KEY MESSAGES

• Debt resolution in Africa, especially outside Paris Club processes, has often been disorderly and protracted, with costly economic consequences. These costs have been less severe in countries that acted preemptively and collaboratively and in those where economic governance was stronger.

• To avoid high debt resolution costs in the future, the international community needs to push for changes to the international financial architecture for sovereign debt restructuring. The current global architecture is challenged by the emergence of new creditors, a lack of transparency that complicates burden-sharing, and a race to seniority, which may make it difficult for future debt restructuring operations.

• African countries also need to innovate or keep abreast of innovations in financing instruments, both legal (such as collective action and aggregation clauses) and financial (such as value recovery and equity-like debt instruments). To deal with the recurrence of debt crises, it is time to reconsider whether state-contingent debt instruments that link debt service payments to a country’s ability to pay can be used extensively as a tool to minimize the possibility of future unsustainable debt dynamics. International financial institutions are in a position to partner in this effort, by providing debtor countries with incentives to own this initiative.

• But, ultimately, only bold governance reforms will help reignite growth and put Africa’s debt on a sustainable path. Africa needs to put in place policies to reignite growth, such as those related to digitalization and enhanced competition, those to reduce leakages, and, critically, those to enhance debt transparency.

Past debt jubilees were customary after wars or dramatic events. By wiping out debts, these debt cancellations sought to avoid polarization and social tensions. Today, the massive dislocations caused by the COVID–19 pandemic provide justification for the international community to hold a modern version of the debt jubilee to deliver significant debt relief—especially for poorer countries, such as many of those in Africa.

But Africa’s experience with debt resolution has historically been disorderly and protracted. For example, the Heavily Indebted Poor Countries (HIPC) initiative took more than a decade to be implemented. There are also ongoing, long-lasting litigations with external creditors over the debt of Angola, Republic of Congo, and Mozambique. Moreover, the changing composition of debt—from concessional creditors to private and nontraditional official creditors (see chapter 2 and the African Economic Outlook 2019)—makes even more pressing the need for changes to the international financial architecture for sovereign debt crisis resolution, especially for African countries.
The absence of orderly and successful sovereign debt resolution, especially with private creditors, makes the prospects worrisome for African economies, where debt has grown rapidly in recent years. Historically, sovereign debt restructuring has come too late and provided too little relief to facilitate a lasting exit from sovereign debt crises. Anticipating debt distress should be a top priority for Africa. Failure to do so could take a critical toll on economic progress.

To avoid another “lost decade” in Africa, regional policymakers and the international community must do their best to help align borrowers’ and creditors’ incentives, avoid disorderly sovereign defaults, and reignite growth. But African countries also need to do their share. They should chart a path forward by decisively shifting their governance systems to foster more sustainable and inclusive economic growth models.

Against this background, the chapter first explores the international financial architecture, and describes what makes sovereign debt resolution so difficult. After describing recent sovereign debt restructuring operations in Africa and elsewhere, it discusses needed changes in the international architecture to provide timely relief. Finally, it explores complementary changes in domestic and regional governance to help the continent turn a corner and lift growth prospects.

The absence of formal bankruptcy procedures has created free riding and asymmetric information problems, rendering orderly sovereign debt restructuring complex to achieve

In theory, sovereign debt crises come in two ways. The crisis can be related to illiquidity, when there are not enough liquid assets to meet debt obligations that come due. Given adequate adjustment and sufficient official support, the country can make its debt sustainable. Alternatively, a crisis can reflect a lack of solvency, when there is no policy path for the country, with or without official support, that will enable it to pay back its debt.

In practice, this is often a distinction without a discernible or practical difference. In either liquidity or solvency crises, a large and often uncertain amount of outstanding debt—potentially issued in multiple jurisdictions and held by different types of investors—raises coordination issues that hinder debt resolution. This is the dark side of countries’ increased access to varied sources of funding. In turn, the lack of coordination among creditors can generate at least two problems. On the one hand, the difficulty of coordinating actions can engender self-defeating strategies, with individual investors deciding to pull funds from a country on the expectation that other investors will also do, turning a liquidity crisis into a solvency one. On the other hand, when debt restructuring is needed, willing countries and investors can end up in the hands of investors who prefer to stay outside of restructuring negotiations (holdouts). Investors can hold out because of a lack of interest (free riders) or to get better conditions (through a unilateral agreement or by litigating).

The fundamental difficulty with sovereign debt is that there are no formal bankruptcy procedures, as there are in corporate bankruptcies. Sovereign debts cannot be legally discharged in bankruptcy, and resolution relies on the willingness of debtors and creditors to negotiate and their ability to successfully extract repayment (through litigation or political pressure).

Because there is no formal international bankruptcy mechanism for sovereigns, debt restructuring procedures have evolved over the past 40 years. The void has created free riding and asymmetric information problems, making it difficult to achieve an orderly resolution of debt default.

The existing architecture for sovereign debt restructuring places good faith negotiations between debtors and creditors at the core and has pushed a number of contractual innovations to facilitate such negotiations and reduce the likelihood that holdouts block the restructuring process. The main such innovation has been the introduction of collective action clauses (box 3.1), which removed the need for unanimity among creditors to restructure sovereign bonds and replaced it with a requirement to have only a majority of votes.
BOX 3.1 A brief history of the international financial architecture for debt resolution

Starting in the 1980s, emerging and developing countries began to dramatically change the way they addressed their financing needs. Their increasing integration in financial markets allowed these countries to reduce their almost exclusive reliance on multilateral banks, official bilateral creditors, and a handful of commercial banks, and instead start issuing bonds in international and domestic markets. The increased access to funds was supported by investors in many different jurisdictions. For investors, the development of hedging instruments (such as credit default swaps) created new opportunities for investment and risk diversification, which helped to increase the depth of sovereign bond markets and reduce financing costs. Unfortunately, rapid financial globalization also created greater vulnerability and increased the complexity of crisis resolution. The expansion and fragmentation of the creditor base complicated debt resolution, facilitating the emergence of holdout problems, which could not be addressed within the pre-existing framework, structured around the London Club, an informal group of private lenders modeled on the Paris Club of official creditors.

The debt crises in the late 1990s and early 2000s ignited a debate on how the international financial architecture should change to limit future crises. Arguments differed, depending on which problem required resolution. For some commentators, the crises were the result of failures in financial markets. For others, crises were mainly due to wrong economic policies. Those who blamed market failures believed any solution required the creation of an official financial safety net, which would function as a lender of last resort. In contrast, those who cited inappropriate economic policies believed it essential to design policies that mitigate moral hazard risks—that do not permit policymakers to take advantage of the protection of debt resolution to carry out suboptimal policies, and that do not permit investors to disregard risks when lending to sovereigns in the expectation of being bailed out. The debate focused on the intimately related nature of the reforms needed to improve crisis prevention and management. Two main approaches surfaced: one statutory-based and the other market-based. Proponents of the statutory approach argued for enacting legislation and creating an international institution with a capacity to guide situations where debt relief is necessary to restore sustainability. Proponents of the market-based approach advocated solutions that involve a minimum of institutional intervention. They advocated the creation of codes of conduct and the inclusion of a voting procedure within sovereign bond contracts, in the form of a collective action clause. It is the market route that was finally chosen.

Collective action clauses (CACs) facilitate the dialog between creditors and debtors. They allow a prespecified majority of bondholders to approve the terms of a restructuring of debt and impose it on dissenting bondholders. But because these CACs did not prevent a minority of lenders from obtaining enough exposure to a single bond to block its restructuring process, they can be used to prolong resolution by rogue creditors such as “vulture funds,” which typically purchase distressed debt on secondary markets at a significant discount and litigate aggressively in relevant jurisdictions.

To counteract the ability of holdouts to get around CACs, an improved version of collective action clauses, which allows bundling different groups of bonds, was published by International Capital Market Association (ICMA) in October 2014, and endorsed by the IMF and the Group of 20 (G20) of the largest global economies. The underlying objective of the reform was to fight holdout strategies by allowing the debtor and majority holders of one or more instruments to agree on restructuring terms and make them binding on all holders of those instruments. Recently Belgium and the United Kingdom introduced antivulture legislation, intended to shield sovereign debtors from rogue creditors.

Notes
1. The institution could take the form of either an international solvency regime (Sachs 1995; Rogoff 2003) or a sovereign debt restructuring mechanism, such as the one proposed by Krueger (2002).
2. These rogue creditors can prevent the operation of CACs if they hold up to a majority of 25 percent of the bond series under consideration, in line with London and New York laws.
3. ICMA is a not-for-profit membership association. It has around 600 members in more than 60 countries. Among its members are private and public sector issuers, banks and securities houses, asset managers and other investors, capital market infrastructure providers, central banks, and law firms.
4. In addition, other modifications of contractual clauses such as pari-passu, have been introduced in sovereign bonds. Pari-passu clauses guarantee that bondholders have the same priority as other creditors.
During restructuring, the IMF often plays an important role. In fact, through its debt sustainability analysis and its lending requirement that debt be sustainable with a high probability, the IMF often acts as the gatekeeper of debt restructuring. Moreover, when present, the IMF provides financing, serves as a commitment device to undertake reforms (through associated conditionality), supports negotiation, and through its macroeconomic framework, provides the relief envelope required to achieve sustainability. To minimize the potential moral hazard that authorities could use the presence of a safety net around the IMF to undertake irresponsible policies, IMF lending requires strict policy conditionality.

