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Sub-Saharan African Sovereigns To Face Increasingly Costly Financing

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Sub-Saharan African Sovereigns To Face Increasingly Costly Financing

Over the past few years, sub-Saharan African (SSA) sovereigns have enjoyed unusually favorable financing conditions. Many have issued maiden bonds in the global capital markets, and yields hit all-time lows in mid-2014. By and large, this has resulted from the exceptionally loose monetary policies that central banks in the developed world have pursued and advantageous commodity prices.

The tide has turned. Standard & Poor's Ratings Services thinks the majority of these sovereigns will direct an increasing share of revenues over the next three years to servicing their debt. The effective management of these changes will pose difficult policy choices for African governments. We see two groups of factors--global and domestic--that contribute to our expectation of higher government interest expenditures.

First, there are global factors. These are to a large extent out of SSA governments' control. The depreciation of local currencies (often related to the recent commodity price decline) has inflated foreign currency debt for several SSA sovereigns in 2015. A number of SSA central banks reacted to weakening currencies by raising interest rates, which, in turn, is fueling increasing domestic borrowing costs. In addition, we anticipate that the continued tightening of global liquidity conditions (with a U.S. Federal Reserve rate hike announced in December 2015) will also raise the future refinancing cost of U.S. dollar-denominated commercial debt.

Second, there are domestic factors centered on the governments' fiscal performance. At present, we project the budgetary performance of most SSA sovereigns will deteriorate over the next three years, keeping debt elevated. In contrast to global developments, governments generally have more direct control over their fiscal positions. Although SSA sovereigns may have limited influence over their revenues, they can cut expenditures and thus face a conscious, albeit challenging, choice between fiscal restraint and incurring additional debt.

As a result, we think many SSA sovereigns will face difficult policy choices in the coming years, weighing front-loaded fiscal consolidation against elevated future debt levels and increasing interest expenditures. These anticipated developments are already largely incorporated in our SSA sovereign ratings, which are forward-looking assessments of creditworthiness. We have lowered a number of ratings in the region over the past two years. Ratings could still come under strain if global factors exerted unexpectedly stronger pressure on the SSA governments, or if the sovereigns' fiscal positions deteriorated more than we presently anticipate, as highlighted in our published outlook statements. Nevertheless, we currently view this scenario as unlikely for most SSA sovereigns. Of the 18 sovereigns we rate in the region, five have a negative outlook and the remainder carry a stable outlook.

Overview

- Over the past few years, sub-Saharan African (SSA) sovereigns have enjoyed unusually favorable financing conditions.
- The tide has turned--these sovereigns will direct an increasing share of revenues over the next three years to servicing their debt.
- Higher interest expenditures are attributable to both global factors, such as exchange rate movements and tightening liquidity conditions; and domestic factors, primarily underlying fiscal performance.
- Our ratings on regional sovereigns largely incorporate these anticipated developments, but they could still come under strain if global factors exert unexpectedly stronger pressure on SSA governments or if the sovereigns' fiscal positions deteriorated beyond our current forecasts, as highlighted in our published outlook statements.
- Nevertheless, we currently view this scenario as unlikely for most SSA sovereigns. Of the 18 sovereigns we rate in the region, five have a negative outlook and the remainder carry a stable outlook.

What Financing Options Have Regional Sovereigns Had?

Historically, the primary financing options for rated SSA sovereigns have been concessional borrowing and, to a somewhat lesser extent, domestic financing. More recently, Eurobond issuance has gained importance, with a host of SSA governments issuing in the global capital markets for the first time in their histories.

Concessional borrowing comprises low interest non-commercial external loans and remains an important financing source. Multilateral loans currently average over 50% of total debt in the SSA region. These facilities are typically extended by international institutions (such as the World Bank or African Development Bank) or groups of creditors and are granted to help facilitate development in low-income countries.

Domestic sources of financing generally occupy a somewhat smaller proportion of total. These are predominantly in local currency with debt held by domestic banking systems (in some countries, including South Africa, Nigeria and Ghana there are also nonresident holdings of local currency denominated debt).

Eurobond issuance has gained more importance for several SSA sovereigns in recent years (see "The Growing Allure Of Eurobonds For African Sovereigns," published May 6, 2013), given the attractive foreign financing conditions. Within the region, the larger Eurobond issuers typically have more developed domestic capital markets and higher GDP per capita, with fewer concessional facilities available--such issuers include Kenya, Zambia, Nigeria, and Ghana.

