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Financing Global Development: The role of Local Currency Bond Markets in Sub-Saharan Africa

Summary

The UN Conference on Financing for Development in Addis Ababa in July 2015 will pave the way for the implementation of the post-2015 development agenda. The Briefing Paper series "Financing Global Development" analyses key financial and non-financial means of implementation for the new Sustainable Development Goals (SDGs) and discusses building blocks of a new framework for development finance.

The enormous deficiencies in Sub-Saharan Africa's (SSA) local and regional infrastructure in areas such as water, sanitation, transport and energy facilities, mean that long-term financial resources must be mobilised to ensure sustainable development. Local currency bond markets (LCBMs) are still generally underdeveloped in SSA in comparison with other regions of the developing world. Yet for all SSA countries, including the poorest economies, LCBMs could become an important means of long-term financing and reduce the financial vulnerability associated with foreign currency borrowing. LCBMs provide alternative sources of financing and reduce a country's dependency on foreign debt. They allow for risk diversification and can mitigate the effects of external shocks. Local currency government bond markets are also important for benchmarking corporate bond markets – another way to finance companies for the long-term.

Policy recommendations for improving LCBM development in SSA

We recommend supporting LCBM development through national and regional initiatives that strengthen the institutional and regulatory environments, broaden the investor base and create more liquid secondary markets. Authorities in SSA need to ensure favourable macroeconomic environments and develop suitable financial infrastructures.

To avoid financial turbulence, capital account liberalisation should be pursued very carefully, with LCBM development going hand-in-hand with solid financial and institutional development. SSA authorities should put into place appropriate strategies for managing debt and capital accounts in order to address capital in- and outflows, and ensure trained personnel to implement them. Authorities should further ensure the safety of investments by guaranteeing profit repatriation. In this respect, law enforcement is crucial.

Bilateral and multilateral donors can support LCBM development by offering technical assistance to realise debt management strategies. The *Debt Management Facility* of the World Bank and the IMF and the *Debt Management and Financial Analysis System* of the United Nations Conference on Trade and Development (UNCTAD) are good examples of donor support for developing countries that provide country-specific technical assistance at different levels. In SSA the African Development Bank has put in place the African Market Initiative (AFMI) which promotes LCBM development in SSA. Another fine example of donor support is the World Bank Group's *Global Emerging Markets Local Currency Bond Program* (Gemloc), which promotes LCBM development in emerging market economies.

Since LCBMs can supply long- or medium-term capital for both governments and companies they have a large potential for financing the infrastructure needed in SSA and for supporting the achievement of the SDGs.

How LCBMs in SSA can support the SDGs

While local currency bond markets (LCBMs) still play a minor role in the long-term financing of Sub-Saharan African (SSA) economies, the experiences of developing and emerging economies in Asia and Latin America over the last two decades suggest that LCBMs have the potential to play important roles also in SSA. There, the outstanding stock of government securities, which on average accounted for only 14.8 per cent of GDP in 2010, presents one indicator for the nascent stage of bond market development in this region. An additional indicator of weakly developed LCBMs in SSA is the fact that many more government securities are issued than corporate bonds, which are of significant importance for financing infrastructure investments. In 2010, government securities accounted for almost 90 per cent of total outstanding local currency denominated bonds in 2010.

In view of the large local and regional infrastructure gaps, LCBMs could play an important potential role in mobilizing long-term domestic financial resources needed to achieve the Sustainable Development Goals (SDGs). Project bonds for infrastructure have the advantage of securing capital for specific projects, which can then be repaid by the project. Kenya, for example, issued three infrastructure bonds in 2009 that raised funds for water, road and energy projects. These public bonds laid the groundwork for private and state-owned enterprises to issue corporate bonds for similar ends.

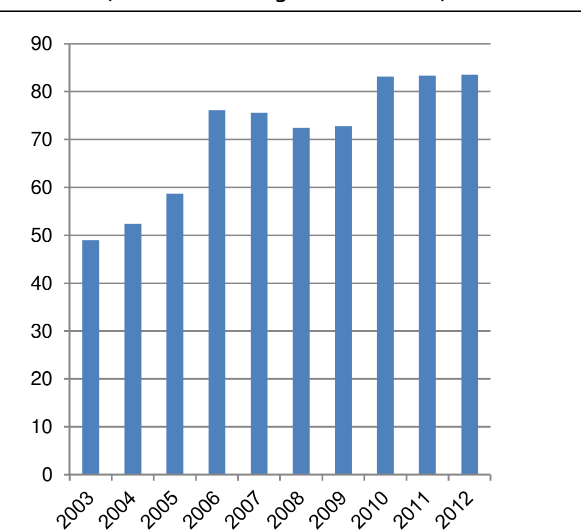
Another advantage of LCBMs in SSA is that they improve capital allocation by supplying alternative sources of financing. They also make it possible to better diversify risks among domestic and foreign investors. LCBMs would offer African pension funds important alternative investment opportunities. As the global financial crisis showed, LCBMs can help to mitigate the effects of external shocks on a domestic economy. LCBMs similarly reduce dependency on foreign debt, thereby helping to lower the risk of currency mismatches.

