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Public Debt and Sustainability: Whither Ghana?

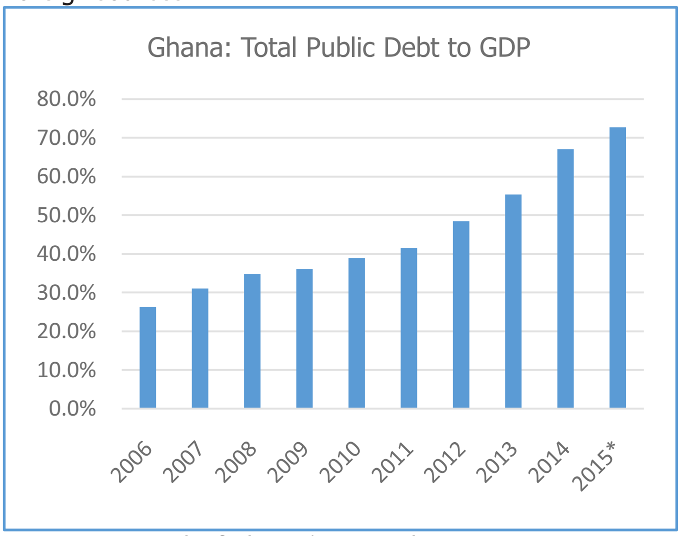
Introduction

Ghana's public debt stock has risen substantially since it enjoyed HIPC/MDRI debt relief in 2005-2006. The highly expansionary fiscal position in 2006-2008, financed by external borrowing, triggered a very rapid deterioration in the country's debt sustainability. This trend was amplified by the resulting balance of payments pressures and currency depreciation, which led to a revaluation of foreign currency-denominated claims relative to domestic GDP. The debt surge was effectively stemmed when the country's access to market financing was closed off due to the global financial crisis in 2008-2009. Huge increases in the issuance of domestic currency debt, alongside increased borrowing from foreign sources after the global financial crisis, have complicated the landscape for the country's debt sustainability and crisis prevention. This paper examines Ghana's public debt and its sustainability implications, and then looks at some policy considerations.

Recent Debt Trends

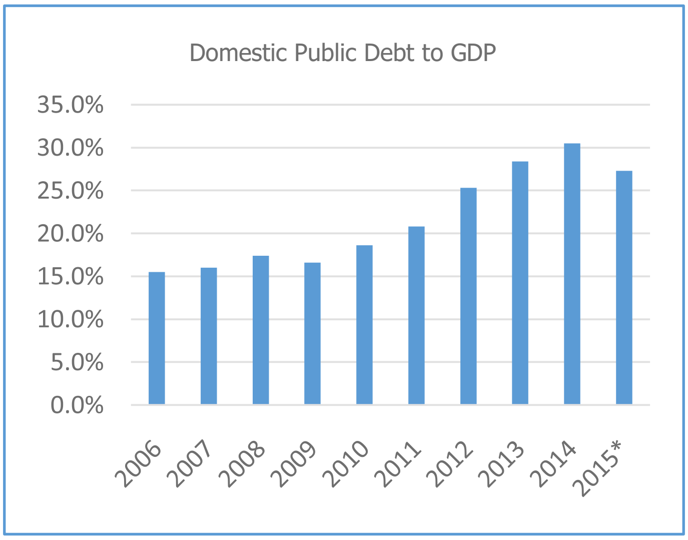
Total Public Debt. Ghana's public debt stood at GH₵4.9 billion, equivalent to 26.2 percent of GDP at the end of the HIPC/MDRI period in 2006. The debt stock increased to GH₵9.8 billion at end-2008, which was equivalent to 34.8 percent of GDP, reflecting the large fiscal deficit of 14.5 percent of GDP posted in the year as well as the impact of the currency depreciation on the foreign debt-to-GDP ratio. At end-2010, total public debt had reached GH₵17.5 billion, equivalent to 38.9 percent of GDP, and reflecting over 78 percent increase from 2008. The 2010 debt figure, which was also 1.0 percentage point higher than the projected target in the IMF program, reflected a larger-than-programed fiscal deficit and the associated increases in domestic financing. In addition, the government continued to accumulate domestic payment arrears which were not reflected in the public debt data. At end-2010, the outstanding stock of arrears and public liabilities in respect of state-owned enterprises debts, which had been excluded from the public debt stock figure, was estimated at 9 percent of GDP (IMF, 2015).

