

Africa's Chronic Liquidity Challenges and the Role of SDR Allocations

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Africa's Chronic Liquidity Challenges and the Role of SDR Allocations

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Contents

List of tables

List of figures

List of abbreviations and acronyms

Abstract

1.	Background	1
2.	The state of debt in Africa and liquidity challenges	3
3.	Improving existing SDR arrangements for Africa and beyond	9
4.	Domestic reforms	17
5.	Conclusions	19
	Notes	21
	References	23

List of tables

1	Correlations between investment, real GDP growth, and net debt in Africa: 1990-2022	7
2	Benefits and challenges of various SDR arrangements	11

List of figures

1	Government net debt and real GDP growth in Africa during the COVID-19 pandemic (2020)	4
2	Debt service and change in official foreign reserves (%)	4
3	Change in government primary balance and exposure to Russia/Ukraine by African countries	5
4	CO ₂ emissions and frequency of annual major natural disasters in Africa	6
5	Change in debt and major natural disasters in Africa	6
6	Interest rates on Special Drawing Rights	12
7	Rule of law and persistent inflation in Africa: 1996-2019	18
8	National savings (% of GDP) and rule of law in Africa: 1996-2019	18

List of abbreviations and acronyms

AfDB	African Development Bank
AU	African Union
CO ₂	Carbon Dioxide
COVID-19	Corona Virus Disease 2019
DSSI	Debt Service Suspension Initiative
GDP	Gross Domestic Product
GMT	Global Mitigation Trust
HCI	Hybrid Capital Instrument
HIPC	Heavily Indebted Poor Countries
IFIs	International Financial Institutions
IMF	International Monetary Fund
LSF	Liquidity and Sustainability Facility
MDBs	Multilateral Development Banks
PRGT	Poverty Reduction and Growth Trust
RSF	Resilience and Sustainability Facility
RST	Resilience and Sustainability Trust
SDGs	Sustainable Development Goals
SDRs	Special Drawing Rights
SMEs	Small and Medium-sized Enterprises
UNECA	United Nations Economic Commission for Africa
WEO	World Economic Outlook

Abstract

The triple and overlapping global shocks faced by African countries have caused severe liquidity challenges in recent years. Many countries are currently experiencing low real GDP growth, higher inflation, exchange rate instability, balance of payments crisis, and a high risk of debt distress. The most critical is the increasing disruption that climate change risks pose to the macroeconomy, including worsening conditions of conflict and instability. In this regard, Africa is at a significant historic moment to resolve its development finance challenges to ensure a transition to a low-carbon economy while achieving the targets set in the Sustainable Development Goals. This paper outlines potential areas of reform in both the domestic and global arenas. It argues that the existing debt resolution mechanisms are obsolete, requiring novel and bold approaches, such as revising the role of Special Drawing Rights in relieving liquidity challenges in developing countries, mainly in Africa. In addition, the paper also notes that African governments need to seize opportunities created by the shocks to implement long-overdue structural and governance reforms to realize the continent's enormous development potential.

1. Background

In a recent announcement, the International Monetary Fund (IMF) approved a 450 billion worth of Special Drawing Rights (SDR)¹ to “boost reserves and foster the resilience and stability of the global economy”. The allocation across member countries would depend on their quota or share they have at the Fund. The unprecedented steps the IMF took in distributing SDRs at this moment in history marks a shift in the role of SDRs, which were designed primarily as payment systems among sovereign countries in the face of severe liquidity problems. In this sense, SDRs are not debt instruments but foreign reserve assets that were created in 1969 to facilitate international payment systems to ease the pressure on US dollar as the universal currency of exchange. Soon after, conversation and debate started on the possibility of using SDR allocations for purposes of development,² but remained elusive to this date as academics and leaders debate on the best vehicle to channel the SDR allocations.³

On the other hand, the fiscal capacity of African governments has continued to shrink since 2013, fuelling debt distress. The COVID-19 pandemic and now the Russo-Ukraine war exacerbated the fragile public finance in most African countries.⁴ Unlike other regions of the world, shocks, even short-lived shocks, have the tendency of persisting in Africa, sometimes affecting the long-term path of key development indicators, and reversing the poverty reduction path. Debt to GDP ratio, on the average, crossed 66% in 2023 for most African countries, up from 56% in 2019, prior to the pandemic. Fiscal and current account deficits hit record levels, while GDP slowed down in many countries with a long-drawn recovery projected. The IMF reported that close to 21⁵ African countries are either at high risk of debt distress or already in debt distress. Some countries such as Ghana, Zambia and Ethiopia have indicated to reschedule their outstanding external debt, suggesting pre-emptive default. Many countries may follow suit without significant support from multilaterals and creditors. This paper provides the wider context in which public finance is debated globally, with a focus on shocks-debt-SDR-allocation as it relates with African countries. The paper presents the shocks-debt nexus in Africa, the implications to development finance, and the context in which SDR allocation could bring convergence between borrowers and creditors. The paper addresses the following specific questions: Given the multiple shocks countries are coping with in the last few years, what is the value proposition for enhanced SDR allocations for African countries? What institutional barriers and conditionalities present constraints to African countries? Going beyond

SDR, what are the possibilities and options for SDR facilities to leverage productive investment and thereby increase domestic resource mobilization?

The rest of the paper is organized as follows. Section 2 outlines the state of debt in Africa, the chronic liquidity challenges and Africa's development financing gaps to tackle particularly climate change risks which are ever increasing in frequency and geographic coverage. The paper proposes key areas of concern, including debt-investment nexus, domestic resource mobilizations, and the political economy underpinning public finance reform. Section 3 outlines possibilities to improve existing arrangements on SDR allocations, and section 4 proposes the institutional and governance reforms necessary to efficiently utilize development finance. Section 5 concludes with key policy messages.

