NANYANG TECHNOLOGICAL UNIVERSITY
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Africa Current Issues

Is Africa's Growing Public Debt Really Crowding out Private Investment?

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Introduction

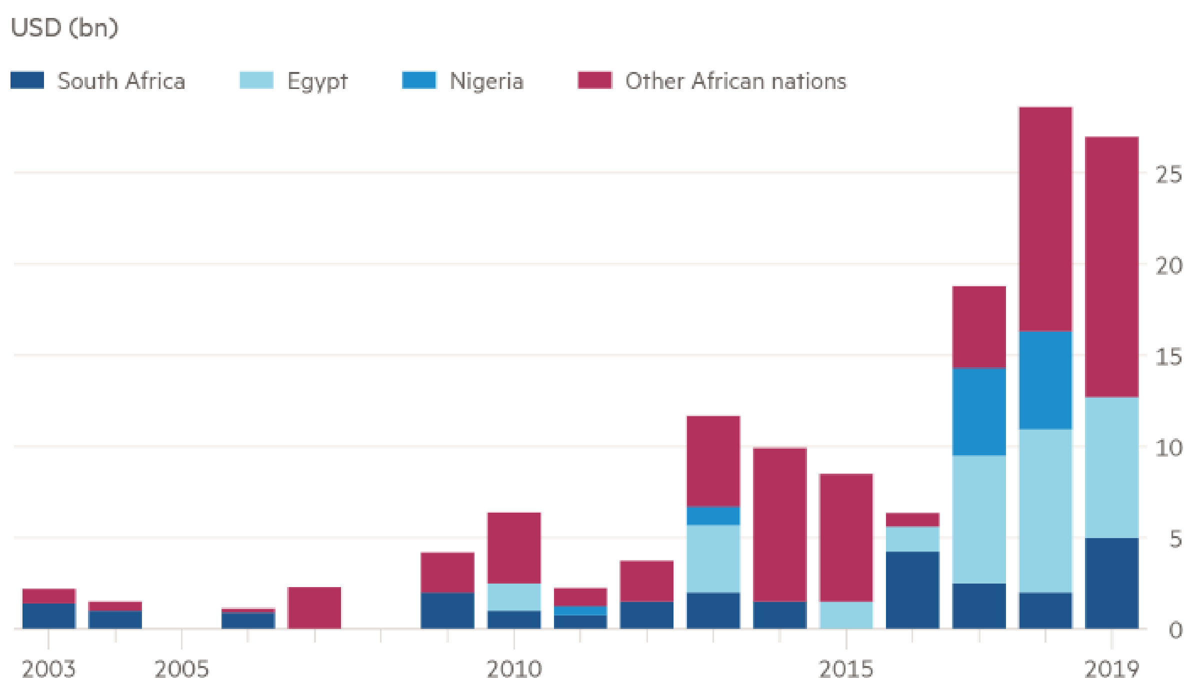
Total external debt for sub-Saharan Africa jumped nearly 150% to $583 billion in 2018, from $236 billion 10 years earlier according to the World Bank. [1] Many now worry the debt burden is unsustainable. Average public debt increased from 2010-2018 by 40%, and now stands at 59% of GDP. This alarming situation initiated a blaming game between the World Bank and regional development banks such as the African Development Bank in March of 2020.The World Bank criticized the African Development Bank for lending too readily to heavily indebted countries that struggle with billions of dollars in debt to China for Belt and Road infrastructure projects. The African Development Bank (ADB) pushed back, arguing that it and similar regional development banks did not contribute to emerging market debt problems. ADB pointed out that it coordinates lending activities, especially its public sector policy-based loans, closely with sister International Financial Institutions (notably the World Bank and the IMF).

