



CEPA

CENTRE FOR POLICY ANALYSIS

# **GHANA MACROECONOMIC REVIEW AND OUTLOOK**

**1997**

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## 1. EXECUTIVE SUMMARY

### *Introduction*

Economic policy making is never a matter of pleasantries. It involves hard choices and costs. There are sacrifices to be made, in order to balance the socio-economic and politico-cultural options in the country. Issues like democratic election processes are essential to maintaining credible governance which impacts positively on all sectors of the economy. Indeed, Ghana's political history is directly linked to the performance of the economy. It is important, however, that in situations of tough political decision making we do not lose rein on the economy.

The country's economic system can be disaggregated into domestic and external sectors. Within the domestic sector, the main agents are the government and the private operators. Action by any of the agents will impact on the rest in one way or the other since they are part of the whole. In other words, in a situation where one party is for instance dissaving, the others will have to save more to keep the economy in equilibrium. For example, to maintain a stable economic environment, Government spending on social services and projects must not be excessive in relation to whatever revenue the country can marshal through taxes and levies. If government spending exceeds its revenues then it means that the private sector, in all likelihood, will be forced to forego its spending or the foreigners must lend us more, to maintain equilibrium. Of course, the private sector can be induced to save more, but this may require interest rates to go up, or in the absence of external finance, the exchange rate will have to depreciate sharply. On the other hand, the country can borrow more from abroad. Interest rate increases and external sector indebtedness, however, have far reaching consequences in terms of future debt service burdens, production, and price levels.

1996 began as a year of potential economic turbulence with inflation registering the highest rates in the ERP period and output growth, for a second consecutive

year, being less than 5 percent. The fear of a poor economic outturn for the year was worsened by the fact that it was an election year with a strong potential for fiscal excesses. CEPA and other concerned observers of the Ghanaian economic scene cautioned about the potential dangers posed by fiscal recklessness and its attendant monetary accommodation. CEPA warned that unless a conscious attempt was made at maintaining the proprieties of macroeconomic stability the country would be heading for economic difficulties which would negate the earlier gains of the ERP. Under such a scenario, not only was Government supposed to maintain strong fiscal discipline, but also the monetary authorities were to chart policies that would ensure that the macroeconomic fundamentals were kept in place.

The main objective of Government economic policy in 1996 was to “prevent a further deterioration in the economy..., reduce inflation to tolerable levels and prevent further ... depreciation of the cedi and to set the stage for accelerated growth”. To this end both fiscal and monetary policies were to focus on the enhancement of growth in output, creation of employment, and stabilization of domestic prices and the exchange rate.

### **Real Sector**

On the basis of provisional estimates obtained from the Ghana Statistical Service, the economy showed signs of buoyancy with the tempo of economic activity, as measured by changes in real GDP, better than expected. The growth rate in real GDP of about 5.2 percent for 1996, is the highest recorded within the past five years. It is also higher than the average growth rate achieved during the previous decade. The improvements in real economic activity in 1996 are partly attributable to the apparently good agricultural sector growth, which reached over 4 percent. Even more importantly, the renewal of growth in the industrial sector (4.2 percent) and the continued strong performance of the services sector (6.3 percent) accounted for the observed improvement in the tempo of economic activity recorded in 1996.

In spite of the better than expected improvements in real economic activity, the dependence on favourable climatic conditions as the key “source” of dynamism especially in crop agriculture, however, underscores the concern about the fluctuations in economic activity as evidenced in past trends. Economic growth continued to be constrained by a dearth of domestic savings, resulting largely from government dissavings coupled with low levels of private savings.

Low domestic savings continue to pose severe challenges to capital formation in addition to current account and thus balance of payments problems. Since aid flows cannot be relied on indefinitely to fill the savings-investment gap, serious efforts need to be directed towards increasing domestic savings mobilisation and attracting more foreign direct investments. The large fiscal imbalance leading to excessive public sector borrowing, high growth in money supply, high even if moderating rates of inflation, high nominal rates of interest, large current account deficits, and a real appreciation of the cedi that were observed in fiscal year 1996, continue to make the economy fragile and raise concerns about the sustainability of the growth process.

In the productive sectors, the task ahead for 1997 remains whether or not the gains achieved in 1996 with respect to stable agricultural sector growth and recovery in the manufacturing sector, can be sustained by policy initiatives in more explicit ways than is discernible in the Budget Statement and Economic Policy of the Government.

In the agricultural sector, the absence of new and significant policy initiatives for food production lead us to believe that sustained growth is possible only with continued favourable climatic conditions. Massive food imports will have to be resorted to if food inventories are to be kept at the levels required for price stability. Having to import food, however, hurts the savings mobilisation efforts. Developments in the cocoa subsector thus far imply a potentially severe shortfall in output. Nevertheless, positive terms of trade

developments may moderate the fall in export earnings on this account. Since cocoa continues to play a vital role in terms of the acquisition of foreign exchange, the importance of a cocoa sector policy and management review cannot be over-emphasized.

Sustaining the recovery in the manufacturing sector will depend on the extent to which a sound and stable macroeconomic environment can be regained. CEPA's fears of a large fiscal deficit and net foreign outflows, implying a rising public sector borrowing requirement (PSBR), and a high even if declining inflation rate, if realised, will have serious adverse consequences on the manufacturing sector.

The services sector is expected to continue to lead economic growth with significant contributions particularly expected from the communications subsector. Sustained production in the agricultural and industrial sectors, if realised, will also boost economic activity in the wholesale, retail trade, hotel and restaurants subsector.

Even though sustained growth is projected in the financial services subsector, this growth is not expected to significantly change the level of private domestic savings since the policy of liberalisation appears not to have enhanced financial intermediation. In addition, with a projected dissavings on the part of government, gross capital formation for 1997 is not expected to exceed the amount recorded in 1996, especially since foreign savings are unlikely to exceed 3.4 percent of GDP. This assessment is based on the expectation that the Export Processing Zones (EPZ) programme, may induce additional investments from both local and foreign companies. On the basis of the foregoing we do not see real GDP growth exceeding 5 percent for 1997.

## **Public Finance**

In the *Budget Statement and Economic Policy* document for 1996 the

Government projected a fiscal surplus of ¢159 billion based on a revenue estimate of ¢2328 billion and an expenditure projection of ¢2170 billion. With an expected net external outflow of ¢66 billion the projected fiscal surplus was large enough to make a contribution to the mobilization of resources for financing private sector investment. In addition net official capital inflows from multilateral and bilateral aid sources were to be channeled to the private sector. Together with foreign private capital inflows these enhanced resources were expected to buttress the private sector's role as the lead engine for growth.

CEPA's reports on the economy in the course of 1996, however, persistently drew attention to the large fiscal imbalances in the system. They insisted that the Government's overall macroeconomic targets for 1996 were overly optimistic and therefore unlikely to be realized. It was the view of CEPA that the cornerstone of the Government's anti-inflation policy -- *namely the large budget surplus* -- was not attainable. Among other things, CEPA was particularly concerned that expectations with regard to the Income and Fees component of non-tax receipts were simply unrealizable. Moreover, expenditures were likely to soar above the budgeted amounts given the high rates of inflation and the heightened propensities for spending that could reasonably be expected in an election year.

Against this background CEPA projected Government receipts of ¢2133 billion and expenditures of ¢2504 billion yielding a budget deficit of ¢371 billion for the 1996 fiscal year. Taking account of the external payments requirements of the Government, CEPA concluded that public sector borrowing requirement (PSBR) in excess of ¢440 billion from domestic sources would be needed by the Government in the course of the year.

According to the domestic debt register, the domestic debt increased by ¢452 billion from a stock of ¢1672 billion at the end of 1995 to a stock of ¢2124 billion at the end of 1996. Banking system data show Government deposits falling by nearly ¢140 billion

from ₵570 billion year end 1995 to ₵430 billion by year end 1996. Together, these figures imply that Government mobilized about ₵590 billion from domestic sources to finance the deficit and net external repayments in 1996.

Maturing foreign loan repayments exceeded new loan disbursements by an estimated ₵196 billion. Netting this external outflow from the resources borrowed domestically provides an estimate of the Budget deficit of ₵396 billion (the equivalent of 3.8 percent of GDP). This realized Budget deficit is ₵25 billion higher than CEPA had projected, more than confirming CEPA's worst fears in the face of the projected surplus by the Government.

What is even more troubling is that the level of ₵142 billion deficit for 1996 presented to Parliament, is clearly an underestimate. In the Bank of Ghana's *Fourth Quarterly Bulletin* for 1996, published after the 1997 Budget, the Bank put the deficit at ₵335 billion. The problem is that even the Bank's estimate is almost 20 percent short, which means that the Bank of Ghana data cannot account for the use to which some ₵60 billion of resources was put.

The large borrowings by the Government in domestic financial markets sustained the high interest rates experienced through most of the year. These high interest rates contributed to the sharp increase in the interest component of Government expenditures. Indeed the data show that the Government interest payments on the public debt exceeded its expenditure on development projects, excluding those financed with external loans and grants. These payments were also only marginally (3.4 percent) less than the wage bill. The conclusion is clear: there are serious structural imbalances in the Government's finances in need of urgent policy attention and rectification. This conclusion is further strengthened by the observation that Government needs to spend more not less on education and health.

This year, just like 1996, a sizeable fiscal surplus is projected which, in CEPA's view, is based on unwarranted optimism and is unrealizable. The underlying assumption in the 1997 fiscal program is that revenue mobilization will be vastly improved while expenditure control and monitoring will be strengthened. The basis of Government optimism appears to be the strength of the administrative machinery to deliver an improved fiscal outcome. Consequently, while the revenue share of GDP is expected to increase from 21.0 percent in 1996 to 23.4 percent in 1997, the expenditure share is projected to drop from the 1996 level of 24.8 percent to 21.9 percent. Additionally, based on the projected fiscal outcome, in spite of another large projected outflow on account of net foreign debt repayments, Government expects to drastically reduce its domestic borrowing requirements from the ₵592 billion recorded in 1996 to just ₵55 billion in 1997. The realization of the objectives set for 1997 thus critically hinges on an expectation of exceptional performance by the Civil Service.

CEPA is forced to the same assessment as in 1996: the Government's 1997 fiscal package is over-optimistic. It is neither credible nor realizable. CEPA's projections are that, with an unchanged "muddling through" policy stance and a realistic appraisal of the strength of the administrative machinery, the more likely outcome is that 1997 will end with a fiscal deficit of about ₵550 billion. Together with a projected net foreign outflow of almost ₵280 billion, this implies a domestic PSBR of about ₵830 billion in 1997. If developments in 1995 and 1996 are useful guides, the Government will most likely borrow massively using very attractive high-yielding Treasury bills, implying that the upward pressure on interest rates will remain as also for an accommodating monetary policy.

### **Money and Credit**

Monetary policy in 1996 continued to be contractionary, although strong fiscal pressures produced an out-turn which suggested some accommodation. According to the

Bank of Ghana, the money supply increased by about 34 percent in 1996. If one, however, treats some “cheques in transit”, particularly the reported ₵100 billion plus in the “A-Life” case, as credit to the private sector which has already been effected, then demand deposits will swell causing the stock of money to increase by about 42 percent in 1996.

A high proportion of the money stock still continued to be held in very liquid forms, i.e. cash and demand deposits. This is an indication of the financial shallowness in the country. The excessive holding of money in form of cash and demand deposits has also impacted negatively on the degree of monetization in the economy as measured by the ratio of broad money to gross domestic product (M2/GDP). From a level of about 15 percent in 1990, it rose to a peak of 20 percent in 1994, and has been on the decline since. It is important to note that a low degree of monetization does not allow for the full exploitation of the economies of scale in the use of money.

The major sources of expansions in the money supply were credit to government and to the private sector. Although on the face of it credit to the private sector seemed to have expanded more than that to government, it must be remembered that part of that credit is actually proxy borrowing by government. In situations where most public sector projects have to be prefinanced by credit from the banks, it means that credit that ordinarily would have been taken directly by government from the banking system is extended to the private sector on its behalf.

Price developments in 1996 gave rather “confusing” signals of the economy’s performance. On the one hand, there were clear signs of fiscal pressures in an election year coupled with monetary accommodation and a not too excellent harvest situation, and yet price developments were showing a declining inflationary trend. Inflation, which at the beginning of the year was at about 71 percent on a year-on-year basis dropped to 33 percent by the end of the year.

Some skepticism has been expressed about the inflation figures given that the levels of prices of food and other items continue their relentless upward climb. But inflation is not about levels; it is about the rate of change of levels: Prices and therefore the cost of living rose very sharply in 1995 and rose again in 1996 except it did so less sharply in the latter year. Moreover, the lower increase in the cost of living in 1996 was not due to any sustainable improvement in policy-making or implementation. It is important to note that the average person “feels” the price level more directly than the rate at which it is changing. However important the rate of increase in the cost of living is therefore, the question of most interest to the general public is whether the cost of living is rising or falling.

After all, the price level computed as the consumer price index is a measure of cost of living of the average household. A rising cost of living is felt in a reducing standard of living. The answer to the question is that the cost of living has been and is still rising at high rates, even if at rates currently lower than in the last year or two. Of even greater concern to CEPA is that the moderation in the rate at which the cost of living has been rising is not the result of policy change for the better. The trend is consequently not sustainable and may in fact be reversed in the second half of the year. The only way for this to be avoided is a bumper harvest.

We have also observed at CEPA that Ghana’s inflationary trends follow a three- year pattern which mimics the business cycle. For example, July 1994 marked the beginning of the present cycle due to end in June this year. Thus we expect the three-year cycle to hit the trough in the second and third quarters for the year-on-year and the average inflation rates respectively. On this basis, CEPA predicts that the year-on-year rate of inflation will by the end of 1997 be between 32 and 38 percent, with the average lying between 30 and 35 percent. It must be emphasized that this prediction is on the assumption that changes in extraneous factors such as the weather and the attitude of labour are not drastic enough to alter the existing trend.

CEPA has assumed that monetary policy in 1997 will be even more “restrictive”. However, this can only be in the form of interest rate hikes which will hurt the private sector. The high interest rates may also be difficult to justify in the light of the lower rates of inflation. The problem is that the general public is highly apprehensive of inflation. Moreover, the Government’s anti-inflationary policy lacks credibility - the underlying fiscal position is simply too expansionary. Interest rates can be reduced only as the expected rate of inflation falls.

For 1997 a tighter monetary control policy has already been announced in the form of a change in the base for calculating the required cash reserves. With the proposed 8 percent on total deposits, inclusive of foreign currency holdings, more reserves may be required. This will, however, have differential impact on the banks. Those with more foreign currency holdings will experience a severe squeeze on their cedi holdings and may hurt their advances. It may also force them to take defensive action which might discourage foreign currency repatriation! On the other hand, even as policy seeks to restrain monetary growth by squeezing the money multiplier, fiscal pressures may cause some loosening of the quantity of reserve money, leading to an overall expansion of about 40 percent in the Broad Money Supply.

CEPA also believes that non-economic factors may help to boost activities on the capital market. The fact that the Government has won a fresh mandate for another four-year term may increase the country’s external credibility and thus lead to an increased interest by foreigners in Ghanaian stocks. From CEPA’s analysis 1997 could be a good year for promoting Foreign Direct Investment.

### **Trade and Payments**

A review of exchange rate policy and market operations for 1996 shows ad

hoc unsterilized intervention in the market based on the use of the exchange rate as a nominal anchor. While official policy implied a money-based stabilization programme, the practice was an exchange rate-based stabilization programme. Thus there was a major de facto change in policy from using the exchange rate to maintain the country's external competitiveness to using it as a nominal anchor against inflation (and sometimes during the year, as part of monetary policy). The result was a real appreciation in the exchange rate and a rundown of the country's external reserves to the point of increasing its vulnerability to external shocks (a possible balance of payments crisis in the event of failure to roll over two short-term loans - cocoa and oil loans). The reliance on short-term commodity loans is consequently in need of policy review.

This policy of Bank of Ghana intervention to prop the currency moderated the rate of nominal depreciation of the cedi. The moderation in nominal depreciation and the continuing high rates of inflation, however, implied that the real exchange rate appreciated significantly for the second year in a row. Successful management of the exchange rate as a nominal anchor, inter alia, requires timely adjustment of the rate before real appreciation becomes excessive so as to avoid the high subsequent adjustment costs on the economy. This does not appear to have been the policy position with intervention pursued vigorously throughout the year. The only restraint was the international reserves position of the Bank of Ghana and the flow of external loans.

An appreciating real exchange rate combined with expansionary fiscal and monetary policies allowed for appropriate response lags, was bound to have adverse effects on the balance of payments. Partly as a result, the balance of payments situation in 1996 worsened in every respect compared to 1995 even when note is taken of the increased consumption expenditures of an election year.

The overall balance of payments, therefore, recorded a deficit of US\$18.9 million. This was financed by drawing down on reserves resulting in a decline in the net

foreign assets of the Bank of Ghana by that amount. Additionally, the monetary short-term capital movements show a decumulation, i.e. use of the international reserves held by the commercial banks to the tune of US\$30 million.

Overall export performance was relatively lackluster in spite of exceptional performance of the agriculture-based cocoa and non-traditional exports. Thus, compared to 1995 when export earnings rose by 16.4 percent, performance in 1996 was a more modest 5.5 percent growth in earnings. Cocoa export volume hit a twenty-year peak though market prices slumped in the first half year before rallying somewhat in the second half year. Gold, timber and diamonds lost ground as a result of the real appreciation of the exchange rate. In spite of the contrast in performance, gold ended the year as the country's leading foreign exchange earner although its share dropped from 45 percent in 1995 to 41 percent in 1996.

The performance of the non-traditional exports was impressive. Earnings more than doubled to US\$275.6 million - a new record. As a result, the sub-sector moved to third place (after gold and cocoa) in foreign exchange earnings, passing the timber and processed wood subsector which had a rather disappointing performance. Unusually high inventories on world markets together with strong environmental lobbying in Europe against certain types of African timber have been cited as reasons for the poor performance. The current strategy of increasing domestic value added appears in the right direction. Making the requisite technical expertise and market information readily accessible to producers as well as continued improvements in port facilities, the transport network and communications infrastructure would no doubt facilitate recovery in this subsector.

The import bill increased sharply by 8 percent in 1996 following a 7 percent rise in 1995 to reach US\$1820 million. While non-oil imports increased by US\$70 million or 4 percent, the oil bill rose by a massive 36 percent. This latter increase was due to a

combination of 6 percent growth in the volume of crude oil imported and an almost 30 percent rise in the world market price.

Imports have been rising both as a result of the real appreciation of the exchange rate - implying a loss in price competitiveness of domestic producers, and specifically in 1996, on account of the high spending typically seen in election years by both the government and the general public. Thus, with the elections behind us, some cutback on spending on imports can be expected although this will not happen as long as exchange rate policies and high inflation continue to make imports especially of food items cheaper than their domestically produced substitutes.

Ghana's external debt increased by a massive US\$270 million last year to a stock level of US\$5.3 billion, representing nearly 85 percent of GDP. Of the components, long-term debt increased the most (9.2 percent) led by a 12 percent increase in bilateral debt. New, though not fully disbursed loans contracted included US\$65 million suppliers' credit for the Tema Oil Refinery and US\$130 million for the three regional hospitals at Cape Coast, Ho, and Sekondi-Takoradi. This raised the share of long-term debt in the total to 78 percent. The short-term debt stock increased by nearly 6 percent to bring its share slightly up to 5.4 percent. Medium term debt in contrast declined by about US\$100 million largely on account of reduction in indebtedness to the IMF. As a result the share of medium-term debt in the total fell from 19.2 percent at the end of 1995 to 16.5 percent at the end of 1996. All this together points to rising debt service burden and payments difficulties in the near term.

CEPA's outlook on the external sector of the economy for 1997 is based on the perception that Ghana has no choice but to adjust to the incipient payments crisis. On the other hand present policy weaknesses imply that the adjustment will be grudgingly done and inadequate. There is no credible option of additional resources to finance the rising levels of consumption seen in 1995 and more so in 1996. The capital account

surplus is expected to decline marginally by some US\$10 million from US\$234 million in 1996 to US\$224 million. The shrinking aid pipeline is also expected to be reflected in reduced official transfers (foreign grants).

Receipts from gold exports in 1997 will depend critically on new investments and the global strategy of Ashanti Goldfields Company. As a multi-plant production unit, the real exchange rate and its effect on profit margins would be one of the critical determinants of its production plans. We expect that at least the 1996 export values will be maintained, sustained by relatively positive exchange rate developments.

Largely on account of the lower volume of cocoa without a compensatory increase in world market prices therefore, export earnings are expected to fall by \$70 million. Thus, on account of cocoa, the capital accounts, and official transfers, the dollar value of imports must fall by almost US\$125 million in 1997 in line with available finance.

Admittedly, last year's imports reflected election spending, so that one should expect a decline in imports as the level of spending drops and domestic savings rise. Note, however, must be taken of the persistently expansionary fiscal and monetary policies. The expectation is that the projected real depreciation of the cedi will be enough to effect the requisite 6 percent fall in the dollar value of imports. The softening of crude oil prices should provide a welcome relief on the crude oil bill, given the otherwise inelastic price elasticity of demand for crude oil. The oil import bill is expected to fall by about US\$40 million despite a projected volume increase.

With largely depleted external reserves, the Bank of Ghana will find itself in a very weak position to intervene in the foreign exchange markets in support of the cedi. On the other hand the Bank has a responsibility to ensure orderly market conditions on the foreign exchanges. In particular, overshooting of the exchange rate will have to be avoided

given the likely inflationary consequences. In the circumstances, CEPA projects that the most optimistic outcome is a zero overall balance in the external accounts.

In order to attain the balance of payments objectives, the nominal exchange rate must depreciate by at least 30 percent in the interbank market. In the forex bureaux, the rate of nominal depreciation is expected to be higher, in part to correct for the relatively higher appreciation of the real exchange rate last year.

Given an expected average rate of inflation of between 30-35 percent, the real exchange rate is expected to depreciate. This reversal of the tendency observed over the last two years, towards real appreciation of the currency, is critical to the attainment of the balance of payments outcome. The economy's international price competitiveness cannot be further eroded without serious adverse consequences. The squeeze on profit margins on exports of both traditional and non-traditional commodities is a disincentive to producers. Though popularly blamed on "excessive trade liberalization", real appreciation of the exchange rate also means a loss of competitiveness of the import-competing domestic sector as imports are made relatively cheaper than domestically produced substitutes.

## **Conclusion**

In spite of the moderation in the rate of inflation, 1996 proved to be worse than CEPA had anticipated especially with regard to the macroeconomic fundamentals. 1997 promises to be another difficult year. In fact the signs are that the country has exhausted its financing options. The aid pipeline is shrinking; and international reserves have been drawn to precariously low levels. Gross reserves in terms of months of import cover is at a decade low. The temptation to borrow our way out on onerous terms must be resisted. It is an illusion which will only bring the economy crashing under a crushing debt burden. Our own experience with suppliers' credit in the First Republic, the Third World

debt crises and the recent Mexican financial crisis should serve as ample lessons.

Nevertheless, on a more optimistic note, foreign direct investment induced by improvements in the infrastructural network, could be an important catalyst in the development process. In particular the energy and communications sectors have seen important investments and the transport network has been vastly improved. Further, political stability, could help boost investor confidence.

Macroeconomic stability, however, is another matter. Ghana has no choice but to alter the current direction of economic policy-making in order to create the enabling environment and build on its potential.

This will no doubt involve hard choices and costs. There are no painless options. The real test is whether Ghana can fashion and put in place a credible policy package, to regain and maintain macroeconomic stability at tolerable social cost, i.e., without having to sacrifice the growth and employment objectives. CEPA believes this is not only necessary and urgent but that it can be done. Procrastination and muddling through will only lead to intolerably costly adjustment sooner rather than later.

## 2. REVIEW OF THE REAL SECTOR

### 2.0 Introduction

On the basis of provisional estimates obtained from the Ghana Statistical Service (GSS), the economy showed signs of buoyancy with the tempo of economic activity, as measured by changes in real GDP, better than expected. The growth rate in real GDP of about 5.2 percent for 1996, is the highest recorded over the past five years. It is also higher than the average growth rate achieved during the previous decade (See Table 2.1). The improvements in real economic activity in 1996, are partly attributable to the apparently good agricultural sector growth, which reached over 4 percent. Even more importantly, the renewal of growth in the industrial sector (4.2 percent) and the continued strong performance of the services sector (6.3 percent) accounted for the observed improvement in the tempo of economic activity.

In spite of the better than expected improvements in real economic activity, the dependence on favourable climatic conditions as the key “source” of dynamism especially in crop agriculture, however, underscores the concern about the fluctuations in economic activity as evidenced in past trends. Economic growth continued to be constrained by a dearth of domestic savings, resulting largely from government disavings coupled with low levels of private savings.

Low domestic savings pose severe challenges to capital formation, in addition to current account and thus balance of payments problems. Since aid flows cannot be relied on indefinitely to fill the savings-investment gap, serious efforts need to be directed towards increasing domestic savings mobilisation and attracting more foreign direct investments. The large fiscal imbalance leading to excessive public sector borrowing, high growth in money supply, high even if moderating rate of inflation, high nominal rates of interest, large current account deficits, and a real appreciation of the cedi that were

observed in fiscal year 1996, continue to make the economy fragile and raise concerns about the sustainability of the growth process.

