# Improve Credit Ratings Reliability to Ease Access to Trade-Led Investment & to Consolidate Crisis Readiness in Africa

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# OUTLINE

## HIGHLIGHTS

The COVID-19 pandemic has reignited debates on Africa's financial capacities and trade resilience. On the one hand, numerous calls for debt relief exposed fiscal revenues shortage but revealed a pernicious issue: the impact of credit ratings in access to investment. To obtain investments, satisfying credit ratings are required from multilateral development banks charged with enacting developmental initiatives including trade-led projects. On the other hand, African trade challenged by the absence or lack of adequate infrastructure, experienced further hurdles related to export prohibitions, tit-for-tat protectionism trends (Evenett and Baldwin, 2020) (World Trade Organization, 2020) and coronavirus-related preventive measures. This policy brief attempts to analyze the nexus between credit rating performance, access to infrastructure finance, and trade resilience in times of crisis. Sustainable Development Goals (SDG) 8, 9 and 17[1] allude to the topic of our analysis. Major findings highlight that credit rating inaccuracy restricts access to finance, tends to amplify the load of emergency responses and jeopardizes the execution of the trade agenda at the continental, regional and domestic levels.

# Chapter 1. RATINGS ACCURACY MATTERS TO BUILT TRADE-LED INFRASTRUCTURE AND TO REDUCE THE BURDEN OF EMERGENCY POLICY RESPONSES IN AFRICA

## The Importance of Credit Rating Agencies in Investment Decisions

According to the Corporate Finance Institute (2020), credit rating agencies (CRA's) are bodies that measure via ratings, financial capacities of certain entities (sovereign nations, stocks, companies, or non-profit organizations) and their solvency. The "Big Three" companies namely Standard & Poor's, Moody's and Fitch dominate over 95% of the rating industry (BNP Paribas, 2015). The remaining market share (5%) is disseminated between seven[2] smaller CRA's, chiefly located in Asia and Latin America (White, 2013). As financial regulation in the United States was a major concern in the 1930s, the "Big Three" seized the opportunity to build a credit rating sector, which may partly justify their leadership (White, 2016).

CRA's provide financial advisory services through their rating system, an issue to be discussed more in-depth in the following lines. Sovereign Credit Ratings (SCR's) indicate countries' economic, financial and political performances which could send strong incentives for global financial markets to invest or not (Pretorius and Botha, 2014). Yalta and Yalta (2018) argue that ratings are critical for emerging and developing nations due to their reliance on external funding to implement developmental projects. An additional aspect of the importance of CRA's is the ability to mitigate information asymmetries in financial markets. Regarding African economies, data pertaining to investment plans, national accounts or public debt are hardly available or inexistent. This type of information is particularly

[1] SDG 8: Decent Work and Economic Growth; SDG 9: Industry, Innovation and Infrastructure and SDG 17: Partnerships for the Goals (United Nations, 2020).

[2] The seven CRA's mentioned are: AM Best Company; Dominion Bond Rating Services (DBRS); Egan Jones; Morningstar Credit Ratings; HR Ratings de Mexico; Japan Credit Rating Agency and Kroll Bond Rating Agency.

demanded to access global, regional and domestic financial markets. Financial indicators collected by rating agencies contribute to disseminate scarce financial cognizance on relevant marketplaces (Raleigh, 2014).

However, despite their role as investment enablers, CRA's face sharp criticism. Our critique will not put an emphasis on their significant partition in the marketing and selling of toxic assets during the Great Financial Crisis of 2008. Topics referring to conformity bias and lack of accountability, pinpointed by authors[3] such as Kuhner, Paulais, Spatt and Sangiorgi, will not be discussed. Our analysis focuses on the one hand, on the cultural bias in leading anglo-saxons rating agencies. Main RCA's do not take into consideration short-run financial and macroeconomic shifts in the rating process. Short-run changes are considered if only they are persistent and sustainable (UNCTAD, 2008). Consequently, a substantial economic growth will not be taken into account in the rating procedure if occurring in a short period of time (Kuhner, 2001) (White, 2016). Sluggishness of rating methodologies was also an issue raised at the 2019 International Conference Sustainable Debt and Development. On the other hand, downgradings performed by CRA's in times of crisis have nurtured the controversy about ratings accuracy, a topic discussed in the second chapter.

