The Economist INTELLIGENCE UNIT

Hard currency availability and debt sustainability in Ethiopia, Kenya, Nigeria, Tanzania and Zambia

A report by The Economist Intelligence Unit

Sponsored by CDC Investment works

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As part of the research process for this project, 43 in-depth interviews were conducted with businesspeople, fund managers, investors and other experts across all five countries. We would like to express our thanks to all the interviewees for their advice and input. For anonymity purposes, the names, organisations and industries have been changed throughout the report.

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About the Economist Intelligence Unit

The Economist Intelligence Unit (EIU) is the research arm of The Economist Group, publisher of The Economist. As the world's leading provider of country intelligence, it helps governments, institutions and businesses by providing timely, reliable and impartial analysis of economic and development strategies. Through its public policy practice, the EIU provides evidence-based research for policymakers and stakeholders seeking measureable outcomes, in fields ranging from gender and finance to energy and technology. It conducts research through interviews, regulatory analysis, quantitative modelling and forecasting, and displays the results via interactive data visualisation tools. Through a global network of more than 650 analysts and contributors, the EIU continuously assesses and forecasts political, economic and business conditions in more than 200 countries.

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Executive summary

Businesses in some of sub-Saharan Africa's largest economies have been forced to close or reduce production as they struggle to access the hard currency or working capital needed to keep their import-dependent operations afloat. The decline of commodities prices in 2014-16 restricted foreign exchange (FX) liquidity, causing local currencies to depreciate and leading to FX shortages. At the same time, sovereign debt has risen sharply across the region, raising the prospect of greater pressure on hard currency availability and currency devaluations. However, despite the challenges posed by FX shortages, currency volatility and rising debt levels, interviews reveal that a sense of opportunity remains in all our sample markets. Resilient businesses examined in this report were able to mitigate these challenges through a wide range of operational and strategic adjustments. Investors we spoke to claimed that certain investment approaches helped them to navigate periods of FX shortage.

In this report, the Economist Intelligence Unit (EIU) examines these trends in five of sub-Saharan Africa's economies: Ethiopia, Kenya, Nigeria, Tanzania and Zambia. With input from a series of extensive interviews with businesses, bankers and economists, we aim to shed light on the ways in which hard currency shortages and rising indebtedness impinge on financial performance, but also the ways in which businesses and investors are tackling these challenges. A summary of our findings is outlined below.

FX shortages hurt businesses in Ethiopia and Nigeria. The continent's two most populous nations closely manage their exchange rates, through a crawling peg, and a peg combined with a system of multiple exchange rates, respectively. This has caused crippling FX shortages due to weak balance-of-payments positions. In turn, this has slowed the operations of import-dependent businesses and bankrupted companies which have been unable to source inputs locally, or pass on rising costs to consumers. Survivors complain of squeezed margins and long waiting times for FX at banks. Some have experienced difficulties remitting local profits overseas, or hedging against commodity price fluctuations, since they do not have control over when purchases in foreign currency can be made.

Local businesses resort to desperate measures to access hard currency. Chronic shortages in Nigeria and Ethiopia have forced some businesses to turn to black markets for FX, where they must pay enormous premiums for hard currency. Other coping strategies have included relying on offshore third parties for dollar funding; and applying to as many local banks as possible for FX allocations. Some businesses may choose to exert pressure on authorities through embassies and law firms, while others reportedly fall back on less legitimate channels such as bribing officials for preferential treatment.

Import-dependent businesses are particularly at risk. Access to imports is fettered in times of FX crisis, forcing companies to turn to domestic suppliers for their raw or semi-processed inputs. This could benefit the local economy, if local suppliers are capable of reliably producing goods and services of acceptable quality and at competitive prices. In practice, local capacity is often wanting in the region, leaving investors with no option but to shutter production when FX runs short and imports are hampered. In cases where it is possible to source inputs domestically, quality and reliability to supply may be compromised.

FX shortages have a negative impact on the economy at large. The impacts of FX shortages can be long-term as firms struggle to source supplies or pay their workers. Rising costs may be passed on to consumers, whose demand for retail products can fall if they are sensitive to pricing; and if goods are consumed by low-income households, higher prices will increase poverty. Inward investment stalls as firms become wary of dedicating capital to countries where shortages are rife. Existing investors may exit countries in crisis, prompting capital flight such as that experienced in Nigeria. When currency pegs are eventually removed, the devaluations can be large, casting a cloud over the economy.

Zambia operates a float, while Kenya and Tanzania have moved to more managed regimes. No FX shortages are reported in Kenya and Tanzania. The banking systems continue to provide businesses with easy access to dollars and dollars accounts, and FX remittances outside the countries are not restricted. Zambia's flexible regime has reduced the risk of businesses suffering FX shortages, but it has resulted in extreme exchange rate volatility. The kwacha has plummeted alongside copper prices since 2013 and currency volatility has discouraged capital inflows. Businesses may therefore experience a tightening of FX liquidity, even when there are no technical FX restrictions in place.

Working capital shortages affect local businesses. Access to finance is a pervasive problem across sub-Saharan Africa's shallow financial markets, for multiple reasons. In Kenya, Tanzania and Zambia interviewees talk about government crowding out credit. In Tanzania, businesses noted that a growing fiscal deficit has pushed up commercial interest rates, as internal public debt grows. In Zambia, government securities are absorbing too much of domestic savings. In Kenya, the situation is exacerbated by a cap on interest rates that has had the unintended effect of drying up credit for local businesses.

Beware of policy uncertainty and protectionism. Policy instability can impact the business climate and supply of hard currency alongside an exchange rate regime. In Nigeria, for instance, the government banned a list of imported products in a bid to defend the naira in 2015, with severe implications for the economy. Kenya's cap on commercial interest rates has caused working capital shortages for small and medium-sized enterprises (SMEs). And in Tanzania, investment by foreign mining companies has fallen in the wake of a ban on unprocessed mineral exports. Interviewees there complained of abrupt tax increases, erratic regulatory changes and a lack of transparency.

Public debt has risen rapidly over the past decade in all five countries. Governments have borrowed heavily to finance the construction of roads, railways and power stations, sending external debt levels soaring in each sample country. A rising share of debt is owed to commercial creditors, which has increased servicing costs and the risks associated with refinancing when bonds mature. Interviewees cite the need for structural reforms, including a broadening of the tax base, to reduce the dependence on revenue from commodities. In our analysis, Zambia is at high risk of debt distress, Ethiopia at moderate risk, and Kenya, Tanzania and Nigeria at low risk. As the costs of servicing debt in foreign currency increase, the availability of FX to businesses may decline.

Investors recommend planning ahead. Investors should plan for shortages in FX by building ample cash reserves and structuring investments to minimise currency mismatches in payments and revenue. Our interviewees mitigated FX risks through other strategies including: investing more in exporting capacity to generate an inflow of hard currency; investing in local production, to reduce dependence on imports; targeting sectors which are assigned priority access to FX; and diversifying across sub-Saharan Africa. Risking diminished returns, some investors operating in these markets have also resorted to funding the working capital of their portfolio businesses.

A sense of opportunity remains in all our sample markets. Despite the challenges posed by FX shortages, currency volatility and rising debt levels, our interviewees remain committed to the markets of sub-Saharan Africa, which can offer high returns relative to the developed world. By proving themselves adaptable, investors have been able to survive, and even thrive, during periods of FX shortages. The crises in Nigeria and Ethiopia have somewhat eased. Investors claimed they would be better prepared to manage FX risks in the future. In some cases, businesses have been prompted to explore new opportunities in sectors such as manufacturing or agro-processing, which might have seemed less attractive when import costs were lower.

Introduction

The fall in commodity prices in 2014-16 caused a generalised slowdown across emerging economies, including those of sub-Saharan Africa. The fall in prices restricted FX liquidity, causing local currencies to depreciate and leading to FX shortages. This situation was highly disruptive for import-dependent businesses, particularly in countries with nascent domestic industries. While commodity prices have since risen, some of the effects and risks associated with devaluations and FX shortages are still being felt. Emerging markets are today again facing the risk of capital outflows and downward pressure on their currencies owing to higher interest rates in the US and tightening global liquidity.

This report examines how five African countries (Ethiopia, Kenya, Nigeria, Tanzania and Zambia) have dealt with these transitions, at both the macro and micro levels. We examine each country in turn and analyse the current availability of FX, and the future outlook. Our goal is to provide business people, investors and policymakers with insights on the main challenges in each market, and to suggest possible solutions. We also aim to draw attention to the often-neglected impact on local firms.

The country sections of the report also examine concerns around current and future debt sustainability. As debt, particularly hard currency-denominated debt, has been rising rapidly in all five countries covered, we assess debt sustainability by looking at the recent trends and projected evolution of a range of key indicators.

Insights were obtained through an interview programme of more than 30 stakeholders including businesses, investors, bankers and economists to canvass a broad range of views on these issues. On-the-ground insight is combined with macroeconomic analysis by the EIU and evidence from a review of key publications on the two central topics.

Why do exchange rate regimes make a difference?

FX availability depends on the choice of exchange rate regime. Flexible, market-determined exchange rates reduce the risk of FX shortages by adjusting in line with the balance between the supply and demand for FX. For example, if dollars are in short supply, the exchange rate weakens until a price is reached at which people become willing to supply dollars, enabling the market to clear.

In economies that are exposed to frequent terms-of-trade shocks—which is the case for all five countries covered in this report—market-determined exchange rates facilitate adjustment to such shocks, help restore competitiveness, safeguard foreign reserves, and reduce incentives for FX-hoarding. But the cost of such flexibility is increased currency volatility that businesses and investors need to take into account when drawing up their business plans and structuring their balance sheets.

Zambia is the only country covered in the report to operate a float. Kenya and Tanzania operated floats in the past but moved to more managed regimes in 2016. FX availability in these two markets remains good but there is a risk of shortages in the future in the event of external shocks.

By contrast, under pegged exchange rate regimes, the central bank keeps the exchange rate unchanged irrespective of the supply and demand for FX. Consequently, when demand for FX exceeds supply, shortages are likely to occur unless the central bank is able to meet this excess demand by drawing down its stock of FX reserves.

Pegged exchange rate regimes can give a false sense of stability and allow imbalances to build up, particularly if they are not supported by the appropriate fiscal and monetary policies. When currency pegs break, the resulting devaluations can be large and can have traumatic effects on the economy. Nigeria, a once fast-growing economy, was plunged into recession after a collapse in world oil prices forced the authorities to adjust the peg and devalue. Currency mismatches were a widespread problem for businesses that had assumed the peg would hold.

FX shortages damage the economy in a number of ways. Failure to obtain dollars to buy imported inputs for a processing industry may lead to the closure of a plant (temporary or permanent). Similarly, failure to obtain dollars to purchase capital goods, or to hire professional services, may endanger an investment project. FX shortages also act as deterrents to inward investment, have an adverse effect on market confidence, raise the cost of doing business, and can lead to policy responses that further feed shortages.

Some fund managers interviewed for this report had been prevented from exiting their investments on time by FX shortages. They advised funds to adopt a conservative approach about the time frame in which capital could be returned to investors.

The burden of debt for emerging economies

Debt—and particularly hard currency-denominated debt—has been rising rapidly in all five countries covered in this report. This rise is generating concern among international financial institutions, the donor community, as well as businesses and investors, as borne out in our interviews. Increased indebtedness to China is of primary concern owing to a lack of transparency around the loans being made, and uncertainty around whether China will adhere to internationally established principles governing responsible lending.

The type of creditor is a further important factor, as highlighted in a recent report entitled *Africa's rising debt* by the Overseas Development Institute (ODI)[1]. As noted by ODI, a growing share of Africa's debt is owed to commercial creditors. This raises the average cost of the debt as some of the official lending on which the region traditionally relied was granted on concessional terms. The increased reliance on commercial creditors also creates a refinancing risk, particularly in the case of Eurobonds which investors may be unwilling to refinance if market conditions are unfavourable at the time. Four of the countries covered in this report (the exception being Tanzania) have issued bonds during the past decade.

In assessing debt sustainability in this report we looked at the recent trends and projected evolution of a range of indicators, including: budget balance and public debt; external debt/GDP and external debt/exports; and debt–service ratio (principal and interest payments on external debt as a percentage of exports of goods and services). We paid particular attention to the debt service ratio as the literature finds that emerging market crises tend to be caused by liquidity crunches (as opposed to questions about solvency). These indicators are identified as explanatory variables in the paper Predicting Sovereign Debt Crises, co-authored by the American economist Nouriel Roubini.[2]

[1] Mustapha and Prizzon—Overseas Development Institute (ODI). 2018. "Africa's rising debt: How to avoid a new crisis" [https://www.odi.org/sites/odi.org.uk/files/resource-documents/12491.pdf]

[2] Manasse, Roubini and Schimmelpfennig. 2003. "Predicting Sovereign Debt Crises". IMF Working Paper [https://www.researchgate.net/publication/5124209_Predicting_Sovereign_Debt_Crises]

Ethiopia

Key findings

- The FX market is closely managed by the central bank. In defending the exchange rate, chronic and severe FX shortages are created. No changes to this regime are expected but the government is taking measures to address currency shortages.
- Difficulties in purchasing foreign inputs have reduced the margins of businesses across the board, forcing some to close. Local companies may need to rely on domestic inputs or may need to obtain FX through unofficial channels. Investors suggest careful planning for FX risks and diversification.
- Fiscal deficits over the years in Ethiopia have resulted in an increase in the public debt/ GDP ratio. The government's fiscal deficit target of 3% of GDP over the medium term is likely to prove overambitious given pressures on spending.
- Large current account deficits have been only partially funded by foreign direct investment (FDI), leaving a sizeable share of the deficits to be financed by external debt. The sharp rise in the debt stock has resulted in a deterioration in external solvency and liquidity indicators.

