



CENTRE FOR POLICY ANALYSIS

GHANA ECONOMIC REVIEW AND OUTLOOK

EXECUTIVE SUMMARY

2009

1 EXECUTIVE SUMMARY

Introduction and Background

The Mills-led NDC government assumed office in early January 2009 and was faced with an environment of macroeconomic instability which manifested itself in, *inter alia*, a huge budget deficit estimated at 14.5 percent of GDP at the end of 2008—including nearly 1.0 percent of GDP in respect of commitments and payments arrears from previous years.

Although the macroeconomic difficulties of 2008 were primarily due to election year spending excesses they, nonetheless, exacerbated an underlining persistent deterioration of fiscal discipline which the Centre for Policy and Analysis (CEPA) had noticed and drawn attention to since 2006 — a phenomenon which the Centre has described in various presentations as “*stubbornly high and widening fiscal deficits*”.

Against this background many high spending-related promises were made by all political parties during the 2008 electioneering campaigns at a time when reality and objectivity rather called for policy packages geared more towards economic stabilisation.

The new Government also had to grapple with the adverse developments on the international scene — the global financial turmoil and the consequent world economic melt down. As a result it found itself in the rather unenviable position of being in a home-grown financial crisis in the midst of a global financial crisis and recession.

The Government was, therefore, confronted with a policy dilemma referred to as “A Tale of Two Cities” by CEPA: on the one hand the own-inflicted financial crisis called for a reduction in government spending whilst, on the other hand, the inhospitable global situation required the provision of massive governmental support in the form a hefty package of fiscal stimulus to re-ignite the ailing economy — a counter-cyclical path chosen by most other countries with relatively better managed and more sound domestic economies.

A Strategy of Growth with Macroeconomic Stability

Not surprisingly, the government made the attainment of macroeconomic stability an important goal in its maiden Budget presented to Parliament on March 5, 2009 with an objective to reducing the broad budget deficit to 9.4 percent of GDP at end-December 2009 from the end-December 2008

outcome of 14.5 percent of GDP. This notwithstanding, and consistent with the social democratic agenda of the Mills-led Government, the 2009 Budget also acknowledged the critical importance of broad-based economic growth in the fight against poverty and in improving the living conditions and welfare of all Ghanaians. Indeed, in its “Assessment and Critique of the 2009 Budget Statement and Economic Policy”, CEPA had contended that the economic programme for 2009 with its social democratic principles (and with the explicit provision of GH¢42 million in support) — presented and approved by Parliament — was consistent with a strategy of “**Growth with Macroeconomic Stability**” in which the growth objective is accorded more prominence.

The Move to a Pro-cyclical Stabilisation Programme

In a letter dated January 7, 2009, the World Bank Ghana Office alerted the incoming Administration of the severity of the domestic financial crisis and rushed it to “request additional and extraordinary assistance from both the World Bank and the IMF

In the ensuing dialogue subsequent to the submission of the letter, the World Bank succeeded in mobilising the IMF, the Development Partners (DPs), and the new Mills Administration to move from the strategy of “**Growth with Macroeconomic Stability**” that informed the 2009 Budget Statement into following a strategy of a “**comprehensive programme of macroeconomic stabilisation and reform**” — a programme consistent with a strategy of “**Macroeconomic Stability with Growth**”, i.e. one that is heavily slanted towards stabilisation rather than pro-poor growth — which is contained in a new PRGF Arrangement with the IMF for the 3-year period July 2009-June-2012.

The Revised Budget and the new PRGF Arrangement

In its mid-year review of the 2009 Budget Statement and Economic Policy to Parliament on August 25, 2009, the Government also presented a revised Budget for the consideration of and approval by Parliament. In a technical sense the revised Budget sought to receive the blessing of Parliament to implement the new PRGF Arrangement with the IMF. Additionally, the revised Budget took into account events and developments which, according to the Minister of Finance and Economic Planning, were not available to Government at the time of presentation of the original Budget in March.

Highlights of the Revised 2009 Budget

Broad Fiscal Targets

The revised 2009 Budget maintained the target for the overall fiscal deficit at the 9.4 percent of GDP set in the original Budget. The target includes a planned settlement of outstanding commitments and

payments arrears equivalent to 3.1 percent of GDP. This deficit target is also preserved in the PRGF Arrangement with the IMF where it is made a programme conditionality and labelled a key quantitative criterion.

Financing Options

Resources for financing the deficit can conveniently be grouped into three categories namely:

- 1) External private inflows of loans and equity (including proceeds from divestiture);
- 2) Net domestic borrowing (excluding borrowing from non-residents) from the domestic bond market; and
- 3) Loans (project and programme) and debt relief from Development Partners.

(1) External Private Inflows of Loans and Equity

Resources from the first category — external private inflows of loans and equity — funded about 56.6 percent of the deficit in 2008. On account of the prevailing domestic and international financial crises, no resources were expected from these external sources of finance, and indeed both the Budget and PRGF Arrangement made no provision for resources from any of these sources for financing government's fiscal operations in 2009.

In the circumstances, the government has had to rely exclusively on the other two sources of financing the deficit — namely borrowing from the domestic bond market (excluding from non-residents); and loans (project and programme) and debt relief from Development Partners.