Thomas L**.** Friedman recognized in 1995 the influence of CRA's on global economy, in a New York Times article: "You could almost say that we live again in a two-superpower world. There is the U.S. and there is Moody's. The U.S. can destroy a country by leveling it with bombs; Moody's can destroy a country by downgrading its bonds". Over decades, the importance of CRA's increased in the financial sphere, especially in grading SCR's.

## Study of Sovereign Credit Ratings Components

Sovereign credit ratings (SCR’s) are assessments of the default risk of a borrower on its obligations. Governments generally seek them to "ease their own access - and the access of other issuers domiciled within their borders - to international capital markets" (Cantor and Packer, 1996). SCR's could be displayed in a quantitative manner (indices) or in a qualitative manner (symbol grades). Symbol grade is the most widespread method used by the "Big Three" (Pretorius and Botha, 2014). For example, AAA is seen as the industry standard and the highest grade. AA, A and BBB are widely seen as investment-quality securities. Ratings of BB or below are speculative grades denoting higher credit risk or risk of default (IG, 2020). Nevertheless, risk perception may include subjective considerations that are meaningful to our analysis: "Risk perception is an individual assessment of the inherent risk in a given situational issue. Such a measure is based on degree of uncertainty, controllability and confidence in a problematic situation. There is a tendency to find in risk

[3] C. Kuhner, *"Financial Rating Agencies: Are They Credible? - Insights into the Reporting Incentives of Rating Agencies in Times of enhanced Risk"*. (Schmalenbach Business Review, 2001) volume 53, p. 2 - 26.
T. Paulais, *"Financing Africa's Cities - The Imperative of local Investment"*. (World Bank, French Development Agency, 2012)
F. Sangiorgi and S. Spatt, *"The Economics of Credit Rating Agencies"*. (Foundations and Trends in Finance, 2017), volume 12, p.1-116.

evaluation cognitive biases resulting from heuristic methods alluding to processing of information through simplification (Hamid et al., 2013).

The construction methodology of SCR's by the Big Three involve several aggregates, as highlighted by Cantor and Packer in 1996: per capita income, GDP growth, inflation rate, external debt, external balance, indicators for economic development, indicators for default history, spreads, ratings from other RCA's. Alfonso (2003) acknowledged an identical structure of SCR's components and underlined that SCR's calculation for developed countries tends to give greater attention to GDP per capita, while in developing economies external debt is considered with scrutiny. Further divergences were found by Prethorius and Botha (2014) in their comparative analysis[4]: SCR's assessed by the Fitch and Standard & Poor's do not systematically take into account macroeconomic fundamentals, as mentioned in Yalta and Yalta's paper (2018). Plus, a study [5] conducted by Gueye and Sy (2010) informs that the GDP growth of African countries is not significant in rating calculations performed by the Big Three. The correlation between GDP growth rate and ratings found in many research papers mostly deal with advanced economies, where high economic growth rate alleviates debt service. African countries are affected by hindrances such as massive debt/GDP ratio, inequalities, extreme poverty and political instability that are also taken into account in rating calculations (Pretorius and Botha, 2014). Moreover, inaccurate CRA calculation have implication on the regional level. The case of the ECOWAS[6] is interesting as the ECOWAS Bank for Investment and Development (EBID), involved in financing intra-regional trade in the region (EBID, 2020) has also a credit risk assessment mandate via the Risk Committee (RiskCo). The financial institution is tasked of "the establishment and compliance with policies relating to credit risk, market risk, operational risk, and reputational risk" and to build a credit risk grading framework. Unfortunately, the EBID lies its analysis on credit rating information issued by external rating agencies (EBID, 2019), which is biased as highlighted in our study.

Despite having robust GDP growth rates, a majority of African countries are graded BB or below and are subjected to downgrades in times of crisis, weakening therefore their crisis response policies. The African Development Bank (AfDB) is also reliant on CRA's evaluations that depreciate its scope of intervention (Humphrey, 2018).