For the restructuring of official debt, the Paris Club—a group of 22 large official creditors—has developed a number of procedures to provide debt relief to less developed and poor countries in coordination with the IMF and the World Bank. For official creditors outside the Paris Club, debt restructurings proceed ad-hoc.

**Restructuring Sovereign Debt**

Countries have dealt with sovereign debt restructuring in different ways, depending on their specific circumstances, resulting in wide heterogeneity in outcomes across restructuring episodes.

Once a sovereign debtor facing default determines that a debt restructuring is needed, it should decide:

- How to announce the operation and how to treat upcoming payments.
- What liabilities will be part of the debt negotiations (the so-called debt perimeter).
- What extent and form of concessions to ask from creditors.

Different countries answer these questions in different ways, depending on their specific circumstances, which results in wildly different restructuring episodes. A growing body of empirical evidence shows that considering such differences helps explain the scale of the economic benefits and costs of debt restructuring operations.

**Announcing the process and managing upcoming payments**

In determining how to treat payments coming due, countries can opt for preemptive negotiations, which avoid accumulating arrears, or for a postdefault restructuring, in which case the relief is felt immediately as upcoming payments are not met, and arrears build up. Accumulating arrears can allow debtors to signal their intention to achieve significant relief. Similarly, governments can engage closely with creditors, or act unilaterally.

Examining various decades of debt restructuring with external private creditors, Asonuma and Trebesch (2016) and Trebesch and Zabel (2017) find that postdefault strategies and those that treat creditors in a harsher manner result in worse growth following debt restructuring. Buchheit and others (2018) note that sovereign debt restructuring can fail because it can result in debt relief that most creditors see as excessive and confiscatory or unnecessarily coercive; and that the longer-term costs of a poorly executed debt restructuring may be large. In part, these costs depend on the market’s perception of how the country will behave during the crisis.

**Defining what liabilities will be part of the debt perimeter**

While generally, trade credits, senior or collateralized debt obligations, and treasury bills (because of the need for continued short-term financing of the government) are left out of the restructuring perimeter (that is, which borrowings are included and which are not), these unwritten rules have been repeatedly broken recently. Both collateralized (including resource-backed loans, in which natural resources can serve as payment in kind, supply an income revenue stream to make repayments, or be used as collateral) and very short-term public debt have been included recently in debt restructuring operations.

One important decision is the extent to which the relief should be granted by holders of debts governed by domestic law versus holders of debt governed by foreign law. According to the African Legal Support Facility (2019) and Buchheit and others (2018), there are several considerations at play. On the one hand, the restructuring process
differs for the two types of debt holders. Authorities can enact domestic legislation to change the terms of domestic law–governed debt, which gives the sovereign strong tools to prevent disruptive holdouts. On the other hand, because local law–governed debt may be disproportionately held by local residents, including domestic banks, any restructuring could trigger a bank crisis and, through an ensuing credit crunch, worsen the prospects for restoring economic growth.

Other important considerations include whether to involve official creditors, how to treat claims held by other public bodies (such as central banks), and whether to include debt from state-owned enterprises (SOEs).

**Defining the extent and form of concessions to ask from creditors**

There are three main modifications to the financial terms of sovereign debt that the authorities can propose to creditors. First, the authorities can try to obtain principal debt reductions (so that the nominal value of debt is reduced). Second, they can attempt to extend maturities (this is almost always part of debt restructuring agreements). Third, they can reduce coupons.

Evidence shows that maturity extensions and interest rate reductions, which merely smooth out and reduce refinancing needs but do not affect nominal debt amounts, are not generally followed by higher economic growth or improved credit ratings. The so-called reprofiling of maturities, where bonds maturing in the short term have their maturities extended, has received recent attention. Reinhart and Trebesch (2016) show that the macroeconomic situation of debtors improves significantly after debt relief operations only if there are principal write-offs. Using Paris Club data, Cheng, Diaz-Cassou, and Erce (2018) find that restructurings involving principal relief lead to faster GDP growth than operations involving only maturity extensions and interest rate reductions (which do not reduce the nominal value of debt, but reduce the market value of debt, delivering net present value relief). Principal debt reductions also lead to a larger reduction in poverty and inequality. The flip side is that fiscal deficits are larger following principal debt reductions.

**Recent debt restructuring in Africa and beyond**

Between 1950 and 2017, African countries have restructured privately held external liabilities 60 times and reached 149 agreements with the Paris Club.

The historical record of sovereign debt restructuring in Africa is long and deep. Data from Asonuma and Trebesch (2016) show that African countries restructured privately held external liabilities 60 times between 1950 and 2017. In the same period, African countries reached 149 agreements with the Paris Club. Since 1980, African countries restructured domestic debt at least 18 times.

The recent period has featured intense debt restructuring activity, both with private external creditors and with China. Since 2015, four countries have restructured privately held liabilities and six have restructured Chinese debt. With a view to learning lessons for future operations, this section examines these processes, and also those outside Africa. Table 3.1 presents ongoing cases.

**Privately held debt restructuring in Africa has been challenging due to collateralized or hidden debts**

In Chad, a high-interest nontransparent resource-backed loan with a multinational trading and mining company allowed the firm to capture a large part of Chad’s oil revenues. The loan proved an obstacle to achieving sufficient debt relief. In 2015, the creditor agreed to lengthen the maturity of the loan, TABLE 3.1 Ongoing restructuring cases in Africa, September 2020

<table>
<thead>
<tr>
<th>Country</th>
<th>Type</th>
<th>Announcement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mozambique (“hidden loans” with foreign private creditors)</td>
<td>Post-default</td>
<td>Oct-16</td>
</tr>
<tr>
<td>The Gambia (private claims)</td>
<td>Preemptive</td>
<td>Jun-18</td>
</tr>
<tr>
<td>Republic of Congo (loans with commodity traders)</td>
<td>Post-default</td>
<td>Apr-18</td>
</tr>
<tr>
<td>Zambia (Eurobonds)</td>
<td>Preemptive*</td>
<td>May-20</td>
</tr>
</tbody>
</table>

In nearly all cases, China offered debt write-offs for zero-interest loans. But the operation raised its net present value. When Chad subsequently sought IMF support, it was required to restructure again. In an important breakthrough, the operation linked principal payments to oil prices, rendering the debt countercyclical. Other external loans remain under negotiation.

In 2016, democratic presidential elections in The Gambia resulted in a political transition to a new government. The government of The Gambia entered into negotiations with the IMF for a new Staff Monitored Program with the aim of ultimately transitioning The Gambia to an Extended Credit Facility (ECF), a medium-term lending facility to help poorer countries maintain sound policies. One of the preconditions to the 39-month ECF that The Gambia obtained in March 2020 was that the country attain “credible and specific” debt relief assurances from enough of its external creditors to ensure that the country’s debt was on a sustainable path.

In Mozambique in 2016, an IMF program went off track after hidden debts with private external contractors were uncovered. These debts led to a sharp deterioration in Mozambique’s debt sustainability rating and to a protracted restructuring process. The authorities reached out to private contractors who had government-guaranteed SOE loans, eurobond holders, and China. The eurobond was swapped in October 2019, three years after it was announced. The loans with contractors remain under litigation.

The Republic of Congo has been in litigation with external private creditors since 2014, with collateralized debt posing a major obstacle. After reaching the completion point in the Highly Indebted Poor Countries debt relief initiative in 2010, Congo accumulated substantial debt with China and commodity traders. This was partly done through nontransparent deals. In 2017, previously undisclosed oil-backed contracts were discovered. Before signing an IMF program in 2019, Congo restructured its debt with China (in 2018 and 2019) and an oil company (in 2018). Congo excluded local banks and regional instruments, as stress tests showed that restructuring bank exposures would trigger a bank crisis.

In Zambia in September 2020, the government initiated a creditor engagement strategy under the auspices of the G20 Debt Service Suspension Initiative (DSSI) and entered into a memorandum of understanding with Paris Club Creditors aimed at securing immediate debt service relief (in the form of postponed payments). The government made similar requests to all external commercial creditors. Consultation between the IMF and the Zambian authorities are ongoing regarding upfront debt management measures. The government sent a solicitation of consent to its eurobond creditors for a deferment of interest payments from October 2020 to April 2021. However, this request was declined. Eurobond creditors raised concerns about lack of transparency by the Zambian authorities to ensure that all creditors were treated equitably. Based on the pressure for equal treatment of all creditors, the government chose to default on a $42.5 million eurobond coupon payment due on 13 November 2020.

**Chinese debt restructuring in Africa mostly consists of write-offs for zero-interest loans**

From 2015 to 2019, China rescheduled $7.1 billion of debt with Angola, Cameroon, Chad, Ethiopia, Mozambique, and Niger. According to Acker, Brautigam, and Huang (2020), these operations had distinct characteristics. In nearly all cases, China offered debt write-offs for zero-interest loans. Importantly, there is no evidence of asset seizures, nor of the use of courts to enforce repayment (despite contract clauses requiring arbitration), or application of penalty rates. The technique used most was providing net present value debt relief, mainly through lower interest rates, longer grace periods, and substantially longer repayment periods. While China’s export-import bank is a lender in most restructuring cases, each of the multiple Chinese banks and companies that have provided credit to African governments negotiates separately.

