Fundamentals

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Macroeconomic update | Strategy | Ghana

Twisting in the Wind

IN BRIEF

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- Turbulent waters lie ahead for Ghana's economy, but the government of Ghana (GoG) has set a course to sail through them.
- While the GoG remains resolute in its decision to not broker a deal with the International Monetary Fund (IMF) to ease some of its near-term funding pressures, it is exhibiting spending restraint – amid headwinds to its revenues - to gain a foothold on its fiscals. As expected, capital expenditure is being rationalised to curtail expenditure growth.
- But do Ghana's investors want the substance or the form?
- We expect Ghana's financial markets to be very volatile over the next couple of months as they try to find a bottom, amid a double whammy of rising interest rates and higher inflation.
- Inflation may ease the GoG's burden of old cedi-denominated debt by making it less valuable in real terms and easier to pay off – especially with fuller government coffers. But Ghana cannot inflate its way out of debt without some pretty serious consequences, no thanks to its foreign debt overhang.
- As such, the Bank of Ghana (BoG) will be facing a very difficult balancing act.
- As Ghana's investors continue to weigh the impact of the global tightening cycle on their portfolios, the mid-year budget will be an avenue to assess if the GoG has been more fiscally responsible.

The government of Ghana (GoG) is putting its money where its mouth is, and reining in its spending, as its access to tap the international capital market remains impaired and domestic borrowing becomes costlier. Also, major revenue line items continue to underperform their targets but showed signs of improvement – with prospects of better outcomes amid the ongoing implementation of fiscal reforms. This resulted in improved compliance with the budgeted fiscal deficit for the period, but the deficit was still north of the target.

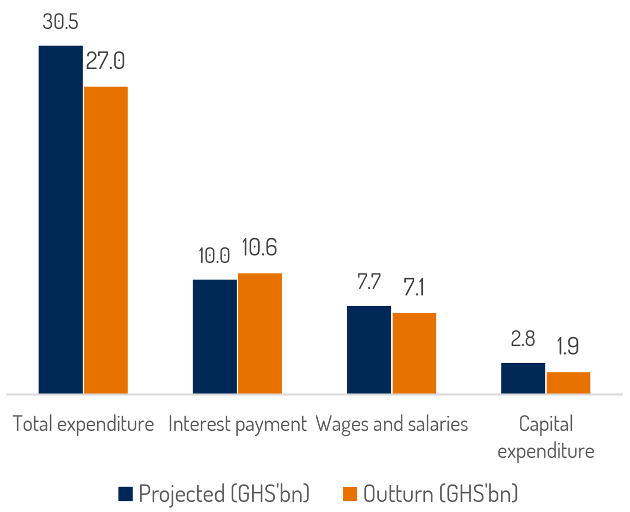
In our opinion, investors in Ghana's papers are now pricing in a sticky inflationary environment, interest rate risk, and even default risk (in the Eurobonds market). As inflation eases the burden of old debt, it makes new debt more expensive for the government and more enticing to investors. Although it may be painful to hold Ghanaian debt instruments now, there are some good reasons to do so. Hence, we recommend a shortening of duration as much as is tolerable.

The GoG is tightening its belt, but financing is still at risk

As Ghana's access to international capital markets continues to be impaired by surging global yields, the local capital market needs to hold the fort amid a funding squeeze that is compelling the GoG to tighten its fiscus strings. The decision by the Bank of Ghana's (BoG) monetary policy committee (MPC) at the March meeting, to stem the pace of capital reversal and currency pressures by hiking its policy rates, sets the stage for tighter financing conditions in the already-stretched local debt market - as debt sustainability concerns linger.

In a show of austerity, the GoG is committed to reining in its expenditure program for 2022 to restore its fiscal balance, amid the fiscal squeeze that has exacerbated its debt situation. Unfortunately, capital expenditure has been backburnered despite its potential to foster economic growth and expand the GoG's fiscal capacity. It is being traded-off for sticky expenditure items like interest payments and wages & salaries - both of which exceeded the GoG's realised tax revenue in 1Q2022, and made up 65.8% of monies spent in the period. A large fraction (98%) of the capital expenditures was foreign-financed, to the tune of GHS 1.9bn (USD 246.3m), and were sourced largely from project loans (GHS 1.8bn or USD 235.3m).

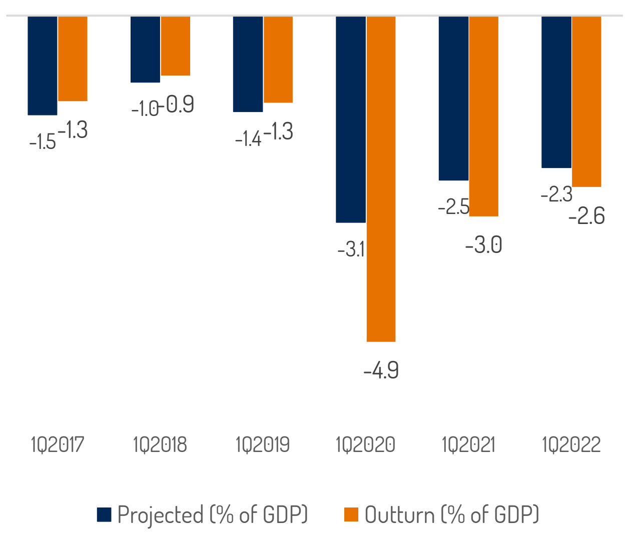
1Q2022 performance of key expenditure items



Source: Ghana's Ministry of Finance

Akin to expenditure, fiscal deficit underperformed (-2.6% of GDP) its target (-2.3% of GDP) for the quarter, but compliance improved compared to 1Q2021. The withdrawal of foreign investors and impairment of Ghana's access to the Eurobond market added to the already-heavy domestic borrowing requirement. The GoG drew down on its deposits with the BoG for 69.2% of its domestic-financing requirement in the period, while commercial banks provided 22.1%.