Part 1: FX trends and outlook

Current policy: Maintaining a fixed exchange rate is creating hard currency shortages

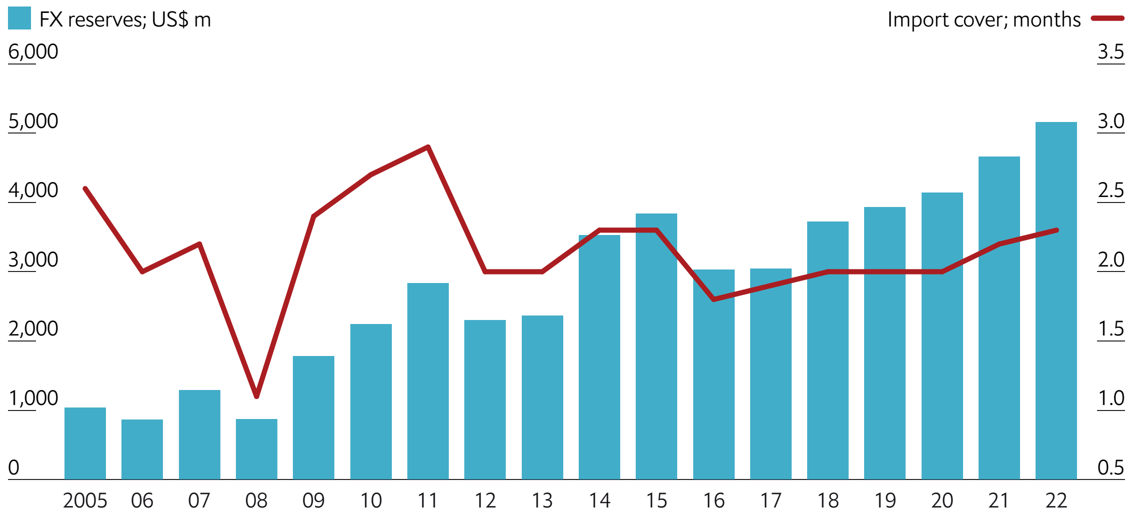
The FX market in Ethiopia is closely managed by the central bank through a crawling peg (a fixed exchange rate system in which a currency's value can fluctuate within a fixed band of rates) which reduces the birr's value by 6% against the dollar each year. This is intended to keep the birr stable in real (inflation-adjusted) terms. In October 2017 the central bank devalued the birr by 15% in order to restore competitiveness, which had been eroded by high domestic inflation. This was the first one-off devaluation since 2010.

A crawling peg leads to chronic FX shortages if the balance of payments position is weak (more dollars are going out of the country than are coming in). In such a situation, to defend the peg, the central bank must sell more dollars in exchange for its own currency. It therefore needs to ensure that it obtains whatever FX enters the economy rather than allowing it to go to private firms. This is what is happening in Ethiopia at present.

> *A common misapprehension is that the FX market is subject to complex regulations. This isn't the case. The problem is simply a lack of dollars in the country.*
>
> **Private equity fund manager**

FX shortages make life difficult for businesses operating in the country and hurt economic performance. Companies are unable to obtain dollars to buy imported inputs for industrial goods or imported capital goods for plants, factories and infrastructure. FX shortages also deter inward investment for the same reason. Firms are wary of committing capital to countries where the performance of their business is likely to suffer from FX shortages. They are also aware that FX shortages indicate that the exchange rate is overvalued and, therefore, likely to undergo a devaluation at some point. In Ethiopia, FX reserves were US$3.2bn in March 2018, providing import cover of only just over two months.

FX reserves and import cover



Source: The Economist Intelligence Unit; Country Data.

An improvement in the balance of payments (increased inflows of foreign currency due to exports being greater than imports) would ease the FX shortages. However, according to several interviewees the real solution lies in floating the birr so that the exchange rate adjusts to clear the market. This would eliminate FX shortages as the prevailing exchange rate would be the one that matches supply and demand of FX. The central bank would no longer need to control or hoard FX as it would no longer need it to buy and sell further FX to defend a particular exchange rate. The IMF is recommending that Ethiopia shift to a more flexible exchange rate but the government has so far made no commitment to doing so.

> *Floating the birr would be the big game changer but I'm not counting on that anytime soon.*
>
> **Private equity fund manager**

It is often thought that the government is reluctant to float the birr because of concern about inflation. A more important reason is concern about the implications for food security. Floating the birr could increase the costs of imports such as wheat, which is a staple food for some of the population.

In light of the current limitations, the government ensures that it has sufficient FX for fuel imports and external debt-servicing. Meanwhile, for the remaining FX, the central bank gives priority access to the pharmaceuticals and manufacturing sectors, as well as companies focused on import substitution[3] and exports. Banks generally adhere to the rules regarding the prioritisation of sectors.

The FX shortage has worsened over the past three years, partly as a result of a political crisis. But there has been a discernible easing of FX availability since the new government took office in March 2018. The new prime minister has announced a series of measures including a call for personal reserves to be brought to the banks, securing hard currency injections from international players and eliminating restrictions on obtaining hard currency from offshore sources.

In October 2018, Reuters reported that Ethiopia's FX reserves grew by 30% over the previous months after falling to "alarming levels".[4] This was caused in part by a boost in remittances after the government started encouraging Ethiopians living abroad to send more cash back home. Another source of this easing was the US$1bn deposit by the UAE into Ethiopia's central bank in July 2018. This was part of the UAE's larger US$3bn pledge in aid and investment to Ethiopia.[5]

The current sentiment: Local businesses severely affected by FX shortages

Interviews with selected stakeholders indicate that FX shortages have had a strong impact on businesses across industries, with long waiting times to obtain FX at local banks reported. Local business people, in particular, report the difficulties these shortages pose for buying imported inputs, squeezing margins to unsustainable levels. This has affected all ranges of businesses, including manufacturers of both luxury and everyday consumer goods. This has pressured some local businesses to rely on domestic inputs while others have been forced to cease production. But reliance on domestic

Effects felt across the board

Risk of bankruptcy: Last year two biscuit manufacturers went bankrupt as they were unable to obtain FX to pay for sugar imports.

Venture capitalist

Import dependency makes things worse: All the fund's companies, which operate in light manufacturing and medicine, are dependent upon imports. FX shortages have sometimes forced them to cease production, resulting in a decline in revenue and profits.

Private equity fund manager

Building resilience: The FX shortages affected manufacturers and traders of luxury goods in particular, but even some pharmaceutical manufacturers (when pharmaceuticals was the highest priority sector for FX) were having to wait six months in line. Nobody was unaffected - everyone was hurt, everyone had to manage.

Private equity fund manager

Hedging and planning limited: When buying products we cannot control what price we buy them for so we cannot hedge against risk. If I see the oil price will drop in 2-3 weeks, we would want to buy it then rather than now, but we cannot as we can only do it at that point in time when we get the cash.

Local manufacturing business

[3] Domestic production of tradeable goods previously imported.

[4] Reuters. 2018. "Ethiopia's forex reserves rise 30 pct after falling to 'alarming' levels". [https://uk.reuters.com/article/ethiopia-reserves/update-1-ethiopias-forex-reserves-rise-30-pct-after-falling-to-alarming-levels-pm-idUKL8N1WY36Y]

5 Reuters. 2018. "UAE to give Ethiopia $3 billion in aid and investments". [https://af.reuters.com/article/investingNews/idAFKBN1JC07G-OZABS]

inputs can damage a business if the product is not available, is more expensive or of lower quality than the imported product. The shortage of FX has further damaged firms' ability to plan and hedge against risk as there is no control over when purchases in foreign currency can be made.

Facing FX restrictions, local businesses have had to resort to varied strategies to obtain US dollars. A local manufacturing company, for example, explained that facing FX shortages, it relied on obtaining dollar funding from its shareholders and offshore third parties. In this instance shareholders were willing to provide additional funding, but this might not always be the case—particularly if the investments were failing to generate the expected returns. Similarly, unless there is a pre-commitment from offshore third parties, such funding might not be available when needed.

Filing applications to as many banks as possible is another strategy. Some businesses have purchased FX on the black market, at a premium. One interviewee mentioned trying to bring pressure to access FX through the embassy or through law firms, while some businesses are likely to resort to paying bribes, if they have internal connections, although interviews point to the rules generally being followed.

Using any solution at hand

Turning to domestic suppliers: We have engaged with local businesses as alternative sources of supply as they are always available but tend to be of lower quality. Sometimes this has meant that we have had to shut down production, with the inevitable hit to sales and profits.

Local manufacturing business

Maximising chances of obtaining FX: It is worth applying to as many banks as possible for FX allocations and joining the queue as early as possible. We have already provided a schedule to multiple Ethiopian banks of all of the raw materials that our portfolio companies will need for the next 18 months.

Venture capitalist

Unofficial channels may be the last resort: Sometimes we have been unable to source FX to buy raw materials at the official rate so we have had to buy it on the black market, at a premium. This had a knock-on effect on the business as we were unable to raise prices to preserve margins.

Local manufacturing business

Local business people advise potential investors in this market to take a conservative approach to funding their businesses, prepare for possible difficulties in obtaining dollars, and consider mechanisms to reduce the risk of currency mismatches in the capital structure. Another option is to focus on export sectors in the new industrial parks and on priority sectors for the government (healthcare, import substitution, light manufacturing).

One fund manager said that to support their businesses they have invested in further backward integration to reduce the value of the goods imported and to expand exports. A venture capitalist resorted to investing its own private equity into its portfolio businesses.

The way forward

Some improvements in sight: We have experienced an improvement in FX availability since the new government was installed in April. More of our applications for FX allocations have been met and delays have shortened.

Local manufacturing business

Be adaptable: We have had to respond to the market. We do not expect any of these markets to be straight lines and we always expect a few surprises. While we didn't expect it to be this severe in the last few years, in the last year we have raised another fund, which is 25% larger than our first fund, and that is because we've been able to demonstrate that we can be responsive in difficult markets.

Private equity fund manager

Develop exporting capacity: The other part of our response has been to invest more in exporting capacity so that we can also generate some FX in that market.

Private equity fund manager

Changing the structure of businesses: We were importing semi-finished goods for one of our businesses, and there is a higher value for the semi-finished goods than the raw material, so now we have put in productive capacity so we can import the raw material. This way the FX requirement is reduced and more value addition is captured in country.

Private equity fund manager

Focus on priority sectors: The government assigns priority access to FX to healthcare and import substitution sectors. This has made a material difference to our businesses in those sectors and will inform the choice of future investments we make.

Investor in pharma and light manufacturing

Diversification can help: Ethiopia offers interesting opportunities but is a challenging market because of the restrictions on FX. We decided to take the risk but to mitigate it through a diversified portfolio that includes more predictable markets such as Kenya.

Private equity fund manager

What is on the horizon? The EIU's forecast

- The EIU forecasts no change in the exchange rate policy. The birr will continue to be managed closely by the central bank, depreciating by 6% a year against the dollar with a view of maintaining broad stability in real terms. This would result in the currency weakening from an average of Birr23.95:US$1 in 2017 to Birr32.88:US$1 in 2022.

- FX availability will remain restricted but the improvement noted by some interviewees since April 2018 should be maintained given the expected growth in exports (13.3% annual growth on average from 2018-22), which will generate increased inflows of hard currency over the medium term (with FX reserves in 2022 being 59.1% higher than in 2017).

Part 2: Debt sustainability trends and outlook

Public debt: Fiscal deficits have pushed debt to worryingly high levels

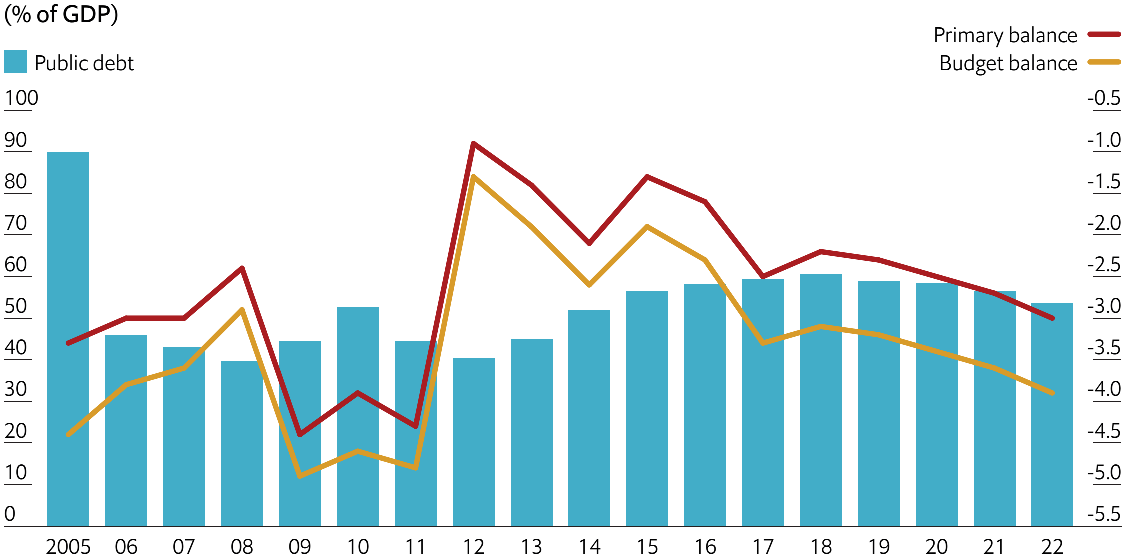
Fiscal deficits in Ethiopia have resulted in an increase in the public debt/GDP ratio from 40% in 2012 to around 60% today. This is the highest level since Ethiopia was granted debt forgiveness under the enhanced Heavily Indebted Poor Countries Initiative in 2006 (an IMF and World Bank scheme to ensure that poor countries do not face unmanageable debt burdens).

Public banks, the central bank and the social security system fund the domestic component of the public debt. Interest rates are kept low—negative in real terms—through administrative measures to contain borrowing costs. This system creates distortions but also provides a captive market for government securities in local currency.

Public external debt has grown strongly in recent years, with an increasing share of debt being raised from commercial creditors. This creates funding risks and leaves the public debt dynamics sensitive to devaluation. Around half of the debt is now denominated in hard currency.

> *The new prime minister is generating a sense of optimism inside the country and within the business community. The question is whether he can deliver on his reform agenda as he will face opposition from the old guard.*
>
> **Private equity fund manager**

Overall, primary budget balance and public debt
(% of GDP)



Source: The Economist Intelligence Unit; Country Data.

Public debt outlook: The EIU's forecast

- The government is targeting a fiscal deficit of 3% of GDP over the medium term. This is likely to prove overambitious given pressures on spending, and we forecast a deficit averaging around 3.5% of GDP in 2022. Strong GDP growth and revenue from privatisations will put the public debt/GDP ratio on a downward trend to around 55% by 2022.

- The main risks to this forecast are: a large devaluation of the birr that would push up the value of hard currency debt; and contingent liabilities of state-owned enterprises that would crystallise if projects generate lower returns than expected.

