The birth of African Eurobond markets.

Its causes and possible implications for domestic financial markets

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Abstract

As the recent international financial crisis unfolded in 2007/08 leading to asset prices and interest rates to slump, financial capital around the globe started to search for new investment opportunities. This flight of international capital allowed several African countries to issue US-Dollar denominated sovereign debt on a large scale, as African Eurobonds combined high yields with the relative safety of government bonds in times of an uncertain investment environment. There are two main research questions addressed by the paper: (1) What were the causes for this recent development; and: (2) What are its resulting effects?

To answer question (1) the concepts of the international currency hierarchy and the original sin are chosen as starting point to analyse the phenomenon of recent sovereign Eurobond issuance in African economies. The currency hierarchy is the underlying cause for foreign currency dependency of developing and emerging markets for imports, debt service and the conduct of monetary policies, which in turn results in export dependency and debt denominated in hard currencies. Governments in many African countries managed – often with the help of de-risking policies – to attract international financial capital to go into newly issued bonds temporarily filling in this gap. Question (2) includes the inquiry on what effects this surge in public external debt denominated in foreign exchange might have on domestic financial markets and overall development prospects.

The paper finds that the nascent sovereign bond issuance by many African governments is fully in line with literature on the deleterious effects of the international currency hierarchy and international financialisation. Though inevitable in the face of striking foreign currency shortages in the face of international developments, the sovereign bond issuance comes with the perils of further limited policy space, potentially destabilising effects on domestic banking and financial sectors additionally to an increased vulnerability vis-à-vis international capital markets adding new imperatives and creditors of African governments.

The paper is structured as follows: After the introduction, the second section gives a brief introduction to the theoretical foundation of the paper followed by a historical overview over the past experiences of Asian and Latin-American countries in the 1980ies and 1990ies. After, aspects of debt sustainability. rating practices, policy space, among others, are critically discussed in the fourth section and whilst the paper concludes in the last section.

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Table of Content

1 Introduction

As the most recent international financial crisis unfolded in 2007/08, leading asset prices to slump, investors around the globe started to search for more profitable and relatively safe investment opportunities. This flight to high yields allowed several African countries to issue sovereign debt on international financial markets on a large scale bringing significant changes to sovereign debt markets in Sub-Saharan African (SSA) countries[2]. As the first one having been subject to multilateral debt relief initiatives to enter international sovereign debt markets, Ghana emitted sovereign bonds worth $25bn in 2007. Other African countries – from Nigeria to Ethiopia – followed. Mozambique's, Ghana's and the Republic of Congo's defaulting call to mind that this sort of government finance comes with certain risks for the countries (Allen 2017). A large share of the bonds will mature in the near future. Hence the analysis of those developments is a pressing issue.

However, there are convincing arguments for why some African governments decided to go down this potentially problematic path of issuing debt denominated in foreign currency on international markets – despite past experience of external public overindebtedness. Three of such reasons will be considered here. Firstly, they strongly rely on foreign exchange as means to pay for imports, redeem debt and conduct monetary policies. As many African countries are undiversified with primary raw materials dominating their export structure, the price swings and falling prices of primary commodities as the crisis evolved hit them particularly hard with declining foreign exchange income as result. Secondly, these governments face the problem of not being able to issue debt denominated in their own currency as the latter is situated in the lowest ranks of the so-called currency hierarchy. Thirdly, falling asset prices due to the financial crisis of 2007 opened a window of opportunity to gain large sums of foreign exchange as international financial capital was seeking relatively safe and still high-yielding investments. These aspects have to be read against the backdrop of international financialisation bringing about fundamental changes to the interrelation of developing and emerging markets (DEM) and international finance (e.g. Bonizzi 2013; Bortz and Kaltenbrunner 2018).

This paper is a novel contribution as it focuses on a region so far neglected in the literature on financialisation and development with South-Africa as exception (Karwowski, Fine, and Ashman 2018). It finds that the dilemma of persistent foreign exchange dependency, falling or stagnant foreign exchange-income and the position in the lower ranks of the currency hierarchy provides a conclusive explanation for why many governments in SSA countries have turned to sovereign bondmarkets in the past decade to temporarily ease balance-of-payment difficulties, roll-over existing debt, conduct stabilisation policies and finance investments. However, the sovereign bond issuance comes with certain risks like a growing vulnerability vis-à-vis external spill-over effects from international financial markets and a further limitation of policy space despite growing economic challenges calling for more governance.

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[2] Though we are aware of the critique brought forward against the widely applied distinction between the North- and Sub-Saharan African countries, as a continuation of the term *Black Africa*, we nevertheless adhere to it. The wide-spread use in the academic literature makes a deviation hard as data is often aggregated and most literature follows this taxonomy.

The paper chooses the onset of the noughties up to today as time frame to allow for a comparison between the pre- and post-crisis period which well-demonstrates the validity of Post-Keynesian reasoning on flight to higher yields of international finance and its consequences. The paper is structured as follows: The next section provides an overview over the theoretical background of the paper followed by a cursory historical insight in past experiences of Asian and Latin-American countries with international capital markets. The fourth section contextualises and analyses the recent Dollar-denominated sovereign bonds (Eurobonds) issuance by many African governments. Section 5 discusses the findings and conclusions are summarised in the last section.

2 Theoretical background: The foreign currency dependence, capital flight and sovereign bond markets

Large-scale borrowing by African governments via the issuance of Eurobonds is rooted in the dire need for foreign exchange. Income in foreign exchange is required for imports, debt redemption and the conduct of monetary policies. Most African countries are still largely dependent on imports of manufactured goods not only in the form of consumer goods, but also of capital goods to diversify production. The latter can be regarded as a prerequisite for structural change, i.e. the shift from the agrarian to the industrial sector generating mass employment and spill-over effects (see Gerschenkron 1962, 6–11; Dasgupta and Singh 2006, 1; Cantore et al. 2017). Often, the borrowing of debt denominated in international currencies is carried out to avoid arrears on older debts. Against the backdrop of such Ponzi-schemes or debt-roll-overs, the question of debt sustainability becomes especially relevant. A third aspect of the dependency on foreign currencies consists of the conduct of monetary policies especially exchange rate stabilisation measures in the face of capital in- and outflows. According to the Guidotti-Greenspan rule, safeguarding provisions of foreign exchange should be as high as three months of imports or as high as a country's short-term external liabilities. The holding of foreign exchange is costly and risky, however: The country holding the foreign exchange bears the risk of exchange rate fluctuations and asset price declines of government bonds in which the foreign exchange is normally held (Akyüz 2013, 13–8). This dependency on foreign currency and its shortage form the core of Latin-American structuralist development theory (see Martinussen 1997, 74ff.).

