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January 27, 2014

The Ghana Cedi – a Perfect Storm in the Making

■ Overview

Over the last two years, the Ghana Cedi has lost a cumulative 31.5%, under the weight of a yawning fiscal gap and chronic current-account deficit. With external reserves at less than three months' import cover for the duration of this period, the currency's decline has been relentless but quite orderly.

However, *a confluence of three new factors is creating the conditions for a perfect storm that is likely to trigger a run on the currency* reminiscent of 2008.

■ New Risk Factors

⇨ *Official manipulation of the money-market has accelerated the Cedi's depreciation rate*

As the CPI continued to defy official predictions during the last five months of 2013[1], benchmark T-bill yields declined by a cumulative 439 b.p. How did the authorities manage this remarkable feat under such inauspicious circumstances? By *the simple expedient of arranging for state-owned entities* like the Social Security and National Insurance Trust (SSNIT) and the Ghana Commercial Bank *to submit unusually aggressive bids in the relevant auctions*[2].

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By reducing the return on Cedi-denominated assets, one of the currency's last remaining props, this ill-advised intervention helped accelerate the currency's depreciation. This in turn has created *a powerful incentive for local farmers to smuggle their cocoa over to the Cote d'Ivoire* where the price of CFA 750/kg guaranteed by the *Conseil national du cacao et du café* represents a premium of 10.975%[3] over the GHC 212 per bag price set by Ghana's COCOBOD.

Reports indicate that, during the six weeks following November 30th, approximately 40,000 MT of Ghanaian cocoa – representing as much as *approximately 20% of the beans harvested locally*[4]*– were smuggled across the Ivorian border*[5]. Were this level of diversion to continue for the rest of the crop year, it would rob Ghana of more than $400 million in foregone export earnings, equivalent to almost 7.5% of its external reserves.

[1] To end the year 250 b.p. above the putative ceiling of 11%.

[2] *A propos*, it will be recalled that the results of the inaugural 7-year auction held on August 22nd, remained mysteriously unavailable at that day's close of business the normal deadline for release. The next morning, the Bank of Ghana was able to announce triumphantly that the auction had been oversubscribed 1.7x, producing a clearing yield of 17.50% - i.e. 300 b.p. inside the rate on the government's next longest dated instrument, the 5-year bond.

[3] i.e. Given exchange rates of CFA 655.957 = €, (fixed); € = $ 1.3675; and $ = GHS 2.415, the Ivorian price of CFA 750/kg in Côte d'Ivoire is equivalent to GHC 235.26 per bag.

[4] Rhombus estimate, based on average of 196,000MT harvested during the same period in the two preceding crop years.

[5] Although a COCOBOD spokesman, Noah Amenyah, denied that the Board had knowledge of any such activity, this was barely 24 hrs. after one of his colleagues had anonymously confirmed to Bloomberg's local correspondent that the Board was investigating reports of smuggling.

⇨ *Ghana's requirements for electricity generation pose a potential threat to the current account.*

Imported oil is a significant item on Ghana's balance of payments, accounting for approximately 17.5% of the 2012 bill for merchandise imports. The state-owned Volta River Authority (VRA), which produces 83% of Ghana's total installed capacity of 2,546 MWH, relies on hydropower for a little more than half its output[6], with thermal generation providing the balance.

The thermal plants are normally fuelled by natural gas pumped from Nigeria along the W. African gas pipeline. However, in August 2012 the pipeline was shut down as a result of major damage[7] to an underwater segment. During the 11½ months it took to repair the damage, *the VRA was forced to run its thermal plants on light crude oil, at a daily cost of as much as USD 3 million*[8] – more than twice the operating cost using gas.

Since the pipeline resumed operation in July 2013, the supply of gas from Nigeria has been running at less than 50% of the contractual daily volume of 123 million ft^3. *In mid-January, however, daily supply plunged to as low as 30 million ft^3, which corresponds to 100% of VRA's operating requirement*, with no reserve margin. To date there has been no explanation for this shortfall but any further deterioration would oblige the VRA to switch its plants back to burning light-crude – with dire implications for both the budget[9] and the current account.

⇨ *Policy-makers face a growing credibility-gap*

Downgrading Ghana's sovereign rating to B last October, Fitch pointedly observed that *"policy credibility has been significantly weakened"*. Although this harsh assessment was prompted by the government's repeated overshoot of its fiscal targets, it would seem applicable across a range of policy areas, including the following, (in addition to the manipulation of money-market rates described above):

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Banking supervision In November 2013, the Bank of Ghana approved the sale of Merchant Bank[10] a troubled lender with SSNIT as its controlling shareholder – in spite of a number of red flags.

- Fortiz, *the buyer was not a banking organization but rather a special-purpose company* established a mere six months earlier and capitalized at only GHC 5 million.
- The largest asset on Merchant's balance sheet was *a non-performing loan of USD 60 million to Engineers and Planners Co. (E&P), a contract mining firm controlled by* Ibrahim Mahama, *the younger brother of President Mahama*.
- The *law firm representing Fortiz* in the purchase-sale transaction *had previously represented E&P in its protracted negotiations with Merchant Bank* aimed at resolving the outstanding loan.

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[6] More specifically, HEP=56.1%; thermal=43.8%; solar=0.1%. However, this mix is likely to shift in favor of thermal generation in the short to medium term, as a result of poor rainfall over the last two years which has left the water level worryingly low at the Akosombo Dam, the country's main hydropower source. In fact, the VRA has explicitly warned that *" [I]f the rains don't become better this year, in 2015 we will have a challenge; the Dam might fail [to produce power] to some extent".* (Mr. Samuel Fletcher, Communications Manager; as reported by *Joyonline*, on Jan. 27th).

[7] The pipeline was struck by a ship off the Togolese coast.

