African Domestic Debt: Reassessing Vulnerabilities Amid Higher-For-Longer Interest Rates

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This report does not constitute a rating action.

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Key Takeaways

- Excluded from global capital markets, African sovereigns are increasingly relying on local financing.
- Egypt, Zambia, Mozambique, and mid-restructuring Ghana face the most challenging domestic financing conditions on the continent, according to S&P Global Ratings' Domestic Debt Index (DDI).
- Geopolitical uncertainty, dollar strength, and persistent inflation have pushed up domestic policy rates, raising the costs and shortening the maturities of domestic financing in Egypt, Kenya, Uganda, and Zambia.
- While nonresident outflows in local bond markets have raised domestic banks' exposure to sovereign credit risk, banking systems vary in size. Total financial sector assets range from just 25% of GDP in the Democratic Republic of the Congo (DRC) to 361% in Mauritius.

Attracted by Africa's enormous economic potential, vibrant demographics, and rich financial returns, between 2015 and 2021 foreign creditors invested an estimated $140 billion in African sovereign foreign and domestic debt, according to IMF data. This increased African general government debt to GDP levels by an average of 20 percentage points of GDP during the five years before the 2020 global pandemic, leading to a series of African sovereign downgrades.

But times have changed for sovereign financing in Africa. Since 2022, a series of global markets shocks has effectively closed commercial Eurobond markets for lower-rated borrowers. This has forced the majority of African sovereign issuers to shift away from external financing and pursue domestic borrowing instead, with varying degrees of success.

Domestic markets have been mixed as have banks' ability to meet high funding demands. A lot depends on the pool of domestic savings, and therefore the size and growth rate of total financial assets in resident banking systems; the availability of non-bank financing sources (including pensions and insurance companies); the stock of pre-existing bank lending to governments; and

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the willingness of households and companies to keep their savings in domestic rather than foreign currencies (which typically negatively correlates with how much the central bank finances the state). Our Domestic Debt Index (DDI) ranks sovereigns according to their domestic refinancing vulnerabilities (see infographics below) although it excludes many other inputs into our sovereign ratings, including governance considerations and external metrics.

Africa domestic debt vulnerability index

	Ratings	Banking sector lending capacity		Non-bank lending capacity	Real yields	Debt structure				Cost of debt		Roll-over ratio	Primary balance	Rank
	LC ratings (LT/outlook/ST) (Oct. 2023)	**Banking assets % GDP**	**Banking claims on CG % total assets**	**Nonbank financial sector assets % GDP**	**Nom. yield on 91-day T-bills minus latest infl. rate %**	**Gross GG debt % GDP 2023f**	**LC debt % total GG debt 2023f**	**Nonres. holdings of domestic debt (DD) % total DD**	**Central bank net claims on GG % GDP**	**Interest spending as % GG revenues 2023f**	**Domestic interest spending as % GDP**	**Roll-over ratio of LC debt % GDP 2023f**	**Primary budgetary position % GDP 2023f**	**Sum of Z-scores 2023**
Egypt	B-/Stable/B	130.5%	39.8%	3.7%	-12.7%	95.2%	67.4%	9.6%	15.5%	42.0%	7.2%	40.4%	1.4%	12.2
Zambia	CCC+/Stable/C	38.5%	32.7%	17.1%	-2.6%	110.6%	34.9%	22.0%	5.1%	30.9%	6.0%	13.8%	-1.4%	11.4
Ghana	CCC+/Stable/C	36.6%	33.1%	8.6%	-8.6%	92.0%	43.7%	7.0%	13.2%	21.7%	5.6%	11.9%	-0.8%	7.7
Mozambique	CCC+/Stable/C	73.5%	21.7%	6.1%	13.5%	73.9%	32.1%	5.0%	8.4%	12.5%	3.1%	17.4%	-1.0%	5.8
Uganda	B-/Stable/B	29.8%	25.7%	16.3%	7.3%	47.3%	37.4%	8.4%	4.5%	24.3%	2.5%	5.8%	-1.8%	3.8
Kenya	B/Negative/B	56.5%	23.4%	18.7%	8.2%	65.8%	48.8%	0.7%	3.5%	28.7%	3.7%	6.5%	-0.8%	2.7
Angola	B-/Stable/B	42.4%	29.2%	4.9%	-4.5%	93.0%	28.8%	1.0%	3.0%	23.9%	2.1%	5.3%	5.5%	0.7
Senegal	B+/Stable/B	66.5%	20.3%	2.0%	1.9%	66.6%	27.7%	1.0%	5.8%	10.3%	0.6%	3.7%	-2.8%	0.5
Cote d'Ivoire	BB-/Stable/B	46.1%	25.1%	2.5%	2.2%	57.0%	39.3%	1.0%	4.9%	14.5%	1.0%	1.2%	-2.8%	0.4
Congo-Brazzaville	B-/Stable/B	34.6%	21.3%	0.8%	2.0%	102.3%	58.2%	1.0%	12.6%	9.8%	1.5%	4.4%	6.1%	-0.1
Benin	B+/Positive/B	53.4%	14.3%	1.7%	2.5%	53.4%	31.4%	1.0%	4.8%	12.6%	0.8%	5.5%	-3.0%	-0.3
Togo	B/Stable/B	80.7%	13.8%	2.0%	2.0%	65.8%	63.5%	1.0%	5.5%	13.9%	2.1%	7.7%	-4.1%	-0.3
Burkina Faso	CCC+/Stable/C	69.7%	12.8%	2.9%	6.5%	58.8%	58.4%	1.0%	2.4%	10.3%	1.6%	7.6%	-6.0%	-0.5
Rwanda	B+/Stable/B	41.5%	16.9%	14.5%	-5.9%	71.4%	18.6%	5.3%	0.7%	8.0%	1.2%	0.6%	-4.2%	-0.5
Madagascar	B-/Stable/B	30.5%	13.9%	3.9%	-2.7%	41.0%	16.6%	1.0%	5.0%	4.6%	0.3%	1.9%	-5.4%	-1.0
Nigeria	B-/Stable/B	38.4%	9.4%	7.7%	-19.3%	43.6%	50.6%	5.0%	12.2%	19.9%	1.1%	3.8%	-3.7%	-1.6
Cameroon	CCC+/Stable/C	31.7%	17.3%	1.9%	-2.7%	40.7%	25.8%	1.0%	4.1%	7.4%	0.2%	2.8%	0.2%	-3.0
South Africa	BB/Stable/B	110.6%	14.8%	218.6%	3.7%	73.9%	89.5%	25.2%	0.6%	17.8%	4.3%	8.5%	0.5%	-3.7
Morocco	BB+/Stable/B	133.2%	17.8%	82.4%	-2.1%	76.0%	70.0%	0.0%	2.2%	7.0%	1.8%	9.8%	-2.6%	-5.0
Ethiopia	CCC/Negative/C	35.0%	6.0%	0.7%	-18.3%	30.2%	43.8%	0.0%	7.0%	7.6%	0.4%	8.3%	-2.8%	-5.2
Congo (DRC)	B-/Stable/B	24.6%	1.6%	2.0%	0.7%	13.9%	47.3%	1.0%	3.2%	1.6%	0.3%	0.6%	-2.2%	-6.5
Botswana	BBB+/Stable/A-2	49.8%	8.2%	57.3%	2.1%	17.6%	53.1%	1.0%	0.0%	2.9%	0.5%	10.3%	0.5%	-7.6
Mauritius	BBB-/Stable/A-3	361.1%	8.4%	34.9%	-4.9%	68.6%	78.5%	0.1%	2.4%	9.7%	2.1%	3.4%	-2.1%	-9.9
Average		**70.2%**	**18.6%**	**22.2%**	**-1.4%**	**63.4%**	**46.3%**	**4.3%**	**5.5%**	**14.9%**	**2.2%**	**7.9%**	**-1.4%**	
Median		**46.1%**	**17.3%**	**4.9%**	**0.7%**	**65.8%**	**43.8%**	**1.0%**	**4.8%**	**12.5%**	**1.6%**	**5.8%**	**-2.1%**	

