ASSESSMENT OF NATIONAL FINANCING AND INVESTMENT POLICIES IN THE EAST AFRICA COMMUNITY (EAC) AND SOUTHERN AFRICA DEVELOPMENT COMMUNITY (SADC) COUNTRIES AGAINST REGIONAL PROTOCOLS

AFRODAD

AFRICAN FORUM AND NETWORK
ON DEBT AND DEVELOPMENT

ABOUT AFRODAD

VISION

A prosperous Africa based on an equitable and sustainable development.

MISSION

To contribute to Africa's inclusive economic growth and sustainable development through influencing policy change on debt management and development finance anchored on a right based approach.

AFRODAD OVERALL STRATEGIC GOAL

The overall goal of AFRODAD is 'to influence African Governments to institute and implement policies and practies for sustainable development and eradication of poverty'.

THEMATIC FOCUS AREA 1: DOMESTIC RESOURCE MOBILISATION

Thematic Goal: To contribute to the development and implementation of transparent, accountable and efficient mechanisms for mobilization and utilization of domestic resources in Africa.

THEMATIC FOCUS AREA 2: DEBT MANAGEMENT

Thematic Goal: To contribute to the development and implementation of sustainable debt policies and practices in Africa.

THEMATIC FOCUS AREA 3: INTERNATIONAL PUBLIC FINANCE

Thematic Goal: To influence the quality, impact and effectiveness of international public finance, in line with the agreed development cooperation effectiveness principles.

AFRICAN FORUM AND NETWORK ON DEBT AND DEVELOPMENT

ASSESSMENT OF THE FINANCING AND INVESTMENT POLICIES IN THE EAST AFRICAN COMMUNITY (EAC) AND SOUTHERN AFRICAN DEVELOPMENT COMMUNITY (SADC) COUNTRIES AGAINST THE REGIONAL PROTOCOLS

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Abbreviations

AFRODAD	African Forum and Network on Debt and Development.
CCBG	Committee of Central Bank Governors.
DSA	Debt Sustainability Analysis.
DSF	Debt Sustainability Framework.
EAC	East African Community
EAMU	East African Monetary Union.
EU	European Union.
FDI	Foreign Direct Investment.
GDP	Gross Domestic Product.
HIPC	Heavily Indebted Poor Countries.
IMF	International Monetary Fund.
LIC	Low-Income Countries.
MAC	Market-Access Countries.
MDRI	Multilateral Debt Relief Initiative.
SADC	Southern African Development Community.
PB	Primary Balance.
PFM	Public Financial Management.
PV	Present Value.
WEO	World Economic Outlook.

Executive summary

The recent high pace of public debt accumulation in Sub Saharan Africa (SSA) countries, including those in the EAC[1] and SADC[2] region, have brought the sustainability of fiscal policy and public debt to the forefront of policy discussions.

While debt burden indicators are still below levels that triggered debt distress episodes of the 1980s and 1990s, risks of a renewed cycle of debt crises and economic disruption are growing, with several countries' risk of external debt distress deteriorating. It is in this context that a key question emerges in the narrative literature and in debates centred on debt dynamics: are EAC and SADC member countries on track to achieve the fiscal deficit and public debt convergence criteria stipulated in the East Africa Monetary Union (EAMU) Protocol and the SADC Financing and Investment Protocol, respectively? This study sought to provide insight into this question by assessing the consistency of National Financing and Investment Policies in SADC and EAC countries against convergence criteria stipulated in the respective two regional blocs with particular focus on overall sustainability of public debt.

The study was conducted through desk reviews of Member States Constitutions, Public Finance Management Acts, Budget Laws, Debt Management Laws and relevant legislation. It also reviewed national budgets, Budget Framework Papers, National Development Plans, National Visions, and other strategy documents to understand the extent to which these documents mention the countries' commitments to SADC and EAMU Protocols.

The study finds that the majority of countries in the two regional blocs regularly monitor progress towards achieving commitments to respective protocols. In addition, some countries in EAC conduct regular debt sustainability analyses to guide borrowing decisions in a way that matches their development financing needs with current and prospective ability to service the ensuing debt without unduly large adjustments, which could otherwise compromise economic stability. These assessments use benchmarks which are closer to those prescribed by regional protocols. Thus, adherence to these thresholds would also put the trajectory of debt on a solid path towards sustainability. Even where countries are classified as strong performers and their applicable debt sustainability thresholds above those prescribed in regional protocols, recent debt sustainability assessment have shown these countries have remained within regional protocols.

In SADC, six (6) countries missed the 60% target for public debt-to-GDP, while ten (10) missed on the 3% budget deficit criterion between 2015 and 2018. In the EAC, the study shows that two (2) countries met the ceiling on fiscal deficit-to-GDP ratio of 3% in 2018, while Kenya is likely to exceed the threshold on debt-to-GDP (of 50% of GDP in present value terms).

An analysis was done to determine the primary balances required to achieve debt-to-GDP ratios prescribed by regional protocols. The results show that Kenya and Mozambique would need to run primary surpluses of 1.03% and 2.26% of GDP, respectively, to converge to regional benchmarks. Countries in both EAC and SADC remain susceptible to macro-fiscal shocks, which continue to derail efforts to comply with the deficit rule. This also compromises progress towards achieving the debt-to-GDP thresholds as fiscal deficits have largely been the key driver of debt dynamics in the two regions.

Based on these and other findings, the study makes the following recommendations:

- **Align national legislation with regional protocols and strengthen monitoring and enforcement mechanisms to ensure adherence. Regular monitoring is required to ensure corrections can be introduced before deviations from convergence paths persist.**

- **Redefine SADC's debt convergence target in present value terms to ensure consistency with international debt sustainability standards.**

- **The dynamic nature of market-based funding environment requires governments to actively manage their public debt portfolios to ensure its evolution is consistent with achieving convergence**

- **For countries not already doing it, make debt sustainability assessment an annual event to assist in identifying potential variations from convergence path far enough in advance so that policy corrections can be introduced before deviations arise.**

. **Countercyclical (spending too much in good times and then forced to cut back at other times) fiscal policy could boost medium-term convergence prospects. A countercyclical fiscal policy plays an important role as it stabilises the debt to GDP ratio over the cycle.**

Chapter 1: Introduction

> The increase in public debt in developing countries has raised concerns about public debt sustainability among policy makers, analysts and international financial institutions.

1.1 Background

The increase in public debt in developing countries has raised concerns about public debt sustainability among policy makers, analysts and international financial institutions. Average public debt in the Sub Saharan African region (SSA) increased from 27.4% of GDP in 2010 to 49.1% in 2018 . In the Southern African Development Community (SADC) and East African Community (EAC) regions, average public debt-to-GDP increased from 34.9% to 54.9% and 26% and 47.5% of GDP during the same period. The pace of debt accumulation during this period raise concerns about prospects for achieving regional macroeconomic convergence benchmarks aimed at maintaining public debt at sustainable levels. It also raises concerns among observers that this could bring back the spectre of debt crises.

It is important, therefore, to assess whether both EAC and SADC member countries are still on track to achieve the targets set in their respective protocols. One of the key determinants to achievement of these targets is a national financing and investment policy framework that is aligned to convergence protocols. It is in this regard that this study sought to assess whether SADC and EAC countries' legislative frameworks, as well as National Financing and Investment Policies are consistent with provisions of Regional Protocols, particularly those relating to public debt and fiscal balances. Mainstreaming regional protocols in national legislations, finance and investment policies is one way of enhancing prospects for convergence.

Specific objectives of the study include:

- **Assess and document trends and dynamics of domestic and external debt in the EAC and SADC regions;**
- **Interrogate the link between national financing and investment policy and the EAC and SADC financing and investment protocols;**
- **Establish the implications of the EAC / SADC financing and investment protocols on the national financing and investment legal and regulatory framework of the member states;**
- **Assess the challenges faced by policymakers in implementing the EAC / SADC financing and investment protocols and consider possible responses to the challenges; and**
- **Assess the link between EAC / SADC debt targets and standard debt sustainability thresholds**

1.2 Methodology

The study was conducted through desk review of Member States constitutions, public finance management acts, budget laws, debt laws and other relevant legislations. National budgets, budget framework papers, national development plans, national visions, and other strategic documents were also reviewed to get insight into the extent to which they are consistent with countries' commitments to convergence benchmarks. This was also aimed at understanding the extent to which the legal and regulatory frameworks are cognizance of the provisions and requirements of the Protocols. A review of the authorities' Debt Sustainability Analysis (DSAs) and Medium-Term Debt Strategy Reports (MTDS) was undertaken to understand the extent to which such reports acknowledge convergence criteria.

The study also looked at the evolution of public and external debt in the two regions to make inferences about the feasibility of countries achieving convergence criteria within the prescribed time frame.

1.3 Structure of Paper

The rest of the study is organised as follows. Chapter 2 discusses the recent trends and dynamics of public debt in the SADC and EAC regions, including the changing landscape of sovereign debt and the key drivers of the debt dynamics. The chapter also discussed macro-financial risks to debt outlook. Chapter 3 highlights the SADC and EAC regional protocols, including specific targets for public debt, fiscal and current account deficits. Chapter 4 presents the findings of the Study, including analysis of how individual countries are performing against regional convergence targets on debt and fiscal deficits. The chapter also evaluates compatibility of individual Member States' national financing and investment protocols with regional financing and investment protocols and discusses challenges faced in achieving regional targets.

Chapter 5 summarizes the findings of the Study and provides recommendations.

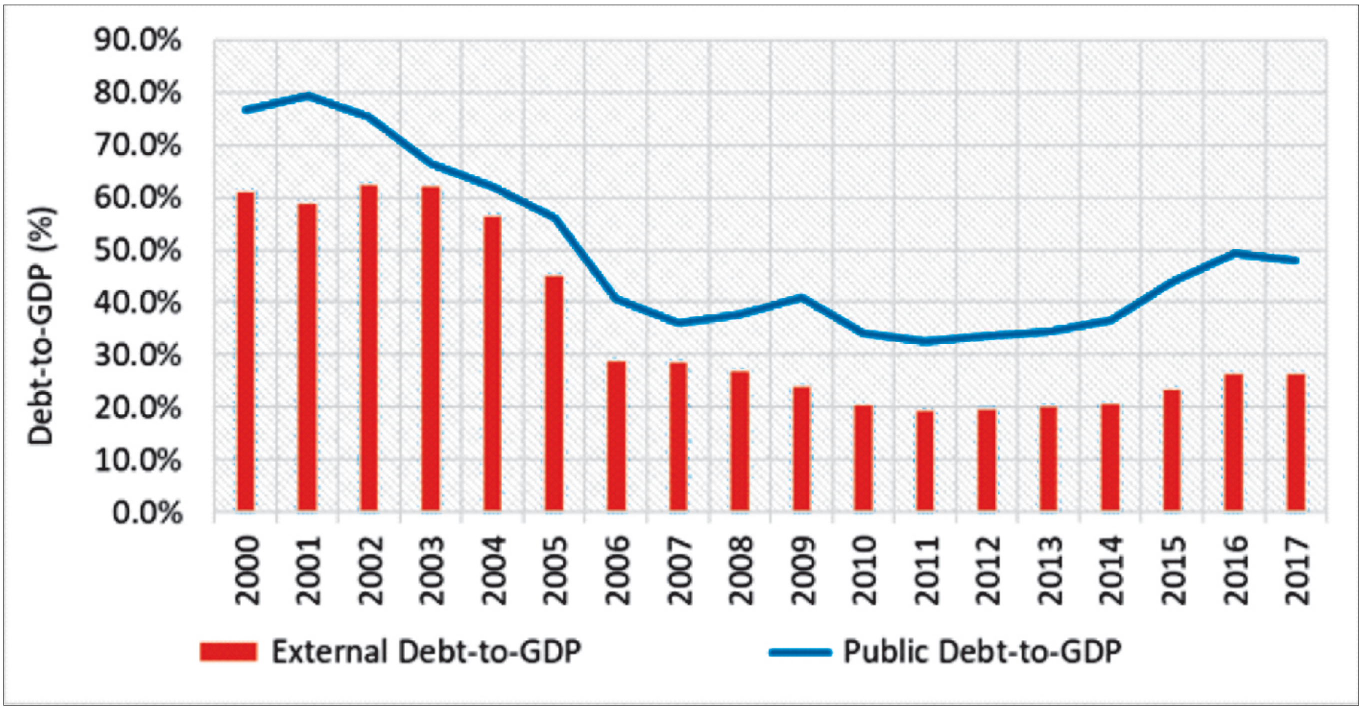
Chapter 2: Public Debt Dynamics in SADC and EAC

> Public debt as a ratio of GDP has declined substantially from early 2000s through end-2011. The average public debt-to-GDP ratio for some 16 SADC member countries declined from 76.8% in 2000 to about 32.7% by end-2011..

