Policy Brief N° 8 May 2019

ACROPOLIS
BeFinD
Belgian Policy Research Group on Financing for Development.

African Eurobonds: why we should (not) worry!

Christian Senga
Institute of Development Policy (IOB)
University of Antwerp

Danny Cassimon
Institute of Development Policy (IOB)
University of Antwerp

Introduction

Africa's sovereign eurobonds passed the $100-billion milestone in end-March 2019, with more than half coming from the Sub-Saharan Africa (SSA) region excluding South Africa. With its 500 million euros ($567 million) debut eurobond of March 19, 2019, Benin has been alongside Ghana (which touted a $3 billion deal at the same date) one of the first countries from the region to tap international markets this year and the 21st country of the region to do so since 2006.

Right from the beginning of the 21st century, the region has marked an impressive economic performance thanks to favorable commodity prices and notable improvements in its countries' macroeconomic stances at the completion of the Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Relief Initiative (MDRI) initiatives by the International Monetary Fund (IMF) and the World Bank. The implementation of these initiatives resulted in over US$100 billion debt cancellation for 30 SSA countries to address the then protracted and unsustainable issue of excessive external debt (Cassimon and Essers, 2017). From 1999 to 2016, the region recorded annual economic growth rates averaging to 4.6% from 1999 to 2016, next to the emerging and developing Asia (7.4%) and above Latin America (2%) and the world average of 3.4% for the same period (IMF, 2017). This SSA growth story has coincided with the rise of new economic powers such as the BRICs and other emerging economies that have intensified their economic presence in SSA providing considerable amounts of aid, loans and foreign direct investment (FDI) to strengthen their diplomatic and economic ties with the region. While the SSA region was experiencing a revival of economic growth, the world economy was suffering the consequences of the global financial and European sovereign debt crises of the mid-2000s

With the support of THE BELGIAN DEVELOPMENT COOPERATION .be

and early 2010s that caused global recession and protracted economic slowdown in advanced economies.

SSA was particularly affected in different ways: on one hand, it experienced direct negative effects due to shrinking exports revenues, FDI and foreign aid. This loss in revenues definitely deprived SSA from valuable resources for economic development fostering and poverty alleviation. On the other hand though, government stimulus packages meant to revive economic activity in advanced economies created more liquidity and thus resulted in unprecedented low interest rates in their domestic markets pushing investors to explore growth possibilities far afield their domestic environment including in frontier markets.

Since 2006, SSA countries (excluding South Africa) have taken this opportunity by issuing eurobonds one after the other in what Willem te Velde (2014) sees like a 'beauty contest' to mobilize financial resources through international capital markets. Parallel to that, they have market significant developments in their local currency bond market allowing the participation of both domestic and international investors (Essers et al., 2016). Altogether, the region has been indeed experiencing the 'age of choice' as coined by Prizzon et al. (2017) to indicate the expanding access of developing countries to a variety of development finance sources beyond official development assistance (ODA).

