1.0 EXECUTIVE SUMMARY

THE YEAR 2010: FROM A COCOA ECONOMY TO AN OIL ECONOMY

The key structural characteristics of the economy of Ghana include the following:

A highly open economy relatively well-integrated into the global trading system and critically dependent on three commodities namely cocoa, gold and oil. A standard measure of openness to international trade (the ratio of the value of trade for both exports and imports to the nominal GDP) stood at nearly 100 percent for Ghana compared to about 75 percent for la Cote d'Ivoire, just under 60 percent for Nigeria and less than 50 percent for Tanzania (using 2008 data). These statistics show why Ghana is often charaterized as highly open and well-integrated into the global trading system.

Revenue from international trade constitutes a significant proportion of the total government revenue; tariffs are relatively low and so is the dispersion across import items.

The exchange rate and payment system has been described as a liberal one in the sense that the system is free from restrictions on payments and transfers involving merchandise trade, profits, dividends and labour incomes as well as official grants and private transfers such as remittances. A consequence of this freedom from payment restrictions, however, is that domestic prices of traded goods and the exchange rate are highly responsive to international market forces and domestic demand pressures.

A "freely floating" but "managed" official exchange rate regime co-exists with a retail market of forex bureaux (licensed and informal) operators. Exchange rates in the latter are particularly important in cross border transactions (smuggling activity).

The interest rate regime is essentially liberalized with the Bank of Ghana (BOG) prime rate, the policy rate, working through the interbank market and the weekly auctions of Treasury bills and Notes to determine money market and longer term interest rates.

Prices of goods and services are largely market-determined except for tariffs on public utilities (electricity and water) and prices of petroleum products which are determined by regulatory institutions – the Public Utilities Regulatory Commission (PURC) and National Petroleum Authority (NPA) respectively.

Ghana is surrounded by CFA franc zone countries which produce the same primary commodities for export. Unrecorded cross border trade or smuggling activity is active and significant with the forex bureaux exchange rates often playing a crucial role.

Smuggling has been blamed for significant movements of cocoa from Ghana to La Cote d'Ivoire. For the current crop year 2009/10, on account of intensified smuggling, CEPA projects that purchases will fall short of the total for the previous crop year by 8 percent and short of its target of 650,000 tonnes by 10 percent. The inducement for smuggling is a function of the official producer prices in the two countries and most importantly the forex bureaux rates in the border areas.

Beyond the structural characteristics, the current macroeconomic policy framework is a three year stabilization programme agreed with the International Monetary Fund (IMF) for the period 2009-12 under its Poverty Reduction and Growth Facility (PRGF) now the Extended Credit Facility (ECF). It is anchored on strong fiscal discipline with a supportive monetary policy regime. Consistent with the orthodoxy of the IMF, great reliance is placed on the sacrifice of output and jobs particularly for new entrants into the labour force — the youth — to achieve the ambitious, rigid and fast paced inflation targets in the stabilization programme.

With a sacrifice ratio, or opportunity cost — a measure of the economic growth foregone to achieve the inflation reduction — estimated at nearly one by the IMF Staff, the 4 percentage points reduction in the rate of inflation — from 20 percent to 16 percent per annum — achieved in 2009 cost the nation an economic slack equivalent to 4 percentage points of GDP. This also means the loss of the jobs that would otherwise have been created to produce this amount of lost output. Interestingly, the instrument for achieving this slack was the 4 percentage point reduction in the budget deficit/GDP ratio from 14.5 percent in 2008 to the CEPA estimate of 10.5 percent in 2009.

CEPA also projects that its forecast of a cumulative 5.7 percentage points reduction in the rate of inflation in 2010 — from 16 percent in December 2009 to 10.3 percent for December 2010 — would require a corresponding loss in output equivalent to 5.7 percentage points of GDP. This measure of output foregone will come with corresponding loss of jobs that would otherwise be used to produce that output. This will be particularly severe for new entrants into the labour force i.e. the youth, but also small-scale farmers may find themselves saddled with unsold produce with possible adverse effects on future consequences for investment and production.