The bells warning of swelling public debt started to ring in mid-2014, when global oil prices crashed, African economic growth slowed, and sovereign debt problems became more frequent (Devarajan et al, 2019). The World Bank and the International Monetary Fund say that, since 2013, the number of African economies in or near debt distress has grown from 6 to 15.[2] However, not all scholars agree that public debt in Africa is becoming problematic. Coulibaly, Gandhi, and Senbet (2019) argue that "commodity prices have retracted their declines, economic growth is recovering, exchange rates have strengthened, and in many cases, fiscal consolidation is under way.[3]" The African Development Bank's former chief economist says that it is time "to stop the misleading, generalizing, and stereotyping narrative about an 'African' debt crisis fueled by China 'threatening' Africa and the world economy." The markets seem to agree with the arguments raised by Africans. In 2018, Kenya's $2 billion bond was seven times oversubscribed. Last year, Ghana's $3 billion bond offering was six times oversubscribed. As illustrated in Figure 1 below, bond offering in Africa rose from less than $10 billion 10 years ago to more than $25 billion today.

Recent research provides evidence that African governments pay more to borrow than other comparable countries. A study of all sovereign bond issues between 2000 and 2014 reveals an unexplained "Africa Premium" approaching 3 percentage points, after controlling for loan duration, credit ratings and macroeconomic fundamentals[4]. Mpapalika and Malikane identified public debt-to-GDP, GDP growth, inflation rates, foreign exchange reserves, market sentiments, and commodity prices as highly significant influencers of sovereign risk premiums.[5] African governments pay from 5% to 16 % interest on their 10-year government bonds. This compares to near zero to negative rates in Europe and America. Interest repayment represents the highest share of expenditure and remains the fastest growing expenditure category in most sub-Saharan Africa fiscal budgets.[6]

Whether debt levels are rising is not the real issue. The main concern should be on whether the returns on public investment exceed the interest rates paid on the loans that fund them. Commentators argue that the loans finance infrastructure projects with returns only in the distant future, compared to the medium term nature of the loan interest payments. The case of the Nairobi-Mombassa rail project in Kenya is often pointed as a prime example of the mismatch.[7] The incongruity between the timing of the cost of servicing the loans and the returns on the public investment they are used for will cause budget deficits because governments will not be able to meet their expenditure commitments by only using revenues and grants. This will prompt African governments to use Treasury bill to fund part of the national budget with loans from domestic commercial banks, a practice that may crowd out private sector investment.

Figure 1: Eurobond offering in Africa



Increased government investment may directly and indirectly crowd out private investment in a number of ways. First, a rise of government investment must be financed, which means the government sector will compete for funds with the private sector in capital markets, causing the interest rate to rise. This reduces the amount of loanable funds available to private investors, thus lowering private investment. This follows the classical Keynesian “financial crowding out” theory. Secondly, Ricardian equivalence provides another explanation for the “crowding out” effect. According to Ricardo, government spending must be financed, now or in the future, by taxes. The more taxes imposed by the government in the future, the less disposable income for the private sector, negatively affecting private investment.

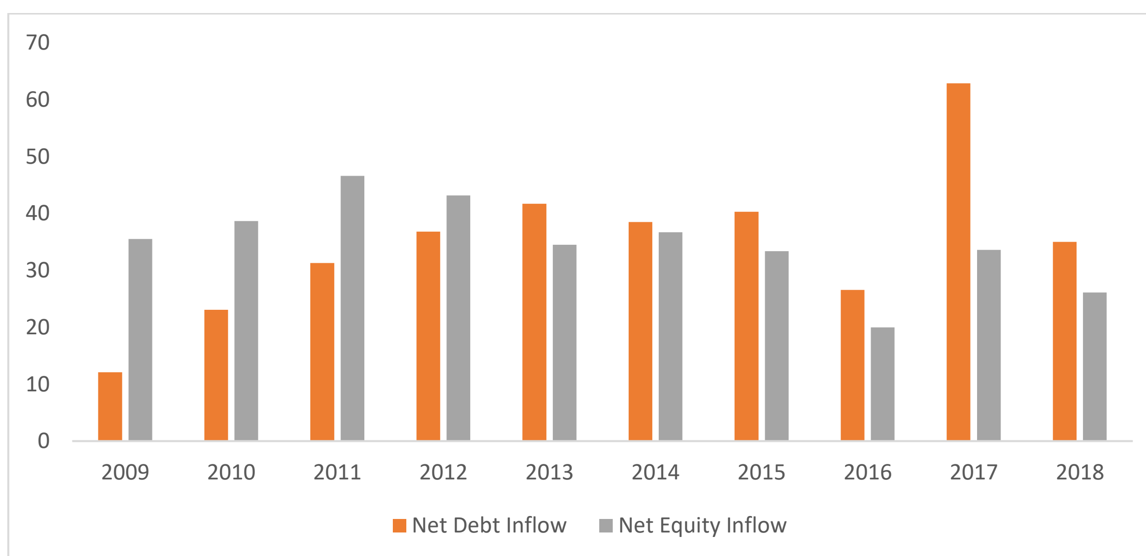
Available empirical evidence on crowding out reveals very weak links between government borrowing and the equilibrium interest rate.[8] This relationship is expected to be even weaker for African countries where the financial sector, especially the banking system, has historically been subject to extensive government interventions, and interest rates are often set administratively by the central bank. To decide whether public debt in Africa is crowding out private investment, we must answer three questions. One, are African debts being productively used? We will use IMF projections of public debt and economic growth across countries to answer this question. Do stronger institutions and a better business environment accompany the accumulation of debt? The answer will inform us whether investors agree that Africa truly has investment potentials that justify large scale infrastructure investment, versus investors responding mainly to higher interest rates. Third, do African firms rely on commercial banks to support both their working capital expenditures and long-term investment? Moreover, how has this changed over the period during which national debts have been rising? We will investigate this question by using evidence from firm level data collected across more than 30,000 firms over 42 African countries between 2006 and 2019.

