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Pandemic-era debt: short-term outlook and implications

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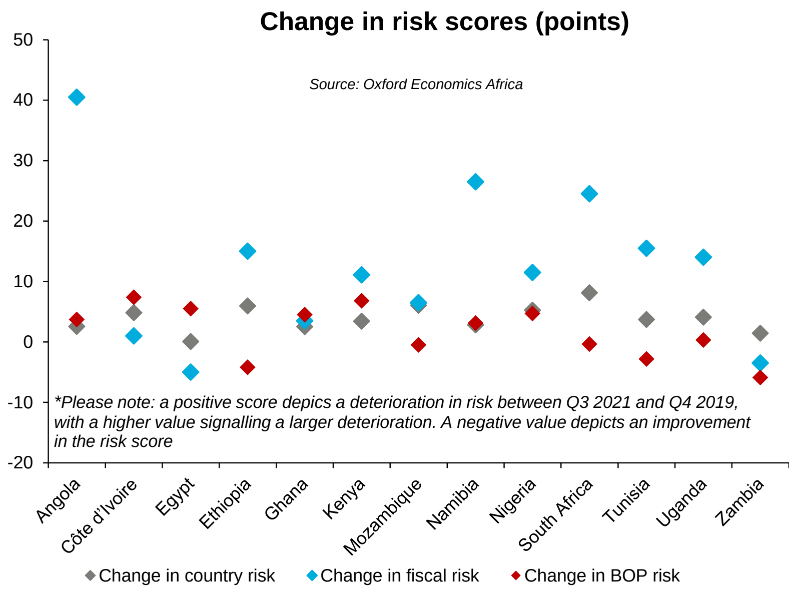
- **Fiscal finance risk has deteriorated over the past 18 months as uptake of debt relief and rescheduling initiatives disappointed, a favourable external pricing environment enticed new debt issuances, and demand-side recovery underperformed. Mirroring the strategies of the past, African issuers are once again utilising the 'high growth' shield as defence against accusations of indiscriminate and unsustainable borrowing.**
- To borrow the analogy of a relay race, we expect a handover of the 'growth baton' from external trade to the demand-side over the course of 2022. The short-term growth narrative is mostly one of a strong external sector and favourable base effects. In fact, these two factors have cushioned the blow dealt to growth by a still-struggling consumer and the absence of fiscal space to boost growth, particularly in Angola.
- In coming months, we anticipate a gradual but sustained decline in commodity prices, which (alongside ongoing recovery in import appetite) factors into the merchandise trade-led loss of current account support. The reversal of current account strength will coincide with ongoing retreat of government consumption, exposing the growth environment to downside risk. This will shift the onus on production factors to shoulder the current account burden and expose growth dynamics to idiosyncratic factors. However, we do not think that this necessarily foreshadows doom, provided that US policy normalisation does not trigger strong global risk-off sentiment.

Figure 1: Between the period Q4 2019 and Q3 2021, our risk scores have deteriorated across various pillars of risk



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Pandemic-era debt: some notable hits but also large misses

Pandemic era brought rapid deterioration in debt metrics, while the jury is still out regarding the impact of support initiatives on longer-term sustainability

The pandemic era brought a wide spectrum of debt relief and restructuring schemes, but a combination of poor uptake, moral hazard concerns, and complications related to a splintered creditor profile undermined the structural reform that these initiatives aimed to achieve. Fiscal and debt sustainability concerns not only remain present, but in fact have been amplified by the pandemic. Notwithstanding programmes and initiatives championed by the IMF, World Bank, and G20 aimed at lowering debt vulnerabilities, uptake of these initiatives by African governments has been slow. In the limited cases where governments did sign up for the collective creditor approach to pre-emptive flow rescheduling, progress has been quite weak. On the other hand, accommodative global funding conditions again opened the avenue of new commercial borrowing in late 2020, with numerous African borrowers taking advantage of a welcome embrace to issue record-size hard currency bonds. These include trouble-stricken Nigeria, which issued an upsized $4bn Eurobond at end-August.

