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THE 2018 MEFMI REGION GOVERNORS' FORUM

THEME: Trends in Sovereign Reserves Management

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ACRONYMS

BIS	Bank for International Settlements
ECB	European Central Bank
GDP	Gross Domestic Product
GFC	Global Financial Crisis
IMF	International Monetary Fund
MEFMI	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
SSA	Sub Saharan Africa
SDR	Special Drawing Rights
USD	United States Dollars
VAR	Value-at-Risk

FOREWORD

In response to the 2007 global financial crisis, major central banks around the world took unprecedented coordinated action with respect to monetary policy. The Federal Reserve implemented a near zero interest-rate policy while the Euro zone implemented negative nominal interest rates in a bid to stimulate aggregate demand and spur their economies. The Fed Funds rate was cut from a level of 5.25% in 2007 and subsequently held below 0.5% from January 2009, only going above 1% in 2017. Similarly the European Central Bank rate on the deposit facility came down from a level of 3.25% in October 2008 to 0% on July 2012 and went to -0.1% in June 2014. With effect from March 2016, the rate has been at -0.4%. The resultant easy monetary stance and liquidity abundance lowered returns on financial assets held in advanced economies especially at the short-end of the market and fuelled stronger investor risk appetite in the Emerging Markets and Developing Economies (EMDEs). Many economies in Sub Saharan Africa experienced surges in capital flows into their securities markets and also supported issuance of Eurobonds during this period, taking on hard currency denominated liabilities.

However, with the start of the normalisation of monetary policies in the advanced economies, deleveraging from the EMDE's is anticipated. The Fed Funds rate has increased to currently 2% and could be hiked further during 2018. The inadvertent consequences may include capital flow reversals and increased exchange rate volatility challenges which could adversely affect those EMDE's that did not build adequate sovereign reserve buffers. The issue for the countries in the MEFMI region facing similar challenges is the appropriate policy interventions needed in the face of these emerging vulnerabilities.

Cognisant of these risks at hand for the region, MEFMI selected the theme "Trends in Sovereign Reserves Management" for the 2018 Executive Fora events. Under this theme, the 2018 MEFMI Central Bank Governors Forum discussed the emerging risks for the region as the environment for the 'search for yield' deteriorates and the related implications for sovereign liabilities with focus on the SSA Eurobond debt.

MEFMI is grateful to Investec Asset Management for their continued support towards the Governors Forum events, both as a technical and financial partner. We look forward to a sustained collaboration as we further discussions on reserves management in the region in an environment of increasing external vulnerabilities. Our appreciation also goes to the Bank for International Settlements (BIS) who once again provided conference facilities for the event on gratis.

It is my hope that the outcomes of the deliberations from this Forum will culminate into policy actions that will avert the threat of a debt crisis that is lingering on our shoulders while at the same time provide sustainable solutions to the huge infrastructure and development financing needs in the region.

Caleb M. Fundanga
MEFMI Executive Director

EXECUTIVE SUMMARY

Policy responses in the aftermath of the global financial crisis were focused on financial institutions, markets and the flow of credit to households and businesses. This was to counter the tightening of financial conditions that occurred as lenders became more risk averse and took steps to conserve capital and liquidity. Most advanced economies kept interest rates at historical lows and implemented quantitative easing programmes which involved large scale purchase of assets that led to the expansion of their central banks' balance sheets. Yet this extremely accommodative monetary policy and abundance of liquidity has not come without some repercussions.

One of the consequences of a generally low interest rate environment has been portfolio diversification by investors in search of higher yields. This has triggered global asset portfolio reallocations towards riskier assets with higher yields. This 'search for yield' has benefitted high yield bond markets especially the emerging markets, and supported frontier markets including SSA countries who were in search of liquidity at relatively lower cost of funding.

Within this context, the issuance of Eurobonds seemed a great opportunity for SSA countries to finance their infrastructure and social development. The countries, previously reliant on bilateral loans and grants, seized on this alternative source of funding following the drying up of donor aid in the aftermath of the global downturn. Starting in 2006 – when the first SSA Eurobond was issued, more than a dozen SSA governments have issued Eurobonds, raising about US$29 billion in 35 issuances between September 2006 and June 2017. Most of these issuances were oversubscribed reflecting high investor interest, mainly driven by the far higher yields on these bonds as opposed to the record low interest rate levels in the advanced markets as a whole. In addition, SSA was basking in periods of record economic growth averaging 5 percent and macroeconomic stability, having shown considerable resilience to financial shocks during the global financial crisis, which also contributed to attracting investors.

However, it is now evident that the business cycle is coming to an end, following the unwinding of the extremely accommodative monetary policy support both from the interest rate perspective and the liquidity perspective as G4 central banks commence quantitative tightening policies. Although fundamentals are still supporting the flow of money into economies or the search for yield, the normalisation of monetary policy presents deleveraging risks for the region. From a valuation perspective, markets are currently at low term premiums where investors are not being compensated for the risk. Moreover, investors took on much larger sized portfolios than they would ordinarily have done because the volatility has been depressed as a result of the quantitative easing. If volatility were to rise suddenly in a previously stable asset class, investors may be forced to rebalance and sell assets which could have a pro-cyclical effect on asset prices and exaggerate volatility.

Discussions on the above highlighted issues took centre stage at the 2018 MEFMI Central Bank Governors Forum. The following is a summary of the outcome of the discussions as presented in this report:

- The reduction of portfolio flows expected to result from monetary policy normalisation in the USA could put countries with weak fundamentals at risk and could cause devastating impact on the beneficiaries of the 'search for yield' flow. Countries with high foreign debt ownership and high external financing needs will be particularly vulnerable to any change in investor sentiment. In addition, those countries that have not used the favourable environment to address risks associated with deleveraging will also be particularly vulnerable to outflows.
- Although the past enthusiasm for SSA Eurobond issuances could be viewed as a vote of confidence for Africa's sustainable growth story, it is most likely transitory because the kind of investors who bought these bonds were just searching for higher yields. The investor appetite for SSA bonds was fuelled by record-low interest rates in advanced economies and commodity price recovery in the aftermath of the global financial crisis, trends that have now reversed.
- Notwithstanding the potential benefits of providing funding for the large infrastructural needs, Eurobond issuances could prove to be a real risk to balance sheets of SSA sovereigns given the pressures that could emerge associated increasing exchange and interest rates costs. The plunge in commodity prices in 2015 left most of these countries with weaker balance of payments, budgetary stress, exchange rate pressures and inadequate foreign exchange reserves to meet their external financial obligations. As some countries struggle to meet their debt service payments, there are warning signs of possible default on the bullet and other maturing debt payments starting in 2022. It is highly likely that any roll over of this debt will be costly.
- Nevertheless SSA's developmental and infrastructure funding needs are still at large and too much for the Eurodollar Market. In this regard, focus on the development of local bond markets as the structural long term solution to mitigate the risks from foreign currency denominated borrowing needs urgent consideration. The ability of most countries in the region to raise long-term financing in the domestic markets has proved challenging, constrained by the low levels of domestic savings, lack of robust institutional frameworks, and the lack of prudent fiscal policy to boost investor confidence in these markets. This makes the case for urgent reforms to develop the long-term financing in light of these observed challenges.

1. OPENING SESSION

1.1 Welcome remarks by **Dr. Caleb Fundanga**, Executive Director, MEFMI

Dr. Caleb M. Fundanga, the MEFMI Executive Director welcomed delegates to the 2018 Governors' Forum. He thanked all the Governors and other guests for accepting MEFMI's invitation to participate in the Forum. He pointed out that the Governors' Forum, which was being held for the fifth year running since 2014, was a unique event that provided a platform for high-level policy makers to discuss issues pertinent to the economic development of the region.