LC--Local currency. LT--Long-term. ST--Short-term. CG--Central government. GG--General government.
DC--Depository corporation. Nonres.--Nonresident. Infl--Inflation. Nom.--Nominal.
Sources: IMF, national authorities, S&P Global Ratings.
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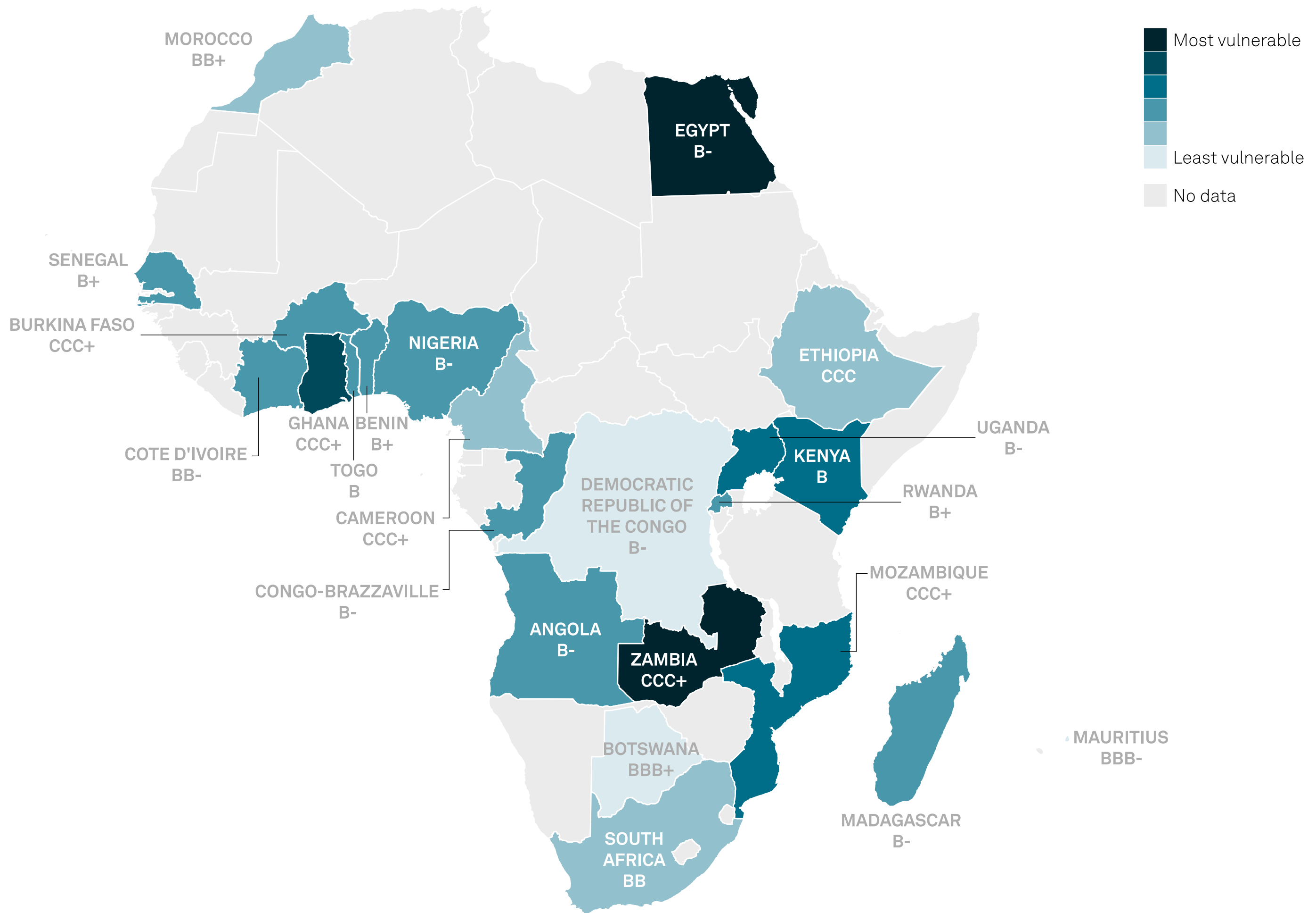
Africa domestic debt vulnerability index



