South African Reserve Bank

An opening address by Lesetja Kganyago,
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at the fourth Annual Distributed Sovereign Debt
Research and Management Conference

University of Pretoria, Pretoria
7 September 2020

Good afternoon, ladies and gentlemen.

All protocols observed.

I would like to thank the International Development Law Unit at the Centre for Human Rights at the University of Pretoria for inviting me to deliver the opening address at this fourth Annual Distributed Sovereign Debt Research and Management Conference, or DebtCon.

DebtCon was launched at Georgetown in January 2016, and its mission is to engage scholars and practitioners across geographical, disciplinary and institutional boundaries to help solve sovereign debt problems. I think this is a very opportune time to bring together the brightest minds to consider the African debt conundrum.

Before I proceed, I should remind you that I am a central banker. Experience since the global financial crisis suggests that whenever central banks are called upon to discuss sovereign debt issues, countries are in real trouble. Today, I'll be making some remarks on the sovereign debt situation from an African central bank perspective.

But first, I should preface my remarks by highlighting that while debt has a very important role to play in economic development, one should also reflect on the challenges and pitfalls presented by debt to developing economies in sub-Saharan Africa (SSA). Experience has shown that unsustainable debt burdens and rising debt-service costs crowd out spending in key development areas such as education, health and infrastructure.

These were exactly the lessons learnt during the African debt crisis of the 1980s and 1990s, which justified debt relief. Consequently, badly managed debt can potentially reverse some of the developmental progress made over the past 20 years. The key is how the funds are utilised and how the debt is managed.

Now for some context.

The advent of the coronavirus disease 2019 (COVID-19) pandemic since the beginning of 2020 has underpinned a surge in sovereign indebtedness globally. The magnitude, pace and spread of the build-up in debt obligations has raised macroeconomic and financial stability concerns, especially for emerging and developing economies (EMDEs). Rising debt levels have increased the vulnerability of the global financial system to financial market stress. Since 2008, global debt has risen to 230% of gross domestic product (GDP), and EMDE debt rose to an historic high of 170% of GDP in 2019.[1] In addition, more than 25% of corporate debt in EMDEs is denominated in foreign currency.

There is also renewed concern about the sustainability of rising debt levels on the continent. The World Bank's *2020 International Debt Statistics*[2] has designated SSA as the region with the fastest-growing debt levels in the world, the pace of increase raising concerns about debt sustainability on the continent. According to the International Monetary Fund (IMF), about 40% of countries on the continent are currently at distressed levels.

A reflection on conjectural policy challenges

At the global level, the COVID-19 pandemic forced a strong fiscal response by many countries in an effort to avert lasting structural damage to the economy. However, the

[1] World Bank, June 2020, *Global Economic Prospects*.
[2] World Bank, 2020, *2020 International Debt Statistics*, available at https://datatopics.worldbank.org/debt/ids/region/SSA.

recessionary conditions, coupled with the significant deterioration in the economic outlook in many countries, have refocused our attention on the record-breaking debt metrics.

Global debt, both public and private, increased to US$253 trillion in the first quarter of 2020[3], with the public sector accounting for around 60% of these issuances. By way of comparison, global debt amounted to US$291 trillion at the end of the fourth quarter of 2008.

According to the age-old adage that 'history serves as a mirror so that we can avoid past tragedies', such is the didactic character of debt oscillations. With each wave of debt comes a composite reflection of causes, consequences and possible lessons for market participants and policymakers alike. A recent publication by the World Bank, titled *Global Waves of Debt: Causes and Consequences*[4], is instructive in this regard.

According to the World Bank, there have been four debt waves in the post-Bretton Woods period.

The first wave was fuelled by a low-interest rate environment and rapid growth in syndicated loans, which induced governments to accumulate high levels of debt during the 1970s and 1980s. This had negative implications for the health of the banking sector in lending countries, mainly the United States (US), and culminated in a debt crisis, which was followed by a prolonged debt relief and debt restructuring episode.