He made special mention of Investec Asset Management, the financial and technical partner of the event. He expressed great appreciation to Investec for their financial contribution towards the event over the years. He stated that this collaborative arrangement had enriched the Governors' Forum in many ways without financially burdening the Institute. He expressed the Institute interest in continued collaboration with Investec. He also welcomed the two (2) presenters for the event: Mr. Johan du Plessis and Mr. Antoon De Klerk.

Similarly he acknowledged the support from the BIS for hosting the Forum on gratis. He specifically appreciated the logistical support provided by Ms. Wenke Soeteber and her team to ensure a seamless event.

Dr. Fundanga informed delegates that MEFMI had taken a deliberate stance to have a common theme for the 2018 Executive Fora activities, that included the Deputy Principal / Permanent Secretaries and Deputy Governors Forum; the Governors Forum and the Combined Forum. He explained that the choice for the theme **"Trends In Sovereign Reserve Management"** was driven by the lingering concerns of the weakening external positions that are faced by the region as a result of the aftermath of the global economy slowdown. He pointed out that most MEFMI countries' official reserves stood barely at or below the traditional three (3) months of import cover benchmark.

Furthermore, he stated that foreign currency denominated public debt was on the increase with rising interest payments. Most of the MEFMI countries were moving to more commercial sources of borrowing to meet their increasing appetite for infrastructure projects. He indicated that debt sustainability had deteriorated in the region, and already the risk ratings for some MEFMI countries had worsened.

He pointed out that the theme would be supported by two presentations – "Sovereign Reserves: is the search for yield over?" and second; "Yield Trends and Implications for Sovereign Liabilities". He hoped that these presentations would stimulate discussion and provide an opportunity for delegates to reflect on the implications for reserve management in the region and what policy options to take.

Dr. Fundanga concluded his remarks by informing delegates that this Forum would be the last event he would officiate as MEFMI Executive Director, as he would be leaving the Institute. He expressed gratitude for all the support he had received from the Governors during his term of office and hoped he would continue to meet and work with them in future.

1.2 Opening Remarks by **Mr. James Hatuikulipi**, Managing Director Africa-ex-SA, Investec Asset Management

Mr. James Hatuikulipi expressed gratitude to MEFMI for choosing Investec Asset Management to be financial and technical partner for the MEFMI Governors' Forum, which he considered a platform of key strategic significance. He stated that Investec collaborates with MEFMI beyond the Governor's Forum, buttressing the strategic initiatives of MEFMI, particularly capacity building programs in reserves management. He stressed that this year's theme for the Forum was very important, as reserve management supports the twin purposes of financial stability and economic growth.

He pointed out the mounting concerns of rising African debt levels in Sub Saharan Africa, including in the MEFMI region. He highlighted three (3) phases that have characterised government debt across the continent in the past two (2) decades. He mentioned that the first phase spanning from 1996 to 2005 included large scale debt forgiveness through the Heavily Indebted Poor Country initiative HIPC), and the Multilateral Debt Relief Initiative (MDRI), which was an attempt to accelerate progress towards the Millennium Development Goals (MDGs). He outlined the second phase that covered 2006 to 2014. This period saw Africa rising, following a sustained period of consolidation with median debt to GDP hitting a low of 38 percent. This was on the back of exponential rises in commodity prices which helped stimulate growth and investment. The easing global monetary policy and increased search for yield prompted the African governments to borrow from the international markets. He underscored that the post 2014 phase had witnessed deterioration in fiscal and current account balances, and increased risks surrounding the quality and sustainability of borrowing compounded by the shocks in commodity prices. He stressed that as a result, there had been significant re-leveraging across the continent and within the MEFMI Region.

Mr. Hatuikulipi mentioned that there was expectation that the continent would register improved balance sheets again due to the improvement and stabilisation in commodity prices and synchronised global growth. However despite these positive expectations, he warned that central banks would have to consider whether they held sufficient foreign exchange reserves to weather the storm and determine the impact of the treasury's financing needs in an environment of reduced global liquidity and the withdrawal of portfolio flows.

He concluded his remarks by expressing that the deliberations of the forum would shed more light to inform and equip the MEFMI region policy makers and monetary policy authorities with tools, during these periods of withdrawal of liquidity and associated strength in the United States Dollar relative to emerging market currencies.

2 FORUM PRESENTATIONS AND DISCUSSIONS

2.1 Session 1: Sovereign Reserves: Is the Search for Yield Over?

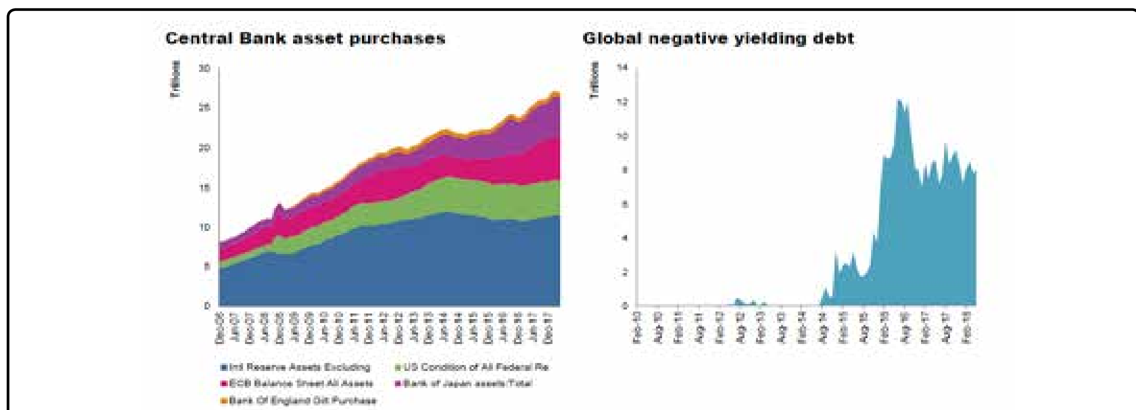
Presenter: ***Mr. Johan du Plessis, Portfolio Manager, Investec Asset Management***
Moderator: ***Dr. Adelaide R. Matlanyane, Governor, Central Bank of Lesotho***

This session aimed to discuss the trends in the search for yield on sovereign reserves. It brought to perspective the cost of holding foreign exchange reserves amid fading returns on these assets that have been witnessed over the past years in the aftermath of the global financial crisis.

Introduction

The 2007 global financial crisis resulted in central banks around the world taking unprecedented action to combat weak aggregate demand in both consumption and investment policy. Responses focused on financial institutions, markets, as well as the flow of credit to households and businesses. This was to counter the tightening of financial conditions that occurred as lenders became more risk averse and took steps to conserve capital and liquidity. To that end, central banks in most advanced economies like the Federal Reserve implemented a zero interest-rate policy while others like the Euro area implemented negative nominal interest rates in a bid to stimulate aggregate demand and spur their economies. To stimulate their economies further; USA, United Kingdom (UK), Japan, and the Euro area subsequently implemented quantitative easing programmes which involved purchasing of large scale assets that included mainly government bonds and mortgage backed securities. This led to an increase in the size of their central banks' balance sheets from 15 percent in 2008 to close to 40 percent of GDP as at the end of 2017. The repercussions for this easy monetary stance and liquidity abundance has been the growth of central bank assets to USD25 trillion as at the end of 2017, with a consequential shoot up of negative yielding assets that have peaked at USD12 trillion.