The high degree of dependence on foreign currency is paired with a low income in foreign reserve currencies. Most SSA-countries still have a largely undiversified economy (see Hausmann et al. 2014, 64ff.). This translates into an export structure dominated by primary commodities. But according to the Prebisch-Singer-Hypothesis there is a long-run price divergence between primary commodities and manufactured goods with the terms-of-trade of commodity exporters deteriorating (Harvey et al. 2010, 367). Even when exceptions to the norm seem to temporarily suspend the validity of the Prebisch-Singer-Hypothesis, i.e. in times of price hikes of primary commodities such as during the oil price peaks in the 1970ies and -80ies, in 2007/08 and 2010/11, exporters of primary commodities do not profit from this price rise (Adam and Ajakaiye

2011). On the contrary, most of them faced foreign exchange shortages as oil price peaks make the import of oil expensive (see for e.g. Ethiopia: Rashid 2010). As many of the commodity-dependent countries rely on the imports of staples, the same applies to the price spikes of foodstuff (Headey and Fan 2010). This shows that even in times of commodity price spikes, countries with raw materials as sole or dominant export goods do not profit from the price rise, but are in contrast harmed (Adam and Ajakaiye 2011). Going against mainstream economic theory, the Harberger-Laursen-Metzler effect describes how deteriorating terms of trade lead to a deterioration of the current account and a reduction in savings as expenditures rise in an attempt to uphold the living standard despite lowered export revenues (Huang and Meng 2007). Additionally to the unfavourable terms-of-trade, the prices of primary commodities have a much higher degree of volatility which, again, has deleterious effects on economic development (UNCTAD 2004; Sindzingre 2006). It becomes clear that the export of raw materials is a poor source for the generation of foreign exchange compared to the export of manufactured goods (Sindzingre 2006).

Looking at the potential of many developing and emerging economies (DEE) to escape this commodity dependence gives little reason to hope. The international division of labour in the global value chains is completed, earlier stepping stones of industrialisation (e.g. apparel production) are occupied by South-East-Asian producers and African low- and middle-income countries have hence little to no chance to find a niche in the market for manufactured goods or high-value services. The unfavourable conditions low- and middle-income African countries are facing take place against the backdrop of overall developments detrimental to the profitability of investments in the "real economy", which have the potential to generate employment and high and stable revenues. Processes of financialisation can lead to economic circumstances where 'nonproducible money can dominate labour-using capital as a means to accumulate wealth' (Paula, Fritz, and Prates 2017, 3; see also Weller and O'Neill 2014; Hein and Treeck 2010). The perpetual dependence on the export of primary commodities not only leads to low capacities to generate foreign exchange but also a higher degree of vulnerability vis-à-vis global developments that lie beyond the sphere of influence of the countries concerned such as price swings of commodities which are much greater than those experienced by earlier developers and those by Asian countries when catching up (Sindzingre 2006, 13).

This discrepancy between the dependency on foreign exchange income and perpetuated low income thereof takes place against the backdrop of the current financial architecture which is characterised by a hierarchical structuring of currencies. The international currency hierarchy describes the hierarchical ranking of currencies in respect to their real or expected liquidity. Liquidity of an asset describes the degree of its property to be exchangeable with little delay and with no or minimised loss in value. The currency hierarchy hence describes the structuring of currencies according to their ability to fulfil all functions of money on an international level; namely to serve as means of exchange, to store value and unit of account. The currency hierarchy as analytical concept is rooted in writings of Keynes, who was already aware of the limits of fiscal policies with the

problems the currency hierarchy pose unaddressed (Paula, Fritz, and Prates 2017, 2–7; quoting Krugman 1978: Taylor 1998, 666).

International reserve currencies are in the highest ranks of the currency hierarchy because they enjoy the highest confidence in their liquidity and therefore the highest liquidity premium, which results in a high expected return (Paula, Fritz, and Prates 2017). The US-Dollar is positioned on the top of the currency hierarchy as it serves as the key currency with the potential to fulfil all three functions of money on an international level: 1. unit of account as most commodities traded internationally and many debt contracts are denominated in US-Dollars; 2. means to store value accepted by institutions such as central banks to store assets and liabilities in; and 3. means of transactions as only reserve currencies with the US-Dollar leading the way are used as invoicing currency for most international exchanges (Schulmeister 1998). The US-Dollar is followed by the Euro, Yen, Swiss Franc and Renminbi etc. Currencies of peripheral countries are situated in the lower tiers of the currency hierarchy (Prates 2017).

The low position in the international currency hierarchy of African currencies is the reason for the foreign currency dependency these economies suffer from: it results in DEE's inability to issue bonds on international markets denominated in their domestic currencies, something what Eichengreen et al. coined the *original sin* (Eichengreen, Hausmann, and Panizza 2003). As currencies issued by DEEs are among the lowest ranks of the currency hierarchy, particularly high interest rates have to be paid on assets denominated in these currencies to compensate for their low liquidity (Paula, Fritz, and Prates 2017, 3). The international currency hierarchy comes with a subordination of global economic conditions under the provision with liquidity in the form of core currencies. Countries that provide international currencies face the so-called Triffin Dilemma: the impossible trinity of sufficient provision with liquidity of international markets, autonomous monetary policies of the international currency issuing nation and a sustained confidence in the international currency by the international community. The sufficient provision of a reserve currency premises the issuers' readiness to run current account deficits. However, once the deficits grow too large, the confidence in the reserve currency might deteriorate rendering other reserve assets such as gold more popular (Akyüz 2013, 16).

As the international financial crisis unfolded, marked by a credit crunch, illiquidity of financial markets in OECD countries and few other exit-options for investors, even government bonds issued by countries formerly considered too risky to invest in became relevant for investment decisions (Allen 2017). Governments by many SSA countries seized the chance to receive credit ratings and to issue Eurobonds met by high demand to cover long-term financing needs denominated in US-Dollar.

Those novel developments are in accordance with Post-Keynesian thinking on international financial flows: portfolio decisions are primarily influenced by the desire to achieve high yields at low risk constituting a competition between investors over profitable investment opportunities yielding the highest rates of expected returns. International capital hence invests in assets denominated in a particular currency where the expected return is the highest (Paula, Fritz, and Prates 2017, 2–3). Portfolio diversification as driving force behind

cross-border capital flows makes these flows riskier as they are likely to be very volatile (Hull and Tesar 2001). Whilst public debt securities are still relatively secure in times of overall heightened uncertainty over economic prospects and with the IMF standing ready as lender-of-last-resort since the early 1980ies (Eichengreen 2004, 42), African Eurobonds were additionally attractive due the extremely high yields paid on them. On average African Eurobonds earn 6%, which makes them the highest yields in the world (Wallace 2018). The denomination of the sovereign bonds in US-Dollar makes them free of exchange rate risks and liquid. This nascent access to international financial markets by some African countries is hence a window of opportunity which has to be read against the backdrop of flight to higher yields of international finance.