In the Budget Statement and Economic Policy Document for 1996, the Government projected a fiscal surplus of €159 billion based on a revenue estimate of €2328 billion and an expenditure projection of €2170 billion. With an expected net external outflow of €66 billion the fiscal surplus was large enough to make a contribution to the mobilization of resources for financing private sector investment. In addition net official capital inflows from multilateral and bilateral aid sources were to be channeled to the private sector. Together with foreign private capital inflows these enhanced resources were expected to buttress the private sector's role as the lead engine for growth. The outcomes for 1996, are however, far from desirable.

In Sections 2.1- 2.4 we review the performance of the economy for 1996, by discussing sectoral growth patterns and contributions to overall economic growth while in Section 2.5 we evaluate trends in investment and savings ratios. Finally, the trends in employment and wages are discussed in Section 2.6.

## **2.1 Sectoral Growth Patterns**

The services sector maintained its dominant role as the key sector of growth consistently growing at rates higher than overall GDP growth, but at a pace slightly lower than previously. The real growth rate achieved in this sector compares favourably with the average growth rate achieved between 1991-1995, though it is slightly less than the 6.9 percent average rate recorded for the 1986-1995 decade. The recovery in the manufacturing subsector, after poor performances in the two previous years, accounted for the improved performance of the industrial sector. Industrial sector activity in 1996, however, was less robust than that for the period 1986- 1995. Growth in the agricultural

sector on the other hand remained stable around the 4 percent also achieved in 1995. This is a remarkable improvement over the average growth rates recorded for the periods 1991-1995 (2.8 percent) and 1986- 1995 (2.3 percent) respectively. In fact since 1989, this is the first time in seven years that agricultural sector output has outpaced population growth for two consecutive years.

## **2.2 Agricultural Sector**

The improved performance of the agricultural sector for 1996 mentioned above, resulted primarily from an historically strong performance in the food and livestock subsector. Cereals production declines were significantly large and widespread. The production of maize and millet declined by over 7 percent, while rice production fell almost 3 percent. On the other hand the tonnage of output for all tubers increased by an average of over 10 percent, with cassava recording the highest increase of 16.4 percent. These statistics imply that in constant 1975 prices, the high growth in tubers more than made up for the sharp declines in cereals production.

The increase in output in the food and livestock subsector for 1996 has been attributed to favourable climatic conditions and improvements in feeder roads in major food production areas. This however, leaves the developments in the output of cereals rather puzzling. It is worth recalling that at least twice before, it is precisely in cereals production that Ghana has demonstrated a capacity to produce an exportable surplus. With the food and livestock subsector maintaining a share of about 27 percent in overall GDP, its contribution to overall GDP growth for 1996, rose marginally from 19 to over 21 percent.

Cocoa maintained the excellent performance of the last five-year period

recording a growth rate of 6 percent, with production in 1996 exceeding a twenty-year peak of over four hundred thousand metric tons, representing an increase in volume of almost thirty-one percent (31 percent). In volume terms the increase was about thirty percent. Value added for the subsector (including marketing) however, increased by a more modest six percent, considerably lower than the 12 percent and 11 percent achieved in 1994 and 1995 respectively. In part this was due to adverse terms of trade developments. Given the agronomic characteristics of cocoa and the fact that it continues to play a vital role in terms of the of foreign exchange earnings, the importance of a cocoa subsector policy and management review cannot be overemphasised, particularly against the background of a much lower crop size this year.

<b>Table 2.1 : Average Sectoral GDP Growth Rates (in percent)</b>			
	<b>1986-95</b>	<b>1991-95</b>	<b>1996</b>
<b>AGRICULTURE</b>	<b>2.3</b>	<b>2.8</b>	<b>4.0</b>
Food & Livestock	1.8	2.2	3.9
Cocoa Production & Marketing	5.1	6.0	6.0
Forestry & Logging	2.2	2.1	2.3
Fishing	1.8	1.7	2.0
<b>INDUSTRY</b>	<b>5.7</b>	<b>4.3</b>	<b>4.2</b>
Mining & Quarrying	7.6	7.4	4.2
Manufacturing	4.4	2.4	3.0
Electricity & Water	11.1	7.9	6.5
Construction	6.8	7.0	6.1
<b>SERVICES</b>	<b>6.9</b>	<b>6.1</b>	<b>6.3</b>

Transport, Storage & Communication	7.9	6.5	6.2
Wholesale, Retail Trade, Hotels&Rest.	9.3	7.8	9.5
Finance, Insurance etc	5.6	5.0	5.4
Government Services	4.9	5.4	3.5
Comm, Social & Personal Service	9.9	2.6	2.3
Producers of Private Services	4.1	2.6	3.0
<b>GDP (Overall)</b>	<b>4.6</b>	<b>4.5</b>	<b>5.2</b>
<i>Source : Computed from Ghana Statistical Service Data.</i>			

The increase in the producer price of cocoa was no doubt a positive factor, but the observed record cocoa output can be explained largely by conducive climatic conditions (favourable winds and “right” amount of rains) which have been found to be the dominant determinants of output in the short term for cocoa, as with crop agriculture in general. This, nevertheless, cannot be a reliable or an adequate basis for managing such an important subsector of the economy. In the meantime cocoa producer price policy must assure farmers of the unflinching commitment to the maintenance of the price incentive. Economic activity in the forestry and logging, and fishing subsectors appeared to have remained on a steady level. The growth rates of 2.3 and 2.0 percent respectively recorded for 1996, are almost identical to the respective averages for the decade 1986-1995. In the timber industry, unusually high stocks and increasing environmental concerns may have dampened economic activity.

### **2.3 Industrial Sector**

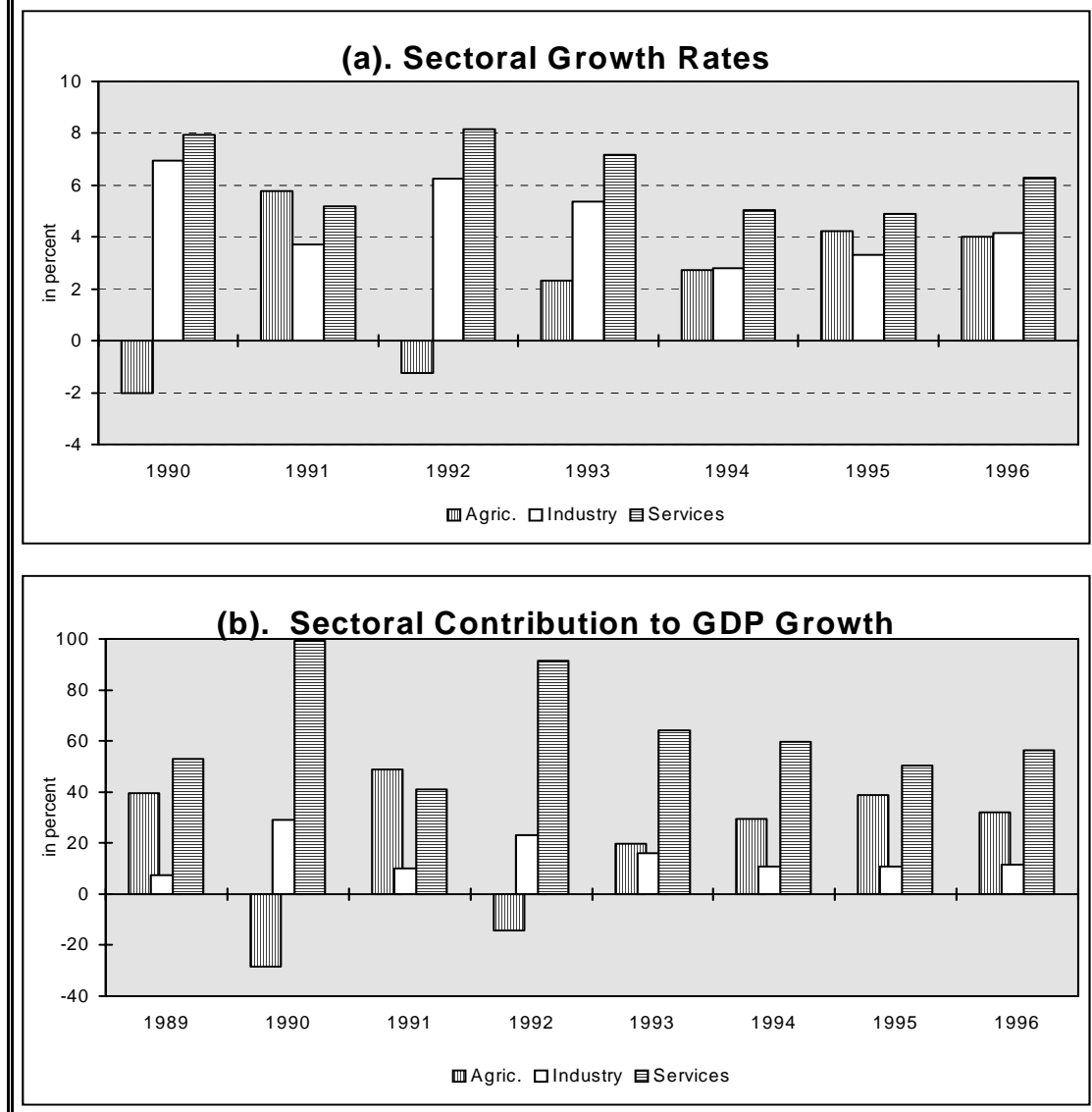
The industrial sector continued to show signs of increased economic

activity, with growth rising from 3.3 percent in 1995 to 4.2 percent in 1996. This was made possible by the recovery in the manufacturing subsector. The manufacturing subsector growth of 3.0 percent recorded for 1996 exceeded the average of 2.4 percent for the preceding five year period, 1991-1995. It is however less than the average growth rate (4.4 percent) recorded for the decade 1986-1995 (See Table 2.1 and Figures 2.1a and 2.1b). As a result the manufacturing subsector's contribution to overall GDP growth rose to 4.8 percent in 1996. This is, nevertheless, a far cry from the almost 16 percent contribution achieved in 1990 or even the 7 percent contribution recorded in 1993. Thus while the improved performance in manufacturing is welcome, it is nonetheless, rather tentative and the subsector clearly has a long way to go. The high cost of credit, high though declining rates of inflation and a real appreciation of the cedi all continued to have adverse implications for domestic manufacturers. The difficulties faced by domestic enterprises are popularly attributed to "excessive liberalisation". This needs rectification in order to avoid inappropriate policy responses which may only go to further aggravate the situation.

The electricity and water, and construction subsectors continued to show buoyancy with growth rates of 6.5 percent and 6.1 percent respectively. Massive rehabilitation of water systems in urban areas, expansive provision of both water and electricity services to rural areas and extensive road construction activities by government, account for the high growth rates recorded in these subsectors. The construction industry benefited from the increased demand for both commercial and residential properties. In a high inflation environment real assets are considered good investment vehicles and not surprisingly investment is being directed into these "inflation-immune" assets. However, growth in the electricity and water subsector while appreciable, has however, slowed down considerably, when compared to earlier trends. (The average growth rates in this subsector recorded for the periods 1986-95 and 1991-1995 were 11.1 and 7.9 percent

respectively). Further investments are clearly called for given the strategic importance of the subsector.

The mining subsector continues to experience positive even if declining growth as a result of the substantial investments that have been made: rehabilitation and expansion of old mines, the establishment of new mines and minerals exploration. The slowdown in the mining subsector in 1996 has been attributed to the fall in gold production at the major producing Ashanti Goldfields Company (AGC) mine at Obuasi. The positive declining pace of economic activity in the mining subsector is particularly worrisome. Specifically, since 1992 when the subsector recorded a growth of 10.4 percent, the trend has been downwards with the 4.2 percent of 1996 representing a ten year low. Faced with higher domestic costs of production and adverse developments in the world market for gold, the trend is unlikely to change significantly in the near future, even with higher output from new mines.



Its importance to the economy as the largest foreign exchange earner is widely acknowledged, its contribution to GDP is an insignificant 2 percent. This has raised some concerns as to the net developmental impact of the subsector especially when the environmental dimension is taken into account.

## **2.4 Services Sector**

The services sector continued to lead in terms of economic growth, with another strong performance (6.2 percent) in 1996. Given its share in GDP of about 47 percent, this sector contributed to over 56 percent of the increase in overall GDP growth for 1996. The sector was buoyed up by the exceptionally heavy demand for services in an election year. It may be recalled that a similar upsurge in economic activity occurred in 1992, with growth recorded at 10 percent. The high performance achieved was as in the past, attributable to robust economic activity in the wholesale, retail trade, hotels and restaurants; and the transport, storage and communications subsectors. In the wholesale, retail trade, hotels and restaurants subsector, economic growth increased from 6.5 percent in 1995 to 9.5 percent in 1996. The improved performance in the primary (agriculture), and secondary (industrial) sectors of the economy no doubt enhanced growth in the subsector.

The contribution of the wholesale, retail trade, hotels and restaurant subsectors to overall GDP growth consequently increased from 23 percent in 1995 to 30 percent in 1996. It is important to observe that while this subsector ranks second to the food and livestock subsector with respect to share in overall GDP, it ranks first in terms of contribution to growth in overall GDP. In addition tourism and tourism-related activities continued to enjoy the growth enhancing activities of a more liberalised economic and political environment. The opening up of the communications subsector to more competition particularly through the divestiture of Ghana Telecom, has led to significant improvements in the infrastructure which may account for the growth rate of 6.2 percent achieved in the transport, storage and communications subsector in 1996.

The financial services subsector improved on its performance with growth increasing from 3 percent in 1995 to over 5 percent in 1996. In the annual reports for 1996,

most commercial banks showed substantial improvements in their after tax profits. Significant improvements were also noticeable in the activities of non-bank financial institutions such as leasing companies, finance companies and savings and loan institutions (which are successfully exploiting the “credit crunch” in the formal banking system). The importance of renewed growth in this subsector, is underscored by the fact that in 1996, the 9.8 percent contribution of the financial services subsector towards overall GDP growth ranked third after the wholesale, retail trade and hotels and restaurant; (30 percent), and the food and livestock subsector ( 21 percent), surpassing that of the cocoa subsector (8.4 percent).

## **2.5 Trends in Investment and Savings**

Gross capital formation, measured as a proportion of GDP (investment ratio), has remained stagnant or declined since 1994. However, the average investment ratio for the period 1991-1995 (14.6 percent) is higher than that for the decade 1986-1995 (13.1 percent). The stagnating or declining investment ratio is especially worrisome since investment, is the primary means of increasing the productive capacity and productivity of a nation. Even though the level of total investments is important, it has been demonstrated that what is even more crucial is the composition of the investment that takes place.

The issue here, is basically that of the extent to which public and private investments are complements or substitutes. For a developing country such as Ghana, it has been shown that during certain stages of economic development, public investment may actually increase the productivity of private capital and hence be beneficial for growth. On other hand there is abundant empirical evidence that public investment, as shown in Latin America in the seventies, may not automatically have a beneficial impact on growth. The obvious question that arises then is, what is the optimal share of public investment in

total investment? One plausible answer from neoclassical growth theory, is that the optimal share of national income to allocate to public investment, is determinable fraction of the output elasticity of that investment.

Preliminary estimates show that in the case of Ghana, the output elasticity of public investment was higher than that of private investment. This is hardly surprising given the generally poor state of public infrastructure at the end of the decade of the seventies. The situation is however reversed for the nineties, with the output elasticity of private sector investments about three times that of public investment. Consequently, the optimal choice is for public investment share to decline. The facts however point to the opposite direction. For example in 1995, over 70 percent of total investment emanated from the government sector. The suboptimality of the public/private investment mix gives cause for concern, for it implies that the country, given the right policy environment, is capable of much higher growth and employment generation than at present. This is further bolstered by the observed falling trend in the incremental capital-output ratio (ICOR).

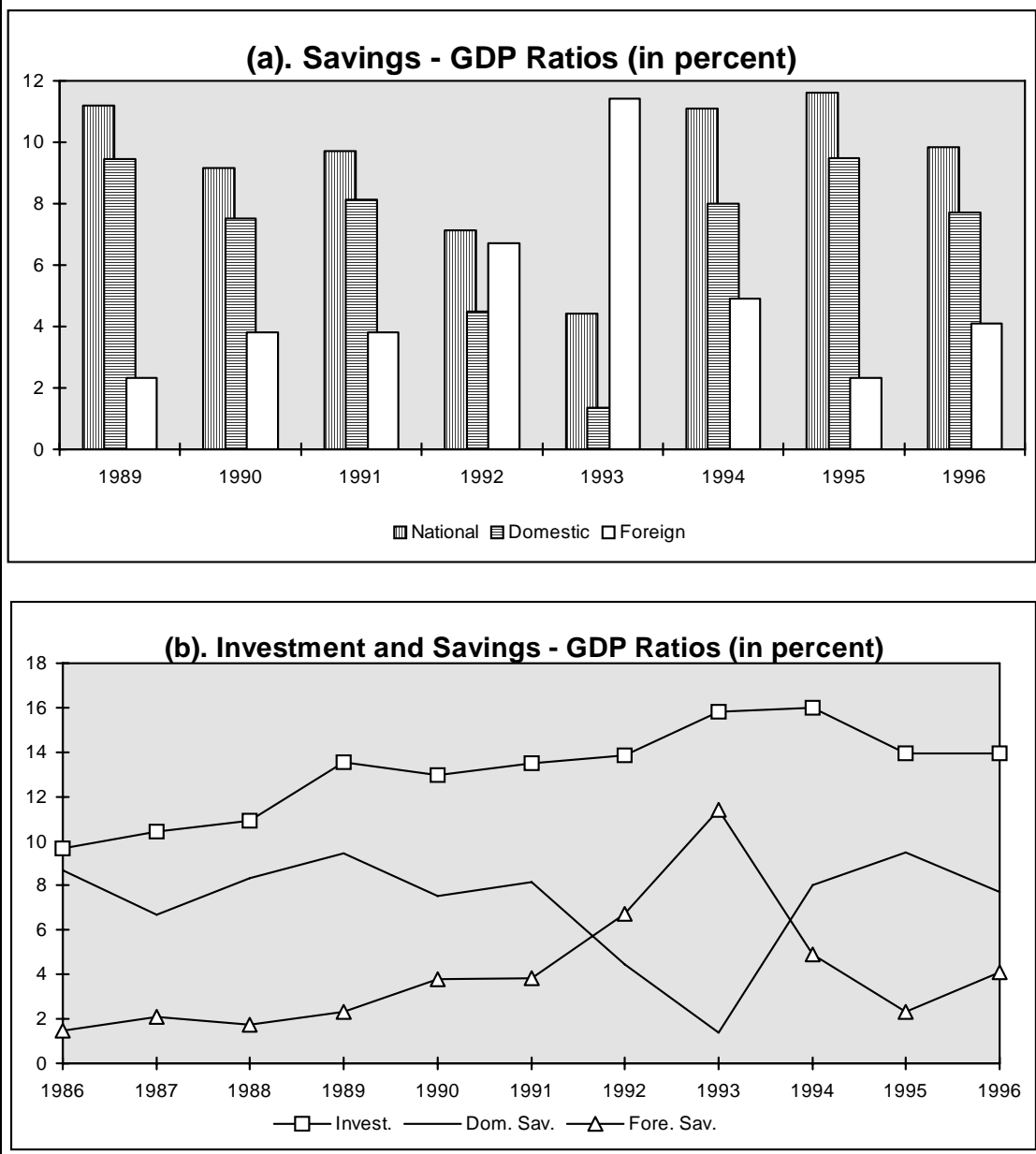
Another issue of concern, is the potential for increased economic instability in the investment choices being made. Several studies have demonstrated the inverse relationship between macroeconomic instability and growth. In these studies a key measure of instability was identified as Public Sector Borrowing Requirement/Gross Domestic Output ratio - (PSBR/GDP). The high PSBR/GDP ration of recent times imply excessive government borrowing in domestic and foreign capital markets. The resultant crowding out of private investments, according to these studies, may be the reason for the unstable growth rates of the nineties.

<b>Table 2.2: Investment and Savings - GDP Ratios (in percent)</b>			
	<b>1986 - 1995</b>	<b>1991 - 1995</b>	<b>1996</b>

<b>Investment Ratio</b>	13.1	14.6	13.9
<b>National Savings Ratio</b>	9.0	8.8	9.8
Government	1.5	0.0	1.0
Private	7.5	8.8	8.8
<b>Domestic Savings - Ratio</b>	7.2	6.3	7.7
Government	-0.3	-2.0	-1.6
Private	7.8	8.8	8.5
Depreciation/GDP Ratio	5.8	5.6	4.3
<b>Foreign Savings Ratio</b>	4.1	5.8	4.1
<i>Source: Computed from Quarterly Digest of Statistics, Budget Statements and Bank of Ghana Data</i>			

The PSBR as a ratio of GDP, has averaged about 2.7 percent during the fourth republic. For the election years of 1992 and 1996 this ratio was above 5 percent. From a policy perspective, unless this trend is reversed by the implementation of immediate and decisive actions on the fiscal front, not only will economic growth be suboptimal but it will exhibit high variability.

Table 2.2 also shows the sources of funding of investment in general and in particular the precarious state of national savings. The decline or stagnation in investment is a reflection of the deterioration in national savings. The national savings ratio, measured as a proportion of GDP fell by 15 percent between 1995 and 1996 (See Figure 2.2a). Even though government savings, measured as total current revenue less recurrent expenditure, improved somewhat in 1996, it is still negative. Government



domestic savings ratio which on the average

stood at -0.3 percent of GDP between 1986-1995, declined precipitously to -2.0 percent of GDP for the period 1991-1995 (See Figure 2.2b). The phenomenon of government dissaving exacerbates the problem of crowding out of private sector investments.

Government dissaving has the potential for putting undue pressure on the current account balance and on the exchange rate.

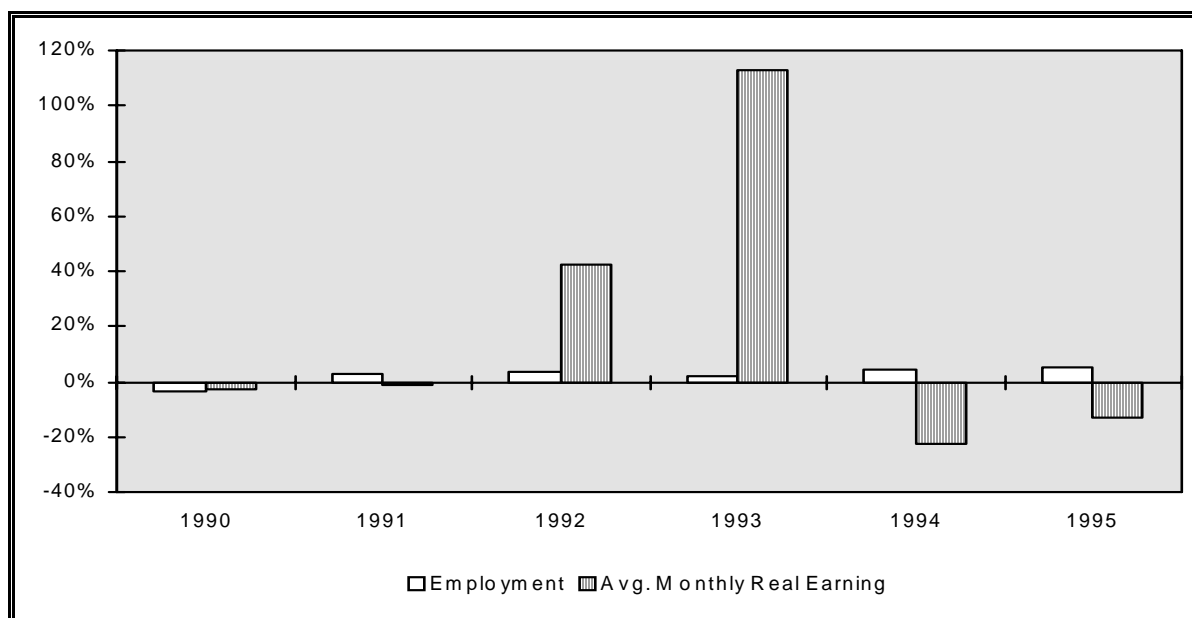
The resource gap, the excess of savings over investment, continued to exert pressure on the external balance, reversing the improvements in the current account achieved from 1994. The foreign savings ratio (current account/GDP) which declined to 2.3 percent in 1995, after picking up at 11.4 percent of GDP in 1993, rose again to 4 percent in 1996 (See Figure 2.2b). As can be seen in Figure 2.2b, since 1986, with the exception of 1994, increases in the investment ratio have been associated with increases in the foreign savings ratio and vice versa. The observed trends in savings efforts suggest that unless there are significant increases in both government and private savings and foreign direct investment inflows, the investment effort and hence growth process cannot be sustained.

