Government debt markets in African developing countries: recent developments and main challenges

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Since 1995, the principal local currency government bond markets in Africa have posted sustained growth. Outstanding government debt amounted to an average of 22% of GDP over the period 2001-2007, as against 15% over the period 1995-2000. However, compared with government bond markets in emerging countries, which often exceed 40% of GDP, African markets appear less significant and show considerable differences in their respective stages of development: in South Africa, Morocco and Mauritius, they are relatively sophisticated, whereas in low-income countries, they are more recent and still very rudimentary.

However, up until the recent financial crisis, African government debt markets were able to take advantage of the favourable economic environment thanks to the improvement of the macroeconomic framework on the African continent and the debt write-offs, which improved the solvency of a large number of countries. The increased interest on the part of foreign investors reflected the attractiveness of these budding markets, which represented an opportunity for diversification in a context where risk premia on sovereign assets had declined significantly overall.

With regard to the advantages of deepening or creating local currency government bond markets to finance development in Africa, it now appears essential to make sure they continue to grow in a balanced and sustainable manner.

However, African government debt markets are still fragile and hampered by structural problems, in particular high default risk, insufficient critical mass, weak infrastructures and insufficient capacities and know how on the side of regulators but also of issuers and subscribers. These obstacles are heightened by the fact that some prerequisites (in the field of public finance or monetary policy management), which are necessary for a contained development of markets, are not always met.

Targeted actions are thus needed to ensure the continued development of government bond markets in Africa.[1] An approach that focuses both on regional integration in monetary unions (in order to lift the size constraints) and on pragmatism (to make

NB: The authors would like to thank Bernard J. Laurens, from the Monetary and Capital Markets Department of the IMF, for his remarks and suggestions.

1 *During their meeting on 3 April 2008, the Finance Ministers and Governors of the Franc Zone approved a series of recommendations for the development of government debt markets in their area.*

headway in an orderly manner on the basis of a few key priorities) seems especially appropriate. Specific instruments, such as guarantee mechanisms for sovereign and corporate issuance, foreign exchange risk coverage instruments or regional investment funds, could also be considered, with the support of international financial institutions or bilateral development partners. Deepening these markets becomes particularly relevant in the context of the financial crisis, which shall lead to a fall in external financing flows on the one hand, and highlights the risks incurred if domestic savings are recycled abroad on the other.

Keywords: government debt securities; African financial markets; African securities markets; financing of Sub-Saharan Africa debt; Sub-Saharan Africa (SSA).

JEL codes: . E44, H63, O23, O55.

1| Strong growth in African government debt markets since 1995

1|1 A steady increase in local currency government bond markets

The development of local currency domestic debt markets is not a recent phenomenon in Africa. From the 1980s onwards, a large number of African countries started to carry out reforms to promote the emergence of this type of financing. It should nevertheless be noted that, after remaining broadly unchanged from 1980 to 1995, the growth rate of outstanding debt increased significantly as from the mid-1990s[2] (see Table 1).

While the ratio of outstanding government debt to GDP remained stable in Sub-Saharan Africa (SSA) at around 11% on average from 1980 to 1994, it reached 15% over the 1995-2000 period then 22% on average between 2001

Table 1 Outstanding government debt in Africa since 1980

(on average by sub-period, as a % of GDP)

	1980 to 1989	1990 to 1994	1995 to 2000	2001 to 2007
South Africa	30	37	45	30
Benin	0	0	0	1
Botswana	0	0	0	19
Burkina Faso	0	0	0	1
Burundi	3	2	6	1
Ivory Coast	0	0	0	2
Ethiopia	16	19	10	24
Ghana	12	8	24	19
Guinea-Bissau	0	0	0	2
Kenya	21	23	22	23
Malawi	13	8	9	15
Mali	0	0	0	1
Morocco	nd	nd	nd	42
Mauritius	27	29	33	52
Niger	0	0	0	0
Nigeria	28	29	16	13
Uganda	2	1	2	11
Rwanda	8	9	5	4
Senegal	0	0	0	2
Tanzania	26	6	12	9
Togo	0	0	0	1
Tunisia	nd	nd	nd	14
Average SSA*	11	12	15	22
Average SSA HIPC**	9	6	8	8
Average SSA non-HIPC	14	18	23	26

**SSA: Sub-Saharan Africa.*
***HIPC: Low income countries eligible for the HIPC (Heavily Indebted Poor Countries) initiative.*
Sources: Christensen (2005) for the period 1980-2000; Banque de France for the period 2001-2007.

