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REPOA Brief

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Finance and African development-dynamics and underlying debt risks [1]

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Key Messages

Parties	**Least Developed Countries**—32 African countries classified by the UN as LDCs.
	The rest (22) are classified as either **Lower Middle-Income Countries or Middle-Income Countries.**
Development	Gradual graduation from Least Developed Country (LDC) category is constrained by lower incomes, social and health challenges, and limited finances for sustained development.
	Adequate supply of infrastructure services has long been viewed as a key ingredient for economic development and driver of growth and productivity.
	In pursuit for transparent inclusivity and graduation from the LDC status, many African countries need significant financing to close the development and infrastructure gaps, meet the SDGs, etc.
Financing	Sustainable financing is a necessary ingredient needed to close the development and infrastructure gaps, address SDGs and sustained demographic dividends.
	Until the late 1990s, most African countries financed their development through domestic resource mobilization and external concessional loans, the latter from the Paris Club and IFIs.
	Southern Africa ranked top in both FDI inflows and outflows between 2000 and 2020.
Debt Risks	External debt service capacity constraints landed most African countries into the HIPC process.
	The outlook for Africa's debt sustainability is challenged by emerging risks and vulnerabilities.
Prospects/Going Forward	Strengthening the links between debt financing and growth returns would play an important role in ensuring sustainable development with debt sustainability on the continent.

Pursuit for Graduation from LDC Status

A total of 32 African countries out of 54 are classified by the UN as the Least Developed Countries (LDCs)[2]. This large number of African countries are in the hard process of graduating from the LDC category. This category since early on continues to face development and financing challenges in terms of:

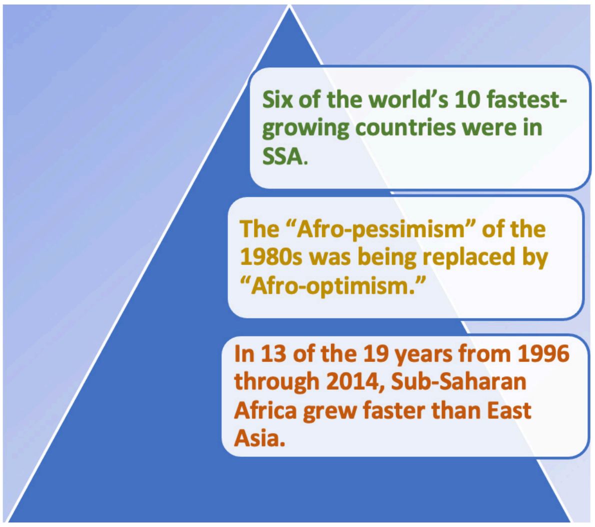
- low incomes
- social and health challenges
- extreme levels of underfinancing for development.

Donors did not expand the Official Development Assistance (ODA) at the pace required to attain and sustain the agreed targeted development thresholds in these countries, but also the ODA was unequally distributed across the various dimensions of development.[3] As a result, the average financing gaps in the African LDCs as a percentage of GDP was:

- Health --- 7.9%
- Education --- 12.1%
- Social protection --- 21%
- Biodiversity conservation --- 0.6%.

In pursuit of graduation from the LDC status, most African countries strived to sustain the growth momentum attained at the turn of the century by enhancing access to long-term finance paralleled by domestic financial deepening. From 1996 to 2014, growth of real economic activity in SSA sharply accelerated to an annual average rate of 4.8 percent, up from 1.4 percent in 1978–95. Most countries in the region experienced the rising hopes and expectations that came along with robust growth.

1 The original article— "Finance and African Development"—was presented and discussed at the "Mwalimu Nyerere Centennial Intellectual Festivals", University of Dar es Salaam, on 8th June 2022.
2 The UN list of the African LDCs include Angola, Benin, Burkina Faso, Burundi, Central African Republic, Chad, Comoros, Congo Dem Rep, Djibouti, Eritrea, Ethiopia, Gambia The, Guinea, Guinea-Bissau, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Niger, Rwanda, Sao Tome & Principe, Senegal, Sierra Leone, Somalia, South Sudan, Sudan, Tanzania, Togo, Uganda
3 UNCTAD—LDC Report 2021, The least developed countries in the post-COVID world: Learning from 50 years of experience..