Local currency ratings as of Oct. 30, 2023. Source: S&P Global Ratings.
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Africa is far from homogenous in terms of local capital markets development, savings rates, and financial inclusion. Financial systems vary in size from more than 100% of GDP in middle income economies such as Egypt, Morocco, Mauritius, and South Africa, to below 40% in heavily-indebted poor countries such as Cameroon, Congo-Brazzaville, DRC, Ethiopia, Madagascar, and Uganda. At the lower end of this range, frontier governments that found themselves locked out of foreign markets by early 2022 quite quickly started to come up against hard domestic-funding constraints.

In Ethiopia, Ghana, and Nigeria, low domestic savings saw governments reverting to central bank deficit financing. This development accelerated monetary growth, exacerbated inflation, and propelled retail demand for U.S. dollars (see chart 1) and/or imports. So what started as a fiscal shock quickly developed into a balance-of-payments shock. Foreign exchange (FX) reserves are now frequently being drawn down as central banks endeavor to fight currency depreciation while households withdraw FX from the formal financial system (see chart 2). One policy response has been governments deciding to negotiate IMF lending arrangements despite the high domestic

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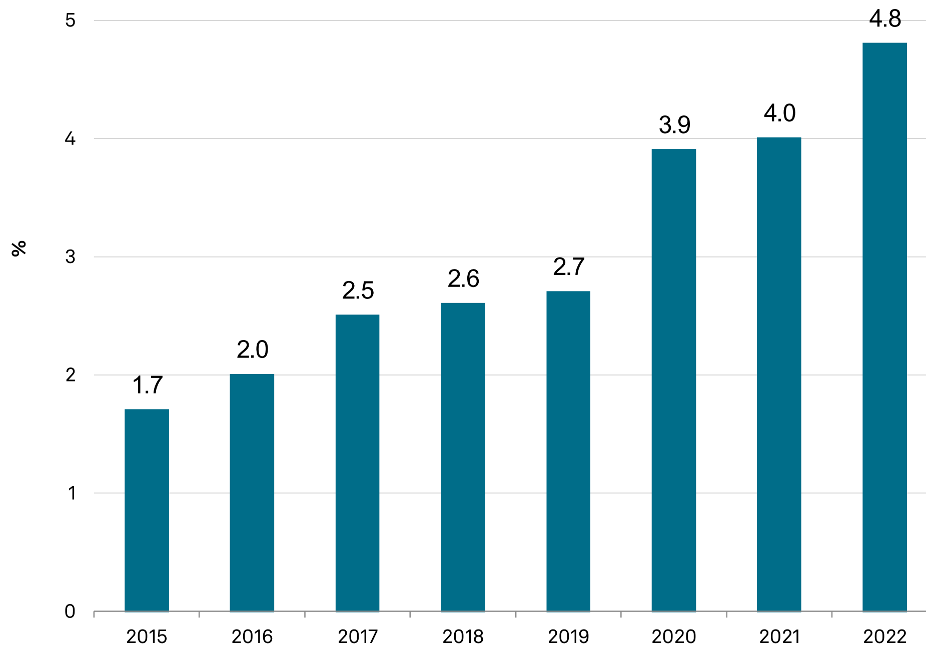
political cost of doing so.