2 See methodological note in the appendix.

and 2007, corresponding to a seven point increase compared to the previous period. Together with Morocco and Tunisia, outstanding government debt accounted for, on average, 24% of GDP of sample countries over the 2001-2007 period (see Table 1).

These overall developments are the result of government policies implemented by African countries, which have sought to diversify their financing methods and equip themselves with more flexible tools to meet their needs. This market-based financing also corresponds to a broader objective of modernising local financial systems, often based on narrow and relatively oligopolistic banking sectors. The development of government bond markets was intended to provide economic agents with alternative financing methods and heighten competition between the different financing channels. In a large number of countries, in particular Ghana, Kenya, Nigeria and WAEMU countries, another factor underlying the growth of domestic debt markets has been the phasing out (encouraged by the international financial community) of the direct advances made by central banks to the government, against the backdrop of a general move towards greater central bank independence. Lastly, in some countries (Botswana for example), the development of government debt markets essentially served monetary policy objectives, with central banks issuing Treasury bills to sterilise the increase in reserves with a view to absorbing the excess liquidity.

However, despite the increase recorded since 1995, African government debt markets are still smaller than those of other emerging countries. According to data from the Bank for International Settlements[3] the local currency debt markets of the major emerging economies accounted for roughly 34% of GDP at end-2005, although in some countries, such as Brazil, South Korea, Turkey and Venezuela, this figure was over 50%. In industrialised countries, the ratio stood at roughly 43% at end-2005.

In addition, the size of African markets remains highly heterogeneous. Apart from the specific case of countries that have not yet set up their own government debt market (in particular Angola, the Democratic Republic of Congo, São Tomé and Principe, and CEMAC countries),[4] three groups may be distinguished. In the first group, which comprises South Africa, Morocco and Mauritius, government debt markets have roughly the same relative size as in the large emerging economies, with ratios of securitised debt to GDP of over 30%. In the second group, which brings together middle-income countries (Botswana, Kenya, Nigeria) and some low-income countries (Ethiopia, Ghana, Malawi, Uganda), the ratio of outstanding government debt to GDP ranges from 10% to 25%. The last group comprises the other low income countries where the size of government debt markets

3 *Committee on the Global Financial System, Financial stability and local currency bond markets, June 2007.*
4 *Cameroon, Chad, Congo (Republic of), Equatorial Guinea, Gabon and Central African Republic (CAR).*

is still very small, accounting for 1 to 10% of GDP. For the third group, average amounts of outstanding debt in 2001-2007 remained close to those in 1995-2000 at around 8% of GDP.

1|2 Common characteristics

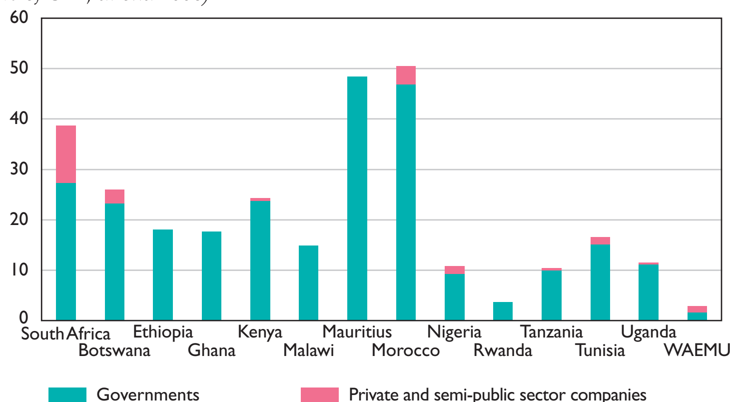
Despite this heterogeneity in terms of relative size, African debt securities markets have a certain number of common characteristics:

• They are mainly government bond markets (see Chart 1). These are almost exclusively made up of securities issued by governments, in some cases also by local authorities (Nigeria) or central banks (Botswana, Malawi, Rwanda). The outstanding amount of securities issued by private sector companies and public enterprises only represent a small share of the total outstanding amount, most often less than 10%, except in the case of South Africa (where private debt accounted for 30% of total outstanding debt securities at end-2006). In the vast majority of countries, private debt securities issuance can essentially be attributed to financial institutions.

• African markets are characterised by a narrow investor base, largely dominated by financial institutions (mainly banks and, to a lesser extent, insurance companies) (see Table 2). At end-2007, these institutions held on average almost 63% of the outstanding amount of government securities, while the non-financial sector and central banks held 32% and 4% respectively. Non-financial sector investors are primarily public and semi-public companies; the share of domestic debt securities held by private

Chart 1 African debt securities markets: breakdown of outstandings by issuer

(as a % of GDP, at end-2006)



Source: Banque de France.