Are debts being productively used?

Debt financed public investment should, directly or indirectly, create favorable conditions for private investment, for instance, by providing infrastructure such as roads, highways, sewage systems, and

harbors. Better facilities may increase the productivity of private investment and reduce the cost of production of the private sector, a positive impact on the profitability of private investment. This would result in a "crowding-in" effect on private investment; a condition that debt financed public work should create to justify the interest payment. Furthermore, government spending itself may directly crowd in private investment, by contracting directly with private. State enterprises can also subcontract to private firms, directly increasing private investment. We can determine whether this pattern is present in Africa by comparing debt stock against Gross National Income (GNI).

Figure 2: Net Debt and Equity Inflows 2009 – 2018 (in US billion)



Source: World Bank 2019

Most African countries have seen a large rise in the external debt stock in recent years. This was followed by major changes in borrowing trends, including increased reliance on non-traditional bilateral creditors such as China, and a substantial rise in loans from private investors, including foreign bond issuance, encouraged by global financial conditions. These trends are illustrated by a marked change in the creditor composition of new debt flows, especially those from official creditors to the 33 countries in the area classified as IDA-only and eligible for highly concessional financing. Long-term loan disbursements to this community of countries amounted to $24.6 billion in 2018, a rise of 25 per cent from the point of 2017. Private creditors ' share of disbursements rose to 46 percent in 2018 (29 percent in 2017), largely due to Cote d'Ivoire, Ghana and Senegal's large Eurobond issues. In addition, one fifth of the region's sole IDA countries have now released Eurobonds.[9]

In several Sub-Saharan African countries, the increase in external debt stocks has outpaced economic growth over the last decade. The overall external debt-to-GNI ratio at the end of 2018 was 36 percent, a small improvement from the previous year, but more than 40% higher than in 2009. Around 2009-2018, the region's combined GNI rose 51 per cent, calculated in U.S. dollar terms, while the combined external stock rose 117 per cent on average. The speed of rise in external debt over this time was even more rapid for some countries.[10] External debt stocks rose 423 percent in Ethiopia, 38 percent in Rwanda and 345 percent in Uganda compared to increases of 159 percent, 74 percent and 49 percent, respectively in GNI. The ratio of external debt-to-export earnings followed a similar trajectory. It averaged 134 percent at end 2018, a small improvement over the prior year (144 percent in 2009), but well over double the comparable ratio at the start of the decade. In over 30 percent of countries, mostly ones that benefitted from Heavily Indebted Poor Country (HIPC) initiative, the ratio at end 2018 was close to, or above, 250 percent.[11]

This uneven growth of external debts stock against GNI implies that most debt is not being used productively, at least in the short run. Some may argue that the loans are being used to fund projects

for which the benefit streams will only occur in the long run. This is the case for most large infrastructure projects funded by Chinese loans. But the issue with financing long-run return projects with shorter term loans is that the future benefit streams stemming from the infrastructure will be heavily discounted by passage of time that it would not pass typical return on investment assessment.

