



PHOTO: © WORLD BANK

TRENDS AND DEVELOPMENTS IN AFRICAN FRONTIER BOND MARKETS

AMADOU N.R. SY

Director and Senior Fellow, Africa Growth Initiative
The Brookings Institution

MARCH 2015

THE BROOKINGS INSTITUTION
1775 MASSACHUSETTS AVE., NW
WASHINGTON, DC 20036

ABSTRACT

Before 2006, only South Africa had issued a foreign-currency denominated sovereign bond in sub-Saharan Africa. From 2006 to 2014, at least 14 other countries have issued a total of \$15 billion or more in international sovereign bonds. This sudden surge in borrowing in a region that contains some of the world's poorest countries is due to a variety of factors, including rapid growth and better economic policies in the region, high commodity prices, and low global interest rates. Increased global liquidity as well as investors' diversification needs, at a time when the correlation between many global assets has increased, have also helped increase the attractiveness of the so-called "frontier" markets, include those in sub-Saharan Africa. Whether the rash of borrowing by sub-Saharan governments (as well as a handful of corporate entities in the region) is sustainable over the medium to long term, however, is open to question. The low interest rate environment is set to change at some point—both raising borrowing costs for the countries and reducing investor interest. In addition, oil prices are falling, which makes it harder for oil-producing countries to service or refinance their loans. In the medium term, heady economic growth may not continue if debt proceeds are only mostly used for current spending, and debt is not adequately managed. Accelerating and sustaining the pace of fiscal reform and appropriate debt management policies should be a policy priority. In addition, unconventional measures such as developing a domestic regional bond market should be considered by African policymakers.

Keywords: Sub-Saharan Africa, Debt, Sovereign Bonds, Push and Pull Factors, First-Time Issuers

JEL classification: F3, F34, G24

AUTHOR'S NOTE:

An earlier version of this paper was published in French in the *Revue d'Économie Financière*, No. 116. I would like to thank Bruno Cabrillac for useful comments and suggestions. All errors remain mine. I can be reached at asy@brookings.edu.

INTRODUCTION

Most sub-Saharan African countries have long had to rely on foreign assistance or loans from international financial institutions to supply part of their foreign currency needs and finance part of their domestic investment, given their low levels of domestic saving. But now many of them, for the first time, are able to borrow in international financial markets, selling so-called eurobonds, which are usually denominated in dollars or euros.

The sudden surge in the demand for international sovereign bonds issued by countries in a region that contains some of the world's poorest countries is due to a variety of factors—including rapid growth and better economic policies in the region, high commodity prices, and low global interest rates. Increased global liquidity as well as investors' diversification needs, at a time when the correlation between many global assets has increased, has also helped increase the attractiveness of the so-called "frontier" markets, including those in sub-Saharan Africa.

At the same time, the issuance of international sovereign bonds is part of a number of African countries' strategies to restructure their debt, finance infrastructure investments, and establish sovereign benchmarks to help develop the sub-sovereign and corporate bond market. The development of the domestic sovereign bond market in many countries has also help strengthen the technical capacity of finance ministries and debt management offices to issue international debt.

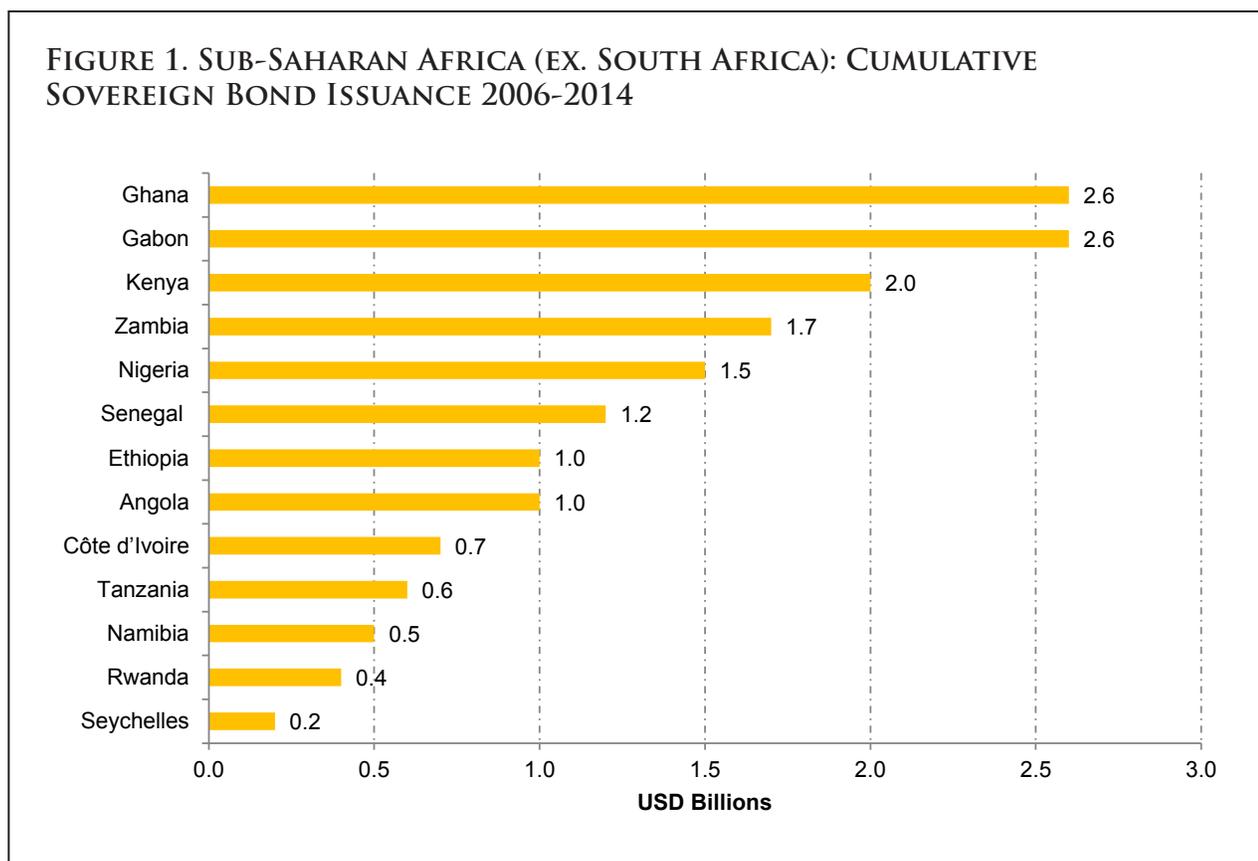
Whether the rash of borrowing by sub-Saharan governments (as well as a handful of corporate entities in the region) is sustainable over the medium to long term, however, is open to question. The low interest rate environment is set to change at some point—both raising borrowing costs for the countries and reducing investor interest. In addition, oil prices are falling, which makes it harder for oil-producing countries to service or refinance their loans. In the medium term, heady economic growth may not continue if debt proceeds are only mostly used for current spending, and debt is not adequately managed.