Figure 1: Central Bank Post Crisis Asset Purchases and Resulting Global Negative Yielding Debt (USD trillions)



Source: Investec Asset Management, 2018

As such, the post global financial crisis (GFC) central bank policy response has reduced the potential returns on most short end developed market government bonds, leaving investors to choose from the following options;

- One option is for the investors to accept to receive the low yields that have been associated with the increasing cost of insurance of holding reserves.
- The alternative option is for investors to search for better yields through three possible ways;
  - First, is to take more interest rate risk by investing in long term bonds of 10 to 30 years which will earn higher yields compared to the shorter term securities.
  - Secondly, the investors could choose to take on more credit risk by investing in emerging markets rather than owning US treasury securities.
  - The third avenue could be to invest in less liquid assets like property or infrastructure bonds.

Post the GFC, due to the extended period of low interest rates, most investors have decided to take more risk and search for more yield. This session discusses the compelling forces framework that can be used to assess whether the search for yield is over.

Fig 2: Compelling Forces framework for assessing search for yield

Source : Investec Asset Management, 2018

In assessing the investment opportunities to determine whether the search for yield is over, a framework of three (3) compelling factors should be considered. These include: first - **economic fundamentals** which guide whether the cyclical environment is supportive for investment. Second – **valuation** which investigates the deviations in prices caused by market inefficiencies. Third is the **market price behaviour** which studies changing expectations of investors and reactions of prices to events. These factors are described in detail below.

a) Fundamental Backdrop

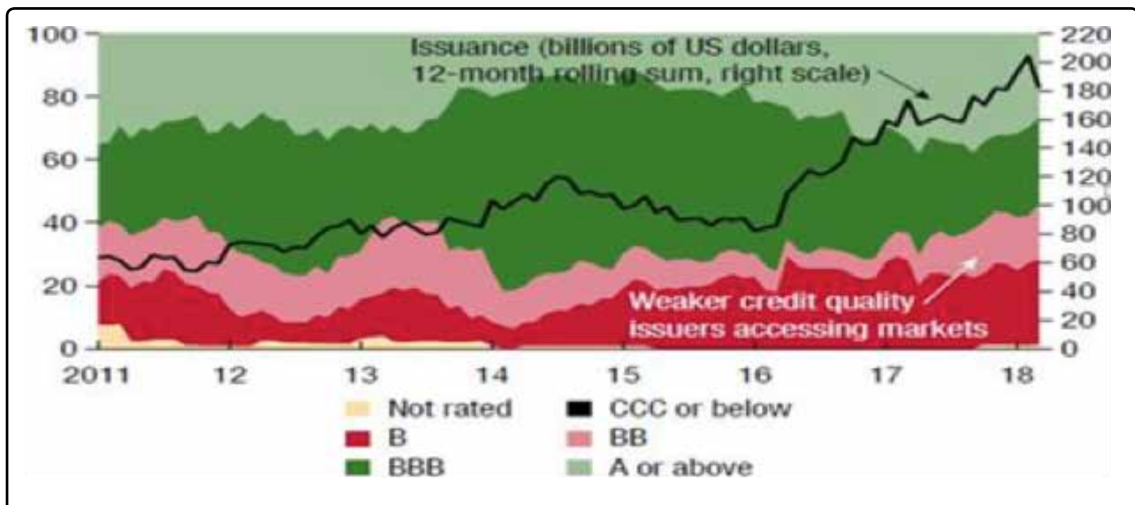
Over the past nine (9) years, extraordinarily accommodative monetary policy has served as the primary catalyst for spurring continued economic growth in the USA and around the globe. Since June 2009, the American business cycle has been in the expansion phase leading to 110 months without a recession and making it the second longest business cycle in history. In this regard, there are high expectations of an impending recession. Even though the macroeconomic backdrop is deteriorating, according to the Fed, there is only a 15 percent probability of a recession in the next 12 months in the USA. In this regard, the actual indicators of the downturn happening any time soon is still fairly low and this points to the likelihood that investors will keep searching

for yield. However, what should not be forgotten is that historically credit spreads have been correlated with the business cycle. Credit spreads have started to widen recently suggesting that markets expect deteriorating economic conditions, however the signs are still flashing amber and not yet red.

The presenter stated that the other thing to note is the shifting monetary policy where G4 central banks are now commencing quantitative tightening to unwind their unconventional accommodative monetary policies adopted after the global financial crisis. They have announced their intentions to let the securities mature without rolling them over. Particularly, the Fed plans to unwind securities to a tune of USD480 billion in 2018, and USD600 billion over 2019. This means that the Fed will need to find buyers for these securities, however the amount of liquidity available to purchase these assets is decreasing. The European Central Bank (ECB) has also announced that they would be ending their quantitative easing programme at the end of 2018. And similarly the Bank of Japan is also reducing their purchases.

The supply of debt is the other side of the coin. Over the past decade, increased demand for debt has been met with additional supply of debt as private and public leverage picked up. This has resulted in global debt to GDP increasing by 12 percent since 2009. However, it is important to note that it is not just the volume of debt but the quality. Hard currency corporate and sovereign debt issuance reached new highs in 2017 and the share of non-investment-grade issuance has risen to more than 40 percent **(Figure 3).** This has transpired in the face of weaker issuer fundamentals (higher debt burdens and lower affordability). As central banks withdraw accommodation by raising short-term interest rates and shrinking their balance sheets, investors could demand higher compensation for holding long term bonds instead of a series of shorter-term bonds. With decreasing demand, there are risks of a debt demand -supply imbalance.

Figure 3: Sovereign Issuance of International Bonds (USD billions)



Source: Investec Asset Management, 2018

b) Valuation

The discussion above pointed out that the policy actions of central banks post the global financial crisis have encouraged the search for yield. This is not a new occurrence as it has happened in several previous cycles. The quantitative easing programmes depressed term premiums to extreme levels and the abundance of liquidity had depressed credit spreads. In this regard, it is paramount to scrutinise if investors are really being compensated for risk. The addiction to the central bank easing witnessed over the past years could have caused a numbness to the underlying risks. However, quantitative tightening might have the opposite effect. The reduction in liquidity caused by the unwinding of the central bank balance sheets could in turn create a more cautious and sceptical investor base scrutinising whether they are really being compensated for holding a long term bond.

c) Market price behaviour

The search for yield has led to an increase of non-resident portfolio flows to emerging markets economies to around USD240 billion as at the end of 2017. However, from a financial stability perspective, these flows could be detrimental to these economies in the event of external shocks that might abruptly reduce the flow of funds. Countries with high foreign debt ownership and high external financing needs will be particularly vulnerable to any change in investor sentiments. Similarly, countries that have not addressed vulnerabilities such as low reserve adequacy during the favourable period will also be at risk in the event of a reversal in capital flows from rapid tightening of global financial conditions. Moreover, the number of countries whose foreign exchange reserves account for less than 50 percent share of external financing needs is on the rise, thus pointing to rising external vulnerabilities in these economies as illustrated in **Figures 4 and 5** below

Fig4: Foreign Currency Denominated Public Debt held by Non-Residents (Share of Total)

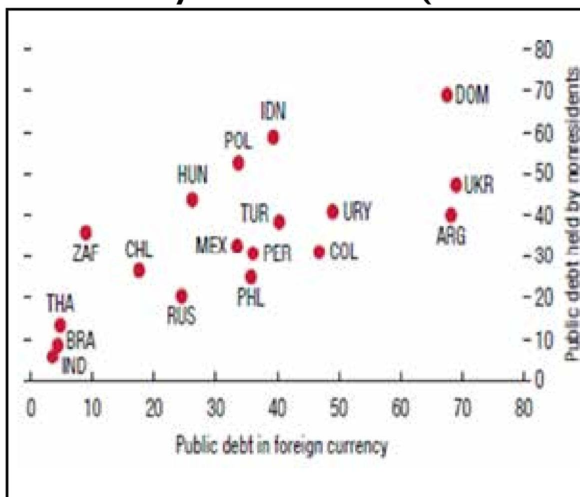
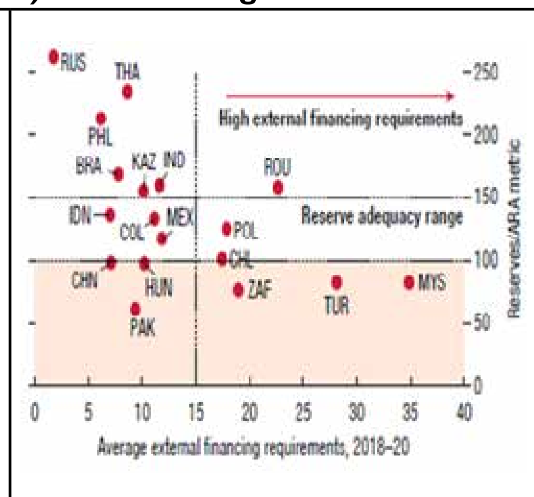


