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The ruinous price for Africa of pernicious 'perception premiums'

Unless fairer financing rules are implemented, historical biases will continue to sabotage sustainable development in the region

Hippolyte Fofack

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Hippolyte Fofack is the chief economist of the African Export-Import Bank.

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Abstract

The COVID-19 pandemic has aggravated one of the most important development challenges confronting Africa—the high cost of perception premiums. This paper argues for fairer financing rules to address the growth-crushing, default-driven rates that undermine the diversification of sources of growth and debt sustainability across the region. Fairer rules that equalize access to development financing at the global level will mitigate the risk of a divergent, two-speed recovery in the post-containment phase of the pandemic. They will also sustainably boost the supply of long-term financing to accelerate the process of structural transformation and reduce the unhealthy correlation in Africa between growth and commodity price cycles.

Keywords: COVID-19, debt sustainability, fairer financing rules, perception premiums, procyclical downgrade

JEL Classification: E44, F33, F34, F65, H63, O55

"*Perceptions of Africa lag behind the brightening reality.*" - FT Editorial Board[1]

1. Introduction

Since the novel coronavirus SARS-CoV-19 began to spread around the globe, the pandemic has inflicted horrifying health and economic costs. In addition to its huge death toll in the face of mutations and recurring waves of infections, the COVID-19 crisis has engendered one of the most dramatic reversals of economic growth on record. The virus and ensuing containment measures brought industrial production and trade to a sudden stop, with the ensuing contraction of world output dwarfing the losses triggered by the 2008 financial crisis (BIS, 2020). Despite the forecasted vaccine-powered economic recovery in 2021, output is not expected to return to pre-pandemic levels before 2022. In many countries, per capita incomes will not return to pre-crisis levels before 2025 (Prasad, 2021; IMF, 2021a).[2]

Additionally, COVID-19 has heightened risk perceptions and exacerbated financing gaps, especially in low-income and emerging-market economies (BIS, 2020; Fofack, 2021a). For instance, even though sovereign spreads in sub-Saharan Africa have dropped by around 700 basis points since reaching all-time highs in April 2020, they still remain elevated, mostly above levels seen following the 2008 financial crisis (IMF, 2021b).[3] The high costs of these negative spillovers are falling disproportionately on countries that have limited fiscal space and are least able to withstand the pandemic's humanitarian, security, and economic consequences (Stiglitz, 2020).

As a result, Africa slipped into its first recession in more than 25 years, with the sharp tightening of global financing conditions triggering sudden stops and massive capital outflows from the continent, alongside one of the most dramatic global demand and supply shocks on record (Fox and Signé, 2020; Fofack, 2021b). These events intensified liquidity constraints, compounded existing macroeconomic management challenges, and undercut investment (UNCTAD, 2021a).[4] The widening of high-yield corporate and sovereign spreads, accelerated by the avalanche of procyclical rating downgrades, also raised the costs of capital and undermined access to financing in a region where large trade and infrastructure financing gaps have long constrained the growth of trade and expansion of aggregate output (Fofack, 2020; Afreximbank, 2020).[5]

Besides the risk of a divergent two-speed recovery associated with widening spreads, the COVID-19 pandemic downturn has aggravated one of the most important development challenges confronting Africa—the high cost of "perception premiums," the overinflated risk perception assigned to the region and countersigned year after year by rating agencies, irrespective of improving macroeconomic fundamentals, the global economic environment, and individual countries' growth prospects (Soto, 2020; Collier, 2020; Fofack, 2021a).

Over the years, these premiums have constrained access to development financing and undermined governments' capacity to diversify the sources of growth to address one of the most important risk drivers on the path of long-run growth and debt sustainability—the

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1 For more details, see https://www.ft.com/content/c683df12-ce32-11e9-99a4-b5ded7a7fe3f (Financial Times Editorial Board, September 4, 2019).

2 For more details, see https://www.imf.org/en/Publications/WEO/Issues/2021/03/23/world-economic-outlook-april-2021

3 For more details, see https://www.imf.org/en/Publications/REO/SSA/Issues/2021/04/15/regional-economic-outlook-for-sub-saharan-africa-april-2021

4 FDI inflows to Africa fell by 18 percent in 2020 compared to 2019 (UNCTAD, 2021a).

5 For more details, see https://www.brookings.edu/wp-content/uploads/2020/12/20.12.28-AfCFTA_Fofack.pdf

correlation between growth and commodity price cycles. This paper argues for a globally coordinated financing mechanism that fosters transparency and strengthens the regulatory environment to address growth-crushing and default-driven rates, with the intention of equalizing access to affordable development finance and accelerating the process of global income convergence.

The rest of this paper is structured as follows. Section 2 provides a historical overview of Africa's engagement with credit-rating agencies. Section 3 provides an empirical assessment of potential costs and implications of perception premiums for the distribution of sovereign risks during the COVID-19 pandemic downturn. Section 4 assesses the potential costs of perception premiums for African economies. Section 5 reflects on the potential implications of high perception premiums in a context of a changing debt profile that is increasingly less concessional. Section 6 discusses the potential implications for high perception premiums for structural transformation as well as fiscal and debt sustainability. Section 7 outlines options for the emergence of market-based solutions for sustainable development financing flows into Africa. The last section concludes with policy recommendations.

2. Ill-founded ratings appraisals

Since 1994, when South Africa received its first sovereign rating, the number of African nations with sovereign credit ratings has increased to 32.[6] This trend reflects countries' increasing reliance on debt capital markets to diversify sources of funding and meet their development financing needs in the context of steadily declining flows of aid (Presbitero et al., 2016; OECD, 2019; Gabor, 2021; Griffith-Jones, 2021). In this context of increasing diversification of funding sources, credit-rating agencies—which also play a key role in macroeconomic management by fostering greater transparency as sovereign and corporate entities seek to improve their credit ratings to enhance access to sustainable development financing—have become important players in the African development scene in recent years. Through their sorting of information and insights into the creditworthiness of borrowers, they determine access to international capital markets and borrowing costs. (Ferri et al., 1999; Bolton et al., 2012; Rhee, 2015; Mensah et al., 2017).

A review of Africa's engagement with credit-rating agencies—which introduced African entities to international capital markets primarily as sub-investment grade borrowers—provides some insights into the development challenges facing the region on its path towards debt sustainability and diversification of funding sources.[7] Despite the region's diversity and the asymmetric nature of shocks, African corporate and sovereign entities have consistently been perceived as riskier than their counterparts elsewhere in the world (Barta and Johnston, 2017; Mutize, 2019; Soto, 2020).[8]

As sub-investment grade borrowers, African entities (both sovereigns and corporates) have issued bonds at high discounts and high interest rates, as several empirical studies make clear. Gueye and Sy (2015), in examining the importance of push and pull factors in

6 The number of African corporate entities rated by the Big Three credit rating agencies has been on the rise as well, in part reflecting the growing role of international capital markets in the financing of growth and balance sheet expansion across the region.

7 Rating agencies use comparable rating scales with 20 rungs from the highest (AAA) to the lowest (D). The upper ten ratings (AAA to BBB-) are referred to as investment grade, and the lower half (starting from BB+) are non-investment grade (also known as speculative grade).

8 But the inherent bias of credit rating agencies is not limited to Africa, but affects most emerging and developing market economies as new empirical evidence shows (Griffith-Jones, 2021).

determining bond yield spreads, showed that countries in sub-Saharan Africa had paid, as of the end of 2009, 300 basis points more on average than the mean for emerging market borrowers. Olabisi and Stein (2015) found similar results in a subsequent study: They estimated that—controlling for differences in income levels, reserves, and indebtedness—countries across the region paid higher coupon rates than other issuing countries.

These growth-crushing constraints, which have been the staple of economic management in Africa, played out vividly during the COVID-19 crisis. Whereas high-yield spreads have undermined macroeconomic management across African countries by constraining fiscal space, the low- and even negative-yielding bonds in advanced economies have kept their debt service costs at manageable levels (IMF, 2020a), which has enabled those economies to extend large fiscal stimulus and monetary support, setting the stage for a divergent, two-speed global recovery in the post-containment phase of the pandemic (Bulow et al., 2020; IMF, 2021a).

These issues are finally being discussed in earnest on the world stage. At the annual meetings of the International Monetary Fund (IMF)—held virtually in October 2020—Managing Director Kristalina Georgieva remarked that "a great deal of attention needs to concentrate on reducing the perceived and real risk for investing in Africa so we can see this huge availability of financing for the rest of the world trickle down into Africa."[9] On May 18, French President Emmanuel Macron, who has called for "fairer financing rules for African economies," hosted an international summit in Paris on providing support to the continent (Fofack, 2021a).[10]

The COVID-19 downturn has greatly amplified the macroeconomic management challenges facing African policymakers (IMF, 2021a, 2021b). Global coordination will be essential to equalize access to development financing and mitigate the risk of a two-speed recovery, which threatens to widen yet further the income gap between Africa and other parts of the world and undermine the implementation of the African Continental Free Trade Agreement (AfCFTA). The AfCFTA has the potential to accelerate the diversification of sources of growth and exports, reducing the region's exposure to global volatility and the credit rating-negative recurrent adverse commodity terms of trade. The latter has been the prime vector of balance of payment pressures and inherent liquidity premiums (Fofack, 2018a, 2020).