## **2.6 Employment and Earnings**

Data obtained recently from the Social Security and National Insurance Trust (SSNIT), paint a different picture about formal sector employment in Ghana, from what has been seen previously. The CEPA Macroeconomic Review and Outlook, 1996, using data obtained from various issues of the Quarterly Digest of Statistics, published by the GSS, was led to the following inference: "The data in Table 2.3 show that from 1987 when the public sector retrenchment, rationalization and redeployment exercises began, up to 1991, total formal sector employment declined from 394,000 to 186,000, a fall about 53 percent".

In contrast the data from SSNIT presented in Table 2.3, below indicate that, except for 1990, formal sector employment has grown continuously on the average by about 2.4 percent per annum. The observed growth rates for 1994 and 1995 of 4.3 percent and 5.3 percent respectively imply that for these years, employment more than kept pace with real GDP. On the face value about 100,000 additional jobs have been created in the

1990's. This is obviously in sharp contrast with the conclusions that emerged from the "old" data set, which suggested that formal sector employment had been on a continuous decline. The point must be made though that, even the new picture does not contradict the common observation of rising unemployment especially among the young coming out of our training institutions in search of modern sector employment.



The trends in real wages in the formal sector. are also presented in Table 2.3.

### Real

monthly earnings of workers in the formal sector declined in four out of the six years of the nineties. Of particular note is the fact the largest declines in real monthly earnings of employees were recorded in 1994 and 1995. In those years formal sector employment also grew the fastest, suggestive of the fact that the formal sector labour market in Ghana

might at least be responding partially to market signals . (See Beaudry and Sowa, 1994).

<b>Table 2.3: Employment and Earnings Trends in Ghana</b>							
	<b>1989</b>	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>
Total Formal Employment (million)	0.56	0.54	0.56	0.57	0.59	0.61	0.64
Nom. Total Earnings (¢ million)	75790	100920	117600	184660	491420	476300	660830
<b>Growth Rates (in percent)</b>							
Employment	n/a	-3.7	3.1	3.2	2.3	4.3	5.3
Avg. Monthly Real Earning	n/a	-2.6	-1.3	42.7	112.9	-22.4	-12.9
Real GDP	5.1	3.3	5.3	3.9	5.0	3.8	4.5
<i>Source: SSNIT and CEPA Staff Estimates</i>							

The highly aggregative nature of this data masks the fact that both wages and employment have been rising in expanding subsectors of the economy such as financial services. It is important, to note the wide variations in the growth of real monthly earnings. For example in 1992, real monthly earnings increased by 43 percent and again by 113 percent in 1993, before falling by about 22 percent in 1994. The large increases in 1992 and 1993 reflect the effect of the 80 percent wage increases granted to civil servants with effect from July 1992, which no doubt reverberated through the modern sector in 1993.

There is, however, a need for extreme caution in drawing conclusions from the SSNIT data. Two important caveats are in order. First is the issue of increasing (wider) coverage. Even though technically speaking formal sector employment refers to employment in establishments employing five or more workers, in attempting to improve its collections of social security contributions, SSNIT has been extending the coverage to include establishments with less than five employees. This has the effect of an upwards bias in the employment numbers presented. Over time therefore, more and more establishments previously excluded by the definition of modern sector, would be included in later years. This is bound to give an illusion of faster growth in employment than warranted.

Secondly, the data show that the earnings data have been estimated on the basis of the 17.5 percent statutory provision - employee contribution of 5 percent and employer contribution of 12.5 percent. Consequently, the earnings data for any one particular year will show an upward bias on account of included arrears of contributions. To the extent that the data include both current and overdue social security contributions, the earnings data would tend to overstate the average earnings of employees for that year.

In all probability therefore, the correct employment and earnings data lie somewhere between the understated data as provided by the GSS and the upwardly-biased data from SSNIT. With these caveats in mind, we conclude with the following preliminary observations.

- formal sector labour market has not been shrinking since the beginning of the public sector rationalisation exercises (at least not in the nineties).
- formal labour market appears to respond to market signals such as changing relative wages, with wages in expanding sectors rising relative to those in

contracting ones. In addition even though employment in the formal sector does not appear to be very responsive to changes in real wages (low elasticity), there might still exist tradeoffs between wages and employment. Real wages growth ahead of productivity could raise unemployment.

- That the state of the labour market institutional relationships, especially between government employees and trade unions does affect formal labour market outcomes.

### 3. REVIEW OF PUBLIC FINANCE AND FISCAL OPERATIONS

#### 3.0 Introduction

CEPA's reports on the economy in the course of 1996 persistently drew attention to the large fiscal imbalances in the system. They insisted that the Government's overall macroeconomic targets for 1996 were overly optimistic and therefore unlikely to be realised. It was the view of CEPA that the cornerstone of the Government's anti-inflation policy – *namely the large budget surplus* – was not attainable. Among other things, CEPA was particularly concerned that expectations with regard to the Income and Fees component of non-tax receipts would be very difficult to realise. Moreover, expenditures were likely to soar above the budgeted amount given the high rates of inflation and the heightened propensities for spending that could reasonably be expected in an election year.

Against this background CEPA projected Government receipts of  $\text{¢}2133$  billion and expenditures of  $\text{¢}2504$  billion yielding a budget deficit of  $\text{¢}371$  billion for the 1996 fiscal year. Taking account of the external payments requirements of the Government, CEPA concluded that public sector borrowing requirement (PSBR) in excess of  $\text{¢}440$  billion from domestic sources would be needed by the Government in the course of the year.

According to the domestic debt register, the domestic debt increased by  $\text{¢}452$  billion – from a stock of  $\text{¢}1672$  at the end of 1995 to a stock of  $\text{¢}2124$  at the end of 1996. Banking system data show Government deposits falling by nearly  $\text{¢}140$  billion from  $\text{¢}570$  billion end 1995 to  $\text{¢}431$  end 1996. Together, these figures imply that Government mobilized about  $\text{¢}590$  billion from domestic sources to finance the deficit and the net external loan repayments in 1996. This level of borrowing is  $\text{¢}150$  more than CEPA had feared. About  $\text{¢}225$  or a little under 40 percent of this was from the banking system (literally printed).

Maturing foreign loan repayments exceeded new loan disbursements by an estimated ₵196 billion. Netting this external outflow from the resources borrowed domestically provides an estimate of the budget deficit of ₵396 billion (the equivalent of 3.8 percent of GDP). This latter figure is ₵25 billion higher than CEPA had projected, more than confirming CEPA's worst fears in the face of a projected surplus by the Government.

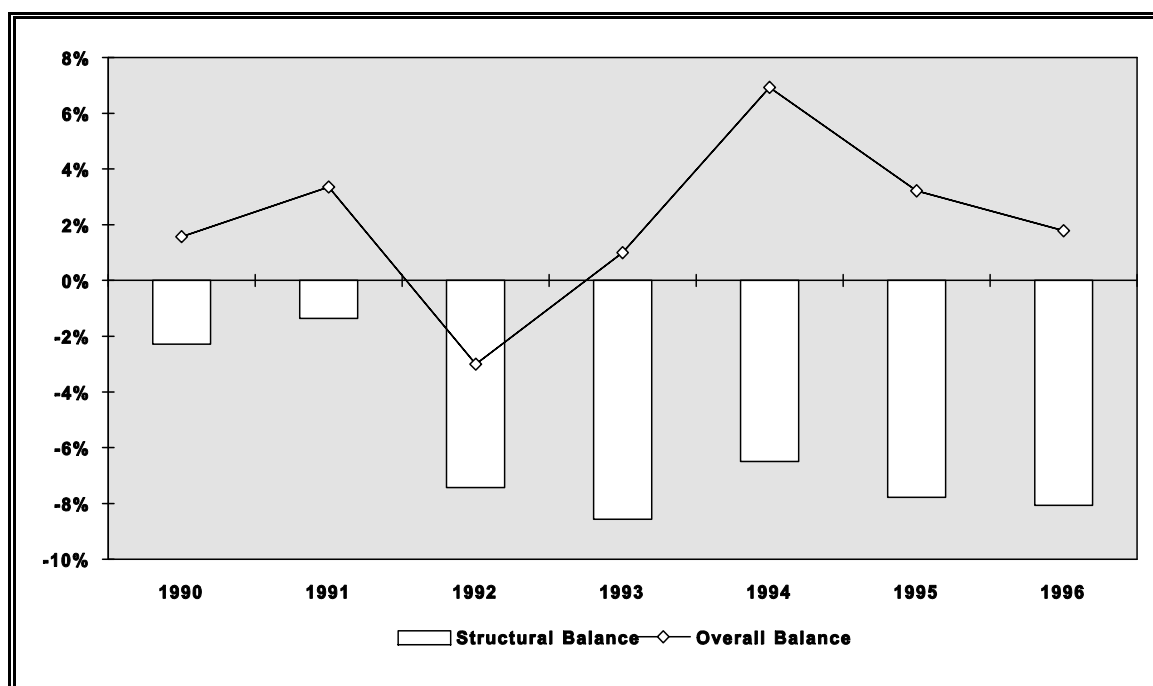
What is even more troubling is that the level of ₵142 billion deficit for 1996 presented to Parliament in the 1997 *Budget Statement and Economic Policy* document is clearly an underestimate. In the Bank of Ghana's *Fourth Quarterly Economic Bulletin* for 1996, published after the 1997 Budget, the Bank put the deficit at ₵335 billion. The problem is that even the Bank of Ghana estimate is almost 20 percent short, which means that the Bank of Ghana data cannot account for the use to which some ₵60 billion of resources was put.

The large borrowing by the Government in domestic financial markets sustained the high interest rates experienced through most of the year. These high interest rates contributed to sharp increase in the interest component of Government expenditures. Indeed the data show that the Government's total interest payments on the public debt exceeded its expenditure on development projects, excluding those financed with external loans and grants. These interest payments were also only marginally (3.4 percent) less than the wage bill. The conclusion is clear: there are serious structural imbalances in the Government's finances in need of urgent attention policy attention and rectification. This conclusion is further strengthened by the observation that Government needs to spend more not less on education and health.

### **3.1 Financing and Fiscal Operations**

In CEPA's Second Quarterly it was stressed that one of the important

barometers of growing indebtedness, was to be found in the net external outflows in the Government's financing operations. In 1994, for the first time this decade, new official loan receipts were less than scheduled principal repayments — a phenomenon which was repeated in both 1995 and 1996. For fiscal year 1996 the Government had to borrow ₵196



billion cedis (about 2 percent of GDP) from domestic sources to finance the excess of amortisation over new loan receipts. The projected external debt repayments obligations for 1997 suggest that a reversal of this phenomenon of net external outflow is unlikely in the near future.

Uncontrolled Government spending has also led to a negative overall fiscal balance in the Fourth Republic, that is if divestiture and other capital receipts are excluded from revenues. The continued reliance on divestiture and other capital receipts raises important concerns about the durability and sustainability of the fiscal agenda. Figure 3.1 shows the trend in both the “structural” and the overall fiscal balance. The structural

balance is defined to consider only tax revenues while the overall balance includes divestiture and other capital receipts. Figure 3.1 clearly illustrates that from 1993 to 1996 the Government used divestiture proceeds and other capital receipts to finance its fiscal operations, thus masking the serious fundamental structural deficits.

Government borrowing from the domestic economy in 1996 amounted to ₵590 billion with nearly ₵365 billion through the issuance of Treasury bills. (See Table 3.1). The onerous future debt service implication of such large borrowings must be noted and urgently addressed.

	1990	1991	1992	1993	1994	1995	1996
<b>TOTAL REVENUE</b>	219.7	319.5	301.8	509.2	826.4	1138.7	1736.5
<b>TOTAL EXPENDITURE</b>	264.0	351.6	510.8	822.9	1149.6	1714.3	2572.3
<b>“Structural” Fiscal Balance</b>	-44.3	-32.2	-209.0	-313.8	-323.2	-575.6	-835.8
Non-Tax Receipts	47.6	71.2	64.4	215.1	434.9	484.7	439.9
<b>Overall Fiscal Balance</b>	3.4	39.0	-144.6	-98.7	111.7	-91.1	-395.9
<b>FINANCING</b>	-3.4	-39.0	144.6	98.7	-111.7	91.0	395.9
<b>Foreign (Net)</b>	24.6	12.7	0.3	44.9	-84.9	-42.6	-195.6
Inflows	58.3	52.0	43.1	111.0	30.0	151.6	241.5
Amortization	-33.7	-39.3	-42.8	-66.1	-115.0	-194.2	-437.1
<b>Dom Borrowing (Net)-PSBR</b>	-28.0	-51.7	144.3	53.8	-26.7	133.6	591.5
Banking	-20.8	-50.7	102.5	-21.9	32.3	-24.5	226.1
Non-Bank (1)	9.3	4.2	41.7	75.7	-59.0	42.2	365.4

Non-Bank (2)	-16.5	-5.2	0.1	0.0	0.0	115.9	0.0
<b>PSBR/GDP (%)</b>	<b>-1.46%</b>	<b>-2.13%</b>	<b>5.15%</b>	<b>1.46%</b>	<b>-0.54%</b>	<b>1.80%</b>	<b>5.70%</b>
<i>Source: Bank of Ghana Annual Reports and CEPA Estimates</i>							

The fiscal challenge of the short- to medium-term is to improve Government savings. This is the only way to free up resources to finance infrastructural and other development expenditures and also honour external payment obligations without fuelling inflationary pressures and crowding out private sector investments. In order to do this a fundamental restructuring of public finances will be necessary. We present below a quick survey of the state of affairs on the basis of four key indicators: the stock of the domestic debt, the primary balance, Government saving, and the narrow/broad deficit. All of these indicators clearly point to one thing: the state of public finances is precarious. This situation cannot be handled with short-term palliatives and, left unattended, the economy is sure to lurch into ever-deepening crises.

### 3.1.1 Stock of Domestic Debt

Table 3.2 presents data on the domestic debt from 1992 to 1996 by holding sector and by debt instrument. Between 1992 and 1995 the nominal stock of domestic debt increased at an annual average compound rate of 48 percent – the result of particularly high increases of 83.5 percent and 49.6 percent in 1993 and 1995, respectively. In 1996, however, the nominal gross debt stock increased by a more moderate 27 percent. This rapid debt build-up is a clear pointer to the fundamentally unhealthy state of public finances.

An even more disturbing feature of this rapid growth in debt is the shortening of the maturity profile. Over the 1992-95 period the stock of Treasury bills (almost

exclusively then held by the non-bank public) rose at an annual average rate of 67 percent. In 1996 the stock of Treasury bills rose by an incredible 255 percent, i.e., more than tripling the year-end 1995 stock by close of 1996. Such shortening of the maturity structure together with the fast build-up is an ominous signal of future debt servicing difficulties. (It may be useful to recall the fact that interest payments are already well poised to be the leading budgetary expenditure category).

<b>Table 3.2: Domestic Public Debt</b> (in billion cedis unless otherwise stated)					
	1992	1993	1994	1995	1996
<b>(A) GROSS STOCK</b>					
<b>Treasury Bills</b> ( <i>nominal</i> )	<b>39.0</b>	<b>57.3</b>	<b>89.9</b>	<b>176.3</b>	<b>626.3</b>
Bank of Ghana	0.4	1.6	2.9	4.2	14.6
Commercial Banks	0.0	0.0	0.0	0.0	68.9
Non-Bank Public	38.6	55.6	87.1	172.1	542.8
<b>Other Instruments</b> ( <i>nominal</i> )	<b>515.2</b>	<b>959.5</b>	<b>1027.2</b>	<b>1495.5</b>	<b>1497.5</b>
Bank of Ghana *	482.1	849.0	890.1	1401.3	1403.5
Commercial Banks	0.3	0.3	0.3	0.3	5.3
Non-Bank Public	32.7	110.2	136.8	93.9	88.6
<b>Total Gross Debt</b> ( <i>nominal</i> )	<b>554.2</b>	<b>1016.7</b>	<b>1117.1</b>	<b>1671.8</b>	<b>2123.7</b>
<b>Total Gross Debt</b> ( <i>real at 1992 cedis</i> )	<b>554.2</b>	<b>814.0</b>	<b>689.3</b>	<b>719.3</b>	<b>686.7</b>
<b>(B) GOVERNMENT DEPOSITS</b>	<b>126.7</b>	<b>300.7</b>	<b>387.3</b>	<b>570.3</b>	<b>430.7</b>
Bank of Ghana	104.2	237.2	318.1	494.3	325.3
Commercial Banks	22.5	63.5	69.2	76.0	105.4
<b>(C) NET STOCK</b>	<b>427.4</b>	<b>716.1</b>	<b>729.8</b>	<b>1101.5</b>	<b>1693.0</b>
Bank of Ghana	378.3	613.4	574.9	911.2	1092.9

Commercial Banks	-22.2	-63.2	-68.9	-75.7	-31.3
Non-Bank Public	71.3	165.8	223.9	266.0	631.4
<b>Percentage Distr. of Gross Dom. Debt.</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
<b>By Holding Sector</b>					
Bank of Ghana	87.1%	83.7%	79.9%	84.1%	66.8%
Commercial Banks	0.1%	0.0%	0.1%	0.0%	3.5%
Non-Bank Public	12.9%	16.3%	20.0%	15.9%	29.7%
<b>By Instrument Type</b>					
Treasury Bills	7.0%	5.6%	8.1%	10.5%	29.5%
Others	93.0%	94.4%	91.9%	89.5%	70.5%
<b>Memorandum Items</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
GDP Deflator (1992=1.000)	1.000	1.249	1.621	2.324	3.093
Gross Debt / GDP Ratio	19.8%	27.7%	22.6%	22.5%	20.5%
%change (nominal stock)	47.5%	83.5%	9.9%	49.6%	27.0%
%change (real stock)	32.7%	46.9%	-15.3%	4.3%	-4.5%
Inflationary Tax on Debt	14.8%	36.6%	25.2%	45.3%	31.6%
* Includes Revaluation Bond					
Source: Bank of Ghana Annual & Quarterly Reports					

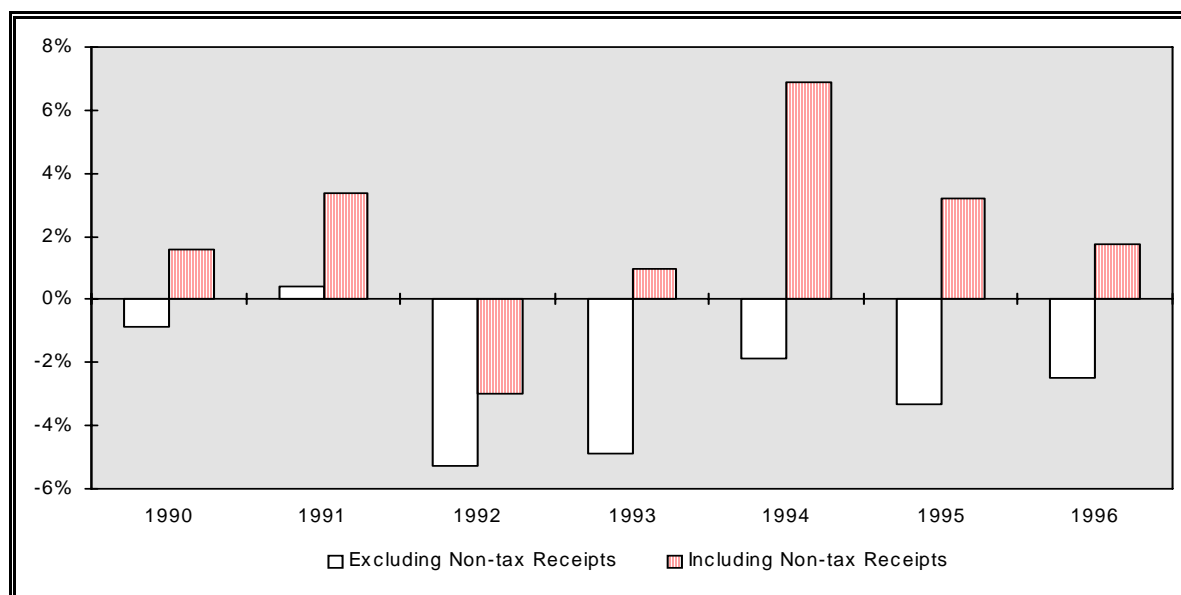
Between 1992 and 1995 Treasury bills accounted for nearly 8 percent of the gross domestic debt stock. In 1996 they constituted nearly 30 percent of the gross stock of outstanding debt. In the face of the large PSBR in 1996 the Bank of Ghana adopted an accommodating monetary stance by allowing the deposit money banks (DMBs) to swap Government Treasury bills for its own OMO bills. As a result the share of the stock of Treasury bills held by the DMBs rose from zero to 11 percent at the end of 1996.

In contrast with the rapid build-up in the nominal stock, the rise in the real stock of debt has been relatively more moderate. This is because between 1992 and 1996

the inflation tax levied on holders of Government debt averaged about 34.7 percent. The inflation-induced reduction in the real stock of debt in 1995 and 1996 were, respectively, 45.3 percent and 31.6 percent. These reductions in the real value of the debt stock means that only a dwindling proportion of the growing interest payments since 1992 can be considered as income to debt holders. As much as 35 percent of Government interest payments on the domestic debt for the 1992-96 period, in effect, represents merely compensation to debt holders for their capital losses on account of inflation. It is important to stress that even in relatively underdeveloped capital markets with a paucity of viable financial alternatives to Government debt, transfers of wealth from the private sector to Government through such inflation-induced debt repudiation will, sooner or later, adversely affect savings behaviour as the public begins to hedge against inflation. This is a costly experiment which the low-savings Ghanaian economy can ill-afford.

### **3.1.2 The Primary Balance**

The primary balance (measured inclusive of non-tax receipts) was a surplus of ¢238 billion or 3.2 percent of GDP in 1995. The corresponding results for 1996 were ¢183 billion and 1.8 percent. When non-tax receipts are excluded, however, the primary balance for the two years plunges into large deficits: ¢247 billion (3.3 percent of GDP) for 1995 and ¢257 billion (2.5 percent of GDP) for 1996. Figure 3.2 displays the trend in the primary balance (with and without divestiture proceeds and other non-tax receipts) for the 1990-96 period. Except for 1991 the entire period was characterised by large primary deficits when non-tax receipts are excluded. And in 1992 the all-receipts-inclusive primary balance was in deficit.



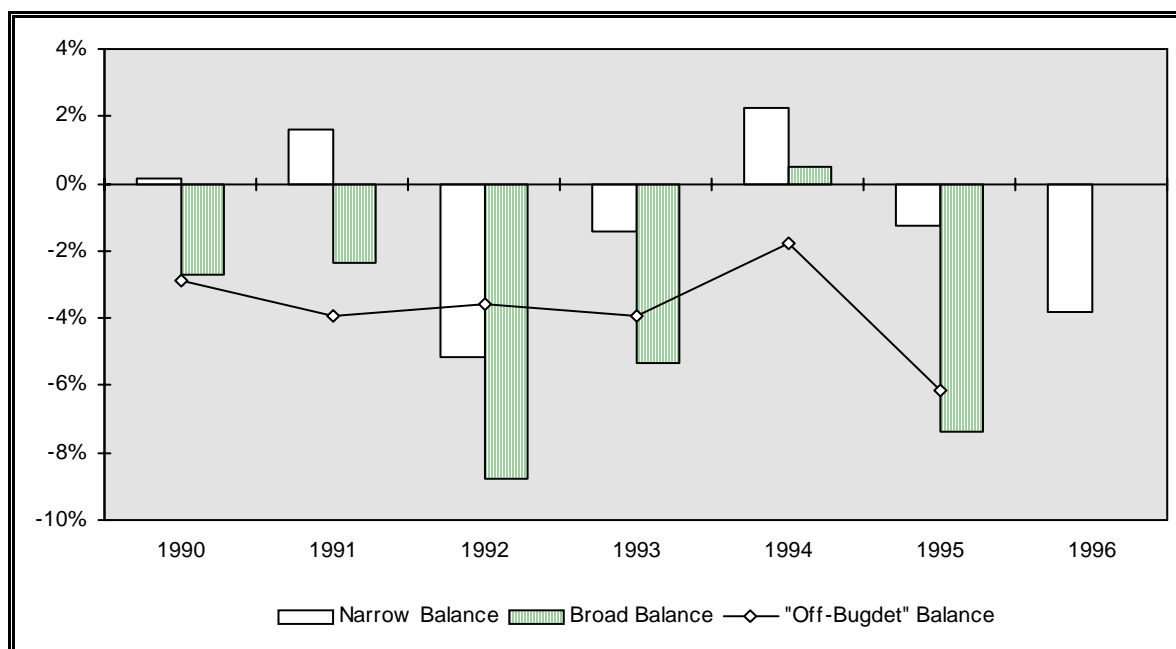
The primary balance measures how current budgetary receipts and outlays improve or worsen the public sector indebtedness. Continued primary deficits imply borrowing not only for debt service. They also, and perhaps more seriously, reflect a propensity to borrow to finance current discretionary expenditures. The differences between the two measures of primary balance illustrate the parlous state of the nation's fiscal health. Grants are highly sensitive to political perceptions and interests of donors. Divestiture receipts lack permanence and sustainability. These unreliable sources of financing expenditures may for a while obscure the reality that the essential expenditures needed for Government to perform its basic functions effectively are becoming increasingly unsustainable by conventional revenues. And yet postponing the necessary policy reforms means even more painful adjustment later on.