Total public debt more than doubled to GH₵35.1 billion between 2010 and 2012, causing the public debt-to-GDP ratio to increase to 48.4 percent and making the country to face a high risk of debt distress and increased overall debt vulnerability. By end-2014, total public debt had risen to GH₵76.1 billion, equivalent to 67.1 percent of GDP, and representing an increase of 116.8 percent from 2012. By June 2015, the total public debt stock had reached a high of GH₵96.9 billion, representing 72.7 percent of GDP. Ghana's public debt stock thus increased by GH₵4.9 billion in 2006-2008, GH₵25.3 billion in 2009-2012, and GH₵61.8 billion in 2013-June 2015. The provisional public debt stock as at September 2015 was GH₵92.2 billion, which was equivalent to 69.1 percent of GDP. The huge surge in the country's public debt stock in just one decade is attributed to the large fiscal deficits registered over the years, which were financed by funds borrowed from both domestic and foreign sources.



Source:GoG, Bank of Ghana *as at end-June

Domestic Debt. Total domestic debt increased steadily from GH₵2.9 billion (equivalent to 15.5 percent of GDP) in 2006 to GH₵11.8 billion (20.8 percent of GDP) in 2011 and sharply thereafter to GH₵18.4 billion (25.3 percent of GDP) in 2012. The sharp rise in the domestic debt stock in 2012 reflected increases mainly in the medium-term instruments, which were driven by changes in the 3-year and 5-year Government of Ghana bonds. The structure of the debt also changed significantly with a shift from short-term instruments towards medium-and long-terminstruments in 2012. The increases in the domestic debt continued after 2012, reaching GH₵34.6 billion (30.2% of GDP) in 2014, GH₵35.9 billion at end-June 2015, and GH₵37.7 billion in September 2015 due to increases in both short-term and medium-term securities. Over the period, the stock of long-term securities also increased but less rapidly compared to the short- and medium-term securities due mainly to the securitization of the 2013 overdrawn government position with Bank of Ghana amounting to GH¢2.6 billion. The banking sector remained the major holder of the domestic debt, although the sector's share in the total domestic debt stock dropped from 67.2 percent in 2009 to 49.9 percent in June 2015. Despite this, the share of the Bank of Ghana in the total domestic debt increased steadily from 17.2 percent in 2010 to 24.5 percent in June 2015.

