INVESTMENT PERSPECTIVES

The Cost of Capital in Developing Countries – Beyond Credit Ratings: Third in a Series

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Why would an investor buy U.S. Treasury securities? The United States has massive debt, huge deficits, and a Congress in structural paralysis. If the United States were a developing country, it might face severe debt distress.

Despite recent speed bumps, U.S. Treasury securities remain the global reference against which dollar funding costs are measured around the world. Sovereign, corporate, and project-related debt carries a "spread"—the difference between the rate paid and the yield on a comparable-maturity U.S. Treasury—compensating investors for real and perceived risks compared to those of U.S. Treasuries.

The cost of financing—equity and debt—is a major constraint on infrastructure projects in developing countries. Financing costs reflect many factors, one of which is the spread on the host country's sovereign debt. Where sovereign debt spreads are high, project financing costs are usually high.

Developing country spreads vary widely. Larger countries that regularly access capital markets pay the lowest spreads, while lower income countries pay more (except on concessional loans from public and multilateral lenders). Sub-Saharan African spreads are the highest, reflecting an "Africa premium" that averages over 150 basis points above similarly-rated Latin American and Asian debt.

Credit rating methodologies are often cited as a main culprit. One widely-cited study says increasing rating agency transparency and removing perceived bias would reduce sub-Saharan Africa funding costs by billions of dollars. Another recent study found that other factors may be more material in determining spreads, noting that spreads vary widely among similarly-rated sovereigns.

However important credit ratings are, developing country spreads reflect many other factors. The market for developing country sovereign bonds is structurally different from the market for U.S. Treasuries, and these differences impact spreads. The main differences fall into three categories:

- *Market Size and Liquidity.* The U.S. Treasury market is huge—a highly liquid market of tens of trillions of dollars. The Treasury issues new bonds constantly, with regular product flow and a deep yield curve (although trending shorter recently). Investors can buy Treasuries in minutes by clicking on a screen, certain the trade will be executed. Everyone invests in U.S. Treasuries—retail investors, U.S. institutions, foreign central banks, stablecoin issuers, and many others, giving the market depth. Investors can sell U.S. Treasuries as easily as they can buy, confident that the price is influenced only by U.S. interest rates (except when Congress threatens default). U.S. Treasuries can be used to collateralize loans or to raise short-term cash in the repo market ("repos" are repurchase agreements, where an investor sells Treasuries, then repurchases them at a slightly higher price, reflecting interest).

  Developing country markets are not close to the size of the U.S. Treasury market. To buy a developing country bond, an investor has to select the country, do due diligence, and pay a broker to find a seller, if there is one. Because investing in developing country bonds is difficult, trading is concentrated among specialized asset managers focused mainly on large markets such as Brazil, Mexico, South Africa, and large Asian issuers. Many developing countries (particularly lower-income countries) issue infrequently, impacting liquidity and investor familiarity. When an investor needs to sell, the market may be distressed or illiquid, with pricing influenced by factors unrelated to the bond, like U.S. interest rates or a general flight from developing country bonds. Prices can be influenced by a few large transactions, sometimes at off-market prices. While developing country bonds can sometimes be pledged as collateral, it is usually at a steep discount. Where repo markets exist, they are limited in size and liquidity.

- *Seniority Structure*. No investor worries that a U.S. Treasury represents anything but a senior obligation of the United States. Developing country bonds are effectively subordinated to debt held by "preferred creditors" like the World Bank and other multilaterals, protected even when private debts are restructured. Lower-income countries are particularly affected, because they borrow heavily from multilaterals. Investors can also be subordinated to debt secured by export revenues, held by creditors like China and global trading companies.

- *Refinancing and Procyclicality*. Despite recent tribulations, there is no meaningful risk for the foreseeable future that the U.S. will be unable to refinance its obligations at maturity. Developing countries sometimes cannot refinance their debt even when they have strong fundamentals and no credit rating issues. Investors come in waves, making markets volatile, cyclical, and sometimes illiquid.

All of this translates into high spreads for developing country sovereign debt, with the highest spreads paid in markets that deviate the most from U.S. Treasury markets.

By influencing spreads, these factors impact the cost of capital for development projects, which is often tied to sovereign spreads. But there is more. A recent study found that project funding costs are largely impacted by investor confidence—investors demand a higher return on their first project than on their second, third, or fourth. That makes sense—a first-time investor has to learn how to do business in a new country, and host authorities have to learn how to work with the investor. Later investments benefit from economies of scale.

This is complex, with implications for crafting policy initiatives to lower the cost of capital in developing countries. Some initiatives are underway. The Liquidity and Sustainability Facility (LSF) recently listed an African sovereign bond index fund on the London Stock Exchange, which could improve liquidity. LSF also offers a repo for African sovereign bonds.

Some issues are more intractable. Seniority structures, for example, could be addressed by reducing financing from multilateral development banks, but that would be counterproductive, particularly in lower-income countries.

Effective initiatives can come from developing countries themselves, which can lower funding costs by improving debt management practices and minimizing hurdles to productive development investments, particularly for first-time investors, as well as deepening domestic capital markets.

Improving credit rating methodologies might help, but it is not enough. To reduce funding costs, developing countries and policymakers need to look beyond credit ratings.

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