irresponsible borrowing

23 Possible options include efforts to combat the transfer mispricing activities of transnational firms more actively and effectively, including: better taxation of mining activities; increasing excise taxes on tobacco and alcohol; reducing tax exemptions for investors; implementing valued added tax (VAT) more effectively; more active taxation of the income and assets of the fast-expanding numbers of rich citizens; taxing the ownership and occupation of urban real estate more heavily; and obliging government agencies to be better 'tax citizens' (Moore and Prichard, 2017).

24 SSA countries could improve public investment efficiency by strengthening their planning and selection of private-public partnerships (PPPs), the credibility of multi-year budgeting, the effectiveness of project appraisal and selection, the monitoring of projects during implementation, and the registration of infrastructure assets (Barhoumi et al., 2018; Miller and Mustapha, 2016).

or lending can lead to 'illegitimate debt',[25] which can contribute to unsustainable debt burdens (Ellmers, 2016).

Attempts to address this problem have tended to focus on codes of conduct to bind official creditors to a common set of lending principles.[26] Examples include UNCTAD's Principles on Promoting Responsible Lending and Borrowing (2012); the G20's Operational Guidelines for Sustainable Financing (2017); and the OECD's Recommendation on Sustainable Lending Practices and Officially Supported Exports Credits (2018). However, none of these principles have been translated into codified law and none of them are binding and enforceable. As a result, they are rarely followed in practice.

Several different codes reflect the lack of a globally agreed set of standards, making it difficult to hold actors to account (Ellmers, 2016). Meanwhile, the growing importance of non-traditional creditors, (such as non-Paris club official bilateral lenders, plurilateral lenders[27] and commercial creditors), which did not participate in the drafting of these principles, is likely to further reduce their value and relevance.

Transparency and information-sharing among creditors is a particular area of concern. In the case of the G20 Operational Guidelines for Sustainable Financing, G20 countries committed to signal 'to IFIs' staff if large public liabilities appear not to have been included in the debt sustainability analysis of a debtor country.' Not only is this ambiguous, recent cases of 'hidden debt' in Mozambique, the Republic of Congo, and Togo also show that this principle is not always applied. Such data surprises are not new, nor are they unique to SSA. They have also been seen in Ecuador and were a feature of the Mexican crisis[28] in 1994 (the 'Tequila' crisis), as well as the more recent global financial crises, with opaque financial innovations involving government debt being one of the triggers.

Ensuring transparency is becoming even more complicated with the rise of collateralised loans. The terms of these loans are often complex and may be revealed only after countries experience debt distress and begin to default (as seen in Chad and the Republic of Congo). The terms may appear favourable at first, but debtors may be required to sell commodities to the lender at below-market prices or sell off public assets as part of the conditions. There are often information gaps beyond the basic lending terms on collateralisation and other types of security, which can make it difficult to determine the extent of risks for the debtor country, or even to assess whether the claims are commercial or official in nature (IMF and World Bank, 2018; Dreher et al., 2017).

In recent cases of insolvency in Chad (and also Venezuela), such collateralisation also made restructuring more complex because it reduces the room for manoeuvre for sovereign borrowers. Collateralisation grants these lenders seniority, limiting the ability of debtors to defer payments to them in the event of any restructuring. Ultimately, the growing importance of new types of lenders underscores the need to ensure that they exercise due diligence in their lending decisions and develop contingency plans to engage in debt restructuring deals.

Although the IMF and the World Bank have supported sustainable lending through direct outreach to Paris Club lenders for several decades, their engagement with non-traditional lenders is less formal and less extensive (IMF

25 For case study examples, see Eurodad et al. (2007).

26 Civil society organisations (CSOs) have developed their own set of principles, such as Eurodad's Responsible Finance Charter and Afrodad's Borrowing Charter. The Institute of International Finance, the global association of the financial industry, has also constituted a Working Group to develop a coordinated and voluntary information-sharing platform to improve the sustainability and transparency of private sector financing.

27 The term plurilateral creditor refers to official lenders with more than one shareholder that extend non-commercial credit to other sovereigns and that do not have universal/open memberships, unlike established multilaterals. See IMF (2018b), p.58 for a list of plurilateral lenders.