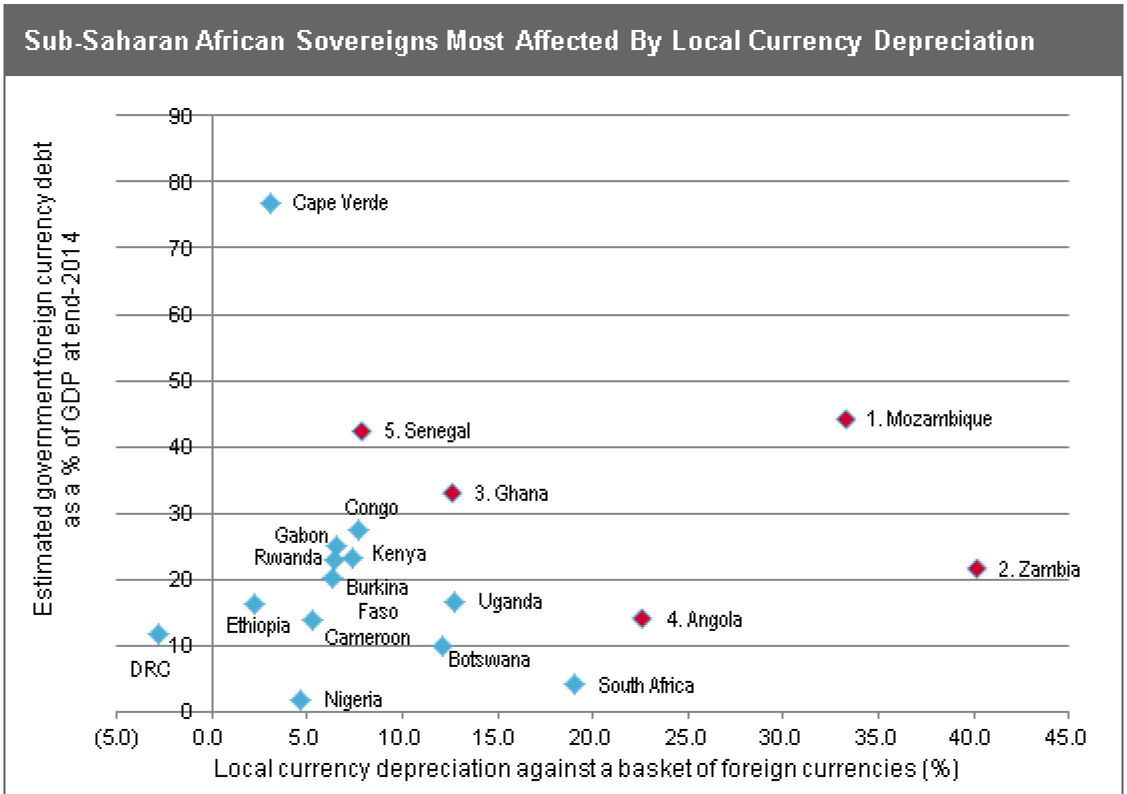
However, as the external environment changes, so does the rationale behind sovereign financing choices. The depreciation of SSA local currencies has made foreign currency debt contracted in the past more burdensome. Moreover, it has forced several SSA central banks to hike interest rates, in turn also increasing domestic borrowing costs.

Local Currency Weakening Is Increasing The Burden Of Existing Foreign Currency Debt

Several SSA sovereigns' currencies have depreciated at a rapid pace this year. The Zambian kwacha and Mozambican metical have lost about 40% versus the U.S. dollar since January 2015, while the currencies of Angola and South Africa have depreciated by more than 20%. Of the 18 countries we rate in the SSA region, only four--Democratic Republic of Congo (DRC), Rwanda, Ethiopia, and Nigeria--experienced currency depreciation of less than 10% over the same period (still, the Nigerian naira had already depreciated at the end of last year, whereas in Ethiopia the black market exchange rate has weakened compared with the official rate we use). We monitor movements in values of local currencies because, among other factors, we have observed that rapidly depreciating currencies have frequently been a leading indicator of sovereign default in the past (see "Common Characteristics Of Rated Sovereigns Prior To Default," published Jan. 17, 2014).