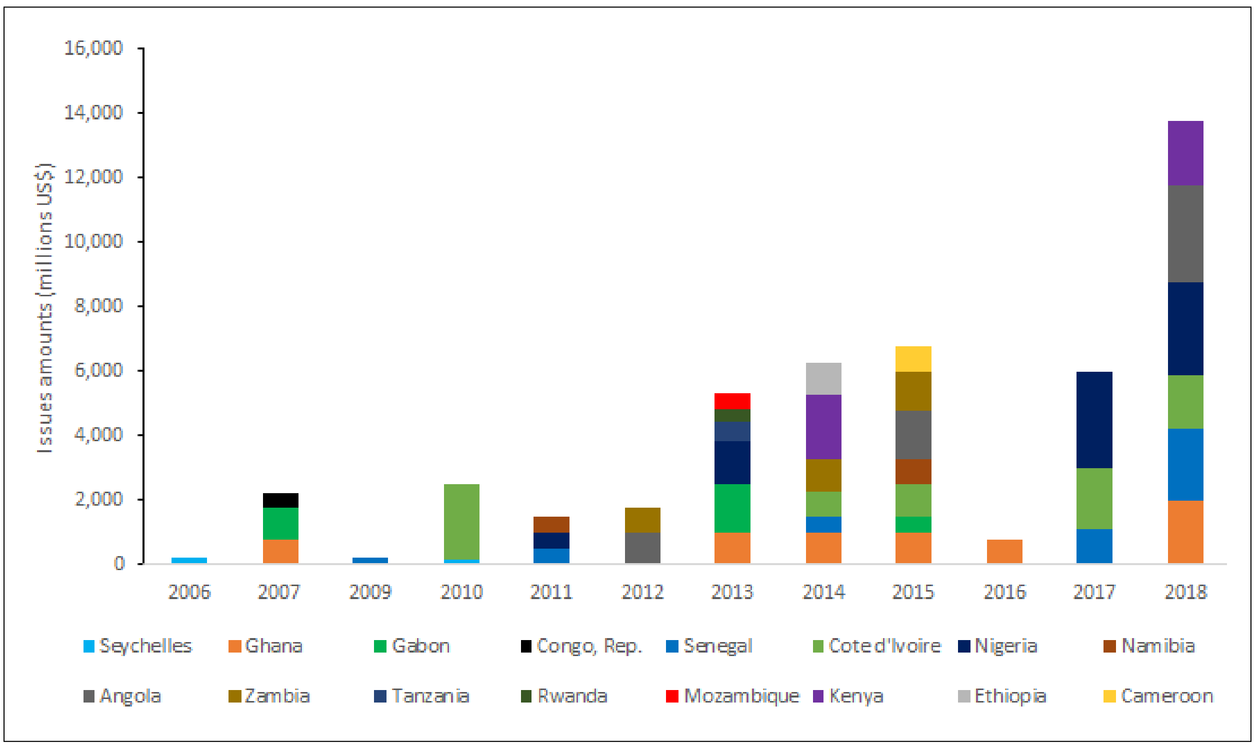


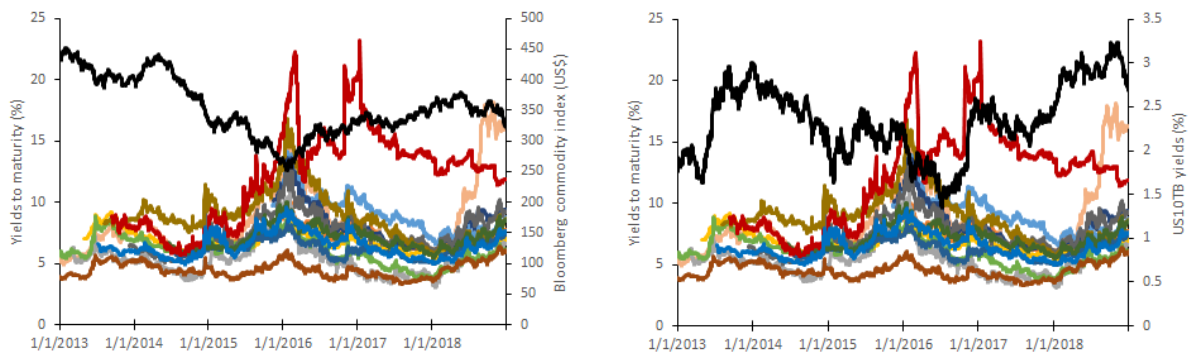
Figure 1: SSA eurobond issues

Fig. 1 shows that, from a timid start by Seychelles in 2006 until December 2018, SSA countries have raised over $47 billion through one of multiple eurobond issues. Over time, except the temporary halt of 2016, SSA eurobond issues have been increasing in sizes and maturities, which allows issuing countries to mobilize financial resources in favorable terms than the ones available in their domestic markets. The high appetite of international investors has as well been instrumental for these securities' success. To name a few, after the African eurobond spree that got issues from this countries such as Zambia in 2012, Rwanda in 2013, Cote d'Ivoire in 2015 and Ghana in 2016 receive order books of respectively 15, 8.5, 4 and more than 5 times their book sizes, recent issues by countries such as Kenya, Senegal and Egypt have been oversubscribed for respectively 7, 5 and 4 times their book sizes in 2018.

