

THE LIQUIDITY AND SUSTAINABILITY FACILITY FOR AFRICAN SOVEREIGN BONDS: WHO BENEFITS?

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PREFACE

Over the past few decades, market-based finance has become central to the global financial system. Huge volumes of financial instruments are traded on a daily basis. In an effort to improve access to global financial markets for African countries, the United Nations Economic Commission for Africa (ECA) – in cooperation with the asset management firm PIMCO – has proposed setting up a Liquidity and Sustainability Facility (LSF). This is designed to create a Special Purpose Vehicle to subsidise private sector investment in African sovereign debt. The LSF would be financed by official development assistance (ODA), multilateral development banks and/or by the central banks of members of the Organisation for Economic Co-operation and Development (OECD).

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The LSF proposal comes at a time when several African countries are desperate to get access to finance to respond to the humanitarian, social and economic crisis triggered by the Covid-19 pandemic. It is presented as a viable alternative to debt restructuring that would accommodate the reluctance of many African countries to endanger market access by joining initiatives such as the Debt Service Suspension Initiative (DSSI), launched by the Group of 20 (G20) and the Paris Club in 2020. These initiatives have so far proved to be insufficient when it comes to addressing existing debt problems.

This quite technical proposal features prominently in the ECA's Building Forward Together agenda, which was released in November 2020. If implemented, this could have significant consequences for the sustainable development of African countries, their access to international finance and the consequent impact on the livelihoods of African citizens. The proposal merits a detailed examination and broader public debate by finance ministries, central banks, parliaments, academia and civil society.

In order to facilitate this debate, the Heinrich Böll Stiftung, Eurodad and Nawi – Afrifem Macroeconomics Collective commissioned Daniela Gabor – Professor of Economics and Macro-Finance at the University of the West of England – to conduct a study on the LSF proposal and its implications. She is a renowned expert on shadow banking, with a particular focus on repo markets.

The aim of this paper is to contribute to an informed dialogue on the most appropriate forms of development finance. In view of the critical debt situation of African countries in the wake of the Covid-19 crisis, and of the longer-term ambition to deliver on the Sustainable Development Goals and the Paris Agreement, this discussion is more vital than ever.

Box 1

THE MAIN FINDINGS OF THIS REPORT IN A NUTSHELL

- In its current form, the LSF proposal raises **underappreciated macrofinancial risks for African governments and central banks**. In short, the LSF's envisaged approach threatens to create cyclical improvements in liquidity: improved market access in good times for African sovereign bonds – when it is needed less – that might rapidly disappear in bad times – when it is needed most. This report outlines an updated LSF framework that would minimise those risks.
- The LSF proposal raises questions about **the institutional risks** underpinning the creation of a supranational entity whose actions have a direct impact on the treatment of African sovereign debt, and monetary policy operations in African countries. Furthermore, the LSF would hand over institutional power to its private commercial bank administrators, with potential conflicts of interest if these have commercial operations in the countries for which they make collateral decisions.
- This report raises broader **questions about a developmental model that promotes a 'de-risking African assets' partnership with institutional investors**. The refusal of private bondholders to join the Debt Service Suspension Initiative raises doubts about the benefits of this public-private finance partnership, and its ability to deliver for poor countries.
- The report fleshes out **the 'Reform' and 'Rethink' approaches to the LSF proposal**. The Reform approach outlines improvements to the institutional design of the LSF that would minimise the macrofinancial risks for African sovereigns and central banks. The Rethink approach in turn maps out alternative development pathways that prioritise local development banking instead of bond finance.

01

SUMMARY AND RECOMMENDATIONS

The Covid-19 pandemic has confronted many poor and middle-income countries with a liquidity crisis. In response, several initiatives have been agreed or are in negotiation (see United Nations, 2020a). The most significant – the G20-Paris Club Debt Service Suspension Initiative (DSSI) – provided 43 countries with around US\$5 billion in fiscal space by suspending official bilateral debt payments over the period April–December 2020. In turn, another 30 DSSI-eligible countries – some at high risk of debt distress (such as Ghana) – did not apply to the DSSI as they were worried about endangering bond market access. Moreover, private bondholders refused to voluntarily participate in the DSSI.

Given such concerns, and as the pandemic blurred the line between liquidity and solvency for many countries, the UN Economic Commission for Africa (ECA) *Building Forward Together* outlines a series of proposals that would improve market access and enable a sustainable recovery for African countries. This is an ambitious roadmap that includes the extension of the DSSI, the issuance of Special Drawing Rights, debt for nature swaps and a fundamental reset of international institutions that would transform the international financial architecture so that it better meets the needs of middle and low-income countries on the African continent. This report explores one of the new instruments that ECA argues is necessary to upgrade the international financial architecture, a Liquidity and Sustainability Facility (LSF) that ECA developed in partnership with the investment manager PIMCO.

The LSF proposes to create a Special Purpose Vehicle that would subsidise private-sector investment in African sovereign debt (ECA, 2020).

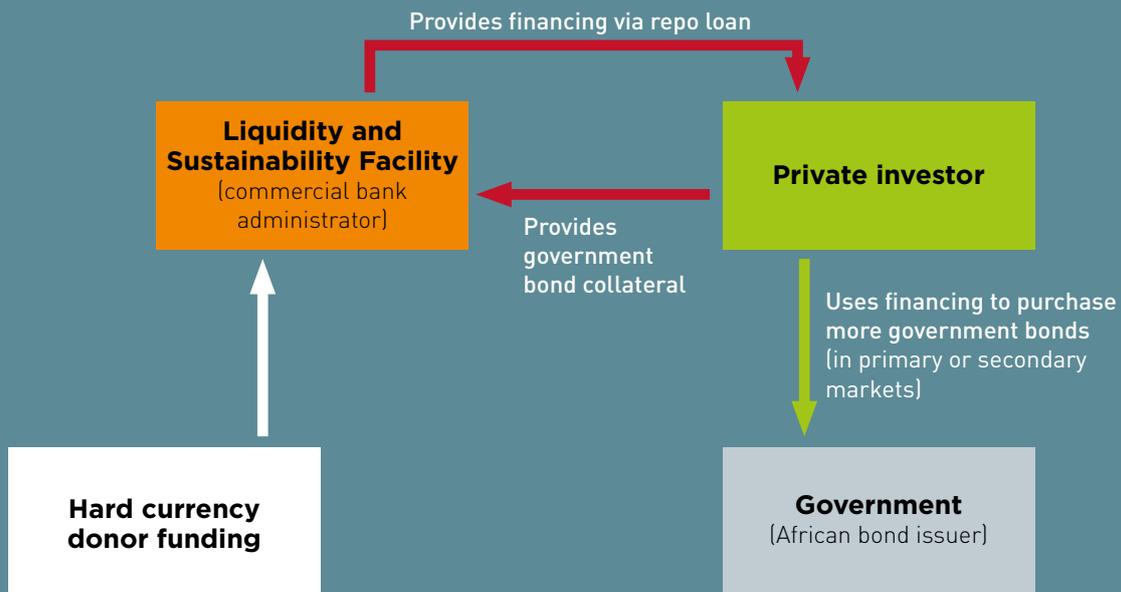
This would incentivise, rather than coerce, private creditors to participate in initiatives towards creating fiscal space for African countries affected by the global pandemic. While the LSF is an ECA proposal, it has received official support from several African governments at the October 2020 annual meetings of the International Monetary Fund (IMF) and World Bank (Financial Times, 2020). These governments view the LSF as an effective response to the liquidity crisis that is threatening African (and other) economies.

Originally, the ECA and PIMCO developed the LSF for African sovereign bonds. By September 2020, the United Nations (2020b) proposals for *Financing for Development in the era of COVID19 and beyond*, prepared for the consideration of Ministries of Finance, envisaged that the LSF could be extended to vulnerable middle-income countries in Latin America and Asia. While this report examines in detail the implications of the LSF for the African continent, its insights apply to other countries too.

How would LSF improve market liquidity for African sovereign bond issuers? The LSF would provide “concessional” repo financing to private bond investors. In a nutshell, investors would borrow from the LSF by pledging African sovereign debt – Eurobonds or local currency bonds – as collateral (see Figure 1). In market speak, investors would finance their African sovereign debt holdings with LSF repo loans. These cheaper loan terms would stimulate further demand for African sovereign debt, and therefore lower borrowing costs. The increased appetite for African sovereign debt, the ECA (2020) estimates, could generate an estimated US\$39–56 billion in savings on interest costs over a five-year period.

Figure 1

THE LSF: CONCESSIONAL REPO LOANS FOR PRIVATE INVESTORS IN AFRICAN SOVEREIGN BONDS



Source: Author

Over the longer term, the LSF would mobilise private finance for the Sustainable Development Goals (SDGs), for instance through SDG Covid-19 bonds (see ECA, 2020). The LSF would be financed by official development assistance, multilateral development banks, and/or by the central banks of members of the Organisation for Economic Co-operation and Development (OECD).

Indeed, the ECA hopes that the LSF would reshape misperceptions about credit risk for African sovereigns. African countries routinely complain of an “African premium” that forces them to pay higher interest rates than non-African countries with similar fundamentals (Soto, 2020). As Vera Songwe, the ECA president put it, “Africa needs its own repo market, [...] that would attract a new class of investors while shaving off the

higher borrowing costs that African nations face because of age-old stubbornly sticky perceptions that they are especially risky” (Songwe, 2020). The LSF “modelled on existing market-based and commonly used facilities in Europe and the US [...] would help cut borrowing costs for African governments by providing incentives for the private sector to increase their portfolio investments on the continent”.

This optimistic message will be welcome in capitals across the continent, given that some 20 African countries had at least one downgrade in credit ratings in 2020, leaving only Botswana, Mauritius, and Morocco with at least one investment grade rating in Africa.

This report maps the balance of benefits and risks underpinning the ECA proposal (see Table 1). It examines the *macrofinancial risks* for African

government bond issuers and for central banks that the LSF repo instrument engenders, as well as *the developmental impact of a private-finance-led development paradigm* with its emphasis on steering the structural transformation of local financial systems towards bond-based finance.

The report first details the *how* and *what* of the LSF proposal, explaining the mechanics of the repo instrument, which is routinely used by private investors in high-income countries to finance their portfolios of sovereign and private bonds, and the mechanics of LSF subsidies.

The subsidy can take two forms: a “concessional” LSF interest rate on repo loans to private investors (positive but close to zero), and a “concessional” LSF haircut on the government bond collateral that private investors provide. As a risk management tool, the haircut establishes how much cash the borrower receives in return for the collateral it provides as a “guarantee”. If collateral has good credit ratings and trades in liquid markets, like US Treasury bills, haircuts would be zero: The repo borrower gets US\$100 in cash for US\$100 of collateral valued at market prices. At lower credit rating and lower liquidity for collateral, the repo borrower would for example only get US\$90 for US\$100 of collateral: a haircut of 10%.

