

AFRICA SOVEREIGN CREDIT RATING REVIEW



MID-YEAR OUTLOOK

African Peer Review Mechanism Continental Secretariat, Midrand, South Africa
Research, Methodology & Development Division

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ABOUT THIS REPORT

This report is authored by the African Peer Review Mechanism, a specialised entity of the African Union, in collaboration with the African Development Bank and the United Nations Economic Commission for Africa. It is a bi-annual publication on developments and trends in the area of sovereign credit rating services by international rating agencies among African countries. It seeks to provide African countries and investors with a corresponding analysis of the sovereign credit ratings' opinion by international agencies. The report therefore presents trends, drivers, interpretation of opinions and policy recommendations on sovereign credit ratings.



FOREWORD

On behalf of the APRM community, I have a pleasure and honour to share with you the first edition of the African Union – APRM African Sovereign Credit Rating Review. The area of international credit rating agencies. It provides additional insights, and where applicable, alternative interpretation on the sovereign rating opinions issued by international credit rating agencies. It is envisaged that the report will augment efforts by countries to pursue reforms aimed at enhancing their engagements with international credit rating agencies and improving ratings. The review also examines the scientific methods of risk assessments employed by credit rating agencies.

This report is the first of its kind to be published on the continent. The outbreak of COVID-19 witnessed rating downgrades of a number of African countries, which led to others shelving their plans to raise funding from international capital markets due to an



abrupt increase in costs of borrowing. Given the important role of rating institutions in the development of our continent, the APRM resolved to produce this report to stimulate debate on the operational accountability of rating agencies and the rating opinions resulting therefrom.

Once again I invite you to interact with the perspectives and recommendations in this report. Your insights are invaluable to countries on the continent and consequently to enhancing their credit rating positions in the medium to long-term.

Prof. Eddy Maloka,

APRM CEO

INTRODUCTION

International credit rating agencies offer opportunities for African countries to participate in the global financial markets. To date, a total of 21 African Union countries have been able to issue international sovereign bonds, an attractive option to diversify financing sources to support fiscal budgets and fund development projects. Since the advent of sovereign ratings on the continent, countries have managed to raise a combined total of more than US\$115 billion. It is generally impossible to issue foreign currency international sovereign bonds without first being assigned a rating by one of the three international rating agencies – Standard and Poor’s (S&P), Fitch and Moody’s.

This report presents an analysis of the trends in the credit ratings of African countries during the first half the 2020, with the aim of sharing information among countries. The objectives of this report are, thus, four fold. First, it examines the legitimacy of risk drivers that led to different rating actions as a basis for countries to engage rating agencies in future reviews. It provides a political economy and technical analysis of both the qualitative and quantitative risk



indicators applied in the determination of sovereign credit ratings. Second, it examines the consistency, objectivity and transparency of the rating process to ensure that countries are not prejudiced. Third, it assesses the impact of the rating dynamics on the public debt servicing costs, which solely depends on credit ratings to determine countries’ borrowing costs. Lastly, it makes recommendations to countries in order to avoid negative rating actions and improve future ratings.

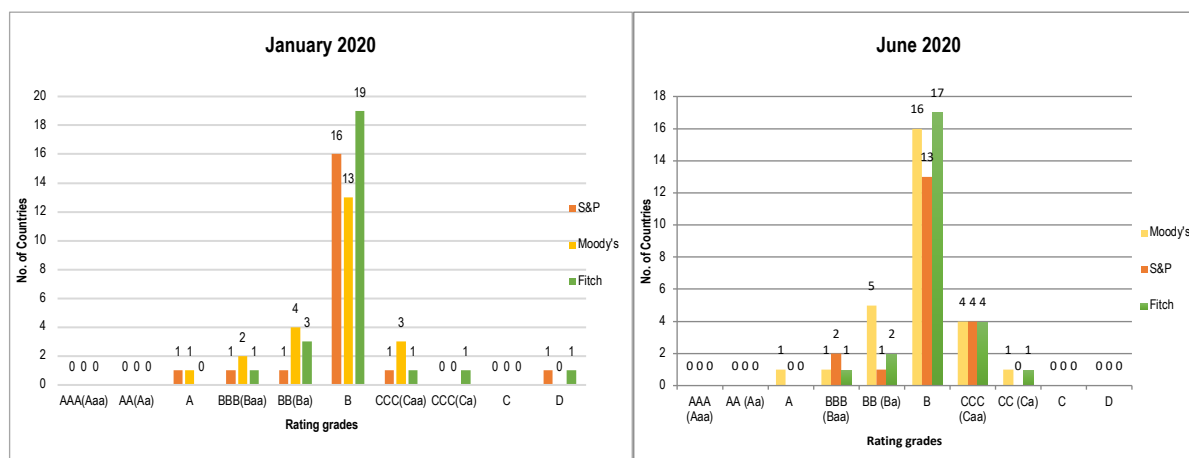
The increasing demand financial instruments being issued by African countries is evident that there is capacity for countries to diversify their fiscal budget support away from multilateral loans and avoid dependency on aid. Oversubscription of all Eurobond issuances shows prospects that investors have confidence and high appetite for investing on the continent. The successful bond issuance events during the peaking period of COVID-19 infections, when the general global financial market sentiment was negative and investors were expected to de-risk their portfolios, indicates investors’ optimism in Africa.