### **3.1.3 Narrow vs. Broad Budget Balance**

Figure 3.3 shows trends in the narrow and broad fiscal balance since 1990. The narrow balance (the standard measure used in the Budget Statement) inclusive of grants and divestiture receipts moved into surplus in 1994 and 1995 after the deficits of the

previous two years. When adjustment is, however, made for the unexplained  $\text{¢}161$  billion of capital receipts, the 1995 surplus of 1.0 percent of GDP reverses into a deficit equivalent to 1.2 percent of GDP. The situation worsened in 1996 when the narrow balance registered a deficit equivalent to 3.8 percent of national income.

The broad Budget balance which includes capital expenditures (Development as well as Net Lending and Equity) financed with external project grants and loans, on the



other hand, has been in substantial deficits with a worsening of the situation since the Fourth Republic. Indications are that developments in 1996, in all likelihood, will be worse than the 1995 outcome.

The difference between the broad Budgetary balance and the narrow, the "off-Budget" balance, gives an indication of the size of foreign project grants and loans. It is therefore a barometer of aid-dependence. The dwindling of the aid pipeline and the importance of political perceptions and interests of the donor community as to the amount

of aid actually disbursed in any given year, show the dangers inherent in our present high dependence on aid.

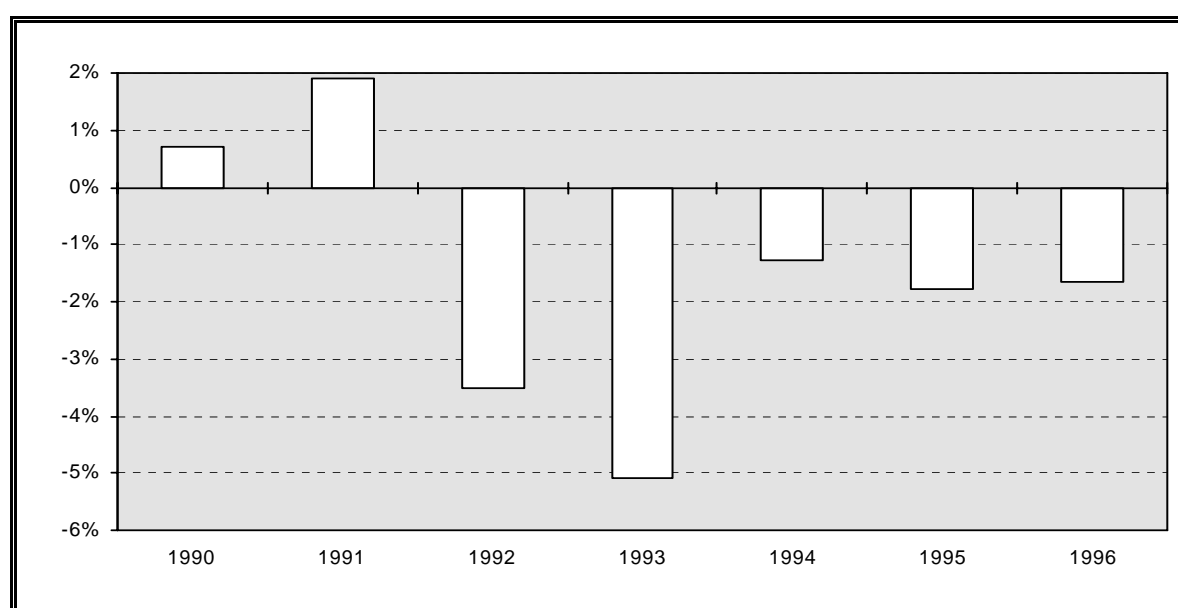
Focusing on the narrow budgetary balance to the exclusion of the broad concept obscures two important considerations. The first relates to the sustainability of the growth path in the medium-term and the second, to the crowding out of “own-financed” capital expenditures.

Project grants and loans typically fund only a portion of the expenditures on these projects. Counterpart domestic finance is therefore required. According to the Government of Ghana Public Expenditure Review (PER) for 1994, the annual budget circular calls on ministries, departments and agencies (MDAs) to provide fully for the matching-funds needed for donor-funded projects. Donor-funded projects are, therefore, assured of both local and foreign funding. This, however, has reportedly motivated MDAs to seek foreign support for the projects they are handling and/or accept project proposals from foreign financial institutions. In the event MDAs are losing the initiative and responsibility over projects despite their better knowledge of local conditions. In short aid-dependency is rising and priority over projects is, if anything, donor-driven. Nor is this all. The PER again pointed out that the mechanism put in place for assuring adequate and timely release of local funds failed, although obligations were met “as they fell due”.

In the competition for funds it is clear that the projects with external finance crowd out those without. For not only do the former have higher priority ranking than the latter, but also where the provision in the Budget is inadequate, the imperatives of our relationship with external aid agencies mean that obligations are met even if to the detriment of the latter projects.

### 3.1.4 Government Saving

Government savings was negative (a dissaving) ₵133 billion or 1.8 percent of GDP in 1995, compared to a dissaving of ₵170 billion or 1.6 percent of GDP in 1996. As Figure 3.4 shows Government savings has been in the red for the most part of the 1990s,



especially since the Fourth Republic. It may be worth pointing out that the period 1985-1991 had shown a welcome reversal of the high government dissaving of the 1972-1984 period – dissavings that were very high (averaging 5.3 percent of GDP in 1974-77 and 5.8 percent of GDP in the 1979-1982 period). Government savings add to the pool of investible resources. Government dissaving, on the other hand, creates two undesirable possibilities: either the Government out-competes and crowds out private investment, or the competition for investment funds spills over into the current account and balance of payments. The re-emergence of large Government dissaving in the Fourth Republic, indicative of the marked deterioration in the Government's finances, is consequently a matter of great national concern.

### 3.2 Revenues

Government revenues consist of tax and non-tax receipts. Tax collections can be classified as “structural” sources of current revenue. Non-tax receipts, whose origin is mainly of a capital nature, tend to be fairly irregular and unsustainable, and therefore cannot be relied upon for planning purposes.

Tax collection in Ghana is administered by two main agencies -- the Internal Revenue Service (IRS) which has responsibility for direct taxes, and the Customs, Excise and Preventive Service (CEPS) which collects indirect taxes (including taxes on petroleum products) and all import-related tariffs. The cocoa sector is currently the sole generator of export taxes which COCOBOD pays directly into the Government’s account with the Bank of Ghana.

These various forms of Government tax revenues are complemented by non-tax receipts from divestiture proceeds (including from the Non-Performing Assets Recovery Trust – NPART), foreign grants, and Income and Fees (which consist of profits of various state enterprises, interest, dividends as well as fees and levies for the delivery of Government services).

CEPA’s revenue projection of  $\text{¢}2133$  billion for 1996 differed from the Government’s estimate of  $\text{¢}2328$  billion principally in the Income and Fees category where the Government’s projection was about  $\text{¢}215$  billion above CEPA’s estimate. There were also minor differences due to different exchange rate assumptions.

<b>Table 3.3: Central Government Revenue (in billion cedis)</b>
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	1990	1991	1992	1993	1994	1995	1996
<b>TAX REVENUE</b>	<b>219.7</b>	<b>319.5</b>	<b>301.8</b>	<b>509.2</b>	<b>826.4</b>	<b>1138.5</b>	<b>1736.5</b>
<b>IRS Collections</b>	<b>55.1</b>	<b>62.4</b>	<b>62.1</b>	<b>110.3</b>	<b>170.5</b>	<b>275.0</b>	<b>457.4</b>
Personal Inc.(PAYE)	10.8	11.7	15.7	37.0	52.0	71.7	118.4
Company	34.0	39.9	34.5	54.3	89.1	147.1	251.8
Self-Employed	6.6	7.0	5.4	7.3	11.1	16.5	22.6
Other (incl. rent)	3.7	3.8	6.5	11.7	18.2	39.7	64.7
<b>CEPS Collections</b>	<b>137.4</b>	<b>220.9</b>	<b>219.4</b>	<b>363.1</b>	<b>522.7</b>	<b>706.3</b>	<b>1001.4</b>
Domestic Gds.& Serv.	71.7	137.9	128.8	222.9	309.0	363.6	576.8
<i>Excise Duty</i>	22.9	29.6	31.0	39.7	57.5	69.9	123.5
<i>Sales Tax</i>	23.4	29.5	27.5	31.2	49.8	69.6	170.5
<i>Petroleum</i>	25.4	78.8	70.3	151.9	201.7	224.0	282.8
Import Duties & Taxes	65.6	83.0	90.6	140.2	213.7	342.8	424.6
Cocoa Export Tax	27.2	36.2	20.4	35.7	133.2	157.2	277.7
<b>NON-TAX RECEIPTS</b>	<b>47.6</b>	<b>71.2</b>	<b>64.4</b>	<b>215.1</b>	<b>434.9</b>	<b>484.7</b>	<b>439.9</b>
Foreign Grants	27.8	36.3	32.7	66.6	39.5	93.8	140.1
Incomes & Fees	19.6	30.2	25.7	62.7	122.1	279.1	119.6
Divestiture & NPART	0.3	4.8	6.0	85.8	273.3	111.8	180.2
<b>TOTAL REVENUE</b>	<b>267.3</b>	<b>390.6</b>	<b>366.3</b>	<b>724.2</b>	<b>1261.3</b>	<b>1623.2</b>	<b>2176.4</b>
<b>Total Revenue as %GDP</b>	<b>13.9%</b>	<b>16.1%</b>	<b>13.1%</b>	<b>19.7%</b>	<b>25.5%</b>	<b>21.9%</b>	<b>21.0%</b>
<i>Sources: Bank of Ghana, Controller and Accountant General's Department, and CEPA Staff estimates</i>							

Table 3.3 shows the trend in Government revenue since 1990. Prior to the

Fourth Republic revenue mobilisation averaged about 14.4 percent of GDP. Improved collection efforts, as well as increases in tax rates, a widening of the tax base and receipts from the divestiture program improved the revenue/GDP ratio in the post-1992 era to almost 22 percent. Total Government receipts – tax and non-tax (including grants and divestiture) – amounted to ₵2176 billion in 1996, equivalent to 21 percent of GDP. This is about ₵152 billion or 6.5 percent less than the Government had expected in its annual Budget Statement although it is some ₵43 billion or 2 percent more than CEPA's original projection.

Total collection of taxes by the IRS for the 1996 fiscal year amounted to nearly ₵457 billion – 2 percent higher than CEPA's original position. A favourable outcome in PAYE and miscellaneous IRS taxes more than made up for shortfalls in company taxes.

Collections by CEPS amounted to ₵1000 billion compared to a CEPA projection of ₵967 billion. Taxes on domestic goods and services collected exceeded targets despite a 6 percent shortfall (the subsidy) in the collection of petroleum taxes. CEPA's Third Quarterly had projected an improved collection of import duties based on an 11 percent fourth quarter increase over the third quarter in the dutiable c.i.f.-valued import base. The provisional out-turn implies both a lower growth in the dutiable c.i.f.-valued import base and a lower effective import duty rate in the closing quarter of the year. The realised ₵425 billion in import duties and taxes was consequently 6.4 percent below the projected ₵454 billion. This import duty shortfall was, however, more than compensated for by sales taxes and excise duties resulting in CEPS exceeding its overall revenue target by 3.4 percent.

Non-tax receipts performed poorly against even the “pessimistic” CEPA projection. Data from the Controller and Account General's department indicate that only 42 percent of CEPA's estimated ₵170 billion income and fees was realised. The latest

information published by the Bank of Ghana indicates a more favourable collection of ₵120 billion. On the basis of the data from the Bank of Ghana and the Account General, CEPA has taken, for final estimate, the Bank of Ghana out-turn of ₵120 billion for Income and Fees. This is nonetheless 30 percent less than its own original projection and less than a third of the Budget estimate. The official provisional out-turn of ₵219 billion presented with the 1997 Budget is, however, nearly double this final estimate.

### **3.3 Expenditures**

In the Annual Report for 1996 CEPA pointed out that the Government's projected expenditure for the fiscal year was too low given the inflationary environment and the increased propensities for spending in an election year. Among other things, CEPA strongly felt that public pressure on the Government to prevent real expenditure cutbacks was likely to be reflected in increases in most components of non-debt recurrent expenditures well in excess of the 20 percent increases projected by the Government. It was also the view of CEPA that pressures from policy advisors and the donor community to maintain positive real interest rates would result in more than the 42 percent increase in interest payments on the domestic debt assumed by the Government. Furthermore, CEPA rationalised that the politics of an election year was more likely to result in an increase in development spending of at least double the 24 percent growth projected by the Government.

Payments data for major expenditure categories are shown in Table 3.4. Whereas expenditures consumed an average of 15.5 percent of GDP between 1990 and 1992, the corresponding share for the 1993-96 period soared to an average of 23.5 percent. Expenditures have risen faster than nominal GDP outstripping revenues. Unsustainable non-tax receipts have become increasingly important sources of financing expenditures. Meanwhile large deficits have led to the emergence of rising national indebtedness and distressing debt service obligations.

CEPA originally projected Government expenditures of ¢2504 billion for the 1996 fiscal year. On the basis of public finance data from the Bank of Ghana and the Accountant General, CEPA has estimated total payments for 1996 at ¢2572 billion. Higher than expected outlays in the fourth quarter in the categories of Development and Items 2-5 expenditures explain the differences.

	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
<b>RECURRENT EXPENDITURE</b>	<b>206.2</b>	<b>273.0</b>	<b>400.4</b>	<b>695.7</b>	<b>890.0</b>	<b>1271.2</b>	<b>1906.8</b>
<b>Non-Debt</b>	<b>178.9</b>	<b>230.2</b>	<b>339.4</b>	<b>560.9</b>	<b>659.8</b>	<b>942.4</b>	<b>1327.4</b>
Personal Emoluments	82.3	105.6	171.1	227.6	297.1	431.0	599.6
Items 2-5 *	42.7	55.5	67.1	141.4	133.0	161.9	324.8
Subventions	26.9	33.6	47.3	139.9	94.8	135.0	211.0
Transfers	27.0	35.5	53.9	52.0	134.9	214.5	192.0
<i>Pensions &amp; Gratuities</i>	12.2	15.0	14.5	0.0	41.7	86.7	105.7
<i>Social Security</i>	6.8	11.2	10.1	0.0	36.5	47.6	55.2
<i>Special Efficiency</i>	8.0	9.3	27.1	50.8	51.0	50.9	21.4
<i>Other</i>	0.0	0.0	2.1	1.2	5.6	29.3	9.7
<b>Interest Payments</b>	<b>27.3</b>	<b>42.8</b>	<b>61.0</b>	<b>134.8</b>	<b>230.1</b>	<b>328.8</b>	<b>579.4</b>
Domestic	17.5	29.6	34.9	94.3	166.4	232.9	434.5
External	9.8	13.2	26.1	40.4	63.7	95.8	144.9
<b>CAPITAL EXPENDITURE</b>	<b>57.8</b>	<b>78.6</b>	<b>110.4</b>	<b>127.3</b>	<b>259.6</b>	<b>443.1</b>	<b>665.5</b>
Development	48.3	67.2	98.4	119.3	165.6	322.5	435.4

Net Lending	9.5	11.4	12.0	8.0	8.3	15.8	93.0
Other (D.A.C.F. & Arrears)	0.0	0.0	0.0	0.0	85.7	104.8	137.1
<b>TOTAL EXPENDITURE</b>	<b>264.0</b>	<b>351.6</b>	<b>510.8</b>	<b>822.9</b>	<b>1149.6</b>	<b>1714.3</b>	<b>2572.3</b>
<b>Total Expenditure as %GDP</b>	<b>13.7%</b>	<b>14.5%</b>	<b>18.2%</b>	<b>22.4%</b>	<b>23.2%</b>	<b>23.1%</b>	<b>24.8%</b>
* Includes Special Outlays							
Sources: Bank of Ghana, Controller and Accountant General's Department, and CEPA Staff estimates							

Non-debt recurrent expenditures amounted to ₵1327 billion, or about 3 percent lower than CEPA had projected. In the projection CEPA had assumed an increase of 50 percent for most categories of recurrent expenditures. The results indicate that with the exception of Items 2-5 payments, the realised out-turn fell below their respective projected levels. For example, the public sector wage bill increased by 40 percent, compared to the 50 percent projected by CEPA. It must be pointed out that the 40 percent increase was higher than the programmed 30 percent in the Budget estimates approved by Parliament.

Payments of Items 2-5 expenditures on the other hand exceeded the projection by about 34 percent. The very nature of these types of expenditures – traveling and transport expenditures; maintenance expenditures; food subsidies (on students in boarding institutions, in the security agencies, on inpatients in hospitals and on inmates in prisons); and expenditures on furniture, fixtures and refurbishments – makes monitoring and control extremely difficult, especially in an election year.

The out-turn for the other categories of non-debt recurrent expenditure showed lower payments than projected. Disbursements to subvented organisations showed a significant and inexplicable slow down during the fourth quarter. For these

categories of expenditure, the possibility of accumulation of payment arrears cannot be ruled out. Regarding social security payments, the effective employers' social security contributions to SSNIT amounted to only 9.2 percent compared to the statutory 12.5 percent. Clearly substantial transfer arrears are owed to SSNIT.

Debt-related recurrent expenditures exceeded the CEPA projection by almost 7 percent. The continued recourse by the Government to extensive borrowing as well as the general rise in interest rates accounted for the domestic component of interest payments well above the CEPA projection. In the event, actual payments were 30 percent above the provision in the Government budgetary estimates.

Capital expenditure outlays in fiscal 1996 were about 10 percent above the CEPA estimate for the year. The 1996 out-turn also confirmed the assessment made by CEPA that the provision for Development expenditure in the Government Budget was unrealistic. The realized payment of was higher than the Budget estimate. Another capital expenditure category which proved particularly difficult to contain in an election year was Net lending and Equity. Disbursements amounted to  $\text{¢}93$  billion compared to a programmed  $\text{¢}19$  billion. An unusually large loan was made to a private organization to pay for imports for its members. New loans extended by the Government in 1996 amounted to  $\text{¢}118$  billion, compared to recoveries of only  $\text{¢}25$  billion.

The final capital expenditure category is transfers to the District Assemblies Common Fund (DACF). The statutory amount of the transfer, based on 5 percent of realised tax revenues, should have been about  $\text{¢}86$  billion. The actual amount transferred was short by about  $\text{¢}10$  billion which, strictly considered, constitutes payment arrears into the DACF.

## **4. REVIEW OF MONEY, CREDIT AND BANKING**

### **4.0 Introduction**

1996 began as a year of potential economic turbulence with inflation registering the highest rates in the ERP period and output growth for a second consecutive year being less than 5 percent. The fear of a poor economic out-turn for the year was worsened by the fact that it was an election year with a strong potential for fiscal excesses. CEPA and other concerned observers of the Ghanaian economic scene cautioned about the potential dangers posed by fiscal recklessness and its attendant monetary accommodation. CEPA warned that unless a conscious attempt was made at maintaining the proprieties of macroeconomic stability the country would be heading for economic difficulties which would negate the earlier gains of the ERP. Under such a scenario, not only was Government supposed to maintain strong fiscal discipline, but also the monetary authorities were to chart policies that would ensure that the macroeconomic fundamentals were kept in place.

In the following sub-sections of this chapter we will review developments in money, credit and banking, and evaluate the impact of monetary policy on the economy. Sections 4.1 and 4.2 are devoted to monetary management. Section 4.3 discusses price developments, while interest rate developments and how they impact on the money and capital markets is taken-up in the last sections.

### **4.1 Monetary Management**

The main objective of Government economic policy in 1996 was to “prevent a further deterioration in the economy..., reduce inflation to tolerable levels and prevent further ... depreciation of the cedi and to set the stage for accelerated growth”. To this end both fiscal and monetary policies were to focus on the enhancement of growth in output, creation of employment, and stabilization of domestic prices and the exchange rate.

Although monetary policy was supposed to work in consonance with fiscal policy to achieve all these objectives, operationally it concentrates more on the stabilization of prices.

Since the beginning of the 1990s, Ghana has liberalized the financial system by removal of direct controls on interest rates, removal of credit ceilings, and the adoption of market based instruments for controlling the stock of money in the economy. The instruments available now for controlling money supply include Open Market Operations (OMO), Foreign Exchange Market Operations (FEMO), and cash and liquid asset reserve requirements. In addition the new capital adequacy requirement of 6 percent places enormous control on the investment behaviour of the banks.

<b>Table 4.1: Average Interest Rate Movements (in percent p.a.)</b>						
	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
Bank Rate	31.8	19.4	34.2	30.8	41.5	45.0
T-Bill Discount Rate (91-Day)	27.7	22.6	31.1	27.7	35.9	41.3
Savings Deposits	18.3	18.0	17.9	17.9	21.9	31.8
Demand Deposits	6.0	4.8	6.1	7.5	11.3	7.5
<i>Lending Rates on selected sectors of the economy</i>						
Agric, Fishing and Forestry	28.5	23.5	28.9	27.8	33.3	38.6
Export Trade	29.2	22.9	28.2	27.3	32.3	39.6
Manufacturing	29.6	24.0	29.5	29.9	34.4	41.5
Others	29.9	24.8	30.9	31.6	37.1	42.9

Source: Bank of Ghana.

The Open Market Operations involves mainly trading in Bank of Ghana bills. The Open Market Committee meets once a week and examines data on monetary aggregates and important macroeconomic variables. From this examination, monthly and then weekly targets for monetary variables (Reserve Money and M2) are obtained, which in turn determine the amount of securities to be offered at the weekly auction. Participants at the auction are the banks. "Successful" bidders at the auction make their purchases at the rates they bid. Unsold securities are offered for sale through the discount houses during the week at a weighted average of the successful bid rates at the auction. The market is not allowed to clear at the auction. This implies that, while the central bank gives the impression that it is operating an indirect monetary policy, by 'managing' the auction, it in fact targets interest rates.

One dilemma facing Ghanaian policy-makers and researchers alike is how to manage interest rates in the economy. Strictly speaking, economic policy precludes fixing both the stock of money and interest rates at the same time: it is not possible to fix both quantity and price at the same time. Thus since, in principle, the policy of financial liberalization presumes the treatment of money as the anchor, interest rates must float 'freely' to determine the stock of financial assets. Unfortunately, because of weaknesses/imbances in the macroeconomy, allowing a free float of the rate of interest can result in rates being so high as to cripple the real sector. Thus, the current situation of high inflationary rates undermines the liberal financial regime. At the same time, restraining interest rate rises will put extra depreciating pressure on the exchange rate, failing which there will be loss of foreign reserves. We wish to suggest that a lot more effort should be made to bring the rate of inflation down so as to allow the monetary authorities to run a credible monetary policy.

Although not intended for the purpose of monetary management, trading in Government Treasury bills also influences interest rates. Until 1996 OMO dealings were only in Bank of Ghana bills. The Banks at that time were allowed to deal in only Bank of Ghana bills. Strictly speaking, there is no difference between the Bank of Ghana and the Treasury bills since they each carry similar terms and yields. Higher than programmed deficits force Government to sell more Treasury bills to meet increased PSBR, and hence cause interest rates to rise.

In 1996, there was a deliberate attempt to phase out the Bank of Ghana bills, which until then had been used solely for monetary management purposes. This phasing out marked the return to a more accommodating monetary policy. Thus, in the course of the year, about ₵138.5 billion of Bank of Ghana bills was liquidated. Correspondingly, the Deposit Money Banks (DMBs) increased their holdings of Treasury bills by about ₵68.8 billion. During the year, non-bank holdings of Treasury bills also increased by ₵370.7 billion.

For 1996, monetary management could not contain growth in money within the specified target. In the first half of the year, the Bank successfully lowered the stock of reserve money, but ended up with a half year growth in money of over 12 percent. It appeared that sensing it was not enough to keep the cap on reserve money, the central bank felt pressured to apply even more stringent monetary measures to factors affecting the money multiplier. In August, the Bank of Ghana doubled the cash reserve ratio from 5 to 10 percent. This doubling of the mandatory primary reserve requirement forced some banks to liquidate some investments. There was no evidence that any bank felt pressured to call in loans. However, soon after the change in the cash reserve ratio, the banks also increased their rates on advances to hedge against any losses. Thus, by its action the central bank had a double squeeze on the money supply: first was through a squeeze on the multiplier, and the second was a credit squeeze accompanying the hike in interest

rates.

In the second half of the year, reserve money started rising again in response to Government financing pressures accommodated through Bank of Ghana repurchases of OMO securities (the beginning of the phase-out of the Bank of Ghana bills). By December 1996, the stock of Reserve Money had increased by about 45 percent increase over its 1995 level. Deposits of the banks at the central bank increased more than four-fold. The rest of the change in Reserve Money was in increased holding of currency by the non-bank

The Open Market Operations (OMO) is one of the important indirect monetary instruments at the disposal of the Central Bank. It is used at the initiative of the monetary authority to influence the cost and availability of bank reserves and hence the amount of money in the country, and, at the margin, credit flows. It is generally conducted in suitably designated securities. A large and active market is essential if the Central Bank is able to effect transactions at its own initiative when and in the size required to meet its day-to-day objectives.

public.