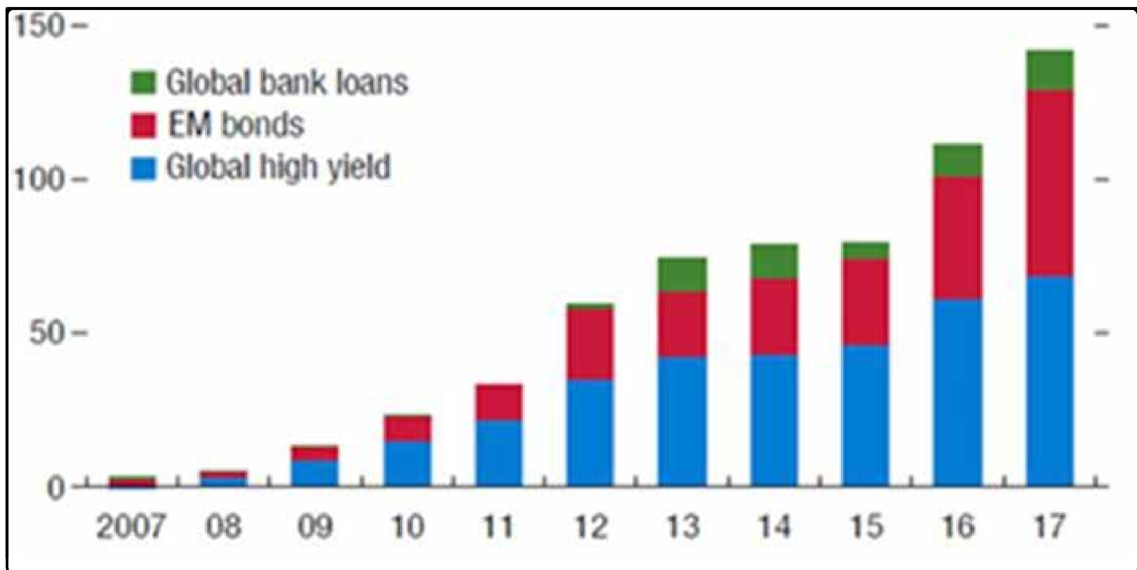
Fig5: Reserve Adequacy and External Financing Needs



Source: IMF Global Financial Stability Report, April 2018

According to the IMF, the investor risk index, which measures the risk associated with changes in the behaviour of an emerging country's investor base, is on an upward trend. The risk of investors fleeing out of the emerging markets is therefore increasing. Previous research has highlighted that mutual fund and exchange traded fund investors are the most sensitive to financial conditions. As at the end of 2017, exchange traded fund investment in illiquid markets had risen to USD140 billion **(Figure 6)**. In some emerging countries, ownership of bonds by investment funds had significantly increased to more than 35 percent.

Figure 6: Assets under management of exchange traded funds invested in illiquid markets (USD billions)



Source: IMF Global Financial Stability Report, April 2018

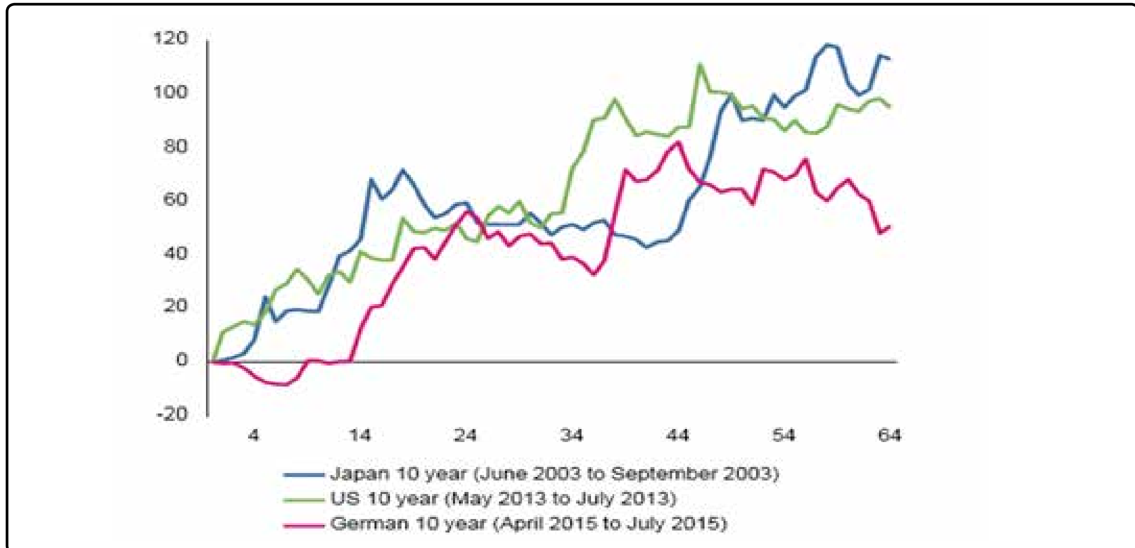
The Volatility Paradox

Another area to be concerned about under the market price behaviour factor is the hidden risks associated with the prolonged period of low market volatility that has been relished as a result of the abundance of liquidity post the financial crisis. Low volatility may lead investors to behave in ways that make the financial system more fragile and prone to crisis; which is what is known as the volatility paradox. Particularly, the use of risk-management models may give faulty signals in low-volatility markets. Low realised volatility can affect the behaviour of banks, hedge funds, and other asset managers that use a risk management framework based on realised volatility, including some Value-At-Risk (VAR) models. These models follow a backward looking approach that captures how much value investments might lose over a set time.

Although VAR models can be a valuable risk management tool, overreliance on them during periods of low volatility can result in pro-cyclical behaviour that makes investors more vulnerable to volatility shocks if market conditions change abruptly. A decline in realised volatility can reduce a portfolio's value at risk, allowing investors to take on large positions. However, when volatility rises, investors may be forced to simultaneously sell assets to avoid their portfolios from breeching

risk limits. VAR shocks contributed to selloffs in the Japanese government bond market in 2003, in the U.S. Treasury market during the 2013 taper tantrum and the selloffs in the German bunds in 2015(**Figure 7**).

Figure 7: Cumulative 10 year government bond yield change



Note: The horizontal axis shows the number of days since the beginning of the sell-off period.
Source: Investec Asset Management, 2018

Therefore as volatility increases with the unwinding of liquidity from the quantitative tightening, investors will be forced to sell the assets to reduce risk which will make the search for yield at the final turning point going forward.

Conclusion

It is evident that the business cycle is coming to an end, however a recession is not imminent as indicators are still fairly low at about 15 percent over the next 12 months. Fundamentals are still supporting the flow of money into economies or the search for yield. Nevertheless, the extremely accommodative monetary policy support is unwinding both from the interest rate perspective and the liquidity perspective. Hence the effect of the fundamentals on the search for yield can be assumed to be neutral for now.