Thus, repo haircuts should not be confused with haircuts in debt restructuring. Repo haircuts are a safety cushion that protects the lender in case the borrower defaults and the lender needs to liquidate collateral. In contrast, haircuts in debt restructuring inflict losses on the lender, writing off a proportion of the debt to share the burden more equally

Proposition 1:

FOR THE LSF SUBSIDY TO IMPROVE PRIVATE CREDITORS’ APPETITE FOR AFRICAN SOVEREIGN DEBT, THE LSF NEEDS TO UNDERSTAND HOW SENSITIVE INVESTORS’ DEMAND IS TO HAIRCUTS AND INTEREST RATES ON REPO LOANS.

The LSF intends to provide repo financing at lower interest rates and haircuts than what private investors would get from the market. While the precise details are not publicly available, the LSF would need to understand the sensitivity of investor demand to repo lending terms (haircuts and interest rates). Where credit risk – that the African sovereign defaults – is particularly relevant in the risk/return calculations of private investors, the LSF may have to provide significant haircut and interest rate subsidies in order to stimulate investor demand.

Proposition 2:

A BETTER UNDERSTANDING OF COLLATERAL RISK MANAGEMENT IS PARAMOUNT TO ENSURING THAT THE LSF DOES NOT WORSEN MARKET ACCESS/SHRINK FISCAL SPACE FOR AFRICAN COUNTRIES.

The ECA (2020, p. 5) recognises that “emerging and developing economies continue to face volatile, expensive and pro-cyclical funding markets”. It hopes that the LSF becomes a powerful stabilising mechanism. Yet, the LSF’s collateral framework can amplify pro-cyclical risks unless it carefully designs them out. The report explores three such potential risks: cyclical liquidity for African sovereign issuers of collateral, perverse incentives for African countries to prioritise Eurobond debt, and institutional conflicts between the LSF (its commercial managers) and national central banks.

Critically, the LSF plans to adopt the private-sector practice of collateral valuation to ensure protection against its borrowers’ default. That implies that the LSF would (a) call for additional collateral (margin calls) when African sovereign bond collateral falls in price, and (b) potentially increase the size of haircuts on African sovereign bonds when credit ratings worsen. With this, the LSF’s envisaged approach to African sovereign bond threatens to create *cyclical improvements in liquidity*: better liquidity in good times for African sovereign bonds – when it is needed less – that might rapidly disappear in bad times, as collateral valuation practices can destroy liquidity.

The report illustrates the cyclical threats with two examples: the European Central Bank (ECB) and Ecuador. Although the LSF’s counterparties would be asset managers/institutional investors rather than commercial banks who typically borrow from central banks via repo loans, the ECB’s experience is instructive. Much like the ECA, the ECB originally designed its repo loans to improve the liquidity of Euro area sovereign bonds.

Yet, during the 2010–2012 sovereign debt crisis, the ECB raised haircuts on some Euro area sovereign collateral and called for additional collateral on repo loans secured by those sovereign bonds that lost liquidity, further eroding the private appetite for these. Similar dynamics may arise in the LSF project and could generate exorbitant privileges for the most liquid sovereigns (such as South Africa). Second, given the threat of default hanging over middle-income and poor countries, Ecuador’s experience with repo loans in the run-up to the 2020 default highlights how the hidden costs of collateral valuation can eventually outweigh the benefits of lower borrowing costs (see Box 2 in text below).

An impact study is necessary to learn the extent to which these liquidity effects are sizeable before the ECA proposal receives donor support.

Proposition 3:
THE LSF RISKS INCREASING AFRICAN COUNTRIES’ VULNERABILITY TO FOREIGN CURRENCY DEBT (EUROBONDS)

It is unclear, thus far, whether the LSF would only target Eurobonds, local currency bonds, or a combination of the two. The LSF’s initial firepower (US\$50bn) would amount to roughly one-third of foreign-currency African sovereign debt securities outstanding mid-2020 (US\$150bn) and a tenth of the local currency sovereign bonds (US\$500bn). Should the LSF accept Eurobond collateral, it risks creating perverse incentives for countries to shift to foreign currency debt, which is not only more difficult to service during periods

of market stress, but also at odds with recent donor/G20 initiatives to promote local currency bond markets.

Proposition 4:
DECISIONS TO CHANGE LSF HAIRCUTS MAY UNDERMINE MONETARY POLICY AUTONOMY IN AFRICAN COUNTRIES AND CREATE CONFLICTS OF INTEREST FOR THE PRIVATE ADMINISTRATOR/S.

The LSF proposal raises questions about the institutional risks underpinning the creation of a supranational entity whose actions directly impact the collateral treatment of African sovereign debt. Should the LSF choose to increase haircuts on some African sovereigns during bad times, the LSF may directly hamper efforts by national central banks to preserve sovereign bond market liquidity. Furthermore, the LSF would hand over institutional power to its private commercial bank administrators, with potential conflicts of interest if these have commercial operations in the countries for which they make collateral decisions.

The LSF should specify concrete mechanisms that preserve local monetary policy autonomy.

Proposition 5:
THE DSSI NEGOTIATIONS THROW INTO QUESTION THE BENEFITS OF THE PUBLIC-PRIVATE FINANCE PARTNERSHIP FOR SDGS IN POOR COUNTRIES THAT THE LSF PROMOTES.

The ECA proposal has the longer-term aim of mobilising private finance to deliver on the SDGs. In this aim – deeper (more liquid) African bond markets to attract more foreign finance – the ECA proposal expands a range of global initiatives focused on escorting private capital to African countries, including the World Bank’s Maximising Finance for Development, the G20’s Infrastructure as an Asset Class, or the IMF and World Bank’s Local Currency Bond Markets initiative. Broadly, this new development paradigm points to a global “portfolio glut”, the trillions managed by institutional investors, mainly from the Global North. Multilateral development banks (MDBs), official development assistance, and governments are to escort these trillions towards SDG asset classes with policies that range from derisking assets (that is, changing their risk/return profile), as the LSF envisages, to the structural transformation of local financial systems, from bank-centric to bond-centric. But the developmental impact of the turn to bond markets is poorly understood, while private bondholders’ refusal to join the DSSI raises doubts about the benefits of this public-private finance partnership.

The report teases out the potential developmental implications of this new paradigm, to then flesh out the “Reform” and “Rethink” approaches to the ECA proposal. The Reform approach outlines improvements to the institutional design of the LSF that would minimise the macrofinancial risks for African sovereigns and central banks. The Rethink approach in turn maps out alternative development pathways that prioritise local development banking instead of bond finance. A combination of the two may be the way forward.

Table 1

**THE LSF REPO INITIATIVE: BENEFITS AND RISKS FOR EUROBONDS
AND LOCAL CURRENCY SOVEREIGN BONDS**

	Mechanics of the LSF subsidy	Benefits	Macro-financial and developmental risks		
			Private investors	LSF	African governments
Eurobond sovereign debt	<p>The LSF finances private investors' Eurobonds via repos:</p> <p><i>The LSF holds Eurobond collateral</i></p>	<p>Cyclical improvement in liquidity & borrowing costs, concentrated for large issuers</p>	<p>*credit risk of sovereign debt</p> <p>*collateral liquidity risk from LSF collateral management</p>	<p>*counterparty risk (private investors)</p> <p>*liquidity risk (of African sovereign bond collateral)</p>	<p>*LSF haircut discrimination between African sovereigns as credit rating changes</p> <p>*LSF collateral valuation: cyclical liquidity/cost of funding</p> <p>*debt sustainability (incentive to shift to Eurobonds)</p>
Local currency sovereign debt	<p>The LSF finances private investors' LC debt portfolios via repos:</p> <p><i>The LSF holds LC sovereign debt collateral</i></p>	<p>Cyclical improvement in liquidity & borrowing costs</p>	<p>*credit risk of sovereign debt</p> <p>*collateral liquidity risk from LSF collateral management</p>	<p>*counterparty risk (private investors)</p> <p>*liquidity risk (of African sovereign bond collateral)</p> <p>*exchange rate risk</p>	<p>*LSF haircut discrimination as credit rating changes</p> <p>*LSF collateral valuation</p> <p>*institutional risk: coordination with national central banks, and conflicts of interest for private administrators of the LSF</p> <p>*doubtful benefits of partnership with private bondholders to finance the SDG</p>

02

THE ECA/PIMCO PROPOSAL IN A NUTSHELL: “LIQUIDITY FOR AFRICAN SOVEREIGNS, FINANCING FOR DEVELOPMENT, BUILDING FORWARD TOGETHER”

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This section details the *how* and *what* of the ECA proposal to create an African repo market.

A. HOW: THE LIQUIDITY BENEFITS OF THE LSF PROPOSAL

The LSF is expected to:

allow these African governments access to new liquidity while enticing private sector investors to re-enter or enter this market for the first time¹. ... Based on the experience of repo facilities in other markets, there is little doubt that the creation of this facility would lead immediately to substantially lower spreads for African sovereigns, allowing them to access markets on more favourable terms.
(Songwe, 2020)

The LSF would subsidise the private investors' purchase of African government bonds as follows.

Typically, private investors finance the purchase of government bonds from own funds, or from borrowing in money markets, including the largest segment: the repo money market. The ECA proposal tasks the LSF with lending to private investors, via repo operations, to finance these purchases.

The repo segment of money markets has grown rapidly in high-income countries since the 1980s, as their financial systems have moved from bank-centric to bond-centric. Financial institutions prefer repos because they offer a cheap form of leverage. Take an investor that wants to finance its holdings (portfolio) of Kenyan government bonds. In a classic repo, the investor "sells" its Kenyan government bonds to the LSF, with a promise to repurchase them (hence the repo) at some point in the future, which can range from overnight to a week, a month, or more (see Figure 2). For the duration of the repo, the investor remains the economic owner of Kenyan government bonds, it bears the risks and receives the returns (interest rate payments by the Kenyan government). However, it gives up legal ownership to the LSF, which can sell it in case Investor 1 defaults. For the LSF, legal ownership of the Kenyan collateral protects it against the risk that Investor 1 defaults, that is, it does not buy back the African sovereign bonds (counterparty risk). The distinction between legal and economic ownership of Kenyan collateral is critical: the LSF does not bear the credit risk of the African sovereign bonds, even if it is the legal owner.

But the LSF still faces collateral liquidity risk: the risk that Kenyan government bonds lose liquidity in a crisis like the Covid-19 pandemic. Less liquid collateral means the LSF stands to lose if Investor 1 defaults. If this occurs, the LSF might have to sell Kenyan collateral at a price lower than when it "bought" bonds from the investor, thus failing to recover its cash loan entirely.

¹ Note that the LSF initiative would complement other mechanisms that increase foreign demand for African bonds, including their inclusion in bond indexes (for example, JP Morgan EM bond index) or bond Exchange Traded Funds (ETFs).

To manage such risks, repo lenders rely on two complementary collateral strategies: haircuts and collateral valuation.