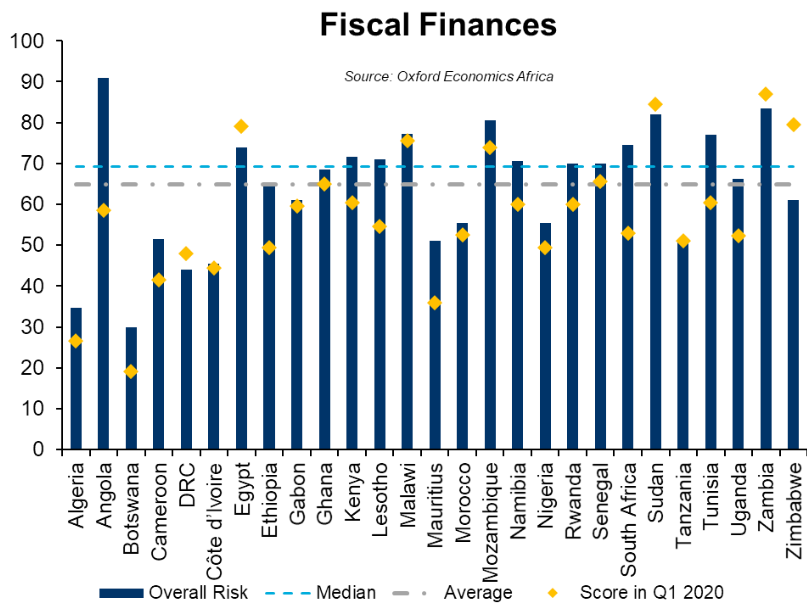
We fear that this borrowing spree will continue as countries seek avenues to fill the fiscal void left by the upcoming expiry of the Debt Service Suspension Initiative (DSSI, at end-2021). Payment on the DSSI-deferred payments is set to coincide with a new dollar-bond issuance cycle. Incentivised by a favourable external pricing environment, some Eurobond issuers have already kicked-off the rollover process, earmarking a portion of new borrowings for the settlement of upcoming maturities, or even commenced with buybacks. Other countries have merely taken advantage of yield-seeking behaviour to front-load borrowing for medium-term expenditure targets. The number of African countries that issued Eurobonds since the start of the pandemic has already hit double-digits. Even with initiatives such as the DSSI and G20 Common Framework, debt servicing costs still outstrip spending on health initiatives and countercyclical support. As a proportion of GDP, DSSI-related savings for sub-Saharan Africa issuers (over the period May 2020 to December 2021) is estimated to average 3% – a sizeable amount.

Commodity price reprieve offered shelter not only to the external trade position this year, but fiscal positions as well. However, outside of fiscal receivables related to the extractive sector, fiscal revenue remains under strain: recurring lockdowns associated with Covid-19 waves, supply-chain disruptions, limited local capacity, and an overburdened consumer bode ill for medium-term fiscal prospects. A number of well-known highly indebted countries, including Namibia and Kenya, have set up sinking funds to redeem upcoming debt maturities, but fiscal stress raises the risk that these facilities may be prematurely exhausted, as was seen in the case of Zambia. Namibia, for instance, has already delved into its sinking fund facilities, and replaced those funds through a debt-to-asset swap whereby it exchanged local-currency assets for foreign-currency assets held by its pension fund. However, these types of swaps raise the risk of government keeping the door open to use financial repression as an avenue to deal with domestic debt problems further along the line. Other countries, specifically in West and Central Africa, have taken a more innovative approach to raising funds to meet targeted spending requirements. The Economic Community of West African States (Ecowas) has launched efforts to create a cross-border debt market by 2023 to increase access to lending polls and reduce borrowing costs.

It is therefore no surprise that our fiscal risk metrics have deteriorated strongly since the beginning of 2020. Our fiscal risk pillar draws upon subcomponents including government's future ability to generate tax revenue, fiscal policy orientation, and the structural deficit. Furthermore, we are now seeing a misalignment between the expiry of debt moratoriums and underlying recovery in some fiscal revenue sources. Combined with poor progress on comprehensive flow rescheduling, the medium-term budget frameworks set out by many governments tend to fall in the so-called ‘high-growth trap’. The high-growth trap refers to the situation in which a country’s medium-term fiscal framework is premised upon rapid economic growth, which is assumed to carry through to fiscal receivables. Expenditure rationalisation (planning and implementation) is minimal, as authorities rely upon a growth (and revenue-led) fiscal consolidation strategy. Disappointment on the revenue-side therefore poses risk of abrupt changes to tax regimes, cancellations of growth-supportive capex projects, higher risk of renegotiations of permits and licenses in hard-currency-earning sectors, delays in payments or the build-up of arrears to suppliers, or asymmetrical enforcement of local participation requirements (e.g. free carry or forced shareholding).

