Technical Note

LOCAL CURRENCY BOND MARKETS IN AFRICA

A Viable Alternative to Public Sector Financing?

Mohammad Mansoor Akbar, MA; Maria Barreiro Palafox, MS; Nemanja Jovanovic, EngD; Jose Pineda, PhD

September 2026

Technical Note

LOCAL CURRENCY BOND MARKETS IN AFRICA: A Viable Alternative to Public Sector Financing?[1]

Mohammad Mansoor Akbar, MA; Maria Barreiro Palafox, MS; Nemanja Jovanovic, EngD; Jose Pineda, PhD

September 2026

Abstract

This technical note examines the conditions under which local currency bond markets can provide a sustainable alternative to external public borrowing in Africa. Drawing on Malawi's experience and comparisons with Ghana, Nigeria and Kenya, it explores their potential to reduce currency mismatches, strengthen monetary policy transmission and support financial sector development. It also examines how weak fiscal discipline, exchange rate distortions and narrow investor bases can generate inflationary pressures, financial repression and crowding out of private credit. The note argues that sustainable market development requires credible fiscal and monetary frameworks, transparent debt issuance, diversified investor participation and market-aligned exchange rates. It concludes that local currency bond markets can strengthen financing resilience when supported by coherent macroeconomic policies and institutional reforms.

[1] Prepared for the AUC/OECD report Africa's Development Dynamics 2026: Debt, Capital and Transformation.

TABLE OF CONTENTS

INTRODUCTION

Over the past decade, African economies have increasingly relied on domestic borrowing as access to international capital markets has tightened (Manger et. al. (2025). External debt vulnerabilities remain high, with exchange rate depreciation significantly contributing to rising debt burdens across the region. The United Nations and World Bank highlight that exchange rate movements have been a major driver of debt increases in recent years (UN DESA, 2025). In response, governments have increasingly relied on domestic bond markets. Local currency borrowing offers an appealing alternative: it eliminates exchange rate risk and allows governments to finance deficits in their own currency. As a result, local currency (LCY) bond markets have expanded significantly across Sub-Saharan Africa.

Yet this shift raises a critical question: under what conditions can LCY bonds provide a sustainable alternative to external financing, rather than simply shifting risks within the domestic economy? This policy brief argues that LCY bonds can be a credible and sustainable financing tool only when embedded in a coherent macroeconomic framework. When developed in weak macroeconomic environments, they can lead to financial repression, crowding out of private credit, and inflationary financing.

The Malawi's experience shows how exchange rate distortions and fiscal imbalances undermine domestic debt markets and limit access to international capital markets (IMF, 2025). Key prerequisites for local currency bond markets to work as intended include low inflation, fiscal discipline, market-based financial systems, and credible exchange rate policies. Without these, domestic debt markets risk becoming instruments of fiscal stress rather than pillars of financial development.

At their best, LCY bond markets deliver three core benefits to government and private sector financing as well as macroeconomic stability. First, they reduce currency mismatches. Governments that borrow in domestic currency avoid the destabilizing effects of exchange rate depreciation on debt servicing. This is particularly important in economies with volatile currencies and limited foreign exchange buffers. Second, LCY markets support monetary policy effectiveness. A functioning domestic yield curve improves policy transmission, allowing central banks to influence financial conditions more effectively. Third, they contribute to financial sector development. Government bond markets provide benchmarks for pricing private sector debt and can catalyze broader capital market growth. These advantages explain why international financial institutions increasingly emphasize the development of domestic bond markets as part of broader financial sector reforms (IMF, 2021).

THE RISKS OF LOCAL BOND MARKETS: FROM CURRENCY MISMATCH TO DOMESTIC DISTORTIONS

Despite the benefits of local currency bond markets, they can also introduce new risks, particularly in countries with weak macroeconomic fundamentals. These risks highlight that under the wrong conditions, local currency bond markets do not eliminate risk; they simply reallocate it, from exchange rate exposure to inflation, financial sector stability, and fiscal credibility.

When governments rely heavily on domestic borrowing, especially in shallow financial systems, there is a risk that deficits are effectively monetized. This undermines price stability and erodes investor confidence. In addition, domestic banks and institutional investors may be incentivized, or compelled, to hold government securities, reducing credit available to the private sector. Over time, this weakens economic growth and financial intermediation.