2.1 Evolution of Public Debt in the SADC region

Public debt as a ratio of GDP has declined substantially from early 2000s through end-2011. The average public debt-to-GDP ratio for some 16 SADC member countries declined from 76.8% in 2000 to about 32.7% by end-2011 (Figure 1). The Figure also shows that while external debt-to-GDP ratio followed a similar trend, the decline was much steeper.

Figure 1 : Evolution of Public Debt-to-GDP in the SADC Region



Source: IMF World Economic Database

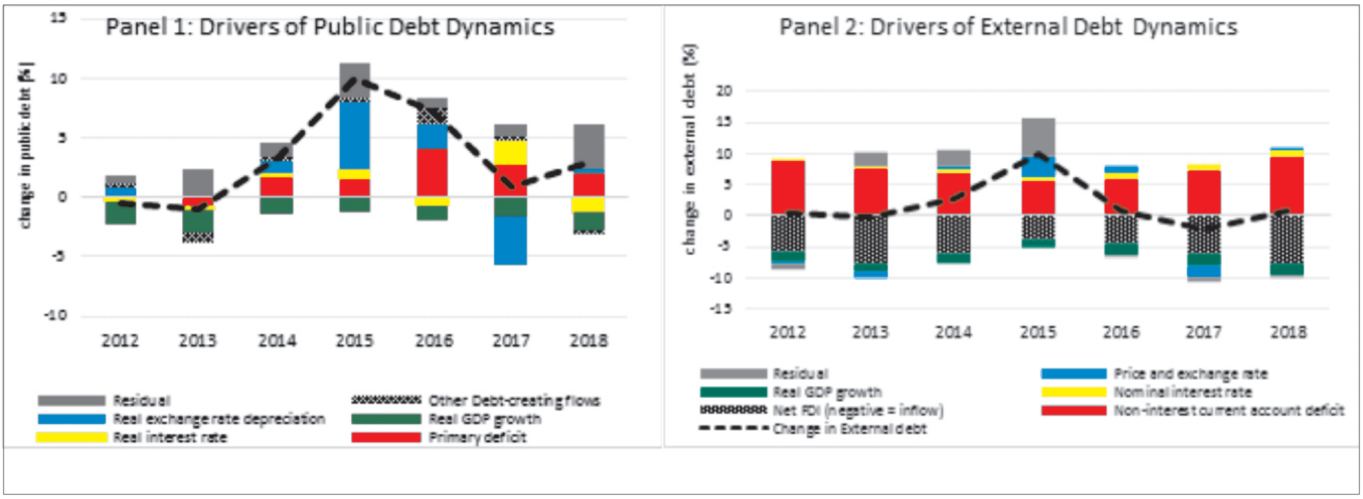
These trends largely reflect the impact of debt relief initiatives, particularly the HIPC and MDRI, which alleviated the external debt burden of some 7 recipient low-income countries[4] (LICs) in the region. The trends also coincided with the period when the "Africa rising" narrative took hold, when several countries registered fairly healthy annual GDP growth rates (averaging over 6 percent per annum, as shown in Figure 3) sustained by sound policy reforms, easing external financing conditions and rising commodity prices (MEFMI, 2019). This substantially improved the region's debt sustainability outlook.

The external position of many countries remained weakened somewhat as the current account deficits widened and reserves declined. Despite declining oil prices, toward the end of 2008, their current account deficits deteriorated, driven by a still-high food import bill, and in some cases declining remittances and tourism receipts as global growth weakened.

Looking beyond 2012, the dynamics and composition of public debt changed significantly. The confluence of supportive conditions that helped stabilise debt ratios since 2008 (notably easy global financing conditions), the deepening of domestic financial markets for some countries, and the growing lending activities of non-Paris Club countries created new opportunities for countries to sustain higher deficits. In addition, more flexible guidelines on external debt limits introduced in IMF and World Bank-supported programmes allowed countries to take on more debt to support substantial investment in potentially high-return critical infrastructure (MEFMI, 2019). As a result, the average public debt-to-GDP ratio increased from 32.7% to 47.9% between 2017 and 2017.

Figure 2 shows that strong economic growth and high FDI inflows played a key role in reducing the pace of debt build-up over the period. A strongly negative interest rate-growth differential has been a key benign force for debt sustainability, showing predominance of concessional borrowing by a majority of LICs and a low (by historical standards) interest rate environment faced by frontier and upper-middle income countries post-global financial crisis. However, the slowdown in economic growth since 2014 may imply that fiscal deficits should be reduced to enhance fiscal sustainability.

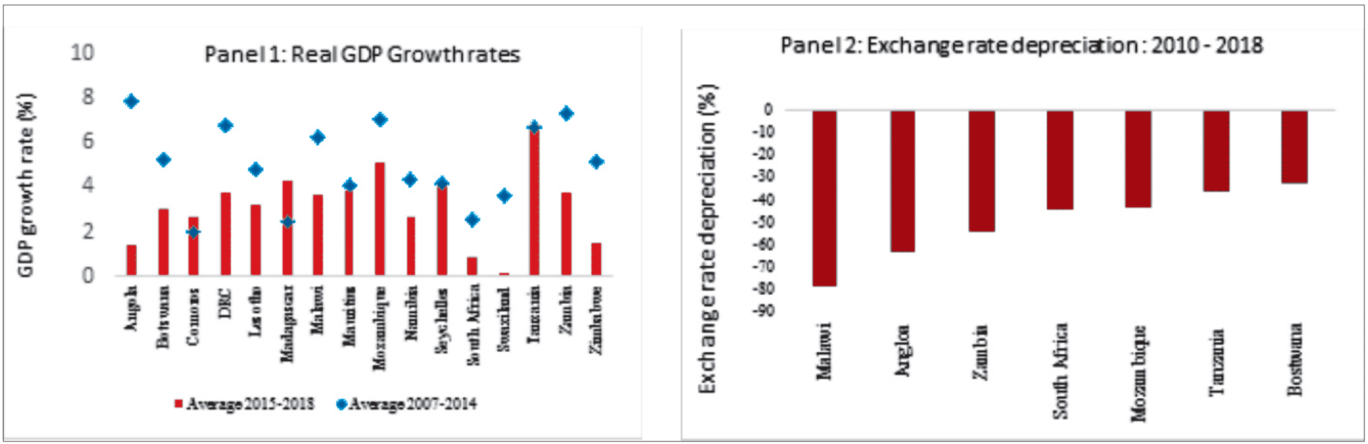
Figure 2 : Drivers of Debt Dynamics in SADC



Source: Authors' Computations based on IMF and World DSA Reports

On the other hand, non-interest current account, exchange rate depreciation and primary deficits exerted considerable upward pressure on debt accumulation. Trends in primary balance reflect several factors, notably: a conscious effort to use the newly created fiscal space for countercyclical policy in the area of infrastructure following the global financial crisis. The current account deficit has mainly been driven by high fiscal deficits and the activities of the private sector, notably, private sector borrowings and foreign direct investment.

Figure 3 : GDP Growth Rates and Exchange Depreciation in selected SADC countries



Source: WEO and SADC Central Banks

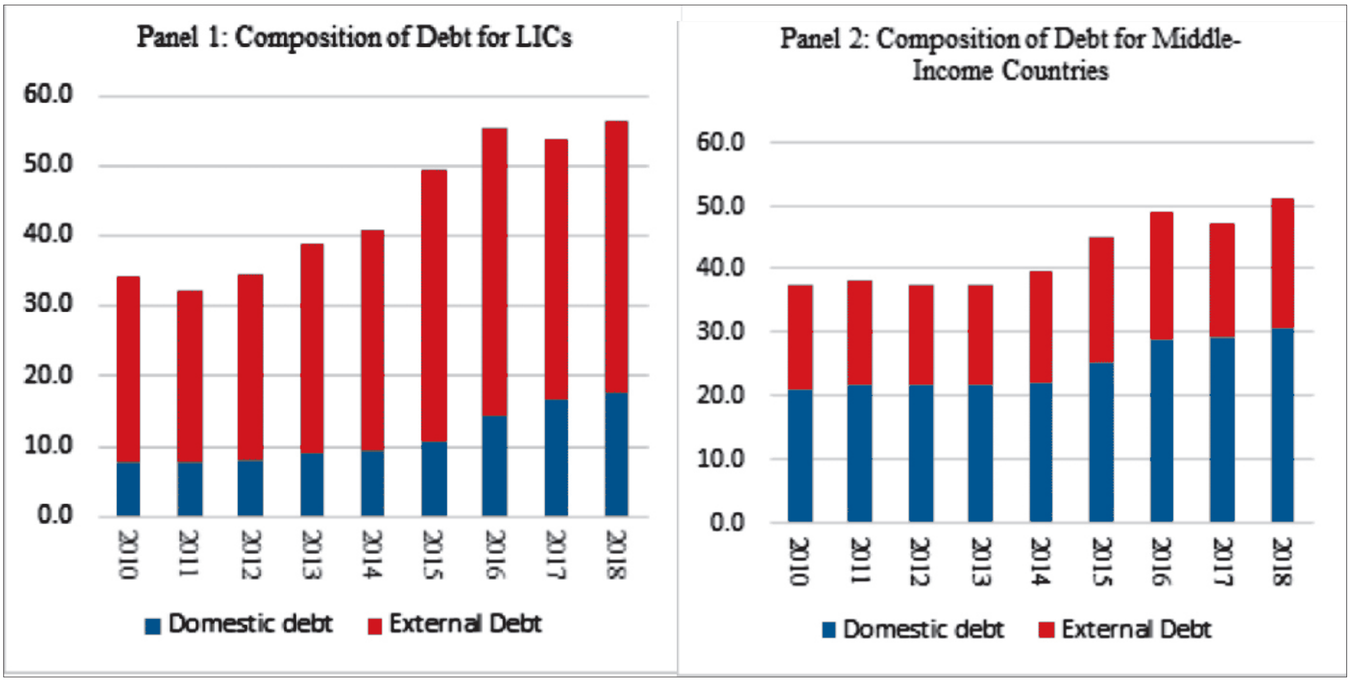
Exchange rate depreciation, particularly following the collapse of commodity prices in 2015 and the strengthening of the United States Dollar, has been one of the key drivers of external debt accumulation. Most SADC countries' exchange rates depreciated sharply in 2015, with deleterious impact on external debt. Figure 3 (On page 9), Panel 2 show depreciation of currencies of selected SADC countries against the United States Dollar during the period 2010 to 2018. This caused a large increase in external debt when expressed in local currency terms.

"The rise in public debt in the SADC region reflects huge borrowing from both domestic and external sources for financing government deficits and infrastructure development.

2.1.1 Debt Composition in SADC

The rise in public debt in the SADC region reflects huge borrowing from both domestic and external sources for financing government deficits and infrastructure development. For the SADC LIC countries, public external debt rose from 26.6% of GDP in 2010 to 38.7% in 2018, while domestic debt followed a similar trend, increasing from 7.6% of GDP to 17.8%, during the same period. On the other hand, SADC middle income countries' external debt only increased slightly from 16.3% of GDP in 2010 to 20.4% in 2018 as shown in Figure 4.

Figure 4 : Composition of Debt in SADC region (% of GDP)



Source: IMF/World Bank Country DSAs

The structure of LICs[5] external debt also reflects a shift from multilateral creditors towards bilateral and private creditors. The proportion of multilateral debt to total debt fell from 67.2% in 2009 to 54.5% in 2017 while bilateral and private debt rose from 29.3% and 3.4% to 33.6% and 12% in 2017, respectively, during the same period (Table 1). In Zambia, concessional debt fell from 80% of external debt in 2009 to 44% in 2017, while Mozambique's concessional debt declined from 96% to 76% during the same period.