Nonetheless, this success of SSA eurobonds has been associated to the prevailing favorable global factors such as low interest rates in the developed world and high commodity prices, factors that are bound to change in the future and lie beyond these countries' span of control. Furthermore, this new wave of government external borrowings has been slowly but steadily reverting the post-HIPC decreasing trend in SSA public debt, thus rekindling the worries about the possibility of debt-crisis resumption in the region in the near future. This caution about the risk of the resurgence of a debt crisis in SSA is beefed up by the fact that there seems to be close similarities between the world economic conditions that prevailed before the debt crisis of 1980 and now, a situation that pushes some experts to look at the current appetite of international investors for these eurobonds with a sense of deja vu. In fact, FDIC (1997) reminds that capital flows from international financial system to Least Developed Countries (LDCs) were also pulled by the economic performance of 6% annual GDP growth on average in the LDCs and the need by these countries to finance the deficits caused by the oil prices rise of 1973-1974. These capital flows were pushed by the need by the international financial market to recycle the increasing Eurodollar funds supplied by oil-exporting countries (see FDIC, 1997, chap. 5), which looks quite similar to the current situation in many respects.

The responsibility of creditors in the defaults of sovereign borrowers is also mentioned by Eichengreen and Portes (1986) who links the 1980's debt crisis to the widespread defaults of the 1930's and say: "... Quite often, defaulting debtors were able to re-enter the international capital market only to default again, occasioning criticism of creditors for engaging in reckless lending ascribed to myopia or excessive competition"(Eichengreen and Portes, 1986, p.600). Hence, whether the development of the SSA sovereign eurobond market will end up triggering a new sovereign debt crisis in the region depends heavily on whether investors integrate the creditworthiness of SSA borrowers into their valuation of these securities.

As it is the case for all quoted fixed-income securities, SSA eurobonds quotes are provided at the highest possible frequency by markets where they are listed, which allows the computation of their secondary market yields at any time before their expiry. In essence, bond yields provide an indication on the confidence and interest of investors in a given debt instrument. Inversely related to the price of the instrument, yields represent the internal rate of return required by the investors to hold an instrument of a certain maturity and risk profile. A lower yield -hence higher price (expressed in percentage of the asset's nominal value)- signals a high demand by investors who are willing to buy the asset.



(a) SSA eurobond yields vs commodity prices (b) SSA eurobond yields vs US10 T-bond yields

Figure 2: Yields and global factors (in black)

Conversely, higher yields -hence lower prices- express a lack of enthusiasm by investors who can only consider buying the asset at a lower percentage value of its nominal price. Although not directly affecting the service of the ongoing debt, yield levels are good indicators of future borrowing costs should the issuer resort to a similar instrument to raise new funds. In light of the 'efficient market hypothesis', it is possible to monitor market participants' sentiment about the creditworthiness of SSA sovereign eurobond issuers through the evolution of these assets' secondary market yields, the underlying assumption being that, ceteris paribus, bonds with better profiles will enjoy higher demands, hence higher prices corresponding to lower yields. In this perspective, lower yields indicate a higher attractiveness of the bond while increases in yields suggest a shrink in the bond attractiveness, everything remaining equal elsewhere.

Global factors matter

Fig. 2 presents the evolution of SSA eurobond yields against global commodity prices (measured by the Bloomberg commodity index) and the global liquidity (measured by the US 10 year Treasury bond yields). Since a good number of these bonds' issuers depend on commodity exports, investors may be tempted to factor commodity prices evolution into the valuation of these securities by raising expectations about these borrowers' repayment capacity in time of favorable commodity prices, and inversely when the opposite materializes, which suggests an inverse relationship between SSA eurobonds and commodity prices everything remaining equal elsewhere. Likewise, interest rates on the US market provide indications of global liquidity while setting the benchmark for the valuation of financial assets. For instance, low US interest rates entail low yields on US fixed-income assets hence more liquidity at the global level, a situation that may be favorable -i.e. entailing lower yields- for markets that are less correlated with the US market should US investors explore opportunities for high yields far afield their domestic markets. SSA eurobond yields are therefore expected to have a positive relationship with yields on the US market.