There is no necessary relation between OMO and the financing of budgetary deficits. OMO is to meet money supply and overall economic policy objectives. They are not increased because of widened fiscal deficits nor contracted because of a decreased deficit. The Government must meet its financing needs by attracting investors in the bills/bonds market (secondary market), paying whatever market rate is necessary. A larger OMO can arise on the occasion of higher deficit by way of mopping up excess liquidity but that assumes prior central bank accommodation, i.e. inflationary financing.

Until sometime in 1996, Bank of Ghana bills were designated for the OMO while Treasury bill sales were used more to meet Public Sector Borrowing Requirement (PSBR). This distinction was helpful in allowing for easy monitoring of any accommodation by the central bank. Bank of Ghana bills are no more. Treasury bills are now used for both open market operations and for meeting the public sector borrowing requirements. Technically, there is no problem with this; but to ensure that there is no over- accommodation by the Bank of Ghana,

- there should be no overdraft facility for Government.
- the central bank must not buy any Treasury bills on its own account - whether new issues or old stock. If it did so, it will be monetizing the debt.
- monetary accommodation should not be disguised in other instruments such as stocks and bonds.

From the foregoing, it seems the Bank of Ghana has no clear answer to the problem of monetary control. So long as structural fiscal deficits persist in the system, it appears no amount of independence - operational or otherwise, can give the Bank of Ghana the capacity or willingness stop accommodating fiscal excesses. With limited revenues and ever growing expenditures, the Budget appears destined to show deficits which have to be financed by the printing of money. Thus, the solution to the monetary problem must include finding the revenues to cover the ever increasing expenditures. By this, CEPA is not endorsing over-expenditure by government. This is rather to emphasize that in the present circumstances, monetary control is well-nigh impossible as long as the

public sector deficit persists. One possible solution which will, in the medium- to long-run increase revenues will be to switch expenditures from less productive sectors to projects with high output elasticities, which could mean faster divestiture and privatization.

#### 4.2 Developments in Money

Table 4.2 presents developments in money and the sources of such developments. In 1996, money supply increased by about ₵455 billion representing a growth rate of about 34.2 percent. Much of the expansion was in narrow money, particularly currency held outside the banking system. In terms of growth rates, however, holdings in time deposit grew the fastest (51 percent) in apparent response to increases in real interest rates. Nevertheless, because of the shares of currency and demand deposits in broad money, their contribution to the growth in broad money was more dominant. With a share of 41 percent in broad money, currency grew at the rate of 33 percent implying a contribution of 13 percentage points to the 34 percent growth in broad money. Demand deposits grew at just about 30 percent, thus making a contribution of 9 percentage points to the growth in broad money. The 41 per cent growth in quasi-money was the equivalent of 12 percentage points contribution to the growth in M2. The fact that a large proportion of broad money is held in the form cash constitutes a drain on financial intermediation and hinders the canalization of idle balances into productive resources. Further, the high concentration of financial assets in cash and demand deposits is evidence of financial shallowing. This high concentration of financial assets in more liquid forms may have been the consequence of the high rates of inflation persisting in the economy.

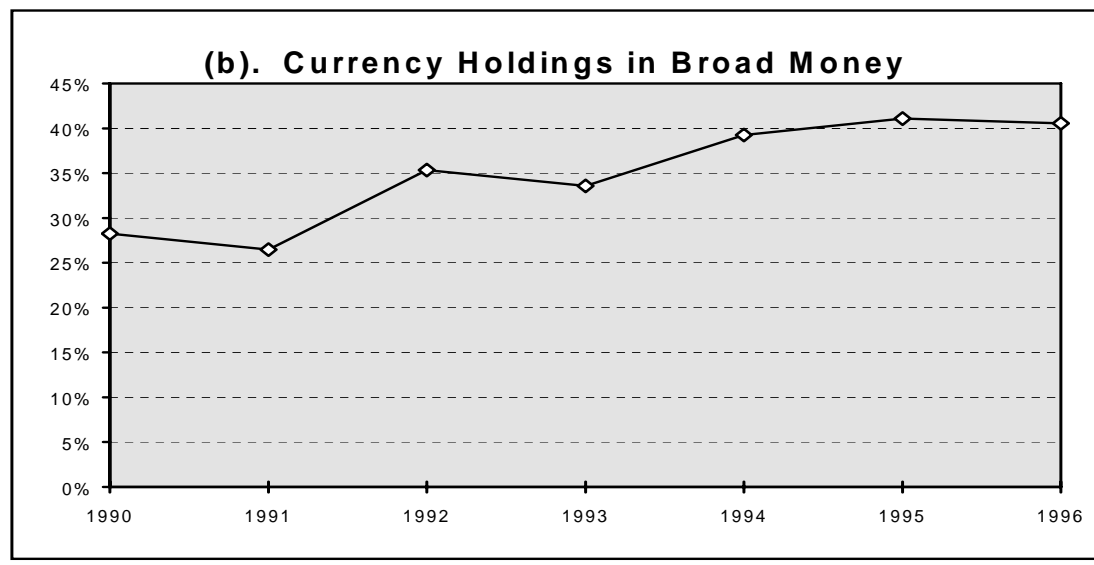
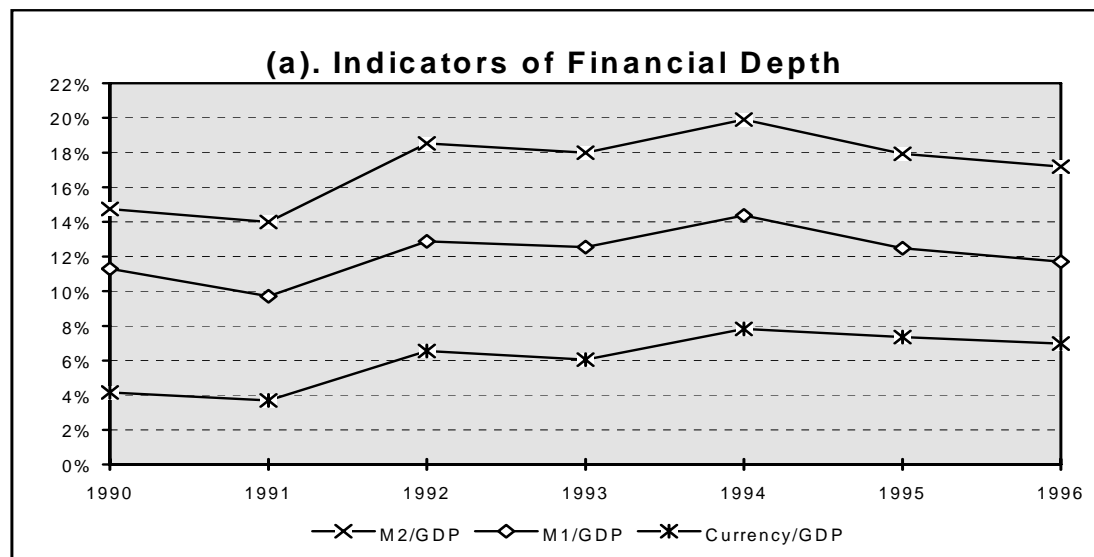
	1991	1992	1993	1994	1995	1996
<b>Narrow Money (M1)</b>	235.7	360.7	461.3	693.5	925.3	1215.1

Currency in circulation	89.9	183.5	222.2	368.8	546.3	724.0
Demand deposits	145.8	177.2	239.1	324.7	379.0	491.2
<b>Quasi Money (QM)</b>	103.9	158.7	200.2	273.8	404.3	569.7
Savings deposits	79.0	116.4	136.6	206.6	259.6	351.0
Time deposits	24.9	42.3	63.6	67.2	144.7	218.7
<b>Broad Money Supply (M2)</b>	<b>339.6</b>	<b>519.4</b>	<b>661.5</b>	<b>967.3</b>	<b>1329.6</b>	<b>1784.8</b>
<b>Net Foreign Assets</b>	-10.3	-108.8	-111.9	35.9	185.7	514.1
<b>Net Domestic Assets</b>	325.6	535.3	675.9	617.9	921.9	900.6
<i>Net Domestic Credit</i>	397.7	566.9	825.4	957.5	1425.2	1951.8
- central government	253.7	356.2	550.3	506.0	835.5	1061.6
- cocoa financing (net)	27.6	48.0	28.7	7.9	8.1	9.1
- other public sector	27.6	24.2	59.1	170.3	188.3	200.2
- private sector	88.8	138.5	187.3	273.3	393.3	680.9
<i>Other Items Net (OIN)</i>	-72.1	-31.6	-149.4	-339.6	-503.3	-1051.2
<b>Rev. Account (less SDR)</b>	24.3	92.8	97.6	313.5	221.9	370.1
<b>Total Assets</b>	<b>339.6</b>	<b>519.3</b>	<b>661.6</b>	<b>967.3</b>	<b>1329.5</b>	<b>1784.8</b>
<i>Source: Bank of Ghana Research Department</i>						

The excessive holding of money in form cash and demand deposits has also impacted negatively on the degree of monetization in the economy as measured by the ratio of broad money to gross domestic product (M2/GDP). From a level of about 15 percent in 1990, it rose to a peak of 20 percent in 1994, and has been on the decline since.

See Figure 4.1(a). By end-1996, the M2/GDP ratio had fallen to only 17 percent, well below the average for Africa. This again may have been the result of the high rates of inflation and associated negative real deposit rates in the country which caused people to hedge by converting their financial holdings into non-money holdings such as bonds and real estate. The evidence also points to increasing dollarization of the economy with foreign currency deposits rising markedly.

Data obtained from the Bank of Ghana's *Quarterly Economic Bulletin* (Oct.-Dec. 1996), shows that the major sources of change in the money supply were Net Domestic Credit (NDC) and Net Foreign Assets (NFA). Between December 1995 and December 1996, NDC expanded by 526.6 billion cedis. The main movers of the NDC were credit extended to both government and the private sector. Credit to the private sector in 1996 amounted to 287.6 billion cedis while that to government was 226.1 billion cedis. On the face of it, it appears therefore that credit to the private sector was the main push as far as increases in NDC were concerned. In fact, in the Government's 1997 Economic Policy Statement and Budget, the increase in the money supply of 34.2 percent was blamed mostly on private sector borrowing. It should be noted, however, that most of the borrowing by the private sector amounts to proxy borrowing by Government. Often, contractors working on State projects have had to prefinance these projects with credit obtained from the banking system. Thus instead of the Government borrowing directly from the banking system, private contractors do so on its behalf. This is buttressed by the fact that each year the Government carries substantial arrears into the following financial year. It must also be noted that the "credit to government" excludes whatever credit it obtained outside the banking system through the sale of Treasury bills, which could crowd out the private sector in non-bank financial markets.



The cedi value of the net foreign assets of the banking system (NFA) presented in Table 4.2 is inclusive of valuation changes (capital gains/losses) arising from the depreciation of the cedi. In order to obtain the monetary consequences of changes in the NFA, it is important to eliminate the revaluation gains/losses (Actually since the NFA is positive, depreciation implies capital gains in cedis).

To achieve our purpose, we obtain the dollar equivalent of the end 1995 NFA stock using the interbank rate of December 1995. Next, the US\$49.4 million loss of reserves by the banking system in 1996 is subtracted. The end 1996 stock thus obtained is converted back into cedis using the December 1996 interbank exchange rate. This result (¢139.6 billion) is the NFA for end 1996 (excluding revaluation gains). The revaluation gain itself is estimated as the difference between the end-December 1996 figure in table 4.2 and the re-estimated NFA (excluding revaluation). That is, the revaluation gain is (¢514.1- ¢139.6 = ¢374.5) billion. The appropriate adjustment is then made in the Other Items Net (OIN).

It is interesting to note that consolidating all the revaluation changes into OIN gives a rough estimate of the net sale of OMO bills to the non-bank public of ¢25.2 billion in 1996 (It may be recalled that in the first half of the year there was net reduction of Reserve Money on account of vigorous OMO (sales). In the second half year, however, there was a net reduction of 138.5 billion.

**Box 4.2 Demand Deposits and “Cheques in Transit”**

In an interesting development, demand deposits registered a drop of over 100 billion cedis in the month of December alone. This development, it appears, resulted from how “cheques in transit” are technically treated by the Bank of Ghana. This line item in the monetary survey represents the total value of cheques which are at the “clearing house” awaiting reconciliation. Since these cheques have corresponding entries in the demand deposit holdings of the commercial banks, the central bank knocks this off the demand deposits to avoid “double counting”. This treatment of the cheques in transit may be erroneous. In the first place the cheques in transit may cancel out since whatever is debited to one bank gets credited to another. Thus, the only way that a positive balance has to be netted out of the demand deposits will be when a particular transaction involves a bank which is not part of the Deposit Money Banks (DMBs) included in the monetary survey. Currently the DMBs include all banks except Cooperative Bank, Trust Bank, Metropolitan and Allied Bank, International Commercial Bank, First Atlantic Bank and Prudential Bank.

If, of the 160 billion cedis “cheques in transit”, we net out 60 billion cedis, consistent with established trends, as those involving dealings outside the DMBs, then it implies that 100 billion cedis more should be added to the demand deposit figure summing up to about 591 billion cedis. In that case, the growth in the stock of broad money for 1996 will be about 42 percent.

### **4.3 Price Trends**

Price developments in 1996 gave rather confusing signals of the economy's performance. On the one hand, there were clear signs of fiscal pressures in an election year coupled with monetary accommodation and a not too excellent harvest situation, and yet price developments were showing a declining inflationary trend. Inflation, which at the beginning of the year was at about 71 percent on a year-on-year basis was by the end of the year about 33 percent. The average rate of inflation also dropped from about 60 percent in 1995 to 47 percent in 1996. See Table 4.2. We have in several of our earlier reports given reason for the decline in the rates of inflation against predicted trends in

1996. We will only recap them here without further explanation, viz, good food inventory at the beginning of the year, the inability to follow through with the petrol deregulation during the course of the year, the frequent central bank interventions in the foreign exchange market, and a cooperative attitude from the labour front.

	Average Inflation			Year on Year Inflation		
	<i>Combine d</i>	<i>Food</i>	<i>Non- Food</i>	<i>Combine d</i>	<i>Food</i>	<i>Non- Food</i>
<b>1990</b>	37.2	40.3	35.0	35.9	32.0	38.1
<b>1991</b>	18.0	9.0	23.2	10.3	4.6	13.3
<b>1992</b>	10.1	10.4	9.9	13.3	17.0	11.5
<b>1993</b>	25.0	25.0	25.0	27.7	26.2	28.4
<b>1994</b>	24.9	25.9	24.4	34.2	40.2	31.2
<b>1995</b>	59.5	62.2	58.0	70.8	67.2	72.8
<b>1996</b>	46.6	35.8	52.3	32.7	20.8	38.8

*Source: Ghana Statistical Service, Accra.*

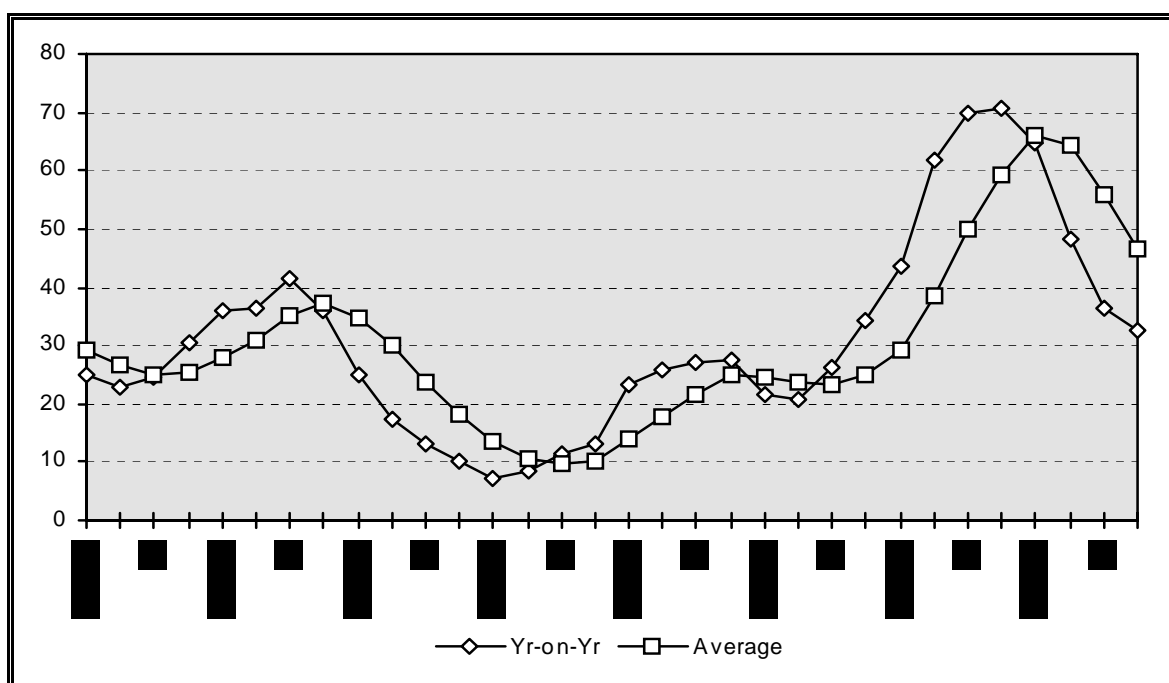
It is important to note that macroeconomic policy did not help much to bring down the level of inflation. A more conscious attempt must be made to ensure that the fundamentals of prudent macro behaviour are maintained. Specifically, serious attempts must be made to eliminate the fiscal deficits which are becoming structural, and thus

reduce the role of monetary policy to only keeping inflation within a small band around the 'underlying level'. Failing that, we cannot expect to bring inflation down. Muddling through, risks stagflation.

Recent econometric estimations at CEPA have confirmed that inflation in Ghana as in most other developing countries is strongly affected by changes in output and money, and to a lesser extent by exchange rate depreciation. Changes in interest rates do not seem to have a significant influence on the rate of inflation. When output is disaggregated into food and non-food, it was found that the former has more influence than the latter. This result is not surprising since food has a very large weight in the Consumer Price Index (CPI) used in computing the rates of inflation. In fact, the Ghana Living Standard Survey concludes that about two-thirds of the expenditure of the average Ghanaian is on food. It is in this light that we welcome the policy by Government of keeping food inventories after good harvests. Apart from ensuring that supply shortage pressures do not keep inflation high, the food inventories also ensure that a glut situation does not unduly depress prices. A well managed harvest will help reduce the level of the 'underlying inflation'.

The underlying inflation refers to the long-run level around which short-run variations in the rates of inflation can occur. In other words, ad hoc policy changes do not immediately alter the underlying inflation. However, consistent application of policy to alter the basic macro structure will in the long-run lead to an alteration of the underlying inflation. Preliminary econometric estimations at CEPA place the underlying inflation for Ghana at about 30 ( $\pm 5$ ) percent. This implies that for Ghana to be able to consistently keep inflation at levels below 25 percent, we must seriously work at the major factors that influence the long run inflation. In other words, a serious effort should be made at increasing the level of output in the economy consistent with the maintenance of a stable macroeconomic position.

Figure 4.2 shows average and year-on-year inflation since 1989. The first notable thing is the cyclical nature of the inflation, which effectively traces Ghana's business cycle to be of about three years duration. The second observable thing about the cycle is the height of the peaks. With an underlying inflation of around 30 percent, the peaks and troughs appear too drastic, still emphasizing the unstable nature of the macroeconomy. It is also possible that since the swings are so wide, policies tend to be



wrongly timed to effect changes in trends. Thus, a policy intended to lower inflation at a peak point tends to overshoot and take the economy momentarily into the trough. It will help if policies are more consistent at maintaining a stable equilibrium. This will avoid the wide swings and thus avoid the problem of overshooting.

Before we close the discussions on the price trends, we wish to point out another interesting technical observation from Figure 4.2. The year-on-year rates of

inflation can be interpreted as *marginal* rates of inflation. Thus, the relationship between the year-on-year and the average inflation rates follow the usual mathematical relation between *marginals* and *averages*. That is, when the *average* is rising, the *marginal* lies above it and when the *average* is falling the *marginal* lies below it; the two are equal only at the turning points of the *average*. The marginal always peaks or troughs before the average. It is important for clarity of public discussion of policy to be consistent in the choice of a measure of the rate of inflation. Since the average rate of inflation takes into account intervening price changes it would appear the more relevant decision variable for the consumer. Nevertheless, since most securities on the money market are redeemable at certain points in the time in the future, the year-on-year rates are more applicable as the relevant rate of inflation to take into account in such transactions.

#### **4.4 Developments on the Capital Market**

1996 was anticipated with mixed feelings by stock market watchers as the preceding year recorded a dismal 6.3 percent return. However, to boost market activities, managers of the stock market took several measures such as the abolition of 2 percent stamp duty previously charged on purchases by foreigners and the extension of the capital gains tax waiver period to the year 2000. 1996 was also a year of uncertainty particularly with the impending Presidential and Parliamentary elections. Thus investors' attention was focused more on the political stability of the country.

The year witnessed the listing of two companies and a Bond. The Ghana Commercial Bank was listed in the first quarter, while the listing of Aluworks Limited and the first Dollar-based bond were issued by the Home Finance Company in third quarter. This increased the number of listed companies from 18 at the end of 1995 to 20 and one listed bond by end 1996. The stock market recorded a moderate growth of 13.8 percent as at end December, 1996. Although the growth was higher than in 1995 it was no where

near the remarkable performances of 1993 and 1994. Volume of shares traded on the stock market was 35.8 million, valued at ¢27.9 billion compared to 55.8 million shares valued at ¢27 billion recorded for 1995. Average volume of shares traded per session was down to 232,143 from 369,792 in 1995 reflecting low levels of trading activities during the year (See Turnover ratios in Table 4.3).

	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
Volume Traded ( million)	0.2	1.8	2.0	37.9	93.0	55.8	35.7
Value Traded (¢ million)	64.4	104.8	173.4	3,177.9	73,088.2	27,085.3	27880.0
Av. Shares traded/session	18,500	17,900	20,650	379,455	715,674	369,792	232,143
Av. Shares offered/session	69,013	187,597	410,056	454,995	1,241,779	748,690	1,332,653
Av.. Shares bid/session	65,820	80,738	91,801	485,312	1,031,798	543,591	516,161
No. Of trading days	12	102	99	100	130	151	154
No. Of listed Companies	11	13	15	15	17	19	21
Mkt. Capitalization (¢ bn)	30.5	29.6	43.8	96.5	1,968.4	2,399.0	2,862.7
Capitalization Ratio (%)	1.6	1.2	1.6	2.6	4.2	3.8	4.4
Turnover Ratio (%)	0.2	0.4	0.4	3.3	3.7	1.1	1.0
GSE-All Share Index	70.3	64.5	62.2	132.9	298.1	316.9	360.7

GSE Returns (%)	--	(16.9)	(3.6)	113.7	124.3	6.3	13.8
Yr-on-Yr.Inflation (%)	37.2	18.0	10.1	25.0	24.9	70.8	32.7
<p><i>The capitalization ratio is computed as the market capitalization divided by GDP at current prices. The Turnover ratio is computed as the value of total shares traded divided by the total market capitalization.</i></p> <p><i>Source: Computed from Ghana Stock Exchange Data.</i></p>							

For the whole period, new foreign investors were not attracted to the stock market in spite of the waiver of the 2 percent stamp duty mainly because of the fact of 1996 being an election year as well as the continuous depreciation in the cedi. Domestic investors, were also attracted to the money market as interest yields on Treasury bills soared to 47.9 percent by December. Market capitalization was up by ¢443.7 billion from the 1995 value to ¢2,862.7 billion by end 1996. This could be largely attributed to the listing of GCB Limited which became the second highest contributor to the total market capitalization of the stock market.