In the aftermath of the Global Financial Crisis and amid a growth slowdown in high-income economies, the region still grew at an average annual rate of 4.8 percent from 2011 to 2014. In addition to health, education, and other key economic sectors, the three key sectors that have attracted much of the new investments are transportation infrastructure, energy, and ICT.

Transportation Infrastructure

In the academic literature and in policy circles, an adequate supply of infrastructure services has long been viewed as a key ingredient for economic development in particular to growth and productivity enhancement.[4] A consensus has emerged that, under the right conditions, infrastructure development can play a major role in promoting growth and equity—and, through both channels, help reduce poverty.

Sub-Saharan Africa ranks at the bottom of all low- and middle-income regions in virtually all dimensions of infrastructure performance. It also has inherent characteristics that may enhance the potential importance of infrastructure to its economic development—notably, the large number of landlocked countries (home to a large proportion of the region's total population) and the remoteness of most of the region's economies from global market centres. However, adequate transportation and communication facilities can help to overcome them, in particular, the impacts on firm outputs and productivity of **three specific infrastructure sectors: transportation, energy, and the digital economy.**

Transportation infrastructure

- Transportation costs plays a key role in determining the location of economic activities;
- Underdeveloped transportation infrastructure limits accessibility to consumers, hampers intraregional trade, and drives up import and export costs;
- Improved transportation networks can spur factor mobility and boost poductivity--lead to scale effects and enhance competition.

Energy sector

- Energy is needed to operate industrial machinery;
- Contributes to human capital productivity by providing power to essential facilities -- schools and hospitals, and ICTs;
- Economic costs of the poor energy infrastructure network is sizable;
- The availability and reliability of energy services is key for the economic development of the African countries.

Digital infrastructure

- ICTs are key ingredients of a country's development startegy because of their:
  - Inclusiveness--expanding market access to individuals and firms,
  - Efficiency--boosting productivity of different inputs,
  - Innovation capacity--via the creation of new business models;
- Facilitating the diffusion of information and knowledge in key sectors--promotion of market transparency, simulation of increased demand, reduction of logistical costs, provide climatic parameters, African mobile money frontier, etc.

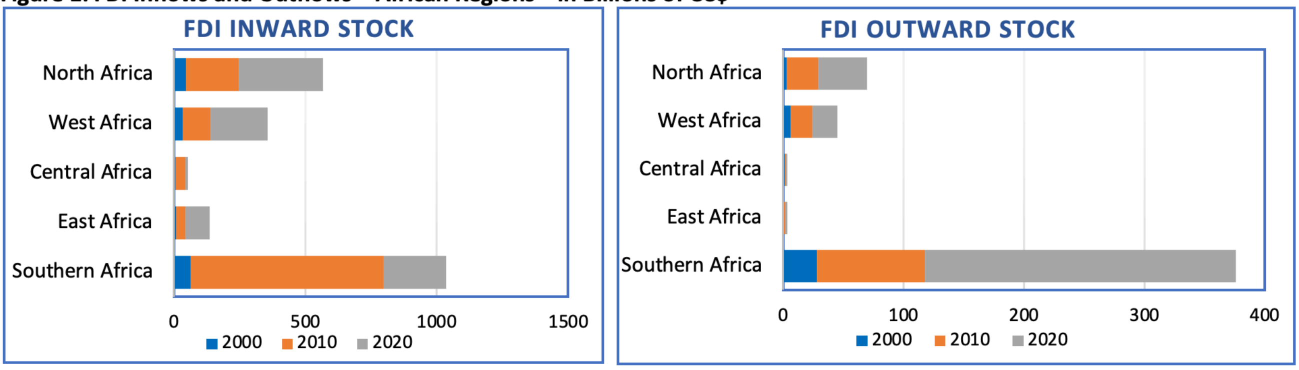
These likely economic benefits of investments in the transportation sector have justified funding for new and improved transportation and other infrastructure related sub-sectors in addition to the key sectors such as education, health, etc.[5]