**Recent defaults outside Africa offer important lessons for the continent**

Recent experience shows that both principal debt reduction and well-designed maturity extensions (reprofiling) can bring debt down to sustainable levels. Reprofiling can be less effective...
Participation was encouraged through techniques to strip holdouts of enforcement powers when a country faces a large debt overhang—when the burden of debt is so large that a country cannot pay it back. In those situations, debt restructuring operations may simply continue to deliver too little debt relief, too late.

Following an injunction from a New York state court obtained by Argentine holdout creditors in 2012 that prevented the authorities from making payments on new bonds, litigation has been on the rise. This increasingly confrontational stance was met with various techniques to facilitate participation and avoid litigation.

Taking advantage of the local nature of their public debt, parliaments in Greece (in 2012) and Barbados (in 2018) passed legislation retrofitting an aggregation clause in all local-law bonds, to allow them to hold a single vote with holders of all bond involved. Both subsequently used the clause to avoid holdouts. Other countries (Belize, Seychelles, and St. Kitts and Nevis) successfully used collective action clauses to restructure their external bonds.20

Participation was further encouraged through techniques to strip holdouts of enforcement powers. These included exit consents, delisting of bonds, and cross-default clauses. Additional techniques used to buy investor acceptance included the use of creditor committees and fiscal agents.21

Two additional factors were critical to generating investor acceptance and preventing long-lasting negotiations and negative effects on market access. First, a high degree of good faith in negotiations by the authorities. Second, the use of innovative financing terms—such as state-contingent debt repayments, value recovery instruments, and step-up coupon structures—to help build consensus. These instruments provided investors with potential pickup in case the countries grew out of their crises, and give authorities incentives to conduct prudent fiscal policies. The nonconventional design of the instruments made them so different from other debt instruments that it drained liquidity from them. An important aspect not always considered when issuing these instruments is that their design affects future financing needs and the cyclical properties of public debt (box 3.2).

CHALLENGES WITH THE CURRENT FRAMEWORK FOR DEBT RESOLUTION IN AFRICA

While restructuring in most emerging markets has been relatively smooth, preemptive, and with high participation of creditors, some episodes, especially in Africa, have been protracted, incomplete, and nontransparent

Chad, the Republic of Congo, and Mozambique have all experienced protracted restructuring processes due to the worsening of creditor coordination problems that has accompanied the broadening of the creditor base for sovereign borrowers.22

Even in countries where bonds had the most recent version of collective action clauses, the negotiations proved fraught since vulture funds remained active and litigated. During 2020, Argentina and Ecuador restructured bonds, which included the latest CACs from International Capital Market Association (ICMA). While both managed to restructure using the two-limb CACs (bond-by-bond voting plus aggregation across bonds), the negotiations showed that the authorities could use the single-limb voting mechanism (aggregate voting across bonds) to their own advantage.23

Not only did the prolonged negotiations required, despite the use of ICMA CACs, show the limits of the current contractual approach, but a significant amount of the sovereign debt has no aggregation clauses.

Another complication is that sovereigns are increasingly using collateralized and resource-backed borrowing, and the lack of transparency in those loans makes fair burden sharing more difficult and limits coordination.24 That complicates debt restructuring negotiations.25 This problem is most prevalent in countries where SOEs are a source of hidden debts, leakages, and corruption.

The shift in the creditor base toward new official lenders and collateralized and nontransparent debt instruments is especially concerning for lower-income African countries. Indeed, the shift to less transparent and collateralized instruments in Africa has already substantially complicated negotiations on debt resolution by making it harder to
The shift to less transparent and collateralized instruments in Africa makes it harder to determine the debt perimeter and the required contribution from different creditors (box 3.3).

While the global financial architecture should address the lack of transparency of some new creditors, which may complicate future debt restructuring operations, it should also acknowledge them as an additional source of financing that African countries badly need to address structural and economic dislocations, and invest in the growth that would make debt service possible in the future.

A final, closely related, concern is that domestic arrears (accrued, say, by not paying suppliers) have become an increasing source of forced financing in some parts of Africa.\footnote{Okwuokei and van Selm 2017.} Figure 3.1 shows the importance of this financing mechanism, using a selection of African economies. The figure uses data on fiscal arrears reported by the Bank of England.\footnote{At any rate, governments and multilateral institutions such as the African Development Bank should pay greater attention to the plight of this class of creditors.
While not paying suppliers (forcing them to become creditors) may free up funds to help cover borrowing needs, it can seriously damage the productive system and delay economic recovery. IMF (2019) finds that domestic arrears have a negative impact on growth through several channels, including hurting the profitability of the private sector and stressing the banking sector.\footnote{Moreover, by undermining trust in government, arrears can even reduce fiscal policy effectiveness. Nevertheless, domestic arrears emerge in all debt crises, and their clearance takes a long time, preventing economic recovery. According to the IMF, domestic arrears figure prominently in.

The experience of Belize, which has restructured its public debt three times in a little more than a decade, is instructive with regard to the risks posed by these coupon structures for future debt sustainability. In the past two Belizean debt restructurings, part of the reason additional debt relief was required was that the step-up coupons were kicking in, creating an increase in financing needs unmanageable for the authorities.\footnote{Note 1. Okwuokei and van Selm 2017.}}

**Box 3.2 The use of state-contingent instruments during sovereign debt restructuring**

The use of innovative techniques and instruments increased the likelihood of success of debt restructuring operations. As described in IMF (2020b), which focuses on the role of state-contingent debt in sovereign debt restructuring, since 2014, countries have deployed multiple features to foster investor participation. These have included more traditional value recovery instruments (VRIs), but also countercyclical and state contingent payouts (that relate debt service to a country’s ability to pay), and even incentives for prudent fiscal policy.

In Greece and Ukraine, VRIs were provided in the form of GDP warrants, which provided creditors with additional payments if GDP growth exceeded preagreed limits. St. Kitts and Nevis offered a portion of future tax revenues. These VRIs increased participation in restructurings, although at the cost of encumbering future revenues. Some debt operations have built-in contingencies that make debt service obligations countercyclical (natural disaster clauses).

Other countries preferred simpler structures, such as a step-up coupon structures, in which countries start paying lower coupons and, over time, pay increasingly larger coupons. Similar to GDP warrants, step-up coupons reflect the willingness of the market to accept that a sovereign’s economic prospects will improve over time. Step-up bonds are long-duration instruments and are more appealing to investors with a long investment horizon. Step-ups can help meet immediate cash flow needs, but problems can reemerge. However, the future increase in interest rates implied by the step-up can put pressure on governments.

The experience of Belize, which has restructured its public debt three times in a little more than a decade, is instructive with regard to the risks posed by these coupon structures for future debt sustainability. In the past two Belizean debt restructurings, part of the reason additional debt relief was required was that the step-up coupons were kicking in, creating an increase in financing needs unmanageable for the authorities.\footnote{Note 1. Okwuokei and van Selm 2017.}
**BOX 3.3 Leveraging natural resources for development financing**

Resource-backed loans (RBLs) are loans provided to a government or a state-owned company, where:

- Repayment is made directly in natural resources, such as oil or minerals, or from a resource-related future income stream.
- Repayment is guaranteed by a resource-related income stream.
- A natural resource asset serves as collateral.

Resource-backed loans are primarily used for infrastructure development. They may offer cheaper financing, can be structured to mitigate volatility, and can be renegotiated if times get difficult.

Between 2004 and 2018, 30 of 52 RBLs analyzed were signed by African countries, and 22 by Latin American countries. The majority of the loans (43) were backed by oil, 6 by minerals, 2 by cocoa and 1 by tobacco. The loans totalled $164 billion, of which $66 billion went to Sub-Saharan African countries, and $98 billion to Latin American countries.

African RBLs have typically represented a higher proportion of their economies than those in Latin America. The largest in this respect is Guinea's $20 billion RBL, signed in 2017 with a consortium of Chinese companies equivalent to nearly 200 percent of the country’s GDP. The second largest ratio was the Republic of Congo's 2006 RBL of $1.6 billion, or 21 percent of the country’s GDP that year. Third is Democratic Republic of Congo's 2008 Sicomines infrastructure deal with China, which was USD 3 billion, or 16 percent of the country’s GDP.

RBLs have been a major source of public finance risk. Of the 14 RBL recipients, 10 experienced serious debt problems after the commodity price crash of 2014, with RBLs often cited as a key contributor. RBLs are also opaque. Contract documents were public in only one case, and even basic information such as the loan’s interest rate was identifiable in just 19 of 52 cases surveyed.

RBLs can undermine a country’s ability to take part in an orderly default, because they may still need to be serviced from oil production or because of the risk of losing the collateral. This can happen even when the country is in default on other obligations and unable to pay for basic services. However, the mutual interdependence between RBL borrower and lender creates stronger opportunities to renegotiate.