Table 1 : External Debt by Creditor (% Total External Debt)

	2009	2010	2011	2012	2013	2014	2015	2016	2017
Multilateral	67.2	71.6	66.7	63.9	58.6	56.4	56.0	54.6	54.5
Concessional	54.6	57.2	52.3	49.7	45.0	43.7	43.2	42.2	42.7
o/w IDA	*38.32*	*39.31*	*36.70*	*35.18*	*30.95*	*30.03*	*29.83*	*29.98*	*31.04*
Non-concessional	12.6	14.3	14.4	14.2	13.6	12.7	12.8	12.4	11.8
Bilateral	29.3	25.1	29.3	29.7	31.8	31.9	31.6	34.0	33.6
Concessional	*22.6*	*19.9*	*25.1*	*25.5*	*28.9*	*29.1*	*29.3*	*31.4*	*31.3*
Non-concessional	*6.7*	*5.2*	*4.2*	*4.2*	*2.9*	*2.8*	*2.4*	*2.6*	*2.3*
Private creditors	3.4	3.3	4.0	6.5	9.6	11.7	12.4	11.4	12.0
Bonds	*0.1*	*0.1*	*0.6*	*3.5*	*5.3*	*6.5*	*7.4*	*6.7*	*5.9*
Commercial banks	*1.3*	*1.4*	*1.6*	*1.6*	*3.2*	*3.4*	*3.3*	*3.2*	*4.7*
Other private	2.0	1.8	1.7	1.3	1.1	1.7	1.6	1.5	1.4

Source: Authors Computation from the International Debt Statistics of the World Bank

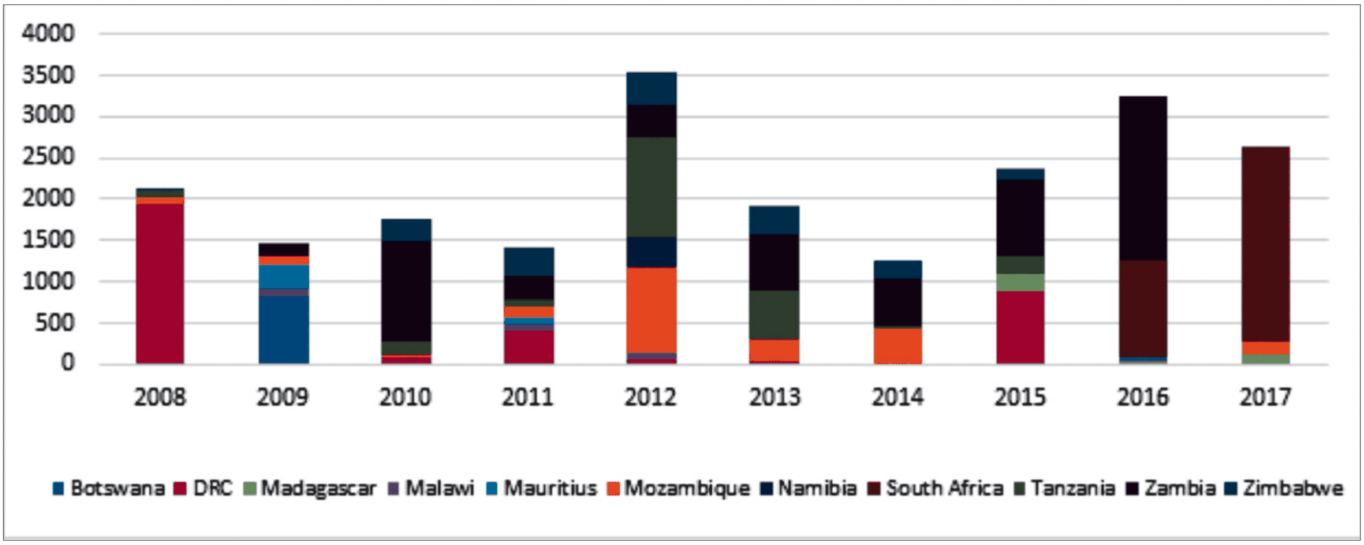
This trend is consistent with the changing development financing landscape brought about by new borrowing opportunities, including access to commercial borrowing and international bond markets, coupled with dwindling financing from traditional bilateral and multilateral creditors. The decline in concessional debt also reflects the graduation of some countries from lower income to middle income status, where they have limited access to the concessional windows of multilateral development institutions. External debt of middle-income countries is dominated mainly by private creditors.

SADC countries are increasingly accessing external loans from private creditors as demonstrated by an increase in commercial debt from 3.4% of total external debt in 2009 to 12% in 2017 (Table 1). Some countries that are now facing external debt challenges are those with a high ratio of private debt, thus threatening the prospects for convergence. The rise in non-concessional debt is partly attributed to the issuance and guaranteeing of international sovereign Eurobonds, which increased since 2007 due to improved international liquidity and search for yields.

The SADC region has also witnessed a rise in external borrowings from China. Figure 5 shows annual loan disbursements from China between 2008 and 2017.

“ The decline in concessional debt also reflects the graduation of some countries from lower income to middle income status, where they have limited access to the concessional windows of multilateral development institutions.

Figure 5 : Loan Disbursements from China to selected SADC countries, USD Million



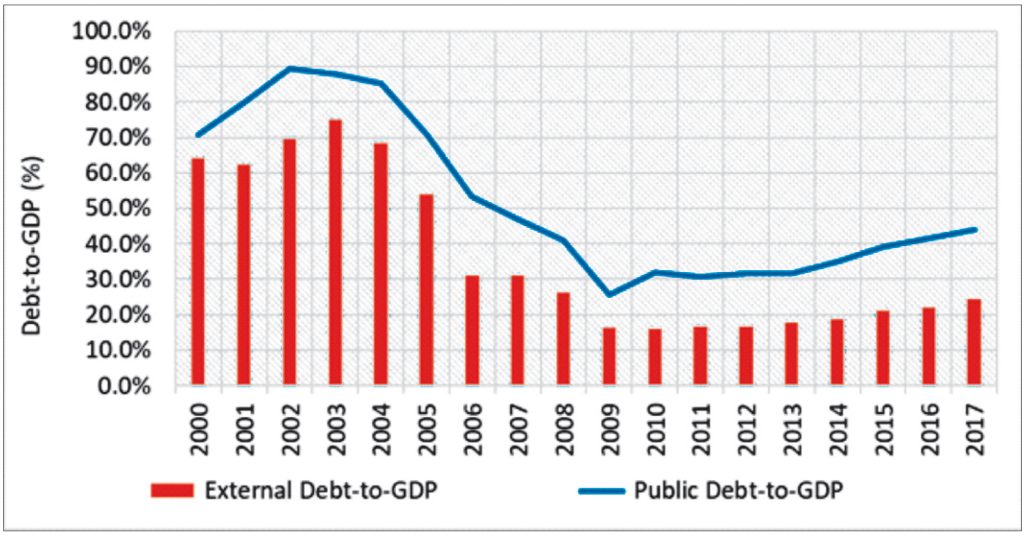
Source: China-Africa Research Initiative, John Hopkins University

2.2 Evolution of Debt Dynamics in the EAC region

Like the SADC region, public debt in the EAC region has increased substantially in the last decade. At the beginning of the millennium, EAC countries had very high debt, and all countries except Kenya were classified as HIPCs. Following debt forgiveness under the HIPC and MDRI, public debt to GDP ratio went down significantly, from an average of 70.8% 2000 to 25.7% in 2009. However, there has been a build-up in debt levels since 2010 and was 43.9% by end 2017 **(Figure 6)**.

“ At the beginning of the millennium, EAC countries had very high debt, and all countries except Kenya were classified as HIPCs.

Figure 6 : Evolution of Public Debt in the EAC region

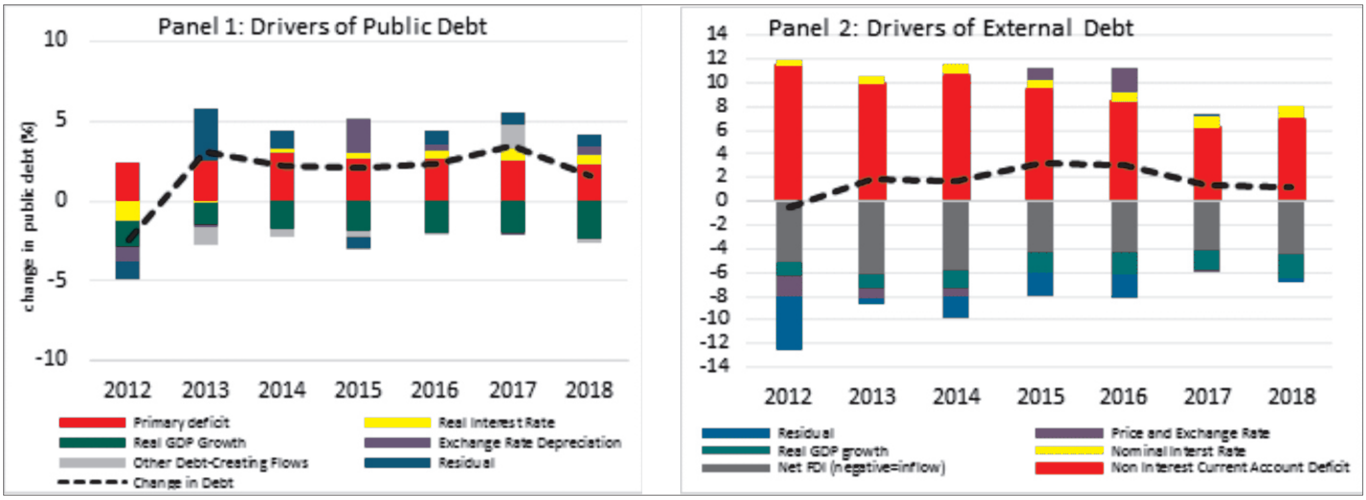


Source: WEO Database, 2018

Like in the SADC region, debt in the EAC region has largely been driven by expansionary fiscal policy, captured by the primary balance, and the non-interest current account (Figure 7). On average, EAC countries recorded fiscal deficits of at least 2% of GDP during 2012-2018.

> Although real GDP growth has mitigated higher increase in debt, its impact has reduced in recent years, illustrating the slowdown in GDP growth in some EAC countries

Figure 7 : Public Debt Drivers in the EAC



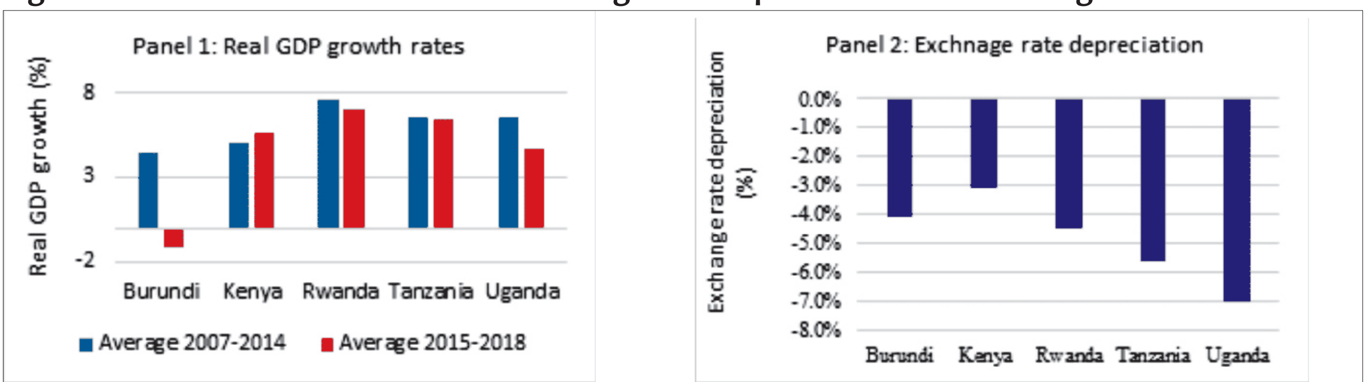
Source: IMF/World Bank DSA Reports

Real interest rates also contributed to an increase in debt, particularly from 2015 to 2018. This mainly reflects the impact of commercial debt which have high interest rates. Exchange rate depreciation also played a role in driving up debt, especially in 2015.

Although real GDP growth has mitigated higher increase in debt, its impact has reduced in recent years, illustrating the slowdown in GDP growth in some EAC countries, particularly Uganda, Burundi and Kenya, notwithstanding the rebasing of GDP in some of these countries. For example, in 2013, Kenya, Tanzania and Uganda all rebased their GDP, leading to nominal increases of between 13% and 27%. Except for Kenya, all other EAC countries grew at a slower pace during the 2015 to 2018 period compared to the 2007-2014 period (**Figure 8**).

> Real interest rates also contributed to an increase in debt, particularly from 2015 to 2018. This mainly reflects the impact of commercial debt which have high interest rates.