Have institutions and policies improvement resulted in better business environment?

One way to determine whether the increase in public debt is being driven by reforms that are simultaneously improving the business environment is to determine if the countries with the biggest increases in debt have also improved their policies and institutions and business environment indicators the most. Adequate policies and institutions and business environment is important to ensure the productivity of the infrastructure that will be funded by the debt. Fortunately, the World Bank's Country Policy and Institutional Assessments (CPIA) are publicly available for all low-income countries in the region. Combined to it, we will also use the Doing Business indicators to determine if there are any correlations.

Table 1 ranks the countries by their ratios of change in public debt to GDP between 2010 and 2017 (2018 for some countries). The table reports the cumulative change in per capita GDP, quality of business environment, and the quality of policies and institutions for all these countries. We note that public debt to GDP ratio increased in 42 of the 46 countries considered here. However, GDP per capita increased in 23 countries out of the 46 countries, results that corroborate our finding in the previous section. This GDP per capita growth seems to imply that debt may have been used for welfare improvement activities, but only in some countries. We also look at both the CPIA and Doing Business scores to determine if institutions have been improving in reflection of investors' confidence. The CPIA index went down for 22 countries, remained the same for 10 countries, and improved for 11 countries. Last, the DB index increased for all countries expect for Sierra Leone.

Table 1: Public Debt, Policies and Institutions, Growth and Business Environment, 2014-2018

Country	Gross Public Debts (% of GDP)			% change in GDP per capita 2014-18	Overall CPIA Score (1 worst; 6 best)			Ease of doing business score (0 = lowest performance to 100 = best performance)		
	2010	2018	Change		2014	2018	Change	2015	2018	% Change
Angola	37%	68%	31%	12.23%	2.39	2.54	0.15	32.01	35.57	11.09%
Benin	28%	54%	26%	-4.59%	3.48	3.47	0	48.66	52.4	7.70%
Botswana	20%	12%	-8%	6.14%			0	65.48	66.2	1.09%
Burkina Faso	31%	38%	7%	1.61%	3.63	3.56	-0.07	50.65	51.4	1.48%
Burundi	46%	52%	6%	-0.63%	3.08	3.23	0.15	41.9	47.73	13.92%
Cabo Verde	72%	124%	52%	1.30%	3.9	3.8	-0.1	53.43	55.04	3.01%
Cameroon	14%	36%	22%	-0.44%	3.14	3.26	0.12	41.89	46.1	10.05%
CAR	21%	52%	31%	-36.54%			0	37.57	41.29	9.89%
Chad	30%	52%	22%	-28.52%	2.66	2.72	0.06	35.3	36.94	4.63%
Comoros	50%	31%	-19%	-6.39%	2.69	2.79	0.09	46.25	47.87	3.51%
Congo	53%	98%	45%	15.41%	2.98	2.69	-0.29	34.36	36.21	5.40%
Cote D'Ivoire	63%	49%	-14%	-28.24%	3.2	3.44	0.24	38.92	39.53	1.58%
DRC	31%	15%	-16%	10.01%	2.92	2.91	-0.01	50.33	60.69	20.58%
Eqtl. Guinea	7%	38%	31%	-47.02%			0	40.03	41.05	2.56%
Eswatini	13%	34%	21%	2.66%			0	56.94	59.49	4.49%
Ethiopia	40%	59%	19%	11.79%			0	58.96	61.7	4.66%
Gabon	21%	58%	37%	-17.60%			0	44.02	45.03	2.28%
Gambia	40%	83%	43%	17.89%	3.15	3.02	-0.13	46.23	50.29	8.78%
Ghana	34%	59%	25%	11.86%	3.42	3.56	0.13	56.99	59.96	5.20%
Guinea Bissau	68%	53%	-15%	11.61%	2.45	2.39	-0.06	44.33	49.43	11.49%
Guinea	68%	40%	-28%	24.98%	3.01	3.16	0.15	40.43	43.23	6.92%
Kenya	44%	54%	10%	30.00%	3.76	3.66	-0.1	58.01	73.22	26.21%
Lesotho	31%	38%	7%	1.78%	3.34	3.31	-0.03	55.19	59.43	7.69%
Liberia	21%	34%	13%	-6.08%	3.07	2.88	-0.19	39.96	43.23	8.18%
Madagascar	34%	40%	6%	-1.13%	3.25	2.91	-0.35	45.57	46.77	2.64%
Malawi	29%	61%	32%	4.88%	3.21	3.24	0.03	49.71	60.94	22.59%
Mali	25%	35%	10%	-13.32%			0	43.76	51.06	16.69%
Mauritania	58%	76%	18%	10.68%	3.38	3.37	0	76.03	81.47	7.16%
Mauritius	57%	65%	8%	-25.97%			0	52.81	55	4.13%
Mozambique	42%	103%	61%	5.46%	3.54	3.22	-0.33	60.04	61.35	2.17%
Namibia	16%	41%	25%	-3.22%			0	46.32	56.76	22.53%
Niger	20%	49%	29%	-12.66%	2.97	3.22	0.25	60.45	66.94	10.73%
Nigeria	9%	28%	19%	6.87%	3.46	3.13	-0.33	67.05	76.48	14.06%
Rwanda	19%	36%	17%	9.12%	3.97	4.03	0.06	49.56	59.28	19.61%
SA	34%	53%	19%	36.23%	3.49	3.49	0	43.78	47.98	9.57%
Sao Tome	79%	88%	9%	-13.06%	3.73	3.45	-0.28	56.63	59.98	5.92%