Chart 1

Median central bank net claims on general government % GDP
For our survey of 23 rated African sovereigns



Source: S&P Global Ratings; IMF; National Authorities.
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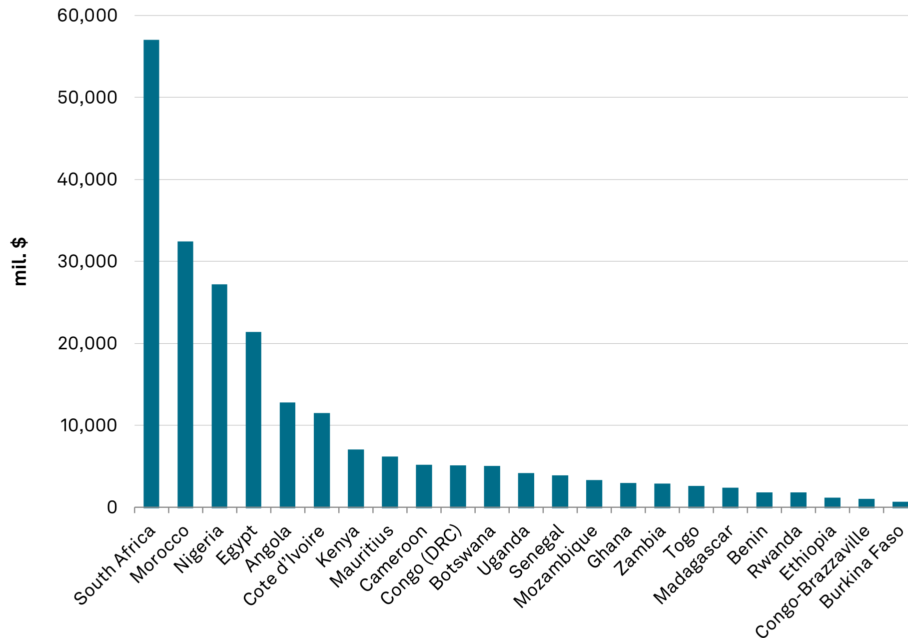
Chart 2

Sovereign useable reserves
For our sample of 23 rated African sovereigns



Source: S&P Global Ratings. f--Forecast.
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Domestic Debt: Limited Savings Is The Greatest Obstacle

African domestic debt markets are generally shallow, with some exceptions. Others are effectively repressed by governments focused on refinancing debt at interest rates below inflation. In several of these jurisdictions (Egypt, Ethiopia, and Nigeria) the financial sector is at least partly publicly owned. As a refinancing strategy, financial repression can "work" by keeping the cost of debt manageable. However, the side effects can include crowding-out lending to the private sector (although difficult to establish empirically) with long-term detrimental effects on productivity, competitiveness, and wealth. Banking systems may prefer financing large top-down public infrastructure projects with unproven returns, rather than small and midsize enterprises, to the detriment of long-term development.

Where African sovereigns have boosted the size of domestic pension savings, and the non-bank financial sector more generally, these financing sources can provide important buffers against nonresident outflows in the face of G7 monetary tightening. Botswana, Mauritius, Morocco, and South Africa have larger pension and other non-bank financial institutions, which typically accept lower returns than sought by foreign investors and commercial banks. Kenya and Zambia have also made progress in growing their non-bank financial sectors.

Nonresident participation in local currency capital markets is a mixed blessing. It can increase the

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supply of domestic lending, but in less developed markets it can also create currency, interest rate, and balance-of-payments volatility during global market shifts--as Egypt has recently experienced. Notable fluctuations in exchange rate and inflation dynamics have led average debt maturities to shorten in Egypt, Ghana, Kenya, and Uganda. In these countries bondholders have abstained from investing in longer-term bonds in anticipation of future rate hikes and currency volatility. This increases annual gross borrowing requirements and the speed of the pass-through of higher market rates into the budget.

Sovereigns have defaulted on local currency debt only half as often as they have on foreign currency obligations (see "2022 Annual Global Sovereign Default And Rating Transition Study," published April 28, 2023). Cameroon and Zambia, for example, missed payments on external obligations in 2022 and 2020, respectively. But the relative unsustainability of local borrowing costs has raised the incidence of domestic debt restructurings across the continent. Since 2020, two African sovereigns (Ghana and Mozambique) have defaulted on domestic obligations, while five (Angola, Ethiopia, Kenya, Uganda, and Nigeria) have engaged in non-commercial debt exchanges (see "Sovereign Domestic Debt Exchanges In Focus," Sept. 14, 2023). While the latter exchanges did not constitute defaults under our methodology (our sovereign ratings solely reflect the ability and willingness of governments to repay commercial obligations), they indicate growing domestic fiscal pressures across the continent.

Over time, limited pools of domestic savings in most African economies--which ultimately reflect lower levels of development--will continue to cause difficulties in a world where the return on risk-free assets is quickly increasing via quantitative tightening in advanced economies. With central banks unlikely to cut rates in the foreseeable future--locking lower-rated sovereigns out of global capital markets and keeping domestic borrowing costs elevated--the way forward will likely entail riskier quasi-fiscal activity or restructurings of local currency debt. This will have broader implications for medium-term social stability, economic growth, and development, already hard-hit by multiple recent exogenous shocks.