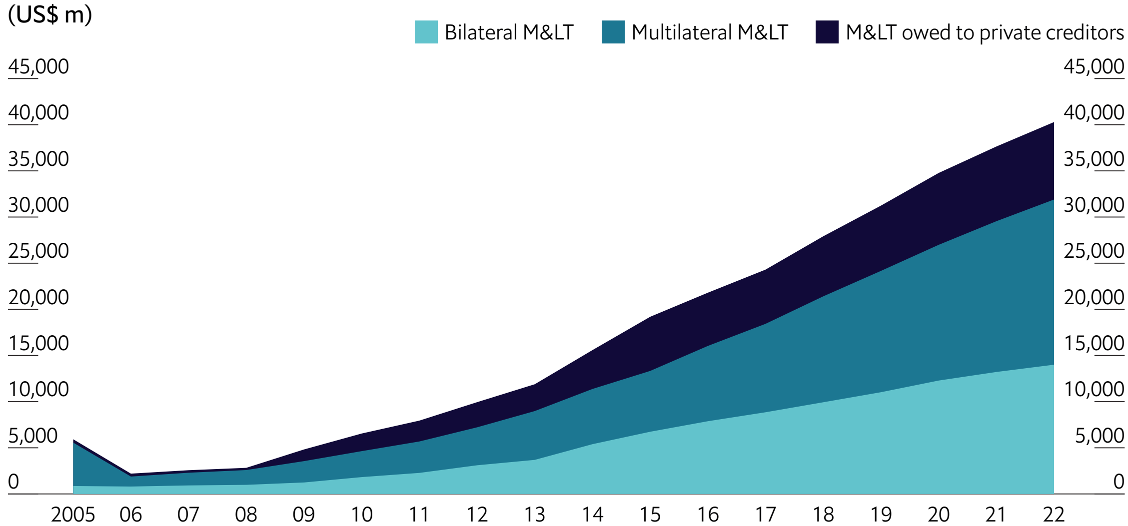
External debt: External debt rising with persistent current account deficits

Persistently large current account deficits since 2012 have been only partly funded by FDI, leaving a sizeable share of the deficits to be financed by external debt, which has risen from US$9.9bn in 2012 to US$24.3bn in 2017. Export growth has been sluggish over this period and, together with a sharp rise in the debt stock, has resulted in a deterioration in external solvency and liquidity indicators.

External debt as a percentage of exports of goods and services rose from 120% in 2012 to 320% in 2017. Meanwhile, the debt–service ratio, which expresses principal and interest payments on external debt as a percentage of exports of goods & services and remittances, rose from 6.2% to 14.9% over the same period. On the basis of expected increases in the value of these two indicators in 2019, the IMF classified the country as at high risk of external debt distress—a conclusion contested by the government (the overall public debt level is still rated as sustainable by the IMF). The increase in the debt–service ratio, which reflects the share of FX earnings absorbed by payments on the external debt, is one of the factors behind the acute shortages of FX.

> *Provided the government makes progress on reforms, it will maintain the support of official creditors, and this reduces the risk of a debt crisis.*
>
> **Investment fund manager**

Medium- and long-term public external debt
(US$ m)



Source: The Economist Intelligence Unit; Country Data.

External debt outlook: The EIU's forecast

- According to our estimates, the debt service ratio peaked at 19.3% in 2016. Since then it has come down to just under 15%, a level at which we forecast it to broadly stabilise over the next five years.
- Principal and interest payments on the debt will continue to rise; they will be matched by an increase in export earnings which will ramp up as investments in industrial and agricultural parks come on stream. The new sources of FX earnings will have the advantage of being less sensitive to swings in commodity prices than the traditional export basket.

Case study: The impact of FX shortages on a local business in Ethiopia

FX shortages in Ethiopia are affecting the operating capacity, efficiency and profit margins of a local B2B manufacturer. Local businesses may resort to using domestic instead of foreign inputs, or passing on the higher costs of imported goods to consumers—although this does not work for all. Meanwhile, obtaining FX requires imaginative solutions.

A business-to-business (B2B) manufacturer in Addis Ababa has produced steel products, including pipes, sheets and rods, for local manufacturers for almost ten years. It has grown to over 200 employees, with a turnover of more than US$2m in 2018. The company relies heavily on imported components, which in turn requires ready access to FX.

As a result of current FX shortages, the firm's manufacturing plant is running at 60-70% capacity. Approximately ten times per year, the firm must cease production completely. With significant overheads, these intermittent closures squeeze the firm's margins.

Imaginative solutions

As banks in Ethiopia rationalise the supply of FX, the manufacturing company has increased the number of banks it works with, from one to eight. The company must now deposit funds into each bank account in order to access FX services. Dealing with multiple banks creates inefficiencies and the process is not straightforward. As the manufacturer reports, "Putting in the same invoice at two different banks is illegal in Ethiopia, so acceptance of my FX applications is all down to chance. It is like a game of Russian roulette that we play every day."

FX shortages also increase input costs. Some companies pass these higher costs on to consumers, but B2B businesses find this more difficult as their customers are very price-sensitive. Raising prices risks losing these customers. As the manufacturer reports, "B2B businesses have no other option. They are stuck. They can't wiggle out on the import side and they cannot push their customers on the domestic market either." Furthermore, domestic inputs are not easily available.

Playing by the book proves difficult

Faced with a chronic lack of FX, some manufacturers in Ethiopia are considering other solutions. Some turn to the black market, although costs are very high. Others set up complex exporting businesses abroad to funnel FX to Ethiopia. However, many businesses, like this manufacturer, prefer to play by the book.

Kenya

Key findings

- Kenya has moved from a float to a stabilised arrangement regime; however, no FX shortages are reported. The main uncertainty for business and investors is around fluctuations of the exchange rate. Local businesses also report difficulties in borrowing for working capital following the imposition of a cap on loan rates.
- Businesses are advised to build relationships with local banks, and to familiarise themselves with seasonality of the exchange rate (such as peaks coinciding with harvest seasons).
- Budget deficits over the years have pushed up the public debt/GDP ratio from 38% in 2008 to almost 60% in 2018. As a response, the government is embarking on a medium-term fiscal consolidation programme.
- A rise in the stock of external debt has been reflected in the deterioration of a range of external solvency and liquidity indicators. Kenya's external debt indicators are worsening but are not forecast to reach critical levels in the period to 2022.

Part 1: FX trends and outlook

Current policy: A market-determined exchange rate enables hard currency availability

Kenya is unusual in the region in having a market-determined exchange rate and no restrictions on the availability of FX. However, the IMF changed the classification of Kenya's exchange rate regime from a float to a stabilised arrangement in November 2015. Nonetheless, no FX shortages have been reported as businesses obtain it from the commercial banks and are able to remit FX overseas without restrictions. Banks offer accounts in US dollars and euros and it is easy to transfer money between accounts.

The Kenyan shilling has been quite stable against the dollar over the past 18 months despite a prolonged period of political uncertainty related to the disputed outcome of the presidential election and, more recently, the tightening of global liquidity that has exerted pressure on many emerging market currencies. The overall performance of the economy has been supported, according to some, by its diversified pool of enterprises.

Investor and business perceptions of the FX market are currently very positive. In contrast to other countries in the study, such as Ethiopia, in Kenya FX is readily and easily available from the commercial banks and transactions typically take place over the internet. There are no restrictions on remitting funds from the country. Additionally, clients can open US dollar accounts as well as local currency accounts, and switching funds between the two types of account is straightforward. The availability of

FX and the ease with which funds can be remitted outside the country make Kenya an attractive place for foreign capital to set up business, including as a regional hub.

The only uncertainty for business and investors is around fluctuations of the exchange rate, which are to be expected given the market-based determination of the rate. Nonetheless, the Kenyan shilling proved resilient to the protracted political uncertainty stemming from the disputed presidential election in 2017, which had to be rerun following a ruling by the supreme court. Several interviewees also noted that the shilling had stood up well to the tightening of global liquidity in 2018, which had led to large devaluations in many emerging market currencies.

The current sentiment: While FX is not an issue, there is some risk of volatility

Although Kenya is not experiencing FX shortages, fluctuations of the exchange rate may pose a challenge for businesses. Interviewees recommended building relationships with local bank staff as early as possible and being informed about the required documentation as these may enable businesses to negotiate better rates for large FX transactions. Businesses should also be aware of certain times when the exchange rate might peak (such as harvest seasons).

The Kenyan banking system is relatively well developed: domestic credit was equivalent to around 40% of GDP in 2018—much higher than the regional average. Loans for working capital are available in both local currency and dollars, although availability has been constrained by a cap on lending rates introduced by parliament in 2016, leading to a sharp slowdown in credit growth. The cap limits lending rates to 400 basis points above the central bank's policy rate. Government attempts to remove the loan cap in August 2018 were unsuccessful in the face of opposition from parliament.

Look out for market volatility

Exchange rate seasonality: As the exchange rate is market driven, it is influenced by seasonal factors, such as the tea harvest. These fluctuations are not always easy to predict. It makes sense to keep an inventory of dollars to reduce the risk of having to buy at a time when the price is high.

Local manufacturing business

Policy changes: Although returns are much higher than in developed markets, you need to be prepared for policy changes that can seriously affect the business climate. The cap on bank lending rates is an example, as the resultant slowdown in credit constrained growth across the economy more broadly.

Local manufacturing business

Crowding out: Government borrowing sometimes crowds out lending to the private sector and this has become a more pressing problem since the interest rate cap was introduced in 2016.

Local commercial bank

In general, interviews captured a sense of optimism and trust in the resilience of the economy facing external shocks, helped by a thriving entrepreneurial environment. The country's entrepreneurial spirit, as exemplified by its development of the M-pesa mobile payments system, was highlighted by several interviewees.

Faith in the economy

Resilience: Kenya is home to a large number of smart entrepreneurs who have shown a capacity to respond to challenges by squeezing costs or by finding new markets. This makes their businesses resilient to external shocks.

Private equity fund manager

Quick to rebound: Kenya typically rebounds quickly from shocks. Recovery from the election-related instability has taken longer than normal but sentiment has strengthened in recent months.

Private equity fund manager

For the future, interviewees believe that there will be a pay-off from infrastructure investments, such as the railway linking Nairobi with the port city Mombasa, opened in 2017, in the form of higher FX earnings from exports.

Projects in the pipeline

Oil: From 2023, oil exports will come on stream, adding US$2-3bn in FX earnings a year. This will help to ease any constraints in the FX market that may arise as a result of the government's increasing external debt repayments.

Government official

Geothermal power: Power generation will be transformed by the development of renewable sources, including wind, solar and geothermal. This should help to reduce energy costs for business, cut the fuel import bill and possibly generate future export earnings.

Developer of alternative power sources

What is on the horizon? The EIU's forecast

- Despite an increase in the absorption of Kenya's FX earnings by debt service in the period to 2022, we do not expect changes in the liberal FX regime. Dollars will remain readily available through the commercial banks, with occasional episodes of tightened liquidity around large external debt capital repayments, such as the Eurobond in 2019.

- We forecast a gradual depreciation of the shilling against the dollar which would see the exchange rate reach KSh118:US$ at the end of 2022. On the basis of our forecast of an average inflation rate of 6.5% over the next five years, this would imply broad stability in inflation-adjusted terms.

Part 2: Debt sustainability trends and outlook

Public debt: Rising levels to be managed through fiscal consolidation

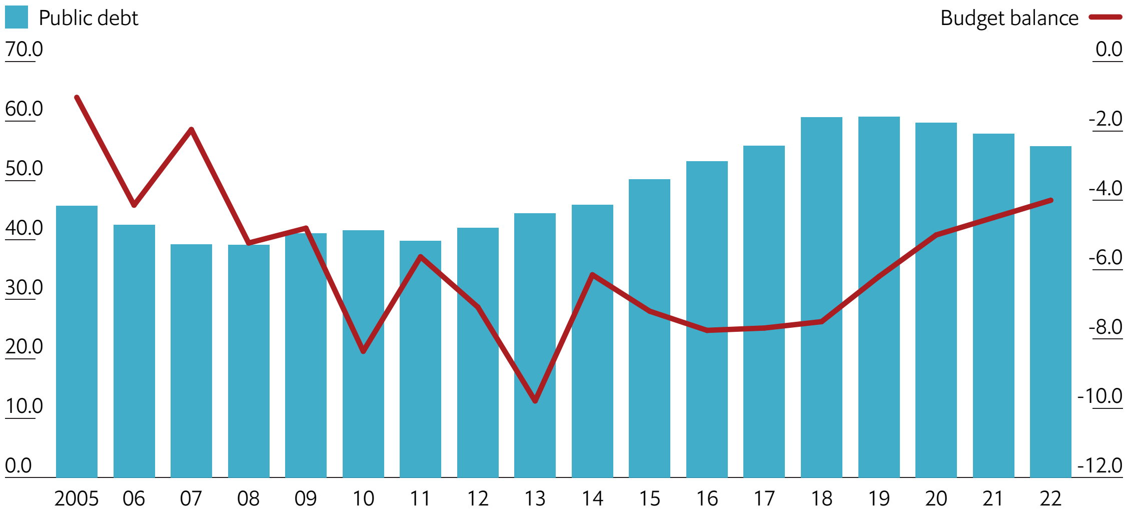
Budget deficits of 7% of GDP in the past four years have pushed up the public debt/GDP ratio from 38% in 2008 to almost 60% in 2018. At the same time the government has been relying increasingly on commercial creditors as a source of funding. At the end of 2016, commercial creditors accounted for 24% of public external debt, up from 6.5% at the end of 2013. Loans from commercial creditors are more expensive and pose more of a risk in terms of refinancing than loans from official creditors.

The government is aware that fiscal policy is unsustainable and is embarking on a medium-term fiscal consolidation programme. Public investment is set to slow following the completion of large infrastructure projects such as the railway linking Nairobi with Mombasa. Over the next five years projects aligned with Mr Kenyatta's Big Four agenda (healthcare, affordable housing, manufacturing and agriculture) will be prioritised.

Although the informal sector is large, the government is relatively efficient at collecting taxes. At almost 20% of GDP, government revenue is higher than in most African countries.

On the revenue side, the government aims to broaden the tax base and improve compliance. Measures in the 2018/19 budget include: a rise in the mobile money levy to 12% (from 10%); a "Robin Hood" tax of 0.05% on financial transfers; and a switch in the value-added tax (VAT) status of several items from exempt to zero-rated (thereby precluding firms from claiming refunds). The government also imposed VAT on fuel for the first time at a rate of 8% (reduced from the initial proposal of 16%).

Public debt and budget balance
(% of GDP)



Source: The Economist Intelligence Unit; Country Data.

Debt sustainability outlook: The EIU's forecast

- We forecast a gradual fiscal consolidation over the medium term. We expect spending to fall from the current record level of 27% of GDP to 23% of GDP by 2022, driven mainly by lower levels of public investment but also retrenchment in current spending, while revenue stabilises at around 19% of GDP.
- On the basis of our forecasts for GDP growth averaging 5.8% a year and a fiscal deficit narrowing from almost 8% of GDP to 3.7% by 2022, the public debt/GDP declines from the current level of 60% to 56%.

External debt: Current stock needs careful management

External debt has risen sharply in the era of low global interest rates since the global financial crisis of 2008-09. The external debt stock has increased from US$7.7bn in 2008 to US$28bn in 2017. The rise in the stock has been reflected in a deterioration in a range of external solvency and liquidity indicators. External debt as a percentage of exports of goods and services has risen from 84% in 2008 to 216% in 2017. The debt–service ratio, which expresses principal and interest payments on external debt as a percentage of exports of goods and services and remittances, has risen from 4.5% in 2008 to 15.5% in 2017.