(2) Net Domestic Borrowing

Consistent with the stabilization programme, a tight ceiling has been placed on net domestic financing of the budget. The level of such financing has been reduced from the 6.7 percent of GDP projected in the original 2009 Budget Statement to a more stringent ceiling of 4.8 percent of GDP.

(3) Loans (project and programme) and debt relief from Development Partners.

The projection for net loan financing from Development Partners in 2009 was revised upward from 2.3 percent of GDP to 4.0 percent of GDP, compared to 1.0 percent of GDP in 2008. In addition, debt relief from bilateral donors under the Enhanced HIPC Initiative, shown in the Budget Statement as *Exceptional Finance*, is also expected in an amount of GH¢134.7 million. This is 73.7 percent higher than the provisional outturn recorded for 2008. Thus, in 2009 the third of the three listed categories of financing the budget — loans (project and programme) and debt relief from Development Partners — is projected to amount to the equivalent of 4.6 percent of GDP which is

over 107.5 percent above the 1.6 percent of GDP reached in 2008 and 58.2 percent greater than the projection in the original Budget.

Resources from these sources financed 9.2 percent of the deficit in 2008. In the original presentation of the 2009 Budget they accounted for 31.0 percent of the projected financing requirements. The projected contribution of these resources to the total financing needs of government, both in the PRGF programme and the revised Budget is 49.2 percent. There is, therefore, the disturbing reality of increased donor-dependence in 2009 and the consequent vulnerability to donor conditionality and inflexibility as well as the proverbial unreliability of aid disbursements. A careful and masterful management of government-donor relations is, therefore, critical to ensure the successful implementation of the 2009 Budget and the achievement of its targets and objectives.

Payment Arrears

The phenomenon of payment arrears and other commitments carried over from previous years continue to undermine the credibility of budget formulation and implementation in Ghana. The accumulation of payment arrears constitutes proxy borrowing by Government which locks up working capital of suppliers of goods and services to Ministries, Departments and Agencies (MDAs) of government. On account of the perennial issue of government payment arrears to private sector contractors and other suppliers of goods and services to state institutions, the interpretation of credit to the private sector by the commercial banks is made extremely difficult, since the large increases in such credit stock could be more a sign of business distress than of buoyancy. Moreover, indigenous firms have complained that arrears of payment work against them — the record shows that large multinational firms that typically borrow at lower rates of interest from the banks are also able to negotiate and receive interest on delayed payments due to them.

Against this background, a total of GH¢491.5 million of non-road arrears has been planned to be cleared in 2009. Beyond the statutory funds of DACF and GETFund (respectively, GH¢35 million and GH¢23.3 million), key areas include:

- GH¢53.2 million in respect of the National Health Insurance Fund (NHIF);
- GH¢128 million in respect of TOR under-recovery of costs associated with the procurement, processing, and sale of petroleum products;
- GH¢58 million in respect of BOST under-recovery; and
- GH¢75 million under an MOU for VRA crude oil lifting.

An amount of GH¢93 million is also planned for clearance in respect of other outstanding commitments including those in respect of court judgements against the state. In addition, payment arrears in the roads sector amounting to GH¢135 million is scheduled to be cleared. This brings the total provision for arrears to GH¢626.5 million, equivalent to 2.9 percent of GDP compared to a reported clearance in 2008 of GH¢142.3 million, equivalent to 0.8 percent of GDP.

Programme Adjustors for Key Fiscal Targets under the new PRGF Arrangement

The Government has agreed with the IMF to take corrective measures in order to remain within the programme budget deficit ceiling of 9.4 percent of GDP, and for the government to not crowd-out the private sector from the domestic credit market. These measures are spelled out below.

(a) Adjustments to Expenditures and Domestic Revenue

Under the PRGF Arrangement any expenditure over-runs or domestic revenue shortfalls that would lead to an increase in the deficit must be adjusted for by “appropriate measures” agreed with the IMF to ensure that the targeted ceiling is respected.

(b) Programme Quantitative Targets

Two key fiscal quantitative targets are spelled out in the PRGF arrangement: (a) one in respect the *overall fiscal deficit of the government*; and (b) the other in respect of *net domestic financing of the government’s fiscal operations*.

(i) Overall fiscal deficit of the government

The adjustment required in respect of the overall fiscal deficit is conditional on the level of disbursements of loans and grants made by DPs for both projects and general budget support.

Specifically, the overall deficit ceiling has to be adjusted upward for the full amount in the event that project loan disbursements are higher than programmed, and adjusted downward also for the full amount when project loan disbursements fall short of the programmed amount. This is to allow higher than anticipated disbursements of project loans to be spent and vice versa.

If disbursements of programme loans (grants) are less than the budgeted amount, the deficit ceiling will be adjusted downward (upward) by 50 percent of the shortfall, up to a maximum amount of GH¢75 million. The ceiling will, however, be adjusted downward fully for higher than programmed program grants.

(ii) Net domestic financing (NDF) of the government’s Fiscal Operations

In the case of net domestic financing of government fiscal operations, the ceiling will be adjusted upward by 50 percent for any shortfall in programmed program loans and grants, up to a maximum adjustment of GH¢75 million. When disbursements of programme loans and grants exceed the programmed amounts, the ceiling will be adjusted downward by the full amount.

The Fiscal Stance

Mid-year 2009 Performance

Domestic Revenue and Grants

Fiscal performance in the first-half of 2009 was characterised by a revenue and grants outturn that fell short of the budgetary target by 7.8 percent.