## Financial Risk Misperception Discourages Trade-led Initiatives at the Continental, Regional and Country Levels

Multilateral Development Banks (MDB's) rely at 99% on ratings issued for government securities: Standard & Poor's (53,3%), Moody's (34,7%) and Fitch (11,1%) (Humphrey, 2018). Fundings of the AfBD are generated from global capital markets which are demanding in high ratings. Surprisingly, despite being assigned a triple-A rating (AfBD,

[4]Their study compared ratings from 27 African countries for the period 2005-2012 on an annual basis. Datas were originated from NKC African Economics, Fitch and S&P ratings. NKC African Economics is an Oxford Economics' company which has developed a sovereign risk rating model. Its knowledge of African economy enables to grade countries unrated by leading credit rating agencies. Moody's ratings are not taken into account as only 6 African countries in the sample period (2005-2012).

[5] C. Gueye and A. Sy, *"Beyond Aid: How Much Should African Countries Pay to Borrow"*. (International Monetary Fund Working Papers, 2010), volume 24.

[6] Economic Community of West African States (ECOWAS)

2020), the bank receives a 20-year maturity (Faure et al. 2015), while the maturity - duration of the loan - required to finance adequately African infrastructure projects is at least 30-years (Songwe, 2019).

Inconsistency between development project maturity and loan size deserves attention as 57% of the AfDB loans are allocated to economic infrastructure (Faure et al. 2015). Such a mismatch restricts the scope of intervention of the bank (Humphrey, 2014) and consequently limit access to fund for members states of the institution. It is necessary to recall that the AfDB sponsors several projects pertaining to trade at the country and continental levels. For instance, the "Integrate Africa" segment of the Hi 5's[7] project refers to regional infrastructure, intra-African trade & investment and movement of people across borders. The Bank supports as well the AfCFTA initiative: $4.8 million were provided by the institution in August 2019 to accelerate the implementation of the agreement (AfBD, 2018) (AfDB, 2019). These restrictions mentioned above take place in a challenging context: annual estimates of Africa's investment needs for infrastructure building and rehabilitation range from $130 to $170 billion (AfDB, 2019). Moreover, risk misperception in Africa prevents the termination of projects across the continent. For instance, the completion rate of the NEPAD Infrastructure Short Term Action Plan (STAP) is low in all sectors: about 15% for energy; 17% for transport; 11% for ICT; and 9% for water and sanitation projects (United Nations Economic Commission for Africa, 2014). African economies tend to experience a similar treatment to fund their infrastructure facilities: as a majority of African nations are not triple-A ranked[8], they receive a 10-year maturity loan (Songwe, 2019). Access to longer financial terms is restricted to developing economies since being perceived as financially speculative or risky (Gurara et al., 2018). Consequently, the cost of borrowing for average SSA borrowers is 2,92% higher than in average emerging nations (Gueye and Sy, 2010).

The following section gives a narrative of financial and infrastructure impediments taking place in time of crisis, likely to question the trade development in Africa.

## Chapter 2. CHALLENGES ENCOUNTERED DURING THE COVID-19 PANDEMIC

### Ratings Downgrading in the ECOWAS Region during the Coronavirus Crisis

Existent literature on CRA's criticism found evidences of ratings downgrading during time of crisis that contributed to inflate economic turmoil. In a 1997 paper[9], Stiglitz, Ferry and Liu revealed via an econometric model that pro-cyclical sovereign ratings calculated during the East Asian financial crisis (1997 -1999) may have contributed to inflate the shock. The authors argued that the ratings of Indonesia, South Korea and Thailand were assessed "more than the worsening in these countries' economic fundamentals would justify".

[7] The Hi 5s is strategy launched in 2015 by the AfDB. It aims to Light up and Power Africa; Feed Africa; Industrialize Africa; Integrate Africa; and Improve the Quality of Life for the People of Africa (AfDB, 2020).

[8] List of Credit Ratings in Africa (2020) available at https://tradingeconomics.com/country-list/rating?continent=africa.