In Africa, there is a limited depth of domestic investor bases (OECD, 2025). Many African economies lack large pension funds or insurance sectors capable of absorbing significant government issuance. As a result, governments often rely on captive investors, creating conditions for financial repression to sustain domestic borrowing. These measures include requiring banks to hold government securities, capping interest rates, or restricting capital flows. While such policies may provide short-term financing relief, they have significant long-term costs. They distort price signals, weaken investor confidence, and undermine the development of market-based financial systems. Crucially, they also deter foreign investors, limiting the integration of domestic bond markets into global capital markets.

Avoiding financial repression requires a commitment to market-based debt management, including transparent auction systems, competitive pricing, and diversified investor participation. Without these, local currency bond markets risk becoming instruments of fiscal dominance rather than platforms for sustainable financing. This is why the World Bank stresses that efficient bond markets require market-based pricing mechanisms, transparent issuance strategies, and diversified investor participation (World Bank, 2021).

EXCHANGE RATE REGIMES AND MARKET CREDIBILITY

MALAWI: A CASE OF DISTORTED INCENTIVES

The effectiveness of local currency bond markets is closely linked to the credibility of exchange rate regimes. Even when debt is denominated in local currency, investors remain sensitive to exchange rate dynamics, which influence inflation, returns, and overall macroeconomic stability. This relationship becomes particularly problematic in countries with multiple or distorted exchange rates. Parallel market premiums signal underlying imbalances and create uncertainty about the true value of domestic assets. In such environments, investors demand higher yields to compensate for risk or exit the market altogether.

Malawi provides a clear illustration of how exchange rate distortions undermine domestic bond markets. The country has faced persistent foreign exchange shortages, leading to the emergence of a parallel market with a significant premium over the official exchange rate. At times, the gap between official and parallel rates has exceeded 50 percent, reflecting severe misalignment and market segmentation. According to IMF analysis, these distortions contribute to inflation, resource misallocation, and reduced investor confidence (IMF, 2025).

This dual exchange rate system has several implications for local currency bonds. First, it raises inflation expectations, as exchange rate pressures feed into domestic prices. Second, it increases uncertainty about the real returns on local currency assets. Third, it discourages foreign participation, as investors are unable to repatriate funds at market-clearing rates. Forth, it creates incentives for political capture where "insiders" with access to transitions at the official exchange rate invest in these instruments with a significant return in foreign currency due to the rate differentials.

As a result, Malawi's domestic bond market remains largely confined to local investors, with yields reflecting both inflation risk and exchange rate uncertainty which magnify macroeconomic distortions. Rather than facilitating access to international markets, the local currency bond market in this context reflects broader macroeconomic imbalances and even crowds out private sector credit. The World Bank indicates that rising government debt service obligations in Malawi have constrained private investment and financial intermediation (World Bank, 2025). The key lesson from Malawi's experience is clear, without exchange rate unification and macroeconomic stabilization, local currency bond markets cannot function as effective financing tools.

Experiences across African countries illustrate that the success of local currency bond markets depends fundamentally on macroeconomic credibility, rather than market size alone. In Ghana, rapid expansion of domestic debt did not prevent a broader sovereign debt crisis. By 2022–2023, Ghana faced severe fiscal and debt sustainability challenges, culminating in a comprehensive debt restructuring that included domestic bonds. The IMF notes that "large fiscal deficits and rising domestic debt contributed to the loss of market access and debt distress" (IMF, 2024b). The restructuring of domestic debt instruments also had significant implications for the banking sector and pension funds, highlighting the risks of excessive reliance on local currency financing without fiscal discipline. The World Bank similarly emphasizes that high domestic borrowing costs and debt service burdens constrained growth and financial stability (World Bank, 2024a).

In Nigeria, the presence of multiple exchange rates and capital flow restrictions has limited foreign participation in domestic bond markets despite their relatively large size. The IMF has repeatedly highlighted that exchange rate fragmentation creates distortions and discourages investment, noting that "exchange rate unification is critical to improving investor confidence and macroeconomic stability" (IMF, 2024c). While Nigeria has a deep domestic government securities market, foreign investor participation has remained volatile due to foreign exchange convertibility concerns and policy uncertainty.

By contrast, Kenya has made more progress in developing a relatively functional local currency bond market with a broader institutional investor base, including pension funds and insurance companies, and a more developed yield curve. According to the World Bank, Kenya's domestic debt market has supported government financing while contributing to financial sector development, although risks remain related to rising debt levels and interest costs (World Bank, 2024b). The IMF also notes that Kenya's more market-based approach to debt issuance has helped sustain investor participation, even amid fiscal pressures (IMF, 2024e).