INDUSTRY TRENDS

The novel coronavirus COVID-19 constitutes the major highlight for the first half of 2020, and is the purported basis for a number of downward rating actions. Eleven countries have been downgraded in the first half of 2020 - Angola, Botswana, Cameroon, Cape Verde, Ethiopia, Gabon, Nigeria,

Seychelles, Tunisia, South Africa and Zambia. And twelve more had a negative change in sovereign rating outlook – meaning they are at risk of being downgraded in the short- to medium-term. Figure 1 below shows the status of ratings at the beginning of the year to the present.

Figure 1: Summary to rating activities Jan – Jun 2020

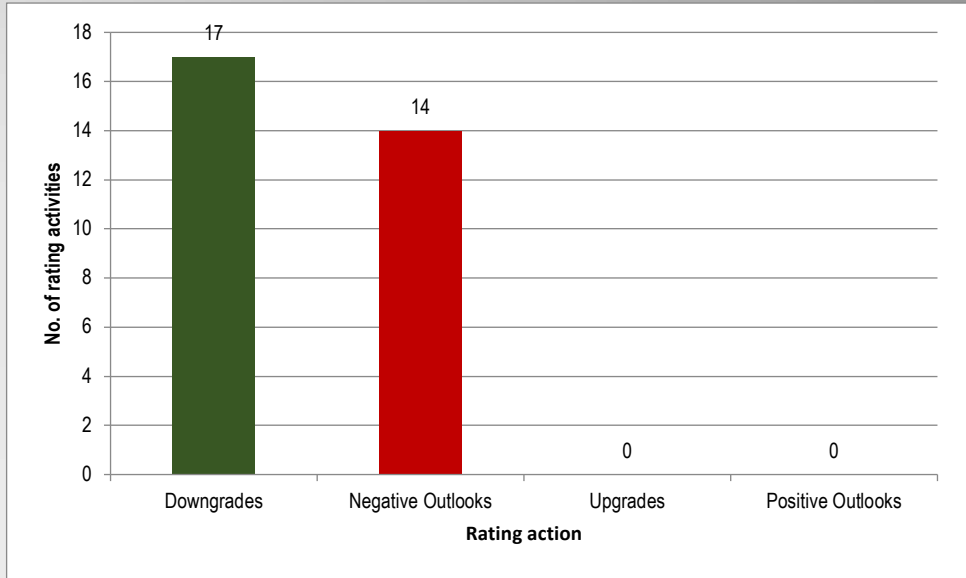


Source: Primary data from Moody's, Fitch and S&P, June 2020

These rating activities were characterised by a persistence downward trend as countries faced the record number of rating downgrades in a shortest space of time. Of the eleven countries downgraded during this period, Angola and Nigeria were downgraded twice whilst South Africa

and Zambia suffered downgrades three times. There was a slowdown in economic activities as countries went into economic lockdown as part of the measures implemented by governments to contain the spread of COVID-19.