The second global debt wave emerged between 1990 and the early 2000s, and occurred against a backdrop of financial liberalisation and innovation that enabled banks and corporations in the East Asia and Pacific region, as well as governments in Europe and Central Asia, to borrow heavily in foreign currencies. Predictably, this debt wave also ended with a series of crises, between 1997 and 2001, when a change in investor sentiment sparked a widespread sell-off.

[3] Institute of International Finance, July 2020, *Global Debt Monitor: Sharp Spike in Global Debt Ratios*, available at https://www.iif.com/Publications/ID/4008/Global-Debt-Monitor-Sharp-Spike-In-Global-Debt-Ratios.

[4] Kose, M A, Nagle, P, Ohnsorge, F and Sugawara, N, 2020, *Global Waves of Debt: Causes and Consequences*, available at https://openknowledge.worldbank.org/handle/10986/32809.

This was followed by a resumption of investor confidence, which set the stage for the third debt wave. The build-up of private sector borrowing lasted several years, until it culminated with the global financial crisis in 2007-09.

Emerging from the global financial crisis, history was about to repeat itself.

A fourth wave of a debt cycle followed, marked with similarities to the previous oscillations. It was fuelled by low global interest rates, a rise in regional banks, increased demand for local currency-denominated bonds, and increased demand for EMDE debt issued by an expanding non-bank financial sector.

African countries have been, and continue to be, active participants in the new debt wave. According to the IMF's Fiscal Monitor, the average general government debt ratio for low-income SSA countries increased from 22% of GDP in 2010 to 43% of GDP in 2019. Even before the shock of COVID-19, public debt ratios were on the rise in the region. However, the COVID-19 pandemic, the global growth shock, the plunge in commodity prices, reduced growth outcomes and lower revenue collections will further exacerbate the already increasing sovereign indebtedness across the continent.

Economic theory can assist in framing the conjectural policy challenges and options to address the high and rising levels of sovereign debt in Africa.

First, the 'debt overhang' theory postulates that future growth could be in jeopardy when a country's debt-service costs exceed its ability to repay.[5] In such cases, the absence of concessions by creditors exacerbates the fiscal constraint and adversely impacts on the growth potential, especially for poor and developing economies.[6]

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[5] *Krugman, P. 1988. Financing vs forgiving a debt overhang. Journal of development economics. P253-268.*
[6] Ajayi, R, 1991, *On the Simultaneous Interactions of External Debt, Exchange Rates, and Other Macroeconomic Variables: the Case of Nigeria*, available at https://msuweb.montclair.edu/~lebelp/CERAFRM026Ajayi1991.pdf.

Second, does the level of indebtedness matter for economic growth? Reinhart and Rogoff[7] argue that growth rates decline significantly when public debt ratios exceed 90% of GDP. This assertion set in motion the 'threshold debate', with some critics pointing out that Reinhart and Rogoff's findings were modestly inflated[8,9]. A decade later, concerns about rising debt metrics have resuscitated the 'threshold debate'. The IMF[10] and later papers by Reinhart and Rogoff have concluded that increased debt does indeed lower the level of economic growth, albeit with a somewhat lower impact than was stated in earlier studies.[11]

As Claessens et al. point out, large external debt and its associated service obligations can affect economic performance through the 'crowding out' effect, the impact on a country's ability to access international financial markets, and its impact on confidence levels.[12] It is worth pointing out that the 'crowding out' effect also applies to local-currency public debt, especially where banks end up recycling depositors' money into government bonds rather than on-lending for productive investment purposes.

Finally, it would be remiss of me not to highlight that high indebtedness also presents risks to the implementation of monetary policy and financial stability. A high level of public debt also raises the risk of fiscal dominance. This is where monetary policy is subordinated to keeping the debt servicing burden manageable, at the expense of price and financial stability.

