10th UNCTAD DEBT MANAGEMENT CONFERENCE

Geneva, 23th – 25th November 2015

Financing Options for Development

by

Mr. Raphael Otieno

Director, Debt Management Programme,

Macroeconomic and Financial Management Institute (MEFMI)

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Growth of Domestic Debt Markets in Selected African Countries

Benefits and Limitations

10th UNCTAD Debt Management Conference

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MEFMI

Discussion Outline

1. Background
2. Domestic Debt Developments
3. Domestic Markets Status and Characteristics
4. Benefits
5. Limitations

Background

- Historically, developing countries including those in the Sub-Saharan Africa have financed their budget deficits mainly through external concessional borrowing.
- Preference for external over domestic borrowing was due to:
  - Low fixed interest rates – below market (and domestic) interest rates
  - Longer maturities – up to 50 years
  - Source of foreign exchange to shield local currencies – build reserves
  - Avoid crowding out effect
- However, starting in 1990s LICs, including those in Africa, started increasingly using domestic debt markets for deficit financing.

Increasing Role of Domestic Debt Markets

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Public debt composition in developing countries

	1994				*1999*				*2005*			
	DD/Y	*ED/Y*	*TD/Y*	*DD/TD*	*DD/Y*	*ED/Y*	*TD/Y*	*DD/TD*	*DD/Y*	*ED/Y*	*TD/Y*	*DD/TD*
Simple average												
EAP	0.13	0.46	0.58	0.30	0.13	0.43	0.55	0.34	0.15	0.35	0.50	0.38
ECA	0.17	0.28	0.46	0.35	0.15	0.32	0.47	0.36	0.17	0.19	0.36	0.43
LAC	0.14	0.58	0.72	0.24	0.17	0.39	0.56	0.33	0.23	0.39	0.62	0.40
MNA	0.42	0.49	0.91	0.45	0.36	0.42	0.78	0.43	0.40	0.34	0.73	0.56
SAS	0.25	0.35	0.60	0.41	0.26	0.34	0.59	0.42	0.31	0.33	0.64	0.47
SSA	0.20	0.84	1.05	0.25	0.33	0.78	1.12	0.32	0.25	0.67	0.92	0.30
Total	0.19	0.55	0.75	0.30	0.22	0.47	0.69	0.35	0.23	0.40	0.64	0.40
Weighted average												
EAP	0.10	0.08	0.18	0.46	0.13	0.06	0.19	0.71	0.18	0.05	0.23	0.80
ECA	0.27	0.29	0.56	0.46	0.20	0.32	0.52	0.45	0.20	0.14	0.34	0.50
LAC	0.15	0.21	0.36	0.40	0.25	0.22	0.47	0.49	0.30	0.14	0.44	0.66
MNA	0.54	0.54	1.08	0.47	0.38	0.39	0.77	0.48	0.40	0.26	0.66	0.59
SAS	0.40	0.14	0.55	0.77	0.44	0.11	0.55	0.81	0.55	0.08	0.63	0.87
SSA	0.43	0.36	0.79	0.73	0.38	0.33	0.71	0.67	0.26	0.19	0.45	0.65
Total	0.22	0.21	0.43	0.48	0.24	0.19	0.43	0.59	0.27	0.11	0.39	0.69

Note: The 1994 average covers 85 countries, the 1999 average covers 103 countries and the 2005 average covers 97 countries. The regional abbreviations are: EAP: East Asia and Pacific; ECA: East Europe and Central Asia; LAC: Latin American and Caribbean; MNA: Middle East and North Africa; SAS: South Asia; SSA: sub-Saharan Africa. DD/Y is domestic public debt divided by GDP, ED/Y is external public debt divided by GDP, TD/Y is total public debt divided by GDP, DD/TD is domestic public debt divided by total public debt.

Interpreting the Global Trends

Simple averages

Simple averages for DCs show that between 1994 and 2005:

- Domestic debt to GDP in DCs increased from 19% to 23 %;
- Average debt levels on the other hand decreased from 75% to 64%;
- As a result, the share of domestic debt in total public debt increased from 30% to 40%.

Weighted averages

Weighted averages show that the switch to domestic borrowing is even more significant in some regions:

- Domestic debt to GDP increased from 22% to 27%;
- The share of domestic debt in total public debt increased from 48% to 69%.

Why Choice of Domestic Debt?

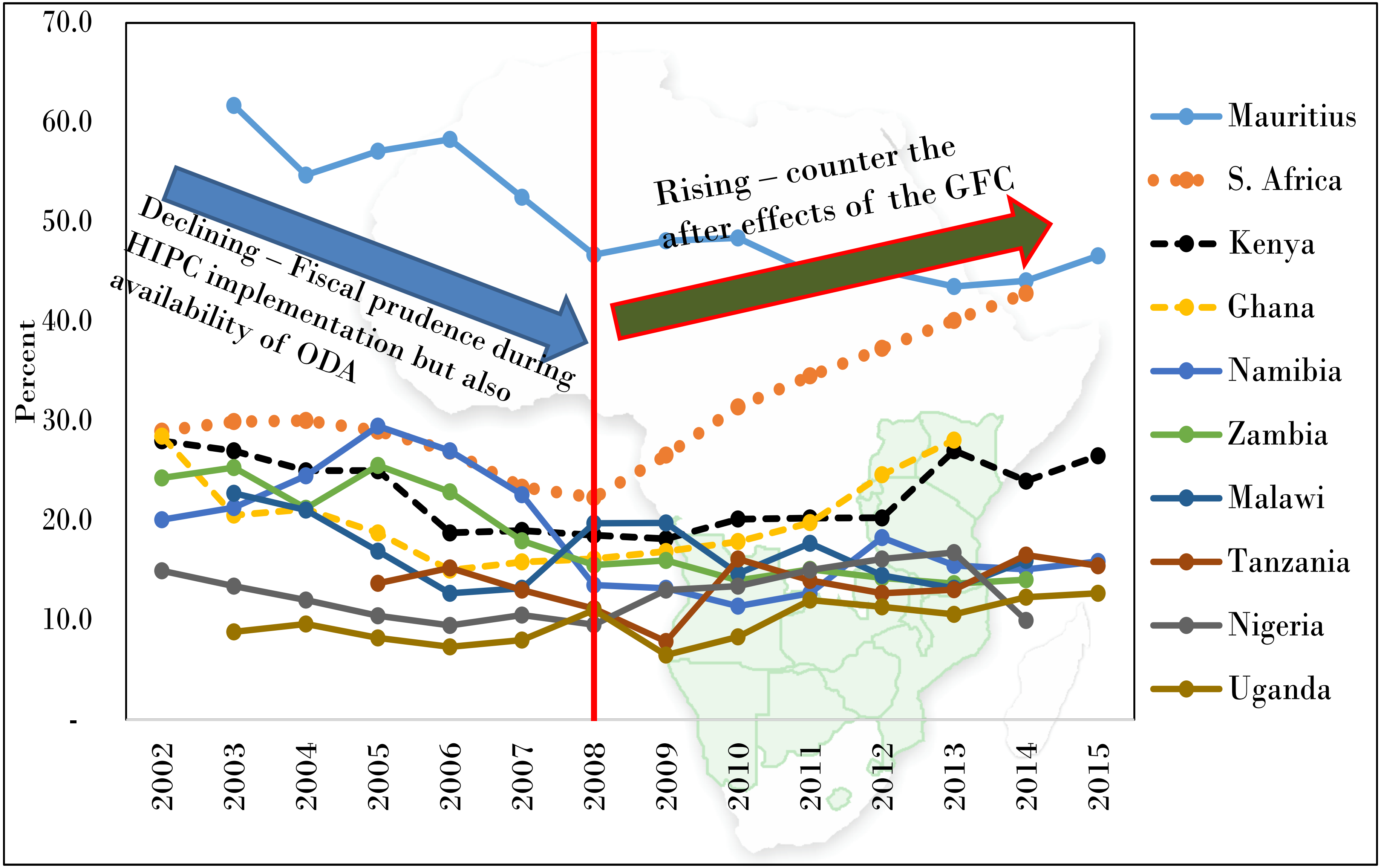
- To reduce exposure to currency risks associated with external borrowing.
- Flexibility in the use of borrowed funds – not project linked
- Predictability of funding – Not determined by extraneous factors such as conditionalities.
- Market development objectives:
  - An efficient market for government securities supports the conduct of monetary policy.
  - A liquid & deep market could help reduce the cost of government financing.
- To provide a benchmark for the issuance of other securitized debt such as corporate bonds.
- To develop interbank money markets by acting as collateral & reducing transaction costs.

What are the trends?

