UNDP Policy Brief

LOWERING THE COST OF BORROWING IN AFRICA

The Role of Sovereign Credit Ratings

Regional Bureau for Africa

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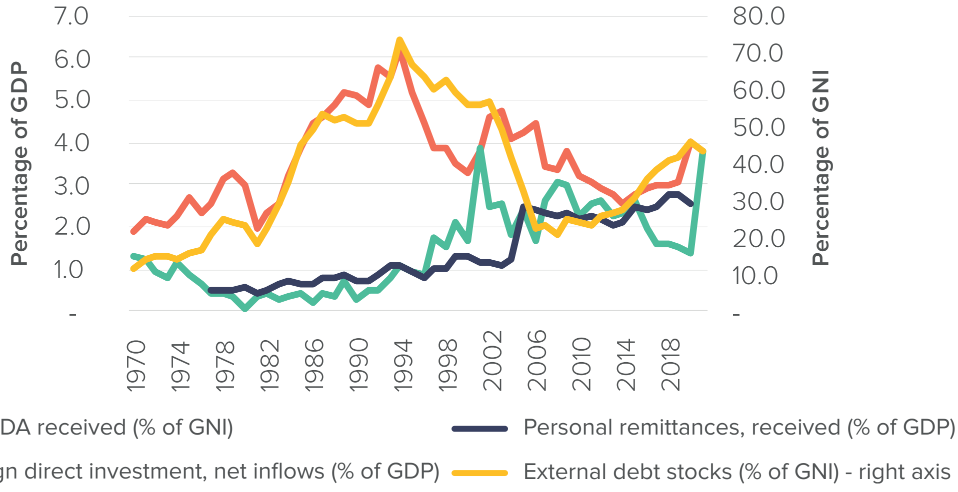
1. Development Finance Has Evolved Beyond Aid

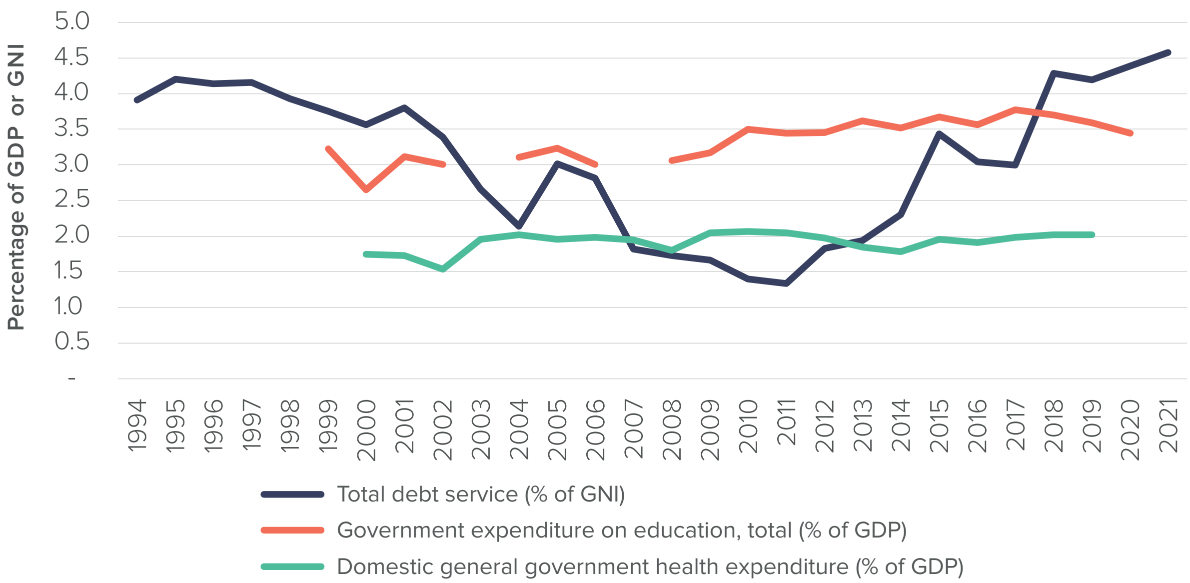
Africa's development financing landscape has changed since the 1970s, when it was dominated by Official Development Assistance (ODA). While ODA still plays an important role in supporting development, other sources of financing - including Foreign Direct Investment (FDI), remittances, and borrowing from international capital markets - have increased in terms of their contribution to the funding of development in Africa.

