Hell Breaks Loose in Mozambique: Is this the beginning of the end of irresponsible Sovereign Borrowing? Or a wakeup call to address Benignity of the International Capital Markets?

By:

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Introduction

The ground for the pandemonium in the current Mozambique's debt crisis had been tilled about seven years ago. The then President Armando Guebuza and his government created three state-owned enterprises, Ematum, ProIndicus and Mozambique Asset Management Company (MAM). In the fiscal year 2013-2014, the enterprises borrowed a total of $2billion worth of loans that were guaranteed by the state government. The financing involved a 622 million-dollar loan to ProIndicus, with the aim of performing security surveillance along the coast, an 850 million-dollar loan to Ematum which was tasked to build a tuna fishing fleet and a 535million-dollar loan to the MAM to construct and maintain shipping yards along the coast of Maputo. Amongst the three, only the loan issued to Ematum was known to the public after a demand from the IMF that the loan be included in the State's budget and legalized through parliamentary approval processes. However, the other two loans, despite being backed by a government guarantee, they remained unbeknown to the public and many players in the sovereign debt market, including the IMF.

Doomsday for Mozambique; Creditor flight and Domestic turmoil

> *"I hold these truths to be self-evident, that in the 21st century no sovereign whether developing or developed, borrows money with the expectation that it will ever have to repay it, if by repay it you mean apply current resources to retire the liability, in the 21st century every sovereign borrows in the sure and certain hope that when the debt matures they will be able to borrow from someone else and when that mature they will be able to borrow from someone else to repay that and so on and endlessly so forth in perpetuity."*

Drawing from Lee Buchheit's observation above, it is easy to conclude why and how Mozambique, despite its precarious financial position had the neck to borrow against its black letter law and exceed the constitutional thresholds. This has now come to be known as the assumption of refinancing, both debtors and creditors at the international capital markets have systematically developed an ingrained presumption that the perpetual benignity of the market will enable a debtor no matter how poor its credit ratings are will be in a position to pay, perhaps by borrowing from another source.

Unfortunately for Mozambique, the markets, both equity and debt run on information and information asymmetry and once that information imbalance is levelled or tilts, the markets respond. It has been doomsday for Mozambique since Ematum's restructuring in 2016; this was when information leaked that the other two debts to ProIndicus and MAM had violated all the budgetary and fiscal laws in Mozambique. In addition, it also became clear that the borrowed monies could not be accounted for. The chain of events in the domestic economy of the south-eastern island nation was anything but usual and foreseeable. The IMF terminated its standby credit facility arrangement, other bilateral lenders constitutive of about eight countries suspended their budgetary support, with Sweden reducing its aid significantly. A country that had initially been labelled as the "darling of the donor community," became the isolated leprotic patient with whom association was avoided at all cost.

Creditor flight and lack of budgetary support have precipitated unprecedented economic challenges in Mozambique. According to the World Bank's 2017 Mozambique Economic update report, economic growth reduced from 7.5% in 2014 to 3.8%. In 2016 the interest rates rose sharply such that the government's reference lending reached 22.75% of GDP, which was one of the highest in Africa. Additionally, the average interest rates for commercial banks rose to 28.6% in comparison to the Libor reference rate for interbank loans which was lower than 2% globally at the time. In respect to government spending, there was a drop by 9% between 2014 and 2016. Spending on wages remained constant against the GDP, but capital spending reduced by about 7% between the two years. Finally, government subsidies on basic commodities reduced. As a result, poor communities within the country bore the brunt of irresponsible and illegal borrowing.