Domestic Debt Trends

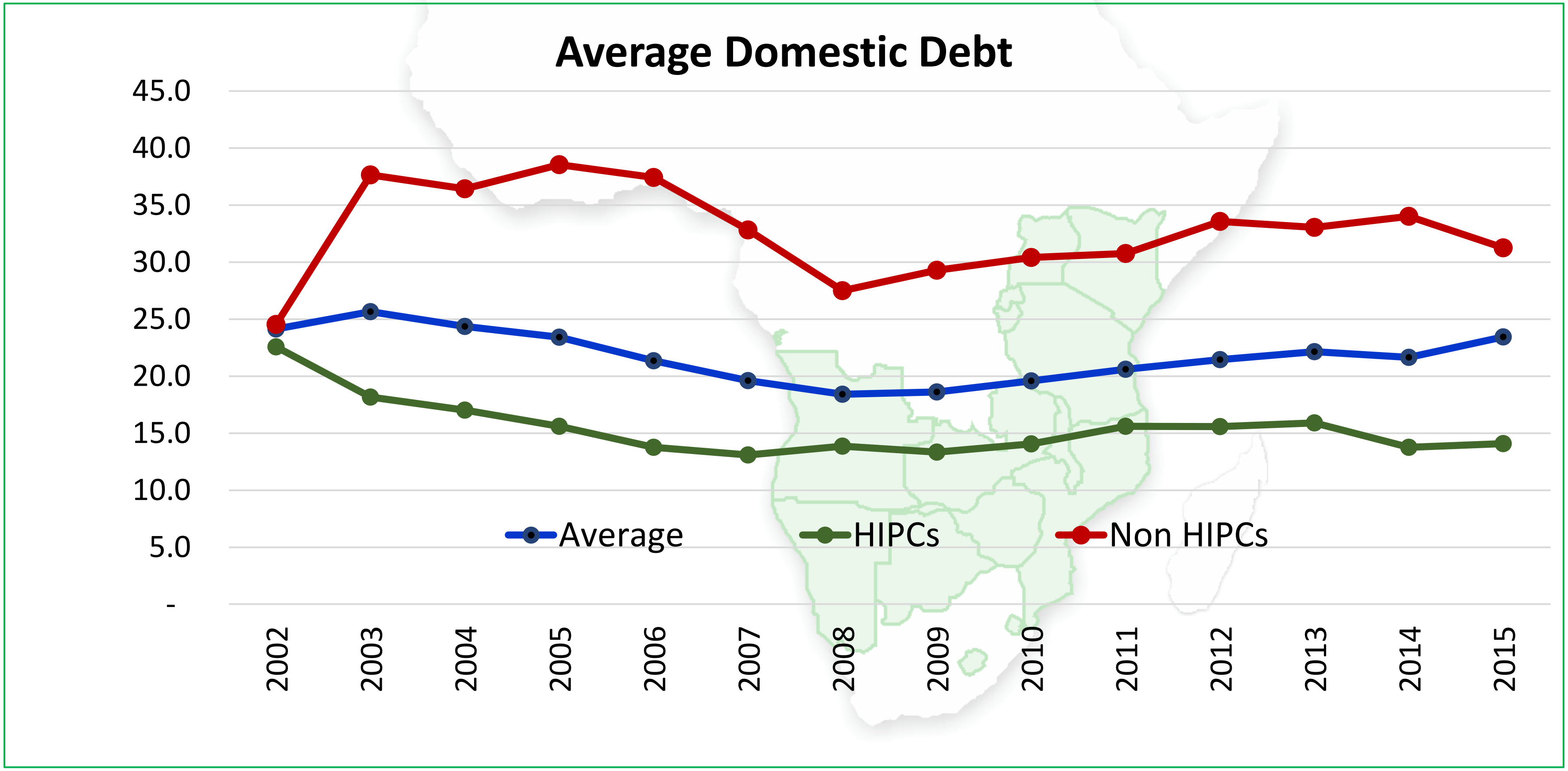
- A sample of domestic debt trends in ten African countries (Mauritius, South Africa, Kenya, Ghana, Namibia, Zambia, Malawi, Tanzania, Nigeria and Uganda) from 2001/02 – 2014/15 shows:
  - Average domestic debt to GDP was about 25% in early 2000s before declining to around 18% in 2008 after which picked again to about 24% in mid 2015;
  - There were differences in trends of individual countries with S.Africa showing the greatest increase but Mauritius retaining highest ratio (50% of GDP);
  - In South Africa dom. debt/GDP ratio grew from 22.3% in 2008 to about 43% in 2014;
  - Kenya and Ghana also recorded steady growth during the same period (Kenya 18% to 25% of GDP);
- In nominal terms the growth has been tremendous – the ratios are cushioned by the good GDP growth in Africa during the period.