Taken together, these cases highlight that local currency bond markets cannot substitute for fiscal discipline. In addition, exchange rate distortions and capital controls significantly limit the ability of domestic markets to attract foreign investors. However, deeper domestic markets can support financing needs, but when supported by relatively credible macroeconomic and institutional frameworks.

FINAL CONSIDERATIONS

The development of sustainable local currency bond markets requires a coordinated set of reforms. First, governments must anchor macroeconomic stability through prudent fiscal policies and credible monetary frameworks. Without this foundation, domestic debt markets will remain fragile. Second, authorities should promote market development by expanding the institutional investor base, improving liquidity, and establishing benchmark yield curves. Third, exchange rate policy must prioritize transparency and market alignment. Moving toward unified, market-clearing exchange rates is essential for restoring investor confidence.

Under the proper context, local currency bond markets offer a promising pathway for African economies to reduce vulnerability to external shocks. Their success depends fundamentally on macroeconomic stability, credible policy frameworks, and well-functioning financial systems. Policymakers must avoid financial repression and instead foster open, competitive financial systems that attract both domestic and foreign investors.

Local currency bonds are not a substitute for sound policy; they are a complement to it. The experiences of Malawi and other African countries illustrate that without exchange rate unification and fiscal discipline; local currency bond markets can exacerbate distortions rather than alleviate them.

REFERENCES

OECD (2025). *Africa Capital Markets Report 2025*. Available at: https://www.oecd.org/en/publications/africa-capital-markets-report-2025_7d26e1d3-en

International Monetary Fund. (2021). *Keeping it local: A secure and stable way to access financing*. https://www.imf.org/en/blogs/articles/2021/03/12/blog-keeping-it-local-a-secure-and-stable-way-to-access-financing

International Monetary Fund. (2023). *Regional economic outlook: Sub-Saharan Africa*. https://www.imf.org/-/media/files/publications/reo/afr/2023/april/english/exchangenote.pdf

International Monetary Fund. (2024a). *Ghana: 2023 Article IV consultation and first review under the Extended Credit Facility*. https://www.imf.org/en/publications/cr/issues/2024/01/25/ghana-2023-article-iv-consultation-first-review-under-the-extended-credit-facility-544137

International Monetary Fund. (2024b). *Ghana: Staff report (debt sustainability analysis)*. https://www.elibrary.imf.org/view/journals/002/2024/030/article-A002-en.xml

International Monetary Fund. (2024c). *Nigeria: 2024 Article IV consultation*. https://www.imf.org/en/publications/cr/issues/2024/05/08/nigeria-2024-article-iv-consultation-press-release-staff-report-staff-statement-and-548726

International Monetary Fund. (2024d). *Nigeria: Executive Board concludes 2024 Article IV consultation*. https://www.imf.org/en/news/articles/2024/05/08/pr-24144-nigeria-executive-board-concludes-2024-art-iv-consultation

International Monetary Fund. (2024e). *Kenya: 2023 Article IV consultation—Staff report*. https://www.imf.org/-/media/Files/Publications/CR/2024/English/1KENEA2024001.ashx

International Monetary Fund. (2025). *Malawi: Article IV consultation report*. https://www.imf.org/-/media/Files/Publications/CR/2025/English/1mwiea2025001-source-pdf.ashx

Manger, M, D Mihalyi, U Panizza, N Rescia, C Trebesch and K Wong (2025), 'DP20747 Africa's Domestic Debt Boom: Evidence from the African Debt Database', CEPR Discussion Paper No. 20747. CEPR Press, Paris & London. https://cepr.org/publications/dp20747

World Bank. (2021). *Guidance note for developing government local currency bond markets*. https://documents1.worldbank.org/curated/en/790921615526044752/pdf/Guidance-Note-for-Developing-Government-Local-Currency-Bond-Markets.pdf

World Bank. (2024a). *Ghana overview*. https://www.worldbank.org/en/country/ghana/overview

World Bank. (2024b). *Kenya economic update*. https://www.worldbank.org/en/country/kenya/publication/kenya-economic-update

World Bank. (2025). *Malawi economic monitor: Rising cost of inaction*. https://reliefweb.int/report/malawi/malawi-economic-monitor-rising-cost-inaction-january-2025

World Bank. (2023). *Real-time exchange rate dataset*. https://microdata.worldbank.org/index.php/catalog/6183

United Nations Department of Economic and Social Affairs. (2025). *Local currency lending and debt sustainability in Africa*. https://www.un.org/osaa/osaa/sites/www.un.org.osaa/files/files/documents/2025/local_currency_lending_and_debt_sustainability.pdf