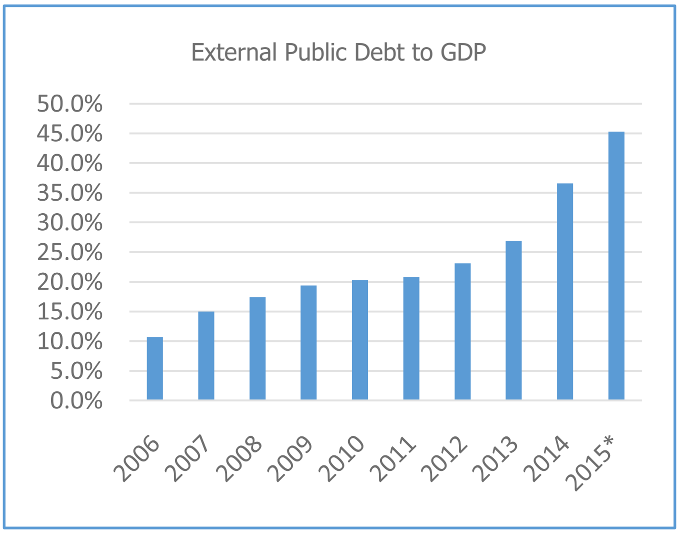


Source: GoG, Bank of Ghana *as at end-June

External Debt. Ghana's total external debt more than doubled from GH¢2.0 billion in 2006 (equivalent to 10.7 percent of GDP) to GH¢4.9 billion (equivalent to 17.4 percent of GDP) in 2008. The increase in the external debt during this period reflected the country's first US$750 million Eurobond issued at end-2007, together with new concessional bilateral financing and new borrowing contracted from the IDA since 2005. From 2008, the external debt increased steadily, reaching GH¢16.6 billion in 2012 (equivalent to 23.1 percent of GDP) and reflecting largely borrowing from both bilateral and multilateral institutions, including the IMF under the Extended Credit Facility arrangement. In June 2015, the external debt reached GH¢58.6 billion, equivalent to 44 percent of GDP, but dropped to GH¢54.5 billion in September.

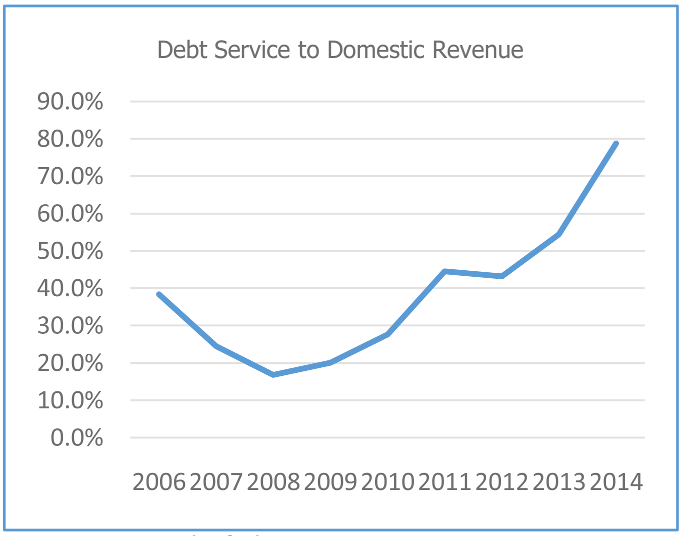
All of Ghana's external public debt are long-term in nature and are owed mainly to official (multilateral and bilateral) creditors. Official creditors accounted for on average over 81 percent of the total external debt in 2007-2012. Private creditors' share in the total external debt averaged 18.8 percent in 2007-2012. Between 2013 and June 2015, however, the share of official creditors in total external debt dropped to 67 percent, while the share of private creditors increased to 33 percent. The increase in the share of private creditors in the country's external debt reflects mainly the country's second and third Eurobonds issued in 2013 and 2014, respectively, as well as various loans obtained from the China and the USA EXIM banks.

The bulk of Ghana's external debt are denominated in three currencies, namely the special drawing rights (SDR), United States dollar (USD) and Euro (EUR). Together, these three currencies accounted for an average of 90 percent of the total external debt contracted in each year of 2006-June 2015 period. About 38 percent of the country's external debt in 2006-2008 was denominated in SDR, the currency mostly used by the multilateral institutions.



Source: GoG, Bank of Ghana *as at end-June

Debt Service. As mentioned earlier, Ghana's public debt-GDP ratio has not only risen astronomically in the last few years, but has reached a level considered to be above the sustainability threshold. Assuming no roll-overs and refinancing of existing debt, US$8.5 billion is required to service the country's external and domestic public debt this year.



Source: GoG, Bank of Ghana

In 2016-2020, a total of US$12.7 billion will be required to service the country's debt and another US$7.7 billion will be required in 2021-2025 to service debt in that period. Together, it is projected that Ghana will need US$28.8 billion to service its debt between this year and 2025. Interest payments alone will amount to US$2.4 billion in 2015, US$4.4 billion in 2016-2020, and US$2.6 billion in 2021-2025, bringing to a total of US$9.4 billion in 2015-2025, with the bulk of it amounting to 63.4 percent being interest on domestic debt. As a percentage of domestic revenue, debt service increased from 20.1 percent in 2009 to 78.8 percent in 2014. In relation to exports, however, debt service increased from 73.5 percent in 2009 to 78.7 percent in 2014.

