DEAD AID

WHY AID IS NOT WORKING AND HOW THERE IS A BETTER WAY FOR AFRICA

Dambisa Moyo

Farrar, Straus and Giroux
New York

Farrar, Straus and Giroux
18 West 18th Street, NY 10011

Copyright © 2009 by Dambisa Moyo
Foreword copyright © 2009 by Niall Ferguson
All rights reserved
Distributed in Canada by Douglas & McIntyre Ltd.
Printed in the United States of America
Originally published in 2009 by Allen Lane, an imprint of Penguin Books,
Great Britain, as *Dead Aid: Why Aid Is Not Working and How There Is Another Way for Africa*
Published in the United States by Farrar, Straus and Giroux
First American edition, 2009

Library of Congress Cataloging-in-Publication Data
Moyo, Dambisa.
Dead aid : why aid is not working and how there is a better way for Africa / Dambisa Moyo.— 1st ed.
p. cm.
Includes bibliographical references and index.
ISBN-13: 978-0-374-13956-8 (hardcover : alk. paper)
ISBN-10: 0-374-13956-3 (hardcover : alk. paper)
1. Economic assistance—Africa. 2. Poor—Africa. 3. Africa—Economic conditions—21st century. I. Title.

HC800 .M69 2009
338.91096—dc22

2008055451

www.fsgbooks.com

3 5 7 9 10 8 6 4 2

For Peter Bauer

The Republic of Dongo

Population: 30 million. Average life expectancy: forty years (down from sixty-five in the past twenty years, mainly because of the HIV–AIDS epidemic; in its cities, one in three adults have the disease). Annual per capita income: US$300, with 70 per cent of its population living on below US$1 a day. Average growth rate in the past twenty years was 1 per cent and 5 per cent in the last five years: has benefited from a recent copper price surge. Chief exports: copper, gold, cotton and sugar. Political system: adopted a nominal democracy ten years ago, having spent twenty years as a one-party state led by the same political party, and the same president.

This is the Republic of Dongo. While fictitious, the Republic of Dongo is not far off the reality of many African countries. Freed from European colonial rule in the 1960s, the country's background and evolution are pretty characteristic of the average African country. A socialist economy in the 1970s, it underwent privatization in the mid-1980s, moved to a democratic regime after *Glasnost* and *Perestroika*,[1] and is ranked 3 out of a possible 10 on the Transparency International Corruption Perceptions Index (where 0 is the least transparent). In the 1980s the country had accrued as much as US$3 billion of debt – twice as much as the country's annual GDP, and more than three times its combined education and health budgets. Dongo benefited from debt relief in the early part of the 2000s, which left minimal debt. Yet the country remains the beneficiary of millions of dollars of aid each year. Aid share of GDP: 10 per cent. Aid as a percentage of government revenues: 75 per cent.

Like Nigeria and Malawi, Dongo was granted its independence in the 1960s. Like Uganda and Botswana, it is struggling under the weight of HIV–AIDS. Like Zambia, Mali, Benin and the

Democratic Republic of Congo, Dongo relies on commodities (mineral and agricultural) as a primary source of export revenue (by comparison, 60 per cent of Zambia's export revenues come from copper, and over 95 per cent of Nigeria's export earnings are from oil and gas). Although not as extreme as the Gambia or Ethiopia, where 97 per cent of the government budget is attributed to foreign aid, Dongo's fiscal revenue is mainly aid-dependent. Like Kenya, it has in place a fragile democracy, which under the confluence of exogenous factors is susceptible to political destabilization. And like the majority of African (and indeed most developing) countries, its population is skewed towards the young: 50 per cent of its citizens are below the age of fifteen. Faced with few obvious prospects, Dongo, like so many of its neighbours, is intensely vulnerable: a breeding ground for disaffection, unrest and civil war.

Where will its young men and women be in twenty years' time? If a country can't produce the next generation of well-educated civil servants, politicians, economists and intellectuals, then how can it not regress? Will Dongo have changed, or will it still be locked in a cycle of disappointment and despair?

This book is not about specific development policy. It is not a book about whether one way of tackling the HIV–AIDS problem is better than another, or if one education strategy yields better results than another. It is about how to *finance* the development agenda so that, whatever the development policy, economic prosperity might be realized. Dongo will only change if its fundamental model of aid-dependency is abandoned and the *Dead Aid* proposal of this book adopted wholesale, in its entirety.

The choice of development finance is at least as important as the policies a government adopts. You can have the best development policy in the world, but without the right financial tools to implement it, the agenda is rendered impotent. Put differently, it matters little whether Dongo is capitalist or socialist in development orientation – of paramount importance is how Dongo finances its economic development. Indeed, neither a capitalist nor a socialist economic agenda can be truly achieved in the longer term without a financing strategy based on free-market tools.

Implicit in the proposals that follow are financing solutions that have their roots in the free-market system. This invites the question: is it possible for a government to raise money in a free-market way and spend it on a socialist agenda (for example, provide free education and healthcare)? The answer is yes: Sweden, Denmark and Norway are just three examples. Whatever the social, political and economic ideology a country chooses, there is a menu of financial alternatives (all better than aid) that can finance its agenda.

Can a government use free-market tools and still maintain its core socialist values? The answer is not only yes, it can, but, perhaps more importantly, it has to. And even when a government finances itself using socialist-like tools (for example, high taxes), it must still rely on some market-based financing tools in order to successfully achieve its economic goals.

