African countries aren't borrowing too much: they're paying too much for debt

By Misheck Mutize

20 Feb 2020

There is renewed concern about the sustainability of rising debt levels in many African countries. Much of this debt is being incurred through foreign currency denominated Eurobonds issued on international financial markets. The total value of Eurobonds issued between 2018 and 2019 was more than the value of all bonds sold between 2003 to 2016.

Ethiopia's economic growth hovered between 8%-11% for over 10 years but its sovereign credit rating has not been upgraded Shutterstock

African governments are issuing and listing their Eurobonds on established international debt markets – usually London and Irish Stock Exchanges. African governments would venture offshore a lot less if domestic bond markets were active and liquid. But besides South Africa, African bond markets are largely underdeveloped with inactive and illiquid secondary markets. This makes it difficult to attract international investor participation locally.

The International Monetary Fund (IMF) believes that African countries are on a Eurobond issuing spree and half of them are near or at distressed levels. It argues that African governments are piling on debt without evaluating the exchange rate risks and the real costs of repaying the debts.

But, in my view, the debt alarm being set off by international debt management organisations is exaggerated. The problem is not that African countries are borrowing too much, but rather they are paying too much interest. There are a number of reasons for this, including badly informed ratings by rating agencies, as well as the behaviour of issuers.

There are solutions. But these require African governments to stand up and take action.

Doing the calculations

There are two key elements that are taken into account in assessing a country's debt burden. One is the level of debt based on the ratio of debt to gross domestic product (GDP). The other is the cost of servicing the debt – interest payments.

Debt levels on the continent, for example, are on average way below the 100% debt-to-GDP ratio mark. But the impression created is that they are much higher. This exaggerated perception of African debt levels has resulted in countries paying higher interest rates on debt. The premiums are much higher than those paid by other countries. In my view these are not justified by the risk profile of African countries.

Save for four countries — Cape Verde, Djibouti, Congo and Mozambique — all the other African countries have debt-to-GDP ratio averaging 60%. A debt-to-GDP ratio of 60% is the IMF's and African Monetary Co-operation Program's threshold for prudent debt levels.

The scale of debt issuances in Africa amounts to only 1% of the continent's total GDP annually – whose average annual growth rate is 4%. In simple terms, this means the value of income generation is higher than the rate of government debt accumulation. These ratios gives a snapshot of the a country's fiscal sustainability.

On the contrary, the amount of interest expenditure has been disproportionate to the debt-to-GDP ratio. Studies show that in developed economies, an increase of 1% in debt-to-GDP ratio is associated with an increase of between 0.02% and 0.03% in interest rates.

African governments are paying interest of 5% to 16% on 10-year government bonds, compared to near zero to negative rates in Europe and America. On average, the interest repayment is the highest expenditure portion and remains the fastest growth expenditure in sub-Saharan Africa's fiscal budgets.

The rising interest rates on Africa's debt should be of major concern. African countries are shortchanging themselves by accepting high yield curves in their Eurobond Initial Public Offerings. This unjustifiably cements the perception that they are high-risk issuers.

The drivers

The high interest rates are driven by several key factors. First, the mismatch between the short-term duration of the debt that African governments have taken on by issuing Eurobonds compared to the long-term nature of the infrastructure projects they propose to fund with the money raised through Eurobonds. The excessive need to attract investors is forcing African governments to borrow short-term to finance long-term projects.

Second, fungibility of Eurobonds proceeds – flexibility to be utilised for purposes other than the ones they were raise for – exposes the funds to the downside vulnerabilities of misappropriation and nonproductive expenditures.

Third, poor credit ratings as the majority of countries are in junk status. Credit ratings are pivotal in determination of both interest rates and the demand for bonds.

The weaknesses of rating agencies' risk assessments have widely been criticised. According to sovereign credit methodologies of the big three rating agencies, economic growth is a decisive factor in past sovereign credit events. There is a strong positive correlation between economic strength and credit worthiness. But in Africa high economic growth has not translated into better sovereign ratings.

Despite consistent positive economic growth averaging 3.6% among 32 rated African states, data show that the number of downgrades and negative outlooks are almost double that of upgrades and positive outlooks. This implies that African countries are now worse off than they previously were. This overlooks the continent's significant progress in governance, economic growth and human development over the past years.

Take Ethiopia. It has a current economic growth of 8.5% and has been hovering between 8%-11% for over 10 years. But it has not had a single upgrade activity from any of the three international rating agencies.

Senegal, one of Africa's most stable countries, experiencing three peaceful political transitions since its independence in 1960, has maintained an economic growth averaging 6% over the past 10 years. It still remains in junk status rating.

Some of what drives higher interest rates also rests with Africa governments. For example, a lack of sufficient information about the specific 'use of proceeds' in prospectuses during Eurobond Initial Public Offerings is magnifying the risk of fiscal indiscipline. It means that funds have no conditionalities or any lines of accountability.

It is also the case that governments use the money they raise on loss-making projects and nonproductive fiscal expenditure. Two examples illustrate the point: the failing Kuraz mega sugar project in Ethiopia was funded from the 2014 Eurobond as was the Kenyan Standard Gauge Railway (SGR) which is failing to stimulate any new economic activity.

Solutions

African countries can act to address the rising interest burden, and to avert falling into a debt trap through the following mechanisms:

- Governments should use the money raised to fund profitable projects and use the profits from these projects to repay interest owed.
- Governments must take control of the bond issuance process during the bond structuring stage. They must exercise their choice of accepting or rejecting investors' bids. It is imperative for African countries to structure bonds with favourable yields and tenure. This process should not be entirely renounced to syndicates of lead-managers, originators and investment banks. The oversubscription of recent Eurobond issues – Eurobond issuances have been oversubscribed by three times on average – simply shows that demand is outweighing supply. Countries should manage lead issuance advisors to negotiate for the lowest interests possible to be saved from unnecessary costs.
- Governments should bargain for competitive interest rates and accept only favourable bids.
- Governments should borrow for productive expenditure and manage proceeds from international bonds more prudently with integrity and transparency.
- African countries should establish a continental position, adopt international standards and guidelines to establish lines of accountability in rating agencies. This will create a platform to enforce adherence to scientific rating methodology, rating appeals, regulating rating agencies and sufficient involvement of rated countries in the rating process.

ABOUT THE AUTHOR

Msheck Mutize, lecturer of finance, Graduate School of Business (GSB), *University of Cape Town*