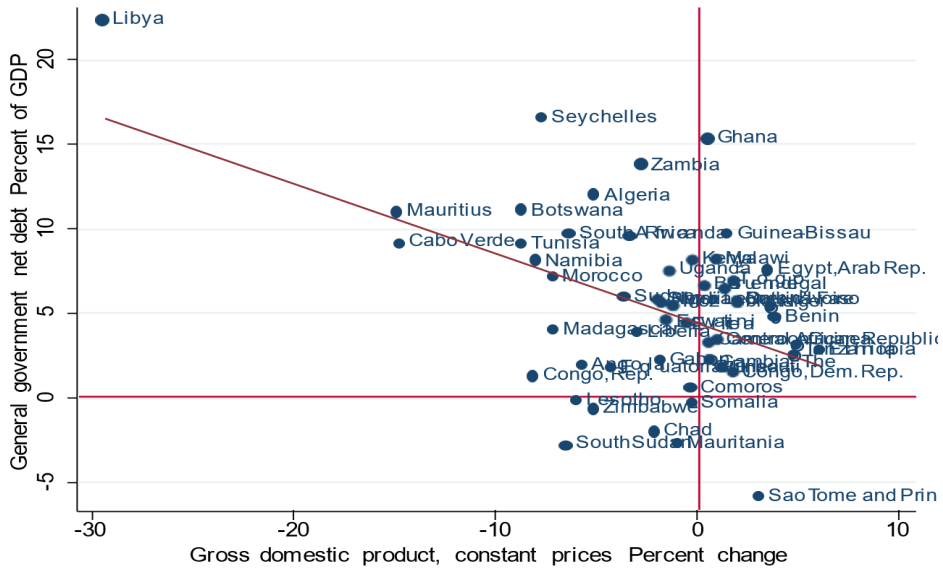
2. The state of debt in Africa and liquidity challenges

The average debt stock (both external and domestic) as a share of GDP started picking up in Africa for the first time in 2008 since the HIPC initiative and accelerated in the wake of the COVID-19 pandemic. Both periods marked significant global shocks. External debt exhibited an upward trend that stemmed from less reliance on concessional lending from multilateral institutions, broader access to long-term finance from international capital markets, and increased access to financing from emerging bilateral creditors such as China. The COVID-19 pandemic accelerated the debt burden from a weighted average of 56% in 2019 to 66% in 2020, a nearly ten percentage point increase or around US\$242 billion (in constant terms) in just one year. Further, Figure 1 illustrates the change in the debt position of governments at the end of 2020, which was the height of the COVID-19 pandemic. Most countries, as shown in Figure 1, experienced significant shrinking in real GDP growth that also partially explains the rise in debt as a share of GDP (note the negative slope displayed in the linear fit). But it is not just reduction in real GDP growth that caused the net debt to rise during the pandemic. As shown in the equation below, change in debt to GDP ratio (vertical axis in Figure 1) increases for at least two reasons. First, if GDP growth (g) is positive, debt to GDP ratio increases so long as new debt increases more than the current debt stock (both as a share of GDP). As indicated in Figure 1, there are several African countries that experienced higher debt burden due to additional borrowings during the COVID-19 pandemic to withstand the fiscal damage it caused. The other reason for debt to GDP ratio to rise is if GDP growth is negative, but new debt accumulation is less than the total debt stock. This is also true for many countries.

$$\Delta \left[\frac{Debt}{GDP} \right] = g \left[\frac{\Delta Debt}{\Delta GDP} - \frac{Debt}{GDP} \right]$$

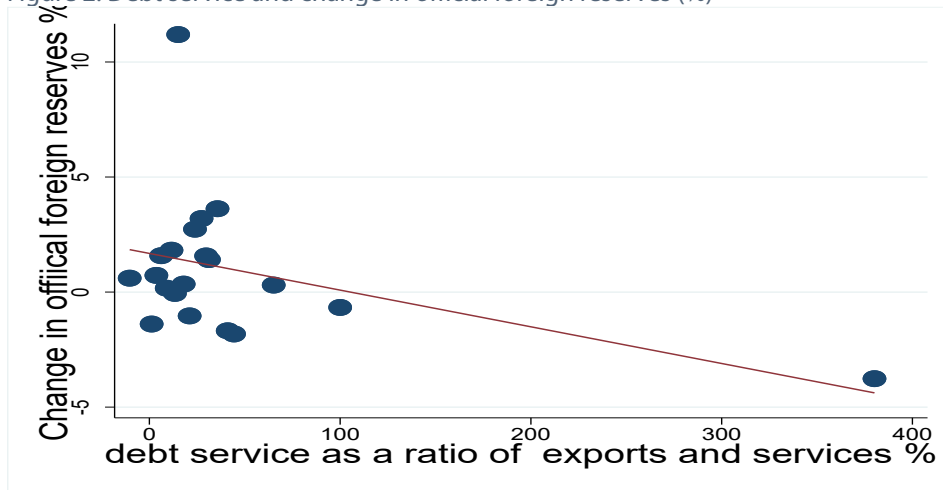
In addition, more than ten African countries experienced increase in net debt to GDP ratio, of more than ten percentage points, at the height of the pandemic.

Figure 1: Government net debt and real GDP growth in Africa during the COVID-19 pandemic (2020)



As debt accumulated, debt service on external debt also increased by US\$3 billion or from 17% in 2019 to 26% in 2021 of total exports of merchandise and services. The cost of debt burden is clear on its impact on fiscal sustainability, macroeconomic stability, and overall progress on key development indicators.⁶ Figure 2 presents the effect of debt service on foreign exchange reserves, suggesting the impact of debt service on balance of payment positions. Rise in the burden of debt-servicing led many African countries to face liquidity crunch in their external sector as reserves continued to dwindle because of high debt servicing burden.

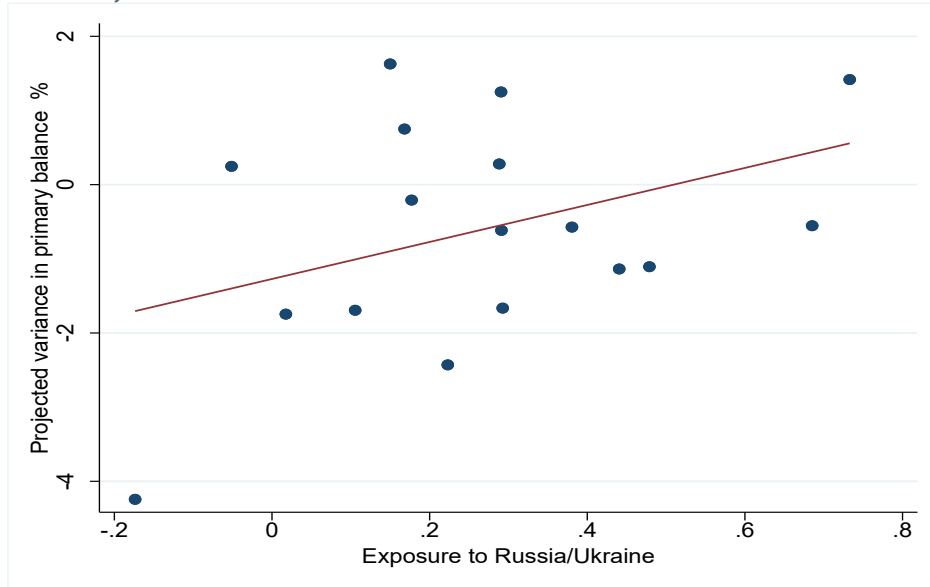
Figure 2: Debt service and change in official foreign reserves (%)



On the heels of the COVID-19 pandemic, the war in Ukraine sent shockwaves to the global economy. Several African countries depended on Russia and Ukraine to import

strategic commodities, such as fertilizers, wheat, edible oil, iron ore, and petroleum. The impacts of the war in Ukraine are evident as shown in Figure 3. The war led to a spike in the prices of strategic commodities, such as fertilizers, wheat, fuel, and edible oil, and pushing in the process millions into poverty and malnourishment (e.g., Sokhanvar & Lee, 2023; Channing et al., 2023; Kibrom et al., 2023). As a result of falling real GDP, rising inflation and worsening current account balance led to a sharp deficit in public finance or increase in external debt (Figure 3).