[9] G. Ferri, L. G. Liu and J. E. Stiglitz "The Procyclical Role of Rating Agencies: Evidences from the East Asian Crisis", (Economic Notes by Monte dei Paschi di Sienna, 1999), volume 28, p. 335 - 355.

Identical conclusions were made towards the 1994/95 Mexican Crisis (UNCTAD, 2008) and the 2008 Great Financial Crisis (Mutize, 2020).

In the context of the COVID-19 pandemic, a couple of ECOWAS State Members were subjected to a downgrade. Indeed, on April 15th 2020, Cabo Verde has been downgraded from B to B- by Fitch (Fitch, 2020). Nigeria was downgraded by Standard &Poor's from B+ to B on March 26th 2020 (Reuters, 2020). The rationale of these declivities is linked to massive fiscal shrinkage. Tax revenues of Cabo Verde and Nigeria are expected to experience a sharp decline ranging from 8% to 20% this year (African Union, 2020). In 2017, the travel and tourism industry - vulnerable to exogenous shocks - accounts for 21% of Cape Verde's GDP (IMF, 2019) (AfDB, 2020). Nigeria, affected by dramatic drops of oil prices is heavily reliant on oil exports which contribute to 8.60% to Nigeria’s GDP but generated in 2018 almost 90% of the country's tax revenues (Export Gov, 2019). Senegal and Côte d'Ivoire have been placed on review for downgrading as the economies are involved in the G-20 debt service suspension initiative, likely to increase default risks on private sector debt (Standard and Poor's, 2020). Nigeria experienced another rating downgrade in time of crisis during the 2014-2016 oil shock. Fitch lowered in March 30th 2015, the Nigerian sovereign rating from stable (BB) to negative (BB-) (Agence Ecofin, 2015) (Le Point, 2015).

The 2020 African Union Report on Sovereign Credit Rating Review recognizes that rating downgrades were delivered prematurely as African economies are still implementing their respective COVID-19 responses strategies. And the effectiveness of these policies remaining unknown, may be determinant on future economic performance. In addition, the devastating effect of the Coronavirus on African countries has been revised downwards (Mutize, 2020).

## Borders Closure Caused by COVID-19 Restrictions Exacerbates Road Harassment

Beyond exacerbating delays in goods transport, non-computerized customs management in Africa causes extra-costs. In order to speed up the clearance of goods, trucks drivers undergo at border checkpoints, arbitrary taxation which is added to the prices of raw materials or products (Peterson, 2017). Excessive customs controls generate considerable delays deteriorating the quality of perishable food products requiring fast delivery times (Barka, 2012). Therefore, trade facilitation reforms including automation of customs procedures are crucial to enable a significant reduction of transportation delays and costs, to allow appropriate customs tax collection and enhancing transparency of transactions (UNCTAD, 2018). Trade facilitation requires substantial investments in equipment, legislative changes, and capacity enhancement for customs staff (Dube and Kanyimo, 2017). However, these initiatives are carried out in a context of weak economic development. For instance, the installation of the ASYCUDA[10] was lengthy in some countries due to funding interruptions or lack of technical assistance, such as in Niger, a least developed country

[10] The Automated System for Customs Data (ASYCUDA) is a computerized system designed by the United Nations Conference on Trade and Development (UNCTAD) to administer a country's customs.

(Montagnat -Rentier and Parent, 2012). Unfortunately, the COVID-19 pandemic tends to consolidate the weaknesses of African customs administration. The occurrence of road harassment increased during the borders closure, one of the non-pharmaceutical measures used to flatten the COVID-19 curve. The CILSS[11] informs that West African traders of perishable products and livestock lost from 10 to 30% of their stocks since the debut of COVID-19 preventive measures generating markets closures and transport disruptions. In addition, illegal tax collection at checkpoints has leapt nearly 50% (Reuters, 2020). However, road harassment phenomena in Africa is prior to the COVID-19 outbreak. The table below lists for 2017, the main road corridors on which food products pass. The main road corridors and their distance, the nature of the food products transported, the amount of illegal taxes and the estimated delays are shown in the following table.