The Ghanaian economy appears set to move from what may be called a cocoa economy to an oil economy. Considerable investments were made in cocoa at the turn of the last century. From about 1911, cocoa cultivation emerged as the dominant productive activity in the country. Since then, the cocoa sector has served as an important source of:

- livelihoods and employment;
- central government revenue; and
- foreign exchange earnings.

Thus, over the last 100 years, in a fundamental sense, Ghana could be said to have had a cocoa economy.

The official accounts time Ghana’s entry into the oil era for the fourth quarter of this year 2010. The World Bank for its part, projects that Ghana’s oil will start to flow in early 2011. Regardless of the exact timing, however, the promise of oil generates high expectations. Anecdotal evidence has it that some Ghanaians desire that the exchange rate of the cedi reverts back to parity with the US dollar. In CEPA’s view that would be the onset of the Dutch Disease.

The Dutch Disease is so named because of the destructive effect — such as choking off the growth and employment potentials in non-oil sectors — on the Dutch economy of the discovery of substantial gas reserves in the 1960s. It is a form of the “resource curse”. It originated from the nominal and real appreciation of the exchange rate that resulted from the large inflows of foreign exchange earnings from the Dutch export of gas. Effective management of the exchange rate will therefore be critical, if oil is to enhance our growth prospects and if Ghana is to avoid the ills of the Dutch Disease.

There have already been **signs of the cedi appreciating against key currencies in the first quarter of this year, 2010** and this trend is expected to continue for the rest of the year. This steady and creeping appreciation of the cedi comes with associated risks of choking off the growth and employment potentials of non-oil sectors in particular, agriculture and manufacturing. The lessons from the experiences of other African oil producers, in which windfalls in foreign exchange earnings have had a number of negative economic repercussions, need to be fully learnt.

These developments and tendencies on the foreign exchange front are the exact opposite of what is currently going on in China. The Chinese appear willing to <u>sacrifice a measure of current well-being in exchange for jobs</u>. Ghana, a much poorer country, even if unconsciously so, appears bent on choosing the opposite — a preference for current well-being even at the expense of having less jobs. Chinese policymakers do not use the yuan as a tool for managing inflation. They use it instead as a tool to maximize exports and employment — a tool they appear not yet ready to give up. China is seen to have kept the value of its currency artificially cheap, thus implicitly subsidizing its exports while taxing its imports.

Developments in the current account of the balance of payments (the external accounts) of Ghana are important because of their consequences for changes in the exchange rate. Specifically, widening current account deficits are causes of potential draw-downs on the country's international reserves and/or depreciating pressure on the exchange rate. In the Ghanaian context such developments could originate from the following:

- adverse changes in the commodities terms of trade (TOT) – falls in the prices of key exports and/or increases in import prices;
- imports, such as of capital equipment and of intermediate inputs of raw materials, components and spare parts, as for example, needed in the oil sector; and
- changes in the budget deficit that produce parallel changes in the so-called twin — the current account deficit — through the impact on domestic aggregate demand.

CEPA analysis leads to the conclusion that no significant adverse developments in the current account deficit are expected from any of these sources in the course of this year. On the contrary, changes in the terms of trade are expected to be benign to positive. The expected imports of capital and oil sector-related inputs are also expected to be fully financed by capital inflows from the relevant mining companies. Finally, on account of the stabilization programme, the budget deficit is expected to have a restraining impact on its twin — the current account deficit.

As Ghana enters the oil era, an "exchange rate effect" symptomatic of the Dutch Disease is expected. The exchange rate effect, together with the yield on Ghana's Eurobond — source of information on the country risk premium on Ghana — and the rate of inflation would be key considerations in the deliberations of the Monetary Policy Committee (MPC) of the Bank of Ghana (BOG) for the determination of both the real and nominal policy rate (prime rate).

