Article

A HEAVY BURDEN

Ghana's Debt Problem

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In the recent campaigning period ahead of the 2016 general elections, Ghana's public debt was one of the key issues on which the (then) opposition New Patriotic Party (NPP) lambasted the ruling government. "Smart borrowing", as the Finance Minister at the time called it, was called out by the NPP's running mate as being reckless. Following the NPP's victory in December and its nine-month rule, the tides have turned. The minority have nicknamed the Vice-President "Borromia", a twist on his surname alluding to his government's decision to borrow "responsibly".

In recent months, analysts, bankers and economists have hailed Ghana's economic recovery. International agencies like Moody's and Reuters have affirmed this position, and the IMF has given a thumbs-up, albeit a cautious one, to the ongoing progress being recorded on the economic front. Indeed the story has been good. Inflation has been trending downwards for most part of the year, interest rates have dropped precipitously and economic growth has picked up amidst increased oil and gold production. Private sector lending has already picked up, ahead of the proposed energy bond that is expected to boost liquidity in the banking sector and help repair some impaired capital positions. Real growth in private sector credit turned positive in January 2017 and averaged 3.4% over the first six months[1], although downward movement in lending rates have remained sticky.

One economic indicator has remained intractable however. Public debt. This records the government's outstanding debt obligations to both Ghanaians and foreigners and stood at $31.7bn (68.6% of projected year-end GDP) as at June 2017. This has tested the 70% limit considered as appropriate for developing economies like Ghana, and our debt stock has actually crossed that threshold for extended periods within the last two years. The government's medium term debt strategy (MTDS), pursued since 2016, has succeeded in changing the profile of the debt stock from being heavily short-term to longer term. In addition to lower inflation, this has served to drive interest rates lower to almost half the levels seen in early 2016. However, despite the economic gains that have been chalked, public debt has stubbornly remained high.

Where did it come from?

Government borrowing may take many forms. Treasury bills and bonds are both examples of government borrowing from the public and from banks. The law precludes foreign investors from buying into shorter term T-bills, but bonds with a maturity of 3 years and above are open to foreigners as well. The Government could also borrow from other nations, or from multilateral organisations such as the World Bank, African Development Bank and the International Monetary Fund. As at May 2017, Ghana's total debt stock included 46.6% in domestic borrowings from Ghanaian investors and institutions, with the remainder held by foreigners and foreign institutions.

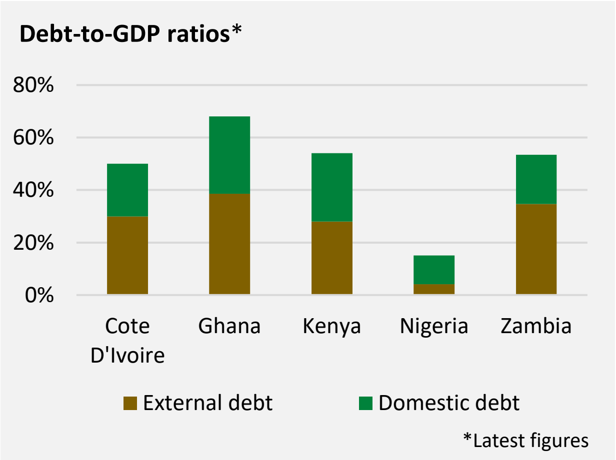
At any point in time, a nation's public debt is made up of fiscal deficits accumulated over time and unpaid arrears that the government owes. Deficits, which simply represent the government's spending above its own revenue, is financed with borrowing from local as well as external sources. As a result, whenever the Government spends more than it collects in revenue during a specific period (called a fiscal deficit in economic jargon), the difference is accounted for by borrowing from investors. Over time, the debt stock grows if the government continually reports fiscal deficits each year, as is the case in most parts of the world. For a nation like Ghana, which has seen sharp volatility in its exchange rate over time, increase in the debt stock could also result from depreciation in the local currency, which would make our foreign debt increase in Cedi terms even if there was a freeze on borrowing and we were actually paying down the debt.

How bad is the situation?

Government borrowing is not inherently bad in and of itself. Almost every nation in the world has debt in some form or the other. Just like companies, borrowing allows governments to fund investments expected to yield significant benefits to the nation that exceed the cost of the debt. As a result, debt is usually associated with developing critical infrastructure that directly support economic development such as roads, railways, ports and bridges, or social services such as education and healthcare that yield direct long-term benefits in the quality of human capital.

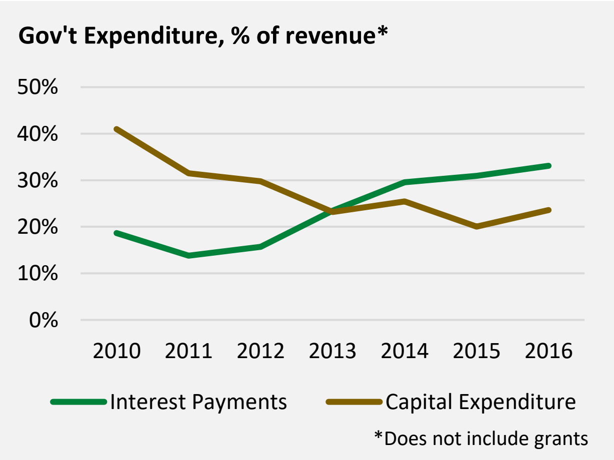
To determine if a nation's debt is at acceptable levels, the debt to GDP ratio is widely accepted as an appropriate measure. It is used by rating agencies, investment banks and multilateral organisations to determine the likelihood of a country being able to pay its debts when they become due. At 68%, Ghana's debt-GDP ratio is relatively higher than its Sub-Saharan African peers at a similar development stage. (See Figure 1 below). To understand the reason why this comparison may be necessary, consider the fact that Ghana necessarily competes with these other nations for investments, both in the form of Foreign Direct Investments (FDIs) and portfolio investments in Ghanaian bonds and the stock market.