Evolution of first quarter fiscal deficit



Source: Ghana's Ministry of Finance

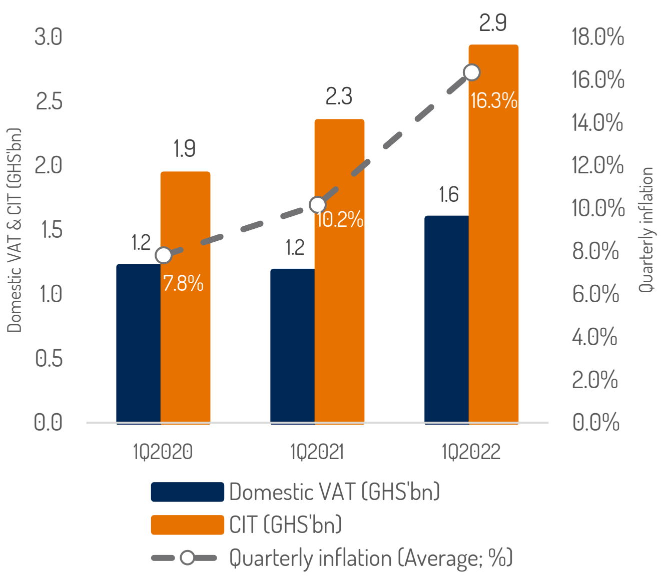
Although we perceive the GoG to be exhibiting some degree of fiscal restraint, the overall impact on Ghana's fiscal profile – amid reforms targeted at mobilising domestic revenues – can only be fully assessed during the review of the 1H2022 fiscal performance in the mid-year budget that is due in July. But the e-levy implementation kick-off and economic growth in 2021 surprising to the upside, leave us with some bright spots.

Inflation has a tongue-in-cheek impact on Ghana's fiscals

As inflation continues to ravage Ghana's economy and dent consumers' pockets, ironically, the GoG's realised nominal revenues are poised to receive a boost while also easing the real burden of its cedi-denominated debt. Unfortunately, inflation-related gains in nominal revenue are likely to be ingloriously eroded by the impact of self-perpetuating inflation from global risk aversion, higher commodity prices, and debt sustainability concerns that are fanning current cedi weakness.

On expected lines, the GoG's realised revenues fell short of their projections in 1Q2022 due to the underperformance of all major tax heads and non-tax revenue categories. Both the corporate income tax (CIT) and the value-added tax (VAT) - which each contributed 22.7% to the GoG's realised tax revenue in the period - recorded deviations of 5.7% and 8.5% respectively. However, businesses have already priced in their higher inflation expectations into the costs of their goods and services, which would translate into higher value-added tax (VAT) and corporate income tax (CIT) remittances into Ghana's kitty. Both line items contributed the most to the fiscus in 1Q2022.

Evolution of VAT and CIT receipts with inflation



Source: Ghana's Ministry of Finance

With the country's growth potential for this year being shrouded by severe global risks (such as the Russia-Ukraine war, and higher global interest rates), the GoG's revenue line items are likely to continue underperforming. Inflation is also not a silver lining for its debt burden because should the cedi depreciate further against major currencies - due to higher inflation rates and normalisation of global monetary policy - debt servicing becomes even costlier.

GoG bonds look ripe for bottom-fishing

As inflation and debt sustainability concerns are going to be a backdrop in Ghana for some time to come, Ghana's shares and bonds will continue to notch a simultaneous fall - leaving gold as a suitable hedge against future volatility. However, with prospects for improving fiscal fundamentals on the horizon, we recommend a shortening of duration as much as is tolerable - by limiting exposure to short to intermediate maturity papers in both the Eurobonds and local bonds markets -, as they are less vulnerable to the United States (US) Federal Reserve Bank's (Fed) boot than their longer-term cousins.

The trade-off is that bonds with shorter maturities tend to pay lower coupons than long-term bonds, but the sooner a bond matures, the sooner the proceeds can be used to buy newer bonds that offer higher coupons. Rising bond yields mean that you will be receiving more income from your portfolio of Ghanaian bonds in a few years, and bond prices have fallen to levels that are too good to pass up. High inflation, lower liquidity, and an overwhelming government borrowing program will exert upward pressure on local interest rates.

The key risk to this position will be a big spike in commodity prices from the current levels that will come as a negative surprise to global financial markets, compelling the central banks to accelerate the pace of ongoing monetary tightening. Although Ghanaian Eurobonds are still too risky for investors, given the US Fed's tightening mood, they could serve as a bulwark against value erosion for portfolios with predominantly cedi-denominated assets.

Conclusion

The GoG is committed to re-writing its fiscal narrative without hand-holding from the International Monetary Fund (IMF). This portends some degree of risk for Ghana's debtholders, amid the persistence of global and idiosyncratic risks. Therefore, investors must proceed with caution.

While we wait to get a better perspective of Ghana's fiscal performance - amid the ongoing implementation of fiscal reforms - from the mid-year budget performance review for 1H2022, we recommend keeping your portfolio duration short while the US Fed is in a combative stance against inflation. In addition, Ghana's investors should be holding assets that tend to flourish in high-inflation environments - like gold.

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