From the valuation perspective, markets are currently at low term premiums where investors are not being compensated for the risk. The reduction in liquidity caused by the unwinding of the central bank balance sheets will create a more cautious and sceptical investor base scrutinising whether they are really being compensated for the risk.

Turning to the market price behaviour perspective, this can be looked at in two-fold. First, the search for yield has led to large flows that have been into more high yielding assets, but the kind that would want to exit the market very quickly. A lot of this debt issuance has been in foreign

currencies and owned by foreign investors who are sensitive to price changes, which in turn exposes economies more to the unwinding of these flows. Secondly, the market price behaviour can be looked at from the side of the VAR shocks. Investors have invested in securities of much larger size than ordinarily would have because the volatility has been depressed as a result of the quantitative easing. If volatility were to rise suddenly in a previously stable asset class, investors may be forced to rebalance and sell assets which could have a pro-cyclical effect on asset prices and exaggerate volatility.

In summary, looking at all the three factors together under the compelling forces framework, the conclusion is that the search for yield is not over. There are still some supporting factors, however there are some flashing risks indicating a deteriorating environment in search for yield. The most concerning point however is the financial stability perspective, where economies that have been receiving these flows could witness detrimental effects when the search for yield unwinds.

Discussion

The presentation was commended for being very enlightening and relevant in light of the key role that central banks play in managing foreign exchange reserves for their countries. It emphasised the likely adverse implications for financial stability and therefore monetary stability when the search for yield comes to an end. In this regard, delegates sought to know if holding gold would present an opportunity for SSA and particularly the MEFMI region as an alternative to the risks highlighted by the presentation. In response, the presenter advised that it was not recommended for countries to hold gold in foreign reserves if their economies were heavily dependent on the export of commodities.

Clarification was further sought on what MEFMI response should be to the developments in the emerging markets especially in Argentina and Turkey. It was noted that although several emerging market firms had piled up worrisome quantities of USD denominated external debt, the risks for countries that have seen large outflows were not equal. The presenter reiterated that the search for yield in emerging markets was not yet over, however there was much more discretion. He stressed that markets had started to realise that countries within the emerging markets are different and hence a great dispersion in yields. He indicated that there was still an opportunity for MEFMI countries to invest in emerging markets but advised the need to practice discretion on which economy to invest in.

A question was asked to establish if there were models that could give some degree of predictability on what the business cycle would look like in the long term. In response, it was noted that long term prediction would be extremely difficult because models are based on historical factors and yet consumer patterns and demographic trends are rapidly changing hence assumptions can only be made for a short term period. Most models predict for the short term and still there is always a degree of variance in the out-turn.

Concerns were raised on how MEFMI countries can protect themselves from the volatility in portfolio flows. The main policy advice that was given to address these concerns was the need to

slow down in fiscal spending, because the environment is changing from the favourable periods of low interest rates and abundance of liquidity. In addition, it was advised for countries that still have closed capital accounts not to open them if they were running current account deficits. Countries were encouraged to open their capital accounts incrementally to avoid possible macroeconomic shocks from rapid exchange rate movements.

It was emphasised that the lack of developed domestic capital markets in the region remained a major impediment for diversification of portfolio investment risk. It was especially noted that pension funds in the region were growing and yet they were investing externally due to the lack of developed domestic capital markets. It was agreed that there is need for countries to tap into these domestic resources to support investment as an alternative to the volatile foreign portfolio flows.

As China remains an area of interest, delegates sought the presenter's opinion regarding the extent to which MEFMI countries should go in adopting the renminbi. They also asked whether they should consider signing bilateral currency swap agreements with China like some countries have done. The presenter stressed that the renminbi was growing in importance in global transaction volumes. Its inclusion in the Special Drawing Rights (SDR) basket of currencies was reflection of its global acceptance. He noted though, that the unpredictability of policy in China remained a problem, but recognised that China was making strides to integrate into the global financial markets. He pointed out that the ease of accessing China's bond market was improving and had become more streamlined. He also said that as a way forward, MEFMI countries could definitely consider doing some investment in Chinese bonds. However, he warned that there would be need for countries to engage specialists that know how to invest in this market. He encouraged countries to provide capacity building that would assist in understanding China's bond market for their reserve management teams as a way of knowledge transfer. In response some delegates stated that they would consider holding the renminbi in their reserve tranche to facilitate trade. However they would exercise caution in investing in the Chinese bonds.

A question was also asked about possible implications of the ongoing trade war between China and USA on portfolio investment. The presenter stated that it was unlikely that China would offload all its portfolio investment in USA in retaliation to the trade tariffs imposed by the USA. This is because China would not find a market big enough to absorb these investments and also a portfolio exit would cause destabilising effects on the global markets which would also affect China.

MEFMI committed to continuing with its efforts in increasing awareness on the Chinese currency. It was highlighted that MEFMI has conducted three (3) events to that effect. This include the 2016 Governors Forum which focused on "Implications of the Inclusion of the Chinese Yuan in the SDR"; the 2016 joint MEFMI-BIS seminar on the "Use of Chinese renminbi as a Trading Currency" held in Hong Kong which was a follow up on recommendations from the 2016 Governors Forum. The third and most recent activity is the 2018 MEFMI Deputy Permanent/Principal Secretaries and Deputy Governors Forum that discussed arguments for the use of the renminbi as a reserve currency and tackled challenges affecting its acceptance in the region. It was emphasised that one

of the recommendations from the Forum was that central banks needed to start holding some of their reserves in Chinese renminbi because of the increasing trade and financial relations with China. It was mentioned that going forward, China will start invoicing some of the transactions in their currency, something that is currently being done in one of the MEFMI member countries.

2.2 Session 2: Yield Trends and Implications for Sovereign Liabilities

Presenter: ***Mr. Antoon de Klerk, Portfolio Manager, Investec Asset Management***
Moderator: ***Mr. John Rwangombwa, Governor, National Bank of Rwanda***

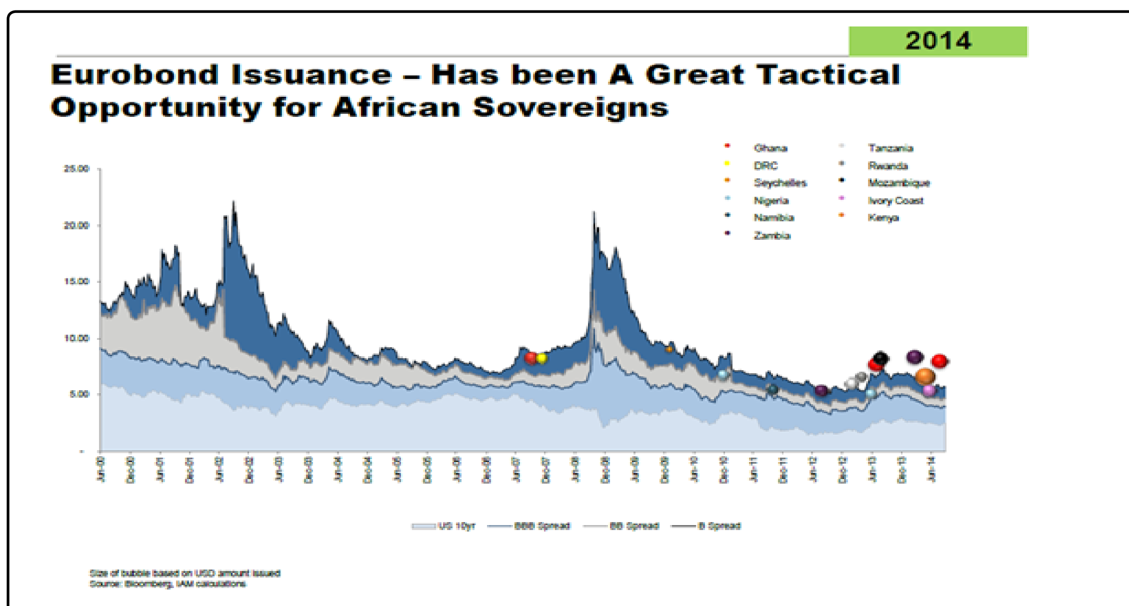
The second session intended to invoke reflections on the developments in the MEFMI region on the debt environment since 2014. It sought to generate discussions on the dollar denominated sovereign debt and its implications for the balance of payments, exchange rate pressures and economic growth at large in the MEFMI region.

