

# Unresolved Issues and Challenges of Bond Markets In Africa

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# Africa's Special Needs

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- In addition to the general benefits of bond markets, Africa has special needs:
- Infrastructure needs are high; investment climate survey data show that business losses due to investment climate constraints—power outages, transport failures, and logistics delays—are largely responsible for shortfalls in productivity observed in Africa



# Africa's Needs

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- To meet Millennium Development Goals for infrastructure, Africa needs US\$5-12 billion a year in additional finance
- In 1990-2004 the region attracted just US\$2.6bn annually in total investment for infrastructure projects with private participation\*
- Over 70% of this was in telecommunications



# Governments need improved access to long-term finance

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- Concessional finance will not do it
  - Inadequate for large infrastructure needs
  - Long funding cycle (initiation to disbursement could be as long as three years)
  - Conditionalities that affect policy flexibility
- Huge financial requirement calls on African governments to continue playing an important role in infrastructure development
  - Need to tap domestic bond market
  - Managed access to international capital market



# Financial Market Characteristics

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- Bank dominated systems with attendant disadvantages
  - Corporate borrowers have limited access to term lending as banks hedge maturity mismatch
  - Most term lending is floating shifting interest rate risk to borrower;
- Financial system not diversified because of bank dominance
- Capital markets are primarily equity-based markets
- Bond market consists primarily of government issues



# Requirements for Efficient Bond Market

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- **Macroeconomic Stability**
- **Regulatory Framework**
- **Government Debt Market**
- **Others**
  - **Pricing of Credit Risk (Rating Agencies)**
  - **Market Capacity**
  - **Public Awareness**

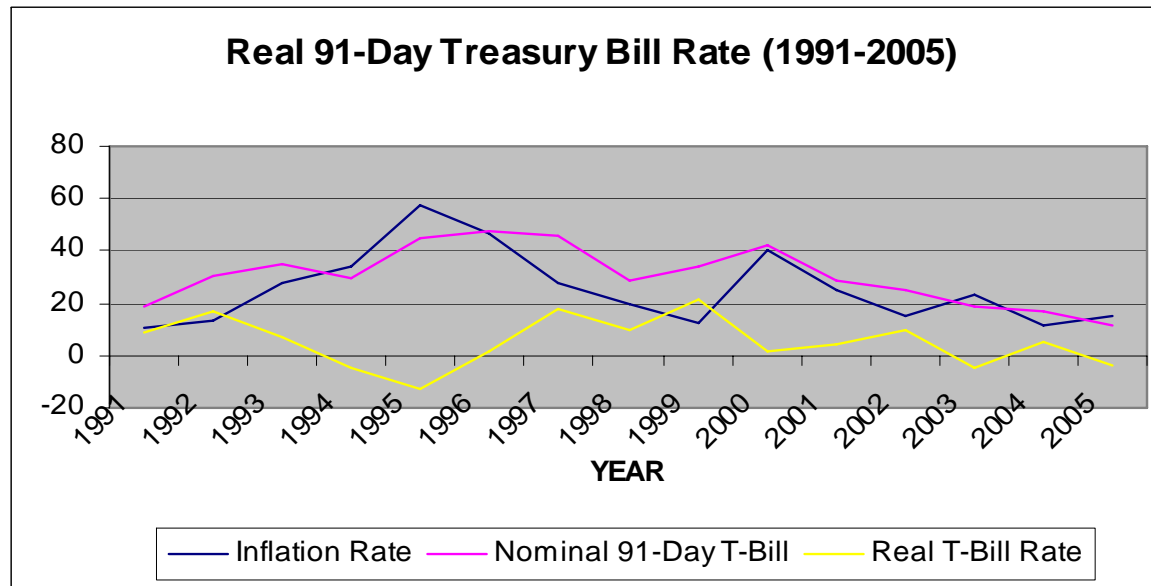


# Macroeconomic Stability

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- ❑ Maintaining sustained stable and low inflation supports investor interest in holding long-term debt
- ❑ Market-driven interest rates provide investors with credible signals for managing their bond portfolios
- ❑ Maintaining consistent positive real returns is a challenge in the absence of a competitive market.

# Ghana's nominal and real interest rates





# Regulatory Framework

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- Securities Regulation
  - Disclosure issues
  - Enforcement capacity
- The law and the rights of bondholders
  - Companies Code
  - Bankruptcy laws
- Borrowing mandates of key parastatals agencies
- Efficiency of judiciary system



# The Most Important Pillar is the Government Debt Market

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- ❑ Provides benchmarks
- ❑ Develops dealer capacity in primary and secondary markets
- ❑ Provides training grounds for bond traders and portfolio managers
- ❑ Introduces investors to bond investing.



# What Needs to Be Done

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- Debt management should go beyond the fiscal needs
- Planned issue program should establish benchmark issues consistently across the maturity spectrum;
- Issue calendar should be maintained to enable portfolio managers to plan for an orderly rebalancing of their portfolios;
- A primary dealer system with sufficient capitalization.
- Secondary trading should be actively be promoted by:
  - Listing on the stock exchange
  - Market making by well capitalized dealers
- The investor base should be broadened by promoting institutional investors (pension funds) and attracting foreign participation.



# Pricing of Credit Risk

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- Rating agency vicious cycle
  - Limited issue activity makes it unattractive for both international and local rating agencies
  - Institutional investors don't want unrated issues
  - Some countries require bank guarantees in lieu of ratings
  - But banks would rather lend than guarantee
- How do we break the rating agency vicious cycle?



# Capacity Development

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- Limited dealing capacity
- Technical Assistance programs are poorly structured
  - Several diagnostic studies with no implementation follow through
  - Overemphasis on debt sustainability at the expense of debt strategy
  - Overemphasis on concessional debt to the neglect of market debt
  - Other options should be tried
    - Resident advisors (e.g. U.S. Treasury)
    - Attachments/internships in more developed markets
    - Support business schools to develop professional training programs with practical content



# Public Awareness

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- ❑ Limited financial literacy makes it difficult to sell anything but the simplest instruments
- ❑ Ghana introduced 3-year inflation-indexed bonds in 2001
- ❑ Phased out in 2005 because of lack of market interest
- ❑ Investors were uncomfortable with pricing, credibility of CPI

# Transition to Capital Account Liberalization comes with Challenges

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- More competitive market with aggressive bidding (In December 2006, Ghana admitted foreign participation in government bond market with instant downward shift in yield curve of 100 – 150BPS)
- Lower cost of government borrowing
- Challenges
  - Local investors used to high interest rates cut off (Zambia's domestic bonds held primarily by non residents)
  - Significant impact on banking sector with large buy and hold portfolios of government securities (rollover risk)
  - Exchange rate risk resulting from immediate high inflows
  - Central bank sterilization challenges in the absence of a well developed bond market



# Thank You!

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