Figure 1: Annual Financial Flows to Africa



External debt, in particular, comes with a cost in the form of interest payments that countries must make on the borrowed amount. This cost, when added to the debt itself, places an additional burden on countries' finances, reducing the resources available for development and often resulting in debt distress.

Figure 2: Debt Service vs. Social Spending



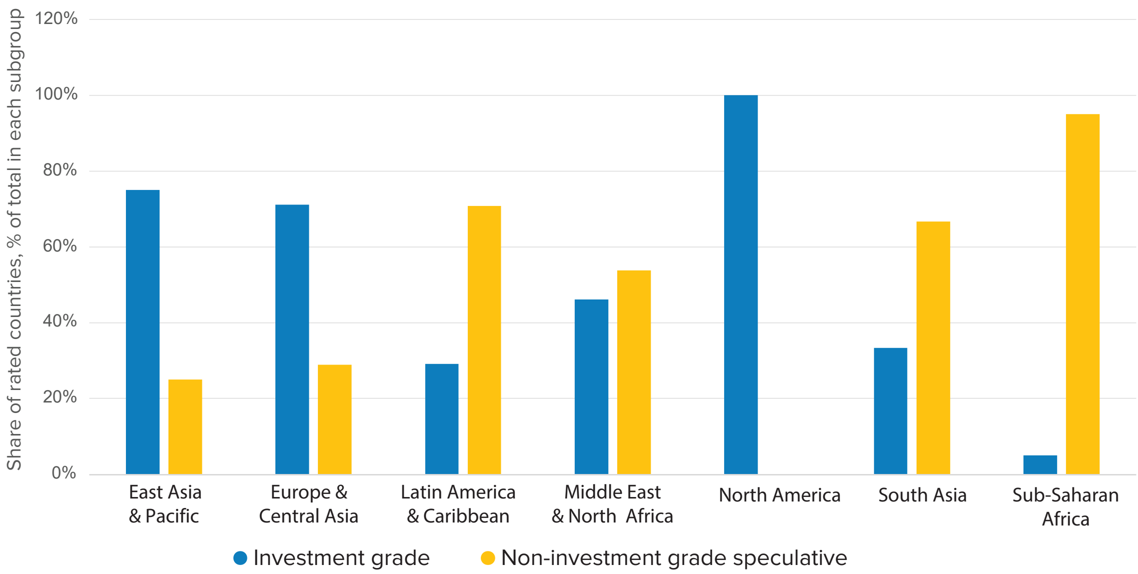
2. The Cost of Financing

The cost of financing for any borrower is determined by its credit risk, whether real or perceived (as well as the probability of default). For sovereign borrowers, this is determined by three global agencies - Standard and Poor's (S&P), Moody's, and Fitch. These ratings serve to inform investors about the risk profile of sovereign borrowers. These ratings bridge information asymmetries, so lenders have fuller information about potential risks.

In most cases, institutional investors such as mutual and pension funds, teachers' unions, and others are required by law to hold securities with an investment-grade credit rating. Additionally, a country's credit rating indirectly serves as a signal to potential investors. Sovereign credit ratings also serve as the highest benchmark for the ratings of the country's corporate and public sector entities, such as regional or municipal bodies.

In 1994, only South Africa had a sovereign credit rating in Africa. Starting in 2003, UNDP partnered with S&P and funded the agency's rating activities of African sovereign borrowers. UNDP also provided technical assistance to African countries, in an initiative that facilitated market access for many countries. By 2004, 13 African countries had been rated, and 32 are rated as of 2023. However, with two exceptions (Botswana and Mauritius), the ratings of African economies are of speculative (non-investment) grade. This is a much lower proportion of countries compared to other regions, as illustrated in Figure 3.