These findings have three implications. The first is that countries where the quality of governance has slipped (or has not improved enough) but where debt has grown are risking another debt crisis. This should bother Africans and the business environment as debt crises is not good for business. Second, the irrelevance of the quality of governance indicates that investors are oversubscribing to African countries issued bonds because of the relatively high interest rates given the near zero interest rates in OECD countries. The third is that change in business environment is independent of the debt levels, implying that short term private investment is not being crowed out of by national debts, but the same cannot be concluded for long term private investment. This means that the limited changes in policy and institution environment make it difficult for firms to secure credit to fund long term investment such as heavy equipment and buildings.

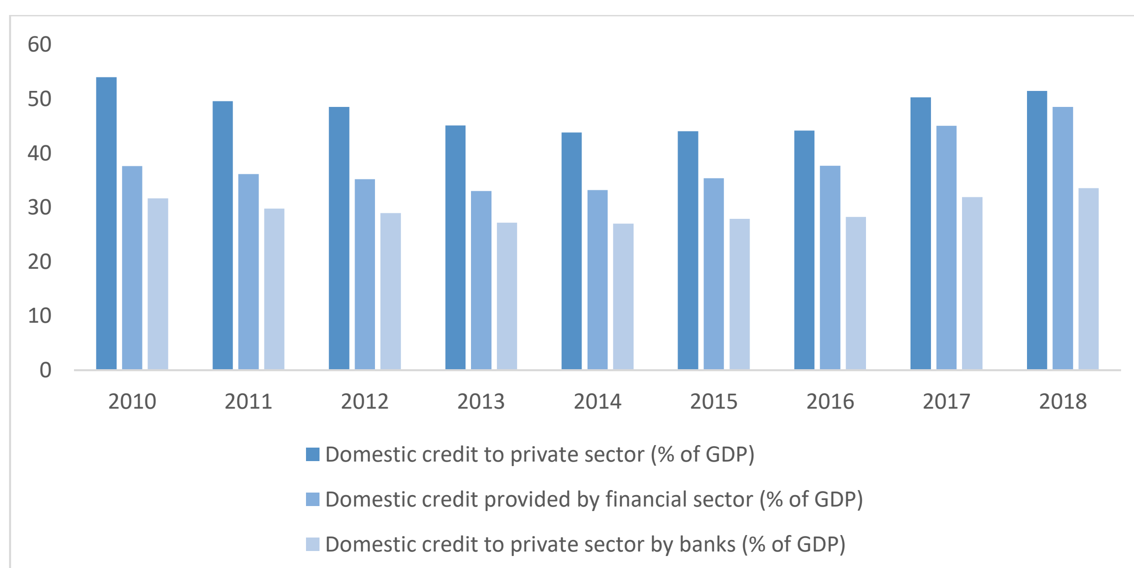
Do local banks support firms' working capital expenditures and long-term investment?