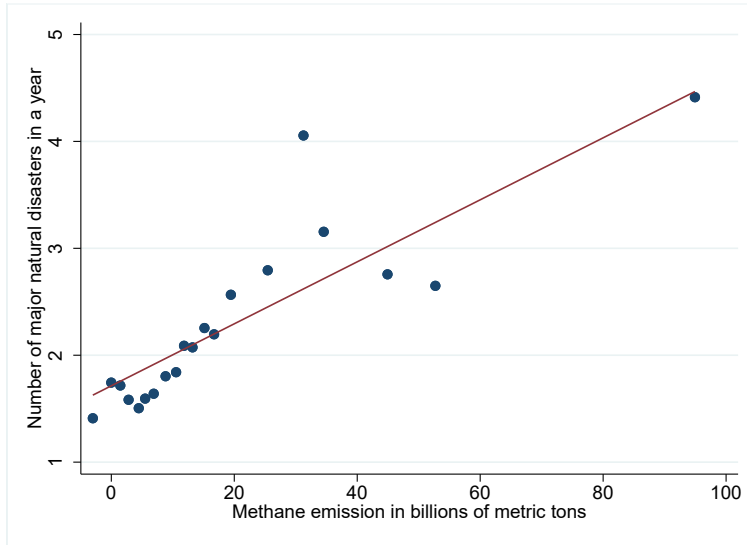
Figure 3: Change in government primary balance and exposure to Russia/Ukraine by African countries



Source: Authors' computations based on data from WEO and an index of exposure to Russia and Ukraine economies. The vertical axis represents variance of forecasts by IMF between October 2021 (before the war) and October 2022 (after the war).

In addition to the major global shocks experienced in the past three years, African countries have also had to deal with the impacts of climate change-related risks. In the last five decades, annual temperature in Africa has been rising at a rate of approximately 0.03 degree centigrade per year. This is largely because of greenhouse effects, where nearly 40% of the variation in the average change in temperature between countries was explained by CO₂ methane emissions. As shown in Figure 4, the frequency of major natural disasters was strongly correlated with CO₂ methane emissions, further suggesting the link between extreme weather and climate change.

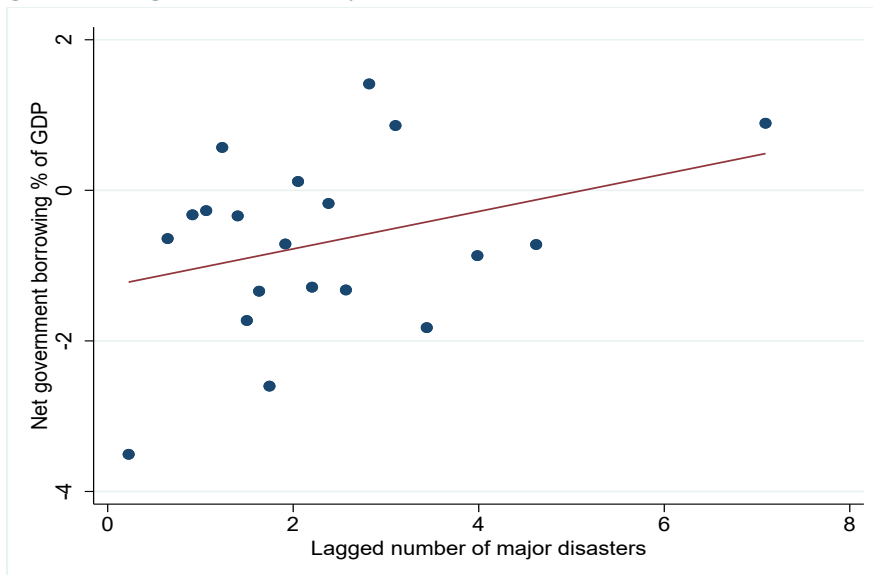
Figure 4: CO₂ emissions and frequency of annual major natural disasters in Africa



Note: Binscatter diagram that controls for effects of trends.

Major natural disasters, which are occurring in increasing frequency, affected fiscal balance of many African governments as they needed to deal with the damages caused and undertake recovery and reconstruction efforts. As shown in Figure 5, current major natural disaster would put a country into high debt situation the next year. Such strong correlation indicates the direct relationships between climate change-induced major natural disasters and fiscal sustainability across African countries.

Figure 5: Change in debt and major natural disasters in Africa



Note: Binscatter diagram that controls for fiscal capacity of governments, institutions, and level of development.

In summary, the contraction in real GDP due to COVID-19 pandemic, and deterioration of government budget balance, punctuated by worsening current account balance, created the perfect conditions for debt to accumulate and morph into a situation of debt distress or debt crisis in Africa in the wake of the COVID-19 pandemic. Inflation has also inched up in many countries, threatening any further borrowing options from domestic sources to meet the financing needs. For many countries in Africa, the most serious problem was the shrinking liquidity position as the debt-service to exports and debt-service to revenue ratios increased substantially, and in some cases beyond the minimum threshold to carry debt. Recognizing this dilemma, the IMF and World Bank urged G20 countries for a Debt Service Suspension Initiative (DSSI) and the Common Framework for the Treatment of Debt to temporarily halt debt servicing through debt reprofiling and restructuring. Recently, the IMF announced the debt reprofiling, restructuring and other measures of relief to 45 African countries to the tune of close to US\$33 billion to assist the recovery process from the COVID-19 pandemic.⁷ However, the appetite for the debt treatment is generally very low (as discussion in Section 3 shows) except by those desperately in need.