In the graph below, please note that a higher value depicts a higher level of risk. In other words, should the gold diamond trend above the blue column, it would imply that fiscal risk is now considered to be lower than at the beginning of 2020. In fact, this is the case in a few countries such as Egypt and Zambia. In the case of the latter, the new regime’s vocal commitment to root out wasteful expenditure and instil a more pragmatic approach to policymaking has played a role in improving the outlook for fiscal policy orientation, enabling the risk to be reduced on this metric. However, in the majority of cases we see that the current risk score is higher than the Q1 2020 level and the lagged impact of the pandemic on fiscal receivables as well as the higher expenditure burden.

Figure 2: Over the past 18 months, fiscal finance risk has deteriorated for the majority of African countries



Growth struggling to gain traction as government support recedes, exposing demand-side weakness

The Covid-19 pandemic has challenged the African growth model across various pillars. At the beginning of the pandemic, most countries employed aggressive countercyclical policy support. Yet, the first phase of retreat of this support has shown that numerous challenges remain, including (i) a struggling and overburdened consumer; (ii) haphazard recovery in manufacturing activity as countries periodically reintroduce stricter lockdown measures; (iii) asymmetrical recovery in global shipping to the detriment of the East African routes; (iv) the limited scope of intra-regional and domestic tourism to fill the gap left by the long-haul flight slump; and (v) the slow pace of improvement in asset quality after the lifting of debt moratoriums. In stark contrast to a number of advanced economies, household consumption as a driver of growth will remain weak well into 2022, with the risk of a more protracted recovery. Households are burdened by escalating inflation, the expiry of fiscal relief measures, and weak employment prospects. In several countries, unemployment rates have hit successive new records this year.

Slow inoculation progress, the result of a combination of vaccine resistance and supply-chain challenges, threatens to delay the achievement of vaccination targets by years. In countries that strictly enforce lockdown measures, the intermittent stringency of lockdowns dampens consumer demand, as consumers adjust spending patterns in preparation for an uncertain employment outlook. Other countries, such as Ghana, have weak enforcement of lockdown measures: in this case, the impact on growth has been much less severe than initially feared, but it does carry a further burden that the pandemic will linger for much longer in the country. In addition to the impact of the overburdened consumer, the private sector is still contending with the shift in fiscal policy from accommodative to consolidation-minded. In the case of Botswana, the change in fiscal gears has been quite rapid and severe.

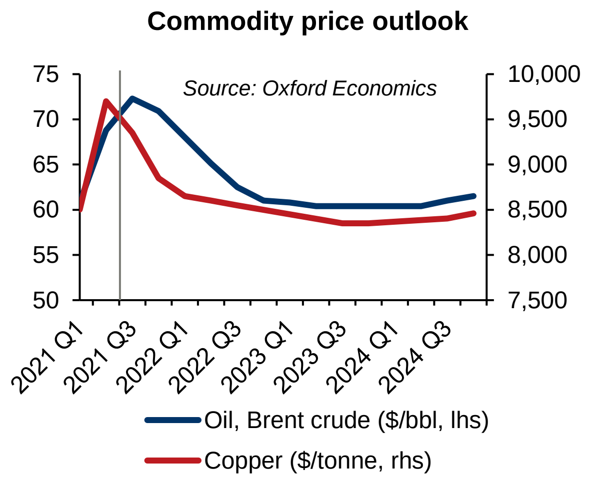
External environment: friend-turning-foe, or can we expect further support?