JOINING THE CROWD

Before 2006, of sub-Saharan African countries, only South Africa had issued a sovereign bond. Since then, countries such as Angola, Côte d'Ivoire, Ghana, Gabon, Kenya, Namibia, Nigeria, Rwanda, Senegal, the Republic of Seychelles, Tanzania, and Zambia have successively raised funds in international debt markets (see Figure 1). From 2006 to 2014, these countries issued a total of \$15 billion, compared to \$10.9 billion for South Africa. Including South Africa, sub-Saharan sovereigns issued more than \$7 billion of foreign-currency denominated bonds as of end-2014. Ghana, in particular, was able to place a \$1 billion bond even before concluding a program with the IMF and in the context of rapidly deteriorating fundamentals. Ethiopia also issued a \$1 billion bond for the first time in December 2014. In several cases, African countries have actually been able to sell bonds at lower interest rates than troubled European economies such as Greece and Portugal.

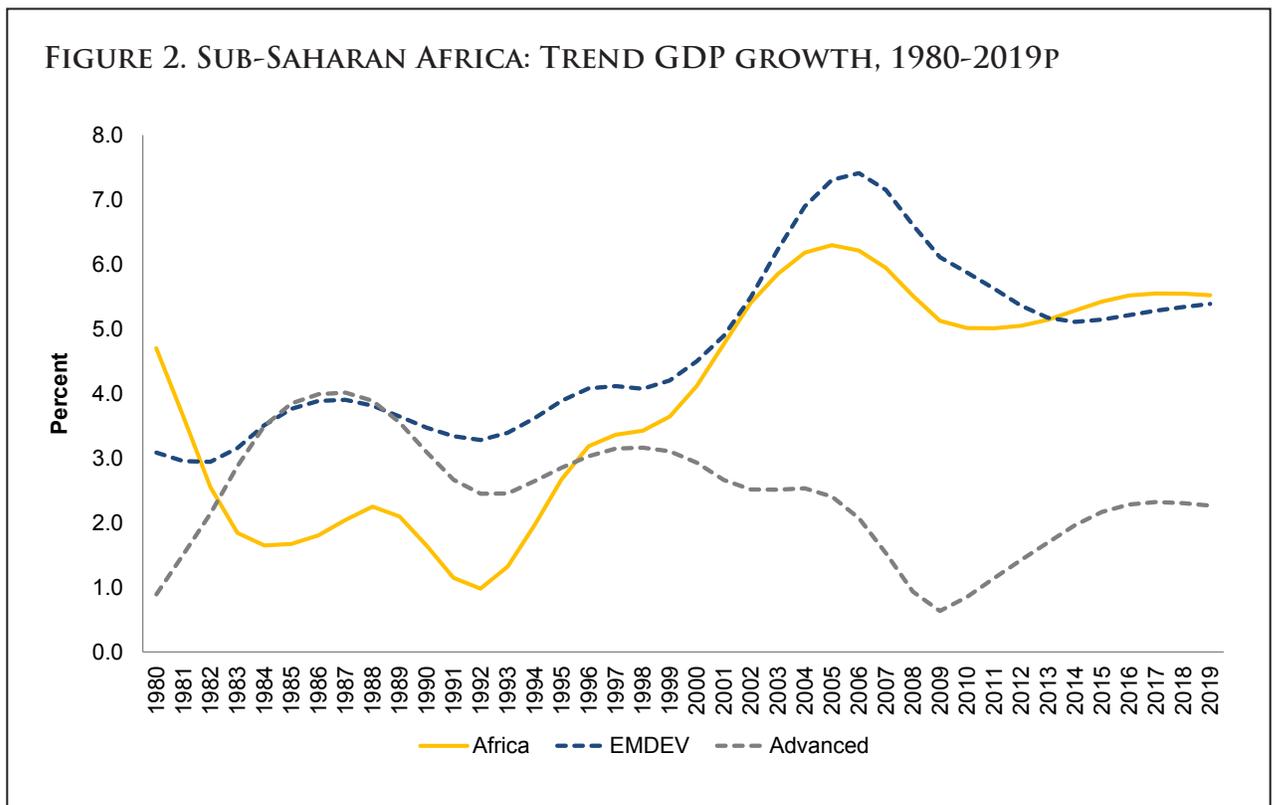
Moreover, a few corporate entities in sub-Saharan Africa have also successfully issued eurobonds, including Guarantee Trust Bank in Nigeria, which sold a 5-year \$500 million bond offering in 2011, and Ghana Telecom, which issued a \$300 million in 5-year bond offering in 2007.