5. A Radical Rethink of the Aid-Dependency Model

Governments need cash

The fact of the matter is, governments need cash. This is true regardless of political leanings – whether a socialist government, which endeavours to provide all goods and services to its citizens, or a more market-driven government, which relies on the markets to provide some public goods (that is, goods and services for which there is a broad public benefit, but for which no one person bears the cost, like, again, a lamppost).

Perhaps nowhere is the role of government more crucial – as a strategist, as a coordinator and even, to some extent, as a financier – than in poor developing countries. For at the early stages of development, the nascent private sector is simply not large enough to assume a central developmental role. Traditionally, this is where aid stepped in. But, as this book has argued, aid has not delivered any meaningful or substantial economic performance. Even if it were true that aid had contributed to economic growth, there are two compelling reasons why Africa should seek alternatives to finance its development.

The donors are growing weary. As shown earlier, over the past twenty years foreign aid to Africa has been on the decline. Whether it is because donors don't believe it works, they don't have the cash or they simply don't care, the fact remains that the donors' African aid purse is slowly shrinking.

Despite the outpourings of Live 8, one survey found that the US public's desire to reduce foreign aid outranked its fear of nuclear war. In a 1980 poll 82 per cent of respondents said foreign economic assistance should be cut.[1] This may, at least in part, explain why, when it comes down to it, most donor countries have failed to meet their pledges of 0.7 per cent of GDP made in Monterrey in 2002.

Another reason for the decline in aid flows may be that donor countries are facing their own financial pressures. It has been estimated that Bush's war on terror – being fought in Iraq, Afghanistan and Pakistan – will cost the US almost US$3 trillion.[2] Demographic shifts are putting further strain on Western economies. Increasing numbers of retirees and fewer productive young people (owing to the ageing baby boomers and lower birth rates) means increasing health costs, lower tax revenues and less to give away. And of course it is worth remembering that the 2008 credit crisis has put immense pressure on the fiscal balances of rich (and rapidly emerging) countries; yet another stark reminder that foreign donor support is an unreliable if not dangerous palliative. For African policymakers to view aid as permanent (even with the noise made by aid proponents for it to be increased) is foolhardy.

Weaning off the addiction: no one said it would be easy

Africa is addicted to aid. For the past sixty years it has been fed aid. Like any addict it needs and depends on its regular fix, finding it hard, if not impossible, to contemplate existence in an aid-less world. In Africa, the West has found its perfect client to deal to.

This book provides a blueprint, a road map, for Africa to wean itself off aid. This goal cannot be easily achieved without the co-operation of the donors. And like the challenges someone addicted to drugs might face, the withdrawal is bound to be painful. Drug-taker, or drug-pusher, in the end someone has to have the courage to say no.

What follows is a menu of alternatives to fund economic development across poor countries. If implemented in the most efficient way, each of these solutions will help to dramatically reduce Africa's dependency on aid. The alternatives to aid are predicated on transparency, do not foster rampant corruption, and through their development provide the life-blood through which Africa's social capital and economies can grow.

The *Dead Aid* proposal envisages a gradual (but uncompromising) reduction in systematic aid over a five- to ten-year period. However worthwhile the goal to reduce and even eliminate aid is, it would not be practical or realistic to see aid immediately drop to zero. Nor, in the interim, might it be desirable.

A reasonable person could, for example, argue that aid in Africa has not worked precisely because it has not been constructed with the idea of promoting growth. The politically driven aid and tied-aid examples discussed in earlier chapters underscore the point that these types of aid flows do not promote development, and nor were they intended to in the first place. That, if executed in a moderate way, Botswana's experience with aid (detailed earlier) is exactly what we would want to see: a country that began with a high ratio of aid to GDP uses the aid wisely to provide important public goods that help support good policies and sound governance that lays the foundation for robust growth. Over time, the ratio of aid to GDP would fall as a country developed. In this way, Botswana would seem like the poster-child for what aid can do in a well-managed country.

It might very well be the case that more-modest aid programmes that are actually designed to address the critical problems faced by African countries can deliver some economic value. The *Dead Aid* proposal does allow for this perspective, by leaving room for modest amounts of aid to be part of Africa's development financing strategy. Systematic aid will be a component of the *Dead Aid* proposal, but only insofar as its presence decreases as other financing alternatives take hold. The ultimate aim is an aid-free world.

6. A Capital Solution

In September 2007, Ghana issued a US$750 million ten-year bond in the international capital markets. About a month later, the Gabonese Republic followed suit, issuing a US$1 billion ten-year bond. Could Dongo do the same?

Bonds are effectively loans or IOUs. On issuing a bond, the government promises to repay the money it borrows to the lender, plus an agreed amount of interest. However, as discussed earlier, bonds issued in the commercial marketplace are fundamentally different from aid given in loans in at least three ways: first, the interest rate charged on aid loans is below (often markedly so) the going market rate; second, aid loans tend to have much longer periods over which the borrowing country has to repay (some World Bank loans are for fifty years, whereas the longest maturities in the private markets rarely exceed thirty years); third, aid transfers tend to carry much more lenient terms in cases of default or non-payment than the relatively more punitive private bond markets.

There is a plentiful history of lesser developing countries issuing bonds – dating as far back as the 1820s. By 1860, for example, Argentina and Brazil were frequent users of the international bond markets, and since then many of the world's poorest countries have, at one time or another, issued bonds. In a report, the rating agency Standard & Poor's lists as many as thirty-five African economies as having had access to the bond markets in the 1970s and 1980s.