We are faced with a myriad of challenges that require a delicate balance between novel ideas and solutions on the one hand, and the prudence required for sustainability on the other hand.

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[7] Reinhart, C M and Rogoff, K S, 2010, 'Growth in a Time of Debt', *American Economic Review,* 100(2): 573–78.
[8] Wray, L R, 20 April 2013, 'Why Reinhart and Rogoff Results are Crap', *EconoMonitor*.
[9] Mencinger, J, Aristovnik, A and Verbič, M, 2014, 'The Impact of Growing Public Debt on Economic Growth in the European Union', *Amfiteatru Economic* 16(35): 403–414.
[10] International Monetary Fund, April 2013, World Economic and Financial Surveys, *World Economic Outlook (WEO)*, 'Hopes, Realities, and Risks', available at http://www.imf.org/external/pubs/ft/weo/2013/01/index.htm.
[11] Reinhart, C M, Reinhart, V R and Rogoff, K S, 2012, 'Public Debt Overhangs: Advanced-Economy Episodes since 1800', *Journal of Economic Perspectives,* 26(3): 69–86.
[12] Claessens, S, 1996, *Analytical aspects of the debt problems of heavily-indebted poor countries*, available at https://trove.nla.gov.au/work/174652.

The African story

Allow me to elaborate on the most recent African experience with debt.

At the turn of the 21st century, billions of dollars' worth of debt was wiped clean across the SSA region. South Africa was instrumental in pushing for debt relief, and succeeded in the late 1990s when the Highly Indebted Poor Countries programme was agreed on through the IMF and the Development Committee of the World Bank. At the time, the solution appeared simple: wipe off the debt and allow countries space to get their affairs in order, and growth and stability will follow.

For a time, significant improvements were observed, with many countries strengthening their macroeconomic frameworks and institutions. A number of countries also gained market access. With the advent of lower global interest rates, countries also had the opportunity to increase their debt issuance.

By 2018, international bond issuances in the region reached a new high, totalling more than US$17 billion, with the average issuance rising to nearly US$3 billion.[13] About 16 SSA countries were at high risk of debt distress – more than double the 2013 levels. Average public debt across the region rose close to 56% of GDP at the end of 2018, with wide disparities in debt dynamics across countries. For example, in 2018, public debt to GDP stood at 72% in Zambia and 100% in Mozambique. Debt-service costs rose sharply, with the median interest payment burden doubling to about 10% of revenue between 2011 and 2018.

By the end of 2019, economic growth in SSA was seen to be improving from the low base of the early 1990s. Real GDP was projected to increase by 3.7% in 2020. But this was still well below the averages of the 2000s.

In mid-2019, however, there was a growing number of voices raising concerns about macroeconomic stability given the weakening of fiscal positions in a number of low-income developing countries. According to the IMF, the debt burdens and

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[13] World Bank, April 2019, *Africa Pulse*.

vulnerabilities of these countries had risen significantly since 2013, reflecting a mix of factors, including exogenous shocks and loose fiscal policies.

The continent's total external debt burden reached nearly US$500 billion in 2019, but governments have been pressured into further borrowing to counter the effects of the COVID-19 pandemic. In part, this has been due to the low returns on most financial assets worldwide triggering an appetite for frontier markets' assets.

Debt levels have been increasing considerably during 2020 with the interplay between various factors, most notably the need to manage the impact of the COVID-19 pandemic.

As mentioned earlier, various international bodies have indicated that SSA is the region with the fastest-growing debt levels in the world, the pace of increase raising concerns about debt sustainability on the continent.[14]

… While in South Africa

Let me use the case of South Africa to reflect on some of the costs of rising debt.

National Treasury has pronounced on the trajectory for the South African fiscal position in the *2020 Budget Review* that the outlook is bleak, which would be the main source of weakness for the domestic sovereign bond market.