For countries to better leverage RBLs for financing their development needs, there is a series of issues to be recognized:

- Recent steps taken by the Extractive Industries Transparency Initiative and others have improved transparency norms applicable to RBLs. Practice should follow so all key terms of each loan contract are promptly made public.
- Given their complex nature and importance, RBLs and the associated spending should not be executed by SOEs. Rather, they should be brought on budget, vetted by countries’ ministries of finance, and made subject to parliamentary scrutiny (where applicable).
- Governments should encourage competition among RBL providers on loan terms. This will help governments secure the best possible deals when presented with alternative options.
- Using resource rights as collateral should be avoided. Rights to subsoil wealth make for poor collateral. They are hard to value appropriately, likely to be politically and legally contested, and likely worth less to a lender who will have difficulties utilizing them without government’s support.
- Governments need robust institutions with the capacity to negotiate deals as complex as RBLs. This includes expertise in contracting economic modeling of loan conditions, valuation of resources used for repayments, and unbiased technical assessment of projects.

Source: Mihalyi, Adam, and Hwang 2020.
The G20 DSSI initiative is too limited for the size of the debt problem.

IMF arrangements. Since 2002, more than two-thirds of IMF arrangements in Sub-Saharan Africa include conditionality related to domestic arrears.\textsuperscript{29}

\textbf{INITIATIVES TO FIX THE INTERNATIONAL ARCHITECTURE FOR DEBT RESOLUTION}

The international architecture for debt resolution could benefit from legal reforms, financial innovation, enhanced global coordination, and a deepening of the toolkit available to international financial institutions.

To ease the burden associated with the COVID–19 pandemic, the international community has stepped in with several initiatives and enhanced international coordination. The Group of 20 (G20) has championed the Debt Service Suspension Initiative (DSSI), a relief initiative aimed at official bilateral creditors, which was recently extended until June 2021.\textsuperscript{30} The DSSI—which includes both the 22 Paris Club creditors and nontraditional official creditors including China—has postponed tens of billions of dollars in debt payments.

The G20 DSSI initiative is positive and welcome. The inclusion of nontraditional official creditors is a significant step toward global coordination. However, it is too limited for the size of the debt problem.\textsuperscript{31} Failure to include all actors limits the scope of any relief agreement. Indeed, although the DSSI called on private creditors to agree to provide similar terms if asked, the initiative has fallen short of including them (as in Zambia). On the one hand, debtors fear that private sector debt relief under DSSI could lead to rating downgrades, hurt reputations, trigger cross-default clauses and bring legal challenges. On the other hand, debt relief should use the contractual interest rate as a discount factor. Because market rates are currently above contractual rates, creditors have no incentive to provide relief. In addition, the initiative does not include debt problems in middle-income countries.

The rest of this section explores different proposals to facilitate debt restructuring and reduce the incidence of debt overhang.

\textbf{Various reforms in contract design seek to enhance countries’ ability to engage with creditors and avoid litigation}

Various alternatives to the design of bond and other debt contracts that could facilitate future

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{fig3-1.png}
\caption{Domestic arrears in Africa}
\end{figure}

Source: Beers, Jones, and Walsh 2020.
Debt restructuring operations are discussed below.

**Legal reforms**
Various legal changes could be considered to enhance the ability of countries to engage with creditors and avoid the negative implications of suffering from holdout creditors willing to litigate. Countries could consider including the ICMA Collective Action Clauses not only on their sovereign bonds, but also on bonds issued by subsovereign bodies and SOEs. Consideration could also be given to including aggregation clauses on bank loans so that they can be bundled with bonded debt. Countries could also consider the use of creditor committees. While debtor countries, usually opted for informal consultations with individual creditors or groups of creditors since the 1990s, committees have reappeared more recently. This is not only because creditors prefer committees, but also because without a formal endorsement by a creditor committee, the consultations may prove ineffective and restructuring may fail. Finally, along the lines of the recent recommendations of the IMF (2020a), it would be advisable that countries include negative pledge clauses in sovereign bonds that prevent sovereigns from pledging certain assets as collateral. This would reduce the impact that collateralized debt can have on bond valuations during default.

**Financial innovation**
Despite the low-growth environment that is propelling debt distress to the forefront of Africa’s policy agenda, the concept of debt restructuring for growth is remarkably absent from ongoing discussions regarding the resolution of sovereign debt crises.

Financing instruments can make debt easier to manage if their terms accommodate the appearance of shocks. This type of state-contingent instrument can be used both during debt restructuring, as a way to elicit creditor participation by offering additional recovery to creditors, and during normal times, as part of a diversified funding strategy. Their use increases a country’s resilience by reducing the procyclicality of debt.

**State-contingent debt as a restructuring technique.** In addition to the value recovery instruments (VRIs) issued by Greece, St. Kitts and Nevis, and Ukraine during their recent sovereign debt restructuring operations (see box 3.2), other countries have ventured into designing restructured debt instruments with built-in contingencies that make debt service obligations countercyclical. Barbados and Grenada included a creative growth-enhancing solution to a critical problem of countries exposed to climate risks: a standstill clause in case of a natural disaster. In Grenada, the clauses were introduced in foreign-law bonds, Paris Club debt, and debt with Taiwan’s export-import bank. They were designed to generate no losses when compared with market rates at the time (what in the jargon is defined as being net present value, or NPV-neutral), making them acceptable to investors. Barbados attempted to introduce the clauses in both domestic and foreign debt, which extended the negotiations, but the country only succeeded with domestic law bonds. In Chad, a 2018 restructuring operation tied principal payments to oil prices so debt service now has countercyclical features. The approach followed in Chad could not only be seen as a template for other countries that may struggle to repay resource backed loans in the future, but as a lending design that could be made a regular approach to sovereign financing.

Regular state-contingent financing. The main idea behind state-contingent financing is to help sovereigns preserve policy space to undertake measures that can mitigate the economic impact of adverse shocks. By tying sovereign obligations to a variable that proxies the sovereign’s capacity to pay, state-contingent financing stabilizes debt stocks and/or financing needs.

Countries such as Portugal, Germany, and the United States have successfully issued part of their liabilities linked to macroeconomic indicators, such as inflation and GDP. Emerging markets also have had experience with contingent instruments (such as Argentina’s use of warrants and Mexico’s use of indexation against oil prices).

Despite the risk-sharing benefits of state-contingent debt instruments, they are expensive, which discourages their use. Debt instruments, given their simple cash flow structure, are informationally less demanding than equity-like
A number of recent restructurings have featured clauses that make debt relief contingent on reform implementation. The objective of these clauses is to provide incentives to pursue responsible fiscal policies. The design of these clauses has varied. Some countries tied the conditions to the country’s performance under an IMF program, while others tied conditions to fiscal policies. In turn, while some designs provided all the debt relief from the start and could claw it back if the targets were missed, others sequenced debt relief, making later parts conditional on meeting specific targets. Regardless of whether the clauses are designed as a carrot or a stick, they have one major advantage and one major drawback. The advantage is that they provide incentives to conduct prudent fiscal policy. The drawback is that they can limit the authorities’ countercyclical firepower, effectively inducing procyclicality. While such an effect may be unavoidable, a better understanding of the instruments can help design more effective debt restructuring operations. Another widely discussed alternative is to introduce a clause in bond contracts that automatically extend the maturity if a country requests an IMF program.

Enhanced global coordination is needed to facilitate debt resolution

There are several potential avenues to minimize the coordination and burden-sharing problems that plague negotiations with private creditors.

Reinforced comparability of treatment clauses

A first, straightforward way to minimize the holdout problem is to leverage the official sector to achieve private sector participation. This would amount to arranging a framework that coordinates all official creditors and can translate official commitments into binding commitments by private creditors. In fact, this is an extended version of the Paris Club. The first necessary element, a framework...
DEBT RESOLUTION AND THE NEXUS BETWEEN GOVERNANCE AND GROWTH

Another way to reduce the deadweight loss of belated and insufficient debt restructuring is to design buffers and policies that reduce their negative effects.

Central credit facility
Bolton and others (2020) made a widely discussed proposal for designing a private sector standstill. They propose that multilateral institutions “create a central credit facility allowing countries requesting temporary relief to deposit their stayed interest payments to official and private creditors and borrow from it for emergency funding to fight the pandemic. Principal amortizations occurring during that period would also be deferred, so that all debt servicing would be postponed”. The facility would be monitored to ensure that the payments are used only for emergency funding related to the global pandemic.

Auction-based debt buyback
Willems (2020) has proposed using an auction-based strategy to restructure sovereign debt that tailors the shape of the restructured debt stock optimally to creditor preferences, subject to debt being sustainable after restructuring. Any debt relief provided to the country gets optimally distributed among its creditors, thus minimizing the pain inflicted upon them.

Other global governance reforms
At times, the international community had the appetite for a more proactive approach. For instance, a UN Security Council resolution was used in 2003 to shield Iraq’s assets from creditors. Buchheit and Gulati (2020) and Gelpert and Hagan (2020) propose to replicate such an approach to resolve the debt crisis that the COVID–19 pandemic has triggered. Also, domestic legal measures in the United States and the United Kingdom—most international sovereign bonds are governed by New York state or English law—could be considered to further reduce incentives to hold out and litigate.

Additionally, there have been two recent proposals for mechanisms to facilitate the resolution of debt overhang using a centralized facility. Neither has been subject to empirical or practical validation, and both should thus be considered with extra caution.