The remarkable appetite for sub-Saharan African credits raises a number of questions regarding short-term and medium-term sustainability of bond flows to the region.



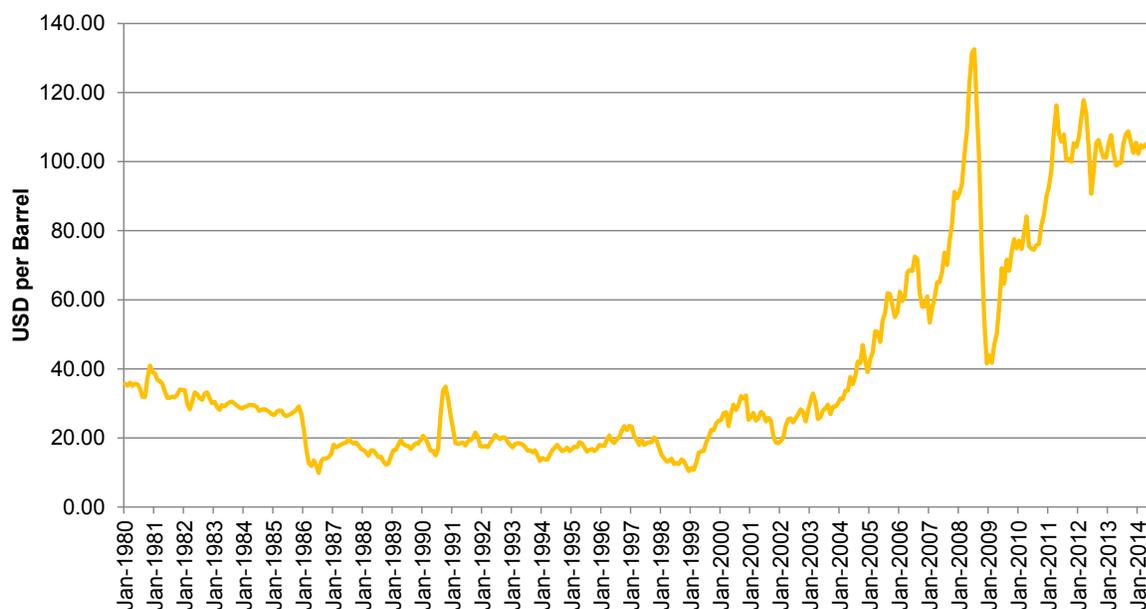
Source: Dealogic.

Africa's recent growth performance relative to developed countries and its resilience to the global crisis have been an important catalyst of foreign investors' focus on the continent (Figure 2). The continent's performance can be attributed to both a favorable global external environment and improved economic and political governance. The so-called commodity "supercycle," in part fueled by China's demand for natural resources, has led to higher export and fiscal revenues for commodity exporters (Figure 3). Low global interest rates have helped reallocate international investment and portfolio flows to the continent. But it is clear that improved economic governance, increased investment and positive total factor productivity (for the first time since the early 1970s), and better political institutions have also played a role in the continent's recent economic performance (Rodrik, 2014).



Source: IMF WEO, April 2014 and HP filter used for the trend component.

FIGURE 3. CRUDE OIL PRICE (2005 =100)



Source: IMF.