In a further bold step to stimulate the global economy, the IMF launched 400 billion SDR for member countries. While a welcome gesture from the leading financial institution in the world, compared with what the pandemic has done to the economies of Africa and the slow recovery from the ripple effects, and growing vulnerability to other global shocks, such a resource is a drop in a bucket. We argue that the financing needs for Africa are enormous and traditional sources of finance are inadequate to close the gaps. In addition, the imperative to transit to a just and sustainable energy transition would require at least US\$200 billion annually until 2030 and almost the same amount to achieve the Sustainable Development Goals.⁸ In terms of current GDP and investment, the overall required additional resource is around 13% and 63%, respectively.

Table 1: Correlations between investment, real GDP growth, and net debt in Africa: 1990-2022

Dependent variable: Investment as a share of GDP	
Real GDP growth	0.35***
	(10.54)
Tax to GDP ratio (residual)	0.09*
	(2.11)
Change in debt to GDP ratio (residual)	0.05**
	(2.78)
Number of observations	1089
Number of countries	49
R-square	0.14

Notes: Results from fixed panel data regression controlling for unobserved time-variant and time-invariant factors. The tax-GDP and net debt-GDP ratios were purged of the influence of real GDP growth.

t statistics in parentheses, * p<0.05, ** p<0.01, *** p<0.001

Noting that investment grows slowly with respect to real GDP growth, government revenue and debt in Africa, it will be very difficult to mobilize the required resources from the domestic economy. As shown in Table 1, critical drivers of investment such as real GDP growth, domestic resource mobilization, and debt are positively associated with investment. But the relative magnitudes tend to be small. For example, a 1% increase in real GDP growth, government tax revenue and debt combined could increase investment by about 0.6 percentage points. To meet the required resources for just energy transition and attainment of SDGs, investment will have to increase from around 24% (average for Africa in 2022) to 37%. In the business-as-usual scenario, it will be very difficult for Africa to mobilize this vast resource.⁹ However, this is a historic moment for Africa to resolve its development finance needs through bold domestic reforms and uniquely novel international cooperations. The combined efforts could allow Africa to close the financing gap easily. Section 3 discusses the role of reforming the global financial arrangements with a focus on relaxing the crushing liquidity constraints that most African countries face in the balance sheets of their economy. Nearly all countries need sufficient foreign exchange reserves to keep the economy humming and growing. On the other hand, effective domestic reforms allow economic fundamentals to improve so that growth accelerates through investment leveraged by public resources (taxes and debt). For example, if all external debt were used for productive investments, it would be sufficient to meet the additional resources required to implement just energy transition and SDGs. These issues are addressed in Section 4.

3. Improving existing SDR arrangements for Africa and beyond

The role of SDR in development finance has been a subject of a long-drawn debate in the last several decades.¹⁰ As is well known, SDRs are not debt instruments but foreign reserve assets that were created in 1969 to facilitate international payment systems, basically to ease the pressure on US dollar as the universal currency of exchange, after the end of the Gold Standard. Soon after started conversation and debate to channel SDR allocations for purposes of development,¹¹ but to this date academics and leaders are yet to figure out the best vehicle to channel the SDR allocations. Irrespective of the mechanism, this section argues that the global economic order has reached a significant historic moment where major global shocks, technologies, warming climate, and geopolitical alignments demand a rethink and reimagination on the role of SDRs, particularly with respect to developing countries.

There is now a broad array of channels and proposals for channels from which African and other developing countries can directly or indirectly access SDR issuances. What is needed most, particularly in the African context, are SDR arrangements that do little to increase the debt burden for African sovereigns, are low risk for creditors, are eligible for all nations that need access, and grant policy autonomy to African nations to manage their own balance sheets and pursue their own development strategies. This section of the paper evaluates the array of SDR arrangements through these criteria and suggests reforms that will make the SDR system work better.

As indicated earlier in the paper, many developing countries (and those in Africa in particular) have suffered from major external shocks over the past five years in the form of COVID-19, the war in Ukraine, climate shocks, inflation, and interest rate hikes. These shocks have triggered significant capital outflows, the depreciation of exchange rates, and the ballooning of external debt levels. Africa now spends more on servicing debt than on health and education-Nigeria spends over 90% of tax revenue on debt service, Kenya 65% (United Nations Global Crisis Response Group, 2023). Not only are debt levels and servicing at alarming highs, but the cost of capital for rollovers and new financing is out of reach for responsible fiscal policy-making in the region.

African countries have been reluctant to engage with the many of the arrangements available to them. Only the countries in the direst circumstances have chosen to resort to the G20's Debt Service Suspension Initiative (DSSI) or the Common Framework for Debt Treatment Beyond the DSSI (Common Framework). Private creditors, the

largest and most expensive source of credit for the region, refused to participate in the programme. Moreover, credit rating agencies downgraded those countries that did participate. The Common Framework has also been plagued by gridlock among different creditor classes, and for those countries that do complete restructurings under the programme the level of debt reduction is not adequate to mount an inclusive and green recovery (Ramos et al., 2023).

Most African countries, except those in the direst circumstances, have also been reluctant to apply for the International Monetary Fund's (IMF) Standby Arrangement and Standby Credit Facility, but have gone for the smaller and less onerous option. The Standby arrangements are accompanied with significant fiscal consolidation programmes, which the IMF and scholars alike have shown slow economic growth and worsen creditworthiness (IMF, 2023a; Steinwald & Stone, 2008; Dreher et al., 2006). In addition, IMF Standby Arrangements are strongly associated with increases in poverty, inequality and worsening health outcomes in Africa (Stubbs et al., 2021; Ray et al., 2022; Stubbs et al., 2017).

As noted across this paper, in view of these external shocks, and the limits of available alternatives, the IMF moved to issue US\$650 billion in Special Drawing Rights under the 12th Basic Period. Under different Basic Periods, the IMF is tasked with assessing the extent to which 'Unexpected Major Developments' have occurred that warrant an SDR allocation. SDR allocations flow to countries relative to the level of quota shares held in the IMF, thus African countries only received roughly US\$33 billion in SDRs. The SDR allocation has been very useful for African countries (Cashman et al., 2022; IMF 2023b)¹². Because the allocation of SDRs was skewed towards more advanced economies that will not make use of them, the G7 and G20 have pledged to 'rechannel' SDRs to countries most in need. As of July of 2023, only 25% of those pledges had been forthcoming (ONE Campaign, 2023). The IMF stipulates that countries pay interest when SDRs are used for on-lending or for direct liquidity purposes until the level of a country's allocations are equal to their holdings (Paduano, 2022). Several arrangements have been designed or proposed for rechanneling SDRs. Table 2 presents those arrangements alongside some of the benefits and challenges of each option.