DEEPENING THE TOOLKIT OF INTERNATIONAL FINANCIAL INSTITUTIONS CAN HELP MITIGATE THE NEGATIVE EFFECTS OF BELATED AND INSUFFICIENT DEBT RESTRUCTURING

Another way to reduce the deadweight loss of belated and insufficient debt restructuring is to design buffers and policies that reduce their negative effects. In fact, one important reason that restructurings occur too late and are suboptimal is the unwillingness of governments to act sooner and more forcefully out of concern for their reputation and the risk of losing access to markets. Institutions directed at supporting the restructuring process, such as the African Legal Support Facility, might help overcome debtors and creditors concerns (box 3.4).
Partial multilateral guarantees were successfully deployed to facilitate buy-in by investors during a few recent debt restructurings. The first operation was for Seychelles, featuring a guarantee from the African Development Bank for part of the interest payments on the debt from a restructuring operation. This was critical to generating investor acceptance of the offer. In 2011, St. Kitts and Nevis carried out a public debt exchange that also included a partial multilateral guarantee, in this case from the Caribbean Development Bank. In Greece, an exchange included a “co-financing agreement” with the European Financial Stability Facility to align the priorities of bondholders with those of some official lenders. Such policy tools could be examined with a view to adapting them to future debt crises.
International financial institutions (IFIs) can also play a key role in jumpstarting a contingent debt market. Moreover, contingent loans can be less capital-intensive, meaning that they require the lender to hold less capital to back the operation, than traditional loans. The African Development Bank and other IFIs are uniquely placed to provide state-contingent lending. Successful examples already exist, such as the lending provided by Petro Caribe and the French Development Agency, and the use of swaps to hedge currency risk by the Caribbean Development Bank. Other attempts—such as the Fight COVID–19 Social Bond of the African Development Bank and the interest rate swaps used by the European Stability Mechanism—may hold important design lessons.\(^{42}\) Along these lines, the IMF (2020a) proposes to use official loans with extendable features and climate-resilient debt instruments.\(^{43}\)

IFIs can also help design a more robust governance system, potentially including fiscal rules and independent and accountable fiscal councils, which will be discussed in the following section. Also, IFIs could try to obtain the right to claw back funds from officials who embezzle and commit fraud and similar crimes, and to prosecute them internationally if needed (currently this is undertaken by individual sovereigns). IFIs may be able to inject more legal strength into the recovery process—which could include criminal penalties applicable not only to individuals but to entities that support such behavior.

IFIs should also lead the way by devising instruments that support investments in low-income countries. These instruments should include the private sector through such mechanisms as public–private partnerships, debt swaps, and equity and quasi-equity investments.

**GROWING OUT OF THE COVID–19 AND DEBT CRISIS: THE NEXUS BETWEEN GOVERNANCE AND GROWTH**

A deep shift in the governance system coupled with reignited growth will be essential for preventing any need for a future debt jubilee

The historical record shows that debt restructuring has not delivered lasting resolution of crises and has instead left countries unreformed and unable to grow. This highlights two intertwined problems of the current framework. First, the framework fails to facilitate early restructuring and fair burden-sharing. Second, the framework fails to elicit genuine reform of economic governance.

Extensive research links governance, debt restructuring, and growth. According to Reinhart, Rogoff, and Savastano (2003), when a country goes into default, its already-weak institutions can become weaker, making the country vulnerable to further debt problems. Fournier and Betin (2018) provide robust evidence that government ineffectiveness, as measured by a broad-based perception index of the World Bank’s Worldwide Governance Indicators database, is a key driver of sovereign default.\(^{44}\)

Moreover, although financing was widely available at historically low rates in the 2010s, many African countries did not take full advantage of that opportunity to support growth, because some spending was wasted or spent on investment projects with low economic and social returns. Evidence suggests that Africa has a public investment efficiency gap of 39 percent, higher than either Europe (17 percent) or Asia (29 percent).

If future investment programs are to pay for themselves, policymakers must be aware that the quality of institutions is the most important determinant of public investment efficiency. Figure 3.2 examines that link for 60 episodes of sovereign default in African countries. The data on sovereign defaults, which comes from Asonuma and Trebesch (2016), cover defaults and restructurings on privately held external sovereign debt. Governance is measured using the International Country Risk Guide (ICRG) index. The figure compares average output dynamics after a sovereign debt restructuring and shows the extent to which growth following debt restructuring depends on a country’s governance structure.

Since primary deficits (excess of expenditure, excluding interest payments, over revenue) and growth are key variables in debt dynamics and sustainability analysis, the rest of this section discusses reforms needed to reduce debt vulnerabilities through better public financial management and higher and sustained growth.\(^{45}\)

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The current framework fails to facilitate early restructuring and fair burden-sharing and to elicit genuine reform of economic governance.
African countries need to do their share by eradicating all forms of leakages in public resource management

A critical governance reform should include the elimination of leakages of all forms in public resources, to ensure that the resources efficiently reach their intended beneficiaries or projects while being used efficiently, productively, and transparently. Leaks have been found to be significant in several public expenditure tracking surveys conducted in Africa. Because government coffers are emptying, countries should consider aggressively eradicating leakages and curbing capital flight to create fiscal space and reignite growth.

Eradicating leakages will require strengthening public financial management (PFM)—a multi-dimensional approach that focuses on how governments raise revenues, set spending priorities, allocate resources, and manage delivery of those resources (box 3.5). While recent public expenditure and financial accountability assessments show that the overall performance of PFM institutions has improved, there is variation across countries and within the PFM components. Upstream, budget formulation and reporting are improving, as is revenue administration and collection, but further improvement is needed in budget execution—including procurement, accounting, and control. Downstream, the key weakness is in checks and balances, especially integrity and oversight institutions (due to the dominance of the executive branch of government). Furthermore, given uneven progress in implementing PFM reforms among African countries, it is hard to assess the impact of reforms on overall PFM system quality and, in turn, on service delivery outcomes. This challenge is far more daunting in fragile states.

Successful reforms typically culminate only after a long process. Furthermore, these successes are underpinned by enhanced capacity of institutions and stakeholders to implement reforms that at times require tough choices. Conversely, uncoordinated initiatives and overly complex solutions (such as premature introduction of information management systems) have yielded unsustainable results with far-reaching implications on countries’ development trajectory. This means that progress in modernizing PFM institutions within countries needs to be measured in small and incremental steps. The conventional approach to PFM reforms is to assess the functionality of PFM systems based on factors such as stability and allocative and operational efficiency. The emerging trend of reforms is to shift the focus toward four fundamental dimensions that PFM functionality should promote: prudent fiscal decisions, credible budgets; reliable and efficient resource flows and transactions; and institutionalized transparency and accountability, including in the natural resource sector.

Improved governance of public finances will not only help create fiscal space in the short run to allow governments to spend on public needs, but will also pave the way for more sustainable medium-term fiscal frameworks, which will help reignite growth. Good governance and more vigorous and robust growth can also set the stage for more profound changes in the way sovereigns obtain financing, potentially enabling African countries to use state-contingent debt instruments that link repayment schedules to capacity to pay based on economic developments.

FIGURE 3.2 Growth and governance in the aftermath of sovereign debt restructuring

Note: Governance is measured using the ICRG political risk index. A value of the index above 40, which corresponds to being outside the top decile of performers, is considered an indicator of bad governance.

Source: Asonuma and Trebesch (2016) for sovereign defaults and IMF World Economic Outlook for real per capita growth rates.
Improved governance of public finances will help create fiscal space in the short run to allow governments to spend on public needs, and pave the way for more sustainable medium-term fiscal frameworks.

The following subsections focus on three key components of PFM—domestic resource mobilization, debt management, and budgeting—and ways to improve them.

**More resources should be mobilized domestically while deepening local capital markets**

Increasing government revenues through taxation and other non-debt income sources is essential to reduce vulnerabilities and allow countries to address their specific development challenges. However, the size of the informal sector in Africa limits the tax base. Informal employment in Africa accounts for 85.8 percent of total jobs, the largest percentage in the world. To promote formalization, policymakers could take a broader strategic approach that seeks to register informal firms not only to tax them but to protect their rights, entitlements, and assets as entrepreneurs. The attractiveness of the formal sector can be enhanced, for example, by providing greater access to resources and information, pension schemes, social insurance, or other incentives—conditioned on registration—through intermediaries such as business associations, nongovernmental organizations, or local community groups.

Effective domestic resource mobilization (DRM) also requires a solid database that allows the identification and location of the individuals, firms, or land properties on which to levy a tax. It is essential for countries to invest in well-managed civil, business, and land registries while building
simple but efficient address systems. The creation of unique identifiers for individuals, firms, and properties in these registries will also be necessary to facilitate information-sharing among different government agencies such as tax authorities, statistical offices, and social security authorities.

In many African countries, tax laws and rules are overly complex and reduce compliance rates. Transparent and easily implementable tax regulations can help increase certainty around the application of legislation, while reducing tax enforcers’ discretionary power (such as the ability to give tax exemptions, determine tax liabilities, and select firms to be audited). Digital technology offers great potential to increase DRM, particularly in the way tax administrations can improve their efficiency and help taxpayers comply. For example, in Kenya the money-transfer system M-Pesa includes an online application for taxes (the iTax System). Such an electronic filing system can save time and increase compliance by making it easier to prepare, file, and pay taxes.