Table 2 Breakdown of outstanding amounts of government securities by holder

(as a %, at end-2007)

	Financial sector			Non-financial sector
	Central bank	Banks	Non-banking financial institutions	
South Africa	2	19	34	45
Botswana	0	90	2	8
Burundi	0	91	7	2
Ethiopia	42	50	8	0
Ghana	10	43	8	39
Kenya	8	44	19	29
Malawi	28	27	12	33
Morocco	0	19	66	16
Mauritius	1	42	15	42
Nigeria	14	65	0	21
Uganda	21	55	10	15
Rwanda	0	54	26	20
Tanzania	19	43	35	3
Tunisia	5	32	21	42
WAEMU	1	80	14	5
Average Africa	4	30	33	32
Average SSA	6	34	24	37
Average SSA HIPC	19	52	14	15
Average SSA non-HIPC	4	32	25	39

Source: Banque de France.

non-financial corporations and private individuals is small, except in a few markets (South Africa, Mauritius, Tunisia). In low-income countries, banks are the primary holders of securities (52% of outstandings), followed by central banks (19%).

• African markets are relatively illiquid given the absence in almost all countries of active secondary markets. This can be attributed to several factors, among which: the small size and lack of depth of these markets, the importance of excess liquidity and the shortage of investment instruments, which lead investors to hold securities until maturity (buy and hold strategy), the very strong concentration in the investor base, and an insufficient market culture, which results in a lack of arbitrage, etc.

While these characteristics appear as permanent features of African countries over the long term, the recent period has brought to light a number of developments that are a sign of greater maturity:

• The term structure of outstanding securities has progressively been rising, as certain African countries, including low-income countries (for example Ghana and WAEMU countries), are now regularly issuing bonds with maturities of over five years (see Table 3). Although the small size of the sample in this study (due to the lack of available data) and the weight

Table 3 Average maturity of government debt securities

(in months)

	2000	2007
South Africa	58.3	97.0
Botswana	2.2	14.1
Burundi	2.6	2.7
Ghana	4.1	19.3
Kenya	12.7	61.7
Morocco	87.6	123.0
Nigeria	7.6	50.9
Tunisia	24.4	52.0
WAEMU	17.5	40.1
Average Africa	43.6	76.6
Average SSA	38.2	52.1
Average SSA HIPC	15.1	35.3
Average SSA non-HIPC	41.9	49.2
By way of comparison:		
Latin America (Argentina, Brazil, Columbia, Mexico, Venezuela)	28.8	46.8
Emerging Asia (China, India, Korea, Taiwan)	32.4	73.2
Central Europe (Hungary, Poland, Czech Republic, Russia)	31.2	43.2
Average emerging economies	38.4	54.0
Average industrialised countries	76.8	68.4

Sources: Christensen (2005) for data at end-December 2000; Banque de France for data at end-December 2007 and data on Morocco, Tunisia and WAEMU; BIS for emerging and industrialised economies

of certain countries, such as South Africa and Nigeria, create biases in the analysis of the average term structure, Table 3 shows the general dynamics over the 2000-2007 period. The average maturity of government debt securities in some African countries is now similar to that in emerging economies, whereas before 2000 African countries mainly issued debt securities with maturities ranging between three months and one year.

- African local currency debt markets are still relatively closed to non-resident investors due to foreign exchange controls and various administrative barriers to the free movement of capital. However, in recent years, these investors have been increasingly participating in these markets. Around 15% of the negotiable public debt of South Africa is held by non-residents. South Africa has, for a long time, been the most attractive issuer of government debt securities in Africa, but other markets have also managed to arouse interest from foreign investors, such as Botswana, Ghana and Tanzania. At end-2005, the share of government debt securities held by non-residents in Nigeria and Zambia amounted to 18% and 16% respectively. Low-income countries have also decided to open up further their market to non-residents. In Ghana, Malawi and Uganda, for instance, close to 10% of government securities were held by foreign investors at end-December 2007. Unsurprisingly, the most attractive countries are those that also issue on international markets and that have few foreign exchange controls.