Table 2: Benefits and challenges of various SDR arrangements

Benefits and Challenges of Various SDR Arrangements		
<u>SDR Arrangement</u>	<u>Benefits</u>	<u>Challenges</u>
<u>New Allocations</u>	New Liquid Reserve Assets No increase in debt burden for sovereigns Full policy autonomy	Political will of advanced economies Skewed distribution of allocation
<u>Bi-lateral re-channeling</u>	New official debt Medium policy autonomy	Moderate increase in debt burden Risk for creditors
<u>IMF Arrangements</u>		
<u>RST</u>	New official debt Low risk for creditors	Moderate increase in debt burden Limited eligibility Cost of debt to borrowers Lack of scale Low policy autonomy for borrowers
<u>PRGT</u>	New official debt Low risk for creditors	(low) increase in debt burden Limited eligibility Low policy autonomy for borrowers
<u>MDB Arrangements</u>		
<u>Hybrid capital</u>	New official 'development' debt Low risk for creditors Strong policy autonomy	Political will of SDR-surplus states Moderate increase in debt burden
<u>SDR-Bonds</u>	New official 'development' debt Low risk for creditors Strong policy autonomy	Political will of SDR-surplus states Moderate increase in debt burden
<u>Private Arrangements</u>		
<u>LCF</u>	Improved liquidity of sovereigns Strong policy autonomy	Moderate increase in debt burden Limited eligibility Pro-cyclicality
<u>GMT</u>	New debt for private borrowers Project finance for global projects	Political will of SDR-surplus states Earmarked only for climate mitigation Potential risk to creditors

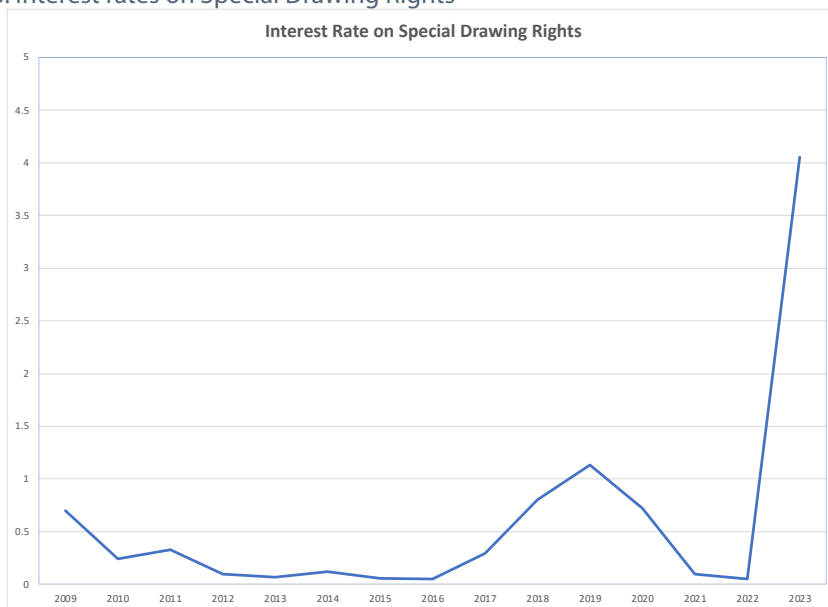
Source: Authors' compilation.

Table 2 outlines the different types of SDR arrangements alongside some of the benefits and challenges that they bring, with the first column indicating the SDR arrangements, followed by columns on the benefits and challenges of each. The first and perhaps the most useful and effective arrangement are new allocations of SDRs. New allocations are debt-free forms of new liquid reserve assets that can be used in the various ways outlined elsewhere in this paper, and they are not attached to fiscal consolidation conditions and grant full policy autonomy. While they do carry the SDR interest rate, countries reserve a certain portion of their allocated SDRs for making interest payments, and thus effectively do not incur an increase in debt obligations. Though skewed towards countries that will not make effective use of SDRs, African countries have made very good use of the allocation they did receive (Cashman et al., 2022; IMF, 2023b). Although calls for new allocations have been loud and widespread, especially from Barbados Prime Minister Mia Mottley and the Bridgetown Initiative,

the major shareholders at the IMF thus far lack the political will to recognize the compound crises and the need for massive resource mobilization as ‘unexpected major developments’ to warrant further allocation.

All the other options available to developing countries increase the debt burden, pose risks to creditor countries, and reduce a country’s policy autonomy to some degree. Bilateral rechanneling of SDRs is another option, which has been exercised for Ukraine, Pakistan, and Egypt (IMF, 2022; Plant, 2022; Central Banking, 2021). This is a promising possibility for some countries and may not necessitate onerous conditionalities. However, this arrangement is in the form of new debt with the interest rate largely determined by the level of the SDR interest rate that the on-lending/rechanneling country would need to recoup. As can be seen in Figure 6, the SDR rates were negligible from the SDR allocation in 2009 through 2022 but have shot up in 2023. The SDR interest rate is a function of the 30-month yields on the sovereign bonds of the US, UK, Japan, China, and Eurozone. As interest rates in those countries have risen, the SDR interest rate has followed (IMF, 2023c). There is some risk for the on-lending creditor countries, as there is no institutional third party to absorb the risk of default by borrowing countries.

Figure 6: Interest rates on Special Drawing Rights



Source: IMF (2023c).

The International Monetary Fund now has two arrangements that can absorb SDRs from on-lending countries and preserve the reserve asset status of SDRs, the Poverty Reduction and Growth Trust (PRGT), and the Resilience and Sustainability Facility (RSF). The PRGT increases the debt burden of a participating country, but because of its subsidy account it can offer no or very low interest rates and thus has the potential to be the least burdensome among all the rechanneling options (Andrews et al., 2021). As the SDRs are housed at the IMF, the IMF offers more of a degree of

risk protection to the on-lending country as well. However, only a limited number of countries can access the PRGT—only the poorest countries but not always the most vulnerable to external shocks—and the PRGT needs to have increasing amounts of hard currency to provide the subsidy. Finally, PRGT programmes are linked to IMF Standby arrangements that reduce policy autonomy and can accentuate growth, stability, and human development trajectories.

The other arrangement currently housed at the IMF is the newly created Resilience and Sustainability Trust (RST). The RST was created with on-lended SDRs in 2022 and offers a 'top-off' to a member state's existing IMF programme if the member undertakes policies to enhance the resilience of the nation's economy to external shocks such as climate change and pandemics. The RST has a tiered interest rate system linked to the SDR interest rate and is low-risk for on-lenders. Middle-income countries pay a slight premium to cap the interest rate on poorer countries (IMF, 2023d). The programme has limited eligibility because it requires that a country have an upper tranche programme with the IMF, which is associated with significant reductions in policy autonomy and fiscal consolidation (Bhandary & Uy, 2023).