Tax administration must invest in human, financial, and technological resources for improved performance. Tax inspectors in particular need appropriate incentives to detect tax evasion and reject bribes offered by noncompliers when caught. Relying on tax inspectors’ intrinsic motivation for honesty is clearly not sufficient. Unfortunately, the question of what incentive structure could motivate inspectors to conduct costly monitoring is important but unanswered. A program for mindset change such as Kaizen, the Japanese process for continuous improvement of operations, could be implemented while working to create a performance-based culture. Although kaizen originated in manufacturing, its principles and practices translate well into other work situations.

Because enforcement capacities are weak in many African countries and hard-to-tax sectors, such as informal companies, predominate, those countries should seek to promote voluntary tax compliance to increase domestic revenue mobilization. Campaigns to increase awareness of the importance of tax compliance could help. More importantly, governments should visibly use tax revenues for public welfare—by providing quality public goods and services. An important issue that is often overlooked in policy discussion is state legitimacy (box 3.6).

Finally, resource mobilization should not be restricted to tax revenue, in part because tax increases are procyclical. Resource mobilization should also include better allocation of savings to productive investments by shifting incentives for the banking system toward the core functions of payment, price discovery, information production, and intermediation. That can be accomplished by a combination of better macro policies and more competition in the financial system, including by nonbank operators, which are making headway on payment systems in the continent.

There is also a need to deepen African capital markets to enable them to play their full role in mobilizing and allocating domestic savings to the real sector. To do so, authorities must address capital market structure, policy, and regulatory framework weaknesses and promote liquidity by deepening the pool of investors, with an emphasis on domestic pension funds and other institutional investors. A well-functioning local market can help to:

- Build a yield curve, which is a key element in pricing risks.
- Extend debt maturities.
- Create benchmark issuances and liquidity of secondary markets.
- Diversify the investor base while enabling the development of new financial products.

African countries should firmly embark on a credible shift to improve fiscal policymaking

African countries should firmly embark on a credible shift in fiscal policymaking by enhancing the effectiveness of fiscal rules to increase discipline and constrain government budgets, while promoting countercyclical policy, setting up fiscal councils to advise governments on tax and spending policies, and using Africa’s regional economic communities (RECs) to help countries better coordinate their fiscal policies. Fiscal rules seek to put a numerical constraint on public spending (box 3.7).

Over the past two decades, an increasing number of countries have adopted fiscal rules. The 2017 IMF Fiscal Rules Dataset identifies 96 countries that adopted fiscal rules both at national and supranational levels between 2000 and 2016.
There is also a need to deepen African capital markets to enable them to play their full role in mobilizing and allocating domestic savings to the real sector.

Of 25 countries in Africa using fiscal rules in 2015, 24 used debt rules; 22, budget balance rules; 9, revenue rules; and 3, expenditure rules. Some 88 percent of these African countries used at least two rules.

Despite the growing appetite for fiscal rules, they are largely ineffective. Compliance with fiscal rules in Africa is undermined by lack of clear mandates, support legislation, and institutions. Furthermore, none of the fiscal rules place emphasis on countercyclical fiscal policy, missing the opportunity to benefit from automatic stabilizers that operate when the economy deviates from the target. Temporary surges in debt during recession, for instance, will be eliminated during boom times, so the fiscal rules should be engineered to produce sufficiently large surpluses during booms to offset increased spending demands during recessions.

More than 50 percent of fiscal rules in Africa are adopted through membership in RECs, such as the West African Economic and Monetary Union, Central Africa Economic and Monetary Community, and East Africa Monetary Union. The benefits of regional commitments to enhance discipline and solidarity mechanisms are at least twofold. First, regionalization allows countries to rise above the intricacies of domestic politics. Second, regionalization offers the benefit of sharing risk. Only a few countries—including Botswana, Kenya, Mauritius, and Nigeria—are implementing national fiscal rules. While empirical evidence suggests that some degree of fiscal convergence occurs, in particular in monetary zones, other evidence suggests...
Establishing fiscal councils should be encouraged to strengthen fiscal policymaking in Africa.

that rules in regional economic communities on the continent tend to favor procyclical behavior. Supranational rules can be important in leading countries to accept fiscal discipline. However, their implementation is weakened by a lack of monitoring and sanction enforcement mechanisms, weak political commitment to impose sanctions, and limited connection with national rules.

In recent years, there has been a surge in independent fiscal councils around the globe. In general, these fiscal councils are responsible for real time implementation and surveillance of public finances rules and policies. To date, four African countries have established fiscal councils: Uganda in 2001, Kenya in 2007, South Africa in 2014, and Ghana in 2019. Empirical evidence shows that fiscal councils enhance policy compliance and transparency, reduce forecasting bias, improve government capacity to comply, and foster government commitment to fiscal discipline. Establishing fiscal councils should be encouraged to strengthen fiscal policymaking in Africa.

Enhancing debt management capabilities and transparency will reduce debt vulnerabilities

Poor and inadequate public debt management contributes to debt sustainability issues. In addition to supporting economic recovery and building resilience in the aftermath of the COVID–19 pandemic, many African countries should place priority on addressing the rising public debt burden, reducing leakages to create a more effective public sector, and promoting an environment that drives investments and private sector growth. The effective management of public resources—including control of fiscal deficits and overall debt management—is important for macroeconomic stability and the establishment of the conditions required for structural transformation.

To enhance debt management, specific attention should be given to strengthening the capability for formulating and implementing debt policies and medium-term debt strategies. Other targeted interventions can include strengthening

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**BOX 3.7 Enhancing the economic stabilization effects of fiscal rules**

*What are fiscal rules?* A fiscal rule is “a long-lasting constraint on fiscal policy through numerical limits on budgetary aggregates.” It can act as a device that ties the hands of a government and limits fiscal discretion, or flexibility, to implement proactive measures through a commitment to binding rules that ensure monetary/fiscal stability and put debt dynamics under control. A fiscal rule can also be a signaling tool that reveals the government’s preferences and plans to the public and financial markets. This contributes to improved credit ratings and reduced public debt costs and supports monetary policy by mitigating inflationary pressures. A good fiscal rule seeks to balance simplicity, flexibility, and enforceability. However, striking that balance can be very difficult.

The main types of fiscal rules include debt rules, which set numeric limits on the public debt-to-GDP ratio, as in Liberia, which limits that ratio to 60 percent and Botswana, which limits it to 40 percent. Balanced budget rules constrain the size of the budget deficit and thus the debt-to-GDP ratio. Ghana’s 2018 fiscal responsibility law, for example, establishes a 5 percent ceiling on fiscal deficits. Expenditure rules put a ceiling on the growth of public spending or its ratio to GDP, a rule instituted in Namibia. Revenue rules put ceilings or floors on revenues or determine the use of windfall revenues. Kenya, for instance, sets revenues at 21 percent of GDP. Fiscal rules are often combined.

**Notes**

4. Eyraud and others 2018.
Specific attention should be given to strengthening the capability for formulating and implementing debt policies and medium-term debt strategies.

Debt transparency has become important because of incidents in Africa of hidden debt—financial commitments and contingent liabilities that are not publicly announced when they are made. To guard against such hidden debt, disclosure should be centralized for loan covenants in all sovereign, subsovereign, and state-owned agreements and exposures. This would apply not only to covenants and payment terms or schedules, but to collateral or other secured pledges. It will also be important to enhance the collation of debt data, and to make information on debt available and publicly accessible through regular reporting and real-time information sharing, including about the implicit guarantees and contingent liabilities of state-owned enterprises. Investments should be made in digitization and modernizing debt information management systems. Besides the long-term benefit of fostering trust in a country’s public finance, full debt disclosure and transparency has

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**BOX 3.8 Institutional framework, tools, and resources for debt management**

Operational responsibility for debt management is generally separated into front, middle, and back offices with distinct functions and accountabilities, and separate reporting lines.

- **The front office** has the responsibility of mobilizing resources from both domestic and external sources at minimal cost and on time. It typically implements the borrowing plan based on the debt management strategy approved by the government; negotiates with creditors, liaises with market players, regularly reviews market conditions, and provides information to donors/creditors, international financial institutions, and commercial banks, among others.

- **The middle office** provides advice and analysis that enables the government to meet its financing needs at the lowest possible cost (for example, by prioritizing concessional borrowing over commercial borrowing) with a prudent level of risk. It monitors the front office’s compliance with the chosen strategy, cost, and risk limits, and it assesses and coordinates all types of risks—market, refinancing, liquidity, credit, operational, and contingent.

- **The back office** typically is responsible for debt registration; handling transaction confirmations, settlements, and payments; and maintaining records of all debt contracts, disbursements, payments, debt restructuring agreements, on-lending arrangements, issued guarantees, and settlements of transactions, among other things. It is also responsible for providing projections of debt servicing to inform the budget planning process.

As part of debt management, all sovereign, subsovereign, and state-owned actors should also have compliance officers in place to ensure that operations (government, commercial, or others) comply with existing multilateral and bilateral agreements that fit within the context of the Paris Club and the London Club—an informal group of private lenders modelled on the Paris Club.

In some African countries, these offices are consolidated into a single debt management office; in others, they are fragmented across several departments within the ministry of finance; and in some, they are located in the central bank. Regardless of the organizational and governance arrangement, a well-organized debt management structure effectively integrates operation, coordination, and monitoring.