For many of these countries, the point of issuing these bonds to international investors was to help finance their development programmes, including infrastructure, education and healthcare. Monies raised by bonds could, however, also be used to fund governments' day-to-day (current) expenditures such as on the military, civil service and trade imbalances.

Accessing the bond markets is not that hard. Having decided to raise money by issuing bonds rather than yet again taking aid (this might prompt the question of why an African government would choose to do this, but following the example set by South Africa and Botswana, a responsible government should see merit in this financing strategy), a country must go through a number of reasonably straightforward stages.

First, it must acquire a rating, very often obtained from reputable internationally recognized rating agencies. The rating might not be great, but it is nonetheless a rating. The rating is a guide to investors of the risk involved – the likelihood that a country will repay its loans – and therefore determines the country's cost of borrowing.

Second, the country must woo the potential investors – those people willing to lend to it. Very often, a country will hire a bank to accompany its representatives on a roadshow to help make the case to an array of investors (institutions like pension funds and asset managers as well as private individuals) as to why they should lend their money to the country. It is also an opportunity to show that it can manage its borrowings in a credible way – after all, many of these countries were not able to keep the relatively low-interest-rate debt of the 1970s from piling up in an unsustainable way. There are good reasons to believe that the greater desire of many African leaders to see their countries excel should give investors the comfort that governments will fare better with private debt flows today than in the past.

Finally, assuming the country's representatives make a compelling case for its credibility and intention to repay, and once the loan terms are agreed upon (the maturity or length of the bond, the cost of the bond, the currency it will be issued in), the country gets its cash.

The market for African countries to issue bonds exists, but only for those countries seriously intent on transforming their economies for the better. The good news is that for countries considering the bond markets, investor interest in emerging countries is on the rise. Traditionally only designated emerging-markets investors sought returns in underdeveloped markets. Over time, thanks to greater information and people being more at ease with the idea of globalization and cross-border linkages, other pools of money have turned their attention to emerging economies. This has broadened a previously narrow base to encompass an almost insatiable demand from mutual funds, pension schemes, hedge funds, insurance companies and private asset managers around the world.

Moreover, as economies have stabilized, and operate under better management, investors themselves have evolved from more short-term speculators (jumping in and out to garner short-term gains) into longer-term players happy to buy and hold developing-country assets for longer periods, and even up to maturity.

While it is true that the Asian crisis of 1997, the Russian debacle in 1998 and the Argentinian default of 2001 all led to a sudden outflow of capital from the emerging markets, these proved to be hiccups in what has been a strong and growing trend of emerging-market interest. And even in those countries where money flowed out on the back of crises, in just one decade investor money has returned.

The reasons for the rapidly growing interest in emerging economies are threefold:

For one thing, investors are always looking for the next, best opportunity. And emerging-market fundamentals make a strong case for being some of the best opportunities around. Countries that exhibit strong economic performance and are seen to be on a sound and credible footing will be rewarded. At a minimum, foreign investors will be willing to lend the country the cash. However, the beauty with bonds is that their very existence lends further credibility to the country seeking funds, thereby encouraging a broader range of high-quality private investment. More credibility equals more money, equals more credibility, equals more money and so on. As part of the macroeconomic improvements, being actively seen to be making strides away from aid, and in doing so shaking off the stigma of being an aid 'basket-case', is in itself an attractive proposition to potential investors.

Second, unsurprisingly, investors are attracted to the prospect of high returns. At the most elementary level, fund managers and commercial banks are themselves rewarded for a decent appreciation on their capital. In some cases, dedicated emerging-market fund managers (those only investing in these markets) look for net returns of at least 10 per cent per annum. By and large, thanks to their rapid growth, and the relative scarcity of investment capital, it is mainly assets in emerging markets and underdeveloped countries that can deliver these high returns.

For example, in 2006, emerging-market debt gave investors a return of around 12 per cent. The performance beat the 3 per cent return for US government bonds in the same year. Moreover, emerging-market debt has almost consistently outperformed international stocks over the past ten years. Whereas the average return for emerging-market bond funds over the past five years has been 40 per cent, US equity indices have only returned 20 per cent. In 2007, emerging-market bonds returned some 35 per cent and J. P. Morgan's EMBI+ index of such bonds performed better against American government bonds by 15 per cent. Over a longer timeframe – say an eighteen-month to two-year window – experienced portfolio managers can make significant returns, averaging 25–30 per cent per annum.

More generally, historically, choosing to invest in the bonds of relatively underdeveloped economies instead of home bonds has paid off. The evidence of ten countries suggests that investors made higher returns on bond lending to foreign countries than in safer home governments; despite the former's wars and recessions, foreign bondholders got a net return premium of 0.44 per cent per annum on all bonds outstanding at any time between 1850 and about 1970.

Third, investing in the broader class of emerging markets can enhance portfolio diversification. The notion of portfolio diversification is at the core of asset management. It pertains to the need to spread your risks and rewards across investments. In essence, you diversify a portfolio to garner the same amount of returns for a reduced amount of risk. A very basic example of the diversification

concept is illustrated by two separate islands, one that produces umbrellas and another that produces sunscreen. If you were to invest only in the island that produces umbrellas, you would make a fortune when it was unseasonably wet, but you would do poorly when it was a very dry year. Conversely, were you to only invest in the island that manufactures sunscreen, you would make a killing in the year when rainfall was extremely low, but would fare poorly if it were a very wet year. However, an investment in both islands could ensure you made money regardless of the climate, thereby reducing the risk to your investment (and, of course, to your expected return).