28 There was a lack of timely information on international reserves and the central bank balance sheet.

and World Bank, 2018). These non-traditional lenders are rarely part of an established creditor coordination and information sharing group. In addition, outreach to plurilateral creditors has been limited to date[29] (IMF and World Bank, 2018). There is a critical lack of clarity on how plurilaterals should be treated under the IMF's policy of non-toleration of arrears owed to official bilateral creditors, which gives individual official bilateral creditors (to which arrears are owed by the member seeking funds) a veto over lending decisions (IMF and World Bank, 2018). This is problematic, because lenders that misperceive their protections may lend too much for too long. More structured outreach to non-Paris Club and plurilateral creditors by the World Bank and IMF is warranted, therefore, and should aim to prevent unsustainable debt.

Building fiscal resilience to shocks through state-contingent instruments

Another important aspect of sustainable financing is the development of new financial instruments that embed more resilience into the debt structure of the recipient country, such as State-Contingent Debt Instruments (SCDIs). SCDIs can play an important role in managing public debt in a world of macroeconomic uncertainty. The impacts of economic shocks on several SSA countries have been exacerbated by structural challenges, including low levels of economic diversification and an acute dependence on commodity markets to drive growth.

SCDIs can build fiscal resilience to such shocks and share risk by linking debt service to pre-defined macroeconomic variables. This, in turn, will alleviate pressure on debt obligation and financing needs in difficult times, avoiding the disruption caused by a formal default. The dead-weight costs of long-term debt restructuring during a crisis would be avoided, as debt would be modified automatically (Bank of England, 2016).

Debt service, for example, can be linked to a country's GDP growth, to changes in commodity prices, or to natural disasters such as hurricanes or earthquakes. This means that any shock that reduces fiscal space – such as an economic downturn or a natural disaster – will reduce or freeze a sovereign's debt service burden. By increasing their fiscal space, governments can increase spending (especially in public investment) to help sustain growth and, therefore, to mitigate the impact of adverse shocks. They can also significantly reduce the likelihood of a sovereign debt crisis or a major debt restructuring.

The economic case for SCDIs as a countercyclical and risk-sharing tool has been around for some time, with many SCDI proposals suggested over the past three decades,[30] but their take-up has been limited to date. These instruments have been used in only a handful of cases in recent years, most often in the context of a debt restructuring exchange.[31]

There are three obstacles to the full implementation of SCDIs. First, the higher liquidity and novelty premium charged when SCDIs are first issued. Second, the potential stigma associated with being such a 'first-mover.' And third, an increased risk of 'moral hazard', with the borrower taking excessive risks in the knowledge that relief will be provided (IMF, 2017).

These obstacles are not insurmountable,[32] however, and some have been seen as exaggerated (Panizza, 2015; Griffith-Jones, 2018). At the same time, the large-scale issuance of SCDIs is unlikely without official sector support, particularly from multilateral and regional development banks and the IMF. This may involve the official sector

29 A few plurilaterals have attended the Multilateral Development Bank Forum organised by the World Bank.

30 Examples include Krugman (1988), Shiller (1993), Borensztein and Mauro (2004), Summers (2015), and Blanchard et al. (2016), Bank of England (2016), Griffith-Jones and Hertova (2012), Williamson (2017).

31 Examples include the use of state-contingent bonds in the Brady deals from 1989 to 1997. More recently, SCDIs have featured as part of the major restructurings of the past decade: Argentina (2005 and 2010), Greece (2012), Ukraine (2015) and Grenada (2015).

32 Careful instrument design, robust institutions, contracts and regulation could help address the key barriers to SCDI market development (IMF, 2017).

partnering with the private sector to develop commonly agreed model contracts to mitigate the start-up costs associated with the design of SCDIs. Work by the Bank of England in a working group with private investors to produce a model contract[33] is an important first step (Manuelides and Crossan, 2018).

Multilateral or regional development banks could play an active role as 'market makers' for GDP-linked bonds and SCDIs more broadly. They could begin by developing a portfolio of loans, with the repayments indexed to the economic growth rate of the debtor country (Griffith-Jones, 2018; Ebrahim and Tavakoli, 2016).