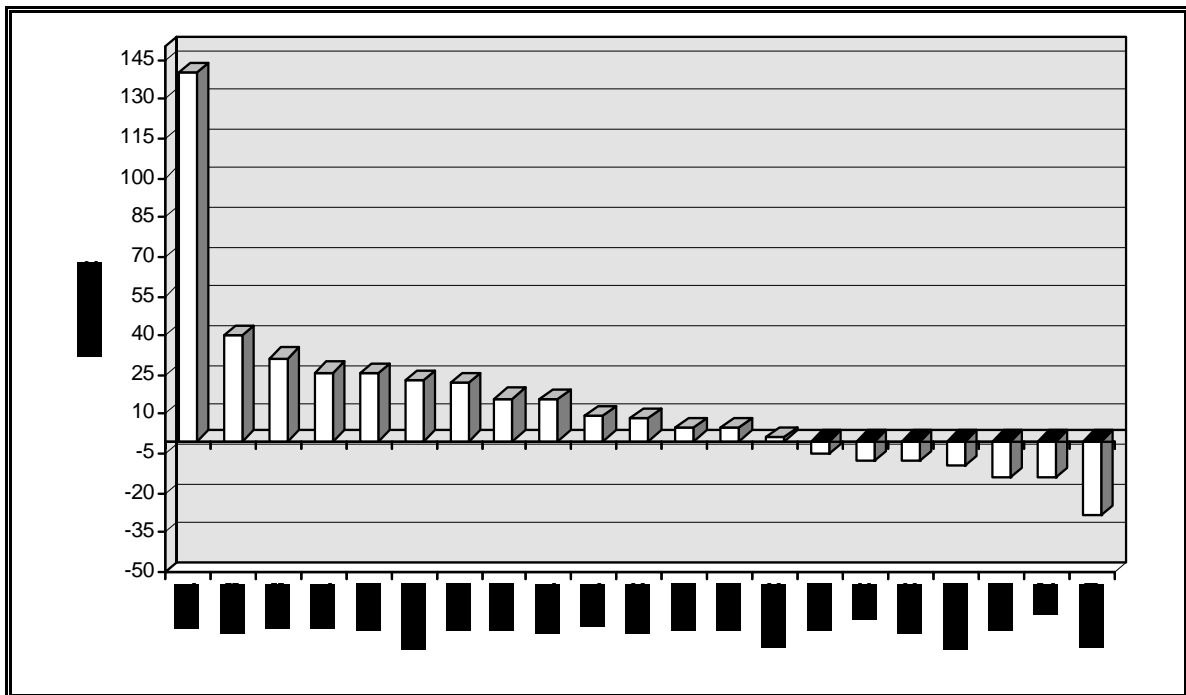
Even though the total return on the market was 14 percent and trading activity was moderate, listed companies on the market produced good earnings and most of them performed creditably as their share prices increased over the period. Out of the 21 listed companies, 6 experienced capital losses and one had no change in its share price. As depicted in Figure 4.3, Accra Brewery Ltd. came out as the best company performer for the year 1996 with a capital gain of 140 percent. ABL's performance was particularly boosted with institutional demand by local strategic investors in April causing the share price to increase rapidly by over 200 percent before falling back as the price earnings ratio of the company climbed to very high levels.

In the course of 1996, AGC acquired Cluff Resources plc and thus expanded its base in Ghana and Zimbabwe. The company was also listed on the New York Stock

Exchange (NYSE) and became the first African operating company to be listed on that market. In addition, the Government of Ghana sold 5.1 million of its shares in AGC on the international market through the London Stock Exchange (LSE) thus reducing the government share holding in the mining company to 22.4 percent. In spite of these impressive achievements, AGC, which holds the biggest share of the total market capitalization of the stock market plummeted from a capital gainer in 1995 to a loser in 1996. One major explanation given was the fall in gold prices on the world market during the year. Other losers on the stock market with strong company performances in the year were Standard Chartered Bank (Gh) Ltd. and Unilever (Gh) Ltd. Both companies had relatively low price-earnings ratios, 3 and 4 respectively.

Since its inception in late 1990, the number of listed companies on the stock market has increased on average by 2 new listings a year. The market capitalization ratio (excluding AGC) gradually increased over the years although it dropped slightly in 1995 and has averaged 2.8 percent over 1990-1996. (See Table 4.3). This implies that with additional listings and improved performance, the GSE has the potential to mobilize capital which could enhance economic growth in the country. High nominal yields in the bond market continue to be a major threat to the performance of the stock market. With the exception of 1993 and 1994, returns on the stock market have been way below the prevailing inflation rates in the economy. Investors have shown increasing interest in the bond market.

The prospects for an improved stock market performance are based on a relatively stable political climate, the level of economic variables such as the inflation rate, interest rates and the exchange rate in the country.



## 5. REVIEW OF TRADE AND PAYMENTS

### 5.0 Introduction

A review of exchange rate policy and market operations in 1996 shows ad hoc unsterilized interventions in the market based on the use of the exchange rate as a nominal anchor. While official policy implied a money-based stabilization programme, the practice was an exchange rate-based stabilization programme. Thus there was a major de facto change in policy from using the exchange rate to maintain the country's external competitiveness to using it as a nominal anchor against inflation. The result was a real appreciation in the exchange rate and a rundown of the country's external reserves to the point of increasing its vulnerability to external shocks (a possible balance of payments crisis in the event of failure to roll over two short-term loans - cocoa and oil loans).

Use of the exchange rate as a nominal anchor against inflation raises a number of issues. To be effective, it requires fiscal discipline. Specifically, to sustain a given rate of nominal depreciation requires a determinate level of the public sector's primary surplus. Failure to quickly adjust the fiscal position consistent with the chosen exchange rate path can create policy inconsistencies that can be disastrous. As indicated elsewhere in this report the tendency to run huge primary deficits over long periods is strong - an indication that, if the past is a dependable guide, an exchange-rate based stabilisation programme is unlikely to succeed.

Under a credible exchange rate anchor the transition to price stability is usually characterised by real exchange rate appreciation. The real appreciation affects traded goods negatively. In the case of importables, the increased competition and relatively cheaper imports can result in distress for domestic industry. This real exchange rate appreciation effect is often confused for the effects of trade liberalization. It is likely, therefore, that the public outcry against "excessive trade liberalization" may in fact be due to the confusion with the effects of appreciation in the real exchange rate.

The output effect of the disincentive created for the tradable goods' sector can be high. In using this policy strategy over the medium term, one has to worry about the sacrifice ratio - i.e., the cumulative loss of real GDP per unit of inflation reduction - and the possible deterioration in the current account. Empirical evidence suggests that slowing down the rate of depreciation in the present may precipitate a large depreciation in the future. Studies of a large number of countries show that real appreciations of 35 percent or more have been followed in all cases by large depreciations. Even in cases of moderate real appreciation, the probability of a large real depreciation following is high.

In 1996, interventions in the foreign exchange market were financed by running down reserves and by short-term external borrowing. In view of the negative effects of the real appreciation on tradables, these methods increase the country's external liabilities in circumstances when the ability to service the increased debt is most likely to deteriorate. The incipient balance of payments crisis can only be postponed by the ability to roll-over debts or through substantial private and public non-debt creating inflows. Holding on to the policy at increasingly high costs to the domestic economy is not sustainable and adjustments will have to be made. The costs of adjustment will be higher the longer the policy continues.

The empirical evidence on the success of exchange rate-based stabilization is mixed. Both the Argentine and Brazilian heterodox disinflation policies based on the exchange rate foundered on their inability to adjust the fiscal program to be consistent with the predetermined exchange rate. In both cases the costs to the domestic economy were very high. In Mexico, the experiment was abandoned. Israel's experience was somewhat more successful. The difference was in the ability to make the necessary fiscal adjustments and the move to '*flexibilization*' - i.e., adjustment of the exchange rate before real appreciation becomes excessive.

<b>Table 5.1 : Nominal, Real and Effective Exchange Rates</b>						
	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
<b>Nominal Exchange Rate (¢/US\$)</b>						
<i>Interbank Rate (End-Dec. Ave)</i>	388.1	498.3	799.5	1046.8	1430.0	1734.1
<i>Forex Bureaux Rate (End-Dec. Ave)</i>	399.0	541.0	816.5	1068.9	1519.2	1767.0
<b>Rates of Nominal Depreciation (%)</b>						
<i>Interbank Rate</i>	12.6	28.4	60.4	30.9	36.6	21.3
<i>Forex Bureaux Rate</i>	13.6	35.6	50.9	30.9	42.1	16.3
<b>Real Exch. Rate Indices (1990=100.0)</b>						
<i>CPI-Based Index 1/</i>	103.2	123.5	147.7	148.1	122.0	113.8
<i>Exporters' Cost-Based Index 2/</i>	79.5	98.5	112.3	123.6	101.3	76.8
<b>Rates of Real Appreciation (%) 3/</b>						
<i>CPI-Based</i>	-0.2	19.7	19.6	0.3	-17.6	-6.7
<i>Exporters' Cost-Based</i>	-8.1	23.9	14.0	10.1	-18.0	-24.2
<b>Spreads in the Foreign Exchange Markets</b>						
<i>Forex Rate as % of Interbank Rate</i>	2.8	8.6	2.1	2.1	6.2	1.9
<i>Forex Selling Rate as % of Buying Rate</i>	3.6	0.4	1.6	1.9	3.1	1.3
<b>Effective Tax Rates</b>						
<i>Imports</i>	0.152	0.095	0.121	0.105	0.191	0.139
<i>Exports</i>	0.087	0.037	0.057	0.098	0.124	0.279
<b>Real Effective Exch. Rate Indices (1990=100.0)</b>						

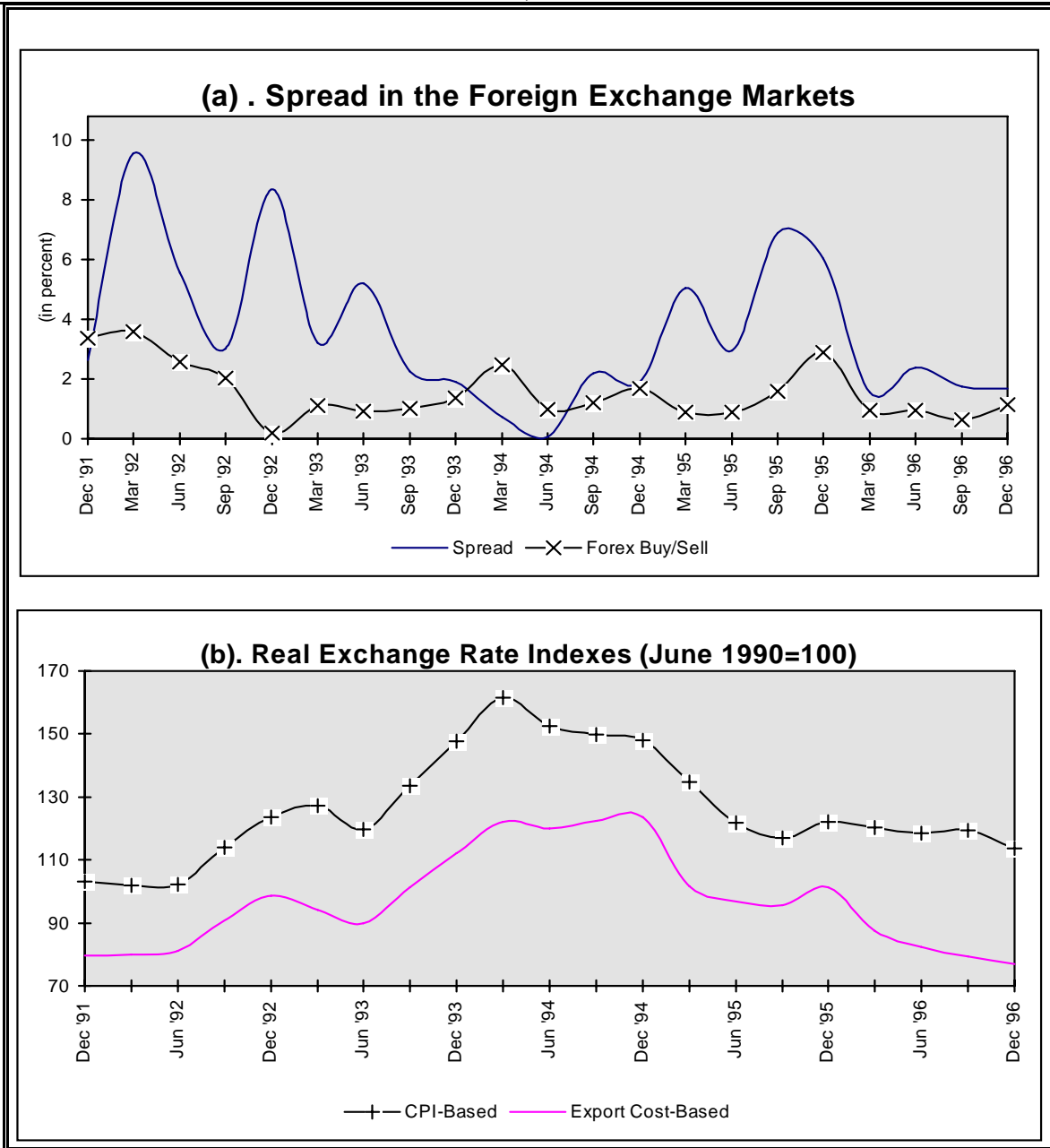
<i>Imports</i>	110.2	130.3	162.6	165.7	144.0	129.6
<i>Exports</i> 4/	84.8	98.2	114.5	128.4	103.8	78.5
<b>Anti-Export Bias</b> 5/	1.30	1.33	1.42	1.29	1.39	1.65
<p>Source : Computed from <i>Quarterly Economic Bulletin (BOG) and IMF data</i></p> <p>1/. Represents the rate at which goods and services are exchanged in the domestic economy and the rest of the world. It is computed by adjusting the nominal exchange rate differentials at home and abroad. A rise implies a real depreciation of the cedi.</p> <p>2/. This measure is the average of two of the sub-indexes that form the national CPI - 'gross rent, fuel and power' and 'transport and communications.'</p> <p>3/. A negative figure indicates a real appreciation of the cedi.</p> <p>4/. As most non-traditional exports depend on the forex bureaux for foreign exchange, we have employed the forex buying rate rather than the interbank rate in our computations. As measured, the real effective exchange rates take account of the effective tax rates.</p> <p>5/. Defined as the ratio of the effective exchange rate on imports to that of exports. Values greater than one indicate an anti-export bias.</p>						

### 5.1 The Foreign Exchange Market

In Table 5.1 and Figure 5.1 we report the effect of the exchange rate policy. As indicated in Table 5.1, the levels of intervention in 1996 implied a lower level of depreciation of the nominal exchange rate compared with both 1994 and 1995. In the interbank market, the nominal exchange rate depreciated by 21.3 percent compared with 30.9 percent and 36.6 percent in 1994 and 1995 respectively. The rate of nominal depreciation was even lower in the forex bureaux. The nominal exchange rate depreciated by only 16.3 percent in the forex bureaux market compared with 30.9 percent in 1994 and 42.1 percent in 1995. This contrasts with previous experience. Prior to 1993, the nominal depreciation in the forex bureaux market was consistently higher than in the interbank market.

In part, the faster depreciation in the interbank market reflects a technical correction for the considerable overvaluation of the currency in the interbank market due to its sheltered nature. The interbank market is accessible to only Depository Money Banks (DMBs). Other large non-bank financial institutions as well as established forex bureaux have no direct access to that market. Transactions in the interbank market are largely for trading businesses and official transfers. Consumer demand for travel, remittances, small scale imports, education, etc., are satisfied through the forex bureaux. While the spread between the two markets cannot be eliminated completely because of the different instruments of transactions and the associated risks, increased access by non-bank financial institutions could increase competition and reduce the fragmentation in the forex bureaux market. The relatively faster depreciation in the interbank market narrowed the spread between the two markets (See Panel (a) of Figure 5.1).

In view of the moderate nominal depreciation and the continuing high rates of inflation, the real exchange rate appreciated significantly for the second year in a row. As noted earlier, successful management of the exchange rate as a nominal anchor, *inter alia*, requires timely adjustment of the rate before real appreciation becomes excessive. This does not appear



to have been the policy position in 1996, with intervention pursued vigorously throughout the year. The only constraint being either the net foreign asset position of the monetary authorities or the flow of short-term external loans.

Thus, the real exchange rate appreciated by 24.2 percent using the exporters' costs index and by about 7 percent using the CPI-based index. In fact, the level of the real exchange rate in December 1996, using the exporters' costs index, was about the same as its level in December 1991. In comparison, using the CPI-based index, the real exchange rate for December 1996 stood at the level of December 1992 (See Panel (b) of Figure 5.1). The difference in the real exchange rate for the two indices reflected the much faster rate of increase in the price index components of transport, communications, and electricity and water, compared with the overall price level. In 1996, whereas the average rate of inflation was 46.6 percent, the rate of inflation for the transport and communication component was 97 percent. In 1995, the average rate of inflation was 59.5 percent while the average for transport and communications was 67 percent - a smaller difference but same pattern.

While both importables and exportables suffered a disincentive from the continuing real appreciation of the exchange rate, exportables were further discriminated against by the trade and payments policies. This is indicated by the increase in the anti-export bias from 1.3 in 1994 to 1.4 in 1995 and further to 1.7 in 1996 (see Table 5.1). This increasing anti-export bias is inconsistent with official development strategy of export-led growth. Clearly, a review of cocoa producer price policy is needed with a view to reducing taxation on this important sector. Over-taxation of the sector over the sixties and seventies almost destroyed the industry with the cessation of new planting and neglect of the tree stock.

## **5.2 The Balance of Payments**

In last year's annual report, CEPA pointed out that the government's fiscal stance was inconsistent with the balance of payments objective. The nation, as indicated in

that report, was relying on trade and exchange rate policies to achieve external balance in the face of expansionary fiscal and monetary policies. The policy instruments mix (in terms of external balance) in fact worsened in 1996 as the role of the exchange rate was switched to internal targets. Unlike previous years when the exchange rate was used as an instrument for international competitiveness and the external balance, in 1996 it was used to contain the inflationary consequences of fiscal indiscipline. Instead of an adjustment in the fiscal and monetary policy stance, the role of the exchange rate was changed. This would be understandable if the emerging balance of payments difficulties were considered to be temporary. Such a perception could have implied that what was required was financing and not adjustment. Financing in the circumstances, however, implied a rundown of the country's external reserves. It also implied a substantial increase in short-term borrowing on cocoa and oil accounts.

The consequences of this perception and the resulting policy mix, as discussed in the previous section, was an appreciation in the real exchange rate. An appreciating real exchange rate combined with expansionary fiscal and monetary policies, sooner or later, were bound to have adverse effects on the balance of payments. Partly as a result, the balance of payments situation in 1996 was much worse than CEPA had feared (CEPA had projected a smaller surplus than Government) and compared unfavourably with both 1994 and 1995 even after due allowance for the rise in consumption expenditures of an election year.

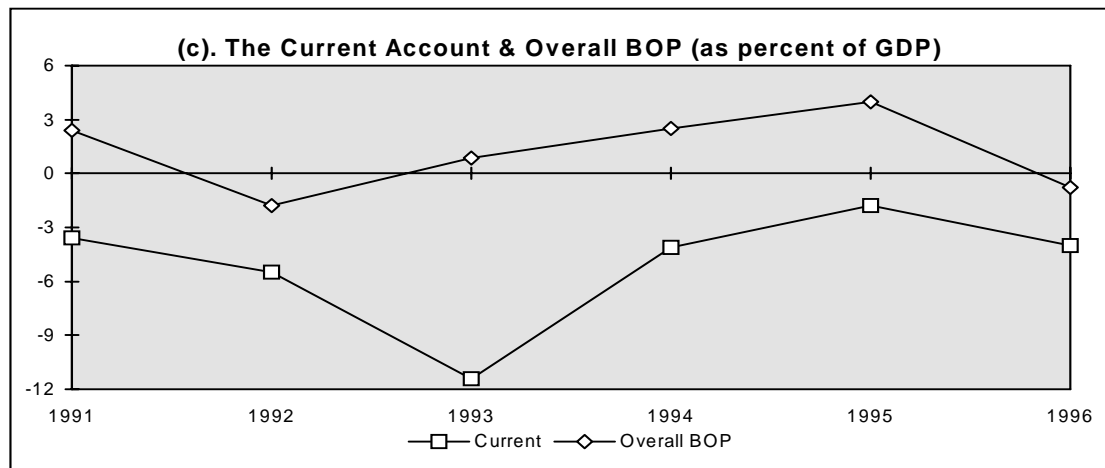
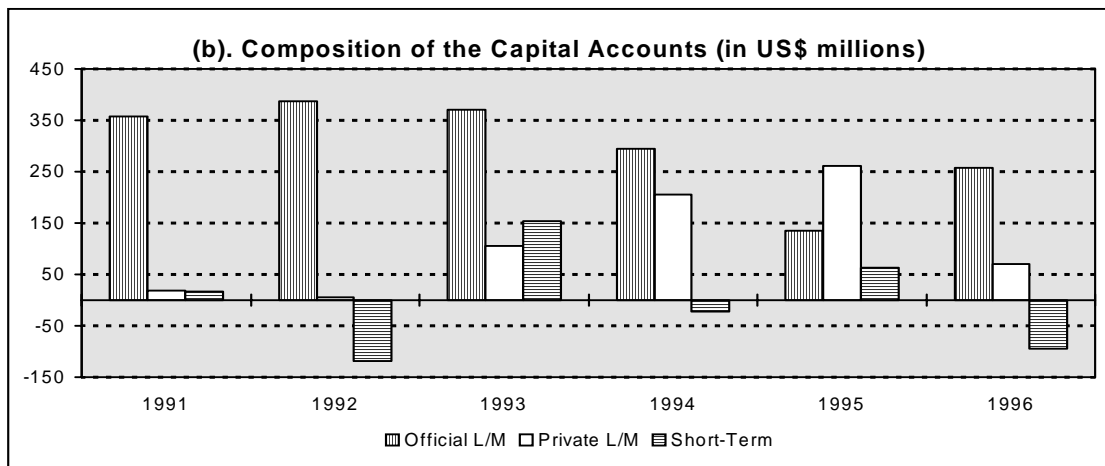
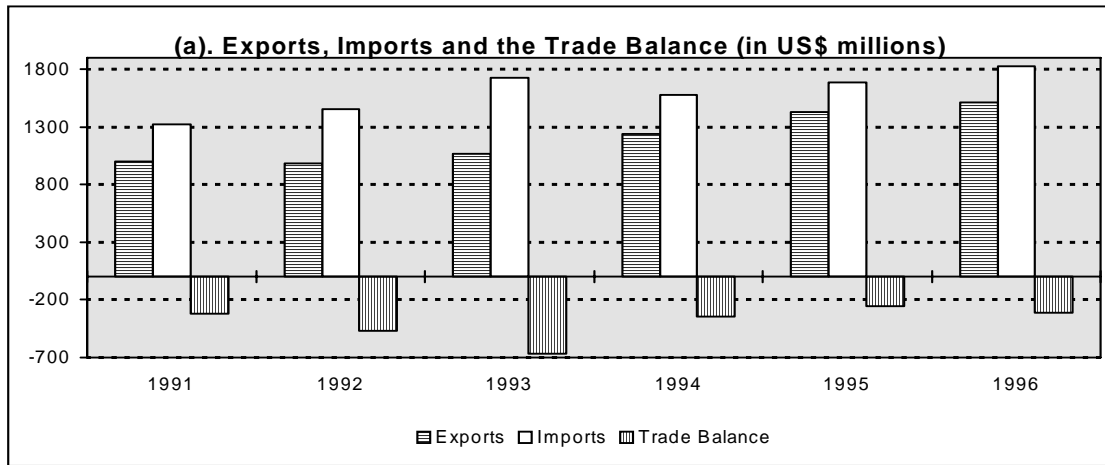
The deficit in the trade balance increased by 22 percent from US\$256.6 million in 1995 to US\$312.8 million in 1996. This was the result of substantial growth in imports and a sluggish export performance. In spite of a twenty-year high in the volume of cocoa exports and a resulting 30.6 percent increase in value, total export earnings increased by only 5.5 percent for the year. This was because timber exports declined by about 26 percent and gold by 5.4 percent. Imports on the other hand, driven by oil, grew by

8 percent. In terms of GDP, the trade deficit increased from 3.8 percent of GDP in 1995 to 4.9 percent in 1996.

	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
<b>Merchandise Exports</b>	<b>997.7</b>	<b>986.3</b>	<b>1063.6</b>	<b>1237.7</b>	<b>1431.2</b>	<b>1510.2</b>
Gold	304.4	343.4	434.0	548.6	647.3	612.4
Cocoa	346.6	302.5	285.9	320.2	389.5	508.6
Timber	124.2	113.9	147.4	165.4	190.6	141.3
Others	222.4	226.6	196.4	203.5	203.9	247.9
<b>Imports</b>	<b>1318.7</b>	<b>1456.5</b>	<b>1728.0</b>	<b>1579.9</b>	<b>1687.8</b>	<b>1823.0</b>
Non-Oil	1153.6	1299	1574.4	1408.8	1496.8	1563.9
Oil	165.1	157.5	153.6	171.1	191	259.1
<b>Trade Balance</b>	<b>-321.0</b>	<b>-470.3</b>	<b>-664.4</b>	<b>-342.2</b>	<b>-256.6</b>	<b>-312.8</b>
Services (net)	-352.5	-376.2	-412.0	-383.5	-410.3	-421.6
Private Transfers (net)	219.5	254.9	261.2	271.0	263.2	276.1
<b>Current Acc. Balance (CAB)</b>	<b>-454.0</b>	<b>-591.6</b>	<b>-815.2</b>	<b>-454.7</b>	<b>-403.7</b>	<b>-458.3</b>
Official transfers (net)	202.4	215.3	256.2	200.8	260.0	205.6
<b>CAB (incl. official transfers)</b>	<b>-251.6</b>	<b>-376.3</b>	<b>-559.0</b>	<b>-253.9</b>	<b>-143.7</b>	<b>-252.7</b>
<b>Capital Account Balance</b>	<b>391.4</b>	<b>274.0</b>	<b>630.1</b>	<b>478.8</b>	<b>459.1</b>	<b>233.8</b>
Official Long/Medium (net)	356.6	386.5	370.2	295.3	135.5	258.1
Private Long/Medium (net)	19.0	6.4	106.3	205.8	261.2	70
Short-term (net)	15.8	-118.9	153.6	-22.3	62.4	-94.3

<i>Non-oil trade credit (net)</i>	-	-	-	-	-	-
<i>Oil trade credit (net)</i>	-	-	-	-	-	-
<i>Monetary Capital</i>	-	-	-	-	-	-
<b>Errors and Omissions</b>	31.0	-22.1	-30.0	-61.1	-66.3	-
<b>Overall Balance</b>	<b>170.8</b>	<b>-124.4</b>	<b>41.1</b>	<b>163.8</b>	<b>249.1</b>	<b>-18.9</b>

Source : Bank of Ghana Annual Report 1995 and Government of Ghana Budget Estimates.



