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Here it goes again! The IMF is calling for urgent debt reduction for developing nations. Governance welcome!

Gloomy global economic forecasts

At the Spring 2022 meeting of the International Monetary Fund and Financial Committee, both the IMF and the World Bank called for urgent and large debt reduction for developing countries through more efficient coordination among creditors. The reasoning goes as follows:

First, global economic prospects have been severely set back, largely because of Russia's invasion of Ukraine, while the geopolitical crisis emerged even as the global economy has not yet fully recovered from the pandemic. Second, inflation is rising due to supply-demand imbalances coupled with a tightening of monetary policy, hence looming hikes in interest rates! Price increases in emerging market and developing economies might accelerate and reach close to 10 percent, the fastest clip since the global financial crisis in 2008, with the largest impact on vulnerable populations in low-income countries[1]. Higher food and fuel prices increase the prospect of social unrest in poorer countries. Third, a recent surge in indebtedness of households and firms poses risks to the pace of recovery[2] while default prospects are looming in China and in many developing countries.

The warning call from the IMF is severe. Global growth will barely reach 3,6% in 2022 and 2023. Actually, more objective growth forecasts take into account the sharp drop in trade and financial transactions in 2022 due to geopolitical turmoil. Economic growth might reach only 3%, and less than 4% in Sub-Saharan Africa: "The war in Ukraine has upended economic forecasts. Its effects have been hugely disruptive, through three main channels: on confidence, by injecting uncertainty; next on supply, by triggering actual or expected shortages; and finally on demand by stoking inflation"[3]. Gone are the years when developing countries enjoyed buoyant annual GDP growth of 6%. More critically, oil-importing Sub-Saharan countries will face large current account deficits, in the neighborhood of 4%. Overall, stagflation and protracted debt crises are not academic threats[4].

Rising number of candidates for "debt-distress category"

Worsening debt prospects will unfold in 2022-23. With large domestic and external deficits, developing countries have taken advantage of low interest rates, search for yield by investors, and buoyant global liquidity, to increase domestic and external indebtedeness. It is not surprising, thus, that tighter monetary policy in OECD's central banks and rising risk aversion now place severe strains on debt sustainability in many countries. According to the IMF, debt vulnerabilities are rising in both low and middle-income countries. Debt is at a 50-year high – equal to roughly 250 percent of government revenues. Around 60 percent of the world's poorest countries are now in debt distress or at high risk of it. The tightening of financial conditions and the war in Ukraine are making this fragile scenario even worse. In Sub-Saharan Africa, 50% of low-income countries are in debt distress. For the vast majority of these countries, the upcoming debt crisis is home-made, hence stemming from a mix of low productivity of investment, exchange rate mismanagement, unsustainable deficits, and capital flight.

Problems ahead for home-made debt crises due to bad governance

In the Spring of 2022, the IMF has identified roughly 30 countries at high risk of debt distress. Nearly all exemplify a combustible combination of bad governance, unabated corruption, authoritarian regimes, and institutional deficiencies. Such aloofness casts strong doubts on the legitimacy of these candidates for debt cancellation operations, as well on the actual benefits for the poorer of the poor. Since the late 1990s, the IMF and the World Bank have gradually opened their eyes regarding corruption and bad governance in developing countries. Today, they acknowledge that numerous countries, particularly in Sub-Saharan Africa, generate protracted socio-political turmoil, that impede buoyant investment and sustainable growth. The region has experienced an increase in the prevalence of political instability and military coups in recent years: "Since August 2020, military forces have assumed control

* **Michel-Henry Bouchet,** *Module Director at CIFE, is Emeritus Global Finance Professor at SKEMA Business School and Strategy Adviser of investment funds. Former Senior Economist at the World Bank, and CEO of Owen Stanley Financial.*

in four countries (Burkina Faso, Chad, Guinea, Mali), and coups have been attempted in two others (Guinea-Bissau, Niger). The region is also confronting several armed conflicts and terrorist threats, including in Burkina Faso, the Central African Republic, the Democratic Republic of the Congo, Ethiopia, Mali, Niger, and Nigeria"[5]. Nevertheless, the IFIs keep preaching generous debt reduction across the board without clear governance conditionality, hence generating moral hazard that boils down to providing blank checks for corrupt elites.

The IMF's debt reduction toolkit: "One size fits all"

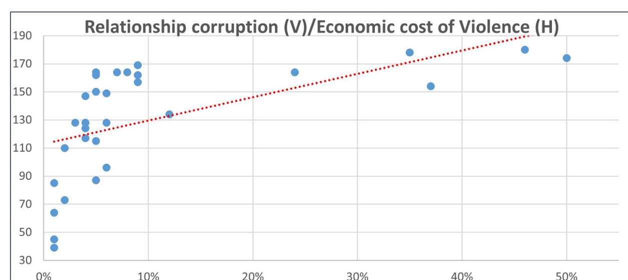
The IMF's objective is restoring debt sustainability with either time, debt cancelation, or new money, i.e., with debt re-profiling or an outright restructuring of public debt. The IMF introduced a new framework beyond COVID-related initiatives such as the G20 Debt Service Suspension Initiative. More recently, the Common Framework for debt treatments is intended to deal with insolvency and severe liquidity problems for 73 low income countries, along with the implementation of an IMF-supported reform program. The IMF demanded that the Common Framework that offers guidance for debt restructuring be improved urgently, coupled with the enforcement of the comparability of treatment among creditors[6]. The key issue is mobilizing support from private creditors, mainly bondholders, whether they like it or not. Importantly, the IMF demands that debt service payments and penalty interest be suspended until an agreement is reached.[7]

The problem is that the global financial architecture has changed since the debt restructuring saga of the 1980s and 90s. Today, international banks have moderate exposure on developing countries while enjoying large loan loss reserves on risky countries in debt distress (i.e., income statement expenses set aside to allow for uncollected loan payments). The composition of creditors has changed with a rising share of non-Paris Club creditors (mainly China and India), coupled with a growing pool of private bondholders and investment funds with little appetite for debt restructuring. They are well equiped for fighting in courts while resisting so-called "hair cuts" and write-offs for countries that show enduring bad governance.