3 History repeating itself? Experiences of Latin-American and Asian countries in the 1980ies and 1990ies

The new emergence of an African Eurobonds market represents a change in the nature of capital flows – a change that was foregone in Asia and Latin-America during the 1980ies and 1990ies. This change was described as a shift from syndicated bank-lending to officials, which still prevailed in the 1980ies, to short-term loans, portfolio lending and equity finance leading to the dominance of market expectations over official policies deciding on the access and conditions of finance (Mishkin 2001, 57; Eichengreen 2004, 14; Mussa et al. 1998). An example for this represents the return of bond finance in the case of Mexico prior to the outbreak of its debt crisis in the 1990ies (Eichengreen 2004, 188). Apart from the nature of the capital flows, the international financial investments of the 1980ies and 1990ies also posed a novelty in respect to the recipient countries. Whilst investments in the 19th century and the 1920ies predominantly went to industrialised countries (and Argentina) and in the 1970ies to middle income countries, investors started to discover low income countries in the 1990ies (Eichengreen 2004, 45).

There were multiple causes for the high influx of capital to new frontiers in the 1980ies. High inflation rates combined with increasing levels of international liquidity in the 1970ies meant a high level of international liquidity where 'large amounts of finance [were] chasing a limited number of investment opportunities' (Eichengreen 2004, 37). A commodity price boom led to a dramatic increase in funds of commodity exporters, in particular oil producers. Borrowers were enticed to make use of those newly available funds as inflation rates were high with real interest being negative. This development was intensified when industrialised countries went into recession in 1979 with impeded global trade and a limitation of capital exports and higher interest rates – the LIBOR for instance hiked from 9% in 1978 to 17% in 1981 – as results. All those factors caused in an increase in sovereign lending to countries previously not considered as investment destinations. Subsequently, there was a massive increase of foreign debt to maintain domestic demand in DEE: the debt-to-export ratio of non-oil-exporters grew by 23% between 1980 and 1983; in Latin-America even by 38% (Eichengreen 2004, 39ff.).

The scope of inflows increased manifold in the 1990ies: whilst capital inflows to Latin-American countries stood at about $8 billion in the middle of the 1980ies, they rose to $40 billion by 1991, of which 45% went to

Mexico. The growth of inflows cannot be explained by reforms undertaken by the countries alone, as some counties did not reform, but more by global structural factors (Calvo, Leiderman, and Reinhart 1997, 339) – though liberalisation policies implemented by military juntas leading to the opening up of capital accounts certainly must have played a role in improving the attractiveness as investment base (for the examples Uruguay and Chile see Hanson 1997). But risen levels of international liquidity were the core determinants of these capital flows. Deepened financial globalisation and the expansionary monetary policies conducted by industrial countries as response to recessional downward pressure led to big interest rate differentials that caused the capital flows e.g. in 1990 to 1991, which did little to lower these spreads. The sudden drop in the US-American interest rate on short-term debt also improved the solvency position of Latin-American countries as much of the previously issued debt had floating rates. This eased the debt service on external debts. However, due to the recession in the USA, export potentials were reduced and the subsequent current account deficits had to be financed out of additional debt, which was aggravated by deteriorating terms-of-trade. The low interest rate in the US led to capital outflows from the US as institutional investors shifted their assets abroad. What is also striking was the mere size of global funds, which grew from $3 billion in 1988 to $28.5 billion in 1992. This was not least caused by financial deregulation – a driving force behind financialisation (Epstein 2005)– by industrialised countries, which came with lower transactions costs of capital movements to emerging markets (Calvo, Leiderman, and Reinhart 1997, 357; Taylor 1998)

The massive capital inflows led to a dramatic appreciation of the real exchange rates of the domestic currencies of these countries, a boom in stock and real estate markets, generally high growth rates and increases in foreign reserves. This helped to keep up consumption despite lower levels of income, but spurred inflation and further contributed to the dramatic appreciation of domestic currencies. The sharp appreciation of the real effective exchange rates after large capital inflows, was observable in all Latin-American countries except in Brazil, despite differences in policy responses (Calvo, Leiderman, and Reinhart 1997, 347ff.; Buch, Heinrich, and Pierdzioch 1999, 6).

The accumulating debt burdens led to a serious of sovereign defaults and banking crises. Whilst the 1980ies saw numerous debt crises mainly originating in banking sectors, the 1990ies saw fewer but more severe crises (Sy 2004, 2847). Crises were normally triggered by a sudden reversal of capital flows as result, leading to a massive loss of reserves and consequently to depreciations of the domestic currencies averaging about 40%, with the domestic economy collapsing as effect (Cline 2001, 55). The devaluation of the domestic currency led to a lower net-worth of domestic banks which resulted in higher refinancing costs for these banks in international capital markets, where interest on foreign loans served as risk premium. The consequential loss in foreign exchange and the resulting inability of governments to conduct exchange rate stabilisation policies accelerated the spill-overs from the initial currency to a banking crisis. Whilst the crises often originated in the banking sector in the case of Asian countries (Buch, Heinrich, and Pierdzioch 1999, 6), in the case of the Latin-American countries, the crises often started off with a sovereign default or arrears. The latter resulted in

a loss of confidence in a country as investment destination as a whole destabilising the domestic banking sector with a recession and spill-overs in other sectors and economies as result. The destabilisation was often brought by from outside. Mexico's defaulting, for instance, sparked panic reactions that spilled over to other countries. The high degree of contagion was not least due to Mexico serving as a kind of benchmark for investors going into emerging markets (Eichengreen 2004, 187f.). The debt crises in Latin-American countries were followed by privatisation and deregulation policies, which made them in interesting destination of international investors once again (Calvo, Leiderman, and Reinhart 1997, 357).