African Domestic Debt Market Data

This is the second edition of our DDI (for the first see "African Domestic Debt: Assessing The Continent's Vulnerabilities," published May 10, 2022). Here we gauge the availability and sustainability of domestic funding for African sovereigns from a purely data-driven perspective. To that effect, we analyse seven features of government debt and broader markets, each of which contribute to a sovereign's capacity to manage domestic debt. The DDI takes the sum of the individual Z-scores of the 12 equally weighted metrics in table 1.

The DDI results closely align with our local currency ratings on African sovereigns and have helped predict the direction of future rating changes. Notably, however, the DDI does not measure all the inputs that factor into our ratings. It does not include institutional effectiveness (the willingness and administrative capacity to pay domestic debt on time and in full; and the independence of public institutions). Nor does it directly measure external buffers, which are often the difference between avoiding or suffering the balance-of-payments shocks and currency crises that frequently lead to defaults, especially on external commercial obligations.

Banking sector lending capacity:

This assesses a banking system's size. In general, the larger the financial sector, the more capacity there is to finance the sovereign. This varies widely, from 25% of GDP in DRC to over 360% in Mauritius.

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We also consider the current level of financial sector claims on the central government because the higher the outstanding claims on the state, the less latitude it has to provide additional financing. For example, while Egypt benefits from a large captive financial system (with assets estimated at 131% of GDP), banking claims against the central government account for 40% of total claims, the highest of all 23 African sovereigns in this survey.

Non-bank lending capacity:

We have compiled comparable data on the size of domestic non-bank financial assets as a percentage of GDP where available. These are made up principally of insurance vehicles and domestic pension systems, but some countries (notably South Africa) also have large private asset management and other non-bank financial companies. Non-bank financial sectors (including pension funds) are far less prevalent in most other African sovereigns in this survey (though data limitations constrain this assessment).

Real yields:

We determine real yields on domestic debt by calculating the difference between current interest rates on 91-day treasury bills (T-bills) and the latest inflation rate. While nominal yields on domestic debt should rise as investors demand a premium for higher inflation risk, certain sovereigns--such as DRC and Senegal--have stabilized the real value of their outstanding debt by issuing at rates broadly on par with current inflation.

Debt structure:

We examine the overall stock of general government debt as a percentage of GDP, a standard metric in debt sustainability analysis. Our average debt-to-GDP forecast for our sample of 23 sovereigns has increased to 62% in 2023 from 48% in 2017, with debt levels falling only in DRC, Ethiopia, and Mozambique.

We also assess the percentage of local currency debt to total debt, postulating that higher shares of domestic debt provide stronger buffers against exposure to global interest rates and nonresident outflows. We observe ratios of over 70% in Mauritius, Morocco, and South Africa relative to our sample average of 46%.

Within debt structures we also look at nonresident participation in domestic markets. Higher participation arguably reflects a more transparent market and debt priced on more commercial terms. That said, foreign holders of local debt have, in many instances, reacted quickly to domestic dynamics and reversed their positions amid rising global interest rates, placing pressure on FX reserves and exchange rates. This has most notably happened in Egypt, Ghana, and South Africa; all have experienced a pronounced dip in foreign investor participation since the onset of the pandemic.

Our final debt metric examines central bank holdings of domestic debt. Sovereigns with higher ratios often have lower domestic savings and less developed and shallow domestic markets, forcing them to rely more on funding from central banks to plug fiscal deficits. This remains the case for Ethiopia, Ghana, and Nigeria; they rely heavily on mandatory direct advances from the central bank to keep funding costs low.

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Fiscal cost of debt:

We assess governments' fiscal cost of debt servicing as a percentage of general government revenue. Egypt, Kenya, and Zambia stand out for their very high cost of debt from a fiscal (rather than real yield) perspective, with total interest bills (domestic and external) consuming almost 30% of state revenue, among the highest of the sovereigns we rate globally.

We also focus on domestic interest costs as a percentage of GDP. These remain highest in Egypt, Ghana, and Zambia, averaging 6%-7% of GDP compared to the sample average of 2%. The medium-term impact of growing interest burdens could divert financing away from more productive capital and human expenditures, hampering medium-term growth.

Rollover ratio:

This ratio estimates the percentage of last year's local currency debt stock that must be refinanced during 2023. The higher the roll-over ratio, the greater the perceived stress in the domestic market, assuming the maturing debt must be refinanced at increasingly higher market-determined real rates. Egypt faces the highest local currency roll-over ratios, at almost 40% of GDP in 2023, reflecting its relatively high share of short-term commercial debt.

The primary fiscal balance:

This captures a government's underlying fiscal position, excluding net interest payments on total public debt. However, it can sometimes be skewed by one-off factors. For example, thanks to the run-up in Brent oil prices above $80 per barrel, Angola and Congo-Brazzaville are projected to post sizable primary surpluses of 5%-6% of GDP in 2023. We note that comprehensive fiscal consolidation measures across various states, including Kenya and Rwanda, have helped reduce average primary deficit positions across the continent to 1.4% in 2023 from 4.1% in 2020.