Two proposals have been directed towards deploying SDRs to expand the balance sheets of Multilateral Development Banks (MDBs). The most advanced proposal is from the African Development Bank (AfDB). The AfDB proposal is for countries to on-lend SDRs into the AfDB's Hybrid Capital Instrument (HCI). The HCI will keep the SDRs in an account at the IMF effectively as equity—therefore preserving their reserve asset status and leverage that equity to expand the balance sheet of the AfDB and subsequently on-lend. The IMF has weighed in (though has no jurisdiction on the final decision) to say that the AfDB's proposal preserves the reserve asset status of SDRs and would not be of significant risk to on-lenders or the AfDB (Plant, 2023a; 2023b). A similar instrument has been proposed by Paduano and Setser (2023), where they call for an SDR-denominated bond at the World Bank that would be rolled over into perpetuity—thus preserve the reserve asset qualities of SDRs, serve as a hybrid version of equity, and allow the World Bank to issue bonds and expand their balance sheet. One of the additional benefits of this scheme is that countries that have thus far been reluctant to on-lend their SDRs could participate by purchasing the bonds. The challenges that remain are the political will of SDR holders, and of course the interest rates that may be associated with the debt that incurs (Development Reimagined, 2023).

There are also two entities, one in effect and one proposed, that would be classified as private arrangements to rechannel SDRs. First is the Liquidity and Sustainability Facility (LSF) originating from the United Nations Economic Commission for Africa (UNECA). The aim of the LSF is to improve the liquidity and cost of capital for African sovereigns through the establishment of repo markets in Africa that are subsidized by on-lended SDRs and from donations from MDBs. The LSF takes African Eurobonds as collateral to provide short-term financing, taking a discount subject to the value of the collateral. UNECA spun the LSF off in 2022 and the programme has begun operating. While the LSF has real promise, it is yet to get fully off the ground, and it is not clear if any SDRs are part of the LSF. Some have expressed concerns that the eligibility will be

small when African countries are in debt distress (and need financing most), and that on top of its pro-cyclical nature, that in good times premiums may only be lowered very modestly (Gabor, 2021; S&P Global, 2021).

Finally, Avinash Persaud, climate advisor for the Government of Barbados and co-architect of the Bridgetown Initiative has proposed a 'Global Mitigation Trust (GMT), where US\$500 billion in SDRs would be held. The GMT would then on-lend directly to private projects in the private sector of low- and middle-income countries. The GMT would vet projects based on their level of technology and social and environmental standards. The benefit of such an arrangement would be that it does not accrue new debt obligations for sovereign states (unless the projects falter and need to be absorbed by the state) and would help develop the private sector. The architects estimate that the trust could trigger up to US\$5 trillion in private financing (Chan, 2022). In terms of challenges, it is not yet clear where the Trust would be housed and thus could pose some risk to those countries that on-lend. Secondly, as currently proposed, the GMT will be eligible to a smaller number of countries given that financing will only be available for climate mitigation. There are only a few countries in Africa where mitigation is a high priority, but rather climate adaptation is the most macro-critical.

This section of the paper has outlined and evaluated the existing channels for obtaining SDRs in Africa and other developing regions. Based on this analysis, the following policy actions could be made to make SDRs more effective in the global economy:

1. **Make new allocations of SDRs:** Current conditions could be classified as 'unexpected major developments' even more so than the conditions that Africa and other developing regions were experiencing in 2021. This analysis shows that new SDR allocations bring new and liquid reserve assets without increasing the debt burden of a country and grant a country the highest degree of policy autonomy.
2. **Provide built-in incentives for rechanneling SDRs:** During this wave of crises, developing countries have had to rely on (sometimes unfulfilled) pledges of rechannelled SDRs. SDR allocations should have built-in rechanneling mechanisms so stakeholders can deliberate about where and how, not whether, SDRs can be re-channelled based on global circumstances.
3. **Reform the SDR interest rate policy:** The current interest rate structure provides disincentives to deploy SDRs. Paduano (2022) proposes that the SDR rate be brought to zero while increasing the floor rate and levies where appropriate and moving towards a single SDR holding rate.
4. **Channel SDRs to MDBs through hybrid capital arrangements:** The African Development Bank (AfDB) proposal is a strong model for maintaining the reserve asset qualities of SDRs while expanding the balance sheets of MDBs so they can provide more development finance to countries in need. SDR-backed bond issuances should also be considered.

5. **Reform IMF instruments and policy:** IMF programmes that can utilize SDRs such as the PRGT and the RST need strong subsidy accounts to bring down the cost of these instruments and broaden the eligibility requirements. Most importantly, conditioning access on fiscal consolidation programmes and rather requiring investment-led recoveries would make these programmes more attractive, achieve better growth and stability outcomes, and improve creditworthiness (Karas & Rivard, 2022).
6. **Flexibility in SDR use:** African countries could be granted more flexibility in how they use their allocated SDRs. For example, they could be allowed to use SDRs to finance development projects, invest in infrastructure, or address social needs, in addition to supporting macroeconomic stability. This may extend to leveraging SDRs for inclusive finance where private entities such as SMEs are poised to benefit from SDR-backed hybrid capital arrangements.

Special Drawing Rights is a welcome component of the international financial architecture that has proven to play an important role in mitigating external shocks. This section of the paper evaluates how SDRs can play an even stronger role to such ends, and an expanded role of forming the basis for expanding development finance so that countries become more resilient to shocks in the first place.

It must be acknowledged, however, that the evolving liquidity challenges of African countries could not be addressed adequately through the SDR allocation, considering the looming climate crisis and the need to accelerate the implementation of the SDGs, both of which imply development financing on concessional basis and at scale. Various estimates indicate that the total resources needed to transit to a low carbon economy, build resilience against major climatic disasters, and invest in critical sectors to advance Africa's progress towards the SDGs, could come to trillions annually. The IMF's RST facility estimated at US\$40 billion does not come close to what is needed to address the liquidity challenges many African countries are currently facing. A comprehensive reform of the global financial architecture is needed to achieve fiscal sustainability among African countries and resolve debt burden and debt traps permanently. As is well known, reforming the global financial architecture has been a topic of discussion among policy makers, economists, and international organizations for many years, especially following major financial crises. Key proposals to reform the global financial architecture include:

- **Strengthening International Financial Institutions (IFIs):** Many proposals focus on enhancing the role and effectiveness of IFIs such as the International Monetary Fund (IMF), World Bank, and regional development banks. This may involve increasing their financial resources, improving governance structures to better represent developing countries, and enhancing their surveillance and lending frameworks.
- **Enhancing Financial Regulation and Supervision:** Reform efforts often include measures to strengthen financial regulation and supervision to prevent excessive risk-taking, enhance transparency and mitigate systemic risks.