Figure 2: Rating activities Jan - Jun 2020



Source: Primary data from Moody's, Fitch and S&P, June 2020



CONTINENTAL RATING DRIVERS

The outbreak of coronavirus in the first half of 2020 led to an immediate knock on the fiscal position of countries as demand for more investment in health care and social support rose drastically. On the other hand, fiscal revenue was shrinking as most businesses closed in compliance with economic lockdown imposed by governments to curb the spread of coronavirus. In Angola, Botswana, Ethiopia, Nigeria, Seychelles, Tunisia, South Africa and Zambia, tax revenue collection is forecasted to fall by between 8 and 20% year-on-year due to economic lockdown and general loss of business because of the COVID-19 pandemic. The economic impact was larger for oil exporting countries such as Nigeria, Angola, Cameroon and Gabon that were already constrained by the low oil prices by due to subdued

- iii. Structurally weak economic growth that the current economic and fiscal policy settings may not be able to address effectively;
- iv. The unprecedented deterioration in the global economic outlook¹ caused by the rapid

demand on the world market. Crude oil prices fell to US\$20 a barrel, crashing to below zero in April, leading to revenue losses of between 50% and 85%. The following key risk factors were cited as rationale for downgrading countries:

- i. Expectation that governments' fiscal and external balance sheets will weaken due to drop in demand for commodities – oil, diamond, copper, uranium – tourism and general economic deceleration caused by COVID-19;
- ii. Risks of low sovereign debt repayment capacity is expected to increase due to liquidity pressure, fall in revenue sources and increased public debt burden due to COVID-19 under any plausible economic and fiscal scenario;



¹ As a result of the pandemic, the International Monetary Fund projected the global economy to contract sharply by 3% in 2020, much worse than during the global financial crisis of 2008-09.

spread of the COVID-19 outbreak will economic and fiscal challenges and will complicate the emergence of effective policy responses;

- v. Structural issues such as weak private investment, labour market rigidities and uncertainty over property rights generated by programs such as the planned land reform in South Africa;
- vi. Deteriorating debt affordability and potentially weakening access to funding at manageable costs,
- vii. High uncertainty about the economic impact of the COVID-19 pandemic and negative economic sentiment;
- viii. Adverse capital flows caused by the spike in global risk-aversion that could magnify and prolong the impact the COVID-19 economic shock.
- ix. Request to participate in the debt service moratorium initiated by the G20 countries and other multilateral institutions to free up financial

exacerbate the

resources for governments to respond to COVID-19, which is assessed as default by credit rating agencies.

Other sub-factors that may not materialize but contributed to ratings downgrades include; the risk of social pressure from rising unemployment and social discontent, adverse climate change-related shocks such as droughts which undermine the agricultural sector's performance and weigh on economic growth, socio-economic inequalities that will complicate policy implementation and spark potential policy resistance from key stakeholders that ultimately fuel political risk, and erosion in institutional strength due to corruption.

Box 1: South Africa responds to Moody's COVID-19 induced rating downgrade

South Africa's long-term foreign and local currency debt ratings were downgraded from investment grade 'Baa3' to sub-investment grade 'Ba1' (also known as 'junk status'), with a negative outlook in March 2020. The decision by Moody's could not have come at a worse time. South Africa, like many other peer countries, was seized with containing the outbreak of COVID-19. The impact of COVID-19 is being felt across various sectors of the economy including the financial markets, which experienced a significant sell-off in equities, bonds and exchange rates as investors retreated to safe haven securities amid the uncertainty. The sovereign downgrade further added to the prevailing financial market stress. The sovereign downgrade further saw South Africa being excluded from the FTSE World Government Bond Index (WGBI) and the government bond market experience further capital outflows as fund managers with investment grade mandates were forced to sell South African government bonds.

Source: Ministry of Finance, South Africa, 27 March 2020

IMPACT OF RATING ACTIONS ON SOVEREIGN DEBT

Credit ratings are a key determinant for countries to access global finance markets through sovereign bond issuance. The option for raising finance through Eurobond is important for countries to financing maturing debt obligations, finance heavy infrastructure projects, reduce financial aid dependence on donors and support budget deficit. The main impact of the sovereign downgrade was that, except for Egypt, Gabon and Ghana, no country has managed to access international capital

markets for sovereign bond issuance. Interest repayments on exist bonds also spiked to approximately two times on average. Ghana and Gabon issued their Eurobonds before the outbreak of COVID-19 on the continent, whilst Egypt issued its Eurobond after the outbreak of COVID-19, capitalising on stable investor confidence in the resilient performance of its economy, which has successfully implemented comprehensive economic reforms since November 2016.