Domestic Debt Developments

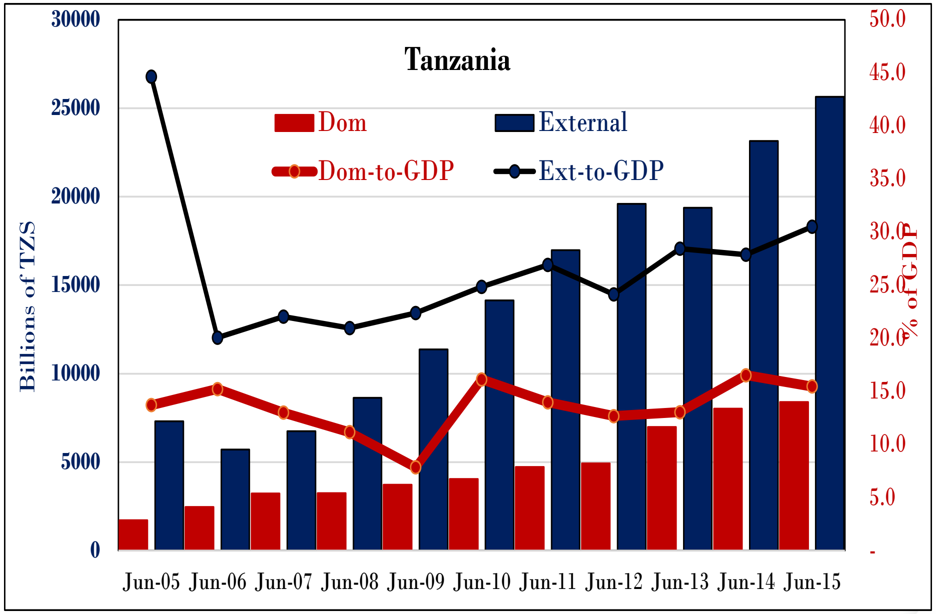


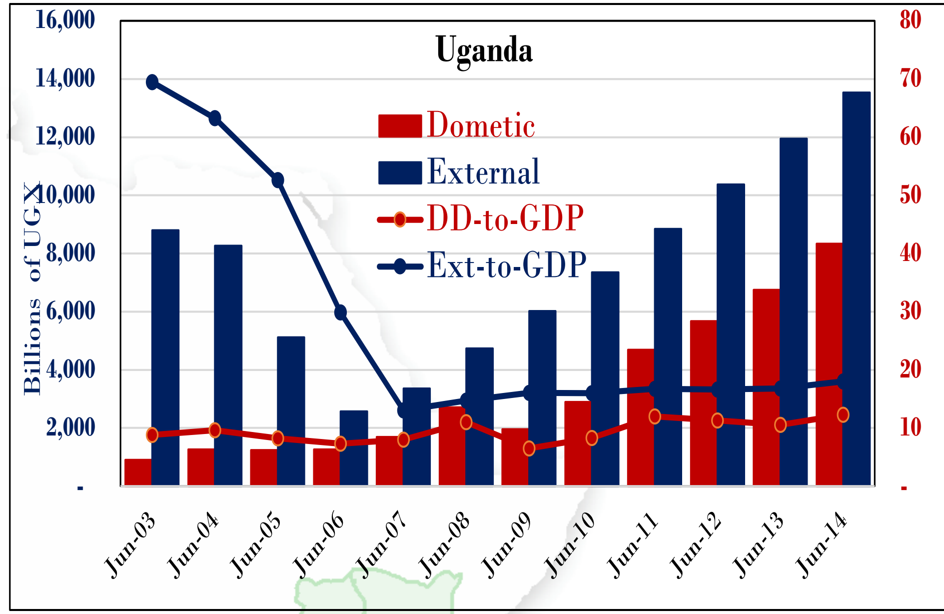
Domestic Debt Developments

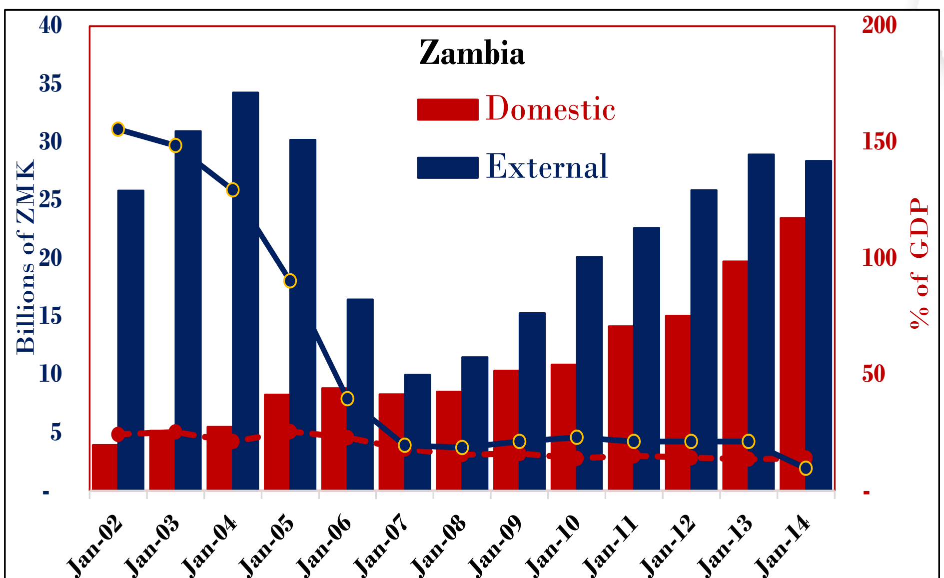
- Based on the sample - average the domestic debt are relatively low in the former HIPCs (Malawi, Ghana, Nigeria, Uganda, Tanzania, Uganda) as compared to non-HIPCs (South Africa, Namibia, Mauritius and Kenya) – this is because former HIPCs relied more on external concessional borrowing.