Figure 8 : Real GDP Growth rates and Exchange rate Depreciation in the EAC region



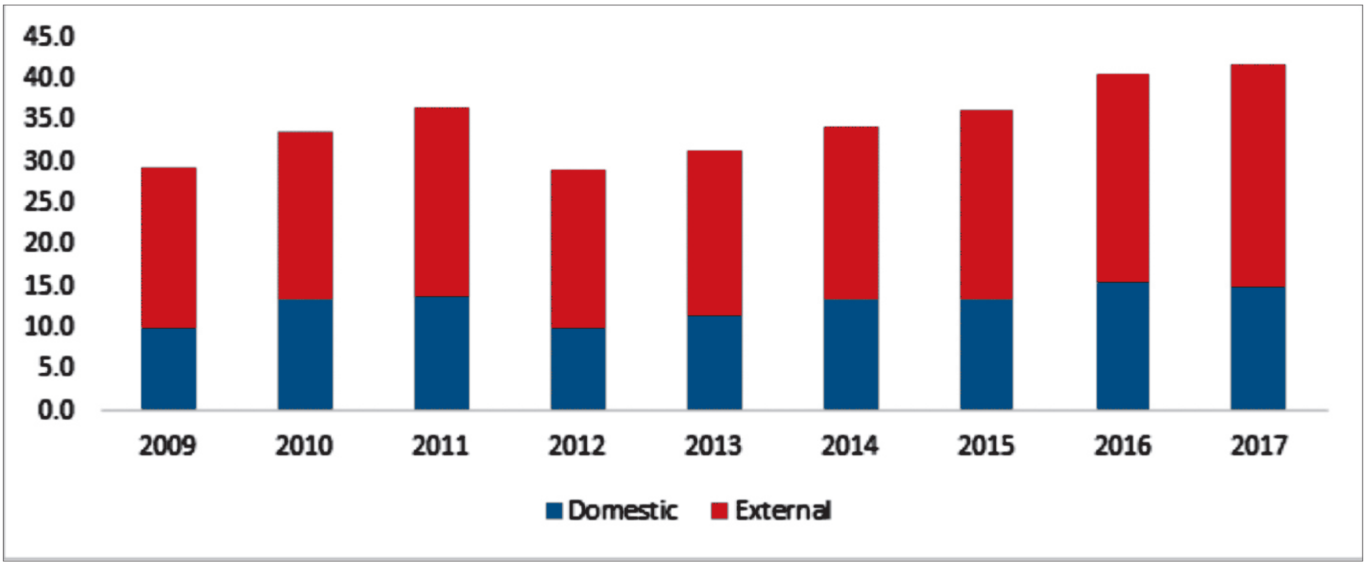
Source: WEO Database and Central Banks

Exchange rate depreciation also contributed significantly to the increase external debt between 2010 and 2018. Uganda had the highest annual depreciation of its currency against the US Dollar between 2010 and 2018, recording an average of 7% over the period **(Figure 8, Panel 2)**. Tanzania, Rwanda and Burundi have also experienced strong annual depreciation against the US Dollar. The Kenyan Shilling, on the other hand, has experienced the least average depreciation in the region over the period analysed (3.1% against the US Dollar).

Figure 9 breaks down the average debt levels across the EAC into external and domestic debt for the period 2009 to 2017. Domestic debt has risen gradually, from 10% of GDP in 2009 to 14.9% while external debt increased from 19.2% to 26.7% of GDP over the same period.

The share of debt owed to multilateral creditors to total debt in EAC declined significantly, from 71% in 2009 to 55% in 2017 **(Table 2)**. The proportion of debt owed to IDA, which is the largest external creditor for most LICs in SSA, declined from 51% to 36%. The share of debt owed to bilateral creditors increased only slightly, with the largest growth experienced in the debt owed to private creditors, particularly bonds and commercial banks. The reduction in the share of debt held by multilateral creditors vis-à-vis private creditors highlights a shift towards non-concessional / commercial sources of financing. Commercial financing typically entails higher interest rates, shorter grace and maturity periods. The increase in bilateral debt from China to EAC countries is moderate at the regional level but pronounced at country level. The 2018 IMF/World Bank DSA report indicates that the share of Chinese debt in total external debt has increased from virtually nothing in 2007/08 to 23.4% in 2017/18. All of this debt was contracted on non-concessional terms, with some of it classified as commercial debt. Similarly, a third of Kenya's outstanding bilateral external debt in 2048 was owed to China.

Figure 9 : Composition of Public Debt in the EAC region (% of GDP)



Source: IMF/World Bank DSA Reports

> The 2018 IMF/World Bank DSA report indicates that the share of Chinese debt in total external debt has increased from virtually nothing in 2007/08 to 23.4% in 2017/18.

Table 2 : Composition of External Debt by Creditor, EAC Average

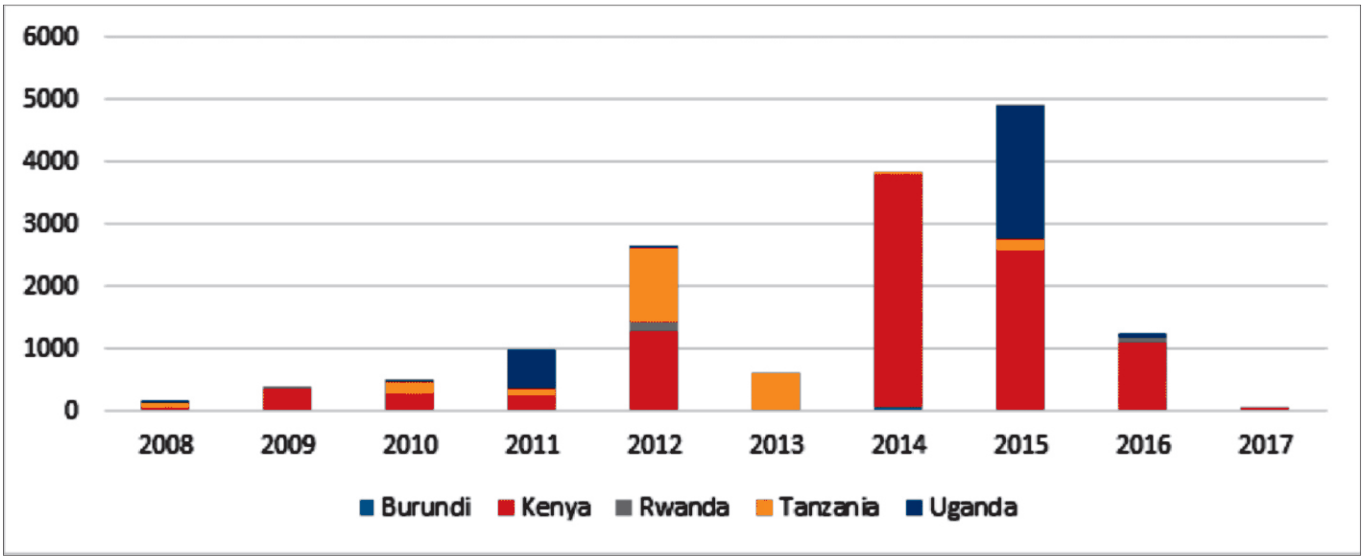
	2009	2010	2011	2012	2013	2014	2015	2016	2017
Multilateral	71%	72%	70%	69%	67%	60%	58%	55%	55%
Concessional	69%	71%	69%	67%	66%	59%	57%	54%	51%
o/w IDA	51%	52%	50%	48%	47%	42%	40%	37%	36%
Non-concessional	2%	2%	1%	1%	1%	1%	1%	2%	4%
Bilateral	26%	25%	26%	24%	22%	23%	25%	29%	29%
Concessional	23%	23%	24%	23%	20%	21%	23%	25%	26%
Non-concessional	2%	2%	2%	2%	1%	2%	2%	4%	3%
Private creditors	3%	2%	4%	7%	11%	16%	16%	16%	16%
Bonds	0%	0%	0%	0%	2%	11%	9%	8%	7%
Commercial banks	2%	2%	3%	7%	9%	5%	7%	6%	8%
Other private	1%	1%	1%	0%	0%	0%	0%	1%	1%

Source: Author's Computation from the International Debt Statistics of the World Bank

Figure 10 shows that annual disbursements from China to EAC countries have increased markedly since 2008, peaking at just under US$5 billion in 2015. The largest borrowers have been Kenya, Uganda and Tanzania.

“ The largest borrowers have been Kenya, Uganda and Tanzania

Figure 10 : Annual Disbursements from China, USD Million



Source: China-Africa Research Initiative, John Hopkins University

Chapter 3: Finance and Investment Protocols in SADC and EAC

This chapter discusses the provisions of the SADC Protocol on Finance and Investment and the EAC Monetary Union Protocol, particularly those that relate to public debt sustainability.

3.1 SADC Treaty

The SADC Protocol on Finance and Investment was ratified in 2006 and became effective in 2010. The protocol aims at ensuring that member countries harmonise their investment regimes to support a favourable investment climate for the region . Article 4 articulates the macroeconomic convergence criteria that the regional bloc aspires to achieve as part of efforts to maintain economic stability. The protocol considers fiscal discipline as sine qua non for achieving macroeconomic stability. As such, two of the three SADC macroeconomic convergence targets relate to fiscal prudence. The target for public debt-to-GDP is set in nominal terms, at 60%. Fiscal deficit target is set at 3% of GDP and allowed to vary within a +/-1% corridor. The SADC protocol also sets a target for the current account deficit of 3% by 2018 as a secondary criterion. **Table 4** shows the envisioned trajectory of fiscal related macroeconomic convergence targets for SADC between 2008.

Table 3 : SADC Fiscal Convergence Targets (% of GDP)

	2008	2012	2018
Fiscal Deficit	5	3, with a range of +/-1	3 as an anchor, with a range of +/-1
Public Debt	60	60	60
Current Account Deficit	9	9	3

Source: SADC, 2018

The monitoring and enforcement of SADC macroeconomic and fiscal convergence targets is done by several institutions. These include the Integrated Committee of Ministers, the Committee of Ministers for Finance and Investment, the Committee of Central Bank Governors (CCBG), the Peer Review Panel and the Secretariat. The Committee of Ministers for Finance and Investment meet at least once a year. The CCBG meet at least once a year and report to the Committee of Ministers for Finance and Investment. The Peer Review Panel is mainly responsible for macroeconomic monitoring and surveillance of macroeconomic convergence. The protocol has a provision for imposing sanctions on any member state that persistently fails, without good reason, to fulfil obligations assumed under the Treaty. However, no explicit sanctions are prescribed for deviating from macroeconomic convergence targets. As a result, the provision has not been invoked since 2006.

3.2 EAC Treaty

The Treaty for the establishment of the EAC was signed in 1999 by three founding member countries: Kenya, Tanzania and Uganda. Burundi and Rwanda joined in 2007, while South Sudan joined in 2016. Ultimately, the EAC aspires to become one political federation. Before reaching that milestone, however, the treaty calls for the establishment of a customs union, a common market and a monetary union among Partner States. Having operationalised both the customs union and the common market, the next step in the integration process is the establishment of a monetary union.

In pursuit of this objective, the member countries signed the EAMU Protocol in 2013. The EAMU Protocol outlines a set of binding convergence criteria, which Partner States must achieve by 2021 and maintain for three consecutive years until 2024, before being allowed to join the monetary union. The EAMU Protocol binding convergence criteria are summarised in **Table 5.**

“ The Treaty for the establishment of the EAC was signed in 1999 by three founding member countries: Kenya, Tanzania and Uganda. Burundi and Rwanda joined in 2007, while South Sudan joined in 2016.

Table 4 : EAMU Protocol Binding Convergence Criteria

Indicator	Target
Headline inflation	A ceiling of 8%
Fiscal deficit (including grants)	A ceiling of 3% of GDP by 2021
Gross public debt in present value terms	A ceiling of 50% of GDP by 2021
Reserve cover	4.5 months of imports

Source: EAMU Protocol

3.3 Assessment of Debt Rules in SADC and EAC

The debt rules in both SADC and EAC do not take into consideration the debt sustainability risks emanating from liquidity as they are both based on solvency indicators. Moreover, the debt rules do not take into consideration the differences in debt carrying capacities based on sound macroeconomic management and quality of policies and institutions as defined in the indicative debt thresholds and benchmarks used by the IMF and the World Bank.

As a result, while most countries public debt levels have appeared somewhat good because of higher GDP or exports, the increases in GDP have not translated to higher fiscal revenues, necessary to service the debts. Consequently, most countries, notably, Mozambique and Zambia have been facing payment difficulties despite their debt ratios being within those prescribed by the protocols. This is a sign of liquidity challenges faced by these countries.

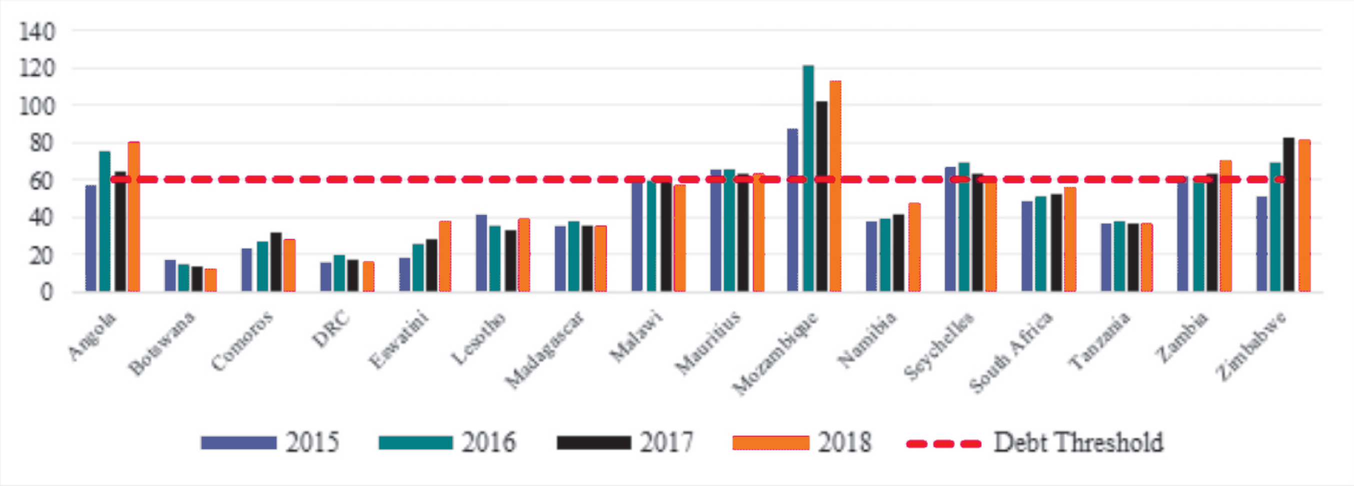
3.4 Status of Fiscal and Public Debt Convergence in the SADC region

3.4.1 Public Debt Criteria

While SADC's average public sector debt remained below the target of 60% of GDP, six (6) countries have recently surpassed the threshold. These countries are Angola, Mauritius, Mozambique, Seychelles, Zambia and Zimbabwe **(Figure 11).**

"...while most countries public debt levels have appeared somewhat good because of higher GDP or exports, the increases in GDP have not translated to higher fiscal revenues, necessary to service the debts.