Total receipts including grants at end-June 2009 amounted to 13.9 percent of GDP. The outturn missed the budget estimate of 15.0 percent of GDP for the period and was below the 14.6 percent of GDP for the corresponding period in 2008. The shortfall was both in respect of the domestic revenue — a mid-year outcome of 11.1 percent of GDP compared to a budgeted 11.9 percent of GDP; and grants (including debt relief) — which registered an outturn of 2.7 percent of GDP compared to the programme target of 3.1 percent of GDP.

Government Expenditures

In response to the resource shortfall, payments (including principal repayment of external debt, tax refunds, and payments for outstanding commitments and arrears clearance) were restrained resulting in an outturn that was below the budget provision by 5.4 percent. The major component, domestic primary expenditures (DPE) fell below the budget by 4.9 percent. The period recorded a budgetary shortfall of 7.9 percent in foreign-financed capital arising primarily from smaller inflows of project loans (17.0 percent less) than programmed. The expenditure programme was also encumbered by outstanding commitments from previous years, with such payments exceeding the budget provision for the half-year by 5.5 percent.

Interest payments overshot the Budget by some 11.8 percent, mainly due to a 29.4 percent overrun in the domestic component. This latter development raises serious concerns about debt sustainability in the medium-term and the adequacy of the fiscal space required to fund pro-poor programmes. External interest payments were, however, below the Budget provision by 22.3 percent.

Broad Fiscal Aggregates

As a result of these developments, the *broad fiscal balance on commitments basis* (OBB-CB) at the end of June 2009 recorded a deficit of GH¢615.7 million, equivalent to 2.8 percent of GDP. Comparatively, this outturn is a marked improvement over the deficit of 4.7 percent of GDP for the corresponding period in 2008. It, however, exceeded the end-June 2009 target of 2.3 percent of GDP.

On *modified commitments basis* — which accounts for outstanding commitments (including arrears clearance and tax refunds) — the OBB registered a deficit of 4.3 percent for GDP, compared to 5.7 percent of GDP and 3.7 percent of GDP for end-June 2008 and the programme ceiling for end-June 2009, respectively.

The measure of the fiscal stance used by the IMF and the international community to monitor Ghana's performance — the *OBB-below-the-line* — indicates that at mid-year the budget registered a deficit of GH¢970.1 million, equivalent to 4.5 percent of GDP. Although this was an improvement over the end-June 2008 performance it, nonetheless, exceeded the end-June 2009 ceiling of GH¢788 million agreed with the IMF under the 3-year PRGF Arrangement. Applying the PRGF programme adjustors for shortfalls in disbursements of project loans, program loans, and program grants leads to a modified PRGF ceiling of GH¢821 million, which was also breached.

The *domestic primary balance* (DPB) — the measure of current fiscal effort — stood at the equivalent of a deficit of 0.5 percent of GDP as of end-June 2009, marginally worse than the programmed 0.3 percent of GDP for the half-year period. The outcome was, however, a substantial improvement over the corresponding 2008 deficit of 3.3 percent of GDP.

Financing of Government's Fiscal Operations

As expected the end-June 2009 overall broad deficit of 4.5 percent of GDP was financed from a combination *domestic borrowing* and *loans and debt relief from Development Partners (DPs)*. The two sources together accounted for 99.4 percent of the financing needs, with the remaining 0.6 percent coming by way of divestiture. Support from DPs in the amount of GH¢331.2 million accounted for 34.1 percent of the financing requirements, whilst domestic borrowing of GH¢634.2 million represented 65.3 percent, which exceeded the PRGF ceiling of GH¢591 million by 7.3 percent.

The programmed financing schedule for the period expected more of the financing to come by way of external support — 57.6 percent of the total — with domestic borrowing accounting for 42.6

percent. The heavy reliance on domestic borrowing was in response to a shortfall in expected support from DPs of 59.1 percent. And according to the September 23, 2009 Press Release by the MPC of the Bank of Ghana: “Donor disbursement for the period was also about 50 percent of the projection, leading to a shortfall in projected budget resource envelop.”

As indicated above, on the face of it, the end-June outturn for domestic borrowing breached the IMF-PRGF ceiling of GH¢591 million by 7.3 percent. However, applying the program adjustors for shortfalls in program grants and program loans (shortfalls of 22.7 percent and 92.2 percent, respectively) makes room for additional domestic financing of GH¢111 million, implying a modified program ceiling of GH¢702 million. Thus, after adjusting for shortfalls in DPs’ support as agreed under the IMF-PRGF program, it would appear that the end-June 2009 outturn in respect of domestic borrowing was within the limit allowed.

End-December 2009 Projected Outlook

Domestic Revenue

August year-to-date receipts in respect of domestic revenue amounted to GH¢3319.3 million (15.3 percent of GDP), compared with GH¢2918.7 million (13.5 percent of GDP) recorded for the same period in 2008. The outturn also represents only 53.8 percent of the annual budget estimate.

Against this backdrop the CEPA 2009 projected outturn for domestic revenue is GH¢5732.6 million, equivalent to 26.5 percent of GDP. It comprises of GH¢5047.0 million (23.3 percent of GDP) of tax revenue and GH¢685.6 million (3.2 percent of GDP) of non-tax revenue — of which GH¢332.0 million is expected to be lodged into government accounts by the collecting MDAs, and GH¢353.7 million retained for their use. The forecast shows domestic revenue ending the year 7.1 percent below its budgetary target of GH¢6172.1 million or 28.5 percent of GDP.