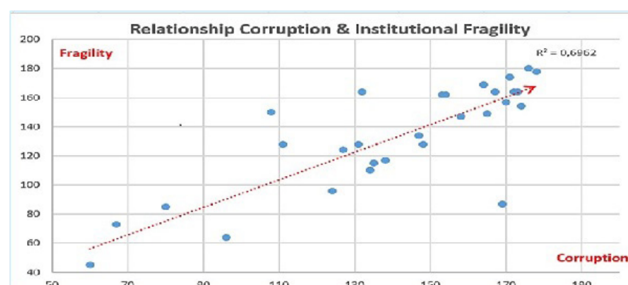
The growing share of China's loans is also a matter of concern for implementing balanced debt-reduction schemes: "Over the past two decades, China has become the leading lender in sub-Saharan Africa, holding 62% of the region's bilateral external debt in 2020, up from only 3% in 2000. Its loans reach $140 billion, and are mostly split between seven countries, which account for two-thirds of Chinese lending[8]» (i.e., Angola, Ethiopia, Zambia, Kenya, Nigeria, Cameroon, and Sudan). Transportation, energy, and mining are the three sectors that received the lion's share of Chinese financing. The lending terms are characterized by much opacity, they are often linked with tied-aid, without questions asked on governance, and the loans are secured with collateral in case of default, hence a de facto subordination of other creditors.

The issue of institutional deficiencies, weak governance, and state failure

For many of the eligible countries, debt problems stem from a deficit of governance, including corruption, unabated capital flight, bad prioritization of spending, and poorly designed fiscal and monetary policies. In these countries, corruption is closely associated with a large economic cost of violence. Measured as a ratio of GDP, that cost reaches more than 5% and up to 50% for 20 countries.

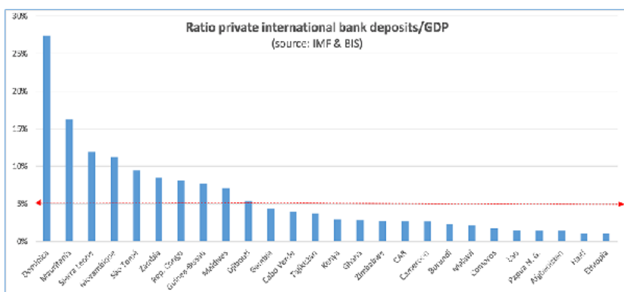


The reason for that substantial violence cost is multifaceted, including authoritarian and repressive regimes, low economic and political freedom, and large institutional deficiencies. The following chart illustrates the strong relationship Corruption/Institutional Fragility for 26 developing countries elegible for debt reduction.



Overall, in countries with very weak institutions, the lack of transmission channels to express social demands for inclusive growth and human rights leads to a vicious circle of violence and repression. This is particulary true in Cameroon, Mozambique, Zimbabwe, Haiti, Zambia, Angola, Mauritania, Sudan, Ethiopia, Kenya, Nicaragua, Lao, Chad, Congo, Somalia, Burundi, and Malawi, among others. Many

of these countries are close to state failure, and poverty is growing while life expectancy is shrinking. In these countries with low development score and high corruption ranking, a good deal of past borrowing has been recycled in offshore banking accounts, without benefiting domestic investment, nor economic growth, nor reduced poverty! The following chart shows the ratio to GDP of expatriated private savings that are deposited in international banks. That ratio is above 5% for ten countries that are eligible for debt reduction, and stands in a 2-4% range for another 16 countries.



Conclusion: Toward discouraging institutionalized kleptocracy?

Overall, it makes little sense to reduce external indebtedness of countries that show little improvement in their governance trajectories. Poverty in nominal GDP terms should never be a necessary nor sufficient criteria for debt reduction eligibility. Most of these countries are rich though with poor people. Often, mining and hydrocarbon-driven growth has been fertile soil for a two-fold power concentration, both economic and political They have enjoyed robust economic growth without paving the way for sustainable and inclusive development. They are all in the worse rankings of human development, democracy, political freedom, and institutional stability. Their debt-distress situation is almost entirely home-made, that is, local elite-driven. Debt reduction as called for by the IMF is a perfect exemple of moral hazard. If implemented with arm-twisting between official and private creditors, it will only convince the latter that developing countries' elites keep enjoying growth, without generating socio-economic development. The latter means GDP growth coupled with those inputs that make it lasting, that is, governance, education, health, shrinking wealth gaps, robust institutions, and property rights, *inter alii*.[9]

Without a strict governance enforcement framework, Paris Club and IFIs-supported external debt cancellation will only keep encouraging institutionalized kleptocracy. With or without debt reduction, the local governments are so corrupt that their unabated commitment is toward maintaining power monopoly. The international civil servants working at the IMF, the World Bank, and the numerous regional development banks should shift their priorities toward funding closely monitored development projects, together with on the ground NGOs, to make sure that fertilizers, seed-system development, irrigation, education and health programs, directly contribute to improving local populations' well-being.

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