Box 2: Egypt's biggest bond issuance during COVID-19

Egypt issued US\$5 billion Eurobonds in May 2020 to provide urgent funding to deal with the novel coronavirus crisis, the biggest international bond issuance in its history. The issuance, structured into three tranches with maturities of 4, 12 and 30 years, was aimed at providing the necessary liquidity to cover the needs of the upcoming 2020/21 fiscal year, deal with the repercussions of coronavirus. With subscription orders reaching US\$22 billion before the end of the issuance, the oversubscription of the offering by more than four times shows the resilience of the country's credit worthiness, despite the impact of COVID-19. Rating agencies also maintains Egypt's credit rating with stable outlook with expectation that the impact of the pandemic will be temporary. This saved Egypt to issue Eurobonds at substantially fair yields in volatile global financial markets.

Source: Ministry of Finance, Arab Republic of Egypt, 23 May 2020.

Table 1 shows summary information of the three countries that successfully issued Eurobonds in during the first half of the year.

Table 1: Eurobond issuance Jan – Jun 2020

Country	Issue date	Amount (US\$B)	Purpose	Tenor	Yield on issue	Current yield	Subscription
Gabon	6/2/2020	1	Budget support	11-year	6.4%	14.1%	3.5x
Ghana	11/2/2020	1,25	Budget support & refinance	7-year	6.3%	13.9	4x
		1		15-year	7.9%	12.3%	
		0,75		41-year	8.7%	12.6%	
Egypt	May-20	1,025	To deal with the repercussions of the coronavirus	4 year	5.75%	13.83%	5x
		1,075		12 year	7.625%	14.31%	
		2		30 year	8.875%		

Source: World Government Bonds, June 2020

All these issues were oversubscribed, with Ghana issuing the record first African longest tenor Eurobond of 41 years.

Box 3: Ghana long-tenor Eurobonds oversubscribed

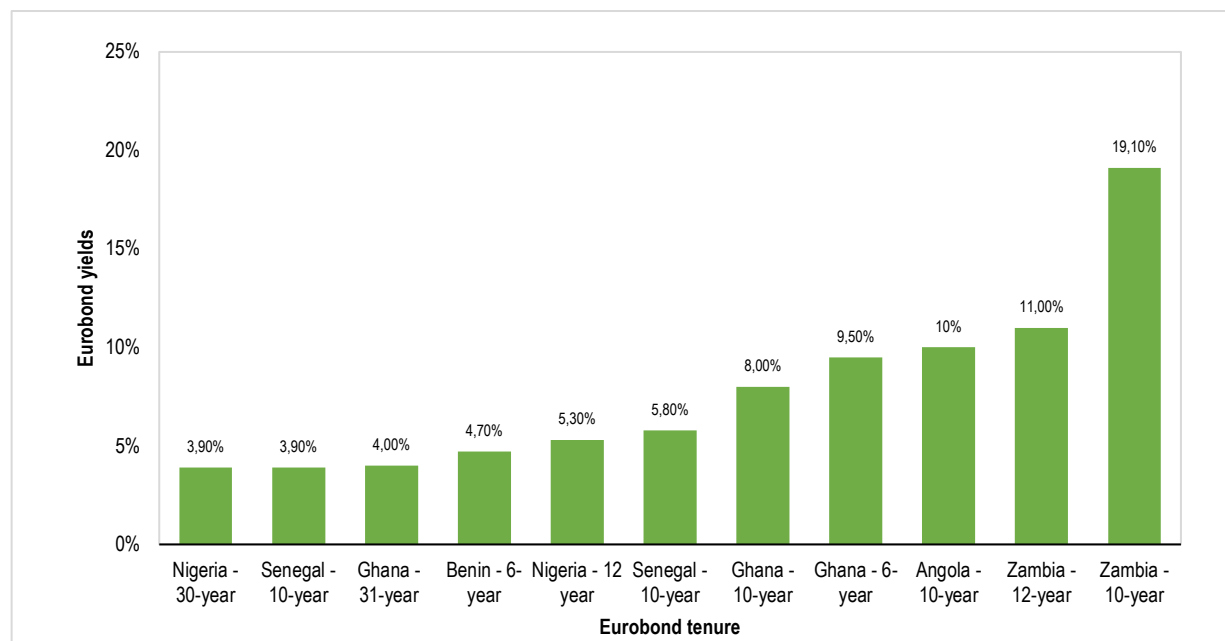
Ghana became the first ever African country to issue a 41-year bond, as it successfully raised US\$3 billion in the international debt capital market in February 2020. The capital markets reaffirmed their increasing confidence in the Ghanaian economy when the Eurobond issuance resulted in an order book 5 times more than the amount required. This bond issuance comes two weeks after Moody's issued an optimistic positive outlook rating review, which gave investors a resounding vote of confidence in the country's economy.