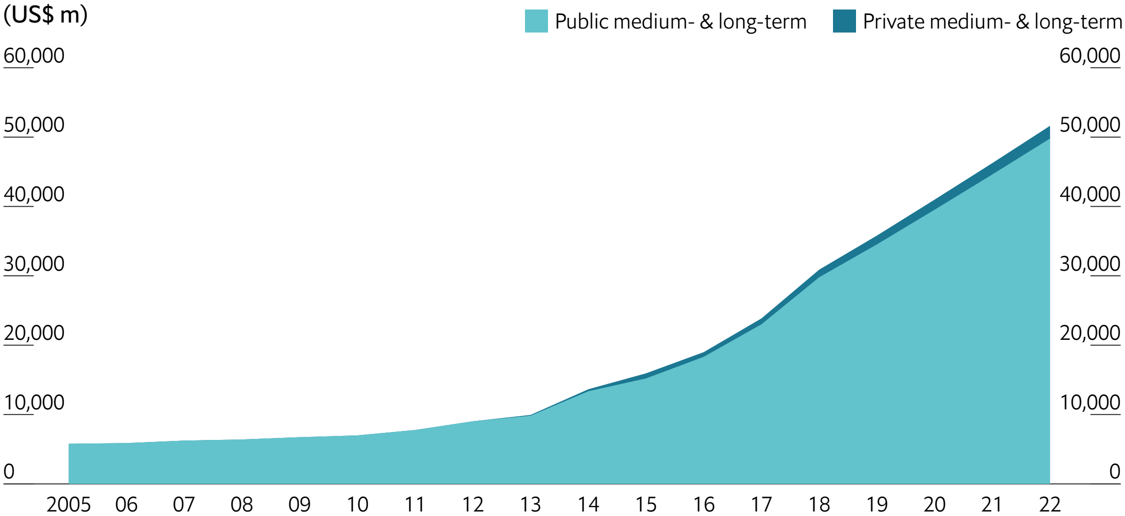
The debt–service ratio will be in the mid-teens most years but will spike to almost 20% in 2019 when a Eurobond matures. The government should be able to refinance the maturing Eurobond in the global capital markets but the cost may be high. The yield on the government's 2028 US$-denominated Eurobond has risen from 7% in February 2018 to 8.3% today, reflecting the tightening of global liquidity due to rising US interest rates and the reversal of quantitative easing.

Even in 2019 the debt–service ratio will be just below the 21% threshold applied by the IMF to Kenya for this indicator. In 2020-21 we forecast that the debt–service ratio will fall back to a range of 14.3-16.5%. Spikes in the debt–service ratio similar to that in 2019 will occur beyond the medium term when bond issues mature.

There is a concern that as future government debt servicing obligations absorb an increasing share of foreign exchange earnings, the availability of dollars for the private sector will tighten.

Local manufacturing business

External debt stock
(US$ m)



Source: The Economist Intelligence Unit; Country Data.

External debt outlook: The EIU's forecast

- Under our baseline scenario, Kenya's external debt indicators worsen but are not forecast to reach critical levels in the period to 2022. FX reserves, currently at US$8.5bn (5-6 months of import cover), will provide a cushion. Fiscal consolidation and the completion of import-intensive infrastructure projects will relieve pressure on the external accounts as well as the budget.

- From 2023 oil exports will come on stream and should generate additional annual earnings of US$2-3bn over the medium term.

> *The government should follow through on its fiscal adjustment programme, particularly on current spending. This will help to crowd in the private sector and reduce the risk that the government's external financing needs will result in a large devaluation of the shilling.*
>
> **Local manufacturing business**

Case study: Kenyan local businesses struggling with working capital shortages

Working capital shortages are a critical drag on SME activity in Kenya. A government cap on interest rates has unintentionally curtailed lending to small businesses. Some businesses are responding by introducing new efficiency measures, but the lack of financing is restricting growth.

Traditionally, Kenyan banks charged high interest rates (around 20%) on loans to SMEs, due to their high-risk profiles. In September 2016, in an attempt to rein in the cost of borrowing, the Kenyan government implemented an interest rate cap at around 14%. In response, banks stopped lending to SMEs altogether. Instead, they chose to park their funds in low-risk government treasuries, which offer returns of 13%.

Taking matters into their own hands

The interest rate cap has curtailed SMEs' access to working capital, according to a Nairobi-based private equity fund manager. With banks unwilling to lend, the fund's two SMEs have had to contemplate expensive alternatives, such as local microfinance institutions. Making matters worse, the fund's SMEs lacked the financial know-how needed to manage the little capital that they were able to access.

As the SMEs' difficulties began to hurt the fund's returns, fund executives decided to tackle management inefficiencies. They brought in a new CFO at one SME and established a new board of directors at the other. These new actors refined the management of working capital and improved links and negotiation processes between the SMEs and banks, which boosted their access to credit. The fund's intervention has proven pivotal. A year later, both businesses are performing better. According to the fund manager, "without our capital management solutions, one of our portfolio businesses would have shut up shop within two years."

However, these solutions can be costly, time-intensive, and do not always work. They also do little to address the underlying challenge of ensuring consistent access to credit for fast-growing SMEs.

Hopes of change

The capital shortage in Kenya has hurt this fund's overall growth prospects, the fund manager reports. But there are hopes that the situation will improve. The Central Bank of Kenya and the National Treasury are proposing an SME credit guarantee scheme. The goal is to reduce SMEs' risk profiles and boost their access to commercial loans. However, the scheme is likely to take at least two years to be fully implemented. In the meantime, companies will need to be adaptable to meet their finance needs.

Nigeria

Key findings

- The collapse of oil export earnings in 2014-16 led to a devaluation of the naira and the imposition of severe restrictions on the availability of FX. The country currently operates a segmented exchange rate that subsidises priority sectors.
- The shortages of foreign currency create severe problems for businesses. Business margins were squeezed by the hurdles needed to obtain foreign inputs. Waiting times for FX have reportedly improved, but businesses are advised to build cash reserves and focus more on risk planning.
- Successive governments have failed to broaden the tax base which leaves the government over-dependent on oil revenues. It has funded the budget deficits by tapping into global capital markets. The public debt/GDP ratio has been rising fast since 2014 but is forecast to stabilise from 2020.
- External borrowing costs have been quite low but this has increased the sensitivity of the public debt dynamics to movements in the exchange rate. The debt/GDP and debt/exports ratios have worsened noticeably as a result but remain at manageable levels.

Part 1: FX trends and outlook

Current policy: A segmented exchange rate regime sensitive to oil revenue

The authorities have traditionally operated a segmented exchange rate that subsidises sectors deemed important for economic or political reasons. For example, favourable exchange rates apply to imports of staple foodstuffs whereas luxury goods are subject to punitive rates.

The collapse of oil export earnings in 2014-16 led to a devaluation of the naira and the imposition by the central bank of severe restrictions on the availability of FX. The shortages of foreign currency that followed created problems for businesses. Companies dependent on imported raw materials were unable to obtain them and, in some cases, had to close. A requirement for naira to be lodged at a bank for six weeks in order to obtain FX put pressure on working capital. At the same time, consumer demand collapsed owing to the decline in real incomes. Many retailers with rent costs indexed to the dollar went bankrupt.

The FX crisis was not well managed by the government. If it really needed to impose bans on some imported goods, at least it could have given notice. That would have given local firms the opportunity to import the machinery needed to produce the goods locally. In the event of another large drop in world oil prices, FX availability will again become restricted unless the authorities shift to a more flexible exchange rate system. But the authorities may at least have learnt from recent mistakes and handle such matters better in future.

Private equity investor

In 2017, the authorities made piecemeal moves towards liberalising the exchange rate. These include:

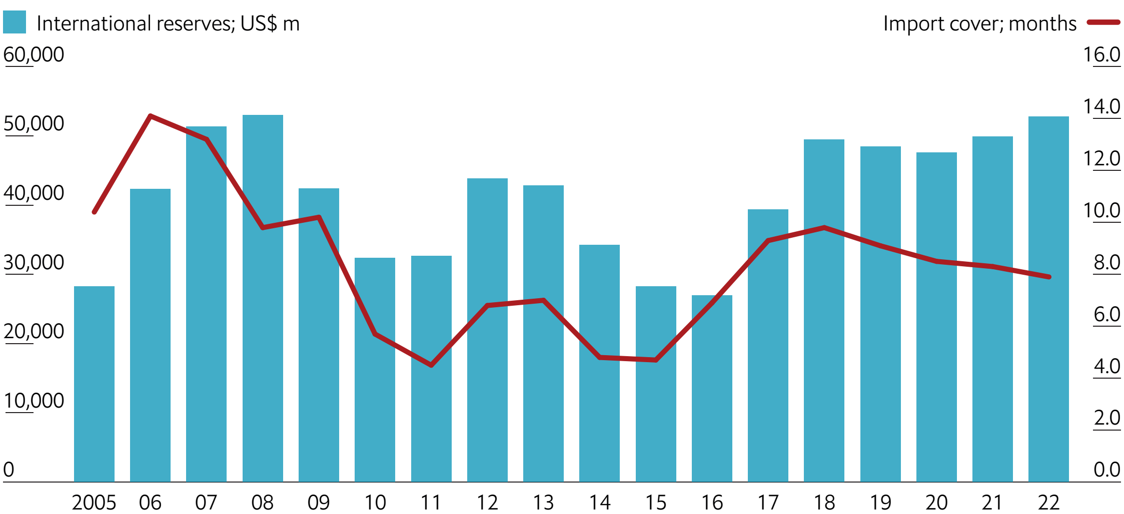
- The introduction in April 2017 of the Investors' and Exporters' (I&E) window for portfolio investment flows, export earnings and trade-related payments such as loan repayments, dividends and interest payments.
- Since April 2017, establishing that central bank approval is no longer needed for interbank trading, but that purchases on the interbank market have to be channelled to clients for permitted transactions.

The amount of hard-currency earnings from oil dictates the level at which the authorities are able to hold the official rate and what the premium is between the official and other, more market-determined, rates. The latter comprise the Nigerian Autonomous Foreign Exchange Fixing (NAFEX) and the I&E window that was opened in April 2017.

> *The current NAFEX (Nigerian Autonomous Foreign Exchange, the interbank FX market) rate is only partly market-determined as buyers and sellers are aware of the rate the central bank is targeting. Rising oil prices and export volumes have ensured there was enough FX liquidity to maintain this rate in 2018 despite a broad-based rout in emerging market currencies.*
>
> **Investment bank**

Portfolio investors attracted by high real yields on Nigerian government securities, exporters and authorised dealers bring FX liquidity to the I&E window, and the central bank then supplements any shortfall from the private sector in order to hold the rate at a targeted level. However, it is believed that the naira is currently trading above fair value and the current policy is not sustainable without higher oil prices. The decline of around 20% in oil prices since late September 2018 will add to pressure on the peg in 2019.

International reserves and import cover



Source: The Economist Intelligence Unit; Country Data.

The current sentiment: After the devaluation, the focus is now on risk-proofing

While the waiting times for FX are reportedly much better today, interviews revealed that the impact of the devaluation in 2016 and the consequent FX shortages on firms, banks and consumers is still being felt. Rising import prices have been reflected in higher costs to consumers and squeezed margins for local businesses.

FX shortages with lasting knock-on effects

Squeeze on margins: Companies can adjust to a devaluation by passing on some of the increase in costs to customers and accepting a squeeze on margins. But a lack of availability of FX makes life very difficult, even for a business like ours which is not particularly import-intensive.

Private equity investor

A perfect storm for retailers: The retail sector has been badly hit. Consumer demand is taking time to recover from the downturn. Margins on imported goods have been squeezed as retailers have been unable to pass on fully to consumers increased costs from the devaluation. Also, some retailers' rents, in malls, for example, are indexed to dollars.

Real estate investor

Consumers take a hit: Nigeria's economy is extremely import-dependent. As a result, currency weakness has broad-based knock-on effects across the whole economy, as the increase in costs for imported staples, such as rice and sugar, squeeze the amount that households can spend on discretionary goods and services.

Private equity investor

Interviews revealed that, facing FX restrictions, businesses resorted to unofficial channels. The situation also pushed for changes in business planning. Cash reserves became a necessity in such an environment.

Adapting for survival

Unofficial channels: At times the only way to access FX was through the black market and this led to a tripling of costs in some cases.

Private equity investor

Build cash reserves: It pays to have ample cash reserves that can be drawn on to ensure the business has sufficient working capital to withstand extended periods when FX is simply not available.

Private equity investor

Local businesses and investors suggest developing conservative business plans, with ample levels of reserves. Currency mismatches (for payments and revenue) should be avoided as far as possible. Mitigating risk by diversifying an investment portfolio geographically is worth considering. Furthermore, interviewees pointed to the need to take opportunities for exits when they present themselves.

Strategies to minimise risk

Regional diversification: The difficulties in Nigeria showed the benefits of having a portfolio that has a diversified exposure across the region. In Africa it can be dangerous to put all your eggs in one basket.

Private equity investor

Match costs and revenue: The devaluation and shortages of FX highlighted the benefits from an operational point of view of matching currency costs with revenue. Wherever possible, firms and investors should borrow in the currency in which they earn.

Fund manager

Research FX structures from the start: With hindsight one thing we would have done differently, given the problems we faced owing to the lack of FX availability, is to have paid more attention to how the investment was structured in terms of FX from the start.

Private equity investor

Difficult exits: It's hard to achieve exits in the current market. We won't attempt this until a government dispute with MTN, the South African mobile operator, over tax and the breach of FX regulations has been settled. The dispute is creating uncertainty among investors.

Private equity investor

Consider shorter investment cycles: Investment cycles have become shorter. If you are offered an exit, take it.

Private equity investor

What is on the horizon? The EIU's forecast

- The multiple-exchange-rate system is likely to remain in place throughout 2019-22, still with a notable differential between the official rate used for government business and the partly market-determined rate applicable to investors and exporters (with various other rates in between).
- Later in 2019 a devaluation is likely, particularly if oil prices fail to recover from the 20% decline suffered since the peak in September. This would help to correct an overvaluation of the currency that has built up owing to persistently high inflation. Over the medium term a pattern of periods of nominal exchange rate stability followed by periodic devaluations is likely.