Total collection of taxes by the *Customs, Excise and Preventive Service (CEPS)* (including import exemptions) for end-year 2009 is projected to be GH¢2549.9 million or 11.8 percent of GDP, representing a 10.3 percent short fall compared with the budget estimate. The projection covers the following tax categories:

- Import duty collections of GH¢876.9 million (4.1 percent of GDP);
- Petroleum taxes of GH¢302.2 million (1.4 percent of GDP);
- Import VAT of GH¢831.7 million (3.8 percent of GDP);
- NHIL of GH¢166.1 million (0.8 percent of GDP); and
- Import exemptions of GH¢373.0 million (1.2 percent of GDP).

The projected outturns for the components are lower than the corresponding Budget estimate, except for NHIL collections.

The end-2009 projected outturn for collections by the *VAT Service* is GH¢571.1 million, equivalent to 2.6 percent of GDP. This is 24.4 percent less than the Budget estimate of GH¢755.3 million or 3.5 percent of GDP.

The projected outturns for the component parts, all of which are lower than the corresponding Budget projections, are as follows:

- Domestic VAT of GH¢440.9 million (2.0 percent of GDP);
- Excise duty collections of GH¢50.0 million (0.2 percent of GDP); and
- NHIL of GH¢80.2 million (0.4 percent of GDP).

The end-year 2009 projected outturn for the *Internal Revenue Service (IRS)* tax collections — based on the strong performance through end-August — is projected at GH¢1719.7 million, equivalent to 8.0 percent of GDP. This is 9.9 percent higher than the Budget estimate of GH¢1565.3 million, equivalent to 7.2 percent of GDP. The projection covers the following tax categories:

- PAYE taxes of GH¢750.2 million (3.5 percent of GDP);
- Self-employed taxes of GH¢83.4 million (0.4 percent of GDP);
- Company taxes of GH¢695.4 million (3.2 percent of GDP); and
- Other direct taxes of GH¢190.7 million (0.9 percent of GDP).

Non-tax Revenue (NTR)

The projected end-year outturn for NTR is GH¢685.6 million, representing 3.2 percent of GDP and 7.8 percent below the annual budget target of GH¢743.8 million. The projected outturn include the GH¢153 million expected from cocoa revenue which was announced in the Minister's mid-year review and revision of the Budget.

Turning to the components, lodgements into the Consolidated Fund are forecasted to be lower than the Budget estimate by 7.0 percent, while the portion retained by MDAs is projected to fall short of the budget estimate by 8.6 percent. This latter is consistent with current government policy to rein in more of these funds into the Consolidated Fund to ensure effective supervision and accountability in their usage.

Donor Grants

All the four grant categories — program grants, HIPC-related debt relief, MDRI-related debt relief, and project grants — recorded shortfalls vis-à-vis the end-August targets: project grants by a marginal 0.6 percent; program grants by 23.1 percent; HIPC assistance by 16.6 percent; and MDRI assistance by 28.2 percent.

Disbursement rates for project grants and program grants were not encouraging, representing only 55.8 percent and 63.9 percent of the yearly commitments, respectively. HIPC and MDRI assistance were equally behind schedule and accounted for 56.9 percent and 50.6 percent of the annual estimate, respectively. The low disbursement rate in respect of program grants is rather worrying given the record of improved predictability and early disbursement of donor aid in recent years associated with the multi-donor budget system (MDBS) arrangement.

Under the rather optimistic assumption of an accelerated pace in the disbursement rates for the rest of the year, the end-year projected outturns for all four categories have maintained the estimates in the revised Budget.

Government Expenditures

An outturn for expenditures (including repayment of external debt, outstanding commitments and clearance of arrears) of GH¢9846.8 million is projected for the 2009 fiscal year, equivalent to 45.5 percent of GDP, compared to the budget estimate of 46.4 percent of GDP and the 2008 provisional outcome of 49.3 percent of GDP.

The projected 2009 outturn for *statutory and quasi-statutory payments* — comprising external debt service (principal and interest), domestic interest cost, transfers to households (pensions, gratuity, and social security contributions), transfers into the various statutory funds, and wages and salaries — amounts to GH¢5346.8 million (24.7 percent of GDP) and represents 54.3 percent of the total. This represents a downward marginal revision of 0.4 percent of GDP from the budget estimate.

A certain category of Central Government expenditures are *linked to Specific Resources for funding*. They consist of: *debt relief-related expenditures (HIPC and MDRI)*; *foreign-financed capital*; and, in the case of 2007 and 2008, expenditures financed by *drawings from the proceeds from sovereign bond issue on international private capital markets*.

The projected outturn for this sub-group is identical to the Budget estimate and amounts to GH¢1698.9 million, equivalent to 7.9 percent of GDP. This represents 17.3 percent of the annual total. The outturn, both for the total and the individual components, is identical to the Budget estimate, reflecting the underlying assumption of full realisation of the resources used to finance these expenditures.

The third group of government expenditures can be described as “*purely discretionary*” in the sense that they are both non-statutory and are not linked to any specific funding sources. Expenditures in this group include: *administration and service-related expenses; domestically-financed development expenditure financed from the Consolidated Fund; net lending; non-statutory transfers and subsidies* (including retentions of IGFs by MDA and import exemptions); and *outstanding commitments and clearance of arrears*.