The direct impact of a depreciating currency is the increase in a sovereign's foreign currency debt burden (in local currency terms) relative to its gross domestic product. At present, we do not project SSA currencies will strengthen over the next few years, so we think this "debt inflation" effect will not reverse. To gauge its impact, we plot the change in value of local currency versus the government's estimated foreign currency debt expressed as a percentage of GDP. We concentrate on currency movements that have happened between January and December 2015, and we measure the movement of local currency against a basket of foreign currencies. The weights of currencies in the basket are specific for each sovereign and correspond to the estimated composition of the sovereign's foreign currency debt (see chart 1).

Chart 1



*The weights of foreign currencies in the basket correspond to the currency composition of the sovereign's foreign currency debt. DRC--Democratic Republic of Congo.

We find that--in descending order--the most affected sovereigns are Mozambique, Zambia, Ghana, Angola, and Senegal (higher and to the right in the chart). Our calculations suggest that due to sharp currency weakening, by the end of 2015, Mozambique will have seen its debt inflated (excluding other factors affecting its debt level) by more than 20% of GDP, while Zambia will have experienced a rise of roughly 15%. We expect this effect for Ghana will be about 6%, while for Angola and Senegal it will be close to 4% of GDP. We consider these effects to be significant given that they come in addition to the already weak fiscal performance exhibited by these sovereigns.

By contrast, the effects have been rather contained for members of West African and Central African CFA Franc zones, reflecting the exchange rates pegged to the euro. The only exception is Senegal, which has relatively higher foreign currency debt, some of which is denominated in U.S. dollars.

The negative impact is also limited for South Africa, which has by far the most developed domestic capital market on the continent, with most government debt denominated in local currency (the South African rand).

Our sovereign ratings have largely captured this currency risk. We had lowered the ratings or outlooks on the three most affected sovereigns--Mozambique, Zambia, and Ghana--by midyear 2014. In these rating actions, we cited external risks as a reason.

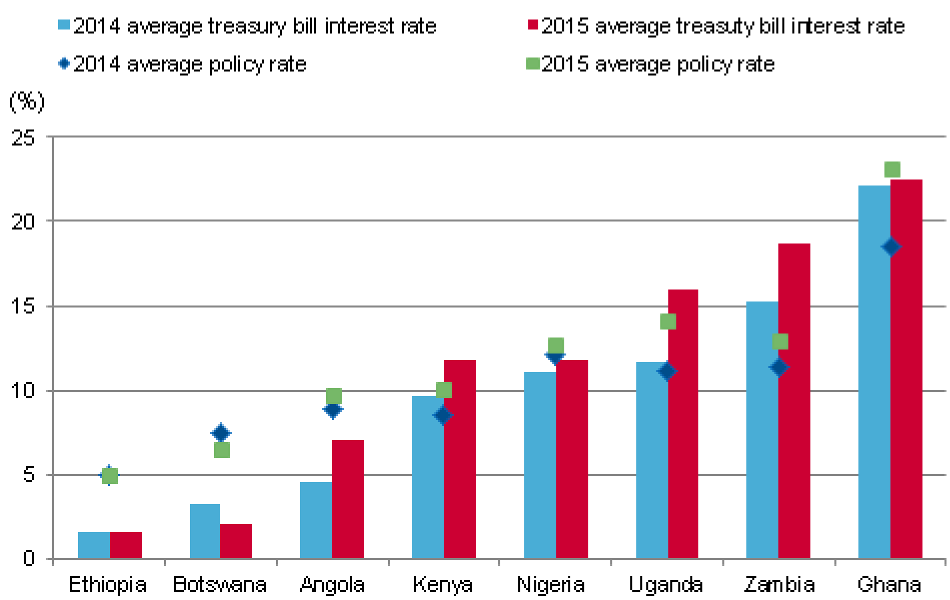
African Central Banks Have Been Compelled To Raise Interest Rates, Making Domestic Borrowing More Expensive

Increased debt has not been the only consequence of weakening currencies in the SSA region this year. In several cases, depreciating currencies have forced the central banks to hike policy rates to stymie inflation.

Taking Zambia, Kenya, Ghana, and Uganda as examples, policy rate hikes have resulted in an increase of treasury bill rates. Between January and November 2015, the policy rate increased by six percentage points in Uganda, 5 percentage points in Ghana, 3 percentage points in Zambia, and 3 percentage points in Kenya. Treasury bill rates have risen correspondingly over the same time period (see chart 2). This increase will contribute to higher interest expenditures for these sovereigns in the future.