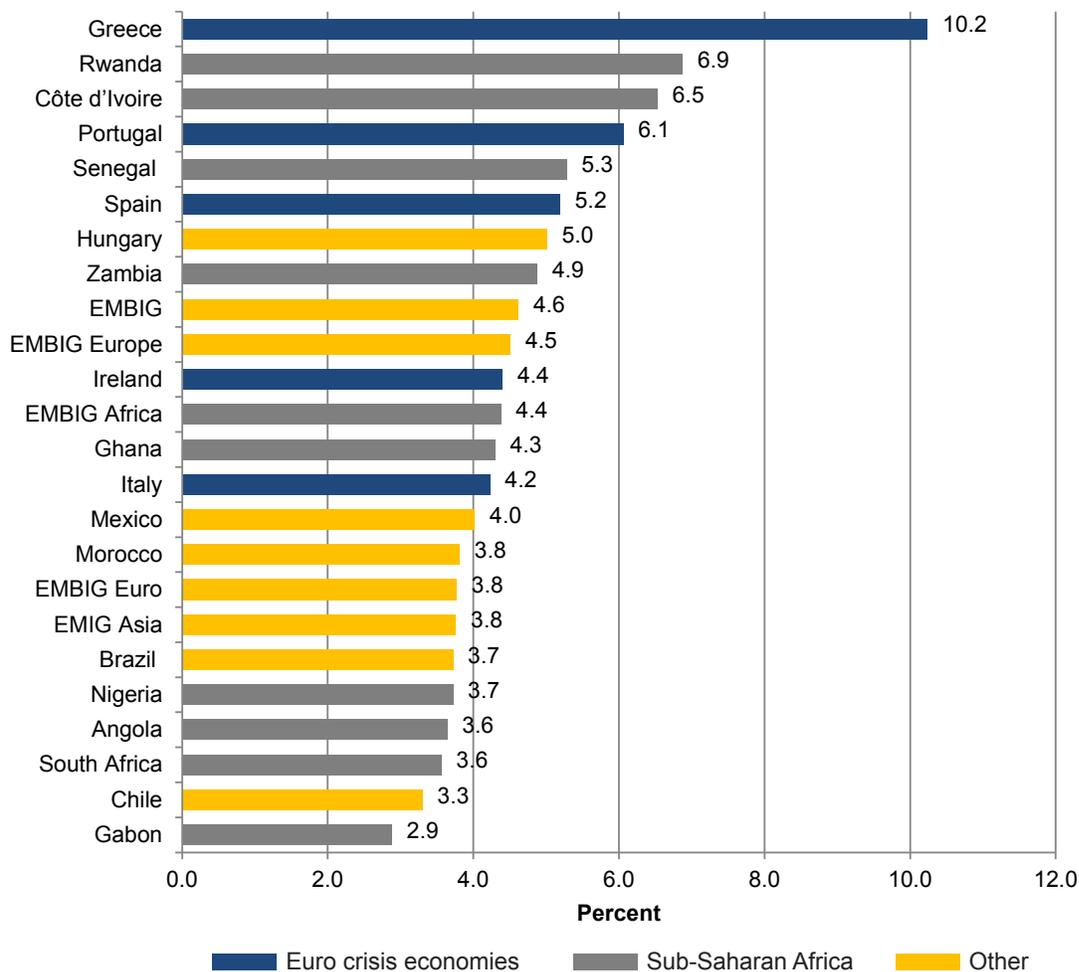
In addition, factors propelling the issuance and the sales of eurobonds by sub-Saharan African sovereigns are:

- **Changes in the institutional environment.** Since 2009, the limit the International Monetary Fund required on borrowing at unsubsidized (nonconcessional) rates for low-income countries (LICs) under an IMF program has become more flexible. It is based on a country's capacity and the extent of debt vulnerabilities. As of 2013, there were only three sub-Saharan African countries with limited or no room for non-concessional borrowing.
- **Reduced debt burden.** The IMF revised its policy after many donor countries and major multilateral financial institutions cancelled debts of many less-developed countries. That reduced debt burden allows countries to borrow in international markets without straining their ability to repay (the median government debt-to-GDP in sub-Saharan Africa is now below 40 percent). In addition, many countries strengthened their macroeconomic management and improved their ability to measure debt sustainability.
- **Large borrowing needs.** Many sub-Saharan African countries have significant infrastructure needs—such as electricity generation and distribution, roads, airports, ports, and railroads—and eurobond proceeds can be crucial to financing infrastructure projects, which can require resources that are larger than aid flows and domestic savings.

- **Debt management needs.** At least four sub-Saharan countries have issued international bonds in exchange of distressed debt (Côte d’Ivoire, Gabon, the Republic of the Congo, and the Republic of Seychelles). As part of a private sector restructuring operation in 2010, both Seychelles (\$168 million, 16-year eurobond in 2010) and Côte d’Ivoire (\$2.3 billion, 23-year eurobond) issued eurobonds in exchange for their defaulted bonds. In 2007, Gabon issued a \$1 billion, 10-year eurobond to buy back its outstanding debt to Paris club creditors at a 15 percent discount. The Republic of the Congo (\$480 million, 22-year eurobond) restructured its debt as part of the Highly Indebted Poor Country (HIPC) debt relief initiative that sought comparable treatment for official and private creditors (Goldman Sachs, 2013).
- **Low borrowing costs.** In recent years, sub-Saharan African countries have been able to borrow at historically low yields—at times even lower than that of euro area crisis countries—and at favorable conditions, such as longer repayment periods (see Figure 4). International borrowing costs are often lower than domestic interest rates, even after adjusting for the exchange rate. Although borrowing costs are historically low, yields of eurobonds from sub-Saharan Africa are high enough to attract foreign investors. The development of domestic sovereign bond markets offering high interest rates has also attracted foreign investors and increased the supply of sovereign debt. At times, appreciating local currencies enable foreign investors to increase further their return on investment in local instruments.

It is not only sub-Saharan African countries that are taking advantage of the prevailing low yields to issue eurobonds for the first time. Some Latin American countries are too. Bolivia recently tapped international markets for the first time in 90 years. Paraguay made an initial offering, and Honduras sold eurobonds in 2013 as well.

FIGURE 4. SOVEREIGN BOND YIELDS: SUB-SAHARAN AFRICAN AND EUROPEAN SOVEREIGN ISSUERS AS OF JANUARY 30, 2013



Source: Bloomberg L.P.

Note: Yields for euro-denominated instruments can be compared to U.S.-dollar denominated bonds using the cost of currency swaps.

CAN IT CONTINUE?