This may involve implementing stricter capital requirements, improving risk management practices, and enhancing oversight of financial institutions, including cross-border activities.

- **Promoting Financial Inclusion:** Addressing financial exclusion and promoting access to financial services for all segments of society, including underserved populations and small businesses, is a key aspect of global financial architecture reform. This may involve promoting innovative financial technologies (FinTech), improving financial literacy and supporting the development of inclusive financial systems.
- **Addressing Sovereign Debt Issues:** Reform proposals aimed to address challenges related to sovereign debt sustainability, debt restructuring mechanisms, and debt transparency. This includes exploring options for orderly debt workouts, promoting responsible lending and borrowing practices, and enhancing debt transparency and data reporting.
- **Managing Capital Flows:** Given the potential risks associated with volatile capital flows, especially in emerging markets and developing countries, reform proposals may focus on enhancing mechanisms to manage and regulate cross-border capital flows. This could involve measures such as capital controls, macroprudential policies, and international cooperation to address spillover effects.
- **Strengthening Financial Safety Nets:** Reform efforts often include proposals to enhance global and regional financial safety nets to provide liquidity and support to countries facing financial crises. This may involve expanding the role of the IMF, improving regional financial arrangements, and exploring new mechanisms for crisis prevention and resolution.
- **Addressing Global Economic Imbalances:** Efforts to reform the global financial architecture often aim to address underlying structural imbalances in the global economy, including trade imbalances, currency issues, and asymmetries in economic development. This may involve coordinated policy actions to promote sustainable and balanced growth, enhance international cooperation on economic policies, and address issues related to exchange rates and reserve currencies.

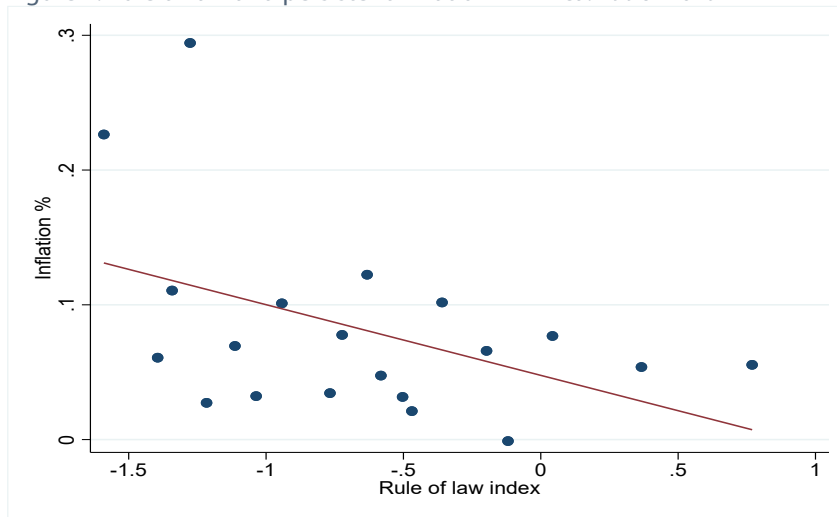
Overall, reforming the global financial architecture requires coordinated efforts at the international level, involving governments, central banks, international organizations, and other stakeholders. These efforts aim to strengthen the resilience, stability, and inclusiveness of the global financial system, while promoting sustainable and balanced economic growth.

4. Domestic reforms

Previous studies on the political economy of foreign aid and debt have brought out important lessons for shaping the global architecture of development finance.¹³ The first is that countries that have 'good policy' tend to utilize aid better. The state of public finance in most African countries is besieged by weak institutional capacity and poor governance that generally impede efficient utilization of public resources. Second, fiscal capacity and development reinforce each other; the stronger the capacity of the state, the greater the chance for a country to sustain development. Third, international partnerships yield better results when transparency and accountability are embedded in the relationships. With these sets of premises, this section briefly presents some stylized facts on the link between public finance, good governance, and macroeconomic stability in Africa that could be helpful in creating conditions for fiscal sustainability and mobilizing resources to finance development aspirations. It is in this virtuous institutional context that the effective use of SDRs can be truly envisaged.

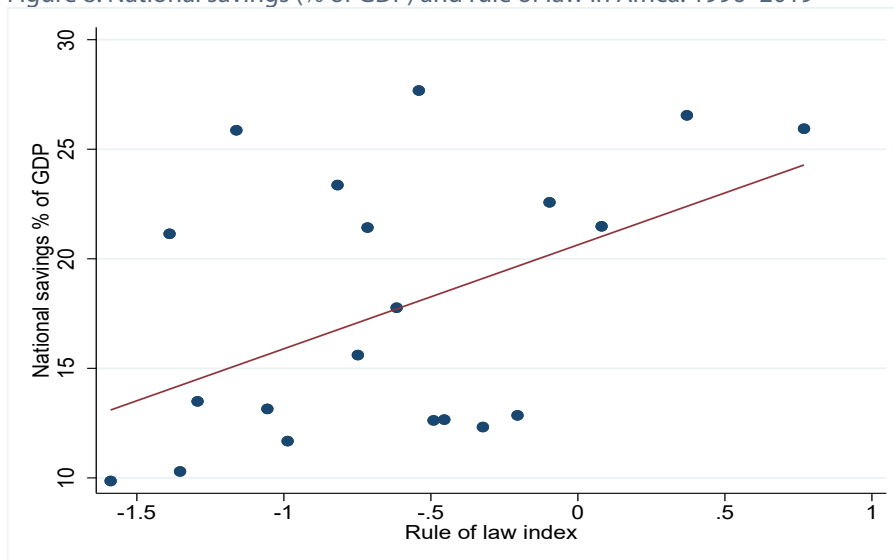
Important indicators, such as inflation, attest to the ability and capacity of governments in overseeing effective economic management. Repressed markets and excessive or undisciplined fiscal stance tend to lead to inflation regimes that are persistent. Chronic governance deficits, including lack of accountability, are primary causes of severe or persistent macroeconomic instability. Figure 7 presents the association between long-term inflation (average of 1996-2021) and rule of law index (average of 1996-2019) for African countries controlling for such factors as differences in the level of development (proxied by GDP). Countries that exhibited higher score on the rule of law index¹⁴ tended to have historically low inflation rates and vice versa. The relationship with macroeconomic stability and governance extends as well to other indicators such as balance of payments deficit, etc.