The projection is for a total amount of GH¢2801.1 million, equivalent to 13.0 percent of GDP and accounts for the remaining 28.4 percent of the projected outturn for the year. The Budget provided for the equivalent of 14.0 percent of GDP. The projection is thus smaller than the Budget provision by 7.2 percent on account of projected outturns for administration and non-statutory transfers and subsidies below the Budget estimates by 21.4 percent and 10.2 percent, respectively. Payment for services is projected to exceed the Budget by 21.6 percent. The projection, however, has maintained the Budget provisions for domestic (own-financed) capital and for outstanding commitments and arrears of clearance.

The projected outturns for the individual components are summarised as follows:

- Administration — GH¢466.4 million (2.2 percent of GDP);
- Service — GH¢226.9 million (1.0 percent of GDP);
- Non-statutory transfers and subsidies — GH¢1176.2 million (5.4 percent of GDP);
- Domestic (own-financed) capital — GH¢261.9 million (1.2 percent of GDP); and
- Outstanding commitments & arrears — GH¢669.7 million (3.1 percent of GDP).

Fiscal Balance and Financing

Based on the above projections of revenues and expenditures, a *broad fiscal deficit* of GH¢2274.2 million, equivalent to 10.5 percent of GDP is projected for end-year 2009. This is 11.8 percent higher than the official estimate of GH¢2033.4 million or 9.4 percent of GDP contained in the revised 2009 Budget and the IMF-PRGF Arrangement. Outstanding commitments account for 29.4 percent of the total, while current operations account for the remaining 70.6 percent. The end-year

projection is also for a *DPB deficit* of GH¢498.9 million or about 2.3 percent of GDP — almost twice the size of the programme target of 1.2 percent of GDP.

The bulk of the amount of projected deficit — GH¢1267.7 million, representing 55.9 percent — is expected to be financed from domestic borrowing, with the remaining 44.1 percent being financed by external borrowing and exceptional financing from Development Partners (DPs).

The projected outturn for net domestic financing is conditional on a 100 percent fulfillment of the donor commitments. Anything short of the promised disbursements could cause the government — especially one committed to implementing its social democratic agenda — to resort to more domestic borrowing than this projected outturn, with obvious consequences for upward movements in interest rates in the short to medium-term and implications for the size of the domestic debt stock

Money, Credit, and Prices

Monetary Policy Framework

The renewed quest for price stability has altered the monetary policy framework of the Bank of Ghana (BoG) from directly targeting monetary aggregates such as reserve money and the money supply to *inflation targeting (IT)*. The BoG formally adopted the IT framework in May 2007 after almost three years of informal IT management.

With the adoption of IT framework, the interest rate became the instrument of choice of monetary policy by the Bank of Ghana. In addition to the prime rate, the Bank of Ghana also relies on a variety of instruments in the conduct of monetary policy, including:

- Reserve requirements (currently only mandatory cash requirements of 9 percent of eligible deposits);
- Open market operations (conducted at the weekly auctions);
- Repurchase and reverse-repurchase agreements (conducted daily on week days); and
- Auctions of government debt instruments of various maturities (also conducted at weekly auctions).

These, together with the prime rate, are what have been described as the traditional market-based non-intrusive ways to absorb liquidity from the system, as well as inject it into the system. The Bank of Ghana uses these instruments to influence: the *cost of borrowing; returns on assets; and to shape the incentives for market participants to hold more cedi balances in the banks and less foreign exchange deposits domestically or abroad.*

Objectives of Monetary Policy

In conformity with the macroeconomic targets set for the 2009 fiscal year, monetary policy is focused on reducing the end-period year-on-year rate of inflation to 12.5 percent by end-2009 and further to 10.0 percent in 2010 and 8.0 percent in 2011. The BoG will, in effect, use its inflation targeting framework to guide inflationary expectations in line with the medium-term forecast.

Underlying the *medium-term forecast* of inflation is a *fiscal consolidation path* which will *stabilize the domestic debt* and help *anchor inflationary expectations*. This will be buoyed up by a tighter control of liquidity — as evidenced by a programmed annual growth of broad money (including foreign currency deposits) of 21.7 percent at end-December 2009 compared to an outturn of 40.2 percent at end-December 2008.

In pursuit of the national goal of *accelerated economic growth with macroeconomic stability*, fiscal policy appears to be assigned the role of instrument for growth while, in a complementary way, monetary policy focuses on *short-term macroeconomic stability*

Monetary policy is, therefore, expected to play a supportive role to fiscal policy, focusing on sharply reducing inflationary pressures and stabilizing price and exchange rate expectations on the market. In particular, the BoG will direct monetary policy toward reducing the end period inflation, and strengthen its inflation targeting framework.

Monetary policy will also seek to actively promote financial deepening. To this end measures will be introduced to:

- encourage further development of the market for bonds and other long-term securities;
- mobilize savings for investment, and restructure the financial system to enhance the flow of credit to the private sector; and
- sustain the current flexible exchange regime and BoG interventions will be confined to smoothing out volatility in the foreign exchange market.

The key challenges to meeting the medium-term inflation forecasts which have been flagged by the GoG and the Breton Woods Institutions include:

- the fiscal stance, and in particular wage policy in 2009; and
- a possible resurgence in prices of crude oil currently forecasted to rebound in 2010.