Source: Ministry of Finance, Republic of Ghana, 5 February 2020

The negative rating actions during this period, that caused a spike in interest rates, forced some countries to abandon their plans to access global markets, making it challenging for them to mobilise resources to support the policy response to COVID-19 as investors became more risk averse. Investors demanded high

interest rates on existing Eurobond of all tenors. The worst affected country was Zambia, whose 10-year Eurobond yields increased from an average of 19.6% to 38.7% depending on the tenor. The following 12 bonds were significantly affected by the negative rating actions during this period.

Table 2: Most affected previously issued Eurobonds



Source: Data from Renaissance Capital, June 2020

Countries that had scheduled to issue Eurobonds in the first half of 2020 – Angola, Nigeria, Côte d’Ivoire, Benin and South Africa – had to abandon their plans as the yield costs approximately doubled following the COVID-19 induced rating downgrades. The three countries – Angola, Nigeria and Côte d’Ivoire – had

planned to issue; US\$3 billion, US\$3.3 billion and US\$822 million, respectively, to fund their fiscal budgets and to refinance existing loans. In Benin and South Africa, the governments had not yet made a final decision on the amount, tenor and currency of the prospective issues.

CONTESTED AREAS OF RATINGS ACTIONS

The downgrades of countries due to the COVID-19 calls into question the procyclical approach of rating agencies – an approach in which bad news is simply piled on bad news. This has been an ongoing criticism against rating downgrades during crisis periods. Evidence² from past

crises proves that aggressive downgrades during periods when economies are already strained create procyclical effects that exacerbate the impact of the crises. With the tremendous power of rating agencies to influence market sentiments and investors’ portfolio allocation decisions, COVID-19-induced downgrades

² <https://www.bis.org/publ/work129.pdf>

could have contributed to deterioration of macroeconomic fundamentals as investors immediately responded by raising the cost of borrowing and withdrawing their capital, aggravating the downside economic situation. Like a 'self-fulfilling prophecy', even countries with strong macroeconomic fundamentals, once downgraded, past evidence shows that fundamentals deteriorate to converge with model-predicted ratings.

In response to COVID-19 pandemic, countries timeously drew comprehensive policy responses to cushion their economies from the severity of the pandemic. The majority of rating downgrades were executed before assessing the impact and effectiveness of countries' policy responses. It was thus premature to downgrade countries solely on 'speculative' expectations without waiting for the implementation of their policy response strategies. The prediction of 'devastating impact of COVID-19 coupled with weak and slow policy response' is evident to the information asymmetries that exist between rating agencies and government authorities. On the contrary, the World Health Organisations (WHO)³ has acknowledged that COVID-19 have had far less impact on the continent than initially anticipated as most countries responded swiftly either before they confirmed first cases or immediately after. This could be sufficient

proof that the rating actions that took place were largely driven by information asymmetry, negative investor confidence and assumptions that would most likely not materialize.

Moody's downgraded Cameroon and Ethiopia precisely because the countries agreed to participate in the debt service moratorium, which was initiated by the G20 countries and other multilateral institutions to free up financial resources for governments to buttress their health services. Multilateral debt is classified as official debt in rating criteria and does not lead to defaults, hence participating in debt moratorium of official multilateral debt should neither be considered as default nor debt restructuring. It also does not significantly change a country's overall debt burden as conditions for debt service moratorium include freezing all interest charges. It thus lacks objectivity for Moody's to view the debt relief initiative as having an impact of reducing the chances for countries to access global markets post crisis.