Figure 3: Global Sovereign Ratings by S&P



However, in Africa, it remains challenging for risk assessments and credit ratings to accurately reflect reality. This is largely due to a dearth of timely data, and partly a function of the frontier nature of many African markets. Also, rating agencies struggle to find experts with sufficient depth and regional knowledge. Consequently, many have questioned the veracity of some ratings. The research literature on credit ratings highlights several issues: a bias in favor of the home country of the ratings agencies or its economic allies[1], a bias against most forms of government intervention[2], a tendency for ratings to fluctuate with the business-cycle[3], and a conflict of interest (since the bond issuer pays the rating agency)[4].

1. Yalta, A. T. and Yalta, A. Y. 2018. Are credit rating agencies regionally biased? Economic Systems, 42(4): 682-694.
2. UNCTAD. 2015. Trade and Development Report, 2015. Geneva: United Nations.
3. Fofack, H. 2021. The ruinous price for Africa of pernicious 'perception premiums'. Brookings Africa Growth Initiative. Available online: https://www.brookings.edu/wp-content/uploads/2021/10/21.10.07_Perception-premiums.pdf
4. Chirikure, N., Abimbola. O, and G. Chelwa. 2022. How are the 'Big Three' rating agencies impacting African countries? Africa Policy Research Institute (April 19). Available online: https://afripoli.org/how-are-the-big-three-rating-agencies-impacting-african-countries-54

> The cost of financing for any borrower is determined by its credit risk, whether real or perceived.

3. The Idiosyncrasies of Sovereign Credit Ratings

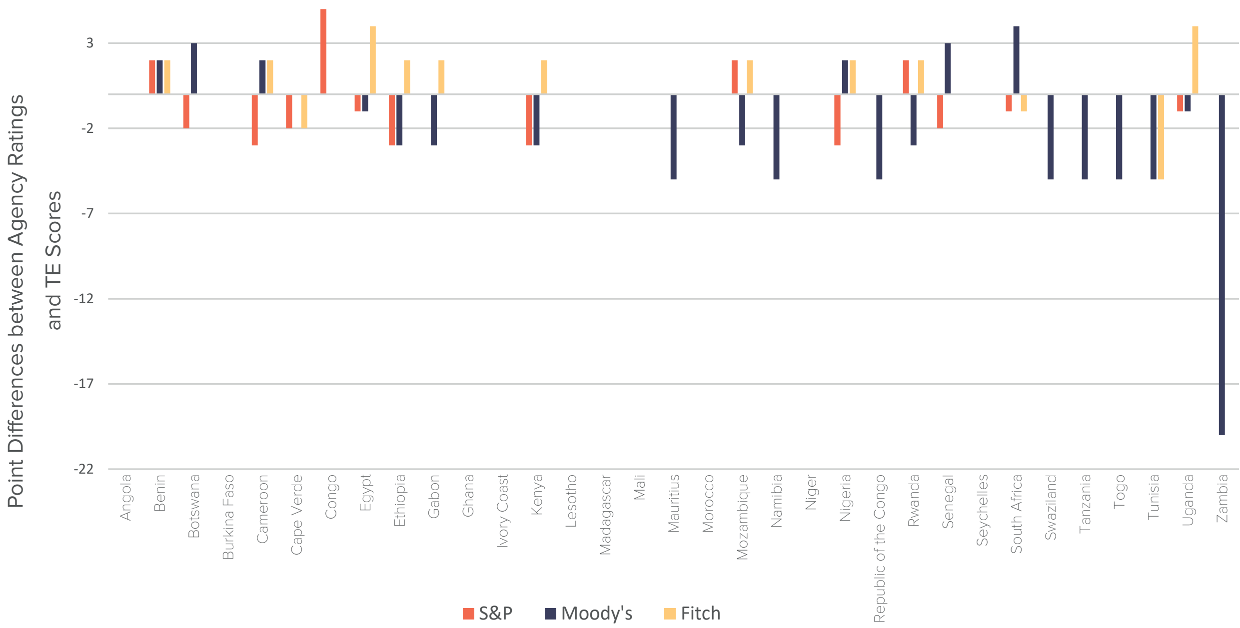
A recent study by the United Nations Development Programme (UNDP) utilizes an approach that goes beyond the traditional assessments of credit ratings and uses a more conservative methodology to assess credit ratings by comparing the ratings of the three major agencies to an algorithm based mostly on macroeconomic fundamentals, thus minimizing subjective inputs[5].