Trends in Monetary Targets and Aggregates

Over the past three years, annual growth of key monetary aggregates — Total liquidity (M2+), Reserve Money (RM), and deposit money banks' (DMBs) credit allocations to the private sector — have tended to exceed the targets set by the Monetary Authorities. The estimated annual growth rates in Total Liquidity (M2+) and Reserve Money remained increasingly strong in both 2007 and 2008, exceeding the set targets by considerable margins. These were in spite of an increase in the demand for money and a decline in income velocity of money in circulation in both years.

The income velocity of money in circulation, defined by the ratio of gross domestic product to average broad money supply (M2) — i.e., total liquidity less foreign currency deposits (FCD) — is estimated to have initially risen from 3.0 in December 2007 to about 3.2 in September 2008 before falling somewhat to 2.8 in December 2008. In the subsequent period up to June 2009, however, the velocity ratio reverted to the September 2008 estimate of 3.2 — signalling continuing demand pressures in the economy as a whole.

Domestic Credit Conditions

Compared to the year 2007, overall credit growth was brisk in 2008. The stock of credit rose by 10.5 percent in the first quarter of 2008 as compared to 7.7 percent in the corresponding quarter of 2007. Adjusted for inflation the picture is the same with a growth of 5.6 percent and 3.9 percent for the first quarters of 2008 and 2007 respectively. According to the Bank of Ghana, part of this reflected financial deepening in the wake of financial sector reforms, a reduction in reserve requirements, and moderation in the buoyant demand conditions a year earlier that seemed to be adding on to the cyclical money demand pressures in the banking system. “The general slowdown in credit allocations over the 12-month period up to June 2009 was both in nominal and real terms”. Growth in credit to the private sector (excluding public sector enterprises and organizations) is reported to have slowed down, as it increased by 42.2 percent per annum in the 12-month period to June 2009, following a 56.2 percent annual increase over the same period a year before in 2008. As a result of the current stabilization programme with BWIs credit growth has decelerated sharply in 2009. The first quarter growth of 8.74 percent was higher than that in 2007 but 16.8 percentage points lower than that recorded for 2008.

The differences are even more marked in the second quarter. In 2007 quarterly credit growth accelerated to 11.6 percent in the second quarter — an increase of 49.7 percent over the rate recorded in the previous quarter. For 2008, growth in the second quarter was a massive 25.9

percent — two and a half times the 10.5 percent growth recorded in the previous quarter. Similar accelerations were observable in respect of real credit growth.

Credit Composition

In the recent period to end-December 2008, there has been a general tendency for the share of credit to the non-government sector to rise. At the end of 2005, the non-government share stood below 60 percent. This rose steadily to reach almost 80 percent at the close of 2007. In the course of 2008, it declined to about 70 percent, recovered somewhat at the end of the first quarter of 2009 before falling again to about 70 percent at the end of the first half of 2009. Given the ceiling on net domestic financing of the government deficit in the stabilization programme, it is expected that the non-government share would rise by end-2009.

Interest Rates and Money Market Developments

At the September 2009 meeting of the Bank of Ghana's Monetary Policy Committee (MPC), the prime rate — an important policy instrument and the lead indicator of interest rates on Ghana's domestic money market — was left unchanged at 18.5 percent per annum. This policy rate has been maintained at that level for well over six months since it was last adjusted upwards by 150 basis points in February 2009 from 17 percent per annum.

According to the MPC Press Release, the decision to leave the prime rate unchanged at 18.5 percent per annum was informed by a number of developments in the domestic economy, the most notable being the following:

- volatility of the exchange rate eased in the third quarter of 2009, with a slowdown in the nominal depreciation of the cedi vis-à-vis the US dollar;
- inflationary expectations were turning around and ...there were signs of reduced volatility in prices;
- fiscal policy, together with a tightening of monetary and credit conditions, were putting pressure on prices as growth eased downward close to trend.

The Press Release also acknowledged risks to the economy relating particularly to the speed with which world market price of crude oil — an important import item in Ghana's consumption basket — might rebound, given the recovery of global demand from the financial crisis and recession.

It is worth noting that the MPC had hitherto — beginning in the fourth quarter of 2007 — adopted a tighter monetary policy stance and adjusted the policy rate upwards in four rapid and unremitting

jumps from October 2007 through July 2008. The purpose, as always, was to respond to the rapidly accelerating rate of domestic price inflation.

Both the interest rates on the short-term money market security, the 91-day Treasury Bills, and the weighted average Interbank Rate — the rate at which domestic money banks (DMBs) borrow from and lend to each other — rose sharply above the prime rate as the latter was adjusted upwards in July 2008 by a hundred basis points to 17 percent. These interest rates remained virtually flat thereafter until about February 2009 in line with the adjustment of the policy rate to 18.5 percent per annum. In the third quarter of 2008, as the prime rate remained “virtually” fixed at 17 percent per annum, a widening spread began to emerge between the interest rates on the short-dated security — the 91-day Treasury bill — and the Interbank Average.

As noted in earlier CEPA publications, serious concerns continue to be raised about the prevailing high interest rates on the domestic money market in the midst of high and increasing inflation and inflationary expectations. Many industrialists, exporters and domestic import-competing producers have complained that successive interest rate hikes have sharply raised the cost of doing business in Ghana — an unwelcome situation, particularly in the present circumstances of a global financial crisis and recession. The latter is already adversely impacting on trade, finance, export earnings, and economic growth.