When the pandemic struck, African corporate and sovereign entities rated as sub-investment grade borrowers were among the first to be spurned by international capital markets. Consequently, most African countries—including Nigeria, South Africa, and Egypt, the continent's three largest economies—sought assistance from the IMF to assuage liquidity constraints and ease balance of payment pressures (Eichengreen, 2020). IMF lending to the region increased more than thirteenfold from its average for the past decade, and South Africa made history in July 2020 by taking its first loan under the IMF Rapid Financing Instrument (Georgieva, 2020).[11]

Over the last two decades, Africa has consistently registered as one of the fastest-growing regions in the world (second only to East Asia), a status galvanized by several rapidly

9 For more details, see https://www.imf.org/en/News/Articles/2020/10/14/tr101420-transcript-of-imf-md-kristalina-georgieva-opening-press-conference-2020-annual-meetings.

10 For more details, see https://uk.news.yahoo.com/frances-macron-calls-fairer-financing-081226681.htmle. Earlier in the month (May 6-7, 2021) the Africa Group in the IMF Office of the Executive Director hosted a seminar on private investment into Africa, focusing on reducing financing costs and boosting infrastructure financing within the region. For more details, see IMF (2021c).

11 For more details, see https://www.imf.org/en/News/Articles/2021/04/07/tr040721-transcript-of-imf-md-kristalina-georgievas-opening-press-conference-2021-spring-meetings.

expanding economies, including Ethiopia, Rwanda, and Côte d’Ivoire, which have consistently been among the fastest-growing economies in the world (Signé and Gurib-Fakim, 2019). Underscoring their resilience, several African countries recorded output expansion during the pandemic downturn, and two of the five fastest-growing economies in the world last year were African (IMF, 2021a).[12]

Moreover, their advances transcend macroeconomic aggregates. To quote again from IMF Managing Director Georgieva, who was invited at the end of 2019 to speak at a conference in Dakar on development and debt financing, “By improving policies and by strengthening institutions, countries in sub-Saharan Africa have made fundamental progress. Over the past two decades, extreme poverty levels have declined by one-third; life expectancy has increased by a fifth, and real per capita income has grown by about 50 percent on average,” (Georgieva, 2019).[13]

Disappointingly, these successes appear to have had little to no impact on the opinions of the dominant international credit-rating agencies. According to the most recent sovereign ratings from the “big three” agencies (Standard & Poor’s, Moody’s, and Fitch), only two African nations qualify for investment grade status—Botswana and Mauritius—out of 32 that have been assigned a credit rating by at least one of the big three agencies (AU, 2020; Gabor, 2021).[14]

III. COVID-19 and procyclical downgrades

The globally synchronized nature of the pandemic-induced economic downturn presents an opportunity to scrutinize the extent to which perception premiums are shaping the distribution of sovereign risk across countries and regions. When the pandemic erupted in the first quarter of 2020, 154 countries globally were rated by at least one of the “big three” credit-rating agencies, including 32 African nations. Even though African countries, most of which are at the tail end of the sovereign risk premia, with a disproportionately higher country risk premium, were, in large part, less affected relatively in terms of COVID-19 infection rates, and appeared more resilient in the face of a sharp downturn—growth in the region contracted by less than 2 percent on average, against a world average of 3.3 percent—more countries were downgraded in Africa compared to other regions (see Figure 1).[15]

At the height of the pandemic, South Africa—the continent’s most sophisticated economy, which accounts for more than 20 percent of total intra-African trade (Afreximbank, 2020) and has been the leading driver of cross-border trade and investment within the region—and several other countries were downgraded to “junk” status (AU, 2020; S&P, 2021; Moody’s, 2021; Griffith-Jones, 2021).[16] This landslide of procyclical downgrades affected more than

12 The two African countries which made it to the top-five fastest-growing economies of the pandemic year are Ethiopia where real GDP expanded by 6.1 percent and Guinea where it expanded by 5.2 percent (IMF, 2021a).

13 https://www.imf.org/en/News/Articles/2019/12/01/sp12022019-development-and-debt-finding-the-right-balance

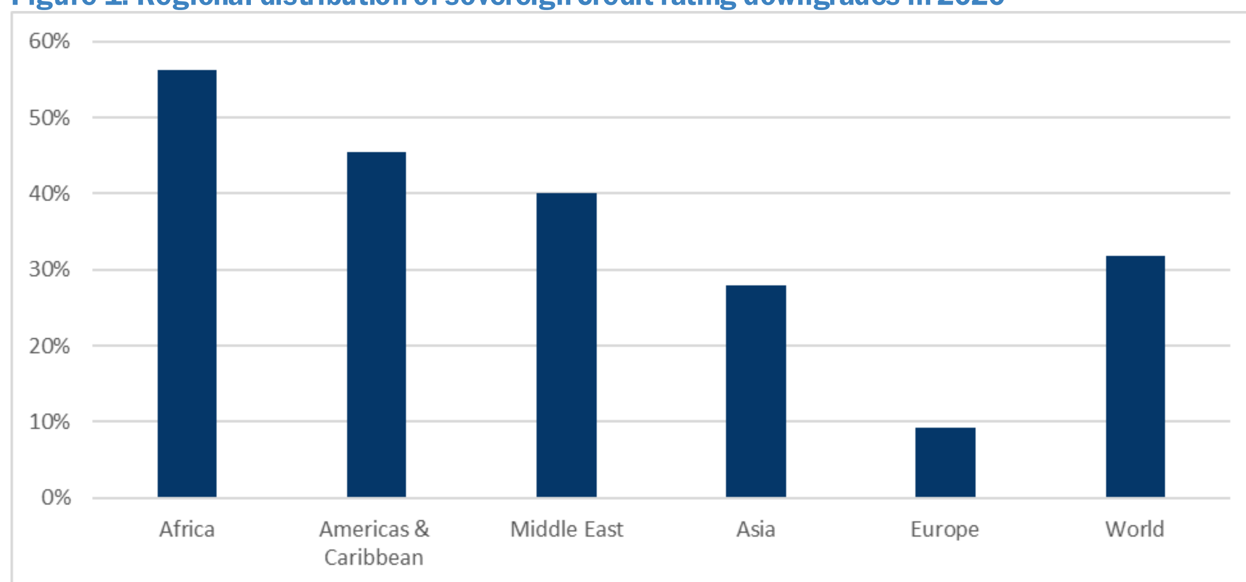
14 Before the pandemic outbreak, four African countries had investment grade status (Botswana, Mauritius, Morocco, and South Africa). The rating agencies downgraded South Africa and Morocco’s default rating for long-term foreign currency bonds to junk status (Herman, 2020).

15 According to IMF October 2020-estimates, advanced economies contracted twice as fast (-4.9 percent) as emerging and developing market economies (-2.4 percent) in 2020. Similarly, the aggregate advanced economies government debt ratio increased by 20 percentage points to 124 percent of GDP; in contrast, the sovereign debt of emerging and developing market economies increased by 9 percentage points to 61 percent of GDP.

16 While the methodology used by the Big Three differs slightly, the building blocks are the same and consist of an analysis of (i) institutional and governance quality; (ii) economic growth and resilience; (iii) public finance; (iv) external accounts; and (v) monetary

56 percent of rated African countries, significantly above the global average of 31.8 percent as well as averages in other parts of the world (45.4 percent in the Americas, 28 percent in Asia, and 9.2 percent in Europe).[17] The share of affected African nations is even higher (62.5 percent) if we extend the period covered to include the two countries downgraded in the first half of 2021.[18] Further curtailing investor confidence, the glut of downgrades has been accompanied by a torrent of negative reviews of African countries’ ratings outlooks. Cumulatively, rating agencies revised downward the outlook of 17 nations, in four cases from positive to stable and in the remaining thirteen from stable to negative.

Figure 1: Regional distribution of sovereign credit rating downgrades in 2020



Sources: Fitch; Moody’s; Standard and Poor’s; Trading Economics; IC Publications and Intelligence.

The significance of these large-scale procyclical moves goes far beyond the total number of downgrades. They have created cliff effects, with two of the very few African countries—Morocco and South Africa—that have enjoyed a relatively low sovereign risk premium losing their investment grade and becoming, in the vernacular of rating agencies, “fallen angels.” For years, four nations in the region—Botswana, Mauritius, Morocco, and South Africa—have enjoyed investment-grade status. By downgrading the latter two to high-yield and junk status, the financial fallout of the COVID-19 downturn has been cataclysmic for Africa’s sovereign risk profile. The region will emerge from the pandemic with more than 93 percent of its sovereigns rated as sub-investment grade borrowers.

These countries were downgraded primarily because falling government revenues and a sharp deterioration of commodity terms of trade triggered by the pandemic downturn would exacerbate liquidity pressures and weaken countries’ fiscal and debt sustainability profiles

flexibility. The rating agencies typically create indicative “anchor scores” for each of the five rating factors and then apply a “qualitative” overlay.

17 Empirical evidence shows that the probability of an African sovereign being downgraded has been consistently higher than the likelihood of an upgrade, and that probability has increased markedly since 2007 (Mutize and Nkhalamba, 2021).