*Source: African Legal Support Facility 2019.*
been shown to help lower the cost of borrowing, with positive effects on countries’ credit ratings.

While most African countries have a credit risk rating from one of the major rating agencies (S&P, Fitch, or Moody’s), the ratings are typically below investment grade, which suggests that the countries should work to improve their credit ratings to lower borrowing costs. Specifically, countries should strive to address information asymmetries by providing investors with as much information as possible about their economic and political developments and prospects, while adopting international benchmarks, such as the International Public Sector Accounting Standards, to signal commitments to managing transparency and liabilities prudently.53 To further lower borrowing costs, African countries and multilateral development banks should embrace innovative lending instruments, such as partial risk guarantees; promote the use of swaps, contingent loans, and nondebt finance; and establish insurance mechanisms that enable cheap access to debt from the international market through jointly issued debt facilities.

STRUCTURAL REFORMS: DIGITIZATION AND FAIR COMPETITION AS FUNDAMENTAL LEVERS

Harnessing digital technologies and promoting free and fair competition will be fundamental in revitalizing African economies

COVID–19 and its aftermath increase the urgency for countries in Africa to not only ensure resilience (for example, by addressing deficiencies in the health sector), but also to chart a course for economic transformation. They need to break with business as usual if they are to deal with existing unemployment and create good jobs for the hundreds of millions of young people who will join the labor force in the coming decades.

With government coffers emptying, new and sustainable engines of growth must replace the large public expenditure programs that provided most jobs in the past. Leaders in the region must take decisive collective actions to remove roadblocks to genuine private sector development (such as corruption, unfair competition, lack of skills, and inadequate access to power or finance) — the only sustainable way to support growth and unleash the potential of young people and women. A regional approach through the African Continental Free Trade Area (AfCFTA) will not only make it easier to remove these roadblocks but also unleash the potential of a large single market.

Two important tasks could underlie programs to revitalize African economies. Governments must add to their quivers growth policy arrows that:

• Create large-scale economic opportunities by undertaking an all-out effort to harness digital technologies to bring their countries into the 21st century—an effort that will require an ambitious, all-in program similar to the one the United States undertook in 1961 for a manned landing on the moon by the end of the decade.
• Promote free and fair competition to end the cozy, stifling relationship between governments and well-connected firms that results in economies in which profits accrue less to genuine productive activity and more to economic rents and monopoly pricing.

Of course, before the region can embark on such an ambitious plan, it must achieve macroeconomic stability. A tendency to delay stabilization and to tolerate overvalued exchange rates has in some cases perpetuated rentier economies, with high dependence on imports and top-down, crony-dominated structures. Even achieving macro stability will not be easy. It is a task many governments have pursued—using instruments such as exchange rate devaluations, tax hikes, subsidy cuts, and the like—often with too little effect.

But even if authorities achieve a level of stability, without modernization and fair competition, the region will remain unable to reduce uncertainty and attract vital foreign direct investment. To do that will require governments to pull out new policy arrows to help revitalize the regional economic systems through technology and competition. The policies are self-enforcing and complementary. More competition will help with innovation, and more technology will help instill more market contestability—that is, make it easier for firms to enter and exit specific sectors.
Accelerated digitalization is needed to propel Africa into the Fourth Industrial Revolution and boost job creation

African countries already have the ingredients needed to jump to a much more productive service sector—and, in the process, modernize more traditional sectors such as agriculture and agribusiness. African countries have increasingly educated young men and women and the digital backbone needed to construct a widely available and affordable high-speed internet. Yet the region ranks near the bottom globally in affordability of mobile broadband and the percentage of the population that has access to it.\(^{54}\)

It is time to empower a young African generation to join their global counterparts in the collaborative effort and spirit of the start-up world. Indeed, Hjort and Poulsen (2019), studying the gradual arrival of submarine internet cables on the African coasts and three datasets covering 12 countries, show positive effects (ranging from 3.1 percent to 13.2 percent) of fast internet on employment rates—including for less-educated worker groups—with little or no job displacement. Average incomes rise, and the firm-level data available for some countries indicate that increased firm entry, productivity, and exporting contribute to higher net job creation. Bahia and others (2020) show that households that had at least one year of mobile broadband coverage experienced an increase in total consumption of about 6 percent. The effects increased over time (though at a decreasing rate) and reduced the proportion of households below the poverty line. These effects are mainly due to an increase in labor force participation and employment, particularly among women.

The digital sector is characterized by a short innovation and development cycle, lower entry barriers, and high demand for human capital. Unlike the medical industry, where the development of a new drug may take more than a decade and cost up to $1 billion, the development of a piece of software or a mobile phone application in the information technology or telecommunications industries can take as little as $3,000, six weeks of development, and a working internet connection.

Governments should consider setting tight deadlines for making high-speed internet, digital, and mobile payments affordable and available to all. And not incrementally, but in an accelerated way akin to the herculean effort set in motion by the late US President John F. Kennedy to send a man to the moon, which helped unleash an extraordinary winning spirit that went well beyond the space sector that launched the lunar craft in July 1969. An accelerated digitalization would aim to propel Africa into the Fourth Industrial Revolution, which integrates technology into everyday economic activity. It would contribute to the emergence of new actors and domestic platforms—including in e-commerce, internet publishing and broadcasting, and web search portals, data processing, and hosting—and would disrupt a number of paralyzed segments of the economy, such as transport, logistics, and banking. It would also help promote a bottom-up approach to development in a region where top-down approaches have long been the rule.

The growth of platforms and additional activities will require new skills. Some of them can be learned on the job, but many will have to be taught.\(^{55}\) That will require a reconfiguration of the education system to train students for the private sector, rather than for jobs in the public sector. African governments should further reduce challenges for start-ups by facilitating connection with the right partners (investors, business associates, universities, and research centers), accessing commercial opportunities (especially procurement contracts), recruiting employees with the right skills from outside if needed, and developing creative spaces—including innovation hubs, incubators, and accelerators.

**Enforcing free and fair competition and investing in transparency will be key to unlocking investment, innovation, and employment**

Creating a modern digital sector is not enough. African countries must also revamp their regulatory apparatus to foster fair competition. While appropriate government agricultural, industrial, and trade policies are necessary, they are not sufficient to spur sustainable and inclusive growth. Free and fair competition policy should complement the government policies, providing a framework and contributing to proper governance.

A well-designed and effective implementation of competition should enhance production efficiency—leading to lower prices, higher quality,
A commitment to radical transparency would go a long way toward improving trust between the state and its citizens. A commitment to radical transparency would go a long way toward improving trust between the state and its citizens. A commitment to radical transparency would go a long way toward improving trust between the state and its citizens.

Competitive neutrality recognizes that SOEs should be at neither a competitive advantage nor a competitive disadvantage to the private sector. The state must be able to put SOEs and existing private sector firms on the same footing when it comes to public subsidies, taxes, debt, and access to public procurement contracts. There may be situations when competitive neutrality is not appropriate—say, if it conflicts with achieving important societal goals—but such an exception must be objectively and rigorously determined.

Unless the independence, competence, and accountability of the regulatory apparatus is reinforced, economic sector reforms will not yield good developmental outcomes. In particular, privatizations would merely change public monopolies to private ones. For example, private foreign firms have entered sectors such as banking and telecom, but the expected benefits did not result because regulators failed to instill competition and tolerated collusion—tacit, or even overt. An independent and accountable regulatory apparatus balancing open markets is key if the benefits of competition are to materialize.

At the regional level, Africa needs to adopt a competition policy that makes markets work for the continent and fosters regional integration, using the African Continental Free Trade Area (AfCFTA). According to Fox (forthcoming), the following policy actions should be given diligent attention:

- Creation of a regional competition/market commission, which should be directly linked with internal market commissions. It should appoint a forceful, proactive commissioner in charge of the competition/market portfolio. The competition program adopted should be manageable, credible, and have enforcement teeth.
- Adoption of laws against cartels with a significant cross-border character, including cartels facilitated by state acts. A credible hypothesis is that cross-border cartels may explain why there are no trade flows from African countries with surpluses to neighboring countries with shortages in some sectors such as cement, fertilizer, or sugar.
- Establishment of a premerger notification clearing house. It could be particularly wasteful to have each African nation (many with small
It is essential to prevent debt sustainability concerns from becoming a major obstacle to Africa’s progress toward prosperity.

CONCLUSION

The COVID–19 pandemic has led to a surge in government financing to fund COVID–19 responses in Africa and to a deterioration of credit ratings of several countries on a continent where public debt levels have been rising for a decade. Large and increasing sovereign debt burdens could pave the way for disorderly defaults and more of the lengthy resolutions that African debtor countries typically experience, with costly economic consequences. It is essential to prevent debt sustainability concerns from becoming a major obstacle to Africa’s progress toward prosperity.

Today, the COVID–19 shock provides a strong rationale for the international community to deliver significant debt relief—especially for poorest African countries—to avoid another “lost decade”. However, past debt relief initiatives, such as those for heavily indebted poor countries, have led to shutting Africa out of financial markets. Because both private and official debts remain legitimate and pivotal sources of financing for countries borrowing to meet their developmental needs, it is critical to mitigate potential negative consequences from debt relief on a sovereign borrower’s reputation and the ability of both the sovereign and its domestic private sector to borrow at reasonable rates in financial markets.