A.1 Haircuts capture the difference between the cash the borrower receives and the value of collateral it provides as a “guarantee”. The level of haircuts reflects lender views on collateral quality (liquidity) first, and may also factor in the credit ratings attached to repo borrowers (see Julliard et al., 2019). Put differently, haircuts provide a cushion of safety to protect repo lenders like the LSF against large price declines in collateral. The higher the likelihood that collateral securities will lose liquidity in a crisis, the higher the cushion of safety. If collateral is traded in less liquid markets – as most African government bonds do – then haircuts would typically be high. But what makes good protection for the repo lender means in practice pro-cyclical pressures for repo borrowers and collateral issuers.

Figure 2 depicts a hypothetical LSF balance sheet and its connection to private investors to whom it would lend via repos. Liabilities capture the modalities through which the LSF receives its funds from senior lenders – envisaged to consist of a coalition of OECD central banks, MDBs, and/or other official donors – that would provide an initial equity injection (funded commitment or guarantee) of US\$1–5 billion, and senior lending capital up to US\$50 billion. Eventually, the LSF may also issue its own debt if it wants to expand its lending capacity.²

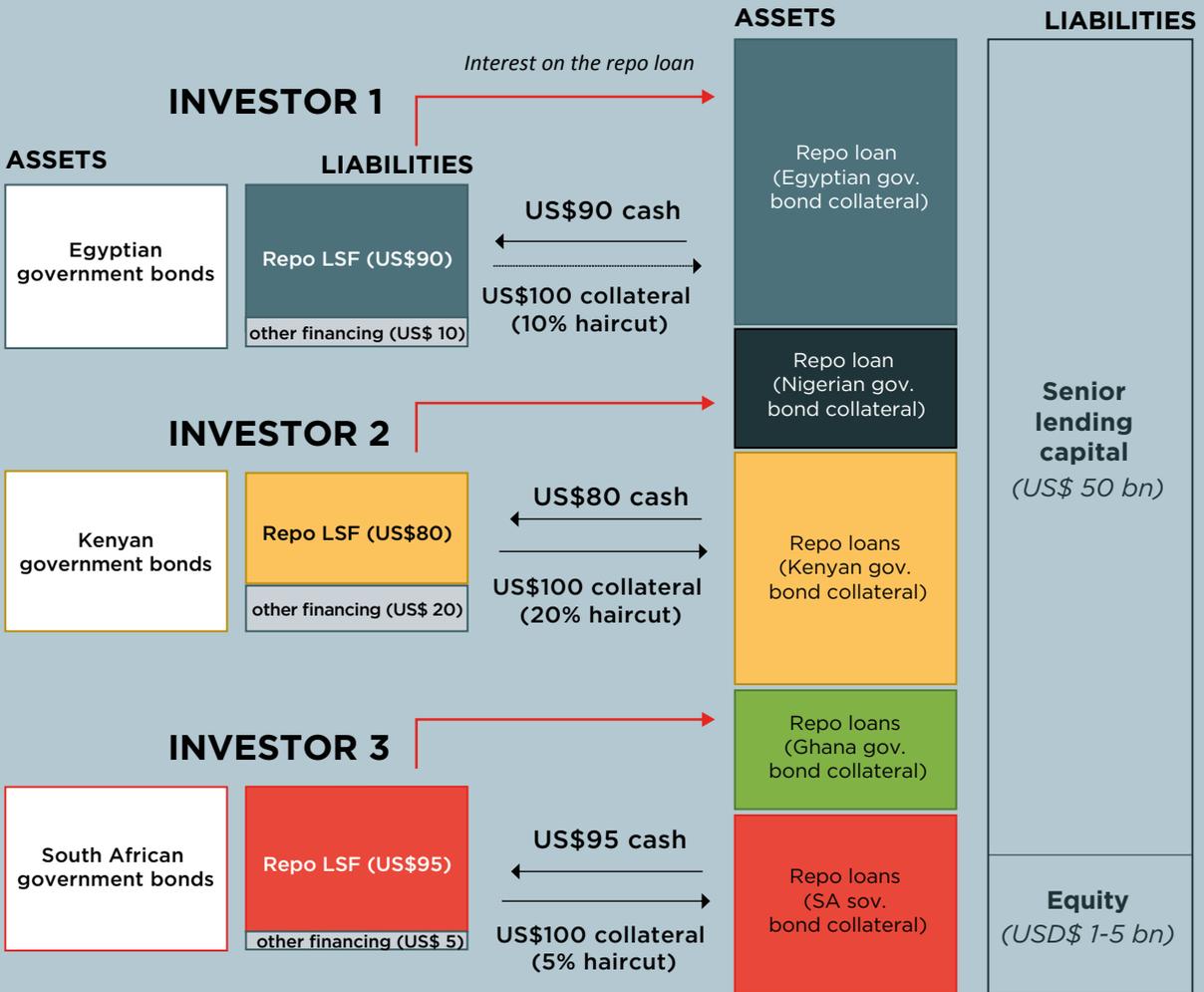
The LSF’s assets capture its revenue-generating activity, that is, repo loans to private investors collateralised by sovereign bonds. The LSF proposal envisages concessional interest rates on the repo loans to private investors (close to zero) and generous haircuts. Indeed, haircuts also play an important role in setting financing conditions for private investors in government and private bond markets.

If, say, the LSF provides US\$80 for US\$100 of Kenyan sovereign bonds at market prices – a 20% haircut – Investor 2 has to pay interest on the US\$80 cash loan. But it also has to find an additional US\$20 to finance its holdings of Kenyan government bonds. This is less expensive than financing US\$100 of Egyptian government bonds with a 10% haircut, or South African government bonds with, say, a 5% haircut. Put differently, even if the LSF interest rate on the repo loan is zero, the level of the haircut makes a difference: the lower the haircut (compared to benchmark private levels), the cheaper it is for investors to finance their bond holdings.

² Although the LSF would seek to leverage a regulatory regime where it is exempted from regulatory capital charges, it may need credit enhancements to obtain a high rating.

Figure 2

HYPOTHETICAL LSF AND PRIVATE INVESTOR BALANCE SHEETS



Source: Author

The hypothetical example in Figure 2 assumes that the LSF would use haircuts as a policy instrument for *liquidity first, and risk management purposes second*. This is an important distinction: Whereas public and private repo lenders use haircuts as a risk management tool,³ the LSF would first prioritise the liquidity of sovereign bond markets, albeit without giving up entirely the risk management aspect.

This is why the LSF would set concessional haircuts at below market levels (prioritising liquidity), but would retain a ratings-based methodology (presumably accounting for the credit worthiness of the private borrowers and for the creditworthiness of the issuer of sovereign collateral) to adjust haircuts (risk management).

What is a meaningful “concessional” haircut? Data on benchmark (representative) private haircuts for African sovereign bonds is scant.

Anecdotal evidence for a series of structured repos between the Egyptian central bank and global banks points to haircuts on Egypt’s foreign currency bonds varying between above 50% in 2016 – when Egypt was negotiating a bailout package with the IMF – and 25% by the end of 2018 (see Box 1). This is most likely at the low end of private haircuts, since Egypt is one of the largest issuers of Eurobonds.

Since private investors worry about the credit risk attached to the African sovereign debt, the LSF would have to carefully calculate how elastic the demand for bonds is to haircuts: In other words, how far below market levels the LSF haircuts would need to fall in order to create meaningful incentives for private investors. Haircuts would likely “discriminate” between African sovereign bonds, with more liquid bonds enjoying lower haircuts; in the example in Figure 2, the LSF charges lower haircuts on the more liquid South African sovereign bonds than on Egyptian or Kenyan ones.

³ See for instance BIS (2015a).

Box 1

THE LSF: CONCREPOS FOR A LIQUIDITY-PRESSURED SOVEREIGN – EGYPT'S STRUCTURED REPO LOAN

In 2016, while negotiating a US\$12 billion loan from the IMF and in preparation for currency devaluation, Egypt sought to boost its international reserves. It agreed on a one-year structured repo loan from HSBC. Egypt would sell US\$4 billion dollar-denominated sovereign bonds to HSBC, for which it would receive US\$2 billion in cash, and repurchase those bonds at that same price in a year. Because it had no access to international capital markets, and therefore no dollar-denominated sovereign bonds, the Ministry of Finance first issued “fictitious” Eurobonds, which it transferred to the central bank. The Eurobonds were “fictitious” in that the Ministry of Finance did not receive US\$4 billion by selling these bonds, from either the central bank or private investors. Rather, the issuance served the purpose of generating collateral for the repo transaction.

In this repo transaction, the Central Bank of Egypt financed its portfolio of Eurobonds at a 50% haircut (for each US\$100 in Eurobond collateral, it received US\$50 in cash). In practice, the haircut was higher, as the central bank had to also provide additional dollar cash collateral (of an undisclosed volume). Since the Eurobonds were issued for this repo transaction, and therefore had no secondary market liquidity, it is likely that Egypt had to hand over a significant volume of dollar cash collateral in order to secure the repo loan. It also had to pay interest on the loan (again undisclosed). The Central Bank of Egypt then renewed repo loans and increased volumes throughout 2017 and 2018. The November 2018 structured repo loan had a longer maturity period (four years) and lower haircuts (25%) (Central Bank of Egypt, n.d.), as the IMF programme enabled Egypt to return to Eurobond markets.

The 2016 repo allowed Egypt to artificially increase international reserves and meet the IMF's requirements.⁴ But such financial engineering – as the case of Ecuador shows in Box 2 – carries high costs for poor countries when they default, and it is more difficult to restructure.

Source: Risk.net (2017)

The LSF's “official” haircut framework can become a powerful force that shapes the liquidity of African sovereign debt. Indeed, the LSF proposal implicitly assumes that concessional LSF haircuts would eventually lead to a reduction in private repo haircuts. The LSF haircut framework would function as a signal to private markets, in the same way that the ECB's haircuts on the collateral it accepts from Eurozone commercial banks signal its view of collateral riskiness and liquidity.

⁴ The Central Bank of Egypt resorted to a new repo in 2018, borrowing US\$3.8 billion from a consortium of international banks, including Citigroup, Credit Suisse AG, Deutsche Bank AG, First Abu Dhabi Bank PJSC, and HSBC. <https://uk.reuters.com/article/egypt-loans-banks/update-1-egypt-central-bank-signs-3-8-blm-finance-accord-with-international-banks-idUSL8N1WR1W2>.

A.2 Collateral valuation can also generate positive, albeit cyclical, liquidity effects (Adrian and Shin, 2010). Following market practice, the LSF would compute the market value of collateral sovereign bonds on a regular (probably daily) basis – known as marking collateral to market. If, say, Kenyan bonds increase in price during good times, Investor 2 will ask the LSF to return bonds until the market value of Ethiopian bond collateral again equalises US\$100 (the original value of the collateral). With this margin call, Investor 2 can then further borrow against the bonds that the LSF has returned, get cash, and buy more bonds. If these price effects were to manifest across the range of African sovereign bonds, LSF borrowers would have additional collateral returned, and therefore increased balance sheet capacity.