Trends in the Financing for Africa's Development

In pursuit for transparent inclusivity and graduation from the LDC status, many African countries need significant financing to close the development and infrastructure gaps, meet the SDGs and attain the sustainable demographic dividends. The continent holds immense opportunities for enhanced investments. It has a youth bulge, abundant natural resources, large markets, and great potential for digital transformation.

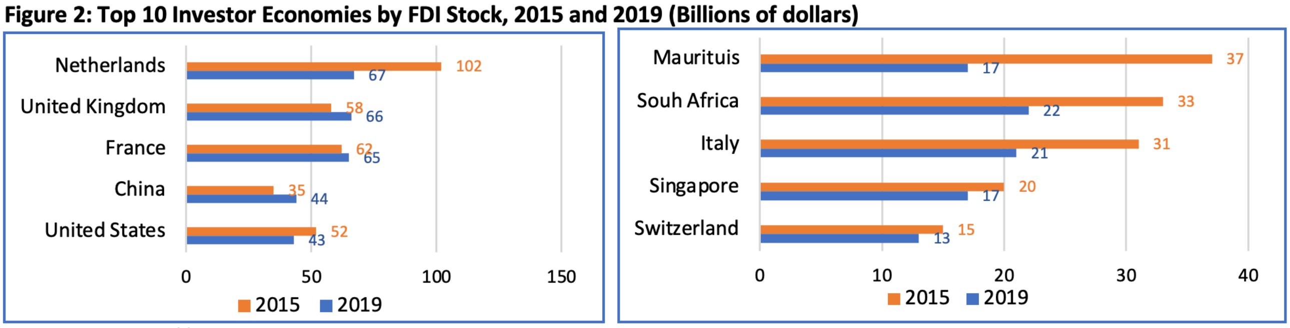
4 IMF Regional Economic Outlook for SSA, 2014; World Bank World Development Report, 1994.
5 César Calderón--World Bank Group, 2021

Figure 1: FDI Inflows and Outflows – African Regions—in Billions of US$



Source: UNCTAD World Investment Report, 2021

Figure 2: Top 10 Investor Economies by FDI Stock, 2015 and 2019 (Billions of dollars)



Source: UNCTAD World Investment Report, 2021

In parallel, most countries pursued fiscal consolidation with the view to reduce debt vulnerabilities and boost resilience while protecting development spending. To that end, revenue mobilization remained a key priority. The multilateral development banks (MDBs), development finance institutions, and development partners played a key role in providing the needed finance and in helping attract private investment. Instruments such as blended finance and guarantees continued to leverage additional private funds. MDBs and other development partners also deployed more equity financing, local currency financing and other risk-sharing instruments. These financing instruments helped reduce the dominance of senior, foreign currency debt financing.

The private creditor landscape has changed significantly over the last 20 years, and domestic debt has also risen rapidly in several African countries, a reflection of expansion in the financing of development and infrastructure projects. The number of creditors and diversity of lending instruments have expanded rapidly (including in bond financing), with many instruments having:

- Complex structures,
- Variable interest rates,
- Acceleration clauses.

Private creditors' claims have become tradeable, exposing borrowers to volatile market sentiments and rollover risks. Claims that are at least partly collateralized or secured constitute a significant share of external debt obligations of borrowers under this market structure. As a result:

- the median domestic debt-to-DGP ratio in most African countries has doubled since 2011--from 7 to 13 percent of GDP;
- with non-resident holdings of local currency debt in some African LDCs reaching levels normally observed in emerging markets.

The interest rate burden already exceeded pre-HIPC levels and, as a result, debt service burdens are highest in Sub-Saharan Africa[6].