18 These are Kenya and Mauritius. S&P downgraded Kenya’s credit rating to ‘B’ in March 2021 due to rising fiscal and external pressures. Moody’s downgraded Mauritius credit rating to ‘Baa2’ the same month to reflect weakening in fiscal and economic strength as a result of the shock brought on by the Coronavirus pandemic.

(Moody's, 2020; S&P, 2021).[19] Even though commodity prices have rebounded, with base metals rising by more than 36 percent between June-December 2020 and oil prices rising by over 56 percent over the same period, the adverse effects of large-scale procyclical downgrades persist. These downgrades are not automatically reversed after recession and recovery from the trough of business cycles.[20]

Pro-cyclical downgrades have a long history across Africa. An empirical study carried out by Pretorius and Botha (2017) and covering 27 African countries for the time period between 2007 and 2014 confirms pro-cyclicality for Fitch and Moody's in their assignment of credit ratings for African sovereigns.[21] Similarly, Broto and Molina (2016) equally find evidence of pro-cyclicality and persistency of high costs associated with such moves over time, with previous downgrades of African sovereigns having a negative influence on future ratings. Interestingly, IMF (2000) empirical analysis based on their own model equally supports the asymmetric behavior of credit rating agencies, with countries downgraded following major crises.

While the procyclical downgrade may preserve the reputational capital of credit-rating agencies, which tends to fluctuate procyclically, it has significant implications and costs for macroeconomic management and growth. In the short term, the expected rise of borrowing costs associated with procyclical downgrades further constrains fiscal space and undermines governments' ability to address the public health and economic effects of the COVID-19 downturn. By compromising the supply of long-term finance for economic transformation, these procyclical downgrades engender long-term costs, and have garnered considerable criticism (Ferri et al., 1999; Cesaroni, 2015; Freitag, 2015; Collier, 2020; Griffith-Jones, 2021).

At the pandemic's peak, the European Securities and Markets Authorities (ESMA) cautioned rating agencies against deepening the coronavirus crisis through "quick-fire" downgrades as the outbreak pushed countries into recession (Jones, 2020; Griffith-Jones, 2021). The European Systemic Risk Board echoed these concerns, stressing the need for greater transparency and the timely incorporation in credit-rating models of changing economic fundamentals. With a view to reducing volatility, these regulators also advocated a through-the-cycle approach to credit-risk assessment (Fofack, 2021d). Likewise, in its Policy Brief (2021) UN Secretary General argues that "a more favourable long-term rating might help countries raise long-term capital to invest more effectively in sustainable development" (Griffith-Jones, 2021).

By amplifying borrowing costs and uncertainty, these demotions also increased the risk of sudden stops and accelerated the pace of capital outflows from the region. South Africa was particularly impacted, with non-resident portfolio outflows (bonds and equities) exceeding $9.7 billion (3.2 percent of GDP) in 2020 (World Bank, 2021a). Furthermore, the country's 10-year bond yields rose by more than 100 basis points (from 8.24 percent to 9.27 percent) between January and September; over the same period, U.S. 10-year bond yields declined by

19 Yet at the height of the COVID-19 crisis, the extension of fiscal stimulus emerged as the most effective response to help households and businesses cope with fallout from the pandemic downturn. These counter-cyclical policies were encouraged by the IMF and widely implemented around the world, especially by advanced economies. For instance, the European Union Commission activated the general escape clause in the EU fiscal rules to allow its member countries to run deficits in excess of 3 percent of GDP.

20 Empirical evidence has shown that it takes an average of 7 years to regain a previous sovereign rating score after downgrade (AU, 2019).

21 Their analysis of S&P did not show clear pro-cyclical results for their ratings.

more than 100 basis points (from 1.83 percent to 0.67 percent, well below the ten-year breakeven inflation rate of 2.4 percent), further amplifying the risk of divergent recovery.

The landslide of procyclical downgrades increased the already long list of African countries deemed to be highly risky with a high probability of defaulting on their debt obligations (see Table 1). Some of these assessments seem, in light of the emboldening performance of many of these economies over the last several years, erroneous (Presbitero et al., 2016; Signé and Gurib-Fakim, 2019; Fofack, 2021b). Ethiopia has seen its GDP grow more than tenfold since the turn of the century, becoming one of the largest economies in East Africa and one of the most successful in terms of poverty alleviation across the region. In fact, it is set to become the first low-income country in Africa to achieve the United Nations’ Sustainable Development Goal of eliminating poverty by 2030 (World Bank, 2020a).

According to the World Bank, Ethiopia has made great strides in fighting poverty, with sustained economic growth supported by a gradual integration into global value chains translating into a sharp reduction in the share of the population below the national poverty line from 44 percent in 2000 to 21 percent in 2018 (WEF, 2021; Rodrik, 2021). The effect has been particularly pronounced in urban areas, where now just 15 percent of the population is considered poor, down from 26 percent (World Bank, 2020a).[22]

But even though faster economic growth is credit rating-positive, Ethiopia remains a sub-investment grade borrower, being described by rating agencies as highly speculative and carrying a negative outlook (Moody’s, 2020; Fitch, 2021). Yet the country has been on a long-run growth trajectory that was not, unlike many other countries throughout the world, entirely derailed by the pandemic downturn (IMF, 2021b; Fofack, 2021b). Furthermore, although Ethiopia had an external debt-to-GDP ratio of about 30.5 percent in the lead-up to the pandemic downturn, below the IMF threshold of 60 percent for prudent debt levels (Greenidge et al., 2012), its 10-year sovereign bond was trading at an average of 6.6 percent, against the global benchmark of 0.74 percent at the height of the pandemic.

Nigeria, one of Africa’s largest economies, is another interesting case. Although it had one of the lowest external debt-to-GDP ratios (about 15 percent) among emerging economies, its 10-year sovereign bond traded at a default-driven rate of 9.1 percent at the height of the COVID-19 crisis, markedly high by emerging market standards, even though the desirable low debt-to-GDP levels are credit rating-positive. But by far the highest is Zambia’s 10-year bond yield rising to a stunning 38 percent at the height of the pandemic downturn.[23] Under these default-driven borrowing rates, Zambia’s interest payments on its $3 billion eurodollar bonds could push the country into a growth-crushing downward spiral, curtailing the expansion of public investment to levels required to crowd-in private capital sustainably in support of robust post-COVID-19 economic growth.

22 For more details, see http://documents1.worldbank.org/curated/en/992661585805283077/pdf/Ethiopia-Poverty-Assessment-Harnessing-Continued-Growth-for-Accelerated-Poverty-Reduction.pdf

23 Although the country’s 10-year bond yield has decreased slightly from the 38 percent peak it still very high, 33.5 percent as of August 2021. For more details, see http://www.worldgovernmentbonds.com/bond-historical-data/zambia/10-years/.

Table 1. Summary of sovereign credit rating actions and outlooks (January-December 2020)

Country	Moody's		S&P		Fitch		Down Graded	Change in Outlook Jan-Dec
Angola	B3 (Stable)	Caa1 (Stable)			B (Negative)	CCC (N/A)	Yes	No
Benin	B2 (Positive)	B1 (Stable)	B+ (Stable)	B+ (Stable)	B (Positive)	B (Stable)	No	Yes (Down)
Botswana**	A2 (Stable)	A2 (Negative)	A- (Stable)	BBB+ (Negative)			Yes	Yes (Down)
Burkina Faso			B (Stable)	B (Stable)			No	No
Cameroon	B2 (Stable)	B2 (Stable)	B (Negative)	B- (Stable)	B (Stable)	B (Negative)	Yes	Yes (Down)
Cabo Verde**			B (Stable)	B (Negative)	B (Positive)	B- (Stable)	Yes	Yes (Down)
Congo DRC	Caa1 (Stable)	Caa1 (Stable)	CCC+ (Positive)	CCC+ (Stable)			No	Yes (Down)
Egypt	B2 (Stable)	B2 (Stable)	B (Stable)	B (Stable)	B+ (Stable)	B+ (Stable)	No	No
Ethiopia**	B1 (Negative	B2 (Negative)	B (Stable)	B (Negative)	B (Negative)		Yes	Yes (Down)
Gabon	Caa1 (Positive)	Caa1 (Stable)			B (Stable)	CCC (N/A)	Yes	Yes (Down)
Ghana	B3 (Stable)	B3 (Negative)	B (Stable)	B- (Stable)	B (Stable)	B (Negative)	Yes	Yes (Down)
Cote d'Ivoire	Ba3 (Stable)	Ba3 (Stable)			B+ (Positive)	B+ (Positive)	No	No
Kenya*	B2 (Stable)	B2 (Negative)	B+ (Stable)	B+ (Negative)	B+ (Stable)	B+ (Negative)	No	Yes (Down)
Lesotho					B (Stable)	B (Negative)	No	Yes (Down)
Mali	B3 (Stable)	Caa1 (Negative)					Yes	Yes (Down)
Mauritius*	Baa1 (Stable)	Baa1 (Negative)					No	Yes (Down)
Morocco**	Ba1 (Stable)	Ba1 (Negative)	BBB- (Stable)	BBB- (Negative)	BBB- (Stable)	BB+ (Stable)	Yes	Yes (Down)
Mozambique	CCa2 (Stable)	CCa2 (Stable)	CCC+ (Stable)	CCC+ (Stable)	CCC (N/A)	CCC (N/A)	No	No
Namibia	Ba2 (Stable)	Ba3 (Negative)			BB (Stable)	BB (Negative)	Yes	Yes (Down)
Niger	B3 (Stable)	B3 (Stable)					No	No
Nigeria	B2 (Negative)	B2 (Negative)	B (Stable)	B- (Stable)	B+ (Negative)	B (Stable)	Yes	Yes (Up)
Congo Republic			B- (Stable)	CCC+ (Stable)	CCC (N/A)	CCC (N/A)	Yes	No