Compared with SSA's alternative financing sources, LCBMs have played a limited role in long-term investments, but they represent a potential to close long-term financing gaps.

The state of LCBM development in SSA

Whilst the development of capital markets in SSA lags in comparison with other world regions, several trends in government financing suggest that LCBMs will assume a more important role in mobilising funds for long-term public investments. One important trend is that SSA governments are increasingly financing themselves through marketable debt – bonds, notes and money market instruments – as opposed to non-marketable debt, comprising mainly loans from official multilateral or bilateral creditors, such as the World Bank, and commercial bank loans (see Figure 1). OECD data (2013) suggests that this development is taking place in SSA countries of all income groups and not just in the wealthier countries.

Figure 1: Central government marketable debt (% of total central government debt) in SSA



Note: The figure includes Angola, Cameroon, Gabon, Kenya, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Nigeria, Sierra Leone, South Africa, Tanzania, Uganda and Zambia. Data for Angola is excluded from 2010 onwards; data for Gabon is excluded from 2003 to 2006 and again from 2010; data for Namibia is excluded from 2008 onwards.

Source: Compiled with data from OECD (2013).

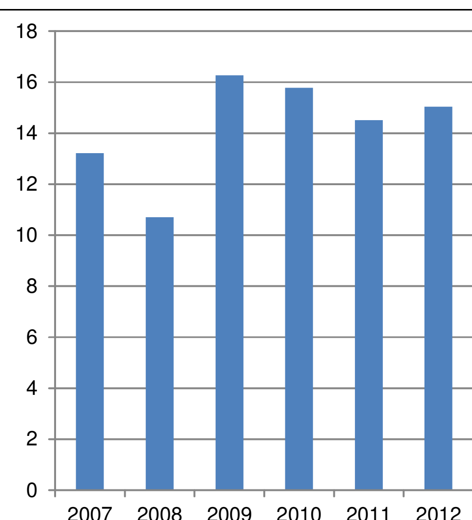
In the last decade another positive trend has been observed in SSA: the issuance of central government marketable debt in local – as opposed to foreign – currencies. Since around 2005, the share of local currency marketable debt in total marketable debt has consistently been above 90 per cent. Only in 2009, when in the wake of the global financial crisis investors were especially cautious, was there a dip in local currency debt issuance. Overall, it appears that currency mismatches in SSA are declining.

Finally, in the last 10 years, several governments in SSA, many of which had been unable to borrow at long maturities, have been able to issue longer-term bonds in the local currency. This, too, is not just happening in wealthier African countries: Since 2005, several low-income countries, such as Mozambique, Niger and Uganda, have issued medium-term bonds with 5 to 10 year maturities (AfDB, 2014). Other low-income countries, including Benin, Burkina Faso, Kenya, Mali, Tanzania and Zambia, have issued bonds with tenors of more than 10 years (AfDB, 2014). Thus, it appears that problems of 'original sin', the inability of countries to borrow at long maturities in the local currency, are slowly alleviating.

Regarding the development of local currency markets for treasury bonds measured as the ratio of outstanding local currency treasury bonds to GDP, the picture is more ambiguous. Figure 2 shows that in SSA as a whole, LCBMs deepened between 2007 and 2012. That said, the amount of outstanding local currency treasury bonds slightly declined between 2010 and 2012.

While LCBMs appear to be deepening in SSA countries of all income groups, there is significant variation across SSA

Figure 2: Local currency treasury bonds outstanding (% of GDP) in SSA



Note: Figure includes Angola, Benin, Botswana, Burkina Faso, Cabo Verde, Cote d'Ivoire, Gabon, Ghana, Kenya, Malawi, Mali, Mauritius, Mozambique, Namibia, Nigeria, Senegal, South Africa, Tanzania, Togo, Uganda and Zambia. Data for Mali is included from 2008 onwards.

Source: Compiled with data from African Development Bank (2014).

regarding the depth of LCBMs. The LCBMs in South Africa and Mauritius are the largest in SSA, when measured as local currency treasury bonds with a maturity of one year or more outstanding as percentage of GDP. In 2013, local currency treasury bonds outstanding exceeded 30 per cent of GDP. Other relatively large government LCBMs are found in Cape Verde, Ghana and Kenya, all of which had stocks of local currency treasury bonds in excess of 10 per cent in 2013. However, LCBM development is still in its early stages in many other countries in SSA.

Why have LCBMs remained so weakly developed in some African countries and deepened significantly in others? Little research has been made on the drivers of LCBM development in SSA, probably due to the lack of high-quality data on LCBMs in SSA. A review of the literature on LCBM development in SSA and other world regions does provide some hints, however.

In SSA, many structural weaknesses exist in LCBMs, including illiquid debt instruments, short maturities, a restricted and undifferentiated investor base and un-developed secondary markets. Country-specific factors, such as weak legal, regulatory and institutional frameworks, also impede the development of LCBMs. In addition, there is a lack of personnel qualified to manage debt, such as by issuing domestic securities.