Our Observations On Individual Sovereigns' Domestic Debt Capacity

All ratings referred to in this report are long-term local currency sovereign credit ratings.

Egypt (B-/Stable/B)

Primary Contact: Trevor Cullinan

We estimate that the Egyptian government allocates over 40% of all revenue collected to interest payments on its high stock of debt. Most of these payments service domestic debt rather than external obligations. Given competing pressures on public spending, including on households hit hard by still-elevated energy and food prices, reducing this high interest-to-revenue ratio (the third highest of all 137 sovereigns we rate globally) will significantly challenge the government.

Along with its very high estimated local currency rollover ratio, whereby about two-fifths of its debt must be rolled over each year (by far the highest in Africa), we view Egypt as acutely sensitive to the global monetary tightening cycle.

Egyptian banks have the greatest exposure to their sovereign relative to their total assets--at 40% versus the median 17% among African sovereigns we rate. Reflecting a still significant pool of domestic savings, Egypt's banking system is Africa's second largest with total assets of 131% of

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GDP, even higher than South Africa (although Egypt's non-bank financial assets are far smaller than in South Africa). Despite a worsening foreign currency shortage at the formal exchange rate, and banks' deteriorating net foreign asset positions, local currency liquidity is ample. So while the average maturity of government debt has been steadily shortening, necessitating larger and more frequent rollovers, we do not anticipate immediate rollover risks.

An estimated 70% of government debt is held by public banks, increasing the state's capacity to use moral suasion/financial repression to refinance debt.

Despite these apparent advantages, we assess Egypt's debt structure as generally weak. Although about three-quarters of debt is denominated in local currency (shielding Egypt's sovereign balance sheet from exchange rate volatility), the previously high reliance on nonresident creditors within local currency debt exposed the government, exchange rate, and FX reserve levels to shifts in international sentiment.

Zambia (CCC+/Stable/C)

Primary Contact: Leon Bezuidenhout

In June 2023, Zambia struck an agreement with bilateral creditors for debt relief under the G-20 Common Framework, first requested by the government in February 2021. This follows the country's default in November 2020 and IMF subsequently withholding support for almost two years absent financing assurances from official creditors. This means Zambia now has to rely extensively on its thin domestic debt market in the absence of external inflows.

Nonresident holdings comprise over one-fifth of Zambia's domestic debt stock, a portion only topped by South Africa. Significant foreign inflows into government securities in 2021--supported by an improved macroeconomic outlook, the kwacha appreciation, and the election of a new president--were partially reversed in 2022. This reflected temporary uncertainty around the potential inclusion of nonresident holders of domestic debt in Zambia's restructuring parameters (resulting in sharp portfolio outflows that drained FX reserves and exacerbated currency pressures). This uncertainty was alleviated after the government publicly announced in June 2023 that local-currency-denominated debt would be out of scope.

One of the greatest risks to Zambia's domestic debt carrying capacity lies in its very weak fiscal flows and stock measures this year; its fiscal deficit (8% of GDP) and gross debt burden (111% of GDP) are the worst in rated Africa. About one-third of this debt is domestic, increasing Zambia's local currency gross borrowing requirement to an estimated 14% of GDP this year, the third highest of all the sovereigns in this survey.

The Zambian banking system's capacity to finance the government is limited by its large exposure to the state, estimated at one-third of total financial assets. Pension funds are also important players in the local debt market, holding about 24% of government securities. That said, it is still unclear how many additional debt issuances banks will be able to absorb following the National Pension Scheme Authority's (NAPSA; one of the key investors in local currency) decision not to participate in the last three local currency bond auctions, citing additional liquidity needs for early pension withdrawals.

Ghana (CCC+/Stable/C)

Primary Contact: Frank Gill

Ghana's fiscal imbalances, high cost of domestic debt, and modest domestic financing capacity

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pre-dated the pandemic. This had left the sovereign in a vulnerable position by early 2022, when the energy and food price shocks stemming from Russia's invasion of Ukraine further inflamed inflationary pressures, and U.S. Federal Reserve rate hikes locked Ghana out of international markets. The subsequent rise in global interest rates, nonresident outflows from Ghana's domestic bond market, and dollar strengthening quickly converted a fiscal shock into a full-fledged external and currency crisis.

The initial policy response was to press the Bank of Ghana to refinance maturing debt off its own balance sheet via an overdraft facility and increased holdings of non-marketable debt. This further intensified pressure on the Ghanian cedi (GHS) by accelerating money growth. As part of the domestic debt restructuring program, in September 2023 the Bank of Ghana (uniquely among creditors) agreed to absorb a 50% haircut on its GHS70.9 billion (9.2% of GDP) in holdings of non-marketable debt. As of Sept. 30, 2023, the central bank's net claims on the general government totaled an estimated GHS102 billion or 13.2% of GDP.

On Dec. 6, 2022, we lowered our local currency rating on Ghana to selective default after the Ministry of Finance initiated a transaction (domestic debt exchange) we classified as a distressed exchange offer on most domestic debt instruments. On Feb. 21, 2023, we raised the local currency ratings to 'CCC+/C' from selective default because we deemed that the distressed exchange on local currency instruments--tantamount to default under our criteria--had been cured (albeit the exchange was reopened in September 2023 on identical terms).