The increased trade deficit combined with a 21 percent decrease in net official transfers resulted in a 76 percent increase in the current account deficit. The deficit on the current account including official transfers increased from US\$143.7 million in 1995 to US\$252.7 million in 1996. In terms of GDP, the deficit increased from 1.8 percent in 1995 to 4.0 percent in 1996. While the 4.0 percent of GDP current account deficit for 1996 is lower than the peak of 11.4 percent in 1993, it represents a reversal of the improving trend of the previous two years.

In contrast to the recent past when the current account deficits were more than financed by net capital inflows resulting in overall balance of payments surpluses, 1996 saw a reversal. The capital account balance declined by 55.7 percent from US\$459.1 million in 1995 to US\$203.3 million in 1996. This represents the lowest capital account balance in the last decade after the trough of 1986.

The decline in the capital account balance was caused by a sharp decline in private capital on account of reduced divestiture receipts. Net private capital inflows consequently dropped to almost a quarter of their 1995 levels - from US\$261.2 million in 1995 to US\$70.0 million in 1996. In spite, therefore, of a near-doubling in official long/medium-term capital, the net capital account slumped to its lowest in ten years.

The overall balance of payments, therefore, recorded a deficit of US\$18.9 million. This was financed by drawing down on reserves resulting in a decline in the net foreign assets of the Bank of Ghana by that amount. Additionally, the monetary short-term capital account shows a decumulation of the reserve assets held by the commercial banks to the tune of US\$30.5 million.

### **5.3 Overall Trends in Exports**

The performance of Ghana's total exports was rather sluggish and disappointing in 1996, with growth sliding precipitously from the peak of 16.4 percent in 1994 to a meagre 5.5 percent. Gross receipts from exports (both traditional and non-traditional) rose slightly from US\$1431.2 million in 1995 to US\$1510.2 million in 1996. While cocoa and non-traditional export commodities seem to have done remarkably well, the performance of gold, timber and diamonds has been dismal, largely on account of their vulnerability to international market prices, real exchange rate appreciation and commercial policy.

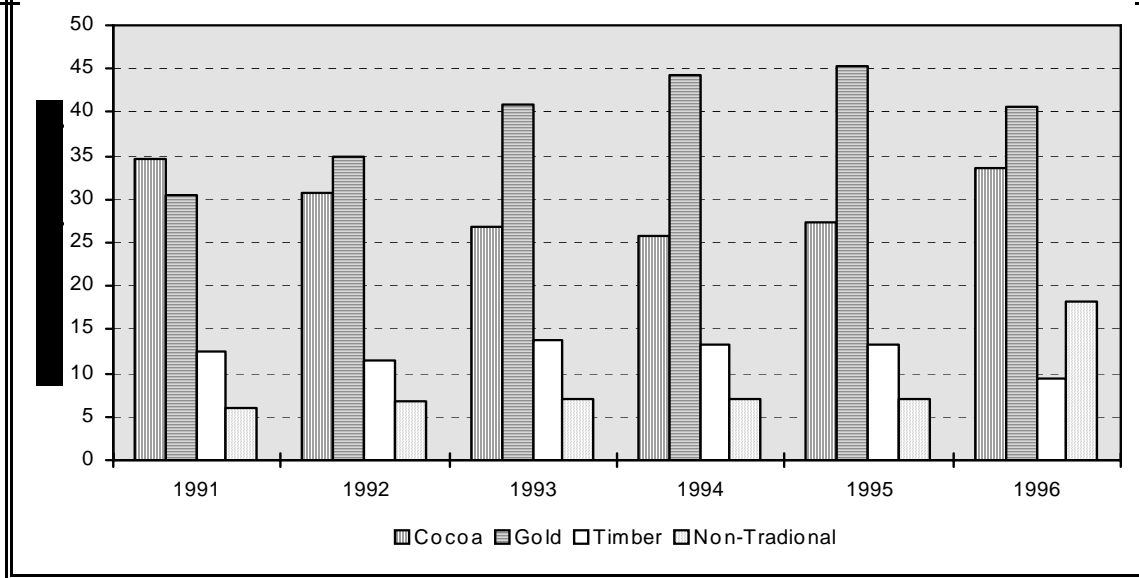
As in other non-oil producing countries of the developing world, swings in the output of key primary export commodities and international price cycles have had a dramatic impact on export revenues in Ghana since the beginning of the 1990s. These have been particularly pronounced in 1996 with cocoa, gold and timber most severely affected. Price developments on the international cocoa market since the beginning of the 1990s have been unstable and erratic. The unit prices of cocoa first dropped to an average of US\$1237 per ton in 1992, dipped further to US\$950 per ton in 1993, but rose dramatically to reach US\$1522 per ton in 1995. In the first half of 1996, however, the average price slumped back to US\$1123 per ton before rising at a grudgingly slow pace to reach US\$1387 per ton at the end of the year.

Despite the disappointing price developments, the volume of cocoa beans and products exported from Ghana shot up by 77.8 thousand metric tons in 1996, i.e. by 31 percent (see Table 5.3). Gross receipts from the exports of cocoa beans and products consequently increased from US\$389.5 million in 1995 to US\$508.6 million in 1996. Higher producer prices (from ¢840,000 per ton in 1995 to nearly ¢1.2 million per ton last year) but mostly the replanting of new seedlings in the late 1980s and favourable climatic conditions

were responsible for the strong growth in the volume of cocoa beans exports. Output has increased from 252.1 thousand metric tons in 1994 to 309.6 thousand metric tons in 1995, and rose further to 404.2 thousand metric tons in 1996.

Gold continues to be the country's highest foreign exchange earner even though its share in total export receipts dropped in 1996. Provisional data from the Bank of Ghana indicates gross receipts of US\$612.4 million in 1996, as against US\$508.6 million for cocoa. The contribution of gold to the country's export receipts, however, dropped from 45.2 percent in 1995 to 40.6 percent in 1996 (See Figure 5.3).

	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
<b>Cocoa Beans (US\$ million)</b>	315.59	276.81	250.46	295.00	361.06	482.49
<i>Volume (metric tons)</i>	243,040	223,774	263,665	238,269	237,262	317,574
<i>Unit Price (US\$/ton)</i>	1298.51	1237.01	949.92	1238.10	1521.78	1386.63
<b>Cocoa Products (US\$ million)</b>	33.10	25.65	35.41	25.22	28.42	26.19
<i>Volume (metric tons)</i>	21,745	19,328	22,839	14,050	13,864	11,358
<i>Unit Price (US\$/ton)</i>	1522.19	1327.09	1551.00	1795.02	2049.91	2050.53
<b>Gold (US\$ millions)</b>	304.44	343.36	433.95	548.62	647.27	612.18
<i>Volume (fine ounces)</i>	834,986	995,377	1,210,474	1,435,415	1,689,470	1,485,047
<i>Unit Price (US\$/fine ounce)</i>	364.60	344.95	358.50	382.20	383.12	369.01
<b>Timber (US\$ millions)</b>	124.22	113.87	147.37	165.36	190.57	141.39
<i>Volume (cubic metres)</i>	393,598	406,662				n/a
			727,813	780,000	590,000	
<i>Unit Price (US\$/cubic metre)</i>	315.60	280.01	202.48	212.00	323.00	n/a



<b>Other Traditional Exports (US\$ m)</b>	163.15	160.06	122.79	114.71	101.87	247.97
1/						
<b>Total Traditional Exports (US\$ m)</b>	940.50	919.75	989.98	1,148.91	1,329.19	1234.59
<b>Non-Traditional (US\$ m)</b>	58.83	66.50	73.65	88.63	101.98	275.63
<b>TOTAL EXPORTS (US\$ millions)</b>	<b>999.33</b>	<b>986.3</b>	<b>1063.6</b>	<b>1237.7</b>	<b>1431.2</b>	<b>1510.22</b>

Source : Bank of Ghana - Annual Report, 1995, p. 27 for 1991-95 data.

Notes : 1996 data are provisional estimates from the Research Department of the Bank of Ghana.

1/. Includes receipts from diamond, bauxite manganese, residual oils, and electricity exports.

The drop in the share of gold export receipts partly reflects the continuing weak world market prices for gold experienced during most of last year, as well as rising operating costs, and appreciation of the real exchange rate. Thus, gold export receipts dipped by nearly 5.5 percent from US\$647 million registered in 1995. At the same time the volume of exports declined, reflecting the slack in output levels (from 1703.7 thousand fine ounces in 1995 to 1485.0 thousand fine ounces at the end of 1996). As noted in CEPA's third *Quarterly* for

1996, export levels during the first nine months of the year were disappointing, and during that period cocoa had threatened to overtake gold as the country's number one foreign exchange earner. That trend appears to have been emphatically reversed in the fourth quarter of 1996, possibly on account of prudent hedging strategies adopted by gold mining companies.

Performance of timber in 1996 continued to be disappointing, and as a result, its share in total export receipts declined from 13.3 percent in 1995 to 9.4 percent in 1996. Official reckoning is that unusually high stocks and environmental lobbying in Western European markets against purchasing of certain types of African timber adversely affected the market demand. The situation calls for more aggressive strategies that would help fledgling exporters to be competitive by, among other things, placing a high priority on port facilities, transport network, and communications infrastructure. The current strategy to encourage exporters to increase value added seems to be in the right direction, but this must be pursued more vigorously. In addition, the requisite technical expertise and marketing facilities must be made increasingly accessible to exporters.

The year 1996 saw an impressive performance in the country's non-traditional exports. Export receipts from this sector more than doubled from US\$102 million in 1995 to US\$275.6 million, in the event contributing almost twice as much as timber exports in 1996. The share of non-traditional exports in total export receipts in 1996 shot up significantly to 18.3 percent from 7.1 percent in 1995. This healthy improvement makes the non-traditional export sector the third largest foreign exchange earner for the country. Improvements in infrastructure and favourable climatic conditions are credited with the excellent performance. Medium-term sustainability, however, calls for appropriate exchange rate policies.

The high growth sub-sectors in the non-traditional export category have been

in agriculture and agro-processing, fish and seafood products, pineapples, cotton seeds, cocoa butter/cake, robusta coffee, canned tuna and processed timber and wood products. The bulk of these products was traded in markets in the European Union and the Economic Community of West African States (ECOWAS), which accounted for about 69 percent and 16 percent respectively of the total.

#### 5.4 Overall Trends in Imports

The country's import bill continued to increase in both 1995 and 1996, after a decline by almost 9 percent in 1994 from the peak level of some US\$1728 million recorded in 1993. While the overall growth in imports in 1995 was 6.8 percent higher than the level registered in 1994 (US\$1579.9 million), the rate shot up to 8 percent in 1996.

<b>Table 5.4 : Trends in Overall Imports</b>							
	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1991-96</b>
<b>Imports fob(US\$ m)</b>	1318.7	1456.5	1728.0	1579.9	1687.8	1823.0	<b>1599.0</b>
<b>Non-Oil Imports</b>	1153.6	1299.0	1574.4	1408.8	1496.8	1563.9	<b>1416.1</b>
<b>Oil Imports</b>	165.1	157.5	153.6	171.1	191.0	259.1	<b>182.9</b>
<b>Actual Growth Rates (%)</b>							
<b>Imports fob</b>	9.4%	10.4%	18.6%	-8.6%	6.8%	8.0%	<b>7.5%</b>
<b>Non-Oil Imports</b>	14.6%	12.6%	21.2%	-10.5%	6.2%	4.5%	<b>8.1%</b>
<b>Oil Imports</b>	-16.8%	-4.6%	-2.5%	11.4%	11.6%	35.7%	<b>5.8%</b>
<b>Percentage Share in Total Import Bill</b>							
<b>Imports fob</b>							
<b>Non-Oil Imports</b>	87.5	89.2	91.1	89.2	88.7	85.8	<b>88.6</b>

<b>Oil Imports</b>	12.5	10.8	8.9	10.8	11.3	14.2	<b>11.4</b>
<i>Memorandum Items</i>							
<b>GDP (¢ billions)</b>	2427.5	2802.9	3674.6	4950.4	7418	10384.5	<b>5276.3</b>
<b>Real GDP Growth</b>	5.3%	3.9%	5.0%	3.8%	4.5%	5.2%	<b>4.6%</b>
	<b>Income Elasticities with respect to Real GDP Growth</b>						
<b>Imports fob</b>	1.8	2.7	3.7	-2.3	1.5	1.5	<b>1.5</b>
<b>Non-Oil Imports</b>	2.8	3.2	4.2	-2.8	1.4	0.9	<b>1.6</b>
<b>Oil Imports</b>	-3.2	-1.2	-0.5	3.0	2.6	6.9	<b>1.3</b>
<i>Source : Bank of Ghana - Annual Report, 1995 and CEPA Staff Estimates</i>							

In the absence of detailed data on the composition of imports, especially for the 1990s, one can only comment on the overall trends. In the first place, the country's import bill has shown a tremendous structural shift since 1993. As indicated in Table 5.4, increasing demand for non-oil imports was the dominant factor behind increasingly high overall growth rates (of between 9.4-18.6 percent) registered between 1991 and 1993. In the post-1993 period, however, the country's oil import bill has been increasing at a somewhat faster pace. In fact in 1996, oil imports increased by about 36 percent compared with less than 5 percent for non-oil imports. This implies that in spite of its smaller share (11 percent) oil imports accounted for half of the growth of the overall import bill.

Changes in international oil prices appear to have little or no impact on the volume of oil imports - a reflection of the inelastic price elasticity of demand for oil in Ghana. The nearly 36 percent growth in expenditure on oil imports in 1996 corresponds to about 6.0 percent growth in volume given the prevailing prices, implying broadly a unitary income demand elasticity.

### 5.5 External Debt and Debt Service Payments

Ghana's total external debt stock (including repurchase obligations to the IMF) increased from US\$5074.26 million in 1995 to US\$5346.95 million in 1996. This represented a growth of 5.4 percent. This increased level of the external debt (Table 5.5), has been on account of rises in long-term and short-term debt. The short-term and long-term debt increased by 5.7 percent and 9.2 percent respectively. Medium-term debt stock, however, decreased by about US\$100 million to US\$880 million from US\$980 million in December 1995.

The decrease in the medium-term debt reflected net repurchases of some US\$106 million from the IMF. This was, however, offset on the long-term account, with multilateral disbursements increasing to about US\$3.0 billion. Over the five year period 1991-96 multilateral debt has risen on average by US\$220 million a year. In comparison, growth in the bilateral component has picked up significantly in the Fourth Republic. Increases have been about US\$160 million a year on average after virtually no growth in the pre-Fourth Republic period of the nineties. Significantly, the share of long-term debt in the total increased from 75.4 percent in 1995 to 78.2 percent in 1996. Meanwhile, the share of bilateral debt in the country's long-term debt obligations rose from 26.8 percent to 27.6 percent. The point of concern about these bilateral debt obligations is that they are non-concessionary and consequently their rapid build-up can pose serious debt servicing challenges soon.

<b>Table 5.5 : Ghana's External Debt</b>							
	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1996 on 95</b>

<b>TOTAL DEBT</b>	<b>3796.8</b>	<b>4064.9</b>	<b>4680.0</b>	<b>5022.2</b>	<b>5074.3</b>	<b>5347.0</b>	<b>5.4%</b>
<b>SHORT-TERM</b>	<b>29.4</b>	<b>71.2</b>	<b>197.2</b>	<b>267.6</b>	<b>270.5</b>	<b>286.0</b>	<b>5.7%</b>
<i>Loans and Overdraft Facilities</i>	0.0	45.0	139.0	225.8	190.5	216.0	13.4%
<i>Short-term Oil</i>	29.4	26.2	58.2	41.8	80.0	70.0	-12.5%
<b>MEDIUM-TERM</b>	<b>1329.8</b>	<b>1262.1</b>	<b>1252.3</b>	<b>1212.9</b>	<b>976.0</b>	<b>881.7</b>	<b>-9.7%</b>
<i>Medium-Term Non-Oil</i>	496.4	415.8	503.5	501.8	316.7	328.3	3.7%
<i>Medium-Term Oil</i>	10.8	106.8	10.8	10.8	10.8	10.8	0.0%
<i>IMF</i>	822.6	739.5	738.0	700.3	648.5	542.6	-16.3%
<i>of which SAF</i>	201.9	196.8	185.4	171.7	135.3	104.4	-22.0%
<i>ESAF</i>	403.9	393.7	393.3	398.8	400.4	353.3	-11.8%
<i>Others 1/</i>	216.8	149.0	159.4	129.9	112.8	84.9	-24.8%
<b>LONG-TERM</b>	<b>2437.7</b>	<b>2731.6</b>	<b>3230.5</b>	<b>3541.7</b>	<b>3827.8</b>	<b>4179.3</b>	<b>9.2%</b>
<i>Bilateral</i>	512.3	526.3	785.1	923.3	1026.9	1154.3	12.4%
<i>Multilateral</i>	1925.4	2205.3	2445.4	2618.4	2800.9	3025.0	8.0%
<b>Memorandum Items</b>							
<i>External Debt/GDP (%)</i>	54.4	60.7	76.2	94.9	82.1	84.3	
<i>External Debt Service Ratio (%)</i>	28.9	25.8	36.5	27.8	26.9	27.0	
<i>External Debt/Export Ratio</i>	3.8	4.1	4.4	4.1	3.6	3.5	
<i>Short-Term/External Debt (%)</i>	0.8	1.8	4.2	5.3	5.3	5.4	
<i>Medium-Term/Ext. Debt (%)</i>	35.0	31.1	26.8	24.2	19.2	16.5	
<i>Long-Term/External Debt (%)</i>	64.2	67.2	69.0	70.5	75.4	78.2	
<i>Source : Bank of Ghana Quarterly Economic Bulletins</i>							
1/. This comprises Standby Facilities, Extended Fund Facility and Compensatory Fund.							

An even more worrisome development is the increase in the short-term debt in 1996. Short-term loans and overdraft facilities increased by 13.4 percent. The provisional data from the Bank of Ghana indicates that this is about the third time in the 1990s the

country has drawn heavily on short-term loans and overdraft facilities to finance increased costs of oil imports. The growing appetite to borrow on non-concessionary terms must be curbed emphatically and quickly too.

## 6. 1997 MACROECONOMIC OUTLOOK

### 6.1 Real Sector

In the productive sectors of the economy, the task ahead for 1997 remains whether or not the gains achieved in 1996 with respect to the stable agricultural sector growth and recovery in the manufacturing sector, can be sustained by the policy initiatives in more explicit ways than is discernible in the Budget statement and Economic Policy of the government. Current government projections target an overall real GDP growth rate of 5.5 percent, with sectoral contributions for agriculture, industry and the services sector estimated at 4.3, 4.9 and 6.5 percent respectively.

In the agricultural sector, the absence of new and significant policy initiatives for food production lead us to believe that sustained growth is possible only with continued favourable climatic conditions. Massive food imports will have to be resorted to, if food inventories are to be kept at the levels required for price stability. Having to import food, however, hurts the savings mobilisation efforts.

Developments in the cocoa subsector thus far imply a potentially severe shortfall in output. Nevertheless, positive terms of trade developments may moderate the fall in export earnings on this account. Since cocoa plays a vital role in terms of the acquisition of foreign exchange, the importance of cocoa subsector policy and management review cannot be over emphasized.

Sustaining the recovery in the manufacturing subsector, will depend on the extent to which a sound and stable macroeconomic environment can be regained. CEPA's fears of a large fiscal deficit and net foreign outflows, implying a higher public sector borrowing requirement (PSBR), a high even if declining inflation rate, if realised, will have adverse consequences on the manufacturing subsector. The expected real depreciation of the cedi, may however, help to restore price competitiveness of domestic

enterprises and moderate these adverse developments.

A continuation of government's policy to improve water and electricity services for the rural areas and rehabilitate major urban road networks, coupled with continued higher demand for residential and commercial housing are all likely to sustain the "boom" in the electricity and water; and construction subsectors. However adverse developments in the international gold market and higher production costs may lead to stagnation in mining production, unless the output from new mines is substantial to make up for the expected shortfall in the production from old mines.

For 1997, the services sector is expected to continue to be the lead engine of economic activity with significant contributions expected from the communications subsector, as a result of the relatively higher capitalisation efforts of the newly privatised Ghana Telecom and the other new companies. Sustained production in the agricultural and industrial subsectors, if realised, will help sustain growth in the wholesale, retail trade, hotel and restaurant subsector. While the financial services subsector is expected to maintain moderate growth, the impact of its performance on domestic savings mobilisation remains doubtful. Consequently potential national savings and hence investment for 1997 are not likely to exceed those observed for 1996.

In fact, the projected deficits of nearly 550 billion cedis, will significantly increase government dissaving. Not only does government dissavings crowd out private sector investments, but it also increases the potential for instability in the investment and hence growth process. As has been pointed out elsewhere in our report, the prospects of our investment growth path becoming overly dependent on foreign net inflows is worrisome in the light of "perceived" donor fatigue and hence dwindling aid resources. Added to this is the fact that donor-financed investments may also distort the investment priorities of the nation.

Furthermore, assuming an ICOR of 3, in order to achieve a GDP growth of 5.5 percent for 1997, will require an investment ratio of 16.5 percent. Historically, not only is this out of trend, but given the projected dissavings on the part of government and hence a lower national savings ratio, it is unrealistic to expect an investment ratio of that magnitude for 1997. Put differently, with the foreign savings ratio projected at about 3.4 percent, a national savings ratio of 13.1 percent will be required to meet the investment requirements, if the government's projected GDP growth is to be achieved. This is unrealistic, since historically the national savings ratio has never exceeded 11.5 percent. On an optimistic note, however, it is quite possible that the incentives structure of the Export Processing Zone (EPZ) programme, such as non-payment of custom and local taxes and export duties, may induce investments from both local and domestic investors. It is estimated that, thus far sixteen companies have been approved to operate in the EPZ's. On the basis of the foregoing, we do not see real GDP growth exceeding 5.0 percent for 1997.

## **6.2 Public Finance**

Government has projected a fiscal surplus of ¢191 billion for 1997 with a revenue expectation of ¢2944 billion (a 30 percent increase over the 1995 out-turn) against programmed expenditure of ¢2753 billion (a 14 percent increase). These projections are based on the realization of the following key macroeconomic targets: a real GDP growth of 5.5 percent; a year-on-year inflation rate of 15 percent for December; and depreciation of the cedi/dollar exchange rate in the interbank market of 15 percent for 1997 compared to the 20.4 percent last year.

The underlying assumption in the 1997 program is that revenue mobilization will be vastly improved (largely through higher collection effort by IRS and CEPS) while the

expenditure control and monitoring machinery will be strengthened. The Government is relying on the strength of its administrative machinery to deliver the promised fiscal package. Consequently, while the revenue share of GDP is expected to increase from 21.0 percent in 1996 to 23.4 percent in 1997, the expenditure share is projected to fall from the 1996 level of 24.8 percent to 21.9 percent. Additionally, based on the projected fiscal outcome, in spite of another large projected outflow on account of net foreign debt repayments, Government expects to drastically reduce its PSBR from the ₵590 billion recorded in 1996 to just ₵55 billion in 1997. The realization of the objectives set for 1997 thus critically hinges on an expectation of exceptional performance by the Civil Service.

While the assumed 1997 macroeconomic targets appear to be mutually consistent in themselves, attainment of the programmed objectives will only be possible if the instruments for attaining the targets were capable of doing so. Reliance on improved performance by the Civil Service alone is just not adequate. This failure of policy to confront the perennial structural imbalances forces CEPA to the same assessment as in 1996: the projected 1997 fiscal surplus is based on unwarranted optimism. Simply put, it is neither credible nor realizable.

After carefully analyzing the Government's fiscal program, CEPA has concluded that the Government's 1997 fiscal package has been influenced by its own underestimate of the fiscal imbalances of 1996 together with an unspecified strengthening of the administrative machinery, especially the revenue collecting agencies. On the basis of the understated PSBR of 1996, the projections for 1997 imply an improvement in the fiscal accounts of ₵283 billion, i.e., that much less PSBR in 1997. Properly estimated, however, the improvement envisaged is a much higher ₵537 billion, i.e., some 90 percent more. The CEPA projection is that, on the basis of present policies, a further deterioration of ₵236 billion (of additional PSBR) rather than any improvement in the more likely outcome. CEPA's revenue and expenditure projection for 1997 are, respectively, ₵2603 billion and

¢3153 billion. The estimated fiscal deficit of ¢550 billion together with a projected net foreign outflow of ¢278 billion implies a 1997 PSBR of ¢830 billion, equivalent to 5.8 percent of GDP, a little worse than the 5.7 percent GDP share established in 1996.