2| The development of these markets, a response to a large number of challenges

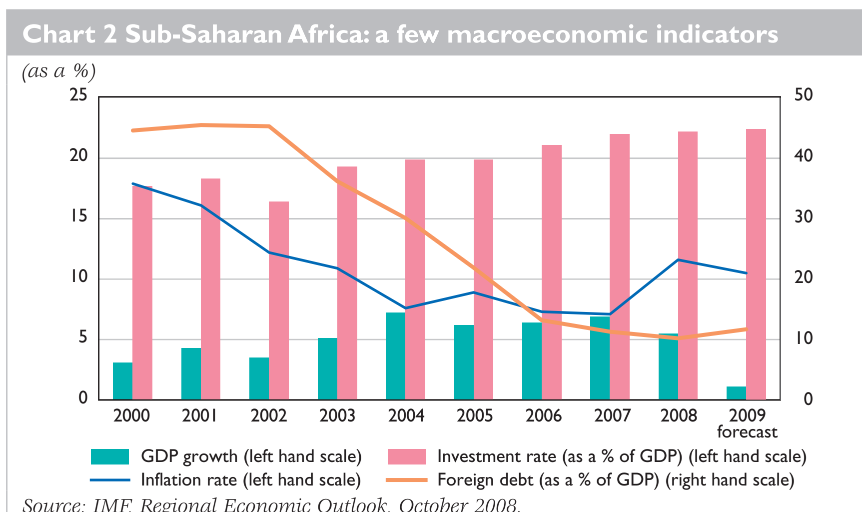
2|1 A favourable economic context

Since the end of the 1990s, the growth of African financial markets has been underpinned by a favourable economic climate, characterised by a significant improvement in the macroeconomic environment in Africa (see Chart 2). Inflation has steadily declined since the start of the century, slipping, in Sub-Saharan Africa, from 15% in 2000 to 7.1% in 2007. However, inflationary pressures increased at the end of 2007 as a result of the rise in food and oil prices. According to the IMF, this led to a significantly higher double-digit inflation rate in 2008, of roughly 11.6% (10.5% in 2009).

Since 2000, GDP growth in Sub-Saharan countries has been less volatile and, from 2004 to 2007, it exceeded 6% per year, a historical performance for the region. According to the IMF, economic growth started to slow down in 2008, with real GDP in SSA countries growing by 5.5%, followed by a 1.1% GDP growth rate in 2009 as a consequence of the worldwide economic downturn. The ratio of investment to GDP, which had stood at an average of 18.7% over the 1997-2002 period, picked up to reach 22.2% in 2007-2008 and is expected to stabilise at this level in 2009 (22.4%).

Government accounts also reflect the efforts made towards establishing a more rigorous management of public finances. After recording an overall fiscal deficit of roughly 2.6% on average over the 1997-2002 period, SSA countries posted a fiscal surplus from 2005 onwards. It stood at 1.3%

Chart 2 Sub-Saharan Africa: a few macroeconomic indicators



Source: IMF, Regional Economic Outlook, October 2008.

of GDP in 2008. This trend came to an end in 2009, with an expected fiscal deficit of 4.8% of GDP.

In addition, the implementation of the HIPC (Heavily Indebted Poor Countries) and MDRI (Multilateral Debt Relief Initiative) initiatives has contributed to improving the solvency of African countries taking part in these arrangements. The vigilance of the international community with regard to the indebtedness of African countries, which took the form of a greater share of donations in aid flows, also played a role in speeding up the process. The external debt ratio of SSA countries vis-à-vis their official creditors dropped from 44.4% of GDP over the 1997-2002 period to 10.2% in 2008 (11.7% in 2009 according to the IMF). This development gives recipient countries room for manoeuvre to look for new funding, provided that this new borrowing is done in a cautious manner and is sustainable over the medium term.

Lastly, it should be noted that the balance of payments of SSA countries improved. After having posted a deficit of 2.5% of GDP on average between 1997 and 2002, the current account of SSA countries registered a surplus from 2006 to 2008. A deficit of 3.1% of GDP is expected in 2009. Foreign exchange reserves increased: at the end of 2008 they represented around 5.3 months of imports of goods and services (5.8 months expected in 2009), compared with an average of 3.8 months between 1997 and 2002. These factors contributed to reducing the volatility of nominal exchange rates of African countries.

In this context, African debt markets were met with renewed interest on the part of non-resident institutional investors. For this category of investors, these markets represented opportunities in terms of yields and investment portfolio diversification, in a period marked by a fall in interest rates on developed and emerging markets and the decline in risk premia on sovereign assets.

African countries' increased recourse to external ratings (for example, Gabon and Kenya made a request for an external rating for the first time at end-2007)[5] has also contributed to making macroeconomic policies more transparent and to fuelling the interest of foreign investors.

While the severe financial market turmoil in developed and emerging countries has opened up a period of uncertainty for African government debt markets, it is, more than ever, important to safeguard the achievement that the existence of financial markets represents for the financing of development and to enable them to continue to grow in a sound and sustainable manner.