Bank interest rates, which are the price customers earn for depositing their monies (or pay for borrowing money) from banks in Ghana, as pertains in a number of countries, are fragmented into ranges. The interest rate segmentation provides the *raison d'être* for banks to reward customers with large bank balances — mostly corporate bodies and high net-worth clientele — higher deposit savings rates as well as lower borrowing rates. The latter is mostly based on the notion that such clients, though in the minority of bank customers, fetch banks higher deposit sizes and thus in many instances have the clout to negotiate for lower lending rates than what prevails on the market. This covert action leaves the rest of bank customers (unfortunately in the majority but with smaller shares of total bank deposits), to bear the full brunt of the banking business by not only earning smaller savings deposit rates on their accounts but also charged higher lending rates.

Inflationary Developments and Outlook

The overall record of monetary policy performance since 2006 has been rather weak. That in 2008 in respect of the disinflation objective was particularly disappointing. In Budget 2008 the Bank of Ghana (BoG) was expected to direct monetary policy towards reducing the end-period inflation to a

target range of 6-8 percent at year-end and further down to a range of 4-6 percent by end-2009. As it turned out, the set target for 2008 was missed — in fact, overshoot by a significant margin.

Given the experience of persistent overshooting of inflation targets, the assessment of CEPA had been that with no change in the monetary policy framework and target setting, the target for 2009 would prove unrealistic and go the way of its predecessors — missed by considerable margins. It was therefore not surprising — indeed, somewhat a validation — when the target for 2009 was revised upwards from 12.5 percent to 14.6 percent.

In its July deliberations, the Monetary Policy Committee (MPC) of the Bank of Ghana had indications from its Composite Index of Economic Activity (CIEA) and elsewhere that the economy was slowing down rapidly — implying potential output and job losses. Consequently, in spite of the inflation rate remaining above the projected path, the MPC concluded that the prime rate should be kept unchanged at 18.5 percent, for the reason that — *“the risks in the outlook for disinflation and growth are balanced”*.

Contrary to a forecast of a decline in the rate of inflation during the second quarter of the year, inflation went up, even if only marginally, from 20.5 percent in March to 20.7 percent in June 2009 — significantly above the 14.6 percent inflation target for the end of the year. At the same time core inflation (which strips out price changes of energy and utility items from the consumer basket) increased by 2 percentage points during the second quarter to 21.3 percent.

Several factors contributed to the 2009 half-year inflationary experience. Key among these include: an increase in the price of petroleum products by 30 percent which pushed up transportation costs — which in turn impacted on the price of most goods and services, especially food staples in the economy; and the pass-through to domestic prices of previous exchange rate depreciations, a situation that impacted adversely on the exchange rate and also on inflationary expectations.

There are leads and lags in the monetary dynamics with changes in the growth rate of money supply impacting on inflation — some three to five months later, in the Ghanaian context. This suggests that the monetary surge in the second half of 2008, particularly in the fourth quarter, was expected to impact in the first half-year of 2009 and, therefore, sustain the surge in inflation which started in fourth quarter of 2007.

As indicated earlier, a tightening of macroeconomic policy was signalled with the approval of the 2009 Budget in March. Subsequently, in June 2009 agreements were reached on a new 3-year PRGF Arrangement with the BWIs which effectively converted the Government's development strategy articulated in the Budget Statement and Economic Policy approved by Parliament to a comprehensive stabilization programme.

CEPA understood the need and importance of the re-establishment of macroeconomic discipline after three continuous years of fiscal excesses. Nonetheless, CEPA sought to draw attention to three important issues vis-à-vis the stabilization programme:

- that there was the need to avoid an inflexible adjustment path that could exact higher than warranted socio-political costs;
- that the disinflation path needed to be more gradualist than implied in the programme; and
- that there was a need to emphasize the critical importance of a *growth with stability strategy* rather than one of *stabilization with growth*, although this would also call for more resources from donors than would appear to be the case in the agreed programme.

Projections from the May 2009 meeting of the MPC indicated that inflation could begin to decline from a peak of around 20 percent early in the second quarter of the year and towards the target range of 12.6–16.6 percent at the end of the year and then to a range of 6.7-12.7 percent by the end of June 2010.

According to the MPC the set of initial conditions which influenced the forecasts at its May meeting have all moved in directions that point to low inflationary pressures in the outlook.

CEPA has also estimated the stabilization effect of the PRGF arrangement and has factored into its forecast of inflation for 2009. The result is that the year-on-year rate of inflation is projected by CEPA to fall further from the 18.37 percent attained in September and it now looks likely that the target rate of 14.5 percent could be achieved — confirming the optimism of the MPC.

On balance — given the downward trend in of the inflation path and the projected steep declines in real economic activity — a strong case could be made for a policy consideration to revise interest rates downwards. Consistent with the growth with macroeconomic stability strategy, a quarter of 1.0 percent adjustment in the policy rate may be recommended.

The stabilization effect of the new PRGF Arrangement with BWIs, which has been quite significant since September 2009, has worked through the following channels:

- sharp reduction in aggregate demand as real GDP growth slowed down from 7.3 percent in 2008 to about 3.8 percent for 2009
- deceleration in the rate of depreciation of the nominal effective exchange rate;
- rising real interest rates as the inflation rate decelerated while nominal lending rate rose; and
- Non-price measures have also been applied by the commercial banks to further tighten credit.

