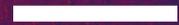




Policy Brief

**FOR AN AFRICAN STABILITY
MECHANISM**



Task Force 7
**International Finance and
Economic Recovery**

FOR AN AFRICAN STABILITY MECHANISM

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Abstract

Africa's financial markets remain vastly underdeveloped, entailing difficult market access through high and volatile financing costs. The lack of financial stability is further damaging African countries that are already facing numerous challenges, including high financing needs for their sustainable transition. This policy brief argues that it is time to create a regional financial arrangement, the African Stability Mechanism (ASM), which can alleviate countries' short-term liquidity constraints by enhancing credit and augmenting liquidity on debt markets, as well as by tackling the liquidity costs of commodity price volatility. This regional financial arrangement, hosted by pan-African institutions, should have independent and credible governance and discipline.

Challenge

Amid wave after wave of COVID-19 outbreaks, African countries face evermore salient needs for financing, namely to tackle a lack of vaccines and infrastructure underinvestment in the short run and to ensure a sustainable transition adapted to the challenges of climate change over the longer run. The war in Ukraine has also further constrained food security, increased inflation and weakened their external situation. When African countries graduate from official development assistance (ODA), they often struggle with obtaining affordable financing from capital markets and expose themselves to high liquidity risks.

At the periphery of international capital markets, African financial markets remain vastly underdeveloped. They suffer from low regional domestic savings, a lack of institutional resilience and credibility, and high volatility driven most notably by the commodity price roller coaster and heightened commodity dependence. This underdevelopment has two main consequences for African countries. First, access to financial markets remains difficult for many countries and, when feasible, is associated with high financing costs – notably because of a specific African risk premium. Second, as the continent is particularly exposed to natural disasters and other external shocks, the underprovision of regional risk-sharing mechanisms pertains to important risks of spillover and snowballing effects. Ensuring macrofinancial stability and reasonable funding costs is of the utmost importance for the African continent, given on one hand the heavily constrained policy space of African national authorities and on the other, the urgent challenge of investing in energy and sustainable transitions.

The African continent remains vastly underprotected by the Global Financial Safety Net (GFSN). Throughout 2020-2021 (Kring et al, 2021), three countries had access to bilateral swap agreements and 10 to a regional financial arrangement (North African countries through the Arab Monetary Fund and South Africa through the BRICS Contingent Reserve Arrangement). The remaining 43 countries only had access to the International Monetary Fund (IMF) for liquidity provisions to stabilise their financial needs. At a time when numerous African governments struggle with rising debt vulnerabilities, when commodity prices are evermore pressured and when action needed to successfully manage the fight against climate change must be undertaken in the next three years, there is a need to ensure that African countries have the means to hedge against liquidity shocks before they deteriorate into solvency or more structural problems, and generate devastating vicious macrofinancial circles.

Proposal

Given the current risks of multiple crises faced by African countries, this proposal advocates for the creation of a new Regional Financing Arrangement (RFA), the African Stability Mechanism (ASM), to alleviate countries' short-term liquidity constraints. The ASM should provide liquidity lines to enhance the quality of African debt by reducing financing costs and facilitating future debt restructuring, as well as to tone down the negative effects of commodity price volatility on countries' liquidity.

AN INDEPENDENT AND CREDIBLE AFRICAN INSTITUTION

The idea of an African RFA is not new. The creation of a dedicated institution has failed since the 1960s for two reasons: scarce political support and a lack of country leadership on one hand, and a lack of financial support for initial paid-in capital on the other. As demonstrated by African Development Bank President Akinwumi Adesina, Ghana President Nana Akufo-Addo, and Senegal and African Union President Macky Sall, the first lock seems to be breaking. The August 2021 allocation of US\$650 billion in Special Drawing Rights (SDR) and Group of (G20) countries' commitments to rechanneling their SDRs offer the opportunity to reshuffle the cards regarding the second lock.