Figure 1



Source: FirstBanC Research; Various Central Banks, Statistical Agencies

Figure 2



Source: Ministry of Finance, Ghana

A nation with a high debt-GDP ratio is considered risky by investors due to the heavy debt burden. This is because investors may be unsure of whether or not that nation may default on its debt in the future. Although government debt is usually considered risk-free because a government could simply print money to pay off its domestic debt (at the risk of inflation), nations can and do default on their foreign debt, as did Argentina in 2001 and Zimbabwe in 2004, in which case bondholders will obviously lose money. A default will also have dire consequences on the nation's ability to raise any more money directly from investors. This will have an adverse effect on the economy, thereby putting any investments in that country at considerable risk. Another concern for investors, particularly those that establish domestic business ventures, would be that the nation might decide to increase tax rates in order to shore up revenue to pay off the debt. This would obviously be bad for business owners. As a result of these potential issues, investors would usually charge a "premium" on the debt of nations with high debt-to-GDP ratios. This means that such nations would pay relatively higher interest rates on their borrowings, in order to account for the increased risk that investors take on by investing in their bond issues. Furthermore, the higher interest rates increase the likelihood of debt default.

Another consequence of high debt-to-GDP ratios is the high interest payments associated with the debt stock. This leaves little room for revenue inflows to be used for the provision of critical infrastructure or social services. This situation forces government to borrow even more in order to meet its developmental goals (and in some cases, election campaign promises), thereby perpetuating a vicious debt cycle that persists even as economic growth slows down on the back of inadequate or poor infrastructure. Between 2010 and 2016, Ghana's interest payments almost doubled from 18.6% of total revenue inflows to 33.1% (See Figure 2 above). In the 2016 fiscal year, interest payments on both domestic and external debt amounted to GH¢10.77bn (20% of total expenditure), compared to GH¢7.68bn spent on capital projects. This points to the need for urgent measures to be taken in order for the Government to reduce its interest burden, along with efforts to increase revenue, so that it can successfully carry out its rather ambitious development agenda. We know how this debt stock has accumulated over time; by extension, we are also aware of what needs to be done in order to ensure a decline in our debt-to-GDP ratio and reduced expenditure on interest payments.

Why is Fiscal Consolidation still important?

Before the Finance minister's mid-year budget review was read before Parliament in July, the airwaves and print media were awash with news of Mr. Ofori-Atta's "refusal" to request a supplementary budget, as had become the norm in recent years. Even more surprising was the Finance Ministry's decision to further tighten its fiscal deficit target from 6.6% to 6.3% of GDP, especially when revenue performance in the first half had been lower than expected. Total Revenue came in at GH¢17.5bn, 14.9% lower than the projected GH¢20.5bn contained in the original budget in March 2017. Some economists and political commentators complained about the decision to make further cuts to public spending, believing that a better approach would be to boost spending in order to provide further support to economic growth.

In my opinion, the Finance Ministry was right. In the past, we have shown that staying within the fiscal deficit targets (or ignoring them) is one of the key drivers of the Cedi's performance. It was as if foreign investors judge our nation's policy makers solely on their ability to remain within stipulated spending targets. As an example, following the general elections in December last year, the Cedi's stability throughout 2016 was eroded when the local currency started making significant losses against all the major trading currencies, mainly on the back of news that GH¢8bn in spending had been unaccounted for in the fiscal data ending September 2016. This amount of previously undisclosed spending put the government way above its deficit target for 2016. The ensuing selloff in the Cedi led to a sharp depreciation between December 2016 and February 2017, which only subsided (and actually reversed) following the reading of the budget on March 3, which restored investor confidence in, among others, the government's willingness to pursue further fiscal consolidation. Since exchange rate volatility is the main driver of inflation in an import-driven economy like ours, anything that causes the Cedi to lose value, no matter how benign, will have the medium term effect of driving inflation higher, with its subsequent effect on interest rates, private sector lending and economic growth. It has therefore become all important for the government to remain within the deficit target, even if it temporarily costs us a few percentage points in economic growth.

Of course, maintaining strict spending rules that prevent fiscal overruns will also check growth in public debt, which is important if we really want to reduce interest payments and free up revenue for capital expenditure and social spending. In addition, as growth in the public debt slows down or is even reversed, rates on foreign-denominated debt issued by the Ghana Government will likely fall, causing the nation to pay out even less of its revenues as interest expenses and to shore up its foreign currency reserves.

Conclusion

Admittedly, being conservative with our finances may sound like the exact opposite of what we would want to do in order to drive economic growth, especially as inflation is on the downtrend and the Central Bank is undertaking its first monetary easing cycle in more than five years. However, that is what **needs** to be done, until the Government's attempts to boost revenue materialize fully. Turning to government spending as a way to boost economic growth might seem like a quick fix to a real economic problem, and that is exactly what it is. It is an unsustainable route that could derail all the recent gains made in the form of Cedi stability, improved investor sentiment and lower inflation. The government must maintain the fiscal discipline it reported in the first half of 2017 and that it demonstrated by the decision to further tighten the fiscal deficit target.

The debt must fall!!!

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