Debt Management

To support the government's goals for debt and fiscal sustainability, the government adopted a public debt management strategy in 2009 which sought to provide clear guidelines for borrowing, establishing the principles that should guide the debt managers' decision regarding the currency composition, maturity, interest rates and other risks of the debt portfolio. Under the strategy, the government planned to explore sources of concessional financing, while seeking to avoid non-concessional borrowing in foreign currency, wherever possible. In cases where high-return infrastructure projects required market-related financing and may not be feasible without state guarantees, the policy was to evaluate the projects on a case-by-case basis to establish their economic rate of return, impact on debt sustainability, and alternatives for achieving the same developmental goals. The government was also required to provide the IMF with a semi-annual listing of projects being considered for market-related foreign financing. On this basis, the government requested that the limits imposed on contracting or guaranteeing of new external non-concessional debt under the Fund program be set to accommodate critical infrastructure projects.

Efforts to strengthen the country's debt management capacity were also undertaken, including a publication of the debt management strategy in December 2010, together with improvements in analyzing alternative borrowing options, and their cost and risk implications. Guidelines were also published to help in project selection and appraisal. Consistent with the then ECF program, limits for non-concessional borrowing and borrowing plans for the key state-owned enterprises were monitored closely, which helped to eliminate data gaps related to SOEs' debts. Furthermore, the Debt Management Division of the Ministry of Finance was reorganized to include units specialized in the functional areas while training was provided to the staff on monitoring and risk-management techniques.

Plans were also put in place to monitor domestic debt flows more closely. The resulting good progress made in 2010 was to be carried over to the following years, particularly given the country's growing access to market financing.

To safeguard the government's overarching goal for debt and fiscal sustainability, a Medium-Term Debt Management Strategy was developed and approved by Cabinet in June 2015. Included in this new strategy was a plan to deepen the domestic debt market and contribute to reducing refinancing and exchange rate risks, while securing a more stable source of financing over the medium term. The government also planned to strengthen risk management practices by developing an operational framework for building cash buffers, strengthening the management of on-lending portfolios, and reducing its exposure to contingent liabilities by minimizing the use of sovereign guarantees.

Debt Sustainability Diagnostics

Despite the debt build-up in 2009-2012, the economy did not show any serious sign of debt distress as the debt-to-GDP ratio was contained below 50 percent of GDP. In fact, the debt-GDP ratio was 48.4 percent as at end-December 2012, the highest recorded in 2009-2012. Moreover, according to the World Bank and the IMF, the projected level and composition of the country's external debt, using 2011 as the base year, showed only a small deterioration in the various debt burden indicators, with all of them remaining below their respective thresholds. In addition, in 2009-2012, the macroeconomic fundamentals were right, with interest rates and the cedi exchange rate moving in the right direction and the economy continuing to show strong growth prospects due partly to the expanding infrastructure base, which part of the increased public debt funded. Nevertheless, there is no denying the fact that the debt build-up after the HIPC/MDRI in 2006 has been substantially large. And, although the standard stress tests showed that the country was not experiencing any serious deterioration in the various debt burden indicators, continuing the same pace of borrowing in the following years made the debt burden indicators to quickly deteriorate, which slowed down the growth of the economy (IMF, 2009; 2015).

The debt sustainability analysis conducted by the IMF in 2013 suggested that the country's risk of debt distress had increased, but remained moderate. Driven by the expansionary fiscal policy in 2012, several of the country's public domestic and external debt indicators deteriorated, but the external debt burden indicators were projected to remain well below their respective indicative thresholds.

Unfortunately, this could not hold because the required fiscal consolidation was not realized as planned and there was no certainty of a strong fiscal consolidation taking place in the medium term. Though pushed up, all the debt stock indicators as well as the debt service-to-export ratio remained under their respective thresholds.