We first discuss changes in private sector access to credit over the past 10 years. Figure 1 indicates that domestic credit taken up by the private sector as a share of GDP is falling. However, domestic credit provided to the public sector is growing. This implies that credit supply growth was not due primarily to private sector demand, but to public sector demand, a notional indicator of crowding out.

Before exploring private investment, we will profile private sector firms in Africa, using data from the World Bank Enterprise Survey. The Enterprise Survey is a firm-level survey of a representative sample of an economy's private sector. The surveys cover a broad range of business environment topics including access to finance, corruption, infrastructure, crime, competition, and performance measures. The Enterprise Surveys provide the world's most comprehensive firm-level data for low income countries. The Enterprise Surveys project is jointly led by the World Bank and various partners, such as the European Bank for Reconstruction and Development, the Inter-American Development Bank (IDB), COMPETE Caribbean, and the UK's Department for International Development (DFID).

The Enterprise Survey data uncover a significant exposure credit among African firms. On average 16.37% and 20.24% of firms use banks to finance their investment and working capital, respectively. We also note interesting changes over time such that in 2006 12% and 13% of firms use banks to finance their investment and working capital, respectively, compared to 24% and 27% respectively, 10 years later in 2016. When assessing 2018 data, we note a slight regression, with averages of 22% and 25% respectively.

Figure 3: Domestic credit trends in Africa



Source: World Development Indicator Online

To some extent, these cross-country differences are due to differences in industry coverage. In fact, the surveys may target different industries in different countries and in different periods. To assess this, we identify a group of "selected" industries that are covered in all Enterprise Surveys. These are Textiles, Garment, Food, Beverages, and Metals and Machinery. The average fraction in these industries is reported in the last two columns of Table 2. The first observation to make is that the shares across selected industries are close to the average across all industries so that the regularities in the data are robust, on aggregate. However, there can be important differences for specific countries/time periods. We interpret this as indicating that our analysis may miss the experience of a particular country but can indeed portray a sufficient accurate experience on average.

Table 2: Enterprise Survey

Country	Survey Year	Number of firms	All firms		Firms in selected industries only	
			Percent of firms using banks to finance investments	Percent of firms using banks to finance working capital	Percent of firms using banks to finance investments	Percent of firms using banks to finance working capital
Angola	2006	425	2.59	2.59	1.12	1.49
Angola	2010	360	12.69	12.89	11.11	10.61
Benin	2009	150	14.55	39.44	17.24	33.80
Benin	2016	150	20.29	34.69	33.33	27.54
Botswana	2006	342	12.28	19.01	13.10	26.21
Botswana	2010	268	34.81	33.71	34.55	27.06
Burkina Faso	2009	394	25.54	34.73	17.50	39.56
Burundi	2006	270	11.11	24.81	12.23	28.78
Burundi	2014	157	37.10	58.06	42.86	57.63
Cameroon	2009	363	34.32	42.38	36.51	40.57
Cameroon	2016	361	18.71	29.36	26.32	29.00
Cape Verde	2009	156	36.00	45.45	23.33	38.71
CAR	2011	150	24.05	24.83	4.17	13.51
Chad	2009	150	8.42	19.33	14.29	21.67
Chad	2018	153	11.11	13.33	5.56	16.67
Congo	2009	151	6.25	10.17	0.00	16.13
Côte d'Ivoire	2009	526	9.28	8.20	12.33	11.71
Côte d'Ivoire	2016	361	23.36	19.66	23.68	19.42
DRC	2006	340	4.41	7.06	6.25	9.38
DRC	2006	359	9.70	12.01	6.78	9.23
DRC	2010	529	7.69	8.81	6.36	7.56
Eritrea	2009	179	10.00	5.62	18.75	8.00
Eswatini	2006	307	8.14	17.59	10.38	25.47
Eswatini	2016	150	30.19	37.21	34.78	45.59
Ethiopia	2011	644	12.97	16.13	10.26	16.72
Ethiopia	2015	848	19.35	27.36	16.36	32.90
Gabon	2009	179	5.88	8.72	10.53	18.18