Commodity price strength steered current account improvement this year as output challenges remained

High tides cover a multitude of sins. Over the past year, a supportive commodity price environment (supported by accommodative external policy measures) enabled African nations to cover a plethora of economic sins, including operational disruptions and output disappointments, the spillover effects of slow inoculation progress, weak policy transmission due to changes in domestic risk appetite, and underwhelming performance on external debt flow rescheduling. Weak policy transmission relates to the increase in risk aversion, as misalignments between debt moratorium expiries and business recovery contributed to deteriorations in asset quality. As a result, the countercyclical policy pulse failed to transmit to business to the degree that policymakers envisioned, while simultaneously diverting a portion of system funds to ‘safer’ government securities instead. Africa is facing a retreat of this ‘high tide’ support in various forms, but the two factors we keep a specific lookout for are (i) monetary policy normalisation in the US, related to both the tapering of purchases of assets under the quantitative easing (QE) programme and interest rate lift-off; as well as (ii) gradual but sustained declines in commodity prices.

Regarding the first factor, we interpreted the September Federal Open Markets Committee (FOMC) policy statement as signalling that **QE tapering will likely be announced at the November policy meeting and finish by mid-2022**. The start of tapering in November would be slightly ahead of our expectation, but in line with our view that the tapering of asset purchases likely spans eight months and consists of a proportional reduction in purchases of both Treasury and mortgage-backed securities. We think a repeat of the taper tantrum sell-off can be avoided: While the tapering of quantitative easing is imminent, we do not think that this will trigger quantitative *tightening*. It was the latter which was instrumental to the repo market stress back in 2018. This time around, we expect that the Fed will reinvest maturing bonds to keep the System Open Market Account (SOMA) and the overall balance sheet from shrinking. In fact, the Fed balance sheet will still be growing each month through mid-2022, effectively eliminating the stress of liquidity withdrawal from the system which is conducive to market stress akin to the previous tapering tantrum fiascos. With Chair Powell all but confirming at the recent meeting that QE tapering will commence in November and run through mid-2022, we do not foresee this event as triggering stress across the African hard currency spectrum. The latest dot plot showed faster and earlier tightening expectations, effectively bringing forward the rate lift-off amid growing unease with higher inflation. However, mindful of the headwinds that loom in 2022, we still expect the first US rate hike to take place in 2023.

Figure 3: Despite some divergence on the starting date, we expect a general trend of commodity price suppression



Weakening commodity prices will coincide with the expiry of debt interest moratoriums, including the DSSI. This should expose the weakness in non-commodity tax receipts. For the majority of African commodity exporters, we expect a goods-trade-led deterioration in the current account from 2022 onwards, as moderate increases in production fail to fill the gap left by retreating commodity prices.

External support starting to recede, but clear communication should allow for a soft landing

The second external factor that we will keep an eye on is the retreat in global commodity price support, and specifically the divergence between metals and energy markets. Our baseline commodity price projections imply that energy producers will soon be entering a phase of gradual price compression. This presents a modest divergence from metals, including copper, which we think has already entered the twilight zone of price support. **Our baseline scenario sees the benchmark oil price as retaining strength through the end of this year, but domestic woes in Angola and Nigeria limit the degree to which these countries can draw benefit from a strong Brent price.** Waning demand from Europe and India, higher appetite for competing grades, and a myriad of production challenges plagued the oil sectors in these two countries, which have been evident in the pricing of West African crude grades. With commodity price support on its last legs before a phase of sustained decline, the onus shifts to commodity exporters to ramp up production. In the cases of both Angola and Nigeria, we fear disappointment on this front. While our projections lay out moderate growth in production over 2022-24, the risks are skewed to the downside, and our baseline output figures, for both countries, are well below the output targets set out by the respective governments.

Does this mean that we are inevitably heading towards another crisis down the line? Not if our baseline scenario plays out, which sees a gradual recovery in household expenditure and strengthening FDI by 2023, to coincide with the tail end of commodity price support. Our baseline scenario already includes slower-than-consensus growth, a much slower pace of fiscal consolidation than envisioned by the consensus, and production assumptions that undershoot official targets. Even with these more conservative assumptions in place, we are optimistic that Africa will not see a repeat of the infamous taper tantrum, provided that forward guidance is well communicated and that, near term, quantitative *tightening* can be avoided. We do expect merchandise trade surpluses to thin from 2022 onwards, but provided that the retreat of price support is as gradual as we currently envision, this will nonetheless buy time for consumer recovery. By 2023, we expect that a stronger consumer and strengthening FDI will carry a portion of the growth burden, allowing some governments to refocus policy towards a consolidation path.