The LSF proposal implicitly assumes that private creditors would use this balance sheet capacity to buy more African sovereign bonds. But there is no guarantee that this would be the case. In practice, private demand for sovereign bonds depends on a broader range of considerations (such as expectations etc).

Furthermore, it is important to note that these liquidity effects can be cyclical. *Both haircuts and collateral valuation* can work to lower borrowing costs for sovereign issuers of collateral during good times, as described in this section, but they can also raise them should the LSF decide to increase haircuts on particular sovereign bonds or when it calls margin on investors as (Ethiopian, Kenyan, or Zambian) sovereign bonds fall in price (see Section 3 for more details).

B. WHAT: EUROBONDS VS LOCAL CURRENCY SOVEREIGN BONDS

The LSF could subsidise private demand for two types of African sovereign debt: Eurobonds (foreign currency) and/or local currency sovereign bonds. The LSF proposals so far have not clearly specified which. These two scenarios have distinctive implications.

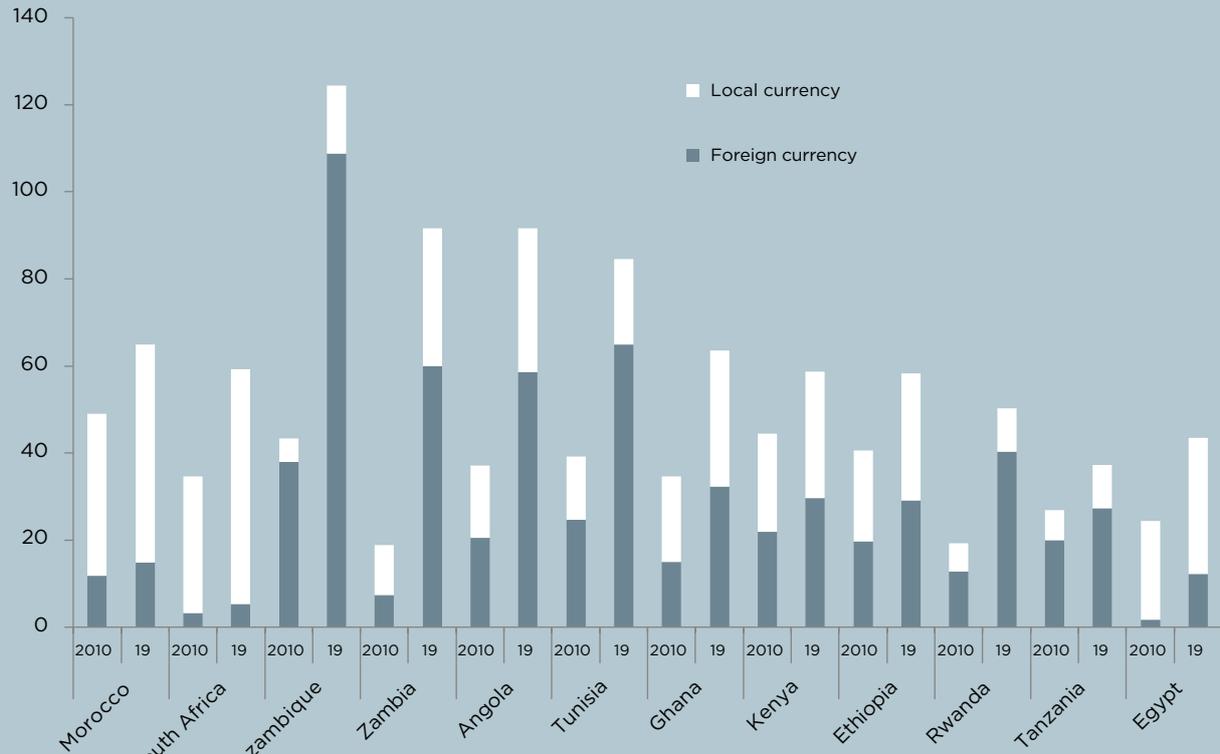
Countries across Africa have increasingly turned to issuing debt securities, rather than relying entirely on bank loans and official development assistance. According to estimates, African countries borrowed one out of four US dollars via bonds; out of this, 80 cents were borrowed via local currency sovereign bonds and 20 cents via Eurobonds.⁵ At the beginning of 2020, the outstanding volume of local currency sovereign bonds across African countries reached roughly US\$500 billion (with significant variation across countries), compared to around US\$150 billion in sovereign Eurobonds.

At a more granular level, the distribution of local vs foreign currency borrowing via bond markets differs significantly across African countries.

⁵ The share of securities outstanding in the stock of government debt increased from 19% in 2012, to 24% in 2017 on average across sub-Saharan Africa. This is driven by “frontier countries”, who borrowed by 2017 on average 35 out of 100 US dollars via securities issuance, compared with 14 US dollars for non-frontier markets. Frontier countries in sub-Saharan Africa include: Ghana, Mozambique, Tanzania, Zambia, Rwanda, Namibia, Kenya, Nigeria, Cameroon, Gabon, Côte d'Ivoire, Uganda, Mauritius, and Senegal. Non-frontier countries include: Guinea-Bissau, Gambia, Burundi, Niger, Benin, Burkina Faso, Sierra Leone, Swaziland, Lesotho, Madagascar, Malawi, Mali, Congo, Republic of DRC Zimbabwe, Ethiopia, Cabo Verde, Central African Republic, Equatorial Guinea, Liberia, and Chad.

Figure 3

GOVERNMENT DEBT, 2010 VS 2019 (SHARE OF GDP)



Source: Data from IMF (2020), and Arslanalp and Tsuda (2014)

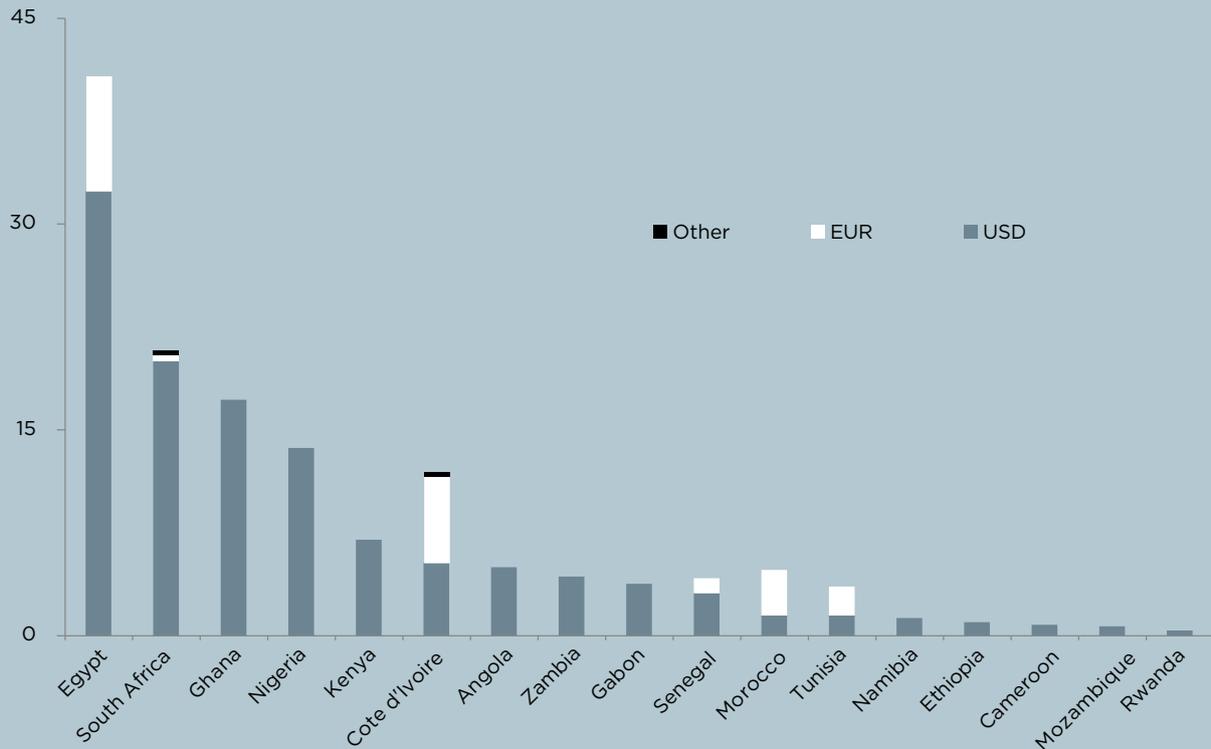
At one end of the spectrum, Morocco, South Africa, and Egypt continue to source the bulk of their market financing via local sovereign bond markets, although the relative share of Eurobonds has increased significantly for Egypt (see Box 1 above). In contrast, countries such as Mozambique, Zambia,⁶ Tunisia, Ghana, Rwanda, and Kenya are relatively more reliant on Eurobonds.

B.1 Eurobonds The LSF's initial firepower of US\$50 billion amounts to roughly one-third of foreign-currency sovereign debt securities outstanding for the African continent by mid-2020 (roughly US\$150bn). Of this, most is USD denominated (US\$122.7bn), with several countries issuing Euro-denominated debt.

⁶ Notably, Zambia defaulted on its Eurobonds in November 2020, whereas several others – Kenya, Ghana – were classified by the World Bank to be “at high risk of default” in the wake of the Covid-19 crisis.

Figure 4

**EUROBONDS – FOREIGN-CURRENCY DEBT, OUTSTANDING VOLUMES
(JUNE 2020, IN US\$ BILLIONS)**



Source: BIS data

In terms of geographic distribution, issuance is concentrated in several countries: Egypt, South Africa, Nigeria, Ghana, and Angola together account for 75% of all outstanding US dollar-denominated sovereign bonds. For instance, Ghana issued US\$3 billion in Eurobonds in February 2020, with an interest rate of 6.35% for US\$1.25 billion in bonds with a six-year maturity, 7.87% for US\$1 billion in bonds with a 14-year maturity, and 8.75% for US\$750 million in bonds with a 41-year maturity.

Furthermore, since the start of the pandemic and through to December 2020, only Egypt and Morocco tapped Eurobond markets, as most African countries turned to domestic financing and concessional borrowing.

There are two reasons why an LSF subsidy for private investors' purchases of Eurobonds is inconsistent with donor-driven policy initiatives to improve debt sustainability.

First, the LSF may generate perverse incentives for countries to shift from issuing local currency to foreign debt, even though the G20, the IMF, and MDBs have spent the last decade and a half promoting local currency bond markets as an alternative to the specific vulnerabilities of foreign currency borrowing (IMF and World Bank, 2020). Indeed, although countries are attracted to Eurobond issuance by cheaper borrowing costs, they do so by bearing exchange rate risks.