In its analysis of the stance of monetary policy, in particular real rates of interest, CEPA prefers to use the average annual rate of inflation rather than the year-on-year annual rate. This is because like all averages, the average annual rate of inflation has a smaller variance (one-twelfth) than the individual year-on-year annual rates of inflation and is consequently more stable — less variable.

High variability in the policy rate could reduce its influence on the relevant market interest rates and thereby weaken the effectiveness of transmission of policy actions. The policy rate is a very short-term rate. The market rates that affect spending and output, however, are not so short-term. Effective transmission of policy actions requires that these market rates respond predictably in line with movements in the policy rate. This requirement of <u>predictable</u> response is perhaps best achieved if the expected policy rate is relatively stable in the sense of it not being subject to frequent reversals.

The current indications are that the real policy rate — the nominal rate adjusted for the average annual rate of inflation — has been on a downward path since the second half of 2009, turned negative, and continued on this path into the first quarter of 2010. Later this year, the economy is expected to enter into the upswing phase of the three-year inflation cycle. Given the anticipated difficulties with further fiscal retrenchment, monetary tightening would have to be relied upon to contain inflationary expectations and the inflation rate. Consequently, CEPA recommends that the real policy rate be raised into positive values, reaching at least 3 percent (in real terms) — the "natural equilibrium rate" estimated by the IMF Staff — by the end of the year.

The empirical record shows that the policy rate has played the role of signalling devise on money markets reasonably well. For a variety of reasons, even in the face of clear signals from the policy rate, bank base and lending rates have been tardy and generally downwardly rigid. Generally speaking, even if not simultaneously or uniformly, **CEPA expectations are that all nominal interest rates will follow the policy rate downwards, and stabilize later in the fourth quarter of 2010**.

Inflationary expectations can be gauged by the compositional shifts in the outstanding stock of Government securities. Using this measure, inflation expectations have been considerably eased since the third quarter of 2009. The MPC Press Release of February 19, 2010 noted that:

> *"the share of the short-dated securities peaked in August and has followed a declining trend ………. in line with easing inflation expectations".*

Important lessons that must be borne in mind in setting inflation targets include the following:

- "very low inflation may do more harm than good" (CEPA research shows that in Ghana "very low" means single digits);
- a flexible approach in target setting is to be preferred to rigid straight line paths which "may not be feasible, let alone desirable"; and
- there are tradeoffs, and unnecessary sacrifice of output and jobs must be avoided.

Taking these lessons into consideration, the inflation targets set by the IMF in the stabilization programme and the pace of disinflation are in CEPA's view too fast. Consequently, the required sacrifice in output and jobs are also inordinately high. Alternative inflation targets based on CEPA's inflation forecasting model and which are more flexible and forward looking are contrasted with those of the IMF in this document.

CEPA expects inflation to continue to decelerate into the third quarter of 2010. After that, however, with the projected entry into the upswing phase of the 3-year inflation cycle, a trend reversal is expected, with a gradual rise in inflation reaching a peak in the first quarter of 2012.

As discussed in an earlier CEPA report, policymaking is an exercise in political economy not in economic theory. Consequently, policy advisors — local and foreign — must resist the temptation to <u>prescribe</u> policies to the Government of Ghana.

There are also identifiable risks to the sustainability of the stabilization package over the three-year period on account of the high socio-political cost. Two key areas are the following:

- political risk — reconciling the social democratic principles of the government of the National Democratic Congress (NDC) with the high sacrifice of output and jobs; and
- fiscal imbalances on account of:
    - public sector wage bill;
    - mounting debt of payment arrears;
    - subsidies on petroleum product prices; and

- the development budget.

Dealing with these risks would call for better balance between the objectives of growth and macroeconomic stability — a decisive move from a single-minded focus on stabilization to a regime of growth with macroeconomic stability. In CEPA's view, stabilization programme of three years of austerity, implying high cumulative losses in output and jobs in a country with deep and pervasive poverty, is politically unsustainable.

Moreover, the pace of the disinflation process itself adds to the rapid build-up of socio-political forces in opposition to the stabilization programme. Economic growth and jobs deserve greater weight.