Chart 2

Policy Interest Rates And Treasury Bill Interest Rates



NOTE: Comparison of average treasury bill interest rates (the simple average of 91, 182, and 364 day treasury bill rates) in 2015 versus 2014.

Tightening External Liquidity Will Raise Foreign Debt Refinancing Costs

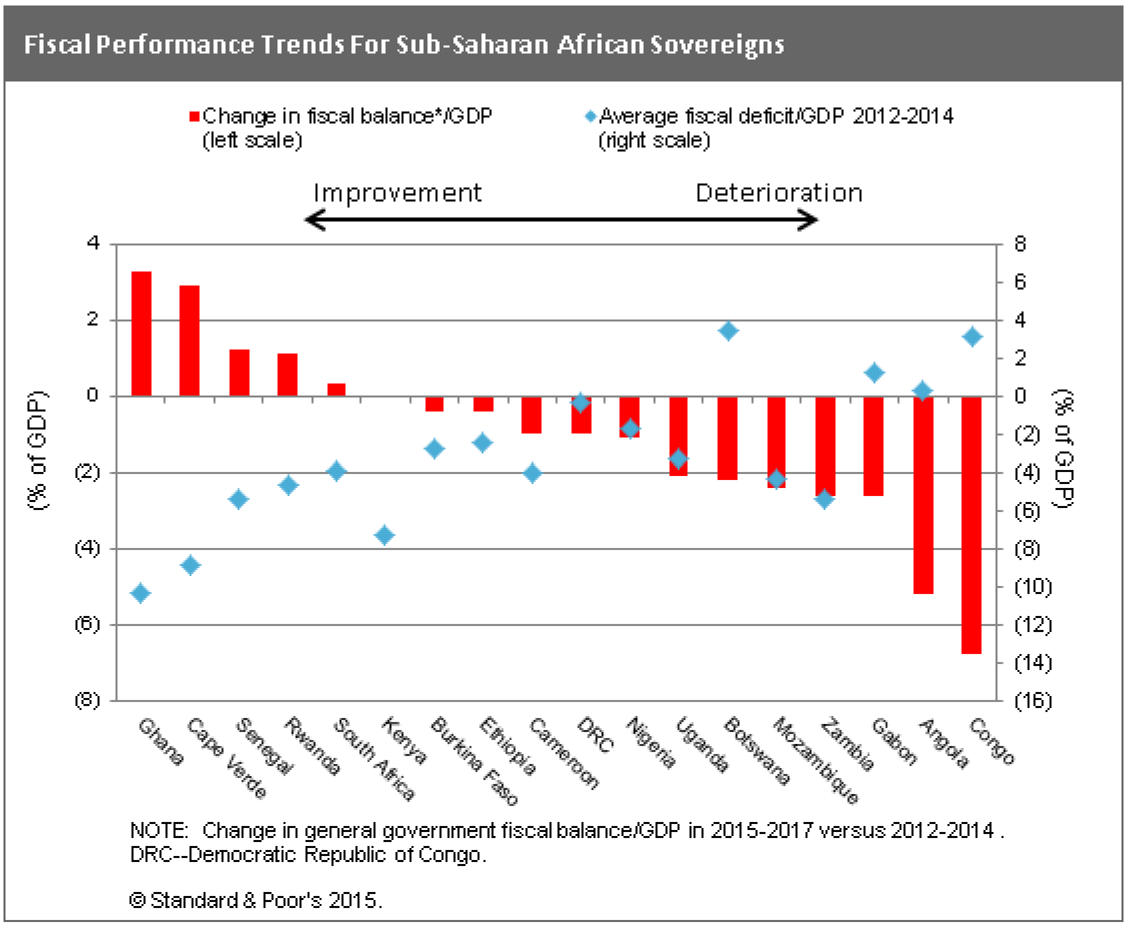
In addition to the rising cost of domestic borrowing, refinancing of existing foreign debt is also set to become more expensive in the future, against the backdrop of the U.S. Federal Reserve's tightening of monetary policy.

After bottoming out in mid-2014, African Eurobond spreads have, without exception, risen since May 2015. We anticipate they will generally stay higher in the coming quarters, compared with average spreads over the past two years and contribute to rising costs of refinancing the existing stock of foreign currency debt.