To assess whether the favorable climate for bond issuance is likely to continue for a sustained period, it is useful to focus on factors that drive the cost of borrowing and determine the direction of capital flows. So-called push factors affect the general climate for bond sales to international investors, and pull factors are country-specific and dependent, to a degree, on a country's policies.²

Among the important push factors are: global liquidity measures such as reserve money (M2) for the euro area, Japan, the United Kingdom, and the United States; measures of investors' risk appetite such as the VIX index; and the price of oil. The factors that pull in funds to a country include macroeconomic variables such as its GDP

per capita, the sustainability of its external financial operations including the current account (which measures what a country spends abroad offset by what foreigners spend in that country), and the ratio of external debt to exports, and macroeconomic stability (mainly measured by inflation performance). Sovereign credit ratings, which are a good proxy for the creditworthiness of a country, capture most of these pull factors.

Recent trends and developments indicate that push factors are becoming less favorable to sub-Saharan African countries. First, the record-low interest rates that prevail in the United States are set to increase. Second, risk appetites of foreign investors, although they remain high, may fall when global interest rates increase and concerns about global growth abate. This was the case during the so-called “tapering tantrum” in 2013 and in October 2014. Third, the price of crude oil has fallen by 25 percent between June and October 2014 and was hovering around \$80 a barrel by mid-November 2014, a level it had not broken since mid-2012. As a result, oil-producing sub-Saharan countries will face a higher cost of borrowing. New issuers will have more flexibility about the timing of their debt issuance as market access conditions become more challenging. They will be able to postpone issuance or reduce the amount of issuance. In contrast, past issuers needing to refinance their debt when it matures will have to pay higher refinancing costs.

In the short-term, oil producers will face less favorable market conditions as their fundamentals deteriorate as a result of the fall in oil price. Among sovereign issuers, Barclays (2014) estimates that a drop of \$10 per barrel in oil prices would lead to a net export loss of \$6.1 billion for Nigeria and \$5.7 billion for Angola, thereby eroding their current account surpluses. The dependence on oil exports and fiscal revenues in these countries is relatively high. Oil exports make up 95 percent of total exports and over 70 percent of fiscal revenues for both Nigeria and Angola, while in Gabon oil accounts for 60 percent of government revenues and over 80 percent of country’s exports.

In spite of the recent credit rating downgrade of South Africa and Ghana, pull factors broadly indicate that, for most countries in sub-Saharan Africa, sovereign debt inflows are sustainable in the short-run. Whether they will pull in capital over the long run depends on the ability of policymakers in sub-Saharan Africa to strengthen them. According to IMF projections, the near-term outlook for the region remains broadly positive. Growth is projected to be 5 percent in 2014 (the same level as in 2013) and 5.75 percent in 2015 underpinned by continued public investment in infrastructure, buoyant services sectors, and strong agricultural production (IMF, 2014).

However, average growth rates can mask important disparities among countries. Recent episodes of market turbulence suggest that countries with the weakest pull factors will be the most vulnerable to changes in push factors. For instance, in early 2014, market participants were unnerved by signs of a slowdown in Chinese growth that exacerbated market anxiousness about the U.S. Federal Reserve’s tapering and higher interest rates. The South African rand plunged to a 5-year low (of 11.39 rand per dollar) as investors started scrutinizing the fundamentals of the so-called “Fragile Five” countries, which also included Brazil, India, Indonesia, and Turkey. These countries were labeled as fragile because they had weaker fundamentals than other countries. Fundamentals include fiscal and current-account deficits (or a combination of the two), falling GDP growth rates, above-target inflation, and political uncertainty due to upcoming elections.

CONVENTIONAL POLICIES

Recent sovereign defaults in sub-Saharan Africa illustrate the importance of strengthening pull factors. The Republic of Seychelles defaulted on a \$230 million eurobond in October 2008 following a sharp fall in tourism revenues during the global crisis as well as years of excess government spending. The default led to debt restructuring and government spending cuts. Following election disputes, Cote d'Ivoire missed a \$29 million interest payment, which led to a default in 2011 (on a bond that was issued in 2010).

Notwithstanding the record low level of global interest rates, questions about a country's policies arise when external debt is significantly cheaper than domestic debt. Ghana's experience is a case in point. In January 2013, its government could pay about 4.3 percent on a 10-year borrowing in dollars (reflected in secondary market yields on the offering). However, when borrowing in local currency domestically, the interest rate is at least 23 percent on 3-month Treasury bills. After inflation differentials are taken into account the difference between the U.S. dollar and local currency borrowing costs reaches 10.6 percent (and 5.4 percent taking into account currency depreciation).³