**Figure 1: State of Road Harassment in Burkina Faso, Chad, Côte d'Ivoire, Ghana, Mali and Nigeria in 2017 - Sources: Cissé et al. (2017)**

| Corridors | Distance | Tranported goods | Number of checks | Cost of illegal tax | Time spent at checkpoints |
|---|---|---|---|---|---|
| **Abidjan - Lagos** | 1043 km | food products and cola nuts | 91 checks carried out, i.e. 9 checks every 100 km | $5201 | 18h 49m |
| **Kouthiala (Mali) - Lagos** | 1722 km | cattle, millet, sorghum, peanut | 65 checks carried out, i.e. 4 checks every 100 km | $586 | 2h 32m |
| **Ouagadougou - Accra** | 1004 km | cattle, tomato, onion | 44 checks carried out, i.e. 4 checks every 100 km | $157 | 4h |
| **Bouaké (Côte d'Ivoire) - Niamey** | 1371 km | maize | 39 checks carried out, i.e. 3 checks every 100 km | $164 | 3h 34m |

The table analysis reveals that the Abidjan-Lagos corridor is the most vulnerable corridor to arbitrary controls and taxes. This recurrence of controls is justified by the regulation of informal cross-border trade (ICBT) in Nigeria. To implement its protectionist policy, Nigeria carries out recurring customs controls (Mitaritonna et al., 2017). ICBT generates nearly 20% of the country's GDP and involves products subjected to high tariffs or import bans such as rice, palm oil, textiles and used cars. Although affecting all transit countries, illegal customs levies represent a serious concern for Sahel located economies critically exposed to food insecurity. For instance, in Mali, 44.9% of the population is dealing with extreme poverty and face massive droughts and floods deteriorating the quality of the crops (World Food Program, 2020). On the Koutiala - Dakar corridor, a significant part of the levies is generated in Mali, i.e. $486 against $100 in Senegal. A similar scenario can be seen on the Bouaké-Niamey corridor: the levies collected in Burkina Faso, Côte d'Ivoire and Niger amount to $32, $26 and $106 dollars respectively (Cissé et al. 2017).

[11] Comité inter-État de Lutte contre la Sécheresse au Sahel

## Supply Chain Disruptions: Case of Cocoa Industry in West Africa

A supply chain is "a network of facilities and distribution options that performs the functions of procurement of materials, the transformation of these materials into intermediate and finished products, and the distribution of these finished products to customers (Ganeshan and Harrison,1995). According to Bvepfepfe (2019), supply chains include availability of production and storage infrastructure, equipment for material handling, transportation and communication facilities for people and systems.

Scarcity and/or inefficiency of supply chain facilities across Africa tends to reinforce trade underperformance. In West Africa, the vulnerability of the cocoa supply chain inflated due to preventive measures related to coronavirus. Nigeria provides 6.5% of the global cocoa supply (NEPC, 2020). The absence or lack of storage facilities caused 6,000 tonnes of cocoa beans remaining quarantined at the Lagos port and warehouses across the country, generating therefore extra storage fees. A $100 million loss is projected from cocoa exports in Nigeria, due to demand contraction in Europe and China, also hardly hit by the COVID-19 pandemic (Reuters, 2020). The case of Côte d'Ivoire is less alarming. The country provides 40% of global demand. Cocoa accounts for 43% of goods exports in Côte d'Ivoire in 2016 and for over 10% of GDP (AfDB, 2018). Despite the opening of markets and ports (Abidjan and San Pedro), delays and slowdown were reported in cocoa distribution. Such disruptions caused by labour force travel restrictions and curfews affect the delivery of cocoa beans to the country's ports (CIRAD, 2020). However, the "forward sale" system ruling Ivorian cocoa sector, protects on the short term, stakeholders, from planters to exporters, from exogenous hazards. Transactions could happen as the whole chain has been paid, stated Youssouf Carius, CEO of Pulsar Partners, an Ivorian investment fund (Le Monde, 2020).