Well-developed local-currency bond markets allow governments to tap debt markets at potentially favourable terms to counter real economic shocks. South Africa's local-currency bond market – which has undergone significant growth since the late 1970s in achieving its level of depth, liquidity and sophistication – has enjoyed these benefits. South Africa's sophisticated level of the local-currency bond market was made possible through a concerted effort by National Treasury to implement a clear debt management strategy.

[14] World Bank, 2020, *2020 International Debt Statistics*, available at https://datatopics.worldbank.org/debt/ids/region/SSA.

The strategy entails reducing borrowing costs and risks through increasing liquidity, managing maturity profiles, diversifying funding instruments, increasing transparency and information flows, and building credibility among market players. National Treasury took specific actions to achieve these price and maturity benefits. One of the first steps was the consolidation of government bonds into benchmark bonds, as well as the development of the yield curve. There was also a deliberate focus on deepening the secondary market for government securities, where the South African Reserve Bank (SARB) played an important role by acting as a market maker and a funding agent in a number of benchmark government bonds. At its peak, the SARB's participation in the secondary market accounted for an estimated 30% of total bond turnover. By the late 1990s, the secondary market was judged to be sufficiently mature for the SARB to reduce its involvement and to improve efficiency and transparency.

When the global financial crisis hit in 2008/09, South Africa had been running small budget surpluses. The debt-to-GDP ratio was under 30%. This allowed for increased government spending, part of which was initially justified as countercyclical stimulus, but which was not subsequently reversed. Persistent fiscal deficits have since caused a dramatic increase in the debt-to-GDP ratio, which incidentally is larger than that of other emerging markets, except Argentina.

Some attempts at fiscal consolidation were made over the decade. However, these were underpinned primarily by tax increases, while aggregate spending kept growing or at least failed to decline as a share of GDP. The main drivers were above-inflation growth in the public sector wage bill, rising interest costs, and bailouts for insolvent state-owned enterprises (SOEs). In short, the domestic fiscal position was already highly challenging before the COVID-19 crisis, with the 2019/20 fiscal deficit being 6.7% of GDP and the debt-to-GDP ratio at 63.5%.

The COVID-19 shock is now projected to result in a budget deficit of 14.6% of GDP, and is widely expected to increase the debt stock past 80% of GDP for the current fiscal year. As is pointed out in the revised *Budget*, there are significant risks of debt exceeding 100% of GDP in a passive scenario over the next few years – unless government implements strong corrective measures to stabilise the debt by 2023/24.

South Africa has now lost its investment-grade credit rating from all the major ratings agencies. Government bond yields are unusually high, with inflation-adjusted yields in the region of 4-5%. With the steepening of the yield curve, National Treasury has had to shorten the maturity of its debt to limit borrowing costs. However, this raises risks, as redemptions are not spread out over as long a period as previously. In addition, capital inflows to South Africa have declined.

With the government deficit approximating the supply of private domestic savings, the implications for private investment spending are bleak. While real, non-interest spending is budgeted to increase further this year, in large part to fund COVID-19 relief measures, South Africa needs a substantial fiscal adjustment, complemented by strong structural reform policies, to minimise the impact on medium-term growth.

Some implications for policy

Let me conclude by making a few remarks on the policy implications associated with the current debt dynamics on the continent.

Interest payments constitute the highest expenditure item of the government budget for many SSA countries.[15] Current estimates indicate that SSA faces a US$44 billion debt-servicing bill in 2020.[16] This is due to a combination of interest rate and exchange rate effects.[17] African countries face high borrowing costs. For example, their 10-year government bond yields range between 5% and 10% compared to near-zero or negative rates in some developed economies.