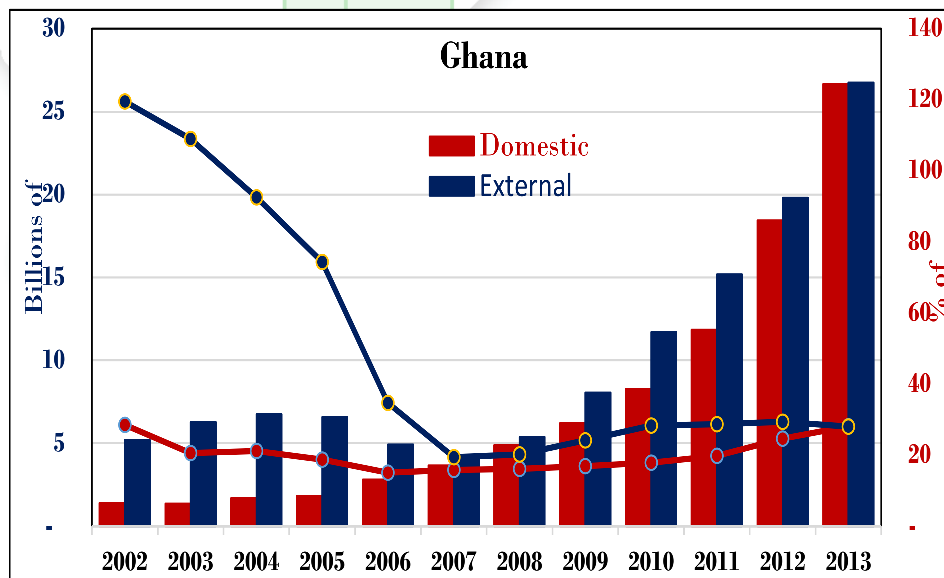


Individual Country Developments

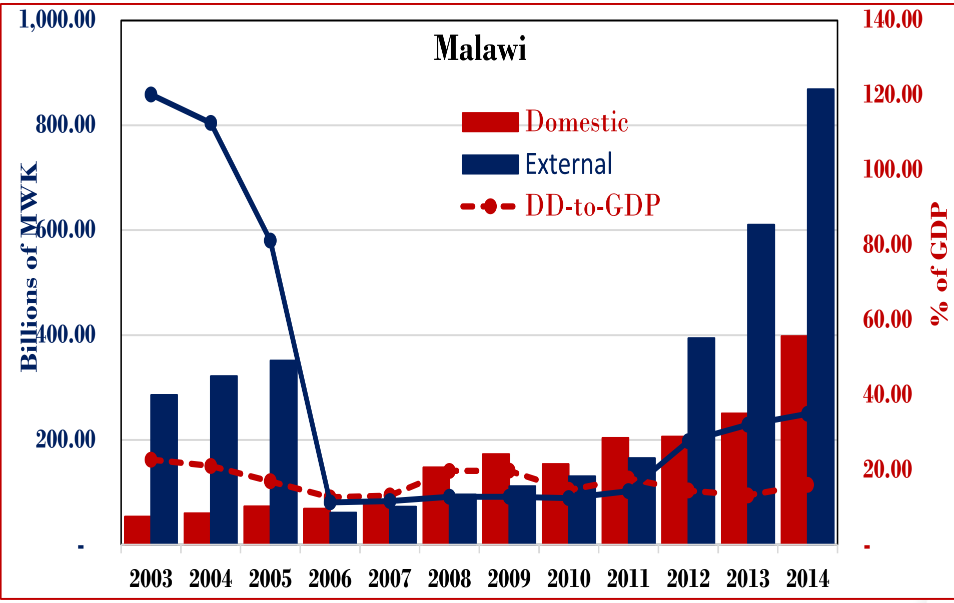


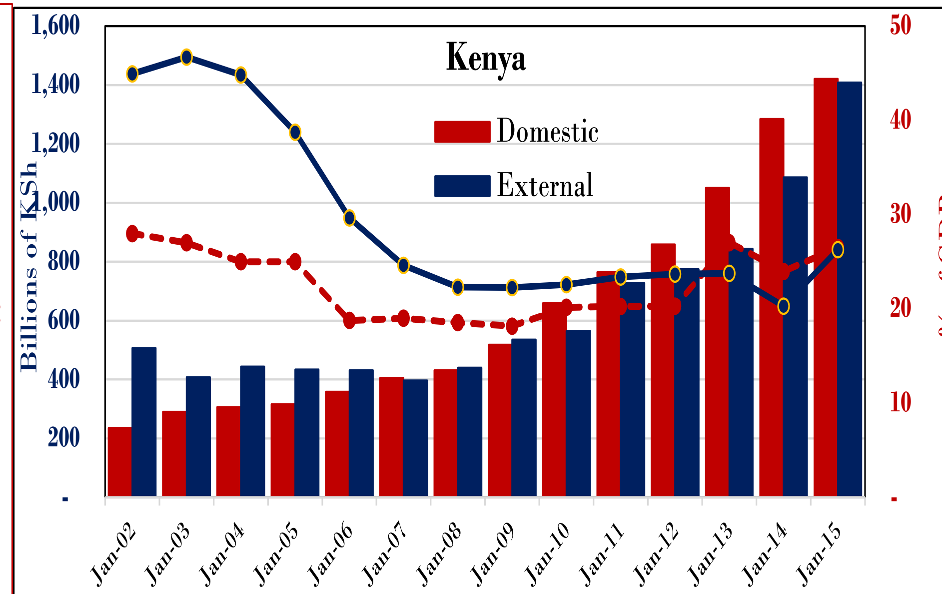




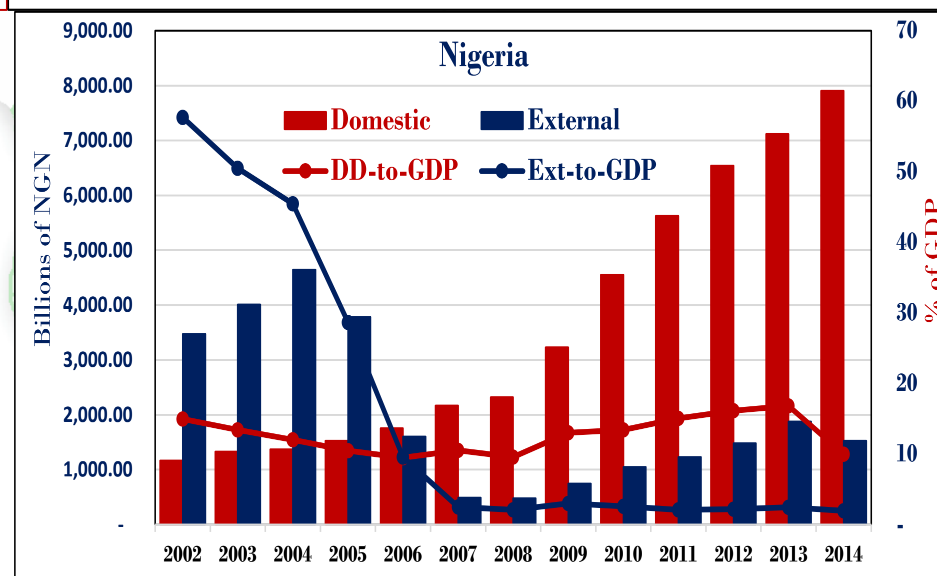


Public Debt Developments



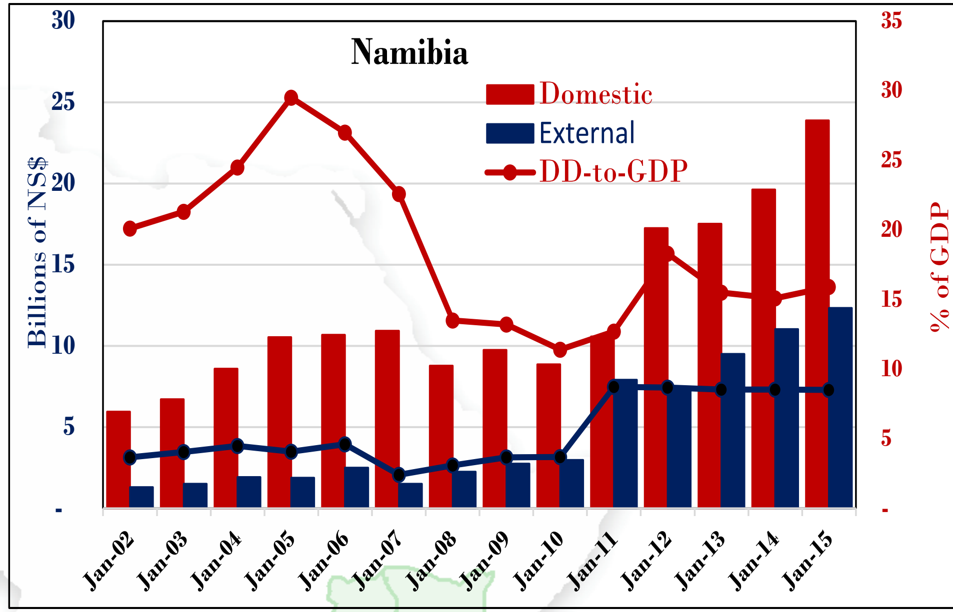


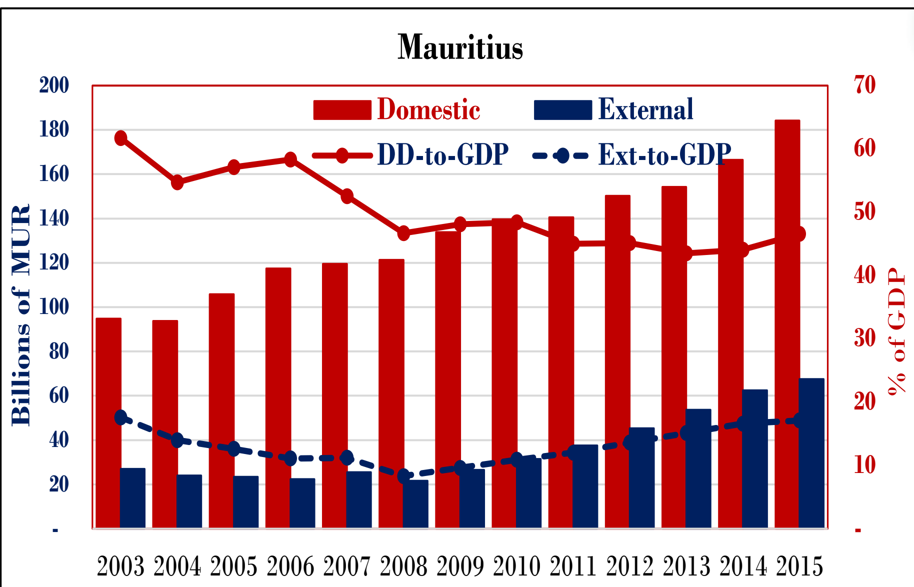
- Nigeria's domestic debt is one of the fastest growing in the region among the former HIPCs in both nominal terms and as ratio of GDP since mid 2000s
  - It has surpassed external debt
  - Attributable to the switch towards domestic debt financing coupled with a decline in domestic revenue

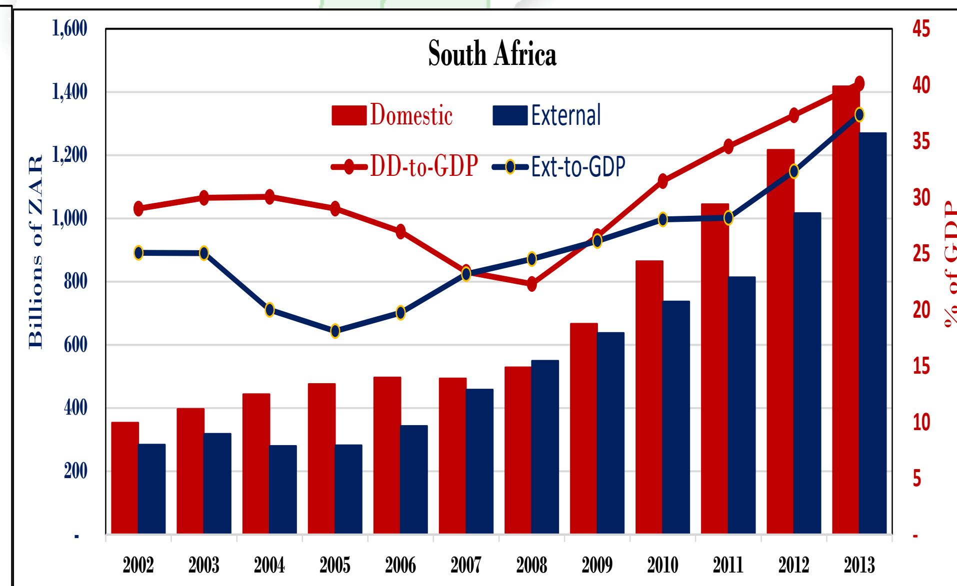


Developments in Other Countries

- Mauritius, Namibia and South Africa have relatively more developed domestic debt markets
- Domestic debt (nominal & as ratio of GDP) has been higher than external for the past 15 years