Ghana continued to face a moderate risk of debt distress in 2014, although the overall debt vulnerabilities increased, and the country's debt service-to-revenue ratio was approaching high-risk levels. Driven by loose fiscal policy, deteriorating financing terms and external pressures, several of the country's public domestic and external debt indicators deteriorated. Total public debt service-to-revenue ratio was not only on a rapidly increasing path but had breached its indicative long-term threshold. Debt service absorbed a large part of domestic revenue, rising from 54.4 percent in 2013 to 78.8 percent in 2014 (IMF, 2015), leaving the country vulnerable to shocks. The external debt service-to-revenue ratio temporarily breached and subsequently stayed close to its indicative threshold in the long term. All other debt indicators deteriorated owing to the worsening domestic and external borrowing conditions, weak fiscal consolidation, and a weakening of the domestic currency. Additional consolidation measures combined with a more ambitious medium-term adjustment were therefore required to reduce the risk of worsening debt and debt service indicators.

Challenges and Risks

First, a major challenge to maintaining macroeconomic stability and growth in the country is related to the mounting public debt. The debt-GDP ratio is not only rising astronomically but has already reached a level considered to be above the sustainability threshold, posing serious headwinds to macroeconomic stability and growth. Restoring macroeconomic stability is also constrained by the composition of the country's public debt. Total public debt rose to 72.7 percent of GDP at end-June 2015 (Bank of Ghana, Nov. 2015), causing amortizations to almost double from what they were a few years ago. In the 2016 national Budget tabled a few days ago, the government intimated that the public debt stock has dropped to GH₵92.2 billion, equivalent to 69.1 percent of GDP. This is still too high and does not give any joy especially because the IMF has projected that the country's public debt/GDP ratio will reach 72 percent again by the year-end (IMF, October 2015).

Given the high level of public debt, there is an urgent need for a well-grounded fiscal framework to anchor fiscal policy and guide it toward the achievement of the medium term objectives. Credible policies to restore debt sustainability, macroeconomic stability, and a return to high growth and job creation are needed. Otherwise, the country will very soon be on a debt meltdown like Greece. As the IMF has indicated, given the high level of public debt and financing constraints, fiscal adjustment will need to be strengthened in 2016 (IMF, Nov. 2015). The real challenge though is whether the government will be able to demonstrate fiscal prudence in the run-up to the 2016 elections.

Second, the debt composition has become a major source of risk, trapping the authorities in a vicious circle of short maturity, high risk currency depreciation-high debt levels. This underscores the call to the government to slow down borrowing, especially borrowing from foreign sources, unless the borrowed funds are used to finance projects that can generate funds within a reasonable time period to pay off the debt. Such foreign-financed projects should also seek to strengthen the structure of the economy by broadening the production base, reducing its over-dependence on a few primary and unprocessed export commodities, support the manufacturing sector, and reduce the high import dependence.

Third, it also needs to be recognized that the current financing conditions of the international market have become tighter and costly for Ghana. The expected hike in the value of the United States dollar and interest rates means that it will be more costly to borrow from foreign capital markets, especially as the country's currency continues to depreciate against the dollar. Many analysts believe that the high coupon rate of 10.75 percent secured for the September US$1.0 billion Eurobond is a reflection of the weakening investor appetite for and loss of confidence in Ghana's debt because of the lingering doubts about long-term macroeconomic stability and fiscal sustainability. High levels of debt, interest costs and continued borrowing may also have serious negative impact on Ghana's sovereign credit rating, impairing the country's ability to service its debt.