***Expenditures:***

Government expenditure data for 1995 and 1996 as well projections for 1997 are presented in Table 6.1. The Government is projecting a 15.5 percent growth in nominal recurrent expenditures based on its assessment of 1996 developments. With an inflation target of 15 percent, the projected increase in nominal expenditures implies a no growth policy in real recurrent spending, i.e., the increase in nominal recurrent spending will just about keep pace with inflation. A serious problem arises when one looks at a more detailed presentation of the recurrent Budget. While expenditures on personal emoluments and Items 2-5 are expected to increase by 20 and 37 percent, respectively, allocations to subvented organizations and transfer payments (consisting mainly of pensions, gratuities, social security contributions) are projected to increase by only 3 and 8 percent, respectively, in nominal terms, implying a massive reduction in real terms. CEPA believes that these projections for 1997 are basically unrealistic.

CEPA's projections point to inflation generally reaching the trough of the current three-year cycle in the second-half of the year. The year-on-year rate is projected to reach a low of about 27 percent per annum at the end of June before rising subsequently to end the year at an annual rate between 32 and 38 percent. Similarly the average rate of inflation is projected to reach its trough at the end of the third quarter. It is expected to end the year at an annual rate of between 30 and 35 percent. On the basis of these projections, the Government wage bill and other major categories of non-debt expenditure, including allocations for development spending, have been projected to increase on average at 30 percent over the out-turn of 1996. This implies a mild reduction in real terms, reflecting the expected cutbacks in expenditure after an election boom.

CEPA is projecting an increase of almost 16 percent in interest payments on the national debt compared to the Government's estimate of nearly 11 percent, the difference being attributable to CEPA's projection of higher debt service obligations on external loans due a relatively more depreciated cedi.

	<b>1995 Revised</b>	<b>1996 CEPA Base Estimates</b>	<b>1997 GOG Projection</b>	<b>1997 CEPA Projection</b>
<b>Recurrent Expenditures</b>	<b>1271.2</b>	<b>1906.8</b>	<b>2084.1</b>	<b>2391.2</b>
<b>Non-Debt Total</b>	<b>942.4</b>	<b>1327.4</b>	<b>1443.8</b>	<b>1717.4</b>
Personal Emoluments	431.0	599.6	720.2	779.5
Items 2 - 5	161.9	324.8	270.9	422.3
Subventions	135.0	211.0	246.3	274.3
Transfers	214.5	192.0	206.5	241.3
<b>Interest Payments</b>	<b>328.8</b>	<b>579.4</b>	<b>640.4</b>	<b>673.8</b>
Domestic	232.9	434.5	460.0	460.0
Foreign	95.8	144.9	180.4	213.8
<b>Capital Expenditure</b>	<b>443.1</b>	<b>665.6</b>	<b>669.0</b>	<b>761.8</b>
Development	322.5	435.4	486.0	566.1
District Assemblies	58.7	78.4	109.1	108.7
Net Lending	15.8	93.0	7.0	20.0
Arrears Clearance	46.0	58.7	67.0	67.0
<b>Total Expenditure</b>	<b>1714.3</b>	<b>2572.4</b>	<b>2753.1</b>	<b>3153.0</b>

*Source: Centre for Policy Analysis, Accra*

### **Revenues:**

Tax revenues account for 83.5 percent of CEPA's revenue projection of ₵2603 billion for 1997. The corresponding representation based on the Government's estimated total revenue of ₵2944 billion is 74.1 percent. (See Table 6.2).

In the revenue projection for 1997 CEPA's underlying hypotheses are that, for taxes on income and domestic goods and services, the respective shares of GDP realised in 1996 will be maintained. For revenue categories that are based on international trade and transactions effective duty rates attained in 1996 are retained in 1997. Consequently, CEPA projects that IRS tax collections will increase by 37.5 percent in 1997 while CEPS revenue mobilisation will grow by 23.4 percent. The Government's estimated increases for these two categories of revenues are, respectively, 40.5 and 30.7 percent.

Despite an expected 13.7 percent drop in cocoa export volume (on account of a projection of lower production level for the 1996/97 crop season), CEPA projects an increase of 12.2 percent in cocoa export taxes, up from the ₵278 billion realised in 1996. The 1997 estimate assumes that the dollar export price and the distribution of the export proceeds between cocoa farmers, internal buying agents and the Government realised in 1996 will remain unchanged in 1997. The difference of ₵72 billion between the CEPA estimate of ₵312 billion and the Government's projection of ₵240 is due mainly to different exchange rate assumptions for 1997. The payment of a bonus to placate farmers to correct for higher inflation could easily wipe out this difference.

<b>Table 6.2: Government Revenue Projections</b> (in billion cedis)				
	<b>1995 Revised</b>	<b>1996 CEPA Base Estimates</b>	<b>1997 GOG Projection</b>	<b>1997 CEPA Projection</b>

<b>Tax Revenue</b>	<b>1138.7</b>	<b>1736.5</b>	<b>2181.0</b>	<b>2174.3</b>
IRS	275.0	457.5	635.0	627.4
CEPS	706.5	1001.3	1306.0	1235.3
Cocoa	157.2	277.7	240.0	311.6
<b>Non-Tax Revenue</b>	<b>484.6</b>	<b>439.9</b>	<b>763.3</b>	<b>428.7</b>
<b>Total Revenue</b>	<b>1623.3</b>	<b>2176.4</b>	<b>2944.3</b>	<b>2603.0</b>
<i>Source: Centre for Policy Analysis, Accra</i>				

CEPA's projection of non-tax receipts for 1997 is almost ₵430 billion, equivalent to 3.0 percent of GDP. A major difference between the projection and Government's estimate of ₵763 billion for this revenue category is in the Income and Fee sub-group. Based on the historical record, and especially developments in 1995 and 1996, CEPA is forecasting that receipts from income and fees for 1997 will be about ₵313 billion less than the Government's projection of ₵477 billion.

### **Financing:**

Table 6.3 provides a summary of Government fiscal operations for 1995 and 1996 in addition to projections for 1997. The Government, in the 1997 Budget Statement projected that the excess of principal repayments on external debt obligations over new loan inflows will amount

<b>Table 6.3: Government Financing Projections (in billion cedis)</b>				
	<b>1995</b>	<b>1996 CEPA</b>	<b>1997 GOG</b>	<b>1997 CEPA</b>

	Revised	Base Estimates	Projection	Projection
<b>Tax Revenue</b>	<b>1138.7</b>	<b>1736.5</b>	<b>2181.0</b>	<b>2174.3</b>
<b>Total Expenditures</b>	<b>1714.3</b>	<b>2572.4</b>	<b>2753.1</b>	<b>3153.0</b>
<i>“Structural” Fiscal Balance</i>	-575.6	-835.8	-572.1	-978.7
<b>Non-Tax Receipts</b>	<b>484.6</b>	<b>439.9</b>	<b>763.3</b>	<b>428.7</b>
<i>“Narrow” Fiscal Balance</i>	-91.0	-395.9	191.2	-550.0
<b>Financing</b>	<b>91.0</b>	<b>395.9</b>	<b>-191.2</b>	<b>550.0</b>
<b>Foreign (Net)</b>	<b>-42.6</b>	<b>-195.6</b>	<b>-245.8</b>	<b>-277.9</b>
<i>Inflows</i>	151.6	241.5	283.5	320.5
<i>Amortization</i>	-194.2	-437.1	-529.3	-598.3
<b>Domestic (Net)</b>	<b>133.5</b>	<b>591.5</b>	<b>54.6</b>	<b>827.8</b>
<i>Source: Centre for Policy Analysis, Accra</i>				

to ¢246 billion cedis in 1997. Due to an expectation of a more depreciated cedi CEPA is projecting the net foreign outflow in 1997 to be close to ¢280 billion. Together with the CEPA projected fiscal deficit (narrow coverage) of ¢550 billion, this implies a PSBR of nearly ¢830 billion. If developments in 1995 and 1996 should serve as useful guides, the Government will most likely meet the PSBR gap by borrowing massively using very attractive high-yielding Treasury bills. The resultant pressure on the monetary authorities to increase interest rates and to adopt an accommodating monetary policy stance is, therefore, likely to remain in 1997.

### 6.3 Money, Credit and Banking

The targets set by the Government in its Budget Statement and Economic Policy for 1997 include an end year inflation of 15 percent, a budgetary surplus of 191 billion cedis and a balance of payments surplus of US\$100 billion. These, in CEPA's view, are rather once again too optimistic and not likely to be realized. Under the Public Finance section, CEPA projects a deficit of ¢550 billion for 1997. It is estimated that Ghana's net external repayment obligations will amount to about ¢280 billion which together with the deficit implies a domestic PSBR of about ¢830 billion. These projections are likely to impact greatly on changes in the money supply in the economy and exert upward pressure on interest rates.

Conservatively, CEPA has assumed that for 1997, the stock of broad money will expand by about 40 percent. Before applying this growth rate to arrive at the 1997 projections, we made a few adjustments to the 1996 base estimates on the basis of the technical conviction we have espoused in Box 4.2 in Chapter 4. We added back ¢100 billion in the demand deposits of the ¢160 billion "cheques in transit" the Bank of Ghana knocked off, on the basis that only "cheques in transit" involving banks outside the DMBs should be netted out of the demand deposits. Thus for example, in the "A-Life" saga, the company reportedly had "cheques in transit" to the tune of about ¢100 billion which *de facto* were unauthorized overdrafts: unauthorized or not this was drawn against the company's demand deposit account and is *ex post* part of the total demand deposits. Correspondingly, Credit to the Private Sector was adjusted as the source of this change in demand deposits.

<b>Table 6.4: Monetary Projections for 1997 (in billion cedis)</b>			
	<b>1995</b>	<b>CEPA 1996 Base Estimates</b>	<b>1997 CEPA Projections</b>
<b>MONEY SUPPLY (M2)</b>	1329.5	1884.9	2638.9

Currency with NBP	546.3	724.0	959.3
Demand Deposits	379.0	591.2*	876.6
Savings & Time Deposits	404.2	569.7	803.0
<b>NET FOREIGN ASSETS</b>	185.7	514.9	669.1
<b>NET DOMESTIC ASSETS</b>	921.9	1000.7	1754.1
Net credit to Government	835.5	1061.6	1484.6
Net credit for cocoa financing	8.1	9.1	9.1
Credit to public institution	188.3	200.2	240.2
Credit to private institution	393.3	780.9	1071.4
Other Items (Net)	-503.3	-1051.2	-1051.2
<b>Revaluation Account (less SDR)</b>	221.9	370.1	215.7
<b>TOTAL ASSETS</b>	1329.5	1884.9	2638.9
<i>Source: Centre for Policy Analysis, Accra</i>			

On the sources side, we expect no change in NFA (exclusive of valuation changes) as we believe the balance of payments will at best achieve a zero overall balance. This means that there will be no change in the dollar value of the Net Foreign Assets. However, because of the depreciation of the cedi, the value in cedi-terms will increase. On the basis that the cedi will depreciate by about 30 percent, NFA moves from ₵514.6 billion to ₵669 billion on account of a revaluation gain (capital gain) of about ₵154.4 billion projected for the year. We assume that net credit for cocoa financing will not change in 1997, but credit to other public institutions will increase marginally by the same rate as the increase in nominal wages. Credit to private institutions is assumed to grow at the

same rate as nominal GDP (37.2 percent). If we assume that Other Items Net (OIN) is unchanged then Credit to Government falls out as a residual. Since bank credit to government increases by about ₵423 billion it means that the remainder of the ₵830 billion domestic financing will be by sale of Treasury Bills. The remainder of about ₵410 billion must be raised from the non-bank public through the sale of Treasury bills.

It is important to note that the above projections have only been based on the *a priori* assumption of a 40 percent increase in the money stock. Based on concerns about interest rate hikes, we doubt if Treasury bill sales can be relied upon for the entire net domestic financing of 830 billion needed. Thus, unless efforts are made to cut down on the size of the deficit, the Bank of Ghana may be forced to “print money” to cover the gap. This may imply that money supply will increase correspondingly, with serious consequences on inflation.

Inflation in Ghana is determined by a number of factors. The most dominant factors being changes in output and money. If the output variable is disaggregated further it is realized that food production plays quite a significant role in explaining inflation. This explanation is almost trivial given the weight of food component in the Consumer Price Index (CPI). The next major factor affecting inflation is changes in money supply. Here it does not really matter how money is defined - whether in the limited sense of the Reserve Money or in the more general sense of the Broad Money, the impact on inflation is virtually the same. This is explained by the fact that as the supply of money becomes more than the volume of output available, then pressure builds on the level of prices to rise. The “parallel” market exchange rate also has some influence on the rate of inflation, although the rate of interest does not seem to have a significant effect on inflation (maybe due to the under-developed nature of the Ghanaian financial market). Using all the above variables and applying econometric estimation and simulation, it was realized that the “long-run” or the underlying average annual rate of inflation for Ghana is 30 ( $\pm 5$ ) percent. This fact and

the evidence obtained from the inflation cycles exhibited in Figure 6.1 have important implications for policy.

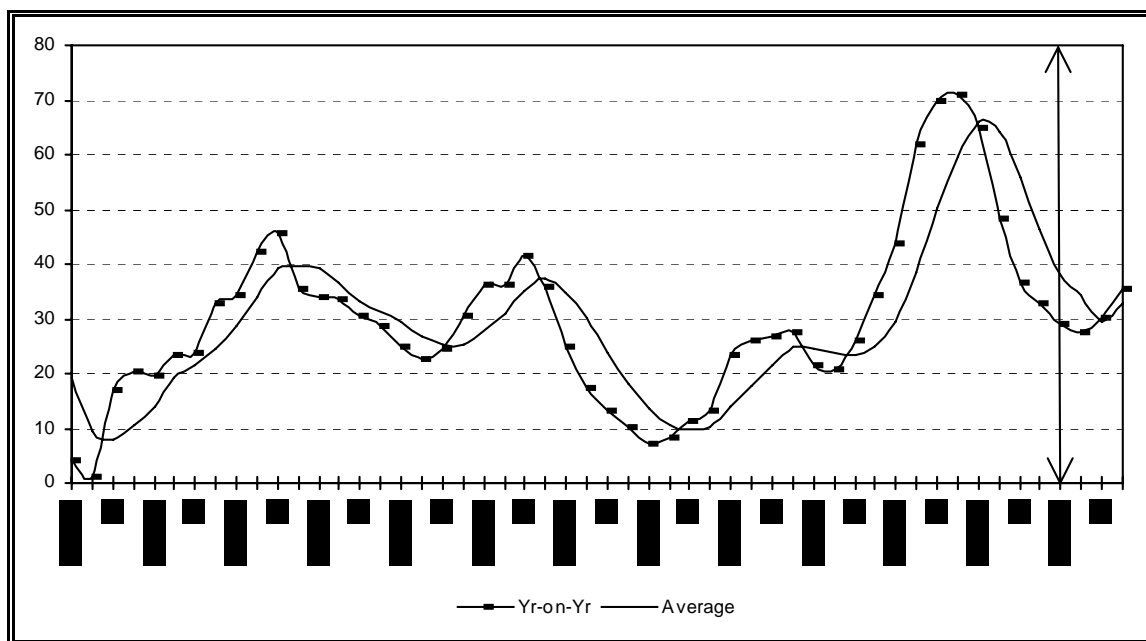


Figure 6.1 reproduces the inflation cycles in Ghana with quarterly projections of both the year-on-year and average inflation rates. It can be deduced from the figure that inflation in Ghana follows about twelve-quarter cycle. The current cycle, in which the year-on-year peaked in troughed in June 1994 and the average in September 1994, will be completed in June 1997 and September 1997 respectively. Thus we expect the marginal to hit its trough by the end of the Second Quarter at a rate of about 27 percent while the average reaches its trough at around 30 percent by the end of the Third Quarter. Thus, the beginning of Third Quarter 1997 starts a new expansionary cycle. Based on the above, unless there is a drastic change in policy, we predict that year-on-year inflation at the end of December will be between 32 and 38 percent, with the average between 30 and 35

percent.

The inflation cycle in Figure 6.1 mimics the business cycle in Ghana. The importance of this graph is that it helps in the timing of policy. Once we know the stage we are on the business cycle we can figure out the exact dose of policy needed. For instance, if the country was already at an inflationary peak and we apply too much of monetary squeeze then we may have a sharp drop in inflation, at the cost of a squeeze on the real sector.

Interest rates developments for the year are more difficult to predict since often what is termed a “free” float turns out to be rather managed rates. However, the possibility of a large deficit strongly suggests that rates may have to go up to convince investors to buy Treasury bills. The fact that the Government has been given a fresh mandate to rule for another four years may increase the country's external credibility and thus lead to an increased interest by foreigners in Ghanaian stocks. This important political factor may help boost activities on the capital market. This may therefore be a good year for Ghanaian enterprises to lobby for strategic investors to go into partnership with, since the non-economic factors are showing a low risk trend.

Before we end this section, it is necessary to dilate on the impact of certain proposed changes in monetary management on the money supply and the financial system. In Bank of Ghana Notice No. BG/GOV/SEC/4 of March 27 1997, the Bank announced the following changes in monetary control to take immediate effect:

- “1.(a) The minimum cash reserve shall be 8% of total deposit liabilities (inclusive of foreign currency deposits)*
- (b) The minimum secondary reserve shall be 35% of total deposit liabilities (inclusive of foreign currency deposits)*

2. The Temporary Special Reserve requirement is hereby abolished.”

<b>Table 6.5: Monetary Policy Measures for 1997 (in billion cedis)</b>								
	<b>Total Cedi Deposits</b>	<b>Forex Deposits</b>	<b>Total Deposits</b>	<b>Actual Com. Bank Reserves</b>	<b>Min. Required Reserves</b>	<b>Min. Required Reserves+6</b>	<b>Reserve Ratio 4/1</b>	<b>Reserve Ratio +4/3</b>
	<b>1</b>	<b>2</b>	<b>1 + 2=3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>4/1</b>	<b>4/3</b>
<i>Dec-95</i>	783.25	317.99	1101.23	106.661	78.32	88.10	14%	10%
<i>Jan-96</i>	822.01	348.59	1170.61	92.12	82.20	93.65	11%	8%
<i>Feb-96</i>	858.89	379.89	1238.78	89.883	85.89	99.10	10%	7%
<i>Mar-96</i>	882.30	396.35	1278.65	90.336	88.23	102.29	10%	7%
<i>Apr-96</i>	926.75	413.39	1340.14	87.245	92.67	107.21	9%	7%
<i>May-96</i>	939.24	405.30	1344.54	79.79	93.92	107.56	8%	6%
<i>Jun-96</i>	960.91	427.67	1388.57	97.671	96.09	111.09	10%	7%
<i>Jul-96</i>	986.72	455.24	1441.96	89.369	98.67	115.36	9%	6%
<i>Aug-96</i>	1030.56	450.11	1480.67	89.317	103.06	118.45	9%	6%
<i>Sep-96</i>	1058.32	478.81	1537.13	136.678	105.83	122.97	13%	9%
<i>Oct-96</i>	1115.11	480.29	1595.40	164.375	111.51	127.63	15%	10%
<i>Nov-96</i>	1139.14	500.72	1639.86	170.401	113.91	131.19	15%	10%
<i>Dec-96</i>	1060.88	521.11	1581.99	194.128	106.09	126.56	18%	12%

**Notes:**

- a) Total Cedi Deposits include Demand, Time and Savings Deposits.
- b) The Minimum Required Reserves in column (5) was computed by multiplying the Total Cedi Deposits with the primary reserve ratio of 10 percent set for 1996.
- 6/ The Minimum Required Reserve (+) was computed by multiplying the Total Deposits (inclusive of Forex Deposits) by 8 percent (the proposed primary reserve ratio set for 1997).
- Source: Computed from Bank of Ghana data*

As with the earlier action of the Central Bank increasing the cash reserve ratio from 5 to 10 per cent in September last year, one has to first conjecture on the intent of this policy. As with the earlier move, this new policy was intended to impact directly on the money multiplier and consequently on the money stock. As with the earlier policy though, the impact on changes in the money supply will be minimal if the High Powered Money is let loose. Whereas in principle there is nothing wrong with the central bank as the lender of last resort requesting banks to deposit with it a portion of their deposit holdings (including foreign currency deposits) we believe this will impose severe credit crunch which could severely damage the private sector. Computations based on historical data as presented in Table 6.1 show that if all the deposits are converted to cedis then the new control measure will require the banks to make more deposits with the Bank of Ghana. If the banks have to satisfy this increased requirement in cedi reserves then this certainly will create a credit crunch. A better option will be for the central bank to insist on the reserves being held separately and independently. In other words, banks should be required to hold 8 per cent of their cedi-deposits as reserves with the Bank of Ghana, as well as 8 per cent of their foreign currency deposits. An added advantage of this separate treatment will be the avoidance of any currency valuation problems.

#### **6.4 Trade and Payments**

CEPA's outlook on the external sector of the economy for 1997 is based on the perception that Ghana has no choice but to adjust to the incipient payments crisis. On the other hand present policy weaknesses imply that the adjustment will be, if at all, only grudgingly done and inadequate. The fact though is that there is no credible option of additional resources to finance the rising levels of consumption of goods and services seen in 1995 and even more so in 1996. The capital account surplus is expected to decline marginally from US\$234 million in 1996 to US\$224 million. This is on account of reduced expected net inflows of both private and official capital. The former on account of lower expected divestiture receipts (there is no big ticket item comparable to the Ashanti Goldfields Company in this year's pipeline though the process of privatisation is expected to accelerate). Official inflows are reduced by some US\$18 million on account of the dwindling aid pipeline and rising loan repayments. The reduced aid pipeline is also expected to show in a reduction of official grants of about US\$42 million.

CEPA also assumes a US\$50 million net short-term capital outflow. This is on the assumption that while the cocoa loan will be rolled over in spite of the lower projected crop, the oil facility will be fully rolled over. Finally, the GOG projection for 1997 assumes a net inflow of short-term monetary capital of some US\$130 million. CEPA assumes that given the precariously low level of reserves, further reduction in the net reserves position is imprudent and unlikely to receive support from the international donor community. The import cover equivalent of the country's gross reserves has steadily declined to the lowest in more than a decade.

Receipts from gold exports in 1997 will depend critically on new investments and the global strategy of Ashanti Goldfields Company as a multi-plant production unit. The Company in its present form may be expected to take a serious look at the real exchange rate and its effect on profit margins in the formulation of its production plans. We expect

that at least the 1996 export values will be maintained, sustained by relatively positive exchange rate developments.

Cocoa exports increased by over 30 percent in 1996 to reach a twenty-year peak. This cannot be sustained in spite of the 42 percent increase in the producer price last year. Largely on account of agronomic and climatic factors, the volume of cocoa exports is expected to decline by 13.7 percent. With uncertain market developments, the average price for last year is expected to apply in 1997. Gross receipts from the exports of cocoa beans and products are therefore expected to decline from US\$508.6 million in 1996 to US\$439.0 million in 1997.

A slight recovery is, however, expected to be made in 1997 over the fall in the exports of timber last year. On the basis of these projections, therefore, gross receipts from the exports of both traditional and non-traditional exports are projected to decline by about US\$70 million or 5 percent in 1997.

Consequently, largely on account of the lower volume of cocoa without a compensatory increase in world market prices, export earnings are expected to fall by US\$70 million. All together the conclusion is that on account of cocoa, the capital accounts, and official transfers, the dollar value of imports must fall by almost US\$125 million in 1997 in line with available finance.

Admittedly, last year's imports reflected election spending, so that one should expect a decline in imports as the level of spending drops and domestic savings rise. Note however, must be taken of the persistently expansionary fiscal and monetary policies. The expectation is that the projected real depreciation of the cedi will be enough to effect the requisite 6 percent fall in the dollar value of import. The softening of crude oil prices should provide a welcome relief on the crude oil bill, given the otherwise inelastic price elasticity of

demand for crude oil. The oil import bill is expected to fall by about US\$40 million despite a projected volume increase.

Overall the trade deficit is projected to fall from US\$312.8 million in 1996 to about US\$287 million in 1997. On the basis of past trends, private transfers are expected to increase by some 9 percent. However, with the Government of Ghana expecting a 20 percent drop in official transfers, the current account balance (including official transfers) will improve modestly from a deficit of US\$252.7 million to a deficit of US\$223.8 million.

With largely depleted external reserves, the Bank of Ghana will find itself in a very weak position to intervene in the foreign exchange markets in support of the cedi. On the other hand the Bank has a responsibility to ensure orderly market conditions on the foreign exchanges. In particular, overshooting of the exchange rate will have to be avoided given the likely inflationary consequences. In the circumstances, CEPA projects that the most optimistic outcome is a zero overall balance.

In order to attain the balance of payments objectives, the nominal exchange rate must depreciate by at least 30 percent in the interbank market. In the forex bureaux, the rate of nominal depreciation is expected to be higher, in part to correct for the relatively higher appreciation of the real exchange rate last year.

Given an expected average rate of inflation of between 30-35 percent, the real exchange rate is expected to depreciate. This reversal of the tendency observed over the last two years, towards real appreciation of the currency, is critical to the attainment of the balance of payments outcome. The economy's international price competitiveness cannot be further eroded without serious adverse consequences. Though popularly blamed on "excessive trade liberalization", real appreciation of the exchange rate also means a loss of competitiveness of the import-competing domestic sector as imports are made relatively

cheaper than domestically produced substitutes.

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