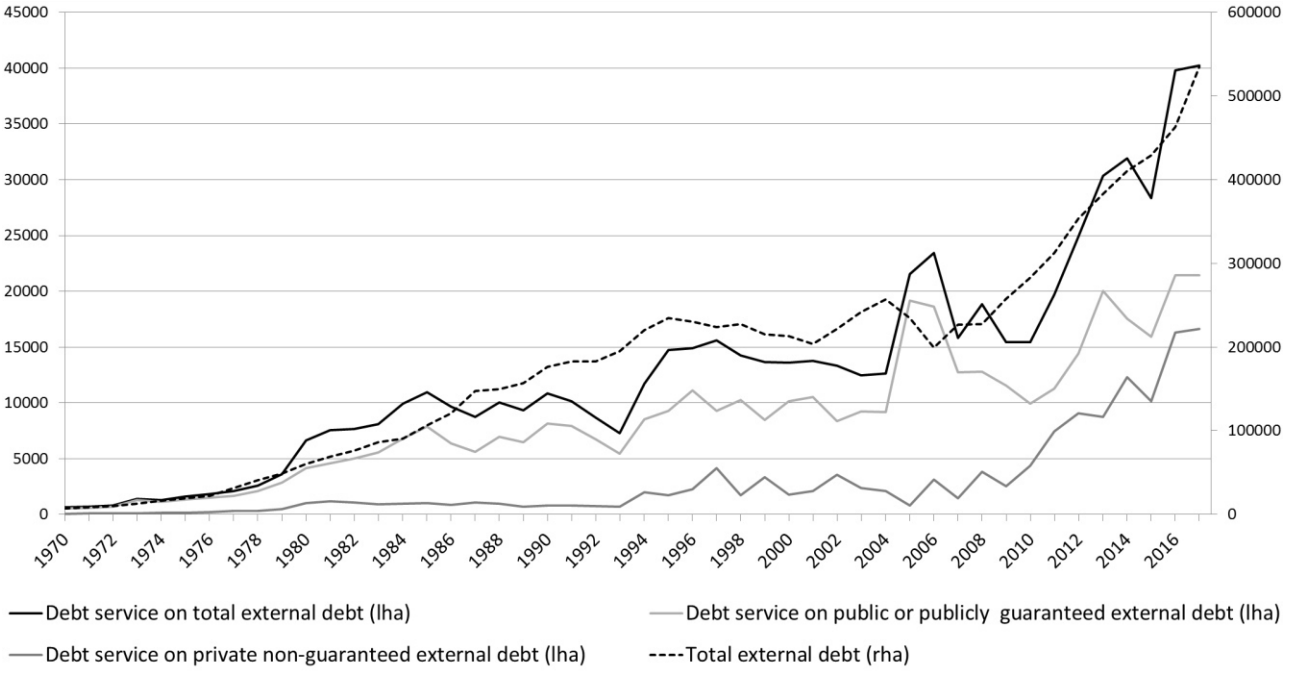
The capital inflows into Latin-American counties were paralleled by other inflows into Asian where seemingly an economic miracle took place. As in the case of Latin-America, Asian countries' capital account as share of GDP increased (in Latin-American countries by 2.5%, in Asian countries by 2.3%), reserves (excluding gold) and stock market values grew. South-Korea started to receive capital inflows in 1988, other Asian countries a year later. Additionally to the structural factors facilitating international flows cited above, in the case of Asian countries, the sluggish rates of profits in Japan and the USA led firms to invest in countries with a lower wage level. What is more, in other Asian countries higher rates of return on investments in stockmarkets were expected compared to those in Japan and the US. In comparison to Latin-America, Calvo et al. (1997, 361) emphasise that about 40% of capital inflows into Asian countries consisted of FDIs, which are assumed to be more prone to go into investment and to be less likely to experience a sudden reversal. However, data on FDIs have to be treated cautiously as FDIs are often used for tax evasion purposes (Bortz and Kaltenbrunner 2018, 380), the claim of FDIs being more stable should therefore be treated with caution. Capital flows to South-East Asian Tigers were reversed once the confidence in benchmark countries like Japan deteriorated and investors scrabbled for funds and fled into US-T-bills to rebalance their portfolio after having lost out in other markets (Calvo, Leiderman, and Reinhart 1997, 357ff.; Eichengreen 2004, 251ff.; Radelet and Sachs 1998).

4 Putting African debt markets into perspective

Though the issuance of Eurobonds by African countries is a novelty since the outbreak of the financial crisis, accumulating public external debt started in the 1980ies. Especially the price slump of non-oil primary commodities vis-à-vis the sudden rise of the US-American policy rate in the mid-1980s deemed many Sub-Saharan countries to fall into unsustainable indebtedness – with growing arrears as result despite bi- and multilateral cut-offs. The defaults in Latin-American countries against the backdrop of the dramatic rise of debt in many African countries raised concerns about the debtor countries' ability to cope with its debt burden and the financial system as a whole. By 1995, the debt burden on the African continent accumulated to US$ 340 billion, 75% of which was official external debt (UNCTAD 2004, 3–5). The debt release initiatives Highly Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) in 1996, 1999 and 2005 initiated by the Paris Club and often attached to conditionality tried to ease the debt burden – however with little success. By 2006, eight out of 13 debt relieved countries trespassed an unsustainable threshold again.

Despite the debt relief, between 2001 and 2014, the Highly Indebted Poor Countries' debt service relative to GDP declined only by 1.8% (IMF 2018, 2).

The reinforcing factors of currency dependency of peripheral countries have to be considered when analysing past and recent developments of public external debt levels in SSA countries. As reasons for this new surge in public external debt, the HIPC's export structure and commodity dependence were pointed out to (Reinhart and Rogoff 2008, 6.32). Especially in non-oil exporting countries, the high volatility of primary commodity prices and their downward trend yield the risk of an unsustainable debt burden for primary commodity exporters. This could be observed after the second oil price shock: in many SSA countries, the debt-to-GDP-ratio rose from 38 to 70% between 1980 and 1987, where most borrowing came from the Bretton-Woods-Institutions (UNCTAD 2004, 8.21). It was observed that non-oil exporting low income countries are more prone to suffer from unsustainable debt levels than their manufactured goods and service exporting counterparts. Hence, this dependence on the export of commodities – and not high levels of debt – seems to be a cause for low GDP and persistent poverty levels.