2.2.1 Introduction

High borrowing appetite by African countries has made foreign currency debt become an important source of development finance for African economies. Starting in 2006 – when the first Sub Saharan African Eurobond was issued, more than a dozen governments in the region have issued Eurobonds, raising about USD29 billion in 35 issuances between September 2006 and June 2017. Most of these issuances were oversubscribed reflecting high investor interest, particularly from the USA and Europe, to take up these SSA bonds. This interest was mainly driven by the high yields on the these bonds as opposed to the record low interest rate levels in the U.S. and in the developed markets, as a whole in the aftermath of the financial crisis. In addition, SSA was basking in periods of record economic growth averaging 5 percent and macroeconomic stability, having shown considerable resilience to financial shocks during the global financial crisis.

Given the existing global economic environment, Eurobond issuance seemed a great tactical opportunity for African sovereigns. Figure 8 below shows the spread between the USD 10 year treasury and other bond issuances in 2014. Most of the SSA Eurobonds are rated BB or B.

Figure 8: Spread between the US 10 year Treasury and SSA Eurobonds



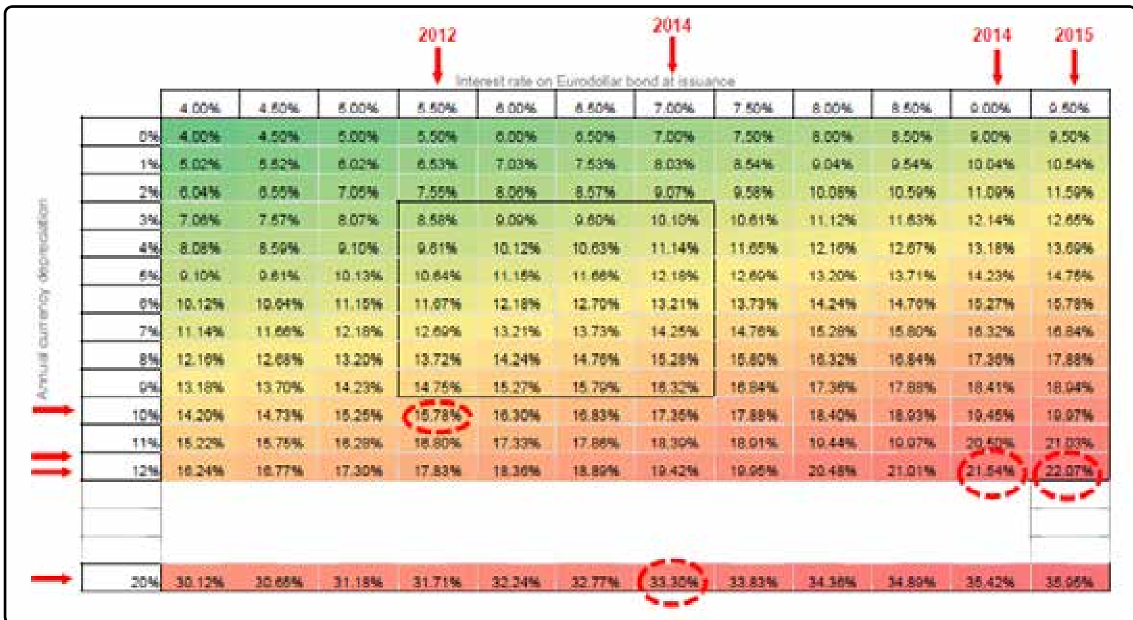
Source: Bloomberg, IAM calculations

2.2.2 Outlook for SSA Eurobond Issuance

To meet the huge infrastructure financing needs, there has been more issuance of SSA Eurobonds since 2014 which has resulted in USD denominated sovereign debt to more than triple over the past four (4) years. In issuing these bonds, the sovereigns anticipated that their economies would stay on a positive upward growth path, and hence hoped that their debt to GDP ratios would remain low. However, fast forward to 2018, the narrative has been very different. The plunge in commodity prices has left countries with weaker balance of payments, budgetary stress, exchange rate pressures and inadequate foreign exchange reserves to meet their external financial obligations.

Moreover, the debt which seemed cheap at the time of issuance has become expensive as a result of depreciation of the currencies of most of the countries. Eurobonds which were then issued at 5 percent interest rate looked relatively cheaper than issuance in the domestic markets at 15 percent. However, the effective cost of borrowing has shot up to the extent that this debt has become too costly for the countries to issue again. The effective cost of borrowing is the interest rate at which a bond is issued, adjusted by the annual currency depreciation rate. **Figure 9** below illustrates the effective cost of borrowing for a country that issued Eurobonds in 2012 and 2014. In 2012, the Eurobond was issued at about 5 percent at an annual currency depreciation of 10 percent, making the effective cost of borrowing 16 percent. However, in 2014, the Eurobond was issued at about 9 percent at an annual currency depreciation of 12 percent, making the effective cost of borrowing 21 percent.

Figure 9: Effective Cost of Funding Eurobond Issuance by Country X



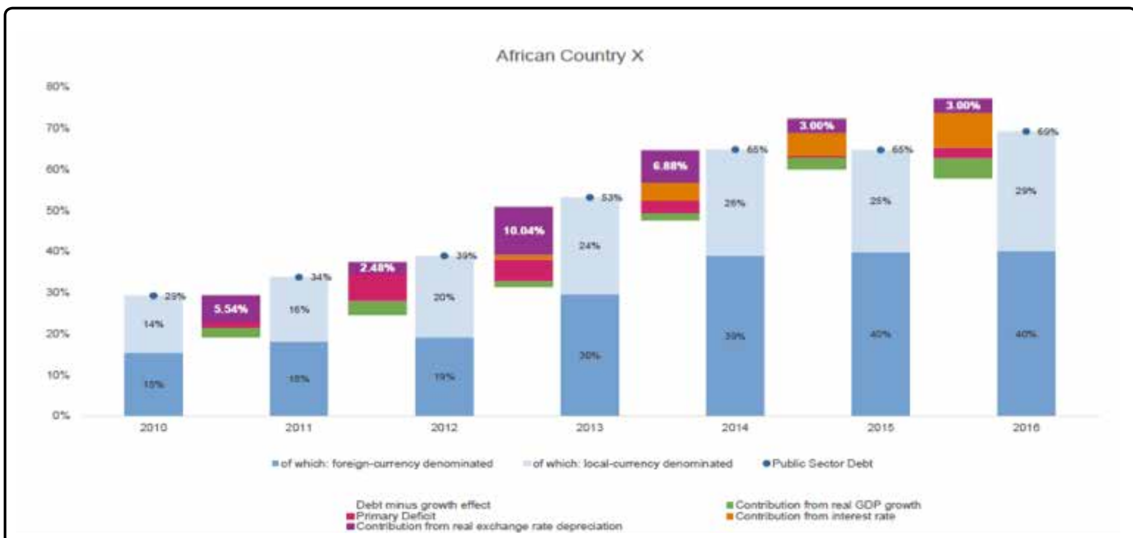
Interest rate on Eurodollar bond at issuance (columns); Annual currency depreciation (rows). Column markers: 2012 (5.50%), 2014 (7.00%), 2014 (9.00%), 2015 (9.50%).