[15] Sallant, S, July 2020, 'External debt complicates Africa's COVID-19 recovery, debt relief needed', *Tralac*, available at https://www.tralac.org/news/article/14827-external-debt-complicates-africa-s-covid-19-recovery-debt-relief-needed.htm.
[16] Jones, M and Arnold, T, May 2020, 'Private creditors push back against blanket debt relief for Africa', *Reuters*, available at https://af.reuters.com/article/topNews/idAFKBN22R20E-OZATP.
[17] For example, Sudan has 95% of its public debt denominated in foreign currency, and has the highest debt ratio in Africa at 207% of GDP. Mozambique follows closely, with public debt at 108% of GDP, 85% of it being issued in foreign currency. South Africa, on the other hand, has about 90% of its public debt denominated in its domestic currency, while 10% is held in foreign currency. However, a large proportion of this debt is held by foreigners.

The increased reliance on non-traditional creditors has raised borrowers' exposure to market risk, at the same time posing additional challenges to the sustainability of external debt in the region. For instance, where countries find themselves in debt distress, it may be more difficult to come to rescheduling agreements with a large number of private creditors than when you had, in the past, a relatively small number of public creditors (Paris Club) and/or commercial bank lenders (London Club).

Challenges such as these highlight the need for countries to strengthen debt management practices and improve transparency, which is fundamental to sustainable financing. However, addressing these challenges would require countries to make tough fiscal choices to prevent debt burdens from becoming unsustainable.

A prudent debt management strategy is thus key to tackling this challenge.

There is wide consensus that countries need to raise more domestic revenue to make debt financing more sustainable. There also needs to be a greater focus on improving the efficiency of public spending in such a way that it helps to improve economic growth. While the primary responsibility for avoiding the build-up of unsustainable debt lies with the borrower, creditors also have a role to play in encouraging greater transparency. Irresponsible borrowing ultimately contributes to unsustainable debt burdens.

More recently, the Debt Service Suspension Initiative (DSSI), which was endorsed by the Group of Twenty (G20) finance ministers and central bank governors on 15 April 2020, has come under renewed focus as a means to addressing the debt burden on the continent.[18] The DSSI seeks to grant debt-service suspension to the poorest countries to mitigate the impact of the COVID-19 pandemic. Its objective is to

[18] World Bank. Undated. Debt Service Suspension Initiative: Q&As. World Bank. Joint Statement World Bank Group and IMF Call to Action on Debt of IDA Countries states that : with immediate effect—and consistent with national laws of the creditor countries—the World Bank Group and the International Monetary Fund call on all official bilateral creditors to suspend debt payments from IDA countries that request forbearance. This will help with IDA countries' immediate liquidity needs to tackle challenges posed by the coronavirus outbreak and allow time for an assessment of the crisis impact and financing needs for each country.

create fiscal space for countries to increase their social, health and economic spending in response to the crisis. The suspension, and the resumption of repayments, will be over a period of three years, with a one-year grace period.

Some see benefits associated with the DSSI, while others have indicated that an application for DSSI participation might send a negative signal about countries' creditworthiness.[19] The three major credit rating agencies have indicated that private sector participation on G20-comparable terms could have negative rating implications for the participants (both the recipients and the providers of the relief).

More recently, Moody's placed four African countries on review for a downgrade for their participation in the DSSI, stating that this raised the risk of losses for investors in the countries' bonds. This presents a dilemma. How can we ensure that debt-service relief does not lead to sovereign downgrades and thus does not compromise the attainment of debt sustainability over the medium term? This is an issue that is receiving increasing attention on the G20 agenda.

Conclusion

In closing, I would like to reiterate that public debt has an important role to play in financing development, particularly in augmenting government budgets. However, it should be clear that debt is not a replacement for domestic revenue mobilisation. Meanwhile, debt levels must remain sustainable so as not to undermine market confidence. To ensure that debt plays a meaningful role, it must be utilised for revenue-generating activities that increase the productive capacity of the economy.

I'm looking forward to hearing some of the novel ideas that will be shared in the next session on how we can tackle the debt-related challenges confronting the continent.

Thank you.

[19] World Bank. Undated. Debt Service Suspension Initiative: Q&As. World Bank. https://www.worldbank.org/en/topic/debt/brief/debt-service-suspension-initiative-qas