Rwanda	B2 (Stable)	B2 (Negative)	B+ (Stable)	B+ (Negative)	B+ (Stable)	B+ (Stable)	No	Yes (Down)
Senegal	Ba3 (Stable)	Ba3 (Negative)	B+ (Stable)	B+ (Stable)			No	Yes (Down)
Seychelles					BB (Stable)	B (Stable)	Yes	No
South Africa	Baa3 (Negative)	Ba2 (Negative)	BB (Negative)	BB- (Stable)	BB+ (Negative)	BB- (Negative)	Yes	Yes (Up)
Swaziland	B2 (Negative)	B3 (Stable)					Yes	Yes (Up)
Tanzania	B1 (Negative)	B2 (Stable)					Yes	Yes (Up)
Togo	B3 (Stable)	B3 (Stable)	B3 (Stable)	B3 (Stable)			No	No
Tunisia**	B2 (Negative)	B2 (Negative)			B+ (Negative)	B (Negative)	Yes	No
Uganda	B2 (Stable)	B2 (Stable)	B (Stable)	B (Stable)	B+ (Stable)	B+ (Negative)	No	Yes (Down)
Zambia	Caa2 (Negative)	Ca (Stable)	CCC+ (Stable)	SD (N/A)	CCC (Negative)	C (N/A)	Yes	Yes (Up)

Note: *: Downgraded in 2021; **: downgraded in 2020 and 2021.
Sources: Fitch; Moody’s; Standard & Poor’s; Trading Economics; IC Publications and Intelligence.

IV. Costs of perception premiums

A comparison of borrowing rates incurred by African governments on their sovereign debt to those borne by more advanced economies, most of which have significantly higher debt-to-GDP ratios is very instructive. For instance, Italy, which over the past two years recorded a debt-to-GDP ratio of 134.8 percent, was paying less than 0.91 percent on its 10-year sovereign bond at the height of the pandemic downturn. Although exceptionally large fiscal support pushed its debt-to-GDP ratio even higher (around 160 percent) by the end of 2020, the Italian government is still paying significantly less on its bonds compared to countries across Africa (Stubbington, 2021).[24]

At the same time, although Italy’s external debt at the height of the COVID-19 crisis totaled $2.6 trillion—more than three times the combined debt owed by African countries ($841.9 billion) to their external creditors at end-2019—it enjoys significantly lower interest payments, in spite of its oft-cited struggles with fiscal and sovereign debt crises (Wheatley, 2021; Rogoff, 2021; Rajan, 2021).[25] This trend reflects, in part, the proximity of interest rates to the effective lower bound under advanced economies’ extant monetary policy regimes and quantitative easing (QE) programs, as well as the effectiveness of the monetary policy transmission mechanism on demand.[26] At the same time, it reflects the effectiveness of the Euro repo markets which have grown to become the predominant source of short-term funding

24 The all-important spread that Italy pays on its debt relative to interest cost on ultra-safe German 10-year bond has remained on a downward trend throughout the pandemic downturn, falling to a five-year trough in February 2021 (Stubbington, 2021).
25 Studies have shown that an increase of 1 percent in the debt-to-GDP ratio in advanced economies is associated with an increase of between 0.02 percent and 0.03 percent in interest rates. See https://www.pgpf.org/blog/2019/05/higher-national-debt-means-higher-interest-rates-for-the-federal-government
26 Across most advanced economies, the equilibrium real interest rate has turned negative, while nominal policy rates cannot be reduced much below zero.

in euro-denominated markets (Schaffner et al., 2019).[27] Perhaps it also reflects the convergence between real and perceived risks in a region where one of the systemically important central banks has acted as insurer of last resort.

These considerations all point to the fact that sovereign credit ratings may not always and consistently be driven by economic fundamentals (such as growth and indebtedness), but other considerations, especially qualitative factors, as empirical results from econometric models consistently show (Ferri et al., 1999; Presbitero et al., 2016; Mutize and Nkhalamba, 2021). Empirical studies have shown that rating agencies attached high weights to their qualitative judgement (Ferri et al., 1999) and that the qualitative aspects of their risk evaluation models are particularly pro-cyclical (Griffith-Jones, 2021).

Africa’s overinflated risk perception is not even informed by a historical record of defaults (Soto, 2020; Mutize, 2019).[28] A comparison between a 10-year dollar-denominated Namibia eurobond with one from Greece is highly indicative. Despite its history of defaults, Greece 10-year bonds (Greece-10s) had a spread (over U.S. Treasury bonds) of around 222.6 basis points at the height of the pandemic. By contrast, Namibia-10s traded with a significantly higher spread—481.6 basis points—even though both countries have similar credit ratings (Ba3). The same pattern emerges when comparing the 10-year bonds with similar maturity of Mauritius and Italy. At Baa1, the former is one of two African countries with an investment grade rating, whereas the latter’s Baa3 is only one notch above junk status. And yet, Mauritius’s 10-year bonds had a spread of 245 basis points, against 92.7 basis points for Italy’s.

Figure 2 compares specific African bonds with those of their emerging-market peers with similar maturity. The countries in Figure 2 (Azerbaijan, Brazil, and South Africa) are all two notches below investment grade. However, despite their similar credit rating profiles, South Africa-30s had a spread of 486 basis points, significantly above Brazil-30s’ 305 basis points and Azerbaijan-30s’ 365.12 basis points. South Africa-30s have been trading at a higher premium, and their spread premium increased sharply at the height of the COVID-19 downturn and remained consistently above the spreads of the country’s peers throughout 2020.

A comparison based on a large sample of eurobonds shows consistent results, with African sovereign issuers facing larger spreads in recent years. Since 2016, African eurobonds in JP Morgan’s EMBI diversified have traded at a premium. The spread for African issuers has increased dramatically relative to the full index average (Figure 3). It set a new record in June 2020, rising by more than 1,000 basis points above U.S. Treasury bonds, and more than 400 basis points above the all-grade EMBI composite index spread. But empirical analysis also shows that African eurobonds have a spread premium at longer duration when compared to emerging market peers (Smith, 2020).

27 Despite the segmentation based on the country source of the collateral used, repo markets have played a major role in redistributing liquidity and collateral between financial institutions within the eurozone (Schaffner et al., 2019)..

28 With the exception of a few countries like Mozambique, Seychelles and, more recently, Zambia, most African sovereigns have remained current on their bond payments since they acceded to the IMF-World Bank Highly Indebted Poor Country (HIPC) initiative almost two decades ago.

Figure 2: USD sovereign eurobond spread (basis points), daily data

Source: Bloomberg.

Throughout the region, the downgrades' short-term implications for borrowing costs on international capital markets are magnified by the predominantly junk status of African sovereign issuers (Fofack, 2021d). Most regional sovereigns were already sub-investment grade borrowers, paying higher coupons to attract investors (Moody's, 2021). The downgrades will raise these costs, as yields are not only inversely proportional to credit rating scores, but are also more sensitive to rating changes within the sub-investment grade bracket.

Moody's own research has shown that yields that are relatively insensitive to downgrading when the rating is above investment grade become very responsive even to small downgrades when the rating plunges below investment grade (Ferri et al., 1999). Perhaps the strengthening correlation between yields and credit rating score within the sub-investment grade bracket helps to explain the large spreads logged across Africa last year and validates policymakers' concerns about the cliff effects associated with the demotions of Morocco and South Africa.

Figure 3: JP Morgan Emerging Market Bond Indices (EMBI) diversified

Sources: J. P. Morgan and Bloomberg.

But perception premiums are also driving huge differentials in refinancing costs across developed and developing economies. Standard & Poor's data show that refinancing costs for the overwhelming majority of advanced economies (15 of the 18 largest economies) have fallen by more than a percentage point below their average costs of borrowing, and most are paying a fraction of 1 percent. In contrast, developing countries are facing prohibitively high refinancing costs. Egypt, for instance, which must refinance a chunk of its debt this year, is paying around 12.1 percent, above its average cost of 11.8 percent. Similarly, Ghana is paying 15 percent, compared with an average of 11.5 percent (Wheatley, 2021).

Africa's negative perception premiums have a long history. Presbitero et al. (2016) found that primary spreads for the average sub-Saharan African issuer were higher than in other regions. Olabisi and Stein (2015) estimated that African sovereigns paid a premium of around 2.9 percent over the rest of the world, or an extra $2.2 billion on outstanding obligations, between 2006-2014, once differences in income levels, reserves, and indebtedness are accounted for.