Figure 11 : SADC Public Debt (% of GDP)



Source: WEO Database, 2018

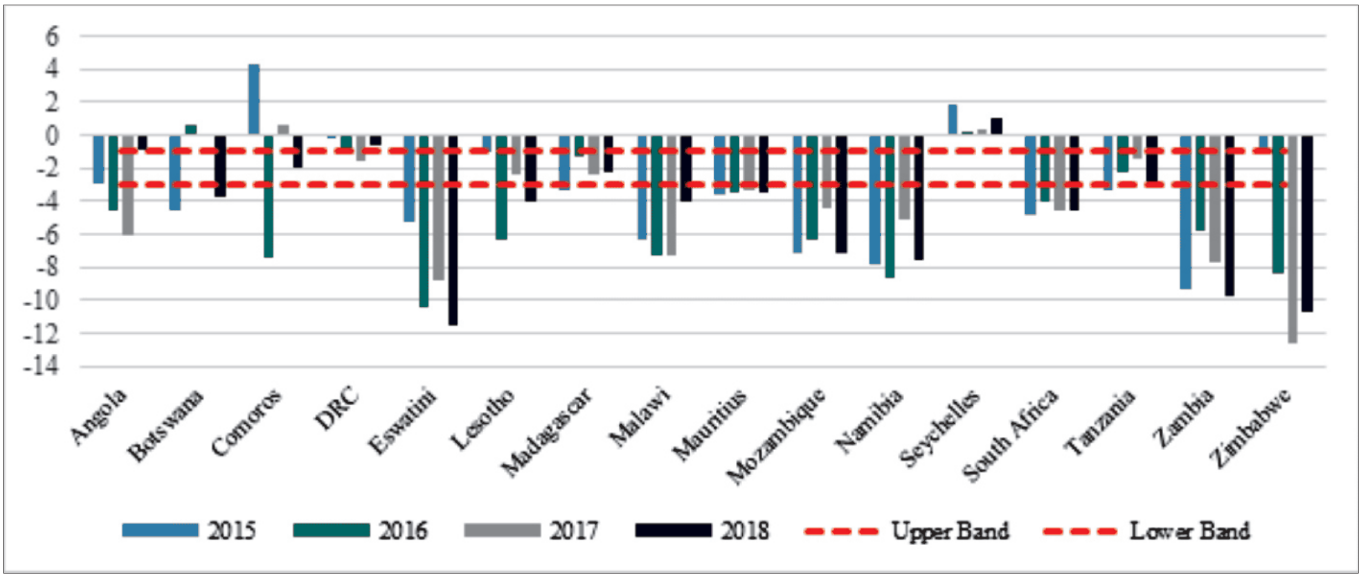
Given the recent increase in public debt, the number of countries in SADC surpassing the target rose from one in during 2010-2013, to 6 countries between 2016 and 2018. The increase in debt reflect increased borrowing mainly to finance infrastructure as well as changes in macro-financial factors such as GDP growth, interest and exchange rate.

3.4.2 Budget Balance Criteria

As discussed in Chapter 2, the increase in public debt also reflects worsening fiscal positions in most SADC countries. The SADC average budget deficit rose from around 2% in 2010 to peak at 4.7% in 2016 and remained elevated at above 4% since then. The number of countries that missed the budget deficit target rose from 3 in 2008 to 11 in 2016 and 10 in 2018. Only Botswana, Seychelles and Comoros recorded budget surpluses during 2010 - 2018 **(Figure 12).**

> ...the increase in public debt also reflects worsening fiscal positions in most SADC countries. The SADC average budget deficit rose from around 2% in 2010 to peak at 4.7% in 2016 and remained elevated at above 4% since then.

Figure 12 : Budget Balances in SADC Countries (2015 to 2018)



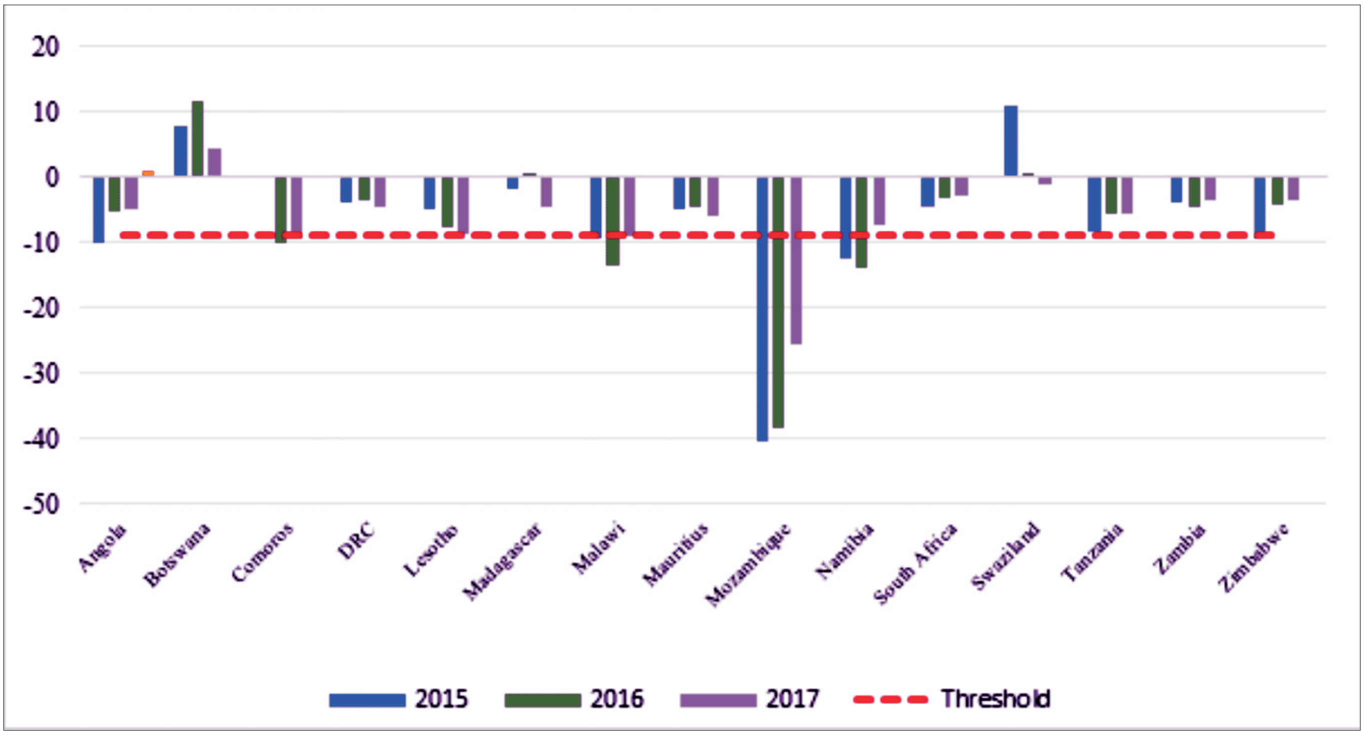
Source: Authors Compilation from WEO Database

3.4.3 Current Account Balance

The current account is a secondary criteria of macroeconomic convergence target under SADC, whereas the budget deficit and public debt are primary targets. Despite the general improvement in current account balances in most SADC countries, Malawi (16.1%), Mozambique (19.4%) and Seychelles (19.9%) did not meet the target in 2017, mainly because of the high imports (Figure 13). As such, current account deficits have also played a significant role in driving up external debt and hence overall public debt. External debt in SADC rose from 13.7% in 2010 to 25.1% in 2018 and is expected to rise further to 25.6% in 2019.

> ..As such, current account deficits have also played a significant role in driving up external debt and hence overall public debt. External debt in SADC rose from 13.7% in 2010 to 25.1% in 2018 and is expected to rise further to 25.6% in 2019.

Figure 13 : Current Account Balances of SADC Countries (% of GDP)



Source: Authors Compilation from WEO Database

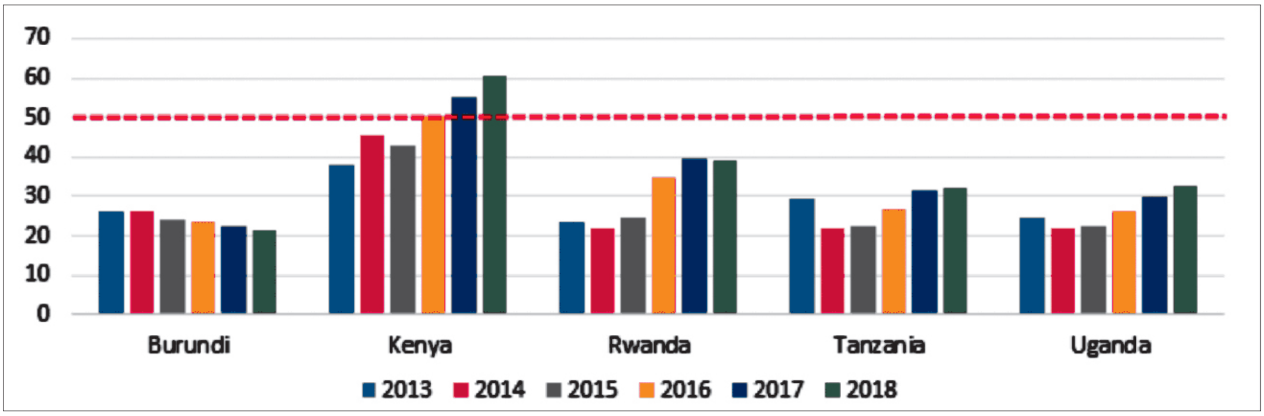
3.5 Status of Fiscal and Public Debt Convergence in EAC

3.5.1 Present Value of Public Debt in the EAC (% of GDP)

Most EAC countries are still below the convergence threshold of the ratio of the PV of debt to GDP of 50% **(Figure 14)**. An exception is Kenya which exceeded the 50% threshold in 2016 and has continued to breach it since then. Other countries are below the threshold and should be able to comply with the debt criterion by the 2021 deadline set out in the EAMU Protocol.

“ ..Other countries are below the threshold and should be able to comply with the debt criterion by the 2021 deadline set out in the EAMU Protocol.

Figure 14 : Present Value of Public Debt in the EAC (% of GDP



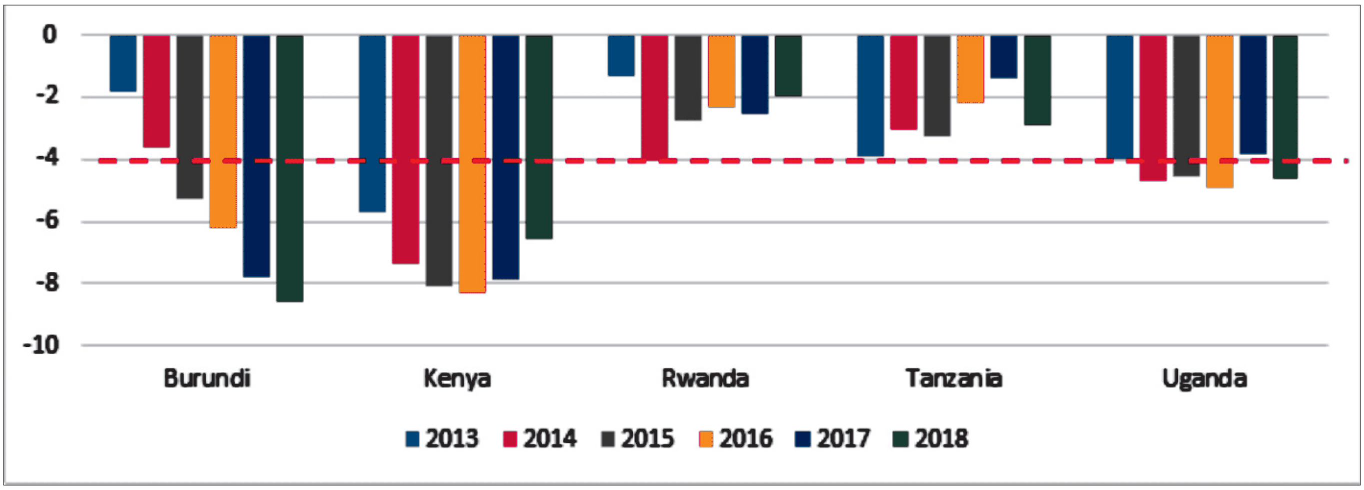
Source: IMF / World Bank DSA Reports

3.5.2 Fiscal Deficit

The EAMU Protocol requires that EAC countries achieve a fiscal deficit (including grants) below 3% of GDP by 2021. The Protocol also requires that countries remain below this threshold for three consecutive years before admission into the single currency area. All EAC countries breached the threshold at least once in the last six years. Rwanda and Tanzania have been below or just above the threshold in recent years.