The analysis reveals significant, but non-systematic 'idiosyncrasies,' which are deviations from macroeconomic fundamentals that are not necessarily driven by bias, economic cycles, or conflict of interest. These deviations may be attributable to varying levels of subjectivity.

The random nature of these deviations from the underlying economic data is evident in the fact that some African countries are under-rated by one agency but overrated by another (see Figure 4). Moreover, there are very different ratings by one or more agencies for countries in similar situations. These discrepancies highlight the importance of including the most comprehensive and accurate information in credit ratings. These differences do not necessarily reflect any systematic credit agency issue, but may be due to data limitations and subjectivity differentials.

5. For more details on the methodology, see the full working paper at https://www.undp.org/africa/publications/lowering-cost-borrowing-africa-role-sovereign-credit-ratings

Figure 4: Point differences between Traditional Ratings and Trading Economics Scores



Based on these idiosyncrasies, the UNDP study was able to estimate the opportunity costs for each country. The study provides results for sovereign bonds in domestic currencies for 13 African countries, with the sample size being limited by data availability[6] in the primary source on sovereign bonds data, namely the S&P Bond Index dataset. The findings are reported in Table 1.

6. Also due to to limited access to contingent liabilities and debt decomposition information.

Table 1: Sovereign Bonds in Domestic Currencies: Observed and Estimated Yield, Volume and Opportunity Costs for 13 African Economies

Country	Observed Yield to Maturity	Par Weighted Coupon, %	Market Value Outstanding (millions of $US)	Weighted Average Maturity, years	Adjusted Yield To Maturity	Interest savings (millions of $US)	Opportunity Cost (millions of $US)
Botswana	6.99	6.20	1,549	7.57	6.22	72	103
Egypt	17.41	13.63	139,597	2.52	16.41	2,757	9,264
Ghana	35.11	19.27	11,393	2.97	33.53	333	756
Kenya	12.93	12.26	32,827	9.83	12.31	1,128	2,178
Mauritius	3.17	3.75	7,163	5.36	2.83	117	475
Morocco	2.31	3.40	68,753	6.73	2.16	641	4,562
Namibia	10.77	9.13	3,013	9.49	10.14	116	200
Nigeria	12.97	13.21	40,600	11.37	12.36	1,454	2,694
South Africa	10.46	8.56	139,704	12.62	9.77	7,096	9,271
Tanzania	10.05	12.77	6,737	11.26	9.61	191	447
Tunisia	8.76	6.85	4,987	4.29	8.32	79	331
Uganda	15.72	15.18	6,527	7.73	15.05	193	433
Zambia	22.17	11.55	2,834	4.15	21.34	66	188
					Total	14,243	30,903

These figures are averages for multiple bonds per country and will not match the figures for any individual bond

The main conclusion drawn from this analysis is that African nations could access an additional US$31 billion in new financing for sovereign credit if credit ratings were based more closely on economic fundamentals and less on subjective assessments. Additionally, the 13 African countries studied could save nearly US$14.2 billion in total interest costs (equivalent to US$2.2 billion annually).

While these sums may be negligible for large investment firms, they are considerable for African countries. If the ratings were more in line with economic fundamentals, the 13 countries analyzed could have an additional US$45 billion in funds available, considering both the savings in interest costs and the additional financing. To put this figure in perspective, the total net ODA received by Sub-Saharan Africa in 2021 was US$59 billion.

In addition to domestically-denominated sovereign bonds, African countries also issue debt in foreign currency, commonly known as Eurobonds, although they can be denominated in US dollars or other currencies. A similar analysis of African Eurobond ratings also found inconsistent deviations from economic fundamentals, i.e., subjective idiosyncrasies.