Second, the uneven distribution of outstanding Eurobonds across African issuers means the uneven, albeit cyclical, distribution of liquidity benefits. If the LSF prioritises Eurobond collateral, it would implicitly advantage countries with higher issuance/credit rating and incentivise others to switch from local to foreign currency debt.

b.2 Local currency sovereign bonds

Since the 2007 G20 meeting in Potsdam, the international policy community has promoted the Local Currency Bond Markets initiative, which is aimed at creating deeper bond markets, both sovereign and private (corporate). The Local Currency Bond Markets initiative would reduce dependency on foreign currency debt and improve poor countries' ability to withstand volatile capital inflows (see IMF and World Bank, 2020). Among a variety of measures, the initiative also advocates the development of local repo markets to "enhance the money and bond market nexus", as "the money market is the starting point to developing liquid securities markets" (Gabor, 2018). The LSF initiative thus builds on existing efforts to increase the attractiveness of African asset classes for global investors, in particular portfolio investors.

For instance, the ECA argued in 2018 that local currency bonds – issued in more liquid capital markets – would enable countries to finance infrastructure and other projects (see Songwe, 2018).

Indeed, local currency bond markets have grown rapidly across the African continent, although issuance is concentrated in several countries: South Africa, Egypt, Nigeria, Morocco, and Kenya together account for 90% of outstanding volumes. Although data on market liquidity is scant,⁷ there is evidence that non-resident investors – foreign banks and institutional investors – hold significant volumes in South Africa (around 35%), Egypt (30%), and Ghana (24%). The rest is held by local banks and local institutional investors, mostly pension funds.

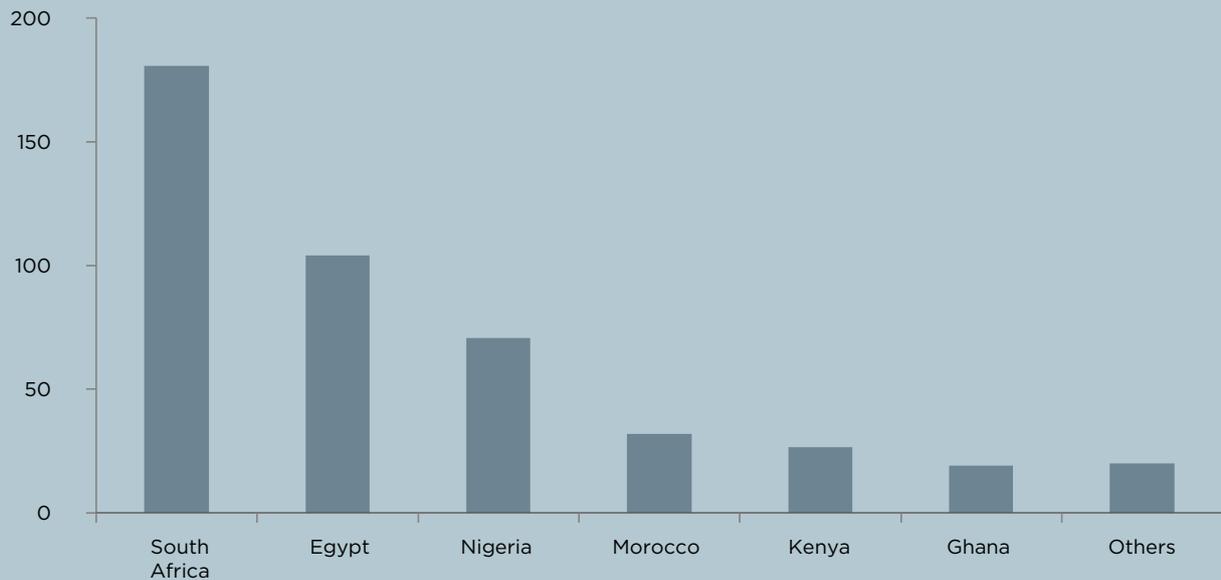
Should the LSF prioritise local currency sovereign bonds for repo lending, it can do so in two ways: by either lending US dollars against local currency bond collateral, or by offering repo loans in local currency against local currency bond collateral.

In the first scenario of a cross-currency repo operation, the LSF needs to address the question of exchange rate risk. If private investors pledge sovereign bonds denominated in, say, South African rand (ZAR) in exchange for US dollar repo loans, the LSF would also be exposed to currency risk if the ZAR/USD exchange rate falls, and vice versa, the private investor becomes exposed to the LSF if the South African currency appreciates.

⁷ The most recent analysis focuses on the 2000–2014 period (see Dafe et al., 2018).

Figure 5

**LOCAL CURRENCY SOVEREIGN BOND MARKETS, OUTSTANDING VOLUMES
(MARCH 2020, IN US\$ BILLIONS)**



Source: BIS and national central banks

The standard practice in such circumstances – as, for example, in the ECB’s US dollar loans to Eurozone commercial banks – is to revalue collateral for exchange rate movements and make margin calls. Collateral posted at the LSF would not just be adjusted for its own price changes, but for exchange rate movements away from those agreed in the repo contract. This may render the instrument less attractive for private investors and potentially defy the entire purpose of the LSF. The LSF could instead decide to subsidise the exchange rate risk for private investors by

not revaluing collateral when exchange rates move against it. This would increase the costs of derisking for the LSF unless it can hedge the currency risk at attractive rates.

In the second scenario, should the LSF decide to lend in local currency, it would have to swap its dollars into the local currency and hedge the exchange rate risk. It may be able to do so, at least for a part of its portfolio, through blended-finance initiatives such as TCX, The Currency Exchange Fund.⁸

⁸ For more details, see <https://www.tcxfund.com/wp-content/uploads/2018/12/TCX-2019-2022.pdf>.

03

LIQUIDITY FOR SOVEREIGNS: THE LESSONS FROM THE EUROPEAN REPO MARKET

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The ECA proposal suggests that the LSF would “mimic facilities and market practices already widely used in developed markets. In essence it would confer the liquidity provisioning benefits enjoyed by developed markets to African markets.” This ambition echoes that of other development finance institutions such as Frontclear⁹ – a development finance institution whose motto is repo “money markets matter” – and that of the repo market promotion in the IMF/ World Bank and G20 Local Currency Bond Markets initiative.

⁹ Frontclear describes its “money markets matter” mission as follows: “Frontclear is a financial markets development company dedicated to stable and inclusive money markets in emerging and developing countries (“EMDCs”). Its core investors are European development financial institutions and governments, including EBRD, DFID (UK), FMO (Netherlands), KfW (Germany), ProPARCO (France). Blended finance is central to Frontclear and defined as the strategic use of donor and development finance to mobilize private capital flows and expertise to emerging markets – a clear contribution to SDG 17. Frontclear blends and leverages donor and development finance capital to support investments by our partner beneficiaries” (Frontclear, n.d.).

However, such ambitions downplay the cyclical effects and systemic fragilities that come with designing repo markets after the blueprint of high-income countries – fragilities that have been well-recognised in global regulatory debates since the collapse of Lehman Brothers and been the target of regulations introduced by the Financial Stability Board and Basel III regulations (see ICMA, n.d.). These pro-cyclical effects arise from the collateral valuation practices described in the previous sections, and they can equally characterise the repo loans extended by public institutions, including central banks or the LSF, where institutions choose to prioritise the risk management function of collateral, rather than providing liquidity to the broader market.

A. NO REPO, NO (CYCLICAL) LIQUIDITY

It is broadly agreed in investor and global policy communities that African countries need to change the architecture of their repo markets if they wish to attract more private (foreign) demand for sovereign bonds.

Take Frontclear’s work in Ghana, a country that “puts bond market development high on the agenda”. The (mostly local) investors in Ghana’s bond markets, it argues, have portfolio strategies that are at odds with market liquidity: They buy Ghanaian government bonds and hold them until maturity. This “buy to hold” strategy means there is little trading, and therefore limited liquidity, in secondary markets.¹⁰ Hoarding, particularly by local banks, damages market liquidity. Yet again, it is broadly agreed in the global regulatory community that well-functioning repo markets do not solve the problem of cyclical market liquidity, as the COVID19 related disruptions in the US Treasury market illustrate.

According to Frontclear, hoarding reflects the absence of a well-functioning local repo market, as the Ghanaian legal and institutional framework does not allow the types of repos that are used in high-income countries (and that the LSF would use in its operations): Repo lenders do not have legal title to collateral securities, so they cannot sell them should repo borrowers default. There is no practice of mark-to-market for collateral securities. To establish a thriving repo market, Frontclear suggests, *Ghana has to “Americanise”* its local money and securities markets, that is, it has to adopt the legal and risk practices used in high-income countries (Gabor, 2020a),¹¹ including collateral valuation (Frontclear, 2019).

¹⁰ Incidentally, Frontclear’s concerns with hoarding would also apply to the LSF, unless the latter decides to lend out its portfolio of sovereign collateral and allow its private repo borrowers to substitute collateral.

¹¹ See Gabor (2020) for an argument that the Americanisation of local financial systems has been a strong force in powering the transition from bank-based to bond-based systems, first in Europe, then in middle-income countries, and then gradually including low-income countries.

For this, Frontclear has been working with the Bank of Ghana (the local central bank) and the International Capital Market Association to accelerate repo market development through the adoption of the Global Master Repurchase Agreement standards (under UK law). In parallel, Frontclear guaranteed a cross-currency repo transaction where Fidelity, a local bank, borrowed US dollars from Société Générale in a repo transaction collateralised with Ghanaian cedi government securities.

Frontclear's diagnostic of Ghana's money-sovereign bond market nexus – *no American-style repo, no liquidity* – applies to most countries in Africa. Indeed, foreign investors typically view the African capital markets as "South Africa with a few countries attached" (Medeiros and Dehn, 2019; see also IMF and World Bank, 2020).

The LSF aims to scale Frontclear's efforts across the continent. To explore the potential effects for African sovereign debt issuers, it is instructive to consider the experience of the ECB. Although the LSF does not have a monetary policy mandate, its strategy of using repos to boost sovereign collateral liquidity overlaps significantly with that of the ECB, at least in the early years of the Euro.

Since its inception as the central bank for the Euro area, the ECB has used repos for its monetary policy operations, lending to commercial banks against private and sovereign collateral. The ECB's promotion of repo markets had a second objective: to increase the liquidity of Euro area sovereign bond markets, similar to the LSF's ambitions (see ECB, 2002).

But in designing its collateral management regime, the ECB found itself confronted with trade-offs between risk management and collateral market liquidity that may be relevant for the LSF, particularly in the types of downside risks it may generate for African sovereigns.¹²

Haircuts: The ECB originally designed its repo instrument to treat Euro area sovereigns equally in terms of haircuts. That is, a commercial bank could post Greek sovereign collateral or German sovereign collateral on equal terms and obtain the same amount of repo funding. Once the 2008 crisis hit and credit ratings agencies downgraded several Euro area sovereigns, the ECB switched to a differentiated haircut regime that reflected credit ratings (and downgrades). It imposed higher haircuts on banks borrowing against Greek (or other downgraded) sovereign collateral, just as the LSF may choose to do for African sovereign bonds with deteriorating credit ratings.