5 *In the framework of issues on international markets in dollars.*

2|2 An appropriate response to the challenges of financing development

Having greater recourse to domestic government debt markets makes it possible to pursue several objectives that are particularly relevant in the framework of a sustainable and balanced growth strategy.

The development of domestic government debt markets enables governments to diversify their sources of financing and allows a gradual substitution of monetary financing. Central bank financing has, for a long time, been a standard financing channel in African countries, but there is now a broad consensus on the fact that it has a negative effect on inflation and is permissive in terms of the management of public finances, creating moral hazard. This has led governments to look for alternative methods of financing, an approach which has been encouraged in all IMF programmes across Africa. A growing number of African governments have gradually given up the monetary financing of public deficits, in favour of debt securities financing (e.g. in WAEMU countries, attempts underway in the CEMAC).

Compared to external or bank financing, market financing offers a number of advantages for the management of public finances, in terms of controlling access to resources (how timetables, amounts and payment dates are set), predictability (no conditions attached to funding) and improved governance. On this last point, having recourse to bond markets encourages governments to be more transparent in the management of public finances and to conduct more rigorous fiscal and cash management policies (given the need for the government to maintain its credibility domestically and the risk of market sanctions). Admittedly, the conditions imposed by external lenders, particularly those that provide budget aid, have the same objectives, but the ownership of domestic economic agents is generally less strong.

Compared to bank financing, market financing also contributes to greater transparency, for the following reasons: first, financing conditions are public; second, it involves the diffusion of independent analyses on public finances. It also avoids possible conflicts of interest, which may arise from the close relations between banking institutions and governments that are both regulators and borrowers.

In addition, market financing helps to extend the maturity of government debt. These objectives of diversification and optimisation of government financing become secondary in two cases:

• when the government budget shows a structural surplus and its net position vis-à-vis the banking system is positive, which is the case for some oil-exporting countries;

• when financing the balance of payments is more of a problem than financing the budget; in this situation, the primary objective of public debt issuance shall be to attract non-resident investors.

Lastly, the case of highly-dollarised countries calls for a slightly different approach, which may justify the issuance of foreign currency denominated government securities. These issues may allow the channelling of foreign currency savings to the government in a situation where wariness about the domestic currency is greater than wariness with regard to the government. However, if conditions are met to expect a decline in the rate of dollarisation, public authorities may give priority to local currency denominated issues, including an indexation clause either to inflation or to another nominal anchor, which will contribute to supporting demand for the local currency.

Achieving rapid growth in private debt markets is generally the second key objective of a government securities issuance strategy.

Issuance of government securities is generally the first stage in the development of a sufficiently structured and liquid bond market, which is often a prerequisite for the growth of a private debt market (through the setting-up of appropriate market infrastructures, the learning benefits for market players, and the constitution of a benchmark securities portfolio). Issuance of government securities thus helps diversify the means of financing the economy by promoting the emergence of a new channel of funding for companies, which is particularly useful as the banking sector is generally narrow and oligopolistic.

However, the development of debt securities markets in African countries is also a source of both microeconomic and macroeconomic efficiency gains. These advantages stem in particular from:

• The coverage of the private sector's long-term financing needs. The long-term financing needs of developing economies are insufficiently met, or not at all, by their banking sectors, which most often give priority to short-term assets on account of the structure of their liabilities and their risk exposure, but also the inertia of practices due to the lack of incentives to carry out maturity transformation. The development of debt securities markets is a way of channelling local savings into medium and long-term investments.

Indeed, Equity markets are underdeveloped, in particular due to the weak stock market culture, in particular on the part of issuers, the risk aversion of local investors, the limited development of institutional investors, in particular due to the undercapitalisation of local private companies, the vulnerability of their environment to external shocks and the lack of diversification of the productive base. The development of debt securities

markets compensates for these inadequacies and offers the private sector an alternative source of financing.

- The improvement of sovereign risk assessment, as well as the risk associated with private issuers. The development of debt securities markets helps increase the number of players involved in risk assessment. Otherwise this assessment would be conducted solely by the banking sector, whose generally high degree of concentration and mode of operation in Africa lead to biases in risk assessment.

- The stimulation of local savings, discouraged by low returns on traditional products (mainly deposits) due to the lack of competition between banks and the absence or scarcity of long-term investment products, resulting in large capital outflows.

- The fulfilment of the needs of institutional investors. Even more so than households, institutional investors (i.e. insurance companies, pension funds, mutual funds, etc.) and, in some cases, governments require new investment products to diversify their risks and increase their income.

- The improvement in the capital account of the balance of payments. The development of debt securities markets helps to attract new non-resident investors and contributes to containing capital flight.