Gambia	2006	174	7.47	14.37	9.09	18.18
Gambia	2018	151	8.64	14.57	2.86	9.21
Ghana	2007	494	16.28	16.19	17.04	17.47
Ghana	2013	720	20.45	23.87	22.45	24.46
Guinea	2006	223	0.90	2.69	1.46	4.38
Guinea	2016	150	8.62	15.65	14.29	29.63
Guinea Bissau	2006	159	0.63	1.26	0.00	1.23
Kenya	2007	657	33.33	36.07	43.32	44.19
Kenya	2013	781	45.91	46.15	47.00	52.63
Kenya	2018	1,001	35.92	38.34	36.41	39.41
Lesotho	2009	151	26.67	29.14	18.60	22.22
Lesotho	2016	150	53.49	44.70	56.52	51.35
Liberia	2009	150	11.54	17.33	10.53	17.81
Liberia	2017	151	19.05	18.54	18.60	16.00
Madagascar	2009	445	11.28	19.18	13.58	17.82
Madagascar	2013	532	14.02	18.60	15.85	20.61
Malawi	2009	150	32.00	41.33	29.41	42.47
Malawi	2014	523	32.09	33.89	36.36	36.67
Mali	2007	490	5.26	4.90	7.20	5.98
Mali	2010	360	22.05	27.24	9.84	25.53
Mali	2016	185	46.99	46.07	43.90	39.58
Mauritania	2006	237	2.95	11.81	3.13	16.41
Mauritania	2014	150	15.15	28.97	18.18	30.00
Mauritius	2009	398	37.33	42.27	39.02	44.09
Mozambique	2007	479	6.55	6.47	5.93	5.28
Mozambique	2018	601	9.80	9.40	7.96	8.87
Namibia	2006	329	10.98	21.04	14.47	27.63
Namibia	2014	580	53.09	32.22	34.67	22.44
Niger	2009	150	13.95	35.92	15.38	42.62
Niger	2017	151	18.46	33.57	12.50	15.38
Nigeria	2007	1,891	3.33	4.87	2.55	4.11
Nigeria	2014	2,676	10.01	19.99	10.18	20.21
Rwanda	2006	212	15.57	30.66	23.53	52.94
Rwanda	2011	241	30.70	46.98	43.59	46.84
Senegal	2007	506	16.20	9.09	18.18	10.04
Senegal	2014	601	18.70	14.02	15.15	12.03
Sierra Leone	2009	150	12.50	28.67	9.76	17.65
Sierra Leone	2017	152	12.09	17.11	5.77	9.09
South Africa	2007	937	35.63	23.05	35.33	25.15
South Sudan	2014	738	7.03	5.66	9.52	14.61
Sudan	2014	662	6.87	2.60	0.00	6.25
Tanzania	2006	419	8.83	22.43	11.19	26.92
Tanzania	2013	813	27.53	14.50	33.33	16.23

Togo	2009	155	13.75	21.05	11.11	16.67
Togo	2016	150	26.39	43.54	17.39	44.19
Uganda	2006	563	7.64	14.39	8.98	17.07
Uganda	2013	762	21.86	27.91	23.66	30.79
Zambia	2007	484	16.93	15.70	22.90	19.08
Zambia	2013	720	16.04	14.35	17.16	19.05
Zimbabwe	2011	599	12.62	12.54	12.40	14.63
Zimbabwe	2016	600	18.59	17.54	20.21	24.47
SSA Average			**18.08**	**22.46**	**18.04**	**23.47**

African firms use short term bank loans to support working capital expenditures. They use medium to long term maturity loans to purchase large scale equipment for capital improvement. Working capital loans are used to support firms' short-term operational needs. Those needs can include costs such as payroll, rent and debt payments. In this way, working capital loans are simply corporate debt borrowings that are used by a company to finance its daily operations. However, to support large purchases such as land, large equipment, and building, longer term credit is necessary. This credit often takes the form of investment loans, which may involve pledges or exchanges of equity.