In a similar vein, portfolio managers look to spread their risk and maximize their returns by choosing across a wide variety of options. Emerging economies (and African investments as well) offer a way for portfolio managers to improve their performance.

Like the sunscreen and umbrella islands, emerging markets and developed markets are so disparate that the opportunity to enhance a portfolio's performance by having some exposure to both markets is considerable; smoothing out the risks and enhancing the returns.

In the past, research has found that emerging-market debt (broadly as a group, as well as for individual countries) has low (and sometimes even negative) correlations with other major asset classes. To put it simply, emerging-market investments tend to fare well when other asset classes (say, developed-market stocks and bonds) fare less well. Indeed, the correlation of key emerging-market spreads (the difference between the risk-free rate and the rate charged to a riskier concern) and US bond returns is typically negative – moving in the same direction when the global economy is universally bad.

Emerging-market debt has the advantage of being counter-cyclical to the developed business cycle, since, in a global recession, poor countries can find it cheaper to repay their debts. As global interest rates decline, which often occurs on the back of a global economic slowdown, the debt service costs for poor countries (denominated in the foreign currency) goes down.

Differences in economic fundamentals between developed and

developing countries also provide support for the diversification argument. Emerging-market debt also benefits from high oil prices. Although oil price shocks may induce a global economic recession (recent oil price heights have so far defied this assumption), the counter-cyclicality of emerging-market debt – the fact that oil-producing countries may fare well when oil prices rise – means emerging-market assets can help protect a more diversified portfolio.

There is an additional factor that can drive demand for the bonds of well-run African countries. Very often, international investors have restrictions on what they can and cannot buy for their portfolios. For example, some pension funds are only allowed to buy securities (stocks or bonds) which are included in approved lists (indices) drawn up by rating agencies or investment banks (for example, the J. P. Morgan Emerging Market Bond Index). Like in football or other sports, these indices are in effect league tables in which countries can go up or down, be included or excluded depending on their overall performance and their liquidity (that is, how easy it is to buy and sell the security). There is, therefore, always constant movement (South Africa, South Korea, Mexico and Brazil each have moved to higher levels of the credit league tables), and, more importantly, there is always room for new entries.

Likewise, sometimes countries leave willingly, and sometimes they are forced out.

As countries mature they may choose to reduce the number of bonds they issue in the international market in favour of domestic bond issues or relying on domestic savings and tax. South Africa is one such example. Over time, as its issuance of international bonds declined, its position in the J. P. Morgan EMBI league table fell, and eventually it was dropped. In another case, when Argentina defaulted on US$132 billion of its debt in 2001, it was also removed from J. P. Morgan's index.

Not every investor uses league tables. For those interested in taking great risks the league tables may not matter. However, for more risk-averse investors league tables matter a lot. The point is, league table or no, there is a huge untapped market available for those African countries that choose to put themselves forward. Clearly the fluidity in these league tables is an obvious opportunity for African countries to raise their game and get on them.

Furthermore, by graduating onto such a bond index, greater name recognition and investor familiarity could improve liquidity and over time reduce a country's cost of borrowing from the international markets; another perk for being responsible and growing up. Today the total amount of hard-currency emerging-market government debt is approximately US$100 billion, and as much as US$3 trillion market trading per day.

But there are challenges. History and experience have taught us that.

As mentioned earlier, in order for borrowers (countries or companies) to access bond investors, they need a credit rating. That is the first hurdle that needs to be jumped; their credit rating determines which investors a borrower gets to see and the cost of borrowing. For the most part, there are three recognized major rating agencies that investors look to: Standard & Poor's, Moody's Investors Service and Fitch Ratings. Their role is to assess a potential borrower's ability (mainly the country's likely future income path based on economic and social factors) and willingness (essentially a political assessment) to repay any debt. On this basis countries are ranked from triple A to triple C – essentially bankrupt.

But rating countries and companies is an art not a science, and rating agencies have been known to get it wrong – sometimes spectacularly, as in the case of Enron, which had received a clean bill of health (rated a solid investment grade Baa3 by Moody's) just five days before the company filed for bankruptcy. In May 2008, the rating agency Moody's was reeling from revelations that the company had allegedly awarded incorrect ratings to securities worth at least US$4 billion because of a bug in its computer models. Although this debacle centred on rating agencies' role in rating complex (derivative) structures, rather than traditional models used to rate sovereigns and large corporates, it is clear that no one is infallible.

If a country is awarded a better credit rating than it deserves, it has little to complain about. But the reverse can happen, and this would be felt in the interest rate that the country would face upon borrowing.

A country's ratings are not only important for its own ability to issue debt, but also dictate the rating for companies within its borders. The notion of a sovereign ceiling means that a company can never obtain a credit rating higher than that of its country. In places where a country has no rating the ability for companies to seek outside investment capital is hampered greatly.

Another challenge is contagion. This is the misguided idea that all emerging countries are tarred with the same brush, and that if one defaults then inevitably all others in the same category, regardless of their unique situations, will follow suit.

