The World Bank Policy-based Guarantee (PBG)

The economy is becoming increasingly integrated into global financial markets. As a result exposure to external shocks is also on the increase.

Over the past three years, as the public debt stock ballooned and the cost of financing increased, the government was forced into increase external borrowing for short-term maturity of domestic debt.

- External debt increased from 48 percent of GDP in 2012to 54 percent of GDP in 2014
- Short-term debt rose from 31 per cent to 39 per cent share of the total domestic debt over the same period

Despite the efforts to keep financing costs under control, interest payments nearly doubled as ratio to GDP from 3.2 percent to 6.2 percent during 2012-2014. Rollover, interest rate and foreign exchange risks all increased.

The cost restraint has entailed increasing liquidity and refinancing risk. Amortization of short-term domestic debt poses significant shot-term liquidity risks since the government has other obligations and faces a cash shortage. Large maturing short-term debt also gives rise to refinancing risk, as short-term interest rates increase with a shift along the yield curve. As a result, average interest rates on the 91-day bill have risen steadily from 18.8 percent in 2012 to 21.9 percent in 2013, further to 24.0 percent and currently (mid 2015) at 25.2 percent.These developments in the domestic bond market from 2013 to the first half of 2015 are shown in figure 1 below.

The focus on cost minimization forced the shift in the debt portfolio composition towards the short end of the yield curve. The intention was to avoid locking-in high real interest rates – a natural reaction of debt managers in the context of liquidity constraints and pressure to achieve overall fiscal deficit targets. However, that shift has affected the general level of interest rates because buyers at the long end of the market are mostly foreign institutional investors not allowed to participate in the short maturities. Capital is not mobile along the yield curve.

The shortening of maturities has also given rise to liquidity and refinancing risks,thereby raising risk premiums. The consequent rise in interest rates feeds into perceptions that Ghana's public debt is unsustainable which in turn raises the risk premium. The stabilization program is to help break this vicious circle. The World Bank's PBG is thus expected to mitigate refinancing and short-term liquidity risks.

These developments have implications for portfolio investment flows and liquidity in the foreign exchange market. Agreement has been reached between the BoG and the Ministry of Finance to open the 2-year Note to non-resident participants.

The latest DSA classifies Ghana as being at high risk of external debt distress which makes it ineligible for a PBG. The PBG is limited to countries at low or moderate risk of debt distress. This is to avoid a situation where a World Bank PBG is supporting raising additional external debt for members at high risk of debt distress, which would potentially lead to debt service defaults to IDA and other lenders to the borrower/member.

The PBG of up to USD 400 million is to support the strategy of refinancing existing debt, without increasing the total debt stock. It is expected to facilitate raising up to USD 1.0 billion (net of fees and other transaction costs). The allocation of the net proceeds between external and domestic debt refinancing, as well as the order in which the net proceeds would be applied, would depend on market and cost conditions prevailing at the time of issuance. The PBG is expected to enable access to longer-term refinancing resources at more attractive rates than would be available on a stand-alone basis. It is also expected to extend the maturity of Ghana's debt and lower interest cost of domestic debt repayments. Without the PBG access to the required terms (long tenor, lower cost) in the capital markets would have to wait until the benefits of the stabilization program are fully realized, which might not coincide with the timing of the government's need to tap markets.

The program with the IMF carries a promise of calming markets but there is a time frame problem. Thus Ghana cannot achieve the front loaded fiscal consolidation alone or even if it can it might take a bit longer.The PBG is expected to have a positive impact on Ghana in the near and medium-term; Ghana would benefit from the guarantee as it mitigates liquidity and refinancing risks, as well as reduces financial cost, and hence, enhances macroeconomic sustainability, which in turn, would reinforce a positive market assessment.

This is the first ever World Bank PBG to be deployed and also the first that contemplates the use of proceeds<u>not to increase the stock of debt but for refinancing the existing stock with a new one with longer maturities and lower interest rates.</u>A waiver has had to be sought from the Executive Board of the World Bank which was granted upon the issuance of a clean bill of health by the IMF.

Figure 1: Domestic Bond Market Developments (2013-1st Half 2015)