OWNERSHIP, CAPITAL AND GOVERNANCE

A strong underlying rationale behind an RFA is to promote countries' ownership in the Global Financial Safety Net (GFSN; Ocampo, 2006). Developing a new pan-African Financial Institution would help empower African countries in the GFSN and in international institutions. Given countries' reluctance to suffer political stigma if soliciting the IMF for a program, this could also ensure a quicker response when faced with liquidity shocks, thus ensuring that the situation does not deteriorate too much (Gallagher et al, 2021).

The African Stability Mechanism should be part of the African Development Bank's (AfDB) galaxy to benefit from its well-established presence in the African continent and its Preferred Creditor Status (PCS). Within the AfrDB, the ASM should be an independent institution, similar in construction to the African Legal Support Facility (ALSF). Initial paid-in capital could be provided by African countries themselves and by advanced economies as ODA or SDR transfers. To enable SDR rechanneling, a specific account system could be installed for the IMF Poverty Reduction and Growth Trust (PRGT) to maintain the SDR reserve asset status (Andrews et al., 2021).

To ensure proper accountability and independence, the ASM could be governed by a board of directors representing member countries and international official financial contributors. Voting powers should be allocated to African countries as the sum of a fixed number of votes and number of votes proportional to their financial contribution, and for international contributors as a number of votes proportional to their contribution.

COMPLEMENTARITY, CREDIBILITY AND SURVEILLANCE

The ASM should not bail out countries in unsustainable macrofinancial situations or act as a substitute for a program with the IMF. Instead, the ASM should focus on specific African financial vulnerabilities that are not yet within the toolkits of international financial institutions. To that end, the creation of the ASM should follow the guidelines for complementarity identified by the G20, the IMF and existing RFAs (G20, 2011; IMF, 2017; Cheng et al., 2020).

Enhancing the quality of African debt can only be possible if available liquidity lines are paired with a way of ensuring disciplined fiscal policy. Hence, all instruments should be associated with clear qualification criteria and strict safeguard measures. To facilitate adequate discipline and credibility, the African Stability Mechanism should be backed by a dedicated and independent Macroeconomic and Financial Research and Surveillance Office. This office should be tasked with following member countries' macroeconomic and financial health, recommending policy guidelines and evaluating countries when requesting assistance from an ASM liquidity line.

DEVELOPING LIQUIDITY LINES ADAPTED TO AFRICA'S NEEDS

The African Stability Mechanism could entail three instruments focused on alleviating financial market pressures, enhancing debt quality, reducing its cost, and an additional tool aimed at tackling the overarching source of volatility.

ENHANCING DEBT MARKET VALUE THROUGH A CREDIT ENHANCEMENT FACILITY

Most African countries gained access to financial markets relatively recently. For low- and middle-income countries (LMIC) graduating from IDA, bond markets offered an opportunity to access additional funding at relatively initially affordable rates. With the COVID-19 crisis and the forthcoming tapering of the United States' monetary policy, it is now obvious that the cost of refinancing this debt will become increasingly expensive. Some countries, through the Debt Service Suspension Initiative (DSSI) or the Common Framework, have already embarked

on a process of debt restructuring. Notwithstanding the outcome of this process, finding means to reduce the cost of funding will be required to maintain market access to African issuers. One potential task of the ASM should be to provide such credit enhancements, blending somehow the affordable cost of funding of Multilateral Development Banks (MDB) and the availability of market resources. These guarantees shall not be limited to international markets and should not cover the refinancing of domestic bond markets.

Brady Bonds were created in the 1980s as a tool to restructure countries' distressed debt obligations into secured and tradable bonds, providing long-dated US Treasury Zero Coupons as collateral to the new issuances. Rolling interest payment guarantees, covering 12 to 24 months of interest payments using at least double-A-rated securities, were introduced at the same time. Today, these options and the foundations they laid for sovereign debt restructurings and cooperation among various stakeholders provide adequate and promising guidelines for tomorrow's instruments. The resulting leverage ratio from providing Zero Coupons as collateral is certainly not as attractive as it used to be in the 1980s and 1990s; still, the tapering firms have the rationale and need for such instruments. Eligibility to such guarantees should be limited to countries with sound economic and financial situations that struggle with tapping necessary liquidity in financial markets. They should be provided when market costs are high enough to make a strong case for these guarantees but low enough so as not to stand in the way of – and add complexities to – a debt restructuring when needed.