The 1997 East Asian crisis is an illustration of this. Although the financial problems were initially confined to the East Asian economies, countries such as Brazil, where the stock market fell by 24 per cent, and South Africa, where it fell by 23 per cent (both in dollar terms) over the same period, also felt the pain. The Mexican tequila crisis of 1994 and the Russian flu of 1998 are other examples of how the international markets' negative reactions to one country spill over and unfairly penalize other countries.

In theory, the risk for an African government is that it could be susceptible to its neighbours' bad news and, without notice, investors could take their money out, leaving a country cash-strapped. With the bond markets effectively shut, a country's carefully scripted economic plans can be suddenly placed in jeopardy, through no fault of its own. During the East Asian crisis the average cost of borrowing for an emerging market rose by as much as 60 per cent.

The good news is that international investors no longer view the markets in such a uniform way. As investors have become savvier, the notion of contagion risk has largely diminished. When Argentina defaulted in 2001, the repercussions elsewhere were insignificant. Borrowing costs money, and some forms more than others. This is a challenge African governments must face up to.

For most poor countries, the obvious financial choice is to go for the cheapest option – that is, aid – but because of the fine print this often proves to be a costly choice. The realities of borrowing are much more nuanced. While it will always be *financially* cheaper for them to borrow from the World Bank and other concessionary lenders, factoring in other costs suggests a more punitive deal.

It all adds up. The status quo of aid-dependency guarantees reputational damage. Ever-present corruption and the negative stigma left in the minds of potential investors (another African begging bowl) are part of the hidden costs when countries access 'cheaper financing'. How much better if a country pays the higher financial rate, and gets quality investment and an improved standing in the world?

The average cost for an African government to draw down on a World Bank loan under its concessional window is around 0.75 per cent. The average cost for an emerging-market country to issue debt in 2007 was 10 per cent, but has been declining.

In just ten years, emerging-market spreads – that is, the premium developing countries have to pay in addition to the borrowing cost of a risk-free borrower (say, the United States government) – shrank from 30 per cent to a record low of 5 per cent in 2006. The narrower spread means a country issuing debt now saves an average of about US$90 million a year in interest for every US$1 billion compared to debt issued in 2002.

Why have the costs of borrowing come down? Two reasons: first, notable improvements in different countries' macroeconomic and political environments. Second, improved liquidity (save perhaps the mid-2008 credit crunch); that is, more cash chasing developing-country assets. The net result is that developing countries' assets become more attractive, and the increase in demand helps lower costs. Some emerging economies have improved so much, and have risen up the credit league tables so dramatically, that they have shed the tag of emerging markets (which bears relatively higher borrowing costs) and joined the ranks of the highest-rated countries. With this, of course, comes access to the cheapest rates of borrowing. Poland and Hungary are two

examples. By 2006, because both countries had made marked improvements on the economic and political fronts, they were able to issue debt of unprecedented size (both topping the €1 billion mark) at very low borrowing cost; Hungary received the cheapest-ever pricing for a central European convergence sovereign.

Globally, developing countries are moving up credit tables. For example, the highest-quality (investment grade) share of the league table has increased from 3 to 42 per cent. And the proportion of countries remaining in the lower ranks has declined from 25 to 6 per cent. Sadly, apart from South Africa, Africa has played no part in this.

Rebounding from a default

Sometimes, factors are beyond a government's control, and these can have far-reaching ramifications for the finances of even the most stable of countries. Environmental disaster (such as the 1975 frost in Brazil which devastated its coffee crop) may force a country to default on its debt obligations.

Spain defaulted on its external debt thirteen times between 1500 and 1900. Since 1824 Venezuela has defaulted nine times. Brazil defaulted on its international debt in 1826, 1898, 1902, 1914, 1931, 1937 and 1983. Argentina defaulted in 1828, 1890, 1982, 1989 and most recently 2001.

There are costs to defaulting, not least of which is that a country drops off the credit rating league table, and its cost of borrowing skyrockets. But, though unfortunate, defaulting is not the end of the world. The debt markets are very forgiving, and investor memory is short.

As long as the borrower is seen to address its troubles, sometimes unforeseen, sometimes of its own making (governments have been known to be time-inconsistent – saying one thing today and doing another tomorrow – the 'read my lips' scenario), it can return to the market. But you can only return to the market once investors are convinced that you are politically and/or economically back on

track (unfortunately, of course, aid will be given to you anyway).

The markets have rewarded reformers. For example, just three years after it defaulted on its internal debt in 1998, the international debt markets welcomed new bond issues from Russia – the City of Moscow issued a €400 million bond in November 2001.

And on the back of the Asia crisis, even though many Asian economies saw their ratings plummet and their costs of borrowing shoot up – to the point where they were effectively locked out of the capital markets until they reformed – they too were rewarded. Before the crisis, South Korea was assigned a high investment grade rating of A+ by the international rating agency Standard & Poor's. At the height of the Asia crises in 1997, it had been downgraded nine notches to a sub-investment grade B+ rating. (It went from A+ to B+ in just two months). However, by addressing investors' specific concerns on the need for the country to restructure its domestic banks, the country was upgraded to investment grade again in a year.

But Africa's defaulters have not done the same, turning away from meaningful reform, and choosing instead the deceptively easier route of aid. The typical recovery period after an emerging-market crisis has been one to two years. However, barring the Ghana and Gabon bond issues of 2007, the last time an African nation tapped the international debt markets was in the mid-1990s (Congo-Brazzaville in 1994 with a US$600 million ten-year bond issue). Of the 35-odd African countries that had issued bonds in the international capital markets around that time, virtually all of them defaulted; and in the subsequent thirty years, none of them have returned.