# Chapter 3. GUIDANCES TO CONSOLIDATE AFRICA'S TRADE RESILIENCE AND CRISIS READINESS

- **SHORT TERM IMPLICATIONS**

## Include the Credit Ratings Issue in the AfCFTA Investment negotiations

The AfCFTA Protocol on Investment aims to ease financial inflows, to facilitate investment across the continent (art. 3c) and targets cooperation on investment (art. 4c) (IDEP, 2020). As all negotiations are ruled to preserve previous achievements of regional integration, the Pan-African Investment Code (PAIC) could serve as a starting point (IDEP, 2020). However, the PAIC draft does not include any disposition alluding to locally assessed ratings. The AfCFTA Secretariat may collaborate with continental institutions such as NKC or the African Risk Capacity and use its financial cognizance of risk pooling and risk transfer (African Risk Capacity, 2020) to build up meaningful ratings for African economies.

### Advocating the Implementation of the Dakar Consensus[12] at the Finance in Common Summit

The Finance in Common Summit to be held in November 2020 will be the first global event gathering all MDB's. The rationale of the panel is to stress "on the crucial role of Public Development Banks in reconciling short-term counter-cyclical crisis responses with recovery measures having a long-term impact on the planet and societies" (Finance in Common, 2020). As discussed, the accuracy of CRA's ratings could be reinvoked during the conference, in order to ease access to investment plus to finance properly short/long term crisis responses and trade-related projects.

- **LONG TERM IMPLICATIONS**

### Reinforce rating issuance mechanisms and rating industry competition at the continental and regional levels

The African Union (2020) supports the issuance of on-request ratings for African economies. This option encourages the publication of ratings in due time with the consent of the countries. For instance, the Financial Sector Conduct Authority, tasked of regulating ratings in South Africa, can set the time for rating publication (Mutize, 2020). Plus, the creation of legislative frameworks enabling rating services is advocated by the Institution in order to achieve direct and close consultations with rated countries (African Union, 2020). At the regional level, the EBID needs to monitor the credit risk grade independently of ratings issued by traditional CRA's, in order to generate grades meeting better the scope of its countries members. Regional CRA's located in Africa would participate to break the Big Three monopoly leading 95% of the industry (BNP Paribas, 2015).

### Improve Fiscal Performance

In the context of the coronavirus pandemic, Africa needs immediately $100 to $200 billion to finance relief plans including trade-led measures (Thiam et al. 2020). Regrettably, Africa lags behind in terms of fiscal management. The continent's tax-to-GDP ratio is estimated at 13.4 percent in 2018, compared to 14 percent in Asia, 25 percent in Europe, and 18 percent in Latin America (IMF, 2019). The use of sovereign funds as commodity funds may contribute to reducing this leap. Commodity funds allow to generate critical amounts of domestic capital flows through sales and exploitation of natural resources (Raymond, 2010). If properly managed in the long run, these financial resources could finance Africa's structural transformation projects or emergency response purposes such as health expenditure, as the COVID-19 pandemic requires it. Africa is home to over 30% of global natural resources reserves (IDEP, 2020). Consequently, the continent has significant room to implement commodity funds mechanisms. Botswana is a leading example in the field with

[12] On December 2, 2019, Senegalese President Macky Sall introduced the Dakar Consensus (contrasting with the Washington Consensus) during his closure speech of the Conference on Sustainable Development and Debt (Diamniadio, Senegal). This speech advocated for a better and adequate perception of risk in African countries, which is overvalued.

its diamond trade and exploitation (IDEP, 2020). However, performant commodity funds require retaliation against Illicit Financial Flows (IFF), causing enormous fiscal shortages for African economies, namely $70 billion dollars per year (Global Financial Integrity, 2017).

## Diversifying Local Investments Tools

A partnership with local investors in Kenya and the United Nations Economic Commission for Africa (ECA) allowed the creation of a $20 billion pension fund offering a 30-year loan maturity (Songwe, 2019). Initiatives of this type could be replicated across the continent if fiscal discipline is practiced and if the private sector arrears - endangering companies' solvency - are paid (Gandhi, 2019) (IMF, 2019).

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