Part 2: Debt sustainability trends and outlook

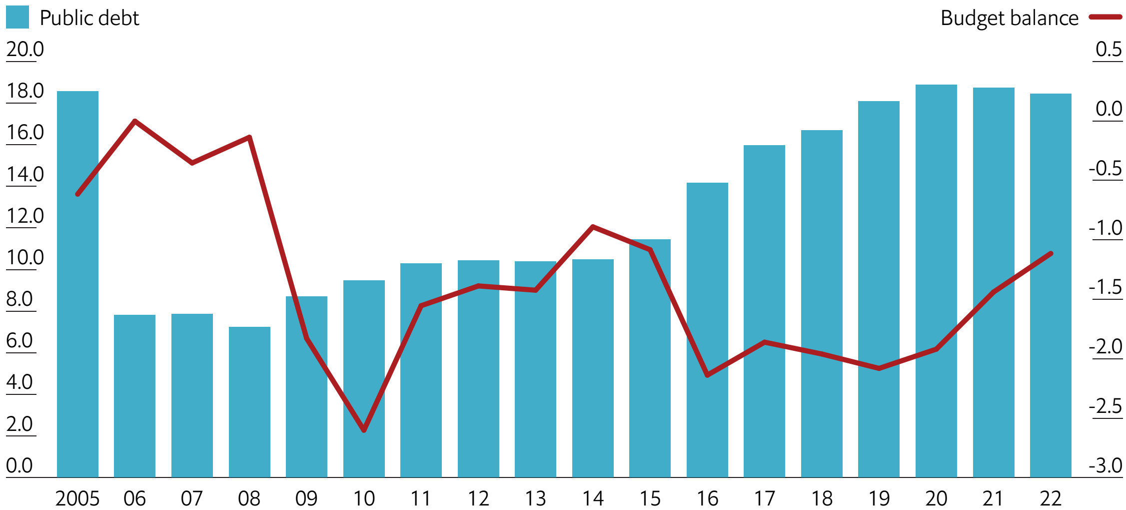
Public debt: Budget deficits increasingly funded by capital markets

Successive governments have failed to broaden the tax base, which leaves the government over-dependent on oil revenues. This was starkly exposed in 2014-16 when general government revenue fell by 50% from 10.5% of GDP to 5.3% of GDP. Despite the low level of public debt (15.9% of GDP in 2017), interest payments absorb around 25% of revenue at the general government level.

On the spending side there is misallocation of resources. Around US$5bn (1% of GDP) is allocated to fuel subsidies which benefit the better off and incentivise smuggling. When revenue declines force cuts in spending, the axe falls on capital programmes, including infrastructure and social initiatives, which would otherwise have a potentially large pay-off in terms of raising productivity.

The government has funded the budget deficits by tapping into global capital markets. Borrowing costs have been quite low but this has increased the sensitivity of the public debt dynamics to movements in the exchange rate.

Public debt and budget balance
(% of GDP)



Source: The Economist Intelligence Unit; Country Data.

Public debt outlook: The EIU's forecast

- We forecast a fiscal deficit of around 2% of GDP in 2018 and 2019 before an improvement from 2020. The public debt/GDP ratio has been rising rapidly since 2014, but is forecast to stabilise from 2020. The risk of a federal government default on its domestic or external liabilities during 2018-22 is low.

- The main risks to this forecast are: a large and sustained fall in world oil prices; increased rebel activity in the Delta region resulting in the interruption of oil production and lower export volumes; a large devaluation of the naira which would increase the value of the growing stock of hard currency debt in naira terms; and repayment difficulties at the state level where revenue collection is even weaker than at the federal level.

> *Structural reforms in the public finances are needed to ensure debt sustainability over the long term. In particular, broadening the tax base is necessary to reduce the amount of revenue absorbed by interest payments. The fuel subsidy also consumes a large share of revenue that would be better channelled into public investment.*
>
> **Investment bank**

External debt: Borrowing has increased but external debt remains manageable

Sizeable current account surpluses until 2014 enabled the government to adopt a conservative approach to external borrowing. Since 2014 it has borrowed more heavily, which has resulted in a doubling of medium- and long-term public debt from US$9.1bn to US$18.9bn. Over the same period private sector medium- and long-term debt rose from US$13.2bn to US$19.9bn. In total, the external debt rose from US$25bn to US$41bn in 2017.

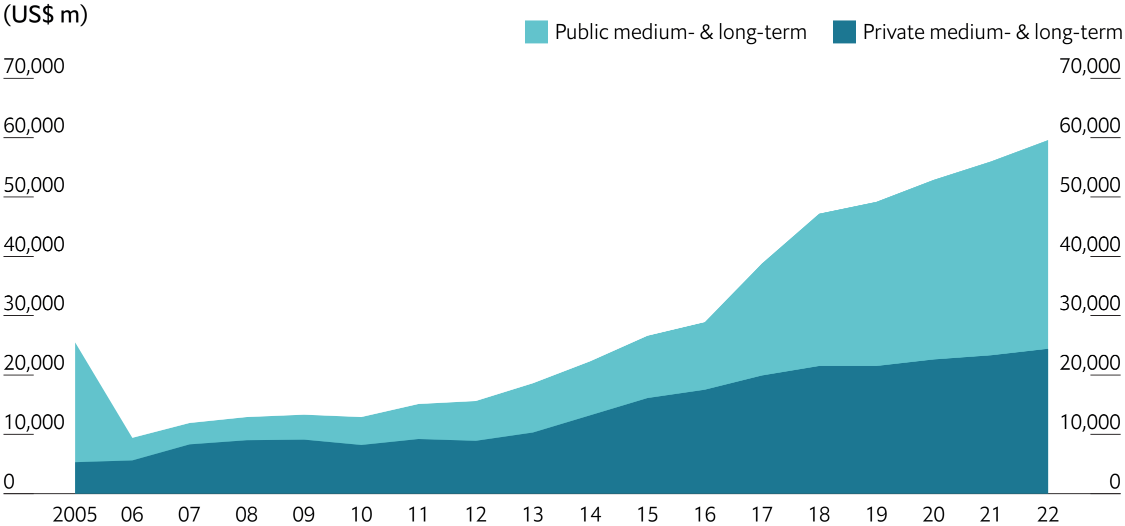
The surge in external borrowing since 2014 reflects both the need to raise external capital to make up a shortfall in foreign currency earnings from oil, and the extraordinarily favourable conditions on global capital markets.

The debt/GDP and debt/exports ratios have worsened noticeably as a result but remain at manageable levels. This remains the case even with the caveat that the GDP denominator is inflated by an overvalued exchange rate.

Nigeria's debt–service ratio and interest/exports of goods & services ratio fell sharply in 2006 when the Paris Club of bilateral creditors provided US$18bn of debt relief. Since then, both ratios have been on an upward trend that accelerated from 2014. However, they remain low at 3.8% and 1%, respectively, in 2017, and were only a small contributory factor to the lack of availability of FX in recent years.

> *The government has taken advantage of favourable conditions on the international capital markets to raise funding at long maturities, 10 years and even 20 years. This eases concerns about a liquidity crunch, at least over the medium term.*
>
> **Investment bank**

External medium and long-term debt
(US$ m)



Source: The Economist Intelligence Unit; Country Data.

External debt outlook: The EIU's forecast

- We forecast that the debt/GDP and debt/exports ratios will stabilise over the medium term. These forecasts are based on an oil price forecast averaging US$75/bn over 2019-22.
- We forecast that the debt–service ratio will rise from 3.8% in 2017 to just under 6% by 2022. Although on an upward trend, the ratio will remain comfortable, reflecting both the level of debt and a long average maturity.

The government needs to do more to incentivise businesses to set up and produce locally. This would help to reduce the economy's import dependence and reduce the need for external financing which contributes to the squeeze on FX availability at times of low oil prices.

Private equity investor

Case study: An investment fund hit by FX shortages in Nigeria

In Nigeria, FX shortages have severely hit local businesses and foreign investors. An investment holding company reports that rising inputs costs and falling sales have squeezed margins of local businesses. The situation has led this investor to rethink its business plans in Nigeria. Meanwhile, local businesses have tried to reduce their import dependency.

In 2016, a Nigerian construction company, backed by a regional investment fund, had two ways to obtain FX: lodge naira at the bank and wait unproductively for the FX to be allocated (the official route), or go to the black market. As the salaries of its foreign workers were due to be paid, the company was forced to pay the higher and unpredictable black market prices. In a short period of time, the company's costs tripled, while overall demand for its services fell.

As the Nigerian business was perceived as a long-term investment, the investment fund chose to retain its stake through the crisis. To help the firm cope with its financial difficulties, the fund contemplated injecting liquidity, but ultimately decided against this due to the market uncertainty. Instead, it focused on funding other companies in its portfolio. The Nigerian company accounted for only 5% of the overall portfolio, but it still weighed down the fund's overall performance. The fund's investment manager could not quantify the precise impact of the crisis in Nigeria on the fund's growth. He noted that it was a "a stressful and chaotic time for the local management team".

Valuable lessons

FX availability is reportedly improving in Nigeria, but the fund has learned to pay close attention to this aspect of the market. In the future, it will weigh FX risks more heavily when valuing companies, the fund manager reports. In the fund manager's view, "people will be much more cautious across the board."

The experience had implications for the local industry too. To reduce its exposure, the portfolio company reduced the number of foreign workers and hired more employees locally. Fluctuating import costs have apparently led local producers to diversify into sectors such as agro-processing which were previously viewed as unattractive owing to the prevalence of lower-cost imported goods.

Tanzania

Key findings

- The Bank of Tanzania operates a partially managed exchange rate regime which keeps the shilling trading within a tight band. This creates some risk of FX shortages. However, businesses report good liquidity in the market.
- Businesses should take advantage of their ability to open dollar accounts and of the lack of restrictions on remitting funds in Tanzania. Those looking to purchase FX should prepare relevant documentation in advance, such as invoices, as these processes can delay purchases. There is also some concern about recent policy changes affecting the business environment.
- Fiscal deficits over the years have pushed up the public debt/GDP ratio, with spending increases driven by capital investment in infrastructure. However, strong GDP growth may contain the rise in the public debt/GDP ratio. Increased government borrowing has raised concerns about the effects of higher interest rates on limited credit availability for local businesses.
- FDI flows have been insufficient to fund large current account deficits averaging almost 9% of GDP over the past decade. The external funding gap has been filled by debt-creating flows. External debt indicators are worsening but are still at manageable levels.

Part 1: FX trends and outlook

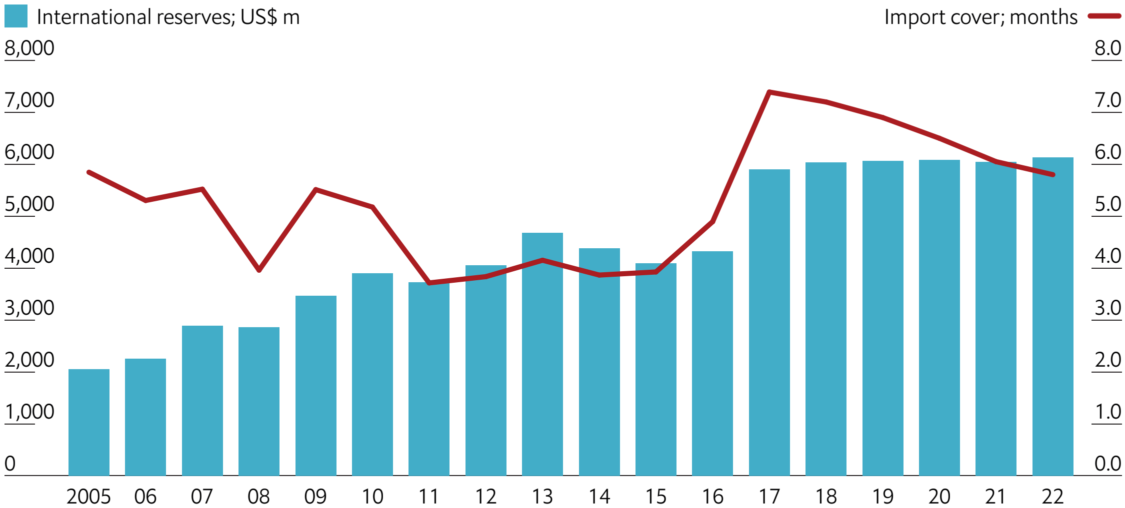
Current policy: A "stabilised" exchange rate system offering enough liquidity

The Bank of Tanzania was operating a managed float of the shilling until the devaluation of 2015. It has since shifted to a less flexible regime which keeps the shilling trading within a tight band. The nominal exchange rate weakened by 1% against the dollar in 2016, 2.6% in 2017 and around 3.5% in 2018. Given annual inflation of around 4.5% in 2016-17, the real exchange rate has been broadly stable.

The IMF classifies the current de facto exchange rate as "stabilised". The shift in exchange rate regime means that there is now more risk of shortages of FX availability than previously. However, according to interviewees, including an FX trader at a commercial bank, there is generally good FX liquidity in the market and, whenever there are shortages, the Bank of Tanzania steps in.

In 2016-17 there was pressure for the shilling to appreciate as a result of a marked narrowing of the current account deficit. The Bank of Tanzania offset this pressure by making net purchases of dollars, thereby injecting liquidity into the domestic financial system. Together with the slow execution of government infrastructure projects, this resulted in an increase in FX reserves from US$4.1bn at the end of 2015 to US$5.9bn at the end of 2017. Reserves fell back in 2018, in part owing to a general flight of capital from emerging markets, but at US$5.5bn in August 2018 still provide a comfortable 5-6 months of import cover.

International reserves and import cover



Source: The Economist Intelligence Unit; Country Data.

Although FX availability is not currently an issue for businesses, it may become so in the future under the present system where the Bank of Tanzania would run down its reserves in the event of the economy suffering an external shock, such as a decline in export earnings due to a fall in commodity prices. The IMF has commented on the need for greater exchange rate flexibility—this would be more compatible with the Bank of Tanzania's new monetary policy framework which is based on interest rates to control inflation.

The supply of FX depends on earnings from mining and agriculture, inflows from donors and external borrowing. If FX supply does not match demand, the Bank of Tanzania steps in to cover the shortfall but it is discretionary in the allocation of FX. It does not fulfil the market requirement 100% of the time. Businesses may therefore face delays in meeting their full FX requirements.

Local commercial bank

According to interviewees, some FDI is being deterred by uncertainty about policy and regulatory stability. Investment by foreign mining companies has fallen following the imposition of a ban on unprocessed mineral exports—despite there being no viable means of processing minerals locally—and revisions to the regulatory framework that erode the sector's attractiveness. FDI inflows slowed to an average of US$1.3bn a year in 2016-17 from US$1.8bn in 2012-15. In the period 2012-17 as a whole, FDI covered just under half of the current account deficit, leaving the remaining half to be funded by debt inflows.

But Tanzania still offers advantages for foreign investors in terms of the availability of FX and the ability of businesses to open dollar accounts and remit funds without restrictions. This makes it easy to import the capital goods needed to set up businesses and to source imported inputs for domestic processing industries.

The current sentiment: Businesses are attentive to policy changes

Although FX availability has generally not been an issue for businesses, they have been affected by currency depreciation. For example, the margins of an agricultural business surveyed were squeezed by higher costs for imported inputs priced in dollars, such as fertilisers and chemicals. In this sense, businesses need to allow for the impact of currency depreciation on profits in their business plans. There are also reported delays in the process of obtaining FX. The availability of credit from the domestic banking system is likely to become more constrained as a rising level of non-performing loans puts pressure on banks' capital adequacy.

FX available, with limitations

Watch out for devaluation: We have had no issues with FX availability. We were affected by devaluation in 2015. This squeezed our margins as the inputs for our agriculture business (chemicals and fertilisers) are imported and priced in dollars.

Local agricultural business

FX allocation is sector-neutral: No sector is assigned priority in the allocation of FX. There are no restrictions on saving in FX but the rates are very low. Preference for US$-denominated deposits increases during electoral periods.