They have a choice of course, but African countries have not come to the markets largely because they have not wanted to. The good news is that there are signs that this is changing. A report titled 'Financial Institutions' Debt Issuance is Likely to Increase in Sub-Saharan Africa', published on 30 April 2008 on Ratings Direct, Standard & Poor's, commented on the prospects for increasing bond issuance from Africa. The international credit rating agency noted that banks from Ghana, Kenya, and the regional monetary

unions of the West African Economic and Monetary Union and the Economic and Monetary Community of Central Africa would be the most likely candidates in the next two to three years to raise long-term debt.[1]

The overall trend is clearly an encouraging one. Although there is still a way to go in rating governments and corporates across Africa, over the past eighteen months Standard & Poor's has assigned long-term credit ratings to four banks in Nigeria, two of which subsequently issued debt in the international capital markets.

It is these strides that Africa desperately needs to take. The prospect of new financial players from Africa's banking and other private sectors bodes well for greater transparency and financial maturity, which will allow them to gain better access to both domestic and international capital markets. But, most of all, acquiring credit ratings and experience in the capital markets is the passport for Africa's participation in the broader world architecture.

It is incumbent on African governments to play ball. The success of the private venture into the capital markets (be they domestic or international) crucially hinges on African governments understanding the very positive economic implications of their constructive actions and grasping the opportunities the capital markets offer (better reputation, transparency, greater investment capital, longer-term reduction in borrowing costs). It also requires efficient management, and an understanding that if they are not supportive, the negative ramifications are damaging and far-reaching.

For sure, there is an institutional imperative – it is always in the interest of international banks to lend and investors to invest – but seduced by the siren call of aid, African governments sink their ships on the rocks of development demise. The discussion thus far has focused on the international debt markets, but African countries should develop their domestic bond markets as well.

The domestic bond markets are a prerequisite for a country's stock market, and yet another means for the nation's corporate sector to finance its own growth. Besides, issuing debt in the domestic markets is often cheaper than issuing debt in a foreign currency (this might explain the evolving trend in more-developed

emerging countries, who have seen a shift from predominantly international debt to now roughly 70 per cent of debt in local currency). In order to pay interest and the principal on foreign debt a country has to find the foreign currency first. The risk posed by fluctuations in currencies means a borrower may have to find more of its own currency to meet the value of its foreign debt.

There have been a number of developments towards the furtherance of these domestic markets. Take the European Investment Bank (EIB), a European financing institution established in 1958 to finance capital projects which further the European Union's objectives (investing in small and medium-sized enterprises and in environmental-sustainability projects, for example).

On 11 February 2008 the EIB launched its first Zambian bond denominated in the local currency. The bond transaction was for 125 billion Zambian kwacha (US$33 million) of two-year notes. Although this was not the first time the EIB had accessed the local markets in an African country – it had already done so in local currencies in Botswana, Ghana, Mauritius, Namibia and, of course, South Africa (where it has issued local-currency denominated debt for more than ten years) – it was the first time an international entity issued debt in Zambia's local currency.

From the EIB's perspective, issuing debt in Zambia's local currency just makes good business sense. It complements the EIB's activities in Zambia as a lender in the mining industry and to small and medium-sized enterprises. Furthermore, the EIB's currency-lending activities are aligned with their funding, which makes for good currency management.

For Zambia, the EIB's transaction marked the first sale of debt in an African currency to international investors, and as with the other African countries who have executed debt transactions in local currencies, the bond issue was just another way of developing and further solidifying the country's credentials in the capital markets. It certainly helped draw the attention of international investors to the Zambian bond market. Thanks to the EIB transaction, Zambia joined a group of countries that met the criteria for issuance to the European institutional market.

The wider debt capital markets viewed the EIB transaction as an innovative way to tap funding possibilities in relevant local currencies, the clear benefit being that the bond issue was supporting the development of local currency markets as well as taking a step towards potential future lending in local currency.

The G8 took the decision to make local bond market development a core focus of its policy agenda. In response to this, and recognizing the importance of a private-sector role in finance in emerging economies, there has been movement in donor quarters.

In October 2007, the World Bank (partly at the instigation of emerging-country governments) launched its Global Emerging Markets Local Currency Bond (GEMLOC) Program, designed to 'support development of local currency bond markets and increase their investability so that more institutional investment from local and global investors can flow into local currency bond markets in developing countries'. In conjunction with private-sector participants, this is the World Bank's first concerted foray into developing the local debt markets across emerging economies.[2]

The establishment and development of local bond markets has obvious benefits to the poorest economies. Stronger, more liquid local currency bond markets can lower the cost of borrowing and reduce financing and investment mismatches and the risks they create. They support development and enhance a country's resilience to shocks, thereby improving its financial stability.

Yet, thus far, the development of the local debt capital markets in many of the poorest countries has been impeded by the absence of longer-term domestic bonds that are liquid (that is, can be easily bought or sold), and by a relatively weak regulatory and financial infrastructure.