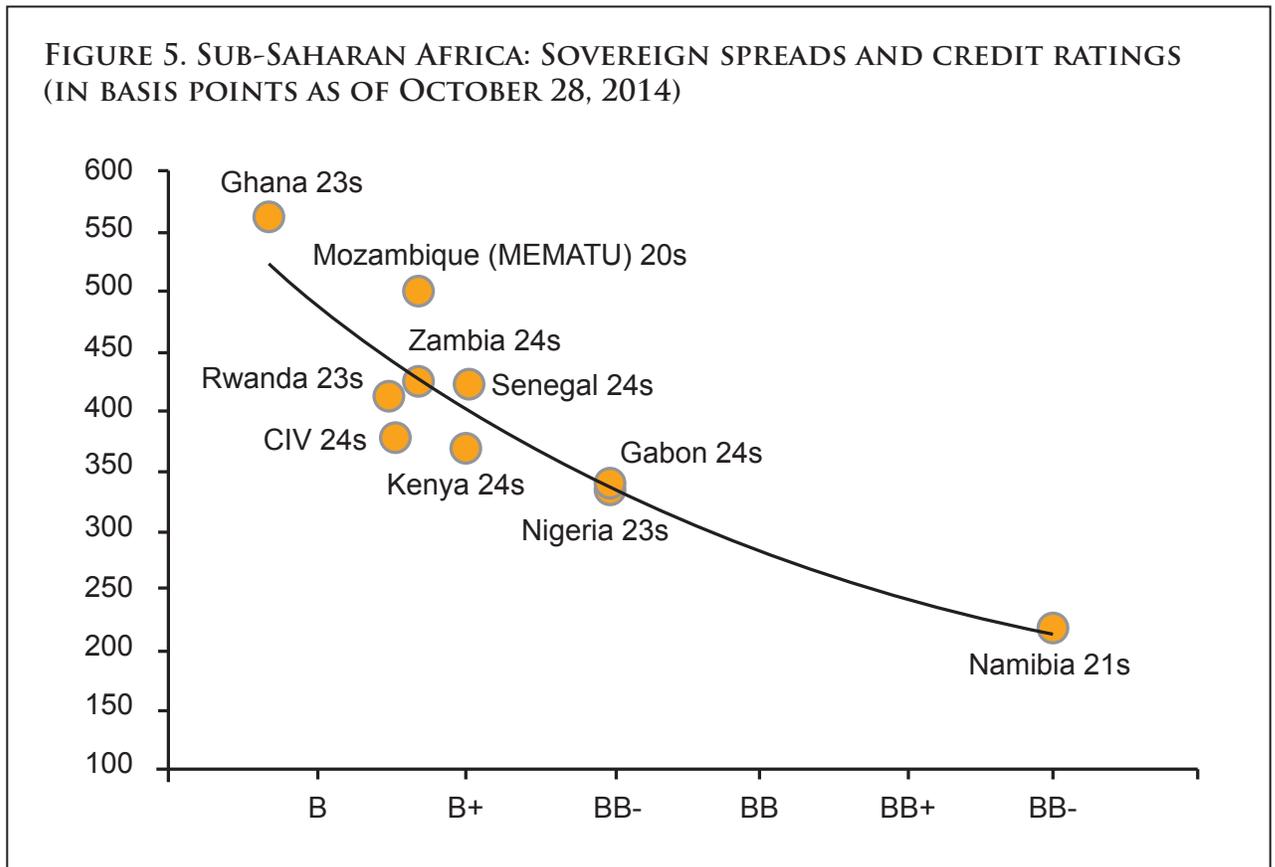
This wedge is due in part to changes in the policy environment—monetary policy was tightened in 2012 and the fiscal deficit increased to about 10-11 percent of GDP. But the wedge is also due to a low external cost that reflects foreign investors' search for yield, their confidence in Ghana's willingness to repay its debt obligations, and its ability to do so because of its positive growth prospects (it is an oil-producing economy). The difference also reflects underdeveloped domestic debt markets with an investor base dominated by banks, which raises domestic borrowing costs. Restrictions on foreign investment in short-term domestic government securities (with a maturity of less than three years) may also explain the wedge. The reluctance of the authorities to open up the capital account and augment and diversify the investor base illustrates the difficult tradeoff facing the authorities. On the one hand, increased foreign investment in the domestic market could increase liquidity and lower borrowing costs. On the other hand, it would also increase the risks associated with capital flow volatility as the channel through which international shocks can spill over to the domestic market widens.

Less than two years later, Ghana's fundamentals have deteriorated significantly, leading the country to request an IMF program. The last time Ghana went to the IMF was five years ago, and, during its resulting 3-year program, the country managed to raise its real GDP growth rate from about 4.0 percent in 2009 to 7.9 percent in 2012 with a peak of 14.4 percent in 2011. This success might not be the case this time around: Last year, growth slowed down to about 5.4 percent and indicators on the macroeconomic dashboard sent alarm signals: Headline inflation was hovering around 15 percent; the Ghanaian currency—the cedi—fell 37 percent against the U.S. dollar; and the central bank increased its policy rate to 19 percent in July. The government had been missing its fiscal deficit forecasts, and social indicators were also sending some warning signals—activists marched through the capital Accra in late July during “Red Friday” to protest the worsening economic situation.

Ghana's economic performance has been plagued by the “twin deficits” of fiscal and current account deficits. In other words, the government has been spending more than it collects in terms of revenues, and the country has been importing more than it exports. This situation cannot be sustained for long and creates macroeconomic imbalances. Two main drivers of the twin deficits are higher salaries that increase government spending, and lower gold and cocoa prices, which then reduce export revenues.

In its latest report on Ghana, IMF staff note that the Ghanaian government’s strategy “is an important first step that now needs to be translated into specific, quantified, and time-bound actions, particularly with respect to the planned rationalization of the public service and tax policy measures.” The report also notes that “in light of Ghana’s significant fiscal and external imbalances, staff would strongly encourage the government to target a larger and more frontloaded fiscal consolidation.”

So far, deteriorating fundamentals in some sub-Saharan African countries have not led to a loss of market access but have resulted in higher borrowing costs. In particular, in September 2014, Ghana was able to raise \$1 billion for a 12-year bond paying a coupon of 8.125 percent at the same time it was negotiating an IMF program. Actually, the anticipation of an IMF program has probably helped attract foreign investors, given their expectation that the associated macroeconomic adjustment would lower Ghana’s credit risk. Ghana is now paying the highest spread among sub-Saharan issuers at about 550 basis points (or 5.50 percent) over U.S. Treasury bond (Figure 5) and has the lowest credit rating.



