<u>PETROLEUM PRICE INCREASE – SOCIO-POLITICAL IMPLICATIONS</u>

(i) Introduction and Background:

One of the identified significant risks for the successful implementation of the stabilization programme agreed with the IMF and World Bank in mid-2009 was that of political feasibility risks given the absence of a solid majority of the Government in Parliament. Moreover the electoral campaign promises (of the ruling NDC) emphasized the need to improve and broaden public services at a time when the reality on the ground called for fiscal stabilization. Smooth implementation of the stabilization programme therefore requires a broader sharing of information and consulting with stakeholders in order to build consensus on the design of a fiscally sustainable programme of reforms.

An important lesson for the country is how to avoid electoral promises that could prove difficult to deliver. It is important to stress that such promises are not new, or peculiar to any one political party. Indeed our economic history points to the politically destabilizing consequences that could result. The military coups that occurred in the seventies produced six different political regimes in the ten-year period 1971 to 1981. The political instability of the period, in turn, brought the economy of Ghana to its knees.

The reality is that both the Kuffour Administration and the Mills Administration came into office without a full grasp of the prevailing state of the economy. The Kuffour Administration signed unto the HIPC Initiative without sufficient appreciation of its implications– time did not permit that– as admitted by his Minister for Finance and Economic Planning. As a result the inherited programme with the IMF in the three-year period 1999- 2002 was abandoned in the last quarter of 2002.

Similarly, the Mills Administration signed unto a <u>stabilization programme</u> for the three year period 2009- 2012 with the IMF and the World Bank in mid-2009 which for all intents and purposes replaced the 2009 Budget and Economic Policy approved in March 2009 by Parliament. The first budget of the NDC government was said to have been prepared "in pursuit of its social democratic agenda to promote 'A Better Ghana' in which <u>real opportunities for gainful employment</u>, prosperous enterprise and social and economic welfare for all people….<u>Job creation will require the expansion of infrastructure</u>, investing in Ghana's human capital and providing transparent and accountable governance." (The Budget Statement and Economic Policy of the GOG for the 2009 Financial Year – March 05 2009, para 2&3; emphasis added).

In both of the above instances, in exchange for additional financial support from the donor community and the Bretton Wood Institutions – IMF and World Bank – the Government of Ghana (GOG) has been required to run tighter macroeconomic policies than they had planned or promised to the electorate.

The World Bank has blamed lack of transparency and accountability for the "deterioration of fiscal management" in the 2006-2008 period. "….poor access to information in a timely manner <u>prevented large deviations from planned expenditures being brought to the public eye</u> – that is to the knowledge of the citizenry – <u>and even to the notice of political parties</u>"(emphasis added).

Without access to information, people lack the means to exercise the roles and rights that define citizenship and promote social accountability….Some civil society organizations (CSOs), such as CEPA , have demonstrated experience and expertise to conduct independent budget analysis but their information base has been weak. The World Bank claims that it has recently launched "a number of initiatives including increasing the accountability of the World Bank-financed projects and programmes, as well as supporting the Government to improve stakeholder oversight of public investments more generally" (Economic Governance and Poverty Reduction Credit). Clearly judging from the current state of affairs, more needs to be done.

The assessment of the situation by the IMF staff is at variance with that of the World Bank. According to the IMF discussions in 2007-08 on a programme with Ghana ''did not advance…..Responsiveness to the Fund's advice in 2008 on fiscal management was also limited''. Thus in spite of its warning to the GOG of the "urgency of fiscal tightening to avoid deteriorating debt dynamics and risks to external sustainability…… a highly expansionary fiscal stance was maintained". Far from lack of transparency and information, in the view of the staff of the IMF there was conscious and deliberate ignoring of the reality and its advice by the GOG. (IMF Country Report August 2009). This may be its rationale for the tough Stabilization Programme package.

(ii) Nature of the Current Oil Price Shock

In a piece entitled "**Oil Price 'enters danger zone'**" the Financial Times of London of January 5 2011 quoted Faith Birol, Chief Economist of the International Energy Agency (IEA) as having said: "Oil prices are entering a dangerous zone for the global economy. The oil import bills are becoming a threat to the economic recovery. This is a wake-up call to the oil consuming countries and to the oil producers".