Additionally, the level at which international investors are able/willing to own locally denominated debt has been dismal; foreign institutional investors (such as pension funds and insurance companies) hold only around 10 per cent of their emerging-markets debt investments in local currency; this despite the arguments for holding local-currency denominated debt being so compelling. A portfolio which includes local emerging-market bonds offers

diversification since correlations with other securities (stocks and bonds) are low, and potential returns from an improving credit environment and currency appreciation in emerging economies are attractive.

The GEMLOC Program has three separate but complementary parts. An investment manager would be assigned to promote investment in the local-currency bonds of emerging-market countries, as well as develop investment strategies for local-currency bond markets. Shortly after the GEMLOC announcement, the bond investment organization PIMCO was selected to fulfil the role of investment manager. Next, Markit, a private-sector data and index firm, was chosen to develop a new independent and transparent bond index, for the emerging-markets local-currency debt asset class. A country's inclusion in the new index (known as GEMX) is based on a country's score on investability indicators, such as market size, and a set of criteria developed by the ratings, risk and research firm CRISIL. The index will open the way for a broad range of countries to be considered for investment, as currently less than 2 per cent of local-currency debt is benchmarked against leading market indices, and these include relatively few countries and instruments. The GEMX index offers an opportunity for investment strategies that include a diversified set of local emerging-market bonds with low correlations and potential returns from an improving credit environment and currency appreciation.

Finally, the World Bank will provide advisory services to low- and middle-income countries to promote reforms aimed at developing local bond markets, improving their investability for domestic and international institutions, and enhancing financial stability. Many local markets have severe impediments on investability, such as red tape, taxes, weak infrastructure and inefficient debt management, all of which make investment in local markets unattractive.

The idea of this leg of the GEMLOC initiative is to improve market infrastructure and regulation, and help transform emerging local-currency bond markets into a better-known and mainstream asset class, ultimately supporting the expansion of corporate bond

markets, infrastructure, and mortgage- and asset-backed financing. The hope is for involvement of the World Bank Group to cease after ten years; almost unwittingly recognizing there are other, better, private ways for emerging economies to finance their development.

Based on the current investability criteria, only two African countries are likely to be included in the bond index – Nigeria and South Africa. Because the GEMX index will focus on countries that have local sovereign bond markets of at least US$3 billion, and sovereign bond issues of at least US$100 million (as well as at least a 50 per cent minimum score on a rank of investibility), initially it is likely that the index will only include fixed-rate government sovereign bonds from twenty countries: Brazil, Chile, China, Colombia, Egypt, Hungary, India, Indonesia, Malaysia, Mexico, Morocco, Nigeria, Peru, Philippines, Poland, Russia, Slovakia, South Africa, Thailand and Turkey.

Over time, additional countries, and additional bond types (for example, company bonds), will be considered for inclusion in order to further improve liquidity. Although the stringent criteria bar many African countries from participation today, there is no reason why other African bonds should not be included over time, as their local debt markets develop. That noted, however, the high bond issuance thresholds laid out in the criteria point again to the fact that smaller African countries ought to consider more unified and integrated regional approaches to the capital markets, rather than necessarily going it alone.

Can Dongo tap the markets?

The capital markets are open, and open for Africa. Any assertions that these countries cannot tap the international capital markets are simply wrong. Developed countries tap the market, developing nations tap the market, even the World Bank taps the market (in a rather circular reasoning, to raise funds which they then lend on to African countries). Africa should tap the markets too. By and

large, the countries that have not thus far issued bonds have not done so because they do not wish to, not because they can't.

The amount of emerging-market bond issuance jumped 52 per cent from US$152 billion in 2004 to US$230 billion in 2007. Currently, the total amount of bonds from government and companies in these countries stands at approximately US$1.5 trillion, of which a relatively minuscule US$10 million is from Africa. In the past ten years forty-three developing countries have issued international bonds – only three were African: South Africa, Ghana and Gabon.

However, there are early indications that more are on the way. Since 2003, fifteen African countries have obtained credit ratings (Benin, Botswana, Burkina Faso, Cameroon, Gabon, Ghana, Kenya, Lesotho, Mali, Mauritius, Mozambique, Namibia, Nigeria, Senegal and Uganda), all of which have ratings high enough to tap the bond market. In July 2006, for instance, Zambia, Africa's largest copper producer, announced it would seek its first credit ratings to enable it to sell bonds in international markets. The Governor of the country's Central Bank argued that a rating would help cut Zambia's funding costs.

The first-order problem is whether you can tap the markets, and the second is for how much. Every year governments set up their budgets in order to determine the amount of money they will need to finance their development objectives. With this figure in mind, and assuming they appreciate the many benefits bond issuance can bring, they must embark on a roadshow. From this beauty parade – their roadshows are of course competing with other countries' roadshows for a finite (albeit large) pool of cash – they can easily gauge how much investor appetite there is.

As Ghana and Gabon have both demonstrated, it is perfectly possible to raise large sums. More generally, judging by the amounts realized by countries with similar ratings, the precedence has been good. For example, Turkey, rated single BB– (similar to Gabon), and Brazil, rated BBB– (as is Namibia), have raised upwards of US$1 billion in a single bond issuance. In 2006, the average bond issue by an emerging market was US$ 1.5 billion.

As with everything, more experience yields greater rewards. As governments become more experienced and investors get to know a country better, countries can come to the markets more often (many emerging economies tap the markets every year) and in transactions of greater size.

Some African countries might initially be viewed as too small, or too risky, to lend to. For these (Togo, Benin and Mali, for instance), and others perceived as too hazardous for individual investments, there are three risk mitigants to consider.