- The search for greater monetary policy efficiency. In the long run, developing domestic debt markets and improving their liquidity and depth should enable central banks to conduct more efficient monetary policies by giving them a pool of collateral for their interventions on money markets and making the key rate transmission channels more effective.

- The improvement in government and corporate cash management. By raising the opportunity cost of liquidity, the development of debt securities markets fosters investment arbitrage and contributes to improving cash management.

- A better breakdown of counterparty and transformation risks. The development of debt securities markets helps to better spread counterparty and maturity mismatch risks by transferring part of them to the investors, thus reducing the exposure of the banking system and increasing the possibility for large borrowers, hitherto limited by risk division ratios, to obtain financing on the local market.

- Lastly, for both public and private borrowers, local currency financing offers considerable advantages compared to foreign currency financing:

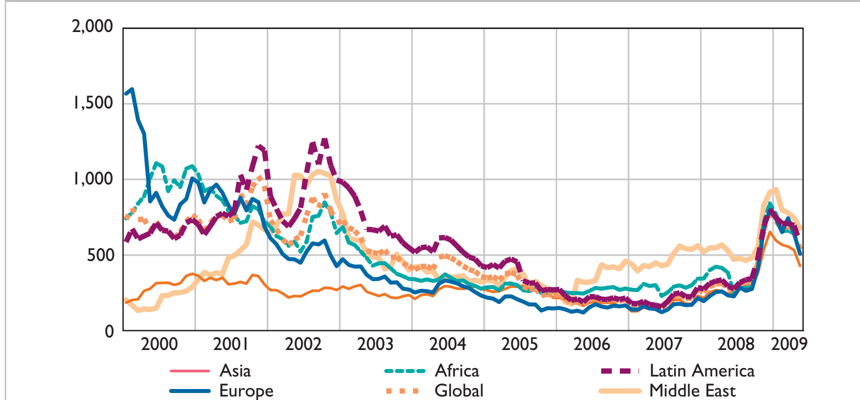
  – by eliminating exchange rate risk, in a context where the volatility of exchange rates is, albeit declining, still very strong (see Table 4);

Table 4 Comparative volatilities (a) of nominal effective exchange rates

	1998-2002	2003-2008
SSA excl. Franc Zone (b)	36.0	9.6
Asia (c)	6.6	5.9
Latin America (d)	14.9	6.8

(a) Standard deviation with monthly data.
(b) South Africa, Democratic Republic of Congo, Ghana, Malawi, Zambia.
(c) China, Korea, India, Malaysia, Pakistan, Philippines, Thailand.
(d) Argentina, Brazil, Chile, Columbia, Mexico, Peru, Venezuela.
Sources: IMF; Banque de France.

Chart 3 Spreads on EMBI indices from 2000 to 2008
5-year bond yields



– by reducing costs, as spreads on African countries are still high on international markets, even though they had dropped significantly before the last financial crisis (see Chart 3).

3| Structural obstacles to further development requiring targeted actions

3|1 Structural obstacles

The further development of African debt securities markets could come up against certain obstacles linked to the vulnerability of developing economies. Indeed, African markets display a certain number of common weaknesses, including:

• The high default risk of both public and private issuers. As regards public issuers, although sovereign risk has declined due to the improved

management of public finances, local investors have a specific perception of risk in view of the payment history of African countries, characterised by the accumulation of major domestic payment arrears. In the case of non-resident investors, the risk of default is heightened by non-transfer risk. In addition, this high level of default risk is not always appropriately rewarded since the information required to evaluate such risks is often insufficient (lack of transparency of public finances, company accounts not certified, scarcity of assessments by recognised rating agencies, etc.).

- Insufficient critical mass in terms of the liquidity and depth of existing markets, leading to high issuance costs and, in particular, high transaction costs due to the high level of fixed costs. The absence or lack of depth of secondary markets, including on the interbank segment, also accounts for the high liquidity risk and price volatility.

- A shortage of reliable and structured data. This shortage stems from a lack of market culture and, more fundamentally, the low level and, in some cases, the deterioration of information systems (national accounts, macro economic statistics, company accounts, etc.). It results in the absence or insufficiency of reliable, accessible and regularly published data and a limited use of ratings.

- The banking system's structural excess liquidity. This is a consequence, in particular, of foreign exchange controls; these increase the risk of interest rate misalignment, which is already high in nascent markets.

- Weak local demand[6] due to:

  - a low financial savings rate, which results from a very inequitable distribution of income, a bias towards investment abroad on the part of the richest and the lack of collective savings mechanisms, in particular pension systems;

  - the underdevelopment of institutional investors, with the exception of banks.