³ <https://www.afro.who.int/news/who-showcases-leading-african-innovations-COVID-19-response>

Box 4: Government of Ethiopia downplays rating downgrades

The Government of Ethiopia downplayed the recent credit rating downgrades by Moody's, S&P and Fitch, which downgraded the country's credit rating status citing participation in the G20 debt moratorium and that the global pandemic is threatening the government's liquidity position. The country's participation in the multilateral debt service moratorium should not have implications on its credit rating. According to the government, the rating outcomes are not an intrinsic reflection of Ethiopia's creditworthiness status. The downgrade will have an implication on the country's debt servicing costs and will further negatively impact government's effort in providing basic services such as healthcare, education and other socio-economic needs.

Source: Ministry of Finance: Federal Democratic Republic of Ethiopia, 23 May 2020

In the majority of COVID-19-induced rating downgrades, rating agencies cautioned countries against adopting coronavirus stimulus packages, citing that the policy would widen fiscal debt burden to unsustainable levels and weaken the economy. This implies that the rating agencies' future short-term actions are likely to be negative for countries that pursue a fiscal and monetary stimulus policy option. However, in a crisis situation, it is a norm for governments to introduce stimulus packages to counter the impact of the crisis, boost spending, increase demand, increase employment, increase income and save the economy from a crisis.

Efficient stimulus productive expenditure is beneficial to governments and effectively repays itself through benefits to the larger economy. Discouraging fiscal stimulus, especially in Africa's developing countries, is thus a faulty and prejudicial assessment of a country's risk profile.

RECOMMENDATIONS

Recommendation for countries

- i. **Country Participation:** Countries should be more involved in the rating processes by setting up a diversely skilled liaison team of experts to engage rating agencies during rating reviews. The liaison team must be well versed with past and current data, records and documentation of processes and decisions on macroeconomic fundamentals that are assessed by rating agencies to minimise asymmetric assumptions that prejudice their sovereign credit risk profile.
- ii. **Legislation:** Countries should develop and strengthen legislative frameworks for rating agencies to be registered in their jurisdiction to offer rating services. This is important to increase physical presence in the countries they are operating for close consultations with their client states.
- iii. **Regulation of Conduct:** Countries should consider adopting and implementing the International Organization of Securities Commissions (IOSCO) Code of Conduct Fundamentals for Credit Rating Agencies (the “IOSCO CRA Code”), a framework of cross-border principles and guidelines for the operation of rating agencies to protect the integrity of the rating process, ensuring that investors and issuers are treated fairly, and safeguarding confidential material information provided to them by issuers.
- iv. **Data and Information:** Countries should subscribe to the Special Data Dissemination Standard (SDDS), General Data Dissemination System (e-GDDS) or the Enhanced General Data Dissemination System (e-GDDS) platforms of the International Monetary Fund (IMF) to disseminate their economic and financial data to the public for transparency and openness. To date, only 6 African countries are subscribed to SDDS – Egypt, Morocco, Tunisia, South Africa, Seychelles, and Senegal.
- v. **Debt Servicing Priorities:** Countries should priorities honouring private commercial debt incurred through market conditions and fundamentals, specifically Eurobonds, to avoid breach of bond covenants in order to maintain their market credibility and integrity. Rating agencies criteria classify debt restructuring or attempt

to negotiate terms of commercial debt obligations held by private investors as a default, which automatically have an impact on countries' credit ratings.

- vi. Quality of Bonds: As a medium-term debt sustainability strategy, countries should structure new bonds with favourable yields and long-term tenor and exercise their choice of rejecting unsustainable Eurobond investors' bids. This process should not be entirely renounced to syndicates of lead-managers, originators and investment banks. Oversubscription of

Eurobond issuances by countries shows that high yield structures are attractive to investors at unnecessarily high costs to issuers, which could be reduced.

- vii. In drafting Eurobond prospectuses, countries should not design terms that restrict their flexibility to seek alternative lines of credit in future without being considered as defaulting, which could trigger both rating downgrades and an immediate demand for the country to pay the entire Eurobonds worth.

APRM support to countries

- i. Engaging rating agencies to revisit their stance on debt moratorium for countries to avoid unnecessary rating actions against official debt.
- ii. Engaging rating agencies to reconfigure austerity-based rating indicators that penalise governments for expansionary policy stance. The capacity of governments to address deficit and debt problems would be comprehensively measured by how it manages to create more and better-paying jobs, invest effectively in human and productive assets that battles inequalities, at the same time driving economic growth.
- iii. Engaging rating agencies issuing unsolicited rating to be more consultative with countries to reduce the cost of poor ratings concluded without their participation.

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