The needed balance between finance and austerity would necessarily raise difficult issues which need careful consideration including the following:

- how much oil revenue to save — an issue of intergenerational equity;
- donor aid in an oil economy — some oil economies such as Nigeria receive reduced or no aid; and
- debt sustainability analysis (DSA) to determine the appropriate spending envelope and annual budget deficit of the GOG in a medium term expenditure framework (MTEF).

CEPA analysis points to the use of fiscal policy to reduce aggregate demand and therefore the tempo of economic activity. This is confirmed by the MPC Press Release dated April 16, 2010 which points out that the economy is indeed slowing down. The factors said to explain this slowdown in economic growth include the following:

- a fall in non-oil imports;
- reduced spending by tourists;
- a slowdown of private sector transfers to SSNIT — indicating a low rate of job creation;
- reduced Value Added Tax (VAT) collections — an indicator of a reduction in consumer spending; and
- tightening of commercial bank credit to the private sector.

Business confidence is also reportedly low although consumers are more upbeat. High bank lending rates were cited by businesses for the downbeat outlook. In contrast, consumer confidence appeared driven by expectations of improved economic conditions, employment opportunities and a slowdown in inflation — perhaps on account of the anticipated entry of the economy into the oil era.

As noted above, the tardy and slow response of bank base and lending rates to the policy rate are a source of concern to businesses. And yet on account of the inefficiencies of the financial intermediation process, the private sector is unable to play the assigned role of lead engine for economic growth and job creation.

Efficiency in bank financial intermediation can be measured by the spread between average lending rates and average deposit rates. Currently, the spread which had been large appears somewhat compressed even though provisions for non-performing loans (NPLs) have increased. This suggests that the banks have succeeded in reducing their operating costs and therefore able to respond to the call to reduce lending rates, even if for now, by small margins. Progress in further reduction in lending rates, however, can only come from arresting the continued rise in the stock of NPLs. It is reported in the April Press Release of the MPC, that as of February this year, <u>one-fifth of all loans and advances in the banking system</u> was classified as non-performing.

The evidence firmly suggests that the payment arrears of the GOG to contractors and other suppliers of goods and services must bear a large share of blame for the non-performing loans in the banking system. This is particularly so of the Tema Oil Refinery (TOR) debt to the Ghana Commercial Bank (GCB). Consequently, action to clear these payment arrears is needed to help the banks improve both access and costs of loans to the indigenous SMEs.

Hopes have been raised by the growing collaboration with some emerging economies such as Brazil, Russia, India, China — the BRICs — and South Korea on a number of potentially growth- enhancing projects. However, the 2010 budget made no provision for the GOG's involvement —whether by provision of loans to, or equity in, these projects. Moreover, the preparatory work for some of these projects to take off does not appear to have been undertaken with the necessary diligence – an example is the jatropha project. The lessons of the HIPC phenomenon must be factored into this effort at strengthening South/South collaboration. This is necessary to ensure that the liability of debt incurred from the BRICs is matched by productive assets in the nation’s balance sheet. This is the way to ensure that we meet our debt service obligations, avoid the indignity of defaulting on these debts and/or the embarrassment of pleading for debt forgiveness in the future.

These considerations on growth and jobs are the more important given the early signs of the Dutch Disease — nominal and real appreciation of the Ghana cedi against key currencies namely the US dollar, the pound sterling and the euro.

Such real appreciation of the exchange rate means loss of price competitiveness of domestic products in international trade.

On the export side, made-in-Ghana goods and services would be over-priced in foreign markets. This would mean a squeeze on profits initially then to loss of market share and finally to cutbacks in domestic production and job losses.

On the import side, imports into Ghana would become increasingly cheaper than their substitutes made in Ghana. Again initially this would place a squeeze on profits of domestic producers engaged in activities that compete with commercial importing. If this is not quickly rectified it would ultimately lead to the collapse of such domestic productive activities with consequent job losses.