As data from the EMBI diversified suggests, that figure has probably increased, especially in light of widening spreads and the avalanche of downgrades. The latter in particular have been on the rise since 2007 and accelerated sharply in 2015, when 12 African countries were downgraded after the collapse of commodity prices, which followed the end of the commodity super-cycle in 2014-2015 (Mutize and Nkhalamba, 2021). The pandemic downturn brought about a new record, with the surge in rating downgrades (18 countries) surpassing previous crises' peaks (Fofack, 2021d).

While increased sub-investment grade issuances by African sovereigns in a global financial environment of easing monetary policy in which foreign investors are hungry for returns in a world awash in cheap money (less than 2 percent of African eurobonds in the EMBI diversified have investment grade ratings, compared to an index average of 54 percent) may offer some justification, the higher spread of African investment grade issuers against their peers suggests other factors are at play.[29] Either the market pricing is out of sync with the credit rating, or the credit rating is out of sync with African sovereigns (Smith, 2020). Concurrently, and to the extent that credit ratings have been less affected by Africa’s improving macroeconomic fundamentals and growth prospects, the stickiness of historical biases and weights assigned to qualitative variables could also be shaping the market pricing (Ferri et al., 1999; Griffith-Jones, 2021).

V. Changed debt profile

The benefits of significantly lower interest rates—negative in real terms—and narrow spreads that the most affluent countries enjoy have been invaluable in navigating the COVID-19 downturn. In effect, despite the unusually high level of debt incurred by advanced economies in extending fiscal stimulus and monetary support to households and businesses, these countries’ debt service costs have remained historically low (IMF, 2020a). But across Africa, where interest rates have remained high and are, in fact, rising, managing the crisis has been markedly more difficult, with interest payments associated with widening spreads further constraining fiscal space (IMF, 2021b; Fofack, 2021a).

The COVID-19 pandemic reached Africa at a time when the fiscal space to absorb such shocks was limited in most countries, especially after 2014-2015, when the sharp deterioration of commodity terms of trade accelerated the accumulation of external liabilities. Yet, even though the fiscal support extended by African governments was narrow in size and scope (around 2.6 percent of GDP compared to 7.2 percent for advanced economies) the negative impact of that support on the region’s debt sustainability profile is expected to be more pronounced, especially with the changing external debt profile of the region (Coulibaly, 2021; Griffith-Jones and Carreras, 2021a).

Africa’s debt profile has changed dramatically over the past decade, shifting from largely concessional and official loans towards private participation to meet the region’s growing trade and infrastructure development needs, with bond issuance in international capital markets becoming an important source of financing (Presbiteros et al., 2016; World Bank, 2020a, 2021b; Gabor, 2021; Griffith-Jones and Carreras, 2021a).[30] Between 2003-2020, the number of African countries raising money through bond issuances rose from three to 21. Combined issuance increased from $2.2 billion to $152.4 billion over that period. According to estimates, African countries borrowed one out of four U.S. dollars via bonds and, as the COVID-19 pandemic erupted, their outstanding volume of foreign currency bonds stood at around $150 billion (Gabor, 2021).[31]

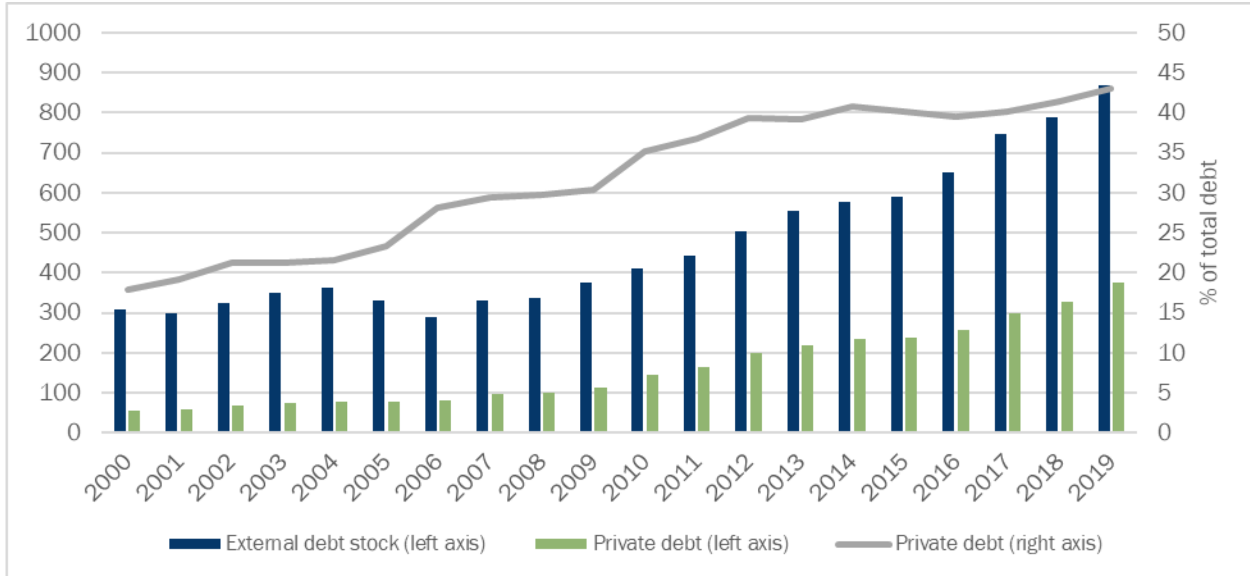
29 With more than 76 percent of developed markets sovereign debt trading at negative, investors in advanced in advanced economies have been forced to search for alternatives in emerging and developing market economies (J.P. Morgan, 2020).

30 In 2000, bilateral lenders, mostly Paris Club members, accounted for 52 percent of Africa’s external debt stock, but by the end of 2019 their share has fallen to 27 percent (AfDB, 2021; Griffith-Jones and Carreras, 2021a).

31 Lending from private creditors has been the fastest-growing component of the external debt of DSSI-eligible borrowers since 2010 (World Bank, 2021b).

As sovereign bonds issued by regional governments attracted a growing number of investors on the hunt for yield in a zero-lower bound environment in most advanced economies, private creditors became a major player in the sovereign debt financing space across Africa, with eurobonds displacing multilateral lenders (J. P. Morgan, 2020). Private creditors and foreign currency-denominated eurobonds issued on international capital markets accounted for around 43 percent ($374.7 billion) of Africa's total external debt in 2019, a more than threefold increase from a decade ago. This increase has been largely driven by rising financing requirements to expand growth-friendly infrastructure investment (Figure 4).

Figure 4: Trend and composition of external debt (sovereign)



Sources: International Financial Statistics; International Debt Statistics; and Afreximbank Research

With African governments paying default-driven borrowing rates, it is unsurprising that interest expenses have become one of their highest and fastest-growing budgetary expenditures, exceeding several countries' health budgets (Collier, 2020; Taylor, 2020).[32] In Zambia, for example, they rose almost thirteenfold within a decade from around $63 million per year to more than $804 million annually by the end of 2019—moreover, the sharp depreciation of the local currency following the outbreak of COVID-19 will make the loans more costly to service. Across Africa, annual interest rate expenses have increased more than threefold over the same period, from $8.1 billion to around $24.9 billion (World Bank, 2021a).

Despite the decrease in 2020 (of around 36.6 percent for Zambia and 26.6 percent for the region), interest expenses are expected to intensify post-crisis (World Bank, 2021a, 20021b). The expected increase in external debt servicing costs will reflect the pandemic-triggered accelerated growth of external liabilities, the avalanche of procyclical downgrades, as well as the expiration of temporary relief measures that have been extended to vulnerable countries under the G-20 Debt Service Suspension Initiative (DSSI) and IMF Catastrophe Containment and Relief Trust (CCRT) (IMF, 2021b). These costs would further constrain African

32 Even before the pandemic outbreak in 2020, 32 African governments were paying more on external debt servicing than on healthcare, according to Jubilee Debt Campaign (Taylor, 2020).

policymakers’ capacity to support the post-crisis recovery underpinned by accelerated digitalization and a shift towards climate-resilient growth models.

Preliminary estimates of financing needs in the developing world are highly indicative. Across Africa, low-income countries are projected to face additional external funding needs of around $245 billion between 2021-2025 (IMF, 2021b). For the whole region, the overall resource envelope—in other words, the maximum limit for expenditure in upcoming national budgets based on expected revenues and deficit and debt targets—is significantly more important, largely exceeding the financial resources that can be generated domestically by improving efficiency in resource mobilization in the short term or by tapping into the global pool of external financing without further eroding countries’ debt sustainability profiles under the current default-driven borrowing rates.

In light of shrinking financing from official creditors—especially of official development assistance (ODA)—in the face of rising development financing needs, the diversification of funding sources and increasing reliance on debt capital markets for development financing appears irreversible. After the sharp tightening of global financing conditions triggered by the pandemic, several countries have returned to international capital markets. The year 2021 could set yet another record in the issuance of sovereign bonds in the region, especially with relatively few principal repayments falling due this year (IMF, 2021b; Griffith-Jones, 2021).

In this context, perception premiums must be adjusted to reflect the genuine risk levels but also the global financing environment of quantitative easing monetary policy that has pushed yield to maturity on eurobonds to historically low levels in advanced economies (ECA, 2020a; Wheatley, 2021); otherwise, African sovereign and corporate entities will perpetually face the looming threat of debt overhang, not because they are borrowing too much, but because they are overburdened by default-driven rates (Soto, 2020; Collier, 2020; Fofack, 2021a; Gabor, 2021).