All EAC countries breached the threshold at least once in the last six years. Rwanda and Tanzania have been below or just above the threshold in recent years.

Figure 15 : Fiscal Balances in the EAC (% of GDP)



Source: WEO Database, 2018.

However, Uganda and Kenya have breached the threshold since 2013; while Burundi's deficit has grown steadily, increasing from 1.8% of GDP in 2013 to 8.6% in 2018, nearly three times the threshold **(Figure 15)**.

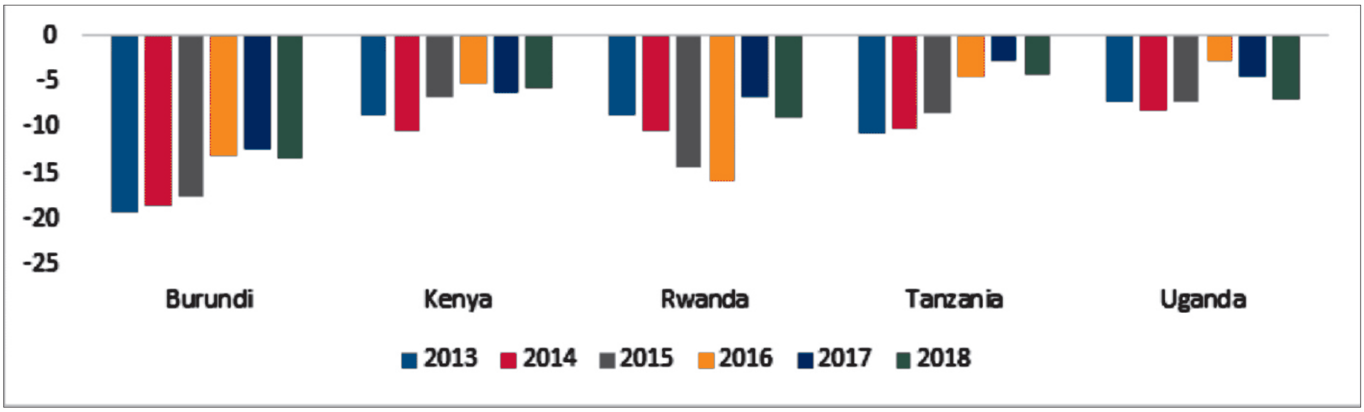
Achieving the target by 2021 is still possible, since a deficit can be changed within one budget cycle. In practice, however, it is very difficult to suddenly reduce a high deficit, since such fiscal consolidation would require severe expenditure cuts and/or significant increases in tax revenue, which might not be feasible. A more realistic approach would entail a gradual reduction of the deficit over a few years.

3.5.3 Current Account Balance

While the EAMU Protocol does not provide for any convergence criteria on the current account deficit, it remains an important variable in explaining changes in the external debt stock. Most countries in the region have had current account deficits of at least 5% of GDP. Burundi, in particular, has had elevated deficits in recent years, averaging 15.7% of GDP between 2013 and 2018 **(Figure 16)**. This is largely explained by the trade deficit, with the Burundi's imports significantly outweighing exports.

Most countries in the region have had current account deficits of at least 5% of GDP. Burundi, in particular, has had elevated deficits in recent years, averaging 15.7% of GDP between 2013 and 2018.

Figure 16 : Current Account Balance in the EAC



Source: WEO Database, 2018

However, there is a general reduction in current account deficits in the region in recent years, with the EAC average declining from 10.9% of GDP in 2013 to 7.8% in 2018. The largest driver of the current account deficits in the EAC is the trade deficit.

“ The largest driver of the current account deficits in the EAC is the trade deficit.

Chapter 4: Compatibility of National Financing and Investment Policies with Regional Protocols

4.1 How compatible are National Financing and Investment Policies with SADC Protocols?

In the SADC region, Botswana and Zimbabwe have formal national debt targets. Botswana has had debt and fiscal limits since 2003. It has one binding debt limit and two fiscal targets. The debt rule limits total domestic and foreign debt to 20% of GDP each. In addition, the country has a balanced budget rule. However, it is only the debt limit that is binding. The other fiscal rules are desired budget targets which are non-binding.

Zimbabwe adopted a debt limit of 70% of gross debt to GDP in 2015, and the limit applies to total debt. The limit is binding and can only be exceeded with approval of Parliament. This debt limit is however above that prescribed by the SADC regional protocol and this creates doubts about the country's commitment to achieve the target. In Mauritius, the Government committed to reduce its debt to GDP ratio, but the legislation does not specify a limit. On the other hand, Zambia's loans and guarantees authorisation Act limits the amount outstanding on external loans to 600 thousand million[6] Zambian kwacha. Table 6 summarises the assessment of member countries national policies against SADC protocols.

Zimbabwe adopted a debt limit of 70% of gross debt to GDP in 2015, and the limit applies to total debt. The limit is binding and can only be exceeded with approval of Parliament.

Table 5 : Assessment of Member Countries National Policies against SADC Protocols

Fiscal Rule	Country	Additional Notes
Budget balance (surplus/ deficit) rule	Botswana	The country has a budget balance rule. It also had an expenditure limit of 30 percent of GDP by the end 2016.
	Angola, Comoros, DRC, Eswatini, Lesotho, Madagascar, Malawi, Mauritius, Namibia, South Africa, Tanzania, Zambia, Zimbabwe	These countries do not have budget balance rules but use SADC targets as guiding posts.
Debt rule	Botswana, Zimbabwe,	Botswana has a public debt target rule of 40% of GDP, which is lower than the SADC target of 60%, allowing for easy convergence. Zimbabwe: -Debt shall not exceed 70% of GDP. This is already above the SADC target of 60%. Mauritius - Debt to GDP ratio should be on a downward trend
	Angola, Comoros, DRC, Eswatini, Lesotho, Madagascar, Malawi, Namibia, South Africa, Tanzania, Zambia, Zimbabwe	These countries do not have debt rules but use SADC and IMF/World Bank targets and benchmarks as guiding posts.

Sources: *Researchers compilation from country legislation, budget and policy documents*

4.2 How Compatible are National Financing and Investment Policy with EAC Protocols?

None of the constitutions or public finance management frameworks specifically mention the EAC convergence targets although the need for macroeconomic stability is emphasised. Public Finance Management Acts recognise the need for prudent fiscal behaviour, making them indirectly consistent with the EAMU convergence criteria. National budgets, Budget Framework Papers, Debt Reports and other fiscal documents also typically recognise the need to be within the EAMU ceilings. Table 7 summarises the assessment of member countries national policies against EAMU protocols.

"Public Finance Management Acts recognise the need for prudent fiscal behaviour, making them indirectly consistent with the EAMU convergence criteria.

Table 6 : Assessment of Member Countries National Policies against EAMU Protocols

Fiscal Rule	Country	Additional Notes
Budget balance (surplus/ deficit) rule	Uganda, Kenya	In line with the EAMU Protocol, the Charter for Fiscal Responsibility in Uganda stipulates that the fiscal deficit (including grants) should not exceed 3 percent of GDP by 2021. Kenya: The primary balance will be designed such that debt doesn't exceed 50% of GDP in PV terms.
	Tanzania, Burundi, Rwanda	Countries have no national legislation on budget balance rules but use EAC targets as guiding posts.
Debt rule	Uganda, Kenya	In line with the EAMU Protocol, the Charter for Fiscal Responsibility in Uganda stipulates that the gross public debt should not exceed 50 percent of GDP (in present value terms) by 2021. The Public Debt Management Framework further splits this target into 20 percent for domestic debt and 30 percent for external. Kenya: -Debt shall not exceed 50% in PV terms. (PFM Regulations) -Over the medium term, debt shall be used only for development, and not recurrent expenditure (PFM Act)
	Tanzania, Burundi, Rwanda	Countries have no national debt rules but use EAC targets as guidelines.

Sources: *Researchers compilation from country legislation, budget and policy documents*

The debt limit for Kenya has, however, proved to be non-binding and has been breached several times. Kenya has also a revenue limit since 1997 of maintaining government revenue to GDP of 21-22 %.

The general lack of compatibility between regional protocols and individual country legislation is a cause for concern as it undermines commitment to meet the regional convergence targets. In the EU, compatibility of national legislation to regional protocols is monitored at regional levels and reported each year as part of the EU fiscal and convergence report. In this regard, Kenya and Uganda have led the way in ensuring compliance to regional protocols and other countries can learn from them.

4.3 Implications of SADC/EAC Financing and Investment Protocols on Convergence

The non-alignment of regional protocols on Finance and Investment with national financing and investment frameworks for individual countries may partly explain slow progress towards convergence in both SADC and EAC, particularly with respect to public debt and fiscal deficit. Some form of convergence has been observed during favourable times while there is a tendency for divergence during bad years. This highlights the importance of favourable macroeconomic dynamics and the sensitivity of the convergence targets to macro-financial shocks. It also shows that most positive developments towards the macro convergence are not exactly due to the deliberate efforts of the member countries but also shaped by global, financial and economic conditions which are beyond their control.

4.3.1 Extent and Degree of Convergence

Despite the absence of absolute alignment between national financing policies and regional protocols, there seem to be convergence with respect to public debt to GDP for SADC countries from 2010 to 2014. Two important aspects underline this development. Firstly, several countries benefited from debt relief initiatives, particularly the HIPC and MDRI. Hence, the decline in debt up to 2010 is as a result of these initiatives. Secondly, the region experienced favourable macroeconomic conditions underpinned by commodity boom. This was accompanied by a high negative interest rate – growth differential, and favourable terms of trade, and stable exchange rates. Public debt was converging towards the 60% target up until 2013 but the situation changed following worsening macroeconomic fundamentals.

The non-alignment of regional protocols on Finance and Investment with national financing and investment frameworks for individual countries may partly explain slow progress towards convergence in both SADC and EAC, particularly with respect to public debt and fiscal deficit.

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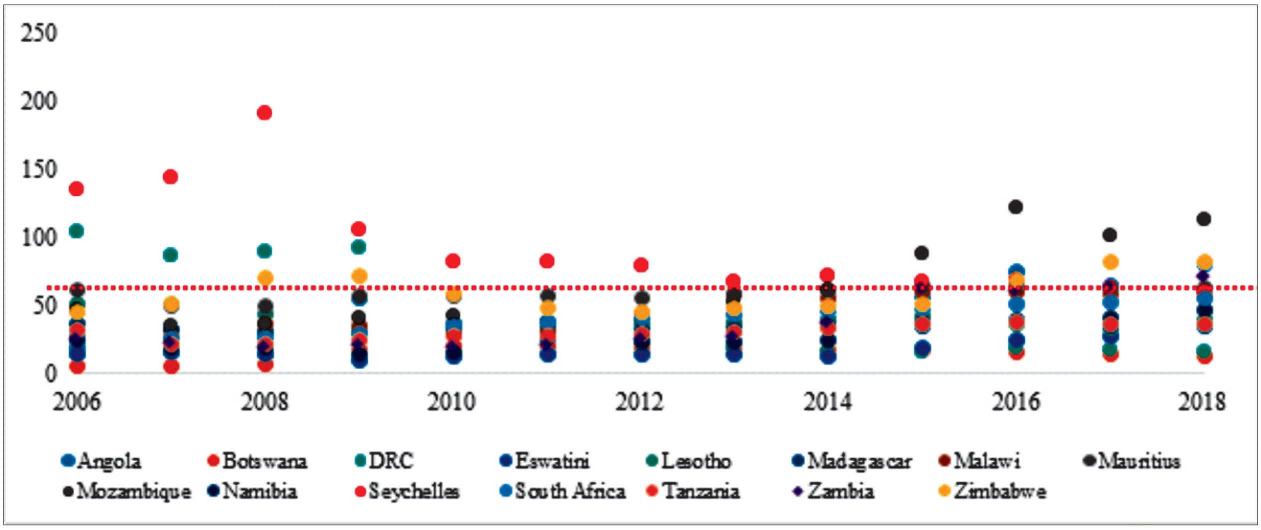
Figure 17 : SADC Member States Public Debt % GDP 2006-2018