- An institutional, legal and regulatory framework which is, in some respects, ill-adapted: inadequate rules on transparency and on government and corporate governance; market access dependent on lengthy administrative procedures, or on certain regulations (for instance, in WAEMU, non-sovereign issuers are required to provide 100% collateral) constitute obstacles to the development of debt markets.

6 *The situation of excess liquidity that has prevailed in most African countries in recent years and which, besides, has triggered renewed interest in local currency debt markets, should not divert attention from the fact that the low level of demand has, in the past, been one of the main obstacles to the development of debt markets.*

• A lack of know-how and skills on the supply side (issuers), on the demand side (institutional investors, but also ill-informed individual investors) and, above all, of intermediaries, as a result of the underdevelopment of the financial system, which is liable to exacerbate and protract the malfunctions traditionally associated with nascent markets (e.g. institutional investors that do not use arbitrage but rather a buy and hold strategy, thus hampering the development of the secondary market).

3|2 Preliminary reforms essential to the balanced development of African financial markets

Experience shows that a certain number of fundamental pre-requisites need to be met in order to ensure the sustainable and balanced development of debt markets. The key requirements for achieving a successful shift to market financing are an appropriate preparation and programming of the establishment of domestic financial markets.

The main preliminary stages concern:

• The management of public finances: the central government budget should meet minimum transparency criteria. Issuing governments should regularly publish high-quality, reliable and transparent data on the government budgetary position. Preliminary reforms in the field of cash management are also needed. Governments should, in particular, have good means of forecasting their short and medium term financing needs, on the basis of regularly updated cash flow plans. This is indeed essential for a proper calibration of issuance and the establishment of reliable issuance programmes.

• The functioning of credit markets: interest rates, as well as the access of financial institutions to central bank lending, need to have been widely liberalised.

• Monetary policy conduct: it must be capable of actively managing the level of liquidity, in order to prevent the situation of excess liquidity from distorting the setting of interest rates and risk assessment. The development of an active interbank market is also an essential prerequisite for a broader use of market financing mechanisms by economic players. The monetary financing of governments should be banned, or at least strictly controlled, and the transmission to the monetary authorities of information on fiscal policy should be strengthened (at least with respect to liquidity forecasts).

In addition, without being a precondition, the liberalisation of capital movements may create incentives to modernise monetary policy

and liberalise financial markets. It is a key element of the opening-up to non-residents of local currency debt markets.

3|3 The need for targeted actions

The inherent limitations of African markets require the implementation of specific actions, which could more specifically be based on:

• A regional approach in order to remove the obstacles linked to the lack of critical mass and improve the governance of market regulators by strengthening their independence. This approach is particularly appropriate in the case of a monetary union (the Franc Zone, for example), provided, however, that the obstacles to intra-regional capital flows are removed and co-ordinated efforts are made to facilitate the development of other sub-regional financial markets (interbank market, stock market, etc.), without focusing exclusively on the government debt market. While WAEMU and CEMAC countries have adopted this approach, other countries that do not belong to the same monetary area may also foster the development of their local markets by promoting a greater convergence of their regulations, by removing certain administrative barriers to the free movement of capital or by setting up common – or at least compatible – market infrastructures. Some countries in southern Africa, in the framework of the Southern African Development Community, and eastern Africa have been seeking since 2006-2007 to establish ties between their financial markets to benefit from regional dynamics.

• A pragmatic approach. The creation and development of local debt securities markets should be underpinned by pragmatic strategies, based on limited but carefully ordered objectives. These could be the following:

– developing a primary market by giving priority to short-term issues, before progressively extending maturities and setting up a bond segment;

– giving priority to regular operations rather than large-value, albeit one-off, operations;

– ensuring the creditworthiness of issuers, in particular governments, by defining cash management strategies, adopting transparent issuance procedures, setting up credible and efficient primary dealers, complying with issuance programmes, systematically disseminating detailed information on operations to the market;

– setting up appropriate market infrastructures (settlement systems, central securities depositories) corresponding to the trading volumes

to be processed.[7] In the case of nascent markets, these tasks may have to be carried out by public structures, either directly (central banks or ad-hoc structures) or indirectly (through subsidies or tax breaks), before entrusting them to private entities;

– avoiding all forms of over-regulation that are likely to generate distortions in the behaviour of issuers and subscribers, without being really effective. When markets are starting up, it is essential that the set of regulations be simple, transparent, sufficiently flexible and easily understandable by all players in order to prevent excessively restrictive effects on the supply of securities.