Annual currency depreciation	4.00%	4.50%	5.00%	5.50%	6.00%	6.50%	7.00%	7.50%	8.00%	8.50%	9.00%	9.50%
0%	4.00%	4.50%	5.00%	5.50%	6.00%	6.50%	7.00%	7.50%	8.00%	8.50%	9.00%	9.50%
1%	5.02%	5.52%	6.02%	6.53%	7.03%	7.53%	8.03%	8.54%	9.04%	9.54%	10.04%	10.54%
2%	6.04%	6.55%	7.05%	7.55%	8.06%	8.57%	9.07%	9.58%	10.08%	10.59%	11.09%	11.59%
3%	7.06%	7.57%	8.07%	8.58%	9.09%	9.60%	10.10%	10.61%	11.12%	11.63%	12.14%	12.65%
4%	8.08%	8.59%	9.10%	9.61%	10.12%	10.63%	11.14%	11.65%	12.16%	12.67%	13.18%	13.69%
5%	9.10%	9.61%	10.13%	10.64%	11.15%	11.66%	12.18%	12.69%	13.20%	13.71%	14.23%	14.75%
6%	10.12%	10.64%	11.15%	11.67%	12.18%	12.70%	13.21%	13.73%	14.24%	14.76%	15.27%	15.78%
7%	11.14%	11.66%	12.18%	12.69%	13.21%	13.73%	14.25%	14.76%	15.28%	15.80%	16.32%	16.84%
8%	12.16%	12.68%	13.20%	13.72%	14.24%	14.76%	15.28%	15.80%	16.32%	16.84%	17.36%	17.88%
9%	13.18%	13.70%	14.23%	14.75%	15.27%	15.79%	16.32%	16.84%	17.36%	17.88%	18.41%	18.94%
10%	14.20%	14.73%	15.25%	15.78%	16.30%	16.83%	17.35%	17.88%	18.40%	18.93%	19.45%	19.97%
11%	15.22%	15.75%	16.28%	16.80%	17.33%	17.86%	18.39%	18.91%	19.44%	19.97%	20.50%	21.03%
12%	16.24%	16.77%	17.30%	17.83%	18.36%	18.89%	19.42%	19.95%	20.48%	21.01%	21.54%	22.07%
20%	30.12%	30.65%	31.18%	31.71%	32.24%	32.77%	33.30%	33.83%	34.36%	34.89%	35.42%	35.95%

Source: Investec Asset Management, 2018

As a result of the increasing yields on bonds since 2012, coupled with the depreciation of its domestic currency, this country had increased its debt as a percentage of GDP from 39 percent in 2012 to 65 percent in 2014 **(Figure 10),** just by issuing USD denominated debt, which has proven a real risk to its balance sheet.

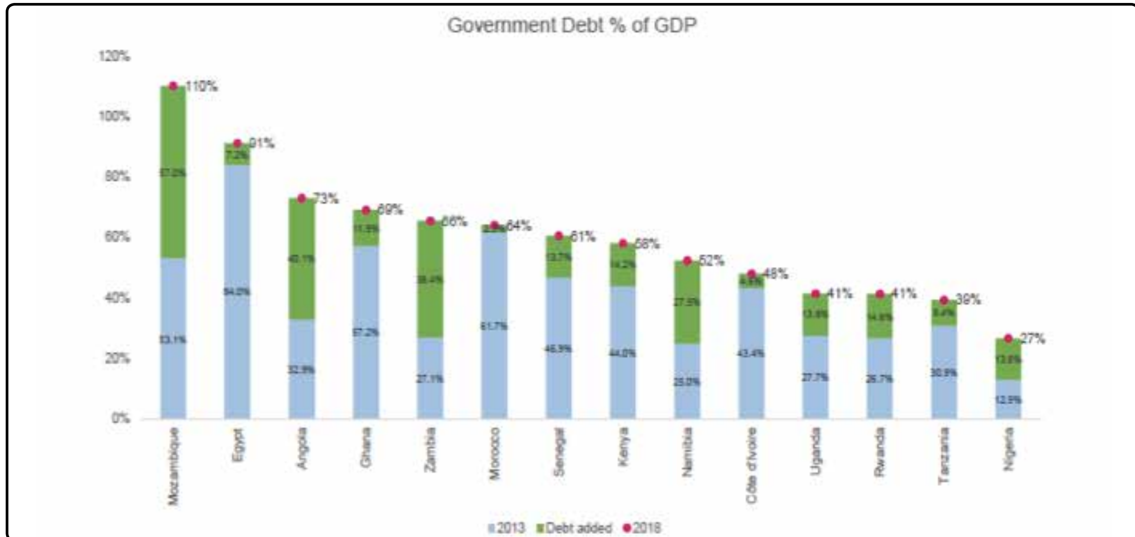
Figure 10: Growth Effect of Debt as a Percentage of GDP for Country X



Source: Investec Asset Management, 2018

The scenario is similar for most Africa sovereign balance sheets. While in 2014, most of the balance sheets looked healthy, but by 2018 balance sheets had heavily deteriorated **(Figure 11).** It is very easy to shoot up the percentage of debt to GDP within three years very easily just by issuing USD denominated debt. However most SSA countries suffer from the original sin hypothesis, where they are not able to borrow abroad in their local currencies. Thus issuing of Eurobonds seemed a great opportunity to access external financing to meet their growing developmental needs.

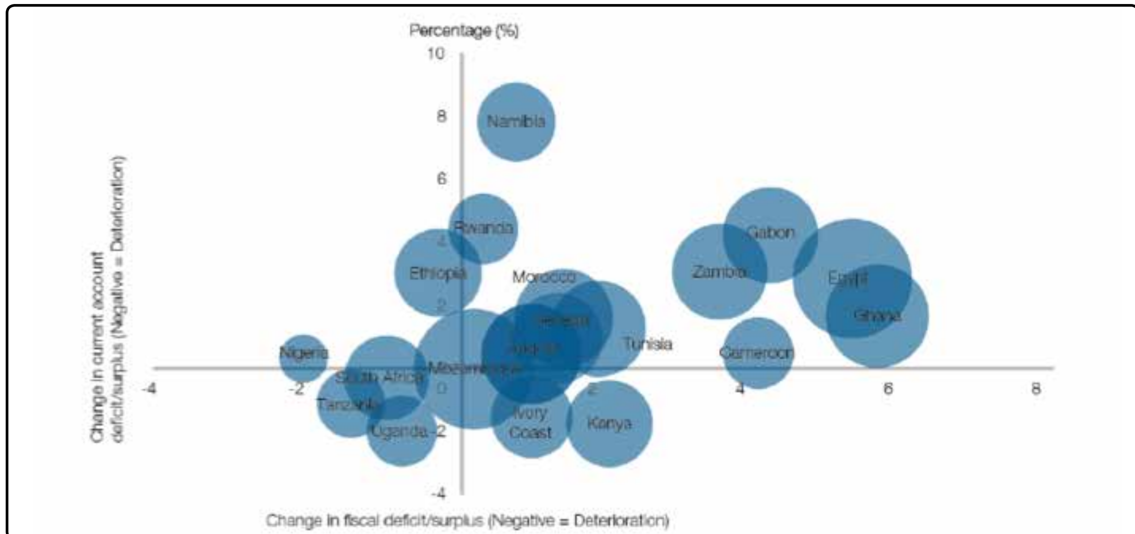
Figure 11: Government Debt as a Percentage of GDP between 2013 and 2018



Source: Investec Asset Management

However there is no single narrative – each country has its individual challenges and opportunities. The funding needs for the region remain too big, however the room for borrowing in foreign markets has become constrained. The structural long term solution for the region is the development of the domestic capital markets, however this remains a political rather than a technical challenge. This is because the value of country's currency is an indication of the faith that the people (both local and international) have in the stability of that society, its ability to produce goods and services and their ability to benefit from their efforts.