Looking at the data presented in the table 2, we note that more firms use working capital loans than investment loans. This implies that banks are less likely to extend longer term credits to finance the type of investments that allow firms to grow in Africa, assuming that firms are profit maximizing entities. This is in line with the argument that firms in developing countries are constrained to invest in new markets and new products because of factors such as access to long term affordable credit.[12] The dynamic nature of the results is also interesting. We also note the share of firms using credit to finance investment had been rapidly growing by annual rate of 23% between 2006 and 2016, but dramatically slowed down to 12% per annual after 2016. However, the growth rate of firms using credit to finance working capital remains constant. This set of results supports the central argument of this article. It implies that banks became less motivated to invest in long term private sector projects in recent years (corresponding to swelling national debt levels). The growing debt financing burden faced by African governments may have put downward pressure on bank resources, which was reallocated to finance government Treasury bills to the detriment of support for long term private sector investment as illustrated in the Kenya case study below.

Conclusion

Rising debt levels is not the key issue in Africa, as the debt to GDP ratio is below the IMF's and African Monetary Cooperation program's threshold of 60 percent. But rising share of high interest rate debt is slowly crippling the ability of African governments to meet their short term budgetary obligations. This puts pressures on limited domestic resources to the detriment of the private sector.

By answering the three questions raised in the introduction, we conclude that:

- GNI in Africa has been growing at a much slower pace than debt to GDP, implying that most debts are not being used productively in the short run.
- Countries where the quality of governance has slipped (or has not improved enough) but where debt has grown are risking another debt crisis.
- The share of firms using credit to finance investment had been rapidly growing until its recent drop a few years ago while the share of firms using credit to finance working capital remain constant. This implies that banks recently became less motivated to invest in private sector long term investment projects.

These results provide indications of a crowding out effect of national debt, but this crowding out effect mainly impacting private sector access to long term finance rather than shorter term loans to support firms' operational needs.

What does this trend mean for key stakeholders?

For governments, it is important to reduce dependence on expensive financial sources and investigate ways to leverage internal resources to finance long term national projects. This will require that government rethink ways to mobilize fiscal and non-fiscal government revenues that do not further undermine private sector activities. To do that, governments must enhance the efficiency of key revenue mobilization institutions. For example, the Tax Policy Unit at the Ghanaian Ministry of Finance is coordinating with the Ghana Revenue Authority to ensure effective mobilization of domestic revenue. There have been extensive reforms in tax administration in the last few years, since the merging of the Tax and Revenue Agencies into the Ghana Revenue Authority in 2009. Extensive work has been undertaken to merge the structures and processes of the domestic tax divisions and to build their capacity with the objective of providing the taxpayer with efficient and seamless service.

Looming debt crisis is not good for business. It will reduce the types of government expenditures that complement private sector investments and increase prevalence of private sector hostile policies since governments will be forced to consolidate their budget. This may further reduce private sector activities, which in turns will reduce government fiscal revenues in the medium term. At the end, the business environment may become hostile to private sector activities, unless governments qualify for budgetary support from the International Monetary Fund.

Heavily indebted Africa governments increasingly turn to domestic financial institutions to support national debt through the issuance of Treasury bills. While Treasury bills carry no risk, they carry lower interest rates compared to credit extended to finance market activities. As the amount of Treasury bills owned by domestic financial institutions grows, governments may artificially lower interest rates to limit the locally owned debt burden. This was the motive for the interest rate cap imposed by Kenya in 2016. Treasury bills may be risk-free business opportunities for domestic banks and other financial institutions. However, this approach runs the risk of further undermining private sector profit margins.

Author: Francis Mulangu

Editor: Dr. A. Lee Gilbert

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Contact Information:
Que Boxi
Email: cas@ntu.edu.sg
Phone: +65 65138089
Address: S3-B1A-35 Nanyang Business School
Nanyang Technological University
50 Nanyang Avenue Singapore 639798