Fiscal Performance Is Poised To Weaken Over The Next Three Years, Keeping Sovereigns' Debt Elevated

We expect fiscal performance will deteriorate for 12 out of 18 rated SSA sovereigns over the next three years (see chart 3). We point to two main reasons for the general deterioration in public finances: continuous upward expenditure momentum, linked to high development and infrastructure needs; and slow revenue-base growth, in addition to the well-known impact of falling commodity prices (see "Plummeting Prices Weigh On Ratings For Some Oil Exporting Sovereigns," published Feb. 11, 2015).

Chart 3



NOTE: Change in general government fiscal balance/GDP in 2015-2017 versus 2012-2014 . DRC--Democratic Republic of Congo.

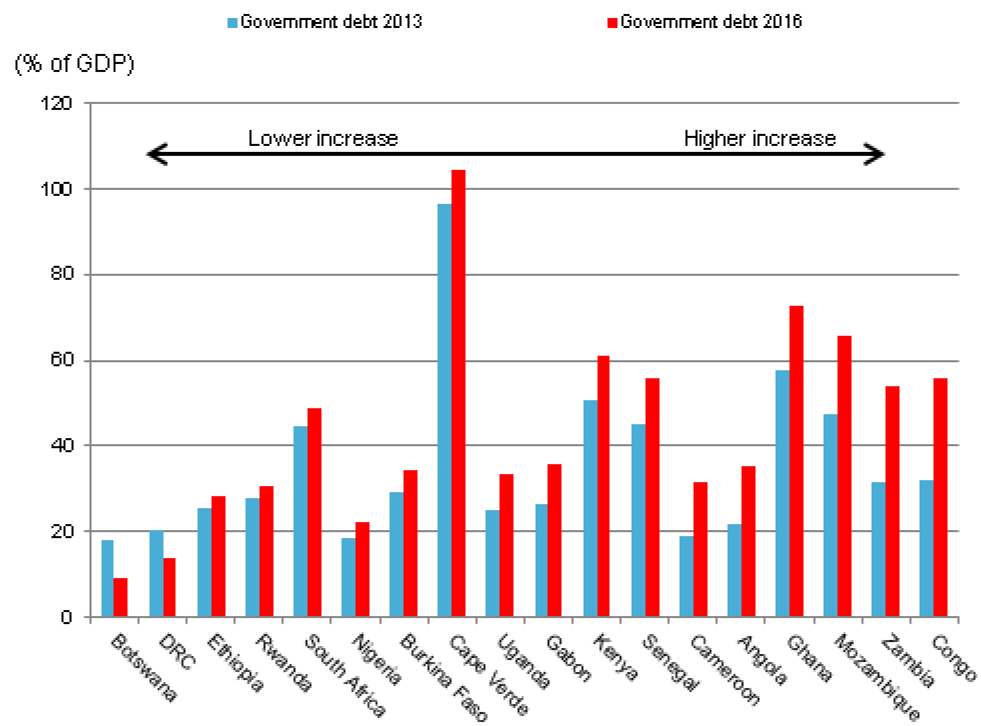
For these 12 sovereigns, we expect the average 2015-2017 general government fiscal balance will be 2.3 percentage points weaker, relative to GDP, compared with 2012-2014. We project the largest deterioration in budgetary performance in the three oil-producing SSA sovereigns: Congo, Angola, and Gabon. Their past fiscal surpluses will turn to deficits over the 2015-2017 forecast horizon, reflecting lower revenues due to commodity price decline, while expenditures pushed up in the "commodity boom years" will likely remain stubbornly high.

We project that the fiscal performance will improve in Ghana, Cape Verde, Senegal, Rwanda, and South Africa. However, Ghana and Cape Verde are the two countries with by far the largest budgetary deficits of all rated SSA sovereigns: they averaged 10 and 9% of GDP in 2012-2014 correspondingly. We anticipate that although budgetary performance is set to improve, shortfalls will remain substantial with the deficit averaging 7% of GDP in Ghana and 6% of GDP in Cape Verde over 2015-2017. In Rwanda and Senegal--ranked third and fourth in terms of expected improvement in budgetary performance--we project deficits will still average close to 4% of GDP over 2015-2017. Lastly, at 1.5% of GDP, the average improvement for SSA sovereigns' fiscal performance is more modest than the 2.3% average deterioration we forecast.