Table 2: Eurobonds: Observed and Estimated Yield, Volume and Opportunity Costs for 16 African Economies

Country	Observed Yield to Maturity	Par Weighted Coupon, %	Market Value Outstanding (millions of $US)	Weighted Average Maturity, years	Adjusted Yield To Maturity	Interest savings (millions of $US)	Opportunity Cost (millions of $US)
Angola	9.95	8.75	9,114	16.58	9.26	538	710
Benin	8.56	5.35	2,290	15.12	7.92	141	178
Cameroon	10.56	6.50	995	10.84	9.86	50	77
Cote d'Ivoire	8.16	5.84	10,089	16.67	7.47	706	786
Egypt	11.81	6.04	54,568	13.61	10.88	4,017	4,250
Ethiopia	35.58	6.63	1,000	10.00	33.56	75	78
Gabon	9.31	6.82	2,573	10.42	8.67	117	200
Ghana	33.47	7.85	14,149	15.73	31.57	929	1,102
Kenya	10.53	7.25	7,100	13.49	9.77	428	553
Morocco	5.37	3.19	9,040	14.77	4.79	608	704
Namibia	8.17	5.25	750	10.00	7.48	38	58
Nigeria	11.56	7.49	15,995	15.54	10.77	1,016	1,246
Rwanda	10.17	5.60	2,042	10.00	9.43	106	159
Senegal	8.70	5.74	13,600	17.17	8.04	897	1,059
South Africa	6.99	5.43	45,401	19.00	6.33	3,466	3,536
Tunisia	21.21	6.17	10,410	8.22	19.87	697	811
					Total	13,829	15,508

These figures are averages for multiple bonds per country and will not match the figures for any individual bond

These deviations indicate that African countries have the potential to raise an additional US$15.5 billion in new funding from international investors through Eurobonds. Furthermore, these 16 economies could save nearly US$14 billion in total interest costs, equivalent to US$933 million per year. In total, adjusting the credit ratings for Eurobonds could result in potential savings of US$29.3 billion for these African countries.

Combining the numbers from both tables, the full cost of credit rating idiosyncrasies in Africa is estimated to be US$74.5 billion in excess interest and foregone funding for the countries. This amount is nearly 12% per cent more than all of Africa's net official development assistance in 2020.