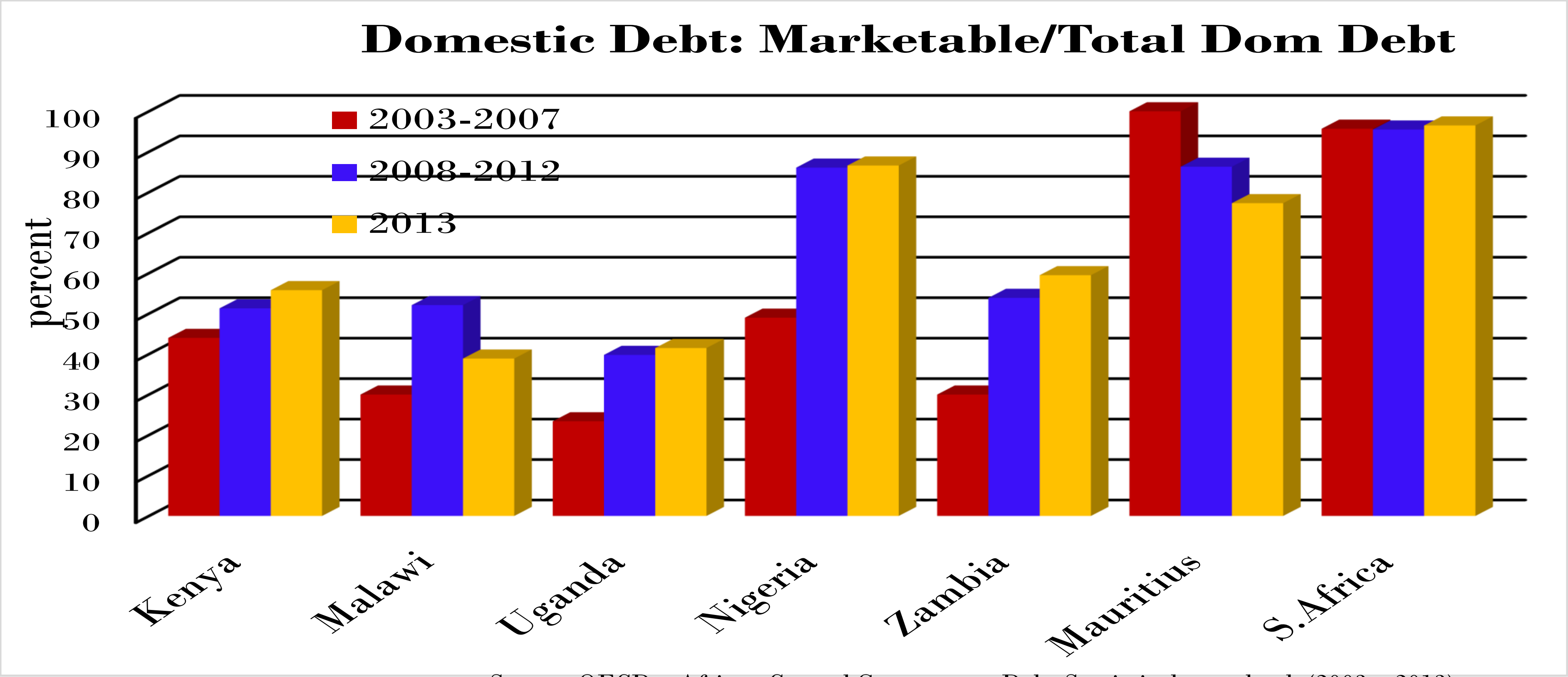






Instruments Traded

- Government remains the major player in the markets
- Countries are increasingly issuing through marketable instruments, mainly treasury bills and bonds
- With an exception of Mauritius and Malawi from the sample in the chart, all other countries recorded a steady growth of their marketable domestic debt in the last ten years (2003 – 2013)



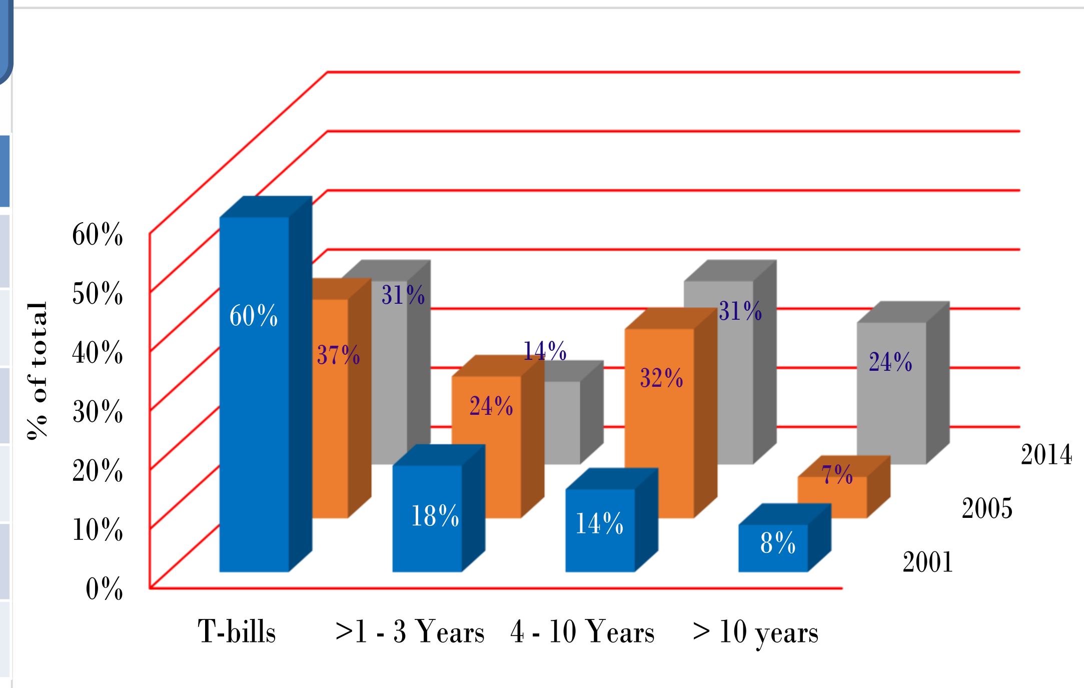
Source: OECD – African Central Government Debt Statistical year book (2003 – 2013)

Instruments have gradually evolved from dominance by T.bills to long term bonds

Maturity Structure

Average Maturity structure of domestic debt for Ghana, Kenya, Nigeria, Tanzania and Zambia

Country	Longest Maturity - 2014
Kenya	30 years
Nigeria	20 years
Uganda	15 years
Zambia	15 years
Tanzania	15 years
Malawi	3 years



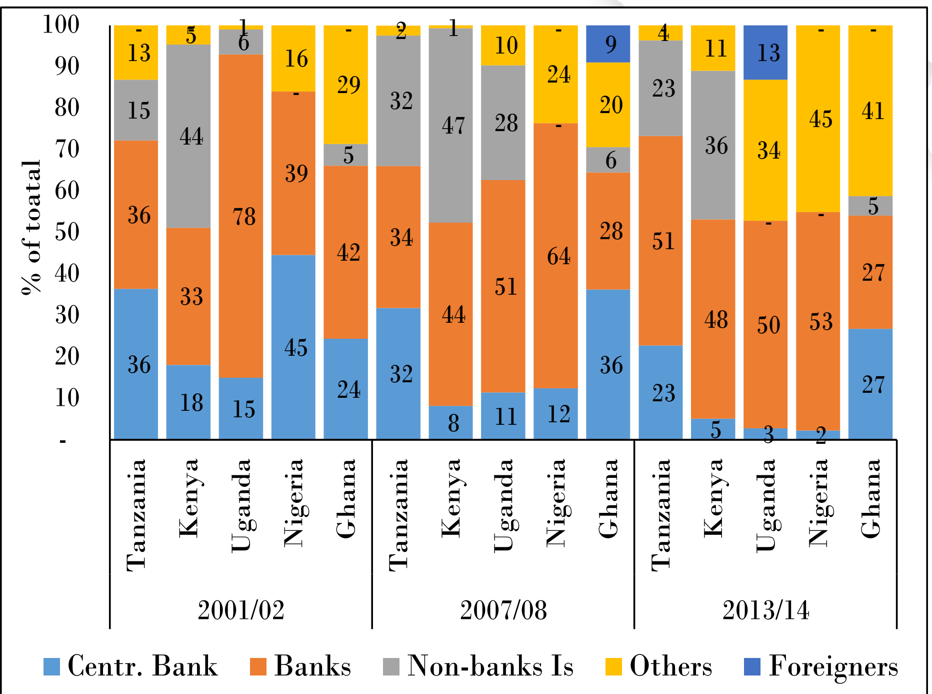
- Lengthening maturity in some countries is constrained by:
  - Low investor base dominated by commercial banks
  - Low secondary market activity

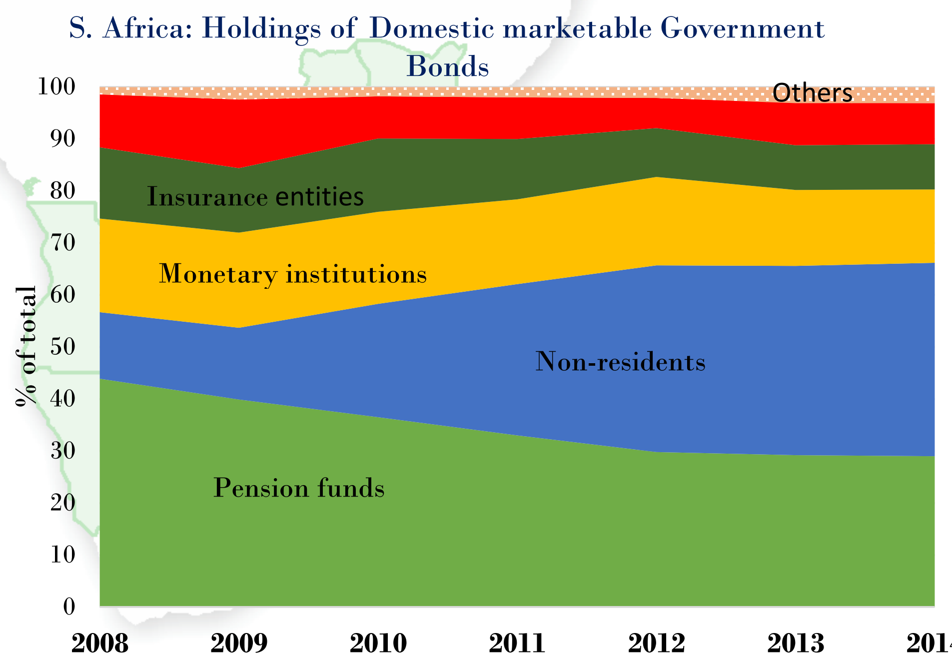
Market Characteristics?