Source: Bloomberg L.P. and Barclays Research.

In spite of countries such as Ghana with weak fundamentals being able to borrow, the spate of international borrowing by sub-Saharan Africa will not be sustainable in the long run unless these countries are able to generate high and sustainable economic growth rates and further reduce macroeconomic volatility.

Policy actions are therefore important. First, short-term policy actions must continue to focus on achieving macroeconomic stability, maintaining debt sustainability, ensuring adequate use of proceeds from the financings and investing in projects with high economic “multipliers,” avoiding the buildup of balance sheet vulnerabilities from currency and maturity mismatches, and managing the risk of significant slowdown or reversal. Second, long-term policy actions should focus on developing domestic capital markets and institutions, and adequately sequencing the liberalization of the capital account. These conventional policies are essential if sub-Saharan countries are to avoid a new debt crisis.

So far, a debt sustainability analysis of the poorest sub-Saharan African countries indicates that the risk of external debt distress is low or moderate for most sovereign issuers (Table 1). Since 2007/2008 the risk of external debt distress had fallen for Rwanda and Côte d’Ivoire and has remained unchanged for Ghana (moderate) and Nigeria, Kenya, Senegal, Tanzania, and Zambia (low).

TABLE 1. LOW-INCOME DEVELOPING COUNTRIES: CHANGES IN RISK RATING FOR EXTERNAL DISTRESS

2013/14	In Debt Distress			Zimbabwe, Sudan	
	High		Chad, São Tomé and Príncipe	Djibouti	Comoros, DRC, Central African Republic, Burundi
	Moderate	Mozambique, Mali, Cameroon	Sierra Leone, Niger, Malawi, Mauritania, Lesotho, Ghana , Burkina Faso	Gambia	Togo, Guinea-Bissau, Guinea, Côte d'Ivoire
	Low	Zambia , Uganda, Tanzania , Senegal , Nigeria , Madagascar, Kenya	Rwanda , Ethiopia, Benin	Congo, Rep.	Liberia
		Low	Moderate	High	In Debt Distress
		2007/08			

Source: IMF.

Note: Sub-Saharan African sovereign issuers in bold.

While the risk of external debt distress appears manageable, fiscal sustainability is proving to be more challenging for many countries (Figure 6). While oil-importing economies typically have lower overall fiscal balances, lower oil prices will have a negative impact on oil-exporting countries because their surpluses are being reduced sharply. In addition, many countries are increasing current spending while others are stepping up capital spending to meet their infrastructure needs.

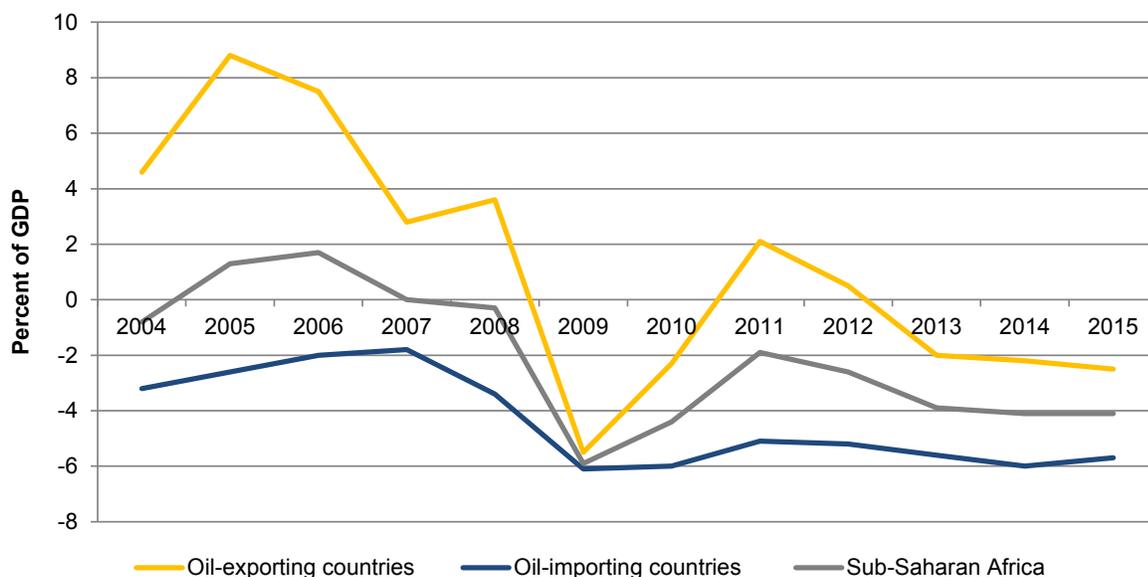
African issuers also need to monitor and manage the foreign exchange risk associated with the repayment of their U.S. dollar debt. Indeed, the strengthening of the U.S. dollar against global currencies has increased the foreign exchange risk of the U.S. dollar denominated debt issued by a number of African countries. As a number of African currencies such as the Ghanaian cedi and the Nigerian naira have been depreciating recently, servicing debt denominated in the U.S. dollar becomes even more expensive for their governments (Tyson, 2015) and (Sy, 2015).