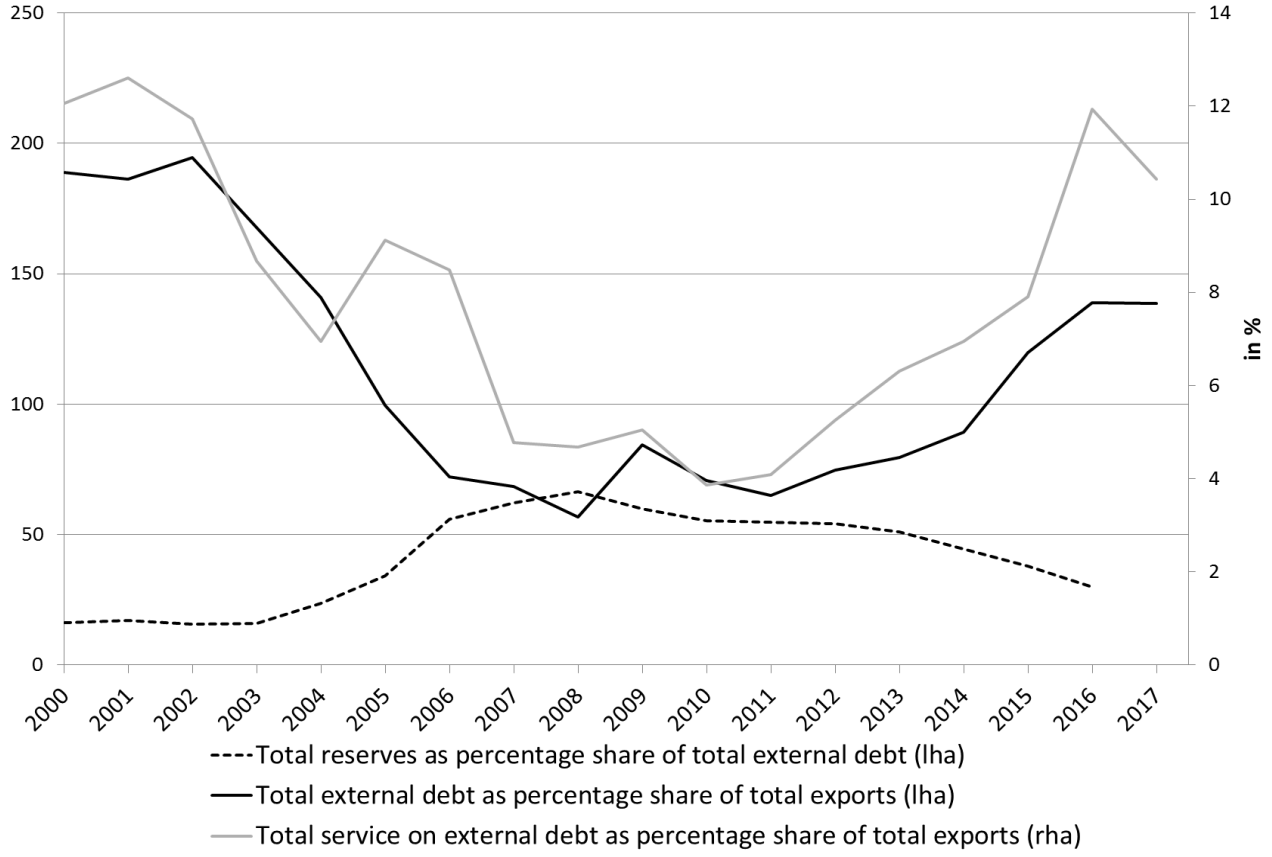


Graph 1: Overall debt stock and debt service on external debt in low- and middle-income SSA countries, in current million US-Dollars, 1970-2017. Own presentation of data from World Bank (2019).

Graph 1 shows the continued increase in debt stock and service on external debt since the 1970ies. Though the overall debt stock is on a continuous rise, only briefly interrupted by small declines thanks to the debt relief initiatives, growth rates of the debt stock are particularly high since 2008. This resulted in an increasingly heavy debt service burden, which rose sharply for private debt since 2009, whilst the debt burden on public and publicly guaranteed debt caught up from 2010 onwards. Interestingly, the composition of the public and publicly guaranteed debt has changes: whilst in 2006, 50% of this debt was denominated in US-Dollars, it was 62% by 2017. The share of debt denominated in non-compound, non-European and non-US-Dollar currencies

has also gone up from 12% in 2006 to 25% in 2017 (World Bank 2019). This indicates a growing importance of the US-Dollar in SSA-debt markets on the one hand, and a higher degree of diversification of the currency composition of external debt away from traditional international currencies on the other hand.

Graph 2 puts the debt burden into relation with the ability to pay it back. Whilst debt-to-export ratios as well as debt-service-to-export ratios grow since 2010, the reserves-to-external-debt ratio declined from 2008 onwards. In fact, the latter halved, dropping from 62% in 2007 to a mere 30% in 2016 (World Bank 2019).



Graph 2: Total external debt and debt service as percentage share of total exports and total reserve as percentage share of total debt of low and middle income SSA economies, in percentage, 2000-2017. Own calculation and presentation of data from World Bank (2019).

It becomes clear that the need of SSA countries to resort to external borrowing to gain hard currency is still unabated and has become a more pressing issue since 2007/08. The mushrooming of sovereign bonded debt denominated in international currencies issued by many African governments since 2007 has to read against this backdrop (see Appendix 1), which added large private institutional investors such pension, mutual and sovereign wealth funds to the list of creditors of African economies (Tyson 2015, 15). Ghana was among the first by issuing a $25 billion bond note at ten years maturity in 2007 (Allen 2017). Ethiopia is the poorest country to enter the sovereign bond market when it issued a $1bn note with ten years maturity in 2014 (Blas and Manson 2014). In 2018 alone, the total volume of newly issued Eurobonds denominated in US-Dollars and Euros in Africa stood at $18.3bn. It is estimated that about 70% of Africa's foreign debt is denominated in

either US-Dollar or Euro (Songwe 2018). It here follows a global trend of a growing US-Dollar denominated bond issuance in emerging markets (B.I.S. 2018).

5 Discussion: Debt sustainability, policy space and implications for domestic markets

The issuance of Eurobonds comes with a number of advantages and disadvantages. As pointed out above, it is rooted in the urgent need to access foreign exchange on the one hand – exacerbated by instabilities originating elsewhere –, and the bad or even deteriorating conditions to generate foreign exchange via exports on the other hand. An advantage of bond issuance is the relatively long maturities, which makes them less risky as they are not subject to quick reversals – often the starting point of a financial crises in emerging markets economies (Mishkin 2001, 55) – and the mere size of funds made available at once. Hence sovereign bonds can provide a big lump-sum of funds dearly needed for macroeconomic stabilisation policies and infrastructural projects and hence temporarily enhance policy space in order to overcome the "survival constraints" (Angrick 2018).

The Eurobond issuance offers an opportunity to receive large sums of foreign currency at once. Bond issuance is an important source of long-term finance and gives governments a longer time horizon necessary for the realisation of investments such as infrastructural projects (World Bank 2018, 6). The long-term maturities of bonds can therefore avoid maturity mismatches arising from short-term finance for long-term projects. The apetite for SSA Eurobonds seems unabated despite rising interest rates in the centre countries: there is a fourfold increase of bond issuance in 2017 compared to 2016 (World Bank 2018, 12).

However, the disadvantages of Eurobonds weigh heavy. The growing vulnerability vis-à-vis a multicity of international financial investors, the threat of over-indebtedness, financial instability and the consequential narrowed policy space constitute downsides to this means to access lump sums in foreign exchange. It has been argued that in the case of over-indebtedness in recent decades, the number and nature of creditors as well as the jurisdiction under which the bonds are issued get in the way of an orderly debt-restructuring mechanism in case of arrears.[3] Comparing the Baring Crisis in the 1890ies in Argentina to the Mexican Crisis (1994-95), Eichengreen comes to the conclusion that the bigger number of stakeholders in modern times makes secret and timely agreements that could avoid escalating panic reactions by investors harder to achieve (Eichengreen 2004, 210f.; similarly: Padoa-Schioppa 2001, 206). Since international capital markets have become the most important source of access to capital, declaring arrears or defaulting on debts prove more costly as they prohibit the access to capital markets in the future and tend therefore to be avoided by governments (Cline 2001). Notwithstanding, for example, Argentina stalled its debt payments from 2001 until 2005 and only managed to issue sovereign debt in 2016 again (Rizzi 2018). The continuation of debt service is made possible even when reserves have come to an end as the IMF stands ready as lender-of-last-resort

[3] Whilst US-American law for instance requires unequivocal consent of all creditors, under British law only the large majority of creditors have to agree on the restructuring of debt (Mishkin 2001, 77).

conditioned to the adherence to structural adjustment programmes (Mishkin 2001). Turning to Bretton-Woods-Institutions as lender-of-last-resort might lead to a Ponzi-Scheme of debt roll-overs with limited policy space due to conditionality of the emergency loans (and the debt reliefs) as result (Sindzingre 2006, 15). Both in the case of denied access to capital markets due to defaults as well as when the IMF imposes structural adjustment programmes, the in any case small policy space of the countries in question is considerably narrowed (Taylor 1998; Kregel 2009).