Investor Base

- The banking sector is still dominant in most of the African countries
- However, there is good investor diversification in South Africa, Kenya & Namibia, and increasing diversification in Nigeria, Uganda and Ghana where non-bank players expanded in 2013/14 compared to previous periods
- Non-residents are increasingly participating in South African market
- Uganda and Ghana also have some foreign participation
- The central bank still plays significant roles in Ghana and Tanzania

Domestic Debt by holders category

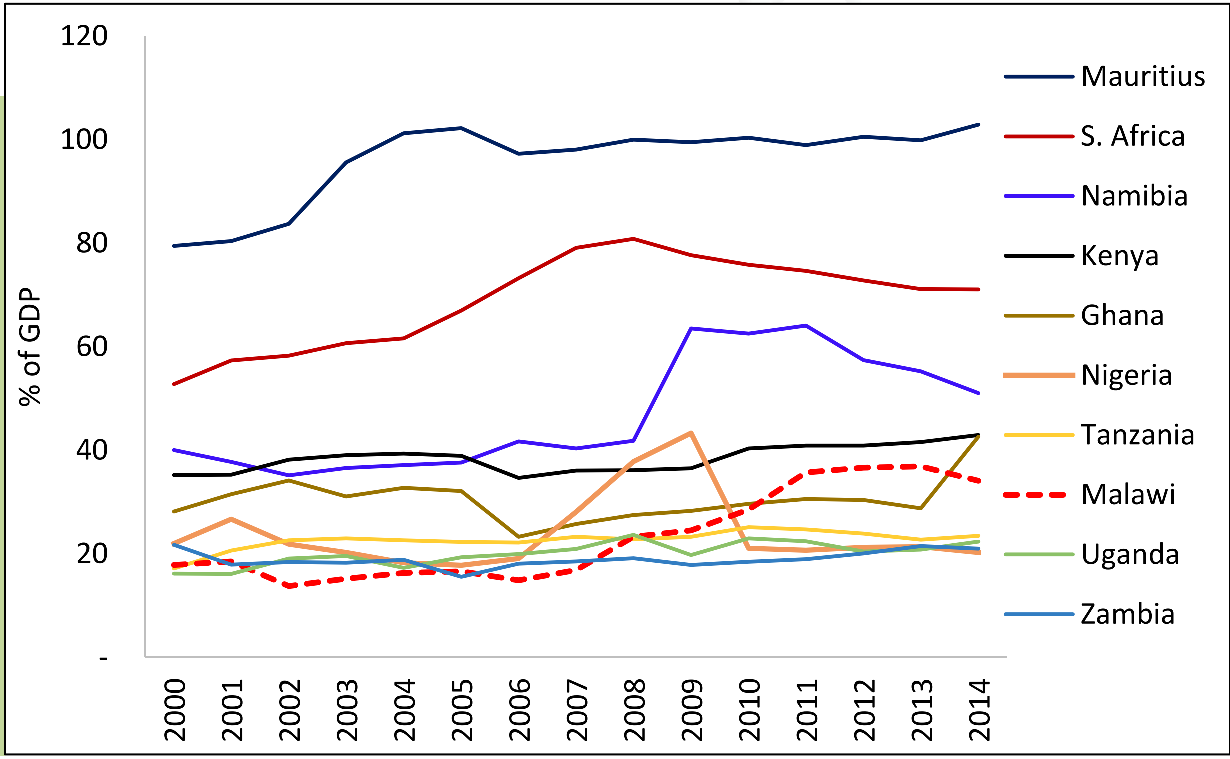




Depth of Financial Sector

- The expansion of domestic debt markets depends on the depth of financial sector as measured by the ratio of broad money (M2) to GDP
  - Mauritius and S.Africa have very deep financial markets with M2/GDP averaging 73% and 60%, respectively during the period 2000 – 2014
  - Namibia (41%) & Kenya (35%) followed with fairly deep financial sectors
  - All other countries have relatively shallow financial sectors with average M2/GDP - below 25% which limits expansion of domestic debt markets

- During period (2000-2014) the economies with deep financial markets also posted growth
- Mauritius (79% to 103%)
- S. Africa (53% to 71%)
- Namibia (40% to 51%)
- Kenya (35% to 43%)



Preliminary Conclusions

- Although still at nascent stages, domestic debt markets have already shown signs of growth in most developing countries, Africa included.
- However, the markets are still facing some constraints partly arising from structural factors

Implications of the growing domestic debt?

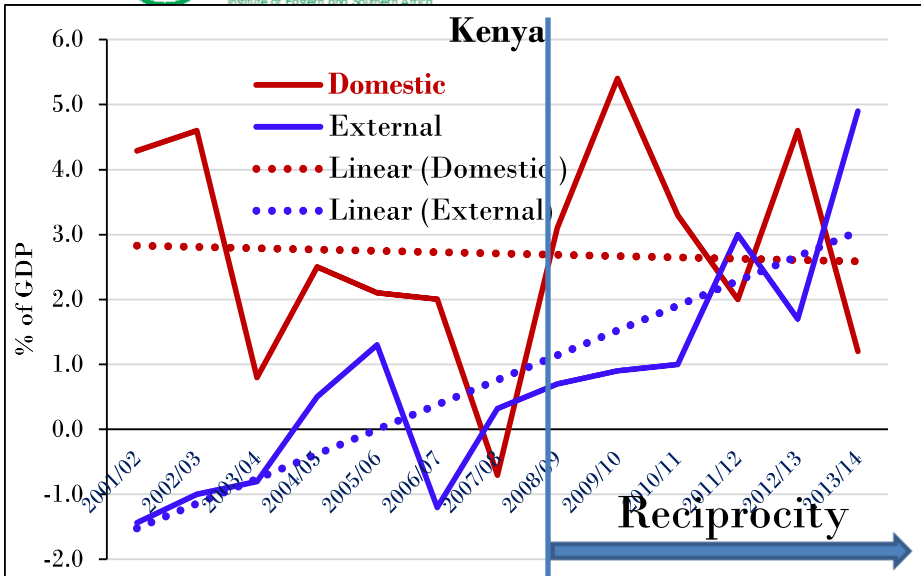
General Benefits

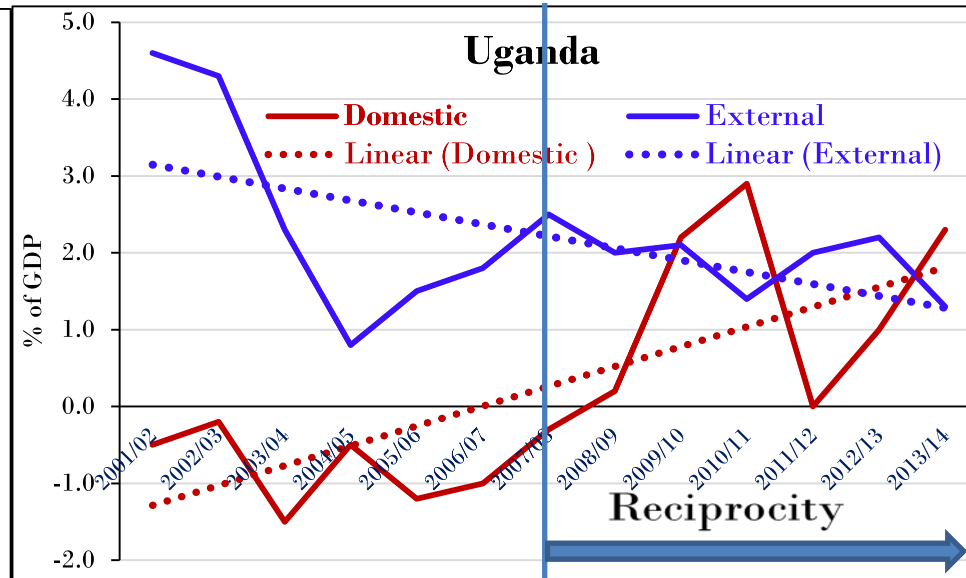
- Lower exposure of the public debt portfolio to currency risk - this is the case for most of the countries in SSA as they issue in local currencies.
  - An exception is Angola which issue some domestic debt in US$ but issuances are also hedged by oil revenue denominated in US$
- Markets have deepened leading to more efficient markets that support the conduct of monetary policy.
- A liquid & deep market could help reduce the cost of government financing.
- Provided a benchmark for the issuance of other securitized debt such as corporate bonds.
- Helped to develop interbank money markets by acting as collateral & reducing transaction costs.