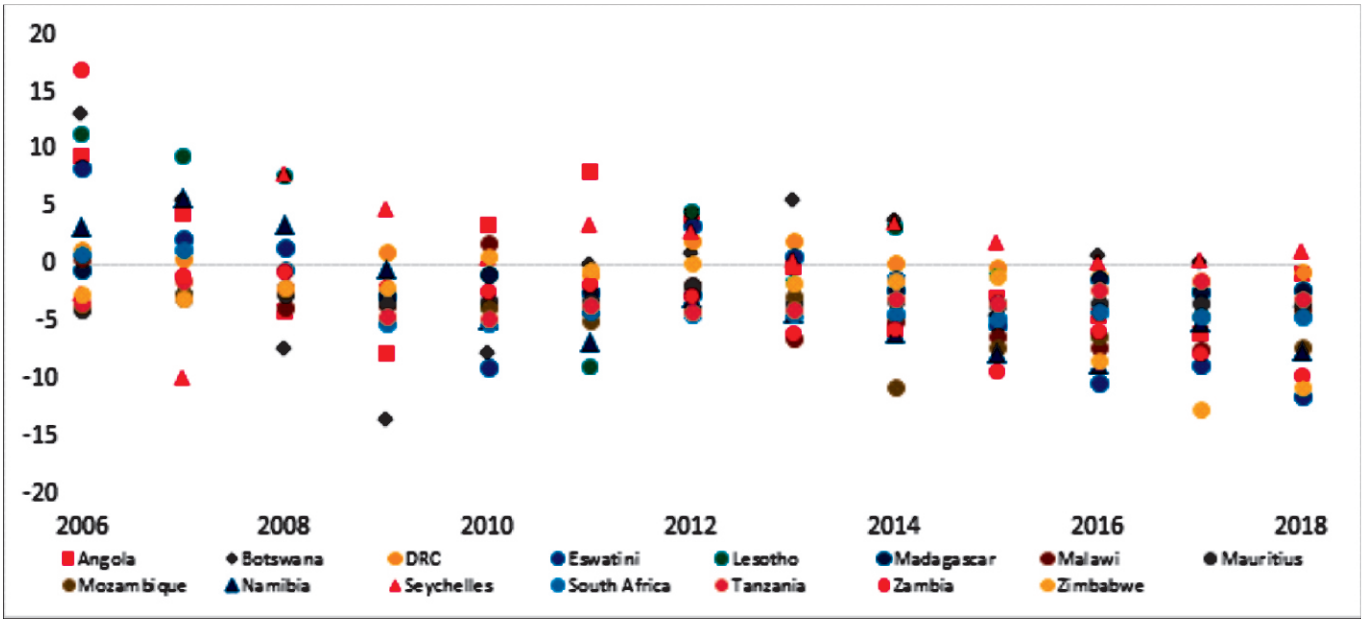


Source: *Authors Compilation from WEO Database*

Similarly, convergence of the fiscal deficits, which was almost achieved around 2012 and 2013, have shown signs of diverging. Most countries have failed to meet the 5% deficit to GDP target which obtained before 2008 and they are likely to fail to meet the 3% with a range of 1%. This may imply that the 3% deficit to GDP target is higher than what countries can achieve within the time frame.

Most countries have failed to meet the 5% deficit to GDP target which obtained before 2008 and they are likely to fail to meet the 3% with a range of 1%.

Figure 18 : SADC Members States Fiscal Deficit % GDP 2006-2018

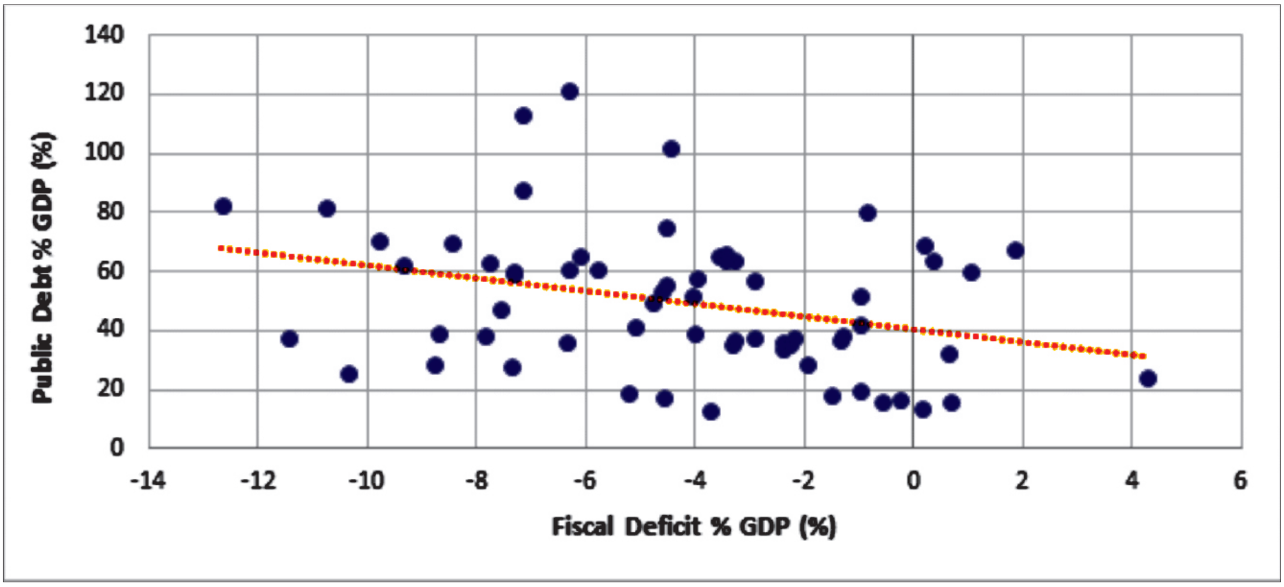


Source: *Authors Compilation from WEO Database*

Fiscal deficits have been worsening since 2015, fuelling public debt increases as shown in Figure **19.** Higher fiscal deficits are associated with worsening public debt to GDP in SADC for the period from 2015 to 2018 as shown in **Figure 23.**

Fiscal deficits have been worsening since 2015, fuelling public debt increases

Figure 19 : Fiscal Deficit % GDP and Public Debt % GDP 2015-2018



Source: *Authors Compilation from WEO Database*

4.3.2 Risk of Debt Distress Ratings

The risk of debt distress ratings for both SADC and EAC countries have been deteriorating since 2010. While the ratios of debt-to-GDP have remained low in some countries, debt sustainability analyses by the IMF and World Bank showed that debt can quickly become unsustainable in the face of increased macro-financial shocks.

The IMF/World Bank benchmarks depend on the debt carrying capacity which is discussed in the following section. Already, two countries are in debt distress (Mozambique and Zimbabwe), while the other two (Zambia and Angola) are in high risk of debt distress (Table 8). EAC countries have low debt risk rating except Kenya and Burundi. In particular, Kenya's risk of external debt distress rating deteriorated from low to moderate in 2018.

While the ratios of debt-to-GDP have remained low in some countries, debt sustainability analyses by the IMF and World Bank showed that debt can quickly become unsustainable in the face of increased macro-financial shocks.

Table 7 : Evolution of Risk of Debt Distress Ratings

	2010	2011	2012	2013	2014	2015	2016	2017	2018
Burundi	High	High	High	High	High	High	High	High	High
Kenya	Low	Low	Low	Low	Low	Low	Low	Low	Moderate
Lesotho	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate	Low	Low
Malawi	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate
Mozambique	Low	Low	Low	Moderate	Moderate	Moderate	Moderate	Distress	Distress
Rwanda	Moderate	Moderate	Moderate	Low	Low	Low	Low	Low	Low
Swaziland	Low	Low	Low	Low	Low	Low	Low	Low	Low
Tanzania	Low	Low	Low	Low	Low	Low	Low	Low	Low
Uganda	Low	Low	Low	Low	Low	Low	Low	Low	Low
Zambia	Low	Low	Low	Low	Low	Moderate	Moderate	High	High
Zimbabwe	Distress	Distress	Distress	Distress	Distress	Distress	Distress	Distress	Distress

Source: *Own Computations from IMF/World Bank DSAs*

The debt risk assessments for SADC MAC countries are summarised in Table 9, and shows that though debt is still sustainable, significant risks are emerging. Specifically, both public and external debt are sensitive to macro-fiscal shocks such as growth, exchange rate and contingent liabilities.

..both public and external debt are sensitive to macro-fiscal shocks such as growth, exchange rate and contingent liabilities.

Table 8 : SADC MAC Countries: Debt Risk Analysis for 2018

	PUBLIC DEBT	EXERTNAL DEBT	COMMENTS
South Africa	Sustainable	Sustainable	Sustainable but public debt and gross financing needs highly sensitive to macro fiscal risks such as growth and contingent liabilities.
Angola	Sustainable	Stable	Debt vulnerable to macro-fiscal shocks-growth oil price and contingent liabilities
Seychelles	Debt around high risk benchmark	External private debt elevated	Debt vulnerable to gross public and external financing needs due to large foreign denominated debt.
Namibia	Sustainable	Sustainable	Debt deteriorating and fast approaching DSA risk thresholds. External debt exposed to exchange rate and current account shocks.
Mauritius	Sustainable	Stable	Debt profile risk related to share of public debt held by non-residents slightly elevated. Gross financing needs vulnerable to growth, real interest and primary balance.

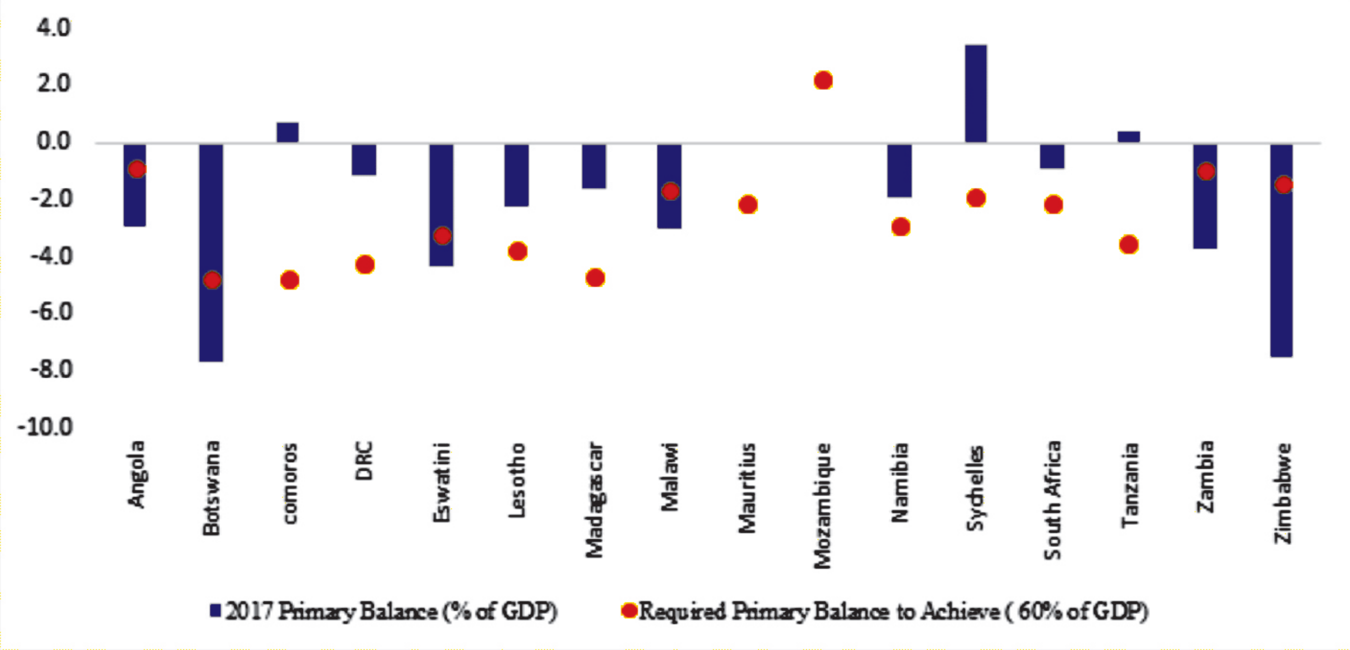
Source: *IMF and World DSA Reports*

4.3.3 Size of Primary Fiscal Balances Required to Meet Public Debt Targets

This section provides the primary balance for each country that will be required to ensure that they meet the debt convergence target. The primary balance is calculated using the debt stabilizing primary balance approach, which is a simple and transparent tool with minimal data requirements. This approach calculated the primary balances to be achieved in order to reach a target debt level, given the set of macroeconomic assumptions relating to real interest rate and growth. The primary balance for the SADC countries by 2026 is shown in **Figure 20.**

This approach calculated the primary balances to be achieved in order to reach a target debt level, given the set of macroeconomic assumptions relating to real interest rate and growth.