Development bank

Restrictions for access: There are no restrictions on obtaining dollars but purchases have to be supported by documentation, such as invoices for imports. This is intended to deter speculations and comply with anti-money-laundering regulations.

Local commercial bank

While FX availability is not currently a major issue for businesses, there is concern about the government's inconsistent economic policy agenda which is leaning towards economic nationalism. Businesses are having to contend with abrupt tax increases, erratic regulatory changes and a lack of transparency. Private investment is likely to fall short of what is needed to achieve the government's development goals.

Government policy is a concern

Erratic decision-making: One thing that does concern us is the erratic nature of decision-taking under the current government. Consistent, predictable policy would help us to plan and achieve our business goals. Government efficiency is being hindered by the centralisation of power.

Local agricultural business

Trust in the private sector: The government's intervention in the mining sector demonstrates a lack of trust in the private sector. It should focus on improving the road network and education and give the private sector a freer hand to contribute to the country's development.

Independent power producer

The government's Development Vision 2025 plan prioritises industrialisation and job creation, with a commitment to pursue a private-sector-led development strategy and promote good governance. This plan is producing results. For example, farmers are setting up cooperatives with a view to improving efficiency, raising income and exporting more.

In the short term, industrialisation tends to be import-intensive, which can create pressures on the currency. But it brings long-term benefits by increasing the country's capacity to generate FX earnings.

The way forward

Promote FDI: The country is not attracting enough FDI. Given the lack of domestic capital, this leaves the government dependent on expensive FX borrowing to fund its industrialisation plan. Mining and energy are sectors with strong potential but foreign investors no longer find the regulatory environment sufficiently attractive or certain.

Research centre

Industrialisation needed: The IMF and World Bank have expressed concerns about the sustainability of the FX regime. But in my view the main long-term challenges are industrialisation and raising living standards. GDP growth has averaged 6% a year over the past decade but job creation has been weak and wages have remained low.

Research centre

Payment in dollars: The government is trying to discourage pricing and payment in dollars. The impact of this on our business will depend on how far it goes. Our inputs, such as spare parts, are priced in dollars and we need dollar payments to match these outgoings. The government needs to be selective in pushing this.

Independent power producer

What is on the horizon? The EIU's forecast

- Existing FX arrangements are likely to remain unchanged over the medium term, which means that businesses should continue to have good access to FX most of the time, with occasional periods when availability is tighter.

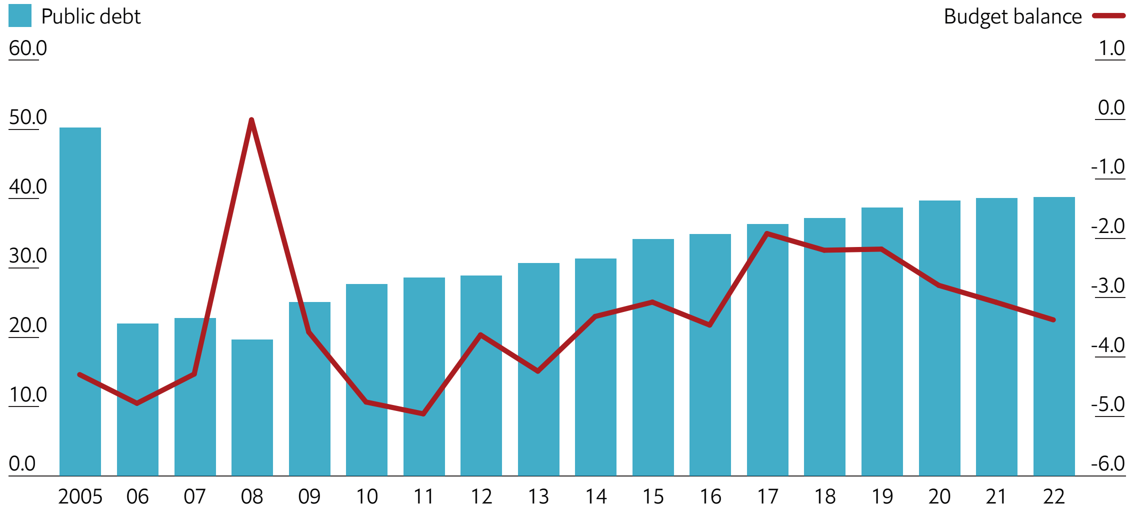
- We expect the shilling to depreciate against the dollar throughout the forecast period, falling from an annual average of TSh2,267.2:US$1 in 2018 to TSh2,745.5:US$1 in 2022. After only a modest depreciation in 2018, the shilling is forecast to weaken more sharply in 2019 as US monetary tightening reaches its peak, before an end to this cycle in 2020.

Part 2: Debt sustainability trends and outlook

Public debt: Rising with capital investment

Fiscal deficits averaging 3.3% of GDP have pushed up the public debt/GDP ratio from 20% in 2008 to 36% in 2017. Spending increases have been driven by capital investment in infrastructure, including road, rural energy and phase II of the Tanzanian segment of the standard gauge railway. Budget revenue was only 16% of GDP in 2017. There is scope for broadening the tax base by streamlining exemptions and simplifying the tax system.

Budget balance and public debt
(% of GDP)



Source: The Economist Intelligence Unit; Country Data

Public debt outlook: The EIU's forecast

- We expect the fiscal deficit to widen from an estimated 2% of GDP in 2017/18 to 3.4% of GDP in 2020/21 as progress on key flagship projects, including road expansion, rural energy infrastructure projects and phase II of the Tanzanian segment of the standard gauge railway, pick up pace.

- Strong GDP growth will contain the rise in the public debt/GDP ratio which we forecast to reach 40% by 2022. The main risks are fiscal slippage and another devaluation of the currency, as in 2015, but neither would bring debt sustainability into question.

External debt: Borrowing has risen, but is still at manageable levels

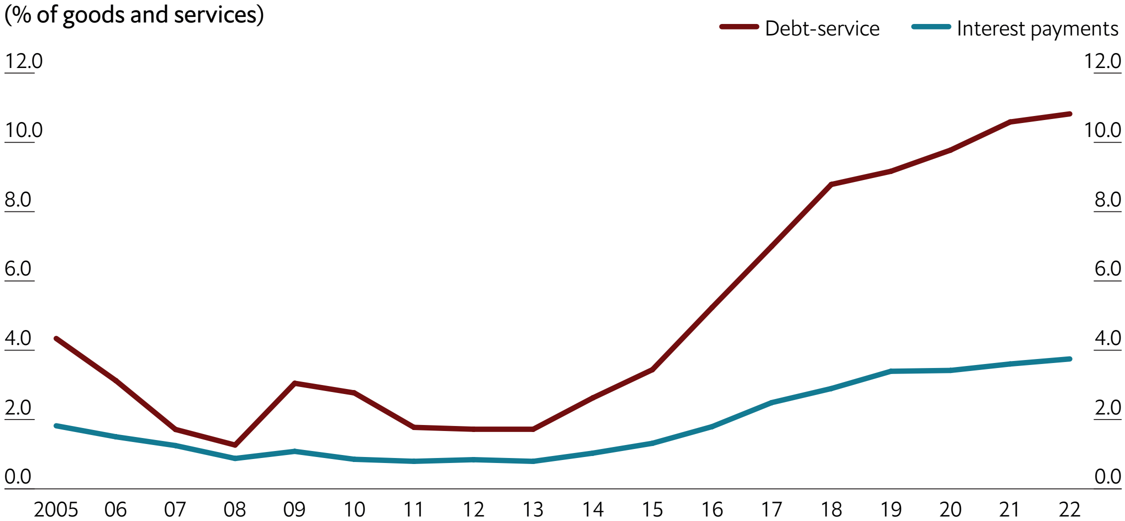
Tanzania has attracted FDI averaging 4% of GDP over the past decade although flows have declined in recent years, in part owing to government disputes with companies in the mining and energy sectors. But even before the recent decline in FDI, flows were insufficient to fund large current account deficits averaging almost 9% of GDP over the decade.

The external funding gap was filled by debt-creating flows. Public external debt grew from US$3.7bn in 2008 to US$12.5bn (24% of GDP) in 2017. Tanzania continues to rely primarily on official funding although the share of funding sourced from commercial creditors has been rising and at US$4.5bn in 2017 is now more than one-third of total medium- and long-term public external debt. A mooted maiden Eurobond has been repeatedly delayed and is unlikely in the short term given more challenging conditions in global capital markets.

Strong GDP growth averaging 6.6% in 2008-17 contained the rise in the external debt/GDP ratio from 22% to 34%. Export growth was uneven over the same period. Export merchandise earnings peaked at US$5.9bn in 2012 but have since fallen back to under US$5bn on commodity price weakness. This has resulted in a rise in the external debt/exports of goods and services ratio from 105% in 2008 to 195% in 2017.

The debt–service ratio, which expresses principal and interest payments on external debt as a percentage of exports of goods & services and remittances, rose from 1.2% (artificially low following debt forgiveness in 2006) to a still comfortable 7% over the same period.

Debt service and interest payments
(% of goods and services)



The Economist Intelligence Unit; Country Data.

External debt outlook: The EIU's forecast

- Over the next five years the debt–service ratio continues to rise, reaching 10.9% in 2022. But this is still a comfortable level and well below the 15% threshold the IMF uses for this indicator for Tanzania.
- Interest charges on the external debt rise over the same period to consume just under 4% of FX generated by goods and services.

Zambia

Key findings

- The central bank's managed float ensures FX availability. Indeed, none of the businesses surveyed complained about their ability to access FX in Zambia. However, weak commodity prices are resulting in devaluation and volatility has discouraged capital inflows. Businesses also report working capital constraints due to credit crowding-out by the public sector.
- Facing exchange rate volatility, businesses are advised to structure their investments to minimise currency mismatches. They should also consider building and maintaining relationships with bank officials.
- The public debt/GDP ratio more than doubled from 30% in 2013 to 65% in 2017 as a result of large fiscal deficits. According to the EIU's forecasts, which are based on the assumption that Zambia avoids default, the public debt ratio stabilises at around 80% until 2020 before falling slightly in 2020-21.
- The current account moved from surplus into deficit while inflows of FDI declined. This left Zambia with an external financing requirement that has been covered mainly through debt inflows. The debt/GDP ratio in particular is forecast to reach worryingly high levels for a poor and commodity-dependent economy.

Part 1: FX trends and outlook

Current trends: A managed float ensures FX liquidity but devaluation is a risk

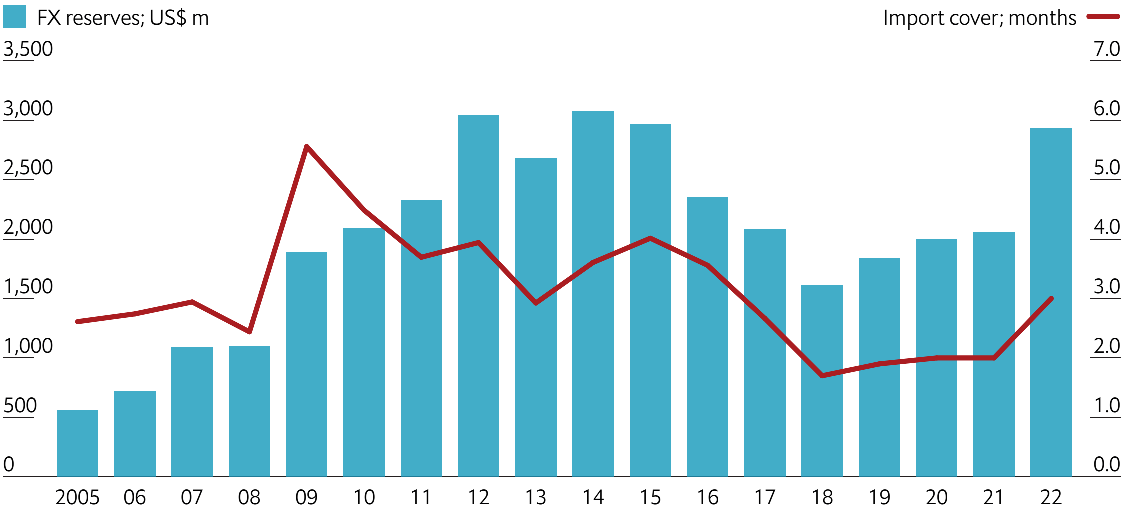
The central bank's managed float ensures FX availability. Indeed, none of the interviewees we spoke to complained about their ability to access FX in Zambia. The problem is the price. Copper and other metals account for three-quarters of export earnings and the kwacha is highly sensitive to swings in world prices. Reflecting this, the kwacha depreciated against the US dollar in 2018 as a result of weak commodity prices and risk aversion regarding emerging markets generally.

The kwacha has lost more than 50% of its value against the dollar since the end of 2013. Devaluations of this magnitude make it difficult to generate the dollar returns that some investors expect, even if the business does very well. After stabilising in 2016-17, the kwacha came under renewed pressure in 2018 as copper prices weakened amid softening Chinese demand. Capital outflows due to tightening global liquidity were also a source of pressure on the kwacha in 2018.

A stabilisation fund, in which revenue is saved at times when copper prices are high and drawn down when prices are low, would cushion the FX market and the economy more broadly from the vagaries of copper prices. An example is the Economic and Social Stabilisation Fund which successfully operates in Chile. However, operating such a fund in Zambia would require more discipline in public finance management.

The government's failure to reach a loan agreement with the IMF has unnerved investors who fear an external debt default which would lead to capital outflows. This is reflected in the yield on Zambian Eurobonds which has risen from 7% in February to 16% in early 2019. International reserves are low and falling and provide import cover of less than two months, signalling a growing risk of hard currency shortages for business.

FX reserves and import cover



Source: The Economist Intelligence Unit; Country Data.

The current sentiment: Finding opportunity in a volatile environment

Interviews with stakeholders highlight the challenges of investing in a commodity-dependent country, with a risk of exchange rate volatility. At the same time, as Zambia is an import-intensive country, the requirement for FX among businesses is high. Although there are no imposed restrictions on FX, businesses have felt a reduction in dollar liquidity in the FX market since August 2018 due to new rules concerning revenues from the mining sector. To improve access to FX, local businesses suggest approaches such as developing good relationships with the banks. Zambia's precarious external liquidity position and the challenges it will face in servicing hard-currency debts falling due in 2019 will heighten expectations of devaluation and constrain the availability of funding. The situation would improve if the government is able to reschedule debts owed to China and sign a loan agreement with the IMF.

FX market with some volatility

FX is being diverted: From August this year, the government decided that mining companies should pay their mineral royalties ... directly to government. It goes into the Control Account ... [previously] mining companies were changing that hard currency on the local market and then paying their local obligations. This left a bit of forex [FX] on the ground ... but now, that has been taken out of the market.

Local business

Currency depreciation: Investing dollars into a soft currency like the kwacha obviously will reduce dollar returns. You need very strong growth to compensate for currency depreciation. This has affected our ability to raise funds from some investors.