Figure 12: Change in Fiscal and Current Account Balances of selected SSA countries between 2015 and 2018



Source: Investec Asset Management

Conclusion

The session came to the conclusion that most of the SSA countries that had issued Eurobonds were at risk of sovereign defaults given the existing macroeconomic vulnerabilities. With the increasing global yields, countries will not be able to afford more borrowing in the foreign markets. In addition, Eurobonds also involve greater redemption risks than amortizing loans because the required principal repayments are concentrated, typically in single 'bullet' repayment structures. For most countries, this debt starts maturing in 2022 and if they fail to roll it over, they will generate a lot of pressure on the local currency in a bid to acquire foreign currency to meet their obligations. In the unfortunate event that these countries default, it is likely that this will result in exclusion from accessing credit in international markets. When this happens, countries will need to ensure that the banks can fund themselves as much as possible from local savings to avoid a banking crisis. Countries need to run a stress exercise to ensure that the banks can be insulated in case of default. The presentation ended with the following quote from John Adams (2nd president of the USA, May 1780), who advised that countries needed to get the politics right first before getting the economics right:

I must study politics…, that our sons may have liberty to study mathematics and philosophy. Our sons ought to study mathematics and philosophy... commerce and agriculture in order to give their children a right to study painting, poetry, music, architecture, etc."

Discussion

Delegates commended the presenter for the very insightful presentation and for being realistic and representative about the situation on the ground in the region. Delegates sought to know the actual prospects for MEFMI countries in rolling over debt and accessing liquidity going forward. The presenter stated that currently, most countries were still able to borrow although rates

would be more expensive ranging from 300 to 400 basis points higher. However, he warned that if the countries continued to increase their debt to GDP ratio, in four years' time, countries will not be able to access borrowing because the markets will not be willing to lend to countries with such high debt ratios.

Delegates noted that the key message from the presentation was that the debt levels in the region had reached unsustainable levels, whether denominated in foreign or domestic currency. The idea of developing the local bond market was welcomed as being a good initiative, to the extent that the debt would be sustainable for government to pay back. It was stressed that as long as the local investors remained sceptic about the risk of default, they would also not be willing to hold this investment. Related to this was the concern of the financial stability risks. It was noted that in most MEFMI countries, the commercial banks were the biggest holders of government securities, and were not receiving much cash flows on maturity as they keep rolling over this debt.

It was noted that the task at hand was to develop an enabling environment for domestic capital markets. It was highlighted that poor governance that has led to high corruption levels and the lack of a steadfast structural reform agenda was a major factor affecting the confidence of investors. It was emphasised that it was critical for governments to implement the necessary fiscal policy reforms going forward.

There was also a general consensus among delegates that coordination of monetary and fiscal policies remains a big challenge in the region. It was also pointed out that one of the issues affecting the coordination between monetary policy and fiscal policy was the lack of bold steps in monetary policy to curb the growing fiscal indiscipline. Delegates expressed some level of frustration that most times the monetary authority were constrained in influencing fiscal policy actions. The presenter advised that the monetary authorities needed to communicate boldly about the consequences of a debt crisis to the population. He also emphasised that the message should be clear to the government that borrowing for consumption would be literally eroding the capital for future generations.

These concerns about the fiscal indiscipline in the region were reiterated. Delegates wondered how they would advise the fiscal authorities yet the decisions were being made by technically competent policy makers. In response, it was advised that one way would be to increase awareness among the population of their right to receive accountability on expenditure of allocated public funds.

Delegates emphasised that there would still be need to identify resources to fund the huge infrastructure needs in the region which remained a bottleneck to economic development. However, concerns were raised that there was a missing link between the funding and the projects in terms of both implementation and their quality. Once funding is obtained, a liability is created on the sovereign balance sheets but many times it has been difficult to link it to the creation of an asset correspond with certainty. The presenter recommended that countries could consider accessing infrastructure project financing which would be a more guaranteed way of linking the liability incurred with creation of an asset. He further noted that this source of funding might not be able to meet all the infrastructure needs but it would be a good starting point.

Delegates raised concern that some of the Eurobond issuances were made on advice from investment fund managers who presented this as a great opportunity to access financing while ignoring the risks. Specifically, one of the delegates shared that their monetary authority had advised against the issuance of a Eurobond and had insisted on holding public debates on the potential costs and benefits of issuing debt in foreign markets. However, this did not materialise as the fiscal authorities went on to approve the issuance based on advisory from the investment fund managers.

Delegates noted the need to tackle the risk of possible debt crisis at regional level (East African Community and the Southern African Development Community) because of the possible spill over effects that could be felt within the region upon default by some countries. Although these countries are heterogeneous with their own individual challenges and opportunities, their bonds have all been categorised to belong to a common frontier market and may therefore be put in the same basket from the investor's perspective. In this case, there is a possibility that defaults by one country might push investors to adjust their outlook on the rest of the countries and possibly re-allocate their investment away from this asset class altogether.

The discussions came to the conclusion that there was need to take this conversation further to the fiscal authorities. The message to them should be that the period of low yields and large supply of liquidity that the region once enjoyed has since turned. Yields are on the rise, liquidity is dwindling, and the region needs to be ready to pay back the debt it is holding. It should be stressed to the authorities that defaulting should not be an option because of the possible repercussions to the banking sector. Further emphasis should be placed on the need for responsible borrowing, getting investment priorities right and borrowing for investment which will increase production and capacity of economy to service the debt. In this regard, the delegates recommended that MEFMI includes a session on this presentation in the upcoming MEFMI Combined Forum that will take place in October 2018.

MEFMI committed to continuing efforts in raising awareness on the debt sustainability risks in the region. Delegates were informed that MEFMI would be preparing a regional paper on the current debt management challenges being experienced. This paper would be presented in a plenary at the upcoming African Economic Research Consortium bi-annual research workshop slated for December 2018. It is expected that the findings would be used to influence policy decisions in the region to mitigate the current debt sustainability risks.

LUNCHEON AND CLOSING SESSION

The Director Financial Sector Management Programme of MEFMI, Mr. Patrick Mutimba thanked delegates for attending the Forum and commended them for their constructive deliberations which made the event very successful and beneficial. He pointed out that the day's deliberations had provided fruitful exchange of views and hoped for a more fruitful discussion at the upcoming Combined Forum where these issues would be deliberated further. He thanked the day's speakers, Mr. Johan du Plessis and Mr. Antoon de Klerk for delivering insightful presentations. He also expressed appreciation to Governor Matlanyane and Governor Rwangombwa for moderating the discussions.

Mr. Mutimba also expressed gratitude to Investec Asset Management for supporting the Forum for the fourth year running. He pointed out that the continued financial support from Investec was testimony of the significance and important role the Forum as it plays a critical role in strategising on policy actions for sovereign reserves management. By the same token, Mr. Mutimba expressed his appreciation to the BIS for providing the conference facilities for the event.

Mr Mutimba concluded by thanking the MEFMI Executive Fora Committee for ably organising a fruitful event and hoped for more successful events in the years to come.

ANNEX I – PARTICIPANTS LIST

Governors Forum
22 June 2018, Basel Switzerland

GOVERNORS' FORUM
22 June 2018, Basel, Switzerland. Confirmation list

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Annex II – Event Programme

2018 MEFMI CENTRAL BANK GOVERNORS FORUM
22 JUNE 2018.
BASEL, SWITZERLAND

THEME: ***TRENDS IN SOVEREIGN RESERVES MANAGEMENT***