My Professor in the Sovereign Debt Restructuring class I took at New York University School of Law, Lee Buchheit, while explaining why sovereign debt is always on the rise attributed poor and irresponsible borrowing and lending practices to the assumption of refinancing. This means that the debtor hopes that it will never have to pay the debt if and when the debt matures, and the debtor hopes to borrow from the ever-generous debt market and pay that debt and hopes the cycle continues in perpetuity. On the other hand, the creditor, due to the love for bullet maturity, that is repayment of the principal sum at once on a certain specific day in the future have ceased applying sinking funds or alternatively amortizing the loans. In my opinion, the foregoing scenario presents room for mischief because creditors lend in the hope that they are not last in the seemingly endless cycle of refinancing. Further, borrowers and in particular political leaders are be tempted to borrow in the hope that in the event the bubble bursts, they will not be in power and it will be the responsibility of someone else. This is borne out by the facts of the drama in Mozambique. Here the illegally procured debts were borrowed by President

Armando Guebuza. At the moment, Prime Minister Carlos Agostinho is having to handle the mess created by his predecessor. The Mozambique case far from being yet another example of the cycle of an endless cycle of borrowing and default should perhaps become a rallying point to end irresponsible sovereign borrowing as well as a wakeup call to the kindness of the markets.

Odious Debts and the Question of Compliance with Domestic Laws

The concept of odious debt refers to debts incurred by an illegitimate regime of a country, making them unenforceable against the State. However, the concept has not been settled in law and the scholarship on this subject is split, although much of it leans towards a restrictive application of the concept. Thus, with respect to Mozambique, although this concept did not primarily arise in the case, some commentators have referred to the debts as odious. For clarity, those debts to the two Mozambican state-owned companies may not qualify under this category since the question regarding the legitimacy of the government was not the basis for the constitutional council's decision.

Instead, the constitutional council in Case No. 05/CC/2019 set a different set of precedent, perhaps a first of its kind in the global south. It did so by declaring the debts illegal because of the failure of the executive to comply with the statutory and constitutional procedure for issuance government guarantees. This is because the government had failed to include the loans in the General Budget of the State in the respective years in which the guarantees were issued. Second, the government had failed to seek approval by the assembly of the State. Third, the government had exceeded the statutorily mandated ceiling for government guarantees on a given fiscal year. As a result, the constitutional council held that these violations rendered the loans and the guarantees issued by the executive null and void.

Against the backdrop of this decision, it can be surmised that it is the responsibility of a creditor to do adequate due diligence to ascertain not only the creditworthiness and the legitimacy of the contracting institution but also the procedural requirements of a nation's domestic law. A reputable market player in the creditor's shoes in the foregoing may not have lent up to $2billion to newly created institutions with whom there is no measure of their creditworthiness. Additionally, the decision also serves the seemingly remote function of curbing illicit financial flows within the international debt market, that is, proceeding on the presumption that a properly placed creditor wouldn't have lent such an amount of money to new players at the debt market (Ematum, ProIndicus & MAM). Indeed, reasonable due diligence would have enabled a properly placed creditor to be aware of the debt ceiling and the requirement for parliamentary approval. Thus, there is only one hypothesis that can be drawn, 'perhaps there is more than meets the eye.'

So, What next for Mozambique? An IMF Bailout with Conditionalities?

The intricacies of a sovereign debt crisis have unmatched consequences on the sovereign, but the consequences have their most adverse impacts on poor communities within those countries. They suffer over-taxation to fund government spending, reduced or withdrawals of subsidies on the most basic commodities and consequently slow rate of economic growth due shrinking of the domestic financial market. Thus, the authors of the problem, i.e. the political class hardly bear the brunt of a debt crisis in the manner that poor populations do. The United Nations Development Programme 2019 Human Development Report estimated that poverty levels are decreasing at a slower rate than anticipated. In Mozambique, the incomes of the bottom 40 percent grew 40 percentage points less than the global average. Thus, be that as it may, a decision to declare the illegal loans a nullity does not in and of itself solve the puzzle. In the meantime, since the re-entry of Mozambique into the international debt markets may take time, the poor communities may not have the wherewithal to survive that long. So, what is the last piece of the puzzle? An IMF arrangement with conditionalities? What conditionalities? My next piece intends to consider this.

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