This can have negative implications for the liquidity and the funding costs of the sovereign. Official haircuts on sovereign bond collateral, such as those used by central banks in repo loans, influence private investors' demand for these securities – indeed, this is the critical premise of the LSF project. But if the public lender increases haircuts, that is, if the LSF provides less cash for a given amount of collateral when it renews or makes new repo loans, it makes it more expensive for private investors to finance these securities, as illustrated in Figure 2 above. It may accelerate the fire sale for those securities that have become expensive to finance at the LSF, including through "cliff effects" (downgrades from investment to speculative grade).

¹² For a full account of the impact of the ECB's collateral policies on sovereign bond markets, see Gabor and Ban (2016).

Investor flight from downgraded securities, often because of mandate constraints, may be worsened if the LSF relies on private credit ratings in its repo haircut framework.¹³ The actions of the LSF can thus reinforce – instead of counterbalance – pro-cyclical pressures for both its private repo borrowers (whose costs of funding sovereign bonds increase) and for sovereign issuers (whose liquidity comes under threat).¹⁴

The LSF may generate negative spillovers for African sovereigns if it chooses to prioritise the risk management function of haircuts during periods of market stress. Should it follow credit ratings, as the ECB does for instance, it risks igniting or accelerating private investor flight from specific sovereign bonds and reinforcing the very pro-cyclical pressures that it intends to fight.

The elusive nature of the liquidity promise that is hardwired into the LSF pan-African repo project becomes obvious in the use of haircuts as a risk management tool.

Mark-to-market/collateral valuation: Even in a scenario where the LSF extends long-term repo loans and therefore does not change haircuts when sovereign collateral suffers downgrades, collateral valuation can generate pro-cyclical effects.

Repo collateral valuation is another critical part of collateral risk management that has consequences for issuers of collateral (in this

case, African governments). Collateral valuation explains why the repo market has grown to become the most important segment of money markets across high-income countries. It feeds cycles of liquidity and leverage (borrowing): During good times, higher bond prices give repo borrowers additional collateral to repo, obtain cash, and buy more bonds (Adrian and Shin, 2010). During bad times, collateral falls in price. Repo borrowers then have to post additional collateral/cash in order to make up the difference; if they cannot they are forced to fire sale the bonds they hold, which then drives down prices, forcing further margin calls on repo collateral positions. Such downward liquidity spirals,¹⁵ which led to the demise of Lehman Brothers and the near implosion of the global financial system in 2008, do not just affect repo borrowers, but also the issuers of collateral.

Indeed, fire sales of sovereign collateral during the European sovereign debt crisis reduced their liquidity and increased the cost of financing for sovereigns.¹⁶ The ECB's own collateral valuation practices also played an important part in eroding the liquidity of several Euro area sovereigns affected by sovereign downgrades.

Closer to the Covid-19 pandemic, Ecuador's use of repos provides a stark warning about the downside risks hardwired into collateral valuation practices (Box 2).

¹³ In 2010, the ECB recognised the dangers of relying on credit ratings to guide its repo haircuts framework, and instead suggested that it would turn to its own internal ratings, see ECB (2011). In its 2020 Covid-19 response, the ECB recognised the pro-cyclical effects of anchoring haircuts in private credit ratings and suspended (albeit temporarily) such practices (ECB, 2020).

¹⁴ Put differently, the risk management function and the liquidity promotion function of haircuts can suddenly come into conflict during periods of market stress, be those triggered by tighter dollar funding conditions worldwide, or by specific developments in African sovereign bond markets.

¹⁵ See Brunnermeier and Pedersen (2009) for a detailed account of liquidity spirals.

¹⁶ The pro-cyclical effects of repo collateral valuation are well recognised in the international policy community, and since 2008, regulated through the Financial Stability Board recommendations on shadow money markets, including the repo market (see Gabor, 2020).

Box 2

ECUADOR: REPO FINANCING IS CHEAPER AS LONG AS COLLATERAL PRICES HOLD UP

Throughout 2018, Ecuador entered a series of four-year repo loans with Goldman Sachs and Credit Suisse. It issued “fictitious” Eurobonds worth US\$2.4 billion to pledge as collateral in exchange for US\$1 billion repo loans from Goldman Sachs and Credit Suisse (a haircut of 58.3%). These Eurobonds were fictitious, in that Ecuador did not sell them to investors to receive hard cash in return, but rather issued them solely for repo collateral purposes. However, to be able to mark them to market, Ecuador and its private creditors agreed on a legal framework that treated the fictitious bonds as equivalent to real bonds of similar maturity that traded in secondary markets at a price available to all parties. If/when the price of equivalent bonds fell, Goldman Sachs and Credit Suisse would make margin calls, asking Ecuador to send hard cash in order to bring the value of collateral pledged back to its original level (US\$2.4 billion).

Collateral valuation increased the risks of debt distress for Ecuador, until it defaulted in April 2020. Although the interest rates on the repo loans were significantly lower than those that Ecuador would have had to pay by borrowing directly in the Eurobond market, Ecuador saw the true costs of repo loans exploding as the price of repo collateral (equivalent bonds) started falling. According to estimates, Ecuador had to pay around US\$700 million back in margin calls – effectively returning a large chunk of the US\$1 billion repo loan much before the end of the four-year maturity of the repo loan – throughout the first three months of 2020, at the height of the Covid-19 pandemic. Having defaulted in April 2020, Ecuador was forced to terminate the repo contract and repay the entire loan in May 2020, and it did not have the option to negotiate a debt restructuring, as it did with other private creditors (Bartenstein, 2020; Arauz, 2020).

The LSF’s reliance on collateral valuation would threaten to put similar pressure on African government bond markets during periods of market stress, worsening rather than improving market access. Even if the LSF decides to freeze haircuts during a crisis, its use of mark-to-market on repo collateral may push its private repo borrowers into fire sales, which would erode the liquidity of sovereign bond markets.

Pro-cyclical pressures on African sovereign bond markets would increase if the LSF were to use collateral valuation as a risk management tool in its repo loans to private investors.

B. EXORBITANT PRIVILEGE OF SAFE ASSET ISSUER

The ECA repo agenda should be understood through the structural specificities of late 20th century capitalism, which increasingly organises credit creation through securities, repo, and derivative markets. Varyingly referred to as collateral-intensive finance, shadow banking, or the age of asset management, market-based finance reflects the growing importance of institutional investors – pension funds, insurance companies, sovereign wealth managers, hedge and bond funds – in a complex global ecosystem dominated by the US dollar. It reflects deeper political processes: growing inequality; erosion of the welfare and tax state, which feeds into the trillions put into institutional investments; and aggressive leverage practices that, when combined, produce a structural need for new asset classes to fill ever growing – often global – balance sheets (Gabor, 2019).

It is this “portfolio glut” that the ECA and similar Maximising Finance for Development initiatives seek to tap into by promoting securities and repo markets (as Frontclear work in Ghana illustrates). The logic is that institutional investors would find local currency bond markets more attractive if they found in them the legal and market practices used in high-income countries. It is such practices that allow easy entry into, and exit from, local currency bonds.

The European experience sheds light on the local political incentives for adopting this bond-centric financial system. In the 1990s, Euro area countries abandoned tight repo regulations, as they were persuaded by the promise of sovereign bond liquidity. At first, the repo-ignited competition for liquidity appeared to work well, as sovereign borrowing costs fell rapidly and liquidity increased – just as the ECA envisages the LSF liquidity benefits to materialise. After the collapse of Long-Term Capital Management hedge fund in 1998, the repo liquidity promise seemed even more appealing, as central banks across high-income countries suggested that a rapid growth of repo markets would have the added benefit of rendering sovereign bonds into safe heavens during crises of market-based finance: When repo borrowers come under funding pressure, they would turn to sovereign bonds as safe assets that preserve their high-quality collateral character, even in crisis (see Gabor, 2020a).

But the 2008 crisis showed that not all sovereign issuers can preserve their “safe” status, even among high-income countries. This highlights the potential risks of African sovereign bonds becoming the subject of a supranational entity’s decision in the framework of an African repo market. In the case of the European repo market, the ECB’s treatment of sovereign collateral – form haircuts guided by credit ratings to margin calls on repos collateralised with “periphery” sovereign bonds – worsened the market discrimination between Euro area sovereigns. Although it did not create it, it certainly entrenched an “exorbitant privilege” for Germany as safe asset issuer in the Eurozone – a privilege that carries exorbitant duties, which Germany refused to assume,¹⁷

¹⁷ The privileged status of German bunds is well recognised in European debates on safe assets, see for instance Pisani-Ferry (2012).

while accelerating flight from lower-rated countries. Put differently, an initiative to improve market access for a set of governments failed to counteract market pressures, and in some cases “helped” shrink fiscal space.

Although the flight to the safety of the most liquid sovereign – South Africa – is complicated in the case of the African repo market by exchange rate considerations, the ECA initiative can potentially generate similar dynamics, which it should take into account and carefully design solutions.

C. INSTITUTIONAL CONFLICT BETWEEN THE LSF AND NATIONAL CENTRAL BANKS

The ECA proposal does not specify any governance mechanism for the institutional relationship between the LSF and national central banks. This matters because African central banks are increasingly seeking to implement monetary policy decisions via national repo markets, lending against local sovereign bonds.

But the haircut decisions of the LSF – made by its private commercial bank administrators – and the haircut decisions of national central banks would need some mechanism of coordination to ensure that the LSF does not impinge on national central bank autonomy. As explained earlier in the case of the ECB, the central bank’s haircut decisions work as a signal to private investors about the perceived collateral riskiness of sovereign bonds. LSF decisions would do the same. Should the LSF decide to raise haircuts on Kenyan local currency sovereign bonds, it would de facto tighten monetary conditions in Kenya, interfering with the central bank’s preferences.

The LSF would hand over institutional power to its private commercial bank administrators, with potential conflicts of interest if they have commercial operations in the countries for which they make collateral decisions, without specifying concrete mechanisms that preserve local monetary policy autonomy.

Even if the LSF were to run its repo operations without private bank administrators, the issue of coordination with national central banks would need to be addressed in order to safeguard the autonomy of central banks across African countries.

04

FINANCING FOR DEVELOPMENT: HOW AN AFRICAN REPO MARKET MAY CONTRIBUTE TO SDG ASSET CLASSES FOR GLOBAL INSTITUTIONAL INVESTORS

For the last decade, the World Bank and other MDBs, the IMF, and the G20 have pursued a new development agenda focused on creating new development or “SDG” asset classes. The logic of this new Wall Street Consensus is simple: The global portfolio glut – the trillions managed by institutional investors, mostly from the Global North – could finance SDG ambitions through new asset classes. For instance, the World Bank’s Maximising Finance for Development promises global institutional investors \$12 trillion in market opportunities that include “transportation, infrastructure, health, welfare, education” to be minted into investable securities via public-private partnerships (PPPs)¹⁸ in (social) infrastructure. The African Development Bank’s 2019 synthetic securitisation deal, known as Room2Run, was similarly hailed as a groundbreaking initiative that illustrates how MDBs can harness the power of financial innovation to create new development asset classes on the African continent (Gabor, 2019).