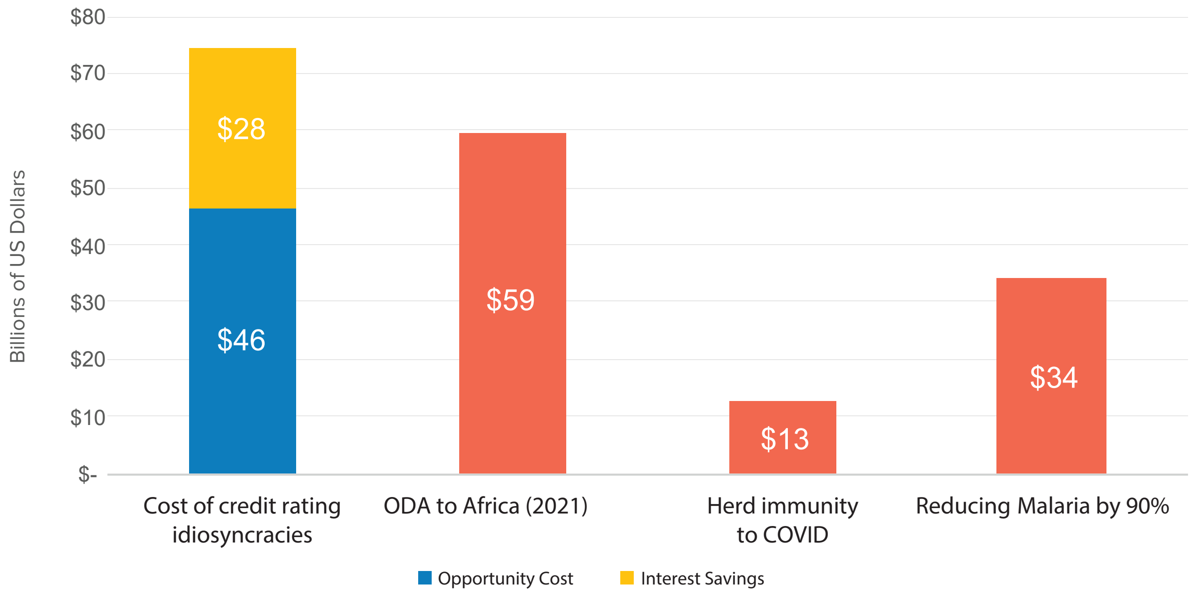
4. Implications for Development

Development cannot be solely measured in dollars and euros. It is important to contextualize the development costs of observed idiosyncrasies in relation to Africa's development financing gaps.

The estimated cost US$74.5 billion is:

- 6 times the cost of vaccinating 70 per cent of Africans (US$12.5 billion) to achieve herd immunity to COVID-19[8].
- 80% of Africa's annual infrastructure investment needs (estimated at US$93 billion)[9].
- More than twice the cost of reducing malaria by 90 per cent (US$34 billion)[10].

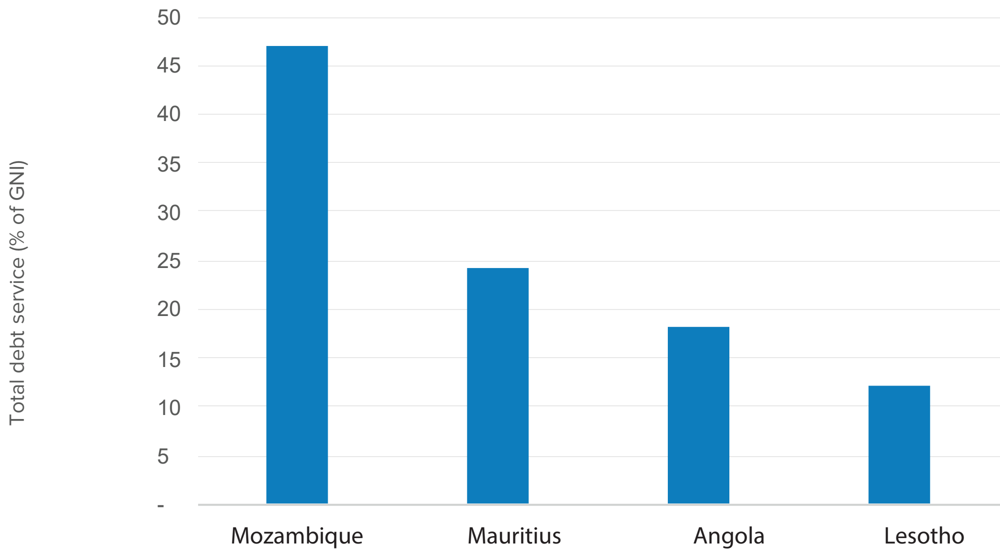
Figure 5: Development Costs of Credit Ratings Idiosyncrasies



Reducing interest rates paid by African countries on both domestic and foreign debt could greatly decrease the debt-service burden they face. This, in turn, would enable them to repay the principal faster and free up funds for more investments in development. This is especially important for African countries that allocate significant proportions of their national income to debt service, as illustrated in Figure 6.

8. https://blogs.worldbank.org/health/calculating-sub-saharan-africas-covid-vaccination-financing-gap.
9. https://documents1.worldbank.org/curated/en/744701582827333101/pdf/Understanding-the-Cost-of-Achieving-the-Sustainable-Development-Goals.pdf
10. https://www.who.int/news/item/23-08-2019-malaria-eradication#:~:text=The%20%2434%20billion%20is%20the,need%20to%20be%20by%202030.

Figure 6: Current Debt Service for Selected African Countries



Adjusting credit ratings that are inconsistent with countries' macroeconomic reality could also improve risk perception and lead to increased FDI flows. This is because credit ratings often indirectly influence FDI by affecting the perception of a country's investment climate and its ability to repay its debts. By improving their credit ratings, African countries could attract more FDI, which is crucial for long-term economic growth and development.