Arrears and defaulting not only result in restricted or more expensive access to international capital markets but also has implications for domestic financial markets. The case of Mexico demonstrated that a governments' defaulting can have implication for the investors' confidence in the country's agents' overall solvency, despite their risk of defaulting being considerably lower (Hanson 1997, 389). Here the sovereign bonds serve as benchmark as it is the least risky. Because of this 'sovereign ceiling', a downgrading of country can lead to a downgrading of financial assets originating in this country (Eichengreen 2004, 272). Vice versa, the issuance of government bonds, the default on them and the subsequent crises can also precede investment in the private sector as could be seen in the aftermath of the Latin-American crises, where privatisation and liberalisation policies increased the attractiveness of the countries for foreign investors once more (Calvo, Leiderman, and Reinhart 1997, 357).

What is more, capital inflows come with an appreciation of the domestic currency, similar to the mechanisms at work with the so-called Dutch Disease (Corden 1984), an increased volatility of the exchange rate, respectively – independent of what policies are applied (Calvo, Leiderman, and Reinhart 1997, 348). A steep appreciation of domestic currencies was observed in all Latin-American countries except Brazil foregoing their crises, as well as in DEMs after the outbreak of the financial crisis and subsequent considerable capital inflows which also seems the case in some African economies such as Ghana and Ethiopia (as e.g. in Kaltenbrunner 2018; Kaltenbrunner and Paincaira 2017, 296). This not only favours imports over exports which leads to a widening current account deficit, terms of trade shocks, respectively (Hanson 1997, 348). But it also leads to a misallocation of resources, when flows are large and sudden. When capital flows are reversible at short notice, capital inflows – or the reversals thereof – often lead to crises which range from financial crises of the domestic financial sector, currency crises and/or governance crises (Calvo, Leiderman, and Reinhart 1997, 343.376; contradicting Hanson 1997, 394, asserts that price fluctuations can be buffered by capital inflows). It is highlighted that normally a currency crisis is followed by a downgrade which in turn as a sovereign default as consequence (Sy 2004). This holds particularly true for when the exchange rate is managed when it is suspected that the government lacks the necessary foreign exchange to conduct necessary stabilisation policies – as might be the case with Ethiopia.

Both in the case of appreciations (due to inflows) and depreciations (due to outflows), the confidence in the country as investment destination and its currency suffer leading to an even higher risk premium to be paid on assets originating in this country, denominated in its currency, respectively (Hanson 1997, 421). The higher

volatility of exchange rates hence leads to a decreased share of portfolio investments held in this currency, i.e. deteriorating the position in the currency hierarchy (Padoa-Schioppa and Papadia 1983).

Apart from an appreciation of the domestic currency and a higher volatility thereof, an additional burden is put on the domestic economy by the rise in interest rates as result of inflows. According to the interest rate parity theorem going back to Irving Fisher, as the appreciation of a currency continues, the expectations of an eventual devaluation strengthen, too. Therefore the holders of the assets denominated in the appreciating currency have to be compensated for this risk with higher interest rates (Hanson 1997, 399). It argued that central banks of countries whose currencies rank in the lower ranks of the currency hierarch have to maintain an interest rate high enough to curb inflation to prevent the flight in assets denominated in foreign exchange by domestic agents as this would undermine the confidence in the currency even more. Central banks of foreign exchange restrained counties also have to sustain the attractiveness of the country as investment destination for international investors in times of when more capital inflows are needed for instance to serve older debts. This need of central banks to obtain the confidence in their currencies via the interest rate is said to entrench the current international division of labour as higher domestic interest rates are to the detriment of economic transition which makes the equalising of income levels across countries impossible (Lüken-Klaßen 1993, 13). It is said that the lowering of the policy rate is feared by central banks as it might result in capital to flow out of the country and that this would devalue domestic financial assets leading to a portfolio shift further deteriorating their ranking (Bortz and Kaltenbrunner 2018, 384).

High interest rates choke the domestic economy and hence pose an additional burden apart from those already imposed by the high volatility of exchange rates (Hanson 1997, 400). In times of distress, the high interest rates combined with lowered levels of capital inflows lead to arrears by debtors to the domestic banking sector which in turn destabilises the domestic financial sector making the need for governmental bail-out policies and subsequent high public deficits more likely (Hanson 1997, 414). What is more, as capital flows out again, this suppresses inflation, letting the real interest rate rise (Hanson 1997, 418). Here it becomes clear that shocks induced by the capital account can have negative impacts on the current account (Hanson 1997, 394).

The pro-cyclicality of financial flows is rooted in conditions lay in global economic conditions with implications for the liquidity of international capital markets. As expansionary policies in reaction to the global financial crisis slowly come to an end, with languishing economic outlooks still lingering on, the conditions on sovereign bond markets of SSA countries seem to change. The potential to service the debts depends on conditions lying in the international sphere such as the provision with liquidity provided by the USA, the Eurozone and other countries issuing international currencies. Protectionism in the Trump-era, trade wars, austerity measures in the Euro-area and the slow abandonment of QE-policies and historical policy rates and the subsequent appreciations of the core currencies might pose problems in the future in the form of debt crises (Reinhart and Rogoff 2008, 6). With the step by step lifting of the US-American policy rate since the end of 2015 – despite

the decision in July 2019 to lower it again –, the ensuing appreciation of the US-Dollar results in the debt burden represented by the Euobond issuance to grow in real terms (Schulmeister 1998; Songwe 2018). As interest rates rise in industrialised countries in the higher rank of the currency hierarchy, investors are less willing to accept higher risks for the sake of higher yields. This trend is already observable in the recent years: the inflows of long-term financing capital into low- and middle-income countries in 2016 is much lower than in the period from 2012 to 2014, which is according to the World Bank the result of downgrades and lowered liquidity of the markets (World Bank 2018, 6–7). At the beginning of 2017, Moody's for instance downgraded four of the 19 sub-Saharan African issuers of sovereign bonds in its rating (Allen 2017). Rating agencies have been said to down-grade after a currency crisis breaks out, exacerbating the distress suffered by the concerned countries even more (Sy 2004). Hence in sovereign distress, the downgrading of sovereign bonds leads to higher spreads on sovereign bonds between the most liquid bonds and those issued by the distressed country and consequently increases the costs of capital when most needed for the latter (Sy 2004, 2847). As a consequence, sources of finance in low-income African countries are drying up as investors go to alternative options now yielding increasing profits at lower risks.