Although there are few concrete examples of introducing state-contingent features into lending, the introduction of countercyclical provisions in the form of Hurricane Clauses by the Government of Grenada and its creditors, and by Agence Française de Développement (AFD), through its countercyclical loan portfolio,[34] has paved the way for other development finance providers and sovereign borrowers to implement and harness the benefits of SCDIs. This type of initiative by bilateral agencies and MDBs would allow financial markets and borrowers to become familiar with such instruments and would be similar to the pioneering role they played in helping to introduce local currency debt.

Another avenue for the issuing of GDP-linked bonds could be for developed countries, whose GDP growth tends to vary less than that of emerging and developing economies, to start issuing such bonds. This has already been a fruitful avenue for financial innovation, as seen in the introduction of collective action clauses[35] into debt contracts, first by developed economies, and later by emerging and developing economies (Griffith-Jones, 2018).

While official sector support is far from guaranteed, the G20 has done important work in this area, and a number of meetings have been organised by the official sector, including the Bank of England and the Banque de France. Most IMF directors see only a limited role for the official sector in fostering the large-scale market development of SCDIs, but there is some appetite for supporting issuances for small economies that are subject to large shocks, including natural disasters (IMF, 2017).

Conclusion and areas for further research

Risks for future debt sustainability in SSA have increased significantly over recent years, and a potential debt crisis could pose a significant challenge to the financing and achievement of national and global development plans, including the pursuit of the SDGs. While sovereign borrowers have the primary responsibility to keep debt on a sustainable path, both borrowers and lenders can take action now to mitigate the risks of a debt crisis and make financial systems more resilient.

As discussed in this paper, these actions include building capacity at the country level to manage debt and public finances, enhancing transparency and information sharing on both the borrowing and lending side, and supporting the issuance of SCDIs. There are, however, some evidence gaps that require further empirical research.

- First, while financing the ambitious SDG agenda has been costed, there have been no analyses to map who is going to foot the bill or the likely implications for debt sustainability and debt service. With official development assistance flat-lining over recent years (and growing pressure on budgets in donor countries), options include loan and bond financing. Partner country governments and development partners need to be aware of the implications of financing

33 This is also called a term sheet for GDP-linked bonds.

34 These loans have adjustable grace period tied to exports.

35 Collective action clauses (CACs) define majority-voting procedures to alter the financial terms of the outstanding debt instruments and can limit the incentive or ability of individual creditors to initiate litigation against the debtor, in case of a sovereign debt restructuring. They may help to bring about a more orderly and prompt restructuring, which in turn could also help governments reduce the large macroeconomic costs that might ensue if they are unable to restructure unsustainable debts in an orderly and predictable fashion.

national and SDG plans for future debt sustainability and debt service, informed by a reality check on the potential financing options. This requires a mapping of the risks associated with the increase in non-concessional sources of finance and the less favourable macroeconomic conditions for debt sustainability.

- Second, there are several public debt management manuals, guidelines (e.g., IMF, 2014) and diagnostic tools to assess a country's debt management capacity, but there is relatively little empirical evidence on which reforms work and why in different contexts. This is in contrast with the numerous political economy studies that have been conducted for tax reform and public investment management (e.g.: Premchand, 2007; World Bank, 2011; de Paepe et al., 2017, Moore, 2015). Given the predominantly technical approach of most debt management literature, there is a particular need for research on the underlying non-technical drivers and constraints facing country officials responsible for keeping debt on a sustainable path, and how these influence efforts to strengthen various aspects of debt management. DeMPAs is a valid starting point for such research, but needs to be supplemented by other sources of information. Research is needed to offer concrete guidance on how stakeholders and external supporters can take non-technical drivers into account and better calibrate their approaches to reforms.
- Third, to ease the impact of adverse shocks on countries, particularly those vulnerable to large external shocks, the international community should aim to unleash the potential of SCDIs. Potential issuers can find it complicated to evaluate the suitability of a particular SCDI design in supporting domestic and international policy objectives—especially in times of distress (IMF, 2017). There is scope for further research that explains the various features of SCDIs in collaboration with IFIs, MDBs and practitioners, both in the public and private sector. This could identify potential investors in the GDP-linked debt of emerging and developing economies. There should also be further research into the value for money of incorporating SCDIs into the lending of official creditors, whether multilateral or bilateral.

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