5. What Can Be Done

The importance of credit ratings that more accurately reflect economic fundamentals for Africa cannot be overstated, as it directly affects the cost of borrowing and has significant implications for both financial and developmental outcomes.

African countries, and their development partners, can take immediate steps to address these credit ratings idiosyncrasies, in partnership with global rating agencies. Several proposals follow.

Instituting greater transparency for credit ratings methodologies

There is a pressing need for greater transparency in the methodologies adopted by the Big Three CRAs, which extends beyond the requirements of African nations. This could be achieved through engagement and cooperation with the agencies, and UNDP can play a key role in providing and analyzing relevant country-focused data for African countries. This would be an essential first step in assisting African borrowers in presenting a more objective view of their macroeconomic positions.

Although the Big Three CRAs attempt to provide general information on their credit rating methodologies, much about the underlying assumptions remains ambiguous. This analysis suggests the existence of idiosyncratic decisions, and discretionary actions that could have dire financial and development implications. Africa-based CRAs could play a greater role in this context, since they may have access to more granular data. This issue underpins calls for concerted efforts to reduce CRA's home bias and pro-cyclical ratings.

Adoption and standardization (for financial markets participants) of alternative ratings

Another proposal for improving credit ratings for African nations is a more complex measure that involves a range of local and multinational actors, along with leading international investor groups and the Big Three CRAs. The aim is to accelerate ongoing efforts in peer reviews of the existing credit ratings systems, methodologies, and their relevance across different country groups. For African nations, this step would require the Big Three CRAs to collaborate with a future pan-African agency and develop effective communication channels with each country's relevant government agencies.

The main objective is to augment the established approach of credit ratings with a more country-specific modality that prioritizes medium-term development over formal compliance with threshold fiscal indicators. For instance, a country's appeal for debt relief assistance in response to a crisis, such as during the COVID-19 pandemic, should not lead to rating downgrades.

Implementing a regional pan-African rating agency

In a similar vein, a proposal for a pan-African rating agency aims to address the observed idiosyncrasies. The African Union, working with national rating and regulatory agencies, as well as ministries of economics and finance, would be best placed to lead this effort. As of the time of writing, efforts are already underway to implement such a strategy. It is important to maintain direct lines of information exchange and regulatory consistency among the involved national stakeholders, as well as to engage with the rating agencies currently operating in Africa, as discussed above.

Renewed focus on ESG and SDG priorities in each economy

Prioritizing medium to long-term macroeconomic development goals necessarily entails prioritizing the ESG and SDG targets as objective measures of a national economy's macroeconomic and financial position. Likewise, considering carbon offsets as collateralized assets could improve ratings in some countries. A more transparent and active inclusion of these priorities in the existing and new model-driven credit rating frameworks can help achieve a more nuanced approach that distinguishes between the long-term needs of a developing economy and the short-term business cycle fluctuations of advanced economies. This proposal can address problems such as home bias and procyclicality while also capturing the macroeconomic benefits of implementing new technologies and environmental efficiencies that lead to sector growth and more sustainable development. To implement this proposal, it will be necessary to engage with local and international stakeholders, and encourage their commitment to incorporating ESG and SDG targets into their rating methodologies.

Strengthen capacity of and promote a more efficient marketplace among already existing Africa-based CRAs

There is significant potential in the existing Africa-based CRAs that serve primarily the local market, and this potential is often overlooked. These agencies have unique analytical capabilities specific to the countries and markets in which they operate, and possess invaluable knowledge and expertise regarding the African continent. Promoting more transparent, timely and detailed reporting of macroeconomic variables would lessen the gap between reality and perception.

To fully utilize this potential, international actors such as the UNDP, UNDESA, APRM, and the African Union may consider providing financial and regulatory assistance to help the African CRAs strengthen and expand their technical and institutional capacity. This would contribute to a more balanced credit ratings field in Africa, and also foster a more inclusive and competitive international capital markets system. The Africa-based CRAs have a competitive edge due to their more nuanced understanding of regional macroeconomic structures and coverage of sectors that are not included in the Big Three's assessments.