Some Policy Considerations

Domestic versus foreign markets. A major decision that the government faces is whether to fund investment projects and budget needs from domestic or foreign markets. The choice between domestic and foreign markets for funding involves a trade-off between costs and risks. The advantage of issuing local currency debt is that it can serve as an effective strategy for the country to reduce its vulnerability to exchange rate valuation effects that may be caused by excessive capital inflows followed by sudden stops and capital reversals. Debt denominated in local currency also increases the policy space because it allows the monetary authorities to respond to external shocks, such as commodity price swings or slowdowns in world demand, through exchange rate depreciations without bringing about a sudden jump in the debt-to-GDP ratio. Domestic debt, on the other hand, increases the government's exposure to refinancing risk due to its short maturity and vulnerability to capital flights, especially portions held by foreign investors.

Ghana's access to the international capital market and the choice of currency and maturity structures of its external borrowings seem to have been driven by the desire to reap immediate fiscal benefits of the borrowing than the cost (coupon rate) and currency in which the debt is denominated. Such debt strategy underestimates the risks associated with unhedged foreign currency borrowings for two key reasons. First, the capacity of the country to generate foreign currency revenues to repay its obligations is generally limited, as the government's assets consist predominantly of discounted value of future taxes denominated in local currency. Second, it is unlikely that the costs, in terms of output, welfare and reputation that the country may incur in the event of an adverse external shock are fully taken into account in the government's external borrowing strategy. Although the likelihood of crises is small, their potential disruption to the economy may be substantial.

Indeed, a net foreign exchange exposure exacerbates the economic impact of external shocks and limits the policy options available during a financial crisis. With such a large foreign currency exposure, it will be difficult for the country to pursue an expansionary monetary policy during a financial crisis because it will cause a sharp drop in the value of the domestic currency. In reducing the country's exposure to external shocks, the government should aim at improving the management of the net foreign exchange exposure by responding to the opportunities created by derivative markets to exploit niches and expand the investor base without incurring exchange rate risk. In addition to the macro economic challenges posed by large and potentially volatile flows, the sizable external foreign currency debt of the country makes it vulnerable to swings in international exchange rates and also to speculative currency attacks. Limiting the currency risk exposure of the country's debt and lengthening the maturity profile should be viewed as a medium-term strategy.

The most critical issue here is the need to reform the institutional arrangements governing public debt management. First, the government should take concrete steps to deepen the domestic debt market, broaden the investor base and issue fixed-rate long-term bonds denominated in domestic currency to provide budget insurance against supply and external shocks. Second, the technical expertise and experience required to manage the risks of external debt in a transparent, efficient and accountable manner should be strengthened. This type of arrangement will signal to the financial markets and the general public the government's commitment to a transparent and accountable debt management policy.

Bond Issuance. It should also be remembered that international bond issuances bring both opportunities and risks that the country will have to manage. Eurobonds provide a potentially important source of funding for infrastructure projects, which often require resources that exceed aid flows and domestic savings. However, the associated foreign currency and rollover risks may have to be considered. Large capital inflows may also lead to undue appreciation of the exchange rate and may create problems for the conduct of monetary policy. The greater risk is that "easy bond financing" may lead to increased public consumption or poor selection and execution of investment projects. More generally, foreign market access to the country raises concerns that borrowing on commercial terms, while increasing the cost of debt service, may not deliver the high growth needed to make the debt sustainable unless the funds are used to finance projects that can generate money to pay off the debt (UN, 2013). The government has confirmed that the US$1.0 billion raised with the 2015 Eurobond would be used to only refinance existing debts that are maturing. The worry is that if the foreign debt is used to refinance maturing existing debts that did not fund directly productive activities, then the government's action will be counterproductive.

Financing instruments. Government should also choose proper financing instruments to ensure debt sustainability. Currently, the sources of financing available to the government are greatly diversified. This provides the government with more financing options and greater opportunities but it has also exposed the country to the vicissitudes of the markets. Since the sensitivity of debt service costs to shocks hitting the economy depends on the composition and maturity of the debt, a long and balanced maturity structure is required to significantly reduce the risk from interest rate fluctuations.

