

Development in Brief



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Government bonds from developing countries: Potentials and risks

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African countries are increasingly issuing government bonds to raise money on the international financial markets. It would seem a favourable time to do so. The boom in the emerging markets and the huge readily available liquidity brought on by the low interest rate policy in Europe and the USA, have attracted the interest of investors in bonds of developing countries.

Government bonds from Africa are in great demand

As the first African country after South Africa, the Seychelles brought government bonds onto the market in 2006, followed by Ghana in 2007 which issued ten-year bonds with a coupon of 8.5% to the value of USD 750 million. The Ghanaian model has been imitated by numerous other countries. Ethiopia, the last newcomer, raised USD 1 billion on the market through government bonds in December 2014. Meanwhile, 14 African countries have issued government bonds, including Malawi and Tanzania, which were considered extremely poor countries and not creditworthy so far. The demand is enormous and exceeds supply many times over. Zambia, for example, increased its original bond volume from USD 500 million to 750 million due to strong demand.

Why do developing countries go into debt?

Inadequate infrastructure represents a significant obstacle to development in many African countries. According to World Bank estimates, funding requirements for the financing of necessary infrastructure investments lie at about USD 1.3 trillion. Government bonds should help to close the funding gap. Eliminating infrastructure bottlenecks (e.g. energy supply, transport links, telecommunications) should accelerate economic growth and thereby create employment and income.

In addition, the restructuring of government debt is an important objective of government bonds: low interest rates mean debt restructuring can reduce the interest burden. And finally, the issuing countries expect to make a long-term reputational gain: if it is possible to get a foot in the door of the international capital market and ensure that the debts are serviced regularly, the country can obtain a positive *track record*. With this they get a better rating and can also attract investor groups to their bonds which previously avoided this segment.

Risks of bond financing

Despite the opportunities inherent in government bonds, they also entail some risks. These are reflected by country ratings, too: while Botswana still has a relatively good A-rating, Gabon's B+ rating already means a highly speculative investment. Tanzania, which issued bonds of USD 600 million in 2013, has yet to be rated at all.

The bonds are usually issued in dollars or euros, so this is a currency risk for the issuers: if the local currency depreciates in value in relation to the dollar/euro, the repayment burden increases. A stress test carried out by UK *Think Tank* ODI estimated possible losses from exchange rate effects of USD 10.8 billion (1.13% of GDP of the issuing countries). Governments of the issuing countries rely on sustained economic growth and stable revenue sources to repay the bonds. The documents are often secured by proceeds from the export of commodities, which do not offer full-scale security on account of global price fluctuations.

The repayment of maturing bonds being financed by the issue of new bonds constitutes an interest rate risk: if the very low interest rates at present are no longer available in

a few years with tighter monetary policies in the OECD countries, this could suddenly impact on debt servicing when there is a circulation of bonds. In the worst-case scenario this could lead to a renewed debt spiral. Long term, there is the risk that the costs of commercial loans – which are higher compared to loans from donors – lead to cuts in social spending in order to secure the debt.

From a development policy perspective, it is also considered critical when poorer developing countries reject concessionary financing provided by international donors to avoid the requirements related to good governance (e.g. transparency and efficiency of public financial management).

Conclusion: How can developing countries take advantage of the opportunities of government bonds and avoid the risks?

Government bonds are a useful form of development financing, provided the servicing of the bonds is secured. Realistically, the funds mobilised in this way are still limited (compared with the enormous financing requirements of these countries). Responsible use of this potential requires

- stable long-term government revenues (e.g. through commodity exports) from which the bonds can be repaid, or a strict rule limiting use to productive investments whose returns are sufficient to cover the debt service,
- “prudent” debt management that avoids excessive dependence on external financing and guarantees repayment even under rising interest rates. ■