This instrument can be a vehicle to facilitate access to international markets, but in many cases, such as the West-African Economic and Monetary Union (WAEMU), it could also provide liquidity in domestic markets.

ENHANCING DEBT MARKET LIQUIDITY THROUGH THE LIQUIDITY AND SUSTAINABILITY FACILITY

The Liquidity and Sustainability Facility (LSF) is a mechanism that the United Nations Economic Commission for Africa (UNECA) introduced along with the world-leading asset manager PIMCO and launched in November 2021 (UNECA, 2021). The LSF is a Special Purpose Vehicle that subsidises private-sector investment in African sovereign debt. It aims at diminishing misperceptions about the credit risk of African sovereigns, with the objective of introducing greater liquidity and competitive tension on pricing, as well as trimming down government borrowing costs across the continent.

To that end, it provides “concessional” repo loans to private investors that would in turn pledge African sovereign debt – Eurobonds or local currency bonds – as collateral. The LSF subsidies entail repo haircuts, which constitute safety cushions supporting lenders in case

there is a need to liquidate collateral when the borrower defaults. This concessional approach to repo incentivises the private sector to increase its portfolio investments on the continent. Cheaper loan terms are expected to stimulate market demand for African sovereign debt and, therefore, limit state's borrowing costs. UNECA estimates that the LSF could generate up to \$50 billion in savings on interest costs over the next five years. Over the longer term, the facility also aims to mobilise finance for Sustainable Development Goals (SDGs). Notably, it would encourage the issuance of green or sustainability-linked bonds by Africa governments that could be used by private investors as collateral in repo transactions at favourable terms.

Given its purpose and already advanced stage, the LSF could be a flag facility for facilitating the creation of the ASM.

HELPING MANAGE FUTURE DEBT RESTRUCTURING

Debt restructuring negotiations are often complex and time-consuming processes. They coalesce debtor and multiple creditors with differing preferences around the objective of finding an agreement that optimally suits all. When countries enter the difficult process of debt restructuring, they do not necessarily have the financial space and flexibility to navigate the negotiations.

Introducing a cash element in sovereign debt restructurings could facilitate discussions and help avoid deadlocks and protracted negotiations that put debtor countries at a disadvantage. The cash could be used as a standalone option for creditors willing to leave the market or brought into the restructuring menu as an enhancement. The introduction of cash options can and should be introduced in a way that doesn't affect debt sustainability considerations, reflecting the country fundamentals and avoiding the boondoggle syndrome of previous experiments.

LIMITING COUNTRIES' HEDGING COSTS

The discussion on the appropriate way to hedge commodity risks has gone on for a very long time – with little success. One possibility is for the country to buy options on the market. The problem is that they are costly, limiting the range of affordable protections to put options against extreme risks. An alternative (and more natural) route would be to sell on the future markets and somehow freeze current prices in the budget – with potential rollover formulas to smooth the guaranteed prices. These alternatives are not attractive because they come with an element of credit risk that requires the recourse to margin calls. However, considering potential mismatches between price volatility in actual income flows, the latter can result in

liquidity crunches for countries. This is where the ASM should step in, offering AAA guarantees on the margin calls.

The need to fight off speculation on commodities for their excessive boost to price volatility and harmful impact on food security has been an item on the agenda for decades, with little implementation success. At the end of 2011, then-Dominican Republic President Leonel Fernandez passed a proposal at the General United Nations, including elements on security deposits intended to cover the premiums to be paid on commodity futures contracts. The World Bank has explored this field but only in a very limited way, as margin call guarantees are counted as another WB exposure on the country and are thus never used by member countries. While they entail no financial risks (they are called upon in good times), these mechanisms are underused.

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