¹⁸ It is no coincidence that the World Bank’s first Head for Maximising Finance for Development was previously Practice Manager for PPPs at the World Bank (n.d.).

Thus, it is no coincidence that the LSF plans were developed by ECA in partnership with PIMCO. Rather, the efforts to build an African repo market should be understood within the broader multilateral efforts to accompany private capital into African development assets, a “grand bargain” with private finance that entails (a) redirecting concessional loans and local fiscal resources into “derisking”/subsidising asset classes that finance commodified infrastructure projects, and (b) re-engineering local financial systems in the image of US market-based finance to allow global investors’ easy entry into, and exit from, new asset classes such as SDG bonds (Gabor, 2020b).¹⁹ Indeed, the ECA’s Building Forward Together agenda envisages an LSF phase 2, in which private investors could finance their purchases of SDG bonds issued in African countries to support investment in infrastructure.

Private investors have called for such efforts to be renewed and scaled-up to deal with the disastrous economic impacts of the Covid-19 global pandemic. For instance, the August 2020 manifesto of the Global Investors for Sustainable Development Alliance (2020), working under the auspices of the United Nations, called on governments to put financial flows on a sustainable path by helping create new SDG asset classes: “[T]he scale of the challenge calls for reinvigorating PPPs to a degree not experienced since World War II – and a degree that has perhaps never been seen in peacetime” (GSDIA, 2020).

A. FROM BANK- TO BOND-CENTRIC FINANCIAL SYSTEMS

The turn to private finance also requires a change in local financial structures, which the LSF and other initiatives seek to accelerate. Bank-dominated financial systems would be transformed into market-based financial systems to accommodate the entry of global institutional investors into local (SDG) securities. It is no coincidence that Frontclear’s “money markets matter” initiative focuses on changing the legal framework governing repo agreements in African countries, such that global portfolio investors – be these institutional investors or global banks – can finance and hedge (government) securities positions via repos and derivative markets. The promotion of the US institutional blueprint for organising the repo–securities market nexus is also hardwired into the IMF and World Bank’s Local Currency Bond Markets initiative.

The promotion of the bond-financing model downplays its attending systemic risks. Although it reduces dependency on foreign currency debt, the shift to market-based finance comes with systemic, shadow-banking type instabilities that turned Lehman into a global systemic event. The LSF/World Bank/IMF template for liquid bond markets calls for importing the fragile liquidity structure of the US bond-based system.

¹⁹ See Gabor (2020b) for the political economy of the Wall Street Consensus.

Yet, it was precisely this model that fed – in the shadow banking world – cycles of liquidity and leverage before Lehman (Adrian and Shin, 2010). When the crisis came, it manifested in fire sales of securities, evaporating market liquidity and wholesale funding runs (BIS, 2015b). As explained in the previous sections, the LSF’s discretionary use of haircuts and collateral valuation generates the same pro-cyclical pressures that were at play in the Lehman crisis, and in Ecuador’s default in 2020.

The structural transformation of financial systems does not protect African countries from the volatility of portfolio flows, nor does it protect institutional investors from currency or liquidity risk. Let us take each in turn.

A growing body of academic and policy literature has documented the increasing importance of the global financial cycle (Rey, 2015). Put simply, the global financial cycle shapes the movements of banking and portfolio flows across borders, moving with the rhythm of the funding conditions for the US dollar. In other words, it is not simply the local monetary and credit conditions that determine bank and portfolio inflows into African countries’ sovereign or SDG assets, but also global dollar financing conditions. Recent research suggests that portfolio flows – that is, the flows into securities markets such as SDG bonds or government bonds – are particularly sensitive to changes in global financing conditions and can lead to sudden stops, or rapid outflows, from securities markets, even for countries where domestic conditions have not altered significantly. In contrast, bank loans are relatively more responsive to local conditions (Eguren-Martin et al., 2020). Put simply, the promotion of

new SDG asset classes issued in local currencies to attract portfolio inflows would not magically restore (monetary) policy autonomy for African countries, as the countries would continue to be confronted with Helene Rey’s dilemma: a choice between free portfolio flows into (SDG) bond markets or monetary policy independence.

In turn, portfolio investors into government/SDG bonds face liquidity and currency risks. Liquidity risk matters because liquidating positions in a less liquid market – that is, selling securities to exit – may generate considerable losses and reduce further the appetite for bonds. Currency risk may amplify losses, as portfolio investors who, say, wish to liquidate their Nigerian sovereign bond portfolios will see their dollar proceeds from the sale shrink if the Nigerian naira depreciates. Exchange rate volatility amplifies the pro-cyclicality of portfolio flows: Currency depreciation accelerates capital flight (Hoffman et al., 2020).

Since Lehman, central banks have introduced two new instruments to address these risks: *dealer/market maker of last resort* and *swapper of last resort*. The market-making central bank intervenes in sovereign or private bond markets during times of market stress to provide market liquidity, that is, to buy when everyone wants to sell. Although such interventions were taboo in emerging and poor countries before the Covid-19 crisis because they evoke phantoms of monetary financing (central banks buying government debt under the pressure of populist governments), since then, several middle-income countries, including South Africa, have adopted them, paving the way for a further normalisation of such prudential interventions.

In turn, the swapper of last resort – the central bank – intervenes in currency markets to stabilise exchange rates by drawing, for instance, on the newly established swaps/repo lines with the US Federal Reserve. Additionally, the World Bank has suggested that state-owned development banks in poor countries could provide hedging facilities for investors in certain infrastructure asset classes, taking over currency risk (Gabor, 2020b). If the LSF prioritises repos with local currency sovereign bond collateral, it may also choose to assume the exchange rate risk of the repo transaction, as explained above.

However, there are significant limits to both the market-maker and swapper of last resort functions. Central banks in poor countries may choose to reduce collateral liquidity risk and currency risks for global investors, but their interventions are constrained by potential local political contestations surrounding the purchase of government bonds, the size of their foreign reserves or swap/repo lines with the Federal Reserve, and ultimately, the decisions of the US Federal Reserve setting dollar funding conditions.

In broader terms, *the developmental impact of the central banks'/LSF's turn to derisking private investors' positions in securities and currency markets is poorly understood*. It may impact central banks' willingness to actively manage capital flows – with capital controls – rather than simply derisking them; perhaps more importantly, it threatens to erode countries' ability to influence domestic credit conditions, and therefore design and finance autonomous developmental strategies.

One common response to such concerns is to encourage local institutional investors that would behave countercyclically: domestic pension funds and insurance companies that would increase their portfolios of domestic assets when foreign (portfolio) investors leave. First, this solution is less effective in the short term than central bank interventions, since it implicitly assumes that local investors may be better placed to shoulder the risks of liquidity and price volatility during bad times than foreign ones (and it creates pressures on managers to do so, potentially at odds with investment mandates). Second, the appeal to promoting local institutional investors ignores the broader developmental questions related to the attending privatisation of pensions and health provision, with the threats therein.

Equally important, embedding development interventions and SDG ambitions in global bond finance cements a developmental approach focused on commodified infrastructure provision, or a *de facto* privatization of key public goods. It defines a good development strategy as successfully accompanying global investors into 'development' asset classes, from infrastructure to nature, and assumes that poor and middle-income countries can only deliver public goods such as green transport, education, health, energy, water, housing, if these are constructed through public-private partnerships, and bundled into 'investible projects'. But the net developmental benefits are far from clear when cash flows to the investors are provided by both citizens who have to pay user fees for access and by the state, who have to use fiscal resources to compensate private investors for a series of risks in order to make PPP projects investible (from demand to political and climate risk, see Gabor

2020b). The turn to derisking 'SDG development' for global finance as a development strategy needs a more careful consideration of the balance of risks and benefits, particularly in light of the COVID19 pandemic dynamics.

B. THE LIMITS OF PUBLIC- PRIVATE FINANCE PARTNERSHIPS FOR ACHIEVING THE SDGs: A COVID-19 LESSON

The position of private creditors in the DSSI negotiations throughout the Covid-19 pandemic raises additional questions about the partnership between poor countries and private finance that the LSF and other initiatives promote. When the G20-Paris Club agreed the Debt Service Suspension Initiative in April 2020 through the end of 2020, it had hoped that the private sector would voluntarily join official creditors in the suspension of payments. But such hopes were misplaced. Private creditors refused to provide temporary liquidity relief.

The implications are serious. By refusing to impose mandatory private participation, the G20 cements an unequal power relationship between private creditors and poor countries – a relationship that the former has few qualms about exploiting and the latter no instruments to challenge.

According to the World Bank, the 43 DSSI countries “gained” around US\$5 billion in fiscal space by suspending official bilateral debt payments. But without private-sector participation, this fiscal space may in practice be used to service the debt owed to bondholders. Take Zambia. Its DSSI participation allows it to suspend around US\$139 million in debt service to official bilateral creditors until the end of 2020. But for that same period, it had to pay US\$156 million to its bondholders. Less stark, but not less significant, Ethiopia received US\$511 million in temporary liquidity relief and has to pay around US\$67 billion. By late 2020, Zambia defaulted on its payments to bondholders.

Private creditors have resisted calls for involvement by levelling threats of retaliatory measures through a stick and two carrots strategy. The stick is market access. As the September 2020 letter of the Institute of International Finance (IIF) to the G20 argues, poor countries would be jeopardising their hard-won access to international bond markets by supporting mandatory private-sector involvement in the DSSI. Indeed, around 30 DSSI-eligible countries – some at high risk of debt distress, such as Ghana and Kenya – chose to not apply to the DSSI in order to preserve market access.

The IIF also warned the G20 that middle-income countries could also see significant capital outflows and/or higher interest rates.

Instead, the “grand bargain” with private finance provides the two carrots that the IIF letter dangles in front of poor countries: the SDG funding gap and the growing mainstreaming of Environmental, Social and Governance (ESG) concerns in institutional portfolios.

The SDG funding gap, the argument goes, cannot be closed without private finance. The trillions of dollars held by institutional investors could find their way into local currency bonds to finance education, health, roads, electricity, water, and sanitation in poor and emerging countries. This often perpetuates a narrative that poor countries are incapable of providing for their citizens, and renders invisible a history of extraction from these very regions that has in turn systematically created bigger inequalities between rich and poor countries. Furthermore, private creditors’ threatening behaviour in the DSSI negotiations throws into doubt the promise of maximising finance for the SDGs. Poor countries are forced to prioritise social pain at the height of a pandemic for the elusive promise of SDG-related inflows – on commercial terms and into user-fee-based public services – sometime later. There is also an important, if underappreciated, gender dimension to this. Since private investors tend to prioritise what is profitable, this may result in underinvestment in services that are crucial to women, such as universal maternal health care provisioning.