Additionally to the procyclicality of financial flows and the ratings accompanying them pose another burden on African governments having engaged on sovereign bond markets. Ratings of debt issued by low- and middle income Sub-Saharan African countries result in extremely high costs for those debt instruments. On the one hand, commentators put forward the claim that there is an under-pricing of risk, i.e. that yields despite being the highest in the world do not fully reflect the full degree of risk which holds particularly true for commodity dependent countries (Allen 2017). Here, ratings add on the risk premium 'related to the price risk on the mono-export' (Hanson 1997, 385). Though this might be true, there is a hen-egg-problem, as the bad ratings lead to yields being very high as compared to those of OECD-countries making the debt service exorbitantly difficult. That ratings are not only based on objective indicators but are often biased against developing and emerging market economies was exemplified prior to the crisis when rating agencies rated low-income Asian countries more unfavourable than European countries (e.g. Iceland) despite the similar fundamentals and the same degree of vulnerability and exposure to financial risks (Akyüz 2013, 27). That SSA-countries suffer from an African stigma which comes with a higher estimation of risk adds to the well-founded concerns that given the unfavourable conditions, sovereign debt issued by SSA-countries bears the risk of arrears and defaulting. One commentator well expressed the tendency to generalise by subsuming extremely heterogeneous countries under the umbrella term Africa by writing: 'potential investors […] have to bear in mind that Africa is not a risk-free asset' (Allen 2017). And furthermore: 'investors should watch for across the continent when contemplating buying into a sovereign bond' (Allen 2017) – a comment hard to imagine in a European context for instance as it is oblivion to the vast degree of heterogeneity on the African continent. This tendency to assess financial assets riskier when they originate in the African continent results in a higher risk premiums paid on these assets and hence aggravates the debt burden. Keynes already pointed out to market

expectations to be formed under fundamental uncertainty (Bortz and Kaltenbrunner 2018, 383; for a conclusive study of how social conventions shape market expectations with performative feedback loops as result in the case of exchange rate markets see: Kaltenbrunner 2018).

As reaction to the high assessments of risk, mainstream authors have proposed to deploy policies to reduce the risks for investors. Cline (2001, 76) for instance proposes to refrain from bond clauses with high protection for the debtor countries as this results in a 'emerging market stigma'. Other policy recommendations encompass the reduction of 'country policy risk' such as taxation, volatile inflation, interest and exchange rates (Hanson 1997, 385) – not withstanding that these 'country policy risks' have the same underlying reasons why governments engage on sovereign markets to begin with. Policies seemingly adhering to this logic have recently put into practice in the form of "de-risking policies" to incentivise investments in debt instruments and/or to lower the interest paid on these. De-risking is currently underway in the context of Green Finance, i.e. debt instruments earmarked to finance renewable energy infrastructural projects (e.g. Sweerts, Longa, and van der Zwaan 2019; IRENA 2016) under which many of the Eurobonds issued by SSA countries can be subsumed. These de-risking policies take measures to further the borrowers' credit worthiness such as flexible rates taken in the 1990ies to a new level (Eichengreen 2004, 192) and pose another limit to policy space of the governments concerned. But they are far from being new: in Argentina, investors were incentivised to invest in railways by public guarantees came into effect when revenues were not high enough (Eichengreen 2004, 194). Given these unfavourable conditions of expensive debt combined with poor potential to generate sufficient foreign exchange for debt service, the debt repayments might hence prove unviable due to maturity and currency mismatches (ADB 2018, xiv). Not least to the recent rise in government Dollar-denominated bonds, debt-to-export- and debt-to-GDP-ratios are on a dramatic rise – a tendency seemingly prevalent in most low and middle income SSA countries (see Graph 1; World Bank 2018, 12–14). The defaults of Ghana, Mozambique and the Democratic Republic of Congo on their sovereign bond debts call the likelihood of debt repayment into question (Allen 2017). High burdens of debt can have deleterious effects on the economy as a whole. It is argued that a debt overhang results in poor policies and disincentives private investments (Arslanalp and Henry 2006).[4] The resulting balance-of-payment crises and subsequent restricted access to capital markets, conditionality imposed by Bretton-Woods-Institutions respectively, further limit the policy space of the governments of the indebted countries as was pointed out above. This represents a vicious circle as autonomous governance is necessary to conduct consistent policies and built up a tax basis crucial to structural change – a prerequisite for overcoming commodity dependence and the resulting chronic foreign exchange crunch (Sindzingre 2006, 15). This applies both to market- and policy-led structural change as the former also needs a predictable macro-economic environment. Where policy space is shrunk and policy

[4] Critiques claim that debt is less of a problem than the lack of growth, particularly of the export sector, which is a the reason why debt initiatives only treat the symptoms but not the problems (Easterly 2002). However, in foreign currency squeezed countries,

decisions are externalised, shocks like exchange rate fluctuations cannot be buffered which increases uncertainty which is turn detrimental to entrepreneurship (Gifford 2010). Some authors cite historical evidence of the East-Asian late developers purporting that structural change has always been state-led as investing in new sectors is too risky for private agents (Chang 2002; Amsden 2008).

Against this backdrop, the new Eurobond issuance of low-income SSA countries seems to constitute a continuation of past trends rooted in the dependency on foreign exchange. With access to international financial markets, the dependency on foreign exchange was wrongly expected to lessen after the end of the Bretton-Woods-System. In contrast, in the course of the liberalisation of capital accounts, deficits grew beyond a manageable scope as they allowed for much greater current account deficits. Capital flows became more flexible and erratic rendering debtor countries vulnerable. The combination of the pro-cyclicality of financial markets, debt burdens and capital account liberalisation led to the necessity to pile up large foreign exchange reserves as buffer to avoid liquidity crises in emerging and developing (Akyüz 2013, 17–8). The currency hierarchy started to have even more adverse effects as result when the mobility of financial capital increased in the course of the financial globalisation. Portfolio decisions and their interference with exchange rates pose serious problems to developing and emerging market economies such as SSA countries and increase their vulnerability to risks implied in capital flight (Paula, Fritz, and Prates 2017; Bortz and Kaltenbrunner 2018; Kaltenbrunner and Paincaira 2017).