Fund manager

Hoarding of dollars: Nervousness about the kwacha has made it harder to obtain FX recently. The public have been making fewer dollar sales in the bureaux and businesses and investors have been holding on to their dollars in the expectation of further kwacha weakness.

FX trader

Build relationships with banks: The economy is slow and businesses are struggling but the FX market is open. It helps if you have a good relationship with the banks and can negotiate the rate. There is no commission charged on FX transactions and the maximum bid-offer spread is 2% by law.

FX trader

As in other African countries, there is concern about the government's large borrowing needs which are crowding out the private sector and absorbing FX liquidity. Multiple voices suggest that it is necessary for the government to consider other funding options, such as expanding the tax base.

Secondary effects of government borrowing

Fiscal weaknesses: Borrowing to fund capital investment is fine but the government has been borrowing to cover current spending. On the revenue side, it needs to broaden the tax base which would reduce the dependence on taxes and royalties from mining.

Fund manager

Local financing: I would like to see more local financing for business. The government could help by reducing its financing needs. Government securities are currently absorbing too large a share of domestic savings.

Fund manager

Equity not debt: Zambia needs infusions of equity rather than more debt, in order to reduce the vulnerability of businesses to the high costs of servicing debts. And private equity investments should have a time horizon of ten years. Five years is not enough.

Investment bank

Interviewees did express some optimism, highlighting that Zambia's geographical position gives it some appeal and the mining sector is still attracting investment. Others referenced a shift towards investors considering impact as well as returns.

Seize opportunity, with caution

Regional hub: Zambia is well positioned geographically. Surrounded by 8 countries, it has an ideal location as a regional hub.

Investment bank

Sentiment unduly negative: Naysayers are drowning out the optimists at present. But Zambia continues to attract investment. US$1bn has been committed to expand activities in the mining sector.

Investment bank

The general mood among the business and investor community is one of caution. Stakeholders suggest taking a careful approach to mitigate risks—for example, through considering new partnerships and a more comprehensive view of investments that considers sustainability and impact, rather than just returns.

Mitigating risks

Partnerships: One trend we are seeing in the current market is family firms with over-leveraged balance sheets forming partnerships with private equity.

Investment bank

Commodity dependence: Take a cautious approach to commodity-dependent economies, particularly if they are running twin deficits (fiscal and current account) as Zambia is.

Fund manager

Risk mitigation: Timing is always important in a market like Zambia. Know the risks before investing. Be conservative on leverage. Structure your investment in such a way that you minimise currency mismatches.

Fund manager

Sustainability and impact: People do want a return on their money but people nowadays are also turning towards sustainability and impact.

Fund manager

What is on the horizon? The EIU's forecast

- Without an IMF programme to provide reassurance, and with foreign reserves too low for sustained intervention, the kwacha is likely to remain under pressure in 2019. The EIU forecasts an average rate of ZK12.58:US$1, compared with an estimated ZK10.46:US$1 in 2018. As well as country-specific factors, the outturn will depend on the pace of monetary tightening in the US.

- From 2020 the EIU forecasts that the exchange rate will stabilise against the dollar on rising world copper prices which will boost export earnings. We forecast an average exchange rate of ZK12.40:US$1 in 2022.

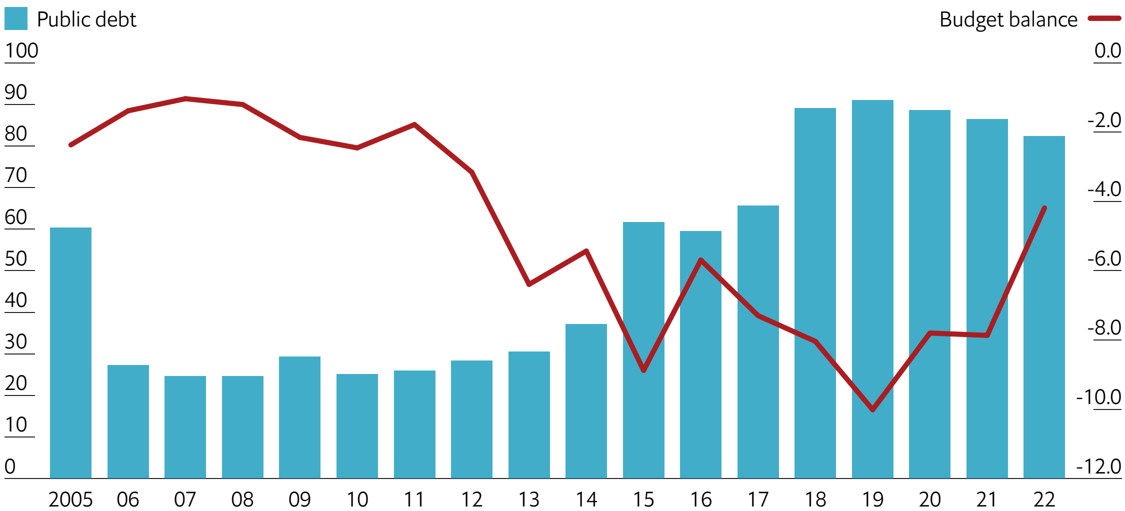
Part 2: Debt sustainability trends and outlook

Public debt: Fiscal deficits cause debt to double up

The public debt/GDP ratio more than doubled from 30% in 2013 to 65% in 2017. This has been the result of large fiscal deficits (averaging 6.7% of GDP in 2013-17). The problem has been on the spending side: the EIU estimates that government spending averaged 25% of GDP in 2013-17, up from 19.4% in the previous five-year period. The depreciation of the kwacha has also had an adverse impact through the revaluation of dollar-denominated debt in local currency terms. Medium- and long-term public external debt increased from US$3.2bn in 2013 to US$9.4bn in 2017; this translated to an increase in local currency terms from ZK17.8bn to ZK94.2bn.

According to EIU estimates, following a further devaluation of the kwacha, the ratio will have jumped further to around 90% in 2018, indicating a high risk of debt distress.

Public debt and budget balance
(% of GDP)



Source: The Economist Intelligence Unit; Country Data.

Public debt outlook: The EIU's forecast

- According to the EIU's forecasts, which are based on the assumption that Zambia avoids default, the public debt ratio stabilises at around 90% until 2020 before falling slightly in 2020-21. Fiscal deficits are expected to remain large and GDP growth only moderate at around 3.5%. But the forecast of exchange rate stability helps to keep the public debt/GDP ratio under control.

- The main risks to this forecast are: further kwacha weakness that would increase the value of dollar-denominated debt; a large drop in world copper prices.

External debt: Reaching worryingly high levels

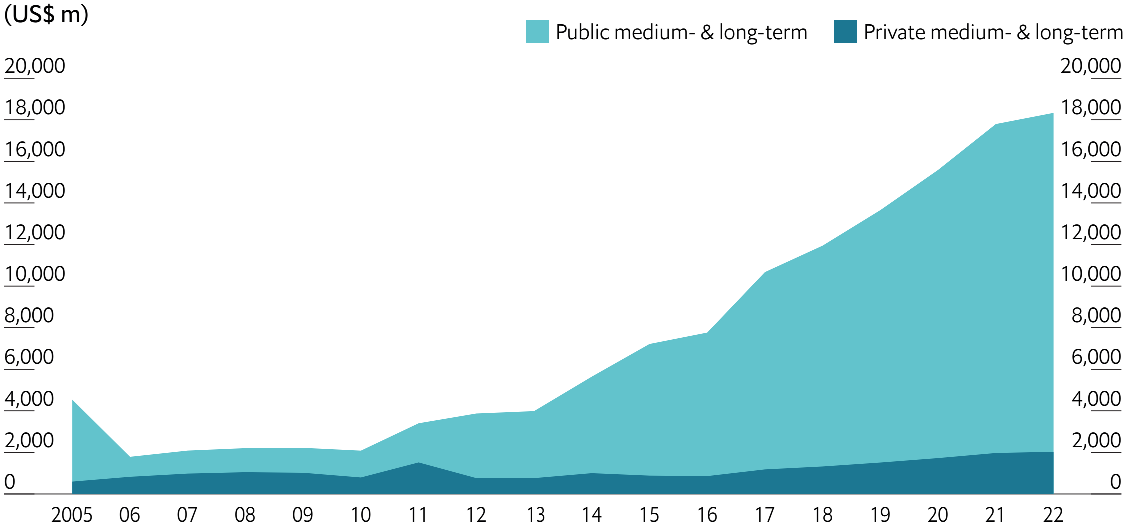
The balance of payments has weakened since 2013 as the current account moved from surplus (averaging 4.9% of GDP in 2009-12) into deficit (averaging 2.9% of GDP in 2013-17), while inflows of FDI declined. This left Zambia with an external financing requirement that has been covered mainly through debt inflows.

Zambia's medium- and long-term public external debt fell from US$4bn in 2005 to US$1bn in 2006 as a result of debt forgiveness under the Heavily Indebted Poor Countries Initiative. It rose at a moderate rate until 2013 but has since almost tripled from US$3.2bn to US$9.5bn.

An increasing share of the public debt is owed to private creditors. Zambia has three outstanding Eurobonds, with a total value of US$3bn. These were launched in 2012, 2014 and 2015. Private sector medium- and long-term debt has also risen but remains modest at around US$1bn.

The external debt/GDP and debt/exports ratios have worsened markedly since 2013. External debt/GDP has risen from 20% to 48% in 2017, and debt/exports from 50% to 137%.

Medium and long-term public and private external debt
(US$ m)



Source: The Economist Intelligence Unit; Country Data.

External debt outlook: The EIU's forecast

- We forecast a further increase in the debt/GDP and debt/exports ratios until the trend starts to reverse in 2020-21 on higher export earnings from copper. The debt/GDP ratio in particular is forecast to reach worryingly high levels for a poor and commodity-dependent economy.
- Liquidity indicators are less stretched than the solvency indicators, reflecting the fact that Zambia is a relatively open economy, with export earnings accounting for around 50% of GDP. The debt service is forecast to stabilise at around 15% until 2022 when it will spike to 22% as the 2012 US$750m Eurobond matures. The other Eurobond maturities are in 2024 (US$1bn) and 2027 (US$1.25bn).
- Principal and interest payments to private creditors will account for around 40% of the total debt service due in 2018-22. Interest payments are forecast to increase from 7% of export earnings in 2017 to 11% in 2022.

Conclusion

- Businesses need to be prepared for the risk of FX shortages and large adjustments in pegged exchange rates in Nigeria and Ethiopia until they shift to more flexible exchange rate regimes. Their respective governments may be hesitant to do so, partly out of concerns about inflation, and in order to ensure that FX continues to be allocated according to government priorities, such as to the imports of staple foods, fuel and debt servicing.

- Investors in Ethiopia and Nigeria will face restricted access to FX and should take this into account in their strategies. Investing in export businesses and in sectors that are assigned priority access to FX by the government, are strategies to manage FX shortages.

- FX shortages are not currently a problem in Kenya, Tanzania and Zambia. However, Zambia's precarious balance of payments position raises the risk of FX shortages, possibly as early as 2019. Kenya and Tanzania are in a much stronger position but, following their shift to less flexible exchange rate regimes in 2016, investors should be aware that FX shortages could affect their businesses over the medium term.

- Working capital shortages are a noticeable problem for businesses in Kenya, Tanzania and Zambia. In Tanzania, businesses noted that a growing fiscal deficit has pushed up commercial interest rates, as internal public debt grows. In Zambia, government securities are absorbing too much of domestic savings. In Kenya, the situation is exacerbated by a cap on interest rates that has had the unintended effect of drying up credit for local businesses.

- Each of the five markets discussed in this report is, to a greater or lesser degree, commodity-dependent. In the absence of stabilisation funds, this dependence exposes their economies and currencies to the vagaries of world commodity prices. Investors should factor the likelihood of devaluations into their business plans and expected dollar returns.

- The governments of all five countries have borrowed heavily in the past decade. This has resulted in a marked deterioration in debt ratios. However, part of the debt has been channelled into public investment in infrastructure and human capital that will help to generate FX earnings in future, as well as improving the operating environment for business.

- Of the five countries, we believe only Zambia faces a high risk of debt distress. If this occurs, it will create very difficult conditions for business for at least a year, with FX shortages and further depreciation of the currency.

Appendix

Data and analysis from the Economist Intelligence Unit (December 2018)

Ethiopia factsheet

Economic background

- With a GDP per head of US$720 in 2017, Ethiopia is one of the poorest countries in the world. However, the economy is in a period of sustained fast growth (10.2% per year on average over 2008-2017), which—together with the country's large population (just over 100m) and population growth—is attracting investment.
- The economy is vulnerable to drought and food insecurity given its dependence on rain-fed agriculture, which accounts for 40-50% of GDP and is the largest source of employment.
- Reliance on commodity exports (coffee accounted for an estimated 27.6% of exports in 2017, and oilseeds an estimated 17.6%) which are exposed to weather patterns is another vulnerability, although this should diminish over time as a result of the development of light manufacturing.
- The economy has traditionally been run along statist lines. The government controls the most important sectors, including finance, and accords privileges to firms with ties to it.
- In June 2018, however, under the new prime minister, the government launched an ambitious plan to open the economy up to private investment in order to drive the next phase of development.
- Ethiopia has been running a large current account deficit, averaging 9.6% of GDP over 2013-17. Less than half of the deficit has been funded by FDI, leaving the remainder to be financed by debt.

Key market data

Nominal GDP (US$bn, 2017)	75.38
EIU currency risk score, rating (November 2018)	65, CCC
EIU sovereign risk score, rating (November 2018)	67, CCC
FX reserves (US$bn, 2017)	3.02
FX reserves (% change over past 12 months, 2017)	0.04
Current account balance as a percentage of GDP (%, 2017)	(7.00)
External debt as a percentage of exports (%, 2017)	785.8
Inward direct investment (US$bn, average 2013-17)	2.68
Inward direct investment as a percentage of current account deficit (%, average 2013-17)	45.0

EIU forecasts

Economic growth
We forecast real GDP growth of 7.6% for 2018 and 7.3% growth in 2019. We forecast an average of about 7.6% for 2020-23, driven by growing consumer markets, greater integration into global and regional value chains and continued infrastructure investment.
Politics
Political prospects over the forecast period will remain in a state of flux following the February 2018 resignation of Hailemariam Desalegn as prime minister and the appointment of a new reformist prime minister, Abiy Ahmed, who was inaugurated in early April.
International relations
The authorities will continue to seek to maintain a wide range of international partners so as to maximise trade and investment opportunities. The recent political changes in Ethiopia will lead to improved relations with donors and Western allies.
Policy trends
One of the most striking economic policy announcements since Mr Abiy took over as prime minister has been the declaration that shares in some state-owned companies will be offered to both domestic and foreign investors.
Exchange rates
The birr will continue to be managed closely by the central bank and we expect the authorities to maintain a policy of gradual depreciation over the forecast period, relying mainly on economic reforms and efficiency improvements to boost competitiveness.
Fiscal policy
The government is targeting a budget deficit of 2.3% of GDP in 2018/19. We expect revenue to fall short of the government's projections, but so too will spending, particularly on existing infrastructure projects. On balance, we forecast a fiscal deficit of 3.2% of GDP in 2018/19.
Monetary policy
With year-on-year inflation averaging almost 14% since the start of 2018, real interest rates are still in negative territory. We expect this to remain the case throughout the forecast period, as the authorities remain reluctant to pursue aggressive monetary tightening.
Inflation
We estimate that inflation will have remained well above the authorities' 8% target throughout 2018, driven by the devaluation of the currency in October 2017 and the impact of drought on food prices. We expect average inflation to decline to 7% in 2020.
External sector
The EIU predicts that the current account deficit will peak at 10.7% of GDP in 2018, driven by high import demand for goods and services, before shrinking to 6.7% of GDP in 2023, as export growth steadily quickens.