A recent empirical analysis by Berensmann, Dafe and Volz (2015) shows that at least four factors appear to be associated with deeper LCBMs in SSA. First, larger economies seem to be associated with deeper LCBMs – a positive relationship, which could be a result of their economies of scale in establishing LCBMs and the greater diversification benefits that larger economies offer investors. Second, more developed LCBMs seem to be linked to deeper banking sectors. One explanation is that banks play important roles as dealers and market makers in the development of liquid and functioning bond markets. The fact that many of the SSA economies are small and have shallow banking sectors may partly explain the slow development of LCBMs. Third, greater trade openness appears to be associated with deeper LCBMs and fourth, better regulatory frameworks and the rule of law seem to help to deepen LCBMs.

The risks associated with LCBMs in SSA

While LCBM development can be an important source of long-term financing for sustainable development, it has a few pitfalls. In particular, problems of financial stability can arise if LCBMs have a restricted and undifferentiated investor base. A high concentration of local currency bond holdings in the domestic banking system is one risk. Since sovereign debt typically makes up a large share of LCBMs, if most local currency bonds are held by the domestic banking system, sovereign debt problems can trigger a full-blown banking crisis. This danger was recently illustrated in the European debt and banking crisis, where the worsening of sovereign debt positions contributed to destabilising the domestic banking systems and vice versa.

Problems can also arise from a high share of foreign bond holdings in LCBMs. While foreign investments in LCBMs can help them to develop by increasing liquidity – helping to lengthen maturities, develop secondary markets and create a more diversified investor base– they can also increase financial vulnerability as markets become more exposed to the risks of international financial contagion and sudden outflows of capital. The global financial crisis exemplified these risks. In many emerging economies, LCBMs acted as a cushion and an alternative source of financing during the global financial crisis, when US and European financial institutions were not extending new loans or rolling over existing debt contracts. However, some emerging markets suffered from large capital out-flows because in order to survive, the same financial institutions had to liquidate their assets wherever possible. That meant that countries with large holdings of foreign bonds in their LCBMs were more exposed to the global crisis than countries whose domestic bases were more diversified. The large capital outflows from a number of LCBMs in emerging economies– after then-Fed-Chairman Ben Bernanke made his famous "tapering" announcement in May 2013 that the Fed would soon start to tighten US monetary policy – illustrates the risks of large-scale foreign investments in relatively shallow markets.

The problems and risks associated with large-scale capital inflows and rapid outflows cannot be overemphasized – especially after globally low interest rates and excessive liquidi-ty have turned several SSA economies into 'frontier markets', which offer higher returns than advanced economies.

Policy recommendations for improving LCBM development in SSA

An enabling macroeconomic environment and an appropriate financial infrastructure represent the *sine qua non* for LCBM development and further economic development in SSA. This is why financial authorities should prioritise on macroeconomic and financial stability while actively promoting financial sector development.

Addressing the difficulties of small economies and small banking systems, including restricted and undifferentiated investor bases, underdeveloped secondary markets, illiquid debt instruments and short-term maturities, calls for regional initiatives to develop bond markets, including efforts to harmonise legal and regulatory frameworks and facilitating the cross-listing of bonds on several national exchanges.

To overcome legal deficiencies and make the investment environment safer, authorities in SSA should ensure and facilitate profit repatriation by reducing payment delays and guaranteeing contract viability. SSA governments must also ensure that laws are enforced.

An appropriate debt management strategy must be in place to address the problems and risks associated with substantial capital in- and outflows, and personnel must be trained in debt management so they can issue domestic securities. International cooperation could provide valuable technical assistance. Multilateral and bilateral donors support several relevant programmes, such as the *Debt Management Facility* of the World Bank and the IMF and the *Debt Management and Financial Analysis System* of the United Nations Conference on Trade and Development (UNCTAD) that provide country-specific technical assistance at different levels to developing countries. In SSA, the African Development Bank has established the African Market Initiative (AFMI) for supporting LCBM development in SSA. The World Bank Group's *Global Emerging Markets Local Currency Bond Program* (Gemloc) promotes LCBM development in emerging market countries; unfortunately, it focuses on emerging economies instead of low-income countries. For this reason the initiative has only supported three SSA countries: South Africa, Nigeria and Kenya.

A robust policy framework to manage capital accounts must be created to adequately deal with the associated risks and minimizing that of a financial crisis. Capital account liberalization and LCBM development should be pursued cautiously, in pace with solid financial and institutional development. The sequencing and intensity of these policy measures largely depend on the economic circumstances and goals of the various LCBMs.

On the one hand, at a time of globally low interest rates and excessive liquidity, when several SSA economies have become 'frontier markets' that offer higher returns than advanced economies, it is important to highlight the problems and risks associated with large-scale capital inflows and rapid outflows. On the other hand, LCBMs can provide long- or medium-term capital – not only for governments but also for companies. LCBMs can help to free long-term funds for needed infrastructure financing in SSA and contribute to achieving the SDGs.

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