One is the pooling of risk. Rather than individual countries reaching for the bond markets independently, African countries could form groups or regional coalitions, issue debt as a single entity, and divide the proceeds (and debt service obligations) accordingly. Every country would get the upside benefit of cash from the bond issue but bear the downside risk of one or many of the countries in the pool defaulting (in which case the non-defaulting countries have to repay the borrowings on behalf of the offending country or countries).

A collective bond would undoubtedly require a unified rating (which would probably be some average of all the countries participating), but, as with the umbrella and sunscreen island example before, there are notable diversification benefits to be gained. For instance, for some countries the pooled cost of borrowing would most likely be lower than that for an individual country alone – a weighted probability of default would be lower than for an individual country's bond issue. And much like the European Union (or any union of countries, for that matter) 'higher-quality' countries would be given the incentive to participate in such a structure to garner positive externalities from the neighbours' growth as well.

Pooling risk invariably introduces a free-rider problem; that is, the risk that one or more countries take relatively more cash out of the pot than they deserve (or add more risk to the pot than is desirable – although in this case the group of countries could simply choose to exclude the country, thereby forcing it to the markets on its own, to earn its stripes). A way around this problem

would be to divide the spoils on a GDP-weighted basis – the bigger the country, the greater the share of the bond pie it receives; or on a needs basis (based on countries' per capita income) – the greater a country's needs, the more of the bond proceeds it would receive.

There is another risk mitigant, which is to offer some type of insurance or payment protection in the event that a country defaults. Like any other credit guarantee, the guarantor (usually of higher credit standing than the country issuing the bond) would promise to cover some part or the full value of the bond if a country reneged on the repayment of its debt obligation.

A recent example of this is South Africa's Pan-African Infrastructure Development Fund (PAIDF). Launched in 2007, the PAIDF invests in infrastructure projects (transport, energy, water and sanitation, and telecommunications) across Africa, while the South African government guarantees the fund's multi-billion-dollar investments.[3] With its respectable triple B credit rating, South Africa is effectively underwriting the risk of the whole continent, and is able to provide comfort to investors, who might otherwise see the fund's investment pool as too risky. As of October 2007, the PAIDF had raised approximately US$625 million from Africa itself (suggesting, as discussed later, that a lot of untapped cash exists on the continent).

Another innovative example in risk mitigation is that of the Republic of Argentina, which issued a US$1.5 billion bond consisting of six bonds, guaranteed in part by the World Bank. Each bond was for US$250 million maturing at different times (one year, eighteen months, two, three, four and five years).

The guarantee structure worked quite simply: the first bond was fully guaranteed by the World Bank. Once Argentina repaid this bond, the guarantee rolled forward to the second bond. Thereafter, it rolled to each successive bond, and so on.

The idea of the guarantee was that if Argentina failed to repay any bond at maturity, the World Bank would immediately step in and repay it. If Argentina then repaid the World Bank within sixty days of the bond's maturity, the guarantee of the World Bank

would roll to the next bond. However, if Argentina failed to repay the World Bank within sixty days (which unfortunately it eventually did), the guarantee would be lost on all the remaining bonds. Because of the World Bank's guarantee, each of Argentina's bonds in the series achieved a highly coveted investment grade rating based on the AAA-rated guarantee of the World Bank. Despite Argentina's default on this structure, this is exactly the type of innovative financing structure that can help bring Africa into the global fold.

Finally, securitizing a bond issue can also mitigate risk and reduce the cost of borrowing. The process of securitization involves ring-fencing, or setting aside, specific cashflows to pay off a debt obligation. Take an oil-producing nation as an example of how this works. The country issues debt with the understanding that all payments (interest and principal) due on the bond will be repaid by specified income earned from oil exports. Of course, there is the risk that something happens to the income stream (again, think of the Brazilian frost and the income lost on the coffee crop), but in general investors are reassured if they can see exactly how they will be repaid their investment money.

In 'Ending Africa's Poverty Trap', the economist Jeffrey Sachs et al. estimated the money needed to meet the Millennium Development Goals (MDG) (excluding government and household contributions) for Ghana, Tanzania and Uganda. They argued that this is the amount that donors would have to provide in order to finance the MDG intervention package.

For Ghana, he estimated the total investment needs for meeting the MDG would average US$2 billion a year (or US$82.8 per year, per person). Of this total, Sachs proposed that US$1.2 billion would need to be funded by annual external assistance. Yet, although Ghana's 2007 foray in the bond markets was only for US$750 million, it was heavily oversubscribed to the tune of US$5 billion of unmet investor demand. On the basis of Sachs's estimate, this would have been enough to cover at least the foreseeable next five years' MDG requirements.

The Ghanaians did the right thing. There was clearly no need

to go down the aid path yet again, and there was a lot of upside to issuing the bond. Although small this time round relative to the investor demand, their approach was prudent – and for this they will be rewarded. In particular, their initial success can be the launch-pad for them to win favour from investors and return to the market regularly in future years.

Tanzania and Uganda's MDG financial needs are far less modest (US$2.5 billion and US$1.6 billion per year, respectively) but no less unachievable. Although they are both in a position to issue bonds (Uganda has a B credit rating from the Fitch rating agency) towards meeting their MDG needs, they have yet to take the plunge.

Depressingly, and maintaining the status quo, the Sachs estimates all require a doubling of aid for each country.