VI. Path to structural transformation

The increasing costs of development financing are undermining the management of the COVID-19 response in the short term and curtailing the supply of development financing for long-term projects and structural transformation by setting unrealistically high expected returns on investment. By raising countries’ risk premiums and ringing investors’ risk-aversion bells, the avalanche of pro-cyclical downgrades could undermine access to the development financing that would support the diversification of sources of growth and trade. Higher premiums will raise the costs of borrowing on international capital markets, and the cold shoulder from investors will diminish demand for African public assets. Prevailing regulations either prohibit investors from holding sub-investment grade securities, or generally deter such investments by requiring that extra capital be held against those securities.

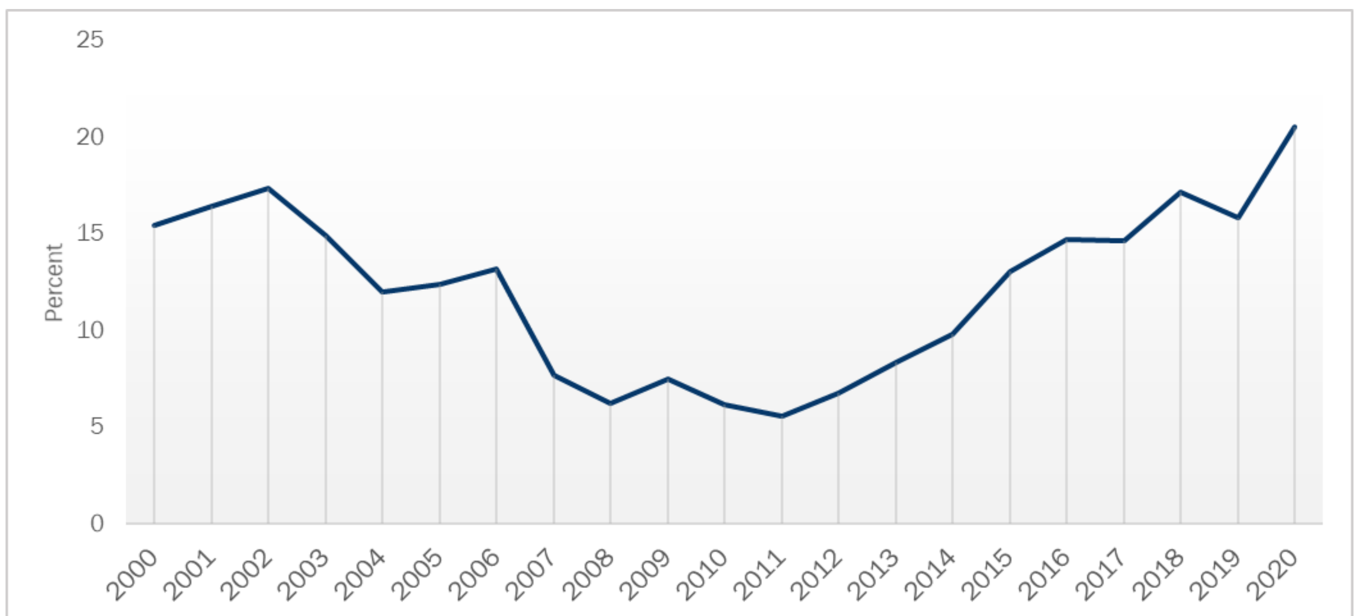
These premiums are major hurdles on the road to fiscal and debt sustainability and structural transformation of African economies (ECA, 2020a; Fofack, 2021a). Although the total external debt owed by Africa to its external creditors is significantly lower (both in absolute and per capita terms) than that owed by advanced economies, the ratio of its external debt service payments to revenues is significantly higher, reflecting the high cost of default-driven rates that constrain growth and heighten debt service payments.

The disproportionately high borrowing costs incurred by African governments are largely the consequence of high perception premiums (Olabisi et al., 2015; Collier, 2020; Mutize and Nkhalamba, 2021). These undermine access to finance and have been doubly damaging during these times of heightened global volatility and widening fiscal and current account deficits. There besides, they raise the overall costs of investment by hiking interest rates and can increase the risk of default, setting countries perceived as riskier on a self-fulfilling path to debt overhang (Ferri et al., 1999; Griffith-Jones, 2021).

Zambia was one of the first African countries to engage in debt restructuring with private creditors and bondholders when the rising scope of social expenditures and liquidity constraints associated with the pandemic downturn constrained its fiscal space (IMF, 2021b; Collier, 2020). Nearly 50 percent of Zambia’s external debt is owed to non-official creditors and bondholders, which tend to extend loans on higher interest rates compared to concessional and official creditors (World Bank, 2020b, 2021b). Still, beyond setting unrealistic expectations for growth and returns on investment, the higher borrowing costs magnify the risk of sovereign defaults by raising governments’ debt burdens and constraining income growth.

African governments’ external debt payments as a percentage of revenue steadily declined at the start of the century, with the average falling from around 18 percent in 2000 to less than 5 percent at the turn of the decade. This process commenced after the accession of eligible countries to debt relief under several complementary initiatives, such as the 1996 Highly Indebted Poor Country (HIPC) initiative, the 1999 Enhanced HIPC, and the 2006 Multilateral Debt Relief Initiative (MDRI). The percentage remained relatively low—in the single digits—until 2014, but has risen rapidly since, with a growing number of governments increasing their external liabilities to cope with both fiscal and current account deficits following the sharp deterioration of commodity terms of trade after the end of the commodities “super-cycle” in 2014-2015 (Figure 5).

Figure 5: Governments’ external debt payments as a percentage of revenue (%)



Sources: World Economic Outlook April 2021 Database; International Financial Statistics; International Debt Statistics; Economist Intelligence Unit; Afreximbank Research

The commodity terms-of-trade shock is one of the main channels through which the pandemic-induced downturn has affected African countries and their debt profile, with the combined drastic cut in global demand and the commodity price shock further constraining resources and liquidity (IMF, 2020b; Afreximbank, 2020).[33] Growth on the continent remains highly correlated with commodity price cycles, and the pandemic-induced terms-of-trade shocks have increased the scope of Africa's external liabilities, with most countries seeking international assistance to cope with widening fiscal and current account deficits.[34]

Over the last several years, negative commodity terms-of-trade shocks have been the main driver of Africa's macroeconomic and sovereign debt challenges. Despite ongoing efforts to diversify its sources of growth and trade, Africa remains the world's most commodity-dependent region (Fofack, 2015, 2019; UNCTAD, 2021b): In the most recent edition of its biennial Commodities and Development Report 2021, UNCTAD classified 45 African countries as commodity dependent (UNCTAD, 2021b). The continued excessive dependency of the region on primary commodities and natural resources for fiscal revenues and foreign exchange earnings partly reflects the stickiness of the development model of resource extraction installed by former colonial powers (Fofack, 2019).[35] The region's exposure to recurrent commodity terms-of-trade shocks, which tend to raise twin deficits and worsen liquidity constraints, have also inflamed the high-risk perception premiums.

Structurally transforming African economies to diversify sources of growth and trade will reduce this risk over time (Fofack, 2020, 2021a). Such an effort will require, as French President Emmanuel Macron and IMF Managing Director Georgieva have rightly stressed, injecting large and sustained sums of patient capital to drive investment beyond the realm of natural resources and primary commodities. However, the default-driven rates and high perception premiums are, in all likelihood, the most acute obstacles on the path towards such structural transformation. These must be addressed urgently with robust, coordinated efforts to change the risk/return profile of African assets and embolden sustainable development and debt sustainability in Africa to promote global financial stability.

VII. Fostering transparency, consistency and appropriate regulation

The international community moved quickly in responding to the crisis and several initiatives were enacted to help low-income countries deal with heightening balance of payment pressures and liquidity constraints after the outbreak of the Covid-19 pandemic. The G-20 DSSI, which reprofiled principal and interest payments falling due for DSSI-eligible countries, provided $1.8 billion in the form of temporary debt-service payment relief (but not forgiveness) between June-December 2020 and offered $4.8 billion in savings between January-June 2021 (IMF, 2021b).[36]

33 IMF forecasts suggest that across Africa the negative effects of the COVID-19 pandemic downturn will be particularly hard on commodity-exporting countries and tourism-dependent economies (IMF, 2020b).

34 IMF's lending to Africa under its Rapid Credit Facility and Rapid Financing Instrument increased dramatically after the outbreak of the pandemic to exceed $25 billion in 2020, from an annual average of $3.5 billion over the previous three years.

35 https://www.brookings.edu/blog/africa-in-focus/2019/01/31/overcoming-the-colonial-development-model-of-resource-extraction-for-sustainable-development-in-africa/.

36 On April 7, 2021, G20 bilateral official creditors agreed to a final extension of the DSSI by 6 months through end-December 2021.

The IMF has been particularly bold and swift in its response and support. Through its CCRT, it granted debt service relief in 2020 to its most vulnerable members, including 22 African countries and recently extended support under the program until October 2021 (IMF, 2021b). Moreover, the decision by the IMF board to proceed with an allocation of special drawing rights (SDRs) will uniformly boost the reserves of all members and further reduce the pressure on balance of payments to enhance countries’ ability to cope with the fallout of the COVID-19 pandemic downturn (Stiglitz, 2020; Fofack, 2021c).