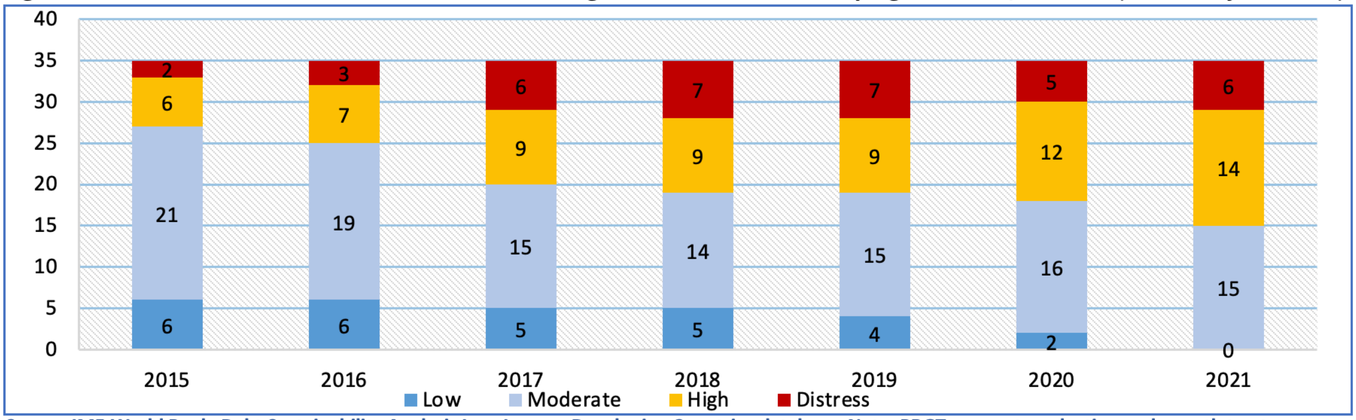
6 IMF—Regional Economic Outlook for SSA, April 2022

Addressing the New Debt Vulnerabilities

The outlook for Africa's debt sustainability is challenged by emerging risks and vulnerabilities. Over the past decade, debt sustainability rat¬ings using the Debt Sustainability Analysis (DSA) framework indicate that a large number of coun¬tries have fallen into debt distress—unable to meet their obligations—and more downgrades are expected as a result of COVID–19. Rising debt levels in the past decade have negatively affected debt sustainability ratings for low-income coun¬tries in Africa.

The changing private creditor landscape in Africa has consequently resulted into an unfolding challenge. By the end of 2019 debt-vulnerabilities were increasing in most African LDCs and frontier markets to the point of a renewed global spotlight on the ensuing financing challenges a quarter of a century after the inception of the HIPC framework. As of end-December 2019, 51 percent of African countries were classified by the IMF and the World Bank as either in or at high risk of debt distress (under the joint Bank-Fund Debt Sustainability Framework for Low-income Countries, LIC DSF), several of which had benefited from the comprehensive HIPC debt relief.

Fig 3: Sub-Saharan Africa: Debt Risk Status for PRGT Eligible Low-Income Developing Countries, 2015–21 *(Number of countries)*



Source: **IMF-World Bank, Debt Sustainability Analysis Low-Income Developing Countries database. Note: PRGT = poverty reduction and growth trust**

In November 2020, the G20 reached an agreement on a Common Framework for Debt Treatments to deal with insolvency and liquidity problems under the G20 Debt Service Suspension Initiative (DSSI) and beyond for the DSSI-eligible countries, including most front-line market countries and LICs in Africa. As of March 8, 2021, more than 60 percent of the eligible countries had made requests for the debt service suspension. Going forward, strengthening the links between debt financing and growth returns would play an important role in ensuring debt sustainability on the continent. Improvements in the efficiency of debt-financed investments would ensure that debt is used to finance the most productive projects that generate sufficient growth and complementarities to pay-off the debt in future.

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