DDI data for Ghana shows its domestic debt financing capacity mid-restructuring. This--alongside its high stock of debt and still significant central bank claims on the general government--explains Ghana's elevated DDI vulnerability score. The final leg of the domestic debt exchange has yet to be concluded.

Moreover, while the Ghanian authorities are anticipating an agreement on bilateral debt treatment with official creditors by November, a final agreement with commercial creditors is likely to require several more months of negotiations. We expect any agreement with external creditors will meet an estimated 2023-2027 external financing gap of $10 billion via a combination of terming-out debt maturities (external debt principal payments excluding multilaterals were $9.5 billion over the period) and some interest relief (total interest payments on external debt excluding MLIs are $5.7 billion from 2023-2027). However, despite recent exchange rate stability and the Bank of Ghana haircut, the 55% 2028 debt-to-GDP target does not appear to us to be feasible without a confluence of favorable developments: real effective exchange rate appreciation, 50+% write-downs on external debt, and a strong economic recovery.

Mozambique (CCC+/Stable/C)

Primary Contact: Leon Bezuidenhout

Mozambique's government made late payments on domestic commercial debt between February and May 2023, constituting a selective default on its local currency rating, according to our criteria (in the absence of a grace period, our criteria requires payments to be made within five business days of the due date). During this period, the government delayed payment of principal and interest on treasury bonds by nine days on average--and in some instances by up to three weeks--owing to administrative shortcomings and an overturn in expenditure on public-sector salaries, alongside broader liquidity flow mismatches.

To absorb excess liquidity in the system, the Bank of Mozambique raised its mandatory reserve requirements twice in first-half 2023 to a cumulative 39.0% and 39.5%, from 10.5% and 11.5% for liabilities in domestic and foreign currencies, respectively. This temporarily suppressed

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commercial banks' appetite and ability to purchase government securities (contributing to delayed payments by the state), although current subscriptions of government securities remain strong due to very high real yields of 13.5% relative to the sample average of -1.4%.

Mozambique's domestic roll-over ratio remains one of the highest in Africa--at 18% of GDP--reflecting sizable local currency bond redemptions in 2023. While the government plans to increase its use of concessional external funds (a three-year IMF program was signed in May 2022), the domestic market will remain a key source of financing. This is expected to increase interest costs to 13% of general government revenue in 2023, from 8% in 2017, raising commercial banks' exposure to the government (currently 22% of total assets) with potential implications for private-sector lending.

The government relies on direct funding from the central bank to finance deficits, capped at 10% of revenue from the previous two financial years. To manage structural liquidity the bank is also involved in the outright purchase and/or sale of T-bills as a monetary policy instrument. Public-debt-management reforms supported by the IMF should help reduce the government's reliance on direct central bank advances--currently a high 8% of GDP or 17% of the central government's domestic debt stock.

Uganda (B-/Stable/B)

Primary Contact: Leon Bezuidenhout

Historically Uganda has benefited from less expensive external concessional borrowing from multilateral and bilateral lenders, but in recent years it has increasingly resorted to costlier, mostly domestic, funding to cover large deficits. Although concessional debt now constitutes over 40% of external general government debt, this share has dropped from 65% in 2019 as the government's large financing needs this year have been plugged mainly by commercial sources.

Uganda's increasing reliance on domestic debt is pushing up already elevated debt-servicing costs and crowding out private-sector credit. Interest expenditure occupies a high 24% of general government revenue, a similar portion of the budget to Angola and Ghana, while domestic interest payments consume about two-thirds of the total interest bill.

To reduce interest rate risk in its domestic debt portfolio, the Bank of Uganda has converted outstanding treasury bonds before maturity into higher yielding, longer-dated paper on several occasions over 2021-2023. We have so far considered these conversions to be part of standard liability management exercises and not distressed exchanges, although we will assess each new exchange on a case-by-case basis.

Offshore investors' holdings of Uganda's domestic debt remain high by African standards (8% versus 4% for the sample in this survey) due to relatively high real yields on domestic debt (7% versus -1% for the group). That said, a recent downward trend in foreign holdings has reduced Uganda's options for funding itself and has placed additional pressure on the domestic banking system to absorb government issuances. Uganda's banking sector is still among the lowest in Africa (30% of GDP versus 70% for the group) and a significant portion of assets are already tied up in government lending (26% of total assets).

Kenya (B/Negative/B)

Primary Contact: Giulia Filocca

One of Kenya's key vulnerabilities is its very high interest burden, which amounts to nearly

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one-third of government revenues. Nominal debt repayments have nearly tripled in six years, reflecting a sharp increase in domestic interest costs to 4% of GDP in 2023, from 2% in 2017. Rising yields in primary markets have been driven by investors' expectations of future rate hikes and a government cash crunch amid a $2 billion Eurobond maturing in June 2024, driving bondholders to withhold investing in longer-dated securities in favor of shorter-term T-bills.

