

Launch Statement

Review and Analysis of Government Economic Policy for 2006

Introduction

The CEPA review and analysis of the Government Economic Policy for 2006 contains an updated assessment of fiscal, monetary and external sector performance in 2005 and presents policy recommendations and forecasts for developments in some indicators in 2006. The official provisional outturn of the fiscal position for 2005 as presented in the Budget Statement for 2006 is a revised projection based on data available only up to September 2005. This is because for the first time in the Fourth Republic, the Government of Ghana presented the budget for the following year, i.e. 2006, in the preceding quarter, i.e. November 2005. In contrast, CEPA provisional actuals for 2005 – as presented in this document - are based on data up to November 2005 from the Controller and Accountant General's Department and more recent data from the Bank of Ghana as well as the Ministry of Finance and Economic Planning.

Growth of Real GDP

Ghana has an economic cycle that is essentially a three-year agricultural cycle. This cycle entered the upswing phase in the fourth quarter of 2005. CEPA projects that real GDP growth will be about 5% in 2006 since the economy has entered the upswing phase. It is recommended that the package of policies ensures that the recovery is enhanced without rekindling inflationary expectations and inflation.

Monetary Policy and Inflation

Empirical research at CEPA has established that changes in the growth of monetary aggregates exert pressures on the rate of inflation with a 4-6 month lag. In 2005 the monetary authorities succeeded in putting breaks on monetary expansion. Aside from blips in March and August 2005, declining growth rate in broad money supply (inclusive of foreign currency) was recorded throughout the year. In the near term, therefore, CEPA expects headline inflation to fall by a cumulative 5 percentage points by March 2006. The expectation is that on the anniversary of the 50% increase in petroleum prices announced in February 2005, the resultant cumulative 5

percentage points increase in the February and March 2005 headline inflation would be reversed. Consequently, headline inflation is projected to fall below 10% by end-March 2006 in spite of the increase in petroleum product prices by an average of 10% in February 2006. In the subsequent months of 2006, headline inflation is projected to remain in single digits in line with the current macroeconomic objective.

Lending rates of interest have remained stubbornly high. Adjusted for inflation, real lending rates declined during most of 2005 but at the close of year, it was a high of about 10%. With inflation expected to fall to single digits, the real interest rate could rise to 15%. This would be burdensome on the real sector of the economy to say the least. Monetary policy has largely succeeded in mopping up excess liquidity in the system. However, the major challenge it now faces is to liaise with the banks to realign lending rates in favour of real sector activities.

There is the likelihood that 2006 will witness better donor inflows than 2005 on account of two developments – the fruition of the Millennium Challenge Account and the Multilateral Debt Cancellation Initiative that will erase some \$4.2 billion of Ghana's external debt stock. Monetary authorities are therefore expected to pursue vigorous foreign exchange and open market operations to sterilize these inflows to prevent the unleashing of inflationary pressures on the economy.

According to the Press Release (January 30, 2006) of the Monetary Policy Committee of the Bank of Ghana, on a year on year basis Reserve Money increased by 13% in 2005 – the lowest in a decade. It is recommended that this be maintained as target in 2006.

Broad money (M2) growth as of November 2005 was estimated at 10.4%. This was almost identical to the 10.6% growth rate for M2+. In line with the projected higher real GDP growth in 2006 and the accompanying need for private sector credit, higher growth of the broader money aggregates in the 14-15% range is recommended. This proposed range moreover, is consistent with the single digit rate of inflation objective.

Fiscal Policy

Government appears to have been won over to the view that monetary policy is less effective compared to fiscal policy in stimulating the economy. In the Budget Statement and Economic Policy for 2006 a number of fiscal initiatives were outlined that are designed to stimulate the ailing economy. These aim at boosting disposable incomes and stimulating investment through cuts in tax rates, increased tax thresholds etc. On account of these, however, a reduced domestic revenue share of GDP is projected for 2006. Therefore, even with the planned reduction in non-interest current spending a lower domestic primary balance is projected for 2006.

The CEPA provisional estimate of the modified overall broad balance (adjusted for clearance of debts and VAT refunds) for 2005 is a deficit that is some 1.8 percentage points worse than the provisional outturn presented by the Government of Ghana in the 2006 budget statement. Therefore, the realisation of the 2006 target for the overall broad balance will require a halving of the deficit from the 4.6% of the GDP realised in 2005 to the 2.3% of GDP announced in the 2006 budget statement.

The net repayment target set for 2006 would appear to be modest and achievable. This is premised on the CEPA estimate of a net repayment in 2005 that was better than the official provisional outturn.

Greater transparency is needed in budget implementation, with the sectoral, spatial and gender dimensions as well as efficiency of capital expenditure better aligned to the growth and poverty reduction objectives. The payments arrears problems must be decisively dealt with once and for all.

The Exchange Rate

The real exchange rate remains overvalued. Corrective action must be taken to rectify the misalignment and thereafter the policy stance must be the avoidance of a return to costly overvaluation. This will only be sustainable if the inconsistent macroeconomic policies responsible for the misalignment are corrected and economic growth accelerates.