Kenya factsheet

Economic background

- Kenya has a tradition of good policy management which has made it one of Africa's more stable economies. Following a period of heavy borrowing to fund infrastructure projects including a railway linking Nairobi with Mombasa, fiscal consolidation is needed to ensure debt sustainability over the medium and long term.

- A stable, market-friendly business climate has fostered the development of a dynamic and relatively deep private sector known for innovations, such as the hugely successful M-Pesa mobile payment system.

- A congressional initiative to impose interest rate caps on the banking sector caused a sharp slowdown in credit growth in 2017. Caps are set to remain in place at least over the short term, constraining the availability of capital for SMEs.

- Kenya has a relatively diverse export profile, led by tea and horticultural products. It has close trade links with fellow members of the Common Market for Eastern and Southern Africa, and especially the East African Community.

- Kenya's good growth prospects and its position as a regional business hub make it an attractive destination for FDI, provided that the government deals with the constraints facing investors. The ongoing reduction in the regulatory burden, the passage of new company and insolvency laws, investment in infrastructure, and the creation of a legal framework for public–private partnerships (PPPs) are all positive steps.

Key market data

Nominal GDP (US$ bn, 2017)	74.94
EIU currency risk score, rating (September 2018)	54, B
EIU sovereign risk score, rating (September 2018)	60, CCC
FX reserves (US$ bn, 2017)	7.35
FX reserves (% change over past 12 months, 2017)	(3.25)
Current account balance as a percentage of GDP (%, 2017)	(6.70)
External debt as a percentage of exports (%, 2017)	476.3
Inward direct investment (US$ bn, average 2013-17)	0.72
Inward direct investment as a percentage of current account deficit (%, average 2013-17)	14.9

EIU forecasts

Economic growth
We forecast real GDP growth of 5.8% for 2018, helped by buoyant agriculture and utilities and strong consumer demand. We forecast 5.8% growth in 2019, and an average of about 6% for 2020-23.
Politics
The outlook for political stability is improving following the surprise rapprochement between the president, Uhuru Kenyatta, and the main opposition leader, Raila Odinga, in March. This could facilitate the fight against corruption.
International relations
Foreign policy will be driven by economic interests, especially the maintenance of close relations with key donors and the advancement of regional integration within the East African Community.
Policy trends
Major investments in the transport and energy networks, sometimes in the form of PPPs, alongside regulatory and other reforms, will lead to gradual improvements.
Exchange rates
The currency weakened slightly to KSh100.8:US$1 in September 2018, but remained stronger year on year (by 2.2%). Resilience in 2018 reflects a decline in political tension after disputed elections in 2017, robust GDP growth and a narrower current account deficit (helped by strong remittance inflows).
Fiscal policy
The budget for fiscal year 2018/19 (July-June) proposes to trim the deficit to 5.7% of GDP, from a provisional 7.2% of GDP in 2017/18, using a mix of tax rises and spending curbs. However, the EIU expects the shortfall to narrow by a slightly smaller margin, to 5.8% of GDP in 2018/19, because of spending overruns.
Monetary policy
Monetary policy will remain prudent, helped by a planned shift to a formal inflation-targeting framework during the forecast period from the current, informal target range (of 2.5-7.5%). The Central Bank of Kenya trimmed the benchmark rate by 50 basis points to 9% in July.
Inflation
After falling to a multi-year low of 5.1% in 2018, average inflation will rise to 6.2% in 2019. Power tariff hikes in mid-2018 and tax rises imposed in September, including VAT on fuel at 8%, will combine with higher world oil prices to maintain the current upward pressure on energy costs.
External sector
The current account deficit will narrow from a provisional 5.2% of GDP in 2018, to less than 5% of GDP in 2019 and 3.9% of GDP in 2020, helped by growth in earnings and nominal GDP. The shortfall will narrow steadily thereafter to 2.9% of GDP in 2023.

Nigeria factsheet

Economic background

- Nigeria's abundant natural resources and population of over 190m make it an attractive market despite low GDP per head (US$1,970 in 2017).
- Companies face the challenges of a complex and chaotic regulatory environment and the logistical difficulties resulting from poor infrastructure. Tax compliance is a time-consuming process. A lack of security is a serious threat in parts of the country, including the oil-rich Delta region.
- Exports are dominated by oil. The non-oil export base has been rendered globally uncompetitive by an overvalued exchange rate, poor infrastructure and erratic power supply. Plans to introduce market-oriented reforms and diversify the economy away from oil will make slow progress.
- Tax revenue is very low as a share of GDP and comes mostly from oil. Although the public debt/GDP ratio is low, interest payments absorb a high share of revenue. When oil prices fall, as in 2014-15, the government has little choice other than to cut capital spending.
- Nigeria ran a current account surplus averaging 4.1% of GDP in 2008-14. The current account went into deficit in 2015 and has posted small surpluses since. FX reserves have recovered from a dip in 2014-16 and currently provide import cover of around ten months.

Key market data

Nominal GDP (US$bn, 2017)	376.39
EIU currency risk score, rating (August 2018)	53, B
EIU sovereign risk score, rating (August 2018)	50, B
FX reserves (US$bn, 2017)	38.77
FX reserves (% change over past 12 months, 2017)	50.00
Current account balance as a percentage of GDP (%, 2017)	2.76
External debt as a percentage of exports (%, 2017)	89.4
Inward direct investment (US$bn, average 2013-17)	4.26
Inward direct investment as a percentage of current account deficit (%, average 2013-17)	(114.4)

EIU forecasts

Economic growth
We forecast real GDP growth of 2.1% for 2018 and 1.9% in 2019. We forecast an average of about 2.7% for 2020-22, driven by global markets strengthening and external demand picking up after 2020.
Politics
The EIU forecasts ongoing severe outbreaks of instability, given slow progress on tackling numerous security and societal challenges at a time of economic difficulty.
International relations
India will remain important as the largest market for Nigerian oil and become a bigger source of FDI. China will remain a significant source of investment. Nigeria will remain an important player on the Sub-Saharan African stage given its size.
Policy trends
Mr Buhari has been ideologically disposed towards state intervention in the economy, meaning there has been little cause for him to overhaul the status quo. A more concerted effort to open up the economy to investment could produce positive results.
Exchange rates
We expect the multiple-exchange-rate system to persist throughout 2019-22, with a notable differential between the official rate used for government business and the market-determined rate applicable to investors and exporters.
Fiscal policy
Fiscal policy will centre on attempting to diversify sources of revenue away from oil while directing more expenditure to pro-poor activities and infrastructure investment. Overall, the deficit will fall steadily from a peak of 2.1% of GDP in 2019 to 1.1% of GDP in 2022.
Monetary policy
On balance, interest rates will not move much in 2019 but they will dip in 2020 as the wider global economy slows and monetary authorities attempt to stimulate activity, with Nigeria following suit.
Inflation
Inflation will generally remain high over the forecast period amid expansionary fiscal policy and high food prices stemming from government efforts to limit imports and support local producers.
External sector
The current account will record small surpluses over the forecast period, as an uptick in oil prices is offset by recovering import demand. The difficult business environment will restrict the development of non-oil exports.

Tanzania factsheet

Economic background

- The economy has grown by an average of 6.6% per year over the past decade, led by telecommunications, financial services and tourism. Tanzania has diversified its export base away from reliance on raw materials through the development of manufactured exports and re-exports. Agriculture still employs three-quarters of the workforce.

- President John Magufuli is pursuing an economic agenda focused on industrialisation and infrastructure. Progress is hindered by a lack of efficiency in state institutions and strained relations with foreign investors in the mining sector.

- Tanzania is mostly open to trade and FDI, although 2017 laws extending state control over minerals and banning the export of unprocessed ores have soured relations with mining companies.

- Management of public finances is generally sound but there is a persistent problem of debt arrears to both contractors and official creditors. Capital spending is sometimes held back owing to delays in raising external debt.

- The Bank of Tanzania has a reasonable record for controlling inflation and maintaining the value of the shilling. The last devaluation was in 2015.

- The reduction in aid flows has led the government to raise more non-concessional financing from governments, including China and Turkey, and from commercial creditors.

Key market data

Nominal GDP (US$bn, 2017)	52.12
EIU currency risk score, rating (September 2018)	43, BB
EIU sovereign risk score, rating (September 2018)	46, BB
FX reserves (US$bn, 2017)	5.91
FX reserves (% change over past 12 months, 2017)	36.54
Current account balance as a percentage of GDP (%, 2017)	(3.30)
External debt as a percentage of exports (%, 2017)	369.2
Inward direct investment (US$bn, average 2013-17)	1.58
Inward direct investment as a percentage of current account deficit (%, average 2013-17)	49.5

EIU forecasts

Economic growth
We forecast that economic growth will be weaker in 2018-22 than the previous five-year average as business confidence slumps. Nevertheless, public investment, the services sector and rising trade flows will underpin decent real GDP growth, averaging 5.3% a year.
Politics
The president, John Magufuli, and the long-standing ruling party, Chama Cha Mapinduzi (CCM), will remain in power. However, the president's centralised leadership model and erratic policymaking could stir frustrations within the CCM and stoke intra-party tensions.
International relations
Relations with traditional trading partners are likely to become strained as they grow suspicious about the government's commitment to democracy and its openness to FDI.
Policy trends
The Development Vision 2025 plan prioritises industrialisation and job creation, with a commitment to pursue a private-sector-led development strategy and promote good governance. However, the plan is undermined by the government's abrupt tax increases, erratic regulatory changes and lack of transparency.
Exchange rates
We expect the shilling to depreciate against the US dollar throughout the forecast period, falling from an annual average of TSh2,267.2:US$1 in 2018 to TSh2,745.5:US$1 in 2022.
Fiscal policy
We expect the fiscal deficit to widen throughout the forecast period (2018-22) as the government's capital spending plans pick up. The shortfall is forecast to reach 3.3% of GDP in fiscal year 2021/22 (July-June), as public investment outpaces steady revenue growth.
Monetary policy
The discount rate was slashed to a five-year low of 9% during 2017 and, amid a relatively stable inflationary environment, we expect the monetary stance to remain accommodative in 2018-19.
Inflation
We expect inflation to edge up slowly, from 4% in 2018 to an average of 4.9% a year in 2019-20, and a stronger 5.4% a year in 2021-22. This reflects a recovery in domestic demand as the central bank's loose monetary stance takes effect.
External sector
The current account deficit is forecast to steadily widen throughout the forecast period, reaching 4.9% of GDP in 2022. This expansion will be driven by costly fuel imports initially and firmer demand for capital imports from 2019.

Zambia factsheet

Economic background

- Real GDP growth will average 3.2% a year in 2018-23; detrimental changes to the tax regime will keep mining growth far below potential, but this will be masked to some extent by government capital spending.
- Zambia was stable for most of its post-colonial history but political divisions have opened up since 2016. In September 2018, the UK, Finland and other European countries froze support over reported mishandling of aid intended for income support programmes.
- Services make up a little over half of GDP; agriculture comprises around 7% but is the main source of employment. Cultivation is still largely rain-fed, making it vulnerable to weather-related shocks. Manufacturing accounts for just less than 8% of GDP. Government attempts to diversify the economy have yielded limited results.
- Mining accounts for around 15% of GDP and generates the majority of FX earnings. Rising copper production will support economic growth over the medium term, but the economy will remain vulnerable to drought and copper price volatility.
- There is a growing risk of default following a sharp rise in public debt over the past decade. A build-up in government arrears to the private sector has caused problems for the banking system and pushed up commercial bank lending rates.
- The national development plan aims to stimulate value-added industrialisation and promote economic diversification through private sector involvement and FDI. State-dominated areas of the economy, such as energy and transport, are also likely to be opened up.

Key market data

Nominal GDP (US$bn, 2017)	25.71
EIU currency risk score, rating (July 2018)	54, B
EIU sovereign risk score, rating (July 2018)	64, CCC
FX reserves (US$bn, 2017)	2.08
FX reserves (% change over past 12 months, 2017)	(11.50)
Current account balance as a percentage of GDP (%, 2017)	(3.92)
External debt as a percentage of exports (%, 2017)	141.9
Inward direct investment (US$bn, average 2013-17)	1.34
Inward direct investment as a percentage of current account deficit (%, average 2013-17)	339.7

EIU forecasts

Economic growth
Economic growth over 2019-23 will be well below potential. Over 2019-21 it will average just 3.4%. Overall we expect growth to average 3.5% in 2022-23.
Politics
Although the ruling Patriotic Front led by the President Edgar Lungu is forecast to retain power, Zambia will face substantial threats to political stability in 2019-23, driven in part by pent-up frustration of the public with governance and economic performance.
International relations
Zambia's relations with Western donors and multilateral financial institutions will deteriorate relatively rapidly over the early part of the forecast period. The IMF is not expected to agree to a deal with Zambia at any time within the forecast period.
Policy trends
The government's need of funds has prompted a suite of tax hikes for the mining sector beginning from 2019—a move that exemplifies the rising fiscal risks investors face, and one that will keep FDI into Zambia well below the 2007-17 average in 2019-23.
Exchange rates
The kwacha has recently plunged against the US dollar, in part because foreign investors are unwinding their positions in the local debt market. A bounce-back is not in prospect in 2019.
Fiscal policy
Fiscal policy will be lax up to 2021 as the government pursues a debt-financed infrastructure programme. Revenue will meanwhile rise on the back of tax hikes, but the fiscal deficit will remain large. We expect deep spending cuts to begin from 2022.
Monetary policy
Monetary policy will be tighter in 2019 to control rising price pressures linked to currency depreciation. With the kwacha and inflation both more stable from 2020, the central bank will begin to reduce the policy rate in a bid to bring down high commercial lending rates.
Inflation
From an estimated headline rate of 8.1% in 2018, we expect inflation to hit an average of 9.8% in 2019. World oil prices are then expected to fall slightly in 2020 and, in tandem with kwacha stability, inflation will fall to 6%.
External sector
The current account will shift from a deficit estimated at 4.6% of GDP in 2018 to a surplus of 2.9% in 2023, as government capital spending winds down and export growth picks up.

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