Nonresident participation in Kenya's domestic bond market is minimal according to reported government statistics (0.7% of total domestic debt) which somewhat shields domestic debt from external markets volatility. However, we understand this figure may be understated as a significant portion of foreign investment, particularly in medium-term infrastructure bonds, is captured through bank intermediaries. This partially explains the undersubscription and subsequent cancellation of a 15-year bond auction in April 2023, alongside sustained depreciation pressures on the Kenyan shilling since the onset of the Russia-Ukraine conflict.

To reduce domestic refinancing risks, the government initiated a voluntary bond switch auction in late 2022 to roll over impending short-term maturities into longer-dated instruments. It had deployed a similar liability management exercise in June 2020. We classified neither as distressed exchanges given their voluntary nature, higher and market-determined yield, and our understanding that the non-converted portions were paid in full and on time.

Positively, the Central Bank of Kenya's independence and institutional strength have been improving. This is reflected in low net central bank holdings of government debt (3.5% of GDP versus 6.0% on average for the surveyed group) keeping inflation in the single digits. That said, banking sector claims on the government have climbed to 23% of total assets in 2023, from 17% in 2015, with ramifications for private-sector lending.

South Africa (BB/Stable/B)

Primary Contact: Zahabia Gupta

Nonresident holdings of South African domestic government debt are somewhat high, which exposes the sovereign to shifts in foreign investor sentiment. That said, foreign holdings of local currency debt dropped to a 10-year low of 25% of total government bonds in 2023, from slightly above 40% in 2017. These outflows have pressured the rand and the government's financing costs. South Africa has limited exposure to foreign currency funding, with 90% of debt being rand-denominated--by far the strongest proportion among rated African sovereigns.

As nonresidents have reduced their weight in South African bonds, domestic banks have increased their exposure to the government. Banks' holdings of government debt rose to about 15% of total assets in 2023 from under 10% in 2015. However, we think there is still room for the large banking system to continue to absorb additional government debt. We note that the banks' exposure to the sovereign remains lower than peers such as Brazil, Mexico, and Turkiye.

South Africa has the largest non-bank financial sector of all the African sovereigns in this survey (219% of GDP), capturing domestic savings and providing a buffer against nonresident outflows. We view the pool of potential funding as significant and, along with South Africa's broader monetary flexibility, an important factor in the higher sovereign rating in a regional context.

However, we view the government's high interest burden as a credit weakness. Even though we expect fiscal deficits to gradually decline, the interest-to-revenue ratio will inch toward 20% through 2026 on the back of decreasing tax windfalls from commodity prices and higher domestic interest rates. Further sell-offs of government bonds by nonresidents could put additional pressure on yields, in our view.

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Our local currency rating on South Africa is one notch higher than our foreign currency rating as we believe default risks differ between the two. In our view, South Africa has well-developed domestic capital markets and an independent monetary policy with a track record of a free-floating exchange rate.

CFA Franc Zone

Primary Contact: Remy Carasse

Our seven rated CFA franc zone members-- Benin, Burkina Faso, Cote d'Ivoire, Senegal, and Togo in the West African Economic and Monetary Union (WAEMU), and Cameroon and Congo-Brazzaville in the Central African Economic and Monetary Community [CEMAC]--all appear to have somewhat more favorable domestic metrics compared to some other African countries.

Membership of WAEMU and CEMAC has contained real yields over time. This is not only positive for debt dynamics, but also drives some of the continent's lowest observed cost-of-debt ratios (both as a proportion of GDP and government budgets). However, real yields on government bonds may not reflect the risk premium these countries would have in the absence of the monetary arrangement. The fixed exchange rate with the euro and France's guarantee of convertibility has long supported confidence in the peg and helped contain rising inflationary pressures, even during political crises and commodity price shocks, unlike in most sub-Saharan African economies.

For most WAEMU and CEMAC members, rollover ratios of local currency debt are among the lowest in Africa. This may be due to the domestic markets in WAEMU, and particularly CEMAC, being shallower (the banking systems are generally some of the smallest in Africa), implying that most of these economies still rely heavily on external financing. Governments' ability to borrow on the regional financial market remains a supportive factor.

We estimate nonresident participation in local debt markets (defined as residents outside the respective two monetary unions, so excluding intra-WAEMU or intra-CEMAC holdings) to be extremely low across all seven sovereigns. This limits the risk of nonresident outflows causing pressure on the currency. WAEMU has been trying to encourage nonresident participation in the WAEMU regional market, but this has not yet taken off. The reason for low nonresident participation despite a stable exchange rate could be explained by lower yields compared with the rest of the region and perceived administrative hurdles.

Related Research

- Sovereign Ratings List, Oct. 13, 2023
- Sovereign Ratings History, Oct. 13, 2023
- Sovereign Risk Indicators, Oct. 9, 2023
- Sovereign Ratings Score Snapshot, Oct. 9, 2023
- Credit Conditions Emerging Markets Q4 2023: Higher Interest Rates Sour The Mood, Sept. 26, 2023
- Sovereign Domestic Debt Exchanges In Focus, Sept. 14, 2023
- Sovereign Debt 2023: Borrowing Will Stay Elevated Despite Rising Cost Of Debt, May 9, 2023
- African Domestic Debt: Assessing The Continent's Vulnerabilities, May 10, 2022

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