The second carrot highlights the Covid-19 pandemic as a watershed moment for investors to mainstream sustainability in their portfolios. High-income countries, the European Union in particular, have committed to put the greening of private finance at the core of low-carbon transitions. The incoming ESG tsunami, the IIF letter argues, would shower poor countries with (sovereign bond) market liquidity, as long as there are no barriers to entry, such as mandatory participation in an extended DSSI.

Yet, this second leg of the “grand bargain” also requires caution. It is well-known that ESG ratings have provided cover for systematic greenwashing (Gabor, 2019). Beyond inconsistent ESG ratings lies another serious challenge. The IIF letter calls for multilateral banks to provide partial guarantees on sustainable bond solutions, recognising that the influx of (ESG) liquidity into SDG asset classes will not arrive without public resources lubricating it. The LSF proposal falls within this logic, too. But the Covid-19 pandemic has clarified that international financial institutions and G20 countries have constructed a derisking partnership that benefits private finance rather than citizens in poor countries.

05

BUILDING FORWARD TOGETHER: REFORM THE LSF AND RETHINK THE DEVELOPMENT FINANCING MODEL

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The ECA proposal for an African repo instrument is motivated by a legitimate concern about the implications that the Covid-19 pandemic has on the ability of African governments to finance recovery plans. As argued in the previous sections, there are two types of challenges that the proposal, as it stands, downplays: *the macrofinancial risks* for African government bond markets and central banks that are hardwired into the design of the LSF, and *the developmental impact of a private-finance-led development paradigm* with its emphasis towards steering the structural transformation of local financial systems.

The Reform approach would target the institutional design of the LSF to minimise the macrofinancial risks. It would eliminate the risk function of collateral from the LSF design, as follows:

- *Local currency only* – and no Eurobond collateral – in LSF repo loans in order to avoid increasing vulnerability to foreign currency debt.
- *Fixed haircuts*: The LSF delinks haircut decisions from changes in credit ratings of the sovereign collateral it accepts. In so doing, the LSF would assume the risks that the repo instrument inherently creates for the issuers of collateral, in this case African governments. Although this may create incentives for private investors to repo the worst-quality sovereign bonds, the LSF can address it by, for example, capping the volumes for each African sovereign issuer that can be posted as collateral.
- *Countercyclical collateral valuation*: no margin calls on private investors. Collateral valuation, it was noted above, works both ways: During times when collateral prices are increasing, private investors make margin calls on the LSF, which has to send back collateral, such that the value of the collateral portfolio it holds remains constant throughout the life of the repo loan. For private investors, this is a critical risk tool, since any collateral held by the LSF that is above the value agreed when the repo loan was made constitutes unsecured risk exposure to the LSF. The LSF has collateral in “excess” and can easily return it to the investor.
- For the LSF, the risk function of collateral valuation matters during periods of falling collateral prices, when it would ask its repo borrowers to “top up” their collateral portfolios via margin calls. It is this topping up that can exacerbate financial instability because investors may not be able to do so without selling securities – accelerating portfolio investors’ exit from African sovereign bond markets. But if the LSF decides to eliminate its margin calls, it signals that this will be a stable source of funding during crises, and would thus indirectly stabilise demand for African sovereign debt. Again, it will need to design out, to the extent possible, the issues concerning adverse selection by limiting collateral substitution and imposing caps on repo-able sovereign bonds issued by a single sovereign.

This new institutional design of the LSF would minimise the pro-cyclical effects, particularly on African sovereign bond markets. It asks the LSF to assume collateral liquidity risk – a risk, it is worth noting again, *that only generates losses for the LSF if private repo borrowers default and the LSF has to resort to fire sales of illiquid collateral.*

The Rethink approach takes seriously the broader concerns with the bond-finance model that is promoted across African financial systems and detailed in the previous sections. Although the developmental impact of the turn to this financial structure is poorly understood, there are significant systemic risks and dubious gains from the partnership with private finance under the umbrella of financing the SDG gap.

Governments' ability to design autonomous policies would be pressured by demands to allocate scarce resources into creating attractive conditions for private finance. Public resources have to be dedicated to subsidising private creditors, to identifying "investable" developmental projects that can easily be transformed into SDG assets, and to mopping up the costs of financial crises associated with this more fragile model, all the while dismantling the financial infrastructure that might support a green developmental state (including developmental banking by state-owned banks).

Developmental banking can arguably better serve a sustainability agenda because banks can easily include, monitor, and enforce safeguard policies in long-term relationships with customers. Most countries with successful experiences of industrialisation (Korea, Japan, China, India, Brazil, the United States, and France) relied on public development banking as a critical pillar of their industrial policies (Naqvi et al., 2018). Public development banking allowed the developmental state to derisk via long-term loans to industrial sectors identified as strategic by an industrial policy aimed at promoting the international competitiveness of local firms.

Developmental banking would be central to a green developmental state, a state that carefully designs a just transition to a low-carbon economy, and that helps correct broader systemic inequalities that pertain, for instance, to gender justice.

The technical complexities, systemic vulnerabilities, and demands on the public purse that lie beneath the powerful rhetoric of Maximising Finance for Development suggest that it is easier – and potentially far cheaper – to design developmental banks that derisk green public and private investments in low-carbon activities. Although the LSF proposal may be viewed as part of the transition to green developmental banking, policy efforts in African capitals should be focussed on designing smart green developmental banks that overcome the well-known political economy failures (from political capture to white elephants, etc.).

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07 GLOSSARY

Collateral: Securities/bonds exchanged in repo contracts for cash.

Collateral valuation: In a repo contract, both borrower and lender calculate the daily market value of collateral to ensure that the value of collateral portfolio posted at the beginning by the borrower remains constant (abstracting from interest rate payments). If collateral falls in market price, it means the borrower 'owes' the repo lender more collateral or more cash, and has to send it. The opposite applies for when collateral securities increase in price, benefitting the repo borrower.

Eurobonds: Bonds issued by governments in a foreign currency, mostly but not exclusively in US dollars.

Global Master Repurchase Agreement: A model legal agreement designed for parties transacting repos and published by the International Capital Market Association, which is the body representing the cross-border bond and repo markets in Europe.

Haircut/margin: The difference between the market value of collateral offered by the repo borrower and the cash provided by the repo lender (or the reduction applied to the value of collateral). Low-rated, low liquidity collateral securities usually incur higher haircuts.

Institutional investors: Financial institutions that invest money on behalf of clients or members. These include hedge funds, mutual funds, endowments, insurance companies, and pension funds.

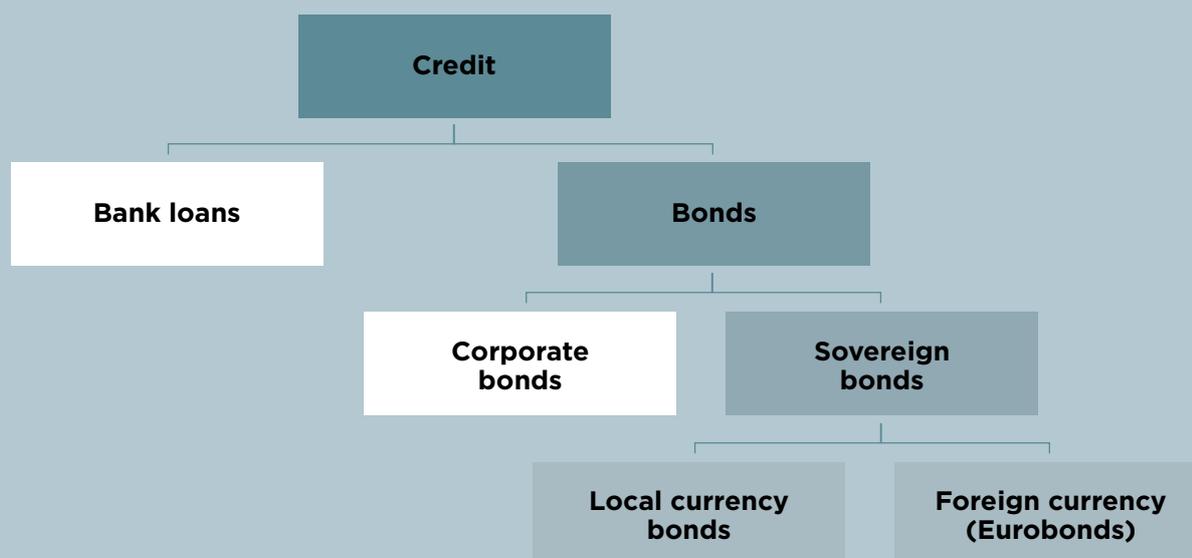
Liquidity: When used in connection to securities/bonds (also known as market liquidity), it refers to the ability to buy and sell securities in secondary markets without massive changes in price. The more liquid the security, the less any single buyer/seller can move its price.

Margin calls: (Typically) daily obligations for repo borrowers to replenish collateral portfolios when the price of that collateral has fallen (with either cash or equivalent collateral), and for repo lenders to send back cash/collateral when the price of that collateral has increased. The guiding principle is that the market value of a collateral portfolio should be – on any day of a repo contract – the same as on the first day of the repo.

Portfolio: Collection of assets/financial products that investors hold.

Figure 6

CREDIT INSTRUMENTS



Portfolio flows: Capital flows into securities and equity markets, reflecting demand from foreign institutional investors and foreign banks.

Repo: The repurchase agreement is also known as a securities financing instrument. It allows investors to finance their securities portfolios by borrowing against them via repo transactions. In economic terms, a repo is structured as a loan against collateral securities. The repo borrower posts securities as collateral, but retains the credit risk on those securities (that is, it remains the economic owner of the securities). In legal terms, a repo is typically structured as a sale and repurchase agreement to allow the repo lender to acquire legal ownership of collateral so it can liquidate it in case the counterparty defaults. The repo instrument can also be used for shorting securities, as it allows financial institutions to have access to those securities in exchange for cash.

Securities or bonds: Also known as fixed-income instruments, these are instruments through which governments and private companies borrow in either local currency or in foreign currency, and on which they pay interest. Unlike bank loans, securities can be traded in secondary markets (see Figure 6 above).

Sovereign: Market-speak for government/public sector.

08

ABBREVIATIONS

BIS	Bank for International Settlements
DSSI	Debt Service Suspension Initiative
ECB	European Central Bank
ECA	United Nations Economic Commission for Africa
ESG	Environmental, Social and Governance
G20	Group of 20
ICMA	International Capital Market Association
IIF	Institute of International Finance
IMF	International Monetary Fund
LC	local currency
LSF	Liquidity and Sustainability Facility
MDB	Multilateral Development Banks
MFD	Maximising Finance for Development
OECD	Organisation for Economic Co-operation and Development
PPP	public-private partnerships
SDG	Sustainable Development Goal
ZAR	South African rand



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