Deteriorating fiscal performance will prevent SSA sovereigns' debt from falling, as a share of GDP (despite projected strong nominal GDP growth). They will consequently be left with elevated debt (see chart 4), which will become more expensive to refinance owing to the influence of the abovementioned global factors. In addition, even though African sovereigns have contracted significant portions of government debt with multilateral lenders at concessional rates or at favorable bilateral rates with countries such as China (see "China In Africa: The Benefits For The Sub-Saharan Region Are Big, But The Potential Risks Are Rising," published May 21, 2015), an increasing share of new borrowing will likely include less attractive commercial debt, particularly for countries that "graduate" from very low income categories.

Chart 4

General Government Debt To GDP

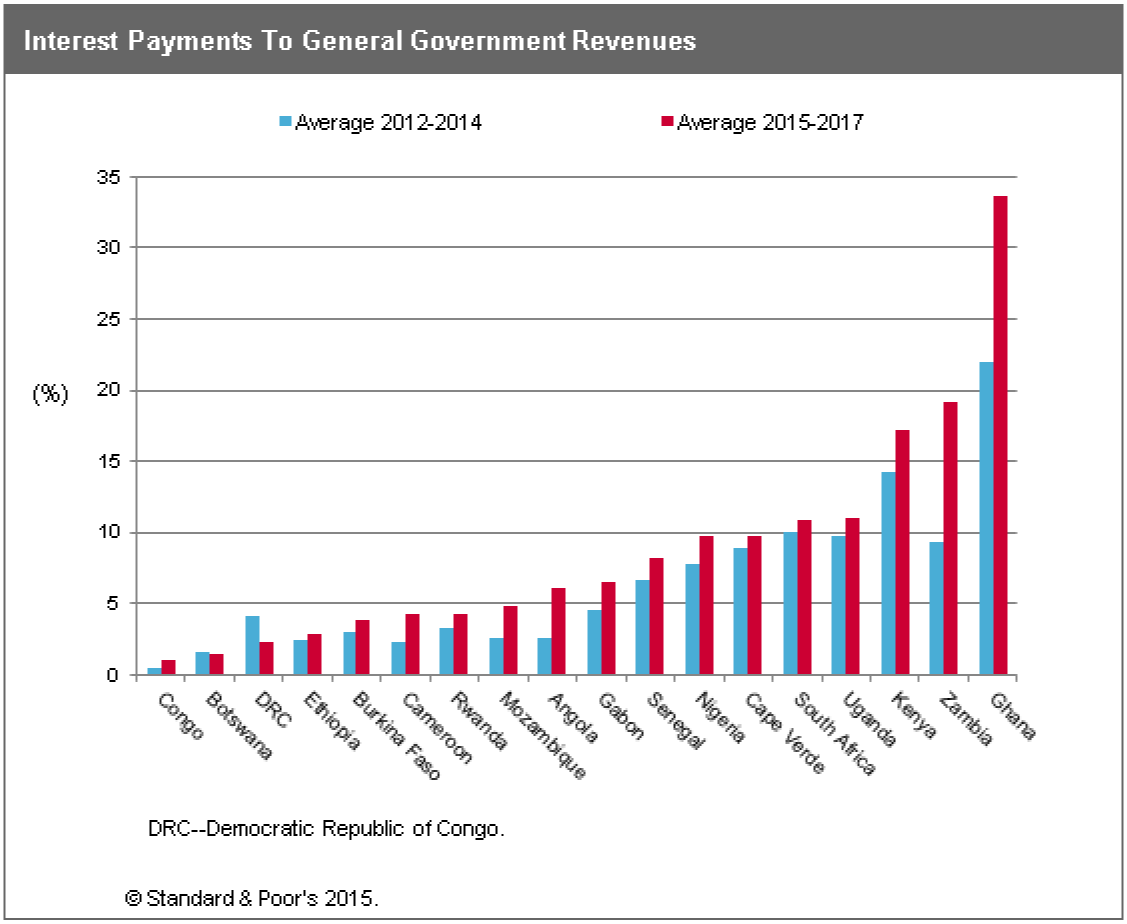


DRC--Democratic Republic of Congo.

Hard Choices Lie Ahead

As a result of the impact of global and domestic factors, we expect that interest expenditures will increase in nearly all of the SSA region, with the exception of Botswana and DRC (see chart 5). We think that Botswana's already low public debt will decline further to just 3% of GDP in 2018, keeping interest expenditures low. Meanwhile, debt levels will remain contained in DRC while the country would also benefit from the prevalence of concessional financing.