The surge in cross-border flows observable in the past decades exemplified by the birth of Eurobonds issuance in many African countries brings about not only a quantitative but also a qualitative change – a change encapsulated in the term 'international financialisation' which combines concepts of closed-border financialisation with financial globalisation (Bortz and Kaltenbrunner 2018, 375ff.). International financialisation is characterised by a greater share of portfolio debt. Debt instruments are furthermore more short-term in nature which is exemplified by the growing importance of carry trade.[5] This short-termism has a particularly adverse effect on exposed economies as in times of deteriorated confidence level of investors capital flight can induce more short-term and dramatic changes in the exchange rate (Bortz and Kaltenbrunner 2018, 380). Qualitative changes are also characterised by new economic agents investing in DEMs. These qualitative changes of the international financial integration of DEE result in financialisation having „more intense, more volatile [effects on DEE] and [are], frequently, entirely independent of domestic economic conditions." (Bortz and Kaltenbrunner 2018, 386) As a result of these qualitative changes, even small quantitative changes in e.g. portfolio shifts of big investors can have striking effects on small DEEs. This seems to be a continuation of

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the debt service might further exasperate the problem of a foreign exchange crunch, particularly when the export sector is affected, imperiling future potential to generate foreign exchange.

[5] Carry trade describes borrowing in foreign currency which gets invested in short-term high interest rate bearing investments in developing and emerging economies in the hope of favourable exchange rate developments (Bortz and Kaltenbrunner 2018, 380).

tendencies already observable when comparing the 1980ies to the 1990ies (Buch, Heinrich, and Pierdzioch 1999, 28).

The international financialisation and its effects got particularly strengthened and magnified through the international financial crisis starting in 2007/08. IMF data shows that between 2008 and 2015, external assets and liabilities in developing and emerging economies grew to a much greater extent than in industrialised countries. What is more, whilst the growth in external assets in industrialised countries outpaced that of external liabilities, in developing and emerging countries the opposite was the case: A surge of external financial assets by 56.7% compares to 70.7% of growth in external liabilities (Bortz and Kaltenbrunner 2018, 379). The growth in bonded sovereign debt in African economies hence has to read against this backdrop. It marks a shift towards portfolio debt as was foregone by South-American experiences in the 1980ies and 1990ies. As was observable before other phases of big inflows (e.g. Eichengreen 2004, 188), the international financial crisis fuelled capital inflows into developing and emerging markets as interest rates in the industrialised world dropped dramatically. But the globalisation of financial flows 'expose countries to the risk of abrupt reversals of foreign capital flows, thus forcing them into severe and prolonged real sector adjustment' (Buch, Heinrich, and Pierdzioch 1999, 3).

It becomes clear that the nascent Eurobond issuance by SSA-countries comes with a heightened degree of vulnerability, instability and risks in the face of international financial flows and crises. The SSA Eurobonds issuance represents an integration of emerging countries' assets in the portfolio of wealth holders making the former decision takers of the latter. This increases the asymmetry of international power relations and the exposure to instability of local financial markets. Because this higher degree of integration comes with a greater degree of erratic capital in- and outflows which affects exchange rates and further aggravates the need to hold foreign exchange. Financial markets of emerging economies are particularly affected by capital movements because of their shallowness, which results in capital flight to translate unhamperedly into domestic financial markets of developing and emerging markets (Paula, Fritz, and Prates 2017, 8).

6 Conclusion

The paper shed light on the evolution and reasons behind the recent growth of external debt stocks in SSA countries, which was highlighted by the birth of the Eurobond market in SSA-countries since 2007. It is argued that this development once more sheds light on SSA countries to be trapped in a dilemma consisting of foreign exchange dependence, low foreign exchange income and their position in the lowest ranks of the currency hierarchy. The issuance of sovereign debt in the form of Eurobonds has to be read as a temporary attempt to ease the burden posed by this dilemma. A finding of this paper is that the financial crisis opened a window of opportunity as financial investors discovered new frontiers of investment destinations in the attempt to diversify their portfolios – a process similar to the experiences made by Latin-American countries where in times of high global liquidity and large spreads led to huge capital inflows into DEE. Though the issuance of Dollar denominated sovereign debt might be a one-off chance to ease balance-of-payment difficulties, downsides are

possible spill-over effects to domestic markets, a high debt service burden and an even smaller policy space for governments in SSA-countries in the future. These processes are in line with the diagnosis of recent heightened levels of international financialisation coming with an increased vulnerability vis-à-vis international financial markets and a diminished potential for structural change and therefore a cementation of a global periphery and centre divide.

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Appendix 1

Issuer	Year	Yield at issue	Tenor	size (in million USD)	S&P rating at issue	Currency	Governing law	Bond type	Coupon type
Seychelles	2006	9,47	5	200	B	USD	England	Bullet	Funged
Ghana	2007	8,50	10	750	B+	USD	England	Bullet	Fixed
Gabon	2007	8,25	10	1000	BB–	USD	United States	Bullet	Fixed
Republic of Congo	2007	8,77	22	480	not rated	USD	Luxembourg	Sink called	Step-up
Senegal	2009	9,47	5	200	B+	USD	England	Bullet	Fixed
Seychelles	2010	5,00	16		not rated	USD	England	Sinkable	Step-up
Côte d'Ivoire	2010	17,35	22	2330	not rated	USD	France	Sinkable	Flat trading
Nigeria	2011	7,13	10	500	B+	USD	England	Bullet	Fixed
Senegal	2011	9,13	10	500	B+	USD	Luxembourg	Bullet	Fixed
Namibia	2011	5,84	10	500	not rated	USD	England	Bullet	Fixed
Angola	2012	7,19	7	1000	BB-	USD		Sinkable	
Zambia	2012	5,63	10	750	B+	USD	England	Bullet	Fixed
Tanzania	2013	6,28	7	600	not rated	USD	England	Sinkable	Floating
Rwanda	2013	6,75	10	400	B	USD	England	Bullet	Fixed
Nigeria	2013	6,63	10	500	not rated	USD			
Nigeria	2013	5,38	5	500	not rated	USD			
Ghana	2013	8,00	10	750	B	USD			
Mozambique	2013	8,00	10	850	B+	USD			
Gabon	2013	6,38	11	1500	BB–	USD	England	Sinkable	Fixed
Zambia	2014	8,63	10	1000	B+	USD			
Kenya	2014	6,88	10	1500	B+	USD			
Kenya	2014	5,88	5	500	B+	USD			
Cote d'Ivoire	2014	5,63	10	750	not rated	USD			
Senegal	2014	6,25	10	500	B+	USD			
Ghana	2014	8,13	12	1000	B	USD			
Ethiopia	2014	6,63	10	1000	B	USD			
South-Africa	2016			4000					
South-Africa	2017			19000					
Nigeria	2017			4800					
Côte d'Ivoire	2017			2000					
Senegal	2017			1100					
Gabon	2017			200					
Mozambique	2018	8,5	7	500					
Kenya	2018	7,25	10	2000			England		
Kenya	2018	8,25	30	2000			England		

Table 1: Overview over sovereign bonds denominated in US-Dollar issued by some African countries. Source: ADB (2018), Mecagni et al. (2014), Tyson (2015), Financial Times.