International Trade and Payments

Foreign Exchange Markets

On the domestic foreign exchange markets, the microstructure characteristics of the market in Ghana have remained unchanged over the last two years, with the US dollar accounting for over 80 percent of the transactions in the market. At the same time, transparency and the ability of market participants to observe information about the trading process remained low. Four authorized dealer participating banks continued to account for the bulk of foreign exchange transactions. The market also continued to be segmented.

However, the ability of the central bank — the Bank of Ghana — to intervene in the market was eroded as a result of dwindling external reserves consequent on the world economic crisis and the decline in private transfers. A huge increase in public sector expenditures as a result of the 2008 Presidential and Parliamentary elections also created increased demand for foreign exchange. At the same time, the uncertainty associated with the election and the subsequent policy stance resulted in heightened expectations and speculative behaviour.

As a result of this combination of factors, the foreign exchange market became volatile in 2008 compared with the stability observed in previous years. Increasing volatility was also characterized by sharp depreciations in the nominal exchange rate and increasing spreads between buying and selling rates in the interbank foreign exchange market.

On the other hand, the cedi appreciated in real terms over the period. The real appreciation of the cedi was, therefore, due to the relatively higher rates of inflation in Ghana compared with her trading partners. This is interpreted as loss in competitiveness as shown in declining market share of Ghana's exports in world markets and particularly her traditional trading markets, the euro zone and the sterling area. There have been no major changes in the destination of Ghana's trade.

Since the major source of the real appreciation or loss of price competitiveness is relative inflation, the situation may not be helped by inducing nominal appreciation as an anchor against inflation. Perhaps, changes in productivity, fiscal and monetary policies may be more appropriate.

Balance of Payments

Ghana continued to face protracted trade and current account deficits on her balance of payments. These twin deficits widened in 2008 in spite of the country benefiting from continuing terms of trade gains. The empirical evidence is that, for the first time in the last five years, the overall balance of payments situation deteriorated sharply, plunging into a huge deficit of US\$940.8 million — the equivalent of 5.8 percent of GDP in 2008.

The worsening of the external payments position in 2008 may be attributed mainly to policy adjustment failures to contain domestic demand pressures on the external accounts. A highly expansionary fiscal policy as a result of election-year spending led to an increased demand for imports, and high inflation and inflationary expectations. At the same time, the inability to pass-on the effects of changes in world market prices of crude oil and petroleum products and the depreciation of the cedi compounded the situation.

Imports amounted to US\$10,261 million at the end of 2008 compared to US\$8,069.2 million in 2007, with almost 33 percent increase in the non-oil imports component. The huge increase in imports was driven by strong domestic demand on account of increasing public expenditure and continuing appreciation of the real effective exchange rate of the cedi vis-à-vis currencies of major trading-partner countries.

On the supply side, Ghana's major export commodities — gold, cocoa beans and products — seemed to have benefited in 2008 from a more favourable external environment even in the midst of the global financial crisis and recession. Ghana's terms of trade — the relative price of imported goods (mainly crude oil) to that of major exports (cocoa beans and gold) on world markets — generally strengthened in 2008, supporting incomes and growth, while the domestic financial system proved to be relatively insulated from the global financial storm.

This situation appeared to have been reversed since the first quarter of 2009, with the core terms of trade sharply deteriorating against Ghana as the average price of crude oil on world markets continue to rise.

CEPA estimates that by the close of the year, the average price of crude oil will be within a range of US\$78 and US\$80 per barrel. Being a net crude oil-importing country, and dependent largely on imports of petroleum products, any further rise in the average price of crude oil beyond the upper limit of US\$80 per barrel will adversely affect Ghana's import bill with ominous consequences for the economy.

Fortunately, the hydro/thermal mix with respect to the energy generation requirements of the economy has been in Ghana's favour for the most part of this year. This favourable development calls for a combination of more practical methods for harnessing the immense water resources with proactive strategies for their effective management. This is deemed very critical not only for purposes of avoiding higher costs associated with thermal generation of power in the future, but also for advancing the socio-economic development of the country as a whole.

There are also indications that for the first time in the last five years, non-oil imports into Ghana decreased by nearly 7 percent per annum in value terms — from US\$3,674.4 million in the first half of 2008 to US\$3,429.1 million in the same period of 2009. This magnitude of decline in the non-oil imports bill compares with annual increases of 12.3 percent and 40 percent per annum registered in the first six months of 2007 and 2008 respectively.

Part of the decrease in the non-oil import bill may be attributed to a moderation in the real appreciation of the exchange rate vis-à-vis those of Ghana's major trading partners. The trade-weighted real effective exchange rate appreciated on a cumulative basis by 11.6 percent in the first six months of 2009 compared with a real appreciation of 18.9 percent over the same period in 2008.

Barring any structural changes in the current hydro/thermal mix for power generation for the rest of the year, CEPA estimates are that by year-end, the overall import bill will amount to no more than US\$8,082 million with the oil import bill being US\$1,214 million while the non-oil component amounts to US\$6,868 million. The CEPA estimates are about US\$523 million less than programmed in the Budget Statement of 2009 and some US\$1,217 million less than the IMF projection for 2009.