Oil prices have edged closer to US$100 a barrel in recent weeks and Brent crude hit US$95 a barrel for the first time in 27 months. Oil consuming countries need to accelerate efforts <u>to reduce their reliance on oil, especially for transportation</u>.

Faced with an adverse exogenous shock– negative circumstance beyond the control of the country– a good rule of thumb distinguishes a-once - and - for - all disturbance from an event likely to persist at least into the medium term. With the former, it is prudent to use resources, borrowed if necessary, to finance the negative effect. With the latter, it is better to adjust – share the burden over the population.

Financing the latter type could bankrupt the economy or lead to unsustainable future debt burdens. Current developments point <u>to continued upward trend of crude oil prices</u> – an event likely to persist into the medium-term – and hence the need to examine what options are available for adjusting to the emerging reality.

(iii) Available Options for Dealing with the Shock

Adjusting to the present adverse external shock will typically involve a combination of the following:

(a) A straight forward full pass-through of the cost for all petroleum products will lead to a rise in the rate of inflation which will imply a lower standard of living for the population at large with serious adverse implications for the poor in terms of rising poverty levels;

(b) Use of macroeconomic policy instruments to contain or expunge inflationary consequences. This however could result in slower economic growth and reduced employment opportunities, as is being experienced in the current stabilization programme.

Monetary policy tightening through raising interest rates would be difficult to implement in the present situation with calls for bringing down commercial bank lending rates especially to indigenous SMEs. And if successful such monetary tightening would result in reduced employment opportunities. In addition workers would also experience downward pressure on wages.

Fiscal policy measures could also be used for similar ends. It is worth pointing out that the provision for subsidy to TOR for under-recovery of GH¢27.2 million is relatively so small that it may be for kerosene and premix fuel. Therefore subsidizing all the other petroleum products would mean a bigger deficit and correspondingly larger borrowing by the Government.

There is also the suggestion that all the subsidies could be taken into the budget but other expenditures compressed in order to remain within the approved deficit while still subsidizing. In reality, the fact that the budgetary expenditures are largely pre-commitments however means however that any such attempt would result in a rise in payment arrears and work stoppages on development projects– roads, bridges, school blocks, hospital and clinics. Payment arrears have had adverse consequences for the banking system – a rise in the stock of non-performing loans contributing to high lending rates charged by commercial banks.

Another possibility suggested is to raise taxes to finance the required subsidies but this can only be done through a supplementary budget approved by Parliament. CEPA believes that in the current economic environment, this will not succeed.

(c) Debt Options – Subsidizing Petroleum Products and borrowing to Finance the Wider Deficit

Inability to raise taxes and or compress spending would mean that transferring the subsidies unto the budget would mean widening the deficit and increased borrowing to finance it, implying the accumulation of debt.

It is worth noting that after falling to 42 percent of GDP in 2006, the public debt has climbed quickly to about 77 percent of GDP in 2010 (un-rebased). A rapidly rising stock of debt raises serious concerns about debt sustainability. It also raises intergenerational issues– avoiding the pain of adjustment (through inflation and unemployment) for now and pushing the burden unto the voiceless future generation which would mean lower standards of living for them.

(iv) The Option Chosen by the GOG and its implication

The Government of Ghana (GOG) chose an option which passes through the increased cost to some petroleum products used relatively more by the higher income segments of society such as petrol or gasoline, diesel oil and LPG on the one hand and absorbing the cost increases in the budget for those products used relatively more by the poorer segment of society such as kerosene and premix fuel. In effect the choice involves a combination of higher inflation and increased debt (a combination of (a) and (c) above).

The option chosen involves consideration other than the dollar price of crude oil in international markets. In the current formula for the cost build-up, the domestic price of the typical petroleum product is determined by:

- the world market price of crude oil per barrel in US$;
- the exchange rate of GH¢ against the US dollar;
- processing and operational costs of Tema Oil Refinery (TOR);
- levies, inputs and taxes; and
- marketers', distributors' and dealers' margin

To access the impact on inflation it would be useful to consider changes in the above list of determinants.

(a) **Changes in Price in international markets (US$)**

In October 2009, the last time adjustments were made to petroleum product prices, a barrel of crude oil was sold at an average price of US75 on the world market. The current price in January 2011 is around an average of US$90 a barrel. This works to an increase of 20 percent and contributes 66.7 percent of the new price built-up.

