Risks and Challenges of Debt-Financed Development

Roots and causes of the rising debt levels in Africa

Jörgen Levin
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The majority of countries in Africa still have sustainable debt ratios, but since 2012, public debts in Africa have increased from a national average of around 36 per cent of GDP to close to 56 per cent. According to the IMF, eight African countries are classified as being in debt distress and another eleven are in high risk of moving into debt distress. Some of these countries are already facing debt default or debt restructuring by replacing short-term loans with long-term loans.

A combination of factors explains developments in debt-distressed countries. Many countries have been running large fiscal deficits, and interest payments have increased due to the depreciation of their currencies. Ex-
Rapid economic growth does not make a country immune to debt distress. Cameroon offers a good illustration of this.

Change rate movements have caused dramatic changes in debt levels in countries such as Senegal, Zambia, Mozambique and Malawi.

Countries like Zimbabwe, Eritrea and Somalia have a high debt burden as a result of arrears that have accumulated over a long period due to conflict and/or mismanagement of the state apparatus. Fraud and embezzlement of public funds should also be mentioned. There are, for example, suspicions that in the 2014 elections in Mozambique, the ruling Frelimo party used state resources for its campaign. In some countries such as Ghana, the “discovery” of hidden loans in state-owned enterprises has added to the debt burden.

In certain countries, economic shocks have been compounded by other shocks (e.g. Ebola) that have aggravated the debt burden, not only in those countries immediately impacted, but also in the surrounding regions. The Ebola outbreaks in Sierra Leone, Liberia and Guinea have affected tourism throughout the region. For example, in Gambia, where tourism accounts for about 20 per cent of GDP, it is estimated that that sector declined by more than 50 per cent in 2015. With real interest rates exceeding GDP growth and with its expansionary fiscal policies, Gambia moved into unsustainable debt dynamics.

Rapid economic growth does not make a country immune to debt distress. Cameroon offers a good illustration of this. Despite its comparatively low debt ratio (38 per cent of GDP) and its reasonable GDP growth (4 per cent), the country is categorised by IMF as being in high risk of debt distress. This vicious circle of growing debts has been caused by a combination of short-term foreign-currency borrowing, depreciation of the local currency and a fall in export prices. The real interest rate on Cameroon’s public debts is high (13 per cent). Budget management is weak and parts of the country’s external borrowing have been brokered by agents lacking in tractability and transparency. For example, the state-owned oil refinery Sonara has used a foreign company that trades in oil products to borrow on unfavourable terms that include high interest rates and repayments that are linked to future sales of Sonara’s oil products.

Social spending vs infrastructural investments

Accumulating debt is not necessarily a bad thing if it’s part of a broader development agenda. Since around 2005, there has been a significant increase in infrastructure investment across the countries of sub-Saharan Africa. This is in some (generalised) way a reaction to the previous doctrine, in which donor countries and NGOs put a heavy emphasis on social spending, such as education and health, traditionally regarded as the key to poverty reduction. The previous bias toward social spending should also be seen as a measure to counter the unwillingness of the political elite in many African countries to support programmes that target the poor. Governments in many developing countries have responded to the donor and NGO bias on social spending by significantly increasing infrastructure spending; with dwindling aid flows, the most readily available option has been to borrow on the global financial market.

Closing the infrastructure gap has been an important component on the agenda to achieve sustained economic growth across African countries. Infrastructure investment has particularly targeted the roads network and the energy sector – important areas in terms of reducing the cost of doing business across African countries. Due to the scale of the infrastructure projects, there is a limit on how much can be financed from taxation and domestic borrowing; this implies that the overwhelming part of the finance has to come from external sources. While taxes could be increased, they would not be a major source of revenue, since more than half of the countries of sub-Saharan Africa already collect as much as can be expected, given their structural characteristics. Increasing tax revenue by adjusting taxation rates could also be costly, as higher rates could have a negative impact on economic growth (by reducing private investment) and hence on future tax revenue.
The IMF and the World Bank use a four-step scale for rating the risk of external public debt distress:

**Low risk**, generally when all the debt burden indicators are below the thresholds in both baseline and stress tests.

**Moderate risk**, generally when debt burden indicators are below the thresholds in the baseline scenario, but stress tests indicate that thresholds could be breached if there are external shocks or abrupt changes in macroeconomic policies.

**High risk**, generally when one or more thresholds are breached under the baseline scenario, but the country does not currently face any repayment difficulties.

**In debt distress**, when the country is already experiencing difficulties in servicing its debt, as evidenced, for example, by the existence of arrears, ongoing or impending debt restructuring, or indications of a high probability of future debt distress.

**No rating.** The 15 African countries marked in white are not on the IMF list of PRGT-eligible countries (PRGT = Poverty Reduction and Growth Trust) and have not been stress tested by the IMF.