Chart 5



At the same time, we project that for over one-third of the regional sovereigns we rate, interest expenditures will reach or surpass 10% of government revenues over the next three years. For Kenya and Zambia, these expenses will be close to 15%, while for Ghana they will be about 35%. We view these levels as high for countries with relatively low levels of development.

The projected increase in interest expenditures as a share of government revenues is mostly explained by rising interest expenditures rather than revenue dynamics. Although we expect nominal government revenues will increase on average by 30% between 2013 and 2016, we anticipate interest expenditures will rise by nearly 90% over the same period.

We believe SSA sovereigns will face tougher policy choices. For most of them, fiscal policy remains the main lever to influence the domestic economic conditions, given the only limited effectiveness of monetary policy. Front-loaded consolidation could be politically difficult to implement but could help to keep debt levels and interest expenditures in check. Alternatively, SSA sovereigns could implement looser fiscal policies but potentially at a cost of more expensive financing and constrained choices in the future.

These anticipated developments are already largely incorporated in our SSA sovereign ratings, which are forward-looking assessments of creditworthiness. We have lowered a number of ratings in the region over the past two years. Ratings could still come under strain if global factors exerted unexpectedly stronger pressure on the SSA governments, or if the sovereigns' fiscal positions deteriorated more than we presently anticipate, as highlighted in our published outlook statements. Nevertheless, we currently view this scenario as unlikely for most SSA sovereigns. Of the 18 sovereigns we rate in the region, five (Angola, Kenya, Gabon, Mozambique, and South Africa) have a negative outlook and the remainder carry a stable outlook.

Related Criteria And Research

Related Criteria

- Sovereign Rating Methodology, Dec. 23, 2014
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Banking Industry Country Risk Assessment Update: December 2015, Dec. 15, 2015
- Standard & Poor's Revises Its Crude Oil And Natural Gas Price Assumptions, Sept. 24, 2015
- Regulations And Fiscal Incentives Could Speed Islamic Finance Development In Africa, Aug. 6, 2015
- Republic of Zambia $1.25 Bil. Eurobond Assigned 'B' Rating, July 30, 2015
- Sub-Saharan Africa Sovereign Rating Trends Mid-Year 2015, July 13, 2015
- Zambia Long-Term Rating Lowered To 'B'; Short-Term Rating Affirmed At 'B'; Outlook Stable, July 1, 2015
- Gabonese Republic's $500 Million 10-Year Notes Assigned 'B+' Rating, June 12, 2015
- China In Africa: The Benefits For The Sub-Saharan Region Are Big, But The Potential Risks Are Rising, May 21, 2015
- Nigeria Rating Lowered To 'B+' Because Of Rising External Vulnerabilities; Outlook Stable, March 20, 2015
- Angola Downgraded To 'B+/B' Following Sharp Decline In Oil Prices; Outlook Stable, Feb. 13, 2015
- Long-Term Ratings On Gabon Lowered To 'B+' Due To Falling Oil Prices; Outlook Stable, Feb. 13, 2015
- Plummeting Prices Weigh On Ratings For Some Oil Exporting Sovereigns, Feb. 11, 2015
- Long-Term Ratings On The Republic of Congo Lowered To 'B' On Lower Oil Prices; Outlook Stable, Feb. 9, 2015
- Ghana Downgraded To 'B-' On External Risks; Outlook Stable, Oct. 24, 2014
- Mozambique Long-Term Rating Lowered To 'B' On High Debt Accumulation; 'B' Short-Term Rating Affirmed; Outlook Stable, Feb. 14, 2014
- Ghana Outlook Revised To Negative On Fiscal Slippage And External Risks; 'B/B' Ratings Affirmed, Dec. 6, 2013
- Outlook On Zambia Revised To Negative On Fiscal Policy Shift And Expected Weaker External Position; Affirmed At 'B+/B', Oct. 25, 2013
- Mozambique Outlook Revised To Negative On Weakening External Position; 'B+/B' Ratings Affirmed, Aug. 16, 2013
- Shielding The Masses From The Market: The Impact Of Subsidies On African Sovereign Ratings, May 3, 2013

We have determined, based solely on the developments described herein, that no rating actions are currently warranted. Only a rating committee may determine a rating action and, as these developments were not viewed as material to the ratings, neither they nor this report were reviewed by a rating committee.

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