In the short term, these initiatives are likely to reduce the overall costs of external debt service payments and bolster eligible countries’ capacity to deal with the fallout from COVID-19, as well as recover faster and better. However, several countries, including those at high risk of debt distress, such as Ghana, chose not to apply to the DSSI in order to preserve market access and to avoid potential downgrades by rating agencies (Gabor, 2021; Griffith-Jones, 2021; World Bank, 2020b).[37] In addition to their limited coverage, these initiatives do not address Africa’s fundamental development challenges—the high cost of perception premiums for macroeconomic management and the need to diversify sources of growth to boost intra-African trade and enhance integration into the global economy.

Until steps are taken to transcend historical biases and the one-size-fits-all approach to risk assessment, as well as to integrate Africa’s brightening realities and diversity of circumstances (growth prospects, stage of development and economic complexity) into sovereign risk models, the region—in spite of accounting for the lowest share of global sovereign debt—will, more often than not, be on the verge of debt distress because it is paying too much interest on its relatively low and even marginal stock of external debt (ECA, 2020a; Fofack, 2021a; Griffith-Jones and Carreras, 2021a). The combined external public debt stock of Africa, which accounts for around 17 percent of the world’s population, is less than 1.5 percent of the total global sovereign debt, which was about $73 trillion at end-2019 and will be significantly higher after the extension of disproportionately larger discretionary fiscal support by advanced economies (IMF, 2021d).[38]

For decades, Africa has been a proving ground for economic reforms. In fact, over the last several years, countries throughout the region have implemented many arduous measures, including highly unpopular internal adjustments such as public sector downsizing and retrenchment, drastic wage cuts in the public sector, and large subsidy cuts (Rodrik, 2006; Akinola, 2020). Its default-driven rates and ruinous perception premiums are neither justified by prevailing macroeconomic fundamentals nor by countries’ growth prospects, especially in light of tremendous potential associated with the AfCFTA, both for the diversification of sources of growth and exports (Georgieva, 2019; World Bank, 2020c; Fofack, 2021a).

They are not even justified by the global economic and financial environment of global interest rate convergence towards the zero-lower bound in light of QE programs implemented by systemically important central banks. These have become entrenched as the “new normal” for monetary policy, as was affirmed by the new policy framework unveiled by the U.S. Federal Reserve in 2020 (Powell, 2020).[39] That new policy framework embraced an average 2-percent

37 The government of Ghana will forgo a combined short-term relief of $735 million (extended to most vulnerable countries in the form of a temporary suspension of debt service payment) under the G-20 DSSI (World Bank, 2021c).

38 The most indebted economies in the world are also the richer ones. The top three borrowers in the world—the U.S., China, and Japan—account for a sizable share of global sovereign debt. For more details, see https://blogs.imf.org/2021/02/01/the-pre-pandemic-debt-landscape-and-why-it-matters/ (IMF, 2021d).

39 For more details, see https://www.federalreserve.gov/newsevents/speech/files/powell20200827a.pdf.

inflation target that would include periods of overshooting. More recently, the new monetary policy strategy of the European Central Bank, which adopted a symmetric inflation target over the medium term early in the second half of 2021, has also been consistent (ECB, 2021).[40]

The benefits of adjusting perception premiums and “levelling the playing field” to achieve “fairer financing rules” for African corporate and sovereign entities are manifold and substantial. Narrowing the gap between actual and perceived risk in the short term will set Africa on a path towards fiscal and debt sustainability (Presbitero at al., 2016; Stiglitz, 2020; Fofack, 2021a). It will reduce the cost and raise the supply of trade finance, which globally supports more than 80 percent of trade flows annually and will be critical for the post-crisis recovery. Doing so will also raise returns on investment and sustain the supply of development finance, as well as buttress long-term investment to tackle supply-side constraints and diversify the sources of growth to hasten the implementation of the AfCFTA.

Accelerating the AfCFTA’s implementation will boost productivity and regional competition to change the patterns of growth and trade, while also addressing Africa’s perception premiums in a region where the credit rating-negative correlation between growth and the commodity price cycles has been one of the most important risk drivers. At the same time, economies of scale associated with the implementation of the AfCFTA will help shift the composition of FDI to support the development of regional value chains and reduce the region’s exposure to recurrent adverse commodity terms-of-trade shocks (IMF, 2019; Fofack, 2018b, 2020; WEF, 2021). Likewise, it will enhance integration into global value chains, the leading drivers of growth and trade, to accelerate global income convergence.[41]

To stay on the existing path, that of Africa being stymied by overinflated risk perceptions, will only impede any meaningful attempts at structural transformation and delay the convergence to higher levels of per capita income. That is an outcome that no nation, African or otherwise, can countenance.

The Paris 18 May summit was an important step in the recognition of development challenges associated with high perception premiums. In addition to exploring financing options to help the most vulnerable countries cope with the humanitarian, social, and economic crises triggered by the COVID-19 pandemic, the summit provided the opportunity to mobilize the international community in the search for market-based solutions for sustainable development financing flows into Africa.[42] To this end, the summit made several recommendations, including:

(i) Leveraging the international financial system to create much-needed fiscal space for African economies;
(ii) Improving country data and information architecture to address information gaps for greater transparency and consistency;
(iii) Developing and reinforcing relevant risk-sharing instruments (including guarantees and political risk insurance) to mobilize more private financing into Africa;

40 For more details, see https://www.ecb.europa.eu/home/search/review/html/ecb.strategyreview_monpol_strategy_overview.en.html.
41 According to World Bank and IMF estimates, the AfCFTA will significantly boost intra-African exports and Manufacturing exports are expected to see the greatest gains (IMF, 2019, World Bank, 2020c).
42https://reliefweb.int/sites/reliefweb.int/files/resources/Summit%20on%20the%20Financing%20of%20African%20Economies.pdf

(iv) Swiftly implementing the general allocation of IMF SDRs to increase reserve assets of African countries;[43]

(v) Promoting more flexibility on debt ceilings by supporting the shift towards an intertemporal approach to fiscal deficit;

(vi) Supporting the development of well-functioning markets for government debt, including tools to improve their access and liquidity, inter alia by exploring the feasibility of a liquidity and sustainability facility; [44] and

(vii) Encouraging a shift toward the adoption of sustainable financing practices, both on the side of borrowers and creditors.

The implementation of these recommendations could have significant implications for the sustainable development of African economies and their access to international finance. In effect, some of these measures have the potential to de-risk African assets' partnership with institutional investors and will go a long way towards lowering borrowing costs and stimulating demand for African debt.

However, reshaping misperceptions about the credit risks for African corporate and sovereign entities and changing the risk/return profile of African assets hinge on transforming the international financial architecture. The international community must continue to compel investors and policymakers the world over to collaborate proactively to foster transparency and eventually equalize opportunities in accessing the large and always-expanding pool of global financial resources. Interestingly, a seminar organized by the Africa Group at the IMF Board in May 2021 to explore options for reducing "Africa risk premium" and financing costs invited governments to urge international financial institutions to engage regulators to motivate them to go beyond "ticking checklists," challenging them to ensure evenhanded treatment with methodologies applied evenly across regions.[45]

Reshaping misperceptions around credit risks and changing African assets' risk/return profile also hinges on fostering consistency and improving oversight of credit rating agencies. This action must be taken at the global level in order to curtail these agencies' biases against emerging market economies—especially African entities, both sovereigns and corporates (Fofack, 2021a, 2021b; Griffith-Jones, 2021)—and ensure their risk assessment models are not pro-cyclical, and instead capture debtors' long-term perspective. Strengthening African regulators' capacity to effectively regulate these rating agencies will complement international efforts and accelerate the convergence towards greater transparency and accountability.

An historical overview of global downturns, including the COVID-19 crisis, reveals that "quick-fire downgrades" of corporate and sovereign entities have been less pronounced in advanced economies, despite the significant deterioration in their public finances. This trend partly reflects the effectiveness of oversight functions and the power of sanctions carried out by the supervisors regulating the rating industries in these countries. Over time, the threat of sanctions and inherent penalties have been a major deterrent, with the industry being held to

43 Collectively, African countries are expected to receive $33 billion from the unconditional general allocation of $650 billion. Leaders attending the Paris summit also made the commitment to magnify the impact of SDR allocation for Africa by exploring, on a voluntary basis, on-lending of SDRs to the Poverty Reduction and Growth Trust (PRGT). For more details, see https://reliefweb.int/sites/reliefweb.int/files/resources/Summit%20on%20the%20Financing%20of%20African%20Economies.pdf

44 Under the Liquidity and Sustainability Facility (LSF) proposed by UNECA, investors would finance their African sovereign debt holdings with LSF repo loans, which are cheaper and will stimulate further demand for African sovereign debt and eventually lower borrowing costs. For more details see ECA (2020) and Gabor (2021).

45 For more details, see IMF (2021c).

higher standards of accountability as a result (Griffith-Jones, 2021).[46] Improving the supervision of these entities in both developed and developing economies will heighten their accountability globally and ultimately mitigate systematic bias in their approach to credit risk assessment.