As a result, improving fiscal policy and public debt management should be a priority. For instance, Moreno-Badia and Presbitero (2014) recommend improvements in several areas, including (i) stronger budgetary institutions; (ii) raising more revenues from countries' own tax bases; (iii) improving spending efficiency, especially investment project selection and management; and (iv) comprehensive medium-term debt-management strategies. These recommendations should be priorities for African governments.

The good news is that African countries, including Ghana, are well aware of this roadmap and have made some progress towards these goals over the past decades. The capacity of African debt management offices has improved thanks to technical assistance from the World Bank, the IMF, and other bilateral partners such as the U.S. Treasury's Office of Technical Assistance.

This said, accelerating and sustaining the pace of fiscal reform and strengthen public debt management should be a top priority, especially for countries that have accessed international bond markets. Success on these two fronts will allow African countries to opportunistically exploit the boom-bust cycle of international interest rates, tapping international markets when borrowing costs fall and relying on local markets when such costs rise.

FIGURE 6. SUB-SAHARAN AFRICA: OVERALL FISCAL BALANCE, EXCLUDING GRANTS



Source: IMF

UNCONVENTIONAL POLICIES

But countries also have to consider the net benefits of unconventional policies because some conventional policies will take time to develop and implement.

For example, developing a well-functioning domestic bond market to attract domestic and foreign savings, especially for the long term, is not easy. To that end, conventional advice is that countries must improve macroeconomic policies; debt management; and regulatory, legal, and market infrastructure—as well as develop the investor base. Money markets are the cornerstone of capital markets and a natural place to start reforms. Commercial banks are typically the largest investors, and a well-functioning interbank market is key. Ensuring the liquidity of domestic markets should also be a priority.

These conventional policies are critical but implementing them takes time. Taking examples from a variety of countries, African policymakers could aim for successful, unconventional, second-best policies, and then transition to the best ones. For instance, by strengthening common institutions, the governments in the West African Economic and Monetary Union are increasingly able to mobilize domestic savings from banks and other investors in the eight union countries and issue separately Treasury bills and bonds. Ghana, Ethiopia, and India have tapped savings from nonresident nationals by issuing diaspora bonds.

Market participants are also increasingly advising African issuers to consider tapping a more stable investor base through the issuance of infrastructure bonds, green bonds, and private placement as well as Islamic securities such as *sukuk*. The increasing trade between China and Africa should also encourage the issuance of renminbi-denominated bonds as they would offer a natural hedge if exports to China are paid in renminbi (IFLR, 2015).

As the international community is elaborating the post-2015 framework for financing for development, the growth of international borrowing by African countries and the development of local capital markets are important issues that deserve the attention of all stakeholders, including African policymakers and development partners, as well as international and domestic market participants. In this regard, the interaction between local and international capital markets should deserve more attention as they can be a source of both opportunities and challenges.

REFERENCES

- Arezki, Rabah, Thorvador Gylfason, and Amadou N.R. Sy, 2012, *Beyond the Curse: Policies to Harness the Power of Natural Resources* (Washington: International Monetary Fund).
- Barclays, 2014, "Commodities and Credit Spreads" *Sub-Saharan Africa Insights*, 28 October 2014.
- Goldman Sachs, 2013, "Africa's Window of Sovereign Bond Opportunity," *CEEMEA Economics Analyst*, Issue No: 13/20, June 14.
- Gueye Cheikh A. and Amadou N. R. Sy, forthcoming, *Beyond Aid: How Much Should African Countries Pay to Borrow*, *Journal of African Economies*.
- Gueye Cheikh A. and Amadou N. R. Sy, 2013, "U. S Interest Rates and Emerging Market Bond Yield Spreads: A Changing Relationship?" *Journal of Fixed Income*, Volume 22, Number 4, pp.48-52.
- International Financial Law Review (IFLR)*, 2015, "How Africa Must Manage Its Eurobond Risks", February 2015.
- International Monetary Fund*, 2012, *Regional Economic Outlook: Sub-Saharan Africa*, Washington: International Monetary Fund, October.
- , 2013, *Regional Economic Outlook: Sub-Saharan Africa*, (Washington: International Monetary Fund).
- , 2014, *Regional Economic Outlook: Sub-Saharan Africa*, (Washington: International Monetary Fund).
- Moreno-Badía M. and A. Presbitero, 2014, "Financing for Development: New Opportunities or the Old Debt Trap," *Brookings Institution*
- Rodrik, Dani, 2014, "An African Growth Miracle?" *NBER Working Paper 20188*, Cambridge, MA, June.
- Tyson, Judith, 2015, "Sub-Saharan Africa International Sovereign Bonds Risks Part 2," *Overseas Development Institute*.
- Sy Amadou N. R., 2015, "The Foreign Exchange Risk of African Sovereign Bonds: Not Yet Time to Sound the Alarm" *Brookings Institution*.

ENDNOTES

1. Senior Fellow, Brookings Institution, 1775 Massachusetts Avenue, NW, Washington, DC 20036-2103, USA. Email: asy@brookings.edu. I would like to thank Bruno Cabrillac for useful comments and suggestions. All errors remain mine. An earlier version of this paper was published in French in the *Revue d'Économie Financière*.
2. See, for instance, Gueye and Sy (forthcoming, *Journal of African Economies*).
3. Given data limitations, these inflation differentials are ex-post. More accurate estimates should be based on inflation expectations.