Figure 20 : Primary Balance to Attain the Public Debt Convergence of 60% in SADC



***Source:** Author's Computations*

Four countries (Angola, Mozambique, Zambia and Zimbabwe) will require significant consolidation effort to improve their primary balances in order to meet the 60% debt-to-GDP threshold as stipulated in the SADC protocol **(Figure 20)**. The difference between the required primary balance and the 2017 outturn show how realistic it will be for the countries to achieve the debt target. Basing on the 2017 primary balance outturn, all the four countries require significant fiscal adjustment, while Mozambique would require a primary surplus. The rest of the countries can still experience worsening of primary balances without threatening to breach of regional protocols.

Regarding the EAC, Kenya will need to improve its primary balance in order to achieve the desired public debt ratio of 50% of GDP in present value terms by 2021 **(Table 10).** In 2018, Kenya's debt was 60.6% of GDP in PV terms, which is above the stipulated 50% for EAC. To ensure convergence to EAC target, Kenya needs to run primary surpluses, which will be a complete shift from historical average primary deficits of -4.66% of GDP between 2015 and 2018. This seems unlikely, since Kenya last achieved a primary surplus in 2005. Moreover, Kenya's 2019 Budget Policy Statement shows that the country will continue to incur fiscal deficits between Fiscal Year 2018/19 and 2020/21 (5.5% of GDP on average).

“ The difference between the required primary balance and the 2017 outturn show how realistic it will be for the countries to achieve the debt target. Basing on the 2017 primary balance outturn, all the four countries require significant fiscal adjustment, while Mozambique would require a primary surplus.

Table 9 : Debt Stabilizing Primary Balance for EAC Countries

	Debt Stabilizing PB	50% PB	Average PB (2015-2018)
Burundi	-0.03%	-9.63%	-4.86%
Kenya	-2.33%	1.03%	-4.66%
Rwanda	-1.42%	-5.31%	-1.54%
Tanzania	-1.17%	-7.04%	-0.53%
Uganda	-1.44%	-6.02%	-2.34%

Source: *Author's calculations*

In addition, results show that countries with higher debt levels would require less fiscal effort to stabilise debt, while countries with lower debt levels would typically require higher primary balances. For instance, Kenya, which has the highest 2018 debt level (60.6% of GDP in PV terms) would require the lowest primary balance (-2.33% of GDP) to stabilize its debt at that level. Burundi, with the lowest 2018 debt levels (21.2% of GDP in PV terms) requires the highest primary balance (-0.03%).

“ ...Kenya, which has the highest 2018 debt level (60.6% of GDP in PV terms) would require the lowest primary balance (-2.33% of GDP) to stabilize its debt at that level.

4.4 Challenges in Implementing SADC/EAC Financing and Investment Protocols

The key challenges faced by SADC and EAC countries in implementing and meeting regional protocols on finance and investment are discussed below:

4.4.1 Lack of Political Commitment

Lack of political commitment is one of the key obstacles to achieving convergence, as indicated by lack of adherence to regional financing and investment protocols. The protocols impose targets on the fiscal behaviour of member countries, which some policy makers might perceive as an infringement on their sovereignty.

4.4.2 Infrastructure Deficits

Most SADC and EAC countries still have huge infrastructure bottlenecks and the pressure to address these deficits push governments to borrow more. Moreover, most countries have development plans, which often require significant investment in physical and human capital, beyond what the countries can finance using their own tax revenues. This means they are compelled to borrow in order to achieve their development aspirations.

4.4.3 Debt Management Capacity

Weak debt management capacity persists in several countries as reflected in Debt Management Performance Assessments (DeMPA) conducted by the World Bank. A stronger focus on the management of overall public debt at country level could help countries ensuring fiscal convergence.

4.4.4 Debt Carrying Capacity

Debt carrying capacity is determined using various factors that have a bearing on the debt management capacity, solvency of debt and ability to repay, which include the CPIA, domestic growth, reserves, remittances and world growth. Most countries in SADC are rated weak and have lower debt carrying capacities, with a threshold of the ratio of the PV of debt to GDP at 35% in **(Table 11)**. This is important for convergence to regional targets as countries will ensure their debt ratios remain below a threshold that is far much lower that the regional convergence target.

Table 10 : Total Public Debt Benchmark in the IMF / World Bank LIC DSF

Debt Carrying Capacity	Public Debt Benchmark (% of GDP, in PV terms)	Countries
Weak	35	Burundi, Zimbabwe, Congo. DR, Mozambique, Malawi, Zambia
Medium	55	Comoros, Lesotho, Madagascar
Strong	70	Kenya, Rwanda, Tanzania, Uganda

Source: *IMF / World Bank LIC DSF*

On the other hand, all EAC countries except Burundi are rated strong in terms of their debt carrying capacity. This means that the IMF / World Bank LIC DSF benchmark for debt to GDP in PV terms for these countries is 70%, which is significantly higher than the 50% provided for by the EAMU Protocol.

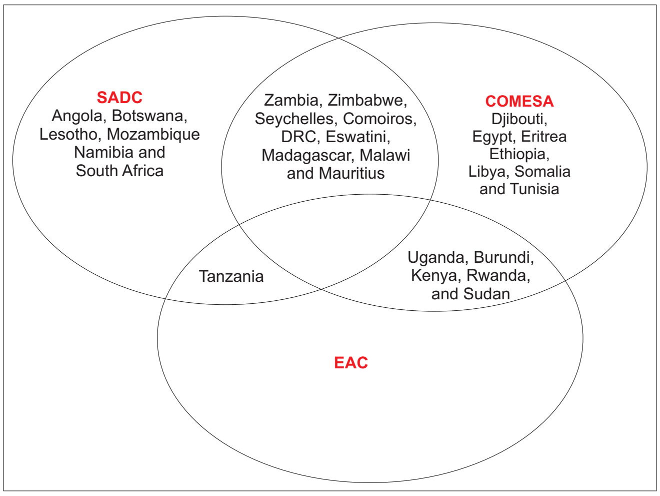
4.4.5 Changing External Financing Landscape

There has been a gradual shift in both the EAC and SADC from the traditional concessional multilateral lenders (mainly the World Bank and the African Development Bank) to non-concessional lenders, including commercial creditors. Non concessional / commercial loans typically come with shorter grace and maturity periods, as well as higher interest rates. This places significant strain on budgets in the form of debt service costs. This is particularly the case for countries such as Angola, Kenya, Zambia and South Africa, which have all issued Eurobonds in the recent past. The changing landscape brought with it challenges and opportunities, which might assist countries in meeting the convergence or miss the target. For instance, risks arising from rising commercial debt might pose debt sustainability challenges that may also compromise attainment of convergence target. On the other hand, the new loans if used productively could boost growth and development, thereby improving the debt and fiscal position of countries towards meeting the convergence criteria

4.4.6 Multiple Regional Economic Community Membership

Most of the countries in both SADC and EAC hold multiple regional economic community membership. These regional economic communities have conflicting targets, and this makes it difficult for individual countries to implement region specific protocols. The realisation of this fact has prompted the African union to initiate the process of harmonising the regional integration agenda. This is expected to go a long way in resolving the challenge of complying with multiple regional protocols. Figure 25 shows that 15 countries belong to two regional groupings.

Figure 21 : Multiple Regional Economic Community Membership



4.4.7 Pro-cyclicality of Fiscal Policies

Government consumption in SADC and EAC is procyclical and this tends to make debt highly susceptible to economic cycles. The pro-cyclicality is more pronounced for natural resource rich countries. Governments tend to spend more during boom and inadvertently forced to consolidate during recessions or incure huge debt, thereby contributing to higher debt. As a result of pro-cyclicality in fiscal policy, SADC and EAC countries tend to meet fiscal and debt targets during favourable growth years as was the case in 2012 and 2013 but experience significant challenges in years of economic slowdown as was the case in 2015 and 2016.

Therefore, fiscal policy in most countries is not playing a stabilising role over the business cycle. To ensure debt sustainability, fiscal policy should be countercyclical. Governments' ability to contain spending and sustain budget surpluses in boom cycles are severely affected by political pressures, which result in procyclical fiscal policy. This partly explains why most governments in SADC and EAC were borrowing heavily during booms and favourable international conditions.

> “ As a result of pro-cyclicality in fiscal policy, SADC and EAC countries tend to meet fiscal and debt targets during favourable growth years as was the case in 2012 and 2013 but experience significant challenges in years of economic slowdown as was the case in 2015 and 2016.

Chapter 5: Conclusions and Recommendations

> "Given the changing external financing landscape and the emergence of new forms of financing such as PPPs, there is need to strengthen debt management capacities in regional member states.

5.1 Summary of Findings

This study assessed the EAC and SADC finance and investment policies against national finance and investment policies, with particular emphasis on public debt convergence criteria. The findings show that both EAC and SADC have criteria on fiscal deficit of 3% and ratio of public debt-to-GDP limit of 60% for SADC and 50% for EAC. The debt rule for EAC is in present value terms whereas the SADC is in nominal terms. Nevertheless, the debt rules only focus on solvency indicators and do not take into consideration the debt sustainability risks that may arise from liquidity challenges. Moreover, the debt targets do not reflect special country circumstances. For example, countries have different debt carrying capacities (defined by macroeconomic management and quality of policies and institutions).

The findings also show that few countries have formal or legislated targets or limits for public debt, fiscal and current account deficits. In most countries, the laws and regulations recognise the need for macroeconomic stability without giving numerical targets. In few cases where targets exist, they are not necessarily aligned to regional protocols and in most cases non-binding. Nevertheless, most country debt reports, national budgets and budget framework papers tend to refer to convergence benchmarks.

Although several countries do not have formal fiscal rules in place, the two regional blocs regularly monitor their progress towards achieving the requirements of these protocols. While the targets set out in the protocols are not usually provided for in country-specific legal frameworks, budget documents and debt reports typically acknowledge the need to attain the targets set out in the respective protocols. Importantly, most countries carry out annual debt sustainability analysis, which shows whether the debt path is sustainable or not and the required action need to ensure sustainability. In assessing the sustainability of debt, countries refer mainly to standard IMF/World Bank debt sustainability benchmarks.

5.2 Recommendations to Member Countries

Compliance with regional protocols particularly on debt calls for prudent management of debt. Moreover, there is need to harmonise national policies with regional convergence protocols. Particularly, governance institutions and sound policies are needed to ensure compliance on a sustainable basis. This is out of the realisation that recent debt accumulation in the two regional blocs have also been influenced by automatic debt dynamics, explained by changes in the growth rate, interest rates and exchange rates over and above the fiscal stance.

While routine debt sustainability assessments and other non-binding mechanisms have assisted in keeping fiscal and debt in check, there is need for national legislations to be compatible with regional protocols. The countries should set national explicit fiscal and debt targets in line with regional protocols as this is critical in ensuring adherence and effective monitoring. The process of aligning national investment and financing protocols will, however, take long and there is need for a framework in the regional protocols that monitors and reports progress by national governments in alignment process.
Most fiscal policies in the SADC and EAC are pro-cyclical, particularly for most natural resource rich countries. There is need for an in-built mechanism to ensure countercyclical fiscal policies are sustained. This may require adoption of the cyclical budget deficit target as opposed to actual budget deficit as is the case with EU. As a non-observable measure, the cyclically or adjusted fiscal deficit, measurement issues, would need to be agreed and overcome before adoption.

Given the changing external financing landscape and the emergence of new forms of financing such as PPPs, there is need to strengthen debt management capacities in regional member states. In addition, there is need to enhance transparency in debt contraction and increase data coverage to fully take into account contingent liabilities.

5.2.1 Recommendations to SADC and EAC Secretariats

Unsustainable public debt in member countries impact negatively on economic development in the region. As such there is need for the regional blocks to strengthen the current regional peer review mechanisms to ensure that sustainable policies are implemented by member countries. In addition, there is need for regional blocs to encourage member countries to harmonise their finance and investment policies to regional protocols. These should be reported as part of the monitoring and review mechanism.

5.2.2 Recommendations to National Parliaments

Parliament plays an important oversight and monitoring role in public debt management. Against this background, the National Parliaments should promulgate national laws that are alight to regional protocols. Lastly, there is need to enhance the capacity of National Parliaments to analyse and monitor borrowing by national governments.

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END NOTES

[1] EAC Member States are: Burundi, Kenya, Tanzania, Rwanda, and Uganda

[2] SADC Member States are: Angola, Botswana, Comoros, Democratic Republic of Congo, eSwatini, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Tanzania, Zambia and Zimbabwe.

[3] See, for example, Jubilee Debt Campaign (2017), UNCTAD (2016), Financial Times (2017) and (IMF,2018).

[4] Comoros, DRC, Madagascar, Malawi, Mozambique, Tanzania, and Zambia

[5] LIC Countries in SADC are Comoros, DRC, Lesotho, Madagascar, Malawi, Mozambique, Tanzania, Zambia and Zimbabwe. MAC countries are Angola, Botswana, Eswatini, Mauritius, Namibia, Seychelles and South Africa – most of these countries have concessional debt.

[6] Equivalent to USD 45 billion, based on exchange rate of ZMW13.33 per dollar as at end May 2019

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