**No data (Eritrea).** IMF’s latest DSA list.

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**Risk levels of debt distress.** Source: IMF, per latest DSA (Debt Sustainability Analysis) as of August 31, 2019.
Conditional World Bank loans vs Chinese loans

Opportunities for borrowing on the domestic financial market are limited, as the markets are thin and excessive borrowing tends to crowd out private investment, which in turn has a negative impact on economic growth. This leads many governments to revert to external borrowing. This in itself is not necessarily a bad thing, so long as the loans are properly monitored, transparent and used to build up productive assets, such as transport, energy and communication infrastructure. Unfortunately, the appetite for taking out commercial loans on the global financial market – rather than taking the less expensive option of borrowing from the World Bank (WB) – has led to a significantly larger share of short-term commercial debt.

Loans from the World Bank usually come with democratic governance and human rights conditions, that do not always fit with the agendas of African government. It is usually such policy conditions associated with WB loans that cause many African governments to seek other options. One such option is the Chinese Belt and Road Initiative (BRI), which since its formation in 2013 has rapidly increased Chinese loans for infrastructure investments in poor countries. It is very difficult to determine the precise amount of Chinese lending, as China is not a member of the Paris Club, which tracks sovereign borrowing from official bilateral creditors. It is estimated that more than half of China’s lending to developing countries consist of hidden loans that have not been recorded in official data, and some guestimates suggest that that in 2017 sub-Saharan African debt owed to China is about ten per cent of GDP. Also, many Chinese loans have higher extended interest rates and short maturities, with collateral that includes commodities, or even important strategic foreign infrastructure.

In some countries, such as Djibouti, Democratic Republic of Congo, Niger, Zambia, Ethiopia and Zimbabwe, borrowing from China has increased significantly. The situation is particularly severe in Zimbabwe, where “new” debts are routinely discovered by the Central Bank. There is also limited transparency, with little accurate data on loan conditions; this serves to create incentives for kickbacks and inflated project costs. For example, Chinese lending – under BRI – to fund the Nairobi–Mombasa railway ended up costing twice the international average per kilometre of track. Another Chinese-funded infrastructure project with undisclosed conditions is the expansion of Bagamoyo port in Tanzania. This project was stalled by President Magufuli when tough conditions were

Workers at the port of Mombasa in Kenya, July 2015. The Mombasa-Nairobi Standard Gauge Railway, officially inaugurated in May 2017, was to a large extent financed by loans from China. It stretches 485 km from the capital Nairobi to Mombasa, which has the largest port in East Africa.
demanded by the Chinese partner. A number of countries are now reverting to the IMF to restructure their debts. Republic of Congo reached an agreement with the IMF in July 2019 to settle part of its Chinese debt.

Policy recommendations
In two conferences organised by the Africa Economic Research Consortium (AERC), the issue of how to handle debt-financed development was discussed by researchers and practitioners. The discussions can roughly be summarised by the following policy recommendations:

• **Debt transparency.** Debts should be reported in a transparent way. The recent “tuna bonds” scandal, which plunged Mozambique into severe financial crisis, is an illuminating examples of how hidden debts cover bribes and fraud. One way of reducing the risk of corruption is to improve the capacity of debt management institutions, such as national debt offices, and address weak capacity in key oversight institutions, such as parliaments.

• **Better maturity matching.** When short-term commercial loans are used to finance long-gestation development projects, there is a risk that the debts need to be serviced before the project starts generating revenue or other benefits. The debt servicing risks creating a debt trap that slows the pace of implementation or halts the project altogether. Ghana’s and Zambia’s successive Eurobond issues occurred at a time of rapidly rising interest rates and with maturities much shorter than those needed for long-gestation infrastructure projects. For large infrastructure projects, international financial institutions like the World Bank or the African Development Bank can be used to frontload a “big bond”, backed by donor countries.

• **Balance revenues and costs.** Although infrastructure investments are important in many African countries, the concept of closing the infrastructure gap has to be modified. In many cases, infrastructure projects need to be scaled down to better match the balance between projected revenues and future costs in the national budget.

• **Prioritise investment projects and beware of white elephants.** Infrastructure investments that launch expensive development projects simultaneously in several different areas are all too often based on unrealistic expectations of synergy effects, hidden and/or multi-purpose agendas. Improved capacity to undertake cost-benefit analysis is needed, not only to rank projects and prioritise infrastructure investments, but also to understand the medium- and long-term revenue implications. Better analysis in evaluating and ranking projects reduces the risk that proposed investments end up in politically motivated development projects that become white elephants – expensive to maintain, ineffective or even useless.

• **Reject pro-cyclical fiscal policies.** A number of African governments follow pro-cyclical fiscal policies — i.e. public spending rises in periods of boom and falls in times of recession. Countries — in particular those rich in natural resources — need to institutionalise rules to save when prices are high (good times) and boost public spending when prices are low (bad times). In other words, treat commodity price booms and revenue windfalls as temporary, not permanent. Rejecting pro-cyclical policies would also reduce the risk of the economy “overheating” — something that can occur when there are large inflows of additional resources in an already booming economy. Otherwise domestic prices will increase and the real exchange appreciate, making it harder for domestic companies to compete on the world market. Institutional reform of how a government’s intertemporal budget constraint is managed remains a serious challenge for many African countries, where cyclical macroeconomic fluctuations have a large impact on the population, particularly on the poor.
About this policy note

This policy note highlights two topical questions: what lies behind increasing levels of debt on the African continent, and what are the challenges when financing development projects through loans?

About the author

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