Global macroeconomic conditions play a determinant role in the determination of African Eurobond yields as shown on Fig. 2a and Fig. 2b. It can be seen that, indeed, SSA eurobond yields have been inversely correlated with global commodity prices (Fig. 2a) and more especially how these yields were propelled to skyrocketing levels during the commodity crisis of 2015-2016. Also, a consistent increase in these yields in tandem with US T-bond yields can be observed in 2018 (Fig. 2b), increase that may arguably be attributed to the ongoing 'quantitative tightening' policy of the FED.

Macroeconomic fundamentals matter too

While global factors seem to explain the general trends in SSA eurobond yields' evolution, they fall short of explaining the observed difference in these yields' levels as well as their idiosyncratic reactions to common global shocks as shown on Fig. 3. This difference appears too significant to be ignored; it instead hints to the influence of country-specific factors that need to be taken into account in the explanation of these yields' determination and evolution. For instance, the graph shows that Namibia yields have consistently evolved around 5% despite the global economic turbulences while those of Angola, Ghana, Mozambique or Zambia shoot up to more than 10% during the oil prices trough of $2015-2016$.

Evidently, it is not random that, for instance, Ghana, Mozambique and Zambia were affected the most by the last commodity price crisis of end-2015. To start with, Ghana issued its debut sovereign eurobond in 2007 amid the discovery of oil and a rapid economic growth. However, several reports converge that the proceeds of the eurobonds were used to increase public sector salaries instead boosting infrastructure investments or undertaking the growth-accelerating reforms and thus generate extra revenues to service the debt. As a result, this country faced unsustainable pressure on its public finance that affected the value of the cedi, leaving no option but to return to the IMF for a three-year rescue package of US $1 billion in 2014.

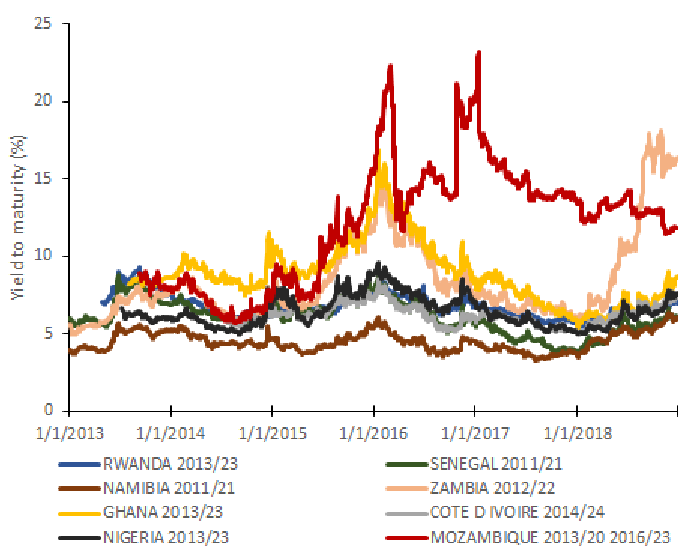


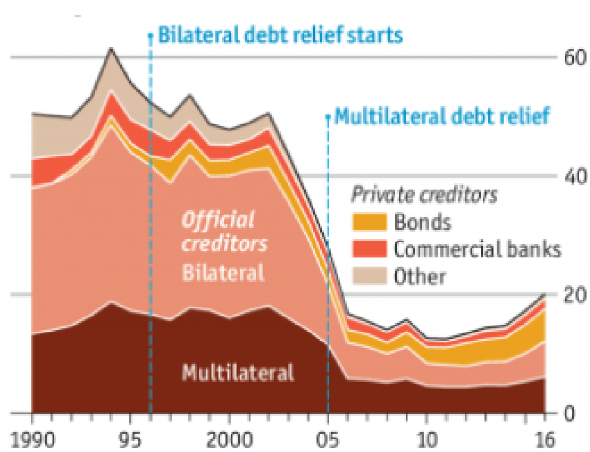
Figure 3: SSA eurobond yields

The Mozambique case is known to derive from a serious breach of trust and lack of transparency vis--vis its partners after the government admitted it had hidden over 1.4 billion US$ from the IMF and other investors. It is also reported that the proceeds of the 850 million US$ eurobonds issued by EMATUM with a government guarantee was spent on naval vessels and other security equipment instead of investments in the tuna fishing company. The suspension of aid disbursement by development partners as well as that of IMF interventions weighed heavily on the country's finances, casting doubt on its ability to service its debts.