• The extension of the guarantee mechanisms for government and corporate bond issuance, by the signature of institutions specialised in development financing, such as the African Development Bank (AfDB), the *Agence française de développement* (AFD), the entrepreneurial development bank of the Netherlands (FMO), the International Finance Corporation (IFC) or PROPARCO.

• The setting-up of multilateral instruments for hedging foreign exchange risk. Like the Currency Exchange Fund (TCX) created by FMO at end-2007, these funds, supplemented by multilateral development agencies, could provide investors buying local currency securities with protection against foreign exchange risk, in the form of currency swaps or futures contracts, when these products are not provided by the private sector.

• The creation of pools of official foreign reserves to be invested in local-currency long-term debt securities in order to overcome the problem of the existence of different, non-convertible currencies and develop intra-regional flows. In the case of countries whose currency is inconvertible and vulnerable, it is desirable to consider ways of reducing risks, for investors for example by limiting the investments of these funds to issues including an indexation clause or a guarantee. In any case, it is important to ensure a prudent management of foreign reserves, by defining strict rules governing the fund management mandate. The initiative launched at the end of 2007 by the AfDB with a view to creating an African bond fund, which would bring together African central banks, is a step in the right direction.

• The gradual opening of the capital account. The opening of local markets to non-resident issuers and investors may be useful for structuring the market and benefiting from learning effects on the one hand, and increasing capital inflows on the other. However, the consequences of such liberalisation must be carefully analysed,[8] in particular with the help of international financial institutions. It may also be necessary to put in place, at least in the beginning, arrangements to limit the impact of this measure on the exchange rate system and exchange rate volatility.

7 *Oversized infrastructures entail large transaction costs that hamper market development.*
8 *Although it does not, in theory, represent a necessary condition for the opening of markets to non-resident investors, the opening of the capital account is, in practice, a key factor for generating significant demand without any excessive risk premium. The opening of markets to non-residents does not imply an opening of the capital account if the proceeds of the issues are invested locally. In addition, the existence of foreign exchange controls creates pockets of liquidity, which may attract non-resident issuers.*

Appendix

Methodological note

There is little available aggregated data on African government debt markets covering the recent period. The most comprehensive work on the subject was published by J. Christensen (2005). It offers a series of detailed data that cover 27 countries from Sub-Saharan Africa over the 1980-2000 period. Countries from the Franc Zone are not included in the analysis.

This study therefore aims at addressing, to the extent possible, the lack of available data since 2000.

To this end, two data sources were used:

– the data released by African central banks, most of which publish relatively precise information about their domestic debt markets on their website. Failing this, the study relied on information provided by the annual reports of central banks;

– the survey conducted by the foreign network of economic missions of the French Ministry of Economy, Industry and Employment for the purpose of this study. This survey collected data on African government securities markets, mainly in countries where there are few or no statistics on the subject, and identified the chief characteristics of the different regulatory frameworks in force.

The sample was defined so as to come close to that chosen by Christensen, in order to extend up to 2007, without any significant methodological break, the series of collected data over the 1980-2000 period. The eight West African countries of the Franc Zone (WAEMU)[1] were nevertheless included in the sample as the financial market conditions in these countries have radically changed compared to the previous period of analysis. Similarly, the main securities markets of North Africa (Morocco, Tunisia) were also taken into account.

Aggregated data were thus provided for four groups of countries:

– the low-income countries of Sub-Saharan Africa (SSA) eligible for the Heavily Indebted Poor Countries (HIPC) Initiative: Benin, Burkina Faso, Burundi, Ivory Coast, Ethiopia, Ghana, Guinea-Bissau, Malawi, Mali, Niger, Uganda, Rwanda, Senegal, Tanzania, Togo;

– the middle-income countries of SSA not eligible for the HIPC Initiative: South Africa, Botswana, Kenya, Mauritius, Nigeria;

1 Benin, Burkina Faso, Ivory Coast, Guinea-Bissau, Mali, Niger, Senegal and Togo.

– Sub-Saharan Africa, including all these countries;

– Africa, including Morocco and Tunisia.

The collected data concerned outstanding government debt, including Treasury notes, bonds and securities issued by central banks. The specific categories of government securitised debt, however, were not taken into account in this study. Statistics were also collected on the maturity structure of outstanding debt securities and on holder categories by economic sector. Insurance companies, pension funds and mutual funds, as well as public and para-public financial bodies (such as the Caisse des dépôts) were included in the non-bank financial sector. The non-financial sector was made up of commercial enterprises from the private and para-public sectors, private individuals and non-residents.

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