Such efforts to strengthen regulatory oversight should be augmented by similar measures to accelerate the diversification of sources of growth and exports with a view to reducing the credit rating-negative correlation between growth and commodity price cycles. While the rules of origin underpinning the AfCFTA has the potential to crowd-in private capital to hasten industrialization (UNCTAD, 2019; IMF, 2019[47]), especially as companies take advantage of preferential duty treatment and economies of scale to spread the risk of investing in smaller markets across the continent, boosting the capital base of multilateral and regional development banks is critical (Griffith-Jones, 2016; ECA, 2020b; Ocampo, 2021). This is especially true in Africa, where large infrastructure financing gaps have long constricted productivity growth and the expansion of processing capacities to increase the production of manufactured goods and boost cross-border trade.

Public development banks have played a crucial role in the structural transformation and diversification of exports in other parts of the world (Griffith-Jones and Ocampo, 2018; Griffith-Jones and Carreras, 2021b), most notably in Asia and Europe.[48] In addition to providing at sufficient-scale long-term capital and more risk-tolerant lending to finance investment in the critical sector of infrastructure to boost productivity and accelerate structural transformation, they have also drawn on counter-cyclical financing to soften economic blows during downturns and expand prosperity during upturns. Furthermore, by supporting the deepening of domestic capital markets to diversify funding sources and reduce foreign currency risks, these banks have also assuaged liquidity constraints to sustain economic expansion, emerging as important instruments for both economic development and crisis management.[49]

VIII. Conclusion and recommendations

The pandemic downturn has heightened one of the most important challenges facing Africa on its treacherous development path—the high costs of perception premiums. While the synchronized nature of the pandemic downturn offers an opportunity to scrutinize the extent to which perception premiums are shaping the distribution of sovereign risk across countries and regions, the disproportionately larger number of African countries affected by procyclical downgrades further supports the Africa premium hypothesis.

In the short term, these premiums heighten the risk of debt overhang and constrain fiscal space, undermining governments’ capacity to respond effectively to recurrent adverse

46 For instance, S&P paid a fine of US$1.5 billion to the US government in 2015 to settle the case brought against it in 2013 by the US Department of Justice. Although sovereign ratings were not the underlying impetus for the case, S&P said at the time that it viewed the lawsuit as ‘retaliation’ for having stripped the US of its ‘triple-A’ rating two years earlier. The US has enjoyed that rating since then, and even the deterioration in its public finances after the outbreak of Covid-19 did not affect the rating. Similarly, rating analysts from several agencies were tried in an Italian criminal court for ratings downgrades enacted during the eurozone crisis (Griffith-Jones, 2021).

47 The originating clause has been the centerpiece of all trade agreements and will shape the patterns of growth during the implementation of the continental trade agreement and determine the scope of gains.

48 For instance, the China Development Bank, the largest public development bank in the world, has been the key financier of China’s five-year strategic plans (Griffith-Jones, 2016; Griffith-Jones and Ocampo, 2018).

49 Through long-term lending and financing of credit-rationed sectors and industries, these banks have also alleviated market imperfections prevalent in the private financial sector.

shocks—as the challenges associated with the management of the COVID-19 crisis have illustrated. While the significantly lower interest rates—negative in real terms—have enabled advanced economies to navigate the pandemic downturn effectively by extending large monetary and fiscal stimulus, the growth-crushing and default-driven borrowing rates on African assets have set the stage for a divergent recovery and are heightening the risk of debt overhang.

These premiums also have wide-ranging consequences for macroeconomic management and sustainable development in the long run. By deterring investors, they heighten liquidity constraints in the short term; and by limiting access to long-term financing, they undermine the process of economic transformation necessary for Africa's effective integration into the global economy, ensnaring countries in a perpetual debt-distress trap that threatens global financial stability.

The Paris summit held on May 18 was an important step in fostering the emergence of a global financial architecture that promotes transparency and fairer rules to equalize access to long-term development financing. The summit made several recommendations in that regard. However, a strong commitment by and effective coordination among stakeholders will be critical for the emergence of an international financial ecosystem that fosters a globally inclusive approach to affordable development financing.

In African nations, governments should intensify ongoing efforts to improve information architecture, deepen economic and institutional reform programs, and accelerate the implementation of the AfCFTA to drive the diversification of sources of growth and exports and broaden the tax base. For example, as the pandemic unfolded, Fitch, in a dramatic "multi-notch move," downgraded Gabon's sovereign rating to CCC from B, largely on the grounds that falling oil prices would widen the country's twin deficits and undermine the government's capacity to honor commitments to external creditors (Haroon, 2020). Standard & Poor's downgraded Botswana, a leading diamonds exporter and the only African country with an A-rating, for the same reason (Dumaual, 2020). Economic diversification will reduce the unhealthy correlation between growth and commodity price cycles and irreversibly boost the growth of foreign reserves and government revenues to put the region on the path towards long-term fiscal and debt sustainability, both of which are credit rating-positive.

But to extricate Africa from this vicious cycle—one in which the colonial development model of resource extraction is both a risk driver and a deterrent to long-term development financing—African sovereign risk models must integrate the diversity of African countries and their brightening economic outlook. Low debt-to-GDP levels and robust economic growth should be positively correlated with sovereign credit scores for greater consistency and enticements on the path towards macroeconomic reform. As strong economic reformers are rewarded by increasing access to sustainable development financing, incentives for more countries to embrace difficult reforms could follow, kickstarting a virtuous cycle of growth acceleration fueled by globally competitive access to affordable development financing.

Simultaneously, rating agencies should refrain from procyclical downgrades, which often trigger sudden stops and reversals in capital flows in a "flight to quality," and instead capture a debtors' long-term perspective. By increasing the costs of borrowing and heightening liquidity constraints, procyclical downgrades can prolong and even deepen economic crises (Ferri et al., 1999). For instance, by heightening balance of payment pressures and undermining investment growth, persistent liquidity crises can morph into long-lasting

solvency crises with a cascade of defaults. Fostering transparency and strengthening coordination between the IMF and credit-rating agencies will ensure greater consistency and transparency, and gradually alleviate the perception gaps driving procyclical downgrades and Africa’s ruinous premiums.

While sovereign credit ratings have a direct impact on an affected country’s ability to mobilize long-term financing, the consequences of large-scale procyclical credit-rating downgrades can be far-reaching, with potential risks for international financial stability. A globally coordinated approach that fosters accountability and transparency in the production of consistent estimates of sovereign risks will be more effective in regulating the business practices of rating agencies. Such a body could follow the models set by the U.S. Securities and Exchange Commission and the ESMA, which already monitor these practices in their respective jurisdictions.[50] Except for South Africa, which assigned its Financial Services Board (now split, as of 2018, into its Prudential Authority and Financial Sector Conduct Authority) to administer the Credit Rating Services Act 2012 and oversee the operations of credit-rating agencies, no other country in the region has a similar structure.

In the medium- and long-term, the development of domestic capital markets that are deep, efficient, and well-regulated will be vital for diversifying funding sources and reducing liquidity and foreign currency risks. These markets will reduce the dependency on foreign currency debt and improve countries’ ability to withstand volatile capital outflows, as witnessed at the height of the COVID-19 pandemic downturn. They will provide a secure and stable source of financing, while also helping countries build proper yield curves to improve investment decisions and sustain them on a long-run trajectory of robust economic growth. Domestic capital markets also have the potential to increase the effectiveness of monetary policy and eventually set countries on the path of cyclical improvement in liquidity and borrowing costs.

That being said, making progress on the development of vibrant local-currency government bond markets in Africa will require transcending national constructs to integrate fragmented and highly illiquid financial markets to mirror the game-changing continental trade integration reform underpinned by the AfCFTA. Thereafter, the emergence of a continental financial ecosystem that fosters the development of a money market to provide short-term liquidity to governments, commercial banks and other large institutions—as well as a vibrant repo market—to provide collateralized interest-bearing loans to meet short-term funding and liquidity will be the next critical piece of economic stability and sustainable development financing puzzle in Africa.

Notably, while a vibrant money market is a necessary condition for the emergence of successful and liquid securities markets, the development of a local repo market is key to enhancing the money and bond market nexus. Still, success in the development of local sovereign bond markets also hinges on intensifying reforms to improve Africa’s regulatory and policy environment and foster policy consistency.

The perceived quality of the institutional setting, which has been singled out as a key driver of market access, is credit rating-positive. When combined with the diversification of sources of growth and exports, which will reduce the correlation between growth and commodity price

50 The credit rating agency Reform Act passed by the US Congress in 2006 mandated the US Securities and Exchange Commission to regulate the business practices of rating agencies, their record keeping and internal operational processes. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 further expanded the regulatory power of the SEC to enforce full disclosure of the rating methodologies. For more details see https://www.congress.gov/111/plaws/publ203/PLAW-111publ203.pdf

cycles and cultivate Africa’s foreign reserve assets, this will act as a credit rating enhancer and multiplier, putting the region on a long-run trajectory of fiscal and debt sustainability. Over time, that mutually reinforcing combination of institutional reforms and diversification of sources of growth will stimulate global demand for African assets and gradually narrow the credit spreads of African issuers of sovereign and corporate bonds to equalize access to the global pool of financial resources and unlock competitive global capital for sustainable economic development.

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