[8] Statement by Mr. Sam Kwesi Fletcher, Public Relations Officer of the Volta River Authority, as reported by Ghana News Agency, March 3, 2013.

[9] Electricity prices are administered by the Public Utilities Regulatory Commission (PURC), which has only recently embarked on the phased elimination of the relevant subsidy – to be effected over the course of 2014 in four quarterly installments

[10] A year earlier the bank had rejected a bid by First Rand Bank of South Africa.

[10] The same Article IV Report reported corresponding discounts of 8%, 11% and 28% to the pump prices in Benin, Togo and Burkina Faso, respectively.

Fuel prices In June 2013, the IMF had warned that the pump price of gasoline in Ghana was significantly cheaper than in neighboring countries - by a factor of 31% in the case of Cote d'Ivoire[11].

After an initial 6% price hike in July, *the Government bowed to political pressure and failed to implement the next two increases scheduled for September and December, respectively*. But then on Jan. 16th 2014, in response to the fuel shortages experienced nationwide since the start of the year, the authorities abruptly hiked the price of gasoline by 6.38%[12]. However this increase represents less than half the Cedi's depreciation since the July price hike and so is unlikely to fully resolve the shortages[13].

Exchange-rate 'management' On January 9th the Bank of Ghana introduced new guidelines that would "help revamp our interbank market and stabilize the local currency". Instead the new measures simply required FX dealers to make a two-way market, with a maximum bid-offer spread of 200 pips (down from 250 pips previously). As if to demonstrate the inadequacy of these strictly procedural adjustments, *the currency slid a further 1.25% in the five subsequent trading days*, to a rate of 2.40 vs. the USD.

The Vice President has since tasked the Minister of Finance and the Governor of the Bank of Ghana to come up with "pragmatic measures" to contain the depreciation of the Cedi. Given the binding constraints upon supply, managing the demand for foreign exchange will have to be the focus of any new initiative.

■ Lighting the fuse

With the Cedi under threat on so many fronts, it will take very little to spark a full-blown currency crisis. Potential precipitating events include, *inter alia*: a spectacular fiscal overshoot[14] for 2013; a sharp deceleration in the growth rate[15] or a strongly negative assessment from the IMF at the conclusion of its Article IV mission in March. In our assessment, however, *the most likely trigger for a disorderly Cedi devaluation is a failed bond auction* – something for which there is a grim precedent in Ghana.

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In June 2008, an auction of 5-year Government bonds that had been expected to attract considerable offshore interest, failed to do so. With so much riding on the anticipated inflow of hard currency, *the failure triggered a massive run on the Cedi which plunged 14% over the next eight weeks alone*. By June 2009, the currency had sustained a cumulative loss of 31%.

On February 17th this year, GHC 401 million in Ghana government bonds are due to mature. Issued in 2011[16] with a coupon of 13.40%, the bonds are largely held by offshore investors[17]. As such, *implicit in the rollover risk associated with this maturity is a very real threat of capital outflow*.

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[11] The same Article IV Report reported corresponding discounts of 8%, 11% and 28% to the pump prices in Benin, Togo and Burkina Faso, respectively.

[12] At the same time prices for diesel were raised 7.08%, liquef ied petroleum gas 8.73 % and kerosene by 19.80%.

[13] This fact is implicitly acknowledged by the Vice President's call the very next day for an urgent meeting of stakeholders in the downstream petroleum sector to address disruptions in the distribution of petroleum products in the country.

[14] e.g. a final print in the vicinity of 11%, which would be 2% higher than the initial year-end target and almost a full percentage point higher than the Government's revised forecast of 10.2%, made in November 2013.

[15] Either outcome would almost certainly trigger a sovereign downgrade by both Moody's and S&P.

[16] i.e. In the middle of phase 2 of the U.S. Fed's program of quantitative easing, when the ocean of related liquidity was beginning to flood the credit markets in pursuit of a yield pick-up.

[17] It will be recalled that non-residents are prohibited from purchasing Ghana government securities with a maturity of less than three years.

Likely market impact

Based on the deteriorating economic conditions on the ground and the increasingly bearish sentiment among investors towards the emerging-market asset class as a whole, *it is very likely that the vast majority of offshore holders will elect to repatriate*, rather than reinvest the proceeds from their maturing bonds. Given the pent-up demand for hard currency already observable in the local FX market[18], and the central bank's conspicuous lack of fire-power, *the sudden injection of even GHC 300 million in incremental bids would represent a huge demand shock*, precipitating a fresh run on the Cedi.

On this basis we see the currency moving from its current level of 2.415 to a range of 2.70-2.75 against the USD over the next three months, a devaluation of 10.5% - 12.15%.

Trade recommendation

The above circumstances create an unusually attractive opportunity[19] to trade the anticipated devaluation. We recommend establishing a 'short' Cedi position via non-deliverable forwards (NDFs), currently priced at approximately 22% p.a. The trade would work as follows.

Assumptions	
Notional principal:	GHS 30,000,000
Tenor:	90 days
Price:	22% per annum
Parameters	
FX_{spot}	USD=GHS2.415
$FX\ rate_{90\ (proj)}$	USD=GHS2.750
Results (in USD)	
FX_{spot} proceeds	12,422,360.25
$FX_{T90\ (proj)}$ proceeds	-10,909,090.91
FX settlement	**1,513,269.34**
NDF cost	- 683,229.81
Net P&L	**830,039.53**

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[18] As of Jan. 24th, for example, one of the major dealers in Accra attempting to work a customer order for USD 10 million, had only been able to source USD 2 million of supply after several days.

[19] A 'short' trade needs to anticipate not only the direction of a projected move but also its timing – typically the greater challenge. Here the impending maturity of the 3-year GoG bond provides crucial guidance.

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