AFRICA'S CAPITAL MARKET APPETITE: CHALLENGES AND OPPORTUNITIES FOR FINANCING RAPID AND SUSTAINED GROWTH

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The Priority

Development financing continues to be a big challenge, but some hope is emerging for African countries. The size of the resources needed to lift countries out of poverty by 2020 or 2030 continues to increase. Some estimates put the resources needed at over $200 billion a year for energy, irrigation, roads and rail; while there are also similar figures required for improvements in health, education and social protection.[1] Countries will need to make progress on all these fronts to reduce poverty and improve the standard of living of their populations. Eleven African countries have grown sustainably at 6 percent or above since 2009. These countries, including Nigeria, Rwanda, Tanzania, Mozambique and Sierra Leone, are now attempting to protect this growth, fast track it and make up for lost time. African countries are looking for ways to accelerate development and meet the expectations of their populations. Financial institutions are making great strides in developing a range of products to match the demands of these countries. Innovation in development financing has the potential to be a determining factor for rapid, sustainable and inclusive growth over the medium term.

Access to capital markets is one recent phenomenon on the African continent that is being facilitated by the Federal Reserve's quantitative easing policy of injecting money into the U.S. economy, and this phenomenon is gaining steam. Between November 2008 and September 2013, the Fed purchased approximately $3.5 trillion in bank debt, mortgage-backed securities and Treasury notes (Evans 2013). As a result, the market was flooded with excess liquidity and unprecedented low interest rates suppressing returns in the U.S. and other developed markets. Investors have turned to emerging and frontier markets for better yields. The response has been strong from sub-Saharan African countries.

[1] This figure is based on the author's own calculations using the World Bank and International Energy Agency estimates.

Why Is It Important?

African countries need to develop stronger capital market access. In the short to medium term, the challenge will be to find new ways of protecting this market access and increasing eligibility to capital markets for sub-Saharan African countries in an economically sustainable way. The international community has an important role to play here. On a continent where access to markets is a novel phenomenon and where it is still difficult to attract investors due to legacy issues of poor macroeconomic management and fiscal discipline as well as persistent corruption and weak institutions, attempts to raise capital from the markets is a laudable goal. The discipline required by the process has no doubt helped countries who have been successful in recognizing the importance of market perceptions and the need for better macro-fiscal discipline.

The number of international bond issuances by sub-Saharan African countries in recent years has accelerated from only three issues in 2006 and 2007 to over six issues so far in 2013, and these issues are set to continue in 2014 (Moody's Analytics 2013). In addition to South Africa, eight countries in the region have tapped the international capital markets in recent years, including first-time issuers Ghana, Gabon, Senegal, Namibia, Nigeria, Tanzania, Zambia and Rwanda. Furthermore, market intelligence suggests that other sub-Saharan African countries may tap international markets in the near future. For instance, Cape Verde is looking to issue its first international bond, while Kenya is looking to issue its inaugural euro bonds in 2014.

As the reality of tapering—a reduction of the Fed's quantitative easing policy—sets in, African countries now face two important questions. Will the tapering squeeze out capital and will the markets be more discerning? Quantitative easing clearly made investors that were previously less interested in Africa take a second look, and some will stay even when tapering occurs. They will stay because investment opportunities exist and on average country macro-fiscal balances remain sound. However, there will most likely be an increase in the average cost of capital for most investors. For example, Nigeria, Rwanda and Mozambique, who all went to market with below-investment grade sovereign ratings, will likely experience higher rates as higher risks are incorporated in the prices. This will be costly. The trade-offs between access to capital and costs will be more important and countries need to manage this transition.

What Should Be Done in 2014

To protect and grow market access, countries will first have to continue to maintain sound macro-fiscal positions. While growth has been robust, in many sub-Saharan countries deficits have been ticking up and, in countries like Zambia, Ghana and Cape Verde, are reaching worrisome levels. Both Zambia and Ghana have recently been downgraded by Fitch from B+ to B due to their high deficit levels. High deficits are also fueling high debts. To improve market and credit agency ratings, countries will need to pay more attention to this.

Second, for countries entering the market, investments financed by international bond issues must help produce correspondingly high economic growth. This is important so that these countries can use the returns on investment over the medium term to pay off the costs associated with the bonds. This is important for debt sustainability.

Structured finance products to help diversify the offerings available to countries will be critical. Recently, Mozambique issued a product that has provided substantial investment capital to a state-owned fishing company to upgrade its capacity. This type of investment-linked offering could be replicated more often. Investors clearly are more willing to take risks on tangibly tested, project-related offers because of the ease with which risks can be assessed and mitigated. The South Africa Eskom issuance is another example of the increasing attractiveness of project and corporate issues. Eskom is well-known and investors are confident that they will have a good investment with such an established entity. The securitization of future revenue flows linked to natural resource exports is an asset class that was used in Latin America in the 1980s, which African countries are also beginning to explore. There are other attractive securities that could be developed without the complexity of sophisticated engineering to meet the needs of countries and corporates on the continent.

A more unified and transparent approach to the process is needed to help facilitate investor and country understanding of the nature and risks of their investments. It is important

that perverse incentives are watched and avoided, such as those that allow countries to raise more resources than they can absorb. The same will be true for credit rating agencies. "Successful" bond issues do not necessarily mean optimal financing for borrowers or returns for investors. Although recent international bond issues by sub-Saharan African countries met strong investor demand, were oversubscribed, and were regarded as highly successful transactions, in-country capacity constraints have led to higher-than-expected carry costs in some cases.

Even as many more countries go to the market, there is a general lack of capital market expertise in many African countries. International capital market access is still relatively new to most sub-Saharan African countries. Local financial markets are underdeveloped and consequently the in-country knowledge and expertise needed to make informed decisions are often weak and lacking. Global investment banks have a role to play. As part of their market penetration strategy, they will need to do more capacity building and client education. In addition to playing the role of solicitor, firms must be more transparent and provide active development training to countries.

International finance institutions like the IMF and other multilateral and regional development banks like the World Bank and African Development Bank have an important role to play. They should increasingly reorient their support toward capital market access. Very few sub-Saharan African countries that have accessed capital markets in the last two years received any support from international finance institutions. As this method of financing becomes more significant, international development agencies will have to play a bigger role in supporting countries' access to markets. In addition, these agencies will have to continue to offer new and more financial products, such as political risk guarantees, that complement this access and increase the attractiveness of the countries' issuances.

At the global level, the Financial Stability Board will have to take into account this emerging trend in Africa and involve more African central banks in the discussions on the new financial regulatory framework. As African countries increasingly access capital markets, they will become more closely linked to world financial systems. Issues of market misconduct, information asymmetry, and anticompetitive behavior will emerge as the continent develops and attracts more investors. Regional institutions will have to work with their global partners to ensure that prudent market regulations are put in place in a timely manner without undermining the development of the sector and markets.

Much more needs to be done to improve access of sub-Saharan African countries to affordable investment grade capital market financing for development. However, the trend is clearly rising and the more African countries that seek global capital, the easier it will be to price the offers, deepen the market, provide the liquidity needed for development and widen the sphere of interest. Tapping these markets is arguably the only certain path to rapid transformative change for the countries on the continent willing and able to live up to the market discipline required to sustainably access capital markets.

References

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