(b) **Exchange rate**

Again in October 2009, the GHC1.45 bought one US dollar but currently has increased to GHC1.48, a nominal depreciation of 2.07 percent and accounts for 6.9 percent in the new price build-up.

TOR Debt Recovery Levy

Parliament in December 2009 passed the Tema Oil Refinery (TOR) Debt Recovery Levy with the stated objective of retiring debts owned by the country's only refinery to the banks. The levy as determined by the National Petroleum Authority (NPA) is o.o28 percent per liter of petrol and 0.025 percent per liter of diesel. The levy contributes an average of 7.5 percent in the new price build-up.

According to the President, the inherited TOR debt stood at about GH1.5 billion. What is not obvious is how much of this debt is solely on account of the subsidies that TOR has been forced to provide in the pricing of petroleum products by the National Petroleum Authority. There is also the issue of interest component in the total.

CEPA has established that the accumulated debt at TOR in 2002 amounted to about GH83.0 million. (see CEPA's Pricing Petroleum Products in Ghana – The Automatic Formula – Selected Economic Issues No. 5 2003). In the budget of 2003 the subsidies were withdrawn resulting in the jump in inflation to 30 percent per annum.

(c) **Margins to Marketers, Distributors and Dealers**

The NPA reports of calls by marketers, distributors and dealers for an upward adjustment in their margins. NPA has approved an increase of 4 percent which contributes to 13 percent in the new price build-up.

(d) **Other Operational Costs**

Other operational costs include cost of chemicals and other items which are used in the refinery process and derived as a residual. It accounts for on average 5.5 percent in the new price build-up.

Direct Impact on Inflation

Kerosene is used in a lot of homes for cooking and lightning. The Ghana Statistical Service (GSS) places it in Household, Goods, Operations and Services with an original weight of 7.83 percent. CEPA analysis shows that the weight has dropped to 6.43 percent as at February 2010. But since there is no change in kerosene prices, there is no <u>direct</u> impact of the announced price changes in inflation.

Indirect Impact on Inflation

Transport has an original weight of 6.21 percent but increased to 8.94 percent as at February 2010. Transport fares were increased by 18.0 percent and thus the indirect effect is measured by .0894*18 = 1.609 percent. Thus CEPA expects that the year-on-year inflation will go up by 1.609 percentage points. This is only the minimum as there are other indirect effects as the ripple effect of increased transport fares works its way through the economy. It is the assumption that the affected operators will pass onto the consumers some of the new cost.

Another area to examine is Housing and Utilities (water, electricity, gas etc), its original weight was 6.98 percent but as at February 2010 it has increased to 8.12 percent. While diesel is used in generating electricity, gas is powering most of the taxi cabs in the country and it is also used by households for cooking. The impact of the utilities can only be determined when the PURC announces new tariffs.

(v) **Conclusion**

The Table below provides the contributory shares of the identified determinants of prices of two petroleum products – petrol and diesel – the prices which have been adjusted upwards by 30 percent.

As shown in the Table, the dollar price change of about 20.0 percent accounts for two-thirds (66.7 percent) of the total increase in prices of the two products. The exchange rate effect amounts to about 7 percent. This contrasts with an earlier work by CEPA when the exchange rate effect was 23 percent in the year 2002 which more than three times in the current adjustment. TOR levy accounts for 7-8 percent of the total price increase. Distributors' margin raised by 4 percent accounts for 13 percent of the total increase. Finally Other Operational Costs account for 5-6 percent.

Clearly there is no escaping the pain that confronts the nation at this time as a result of the shock. The only question is how that burden is to be shared over the current population in terms of higher inflation (higher cost of living) and or reduced opportunities for jobs (enterprise failures) and higher poverty. Giving relief to the present generation by borrowing to finance the shock pushes the burden to the future generation – which is voiceless.

Shares of Contributions of key Components (percent)

Product	Initial Price per liter GH¢	Changes in Price in International Markets (US$)	Exchange rate	TOR Levy	Margins	Other Operational Costs	Adjusted Price per liter GH¢
Petrol	1.1698	66.7	6.9	8.0	13.3	5.1	1.52
Diesel	1.1805	66.7	6.9	7.1	13.3	6.0	1.53

Source: NPA Press Release January 03 2011