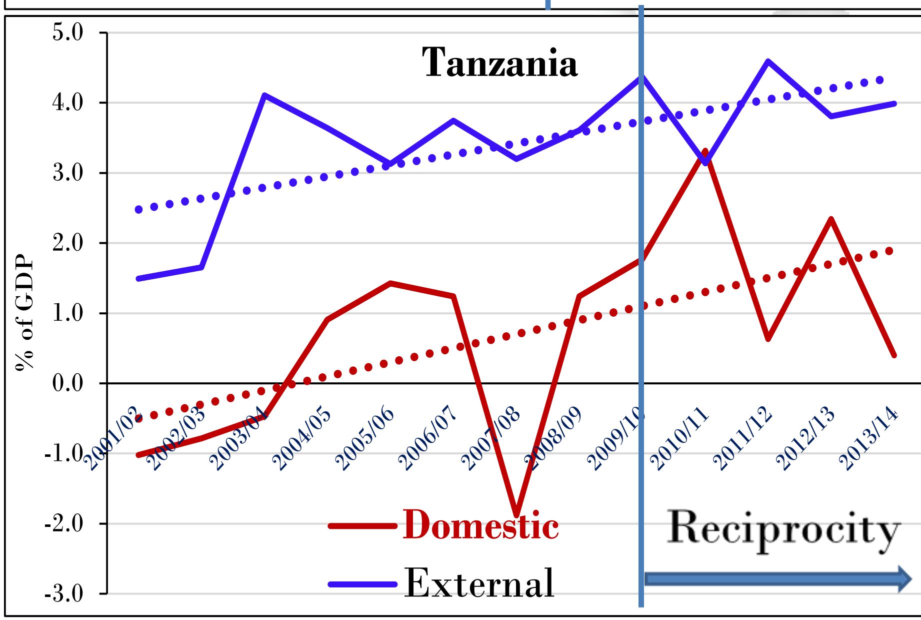
Benefits to Govt Budgets

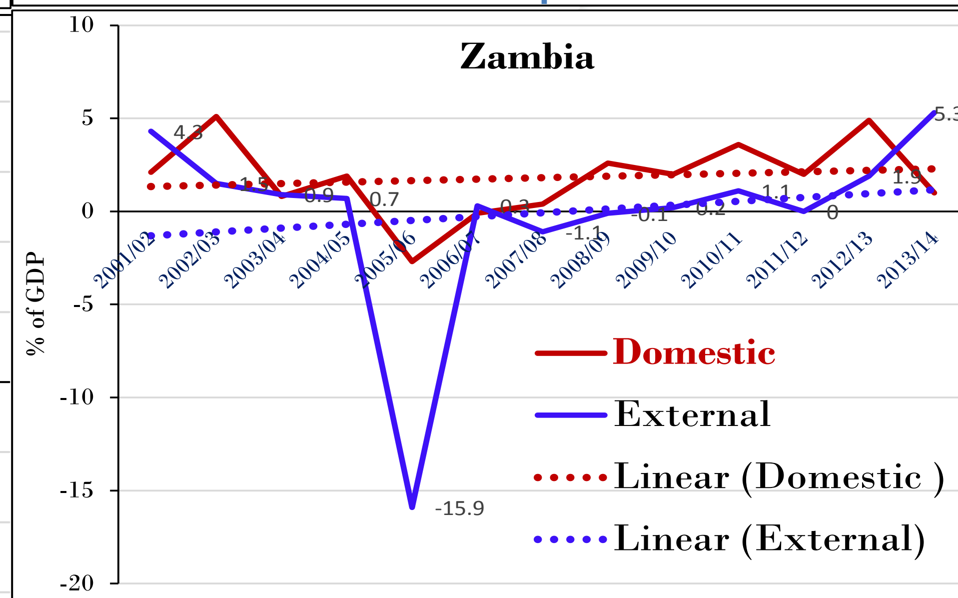
- A common feature in almost all the countries is the reciprocity between external and domestic finance starting late 2000s, particularly after the Global Financial crisis.
  - This suggests that domestic financing is widely used as residual after exhausting other sources including external financing

Domestic Financing (% of GDP)









Limitations of Domestic Debt Markets

- The domestic debt markets are still underdeveloped in most of the countries. Consequently:
  - Relatively higher cost of borrowing as compared to external sources
  - The markets are shallow, narrow and illiquid hence vulnerable to refinancing risks. Govts are likely to be held hostage by a small group of investors – the few prominent commercial banks (World Bank and IMF, 2001)
  - Issuances are still in local currencies – some of governments' (capital) expenditure involves importation which requires foreign currencies
  - Interest rate risks – this is more in countries with significant portion of domestic debt being issued on variable interest e.g. Angola, Mozambique, Namibia and S. Africa
  - Governments are still the major issuers of domestic debt – limited corporate bonds
- Balance of Payments positions for most countries are still weak necessitating external borrowing to fill the foreign exchange gap
- Thus there is scope for more reforms to realize the full potential of domestic debt markets.

Implication - cost and risks

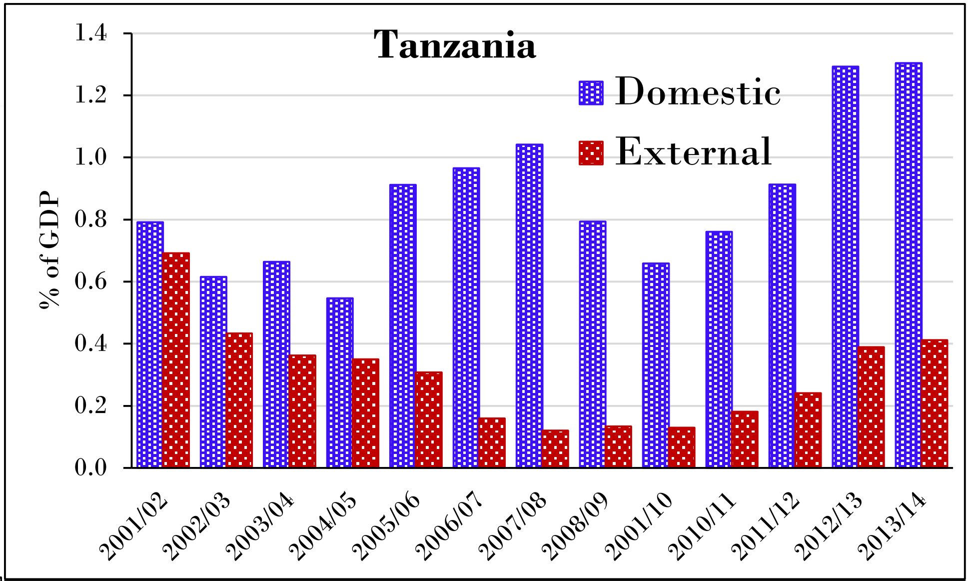
- Higher cost of domestic borrowing - from the sample below domestic WAIR is 11.5% against 2% for external
- Higher refinancing and interest risks as measured by ATM (3.1 yrs), Debt maturing in 1 year (43.5%), ATR(3 years) and debt refixing in 1 year(48.8%)
    - These risks indicators have been moderated by Kenya with relatively advanced domestic markets