The existence of contingent liabilities also suggests that the country's debt sustainability can no longer be examined with sole reference to the central government debt; it must also involve the assessment of all assets and liabilities of the public sector. Greater attention to the relation between assets and liabilities in the government balance sheet is critical because it naturally leads to the analysis of debt sustainability, as the costs of debt financing are directly linked to its benefits in terms of investment/asset returns. An asset and liability approach also puts in place a prudential framework to monitor all relevant risks to which the country is exposed, such as commodity price risk, fiscal risk and the emergence of contingent liabilities, in addition to liquidity, currency, and interest rate risks

Use of borrowed funds. The decision on how to use borrowed funds is important to ensuring debt sustainability. At all costs, funds raised by issuing debt should be invested in projects that have a high private or social return. When borrowing in foreign currencies, the government should take great care to ensure that future export revenues will be sufficient to service the debt. Clearly, debt accumulation is unlikely to be sustainable if domestic or foreign borrowing is used to finance public or private consumption with no effect on long-term growth. But, there are conditions under which even debt used to finance productive investment could turnout to be unsustainable. This happens if the ex-post returns on a project end up being lower than the interest and principal debt repayments. In fact, not only are investment returns difficult to predict, but debt service costs are uncertain. Debt service costs depend on the characteristics of the debt, such as whether debt instruments are denominated in domestic or foreign currency; have a short or long maturity; and pay fixed or index-linked rates.

Foreign Direct Investment. While the opportunities and risks implied by commercial loans and portfolio investments and the necessary restrictions to accessing such resources are debatable, non-debt-creating capital flows should generally be welcomed by the country. Indeed, over the past two decades and until the last three years, Ghana has experienced a dramatic surge in foreign direct investment (FDI), which now plays an important financing role. FDI flows do not create debt, but a trade-off emerges between financial soundness and the appropriation of investment returns. The insurance that FDIs provide against debt crises comes at the cost of surrendering a large share of the country's value added to foreign investors. The problem is compounded by the use of fiscal incentives to attract FDIs and the concentration of foreign investments into capital-intensive sectors, such as the oil, gas and the minerals industry, which generate little employment. These implications should also be taken into account by the government in the design of a policy framework for commercial loans that is not unduly restrictive and delivers an optimal financing strategy for the country.

IMF concessionality requirement. Greater access to private foreign capital can bring to Ghana the much-needed resources to overcome the huge infrastructure deficit that is constraining sustainable economic growth. The current policy framework under the IMF program which restricts borrowing on commercial terms raises a serious concern as it affects the country's growth and development. Indeed, under the program Ghana must satisfy strong concessionality requirements to continue to receive assistance and in this case a minimum of 35 percent grant element is required on new loans. Coupled with the declining interest rates used to compute the grant element of new loans, the framework severely restricts the country's access to private development finance. There is urgent need for greater flexibility in regard to the concessionality of loans and debt limits in the Fund program.

Conclusion

Ghana's public debt situation has worsened in recent years and the country now faces a high risk of debt distress and increased overall debt vulnerability. Total public debt service-to-revenue ratio (including payments on external and domestic debt) is not only on a rapidly increasing path but has breached the indicative long term threshold. Debt service now absorbs a large part of domestic revenues, leaving the country vulnerable to shocks. All other debt indicators have deteriorated owing to deteriorated domestic and external borrowing conditions, weak fiscal consolidation, and weakening of the domestic currency. Maintaining the country's debt sustainability will require carefully designed fiscal consolidation measures combined with a more ambitious medium-term adjustment to spur robust economic growth, enhance domestic revenue mobilization and reduce the worsening debt and debt-service indicators.

Maintaining Ghana's debt sustainability will also depend on a multitude of other factors that include not only strong and sustained future economic growth but also appropriate borrowing conditions, terms of trade, foreign exchange and interest rate risks, among others. In the light of these considerations, the government needs to pay particular attention to the following issues in its attempts at maintaining debt sustainability: (a) formulate and implement a prudent, effective and sound debt management strategy (b) balance the choice of financing sources and instruments; (c) use borrowed funds to invest in projects that have a high private or social return; (d) engage in responsible borrowing; and (e) formulate an international debt workout mechanism.

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