Regional policymakers and the international actors—such as multilateral development banks, bilateral official donors, private creditors, and rating agencies—must push for changes to the international financial architecture for sovereign debt restructuring and do their best to align borrowers’ and creditors’ incentives to avoid disorderly sovereign defaults. A lasting solution will require a comprehensive debt restructuring and cancellation program that involves both private and official creditors, under the comparability of treatment principle. The new G20 and Paris Club “Common Framework for Debt Treatments beyond the DSSI” is a step in this direction. The promotion of legal reforms or innovations in financing instruments can provide another venue. Examples of such legal reforms include collective action clauses, aggregation clauses on bank loans, creditor committees, and negative pledge clauses. Innovative state-contingent or policy-contingent instruments (such as value recovery instruments and equity-like debt instruments) can be considered as ways to facilitate debt restructuring. Making future debt service obligations countercyclical would greatly minimize debt vulnerabilities. Additionally, African countries will need to leverage resourced-backed loans better and transparently for financing their development needs.

The Bank will continue to deploy its own critical actions and initiatives to assist regional member countries in taking and maintaining a sustainable debt path. Specifically, the Bank will:

- Try to tap into new sources of funding to lower the cost of debt.
- Strengthen countries’ capability to manage their public debt transparently and productively.
- Engage in policy dialogue to raise awareness on debt sustainability at the highest political level.
- Help regional member countries in debt resolutions.

In addition to its own efforts, the Bank plans to enhance outreach and strategic partnerships...
with bilateral donors and multilateral development banks, think tanks, academia, and non-governmental organizations.

But African countries need to do their share. They should chart a path forward by decisively shifting their governance systems to foster more sustainable and inclusive economic growth models. These governance system reforms should include strengthening public financial management to eliminate all forms of public resource leakage, and to ensure an efficient, productive, and transparent use of scarce resources. There will also be a need for an accelerated digitalization and for enhanced competition (both at the national and continental level) to unlock investment innovation, boost employment, and reignite growth.

In summary, in the short term the international community needs to consider debt relief or restructuring for countries in need to preserve lives and livelihoods and maintain macroeconomic stability. In the longer term, a more conducive debt resolution architecture at the global level, combined with bold governance system reforms in Africa, would significantly help put the continent on a sustainable debt path.
NOTES

1. IMF 2020a.
2. The cost of disorderly debt resolution can be significant to the domestic economy, including loss of access to credit markets, trade sanctions, financial sector instability, and withdrawal of foreign direct investments (Sandleris 2016).
3. Countries and markets often rely on the IMF’s debt sustainability analysis (DSA). The problems with DSA are, however multiple, as described in Gelpern (2016), Corsetti (2018), and Corsetti, Erce, and Uy (2020).
4. As noted by Buchheit and others (2018), assets abroad such as embassies or consulates are typically shielded from attachment by national and international law. Only sovereign assets used for a commercial purpose will generally be in harm’s way. This suggests that it is easier for creditors to get court judgments against a sovereign than to enforce payment.
5. Gelpern 2016. Various IMF policies shape decisions related to debt restructuring. IMF arrears policies require that authorities negotiate with creditors in good faith. IMF lending requires the country’s debt passes the IMF debt sustainability analysis. Finally, the exceptional access policy requires “high probability” of debt sustainability as a prerequisite to enter into a program.
7. Despite the presence of CACs and of well-developed procedures within the Paris Club, the activity of vulture creditors proved very destabilizing during the HIPC initiative. Most HIPC countries suffered litigation from vulture funds, and a number of them agreed to repay beyond what had been agreed with the Paris Club.
8. These questions are often answered with the help of advisors. When the IMF is present, its DSA is a driving force for how countries answer these questions.
10. Asonuma, Chamon, and Sasahara (2016) show that this happens because preemptive debt restructurings, and those where the authorities act more collaboratively, attenuate the impact of default on trade, credit, and investment.
11. Traditionally, domestic debt was governed by domestic law, denominated in local currency, and locally held, while external debt was foreign law-governed, held abroad, and denominated in foreign currency. These lines are increasingly blurred.
12. According to Buchheit and others (2018), governments may also have political incentives not to restructure domestic debt, as those claims are often held by voters. Erce, Mallucci, and Picarelli (2020) compare the macroeconomic implications of foreign and domestic law default.
13. If the debt is denominated in local currency, governments can try to inflate it away and avoid default in nominal terms.
14. Cheng, Diaz-Cassou, and Erce 2018
16. This happened because, in addition to the lengthening of maturities, the coupons were adjusted to provide better-than-market terms.
17. In this context, the government of The Gambia requested technical and financial assistance from the African Legal Support Facility to further the country’s negotiations with its creditors, to develop a prudent and sustainable debt restructuring strategy, and to build its institutional capacity in the area of sovereign debt. In response to the government’s request, the African Legal Support Facility offered its support by engaging legal and financial advisors to assist with those activities.
18. From 2000 to 2012, rescheduling with Benin, Cameroon, Seychelles, Sudan, and Zimbabwe involved $415 million.
19. Ackher and others (2020) notes that Chinese lenders tend to treat restructuring loan-by-loan and not on the basis of the entire country debt portfolio. This parallels the emphasis of the early years of the Paris Club on “development sustainability” rather than “debt sustainability” (Cheng, Diaz-Cassou, and Erce 2018).
20. Instead, in Ukraine and Greece, CACs proved insufficient to successfully restructure all foreign law bonds.
22. Other recent cases outside Africa that have shown the limits of CACs for resolving debt crises include Greece, the largest debt restructuring in history in 2012, Ukraine (in 2015), and the long litigation against Argentina and Grenada.
23. Empirical analyses have consistently found that CACs do not have an observable effect on pricing or result in significantly higher yields. Still, Fang, Schumacher, and Trebesch (2020) find that despite CACs, the higher the losses on a given bond, the
higher the share of holdouts. They also find that smaller bonds, bonds issued under foreign law, bonds with higher coupons, and more actively traded bonds tend to raise the share of holdouts. The authors’ results point to the benefits of aggregation clauses.


28. According to the IMF analysis, a 1 percentage point increase in domestic arrears is associated with a fall in real GDP per capita growth of 0.3 percentage points, and with an increase in non-performing loans of 0.3 percentage points.

29. Breaches of conditionality related to domestic arrears are commonplace during IMF programs.

30. The 40 African countries which are eligible for IDA support (of which 37 are ADF-eligible countries) can benefit from this moratorium.

31. The participation of MDBs in the initiative was heavily debated. Given concerns regarding the resulting negative impact on MDBs ratings and preferred creditor status should they agree to the proposed suspension of debt service payments, MDBs did not participate.

32. UNDESA 2017.
34. Kearce 2020. With a negative pledge clause, the borrower commits to not pledging or encumbering certain assets (present or future) to secure other creditors, without equally and ratably securing the lender in whose credit agreement the clause appears.

35. Bonds issued by Nigeria (among others) to commercial banks in exchange for defaulted loans as part of Brady restructuring agreements were issued with value recovery rights designed to provide additional payments in the event of an increase in the prices of commodities such as oil. Also as part of the Brady deals, Bosnia and Herzegovina, Bulgaria, and Costa Rica issued bonds containing an element of indexation to GDP. They contain warrants that increase bond payments if the debtor’s GDP (or GDP per capita) rises above a certain level.

37. Concerned about liquidity, external creditors didn’t buy the clause (Caribbean Business Report 2020). They only agreed to a version where enacting the clause requires majority acceptance by the committee.

38. While fixed obligation debt contracts are less informationally sensitive and have low verification cost, they engender moral hazard and a host of agency problems, including excessive risk-taking.

40. IMF 2020a.
42. ESM 2020.

43. The IMF has exceptionally made loan disbursements conditional on economic activity. The 1986 Mexican SBA program with the IMF included a growth contingency (activated in 1998) such that, should GDP growth fall below a benchmark level, the authorities would be allowed to implement an additional public investment program, financed with loans from the World Bank and commercial banks.

44. Asonuma and Trebesch (2016) shows that where political risks are high, borrowing costs after default are higher for longer.

45. The standard debt accumulation equation suggests that the current debt ratio in a country ($d_t$) depends on the previous ratio ($d_{t-1}$), real interest rate paid on debt ($r_t$), real GDP growth ($g_t$) and primary balance ($p_t$): $d_t = (1 + r_t - g_t)d_{t-1} - p_t$. Note that this formula abstracts from the use of privatization proceeds, off-budget operations, gains and losses on (below-the-line) financial operations, or valuation changes due to exchange rate moves.

46. Svensson and Renikka 2004; Gauthier and Wane 2009; Francken, Minter, and Swinnen 2009.
47. Arezki and Devarajan 2020.
49. ILO 2018.
51. Gammadigbe and others 2018.
52. Bikai 2015.
54. Alliance for Affordable Internet 2020; ITU 2020.
55. See African Development Bank (2020) for a detailed discussion.
56. UNCTAD 2015.
57. See UNECA, AUC, and African Development Bank (2019) and Fox and Bakhoum (2019).
60. Fox and Bakhoum 2019; World Bank 2020.
REFERENCES