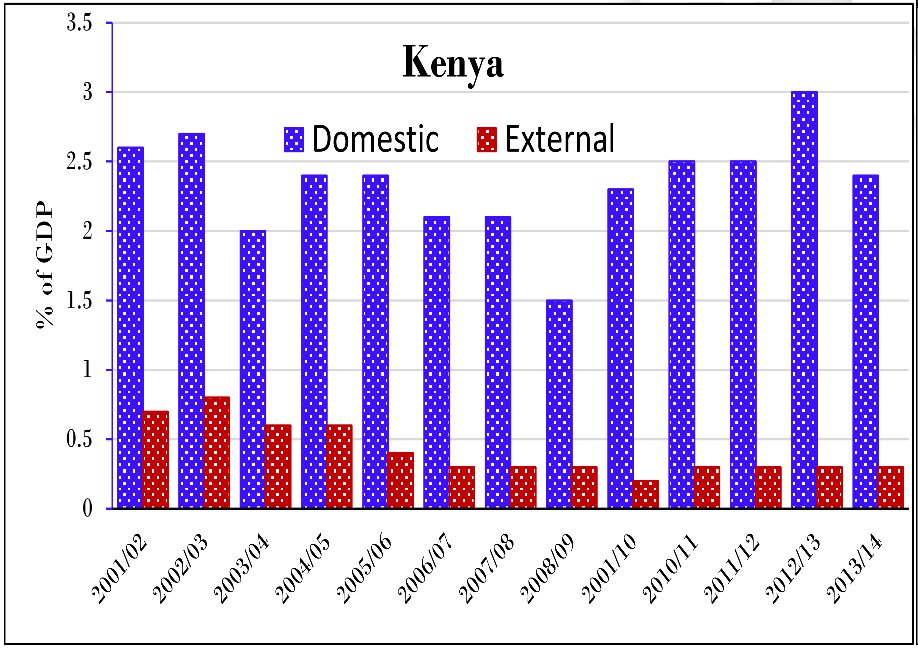
Cost and Risks of Public Debt

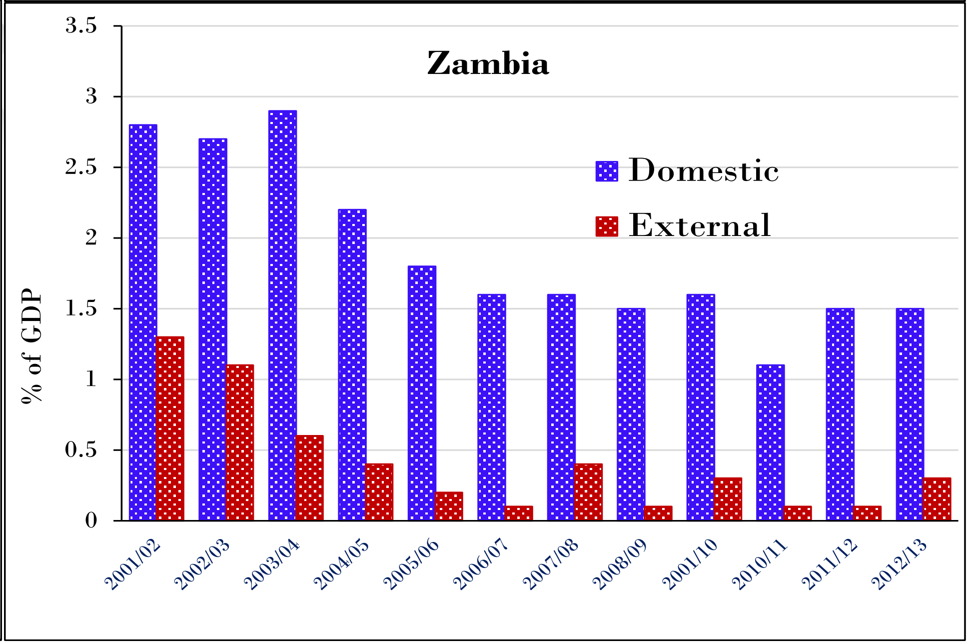
Cost-Risk	Indicator	Debt Category	Lesotho (2013)	Malawi (2013)	Mozambique (2014)	Namibia (2012)	Tanzania (2013)	Uganda (2014)	Zambia (2014)	Nigeria (2010)	Ghana (2010)	Kenya (2014)	Average
Cost	WAIR	Ext	1.2	1.3	1.4	3.6	1.5	1.0	4.9	1.1	2.3	1.7	2.0
		Dom	7.9	17.9	8.5	7.8	14.1	12.3	13.7	8.7	17.8	6.2	11.5
Refinancing Risk	ATM (yrs)	Ext	12.5	16.2	15.7	7.8	17.5	18.9	11.8	16.4	12.5	12.8	14.2
		Dom	1.9	1.2	1.5	3.4	6.9	2.3	2.2	5.0	1.3	5.0	3.1
	Debt maturing in 1yr (% of total)	Ext	3.7	2.1	1.8	4.0	1.4	3.3	1.9	4.6	3.5	2.4	2.9
		Dom	54.9	75.0	38.3	49.0	16.3	49.5	58.5	32.4	47.6	13.4	43.5
Interest Rate Risks	ATR(yrs)	Ext	12.5	16.2	14.4	7.5	16.9	18.9	11.3	16.4	12.0	12.8	13.9
		Dom	1.9	1.2	0.9	3.4	6.9	2.3	2.2	5.0	1.2	5.0	3.0
	Debt refixing in 1yr (% of total)	Ext	4.2	2.1	10.3	9.2	16.9	3.3	8.4	5.6	13.5	2.4	7.6
		Dom	56.7	75.0	82.7	49.0	16.3	49.5	58.5	32.4	54.8	13.4	48.8
	Fixed rate debt (% of total)	Ext	99.5	100.0	91.5	94.2	83.5	100.0	92.9	98.1	89.0	100.0	94.9
		Dom	95.1	100.0	82.6	100.0	100.0	100.0	100.0	100.0	57.7	100.0	93.5

Example of Interest Payments

- The cost of borrowing from domestic debt markets as a ratio of GDP is higher than external
- E.g. in Tanzania, Zambia and Kenya the cost of domestic debt is about 3, 5 and 6 times that of external debt, respectively



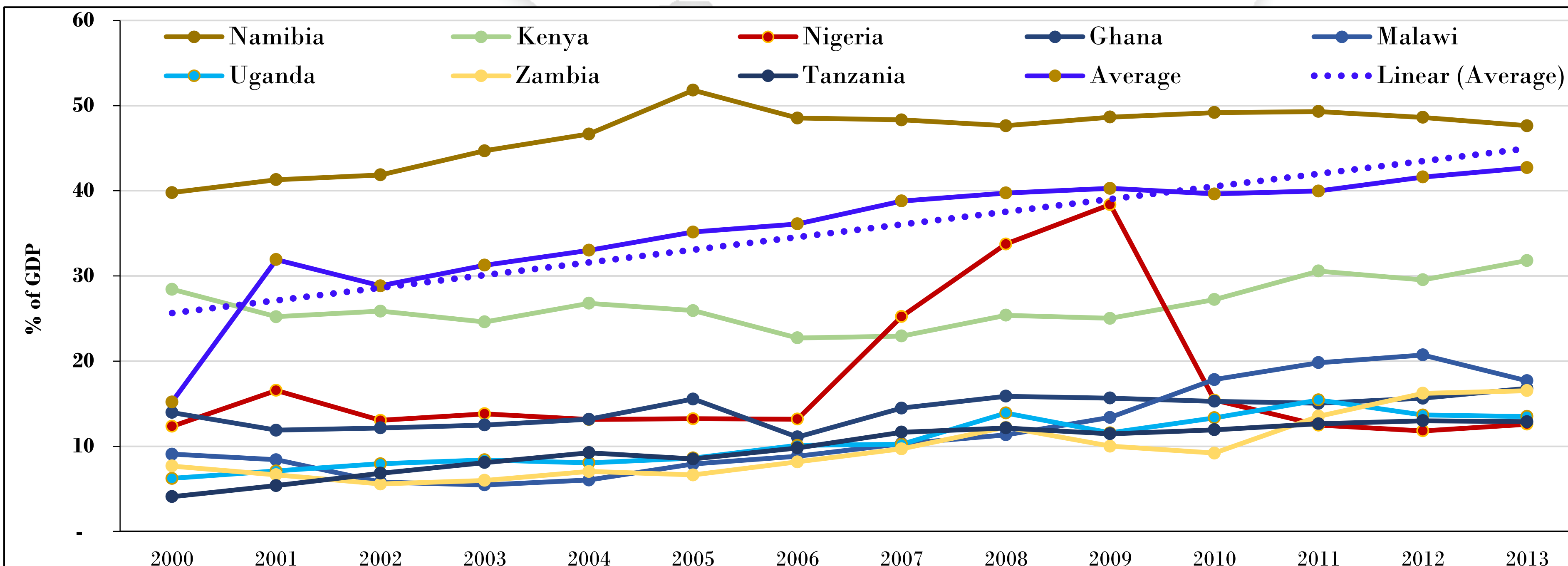




Crowding Out effects

- Raise the cost of borrowing (for flexible rate markets) and credit rationing (for fixed rate markets). The crowding out effect is more pronounced under capital account restriction jurisdictions and in the absence of nonbank investors such as insurance, pension funds and any other specialized funds
- From the sample, average credit to private sector has been growing despite the increasing government borrowing from the market - not yet a big threat to the sampled countries

Domestic Credit to Private Sector



Way Forward

- Strengthen and deepen domestic debt markets. Focus should be on enhancing secondary trading and expanding the investor base.
- Improve public expenditure management: expenditure rationalisation, efficiency of expenditures. Improve overall fiscal discipline.
- Increase tax effort.
- Maintain strong GDP growth.
- Maintain prudent monetary and fiscal policies that are anti-inflation and keeps interest rates low and stable.

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