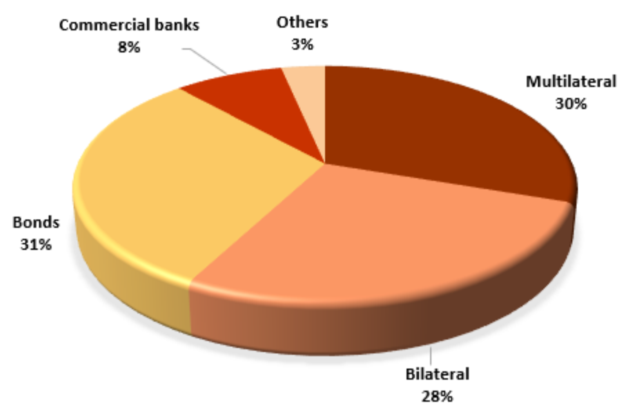
While Angola and Zambia suffered from their over-reliance on single commodity exports in the period 2015-2016, Zambia has since July 2018 been particularly hit by a series of credit rating downgrades to junk by the 'Big Three' credit rating agencies citing fast debt accumulation and fiscal deficits. This has sufficed to affect investors' sentiment that translated into exceptionally soaring yields for this country.

Overall, there seems to be substantial evidences of significant influence of these countries' country-specific factors on the performance of their respective eurobonds, thus indicating that financial markets factor the soundness of these countries' macroeconomic fundamentals in the valuation of these securities. This observation is underscored, among others, in empirical results by Senga et al. (2018) who find a predominant influence of country-specific factors over both global and bond-specific factors on the performance of these securities at secondary markets. The importance of sound macroeconomic fundamentals is also underscored in the propensity of idiosyncratic shocks to SSA eurbond issuers to spillover to their peers, with countries with strong fundamentals being more resilient to –and transmitting less– spillovers (Senga and Cassimon, 2019).

Public external debt on an increasing path!



(a) SSA public and publicly-guaranteed external debt (% GNI). Source: The Economist (March 2018)



(b) Public and publicly-guaranteed external debt composition 2017 (SSA excl. high income). Source: The World Bank (2019 International debt statistics)

Figure 4: SSA public and publicly-guaranteed external debt

Fig. 4a shows that the HIPC and MDRI initiatives have been successful in bringing progressively but drastically SSA public external debt to sustainable levels. However, there appears to be not only a reversal in this trend in the period after 2010 but also a readjustment in debt composition with respect to the creditors. Fig. 4b shows that, in 2017, SSA public external debt was dominated by eurobonds unlike the pre-HIPC era where it was mainly owed to bilateral and multilateral creditors.

The absence of conditionalities and the possibility to raise substantial amounts are some of the appealing features of eurobonds as compared to bilateral or multilateral funding opportunities. In some cases, African countries are reported to have resorted to international markets to circumvent high interest rates in their domestic markets or to take advantage of favorable market conditions to restructure their onerous debts by assigning more convenient terms to their issues. Eurobond issues are also considered as an opportunity for these countries to register on international investors' 'radar' as noted by Bertin (2016). Nevertheless, these seemingly advantages should not overshadow the detrimental effects of over-indebtedness that may still jeopardize development prospects in these countries. The case in point is Zambia which is reported to currently spend more on debt service than on education (The Economist, 2018).

Eurobonds in the dock?

Compared to their alternatives, eurobonds have been perceived to bear a certain number of risks and concerns that might be of serious concern in the particular case of SSA. One of them is that the redemption structure of many of these bonds expose issuers to serious financial risks at maturity especially in the case of 'bullet' bonds where the principal has to be redeemed in one payment. This is exacerbated by the diffuse structure of bondholding entailing a diversity of creditors with sometimes antagonist strategies and interests that might hinder the possibility of common agreement (collective action) in case of default and/or restructuring.