Figure 7: Rule of law and persistent inflation in Africa: 1996–2019



In addition to macroeconomic stability, institutional strength is useful for domestic resource mobilizations. As shown in Figure 8, long-term savings tend to be much higher in countries where rule of law prevails consistently over a long period of time irrespective of differences in the level of GDP, further establishing the need for African governments to work towards an effective system of political and economic governance to benefit from the opportunities afforded in the global arena to finance development aspirations.

Figure 8: National savings (% of GDP) and rule of law in Africa: 1996–2019



Note: Figure controls for differences in GDP levels.

Reforms to improve political and economic governance also pay off in reducing the cost of borrowing as global rating agencies incorporate these features in their analysis of a country's risk ratings.

5. Conclusions

The paper noted that African countries have suffered greatly from the multiple, overlapping and recurring global shocks in recent years aggravating stability of already fragile macroeconomic conditions. Most countries currently face severe liquidity constraints with external debt services reaching a historic high level, endangering solvency of sovereigns. Against this background, African countries have also pledged to join the global effort to fight climate change by transitioning gradually to low carbon energy sources, while striving to achieve the Sustainable Development Goals, the progress of which has stalled or reversed in recent years. The additional resources required to achieve these objectives are estimated at around US\$400 billion annually, or around 13% of current GDP which are difficult to mobilize in conditions of severe debt distress and macroeconomic fragilities.

The paper further notes that the established debt resolution mechanisms are inadequate to deal with the current financing needs of African countries for various reasons. First, the profile of the creditors has changed so much that the established debt resolution platforms, such as the Paris Club, are inadequate and obsolete to implement the principles of comparability of debt treatments (e.g., Diwan et al., 2023), further fuelling the liquidity crisis countries are facing. Second, the widely used Debt Sustainability Analysis frameworks, which establish benchmarks for debt resolution, tend to focus on a country's ability to repay its debt, rather than its financing needs for realizing its development potential. Relatedly, the third reason is that the high interest rate many African countries pay on debt borrowed from non-concessional sources have been a sticking point in the whole debt resolution discussion. For example, as discussed in the paper, many African countries are reluctant to sign for the Comprehensive Debt Framework partly because this could signal a desire to default, thereby diminishing their access to the financial market. On the other hand, borrowing costs for several African countries have increased significantly in recent years, further raising the interest rate on, for example, Eurobonds. This dilemma, seen from the broader perspective of debt sustainability, is costing African countries precious time and resources. There is already widespread belief that there is an "African bias or premium" imposed by rating agencies when they assess the credit risk of African countries (The Economist, 2023). Such belief is so profound, the call for an African Credit Rating Agency is louder than ever (e.g., Kotecha, 2022). Recent studies, however, showed that once economic structure (including the size of informality) and

quality of institutions, such as rule of law, are considered, the claim of an African bias by credit rating agencies does not seem to be valid (Gbohoui et al., 2023). Regardless, African countries for certain do not have fundamental solvency problems, rather temporary liquidity problems, mainly on their external debt that needs sustainable and just solutions such as from the SDR reallocations.

The paper outlines practical and innovative solutions to leverage the SDR facilities to address the critical liquidity challenges African countries face considering the fundamental principles governing the creation of the SDRs. In this regard, the paper suggests five critical areas of policy actions: (i) Make new allocations of SDRs; (ii) Provide built-in incentives for rechannelling SDRs; (iii) Reform the SDR interest rate policy; (iv) Channel SDRs to MDBs through hybrid capital arrangements; and (v) Reform IMF instruments and policy. The liquidity challenges that African countries face today cannot be addressed adequately by reforming the SDR allocations alone. It calls for a comprehensive reform of the international financial architecture that considers the emerging and looming climate crisis the continent faces, while recognizing the immense potential it has in carbon sequestration. Access to concessional funding at scale needs to come forth to accelerate Africa's progress towards the SDGs.

Notes

- 1 About US\$650 billion.
- 2 Herman (2020), <https://www.tandfonline.com/doi/pdf/10.1080/05775132.2020.1802178?needAccess=true>
- 3 Gallagher et al. (2020).
- 4 It is feasible that some African countries (such as Nigeria, Senegal, Tanzania, and others) may gain from the war as Europe attempts to diversify its source of energy and reduce dependency on Russia (see <https://www.brookings.edu/blog/africa-in-focus/2022/02/25/what-does-the-war-in-ukraine-mean-for-africa/>). Overall, however, the impact on domestic prices of petroleum, edible oil, and food is substantial (see https://www.hrw.org/news/2022/04/28/ukraine/russia-war-continues-africa-food-crisis-looms#:~:text=Many%20countries%20in%20East%2C%20West,food%20prices%20in%20the%20region.)).
- 5 <https://www.imf.org/external/pubs/ft/dsa/dsalist.pdf>
- 6 IMF World Economic Outlook (2023).
- 7 See <https://www.imf.org/en/Topics/imf-and-covid19/COVID-Lending-Tracker#AFR>
- 8 AUC/OECD (2023) <https://au.int/en/afdd2023> and Guzmán, S. Dobrovich, G., Balm, A. and Meattle C. (2022) <https://www.climatepolicyinitiative.org/wp-content/uploads/2022/06/Climate-Finance-Needs-of-African-Countries-1.pdf>
- 9 From Table 1, if annual real GDP grows at 10%, tax-GDP ratio and new debt-GDP ratio increase each by ten percentage points, investment will increase by only six percentage points, roughly enough to cover 50% of the additional resources required.
- 10 A comprehensive review of the origin and use of SDR can be found in Fleming (1971). Cameron (1981) discussed the global macroeconomic context that led to the SDR as fiduciary instrument of international reserves. Howe (1972) was among the first to elaborate the need for reforming the rules governing the SDR allocations, including its use by the countries that needed it most, mainly poor and developing countries.

- 11 See also Herman (2020), <https://www.tandfonline.com/doi/pdf/10.1080/05775132.2020.1802178?needAccess=true>
- 12 Recent papers by Hussein et al. (2023) for Ethiopia; Quartey et al. (2023) for Ghana; Omanyo et al. (2023) for Kenya; and Sylla and Diagne (2023) for Senegal demonstrated the role SDRs played in building a lifeline, particularly at the time of liquidity crunches.
- 13 The earliest being Dollar and Collier (1999), [https://papers.ssrn.com/sol3/papers.cfm?abstract_id=629108
- 14 The rule of law index, inflation, and real GDP were taken from World Bank Development Indicators. The higher the values of the rule of law index for a country, the better respect of the rule of law according to international standards.

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