More than a decade down the road, the experience of SSA eurobonds provides an opportunity to assess the validity of these concerns and draw some lessons. On one hand, Gabon and Ghana have been able to redeem their debut 10 year eurobonds issued in 2007 for respectively US$ one billion and 750 million; the same as Nigeria which has successfully paid back its US$500 million 5 year eurobond issued in 2013. In addition to building a track-record and thus sending a positive signal to markets, these repayments soften somehow the concerns associated to eurobonds' redemption structures.

On the other hand, countries such as Angola, Congo Republic, Ghana, Mozambique and Zambia have at one point in time experienced a certain degree of market disapproval translated in abnormally high levels of yields. More specifically, Congo and Mozambique even fell into the default territory by failing to meet their debt services as contracted. However, the crucial question here is whether the blame should be put on the debt instrument characteristics or merely on the characteristics of the borrowers themselves?

The whole point of this discussion is that the eurobond market offers SSA countries unique advantages that could hardly be obtained from multilateral or bilateral creditors, or even from their own domestic markets. These advantages range from the lack of conditionalities to the maturity and amounts to be collected. The experience of SSA shows that the itemized cases of failure appear to have their roots in borrowers macroeconomic structures rather than being related to eurobonds characteristics as debt instruments. In fact, rather than being the cause, international capital markets reveal changes in the quality of borrowers' fundamentals by promptly adjusting the yields accordingly – there is no point in shooting the messenger.

References

Bertin, N. (2016). Economic risks and rewards for first-time sovereign bond issuers since 2007. Technical Report 186, Tresor-Economics.

Cassimon, D. and Essers, D. (2017). A chameleon called debt relief: Aid modality equivalence of official debt relief to poor countries. In Biekpe, N., Cassimon, D., and Mullineux, A., editors, *Development finance: Innovations for Sustainable Growth*, pages 161–197. Palgrave Macmillan, Cham.

Eichengreen, B. and Portes, R. (1986). Debt and Default in the 1930s: Causes and Consequences. *European Economic Review*, 30:599–640.

Essers, D., Blommestein, H. J., Cassimon, D., and Flores, P. I. (2016). Local Currency Bond Market Development in Sub-Saharan Africa: A Stock-Taking Exercise and Analysis of Key Drivers. *Emerging Markets Finance & Trade*, 52(5):1167–1194.

FDIC (1997). History of the Eighties - Lessons for the Future. https://www.fdic.gov/bank/historical/history/.

IMF (2017). Seeking Sustainable Growth: Short-Term Recovery, Long-Term Challenges. World Economic Outlook October, International Monetary Fund.

Prizzon, A., Greenhill, R., and Mustapha, S. (2017). An 'age of choice' for development finance? Evidence from country case studies. *Development Policy Review*, 35:O29–O45.

Senga, C. and Cassimon, D. (2019). Spillovers in sub-saharan africas sovereign eurobond yields. *Emerging Markets Finance and Trade*, 0(0):1–17.

Senga, C., Cassimon, D., and Essers, D. (2018). Sub-Saharan African Eurobond yields: What really matters beyond global factors? *Review of Development Finance*, 8:49–62.

The Economist (2018). African countries are borrowing too much. https://www.economist.com/leaders/2018/03/08/african-countries-are-borrowing-too-much.

Willem te Velde, D. (2014). Sovereign Bonds in sub-Saharan Africa: Good for growth or ahead of time? ODI Briefing 87, Overseas Development Institute.

This research has been supported by the Belgian Development Cooperation through VLIR-UOS. VLIR-UOS supports partnerships between universities and university colleges in Flanders (Belgium) and the South looking for innovative responses to global and local challenges. Visit www.vliruos.be for more information.

Disclaimer: The views expressed in this policy brief are solely those of the author and do not necessarily represent the views of the Directorate General of Development Cooperation of the Belgian Ministry of Foreign Affairs, Foreign Trade and Development Cooperation or any other entity of the Belgian Government